



2020

THE ROAD AHEAD

BARINGS



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Europe's Time to Shine?



Dr. Christopher Smart
Chief Global Strategist &
Head of the Barings
Investment Institute

MACROECONOMIC & GEOPOLITICAL

If Brexit headwinds begin to clear, and the German economy sees improvement, it would support the European economy as a whole. At the same time, any weakness in the U.S. dollar could further propel international markets, potentially reversing a decade of underperformance.

Biggest Risk

From a macro perspective, there are two types of risk we're watching closely. One is a series of cyclical risks driven by the fact that we're late in the cycle. Specifically, there are questions around how long the strength of the U.S. consumer can persist, and the extent to which that will continue to drive global growth. With these concerns, there appear to be rising doubts over fixed-asset investments. In general, that portion of the economy has been lagging for a couple of years, mainly due to uncertainty around global trade and the broader outlook. When there is uncertainty over how or when the global supply chain will be impacted by tariffs, business investment tends to decline. So we think one of the biggest risks going into 2020 is that business investment doesn't recover.

The other risk is a secular trend that's building around climate risks and climate policy. Regardless of where you stand on the science of climate, these factors appear to be moving toward the center of investors' concerns. Rules are changing, laws are changing, regulations are changing; in some parts of the world, the cost of carbon is changing. And the technology around energy, energy production and energy transformation is also changing. Whether or not these concerns become front-and-center next year is uncertain, but they are undoubtedly advancing quickly.

Biggest Opportunity

Many of the biggest opportunities we see heading into 2020 revolve around technology. We appear to be on the cusp of some very disruptive changes from the **Internet of Things**. Specifically, we're seeing a convergence of forces around **cloud technology**, cloud storage, inexpensive sensor technology, mobile networks and data analysis. Advancements in these areas have allowed us to monitor and manage the physical world in ways we never imagined, even 20 years ago. From less downtime for airplanes to more productivity for oil rigs, these growing capabilities have created opportunities for businesses across the economy. And on the flip side, businesses that are not seriously considering how to take advantage of these technologies are likely to be disrupted by competitors who can.

Bold Prediction

This may not be particularly bold, but one mildly courageous prediction is that 2020 turns out better than current sentiment suggests. There is a good deal of uncertainty in the market right now, particularly around the political and economic outlook. But in our view, it's entirely plausible that we see a year in which inflation remains under control, driving central banks down a more accommodative path and providing support to company earnings. It's also possible that we continue to see decent economic growth, and that the political headwinds we're bracing for end up being less severe than expected.

A slightly bolder prediction would be that Europe and emerging markets outperform the U.S. after a long period of underperformance. If some of the headwinds around Brexit begin to clear, which seems to be the direction we're headed, it would be supportive of the economy as a whole. The German economy—the biggest in Europe—could also see improvement, particularly if the government provides even a little fiscal support. Finally, any weakness in the U.S. dollar would have the potential to further propel international markets.

Are International and Emerging Equities Set to Outperform?
Global Equity Markets Indexed Price Return



SOURCE: Bloomberg. As of November 25, 2019.

Fear of Fallen Angels May Be Overblown



David Mihalick
Head of U.S. Public
Fixed Income & Head
of U.S. High Yield

FIXED INCOME

Many headlines over the last year have called attention to the growth of the lower-rated BBB portion of the investment grade market—and predicted a wave of fallen angels to high yield. But in that time frame, we have seen more HY companies upgraded to IG than the other way around.

Biggest Risk

One of the biggest potential risks facing fixed income markets is that current valuations are not reflecting the potential for an economic slowdown. As we wrote in a [recent blog post](#), a near-term recession is not our base case scenario. Nonetheless, there are a number of macro risks on the horizon—from trade wars to Brexit to political rhetoric that could impact global growth. It is plausible that these risks could affect the real economy in a more substantial way than what we are forecasting based on what we’re currently seeing from individual issuers. With spreads at fairly tight levels today, particularly in the higher-quality part of the high yield market, any change in growth expectations could lead to spread widening.

