In 2020, commercial real estate markets were dominated by the economic impact of COVID-19. With the expected arrival of a vaccine, there are good reasons to be more optimistic for 2021 and beyond.

Liquidity in global real estate investment markets has declined due to restrictions on international travel and more cautious market participants, while prime office yields remained largely stable. Currently, there is no sign of distress outside the retail and hotel sectors.

Working from home (WFH) is likely to have a lasting impact on office markets. However, we believe that cyclical impact is likely to matter more for investors over the next two to three years.

Nevertheless, WFH can magnify cyclical effects, and we have identified markets where rents are likely to see some downside. These are largely markets exposed to the tech sector (San Francisco, Dublin) or with increased construction activity (Paris La Défense) or some demand issues (Australia, Spain, Singapore). These markets should be on the watchlist of value-added investors, as they could pose interesting entry points in 2021.

We have also identified markets that are likely to see only limited downside in rents. These cities can be found in the DACH region (Munich, Hamburg, Vienna), Benelux, Scandinavia and Japan. Although yields are typically between 2.5% and 3.5% in these markets, they offer investors stability and are good candidates for core real estate strategies.

Rental market performance and good asset management on the asset level remain the key success criteria in the current environment. That is why we have introduced the term "sound income perspectives", which we think is especially useful for core investments.

Do not write off London despite the uncertainties regarding the UK’s divorce from the EU and the lockdowns. Investment transaction volumes during the COVID-19 crisis only dropped by 20% YoY from January to end September 2020. COVID-19 making it the most resilient among the top 30 cities. While rents are likely to adjust downward, valuations remain convincing and we expect a rebound later in 2021.

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**Welcome to the latest edition of Real Estate Strategies**

- A challenging year for the global economy
- Strong and unprecedented policy responses
- Upbeat economic outlook for 2021 due to expected arrival of a COVID-19 vaccine
- Substantial drop in global transaction volumes: London and Paris with high levels of activity
- Investment demand for core real estate with "sound income perspectives"
- Structural changes continue to accelerate: retail vs logistics
- Office markets: cyclical impact more important than WFH
- Markets with a cyclical downward adjustment to offer interesting value-added opportunities
- Strong resilience in Germany, Scandinavia, Benelux and Japan makes them good candidates for core strategies
- And what about London?
- Conclusion
In this issue of Real Estate Strategies, we review the evolution of real estate markets in 2020 and aim to provide an outlook for 2021, with a particular focus on value-added real estate across the globe and European core strategies.

**A challenging year for the global economy**

In 2020, the economy was hit by a global health crisis, as COVID-19 caused more than 1.2 million deaths globally between January and November. This threat has not yet been eliminated. Europe is currently facing its second wave, with shutdowns in Germany, France and the UK. In the US, the third wave of the virus is on the rise. The various restrictions on economic activity, such as shutdowns and measures to restrict international travel, took a toll on global GDP growth. Credit Suisse Research forecasts that the global economy will ultimately shrink by around 4% in 2020.

Overall, in Q3 2020 the economy succeeded in recovering from the depths it reached during the lockdown in the second quarter. The recovery in China and Asia has been faster than expected. In the United States and the Eurozone, household incomes were supported by government transfers, which provided more stabilization, and the decline in economic activity was less pronounced than originally feared, thanks to active fiscal policies. However, the character of the recession is a different one. In the current recession, the service-oriented sectors, which are normally less affected than, for example, manufacturing and construction, have also had a significant setback. Services requiring face-to-face interactions with clients, particularly in sectors such as retail, hospitality, entertainment, and healthcare, had to adapt to new standards and establish new ways of conducting their activities. This will lead to supplementary costs before they are able to resume their daily operations.

These service activities with a stabilizing effect on the economy are, in many cases substantially reduced for now in some areas, and are unlikely to return to normal without effective therapies available to combat the virus. Nevertheless, retail sales and wholesale figures point to a stronger interim recovery compared to industrial production. In some areas, pent-up demand effects led to this result, supported by a pick-up in global trade as soon as lockdowns were eased. This development was evidenced by lower unemployment rates in the US, a fall in Germany’s Kurzarbeit applications (reduced work hours program) and the high frequency indicator Purchasing Managers’ Index reading above the expansion level of 50, with 54.7 in September and 54.5 in October.

**Strong and unprecedented policy responses**

The pandemic has triggered massive global policy responses. Fiscal conditions have generally continued to ease and play a vital role in supporting the overall sentiment. The financial markets have had a stabilizing effect to date, but the overall reduced economic activity affects public finance budgets through their revenues and expenditures accounts. Expanded unemployment insurance programs, tax deferrals, regulatory initiatives to ease classification rules and provisioning requirements for banks’ non-performing loans along with a wide range of other temporary lifeline extensions on a global scale are expected to leave governments with huge debt burdens. The EUR 750 billion European Union pandemic recovery package is only one example.

