

INVESTMENT STRATEGY

# Real Estate Focus: Look past the rate shock

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# In short: Patience required, the worst may be past

## Key Points

- Interest rate effect on Real Estate fades:** US and European central banks near the end of the rate hiking cycles, with policy rates already at 15-year highs. As inflation rates decline, long-term bond yields are also cooling, reducing the pressure on property prices.
- US benefits from weaker inflation, coming soon to Europe:** US and European inflation should decline further to year-end, allowing stable to lower long-term interest rates. We forecast end-2023 10-year bond yields of 3.5% (v 3.8% now) in the US and 2.5% (v. 2.4%) in Germany.
- Commercial Real Estate outlook mixed:** from a structural viewpoint, we see greater growth potential from Logistics and Hospitality segments given robust demand. In contrast, the environment is more challenging for secondary Office and Retail segments.
- Modest correction in most Residential property markets:** Australia and Sweden are the most impacted residential property markets due to i) high loan-to-value ratios, and ii) high exposure to variable interests rates, France and the US fare better, with moderate borrowing levels and 90% exposure to long-term fixed rates.
- Employment market remains key:** economic stability is key to underpinning Residential and Commercial Real Estate demand. Today's starting point is encouraging: decade highs in US, UK and European employment.

## Main recommendations

**=** Maintain Neutral stance on Real Estate. We look for stability in European Commercial Real Estate over H2 2023, then a potential price rebound in 2024. Lower long-term interest rates together with stable economic activity could prompt us to review our Neutral rating.

**Potential catalysts:** lower inflation expectations, continued Residential and last-mile Logistics under-supply of land. Value-add strategies of upgrading older Real Estate assets looks appealing in this context.

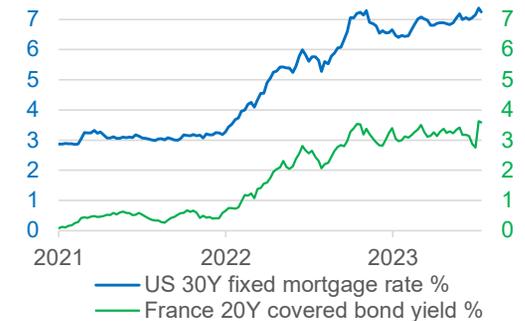
**+** Regionally, UK, Continental Europe and Poland look more attractive given higher starting yields and encouraging rental growth trends.

**Commercial Real Estate segments to favour:** More conservative investors should look to the lower volatility European Healthcare and Residential segments. More dynamic investors can favour an expected rebound in Industrial/Logistics demand.

**!** **Key risks:** significant contraction in global economic activity driving higher unemployment rates, lower Residential and Commercial Real Estate demand. **Inflation persistence,** obliging central banks to continue hiking interest rates is a second key risk.

**Remember:** Real Estate is a long-term, illiquid investment with positive rental growth that generally provides a reasonable inflation hedge over time.

## US, French fixed-interest rates plateau



Source: BNP Paribas, Bloomberg

## Global inflation momentum reverses



Source: BNP Paribas, Bloomberg



<b>+</b>	<b>-</b>	<b>=</b>	Our position this month
<b>▲</b>	<b>▼</b>	<b>▲▼</b>	Change in our position since last month

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# 1. Real Estate Outlook

Searching for H2 2023 stability

## REAL ESTATE PRICES ALREADY BEGIN TO STABILISE POST 2022-Q1 23 CORRECTION

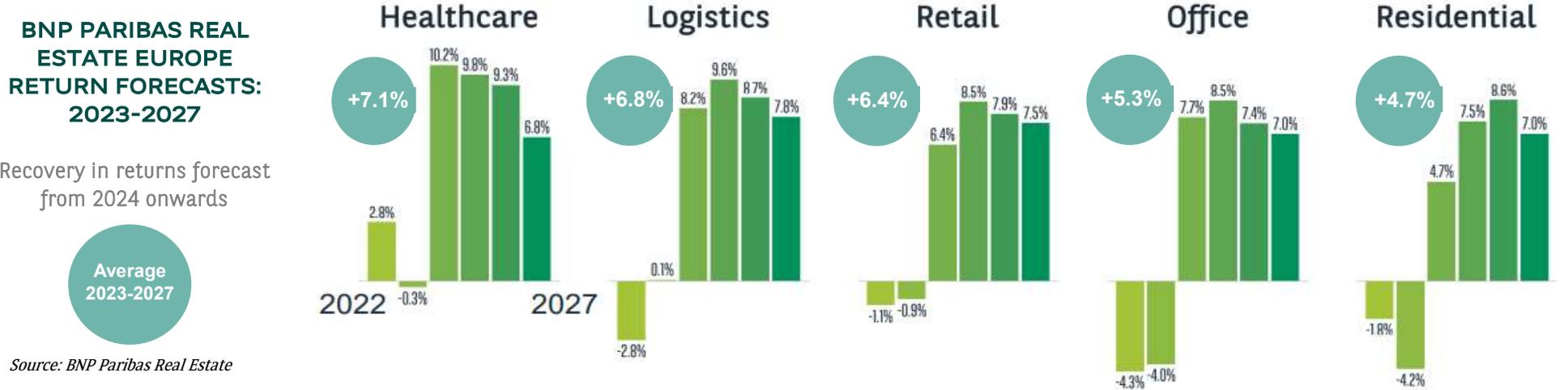
After a long period of robust compound returns for global Real Estate markets post the 2008 Global Financial Crisis, 2022 and Q1 2023 delivered an unwelcome correction.

