CREDIT SUISSE

December 2022

Global Real Estate Strategies
This is not the cycle we are used to

Welcome to the latest edition of Global Real Estate Strategies

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Summary and key takeaways:

- The year 2022: Seldom has the economic outlook changed so much and so widely in such a short time. The economy has experienced a fundamental reset.
- Persistently high inflation has forced central banks to tighten their policies substantially, sacrificing growth for the benefit of getting inflation back under control.
- Interest rates are expected to continue trending upward: the US 10-year Treasury and German 10-year Bund are likely to hit approximately 4.1% and 2.8% respectively by year end (YE) 2023.
- Cap rates (net initial yields) are under pressure, and an additional expansion of 50–100 basis points (bps) should be expected in multiple market segments over the next two to four quarters, given the interest rate outlook and the necessary shift in cap rates toward fair-range risk premiums. Capital values are consequently under pressure.
- Contrary to the usual cycle, we expect to see rental growth in multiple markets where supply-demand imbalances persist. This rental growth will lend support to capital values, including selected prime offices, multifamily, and logistics assets in particular. An accumulated drop in real estate values of 10–15% over the next year or so should, however, be expected in multiple markets. But seldom has the short-term outlook been so divergent between markets as different rental growth and interest rate dynamics work their ways through the system.
- The long-term underlying cycle has accelerated in the wake of the economy's fundamental reset. This will serve as the springboard into the expected recovery of values in 2024.
- One of the most prominent aspects of the long-term cycle is the accelerated focus on energy efficiency. This accelerated shift to improving energy efficiency and renewable energy production will require added capex in the coming years. Asset management's importance in delivering value for real estate portfolios has structurally increased. Granular knowledge of markets is needed to know where to hunt for the supply-demand imbalances that drive long-term rental growth and value creation.
- Core investors must focus on asset management to maintain and grow their rental income in order to deliver attractive risk-adjusted returns through the cycle. Maintaining assets' quality is growing in importance. The time to trim structurally weak assets off portfolios is getting short.
- The year 2023 has potential to be an interesting vintage year for value-add investors, as multiple opportunities exist despite higher interest rates. Squarely focusing on energy efficiency is essential for any value-add investor. Focusing on the spreads between different qualities of properties in each market is also key when capital value outlooks turn negative: profits can be generated even if prime capital values drop. Nimble investors will also be able to find markets driven by rental growth.

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A year to forget

EThe year 2022 has been one for the history books, but many will want to forget it. One of the most significant geopolitical – and economic – events is of course the Russian invasion of Ukraine, which threw a wrench in the works of the global economy, especially in Europe. At the beginning of the year, the world economy was looking at relatively robust fundamentals, with purchasing managers' indices (PMIs) generally in the approximately 55–60 range in various regions of the world. Normalization after the COVID-19 pandemic was slowly making its way through the economy while societies were increasingly reopening. And, while the inflation dynamic was already urging central banks to start reacting – annual US inflation in January 2022 was 7.5% while monetary policy target rates were at 0–0.25% – the inflation outlook darkened considerably after the invasion as energy and food prices shot up.

Inflation has surprised on the upside, reaching 10.6% in the Eurozone, 9.1% in the US, and 7.4% in Australia, just to name a few examples. Higher energy prices and a more hawkish stance from central banks weakened the economic fundamentals in the meantime, pulling PMIs down to the current approximately 45–50 range, signaling a slowdown ahead. Seldom has the outlook changed so much and so widely in such a short time.

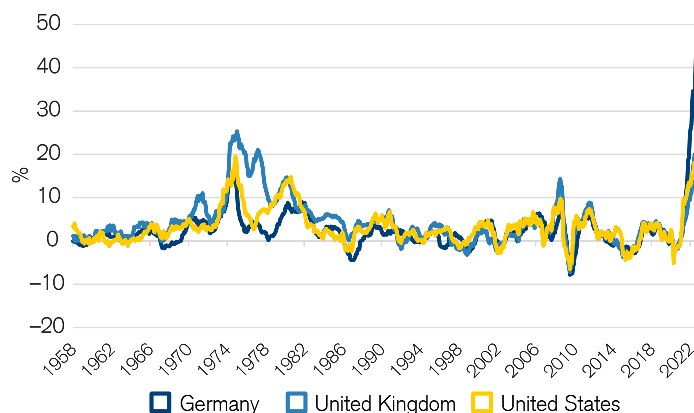
Weaker growth and higher interest rates with a structural shift

The economic outlook for 2023 is one of weakness. But there is more. As we cover in our article Investment Outlook 2023 – a fundamental reset, there is reason to believe that the global economy has undergone a lasting paradigm shift, originating from, among other trends, the COVID-19 pandemic, shifting demographics, climate change, weakening business investment, and geopolitical ruptures. This will have lasting consequences for the underlying economic dynamics.

As an example, while inflation is close to its peak, we expect it to remain above central bank targets in 2023 in most major developed economies, including the US, the UK, and the Eurozone. The era of "lowflation," supported by the globalization in recent decades, has run its course due to a structural, geopolitical shift toward a more multipolar world.

The access to cheap Russian gas that European industries have enjoyed has come to an abrupt halt, affecting the long-term industrial and inflation outlook for the region. All in all, COVID-related disruptions of global supply chains (e.g. in China), more decisive climate policy action, and a full-fledged energy crisis and food price shock in the wake of the war in Ukraine have helped to give birth to the new regime of elevated inflation. Volatile energy and food prices are driving up headline inflation, while wage increases have also allowed less volatile price categories like travel, hospitality, and medical services to rise in price. This has lifted core inflation to multidecade highs. Another manifestation of this new regime of elevated inflation is the multidecade increase in producer prices, reaching similar or higher levels than during the energy crises of the 1970s (Fig. 1).

