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REAL ESTATE PERSPECTIVE AND OUTLOOK FOR 2023

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Introduction

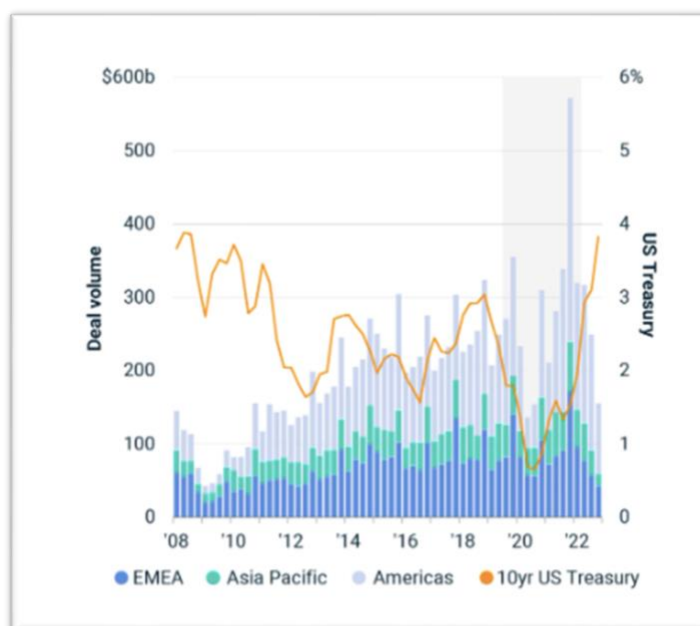
Real estate is one of the most recognizable asset classes in the world, and the most popular among the so-called “alternative investments”. The sector can be broadly defined as including land and whatever is attached/built on top of it, thus becoming part of the valuation of the land. Narrowing down the scope a little, we can distinguish between 4 different classifications of real estate: Residential, Commercial, Industrial, and Special use. In this report, we focus on the macro trends affecting real estate as an asset class and analyze the determinants driving forecasts within the sub-categories of residential and commercial. Moreover, we examine different strategies to invest in the real estate market and provide recommendations for doing so at the current time.

Past Trends

There are certain effects that need to be examined in order to understand the current state of the real estate market. The focus in this part will be on central banks’ monetary policy around the world, risks of recession in the Western hemisphere, and the post-covid trends of the market.

Inflation, Surging Interest Rates, and Rising Cost of Capital:

Over the last 18 months, most countries around the world, including the major Western economies, tightened their monetary policy and began a rapid cycle of interest rate hikes to combat increasing inflationary pressures. The decade-long era of zero (or even negative) interest rates has ended abruptly, with the markets having entered a phase of lower liquidity and the availability of cheap financing. In the real estate sector, this has directly translated to a decrease in transaction and deal volumes, as investors reassess their position and remain wary of further central banks' announcements of hikes.



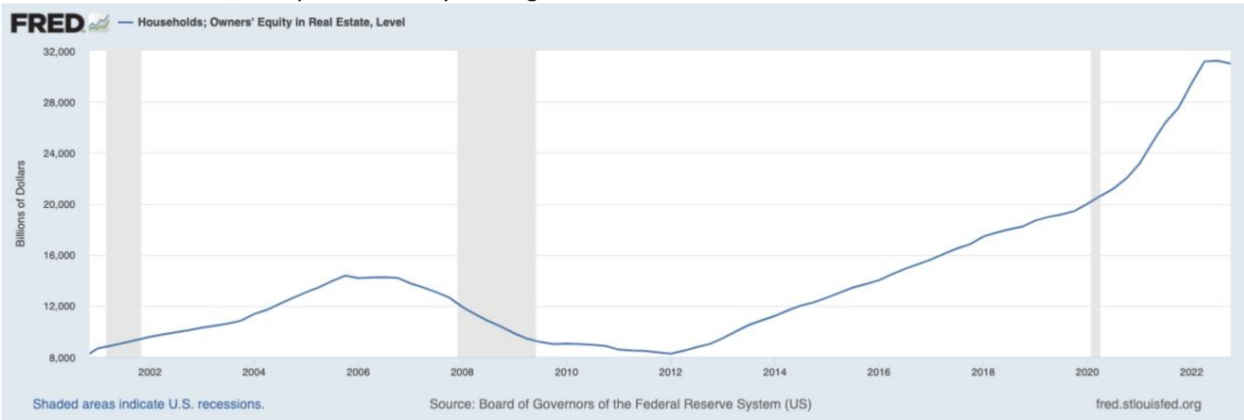
MSCI, Deal volume for all major property types except development sites, for deals of USD 10 million and greater

