

## Global Real Estate Strategic Outlook

January 2024

### IN A NUTSHELL

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- We believe the global real estate recovery is not far off. Lower real estate values, a rally in bonds and equities, and resilient occupier fundamentals all suggest the market could return to growth in 2024.
  - We're already seeing signs of recovery in the most highly sought-after parts of the market. From US logistics to Australian BTR, a steadying of yields, coupled with strong rental growth, is once again pushing prices higher. Over the year we expect recovery to broaden across sectors and markets.
  - It is often the case that the years after a major price correction tend to be some of the best vintage. As we go into the middle of the decade, we anticipate interest rate cuts could stimulate the global economy and increase liquidity, while also supporting the relative attractiveness of real estate pricing.
  - Residential and logistics remain our top calls across all three regions, while a sharp fall in new construction supports the case for active asset management, including repositioning obsolete office stock. Private real estate debt remains an attractive alternative, providing a relatively high cash return alongside downside protection to further value decline.
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## 1 / Market Outlook

Global real estate has endured an exceptionally difficult eighteen months. Despite better-than-expected economic growth and robust real estate fundamentals, rising interest rates have seen a souring of sentiment, a slump in transactions, and values falling across almost every major market. Having previously expected the US and Europe to stabilise during the second half of last year, a summer run-up in globe bond yields has prolonged the pain. By the end of 2023 we estimated a fall in values from peak of 10% in APAC, 15% in the US and 20% in Europe.<sup>1</sup>

Despite this setback, we believe that recovery is not far off. While not expecting to see a surge in activity over the coming months, lower real estate values, alongside a recent rally in bonds and equities, suggests that the denominator effect, which haunted the sector twelve months ago, should no longer be a major issue.

Financing may remain a constraint on activity. Refinancing loans made during the ultra-low interest rate environment could be expensive and painful. However, we're far from the levels of distress seen during the GFC. Not only is the sector less leveraged, but also private debt is an increasingly active part of the market, as high interest rates and downside protections draw an increasing number of non-traditional lenders into the market.

<sup>1</sup> DWS, ANREV, INREV, NCREIF, DWS, January 2024

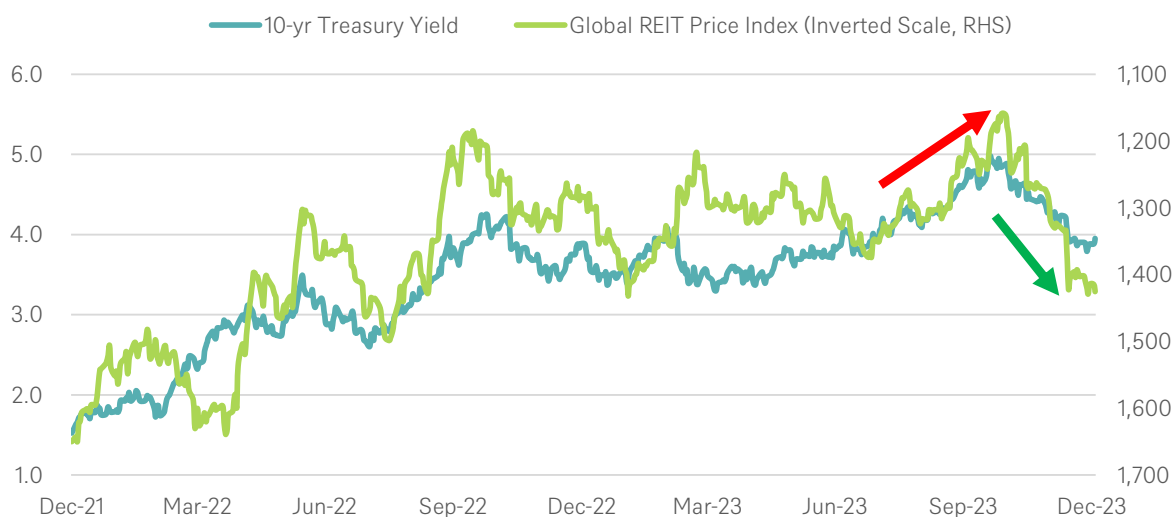
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The rally in listed real estate during the final three months of 2023 provides us with another positive indicator. Typically leading the direct market, the listed market jumped around 15% in the final quarter of the year in response to lower bond yields. From the very beginning of this downturn, we've seen an incredibly close 85% correlation between the 10-year Treasury and Global REIT pricing<sup>2</sup>, and as such with inflation moderating and central banks expected to start cutting interest rates in 2024, this rally in the listed market could be a precursor to a recovery in the direct market.

