Real Estate Outlook

Global overview – Edition 2, 2022

Sensing headwinds coming.

UBS Asset Management

Fergus Hicks
Real Estate Strategist

Global overview

Strong performance continues.

Global real estate performance remained strong in the first quarter. Investment activity pulled back slightly from the record high at the end of 2021 and the pace of cap rate and yield compression eased. The war in Ukraine is curbing economic growth, boosting inflation and is expected to have a cooling impact on real estate returns.

Market overview and outlook

Strong performance to cool as headwinds build.

As restrictions due to COVID-19 gradually fade away and life returns to pre-pandemic-like conditions, apart from China and Hong Kong where new lockdowns have been imposed, the global economy faces new challenges. The unexpected war in Ukraine has rocked the international order and had a big impact on energy and agricultural markets and on specialist products produced by Russia and Ukraine. The war is expected to curb economic growth in the advanced economies by up to one percentage point this year, with Europe the most affected. For example, in April the IMF downgraded its growth forecast for 2022 for the advanced economies to 3.3% from 3.9% in January and further downgrades look likely.

The war has stoked already high inflation by turbo-charging energy prices even further, and in many countries inflation is running at multi-decade highs. For example, US inflation was 8.3% in April, down slightly from 8.5% in March, and eurozone inflation was 7.4% in April. Meanwhile, in Japan inflation has turned positive, reaching 1.2% in March. The big uptick has crushed the 2021 narrative of transitory inflation. This has been particularly uncomfortable for central banks as they look significantly behind the curve and are now rushing to tighten policy.

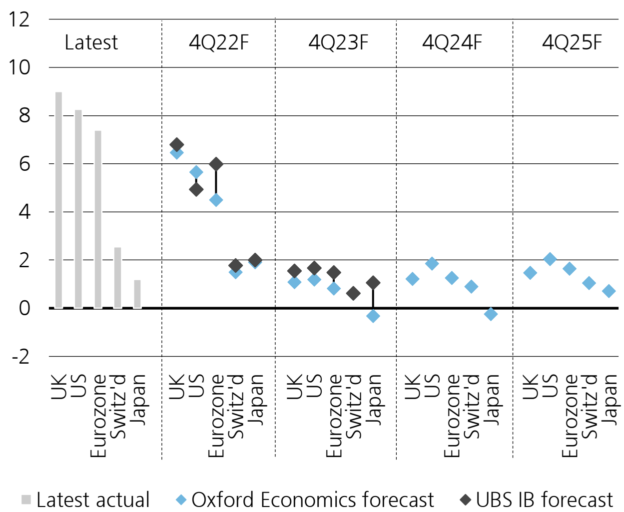
The global real estate market continued to perform well in the first quarter, with robust levels of transaction activity. According to Real Capital Analytics, global investment volumes were USD 266 billion during 1Q22. After adjusting for seasonal effects, volumes fell 11% from the exceptionally strong 4Q21. However, they remained close to record highs and were still nearly 30% above 4Q19 levels. Industrial and apartments continued to drive global activity, both up by more than 50% from pre-pandemic levels, while activity in the office and retail sectors has recovered and was broadly similar to pre-pandemic levels.

Following widespread falls in prime cap rates and yields in the second half of 2021, the market was more balanced in the first quarter of 2022. Yields and cap rates were flat in the vast majority (75%) of 300-plus city-sector markets we monitor globally. In the industrial sector, where a majority of markets had seen a reduction in yields each quarter since 4Q20, downward pressures eased, with 32% reporting a fall in 1Q22. Data from Real Capital Analytics on transaction cap rates show a similar picture. Global industrial cap rates were 5.0% in 1Q22, just above residential at 4.6%. This left a reasonable gap to offices at 5.5% and retail at 5.9%.

Property market performance in the first quarter maintained the strong momentum from 2021, when global all property total returns were 12.6% for the year according to MSCI data. In 1Q22, US all property returns were 5.3% QoQ according to NCREIF, while UK total returns were not far behind at 4.7% QoQ according to MSCI. Canada total returns were 2.1% QoQ and Ireland 1.5% QoQ, also according to MSCI data. Industrial continued to outperform across countries, while office and retail returns were more muted at around 1-2% QoQ. UK retail returns were stronger at 4.5% QoQ. The residential market continued to perform well, and in the US, total returns were 5.3% QoQ according to NCREIF data[1].

Going forward, what happens in the economy will be key in determining what happens in real estate markets. We expect inflation to remain high for the rest of the year. However, we expect central banks to return it to target over the next two years (see Figure 1). What is much less certain is the journey economies will endure as a result of rapid policy tightening. Recession signals are flashing and a downturn is a real possibility, as the cost of living crisis and rate rises squeeze disposable incomes. We think that a controlled slowdown would see real estate returns slow but remain positive. A sharper downturn, or recession even, would likely weigh more heavily on real estate markets and performance.

Figure 1: Annual inflation rates (%)



Note: UBS Investment Bank forecasts not available for 2024 and 2025
Source: Oxford Economics; Thomson Refinitiv Datastream; UBS Investment Bank, May 2022

[1] Past performance is not a guarantee for future results.

Real estate outperformed during stagflation.

Inflation is at a multi-decade high, boosted by the war in Ukraine, and Oxford Economics expects it to average at 6% in the advanced economies this year. Sharp rises in food and energy and prices are pushing inflation higher. Furthermore, compared to before the war in Ukraine started, Oxford Economics has cut its forecast for GDP growth in the advanced economies by 0.8%pts for this year and by 0.4%pts for 2023.

