

# Global Market Insights

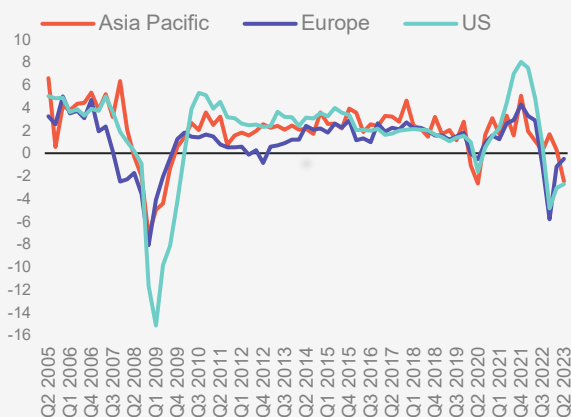
## November 2023

### Q2 GREFI assesses impact of inflation and interest rates on global property markets

In the fifteen years since the global financial crisis began, property markets worldwide enjoyed a mostly stable macroeconomic environment characterized by moderate inflation and low interest rates. 2023, however, marked a significant shift as inflation spiked across developed markets, prompting major central banks to revise or reverse their benign policies. The US Federal Reserve raised the federal funds rate from 0.7% to 5.3%, reflecting a global trend across OECD economies, with the notable exceptions being Japan and China. The Bank of Japan continues its decade long quantitative easing practice and maintains a policy rate of -0.1%, despite now allowing some flexibility at the longer end of the yield curve.

The Q2 Global Real Estate Funds Index reveals a 7.6% year-over-year decline in aggregated non-listed real estate returns across North America, Europe, and Asia Pacific. However, the diverse macroeconomic and property fundamentals between and within these regions are associated with differing rates of revaluation. In the US, the real estate market experienced a -9.6% annual return, with significant declines across all sectors. The NPI-ODCE funds' office sector faced a nearly 18% drop, influenced in part by

Figure 1: Total returns GREFI Q2 2023



the continuing tendency toward remote work in some submarkets and industries, initiated during the COVID-19 pandemic. US office vacancy rates are higher than elsewhere in level terms and in relation to long term trend levels, though another wave of return-to-office mandates planned for October 2023 to January 2024 can reasonably be expected to boost office attendance and physical occupancy.<sup>1</sup>

Europe's private real estate market saw an annual decline of 8.4%, positioning it as the second most affected region, though Europe outperformed the other regions on a quarterly basis with a return of -0.5%. The Q2 total returns turned more negative for three of the four main countries within the asset-level index, with only the Netherlands reporting a q-on-q improvement in office performance, albeit remaining in the negative overall. The latest office results are most unfavorable for UK (-4.4%) and Netherlands (-3.5%), as compared to Germany (-3.3%) and France (-2.5%)..

Asia Pacific faced a -2.5% return in Q2, but its annual performance was the strongest among the three regions, with only a -0.3% decline. In a nod to the region's heterogeneity, Japan maintains its policy of quantitative easing despite finally pushing inflation above their 2% target and has a less negative outlook than some other APAC markets. In Australia, office usage in major cities has farther to go to recover from pandemic-inspired remote working trends. And in China, the world's second largest economy, economic weakness led to a decline in returns of 2.8%.

The revaluation of property markets is an inevitable response to substantial changes in financial markets and macroeconomic conditions. While Asia Pacific might seem to be the more stable of the three regions, being more insulated from trends like the slower return to the office that hinders the US and Europe, its smaller run-up prior to 2022 suggests a lesser need for correction. The contrasting quarterly performances between regions could also be an indicator that revaluation in Asia is simply lagging behind the other regions.

1 JLL US Office Outlook

## “Higher for longer” rate policies expected to lead to greater debt opportunities

In Q2 2023, GREFI reported average gearing of 24.7%, a slight increase from 22.4% in the previous year but significantly lower than the 38% observed in 2009, in the depth of the global financial crisis. This trend reflects a shift in the financing landscape, as alternative debt sources gain traction in Europe, North America, and Asia Pacific due to the retreat of traditional lending.