Fig. 1 – Producer price indices, annual change



Source: Datastream. Last data point: October 2022.

Although we believe inflation is peaking in most countries as a result of decisive monetary policy action, fading fiscal policies, and a reduction in energy prices from their peaks, central banks are signaling that they need to hike rates further in order to reduce demand and create slack in labor markets. Otherwise, they risk price increases becoming even more ingrained and broader than they already are.

This has prompted us to increase our forecasts for central bank policy rates in all major economies except China. We now expect the fastest pace of tightening on a twelve-month basis and of the largest magnitude globally since 1979. We do not forecast any developed market central bank to cut interest rates in 2023. Expected real GDP growth is set to stay below the long-term trend, with the United Kingdom and the Eurozone experiencing a recession. The probability of a recession in the United States is also high. Parallel to that, inflation is set to stay well above the long-term average (Table 1). This will urge 10-year government bond rates to continue on their upward trend: by YE 2023, we expect the 10-year US Treasury to be close to 4.1%, and the German 10-year Bund to be around 2.8%.

Table 1 – Selected countries' annual GDP growth numbers

	Inflation, %		Real GDP growth, %	
	Avg. last 10 years	2023F	Avg. last 10 years	2023F
Americas				
Brazil	5.9	5.1	0.5	0.9
Canada	2.3	3.8	1.8	1.0
United States	2.6	4.2	2.1	0.9
Europe				
Eurozone	2.0	6.0	1.4	-0.2
France	1.4	4.8	1.1	0.2
Germany	2.3	6.4	1.1	-0.8
Italy	1.8	6.0	0.5	-0.2
Spain	1.5	4.6	1.3	0.8
Poland	1.3	12.4	3.4	0.6
United Kingdom	2.7	7.6	1.5	-1.3
Switzerland	0.3	1.5	1.6	1.0
APAC				
Australia	2.4	5.2	2.3	1.6
China	0.0	2.0	6.2	4.5
Hong Kong	2.3	2.1	1.0	3.5
Japan	0.9	1.7	0.5	0.4
New Zealand	2.1	3.3	3.2	1.8
Singapore	1.8	4.3	3.3	2.4
South Korea	1.7	3.1	2.7	1.4

Sources: Refinitiv Datastream, Credit Suisse. Data as of December 2022.

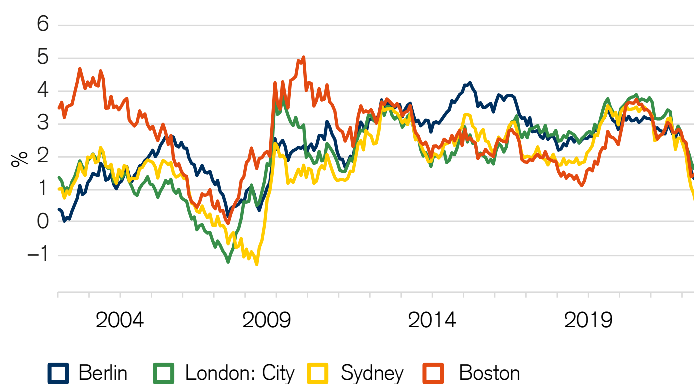
Higher rates continue to pressure yields

The consequence of the shift toward a higher interest rate environment has clearly been felt in real estate markets. Transaction activity has contracted sharply, with large (approx. 15–25%) spreads between bid and ask offers on the market as buyers adjust their required return estimates upward and consequently increase their necessary entry-yield estimates.

At the same time, however, and contrary to many downturns of the past, most owners are not in a serious hurry to exit their investments, as generally low leverage ratios create relatively robust financial structures on investors' balance sheets. This has allowed many sellers to pull back their for-sale assets rather than entering a forced-sale deal, choosing instead to collect the income the assets are generating and wait until the most acute pressure on capital markets subsides. We therefore have not seen the kind of debt-driven panic environment we saw during the global financial crisis (GFC) in 2007–2009.

The pressure on yields is nevertheless significant. Yield spreads, that is, the difference between property yields (cap rates) and local 10-year government bond rates, have sunk to their lowest levels since the GFC (Fig. 2). Despite the relatively favorable rental growth outlook (which we will get to later), yields have consequently started to rise as investors move their estimates of fair entry yields upward.

Fig. 2 – Spreads between local 10-year government bond rates and office net initial yields

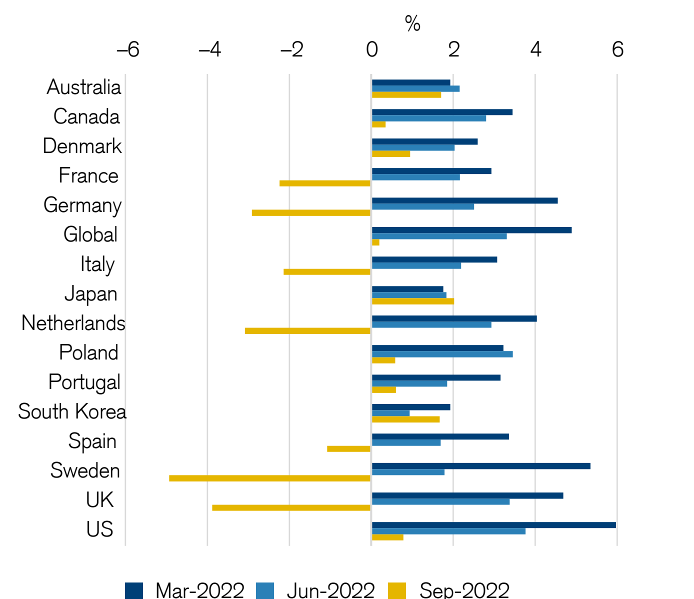


Source: PMA, Datastream. Data as of November 2022.

