Is the Residential Sector Losing Its Luster?

European Real Estate Research Quarterly

AUGUST 2022

22-2313016

Executive Summary

ECONOMY

- High inflation will likely continue this year—while a global commodity price shock for the history books is currently playing out.
- Central banks, especially the Fed, are in the aggressive tightening phase, as they attempt to wrestle inflation back under control, irrespective of the consequences for growth. But are markets overplaying these fears?

PROPERTY MARKETS

- A higher cost of real estate debt, a decline in economic sentiment, and lower letting/rental growth expectations are resulting in European property yields beginning to rise.
- Upward shifts in property yield have begun. Although external macro risks are high and rising, the internal risk to the property market remains relatively modest.
- Property market mitigators for potential downside risk include:
    - The increasing probability that concerns around rate hikes are easing
    - Low existing vacancy
    - Modest development likely to trend yet lower
    - Chronic shortages of modern stock (especially with strong ESG credentials)
    - Property market leverage that is much reduced compared to previous cycles

Economic Outlook

High inflation will likely continue this year—while a global commodity price shock for the history books is currently playing out. Global supply chains were already struggling to crank back to life, and these pressures have been ratcheted upward by the Ukrainian conflict. We think the world needs to rapidly readjust to the consequences of prolonged economic sanctions. At the same time, the adverse growth impact/recession risk for Europe is higher than the U.S., given Europe's energy dependence on Russia. The implication for food supplies and social stability for emerging markets is also a worry.

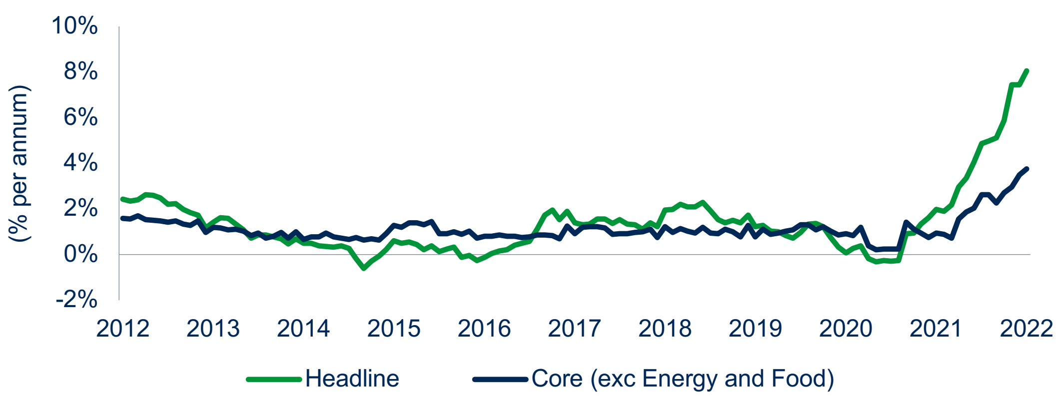
Central banks, especially the U.S. Federal Reserve (Fed), are in the aggressive tightening phase as they attempt to wrestle inflation back under control, almost irrespective of the consequences for growth. And while a degree of "talk the talk now, to avoid the whole of the walk" may be at play, market expectations for interest rates are elevated—and this is key for the cost of real estate debt and therefore property investment pricing.

While the Eurozone PMI still shows positive growth for the corporate sector at 52 in June 2022, down from 54.8 the previous month, manufacturing is contracting and even the service sector is now beginning to show signs it will fade as well. While backlogs of work remain, which is supportive, new orders are now rapidly receding. On the upside, with ongoing capacity pressures, job creation prospects remained positive. The economic slowdown is broad and similar in nature across all major European economies.

CPI inflation for the Eurozone continues to increase, up to a record high of 8.6% pa in June 2022 versus 8.1% pa in May. Commodity price increases continue to be the primary driver with energy up around 40% pa, while food could soon be pushing toward 10% pa. Core inflation, while still a fraction of that in the U.S. or U.K., is also accelerating at 3.7% pa in June. While labor markets remain in good shape, wage growth at around 2% pa is lagging well behind the rise in living costs.

European households have seen an erosion in purchasing power—or in other words, a "cost of living crisis". As a result, household spending on non-essential goods and services will likely come under pressure. Business spending and investment will also likely begin to fade as corporate confidence wanes and reduced earnings expectation kick in, not to mention tightening financial conditions (i.e. higher borrowing costs).

EUROZONE: CONSUMER PRICE INDEX (CI)



Source: ifo Institute. As of July 2022.