### Treasure Yields and Global REIT Pricing



Source: DWS, Macrobond, January 2023

Importantly we're already seeing signs of recovery in the most highly sought-after parts of the market. From US logistics to Australian BTR, a steadying of yields coupled with strong rental growth is once again pushing prices higher.<sup>3</sup> Over the year we expect recovery to broaden across markets and sectors, with almost all major markets outside of Japan resuming capital growth by the second half of 2024. Initially led by the strength of the occupier market, in time, lower interest rates and the return of liquidity should also weigh upon real estate yields, potentially setting the market up well for a period of above average performance.

The return of core capital could be relatively slow at first but gain momentum as valuations are confirmed to have reached a low point. A relatively weak economic backdrop could also bring capital back to core, attracted by solid income during a period of macroeconomic uncertainty.

Having aggressively fundraised over the past year, opportunistic investors may be some of the first to return to the market, looking for distress and mispricing. Distress may well be found in parts of the office market but given generally strong real estate fundamentals and a far more stable lending environment than the Global Financial Crisis, these investors may be disappointed, left targeting assets with less discount or with poor long-term fundamentals, and less scope for recovery.

Further ahead than other regions, we expect appraisal values to reach a low point first in Europe, followed soon after by the US. The process may take a little longer in APAC, although, after a slow start, appraisers in markets such as Australia now look to be catching up with spot-pricing.

<sup>2</sup> DWS, Macrobond, January 2024

<sup>3</sup> Green Street, CBRE, January 2024

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## Performance outlook

Recovery expected to accelerate in response to rising demand, supply shortages and the return of liquidity.

It is often the case that the years after a major price correction tend to be some of the best vintage. We don't expect this cycle to be any different. As we go into the middle of the decade, we anticipate interest rate cuts could stimulate the global economy and increase liquidity, while also supporting the relative attractiveness of real estate pricing. On top of this, we see potential for major shortages in the delivery of new stock across most major markets. Covid disruptions, rising construction costs, skills shortages, a lack of finance and falling prices, have all resulted in construction activity sinking to exceptionally low levels. Far from good news for the economy or society, this could help to sustain above average rental growth over the coming five years.

Residential and industrial continue to be our expected top performing sectors over the coming five years. Having relinquished some of the extraordinary gains made during the covid years, industrial assets still look well placed for rental growth, while also now offering a more compelling entry yield. And while recent years haven't necessarily been easy for all residential markets – particularly in some highly regulated European markets – persistent supply shortages and major reductions in development, coupled with increased migration and the return of urban population growth, are expected to push rents to record high levels.

US office is by far the weakest sector globally, recording double-digit vacancy across all investable markets. However, this is not true for all parts of the globe, notably Germany and Korea – with Seoul vacancy at less than 3%.<sup>4</sup> Looking forward, prime buildings outside of the US are projected to record robust rental growth, as a scarcity of grade A stock and demand for best-in-class space continue to push on rents. As older stock is withdrawn from the market, often being converted to better use, this should help to improve the balance more generally, and in time including even the US market - although perhaps not before the end of 2025.

In contrast to office, US retail goes from strength to strength, with vacancy falling to its lowest since at least 2005,<sup>5</sup> and while rents are unlikely to match the levels achieved in industrial or residential, the sector looks well positioned to produce competitive and relatively stable returns. We're more cautious in our outlook for Europe and APAC. It's true that as a higher yielding sector retail has tended to hold up better in the face of rising interest rates, while a rebound in tourism has helped high street retail in the likes of London, Paris, Tokyo, and Singapore. Nonetheless, overall, long-term demand drivers are weak, particularly for shopping centres, and while the repricing of the sector does suggest there may now be more opportunities in places such as the UK and Spain, we expect investors to remain cautious for some time.