Total returns have nevertheless been relatively robust, especially compared to other asset classes. One reason is the relatively high income return in real estate compared to both bonds and stock markets. Another reason is the intrinsic delay between capital market signals, which point toward a drop in values, and appraisal values. Importantly, appraisers must apply "fair but careful" assumptions when they estimate the value of a building, which commonly leads to a small buffer between transaction prices and valuation prices. Therefore, during downturns, appraisal values in direct real estate markets react not only more slowly but also to a lesser extent to economic developments than listed real estate investment trusts (REITs), for example, where returns are strongly correlated with equity markets over short time spans.

Changing appraisal values have now started to become a drag on total returns in multiple countries. Fig. 3 shows how European countries in particular are seeing a decrease in total returns as values are marked downward, while markets in the Asia-Pacific (APAC) region and North America continue to deliver positive total returns. However, the downturn is far from as serious as, for example, on many bond and stock markets.

Fig. 3 – Institutional real estate markets, quarterly total returns



Source: MSCI. Data as of September 2022.

Rising yields offering a once-in-a-cycle opportunity
Yet, there is still a considerable way to go for yields before they reach their fair values. In July, when we last issued this newsletter, we penciled in a 50–100 bps rise in prime net yields across multiple market segments by YE 2023. Given the rise in interest rates since then (10-year government bond rates are up by approximately 40–120 bps since July, depending on the country), the deteriorated inflation outlook (stickier for longer), and the weaker growth outlook, we see prime yields in the transaction market still commonly approximately 100 bps away from what we would consider a trough. This is on top of the approximately 25–75 bps shift in prime yields that has already occurred since the middle of this year. The shift in yields has somewhat exceeded our expectations since July, pushed by the sharper-than-expected rise in interest rates.

That said, the shift in fair entry yields is not as prominent, even if required returns have increased due to higher interest rates.[1] The reason is the expected rental growth on the market and the usual 5–10-year holding period of a real estate asset, a period over which the investor has the opportunity to get returns that are high enough to justify the investment into an asset today even if market yields are still on an upward trend. This is also why many appraisers are slow to adjust their valuation models to immediate signals in the capital market.

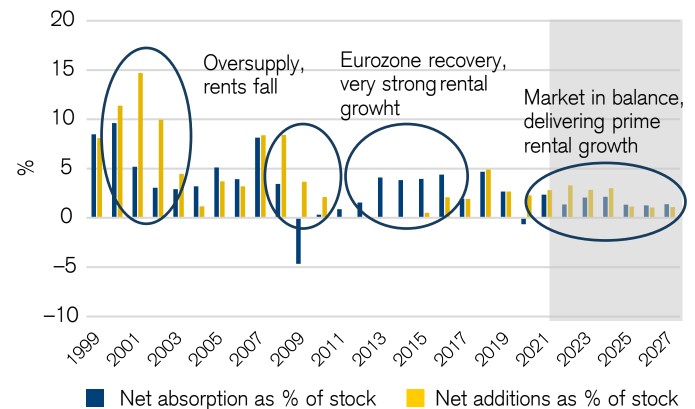
For a back-of-the-envelope example, consider a market where yields are currently 4.0%. Medium-term annual rental growth is expected to be 5%, and the expected cyclical yield shift, due to higher interest rates, for example, is 100 bps. The required annual return, driven by market risk, is 6.0% for a non-leveraged asset. The fair entry yield, that is, the yield at which the investor should accept buying an asset given its expected rental growth, market yield shift, and required return, then works out to be approximately 4.6%, around 40 bps lower than the expected cyclical high (4.0% + 100 bps = 5.0%) in yields. Had the medium-term rental growth expectation been –5% per annum, as has happened in previous cycles, the fair entry yield would have been approximately 6.0%. Therefore, if they find an asset they trust to deliver attractive rental growth, long-term-oriented investors should not hesitate to enter the market at yields below those at the market's trough. This is how they can find the juiciest bits.

This is not the usual cycle
It is here that real estate investors, as long-term-oriented investors, need to gather their thoughts. There are multiple underlying dynamics happening at the same time, making this downturn unusual.

First, we have a cyclical slowdown in 2023. Rising interest rates and tighter spreads are likely to continue to put pressure on values both in real estate transaction markets and in appraisers' books. The sharp slowdown in returns (Fig. 3) is likely to continue for the next two to four quarters (however, the downside risk is far from equal to the risk on equity or REIT markets).

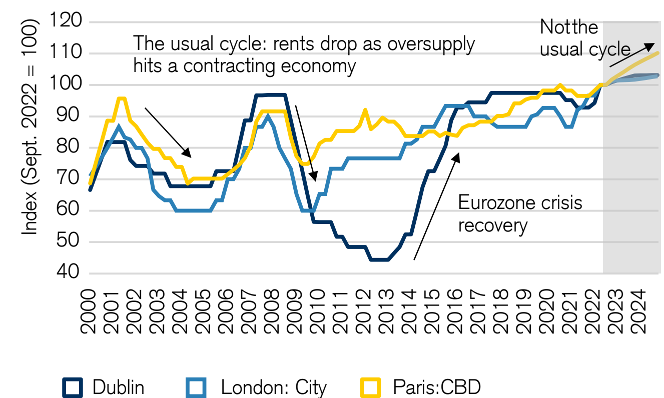
What is noteworthy, and not in line with the usual cycle, is that the rental growth outlook is relatively favorable. This is because the supply side of the leasing market has been relatively weak, while, at the same time, the expectations are that the demand side should be relatively robust: Unemployment is not expected to rise significantly, e-commerce continues to grow in prevalence, and urbanization continues. This builds a foundation under the demand side in leasing markets for the office, logistics, and residential sectors, respectively. We can see an example of this dynamic in Fig. 4 for Dublin offices along with Fig. 5 where the prime office rents for selected markets are depicted. Contrary to the usual cycle, rents should generally continue growing through this downturn. We believe this will counter at least some of the pressure on values coming from higher interest rates.