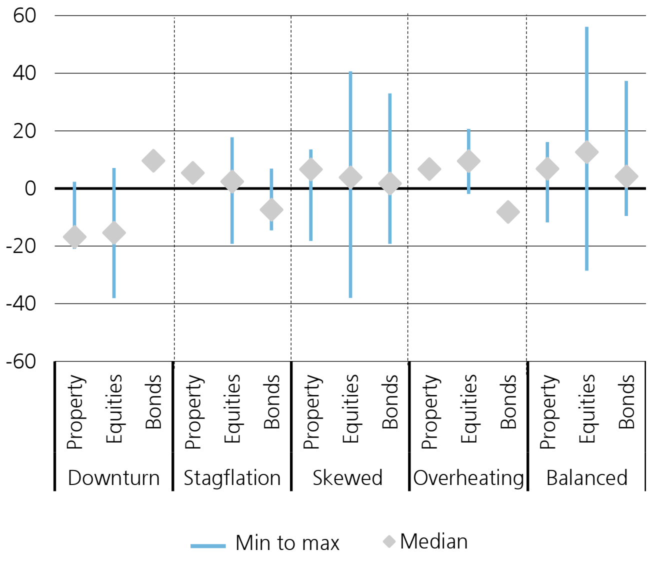
High inflation is eroding real disposable incomes and households are financing some of their spending from savings. Consequently, personal savings rates are falling. The 1970s *oil shock* and stagflation period saw high inflation accompanied by a rise in unemployment and recession. The cost of a barrel of oil rose four times during the 1973-74 oil embargo and today prices have rebounded even more sharply from their low in 2020. The risk of a similar economic environment arising now is increasing.

The question is what effect stagflation would have on the real estate market. Yet, there is limited evidence on real estate performance during stagflation, since the main historical episode of stagflation occurred during the 1970s; a period when performance data is unavailable for most real estate markets. However, data from NCREIF is available for the US from the late 1970s. We have looked at this data to try to understand the performance of property during stagflation.

We compared the performance of property, equities and bonds in real terms – after inflation – in different states of the economy. The states of the economy were downturn, stagflation, balanced, skewed and overheating. Stagflation occurs when inflation is above average and GDP growth is below average. Downturns occur when both inflation and GDP growth are below average and overheating when they are both above average. Skewed periods are when either inflation or GDP growth is outside of the average. Balanced is when both GDP growth and inflation are around average.

We plotted the minimum, maximum and median annual real total returns for the three asset classes in the various economic states (see Figure 2). Since 1978, US real estate has typically delivered annual real total returns of 6-7%, with a median of 6.9% during periods when the economy was balanced. During the small number of stagflation periods observed, real estate outperformed equities and bonds on the basis of median real annual total returns, but at 5.5% median real total returns were weaker than during all other states of the economy bar downturns. During downturns, median real annual property total returns were negative at -16.8%[1].

Figure 2: US real total returns by asset class (% YoY, 4Q78-1Q22)



Note: Equities = S&P 500; government bonds = ICE Bank of America Merrill Lynch 7-10 Year US Treasury Index; average defined as within one standard deviation of mean; inflation = 3.5% average and 2.7% standard deviation; annual GDP growth = 2.6% average and 2.3% standard deviation
Source: Thomson Refinitiv Datastream; NCREIF; UBS Asset Management, Real Estate & Private Markets (REPM), May 2022. **1** Past performance is not a guarantee for future results.

Hence, on the limited evidence available real estate outperformed equities and bonds during stagflation. During the stagflation periods, the median real total return on equities was 2.5% and for government bonds it was -7.3%. Real estate did not show negative real total returns for nearly all periods when inflation was above average. The range of return outcomes for real estate was less than for equities, which is consistent with the lower volatility of real estate as an asset class compared to equities[1].

Overall, we think that recession accompanied by average or below average inflation, is the biggest risk for the real estate market. Compared to the Global Financial Crisis (GFC) period, we do see factors which we believe would mitigate the impact of any recession. New supply and development are more balanced than prior to the GFC, loan-to-value ratios are not as stretched and spreads between real estate yields and bond yields are less compressed. This should provide some cushion for the real estate market in the event of an economic downturn.

Real estate investment performance outlook

2021 actual and 2022-24 outlook are measured against the country-sector's long-term average total return, with the average +/- 100bps described as "in line with long-term average". The long-term average refers to the period 2002-21. The red underperformance quadrant refers to negative absolute total returns, either in 2021 actual or the 2022-24 outlook.

		LTA	Office	LTA	Retail	LTA	Industrial	LTA	Multifamily
North America	Canada	8.6		8.4		11.2		n/a	
	US	7.5		8.7		11.4		8.5	
Europe	France	7.6		9.1		10.0		n/a	
	Germany	5.0		5.2		8.5		n/a	
	Switzerland	5.7		6.1		n/a		6.4	
	UK	6.9		4.9		10.7		n/a	
Asia Pacific	Australia	10.0		8.8		11.9		n/a	
	Japan	5.2		5.3		6.1		5.7	

: Actual 2021

: Outlook 2022-24

: Underperformance (negative absolute returns)
: Underperformance vs. long-term average
: In line with long-term average
: Outperformance vs. long-term average

Source: UBS Asset Management, Real Estate & Private Markets (REPM), May 2022. Note: Abbreviation LTA: long-term average. Expected / past performance is not a guarantee for future results.

For more information, please contact:

UBS Asset Management
Real Estate & Private Markets (REPM)
Research & Strategy

Fergus Hicks
+44-20-7901 6022
fergus.hicks@ubs.com

Follow us on LinkedIn

To visit our research platform, scan me!

www.ubs.com/repm-research