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What do replacement costs tell us about the outlook for global listed property?

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"Building cost trends continue to show an unprecedented increase in construction cost inflation for the year ending January 2023 with an average increase of 12.90% for the year" - Zurich Resilience Solutions[1]. While cost inflation may be slowing – 1.2% over the 12 months to January 2024, according to insurance giant Zurich – we have still experienced several years of rapid price growth. Yet, counterintuitively, property prices have at times fallen during that same period[2].

Falling property prices and rising construction costs isn't a dynamic that can continue indefinitely. The squeeze on developers' margins makes construction less and less profitable. When prices eventually fall below replacement cost (marginal price < marginal cost), there is clearly no incentive for developers to increase supply. No new supply means growing demand can't be met, and instead a portion of this demand has to be squeezed out by higher prices, a situation that continues until prices exceed replacement cost and supply is turned back on.

The sight of prices below replacement cost is therefore bullish for property from a demand-supply perspective. The opposite is also true: prices above replacement cost incentivise new supply and are therefore a bearish signal, kick-starting a new development cycle. Replacement cost, therefore, is a fundamental force in the property market and one worth paying attention to.

The data is patchy: you are more likely to find a meme stock index[3] than something high quality like 'enterprise value to replacement cost' for the global listed property universe. However, data from Zurich Resilience Solutions[4] shows that construction costs in the United States have risen by an average of 43% since 2020, or 9.3% per annum. Over the same period, global listed property companies, representing a liquid way to buy and sell real estate, have fallen by 3.7%[5].

This divergence looks stark. If it results in less development, then this bodes well for rental growth in the coming years. We would argue, however, that higher rental growth is a necessary condition for one to start constructing a bullish case for property, rather than a nice to have. Our analysis[6] suggests realised growth over the past 20 years hasn't been adequate to compensate investors for risks associated with investing in global listed property: this new environment may help to correct that.

Rising replacement costs and falling prices are certainly relevant, but up to a point. A higher cost of production doesn't always translate into a higher sales price: there are plenty of things that aren't meant to be made, because the process of making them uses up more utility than the finished goods add. If, for example, demand for secondary office space is fundamentally lower today than in the past, then it may take a long time for demand to absorb current capacity, with downward pressure on prices during that period. Development cycles are also long, while spending by occupiers on new space is lumpy, meaning it may take some time before the effects of constrained supply start to show up in higher rents and prices.

Overall, the current trend in replacement costs and prices isn't sufficient to construct a bullish case for global listed property today. It is, however, an important data point and a positive one.

"Higher rental growth is a necessary condition for one to start constructing a bullish case for property, rather than a nice to have"

Sources: [1]"Replacement value cost trends" by Zurich Resilience Solutions, January 2024. [2]The S&P CoreLogic Case-Shiller 20-City Composite City Home Price NSA Index (ticker SPCS20Y% Index) turned negative in 2023. Bloomberg Finance L.P. [3] Bloomberg Finance L.P., Most popular meme stocks (UBXXMEME Index) [4]Refer to [2]above [5]Bloomberg Finance L.P., S&P Global Property USD Total Return Index (SPBMGPTU Index), 31/12/2019-01/01/2024 [6]Bloomberg Finance L.P., global listed property dividend per share growth between March 2005 and May 2023, plotted against variability of 12 month dividend growth and compared against global equities.

Market Review - week ending 19 July 2024

- Global equities fell 2.0% last week
- Joe Biden won't run for the next US presidency and endorses VP Kamala Harris to be his successor
- Brent crude fell 2.8% to $82.63 a barrel
- Gold fell 0.4% last week to $2400.83 per ounce

US

- US equities fell 2.0% driven by a sharp decline in semiconductor stocks following Biden's threat of export curbs
- Industrial production increased 0.6% in June, roughly double estimates
- Retail sales, excluding the volatile gas and auto segments, jumped 0.8% in June, well above consensus and the most since January 2023
- Weekly jobless claims increased to 243,000, a nine-month high

UK

- UK equities fell 1.2%
- Average earnings, excluding bonuses, grew by an annual 5.7% in the three months to May, down from 6.0% in April and the lowest level since mid-2022
- Headline annual inflation held at 2% in June, due in part to falling energy costs compared with last year

Europe

- European equities fell 3.1%
- The European Central Bank kept its key interest rates unchanged at 3.75%, as expected
- Industrial production in the euro area fell 0.6% in May, declining for the first time since January

