GLOBAL CAPITAL MARKETS

Insights & Outlook

Global markets continued on their journey of price discovery during Q1 2023, with investment activity subdued relative to previous years.

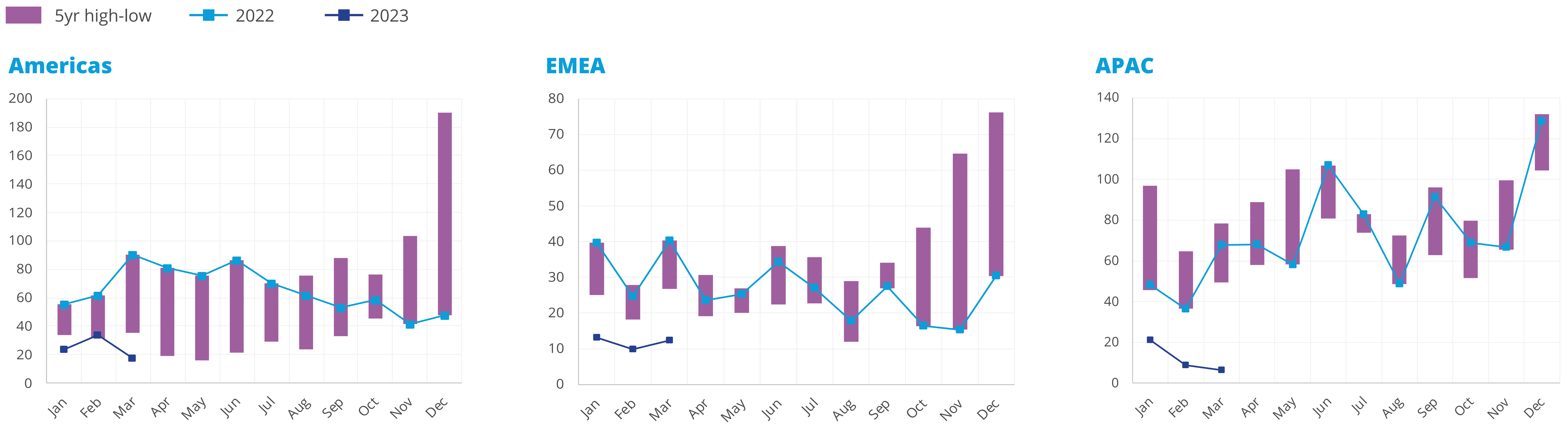
APRIL 2023

As of the beginning of April, **investment volumes continue to transact well below five-year norms.** January and February investment volumes were -56% below five-year norms, and provisional figures for March were -76% down.

While these figures will improve as more deals are registered, there is a big gulf in activity compared to the five-year average. This clearly reflects the **level of anxiety around pricing that is stifling activity.** Markets were stretched further in March by tension in the banking world, which faced up to liquidity issues in North America and Europe.

