Keep calm and carry on? The *ISA Outlook 2025*, six months in

In a recent conversation[1], Dominic Silman and Brian Klinksiek revisited LaSalle's ISA Outlook themes amid 2025's rapidly developing and unpredictable geopolitical and macroeconomic climate.

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Brian Klinksiek (BK): The theme of our *ISA Outlook 2025* was the 'Dawn of a New Real Estate Cycle'. Looking back six months later, we've been through a rollercoaster of policy change with meaningful shifts in the economic narrative. We covered this in two recent Briefing notes. In the first, we recommended that investors "work backwards" from strategic actions that make sense regardless of macropolitical outcomes; in the second, we pointed to signals from key relativities among asset classes, geographies, and sectors. All those recommendations still stand, but we provide a further update on recent developments in our latest *LaSalle Macro Quarterly* deck (LMQ), which we released today. Thankfully, many of the most extreme US policies – such as the full "Liberation Day" tariffs – have been paused, at least for now. But as we have pointed out, uncertainty itself has a cost.

Beyond the trade war, in the past two weeks a real kinetic war unfolded between **Israel and Iran**, with the US stepping in as well. This is driving energy price volatility and, in the unlikely case of a severe escalation, could lead to the destruction of energy infrastructure in the region, or to the closure of the Strait of Hormuz, a major chokepoint on the global energy map.[2] Both could potentially bring stagflation to the global economy.[3] In the background, the global political calendar has also been very busy – we've seen election results in Canada, Australia, South Korea and Poland, as well as the new German coalition's shift toward higher spending and investment. Given all this change, where do we stand today? Do we still think it's the dawn of a new real estate cycle?

> "It's helpful to take a step back and ask: What is actually changing and what is likely to stay the same?"

Dominic Silman (DS): As you say, it's been quite a six months! It's helpful to take a step back and ask: What is actually changing and what is likely to stay the same? For example,

[1] LaSalle has utilised JLL GPT to transform a transcript of a recorded verbal conversation that is documented in this publication. JLL GPT is a secure, in-house generative artificial intelligence (AI) interface that draws on the underlying models from OpenAI's ChatGPT and other AI firms.
[2] Source: Signum Global Advisors, Piper Sandler
[3] Source: Oxford Economics

ISA OUTLOOK 2025 THEME:

THE MORNING SKY
Falling rates but risks on the horizon

MID-YEAR UPDATE:

Divergent rates and significant policy uncertainty, but solid real estate fundamentals.

despite the movement and uncertainty, it bears mentioning how little has so far changed on the ground in property markets, which we will talk about later.

Among the many changes, we should also ask which are likely temporary and which are permanent. April's extreme volatility has so far proven temporary; markets are a lot calmer today.[4] It reminds me of that British Second World War poster: 'Keep Calm and Carry On'. Are we carrying on? Certainly. Are markets actually keeping too calm recently, especially given still elevated uncertainty? I think there's a risk of too much calmness, and too much of an instinct to assume that everything always works out absolutely fine and reverts to "normal".

BK: Over my whole career, events that felt very concerning at the time have had this tendency to work out. Examples that come to mind are things like the euro debt crisis or the post-COVID regional bank non-crisis in the US. I am even tempted to put the Global Financial Crisis (GFC) in that basket – the GFC was extremely challenging, but things did not turn out as bad as it seemed they might at the scariest moments. That said, the economy's resilience isn't an immutable property of nature and should not be taken as a given. Are any of the fundamental drivers of that resilience at risk today?

DS: The key drivers of global and US economic growth are intact. In particular, we remain bullish on the impact of technological innovation and the adoption of transformative technologies like AI.[5] If there's an aspect of the global economy that seems to be particularly in focus right now, it's **trade.** But even before April 2025, there were signs that trade as a share of global GDP had already plateaued, and was possibly starting to pull back after the first Trump-China trade dispute in 2018-19 and the 2020 pandemic-related supply chain challenges.

BK: A lot of labels for this have been thrown around – deglobalization or slow-balization, fracturing, and the like.[6] What does it mean for real estate? For one thing, it may lead to less synchronized cycles across geographies. An increase in the dispersion of economic performance across the globe reinforces the potential value of diversification.[7] We already see signs that correlations across global listed real estate markets have fallen. In a less integrated world, some economies will be focused on trying to support growth,

> "An **increase in the dispersion** of economic performance globally reinforces the potential value of **diversification**"

[4] As indicated by a significant moderation in indicators of market volatility, such as the VIX for US equities and the MOVE index for US government bonds. Source: LaSalle analysis of Refinitiv data.
[5] Source: LaSalle analysis of various sources, including Capital Economics, Oxford Economics
[6] For a more detailed discussion of fracturing and its implications, see a report by Capital Economics, "The Fracturing of the Global Economy".
[7] See our *ISA Portfolio View* for a summary of the case for diversification in real estate portfolios.

some on trying to control inflation. This has been observed already with the Fed staying put while many other major central banks continue to cut policy rates, leading to a widening global divergence in interest rates.

