28 Jan 2022

Research Briefing | Global

Real estate to outperform bonds and equities

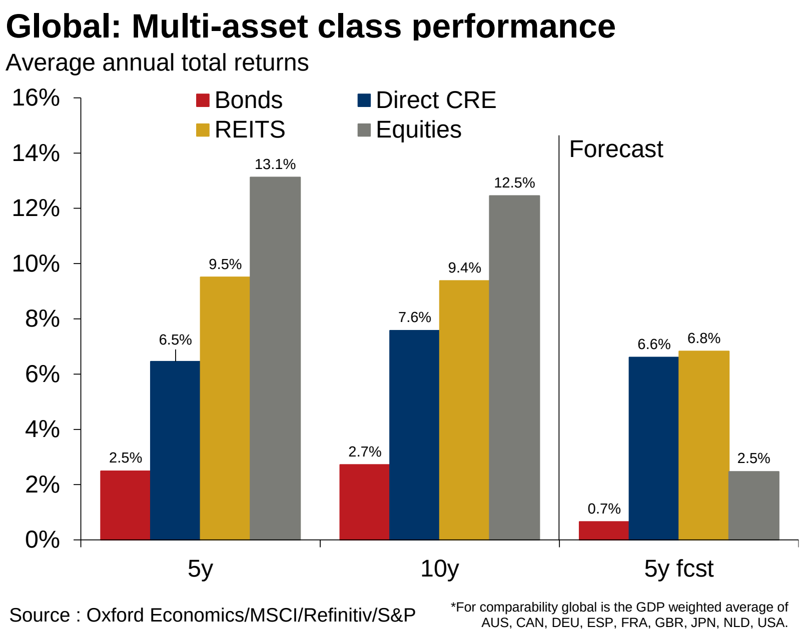
Economist

Mark Unsworth
Associate Director
+44(0)20 3910 8129

- **Global real estate returns are looking healthy over the next five years, providing a strong relative performance versus bonds and equities.**
- **We forecast total returns for global direct real estate and REITs to average 6.5% to 7% annually over 2022-2026, significantly above bonds and equities, which are projected to return 0.7% and 2.5% per annum, respectively.**
- **We also expect global economic expansion to support real estate income growth while structural forces keep long-run interest rates low, thus moderating the near-term impact of rate increases on property yields.**
- **That said, risks from persistently higher inflation remain. Plus, there are uncertainties regarding the longer-term real estate outlook, such as the effect of structural forces on demand and the degree to which the climate transition affects obsolescence and future supply.**

Global real estate returns have outperformed bonds over the past five and 10 years, and we expect that trend to continue over the forecast horizon, with global direct real estate and REITs delivering returns of around 6.5% to 7% on average over 2022-2026, well above the 0.7% that we expect for bonds and the 2.5% for equities **(Figure 1)**. In particular, stocks look overvalued relative to macroeconomic fundamentals, given their high starting valuations, as reflected in the higher dividend yield on offer for REITs.

Figure 1: Global public and private real estate are projected to outperform



Contact: Mark Unsworth | munsworth@oxfordeconomics.com

Real estate to outperform bonds and equities

Allocations to bonds are declining

In 2021, global bond markets recorded their lowest annual return since 1999 **(Figure 2)** on the back of inflationary pressures due to supply-chain challenges, energy and commodity price rises, and labour supply constraints. Higher inflation pushed real returns lower and has raised the likelihood of faster monetary policy tightening, with the Bank of England having already acted in December and the US Federal Reserve looking set to follow this March.

In this environment, investors continue to reduce their exposure to bonds and look for alternative opportunities to invest in stable and predictable income streams. In fact, bond allocations have been declining for some time now, according to data on pension fund allocations from the OECD **(Figure 3)**.

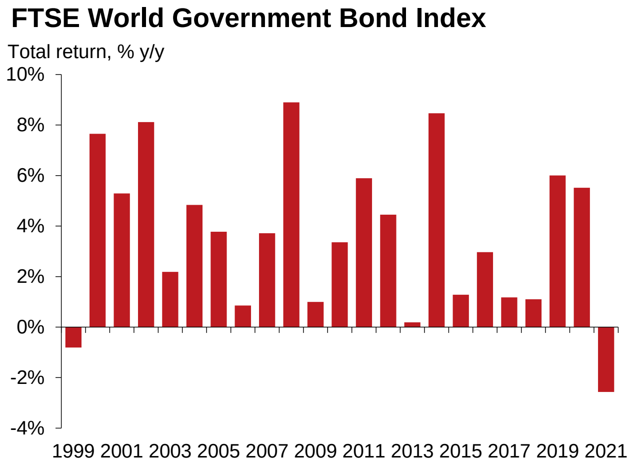
Real assets, and real estate in particular, have gained in popularity as an alternative due to their fixed-income-like characteristics, despite greater illiquidity and depreciation risks. This has been especially true for real estate with long leases and some inflation protection, whether that's directly from indexation or indirectly through structural supply-demand imbalance.

