DWS

Marketing Material

GLOBAL REAL ESTATE STRATEGIC OUTLOOK

Mid-Year 2021

IN A NUTSHELL

- In our view, the macroeconomic backdrop is unusually positive for real estate. We believe that resurgent economies, low real interest rates, and rising inflation are an ideal mix.
- However, structural forces are driving shifts in fundamentals that have not yet been fully priced into asset values, in our view. We believe that logistics and residential property have further upside, while office and retail property may struggle.
- We believe that countries at the leading edge of the economic rebound, including the U.S. and UK, will outperform through 2022. Over the medium-term, fast-growing cities, typically characterized by healthy demographics and a dynamic technology industry, are expected to fare well.

Market Outlook

The global property market has embarked on what we believe will be a powerful upswing. Having dipped only modestly amid last year's economic dislocation, thanks to healthy initial conditions (low vacancy rates, moderate construction, fair valuations, and disciplined leverage) along with abundant fiscal and monetary stimulus, real estate investment returns edged higher again at the beginning of 2021.[1] In our view, the ingredients are falling into place for real estate to sustain this positive momentum well into 2022 and likely beyond.

We believe that the macroeconomic and financial environment is especially conducive to real estate. Global property returns have historically displayed a strong correlation to GDP growth (0.75 over the past 20 years).[2] To be sure, an improving economy is positive for many industries, but it is noteworthy that real estate prices generally do not front-run the fundamentals (see Exhibit 1). Despite the vagaries of the Delta COVID variant, DWS believes that economic reopening, coupled with the release of pent-up demand and ample fiscal and monetary support, will produce global GDP growth of 5.8% in 2021 and 4.5% in 2022.[3] Given the historical relationship to real estate, we would anticipate a meaningful boost to property returns driven by strong leasing activity.

[1] NCREIF (GREFI) as of June 2021.
[2] NCREIF (GREFI), IMF (GDP) and DWS as of August 2021.
[3] DWS as of August 2021.

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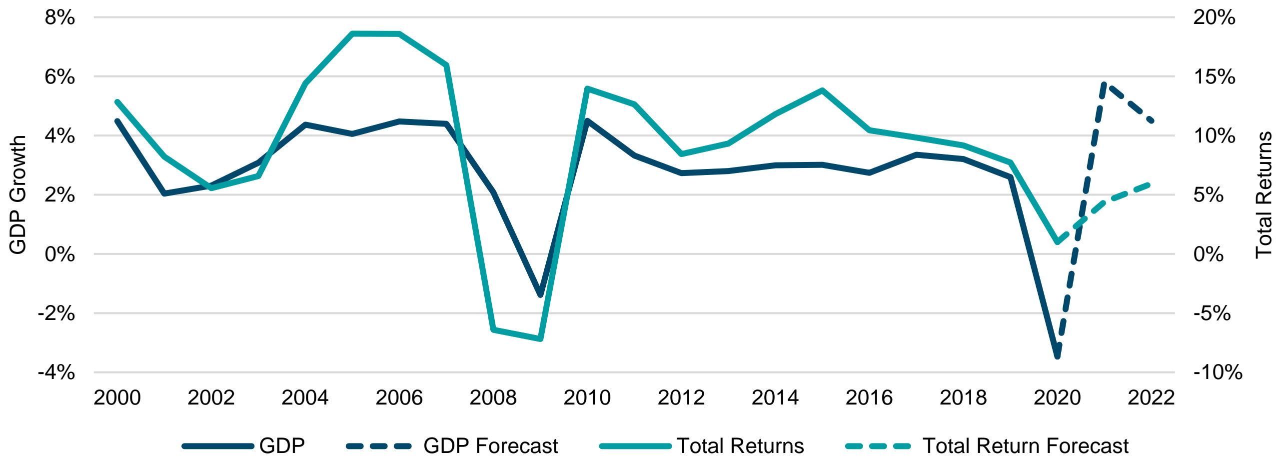
EXHIBIT 1: GLOBAL GDP GROWTH AND REAL ESTATE TOTAL RETURNS



Source: DWS as of August 2021.

There are two key risks to the outlook, in our view. First, COVID could evolve into a virus that is more resistant to vaccines, leading policymakers to reimpose business restrictions and workers and consumers to retrench. Any "double dip" of the COVID recession would likely be shallower, in our view, assuming that vaccines remain at least partially effective and governments, health care systems, schools, businesses, and households respond to virus pressures more effectively. Nevertheless, it could hinder leasing and transaction activity and dent investment performance.