Economic Outlook

While the European Central Bank's (ECB) has lagged behind the Fed, they recently ended an 8-year era of negative interest rates at their July 2022 meeting, hiking for the first time in over a decade by increasing their deposit rate by 50 basis points (bps) to 0%. But the central bank remains more dovish than the Fed. Additional measures to handle any potential spikes in peripheral sovereign debt yields were also announced.

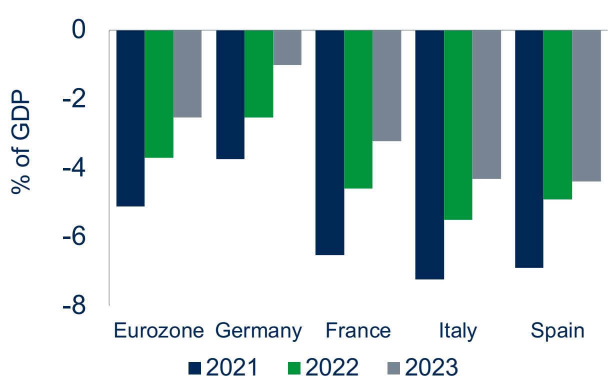
Suspension of the Stability and Growth Pact fiscal rules, announced in late May by the European Commission, is a green light for governments to push ahead with policies to temporarily shield vulnerable populations for the duration of the energy price shocks and also speed up the green transition (see chart below). This is a structural change to Europe's ability to temporarily add fiscal policy measures as a tool for macro stabilization in times of duress.

GDP COUNTRY FORECASTS (% P.A.)

	2020	2021	2022	2023	2024	2025	2026	2022–2026
France	-7.9%	6.8%	2.6%	2.2%	2.2%	1.8%	1.5%	2.1%
Germany	-4.9%	2.9%	1.7%	3.1%	2.4%	1.2%	1.0%	1.9%
Italy	-9.1%	6.6%	3.2%	1.9%	1.6%	0.7%	0.3%	1.5%
Netherlands	-3.8%	5.0%	3.1%	1.7%	1.8%	1.6%	1.3%	1.9%
Spain	-10.8%	5.1%	4.5%	3.6%	3.5%	2.1%	1.2%	3.0%
Sweden	-2.3%	4.9%	2.1%	2.1%	1.9%	1.9%	1.9%	2.0%
United Kingdom	-9.3%	7.4%	3.6%	1.3%	2.3%	2.2%	1.8%	2.2%

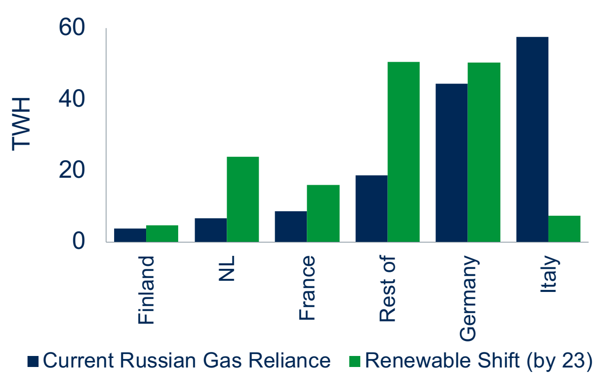
Source: Oxford Economics. As of July 2022.

FISCAL DEFICIT FORECASTS



Source: European Commission. As of June 2022.

ELECTICITY GENERATION (TERRA WHATT HOURS)



Source: International Energy Agency. As of December 2021.

Capital Markets

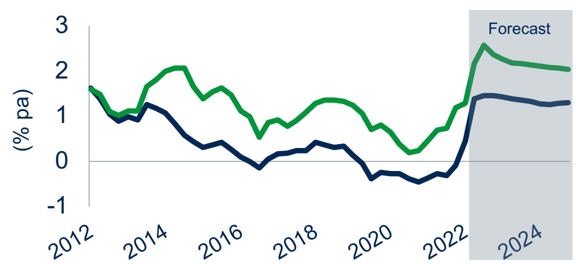
According to RCA, European investment transactions totaled €73.2 billion in Q1 2022, 10% up on the same period last year and broadly in line with the long-run average. Activity was heavily focused on the industrial and residential sectors, where the structural support is best. Recovery also occurred in office, retail and hotel investment, which are beneficiaries of the pandemic reopening. However, these transaction volume data lag and are reflective of 2021 investment decisions and strategies.

