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INVESTMENT MANAGEMENT

Tales From the Emerging World

Global Real Estate: One Size Doesn't Fit All

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In June, one of New York's most prominent real estate owners ceased making payments on a $240 million loan and instead handed back the keys to 61 Broadway, an iconic building near Wall Street with 40 stories of office space. It was the latest in a succession of major institutional owners choosing to walk away from trophy buildings and costly mortgages as they wrestle with post-pandemic changes in workplace habits. But beyond the headlines, the story of global real estate is more nuanced.

The anemic return to the workplace in the U.S. has resulted in many once-bustling office towers now operating at half capacity, putting pressure on developers who need to pay back their loans or refinance at higher rates. The total outstanding debt for real estate stands at $1.8 trillion with some $165 billion coming due this year.

In contrast, the U.S. residential market has shown remarkable resilience driven by limited supply and pent-up demand from families seeking larger homes and an increasing number of millennials, benefiting from a tight job market, a generous stimulus package and a moratorium on student debt. Despite rising mortgage rates, the market is unlikely to experience a correction like we have seen in the past, as almost 60% of housing stock is held by those aged 55 and older who are typically reluctant to sell and surrender low mortgage rates obtained pre-pandemic. The median age of U.S. housing stock is now at a post-war high of 40 years.

While the U.S. residential market is strong, other developed economies face vulnerabilities due to the widespread use of variable mortgages. Unlike U.S. home loans, which typically have fixed rates for long durations, borrowers in countries like Australia, Canada, New Zealand and Sweden have adjustable mortgages that will reset to higher interest payments. On the contrary, other European countries like Italy and France, where a higher portion of the housing stock is owned outright without a mortgage, are insulated from rising rates.

A disparity between emerging markets and developed economies arises when comparing house-price-to-income ratios, revealing affordability gaps within the global real estate market. Lower house-price-to-income ratios in emerging markets indicate that incomes are growing faster than home prices, creating a more favorable environment for potential home buyers. Several factors, such as lower land and construction costs, relaxed regulatory barriers and reduced speculative investment inflows signify a healthy real estate market, making investments in real estate a compelling opportunity. However, income growth in several developed economies has failed to keep pace with real estate prices, hereby eroding affordability.

Real estate prospects in emerging economies vary significantly depending on the country. China, for instance, has an 80% home ownership rate, but an excessively supplied housing market, declining affordability in Tier 1 cities and limits to local government revenues from land sales has dampened real estate investment. The government is trying to rightsize the sector as it accounts for 2.5 times the country's GDP, as compared to 1.5 times in the U.S., and contributes about 25% to the economy. The fall in property prices is keenly felt, as the typical Chinese household has two-thirds of their wealth tied up in real estate. Structural factors such as shifting demographics, slowing income growth and an unwinding of 15 years of speculative excesses have set the property market on a downtrend trajectory.

In stark contrast to China's property woes, India's real estate is bottoming out as more of its population migrates to cities, increasing the need for housing and high affordability. House prices in India are 3.2 times average income, compared to 6.7 times in China. Nominal wage growth of around 8% should fuel demand, at a time of declining supply amid industry consolidation. The real estate sector further benefits from the strong financial health of property developers, consumers and banks which together serve as another tailwind for the market.

Shifts in global trade patterns will favor select markets in Mexico and some ASEAN (Association of Southeast Asian Nations) countries which stand to gain as companies follow a "China Plus One" or nearshoring strategy. Mexico is experiencing an increased need for more industrial space as companies diversify their supply chains away from China. In the Philippines, commercial property sales have rebounded to 70% of pre-COVID levels. Singapore, with its skilled workforce and advanced infrastructure, attracts tech firms expanding in the region. Both residential and commercial real estate are entering an expansion cycle of construction activity.

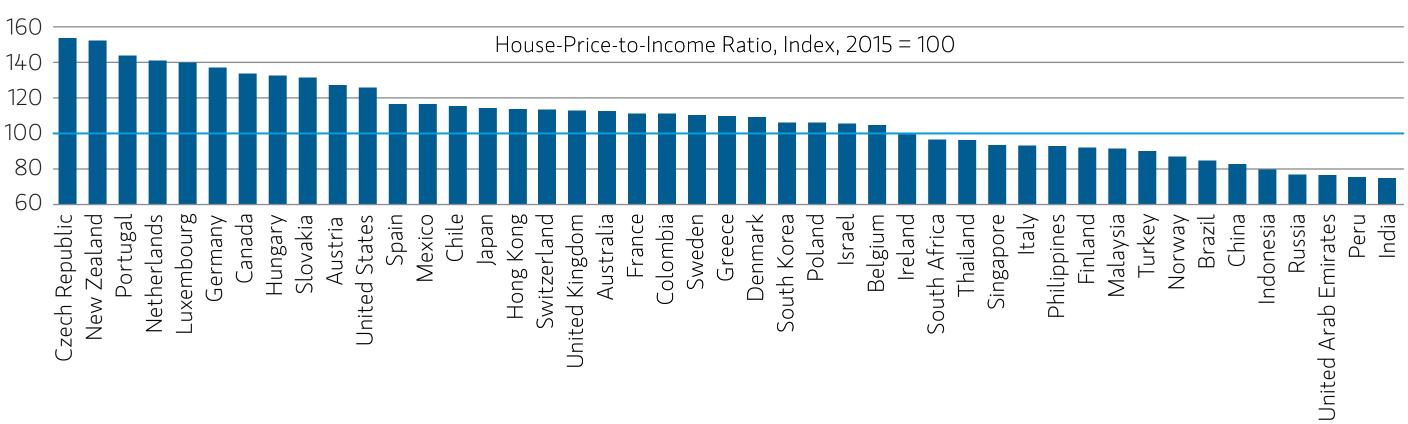
In the Middle East, Dubai's low taxes, warm weather and lax restrictions had lured expats over the years. Russia's invasion of Ukraine added another stream of new residents. More than 4,000 high-net-worth individuals settled in the UAE last year, pushing up apartment prices 14% and rents by 27% in 2022. Saudi Arabia is currently in the midst of massive construction projects, including the Riyadh Airport expansion and smart cities like NEOM and the Red Sea Project, designed to increase annual visitors by 100 million by 2030.

While U.S. office towers remain empty, the country's residential market dynamics are much more favorable—employment remains strong, borrowers have better credit and loan delinquencies are low. We'll be watching the impact of interest rate increases on variable mortgages and China's struggles to fix its property market. But in many other emerging economies, we expect to see a new real estate investment cycle driven by high growth, limited supply and secular demographic trends that will create opportunities as interest rates decline.

DISPLAY 1

House Affordability: Diverging Paths in Developing and Emerging Markets

A measure of home affordability across markets, lower = more affordable, higher = less affordable



Source: IMF, 2023. Note: 100 represents average ratio across countries in 2015.

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