Morgan Stanley

INVESTMENT MANAGEMENT

# 2024 Global Real Estate Outlook

**INVESTMENT INSIGHT** | REAL ASSETS INVESTING TEAM | February 2024

2023 was a challenging year for real estate economists and researchers. Long-term bond yields continued to climb, breaching five percent in the US, close to three percent in Germany and one percent in Japan, despite easing inflation in the US and Europe. As a result, cap rates continued to expand beyond levels predicted at the start of 2023, and the expectation that values would bottom and investor activity would increase in the second half of the year proved mistimed. In our opinion, one constant throughout 2023 was the resilience of real estate fundamentals, generally supported by the strength of the consumer. Except for office in most markets and some pockets of residential, above average rent growth helped offset the impact of higher cap rates, cushioning value declines.

Two years into the real estate price correction, we believe that conditions in 2024 should be conducive for investors to wade back into the real estate waters. Stabilization in interest rates, falling inflation and higher conviction in a soft landing in the U.S. should increase investment activity, albeit likely in the back half of 2024. However, crosscurrents may continue and the spread between "winners" and "losers" will likely widen. Investors will need to pay attention to longer-term trends that impact the amount, type, and locational preferences of real estate users. This is particularly important as they likely cannot rely on outsized economic growth or accretive financing to drive returns. Furthermore, in the absence of cap rate compression, returns will be driven by NOI growth, requiring an intense focus on asset management initiatives. Even in sectors supported by strong tailwinds, such as industrial and residential, investors will need to sift through evolving demand preferences, supply, and regulatory risks to identify the most compelling strategies and opportunities. Our expectations for cyclical and structural trends are summarized below:


AUTHORS

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*One of the most active property investors in the world for over three decades, MSREI employs a patient, disciplined approach through global value-add/opportunistic and regional core real estate investment strategies. With 17 offices throughout the U.S., Europe and Asia, regional teams of dedicated real estate professionals combine a unique global perspective with local presence and significant transaction execution expertise.*

**DISPLAY 1**

**Summary of Cyclical and Structural Trends**

**CYCLICAL**

- Decelerating macro environment
- Slowing inflation towards central bank targets
- More stable (slightly lower) rate environment
- Financing availability challenged but cost improved
- Values bottoming, but not expected to "bounce"
- Transaction activity expected to increase
- More idiosyncratic distress likely
- Real estate fundamentals will slow and normalize
- Occupier preferences narrow, wider performance dispersion

+

**STRUCTURAL**

- De-globalization and supply chain shifts
- Increasing geopolitical tensions
- Aging / declining populations
- Housing shortages and affordability challenges
- Work-from-home / hybrid work
- Artificial intelligence
- Rising tourism
- Heightened regulatory risk
- ESG and climate change

## Macroeconomic Environment Expected to Slow

While the global economy is expected to slow this year because of the lagged impact of higher interest rates on consumers and businesses, the prospect of rate cuts in many markets has buoyed market sentiment. We believe that this may result in a soft landing in the US, a rebounding economy in Europe following negative growth in the second half of 2023, and a return to one percent GDP growth in Japan. We expect geopolitical risks to be even more elevated this year, with 50 percent of the global economy facing an election cycle, in addition to regional conflicts and continued tension between the US and China. Against this backdrop of uncertainty and volatility, we anticipate a shift into safe-haven assets with stable cashflows, including real estate.

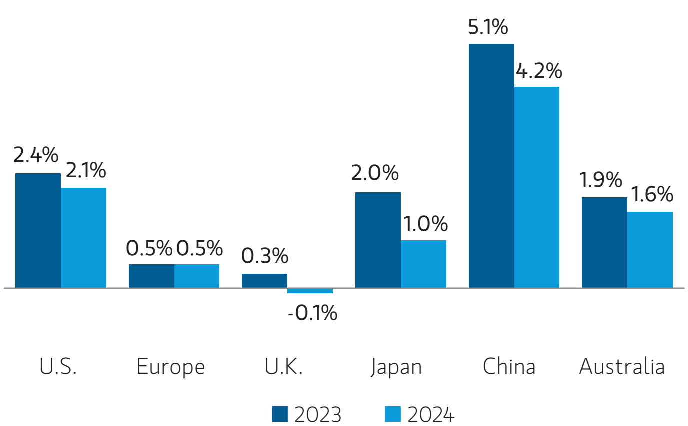
## More Stable Interest Rate Environment

Long-term bond rates have been very volatile for the last six months. For example, the 10Y US Treasury increased by 130bps from July to October, fell by 115bps through December, and rose again by 25bps through mid-January.