Fig. 4 – Dublin offices, periods of relative oversupply and demand



Source: PMA. Data as of September 2022; forecast from October 2022.

Fig. 5 – Prime office rents (index), selected markets



Source: PMA. Data as of September 2022; forecast from October 2022.

This is the short-term cycle: a spike in interest rates putting pressure on capital values while leasing markets lend relative support, keeping rents elevated. Overall, the pressure on values from the short-term cycle is downward.

There is a long-term cycle as well, and we believe it is accelerating. As we previously argued, the global economy is likely to have experienced a fundamental reset. In 2023, and for the foreseeable future, we should expect inflation and interest rates to stay elevated compared to the last decade or so. The lack of energy, especially in Europe, exhibits parallels to the 1970s stagflation

[1] Fair entry yield is the yield at which an asset is bought that will make its expected return equal to the market-risk-driven required return. Fair entry yields can differ from market yields due to, for example, different expectations for rental growth.

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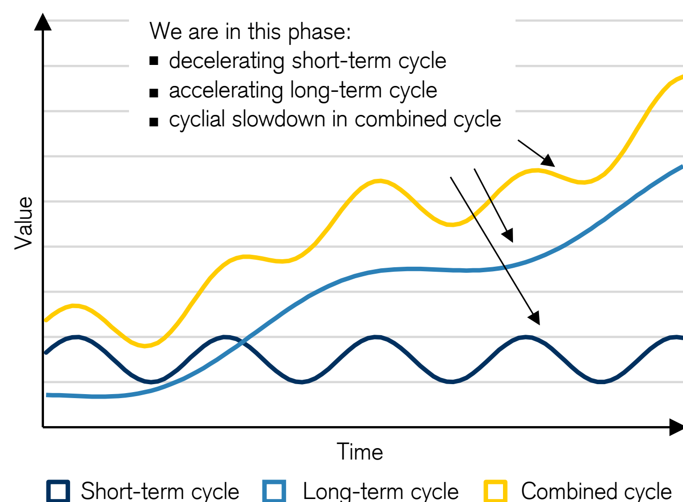
period when interest rates were relatively high and volatile. Other aspects of this fundamental shift include accelerated climate-change policies, industrialization dynamics (e.g. computer chip investments in Arizona US and the green investments incentives for the private sector in the Inflation Reduction Act), the continued rise of e-commerce, and the ongoing pressure from demographics and work from home (WFH). Overall, the pressure on values from the long-term cycle differ depending on the quality of the asset. For example, low-quality, energy-inefficient buildings' values are under pressure from the long-term cycle dynamics, while the opposite is true in the case of high-quality, energy-efficient buildings. Further examples include the WFH pressure on offices, while residential assets are likely to benefit from the WFH trend. Likewise, shifts in industrialization trends aimed at reducing reliance on geopolitical adversaries in a region's supply chain are likely to spur further long-term growth for light industrial and warehouse space.

What real estate investors need to do is to add the dynamics from the short-term cycle and the long-term cycle together (Fig. 6). With this in mind, it is easy to see how 2023 is likely to offer an exceptional entry point. This is because, while the short-term cycle pulls values downward, the long-term cycle continues to be the main creator of value that real estate investors, as natural long-term investors, are after.

Fig. 6 – The combined picture: long-term and short-term value cycles



Source: Credit Suisse. For illustrative purposes only.

What are the fundamentals of the long-term cycle?

There are several different factors driving the long-term fundamentals depending on the sector. We can group them as follows:

Logistics/industrial:
- Structural shortage of high-quality warehouse and industrial space.
- Increased e-commerce, driving demand for logistics.
- Relocation of manufacturing sites and added focus on "just-in-case" in supply chains.

Residential:
- Today's apartments do not sufficiently accommodate WFH.
- Urbanization and an aging population.
- Increased institutionalization of student housing.

Offices:
- Demand for high-quality offices is outpacing supply.
- Locations close to public transportation hubs remain in demand.
- WFH has reduced and changed the type of office that is needed.

Energy:
- Strong pressure on energy efficiency is pushing companies to lease high-quality space.
- Cost of energy and need to improve heating and cooling efficiency.
- Regulatory and market standards are being tightened.

We have already briefly mentioned the impact of the long-term cycle on different sectors. We can further highlight those with regards to energy. For years, the real estate sector has been searching for a refutation or a confirmation of whether investing in line with environmental, social, and governance (ESG) factors pays off or not. This has yielded inconclusive evidence in the past, but the most recent research does seem to confirm that there is a bifurcation happening between the performance of "brown" and "green" buildings: the long-term value cycle for real estate investors with regards to energy is accelerating.

As an example, CBRE recently estimated that the rent premium for LEED-certified office buildings in the United States is approximately 4% but approximately 6% in Europe (after having corrected for other factors such as age, location, and quality).[2] Importantly, LEED-certified buildings had shorter void periods due to higher tenant demand, making them less susceptible to downside risks due to macroeconomic slowdowns.

Furthermore, using data from the London and Paris office markets, MSCI Real Assets estimated that the price gap between buildings with and without environmental ratings has recently widened to approximately 25–35%, up from approximately 5–10% before the COVID-19 pandemic (Fig. 7). In terms of yield, this translates to a widening of yield differences from approximately 10–20 bps before the pandemic to approximately 50–75 bps today. In other words: assets without environmental ratings have seen their yields expand by approximately 30–65 bps more than assets with environmental ratings.

[2] LEED: Leadership in Energy and Environmental Design.

