jlp asset management

Global Property Market Review & Outlook

2Q 2022

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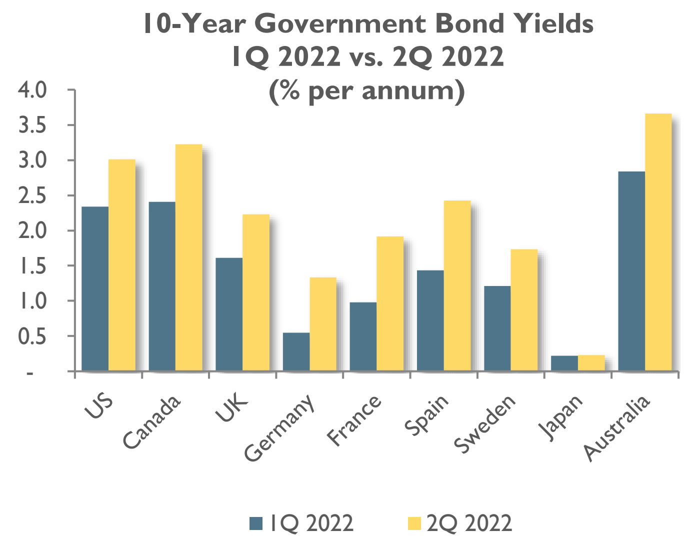
Slowing Growth But No Recession?

Market Overview

As we noted in our last Outlook, a global slowdown was developing but not necessarily imminent and that now seems to be the case. Whether it is defined as an actual recession is more a question of semantics as the rate of economic growth in most if not all major markets are slowing or already negative as in the case of the US. Throughout the quarter, the impact of a variety of factors – rising food and energy costs, recurring supply chain issues, and the efforts by the Central Banks of the world to dampen inflation through rate increases and reduced asset purchases – started to weigh on consumer demand and sentiment by the end of the quarter. Global sentiment gauges are starting to confirm this trend as captured in the "misery indexes" (Bloomberg July 5) in the US, UK, Japan, and Canada which in some cases have hit the levels of the GFC in 2008. This trend is somewhat surprising given the fact that this index is comprised of the employment rate and inflation, and most markets are experiencing strong employment data.

With inflation dominating the headlines, it is notable that the most recent sizable downturn in bond yields after peaking during the quarter in virtually every market has been somewhat surprising and could be presaging an economic slowdown – or a preference for lower risk assets in a volatile market environment. As shown below, the 10-year bond yields rose during the quarter and for markets that have been experiencing negative yields – Germany, Switzerland, and Japan – they have now moved into positive territory.



Data from Bloomberg as of 6/30/2022. Bonds analyzed: US (USGG10YR Index), Canada (GCAN10Y Index), UK (GUKG10 Index), Germany (GDBR10 Index), France (GFRN10 Index), Spain (GSPG10YR Index), Sweden (GSGB10YR Index), Japan (GJGB10 Index) and Australia (GACGB10 Index).

At the end of the quarter, the European nations realized that the twin objectives of terminating Russian energy supplies and meeting environmental objectives would result in a catastrophic rise in energy prices and potential shortages. The EU is now receiving only 1/3 of the Russian gas supplies as it averaged during the 2018-2020 period (Gavekal July 1). As a result, plans to resume coal and seek other sources of natural gas were initiated by the end of the quarter which should help to alleviate this sector's impact on inflation in the future. There is growing concern of an energy shortage as Europe moves into the colder season which could further dampen economic growth.

As the second largest economy in the world experiences continued lockdowns and slowing economic growth, China clearly has an impact on global markets and supply chains. The slowdown has actually helped ease global inflation as the renminbi has weakened and producers there have much less pricing power. While the news about

Shanghai's lockdown (lifted in June) was of concern to global markets, the sharp decline in container traffic was picked up by other ports that are open for business, alleviating supply chain pressures (Gavekal July 5).

One of the few bright spots in the developed world has been Japan which began to lift Covid mobility restrictions in late March and the result has been a rebound in the economy as reflected in the GDP growth projection of 3.1% for Q2 (Japan Center for Economic Research). While office vacancy has remained flat at 6.4% in the major Tokyo wards, workers are returning to the office and retailers are reporting sales that are approaching pre-covid levels. Unlike the rest of the world, the Japanese are not plagued with surging inflation as is evident based on the latest data for June Tokyo CPI ex-food and energy down 0.1% and core CPI up 2.1% YOY. This is somewhat surprising given the massive decline in the currency relative to USD this year. As in the case of China, this market has room for added stimulus given the low inflation rate and the Bank of Japan's determination to focus on growth. It should also be noted that a depreciating yen is not only a positive for this export-oriented country, but it also benefits its pensioners as their government pension fund (GPIF) holds nearly $1trillion in non-yen denominated assets, mostly USD.

