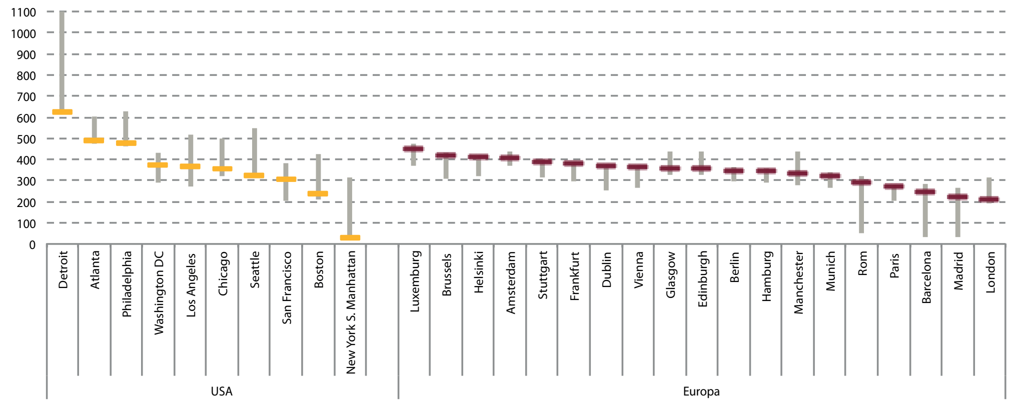
WHERE TO INVEST? – A LONG TERM EQUILIBRIUM ANALYSIS FROM A CORE PERSPECTIVE

DR. MARCUS CIELEBACK
Group Head of Research

Bond yield gap: Comparison of the US and European office markets (Max-min-range and last value)



Source: PATRIZIA, Colliers, PMA, Reuters (data from 2012 Q1 until 2016 Q3).

Looking at investment intention surveys over the last years a common theme can be observed: Target real estate allocations of institutional investors have been increasing constantly! Since 2010 this development has lead to continuously increasing investment volumes as investors try to chase their moving target. But 2016 was different. Not only did the political landscape create a lot of uncertainty resulting in investors being more cautious when making their investment decisions, but especially the investment markets struggled with product availability, leading to flat or even declining investment volumes in many European countries although target allocations had risen again. Political uncertainties are clouding economic outlooks, interest-rate increases are on the horizon – or have already started – and the availability of product is challenging. Against this backdrop, investors are confronted with the question of where to deploy their money in 2017 according to their risk preferences and return expectations.

Looking at the different investment intention surveys the Asian and European investors are the ones most under allocated in real estate compared with their target allocations, while US investors seem to be closer to their targets. This might be one of the reasons why we have seen so many Asian investors entering the European Real Estate market in the past years, but it is no answer why they choose Europe and not North America or Asia/Oceania for their investments.

First of all, every institutional investor has a home bias in his investment intentions and decisions as the existing investment intentions surveys confirm. Therefore any decision to move outside ones home turf will consequently be done after careful evaluation. Some thoughts on demographics, growth perspectives, the equilibrium interest rate and the risk preferences of the investors shed light on the relative attractiveness of the different regions and explain to a large extend the attractiveness of Europe for specific investor groups.

Coming from a theoretical equilibrium analysis, interest rates should be on par with nominal growth. As a consequence, todays low interest rates are the result of low real growth and low inflation. However, the very expansionary monetary policy of most central banks has pushed bond yields to levels that are even below the already very low equilibrium levels. Going forward this will be a drawback for capital growth perspectives of fixed-income investments, if interest rates start to adjust to their equilibrium level. But low interest rates and high central bank liquidity also resulted in high valuations of many alternative asset classes despite weak growth, as institutional investors were looking for yield. This suggests that ultimately capital growth of most of these alternatives will also be below historical averages going forward. Investors have to keep this in mind when planning their allocations and investments.

In addition, demographics and productivity developments in most advanced economies indicate that it is unlikely that the high (nominal) GDP growth rates of the past will return in the (near) future to support capital growth. Overall this leads to a challenging investment situation with weak structural nominal growth and historically high valuations of many asset classes. It is therefore not surprising that institutional investor's favour core and value add strategies when asked about their property investment intentions.

Against the background of these investor risk preferences a closer look at the performance of real estate investments around the world and its components is useful. The importance of capital growth in the total return performance sheds some light on the fact by how much investors will have to adjust their expectations about future returns in comparison with past performance when making allocations and investment decisions.

As we are facing a lower growth environment, capital growth in the future will be significantly lower compared with past experience, leading to overall lower total returns. At the same time the importance of the income return for investment performance will increase, making asset management a key performance driver going forward to achieve the expected lower returns. From that perspective Europe with its low volatility and low average capital growth in the past will be the region, where future returns will be closer to past performance, especially when compared with North America or the UK, which underpins the stability of the European market in a global comparison. In addition, looking at the ability of market yields – especially prime yields – to cope with rising interest rates, it is again Europe offering better perspectives in comparison with North America. The gap between prime yields and national government bonds is at an all time high in Europe, while in North America the gap is nearing or at historical lows, especially after the second move of the Fed in December and the expectations for debt financed government spending during 2017 and 2018 under the Trump administration with the corresponding consequences for bond yields.

Overall this leads to a market situation in which risk averse long term buy and hold investors following a core or value add strategy should favour (old) Continental Europe over the other investment regions, as downside risks will be lower. Based on such a strategic long-term European allocation investors have to select investment locations and sectors on tactical considerations when building their portfolio. When doing this, investors always have to remember: "The future is not like the past, they have to leave their usual way of thinking behind and adapt flexibly to secure investment success."

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