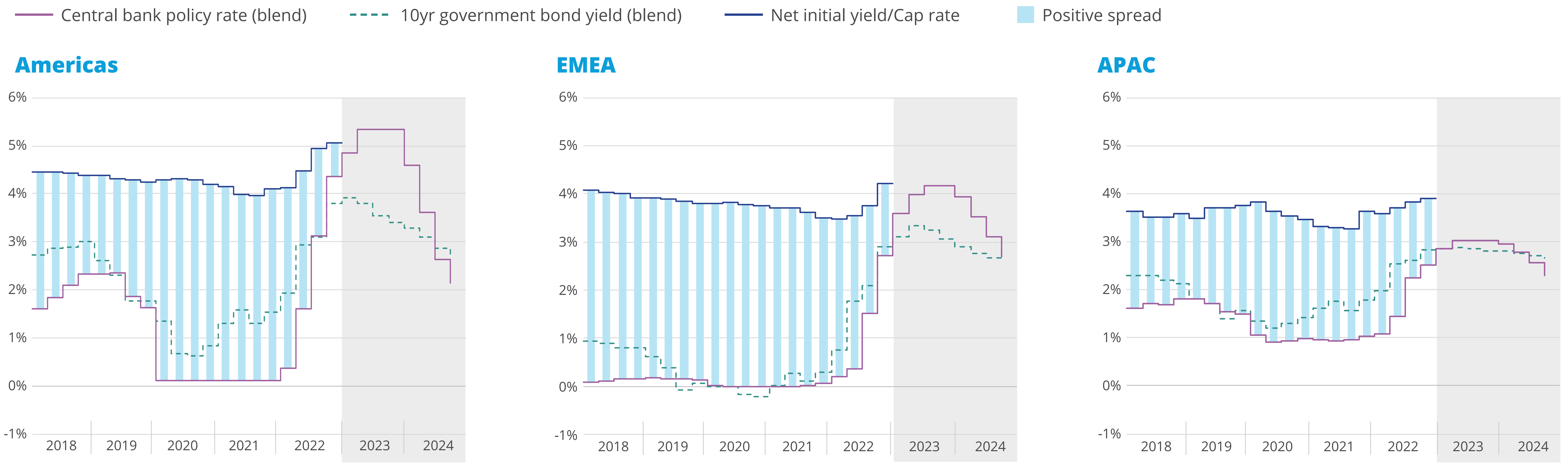
On the whole, this did not prevent major central banks raising rates to curb inflation - thus driving, rather than delaying, the inevitable pricing reset. **The U.S. Federal Reserve, European Central Bank and Bank of England all upped their rates in March to tackle inflation, although the Reserve Bank of Australia kept their rates on hold.**

Figure 1: Investment volume monthly, US$ bn [all sectors]



Source: Colliers, MSCI Real Capital Analytics

Figure 2: Yield/Cap rate spreads [all sector average]



Source: Colliers, Macrobond, Oxford Economics

Regional all sector yield spreads relative to central bank policy rates **[Figure 2]**, suggest that rate rises are nearing their peak, and that pricing may not need to adjust by much more when looking at a broad blend of markets.