Central bank actions in advanced economies have involved more diverse, larger-scale asset purchases and relending facilities. Before COVID-19, the Federal Reserve was moving to a flexible average inflation target of 2.0% and allowed to overshoot. Now, no one expects the labor market to overshoot. Emerging-market central banks’ responses included interest rate cuts, and in some cases, for the first time, asset purchases.

**Upbeat economic outlook for 2021 due to expected arrival of a COVID-19 vaccine**

Nevertheless, the current projected recovery is more gradual than previously forecasted in spring, and is starting to look anemic in the months to come, with the COVID-19 pandemic continuing to spread in Q4 2020 and many countries in the Western world recently reinstating partial lockdowns. This raises the risk of double-dip recessions in some countries in the West. The economic situation in Asia Pacific looks better and more stable. Obviously, this region is benefitting from recent SARS and swine flu pandemic experiences, as many countries took drastic but appropriate measures.

In positive news, on November 9, Pfizer announced on encouraging test results for a vaccine against COVID-19. Also, other pharmaceutical companies are apparently in the final stages of developing their vaccines. Listed real estate and stock markets immediately reacted positively to this news. Provided that these results are confirmed, we believe the arrival of a vaccine could trigger a strong rebound in economic activity in 2021. Credit Suisse Research projects that some European countries that suffered the strongest GDP drops should also bounce back the strongest, as highlighted in Table 1.

**Table 1: Global GDP forecasts**

<table>
<thead>
<tr>
<th>Real GDP growth</th>
<th>2018</th>
<th>2019</th>
<th>2020E</th>
<th>2021E</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Global</strong></td>
<td>3.2</td>
<td>2.7</td>
<td>−3.9</td>
<td>4.5</td>
</tr>
<tr>
<td><strong>Americas</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>United States</td>
<td>2.9</td>
<td>2.3</td>
<td>−3.9</td>
<td>3.8</td>
</tr>
<tr>
<td>Canada</td>
<td>2.0</td>
<td>1.5</td>
<td>−5.2</td>
<td>6.0</td>
</tr>
<tr>
<td>Brazil</td>
<td>1.3</td>
<td>1.2</td>
<td>−4.8</td>
<td>4.1</td>
</tr>
<tr>
<td>Mexico</td>
<td>2.1</td>
<td>−0.1</td>
<td>−9.5</td>
<td>3.2</td>
</tr>
<tr>
<td><strong>Europe</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Eurozone</td>
<td>1.9</td>
<td>1.2</td>
<td>−8.0</td>
<td>5.5</td>
</tr>
<tr>
<td>France</td>
<td>1.7</td>
<td>1.2</td>
<td>−10.5</td>
<td>6.3</td>
</tr>
<tr>
<td>Germany</td>
<td>1.5</td>
<td>0.6</td>
<td>−6.0</td>
<td>4.4</td>
</tr>
<tr>
<td>Italy</td>
<td>0.7</td>
<td>0.2</td>
<td>−10.6</td>
<td>5.0</td>
</tr>
<tr>
<td>Netherlands</td>
<td>2.6</td>
<td>1.7</td>
<td>−6.5</td>
<td>4.5</td>
</tr>
<tr>
<td>Spain</td>
<td>2.4</td>
<td>2.0</td>
<td>−12.4</td>
<td>6.9</td>
</tr>
<tr>
<td>Ireland</td>
<td>8.2</td>
<td>5.6</td>
<td>−8.5</td>
<td>5.2</td>
</tr>
<tr>
<td>Poland</td>
<td>5.2</td>
<td>4.6</td>
<td>−5.0</td>
<td>4.0</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>1.3</td>
<td>1.4</td>
<td>−10.7</td>
<td>5.8</td>
</tr>
<tr>
<td>Switzerland</td>
<td>2.8</td>
<td>0.9</td>
<td>−4.0</td>
<td>3.5</td>
</tr>
<tr>
<td><strong>Asia-Pacific</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>0.3</td>
<td>0.7</td>
<td>−5.0</td>
<td>1.5</td>
</tr>
<tr>
<td>Australia</td>
<td>2.7</td>
<td>2.0</td>
<td>−6.0</td>
<td>5.0</td>
</tr>
<tr>
<td>China</td>
<td>6.6</td>
<td>6.1</td>
<td>3.3</td>
<td>5.6</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>3.0</td>
<td>−1.2</td>
<td>−7.0</td>
<td>4.2</td>
</tr>
<tr>
<td>South Korea</td>
<td>2.7</td>
<td>2.0</td>
<td>−1.9</td>
<td>2.9</td>
</tr>
<tr>
<td>Singapore</td>
<td>3.1</td>
<td>0.7</td>
<td>−6.0</td>
<td>5.5</td>
</tr>
</tbody>
</table>