Both Residential and Commercial Real Estate markets have suffered from a readjustment phase due to a sharp spike in US and European interest rates. The return of high inflation has obliged central banks to abandon their long-held zero interest rate policies. US and European policy interest rates stand today at 15-year highs, pushing both bond and Real Estate yields higher.

**Is the worst now past?** The Q1 2023 performance suggested that stability may be in view for global Real Estate - unlisted European Commercial Real Estate funds saw a drop of only 1% in their quarterly returns versus Q4 2022. BNP Paribas Real Estate forecast stability in European Commercial Real Estate Prices over H2 2023, then a progressive rebound from 2024 onwards. **Avoiding deep recession is key:** we look for a combination of robust employment trends,

easing inflation rates and a modest recovery in European economic activity by end-2023 to support a combination of stable property yields and positive rental growth. The end of the programme of interest rate hikes by the European Central Bank and the US Federal Reserve in the coming months would also be welcome for both Residential and Commercial Real Estate.

**Segments and Regions to Favour:** More conservative investors should look to the lower volatility European Healthcare and Residential segments. Dynamic investors can favour segments with strong rental growth: city centre Logistics, Hospitality, Healthcare, Multifamily Residential. Regionally, the UK and Europe look better value today for long-term investors given higher rental yields + growth. **In contrast, Offices will take longer to recover fully;** secondary offices are at risk from value impairment, as companies reassess their post-COVID space requirements.

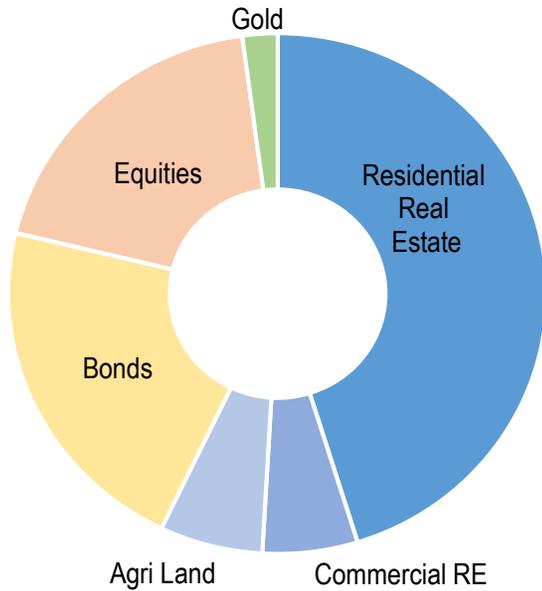


Source: BNP Paribas Real Estate

## 2. Real Estate: > 50% of Global Assets

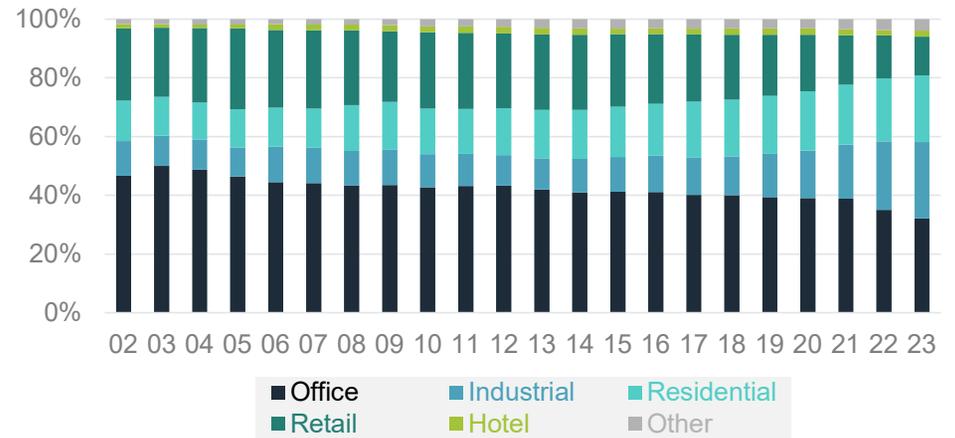
REAL ESTATE IS BY FAR THE BIGGEST ASSET CLASS, DOMINATED BY RESIDENTIAL PROPERTY

**Size of Global Asset Markets:  
Residential Real Estate 45%, Commercial RE 6% of Total Assets**



Source: Savills (2020)