Higher interest rates increased the cost of capital on the financing of new deals or projects, affecting buyers' valuation of investment opportunities, particularly as we consider that mortgage rates have more than tripled in certain areas[1]. On the other hand, sellers have yet to adjust their expectations to the new market environment, which has resulted in a large spread between bids and asks. This moment referred to as the price settlement process, is both evidenced and exacerbated by the figures of low investment volumes and low liquidity levels and is a period where it becomes much harder to set accurate prices in the market.

Fear of a Market Recession:

With increased pessimism surrounding the real estate sector, withdrawal requests from both private and open-ended property funds have increased. The case of Blackrock and M&G in the UK is one example of the big surge in withdrawal requests. Many institutional and retail investors' requests were deferred by these two banks, in order to rebuild liquidity (and avoid firesales). Property capital values in the UK have dropped by 12.8 percent in the last quarter of 2022 alone and this on top of high inflation has added fuel to the fire.[2] Pension schemes are now trying to cut exposure to real estate after they sold more liquid assets from their portfolio when economic uncertainty from Lizz Truss's package of unfunded tax cuts sent the UK bonds into a freefall. Hence, the recovery of the credibility of the Bank of England after the political uncertainty is yet another consideration to understanding the economic climate behind the real estate market.

It can be further observed that information asymmetry and high levels of uncertainty create an environment where many are in fear of a recession. However, analysts point out that today's homeowners stand on much more secure footing than those coming out of the 2008 financial crisis, with a higher number of borrowers having positive equity in their homes. Consequently, the likelihood of a housing market crash is low, compared to 15 years ago.



FRED, U.S. Department of Housing and Urban Development

After the expiration of the Covid-19 foreclosure moratorium (the act intended to provide relief to mortgage borrowers who experienced hardship due to the impact of COVID-19) in September 2021, the rates of foreclosures did increase but they were still below pre-pandemic levels. In reality, by 2022, foreclosures were down 34% compared to 2019[3].

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[1] Source: Philipps, Mike. "Emerging Trends in Real Estate®: The Global Outlook 2023." *PwC*

[2] Source: Howcroft and Cohn, *Reuters*

[3] Source: ATTOM Data's Year-End 2022 U.S. Foreclosure Market Report.

The data shows that after the Great Financial Crisis in 2008, the housing market became a more steady and secure environment even though there is still a lack of supply in the most populated cities around the globe. Therefore, high earners globally are still buying property to hedge the inflation risk which gives a more optimistic view of the market.

Post-Covid Behavior of the Commercial Real Estate Market:
After 2 years of Covid, workplaces, and offices are facing a new trend of hybrid or remote working which creates uncertainty about how much office space companies and their employees will require in the future. While the level of impact differs from country to country, and sector to sector, in the US, "the entire office sector, including the good assets, is impacted by remote working", arguing that it is a much stronger phenomenon there than in Europe and the Asia Pacific.[4] It is much debatable, however, that there is much greater clarity over future office trends in Europe than in the US. The problem in Europe is compounded by energy prices, which act as a drag on demand for short-term leases (on the commercial or residential property) as compared to other regions.

Real Estate in the Macroeconomy

Understanding the role of real estate in the macroeconomy as well as how the real estate market correlates to macroeconomic indicators is crucial before making investment decisions. The real estate market plays a huge role in various sectors of the economy, primarily through channels like banking credit exposures, construction activity, and household wealth. Property development and its related services make up a significant portion of an economy, by providing employment opportunities, and income through spaces for offices, retail, and manufacturing which creates more employment.

