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GLOBAL OUTLOOK

Grosvenor's research perspective on world real estate markets

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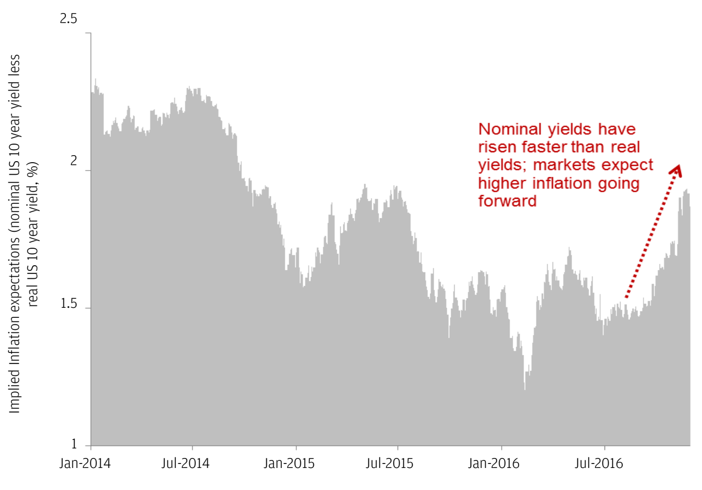
Positive growth despite year of turmoil

The year looks likely to end on a surprisingly positive note. Although forecasts have been progressively downgraded since the start of the year, most forecasters are now expecting a better end to the year compared with the dire predictions made in the immediate aftermath of the 23 June Brexit vote. IHS Global Insight expects global growth to average 2.3% in 2016, compared with an initial 2016 forecast of 2.6%, made at the beginning of the year.

Markets are continuing to digest the surprise US election results. Although little is known about the specific policy initiatives of the new administration, government bond yields have increased noticeably over the past month in response to president-elect Donald Trump's believed preference for renewed large-scale public infrastructure spending. These movements in US bonds have also been reflected in global bond markets, with the prospect of a US-led recovery in growth and inflation having a positive spill-over on the global economy.

Despite the headline movement in bond yields it is notable that nominal bond yields have risen much more than inflation-adjusted yields since the US election. This divergence highlights that markets currently expect Trump policies to have a more pronounced effect on inflation than growth (Chart). This is largely because many of Trump's notable policies, including restricting the flow of labour and trade, would restrict supply and push up prices. Though infrastructure spending would provide a welcome boost to short-term growth, it remains uncertain on whether the scale and scope of these initiatives is enough to offset long-term headwinds.

Implied inflation (spread between nominal and real yields)



Source: Bloomberg, Grosvenor Research

The US continued to be the leading light for the global economy. Q3 GDP growth was revised up to 3.2% annualised from an initial reading of 2.9%. The US's medium-term growth prospects hinge on the Trump administration's economic policies over the next four years.

Third quarter UK GDP growth was 2.3% y-o-y, higher than most immediate post-Brexit forecasts. Recent Office for Budget Responsibility forecasts noted that UK GDP growth will slow due to the Brexit vote, forecasting 1.4% annual growth in 2017 compared with an initial forecast of 2.2%, and Brexit is estimated to increase government debt by £58bn.

The Eurozone ends the year on a muted note with the economy growing 1.6% in Q3. The European Central Bank has not signalled any intention to change course on their monetary stimulus programme. This is important as there are several national elections during 2017 where hard-right nationalist parties are expected to make a strong showing, potentially frightening investors.

The Chinese economy has remained relatively stable throughout 2016 and annual growth is expected to hit the government's target of 6.7%. The scale of China's credit market and risks around bad debts remain concerning. Destabilisation could spark a significant downturn in Chinese – and potentially global – asset markets.

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Is the US market reaching a turning point?

The US economy emerged from the Great Financial Crisis (GFC) in mid-2009. Already the third-longest recovery since WWII, its eight-year expansion is clearly maturing, and the growth outlook has implications for the real estate sector. This article outlines our thinking on the current position and likely near-term path for both the US economy and core real estate sectors.

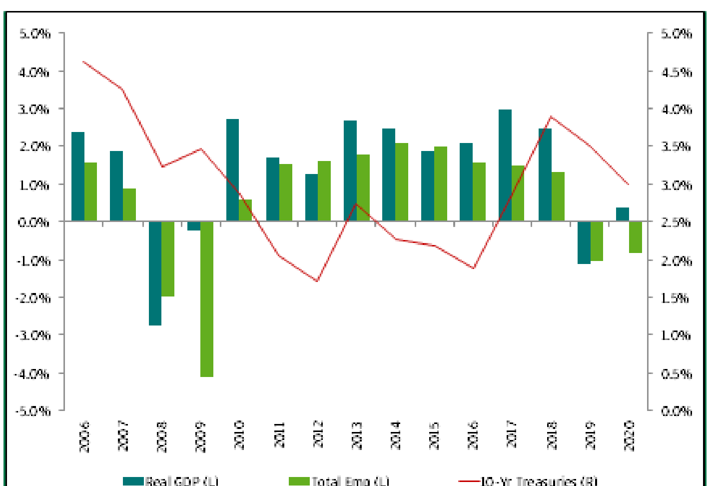
Economic Overview

Real GDP has been very uneven since the US emerged from recession (Chart 1). It has struggled to maintain a modest 2.0% average rate of growth; far below its normal post-recession trajectory of 3.5% - 4.0% p.a. Despite its lack of strong momentum, there is less slack in the economy than is generally recognised.