Benchmark five-year Euro swaps rates rose from 0% to 1% during the first quarter and further increased to 1.8% by the end of the second quarter. CRE lenders' margins are now also widening to maintain relative value to corporate bond yields that have trended higher. A higher cost of real estate debt, a drop in economic sentiment, and lower letting/rental growth expectations are likely to see transaction pipelines cool off for the rest of this year.

The deterioration in pricing is just beginning to come through, with CBRE prime yields rising roughly five bps on average during June. The monthly trend was highest for logistics (10 bps), followed by PRS residential and prime CBD office (five to 10 bps range on average). Grocery retail (0 bps) showed typical stability in the face of a downswing. Perhaps more surprisingly, given the 'cost of living crisis' nature of the slowdown, prime French retail segments compressed in June with the suggestion that the investment trend was strengthening. This is perhaps a lagging investor demand impact upon the pandemic reopening bounce that is now over.

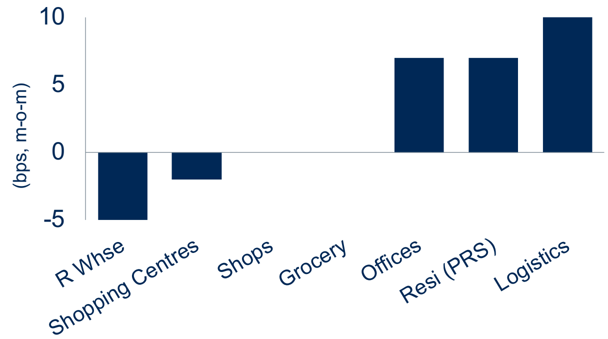
Upward shifts in property yield have begun. Although external macro risks are high and rising, the internal risk to the property market remains relatively modest. Mitigators include the increasing probability that concerns around rate hikes are already easing; a benign occupational supply side with low vacancy, limited development and chronic shortages of modern space (especially with strong ESG credentials); and that property market leverage is much reduced compared to previous property "boom-bust" cycles.

EUROPEAN INTEREST RATES: 5-YEAR SWAPS



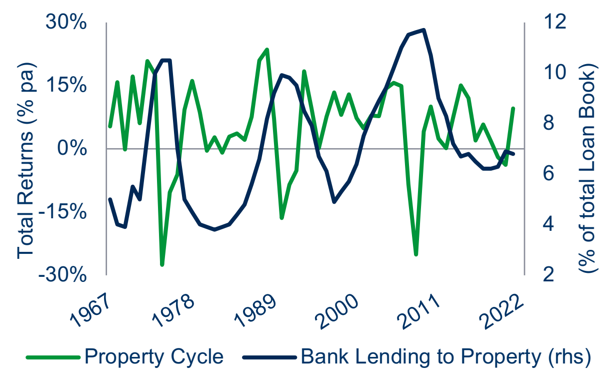
Source: Oxford Economics. As of July 2022.

EUROPEAN PRIME YIELD MOVEMENTS (JUNE 2022)



Source: CBRE; Cushman & Wakefield. As of July 2022.

U.K. PROPERTY AND CREDIT CYCLES



Source: MSCI/IPD, BoE. As of March 2022.

Occupier & Investment Markets

OFFICE SECTOR

Vacancy stabilized during Q1 2022 at 7.5%. Shortages of Grade A space are intensifying with new development completions low and tenants of existing prime buildings now withdrawing their "work-from-home (WFH) surplus" accommodation from the market.

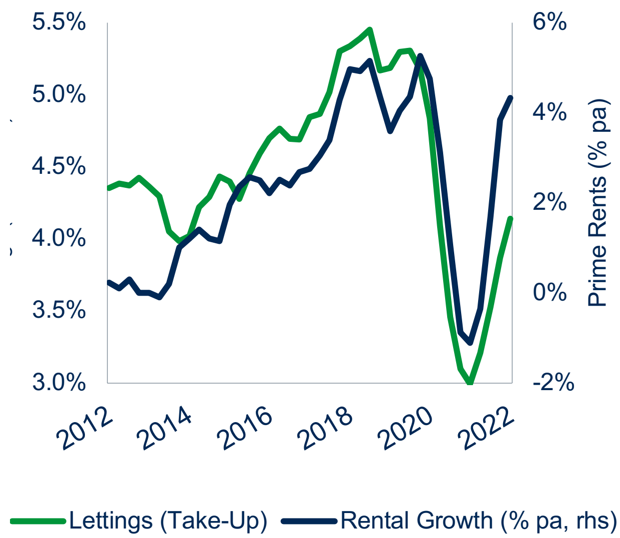
Office demand increased 40% over the year to March 2022. The letting recovery has lagged in Dublin (12%) but rebounded the hardest from the lowest base in central London (160%). However, the deterioration in economic conditions means the demand rebound will now likely stall.

