Research & Strategy

COVID-19 update: risk-off-led sentiment to remain

Key takeaways:

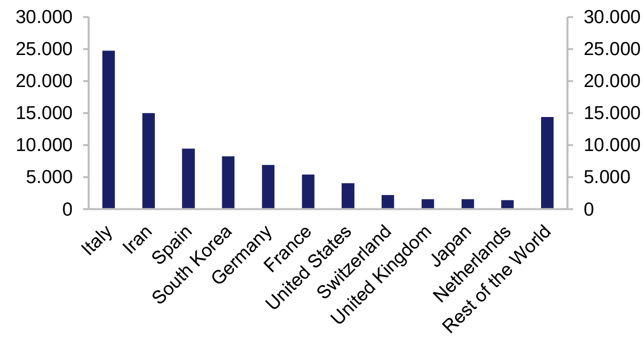
- Risk-off sentiment is to remain in the short term as global governments rely on fiscal and monetary policies to support economic growth. COVID-19 is set to underpin a downgrade in global economic growth as a U-shape recovery becomes increasingly the base case.
- The extension of the lower-for-longer narrative provides some support to real estate amid low bond yields, but downbeat equity markets globally may have a worrying impact on corporate profits and, hence, tenants' ability to support current rental levels.
- There is also the denominator effect on real estate allocations, as valuations are slow to reflect the full impact of the downturn.
- The downturn itself will also be influenced by the quantum of defaults (both tenant and banking covenants). This is an area to monitor, as well as the impact on employment trends.
- The retail, leisure and hospitality sectors are set to bear the brunt of the COVID-19 outbreak. Risk aversion is likely to drive some short-term tightening in the credit market, which highlights the importance of secure income streams and reducing exposure to overleveraged strategies.

Global impact of COVID-19

Risk-off sentiment set to linger

- Over the last month, the coronavirus outbreak (COVID-19) has turned for better and worse at the same time: better in China, but worse globally. What was initially viewed as a China- or Asia-focused issue has gone global as COVID-19 risks are being priced aggressively across all asset classes, and some fear that it may cause a recession in the global economy.
- In our previous note, we discussed the outbreak of the virus in Asia. But the spread continues to worsen and has become a pandemic, with more cases of infection and deaths in Europe, the Middle East and elsewhere. A sudden surge of new infections in South Korea, Iran and Italy has sparked rising concerns (figure 1). Mortality rates in Italy and Iran are also higher than elsewhere, which has further fuelled action by governments to contain the spread of the virus and to coordinate stimulus measures to counter the economic effects.
- The impact of a supply chain disruption is now clearer than a month ago even though the situation is evolving daily. Workers have slowly started to return to work in China, but travel restrictions keep factories and manufacturers from operating at full capacity. Large corporates such as tech giant Apple, sporting apparel giant Under Armour and major airline carriers are some examples of companies who have pencilled in lower revenue targets in Q1. Q2 is unlikely to be any different.

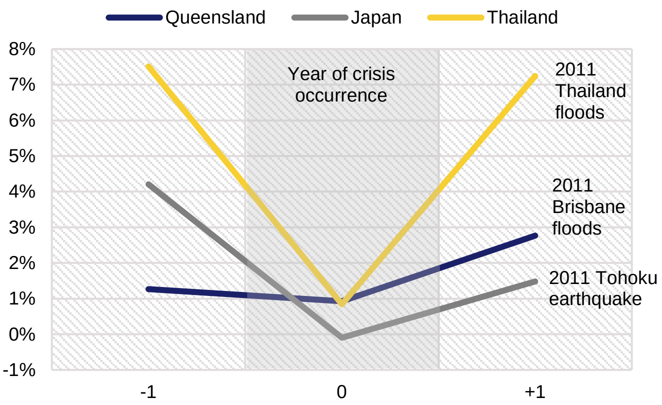
Figure 1: Confirmed COVID-19 cases as of 16 March 2020 (excluding China)



Source: Worldometer

- The full extent of the COVID-19 impact is uncertain as the economic damage continues to increase. China's impact on global commerce has grown substantially, from 2% of global GDP in 2003 during the SARS outbreak to 20% by end-2019, based on Oxford Economics data. Any disruption to supply chains has the potential to derail economic recovery, as seen in Japan and Thailand where natural disasters led production to stall and economic growth in those markets to fall into recession or close to zero (figure 2).

