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Asia Pacific Real Estate Market Outlook

Q3 2019

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Executive summary

- Trade-related concerns continued to weigh on growth in Asia during 2Q19 and central banks in the region have all stepped up to the plate to support growth by cutting interest rates during the quarter. While we expect the synchronized economic slowdown to continue in the near term, we think there is enough room for counter-cyclical stimulus to be introduced to avoid a significant contraction.
- Notwithstanding the macro uncertainties, demand for real estate space in the Asia Pacific region trended broadly in line with our expectation in 2Q19. Technology companies, co-working operators and financial services providers continued to underpin demand for office space during the quarter. This translated into positive net absorption of office space in Japan, Hong Kong, Singapore and Australia, which in turn raised average rents by 3%y-y in 2Q19.
- Total real estate transactions across Asia Pacific in year through 1Q19 fell by more than 10%y-y but were largely off a higher base in 2018. Investors' demand for real estate opportunities in the region though remains robust, as evident by the tight cap rates that assets are still transacting at (with possibly the exception of retail). We expect the new monetary easing cycle as well as rich equity market valuation (relative to earnings outlook) to continue to support investors' demand for real estate opportunities in Asia Pacific.
- Assets backed by long term structural growth drivers – such as secondary office, logistics, multi-family and residential products (such as nursing homes and student accommodation) – remain our strongest conviction ideas in the region.

Economic outlook

- Global economic growth continues to slow in the second quarter, with all signs pointing towards growth having peaked for this cycle. Market expectations are for growth to remain positive still, with no signs of technical recession except is 1-2 economies. A positive note, major economies like China, Japan and Australia have all indicated their willingness to provide stimulus in the event of lackluster growth. We maintain our prior expectation for growth to slow over the next two-three years.
- Broadly, economic momentum has stabilized, and financial conditions have eased over the second quarter as global equity prices continue its positive trend starting from end of 2018. Fears of an escalating global economic slowdown have led several central banks to suggest that rate rises are on hold for now, with many contemplating a rate cut instead.
- In China, GDP growth came in at 6.2%, lower than the 6.4% in 1Q2019. The slowdown was prompted by the effects of the trade war with the US as outbound exports showed a markedly slowdown. However, the economy is propped up by the increased in domestic consumption. All these factors were in line with expectations. Even as active bilateral talks suggest there is progress towards a final agreement, the strategic stance of both government points towards an ensuing long drawn battle between the United States and China. The Chinese business cycle after the global financial crisis has had a very distinct pattern. In response to deteriorating economic conditions, the authorities aggressively loosen monetary and fiscal policy until growth accelerates. The economy then inevitably overheats forcing the authorities to tighten policy to rein in credit growth. Then, when growth overshoots on the downside, the stimulus cycle kicks in again. The past 6-12 months have followed this same playbook but with a few twists. Fiscal policy has eased but, instead of focusing on boosting fixed-asset investment, the emphasis has been on corporate, individual and indirect tax cuts. Monetary policy has also loosened, but the authorities have avoided relaxing regulatory constraints on the shadow banking sector, so as to avoid generating more severe financial imbalances.
- Japan economy is deemed to be going from "weakening" to "worsening" in 2Q2019. Its close connection to the global production and trade cycles resulted in its struggle over recent quarters. The anticipated rebound in the external backdrop has not (yet) arrived to provide any support, and the domestic economy will have to contend with a consumption tax hike in October 2019. We have revised down our expectations for economic growth in 2019, reflecting continued weak trends in both industrial production and retail sales growth.

Real estate occupier trends

- No major change in trends this second quarter of 2019 as there is positive occupational take-up of real estate space region wide. Office occupier demand stems from technology, co-working, finance, and service sectors. Positive net absorption is seen in the mature economies of Japan, Hong Kong, Singapore and

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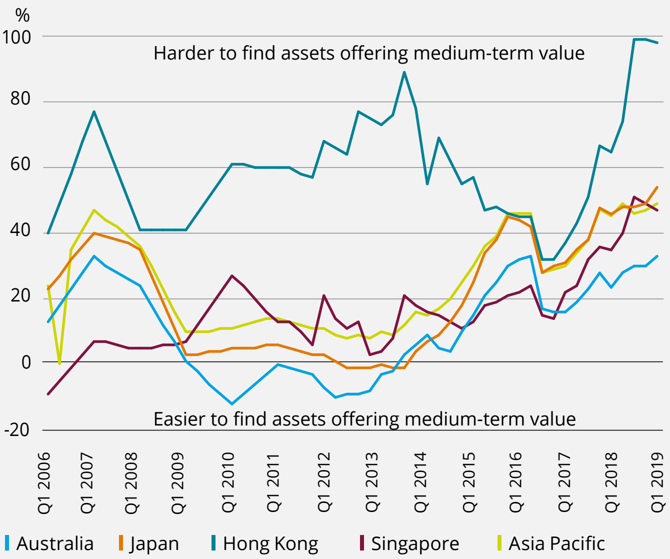
Australia. Despite healthy supply levels, stronger end user demand resulted in rental growth of nearly 3% per annum.

