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The impact of megatrends

and picking tomorrow's best cities

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Global megatrends are re-shaping the world economic order. From mass urbanisation, to the rise of the global middle classes, aging populations, technological trends and the shift of economic power from the West to the emerging world, all pose major implications for the built environment and the long run demand for real estate.

At Nuveen, we are considering megatrends in both defensive and offensive strategies for our clients. We carry out in-depth research in order to determine the best way to capture long-term, structural changes in both occupational demand and capital flows, to create sustainable real estate products relevant to occupiers and investors, whilst future-proofing our clients' interests.

By definition, these megatrends are multi-jurisdictional but the consequences could be quite local in nature. As such, our top-down analysis is focused on cities rather than countries. We believe that the impact of megatrends at a city level is fundamental to delivering performance to clients in an increasingly crowded global real estate market.

> "Real estate fundamentals are expected to remain solid in 2019, despite the market's late cycle, rising interest rates and structural change disrupting the industry, most notably the retail sector"

We use a proprietary research process to identify the top 2% of global cities. This methodical and balanced approach takes into account a wide range of characteristics: scale, transparency, stability and most importantly, structural megatrends, helping to future-proof a portfolio for long-term relevance and growth. Traditional structural measures of specific real estate risk must not be overlooked, so potential city targets must also score adequately against liquidity, transparency, and income security measures. This is why institutional investors often struggle to access opportunities in emerging world cities, where megatrends are producing dramatic impacts and leading to an explosion in new consumer markets. In developed world cities, where real estate risk is more palatable, the emphasis should be on cities which have the ability to attract talent, tourism and international tenants.

Overlaying and complementing our cities strategy is a clear tactical understanding of market fundamentals, which aims to deliver alpha to a portfolio at different points of the cycle. This involves a broader appreciation of sector dynamics across the whole city, as well as a deep dive into sub-market conditions to supplement our house view of the broader economic and capital market environment.

When constructing a portfolio, the benefits of diversification, whether location, sector or demand drivers, should also be at the forefront of any acquisition strategy. Common sense might suggest that we would bias our portfolios towards opportunities in Tier 1 cities. However, as investors, we also want to maximise the benefits of diversification in terms of location, sector and drivers of demand. The largest real estate markets - such as London and Paris - are typically closely-correlated, as they are driven by financial and business services. This means that they do not provide the normal benefits of geographical diversification. A balance of occupiers by industry type helps lower the volatility of growth and void risk; investments underpinned by financial and business services, for example, might be complemented with investments in resource or technology-led cities.

The focus on long term demographic, social and environmental trends does not mean the timing entry and exit points and asset management initiatives are not also critical factors in day-to-day portfolio management decisions: Although the universe of "winning" cities based on long run fundamentals might not change very much, short to medium term buy and/or sell priorities will inevitably evolve to reflect the cycle and enhance performance:

Our 2019 Outlook:

Real estate fundamentals are expected to remain solid in 2019, despite the market's late cycle, rising interest rates and structural change disrupting the industry, most notably the retail sector. Positive global growth forecasts and an overall balance of supply and demand continue to support net operating income and property values. Commercial real estate continues to attract new capital, with stable income returns generally exceeding those available in fixed income. However, little or no capital appreciation can be expected, and putting new capital to work will be challenging in 2019.

Structural change driven by demographics, technology and consumer trends are creating opportunities to add alpha. We expect global cities benefiting from advanced technology, sustainable development and rising urbanisation to outperform through the next market cycle. The upheavals impacting office and retail are generating demand for high-tech buildings with flexible office space and light industrial warehouses. We believe some of the best opportunities exist in alternative sectors, such as data centres, purpose-built student housing or manufactured housing.

Residential apartments globally are benefiting from strong demand among middle-income families and millennials priced out of home ownership. Global real estate debt's stable income returns and lower volatility offer risk protection for real estate equity portfolios.

US

The US economy and labour markets have been growing robustly in 2018 due to the tax cuts and fiscal stimulus passed at the end of 2017. With unemployment at its lowest rate for a decade, consumer confidence is at its highest level for 18 years. This provides a sound foundation entering 2019, with GDP growth forecast to be 2.6% for the year. Rising interest rates have not slowed real estate investment volumes, and with solid fundamentals in place - a healthy demand supply balance - we expect the yield cycle to last another year. However, we don't anticipate any yield compression in 2019 with returns being largely driven by income. We expect the structurally driven sectors of logistics and apartments - underpinned by ecommerce and demographics, respectively – to outperform. Office and retail, to a greater extent, are likely to fall further out of favour during the course of the year.

Europe

Political uncertainty and rising trade tensions are undermining exports and investment, and will temper near-term output. Jittery financial markets are illustrative of widespread political uncertainty, particularly in the UK and Italy.

Yield compression has come to an end in Europe and while we don't expect an imminent yield softening, there will be no additional support from capital markets. Real estate capital values may still rise further in 2019 due to the persistent rental cycle, albeit at a somewhat slower pace compared to 2018.

Logistics is set to be the best performing mainstream sector with healthy rental growth and even some further yield shift driving returns in 2019. However, it will be non-established sectors such as student housing or other sub-sectors in the living space, which are poised to perform best overall. These sectors are supported by new technology and demographics, as well as first mover advantages for investors which already have exposure to these segments.

Asia Pacific

Among the developed Asia Pacific economies, Australia and Japan are expected to be the stand-out performers in 2019. Positive demographic dividends and more diversified growth are expected to continue driving an uninterrupted economic expansion in Australia. Similarly, the positive pass-through from Abenomics will likely continue strengthening the investment and consumption outlook in Japan, on top of ongoing stimulus from very supportive monetary and financial conditions. On the other hand, the more open and financial services dependent economies such as Hong Kong and Singapore may face more uneven growth prospects from a less certain manufacturing and export outlook. Overall, expect slower but still resilient economic growth across Asia Pacific, by virtue of still relatively more accommodative monetary policy.

Over the short-term, we anticipate the under-rented, principal cities of Sydney, Brisbane and Tokyo to deliver the best risk-adjusted returns. Tokyo particularly will continue to benefit from the boost to domestic demand in the run up to the Olympics and associated infrastructure investment and, in turn, underscoring the already positive occupier outlook.

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