

# Global Real Estate Trends and Opportunities

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The global macroeconomic landscape remains in a sweetspot highlighted by accelerating economic growth that is stronger than average and inflation that remains below central bank targets.

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Consumers continue to fuel the late cycle expansion helped by robust job markets and wage gains. Global monetary policy is slowly turning, starting with the Federal Reserve and likely extending to Europe next year, but the pace of tightening will be modest in the near term due to weak inflation prints globally. Property market returns are expected to continue to decelerate as cap rate compression subsides and income growth becomes the primary driver of returns. Investment markets continue to normalize from 2015 peak levels, but declining activity has not negatively impacted prices, suggesting scarcity of quality product for sale, thinner bidder pools and a wider bid-ask spread. Structural trends, most notably e-commerce and aging populations, continue to influence growth patterns, investment strategies and underwriting decisions. Morgan Stanley Real Estate Investing (MSREI) believes these themes (discussed in more detail below), combined with unprecedented volatility and uncertainty in the market, continue to create a potentially very favorable environment for real estate investing globally.

### **MACRO #1: Accelerating, Above-Trend Growth with Below Target Inflation**

Global GDP growth is accelerating aided by the synchronous recovery across developed and emerging markets. Morgan Stanley Research estimates global growth at a very robust 4.4% for 2Q, the highest rate since 4Q 2010 and on track to exceed the 3.6% forecast outlined at the start of the



year.<sup>1</sup> On the other hand, inflation has not accelerated as much as forecasted, with the most recent prints coming in well below central bank targets (for example 1.7% in the U.S. and 1.2% in Europe, the exception being the UK where a weak pound has contributed to inflation of above 3%).<sup>2</sup> Overall economic growth is expected to moderate in 2H17 as geopolitical tensions, volatility and uncertainty rise.<sup>3</sup> The U.S. Government is faced with major policy challenges including raising the debt ceiling (which has been pushed back to mid-December), passing a budget and embarking on tax reform, while at the same time managing increased tensions with North Korea. In the UK, there will be increased scrutiny of the progress (or lack of) in Brexit negotiations, with a choice needing to be made between “soft” versions that still encourage trade and “hard” versions that curtail immigration sharply.

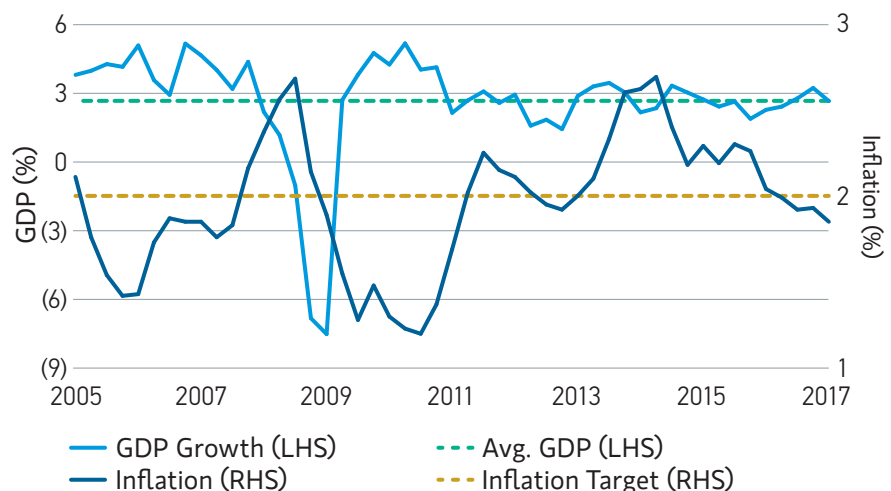
## MACRO #2: Consumer to Drive Late Cycle Expansion