The amount of space under construction is around 5.3%, broadly in line with the 5-year average and close to the pace of natural stock attrition (i.e. 5% based on two years of 2.5% of stock that assumes a 40-year office building lifespan). Dublin (11%) and Budapest (15%) are the development hotspots, while the lowest levels of new construction are in Stockholm (2%). However, JLL reports that one million sq m of development space has been delayed (or even cancelled), with build costs increasing as much as 10%. New development is thus trending downward.

A permanence from the pandemic is lingering hybrid working arrangements for white collar employees. New data indicates that this has been mainly driven by workers who have established their careers (25-49 year olds), with the old and young preferring to work in the office. The greatest WFH prevalence remains in places where it was highest pre-COVID (e.g. Netherlands and the U.K.).

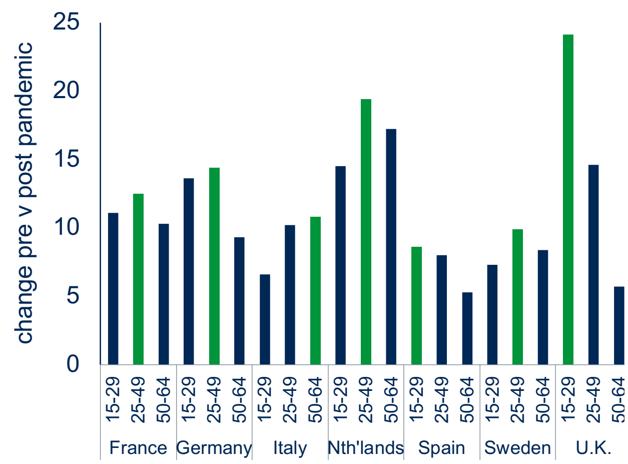
The benefits of a physical office building as a centralized meeting place for corporates to collaborate, build culture, recruit, train, retain and enthuse their 'talent' is very much to the fore for top tier businesses. The highest quality buildings able to meet this demand are fully flexible, with top class amenities with the strongest ESG credentials. Incoming, stringent energy efficiency standards also boost the case for modern offices, given the required capex for non-compliant office stock.

EUROPEAN OFFICE: LETTINGS VS. RENTAL GROWTH



Source: Cushman & Wakefield. As of Q1 2022.

WORKING FROM HOME (2019–21)



Source: Eurostat & Office of National Statistics (U.K.). As of July 2022.

Occupier & Investment Markets

RETAIL SECTOR

European (EU) retail sales growth slowed to 0.8% in May over the same month a year ago. This compares to a 5% pa increase for April.

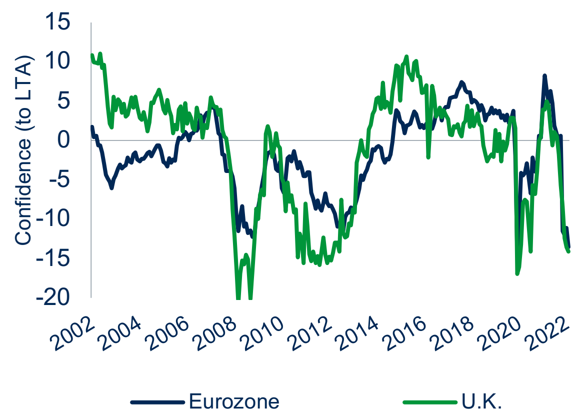
The theme of high inflation leading to reduced consumer purchasing power is currently evolving. This ‘cost of living crisis’ has seen a plunge in consumer confidence that especially bodes ill for large ticket consumer durable purchases (i.e. furniture and household goods). With more subdued housing transaction numbers also likely, this suggests the recent ‘purple patch’ for trading from out of town retail parks locations may be drawing to a close.

Levels of retail floor space per capita and cultural differences in a shopping context are important, as they will determine future floor space redundancy. With most countries now increasingly comfortable with transacting online, the speed of logistics supply chains and their ability to meet online customer delivery expectations will likely dictate the pace of adoption.

Grocery retail remains resilient, but not immune, to online growth. This is because low margins on food and high delivery costs are still a profitability challenge for grocery operators. Neighborhood retail remains investable due to its convenience nature, as do some retail warehousing schemes that are optimally sited for final mile logistics repurposing, mixed used or residential conversion.

