Toh Shaowei, UBS Asset Management

Toh Shaowei is head of research and strategy, Asia Pacific and joined UBS Asset Management's real estate business – which forms part of real estate and private markets (REPM) – in 2015. Toh is responsible for formulating and coordinating real estate research and strategic initiatives in Asia Pacific.

Adeline Chan, UBS Asset Management

Adeline Chan is an analyst in research and strategy, Asia Pacific and joined UBS Asset Management's real estate business in 2018. Adeline is responsible for real estate research and strategic initiatives in Asia Pacific.

ASIA PACIFIC CORE REAL ESTATE

The APAC Growth Era: Spring is Here to Stay

Toh Shaowei and Adeline Chan

Even though much has already been spoken about the coming Asia Pacific (APAC) growth era, the investment universe is still caught in a tug-of-war between the familiar comforts of growth in the West and the alien new growth in the East. Possibly the only region where emerging and developed economies interface to good effect, not only will APAC be the main engine of growth in the coming few decades, it also offers diversification and downside protection for investors.

With the synchronised global growth offering ample opportunities across geographies, we believe the savvy investor would be well-advised not to overlook APAC. This may sound like a broken record but it is absolutely necessary to belabour the point. The APAC region is no longer what it was twenty years ago – capital markets have significantly deepened, reliance on foreign capital inflows have largely been weaned off, and financial systems are now more resilient to shocks. Notably, most of APAC is well placed to sustain expansionary policies over the next decade, as governments ramp up on infrastructure spending and social programs that will foster longer term inclusive growth, which all feed into the economy and ultimately demand for real estate.

Spring awakening

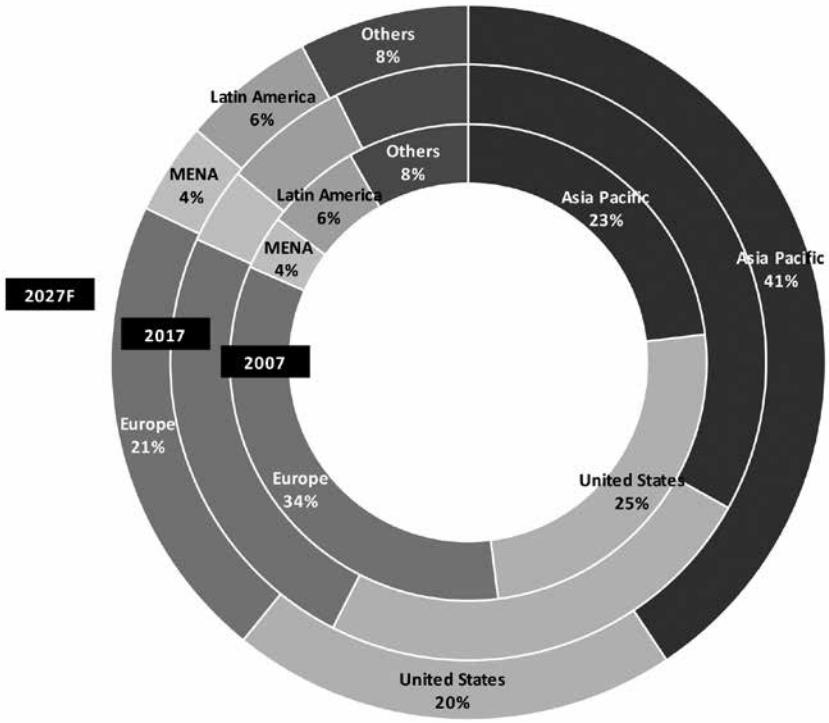
The 19th century was termed Britain's Imperial Century due to the rapid expansion of the British Empire and the 20th century the American Century due to the emergence of the US as the world's superpower. The world has been anticipating that Asia would take over the reins of influence and power when the 21st century arrived. Indeed, the world already got a taste of the economic prowess of the region when Japan's economic miracle took place after the Second World War and further ahead, when the "Four Asian Tigers" of Hong Kong, Singapore, Taiwan and South Korea experienced their economic transformation. But those expecting the Asian century to arrive with pomp and grandiose are likely to be disappointed. While some Asian economies have taken off, others are just warming up and still others (such as China) are transiting to a structurally different make-up. If the 21st century is to eventually see the APAC region come of age, this is likely to be just the start of a new world order.

From 2007, APAC made up around 23% of the global GDP, lagging that of the US and Europe (25% and 34% respectively) but that has since risen to 33% in 2017 (Figure 1). With growth rates forecast to outpace that of other regions (Figure 2), APAC's share of the global economic pie is projected to continue to grow to 41% in another 10 years' time.