**Worldwide, Offices Now Only 1/3<sup>rd</sup> of Commercial Real Estate Market**

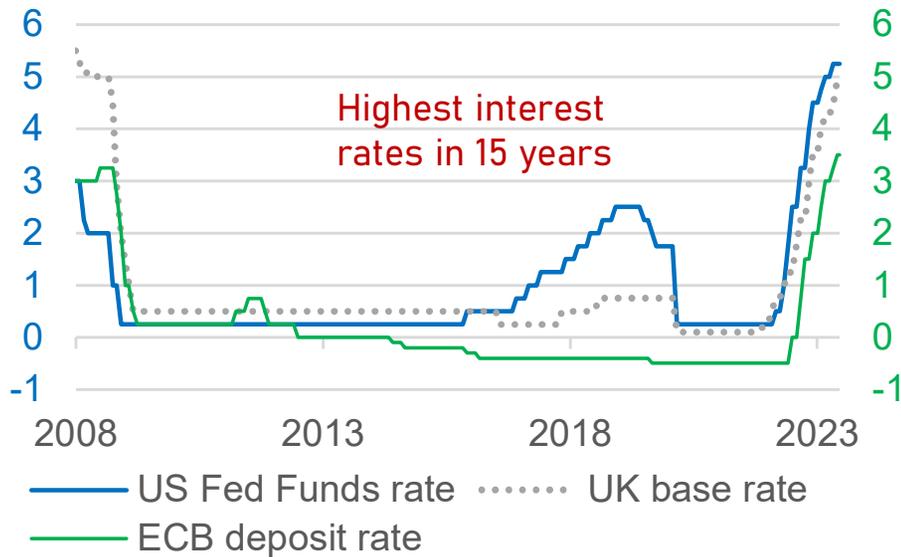


Source: BNP Paribas Real Estate, MSCI

# 3. Interest Rate Shock: Hits Real Estate after Low Rate Era

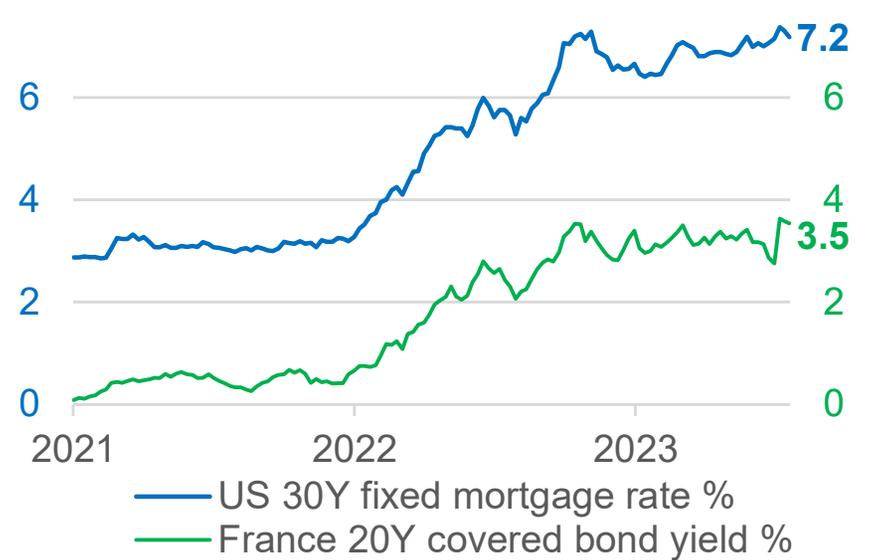
INFLATION SURGE AND RESULTANT CENTRAL BANK INTEREST RATE HIKES IMPACT REAL ESTATE

