

GLOBAL OUTLOOK

Grosvenor's research perspective on world real estate markets

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Global growth continues to underwhelm

The global economy continues to underperform and risks remain skewed to the downside. World real GDP is forecast to grow by a moderate 2.5% p.a. in 2016, marking the fifth consecutive year of sub-3% p.a. in the global economy. The outlook for 2017 has also been revised lower, with the negative impact of Brexit expected to peak over the next twelve months. Overall, we expect Brexit to detract around 0.25-0.5% pts off global growth over the next year, with much of the impact concentrated in the UK and Europe. In the absence of any further financial market dislocation or wider political instability, the impact of Brexit in the US and Asia is expected to be relatively muted.

With global growth continuing to underwhelm, OECD output gaps remain relatively wide for this stage of the cycle (see chart) and inflationary pressures remain quiescent. Central banks globally are continuing to ease policy to stimulate inflation, with the UK, Japan, Australia and New Zealand all easing monetary policy further over the past month. Unsurprisingly, the economic outlook for the UK remains highly uncertain. Most forecasters have lowered their UK GDP growth forecasts; the consensus is for UK growth to slow to around 1.5%

in 2016 and 0.7% in 2017. Economic uncertainty is expected to persist for at least two years, which will weigh on business and household confidence, reduce corporate investment and employment growth and slow consumer spending. In addition, tighter lending conditions have increased the risk of a correction in the housing market, particularly in London where affordability is stretched.

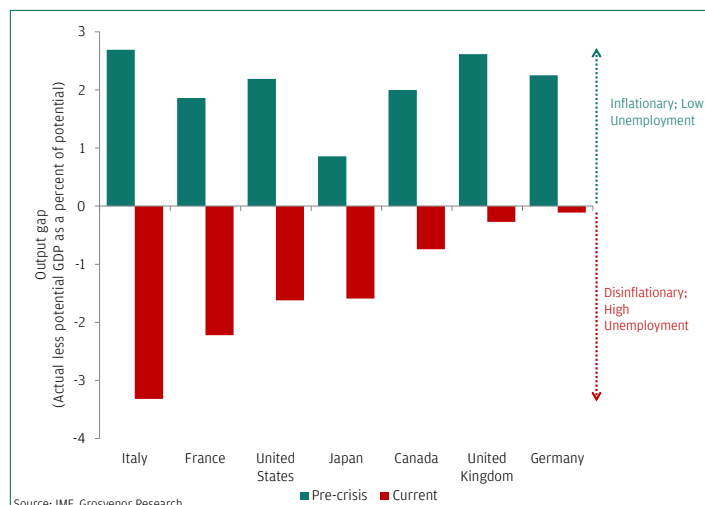
In the face of these challenges, the Bank of England delivered a substantial support package in early August, including a 25bp rate cut, an additional £60billion in QE and a new Term Funding Scheme for banks.

The outlook for the Eurozone has also weakened following Brexit. Eurozone exports to the UK are likely to suffer from weaker UK growth and the stronger currency. Further policy support seems likely if the ECB is to fulfil its pledge to ensure price and financial stability.

In Asia, the Japanese government has once again postponed the next scheduled increase in the consumption tax until October 2019 and announced additional fiscal stimulus measures. The new fiscal stimulus package is expected to boost Japanese growth by 0.6% in 2017. Further QE by the Bank of Japan may also be needed if growth continues to falter.

In the US, employment growth has continued to impress in recent months; non-farm payrolls in July increased by 255,000 and the unemployment rate was unchanged at 4.9%. Continued employment gains are now translating into a stronger consumer spending and a sustained recovery in housing activity. Nonetheless, with the US election now approaching we still think a further rise in US rates is unlikely until 2017.

Output gaps in advanced economies



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Inflation: Dead or Hibernating?

