“IS REAL ESTATE PORTFOLIO DIVERSIFICATION STARTING TO PAY OFF?”

BNP PARIBAS
WEALTH MANAGEMENT

The bank
for a changing
world

IS AN INTERNATIONAL PROPERTY INVESTMENT A SMART IDEA?

We have always been in favour even though real estate diversification has not always come up trumps in recent years. For example, capital markets and monetary policies have generated converging gross initial yields on various commercial prime markets over the last few years. In fact, it has not always been possible for investors to capture superior total returns outside their home country, certainly after factoring in obstacles and risks (e.g. currency movements) associated with going international. Furthermore, many property 'commercial and residential' markets have moved in a more synchronised way over the past few years.

HOWEVER, WE BELIEVE THAT THE RATIONALE FOR GOING INTERNATIONAL IS FAR FROM DEAD. TODAY, PROPERTY MARKETS APPEAR TO BECOMING INCREASINGLY DE-CORRELATED.

While there are no imminent signs that US commercial property markets will reach a turning point soon, there are mounting concerns about how far commercial property prices could go (the sky's the limit!). Across Europe, the Brexit saga (and the British fractious government) continues to cast shadows of uncertainty over the UK. Meanwhile, Continental Europe is enjoying an improvement in economic growth, which could spur demand from investors for every category of commercial real estate. In China, we are starting to see a discrepancy between top-tier housing markets (Beijing, Shanghai etc.) and 'smaller' cities. For the first time, lower-tiered markets are expected to outperform prime markets in the coming months.

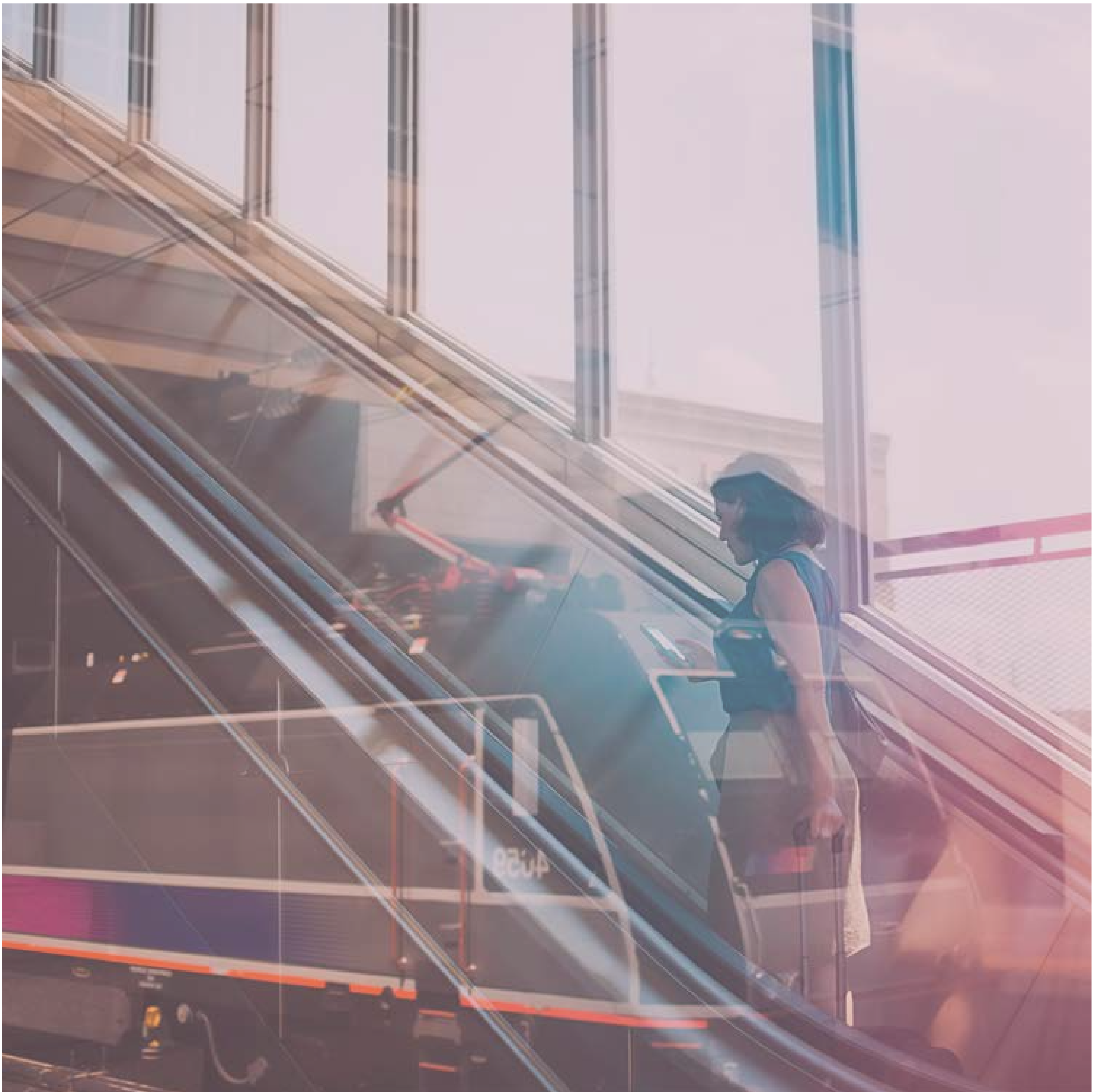
Likewise, discrepancies are seen between retail and logistics markets, particularly in the US: traditional retailers are progressively under pressure because of the booming e-commerce activity, whereas investment appetite for logistics is very robust at present. A similar divergence is observed in listed property markets, with retailers having suffered from tumbling share prices year-to-date.

Overall, US REITs accumulated a loss of more than 4% in dollars in the 12-month period to 31 August 2017 (source: RESIG, BNP Paribas Wealth Management).

In Asia, Japan is deemed a safe haven, considering the growing uncertainty about neighbouring countries (e.g. North Korea). Australia's housing markets have been isolated from other Asian countries, performance-wise, in the past few years. As such, they have provided a perfect means of diversification mainly for Asian investors. Nonetheless, local residential markets may eventually see a significant correction in the coming months.

The whole correlation/de-correlation issue is a difficult matter to address, for both real estate and other asset classes.

Could it be that real estate correlations (implying a weaker case for diversification across property markets) tend to be stronger during a global financial crisis and weaker at other times?



REAL ESTATE MARKETS TODAY: WHAT ARE THE MAIN CONCERNS?

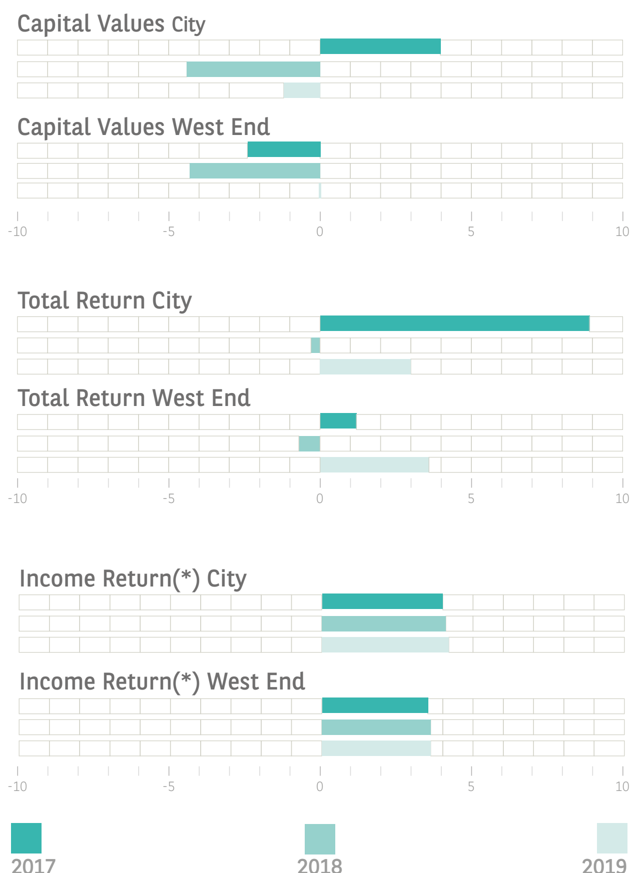
WHERE DO WE STAND WITH BREXIT?