2022-2023: End of Central Banks' Zero Interest Rate Policy



Source: BNP Paribas, Bloomberg

US, French fixed rate mortgages become more expensive



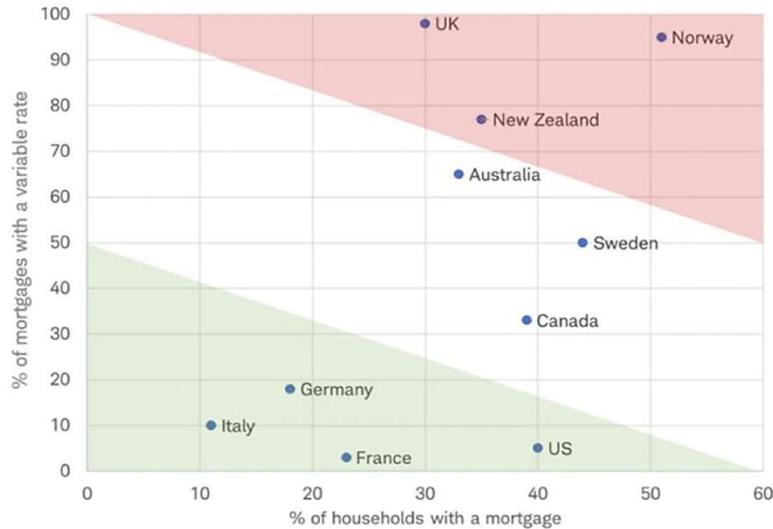
Source: BNP Paribas, Bloomberg

# 4. Residential Property: Australia, UK, Norway exposed to higher rates

WHILE US, FRENCH, GERMAN, ITALIAN HOUSING MARKETS HAVE RELATIVELY LOW EXPOSURE

**Key Eurozone housing markets, US not exposed to variable interest rates; while UK, Norway, New Zealand are**

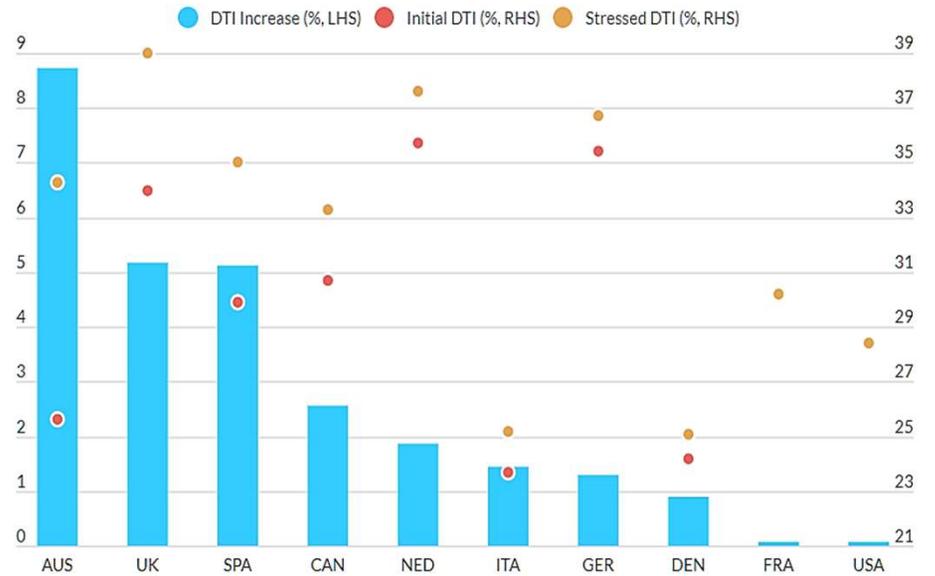
**Risk of mortgage shock greater in U.K., Norway, and New Zealand**



Source: Charles Schwab, OECD, Reserve Bank of Australia, Bank of Canada, CoreLogic, Hypostat, data as of 11/8/2022.

**Australian homeowners are most sensitive to rising mortgage rates : US and France least sensitive**

Estimated DTI Impact of 3% Rate Rise

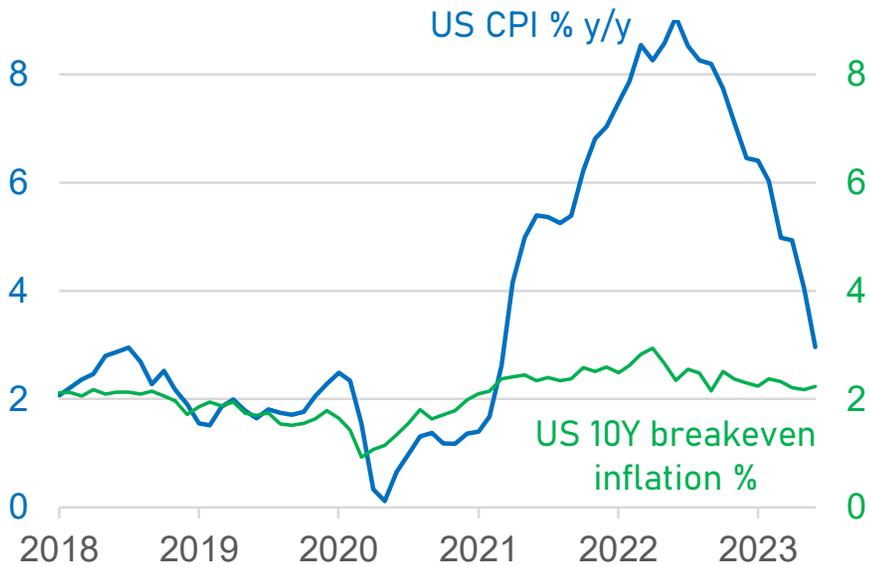


Source: Fitch Ratings. Note: DTI = cost of servicing debt as proportion of net household income in %

# 5. Inflation Spike Reverses: Return to/below Target?

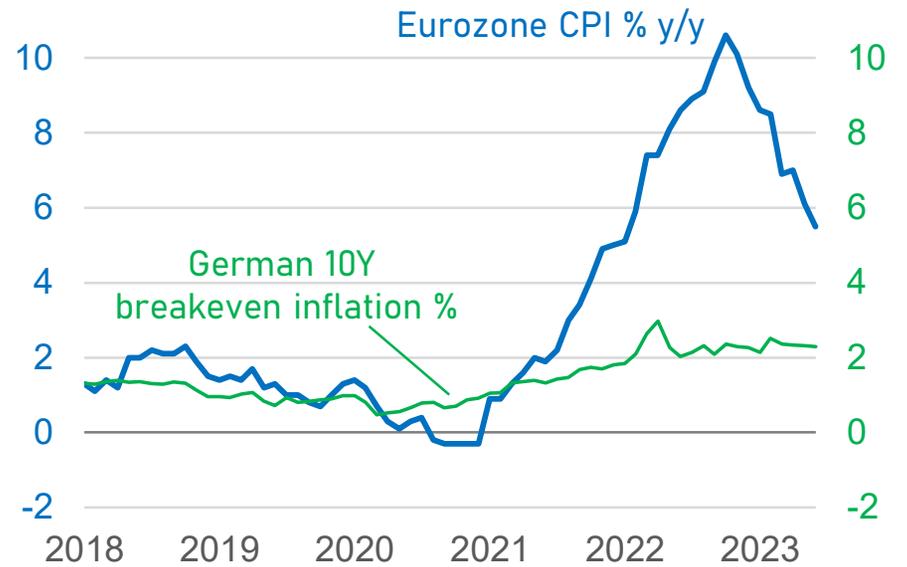
BOND MARKETS INCREASINGLY LOOK THROUGH INFLATION SPIKE: LONG-TERM BREAKEVEN RATES CLOSE TO 2%