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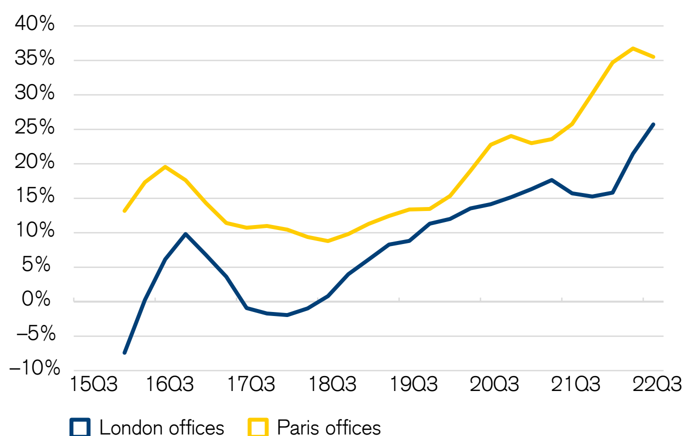
Fig. 7 – Modelled sale price gap: offices with an environmental rating vs. offices without an environmental rating



Source: MSCI Real Assets. Data as of Q3 2022.

How to manage portfolios after the fundamental reset

Real estate investors have several different ways they can change their portfolios to protect their value from the short-term cyclical slowdown while simultaneously structuring them in such a way that they will be able to capture the growth dynamic from the long-term cycle.

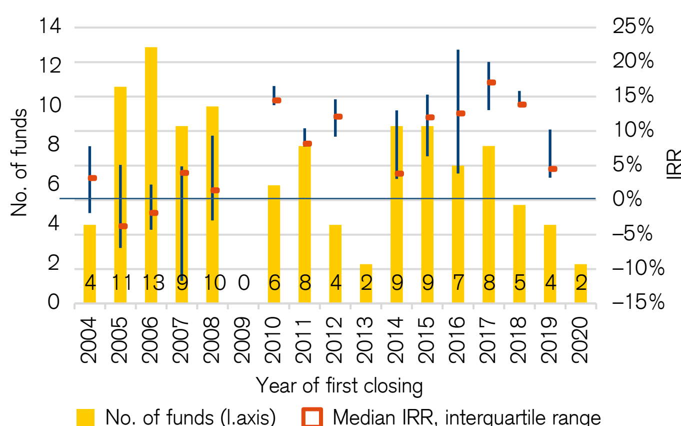
For core-type investors, the following points can be highlighted:

- Closely monitor the energy efficiency of your buildings. The long-term cycle is set to favor energy-efficient buildings over those that are lower on the spectrum of energy efficiency. The first step is to know where your assets are on the spectrum, then manage the assets toward a higher level of energy efficiency.
- Increase the granularity of your portfolio management. The long-term tailwind of falling interest rates is over. Going forward, rental growth – and not downward-trending yields – will be increasingly responsible for your total returns. This means you need to increase the granularity of your market research in order to know where the supply-demand imbalances are that will generate said rental growth. Be ready to mercilessly cut your position in a specific market and deploy the capital in another if the relative rental market outlook dynamics change. Work with locals to understand local market dynamics.
- Allocate more funds for capital expenditures. The accelerated long-term dynamic toward higher energy efficiency, for example, means that the rate of obsolescence of "brown assets" has increased. If nothing is done, "brown assets" may easily become stranded, that is, their value cannot be recouped, and they must be written off. Upgrading your assets, if they have a chance of capturing other long-term growth dynamics specific for the location or the sector, will be increasingly important, especially as regulators increase requirements for building specifications (e.g. energy performance certificates (EPCs)).
- Sell nonperforming assets and assets with weak long-term fundamentals, and allocate the capital into long-term growing sectors and regions. Trimming portfolios is an ongoing task of core portfolio management, and its importance only increases when fundamental resets take place.

For value-add investors, the following points can be highlighted:

- Manage the asset up to a high level of energy efficiency. This means up-to-date insulation, better heating, ventilation, and air conditioning (HVAC) systems, and on-site energy production (e.g. solar panels on the roof) to name a few examples. The marketability of such assets increases substantially both on the leasing market and in the capital market with clear differences in price (Fig. 7).
- Keep the "S" and the "G" in ESG in mind. So far, the focus of ESG certifications have been on "E" (environmental). In the longer run, it is likely that factors related to "S" (social) and "G" (governance) will increase in importance. This means that the design of the asset must take those factors into account. Does it have a courtyard? Consider making it accessible to all. Do you have solar panels on the roof? Share the data on energy generation with all tenants. Get tenants involved in the governance of the building with green leases, etc.
- Be ready to deploy capital. The short-term cycle is working against existing value-add investors, but as values trend downward in 2023, the trough gets closer in time. Judging from history, 2023 looks like it will be an interesting vintage year for value-add investments. Fig. 8 shows that noncore European funds have performed relatively well if they completed their initial closing in or shortly after a recession (see the years after the GFC and the Eurozone crisis). As we cover in a recent value-add-focused note (available on request, please get in touch with your relationship manager), the bifurcating development in values between low-quality and high-quality office assets is an excellent investment opportunity for value-add investors. Even if the growth of prime office rents is likely to be fundamentally weaker due to WFH and the cyclical increase in unemployment, the relatively deeper drop in values of low-quality offices offers investors the opportunity to buy the latter, upgrade them, and sell them as prime office space. Remember that capital values do not generally need to rise for value-add investors to make a profit; it is the spread in values between low-value and high-value assets that creates the opportunity for them.

Fig. 8 – Noncore real estate funds' performance by year, Europe



Source: MSCI Real Assets. Data as of Q3 2022.

