Research Alert

Investment horizon: 3-6 months, 28/03/2017

Real Estate

We favor global real estate equities

- Global real estate equities offer yield, rising earnings and should prove resilient to Fed tightening, in our view.
- High dividend yields and muted interest rate sensitivity make real estate equities look appealing against equities and bonds.
- Regionally, we prefer UK real estate equities while Japanese and Swiss real estate stocks are less appealing.

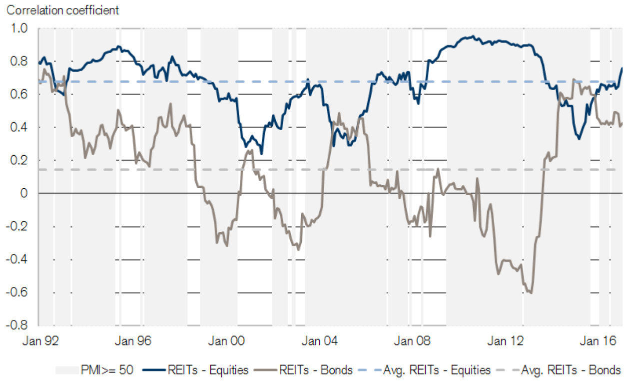
Jelena Kucenko
Global Real Estate Research

Sarah Leissner
Research Economist - Global Real Estate

Real estate should benefit from positive economic growth

In a growth environment, real estate tends to benefit from improving income streams due to rising rents and asset values. As a result, real estate companies' revenues and balance sheets improve. The positive growth development usually more than counterbalances the accompanying tightening in monetary policy. Indeed, when the economy is expanding, real estate equities' correlations with bonds falter as they start moving with the broader equity market, as shown in Figure 1. The current correlation with equities is at 76% and expected to increase further as real estate continues to benefit from its embedded cyclicality, similar to the broader equity market. By contrast, the current correlation of 40% with bonds is at an elevated level compared with c.15% historically. As economic momentum improves, we expect this correlation to fall towards its historical average, making real estate less sensitive to interest rate rises and better positioned to benefit from growth.

Figure 1: FTSE EPRA/NAREIT Global: Correlation with equities and government bonds prices



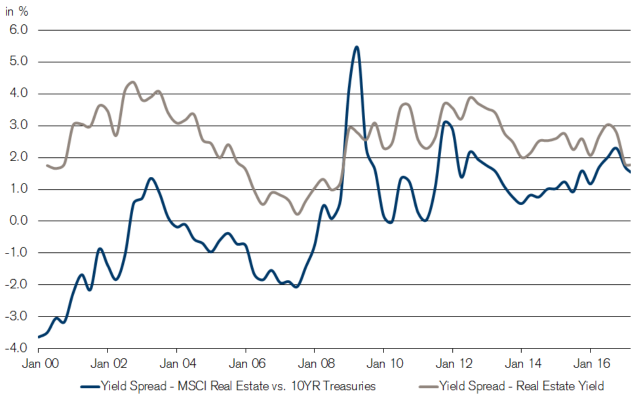
2-year rolling correlation.

Last data point: 28/02/2017. Source: Datastream, Credit Suisse / IDC

Currently, real estate equities are relatively immune to interest rate rises

In addition to the cyclicality, there are other reasons for real estate equities' resilience against a rise in interest rates. First, companies have deleveraged significantly post 2007, making their debt structure more solid. Second, although direct real estate yields have come down over the past decade, bond yields have compressed even more, making yields spreads between real estate and bonds more attractive. Third, the underlying market is still showing positive growth momentum which also tends to mute interest rate sensitivity. Moreover, as the March rate hike by the Fed was considered dovish and further interest rates in the USA are well communicated and therefore expected by the markets, this should help to reduce the sensitivity to increasing rates. Having said that, the main risk to our positive view is a much faster and steeper move in the yield curve as our analysis shows that moves larger than 50 bp tend to be followed by a correction in real estate equities.

