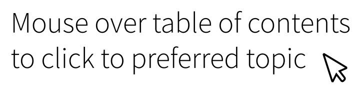
March 2021

Asia Pacific Capital Markets

Asset yields and interest rates:

What's priced in and how will yields compress from here?

Contents



01 Executive summary

Interest rates in Asia Pacific have fallen sharply over the last year, providing a conducive environment for real estate investments and support for capital values. While asset yields have compressed to some extent, they have not fully priced in the current low rates.

1. **Investors seem to have priced in some increase in interest rates in Sydney and Singapore** over the next five years. Thus, we expect office cap rates in these cities to remains stable even if interest rates rise by 100bps.

2. **Logistics Yields could potentially compress by a further 50-100bps over the next five years, driven by** strong growth in capital flows into the sector, robust demand tailwinds and continued improvement in tenancy profiles. We expect logistics assets to become a core part of Asia Pacific institutional real estate portfolios over the next five years and the yield gap between office and logistics assets to narrow. Logistics spreads have compressed by 60 bps more than other sectors across the region in 2016-2020 as investor allocation to the sector for diversification increased.

3. **Retail assets could be contrarian investment opportunities as yields have expanded sufficiently in Singapore, Hong Kong and Sydney**. Retail yield spreads moved 50bps wider than office spread adjustments over the past 4-6 years, and investors may have become too cautious towards the sector as the structural changes from online retail have already been at play and adjusted rents.

4. **Investors seem more cautious towards Sydney office rents, see bottoming in Hong Kong outlook:** Sydney office yield spreads widened 50bps further than other Asia Pacific cities, potentially signalling investors believe rents could weaken further. If conditions surprise on the upside, there could be further office yield compression in Sydney. On the other hand, there is some **bottoming out in Hong Kong rents or rates**, as yield spreads are not pricing in any future rate rises.

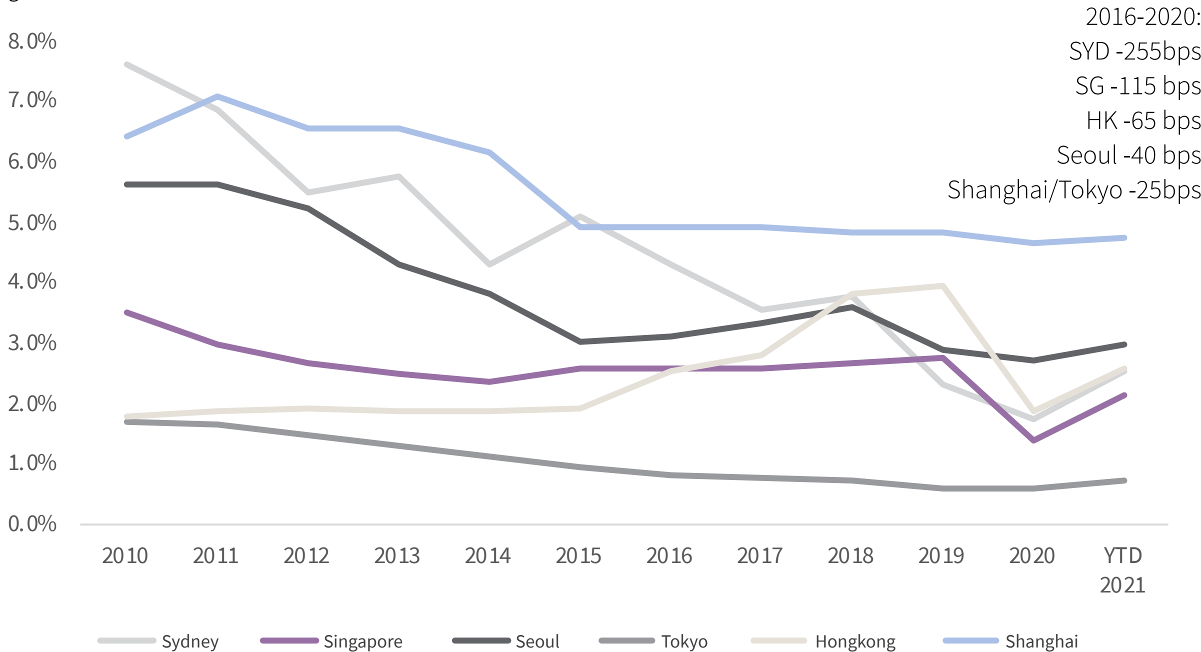
5. **Multifamily and build-to-rent yields may compress further in Japan and Australia**, as globally, yields for this asset class have traded below office yields as institutional capital seeks exposure to the resilient, low-volatility sector for diversification. In Asia Pacific, we also expect structural changes to government policy incentives, a new generation of renters in China, Japan and Australia and low interest rates to act as catalysts that would boost investments into the asset class.

02
Asia Pacific asset yields have not fully priced in low interest rates

In the last four years, interest rates fell 30-250 bps across Asia Pacific, as slower economic growth and low inflation rates allowed for more accommodative monetary policies globally. While bond yields in Australia, Singapore and Hongkong retraced 70 bps year to date, borrowing costs in these countries are still 60-125bps lower than 2018 levels.

As interest rates declined, real estate yields also compressed to some extent but have not fully priced in the current low rates. Markets seem to have priced in some rate increases for some cities and seem to be more cautious about Sydney and more comfortable with Hong Kong.

Figure 1: Cost of Debt for institutional investors in Asia Pacific 2010-2020

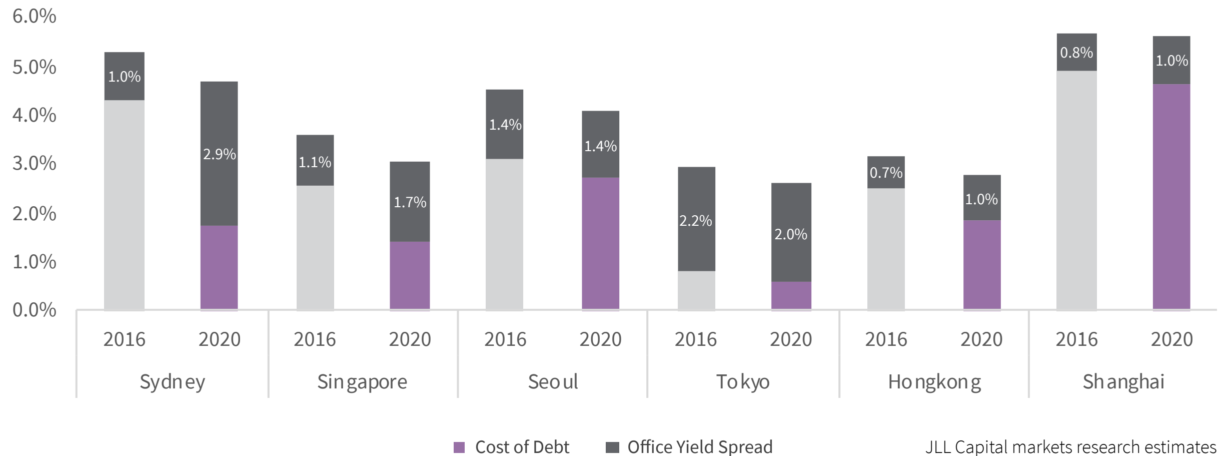


Source: JLL Capital markets research estimates

Our key observations are below:

1 **Office Yield Spreads have priced in 50-100 bps increase in interest rates in Sydney, Singapore and Hong Kong:** In 2016-2020, office spreads over cost of funding widened by 190 bps in Sydney, 60 bps in Singapore and 20bps in Hong Kong. While bond yields have risen by 70 bps year to date, we do not expect office yields to expand, as these increases seem to have been largely priced in by investors. In Tokyo and Seoul, yield spreads are stable as cost of debt did not decline significantly.

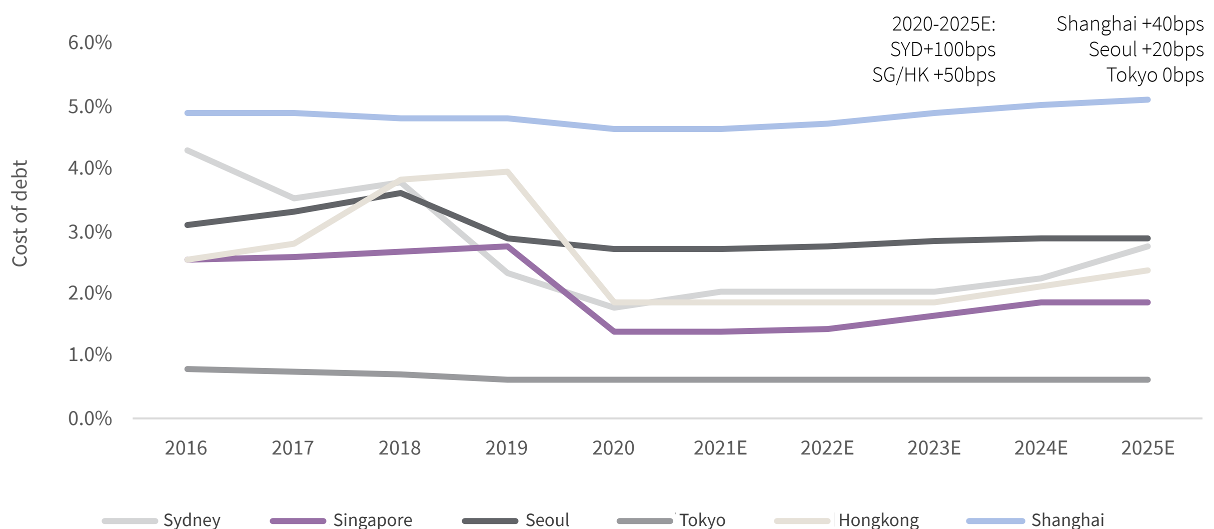
Figure 2: Prime Office Yields and Cost of Debt in 2016 and 2020



JLL Capital markets research estimates

Another indicator that investors have priced in interest rate increases in Sydney, Singapore and Hongkong can be observed in logistics yields, which adjusted less in these cities, relative to other Asia Pacific cities. These expectations seem sensible, as corroborated by the forecast bond yields in these countries.

Figure 3: Debt Costs Are Expected to Rise 20-100bps in Asia Pacific in 2021-2025

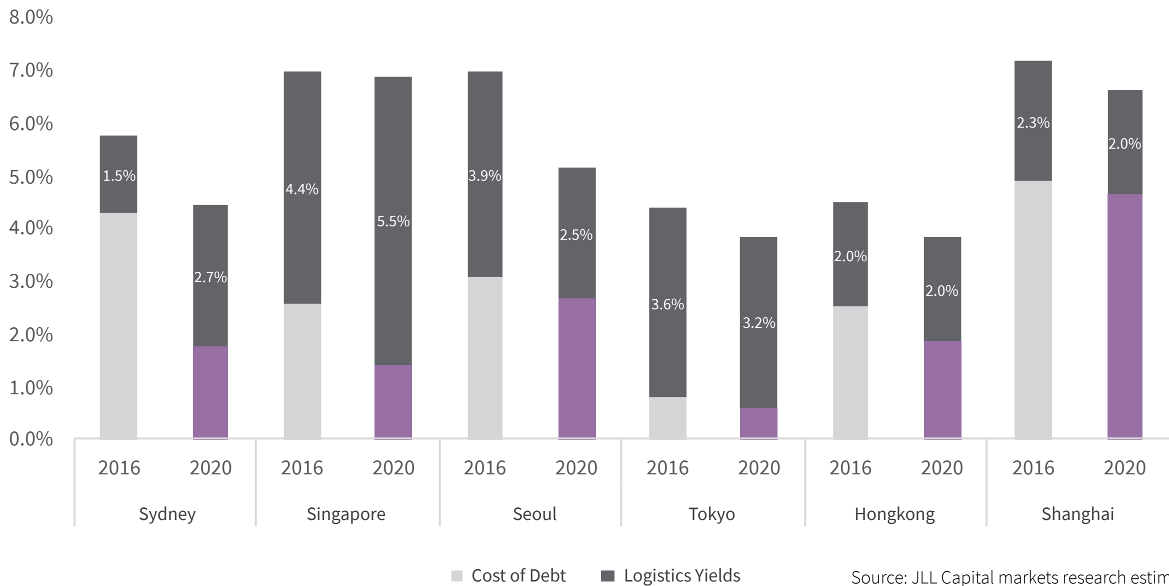


Source: JLL Capital markets research estimates

Investors seem more cautious towards Sydney office rents, more comfortable with Hong Kong outlook: Sydney office yield spreads widened 50bps further than other Asia Pacific cities, potentially signalling investors believe rents could weaken further. If conditions surprise on the upside, there could be further office yield compression in Sydney. On the other hand, there is some **bottoming out in Hong Kong rents or rates**, as yield spreads are not pricing in any future rate rises.

