"THE SKY'S THE LIMIT". BUT IS THIS STILL TRUE FOR TODAY'S REAL-ESTATE MARKETS?

BNP PARIBAS
WEALTH MANAGEMENT

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Highlights of the report

The past can be used to suggest many things, with history believed to repeat itself. Some examples:

"Property values will fall if interest rates rise". Which interest rates? Nominal rates? Real rates? What type of property: prime or secondary? Which areas?

"Property cycles are linked to economic cycles". Is the relationship between economic fundamentals and real estate performance clearly defined? Are capital markets capable of distorting this linkage? Has property management progressed more professionally in recent years, allowing for better performances anyway?

"UK property markets will suffer a disastrous slump due to Brexit as they did in the early nineties." Are UK interest rates hovering at similar levels presently? Can the impact of Brexit – based on facts – be fully assessed today?

We believe history will not necessarily repeat itself by following a standard pattern. But one cannot ignore that both occupational and investment markets react to events with a lot of media coverage – such as Brexit - and economic data (instantly or with a time lag). In short, some evidence of property cyclicality may eventually emerge. ***We are of the opinion that it is too dangerous for investors to assume that "cycles are a thing of the past", making valuation multiples less relevant.***

This year appears to be more uncertain for property investors. It is too early to say whether the various real estate markets are nearing a tipping point, ready for re-pricing

Which measurable indicators of a change in risk sentiment swept across the property markets in 1H16?

- **European commercial real estate volumes.** CBRE European Investment Quarterly, 2Q16), with Europe's two largest markets – the UK and Germany – losing steam, though for various reasons. The UK showed a slowdown in commercial real estate investment in the first half of 2016, registering a 45% decline from a year earlier (source: Real Capital Analytics). In Germany, prime property has become a scarce commodity.

- **Commercial property markets in the UK** had already been affected in the run-up to the Brexit vote, and a weak property performance was apparent in July, the first month after the referendum. As a matter of fact, lower investment volumes translated into capital losses. For example, office values in the City of London fell by 6%, sacrificing equity appreciation returns even more (depending on leverage, source: CBRE United Kingdom Monthly Index of July 2016). In addition, Norway's sovereign wealth fund did not await convincing property data to revise down the value of its UK holdings by 5% in the second quarter. And the Brexit outcome was very tough for the UK's open-ended property funds, as 7 large property vehicles had to suspend trading almost straightaway amid volatile market conditions.

- **The performance of the world's major housing markets** is dispersed to an increasing extent, marking a differentiated price pattern. Hong Kong's overvalued residential market saw property prices tumble by around 30% between October and July 2016 (depending on sources). Singapore's mature housing market continued to erode as well, albeit in a "controlled" way. Alternatively, Chinese housing prices soared in 55 of 70 medium and large-sized cities in June 2016, but the markets remain "tiered", as did growth in housing prices. In Latin America – and especially in economically-battered Brazil – housing prices do not offer any protection against inflation, contrary to popular believe. In Rio de Janeiro, the local real estate market plunged by over 12% in real terms in the year to end-July 2016 (source: FipeZap index). In contrast to average housing prices across the US that posted year-on-year gains of about 5% in May 2016, easily outpacing inflation levels (source: Standard & Poor's CoreLogic Case-Shiller home price index). And Europe would not be Europe if the housing market was not fragmented altogether. London's high-end real estate prices have become seriously under pressure in recent months. Notwithstanding, it is difficult to ascertain whether price declines resulted from a higher stamp duty or waning risk appetite from international investors, causing a bandwagon effect. Maybe all factors come into play.

  In April 2016, annual investment volumes were 19% higher in France (source: Notaires de France), even though investment appetite did not lift prices significantly higher until this point. And an "unknown" country like Sweden reported a fabulous 12.1% increase in real housing prices in the year ended 31 March 2016, which was the result of negative interest rates. In Spain, housing values have been edging up for 2 years, yet housing transactions fell in 2Q16 given a couple of challenges;

- Many of the **mature economies** have developed **commercial and residential property markets**,

with large institutional investors and a structural oversupply of capital. This "wall of capital" may chase too few real estate assets, leading to high prices and low gross initial yields. But it is increasingly disturbing that diversification through investments in emerging markets does not smoothly translate into higher returns for any incremental risk incurred (for instance currency effects), whether in the Middle East (Dubai), Latin America (Brazil and neighbouring countries) or Asia (weaker capital growth rates in many areas);

- Renewed volatility in the **listed Real Estate Investment Trust (REIT) markets** reached a climax on 24 June 2016, with UK REITs diving by 14% in the pound on the same day. Losses widened in "stronger" currencies like the US dollar and the euro. However, price declines were very uneven (between the UK on the one hand and Continental Europe, the US and Asia on the other). Manifestly, there was no reason for investors to panic.

A current swing in risk sentiment is possible, with the risk-pricing pendulum switching in favour of "fear". We nevertheless believe investors may survive the latest challenges, as conditions are still conducive to property investments:

- **Nominal (and real) interest rates** have been edging lower, again, since the publication of our previous property report in April 2016. Although a market overheating may be a threat, lower long bond yields enabled gross initial yields to remain stable or compress marginally in 1H16, as observed in Europe and the US. Our conclusion is that real estate pricing is beefed up by comparing real estate capitalisation rates with risk-free long-term interest rates. This pricing comparison may look ridiculous, but it is not. Property is a true asset class, and institutional and individual investors increasingly look at real estate in relation to equities, bonds and alternative investments. Obviously, real estate is very different from other asset classes for a number of reasons: a) property may be a physical asset; b) revenue from real estate is governed by reasonably long contracts (certainly in the UK), and rents are expected to increase through indexation (to upcoming inflation) or rent reviews. This is a key factor for investors today; c) the supply of property is somehow regulated by various authorities (construction permits, fiscal regulations).

- **The performance of real estate**, as different as it may be, is ultimately linked to the performance of capital markets. The good news is that our economists are projecting interest rates to remain steadily low for a prolonged period, certainly in Continental Europe, the UK (given the interest rate cut by the Bank of England on 4 August), Japan and other regions of mature Asia (including China). Although monetary policy in the US is diverging from other regions, with an interest rate hike on the cards before year-end, rates will remain very low in absolute terms thereafter. The wall of money needs to be invested in the end, even if investors temporarily allocate their cash elsewhere. Reasonable debt-enhanced equity real estate returns are still possible;

- Some **property markets** can benefit from turmoil at the expense of other markets, paving the way for new investment options. This can be said of capitals in Continental Europe (Frankfurt, Dublin, Paris, Luxembourg, etc.) with respect to London or the overall mature markets (the US, Europe including the UK and mature Asia like Australia) in relation to specific emerging market countries. In particular Asian owners are likely to continue their expansion into promising commercial and residential real estate markets, often supported by beneficial government regulations (e.g. Golden visa rules for residential investments in Southern Europe, fiscal rulings for commercial property);

- The volatility of **property shares (REITs)** is higher than that of the physical real estate markets, at least in the short run. But REIT markets are similarly governed by key fundamentals such as the intrinsic value of the underlying properties (through implied capitalisation rates) and external drivers like low interest rates, inflation prospects and the health of the capital markets. As a consequence, REIT total returns tend to mirror those of direct markets, at least in the long run. The day after the "Leave" vote, share prices of REITs fell (in an unequal manner) before quickly recovering afterwards. In Europe excluding the UK, Asia and the US, any "Brexit" losses reported on the blackboard right after the referendum have been wiped off since (as at 6 September 2016) because fundamental parameters – such as very low interest rates – have not altered at this point.

Our real estate investment strategy for long-term investors with a growth and/or income investment objective

- *Investors with little appetite for risk could invest in commercial and residential core/prime assets in Continental Europe, even though they will need to accept fairly low income returns from these assets (single-digits)*. Unfortunately, capital gains may be virtually non-existent in the coming years, with gross initial yields teetering on the brink of very low levels. Investments could become the "traditional" way by purchasing physical assets. Although these investments

are not liquid and often require high amounts of capital, they are generating a higher (indexed) cash yield compared with other asset classes like investment-grade bonds. Furthermore, solid properties would help owners to "weather" any real estate downturn in a (very unlikely) worst-case scenario. Secured income streams would be paramount to offset (unrealised) fluctuations in capital values in such a scenario. We favour Continental Europe over the US as North America has been advancing somewhat further on the property cycle while US dollar-denominated investments are expensive for international investors given the strong greenback.

- ***Investors who do not shun "reasonable" risk have another attractive option. They can invest in private equity real estate funds which pursue a value-added strategy when making property investments in the "primary" as well as "secondary" real estate markets***. Adding value entails buying property, improving them one way or another (physical upgrade, better management, resolving capital constraints, etc.) and selling them once sizeable capital gains can be booked. In addition, value can also be created through purchasing trades (of interests in other property funds) on the secondary market at attractive discounts. As these investments have a "private equity" style and are illiquid, total returns should be double-digits to compensate for any additional risk taken. The investment league can be extended to the UK because Brexit will eventually lead to fresh investment opportunities. To cite but one example, New York-based Madison International Realty contacted several open-ended property funds that froze redemptions in order to take advantage of any downturn in the UK market (source: Financial Times, 11 July 2016).

Our property report examines in more depth the trends and forecasts of commercial property markets, with specific attention to listed real estate. We also look at how the global housing markets are trending at this moment, with a specific focus on the UK, France, the Iberian peninsula, China, Singapore, Hong Kong, the US, Brazil and Dubai. All our recommendations are set out in our "real estate strategy in brief" section.

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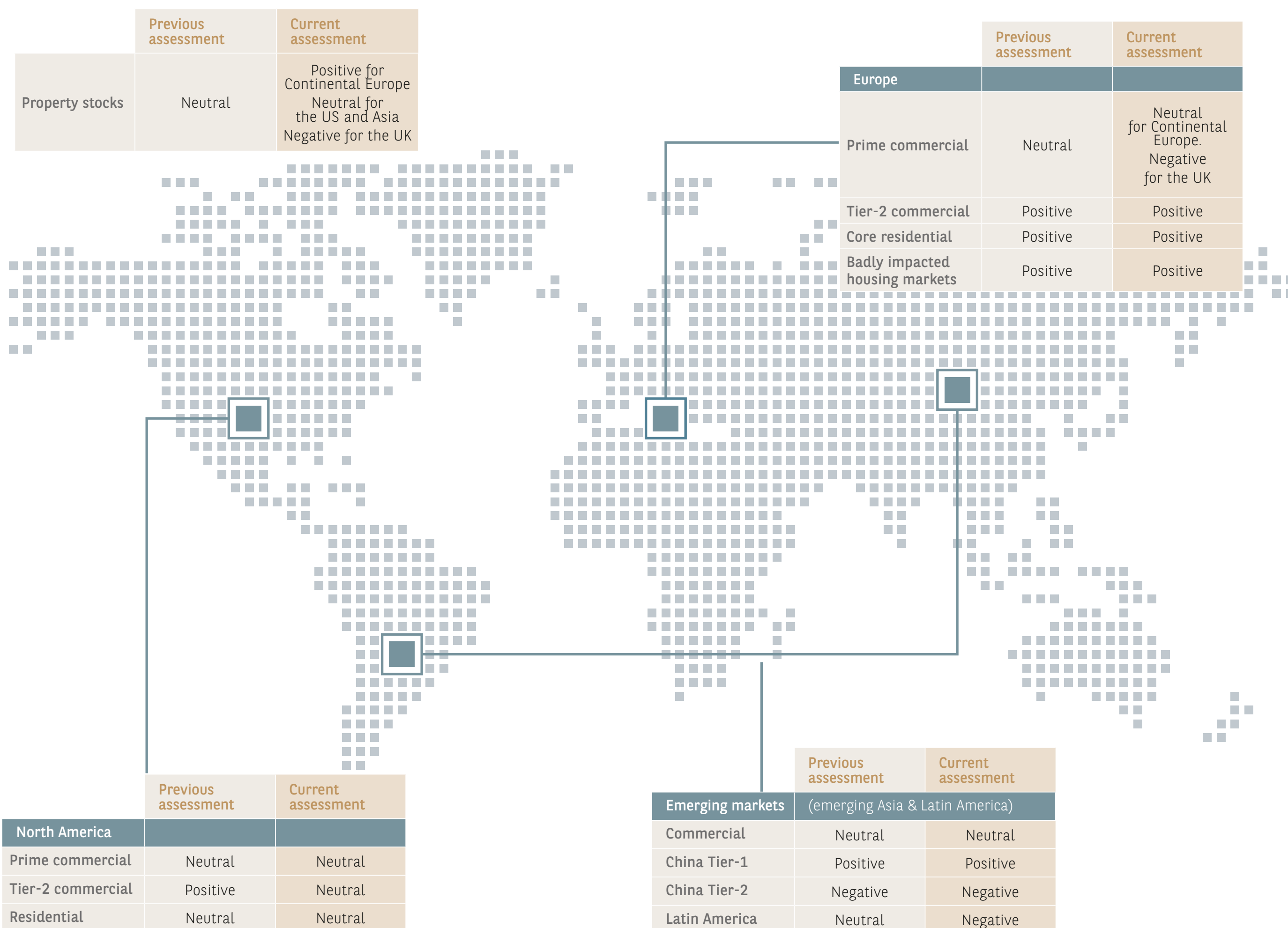


	Previous assessment	Current assessment
Property stocks	Neutral	Positive for Continental Europe Neutral for the US and Asia Negative for the UK

Europe	Previous assessment	Current assessment
Prime commercial	Neutral	Neutral for Continental Europe. Negative for the UK
Tier-2 commercial	Positive	Positive
Core residential	Positive	Positive
Badly impacted housing markets	Positive	Positive

North America	Previous assessment	Current assessment
Prime commercial	Neutral	Neutral
Tier-2 commercial	Positive	Neutral
Residential	Neutral	Neutral

Emerging markets (emerging Asia & Latin America)	Previous assessment	Current assessment
Commercial	Neutral	Neutral
China Tier-1	Positive	Positive
China Tier-2	Negative	Negative
Latin America	Neutral	Negative

Our real estate strategy in brief

Europe

Commercial real estate (CRE)

Tier-1 real estate markets (prime real estate)

We maintain our neutral stance for prime assets as we believe they can still play a significant role within a strategic asset allocation process.

They have certainly done in recent years, in spite of demanding valuations and a lack of available products (in some capital cities). The allocation of European countries to core investments may be somehow arbitrary, and is conditional to product sourcing. As such, we do not favour a so-called "Top-down investing investment approach" that looks first at the overall picture of the economy before breaking down the various components and selecting specific assets. Finding top deals across Europe (France, Germany, Southern Europe, Scandinavian countries) is more relevant today.

However, core markets do have a benchmark: they should be stable and have a stable currency. So broadly speaking, the UK – and in particular London – should be avoided as a prime investment market. Investment volumes had tumbled in the run-up to the Brexit vote, whereas the pound dived against the dollar and the euro in the referendum's aftershock. But above all, capital values for offices started declining in July. Although the correlation between investment volumes and values is often unclear (subject to time lags for instance), we believe investors may be perturbed by fresh losses in the coming months, maybe a further 10% of overall property values which would exacerbate losses for equity appreciation returns (depending on leverage). So we could be at the beginning of a downswing.

As always, pioneer investors could soon detect new investment opportunities across the UK at more reasonable prices (expressed in sterling). For this reason, the UK real estate market should be viewed more as a "value-added" play for the time being.

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

Tier-2 real estate markets

Property markets are segmented according to the location (capital cities and regional cities, differentiation of areas within capitals) and quality of the product (trophy assets vs. refurbishment and conversion of properties for instance). So real estate markets are "tiered", with "tier-1" areas being very expensive and "tier-2" areas offering "value". Tier-2 markets – "next-to-prime" may be a better definition – still offer value today. Fund managers are screening the investment universe to spot owners who are willing to sell their properties "off-market" (without using estate agents). "Off-market" deals can mean less competition and involve a "quick" sale (for cash-rich investors/fund managers). Alternatively, investors could investigate local markets for deals that are "in the market" and yet off the radar for institutional investors (because of the lack of size for instance). In any case, investment managers should never comprise on specific pre-deal investigations and analysis procedures (often referred to as due diligence), whether opportunities are found in or outside the market.

