21 March 2024

EUROPEAN ELECTIONS: WHEN "BORING" ISN'T A BAD THING

This year, a greater proportion of humanity gets to enjoy the fun of an election than ever before. Approximately 64 countries (representing about 49% of the global population) will have gone through an election by the end of this year. Commercial breaks will fill with attack ads and social media will teem with celebrities reminding people to vote. As the big day emerges, politicians will publicly squabble over their personal histories, and voters will look up party positions minutes before stepping into voting booths. National governments will be grilled over their responses to inflation in 2023, as well as their ability to navigate a period of intense geopolitical unrest. There is more riding on these elections than in most years.

Despite the sheer number of races this year, it's difficult for businesses not to focus on the elephant (and the donkey) in the room. The match between Joe Biden and Donald Trump presents no obvious winner at this point, and it's unclear whether America is prepared for its first election with mass-produced AI-generated content, which threatens to destroy public trust in every institution.

On one side of the aisle, businesses may expect that another Trump term would bring about deregulation, cheap fossil fuels, and a shot of optimism to the markets. But they would also have to deal with Trump's promises to raise tariffs universally by 10% and expand his trade war with China. On the other side of the aisle, Joe Biden has been largely successful so far in keeping the US economy out of recession in the wake of the pandemic. Yet, the incumbent has failed to realise a significant boost in popularity, and even his Democratic allies have concerns about his age as he prepares for a gruelling campaign and (possibly) four more years of the presidency.

The only thing we can be certain of in this upcoming American election is its uncertainty. No matter how the votes are cast in November, the winning candidate will be forced to spend almost all his political capital in Washington trying to assert legitimacy to the "losing" side.

This trend of uncertainty is also palpable in Asia. The economic and political mass of the continent provides ample opportunity for elections to disrupt global flows and stability. Regional disputes between governments across the Asia-Pacific region continue to raise geopolitical tensions. Such matters were among the deciding issues in Taiwan's most recent election. Additionally, China's prolonged economic concerns, including low consumption, price deflation, and a debt issues in the real estate sector, raise a lot of questions among the investment community about the country's economic trajectory.

Other Asian nations also face or have faced pivotal elections. While elections in Indonesia proceeded relatively smoothly, the president-elect has an opportunity to reshape relations with China through trade and participation within the Belt and Road Initiative. This sheds light on the fact that other emerging markets will have to reconsider their China-backed infrastructure and investment projects given the macroeconomic landscape of the past year as well as China's current economic state. Meanwhile, elections in South Korea hold sway over relations with North Korea and Japan. However, this year's contests are politically charged, marked by scandals involving the current first lady and political violence against an opposition leader. These scandals make it more difficult to predict future outcomes in the country and the region.

As electoral chaos continues to rattle North America and Asia, it doesn't take a political science major to recognise that things seem different in Europe. Take the United Kingdom, for example. The country has had a turbulent few years. If Keir Starmer wins the next election, 10 Downing Street will have had five occupants in as many years. Yet, the race between Starmer and Sunak is not nearly as

vitriolic as the campaigns in the US. Issues at stake include fixing the planning system, fighting inflation, and making the best of Brexit. The Conservatives and Labour parties have different views on how to govern Britain, but the outcome of the next election will not create the sort of volatility we see elsewhere. The United Kingdom will have either a centre-right party in power, or a centre-left one. The men in office will have solid establishment backgrounds, and there are no upstart politicians claiming radical change. Starmer was the Director of Public Prosecutions for half a decade, and his chancellor will have once worked as a Bank of England economist. The upcoming UK election is not meant to be a stress-test of democracy, but rather an exercise of it.

In fact, we see much of the same across the rest of Continental Europe. While fringe parties may command a lot of attention in public discourse, the centre is expected to hold across most European countries. Even when fringe parties do come to power, their political agendas regarding the business community tend to be tamer than those seen elsewhere. Instead, their main objectives revolve around curbing the flow of migrants from outside of Europe, which rarely does much to cause massive uncertainty for businesses. Giorgia Meloni, for example, can be credited with trying to reduce illegal immigration, but not much in terms of economic change. While Viktor Orbán claims to want to conquer the EU, he knows quite well from Brexit the economic importance of regional integration. As his recent vote (which was supposedly brokered by Meloni herself) on aid to Ukraine shows, there are limits to how far he is willing to rock the boat.