The consumer sector around the world remains in relatively good health. Consumer confidence remains high across major markets, only slightly below the levels seen in 2006 and leverage is below 2007 peak levels (except in Australia, due in part to the housing market boom).<sup>3</sup> In the U.S., households underwent the largest deleveraging among major economies since 2006, with household debt-to-GDP falling by 15 percentage points. Debt service obligations are now at their lowest level since 1980.<sup>4</sup> Despite these tailwinds, consumers are saving more and spending on healthcare, restaurants, travel, and “other experiences”, rather than goods such as apparel which is hurting the retail sector. In the U.S., the personal savings rate is hovering around 5.5%,<sup>5</sup> 150 bps above the 4% pre-crisis average. Real per capita incomes are expected to accelerate in the Eurozone as the labor

### DISPLAY 1

#### Global Real GDP Above Trend & Inflation Below Central Bank Targets

QoQ SAAR GDP & Core Inflation



Source: World Bank, MSREI Strategy, data as of August 2017.

market continues to tighten and in Japan as wage growth picks up, but decelerate in the U.S. and Australia.<sup>6</sup> Across all major markets, consumption is expected to outpace income growth, suggesting that the consumer will either have to delve into their savings or take advantage of low interest rates and lever up.<sup>7</sup>

## MACRO #3: Global Monetary Policy Slowly Turning But Will Remain Accommodative

The global monetary policy cycle continues to turn. While tightening began in the U.S. late last year, it appears most central bankers are ready to look through the dip in inflation prints during the first half of this year and tighten monetary policy at various stages over the next two years. As a result, long term bond yields had risen by 20-40 bps+ in the U.S., UK, and Germany since the start of the year, although they have subsequently flattened since mid-July given increasing tensions with North Korea and other geopolitical risks.

In the U.S., Morgan Stanley Research expects the Fed to deliver four more hikes between now and the end of 2018 as well as beginning to shrink its balance sheet in September (rough estimates expect it to be normalized by 2023/24). The ECB is expected to scale back its asset purchases and transition to a less dovish stance, potentially raising rates as early as next year. China has also begun tightening and while Korea is likely to remain on hold for now, we expect tightening to begin over the next 12 months. Japan may raise its long term bond target in 2018, depending on growth and inflation.

So far, we have seen negligible impact of higher rates on cap rates in the U.S. Long term rates have increased 60 bps (1.6-2.2%) since 3Q last year while cap rates have remained flat or actually compressed further (depending on market and sector), supported by strong transaction activity and the tailwind of increased allocations to real assets.<sup>8</sup> Cap rate spreads have declined by 70 bps in the U.S. but are

<sup>1</sup> Morgan Stanley Research, August 2017

<sup>2</sup> Bloomberg, August 2017

<sup>3</sup> Morgan Stanley Research, as at October 2017

<sup>4</sup> Bank for International Settlements, August 2017

<sup>5</sup> Morgan Stanley Research, August 2017

<sup>6</sup> National Sources, Oxford Economics, MSREI Strategy, data as of August 2017

<sup>7</sup> Source: MSREI Strategy, October 2017

<sup>8</sup> Real Capital Analytics, Bloomberg, MSREI Strategy, data as at September 2017

still averaging 270 bps<sup>9</sup> providing a cushion against further rate increases. That being said, MSREI expects cap rates to rise 30-50 bps over the next four years across major markets and sectors.<sup>10</sup> Even if cap rates increase, NOI growth from stronger economic growth should outweigh the negative impact and keep

values flat to marginally up for better quality properties.

### CAPITAL MARKETS #1: Lower Returns Given Late Cycle Dynamics

From a real estate standpoint, MSREI believes returns over the past four years have been above average, driven largely

