12th October 2017

Positive prospects for international real estate prices

Real estate markets buoyed up by the increased pace of economic growth. Rent and prices rise. Rates remain a positive factor. The Eurozone and Asia overperform.

Key points

- International real estate grows +1.6% in 1st quarter and +10.8% over nine months
- Interest rate rises have no negative effect
- Historically low real terms interest rates
- Listed real estate will benefit from the increasing pace of world growth
- Rent rises in most regions
- US real estate cycle is losing momentum
- The Eurozone takes advantage from better conditions
- Asia is benefiting from more dynamic growth
- Ten years on from the 2007 real estate crash, the current cycle suggests no systemic risk

Listed real estate rises in the 3rd quarter

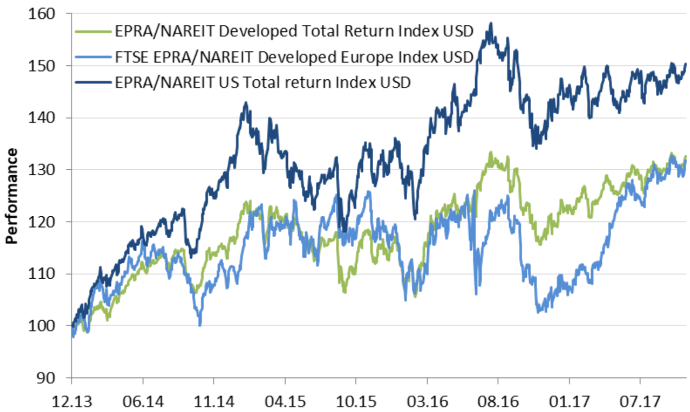
International real estate (Epra Nareit Global Index TR in USD) has seen its growth slow, but still moved up +1.6% overall in the 3rd quarter, and +10.8% since the start of the year. Over nine months, Europe as a whole has made a significant contribution to global growth thanks to a +19.5% rise, or +6.8% in Euro. However, the Eurozone (Epra Nareit Europe ex-UK TRI in USD) was particularly strong, increasing +21.6%, pushing the index to high levels.

In local currency, the Eurozone posted an excellent result (+8.1%), which was rather different from Europe as a whole (+7.5%) due to the stagnation on British indices. Asian indices for developed markets hardly moved up (+1.2%), but the increase was even smaller for the US index which only posted a slight +0.7% rise.

This quarter, the exchange rate is still affecting results due to the depreciation of the US dollar. The performance of European indices in US dollars are therefore particularly exceptional.

Key rate normalisation in the United States and higher yields in US dollars have made diversifying into US real estate assets a less attractive prospect.

EPRA/NAREIT USA Europe World Indices



Sources : Bloomberg Finance L.P., BBGI Group SA

In the Eurozone, the fall in political uncertainty is benefiting Italy, which has posted strong growth of +15.6%, coming in much higher than listed real estate in Germany (+4.3%), for example.

The stability observed in the United Kingdom may seem surprising; real estate assets have not seen decommitment, and posted a neutral quarter.

Interest rate rise has no effect

The last quarter has seen interest rates bounce back considerably in most countries. For a few months now, regional and global growth forecasts have been revised one after the other to increase forecasts for this year and next. In the United States, long rates are once again close to their 1st quarter peak, and in the Eurozone, government bonds will all soon finally offer positive yield across the yield curve. We were expecting this long-term rate recovery on most bond markets, also predicting that it was likely the global economy would improve in the second half of the year. However, we believe that this recovery is still insufficient and not yet mature to compete with real estate investments.

The yield spreads (or risk premia) between long term interest rates and listed real estate investment yield have shrunk slightly, but they still remain attractive in past comparison, particularly in the Eurozone.

The modest rise in nominal long rates comes in a slightly more inflationary domestic context. It should not have a lasting effect on real estate fundamentals at the current point in the economic cycle.

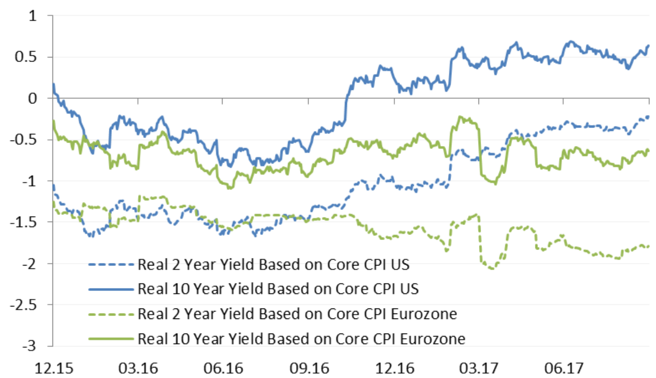
Consequently, prospects for international real estate investments remain favourable. The need to diversify portfolios and find an alternative to nil yield, particularly in the Eurozone, should still prop up demand for liquid real estate investments for some time to come.