DS: Luckily, the range of economic characteristics that we have seen in different countries over time remind us that it's possible to invest successfully in real estate under all kinds of different macro scenarios.[8] That is not to say that interest rate divergences will not have an impact on near-term capital flows. For example, they make currency hedging a lot more expensive, or a lot cheaper, depending on the origin and destination country.[9]

BK: I want to go back to what you said about financial markets, that they are strangely calm as we enter the second half of the year. I mostly agree, but a big story in recent weeks has been volatility at the long end of the government yield curve. There seems to have been a shift away from short-term concerns about specific policies like tariffs, to bouts of longer-term worries around the fiscal sustainability of many rich world governments.[10] In Europe, France has been in focus for that. In Asia, Japan has seen long bond yields jump.

But in terms of global consequences, **US debt sustainability** is the most impactful concern. In May, Moody's became the last of the three major credit ratings agencies to downgrade the US from AAA status. The so-called "One Big Beautiful Bill" (OBBB) working its way through the US Congress, is likely to increase the fiscal deficit.[11] If tariff pauses are made permanent, or if tariffs are negotiated down or struck down by courts, that would be good for the global economy. But tariff revenues would also be lower than originally expected, adding to the US fiscal deficit.

One silver lining is that the OBBB could be less of a hit to US government finances if the proposed full expensing of businesses investment strongly boosts growth. And we are encouraged that negotiations between the US and its trading partners seem to have averted a proposed amendment to the tax code called Section 899, which until last week looked like it would be embedded in the bill. It would have raised taxes on some foreign investment into the US, including into real estate.[12]

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[8] According to LaSalle analysis of data from MSCI, INREV, ANREV, and NCREIF.
[9] The cost of hedging is a mechanical byproduct of how it is implemented, with investors from higher-yielding countries investing in lower-yielding markets seeking to hedge back to their local currency experiencing an uplift in nominal returns. The reverse is true for hedged investors from lower-yielding countries investing in higher-yielding markets.
[10] Source: Piper Sandler, Capital Economics
[11] Source: Moody's Analytics, Piper Sandler
[12] Sources: LaSalle's internal tax team, Green Street Advisors, Signum Global Advisors

DS: Zooming out, it seems to me that the long-run question is whether fiscal sustainability issues will be resolved positively through structural reform and/or through economic growth, or negatively through allowing sustained above-target inflation to happen.[13] The longer-term worries are about whether we're going to have a disinflation episode, or whether we're going back to higher inflation.

BK: The latter could certainly give the bond markets the jitters. But while a world of higher and more volatile inflation is a risk, such a world is not necessarily a bad one for real estate. That might seem counterintuitive after the recent experience of what felt like a simple cause and effect that ran from a globally correlated surge in inflation, to a correlated global increase in bond yields, to a mostly correlated increase in real estate cap rates, repricing, and thus falling values.[14] But real estate's fundamental nature as a tangible asset class with partial inflation-hedging properties[15] could make it more strongly sought after by investors if inflation becomes stickier and more unpredictable. You could even imagine a weaker link in the future between government bond yields and how real estate is priced.

> "While a world of higher and **more volatile inflation** is a risk, such a world is not necessarily a bad one for **real estate**"

DS: That goes along with greater dispersion in the drivers of real estate investment performance. While the 2022-23 rate hikes were highly globally correlated, the near future perhaps looks more like a dispersion, an increase in variance of outcomes across markets that have increasingly different drivers.[16] Those divergences amplify the inherent variation that comes from the local nature of real estate, which has always been a fact in our asset class. Capital markets may be partly global, but occupier market supply and demand are intensely local. Which reminds me, we said we'd look at how our views on occupier markets are holding up.

BK: Right! The lion's share of what we predicted for property market fundamentals in the *ISA Outlook 2025* has held up, with mixed but generally solid fundamentals across most sectors and geographies.[17] If you just look at supply, we said new construction was going to fall a lot, and now it's falling a lot. That should only continue as tariffs on construction materials like steel likely

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[13] The economic literature suggests that government debt sustainability is a function of the size of government deficits, the cost to service government debt and economic growth. Factors that can improve debt sustainability include fiscal consolidation (cutting deficits/growing surpluses), higher economic growth (reducing the debt load relative to the size of the economy) or allowing unexpected inflation to occur (reducing the real value of the outstanding debt). Source: International Monetary Fund.
[14] For a summary of the repricing process in real estate, see our *ISA Outlook 2023* global theme "The math of spiking rates driving a repricing of real estate".
[15] For a more complete discussion of real estate's inflation-hedging characteristics, see the *ISA Portfolio View*.
[16] Source: Oxford Economics, Capital Economics
[17] Sources for the commentary on property fundamentals that follows: LaSalle analysis of property market data, principally CoStar, CBRE, JLL, PMA, Green Street Advisors

drive higher replacement costs, at least in the US, meaning you need even higher rents to justify new development. We thought European property fundamentals were going to be stable and not highly correlated to the global macroeconomy. And that's what we found. We said retail had rebalanced and would be a strong performer in most markets, and that has absolutely been the case.