The quote

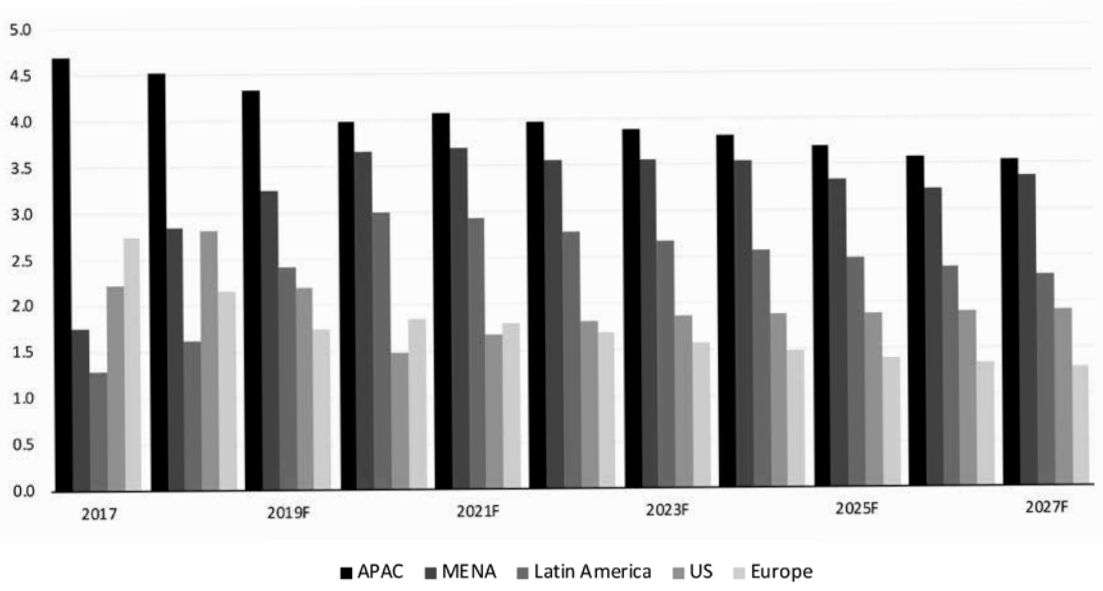
With fundamentals taking over as the key driver of performance, Asia's growth premium is likely to underpin the region's outperformance in real estate.

Figure 1. Share of world GDP (%)



Source: Oxford Economics, August 2018

Figure 2. Real annual GDP growth rate (% YoY)



Source: Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), August 2018

Compelling top down drivers

The factors that will work together to drive APAC's growth going forward are similarly positive for real estate.

Urbanisation

The urbanisation story in APAC is well-hashed out but we think it bears repeating so as not to lose sight of just how staggering the proportions are. According to United Nations estimates, the urban population in Asia has risen from 32% of the total population in 1990 to 48% in 2015, and by the end of the decade that would have crossed the halfway mark to hit 51% by 2020. In absolute terms, Asia will see 2.4 billion people living in urban areas by 2020, or an addition of 48 million people each year between 2015 and 2020, representing huge opportunities for real estate in urban areas.

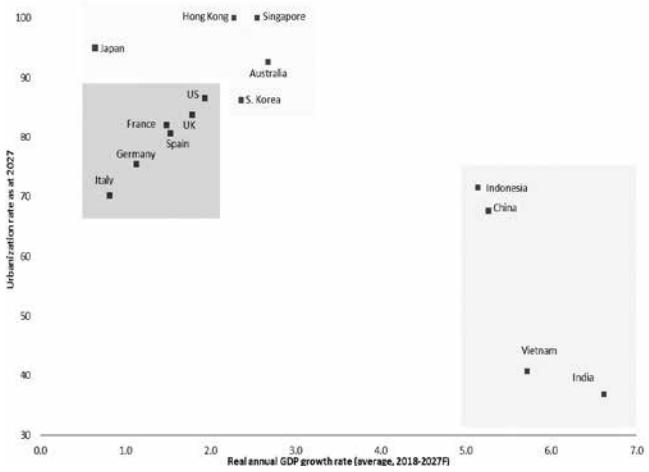
We are aware that urbanisation can equally be a negative catalyst should it not be accompanied by economic growth to absorb the sheer increment to the urban workforce. However, we do not see that being the case for the major APAC countries. In developing Asia, overall urbanisation rates may be lower than that of developed economies but that represents greater growth potential and is similarly accompanied by higher expected GDP growth rates (Figure 3). Even in developed Asia where the urbanisation dividend is diminished, most economies are still expected to experience higher growth rates than in the West.

Growing wealth and income levels

APAC remains the epicenter of global wealth creation with the total population of high-net-worth individuals (HNWI) growing at an estimated compound annual growth rate (CAGR) of 9.4% year-on-year (YoY) between 2010 and 2017, the second highest globally (after Africa). In absolute terms, the region also holds for the largest HNWI population totaling 6.2 million in 2017 compared to 5.7 million in North America and 4.8 million in Europe.

