ISA by LaSalle
Insights
Strategy
Analysis

Global
Outlook 2024

Published November 14, 2023

LaSalle®
Investing today. For tomorrow.

LaSalle's Research and Strategy team plays a fundamental role in our investment process. Our global team of around 30 researchers, strategists and data scientists have developed a range of tools and models to help drive outcomes for our investors. LaSalle's investment leaders and I look to the team primarily for this proprietary analysis, but Research and Strategy is also instrumental in articulating our views to help our clients and partners navigate changing market conditions.

Each year, we share our global real estate investment outlook for the year ahead in this – our flagship report – the *ISA Outlook*. Now in its 31st year, the report brings together perspectives and investment ideas from our teams around the globe, based on a wide range of data sources and proprietary intelligence gleaned from our more than 1,500 assets that span geographies, property types and risk profiles. The *ISA Outlook* sits alongside the seven *ISA Briefing* notes and two *ISA Focus* reports that we released in 2023, as well as our first ever *ISA Portfolio View*, in addressing the key questions faced by global real estate investors.

An unsettled market

The opening sentence of this year's report says that "the context for real estate remains unsettled." It is indeed a complex and uncertain environment. This global chapter seeks to cut through the noise and focus on the key themes that underpin our analysis in this edition:

1. Searching for peak interest rates
2. Solving the capital stack equation
3. Fundamentals moderating in strong sectors
4. Understanding bifurcation within real estate sectors
5. The changing definition of quality and core real estate

What's new for 2024

This year, we will be releasing the *ISA Outlook* chapters sequentially, starting with the global outlook in mid-November, and continuing until early December with chapters framing the outlook for Europe, North America and Asia Pacific. This will allow us to do deeper dives into the regional and local nuances that shape the challenges and opportunities set across the geographies where LaSalle has exposure and is analyzing for relative value.

We are also introducing new "In hindsight" sidebars within the 2024 report, in which we look back at predictions and recommendations we made in 2023, noting what we got right as well as what we got wrong. No forecaster is always correct, but transparency and accountability about past views is a good foundation for improving future projections.

We look forward to hearing your feedback on this outlook and meeting with you as we conclude 2023 and advance toward the opportunities that 2024 will provide.

Best regards,

Mark Gabbay
Global CEO

EXECUTIVE SUMMARY: LaSalle's global themes for 2024

In this global chapter of the *ISA Outlook 2024*, we will tackle our key themes for real estate across the globe. While not every one of them applies equally or in quite the same way in every market where we invest, we find tremendous value in engaging in "pattern recognition" – finding similarities and differences that can help inform strategy.

We start at high level, where we find that the macro context for real estate remains unsettled. Bond markets continue to exhibit volatility as markets **search for peak interest rates**. The bid-ask spread that is holding back real estate transaction activity is likely to persist until rates settle.

A lack of transaction activity increases the challenges around recapitalizing real estate investments that have been impacted by repricing. The math of higher interest rates has triggered a need to **solve the capital stack equation**, requiring injections of equity and debt. While there will no doubt be challenges, they come with opportunities to generate attractive risk-adjusted returns as a lender, or in providing rescue equity.

The good news is that, with some exceptions, real estate fundamentals remain strong. The "winning sectors" of logistics and residential continue to outperform on a relative basis, although the heat in their fundamentals is **coming off the boil**, causing a marked reduction in their NOI growth on an absolute basis.

Across the property markets, but especially in office and retail, there are clear performance gaps opening within sectors around differentiators like quality, sustainability features and submarket vibrancy. But whether this presents an investable opportunity requires investors to go **beyond bifurcation** to assess these changes within an intrinsic value framework.

Our **investment recommendations** remain focused on logistics, residential and their adjacent sub-sectors. Because they reprice quickly, debt and listed real estate also look attractive. All investment strategies should be aligned with changing definitions of quality and core.

Introducing

IN HINDSIGHT

Looking back on key calls from last year's *ISA Outlook* global chapter

Beginning with last year's *ISA Outlook*, we implemented a new section called "Looking ahead," which takes a forward view on markets and recommends strategies. In this year's edition, we introduce a new sidebar called "In hindsight," where we look back on key calls from the prior year's edition, assessing how well we did at predicting the direction of economies and property markets. We do not have a crystal ball. But we can learn a lot from looking back at our past predictions with honesty and accountability.

Right / Mostly right | Remains to be seen | Not right / Not quite right

Searching for peak rates

Mapping the macroeconomic context

The macro context for real estate remains unsettled, and more so than earlier in 2023. What a difference a few months makes. Until late summer, interest rates in most major markets[1] exhibited high volatility, but little overall trend. They moved mainly sideways, owing to cooling inflation and expectations that central banks were reaching the end of their tightening cycles. Speaking to clients earlier in the year, we likened rates to a hiker traversing the ridge line of a mountain trail, cautiously traveling an up-and-down section after a long earlier climb, but with no steep ascent ahead.

This relative stability – as well as the acceptance of new market realities that comes with the passage of time – had started to lay the foundation for a recovery in real estate transaction activity. With rates no longer subject to 2022's sharp upward climb, seller expectations could "catch down" to bids that had been driven lower by higher debt costs and higher yields on alternative investments.

An upward turn in the trail

As of the time of writing, this tentative easing in the standoff between buyers and sellers has been called into question by a renewed surge in interest rates in several key markets (see exhibit G-a). It has been as if the mountain hiker had turned a corner to see, unexpectedly, the trail rising sharply ahead. Corporate bond yields, which we use as a building block for our pricing models, have taken a clear turn upwards, reaching or surpassing levels last seen in late 2022.

IN HINDSIGHT

Energy-induced European recession

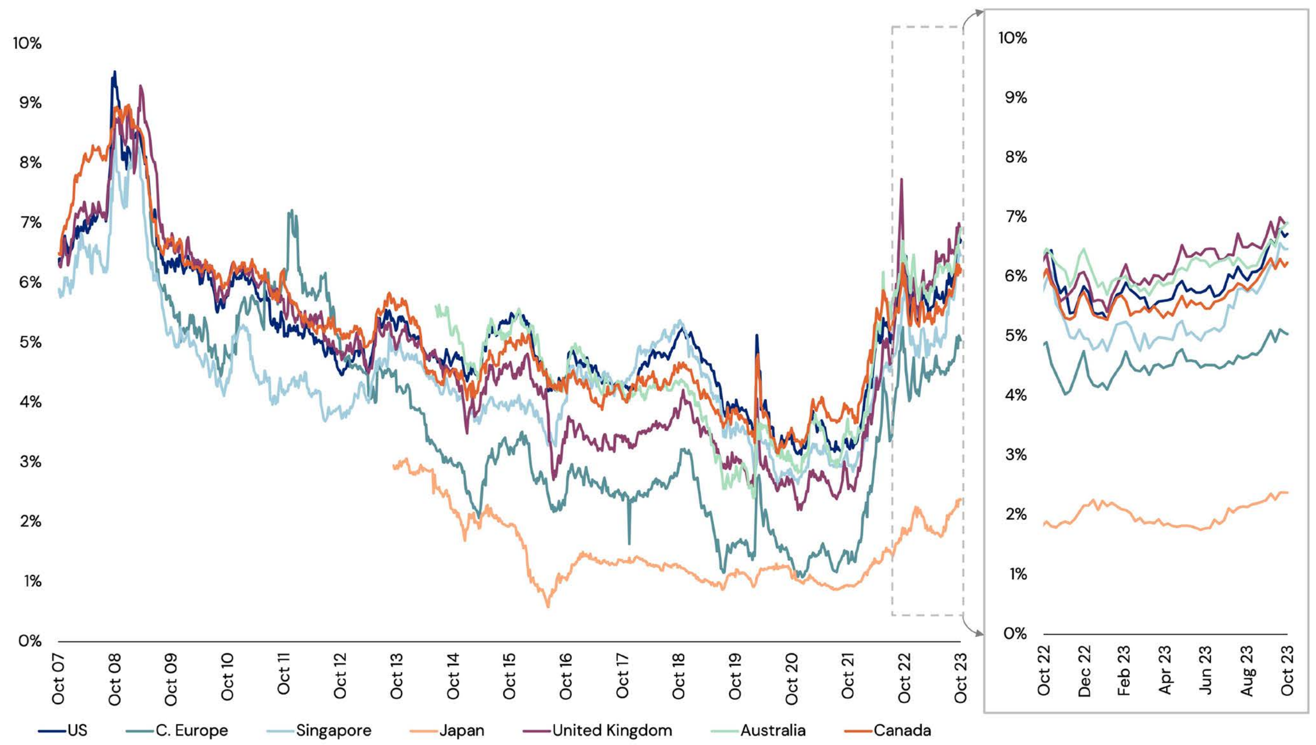
"Europe faces especially severe challenges stemming from an energy price shock, with ripple effects of unknown global scope... A recession is almost certainly already underway across Europe."
(*ISA Outlook 2023* p15)

We underestimated Europe's resilience and called a recession too soon. Energy markets adjusted much more quickly than we expected to the shock caused by the end of Russian gas flows. Renewables and floating liquefied natural gas terminals picked up the slack. This allowed energy prices to moderate quickly, taking the pressure off European households (see our *ISA Briefing: Energy back as key in real estate outcomes*).

