REAL ESTATE AND INFLATION: NOT NECESSARILY A BAD COMBINATION!

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BNP PARIBAS WEALTH MANAGEMENT

The bank for a changing world

Real Estate and inflation: Not necessarily a bad combination!

SUMMARY

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These are interesting times for real-estate investors. Nominal interest rates remain relatively low in many countries of the world, even though monetary policy is set to change.

The United States is in the lead, with the Federal Reserve Bank gradually raising policy rates, as expected. Moreover, it has become clear in recent months that investors should ‘demand’ an adequate risk premium to compensate for specific property and market risks.

In our previous research, we explained that investors, intoxicated with zero-interest rates, may not be paying enough attention to investment risk. The major depreciation of several currencies, holding a grip over emerging markets in recent months, has left international real-estate investors with large ‘book’ losses (at least for the time being).

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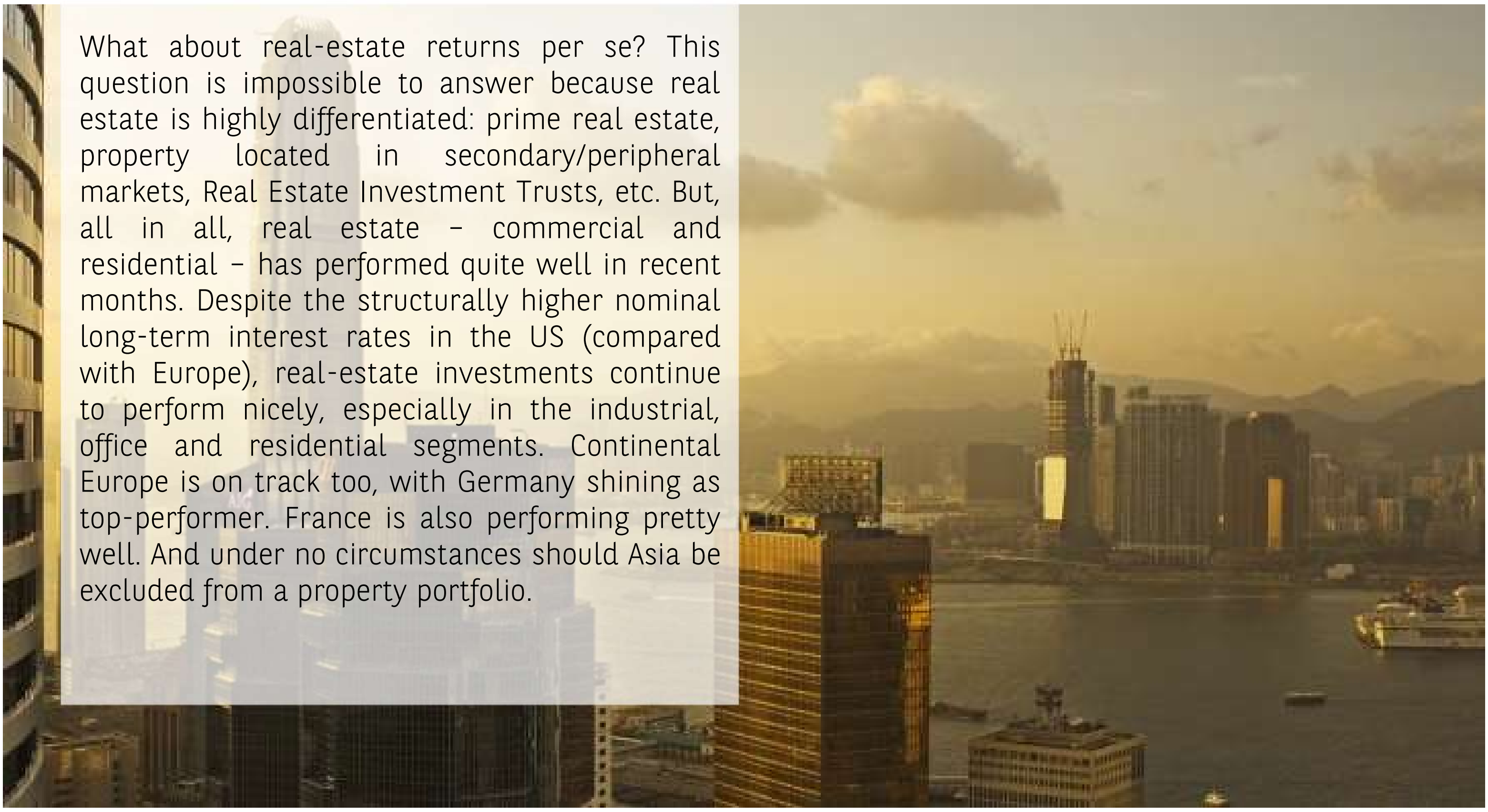
SUMMARY

We have never recommended or discouraged real estate on the sole basis that currency effects may lead to gains or losses. Property should be purchased primarily because of its intrinsic qualities (net rental yield, protection against inflation etc.), or for the tangible character of bricks and mortar. Nevertheless, exchange rate fluctuations are an ever-important factor to be considered in an internationally diversified property portfolio. Just think of Asian investors – many of them 'calculating' in USD – who buy trophy buildings in London (in pound sterling), or in Australia, Canada, America ... And American and Continental European property investors who are currently eyeing the United Kingdom in search of investment opportunities in pound sterling.

What about real-estate returns per se? This question is impossible to answer because real estate is highly differentiated: prime real estate, property located in secondary/peripheral markets, Real Estate Investment Trusts, etc. But, all in all, real estate – commercial and residential – has performed quite well in recent months. Despite the structurally higher nominal long-term interest rates in the US (compared with Europe), real-estate investments continue to perform nicely, especially in the industrial, office and residential segments. Continental Europe is on track too, with Germany shining as top-performer. France is also performing pretty well. And under no circumstances should Asia be excluded from a property portfolio.

Total property returns can be higher than in other core economies. Offices located in Hong Kong, with projected total returns of 15% this year, are a good example of this. As a matter of fact, unlevered total returns – rental streams and capital appreciation – are satisfactory in many parts of the world, sometimes cruising at double digits (in other words well above inflation).

The UK is a more complicated case, and much will depend on the outcome of the 'Brexit negotiations' with the European Union. Failure to reach a deal could have drastic consequences on total property returns. The Bank of England warned recently of this risk, and BNP Paribas Real Estate's predictions are not rosy in the event of a worst-case scenario.



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Much ink has been spilled about the impact of higher nominal long-term interest rates on property returns. We remain of the opinion that a modest rise in rates is not necessarily bad news for real-estate investors in the long term, especially if the rally proves to be the result of spiralling 'core inflation', and thus better economic growth prospects. In other words, the real interest rate – adjusted for inflation – should remain more or less stable. That said, rising interest rates usually fuel nervousness anyway, especially about very liquid property shares.

Our real-estate investment strategy remains unchanged, with a particular recommendation for the 'value-added' property segment, especially in Europe (including the United Kingdom). We will stick to our strategy, even if market conditions deteriorate. Nevertheless, real-estate investments in top-tiered locations also remain attractive, even though trophy bricks are quite pricey. The focus should therefore be on the net rental yield, i.e. on the tenant, and less on capital appreciation returns.

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IS THE ECONOMY HELPING REAL-ESTATE INVESTORS?

