

# GLOBAL OUTLOOK

Grosvenor's research perspective on world real estate markets



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## The world faces up to fiscal tightening

Since the end of July, world stock markets have fallen by between 10% and 15%. It is easy to say with hindsight, but this should not have come as a surprise. The global economy is being caught in a pincer movement between monetary tightening in the emerging markets and the prospect of fiscal contraction in the OECD. Since these two factors have played a major role in the recovery from the GFC their removal was always likely to be significant.

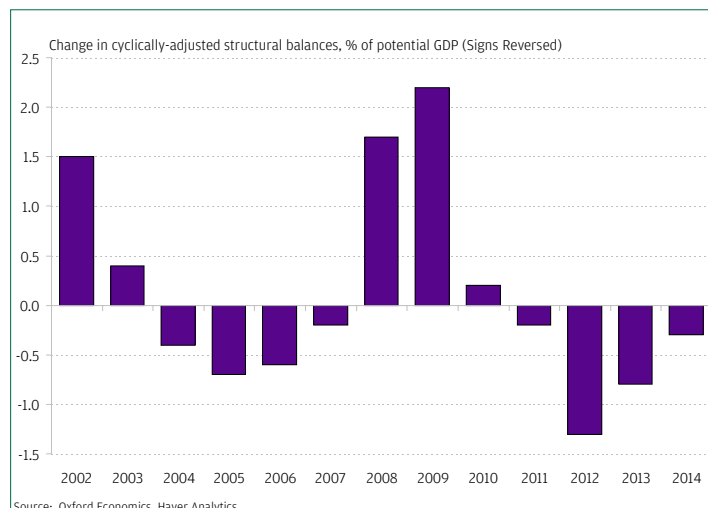
Policy tightening in the emerging markets, due to the build up of inflation has been in play for some months and was probably priced in by world markets. It is the so called 'debt ceiling debate' in the US which seems to have focussed markets on the scale of the fiscal wind back in the developed world. It was not the fact that US politicians appeared to be willing to allow the US to drift into default – this was rightly seen by the markets as political posturing – but that the debt ceiling agreement enshrined fiscal tightening of at least \$2trn over the next decade, at a time when the economy is already struggling. Ironically, it was the increased risk of the US economy being dragged

back into recession that prompted the President to outline proposals for a further stimulus package worth in excess of \$400bn. How much of his 'American Jobs Act' can make it through Congress is yet to be seen, but even if fully enacted this would result in fiscal policy being neutral (at best) in 2012.

Moreover, as markets realised, the US is far from being the only OECD government with fiscal consolidation on the agenda. In fact many European nations would like to be in the US position. The Chart shows the consolidated cyclically adjusted government balance over the next three years. By some calculations it is the sharpest fiscal contraction since 1981. At a time when economic activity is weakening in response to some temporary factors and the policy engineered slowdown in emerging markets, the lack of a potential fiscal boost is extremely worrying.

What is likely to happen? There is now a very high chance of additional quantitative easing in the US, UK and the Eurozone. Arguably the Eurozone has already started down this path with its intervention in the Spanish and Italian bond markets. The ECB will also probably reverse the interest rate cuts it has recently made. We will also probably see monetary easing in the emerging markets. Although inflation remains undefeated, we think that emerging markets, particularly China, will opt for growth over price control in the short term. However, since global growth will probably recover a little in the next six months we see this further round of monetary stimulation taking place in 2012.

### The world is facing a severe fiscal contraction



Richard Barkham  
Group Research Director

# Property cycles and gearing levels

If the root of the Great Financial Crisis was over-gearing in the banking sector, the real estate industry was no exception. Real estate is a very cyclical industry and it ought to be intuitive that gearing be adjusted accordingly. Nonetheless, this has proven difficult to achieve.

The purpose of this research is to take some intuitive approaches in setting gearing levels in real estate portfolios and make them more systematic. In this way they can be more easily applied when confidence is high and markets are over-heating and when confidence is low but there is a clear signal for a buy opportunity.

Below we outline a method of setting gearing levels<sup>1</sup> by reference to an indicator of the global property cycle in order to minimise risk, enhance returns and maximise NAV growth. To be more specific, we outline an approach that helps to ensure that gearing is low at the top of the cycle, high in the trough and the early upswing and moderate in the final part of the upswing.

## Choosing the right indicator

To be useful in setting the level of overall gearing in an international property company a property cycle indicator needs to be:

- Market driven - not subject to the errors that can arise in official data, nor surveys that can be affected by sentiment;
- Timely - available shortly after the month or quarter end to which it applies;
- Smooth - providing a clear rather than a 'noisy' or ambiguous signal;
- Predictive - reliably moves up or down in advance of average commercial property values.

We have evaluated a wide array of economic variables in order to construct a global property cycle indicator including: stock market indices, bond rates, real estate spreads over bonds, GDP growth, national and international output gaps and indices of real estate rents and yields. We found the global office yield composite indicator to perform the best in setting gearing levels.

