

Second half-year 2024

Key takeaways

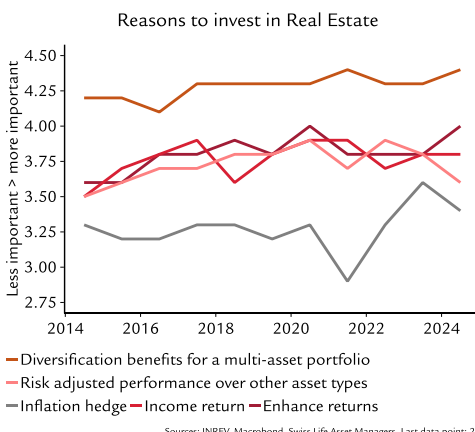
- **Market entry opportunity:** with central banks reaching their targets, monetary policy normalising and hence generating more visibility for investors, entering the market now is advantageous, and long-term investors in particular are in a strong position.
- **No return to pre-pandemic spreads:** focusing on income generation is the approach moving forward, as there are limited opportunities for substantial yield-driven capital growth.
- **Self-responsibility:** one of real estate’s key strengths is the ability to improve income streams by leveraging professional asset management expertise to drive outperformance.
- **Asset and sectoral performance will vary more in the coming years:** adopting a case-by-case investment conviction and formulating themes (such as 4 L’s) based on mega-trends rather than following a pre-defined sectoral allocation creates value for investors.
- **Partner up: close collaboration with tenants, operators and developers** to find innovative solutions for assets and spaces that have potential for profitable outcomes.

Triple normalisation

The sharp surge in inflation prompted central banks to implement the most aggressive monetary policy tightening for at least four decades. Now that inflation is returning to the central banks’ target values, a shift in monetary policy to a neutral orientation is expected over the next few quarters, with central banks cutting interest rates. These developments entail a third normalisation: as interest rates are declining rapidly for

short maturities and remain stable at the longer end of the yield curve in the coming year, the anomaly of the inverse yield curve is expected to disappear. Furthermore, structural factors suggest a higher inflation rate than what was experienced during the decade preceding the pandemic. For Europe’s economies, we estimate this premium to be around 0.7 to 1.0 percentage points.

Chart in focus



Why do investors invest in real estate? With the “TINA” (There Is No Alternative) assumption now a thing of the past, and as we transition to a new interest rate environment, many investors might find themselves asking this question. INREV conducted a global study on this topic, revealing that diversification benefits within a multi-asset portfolio remain the most important factor. A clear sign why real estate remains an investment alternative. And although inflation hedging has gained significance in response to rising inflation, this is actually the least influential factor in the study’s findings.

In several European economies, the inflation target set by the central banks has now been achieved, thanks to previous monetary policy tightening. Consequently, long-term inflation expectations among investors and households are once again firmly anchored. And the risk of a wage/price spiral appears to have been averted in Europe. With these developments, there is no longer a reason not to benefit from this normalisation and steer monetary policy back into the normal range. This normalisation supports an ongoing positive trend: lower financing charges are bolstering corporate investment activity. Anecdotal evidence and the ECB survey of commercial banks indicate that banks have stopped making their lending policies any more restrictive. In addition to the improved investment climate, the rise in real wages is contributing to an enhanced economic environment. We expect this revival of economic momentum to guide us back to long-term potential growth in 2025.

Market entry opportunity

While we forecast central bank rate cuts over the course of 2024, we do not expect key interest rates to return to their pre-pandemic lows. Although inflation will decline, it is unlikely to fall much below central banks' targets, necessitating that rates remain sufficiently restrictive. Consequently, we believe we have entered a new macroeconomic environment of higher long-term rates. Real estate yields have increased to accommodate higher interest rates, and pricing is settling into a new normal. The repricing creates opportunities for long-term positive performance. We believe that price corrections have reached a level where it makes sense to (re-)enter the market.

Investments to pick up again

This is why we believe that investment activity is expected to normalise as we enter the second half of the year. Many investors find it encouraging that that yield adjustments are fading out, many European elections are already completed, and that there is an overall acceptance that we have arrived in a new cycle. Data from RCA shows that the investment volume in the second quarter of 2024 has increased by around 28% compared to the first quarter, while remaining 2% lower than a year ago. We expect overall transactions to be 20% higher in 2024 than in 2023, underpinning our belief that there will be an upturn in investment activity in the coming months. Considering the first two quarters, our investment preference around the 4L's (Living, Logistics, Light Industrial, Life Science &

Tech) is confirmed once again: for Residential, the most prominent living theme, investment volume was 78% higher in the second quarter than in the first. Re-financing pressure will continue to bring sellers to the market while equity dry powder remains high.

Normalising developments

The pace of rental and yield development is slowing across sectors. For example, in the office segment, prime initial yields expanded further in nearly 60% of centres in the first quarter of 2024 compared to 90% of markets in the fourth quarter of 2023, according to PMA. UK provincial markets continue to record yield levels above those of continental Europe, while the lowest net yields, at 4% and 4.1%, were once again seen in the Nordic markets of Copenhagen and Stockholm respectively. The slowing of yield adjustments is a clear sign of market adjustment to the new environment and another indication of a market entry window. The pace of rental movements is also slowing: while no rental declines were recorded during Q1 2024, the rental uplifts were relatively modest. Only four markets experienced quarterly growth exceeding 3% according to PMA: M25 West in the UK (7.5% q-o-q), Düsseldorf and Munich (both at 5.3% q-o-q) and Edinburgh (4.7% q-o-q). As supply of quality floor space will be scarcer in the future, we expect rental growth to pick up again.