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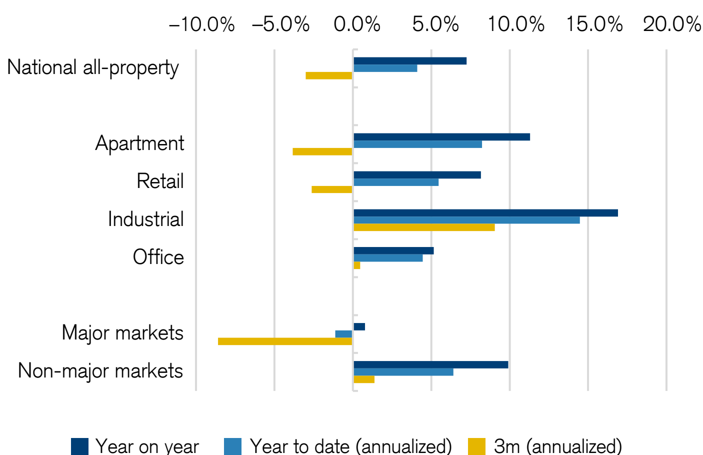
Regional highlights: United States
Pushed by higher prices, property prices in the US have started to soften. Looking at the Commercial Property Price Index from MSCI, we see that all property values are down 0.8% over the last three months (last data point: October 2022).

However, reflecting the importance of granularity, the dynamic is noticeably different between sectors and regions (Fig. 9). As an example, the industrial sector continues to deliver positive capital growth on the back of rising rents. And major markets (including Boston, Chicago, Los Angeles, New York, San Francisco, and Washington D.C.) are struggling while the other nonmajor markets (all secondary and tertiary markets) continue to experience an increase, albeit weak, in values. One of the primary reasons is that secondary cities' competitiveness has improved in the post-COVID world, as companies are now more open to WFH. This has led many people to move from the larger, more expensive urban areas to secondary cities, which still offer an ample range of "work-play-live" amenities and opportunities. The cost of doing business has also urged companies to move from major markets to nonmajor markets, evident in many firms moving from California (San Francisco, Los Angeles) to Texas (Austin, Dallas) or Arizona (Phoenix).

Fig. 9 – Change in the Commercial Property Price Index, US



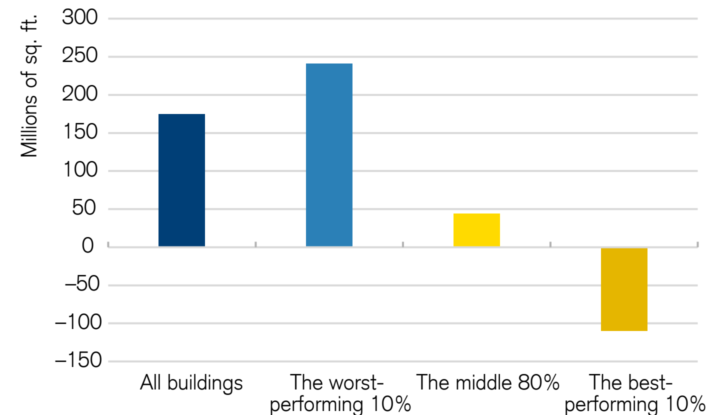
Source: MSCI Real Assets. Data as of October 2022.

The fundamentals in the US leasing market in most sectors are sound. The rental vacancy rate in the residential sector stands at 6.0% as of Q3 2022, only slightly up from Q4 2021 (5.6%) and at levels last seen almost four decades ago. The situation is similar in the industrial sector, but the availability rate in the US as a whole stands close to 5.0%. While it is expected to trend upward, it is not set to reach the pre-COVID-19 levels of 7.5% before YE 2026. This structural lack of residential and industrial housing supports rental growth in multiple apartment and industrial markets across the country.

Offices are something of an exception. The structural vacancy rate in the US office market has always been high, and it reached a cyclical low of 12.5% before the COVID-19 pandemic hit. Since then, and on the back of weaker office demand, the vacancy rate has shot up to more than 17% today. It is expected to climb further still and reach a 30-year high of 19% at the beginning of 2024 before recovering. The outlook for rental growth in the sector in the US is consequently weak, with net operating income (NOI) levels dropping by approximately 5% over the next couple of years. For comparison, NOI levels in the industrial sector are expected to climb by approximately 15% over the same time period.

The devil lies in the details, however: CBRE has pointed out that while vacancy in the US office sector as a whole has increased by approximately 170 million square feet (sq. ft.) since the beginning of the pandemic, that increase is largely (approx. 240 million sq. ft.) driven by only 10% of the existing stock of office space. 80% of the stock has only seen an increase of approximately 40 million sq. ft., while the 10% best-performing part of the total office stock has seen its vacancy drop by approximately 110 million sq. ft. (Fig. 10). The bifurcation in the US office market is therefore extremely important to keep in mind. While the sector as a whole is unlikely to deliver attractive risk-adjusted returns over the short to medium term, there are multiple assets in the sector that will do so.

Fig. 10 – Change in vacant space, Q2 2022 vs. Q1 2020, US offices



Source: PMA, Datastream. Data as of Q2 2022.

Overall, we favor the industrial and apartment markets in the US direct real estate market. Some green shoots can be found in the retail sector after years of underperformance. Careful, in-depth market selection needs to be done, however, similar to what we present in Fig. 11. Here we have estimated a market-risk-driven required return for a core investor for each US industrial market. This takes into account the return that a core investor is likely to require (x-axis) as compensation for investing in the market for the long term, thereby taking on the added market (systemic) risk compared to buying a US 10-year Treasury bond. On the y-axis, we have the expected market-level return for each city given the local expectations of rental growth and net initial yields (cap rates).