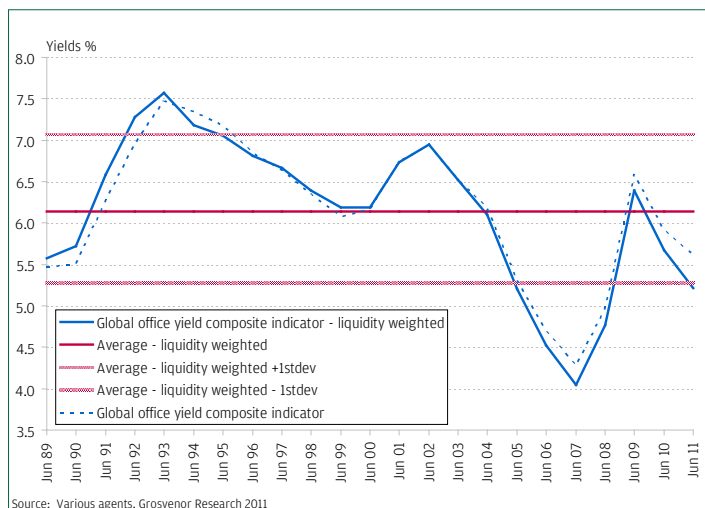
This is a composite index of the Grade A capitalisation rates (prime initial yields) from some of the most important office markets around the world. Office markets in the world's leading cities are preferred over retail ones as they are linked to stock markets which, in turn, anticipate economic growth. The larger office markets are highly liquid and dominated by the larger more sophisticated investors and so tend to 'price' future rental movements more quickly and efficiently than other parts of the real estate market. Chart 1 shows the global office yield composite index to June 2011. Together with the 'raw' index which is a simple arithmetic average of the key office market yields, the version of the index weighted by the liquidity of each market is also shown. Various weighting systems have been tested but it is liquidity which most improves the predictive ability of the indicator<sup>2</sup>. This is the indicator we adopt.

## Using the indicator

In order to benchmark the phase of the cycle and make a gearing recommendation we use the indicator's long term average and the long term average plus and minus one standard deviation as boundaries (as seen in Chart 1). The cycle is split into five phases: peak, downswing, trough, upswing-low, and upswing-hi. The latter two phases might also be termed the early upswing and the late upswing. Specifically:

- A trough is when the index is above the plus one standard deviation line;
- A peak is when the index is below the minus one standard deviation line;
- The market is in downswing phase when the index is moving up between peak and trough;
- The upswing-low phase is when the index is moving down between the plus one standard deviation and the long run average;
- The upswing-hi phase is when the index is approaching the minus one standard deviation line.

**Chart 1: Global office yields composite adjusted for market liquidity**



<sup>1</sup> Gearing: debt expressed as a percentage of equity

<sup>2</sup> The index is relatively smooth and gives a clear signal of the peaks and troughs of the global real estate market. Moreover, the peaks and troughs broadly accord with how the real estate market behaved over the period. On this, admittedly limited, evidence the global real estate cycle appears to be getting shorter and more powerful.

We assume a conservative approach to gearing and hence a desired maximum gearing level of about 70%. The minimum gearing is set at 30%. The very simple decision rules we use to convert the phase of the cycle to a gearing recommendation are:

- Peak - gearing is at minimum: assumed to be 30%;
- Downswing - gearing is at minimum: assumed to be 30%;
- Trough - gearing is at maximum: assumed to be 70%;
- Upswing low - gearing is at maximum: assumed to be 70%;
- Upswing hi - gearing is at medium: assumed to be 50%.

Obviously these simple rules can be revised according to the risk tolerance of the fund or company using them.

## Results

We have tested the impact of setting gearing according to our indicator on the returns of a simulated real estate investment company<sup>3</sup>. For comparison purposes we have also tested two further scenarios where gearing is kept constant at the minimum level of 30% and at a medium level of 50%. The results from all simulations are summarised in Table. 1

It can be seen that, if this rule had been used in the past, as it could have been since it relies only on existing data, average equity returns would have outperformed un-gearred property returns, over the period analysed. The indicator provides better equity returns (average and annualised both before and after tax) than a 'naïve' approach where gearing is kept constant over the cycle.

Using gearing increases the volatility of the returns and as expected risk adjusted equity returns, using any

of the approaches above, are lower than un-gearred risk adjusted returns. That said, the use of the global composite yield indicator provides better risk adjusted equity returns compared to a 'naïve' gearing approach.

Overall, setting gearing according to the indicator enhances NAV growth over the long run.

## Conclusion

The global office yield composite indicator (adjusted for liquidity), provides recommendations that are cautious and in line with the long term history of the property cycle. Using the indicator helps enhance average equity performance in the long run (before and after tax) and improves NAV growth compared to a 'naïve' approach where gearing is kept constant. In addition, it is a simple rule and places the most emphasis on the current position of the real estate market relative to its long term history.

However, the current level of the indicator shows property to be overpriced and indicates that gearing should now be set at the minimum level of 30% (equivalent LTV 23%).

It is possible that the office yield series trends downwards and so the long term average (and associated standard deviations) is 'too high'. Statistical tests show that the average yield since 2000 is 100 basis points lower than in the period 1989 to 1999. However, it is far from clear that we should ignore the signal produced by the long term average. It can easily be argued that the last ten years are unique: it was the era of 'cheap capital', extreme gearing in the banking sector and super-loose monetary policy.