Value could build up as a result of many actions (often taking place simultaneously): physical upgrade of buildings before selling up, conversion of properties (ugly offices in loft apartments for example), enhanced asset management (selection of new tenants), cash injections in debt-burdened buildings, restructuring of vehicles where properties are lodged, etc. Although the investment focus should be geared towards drivers creating value, enabling capital gains upon exit, cash income could also constitute part of the overall equity return.

Similarly to our stance on prime assets, we are not developing any "top-down" approach. On the contrary a "bottom-up approach" – drawing on deal execution skills to originate value – is more pertinent. ***Consequently, the UK should not be ruled out from any value-added investment strategy (as opposed to a prime asset play). Target Internal Rate of Returns should be in double-digits to compensate for the higher risk borne and are likely to hover in the early double digits as discounts are narrowing.***

In addition to investments in the overall physical market, investment managers could also attempt to acquire stakes in other property funds that are traded in the secondary market (at a discount). Transactions regularly arise from investment players who need to adjust their investment strategy or want to dispose of interests in property funds for whatever reason (sometimes at a loss).

Residential real estate

We are positive on Europe's core housing markets, even though the difference in European house prices has been accelerating in recent months.

Several observations can be made. First, the interconnection between housing values and investment volumes has been ambiguous until now. In France, annual investment volumes were similar to pre-crisis levels as at end-April 2016, but in essence, the rebound in prices has been modest or uneven (source: Notaires de France). The Belgian coast saw transaction volumes climb by up to 50% in the first half of the year, though prices of apartments and houses stayed flat (source: La Libre Belgique Immo, 18 August). In Spain, annual housing volumes increased by over 20% in the year to end-March 2016, but fell by 10.2% in the first quarter of the year (source: Ministry of Development). Generally speaking, prices are lagging volumes, but the question is how long will this last?

In the UK – like commercial real estate – residential prices have been under pressure. This became pretty obvious in the high-end housing market, for which prices started to decline well ahead of the Brexit referendum. Initially, prices began to erode because of the higher amount of stamp duty last April. It remains to be seen how the "affordable" housing markets will be affected eventually. Housing prices fell by 1% in July following the vote to leave the EU (a survey from Halifax, Britain's biggest mortgage lender). Given the very low interest rates, and insufficient supply levels for housing units at reasonable prices, we do not predict a sudden crash for affordable housing in London. But prices may lose a few more percentage points in 2017 anyway (or be gridlocked at best).

Consequently, we see more potential for purchases in Continental European cities for the time being (Benelux, France, Germany, etc.).

Residential investments are providing a tangible cushion for investors' wealth (whether for owner-occupiers or for landlords renting out). And this should be the first investment rationale. Nevertheless, it may be somewhat laborious to beat inflation levels – albeit very low today – in the coming months, with capital values a little "rigid" in a number of countries. Beyond compare, existing attractive financing conditions (affordable monthly mortgage instalments, refinancing options) appear to be important key drivers for value preservation.

There are exceptions, with housing markets having accumulated much more value in recent years than what inflation would have suggested. Sweden's housing prices exceeded inflation by 12.1% in real terms in the year ended 31 March 2016 (source: Global Property Guide GPG), and we believe the negative yield on long-term sovereign bonds has been a remarkable "external" parameter for (overheated) growth in the country's housing values. Obviously, recovering residential markets has beaten inflation as well over the past 2 years (Spain, Ireland) although these countries were badly impacted by a slump in housing prices in 2008-2010. As the saying goes: "you can't compare apples to oranges".

So we remain positive on Europe's improving housing markets (Spain, Portugal, the Netherlands, Ireland) except Greece. And we warn investors that the biggest price hikes may be behind us (Ireland, possibly Spain)

North America

Commercial real estate

Tier-1 real markets (prime real estate)

We maintain our neutral view on prime real estate for the US markets.

Capital growth rates were still remarkable for the second quarter, "All Property" carrying an unlevered total return of 10.64% (source: NCREIF). But capital growth rates are expected to deteriorate in the coming months, as this is already evident right now, with pension funds in the US increasingly pulling capital out of the country's large open-ended property funds. The JP Morgan Strategic Property Fund alone has received USD 1bn (EUR 888m) in requests so far this year, while PRISA I, managed by PGIM Real Estate, has received USD 700m (source: IPE Real Estate, 24 August 2016). An additional risk consists in a further tightening of the monetary policy by the Fed before year-end.

Tier-2 markets

We change our recommendation from Buy to Neutral, as the price growth may come to an end. For overseas investors, the strong US dollar is making local real estate more expensive, which is a competitive disadvantage for the US.

Residential real estate

We are Neutral on the US housing markets, although the latest data of S&P Dow Jones on the US housing markets divulged still higher annual housing prices in May 2016, with Portland and Seattle being in pole position. Even though housing is doing quite well – supported by the relatively low interest rates (below 4% for 30-year mortgages) – we are projecting diminishing growth rates for housing values in the near future. Our story is comparable with what we have said about commercial real estate.

Emerging markets
(emerging Asia & Latin America)

Commercial real estate

Prime real estate
We are Neutral on selective investments across the emerging markets, in both Asia and Latin America.

We have always considered extra return opportunities as a first rationale for investing in the emerging markets. Prospects of better return opportunities may be structural (growing middle-class populations, economic development, favourable demographics and the like). Or return opportunities may be of a cyclical nature (opportunities for market timing). Unfortunately, from a European/American point of view, diversification into emerging markets has not always produced the expected total returns for the risk taken. Latin America is a good example, with Brazil severely suffering and currency effects dampening local property returns. The vicious downward spiral of depreciating (commodity) currencies nevertheless seems to have halted, with a number of emerging market currencies having appreciated somewhat in recent months (against both the US dollar and the euro). In Asia Pacific, investment volumes fell by 5% last year (source: Jones Lang LaSalle). In China, some development schemes have not produced the desired effects for investors whereas India's property markets have showed a lacklustre performance over the past few years. Hong Kong's high street rents may fall a further 10 to 15% this year.

Of course we acknowledge that property growth drivers remain fundamentally different (more positive) from other economically advanced regions, yet this will not automatically lead to (much) higher returns at this stage. There is still an additional risk involved. Generally speaking, Asian and Latin American property markets are affected by weaker growth in capital appreciation returns and the risk of an oversupply. Growth is steady but declining.

Some Asian "mature" markets have not been performing well, as evidenced by Singapore, where office rents fell by 13% in the year to end-March 2016 (source: Jones Lang La Salle). Other countries, like Japan, were put back on the investors' radar, pushing up prices (especially in Tokyo). But investors are now wondering whether Abenomics will eventually bring back economic growth and inflation on a sustainable basis. Can gross initial yields carried by commercial property fall much further in Tokyo? We do not think so. Australia in contrast has been performing well in the year to end-March 2016, with office rents soaring by 13% (source: Jones Lang LaSalle). But rents and capital values are projected to grow at less ambitious rates in the months ahead.

Our recommendation is Neutral for selective investments. Asia and Latin America are vast continents that are hugely differentiated property-wise, i.e. very similar to Europe. As a consequence, investors should seek advice from experienced fund managers/analysts to explore local markets and identify investment opportunities, with total returns mildly exceeding those booked by similar investments in Europe and North America. Unsurprisingly, deal execution skills and due diligence procedures are also important in this part of the world.

Residential real estate

Property in China's Tier-1 cities
We remain positive on property located in China's Tier-1 cities. China's new house prices continue to soar in June 2016 on a monthly basis. Hot spots are Shenzen, Xiamen, Nanjing, Shanghai and Beijing. But the overall Chinese housing market is a double-tiered market: Tier-2 and tier-3 markets still lost some value over the same period. For this reason, we are recommending investments in prime markets only.

We change our recommendation for Latin America's housing markets from Neutral to Sell, in particular for Brazil. In this country of the Samba, investors in residential real estate have not been shielded from the high inflation in recent months, losing almost 9% in real terms in the year ended 30 June 2016 (source: FipeZap index). What's more, nominal housing prices are set to decline as well in the coming months given the harsh economic (and political) conditions in this country. Currency movements across Latin America remain a risk for overseas investors in spite of some appreciation seen in recent months (e.g. +27% on 3 August 2016 for the Brazilian real since historical lows, source: Bloomberg).

What is the situation today?

Listed real estate

There is no doubt that REITs have offered international investors excellent potential to access real estate markets in general and enjoy attractive annual total returns (+6% for global listed real estate in the 10 years to end-August 2016, source: EPRA).

Property shares have higher volatility compared with the direct property market. UK REITs slumped by a staggering 14% (in sterling) on 24 June 2016, the day after the referendum, a wake-up call for many investors. A projected decline in real estate values can rapidly translate into share prices of liquid REITs. Nonetheless, REITs in other regions (Continental Europe, North America, etc.) reacted less aggressively on that day.

Share prices of REITs have since rallied, posting reasonable total returns in July and August 2016 (for example +6.25% for the FTSE EPRA/NAREIT Eurozone index in the three-month period ended on 8 September, source: EPRA). This is somehow logical because the supportive drivers of REITs have not disappeared over time: zero-interest rates and the subsequent spread of 300bp with gross average dividend yields. UK REITs were the sole exception to the recovery given the change in the local occupier markets (-11.85% for the FTSE EPRA/NAREIT UK index in pound sterling over the same period, source: EPRA).

We keep our positive recommendation for Continental European REITs, how astonishing this may be. Monetary policy remains a key driver. We now turn negative on UK REITs, as share prices may fall again in view of expected losses in capital values. We keep our neutral recommendation for US and Asian REITs. In North America, benchmark interest rates are projected to be raised once this year by the Fed (twice next year) whereas Asian REITs (including Japanese REITs) may not outperform due to weaker capital growth rates projected for a couple of occupational markets.

1. Macro-economic news

Economic factors affecting property
What is the expected impact of Brexit on the European economy, as well as on the UK economy? This is an important question as housing and commercial real estate are key components of any economy. So any changes in the real economy may have an effect on the volatility of real estate returns, the valuation of real estate itself (possibly with impairments) and the liquidity which property and related real estate investment vehicles may offer. For example, surveyors may be cautious about providing valuations reflecting projected changes in the economy, so a valuation bias may be introduced. Therefore, investors may decide to rapidly dispose of their assets or units in (open-ended) property funds to stay ahead of any upcoming valuation impairments.

Major economic factors affecting property values

- GDP growth rates. Any economic downturn may lead to tenant defaults while negative equity may affect home owners. At present, growth is weak in many parts of the world, though abundant capital has been offsetting the lack of growth and, more importantly, inflation so far in many areas;

- Purchasing power (of the middle classes) is a key issue. Retail spending (resulting into higher retail space and industrial space) and demand for housing are clear examples. Purchasing power and the level of nominal interest rates go hand in hand. The higher the interest rates, the weaker the mortgage reimbursement capacity, and vice versa. Therefore, the very low cost of borrowing has fuelled real estate markets in recent years. In countries where monetary policy is tight – such as Brazil today – housing prices have been lagging behind inflation (creating losses in real terms);

- Employment levels are drivers of office space. The City of London instantly posted capital losses in the month after the Brexit referendum.

Economic growth and inflation rates for mature market countries. Now that the dust is settling, our economists are focusing on real news. For example, are there any fears of an imminent recession in the UK? This could be dramatic for the country's inflated property (commercial and residential) values.

BNP Paribas Wealth Management expects UK economic growth rates to be affected, so GDP rates were revised downward a few days after the outcome of the referendum. ***First, UK growth should be almost 2% lower by the end of 2018 than it would have been if UK voters had opted to remain in the European Union.*** For 2016 and 2017, growth expectations rates have been set at 1.6% and 0.7%, respectively (source: BNP Paribas Wealth Management). Direct effects of the Brexit vote on the US are believed to be minimal. The Eurozone might see its economy expand by an unchanged 1.5% whereas Japan is still believed to be growing, albeit minimally.

With respect to the global economy, growth rates may slow from 3.1% in 2015 to 3% this year. Fortunately, the outlook looks a little brighter, with the growth rate of the global economy to inch up to 3.3% in 2017.

Main economic forecasts for mature countries (10/09/2016)

GDP growth (%)	2015	2016e	2017e
United States	2.6	1.5	1.6
Euro zone	1.6	1.5	1.0
Japan	0.5	0.4	0.1
United Kingdom	2.2	1.6	0.7
Inflation (%)	**2015**	**2016e**	**2017e**
United States	0.1	1.2	2.1
Euro zone	0.0	0.2	1.1
Japan	0.5	-0.2	0.5
United Kingdom	0.1	0.5	2.2

Table 1. Source: BNP Paribas Wealth Management

Obviously, Europe – and in particular Continental Europe is still perturbed by a lack of headline (and core) inflation. Consumer prices in the Eurozone rose by 0.2% y-o-y in July 2016, following a 0.1% gain in the previous month. Although this was the biggest rise since January 2016 (because of higher prices of food and services), consumer prices fell by 0.6% on the previous month (source: TradingEconomics). The core inflation rate, which excludes energy, food, alcohol and tobacco prices, was confirmed at 0.9%, the same as in the previous month. In other words, the loose monetary policy conducted by the European Central Bank has still not led to desirable inflation levels, prompting the ECB to keep its deposit rate at minus 0.4% and the main refinancing rate at 0.00% (source: ECB, 21 July 2016). The ECB also repeated that its EUR 80bn per month asset-buying programme would run until March 2017, or beyond if necessary, until it sees an upward adjustment of inflation toward its 2% target.

All in all, the Eurozone is expected to see a headline inflation of a pointless 0.2% in 2016, similar to Japan (-0.2%) where Abenomics has not yet brought the preferred effects with respect to inflation. Elsewhere, inflation forecasts for the UK and the US are set at 0.5 and 1.2% respectively.

Meanwhile, the Bank of England's Monetary Policy Committee activated its Quantitative Easing programme again: it slashed the Bank Rate to 0.25% on 4 August 2016, the first rate cut in seven years, in order to provide additional support to growth and to achieve a sustainable return of inflation to the 2% target. Additional measures included: the purchase of up to GBP 10bn of UK corporate bonds and an expansion of the asset purchase scheme for UK government bonds of GBP 60bn, taking the total stock of these asset purchases to GBP 435bn (source: Bank of England, 4 August).

Economic growth and inflation rates for emerging market countries. With respect to emerging markets, the key question is whether past growth will return. As a reminder, economic growth rates are currently subdued whereas inflation rates are often approaching levels seen in mature countries. Emerging market currencies struck a serious blow last year, along with a number of commodity currencies of mature markets, as explained in the next chapter, though the worst seems to be behind us.

In China, BNP Paribas Wealth Management economists reckon that China will achieve an economic growth of 6.6% for 2016 (vs. 6.9% last year) and 6.3% in 2017. The country's inflation level should come in at a mere 2% this year before slightly accelerating thereafter. Indeed, consumer prices in China rose by 1.8% y-o-y in July of 2016, compared with a 1.9% rise in June. This is the lowest inflation rate since January 2016.

Brazil is a very difficult case, as it has been in a deep recession since early 2015. Its economy should contract by a hefty 3% this year (vs. -3.8% in 2015) whereas inflation increased by 8.74% y-o-y in July 2016, easing from an 8.84% growth in June but well above the central bank's official target of 4.5%. Meanwhile, the central bank's key interest rate remained unchanged at an outrageous 14.25% in July 2016. For 2016, we are projecting an inflation rate of 8.8%. As outlined in the section on Latin America's housing markets, housing prices are not capable of keeping up with rolling inflation. As a result, values have started falling in real terms (and recently even in nominal terms).

Main economic forecasts for emerging market countries (10/09/2016)

GDP growth (%)	2015	2016e	2017e
China	6.9	6.6	6.3
India	7.2	7.9	8.3
Brazil	-3.8	-3.0	2.0
Inflation (%)	**2015**	**2016e**	**2017e**
China	1.4	2.0	2.2
India	4.9	5.4	5.0
Brazil	9.0	8.8	5.0

Table 2. Source: BNP Paribas Wealth Management

Last but not least, there are a number of positive factors... - The still very low nominal (and real) interest (or outright negative) rates in many parts of the world. How stunning this zero-interest rate environment is! And not only for the "usual" Continental European countries such as Switzerland and Germany, followed by the UK, but also for mature countries in the Eastern hemisphere (Singapore, Hong Kong, China, etc.).

