PGIM REAL ESTATE

3Q23

Global Real Estate Securities Market Review

					Annualized			
GRES Strategy Performance (%)	Inception Date	Third Quarter	Year-to-Date	1 Year	3 Year	5 Year	10 Year	Since Inception
Global Real Estate Strategy (gross)	1/31/2007	-5.37	-1.72	5.60	0.96	1.55	3.90	2.82
Global Real Estate Strategy (net)		-5.60	-2.40	4.62	0.03	0.61	2.93	1.89
FTSE EPRA/NAREIT Developed Index		-5.84	-4.88	1.64	0.59	-1.24	2.04	0.83
Variance (gross – benchmark)		**0.47**	**3.16**	**3.96**	**0.37**	**2.79**	**1.86**	**1.99**
U.S. Real Estate Strategy (gross)	12/21/2010	-5.37	2.97	8.54	7.33	6.53	8.28	8.86
U.S. Real Estate Strategy (net)		-5.61	2.20	7.45	6.26	5.46	7.09	7.61
FTSE NAREIT Equity REIT Index		-7.13	-2.14	2.99	5.76	2.77	5.96	7.10
Variance (gross – benchmark)		**1.76**	**5.11**	**5.55**	**1.57**	**3.76**	**2.32**	**1.76**
Select Real Estate Strategy (gross)	8/1/2014	-5.03	-0.84	5.63	1.55	5.37	--	5.93
Select Real Estate Strategy (net)		-5.27	-1.59	4.57	0.52	4.29	--	4.82
FTSE EPRA/NAREIT Developed Index		-5.84	-4.88	1.64	0.59	-1.24	--	1.09
Variance (gross – benchmark)		**0.81**	**4.04**	**3.99**	**0.96**	**6.61**	--	**4.84**
Real Estate Income Strategy (gross)	9/29/2014	-4.65	-2.64	5.58	4.27	2.87	--	3.47
Real Estate Income Strategy (net)		-4.91	-3.44	4.43	3.13	1.74	--	2.35
Blended Benchmark[1]		-6.25	-2.31	2.36	-0.57	-0.84	--	1.09
Variance (gross – benchmark)		**1.60**	**-0.33**	**3.22**	**4.84**	**3.71**	--	**2.38**

Source: PGIM Real Estate, Bloomberg. Performance as of September 30, 2023. Net performance shown is based on the mutual fund fee schedule. **Past performance is not a guarantee or a reliable indicator of future results.**

United States[2]

Market Review

The U.S. real estate investment trust (REIT) market dropped 7.5%, essentially giving back all of its year-to-date returns. On a relative basis, REITs have lagged the tech-heavy Standard and Poor's 500 (S&P 500), which declined 3.4% in the quarter but still boasts a 13% gain overall for 2023. U.S. REIT sentiment was hit with an incremental sentiment headwind from a dramatic rise in rates, with the yield on the 10-year Treasury note jumping 70 basis points during the quarter — from 3.8–4.5%. Although that recent move in rates has weighed on sentiment and created more volatility in equities, we continue to believe we are nearing the end of the current rate cycle and the recent headwind, with a shift into a tailwind as we move into the end of 2023 and move throughout 2024. The U.S. REIT market has a demonstrated record of outperformance after the conclusions of past tightening cycles. Moreover, given today's low supply risk and strong secular demand trends, fundamentals are likely to remain resilient even if economic growth softens.

