Japan - August 2022

SPOTLIGHT

Savills Research

2022 Investment Strategy

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Investment in a rising interest rate environment

Summary

- The CPI has only seen a moderate increment because wage growth remains stagnant.
- The Bank of Japan (BOJ) has decided to maintain its loose monetary policies as inflation in the country has been moderate, and thus has little reason to increase interest rates.
- Other major economies have seen interest rate hikes in contrast, which has led to the weakening of the yen, and the rising costs stemming from this has become a political issue for Japan.
- Subsequent actions of other central banks will likely have a large impact on the Japanese economy through exchange rate movements.
- The government is considering recommencing nuclear power plants and has plans to welcome inbound tourists, especially high-end tourists. These measures should lead to a more stable trade balance and strengthen the yen.
- The BOJ will likely revise its monetary policy by next spring at the latest when a new governor is appointed.
- We predict a mild interest rate increment of 20-30 basis points (bps), and up to 50bps from the current 25 bps. The adjustment should be milder for the 5-year swap rate.
- An increase in interest rates will likely disproportionately affect sectors that have seen sharp pricing and compressed cap rates, like logistics and residential.
- On the other hand, retail and hotel assets might become more appealing as they are expected to continue recovering.

INTRODUCTION

Japan has traditionally been regarded as a stable destination for real estate investments due to its sound fundamentals and its social and economic stability. This view has not wavered since the onset of the pandemic, especially after the country demonstrated stable performance in multiple real estate sectors. Indeed, during the pandemic, Japanese real estate garnered significant levels on interest from international investors, especially in the logistics and residential sectors, which has caused cap rates to compress further. Japan's attractive funding options have similarly helped the country to remain popular and competitive amongst peers in Asia as a destination for foreign capital.

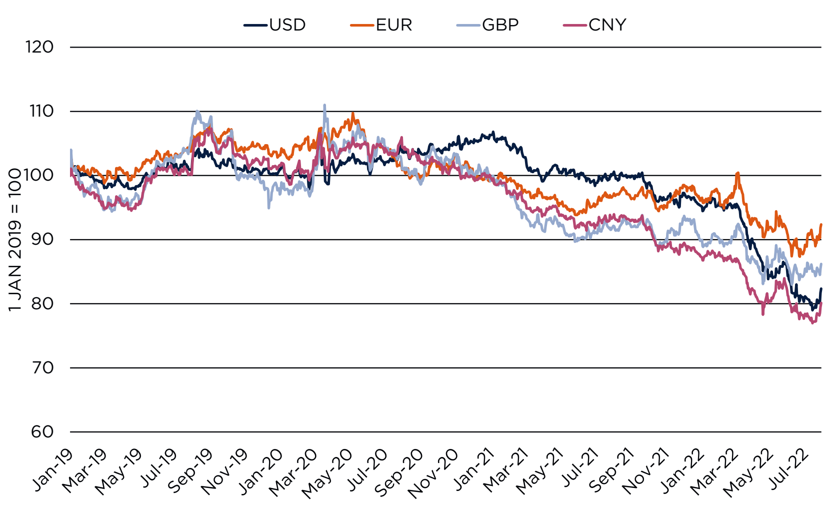
However, a myriad of factors have shaped the world economy in 2022. The crisis in Ukraine has resulted in a steep increase in commodity and energy prices, causing inflation to rise rapidly worldwide. In response, central banks across the globe have increased interest rates to curb inflation. In contrast, the Bank of Japan (BOJ) has had little reason to increase interest rates because inflation in Japan has been moderate and has therefore decided to maintain its loose monetary policy. The stark difference in interest rates and monetary policies has resulted in the weakening of the Japanese yen, which has put additional inflationary pressure on the Japanese economy. The weakened yen, which dramatically increased the prices of energy and food, is a problem for average households with stagnant wage growth. Indeed, the rise in prices was a hot topic in the recent national election. Hence, the BOJ may need to revise strategies in light of the changing market environment. This report will discuss the current situation and the prospects of the real estate market.