The second risk — inflation — is more nuanced. The U.S. and Europe have experienced an uptick in inflation in 2021: In the U.S., price increases of 4%-5% year-over-year in July (depending on the index) were the highest since 2008; stripping out the volatile food and energy components, they were the highest since 1991.[4] The key debate is whether these inflationary pressures are transitory, resulting from bottlenecks that will dissipate as the economy reopens, or more permanent, stemming from rampant and sustained fiscal and monetary stimulus. Regardless of the catalyst, once ignited, inflation could become self-perpetuating if it became embedded in expectations, spawning a wage-price spiral.

Inflation could be detrimental to the economy in two ways: First, higher prices could undermine households' spending power. Second, in a replay of the early-1980s, it could force central banks to hike interest rates aggressively, inducing a recession. In both cases, slower economic activity could undermine physical demand for real estate. Yet the implications for investment performance are more complicated. Inflation may lift the nominal earnings of renters. It may also put upward pressure on construction costs, constraining competitive supply. In the U.S., building materials prices increased 35% year-over-year in July, the most on record, including during the inflationary 1970s (see Exhibit 2).[5] Over time, real estate prices have tracked replacement costs, which are directly tied to inflation.

[4] Bureau of Economic Analysis as of July 2021.

[5] Bureau of Labor Statistics as of July 2021.

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EXHIBIT 2: CONSTRUCTION MATERIALS PRICE GROWTH

Source: U.S. Bureau of Labor Statistics as of July 2021.

Along with economic growth and inflation, low real interest rates may add further support. Unlike in previous cycles, real estate yields did not rise during the COVID recession (increases in Office and Retail were generally offset by declines in Logistics and Residential).[6] Nominal interest rates have perked up from their 2020 nadir, but for real assets like property, real (inflation-adjusted) interest rates are arguably a more appropriate reference point. By this measure, yields continue to provide an attractive spread to risk-free rates, which remain deeply negative in most economies.[7] This implies that yields have room to fall, or at least hold steady should real rates creep higher.

Investment Strategy

While the macro environment is favorable for real estate overall, disruptive forces are upending the asset class in ways that in our view have not yet been fully factored into building values. In particular, we believe that digitalization (including e-commerce and technology-enabled remote working) and demographics will drive important disparities in performance across sectors and markets.

According to CBRE, global online sales increased 140% from 2015 to 2020, more than doubling (to 18%) as a proportion of overall retail sales.[8] To be sure, COVID lockdowns likely contributed to e-commerce growth, as consumers eschewed physical shopping and stores closed. But this trend was underway before COVID, and we believe it will persist after the pandemic.

The relentless growth of e-commerce is a double-edged sword, generating unprecedented demand for logistics buildings used for online fulfillment while throttling traditional retailers and the properties they occupy. At some point logistics could become overbuilt and/or overpriced. Conversely, a dearth of construction and attractive yields could put a floor under retail values. Indeed, we believe that some of the shine may have come off European corridor logistics (we prefer infill warehouses) and see opportunities in necessity- and service-oriented retail centers. But overall, we believe that rents will grow faster in logistics than retail properties over the next five years (see Exhibit 3).

[6] DWS as of June 2021.
[7] Oxford Economics (interest rates, inflation) and DWS (property yields) as of June 2021.
[8] CBRE "Global E-Commerce Outlook" as of June 2021.

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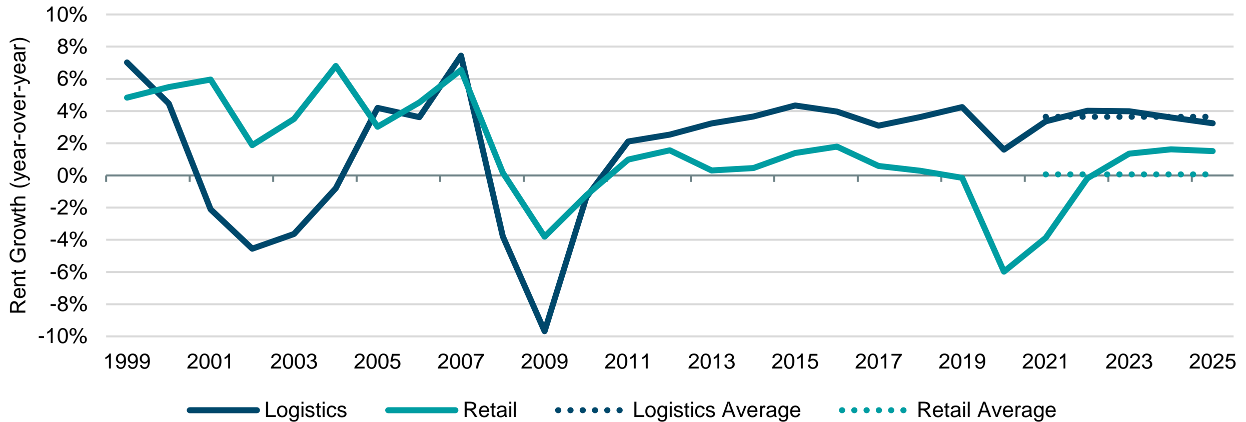
EXHIBIT 3: GLOBAL LOGISTICS AND RETAIL RENT GROWTH