An analysis of annual total returns (before debt financing) over the 12-month period to 30 June 2017 shows that UK commercial property remained relatively resilient (source: CBRE Research, 2Q17). Capital values – for a mix of offices, retail and industrial assets across the UK – rose by 3.7% in the year to June 2017, bringing total annual returns (supplemented with net rents) well above 5% for the 12-month period. Nevertheless, overall average annual returns were distorted by the exceptional performance of the industrial sector. Strikingly, industrial assets performed the best, with ungeared total returns close to 16% in the year to June 2017. Offices plateaued during this period, reporting modest capital losses in the couple of months after the Brexit vote before generating a positive capital appreciation return in 1H17.

In any case, we are a long way off the apocalyptic forecasts of capital appreciation returns made just after the Brexit vote of June last year.

The question on everyone's lips is what will happen on the London office market in the years ahead? BNP Paribas Real Estate predicts modest annual total returns overall for the City and for the West End in 2017-2019, despite a capital loss of more than 4% in 2018.

Table 1: Total annual returns for the London office market from 2017 to 2019 (%, ungeared)



Notes: * Income return is equal to the prevailing purchasing yield
Source: BNP Paribas Real Estate, August 2017

MOODY'S opinion

Moody's Investors Service is not very positive about the UK. "The country's creditworthiness is under pressure and the economy will weaken significantly this year due to rising political and fiscal risks following the recent general election and last year's vote to leave the European Union." (source: Moody's Investors Service, 11 July 2017).

"While the negotiations with the European Union have recently started, it remains unclear whether the UK government can eventually deliver a reasonably good outcome for the UK. The likelihood of an abrupt - and damaging - exit with no agreement and reversion to World Trade Organization (WTO) trading rules has increased compared to our expectation directly after the referendum, with the government so far pursuing objectives that imply a 'hard' exit." (source: Kathrin Muehlbronner, a Moody's Senior Vice President).

WILL THE UK AND CONTINENTAL EUROPE EVENTUALLY PUSH THROUGH A HARD BREXIT POLICY? A VERY TOUGH QUESTION.

BNP Paribas Wealth Management economists predict that the UK economy will remain stable this year compared with 2016. Their baseline scenario is constant growth of 1.8% this year, declining to 1.1% in 2018 (source: BNP Paribas WM, September 2017).

Meanwhile, banks and insurance companies based in the UK have started announcing plans to relocate jobs to Continental Europe. But it is very difficult to assess how many jobs are at stake. To illustrate this, Citigroup Inc. has chosen Frankfurt to be the 'New European Trading Hub', moving about 150 to 250 jobs to the German city. However, the UK will remain Citi's headquarters for Europe, the Middle East and Africa (source: Bloomberg, 18 July 2017). Frankfurt could be one of the principal beneficiaries of the Brexit vote, with Standard Chartered Plc, Nomura Holdings Inc., Sumitomo Mitsui Financial Group Inc. and Daiwa Securities Group Inc. also announcing it as their EU hub in recent weeks. Deutsche Bank AG is also said to be transferring large chunks of its London-based trading and investment-banking assets to its hometown of Frankfurt (source: Bloomberg, 5 July 2017). With many firms not having made any public announcements so far, numbers remain imprecise at this stage.

However, High Net Worth Individuals (HNWIs) are still eager to invest in the UK and particular in London.

Most of the questions from our Asian key clients are related to the UK property markets – especially the high-end residential markets – and the prospects in the wake of the depreciating pound and lower nominal prices.

WHAT ABOUT TRUMPONOMICS?

It remains to be seen whether President Trump's campaign rhetoric with regards to issues such as trade protectionism, infrastructure spending and lower taxes, will effectively materialise, or whether his economic strategy will be watered down in the political (and even legal) process.

Actually, financial markets have started doubting the feasibility of the US President's plans, with the greenback having nosedived by 15% against the euro since 20 December 2016 (source: xe.com, 30 August 2017).

That said, currency movements (hence risk) are equally important to property investors wishing to benefit from the anticipated upward currency movements. Nonetheless, BNP Paribas Wealth Management expects the US dollar to strengthen against the euro by roughly 8%, forecasting a EUR/USD exchange rate of 1.10 in 12 months (source: BNP Paribas Wealth Management, 1 September 2017).

Another impact of the US President's economic policy would be on long-term nominal interest rates (not exclusively in North America). We will examine this issue in more detail in this report. Meanwhile, Europe has outstripped the US in terms of economic growth projections

RETAIL WOES IN THE US (AND INCREASINGLY OTHER PARTS OF THE WORLD)

Undeniably, traditional retail stores have been seriously squeezed by the growing e-commerce activity in the US. Retailers are shutting up shop at a staggering rate. About 2,000 store closures have been announced in recent weeks and months, bringing the total number of planned closures this year to nearly 5,100 (source: Business Insider, 3 June 2017). Furthermore, Credit Suisse estimates that the number of closures could rise to 8,640 by the end of 2017, and expects 20-25% of malls (or roughly 220-275) to shut down over the next five years. While growth in online shopping has negatively impacted foot traffic at some brick-and mortar stores, credit rating agency Fitch estimates that 70% of retail sales will be generated in physical (walk-in) stores in 2020, down from 80% today (Fitch, 8 June 2017).

THE LOGISTICS SECTOR IN HIGH DEMAND

Indeed, the logistics sector continues to be underpinned by structural changes such as online retailing. In 1Q17 prime logistics rents continued to edge up by 2.2% in global markets (based on 70 global hubs tracked by CBRE Research, Global Industrial & Logistics Rents, July 2017). US coastal hubs, such as Seattle and Pennsylvania's Interstate 78/Interstate 81 Corridor, delivered exceptional growth in rental values (+16.9% and +10% respectively). Furthermore, some 'in-land' markets witnessed significant progress as well, with Atlanta and Chicago posting surges of 9.2% and 5.6%, respectively.

Demand stayed rather strong for logistic assets in Chinese coastal and tier-one markets, with Suzhou, Hangzhou, Ningbo, Wuxi Nanjing and Shenzhen reporting rental growth of over 5% (though growth in rental values was more moderate elsewhere in the country). Europe is performing very well too, even though gross initial yields carried by existing logistic assets are very low (thus expensive). This has led to strong property development activity, particularly in the UK, where schemes must offer lower rents to attract tenants (source: CBRE Research).

INTEREST RATES, INFLATION AND MORTGAGES

Arguably, the currently low nominal ten-year sovereign bond yields are unsustainable (irrespective of geography and despite regional differences), so interest rates are likely to rise in the coming years to reflect better macro-economic conditions. But by historical standards, our economists project rates to remain low. In addition, nominal long-term interest rates had edged up in the three weeks to 7 July 2017 before declining somewhat (source: TradingEconomics), shown in the table below.

With respect to the US, inflation-adjusted bond yields have been falling as well since July. Indeed, the yield on 10-year Treasury Inflation Protected Securities ('TIPS') pulled back to 0.41% on 25 August, from 0.646% on 7 July (source: FRED, Economic Research).

A lower 'real' yield - adjusted for expected inflation - reflects a lower growth potential for the US economy, and makes real estate a more attractive asset class. Declining real bond yields may fuel less confidence in 'Trumponomics'.