In trying to understand why rates have surged and what that means, it is helpful to break out the three components of bond yields: **the real risk-free rate of interest, inflation expectations** and **risk spreads**. Our analysis shows that, despite elevated headline inflation in the last year, long-run inflation expectations have not been driving the recent increase in rates (see exhibit G-b). As was discussed in the *ISA Outlook 2023*, inflation is not necessarily a bad thing for real estate.[2]

G-a Ridge line's corridor and recent spike

Nominal corporate bond yields



Source: LaSalle Global Solutions, Bloomberg data through October 31, 2023. The bond indices above are based on Moody's Baa US bonds with terms of 20 to 30 years. In other countries, comparables are used of similar credit quality and term.
Note: No assurances are given that these trends will continue or materialize as expected. Nothing herein constitutes a guarantee or prediction of future events or results and accordingly the information is subject to a high degree of uncertainty.

Nor has late 2023's increase in corporate bond yields[3] been caused by an expansion in credit spreads,[4] which can occur when businesses are under strain, such as when going into a recession. These spreads have been mostly stable. That is encouraging and reflects still mostly benign corporate operating conditions and labor markets that remain tight, at least for now.

That leaves **real risk-free rates**, which have been driving the move.[5] The determinants of real interest rates are nebulous but reflect the fundamental characteristics of an economy that define its productive capacity – demographic profile, productivity growth potential, technological advancement and other factors that shape an economy's "desired" balance of savings and investment.

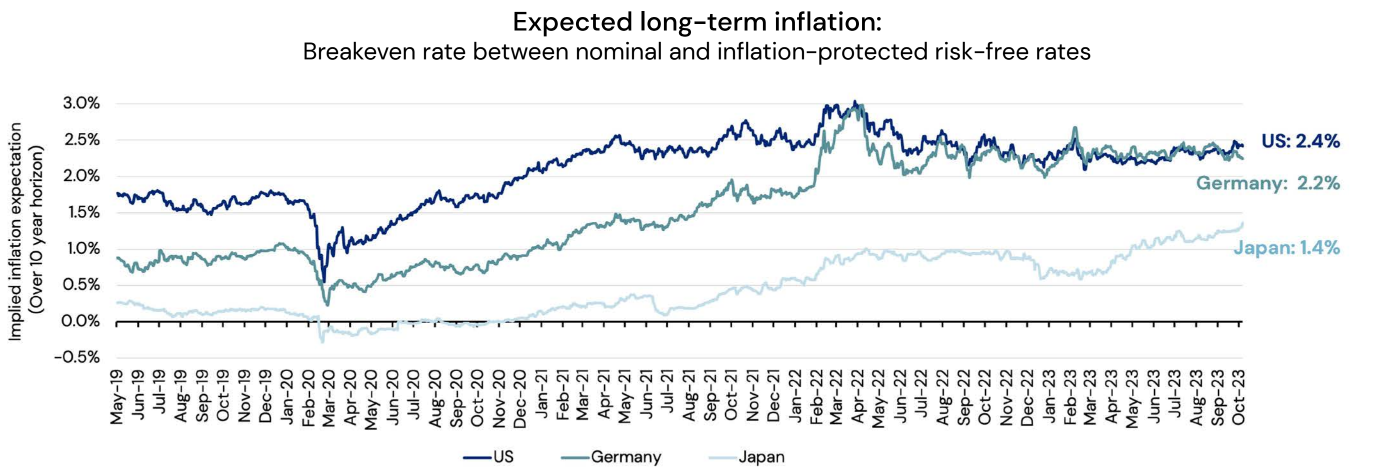
An upbeat interpretation of the uplift in real rates may be that markets are expecting technology – especially artificial intelligence (AI) – to drive a wave of productivity growth and thus spawn many attractive uses of capital. This would clearly be good for economic growth, though returns on all other types of investments would need to be higher for them to continue attracting capital. In other words, bonds, real estate and everything else would need to reprice accordingly.

A less cheerful take on the move in "risk-free" real rates is that benchmark government bonds are increasing because government fiscal profligacy is creating expectations of a surplus in government bond issuance relative to demand, "crowding out" other investment opportunities. No matter the explanation, higher real rates are likely to have a further negative impact on property pricing.

1 As always, there is variation at the country level that partially defies these global generalizations. In particular, trends in the two largest Asia Pacific markets – Japan and China – are substantially different from those in other developed economies. We discuss these differences briefly below and dive deeper in the respective regional chapters of this *ISA Outlook*.
2 Real estate is a real-returning asset class; in other words, there is strong potential for the pass-through of inflation into higher cash flows. This means real estate should not necessarily suffer from higher inflation; rather, its impact depends on occupational fundamentals, lease structures and other factors.

3 These comments apply to Baa corporate bond yields, which we view as a key benchmark for pricing real estate in most markets. Other dynamics around credit spreads may be evident, for example in high-yield bond markets for some countries and sectors.
4 Statements about drivers of interest rate moves is based on LaSalle's analysis of Bloomberg data as of October 31, 2023.
5 This is especially true of the long end of the yield curve, which is why it could be argued that the increase in rates has been driven by higher "term premia".

G-b Long-term inflation expectations remained relatively stable this year except Japan



Source: Bloomberg. As of October 31, 2023.
Note: No assurances are given that these trends will continue or materialize as expected. Nothing herein constitutes a guarantee or prediction of future events or results and accordingly the information is subject to a high degree of uncertainty.

No map to a soft or hard landing

It is notoriously difficult to predict the path of interest rates; our mountain hiker does not have a map, because none exists. The recent upward trend in rates may prove short-lived. But history suggests that whenever there is a big increase in interest rates, there is an increased risk that "something breaks" - whether a financial institution, a part of the capital markets or the like. History has also shown that extended periods of yield curve inversion (i.e., long-term rates below short-term rates) tend to presage economic downturns.[6] Both factors should raise the alert level for the global economy in 2024.

That said, real-time evidence does not point to an imminent global downturn, not least given the strength in the US and several other key economies. Labor markets have been surprisingly resilient and forecasts of economic growth have mostly been revised upward for 2023, as a potential slowdown is pushed into the future (see exhibit G-c).

The observed strength could merely reflect insufficient time for tighter policy to impact employment. As Milton Friedman said, monetary policy "operates with long and variable lags."

But it is possible the inverted yield curve could prove a false signal, although this is rare.[7]

Cooler conditions

Fortunately, inflation is already cooling across advanced economies, especially in the US, Canada and the eurozone (see exhibit G-d). This has been partly enabled by less challenging year-over-year comparisons, as well as an energy market that adapted surprisingly well to the intense but short-lived shock triggered by the Russia-Ukraine war (see *ISA Briefing: Energy back as key in real estate outcomes*). But genuinely cooling core price pressures are also in evidence.[8]

Either way, inflation is moderating slowly and remains meaningfully above central bank targets. New risks, especially to energy prices, have emerged owing to the Israel-Hamas conflict. It is still far from clear that a so-called "immaculate disinflation" - a smooth reduction of inflation without a recession - can be achieved in the US or Europe.

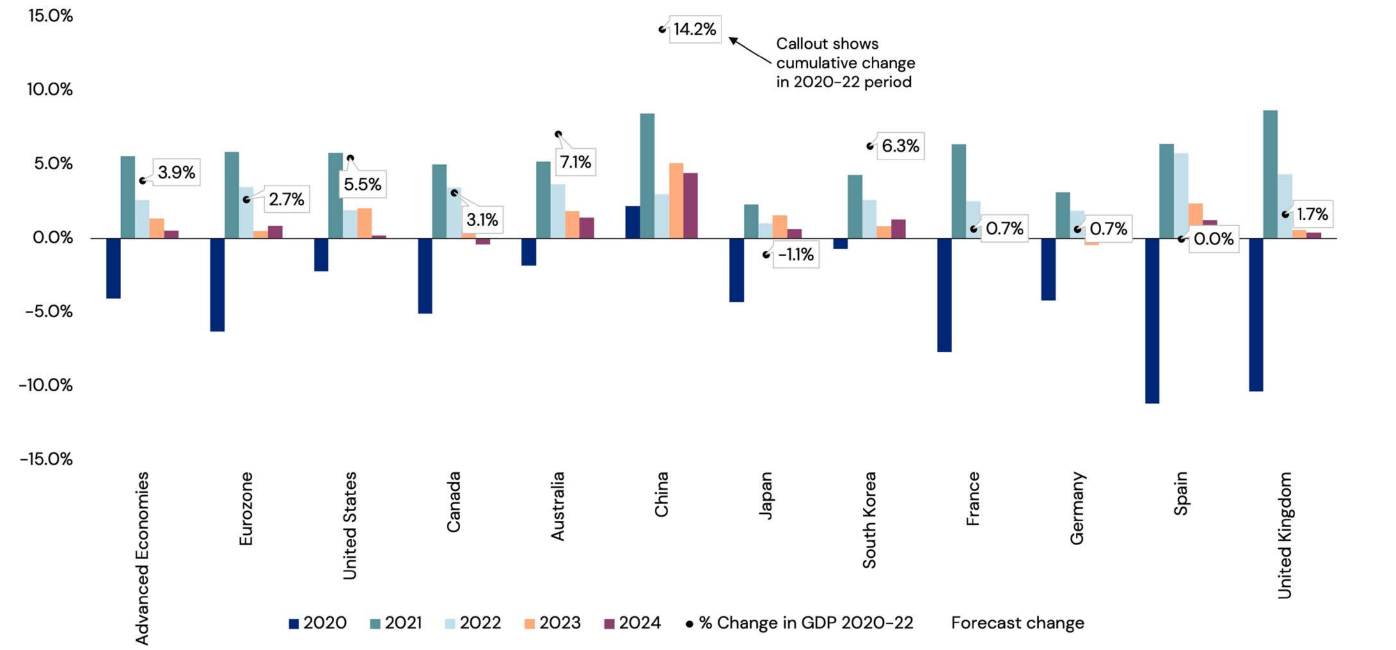
6 Source: https://www.chicagofed.org/publications/chicago-fed-letter/2018/404
7 False positive signals from an inverted US yield curve have been rare in over the last half century, with the most recent instances dating back to the 1960s. However, more recently the UK yield curve was inverted during the mid-1980s as well as around the turn of the millennium without leading to a recession.
8 Source: Oxford Economics