While this is certainly a potential risk, it is not what we view as the most likely scenario, for a few reasons. From a fundamental perspective, we believe corporate earnings and balance sheets look relatively healthy, and we generally see a strong consumer in the U.S. driving steady economic growth. Defaults remain low by historical standards, and while we might see an uptick in more challenged sectors such as energy, retail and health care, we don’t expect to see a widespread increase. We are also fairly optimistic that some of today’s more pressing macro issues will reach a reasonable conclusion.

Biggest Opportunity

In the high yield market, one of the most interesting opportunities we see is being driven by the bifurcation in the market—which we discuss in our recent podcast, [High Yield: Rates, Recession and Relative Value](#). Over the last year, the higher-rated BB part of the market has outperformed lower-rated B and CCC credits. As a result, spreads on BB credits today are somewhat compressed, whereas spreads in the lower part of the market have stayed relatively wide. Looking at the market today, we think there are select opportunities in B and CCC credits—but it’s not a case of just buying the market. In order to find the hidden gems in the lower-rated part of the market, it’s critical to do the due diligence and gain a thorough understanding of a company, and how it’s going to perform going forward. With the right amount of research, this is where the opportunities will continue to materialize over the next year, in our view.

In fixed income more broadly, we are increasingly seeing opportunities outside of traditional corporate and government bonds—in areas like collateralized loan obligations (CLOs), distressed debt and certain parts of the [asset-backed securities \(ABS\) market](#). In addition to diversifying risk exposure and lowering the correlation of the asset classes in the portfolio, allocations to these areas can offer an opportunity to earn incremental yield relative to traditional corporate credit.

Bold Prediction

There have been numerous headlines over the last year calling attention to the growth of the lower-rated BBB portion of the investment grade market—and predicting a wave of fallen angels, or credits that fall from the lowest IG rating to a high high-yield rating. It’s important to remember that credit ratings are not always painting a complete picture of a corporate issuer’s financial health, but can be more indicative of what corporate treasurers have been incentivized to do. In recent years, continued low rates and very little penalty associated with falling from A to BBB have incentivized companies to add more leverage. But in many cases, these are high-quality companies that have the ability to make adjustments to their balance sheets and deleverage as needed. In this context, one bold prediction is that despite the headlines, we will not see a wave of fallen angel credits disrupting the high yield markets in 2020. In fact, in the last year, we have seen many more high yield companies upgraded to investment grade than the other way around.

Despite Headwinds, Upgrades Have Outpaced Downgrades in the U.S.

U.S. Rising Star/Falling Angel Volume



SOURCE: Credit Suisse. As of September 30, 2019.

2020: An Inflection Point for EM Currencies?



Dr. Ricardo Adrogué
Head of Global Sovereign Debt and Currencies

SOVEREIGN DEBT & CURRENCIES

With the financial crisis more than a decade behind us, the global financial system seems poised to begin releveraging. This process, which would likely take years to play out, would provide a source of funding for EM currencies, and represent a significant tailwind.

Biggest Risk

The biggest risk in 2020—meaning the one with the potential to have the largest negative impact on emerging markets (EM) and the broader global economy—would be a recession in China. While this is not our base case scenario, it is the risk that keeps us awake at night, simply because of all of the negative knock-on effects that could ripple through the global economy. In recent years, the Chinese government has taken strides to reduce leverage, which had been increasing steadily since the 2007/2008 global financial crisis. As we saw in the U.S. a decade ago, the process of deleveraging an economy is complex, as it can ultimately lead to a shortage of capital or credit—and a lack of liquidity—in financial markets. Ultimately, this can make it more difficult for issuers to meet their financial obligations, increasing the likelihood of defaults. If defaults in China were to become material and widespread, we would expect there to be fairly serious consequences for the global financial system.