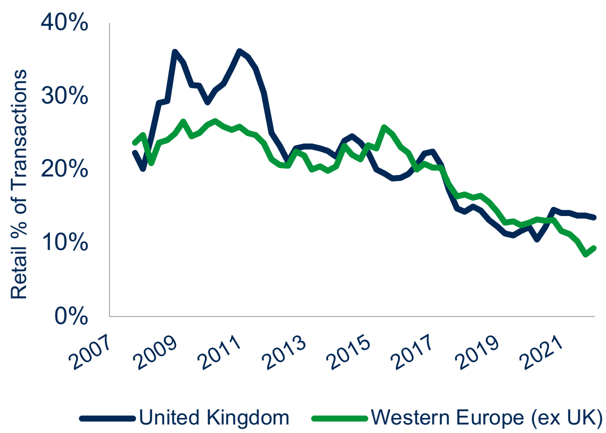
With investors frustrated in their efforts to find assets in the strongest sectors, capital has trickled back into the retail sector. While still very much convenience and grocery focused, the recovery in rents from pandemic lows has also attracted those with short-term investment perspectives. With e-commerce growth having ratcheted upward during the pandemic, stronger structural headwinds for physical shops exist today than pre-pandemic.

EUROPEAN CONSUMER CONFIDENCE



Source: Eurostat, GfK. As of July 2022.

EUROPEAN RETAIL: INVESTMENT TRANSACTIONS



Source: RCA. As of Q1 2022.

Occupier & Investment Markets

INDUSTRIAL SECTOR

Logistics demand remains robust. JLL reported a record first quarter European take-up at over 7.6 million sq m in Q1 2022. This strong performance was across the board, with nearly all markets recording double-digit year-on-year rises, led by the Netherlands (63%) and France (44%).

Supply remains incredibility tight, with most local markets estimated to have less than one-year's supply, at average levels of demand. The Netherlands, Germany and Czech Republic are the lowest supplied at 0.3 years of space.

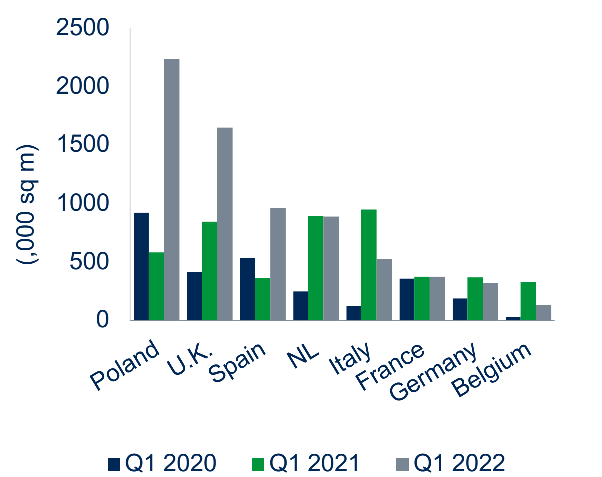
There was a record 22 million sq m of logistics space under construction across Europe through March 2022, of which roughly one-third was speculative. More than half of the speculative space is in Poland and the U.K. Polish construction is to meet outsourcing from Germany, while the U.K. pipeline is responding to surging rents. However, rising build costs will likely now temper new starts where rents are not moving ahead of build cost inflation.

Upward pressure on prime rental levels remain, with prime European logistics rent rising by almost 10% pa through March 2022. Standout markets included London (36% pa), Prague (33% pa), and Manchester (14% pa).

While rising interest rates are a legitimate concern for property investors, and yields may edge upward in the near term, it was an Amazon profit warning and rumors that the company had over-ordered new U.S. warehouse facilities that sparked a heavy sell off among European industrial REIT specialists (e.g. Segro). Further concerns also centered on rising development costs and falling developer profits. Lower development implies higher rental values over the mid term.

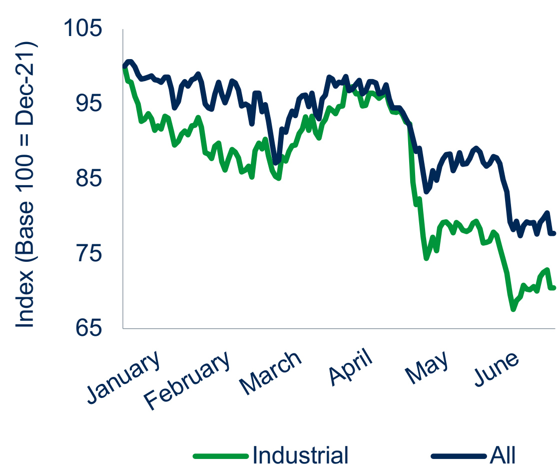
The need for corporates to bolster and future proof their supply chains remains—and when combined with the expected growth in European e-commerce in the coming decade, suggests that the structural tailwinds remain considerable for the logistics sector.