**DISPLAY 2**

**GDP Growth Expected to Slow**

%

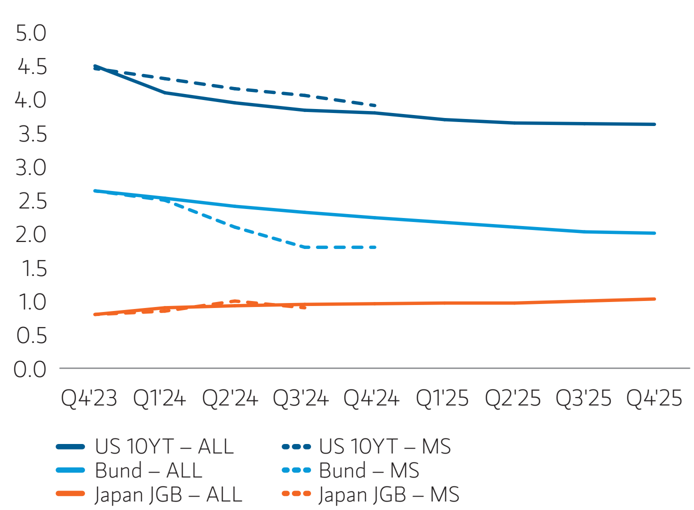



Source: MS Research, MSREI Strategy, as of January 2024

**DISPLAY 3**

**Long Term Interest Rates Expected to Edge Down (ex. Japan)**

*% 10 Year Bond Rates Consensus vs Morgan Stanley Forecasts*




Source: MS Research, Bloomberg, MSREI Strategy, as of January 2024

The Federal Reserve has signaled that peak rates have been reached and that rate cuts will commence in 2024, although the timing and degree remains unclear. Based on the latest Fed dot-plot, 2024YE policy rates are forecasted to drop to 4.375%. Long-term bond rates are expected to remain elevated and oscillate around 4 percent for most of the year. As a result, the yield curve (10Y minus 2Y) is expected to uninvert in the back half of 2024. The ECB, which has largely followed the Fed's rate hiking path, is expected again to mirror planned rate cuts with 25bps per quarter, starting in 2Q this year. Meanwhile, Morgan Stanley Research expects that the Bank of Japan will remove the negative interest rate policy in March or April after the results of the Spring wage negotiations.

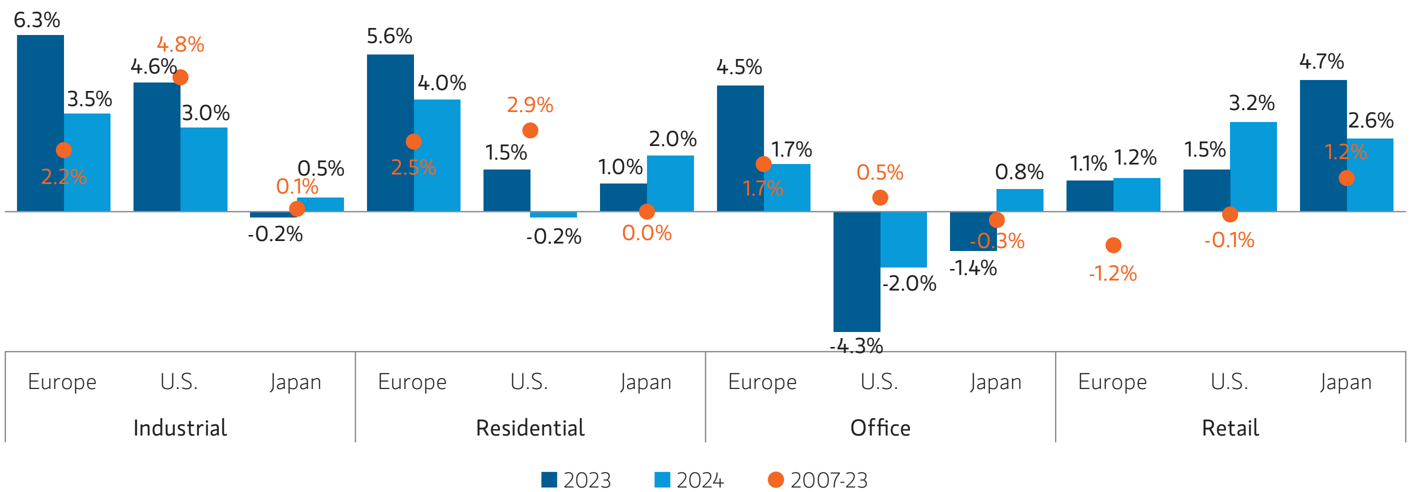
## Real Estate Fundamentals to Normalize

Given the slowdown in the economy, we expect real estate fundamentals to decelerate and revert to historical averages across most asset classes and markets--with the exception of office, which will remain the most challenged sector. We expect industrial to outperform other asset classes, given lower levels of new supply and diverse demand drivers, such as eCommerce and supply chain diversification. The definition of "quality" will likely continue to narrow as occupier preferences shift and affordability becomes a greater priority. As a result, we expect that tenants will continue to narrow their requirements to the best assets and locations, leading to wide performance dispersion between the "haves" and "have nots."