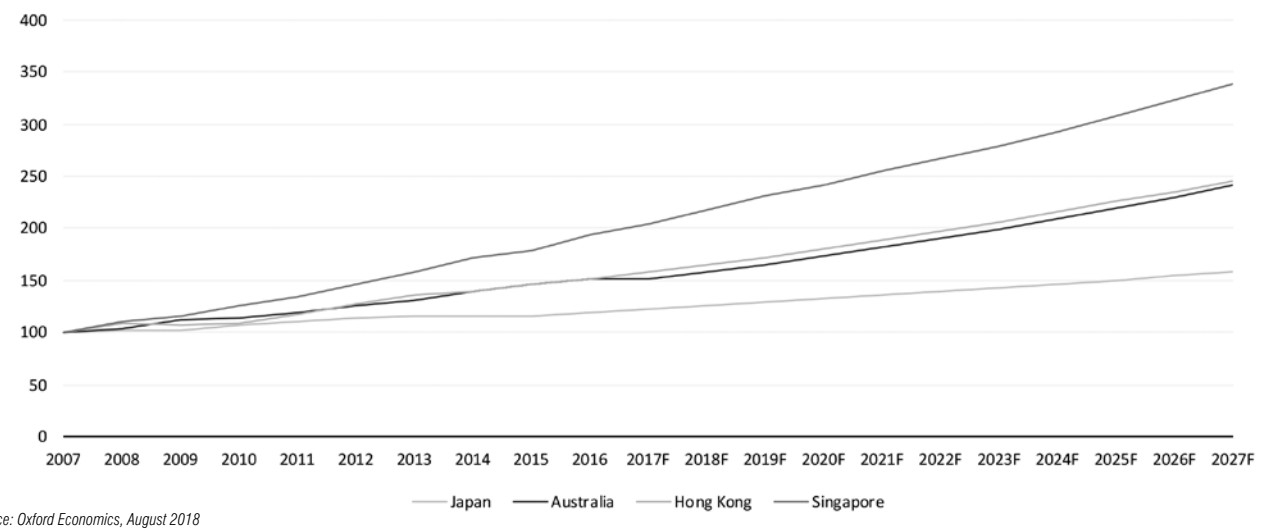
Wealth creation is not isolated to only the upper echelons of society; rather, economic growth has resulted in a growing middle class and a rise in average household wealth. Across Australia, Japan, Hong Kong and Singapore, the average household personal disposable income has grown at an average CAGR of 3.1% YoY between 2007 and 2017 and that is projected to pick up to 3.4% YoY over the coming decade (Figure 4). Similarly, growth in total household personal disposable income across the four countries will accelerate from 31.7% between 2007 and 2017 to 38.4% from 2017 through 2027, which has tremendous implications for domestic spending and retail property. As it stands, private consumption makes up about 48% of GDP in APAC in 2017, less than that of the EU and US (roughly 56% and 70% respectively) and signifying room for domestic demand to grow.

Figure 3. Urbanisation rate and real GDP growth rate (%, % YoY)



Source: Oxford Economics, August 2018

Figure 4. Total household personal disposable income (Indexed; 2007 = 100)



Source: Oxford Economics, August 2018

Strong labour markets

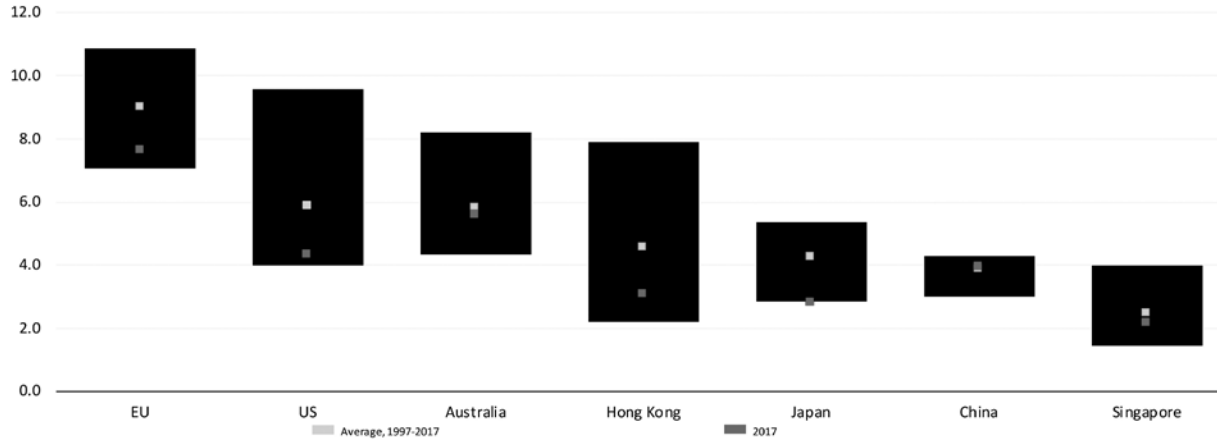
The labour market has undoubtedly been a beneficiary of economic growth in APAC, seen not just in rising incomes but in the lower unemployment rates vis-à-vis the West. Unemployment rates in the region have tracked lower over a 20-year period compared to the EU and the US, both in terms of the average rate as well as the highest rate recorded (Figure 5). Importantly, countries such as Singapore and Australia have experienced structural transformations away from the agricultural and manufacturing sectors towards the higher value-added services sector and yet have maintained relatively low unemployment rates. This reflects well-managed economies which have managed to create and absorb jobs amidst structural adjustments. Job creation is inextricably linked to office demand, and while it may seem that countries which are close to full employment will have limited capacity for job growth, we would argue that the low unemployment rates are a sign of a robust economy and strong corporate health.

Financial resilience

'It's always darkest before the dawn' so the familiar phrase goes. If this is the dawn of the Asian century, one of the darkest hours in recent history would no doubt be the Asian Financial Crisis (AFC). Bursting of asset bubbles, massive currency devaluations and a debilitating economic downturn were painful to endure, but they proved to be useful lessons that went on to shape the public and private sector's response and readiness to future crises. The decade following the AFC was spent embarking on financial and structural reforms and the result is healthier economies with stronger legs to stand on, evident in the years of the Global Financial Crisis (GFC) which APAC weathered relatively well. In fact, Asian exports began to make their recovery three quarters ahead of that of global trade and Asia was driving the global recovery by end 2010.

