AEW RESEARCH

European Research Flash Report

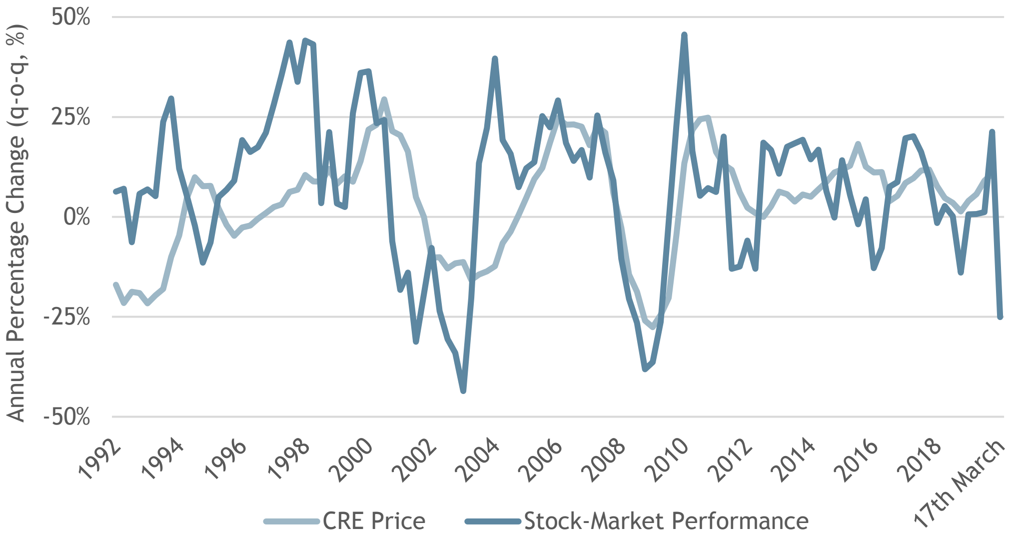
18th March 2020

AEW

CORONAVIRUS SPECIAL UPDATE: KEEP CALM AND STAY HOME

- Global economic growth expectations for 2020 have been adjusted significantly downwards amid the spreading of the COVID-19 virus and oil price decline. Based on this, at least some leading European economies are expected to go into recession in 2020. But, in contrast to the GFC, the current event-driven crisis could prove temporary as economic fundamentals were strong at its outset, possibly signalling a V-shaped recovery.
- As a result of slowdown, many stock markets have dropped well over 30% from their recent highs while safe havens such as government bond yields have been volatile as well. Not all government bond yields move in tandem as observed in Italy and Spain. We also saw high yield corporate bond yields widen as investor have priced in more default risk.
- To investigate the potential implications for the commercial property market, we take a closer look at previous bond and stock-market corrections' impacts on prime rents, investment volumes and prime property values and find that:
  - Market rents have typically declined when corporate bond yields have moved out, but investors are protected from these moves in the short term due to existing lease contracts, the basic need for space and credit of the tenants.
  - Commercial real estate investment volumes have historically responded with a delay to moves in the stock-market over the long-run. In the short term, we expect practical issues with site visits to temporarily slow down activity.
  - Prime capital values have typically also responded to stock market moves over the long-run. This means that if stock markets remain where they are now, we expect values to come down - albeit more slowly than stocks.
- The long term repercussions on real estate remain uncertain as it is unclear how long exactly this global public health crisis will last. Many policy makers are still announcing significant new fiscal and/or monetary stimulus as well as temporary guarantees and tax breaks to limit the impact of the virus on consumers, businesses and banks alike.

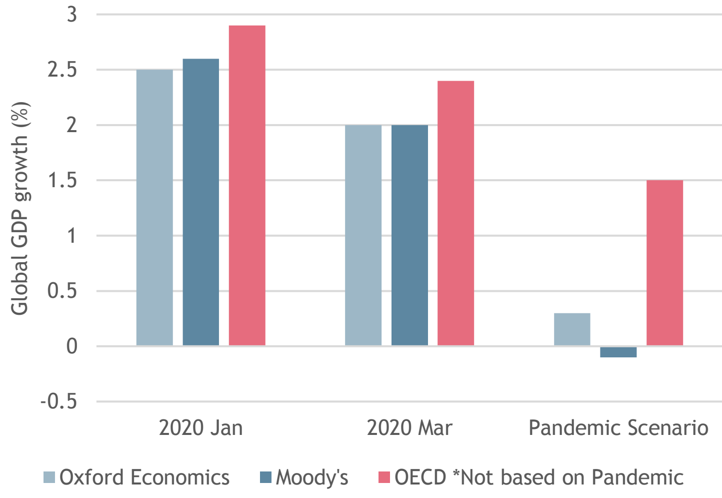
STOCK MARKET PERFORMANCE CORRELATES WITH COMMERCIAL REAL ESTATE PRICES OVER THE LONG-RUN



