Global Capital Flows Are Slowing

Aaron Jodka
Colliers

The investment sales market remains fragile. Activity in 2Q2023 showed signs of recovery, with increasing sales volume and improvement relative to the five-year high-low range (Exhibit 1). North America was the leader in this broader activity. However, Q3 started with a whimper, with US volume off 50% from June levels. A bit of seasonality isn't uncommon, but this type of decline was unusual. August statistics showed signs of a rebound, and some larger-scale transactions were announced.

With government bond rates increasing at the end of Q3 and into Q4, the market is undergoing another adjustment. In the US, the benchmark ten-year Treasury traded at 5.0% in late October, the highest rate since 2007. The current and future paths of inflation and interest rates remain critical factors influencing market sentiment. Interest rate decisions made across the globe in September will take time to filter through to activity in Q4. Conditions vary from region to region, likely creating a staggered return-to-investment momentum heading into 2024.

Global Inflation and Interest Rate Movement

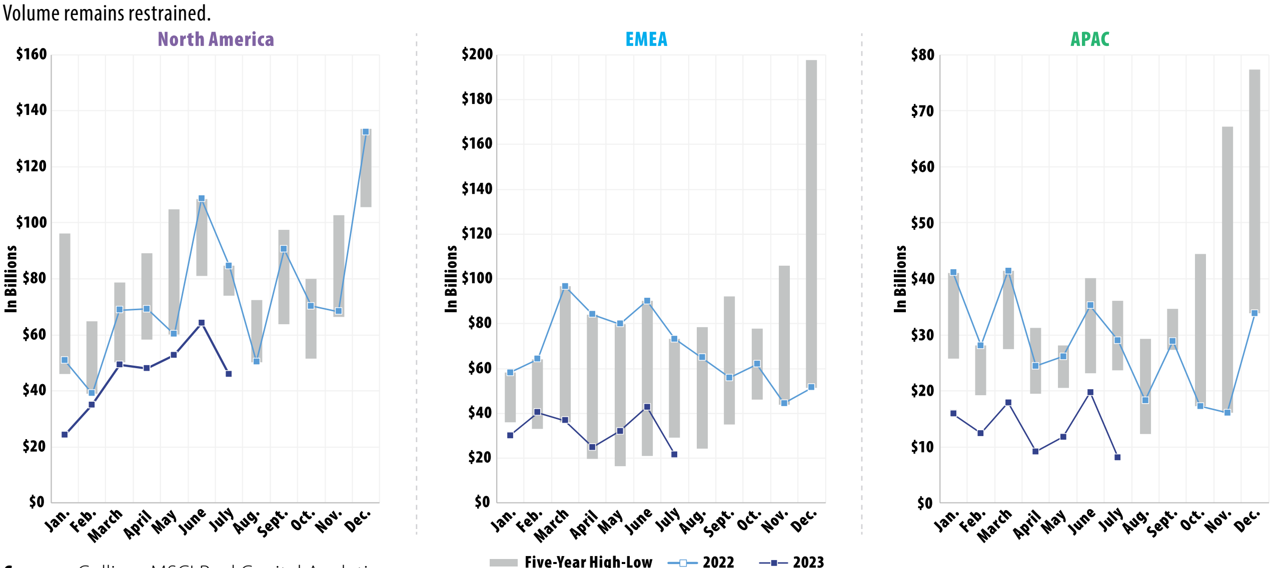
Inflation's path and subsequent shifts in interest rates over the past 12 to 18 months have varied markedly by region. This trend is expected to continue, as underlying fundamentals differ globally.

In North America, the sense that rates will peak and could be dialed back in early 2024 is on hold. After 12 consecutive months of inflation declines to June 2023, interest rates appeared to have done their job. They held at 5.25% in July, although the Consumer Price Index (CPI) of inflation increased marginally by 20 basis points (bps). The hawkish tones of the Federal Reserve suggest future rate rises may not be over, but a decision to keep them on hold in September didn't set markets at ease. At the same time, Canada also confirmed its decision to keep rates on hold.