Ten-year government bond yields, ranked from low to high (as at 9 September 2016)

Major Countries	Actual (%)	2/24/16	change (bp)
Switzerland	-0.46	-0.40	5.6
Germany	-0.04	0.14	17.8
Japan	-0.02	-0.05	-3.0
UK	0.80	1.37	56.6
Hong Kong	0.89	1.38	49.0
Spain	1.02	1.64	62.0
Canada	1.08	1.10	1.7
Italy	1.18	1.55	37.1
US	1.62	1.69	7.4
Singapore	1.67	2.19	52.0
Australia	1.96	2.39	42.6
China	2.83	2.89	6.0
Portugal	3.14	3.25	11.3
Peru	5.68	7.02	134.0
Indonesia	6.89	8.26	137.0
Colombia	7.02	8.84	182.0
Greece	8.27	10.98	271.5
Turkey	9.36	10.53	117.0
Brazil	12.05	15.63	358.0

Table 3. Source: Bloomberg, TradingEconomics

Some countries are actually subject to negative long-term interest rates, such as Switzerland, Germany and Japan. Another striking trend is that the yield carried by 10-year Chinese sovereign bonds seems to be converging towards the yield on similar US government bonds, namely 2.83% in China vs. 1.62% in the US Consequently, the difference is a mere 1.21% (source: Bloomberg, 9 September 2016). We could argue that these very low interest rates have in some manner distorted capital markets, with investors favouring "alternative" investments such as real estate. Actually, real estate still looks attractive if we compare property yields with risk-free interest rates, thus from a relative point of view. As a result, property values have been strengthening in many countries because of monetary policy, whether or not this performance has been justified by the occupier markets.

It is still unclear when the Fed will raise its benchmark rate a second time (first time end-December 2015), but our strategists predict a hike of 25 bp (to 0.75%) before year-end (with two additional hikes of 25 bp in 2017). If the increase were to materialise, this would imply a divergence between monetary policies across the world, though to a limited extent. Having said this, prospects of a further increase – together with the uncertainty about timing – occasionally brings butterflies in investors' stomachs. In Continental Europe, no interest hikes are expected before the end of next year.

Wide losses on emerging market currencies have been reversed in part. This is good news, at least for international investors. Latin American (as well as other emerging markets) currencies hit bottom, and started reversing part of previous losses. The Brazilian real is a good example, because it appreciated against both the euro and the dollar by 26.97% and 29.13% respectively in the 6 months to 11 August 2016. Other currencies – such as the Colombian and the Chilean peso – were also capable of erasing part of previous currency losses, even though there's still a long way to go. For example, the Brazilian real was barely trading at 1.6 against the greenback on 18 July 2008 (still 49% higher than on 11 August 2016, source: www.xe.com).

Currency movements against the euro and the dollar in the 6 months to 11 August 2016 (appreciation against the EUR ranked from high to low)		
Major Countries	6-month change against the EUR (%)	6-month change against the USD (%)
Brazil (BRL)	26.97	29.13
Russia (RUB)	21.66	22.75
Colombia (COP)	18.97	19.46
Chile (CLP)	11.00	13.03
Australia (AUD)	8.96	9.16
Canada (CAD)	6.71	7.76
Peru (PEN)	6.44	8.24
Norway (NOK)	4.53	5.52
Singapore (SGD)	3.79	4.80
Indonesia (IDR)	2.84	3.99
Poland (PLN)	2.25	3.34
Thailand (THB)	2.21	3.17
Hong Kong (HKD)	0.42	1.33
Argentina (ARS)	-0.43	1.19
Turkey (TRY)	-0.99	-0.11
Hungary (HUF)	-1.02	-0.06
China (CNY)	-1.08	-0.27

Table 4. Source: Bloomberg

There are negative factors as well. The British pound has slipped by 9.9% since British voters decided to leave the European Union (source: Bloomberg, 9 September 2016). Wealth Management forecasts the pound to settle at 0.83 against the euro before year-end. In addition, the greenback is expected to trade at 1.08 against the euro in 3 months.

2. News from the investor front

Open-ended structures and liquidity are not necessarily a cosy tandem.

Liquidity may be an issue for specific property vehicles, and this has been plainly demonstrated in the days after the Brexit shock. As investors felt uncomfortable with the "leave" vote, fearing a negative impact on overall property valuations, they started redeeming part of their units that they had built up in "open-ended" fund structures. The open-ended structure of property funds allows for regular redemption, yet the system falls apart if investors massively ask for their money back. As a consequence, several UK open-ended property funds (with about GBP 18bn of properties under management) had no other option but to "freeze" redemption requests (or mark down asset values) in the first few days after the referendum.

Property funds suffered GBP 1.4bn on the Brexit announcement and trading for open-ended funds was suspended.

Retail investors withdrew GBP 1.4bn from property funds in June 2016, 6% of the sector's assets. Overall, a net GBP 3.5bn was withdrawn from retail funds during the referendum month (source: Investment Association, Financial Times, 3 August 2016). This was a greater outflow than during any month during the 2008 crisis. Moreover, it was a tough week for commercial open-ended property funds immediately after the referendum. Seven large vehicles with combined assets of GBP 15bn were forced to halt trading, thus leaving investors trapped. Open-ended vehicles run by Standard Life, Aviva and M&G first interrupted trading after investors' redemption requests absorbed their holdings of cash and listed real estate investment trusts (REITs), held alongside direct property assets. Subsequently, Columbia Threadneedle and Henderson Global Investors also suspended their UK property funds while Canada Life stopped trading in a smaller property fund holding. Aberdeen Asset Management applied a 17% discount to its fund on 27 June Before reducing the discount to 7% on 21 July 2016.

UK real estate investment volumes were in free fall in the months prior to the Brexit vote.

The UK saw a slowdown in commercial real estate investment across Europe in the first half of 2016 (source: Real Capital Analytics), showing that uncertainty deterred buyers from new investments. Consequently, the UK registered a 45% decline from a year earlier to EUR 29.5bn, and accounted for more than half of the total decline in investments in European commercial real estate over the period. With respect to London, the value

of transactions in the capital fell by 52% to EUR 14bn in the first half of this year.

Meanwhile, international buyers remain a key driver for UK property investments, accounting for a 28% slice of overall transactions today (source: Investment Property Forum research). This compares very favourably with the 17% registered in 2007.

The UK's London City office market is 61%-owned by overseas investors, while the West End and Midtown office markets now make up 39% of overseas investments. It will be interesting to see whether overseas investors will continue to pick the London as a top investment spot in the coming months.

Cross-border investments buoy up the Italian property markets.

Cross-border investments in Italy's property market were very energetic in the first half of this year. They represented EUR 3.4bn of overall investment transactions or an increase of 35% on the same period last year. Significantly, cross-border investment volumes absorbed more than half of the 1H16 total investment volumes (source: Savills Europe). International funds are predominantly dominating the market, with 80% of foreign capital from Europe.

Russian investors head back to the Dubai real estate market.

Russian investors have returned to the Dubai real estate market after staying away due to the record fall in the value of the rouble in 2015. Statistics published by Dubai real estate portal PropertyTrader.ae for the first half of 2016 disclosed a significant rise in overseas enquiries from Russian visitors, highlighting a renewed interest in the emirate. Russia has always been a key market for Dubai (such as Emirates Hills and the Palm Jumeirah) though appetite from Russian buyers waned when the local dirham became too expensive for them. In January 2016, search engine hits on PropertyTrader.ae from Russia made up a low 6% of overall internet traffic, yet in July it was up by nearly three times at 17%. In 2015, the Dubai Land Department ranked Russian investors as the sixth-largest group of foreign buyers in Dubai's realty sector.

3. News from the listed real estate sector

High volatility in REIT performances in the days after the Brexit vote.

REITs are property stocks: they are invested in real estate, yet they have the characteristics of common stocks **in the short term** (for example with respect to volatility). This was particularly striking on 24 June 2016, the day after the referendum, with share prices of REITs tumbling. The UK's listed REIT market was the biggest loser of the turmoil. According to the European Public Real Estate Association (EPRA), the FTSE EPRA/NAREIT UK dived by roughly 14% that day. However, the latter losses were expressed in pound. Once converted in Euro, losses hit an appalling 19.2%.

However, price declines were very uneven, and there was no reason for investors to start panicking. The listed UK sector had been underperforming Continental Europe in a dramatic way well ahead of the Brexit vote. The fear of an increase in implied gross initial yields (capitalisation rates) carried by the REITs' underlying property assets caused share prices in UK REITs to nose-dive by 14% in pound sterling. With an average LTV ratio of about 30% posted by UK REITs (source: EPRA, July 2016), this corresponds to a 4.2% capital loss at the property level (equity and debt combined). In the chapter on European commercial markets, we expect commercial values to fall between 10 and 15% on average in the next 18 months.

In point of fact, Hammerson – the FTSE 100 retail REIT – revealed a decline in the value of the British part of its overall portfolio in the first half of this year (source: Hammerson, 1H16 results, 25 July 2016). This REIT, which owns UK shopping centres including Brent Cross and a stake in the Bullring in Birmingham, said that GBP 51m was wiped off the value of its UK properties in the 6 months to the end of June. The company blamed the increase in stamp duty last April and price weakening for UK retail parks (upward yield shift for parks, no yield shift for shopping centres). Relevantly, **the drop in Hammerson's UK assets was more than offset by the rise in the value of its French portfolio in the first half of the financial year.**

In contrast to UK REITs, Continental European REITs were much better off: even though the FTSE EPRA/ NAREIT Europe ex UK index fell by 4% (in euro) on Friday 24 June, the index managed to reverse losses on Monday 27 June. Furthermore, Asian (ex. Japan) and North American REITs were more insulated from the stock market turbulence as well.

A huge discrepancy in performances in Europe.

In mid-August 2016, we studied the following performance for REITs: a huge disparity in REIT performance was observed across Europe in the 6 months to 18 August 2016. Continental Europe was the top performer in euro (+15.53%), which was in sharp contrast to the UK, reporting an 11.09% loss (in euro including currency losses on the pound) over the same period. Remarkably, UK REITs lost a minor 1% in pound in the 6-month period ending on 18 August 2016. North America fared slightly better than Continental Europe, with a 16.89% total return (in euro, +19.3% in US dollar). Conclusion: currency movements do matter! The table below shows total returns generated by REITs for different periods ended 31 August 2016.

REIT Total return (local currency - including gross dividends) as at 6 September 2016

	1M	1Y	5Y*	10Y*
Real Estate Asia ex. Japan	4.3%	15.3%	6.9%	6.5%
Real Estate Japan	2.8%	-2.1%	16.2%	0.6%
Real Estate Europe excl. UK	2.5%	22.0%	16.0%	6.3%
REITS UK	4.1%	-6.3%	13.9%	-0.4%
REITs North America	-1.0%	29.3%	13.9%	6.4%

**Annualised return*

Table 5. Source: BNP Paribas Wealth Management RESIG

The combination of declining long sovereign bond yields in many parts of the world and the decline in capitalisation rates carried by prime/core assets make these dividend plays very appealing in relation to the almost zero-income derived from other asset classes, such as overpriced investment-grade government and corporate bonds. The loose monetary policy implemented by the ECB has been helping the above situation a great deal in recent months. And in other continents, such as the US and Asia, 10-year government bond yields have been gradually declining as well, although the monetary policy started diverging between the US and Continental Europe/Japan when the Fed raised its benchmark rate by 25 bps last December. Nonetheless, upcoming interest rate hikes may be limited in the near future, maybe one hike before year-end (and in spite of the anxiety this one single-rate move is already causing). In Asia, there seems to be more confidence about REITs, although J-Japan performance has been unsatisfactory so far. As expected, the Japanese economy showed no growth in the second quarter of 2016 (following a 0.5% expansion in the first quarter). On an annualised basis, the economy advanced by a poor 0.2%. Investors have started wondering whether Abenomics will ever work.

Pricing of public real estate (liquid property shares) is more sensitive to a change in interest rates, at least in the short run. REITs can be easily sold by primarily institutional investors, bringing down share prices. But today, jitters over higher interest rates are somehow easing, and we expect investors to continue to focus on the spread between the usual risk-free interest rates and gross dividend yields. The difference can be as high as 300bp, even if we acknowledge - similar to gross initial yields carried by prime assets - that the divergence emanates more from the artificially low nominal interest rates than the "high" dividend yields.

Recommendation

We maintain our Buy recommendation for Continental European REITs at this stage given the zero-interest rate monetary policy. We think it is still too early to take profit, how astonishing this may appear.

Conversely, we stay Neutral on the US. Although North America REITs are very popular, interest rates may rise before year-end and overseas investors could be affected by a mildly weakening dollar. We also keep our Neutral opinion on Asian REITs (including for Japan, where we really hope the monetary policy will pay off in the end).

For the UK, we change our recommendation from Neutral to Negative. It is true that UK REITs have not suffered too much in pound sterling in recent months, aside from high volatility on certain days and even though the negative currency effect against other currencies has been ignored. But we believe that prices of private real estate can fall further in the months ahead, which would exert downward pressure on the net asset values of REITs, and on share prices too.

4. News from the world's residential markets

The housing data below were taken from the Global Property Guide (GPG, www.globalpropertyguide.com). The table shows the performance of the world's major housing markets, with official statistics for the year to end-March 2016 as well as the quarterly changes in 1Q16. Data are shown in real terms (adjusted for inflation), allowing oranges to be compared with oranges (data for countries that have inflation look "better" in nominal terms).

We note the huge difference with the ranking for the 12-month period to end-September 2015, published in our previous report published in mid-March 2016!

In 1Q16, **Hong Kong** ended up bottom of the list, with an annual loss of 9.9% (-5.93% quarterly). Hardly 6 months earlier, Hong Kong still ranked in third position, with a 12.64% hike in prices in the 12-month period to 30 September 2015. In addition, **São Paolo** was also a loser in the first quarter of the year, for the first time in a long time. Prices in the economic capital of Brazil dived by over 7% in real terms (due to high local inflation). Even "mature" **Singapore** had to stomach a price decline in real terms.

There are other striking divergences. **Turkey** came first in 1Q16, with annual housing prices having accelerated by over 19% in March 2016 (vs. 11.6% in the 12-month period to end-March 2015, so capital growth rates held up). Turkey's housing market has been elevated by strong foreign investment and a growing population, despite an eroding currency, dissatisfaction with the government, chaos on Turkey's doorstep in Syria and Kurdish Iraq and rising internal tensions. Manifestly, it remains to be seen whether growth in prices will prove sustainable or not in the near future, certainly in the aftermath of the failed July coup.