G-c The impact of tighter monetary policy on growth may be lagged

Oxford Economics global annual GDP forecasts

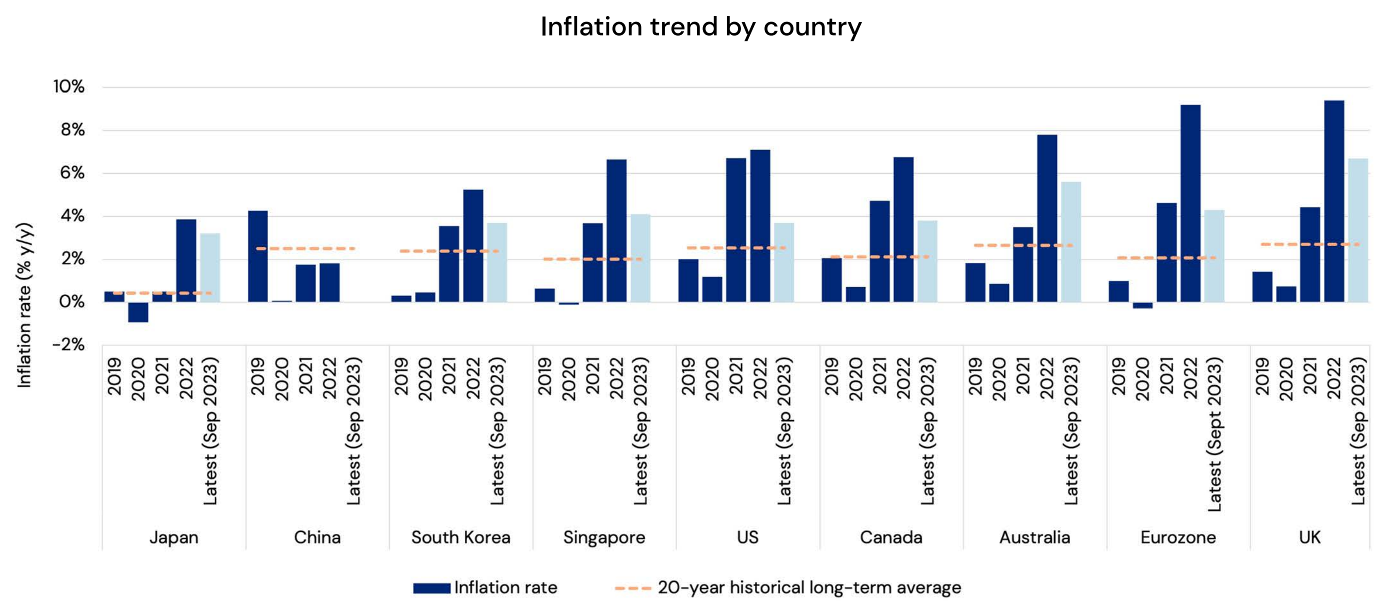
Full-year forecast revisions from the last ISA release (Oxford Economics)

	Advanced Economies	Eurozone	United States	Canada	Australia	China	Japan	South Korea	France	Germany	Spain	United Kingdom
2023	141bps	63bps	240bps	206bps	12bps	92bps	69bps	-15bps	65bps	63bps	157bps	128bps
2024	-124bps	-129bps	-118bps	-298bps	-59bps	-23bps	-101bps	-106bps	-122bps	-238bps	-121bps	-134bps



*Aggregation based on Oxford Economics country classification: https://services.oxfordeconomics.com/api/definitions/WDMacro/GlobalMacroEconomicDatabank.pdf
Source: Oxford Economics Forecast most recent as of October 31, 2023
Note: No assurances are given that these trends will continue or materialize as expected. Nothing herein constitutes a guarantee or prediction of future events or results and accordingly the information is subject to a high degree of uncertainty.

G-d Inflation cooling, especially in US, Canada and Eurozone



Note: 20-year historical long term average inflation rate is the average quarterly inflation rate from Q3 2003 to Q2 2023.
Source: Oxford Economics; latest monthly data from Australia Bureau of Statistics, Eurostat (eurozone), Singapore Department of Statistics, Statistical Bureau (Japan), Statistics Korea, National Bureau of Statistics (China), Statistics Canada, Office for National Statistics (UK), US Bureau of Labor Statistics. Latest data available as of October 31, 2023.
No assurances are given that these trends will continue or materialize as expected. Nothing herein constitutes a guarantee or prediction of future events or results and accordingly the information is subject to a high degree of uncertainty.

No single global path

To this point, we have been generalizing about the global economy; of course, not all economies are in the equivalent part of their cycle or face the same circumstances. For example,[9] Canada is probably in recession now and growth in Germany has already turned negative, owing to its exposure to weak export markets. The US has a unique combination of risk from its quarrelsome policymakers and opportunity from its strong position to benefit from AI. Japan stands out as having loose monetary policy, which is gradually and partially normalizing but should remain far more accommodative than elsewhere. Chinese policymakers have been cutting rates amid a rebound that has undershot expectations, but tentative signs of improvement in its housing market are encouraging (see our ISA Briefing: Key economic questions for China and Japan). These and other regional and national nuances around economic factors, and their implications for real estate, will be explored in greater depth in the regional chapters of this *ISA Outlook*.

(L-R) LaSalle's Brian Klinksiek, Elysia Tse, Fred Tang and Wayne Qin discuss
ISA Briefing: Key economic questions for China and Japan

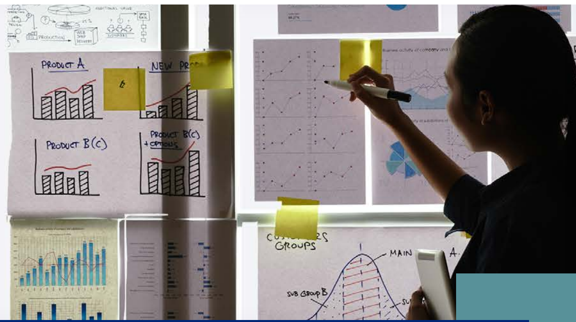
9 The country-level assessments that follow are based on LaSalle analysis of various economic data points, mostly national sources and publications of our economic analysis providers, principally Oxford Economics and Capital Economics.

LOOKING AHEAD

- **As of the time of writing, the semblance of interest rates stability that was observed earlier in 2023 is in doubt as rates experience a renewed spike. This could prove short lived, but it is having an impact on real estate capital markets, as discussed in the next section.**
- **We are loathe to make a specific interest rate forecast. Investors in real estate should approach macroeconomic questions with humility. If an investor had unique, high-conviction insight into the path of interest rates, trying to monetize that insight through specific bets on real estate – a lumpy, idiosyncratic asset class with inherent frictions like non-trivial transaction costs and incomplete information – would be inefficient to say the least.**
- **Questioning what the bond markets are indicating about the future is the same thing as taking a novel stance on macro. Our recommendation is to largely be a "taker" of bond market signals, reflecting them in valuation models but focusing on insight within real estate to find the best relative value. That is the focus of the remainder of the *ISA Outlook 2024*.**

Solving the capital stack equation

The math of higher interest rates driving challenges and opportunities



In last year's *ISA Outlook*, we noted that "the math" of higher interest rates was driving a repricing of real estate in many markets. This should be an instantaneous recalculation, but for private equity real estate, it is more of a process. There is a button in Microsoft Excel called "Update Values" that immediately triggers changed numbers in one cell to flow through to linked cells. How changes in the interest rate environment flow through into private equity real estate pricing and valuations is far less efficient than that; it also varies by market.

Debates around which markets are "ahead" and which are "behind" in repricing rely on a wide variety of data sources, which can paint contradictory pictures. At LaSalle, we approach this topic through an intrinsic value framework that is proprietary to our investment teams. Repricing is not a single road on which a market leads or follows, but a process of re-alignment with changed capital and occupier market relativities, which vary from market to market.

We are beginning to see pressures around how individual real estate deals are capitalized and property businesses are funded. The basic challenge is how to resolve issues in the capital stack of repriced real estate, especially as debt comes due and replacement finance is less available and more expensive. Solving the capital stack equation can either create risks or investment opportunities, depending on the situation of the investor, the assets and their current capitalization.

IN HINDSIGHT

Stabilizing rates, healing transaction markets

"The relentless math of higher interest rates will continue to weigh heavily on real estate values, at least until interest rates stabilize as inflation begins to subside. The bid-ask spread for private real estate should eventually close and transactions will resume in earnest at a rebased level." (ISA Outlook 2023 p14)

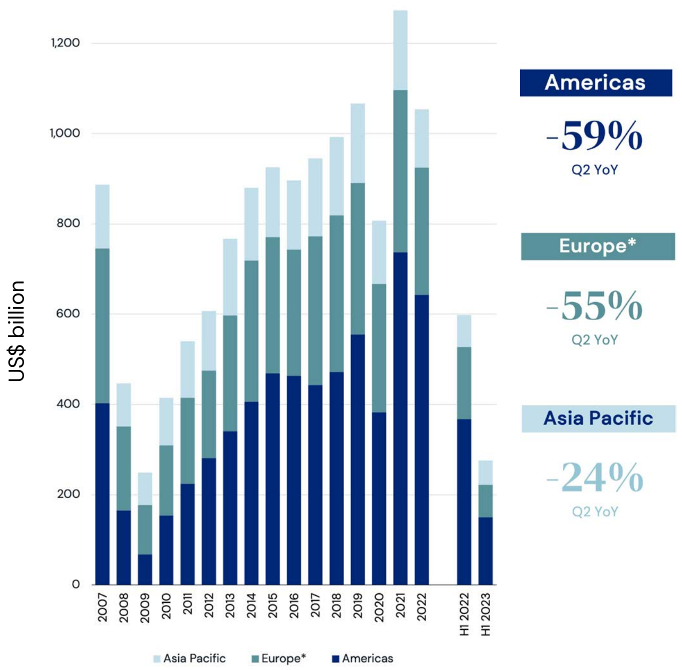
We stand by this call. The only question is: when? For much of 2023, interest rates remained volatile but moved largely sideways, exhibiting no overarching trend. This relative stability did indeed allow for tentative signs of improvement to emerge in real estate transaction markets. Later in 2023, however, a surge in interest rates pushed up borrowing costs again, acting like a wedge to drive the bid-ask spread wider again and causing a renewed slowdown in transactions.