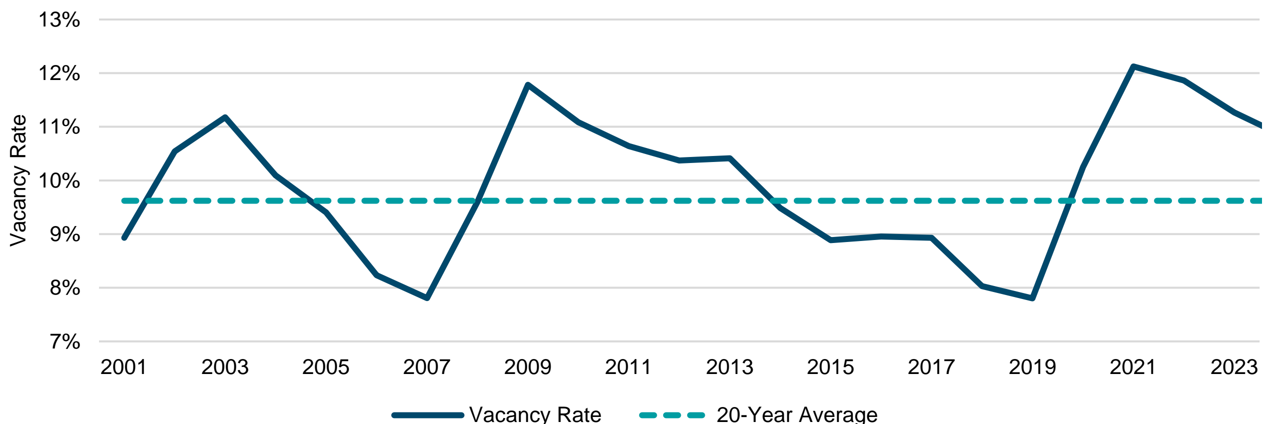


Source: DWS as of August 2021.

People are not just shopping from home; they are working from there as well. Office property values have generally remained resilient, perhaps because healthy corporate finances and extended leases have preserved rental cash flow. Still, the widespread adoption of work-from-home (WFH) arrangements has called into question the long-term viability of office space. Opinions run the spectrum from the apocalyptic (offices are dead) to the sanguine (WFH is an aberration). Our view is more nuanced. We believe that offices, critical to fostering collaboration, culture, and employee development, will reclaim their central place in professional life. But even a marginal shift toward remote working — one day per week — would result in 20% fewer office-working hours.

Employers may not reduce their space use commensurately, as they strive to create healthier working environments. Any recalibration would take time given existing lease commitments. Labor force growth may also pick up some of the slack, and office construction will likely subside. Nevertheless, we believe that WFH could weigh on office fundamentals for several years (see Exhibit 4). Globally, we expect that rents will remain flat through 2023. But not all office markets and assets are created equal. In our view, a cultural preference for office-based work may drive better outcomes in Asia. High-growth markets may also be better positioned to weather the headwind. And Environmental, Social, and Governance (ESG) considerations as well as efforts to recruit talented professionals may put a premium on the highest-quality, healthiest, and most energy-efficient buildings.

EXHIBIT 4: GLOBAL OFFICE VACANCY RATE



Source: DWS as of August 2021.