EUROPEAN LOGISTICS: SPECUALTIVE DEVELOPMENT



Source: JLL. As of May 2022.

EUROPEAN REIT PRICES IN 2022



Source: Bloomberg. As of June 30, 2022.

Occupier & Investment Markets

ACCOMMODATION SECTOR

European house prices have increased by around 10% pa through Q1 2022. The Netherlands heads the European national pack at nearly 20% pa, with Italy seeing a more modest pace of appreciation at 3%–4% pa.

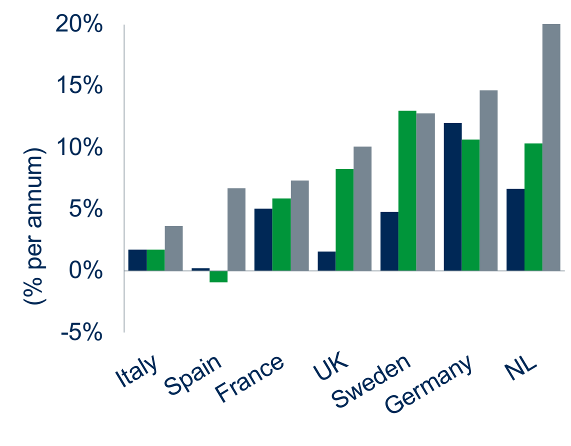
Market momentum is now expected to ebb away in the coming quarters, due to the combination of higher interest rates and poor consumer confidence levels. Risks to the downside are increasing, but providing labor market shortages remain supportive and job security anxieties low, a possible price correction could be modest. Prices will remain out of reach for most first-time-buyers, with positive implications for sustaining rental demand.

Due to more stringent bank regulation in the post-Global Financial Crisis era, there has been no bubble in mortgage debt. As a result, still low rates (by historical standards) mean mortgage payments as a proportion of household income remain low. Rising interest rates will negatively impact affordability, but the shift away from variable to fixed rate mortgages means the impact will only gradually drip feed into housing markets.

Investment interest in European residential property has surged, with transaction volumes trebling to nearly 30% of total deal flow over the past decade. With home ownership out of reach for the majority, even if prices were to drop sharply, the case for sustained and rising rental demand underpins a compelling investment case for residential assets in the right locations.

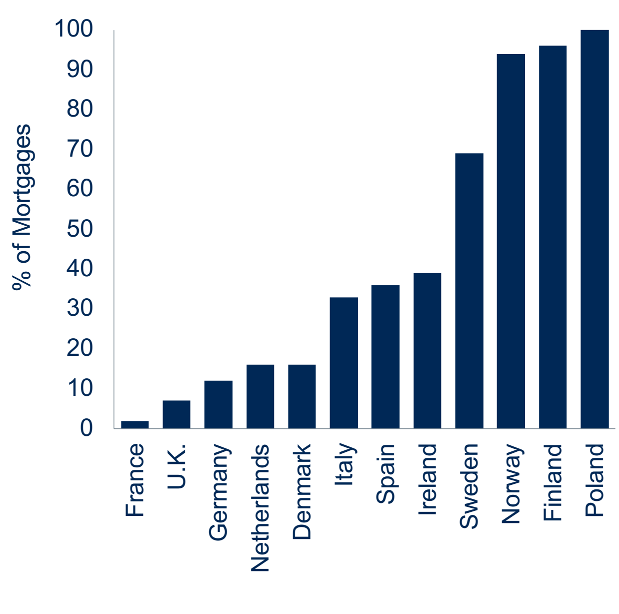
More stringent regulations are an increasing political risk to the sector. While rent controls would limit future growth potential, on the upside, increased security of tenure reduces tenant turnover and increases certainty and duration of rental income. Rising pressure to modernize existing housing stock via a stricter ESG regulatory environment will likely present additional investment opportunities.

EUROPEAN HOUSE PRICES



Source: Oxford Economics. As of July 2022.

EUROPEAN RESIDENTIAL: VARIABLE MORTGAGE RATES



Source: OECD, Knight Frank, The Economist. As of May 2022.

About the Team

Barings Real Estate's research team is structured by sector and geographic expertise, with efforts led by Dags Chen in the U.S. and Paul Stewart in Europe. The team has a diverse background covering various industries, asset classes and countries, which is complemented by an analytics function enhancing the team's ability to collect, augment and analyze data to inform better decision making.