**DISPLAY 4**

**Fundamentals Slowing in Industrial and Residential, Strengthening in Retail and Remaining Challenging in Office**

*Rent Growth (%)*




Source: Greenstreet, PMA, MSREI Strategy, as of January 2024

## Real Estate Values Have Fallen Meaningfully

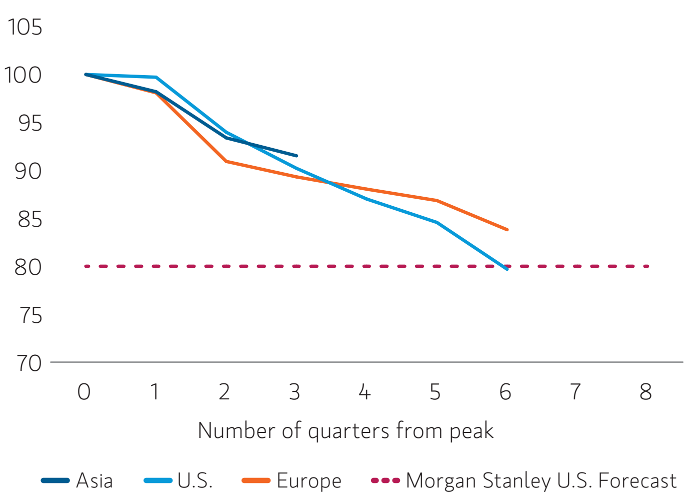
Private real estate valuations have fallen by approximately twenty percent in Europe and the US over the past two years, driven by cap rate expansion. While Asia values have adjusted by a smaller amount, they did not appreciate to the same degree prior to 2022. Typically, European value depreciation lags the U.S., but this cycle has seen values fall in-line with the magnitude and timing experienced in the U.S. due to synchronous central bank actions and less growth to offset yield expansion.

Additionally, average cap rate spreads across all sectors in the US and Europe have expanded above historical norms and may widen further if interest rates edge lower. Given the +/-20% correction in private real estate, values are now relatively attractive compared with other asset classes, particularly versus a year ago. Private real estate also looks fairly valued compared with public real estate – the listed market discount to NAV has moved from -23% in October to -4% today (in the U.S.) and from -28% to +1% (in Europe).

**DISPLAY 5**

**Values have Already Fallen Meaningfully**

*Core Real Estate Value Depreciation from Peak (US and Europe =2022Q2, Asia = 2023Q1)*

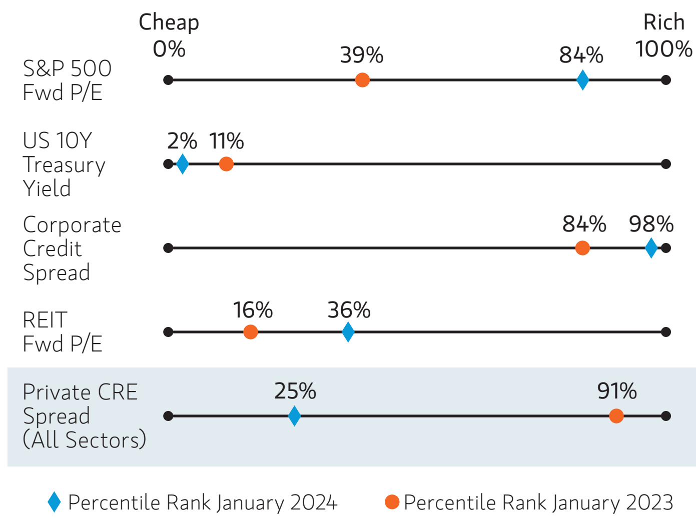



Source: INREV, NCREIF, ANREV, MSREI Strategy, data through December 2023

**DISPLAY 6**

**U.S. Private Real Estate vs Other Asset Class Relative Valuation**

*Percentile Rank, Last 10 Years*




Source: NCREIF, NAREIT, Bloomberg, MSREI Strategy, as of January 2024

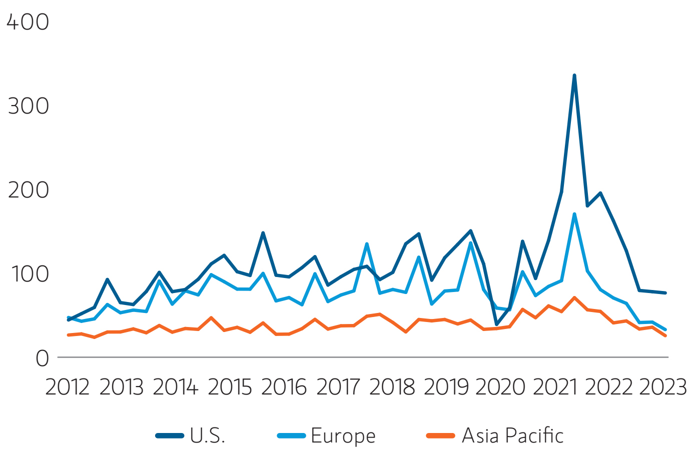
## Transaction Activity Likely to Increase in the Back Half of 2024

