



THE REAL ESTATE – BOND YIELD GAP

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OVERVIEW

The recent (July/August 2011) crisis in the financial markets has driven down yields on certain government bonds. As a result the gap between the yield on real estate and that on government bonds is at an historically high level, particularly in the Eurozone. Last time this happened it was a strong buy signal for real estate, but is that the case this time around?

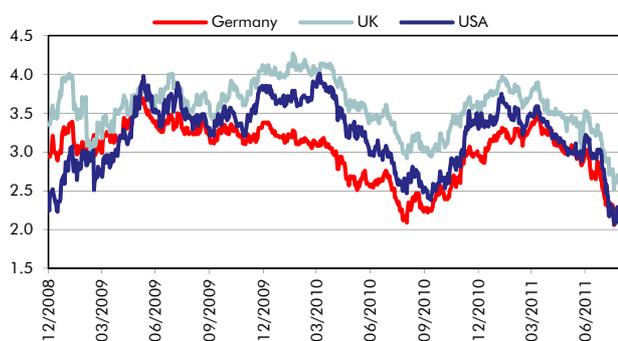
To some extent the widening yield gap can be explained by a sudden (and hopefully temporary) rise in the liquidity risk premium. Expectations of weaker economic growth also explain part of the increase.

There are groups of investors for whom this is an opportunity to exploit the attractive relative pricing of the two asset classes. For long-term investors who are relatively insensitive to short-term liquidity, this could be an opportunity to exploit the yield gap. However, we expect that such investors will be concentrated at the prime end of the market, further diverging the performance of prime property and the rest.

INTRODUCTION

Late July and early August 2011 saw extreme volatility in the financial markets. Most obviously this has been reflected in substantial movements in stock markets worldwide. However, one of the other effects has been a sharp downward movement in the yield on certain government bond yields. In the case of the UK, for example, the benchmark 10-year government bond yield reached a level last seen in 1899.

Government bond yield (10-year benchmark)



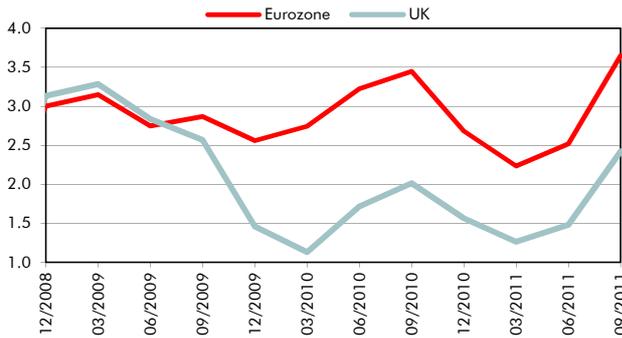
Source: Macrobond

The downshift in yield is selective. Not all government bond markets have seen the same degree of movement. It is ironic that the downgrade in the rating of US treasury bonds that was one of the triggers of the crisis has resulted in these same assets increasing in value. The fall in the yield on US bonds since the beginning of July has been even greater than that on German government bonds.

Sharply lower government bond yields mean that, in terms of relative pricing between asset classes, real estate looks more attractive. The yield gap – the difference between the yield on property and the yield on government bonds – has widened considerably. In fact for the Eurozone, the yield gap has widened to the extent that it is now bigger than was the case in Spring 2009.

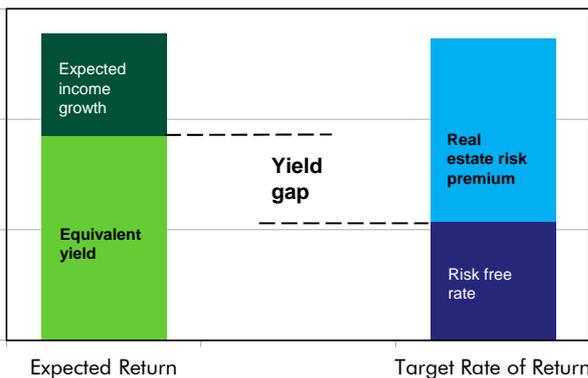
In retrospect, spring 2009 was clearly the bottom of the real estate market and the size of the yield gap was a clear buy signal, at least for real estate that had a secure, long-term income. Of course at that time property yields were also high in absolute terms and relative to their own long-term average levels, meaning that there were other buy signals for real estate at that time. Nonetheless, for the multi-asset investor, the recent expansion of the yield gap looks significant.

Yield gap*



On the face of it this seems to indicate that in relative terms real estate has become much more attractive over the last four or five months. However, before jumping to that conclusion it is worth considering how some other parts of the relationship between property yields and bond yields might have changed over that period.