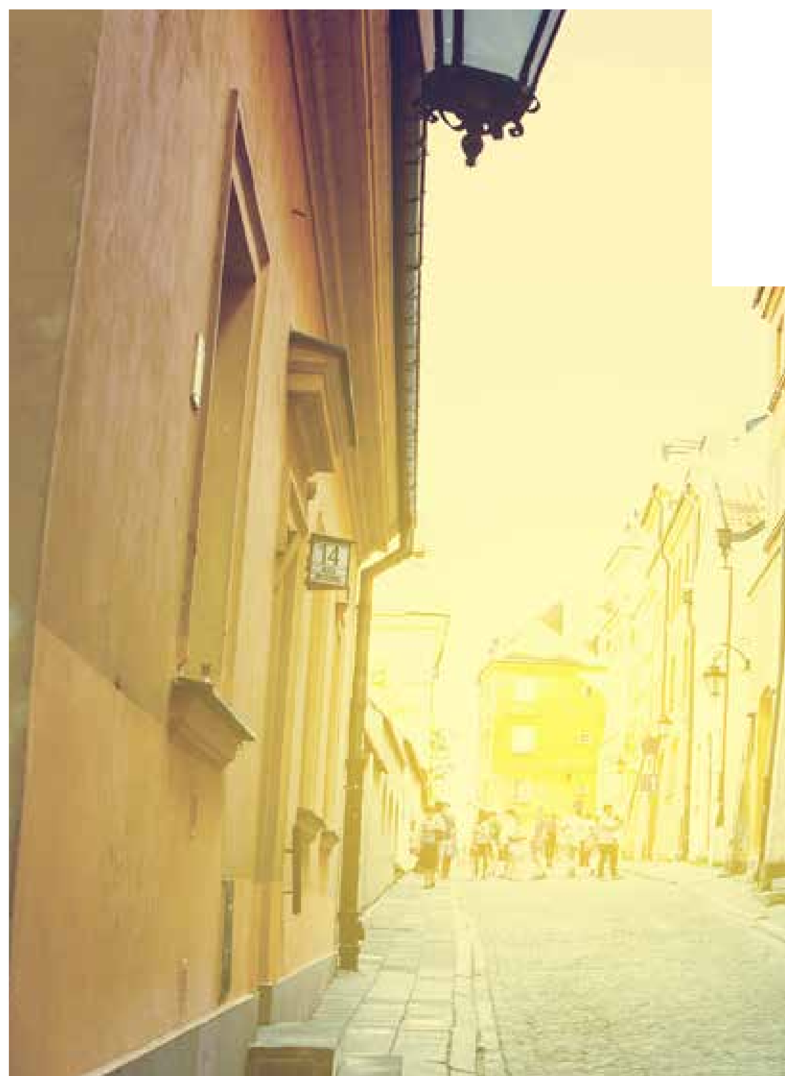
Secondly, six of the eleven Asian markets reported in the table benefitted from housing price increases in 1Q16, albeit modestly. But **Shanghai** performed genuinely well, posting a strong growth of 16% y-o-y because of new government measures to support the housing market. As a matter of fact, the increase in Shanghai – the highest annual rise since 2Q08 - needs to be compared with the decline of 2.9% observed last year over the same period.

Thirdly, **Sweden** remains very strong with housing prices having soared by 12.1% in the period to March 2016. We think this magnificent outcome is the result of a combination of factors, namely the central bank's negative interest rates, a lack of housing supply and the country's robust economic growth. Quarterly housing prices climbed by a further 2.4% in the first quarter of 2016.

Qatar's property market is rapidly weakening (in spite of the 2022 FIFA World Cup), though it remained the world's fifth-strongest housing market in 1Q16. The nationwide real estate price index rose by 9.27% during the 12-month period to March 2016, sharply down from a y-o-y rise of 27.81% in 1Q15 (source: Global Property Guide).

There are some striking consistencies as well. **Russia** came last mainly due to low oil prices, the collapse of the rouble and a steep economic contraction. Russian annual residential property prices tumbled by 13% in 1Q16, worse than the 9.7% slump in 1Q15. **Ukraine** is also still in red territory. And **Dubai** housing prices remained likewise depressed: it looks as if the current property downward property cycle will last longer than initially expected because of structural oversupply in specific areas.

Price changes in real terms for 46 countries for the 12 months to end-March 2016, together with quarterly changes in 1Q16. Annual price changes in 1Q16 are ranked from high to low



Price changes in real terms for 46 countries for the 12 months to end-March 2016, together with quarterly changes in 1Q2016. Annual price changes in 1Q2016 are ranked from high to low

Rank	Country	y-o-y (%)		q-o-q (%)*	Rank	Country	y-o-y (%)		q-o-q (%)*
		1Q15	1Q16	1Q16			1Q15	1Q16	1Q16
1	Turkey - Istanbul	11.61	19.05	4.99	24	South Korea	1.38	1.81	0.27
2	China - Shanghai	2.90	16.64	6.18	25	Spain	2.12	1.69	3.85
3	Sweden	9.14	12.10	2.37	26	Slovak Republic	0.78	1.53	0.94
4	Romania	0.99	11.55	7.50	27	Norway	5.17	1.38	2.79
5	Qatar	27.81	9.27	4.51	28	Estonia - Tallin	9.59	1.14	0.14
6	Ireland	17.57	7.74	0.12	29	Finland	1.04	0.82	0.91
7	Germany	6.04	6.25	1.95	30	Jersey	5.22	0.70	1.75
8	Netherlands	2.55	6.09	1.13	31	Thailand	7.04	0.42	0.54
9	Canada	3.57	5.67	0.20	32	Switzerland	2.80	0.33	0.07
10	Japan - Tokyo	6.34	5.50	5.49	33	Indonesia	0.26	0.16	0.24
11	Mexico	1.73	5.26	1.57	34	Montenegro	12.81	1.06	5.38
12	Iceland	7.71	5.10	1.43	35	South Africa	1.52	1.30	2.18
13	UK (Nationwide)	5.86	4.78	0.87	36	Singapore	3.54	2.35	0.43
14	US (FHFA)	5.29	4.54	1.24	37	Ukraine - Kiev	36.52	2.97	0.65
15	Israel	8.50	4.52	1.37	38	Greece	1.78	4.39	1.71
16	US (Case-Shiller)	4.41	4.29	0.21	39	Brazil - São Paulo	1.20	7.59	2.37
17	Philippines - Makati CBD	5.40	3.90	2.54	40	Taiwan	0.98	7.65	2.09
18	New Zealand	7.85	3.63	6.25	41	UAE - Dubai	2.72	9.26	0.33
19	Lithuania - Vilnius	4.00	3.56	1.00	42	Egypt	2.07	9.49	12.21
20	Macedonia	2.46	3.29	3.84	43	Hong Kong	14.62	9.91	5.93
21	Portugal	1.53	3.18	0.56	44	Puerto Rico	5.53	10.33	1.92
22	Latvia - Riga	0.37	2.24	0.46	45	Mongolia	14.28	11.93	2.45
23	Vietnam	0.48	1.93	0.67	46	Russia	9.65	13.04	3.93

Table 6. Source: Global Property Guide

News from the various regions

1. News from Europe

1.1 Commercial markets

Brexit and risk catapulted to higher levels
Could UK commercial (and even Continental European) real estate be subject to a swing in risk sentiment, for example a swing triggered by the outcome of the Brexit referendum held on 23 June? As always, a swing could be psychological rather than economic with respect to commercial real estate, yet we believe the risk-pricing pendulum might swing towards fear – thus leading to risk-aversion. But Brexit is not the only driver.

As a matter of fact, the nervousness sparked by the referendum almost immediately affected commercial values in London. But not all the "mayhem" is due to Brexit; the fact is that record prices – with very low gross initial yields as a result – have prevailed for almost all prime/core assets in London over the past few years, and in many other prime areas of Europe as well. Actually, real estate pricing was reinforced by comparing the expected real estate returns implied by the very low capitalisation rates with long-term sovereign bonds. The yield on the latter was – and still is – very low (like in the UK) or even outright negative in countries like Germany, Switzerland and Sweden. As such, risk premiums have been reversing in recent years, though they are still hovering in the region of 3% given the differential between property yields and "risk-free" rates. As stated in our previous reports, the 300 bps spread can be misleading one way or another, with risk-free rates artificially kept at insignificant levels.

So even before the Brexit announcement, a healthy and probably mild re-pricing has been on the cards. And this could occur once capital markets start functioning properly with nominal interest rates ending at (slightly) higher levels than today.

A number of questions should be asked:

- Will prime gross initial yields move up in the UK? And in Europe as a whole?

- Will Continental Europe benefit from the overall uncertainty hanging over the UK, and will this lead to attractive investment opportunities across the continent? Will real estate grow at different paces?

- Will volatility across property markets be long-lasting? Or is this a short-term phenomenon, with investors gradually screening the UK market for new opportunities?

- Would a change in interest rates be more dangerous than Brexit?

Before determining which direction Europe's commercial real estate will take, we analysed the European commercial property markets in 1H16.

Lower investment volumes in 2Q16
Commercial real estate investment volumes totalled EUR 54bn in 2Q16, marginally up on the first quarter, yet 18% down on the EUR 66bn recorded in 2Q15 (source: CBRE European Investment Quarterly, 2Q16). On a half-year basis, the first half of 2016 was less strong than 1H15. Europe's two largest markets, the UK and Germany, pushed overall investment volumes lower in 2Q16, though for different reasons. Understandably, the UK saw lower volumes in the run-up to the Brexit vote whereas Germany simply lacks available core/prime products for investors. Conversely, France and Sweden witnessed a strong quarter, with investment volumes growing significantly. Offices still took a considerable slice (44%) of total transaction volumes in 2Q16. With regards to the hotel sector, volumes surprisingly halved to a 7% compared with 2Q15.

Capital values were barely higher while prime gross initial yields were unchanged or slightly lower in 1H16
Commercial property values across all asset classes in Europe either stabilised or continued to go up in 2Q16 (source: Jones Lang LaSalle, EMEA Research 2Q16).

With respect to **offices**, Paris recorded the lowest prime yields in the second quarter, at a paltry 3.25%. London prime offices traded at 3.50% in the same quarter. Berlin, Frankfurt, Milan, Brussels and Warsaw were subject to an inward yield shift (lower yields) while property yields in other cities remained unchanged.

Moreover, **retail** assets also performed very well in the same period, with London experiencing prime yields as meagre as 2%! Retail prime yields hovered below 4% in most cities in the second quarter. Madrid, Milan, Frankfurt and Berlin saw their prime yields compress further.

Meanwhile, the **warehousing** sector pursued its contribution to capital performance, with prime yields varying from 4.50% in London to 6.75% in Warsaw (apart from Moscow carrying 12%). Prime property yields in Milan and Amsterdam decreased by 15 bps in 2Q16 whereas warehousing yields fell by a more tangible 65 bps in Madrid.

Prime GIYs carried by Offices, Retail and Warehousing in 2Q16 (with yield shift, if any)

Office

City	Prime Yield (%)	Yield Shift q-o-q (bp)
Paris	3.25	0
London	3.50	0
Stockholm	3.75	0
Berlin	3.85	-15
Madrid	4.00	0
Frankfurt	4.15	-20
Milan	4.35	-5
Amsterdam	4.75	0
Brussels	4.75	-50
Warsaw	5.00	-25
Moscow	10.50	0

Retail

City	Prime Yield (%)	Yield Shift q-o-q (bp)
London	2.00	0
Paris	3.00	0
Amsterdam	3.50	0
Madrid	3.50	-25
Berlin	3.70	-5
Brussels	3.75	0
Frankfurt	3.75	-5
Stockholm	3.75	0
Milan	3.90	-10
Warsaw	5.00	0
Moscow	11.00	0

Warehousing

City	Prime Yield (%)	Yield Shift q-o-q (bp)
London	4.50	0
Frankfurt	5.25	0
Amsterdam	5.35	-15
Berlin	5.40	0
Paris	5.50	-20
Stockholm	5.75	0
Madrid	6.10	-65
Brussels	6.50	0
Milan	6.75	-15
Warsaw	6.75	0
Moscow	12.00	0

Table 7. Source: Jones Lang LaSalle. EMEA Research 2Q16

Even though prime yields registered record lows in 2Q16, spreads between net income yields (after operating costs) and long-term "risk-free" interest rates have remained intact (often above 200 bps) due to the ever-falling long-term sovereign bond yields across Europe (including the UK). In this zero-interest rate environment, risk premiums can be ambiguous. The 2% spread could be perceived as a compensation for interest rate risk (unanticipated higher interest rates in the future) rather than a remuneration for embedded real estate risk.

Is capital performance based on rental growth?

According to BNP Paribas Real Estate (At a glance - Main office markets in Western Europe, 2Q16) half of European city prime office rents have increased over the past 12 months, *"but no significant change occurred in 1H16 except a rise for Berlin (+6%), which hit a historic high. The apparent stability of rents in other cities may be hiding a gradual reduction in incentive packages which typically anticipate headline rents increases".*

In recent years, income trends have not always been synchronised with values in the sense that office values have been appreciating much faster than office rents. The London office market was maybe an exception to this observation, as rents have grown considerably as well over the last few years. The reason is that factors which may determine capital values – such as strong investment appetite - are not necessarily reflected in rents. In fact, rental values mirror more the strength of the occupational markets. Prime housing markets (worldwide) are another good example.

Change in European office rents in the 12-month period to end-June 2016

City	EUR/m²/year		Change
	2Q16	2Q15	
Central London	1 850	1 700	8,8 %
Central Paris	800	780	2,6 %
Dublin	610	590	3,4 %
Luxembourg	570	540	5,6 %
Milan	480	480	0,0 %
Frankfurt	450	450	0,0 %
Munich	420	420	0,0 %
Amsterdam	370	360	2,8 %
Madrid	350	330	6,1 %
Berlin	320	280	14,3 %
Vienna	310	310	0,0 %
Hamburg	310	300	3,3 %
Brussels	280	280	0,0 %
Lisbon	210	220	-4,5 %

Table 8. Source: BNP Paribas Real Estate, 2Q16

The Brexit aftershock…

We believe GIYs are set to move out not only in London but also in the rest of the UK. This was already evidenced by the CBRE's United Kingdom Monthly Index of July 2016. Rental values across the UK's commercial property market were steady in July, while capital values fell by 3.3%. The City of London was markedly affected, with capital values deflating by 6.1%. Assuming acceptable loan-to-value ratios of 50% on average, equity **appreciation returns** dived by 12%.

Overall, capital value declines in the Central London office market was the same as for offices across the UK, at minus 4.1%. This came somewhat as a surprise to us. Capital values for "All Retail" fell by 3.6%, but the industrial property segment was more insulated with a lower fall of -2.2% for the month (source: CBRE Monthly Index, July 2016).

It is somewhat logical that the office sector has been impacted most by the Brexit vote. Bankers and financial services companies have been trying to weather the turmoil since the Brexit vote, yet they will have to decide in the coming months whether Brexit means that businesses and jobs will be shifted away from London or not. And if so, to what extent? Much will depend on the EU's "passport" rules, under which banks, asset managers and other financial firms in one member state may serve customers in the other 27 without setting up local operations. *"That is how the British subsidiaries of non-EU banks (American, Japanese and Swiss) are able to do business throughout Europe from London, and a big reason why London has become the EU's financial capital"* (source: The Economist, 24 June 2016). It is possible that these passport rights will be lost in the EU, so staff could be relocated to other capitals such as Dublin, Frankfurt, Paris and Luxembourg.

Let's analyse a theoretical example. If about 100,000 people from financial firms were to move to other European capitals, assuming an office standard of roughly 13 m² per person, this would lead to a fresh office take-up of 1.3 million m². An incremental 1.3m m² of office space may eventually result in higher rents, declining vacancy rates and higher values, depending on local supply-demand patterns.

Moreover, international investors may adopt a "wait-and-see attitude" in the short term (before possibly returning to the UK market thereafter). Asian investors are the largest international group with direct real estate investments in the UK (source: Jones Lang LaSalle). Hong Kong-based Great Eagle, which owns The Langham, London, had negotiated to buy private land in London's trendy Shoreditch neighbourhood to build an Eaton Hotel, part of the group's lifestyle brand. But the group announced mid-July it had suspended plans for the GBP 250m real estate project because of the uncertainty following Britain's decision to withdraw from the European Union (source: Bloomberg, 15 July 2016).

Interestingly, Norway's sovereign wealth fund Norges Bank Investment Management (NBIM) wrote down the value of its UK property holdings by 5% following Britain's vote to leave the European Union, citing market uncertainty. The Government Pension Fund Global has significant exposure to UK property, with 16% of its NOK 221bn (EUR 23.6bn) real estate portfolio in London and 23% in the UK. NBIM stated in its 2Q16 report that the fund's external valuers had decided against any change to the UK portfolio's value, as there was a shortage of data on the impact of Brexit. But NBIM decided to write down the value of its UK property assets by 5% (source: IPE Real Estate, 17 August 2016).

Other news from Europe: a Dutch pension fund to transform Amsterdam's red light district

Syntrus Achmea Real Estate & Finance is to take part in a EUR 300m makeover of Amsterdam's red light district. The private-public project between the Amsterdam's city council and housing corporation Stadgenoot aims to transform part of the area into residential housing while increasing the variety of shops. According to Syntrus Achmea, the project already represents around EUR 150m of real estate taken over by the council. The Dutch investment manager said this amount could double when all planned takeovers in the area have been completed, including a number of properties owned by housing corporation Ymere (source: IPE Real Estate, 17 May 2016). Syntrus Achmea said pension funds would be able to subscribe to the investment and generate "stable and low risk returns of 4%".