This isn't to say that European affairs are without their issues. The Russia-Ukraine war tests the ability of NATO to create a cooperative security arrangement, and the continent has had its fair share of weaker economic news recently. Still, investors should seriously consider the ways in which electoral stability aids business performance. Perhaps worse than a struggling economy is an unpredictable one. European elections deal with plenty of problems, but right now, the mercurial American political arena makes them look positively placid. Investors should take note.

UK IMMIGRATION, AND WHY BREXIT DIDN'T LIVE UP TO THE HYPE

Brexit has been blamed for a lot of things. It buffeted British politics for years, drew international ridicule, stranded tourists in airport queues, forced international banks to relocate staff out of London, and raised the price of tea. Yet despite these changes, it feels as if the promises made during the time of Brexit went undelivered. It didn't, as Nigel Farage proclaimed, lead to a political revolution bringing down the EU. But it also didn't turn the United Kingdom into a pariah state, as the Greens admonished.

Without a doubt, the United Kingdom has faced challenging years, both in terms of politics and its economy. Prime Ministers were churned like butter, and the price of Euroscepticism still stings people's wallets. But, if you have to say anything about Brexit, it's that it didn't live up to the hype that the cage match in 2016 would have you prepared for. The reason is not yet fully clear, but we believe that immigration played, and continues to play, a key role in keeping things together.

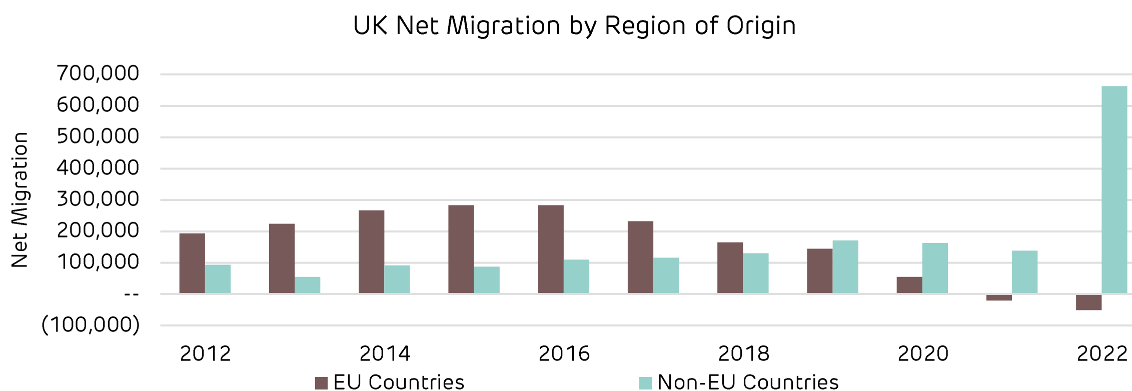
Among all the resources that Britain had easy access to as an EU member, people – especially skilled workers – might have been the most important. The sudden loss of young, skilled workers from the EU posed a threat to a population with a rising old-age dependency ratio and an average age of 41.[1]

However, for now, immigration from non-EU countries has been a key buffer against the sort of collapse that anti-Brexit advocates warned of years ago. Even though it is much harder for Europeans to work and study in the UK, centuries of global ties, rule of law, strong universities, and prevalence

[1] ONS

of the English language make Britain an attractive place for skilled and talented individuals to work on a global scale. Since 2020, immigration into the United Kingdom has risen, especially from students and workers, and the percentage of immigrants from non-EU backgrounds has skyrocketed dramatically to fill the gap left by the departure of EU citizens.

Figure 1. Hey, EU, get out of here![2]



Students and workers from non-EU countries have provided the UK labour market with much-needed flexibility by filling roles in undersupplied sectors such as healthcare. Additionally, the continued supply of young workers helps the United Kingdom avoid a demographic slowdown. With a current total fertility rate of only around 1.49 in England and Wales, Britain must seriously consider how proposals to curb immigration will affect the nation's median age and dependency ratio.[3] Finally, the continued inflow of skilled workers and students keeps the United Kingdom competitive globally. These workers strengthen the ties of the United Kingdom with the rest of the world, allowing for more trade and strengthening the country's soft power projection.

