# The Investment Podcast

M&G Investments

**Episode 5: Global Real Estate Outlook**
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**José** [00:00:33] Buenos Dias. My name is José Pellicer and I'm the Global Head of Investment Strategy at M&G Real Estate. Welcome to another episode of the real estate series at the M&G Investment Podcast. Today is the time where there the real estate research team produce its biannual global outlook. On this occasion, the report focuses on recovery. Everyone thinks this is a done deal, but surely it has to be more complicated than that? The second related theme of the report addresses the good old business cycle. With everyone focusing on the future of living, the future of work, the future of shopping – is it worth remembering that change tends to happen in cycles? The real estate industry is affected by many of these cycles. In order to cast some light on these issues, we have Richard Gwilliam, who is the Head of Property Research at M&G Real Estate, and Jonathan Hsu, who is the Head of Asia Research at M&G Real Estate. So, Rich, John, welcome to the podcast.

**Richard** [00:01:52] Hi there.

**Jonathan** [00:01:53] Hello, hi.

**José** [00:01:54] So, it looks like the vaccination program is underway and it looks like we are heading towards an economic recovery. But is it as simple as that? In the last crisis, the recovery was pretty uneven geographically and also across sectors, and it took a long time. So Rich, what do you think? Is the recovery going to be unequal, do you think?

**Richard** [00:02:23] In one word, yes. The degree of hit that economies have taken is different. The UK, for instance, took a pretty big hit and therefore stands to have very strong growth this year, but partly because it's recovering from a very low base. But the UK has also been helped by a really rapid vaccine rollout. Other economies around the world have been slower. Within Europe, there are differences too. So, Germany and the Nordics are leading the charge in economic terms. But I believe that southern Europe will probably lag its northern neighbours, partly because they're more dependent on tourism, which even now, tourism is very depressed in terms of activity. So, yes, an uneven recovery, I think.

**José** [00:03:25] OK, and how about in Asia? How uneven, if at all, do you see it, John?

**Jonathan** [00:03:31] Yeah, I would say similar to what Richard has said about the UK. Hong Kong had a double whammy what with the protests pre-pandemic and that did lead to an economy that was quite depressed in terms of output and activity. When you add the pandemic to that which was more synchronized across the region, although not evenly – places like Korea were still able to continue on almost as normal. In Japan, aside from the three recent states of emergency, were still carrying on as normal. But I think that because they did not go into a full lockdown, it might take longer for them to recover. Places that did go into a lockdown like Singapore should see a faster or speedier recovery out of this pandemic in 2021.

**José** [00:04:20] OK. So, Rich, you were talking about tourism and the countries that are highly exposed to tourism. Clearly, the hospitality sector and the retail sector have been hit quite severely by the pandemic and there are a number of retailers that are no more, they have gone under. So how do you feel about the recovery of these sectors?

**Richard** [00:04:46] Yeah, again, there's this high degree of unevenness about it. So, we've been thinking about this as a K shaped recovery. What I mean by that is some parts of the economy, some sectors, some industries, etc., will be doing quite well even throughout the pandemic. In some cases, they actually grew. So that would be the likes of tech, innovation companies, healthcare and larger firms which were more generally insulated. But within other industries and sectors that effectively rely on the agglomeration of people, they have suffered tremendous damage as people have been prevented from coming together and congregating. So, travel, hospitality, entertainment, leisure, bricks and mortar, retail, etc., they've taken such a big hit and their finances need to be repaired. There are long-lasting scars there, and as you pointed out, some of those businesses are no more. So, those kinds of sectors are unlikely to expand for a long time to come. Now, they're clearly going to rebound from taking such a big hit but the idea of them recovering back to pre-pandemic levels any time soon, I don't think that's going to happen. It's going to take quite a bit longer.

**José** [00:06:06] OK, thank you, Rich. And John, in Asia is there a similar trend or does it depend a little bit on the individual characteristics of the retail sector in different countries?

**Jonathan** [00:06:19] I would say you're right. It does very much depend on the characteristics of each market, so each gateway city that we do look at, care for and monitor. City-states like Singapore and Hong Kong, where they are largely dependent on international tourism to come and boost the retail and hospitality sector, will take a while longer to recover. I think that's part of the downward K where, unless we really trust each other to open our borders freely, to allow for intraregional or international travel to come through, those sectors are going to continue bouncing along the bottom. Looking at Japan, this is a market where 80% of travel is supported by domestic business or leisure travel. So, the sectors like retail as well as hotels will continue to do well once they get their case numbers down and once vaccination programs are in place. So, I do believe it's quite reliant on the characteristics of each of the cities within the region.