We analyze the relations of the real estate sector with the macroeconomic conditions of the last two decades to better understand the performance of real estate markets in different regions. The relations we will analyze include Inflation, Unemployment and Real GDP

Inflation
Real estate has proven to be a reliable inflation hedge over time (keeping the Fisher Effect constant) due to the ability of landlords to re-price rents upward. This upward pressure is driven by the increased cost of materials and labor required for construction and maintenance, which can lead to a rise in the overall cost of real estate projects, and limit new supply, resulting in higher rent prices[5]. Moreover, as real estate is generally financed with debt (which is fixed beforehand), owners of real estate benefit from future inflation as it reduces the value of their debts, urging them to hike up rental prices. According to the ECB, in Europe, real estate prices increased by an average of 50% in response to inflation over the last two decades. In contrast, the US saw a relatively modest increase of around 30%, while China experienced a more significant surge of 85% during the same period.

Unemployment
The unemployment rate is a key economic indicator when assessing the overall health of the real estate market as housing prices are highly sensitive to changes in unemployment rates. During the global financial crisis of 2008, high levels of unemployment in both the US and Europe led to a decline in the demand for housing, which in turn caused real estate prices to drop. In the US, for instance, the

[4] Source: Philipps, Mike. "Emerging Trends in Real Estate®: The Global Outlook 2023." *PwC*.
[5] Source: Creedon, *Goldman Sachs Insights*

unemployment rate rose from around 5% in 2007 to a peak of 10% in 2009, while the real estate market experienced a sharp decline, with home prices falling by around 30% on average. It's important to note that a chunk of labor was tied up in real estate construction (around 1 million) which almost halved after the crisis, making the supply chain disruption very clear. Similarly, in Europe, the unemployment rate rose from around 7% in 2008 to a peak of 11% in 2013, and the real estate market also experienced a significant decline in prices. Since then, the industry has slowly regained strength with employment numbers increasing (apart from a brief decline during the 2020 recession).

Real GDP

Real estate is strongly influenced by changes in the business cycle and real GDP growth. Over the past two decades, the US and China have shown strong positive relationships between real GDP growth and real estate prices, with the real estate market expanding rapidly during periods of robust GDP growth. In contrast, the European real estate market has grown at a slower pace, with a weaker correlation to real GDP. The 2008 crisis contracted the real GDP significantly in both the US and Europe, with real GDP declining by 2.5% and 4.3%, respectively. This contraction, reflected in real estate markets shows how property prices fell sharply as demand decreased due to the loss of household income. During the period 2007-2009, In Europe, the number of housing transactions decreased by 17%, and real estate prices fell by an average of 7.6%. On the other hand, in the US, the number of housing transactions fell from over 2 million to just over 500,000, and home prices fell by more than 30% in the same period. However, the real estate market of China has remained strong due to government stimulus measures even though real GDP growth had slowed by 2009.[6]

Government stimulus through monetary and fiscal policy plays a huge role in stabilizing the fluctuations in the business cycle and hence, inflation and unemployment. Hence, these variables determine the health of the macroeconomy and help understand the systematic risk of investing in real estate.

Determinants in the future of the real estate sector

As the analysis above depicts, the outlook after the first quarter of 2023 generally has been considered to be weak, as inflation, rental rates, and interest rates are set to stay on a higher plateau for the short-medium term. However, when analyzing what will be the drivers of the sector, we can restore at least a bit of optimism in the market. The underlying factors of the future attractiveness of real estate as an asset class can be summarized by the reasons below.

Inflation and Interest Rates:

The determinants of heightened prices and rental rates include rising inflation and interest rates, which play a role often hand in hand in reducing the benefit of holding real estate as a possible hedge against inflation. This stems from the combat of inflation from, among others, the FED and ECB which set expectations of a growing interest rate. The *Fisher effect* implies that real interest rate differentials between two countries are equal to the differential in inflation expectations, ceteris paribus.