Figure 3, however, illustrates the extent to which real estate pricing (yields/cap rates) are set relative to central bank policy rates and 10-year government bonds. **The APAC region in particular, has markets priced at opposite ends of the spectrum in Tokyo and Hong Kong.**

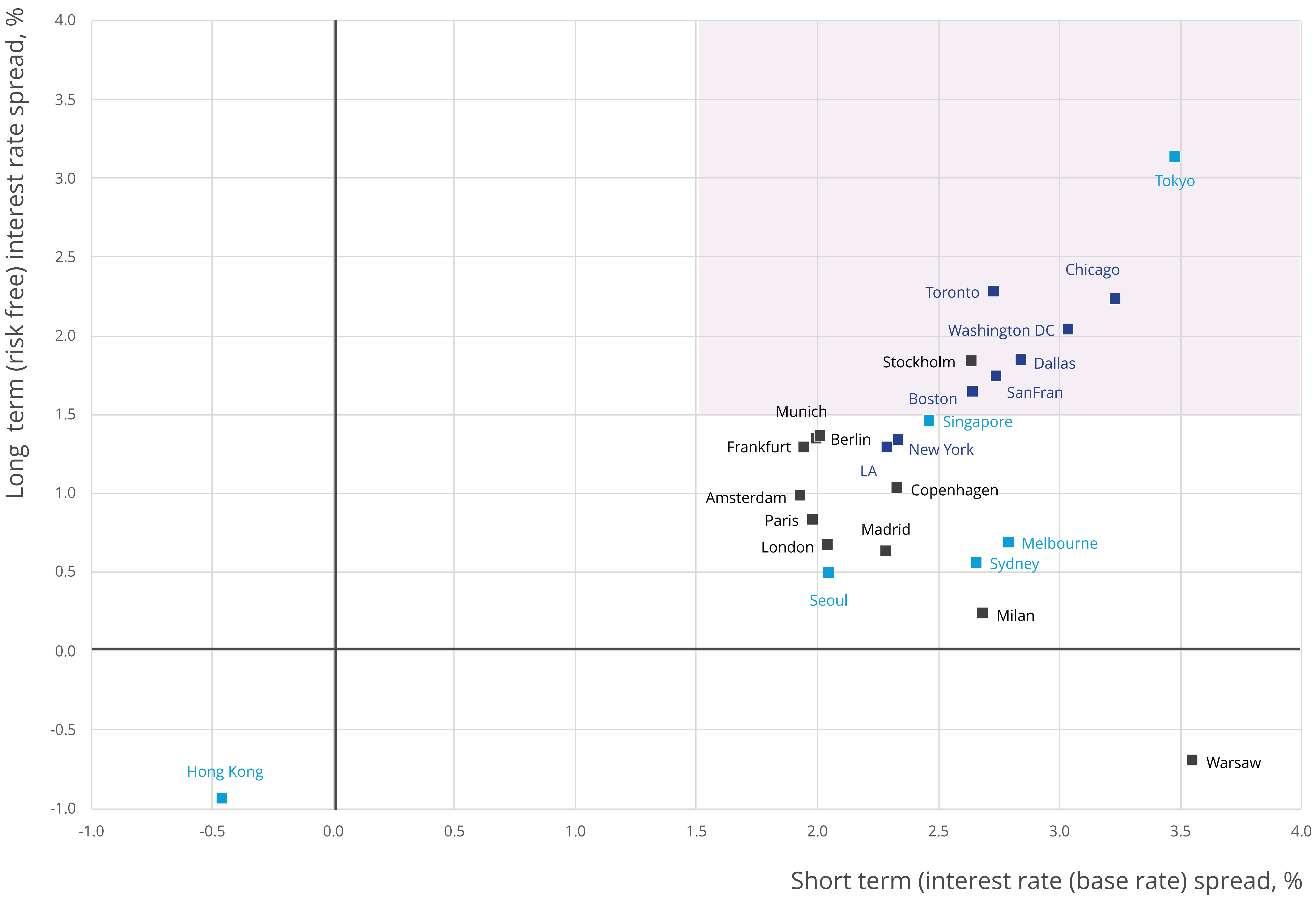
The individual position of key global markets illustrates there is significant divergence in how they are currently priced **[see figure 3]** (on an all sector yield/cap rate basis), relative to 10-year government bond rates (Y-axis) and central bank policy rates (X-axis) - for the latter we assume pricing is based on adopting a 50% loan-to-value (LTV) debt ratio.