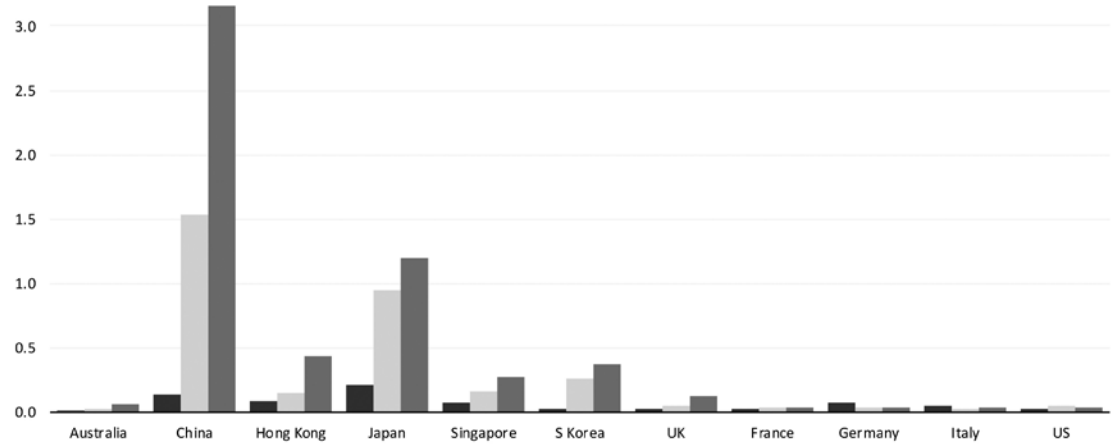
All this bears testimony to the importance of building economic defenses, which APAC countries have continued to do. Over the past two decades, APAC has been building buffers that will allow it to

Figure 5. Historical range of unemployment rate, 1997-2017 (%)



Source: Oxford Economics, August 2018

Figure 6. Foreign exchange reserves (USD trillion)



Source: Oxford Economics, August 2018

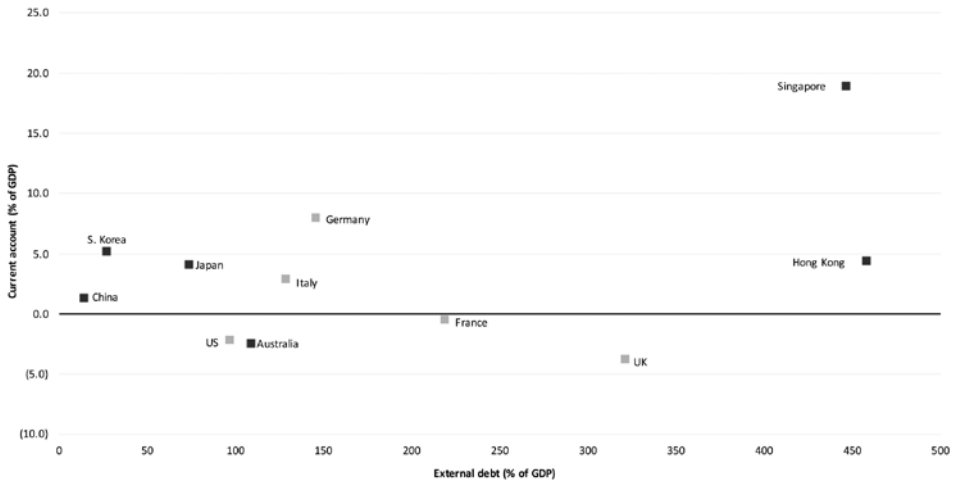
deal with a sudden capital outflow again – across China, Japan, Hong Kong, Singapore, Australia and South Korea. Total foreign exchange reserves have grown by almost ten times between 2017 and 1997, compared to the 30% increase seen in the EU countries of France, Germany, Italy and the UK over the same period of time (Figure 6).

External vulnerabilities have also by and large improved. Most Asian economies now have low external debt-to-GDP ratios, run current account surpluses (Figure 7), and many more have abandoned fixed exchange rates in favour of floating rate regimes. This has effectively reduced the exposure to foreign currency risk. The exceptions are Singapore and Hong Kong both of which have high(er) external debt ratios. This is reflective of the status of both cities as major global financial centers where overseas capital deposited in domestic banks are recorded as liabilities, rather than external weakness per se.

Economic dynamism

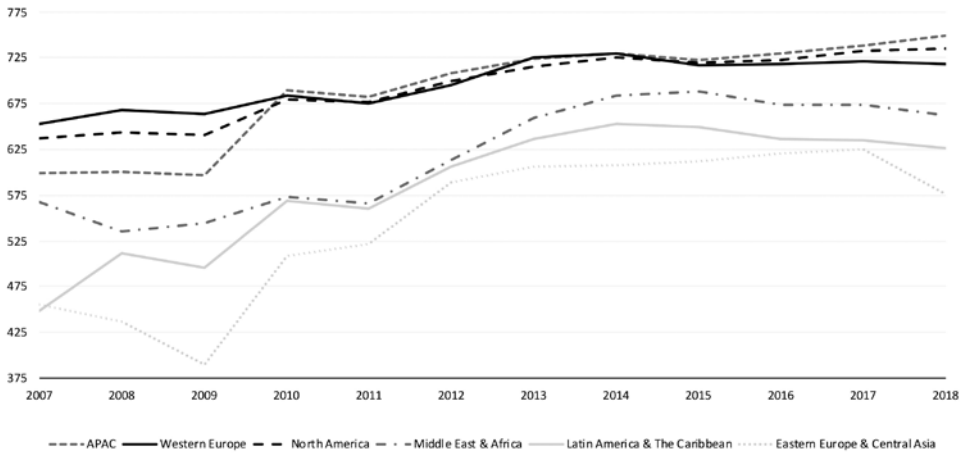
Economic dynamism of the region is implied in the projected growth rates alluded to earlier, and this is validated by the different indicators that place APAC countries in the major leagues. Grant Thornton's latest Global Dynamism Index, which assesses 60 economies according to five growth areas, ranked Singapore and Australia in 1st and 3rd place globally in 2015 in terms of the most dynamic business growth environments. In the World Bank's 2018 Ease of Doing Business Index, APAC countries took four of the top five spots – New Zealand and Singapore took 1st and 2nd place, followed by South Korea and Hong Kong in 4th and 5th. According to the 23rd Edition of Z/Yen's Global Financial Centres Index, APAC cities accounted for five of the top 10 financial centres worldwide. In fact, since about 2016, APAC has started to take over the reins of dominance from Western Europe and North America, which have historically led the global ratings (Figure 8).