Rest of the World/Asia

- Global emerging market equities fell 3.0%
- Japanese equities fell 1.2%, Technology stocks suffered on rising concerns about tighter U.S. restrictions on exporters of advanced semiconductor technology to China, including several Japanese chip makers
- Chinese equities fell 4.8%
- China's GDP expanded at 4.7% in the second quarter from a year earlier, slowing from 5.3% growth in the first quarter
- Chinese retail sales grew by a below-forecast 2% in June from a year earlier, down from a 3.7% increase in May

Market Performance - week ending 19 July 2024

		Cumulative returns			
Asset Class / Region	Currency	Week ending 19 July	Month to date	YTD 2024	12 months
Developed Markets Equities					
United States	USD	-2.0%	0.9%	16.0%	21.8%
United Kingdom	GBP	-1.2%	-0.1%	7.7%	12.2%
Continental Europe	EUR	-3.1%	-0.7%	7.9%	12.6%
Japan	JPY	-1.2%	1.8%	22.3%	28.4%
Asia Pacific (ex Japan)	USD	-3.0%	0.7%	9.3%	10.4%
Australia	AUD	0.2%	2.6%	7.0%	13.2%
Global	USD	-2.0%	1.2%	13.1%	18.4%
Emerging Markets Equities					
Emerging Europe	USD	-0.7%	2.9%	18.7%	26.7%
Emerging Asia	USD	-3.5%	0.1%	11.2%	11.5%
Emerging Latin America	USD	-2.7%	3.8%	-12.5%	-3.6%
BRICs	USD	-3.1%	0.4%	6.7%	6.7%
China	USD	-4.8%	-0.6%	4.1%	-4.5%
MENA countries	USD	2.3%	3.2%	-0.3%	0.2%
South Africa	USD	-3.7%	0.3%	4.9%	3.7%
*India	USD	0.3%	2.2%	13.6%	23.3%
Global emerging markets	USD	-3.0%	0.7%	8.2%	9.6%
Bonds					
US Treasuries	USD	-0.3%	1.1%	0.2%	1.8%
US Treasuries (inflation protected)	USD	-0.2%	1.0%	1.6%	3.0%
US Corporate (investment grade)	USD	-0.4%	1.4%	1.4%	5.5%
US High Yield	USD	0.3%	1.4%	4.1%	10.5%
UK Gilts	GBP	0.0%	0.7%	-1.9%	3.8%
UK Corporate (investment grade)	GBP	0.1%	1.2%	1.1%	9.5%
Euro Government Bonds	EUR	0.3%	1.2%	-0.7%	3.5%
Euro Corporate (investment grade)	EUR	0.2%	0.9%	1.4%	6.4%
Euro High Yield	EUR	0.1%	0.8%	4.0%	11.0%
Global Government Bonds	USD	-0.1%	1.7%	-2.7%	-1.2%
Global Bonds	USD	-0.2%	1.7%	-1.2%	1.3%
Global Convertible Bonds	USD	-0.7%	1.9%	0.7%	1.6%
Emerging Market Bonds	USD	-0.5%	1.1%	2.4%	7.4%

		Cumulative returns			
Asset Class / Region	Currency	Week ending 19 July	Month to date	YTD 2024	12 months
Property					
US Property Securities	USD	1.7%	5.5%	4.6%	8.5%
Australian Property Securities	AUD	1.9%	6.8%	15.4%	24.4%
Asia Property Securities	USD	-1.5%	4.9%	-7.1%	-5.3%
Global Property Securities	USD	0.5%	5.4%	2.9%	8.1%
Currencies					
Euro	USD	-0.2%	1.6%	-1.6%	-2.7%
UK Pound Sterling	USD	-0.6%	2.2%	1.2%	0.0%
Japanese Yen	USD	0.3%	2.2%	-10.5%	-11.3%
Australian Dollar	USD	-1.5%	0.2%	-2.2%	-1.2%
South African Rand	USD	-1.6%	-0.3%	-0.1%	-2.1%
Swiss Franc	USD	0.7%	1.1%	-5.5%	-3.2%
Chinese Yuan	USD	-0.3%	0.0%	-2.3%	-0.6%
Commodities & Alternatives					
Commodities	USD	-2.9%	-3.0%	4.4%	1.7%
Agricultural Commodities	USD	-1.1%	-1.4%	-1.2%	-7.9%
Oil	USD	-2.8%	-4.4%	7.3%	4.0%
Gold	USD	-0.4%	3.2%	16.4%	21.4%

Source: Bloomberg Finance L.P. Past performance is not indicative of future returns.

*Data as at 15 July due to Bank Holidays in India

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