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Trade wars are here to stay - How can European real estate investors build portfolio resilience?

THE IMPACT OF RISING PROTECTIONISM ON EUROPEAN REAL ESTATE

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LaSalle has looked at the likely macroeconomic costs of increased barriers to trade and their potential consequences for European real estate markets.

Up until recently, free trade seemed to be a crucial ingredient to the dominant political and economic narrative. After several rounds of trade liberalisation, and except for the immediate aftermath of Lehman Brothers' collapse in 2008, the world economy enjoyed virtually seven decades of uninterrupted growth in export volumes. Global tariffs dropped tenfold from 40% fifty years ago to just 4% currently. Rapid evolution of supply chains was facilitated by the removal of trade barriers that followed the completion of the Uruguay Round in 1994 and the creation of the WTO, plus the integration of China and the Soviet Union. Over that period global trade growth outstripped economic growth by nearly a factor of two resulting in world trade (imports + exports of goods and services) accounting for nearly 45% of world GDP growth since 1990.

Three of the top five bilateral trade relationships are or have just been renegotiated

Largest Bilateral Trade Relationships
(Merchandise Trade Only, Imports + Exports)

Trading Partners	$ Billion 2016
US - China	$597
US - Canada	$550
US - Mexico	$526
China – Hong Kong	$304
China – Japan	$275
China – South Korea	$253
US – Japan	$198
Germany – France	$184
Germany – Neth.	$179
US – Germany	$165
China - Germany	$151
Germany - UK	$132
Germany – Italy	$125
Germany - Belgium	$117
US – South Korea	$114

Source: World Bank Integrated Trade Solution (2016), LaSalle 2018

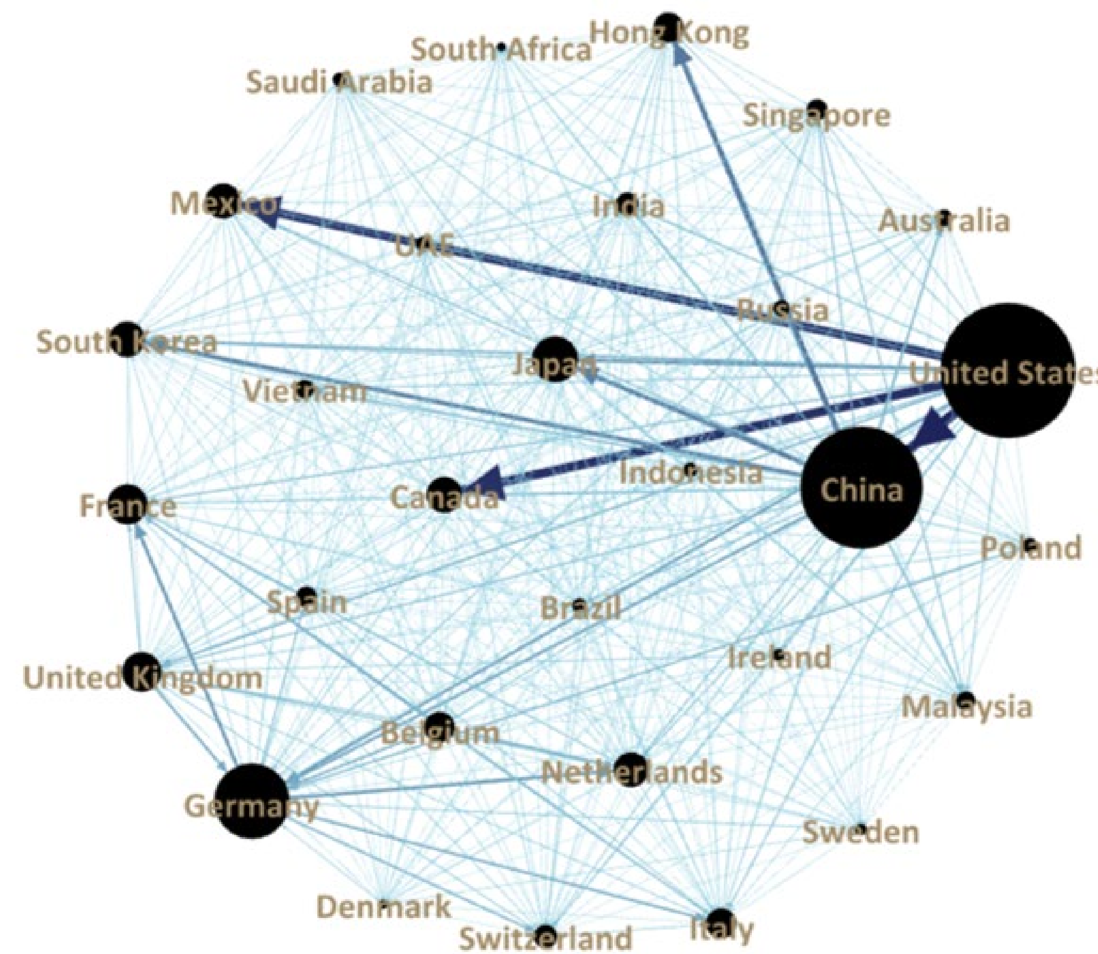
World trade today represents nearly 30% of world GDP, and just over 100% of global industrial production but, according to experts, has been facing declining marginal returns for the past years (as an illustration, container shipping now represents 90% of non-bulk cargo globally – it can't go much higher). This means that global trade trend growth expectations, even in the absence of any trade tensions, would've probably significantly moderated going forward (absent a boost in global productivity). To make matters worse, exports have concentrated in fewer countries, with China now accounting for a record 14.6% of world exports. This concentration has resulted in the huge imbalances of FX reserves we have today, and many are of the view (including in Washington D.C) that that these imbalances ultimately undermine the export market by weakening net importers and ultimately the global economy. The resulting trade tensions that have been grabbing news headlines have become a more salient source of concern for policy makers, CEOs and investors alike.