Sources: CBRE, Bloomberg & AEW

WEAK GLOBAL ECONOMIC GROWTH MIGHT TRIGGER 2020 RECESSION IN EUROPE

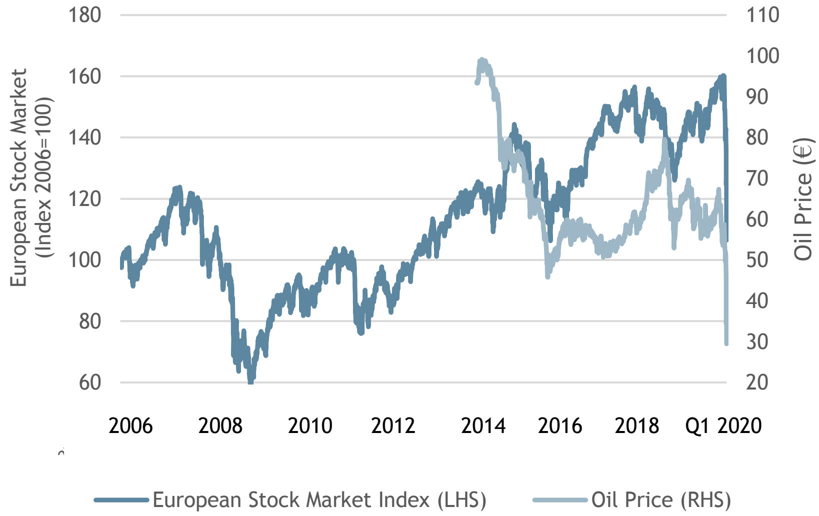
- Economic growth expectations for 2020 have been adjusted downwards amid the recent spreading of the COVID-19 virus and the oil price war, as indicated in the graph.
- Interestingly, the 2020 March forecast was 0.5% below the January forecast while the most recent pandemic scenario forecast, is showing a significant drop in economic activity.
- Weak global growth will likely push some of the leading European economies into recession.
- But the long term repercussions remain unclear and depend on the duration of the crisis and on the broadening range of policy responses.
- In contrast to the GFC, the current event-driven crisis could prove temporary as economic fundamentals were strong at its outset, possibly signalling a V-shaped recovery.



Sources: Oxford Economics, Moody’s, OECD & AEW

STOCK MARKET CORRECTION PARTLY OFFSET BY OIL PRICE DECLINE

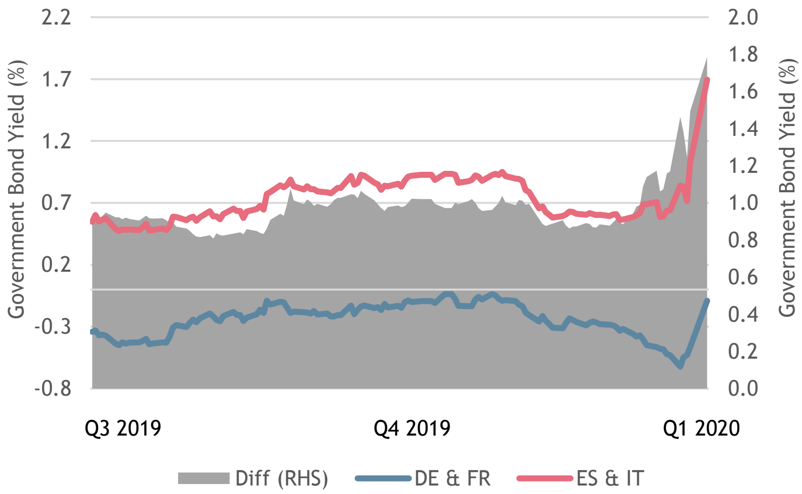
- The lower economic growth expectations, together with the unexpected all-out oil price war have resulted in an historic over 30% stock market correction.
- In the graph, we use the combined European stock market index (FTSE100, DAX30 & CAC40) together with the oil price and observe a larger drop than noticed in 2016 and 2018, respectively.
- This correction, urged countries to adopt different policy responses including fiscal stimulus, rate cuts (to near 0% for the FED and by 25bps by the BOE), monetary stimulus (the 120bn purchasing programme by the ECB) to complete lockdowns (as seen in Italy and other countries).