Source: Credit Suisse Research forecasts, Last data point: October 24, 2020

Past performance is not a reliable guide to future performance. These figures are estimates only. They are not a reliable guide to the future performance of this investment.
Substantial drop in global transaction volumes: London and Paris with high levels of activity

GDP and employment growth are the most important drivers of office rental growth, but real estate pricing is also affected by the general interest rate and financial market environment. In contrast to the efficient pricing in stock markets, real estate values are influenced by mid-term underlying trends and structural effects. Real estate prices move in a more gradual way than the more volatile liquid financial assets. Likewise, the liquidity in real estate markets reacts quickly to uncertainty. In such times, investors typically prefer to stay on the sidelines rather than do deals, except for forced sellers.

International real estate also has a strong cross-border component and deal due diligence often depends on international travel. It is therefore not surprising that transaction volumes have dropped substantially due to limitations on international travel and the more cautious nature of buyers.

Figure 1: Global real estate transaction volumes in USD bn

![Figure 1: Global real estate transaction volumes in USD bn](image)

Figure 1 shows that in the two most recent quarters, globally, only USD 127 billion of real estate was transacted compared to over USD 220 billion on average per quarter in the three preceding years. In spite of everything, deals are still being done. Even with severe lockdowns, London and Paris emerged as the most resilient global cities in terms of transaction activity. These two global cities only experienced a YoY decline of year-to-date transaction volumes in the first nine months by roughly 20% and 27%, compared to the average drop of 34% for the 30 most liquid cities globally.

As argued in previous issues, the focus on liquid markets pays off in times of greater uncertainty. The cities that see the most transactions over a longer period are also those where opportunities are likely to emerge first due to the focus of a wide array of investors and lenders.

Due to the local presence of international investors in London, on-site due diligence was still possible, despite extended travel limitations. As such, it still remains one of the key global destinations for cross-border capital despite Brexit and a second COVID-19 lockdown.

Investment demand for core real estate with “sound income perspectives”

Core real estate properties in the office, residential and logistics sectors still saw generally resilient demand globally, from predominantly domestic institutional buyers, while retail and hotel properties were shunned.

The vigorous response by the ECB, Fed and other major central banks to the COVID-19 crisis has pushed the amount of negative-yielding debt to over USD 17 trillion, which is an all-time high (as of mid-November 2020, see Figure 2). This means that the pressure on investors to find positive-yielding assets has been further intensified. Core real estate remains one of the few alternatives outside of fixed income to find income returns with a low volatility. European real estate is the region with the lowest volatility of returns globally. That puts this asset class in the prime spot for investors looking for sound income perspectives.

Figure 2: Net prime office yields and the volume of negative-yielding bonds outstanding

![Figure 2: Net prime office yields and the volume of negative-yielding bonds outstanding](image)

We believe “sound income perspectives” are derived from two main criteria:

- **Location**: The right location remains key for the position of a real estate asset and the income it is able to generate in the future.
- **Tenants** with high ability and willingness to honor their rental commitment. The right tenants and tenant mix in the portfolio makes income returns more resilient.

Both the location of property and tenants’ business models, are affecting investors’ future rental streams. However, it is not only the business prospects of the underlying business or the credit risks of the tenants that matter but also what role the real estate plays in delivering their services or products.

For example, a grocer in a neighborhood shop that still sees high footfall and makes strong sales is a tenant with sound income perspectives. Here, the tenant is not only able to pay the rent but recognizes the property as a key factor for its profitability. The same applies to a modern grade-A office that appeals to the highly talented workforce that some companies are competing for. A fashion store that no longer makes enough in-store sales volume, or an outdated office that no longer fulfills the tenant needs for a firm that adopted working from home, are negative examples.

Past performance is not a reliable guide to future performance.
Structural changes continue to accelerate: retail vs logistics
The examples above should illustrate that investment managers need to look beyond the different real estate sectors to be able to identify strong assets and markets. Nevertheless, sector strategy has been the key factor in recent years of outperformance vs underperformance due to the structural changes that are unfolding. Extraordinary times, such as the lockdowns, can even be an accelerator of such trends.