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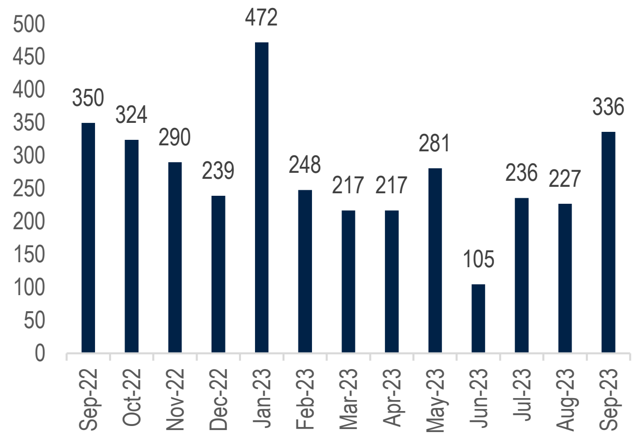
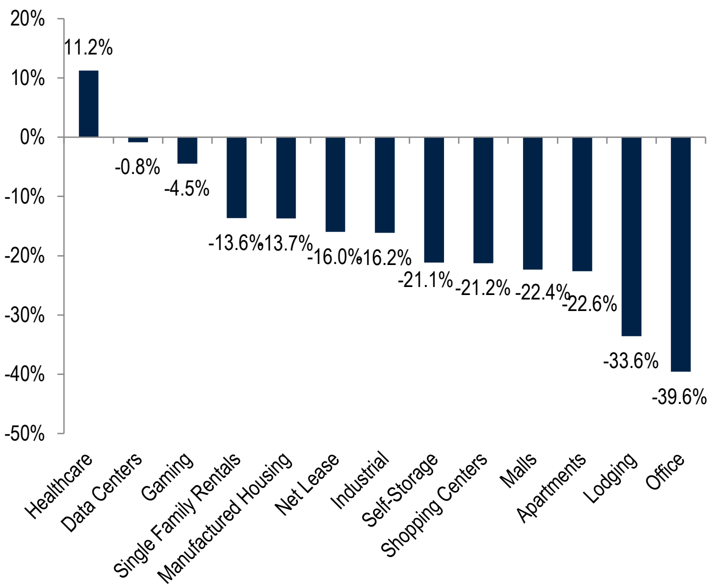
The purgatory state of the U.S. economy has remained relatively constant during the past several months. The heavy lifting involved in reducing the risk of a severe inflation spike has been achieved, but persistently strong consumers have largely shrugged off the dramatic increase in rates. Meanwhile, the labor picture remains strong, with unemployment staying below 4% (3.8% currently) and roughly 200,000 new jobs being added each month (336,000 added in September). Leading economic indicators suggest some slowdown in consumer spending is likely, but overall, the path toward a soft landing remains a possibility. Either way, it's likely the Fed has nearly completed its current rate-hiking phase and will take a long pause to assess the impact on inflation and growth. That pause should bode well for REITs' relative performance going forward. From a historical perspective, the REIT market has outperformed the S&P 500 after the conclusions of the past three Fed-tightening cycles for the proceeding one-year periods. The underlying makeup of the U.S. REIT market has also shifted dramatically versus prior cycles, with more-defensive sectors with secular demand support such as data centers, healthcare and industrial having grown dramatically in size. Meanwhile, challenged sectors with more sensitivity to economic cycles — such as office, lodging and malls — have witnessed a considerable drop in market cap within the REIT benchmarks.

Monthly Gains (000) for Office-Using and Non-Office-Using Jobs[3]



With regard to the quarter's results, the best-performing sectors were office and lodging. The office sector has underperformed the REIT sector consistently for the past three years. After a very weak start to 2023, the sector rallied back significantly from its depressed levels early in the third quarter. We have been significantly underweight office for the past several years but did tactically add to the office sector during the second quarter because some of the higher-quality names became too cheap to ignore. We remain cautious on the sector longer term given a very challenged demand outlook. Despite a relatively disappointing second quarter 2023 earnings season for lodging REITs, the group staged a strong relative comeback in September, as the outlook for consumer and business travel looked to be more resilient than feared.

U.S.-Sector Price/Net Asset Value[4]



The worst-performing sectors during the quarter were storage and net lease. The self-storage sector suffered a challenging second quarter 2023 reporting season when several REITs reduced their guidance for 2023 given weaker-than-expected demand. The dramatic slowdown in existing home sales appears to finally be weighing on storage demand, and even though occupancy and rents remain at very healthy levels, the slowdown in transaction activity is likely to further weigh on rents as we head into 2024, so we remain cautious. The net lease sector is most sensitive to movements in rates given a longer lease duration and growth model dependent on low cost of capital.

Market Outlook

Recent volatility in interest rates has created a sentiment headwind for the U.S. REIT market. However, given the group's dramatic underperformance since the beginning of 2022 and its discounted valuation, we believe the market has already priced in that incremental risk. Moreover, a more resilient labor market, combined with softening inflation data, bodes well for a near-term end of the Fed's current rate-tightening cycle and improved REIT sentiment. Outside the office sector, fundamentals remain steady, with roughly 4% funds-from-operations-per-share growth expected in 2023, followed by 7% in 2024. Barring a major economic contraction, we expect REIT fundamentals to remain steady for most property types given long lease durations, low supply risk and defensive- and secular-based demand.

