Global Real Estate Strategic Outlook

Mid-Year 2023

IN A NUTSHELL

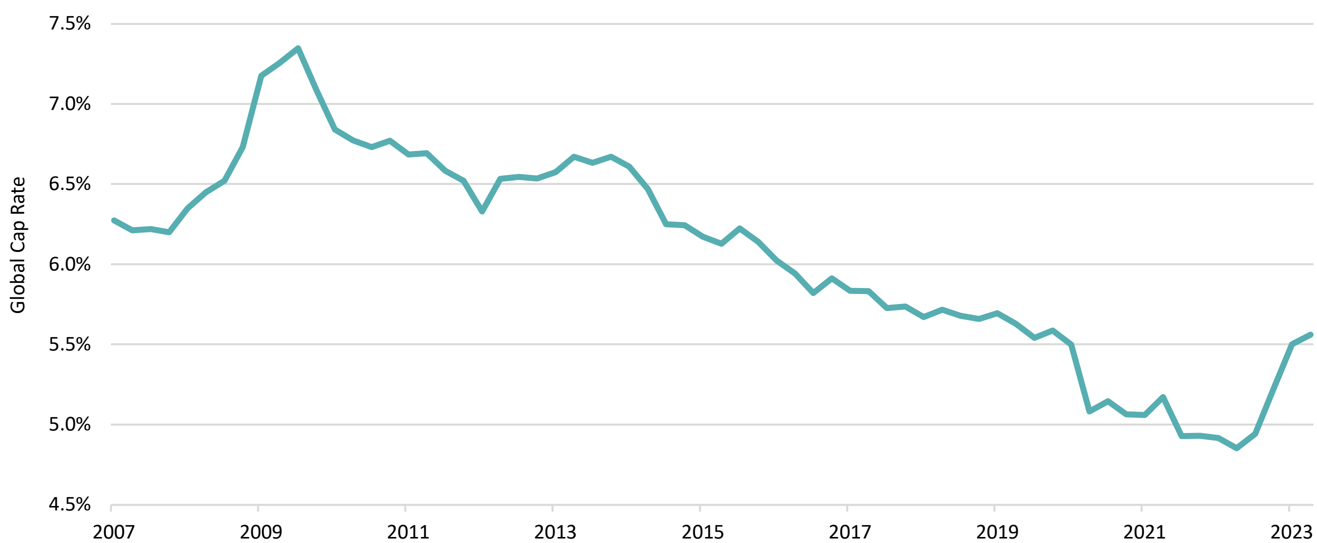
— Higher interest rates have filtered into real estate, causing prices to drop 10%-20% globally.[1]
— Fundamentals are generally stalwart, evidenced in tight vacancies and rising rents. E-commerce, coupled with efforts to bolster supply chains, is driving demand for warehouses. Chronic housing shortages also persist across most major European, Asian, and U.S. cities.[2]
— We believe that the outlook is positive for the next 12 months. Real estate has largely priced-in today's interest rates, in our view. Rent growth may slacken as economies slow, but any leasing pullback should be mild. Meanwhile, tighter financing should curb construction, paving the way for fundamentals to re-tighten next year as economies gather momentum.
— Our top picks include industrial and residential properties, which are fueled by structural tailwinds. A flight to quality has also created opportunities for office refurbishment in Europe, where many cities (e.g., Paris and Berlin) suffer a dearth of prime, ESG-friendly options.

[1] Real Capital Analytics; GREFI; FTSE/NAREIT; DWS. As of July 2023.
[2] DWS. As of July 2023.

1 / Recent Performance

Global real estate prices slid over the past year as interest rates increased. Measuring the magnitude of the decline is somewhat challenging, not least because trading activity also tumbled (down 48% year-over-year in the first half of 2023).[3] A global core fund return index (which includes income and is levered) showed a drawdown of 6.5% through the first quarter of 2023.[4] A commercial property price index of global cities was down 6.6% year-over-year in the second quarter of 2023.[5] Global transactions-based cap rates increased 70 basis points (bps), equivalent to a roughly 15% drop in values, although income growth may have offset some of this decline (see Exhibit 1).[6]