Hunt for Agricultural land in Romania.

Romania seems to be the favourite playground for investors who want to buy "cheap" agricultural land (and forests). In this country, the price of one hectare ranges from EUR 2,500 to EUR 6,000, a fraction of the average of EUR 40,000 fetched in Western Europe (source: Trends/Tendances, 3 August 2016).

What direction is Europe's commercial real estate taking?

Since August, there have been no new data on capital appreciation returns for the rest of Europe. We are of the opinion that Continental Europe will be insulated due to the Brexit saga, with capital values continuing to hold steady for a few months. Commercial real estate (in particular prime) is likely to be priced the same by investors (thus expensive), given the scarcity of prime

products in a couple of regions (Germany for instance), overseas investors hunting for core assets across Continental Europe (expanding their asset base while putting their faith in the euro as well) and the very low nominal interest rates which are projected to hover at ridiculously low levels for a while.

A significant impact on investment volumes and capital values in the UK.
Without a doubt the impact on both occupier and investment markets may be pronounced, certainly in the short to mid-term. We believe the uncertainty is more related to the demanding valuation multiples observed over the past few years than to Brexit in itself. What might be the fair value for offices in the City in the coming months for instance?

BNP Paribas Real Estate (press release on Brexit, 5 July 2016) expects investment volumes to fall by about 25% in 2016, and as said previously, the slowdown in the market had already been underway well before the referendum. Be that as it may, what will be the impact of declining investment volumes on capital growth returns? In other words, how will gross initial yields progress over time? As always, the extent to which gross initial yields move out in the near future will primarily depend on the intrinsic quality of the type of property and on the (sub)location.

Although the answer to this question is not easy, we believe that Brexit may erode 10 to 15% on average of the appreciation return at the property level over the coming 18 months. In this case, **equity appreciation returns** – with a presumed LTV ratio of 50% - could plummet by a heavy 20 to 30%. As a reminder, office values in the City fell by 6% in the month of July alone, implying an equity appreciation return of minus 12%. Evidently, income returns (net rents) need to be added in order to establish the overall total return, yet cash returns come in at a few per cent only per year. For overseas investors, the picture may look even more alarming when factoring in the depreciation of more than 10% of the pound (against both the US dollar and the euro since the Brexit vote (as at 19 August 2016).

We remind the reader that other parameters need to enter into the equation as well to forecast upcoming real estate pricing, such as a change in nominal interest rates, the pace of forthcoming development schemes, availability of investment capital and inflation. Fortunately, our economists are projecting interest rates to stay at very low levels in the coming months because higher interest rates would be reflected in higher capitalisation rates, and this would be a serious challenge not only for the UK but for all markets affected by soaring interest rates. The Bank of England's Monetary Policy Committee cut the Bank Rate to 0.25% on 4 August 2016, the first rate cut in seven years, in order to provide additional support to growth and to achieve a sustainable return of inflation to the target. This will certainly provide some support to the property markets as well. And investment appetite from overseas investors may eventually return if the weaker pound is considered "attractive". Retail sales statistics, released on 18 August, surprised and revealed a 1.4% post-Brexit jump, even though instant sales to tourists can, by no means, be compared with long-term acquisitions by institutional and other wealthy investors (source: Bloomberg).

A fragmented impact for the Eurozone investment market.
BNP Paribas expects the overall investment market to decrease by around 10% in 2017 compared with 2016 on average for Eurozone markets (source: press release on Brexit, 5 July 2016). *"A more limited effect is expected in 2016 given the delay effect and the advancement of the year."*

The main question is whether we will have a swing in risk and investment sentiment in the Eurozone in the next 2 years. At this stage, the rhetoric has probably been more psychological than economic as it is too early to assess the physical impact of the "leave" vote on the various occupational Eurozone markets (for example in terms of headcount that may be relocated from the UK to other capitals). It is widely believed that cities such as Dublin, Frankfurt, Paris and Luxembourg may somewhat benefit from the UK exit. In particular, Frankfurt is aspiring to be a good alternative to London's financial services centre.

Any additional impact on investment volumes (which were lower in 1H16 anyway) is likely to be limited, with investors still searching for solid investment opportunities. In addition, overseas investors have been adding Europe (Eurozone and the UK) to their investment universe to allow diversification (and maybe to earn an extra bonus on the euro in the long term).

Notwithstanding, only specific spots are favoured by these investors, creating a contrasting property picture. As such, "established" markets are steadily sought after, such as Germany, France and the Nordic countries. Therefore, ***we recommend buying core/prime assets in prime locations, and/or in recovering markets (Spain, Portugal, the Netherlands, etc.). Investors will be more protected in the event of a downturn (higher interest rates) or if property fundamentals weaken for whatever reason. Assets should be acquired at a fixed – and very low – financing cost, so that any return of inflation would do the trick for equity holders (through higher rents and values).*** Unfortunately, we are nowhere near an "inflation" inflection point, even though the same can be said of (attractive) interest rates.

We believe the outlook is still reasonably positive, even though return expectations from investors should not be overly ambitious. Total annual equity returns (after acceptable leverage) are likely to be only single-digits because the currently low GIYs have touched bottom, so they may even calmly rise if the current low risk premiums invert for some reason. Therefore, growth in capital values may not occur for quite some time (apart from specific recovering markets).

Investors "seeking value" will need to take more risk through "off-market" deals and secondary trades across Europe. But discounts have been narrowing as well in recent months, hence IRRs should not be blown out of proportion. We believe any IRR from 10% derived from a European value-added investment strategy is attractive for investors today (irrespective of nationality).

Below is the commercial real estate matrix, with risk and opportunities:

Opportunities

1. No change in overall risk sentiment as a result of:
   - **A.** Continued purchases by domestic and overseas investors with the aid of very cheap long-term money;
   - **B.** Buyers capturing the spread between (modest) total real estate returns and zero-rate risk-free rates
   - **C.** Stable property prices implied by low capitalisation rates combined with secure rental income;
2. Better occupier market performance (rental growth, stronger occupancy rates, higher values, etc.) in Europe's recover (mainly Southern) markets;
3. Better-than-anticipated resilience of the UK's real estate markets, resulting in "anchored" real estate pricing.

Threats

1. An overall change in risk sentiment with risk premiums shooting upwards, triggered by:
   - **A.** Higher real interest rates (soaring nominal rates without healthy demand inflation);
   - **B.** Renewed volatility in financial markets (equities, bonds, currencies, commodities) because of monetary policy not producing the necessary effects;
2. Enduring problems in the UK's occupational markets – lower values and rents – in the wake of the Brexit vote, with policy makers incapable of reversing the pendulum;
3. Continued sluggish demand from investors from troubled emerging markets.

1.2. Residential markets

What are the forces that are influencing housing values today?

- **The usual economic circumstances** such as local supply and demand factors, employment levels, changing real interest rates, changing inflation rates, currency movements, political instability etc. Actually, economic forces could be considered as external factors. The principle of externalities says that real estate values can be affected by conditions not relating to property.

Spain is a good example. It was subject to overproduction (falling demand coupled with oversupply) of millions of properties in 2008-2010, which resulted in a price slump (of 40% in some areas).

Higher real interest rates normally lead to lower values as well, and the key question is how long will nominal and real interest rates continue to hover at almost artificially low levels? After all, very low mortgage rates allow for "reasonable" monthly instalments, even though property prices continue to soar.

And healthy (demand) inflation should lift rents (through indexation or market reviews) and subsequently values. However, many countries and thus property markets have entered into a gentle deflationary spiral (across Continental Europe and even "mature" Asia) which is bad news for real estate investors in the longer run. Nonetheless, strong investment appetite (from overseas investors) may outweigh any depreciation caused by deflation. Foreign investors who pushed up values in London last year (often by 20%, leading to very low gross initial yields) did not seem to have made a strong "inflation" analysis when investing. But from a fundamental perspective, real estate values need to be lifted by some inflation in the longer run.

Currency movements may eat into the returns of overseas investors, with Latin America (in particular Brazil) being an eye-catching case.

- **Government controls and regulations such as zoning, access to public transport and other amenities, fiscal policies, availability of credit.** Fiscal policy is key, in particular changes to the tax treatment of real estate. Is stamp duty about to rise? What about capital gains tax in the event of a property sale? Or inheritance tax? Are mortgage interest rate payments deductible from the taxable base? If so, to what extent? Could a government cut in mortgage tax relief measures lead to lower housing prices?

  The UK introduced a capital gains tax for foreign buyers from 1 April 2016 (to close a legal loophole, only domestic investors were subject to CGT before). Stamp duty for the purchase of a second residence was raised. Some Belgian regions (Flanders, Brussels, Wallonia) have reduced tax mortgage advantages in ... Although there are so many examples to illustrate this, it is even more crucial to assess the fiscal impact on housing values. If a government allows almost unlimited tax deductions of interest charges, in a way it "subsidises" swelling housing values, and the nation may become "over mortgaged". This occurred in the Netherlands for decades. The system finally changed in 2013 with some mild reforms (e.g. reducing tax relief).

- **Social forces.** due to demographic changes. Houses/flats need to be smaller because the number of single people has been rising in many countries. At the same time, populations are rapidly ageing (Europe, Japan), creating the need for more "serviced" housing schemes. There is often a lack of "affordable" housing as well (e.g. London). So the supply and demand of "products" will change over time as well as their prices.

UK

Are UK housing markets overvalued? Although it is probably too early to determine the after-effects of the EU referendum on UK housing prices, growth in housing prices weakened in July, reflecting the traditional summer lull.

While housing prices grew by 8.4% in July compared with a year ago, monthly values dwindled by almost 1% between June and July, with average prices slipping from GBP 216,726 to GBP 214,678 (source: House Price Index, Halifax, 5 August 2016). *"Housing prices in the three months to July were 1.6% higher than in the previous quarter; up from 1.1% in June but comfortably lower than earlier in the year. The annual rate of growth was unchanged at 8.4%; the lowest since July 2015.*

There are signs that housing price growth is slowing with a deceleration in both the annual and quarterly rates of increase in the past few months. Nonetheless, the current rates remain robust."

Sales have been heavily distorted in recent months by the introduction of higher stamp duty rates for "buy to let" and second home purchases in April (a 3% rise for each stamp duty band). So, many buyers pushed through sales ahead of the tax change, inducing a sharp rise in March. Evidently, higher volumes in March were followed by a substantial decline in April. UK home sales continued to recover in June with a 5% increase compared with May. On the whole, sales in 1H16 were still 11% higher on the same period last year.

What about the high-end housing market? In June 2014, annual growth in prime central London was 8.1%, the last peak before a period that saw growth fall steadily to minus 1.5% in July 2016. This downtrend was a natural consequence of strong price rises between 2009 and 2013. But the process was accelerated by two stamp duty increases and a series of other tax measures. Knight Frank believes that a change in stamp duty was a bigger issue than Brexit.

As always, averages hide a much differentiated price pattern between areas. Housing prices in Knightsbridge (the neighbourhood of the department store, Harrods) fell by 7.3% in the 12-month period to July 2016, followed by Chelsea (-7.2%) and Hyde Park (-5%). Instead, Mayfair picked up marginally by 0.8% whereas Islington and City & Fringe saw higher prices of 4.3% and 5.3% respectively (source: Knight Frank's Prime Central London Sales Index, July 2016). Put into perspective, prices of luxury housing are still 50% higher compared with end-2009.

A marked slowdown or a major crash in London? It is very difficult to make serious forecasts, but we have always said that the pace of average housing prices were growing and would deteriorate sooner or later (way before the EUR referendum was organised). Given the uncertainty, we expect London housing prices to deteriorate somewhat further in the months ahead. If a fresh decline were to materialise, housing prices would not have seen any growth this year (ending up below inflation rates). Next year could be difficult as well, with no tangible growth (on average) on the cards. From 2018, housing price growth could pick up again (certainly in the "affordable" segment which is characterised by supply shortage).

It is very difficult to tell how luxury housing pricing will progress. Prices of very expensive property are under severe pressure. Much will depend on investment appetite from overseas investors. They could gradually shift away from the London market given unfavourable currency movements, general uncertainty and a less favourable tax environment. But it is equally possible that investors stay in, or return to, the London market, seizing new opportunities (lower prices quoted in a weaker pound) because market conditions may prove very difficult for them at home as well (Brazil, China, etc.).

Home ownership in England hitting 30-year lows
Home ownership in England has fallen to its lowest levels in 30 years given the widening gap between income and property prices. It is not easy to get onto the property ladder. Home ownership across England reached a peak in April 2003, when 71% of households owned their home, either outright or through a mortgage. But in February, the figure had fallen to 64% (source: the Resolution Foundation, The Guardian, 2 August 2016). The figure was the lowest since 1986.

To recapitulate, growth in average housing prices is likely to be frozen in the coming 18 months. The environment is not very favourable to further growth anyway: overall uncertainty and the less favourable fiscal treatment of real estate in general. Nonetheless, the "average" segment (below GBP 1m) is symbolised by a lack of supply which may support prices in the longer run. The high-end markets could endure bad conditions if international wealthy investors further retreat from the market, scaling back their investments. But as always, they could return to the market once prime prices, quoted in a less expensive pound, are recognised as "tempting".

Ireland

More "healthy" housing prices in Ireland Irish housing prices nationwide rose by an average of 6.3% in the 12-month period to June 2016 (source: The Daft.ie House Price Report, An analysis of recent trends in the Irish residential sales market, 2Q16). According to Daft.ie, there is only a 1.5% gap between the ultimate transaction price and the property's initial list price, which is a sign of an improving property market. Another conclusion is that Dublin prices showed subdued housing price growth. Actually, housing prices tend to increase at almost the same rate as general inflation in a "healthy" housing market. As a reminder, general inflation has been effectively close to zero over the past decade, even though housing prices fell first by 55% before rising by more than 40% in Dublin. A bit similar with what a number of US metropolitan areas experienced after the 2008-2010 slump in housing prices. The average annual increase in national housing prices stood at 6.3% at the end of June 2016, compared with 8.5% six months ago and 15.5% at the start of 2015.

The divide between Dublin and the rest of the country has persisted, with prices pretty stable in the capital - rising by just 1.1% in the last year in 2Q16 - compared to a rise of 10.2% on average outside Dublin.

The national average asking price in 2Q16 was EUR 215,000, compared with EUR 202,000 a year ago and EUR 164,000 at its low. In Dublin, prices have risen by an average of EUR 94,000 - or 42% - from their lowest point in mid-2012. Outside the capital, the average increase has been EUR 43,300, or 32%, since the end of 2013. While prices were stable in Dublin, they continued to increase strongly in other cities. Compared with the same period in 2015, prices in the second quarter of 2016 were 11.2% higher in Cork and 14% higher in Galway. In Limerick City, the increase was 15.2%, while in Waterford prices rose by 17.4% in 12 months.

France

The usual main factors drive the French real estate market

- Mortgage rates are extremely low: they hovered around 1.2% for 10 year-mortgages for "good" files in Ile-de-France (Greater Paris region), while trading at a mere 0.85% for "excellent" files", source: Emprunt Direct, 29 July 2016). By comparison, 20-year mortgage rates

for "good" investors fluctuated at around 2.4% in early September 2015, double the rates only a year ago;

- Annual investment volumes are back to pre-crisis levels, with 830,000 transactions for second-hand properties registered at the end of April 2016. This represented an increase of 19% y-o-y. Nonetheless, prices have rebounded to the same extent, so "reasonable" prices can be found across the country. This "disconnection" between volumes and prices can be seen in other parts of Europe too. The Belgian coast, stretched over an insignificant 66km, saw almost 30% more transactions in 1H16 while prices barely edged up. In essence, there's a time lag – up to 12 months – between volumes and prices in property markets that cannot be considered as tight (lack of supply in conjunction with high demand).

- Data on buyers' confidence, provided by INSEE; with a score of 96 in July 2016. The score still ends below the long-term average of 100 and was obtained just before the terrorist attack in Nice (South of France). It remains to be seen whether households will become "optimistic" (source: Institut national de la statistique et des études économiques INSEE, July 2016).