INFLATIONARY PRESSURES IN JAPAN

Japan's June CPI excluding fresh food has risen by 2.2% year-on-year (YoY) – moderate enough that the BOJ has decided not to take action. However, prices of some fresh foods have increased by more than 10%, which has had a severe negative impact on households and consequentially became a political issue given the stagnant wage growth in Japan. It is important to note that the inflation experienced in Japan was predominantly the result of rising costs rather than demand-driven inflation. Indeed, the growth of real wages in Japan has remained weak over the past three decades, which curbs demand in the event of rising prices.

One root of this inflation was the sharp increase in energy prices. After the 2011 Tohoku earthquake and tsunami, Japan shut down almost all of its nuclear power plants which previously provided almost a third of the country's electricity. This change in energy policy has greatly increased its dependence on fossil fuels for energy. The

GRAPH 1: Value of Japanese Yen versus Other Currencies, 2019 to July 2022



Source Bank of Japan, Respective Central Banks, Savills Research & Consultancy crisis in Ukraine in early 2022 has led to soaring prices of natural gas and crude oil, consequently resulting in the high energy prices that have persisted since.

In addition, the yen weakening rapidly to historically low levels may impede the government's ability to act as the weak yen has significantly worsened the situation through elevated import prices. In fact, Japan posted its largest half-year trade deficit of JPY7.9 trillion in the first half of 2022, underscoring the gravity of the situation. Given the adverse effects this has had on daily consumers, households expect the government to provide measures to stabilise the exchange rate and counteract rising prices, undoubtedly applying some pressure on the BOJ.

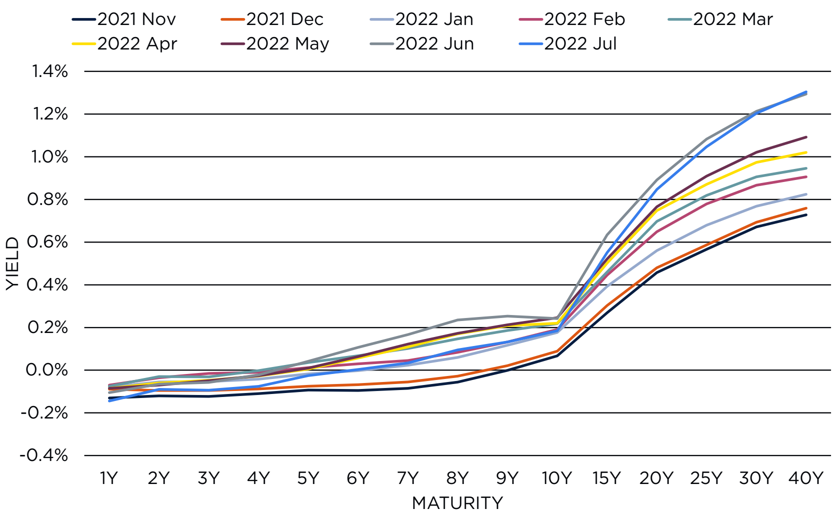
Prime Minister Fumio Kishida's government won the councillor's election in summer 2022, giving his administration a few years of breathing room until the next election to tackle the problem. Items that appear to be on the agenda include the recommissioning of nuclear power stations in order to deflate current high energy costs. Another could be the expedited opening of borders to inbound tourism. In particular, the coalition government with reform-minded Taro Kono as the chairman is reportedly discussing ramping up efforts to attract high-end inbound tourists, which is a promising sign of potential action. The inflow of foreign currencies that these measures should help generate will keep a healthier trade balance and stabilise the exchange rate.

In the face of inflation and a weakening yen, the BOJ is likely to revise its monetary policies and a moderate increment in interest rates is expected. Mild price corrections could be observed in sectors that have seen sharp pricing and compressed cap rates, while other sectors that were less popular during the pandemic could become more appealing as recovery is expected to continue.

THE BANK OF JAPAN

Many major economies have seen interest hikes in an attempt to curb inflation. For instance, the Federal Reserve Board has opted to raise interest rates, and the European Central Bank has chosen to increase interest rates for the first time in 11 years. In contrast, the Bank of Japan has kept its monetary easing policy unchanged, and the stark disparity between Japan's policies and global counterparts has resulted in the steep weakening of the yen, especially against the US dollar.