Property is often considered an attractive inflation hedge, as rental growth exhibits a strong long-run correlation with price inflation in the broader economy. But what happens when inflation is persistently low? This article examines the conspicuous lack of inflation in the years following the Global Financial Crisis (GFC), where a number of structural changes have continued to keep inflation weak. If these changes persist, interest rates are likely to remain lower for longer and total return expectations should likewise be revised down.

Inflation has flat-lined since the GFC. One of the unusual features of the post-GFC recovery is the lack of inflation at a relatively advanced stage of the cycle. In the post-war period, inflation has generally risen towards the peak of the cycle as demand outpaces supply, to prevent shortages. A typical economic cycle lasts around eight years on average and it is eight years since the collapse of Lehman Brothers. Yet inflation across most advanced economies remains woefully short of central bank inflation targets (Chart 1). Since 2009, the OECD average inflation rate has been below 2% for 81 of the last 89 months (and averaged just 1.3% p.a.).

The prolonged slump in inflation is now causing a sharp divergence among forecasters about its future. Most macroeconomic models continue to assume that inflation will soon return to its long run trend of just over 2% (e.g. IHS are forecasting US inflation to average 2.2% p.a. over the next five years). Financial markets, however, appear to have lost faith in policy-makers; the implied inflation expectations from bond markets have inflation over the next five years averaging just 1.3% p.a.

What determines inflation? So who is right? To assess the outlook for inflation, it is helpful to

outline a basic economic framework for inflation. In the very long run inflation depends on a country's money supply and is therefore ultimately anchored to the central bank's policy objective¹. But in the short- to medium-term (i.e. over a three to five year horizon) inflation is more typically explained using an "Expectations-Augmented Phillips Curve". This Philips Curve framework argues that current inflation is a function of two factors: (i) expected inflation and (ii) the amount of spare capacity in the economy (the output gap).

If there are any factors that prevent actual output growth from reaching its potential for an extended period, this will reduce inflation via the output gap. Furthermore, the longer that low inflation persists, the more it becomes self-reinforcing as low inflation expectations become embedded, which in turn reduces future inflation. Viewed from this perspective, there are several legacies of the pre-GFC era that still constrain aggregate demand, keeping output gaps wider than normal and eroding inflation expectations:

- **Deleveraging headwinds:** The GFC was precipitated by a 30-year bull run in debt markets, underpinned by a sustained increase in debt levels. Private non-financial sector debt in advanced economies nearly doubled through this period, from around 87% of GDP in the early 1980s to around 170% in 2009. Since the GFC, households, companies (and to a lesser extent governments) have prioritised paying down debt to reduce leverage rather than fund new spending. This situation is sometimes described as a "balance sheet recession", and looks to be one of the structural factors that have kept output gaps wide in recent years.
- **Weak confidence:** Because of these continued deleveraging headwinds, we have not seen the typical above-average "take-off" rates of growth that normally accompany economic recoveries. Since the GFC, there have been several recurring bouts of economic pessimism. The unusual number of economic speed bumps in this recovery cycle has stunted a stronger rebound in confidence, which has help maintain a wider output gap and depressed inflation expectations.
- **Subdued wage growth:** Despite the weak recovery, one seemingly bright spot in the post-GFC recovery has been the sustained improvement in employment. Across advanced economies, unemployment is now at or near pre-crisis levels (in some cases near NAIRU²). This would typically indicate a scarcity of workers, which should stoke wage and