**José** [00:07:33] Yeah, exactly. I think that with Japan, it is a country where old habits die really hard. I would now like to move to a topic that is a consequence of the recovery and one that is pretty topical right now, and that is inflation. There is this complacency amongst central banks that they're not going to raise interest rates but in in the US, the consumer price index has gone up to, 3.8, 4.2, something like that, so it is pretty high. So, John, how about in Asia? Do you feel that there are inflation risks in Asia and that some of the US's inflation could be imported there?

**Jonathan** [00:08:19] Certainly the US inflation risk is real for Asia. I think particularly for Hong Kong where the Hong Kong dollar is pegged to the US dollar. Any movements in US interest rates are going to directly have an impact on the Hong Kong markets. In terms of the rents, APAC rents have mostly kept up with inflation over the last 20 years. So, we are quite comfortable with that and typically the short lease terms in Singapore and Hong Kong have done well to capture the up-cycle when rents have started to rebound even though it has the opposite effect during a down-cycle. In markets like South Korea as well as Australia, there is an element of inflation-link written into the leases. So again, that gives investors that protection against inflation. Lastly, on the yield spread, I think that even if inflation does cause interest rates to go up and push borrowing costs up, there is still sufficient spread. So, it's around 280 basis points on average for Asia Pacific as assets buffer against any rise in interest rates or borrowing costs.

**José** [00:09:34] Yeah, exactly. I think that is one of the key attractions of real estate at the moment, the fact that we are offering a very healthy spread relative to the borrowing costs. And how about in Europe Rich? Do you see inflation being imported from the US?

**Richard** [00:09:56] I think there is a risk of that but these are still distinct economies. In Europe, the ECB has made it pretty clear that it's intending to keep interest rates ultra-low because they don't really see inflation as a problem. Now, they might be wrong on that or indeed, they might just be attempting to calm the markets whilst behind the scenes they might be a bit more worried. But I think the dynamics within the European economy or economies are different to the US. Firstly, if the US has an inflation problem, I think that the likes of returning to the 70s and 80s, that double-digit inflation, the probability of that happening seems very low. But you're right, there might be a possibility of higher inflation that we've been used to in the last few years. So, the impact on property in that scenario could be limited unless it's very high inflation but if you look at what the financial markets are pricing in for interest rates going forward, they don't seem all that concerned in the UK and Europe.

**José** [00:11:02] You've made a very interesting point about real estate and how inflation affects real estate. Traditional people tend to say that real estate is a hedge against inflation. I don't totally believe that but do you think that there is some merit in that comment?

**Richard** [00:11:26] I think that there is some merit. We've got to be careful that we don't assume that property is a perfect inflation hedge. There can be a spike in inflation that does not tend to correlate with a positive spike in property performance, in some cases it is the opposite, or at least in our experience historically. But if it's a period of prolonged high inflation, then real estate tends to perform far better and does offer inflation protection. So why is that? Well, it's a real asset. It offers, like commodities it's tangible, It has a limited supply and it offers a function to the users such as the occupiers as the tenants pay rents. As general price levels go up in the economy, rent as a price should also go up too. So over time, property prices, which are obviously determined quite heavily by rental levels – they should stand to rise similarly. So, running some analysis in the UK, at least historically, back in the 70s and 80s, when inflation was high for prolonged periods, the nominal returns and nominal capital growth from property was similarly high. Over the long term, nominal capital values tend to track inflation quite closely. Furthermore, the inflation-linked to leases can offer further protection. Clearly, if you've got your underlying cash flows going up in line with inflation because of the structure of the lease, that should be pretty helpful to you.

**José** [00:13:04] Yeah, exactly. Yeah. I think that there are a number of countries where that is quite explicit, but there are other countries where it is not. OK. I'd like to move to one of the key topics of the global outlook. Actually, John, you've mentioned it in your previous answer. It's about cycles. So, everybody's talking about the change in work, the change in retail and the new ways of living but of course, very few people seem to be talking about the good old business cycle. Since I've been around or, since the 20th century, it seems that economic and investment phenomena have always occurred in cycles. Therefore, the real estate industry is affected by a number of cycles. So, let me start with the development cycle, which is the traditional cycle that affects us as an industry quite heavily. How do you see the development cycle Rich in your regions? Is there a spike in development? Is there a massive drop in development? How do you see it?