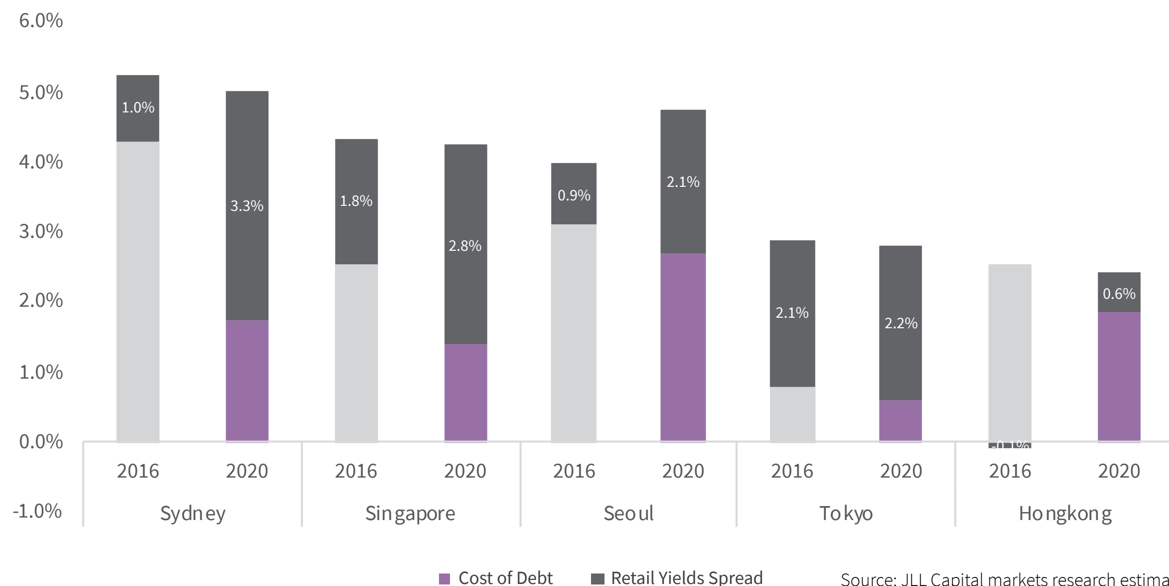
2 **Logistics yield spreads compressed by 60bps more than other sectors** in 2016-2020 across the region. This occurred even in cities where financing costs did not decline significantly. Logistics assets clearly gained investment interest in recent years. In Seoul, logistics yields compressed 180 bps, outperforming the 40bps decline in funding costs. Logistics yield spreads widened in Sydney and Singapore by 110-120 bps, mostly because of the steep decline in interest costs.

Figure 4: Prime Logistics Yields and Cost of Debt in 2016 and 2020



3 **Retail yield spreads moved 50bps wider than office spread adjustments**, as investors reduced their exposure to the sector amidst structural changes brought on by online retail. We think investors could be too cautious as these structural changes have already been at play and adjusted rents over the past 4-6 years.

Figure 5: Retail Yields in Asia Pacific 2016-2020

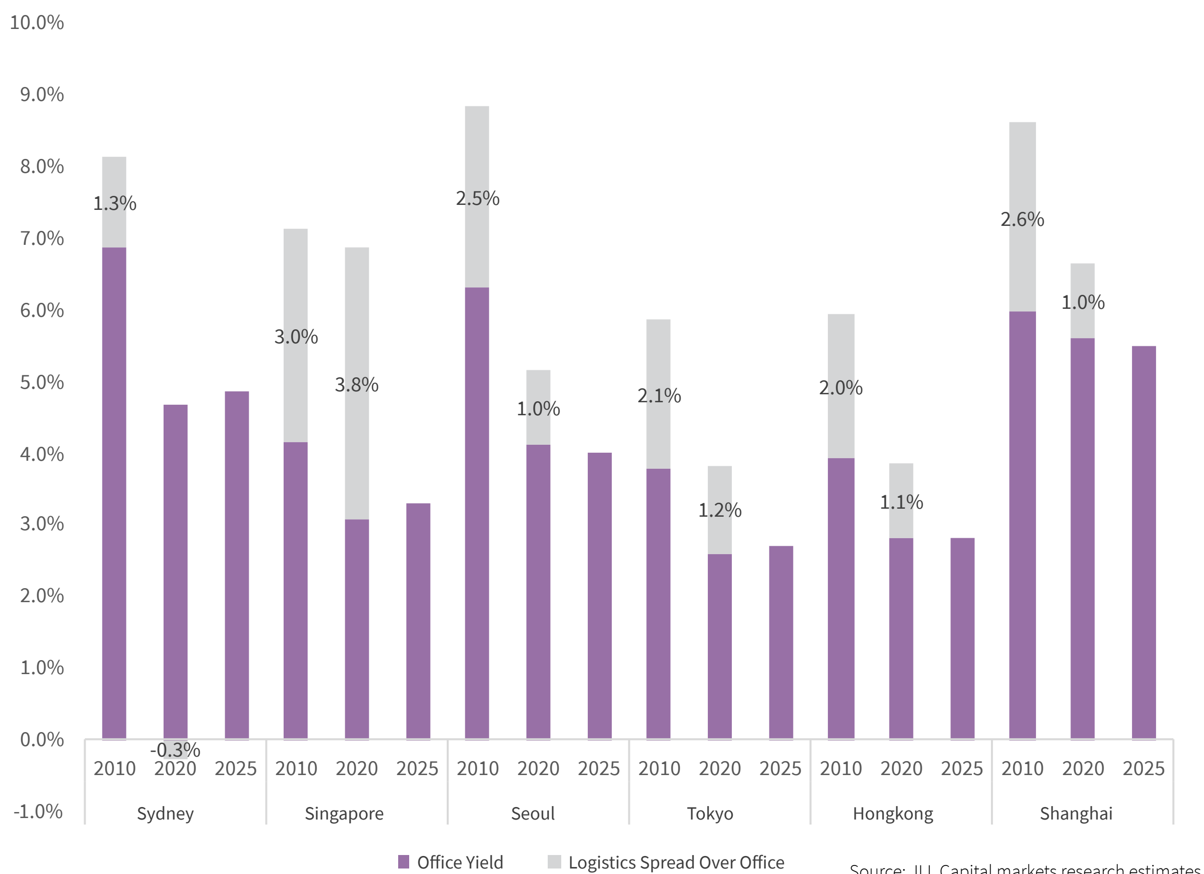


03
Expect further yield compression for multifamily, Singapore & selected retail

Based on the yield adjustments, we came to the following conclusions:

1. **Logistics Yields in Tokyo, Hong Kong, Seoul, Shanghai and Singapore could compress a further 50-100 bps by 2025**. Over the past decade, the spread between office and logistics assets in Asia Pacific have narrowed by 100-150bps. In Sydney, logistics yields are now matching office yields. In Tokyo, retail and residential yields have also compressed to match office yields. We expect logistics assets to become a core part of Asia Pacific institutional real estate portfolios over the next five years due to their stable income profile, strong structural demand drivers and diversification benefits. This could further narrow the yield gap between office and logistics assets. In Singapore, we expect logistics yields to compress by 100-150bps, but still sit 250bps above office yields due to the shorter land tenure of most logistics assets in the city. In China, yield compression could lower than 50bps as supply remains elevated but demand drivers are still intact. Globally, logistics yields continued to compress. In New York, Los Angeles and London, logistics yields now match office yields

Figure 6: Logistics Yields over office yields in Asia Pacific 2010-2025



Source: JLL Capital markets research estimates

Figure 7: Prime Logistics Yields & Y-oY Yield Shift (Q3 2020 vs Q3 2019), 26 Global Metro Areas

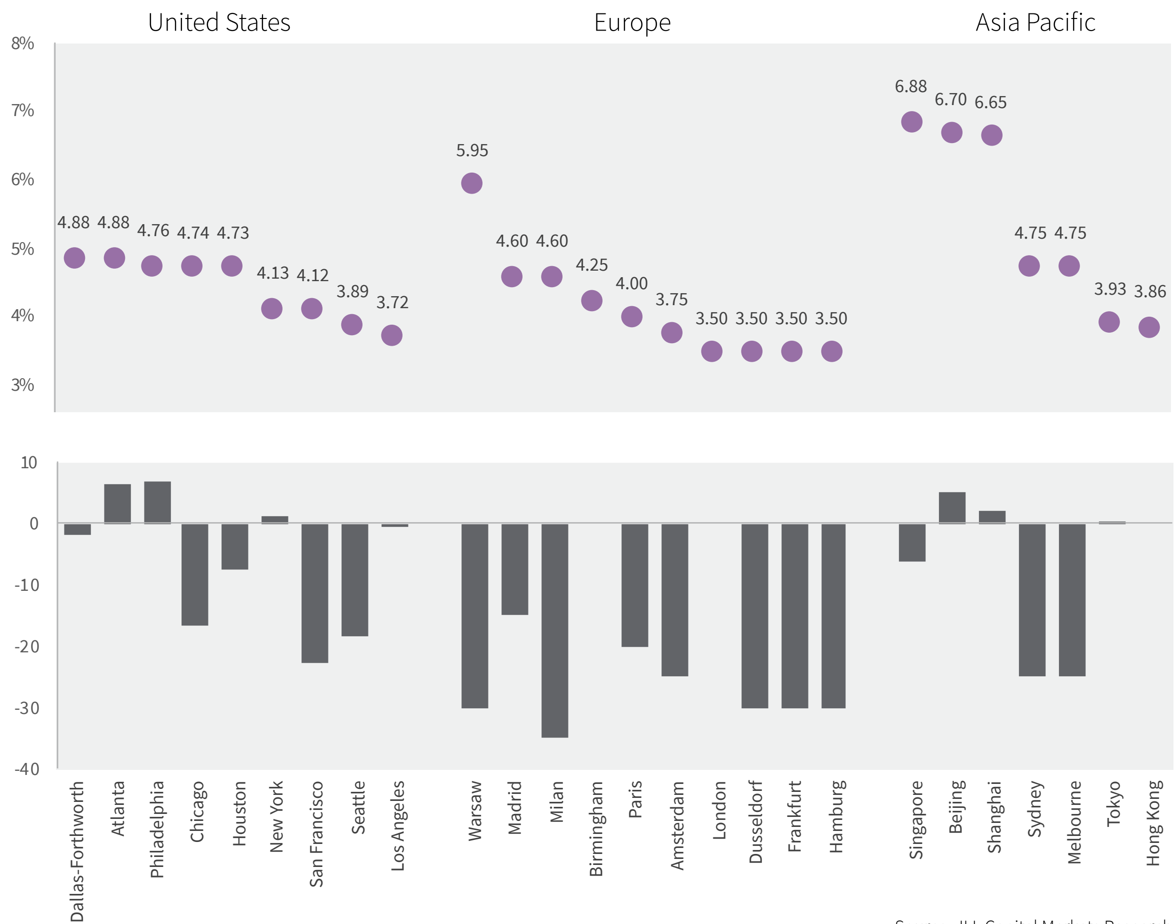
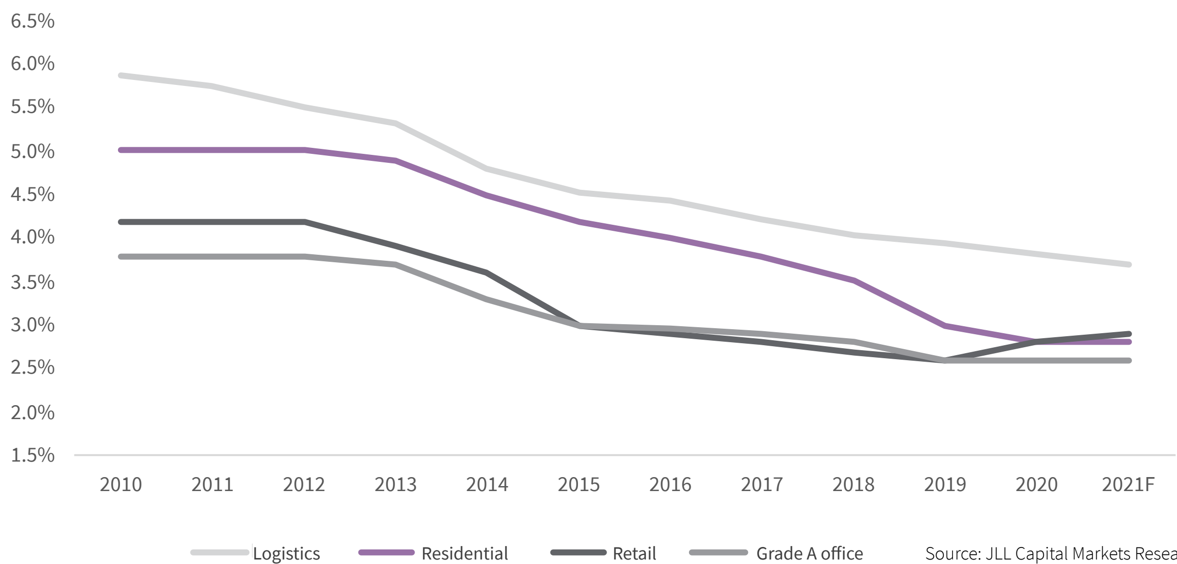
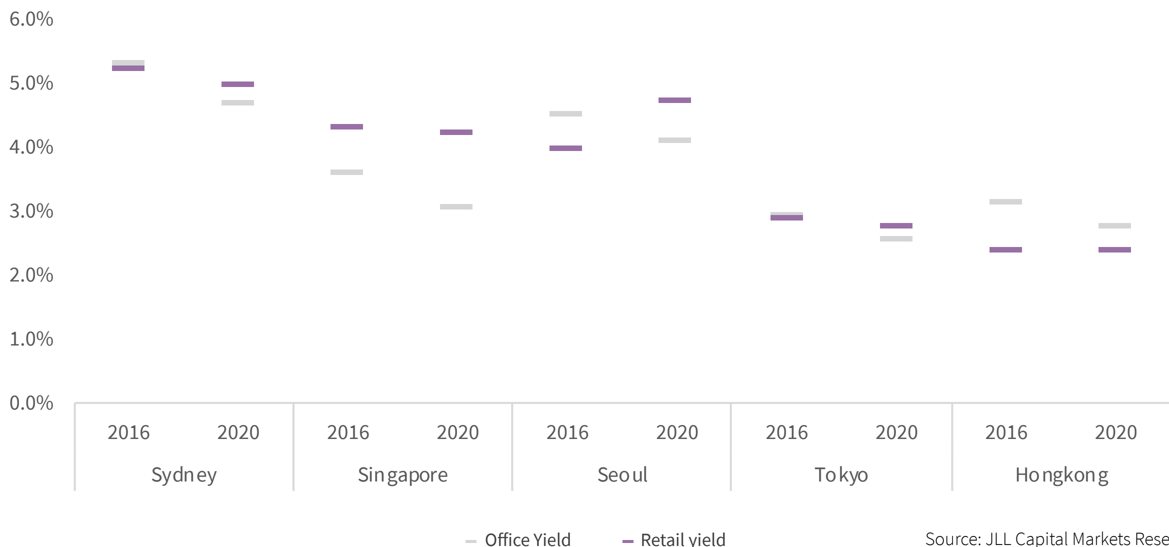