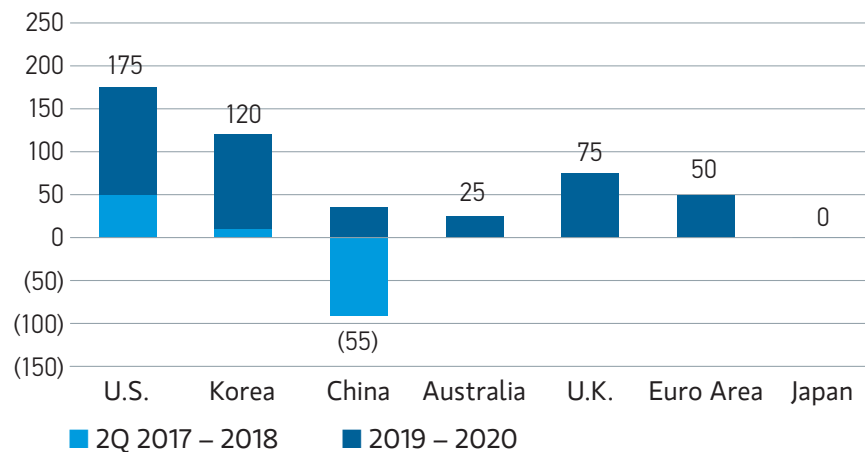
by cap rate compression, and we expect returns to decelerate over the next four years as cap rates continue to stabilize, with the driver of returns coming predominately from income growth.

Regional real estate markets are expected to vary widely due to different underlying economic growth drivers and divergent interest rate policies, as reflected in the office sector market cycle in *Display 4*. In fact, the trailing 5-year correlation of office market returns among major markets is -0.05, compared to a long run correlation of 0.59 (and a rolling correlation high in 2013 of 0.81).<sup>11</sup> While the majority of markets are late cycle, characterized by decelerating rent and value growth, MSREI believes the current cycle has further room to extend due to high occupancy levels across most asset classes and markets, functioning debt markets and continued strong liquidity/allocation to real assets.

#### DISPLAY 2

##### Policy Rates Rising Slowly

Change in Policy Rates (Bps)

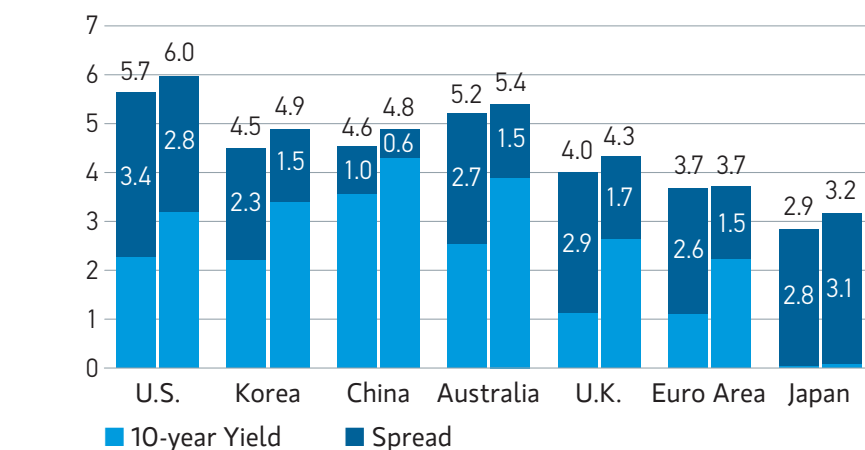


Source: Oxford Economics, MSREI Strategy, data as of August 2017.

#### DISPLAY 3

##### Attractive Cap Rate Spreads

Office Cap Rates, 2Q 2017 & 4Q 2020 (%)



#### Spread

Historical Average:	450	190	230	200	140	220	310
2007:	250	(10)	220	(40)	(40)	(60)	210

Source: CoStar, PMA, MSREI Strategy, data as of August 2017.