Chart 1: Core inflation ranges : high, low, and average

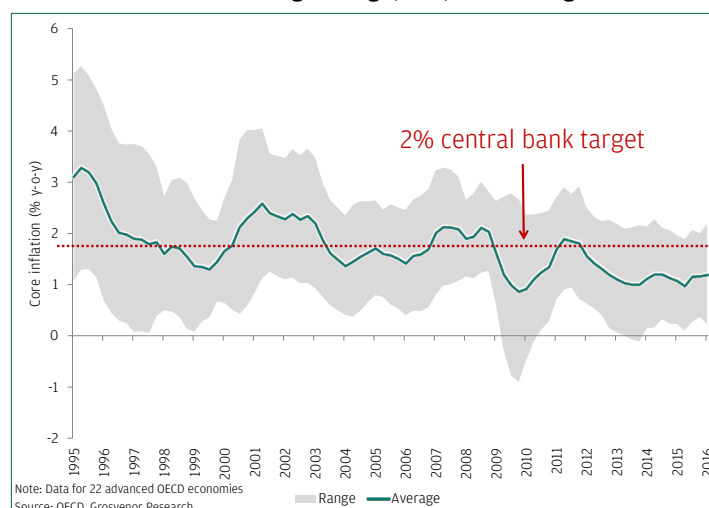


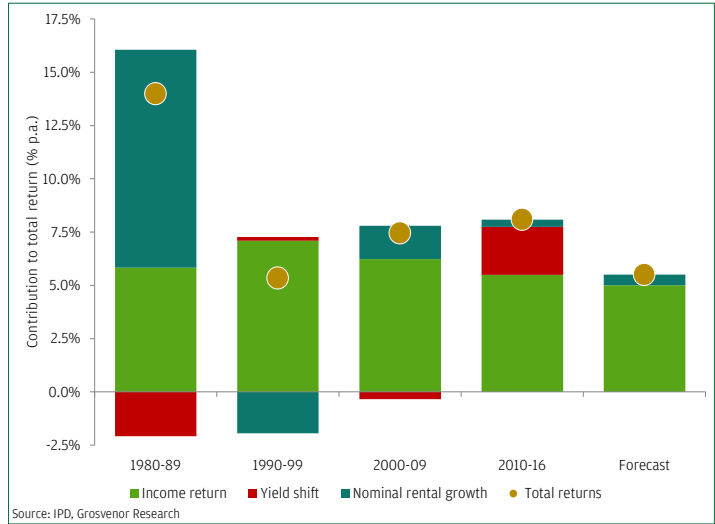
Chart 2: Long-run price and labour cost inflation



inflationary pressures (Chart 2).³ Yet despite low unemployment, wage growth remains subdued. Since 2008, average nominal wages in the G7 have risen by just 1.5% p.a., compared with 2.9% p.a. in the preceding cycle (i.e from 1991 to 2007).

- Declining job security:** Part of the reason for weak jobs growth is increased job insecurity. Despite the significant recovery in the number of jobs since the GFC, it appears that jobs quality has been deteriorating. Underemployed workers usually command less bargaining power, which is one explanation for anaemic wage growth and thus inflation since the crisis. The gap between actual and potential employment in advanced economies may be materially wider than headline unemployment figures suggest.

Chart 3: Historic and forecast all-property total return components in the G7



- Globalisation and technological change:** Labour market polarisation and the decline in full-time work are connected to the continued impact of globalisation and the disruptive impact of technology on lower-skilled work. Globalisation and technological advances have encouraged the development of complex global supply chains, allowing companies to maximise cost efficiency regardless of location. This shifts the balance of bargaining power from labour to capital and keeps wage inflation low.

What more can central banks do? The prolonged slump in inflation has created a dilemma for central banks. Advanced economies appear to be in a “liquidity trap”, where loose monetary policy simply generates asset price inflation (including real estate) but has little tangible impact on consumer inflation and the real economy. The next major step for central banks mooted by some commentators, is a “helicopter money” approach, which entails the central bank bypassing the banking system and directly funding new spending in the economy. This is a drastic and potentially risky step that could have unintended consequences (e.g. a loss of monetary credibility).

Total returns to remain low. While the jury is still out on whether the slowdown in inflation is dead or hibernating, in the absence of more drastic monetary action, the structural headwinds constraining inflation are likely to persist. We expect that the level of inflation is likely to continue averaging between 1% and 2% for some time to come while central banks maintain record low rates.