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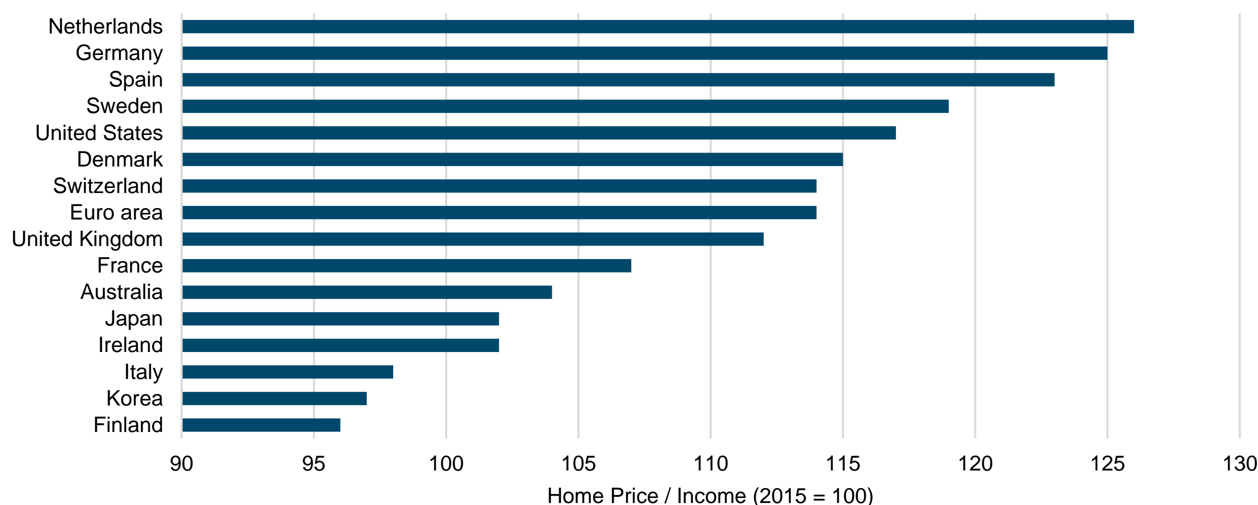
Footloose workers have reportedly swelled demand for residential properties in suburbs and cheaper lifestyle locations. In the U.S., home prices jumped 15%-25% year-over-year in July 2021 (depending on the index).[9] But the residential boom did not start with COVID; it is rooted in a supply-demand imbalance that formed following the global financial crisis (GFC), when homebuilding collapsed. Home prices relative to incomes are 10%-15% above 2015 levels (see Exhibit 5).[10] A shortage of affordable housing has fueled rental demand, creating opportunities for institutional investors.

EXHIBIT 5: HOME PRICE / INCOME BY COUNTRY



Source: IMF as of June 2021.

Recalling the tight correlation between GDP growth and real estate performance, we expect that countries at the leading edge of the post-COVID recovery will also produce stronger property returns. In our view, the U.S., fueled by world-beating infusions of fiscal support, will outperform Europe and Asia through 2022, although we see also see bright prospects in the UK, Sweden, Singapore, and South Korea. The near-term outlook is weaker in France, Spain, Italy (which suffered substantial economic setbacks) and Japan (where the recovery is more subdued).[11]

Over the medium-term, we believe that local markets experiencing strong growth, whether due to demographics (domestic or international migration) or positive economic drivers, including vibrant technology clusters, are positioned to outperform. These include Beijing, Shanghai, Sydney, Barcelona, Madrid, Atlanta, and Dallas (demographics) and Seoul, Dublin, Stockholm, Amsterdam, Austin, and Denver (technology). London, home to a thriving FinTech industry and sporting valuations that have been capped by Brexit, represents an interesting opportunity, in our view (see Exhibit 6).

Regardless of region, ESG is gaining prominence in investment strategy. Recent floods in Europe and hurricanes in the U.S., as well as the ongoing COVID health crisis, have underscored the importance of protecting portfolios. Risks include uninsured property damage (or rising insurance fees), the cost of complying with more demanding environmental regulation (including fines and remediation efforts), and waning tenant demand due to climate-driven migration. At the same time, shifting migration patterns may benefit some cities, energy- and water-efficiency initiatives may generate attractive returns on investment, and buildings with strong environmental credentials may command higher rents and prices.[12] Investment strategy will, in our view, increasingly aim to capture the full range of ESG risks and benefits.

[9] Case-Shiller and National Association of Realtors as of July 2021.
[10] IMF as of June 2021.
[11] DWS as of August 2021.
[12] Cushman & Wakefield, "Green Is Good: Sustainable Office Outperforms in Class A Urban Markets." As of August 2021.

