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Global Real Estate Market Outlook

January 23, 2019—Portfolio managers Rick Romano, Daniel Cooney, and Michael Gallagher of PGIM Real Estate recently shared their quarterly review and outlook of the global real estate market, including recent performance insights, an update on portfolio positioning, and why they believe investors should consider global real estate. Below are the call highlights.

Market Overview

- In the fourth quarter 2018, North America's real estate market declined -6.5%, underperforming the global real estate market's -5.7% drop. North America underperformed Asia (-0.9%) and outperformed Europe (-10.2%). 2018 continued to be a volatile year for the real estate market and equities as a whole, but during the end of the year REITs and real estate securities generally performed better than the broad equity markets.

United States

- U.S. REITs delivered a -4.5% total return in the fourth quarter of 2018. The U.S. REIT market's recent relative strength is consistent with prior periods of broader market volatility. The REIT market's appeal in such volatility is driven by strong dividends yields, stable cash flow, and valuation rooted in commercial real estate.
- Despite growing fears surrounding a slowdown in economic growth, the fundamental backdrop during the quarter remained steady for the U.S. REIT market. The U.S. economy produced average monthly job growth of approximately 250,000 jobs during the fourth quarter, up from the 190,000 monthly average in 3Q18 and representing the strongest quarter in 2018. New real estate supply growth remains well below historical averages of 2% and near historical lows at 1.5% of existing supply.
- The best performing real estate sectors for the quarter were the healthcare and storage sectors. The healthcare sector's defensive attributes - longer-term leases, demographic-based demand trends, and above-average dividend yields - drove that sector's outperformance during the quarter. The storage sector likely benefited from improving market expectations for 2019 with the assumptions that recent supply headwinds in 2018 may be slowing.
- The worst performing sectors for the month were lodging and office. As the most economically sensitive sector among U.S. REITs, lodging's underperformance was not surprising given the increased concerns surrounding global economic growth during the quarter. Office continues to suffer from limited rental growth in several key markets, including New York City.
- The team continues to believe the best opportunities lie with companies that can deliver sector leading cash flow growth at an attractive valuation. It is a stock picker's market and given economic volatility and M&A activity, 2019 remains a good environment for active investment management; we continue to find very attractive investment opportunities in REITs.

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Europe

- Europe was a laggard of the three regions, with the weakest performance of the global regions in the fourth quarter and on a year-to-date basis. U.S. dollar strengthening against the pound, euro and Swedish krona over the year played a significant role in depressing U.S. dollar total returns in the region, reversing the trend from the previous year. In 2018, U.S. Fed interest rate tightening and political risks such as Brexit in the UK combined to boost the dollar compared to European currencies.
- Investor concerns over imminent interest rate tightening and threats to global trade and growth impacted all regions, but Europe suffered additional pressures from the approaching Brexit deadline and other outbreaks of political risk across the region. All European markets posted negative U.S. dollar total returns in the fourth quarter, many with double-digit negative quarterly returns. The worst performer for the forth quarter was France with -20.1% as the retail landlords that dominate this index collapsed in value and violent popular protests against government tax proposals came to a head in November and December, disrupting the real economy across the country. The disappointing 4Q was enough to secure the bottom performer slot for France on a full-year basis with a USD total return of -30.1%. Also weak in 4Q were Italy (-12.5%), Ireland (-12.1%) and the UK (-11.6%).
- The only relative bright spots in 4Q18 were Sweden with -3.1% and Belgium with -0.8%. These were the only two countries with positive returns for the full year 2018, with Sweden returning 5.6% despite SEK weakening against the USD and Belgium returning 1.8%.

Asia

- Asia Pacific posted a -0.9% in the fourth quarter and -1.97% in 2018, negatively impacted by the on-going trade war between the U.S. and China and the ensuing uncertain economic outlook for the Chinese and global economy. With the exception of Japanese REITs, Asia Pacific listed real estate sectors all recorded negative returns for the year.
- Asia continues to offer an attractive risk-adjusted real estate return from a global perspective, supported by strong fundamentals and manageable interest rate levels. More importantly, with the exception of JREITs, Asia is trading at the lower end of its historical price to NAV. Given the more dovish tone adopted by the Fed and the subsequent dial-down in 2019 hike expectations from three to two, it's our sense that the pace of interest rate increases in Singapore and Hong Kong would not result in cap rate expansion. Japan and Australia central bankers are keen to maintain their accommodative monetary policy for the foreseeable future. While trade negotiations between the U.S. and China remain in balance, it's clear the latter is strongly incentivized to achieve compromise. We think the following themes will dominate focus in the coming months: trade war clarity, impact of lower bond yields on REITs, lack of quality supply (prime Singapore/Hong Kong office), conducive yield spread (JREITs), and strong office fundamentals (JP office).
- Markets remain vulnerable, subject to the intensity and outcome of the trade conflict as well as guided policy statements by the Fed. Recent guidance has tempered interest rate risk somewhat, but markets continue to focus on potential signs of weakness in both U.S. and global economic growth. Within our individual sectors, a sharper rise in sovereign bond yields could negatively impact regional REIT valuations. A weaker U.S. dollar/stronger Yen could negatively impact economic momentum in Japan and underlying demand for condos and office space. On the other hand, reduced expectations of Fed hikes could be positive for the Hong Kong and Singapore developers.

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