Sources: Bloomberg & AEW

RISK-OFF MENTALITY TRIGGERS GOVERNMENT BOND YIELDS DIVERGENCE

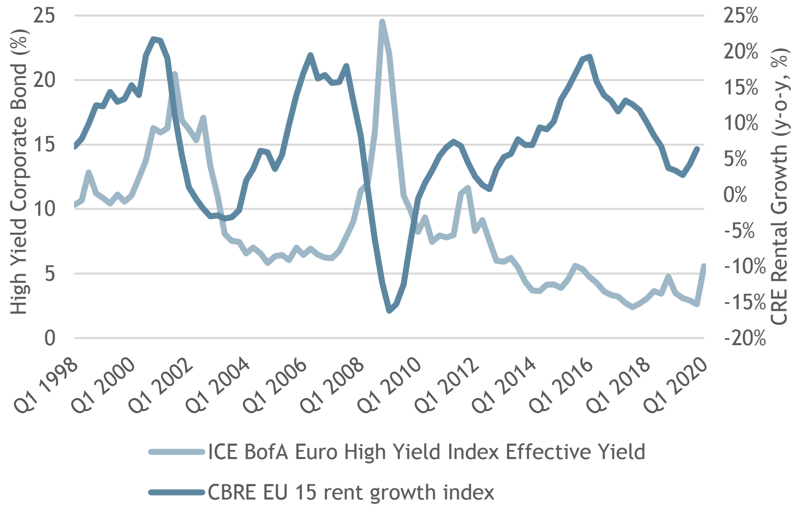
- The economic and market turmoil in recent weeks triggered a flight by investors to ‘safe-havens’, i.e., government bonds.
- Hence, an interesting pattern occurred with government bond yields for countries such as Germany (-0.45bps as of the 17th of March) and France (20bps), on average, moving in since the beginning of the month.
- In contrast, Government bond yields of Southern European countries such as Italy and Spain increased, marking a divergence between Northern and Southern European government bond yields.
- This largely underpins the risk perception (risk-off) of investors with respect to the risk associated with these countries.



Sources: Bloomberg & AEW

CORPORATE CREDIT MARKET YIELDS SPIKES LINKED TO DECLINES IN MARKET RENTS

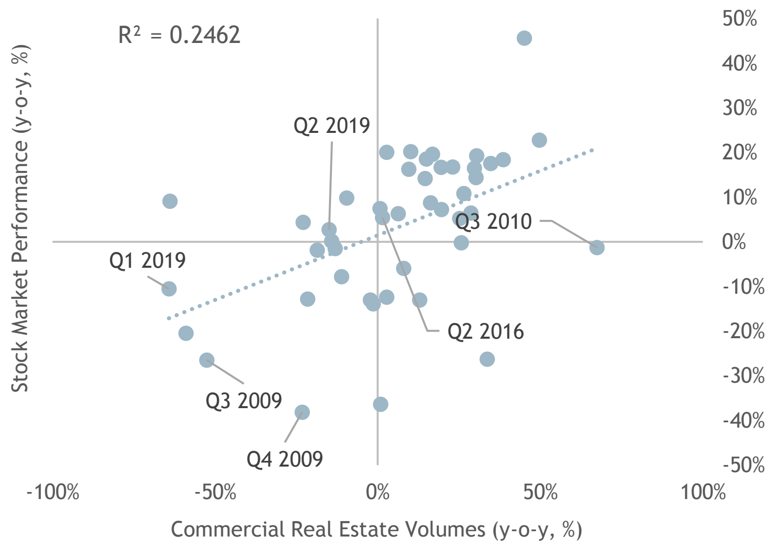
- Fears that an extended slowdown will hurt corporate profitability and the ability to re-pay debt and pay rent can be quantified.
- To do this, we calculate the correlation between the ICE BofA Euro High Yield and the CBRE EU-15 prime market rent index.
- The graph shows a correlation of 0.33, indicating that corporate credit spikes are often coincided with prime rental corrections.
- However, investors are protected from market rent moves in the short term due to existing leases, basic needs for space and the credit quality of the tenants.
- With little migration from BBB to below IG in a typical year, loss severity of BBB and BB tenants are less than 0.2% and 2.0% pa (source: Income analytics).