Real estate transaction activity declined by 50 percent in 2023, with the largest drop-off witnessed in Europe, Australia, and South Korea and in the office and residential sectors. Japan experienced the lowest YOY decline (~10 percent), helped by low financing costs and above average economic growth. We believe that investors will re-enter the investment market in 2024: falling inflation and stabilizing rates should create greater underwriting certainty, while value declines of 20 percent now represent what we view as an attractive entry point, particularly in relation to public real estate pricing and other asset classes. The rise in equities (+32 percent) and fall in private real estate (-20 percent) since September 2022 has meant that an investor with a traditional 60/30/10 allocation to equities/fixed income/real estate is now under-allocated to U.S. real estate by ~100bps. Additionally, buyer and seller expectations should converge as market participants accept and adjust to the higher interest rate and cap rate environment that is now into its third year.

**DISPLAY 7**

**Transaction Activity Dropped by 50%+ Globally, US Stabilizing**

*$B*

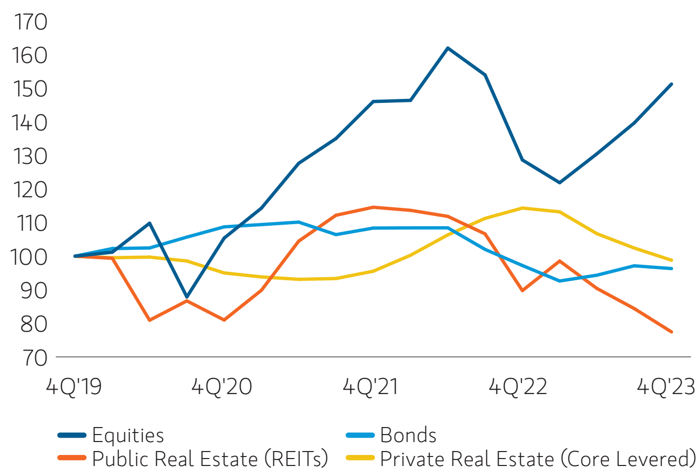



Source: Real Capital Analytics, MSREI Strategy, as of November 9, 2023

**DISPLAY 8**

**Private Real Estate vs Other Asset Class Performance**

*Appreciation Index, Q4'19=100*




Source: NCREIF, NAREIT, MSREI Strategy, as of January 2024

## Debt Maturities will Likely Lead to More Idiosyncratic Distress

The much-publicized wall of commercial real estate debt maturities did not lead to elevated levels of distress in 2023. The same situation exists in 2024, with nearly $900B of debt maturing globally, of which two-thirds will be in the US. Higher than expected payoffs and a willingness for lenders to modify loans and extend duration in return for partial pay-downs contributed to lower than expected delinquency rates and fewer instances of distress last year. As an example, according to CREDiQ, the number of modified loans in the securitized universe doubled in 2023, with extending term the most popular modification type. Office and multifamily accounted for 60 percent of modifications, matching their approximate share of maturities in 2023.

In 2024 and 2025, the expiration of these short-term extensions on top of existing maturities should lead to greater levels of distress. Additionally, traditional bank lenders may be less willing to extend because of capacity constraints. CBRE estimates the global debt funding gap to be ~$250B over the next three years based on pending maturities, LTVs at origination and changes in value over the last several years. This could provide interesting opportunities to acquire assets from sellers in need of liquidity or to provide real estate credit, given the pullback from traditional financing sources.

We believe that the major pockets of distress will include lesser quality US office and multifamily, which has more floating rate debt than other sectors, over-levered European public real estate companies (for example LTVs for European residential REITs are 72 percent vs 24 percent for the US), and developers who need funding to stabilize projects.

**DISPLAY 9**

**Looming Maturity Wall. United States is 2-3X Europe**

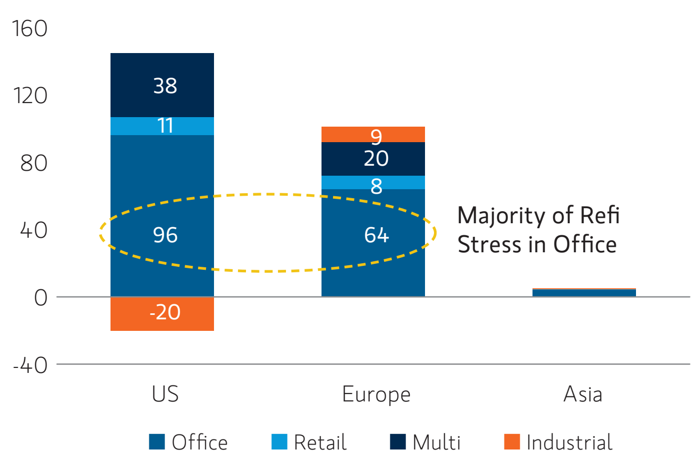
*Maturing CRE Debt, US $B*


Note: Asia excludes corporate bond issuance for real estate companies ~$200B per year (China ~80%)Source: IMF, TS Lombard, MSREI Strategy, data as December 2023