Labour force slack is diminishing. Unemployment is already a low 4.9%, and job growth has slowed as firms struggle to locate qualified workers. Although job openings are at an all-time high, employment gains have fallen from 229,000 per month in 2015 to 180,000 per month thus far in 2016. Labour force participation will continue to move up and underemployment to fall. Wage and salary income has begun to accelerate meaningfully in response to tightening labour market conditions.

Inflation is not as quiescent as it appears. Core CPI (excluding volatile energy and food components) has been steady at 2.2% for many months, just above the Fed's 2.0% target. Headline inflation has already risen from 1.1% in August to 1.6% in October and is expected to rise further as last year's oil price declines and US dollar appreciation drop out of the year-on-year comparisons, converging to core inflation.

Chart 1: Trends in GDP & Employment Growth, 10-Year Treasury Rates



Source: Moody's (Nov 2016), Grosvenor Research

There is a growing disconnect between corporate operating performance, which has deteriorated on a year-on-year basis for five consecutive quarters and the general stock market, which continues to reach new highs. Consumer, investor, and business confidence is good but very fragile, yielding considerable volatility when events fail to unfold as expected.

Although growth will continue to be positive in the near term, we believe the Fed will raise interest rates more quickly than the consensus currently projects as signs of overheating develop. The economy will slow in response. We believe that the probability of a recession in the next five years is high, and assume it will start by 2019; ten years after recovery began. Unlike the last US downturn, which significantly impacted all geographic regions and all sectors of the economy, this should be a more "normal" cyclical recession, i.e. three – four quarters long; real GDP decline of 1.75% - 2.0%; loss of ~3.0 million jobs; unemployment rate rising from 4.5% -7.5%; impact focused in one or more economic sector(s) and geographic region(s). The economy will return to positive growth thereafter and expand through mid-decade.

The Real Estate Environment

Apartment softening: First and fastest to recover from the 2008-09 downturn, the apartment sector has passed its peak and begun to soften. Multifamily construction is both significant and widespread across markets. Since mid-2015, quarterly completions have exceeded rental demand and in 2016 less than 80% of new units being delivered have been absorbed. Pittsburgh, San Francisco, and Philadelphia stand out for the size of their apartment pipelines; expected completions in all three will be four to five times their respective long-term average, despite rising vacancy. Although still low at 4.5%, US apartment vacancy has been gradually rising (Chart 2). Average effective rent growth still exceeds inflation but has been progressively easing. However demographic trends are becoming less favorable for the sector as the key rental cohort of 20-34 year olds will add fewer than 0.3 million in each of the next ten years, after expanding by 0.8 million annually since 2007.

Office stabilising: The office sector made substantial progress during the past two years with vacancy rates falling 180 bps. Although fundamentals continue to improve, progress is decelerating as demand/supply fundamentals approach balance. Office construction pipelines are expanding.

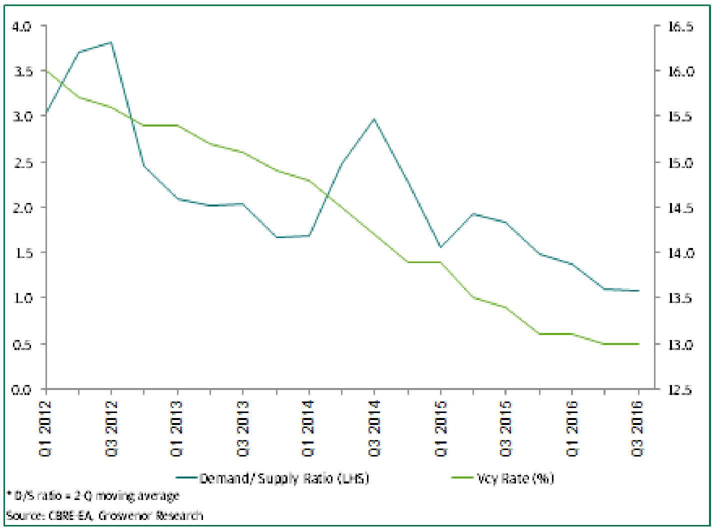
Chart 2: US Apartment Demand/Supply Ratio & Vacancy

Source: REIS, Grosvenor Research

Although activity has begun broadening to include more metro areas, development remains fairly concentrated: two-thirds of the ~100 million square feet currently underway are in ten metros, including New York, Chicago (financial); San Francisco, San Jose, Boston (Tech); Dallas and Houston (energy). Meanwhile half of the 63 markets tracked by CBRE-EA report little or no new rental product underway. Vacancy rates in the top ten metros range from a low of 6.5% (San Francisco) to a high of 17.5% (both Dallas and Houston).