Table 2: Long-term nominal interest rates (as at 1 September 2017)

Major Countries	01 sept. 2017	13 oct. 2016	change (bp)
Switzerland	-0.14	-0.47	33
Japan	0.01	-0.05	6
Germany	0.36	0.06	30
US TIPS	0.41	0.09	32
United Kingdom	1.03	1.08	-5
Hong Kong	1.46	1.04	42
Spain	1.58	1.12	46
Canada	1.84	1.18	66
Italy	2.08	1.39	70
Singapore	2.10	1.89	21
United States	2.15	1.77	38
Australia	2.72	2.26	46
Portugal	2.86	3.34	-48
China	3.69	2.74	95
Peru	5.16	5.74	-58
Greece	5.54	8.40	-286
Indonesia	6.72	7.09	-37
Colombia	6.78	7.27	-49
Brazil	10.08	11.42	-134
Turkey	10.34	9.45	89

Source: TradingEconomics, Bloomberg (1 September 2017)

LET'S NOW FOCUS ON EUROPE'S MONETARY POLICY

Let's now focus on Europe's monetary policy. Firstly, the eurozone economy grew by 2.1% year-to-year (y-o-y) in the second quarter of 2017 (vs. +1.9% in 1Q17). This result is bang in line with US annual Gross Domestic Product (GDP) growth for the same period.

Europe is in its best shape since the financial crisis (source: TradingEconomics).

Nonetheless, consumer prices in the euro area increased by a mere 1.3% y-o-y in July 2017, the same pace as in the previous month, having eased from a 1.4% rise in May. This is the lowest inflation rate since December last year, as prices of services rose at a slower pace while the cost of energy grew further. Annual core inflation, which excludes volatile prices of unprocessed food and energy, and an indicator the ECB uses for its monetary policy decisions, rose to 1.2% from 1.1% in June and 0.9% in May (source: TradingEconomics).

Inevitably, stronger economic growth has raised the issue of a scaling back of the European Central Bank's Quantitative Easing (QE) programme (accommodative or loose monetary policy).

Our economists predict that tapering will begin in January 2018 with a reversal as from 2019 if conditions allow. So the clock is ticking on the monetary policy of cheap money.

However, the market consensus is slowly rising long rates but any change over the next two years will probably be modest, with a minor impact on real-estate prices (as long as the economic recovery continues to be accompanied by healthy inflation). Still, the era of low interest rates – in absolute terms – should continue for a while, allowing investors to enhance their equity returns through debt finance. Rents usually pay interest and partial capital repayments (as a reminder, so-called 'geared' equity returns are not always reported, which explains the high number of property investments in commercial and residential real estate nowadays). As always, this positive leverage works very well in times of rising values, yet caution is needed once values start to stabilise or fall.

Mr Draghi might announce an internal review of different exit strategies in the near term. The most obvious plan would be to reduce QE by EUR 10 billion per month as of January 2018, following in the footsteps of the Federal Reserve, but numerous analysts expect a staggering EUR 20 billion reduction at three-month intervals.

If there is a swing in long-term bond yields (upwards or downwards), long-term mortgage rates are impacted in the same way (though correlation does not follow this pattern to such an extent due to bank margins). So higher bond yields may trigger a tick-up in long-term mortgage rates. As at 1 September, mortgage rates were still very reasonable. The yield on the 30-year fixed rate mortgage average remained marginally above 4% in the US (source: Bankrate.com). Lastly, European mortgages with a maturity of less than 20 years continued to carry low yields.

HOW ARE UK LUXURY HOUSING MARKETS PERFORMING?

At the upper end of the Prime Central London market (where values top GBP 20m), the weakened sterling is having a positive impact on transaction volumes. Even though the pound has gained about 5% against the dollar year-to-date (as at 30 August 2017), it still remains 24% lower versus 1 June 2014 (source: bloombertg)

"This, combined with reduced vendor expectation can mean a saving of more than 20% in real terms for a dollar-based buyer."(source: Black Brick, 30 August 2017). Currency movements may continue to have a major impact in the foreseeable future. "Some HNWIs are taking the view that the high-end market may weaken further because of Brexit negotiations in combination with a weak post-election Conservative party affecting the outlook for the UK."

However, Brexit is not the only fly in the ointment. Without a doubt, higher taxes can be blamed for a lot of the damage. As part of the Stamp Duty Land Tax (SDLT) reforms, implemented in December 2014, the tax increased on all homes priced over GBP 937,500, plus an additional 3% stamp duty on all second homes bought on or after 1 April 2016.

Meanwhile, money laundering rules applying to estate agents have been tightened. Since 26 June, under the Money Laundering Regulations 2017, agents have been required to carry out due diligence on all buyers and sellers they represent, in a bid to help protect the London property market from money laundering activity.

We believe that prices on the high-end London luxury market may stabilis
in the coming months. Indeed, ted to show sluggish growth over the next two years.

Table 3: Changes in the Stamp Duty Land Tax

Property value	SDLT prior to 2014 changes	SDLT 2017 sale property	Plus 3% surcharge
£GB 1 000 000.00	£GB 40 000	£GB 43 750	£GB 73 750
£GB 2 000 000.00	£GB 100 000	£GB 153 750	£GB 213 750
£GB 3 000 000.00	£GB 210 000	£GB 273 750	£GB 363 750
£GB 3 000 000.00	£GB 350 000	£GB 513 750	£GB 663 750
£GB 10 000 000.00	£GB 700 000	£GB 1 113 750	£GB 1 413 750

Source: Black Brick, June 2017

WHAT TYPE OF ASSETS SHOULD INVESTORS BUY TODAY, AND WHERE?

OVERVIEW

Defensive commercial real-estate assets tend to be 'cash generators' compared with other asset classes (e.g. stocks and investment-grade bonds), particularly in a low-interest rate environment.

This aspect results from property investors holding investments over the long term. Indeed, keeping a property for a lengthy period magnifies the importance of net rental income generation in the overall investment return. As a matter of fact, we reiterate our Neutral stance on prime commercial assets in spite of currently high valuation multiples and 'the wall of money' chasing this type of product. **Prime assets include high-quality, stable, income-generating properties, and are relatively liquid.**

The internal rate of return (IRR) carried by a real-estate asset can be broken down into an initial cash-flow yield (since the building was bought), a subsequent cash-flow change through rental indexation, upward market revisions, higher or lower headline rents (upon expiration of leases, change in gratuities etc.) and the yield change ('valuation change'). However, investors should pay more attention to the cash yield than the capital appreciation return. And properties should be financed at 'capped' borrowing costs to weather a rise in interest rates.

Interestingly, there has been no strong correlation between rental growth and capital value growth (apart from London-based offices) in recent years. For example, office yields in Europe have compressed (making property more expensive), owing to international capital flows rather than better prospects for (or the recovery of) occupational markets.

With the European economy gradually picking up, we can hope for a correlation between rents and capital values on the one hand and economic growth on the other.

In most office markets, we expect to see meaningful real rental growth for 2017/2018, if as expected the economic recovery continues to support office demand. The German cities (Munich 2.8% p.a; Berlin 6.9% p.a and Hamburg 3.8% p.a) are in pole position. But growth is expected to be equally strong in Madrid 4.5% and Milan 4.0% (source: BNP Paribas Real Estate, September 2017).

We have established that property cycles remain correlated to economic cycles, though the precise nature of the relationship is difficult to establish. Consequently, we recommend that investors eye Continental Europe with a view to buying properties today, and monitor the UK to seize investment opportunities tomorrow (if a further correction in pricing unfolds). The US is facing a deceleration in capital appreciation returns, while waning confidence in President Trump's economic policy has fuelled some (temporary?) dollar weakness. But prime assets in North America remain in high demand, with a similar scenario in Asia. For example, in Japan, the corporate sector supports the vibrant Tokyo office market, and the capital of the Rising Sun is at the forefront of a logistics innovation.

Evidently, we believe many investors should continue to consider a wide range of 'alternative' property segments as well, in the primary and secondary markets. Such investors would have less of a so-called 'top-down portfolio approach'. Indeed, a top-down policy involves tracking a benchmark against which the property portfolio is measured using market analysis and forecasts (source: Andrew Baum, Commercial Real Estate Investment, 2000).

