Morgan Stanley

INVESTMENT MANAGEMENT

Global Real Estate
Outlook *Revisited*

Shifting Macro Landscape Requires More Discerning Investment Strategy

The global economic environment remains highly uncertain. On top of the unknown path and outcome of the war in Ukraine, many parts of the world are faced with record levels of inflation, rising interest rates and ongoing COVID challenges, most notably in China where the recent lockdowns affect supply chain costs and create delays. As a result, economic growth expectations have been lowered, most notably in Europe and China. Capital markets volatility across all asset classes has been extreme and is expected to continue. Given a moderated growth outlook and higher interest rates, real estate returns could potentially be lower over the next few years but still outperform other asset classes. Investor capital flows should remain steady, attracted to the durable, inflation-hedging income characteristics, which in turn should continue to support strong pricing for a narrower definition of core real estate. Class A residential and industrial markets will likely continue to outperform, while the office and retail sectors' performance will likely remain challenged and highly bifurcated.

REAL ASSETS | REAL ESTATE INVESTING RESEARCH & STRATEGY TEAM

Above Trend but *Slower* Growth

GDP forecasts have come down due to lower demand as a result of higher prices, weaker market sentiment and squeezed consumer incomes. Despite this, real growth rate projections over the next two years still compare relatively favorably against the last 10 years (3.1% in the U.S., 2.7% in Europe and above 5% in Asia).

Europe's growth is likely to be more impacted by the war in Ukraine compared with the U.S. and Asia given its weaker macroeconomic conditions, greater dependency on Russia for energy, more supply chain linkages in key industries (e.g., autos) and greater trade exposure. Asia's growth is likely to be less impacted as most countries are in the early-to-mid cycle phase of their economic expansion (due to stricter COVID policies), have less dependence on Russian oil, lower inflation and higher current account surpluses (compared with past crises). However, COVID-lockdowns have the potential to lower growth in China (and for the region) and further disrupt global supply chains.

Growth in the U.S. should remain above-trend, helped by a healthy labor market (dynamic job market, rising participation rates and wage increases), de-levered consumer balance sheets and a strong capex cycle.

Elevated and *Sticky* Inflation

Rising energy and food prices, exacerbated by the war, has added more pressure on already high inflation prints in many countries, most notably in the U.S. (6.8%), Europe (6.8%) and the U.K. (6.7%). Governments in Europe and Asia are planning to reduce the burden from energy prices on consumers via tax reductions, subsidies and targeted income support measures. While higher energy and food prices will continue to affect all regions, MSREI believes that U.S. inflation may be more persistent relative to the other regions given higher wages and housing costs.

From a real estate investing standpoint, it will be even more important to focus on sectors and opportunities where rents can grow faster than costs and where market fundamentals are more resilient to a pullback in consumer spending. Sectors best positioned to outperform in this environment include those with the strongest secular tailwinds, notably industrial and residential.

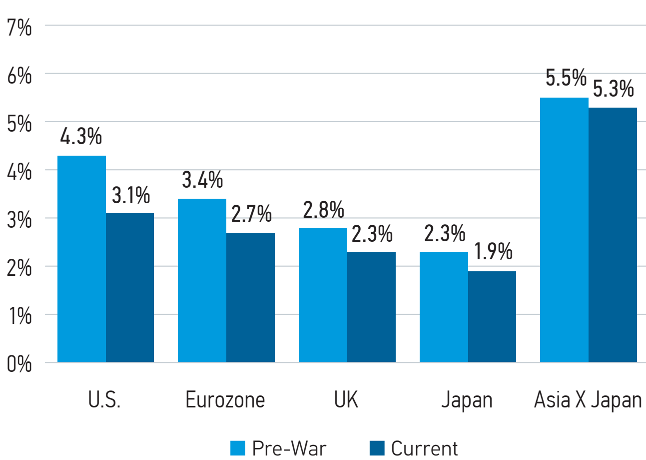
Steeper Interest Rate Increases and *Accelerated* Unwinding of QE