The interrelationship between the two can be represented by the chart below:



Thus, a fall in the risk free rate (taken in this analysis to be represented by the 10-year government bond yield) results in a fall in the target rate of return from real estate, and **if the other parts of the equation remain constant**, should result in investors bidding up the price of property investments, reducing the equivalent yield and returning the yield gap to its former level.

However, in the current circumstances it is not the case and other parts of the equation have changed.

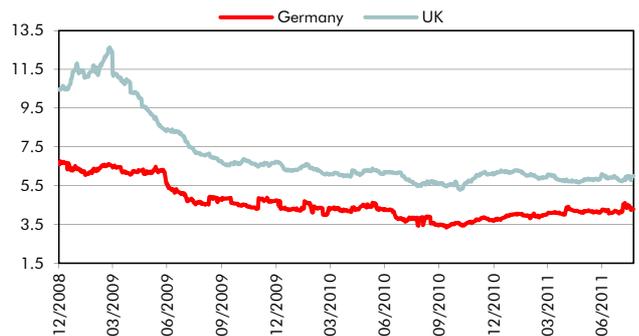
*For the purposes of this chart the yield gap is defined as the average prime office yield, minus the redemption yield on 10-year government bonds. The final data point is based on closing values on 9/9/2011. For the Eurozone, the average prime yield is taken from the CB Richard Ellis Index and represents a weighted average of the prime office yield in a selection of cities in the Eurozone. For the UK, the average prime yield is a weighted average of the prime office yield in a selection of major cities in the UK. In both cases these average prime yield series are quarterly and so in order to calculate the yield gap as at mid August the average prime yield as at the end of Q2 has been used. This is broadly in line with the trend, which has been very small quarterly declines so far in 2011.

The current financial turmoil, has to a great extent been precipitated by a realisation that economic growth in much of the developed world will not be as strong as had been expected. In fact there are many who believe that there is a strong possibility of another recession. As a result, for many property investments, expected income growth is now lower than was the case a few months ago.

There are also elements of the real estate risk premium that will have changed: For the same reasons as investors' income growth expectations are probably lower now than at the beginning of the year, they should also factor in a higher probability of tenant default.

This is illustrated by the fact that the yield on corporate bonds has not followed the same downward trend as government bonds over the last few weeks. The yield gap between government bonds and most corporate bonds has thus increased substantially over that time, although higher default risk is not the only factor explaining this higher premium.

Corporate bond yields



Source: Macrobond

LIQUIDITY RISK PREMIUM

Beyond lower expected income growth and higher default risk, probably the most significant factor explaining the increase in the yield gap between government bonds and real estate is the change in the liquidity risk premium.

In uncertain times capital tends to flow towards the more liquid assets. At times of extreme uncertainty the market's perception of what is a liquid asset becomes narrower and narrower, including the government bonds of only a relatively small number of countries.

With an illiquid asset class such as real estate, even in normal market conditions the liquidity risk premium is already significant and at times of financial crisis it can increase rapidly.

CONCLUSIONS

A simple conclusion from the increase in the yield gap would be that the relative attractiveness of real estate has increased as a result.

It would also appear, taking a slightly longer term look at how the yield gap has evolved, that this effect is more evident in the Eurozone than in the UK. Gains in capital value in the UK have gone some way to closing the record yield gap that had emerged by March 2009. In the Eurozone, despite some gains in capital value, the yield gap has increased.

However, to draw this conclusion is to ignore the fact that expectations for the future have changed since the start of July. Along with weaker economic growth expectations, have come lower expectations of rental growth and higher expectations of tenant default.

As a result the real estate that is most likely to benefit from the re-rating of government bonds is the most prime property – that which is least exposed to changes in market conditions as a result of long leases to the highest quality tenants, preferably with fixed uplifts or indexation. The flight to quality within the real estate sector that has been such a feature of the last few years is therefore likely to become even more pronounced.

The other factor that has changed is the liquidity risk premium. At the moment investors are prepared to pay a substantial price (in terms of a very low yield) for investing in the most liquid assets. At the close of the market on 8th September, the redemption yield on a ten-year German government bond was just 1.88%.

However, for long-term investors who are not sensitive to issues of short-term liquidity this does represent something of an opportunity in real estate. It would be a mistake for them to pay the currently very high price for liquidity that they do not need, in assets such as government bonds.

Such investors, where they invest in real estate, tend to be concentrated at the prime end of the property market. This has been very crowded over the last year and they have been finding it hard to source buying opportunities. If liquidity sensitive investors take a step back from the real estate market then long-term investors should probably use it as an opportunity to become more active rather than less.

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