It's fair to note that continued immigration also presents certain economic challenges. These include pressures on public services, higher competition for knowledge sector jobs, and increased demand for housing. The last point is acute in major cities like London, as large urban areas with plentiful job opportunities tend to attract a greater share of migrants. New legislation to limit the entry of skilled workers is often justified on the grounds that it will help fix the ailing housing market in population centres.

However, it is our belief that trying to cut demand alone will not fix the structural issues plaguing the UK housing market. Instead, broader structural changes are needed to address the UK's inability to build new housing – namely the tangled planning system that defies any government housebuilding target. These changes would be needed even if demand for housing was lower than it is now. As we've noted before, an unsustainable percentage of the country's housing stock is in poor or obsolete condition.

With thoughtful policy-making and strategic planning, the UK can effectively manage these issues while continuing to reap the benefits of immigration. In the grand scheme of things, the positive impact of non-EU immigration on the UK's economy far outweighs the challenges. It has not only helped to cushion the economic blow of Brexit but also contributed to the UK's resilience and

[2] Oxford Migration Observatory
[3] ONS

adaptability in the face of change. As the UK continues to navigate its post-Brexit journey, continued immigration will undoubtedly remain a vital component of its strategy for economic recovery and growth.

BETTER LATE THAN NEVER: THE EUROPEAN TOURISM REBOUND DELAYED

Following the end of pandemic-era restrictions, there were proclamations of a surge in "revenge travel" as vaccines were administered and masks came off. However, escalating geopolitical tensions and a rising cost of living have led to an underwhelming reality. While approximately 700 million international tourists arrived in Europe in 2023, we've not yet returned to the activity of 2019, which measured at 742 million.[4] This leads us to wonder what the next year holds for the future of European hospitality.

While Europe's tourism industry may be eager for a return to pre-pandemic normalcy, the current economic and political climate still demonstrate some barriers to a full recovery. 2023 was a markedly volatile year for the global economy and for geopolitics. Potential travellers in the United States and China, the two most important markets for European tourism, may still feel deterred from international travel until a full recovery is more certain.

Despite these headwinds, though, we believe that the broader economic picture is trending positively. This optimism is rooted in several key factors that are reshaping the global tourism landscape.

For one, consumer sentiment toward travel is still strong in the United States and China, despite economic challenges. In 2023, a poll by IPK found that approximately 80% of Chinese respondents wanted to travel, and that interest in Europe was higher than seen in previous studies as well. Airlines, hotels, and luxury product sellers have plenty of reasons to rejoice – the Chinese were the world's biggest spenders on tourism before 2020.[5] Similarly, recent surveys on potential American tourists suggest that heightened travel interest from the United States may persist even as the revenge travel narrative winds down.[6] While tourism may have been delayed due to economic and political concerns, we can still see that plans to travel are still in play for people in China and the United States.

Additionally, the middle classes in China and the United States are expanding at an unprecedented rate. This demographic shift is creating a new wave of potential tourists with the financial means to explore destinations beyond their national borders. Flexible working arrangements also make it more viable for ordinary employees to travel to more remote destinations without adversely impacting the amount of work they can get done.

Finally, the strengthening of the Chinese and American currencies against the Euro and Sterling has made travel to Europe more affordable for these tourists. Since the Global Financial Crisis in 2008, the dollar has seen significant growth. Similarly, China's GDP per capita has witnessed a remarkable increase over the past few years. This economic progress has effectively raised the competitiveness of the European tourism industry relative to other global destinations for American and Chinese tourists.

While the road to a full recovery in European tourism may still face some headwinds, we believe that the long-term picture looks very favourable for the sector. The major drivers of inbound tourism to

[4] UNWTO
[5] New York Times
[6] Deloitte

Europe are moving in the right direction, and we are confident that the industry will find plenty of room to grow in the coming years.

DON'T JUDGE AN OFFICE BY ITS EMISSIONS

Over the past few months, a significant backlash against ESG has been emerging in the investment space in the United States. Businesses and investors are quietly stepping away from climate pledges, sustainability agreements, and equity programs. European investment funds, by contrast, are not as willing to take such steps, and it is easy for them to look at the US and brush the trend off as nothing more than the Americans being dramatic (again). While there is undoubtedly an element of politics at play here, it would be wrong to dismiss it entirely as such.