GRAPH 2: JGB Yield Curve at Each Month End, November 2021 to July 2022



Source Ministry of Finance, Savills Research & Consultancy

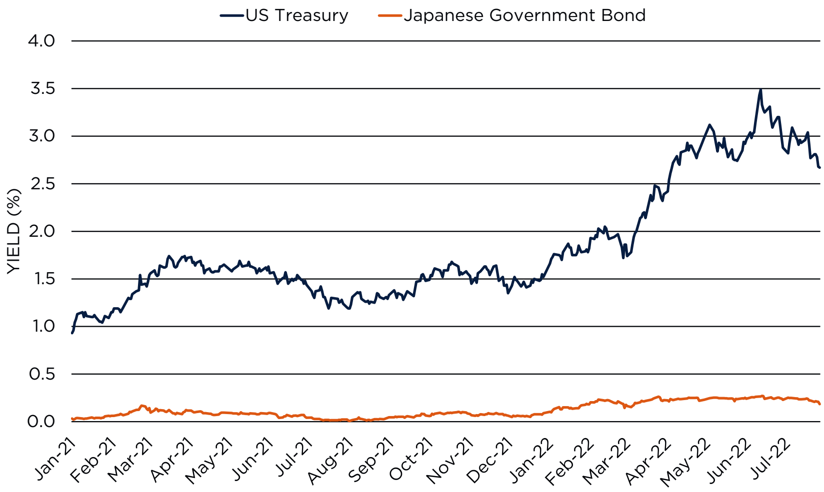
The inflationary environment has brought the sustainability of loose monetary policies into question. The BOJ has purchased large amounts of Japanese government bonds (JGBs) to control the yield curve, even purchasing a record amount of 14.8 trillion yen in June 2022 when the market was volatile and US interest rates went up. Until now, the BOJ has had the ability to buy an enormous amount of JGBs at a determined yield to suppress interest rates. As a result, more than 50% of JGBs outstanding are currently owned by the BOJ, in stark contrast to the 10% owned by the BOJ in 2013 when Governor Kuroda first started the monetary easing program. The BOJ also owns notably more government bonds than other central banks – the Federal Reserve Board holds approximately 30% of US Treasuries, while the European Central Bank holds approximately 40% of EU Bonds. Hence, this additional easing by the BOJ may not be sustainable.

Overall, the BOJ is likely to revise its policies at the latest in next spring when Kuroda's term ends, and a new governor is nominated. At the same time, if global interest rates see further hikes earlier, the BOJ may see the need to react and change its policies sooner.

IMPACT ON THE REAL ESTATE MARKET

With Japanese interest rate hikes in the crosshairs, movements in capital markets have begun taking place. Some international

GRAPH 3: 10-Year US Treasury Yield vs Japanese Government Bond yield, 2021 to July 2022



Source Ministry of Finance, US Department of the Treasury, Savills Research & Consultancy

investors, especially those with sizable AUM, are currently suspending investment activities and are taking a wait-and-see stance. Nonetheless, signs of real estate asset repricing have not yet been observed due to the large amounts of dry powder available for alternative assets held, particularly by latecomers hoping to catch up in the Japanese market. Indeed, this may be a great opportunity for those who have struggled to acquire assets under the extremely fierce competition so far. If the interest rate movement concludes with only a moderate upward shift, it could turn out to be an opportune situation for new acquisitions.

Although the Japan market looks to remain stable by itself, the subsequent actions of global central banks will have a significant impact on the direction that the Japanese real estate market will move in. While the economy of the United States appears strong, there are beliefs and signs that even the economy of the United States does not have the capacity to digest further interest rates hikes. The recent interest rate movements in the United States may support this view. After the 10-year treasury yield reached 3.5% in June, interest rate movements have fluctuated around 3.0%. At this moment, as the current yield curve in Japan suggests, Japanese 10-year bond yields are likely to see increases of 20-30 bps if the Bank of Japan stops purchasing government bonds now. Interest rates have actually gone up nominally, and marginal adjustments have also been observable from J-REIT disclosures. At this moment, the impact still looks manageable, especially for investors that have been disciplined.