VOLATILITY IN EMERGING MARKETS

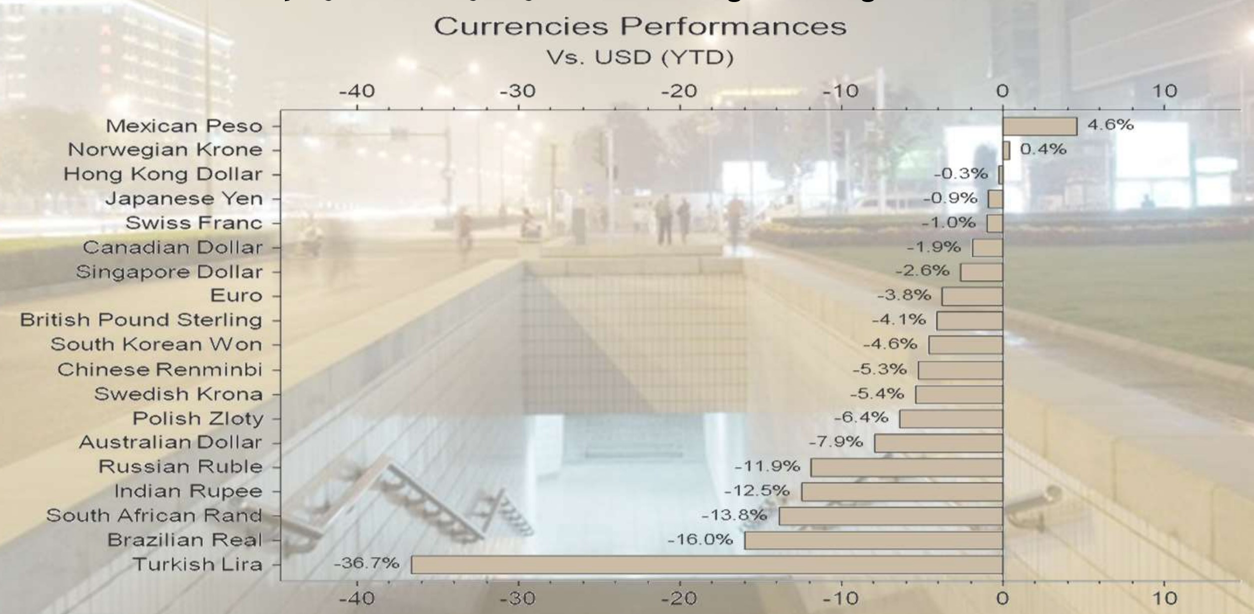
The macro-economic environment has been quite challenging for real-estate investors in recent months. On the one hand, we have seen an increase in market volatility across emerging markets (EM), particularly at end-September.

On the other hand, the US economy is doing very well for the time being, with an expected GDP growth rate of 2.8% in 2018 (source: BNP Paribas Wealth Management). Just look at the movement of exchange rates since the beginning of the year to apprehend the currency 'disparities' within the global economy, for example the dollar's rally vs. emerging market currencies. However, market concerns over the Turkish economy, for instance, are not new.

The Turkish lira was already one of the worst performers even before tensions started to escalate this year between the US and Turkey.

Turning to global trade tensions, BNP Paribas Wealth Management economists believe that "things could get worse before they get better." So pressure on emerging markets will remain. The persistent risk is a further depreciation of currencies across the EM region. Nonetheless, uncertainty over escalating commercial trade tensions is the main risk for investors today (and not only property investors). The other side of the coin is that we see potential for positive surprises following the mid-term elections in the United States (source: BNP Paribas Wealth Management, 19 September 2018).

Table 1: Year-to-date performance of major currencies against the greenback as at 3 October 2018



Source: Thomson Reuters Datastream, 3 October 2018

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As far as growth and inflation projections are concerned, the **US is on track to achieve a GDP growth rate of 2.8%** this year. But economic growth could slow to 1.8% in 2019 due to less fiscal stimulus coupled with a normalisation of monetary policy. In the **euro area, economic activity has decelerated somewhat in recent months,** and business sentiment has been revised down. BNP Paribas Wealth Management forecasts economic growth to stabilise at 2% this year, before falling to 1.5% next year.

Real-estate investors are facing a dilemma: even though there are a host of investment opportunities in emerging markets, currency risks are particularly high: if rents are expressed in US dollars, tenants must be able (or willing) to continue paying for them. Meanwhile, many property markets – which investors consider as 'top-tiered' – remain expensive in Europe, the United States or Asia. This is particularly evident in the United States in spite of the fact that the ten-year nominal government bond yield has been above European levels for a long time.

Table 2: GDP growth and inflation rates in the world's mature economies

Main economic forecasts (03/10/2018)			
GDP growth (%)	2017	2018e	2019e
United States	2.2	2.8	1.8
Eurozone	2.5	2.0	1.5
Japan	1.7	0.9	0.6
United Kingdom	1.7	1.3	1.6
Inflation (%)	2017	2018e	2019e
United States	2.1	2.1	2.5
Eurozone	1.5	1.9	1.9
Japan	0.5	1.0	1.0
United Kingdom	2.7	2.4	2.1

Source: BNP Paribas Wealth Management, 3 October 2018

Table 3: GDP growth and inflation rates in the world's emerging economies

Main economic forecasts (03/10/2018)			
GDP growth (%)	2017	2018e	2019e
China	6.9	6.4	6.1
India	6.7	7.4	7.6
Brazil	1.0	1.5	3.0
Inflation (%)	2017	2018e	2019e
China	1.6	2.1	1.9
India	3.6	4.5	4.4
Brazil	3.4	3.7	3.7

Source: BNP Paribas Wealth Management, 3 October 2018

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THE MOVEMENT OF INTEREST RATES AND BNP PARIBAS WEALTH MANAGEMENT EXPECTATIONS

Ten-year nominal interest rates have remained low in many key markets, such as Switzerland, Japan and Germany. That said, we can talk about 'emerging market' stress, in Turkey, for example, given that its ten-year government bond rose by almost 650 basis points in the 12-month period to 3 October 2018. It is striking that Southern European countries – including Greece – have performed quite well over the same period, with the exception of Italy and the Italians may not want to adopt enough budget discipline in the near future.

We expect the American Federal Reserve Bank (Fed) to raise the federal funds rate one more time this year, to 2.5%, and twice next year. After these hikes, the benchmark rate would reach 3% by the end of 2019. The European Central Bank (ECB) announced its roadmap last June. Its Quantitative Easing programme will be stopped at the end of December, while the policy rate will remain on hold until next summer. The first increase in the benchmark refinancing rate is expected to take place in December 2019 (from 0 to 0.25%, source: BNP Paribas Wealth Management).

Table 4: Sovereign bond yields as at 3 October 2018

Ten-year government bond yields			
Major countries	**3/10/2018**	**5/10/2017**	**change (bp)**
Switzerland	0.02	-0.01	3.00
Japan	0.14	0.05	9.00
Germany	0.42	0.44	-2.00
United Kingdom	1.53	1.27	26.00
Spain	1.54	1.75	-21.00
Portugal	1.90	2.41	-51.00
Hong Kong	2.41	1.72	69.00
Canada	2.51	2.12	39.00
Singapore	2.53	2.13	40.00
Australia	2.64	2.78	-14.00
United States	3.06	2.33	73.00
Italy	3.43	2.17	126.00
China	3.64	3.65	-1.00
Greece	4.31	5.60	-129.00
Peru	5.32	4.87	45.00
Colombia	6.92	6.49	43.00
Indonesia	8.09	6.51	158.00
Russia	8.45	7.59	86.00
Brazil	11.47	9.77	170.00
Turkey	17.18	10.74	644.00

Source: TradingEconomics 3 October 2018

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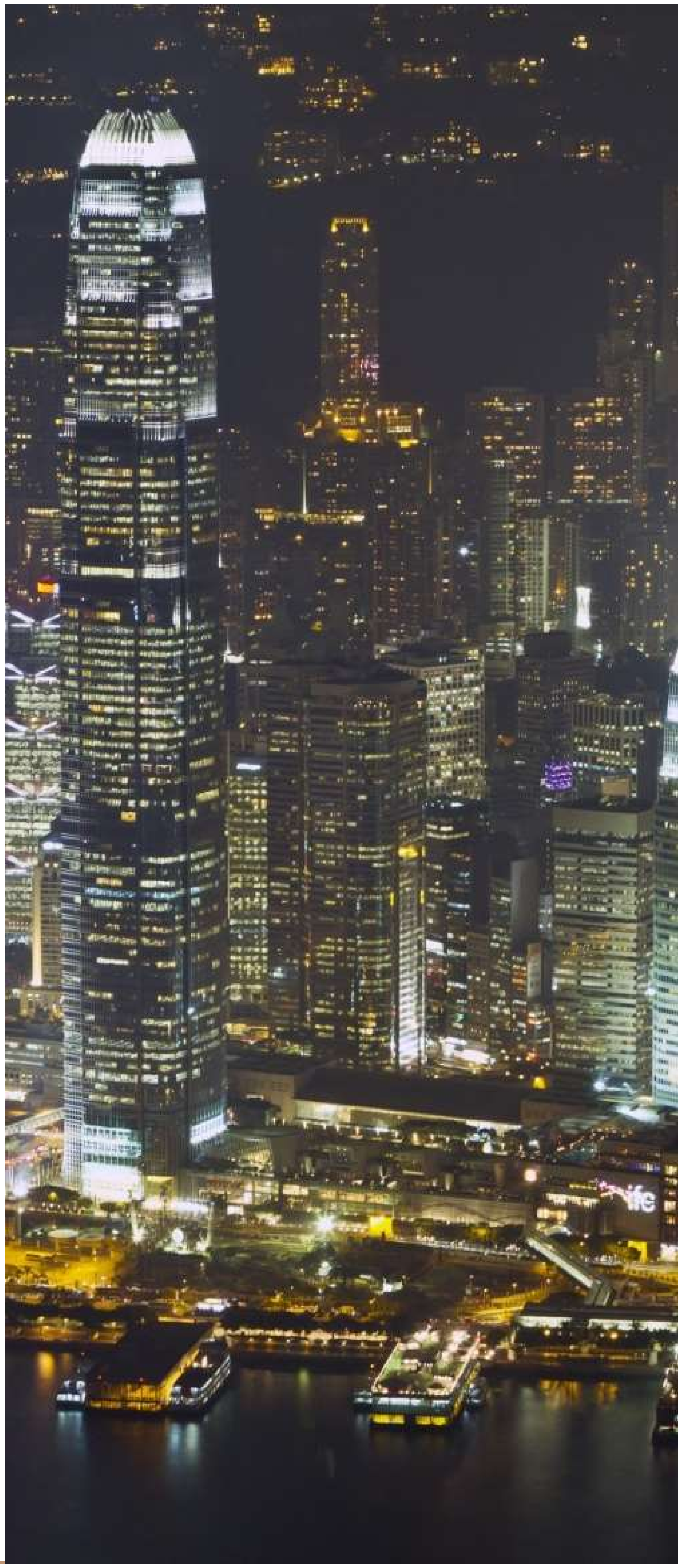