### US Headline Inflation Already Below 3%: To Go Lower



Source: BNP Paribas, Bloomberg

### Eurozone Inflation High But Cooling Fast

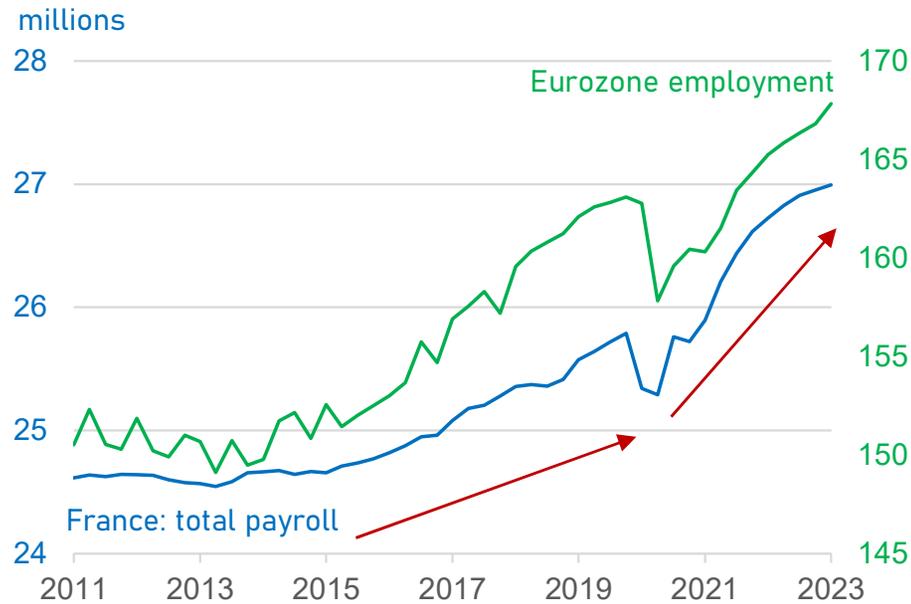


Source: BNP Paribas, Bloomberg

# 6. Real Estate Demand Supported by Strong Employment Climate

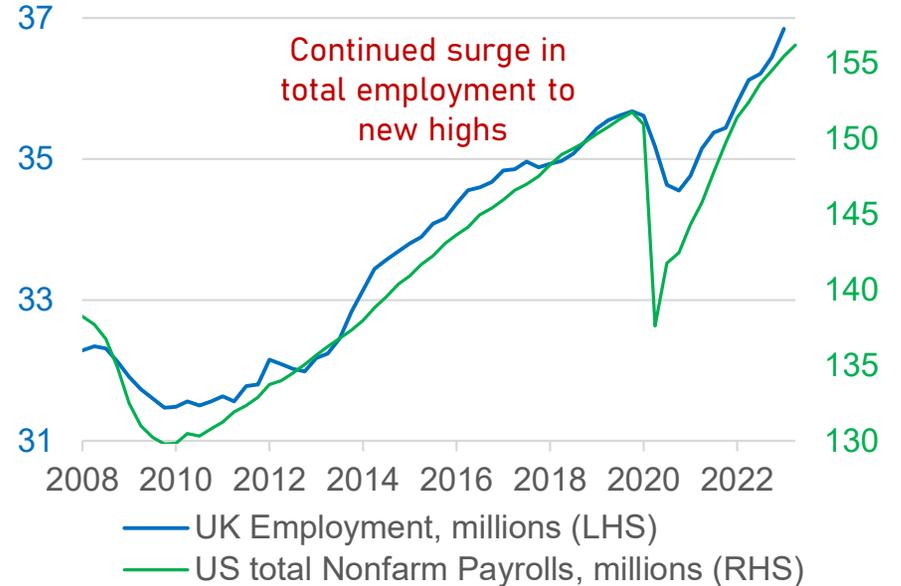
RESIDENTIAL, COMMERCIAL PROPERTY DEMAND SUPPORTED BY GROWING EMPLOYMENT, THUS MORE ROBUST CONSUMER