Committed capital to real estate is elevated

Real estate's strong relative performance in a multi-asset class context is reflected by rising target allocations and higher committed capital. [INREV recently reported]() their 2022 investor intentions survey results which estimated an average global real estate allocation of just under 9% with a target allocation at just over 10%, suggesting plenty of scope for higher investment activity this year. Indeed, this is corroborated by the Cornell University and Hodes Weill allocations survey (November 2021) showing that target allocations have been rising globally, albeit with APAC and EMEA seeing the largest gains **(Figure 4)**.

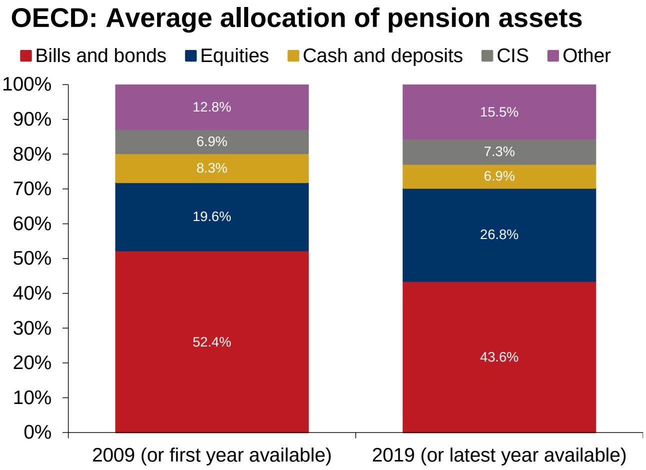
In terms of real estate investment strategies, INREV reported an increased preference for value-added strategies at 57%, the highest level since 2008. This is perhaps indicative of the degree of structural change facing the asset class currently, whether from rising online penetration rates impacting the retail and logistics sectors, hybrid working impacting offices, or the climate transition and net-zero affecting all sectors.

Figure 2: Last year, global bonds recorded the lowest return since 1999



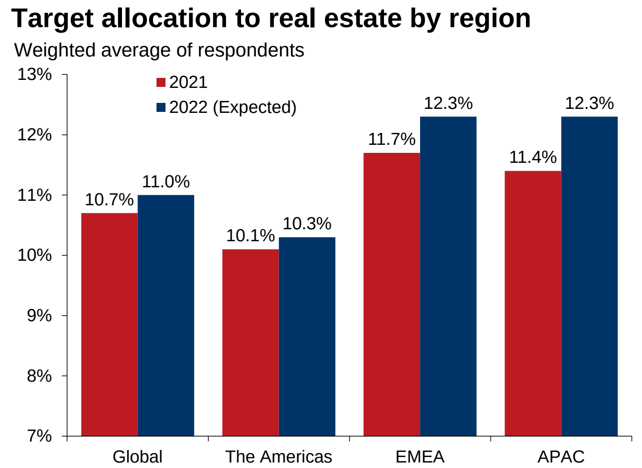
Source : Oxford Economics/Refinitiv

Figure 3: A long-run reduction in bond allocations



Source : Oxford Economics/OECD

Figure 4: Allocations to real estate are on the rise, particularly in APAC and EMEA



Source : Oxford Economics/Cornell University/Hodes Weill

OXFORD ECONOMICS

Real estate to outperform bonds and equities

This is supported by global real estate dry powder which is near a record high, with value-added and opportunistic strategies accounting for the largest share **(Figure 5)**. Notably, the real estate debt investment strategy has experienced continued growth, doubling its share from 10% of dry powder 10 years ago to around 20% in 2021. The rise of nonbank lending has been driven by increases in banks' regulatory capital, which have constrained traditional lending to real estate.

Structural forces to keep long-run rates low

The positivity towards real estate has been supported by the generous spread to bonds. For example, in 2021 the spread was around 200 basis points in the US and 350 basis points in Germany **(Figure 6)**. However, the risk premium gradually reduces over the coming years as interest rates rise. We do anticipate a reaction from property yields, albeit delayed and relatively muted, due to the weight of capital targeting the asset class and the healthy economic outlook. That outward yield shift returns the risk premium to around 150bps to 200bps, which looks more akin to a normalisation in relative pricing.