While Central Banks have noted the downside risks to economic growth stemming from the war in Ukraine, they have placed a higher priority on addressing inflation and therefore have adopted a more hawkish stance on monetary policy. Facing an unprecedented macro environment that includes supply chain issues, economic sanctions, war and unparalleled inflation, the Fed is expected to reduce the size of its balance sheet by $1.1T per year and aggressively raise interest rates. Morgan Stanley Research is anticipating a 50bps hike in May and in June, with additional 25bps hikes at all subsequent meetings through mid-2023, with the hiking cycle ending at 3.125%.

DISPLAY 1

GDP Forecasts have Weakened

2022-2023 Annualized

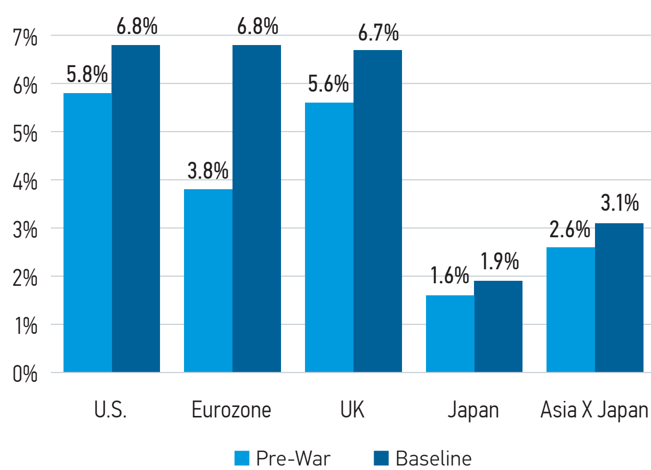


Source: Morgan Stanley Research, data as of April 9, 2022

DISPLAY 2

CPI Forecasts have Increased

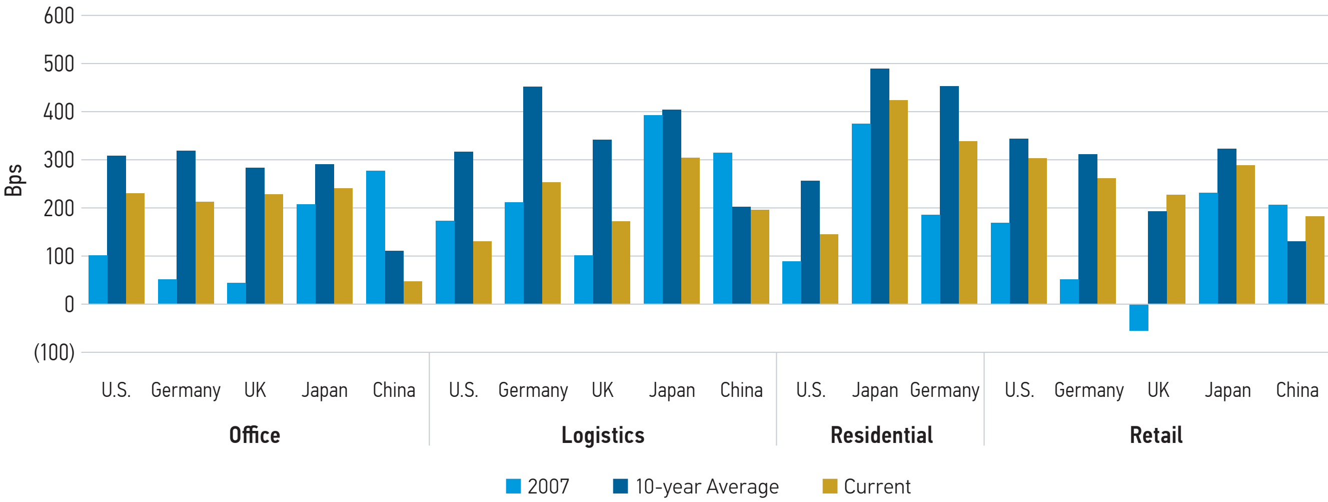
2022 YOY



Source: Morgan Stanley Research, data as of April 9, 2022

DISPLAY 3

Cap Rate Spreads Trending Below Historical Averages



Source: NCREIF, PMA, MSCI, Bloomberg, MSREI Strategy, data as of March 2022

Outside the U.S., the Bank of England started to hike rates last year and is expected to continue in the first half of 2022, but may then decide to pause as pinched consumer incomes start to impact economic growth in the second half of the year. In Europe, markets are expecting more than two rate increases in 2022 and accelerated winding down of the ECB's asset purchases this year. In Asia, the Reserve Bank of Australia has shifted to a more hawkish tone, with Morgan Stanley Research now expecting rate hikes totaling 250bps through the end of 2023. South Korea is also expected to raise its rates by 160bps through year-end 2023. Overall higher policy rates have already begun to flow through to higher real estate borrowing costs in certain markets, including the U.S., U.K., Australia and South Korea.

Given the expected magnitude of interest rate increases, MSREI believes that the weight of capital targeting real estate may not be enough to offset an increase in cap rates resulting from higher borrowing costs and significantly compressed yield spreads. As a result, investors will need to search for opportunities to drive higher income growth in order to offset higher cap rates and keep values from declining.

Shifting Longer-Term Secular Trends as a Result of the War

The war's longer-term de-globalization impacts on trading relationships, on-shoring/near-shoring trends, overall input costs and supply chains, may result in prolonged higher inflation and interest rates in some parts of the world, shifting trade routes and may create a new set of market winners and losers. A potentially stronger and more integrated Europe driven by fiscal stimulus to build out energy and defense infrastructure may lead to an above-trend, medium-term growth outlook. In the meantime, heightened political tensions and a potentially more fractured