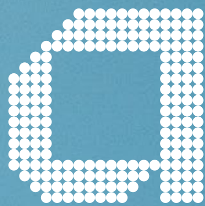

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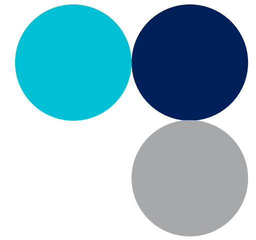
Global Real Estate Market Outlook

Q2 2023

abrdn.com

Executive summary



"Heightened market volatility, as a result of banking sector problems, has knocked real estate investors' confidence recently. Investment activity is likely to remain relatively subdued over the next few months. However, there is long-term capital on the sidelines that is looking to invest when the market stabilises."

The abrdn Research Institute (aRI) expects a recession is needed to correct some of the imbalances in the global economy that have created the current levels of inflation. aRI anticipates that the strength of the current economic data is pushing the necessary recession further on into 2023, and that the expected cutting cycle is not priced into markets as yet.

Further, aRI thinks that central banks have more to do as sufficient conditions for the necessary recession are not yet in place. The team view is that although inflation is falling sharply almost everywhere, with a few exceptions due to energy base effects, it will be recession and the rise in unemployment that ultimately bring down inflation.

The team forecasts a range of economic scenarios that could play out in the future, with the most likely upside scenario being "the Federal Reserve (Fed) walks the tightrope". This indicates that there is still a path to a soft landing, along with the other likely scenarios. The aRI view is that the risk distribution is skewed towards weaker growth, but that inflation will be higher than the consensus expects.

The UK is likely to suffer a recession, given aRI is predicting one for the US later this year. Greater monetary tightening and weaker economic conditions remain the backdrop for our real estate forecasts. We expect prices to fall further to a new equilibrium level in phase one of the real estate cycle, before income and tenant resilience become the focus in phase two as recession hits demand.

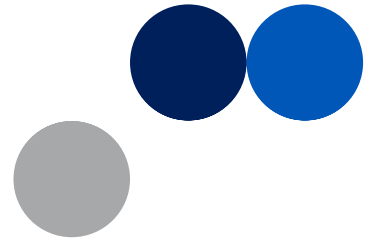
We then expect attractively priced opportunities to materialise as the market recovers further on into 2023. A significant proportion of the anticipated value correction in this downturn has now passed, although some modest declines in prices are still expected, particularly for the sectors that have underlying demand concerns. The recent banking sector problems are expected to have a modest impact on our real estate projections, as the availability of credit contracts further. However, if there is a crisis of confidence and the problems morph into a more serious situation, this could have more of a negative impact on our overall view.

We expect poorer-quality assets and those that are consumer-facing to be marked down more significantly, as the economy weakens and as consumer spending falls more rapidly. We expect attractively priced opportunities to materialise, as the market recovers later in 2023/2024 and as central banks start to move into the next interest-rate-cutting cycle.

In terms of sector trends, we remain steadfast regarding our sector preferences. The drivers of these sector convictions are structural rather than cyclical: demographics, urbanisation, technology, and sustainability. Given these structural factors, our preference remains for the industrial and residential sectors, along with high-quality sustainable offices. We also prefer parts of the 'other' sector, such as healthcare, life sciences, data centres, and student accommodation.

We continue to take a cautious stance towards parts of the retail sector that cater to discretionary purchases, and we expect the decline in prices for poor-quality offices to be more significant than for other parts of the market. We anticipate that the polarisation of assets that is playing out at present, driven by green premiums for sustainable assets and brown discounts for polluting assets, to become more pronounced. Recent evidence suggests that the polarisation is beginning to accelerate as the market focuses more on 'future-fit' assets. We expect the costs associated with decarbonisation to become even more onerous, given strengthening regulatory pressures.

Global real estate overview



Although investor activity is being affected by poor sentiment, rising costs, weaker economic growth and differing expectations between buyers and sellers, there is capital on the sidelines that is looking to take advantage of cheaper pricing when the market stabilises. However, the recent banking sector turmoil has exacerbated investors' caution towards transactions. Globally, the various country indices are reporting that capital values have reduced or are stabilising, as a direct result of rising interest rates.