**DISPLAY 10**

**Debt Funding Gap Provides Credit Opportunity, Particularly in U.S. Office**

*$B*




Source: CBRE, MSREI Strategy, data as of December 2023

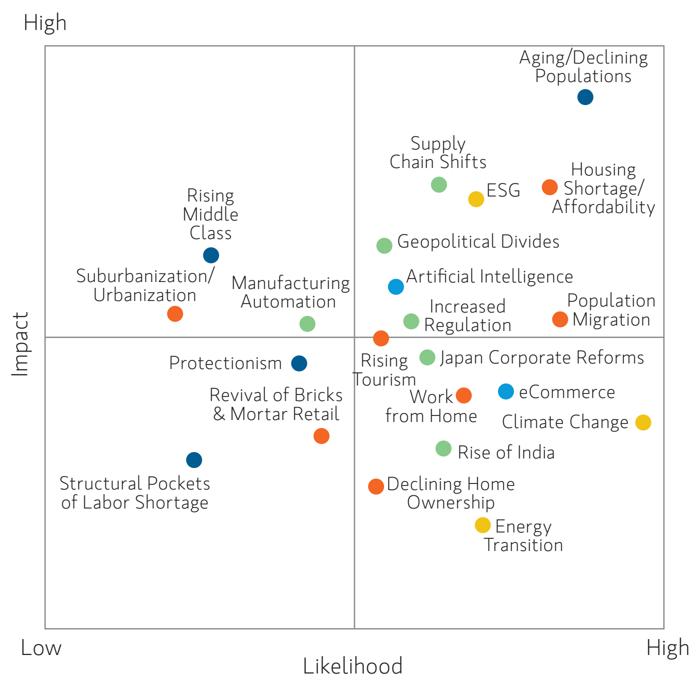
## Next Generation Trends Shaping Occupier Demand

Given the slowdown in economic growth and elevated interest rate environment, we believe that investors need to adopt a more nuanced investment strategy and pay more attention to long-term trends that will shift aggregate demand across and within sectors and markets.

We have updated the framework we introduced in 2017 that examines our view of the likelihood of a trend playing out over the next 10 years versus the potential impact on commercial real estate. 2017 trends, such as autonomous vehicles, coworking and rising commodity prices, have been replaced by new drivers, including artificial intelligence, geopolitical divides, supply chain shifts and work-from-home. Meanwhile, the importance of climate change and demographic shifts have been further accentuated-- shifting further to the upper right quadrant.

**DISPLAY 11**

### Trends and Disruptors




**DISPLAY 12**

### Potential Sector Impacts

| | RESI | OFFICE | RETAIL | IND. | ALTS |
|---|---|---|---|---|---|
| Demographics and aging | + | – | – | – | + |
| Data and automation | O | – | – | + | + |
| Mobility and Travel | + | – | + | + | + |
| Natural Resources | + | – | + | + | + |
| Slowdown in globalization | – | O | + | + | + |

+ positive  O neutral  – negative

## Trend #1: Supply Chain Diversification Will Increase and Shift Industrial Demand

The rise in e-commerce has driven a sharp increase in industrial demand over the last decade, accounting for ~35 percent of US leasing. While we expect e-commerce sales to continue growing at a healthy 8 to 9 percent per annum, we see a second secular demand driver, supply chain diversification, having a pronounced impact on the type and location of industrial demand. This has already influenced product and market selection and we expect it to continue to do so. As a result of deglobalization and the supply shocks of COVID, companies are shifting where they manufacture goods and how they ship them, favoring a supply chain model that includes onshoring, near-shoring, and friend-shoring.