Figure 7. Current account and external debt, 2017



Source: Oxford Economics, August 2018

Figure 8. Mean rating of top five centres in each region



Source: Z/Yen Global Financial Centres Index, August 2018

The other side of the economic dynamism coin is downside protection. While this is not necessarily a growth driver, it points to the importance of diversification, specifically into APAC which history has shown to largely run counter to the West. In years where the US or other major Western economies have had an economic downturn, countries in APAC have largely turned out positive growth (Table 1). In contrast, aside from the GFC, the only other time period within the past 40 years that major APAC economies saw widespread GDP contraction was during the AFC.

Table 1. Years when major Western countries had GDP contraction GDP (% YoY)

Country	1980	1982	1991	1993	2008	2009
Australia	2.9	0.2	**-1.0**	3.9	2.7	1.9
China	7.8	9.0	9.3	14.0	9.7	9.3
Hong Kong	10.0	2.9	5.7	6.2	2.3	**-2.5**
Japan	4.2	3.3	3.4	**-0.6**	**-1.1**	**-5.4**
Singapore	10.1	7.2	6.7	11.5	1.9	**-0.5**
S Korea	**-1.7**	8.3	10.4	6.8	2.9	0.7
France	1.5	2.4	1.0	**-0.6**	0.1	**-2.8**
Germany	1.3	**-0.5**	2.8	**-1.0**	0.8	**-5.5**
Italy	3.5	0.3	2.0	**-0.9**	**-1.1**	**-5.5**
UK	**-2.0**	2.2	**-1.1**	2.5	**-0.3**	**-4.2**
US	**-0.3**	**-1.8**	**-0.1**	2.8	**-0.1**	**-2.5**

Source: Oxford Economics, August 2018

A balanced view on key risks and considerations

Notwithstanding APAC's growth potential, there are still considerations to bear in mind when investing in the region.

Increased private sector debt and rising interest rates

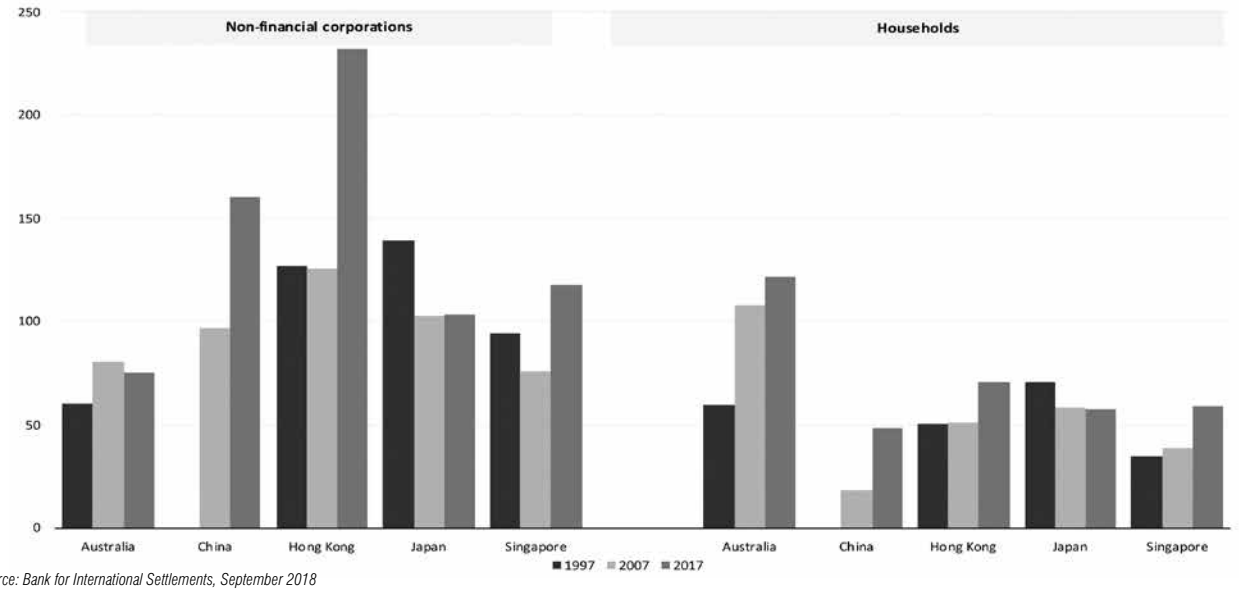
Chief of these is the increased levels of private sector debt amid an environment of rising interest rates. While APAC has made significant progress in the building up of external buffers, leverage undertaken by businesses and households have grown, fueled by an era of cheap credit (Figure 9). This exposes corporates and households to greater debt servicing pressure once interest rates start to rise, and further acts as an impediment to spending and investments. In cities such as Sydney and Hong Kong where home prices have risen sharply in recent years, a tightening of monetary conditions could trigger housing price corrections, which will likely place added stress on households through a negative wealth effect.