This will have significant implications for real estate returns. Inflation drives real estate returns through its impact on rents and yields. The initial impact of low inflation is to boost total return through yield shift; we estimate that yield compression has contributed around 2.3% pts of the 8.1% p.a. real estate total return in G7 markets since the crisis. But with interest rates near zero in most advanced economies, property yields are unlikely to come in much more. Assuming no additional inward yield shift and a 5.0% income return, total returns in a low inflation environment could be around 5.5% going forward (Chart 3), or a full 200 bps lower than the historic average.

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1. It also depends on the central bank's ability to successfully implement that policy.
2. NAIRU stands for the “Non-Accelerating Inflation Rate of Unemployment”.
3. We proxy long-run wage growth with unit labour cost growth; this is wage growth above increases in labour productivity.

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Questions & Answers with Cynthia Parpa, Director, Global

Q: Real estate equities¹ are being elevated to a dedicated industry class, why is this significant?

A: On September 1st, 2016, real estate equities will be elevated to a class of their own and will become the eleventh sector under the global industry classification standards (GICS)² for equities, the first new sector since their introduction in 1999. The elevation reflects an appreciation of the sector's special attributes by index providers and its recognition as a distinct asset class with an increasing role in global equity markets and portfolio diversification. Real estate has been historically classified as a sub-group of financials, along with banks, insurance companies, and asset managers, despite its distinct operating characteristics and performance drivers. As a standalone sector, real estate will represent around 5% of the global equities universe.

Q: What impact will the reclassification have on the sector?

A: Improved awareness: The reclassification is likely to bring real estate into focus for international investors and highlight the attributes of a sector that has been amongst the top performing asset classes over the last 20 years. Separating real estate from financials will improve sector performance measurement and attribution and could result in increased

attention from investors promoting a debate as to the appropriate allocation to the sector.

Increased fund flows: Real estate has historically been underweight in all-sector equity fund (by as much as 50% of their respective benchmarks), especially in the US, UK and Continental Europe. With real estate as part of financials this underweight bias has not always been obvious. Capital flows into real estate equities are expected to increase following the reclassification, with estimates reaching \$100 billion³. Although possible we do not expect to see a sudden inflow into the sector but we should see an increased interest in real estate equities that brings more understanding of its special characteristics and valuation metrics, leading to increased investment over time.

Reduced volatility: Listed real estate has historically been more volatile than the underlying asset class partly due to the effects of leverage but also due to equity market influences unrelated to the sector. The financials sector has historically been one of the most volatile equity sectors. Over time, the separation of real estate from the financials sector may reduce trading linkages between real estate stocks and other financial companies such as banks and insurance companies, in that way removing a potential source of volatility.

Q: Why should investors take a closer look at listed real estate?

A: Listed real estate equities can provide easy and efficient access to the global real estate markets and have historically provided attractive total returns of circa 9% p.a. over the last 20 years, exhibited relatively low correlation with bonds (0.48) and general equities (0.31) over the same period, and today offer a 3.9% dividend yield. The listed real estate universe is geographically well diversified, providing access to the underlying real estate markets in all continents. Sector diversification is also possible in most markets, especially in the US, where sector specialist REITs represent the traditional sectors like office, retail, residential and industrial but also alternative niche sectors like healthcare, student housing and self-storage.

Given the cyclical nature of the economy and the links of real estate to it, a long/short strategy may be the most effective way for investors to reduce volatility and achieve absolute returns at any point in the cycle.

The search for assets that provide the potential for growing income and capital appreciation will continue to drive interest in listed real estate, which will only intensify as real estate gains a higher profile with its elevation to a distinct industry sector.

1. Includes real estate investment trusts (REITs) and real estate management and development companies (REOCs), excludes Mortgage REITs.

2. GICS is an industry taxonomy for equities developed in 1999 by MSCI and Standard & Poor's (S&P) and it currently consists of ten industry sectors that break into 24 industry groups and many further sub-groups.

3. As estimated by JP Morgan Research.

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