While the ongoing trade tension between the U.S. and China does create some additional pressure, we don't consider it to be a major, or unmanageable, threat to emerging markets. This is largely because China has been able to reallocate resources quite effectively in the past, and we have confidence that the country will continue to do so going forward. As we mentioned in a [recent Q&A](#), the Chinese government has also managed the trade restrictions from the U.S. very successfully over the past year, and in our view is willing to tolerate the negative consequences of the trade tensions through 2020. The greater concern is a longer-term misstep in policy, particularly in the effort to deleverage the economy.

Biggest Opportunity

EM currencies represent the most compelling opportunity in 2020, and could drive strength in EM local debt and EM equities in the year ahead. The global economy has gone through a massive deleveraging exercise in the 11 years since the Global Financial Crisis (GFC). This has manifested itself in portfolio and banking flows moving out of riskier assets—emerging markets chief among them. Now, with the GFC more than a decade in the rear-view mirror, the global financial system seems

poised to begin releveraging. This process, which would likely take years to play out, would provide a source of funding for EM currencies, and represent a significant tailwind.

It's important to highlight that most emerging markets, because they've faced outflows due to restrictions on their external accounts, have been running smaller and smaller current account deficits in aggregate—with some EMs now running current account surpluses. That means that the financial needs of EMs have continued to come down—or in other words, their balance sheets are in better shape. We believe that in 2020, this decade-old risk aversion may begin to turn, providing support for EM currencies to outperform, potentially driving strength in asset classes like EM local debt and EM equities.

Are EM Currencies Poised to Outperform?
Real Effective Exchange Rate/Terms of Trade



SOURCES: Haver Analytics; Barings. As of October 2019.

Bold Prediction

A bold prediction for 2020 is that the opportunity we've identified above—that EM currencies look cheap and that structural forces are in motion to potentially reverse their underperformance—actually begins to play out. In fairness, we cannot point to one clear catalyst in 2020 that will drive this reversal, but in surveying the global landscape for value, EM currencies stand out as a clear opportunity.

A Bright Spot in Higher-Yielding EM Corporate Debt



Omotunde Lawal
Head of Emerging Markets Corporate Debt

EM CORPORATE DEBT

Many EM regions have been engulfed in uncertainty for weeks or months. While these situations certainly represent risks, we also continue to find value—often in globally diversified companies that have been unfairly punished by markets because of where they’re domiciled.

Biggest Risk

There has been no shortage of risks facing emerging markets (EM) over the last couple of years. 2018, in particular, was challenging, as we saw escalating trade tensions between the U.S. and China, higher oil prices, U.S. Federal Reserve rate hikes and U.S. sanctions against Russia—not to mention the presidential elections in Brazil and Mexico and political crises in Turkey and Argentina. Over the last year, many of these headwinds have dissipated, and some have actually turned into tailwinds—most notably the Fed pivoting to a more dovish policy.

As we think about 2020 in this context, the biggest risk revolves around the potential U.S.-China trade deal and, related to that, the possible knock-on effects of a divisive U.S. election year. With respect to the trajectory of the trade deal—at the peak of the tensions, the U.S. proposed about \$120 billion in tariffs. When the dust settled, that number was down to about \$67 billion, and the U.S. announced additional product exclusions worth about \$7.5 billion. In aggregate, the U.S. essentially peeled back the tariffs to roughly 50% of what was threatened in late

August 2019. Heading into the U.S. election, we may see a managed trade truce with China, whereby President Trump wants to focus more on growth and positivity. But depending on how it plays out, it could also have the opposite effect and cause renewed volatility in the markets.

Aside from that, we are also keeping an eye on the unintended consequences that could arise from global discontent. Several EM regions—Hong Kong, Ecuador, Bolivia, Chile, Peru, Indonesia and Lebanon—have been engulfed in waves of civil protests for weeks or months. These situations certainly represent risks for investors but we have also continued to find value opportunities in EM corporate issuers—often globally diversified companies—that have been unfairly punished by markets because of the country in which they’re domiciled.