Figure 8: Asset Yields in Tokyo in 2010-2021



2 **Retail assets could be contrarian investment opportunities as yields have expanded sufficiently in Singapore, Hong Kong and Sydney:** Retail rents have already adjusted over the last 4-6 years due to structural changes to the sector. In Singapore, Sydney and Hong Kong, retail spreads widened by 40-50 bps more than office spreads did.

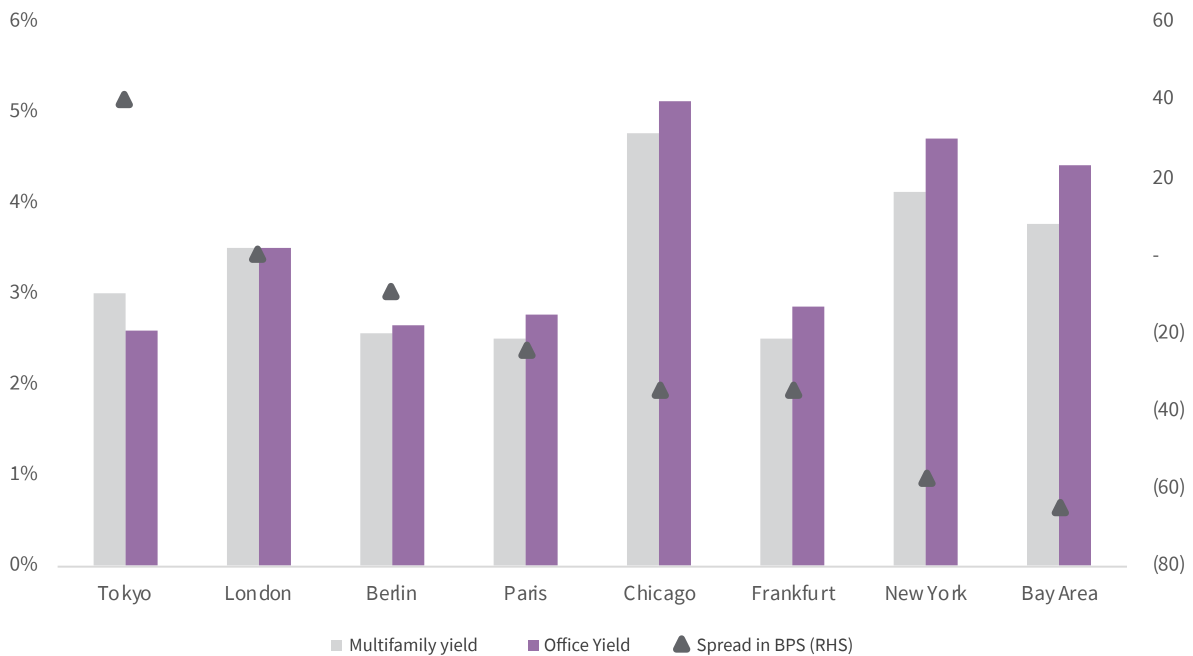
Figure 9: Retail Yields vs Office Yields in Asia Pacific 2016-2020