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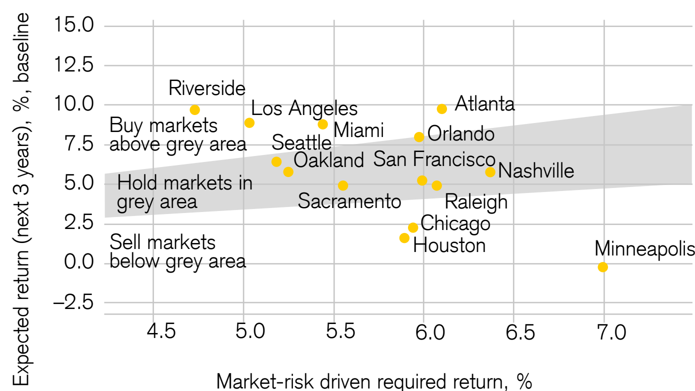
Fig. 11 – Required return vs. expected return, selected industrial markets



Sources: CBRE, Credit Suisse. Data as of Q3 2022, forecast from November 2022.

This simple comparison allows us to focus our investments on industrial markets that are likely to deliver attractive risk-adjusted returns over the long run. Some markets are rated as "sell" due to the expected slowdown in 2023, while others get a "hold" or a "buy" rating due, for example, to the expected rental growth, which is set to compensate the investor for the downside in the form of higher cap rates.

Regional highlights: Europe

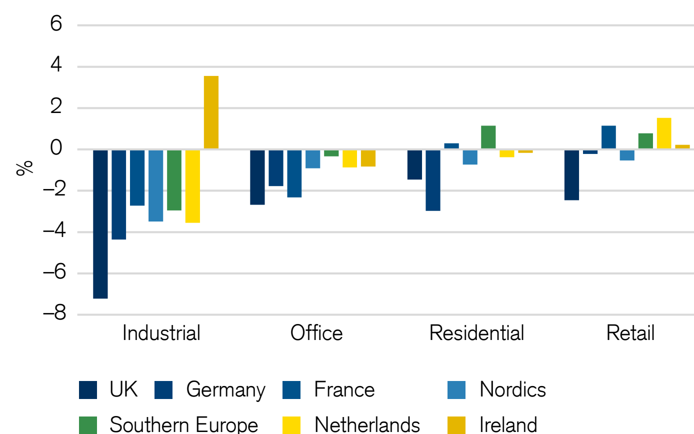
As we have already seen in Fig. 3, total returns in European countries have started to turn negative on a quarterly basis due to negative capital growth. Looking a bit deeper, however, we can see that it is primarily the industrial (logistics) sector that is a drag on performance (Fig. 12). This applies especially to the United Kingdom. The reasons are manifold.

First, yields in the logistics market in the UK had sunk to extreme lows (approx. 3.0% in the Greater London area) by YE 2021. They continued to trend downward, hitting approximately 2.85% in June 2022 despite the approximately 120 bps increase in 10-year Gilts from YE 2021 to the middle of 2022. The instability that followed the "minibudget" in Q3 2022 affected the market greatly, however, as financing dried up or became extremely expensive (debt financing hit approx. 6.0%–7.0%, depending on the risk profile). This, along with rising construction costs, pushed some logistics developers to exit their positions, while UK property funds needed to sell part of their positions to meet a wave of redemptions from UK investors who were badly affected by the Gilt market instability.

Therefore, and importantly, it was not operational weakness on the leasing market or high loan-to-value levels on investors' books that forced a correction in logistics capital values, but rather instability in other asset classes spilling over into the real estate sector. Some UK fund managers therefore took the decision to gate their funds to protect investors' interests. Given the relatively sound operational fundamentals in the sector (according to CBRE, take-up was approx. 7.7 million sq. ft. in Q3 2022, 8% higher than the ten-year average, while the UK-wide vacancy rate stood at 1.3%), we believe that while the correction is sharp, it is not a part of a medium- or long-term trend.

The low yields in the logistics sector in continental Europe were another reason, along with heightened interest rates, why the sector has been proportionally worse hit than the retail sector, for example. The latter sector enjoys somewhat higher income returns, which helps investors to meet higher financing costs. Furthermore, because the yields are somewhat higher in the retail sector than in others, the same yield shift does not affect it as much as in low-yielding sectors: a yield shift from 3.0% to 3.5% affects capital values more than a yield shift from 5.0% to 5.5%.

Fig. 12 – Q3 2022 total return by sector and market



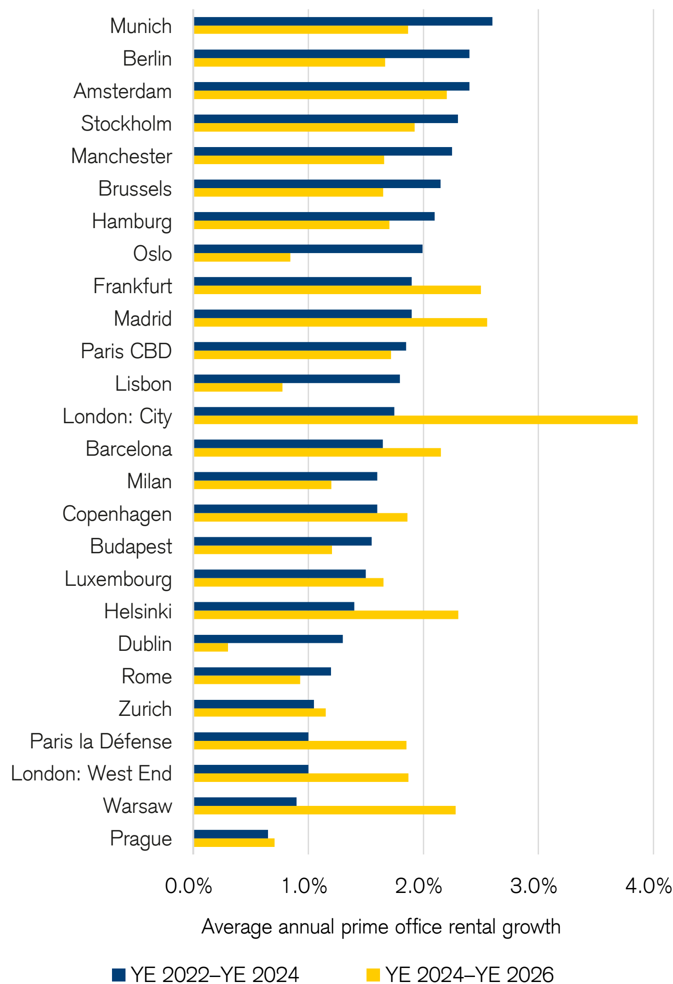
Source: MSCI. Data as of Q3 2022.

