BearBull
Global Investments Group


*2nd May 2018*

# New opportunities on real estate markets in the Eurozone

**Expected recovery in real estate in April. Rates are not yet a real threat. Favorable risk premium. The Eurozone outperforms. Return of interest for the US.**

## Key Points

- Sharp rebound in real estate after a temporary correction of the indices
- International growth favorable to real estate
- Rising interest rates may soon be threatening in some countries
- Inflation will hold up real rates
- Expected rebound in US after a difficult quarter
- The economy will support real estate in the euro zone
- The real estate market in Asia follows another dynamic

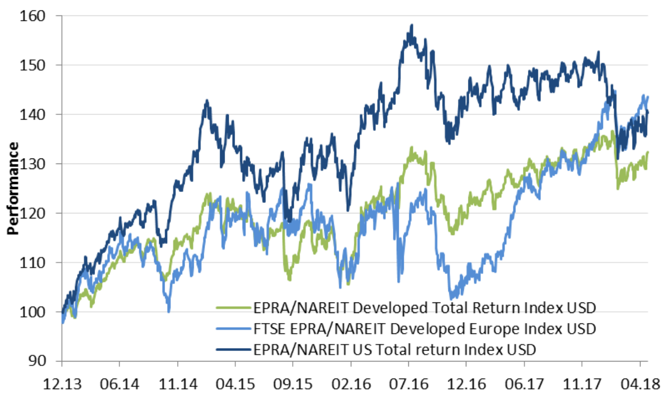
## Sharp rebound in real estate after a temporary correction of the indices

**International real estate was not completely unaffected by the increase in volatility in the equities markets in Q1. Most regional markets wrapped up 2017 with strong performances, which made for a stark contrast at the beginning of the year. A -6.8% correction in the global index in USD thus erased the +4% increase in Q4 and just under half of the total increase for the year (+15% in USD). However, this correction in real estate markets was once again significantly impacted by the substantial underperformance of the US market. Indeed, the US REITs index lost -10% over the period, while European markets fell back only -1.6% (in USD) and Asian markets remained particularly resilient and stable (+0.01% in USD).**

At the beginning of the year, our diversified real estate investment strategy was still overweight the latter two regions within our relative allocation and underweight the US. This approach contributed significantly to our positive results for Q1. In local currencies, the Eurozone posted a similar consolidation (-4.6%) to that of the United Kingdom (-4.6% and -3.2% in euro) which made out relatively well considering the Brexit context, which continues to be extremely uncertain. Developed markets in Asia only slipped 0.9% in dollars, while markets in the Asia Pacific region even grew +1.4% in USD. The performance of Asian markets thus also exceeds that of US real estate, far more affected by rate hike risks than most other markets.

**In recent weeks, the rebound in real estates values is very clear especially in the euro zone with values rising by + 10% since mid-February.**

**EPRA/NAREIT USA Europe World Indices**




*Sources : Bloomberg, BBGI Group SA*

The normalisation of policy rates and of long-term yield had reduced the attractiveness of diversifying into US real estate.

But the rebound of the European REITs as well as the stabilization period on the US interest rate market could constitute a reason for the return of investors' interest in US real estate in the upcoming months.

## International growth favorable to real estate

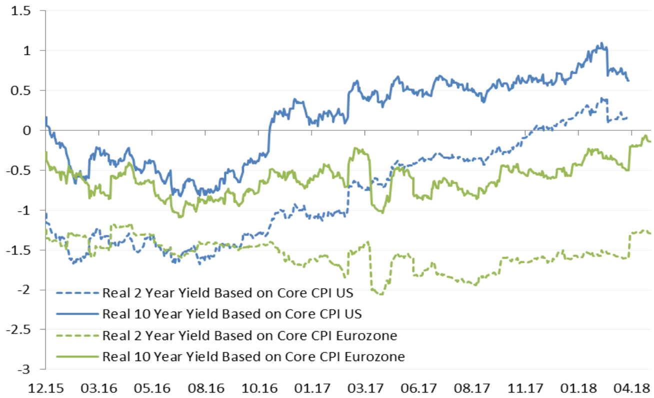
Global GDP growth reached +3.7% in 2017 and should tick up to +3.9% in 2018 and 4% in 2019 according to the OECD. In all likelihood it will thus reach its highest level in 2018 since 2011 and will benefit from the synchronisation of regional business cycles. The global economic expansion is gaining strength on the back of a robust increase in investment along with an upswing in trade and an employment boost that is driving an overall increase in growth according to the institution. Both developed and emerging countries will largely participate in this stronger growth. These upward revisions in expectations will also be advantageous to long-term real estate investments which will benefit from the improvement in economic factors and from the likely increase in global demand will have a relatively significant impact on both occupancy rates and rents given an environment characterised by sluggish supply. The macroeconomic environment will thus likely support real estate investments in view of the positive combination of several factors.