Biggest Opportunity

Given the material amount of negative-yielding assets in developed markets, asset classes that offer decent positive yields, such as high yield and EM debt, will likely continue to look attractive over the next year, in our view. Looking at EM corporates, for example—corporate fundamentals have been stable, with many companies exhibiting attractive growth in revenues and EBITDA over the last few years. Balance sheets appear healthy, and defaults have remained low. When factoring in the 2018 headwinds—some of which turned into tailwinds in 2019 and look likely to remain supportive in 2020—coupled with expected supportive growth for emerging markets¹—we think EM corporates will remain attractive.

Within the broader universe of EM corporates, we see a particular opportunity in short duration high yield debt. Given the various idiosyncratic risk flare-ups in several high yield countries over the last few years, spreads have widened relative to investment grade-rated EM corporates. While this has normalized somewhat in recent months, the spread differential is still wide relative to history, suggesting there is still value in high yield-rated EM corporates.

Bold Prediction

While it’s difficult to make sweeping predictions, one prediction over the coming months is that we see stability in U.S. rates and global growth—particularly if the U.S. and China reach a managed truce over trade. In this type of environment, we would expect to see strong performance from the shorter-dated, higher-yielding portion of EM corporate debt.

Short-Duration, High Yield Corporates Look Attractive
EM High Yield vs. EM IG Spread Differential



SOURCE: J.P. Morgan. As of November 2019.

1. IMF expectations are for Emerging Markets to grow roughly 4.5% in 2020. This compares to expectations for low single digit growth for developed market economies.

How Crucial is a Weaker Dollar in Supporting an EM Rally?



Khiem Do
Head of Greater China Investments,
Global Markets

ASIAN MARKETS

As concerns of a near-term recession seem to have dissipated, we think—in what may be somewhat of a contrarian call—riskier assets look well-positioned to potentially outperform in the year ahead.

Biggest Risk

Heading into 2020, one risk facing the Asian region is an escalation of the trade and technology tensions between the U.S. and China. While higher U.S. tariffs and technology sanctions would undoubtedly have a direct impact on Chinese exports, an even greater negative effect could arguably be that on Chinese corporates. If corporates were to further slow—or halt their capital expenditures altogether—it would pose a serious obstacle to the growth of the manufacturing and construction sectors. In an extreme case, it could even push China into a recession—this is not a base case but also not outside of the realm of possibility.

Tensions between the U.S. and China will likely ebb and flow over the course of multiple years, and are unlikely to be resolved in the next year. However, given the importance of the U.S. presidential election in 2020—and the fact that both President Trump and President Xi are facing other political and economic pressures domestically—the two administrations have expressed a willingness to reach a solution. To that end, we believe the likelihood of these risks coming to fruition in 2020 is relatively low. And if our assumption holds true, it would be quite constructive for the Asian region’s corporate earnings and economic outlook, as well as its currencies and equity markets.

Biggest Opportunity

As we look ahead to the next year, we think there will be attractive opportunities in emerging markets local debt as well as emerging equities. There are three key reasons for this. First, we believe that the U.S. dollar may weaken in 2020 as the differential between U.S. and emerging market economic growth and interest rates continues to narrow in favor of emerging markets. The Fed’s dovish policy and a potential reversal in the trend of investors “hiding” in safe haven currencies could accentuate U.S. dollar weakness.

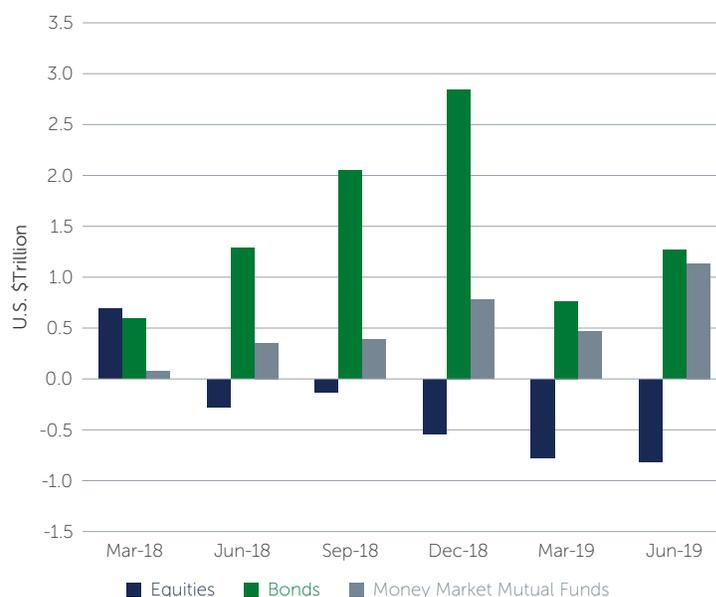
Second, we believe there is a possibility we will see a recovery in the economic growth of some Asian countries in the coming six to 12 months—thanks to the implementation of an easier monetary policy, as well as greater government spending in China, India, Korea and some ASEAN nations. The third reason is that valuations of Asian and EM financial assets appear relatively inexpensive, as they’ve been