relationship between the U.S. and China may lead to decoupling in some spheres (e.g., technology), potentially causing a decrease in trade and a greater focus on maintaining buffer supplies of critical inventories in both regions. A shift to bi-polar and multi-polar economic and political relationships may create demand for more localized technology, research and development, spurring jobs in markets with access to that talent, while shifting trade patterns and re-shoring/near-shoring trends may benefit some industrial markets at the expense of others.

DISPLAY 4

Despite Prevailing Uncertainties, Near and Long-Term Macro Implications are Beginning to Emerge

	NEAR-TERM	LONGER-TERM
Financial Markets	• Very high inflation in the U.S. and Europe • High oil prices (above $100/barrel) • Stronger USD, weaker euro and JPY • Cyclically higher US interest rates	• Secularly higher inflation (above 10Y average) • Moderate oil prices as supply is re-oriented and increased • Weaker USD and JPY as reserve managers diversify • Secularly higher US interest rates
Macro Sector Impacts	• Lower auto production • Supply chain shortages and delays • Trade embargo with Russia • Shift away from globalization • Reduced energy dependency on Russia	• Onshoring/near-shoring of critical inputs • Buffer storage of critical inventories • Potentially less trade with China & Russia • Bi-polar (military, politics, ideology) and multi-polar (economics) • Higher U.S. LNG exports, diversified energy sources
Real Estate Implications	• U.S. and Asia fundamentals more insulated vs Europe • Flight to quality • Sectors with inflation hedging attributes and secular growth drivers • Potentially higher cap rates in the U.S. partially offset by weight of capital • Higher construction costs and greater delays	• Fiscal stimulus in Europe to build out energy and military infrastructure • Higher risk premium for China given potential decoupling • Market winners tied to on-shoring/re-shoring and higher share of jobs in defense, energy and tech • Potentially higher cap rates and capital re-allocation requires strong growth to support values

Real Estate should Outperform in Near-Term and Long-Term Given Inflation Hedging Attributes and Ability to Drive Growth in Sectors with Secular Tailwinds to Offset Potentially Higher Cap Rates

Flight to Quality *More* Pronounced

Given the mix of macroeconomic unknowns discussed above and heightened market volatility, MSREI believes investors will need to follow a more cautious investing approach and adopt a more restricted definition of core real estate from a country, sector and location perspective. This could lead to lower return expectations for buyers of "true core" investments and the potential for transaction volumes to fall from last year's highs due to a widening gap between seller and purchaser expectations. Additionally, higher real estate financing and hedging costs may result in a smaller and narrower buyer universe.