Undeniably, many professionally-managed portfolios focus on 'non-core', 'alternative', 'added-value' or 'turnaround' properties. These investments are held through illiquid private structures (even though a degree of liquidity may be provided in some particular cases). Unsurprisingly, and in spite of the professionalism of portfolio managers, this type of investment presents more (execution) risks which should be remunerated with a higher IRR, preferably in excess of 10%.

Higher risk and the presence of opportunities go hand in hand. Countless investors are concerned about nominal interest rates rising in the coming months and years. Not to mention higher real rates when adjusted for inflation. However, as interest rates climb, opportunities may arise when debt-saddled owners need to recapitalise their asset base.

Table 4: Total REIT performance (after leverage) as at 31 August 2017

Region	1M	1Y	5Y*	5Y*
Real Estate Asia ex. Japan	0.1 %	20.7 %	9.8 %	5.2 %
Real Estate Japan	-2.9 %	-0.5 %	12.4 %	-0.5 %
Real Estate Europe excl. UK	-1.3 %	0.2 %	13.3 %	5.5 %
REITS UK	-2.4 %	3.3 %	11.5 %	-0.1 %
REITs North America	-1.8 %	-4.0 %	7.8 %	5.7 %

*Annualised return in local currency - **Source:** BNP Paribas Wealth Management RESIG

A typical value-added strategy consists of acquiring property at a discount to the replacement cost, with a view to generating attractive returns even if the market stays flat. Alternatively, note that gateway cities still offer older assets, which need refurbishing and redesigning to accommodate modern tenants, hence incurring a significant capital expenditure. Project development may also be a consideration.

A final word on listed real-estate markets (Real Estate Investment Trusts or REITs). Some investors question whether REITs are beneficial for their property portfolio. Indeed, we believe that they are, for most regions, as shown in the table below, with Japan and the UK being clear exceptions.

But Asia (ex. Japan), Continental Europe and North America produced attractive total levered returns of above 5% over the 10 years to end-August 2017. REITs offer more liquidity than direct property while currency risks are similar for all other asset classes.

UK REITs were capable of reversing most losses suffered in the wake of the Brexit vote (in GBP at least). Nonetheless, we have been concerned about the lack of potential of UK REITs in general, certainly since the general election of 8 June.

AND WHAT ABOUT THE US?

President Trump's tax plans could hurt US REITs. Trump's 15 per cent business rate is expected to apply to corporations and pass-through entities.

Because REITs are not taxed and instead pass on the liability to stockholders, it is possible (albeit unlikely) that they will be subject to the 15 per cent rate provided under Mr Trump's tax plan. If not, this could make REITs a less attractive investment option than before.

All things considered, we believe REITs should be added to all real-estate wealth portfolios, even though listed property companies may be subject to excessive volatility, at least in the short run.

LISTED REAL ESTATE

With respect to the listed real-estate markets, investors often have two key questions in mind: The first is the following: 'Is it too late to invest in REITs given the uncertainty over interest rates?' And the second is 'What are the benefits of REITs for a property investor?'

Depending on the research source, investment horizon and geography, we could argue that REITs perform similarly to long-term investment-grade bonds. This pattern has become apparent lately amid the zero-interest rate environment. Yet, property stocks can be volatile in the short term, because they do not offer a real means of diversification like common stocks. And returns from private real-estate markets can be higher as well, seen in the UK in recent years. That said, much is determined by the different case studies and general data, but we consider that REITs should be used for property investors seeking international diversification (rather than for so-called multi-asset managers owning all major asset classes like shares, bonds, private equity, and so on). For example, today, US real-estate investors may want to increase their exposure to Europe, whereas others may choose to reduce or expand their coverage of the UK (Brexit issues) and/or Asia.

As always, there is a lingering perception that "it is too late to buy and too early to sell".

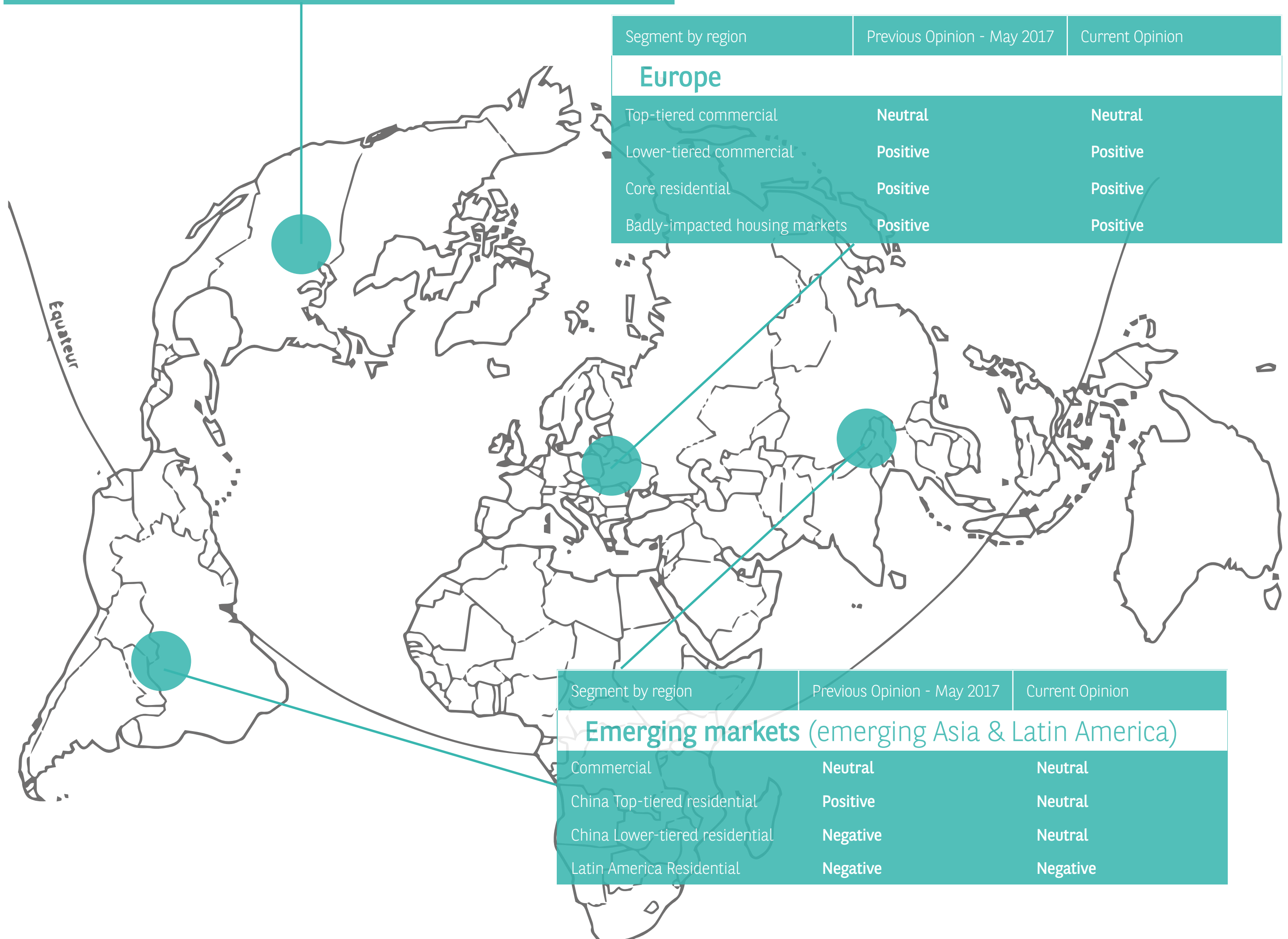
There is no doubt that REITs have offered international investors reasonable potential through the real-estate markets. When interest rates rise, REITs tend to be sensitive to stock market volatility in the short term. Investors could strengthen their positions accordingly. In addition, a rosier economic outlook could support underlying property values in the longer run.