Increasing numbers of investors will be moved by this in 2018, and will contribute to rotating assets away from bonds and towards real estate investments to a considerable degree.

Historically low real terms interest rates are still propping up real estate

The expected recovery on price indices should gain in strength in 2018, further affecting long term interest rates. Despite recent leaps, the relative stability of long rates over the last few months has gone hand in hand with comparable stability on price indices.

Real Interest Rates – USA and Eurozone

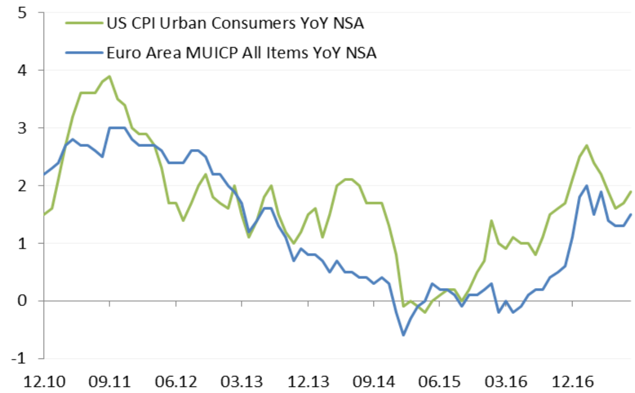


Sources : Bloomberg Finance L.P., BBGI Group SA

In the Eurozone, real rates are digging down into negative ground, falling from -0.8% to -1.2% over the quarter. Real terms interest rates in US dollars have therefore fallen, from 0.6% to less than 0.2%. Despite monetary policy normalisation currently taking place in the United States, and to come at a later date in the Eurozone, we believe that inflation will rise faster than long rates.

Over the next few quarters we should still see real terms interest rates drop off further, favouring real estate markets, particularly in the United States, Europe, and Japan. Regular increases in inflation will only bolster this trend, which we believe will benefit the sector.

Inflation – USA and Eurozone



Sources : Bloomberg Finance L.P., BBGI Group SA

Real estate market performances should therefore be higher when real term interest rates are low, and when growth prospects are equal to or greater than their historical average. The improvement to the global economic trend will go hand in hand with greater rent growth forecasts, working in favour of valuations of real estate assets.

Listed real estate will benefit from the increasing pace of global growth

The latest OECD forecasts highlighted the fact that world growth could be at its highest since 2011 thanks to a very considerable resurgence in economic actors' confidence. These forecasts were then bolstered by increasingly confident statements on the part of central banks regarding economic conditions and growth prospects. According to OECD experts, global growth should even head north of 3.5% in 2017, and 3.6% in 2018. These upward forecast revisions will also have a positive effect on long-term investments in real estate, due to real estate benefiting from improved economic factors and a likely rise in demand for commercial and residential premises. We still believe that this rise in global demand will have a relatively stark effect on both occupancy rates and rents, in a context of weaker supply. As such, the macroeconomic environment should prop up real estate investment, due to a combination of several key factors.

At current short- and long-term interest rates, we do not believe that key rate normalisation and lower levels of liquidity injections will have a negative impact on real estate markets in 2017 and 2018. Real estate yields remain attractive and should still enable prices to rise.

US real estate cycle is losing momentum

The American real estate cycle is losing momentum, but remains positive after six years of price rises. Developments in real estate prices still show appreciation, of +0.4% in July (S&P CoreLogic Case-Shiller Index), bringing the price increase to +5.8% year on year. Real estate assets seem to be appreciating rather steadily, with no sign of the pace picking up. Supply still seems to be slightly lower than demand, and this situation should not change over the coming quarters. The rise in financing costs could place some restrictions on demand and slow down the price rise. Growth in employment rates and prospects of salary increases will be positive, but for the time being we are seeing a slight dip in new mortgage applications.

The construction sector is in rather good shape, with the +0.5% increase in spending in August demonstrating steady growth, though operator sentiment did nonetheless wane in September. Sales in new houses should bounce back after the hurricane season, but overall housing starts have levelled off since 2015, at a rate of 1,180,000 per month. In the commercial sector, rent rises are in step with the slowdown in the United States. The supply to come onto the market should prevent a sharp rent rise. Growth rates will therefore be significantly lower than in other regions, especially the Eurozone. The below-par performance of listed US real estate reflects a loss of momentum on the real estate cycle. Despite good economic prospects, listed US real estate is certainly ahead of the revaluation cycle.