Property Sector Fundamentals and Investment Strategy

Despite the shifting market environment, MSREI believes that continuing to focus on opportunities in the higher growth industrial and residential sectors, while staying cautious on the retail and office sectors, will continue to deliver strong performance. However, within those high growth segments, investment strategies and market selection need to be more nuanced given the secular shifts across the macro landscape. Specifically, MSREI believes investors should target locations that are more resilient to a pullback in occupier and investor demand and that benefit from demographic and supply chain shifts as this may support enough rent growth to offset rising costs and potentially higher cap rates.

Industrial – Diverse Set of Demand Drivers, Fewer Affordability Constraints. Development Strategy Most Attractive

Industrial markets around the world continue to exhibit extremely low levels of vacancy generating record rent growth in most global locations. Despite the big uptick in rents, other supply chain costs have increased by an even greater amount (e.g., spot ocean container freight costs up 200% yoy), as a result rents still remain a relatively small fraction of the overall supply chain (5-10%), suggesting some further upside, particularly in markets in Asia and Europe which have not seen as much rent growth. Additionally, third-party logistics, retailer and wholesaler margins are yet to be materially impacted by rising costs, suggesting rent affordability remains manageable. Squeezed consumer incomes, however, may challenge the pass through of these higher costs which, combined with higher supply, may lead to slower rent growth over the next couple of years, particularly in secondary markets with fewer barriers to new construction.

As mentioned above, potential supply chain shifts from de-globalization may alter relative market attractiveness. Within the U.S., re-shoring of semi-conductor and chip production may benefit fabrication locations such as Phoenix, Austin and Columbus, near-shoring manufacturing to

DISPLAY 5

Disciplined Execution of Current Investment Strategies

SECTOR	FUNDAMENTALS	INVESTMENT STRATEGY
Industrial	• eCommerce and just-in-case demand offset by weaker consumption and new supply (despite higher build costs) • De-globalization, near-shoring and on-shoring may shift occupier locational preferences • Spread between primary and secondary markets has been compressing, however that trend may reverse in some markets where significant supply has been added • Rising construction costs will increase replacement cost, which could mitigate supply risk and support strong existing asset values	• Given tightness of yields, focus on locations that will drive continued rent growth • Develop (underwrite higher construction costs) in primary markets and locations that will benefit from de-globalization and longer-term supply chain shifts • Selectively consider strong secondary markets poised to benefit from secular shifts
Residential	• Stretched for-sale affordability and strong income growth continues to support renter demand in growth markets • Higher food and energy prices may squeeze consumer incomes, with disproportionate impact to lower income renters • Rising construction costs increase replacement cost, which could mitigate supply risk and support strong existing asset values • Supply growth and regulation remain key risks to rental growth	• Target multifamily and purpose-built single-family rental product in high growth markets with strong liquidity • For development, prioritize shorter duration business plans with fixed price construction contracts to mitigate inflation and supply risk
Office	• Uncertainty over WFH impacts and potentially lower demand from economic slowdown and higher costs • ESG and obsolescence risk may lead to higher capex, particularly for older vintage assets • Significant bifurcation by market and asset quality	• Selectively reposition existing assets to meet demands of modern occupiers and core investors (e.g., ESG) • Continue to pursue smaller, off-market investments in Japan with attractive leverage
Retail	• Squeezed consumer incomes may impact retail sales • Weak demand-supply balance may stress real rents • Retail has the highest yield of the main property sectors	• Selectively target core assets in strategic, tourism-oriented locations
Hotel	• Majority of hotels globally continue to experience operational distress • Leisure-oriented hotels have recovered well, ahead of hotels dependent on international and business travel	• Selectively acquire assets with operating challenges and impaired cashflows that are most likely to benefit from resumption of travel and increasing consumer confidence
Alternative Sectors	• Aging demographics continue to support healthcare real estate (life sciences, senior living and medical office) • Student housing demand is recovering and trading at attractive yield spread to residential	• Reposition healthcare (senior living, life science/MOB) and student housing assets at attractive yields on cost (e.g., U.K., Europe, U.S.) • Selectively build life science in strong market clusters