Figure 3: Online share of retail sales in %

![Graph showing online share of retail sales in % from 2010 to 2023E.]

Sources: PMA, Credit Suisse  Last data point: October 2020

Figure 3 highlights the rising online share of retail sales. The stronger adoption of smartphones in recent years had already had a strong effect on consumer behavior prior to the COVID-19 pandemic. In Germany, the share of the share of total retail sales made online increased from 4% to 10% between 2010 and 2019. The UK, the leader of the online transformation in Europe, saw a rise from 7% to 19% in the same period. Although there will hopefully be no further lockdowns next year, they are likely to have a permanent effect on consumer behavior. Therefore, we believe these trends are likely to accelerate further and push many store-based purchases online. The final result is that store-based retail sales revenue share is likely to drop even further up to 2023 due to the effects of COVID-19, than we had assumed last year.

This is highly relevant for real estate investors and is impacting both the rental and investment markets. Despite the most severe recession in Europe since WW2, the amount of logistics leases signed during the first nine month of 2020 is up YoY by 7.5%, according to data from BNP Paribas. Rental growth has continued at a pace of 2% to 3% p.a. in most European countries, as data from Q3 2020 shows. Logistics yields have remained stable and are under downward pressure for prime assets at strategic locations. We believe that the current logistics yields are too low and that yields could increase over the mid-term.

At the same time, a substantial amount of retail tenants are under the threat of insolvency. Many retailers are reducing their store-based footprint. Recently, Inditex announced that it is likely to close down 1,200 of Zara’s 7,300 global branches. Thus, the downward pressure on retail rents is likely to remain and yields are on strong upside pressure.

Office markets: cyclical impact more important than WFH
The office sector is the most liquid investor sector globally and takes up the largest allocation of most core and value-added portfolios. Despite the negative headlines from WFH and the volatile performance of listed real estate, office yields have stayed at historical lows as institutional investors continue to believe in the longer-term perspectives of office markets (Figure 2). However, we believe the experiences during the lockdowns are likely to have a lasting impact on working models. A broader adoption of WFH will be a characteristic of the future workplace. The implication for us, however, is not the end of office life. We rather see modern office space with more space for personal interactions and meeting facilities to be in high demand in a post-COVID-19 world as the economy bounces back. At the same time, there will be a lower total amount of office space needed. Older office buildings with outdated office floorplans might take a hit, but the transformation of office markets will take time and will not happen overnight.

Investors need to focus on the next two to three years and, over this period, the cyclical effects should dominate. The weaker labor market situation that is still likely to remain in H1 2021 is exerting a negative effect on office demand.

Markets with a cyclical downward adjustment to offer interesting value-added opportunities
We observed very resilient rental markets in the first nine months of this year. However, opportunities will still arise in those that have a stronger cyclical component on a global level. Interestingly, markets with an ongoing stronger cyclical adjustment can be found in all regions, as shown in Table 2. In the US, New York and San Francisco seem to have been hit particularly hard, as technological companies are those that appear to switch most quickly to WFH, and many companies are trying to sublease their space. This will lead to further increases in the vacancy rates that have already taken a hit, as highlighted in Figure 4 for San Francisco. In some other markets increased construction activity, such as Paris La Défense or CEE, is the reason why rents are seeing some more downside. Lack of demand is affecting some Australian cities, Singapore and Hong Kong.

Table 2: Markets with a stronger cyclical impact

<table>
<thead>
<tr>
<th>Region</th>
<th>Markets</th>
<th>Rental market impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Europe</td>
<td>Madrid, Barcelona</td>
<td>Vacancy rates to rise by 3-5%, rents to drop by more than 10%, incentives increasing; yields to increase by 25-50 bps until 2021E</td>
</tr>
<tr>
<td>Europe</td>
<td>Dublin</td>
<td>Dublin hit by weak demand of US tech companies; we anticipate a 12% drop in rents until end 2021</td>
</tr>
<tr>
<td>Europe</td>
<td>Paris La Défense, CEE</td>
<td>Supply pipeline cannot be absorbed due to negative net absorption; mid-term we remain positive on CEE</td>
</tr>
<tr>
<td>APAC</td>
<td>Sydney, Melbourne</td>
<td>Net effective rents to drop by 20% cumulative peak to trough; 2021 to remain difficult, recovery from 2022 onward</td>
</tr>
<tr>
<td>APAC</td>
<td>Singapore</td>
<td>Cyclical demand weakness, rents dropped by 7% YoY as of Q3 2020; further rise in vacancy rate and rental decline in 2021 before markets recover</td>
</tr>
<tr>
<td>APAC</td>
<td>China/Hong Kong</td>
<td>Hong Kong with drop of 35% in capital values since 2018, further downside; China gateways with oversupply and lower rental trend</td>
</tr>
<tr>
<td>Americas</td>
<td>New York, San Francisco</td>
<td>Weak tech demand, strong adoption of WFH; amount of sublease space and vacancies sharply increasing; peak-to-trough capital value adjustment of 20-25% likely until 2021E</td>
</tr>
<tr>
<td>Americas</td>
<td>Houston, Calgary</td>
<td>Weak demand from energy industry; markets were weak before, but further downside of 15%-20% in capital values expected</td>
</tr>
</tbody>
</table>