### CAPITAL MARKETS #2: Investment Markets Normalizing

Transaction activity through the first half of 2017 slowed by 8% to \$378Bn.<sup>12</sup> Asia Pacific recorded 5% YOY growth in income-producing asset transactions during 1H17, whilst EMEA fell 12% and the Americas dropped 10%.<sup>13</sup> Counter to the global trend, the sale of retail assets supported Asian volume growth, driven by acquisitions in Japan, China and Singapore.<sup>13</sup> The logistics sector in each region recorded positive volume growth and declining cap rates, supported by e-commerce tailwinds and stronger global trade, while the retail sector suffered declining volumes and rising cap rates, most notably in the U.S.<sup>13</sup>

A common theme across global markets is the disconnect between pricing and volume. Cap rates have stabilized or even

<sup>9</sup> Real Capital Analytics, Bloomberg, August 2017

<sup>10</sup> Costar, MSREI Strategy, September 2017

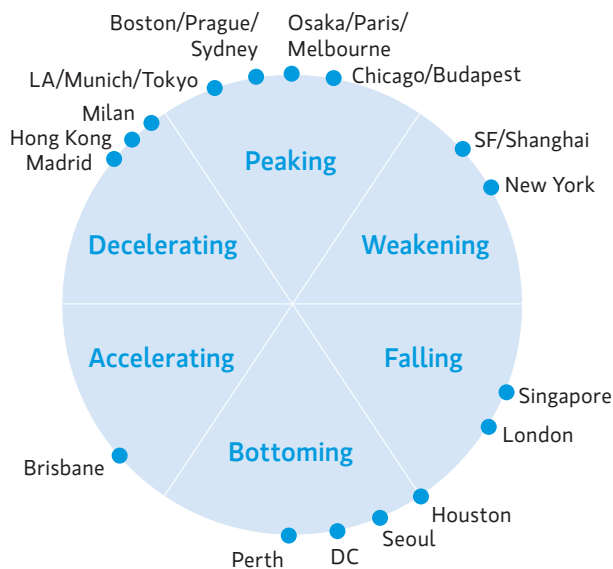
<sup>11</sup> IPD, PMA, CoStar, MSREI Strategy, September 2017

<sup>12</sup> Real Capital Analytics, September 2017

<sup>13</sup> Source: Real Capital Analytics, data as at September, 2017

**DISPLAY 4****Divergent Market Cycle<sup>15</sup>**

Office, 2Q 2017



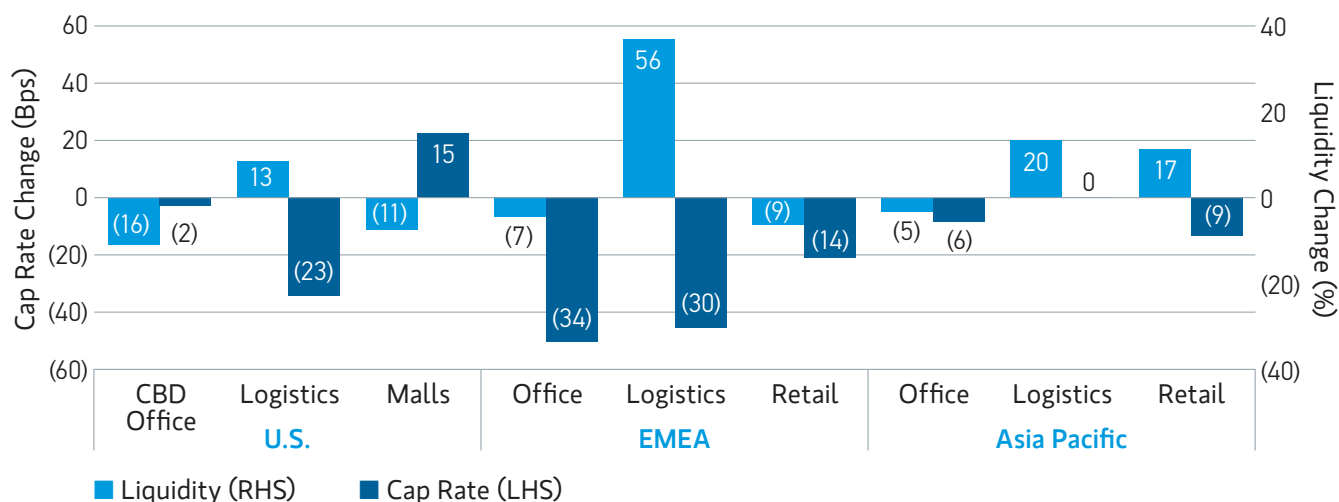
Source: MSREI Strategy, data as of August 2017.

compressed, whilst volume has fallen for six consecutive quarters, due to a growing divergence between buyer/seller price expectations, scarcity of quality product for sale and thinning bidder pools.