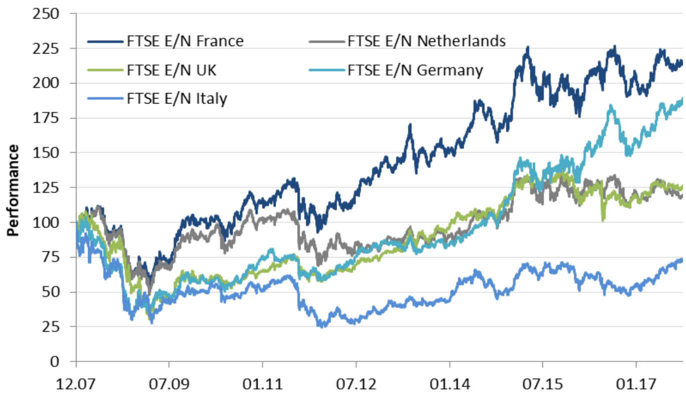
Despite potential for appreciation, the US market should under-perform compared to other developed and emerging markets over the next few quarters.

The Eurozone is enjoying better conditions

In our previous forecasts, we predicted an easing of political tensions and risks in Europe, working in real estate markets' favour, despite uncertainty linked to Brexit. Today, we can see that uncertainty has fallen in the Eurozone, despite looming confrontation with the United Kingdom, which does not seem to be affecting the political or economic trend in Europe. Enthusiasm for reform, spearheaded by the new French president and the German chancellor, will certainly be held back by the issue of German government coming out of the latest elections, but generally speaking, the Eurozone is in good economic shape, which should prove positive for investment and real estate. Leading indicators are suggesting a boost for economic activity at the end of 2017 and in 2018. These developments could enable rent to continue to rise in Europe. The change in the interest rate trend will certainly increase financing costs, but the real cost (after inflation) and the want of any alternative will mean that European real estate markets will still be able to draw in new investors.

In terms of regional allocation, the Eurozone should still enjoy greater potential for rent revaluation and more sustained price growth. Commercial rents have already benefited from the improved economic conditions, and are posting +2.3% year on year growth.

European Real Estate Markets FTSE E/N



Sources : Bloomberg Finance L.P., BBGI Group SA

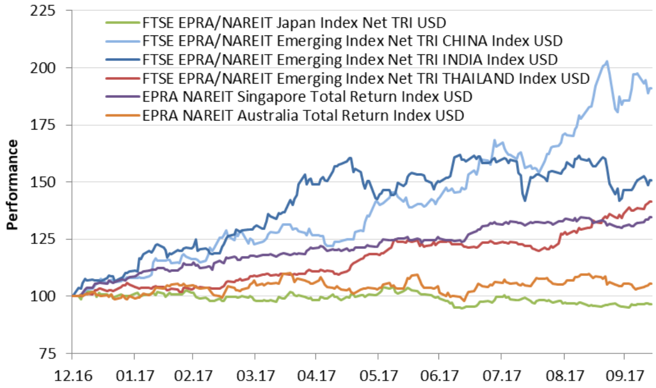
The greatest rises were posted in the Netherlands and Sweden. Berlin, Barcelona, Madrid and Milan are all still enjoying robust demand. Vacancy rates have fallen in Germany.

Asia is benefiting from more dynamic growth

GDP growth in Asia is robust, but significant interest rate hikes remain unlikely. Despite being higher compared to others internationally, inflation remains very much lower than the historical average. There are still prospects of an increase in rent, but this is partially limited by growing supply. Prospects of an increase in prices now seem a little contained.

The rent rise in Asia in the office sector moved up +2% year on year, bolstered by positive developments on the Australian and Indian markets. Rents in China seemed to have dropped off a little due to new capacity coming onto the market. However, absorption rates are good, and demand remains robust, particularly on the part of domestic companies.

Real Estate Markets in Asia



Sources : Bloomberg Finance L.P., BBGI Group SA

In Singapore, demand for resettlement has remained relatively strong, though with no noticeable impact on rent. In Hong-Kong and Tokyo demand has weakened slightly. In India, the government's demonetisation policy has had no major effect on the commercial real estate market; demand for offices and retail premises from international companies has remained strong, with a rise in rents as a result of this. The residential sector is a little weaker, however.

Asia continues to benefit from a better trend and is still prioritised in our regional allocation.

Ten years on from the 2007 real estate crash, the current cycle suggests no systemic risk

International real estate markets are still enjoying considerable rises and favourable prospects. Ten years on from the last real estate bubble, we believe it is still too early to fear another major international incident in this asset class.

Price growth is still far from comparable to rises in the previous cycle, and in the few regions where the increases are significant, we detect no major risks that could affect the economy.

Interest rate rises and monetary policy normalisation will be gradual and most real estate markets will withstand it. Risks of brutal rate hikes can be ruled out due to the lack of signs of an uncontrolled acceleration in inflation.

Global growth is therefore providing broad-based support for the still-favourable developments in rental income and real estate asset prices. Residential real estate could however suffer, should there be no salary increase in certain regions, making property ownership more difficult.

Our strategy prioritises the Eurozone and Asia, whilst keeping overall high allocation for the US market. It is still too early to consider new investments in the British market.

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