INFLATION pandemic

PATIENCE AND FORTITUDE WITH AN EYE FOR OPPORTUNITY COULD BE THE KEY REQUIREMENTS OF CAPITAL INVESTORS HEADING INTO 2023.

INVESTOR HOPES THAT THE FINAL months of 2022 would mark the peak of the year's economic volatility have been quashed in a climate of inflation and ongoing global upheaval.

October's shock inflation announcement of 7.2 percent, may have been down slightly on June's 32-year high of 7.3 percent but was significantly higher than the figure of around 6.4 percent that had been predicted by the Reserve Bank of New Zealand (RBMZ) and economic commentators.

The announcement immediately caused significant surges in the interest rate swap rate curve - up 20 basis points on two-year swap rates - and led to forecasts that the RBNZ's next Official Cash Rate (OCR) announcement in November would hit 4.25 percent.

The inflation announcement coincided with a webinar by Bayleys' international real estate partner Knight Frank on global active capital, which backed up the realisation that this period of economic upheaval is far from done.

Bayleys national director commercial and industrial Ryan Johnson says the Knight Frank global metrics indicate now that hopes a peak was in sight, were optimistic.

"What we can expect now is more of the same - and even more of it. That inflation announcement was a huge indicator of how things are going to play out over the next few months.

"A lot of people were hoping for, and predicting, signs that the volatility was reaching its peak. The fact it didn't happen that way meant people reacted strongly in the other direction, particularly in the significant surges on the interest rate swap curve."

With key economies including the US, UK and Australia predicting they will be in recession in 2023, the message for investors is really to hold, but watch for opportunities, Johnson says.

"That expected forecast change in the OCR is going to create another pause on a lot of institutional capital as investors wait out interest rate volatility."

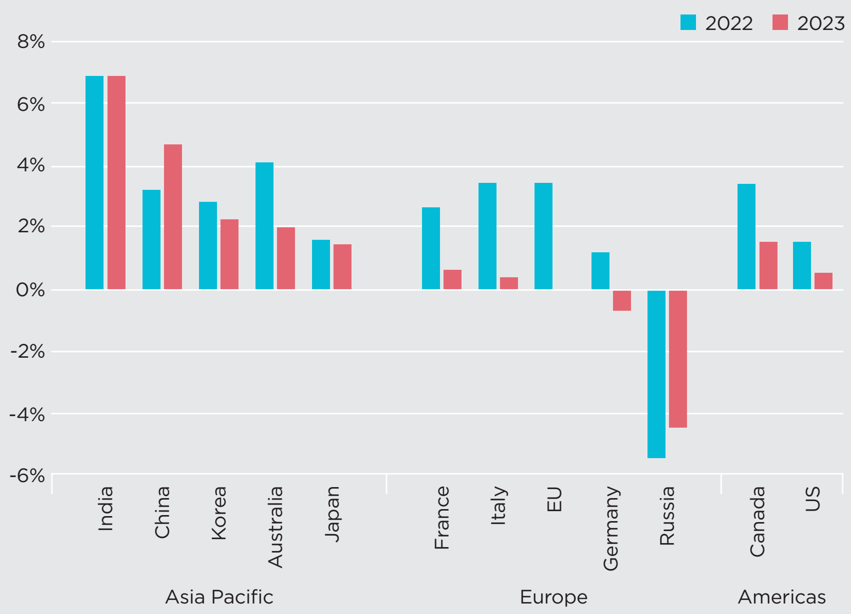
GLOBAL SNAPSHOT

The clear overall picture coming through from Knight Frank data is that ongoing, even escalating, global economic and political upheaval is still making investors more cautious.

Energy crises in the UK and Europe, war in Ukraine and continued lockdowns in China all add up to too many unknowns for investors. That perfect storm also comes against a backdrop of increasing interest rates from central banks around the world as they battle to bring inflation back to manageable levels.