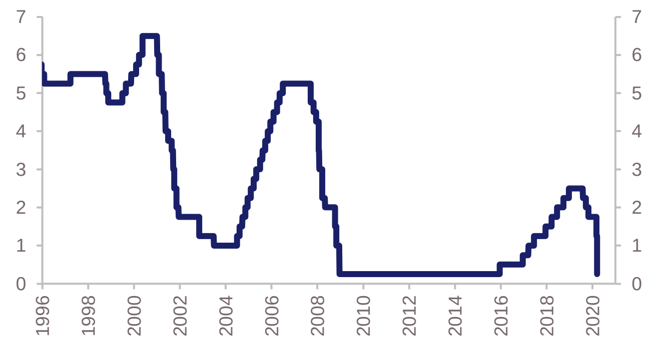
Figure 2: Annual GDP growth (%) comparison following major natural disasters in Asia-Pacific



Source: Oxford Economics

- While retail, hotel and restaurant assets are bearing the brunt of the impact, other asset classes are suffering tertiary effects, prompting most economists to project slower global GDP growth. Public sentiment is fast eroding globally, leading to a major sell-off in the equity markets. Economic consequences may arise if COVID-19 provokes a collapse in public confidence, according to the Bank of England (BoE) governor.
- At the same time, central banks are trying to boost confidence by coordinating fiscal stimulus measures and monetary policies globally. The US Federal Reserve (Fed) has already slashed interest rates twice (1.5 percentage points) to near-zero levels in response to mounting concerns about the economic impact of the coronavirus (figure 3). Statements by the European Central Bank (ECB) and the BoE also suggest more loosening ahead.

Figure 3: Fed fund rate (%)



Source: Macrobond

Economic impact and recovery

Economic impact set to be sharp, with recovery hinging on varying factors

- Admittedly, the trajectory of the virus is unknown, as is the effectiveness of containment efforts and the impact on the economy and well as consumers' and firms' confidence. So far, the 150–basis point rate cut by the Fed has failed to instil confidence as equity markets have continued to falter. But a key message from the Fed cut is that the low interest rate environment should prevail, with central banks around the world set to take a leaf out of the Fed's book.
- The recessionary risk is real. The vulnerability of major economies, including that of the US, has risen as growth has slowed and various countries are now less able to absorb shocks. Indeed, financial markets have seemingly priced in a supply shock (disruption to supply chains), sparking a flight to safe-haven assets (bonds, US dollar, Japanese yen and gold).
- Many observers have compared the global economic impact of the COVID-19 outbreak to the global financial crisis (GFC) of 2008 (besides the SARS epidemic in 2003, which was Asia-focused). While the GFC mainly hit the demand side of the economy, the COVID-19 shock affects both the demand and supply side of the economy.
- Factory shutdowns, travel bans, supply-chain disruptions and school closures represent a supply shock, Capital Economics reports, diminishing the ability of the economy to produce goods and services.
- These effects can be self-reinforcing, since factory shutdowns can reduce the income of workers, which in turn reduces spending. A rise in unemployment is a key indicator to watch out for.
- Oxford Economics expects global GDP growth to slow to 2.0% this year from 2.6% in 2019, before picking up to 3.0% in 2021. While its base case is a slowdown in H1 2020, larger revisions may be required if the situation worsens.
- Which markets underpin a U-shape recovery mainly hinges on the effectiveness of fiscal and monetary policies. Various quantitative easing (QE) programmes have started to lose their effectiveness in boosting economic growth, akin to viruses becoming more resistant to antibodies.
- Back in 2003 and 2009, stimulus worked due to an era of global growth thanks to rapid economic expansion. But we were already in a subdued economic growth environment before the coronavirus outbreak. The speed of recovery will largely depend on how the virus spreads as well as when the containment measures are lifted and life returns to normal.
- Investors would expect more aggressive rate cuts under a U-shape scenario, which could possibly send US Department of the Treasury yields into negative territory.