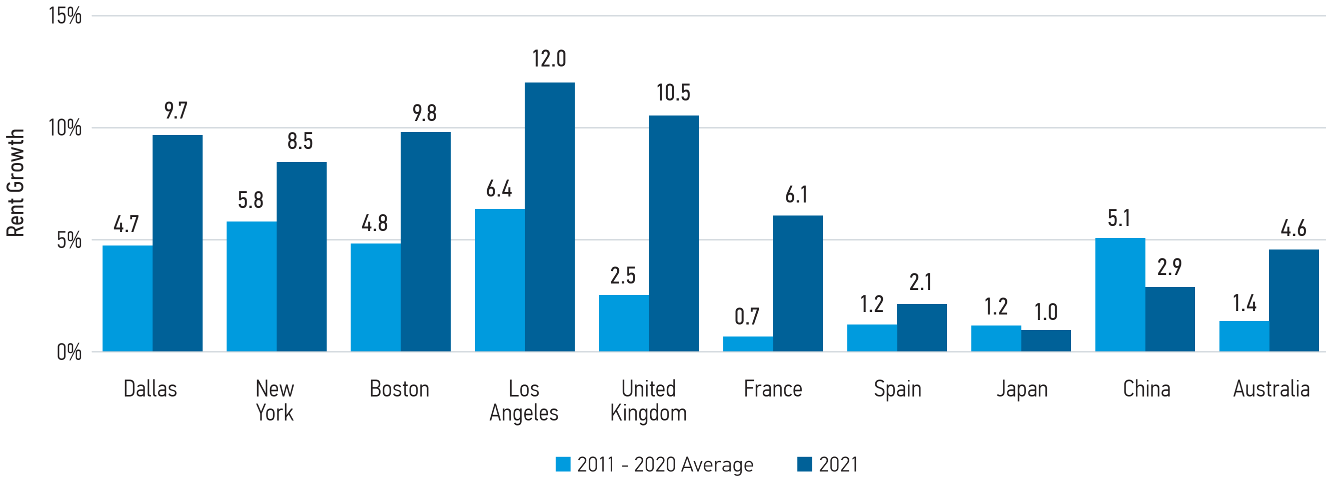
Mexico should benefit border markets like San Diego and El Paso, while a focus on just-in-case supplies of crucial inventories could benefit markets like Atlanta and Dallas among others.

Residential – Surge in Fundamentals should Moderate as Demand/Supply Rebalance

The residential rental sector has historically offered the greatest inflation protection, with a short-term lease structure that enables regular rent resets and growth tied to wages which typically tracks inflation. Additionally, rising mortgage rates should support continued strong residential rental demand, specifically in segments that target renters by choice. With higher energy and food prices threatening affordability, MSREI believes it will be critical to target markets that continue to benefit from demographic shifts and have the strongest income growth potential to keep affordability ratios at reasonable levels. Similar to the industrial sector, where shifting preferences to on-line shopping as a result of COVID have fueled demand, residential preferences in the U.S. have shifted with suburban, sunbelt and larger accommodations seeing stronger occupancy levels. However, over the past 12 months, there has been some reversion back towards urban or higher-density suburban areas, as well as gateway markets, following the return-to-office shift. Supply is also a risk in the residential

DISPLAY 6

Historically Tight Industrial Vacancy has Translated into Record Rent Growth



Source: CoStar, PMA, MSREI Strategy, data as of February 2022

sector, more so in exurban locations, but again, due to rapidly rising construction costs and supply chain delays, existing projects may be insulated against this risk for longer.