Fisher Effect: $R_H - R_F = \pi_H - \pi_F$

Where H represents the home country and F the foreign.

[6] All the data for changes in macro-economic indicators is taken from the Global Economic Prospects Report from the World Bank (See References)

Hence, a rise in the expected inflation of a country eventually causes an increase in the nominal interest rates. This has increased the bearish outlook on real estate, by dampening transaction quantities and the capitalization rates in the sector and increasing withdrawal requests from private, open-ended property funds (as in the case of Blackrock and M&G above)

Expectations and Uncertainty

Another very important determinant of the outlook of the real estate market is uncertainty. The high credibility of the central banks would imply that interest rates are going to continue to rise and be reflected in the real estate market. Institutional investors react to these hikes and undergo the *"denominator effect"* which refers to the inability of investors to invest in private real estate when their equity and bond portfolios weaken, making the reallocation of assets slower following changes in the macroeconomic conditions.

However, the behavior of the non-bank financial institutions to changes in uncertainty is an important factor in order to gauge the impact on refinancing and mortgaging (see in the role of financial institutions).

Uncertainty, moreover, comes into play in a number of aspects of the real estate industry, where the underlying assets are doubted not just on their method of financing and their underlying value, but also on their primary use. This is particularly important in the post-Covid-19 world, where hybrid working has complicated the use of offices by employees. This is affecting not just the office but also the residential sector, as the latter is growingly representing a dual function of the home as a residence and co-working space. Similarly, the growth of online shopping is expected to lessen or substitute the role of retail real estate with the role of warehouses (industrial real estate). The blurring distinctions between real estate property types mean to understand the mechanism of the macro-movement of the industry, there's a need to identify new practices in real estate to adapt to the new financial reality we are expected to enter post-recession.

Demand-side and Supply-side factors:

The supply-side disruptions, which may even trace their roots back to the financial crisis of 2008, have not fully subsided in Europe. If anything, supply shortages have increased due to exogenous shocks such as the Russian invasion of Ukraine and essentially pulled prices and rental rates up (although the biggest grunt of increase is faced by the energy sector, which essentially affects real estate construction).

On the flip side, the demand for real estate is facing shocks that stem from declining consumer spending. This has also negatively impacted retail real estate, in the recessionary climate where individuals defer consumption with the increasing real rate, on top of deferring big investment decisions like relocation, or encouraging renting real estate instead of buying.

The Growing Role of Environmental, and Social Governance (ESG):

An important long-term driver in the demand for real estate is ESG, as the industry is trying to adapt more to energy-efficient methods, and this is tightening the relationship between rental income and returns in accordance with a sustainable and environmentally friendly agenda. Investing in long-term solutions to incorporate ESG is a short-term cost that firms may bear but it is for the inevitable transition to more energy-efficient methods of production. The role of ESG has been considered the most important factor for profitability by 93% of industry leaders in Europe[7], not just as a 'nice to have' agenda but as a means to identify and more effectively calculate risk in the real estate market.

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[7] Source: Philipps, Mike. "Emerging Trends in Real Estate®: The Global Outlook 2023*." PwC.*

Role of financial institutions

Bank and non-bank financial institutions are important as influencing participants in the sector, but also as parties affected by the real estate market conditions. Overall, financial institutions are putting forward a positive outlook for 2023, with the expectation that inflation (along with interest rates) will stabilize and real estate fundamentals (rental rate growth, occupancy rates, supply) will remain strong.

As participants in the real estate market, however, we can see that lending institutions like banks and debt funds are increasing their confidence slowly, as the recessionary climate brought through 2022 thaws. Investment opportunities in high-quality properties that have high yields, lower leverage, and higher covenants benefit these lending institutions and are perceived to rise in the post-recessionary climate. Until this happens, the banks are nudged to the side and only large loans which are characterized by a strong lending relationship between the borrower and lender are going to benefit from these terms the most.