The current situation is very unusual from a historical perspective. Yields are low despite the fragility of the global economy and high levels of vacancy in real estate markets. The answer, no doubt, lies in the monetary arena, with quantitative easing being the most likely culprit. On balance therefore it would be unwise to adapt the analysis to suit current conditions as the potential for the long run trend in yields to reassert itself grows.

Cynthia Parpa  
Global

**Table 1: Results**

Indicator	Global Office Yield Composite	Constant Gearing 30%	Constant Gearing 50%
Property Return p.a.- Average	7.8%	7.8%	7.8%
Equity Returns p.a. - Average	8.6%	7.7%	7.6%
Property Return After Tax p.a.- Average	4.7%	4.7%	4.7%
Equity Returns After Tax p.a. - Average	4.9%	4.3%	4.0%
Property Return p.a.- Annualised	7.3%	7.3%	7.3%
Equity Returns p.a. - Annualised	7.5%	6.8%	6.3%
Property Return After Tax p.a.- Annualised	4.3%	4.3%	4.3%
Equity Returns After Tax p.a. - Annualised	4.0%	3.5%	2.9%
Standard Deviation of Property Returns	10.4%	10.4%	10.4%
Standard Deviation of Equity Returns	14.9%	13.7%	15.9%
Risk Adjusted Property Returns	0.75	0.75	0.75
Risk Adjusted Equity Returns	0.58	0.56	0.47

Note: Period of analysis: 1989-2010  
Source: Grosvenor Research 2011

<sup>3</sup> A simulated balance sheet of a UK real estate investment company was used as a proxy. Property returns are derived as per the IPD UK All Property index (from 1989 to 2010). Acquisitions and disposals are assumed according to debt level movements, i.e. when gearing increases assets are acquired and when gearing needs to decrease assets are sold to repay debt. Loan interest is calculated using the relevant five year swap rate plus a margin of 120 bps. Effective tax rate is taken as 28%.

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## Questions & Answers with Dr Béatrice Guedj, Continental Europe

**Q: How does the recent 'recapitalisation call' to the European banks from the IMF chief relate to the bank stress tests published in mid-July?**

A: The stress tests covered 90 European banks (65% of the EU banking sector assets) and give an accurate overview of each bank's sovereign debt exposure. Only eight banks failed the test (five Spanish, two Greek and one Austrian) on a 5% Core Tier I capital pass mark. The total capital shortfall was minor €2.5bn. There were a further 16 near-fail banks, with a Core Tier I between 5% and 6% (all Spanish).

In Greece, domestic sovereign debt exposure at default is at €98.2bn, of which 67% is held by Greek banks. For Portugal and Ireland, the amounts are €43.2bn and €52.7bn respectively, with 63% and 61% held by home banks. As the largest exposure to the weakest sovereigns is currently held by domestic banks, the market was not overly concerned last July. Altogether, exposure of non-domestic banks to PIGS is moderate but when Italian sovereign debt is added to the equation, the landscape is very different.

The relatively high exposure of foreign banks to Italian sovereign debt, combined with the underlying global interaction across the banking system explains the contagion effect concerns observed in the Euro area bond markets. As Italy has not quickly adopted its austerity plan and Greek debt restructuring is looming, the European banking sector appears extremely fragile. This explains the IMF's call for recapitalisation.

**Q: How would the banking sector cope with a general sovereign default in southern Europe?**

A: If a 50% haircut is applied on Greece and Portugal, four Greek banks and three Portuguese banks would fail with a capital shortfall of around €12 billion. When a 20% haircut on Italy and Spain is included, two Italian banks and three small Spanish banks would fail the stress tests. This would definitely explain a need for recapitalisation. With such a downside scenario, Nordic banks would remain in a healthy shape with Core Tier I between 8% and 14%, as would Austrian and large Spanish banks with Core Tier I between 7.5% and 9%. The middle ground would

include French, British and large Italian banks (with a Core Tier I between 6% and 7.5%). The magnitude of the decrease in European bank share prices is in line with these downside fears.

**Q: What measures has the ECB taken to calm the markets?**

A: The ECB took steps to stabilise the markets, by triggering its Long Term Refinancing Operations but also by re-conducting all refinancing operations at full allotment for Q4. On top of that, the council has reactivated its Securities and Market Program to buy Spanish and Italian debt securities on the secondary market; €14bn in August alone. The ECB has also triggered the Emergency Liquidity Assistance to Greek banks as it can no longer accept Greek bonds as collateral. Despite these interventions, the 3-month OIS-BOR, which measures the financing cost on the interbank market compared to the interest rates offered by the ECB, increased by over 70 bps. It has doubled in less than one month suggesting that the financial contagion has spread quickly.

Q&A article is dated 8/9/2011

This edition of the Global Outlook, along with all previous articles can be found on the 'Latest Research' and the 'Research Archive' sections of our website [www.grosvenor.com/research](http://www.grosvenor.com/research).

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