significantly devalued as a result of the many macro uncertainties at play. If some of these headwinds start to clear, we think the valuations of emerging market assets could be partially restored, which could lead to better overall returns.

Bold Prediction

One bold prediction for 2020 is that we could see a bear market in government bonds and other defensive assets, and a bull market in growth assets like equities, high yield bonds and cyclical stocks. Concerns over a coming recession have been at the forefront over the last year, with the U.S. economy moving through the late stages of an elongated credit cycle and the inversion of the yield curve in mid-2019. More recently, however, some of these trends have reversed or moderated. As a result, concerns of a near-term recession seem to have dissipated. In this type of environment, while possibly somewhat of a contrarian call, we think riskier assets look well-positioned to potentially outperform in the year ahead.

Is the Risk-Off Trade Set to Reverse?
U.S. Financial Account Year-To-Date Transactions by Asset



SOURCES: Federal Reserve Board; Haver. As of June 30, 2019.

Comeback Time for International Equities?



David Bertocchi
Head, International & World Equity Group

EQUITIES

Because the U.S. equity market is broad and deep, there will almost always be opportunities—but in aggregate, we think international equity markets may be more compelling over the next year.

Biggest Risk

In our view, the biggest risk to investment markets in 2020 is stagflation—a combination of low economic growth and rising inflation. This business cycle has been characterized by low growth, but also—fortunately—low inflation and, therefore, low interest rates. This has been very supportive for growth stocks, as companies that have been able to grow their earnings during this period of scarce economic growth have benefited, not only from their higher earnings but also from higher valuations.

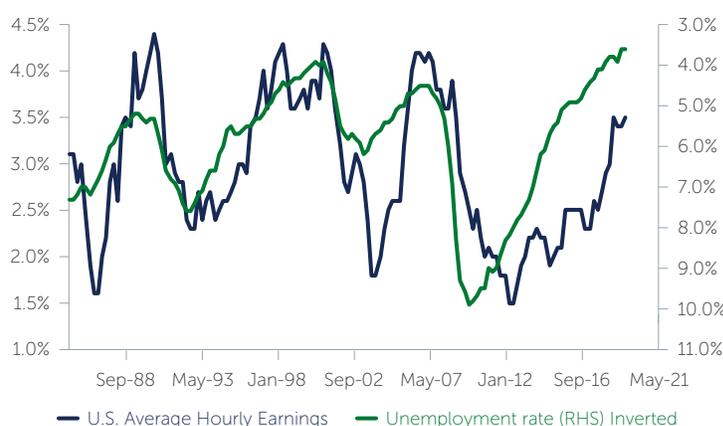
Potentially adding inflation into this mix changes the overall investment dynamic. Higher inflation would likely mean higher global interest rates, presenting a challenge to some parts of the equity market. In this scenario, companies that are not credit dependent, that have growth in their end markets, and that have pricing power, will likely fare relatively well. In other words, it is important to find those companies that have strong balance sheets, the ability to fund growth from internally generated cash, and customers whose purchase decisions do not require borrowing large sums of money.