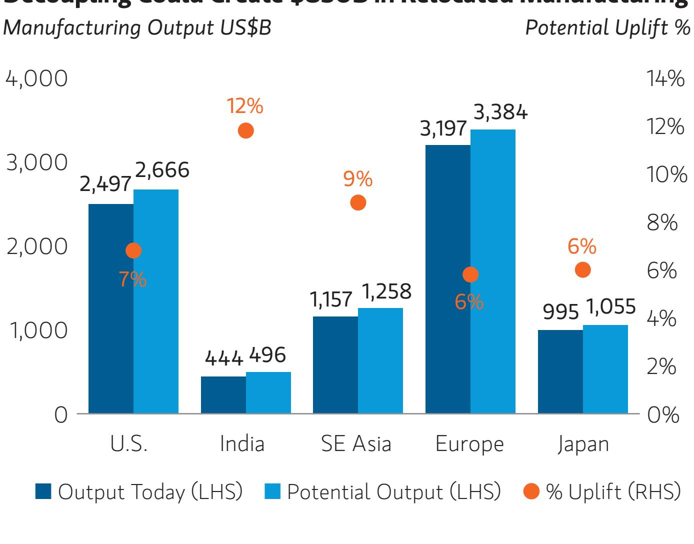
Onshoring, which involves bringing back advanced manufacturing, including semi-conductors, batteries, and robotics to home countries, has been supported by significant public and private funding. We expect this to drive demand for smaller scale, heavier power use, light manufacturing facilities. Indeed, we anticipate 50 percent of reshoring investment to occur in the Southeast, Texas, and Arizona. Outside of the US, key manufacturing clusters in Japan, France, Germany, the Nordics and the UK should also benefit.

Industrial real estate should also benefit from *near-shoring*, which involves the shifting of manufacturing of sensitive, value-add products to cost competitive, neighboring markets. Among the greatest beneficiaries should be US markets tied to Mexico, European markets integrated with Central and Eastern Europe, and India and Southeast Asia. Near-shoring initiatives will likely drive incremental demand for mid-sized and larger distribution centers.

This product type should also be supported by *friend-shoring*, which involves occupiers diversifying their supply chains to mitigate geopolitical risks, labor shortages and climate change. Shipping routes are derivatively impacted, thereby shifting demand between different port markets. For example, shifting production from China to India would be expected to shift port demand from the West Coast to the East Coast of the US.

**DISPLAY 13**

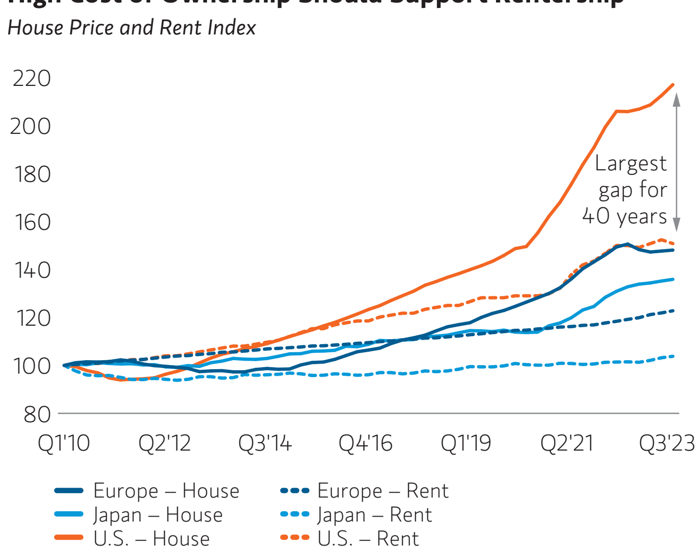
### Decoupling Could Create $850B in Relocated Manufacturing




Source: MS Research, MSREI Strategy, as of August 2023

**DISPLAY 14**

### High Cost of Ownership Should Support Rentership




Source: AREP, Costar, Oxford, Eurostat, MSREI Strategy, as of January 2024

## Trend #2: Housing Shortage will Support Residential, Although Demographics will Shift Demand

The residential sector continues to be supported by favorable long-term trends, including a shortage of housing (different products in different markets), strong liquidity, and unaffordability in the for-sale segment. The shortage is most pronounced in Europe, given the regulatory environment and unfavorable development economics. In the US, record deliveries in sunbelt markets (such as Nashville, Austin and Raleigh) have resulted in approximately 15 percent added to their multifamily stock this year. This should pressure near-term fundamentals, which were already challenged by higher expenses, less in-migration and decelerating demand. Japan has been in a rare wage growth cycle, which on top of urbanization into central locations of major cities, is fueling rent growth for the first time in many years.

Demographic changes should also shift demand. In the US and abroad, the millennial age group is one of the largest population segments, accounting for 25 to 30 percent. This segment is seeking more space and either migrating to more affordable for-sale locations (e.g., sunbelt markets in the U.S.) or renting single family homes because they cannot afford to purchase them.

## Trend #3: Aging Populations

Never before has the global population been so heavily skewed towards the elderly. Globally, the senior cohort (75+) is growing at 3 percent per annum and the 60-75 segment is growing at 1.5 percent, while the total population is growing at 0.5 percent. Rapid growth in older populations will be felt throughout the economy and most real estate sectors. Aging will weigh on workforce growth as retirees exit the labor force, likely lowering demand for office space. Furthermore, we believe that it will have significant impacts on spending patterns and residential needs. Older populations spend more on healthcare services and less on consumer goods.