> "Tariffs on construction materials like steel likely drive **higher replacement costs**"

DS: That is not to say that there are not some real impacts from policy. For example, take US **life sciences** real estate. We had expected demand for life sciences to finally start recovering this year, but it is getting hit again by the scientific research and medical research funding pullback in the US.

ISA OUTLOOK 2025 THEME:

THE CAPITAL STACK HANGOVER
Clear headed investors have an advantage

MID-YEAR UPDATE:

Distress has remained relatively limited, but need for creative capital structure solutions persists.

But the biggest topic is probably the **logistics** sector – it houses global supply chains, so clearly faces uncertainties. However, tariffs are not a blanket issue for logistics; for example, port-oriented locations have more of a cloud hanging over them than a truck hub market. Most logistics space demand happens close to the place of consumption and import, rather than the point of manufacture and export. Since European imports are less likely to be directly reduced through tariffs, we expect European logistics to be relatively insulated.

This highlights the potential for market share shifts, and for relative winners and losers. For example, the outlook for inbound visitation to the US has weakened, likely hitting US **hotels** in tourist locations and US **student housing.** Europe may be the beneficiary of a demand shift away from the US in both of these sectors.

BK: We need to talk about **office.** We said in the *Outlook 2025* that the sector remained "all over the map" globally. We saw strength in some Asia Pacific markets like Seoul and Tokyo, as well as at the top end of the European office market by quality and location, but severe weakness in the US and a few other places. We correctly predicted the beginnings of an early recovery in the US, as spreading return-to-the-office policies are unlocking some confidence in the sector. The space-per-worker adjustment process looks complete, which is why we are starting to see office net absorption tip slightly into positive territory alongside negative net supply, stabilizing the vacancy rate.

ISA OUTLOOK 2025 THEME:

THE BREAKFAST MENU
Making sense of complex investment options

MID-YEAR UPDATE:

Policy shifts have made identifying winning sectors and markets even more complex, benefiting investors with a rigorous relative value approach.

There's a capital stack aspect to this as well. The US office market is the most obvious concentration of distress in all of global real estate. Whoever has capital structures that allow them to invest the capex needed to make buildings competitive and to get leasing done are well placed. The process of sorting out between the winners and losers will have to take place alongside the slow recovery in the overall market.[18]

DS: Keeping up with capex is just one of the many needs for capital in today's environment. While distress isn't widespread[19], as you say, there are pockets where capital is still relatively scarce. For example, in some sectors and geographies, there is less capital backing development projects or recently completed assets in their lease-up phase. A great way to provide this capital in a volatile, uncertain environment is to be a lender. We remain structurally bullish on investment in real estate credit.

BK: In summary, it's fair to say that "keep calm and carry on" applies to most of what's going on in the property markets. Adding to the case for carrying on is that real estate **repricing is mostly complete** in the markets where we invest.[20] Real estate valuations appear far less stretched than, say, those of large cap equities.[21]

ISA OUTLOOK 2025 THEME:

THE EARLY BIRD
The best market entry points tend to be early in the cycle

MID-YEAR UPDATE:

The slope of recovery will be shallower than we had expected, but real estate remains well positioned.

We'll have to try our best to see through the policy uncertainty, and to **be ready for shocks** such as a spike in oil prices from what's happening in the Middle East. But the new cycle is still upon us, it's just not likely to be an environment supercharged by universally falling rates. The policy and geopolitical turbulence also mean there will be squiggles around the bigger cyclical trend line. Dom, in your new role as LaSalle's Chief Economist, you'll be helping us make sense of what this all means for real estate.

DS: That's right, my new role is to help connect what's going on in global macro, geopolitics and capital markets with the work our regional research teams are doing to inform strategy. I'm excited to get started!

[18] See our report, "ISA Focus: Rebalancing past and present", for more discussion on the outlook for the US office sector and insights on how it may rebalance.
[19] MSCI data on distress shows it remains significantly below the GFC and pandemic periods.
[20] Based on LaSalle's proprietary fair value analysis.
[21] As addressed in our report, "ISA Briefing: The trade war, relatively speaking".