Source: JLL Capital Markets Research

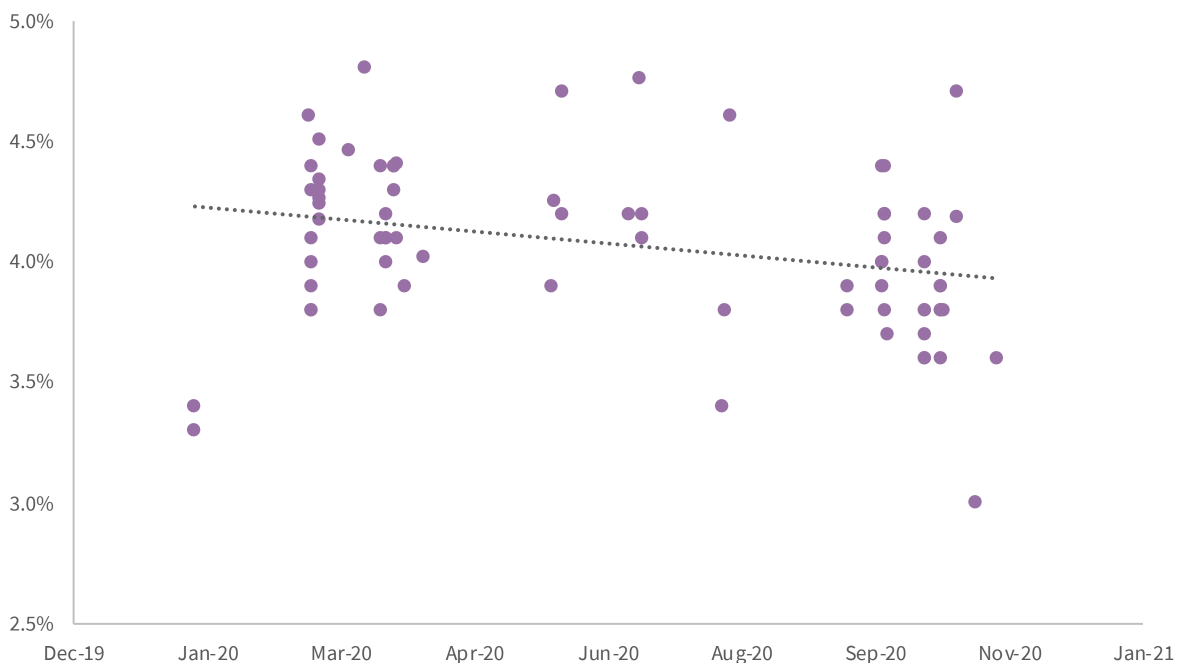
3 **Multifamily and build-to-rent yields may compress further in Japan and Australia**, as globally, yields for this asset class have traded below office yields as institutional capital seeks exposure to the resilient, low-volatility sector for diversification. In Asia Pacific, we also expect structural changes to government policy incentives, a new generation of renters in China, Japan and Australia and low interest rates to act as catalysts that would boost investments into the asset class.

Figure 10: MF Yield Spread Over Office Yield By Gateway Cities



Source: JLL Capital Markets Research

Figure 11: MF Yields in Tokyo Compressed in 2020

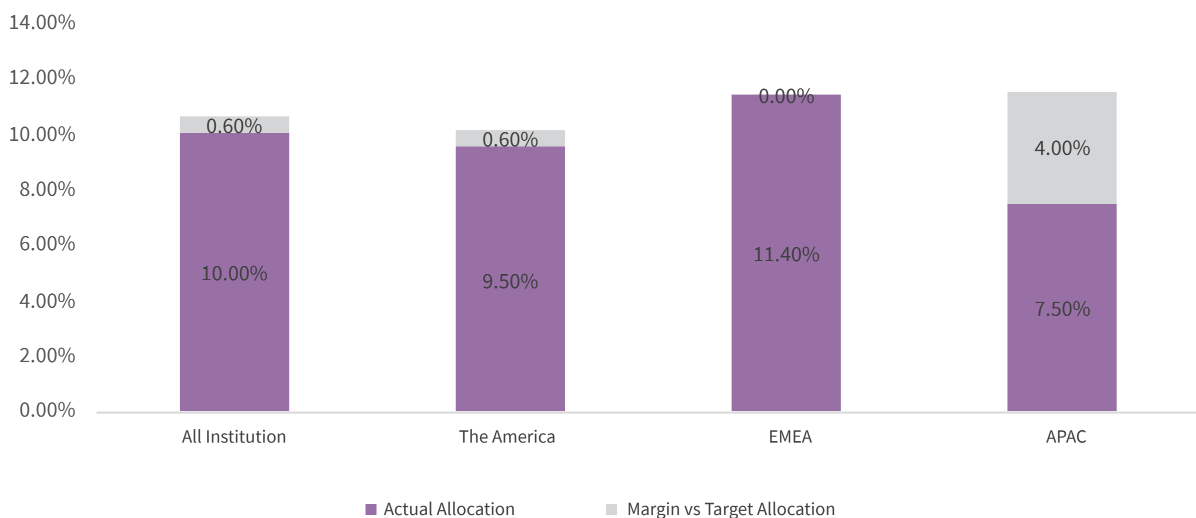


Source: JLL Capital Markets Research

04
Fund flows and inflation expectations are supportive of stable to lower yields

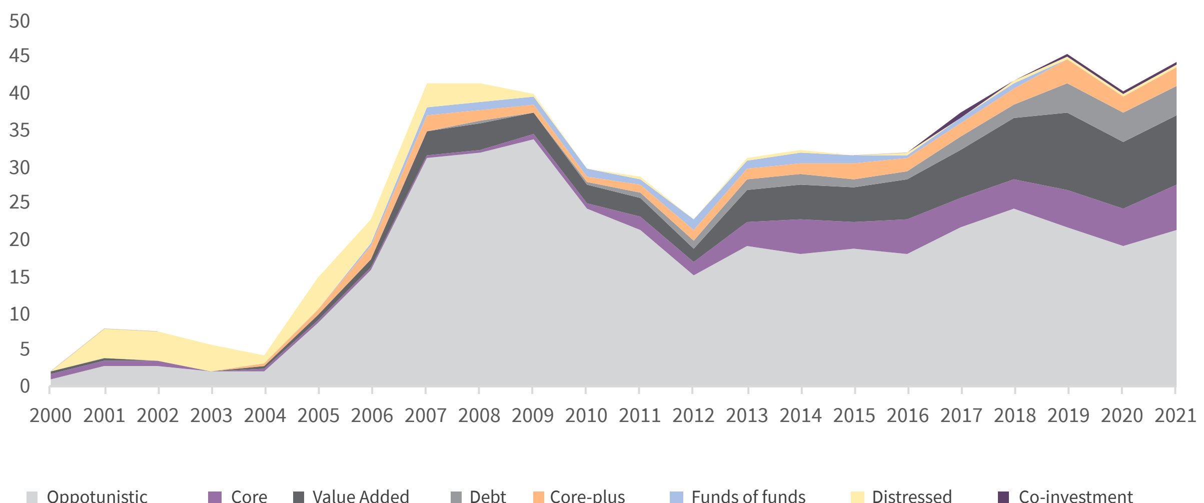
Over the past year, despite worsening economic conditions, Asia Pacific institutional investors remained committed to deploying capital into real estate. According to Hodes Weills and associates, Asia Pacific institutions target to place 11.5% of their funds into real estate but actual allocation is well beneath this level, at 7.5%. In addition, although fund raising activities moderated in 2020 in the face of the pandemic, core, value-add and opportunistic strategies all have seen a boost in raising activity early this year. Overall private equity real estate dry powder in Asia Pacific have now bounded back strongly, nearing its historical peak.