Despite this, we think it's important to look critically at ESG and its role in finance today. There are reasons for growing hostility to ESG apart from the particulars of American politics. For one, between geopolitical volatility and high interest rates, global markets have had a turbulent few months. As times have gotten leaner and less certain, ESG to many has become a luxury, rather than a necessity, for investors and clients alike. There's also increasing indifference towards companies' superficial approach to corporate social responsibility, as they often resort to token gestures rather than substantive policy changes.

Despite these headwinds, we're confident that ESG considerations will remain an important part of how commercial real estate thinks about offices. However, we also believe that there's more to evaluating the viability of an office asset than its carbon footprint.

We've written about some of these factors in previous articles. In our view, successful offices in the era of hybrid work fit into two categories: large (100,000 square feet or larger), top-quality offices in tier-1 cities attracting multinational companies, and flexible offices that offer short lease terms and reduced moving costs. While ESG is important, it is by no means the only thing that determines cash flow or likelihood of success.

Equating the financial viability of an office asset with its carbon footprint ignores certain crucial factors. Assuming that tenants only want to occupy so-called "ESG-positive" buildings ignores the day-to-day interests of employees and businesses alike. Unless someone's burning tyres on the rooftop, employees rarely think about their offices' carbon emissions. LEED or BREEAM certifications won't sway an employee's opinions on return-to-office policies if their daily commute is unacceptable or if their office location is devoid of things to do after work. Roots in the Sky, a recently-bankrupted project that was supposed to bring a lush 1.4 acre urban rooftop to Blackfriars, is a case in point.

Business owners, meanwhile, are chiefly concerned with affordable rents and employee engagement. Carbon neutral office spaces are certainly a "nice to have", but in this macroeconomic environment, there is only so much that business owners are willing to pay for it. Investors face a risk of overlooking crucial practical factors when assessing office spaces. By narrowly concentrating on carbon neutrality, they may neglect other critical aspects like floor layout, location, and amenities. These additional factors significantly influence the investment potential of an existing office asset. In their wake, investors leave a swathe of fully occupied and clearly viable offices to gather dust. This is detrimental to the environment, cities, and investors themselves, who regularly throw the baby out with the bathwater.

Instead, it's important to pivot to ways in which investors can maximise the value of buildings by working on operations, amenities, and hospitality. Office spaces with lower ratings often trade at a

discount, and investors should consider ways in which those potential savings could be used efficiently to reduce carbon footprints, improve experiences, and raise the real value of the assets. Such thinking guides our office portfolio in London. Our improvement projects for 75 London Wall and 1 Golden Lane, for example, are in the process of taking well-located offices with good fundamentals and raising their environmental ratings to the highest standards. In the process, we believe we will be better able to cater to client needs while being responsible to the environment, our investors, and the surrounding community.

ICYMI

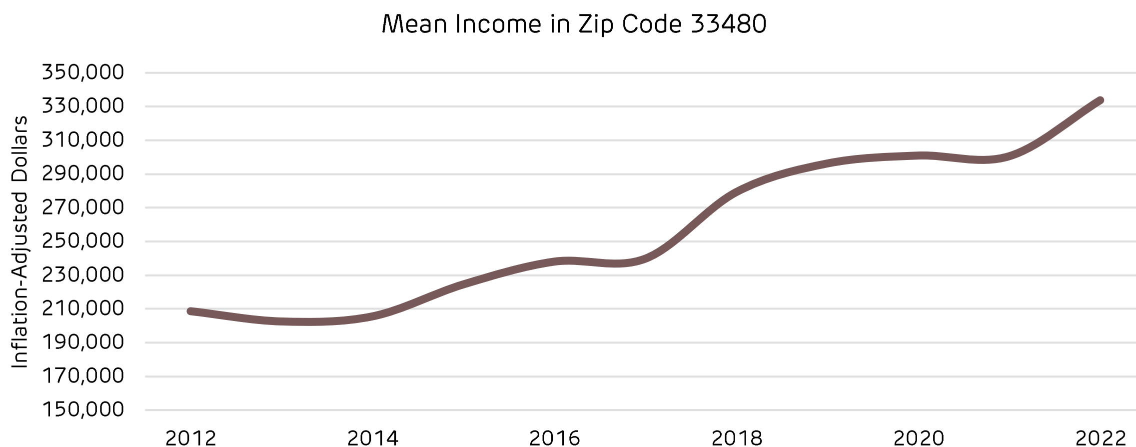
It's official: retail and offices are now investable again.