The current spread between REIT implied valuations and private real estate values is at a historically wide spread, at roughly 24% on an equally weighted basis. As rates stabilize, that valuation discrepancy is likely to lead to increased M&A opportunities for private-equity players that are looking to deploy capital toward the discounted REIT sector. We also expect large institutional investors to rotate their real estate allocations from private to public to take advantage of this arbitrage opportunity. The liquidity benefit of the publicly traded REIT structure has become abundantly clear in recent months and will likely have long-term implications for real estate allocations.

Public REIT-to-REIT M&A has also increased in recent months, with Regency Centers' buying smaller-cap peer Urstadt Biddle Properties and Kimco acquiring RPT properties. The current environment is rewarding REITs with better balance sheets and superior platforms with premium valuation. As such, many REITs are taking advantage of the valuation spread to consolidate attractive, smaller-cap peers. We've even witnessed some hostile REIT-to-REIT M&A activity in the past 12 months. Without a dramatic change in the current macro backdrop, we see that trend as likely to continue. We also witnessed a REIT privatization, with small-cap Hersha Hospitality announcing a take-private transaction by KSL Homes at a 55% premium to its previous close. In our opinion, REIT privatization is likely limited to smaller transactions until we see an improvement in the debt markets, but plenty of opportunity exists today.

We continue to favor a barbell approach to our sector allocation, minimizing unintended factor exposure. We have added to our data center overweight given attractive valuation and defensive net-operating-income (NOI) growth. Despite data centers' outperformance year to date, the sector remains discounted and represents the only sector in REITs to directly benefit from the artificial-intelligence-related demand. In addition, we remain positive on sectors with embedded occupancy upside and limited economic sensitivity, such as healthcare and cold storage. Both sectors were negatively affected by labor cost pressures in 2022, but we expect such pressures to moderate in 2023. In addition, occupancy overall remains roughly 400–600 basis points below pre-COVID levels, which should allow for significant top-line growth as trends continue to normalize.

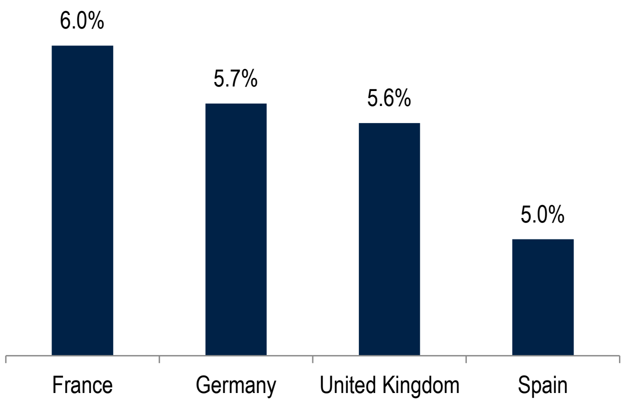
A recent decline in retail at both shopping centers and malls has increased the attractiveness of the sector given decent growth prospects for 2024 and beyond. In retail, we've become slightly more constructive on the mall sector relative to shopping centers' given valuation. We remain cautious on office despite discounted valuations because we view the sector as only in the early stages of a multiyear secular headwind. We reduced our weighting to the office group after the group's recent outperformance and numerous secular headwinds in coming years. We also reduced our industrial and storage weights because we've become more cautious about the sector's ability to sustain above-average growth in 2024.

Europe[2]

Market Review

The European REIT market saw a positive return of 1.4% (USD gross total return). Europe experienced a rebound in that third quarter despite the generally increasing global bond yield environment, led by sectors and countries that had largely underperformed in the previous 12-month period. For the year-to-date period until the end of September, Europe returned minus 5.0%.