Figure 12: Target and Actual Allocation to Real Estate by Location



Source: Hodes Weil, JLL estimates, 2020

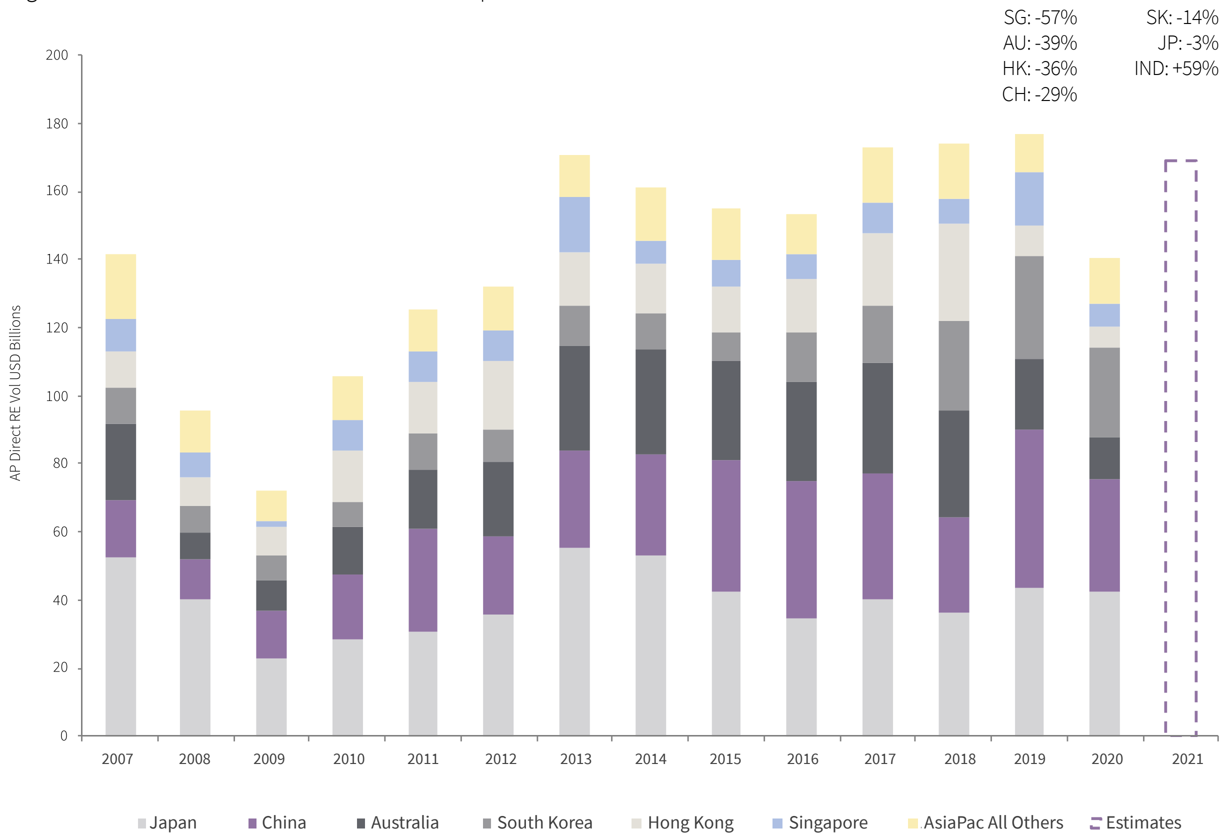
Figure 13: Asia Pacific Dry Powder 2000-2021



Source: JLL Capital markets research estimates

Capital deployment has slowed in 2020 due to travel restrictions and uncertainty over COVID-19 infection rates and the relevance of the office. Asia Pacific direct real estate transactions fell 20% in the year but recovered from July 2020. By 4Q2020, transaction volumes were flat year on year as most countries started to effectively reduce infection rates with targeted lockdowns. In 1H2021, vaccine rollouts have been initiated and we expect investment volumes to rise by 15-20% in 2021. The competition of assets is likely to pave the way for further yield compression so long as interest rates are relatively stable.