REAL ESTATE MARKETS – A Global Perspective

Overview

We regularly get questions from investors and consultants about emerging real estate issues including:

- Overheating residential markets in contrast with China's faltering residential market
- The future of the office market given the changes brought about by Covid
- Ecommerce and supply chain disruption impact on the logistics/warehouse sector
- The European market given the impact of the Ukraine war and political developments

Given the extremely wide gap between public and private valuations for real estate today, we also are asked about when to enter (or increase) the public real estate market and how much of a decline in property values do we expect the private equity funds will reflect in their investor returns over the coming quarters. While we can't really answer either question, we can suggest that the discounts to value in the public markets are reminiscent of the GFC in 2008 but that overall conditions for the commercial and residential sectors are in much better shape both in terms of leverage and supply/demand.

Residential

As interest rates rise globally, the housing sector in many countries have been most directly affected not only by the rise in rates but also the reduction in availability as lenders brace for defaults in the future. At the end of the quarter, the booming housing markets in Sweden, Canada, the US, and most of Europe are reporting sharp declines in prices off historically high levels. Toronto reported a decline in selling prices of 9% last quarter and the pace appears to be accelerating nationwide. US mortgage rates have doubled over the past year and have reached 2008 levels as banks have announced a virtual shutdown of their home mortgage origination groups. While potential for a slowdown in the housing market is not surprising, the pace of price adjustment has been remarkable and appraisers and lenders are trying to get ahead of this, resulting in further sales declines. Bidding wars are suddenly a thing of the past.

A key risk for the residential housing sector is that on the margin, speculators, not end-users, have become significant home buyers and these tend to be a greater percentage of debt for their purchases. This was a significant issue in the US during the GFC but unlike that period, the current home rental market is dominated by public companies buying single family homes for rent (SFR) with solid balance sheets and tenants. However, this is not the case in most other markets like Canada where 20% of homebuyers are highly leveraged speculators/landlords and we can expect further challenges for these markets as interest rates rise and economies slow (Bloomberg June 17).

While the European and US markets for residential property are experiencing a price adjustment, the markets in Asia have already been struggling with the notable exception of Australia which is undergoing a housing price adjustment currently.

The rise in interest rates is deterring home purchases, especially for first timers, we should note that the supply of housing in the major markets like the US, Canada, Europe and even China has not kept pace with demand, which also partly explains the rise in home prices over the past several years. Melbourne (Australia) reports a "severe medium-term undersupply" that is getting elongated due to rising materials costs, planning delays and a shortage of labor, as well as cancellations of new construction due to financing pressures. This housing shortfall is resulting in a growing market opportunity for "build-to-rent" properties in markets like Australia and China that have been traditionally biased to home ownership. While this doesn't solve the housing shortage problem, it does enhance overall access to housing at a lower burden on the end-user due to lower overall cost of occupancy – no need for down payment and financing costs.

China's residential markets began to show signs of improvement due primarily to increased mobility and also government efforts to stimulate demand and encourage lenders to finance acquisitions. Since the onset of Covid, this market was in oversupply but the sharp decline in new construction since that time appears to have shifted the residential market more toward equilibrium. However, the publicly listed companies in this sector continue to struggle with leverage and unsold inventory and it may be some time before the property market can recover. Trading at the widest discounts to NAV in history, the sector is due for a positive reversal in this trend as this may be the only market in the world with declining mortgage rates and rising affordability. As noted earlier, the government is actively promoting the development of a rental housing industry for the low-to-moderate income households which will ultimately emerge as public companies utilizing a REIT-type structure. This will be targeted at the major urban centers which currently have a 70-80% home ownership rate, but lower income households tend to get priced out or can't get financing.

Commercial Real Estate Market

The Global Office Market – Permanently Damaged?

The global office sector is now confronting a seemingly existential challenge after nearly 3 years of Covid-induced working from home. With the exception of Tokyo, Singapore and Hong Kong where going to the office allows workers to escape from tight quarters at home, office tenants and landlords are actively discussing options for space that provide more flexible terms and open space plans. Employers are still trying to determine the extent of their current and future office space requirements as it appears that many employees are also opting for more return-to-office (RTO) options.

In the US, there also seems to be an increasing correlation between commuting time and cost and RTO rates, and this relationship could change further as fuel costs and safety issues increase (perceptions of rising crime rates for public transport). There also seems to be a relationship between the industry and type of worker it attracts as the more tech-oriented companies in San Francisco are more reluctant to return to the office while financial services workers are more inclined to go to the office for at least 3 days a week. It does seem clear that most office buildings in the major cities in the US will be largely vacant over the near term and overall US office vacancy is now at 17.5% as compared with a more normal level of 13% which is roughly the long-term average (C&W, WSJ July 13). Currently, San Francisco and New York remain well below the US national average physical occupancy rate of 44% with both markets in the 30% range, while major cities in Texas like Austin, Houston and Dallas are well above the average led by Austin now at over 60% of pre-pandemic physical occupancy levels.