As the growth of credit takes place alongside the opening up of the economy (especially with the relaxation of China's 'zero-covid policy') we can expect to see that the role of financial institutions will become more active in the real estate market. Until then, the effects of the credit availability slowdown are still apparent as banks prioritize existing clients and maintain a bearish outlook on the development real estate side. This uncertainty may stem, or even derive from, the banking turmoil over 2022 and 2023, with the failure of Silvergate, Silicon Valley, and Signature Bank in America as well as the bailout of Credit Suisse in Switzerland.

However, the distress of these institutions resulting from the refinancing of loans is not as painful as we expected pre-recession in the first half of 2022 when the fear of non-performing loans loomed over the financial sector. We can now see that the cause of the crisis may have been not the non-performing loans (which was the primary factor of distress in 2008), but the higher interest rates and inflation. Hence, even if the present looks grim, the readjustment of markets, and financial institutions as well as the expectations of these institutions for higher interest rates will lessen the pain from interest rates soon.

Investment Recommendations

There are a number of different ways in which one can invest in the real estate market, with different instruments allowing one to take bullish or bearish positions with varying degrees of risk and diversification. We begin this section by giving an overview of the main types of instruments that grant exposure to real estate, before delving deeper into a recommendation of the most suitable ones given the market conditions illustrated above.

<u>Real Estate Investment Trusts</u>

The most traditional investment vehicles within the real estate space are Real Estate Investment Trusts (REITs). Most REITs are equity-oriented, i.e. they are companies that own, operate, and finance income-generating real estate properties (alternatively a mortgage REIT holds debt instruments, typically mortgages, towards real estate developers and operators). A REIT pools capital from outside investors and invests it into assets such as offices, apartment buildings, warehouses, retail centers, medical facilities, data centers, cell towers, infrastructure, and hotels. The main source of revenues is rental income, with the additional target of property appreciation providing a long-term return as well. The key benefits of REITs are liquidity, as many are publicly traded (e.g. Prologis Inc., American Towers Corp., Realty Income Corp); affordability, as the share structure allows you to earn rental income on a

commercial property with a flexible amount of capital invested; and practicality, in the sense that the investor does not have to manage the day-to-day of the properties himself.

Real Estate Mutual Funds and ETFs

Two corollary investment instruments linked to REITs are Real Estate Mutual Funds and Real Estate ETFs. Both consist in entities that pool money from investors and, much like a regular mutual fund or ETF would build a portfolio of shares of different companies and allocate their capital into a number of different REITs. Therefore, given their nature, the main advantages they offer are high liquidity, low transaction costs, and maybe most importantly, diversification. Indeed, a Real Estate ETF or mutual fund can allow you to gain exposure to different sub-sectors of the residential and commercial real estate market, all while investing in a single product. Examples of such mutual funds are the Schwab Global Real Estate Fund, or the Fidelity Real Estate Investment Portfolio, while notable ETFs include the Vanguard Real Estate ETF, as well as the iShares Core US REIT ETF by Blackrock, just to name a few of the many out there.

Direct Investment

A different way of investing in the real estate economy can be achieved by investing directly in the market for new properties, by trading shares of commercial construction companies, or, for exposure to the residential market, developers of housing projects, the so-called “homebuilders”. These stocks faced considerable headwinds last year, as construction was affected by raw material shortages caused by supply chain bottlenecks and overall sharp inflation in the prices of inputs such as lumber, aluminum, concrete, and iron. However, in recent months such concerns have eased, particularly on the supply chain side, and the undersupply of new homes remains a significant issue (or in the case of home builders, a profitable condition) in most major markets across Europe and the US. Further, the resale market does not only have little inventory for sale, as higher mortgage rates compared to the past disincentivize homeowners from selling and relocating, but it also exhibits a large gap between bids and asks, as prices have been sticky since sellers have yet to adjust their expectations to current conditions. The resulting consideration from these factors is that new construction, on the housing side, remains one of the only sides of the real estate market where general optimism is prevailing, as evidenced by the fact that the S&P Homebuilders Select Industry Index (SPSIHO), as at time of writing, is up almost 10% Year-to-Date and 9% YoY. Compare this to the REIT ETFs and mutual funds mentioned earlier, which are down between 20-25% since this time last year, and in the green by around 1-3% YTD. On the office and professional spaces side, however, the outlook appears less optimistic, driven by concerns for permanently lower demand for office spaces as a result of hybrid and remote working shifts both in Europe and the US.