Exhibit 1: Global Real Estate Cap Rates

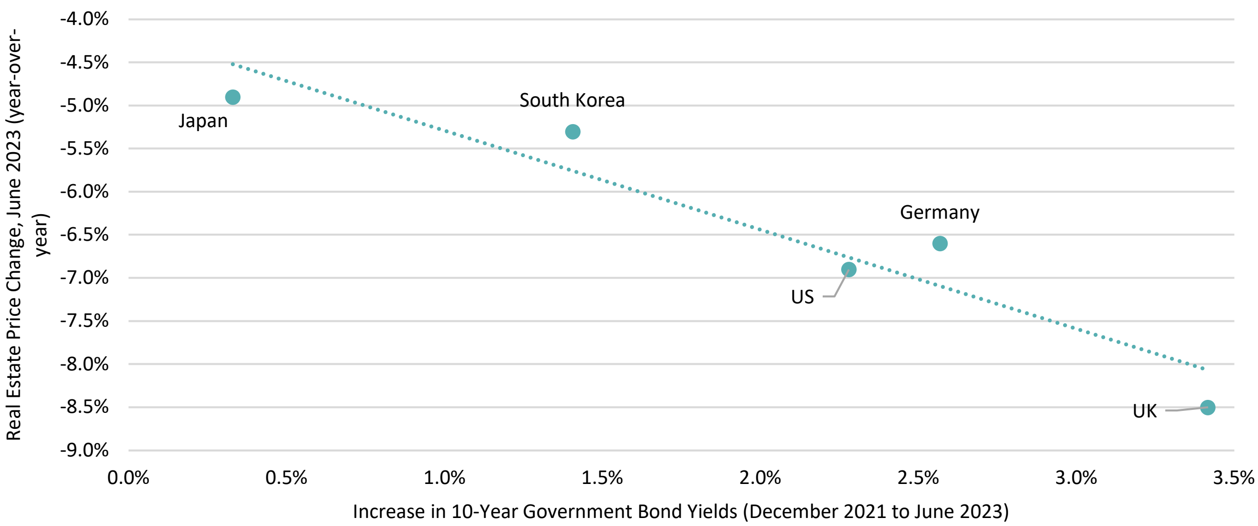


Source: Real Capital Analytics. As of June 2023.

Unfortunately, each of these measures has limitations. Fund index returns are based on appraisals that may be lagged and smoothed. Price indices and cap rates are more timely but could suffer a quality bias if inferior properties fail to trade. Listed REITs offer another reference point, having historically led private markets by about one year.[7] REITs are also an imperfect indicator: they are more volatile and have typically overshot underlying asset values, sometimes dramatically. Still, they imply that private real estate prices have declined about 15% globally, a figure that is consistent with the anecdotal observations of our transaction teams around the world.[8] Relative price moves across major currency areas appear to have generally tracked shifts in long-term interest rates, although these figures likely understate the magnitude absolute declines, in our view (see Exhibit 2).[9]

[3] Real Capital Analytics. As of June 2023.
[4] GREFI. As of March 2023.
[5] Real Capital Analytics CPPI. As of June 2023.
[6] Real Capital Analytics. As of June 2023.
[7] GREFI (private real estate); FTSE/NAREIT (REITs); DWS calculations. As of March 2023.
[8] GREFI (private real estate); FTSE/NAREIT (REITs); DWS calculations. As of March 2023.
[9] Bloomberg (bond yields); Real Capital Analytics CPPI (price changes). As of June 2023.

Exhibit 2: Change in Government Bond Yields and Real Estate Prices



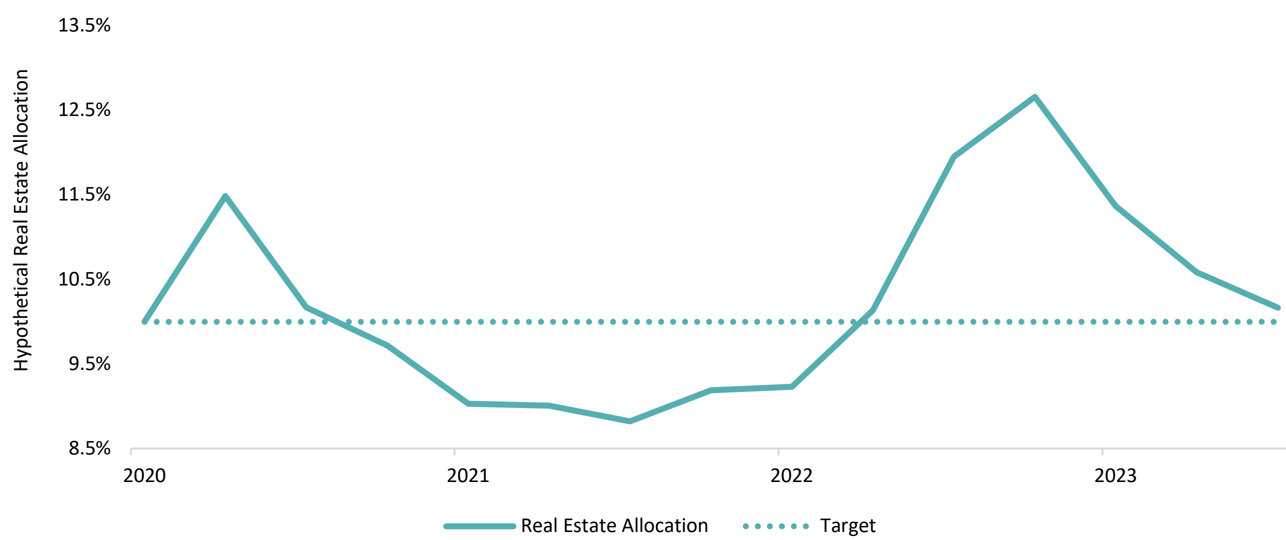
Sources: Bloomberg (bond yields); Real Capital Analytics (real estate prices).