Figure 2: Yield spreads (div. yield and initial yield vs. 10-year government bonds)

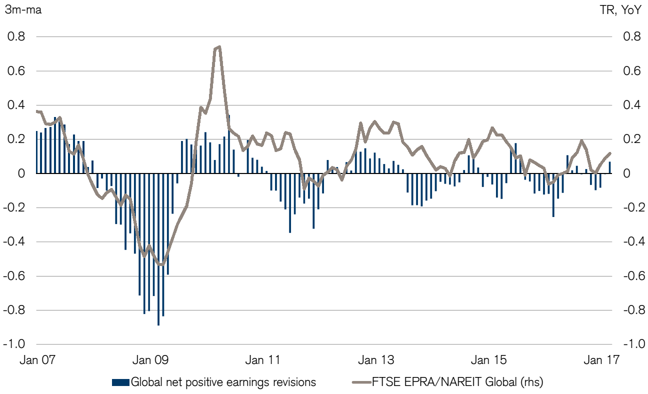


Last data point: 01/03/2017. Source: Bloomberg, Datastream, Credit Suisse

Real estate earnings growth expectations likely to improve

Global consensus earnings growth expectations for the next 12 months are in a negative territory, with analysts forecasting earnings to contract by 8%. This would be the worst outcome since the 2008 financial crisis. We deem this unlikely and overly pessimistic, considering that the leading economic indicators are at multi-year highs globally. Therefore, we expect further positive earnings revisions amid an improving economic growth environment. This should continue lifting real estate share prices higher. In fact, the correlation between real estate share prices and global earnings revisions have been over 70% since 2007, as shown in Figure 3.

Figure 3: FTSE EPRA/NAREIT Global: Net positive earnings revisions vs. performance



Last data point: 01/03/2017. Source: Datastream, Credit Suisse / IDC

Real estate looks attractive when compared with other asset classes

Unlike global equities, where forward dividend yields have been falling while bond yields have risen, listed real estate dividend yields have kept closer pace with bond yields over the past year, as shown in Figure 4. Against this backdrop, bonds look better valued, but are more vulnerable to interest rate rises given fixed income streams and the prospect of further interest rate increases. With the combination of higher dividend yields and lower interest rate sensitivity, muted by the large yield spreads and other aforementioned factors, we believe that real estate equities have the potential to perform well in the current environment.

Figure 4: Global real estate dividend yield vs. equities and bond yields

Last data point: 22/03/2017. Source: Bloomberg, Datastream, Credit Suisse / IDC

Regionally, we favor UK real estate equities; while Japanese and Swiss real estate stocks are less appealing

We move the UK to outperform as current steep discounts to NAVs appear to overestimate the downside risks in the underlying market given the resilience of the physical market, improved debt structure and the quality of the underlying real estate portfolios. We simultaneously move Japan to underperform as Japanese real estate equity prices have yet to reflect weakening market fundamentals and support from the Bank of Japan appears to already be priced in. In fact, J-REITs already have seen negative outflows last month, the first time since

June 2016. We keep a negative stance on Swiss real estate stocks as close to record levels premiums to NAVs do not reflect weakness seen in the physical market.

(28/03/2017)

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Absolute stock rating allocation as of (28/03/2017)

Rating	Overall	Investment banking interests only	Allocation over 12 months*
BUY	43.51 %	68.66 %	868
HOLD	40.31 %	66.29 %	805
SELL	14.24 %	55.09 %	285
RESTRICTED	1.95 %	92.31 %	26

*This includes recommendations of issuers where investment firm services have been provided.

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SELL	10% or more decrease in absolute share price
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HOLD	Expectation that the bond issue will perform in line with the specified benchmark
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Authors

Jelena Kucenko
Global Real Estate Research
+41 44 334 32 89
jelena.kucenko@credit-suisse.com

Sarah Leissner
Research Economist - Global Real Estate
+41 44 333 05 28
sarah.leissner@credit-suisse.com