Equity flows reduced

Would-be buyers of real estate, at least those that use leverage, feel the math of higher rates promptly. They borrow at today's cost of debt. By contrast, would-be sellers of real estate are slower to catch up; they may have fixed debt costs at lower levels and may opt to wait and see if their assets will eventually fetch backward-looking book valuations. This is the classic set-up for a bid-ask spread, which continues to characterize the market, resulting in today's subdued levels of transaction activity (see exhibit G-e). As noted above, signs of

G-e Uncertainty stalls transaction volumes

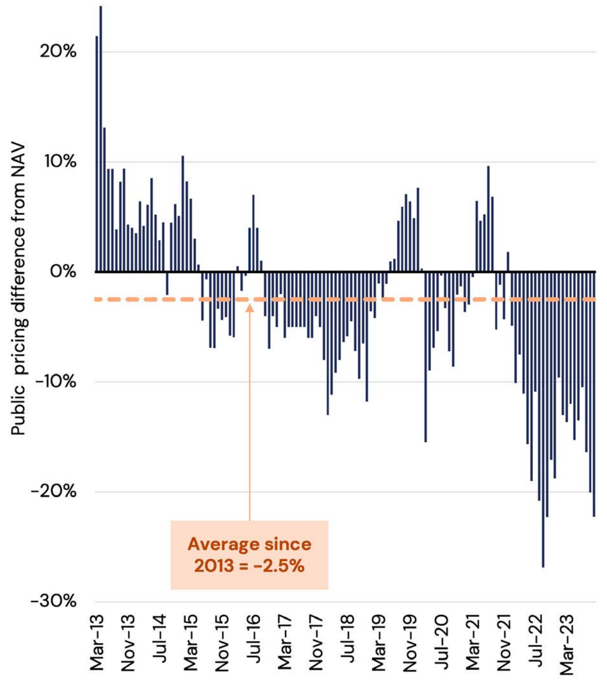
Direct global real estate investment volumes



* Includes a small amount of ex-Europe EMEA markets
Source: JLL Research, latest July 2023.
Note: No assurances are given that these trends will continue or materialize as expected. Nothing herein constitutes a guarantee or prediction of future events or results and accordingly the information is subject to a high degree of uncertainty.

G-f Global REIT discount to NAV widened

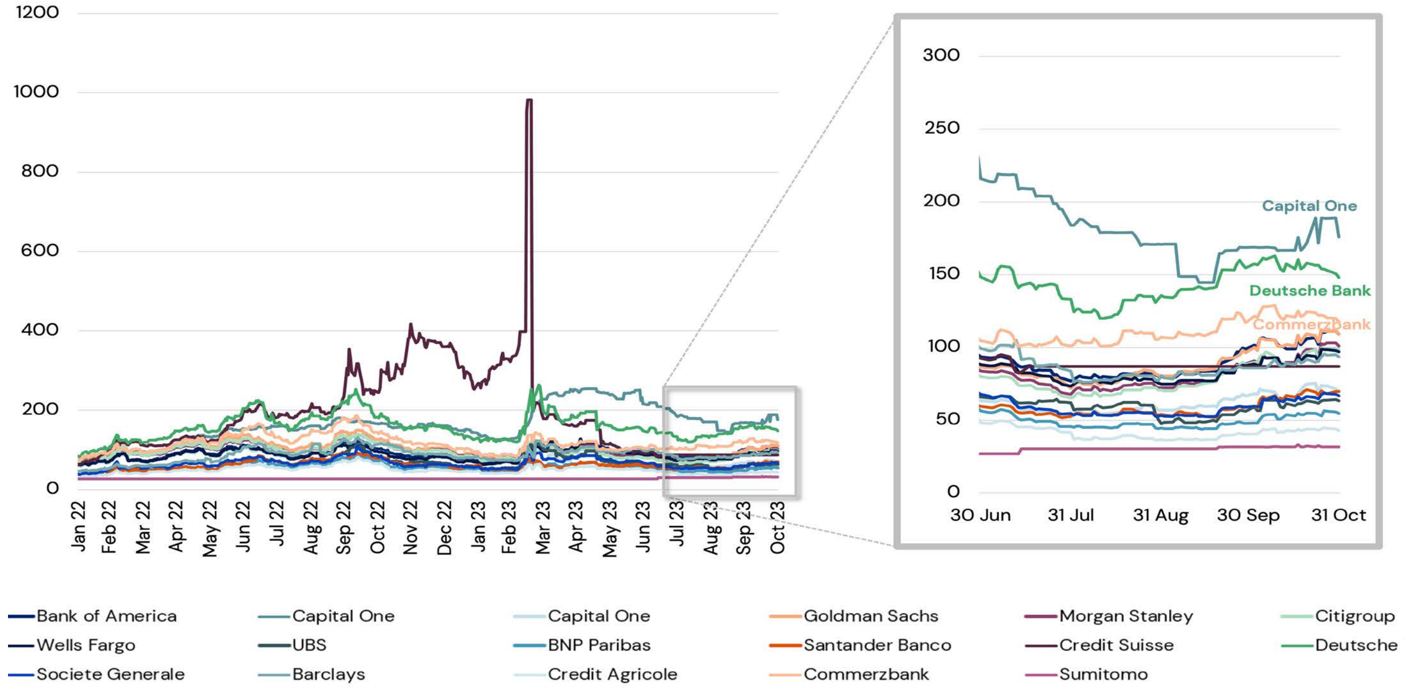
Global real estate securities premium / discount to net asset value



Source: EPRA/NAREIT, LaSalle Investment Management Securities. Discount to NAV data to October 31, 2023.
Note: No assurances are given that these trends will continue or materialize as expected. Nothing herein constitutes a guarantee or prediction of future events or results and accordingly the information is subject to a high degree of uncertainty.

G-g Bank CDS spreads trend lower since the banking crisis

5-year CDS spreads on key global banks



Source: Refinitiv. As of October 31, 2023.
Note: No assurances are given that these trends will continue or materialize as expected. Nothing herein constitutes a guarantee or prediction of future events or results and accordingly the information is subject to a high degree of uncertainty.

the bid-ask spread starting to resolve in mid-2023 had been called into question by volatile upward movement in rates and sluggish transactions markets by the time of writing.

In contrast to private equity markets, changes in rates flow through more quickly into the prices of listed real estate companies. Real estate securities continue to trade at meaningful discounts to NAV, because listed share prices have adjusted more than private market prices (see exhibit G-f). This gap persists even after accounting for differences in the composition of listed and private real estate market exposures.

Encouragingly, there is evidence that significant amounts of "dry powder" is waiting on the sidelines for transactions that meet its objectives. As of October 2023, Preqin estimated that dry powder destined for private real estate funds totaled US$406 billion, down only by 10% from its December 2022 peak.[10] This amount of dry powder is unlikely to prove as powerful as in the past given the dynamics in debt markets discussed below, and the fact that much of this capital is targeting higher-return strategies.

Debt more costly, less available

Higher debt costs, less debt availability, lower loan-to-value (LTV) ratios, tighter underwriting standards and reduced valuations can intersect to create a debt refinancing gap.[11] Putting a single figure on the size of this gap is virtually impossible, but suffice to say, it is not small. There will be "workouts" in some markets, and this process has only just begun, implying opportunities for investors prepared to find situational value.

Debt market dynamics remain complex, not least because of the role of banks. While the largest banks are healthier than they were going into the GFC, the failures of Silicon Valley Bank, Signature Bank and First Republic, and the hastily arranged merger of Credit Suisse into UBS, have brought banking sector risks into focus.[12] Worries abounded that commercial real estate loan exposures on bank balance sheets, particularly those of US regional banks, were going to put strain not only on the availability of real estate debt capital, but also the banking system generally. Our view has been that real estate's most acute challenges are concentrated in select market segments, such as US offices and Chinese for-sale residential, which are only subsets of banks' exposures and not large enough to be systemic.