BEACHSIDE BUSINESS

Mike was looking at US house prices the other day when he nearly fell off his chair. The parents of a close friend of his had bought a place on Palm Beach Island a few years after the GFC price crash for under a couple million dollars, which felt like a good deal at the time, given the mortgage rates then. It turned out to be a very good bet: a nearby similar 3,500 square foot house just had sold for $9 million, despite nearly doubled mortgage rates and insurance probably having gone up even more (when it's even available). At $2,500 per square foot, the house price is mainly lot value, equating to over $20 million per acre of non-beachfront land.

It got Mike thinking about what had to have happened for the house price to increase by a factor of five over the previous decade. It's not as if the average person working the average job in Palm Beach has seen their income increase by five times. The carrying costs put a purchase even more out of reach, even if salaries did grow that much. It's more likely that the average worker and the average job on Palm Beach Island has changed dramatically. Today, it is likely that the average job of someone living in a multimillion-dollar house on the Island isn't actually "on" the Island anymore.

Figure 2. Working Overtime on the Beach[7]



Technological advances such as remote work, cloud computing, 5G, and high-speed broadband – subjects that we have discussed at length in previous papers – have combined to turn Palm Beach into a place where the limit to one's salary is not constrained by primarily doing work *in* Palm Beach – which is one of the reasons why the mean salary has increased over 60% over the past decade. While

[7] American Community Survey via US Census

people could theoretically log in from anywhere in the early 2000s through software like Citrix Remote Access (remember that?), the technologies supporting remote work have finally reached maturity for the mass market. We've discussed previously that one's salary should closely approximate one's marginal productivity, and today that productivity can be achieved almost anywhere, be it a Midtown Manhattan office block or the den of a $9 million Palm Beach house. And, for a New Yorker or a Londoner, $2,500 per square foot is "entirely reasonable" for a good home.

So, what are the implications for other types of real estate? And how can we apply what we've seen over the past decade on Palm Beach houses to similar price fluctuations for assets everywhere? Technological and cultural shifts impact where people want to locate. We've talked about it before in our paper about what makes people choose to live in the places they do. Still, these shifts not only impact land along a certain desirability gradient – where Florida houses with higher natural advantages in consumption command higher prices than Cleveland houses with lower ones – but also what sort of land could be valuable for certain purposes, entirely.

Take the case of industrial warehouses. Fifteen years ago, you couldn't give away warehouse space, both in terms of rents and real estate investors' desire to commit capital to the sector. Industrial production had halved among most developed economies. In the US it fell from over 25% of GDP to just 12% in the four decades leading up to the GFC. Warehouses were in high supply, and rents had gone nowhere for a long time. That is, until "Amazon" became a household name and "e-commerce" added a new use case for the spaces.

Suddenly, demand for warehouses skyrocketed, even if what was on site wasn't the kind of warehouse a 3PL or e-commerce provider necessarily wanted. New warehouses could be built on the now-valuable industrial-zoned land that met their needs, much in the same way that "Old Florida" houses in Palm Beach get torn down for the underlying lot value faster than you can say "no state income taxes".

In the UK, due to slow planning authorities, the rigid supply curve means increased demand significantly boosts land value with new use cases. For instance, a multi-let industrial park we bought post-GFC now trades at four times the price within 15 years, with doubled rent and halved cap rate.

Any one of our readers in the US will hear a familiar story with respect to nearly every kind of real estate in the Sunbelt. The population of Texas went from 20 to 30 million in the last two decades alone, and those extra 10 million people needed homes and e-commerce warehouses, and even offices and retail, too.

Great investing requires understanding how technological and demographic shifts affect land values. While trends in real estate may seem predictable in retrospect, they are often unclear as they unfold and require real effort to spot. How many times have we seen new technologies promise to lead a remote-work revolution, only to fizzle out after? It took a (hopefully) once-in-a-lifetime pandemic to transform what was a novelty into normalcy, and even then, we're noticing that affects are different depending on what part of the world you're in. While we're still dealing with the aftershocks of that pandemic, one of the things that it has brought into focus is just how important underlying land value is to long-term investment values.

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