Global Property Strategy

From safe haven to the next bubble?

March 2012

Summary:

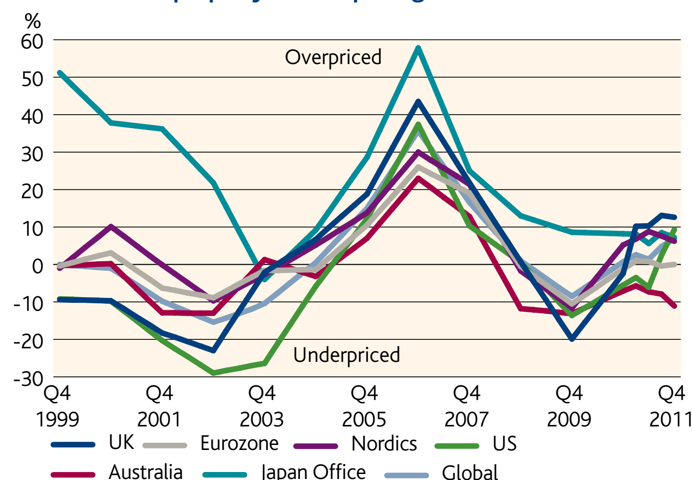
- Aberdeen's long term leading indicator suggests that pricing of the global property market deteriorated markedly in 2011
- Negative real interest rates risk overheating of core property in major markets
- Neglected markets and strategies should eventually present best medium term investment prospects

Property market overpricing becoming more marked

Aberdeen's long term leading indicator suggests a 7% overpricing of the global property market in Q4 2011, which is a marked deterioration from a fairly priced position at the end of 2010 (see chart 1). A jump in capital values in North America is the most notable development in the past six months pushing the market into the most overpriced position since Q4 2007. The US joins the UK and the Nordics in making a transition from significant underpricing back in 2009 to a position of overpricing today.

Pricing of the eurozone, on the other hand, has been stable; a weaker outlook for property income has been offset by a 50 basis point cut in interest rates in Q4 2011. Eurozone markets present far from a uniform picture, with northern Europe underpriced, while southern markets appear overpriced by almost 10%. In the Asia Pacific region, lower interest rates have made Australia even more attractive among major global markets, while in Japan the office market remains expensive but other Japanese sectors are estimated to be underpriced.

Chart 1: Global property market pricing[A]



Source: Aberdeen Asset Management, Feb 2012.
PAST PERFORMANCE IS NOT A GUIDE TO FUTURE RESULTS.

Market pricing can change because of an adjustment in interest rates, a revision to income growth prospects, or a movement in capital values. Interest rates are close to zero in most economies but could fall further in the eurozone and Nordics because of weak growth. Australian interest rates could also drop in the face of a moderate slowdown in activity in the Asia Pacific region. Increases in interest rates seem to be off the cards for now, with, for example, the Federal Reserve forecasting (though not promising) that interest rates will not rise in the US until 2014. Other major central banks are unlikely to deviate significantly from the US position, to prevent an undesired rise in their local currency.

US and Germany stand out from the crowd

We expect capital values to be lower across much of Europe in the next three to six months as bank lending terms have tightened significantly and investor and occupier market sentiment has deteriorated (see chart 2). Germany is the odd man out in Europe, with unemployment falling to post-unification lows, and property lending markets improving as local banks focus on the domestic market rather than lending externally. Outside of Europe, we expect capital values to broadly hold-up due to a combination of better economic prospects and credit market conditions, with US property values likely to continue rising.

[A] Note that historic pricing estimates for Japan are only available for the office sector

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Chart 2: Short term market indicators

Indicators of momentum and short term forecast	Property yield versus nominal and real bond yields	Financial market conditions	Employment growth (expected)	GDP growth (expected)	Occupier market sentiment	Investment market sentiment	Expected direction of capital values in the next 3-6 months
USA	+		+		-	+	Up
UK	+	-	-	-	-		Down
Nordics	+	-	-	-	-		Down
Canada	+	-	+		+	+	Up
Germany	+	-	+		+	+	Up
France	+	-	-	-	-		Down
Spain	-	-	-	-	-	-	Down
Italy	-	-	-	-	-	-	Down
Australia	+	-				-	Stable
Japan	-	-	-			+	Down
Global	+	-		-	-	-	Down

Note: Across the six short term indicators, net scores are calculated by subtracting negative results from positive results. Capital value direction is judged as follows: Net score of +2 or greater is 'Up', net score between -1 and +1 is 'Stable', and a negative score of -2 or weaker is "Down".

Source: Aberdeen Asset Management, Feb 2012.