Sources: Bloomberg, CBRE & AEW

STOCK MARKET MOVES ARE ASSOCIATED WITH DELAYED CHANGES IN INVESTMENT VOLUMES

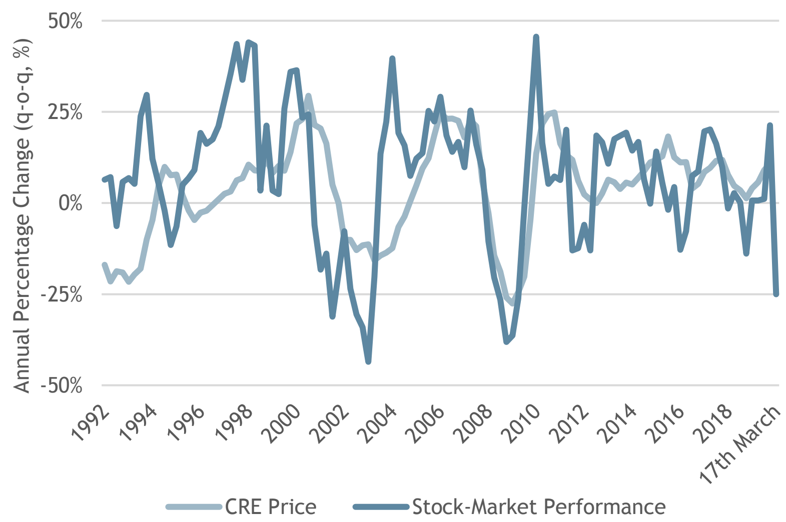
- Furthermore, we take a closer look at previous stock-market corrections and commercial property investment volumes (FR, UK & DE, 2008-2020) and pricing (FR, UK & DE 1992-2020 period) to quantify possible implications.
- The graph shows that there is a significant correlation between stock-market moves and investment volumes (total FR, UK & DE), however, it is stronger (0.5 correlation) when we use stock-market moves as a leading indicator.
- The latter is important as stock-markets, in contrast to the private direct property market, benefit from daily price information and could help us to investigate implications for the CRE market.
- Of course, this only indicates association and doesn't automatically indicate causality.



Sources: RCA, Bloomberg & AEW

CRE VALUES TYPICALLY RESPOND TO STOCK-MARKET MOVES IN THE LONG-RUN

- As a last step, we look at prime capital values (average FR, UK & DE), and observe a robust correlation between moves in stock markets and CRE prices both contemporaneous (0.4) and lagged (0.45).
- The strength of the correlation is lower in Germany compared to France and the UK.
- There could be several reasons for this like the structure of the index, the polycentric structure of the country, the structure of the economy and the German property valuation system.
- All in all, it is important to note that many economies are implementing fiscal or monetary stimulus to fight the current situation and that therefore stock markets may recover quickly just like the stock-market wobble observed in late 2018.



Sources: CBRE, Bloomberg & AEW

ABOUT AEW

AEW is one of the world's largest real estate asset managers, with €69.5bn of assets under management as at 31 December 2019. AEW has over 700 employees, with its main offices located in Boston, London, Paris and Hong Kong and offers a wide range of real estate investment products including comingled funds, separate accounts and securities mandates across the full spectrum of investment strategies. AEW represents the real estate asset management platform of Natixis Investment Managers, one of the largest asset managers in the world.

As at 31 December 2019, AEW managed €33.0bn of real estate assets in Europe on behalf of a number of funds and separate accounts. AEW has over 400 employees based in 9 offices across Europe and has a long track record of successfully implementing core, value-add and opportunistic investment strategies on behalf of its clients. In the last five years, AEW has invested and divested a total volume of over €20bn of real estate across European markets.

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