The level of debt used in commercial real estate transactions remains relatively low compared with 2007 levels suggesting that the forced selling, that led to rapid price declines in the last crisis, is less likely this time around. However, while debt appears to be less of a problem, the amount of equity capital ready to be deployed into commercial real estate remains at all-time highs. Equity-rich, cross-border investors now account for up to 35% of global transaction activity.<sup>14</sup> While this capital originates from diverse sources, it is susceptible to domestic politics and may be subject to repatriation of capital (e.g., China), thereby further lowering transaction volumes.

**DISPLAY 5****Cap Rates Remain Stable or Continue to Compress**

1H 2017 over 1H 2016



Source: NCREIF, PMA, Real Capital Analytics, MSREI Strategy, data as of August 2017.

<sup>14</sup> Real Capital Analytics, September 2017<sup>15</sup> The market cycle positioning framework is the outcome of the use of an internal tool being developed by MSREI based on a consistent set of real estate metrics available on a country-by-country basis. It is aimed to help identify drivers of market performance, market positioning relative to prior cyclical peaks and troughs, turning points and

implications for investing strategies. It is updated on a quarterly basis in line with the release of macroeconomic and commercial real estate data. The tool uses a mix of real estate fundamentals and capital markets metrics that are generally available in applicable countries (including rent, occupancy, cap rates and spreads and liquidity and values metrics). The majority of the metrics are based on

"actuals", versus relying on forecast data. Note that other outcomes could result if different inputs or assumptions are made. The market cycle positioning constitutes a "forward looking statement." Due to various risks and uncertainties, actual events or results may differ materially from those reflected or contemplated in such forward-looking statement.



### INVESTMENT THEME #1: Aging Populations Driving Healthcare Demand

Structural trends continue to disrupt each and every real estate sector. The two most significant trends impacting real estate fundamentals and investment strategies today are demographics and e-commerce.

Starting with demographics, the senior age cohort (>65) is expected to increase by 54 percent in the U.S. over the next 15 years.<sup>16</sup> Globally, the senior cohort is growing at 2.5 percent while the total population is growing at 1.2 percent,<sup>17</sup> and this trend is expected to accelerate. Aging will weigh on workforce growth as retirees exit the labor force, lowering the demand for office space relative to history. This is of particular concern in countries like Japan and South Korea that do not currently openly support immigration. Older populations spend more on healthcare services and less on consumer goods. The 65+ cohort consumes, on average, nearly \$6,000 in healthcare services annually,<sup>18</sup> more than twice the average health expenses of millennials. Aging populations are driving demand for senior living services, medical services and life science, contributing to the tight yields in those sectors.

At the other end of the age spectrum are millennials. Asia has the highest share of millennials at 32 percent versus 30 percent in the Americas and 25 percent in Europe.<sup>16</sup> They have contributed to continued urbanization, particularly in markets like China and India, and have driven a surge in rental housing in the U.S. Since 2008, the U.S. has added 6.8 million renter households while losing one million home-owning households.<sup>19</sup> The extent to which millennials will eventually shift preferences towards buying versus renting and the suburbs versus downtown will have significant impacts on the multifamily and single family markets, for-sale and for-rent strategies.