FUTURE INFLATION IS MORE IMPORTANT THAN CURRENT NOMINAL INTEREST RATES

We need to adopt a forward-looking view, by considering the three components of expected return: the real return, the compensation for future inflation and the reward for risk. As a rule of thumb, most assets are not inflation-protected. So while forecasting inflation can be a difficult task, real estate is one of the few asset classes that incorporate an inflation forecast into the expected returns.

Headline inflation in Europe could stabilise to around 1.9% by year-end, which is still below the ECB's target of 2%. The good news is that the risk of deflation has clearly dwindled. In the US, BNP Paribas Wealth Management economists expect inflation to hover at around 2.5% this year and 2.1% next year.

The key question is whether property investors are demanding a sufficient risk premium at present. Indeed, an adequate risk premium should be offered at all times, although some investors are not sufficiently rewarded for the risk they take. Nevertheless, it is obvious that the risk, resulting from currency movements for instance, must be correctly remunerated.

Why are today's property risk premiums so low? Admittedly, buyers can live with modest risk premiums booked by 'core' real estate products. This is similar to what has happened to investment-grade bonds in recent years.

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Not only have bond investors been willing to forego the extra return for taking duration risk, but they have also sacrificed return when buying long-term bonds.

There are two main reasons why the risk premium in bonds has fallen: firstly, **long-term inflation expectations have been moderate in the world's core economies**, making bonds a good hedge against a weakening in economic performance. And secondly, **central bank purchases have reduced yields further**, thus dampening interest rate volatility.

As we expect real-estate investors to have a long-term investment horizon (at least five years), an adequate risk premium should be essential to cover ‘normal’ property risk (tenant, vacancy, depreciation, obsolescence, etc.) along with specific market risks.

However, we consider that future inflation does not necessarily imply an increased risk for property investors. In the short term, rising inflation may lead to higher volatility because nominal interest rates will also rise. Investors may decide to invest in other asset classes – such as investment-grade bonds – because their rate of return is becoming more attractive. Moreover, the financing costs of real-estate companies may also grow (even sharply). However, in the longer term, in many countries, rising inflation will gradually flow into rental income. This will boost the value of properties, yet only after a time lag of 6 to 18 months (depending on geographical location).

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REITS ARE CONSIDERED AS THE MOST SENSITIVE ASSET CLASS TO HIGHER NOMINAL INTEREST RATES, BUT ARE THEY REALLY?

In the US, the upward trend of ten-year government bond yields has made REIT investors consider some 'traditional' questions about the relationship between REITs and rising interest rates. Contrary to popular belief, there is little empirical evidence to suggest that the historical correlations of these measures have always been negative or positive over time. Clearly, higher nominal interest rates may lead to temporary market instability as investors are seeking to get rid of their REITs. The reason for a sell-off is that gross dividend yields are now less attractive compared with income reaped from fixed-income securities. **As said, higher interest rates could also push up borrowing costs.**

This blurred correlation is probably the result of the inflationary nature of real-estate values that provides a partial hedge against inflation (unlike non-indexed fixed-income investments). Evidently, this also applies to direct real-estate investments.

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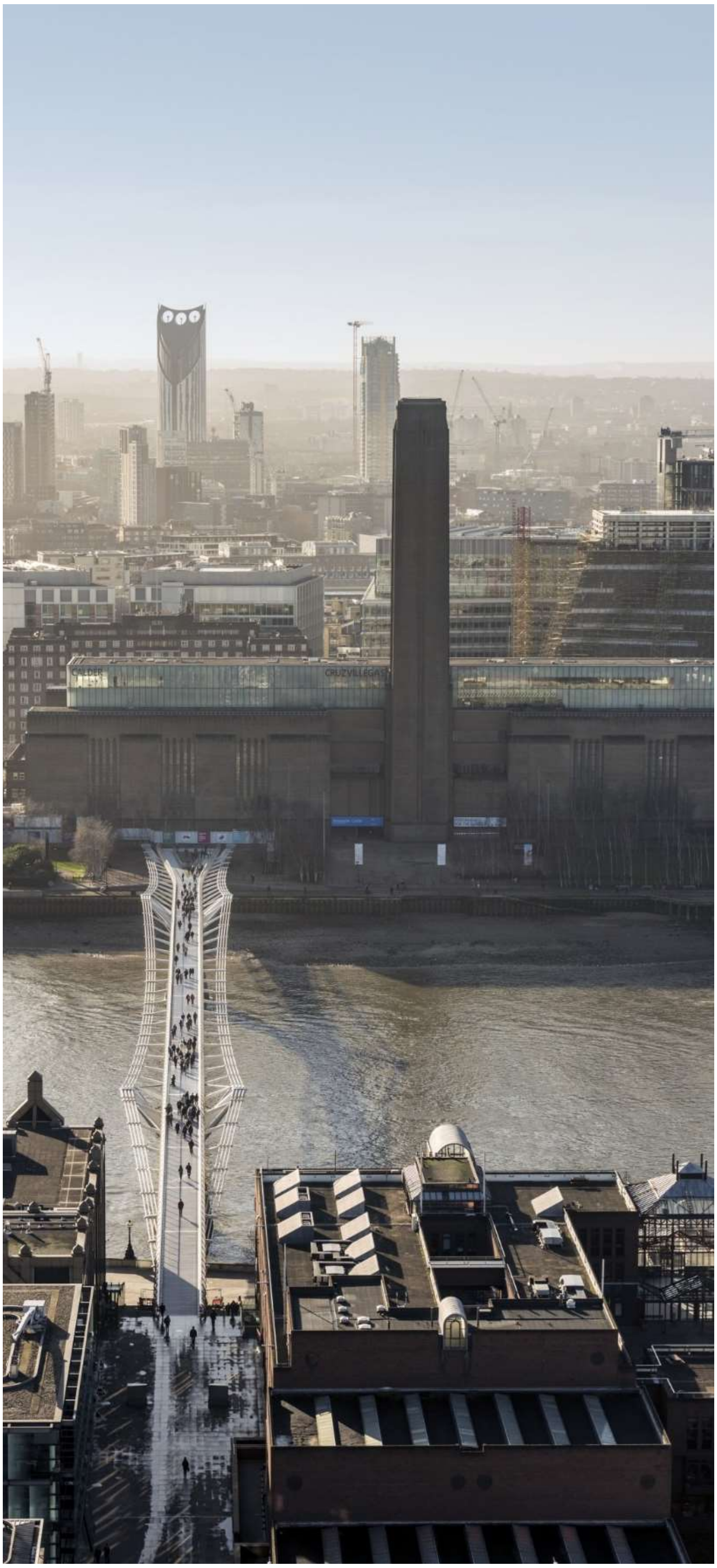

CONCLUSION

An important factor for property investors is that real interest rates remain stable at any cost, but this is not necessarily the case for nominal rates! If interest rates rise in line with economic growth, and core inflation escalates as a result, this may be positive for both listed and non-listed real estate. In the event of higher inflation, property owners would be entitled to increase rents in many parts of the world (indexation/rent reviews). Higher rents would eventually lift values, taking into account the usual 6 to 18-month time lag. Indeed, we must assess the factors that drive interest rates in general, such as GDP growth, inflation, job creation and monetary policy.