The listed real-estate sector remains a good indicator of future direct-market performance. The listed sector continues to price in modest declines for the direct market. The sector has fallen by close to 4% since the start of the year. The best-performing sectors so far this year have been US self-storage, Parisian offices and Australian self-storage. US central business district offices, US suburban offices and US lab offices have been the worst-performing sectors since the start of the year.

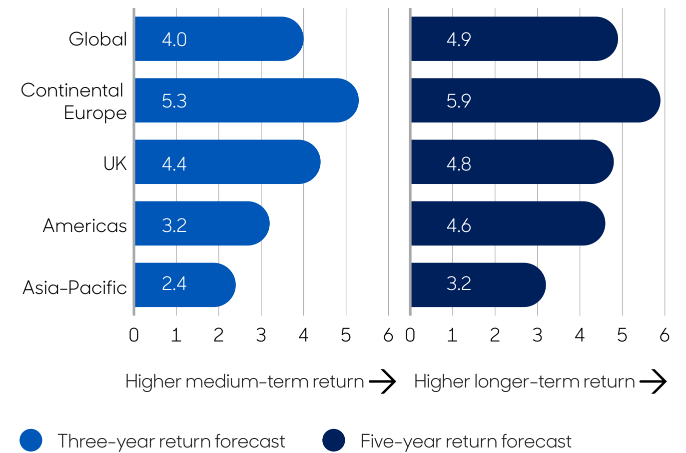
Debt is available in the lending market, although only to high-quality borrowers and if there is a long-term established relationship. Lenders remain selective in what they finance and continue to gravitate towards sectors with strong fundamentals, such as industrials, residential and high-quality offices.

Our preferred sectors remain unchanged. We favour industrials and residential because of their attractive current and expected fundamentals, and because of the tailwinds provided by long-term structural factors. As a result of their favourable liquidity, the expected decline in prices for industrials and residential was likely to occur more rapidly than in other sectors. This forecast has been borne out. However, we expect future price declines in the less-attractive sectors – such as parts of the retail market and the poorer-quality segments of the office sector – to be steeper as more transactions take place. We also favour alternative sectors that are linked to the ageing demographic, including retirement homes and aged-care facilities.

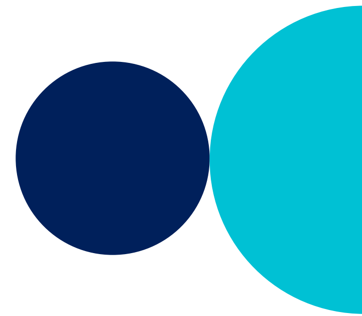
Our global forecasts have improved this quarter, as a significant proportion of the capital decline we were expecting has now passed. Across regions, continental Europe has the strongest expected returns over the next three years, bolstered by indexation in rents and low supply pipelines. Asia-Pacific has the weakest expected returns, as a result of lower yields, poorer capital growth, and higher supply than the other regions.

Table 1: abrdn's three- and five-year total return forecasts

(% p.a.)



Global real estate overview



"The global performance signals that we monitor have improved further this quarter. They indicate that the worst of the real estate capital value correction may have passed."

We aim to monitor market behaviour via our global performance signals. These help us understand the drivers of prevailing market prices (Table 2). The large number of red (unsupportive) indicators reported in the first quarter has reduced. The number of yellow (neutral) indicators has also increased. Both of these improvements point to the market's nadir being close. In turn, this suggests that a range of better-priced market opportunities are likely to be on the horizon.

Table 2: abrdn's global performance signals

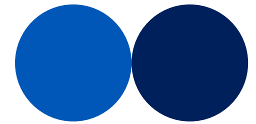
	Performance signals	UK	Europe	North America	APAC	Global
Macro	Economic fundamentals	↘	→	↘	↘	↘
	Monetary policy	→	→	→	↘	→
	Margin over bonds	↘	→	→	↘	↘
Real estate	Supply	→	↗	↘	↗	↗
	Transaction activity	→	→	→	↘	→
	Flows of capital	↘	↗	→	→	→
	Lending	→	→	↘	↘	↘
	360° view	→	→	→	↘	→

Source: MSCINPD; Thomson Reuters Elkon; CBRE, Investment Association abrdn 360° view encompasses direct, indirect lending and multi-manager views and market signals, Q2 2023.