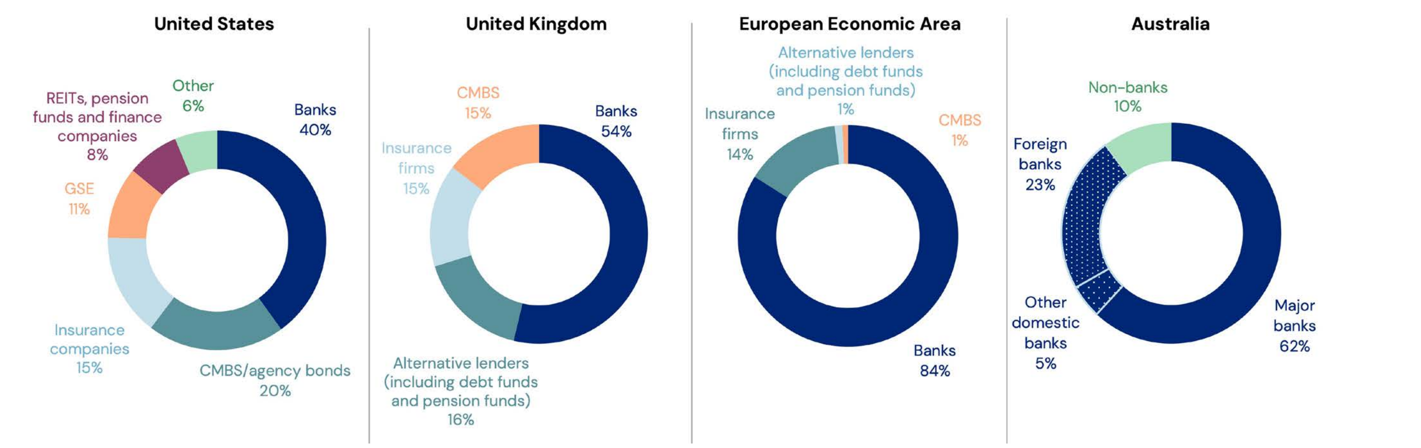
That perspective has been borne out by a general moderation in markets' pricing of bank failure risk (see stable or falling bank CDS spreads in exhibit G-g). While we do not expect systemic banking sector distress, further banking sector turbulence cannot be ruled out. This creates risks around the orderly flow of capital to real estate, though it could also surface attractive opportunities for private lenders.

Moreover, banks are only one piece of the real estate debt pie. In the US, banks account for 40% of outstanding debt collateralized by income-producing real estate, with insurance companies, government-sponsored enterprises, mortgage-backed securities and private debt funds also accounting for large shares (see exhibit G-h). Debt markets in other parts of the world tend to be more bank-dependent, though ex-US bank capital buffers mostly look healthy, and we do expect to see continued diversification of debt sources as has occured in the US.

10 Source: Preqin Dry Powder data as of October 2023
11 Based on LaSalle's analysis of data from JP Morgan, American Council of Life Insurers, Green Street Advisors, CBRE, CREFCOA, Cushman & Wakefield and PMA.
12 The fundamental trigger of these bank's challenges was unhedged long duration interest rate exposures on bonds in a rising rate environment, not real estate (see our *ISA Briefing: Banks, rates and the impact on property*).

G-h **Banks are still an important source of real estate debt capital, but not the only one**

Sources of debt market capital by geography



Source: Federal Reserve Flow of Funds, Bank of England, Refinitiv, Bayes Business School, European Banking Authority, European Insurance and Occupational Pensions Authority, Real Estate Capital, LaSalle (June 2023), Australian Prudential Regulation Authority, CLI Group Research (August 2023).
Note: No assurances are given that these trends will continue or materialize as expected. Nothing herein constitutes a guarantee or prediction of future events or results and accordingly the information is subject to a high degree of uncertainty.

Different markets, different equations

It should be noted that the dynamic around bond markets and real estate pricing is not the same in all global markets. In some cases, that is simply because the bond market has not adjusted as significantly. In Japan, the relativities between real estate debt pricing and cap rates still allow levered real estate buyers to benefit from "positive leverage."[13] In other instances, bond markets may have adjusted, but the link to real estate pricing is weak for structural reasons, meaning the adjustment may be delayed or remain incomplete.[14] We will explore market-specific pricing dynamics in the forthcoming regional chapters.

13 Based on LaSalle's investment experience and supported by analysis of JLL and Bloomberg data as of Q2 2023
14 Barriers to the efficient flow of capital between asset classes, or across borders, can create segmentation in capital markets that allow real estate to price indefinitely at levels that might look expensive when viewed only in the context of relevant benchmark rates. Such disconnects can also occur when a market segment is considered a "store of value;" for example, prime, centrally located assets in global superstar cities may be seen by some investors as akin to a rare antique or precious metal, generating demand for assets that is insensitive to the broader capital markets. Investors in such segments should evaluate whether the underpinnings of such structural disconnects will remain in place before they accept pricing that appears disconnected to interest rates. History has both examples of such pricing disconnects persisting and of them ending.

LOOKING AHEAD

- **Widespread distress is unlikely – especially outside of US offices – but there will be ongoing market stress to solve the capital stack equation. On the equity side, this can create opportunities for investors with higher return targets in the form of equity rescues at adjusted values. Situations requiring the recapitalization of portfolios can also create opportunities for long-term core investors to get access to quality assets that would otherwise be inaccessible.**
- **The silver lining of the negative leverage faced by equity investors in some markets is that nimble investors able to invest in debt can potentially get a higher return for a safer part of the capital stack. We see a broad opportunity set in real estate debt, and in structured transactions with debt-like characteristics. Pricing in listed markets also looks relatively attractive.**
- **The limited willingness of debt and equity investors to fund development in many markets will help to limit supply of new properties over the medium term, limiting downside risk in real estate fundamentals. Occupier market conditions are the focus of the next section.**

Coming off the boil

"Winning sectors" decelerate, but remain relatively strong

The German proverb "trees don't grow to the sky" suggests that there are natural limits to growth; this also applies to real estate. To put it in the extreme, rent growth cannot exceed inflation by a large amount forever, or else it would cause an unreasonably large share of the economy to be devoted to paying rent. More prosaically, there are feedback mechanisms that limit how long a property market can stay hot until demand moderates or supply kicks in.

Occupational fundamentals are solid in many of the sectors and markets in which we invest. But we also see a significant cooling in sectors that have been riding high, especially logistics, rental housing and life sciences real estate. For example, logistics rent growth shows a marked slowing from peak levels, though it remains very strong compared to history and to other sectors (see chart G-i on next page).

The cooling trend in these recently boiling hot sectors can be attributed, in part, to macroeconomic slowing. It is also related to ripple effects originating from the pandemic shock. The onset of Covid-19 lockdowns triggered waves of disruption, adjustment and – eventually – normalization. Large segments of the economy were reconfigured almost overnight, dramatically shifting activity and investment. The waves of change have reverberated and attenuated; the hottest sectors coming off the boil is the tail end of that.

IN HINDSIGHT

Bullish on sheds and beds

"We remain reasonably bullish about the path of NOI in many logistics and residential or residential-adjacent assets across the globe." (ISA Outlook 2023 p17)

We got this one right. Most logistics and rental housing markets across the globe performed very strongly in 2023 in terms of rents and occupancy. We continue to expect them to perform well on a relative basis, if moderating in absolute terms, as we discuss in our *ISA Outlook 2024* global theme "Coming off the boil."

Demand ripples

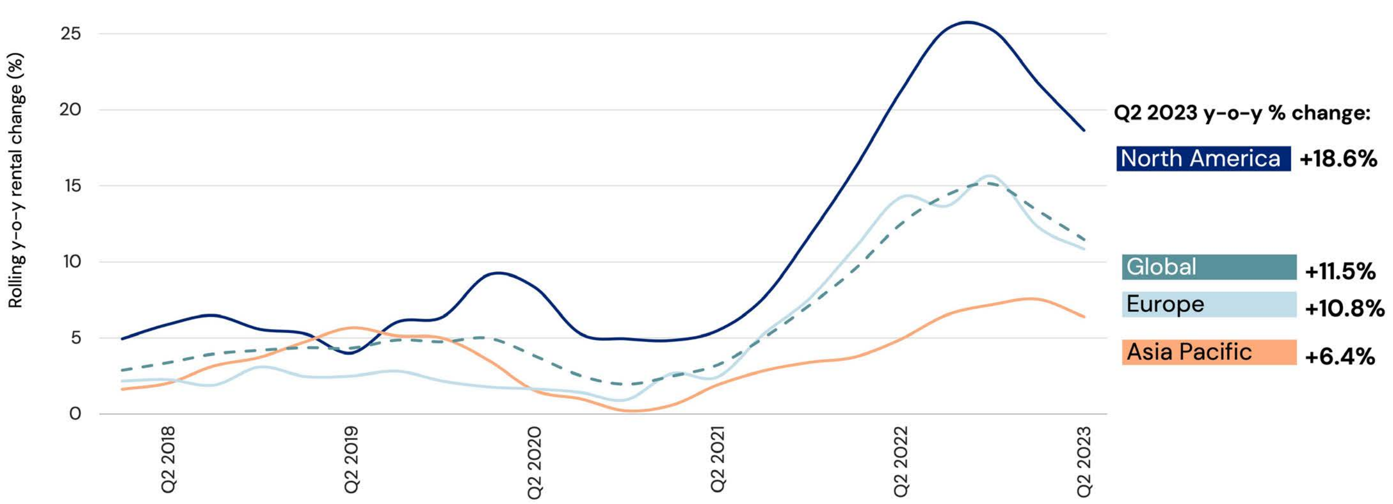
Some of the ripples relate to demand. The logistics sector is a case in point. Lockdowns caused a sudden step change in already growing e-commerce penetration, driving a frenzy of logistics leasing and pushing vacancy down sharply. Supply-chain issues prompted mindset shift from "just in time" to "just in case", further driving up desired inventory levels and requiring more space. But in 2022, as a portion of activity returned to physical retail, signs of logistics overcapacity emerged, most notably a halt by Amazon to large scale investment in new logistics facilities.[15] The normalizing trend in logistics demand continued in 2023.[16]

The theme of demand normalization is not confined to logistics.[17] In many markets, demand for rental housing slumped in 2020 as remote work and job

15 Source: https://www.bloomberg.com/news/articles/2022-09-02/amazon-closes-abandons-plans-for-dozens-of-us-warehouses
16 Sources: Green Street Advisors, LaSalle operating experience
17 The principal sources for the observations in these paragraph are Green Street Advisors, LaSalle analysis of various real estate data providers and LaSalle operating experience.