### INVESTMENT THEME #2: Housing Shortage Will Propel Residential Sector Growth in Europe and the U.S.

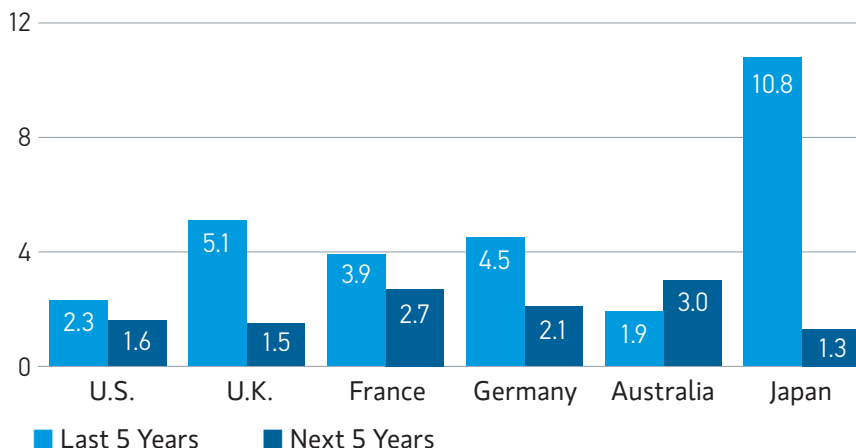
The rapid growth in household formation amongst the millennial generation has contributed to the housing shortage faced in many countries around the world. While residential construction is beginning to recover from the housing crises in Europe and the U.S., construction volumes remain significantly below the pre-bubble average. Since 2011, housing sales in the U.S., including apartments, have averaged 900,000 per annum,

failing to keep pace with household formation which has averaged 1.4 million per annum.<sup>20</sup> This has resulted in above average occupancies for apartments and below average inventory of for-sale housing, with the biggest shortage occurring in the entry level segment which currently has only 3.3 months supply of inventory (compared with a normalized market of 6 months).<sup>21</sup> In Spain, residential construction is only 15% of pre-peak levels, job growth is creating housing demand and prices have begun to increase.

### INVESTMENT THEME #3: E-Commerce Disrupting Retail and Benefitting Logistics

The rapid acceleration in global e-commerce continues to threaten the retail sector, with the largest impact in countries that are the most over-retailed, specifically the U.S., which has twenty four square feet of shopping space per capita, compared with four square feet per capita in Europe.<sup>22</sup> Additionally, the U.S. has high department store exposure with one department store per 62,000 people, compared with France, which maintains one department store per 777,000 people.<sup>23</sup> Department store sales of apparel have halved over the past 10 years, while sales by internet retailers of apparel have grown fourfold,<sup>24</sup> suggesting that department stores are one of the most vulnerable formats to disintermediation from e-commerce (Amazon is effectively an on-line department store). As a result, it is likely that the U.S. will see additional closings of department stores, outside

**DISPLAY 6**  
**Retail Rent Growth Expected to Decelerate**  
Annualized (%)



Source: CoStar, PMA, MSREI Strategy, data as of August 2017.

<sup>16</sup> UN Population Division, World Population Prospects as of December 2016

<sup>17</sup> United Nations, September 2017

<sup>18</sup> US Bureau of Labor Statistics Consumer Expenditure Survey, July 2017

<sup>19</sup> Bureau of Census, Moodys Analytics, MSREI Strategy, August 2017

<sup>20</sup> Moodys Analytics, data as at September 2017

<sup>21</sup> Source: Core Logic, MRIS, Zellman & Associates, MSREI Strategy, September 2017