## Rising interest rates may soon be threatening in some countries

As we mentioned in our previous economic outlooks, in 2018 we will likely see a shift in the global monetary policy paradigm. The Federal Reserve has initiated a process of rate normalisation that will likely intensify once inflation is found to be persistently higher than the Fed's 2% target. Financial markets barely considered this risk until January 2018, when they started taking into account the increasing risk of stronger action by the central bank given rising inflationary expectations in the US. At the international level, it is probably still somewhat early to fear a complete reversal of monetary policies, but the future is clearly trending towards normalisation. The key question is to determine when investors will truly start to worry about the impact of this shift on real estate valuations.

**We believe that if long-term interest rates indeed follow an upward trend in 2018, this upturn in long-term rates will remain entirely insufficient to impact the valuation of real estate investments or even to compete with this asset class in terms of diversification strategies.**

**<u>Real Interest Rates – USA and Eurozone</u>**




*Sources : Bloomberg, BBGI Group SA*

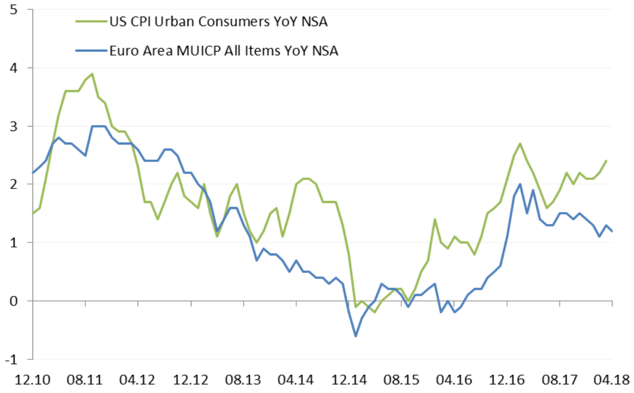
Yield spreads (or risk premiums) between long-term interest rates and the yields on indirect real estate investments have tightened slightly in the last quarter, essentially due to the rise in long rates in recent months. They remain attractive by historical comparison, in particular in the Eurozone. Note that the normalisation of interest rates has not even been truly initiated in several economic zones (Eurozone and Japan). It is thus premature to worry about its negative effects on real estate capitalisation rates in 2018 in general. At the current stage in the global business cycle, this phenomenon is unlikely to have a lasting impact on real estate fundamentals except in the US market, whose growth cycle is already well under way.

## Inflation will hold up real rates

We continue to predict that inflation will rise faster than expected in 2018, in particular in the US. Indeed, inflation will ultimately likely increase due to a tighter job market and have an even greater impact on real interest rates. In spite of the normalisation of monetary policy currently under way in the US and forthcoming in the Eurozone, the upturn in inflation could be swifter than that of long-term rates in our view. Over the next few quarters, real interest rates are thus likely to stabilize or slightly decline, which would be favourable to real estate markets in the US, Europe, and Japan in particular. The steady increase in inflation will only further reinforce this trend, which we believe will indeed benefit the sector. The performance of real estate markets should thus be stronger when real interest rates are low and when the growth outlook is equal to or better than its historical average.

**The acceleration of global economic momentum will be accompanied by expectations of higher rent growth, which should benefit the valuation of real estate assets.**

**Inflation – USA and Eurozone**




*Sources : Bloomberg, BBGI Group SA*

## Expected rebound in US after a difficult quarter

Our growth forecast for the quarter with regard to the US real estate market noted the very clear risk that the US market would underperform relative to other developed markets in the Eurozone and Asia. Thus, we recommended under-exposure to this market within our international diversified investment strategy. Over the quarter, the US real estate market was indeed the most impacted by the change in the assessment of the risk of rising inflation and policy rates. The sharp -10% correction over just a few weeks in conjunction with the correction in equity markets turned out to be close to the most significant among regional real estate markets. We mentioned the fact that the US real estate cycle was ahead of most other regional cycles and that the increase in real estate prices had already been quite substantial, as prices had already exceeded those reached before the real estate bubble burst in 2007. US real estate market fundamentals are not negative, but the risks involved seem to be higher given that the US market is ahead in the cycle. Short-term interest rates will be above +2% in 2018 and should exceed +3% for 10-year terms. Mortgage rates are already above 4% (10-year) and could also reach 4.5% by the end of the year.

Overall, the increase in borrowing costs could have some constraining effects on demand and slow the rise in prices. The underperformance of listed US real estate shares reflects the real estate sector's loss of momentum. In spite of a positive economic outlook, US securitised real estate is doubtless ahead in the growth cycle. However, the recent correction has partially reconstituted risk premiums, which could sustain an increase in prices in Q2. At current levels, valuations are no longer as unfavourable, even if competition from risk-free bond yields remains an important factor that could hamper REITs' progression.

