March 2020 / Research Report

CORONAVIRUS: IMPACT ON GLOBAL REAL ESTATE

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1 / Introduction

1.1 Key Points

- COVID-19 (coronavirus) has increased the risk of global recession in 2020.
- A recession would weaken fundamentals, including demand, occupancies, and rent growth.
- Disciplined supply and attractive valuations should temper the downside to prices.
- The impact would vary by sector and market. Office and Retail in our opinion are more vulnerable than Industrial and Apartment.

1.2 Background

In recent weeks, global financial markets have been upended by the spread of the coronavirus. While the number of new infections in China has seemingly dwindled, the virus has begun to proliferate around the world. As of March 17, ex-China infection rates were rising at an accelerating, double-digit daily pace, notably in Iran, Italy, France, Germany, Spain, and the U.S., pushing global totals past 190,000.¹

Fears surrounding the potential impact of the virus on national economies and corporate profits have reverberated through the financial markets. Equity markets plunged more than 25% from their peak and credit spreads blew out.² Oil prices collapsed as weakening global demand sparked a Russia-Saudi Arabia price war. Central banks responded with loosening measures: The People’s Bank of China was the first to act in February with significant liquidity injections into financial markets; the Federal Reserve and Bank of England delivered emergency cuts to policy rates of 150 and 50 basis points (bps), respectively; and the European Central Bank stepped up asset purchases, a move that the Bank of Japan was expected to soon follow. As investors priced in looser monetary policy and the deflationary effects of weaker economic activity and lower oil prices, 10-year sovereign bond rates tumbled below 1% in the U.S., near-zero in the UK and Japan, and close to -0.5% in Germany.³

¹ Johns Hopkins University. As of March 17, 2020.
² Bloomberg. As of March 17, 2020.

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2 / Economic Impact

Given the speed of developments, it is difficult to measure the impact on economies to date. Japan’s economy contracted in the fourth quarter of 2019, but this was largely attributed to an ill-timed tax hike. More to the point, China’s Purchasing Managers Index (PMI) slid to an all-time low in February 2020, implying a sharp slowdown — perhaps even a contraction — in China’s economy in the first quarter 2020. Otherwise, incoming data largely reflects pre-virus conditions. Given that quarterly GDP data is often released with a considerable lag, investors will no doubt be keenly focused on monthly reports covering labor markets, retail sales, PMIs, and industrial production.

In a data vacuum, economic predictions are inherently speculative. However, at least from a qualitative perspective, the scope of the impact is coming into view. In particular, the coronavirus has the potential to damage the economy through several channels (albeit to varying degrees across countries and cities).

- **Social Distancing**: Measures to contain the spread (school and business closures and event cancellations) impede economic activity and undermine confidence.
- **Supply chains**: In a globalized economy, supply disruptions in other countries stall domestic manufacturing activity.
- **Tourism**: Corporate restrictions and consumer caution reduce both business and personal travel.
- **Exports**: Weakness in foreign economies reduce demand for exported goods and services.
- **Financial conditions**: Stock-market declines increase the cost of capital and erode business and consumer confidence.

The severity of the impact, both globally and nationally, will in our opinion depend in part on the path of coronavirus infections. We believe that the virus will likely peak mid-year, either because containment efforts prove effective (as we have arguably witnessed in China) or because infections have reached saturation levels. To be sure, governments and central banks will probably combat the fallout with injections of fiscal and monetary stimulus. Lower oil prices could act like a tax cut for manufacturers and consumers. Nevertheless, under this scenario, we believe that Japan and Europe will likely endure recessions, and China and the U.S. will probably experience meaningful slowdowns, before staging a recovery toward the end of the year (see Exhibit). Downside risks include a more protracted epidemic, a more pronounced deterioration in financial markets, or the emergence of job losses that could further undermine consumer spending.

**EXHIBIT: GDP GROWTH**

<table>
<thead>
<tr>
<th>Country</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>6.1%</td>
<td>5.0%</td>
</tr>
<tr>
<td>United States</td>
<td>2.3%</td>
<td>1.0%</td>
</tr>
<tr>
<td>Eurozone</td>
<td>1.2%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Japan</td>
<td>0.9%</td>
<td>-0.8%</td>
</tr>
</tbody>
</table>

3 / Real Estate Impact

While the economic data has been sparse, real estate data has been nonexistent. Moreover, any impact on real estate will likely occur with a lag of perhaps two to three quarters: it takes time for changes in the economy to filter down to leasing activity and transactions markets, not to mention appraisals. Still, we can begin to anticipate what the implications might be.

Notwithstanding the tumultuous economic and financial backdrop, we are relatively sanguine about prospects for real estate, particularly on a relative basis. To be sure, a slowdown would dent real estate fundamentals through its negative effects on job creation (office), consumer spending (retail and industrial), and household formation (apartment). While conditions would vary by market, we believe that vacancy rates could begin escalate, and rent growth turn negative, toward the end of 2020. Still, the fallout may be limited thanks to the low level of existing vacancies and the generally disciplined levels of construction underway in most markets.

From a capital markets perspective, the potential consequences are mixed. There is no doubt that recent volatility could squeeze capital flows into real estate from institutions (which may rebalance portfolios) and listed REITs (whose cost of equity has increased). Yet lower interest rates could attract capital from levered buyers and yield-seeking investors. Meanwhile, the general discipline observed in debt markets over the course of this cycle minimizes the risk of widespread distressed selling. Ultimately, we believe that we could see some upward pressure on yields, but only modestly.