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THE WORLD'S COMMERCIAL REAL-ESTATE MARKETS

HIGHER INVESTMENT VOLUMES IN EUROPE

The positive momentum of commercial real-estate investments in Europe continues in 2018, with an investment volume of EUR 115.4 billion at the end of June, up 2% on 1H17 (source: BNP Paribas Real Estate, Main Investment Markets in Europe, 2Q18).

Germany posted the second-best half-year turnover ever. "This result is due to a record number of single transactions rather than the portfolio transactions that often stimulate German performance." The four major German markets that contributed to this performance all had a large number of mega-transactions (> EUR 100 million), with a new record set by Munich and Berlin, and a second-best result for Frankfurt and Hamburg. With an investment of EUR 9.3 billion in 1H18, Central London remains the largest European market, despite a 21% decline compared with 2017. The Paris investment market enjoyed an exceptional first half-year (+66%) thanks to clocking up a high number of mega-transactions in Paris and the Western Crescent.

According to BNP Paribas Real Estate, gross initial yields (GIYs) were stable in the first half of the year. Going forward, GIYs are not expected to fall further in the short term.

SLOWING CAPITAL APPRECIATION RATES FOR EUROPEAN OFFICES IN THE COMING YEARS

We have warned several times in previous reports that office values may dwindle in the coming years, although this year should still be a fairly good one. This is because capital values were (until recently) influenced more by capital markets (very low interest rates and an abundant supply of international capital) than by physical characteristics of occupier markets. To cut a long story short: **GIYs cannot shrink any further.**

This new situation is very apparent in London, exacerbated by the Brexit saga. Indeed 2020 will be characterised by either capital losses, or at best, a modest growth in capital values. The motto for core/prime real estate is very appropriate: 'Cash is King' thanks to secured rental income.

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Table 5: Total return projections for European office markets

	Capital Growth (%)			Income Return / Prime Yield (%)			Total Return (%)		
	2018	2019	2020	2018	2019	2020	2018	2019	2020
Helsinki	17.5	-7.0	1.9	3.50	3.70	3.60	21.0	-3.3	5.5
Milan	15.5	-1.3	-4.3	3.25	3.35	3.50	18.8	2.0	-0.8
Prague	13.2	-2.4	-2.2	4.50	4.75	5.00	17.7	2.3	2.9
Lisbon	12.9	1.5	-3.8	4.50	4.50	4.75	17.4	6.0	0.9
Madrid	11.7	2.0	-7.7	3.20	3.20	3.50	14.9	5.2	-4.2
Brussels	10.7	-2.3	-2.3	4.20	4.30	4.40	14.9	2.0	2.1
Rome	10.4	-0.1	-2.6	3.85	3.90	4.05	14.2	3.8	1.5
Frankfurt	9.0	3.4	0.1	3.10	3.10	3.20	12.1	6.5	3.3
Warsaw	6.0	-1.9	-4.7	5.10	5.20	5.35	11.1	3.3	0.6
Berlin	7.6	7.0	3.5	2.90	2.90	2.95	10.5	9.9	6.4
Barcelona	6.5	1.5	0.7	3.75	3.75	3.80	10.3	5.2	4.5
Birmingham	5.3	-4.0	-4.0	4.75	4.85	5.00	10.0	0.8	1.0
Cologne	5.5	6.5	1.2	3.55	3.55	3.65	9.1	10.1	4.9
Munich	5.8	3.9	0.3	2.95	2.95	3.05	8.8	6.8	3.4
Hamburg	5.4	3.6	0.3	3.10	3.10	3.20	8.5	6.7	3.5
Amsterdam	4.5	0.4	0.5	3.70	3.75	3.80	8.2	4.2	4.3
Budapest	1.5	-2.3	-3.2	6.50	6.65	6.80	8.0	4.4	3.6
Copenhagen	2.9	1.5	0.8	4.20	4.20	4.25	7.1	5.7	5.0
Greater Paris	2.9	1.2	-3.2	3.00	3.00	3.10	5.9	4.2	-0.1
Central Paris	2.9	1.2	-3.2	3.00	3.00	3.10	5.9	4.2	-0.1
Paris CBD	2.9	1.2	-3.2	3.00	3.00	3.10	5.9	4.2	-0.1
La Défense	1.9	5.5	-5.9	3.90	3.90	4.00	5.8	9.4	-1.9
Dublin	1.5	-5.2	-7.6	4.00	4.25	4.50	5.5	-0.9	-3.1
Stockholm	1.9	2.5	-2.5	3.50	3.60	3.80	5.4	6.1	1.3
Düsseldorf	1.9	3.6	-1.1	3.50	3.50	3.60	5.4	7.1	2.5
Lyon	0.0	1.7	-2.5	3.90	3.90	4.00	3.9	5.6	1.5
City	-2.5	-7.8	-4.7	4.00	4.25	4.55	1.5	-3.5	-0.2
Central London	-3.0	-7.3	-5.6	3.50	3.70	4.00	0.5	-3.6	-1.6
West End	-3.0	-7.3	-5.6	3.50	3.70	4.00	0.5	-3.6	-1.6

Source: BNP Paribas Real Estate, August 2018

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THE BREXIT SAGA

The outcome of the ongoing negotiations between the United Kingdom and the European Union, which will shape their future relationship, is still not clear. While the analysis of all plausible scenarios is beyond the scope of this report, we will assess the impact of a worst-case scenario – a 'hard' Brexit, or no deal – on commercial and residential real estate.

In the short term, BNP Paribas Real Estate expects a tangible impact on the market, similar to what investors observed in the aftermath of the referendum. "The fall in the UK's investment volume could reach 25%-30%, with capital values in City offices falling the most, by 15%, and by 10% in the West End. These will be driven primarily by rental falls, on the back of further weakness in the occupier market." Even assuming a deal with the EU, the impact on the property market could still be somewhat negative, yet to a much lesser extent. "Investment volume is expected to fall by 11% with an average capital value fall of 5% p.a. over the next 3 years in London." (source: BNP Paribas Real Estate). We remind the reader that the current uncertainty linked to Brexit is not the only factor responsible for the bout of market weakness. Anyway the London office market is entering the final stage of its current property cycle.

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Nonetheless, we believe that London will always be popular among investors – institutional and private alike – and the commercial market should be supported by the weaker pound. A similar situation should be seen in the capital's housing markets, with European investors progressively returning there.

Warehousing would experience much stronger demand around port areas in the event of a hard Brexit. "Processing goods and clearing them through customs at port locations will mean more storage is needed, especially in the short term. We are already seeing increased speculative development in storage space around the port of Dover. Further yield compression and rental growth in logistics property could be likely" (source: BNP Paribas Real Estate, September 2018).

The long-term future of the market is more difficult to predict, as it will largely depend on the nature of an agreement with the EU and the long-term performance of the British economy. Spillover effects on real-estate occupancy, with vacancy rates likely to increase sharply, will put downward pressure on rents. Selling pressure will emerge, forcing a correction in asset valuations.

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AMERICAN INVESTORS ARE STILL ACTIVE IN THE UK

While some American investors are entering the property market in the UK, the ones already there are trading London for regional cities. Total real-estate investment by Americans in the UK reached a meagre USD 3.1 billion between the beginning of the year and mid-August. “This is a much slower pace than the USD 16 billion transacted in 2015, the year before the Brexit vote.” (source: Real Capital Analytics, August 2018).

Asian investors continue to acquire London's trophy buildings, such as Plumtree Court, London's ten-storey building that will become Goldman Sachs' European headquarters. This building was purchased by the Korean National Pension Service (NPS) for GBP 1.17 billion as part of a sale and leaseback agreement (the transaction is expected to be closed next January, source: IPE, 23 August 2018).

American investors are willing to take higher risks, while Asian investors are less keen. The reason is simple: Asian investors can still find properties whose GIYs are trading well above those of similar buildings in their top-tiered home markets. This is not the case for American investors, with UK property capitalisation rates clearly below those in the US. Consequently, they must incur additional risks when investing in the United Kingdom in order to obtain a total return that is acceptable (at least to them).