There are several factors which will mitigate the impact of rising rates. Firstly, household net wealth has grown and corporate profitability in countries such as Australia and Japan has improved, which suggests that the private sector has the bandwidth to cope with a gradual increase in debt servicing costs. Secondly, most of APAC's debt is domestic, which at least ensures that any financial problems that emerge as a result of being overleveraged is ring-fenced and protected from external pressure, as mentioned earlier.

Sluggish wage growth

The conundrum facing labour markets globally, and not just in APAC, is that despite the low unemployment rates, wage growth has remained relatively muted. Across the region, the unemployment rate has generally trended downwards since peaking in 2009 after the GFC, and the immediate years after were followed by a rebound in wage growth. Since 2014, however, the pace of wage increase has tapered off (aside

Figure 10. Credit to non-financial corporations and households (% of GDP)



Source: Bank for International Settlements, September 2018

from Japan) despite continued tightening of the labour market. Reasons for the muted wage growth include weak labour productivity growth, automation, integration of global value chains and an aging population, factors which reduce the bargaining power of workers. To be sure, wages and income are still increasing, but the moderation in growth could be a limiting factor to domestic demand.

Aging population

Although much of East Asia has benefited from the demographic dividend of a growing young population in past decades, the challenge facing APAC moving forward is a rapidly aging population (Figure 10).

Declining fertility rates and increasing life expectancy are resulting in growing old-age dependency ratios, which could act as constraints on an economy to the extent that healthcare costs rise, growth in the labour force slows or reverses, and productivity growth moderates. The speed at which APAC is aging is also concerning – according to the IMF, Europe and the US took 26 years and more than 50 years respectively for their old-age dependency ratio to rise from 15% to 20%. For Japan, China, Singapore and South Korea, that transition is estimated to take less than 10 years, which means that these economies have less time to adjust to the challenges posed by graying populations.

The issue of aging populations is particularly detrimental for countries in developing Asia such as China, India and Indonesia, where the working age population share of total population will peak when per capita income levels are much lower than in the West. This is less damaging an issue for economies such as Japan, Singapore, Australia and Hong Kong which are already experiencing high income levels. Furthermore, the challenges of an aging population are not insurmountable and can be managed through proactive government policies. In Japan, the Abe administration has successfully raised the labour force participation rates of both female and older workers, although more can be done to ensure fiscal sustainability in light of rising social expenditure. Countries such as Australia, Hong Kong and Singapore also show that immigration can be a useful avenue to maintain economic vibrancy and momentum.

Era of yield compression is ending

The past decade of APAC real estate investments has been characterised by steady yield compression, enabling capital gains for investors who managed to capture the trend (Figure 11). However, that trend looks set to reverse in the coming years due to the rising rate environment, which signals an imminent end to the yield compression cycle.

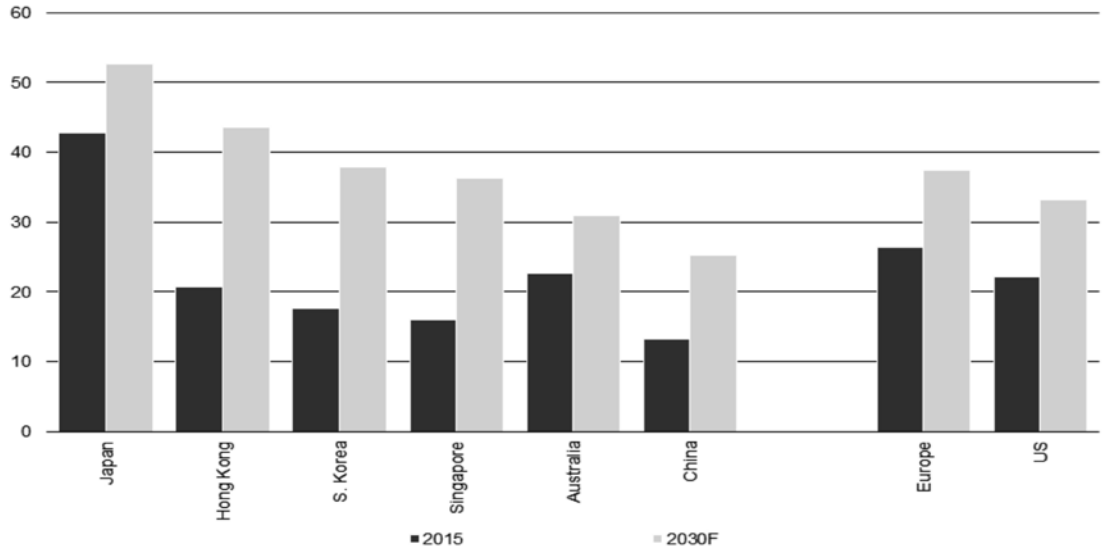
Several factors, however, could prolong the yield compression cycle although that is not something we would encourage investors to underwrite. Markets are still awash with liquidity and the amount of capital looking for assets remains substantial. Furthermore, current yield spreads in general remain above historical lows, suggesting that there is still (limited) room for yield compression.

Real estate: Risk-adjusted return profile remains attractive

The combination of high economic output and enhanced risk buffers have resulted in a favourable risk-adjusted return profile for APAC property markets. Between 2008 and 2017, major developed APAC countries have delivered total returns that are higher than the global benchmark at a lower volatility rate than developed markets like the US and UK (Figure 12). The exceptions are Japan, which has compensated for its lower returns with lower volatility, and Hong Kong, where the converse is true. Going forward, the forecasted total returns for APAC are also largely expected to continue to outperform the global benchmark (Figure 13).