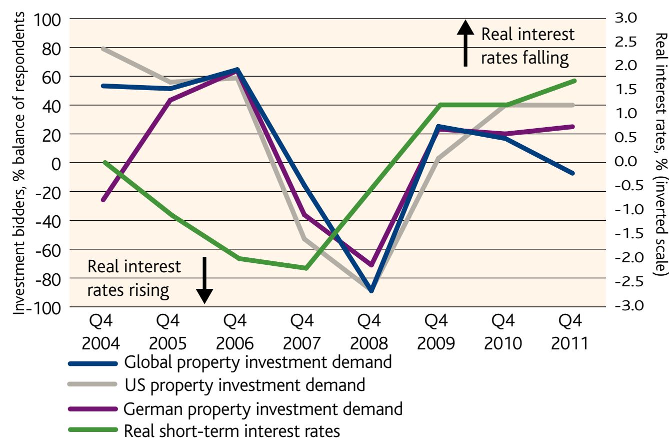
Projections are offered as strategy goals and are not referenced to past performance. Projections are not guaranteed and actual events or results may differ materially.

Negative real interest rates risk the next bubble?

The main thrust of economic policy in major advanced economies is to keep interest rates below the rate of inflation on a sustained basis, forcing investors with liabilities linked to inflation to invest into risky assets, including property. We believe that the weight of demand for perceived safe-haven property assets may push capital values strongly above their fundamental value in the next 12 months. Investment demand is only evident for core assets in major economies, and markets with a perceived stable economic environment, such as the US and Germany (see chart 3). Determining a property bubble even amid rapid price rises is notoriously difficult, let alone projecting a bubble in advance; nonetheless we fear that rising demand for property in core markets risks significant overheating, with some markets already priced at highly elevated levels.

Further increases in US capital values may push the market to an even more extreme position of overvaluation. In the case of Germany, while we believe that retail and industrial property represent good value today, the window of opportunity could be closing given that the country tops most investors' target for deploying capital in 2012. In the Asia Pacific region, the smaller markets of Hong Kong and Singapore are already in extremely overheated territory, but we don't see overheating risks in Australia and Japan due to still relatively high domestic interest rates in the former, and only modest economic growth in the latter.

Chart 3: Global investor sentiment and real interest rates



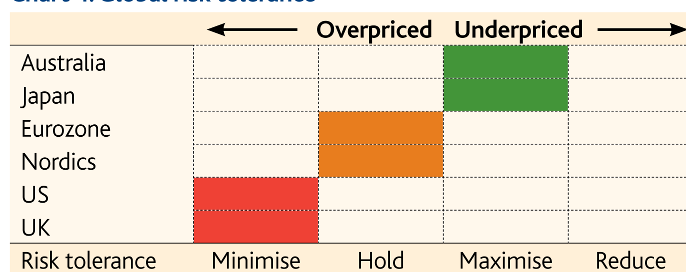
Source: RICS, Reuters Ecowin, Aberdeen Asset Management, Feb 2012.

Low nominal and real interest rates cannot "float all boats" as investors are likely to avoid markets with significant question marks over economic prospects. Moreover, secondary property continues to be shunned in Europe and the US. A particular concern is the rising volume of maturing bank and CMBS loans over 2012/2013 with poor quality assets, and mounting regulatory and capital adequacy requirements on banks which increases pressure to shed risky property loans from balance sheets. However, by the end of 2012 and the first half of 2013, neglected markets and strategies (such as value add) may present opportunities for reaping strong medium term returns. Safe haven assets are unlikely to generate good returns over the medium term even if they sustain an overpriced position for a prolonged period of time.

Low risk tolerance warranted but some opportunities opening up

For core investors, we still favour low risk tolerance in most markets, and investors should be reducing risk or holding low risk portfolios (see chart 4). Low risk does not necessarily mean selling all holdings; core assets can be held so long as the income stream is secure (buildings with long leases and low vacancy rates) but secondary assets are deemed vulnerable to a correction in values. Only in the case of the major Asia Pacific markets of Australia and Japan, do we recommend raising risk. By sector, offices are very expensive on a global basis, particularly in first tier/gateway cities, and investors do not appear to be compensated for taking risk. Long term value though can be still found in the retail and industrial markets in selected markets, where higher risk positions are warranted.

Chart 4: Global risk tolerance



Risk tolerance is defined as the following:

- Minimise: risk tolerance low; sell risky assets; create / hold low risk assets
- Hold: risk tolerance low; hold low risk portfolio
- Maximise: risk tolerance high; buy assets, typically riskier assets offer best value but not appropriate for all funds
- Reduce: risk tolerance medium; buy assets; create low risk assets; sell risky assets if asset management initiatives not feasible

Source: Aberdeen Asset Management, Feb 2012.

Conclusion: Go East

On a global basis, we believe major advanced Asia Pacific markets offer the best opportunity to pursue at this point in time, with a slowdown in key emerging markets like China, already factored into property market pricing. Looking 12 months ahead, lower capital values in Europe should put the region in a better priced position, with underpricing a strong possibility. If the eurozone sovereign debt crisis were to worsen in 2012, the eventual low in property prices should be even deeper. We would again highlight that Spanish retail and industrial property are underpriced, and the new government's attempt to tackle problem loans on bank balance sheets should facilitate price falls to market clearing levels. On the other hand, for the overpriced US market, there may well be short term upward momentum in capital values, but this implies a greater degree of overpricing and very moderate core asset returns on a 3 to 5 year horizon.

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