G-i Double-digit logistics rental growth slowing

Annual logistics rental growth by region



North America: average asking rents (inclusive of all stock A/B/C gradations) based on 55 city markets in the US and 9 city markets in Canada;
Europe: aggregate nominal rental growth based on prime headline rents in 23 city markets (weighted by city nominal GDP);
Asia Pacific: based on net effective rent in 40 city markets (unweighted);
Global: weighted average according to region's (US/Europe/Asia Pacific) share of total GDP.
Source: JLL, July 2023.
Note: No assurances are given that these trends will continue or materialize as expected. Nothing herein constitutes a guarantee or prediction of future events or results and accordingly the information is subject to a high degree of uncertainty.

losses killed household formation, enabling a robust recovery in for-rent residential demand as the world reopened in 2021-22; this has since moderated as more normal demand patterns returned. Similarly, leisure-driven demand growth for resort hotels has cooled as travel to cities rebounded. Self-storage demand has likewise normalized. The market for life sciences space has also softened as a surge in funding for early-stage biotech ventures faded with higher interest rates.

Supply ripples

Other ripples relate to post-pandemic lumpiness in supply. In many pandemic-favored sectors - such as rented residential, logistics and life sciences - a temporary spike in supply is underway today before deliveries are expected to taper substantially later in 2024.[18] The current spikes stem from construction disruptions in 2020 pushing back deliveries, and a frothy capital markets environment in 2021. This flattered development economics, at least until construction cost escalation started to bite and exit yield assumptions headed back up. Encouragingly, unlike during the Global Financial Crisis (GFC), new supply is not elevated in all sectors and markets.

Cooling, not freezing

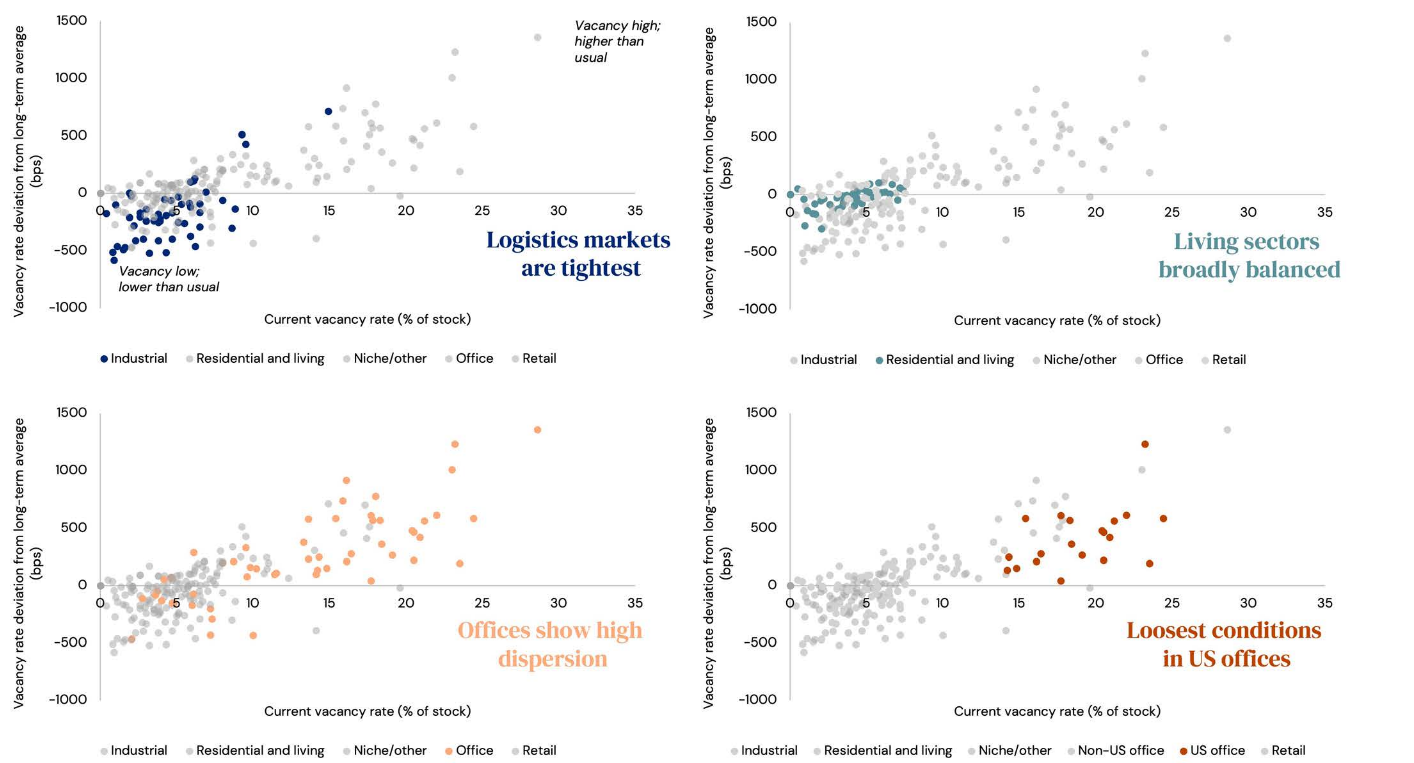
The pattern of cooling absolute growth in the strongest market segments does not substantially shift the relativities between sectors; our most favored sectors are still positioned for strong relative rental growth. One way to assess the "tightness" of a market is to compare current and long-term vacancy; markets tighter than normal tend to see growing rents (see exhibit G-j).

On this basis, logistics markets display some of the most consistently tight fundamentals, whilst residential and other living sectors are also tight, if a bit less so. The office sector stands out by the dispersion of markets as well as the deeply unfavorable conditions for rental growth in the US. Offices in other parts of the world display a fair amount of variability between tight and loose conditions.

18 Sources: Green Street Advisors, LaSalle analysis of real estate market data

G-j Global fundamentals closely tied to sector

Global vacancy rates by property type



The current vacancy rate refers to the latest available data point for each location and these dates range between Q1 and Q3 of 2023. Similarly, the measurement period of the long-term average will depend on data availability but represents the longest period available for each series.
Sources: JLL, CBRE-EA, CBRE, Real Page, MSCI, NCREIF, Canada Mortgage and Housing Corporation, ARES, Ichigo Real Estate Service, company reports and LaSalle Research and Strategy as of October 2023. Note: No assurances are given that these trends will continue or materialize as expected. Nothing herein constitutes a guarantee or prediction of future events or results and accordingly the information is subject to a high degree of uncertainty.

LOOKING AHEAD

- **Our favored sectors of logistics and residential remain strong in terms of relative growth prospects, but their hot fundamentals coming off the boil are a reminder that above-inflation growth cannot continue forever. Lower absolute NOI growth prospects have made their fair value math incrementally more challenging, especially considering interest rate movements.**
- **Investors should be careful to apply reasonable assumptions for rental growth and occupancy. Predicting that frothy growth around peaks continues is a recipe for overpaying. Rigorous proprietary forecasts that span multiple years and include long-run assumptions, such as those developed by LaSalle, should help avoid simplistic extrapolation of current run rates.**
- **US offices stand out as having the weakest fundamentals of the many segments we track. Offices in other regions are better, but there is still dispersion. Retail segments have been unloved by investors, but merit another look as the sector is well advanced in the nearly decade-long adaptation to the realities of e-commerce; the surviving convenience and experience-focused retail properties clearly have a future, and the ranks of weaker assets have been heavily culled.**
- **Investors should also consider which property types are more and less sensitive to economic downturns, with an eye toward constructing portfolios anchored by defensive income.**
- **Global trends set the backdrop, but real estate remains very driven by local forces, and recognition of this nuance is essential. The Europe, North America and Asia Pacific chapters of the *ISA Outlook* will explore local market conditions in much greater depth than is possible here.**

Beyond "bifurcation"

Making sense of the changing definition of quality and core

The word "bifurcation" appears with increasing frequency in descriptions of real estate fundamentals. Higher- and lower-quality properties performing differently is nothing new. But there is a sense that divides within segments of the real estate market are widening, joining divides between sectors as key drivers of performance. In last year's *ISA Outlook*, we encouraged investors to look "beyond the sector chasm" to consider "widening gaps within sectors" around traits such as location, asset quality and energy efficiency. Since then, references to bifurcation have only become more widespread.

Is bifurcation the right word? Merriam-Webster defines it as "the state of being divided into two branches or parts." The actual underlying trends are more complex than that. Some have argued that there should be three branches - the best assets, properties that could be improved to restore competitiveness, and buildings that are hopelessly stranded. But "trifurcation" is still an arbitrary and inadequate concept. In practice, asset attractiveness is a spectrum, and it is futile to divide assets into a fixed number of discrete buckets.

No matter the terminology, performance gaps on a variety of dimensions have come to matter deeply. We are monitoring a variety of key divides in asset performance, for example:

- **Sustainability credentials** such as green certifications and alignment with net zero carbon pathways can be key differentiators for buildings. Our recent ISA Focus report on the *Value of Green* identified many empirical studies showing significant positive differences in rents and asset values for buildings with green features as compared to those that lack them.