Office – Significant Bifurcation in Performance

Significant uncertainty remains over future occupier working models, although Europe and Asia are further along in the return-to-office timeline compared to the U.S. Broadly, MSREI expects to see lower demand in the future compared to pre-COVID levels and a greater focus by occupiers and investors on quality, amenities, ESG compliance and micro location. These preferences are reflected in current absorption, rent and pricing trends.

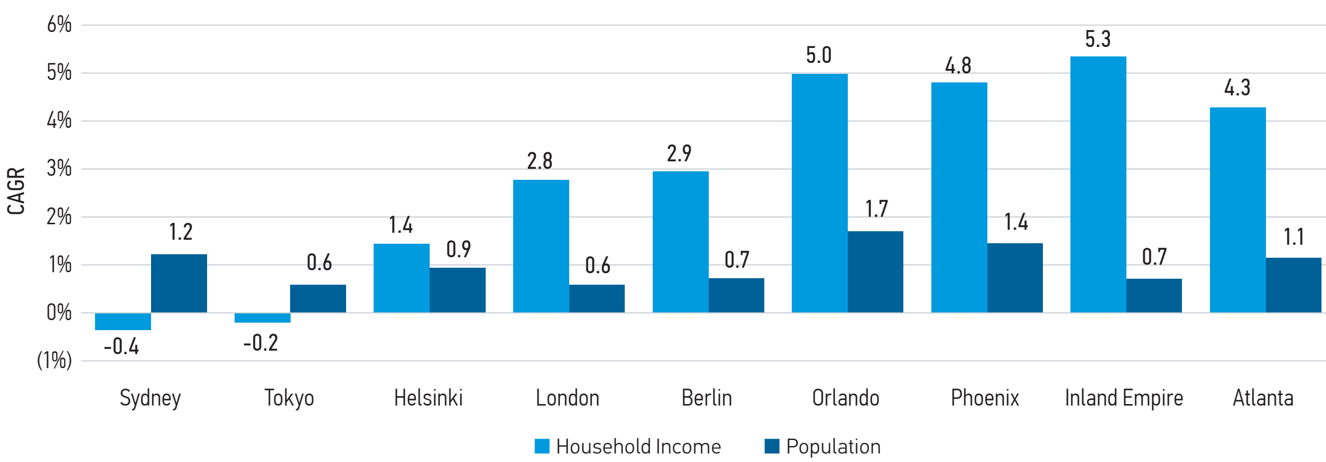
Retail

Similar to the office sector, the retail market has become more bifurcated, with convenience and experiential formats continuing to outperform older, less relevant assets in less-trafficked locations. Retail exhibits the highest yield of the main property sectors, and has begun to attract investor interest resulting in cap rates stabilizing or even compressing for