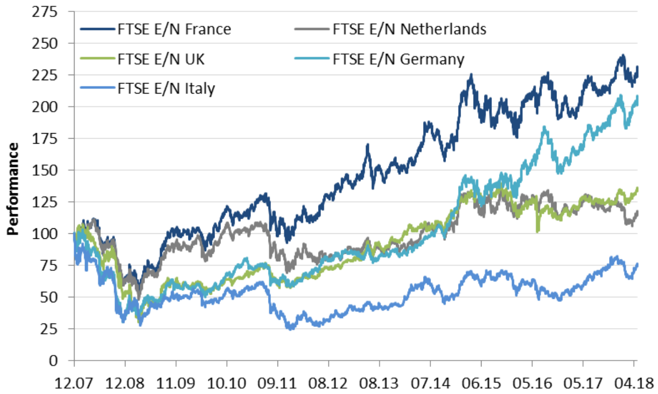
**The US real estate market could surprise investors in the next few months by rebounding and potentially catching up with other developed markets. We are thus changing our outlook and reducing our under-exposure to this market in our tactical real estate allocation.**

## The economy will support real estate in the euro zone

In our previous outlook reviews, we forecast that economic growth in Europe would accelerate, and indeed it did; in fact it seems like it may well strengthen further in 2018 and 2019. Our positive outlook on European economic growth and in particular with regard to those drivers of growth such as Germany, Spain, and even France should have a positive impact on these countries' respective real estate markets. The resumption of talks between the European Union and the British government has also eased political tensions without entirely removing the uncertainty stemming from Brexit. It is important to note that for now the prospects of Brexit have no impact on the future improvement of economic conditions in the Eurozone.

Inflation in the Eurozone remains below the ECB's stated target, but the time of the change in monetary policy is even more precise, even though the probability that policy rates will increase, even modestly, in 2018 is low. The European economy is not at the same stage in its economic cycle as the US's, but it is now growing at a similar pace. Long-term interest rate normalisation in the Eurozone could occur faster than predicted and could subsequently affect European securitised real estate similarly to what happened in the US over the past few months the acceleration of European growth already warrants an adjustment of long-term rates, which will doubtless be more brutal than in the US.

## European Real Estate Markets FTSE E/N




*Sources : Bloomberg, BBGI Group SA*

For the European real estate market, the economic context in 2018 will likely boost demand for commercial real estate and gradually reduce excess supply in certain large cities. The uncertain context of previous years had somewhat hampered development projects especially given the environment already presented excess supply. These developments will allow rents to continue rising in Europe. The trend reversal with regard to interest rates will likely increase borrowing costs, but real costs (after inflation) and the lack of alternatives will enable the European real estate market to attract new investors. We do not believe that rising borrowing costs will be enough to impede real estate investment in 2018. The yield spread between real estate investments and government bonds in euros at the beginning of 2018 remains at 20-year highs. More particularly, the spread for investments in premium real estate is approximately 250 basis points, while for less central areas the yield spread is much higher and more attractive by historical comparison.

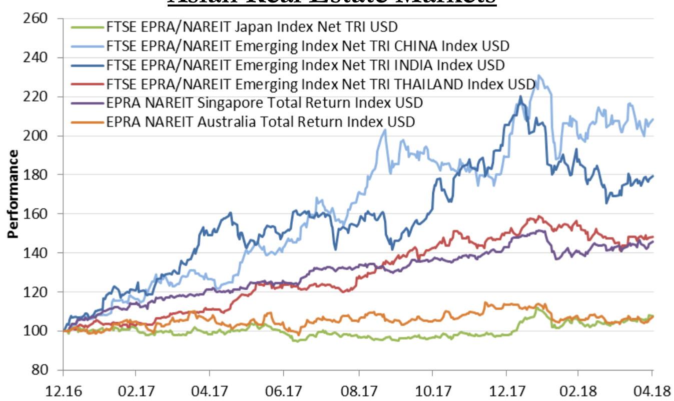
We continue to maintain that European real estate investments thus provide a very attractive alternative to bonds. With regard to securitised real estate, we believe that the increasing risk of capital losses on bonds will support a reallocation of assets to real estate in institutional portfolios more broadly in 2018.

In terms of regional allocations, the Eurozone will continue to present a higher likelihood of rent growth and of more sustained price increases.

## The real estate market in Asia follows another dynamic

Securitised real estate in Asia did not suffer from the change in expectations regarding rates in the US in Q1. A very specific economic situation is bolstering investment demand. Economic growth will likely strengthen in 2018 thanks to positive regional and international momentum. It will continue to be much stronger than in Europe or the US; however, it is unlikely that interest rates will rise significantly. There is a real likelihood that rents will rise, although constrained in part by the increase in supply. The likelihood of price increases is certainly limited. The progression of rents for the office segment in Asia will benefit from positive developments in the Australian and Indian markets. In China, rents seem to have decreased somewhat due to the arrival on the market of new capacity. In Singapore, relocation demand has remained relatively strong, without significantly impacting rents. In Hong Kong and Tokyo, however, demand has weakened somewhat. In India, demand for office and retail space will likely remain solid and will boost rent growth. Asia continues to benefit from better economic conditions and remains overweight in our regional allocation.

## Asian Real Estate Markets




*Sources : Bloomberg, BBGI Group SA*

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