IN HINDSIGHT

Widening divides within sectors

"Our analysis suggests that sector selection will continue to matter, but other asset and strategy traits are rising in importance. We expect quality divides to widen everywhere as the balance of power tips in favor of tenants and structural trends to accelerate the obsolescence of less modern and less green assets." (ISA Outlook 2023 p20)

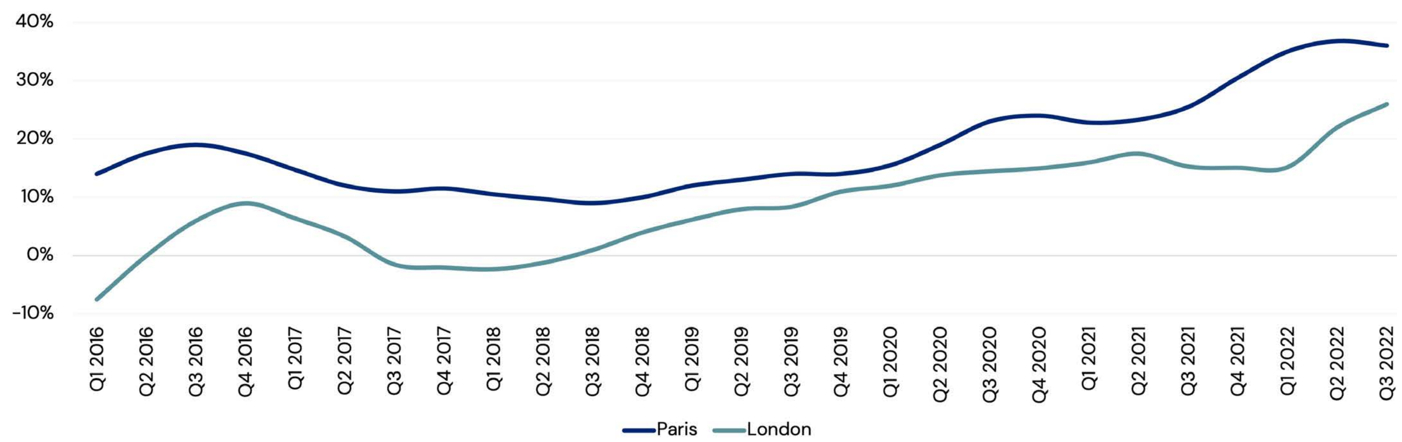
This call proved accurate. Gaps within sectors, particularly along building quality and sustainability lines, continued to widen throughout 2023. We discuss this in greater depth in our global theme, "Beyond bifurcation."

No big gains in return-to-office (RTO)

"Further large changes in the balance between in-person and virtual interaction are probably unlikely… It is probably wishful thinking to expect further large gains in office attendance anywhere in the world." (*ISA Outlook 2023* p23)

We got this mostly right. Throughout 2023, office attendance has trended essentially sideways, if with some slight improvement in the US, largely driven by companies tightening RTO policies. Investors dropping their "wishful thinking" about RTO has contributed to sharper price declines in office than in other sectors. The big exception has been China, where the end to start-stop lockdowns since its rapid reopening at the beginning of the year has allowed a swift and almost complete return to office normality.

G-k Sustainability agenda driving "Green Premium"



Source: MSCI, latest available November 2022.
Note: No assurances are given that these trends will continue or materialize as expected. Nothing herein constitutes a guarantee or prediction of future events or results and accordingly the information is subject to a high degree of uncertainty.

These are borne out in the property market data that we monitor; for example, MSCI data show a steadily widening green premium for office buildings in London and Paris (see chart G-k). Sustainability-related bifurcation is driven by increased regulation of the built environment's energy intensity and a shortage of space that meets corporates' sustainability commitments. Research from JLL shows that demand for low-carbon office space in the US is expected to exceed supply by 75% through 2030.[19]

- **Quality of design and amenities** often separate successful office and retail properties from challenged ones. The rise of virtual modes of interacting, collaborating and shopping mean that the end-users of space have greater choice of where they do those things. On the discretionary retail side, shopping environments that offer compelling experiences have outperformed relative to less stimulating places, at least since the spike in e-commerce penetration in the 2010s.[20] "Compelling" generally means a high quotient of food and beverage outlets, a curated selection of popular and niche brands, and

19 Source: https://www.us.jll.com/en/trends-and-insights/research/soaring-demand-for-low-carbon-offices-will-outstrip-supply
20 Source: Green Street Advisors.

Canary Wharf, London   West End, London

Fulton Market District, Chicago   The Loop, Chicago

unique, locally inspired experiences. The rise of "experiential office" is a little more recent but involves similar differentiators such as a wide range of flexible work areas, wellness features and vibrant, socially focused amenities.
For workers given the choice, the decision to come into the office is a matter of balancing the costs of a commute – money, time and discomfort – against the benefits. In many markets, the most successful office assets are those that enable a "**commute-worthy**" experience. A large share of the existing stock of office stock does not live up to this test, spelling trouble for their rents and values.

- **The resilience of live/work/play locations with gravitational pull** shows that the "commute-worthy" principle applies beyond the four walls of the office. In last year's *ISA Outlook*, we wrote that "urban places that offer a strong quality of life, a good amenity base and a sense of place [remain] resilient." Precincts that offer opportunities for acvitivies beyond just going to work – such as bars, restaurants and entertainment – have seen a generally stronger return to the office than submarkets dominated by office towers. For example, anecdotal evidence suggests that London's return-to-office rates vary significantly by submarket, with the mixed-use West End leading the way and Canary Wharf – which has a mix of uses more similar to a North American high-rise financial district – lagging. The relative resilience of mixed-use submarkets is also evident in patterns of residential choice. Research from the McKinsey Global Institute found that since the onset of the pandemic, outmigration from urban neighborhoods was greater for submarkets dominated by office buildings as compared to those with a wide range of uses (although suburban locations mostly outperformed both).[21]

It is clear that bifurcation – or whatever you choose to call it – is happening across many property market segments on a growing number of dimensions. The more important question is: What to do about it? Merely observing that part of a troubled market continues to do well is insufficient insight to inform strategy. Investors must go beyond the fact of bifurcation, to slice their market assessments according to new fault lines and devise differential assumptions. This way they can assess what outcomes are likely and compare those to what outcomes are priced in by asset markets.

21 "Empty space and hybrid places," McKinsey Global Institute, July 2023.

LOOKING AHEAD

- **Assessing how bifurcation should inform investment strategy requires assessing what future is priced into assets today; for example:**
  - **Is the winning side of a bifurcated sector strong enough and priced appropriately to generate a suitable risk-adjusted return? Maintaining occupancy levels is not the same as delivering a return commensurate with an appropriately risk-adjusted cost of capital.**
  - **How do the best segments of challenged sectors compare to the range of other investment alternatives? Sometimes the best segments of a weak sector are still inferior investments compared to the worst segment of a strong sector.**
  - **Is the value gap between winning and losing assets bridgeable through refurbishment and repositioning, and if so, does bridging that gap generate an appropriate risk-adjusted return? If not, pricing on the losing side may need to fall more, and sometimes the weak asset is simply "stranded" and will require redevelopment.**
  - **Is the driver of bifurcation sustainable for the long-term, or is it due to a more transitory factor? The value of being in a long-term vibrant location is less likely to erode than that from being in the newest building with the most up-to-date amenities.**
- **The best way to answer these questions rigorously is with a fair/intrinsic value framework that segments markets not at the level of traditional, aggregated definitions, but uses different assumptions based on how assets are positioned vis-à-vis bifurcation divides. It should be kept in mind that the best way to segment a market today does not need to be the most appropriate way to do so in the future. Discovering new dimensions of bifurcation before others should help drive outperformance.**
- **Differential performance by asset quality is nothing new. Real estate's enduring need for capital expenditure should not be mistaken for a novel bifurcation trend. It is essential to underwrite appropriate capex to keep an asset competitive for the long-term.**

Global recommendations summary

Growth, repriced assets, situational opportunities

> *"Now is always the hardest time to invest."*
> – Bernard Baruch

Tactics: Stay the course

Our investment recommendations have changed only subtly since last year's *ISA Outlook* (see exhibit G-l on the next page). We remain drawn to the long-term growth potential of logistics and residential, and their various adjacent sub-sectors. Office and retail sectors are by no means uninvestable, but their investment prospects are highly variable by market and sub-type, as well as vulnerable to divides by factors like property quality. We continue to be advocates for investing in the most dynamically repriced segments of the market such as listed equity and debt, and in structured investments with debt-like structures that allow the bridging of bid-ask spreads.

We recommend patient and flexible deployment of dry powder, given we expect situational opportunities to arise from dislocation within capital stacks in some markets. But over-caution can come to at the cost of missed opportunities. Although uncertainties abound as to the path of interest rates, economic growth and real estate fundamentals, history has shown that the best investment vintages tend to be those immediately following periods of disruption.[22]

More detailed, granular discussion of investment opportunities at the regional level will be contained in forthcoming *ISA Outlook 2024* chapters on real estate markets in Europe, North America and Asia Pacific.

Strategy: The changing definition of quality and core

Our investment recommendations for 2024 align with bigger-picture, longer-term shifts in the real estate universe that we expect to reshape the definition of high-quality, core real estate. As discussed in our analysis of property market bifurcation, the features that define the best quality assets increasingly incorporate experiential and sustainability-related factors.

Perhaps the most significant shift is around what is considered a "core" property type. The traditional "four food groups" of real estate – office, retail, industrial and apartments – have been joined by a host of niche sectors that do not fit within these categories, as well as various growing sub-sectors within them. Allocations are mostly falling for the most traditional of the four food groups – office and retail – and rising for everything else. Survey data on investors' target sector allocations show that between 2019 and 2023, retail allocations have fallen dramatically in all three global regions, while those for office have shrunk in the US and Europe and held steady in Asia Pacific (see exhibit G-m on the next page). Residential, logistics and niche allocations have all grown.