2 / Real Estate Outlook

Just as interest rates have been pivotal to real estate's recent performance, we believe they will play a critical role in shaping the near-term outlook. On this front, there is scope for optimism. While central banks have continued to increase short-term interest rates, long-term bond yields ended July 2023 roughly where they were at the beginning of the year.[10] As inflation begins to ebb, DWS believes that bond yields have essentially peaked (with some potential relief on the horizon in the UK).[11] In our view, a more stable interest-rate environment should relieve upward pressure on cap rates, which have largely priced-in earlier increases (in spot markets, if not in appraisal valuations).

From a technical standpoint, interest-rate stability may also help to catalyze increased capital flows into the asset class. Listed markets have improved, with global bonds and stocks up 2% and 19%, respectively, year-to-date in July 2023.[12] Coupled with real estate write-downs, this recovery may have largely neutralized the "denominator effect" (lower overall portfolio values pushing real estate above target allocations) that has kept some institutional investors on the sidelines (see Exhibit 3).[13]

Exhibit 3: Hypothetical Real Estate Allocation



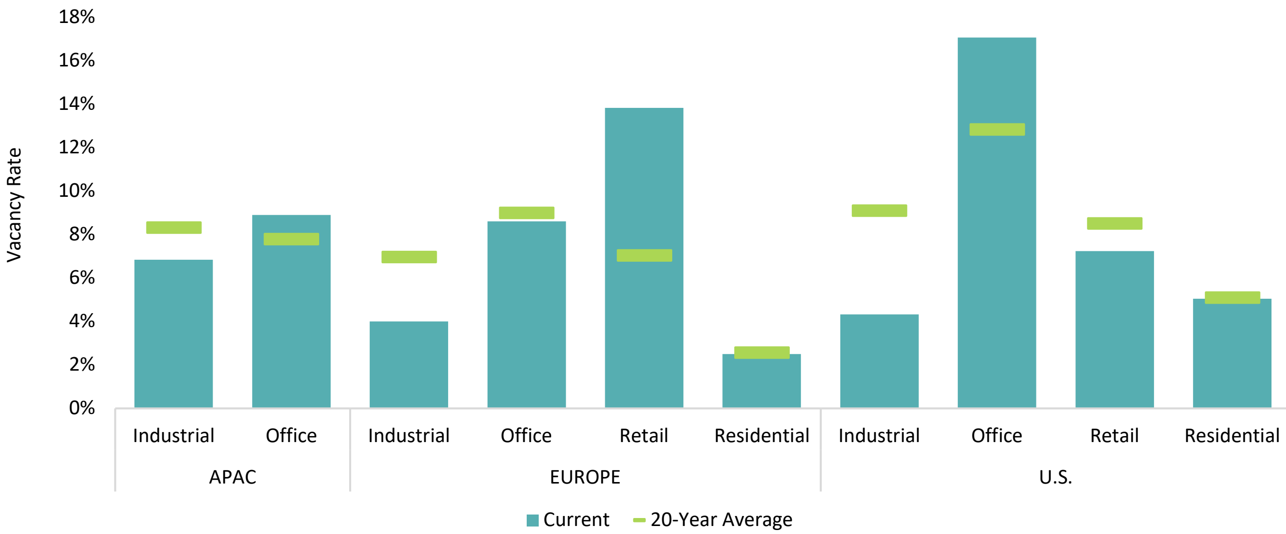
Note: Assumes target allocations of 60% (stocks), 30% (bonds), and 10% (real estate).
Sources: MSCI World (stocks); Bloomberg Barclays Global Aggregate (bonds); GREFI (real estate); DWS calculations. As of March 2023.