<sup>22</sup> LCSC, Morgan Stanley Research, data as at August 2017

<sup>23</sup> ABS, Euromonitor, Montel, Kantar, August 2017

<sup>24</sup> Euromonitor, August 2017

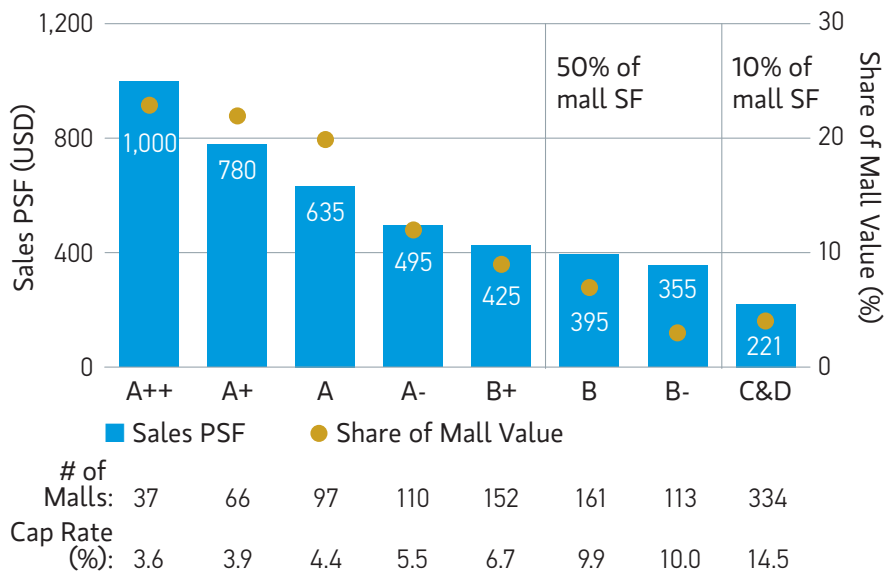
those already announced by Sears, JC Penney and Macy's. Other formats under threat in the U.S. include power centers, grocery-anchored centers due to likely grocer margin compression following the Amazon/Whole Foods combination, and low productivity Class C/D malls.

With goods spending moderating in most parts of the world and e-commerce taking increasing market share, retail sector fundamentals are likely to weaken, with rent growth expected to halve from 4% per annum over the last five years to 2% per annum over the next five across major

markets.<sup>25</sup> The greatest impact will be felt in the weakest centers, while the top 10% of centers will continue to outperform broad market averages. Negative impacts felt in the retail sector have been somewhat offset by the outperformance witnessed in the logistics sector, broad-based strength in e-commerce leasing, whereas global trade and higher inventory to sales ratios have driven occupancies up to record highs and yields down to record lows.

**DISPLAY 7****U.S. Mall Landscape Very Bifurcated**

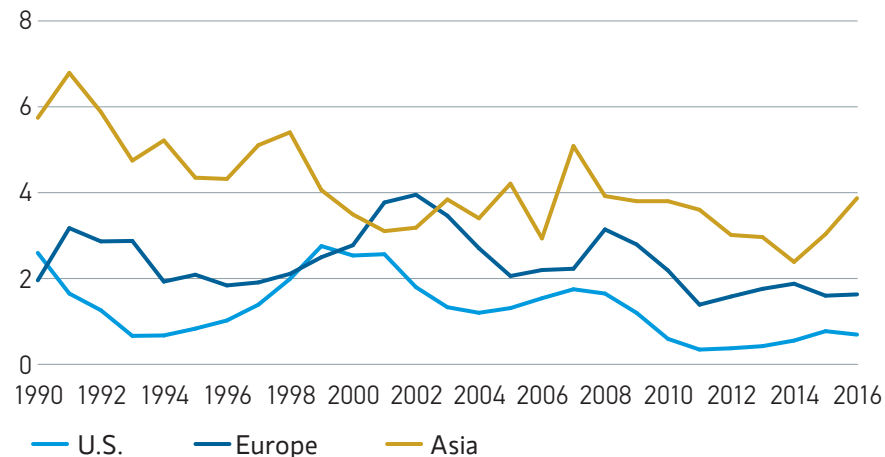
Sales PSF &amp; Cap Rates



Source: Greenstreet, MSREI strategy, data as of August 2017.

**DISPLAY 8****New Construction Below Historical Average**

As a Percent of Existing Stock



Source: CoStar, PMA, MSREI Strategy, data as of August 2017.