Performance signal
- ● Supportive (green)
- ● Neutral (yellow)
- ● Unsupportive (red)

Trend
- ↗ Upward trend
- → Stable
- ↘ Downward trend

Regional outlooks



"The sectors with strong underlying structural growth drivers will be best placed to outperform on a long-term horizon. These are technological, demographic, and environmental-related factors."

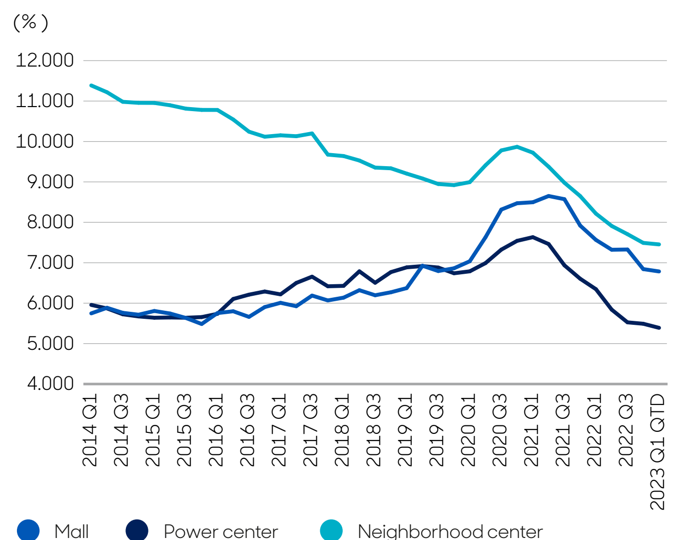
North America

The industrial sector is expected to perform relatively well in 2023. Market rental growth forecasts are favourable along the I-85 corridor in Atlanta and the East Coast. Gulf ports, such as Northern New Jersey and Houston, have also taken a chunk of shipping traffic from the West Coast during the pandemic. Shippers have realised that the Gulf ports are a viable option to diversify their supply chain network. There have been concerns that negotiations with the International Longshore and Warehouse Union (ILWU) about the West-Coast ports would evolve into a strike. Around 40% of shippers on the December 2022 CNBC supply chain survey indicated that they have diverted trade from West-Coast ports to either the Gulf or East-Coast ports. The longer these talks drag on, the greater the risk of a permanent loss of traffic into these ports. This would also lead to lower industrial demand in the port markets.

While Class A offices are rather resilient, they aren't immune to the sublease wave hitting the market. As the technology sector continues to weaken, and this translates into prolonged sublease activities, we could see further rental discounts from landlords in order to compete with sublease prices. There have been more conversions of offices to residential in markets with apartment rental premiums. We expect this to be a growing trend, although only a limited stock of offices have been identified as economically viable for conversion to multifamily.

Multifamily is still one of the more preferred sectors. Long-term drivers, such as a shortage of housing and unaffordability, continue to persist. However, some things have changed. The Sun Belt market no longer dominates the rental leader board and rental growth will continue to moderate as a substantial amount of supply comes on the market this quarter, especially in Phoenix. However, only 1.9% of new supply was added to the overall inventory in the Midwest, compared with an average of 2.3% at the national level. Therefore, the Midwest markets saw a better balance between supply and demand than the rest of the market. The cost of living in the Midwest has barely budged and we think that the region will outperform in terms of rental growth. But apartment rental growth will be weighed down by the overbuilt Sun Belt and expensive technology markets.

Chart 1: Availability rates are falling for US retail



Source: CoStar, abrdn, March 2023.

Our outlook has become a bit more positive for the retail sector. Further bifurcation of retail is expected, with older malls and super regionals potentially underperforming further. But open-air retail – especially grocery-anchored lifestyle centres and single-tenant retail spaces – should perform quite well, as availability diminishes for these assets.

There could also be some opportunities in large loans, where the absence of banks and a slower commercial mortgage-backed securities market hit most acutely; and in transitional loans, where the pullback from debt funds is creating a vacuum.

For further information about our regional outlooks, please use the links below:

- aRI global economic outlook – Q2 2023
- abrdn UK real estate outlook – Q2 2023
- abrdn European real estate outlook – Q2 2023
- abrdn Asia-Pacific real estate outlook – Q2 2023

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