Third, due to higher levels of transparency and liquidity, appraisers in the UK are much more in line with the transaction market than is the case in many countries in continental Europe. UK appraisers therefore quickly adjusted their appraisal values for assets, even if the relevant asset was not being sold, given the signals they received from the local transaction market. Those signals are not as strong in continental European markets, although they certainly point toward a weakness in the market.

As is the case in the US, and as previously mentioned, the rental growth outlook, given where we are in the economic cycle, is positive overall, with prime office rents seen to be growing through the downturn (Fig. 13). The dynamic is similar in logistics and residential markets, especially as the shortage of space in those sectors continues to develop. As we previously mentioned, this is an unusual cycle in this regard because in previous downturns, we saw rents drop rather than climb on the back of economic weakness. This comes on top of the fact that in many markets in Europe, in-place rents are indexed to the general price level (or a similar index), causing rents to rise in an inflationary environment. This indexation, along with the expected market rental growth, should somewhat cushion the drop in values in 2023 due to higher interest rates and market yields.

To the extent that these materials contain statements about the future, such statements are forward looking and are subject to a number of risks and uncertainties and are not a guarantee of future results/performance.

Fig. 13 – Annual market rental growth in prime offices, Europe



Source: Investment Property Forum. Data as of November 2022.

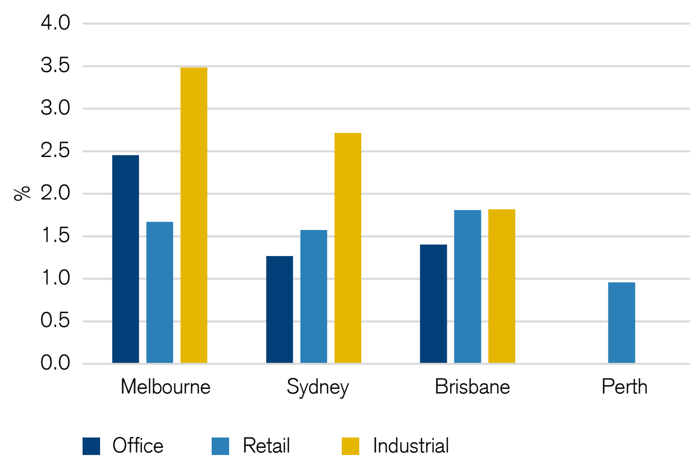
Overall, we favor the logistics and residential sectors in Europe. Student housing, for example, is an interesting subsector within the residential segment, where fundamentals driven by the long-term cycle (see Fig. 6 and related discussion) are strong. Prime office spaces should also deliver attractive risk-adjusted returns after around mid-2023 as the focus on energy efficiency builds up. The case is also strong for a value-add strategy – as we cover in a separately published note, which is available on request – focusing, for example, on upgrading existing offices and other assets to a more future-proof state.

Regional highlights: Asia-Pacific

As we have already seen in Fig. 3, APAC markets showed considerable resilience, in Q3 2022 in particular, compared to other markets. This applies to South Korea, Australia, and, where interest rates are being compressed by the local monetary powers, Japan.

Digging deeper into the data, and taking Australia as an example, we can see that as in the case of the US, the industrial market is outperforming. The overall performance is nevertheless quite broad, with offices and retail still delivering approximately 1–2% total returns in Q3 2022 alone (Fig. 14). Keep in mind that this is despite the approximately 170 bps increase in Australian 10-year government bonds since December 2021.

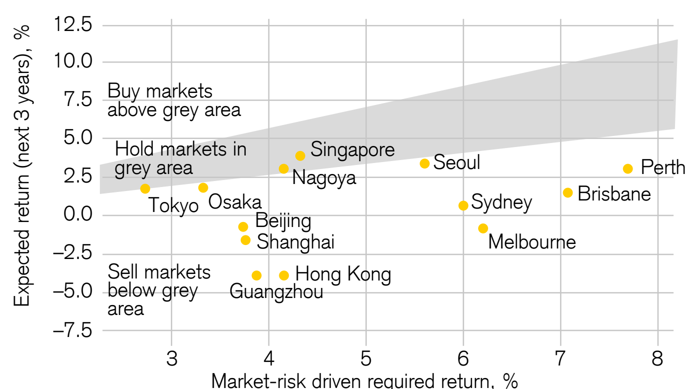
Fig. 14 – Q3 2022 total return by city and sector, Australia



Source: MSCI. Data as of September 2022.

Going forward, and despite the relatively robust performance so far, it is likely that the region will see its returns slow in 2023. The differences within the area are broad, however. For example, we estimate that from the top-down point of view, offices in Japan and Singapore should deliver relatively attractive risk-adjusted returns over the medium-term, despite the expected weakness in returns in 2023. This is due to strong rental growth expectations for Singapore (approx. 7.0% p.a. until YE 2024) and low interest rates in Japan, which will mitigate the pressure on yields.

Fig. 15 – APAC: markets' risk vs. return trade-off, offices



Sources: PMA, Credit Suisse. Data as of September 2022, forecast as of October 2022.

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