Is the French property market poised for growth in 2016? After French housing prices fell in 2013-2015 (apart from Bordeaux and Lyon), the key question is now whether they will gradually pick up with higher investment volumes. Les Notaires de France wrote in their note de conjoncture of July 2016 ***"if prices were to resurge, this would not necessary alter the spending capacity of French households (on property) as long as these price increases are reasonable"***. This is due to the very low interest rates. However, it is reasonable to assume that interest rates cannot fall any further (and thus mortgage rates) even though we argued this a year ago. To summarize, there is a need for new growth drivers to support/boost housing prices like new economic growth combined with some healthy demand inflation.

Sizeable variations from stable averages. Prices fluctuated significantly in France in the 12-month period to 31 March 2016, both in Ile-de-France and the rest of the country ("Province"). In the 12-month period to 1Q16, prices of existing flats fell by 0.4% on average whereas prices of existing houses edge up by 1% at the national level. In Ile-de-France, prices of existing flats shed a mere 0.1% over the same period while prices gained an equally miserable 0.1% in the rest of France, which was also immaterial. Prices of existing houses increased by 0.9% in the 12 months to 1Q16, both in Paris and in the rest of the country.

But averages do not show the variation around the mean. Annual prices of existing flats declined in many areas of France in 1Q16. For example, median prices of older apartments dropped by 9.9% in Nîmes, 7.3% in Poitiers, 6.7% in Saint-Etienne and 6% in Caen (source: Notaires de France). In other cities, declines were less noticeable, whereas Clermont-Ferrand, Metz, Corse-du-Sud and Lyon posted decidedly higher prices, varying from +7.7% for Clermont-Ferrand to 3.5% for Lyon. In Paris, prices of existing flats hovered at around EUR 8,000/m² as at the end of 1Q16 (source: Notaires de France, July 2016). To complicate matters more, a different pattern was observed for existing houses over the same period. For instance, prices of houses in Poitiers gained 11.3% compared with a loss of 7.3% for apartments. Many other regions underwent higher prices as well such as Metz (+13.8%), Dijon (+12.4%), Montpellier (+9.9%) and Limoges (+9.5%), to mention just a few with the highest price increases.

On 1 August, MeilleursAgents.com communicated on the latest price evolution for the Paris region: prices of existing flats stood at EUR 7,905/m² on average (ranging from EUR 5,414 to EUR 12,992 /m²). On an annual basis, prices of flats rose by 2.1% on 1 August.

France and foreign investors. Incontestably, there is uncertainty about the upcoming investment pattern of British investors in the aftermath of the Brexit vote. In other words, could the Brexit issue have an adverse effect on British investors buying not only at home but also "overseas" (such as Continental Europe and more specifically France)?

According to market experts, British buyers' appetite for French property has not come under pressure at this point, yet it is way too early to draw any meaningful conclusions. Will the pound continue to depreciate against the euro, making French property more expensive? Will UK housing values eventually fall, making them competitive again with other countries? Or could general economic and political uncertainties entice more British buyers to invest outside their home country, in Continental Europe? In addition, there are numerous Dutch, Belgian, German, Scandinavian, Swiss, American and Middle Eastern buyers in the French property market. What investment pattern will develop in the mid-future?

Besides, British as well as buyers of other nationalities may be attracted to the better transport links which will be operational in the near future. To cite but two examples: the new LGV (Ligne à Grande Vitesse or high-speed line) will connect Bordeaux with Paris in 2017, and this will undoubtedly lead to higher property values in the area. Similarly, the TGV which now runs from London to Marseille and areas of Provence (Aix-en-Provence), making these regions more popular as a result.

Stable housing prices at best on the French Riviera. Latest data from MeilleursAgents.com are compiled below. Beausoleil posted significant housing prices (EUR 6,692/m² in August 2016), exceeding prices observed in Antibes. Compared with August 2015, prices were nevertheless hovering at an unchanged level on the French Riviera. Meanwhile, housing prices rose by 2.1% in Paris to EUR 8,006/m², Lyon (+2.0%) and Bordeaux (+2.6%). Strikingly, the French Riviera reported the longest period to complete a transaction (70-80 days) while Paris has the shortest.

Overall, the investment market on the Riviera is active, boosted by price falls inland coupled with an increase in sales in coastal locations such as Cannes and Saint-Tropez. The prime markets on the Riviera, in Paris, Toulouse, Bordeaux and parts of Provence and the Alps are likely to see modest price rises throughout 2016.

Housing prices in France, 1 August 2016

City	Average housing price (EUR/m²)	Annual change	Average transaction period (days)
Paris	8 006	2,10 %	46
Beausoleil	6 692	0,00 %	74
Antibes	5 571	-0,60 %	87
Cannes	5 090	-0,80 %	77
Lyon	3 571	2,00 %	60
Ajaccio	3 356	0,80 %	62
Bordeaux	3 109	2,60 %	58
Marseille	3 103	-1,00 %	68
Toulouse	2 924	-0,80 %	58
Lille	2 034	-2,30 %	61

Table 9. Source: MeilleursAgents.com

Spain

Spanish property is very popular. Like in many other parts of the world, demand from foreign buyers for residential property on the Spanish coasts has been expanding thanks to the very low mortgage rates and a gradual recovery of the country's property markets (whether owners-occupiers or pure investors). Spanish housing transactions were up by over 20% in 1Q16 on an annual basis, though they fell by 10.2% on a quarterly basis (source: Ministry of Development). Factors for Spanish property should not be too favourable given the ongoing political uncertainty and deflationary environment. In fact, consumer prices in Spain fell by 0.6% y-o-y in July of 2016, following an 0.8% drop in June (source: TradingEconomics). And in usual times this would not be very encouraging news for property values. But as previously mentioned, the interconnection between property values and inflation is not so relevant if the markets are in the recovery phase of the property cycle. Values and inflation start to be correlated if markets enter a more "mature" phase of the property cycle (see the Irish housing prices).

Housing transactions in Spain, 1Q16

Region	1Q16 Transactions	4Q15 Transactions	Annual change	Market peak	Peak volume
Cataluña	16 566	14 469	28,25 %	Q2 2006	43 948
Balearic	3 122	3 902	17,81 %	Q4 2006	7 841
Canary	5 186	5 336	16,99 %	Q2 2006	11 610
Andalusia	19 697	21 244	18,56 %	Q1 2007	47 449

Table 10. Source: Fotocasa

What are the challenges ahead?
Firstly, **political uncertainty:** to make a long story short, we presume a coalition government will be formed eventually. There's no other option left. A third round of elections would be problematic.

Secondly, **the Brexit story:** by analogy with France, the Brexit story could speed up purchases from British buyers. Or British buyers might hesitate instead to buy up in Continental Europe. Only time will tell. Housing prices are climbing in pound terms, with Sterling having fallen by almost 13% since the Brexit referendum on 23 June 2016 (source: xe.com, 16 August 2016).

In our opinion, it would be rash to say that British buyers would be forced out of the market altogether (similarly to what happened to Russian investors after the collapse of the rouble, which was far more dramatic: minus 44% against the euro between August 2014 and February 2016, after bouncing back somewhat thereafter). The British were the top foreign homebuyers, accounting for about 21% of all home purchases by foreigners in 2015. They were followed by the French, Germans, and Swedish buyers, each accounting for roughly 6 to 7% of all housing transactions carried out by foreign investors. Chinese buyers ramped up their presence, representing 4% of total transactions. Unsurprisingly, the Balearic Islands are especially attractive to foreigners taking a 40% chunk of total demand. The Valencian community comes next with foreign demand accounting for 35%; the Canary Islands with 34% and Murcia with 24% (source: www.propertywire.com).

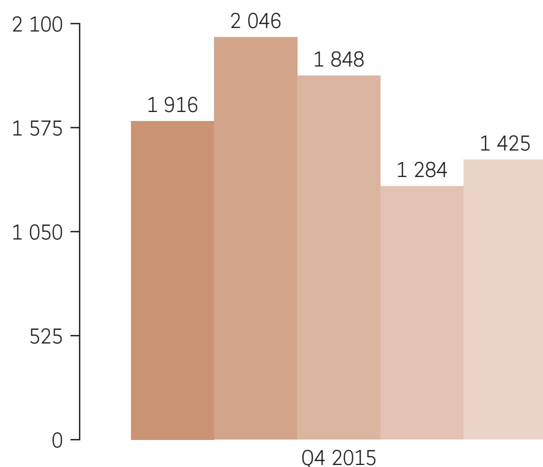
We remind the reader that the Spanish government implemented measures to enhance real estate investments across the country. Indeed, Spain relaxed residency permit rules for non-EU property investors. This system, called "Golden Visa", enables a foreigner investing more than EUR 500,000 to be automatically granted a permanent residency permit. Over 350 residency permits has been issued to non-EU investors per year since the scheme was launched in September 2013. Residency permits are also open to those investing in Spanish public debt and businesses. Spain is one of the many European countries (including Portugal, Cyprus, Hungry and Greece) to have introduced schemes by which residency permits are granted to wealthy foreign real estate investors in return for buying prime properties (source: www.spanishpropertyinsight.com).

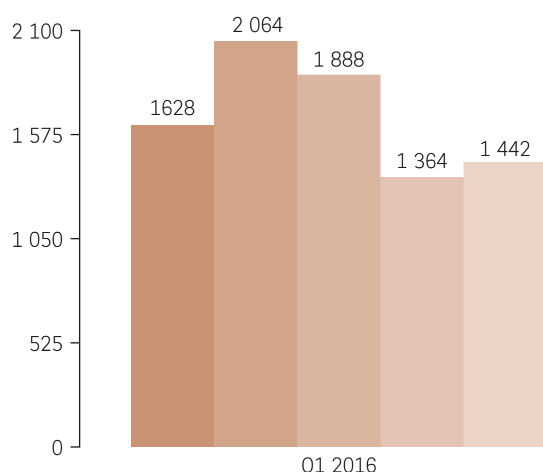
Are there valuation impairments for assets owned by Spanish banks?
Another concern is the stance of the various Spanish banks on the valuation of property. Actually, local banks still own a lot of property due to the 2008-2010 crisis, and they are obliged to update the valuation of their assets through an annual or bi-annual revaluation of each individual property. For instance, Sareb, the Spanish rescue bank ("bad bank"), announced a decrease in value by more than EUR 2bn of their portfolio in addition to a EUR 968m write-down in the past two years (source:www.sareb.es, publication on 31 March 2016).

Private banks may face a similar situation in the coming months, forcing them to lower the asking price for properties they intend to sell, **with a risk to reduce the market value of properties in general.** If values were to fall, this would probably incite banks to cease offering mortgages to clients. Last but not least, there is still an excess supply in certain areas, and as mentioned in our previous property report, it may take a few years before all units are digested by the investment market.

Will Spanish housing prices come to a standstill in 2Q16?
Somewhat unexpectedly, housing prices stalled in 2Q16, with prices/m² simply freezing. We believe political uncertainty was at the origin of this lull in prices coupled with questions over valuation. In fact, prices for resale properties did not show a significant increase in the second quarter, with supply not slowing, due to sales being offset by new properties coming onto the market. There are still sizeable discounts offered to achieve sales in certain areas, although discounts are no longer very spectacular along the Mediterranean coastal area which is popular with tourists.

Spanish property prices in July 2016





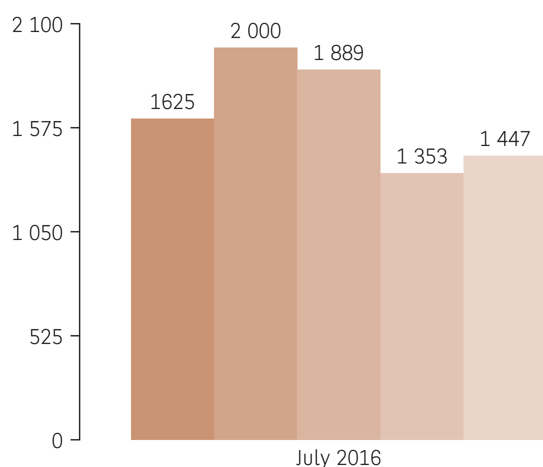


Chart 1. Source: Fotocasa

Portugal

Investors are increasingly eying Portugal (particularly in the Algarve)

The property market in the Algarve has been recovering thanks to a favourable environment (availability of cheap credit and appealing tax initiatives), investment in infrastructure and a return to sensible pricing. Since the economic downturn in 2008, the Portuguese housing market has been suffering, with prices falling as much as 50% in certain areas compared with pre-crisis levels (source: www.propertywire.com).

According to the latest analysis from Knight Frank (Knight Frank Portugal Insight 2016), vendors started adjusting (lowering) their prices in 2013, which has led to an improvement in transaction volumes.

In 2015 the Algarve recorded a 32% increase in sales compared with 2014, representing its first annual increase in prime prices since 2008. "Above all, what set the Algarve apart from the other Portuguese regions during the downturn was the continual investment in infrastructure" (source: Knight Frank). This was particularly evident with the upgrade of the coastal motorway A22, the improvement of the European route E1 from Lisbon and Porto, and the 32m expansion of Faro Airport.

Although British, Irish and German buyers are certainly present in the Algarve, French, Scandinavian and non-Europeans (including South Africans and the Chinese), are equally scrutinizing the local market.

The introduction of Portugal's Non-Habitual Tax Residency (NHR) regime in 2009 created a fabulous incentive for foreign buyers to invest in Portugal. The NHR exempts non-residents who spend at least 183 days a year in Portugal—or those with their primary residence there—from paying income tax on non-Portuguese income, including pensions, salaries and capital gains for a period of 10 years (source: www.nonhabitualresidents.com).

Another successful initiative is Portugal's Golden Visa rule. The holders of "Golden Residence Permits for Investment Activity" are entitled to family regrouping, and may obtain a permanent residence permit, on top of Portuguese citizenship and the right to travel freely in EU countries in the Schengen area. As a result, Chinese buyers have obtained 79% of the 2,853 visas granted since 2012 (source: www.bradleyhackford.com).

2. News from Asia

2.1. Commercial markets

A challenging low interest-rate environment with a couple of countries on the brink of deflation

Zero-interest rates and deflation have been affecting both the economically mature markets in the West and the more mature markets across Asia.

For example, consumer prices in Singapore fell 1.6% y-o-y in May 2016, following a 0.5% drop in April. It was the 19th consecutive month of falls and the sharpest decline since August 1986. Deflation nevertheless eased somewhat in June, with a 0.7% annual decline.

The land of the rising sun unexpectedly showed no growth in the June quarter of 2016, following a 0.5% expansion in 1Q16. Moreover, the Japanese inflation rate stood at minus 0.4% y-o-y in June, virtually the same rate as in May and April (-0.4 and -0.3% respectively). In South Korea, annual inflation came in at a mere 0.7% in July, yet GDP advanced by 3.2% on an annual basis as at end-June 2016.

In China, consumer prices increased by 1.8% on an annual basis in July of 2016, compared with a 1.9% annual rise in June. It was the lowest inflation rate since January. Furthermore, Chinese 10-year government bonds carried a yield of 2.7% in August 2016. Obviously, other emerging market countries (India, Indonesia, etc.) experienced much higher inflation and bond yields in the same period (source: TradingEconomics).

A more challenging environment for commercial real estate

Investment volumes in Asia Pacific came in at USD 24bn in 1Q16, representing a 5% decline on the same period last year. As a reminder, overall annual investment volumes in Asia slid by 5% in 2015 compared with 2014. Noticeably, market conditions were very difficult in the first quarter this year given the high volatility on different stock markets. Australia experienced strong activity, and volumes also rose in China and Hong Kong. In contrast, Japan and Singapore were impacted by weaker volumes (source: Asia Pacific Property Digest, 1Q16, Jones Lang LaSalle).

Short-term forecasts for Asian property markets for 2H16

Essentially, we believe that demand for property may soften somewhat, implying weaker rents and capital appreciation growth rates.

Offices

In short: lower rents and values.