Demand for office space continues to exceed new supply. Vacancy has declined only 10 bps, to 13.0% in 2016 (Chart 3). The nation's downtown markets – where most office construction is taking place – led the recovery but are now beginning to cool. By contrast, suburban submarkets continue to improve (although at 14.3% Q3 suburban vacancy is still 360 bps above the CBD average). Office rent growth has also slowed significantly this year, from a robust 4.3% yoy rate in Q1 2016 to 1.4% yoy by Q3 2016. Slowing job growth will constrain further office sector improvement, even if construction stabilises near its current level. Because of the sector's strong cyclicality and the wide divergence in conditions across individual markets, office trends will most appropriately be evaluated on a metro-by-metro basis.

Chart 3: US Office Demand/Supply Ratio* & Vacancy



* D/S ratio = 2 Q moving average

Source: CBRE-EA, Grosvenor Research

Retail uneven: Retail real estate has been contending with significant structural change as well as lingering impacts from the severe 2008-09 downturn. Post-recession retail sales growth has been dominated by non-store retailers (Amazon). Consequently demand for bricks and mortar space has been weak and inconsistent, which has suppressed new supply in many US metros. As a result, vacancy has fallen very slowly from its mid-2011 peak. Effective retail rent only turned positive in 2014, but is gathering pace, rising 2.4% (yoy) in Q3 2016. Although consumer spending is strengthening, retail sector improvement will continue to be uneven as retailers struggle to integrate online and store-based offerings into a profitable omni-channel operation.

Returns moderating: Quarterly return for NCREIF's benchmark all-sector index (NPI) peaked at 3.6% in Q1 2015, and has declined steadily to 2.0% in Q3 2016. After posting six consecutive years of double-digit returns (2010-2015), the NPI was 9.2% above its year-ago level in Q3 2016. Deceleration has focused in its appreciation component, as is typical in a maturing expansion.

Summary

We are no longer in a "rising tide lifts all boats" environment. As the cycle continues to turn, a solid understanding of individual metro economies and markets and of real estate sector characteristics become critical in order to optimize investment and portfolio management decisions. With a Trump administration entering office in January 2017, our contention that inflation and interest rates will rise more sharply and quickly has greater plausibility. If implemented, the president-elect's campaign promise of ample fiscal stimulus in the form of spending expansion and tax reduction would bolster near-term growth, although lower trade flows could be a potential offset. Economists continue to parse the tea leaves about his plans and priorities

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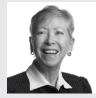

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Questions & Answers with David Rees, Senior Analyst, Continental Europe

Q: How has the Paris residential market performed historically?

A: The Paris residential market has been one of the top performing real estate markets in Europe over the past 15 years, with total returns averaging 8.3% p.a., underpinned by robust capital growth of 4.6% p.a. Despite outperforming the national housing market, Paris house prices are not immune to fluctuations in the national economy. Returns have moderated in recent years as Paris house prices outpaced incomes, and economic growth was impacted by the Eurozone sovereign debt crisis.

Q: Which areas have seen the strongest growth?

A: Population growth in the Greater Paris Metropolitan area has averaged 0.4% p.a. over the past 25 years, rising to 6.8 million in 2015. Limited new supply in the city centre has meant that much of the growth has been concentrated in the Paris suburbs, particularly in the less affluent Seine-Saint-Denis (north) and the wealthier Hauts-de-Seine (west), where new development is less restricted.
The highest residential values are found in the city of Paris, which has a population of 2.2 million people living within a 99 km² area. This makes Paris the densest city in Europe with 23,000 inhabitants per km², compared with 8,100 inhabitants per km² in inner London – the second densest European city. The fastest growing areas in the past 25 years have been in locations with a high concentration of young professionals, which gravitate to vibrant neighbourhoods with a strong amenity offering such as in the 10th and 11th Arrondissements in the north east of the city.

Q: How do you expect the sector to perform in future?

A: We believe that the market is at a turning point following a mild correction since house prices reached their recent peak in 2011. At a national level, the volume of new lending for house purchases reached a 13 year high in Q3 2016, supported by historically low mortgage rates. This has resulted in a sharp uptick in transaction activity in Paris, filtering through to house price growth of 3.6% y-o-y in Q3 2016.
With interest rates expected to remain lower for longer, debt will remain affordable in the short-term, which should sustain demand despite the subdued national economic outlook.

Unlike other European countries, such as the Netherlands and the Nordic countries, French households are not encumbered by significant debt, providing a buffer for when interest rates eventually move out. Longer-term, improving output growth and rising disposable incomes are expected to support moderate growth over the next ten years.

Q: Which areas offer the best long-term investment opportunities?

A: Population in the city of Paris is forecast to increase by 0.1% p.a. over the next ten years, meaning that the movements of high income households within the city will be an important driver of house price growth. We believe that the neighbourhoods that will outperform will offer a combination of value and vibrancy. The trend is expected to be strongest in the north east of the city, where accommodation is more affordable and new restaurant openings are establishing emerging vibrant areas that appeal to young professionals.

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