Real estate is not homogeneous, and we expect that sectors will respond to virus and economic pressures differently. In particular:

- **Retail** is historically defensive in recessions. However, the sector is struggling in the face of e-commerce, and while services such as dining and fitness have helped fill the void, these could be adversely affected by coronavirus concerns. Malls and high-street retail are especially vulnerable to a pullback in tourism and consumer spending: department stores and apparel vendors that were already on the brink may struggle to ride out the downturn. Yet retail centers that provide daily necessities (e.g., supermarkets, health care providers, and pharmacies) may hold up better.

- The **office** sector is sensitive to the economy. While in-place leases protect cash flows for a time, valuations price-in future vacancies more quickly. Additionally, the virus could pose a test for co-working companies and their landlords: if monthly leasing dwindles due to contagion fears or a general slowdown in the economy, co-working tenants may struggle to honor longer-term lease commitments. While co-working represents a small share of overall office tenancy (e.g., less than 2% in the U.S and 4% in New York), it has accounted for a significant share of recent leasing activity.

- **Industrial** should continue to benefit from e-commerce, which may gain added momentum as some consumers substitute delivery for shopping excursions. Vendors might also choose to accumulate more inventory — perhaps permanently — in order to protect against supply disruptions. However, markets that draw demand from major ports might feel the effects of reduced international trade.

- **Residential** might suffer from weaker household formation. In general, however, **Apartments** tend to hold up well in recessions, as risk-averse households eschew homeownership, notwithstanding lower mortgage rates. Moreover, we believe that housing shortages and affordability challenges will probably continue to provide structural support to this sector in many cities.

The bottom line is that while real estate could certainly be adversely affected this year by a slowing economy, we believe that the downside will probably be relatively limited. Current developments are reminiscent of 2001, a time when a global shock (9/11) similarly battered a vulnerable economy, while real estate supply and valuations were benign. Real estate was not immune to that cycle, but it suffered only modest declines in pricing overall (there were exceptions). And when the storm passed, attractive valuations (relative to reduced interest rates) supported a strong rally through most of the decade.

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3.1 United States

The yield curve has been inverted for most of the past year, a historically reliable harbinger of recession. We had expected that consumer spending, supported by low interest rates, would carry the economy through 2020, giving way to a downturn in 2021. However, it is possible that the coronavirus has pulled forward the recession’s arrival to the middle of 2020.

The slowdown is expected to disproportionately affect local economies — and real estate markets — that are more exposed to Asia trade (Seattle, San Francisco, and Los Angeles), travel and tourism (Florida), and energy (Houston and to some extent Denver). Washington D.C. should remain relatively insulated thanks to its large government employment base. Nevertheless, over the longer term we continue to favor markets driven by technology (e.g., Seattle, Bay Area, Denver), population growth (e.g., Texas, Atlanta, Florida), or both (e.g., Austin, Raleigh).

3.2 Europe

Europe entered 2020 already experiencing a period weak economic growth. While we had not expected this to result in recession, it now seems increasingly likely that this will be the case for a number of countries, including Italy and Germany. To date, the virus has had by far the biggest impact on Italy, with extended restrictions on movement and commerce implemented across the country. However, with the number of cases growing quickly, almost all major cities in Europe are likely to face further disruption and a period of reduced economic activity.

Similar to other regions, the European real estate market entered this period in good health. Vacancy rates, outside of the retail sector, were near record lows, the development pipeline was under control and relative pricing looked attractive. So far this picture hasn’t changed, and indeed relative pricing has only improved. Nonetheless, lower business and consumer confidence, the potential for business failure, and probable reduction in market liquidity suggest real estate performance will likely weaken this year — particularly for non-core assets.

At the sector level, residential and urban logistics look to be most resilient. Mass market residential in particular looks well placed to preserve occupancy and NOI given the current supply demand imbalances across many European cities. Hotels and retail look to be most exposed to both restrictions on travel, lower consumer confidence and less tourist demand.

3.3 Asia Pacific

The virus outbreak has increased the risk of a significant economic slowdown, and possibly recession, in Asia Pacific economies in the first half of 2020, including China, Hong Kong, Japan and South Korea, and to some degree Singapore and Australia. We believe real estate transaction volumes would likely decline sharply in the first half in the region, although the impact on asset values should be mitigated by lower interest rates, modest leverage, low vacancy and disciplined supply. A further prolonged recession scenario, however, could undermine real estate fundamentals and hurt occupier leasing demand in the commercial sectors, and potentially lead to weaker valuation.

Among the real estate sectors, hospitality will likely be most affected, followed by high street retail due to the significant decline in tourist arrivals as well as lower foot traffic from domestic consumers. Those asset owners face increases in tenant incentives, rent abatements and expenditures. Within retail we favor assets with non-discretionary exposure. Demand for space expansion and relocation will probably be muted in the office sector while we favor markets with controlled supply and relatively resilient demand (e.g., Sydney, Melbourne, Brisbane, Osaka, Nagoya, Fukuoka, Seoul Gangnam). Logistics assets catering to domestic consumption and e-commerce retailing will probably continue to outperform other sectors (key markets in Australia and Japan, Seoul and Singapore). Occupier fundamentals remain strong in Japan’s residential sector, while in the investment market the travel restrictions could be a stumbling block for cross border investors who have been the main driver of mega deals in the past two to three years.

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- Adverse changes in law and regulation including environmental laws and regulations, zoning laws and other governmental rules and fiscal policies;
- Environmental claims arising in respect of real estate acquired with undisclosed or unknown environmental problems or as to which inadequate reserves have been established;
- Changes in the relative popularity of property types and locations;
- Risks and operating problems arising out of the presence of certain construction materials; and
- Currency / exchange rate risks where the investments are denominated in a currency other than the investor’s home currency.

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