We have a Neutral recommendation on Continental European REITs.
The current accommodative monetary policy remains a key driver.
We stay Negative on UK REITs (in spite of soaring share prices in recent months), as share prices may fall to price in future losses in capital values.
We keep our Neutral recommendation for US and Asian REITs.

OUR REAL-ESTATE STRATEGY BY LOCATION

Segment by region	Previous Opinion - May 2017	Current Opinion
North America		
Top-tiered commercial	**Neutral**	**Neutral**
Lower-tiered commercial	**Neutral**	**Neutral**
Residential	**Neutral**	**Neutral**

Segment by region	Previous Opinion - May 2017	Current Opinion
Europe		
Top-tiered commercial	**Neutral**	**Neutral**
Lower-tiered commercial	**Positive**	**Positive**
Core residential	**Positive**	**Positive**
Badly-impacted housing markets	**Positive**	**Positive**



Segment by region	Previous Opinion - May 2017	Current Opinion
Emerging markets (emerging Asia & Latin America)		
Commercial	**Neutral**	**Neutral**
China Top-tiered residential	**Positive**	**Neutral**
China Lower-tiered residential	**Negative**	**Neutral**
Latin America Residential	**Negative**	**Negative**

Property stocks	Neutral on Continental Europe, the US and Asia. Negative on the UK	Neutral on Continental Europe, the US and Asia. Negative on the UK

EUROPE

COMMERCIAL REAL ESTATE (CRE)

Top-tiered (prime) real-estate markets

We maintain our Neutral stance on prime assets located in Continental Europe (unchanged for several years, and in spite of demanding valuation metrics). We are of the opinion that investors may continue to target trophy assets (if available) in the months ahead. These investors predominantly focus on secured cash flows. Another investment rationale might be that prime locations are relatively protected from any (unlikely) downturn compared with the lower-tiered property markets. Location, location, location!

In the UK, offices (and retail space) might suffer from a fresh fall in capital values, especially in 2018 (exacerbated by the fragile pound). Yet, this would open up new investment opportunities in the medium term. So a cautious stance is appropriate now but investors should look out for investment opportunities further down the road.

Gross initial yields are expected to stabilise this year. We anticipate total returns of circa 5% p.a. on average investment-grade European offices over the next three years, assuming the eurozone economy continues to grow. Drivers underpinning this return will be a shift from yield compression to income growth, while capital values will be driven primarily by a steady increase in rents. We forecast attractive risk-adjusted returns for the core markets of France, Germany and the Nordics, while in the recovering markets of Hungary, Spain and the Netherlands, we anticipate stronger absolute returns (source: BNP Paribas Real Estate, September 2017).

We believe that rents that landowners could command on new leases will grow sharply, as the logical result of a perkier economic outlook (and a relatively modest supply pipeline). Property values should reflect the stronger (expected) cash flows.

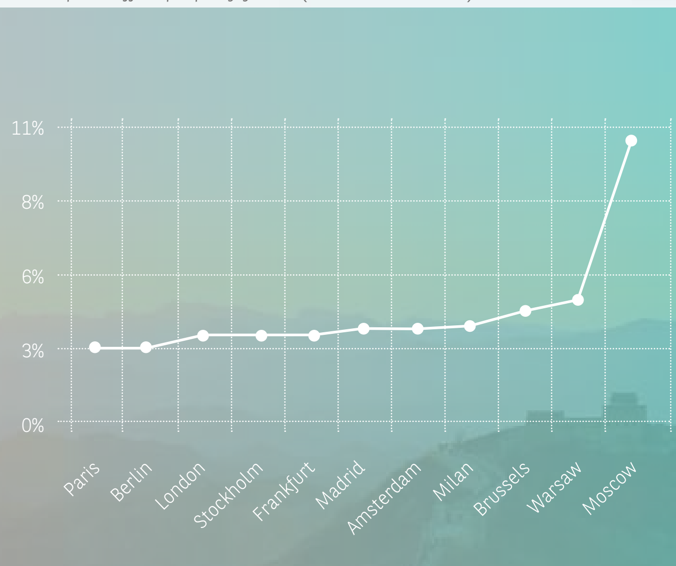
We reiterate our recommendation to cap the cost of borrowing at a level below net rental yields (net rents after operating costs).

Tableau 5:
European office property yields (as at 30 June 2017)

Offices		
City	Prime yield (%)	Yield shift q-o-q (bps)
Paris	3,00	0
Berlin	3,00	0
London	3,50	0
Stockholm	3,50	25
Frankfurt	3,50	0
Madrid	3,75	0
Amsterdam	3,75	25
Milan	3,80	15
Brussels	4,50	25
Warsaw	5,00	0
Moscow	10,50	0

Source: Jones Lang LaSalle, Key Market Indicators, July 2017

Chart 5:
European office property yields (as at 30 June 2017)



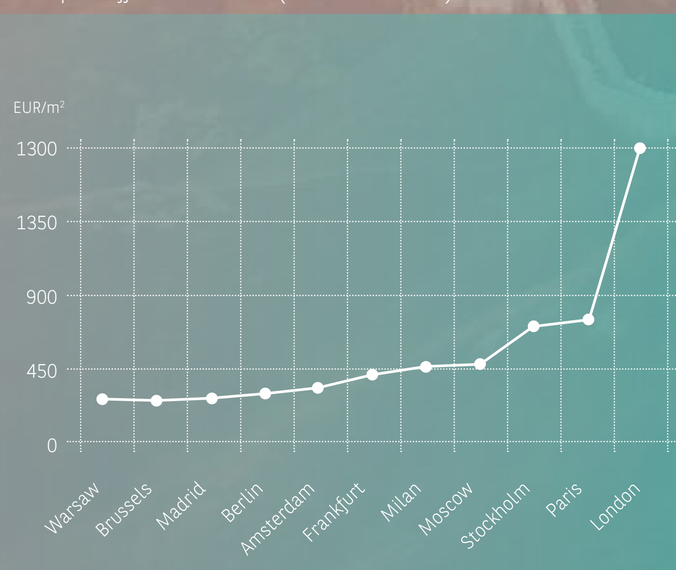
Source: Jones Lang LaSalle, Key Market Indicators, July 2017

Tableau 6:
European office property yields and vacancy levels (as at 30 June 2017)

Prime office rents as at 2Q17		
City	EUR/m²/year	q-o-q (%)
Warsaw	276	-2,1
Brussels	300	9,1
Madrid	300	1,7
Berlin	336	4,3
Amsterdam	380	2,7
Frankfurt	444	0,0
Milan	525	1,0
Moscow	625	0,0
Stockholm	715	6,3
Paris	720	-0,7
London	1 273	0,0

Source: Jones Lang LaSalle, Key Market Indicators, July 2017

Chart 6:
European office rental values (as at 30 June 2017)



Source: Jones Lang LaSalle, Key Market Indicators, July 2017

Lower-tiered (second and third tier) property markets

We are really in favour of a so-called 'value-add' investment approach, in both Continental Europe and the UK. The idea is to enhance return on equity by adding value to the property investment over time (combined with debt). As previously said, a higher investment performance can be reached with higher cash flows coupled with higher valuations.

Lower-tiered markets could be targeted but tier-1 property markets too. Examples are numerous: some southern European markets still have pools of troubled assets on the books of forced sellers. Blackstone Group LP, a private-equity giant, has announced that it will acquire a majority stake in rescued Spanish lender Banco Popular Español SA's real-estate portfolio. Blackstone will take a 51% stake in a newly-created company that will include approximately EUR 30 billion (USD 35.2 billion) of real-estate assets owned by Banco Popular. The deal will also include the bank's real-estate management company, Aliseda (source: Dow Jones Newswires, 8 August 2017). Note that this transaction is huge and aimed at a small amount of (private equity) players.

Assets could still be bought at a discount, though discounts have been rapidly narrowing. The idea is to buy assets below the replacement cost. The focus could be on offices and logistics (maybe less on retail given the growing impact of e-commerce).