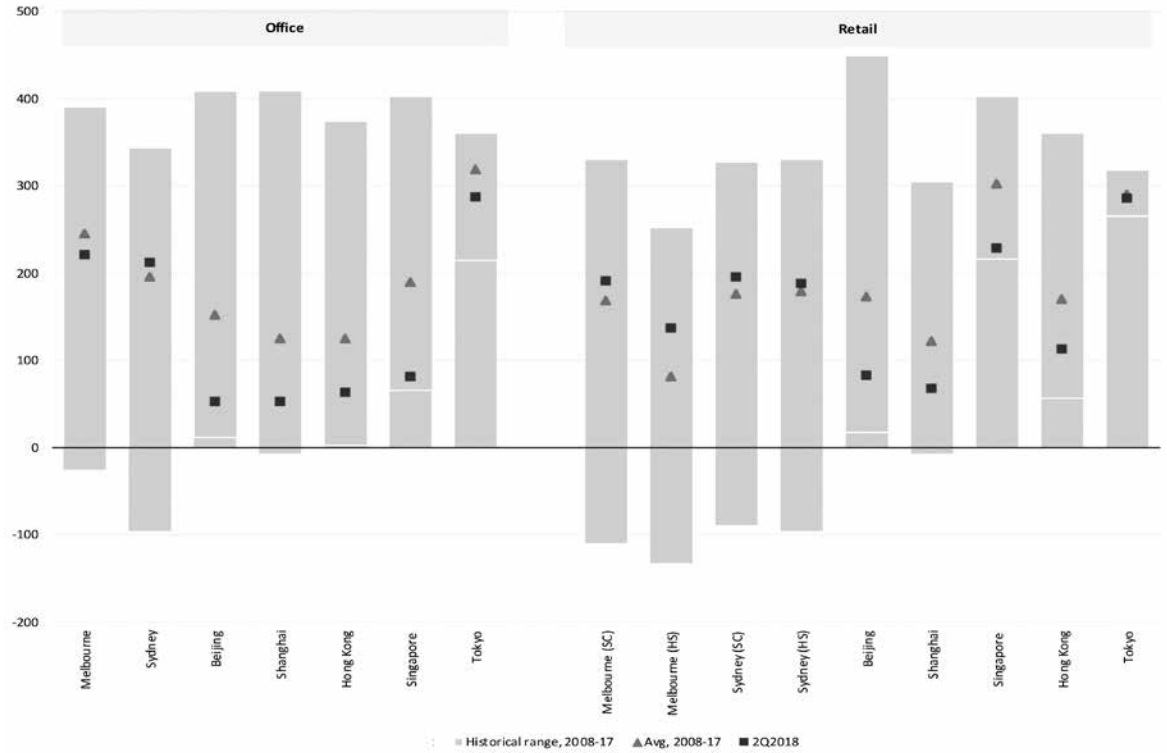
Figure 11. Projected old age dependency ratio

(Ratio of population > 65 yrs. per 100 people aged 15-64 yrs., %)



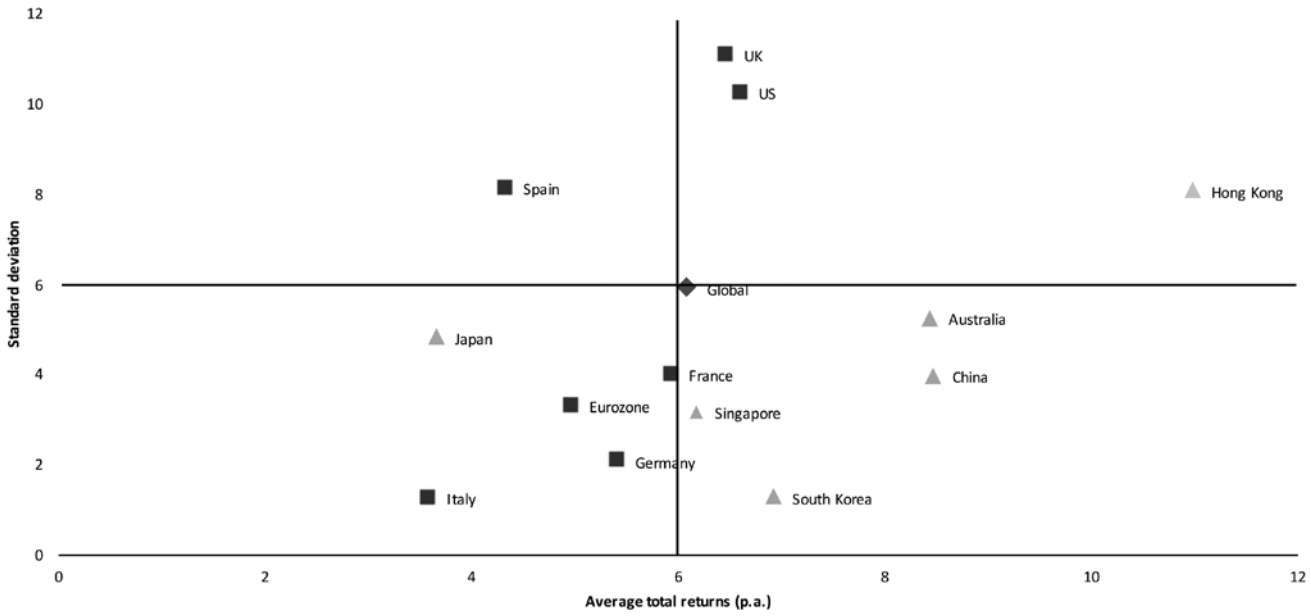
Source: UN World Population Prospects 2017