Among the deals made by US investors outside London this year we highlight that of private equity firm LCN Capital Partners which bought the first phase of Aberdeen International Business Park – Aker Solutions' 335,000 m² headquarters – for around GBP 114 million, offering a return of around 6.9% (source: CoStar News, 22 March 2018). And the asset manager Invesco has announced that it is partnering with developers Patten Properties and Panacea Property Development to deliver 383 build-to-rent units in Liverpool City Centre (source: Wall Street Journal, 28 August 2018).

A big advantage for US investors is the lower prices when converted into US dollars. The weakening British pound – which has depreciated by about 15% against the greenback since the Brexit vote in summer 2016 – makes it cheaper for dollar-based investors to purchase in the UK. As a reminder, Americans have accounted for the lion’s share of non-British investors in the country for years. They have disbursed more than USD 90 billion on commercial real estate in the UK since 2007 (source: Real Capital Analytics).

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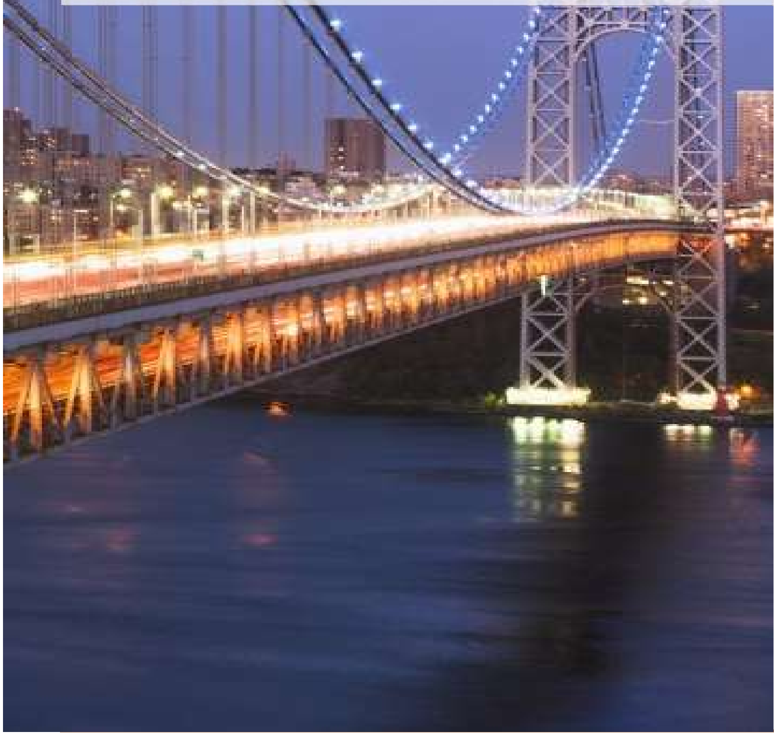
HOW ARE US COMMERCIAL PROPERTY MARKETS TRENDING?

The National Council of Real Estate Investment Fiduciaries (NCREIF) has published the 2Q18 results for the NCREIF Property Index (NPI). While the NPI's quarterly total return – generated by a combination of offices, retail, industry, hotels and apartments – was modest, returns in the second quarter were the highest since 2Q16. The total return was 1.81% in 2Q18, up slightly from 1.70% in the previous quarter. This is an unlevered return for mainly 'core' real estate held by institutional investors across the United States (source: NCREIF, 25 July 2018).



The average quarterly return over the past five years stands at 2.38%, or 9.85% annualised. "Although the annualised return of 1.81% or 7.44% for the second quarter is down from the hectic pace of the past five years, the decline in returns we have experienced for several years stopped in early 2017, and returns have remained remarkably stable since then."

Industrial properties, mainly warehouses, remain the best-performing property asset class, with a return of 3.58% in the second quarter. The Hotel segment ranked second with 1.95%, followed by the Office and Apartment activities, which both posted 1.54%. Retail recovered noticeably, edging up from 0.72% in the previous quarter to 1.32% in 2Q18.

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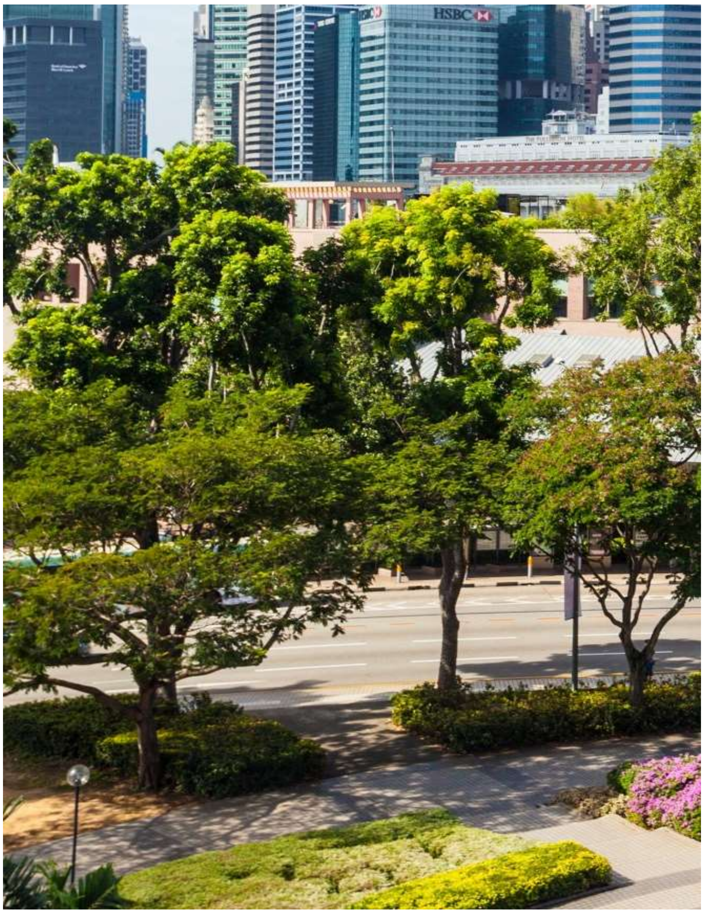
ASIA: SLOWING CAPITAL APPRECIATION RETURNS FOR OFFICES

Real-estate investments and leasing activity remain high, as office rents continue to grow. Overall, rental activity in Asia Pacific jumped by a whopping 45% y-o-y in 2Q18. This trend is mainly due to the good performance by a small number of markets, namely India, Manila and Hong Kong (source: Jones Lang LaSalle, Asia Pacific Property Digest, 2Q18).

Hong Kong, in particular, remains a very active market for offices, with capital values hitting new highs. However, various market players believe that the market may be dominated by sellers rather than short-term buyers. Office property is in the final phase of the current market cycle, so prospects for higher capital appreciation returns are fading. Even though this year will still be a very good one, with office values likely to trend 15% higher, the Hong Kong office market could prove much more challenging in the coming years. In Shanghai, demand for office space will fall as a number of banks terminate their leases early. Therefore, growth in rents could be practically non-existent in the near future (source: Jones Lang LaSalle, 2Q18).

Meanwhile, Australia's office markets remain very dynamic, particularly core markets. Canadian Oxford Properties Group has raised its offer to buy Australian office owner Investa Office Fund for AUD 5.60 per share, intensifying a bidding war with private equity giant Blackstone Group. Investa Office Fund's share price was AUD 5.54 on 3 October 2018. Oxford's latest attempt to buy Investa – listed on the Sydney Stock Exchange – highlights the value of the Australian company at a time when tight supply is swelling rents in the country, particularly in Sydney where the Oxford's towers are concentrated (source: Reuters, 13 September 2018).