Across all three regions we expect to see a considerable divergence in city-level performance. This is particularly true for APAC where the Japanese market has so far seen little in the way of correction. In APAC we expect Australian and Korea to be some of the top performers over the coming five-years, recovering strongly on the back of robust economic growth. In Europe, having experienced considerable price correction, we're increasingly positive in our outlook for the German cities, where sustained low vacancy should help support rents over the medium term. London and Paris stand out within their respective markets, with Amsterdam and Warsaw also doing well. Finally, in the US we generally favour markets in the Sun Belt and Mountain West, which should continue to profit from outsized population and job growth for the foreseeable future.

<sup>4</sup> Colliers, December 2023

<sup>5</sup> NCREIF, December 2023

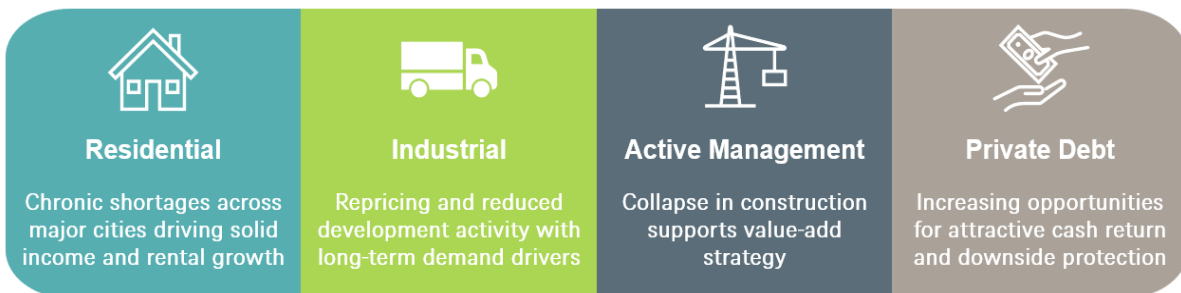
## 2 / Investment Strategies

The residential sector features highly across all three regions. Historically resilient in the face of recession, a hedge against inflation, rental growth outperformance, and a recent history of repricing, the sector looks well placed for many upcoming scenarios. In APAC we favour the strongly growing Australian cities, where upcoming tax changes may further open the market to international capital, and in the US, the suburbs of fast-growing cities such as Austin and Salt Lake City, benefitting from migration and demographic changes. And while parts of Europe have been through tougher times in recent years, with repricing now well advanced, the German cities, alongside London, Amsterdam and Dublin look well positioned. There are however risks, with regulation an increasing feature in the European market, leading some to consider other fast-growing subsectors such as student housing or co-living, where regulation tends to be less of a feature.

Logistics is also prominent in all regions. One the top performing sectors, we see tactical opportunities across Australia and North Asia – particularly regional cities in Japan and Korea – while repriced and high barrier markets in Europe, such as London and Amsterdam, look to be good value. With a collapse in construction starts, the outlook for US industrial rental growth is expected to be well above the global average from the middle of the decade, with infill locations in major coastal cities such as Boston and Seattle projected to outperform.

This collapse in construction is being repeated across almost all regions and sectors, potentially opening opportunities to take a more active approach, developing, refurbishing or repositioning, delivering ESG compliant, best-in-class stock into undersupplied and aging markets. Given both investor and lender caution, development projects and older stock are likely to have underperformed over the past year and may continue to lose value. And while this is unfavourable to the current owners, a lower entry price should help to boost the return when successfully delivered. We would include office in this strategy – particularly in Europe – transforming centrally located stock into best-in-class office, or fringe and suburban assets to a better use, such as student and co-living space.

For those investors looking for a higher cash return, or wanting downside protection against further capital value loss, private real estate debt could offer an attractive alternative to equity. Interest rates may have peaked, but we continue to see interesting opportunities in this space from both the upcoming wave of refinancing as well as an increasing number of new deals as transaction activity gradually begins to improve. We tend to favour junior and whole loans—where competition from traditional lenders is less—across a broader range of sectors than equity, including the likes of Europe retail or Korean construction finance.



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