Paul Stewart

Head of Real Estate Research & Strategy—Europe

Ben Thatcher

Associate Director

Jo Warren

Director

Important Information

Any forecasts in this document are based upon Barings opinion of the market at the date of preparation and are subject to change without notice, dependent upon many factors. Any prediction, projection or forecast is not necessarily indicative of the future or likely performance. Investment involves risk. The value of any investments and any income generated may go down as well as up and is not guaranteed. Past performance is no indication of current or future performance. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. Any investment results, portfolio compositions and or examples set forth in this document are provided for illustrative purposes only and are not indicative of any future investment results, future portfolio composition or investments. The composition, size of, and risks associated with an investment may differ substantially from any examples set forth in this document. No representation is made that an investment will be profitable or will not incur losses. Where appropriate, changes in the currency exchange rates may affect the value of investments. Prospective investors should read the offering documents, if applicable, for the details and specific risk factors of any Fund/Strategy discussed in this document. For Professional Investors / Institutional Investors only. This document should not be distributed to or relied on by Retail / Individual Investors. Barings LLC, Barings Securities LLC, Barings (U.K.) Limited, Barings Global Advisers Limited, Barings Australia Pty Ltd, Barings Japan Limited, Barings Real Estate Advisers Europe Finance LLP, BREAE AIFM LLP, Baring Asset Management Limited, Baring International Investment Limited, Baring Fund Managers Limited, Baring International Fund Managers (Ireland) Limited, Baring Asset Management (Asia) Limited, Baring SICE (Taiwan) Limited, Baring Asset Management Switzerland Sarl, and Baring Asset Management Korea Limited each are affiliated financial service companies owned by Barings LLC (each, individually, an "Affiliate"), together known as "Barings." Some Affiliates may act as an introducer or distributor of the products and services of some others and may be paid a fee for doing so.

NO OFFER: solicitation for the purchase or sale of any financial instrument or service in any jurisdiction. The material herein was prepared without any consideration of the investment objectives, financial situation or particular needs of anyone who may receive it. This document is not, and must not be treated as, investment advice, an investment recommendation, investment research, or a recommendation about the suitability or appropriateness of any security, commodity, investment, or particular investment strategy, and must not be construed as a projection or prediction.

In making an investment decision, prospective investors must rely on their own examination of the merits and risks involved and before making any investment decision, it is recommended that prospective investors seek independent investment, legal, tax, accounting or other professional advice as appropriate.

Unless otherwise mentioned, the views contained in this document are those of Barings.

These views are made in good faith in relation to the facts known at the time of preparation and are subject to change without notice. Individual portfolio management teams may hold different views than the views expressed herein and may make different investment decisions for different clients. Parts of this document may be based on information received from sources we believe to be reliable. Although every effort is taken to ensure that the information contained in this document is accurate, Barings makes no representation or warranty, express or implied, regarding the accuracy, completeness or adequacy of the information.

These materials are being provided on the express basis that they and any related communications (whether written or oral) will not cause Barings to become an investment advice fiduciary under ERISA or the Internal Revenue Code with respect to any retirement plan, IRA investor, individual retirement account or individual retirement annuity as the recipients are fully aware that Barings (i) is not undertaking to provide impartial investment advice, make a recommendation regarding the acquisition, holding or disposal of an investment, act as an impartial adviser, or give advice in a fiduciary capacity, and (ii) has a financial interest in the offering and sale of one or more products and services, which may depend on a number of factors relating to Barings' business objectives, and which has been disclosed to the recipient.

OTHER RESTRICTIONS: The distribution of this document is restricted by law. No action has been or will be taken by Barings to permit the possession or distribution of the document in any jurisdiction, where action for that purpose may be required.

Accordingly, the document may not be used in any jurisdiction except under circumstances that will result in compliance with all applicable laws and regulations.

Any service, security, investment or product outlined in this document may not be suitable for a prospective investor or available in their jurisdiction. Any information with respect to UCITS Funds is not intended for U.S. Persons, as defined in Regulation S under the U.S. Securities Act of 1933, or persons in any other jurisdictions where such use or distribution would be contrary to law or local regulation.