What type of companies may do well in this environment? If we see greater wage inflation, it would likely support companies selling consumer staples or luxury goods—leisure providers and restaurants would also likely do well. If we see commodity price inflation, we would expect resource companies, as well as the industrial companies that provide capital equipment to them, to hold up very well.

Biggest Opportunity

We believe international equities—especially in emerging markets, the U.K. and Japan—present a particularly compelling opportunity. U.S. equities have had a fantastic run over the past 10 years, supported by healthy economic growth, strong earnings growth, a rising corporate profit share of GDP and falling corporate taxes. However, a number of the tailwinds seem likely to dissipate. For instance, it will be difficult to further reduce U.S. corporate taxes beyond the tax cuts implemented by President Trump in 2017, and the corporate profit share of GDP is unlikely to rise further without becoming an even bigger political issue than it is already. Because the U.S. equity market is broad and deep, there will almost always be opportunities—but in aggregate, we think international equity markets may be more compelling over the next year.

Will 2020 Bring the Re-emergence of Wage Inflation in the U.S.? U.S. Unemployment and Hourly Earnings



SOURCES: S&P 500, MSCI. As of September 30, 2019.

Bold Prediction

One prediction is that 2020 brings with it the re-emergence of wage inflation in the U.S. The current economic cycle is the longest in history, and U.S. unemployment stands at 3.6% today. Based on past cycles, U.S. hourly earnings should be rising around 4.5% per annum—but they are currently only rising by about 3.5%. The acceleration that we’ve seen in recent quarters, however, suggests more wage inflation is on the horizon.

There are two potential catalysts for this. The first is the global trade decline that we’ve seen in recent years. The prior period of global trade growth allowed cheaper labor markets to access the lucrative U.S. market via exports. The U.S. benefited from importing cheap goods, but in return saw an erosion of pricing power for its workers. We think declining global trade could cause some of that pricing power to return. The second catalyst is politics. Wages, income distribution and other forms of inequality look likely to become key issues for the 2020 election—and regardless of the election outcome, we believe there will be a continued political undertaking to help U.S. workers, which should lead to a wage inflation rise.

While rising wages would certainly present challenges in the equity market, companies with pricing power, strong labor relations and high employee satisfaction will likely be better positioned to withstand any resulting pressure.

Amid Rising ‘Mequity’ Risk, Boring Can Be Beautiful



Ian Fowler
Co-Head,
Global Private Finance

PRIVATE CREDIT

In both the U.S. and Europe, there is significant pressure both at the top and bottom ends of the middle market. As a result, we’re seeing potentially attractive value today in the more traditional, true middle market.

Biggest Risk

Market participants have been trying to call the end of this credit cycle for years. And while the end still might not be imminent, late-cycle behavior has become apparent in parts of the private credit market. Specifically, as more managers have raised larger and larger funds, there is more capital chasing deals in the space—especially for the very largest transactions in the upper middle market. Additionally, as the popularity of unitranche—essentially a hybrid between senior and mezzanine debt—has increased and leverage has continued to rise, some market dynamics have become distorted. Most notably, the spread paid to investors for taking increased risk has tightened relative to historical levels.

As a result of this, we have witnessed some instances in which deep first-lien debt has a much higher risk profile than is typical of traditional senior debt. In fact, in many cases, these highly leveraged first-lien deals—often marketed as senior debt—represent something more akin to “mequity” risk—or mezzanine/equity risk—given the deep leverage and often high level of execution risk in converting adjustments to cash.

Ultimately, we do not believe that credit spreads in many of these transactions are providing adequate compensation for the junior capital type of risks that are inherent in these structures.

Biggest Opportunity

There is an interesting dynamic playing out in private credit today, both in the U.S. and in Europe. Essentially, there is significant pressure both at the top and bottom ends of the middle market. As a result, and as we discussed in detail in a [recent podcast](#), we see the most attractive value today in the more traditional, true middle market—in essence, boring is beautiful. Within this space, we see particular value in traditional first lien senior structures that are backed by junior capital, where the potential return relative to the amount of leverage looks more attractive, in our view, relative to more highly leveraged deals.