## Highest Ever Total European Employment



Sources: BNP Paribas, Bloomberg

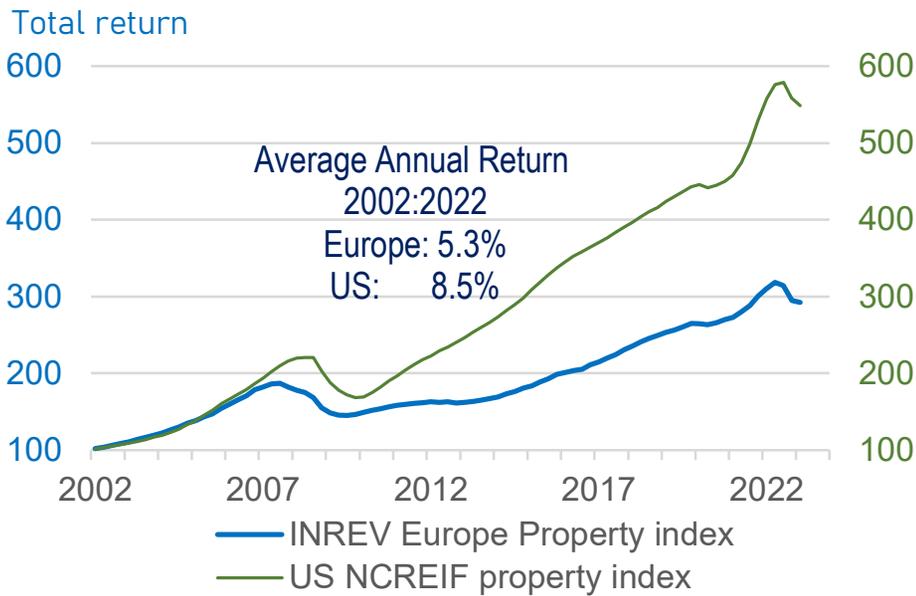
## US, UK Employment Well Above Pre-COVID Levels