Europe-Sector Implied Cap Rates[5]



The rebound in the third quarter in Europe was fairly limited, however, with the only countries showing positive returns in the third quarter being Germany, Switzerland and Sweden. After underperforming significantly in 2022 and the first quarter of 2023, Germany continued its bounce-back with a total return of 19.3% in the third quarter, thanks to its large multifamily residential sector. Despite ongoing concerns surrounding overextended balance sheets and bond refinancings in the multifamily sector, investors covered shorts and returned to the stocks because they considered them oversold after an extended period of major underperformance. The only other countries with positive returns in the third quarter were Switzerland, at 3.1%) and Sweden, at 2.6%). Both the UK, at minus 2.9%, and France, at minus 3.4%, posted negative total returns in the quarter, as stocks there suffered in an environment of climbing bond rates and expectations for extended high interest rates weighing on the economic outlook

Market Outlook

Inflation figures have been on the decline in Europe since November 2022, and that continued in the third quarter. However, the level of inflation still remains high throughout the region relative to other global regions. That high level especially true in the UK and Sweden despite gradually declining figures for both headline and core. Inflation levels in the UK remain materially higher than in Continental Europe and much higher than in the United States. Government bond yields at both the short and long ends of the curve have been climbing throughout the region and remain elevated. In spite of that, the Bank of England did hold rates unchanged in its September decision, whereas the European Central Bank tightened but indicated an intention to pause.

Companies with weak balance sheets remain on near-record discounts to net and gross asset values, as they are still exposed to refinancing risk and falling cash flows. Cap rates moved up quickly in the second half of 2022 in response to major upward moves in bond yields in that year, and they moved out further in the first nine months of this year; but share prices are still implying further moves in private market cap rates. Our focus remains on companies better equipped to withstand the risks of further corrections because macroeconomic and geopolitical risks remain prevalent in the region. However, we have added to selected names in our portfolio to gradually moderate our defensive positioning as we have neared or potentially reached the peak of the interest rate cycle in most of Europe.

Asia Pacific[2]

Market Review

The Asian real estate equity market retreated by minus 4.2% in September. Hong Kong led the decline, at minus 12.5%, followed by Australia at minus 9.3% and Singapore at minus 4.6%. Japan was the exception, at +1.7%.

In Australia, the central bank paused the cash rate hike in the September quarter — and also in October — after a cooling of inflation and softer household spending, which suggests that the central bank could be approaching the end of its tightening cycle. However, higher bond yields dragged the rate-sensitive Australian REIT sector's performance. Managements conducted nondeal roadshows post-results in the month. Retail REIT managements are confident with leasing demand despite a slowing retail sales trend. Office landlords remain cautious about demand outlook. Data center operator management sees strong demand for low-latency location and expects continuous contract wins. Industrial sector managements see rent growth supported by low vacancy.

In Japan, the September quarter was results-reporting time, as the big three developers — Mitsui Fudosan, Mitsubishi Estate and Sumitomo R&D — reported their first-quarter fiscal year 2024 (ended June) earnings. Mitsui Fudosan and Sumitomo R&D's reported operating profits were above consensus, whereas Mitsubishi Estate undershot expectations, primarily due to a significant fall in overseas sales gains. Key takeaways include the fact that Sumitomo R&D had already sold in the first quarter the target number of condominiums it had planned for the full year. For Mitsui Fudosan, leasing got off to a steady start — at 27.2% of the full-year plan — on contributions from 50 Hudson Yards, etc. For the REITs, hotel REITs at 2.5% outperformed the other sectors, thanks to better-than-expected hotel market recovery. Both Japan Hotel REIT and Invincible now forecast their full-year-2023 dividend at about 70–90% of pre-COVID levels, reflecting the ensuing end of COVID-19 impacts. Inbound consumption in July and August recovered to 81% of 2019's pre-COVID levels.

Hang Seng Property Index and Price to Book[6]

Hong Kong's lackluster performance for the came from several fronts. Discretionary-retail landlords were under pressure from a weak renminbi that makes tourist spending lag tourist arrival volume. For office, demand remains weak because China's economic outlook remains uncertain, and the significant office supply is expected to take a long time to be absorbed. For residential developers, high interest rates and a weak economic outlook are hurting buyer sentiment. House prices and transaction volumes are under downward pressure. Amid the higher-for-longer interest rate environment, large-cap developers such as Sun Hung Kai Properties implied that it would revert to a 40–50% payout ratio in fiscal year 2024, abandoning its current dividend policy of keeping absolute distribution per unit (DPU).