Commercial real estate impact

The occupier perspective

- In the current situation, decisions to rent new space will likely be postponed in various cases due to existing travel restrictions and uncertainty regarding the short-to-midterm economic development. Some effects, particularly on the occupier markets, have already been felt, with tenants requesting rental costs support, mainly in retail and food and beverage industries.
- Hotels are the most affected across the globe. Travel restrictions and cancellations of exhibitions, sports or cultural events have already reduced business and tourist travel. Airlines have cut flight plans drastically.
- Retailers and restaurants in high street locations, shopping centres and outlet malls that rely heavily on strong footfall and tourists would be most affected by the consequences of a further spread of COVID-19. For instance, the Italian and French governments ordered shops, bars and restaurants to close countrywide, except for supermarkets, food stores and pharmacies.
- Shops and restaurants in railway stations and airports are also likely to experience a sharp drop in sales. In this context, investors will be faced with disruptions in income streams in case of turnover-based rents. In a worst-case scenario, longer-lasting shop closures could cause an increase in insolvencies.
- The student accommodation sector in Europe is also likely to be impacted by stricter measures such as travel bans, particularly those accommodations hosting mainland Chinese students, as one in every three non-EU students is from China, based on Higher Education Student Statistics data.
- The outlook for logistics is mixed. On the one hand, the reduction or even shutdown of certain production as well as transportation restrictions pose a significant risk to the supply chain and, thus, occupier demand. Global shipping and air cargo are also hit by COVID-19, meaning goods cannot be picked up or get stranded somewhere.
- On the other hand, online retailers are most likely benefitting from closures of brick-and-mortar shops, travel restrictions and quarantine increasing occupier demand for fulfilment centres, distribution warehouses and urban logistics facilities.
- For the time being, the office sector is looking mostly stable providing a secure income stream. That said, a slower economy would affect business expansion plans and revenues, underpinning slower demand and, hence, reduced rental growth expectations.

The investment perspective

- Investment market transactions are also likely to be delayed due to possible travel restrictions of the contractual partners as well as increased uncertainty. The turmoil on the equity markets may result in an increase of real estate exposure in multiasset portfolios. In a lower-for-even-longer interest rate narrative under a U-shape economic recovery scenario, real estate has some support owing to its bond-like characteristics and relative value from a yield-spread perspective, Savills reports.
- But the asset class itself is not totally immune due to the impact on corporate profits, the denominator effect and the possible breaches to debt covenants.
- We expect an increasing risk aversion and a flight to core, which is why further downwards pressure on prime yields is as likely as a mounting yield spread between core and secondary property.

Conclusions

- As per past black-swan events such as SARS or the GFC, we expect the COVID-19 outbreak to be a short-term economic disruption, which would have a negative but sharp impact on certain sectors of the commercial real estate market.
- The further transmission and evolution of the virus remains difficult to predict. If COVID-19 spreads aggressively across Europe, the Middle East, Africa and Asia-Pacific, it will conceivably have a significant impact on economic growth and, therefore, commercial real estate investment volumes in 2020.
- We believe that investment markets could dry up in the short- to mid-term due to the restrictions on business travel, face-to-face meetings and site visits. Anecdotal evidence suggests that leasing is challenging in almost every sector today, which would place downwards pressure on rentals across all sectors.
- Since the real estate markets are in the final phase of the current cycle, we have already started to advise investors to consider core- and core-plus strategies in late 2018/early 2019. We maintain our view that long-term income streams are more resilient to short- to mid-term market volatility.
- However, we will closely monitor key indicators that could signal occupier market turning points, such as rising unemployment because of long shutdowns, insolvencies and dislocations, among others.

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