DISPLAY 7

Target Residential Opportunities in High Growth Markets

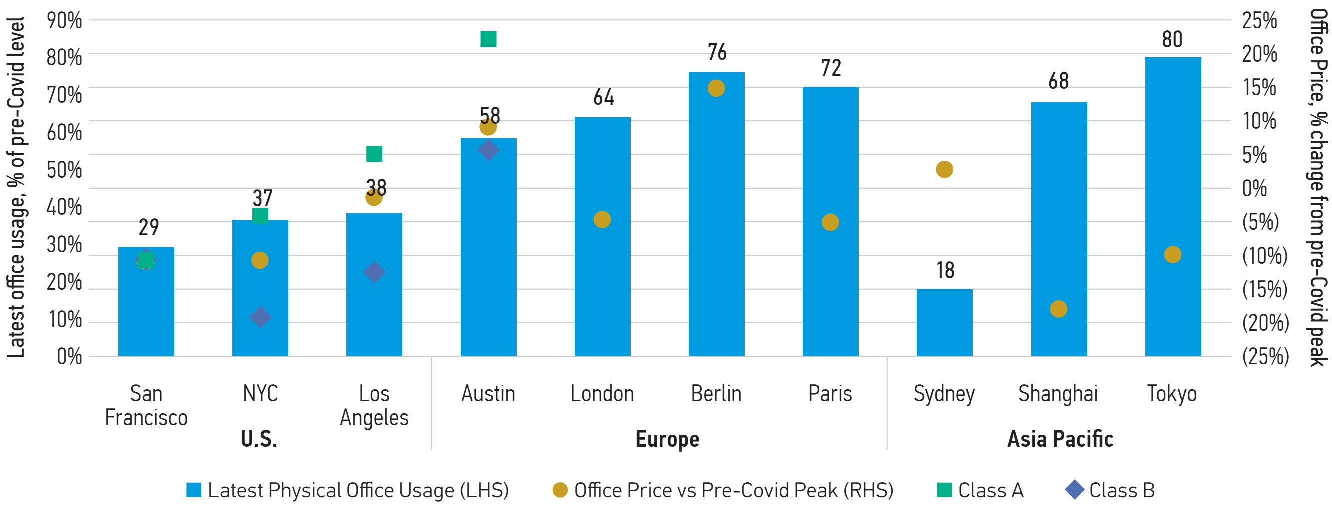
1Q 2017 – 4Q 2021



Source: OECD, MSREI Strategy, data as of February 2022

DISPLAY 8

Regional Differences in Work-From-Home



Source: Kastle Return-to-Work Office Barometer, Google Mobility Trends, PCA, MSREI Strategy, as of March 2022

the best quality centers and locations. Potentially more exposed to high inflation and an economic slowdown induced by the impact of squeezed consumer incomes on discretionary spending, MSREI believes it will be important to remain very selective when deploying capital in this sector.