Sources: Credit Suisse

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Such cyclical adjustments have shown in the past that they also offer great opportunities for investors looking for higher, value-added types of returns. As the labor markets are likely to recover from 2022 onward, rental markets will also rebound. Therefore, we believe that 2021 could be an interesting year to identify value-added investments in some of these cities. US gateways and Australian cities may present unique opportunities. These are on a long-term upward trend, and the current correction could be a convincing entry opportunity not seen for more than a decade.

**Strong resilience in Germany, Scandinavia, Benelux and Japan makes them good candidates for core strategies**

The impact of the deep economic shock on some other office rental markets has been limited. We believe that cities from the DACH (Germany, Austria, Switzerland) region, Benelux, Scandinavia and Japan typically fall in this category (see Table 3).

<table>
<thead>
<tr>
<th>Region</th>
<th>Markets</th>
<th>Rental market impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>DACH region</td>
<td>Munich, Hamburg, Vienna</td>
<td>Peak-to-trough decline of rents lower than 2% expected, rental growth to rebound in 2022; vacancy rates to remain low</td>
</tr>
<tr>
<td>Benelux</td>
<td>Amsterdam, Brussels</td>
<td>Light impact on effective rents expected due to higher incentives; stable demand situation</td>
</tr>
<tr>
<td>Japan</td>
<td>Tokyo, Osaka</td>
<td>Only slowdown in rental growth, limited impact on rental markets expected</td>
</tr>
<tr>
<td>Scandinavia</td>
<td>Stockholm, Copenhagen, Helsinki</td>
<td>Limited peak-to-trough decline between 2% and 4% expected, depending on city</td>
</tr>
</tbody>
</table>

Source: Credit Suisse

Figure 4 shows the evolution of vacancy rates of some in these selected cities compared with Melbourne and San Francisco. Vacancy rates have remained largely stable at historically low levels. Although we will also see some weakening in these cities in 2021 as government support measures expire, the downside in rents remains largely limited. After 2022, as labor markets eventually rebound, rental growth could pick up again.

**Figure 4: Evolution of office vacancy rates in %**

And what about London?

Having experienced two lockdowns, the London office rental market had a slow year. Rental space leased dropped by more than 70% YoY in the first nine months. Rents are likely to take a cyclical hit. We anticipate a peak-to-trough decline in rents of around 10% until the end of 2021. However, as there is very limited supply in the pipeline, we believe this market may outperform in terms of rental growth in 2022. This might also depend on the ability of the UK to secure a decent trade agreement with the EU, which is still uncertain at the time of writing (November 2020).

As highlighted above, London has been the most resilient top-30 global city in terms of investment demand. There are two reasons why we believe valuations to be appealing. Firstly, core office yields in London offer a pickup of 100 to 150 bps compared to cities in the Eurozone, despite higher liquidity. Secondly, as shown in Figure 5, the risk premia at the end of Q3 compare favorably with historical rates. In these terms, valuations become attractive, as risk premia in London are currently twice the 19-year historical average. Therefore, we expect that with the renewal of international travel, London is likely to experience a flurry of transactions due to pent-up investment demand.

**Figure 5: Risk premia for office investments**

Conclusion

The impact of the COVID-19 recession cannot be compared with the effects of the 2008 financial crisis. Given the lower leverage applied in recent years, there are very limited signs of distress outside the hospitality and retail sectors. In the wake of the lockdowns, rental perspectives and the evolution of tenants’ risk profiles have taken on greater importance. This is why we have introduced the term “sound income perspective,” which we believe core investors should employ. Markets are likely to see some negative short-term impact due to the cyclical nature of real estate. However, we remain confident that European core real estate is a good place to be in times of greater uncertainties (Table 3).

The expected arrival of a COVID-19 vaccine in 2021, also gives us good cause for optimism. Value-add investors should take a close look at the markets we highlighted in Table 2, as we believe 2021 could provide decent entry opportunities to deploy money at lower valuations in those markets. However, such strategies also involve higher risks.

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