Indeed, online sales in Europe are growing rapidly and in 2016 reached nearly EUR 500 billion, representing 14% of total retail sales. This share is expected to be close to 18% at the end of 2018. (source: e-Commerce: online sales in Europe. A paper by BNP Paribas Real Estate, May 2017).

Potential buyers could focus on 'small' middle-market transactions of approximately EUR 20 million to EUR 50 million in off-market situations, and be involved in recapitalisations and asset management repositioning to create value. As previously said, leverage is a good thing but should be used at 'reasonable levels' (50 to 70% on average). As always, the higher risks (of a non-liquidity and difficult disposal) ought to be fully appreciated by investors, who should ideally acquire a target total IRR of at least 10% on a net basis (with an investment horizon of 5 to 10 years).

RESIDENTIAL REAL ESTATE

We are Positive on Europe's core housing markets, as we believe rents and values will keep pace with inflation.

Apart from interest rates, many factors influence the housing markets, such as local supply and demand, employment rates, anti-laundering measures, fiscal treatment of mortgages, rents and capital gains etc.

But interest rates remain a key factor, at least in the short term. As a matter of fact, higher nominal interest rates usually impact mortgage rates and thus affordability. When fewer citizens can afford to buy their first home, housing values are negatively affected. Would-be buyers may withdraw from the buying market and turn to the lettings market (thereby pushing up rents, though not necessarily values).

We do not believe a housing catastrophe will occur in the event of higher interest rates, for the following reasons:

- Nominal long-term interest rates in Europe may rise very slowly (as at 11 August, they had edged down slightly instead of up). This would allow mortgage rates to continue to hover at around very reasonable levels. So investors would have a degree of 'predictability' with respect to their cost of borrowing;

- If nominal interest rates were to climb on the back of an improved economic outlook (implying higher core inflation), this would not necessarily be bad news for homebuyers. Economic growth may increase liquidity in the housing market and boost consumer sentiment in general, with real rates (adjusted for inflation) staying flat;

- Excess cash levels, coupled with the borrowing of additional cheap money, cannot continue to give impetus to housing values for ever. Some stability needs to return to the housing markets, which should be supported by 'real' factors rather than cheap money. This would bring stability to the various residential markets in the long run. For instance, the Czech central bank has asked the government for 'tools' to tame the property market (source: Reuters, 16 July 2017). The central bank's Vice-Governor, Mojmir Hampl, said that the euphoria would not last forever.

Consequently, Europe's housing markets performed reasonably to very well during the 12 months to 31 March 2017, with many European countries posting decent real returns. Housing prices in Ireland gained almost 9% in real terms, closely followed by Montenegro, Romania, Norway and the Netherlands. Other countries, such as the Slovak Republic, Sweden and Germany, saw annual real housing prices soar by more than 5% over the same period. Capital appreciation returns must be supplemented with annual net rental income in order to determine annual total returns.

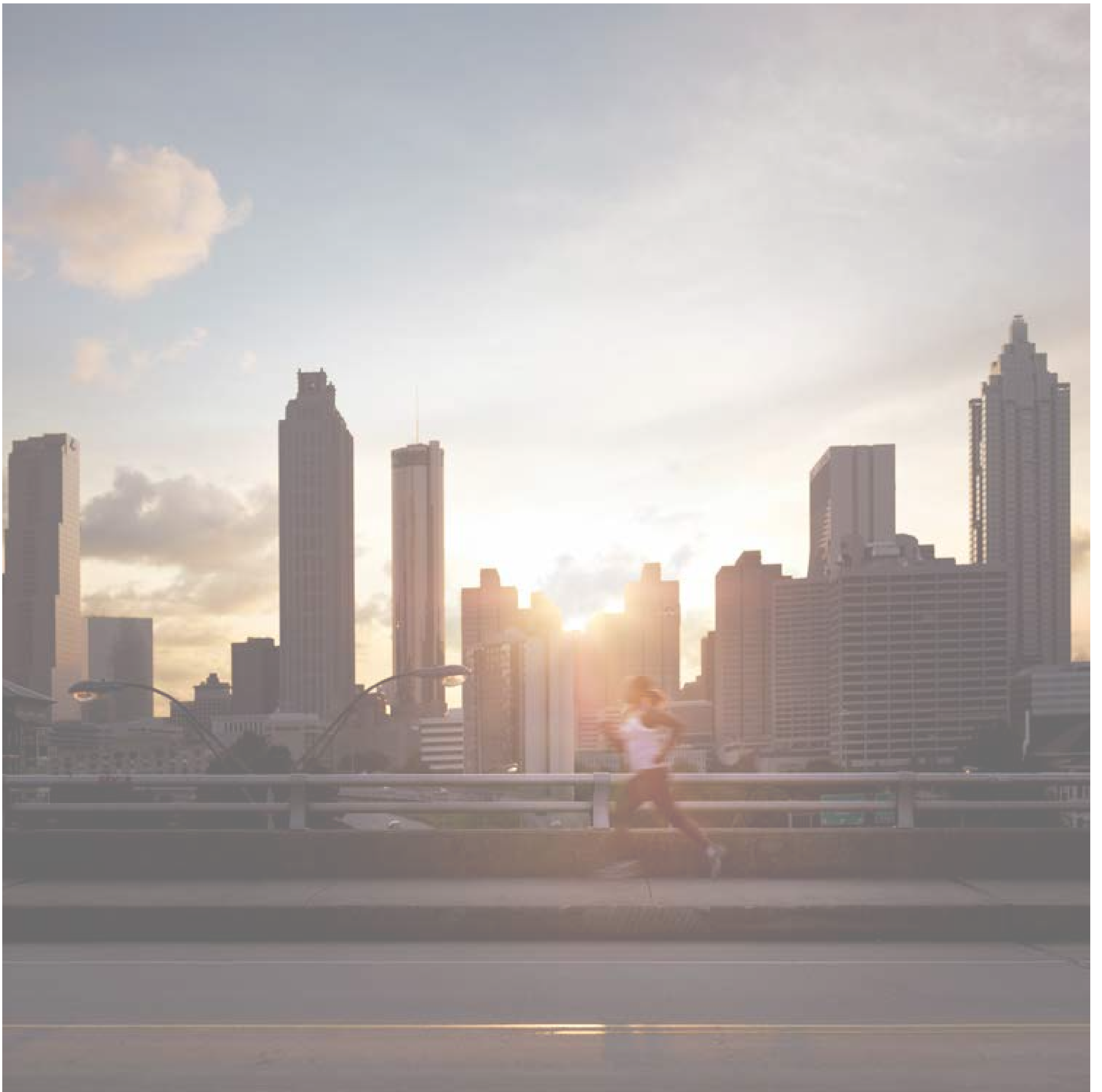
Last but not least, there is still a huge need for 'affordable' housing schemes almost everywhere in Europe. We project that values of medium-sized houses will hold up better than values carried by the high-end residential market. Obviously, 'affordability' is a relative concept and depends on geography. Annual rents per m², generated by this housing segment, typically vary from EUR 700 to EUR 1,000 per year.

We remain Positive on Europe's improving housing markets (Spain, Portugal, the Netherlands and Ireland) because domestic and international investors are still on a buying spree. Nonetheless, the biggest price hikes are most likely behind us.