# 7. Real Estate Funds: Only a small drop in returns in Q1 2023

REAL ESTATE RETURNS ALREADY STABILISING IN Q1 2023 POST CORRECTION

2010 - 2021: Real Estate revalued up on lower rates



Source: BNP Paribas, NCREIF, INREV

Hoping to see stability in Real Estate values in mid-2023



Source: BNP Paribas, NCREIF, INREV. Note: quarterly returns to Q1 2023

# 8. Europe Commercial RE: Improving Yields, Robust Rental Growth

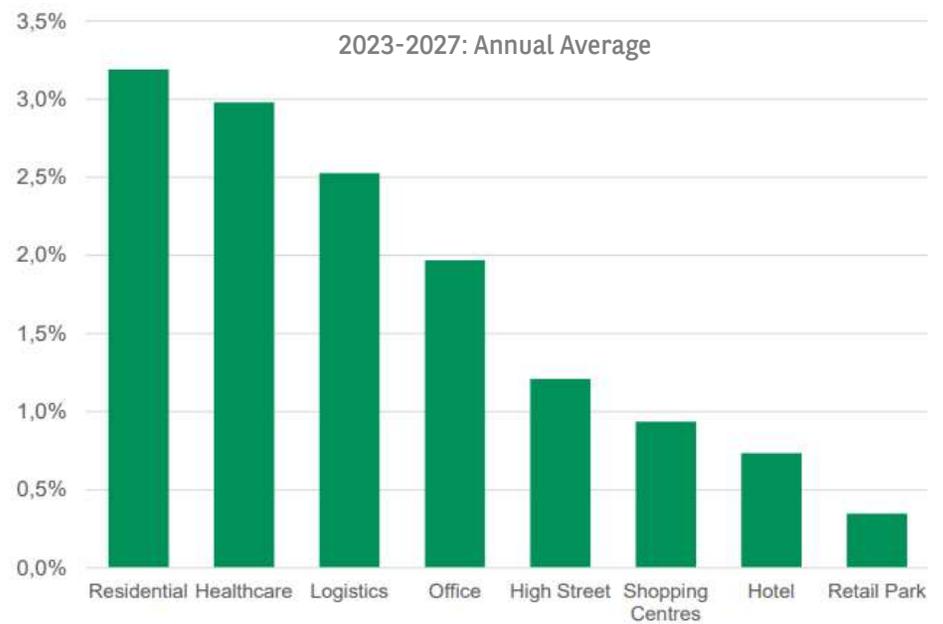
HIGHER FINANCING RATES DRIVE PROPERTY YIELDS HIGHER

Europe Prime Yields: Still Adjusting on Higher Rates



Source: BNP Paribas Real Estate

Europe Rental Growth: Expected to Remain Robust



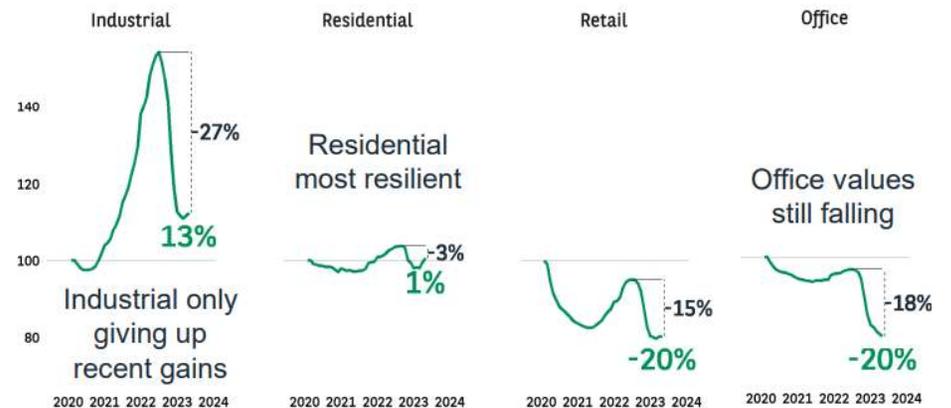
Source: BNP Paribas Real Estate

# 9. BNP Paribas REIM: Expects Europe Property Prices to Rise in 2024

FORECAST LOWER 2024 EUROPEAN PROPERTY YIELDS = EXPECTED REBOUND IN COMMERCIAL REAL ESTATE PRICES

**2022-23 = Property Yields Rise/Prices Fall;  
2024 = Yields Fall/Prices Recover**

**UK Real Estate: After Price Correction,  
Values Up in March + April 2023**

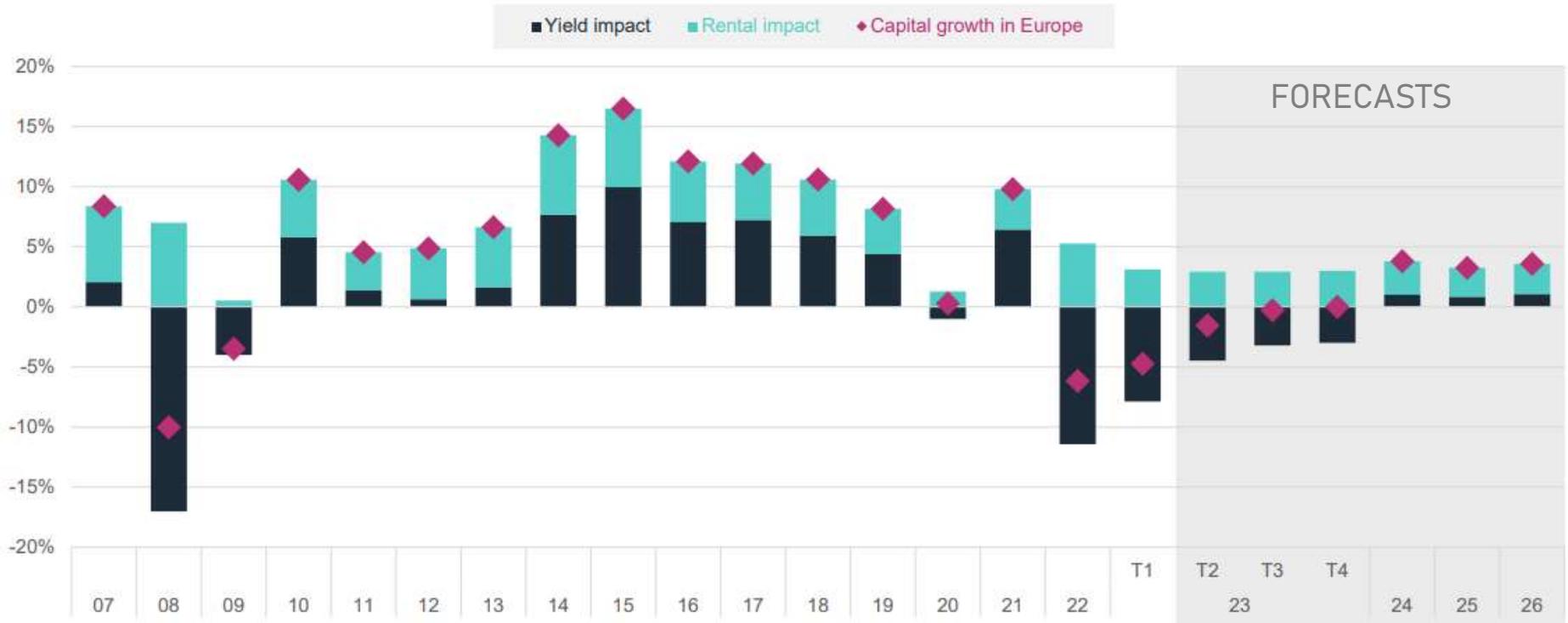


Source: BNP Paribas REIM ((Lighthouse H2 2023 report)

Source: BNP Paribas REIM ((Lighthouse H2 2023 report), MSCI. Data as of April 2023