Recommendations

Based on the analysis performed in the previous chapters of the report, as well as the outline of different investment industries just presented, our investment recommendations are the following. We find the real estate market to be navigating challenging circumstances at the moment, both in Europe and the US, and considerable uncertainty and skepticism is the prevailing sentiment at the moment. However, we believe the investment industry to have largely priced this in by now, and recognize the opportunity presented by recent and sizable pricing corrections across the commercial real estate space. As we remain confident about the long-term prospects of the sector and cautiously optimistic about the short-term outlook of the current situation, we see this as an appropriate time to build up a position in the real estate market. To do so, we recommend an approach targeted around selecting high-quality investments, while still maintaining appropriate diversification across geographical regions and asset classes. In particular, this would consist of a strategy of purchasing a combination of REITs specialized in steady income properties such as rentals or big box retail spaces, and a number of homebuilder stocks between Europe and the US. A position in broad ETFs or mutual funds can be suitable for the reduction of idiosyncratic risk

related to individual stock picks, but we find that given that the nature of the real estate is one of high interdependence and diversification is difficult to achieve (as seen in the subprime mortgage crisis, where MBS had AAA ratings for their supposed diversification strength), the negative effects of having partial exposure to the less bright parts of the market outweighs the positives. In particular, we refer to the office space subsector, which we considered to have a particularly uncertain, but overall, less positive, outlook.

Forecast for 2023/2024

	2023e Real GDP Growth		2023e Inflation		2024e Real GDP Growth		2024e Inflation	
	GMAA New	Bloomberg Consensus	GMAA New	Bloomberg Consensus	GMAA New	Bloomberg Consensus	GMAA New	Bloomberg Consensus
U.S.	0.3%	0.4%	3.9%	4.3%	1.5%	1.3%	2.5%	2.5%
Euro Area	-0.2%	0.2%	6.3%	5.9%	1.6%	1.6%	2.6%	2.5%
China	5.2%	4.8%	2.3%	2.3%	5.4%	4.8%	2.6%	2.5%

Source: KKR

For more than a decade, global markets witnessed the era of abundant capital and low-interest rates, and as the world entered a changing macro environment, rising borrowing costs since 2022 halves become the new financial reality. According to the World Bank, in 2023, many economies are likely to have slower growth in incomes, and about 76% of economies are expected to experience disinflation. This projection reflects the expected cooling effects of contractionary policies and as interest rate hikes slow down and correction in pricing occurs, housing prices can have greater stability. While the mortgage rates dropped to 6.27% in the US for the week ending April 13, buyers gained confidence in their purchasing power, based on the increase in application activity, compared to the two-decade high of 7.1% last year.[8]

Overall, there is a positive outlook for real estate in 2023, with markets cooling down; however, economies with elevated house prices and high levels of debt are still vulnerable to any financial sector risk, which is the case for Australia. According to KKR's forecasts of real GDP growth and inflation for the next two years in the US, Euro Area, and China, the inflation rate will slowly fall back, and the real GDP growth will start rising in 2024, mitigating the effects of the economic slowdown amid fear of recession.

Conclusion

The internal efficiency of real estate market actors, especially developers, matters now more than ever, in order to adapt to the new economic context where interest rates may stop rising but settle at elevated levels, capital growth may be limited and there are increasing requirements with regards to the environment, and demographic patterns. Dealing with this higher cost of finance and redefining the quality requirements in this new environment is crucial in order to contribute to the growth of the real estate sector. The outlook, hence, doesn't admit to the fact that good opportunities are decreasing, but that the definition of 'good' is changing.

[8] Source: World Bank – Global Economic Prospects

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