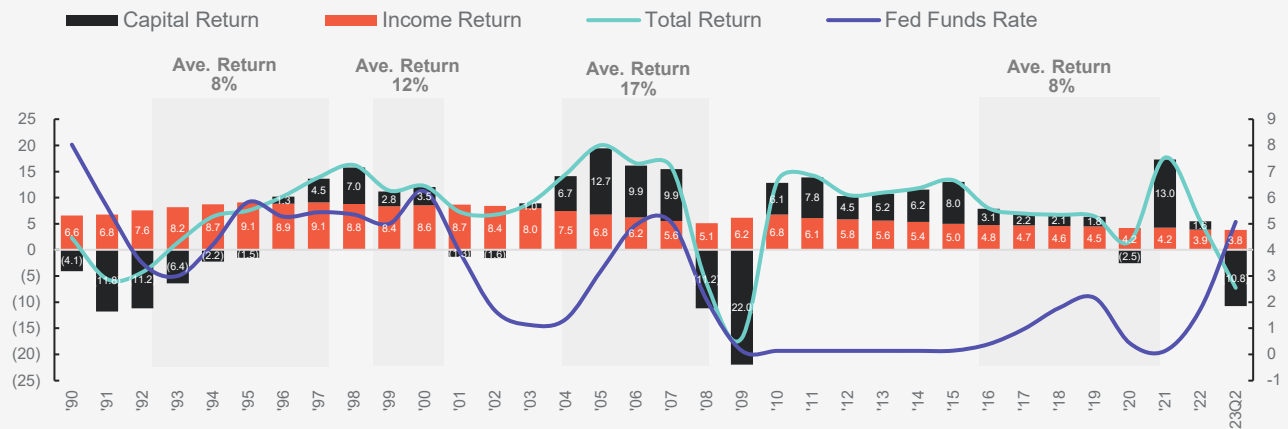
In Europe, debt funds are emerging as a prominent sector. The INREV Debt Vehicles Universe 2023 tracks 117 vehicles, representing targeted equity of EUR 62.9 billion (approx. USD 68.5 billion), which is more than double the amount tracked in 2016. The US continues to be the largest and most established market for non-listed debt vehicles, with an estimated size of nearly USD 3,200 even as of Q3 2020.<sup>1</sup>

Meanwhile, the debt vehicle sector in Asia Pacific is still in its infancy compared to the other regions.

Looming debt maturities combined with the constrained availability of traditional financing, point towards an increased demand for refinancing options, creating lucrative opportunities for alternative lenders. In the current environment of prolonged high interest rates, debt vehicles are poised to provide downside protection as well as higher returns than before. The NCREIF / CREFC Open End Debt Aggregate demonstrates a low to moderate correlation between the returns on US debt vehicles and US core real estate equity, underscoring the complementary nature of non-listed real estate debt and equity strategies. To the extent this relationship holds in other regions as well, this suggests a promising expansion of the debt vehicle sector and a diversified range of investment opportunities in lower-risk non-listed debt strategies.

1 PREA

**Figure 2: US Private Real Estate Core Returns - NPI, Annual Unlevered Returns (%)**



Source: NCREIF, MSREI Strategy, data through July 2023

## Global Research Committee's Review



The sharp increase and ongoing volatility in long term bond yields has put added pressure on real estate financing costs and cap rates, and continues to stifle investor activity. In the United States, the 10Y government bond yield recently passed 5% due to a combination of strong growth and higher term premiums due to deficit funding fears. Even in Japan, the yield on government bonds recently hit 95 basis points, the highest in more than a decade, prompting the Bank of Japan to further relax yield curve control guidelines. While spreads between cap rates and bond yields remain wide in Japan, cushioning the impact on cap rates and supporting capital inflows to-date, in other developed markets cap rates have increased, with marked bifurcation by market, sector and asset quality. Contrary to conventional wisdom which would suggest that higher interest rates are bad for real estate, in past rising rate environments core real estate returns have outperformed the long run average. This can largely be attributed to strong income growth supported by a resilient economic backdrop, offsetting the impact of higher interest rates on cap rates. During this current period of higher interest rates, value declines could have been greater if not for the effect of strong real estate fundamentals in sectors such as industrial and residential, a fact perhaps underappreciated today.

Additionally, a high and volatile interest rate environment can lead to an interesting set of real estate investing opportunities for those investors with capital. Recently originated loans will need to refinance at significantly higher debt costs and lower proceeds which may give rise to attractive real estate credit opportunities, which alternative lenders are taking advantage of today. Moving forward, a more stable interest rate environment and associated underwriting certainty should entice a broader set of investors to cautiously reenter the real estate capital markets.