Ideally, and purely from a financial/risk spread perspective, **markets should be in the top right corner** - providing a clear buffer relative to the cost of debt, and a suffice premium to 10-year government bonds. **Tokyo continues to be the stand-out 'attractive' market globally, on this basis, with the majority of U.S. big cities closely behind.**

As of today, taking account of recent rate rises, Figure 3 suggests that many markets require a further pricing adjustment. The challenge remains a moving target given the various patterns of inflation, and subsequent potential impact on the need for further interest rate rises.

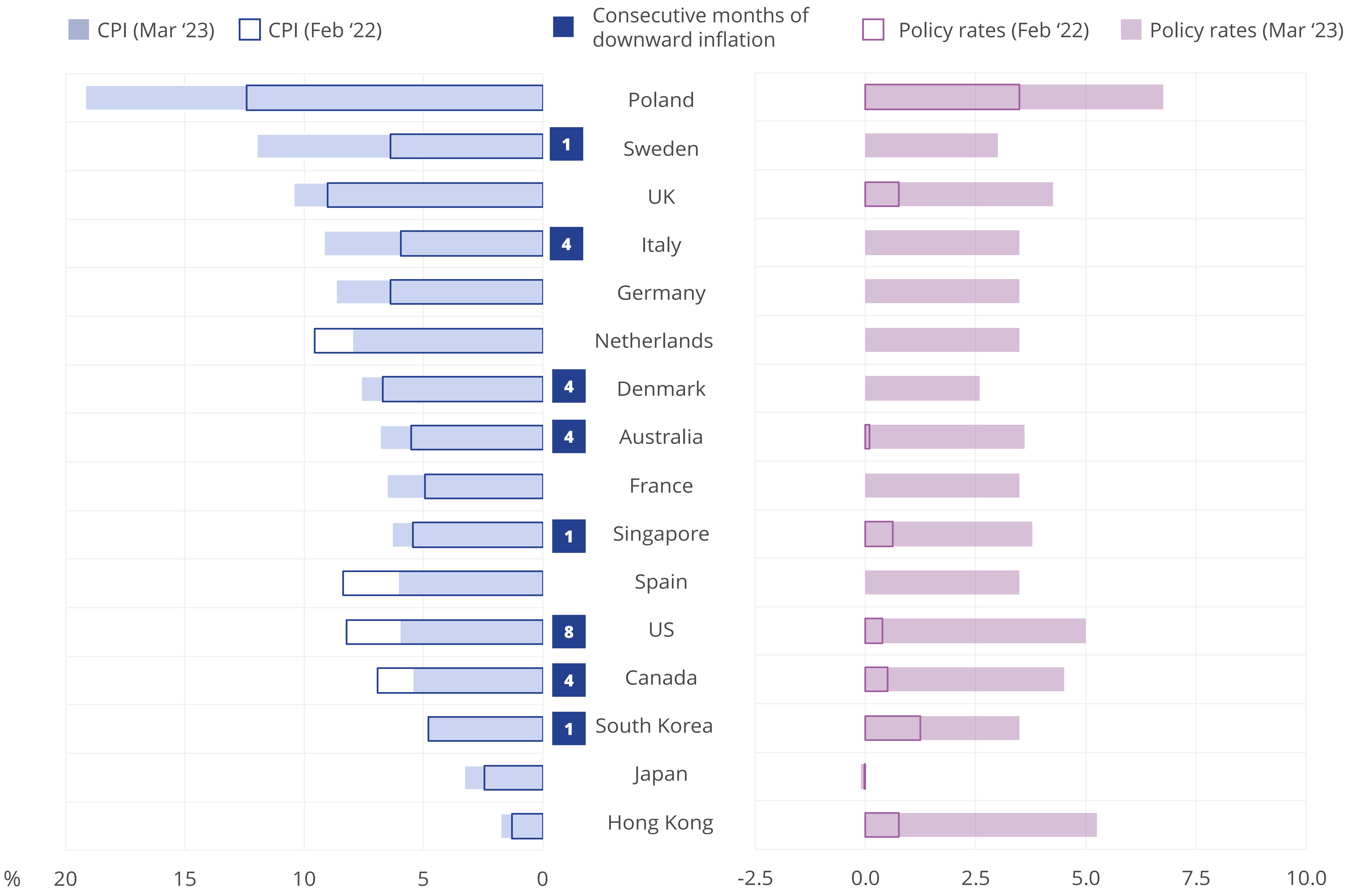
Additionally, each city needs to be considered by sector, relative to the fundamental drivers of supply and demand in each location. This can paint a very different picture as to whether the pricing of each market is fairly, or reasonably positioned. For example, it is clear that some market/location positions support rental growth, enabling a lower yield/cap rate. **We will be looking at markets by sector in subsequent monthly updates.**

Figure 3: All sector prime yield/Cap rate - weighted average (net initial) vs STIR & LTIR



Source: Colliers, Macrobond

Figure 4: Are we there yet? CPI/base rate alignment



Source: Colliers, Macrobond

Have we hit peak interest rates?

The rate rises that continued during the end of March suggest **central bank policy rates in North America, part of Europe and Japan are at, or close to, peak forecast levels set at the start of 2023.**

In APAC, the decision of the Reserve Bank of Australia to hold rates surprised many – with inflation rates still above those of one year ago, despite consecutive declines.

Parts of mainland Europe, the UK and Australia may have further to go, when considered relative to the path of inflation. In the U.S. and Canada, slower policy rate expansion could well be justified, **with inflation on a more sustained downward trend, particularly for the U.S.**

In Europe, the picture is very mixed. Only the **Netherlands and Spain have seen inflation drop from inflation rates of February 2022**, but a continued decline in rates is not evident. While Sweden, Italy and Denmark have seen rates rescind for four consecutive months, inflation remains above levels of over one year ago. **This suggests that pricing alignment is likely to happen in these locations before other parts of the world – bar Japan.**

On this evidence, **pricing alignment is most likely to happen first in North America and Japan**. It will be another quarter at least, until the inflation picture/trend becomes clearer in other global locations, and thus the future path of interest rates. Market yields/cap rates face another quarter of adjustments, before stabilising. Q2 2023 will likely see limited investment activity, but hopefully there is more evidence of a pricing shift. Markets will then require valuations to absorb the changes, enabling capital to mobilise.

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