Table 5: House price changes (inflation-adjusted) as at 31 March 2017

Rank	Country	y-o-y (%)		q-o-q (%)
		1Q16	1Q17	1Q17
1	Hong Kong	-9.51	17.27	3.93
2	Iceland	5.10	16.01	4.57
3	China - Shanghai	16.99	13.16	-0.95
4	Canada	5.67	11.70	1.15
5	Ireland	5.84	8.91	0.21
6	Montenegro	-3.17	8.68	19.55
7	Romania	11.55	7.61	4.21
8	Norway	1.34	7.38	3.76
9	New Zealand	3.63	7.26	4.11
10	Netherlands	6.09	7.11	3.79
11	Slovakia	1.53	6.61	1.52
12	Germany	6.25	5.79	0.93
13	Latvia - Riga	2.24	5.13	-0.22
14	Estonia	-1.31	4.76	-5.82
15	Portugal	3.18	4.18	-0.28
16	Lithuania	3.56	3.56	-0.46
17	US (FHFA)	4.87	3.37	0.60
18	US (Case-Shiller)	4.24	3.29	0.17
19	Japan - Tokyo	5.45	2.93	-0.81
20	Turkey - Istanbul	7.37	1.84	-0.86
21	UK	4.57	1.84	-0.04
22	Vietnam	1.93	1.13	-1.06
23	Taiwan	-7.65	0.69	1.65
24	Spain	1.69	0.41	4.17
25	Mexico	5.26	0.17	-2.24
26	Chile	6.75	-0.37	4.72
27	Israel	6.23	-0.54	-2.64
28	Finland	0.46	-0.60	-0.26
29	Indonesia	-0.16	-0.98	-0.33
30	South Korea	1.81	-1.35	-1.10
31	Thailand	0.38	-1.37	0.10
32	Switzerland	2.18	-1.69	-1.62
33	Greece	-3.65	-3.13	-0.45
34	Singapore	-2.35	-3.45	-0.56
35	UAE -Dubai	-9.26	-3.69	-2.40
36	Brazil - São Paulo	-7.62	-3.75	-0.58
37	Ukraine	-2.97	-5.05	-2.41
38	Macedonia	3.28	-7.92	-3.51
39	Russia	-13.05	-8.33	-2.94
40	Qatar	9.36	-10.63	-1.35
41	Egypt	-9.49	-10.63	-1.35

Source: Global Property Guide



NORTH AMERICA

COMMERCIAL REAL ESTATE

Top-tiered real-estate markets (prime real estate)

We maintain our Neutral view on prime real estat for the US markets. Capital growth rates slowed down in 2Q17, with 'All Property' carrying an ungeared total return of 2.03%. Over a 12-month period, the annual total return was 6.97%, consisting of a 4.69% income return and a 2.20% capital appreciation return. 'Industrial' property secured its lead for annual total returns (12.37%) with other property types trailing by a wide margin (source: NCREIF, 25 July 2017).

We believe capital appreciation returns will slow in the coming months, yet much will depend on the progression of long-term nominal interest rates (coupled with the impact of Trumponomics on inflation and interest rates). Even though the weakening US dollar (as at end-August) may be a concern for some international investors, others may consider the lower greenback as an investment opportunity (a similar situation to the falling British pound and property investments in the UK).

While there are no imminent signs that a decline in property returns – in commercial real estate – is looming, the Federal Reserve Bank of Boston's President, Eric Rosengren, recently warned that valuations represented a risk that he "will continue to watch carefully" (source: The Wall Street Journal, 26 June 2017). The rationale behind this remains the same: the decline in long-term interest rates has spurred commercial real-estate investments, pushing down capitalisation rates even more. Banks may somewhat pull back on lending, albeit slightly (growth for commercial real-estate loans has slowed over the past two years) whereas retail firms have been under pressure. The key question is this: "To what extent do investors understand these risks?".

Lower-tiered real-estate markets

Even if the weakening US dollar is making local real estate slightly less expensive for overseas investors, we maintain our Neutral recommendation on these markets, because price growth may level off.

RESIDENTIAL REAL ESTATE

We are Neutral on the US housing markets, even though the latest S&P Dow Jones data on the US housing markets revealed persistently higher annual housing prices in May 2017, with Seattle (>13%) in pole position.

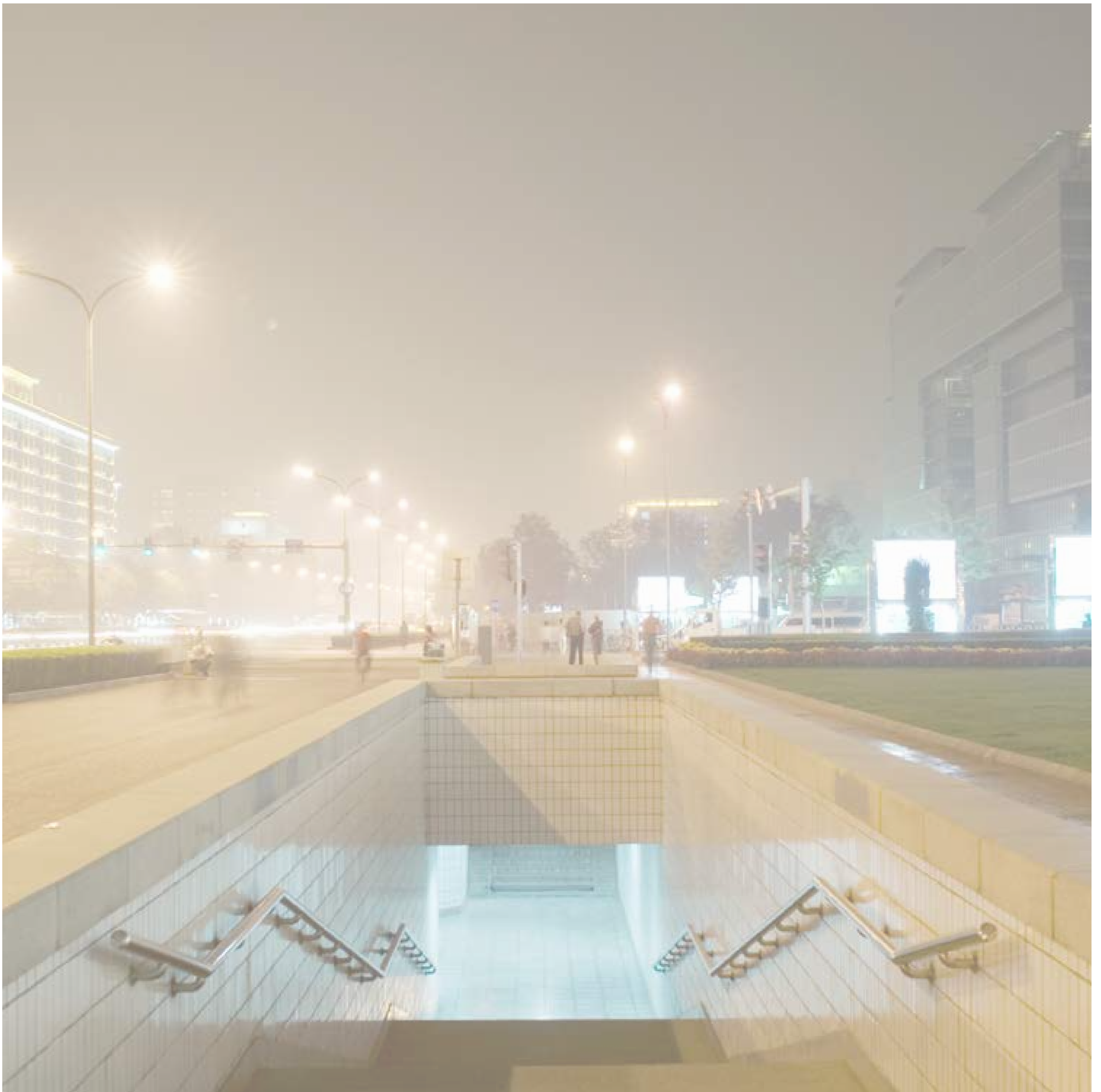
Even if the housing markets are performing quite well – supported by relatively low mortgage rates – we project diminishing growth rates for housing values in the near future. Our scenario is similar to that of commercial real estate.

San Francisco has the largest gains, with average home prices more than doubling since 2009. The proportion of owner-occupied homes is the lowest, at 36% (vs. 64% nationwide, source: S&P Dow Jones Indices). Furthermore, population growth is also sky-high in this city (along with Portland and Seattle). But technology-employment growth is decelerating somewhat, and it remains to be seen whether the tech sector will continue to boost the local economy enough to support today's sky-high housing prices. A slowdown could well be on the cards.