**INVESTMENT THEME #4: Income Growth Opportunities in the Office Sector, Despite Moderating Fundamentals**

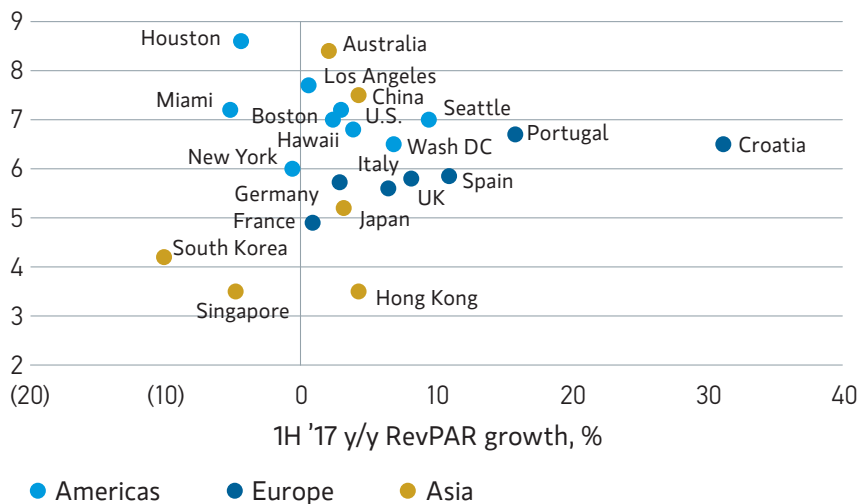
The global office sector continues to generate moderate NOI growth helped by low levels of new construction in most markets and continued job growth. Cross-border investors have contributed to the rapid increase in prices of core office assets in primary, gateway markets resulting in yield spreads in core and non-core markets widening beyond historical averages in Europe and the U.S. For example, the yield gap between the top six office markets and the rest of the U.S. office markets is currently 82 bps versus an historical average of 38 bps. Similarly in Europe, the spread is 111 bps versus 81 bps.<sup>26</sup>

Additionally, given income growth will be the primary driver of future returns, investors may target markets where current rent levels remain below prior peak levels, potentially offering strong upside rent growth potential. For example, Tokyo office rents are 30 percent below the prior peak, Singapore rents are 55 percent below peak, while Madrid, Milan and CEE office remain 29%, 15% and 13% below peak levels, respectively.<sup>27</sup> Select repositioning opportunities may also exist where physical product no longer meets market needs.

<sup>25</sup> PMA CoStar, August 2017<sup>26</sup> NCREIF, PMA, RCA, August 2017<sup>27</sup> CoStar, PMA, MSREI Strategy, August 2017

**DISPLAY 9****Hotel Fundamentals Vary Widely**

RevPar Growth &amp; Income Yield (%)



Source: STR Global, Colliers, Real Capital Analytics, MSREI Strategy, as of August 2017.

**INVESTMENT THEME #5: Strong Tourism Flows Creating Hotel Opportunities**

Tourism continues to grow rapidly, particularly in countries like Japan, where foreign visitors reached 20 million in 2016, double that of 2013 levels.<sup>28</sup> The growth of tourism can be attributed to many factors, including the flourishing middle class in China (outbound travel from China has increased by over 100 per cent since 2009)<sup>29</sup> and stronger travel preferences for the rapidly expanding millennial age cohort. This is creating attractive growth opportunities in markets such as Spain, Portugal and Croatia, where revpar growth has exceeded 10% over the past twelve months.<sup>30</sup> In contrast, several other hotel markets are facing weaker revpar growth and potential distress caused by oversupply or weaker demand (e.g., New York, Miami, Paris), providing opportunities to acquire or reposition mismanaged properties at an attractive basis.

**Conclusion**

In conclusion, the combination of stronger global growth, driven primarily by the consumer, and a likely continued low rate environment will provide an attractive backdrop for real estate investing over the next several years. While returns are likely to be lower across most countries and sectors as investment markets normalize, structural trends such as demographic shifts and technology changes will continue to disrupt real estate fundamentals and impact strategies. This will likely create a new set of attractive investment opportunities across the U.S., Europe and Asia.

<sup>28</sup> World Bank, August 2017<sup>29</sup> UN World Tourism Organization, World Bank, MSREI Strategy as at September 2017<sup>30</sup> STR Global, Colliers, MSREI Strategy as of August 2017

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