Asia-Pacific (APAC) is next up on the CPI–interest rate cycle. It is the most diverse market in terms of factors at play, with rates in Japan holding at 0.1% for many years. Inflation in other key regions remains manageable, and all markets have CPI rates below 5%, suggesting future rate hikes are no longer necessary. In Australia, rates have been on hold, as inflation has loosened its grip

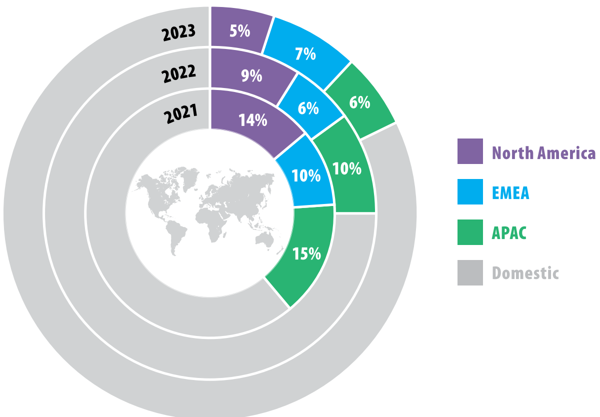
Exhibit 1: Investment Volume

Volume remains restrained.



Sources: Colliers, MSCI Real Capital Analytics

Exhibit 2: Historical Capital Sources



Sources: Colliers, MSCI Real Capital Analytics

since April 2023 highs, with clearer signals that rates are peaking.

The Europe, Middle East, and Africa (EMEA) region sits at the back of the pack with much lower investment volumes relative to the five-year high-low range. Inflation has remained persistently high, though it is on a gradual downward path, with CPI in the UK at 6.2% in July and 5.3% in the eurozone. Until August, the view was that UK rates had most likely peaked at 5.25%, but the eurozone faced further hikes in September. However, the European economic outlook has deteriorated, with the Purchasing Managers' Index dropping to well below 50. Despite this, the European Central Bank pushed forward with another rate rise in September, but it will take months to see whether this action drives down CPI. It has some way to go before closing in on target levels of 2%.

Foreign Exchange Rates Driving Lower Cross-Border Capital Flows

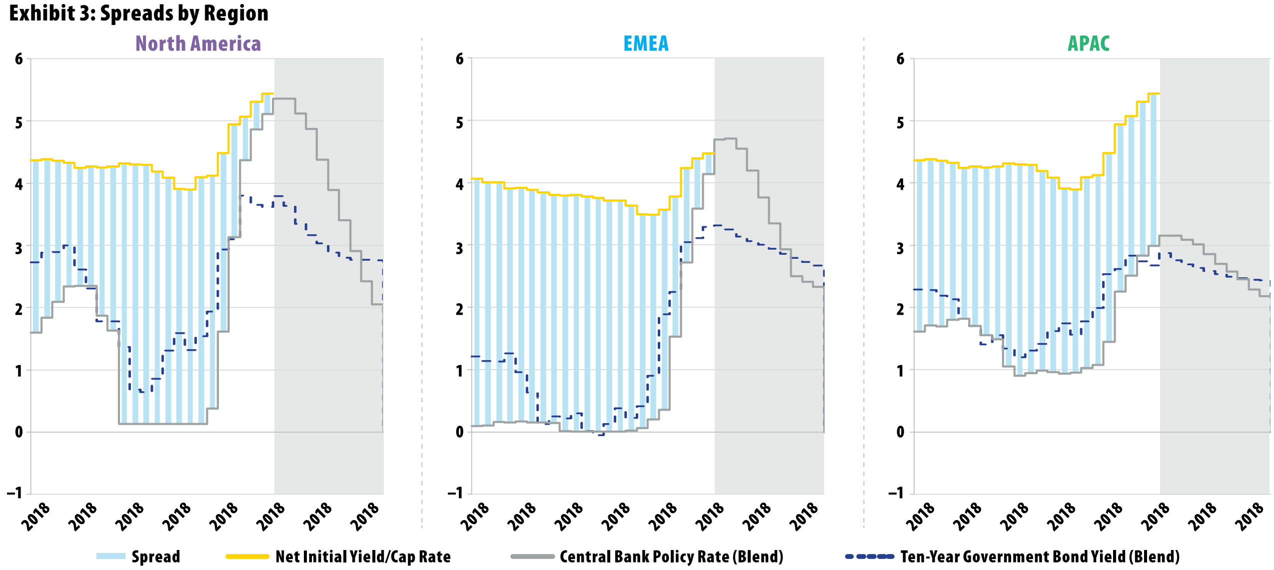
Interest rate changes have also played havoc with foreign exchange rates over the past 12 months. Cross-border investment activity has diminished markedly in 2023, dropping to 18% of volumes, representing 39% in 2021 and 25% in 2022 (Exhibit 2).

Three of the top four sources of capital (Singapore, US, and Hong Kong) have had the highest foreign exchange appreciation over a global basket of currencies. APAC capital has expanded its influence as an international capital source, reflected by the prominence of Singapore, Hong Kong, and Japan in the global top ten. Singapore tops the charts for global spending in 2023, followed by the US. These markets significantly outsize Canada, the third largest spender.