GLOBAL OUTLOOK - GDP GROWTH FORECASTS

OECD forecasts, September 2022



Source: OECD

The report includes OECD GDP growth forecasts that make for sobering reading. GDP growth in the US is predicted to drop from around 1.8 percent in 2022 to around 0.5 percent in 2023, while the EU's GDP growth is expected to sit around zero percent. Australian GDP growth is predicted to drop from four percent to two percent in 2023. One country bucking the trend is China, with predicted GDP growth rising from around 3.5 percent in 2022 to around 4.5 percent next year.

Meanwhile, investment volumes in Europe are predicted to be around EU$45 billion for the third quarter of 2022, down from their peak of more than $140 billion in the last quarter of 2021. In the Asia Pacific region, investment volumes for the third quarter of 2022 are at a five-year low of around US$28 billion, down from the 2021 high of close to $75 million.

The report indicates that with investors holding their assets and the impacts of tighter monetary policy still playing out, the effect of the rapid market changes on global property values is yet to fully play out. However, yields are predicted to widen as buyers expect higher returns from property compared to alternative fixed-income investments.

THE LOCAL IMPACT

Back in June, Knight Frank's *Rising Capital in Uncertain Times; Active Capital Asia-Pacific Perspective* report, outlined the key issues for the capital market then as:

- increasing caution and risk aversion as a result of geopolitical and economic uncertainty
- limited stock for investment
- widening bid-ask spreads
- a downturn in activity due to inflation and cost of debt.

The ongoing volatility and uncertainty mean most of those are still at play in the local market to an even greater extent, says Johnson.

The latest data from Bayleys' Insights and Data team and CoreLogic puts transactions of over $20 million in New Zealand at $1.8 billion for the first half of 2022, that's 66 percent down on $4.02 billion for the same period in 2021.

"That theme of low transactions is going to continue over the next few months and that offshore volatility continues to spook the sophisticated capital. We are seeing some off-market deals happen, but vendors are reluctant," Johnson says.

A survey of investors at a recent Bayleys event also demonstrated an overwhelming majority were planning to sit tight and hold on to their assets in the near term.

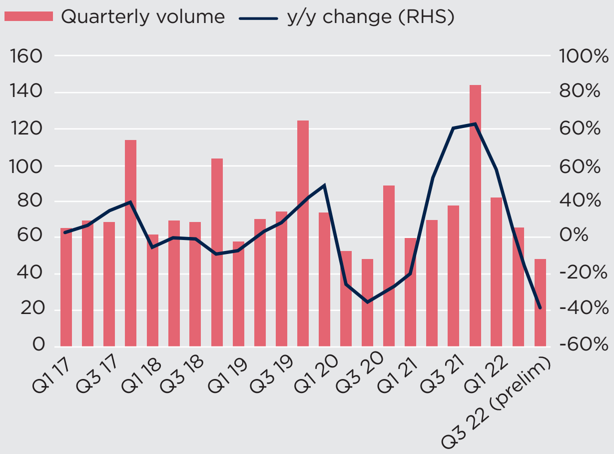
"That may change as the pace of increases to the cost of debt escalates," Johnson says.

In the secondary market bid-ask spreads have continued to widen as owners continue to hold and the cost of debt rises, with vendor expectations and investor willingness increasingly misaligned.

One of the other key constants in the New Zealand landscape, particularly in the two years since the initial COVID-19 lockdowns, has been the increased emphasis on industrial space as an appealing, robust asset class offering good returns.

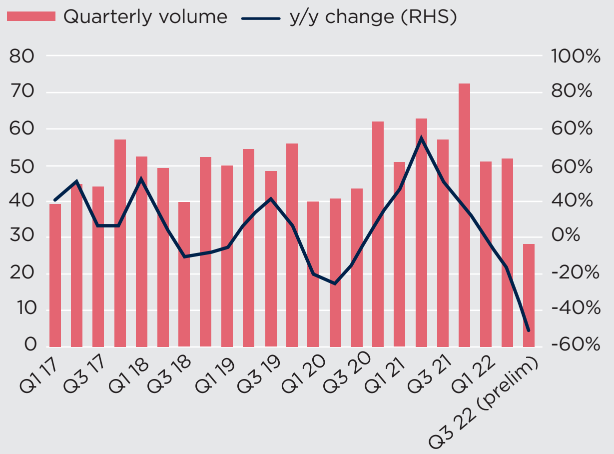
INVESTMENT VOLUMES - EUROPE

Quarterly deal volume (EUR billions) and number of assets traded (RHS)



INVESTMENT VOLUMES - ASIA PACIFIC

Quarterly deal volume (USD billions) and number of assets traded (RHS)



Source: RCA

While that remains true, there are signs it isn't immune from the current global uncertainties, Johnson says.