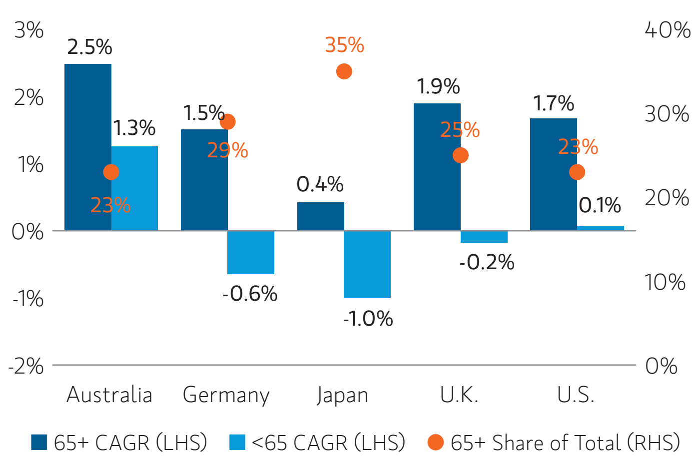
This should fuel ongoing demand for senior living facilities, although different regulations and healthcare systems render this more of an opportunity in markets like the US and Australia as compared with Europe. However, there are some risks to be considered for healthcare. Given the slowdown in the velocity of the housing market because of high interest rates, some seniors have opted to age at-home, which has slowed overall demand, particularly in the independent living segment. Similarly, while long-term demand for life science facilities remains strong, the pullback in venture capital in the US over the last two years has challenged leasing for early-stage biotech companies. Additionally, significant new and converted supply (up to 50 percent of existing stock in markets like Boston and San Francisco) will likely result in weak fundamentals for the next several years.

**DISPLAY 15**

**Baby Boomers Are Large and Growing Share of Global Population**

*5YR Growth Rate (2022-27) 60+ vs <60 Age Cohorts*

*Share of Total Population*

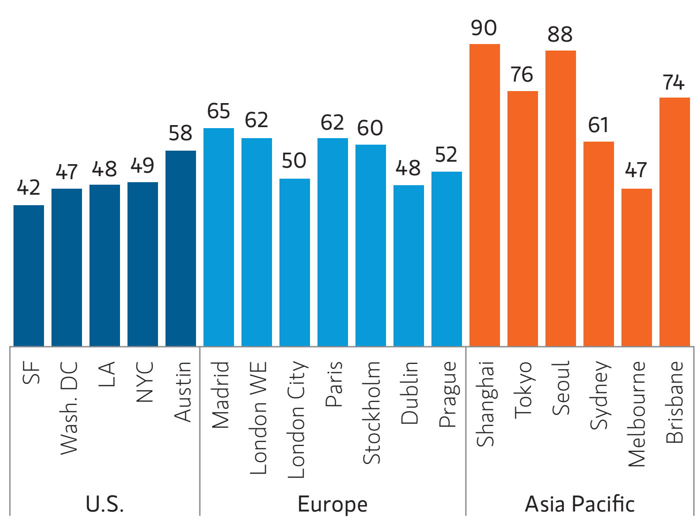



Source: Oxford Economics, MSREI Strategy, as of January 2024

**DISPLAY 16**

**Within Office, Regional Differences in Utilization**

*Latest Office Utilization as % of Pre-COVID*




Source: Kastle, Savills, PCA, NLI Research Institute, Shiftee, Remit Consulting, Locatee, PMA, as of November 2023

## Trend #4: Negative Perceptions About Office Will Continue Because of WFH Trends

Office fundamentals remain challenged, most notably in the US, where vacancy rates are pushing 20 percent in most markets, more than four times the level seen in core locations in Europe such as London's West End and Paris's Central Business District. Occupiers are choosing to trade up in quality and down in size requirements resulting in demand consolidating to the highest quality assets in the most vibrant locations. Given the magnitude of office debt maturities coming due over the next several years, we believe that weak fundamentals on top of high capex needs will result in greater capital requirements culminating in distress and significant price declines for more challenged assets.

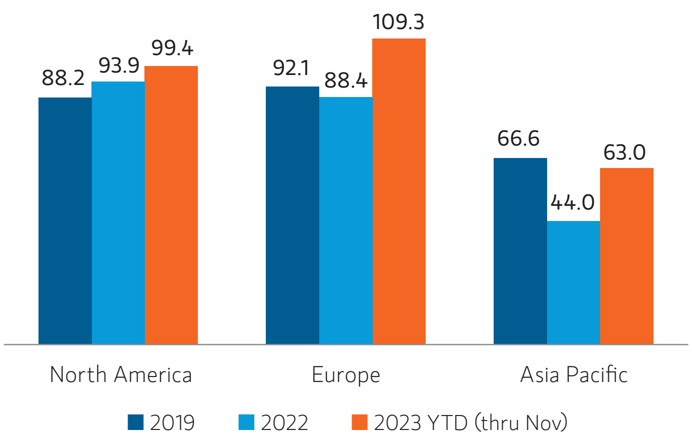
## Trend #5: Increasing Tourism

While post-COVID "revenge" travel has fueled hotel fundamentals in the US and Europe in 2023, we expect the cyclical economic slowdown and ongoing geopolitical tensions to normalize demand in 2024. Offsetting the macro and geopolitical risks will likely be the continued recovery of corporate and international travel, the growing middle class, millennial's preference for experiences over goods, low supply growth, and shadow supply (e.g., Airbnb) relief.