Three of the top five bilateral trade relationships are or have just been renegotiated

We have looked at the likely macroeconomic costs of increased barriers to trade and their potential consequences for European real estate markets. There are four key takeaways from our research. Firstly, due to the necessary legislative decoupling and the imposition of tariff and non-tariff barriers on UK and EU goods, the risk posed by a No-Deal Brexit is significantly larger than increased barriers for EU goods destined say for the US; the Brexit debate can be fundamentally thought of as a rejection of liberal trade, mobility policies and international integration.
Secondly, the regional and complex nature of supply-chains means that wholesale shifts in production patterns outside of Europe seems unlikely; however, that also implies that losing membership of a closely integrated trading bloc (like the EU) is a paramount risk to the UK. Thirdly, the expected impact of a global trade war, and the corresponding negative impact on growth in the US and China, are expected to be quantitatively modest in most key European countries and cities, as no outright falls in employment or output are forecast.

Fortunately European supply-chains are more regional than global

- Supply-chains are more often regional rather than global clusters
- A sizable portion of trade is simply intermediate goods traded within regions and not globally
- More than half of UK inputs sourced in the EU



Source: Visualization created by LaSalle. Data is based on World Bank Integrated Trade Solution (https://wits.worldbank.org/countrystats.aspx) using import and export data for 2016, the most recent year available.

What does this mean for Europe's office, retail and industrial markets?