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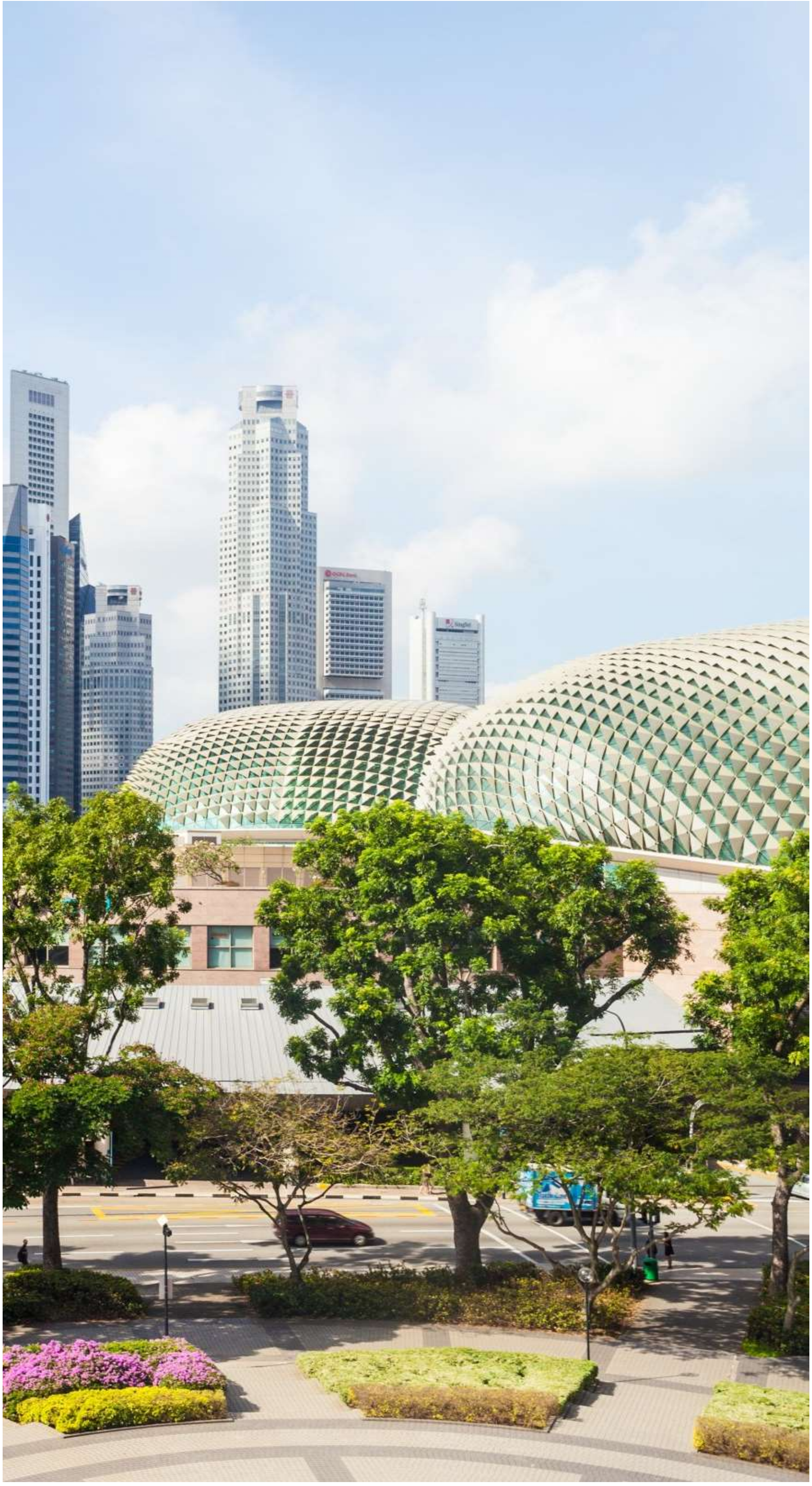

CONCLUSION

Commercial real-estate markets are still faring well in many countries of the world, but a degree of caution must be taken. A number of core markets are very attractive, so prospects of long-term capital gains are weakening gradually. However, as long as rental growth remains intact, investors should not worry too much about this. Some disturbing factors remain, such as whether or not a solid Brexit deal will be reached before March 2019.

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THE WORLD'S HOUSING MARKETS

THE STRONGEST CLIMB IN REAL HOUSING PRICES SEEN IN … HONG KONG

Hong Kong is the strongest housing market in the Global Property Guide global survey, up from fourth spot in the previous quarter. House prices surged 13.15% during the first and second quarters, after y-o-y rises of 12.28% in 1Q18, 12.78% in 4Q17, 13.41% in 3Q17 and 19.27% in 2Q17. This stellar performance, achieved on a sustained basis, is really beyond imagination particularly as local authorities have increased the stamp duty for all non-first-time buyers on top of other measures such as a tax on vacant flats, source: Global Property Guide, 2Q18).

Ireland's housing market is also growing at a fast speed. Residential property prices were up by 11.57% during the first half of the year after y-o-y rises of 12.4% in 1Q18, 11.7% in 4Q17, 11.75% in 3Q17, and 11.8% in 2Q17. But the big difference with Hong Kong is that the Irish housing market suffered a severe crisis in 2007-2009, and Hong Kong was spared.

Singapore, the Netherlands and Macau have also bounced back fabulously in recent months and years, albeit from different levels. There is nothing new under the sun, in Qatar, Ukraine and Dubai at least! Will Dubai house prices ever recover, and if so, when? Prices differ greatly from one district to the next.

Table 6: Real house prices as at 30 June 2018

Rank	Country	y-o-y (%)		q-o-q (%)
		2Q17	2Q18	2Q18
1	Hong Kong	19.27	13.15	5.05
2	Ireland	11.8	11.57	2.22
3	Singapore	-3.20	8.53	3.19
4	Netherlands	6.39	7.24	0.85
5	Macau	11.79	6.31	5.21
	…			
10	Portugal	3.47	4.53	-0.02
	…			
15	Spain	0.85	4.01	0.29
	…			
37	Brazil – São Paulo	-2.15	-2.38	-1.22
38	Peru	-2.27	-3.12	-1.07
39	Switzerland	1.09	-3.49	-1.28
40	China - Shanghai	6.76	-3.51	-0.81
41	Turkey	1.62	-4.21	-1.99
42	Dubai	-2.51	-7.63	-1.33
43	Ukraine - Kiev	-5.13	-7.81	-1.94
44	Qatar	-4.52	-16.91	-6.62

Source: Global Property Guide. Prices in real terms, June 2018

Real Estate and inflation:
Not necessarily a bad combination!

HIGHER PRICES, ESPECIALLY OUTSIDE LONDON

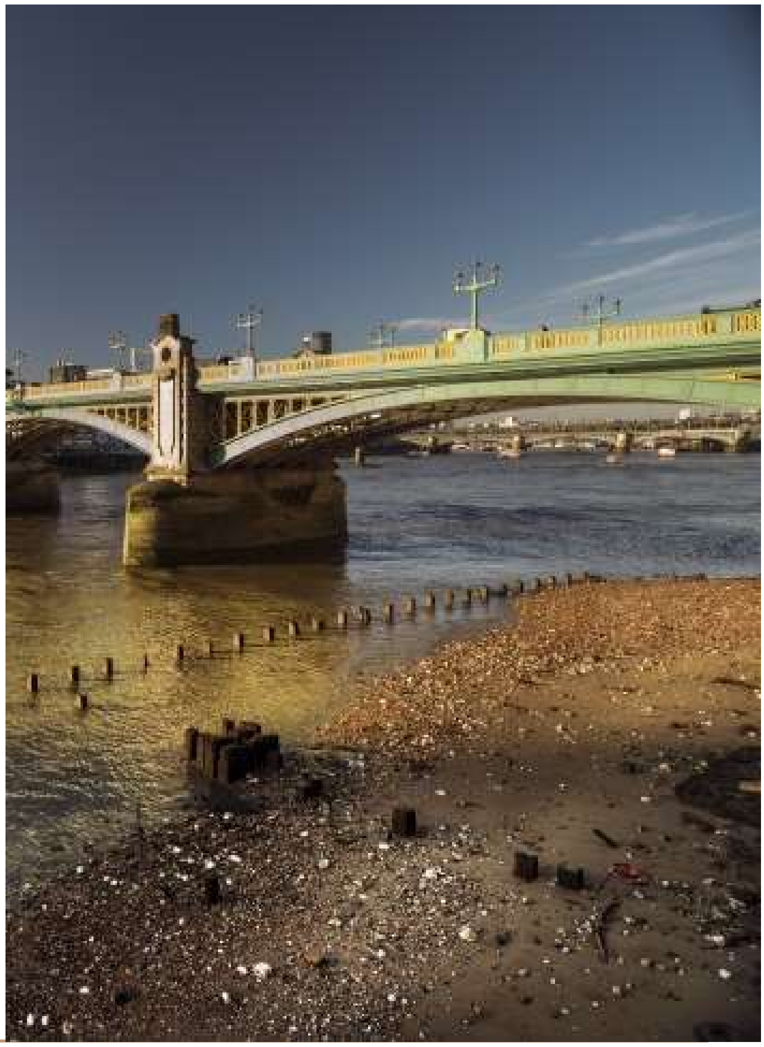
The average asking price for a 'new-to-the-market property' in September was up 0.7% to GBP 304,061, though the annual rise remains subdued at 1.2% (source: Rightmove's house price index, September 2018). "The Autumn market has stronger momentum in areas with better affordability and sentiment, with Wales, East Midlands, West Midlands and Yorkshire & the Humber all recording average annual price rises of at least 4%."