**Richard** [00:14:36] Generally speaking, as we headed into the crisis last year, the development cycle wasn't really a big worry, except in some relatively isolated cases. Notably, the industrial sector has, for a number of years now, seen an increase in the amount of supply being added to the market. But most sectors, generally within property and since the financial crisis, about a decade or so following the period has seen a relatively contained and limited amount of new supply being built. So as a result of that, the vacancy rates that we saw coming into this crisis were pretty low cyclically and that should offer some support to the recovery as well.

**José** [00:15:24] OK, yeah, that actually makes a lot of sense. I think that lack of development finance was probably one of the explanations for that. That now takes me to the other important cycle that affects our industry, which is the lending cycle. Before, as we recovered from the global financial crisis, that was an extremely important factor that affected real estate markets. It wasn't always obvious that you would find finance. So how do you see the lending cycle now, John?

**Jonathan** [00:16:02] I would say the lending cycle right now is still offering liquidity to real estate investors and especially on the core plus side. But I would say that where you're taking a bit more risk, the lenders are still a bit shyer, at least traditional lenders like banks and insurers. They are a bit more shy to lend to more speculative development. It's funny you mentioned the GFC because, since the GFC in Australia, banks actually require developments to get a certain percentage, 40, 50, 60% in pre-commitments before they go ahead with the loan to cover development for office buildings. So, I think ever since the GFC, a lot of banks who have had their fingers burnt, have become more cautious and that's why we haven't seen the development cycle go out of hand, as Richard alluded to for Europe and UK.

**José** [00:17:11] Do you think, John, that there is any difference across sectors? So, is it as easy to get finance for a fully occupied office as it is for a fully occupied shopping center?

**Jonathan** [00:17:14] I would say it definitely isn't. I think if you're looking to finance retail, a lot of banks, like a lot of real estate investors, are still shying away from retail assets, and especially during the pandemic, hotel assets are almost impossible to finance in many markets that we cover here.

**José** [00:17:36] Yeah, exactly. So, Rich, the last cycle I wanted to touch on is the investment cycle. This is about investor activity in real estate, deal flow and deal volume. Do you feel that is back in full steam or do you think that it is fairly unequal at the moment?

**Richard** [00:17:59] Yeah, I think it is pretty unequal. There have been some market-wide characteristics since we went into the crisis. Clearly, there was heightened uncertainty and for the whole of the real estate market, it was characterized by risk-off attitudes from investors. But within the sector, we can look at quite starkly different attitudes and therefore points, if you like, in the investment cycle. So, if you contrast retail with industrial, with the industrial or logistics sector, investors are trying to get exposure to that sector. There's a lot of competition for stock. There's pressure on pricing going upwards and generally, there is a fear of missing out attitude. There is this enthusiasm and optimism about the sector. That is starkly different to the attitudes in retail, where investors are really fearful, they're worried about losing money and they don't want to catch a falling knife. So, the investment cycle for those two sectors are at completely different points. Now, coming back to the original question at the start, cycles exist and it's not just about structural changes. We are fully aware of the structural changes that are characterizing those markets, but cycles will happen and cycles do turn. So, something that we should look out for going forward is, a potential turn in the attitudes and the psychology from investors looking at those two sectors.

**José** [00:19:33] OK, yeah, I think that makes a lot of sense. I will certainly go back to a shop at some point in my life. I don't think that I will buy only online from now on. So, John, do you feel that it is a similar situation in Asia, and I would like to expand the question to sectors like hospitality or even all the sectors that are not part of the traditional real estate portfolios, such as, data centers, sciences, et cetera.

**Jonathan** [00:20:12] Yeah, I would say that in terms of the cycle, we discussed this earlier. I think hotels are definitely in the down cycle. Retail, it's a global phenomenon and there are structural headwinds facing retail, so again, it is in the down cycle. I would say there are interesting opportunities emerging out of these down cycles. Again, we did talk about Hong Kong at length. Rents for the retail high street, basically corrected by 80% - imagine you were getting 100 dollars three or seven years ago – not you would be getting 20 dollars in rents today. So even if that rent goes up to 30 dollars, that's a 50% increase in your rental income and therefore it's going to impact the value similarly. So, I would say places like Hong Kong do start to look interesting when you look at cycles and you can expect some rebound, especially for retail once things start to normalise.

**José** [00:21:11] OK, I think that is a great way of finishing this podcast. So, by increasing to 30 dollars in Hong Kong high street retail, 70% to where it was before - you can still make a killing. Some food for thought. Anyway, John, Rich, thanks so much for joining us on this podcast and see you soon everybody.