- In **Hong Kong**, rental growth could slow to a more reasonable 0-5% in 2016 (in light of the 14.7% growth in rents seen in the year ended 31 March 2016). Also, "landlords are likely to keep rents unchanged in Beijing" (source: Jones Lang LaSalle). Shanghai is in a phase of deteriorating rental growth, albeit not to the same extent as in Beijing. Much will depend on upcoming supply;

- In **Japan**, it remains to be seen how much further capital values can grow given the low gross initial yields at which prime offices are currently trading. Average prime office vacancy rates in Tokyo CBD (Central Business District) hit a low of 1.6% in 2Q16, with prime rents soaring by 0.8% q-o-q in 2Q16 (3.5% y-o-y, source: Savills World Research, Tokyo, 2Q16). Demanding valuation multiples in Tokyo, general economic uncertainty and the effectiveness of Abenomics may hamper growth in rental and capital values going forward. We expect a stabilisation before year-end;

- Oversupply risks in **other Asian markets** continue to persist (Seoul, Bangkok Jakarta, outside the CBD, etc.);

- The **Sydney** office market has been faring very well, with rents climbing more than 13% in the 12 months to end-March. This city has been in a "cyclical upswing" for 2 years (source: Jones Lang LaSalle), with 1Q16 vacancy rates at their lowest levels (5.5% for prime Sydney offices in 1Q16 vs. 11.5% in 1Q14). Rents and capital values are still forecast to grow this year, albeit at lower growth rates. Capital values have been edging higher at a much faster pace than rents, resulting in low property yields. Solid rental growth is still expected in Melbourne;

- **Singapore** is a different cup of tea, with rents falling more than 14% in the 12 months to end-31 March 2016 (source: Jones Lang LaSalle). Also capital values have been eroding since 4Q15. JLL is far from optimistic: *"The leasing market in 2016 is likely to be a re-run of 2015"*.

Some market players believe that specific Asian spots have become attractive opportunistic bets. For example, the Qatar Investment Authority (QIA) has reached an agreement with BlackRock to acquire Asia Square Tower 1 in Singapore for approximately SGD 3.4bn (USD 2.45bn). This marks the largest single-tower real estate transaction in Asia Pacific to date, and the second largest single-tower real estate transaction worldwide (source: BlackRock, 6 June 2016),

despite an overall vacancy rate of about 14% (source: Cushman & Wakefield).

Retail

In a nutshell: slower rental and capital value growth – often weaker occupier demand – lacklustre performance in Singapore.

- **Hong Kong** retail – and in particular the high street shop segment – has suffered severely from the slump in retail sales since 4Q14, due to a contraction of the tourism market, with fewer Chinese investors visiting the city. High street rents may fall a further 10 to 15% this year (source: Jones Lang LaSalle), and it remains to be seen whether larger shopping malls will also be affected. This will be seen in upcoming retail sales volumes.

- The supply pipeline remains a challenge, especially for **Chinese cities**. Supply in Shanghai is forecast at over 400,000m² in 2016, "with 15 malls in core areas and 21 malls in non-core areas expected to enter the market in the remainder of 2016".

- Retail rental growth is set to stabilise in **Tokyo**. Finding prime products is a challenge at present, which should at least underpin rents and capital values for the time being. Jakarta is expected to witness weaker growth in rental values in spite of the scarcity of prime products in this city;

- Rental gross initial yields will likely move out slightly in **Singapore**, with rents and capital values projected to fall again. The retail markets in **Sydney** and **Melbourne** will presumably remain stable (at best).

2.2. Residential markets

Higher housing prices in China is supporting investor optimism.

China's new housing prices increased in June 2016, again. Among 70 medium and large-sized cities, monthly prices of new houses registered an increase in 55 cities whereas price erosion was observed in 10 other cities (with 5 cities experiencing stable prices). Unsurprisingly, the price pattern for new houses is still differentiated between Chinese residential markets. In Shenzhen (close to Hong Kong), Xiamen, Nanjing, Shanghai and Beijing annual housing prices climbed by 46.7%, 33.6%, 29.7%, 27.7% and 20.3% respectively. Yet many Tier-2/Tier-3 cities lost 1 to 3% in the same period (12 months to end-June 2016).

A similar story in the country's second-hand housing markets in June 2016, with monthly prices soaring in 48 cities while slightly falling/stabilising in 22 others. Annual prices of second-hand houses followed a similar path, with Shenzhen (+38.5%), Beijing (33.4%, outperforming new housing prices) and Xiamen and Shanghai (30.5%) outperforming all other cities (source: National Statistical Office of China, 18 July 2016).

Where is the Singaporean housing market heading?
The Urban Redevelopment Authority (URA) released its real estate statistics for 2Q16 on 22 July 2016.

The Singaporean residential market at a glance

Key indicators	Change	1Q16	2Q16
Price index	-0,40 %	140,6	140
Rental index	-0,60 %	107,5	106,9
Take-up	59 %	1 419	2 256
Pipeline supply	-11,70 %	53 512	47 250
Vacancy rate	1,40 %	7,50 %	8,90 %

Table 11. Source: The Urban Redevelopment Authority

Prices of private residential properties decreased by 0.4% in 2Q16, compared with a 0.7% decline in the previous quarter. In 2Q16, prices of "non-landed" properties marginally increased by 0.3% in the Core Central Region (CCR) which was pretty similar to the 0.2% increase in prices observed in the Rest of Central Region (RCR). In the Outside Central Region (OCR), prices eroded by 0.5% (vs. -1.3% q-o-q). Prices of "landed" property decreased by 1.5% in 2Q16, somewhat exceeding the 1.1% decline in the previous quarter. As a reminder, landed property in Singapore refers to residential property where the owner has the title to the land. By contrast, non-landed property refers to apartments and condominiums, which are strata-titled, where the owners own the land in common.

Rentals of private residential property fell by 0.6% in 2Q16, vs. a 1.3% loss in 1Q16.

Are Singapore's cooling property measures working?
It is "too early" for the Singaporean government to consider lifting the property cooling measures currently in place, as it needs to make sure that the "painstakingly made" gains are entrenched (source: Mr Ravi Menon, managing director of the Monetary Authority of Singapore (MAS), 25 July 2016). Singaporean authorities want to ensure that the local property market is on a sustainable path and that household balance sheets become stronger to withstand new shocks. Indeed, housing data should be put into perspective. Even though average housing prices have been falling by a few per cent in recent years (more sharply for luxury residential), this "slump" in prices is not serious compared with the 60% explosion of housing prices

between 2009 and 2013 (by comparison national income soared by only half this rate). Consequently, the authorities fear a "premature" market rebound. At the current zero-interest rate rates, buyers could hunt for low (yet more attractive) property yields carried by residential real estate, but this scenario raises fears of a property bubble. This is what occurred in other "small" property markets such as that of the Belgian coast in 1H16.

Serious downward pressure on Hong Kong's real estate prices

Squarefoot.com.hk, a residential real estate website in Hong Kong is crystal-clear. Overall property prices fell by around 30% between October 2015 and July 2016. The downturn has been noticeable in recent months, with housing prices falling rapidly. Hong Kong's housing prices – including Hong Kong Island, Kowloon and the New Territories & Outlying islands – tumbled from HKD 10,838/sq ft (USD 15,041/m²) in May to HKD 9,071/sq ft (USD 12,588/m²) in July, representing a 16% decline in 2 months. Data look even more drastic for Hong Kong Island, revealing a slump of 29% in the same two-month period (from HKD 15,860/sq ft in May to HKD 11,253/sq ft in July corresponding to a USD 22,010-15,617/m² range, 11 August 2016).

We remind the reader that the Hong Kong dollar is pegged to the greenback, which means that interest rates in this Asian city tend to track the benchmark rates set by the US Federal Reserve. Indeed the Fed might raise its benchmark interest rate before year-end. The Hong Kong Monetary Authority raised its benchmark interest rate by 25 basis points (bps) to 0.75% on 17 December 2015. The decision was the first rate adjustment since December 2008 and followed the 25-basis point upward shift in the target range for the US federal funds rate.

All in all, Hong Kong's interest rates have been very low for years, fuelling massive investments in the city's real estate market (luxury apartments and houses command astronomically high prices) by domestic (including Chinese from the Mainland) and international buyers alike. Indeed, many mainland investors have been purchasing property in Hong Kong as well, stretching prices even further.

With residential prices taking a nosedive in Hong Kong, domestic and international investors could become increasingly "nervous". In our opinion, much will depend on the Fed. Any hike in interest rates could spark fresh volatility in Hong Kong's residential markets. Generally speaking, the city's housing market is projected to remain "sluggish' for the coming months due to the lack of demand in new developments and low sales transactions. Residential prices could fall by a further 10% over the coming two years.

Australian state of Victoria penalizes foreign homebuyers.

The Australian state of Victoria has doubled the tax rate levied on foreign property buyers, reflecting public concern over the volume of Chinese money flowing into the local real estate market (with an ensuing impact on prices).

Stamp duty surcharges on foreigners were raised to 7% on 1 July 2016, up from 3% previously. New Zealand too is considering a land tax on foreigners. And Fiji has already tightened rules on property and land purchases by foreigners to curb "speculation".

3. News from US

3.1. Commercial markets

The unleveraged quarterly total return from "All Property" investments (a mix of industrial assets, offices, retail and residential investments) was 2.03% in 2Q16 (source: NCREIF Quarterly Property Index, based on USD 505.3bn of institutional property investments, 25 July 2016). The 3-month return comprised an income return of 1.19% and a capital appreciation of 0.84%. Although the 2Q16 quarterly total returns trended down modestly (from 2.21% in the previous quarter), the annual return for the year-ending second quarter 2016 was still 10.64% (consisting of a 4.88% income return and a 5.56% appreciation. Looking at the long-term picture, the annualised average total return for the past five years was 11.52% and 7.40% over the past decade (source: NCREIF, July 2016).

"Industrial and retail remain the leading performers for the quarter and the trailing year. Both property types had total returns above 2% for the quarter and both were the only property types with double-digit total returns for the trailing year. Apartment and office total returns are trending close together with apartments slightly leading for the quarter and the year. Even with 2Q16 total returns below 2%, annual total returns were 9.74% for apartments and 9.31% for offices. Albeit improved versus the previous quarter, hotels were again the weakest property type with a 1.46% quarterly total return in two consecutive quarters of depreciation. Total annual hotel returns were 9.46%, thus outpacing office returns."

US office markets remain in good shape.

CBRE's research reveals that the office market fared pretty well in 2Q16, with suburban markets driving net absorption and rental growth (source: CBRE MarketView Snapshot US Office, 2Q16, 22 July 2016). The main conclusions are presented below:

- Suburban markets are driving net absorption. Net absorption reached 11.5m sq ft in 2Q16, an increase from 1Q16 but the weakest quarter total since 2013. The suburban markets registered 9.8m sq ft of absorption, i.e. 85% of the total - an outsized proportion given these markets' 65% share of existing inventory. Year-to-date, Dallas/Ft. Worth and Phoenix driven by more than 2 million sq ft of net absorption, followed by Los Angeles, Seattle, Philadelphia, Nashville, Detroit and Orlando, each with more than 1 million sq ft of net absorption;

- New supply slows down as Houston projects deliver. Construction completions slowed for the third quarter in a row to 7.7m sq ft, largely due to reduced construction activity in Houston (the most active development market by far prior to the decline in oil prices). Manhattan has the largest amount of construction underway, while San Jose, Dallas/Ft. Worth, Seattle and San Francisco rank among the top 10 markets for both total square foot underway and square foot underway as a percentage of existing inventory;

- The vacancy rate decreased to their lowest levels since 1Q08. The vacancy rate decreased by 10 basis points (bps) to 13% in 2Q16, the lowest level since 1Q08 (but structurally higher than in Europe). The decrease was entirely attributable to the suburban markets, which recorded a 20 bps decrease in vacancy to 14.4%. The Downtown vacancy rate rose by 10 bps for the second consecutive quarter to 10.5%.

- Annual rent growth reached a new post-recession high. Gross asking rents increased by 6.2% year-on-year, the fastest pace since 2Q08. Suburban rent growth reached the highest annual rate in the current cycle (4%), while Downtown rent growth dropped slightly to 7% from an 8.8% annual rate in 1Q16.

Allianz Real Estate pays USD 420m for a stake in Manhattan office asset.

Allianz Real Estate paid USD 420m (EUR 378m) for a 44% stake in a Manhattan office tower. The deal puts Allianz in partnership with Related Companies, Oxford Properties Group and institutional investors advised by JP Morgan Asset Management. The block is part of the wider mixed-use Hudson Yards development on Manhattan's west side. The 10 Hudson Yards asset is 94% let, with a weighted average lease term of nearly 17 years (source: IP Real Estate 3 Aug 2016).

3.2. Residential markets

Data from S&P Dow Jones unveiled that most US housing prices continued to improve, yet at slowing capital growth rates. The Standard & Poor's CoreLogic Case-Shiller home price index for May 2016 showed that the 10-City and 20-City Composites posted y-o-y gains of 4.4% and 5.2% respectively. Portland and Seattle were in pole position, posting an annual return of above 10% in May, followed by Denver (+9.5%), Dallas (9%) and Tampa (+7.7%).

Annual housing prices, ranked from high to low (May 2016)

Metropolitan Area	Monthly change (%)	Annual change (%)
Portland	**1,60 %**	**12,50 %**
Seattle	**1,40 %**	**10,70 %**
Denver	**1,10 %**	**9,50 %**
Dallas	1,30 %	9,00 %
Tampa	0,80 %	7,70 %
Miami	0,90 %	6,60 %
San Francisco	0,10 %	6,50 %
San Diego	0,90 %	6,40 %
Atlanta	1,40 %	5,60 %
Detroit	1,30 %	5,60 %
Los Angeles	0,70 %	5,40 %
Phoenix	0,60 %	5,40 %
Minneapolis	1,50 %	5,20 %
Composite-20	**0,90 %**	**5,20 %**
Las Vegas	0,80 %	5,20 %
U.S. National	1,20 %	5,00 %
Charlotte	0,80 %	5,00 %
Boston	-0,20 %	4,50 %
Composite-10	**0,80 %**	**4,40 %**
Chicago	1,80 %	3,70 %
Cleveland	1,30 %	2,50 %
Washington	1,30 %	2,40 %
New York	0,30 %	2,00 %

Table 12. Source: S&P Dow Jones indices & CoreLogic, 26 July 2016

Also, on a monthly basis, the overall picture looks reasonably good. The Composite-10 and Composite-20 both posted an 0.8% and 0.9% gain. All cities registered higher prices (driven by Chicago, Portland and Minneapolis) with the exception of Boston (-0.2%).

"Overall, housing is doing quite well. In addition to strong prices, sales of existing homes reached the highest monthly level since 2007 as construction of new homes showed continuing gains. The SCE Housing Expectations Survey published by the New York Federal Reserve Bank shows that consumers expect home prices to continue rising, though at a somewhat slower pace.

Regional patterns seen in home prices are shifting. Over the last year, the Pacific Northwest has been quite strong while prices in the previously strong spots of San Diego, San Francisco and Los Angeles saw more modest increases. The two hottest areas during the housing boom were Florida and the Southwest. Miami and Tampa have recovered in the last few months while Las Vegas and Phoenix remain weak. When home prices began to recover, New York and Washington saw steady price growth; now both are among the weakest areas in the country."

In May 2016, average housing prices across the United States (thus at a national level) were barely 2.1% below their July 2006 peak levels. Measured in relation to their June/July 2006 peaks, the peak-to-current decline for both Composites was approximately 8-10%. The recovery from the March 2012 lows was 38.1% and 40.4% for the 10-City and 20-City Composites respectively.

Low cost of borrowing – somewhat below expectations.
Mortgage rates in the week beginning 8 August fell again according to Bankrate's latest survey of large lenders. The benchmark 30-year fixed-rate mortgage fell 7 bps to 3.56%. The benchmark 15-year fixed-rate mortgage dropped 6 bps to 2.83%. The typical 30-year fixed-rate jumbo fell 7 bps to 3.62%. For the purposes of Bankrate's survey, a jumbo mortgage is a loan that is at least USD 650,000. We believe mortgage rates will continue to hover around current levels as long as the Federal Reserve does not hike its rates (probably not before year-end).

