

# Real estate – **Safe-haven status?**

UBS Global Asset Management, Global Real Estate Research & Strategy

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Elisabeth Troni, Global Strategist

### Context

A lot has changed in the last week with some large potential implications for real estate. The stock market has experienced its worst performance since the depths of the bear market in late 2008 and 2009 when US banks were being priced for insolvency. GDP revisions from key developed market countries have been severe, with non-trivial shavings to 2011 growth estimates in the US, Europe, and Japan. The disappointing global growth data has spooked the markets, suggesting that a revision to history is necessary – the recovery has been weaker than previously reported. The downward revisions to growth have sparked increased concern that some countries will not be in a position to pay their debts. Such fears have intensified in the face of weak or ineffective government action. Currency impacts expose the underlying fault lines as investors retreated to the Swiss franc and yen, with the US dollar down against these two traditional safe havens; but higher against the euro and pound.

In the US, recent crisis concerning the debt ceiling and credit downgrade, have revealed concerns about the effectiveness of the political process. Furthermore, recent growth downgrades have raised concern over plans to remove (and rapidly reverse) fiscal policy support just as doubts about the sustainability of the recovery have intensified. Of concern is the apparent willingness of the US to focus on fiscal issues at the expense of the country's current plight which is fundamentally about a growth crisis.

In Europe, ongoing policymaker inertia has failed to support investor confidence and it has become increasingly evident that aid packages offered to the peripheral countries in late July were insufficient, particularly in the cases of Spain and Italy. At the time of writing, a sense of deepening crisis has spread into the core of the eurozone with France's triple A credit rating rumored to be at risk. It appears that the recent hit to confidence has left the markets exposed to ongoing speculation with the European region likely to remain a key concern for the time being.

For Asia, the picture is relatively optimistic despite its largest trading partners struggling to sustain growth. That said, there will likely be knock-on effects for small open Asian economies that rely heavily on exports to advanced economies (particularly Korea, Singapore and Taiwan). The larger economies of China, India and Indonesia will be less affected by a deteriorating

outlook for exports. Broadly for the region, the good news is that weaker global growth should restrain inflation later in the year. In contrast to the US and Europe, the region has plenty of scope to loosen policy further in the event of a more severe downturn.

With events still unfolding, it feels premature to make pronouncements on the implications for global real estate. What does appear certain is heightened global risk aversion with investors fleeing into the safety of havens. In this context, the most immediate impact of recent economic turmoil could be positive for the sector in pushing more investors towards safe-haven investments in prime property. While the range of possible outcomes remains wide, we try and narrow the scope to identify some key areas of potential consequence for global real estate:

### Downside risks

#### 1. Heightened liquidity concerns

In response to recent volatility, investors have declared a strong preference for liquid positions evidenced by a sell-off in risk assets and a rally in core bonds. Against this backdrop, it is unlikely that such investors will look to increase their exposures to more illiquid assets including real estate. However, we do not expect such concerns to impact those investors focused on prime assets and for whom real estate offers relative safe-haven status (see pt 8).

#### 2. Weaker fundamentals

Recent financial market turmoil was broadly a response to a weakening global economic outlook. With broad revisions to global growth figures, there is an implication of increased risks to the income growth prospects of real estate assets. Secondary assets which are characterized by greater asset level risks, including weaker income prospects, are particularly sensitive to an increase in downside risks.

#### 3. Deteriorating valuer sentiment

With investor demand sharply focused on core income producing assets, there has been little visibility on the pricing of secondary and tertiary assets. As a result, it is widely believed that valuers have been reluctant to mark down the values of secondary assets in the absence of comparable transactional evidence or a sharp downward revision to growth assumptions. The result has been a perception that secondary assets have

looked overvalued and potentially vulnerable to a change in valuer sentiment. Recent market turmoil may provide support for valuers to apply more negative assumptions to the prospects for secondary assets.

## Neutral

### 4. Increased pressure on banking sector

The recent sell-off in risk asset positions hit bank shares particularly hard. Prior to the recent turmoil, we had concerns that banks were under pressure to reduce their exposure to real estate thereby limiting debt availability. Looming refinancing requirements of the sector have been identified as a significant source of risk for some time. Recent events have increased balance sheet stress suggesting that banks are now more likely to be cautious about lending to the sector. There is also a risk that they will be under more immediate pressure to reduce their exposure to the sector resulting in an increase in motivated dispositions. Certainly, reduced debt availability would be negative for the sector as a whole. But, conversely, an increased supply of assets would enhance liquidity. Given the uncertainty surrounding banks at this time, it is hard to judge the balance of risks on this issue.

### 5. Denominator effect

Given the recent sharp declines in equity market values, some multi-asset funds may find themselves overweight to real estate. This quandary is known as the *denominator effect*. As the value of different asset

classes — stocks and bonds for example — falls, the value of allocations to other assets, including commercial real estate, rises above allocation targets, triggering needed adjustments, i.e. sales. A degree of selling, and therefore downward pressure on prices, may therefore feature in the coming months as funds work to meet redemptions. However, with events still unfolding, it is hard to estimate the potential impact of any changes on actual allocations. Given the stated intention of many investors pre-crisis to increase their allocation to real estate, this may turn out to be a non event.

## Upside risks

### 6. Lower government bond yields

With confidence shaky, investors have returned to core bonds. The continued long-term decline of debt yields has led to a dramatic increase in commercial real estate risk premiums over the last three years. Not only have risk premiums completely retraced the decline during the bubble years, but due to recent turmoil they are currently at the highest level in 20 years. With fixed income streams in high demand and interest rates low, the relative pricing of core real estate should remain attractive.

### 7. Inflation protection characteristics

In preparation for a scenario in which low or no growth means that governments of many developed economies look unable to meet their debt obligations and central



banks aim to ease the burden by generating slightly higher inflation, the inflation protection characteristics of real estate will be highly valued. Tangible assets, such as real estate and gold, are highly sought after by investors during periods of higher inflation. Such a debt monetization scenario now seems judged to be more likely than a few weeks ago, though still not necessarily probable.

### 8. Safe-haven asset

With trading screens a sea of red digits, investment managers are reducing risk in their client's portfolios and moving into safe-haven assets. As mentioned earlier, aside from the traditional safe-haven commodity assets such as the Swiss franc and gold, there are not many options. The options are even further limited for investors who would prefer not to give up some of their short-term cash flow for the price of hedging some of their risk. Investors seeking safe havens have to accept a loss of income on their portfolios with assets such as gold that do not pay a dividend. This is not the case with real estate which offers revenue cash flows alongside capital appreciation potential.

We believe that prime real estate in key global markets has a role to play for investors looking to hedge some of their risk but not sacrifice a predictable income

stream. It has been widely reported that prime real estate assets in key global markets have recovered in value and in some cases are approaching peak pricing levels. As we mentioned earlier, the attractive risk premium available on commercial real estate has supported the relative pricing of real estate given the low level of bond yields. If lower government bond yields are sustained, yields on prime assets may compress even further. In this increasingly probable scenario, there is potential upside for prime real estate assets.

### Impact on UBS Global Research & Strategy 2H11 forecasts

We have recently published our 2H11 forecasts for global real estate markets. The forecasts were completed in late July and broadly reflect recent market turbulence. Should sentiment deteriorate further or events evolve into a second banking crisis we would clearly need to revise our central assumptions.



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