In Europe, we see a potentially attractive opportunity in first lien debt with no junior capital behind it. This type of debt, on average, tends to exhibit lower leverage relative to the U.S. market, with attractive yield per turn of leverage—a critical component of evaluating true risk-adjusted return.

“Highly leveraged first-lien deals—often marketed as senior debt—represent something more akin to ‘mequity’ risk—or mezzanine/equity risk—given the deep leverage and often high level of execution risk in converting adjustments to cash.”

Bold Prediction

The strong fundraising environment in recent years has encouraged managers to move up in the market and raise bigger funds. Because these managers still need to deploy capital over a specific period of time, typically two or three years, it can be more efficient to ramp these vehicles with larger investments in upper middle market companies than to try and find enough smaller, more traditional middle market investment opportunities. You could argue that makes some sense in terms of efficiency, but in our view, it has introduced significant style drift.

In fact, the willingness to invest in these larger deals has actually blurred the lines with the broadly syndicated loan market—resulting in private market transactions with loose covenants and weaker structural protections. While this isn’t necessarily a bad thing in the more liquid broadly syndicated market, it is more troubling in the private lending space, where the ability to sell out of a deal is, at best, very limited. In the context of today’s late-cycle environment, one bold prediction going into 2020 is that this type of strategy—even if it looks somewhat attractive in the short-term—will not prove beneficial longer-term, particularly if the economy takes a turn for the worse and we start to see an increase in defaults.

The Continued Democratization of Private Equity



Elizabeth Weindruch
 Managing Director,
 Barings Alternative
 Investments

PRIVATE EQUITY

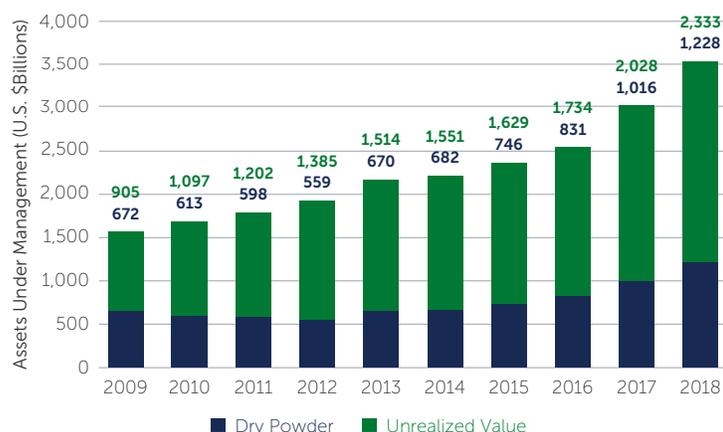
Private equity is an asset class that has traditionally been available only to very large, sophisticated institutional investors. But this is changing rapidly—a trend we expect to accelerate in 2020.

Biggest Risk

There are a number of late-cycle risks in the private markets today, many of which result from a combination of high purchase price multiples, high leverage and increased competition at the larger end of the market. The sheer amount of dry powder in the market is exacerbating the problem and driving concern among investors. As a result, we're seeing compressed deal timelines, accelerated due diligence periods and adjustments to business earnings—all of which create a climate of stretched valuations, or deals that have essentially been priced to perfection. Despite being somewhat typical late-cycle behavior, this is a risky trend as we think about the ability of businesses to withstand a downturn from both a performance and leverage perspective.

Private Equity Dry Powder has Grown Substantially Over the Last Decade

PE: Assets Under Management (2009–2018)



SOURCES: Preqin. As of December 2018.

Biggest Opportunity

Despite the risks, there are a number of bright spots. Looking across the private equity markets, we are seeing three particularly compelling pockets of opportunity. The first is at the lower end of the private equity market, particularly with emerging managers. As we mention in our podcast episode, [Private Equity: Emerging, Women & Diverse Managers](#), these are often first-time private equity funds that have spun out from larger institutions. Often, these funds have proven track records and, importantly, exhibit a strong hunger and desire to succeed—that tends to be strongly aligned with their investors. Another interesting opportunity we're seeing today is in [private equity co-investments](#), which can provide access to highly coveted deal flow.