OUTLOOK

Given the current inflationary environment and immense amount of quantitative easing across the globe, an increase in interest rates appeared necessary. At the same time, the world economy does not appear strong enough to receive significant interest rate hikes, especially considering the crisis in Ukraine and the zero-COVID policy in China, suggesting that interest rate increments will likely remain moderate. Moreover, the rapid ageing of the population of many major nations should lead to savings gluts for pension management, further disincentivising large hikes. Given the circumstances, we predict the 10-year interest rate in Japan will increase but moderately; the increment should be approximately by 20 to 30 bps, or up to 50bps, as suggested by the present JGB yield curves.

These changes should be manageable for disciplined players with some room for adjustment. However, given the rapidly compressed cap rates, even moderate interest rate shifts could lead to noteworthy corrections of some real estate assets, as the sharp pricing does not leave much room for adjustment. This appears to be the case especially for sectors such as logistics and multifamily, which have seen robust investment appetite and sharp cap rate compressions. Indeed, even a 20-bps interest rate revaluation may strike a heavy blow on a 3.0% cap rate and exhibit a stark difference when compared to a 4.0% cap rate.

The fierce competition for logistics facilities, as pointed out in our "Evidence of Caution" report, has resulted in stretched valuation for some assets. Furthermore, logistics facilities tend to have a stable long-term lease, which has a bond-like nature and is vulnerable to interest rate hikes. Meanwhile, residential properties have been highly sought after and pricing appears to have become even sharper this year and may face a similar predicament due to the nature of residential rents with laws that protect housing tenants. Indeed, significantly fiercer competition for residential assets has been observed recently, similar to that of logistic facilities. In addition, with the gloomy prospects surrounding the world economy, rental increments might be more difficult going forward. Hence, assets that were bought at sharp pricings may suffer from an interest rate adjustment. Nonetheless, these sectors are likely to stabilise again after some possible mild corrections as their fundamentals are still sound.

On the other hand, the retail sector that was recently unpopular could see more attention after its noticeable pricing corrections. For instance, as society progresses toward an endemic state and more people have returned to offices for work, the retail sector should also see more recovery in tandem. Also, retail assets have shown resilience during the pandemic; the pleasure derived from the retail experience is important and has been integrated into Japanese culture. Furthermore, the expected resumption of inbound travel should provide additional tailwind for the retail sector. Elsewhere, the hotel sector is also likely to rise in popularity. Indeed, the hotel sector is more impacted by changes in inbound demand than interest rates. Overall, we predict interest rate increases are likely to accelerate the reversal of some effects that the pandemic has had on real estate.

Exchange rates should stabilise once interest rates increase, probably around the US$1 to JPY120 range, especially after some countermeasures to defuse inflation are introduced. The recommencement of some nuclear power generators should reduce energy imports and appease the potential threat to Japan's national security. Elsewhere, the revival of inbound tourism, particularly geared toward high-end travellers, will boost foreign currency inflows, leading to a healthier trade balance and helping to stabilise the yen. If the global economy slows down even more, the yen may actually appreciate.

While the BOJ has not wavered from its consistent policies so far, they are likely to be revised at the latest next spring when a new governor is appointed. Revisions may come even earlier if the global interest rate environment becomes more volatile.

Overall, the real estate market in Japan looks to remain stable but may see some corrections from an increase in interest rates, especially in sectors that have had cap rates compressed recently. However, these corrections are likely to be mild, and attention may shift toward sectors that are forecast for further recovery, like retail and hotel. Investors will need to be aware of the potential risks that could surface in the case that interest rates are increased. A change in strategy could also be necessary as some narrowed yield spreads might not be justifiable anymore. Some investors, especially those already with sizeable AUM, are more likely to keep a wait-and-see stance for the time being. This may be a great opportunity for them to focus on asset management, and at the same time be an ideal window for late comers to play catch-up.

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