The story behind this property type rotation goes beyond medium-term differences in growth rates and relative value. It also reflects a reassessment of the basic qualities what makes a "good" real estate investment. Investors are moving beyond traditional rules-of-thumb (e.g., metrics like lease length) to consider how a sector performs in the real world. These indicators can still be useful proxies for risk, but they do not give the full picture of the central driver of any asset's value: its cash flows. (A stylized description of what we call the "new core" mindset is in exhibit G-m on the next page.)

22 Source: LaSalle's analysis of data from the INREV Global IRR Index through Q4 2022 highlights that the IRRs of funds closed between 2008-2010 comfortable outperformed those raised before the GFC. See page 30 of our *ISA Portfolio View* for a more complete discussion of this analysis.

G-l

Global reccomendations summary

Strategic recommendations

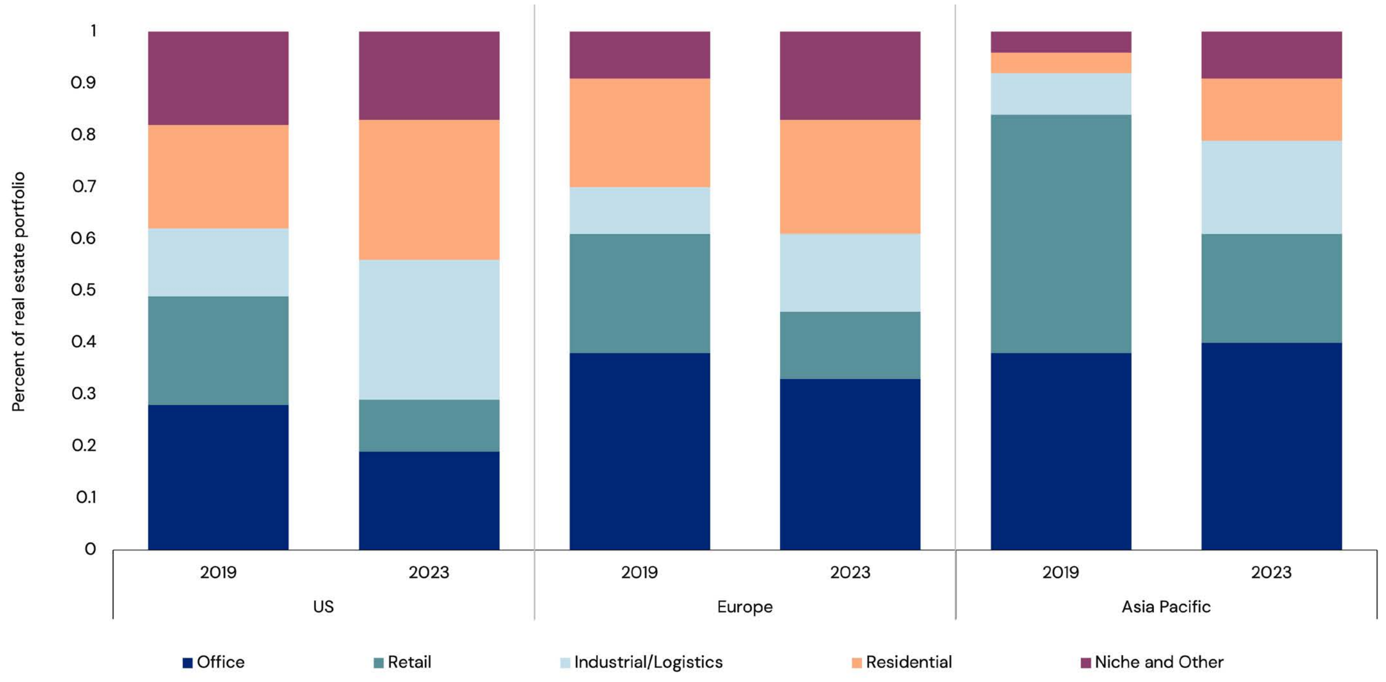
North America	Europe	Asia Pacific
Debt, debt-like positions and/or distressed equity		
Logistics Healthy markets with strong long-term demand and growth potential		
Residential / beds		
Apartment recaps with operational upside Scattered-site single-family rental	Student accommodation Tech-enabled hotel repositioning	Multi-family rental in Japan, Australia, China Tier 1 cities Hotel markets with recovery momentum
Other sectors		
Trade area-dominant retail with income growth potential	Top-quality office in high-barrier markets	Reposition office in highly selective markets Japan retail anchored by non-discretionary tenants
Climate hardening and/or decarbonisation		
Listed real estate		

Caution

Office	Regulated residential Commodity office	For-sale residential in China, South Korea

G-m **Sector allocations undergoing long-term shift**

Sector allocations by region: Survey data



Source: PREA Investor Intentions Survey, 2019 and 2023; NCREIF; NAREIT; NAV REIT data as of end-2022 from company reports published in 2023.
Note: No assurances are given that these trends will continue or materialize as expected. Nothing herein constitutes a guarantee or prediction of future events or results and accordingly the information is subject to a high degree of uncertainty.

Assets with ostensibly short leases, like apartments or self-storage, can exhibit stable cash flows owing to the inherent granularity and diversification of their tenant base, as well as a liquid leasing market. Operational intensity and near-term capital expenditure are not to be feared, but embraced if execution risk is manageable, costs are predictable, and it comes with income growth potential. All these factors are supportive of more investment in our tactical target sectors; alignment of the medium and long view increases our conviction level in these calls.

As discussed in our *ISA Portfolio View*, key reasons to include real estate in the portfolio include the size of the asset class, the diversification potential it brings, and the potential for cash flow growth. None of these have been fundamentally altered by the recent shift in the capital market environment.

But with reversal of the multi-decade falling interest rate trend, care must be taken to align exposures with structural trends. Core investors should consider adjusting their portfolio allocations to be consistent with (or ahead of) evolving views on what constitutes core, quality real estate; value-add investors should consider creating stock that meets the evolving criteria of core investors through development or repositioning.

G-n

Traditional core mindset	"New core" mindset
Factors that are changing...	
Long leases[23]	Observed long-run income resilience and growth potential
Credit tenants	Low sensitivity of cash flows to the economic cycle
Lease clauses pass inflation on to tenants	Market conditions pass inflation into market rents
Minimal near-term capex	Predictable long-term capex
Low operational intensity	Established operating model
Traditional sector – office, retail, industrial, multi-family rented residential	Any sector that offers the above
Factors that have stayed the same...	
Flexible and defensive capital structure	
Locations with long-term tenant demand	

23 Only applies to markets that have long leases. In Japan, for example, the traditional lease length is two years and this has been viewed as core in that market.

Managing editors

Petra Blazkova
Europe Head of Core and Core-plus Research and Strategy

Eduardo Gorab
Head of Global Portfolio Research and Strategy

Richard Kleinman
Head of Americas Research and Strategy, Co-CIO Americas

Brian Klinksiek
Global Head of Research and Strategy

Chris Langstaff
Canada Head of Research and Strategy

Daniel Mahoney
Europe Head of Research and Strategy

Dominic Silman
Europe Head of Debt and Value-Add Capital Research and Strategy

Fred Tang
Greater China Head of Research and Strategy

Elysia Tse
Asia Pacific Head of Research and Strategy

Dennis Wong
Senior Strategist, Asia Pacific

Contributors: Research and Strategy team

Mary Burke
Frederik Burmester
Zuhaib Butt
Simone Caschili
Jade Cheong
Amanda Chiang
Ryan Daily
Carly Ellis
Heidi Hannah
Kayley Knight
Tobias Lindqvist
Sierra Pierre
Chris Psaras
Wayne Qin
Kyra Spotte-Smith
Sophia Sul
Matthew Wapelhorst
Jen Wichmann
Jannie Wu
Hina Yamada

LaSalle leadership

Keith Fujii
Head of Asia Pacific

Mark Gabbay
Chief Executive Officer

Brad Gries
Co-Head of the Americas

Kristy Heuberger
Co-Head of the Americas

Samer Honein
Global Head of Investor Relations

Lisa Kaufman
Head of LaSalle Global Solutions

Tim Kessler
Global Chief Operating Officer

Philip La Pierre
Head of Europe

Julie Manning
Global Head of Climate and Carbon

Joe Muñoz
Co-Chief Investment Officer, Americas

Kunihiko Okumura
Head of Japan and Co-Chief Investment Officer, Asia Pacific

Gordon Repp
General Counsel

Mike Ricketts
Chief Financial Officer

Darline Scelzo
Global Head of Human Resources

Matt Sgrizzi
Co-Chief Investment Officer, LaSalle Global Solutions

Claire Tang
Head of Greater China and Co-Chief Investment Officer, Asia Pacific

Dan Witte
Co-Chief Investment Officer, LaSalle Global Solutions

Jon Zehner
Vice Chairman

Michael Zerda
Head of Debt and Value-Add Strategies, Europe, and Co-Chief Investment Officer, Europe

Contributors: Marketing and Communications

Alexandra Constantin
Josh Coger
Liam Fitzpatrick
Joe Oslawski

LaSalle®
Investing today.
For tomorrow.

Amsterdam
Atlanta
Baltimore
Beverly Hills
Chicago
Denver
El Segundo
Hong Kong
London
Luxembourg
Madrid
Munich
New York
Paris
San Diego
Seoul
Shanghai
Singapore
Sydney
Tokyo
Toronto
Vancouver

lasalle.com