In a more stable capital-markets environment, we would expect that real estate performance — both in absolute and relative terms — would more closely align with underlying fundamentals. As of mid-year 2023, these fundamentals were generally solid. To be sure, there are exceptions. In the U.S., office vacancies have soared as low utilization rates and technology layoffs have stifled demand.[14] European retail and global logistics also softened as spending shifted from goods, including online orders, to services.[15] (U.S. apartments experienced a similar pullback in 2022 but picked up in the first half of 2023.)[16]

[10] Bloomberg. As of July 2023.
[11] DWS Strategic CIO View. As of August 2023.
[12] Bloomberg Barclays Global Aggregate (bonds); MSCI World (stocks). As of July 2023.
[13] MSCI World (stocks); Bloomberg Barclays Global Aggregate (bonds); GREFI (real estate); DWS calculations. As of March 2023.
[14] CBRE-EA. As of June 2023.
[15] DWS. As of June 2023.
[16] CBRE-EA. As of June 2023.

In general, however, developed economies have seemingly withstood war, inflation, and surging interest rates with a remarkable resilience that has sustained leasing activity. Meanwhile, pandemic-related supply-chain disruptions and elevated construction costs — though easing — have constrained the delivery of new supply. As a result, vacancy rates have remained low across most regions and sectors (see Exhibit 4).[17]

Exhibit 4: Vacancy Rates



Source: DWS. As of June 2023.

We believe that real estate fundamentals will bend, but not break, over the next 12 months. DWS forecasts that the global economy will slow as past interest-rate hikes begin to bite.[18] We also anticipate that a wave a COVID-delayed construction will temporarily lift U.S. apartment and industrial supply, and office supply in London and Tokyo. Still, we believe that unemployment will remain low, buttressing leasing activity, while construction retreats amid tighter financing. In our view, vacancies will escalate and rent growth slacken, but only modestly, before re-accelerating later next year as economies recover and supply subsides.

[17] DWS. As of June 2023.

[18] DWS Strategic CIO View. As of August 2023.

3 / Investment Strategy

As financial conditions normalize, we believe that relative investment performance across sectors and markets will be distinguished by fundamental factors, particularly over a long-term investment horizon.

We remain bullish on industrial property globally. COVID created temporary distortions around goods consumption, e-commerce, and trade that initially inflated and later cooled demand and rental growth. However, we believe that the long-term structural trends supporting the sector — e-commerce and efforts to strengthen supply chains — remain firmly intact. For a time, this thesis appeared overbought in Europe, but the past year's price correction has rendered the sector attractive once again. In Europe, we favor the Netherlands, UK, Barcelona, and Poland; in Asia-Pacific, Australia, Singapore, and regional Japan and Korea; and in the U.S., the coastal gateways of New York, Los Angeles, and Miami.

We are also optimistic about prospects for residential real estate. A host of factors — natural population growth, migration, an increase in single-person households, land constraints, rising labor and materials costs, and more recently, a pullback in construction financing — has created housing shortages in most major cities around the world.[19] In the U.S., apartment vacancies have increased following a transitory demand slowdown in 2022 and the completion of delayed projects this year, yet total housing vacancies remain near their lowest levels since the mid-1980s.[20] In Europe, vacancy rates are 2.5% in the UK and less than 1% in Germany.[21] While residential is less institutionalized in Asia, vacancy rates are historically low in Japan (3%) and less than 1% in parts of Melbourne and Sydney.[22] Our strategy favors suburban housing in the fast-growing Sun Belt region of the U.S.; operational residential such as student and senior housing (which feature higher yields and less rental regulation than traditional multifamily) in Europe; and Australian build-to-rent (which will benefit from tax concessions in 2024) in Asia.