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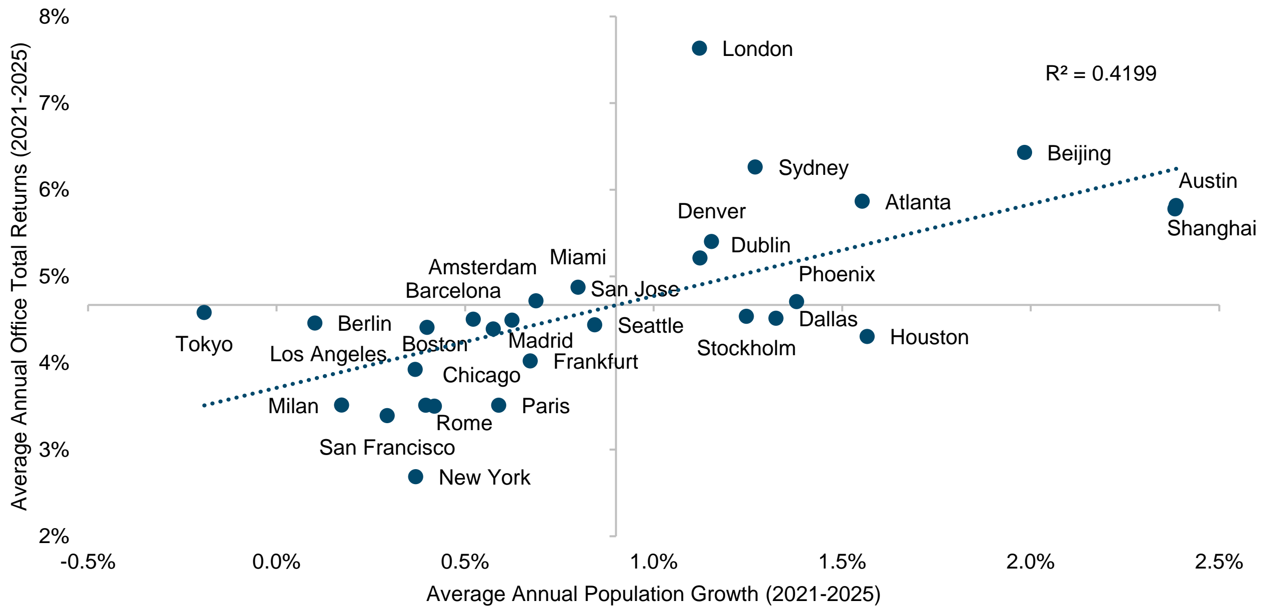
EXHIBIT 6: POPULATION GROWTH AND OFFICE TOTAL RETURNS



Source: UN (population growth) and DWS (total returns) as of June 2021.

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Research & Strategy—Alternatives

OFFICE LOCATIONS:

Chicago
222 South Riverside Plaza
34th Floor
Chicago
IL 60606-1901
United States
Tel: +1 312 537 7000

Frankfurt
Mainzer Landstrasse 11-17
60329 Frankfurt am Main
Germany
Tel: +49 69 71909 0

London
Winchester House
1 Great Winchester Street
London EC2N 2DB
United Kingdom
Tel: +44 20 754 58000

New York
875 Third Avenue
26th Floor
New York
NY 10022-6225
United States
Tel: +1 212 454 3414

San Francisco
101 California Street
24th Floor
San Francisco
CA 94111
United States
Tel: +1 415 781 3300

Singapore
One Raffles Quay
South Tower
20th Floor
Singapore 048583
Tel: +65 6538 7011

Tokyo
Sanno Park Tower
2-11-1 Nagata-cho
Chiyoda-Ku
18th Floor
Tokyo
Japan
Tel: +81 3 5156 6000

TEAM:

Global

Kevin White, CFA
Co-Head of Real Estate Research & Strategy

Simon Wallace
Co-Head of Real Estate Research & Strategy

Gianluca Minella
Head of Infrastructure Research

Americas

Brooks Wells
Head of Research, Americas

Liliana Diaconu, CFA
Office Research

Ross Adams
Industrial Research

Ryan DeFeo
Property Market Research

Ana Leon
Retail Research

Joseph Pecora, CFA
Apartment Research

Europe

Tom Francis
Property Market Research

Siena Golan
Property Market Research

Rosie Hunt
Property Market Research

Martin Lippmann
Property Market Research

Aizhan Meldebek
Infrastructure Research

Asia Pacific

Koichiro Obu
Head of Research & Strategy, Asia Pacific

Natasha Lee
Property Market Research

Seng-Hong Teng
Property Market Research

Hyunwoo Kim
Property Market Research

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The authors

Simon Wallace
Co-Head of Real Estate Research & Strategy

Kevin White
Co-Head of Real Estate Research & Strategy

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