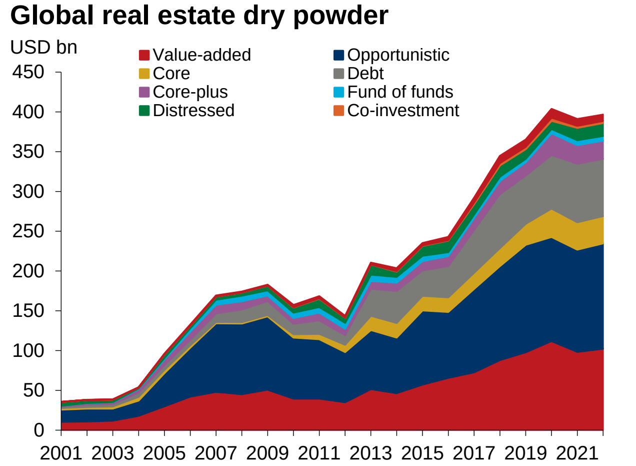
Our medium-to-long-term property yield forecast is low by historic standards, despite moving outwards within the next five years. We believe that structural forces will keep long-run interest rates low – with increased longevity and lower fertility rates resulting in a savings glut that persists over the coming decades, keeping the real neutral interest rate negative.

Nonetheless, the outward movement of property yields over the medium term does switch the focus to rental growth and the real economy, in order to drive future capital value appreciation.

Economic growth supports rental growth

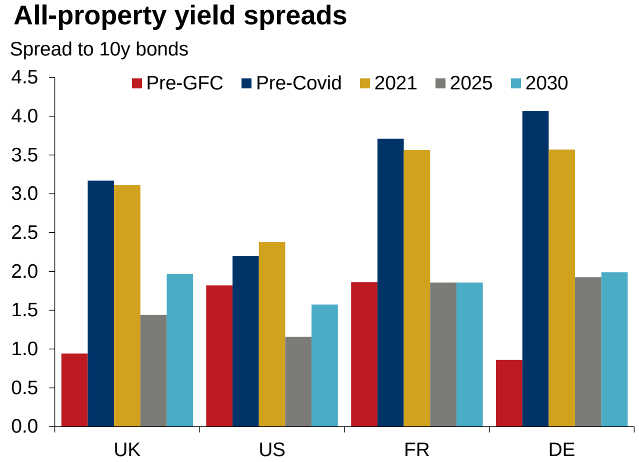
There is a strong relationship historically between economic growth and rental growth at the all-property level **(Figure 7)**. In the near term, we expect economic growth to be above average, before returning to its long-term trend level in the latter forecast years. This profile should generate a decent uplift in all-property rental growth rates. In fact, by 2026 we believe rental growth in Europe will still be higher than the period since the GFC, supported by the industrial and residential sectors and the modest recovery in retail – which removes its drag on performance.

Figure 5: Committed capital is near all-time highs



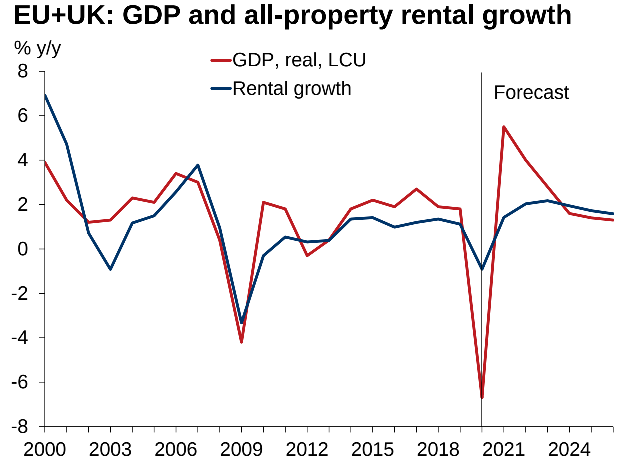
Source: Oxford Economics/Preqin

Figure 6: The real estate risk premium normalises over the long run



Source : Oxford Economics/Haver Analytics/MSCI

Figure 7: Healthy economic growth supports rental growth over the next five years



Source : Oxford Economics/Haver Analytics/MSCI

Centre stage for sectors

We have a high conviction on the industrial sector, expecting global returns of nearly 9% pa over the next five years **(Figure 8)**. The structural tailwind provided by e-commerce provides compelling support for demand while the low energy intensity and shallower decarbonisation pathway makes good sense for portfolios with net-zero commitments.

At the other end of the spectrum are hotels with returns of 5.5% pa globally over 2022-2026. International tourism is set to be slow to recover – reaching 2019 levels by 2024 – while business travel could lag as companies examine both the cost and carbon footprint of business trips more closely.

Globally, allocations are increasing to residential which is supported by demand from urbanisation, smaller households, and affordability constraints on home ownership. Residential therefore has the second-highest return globally, at nearly 7% pa for 2022-2026.