INFORMATION: Barings is the brand name for the worldwide asset management or associated businesses of Barings. This document is issued by one or more of the following entities:

Barings LLC, which is a registered investment adviser with the Securities and Exchange Commission (SEC) under the Investment Advisers Act of 1940, as amended (Barings LLC also relies on section 8.26 of NI 31-103 (international adviser exemption) and has filed the Form 31-103F2 in Ontario, Quebec, British Columbia, Alberta, Nova Scotia, Manitoba, New Brunswick, Newfoundland and Labrador, Prince Edward Island and Saskatchewan); Barings Securities LLC, which is a registered limited purpose broker-dealer with the Financial Industry Regulatory Authority (Barings Securities LLC also relies on section 8.18 of NI 31-103 (international dealer exemption) and has filed the Form 31-103F2 in Ontario, Quebec, British Columbia, Alberta, Nova Scotia, Manitoba, New Brunswick, Newfoundland and Labrador, Prince Edward Island and Saskatchewan);

Barings (U.K.) Limited, which is authorized and regulated by the Financial Conduct Authority in the United Kingdom (Ref No. 194662) and is a Company registered in England and Wales (No. 03005774) whose registered address is 20 Old Bailey, London, EC4M 7BF.

The document is for informational purposes only and is not an offer or Barings Global Advisers Limited, which is authorized and regulated by the Financial Conduct Authority in the United Kingdom (Ref No. 552931) and is a Company registered in England and Wales (No. 07622519) whose registered address is 20 Old Bailey, London, EC4M 7BF and is a registered investment adviser with the SEC; Baring Asset Management Limited, which is authorized and regulated by the Financial Conduct Authority in the United Kingdom (Ref No. 170601) and is a Company registered in England and Wales (No. 02915887) whose registered address is 20 Old Bailey, London, EC4M 7BF; Baring International Investment Limited, which is authorized and regulated by the Financial Conduct Authority in the United Kingdom (Ref No. 122628), and is a Company registered in England and Wales (No. 01426546) whose registered address is 20 Old Bailey, London, EC4M 7BF, is a registered investment adviser with the SEC (Baring International Investment Limited also relies on section 8.26 of NI 31-103 (international adviser exemption) and has filed the Form 31-103F2 in Quebec and Manitoba;

Barings Real Estate Advisers Europe Finance LLP, which is authorized and regulated by the Financial Conduct Authority in the United Kingdom (Ref No. 401543); or

BREAE AIFM LLP, which is authorized and regulated by the Financial Conduct Authority in the United Kingdom (Ref No. 709904);

Baring Fund Managers Limited, which is authorized as a manager of collective investment schemes with the Financial Conduct Authority in the United Kingdom and is authorized as an Alternative Investment Fund Manager in several European Union jurisdictions under the Alternative Investment Fund Managers Directive (AIFMD) passport regime;

Baring International Fund Managers (Ireland) Limited), which is authorized as an Alternative Investment Fund Manager in several European Union jurisdictions under the Alternative Investment Fund Managers Directive (AIFMD) passport regime and, since April 28, 2006, as a UCITS management company with the Central Bank of Ireland;

Baring Asset Management Switzerland Sàrl, which is authorized by the Switzerland Financial Market Supervisory Authority to offer and/or distribute collective capital investments;

Barings Australia Pty Ltd (ACN 140 045 656), which is authorized to offer financial services in Australia under its Australian Financial Services License (No: 342787) issued by the Australian Securities and Investments Commission;

Baring Asset Management (Asia) Limited, which is licensed by the Securities and Futures Commission of Hong Kong to carry on regulated activities Type 1 (dealing in securities), Type 2 (dealing in futures contracts), Type 4 (advising on securities), Type 5 (advising on futures contracts) and Type 9 (asset management) in Hong Kong in accordance with the requirements set out in the Securities and Futures Ordinance (Cap 571);

Barings Japan Limited, which is registered as a Financial Business Operator (Registration No. 396-KLFB) for Type II Financial Instruments Business, Investment Advisory and Agency Business, and Investment Management Business with the Financial Services Agency in Japan under the Financial Instruments and Exchange Act (Act No. 25 of 1948);Baring SICE (Taiwan) Limited, an independently operated business (Business license number: 2008 FSC- SICE- Xin- 030; Address: 21 F, No.333, Sec. 1 Keelung Road, Taipei 11012; Taiwan Contact telephone number: 0800 062 068); or

Baring Asset Management Korea Limited, which is authorized by the Korean Financial Services Commission to engage in collective investment business and is registered with the Korean Financial Services Commission to engage in privately placed collective investment business for professional investors, discretionary investment business and advisory business.

Copyright

Copyright in this document is owned by Barings. Information in this document may be used for your own personal use, but may not be altered, reproduced or distributed without Barings' consent.