PGIM REAL ESTATE

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Strategic Outlook – Getting Comfortable with Uncertainty

This year the global economy has been defined by uncertainty. Volatility and confusion have combined to convulse financial markets on an almost daily basis.

The noise generated from these events has spilled over into real estate and has caused some market participants to pause in an effort to achieve some sort of clarity.

But we are clear about where we see potential value and believe we are in the early stages of a potentially generational investing opportunity in real estate.

Confidence during times like these comes from focusing on facts that have shown to be true. We know that values have reset significantly over the last three years, which is a widespread phenomenon that has appeared across real estate markets globally.

We also know that supply has been constrained, and occupancy rates are high in most property types. Meanwhile, the cost of capital is stabilizing, and debt is plentiful across a diverse array of lenders.

These are all strong factors in why we believe the time is now to invest despite the uncertainty blurring the picture at the macro level. The question remains though of exactly how to navigate the opportunity at a time of such extreme uncertainty.

Hearing the signal through the noise is critical. One clear signal is that capital is being reallocated from the U.S. to Europe and Asia – according to AFIRE's most recent survey, 63% of non-US investors have a negative view of the U.S. despite intending to continue allocating to the market. Investors are rethinking their capital allocations and focusing on their home market. This is particularly pronounced with German investors.

On the other hand, an area where there is a lot of noise is the supply change implications of tariffs. The generally accepted wisdom is that companies are looking to move but the signal we are getting from our tenants is clear: they are more focused on trying to understand where tariff negotiations will settle, rather than changing where their operations take place.

In Mexico, most of our tenants are multinational companies that have set up nearshoring operations to access the US market, and currently none have expressed any interest in leaving the country. Similarly, our conversations with local institutional investors in Mexico suggests no loss of faith in the country's nearshoring trend.

There is also noise about data center development, with some expressing concern that there is an arms race by technology companies to announce ever larger data processing requirements linked to artificial intelligence investment. The reality is that many data center operators are aware that when technology companies announce their data center investments, they overstate their requirements and end up needing less.

In other words, there is a difference between the (very big) numbers announced and what technology companies end up needing, and therefore what ends up getting developed. The restated demand is still much higher than supply, so fundamentals are strong once the headline announcement figures are contextualized.

Another consideration is understanding that now, more than ever, **different geographic regions offer different dynamics**.

The U.S. appears to be moving from exceptionalism to a form of 'new realism'. Lower economic growth and more elevated inflation could indicate lower real estate returns than expected just a few months ago. This reality focuses minds on where resilient opportunity lies. For us, is affordable and senior housing are promising, both of which are underpinned by entrenched demographic and supply/demand factors.

Meanwhile, Europe's new desire for self-reliance creates the prospect of significant state-led investment. While economic growth is still very low, this investment could bolster a market that already benefits from a low cost of capital, low supply, a recovering transaction market, and which has experienced a significant repricing.

Asia is differentiated primarily by having the highest growth potential. Australia offers one of the best risk-adjusted investment opportunities at the moment, with tight occupier markets and the potential for cap rate compression as interest rates come down. Japan's shift from deflation to inflation is creating the race by technology companies to announce ever larger data processing requirements linked to artificial conditions for sustainable long-term growth, including all major property types in Tokyo and Osaka.

Finally, investors should be able to **pinpoint pockets of resilient income growth**. Real estate is recovering but a re-run of the post financial crisis years where ultra-low interest rates lifted all real estate sectors in unison is not likely. Credit represents one of the most significant opportunities. New loan coupons are high, reflecting higher base rates and competitive lending margins. Equally, higher rates can help moderate leverage levels; and elevated buy-in yields, low attachment points and improving credit profiles should support attractive returns.

Within asset classes, not every logistics asset may deliver good performance, but we believe the fundamentals for infill assets are very strong. In housing, focusing on supply constrained sub-markets and on affordability are key.

These themes are underpinned by long term trends but analyzing local dynamics can throw up tactical opportunities too. The upsurge in tourism in Southern Europe and Japan has created a squeeze on hospitality assets. Grocery anchored retail has proven resilient in the US, Europe and Australia. Australia and Japan have an under-supply of appropriate office assets as the appetite for working in-person has bounced back.

Our challenge as real estate investors is to shut out the noise beyond our sector. Ambiguity is uncomfortable, but we saw from the period following the global financial crisis that the most compelling investment opportunities present themselves at the start of a cycle.

The last few months may have slowed the pace, but the recovery appears to already be underway. This is the time for seasoned investors to demonstrate the benefit of their experience and to be selective, not on the sidelines.

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