For the first time in several years, capitalisation rates are starting to soften on industrial properties.

"We are still seeing rents accelerating in industrial, but something will have to give there because land values are elevated and those cap rates are starting to soften," Johnson says.

"That indicates industrial, is not immune from the overall market volatility and increased risk."

One thing to look out for as the market adapts to greater risk, he says, is the increase in the amount of institutional equity being redirected to repay debt and offset some of the cost of that debt.

"A lot of owners are trying to reduce their gearing significantly and they'll do that with equity where they can. So that means less equity to buy industrial or other sector assets as those owners try and de-lever their balance sheets.

"Less capital means less buyers. Less buyers means prices are going to soften."

This environment of decreasing transactions and asset-holding, also causes a flow-on effect of impacting property valuations.

Bayleys associate director valuation and advisory services Jessica McKenzie says at a time when banks are pushing for more formal valuations as security for refinancing, the lack of recent sales makes it more difficult to see the true impact of global volatility on values here.

"As valuers we are always looking to the view in the rear-vision mirror from recent sales to guide where the market is. Those sales just aren't coming through to give us that full picture of how all these factors are impacting the market," McKenzie says.

She predicts that sales hiatus will be broken first by mortgagee sales of secondary assets leading to an initial price dip. "I think the results from those first sales won't be great, but after that things will start to normalise a bit and we'll begin to get a better picture of the new normal for values."

That gap between secondary and primary assets is expected to widen over the coming months, McKenzie says, with prime assets likely to hold their value reasonably well. "They could dip by a couple of percent but I think secondary assets could come back a lot further. They are always hit a lot harder when times get tougher.

"If you can, the best bet is to hold and wait things out; probably for about the next 18 months."

THE DOLLAR UPS AND DOWNS

The other more recent factor impacting local market forces is the devaluing of the New Zealand dollar against other key currencies.

As of mid-October, the NZD was sitting at around US56c, AU90c and SGD80c, making New Zealand a suddenly more attractive opposition for foreign capital.

"The shift in exchange rates for the New Zealand dollar will be a big factor in how our investment markets adapt to the current conditions in the coming months," says Johnson.

"There have been some significant devaluations against come currencies, like the US and we are definitely seeing an increase in interest from the capital from those regions.

"That is underpinned by the fact that New Zealand is seen as a safe harbour within APAC and has a long-term, overall macro story that is very positive," he says.

Knight Frank forecasts that 66 percent of capital invested in the whole APAC region is likely to come from the US, making it the largest investor in the region by a long way. The next largest source of capital will be Singapore at 16 percent, followed by Hong Kong at six percent with Germany at four percent and the UK at three percent rounding out the top five.

THE ART OF ADAPTING

If there is one thing the latest inflation figures have brought home, it is that there are too many geopolitical and economic uncertainties and shifting contributing factors to accurately predict when we might see things bottom out and start to change, says Johnson.

But, he adds, a challenging market environment will always bring opportunities as well as challenges.

The global trend for strong investor interest in prime quality assets with high environmental, social and governance (ESG) ratings is also playing out in New Zealand, as is the growing interest in residential asset classes such as senior living and build-to-rent apartment complexes.

"ESGs in particular are becoming a bigger and bigger area of interest for active capital investors. It's a global trend that will play out here with high-rated buildings in good locations holding their appeal," Johnson says.

Beyond those emerging asset classes there will also be opportunities for motivated capital from investors who are well-informed keeping their eye on the ball, he says.

"There is plenty of opportunity, it will often just come down to timing. As balance sheets and capital get recycled we'll see more transactions offering good opportunities. Where you have a willing seller there will be a willing bidder at the right price."