**Distressed sales at reasonable levels,
with Miami outperforming.**
Roughly 6.7 million US properties had negative equity at the end of June 2016 according to ATTOM Data Solutions' (the new parent company of RealtyTrac) new US Home Equity & Underwater Report of 2Q16. US properties that are seriously "underwater" signifies that the combined loan amount secured by the property is at least 25% higher than the property's estimated market value (hence commanding a loan-to-value ratio of 125% or more). This represented some 11.9% of all properties with a mortgage as at the end of 1Q16, down from 12% in the previous quarter and 13.3% in 2Q15.

Among 88 metropolitan statistical areas analysed for the report with a population of 500,000 or more and sufficient data, those with the highest share of seriously underwater properties were Cleveland, Ohio (27.5%), Las Vegas (25.7%), Akron, Ohio (24.9%), Dayton, Ohio (24.1%) and Toledo, Ohio (23.6%).

Other major markets with a population of at least 2 million where the proportion of seriously underwater homeowners exceeded 15% included Chicago (22.5%), Detroit (21.3%), Kansas City (21.2%), Orlando (19.1%), St. Louis (17.8%), Tampa-St. Petersburg (17.8%), Miami (17.3%), Baltimore (16.4%) and Cincinnati (15.6%).

South Florida continues to see an equity improvement exceeding the national average, with "underwater homes" showing a 3x improvement compared with the average (source: 2Q16 US Home Equity and Underwater Report, 11 August 2016).

**Grocery stores and elementary schools
are strong value drivers.**
According to Redfin, one "Walk Score Point" can increase the price of a US home by an average of USD 3,250 or 0.9% of the total value. Walk Score measures a location's "walkability" by assigning a value from 0 to 100, reflecting how many amenities, such as restaurants and grocery stores, can be easily and quickly reached on foot. Redffin examined the sales prices of more than one million houses sold between January 2014 and April 2016 across 14 metropolitan areas to determine the average value of one Walk Score point. Atlanta saw the highest One Walk Score point, namely USD 2,838 or 1.69% of the sales price on average. In Orange County, California, one Walk Score point added just 0.02% to the value of a house (source: World Property Journal, 8 August 2016).

Moreover, ATTOM Data Solutions released its 2016 Schools and Housing Report on 4 August 2016, showing that houses in zip codes with at least one good elementary school have higher values and stronger housing price appreciation over the long term than houses in zip codes without any good elementary schools. *"Out of 1,661 zip codes with at least one good school, the average estimated home value as of July 2016 was USD 427,402, 77% higher than the average home value of USD 241,096 in 2,774 zip codes without any good schools. Out of 173 metropolitan statistical areas analysed for the report, 143 metros (83%) had higher average home values in zip codes with good schools than in zip codes without good schools, including Los Angeles (65%), Chicago (65%), Atlanta (91%), New York (52%) and Miami (31%)."*

**Chinese strong buyers in the US;
Florida and California are prime targets.**
According to the National Association of Realtors' (NAR) annual survey of residential purchases from international buyers (2016 Profile of International Activity in US Residential Real Estate, April 2015-March 2016), deteriorating economic conditions in a number of countries combined with higher housing prices due to

an appreciating US dollar have resulted in a decline in international sales dollar volumes of US property over the past year and a fall in buying from non-resident foreigners. Indeed, foreign buyers purchased USD 102.6bn of residential property in the year to March 2016, a 1.3% decline from the USD 103.9bn of property purchased according to last year's survey.

4. News from Latin America

4.1. Commercial markets in Latin America

Commercial real estate has been under pressure in recent months, and the outlook is not very promising because of projected oversupply. Rents are under pressure and occupancy rates are falling.

Brazil in particular is problematic given its serious political and economic crises. Brazilian President Dilma Rousseff was suspended from her post on 12 May 2016 amid corruption charges before effectively be impeached in the last week of August. In addition, former President Luiz Inacio Lula da Silva will stand trial for obstruction of justice given his role in a massive corruption scandal over the State's oil giant. Petrobras – accounting for about 5% of the country's GDP – is struggling to pay its massive multibillion-dollar debts.

In any case, Brazil is currently experiencing one of the worst recessions in its history, with the economy likely to contract by at least 4% in 2016 (source: BNP Paribas Wealth Management).

There is some good news as well, at least for international investors. Currencies in Latin America (and in other emerging markets) hit a trough, and started offsetting part of their previous losses. The Brazilian real is a good example, appreciating against both the euro and the dollar by 26.97% and 29.13% respectively in the 6 months to 11 August 2016. Other currencies (Colombian and Chilean peso) were also capable of making up for some previous currency losses, even though there's still a long way to go. For example, the Brazilian real was barely trading at 1.6 against the greenback on 18 July 2008 (still 49% higher than on 11 August 2016, source: www.xe.com).

Brazil's office markets.
The vacancy rate in São Paulo reached 23.6% in 2015 (!) and is expected to rise to 25% in 2016, "a historical milestone for the metropolis" (source: Jones Lang LaSalle, Latin America, Office Market Overview, Mid-year 2016). The submarkets that are driving rising vacancy rates are Alphaville, Barra Funda, Bernini, Marignal and Vila Olimpia. Net office absorption surpassed 200,000m² for the second year in a row, as tenants took advantage of favourable market conditions to expand and/or consolidate their operations. Prime rents were down 5.5% from 2014 and 9.4% from 2013. *"With another 800,000 m² in the pipeline from 2016-2018, the current trends of high vacancy and falling rents will persist" (source: Jones Lang LaSalle).*

Rio de Janeiro's office market has not improved its performance.
The overall vacancy rate in Rio de Janeiro is approaching record levels of 24.2% due to weak occupancy in submarkets such as Barra de Tijuca, Centro, Orla and Porto Maravilha (source: Jones Lang LaSalle). In addition, net absorption in Rio was very low for the second consecutive year, as several companies downsized and returned space while rents dived by 12% on average y-o-y. Rents fell hardest in the ZonaSul, Orla and Porto Maravilha sub-markets. Rents are projected to decline further in Rio whereas the vacancy rate should continue to climb. The impact of the Summer Olympics on local property markets remains to be seen.

The Santiago office market (Chile).
Vacancy is close to 10%, the highest level in a decade. With 170,000m² more space in the pipeline for 2016, the vacancy rate is forecast to reach 11% in a year. Furthermore, rental values have fallen by 10% since 2014 in local peso. Fortunately for existing overseas investors, the Chilean peso strengthened by about 13% against the US dollar in the 6-month period to 11 August 2016. Nevertheless, rents are expected to fall modestly in peso, with widening spreads between asking and closing rents (source: Jones Lang LaSalle, Office Market Overview, 2Q16). The Santiago office market has grown steadily to the northeast over the past decade, and today is mostly contained in the Las Condes submarket. This trend could continue over the next few years as neighbourhoods like Los Dominicos, Estoril, and La Dehesaare become increasingly consolidated.

The same can be said of **the Bogota office market (Colombia).** Rising supply brought the overall vacancy rate above 11% at the end of 2015. Vacancy rates should jump further, maybe to a high 20% by 2018, with new supply flooding onto the market (JLL projects an overall production of 331,000m² compared with a forecast net take-up of 137,000m² for 2016). Headline rents are likely to dwindle again in the coming months – however without nose-diving. Prime offices that were leased at USD 35-40/m²/month a year ago are now commanding rents between USD 20-25/m²/month. However, upcoming rental declines may prove less aggressive once the (appreciating) Colombian peso is converted into US dollar. At any rate, the property landscape does not look good.

Oversupply on the Mexico City office market.
The Mexican peso did not recover in the 6 months to 11 August 2016, with the currency trading at 18.20 to the US dollar on 11 August 2016. The peso was rather volatile over the period, trading between 17.5 and 19.5 to the greenback

(source: xe.com). The central bank of Mexico decided to keep its benchmark interest rate on hold at a rather high 4.25% on 11 August (as a reminder, the benchmark rate was 3% at end-2016, source: TradingEconomics), stating *"the current monetary policy stance is adequate to bring inflation back to target of 3%".*

Mexico City is also witnessing a huge pipeline, with over 1,000,000 m² of office space to be completed in the city between 2016 and 2017. As such, the vacancy rate – which currently stands at 12% - is thought to rise further in the coming months. JLL is projecting lower rents: *"On the whole it is likely that they will show a downward trend due to the immense amount of supply in the pipeline." (source: Jones Lang LaSalle Office Market Review, Latin America, 2Q16).* Remarkably, many landlords have begun quoting rents in Mexican pesos due to currency volatility.

4.2. Residential markets in Brazil

Housing cannot be used to hedge against inflation.
The high rate of inflation in Brazil – 8.74% in July 2016 (source: TradingEconomics) – has resulted in an overall fall in real residential prices across the country. Even in nominal terms, prices have spiralled downwards for the first time in a long while!

The residential markets in Brazil have been under pressure because of challenging political and economic conditions. The country is beleaguered by an old-fashioned recession and high interest rates.

According to the FipeZap index, the nominal price of residential real estate marginally eroded by 0.1% (on average) in the 12 months to June 2016. This is the worst performance since the index was launched in 2008. Consequently, the housing market tumbled by roughly 8.9% in real terms due to high inflation (although inflation has somewhat eased from the 10% highs seen in January 2016).

All main Brazilian cities posted housing price growth below consumer prices. By way of comparison, the index gained over 13.4% in the three years to end-July 2016. The FipeZap index also releaved a remarkable reduction of 3.6% in Rio de Janeiro's housing prices in the 12 months to end-July (in spite of the Olympic Games). Adjusted for inflation, this local real estate market plunged by over 12% in real terms.

As a reminder, the FipeZap index is the main indicator for the Brazilian residential real estate market. It looks at the property market in 16 main cities of the country ("FipeZap Ampliado"). The index is developed by FIPE (the Institute of Economic Research Foundation, linked to the School of Economics, Business Administration and Accounting of the University of São Paulo), in partnership with the ZAP Imoveis web portal.

The picture looks even more dismal for overseas investors, especially those with an asset base denominated in US dollars. Although the Brazilian real has appreciated by 27% (3.14 on 10 August 2016, source: Bloomberg) since the historical lows against the dollar early this year, long-term investors who entered the market several years ago are still facing steep currency losses, preventing them from taking (virtual) profits.

What is around the corner?
We believe much will depend on economic growth drivers in the near future, the health of the labour market (unemployment figures), financing conditions for buying property, inflation levels, the political situation and commodity prices. We admit that none of these factors look very promising at present. As a result of the depressed mood, housing prices should stabilise at best in nominal terms. Or they might collapse if the economic situation deteriorates further. In other words, current and projected housing prices do not offer protection for upcoming inflation in Brazil. The future does not look very encouraging, yet opportunistic investors should be scrutinizing the country's investment market.

5. News from the Middle East

5.1. Commercial markets

Declining occupier demand in the UAE.
The RICS Global Cities Commercial Property Monitor 2Q16 (a property survey conducted by RICS - the Royal Institution of Chartered Surveyors -24 July 2016) reported a 23% decline in occupier demand in the United Arab Emirates' property market in 2Q16. This is the third consecutive quarter of declines. In addition, more surveyors reported a fall in tenant interest, demonstrating that the supply of available space continued to increase as property development activity in recent years came onto the market. The RICS report stated that 10% of contributors reported a deterioration in credit conditions in 2Q16, the third consecutive tightening in lending standards. ***"The largest proportion (45%) of contributors thinks that current prices are around fair value while 42% think that they are still expensive relative to fundamentals."***

In any case, the demand for office space in Dubai has receded in the six months to end-June 2016, as the negative effect of the oil price collapse and the subsequent economic slowdown in the rest of the Gulf has spread to the whole city's commercial property market (source: Cluttons, bi-annual Dubai Office Market Bulletin).

Prime office occupancy costs in Dubai are the highest in the Middle East.

Prime office space in Dubai remained the most expensive in the Middle East in 1Q16, even though occupancy costs represented only a third of demand in Hong Kong. Dubai ranks 23rd in the world with office occupancy costs totalling AED 280 (USD 92.57) per sq ft per year (source: CBRE Global Prime Office Occupancy Costs survey, June 2016).

Market fundamentals in Dubai's commercial sector remain positive, particularly for well-located top-end buildings. But poorly-located offices with mediocre amenities, (particularly badly managed), will struggle to compete with the more affordable new stock. Today, Dubai's office market is a two-tiered market, with TECOM Free zone performing well, with the Business Bay market and strata properties, i.e. different owners in one building (which are located further away from transportation links) underperforming. According to CBRE research, Hong Kong (Central) scored the world's highest-priced office market, with Asia continuing to dominate the world's most expensive office locations. Hong Kong's (Central) overall occupancy costs of USD 290.21 per sq ft per year topped the "most expensive" list, followed by London-Central (West End, USD 262.29), Beijing (Finance Street, USD 188.07), Beijing CBD (Central Business District), USD 181.60) and Hong Kong (West Kowloon, USD 179.49). Worldwide/Total prime office occupancy costs increased by 2.4% in the 12 months to 1Q16.

Dubai housing prices and rents may not rebound until 2018.

Residential housing prices deepened losses in 1H16, with values expected to decline until the end of 2017. Phidar Advisory's latest Dubai residential research note published mid-quarter (2Q16) suggested that "soft demand" was the cause of the latest price drops rather than supply which has expanded slowly over the past 30 months.

In the first half of 2Q16, apartment lease rates declined by 1.5%, while sale prices lost 3%, pushing up gross yields to 7.8%. This corresponded to a six-week gain of 12 bps (source: Phidar House Price Index). Gross property yields carried by Dubai apartments have always been very high compared with other prime or "next-to-prime" areas in the world in recent years, and this trend seems to be accelerating. Lease rates for single family homes (also referred to as "villas") diminished by 3.2% whereas sale prices remained stable. Consequently, property yields were pushed downward to 4.6%, a loss of 15 bps, thus widening the gap with apartment yields. As such, the compression of villa yields is unsustainable and could be reversed in the next months. Overall, the Dubai residential market is still hovering in a downward cycle (which started 18 months ago), with the strong US dollar (and thus dirham) not helping things either, in particular for foreign buyers. According to Phidar Advisory, a strong dollar is usually associated with a low oil price, implying a double blow to the market. ***We believe the market has fallen by about 15% from its peak in mid-2014.***

In 2015, foreign investors purchased over 80% of real estate investment in Dubai. Of this amount, 82% was purchased from foreign nationals outside the GCC, most of whom are from countries with floating exchange rates.

UAE's property loans are improving despite price declines.

The quality of real estate loans in the United Arab Emirates has continued to improve despite falling housing prices (source: International Monetary Fund, IMF). As a result, the UAE is coping better with the real estate downturn than during the last crisis seven years ago. Dubai's average residential real estate prices plunged by 11% in 2015 and in neighbouring Abu Dhabi prices fell by 0.8% (source: Reuters, IMF, 27 July 2016).

But non-performing loans in the construction and real estate development industries shrank to 7.5% of the total at the end of March 2016, from 12.3% in 2013. The quality of loans to households has also been improving, with the ratio of non-performing loans dropping to 4.9% from 10% over the same period. In Dubai, whose economy does not directly rely on oil and state-run firms vigorously pushing tourism and real estate projects, the IMF expects growth to accelerate marginally, to 3.7% from 3.6%.

Russian investors are returning to the Dubai real estate market.

Russian investors are returning to the Dubai real estate market after staying away due to a record fall in the value of the rouble last year. Data published by Dubai real estate portal PropertyTrader.ae for the first half of 2016 revealed a significant rise in overseas enquiries from Russian site visitors – demonstrating a renewed interest in the emirate as an investment hotspot. Obviously, Russian investors have always been important for Dubai (in particular for the Emirates Hills and the Palm Jumeirah regions, well-known for luxury real estate). But investment appetite eroded after the record fall of the rouble last year.

According to PropertyTrader.ae, Russia made up just 6% of our overall traffic in January 2016, yet it was up by nearly three times at 17% in July. In 2015, the Dubai Land Department ranked Russian investors as the sixth-largest group of foreign buyers in Dubai's realty sector.

In our opinion, it is too early to have "stabilising housing prices" as a key assumption for 2016. Foreign investors should investigate local opportunities from 2017 onwards.

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- **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.

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