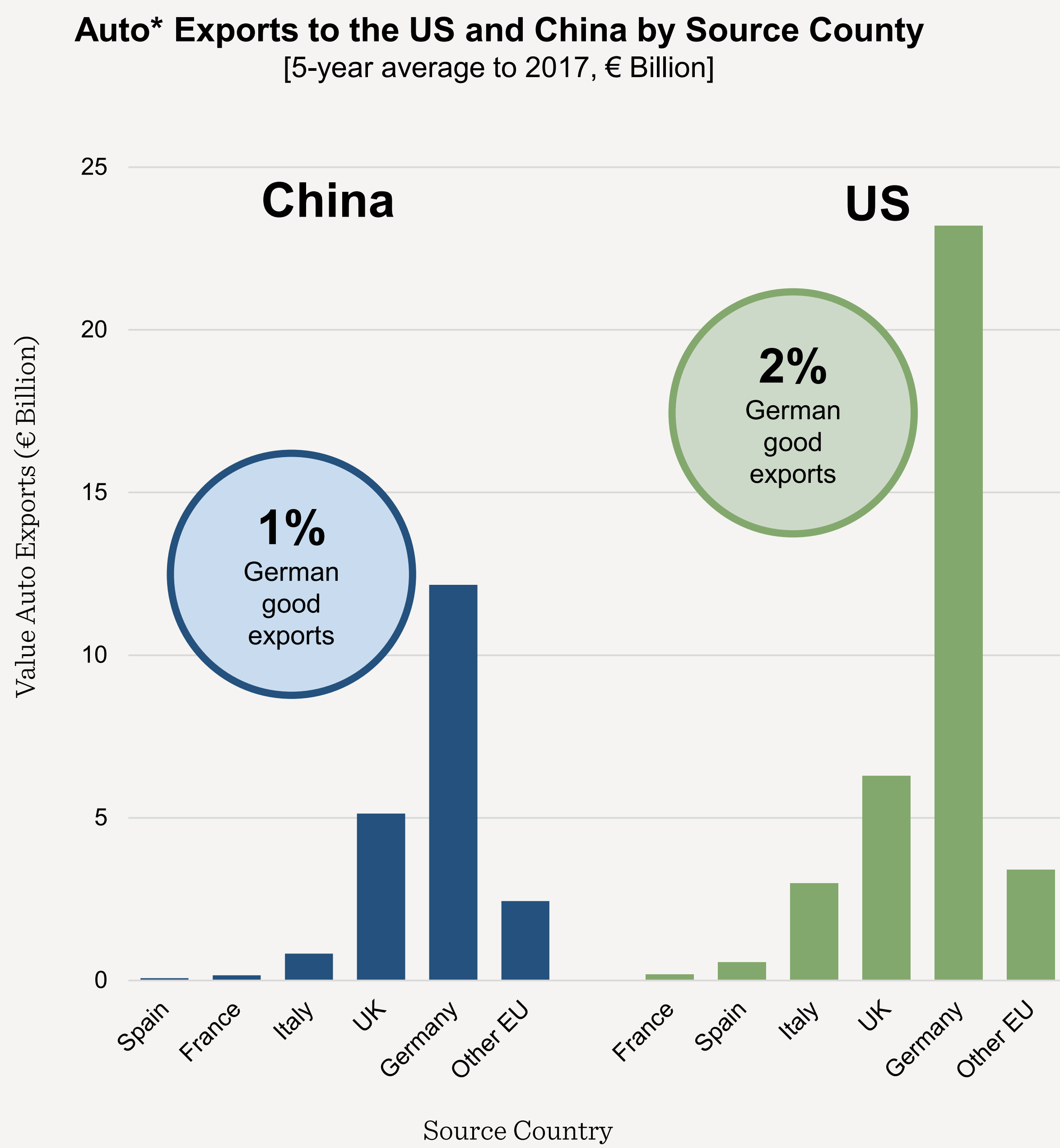
We used the robust relationships that exist between macroeconomic variables and real estate rents to determine the potential impact of a trade war on the office, industrial / logistics and retail sectors in European metros.

It is perhaps unsurprising that the main UK office markets seem most exposed to the risks posed by escalated trade frictions. That in part reflects their greater exposure to Brexit-related risks. Indeed, London and Bristol face the largest hits to their employment growth rates on a pan-European basis. Also hard hit will be office markets in smaller single-industry towns where the impact of, for example, the closure of car production factories will take its toll. These may include Sunderland, Swindon, and parts of South Wales. By comparison, while the expected shortfall in employment growth in Manchester and Birmingham is smaller, these markets have been more sensitive to changes in employment conditions in the past. At the opposite end of the scale, Paris, Barcelona, Madrid, and Berlin look relatively insulated from trade risks by virtue of their small estimated trade impacts on demand. Meanwhile, Lyon seems the office market least at risk as the expected hit to jobs is amongst the smallest.

As in the office sector, we think the non-urban industrial space in the UK looks more exposed to the increase in trade barriers than on the Continent. London, Bristol, and Birmingham are expected to see some of the largest hits to demand, and rents have tended to be moderately sensitive to changes in demand. Similar to the office sector, the industrial and logistics markets tied to manufacturing (including car production) and ports could be impacted. Continental markets like Berlin, Lyon, and Paris are expected to see some of the least notable decreases in GDP growth as a result of a trade war, making them amongst the most insulated to a prolonged global trade war.