Within the real assets space, the metals and mining sector offers an interesting opportunity, in our view. Given where commodity prices are today and where they've been in recent years, we think there is attractive value in what we refer to as later-stage development deals. In particular, we are seeing potentially attractive gold, copper and other high-quality base metal projects that have been under-capitalized for an extended period of time.

Bold Prediction

We think 2020 will bring with it the continued democratization of private equity. Private equity is an asset class that has traditionally been available only to very large, sophisticated institutional investors. But in the past 10 years, private market investment opportunities, including private equity, have become increasingly available, whether through 40 Act funds for retail investors or interval funds for everyday investors. One big contributor to this has been the strong historical performance of the asset class. And to the extent that it continues to outperform, we will likely see a continued push to make it available to everyone.

To be clear, this doesn't necessarily mean we will start to see private equity investments within our 401(k)s. But we will likely see interesting and innovative structures that provide broader access to the asset class. While we are cognizant of the risks that come along with that—such as liquidity, valuations and the complexity of the market—we think the space is a good diversifier overall, and may make big strides in 2020 among a less traditional investor base.

U.S. Real Estate: More Reward in Core?



John Ockerbloom

Head of U.S.

Real Estate Equity

REAL ESTATE

As investors in the market continue to chase yield, the risk premium—or the reward for taking that risk—appears to be diminishing. In this environment, we’re seeing some of the best opportunities in the highest-quality assets.

Biggest Risk

In our view, one of the biggest risks for U.S. real estate markets is the cumulative effect of the election cycle, almost irrespective of the outcome. Elections, by nature, generate uncertainty, and uncertainty often results in inaction when it comes to real estate—transaction volumes slow, and investors’ willingness to take risk diminishes. That’s expected, and can even be healthy if it’s temporary. The bigger concern in our view is whether, once the election is over, market participants will be willing to wade back into the high water of where we stand today, where everything is priced to perfection, credit is inexpensive and growth seems, if not automatic, then highly likely.

The risk is that the election has a sobering effect on markets—like bright lights going on in a crowded bar right before closing time—and that decisions that seemed perfectly reasonable just moments before no longer seem like such a good idea. If the market experiences a post-election surge in risk-off sentiment, will today’s elevated valuation levels still look attractive, or will there be a prolonged period of reflection? Just like the end of a long night, reflection periods in the real estate market tend to bring about sounder reasoning, and perhaps a more risk-averse orientation, that could have a slowing effect on the market.

Biggest Opportunity

Looking across the real estate markets, we see some of the best opportunities in the highest-quality assets—certainly on a relative basis, but also, in some cases, on an absolute basis. For us that means core real estate assets that are well occupied, stable and best-in-class. As investors in the market continue to chase yield, the risk premium—or the reward for taking that risk—is diminishing. In other words, it’s

not clear that investors are being adequately compensated for the risk they’re taking in pursuing the extra yield. While it appears that all-in returns have declined to some extent across the board, yields on the very best assets have come down to a lesser degree, based on our observations, and still look fairly attractive on a relative basis.

In our experience, the best assets in the market are determined by their competitive advantages, such as their location and amenities. For an industrial asset like a warehouse, that could mean proximity to major interchanges or distribution channels. For a multifamily asset, it could mean walkability, or the quality of its city score—where the city is in terms of its population growth and household formation, for instance. As we look at the markets today, we think these assets are providing the most attractive value.

“While it appears that all-in returns have declined to some extent across the board, yields on the very best assets have come down to a lesser degree, based on our observations, and still look fairly attractive on a relative basis.”

Bold Prediction

One prediction for the next three to five years is that core real estate assets could outperform value-add and opportunistic assets on an absolute and relative basis. In other words, the higher-risk/higher-reward assets that seem on track to produce outsized returns, do not. This isn’t necessarily our base case scenario, but given the spread compression in the market today, coupled with the return expectations for value add versus core assets, we think it’s within the realm of possibility.

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