Figure 12. Yield spread (office and retail yield vs 10yr govt. bond, bps)



Source: CBRE; Bloomberg, September 2018

Figure 13. Average total returns and standard deviation, 2008-2017 (all property; % YoY)



Source: UBS Asset Management, Real Estate & Private Markets (REPM), August 2018

The allure of the investment market and liquidity

To be sure, the growth potential of APAC has been well established for some time now. The challenge was more about the availability of investment opportunities and the overall investing environment, and there are reasons to believe that investing in the APAC real estate investment market now is more viable than before.

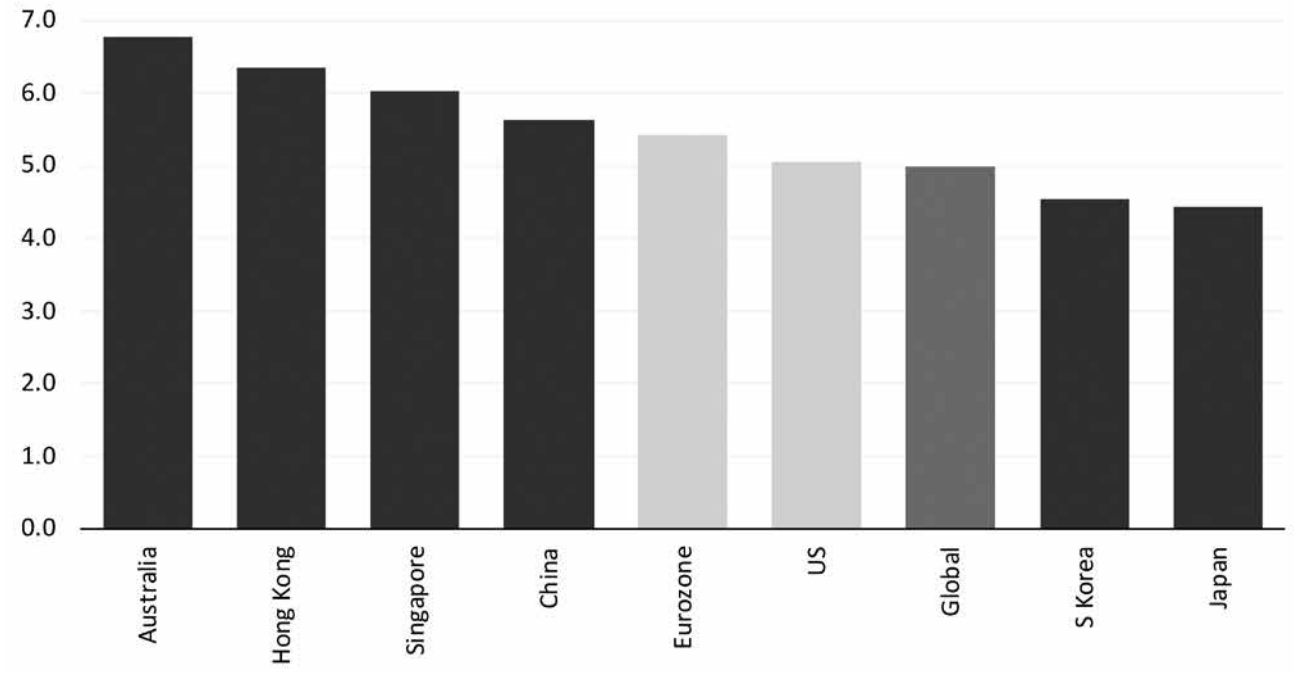
On top of the existing deep markets in Japan and Australia, the maturation of the property market in the region will lead to a substantial expansion of the stock of institutional grade real estate, signaling tremendous potential for new investment opportunities. Correspondingly, the availability of capital has grown and as capital markets mature, the liquidity is likely to increasingly find its way into real estate, enabling the real estate investment market to gain greater institutional depth. CBRE projects that the total assets under management (AuM) held by APAC institutional investors will hit USD 18.6 trillion by 2020 from USD 14.8 trillion in 2014, with the allocation to real estate expected to rise from 2% to 3%. This represents an increase of USD 240 billion worth of real estate investments between 2014 and 2020, and the growth potential remains huge given that this level of investments is still below the average allocation of 5-10% to real estate by institutional investors in developed markets.

Conclusion – Spring beckons and is here to stay

The growth epicenter of the world is only just beginning to shift toward APAC. In the developing APAC markets, real estate still has a long runway when it comes to gaining depth as an institutional investment asset class. In the developed markets such as Japan, Australia and Singapore, the already strong property market fundamentals will be further enhanced by the increased regionalisation of investment and capital flows. While we acknowledge that there are risks to investing in APAC, we are also conscious not to be crippled by uncertainty and lose sight of the growth potential of the region.

As the uplift in values from yield compression fades globally, investors must reassess their underweight position in regions such as Asia. With fundamentals taking over as the key driver of performance, Asia's growth premium is likely to underpin the region's outperformance in real estate markets in the medium to long term. **FS**

Figure 14. Average forecasted total returns, 2018-2022 (all property; % YoY)



Source: UBS Asset Management, Real Estate & Private Markets (REPM), August 2018