Moreover, **after several years of prices falling in pockets of London, there are signs of renewed buyer activity at the upper end**, with a 6% rise in the number of sales agreed for homes worth GBP 750,000 and more, compared with September last year.

Meanwhile, Mark Carney, Governor of the Bank of England, is rather pessimistic about the country's housing market. He warned the British government in mid-September that house prices could fall by between 25% and 35% in the event of a 'hard' Brexit. In the worst-case scenario, house prices would fall by the same proportions over the next three years, the unemployment rate would surge from 4% today to more than 10%, and travelling by air or rail between the UK and Continental Europe would be more complicated.

THE WEAKER POUND IS ENTICING EUROPEAN BUYERS BACK TO LONDON

European buyers are returning to the London real-estate market for the first time since the Brexit vote. The proportion of houses sold to a European Union buyer in London rose from 10% a year ago to 13% in 1H18 (source: Hamptons International). In 2017, the year following the referendum, the proportion of European buyers in London fell sharply, particularly in Central London, in the most expensive postal codes, including Mayfair and Belgravia. There, EU buyers accounted for a massive 28% of transactions in 2Q16. This figure had fallen to 8% by the first quarter of 2017.



Real Estate and inflation: Not necessarily a bad combination!

IRISH HOUSE PRICES ARE BECOMING EXPENSIVE

Dublin house prices are overvalued by 25% (source: The Economist/The Irish Times, 27 August 2018). “The cost of buying a house in the capital had risen faster than both the rental revenue an average property could generate and the ability of someone earning an average wage to repay a mortgage.” Ireland’s house prices have been soaring by roughly 80% from their 2012 lows, with Dublin prices practically doubling, up by 92.7%!

In the year to July, house prices at the national level advanced by 10.4%. By comparison, the increase was 11.9% over the 12-month period to the end of June 2017 and 11.6% during the 12-month period ending July 2017. In Dublin, residential property prices jumped 7.2% in the year to July. House prices in Dublin rose by 6.5%. Apartments in Dublin increased by 11% over the same period (source: Central Statistics Office, Ireland, 11 September 2018).

Residential property prices in the rest of Ireland rose by 13.7% in the year to July. The Mid-West region posted the sharpest price growth, with house prices surging by 23.7%. The Border region recorded the lowest growth, with house prices rising by a relatively small 6%.

BELGIUM: NO CRASH ON THE CARDS, THOUGH MODEST RETURNS AROUND THE CORNER

We believe that real-estate prices may stabilise or fall slightly in the next three years. We admit that we have been expecting a mild cooling of Belgian house prices for a few years, though this has not materialised. On the contrary. At the end of June, house prices edged up by over 2% annually, in line with current core inflation of about 2% (source: Notarisbarometer, 2Q18). We think that residential prices are based on more than purely economic factors, such as a buyer’s annual disposable household income. Important cultural factors come into play, for example the fact that the older generation donates real estate to the younger generation much faster than before (and often enjoys tax advantages by doing so).

As said, we would not be surprised if nominal property prices were to fall slightly in both 2019 and 2020. In practice, investors would lose out due to inflation. Nevertheless, we do not expect a real-estate crash as such.

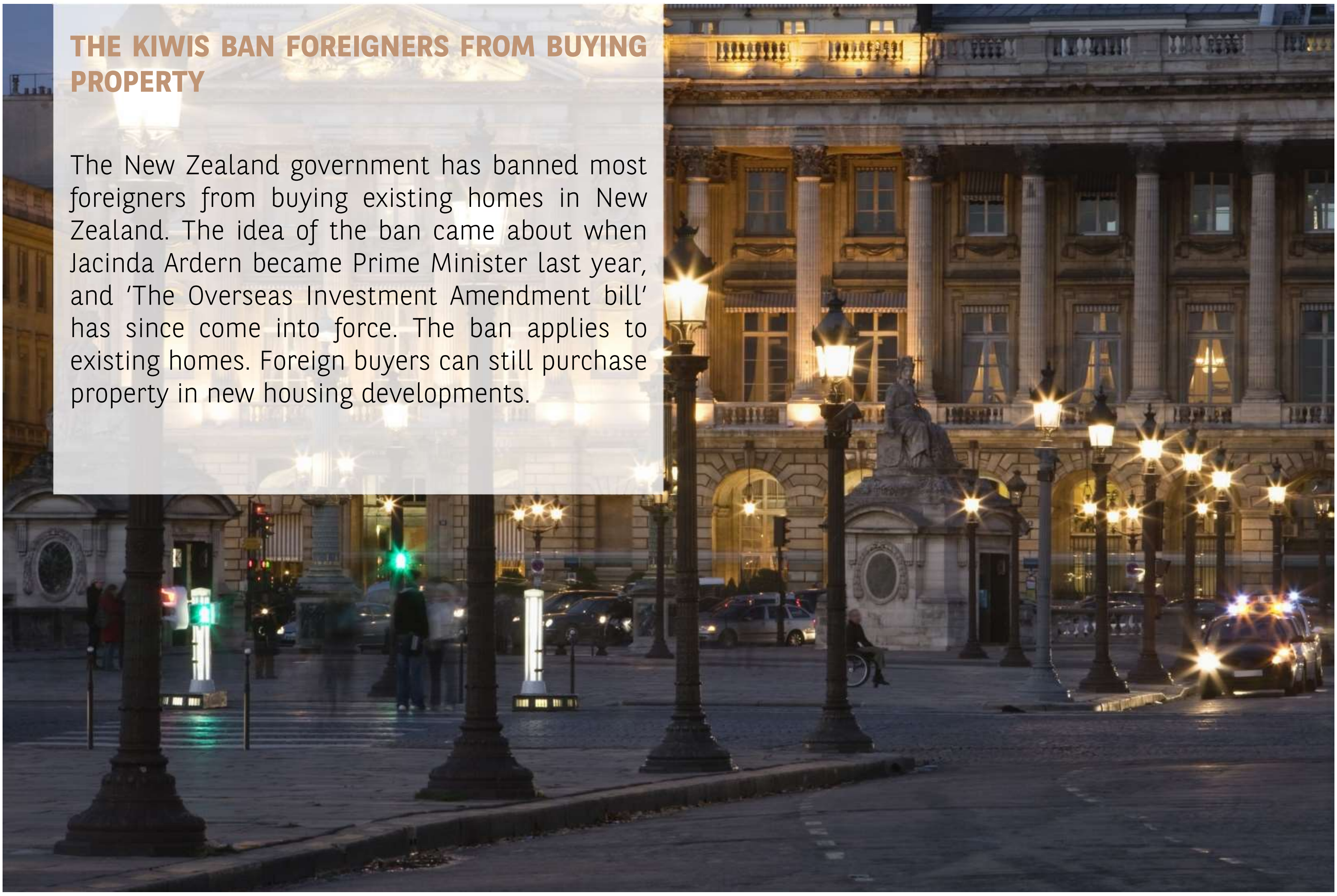
Real Estate and inflation:
Not necessarily a bad combination!

PARIS: THE SKY IS THE LIMIT

While 100% of Parisian districts are experiencing an annual increase in property prices, some stand out from the rest. For example, in the 4th *arrondissement*, apartment prices increased by more than 12% during the 12-month period to the end of June (source: LPI-SeLoger barometer, October 2018). "From rue des Archives to rue Vieille-du-Temple, via rue des Hospitalières-Saint-Gervais and rue de Lutèce, the purchase of an old apartment will cost you 12.8% more than at the same time last year." About 30% of Parisian districts saw their annual property prices surge by 9% or more in 2Q18. Buyers must pay more than EUR 10,000/m² in half of the 20 *arrondissements*.

CONCLUSION

In many countries, residential prices have posted very attractive returns in recent years, with buyers making fat profits in real terms. It goes without saying that the still very low interest rates have contributed to this outperformance. And yet, as interest rates are starting to trend upwards, capital returns may come under pressure. Meanwhile, net rental yields remain low.



THE KIWIS BAN FOREIGNERS FROM BUYING PROPERTY

The New Zealand government has banned most foreigners from buying existing homes in New Zealand. The idea of the ban came about when Jacinda Ardern became Prime Minister last year, and 'The Overseas Investment Amendment bill' has since come into force. The ban applies to existing homes. Foreign buyers can still purchase property in new housing developments.

Real Estate and inflation: Not necessarily a bad combination!