Spreads Vary Regionally

Exhibit 3 depicts the sensitivity of potential shifts in interest rates. These shifts illustrate the spread between

Exhibit 3: Spreads by Region



Sources: Colliers, Oxford Economics, Macrobond, FactSet

Identifying potential that others may overlook

$3.3B
LIFE SCIENCE ASSETS UNDER MANAGEMENT

2.6 million
SQUARE FEET

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all-sector yields/cap rates and central bank policy rates, highlighting significant differences between regions.

North American cap rates have stayed slightly ahead of central bank policy rates, even though the spread itself is minimal. Although interest rates are not likely to be wound back until 2024, generating more positive income spreads, cap rates have adjusted enough to support a return to investment momentum.

For EMEA, spreads remain behind the interest rate curve, and further positive shifts in CPI fundamentals are needed before more-precise, established signals emerge that rates have peaked. Markets may need to price in a further correction in yields, or current bid-ask uncertainty will continue to drag on short-term investment activity.

The APAC region has the most diverse range of markets and the most extensive spread range. Although they are wholly positive, markets such as Japan and Singapore, where yields are trading the widest, are the main drivers. Australian all-sector spreads are also positive, at 75 bps. The growing consensus that rates may have peaked is feeding into more-positive investment sentiment in the market.

Market Repricing Has Not Been Consistent

Each region has repriced at a different magnitude and speed. Yield/cap rates in North America have repriced the hardest and fastest, in line with the solid outward movement in interest rates in the US and Canada over the past 12 months. This scenario supports a strong capital value correction, accelerating activity in Q2.

EMEA has also had a strong yield and capital value correction, although not to the same extent as North America. However, as the analysis of the previous spreads shows, whether this adjustment is sufficient remains to be seen. What is clear is that core investment activity is markedly down, with value-added investment picking up, not least supported by higher-yield entry levels.

The yield rate adjustment in APAC has been much more benign, and the capital value adjustment is negligible. This lack of change plays a role in a slower return to investment flows. Underlying fundamentals in the region are generally more favorable than in other areas, but the availability/liquidity of product is tighter.

Exhibit 4: Capital Flows by Country, 1H2023

	Cross-Border Total (In Millions)	Cross-Border Global (In Millions)	Cross-Border Regional (In Millions)	2023 % of Total	2018–2023 % of Total
US	$21,902	$16,927	$4,975	33.9%	26.1%
UK	$11,158	$8,545	$2,613	17.3%	13.3%
Japan	$7,139	$3,879	$3,260	11.1%	8.5%
Canada	$6,677	$5,340	$1,336	10.7%	7.9%
Germany	$5,459	$2,088	$3,370	8.5%	6.5%
Spain	$4,736	$1,402	$3,334	7.3%	5.6%
France	$4,684	$886	$3,797	7.3%	5.6%
China	$3,783	$302	$3,481	5.9%	4.5%
Australia	$2,624	$725	$1,899	4.1%	3.1%
Singapore	$2,469	$–	$2,469	3.8%	2.9%

Sources: Colliers, MSCI Real Capital Analytics
Note: All amounts are in US$.

Smaller Trades Are Driving Volume

One critical enabler of a pickup in activity is the depth/liquidity of the market, particularly when it comes to deal size. Big, direct deals are scarce in the current environment, with activity focused on the sub-$50 million range. Tellingly, trades in this size range have increased across all three regions so far this year. Equally, sales north of $100 million have been clearly on the decline.

Historically, the North American market operated with greater liquidity from a deal-size perspective, with sub-$50 million transactions composing 55% of the market. To date, the US has been the biggest recipient of cross-border capital in 2023 (Exhibit 4) and showed the most positive momentum in investment activity until the end of Q2.

EMEA and APAC have shown positive signs, where sub-$50 million trades historically composed a lower proportion of activity. These regions have seen the highest rates of activity growth for this deal size and the highest rates of decline in deals over $100 million. However, this contributes to slower deal-flow recovery as these regions adjust.

Conclusion

Although interest rates and inflation expectations continue to hinder investment sales activity, repricing assets in the US could make it an attractive capital target. Japan's investors have low capital costs and are considering expanding their US portfolios. It is unlikely that this will be a repeat of the 1980s Japanese investment boom, though. That said, cash-rich buyers have an advantage today. Higher going-in cap rates look attractive relative to alternative yield-producing assets. ■

Aaron Jodka is the National Director of Capital Markets Research at Colliers.