The challenge is for appraisers, lenders, and investors to determine the current and future value of office space globally, and given this degree of uncertainty, public markets are building in historically high margins for error. In our view, there are a couple of key elements that offset some of this risk that are not factored into current share prices:

- The massive amount of capital slated to be invested in the real estate markets by sovereign wealth funds, institutions, and private equity firms; and
- The relative lack of future supply that has been suppressed by the current degree of uncertainty, rising construction and financing costs and, most recently, risk of obsolescence. This latter issue has become a major supply challenge as office owners of older buildings are now facing the potential for obsolescence that did not exist pre-Covid – the need for more open space plans, wider corridors, fewer columns, and better ventilation systems. While some buildings can afford to be retrofitted, for many owners the costs will far outweigh the benefits. JPMorgan tracks the availability of high quality, energy efficient and environmentally friendly office space (BREEAM Outstanding) and notes that only 1% of office space in London currently meets this standard. As a result, JPM expects a major supply shortage of high-quality space over the coming years without regard to the pace of economic growth (JPM April 29).

While a CEO of a warehouse REIT in the UK refers to the office buildings in London as "melting icebergs" due to their perennial capex requirements that erode cash returns, we believe that the extreme discounts for this sector (30-50%) are attractive given the potential for future supply shortages. We also assume a gradual RTO trend will ultimately enhance returns, but a global economic slowdown and tight financing markets will further limit new supply, ultimately positive for long-term value. Notwithstanding our CEO friend's comments about "melting icebergs", global investor interest in London continues with a major Australian sovereign wealth fund (New South Wales government) agreeing to acquire Land Securities' (UK REIT) newly built office building leased to Deutsche Bank in the City at a sub-4% yield (GBP 1,600/sf). Note that this price is well-above the public market valuation for Land which has a dividend yield of 5.3% and trading at a 35% discount to NAV (Jefferies Research June 18).

Note that these discounts for office-oriented public companies also exist in Asian markets that are operating at close to pre-pandemic levels, unlike their US and European peers. In fact, Singapore landlords continue to raise rents (up 2.7% QoQ) in a relatively robust demand environment and recently experienced the highest net absorption rate in over 4 years. However, even this market is beset by skepticism about the future economic environment and is also experiencing a public/private market valuation gap, although less extreme (averaging 24%, JPM data June 30) as in markets where workers are reluctant to return to the office.

At the moment, it is clearly a buyer's market if the seller is struggling with excessive leverage, rising interest rates and downward pressure on rents, which is clearly not the case for most publicly listed property companies and REITs. In fact, many of the office companies have been preparing for this moment and are looking for distressed opportunities, although they will probably be outbid by the private equity firms and sovereign wealth funds with their massive amounts of dry powder at the ready. The more likely scenario is for more public companies to be taken private at premiums of 25-30% to current share prices but discounts to fair value.

Global Industrial/Logistics Market – Oversold or Presaging a Global Recession?

This property type tends to be at the epicenter of the supply chain and has clearly benefited from surging demand and a shortage of inventory. The major US ports have run out of storage space to such an extent that they are leasing land on which to put the abundance of trailers/containers. Impediments to new construction that include zoning issues and rising construction and land costs are making new development more challenging. Even renting raw land is now becoming as expensive as leasing space in a storage facility (WSJ June 15). Vacant shopping centers are now becoming warehouse facilities and their parking lots are being rented to companies like Amazon for their delivery trucks.

Rental rates globally are surging and the companies in this sector report no reduction in demand over the past quarter. Quite the opposite, as most are reporting rental rate increases on renewals at record high levels (in some cases over 50%) and record low vacancy rates. So why did virtually every public company in this sector worldwide get hit by Amazon's comments – and still haven't recovered after declining nearly 20-30% (USD) during the quarter?

Based on commentary from the public companies, Amazon's quest for growth at any cost and one-day delivery times exceeded its actual needs, but this situation has been occurring over the past 12 months and was well-known in the industry. However, it was only after Amazon's announcement on April 28 that the stocks dropped sharply on the news. Following soon after the US Fed's declaration that it would get tougher on inflation, the combined effect may have led to investors interpreting this as a sign of a slowdown in the global economy in general and ecommerce specifically. In many of our key markets, especially Asia and Europe, Amazon's tenancy is a very small part of the overall market and the company's decision to either cancel contracts or sub-lease space is not material.