THE WORLD'S LISTED REAL-ESTATE MARKETS

Listed real-estate markets are no longer what they were and the golden years seem to be something of the past. We have already explained in previous reports that growth in total returns (gross dividend + change in share price) on REITs would decrease.

This year has not been amazing, with total returns varying greatly. However, it is not all pain and suffering. Germany has performed relatively well, posting a 9% return year-to-date (as at 2 October), which contrasts sharply with France, and the United Kingdom (in pound sterling). Asia and North America have also had better times.

That said, many regions generated attractive returns over a longer period, for instance five years. Only Asia was lagging behind. Europe scored brilliantly over the period under review, with Germany shining as the absolute leader.

Table 7: Annual performance of REITs as at 2 October 2018 (in local currency)

Name Index	Currency	1M	YTD	1Y	3Y	5Y
FTSE EPRA/NAREIT Europe ex UK	Euro	-3.25	2.17	7.80	9.74	12.98
FTSE EPRA/NAREIT Europe	Euro	-2.65	0.16	6.28	3.90	10.92
FTSE EPRA/NAREIT France	Euro	-3.02	-6.85	2.77	5.42	8.10
FTSE EPRA/NAREIT Germany	Euro	-4.27	9.01	18.93	17.29	21.48
FTSE EPRA/NAREIT UK	GBP	-2.32	-4.63	3.05	-1.18	7.29
FTSE EPRA/NAREIT Belgium/Luxembourg	Euro	-4.87	6.39	6.95	11.94	12.37
FTSE EPRA/NAREIT Asia	USD	-0.94	-2.16	3.38	6.72	1.80
FTSE EPRA/NAREIT Japan	Yen	3.52	6.07	9.13	-0.02	0.78
FTSE EPRA/NAREIT Singapore	SGD	-0.85	-5.78	0.62	11.34	5.68
FTSE EPRA/NAREIT Hong Kong	HKD	-2.52	-7.29	-1.01	10.40	4.73
FTSE EPRA/NAREIT North America	USD	-3.65	1.22	3.18	6.44	7.92

Source: EPRA, 2 October 2018

Real Estate and inflation:
Not necessarily a bad combination!

A word on UK REITs. The Central London real-estate market has remained reasonably calm with valuations underpinned by cheap money and overseas capital in the past few years. This has allowed UK REITs to tidy things up, but "they are now largely priced out of the market, awaiting a correction" (source: Exane BNP Paribas Research, 23 July 2018). "Our positioning remains broadly neutral on London-exposed names despite low leverage (debt ratios of about 30%) and wide NAV discounts. Brexit weighs on future returns and it is too early to pay for a recovery trade that may not materialise."

The United States has higher nominal interest rates than other parts of the world, such as Europe and Asia. This has resulted in REIT share price volatility in recent months, although total returns remain acceptable (certainly in the long term) as the dollar has appreciated against major currencies as well.

We are of the opinion that investors should not be concerned about the US because there is no real empirical evidence that inflation is negatively correlated with the long-term performance of REIT share prices. After all, if nominal interest rates were to rise due to unexpected core inflation, rents and values would also rise (after a time lag). In addition, this applies not only to the United States, but to all REIT core markets.

Asia is a vast region, with many listed REITs (Singapore, Hong Kong and Japan are well-established REIT markets). Volatility seems to be higher than in other markets, while unfortunately total returns do not necessarily compensate for additional risks.

Real Estate and inflation: Not necessarily a bad combination!

CONCLUSION

From an absolute total return perspective, we do not expect a fat total return over the next three years. Only a few percent, generated mainly by dividends. However, from a relative investment perspective, total returns are expected to exceed those of other asset classes, particularly fixed-income securities. We therefore believe that many investors will still be attracted to REITs in general, and that they will adopt a buy-and-hold strategy.

Real Estate and inflation: Not necessarily a bad combination!

REAL-ESTATE INVESTMENT STRATEGY

Our strategy for real-estate investors remains quite simple, even if market conditions are not straightforward.

We are convinced that investors must build a property portfolio that includes both listed and direct real-estate investments. Direct real estate may be purchased directly or indirectly, through a private real-estate fund. Property shares may be purchased either on the stock exchange or through a fund (or fund of funds) that, in turn, is invested in property shares or, more specifically, in real-estate investment trusts (REITs).

Any investment strategy needs to incorporate the investor's future liquidity needs, financial return expectations and investment horizon, and these parameters vary from one investor to the next.

Real Estate and inflation: Not necessarily a bad combination!

WHAT TYPE OF REAL-ESTATE STRATEGY DO WE CURRENTLY RECOMMEND?

Top-tiered markets are expensive at present, resulting in low gross initial yields (GIYS). In addition, it is far from certain that 'the best' markets would be more value-resistant than lower-tiered markets if market conditions deteriorate. Nonetheless, **we believe that rental income streams generated by prime properties should be more protected in a worst-case scenario, which would allow the owner/investor to continue to collect net rents**. Indeed, in the event of a property downturn, vacancy rates could spike much more rapidly in secondary/lower-tiered property markets.

Alternatively, a cooling real-estate market can offer new opportunities to property investors because new buildings may be purchased at a more advantageous (discounted) price. Hence, we believe that it is important to invest in a 'value-added' real-estate fund, managed by a competent asset manager. **We advise against going on a rushed shopping spree, to avoid investing at the top of the cycle**. In other words, the investment period of such private fund should span at least a few years to avoid putting all one's eggs in one basket, by acquiring everything in an 'unfavourable' (expensive) phase of a property cycle.

This is why we put forward an investment strategy with two alternatives:

- The direct purchase of real estate in top-tiered property markets. This is certainly the case for prime real estate in Europe (including the United Kingdom at a later stage). However, the condition is that the investor's asset-base is large enough to allow him or her to buy assets directly, or

- the purchase of units in a 'real-estate private equity fund', with a manager who creates value on his/her own (cheaper acquisitions, identification of 'off-market' transactions, extension of existing buildings, office to flat conversions, upgrading of buildings to collect higher net rents, etc.).

Of course, investors can choose a combination of these two options.

REAL-ESTATE RECOMMENDATIONS

As mentioned, we are positive on the value-added real-estate segment irrespective of geography. We keep a negative stance on UK REITs due to deteriorating conditions in the country's office markets (particularly London) and we are negative too on a number of emerging markets.

OUR REAL-ESTATE STRATEGY BY LOCATION

NORTH AMERICA

Segment by region	Previous opinion	Current opinion
Top-tiered commercial	Neutral	Neutral
Lower-tiered commercial	Neutral	Neutral
Residential	Neutral	Neutral

EUROPE

Segment by region	Previous opinion	Current opinion
Top-tiered commercial	Neutral	Neutral
Lower-tiered commercial	Positive	Positive
Core residential	Neutral	Neutral
Badly-impacted housing markets	Neutral	Neutral

EMERGING MARKETS (EMERGING ASIA & LATIN AMERICA)

Segment by region	Previous opinion	Current opinion
Commercial	Neutral	Neutral
China Top-tiered residential	Neutral	Neutral
China Lower-tiered residential	Neutral	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.

BNP PARIBAS WEALTH MANAGEMENT

The bank for a changing world

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• **Liquidity risk:** For a real estate investment, the liquidity is the possibility to sell rapidly the underlying asset or the asset directly held, without affecting its price. According to their characteristics, real estate assets have varying degrees of liquidity.

• **Yield risk:** Depending on the macro-economic, financial and fiscal, environment of the asset, the performance of a real estate investment may vary unpredictably over time.

• **Financial risk:** The change in interest rates, inflation and credit access conditions constitutes the financial risk of real estate investments.

• **Economic and rental risks:** The performance of real estate investments is closely linked to tenants' demand, purchasing power and solvency. Tenants represent both default risk and vacancy risks.

• **Risk related to the location:** A real estate asset is exposed to the risk of depreciation of the location that may directly affect its value or yield (town planning, projects to enhance the value of the area or not, quality of the neighbourhood ...)

• **Real estate risk:** Real estate assets are subject to a risk of obsolescence that may have an impact on the building's capacity to generate income over time (rental risk). The obsolescence risk is higher today in the face of the appearance of new environmental norms.

• **Capital risk:** Real estate assets cannot be guaranteed and, when selling his/her real estate investment, an investor may suffer from partial or total loss of the capital initially invested.

• **Changes in the legal, regulatory and tax environment:** Any changes of a legal, tax or regulatory nature occurring during the life of a real estate fund may have detrimental effects on the performance of the fund itself or its investments.

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