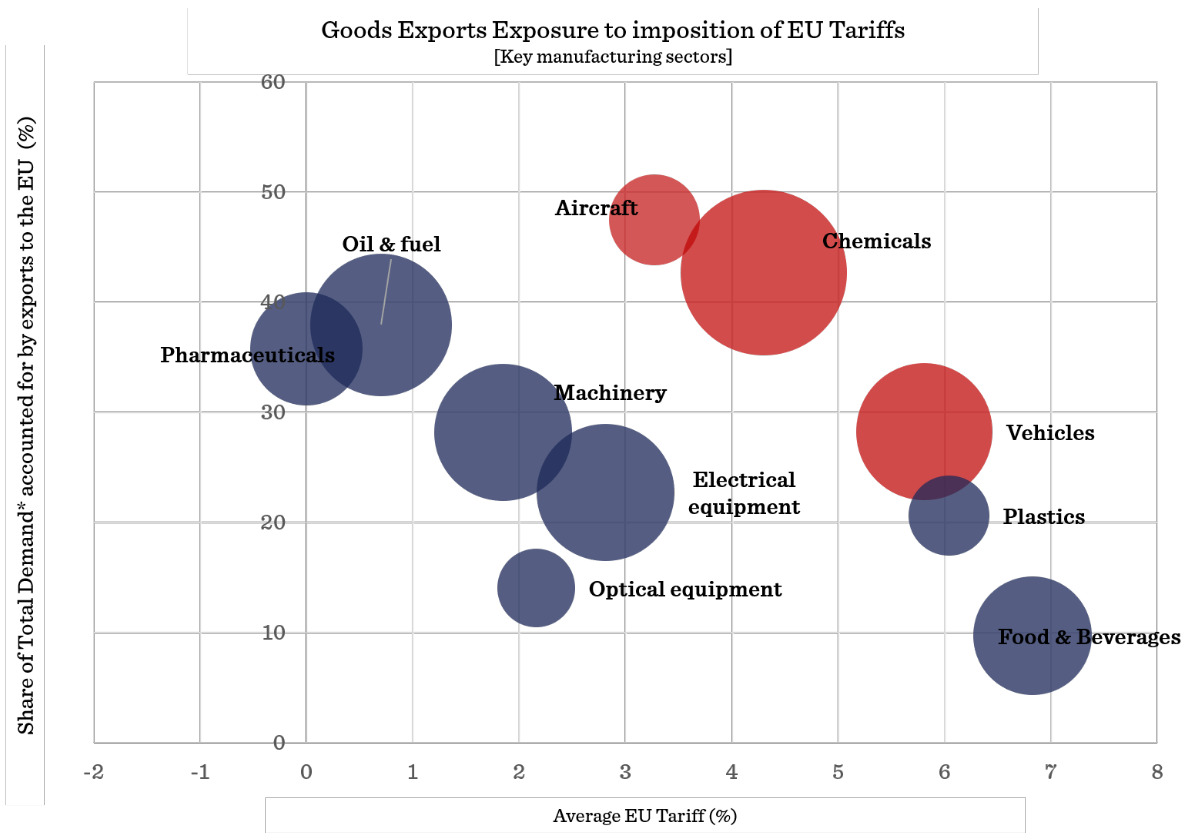
Auto exports only a small part of German exports

SUPPLY-CHAIN COMPLEXITY MEAN THAT IMPACT MORE LIKELY THROUGH PRICES THAN EMPLOYMENT



**Motor vehicles for transport of 10+ people, Motor vehicles for transport of people, goods, special purpose motor vehicles, motorcycles*
Source: Eurostat (10/18), Oxford Economics (8/18)

No-Deal Brexit Risk on UK's Goods Economy - Chemical, aircraft vehicle manufacturing most at risk of a no-deal Brexit



**Total Demand = Domestic demand + Exports*
Source: Oxford Economics (8/18 and 3/16)

It'll get worse before it gets better

Coupled with the recent increase in protectionist rhetoric, and the momentum gained by protectionist movements in an increased number of European countries and more recently in the EU parliament, the threat of increased barriers to trade to European economies should be on investors' minds. At the national level, we expect these impacts to be generally modest but with pockets of potential weakness, and be tied more to the outcome of the Brexit process than to global trade risks such as the imposition of higher auto or food tariffs on European exports.

Looking ahead, there is however a latent risk that trade tensions can escalate quite rapidly to encompass an even more restrictive environment. Indeed, President Trump's latest move to instrumentalise trade tariffs to address the geopolitical issue of illegal immigration from Mexico suggests that trade wars could be here to stay. There is a fair chance that the US and China may be stuck in a cycle of "fighting and talking" for many years before pivoting to a more "rational cooperation".

The most important point to remember is that global trade linkages have become more complex and interrelated over the last decades. The international nature of our global supply chain probably explains why the Fed has been held hostage by the 2018 appreciation of the dollar on the rest of the world. The Fed, and other developed world's central bankers, are aware that, if one were to strip out the positive impact of trade, world growth would've only managed a pace of 1.9% pa since the early 1990s. Given the scale of outstanding debt that needs to be serviced globally, this is a dangerously low level if it were to become the new norm.

Investors should thus expect trade frictions to get worse before they get better. Understandably planning against reduced resilience is something few CEOs, CIOs and fund managers are prepared as this may hurt equity or portfolio returns. We would nevertheless encourage investors to consider the potential regional and property type implications of future trade tension outlined above when constructing and building resilience in their real estate portfolios.

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