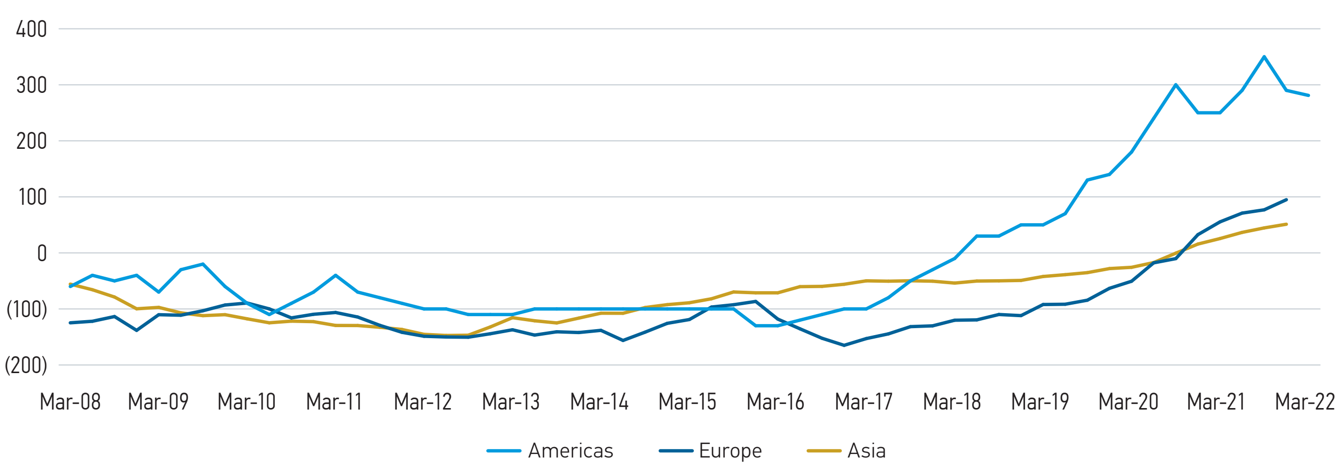
Alternative Sectors

Investors are increasing allocations to alternative asset types, particularly healthcare and sectors linked to industrial and residential. Life science fundamentals remain extremely strong with vacancy rates near zero in prominent clusters, attracting capital and keeping yields at record-low levels. However, new development and office-to-lab conversions are increasing supply levels. Senior living fundamentals are accelerating, supported by aging baby boomers. Supply levels are lower compared with pre-COVID levels and yields are relatively higher than other healthcare sectors, partially due to higher operating risk. Student housing offers an attractive yield spread to multifamily,

DISPLAY 9

Less Capital = Wider Retail Cap Rate Spreads

Mall Cap Rate Spread over Industrial

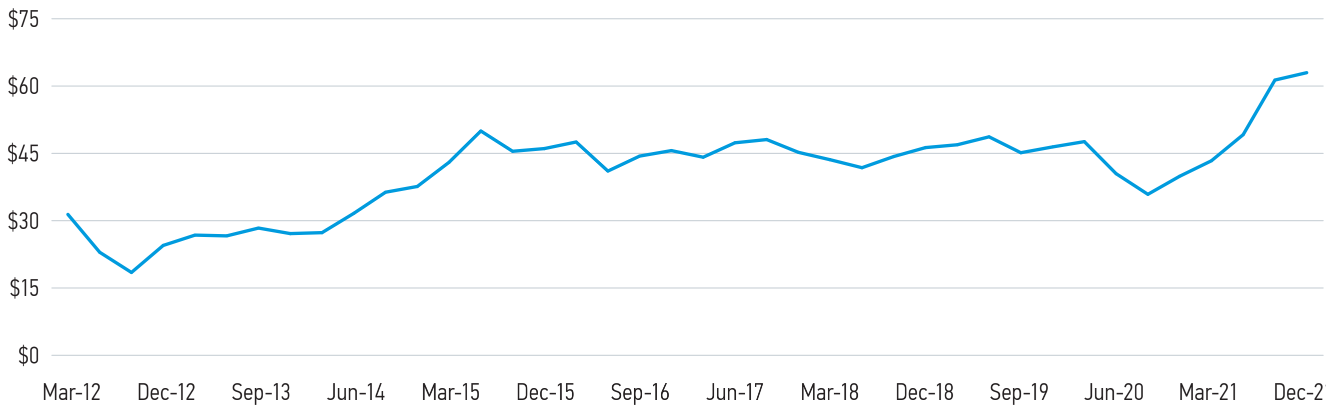


Source: Green Street Advisors, PMA, MSREI Strategy, data as of March 2022

DISPLAY 10

Alternatives Sector[1] Investment Share

U.S. Rolling 4Q Niche Sector Transaction Volume $B



Source: Real Capital Analytics, MSREI Strategy, data as of March 2022

thanks to stable and countercyclical demand and reduced supply levels. Self-storage fundamentals have also been very strong due to increased housing demand and above average business demand. Lastly, leisure hotels that don't depend on international, business-transient or group travel continue to recover strongly, with RevPAR ahead of pre-COVID levels in U.S. markets. However, the durability of that strong performance may be challenged given headwinds to consumer spending and a transition back to a more normalized share of international outbound travel as COVID restrictions are lifted abroad. Outside the U.S., the recovery in hotel performance has lagged due to COVID-related lockdowns and travel restrictions.

Conclusion

MSREI believes that the shifting and more volatile macro environment will support attractive investment opportunities for discerning investors. The ability to reallocate capital between and within regions and sectors to take advantage of differing underlying growth drivers and central bank policies should differentiate managers. MSREI believes local market perspective, knowledge, presence and relationships, combined with the ability to actively manage assets to drive NOI growth, will be more critical than ever to deliver attractive risk-adjusted returns.

[1] Includes self-storage, student housing, senior living, data centers

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