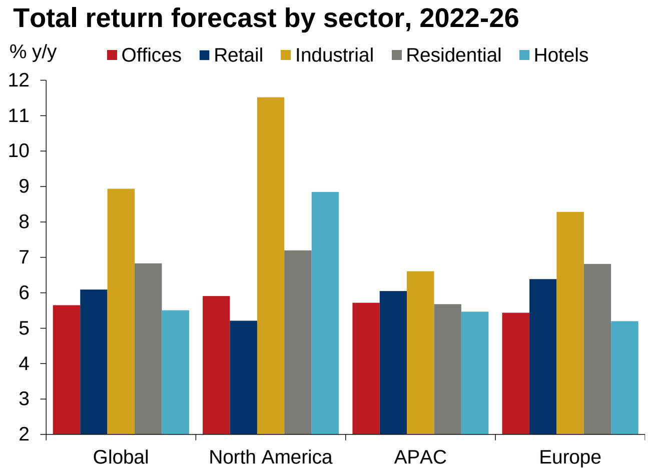
For offices, the pandemic has accelerated hybrid working practices and the focus on net zero. Retrofitting existing buildings to improve sustainability and let-ability is now key to supporting value and defending against obsolescence. We expect global office returns to be 5.6% pa over 2022-2026, with variation depending on quality and location.

The retail outlook is mixed, with the UK entering a recovery phase, while structural headwinds in the US and Canada will continue to act as a drag on performance. Overall, we forecast a return of 6% pa over the next five years, better than hotels and offices but below residential and industrial.

A return of inflation poses the biggest risk

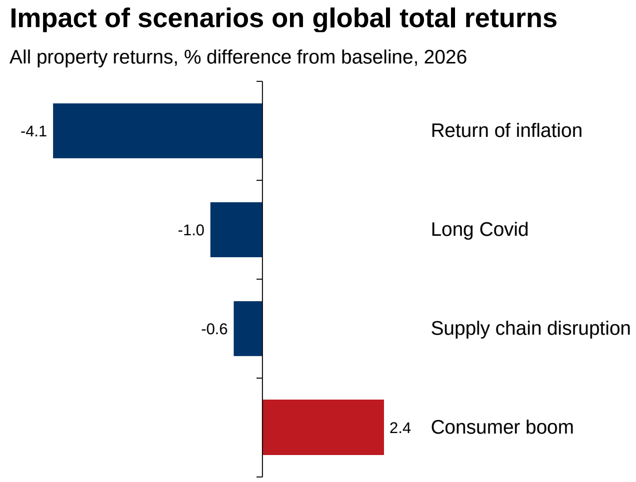
However, our baseline forecasts are subject to uncertainty, particularly given the inflationary environment. Global real estate returns suffer in our return-of-inflation scenario **(Figure 9)**, as commodity prices rise, labour market participation stays low, and bond yields surge. While property can serve as a strong hedge against inflation in certain instances, it doesn't act as an effective hedge against cost-push inflation, which we believe is still the most significant type of inflation globally at present, albeit with some regional variation. Overall, this is the most damaging scenario for property, with global returns 4% below the baseline by 2026.

Figure 8: Industrial and residential performance leads the way, with hotels lagging



Source : Oxford Economics/MSCI

Figure 9: A return of inflation scenario is most damaging for real estate



Source: Oxford Economics/MSCI

Appendix – Model-driven real estate forecasts

Global real estate returns are looking healthy over the next five years, reflecting the continued weight of capital targeting the asset class and the strong expected performance for the residential and industrial sectors in particular.

Oxford Economics asset class forecasts are driven by our Global Economic Model which provides a consistent and transparent framework for the assessment of returns based on macroeconomic fundamentals.

Below we outline the prospects for some of the key drivers of real estate performance in our Global Economic Model.

Drivers of real estate performance

Employment in financial, business, and professional services: generally weaker growth over the next five years relative to the past five years, especially where demographics start to act as a drag on growth.

GVA in manufacturing, transportation, and storage: strong growth over the next five years, and generally better than the past five years, with national nuance depending on the pandemic period expansion in online sales and the impact of supply-chain disruption on manufacturing activity.

GVA in hotels and catering: a strong recovery over the next five years in response to the removal of pandemic restrictions and the re-emergence of travel and tourism demand.

GVA in construction activity: above-average construction activity in the near term before stabilising, which suggests new development supply for real estate will moderately increase over the coming years, albeit from low levels.

Private consumption: excess savings boost consumption in the near term before reverting to a growth rate consistent with the pre-pandemic period.

House prices: house price growth to slow from the exceptional pace of recent years, but affordability constraints remain an issue.

CPI Inflation: inflation remains above target in 2022 before falling back in 2023 as supply chain and energy price distortions dissipate, albeit inflation remains higher than generally recorded over 2015-19 and with regional variation.

Ten-year government bond yields: bonds continue to rise in response to higher inflation and monetary policy tightening but remain low by historic standards.

Share price index: high valuations for equities, relative to macroeconomic fundamentals, act as a drag on future performance.

For more details on our approach, please see our full real estate model methodology paper.