While we would expect this turn in investor sentiment will have some impact on asset values and pricing, the most recent data indicate that demand for this property type remains robust. The UK market experienced record high take-up during the first half of the year according to Savills which noted that the level was 90% above the long-term average. This has occurred despite an economy that is weakening which is offset by a lack of supply and a need for companies to stockpile inventory due to concerns about supply chain challenges. Demand for warehouse space is also strong in Asia and cap rates in this market remain below 3% in key markets. Based on the latest data from the companies and public and private market transactions, we can conclude that public market share prices are in oversold territory.

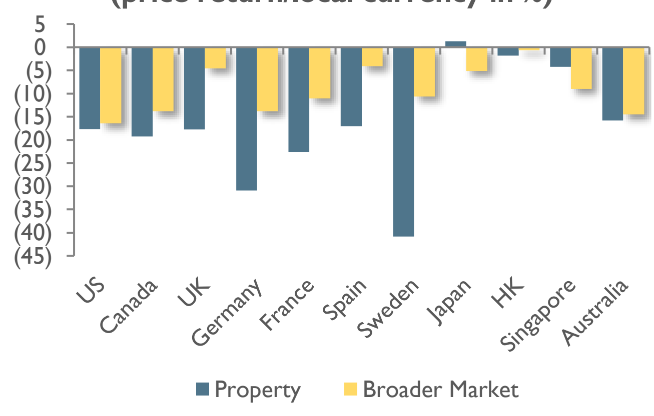
Europe

The Ukraine war continues to drag on without any indication of ending in the near term which is affecting fuel and food costs and availability as well as generally dampening consumer sentiment and economic growth. Just after the end of the quarter, the UK's Prime Minister resigned, adding another level of uncertainty to the mix for investors. Despite efforts by the UK and EU Central Banks to stem the rise in inflation through raising rates, the currencies continue to weaken, and the Euro is at parity with the USD, a 20-year low. The Nordic region, and Sweden in particular, has been most negatively affected by the potential for a Russian incursion into the region, rising interest rates and a "bubbly" housing market – expensive and highly leveraged.

The dramatic change in the interest rate environment in Europe has undoubtedly affected investor sentiment regarding the property sector as real estate debt markets are now this year's worst performing asset class with prime rates hitting 4.6% as compared with 0.4% only a year ago. High grade bonds are trading at junk levels for unsecured senior debt, but secured lending rates (covered bonds) remain accessible at 2-3% interest rates. The European property companies are reporting much tighter financing conditions, and this will clearly reduce their development activity although when compared to 2007, before the GFC, companies are far less leveraged with longer term, lower cost debt. Current leverage in the UK is roughly 30% LTV and were 60% or more pre-GFC. As the chart below clearly shows, the European property sector has been the hardest hit.

While the fear of rampant and uncontrollable inflation dominates the headlines and in the case of Europe has a clearly definable source, the Ukraine war, another potential source of inflation – labor costs – appears to be less of an issue than in the US. As reported by global research firm Gavekal, the recent wage growth includes a one-time bonus to offset the impact of Covid for households while the pace of standard wage growth is much more stable – and benign by comparison. Unlike the US, unemployment in the Eurozone is much higher at 7% and in the case of Spain, 13%. This may explain that while long-term interest rates are up substantially from last year, they may be nearing an upper limit.

2Q22 Performance
Property Sector vs. Broader Equity Market[1]
(price return/local currency in %)



Data from Bloomberg as of 6/30/2022.

Outlook/Portfolio Positioning

With more US Fed tightening on the horizon near-term, Ukraine and Russia still battling, and the potential for more lockdowns in China due to rising Omicron cases, the case for an improvement in the global economy becomes more challenging. The critical issue will be whether the efforts to stem the rise in inflation will result in a more seriously negative outcome than intended. For the property sector, the near-term pain should result in building a long-term potential for growth in value as the supply of most property types is lower than historical norms and trending even lower. As we have experienced in the past, increased inflation is positive for the sector, especially in light of the supply trends. At the very least, we expect some regression to the mean for discounts to NAV which suggests a 20% return from current levels.

JLP Global Investment Team, June 2022.

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[1]**Property Sector includes:** US: RMZ Index, Canada: ELCA Index, UK: ELUK Index, Germany: EPGR Index, France: EPFR Index, Spain: EPSP Index, Sweden: ELSD Index, Japan: ELJP Index, HK: ELHK Index, Singapore: ELSI Index, and Australia: ELAU Index.

Broader Equity Market includes: US: SPX Index, Canada: SPTSX Index, UK: UKX Index, Germany: DAXK Index, France: CAC Index, Spain: IBEX Index, Sweden: OMX Index, Japan: NKY Index, HK: HSI Index, Singapore: FSSTI Index, and Australia: RDAU Index.