Future winners

Over the past ten years, the industrial sector has been the top performer in Europe according to MSCI (with the exception of 2016 where its performance of 7.9% was eclipsed by hotel at 9.9% and residential at 8.5%). Over the decade, industrial and logistics performed at 11.3% (followed by residential at 7.1%). It comes as no surprise that investors – including us – currently have a clear preference for these two sectors, backed by robust fundamentals. However, as we look forward, we believe that performances across sectors will vary more significantly than in the past. We anticipate that the strength of demand and relative supply levels will differ by sector and market. Although supply pipelines vary, limited financing is expected to curb new project starts. Long-term trends will influence the rental growth outlook, which will, in turn, impact sector performance. This means that we strongly encourage a case-by-case conviction or a theme-driven investment approach, with a strong focus on 4L's, especially living and logistics, while all other sectors still harbour opportunities, for example in Light Industrial or Life

Science & Tech. Only those who are able to anticipate long-term income will be ahead of the crowd.

Cycles matter, mega-trends even more

One and a half years ago, we wrote that cycles matter, but structural trends matter even more. Now, as we enter a new market cycle with a positive outlook for long-term investors, it is important to remember the fundamentals of long-term income growth. For example, the mega-trend for urbanisation continues to drive residential investment, but what about last-mile solutions that meet the needs of people within a 15-minute range? In our view, this is part of the solution and hence an investment to consider in detail, to foster the living investment fundamentals. How does remote working impact not only office space but also mobility, including how people and goods are transported from one point to another? In our view, the change in mobility is top of the list when it comes to investing in office space. Only commutable offices will be attractive offices. How will the increased focus on preventative health influence future retail spaces, which might be occupied by sports facilities or nutritional vendors? For us, investing in a boutique sports facility could be a solution for empty retail space, enabling consumers' needs to increase their health. And what about actual redevelopment of unused spaces? Identifying tenant needs and working with them to create a narrative for a space or asset is crucial. This approach to asset management is essential for driving income growth.

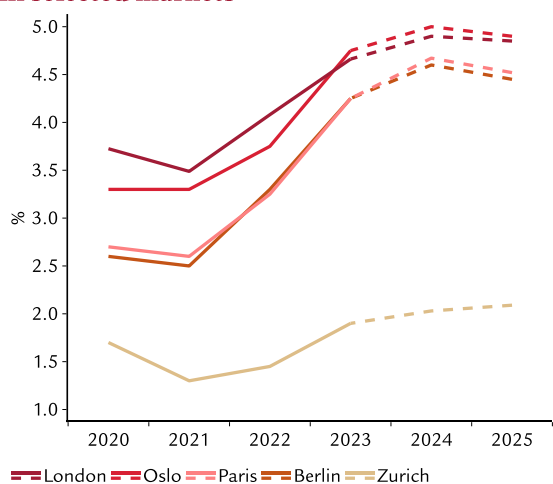
Advantageous self-responsibility

While we might not describe them as “easy gains”, the low-interest-rate environment of the previous cycle did foster steady and relatively high capital growth, leading to strong overall performance in real estate. With the shift to a new interest environment, this advantage has diminished. However, real estate still offers a unique benefit within the spectrum of asset classes: the ability to impact income streams by professional asset management. Unlike other investments, real estate allows asset managers to generate steady income or even increase income by selecting and engaging with tenants effectively. This capability is a key driver of out-performance.

4L's as strong case for investment

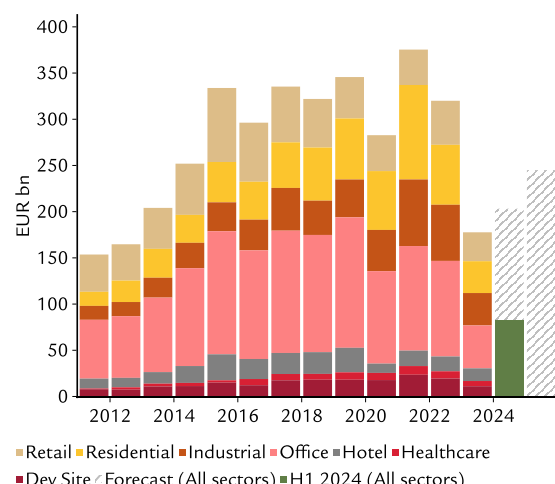
We firmly believe in the potential for opportunities across all sectors by closely monitoring market trends. However, our target allocation strategy is founded on robust, long-term themes that lead to a more resilient sector allocation. We advocate for the 4 L's: Living, Logistics, Light Industrial, and Life Science & Tech. While the first two have already been described, the last two are themes that naturally emerge due to evolving market dynamics driven by the mega trends. Meanwhile, large pharmaceutical companies, for example, are moving away from recognising the investment and operation of their research and laboratory buildings on their own balance sheets and instead seeking external real estate specialists as partners. By aligning investments with the 4 L's, benefitting from long-term market dynamics and emerging opportunities are in reach.

Figure 1: Office prime net initial yield forecasts in selected markets



Sources: PMA, Macrobond, SLAM. Last data point: 2023

Figure 2: Transaction volume incl. forecast



Sources: RCA, Macrobond, SLAM. Last data point: 2024

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