# 10. Europe Prime Property: Stability in H2 2023, then Positive Returns

EUROPE PRIME PROPERTY YIELDS TO STOP RISING BY END-2023, RENTAL GROWTH TO THEN DRIVE PRICES

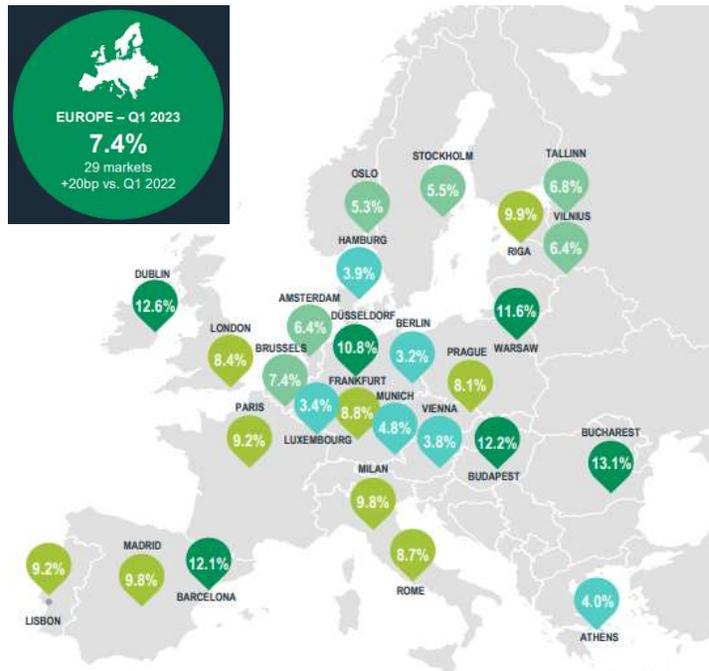


Source: BNP Paribas Real Estate

# 11. Europe Offices: Only Modest Rise in Prime Office Vacancy Rate

FEARS OVER WORK FROM HOME IMPACT ON OFFICE DEMAND EXAGGERATED?

## Office Vacancies Rise Only Modestly to Q1 2023



Source: BNP Paribas Real Estate

## Europe Prime Office Rents: Still Growing

### Q1 2023 vs Q1 2022

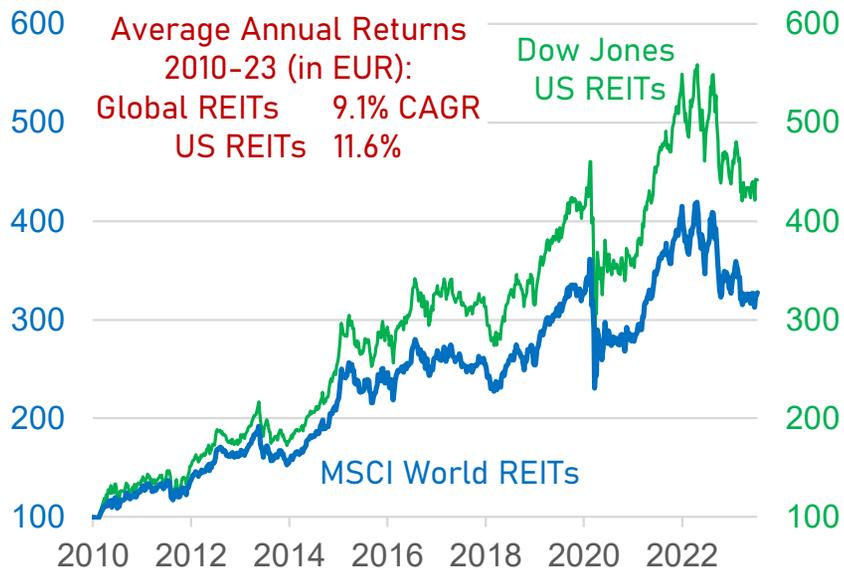


Source: BNP Paribas Real Estate

# 12. Global Listed Real Estate: US, Logistics Have Led since 2016

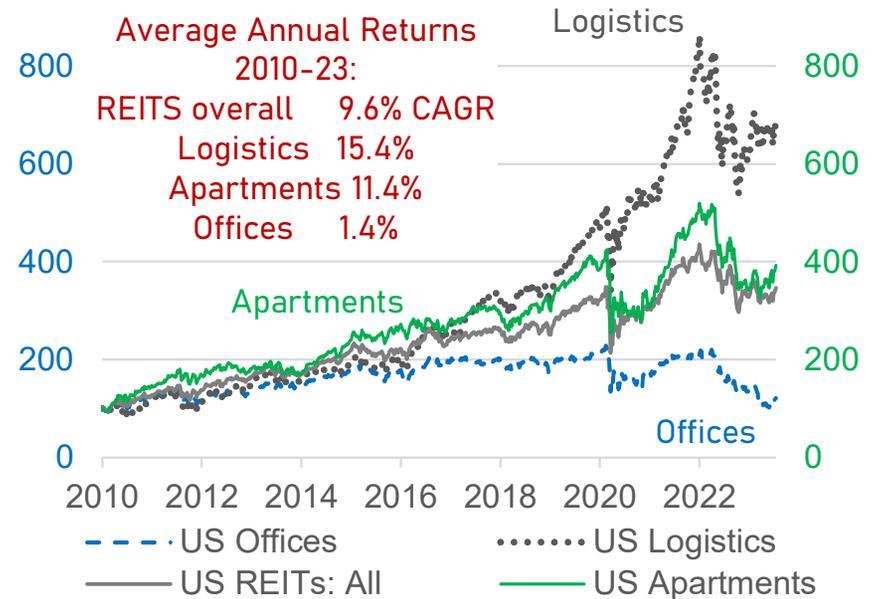
EVEN INCLUDING THE 2022-23 MARKET CORRECTION, LONG-TERM LISTED REAL ESTATE RETURNS HAVE BEEN STRONG

**Global Listed Real Estate (REITs): Strong Long-Term Returns**



Source: BNP Paribas, Bloomberg. Note: total return indices in Euros

**US REITs: Logistics has led, Offices have lagged since 2016**



Source: BNP Paribas, Bloomberg. Note: total return indices in US dollars



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