- Asia's logistics sector continues to grow from strength to strength. Occupier demand is strong across most of Asia (except China) as vacancy rates continue to inch downwards. Market trends continue its path as source of demand is apparent from third-party logistics, e-commerce retailers and manufacturers. There are increased concerns around global trade, this did not deter net positive absorption in the first half of 2019, as there is an undersupply. New modern logistics space is finding ready occupiers when it hits the market, although consistent new supply is guiding market rental growth to a healthy 2.8% y-y growth in 2Q2019, an increase over the 2.0% y-y in 1Q2019.
- The outlook for retail occupier demand remains downcast. Landlords and tenants are still in the midst of reinventing themselves, in the face of competition from e-commerce. Rental growth was slightly negative over the past 12 months. Landlords are continually seeking experience based retail as a leasing theme, although this is simply having a higher proportion of F&B tenants in Asia. Effective rents are thus negatively impacted as these tenants are not known for paying high rent levels. By contrast, luxury retailers and other tenants responsible for high rents are focused on optimizing their current store footage and are not expanding. Key locations with high footfall have seen stable rents, while secondary locations are struggling.

Chart 1: ASI long-term leading indicator – market price versus long-term worth



Source: Aberdeen Standard Investments, July 2019.

Investment trends

- The headwinds and tailwinds are matching up in strength. On one side, the governments are continually committing to supporting growth and providing stimulus, when the economic growth disappoints. Yet, the trade war is shaping up to become a long drawn battle between the two largest economic powers. Investors have since adopted a wait-and-see attitude, as a lack of market direction is prompting unease in investors' actions. Overall, the total real estate transactions over the rolling 4 quarters up to 1Q2019 has dropped by 10-15%, but still represents an 15-20% premium to the long term average transaction volume. The falloff in volume is largely attributable to the all-time 2018 figures. Coming off a high base, market is already expecting deal activity to moderate in the major mature Asian markets in 2019. year-on-year, and represents an all-time high since the global financial crisis. Coming off a high base, we expect deal activity to moderate in the major mature Asian markets in 2019.
- Much slower growth in investment turnover at higher prices serves as an indication of softer investment appetite. While capital values for core assets continued to appreciate in the office and logistics sector, market expectations are for capital value appreciation to slow to 2-4% in 2019 (from 6.0% in 2018). As of 2Q2019, capital value growth stands at 1.1% year to date.
- Compared to its history, current market pricing suggests that core assets are expensive. The market has been in this position for several years without resulting in a correction. Low prime yields are prompting investors to consider non-prime assets and secondary locations, which offer higher entry yields. Also, there is a growing appetite for higher risk investment strategies in the value-add/development space.

Performance and risk outlook

- According to our long-term leading indicator, prices are higher relative to their fundamental value or long-term worth, making it hard to find value in the market at present (chart 1). There will be opportunities where we believe assets are mispriced, but these opportunities are becoming more elusive in the current market environment.
- Given the tighter entry point and moderated rental growth forecast, our five-year total return forecast for property returns in aggregate is below the long-term average. Prime yields are likely to expand slightly over the same five-year period, despite the presence of near-term downward momentum in yields for the next 12 months. Returns in the future will be driven by income and, as such, a key focus will be the appropriate management of income risk at the asset and portfolio level.
- The focus on income is reflected in our projected sub-sector returns, which have become more divergent in the short term. Industrials and income-focused sectors, including the residential and secondary office sector, are expected to be the strongest performing areas of the market.
- The long-term leading indicator continues to suggest that portfolios should be positioned more defensively. We advocate a low-risk profile for portfolios in the current environment given the risk of capital decline, which becomes higher the longer prices remain above their long-term equilibrium level.

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Investment themes

- Investors in the mature markets have long identified the need to diversify investment allocation to APAC, as it continues to mature. The trend of positive net capital inflow will continue for the foreseeable future. The current and ongoing low interest rate environment globally will continue to prompt strong demand of income-producing assets in the mature markets of Asia-Pacific.
- That said, it is getting more challenging for investors to find assets at the right prices and greater interest is being shown in income-producing secondary assets, or higher risk investment strategies. Against a background of a turn in the interest rate cycle and slowing economic growth, we believe some core property sectors are vulnerable to a correction over the medium term, where prices appear stretched relative to fundamentals.
- However, we do see opportunities across the region in the right spectrum of major asset classes. We believe that assets backed by structural growth drivers – such as secondary office, logistics, multi-family, and other living sectors, such as nursing homes and student accommodation – may present good value. While it might be a concern previous that investors are trying to enter what are relatively smaller markets, the ability to stay nimble and fluid on their investments is a plus point now.

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