Table 6: US housing prices (as at 31 May 2017)

Metropolitan Area	Monthly change (%)	Annual change (%)
Seattle	1.8 %	13.3 %
Portland	1.3 %	8.9 %
Denver	0.9 %	7.9 %
Dallas	0.7 %	7.8 %
Detroit	1.0 %	7.6 %
Las Vegas	1.3 %	6.9 %
Tampa	1.1 %	6.8 %
San Diego	1.0 %	6.6 %
Boston	0.8 %	6.1 %
Charlotte	0.9 %	6.1 %
Composite-20	0.8 %	5.7 %
Minneapolis	1.0 %	5.7 %
Phoenix	0.6 %	5.7 %
Los Angeles	1.0 %	5.6 %
U.S. National	1.0 %	5.6 %
Atlanta	0.9 %	5.5 %
San Francisco	0.5 %	5.4 %
Miami	0.8 %	5.3 %
Composite-10	0.7 %	4.9 %
New York	0.1 %	4.0 %
Cleveland	1.3 %	3.6 %
Washington	1.0 %	3.6 %
Chicago	1.0 %	3.3 %

Source: S&P Dow Jones Indices and CoreLogic, May 2017



EMERGING MARKETS (EMERGING ASIA & LATIN AMERICA)

COMMERCIAL REAL ESTATE

We are Neutral on selective investments across emerging markets, in both Asia and Latin America. In reality, on both mature and emerging property markets, investors' strategies are very similar. Most of the time, money can be made with only a value-added/opportunistic approach.

Unsurprisingly, skyscrapers in Hong Kong are the most expensive commercial real estate in the world. Prices for space in skyscrapers in Hong Kong have reached USD 8,000 per square foot (sq.ft), or USD 86,400 per m², 60% more expensive than the price for tall buildings in Tokyo (USD 4,900 per sq.ft). In third place is Manhattan with USD 3,700 per sq.ft, followed by San Francisco at USD 2,500 per sq.ft, and then the City of London at USD 2,450 per sq.ft. (source: Knight Frank, 7 July 2017).

Besides, Hong Kong developer Henderson Land recently paid USD 3 billion for an old five-story car park, demonstrating the agitated state of Hong Kong's property market.

Tokyo is also an important investment market, though some headwinds are blowing. 'Abenomics', Japan's stimulus package, has run out of steam. Is the Bank of Japan capable of bringing back inflation to 2% in the longer run? Could the mounting uncertainty (over North Korea for instance) lead to an appreciating yen, although the opposite happened in the 12 months to end-August 2017? What about the ageing population in the Land of the Rising Sun?

Meanwhile, local interest rates remain at an all-time low, with commercial real-estate values rising in major cities. Tokyo's office market accounts for about 60% of office rental property in Japan, with Osaka ranking second with a mere 15% slice. Although prime gross initial yields often hover at around or below 4%, the spread with the risk-free interest rate (in yen) remains generous. All in all, we believe that Japan (particularly its capital) will continue to be a key real-estate investment market in the coming years.

With respect to the Indian office markets, we are likely to see strong demand for core products from technology firms, financial services and the industrial sector in the coming months. This should result in rental growth, driven by existing luxury buildings with good occupancy levels. It is expected that private equity players will continue to target reasonably priced assets showing potential, given the underperformance of the Indian office market in the past few years. Prospects are also very good for Indian retail, especially for project developers willing to initiate new prime retail schemes. As a matter of fact, there is still a lack of prime assets.

We have been a bit disappointed about realised total returns in both Asia and Latin America in recent years. That said, investment opportunities abound and investors appear to be more confident about local property markets (reflected in soaring REIT share prices, see table 4).

We believe that investors should seek a value-added investment strategy, allowing for IRRs well above 10%, because the overall real-estate markets do not always command high real-estate total returns. So there is nothing new under the sun! In other words, prime returns should not automatically outpace prime returns carried by properties located in 'mature' markets such as large parts of Europe and the US. But the appetite for diversification is growing among investors, and Asia will play a key role for investors seeking international diversification.

Our recommendation is Neutral for selective investments (both in the primary and secondary markets).

RESIDENTIAL REAL ESTATE

Property In China's Tier-1 Cities

We are Neutral on property located in China's Tier-1 cities, and upgrade our opinion on lower-tiered property markets from Sell to Neutral.

The more China tries to control its thriving housing market, the more obsessed people become about buying property. Guangzhou is a good example. In February, state banks raised their mortgage rates. Subsequently, higher down-payment rules for second homes and limits on ownership of multiple apartments were implemented. The result: prices in Guangzhou continued to climb, chalking up a 17.8% increase during the 12 months to end-June 2017 (source: National Bureau of Statistics of China). Compare this with 2015, when Guangzhou house prices had rocketed by roughly 40%. Some markets (Nanjing, Hefei, Shenzhen and Xiamen) outperformed other regions over the same period to June 2017, with Xiamen delivering a +50% price increase.

A decade ago, the real-estate sector, including construction and home furnishings, contributed about 10% to China's GDP (source: Moody's Investors Service). This chunk is now one-third! Household debt is a whopping 42% of GDP (source: Moody's). This ratio has jumped 9% in three years, and now surpasses China's peers including Brazil, Mexico, Turkey and Russia. In the US, the debt ratio hit about 85% during the 2007 housing crisis (source: The Wall Street Journal, 12 July 2017).

Average prices in the biggest cities – including Shanghai, Beijing and Shenzhen – are basically flat. Investors should be cautious about prime cities for the time being, whereas 'regional' cities may offer rosier prospects, because households are increasingly keen to get on to the property ladder.

What about Singapore?

In 'mature' Singapore, its central bank said on 28 June 2017 that it was not yet time to ease property cooling measures, despite the real-estate market having "substantially stabilised" over the past three years. The central bank assumed that the cooling measures remain necessary. Underlying demand for private residential properties remains firm amid low interest rates and investors' continuous search for yield. After rising by nearly 60% over four years, property prices in Singapore have slid 12% over the past 3 years.

Middle East

The total number of Dubai-based residential transactions in the second quarter of 2017 declined by 23% on the previous quarter, signalling "the onset of a summer slump" (source: Chestertons MENA). After a promising start to 2017, sales for off-plan properties plummeted by 28% in volume terms and by a massive 43% in value! However, apartment sales provided some consolation for the market as they remained flat compared with 1Q17 while villas saw a 3% increase.

"The positive momentum from the first quarter did not translate into increased activity in the second quarter, as the decline was evident in both completed-units and off-plan transactions, with the total volume of residential transactions down 23 per cent'. (source: Ivana Gazivoda Vucinic, Head of Advisory and Research, Chestertons MENA).

The Dubai property market may be boosted somewhat in the coming markets, with the dirham having depreciated against the euro in recent months (though not against the US dollar).

Latin America

We stick to our Negative opinion on Latin America's housing markets, in particular in Brazil. At almost 7.5%, Brazil's real interest rates are among the highest in the world (source: Trading Economics, 14 August 2017). The higher the real interest rates, the less appealing property purchases are (as an asset class) for would-be investors. Owners of apartments in Brazil have failed to protect themselves against eroding purchasing power in recent years.

The FipeZap Index - which tracks the sale price of residential properties in 20 Brazilian cities - registered a tiny fall of 0.15% between June and July 2017 (source: FipeZap, 3 August 2017). This was the fifth consecutive month of a nominal price decline, resulting in a cumulative decrease of 0.38% in the price of residential properties in 2017. When accounting for inflation (though growth in inflation has been declining in recent months), capital appreciation returns were negative in real terms. Twelve out of the 20 cities surveyed suffered a nominal decline in sales prices between June and July: such as Rio de Janeiro (-0.53%) and Salvador (-0.45%). In São Paulo, the FipeZap Index revealed that the sale price of residential real estate remained practically stable over the period. "Considering the last 12 months, the FipeZap Index registered a rise of 0.10%, against accumulated inflation of 2.62% for the period."

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