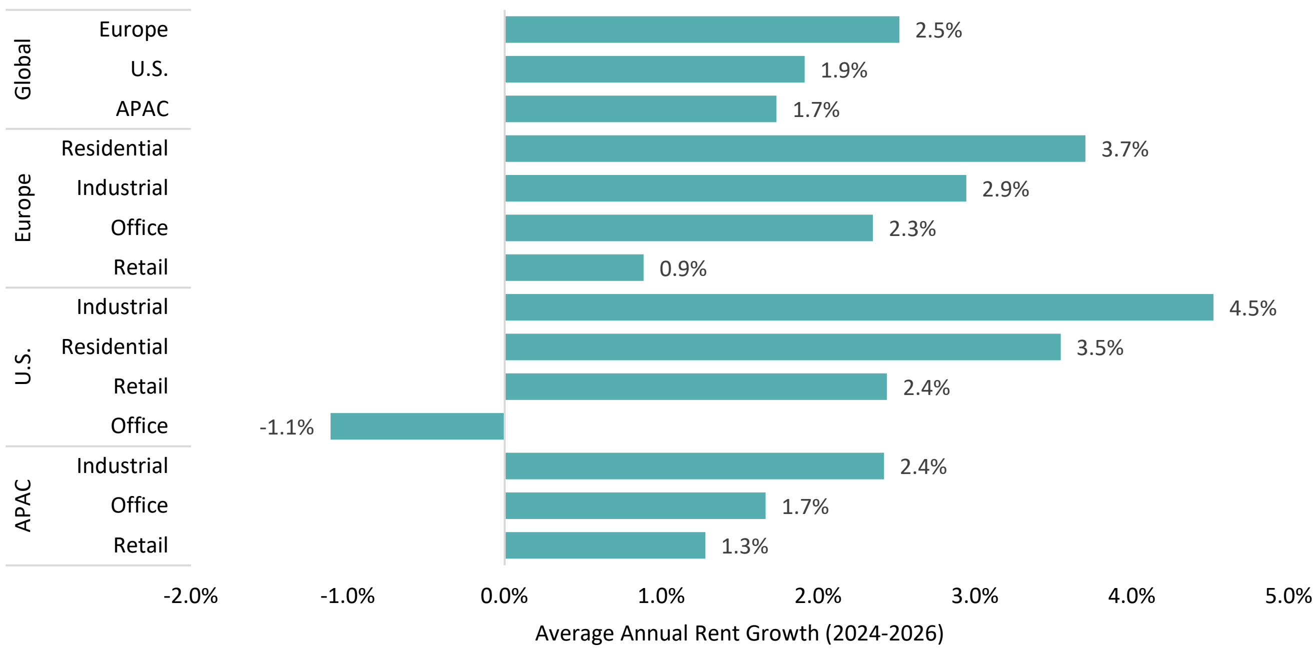
Our position on Retail is mixed. The sector remains structurally weak in much of Asia and Europe, as e-commerce continues to cannibalize store activity. In the U.S., however, retail property has turned the corner, as centers have been repositioned to provide services (e.g., health care and restaurants) and for e-commerce distribution. As with residential, we favor suburban assets in the southern U.S., where population growth is strongest (following the maxim that "retail follows rooftops").

Conversely, we believe that Office will continue to struggle in the U.S., where vacancies rival early-1990s and Global Financial Crisis peaks. Like U.S. Retail, it is not forever doomed: it will recover over time as the country's workforce expands and some buildings are converted to other uses, but this recovery could take several years. In Asia, however, a cultural affinity for office-based interaction has limited the damage from remote working, particularly in South Korea and Japan. And some European markets (e.g., Paris and Berlin) boast low vacancy rates, particularly for prime, environmentally friendly buildings that are enjoying a flight-to-quality. Here we see a generational opportunity to acquire older, class B buildings and convert them into next generation space.

From a geographic perspective, we believe that no major region offers an unqualified advantage. Averaging across sectors, we forecast that Europe will generate the strongest rental growth from 2024-2026 (see Exhibit 5). However, the U.S. and Asia are negatively skewed by Office and Japan (where inflation is also lower), respectively. Indeed, U.S. industrial is forecast to outpace all other segments, while Australia and South Korea are also expected to perform well.

[19] World Economic Forum, "What has caused the global housing crisis – and how can we fix it?" June 16, 2022; DWS. As of August 2023.
[20] CBRE-EA (apartments); Census Bureau (total housing). As of June 2023.
[21] DWS. As of June 2023.
[22] DWS. As of June 2023.

Exhibit 5: Rent Growth by Region and Sector



Source: DWS. As of August 2023.

The next year might be somewhat choppy as improving capital markets collide with a soft patch in fundamentals. But conflicting signals are the hallmark of inflection points, where opportunities are often at their greatest. Fortune may favor the brave investor who can look through the dip, capitalize on attractive valuations, and ride the next cycle.

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