In Singapore, the quarter was the reporting season of some large-cap real estate players, such as CapitaLand Integrated Commercial Trust (CICT) and CapitaLand Investment (CLI). CICT's NOI in the first half of 2023 rose by 10% year over year (yoy). DPU increased 1.5% yoy despite a 48% rise in interest cost. Going forward, CICT management continues to see a strong reversion outlook in office and retail, with signs of stabilizing interest costs. On the other hand, CLI posted a minus 19% decline in headline profit due to a slowdown in capital market activity. Fees for funds under management declined by minus 13% yoy, aggravated by a minus 65% yoy decline in event-driven fees.

Market Outlook

Since 2022, REITs faced a perfect storm composed of rising inflation, sustained rate hikes, the Ukraine–Russia war and COVID-19-pandemic-disrupted supply chains that affected millions of people. The pandemic ushered in a period of unprecedented global monetary easing and stimulus. As a consequence, the world is now witnessing sustained and heightened inflation. Equity and bond market volatility is the norm as markets alternate between greater rate hike expectations induced by strong inflation data and slower hikes on indications of weaker economic data.

The consequence of that volatility presents an interesting dilemma wherein bad macroeconomic news could benefit real estate equities as long as interest rate hikes slow while NOI is maintained. In Asia Pacific, attention would center on how the Fed, the Bank of Japan (BOJ) and the Chinese government move in the coming months. With increasing evidence of inflation slowing at the margin — but without a recession looming — the Fed has sounded less hawkish in recent times. The market expects at most a further hike in 2023 followed by rate cuts in 2024. With 2024 an election year, the Fed would likely be pragmatic on rates, especially if inflation does moderate more. In China, the central government has announced relaxation measures in the property sector in an effort to spur a market rebound. Without a necessary increase in consumer confidence, we think any economic recovery could be short-lived. The BOJ adjusted monetary policy at its most recent meeting as a result of stronger wage and inflation data. However, we doubt that the BOJ would tighten more unless inflation expectations surprise significantly on the upside. The BOJ still expects a new, core consumer price index, excluding fresh food and energy, to come in below 2% in 2024.

We are positive on Australian data centers and self-storage. Artificial intelligence, cloud-computing-driven demand and increasing self-storage penetration trends provide structural tailwinds for the two sectors. In Hong Kong, which is saddled by a slow economic outlook, we are positioned in the retail sector because tourist arrival recovery is the most visible upward trend in the market. We are slightly overweight the Japanese developers and prefer names that exhibit strong shareholder returns with greater reopening exposure. We are slightly underweight the JREITs but maintain sizable overweight in hospitality names that benefit from the reopening of tourism. We are also overweight logistic JREITs given their strong fundamentals leading to DPU growth. In Singapore, we are overweight fund manager and landlord plays. For SREITs, we like hospitality and industrial names with solid dividend growth underpinned by strong fundamentals.

In recent weeks, the narrative with regard to potential U.S. recession has notably softened, and instead, a soft-landing narrative seems to be taking root. Although a soft landing would be an unprecedented outcome given the pace and extent of the Fed's hike this time around, the strong jobs market seems to suggest tailwinds are strong for companies to continue hiring. Notwithstanding that, a more hawkish Fed that hikes more to cool core inflationary pressures would be a risk in 2024. Deglobalization and geopolitics such as continuation of the Ukraine–Russia conflict and United States–China relations are other factors that warrant concern. In Asia, managing higher costs of living while ensuring economic growth remains the predominant challenge. The path by which China manages its fiscal and monetary policies to boost economic growth, as well as the country's housing market policies, presents an uncertain economic outlook. For the rest of Asia, economic growth and monetary policy outlook remain largely dependent on Fed policy and global growth. Within our individual sectors, a sharper rise in long-term real interest rates could negatively affect regional REIT valuations. In the event of setbacks on the geopolitical front and the severity of a potential U.S. recession, risk appetite could remain in check heading into the latter half of the year.

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[1] Blended benchmark is 80% FTSE/EPRA NAREIT Developed Index/ 20% BofA Merrill Lynch 7 Const. REIT Preferred Securities Index

[2] Reference to out- and under-performance is within the context of and relative to the specific region's REIT market unless otherwise noted.

[3] Bloomberg. As of September 30, 2023

[4] PGIM Real Estate. As of September 30, 2023

[5] Morgan Stanley, Citi. As of September 30, 2023

[6] Bloomberg. As of September 30, 2023.