**DISPLAY 17**

**Hotel Markets Recovering at Different Speeds**

*RevPAR (USD)*

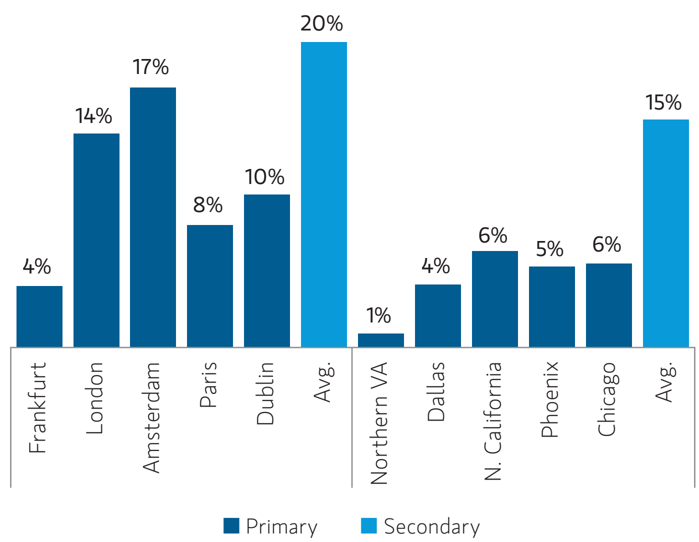



Source: STR, MSREI Strategy, data through December 2023

**DISPLAY 18**

**Market Vacancy Rates are Lower in the United States**

*%, Colocation Data Centers*




Source: CBRE Research, JLL, MSREI Strategy as at January 2024

## Trend #6: Artificial Intelligence will Fuel Data Center Growth

One of the most discussed trends in 2023 was the rise of Artificial Intelligence. While it is too early to determine all the real estate implications, the manipulation and storage of data associated with AI has already led to higher aggregate demand for data centers. Additionally, severely constrained supply underpinned by the shortage of power will likely lead to very robust fundamentals over the medium term. This attractive demand/supply balance has led to strong capital flows and has reduced cap rates which are now trading in-line with industrial real estate, despite the higher operational and obsolescence risk. Given AI should improve economic productivity, we believe that it will likely lead to lower job growth. While this may result in reduced, longer term office, housing and consumer demand, investments in AI technology should fuel job growth and demand in key knowledge clusters including Seattle, San Francisco, Boston and New York in the U.S.

## Conclusion

We expect 2024 may be a fruitful year for real estate investors to find attractive risk-adjusted returns in a less competitive capital markets environment. A soft landing, slowing inflation and more stable interest rates should reduce bid/ask spreads stimulating more investment activity in the back half of the year. We believe that investors should target a diversified set of opportunities that include acquiring assets from or providing capital solutions to public companies, funds, and owners in need of liquidity at cyclically low values, while at the same time pursuing investments in sectors and markets where structural trends will propel growth ahead of the overall economy. Further, we believe that investors will need to focus on a narrower definition of quality that meets the changing locational and asset attribute preferences of occupiers.

**DISPLAY 19**

### Potential Real Estate Investing Themes

| GROWTH (SUPPORTED BY LONG TERM TRENDS) | VALUE (POCKETS OF POTENTIAL DISTRESS) |
|---|---|
| ▪ Industrial in US, Europe, Japan and Korea that benefit from supply chain shifts<br>▪ Residential lease up / aggregation play in urban locations in major cities in Japan and Europe<br>▪ Senior housing in the U.S.<br>▪ BTR/Co-living in high growth, supply constrained markets (U.S., Australia)<br>▪ Hotels in Asia, Europe, U.S. supported by tourism flows<br>▪ Student housing reposition/value-add in core markets in the U.S. and Europe<br>▪ Industrial development in India | ▪ Distressed/over-levered corporates in Europe<br>▪ Non-core, corporate-owned real estate in Japan<br>▪ Multifamily distress in the U.S.<br>▪ Structured investments (preferred, mezz) in South Korea<br>▪ Re-priced retail with reset rents in strategic, growth locations, e.g., Australia, Europe, U.S. |

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