Figure 14: Asia Pacific Real Estate Transactions Expected to Rise 15-20% in 2021

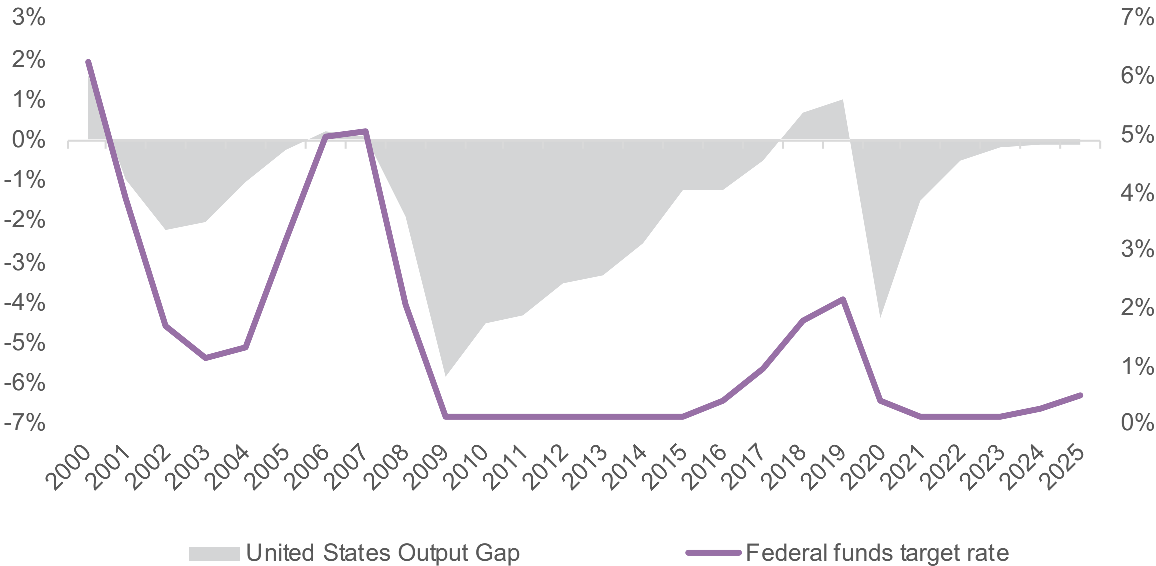


Source: JLL Capital Markets Research

US rate hikes unlikely to occur before 2022

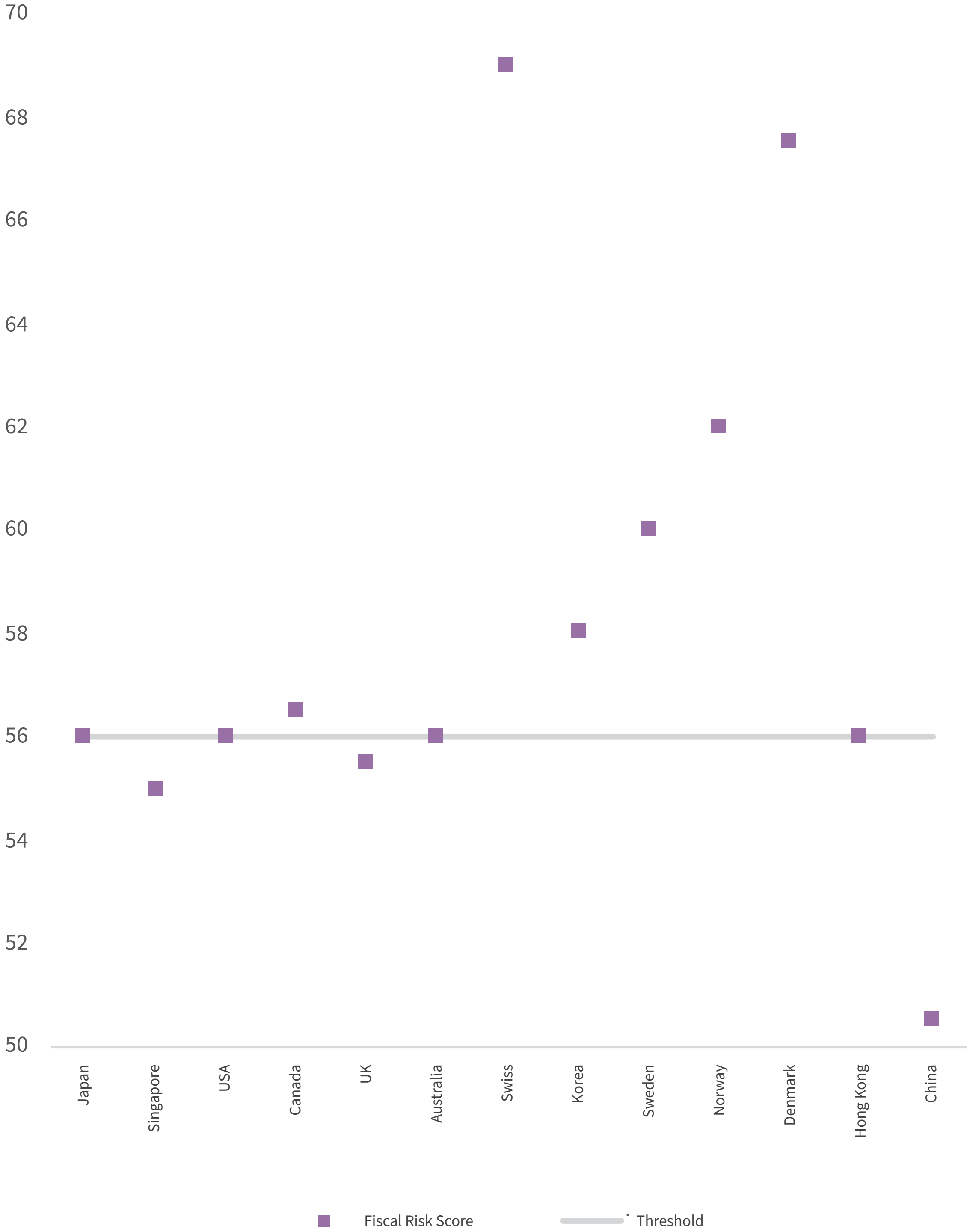
While global bond yields have risen in 30-100 bps over the last three months, we think the likelihood that a sustained and substantial increase in Asia Pacific interest rates remains low. Historically, rates in Asia track US interest rates closely and the US Federal Reserves had raised policy rates only when the US output gap narrows below 1%. The IMF expects this to occur only in 2022-2023. In mid-2020, the US Federal Reserves also adopted a policy of "average inflation targeting", which may allow them to remain dovish even if inflation rises above 2% and thus delay a rate hike beyond 2023.

Figure 15: United States Output Gap & Fed Fund Rate



Source: Oxford Economics, JLL, as at February, 2021

Figure 16: Fiscal Risk Monitoring Score



In their latest outlook, the IMF also commented that most of Asian economies' fiscal positions do not allow for further substantive fiscal stimulus, reducing the likelihood of another round of government bond issuance. This may imply that the upward pressure recently experienced in Asia Pacific interest rates due to governments raising funds may be largely absent going forward.

05
Australia

Economy and Bond Yields

The Australian economy received significant fiscal and monetary policy support over 2020, providing a level of downside protection from the impact of COVID-19. It is estimated that Australia's GDP only contracted by 2.8% in 2020. While the full-year GDP result is expected to be negative, the Australian economy exited technical recession in 3Q20 with quarterly GDP growth of 3.3%. Oxford Economics project the Australian economic recovery will gather momentum with GDP growth of 2.9% in 2021 and 3.2% in 2022.

The Australian Bureau of Statistics (ABS) reported that total employment was 12.91 million people in December 2020 – only 0.7% below the pre-COVID peak recorded in February 2020. The lead indicators for the Australian labour market have started to firm. ANZ's Job Advertisement Series (January 2021) revealed that job advertisements increased for an eighth successive month and are now 5.3% higher than the pre-pandemic level.

The Reserve Bank of Australia (RBA) eased monetary policy to an all-time low through COVID-19 with the official cash rate falling to 0.10%. The RBA has implemented a range of policy measures for the Australian economy – bond purchases, the Term Funding Facility, the 3 year bond yield target, the record low cash rate for all borrowers and helped ensure that the banking system is able to provide the credit that is needed for the recovery.

The RBA expects the official cash rate to remain unchanged through 2024. The RBA stated that very significant monetary policy support will be required in Australia for a few years and that inflation should be within the 2% to 3% target range before they would consider raising the official cash rate. To meet this inflation target, the Australian economy would need to experience a tighter labour market and stronger wages growth. Australian Government bond yields have traded in the 0.60% to 1.40% range over the past 12 months. Over the next 3-4 years, bond yields are forecast to remain low with Oxford Economics projecting they move out to 1.50% by 2024 and 2.80% by 2030.

Financing Costs for Investors

Bank lending criteria has remained disciplined with conservative Loan-to-Value (LTV) and Interest Coverage Ratios (ICRs). Offshore banks and non-bank lenders' are looking to increase their exposure to the Australian commercial property sector and typically compete on loan tenor. Australian banks will normally provide loan facilities for up to five years, but a number of offshore banks and non-bank lenders' will provide 7-10 years (at an additional margin).

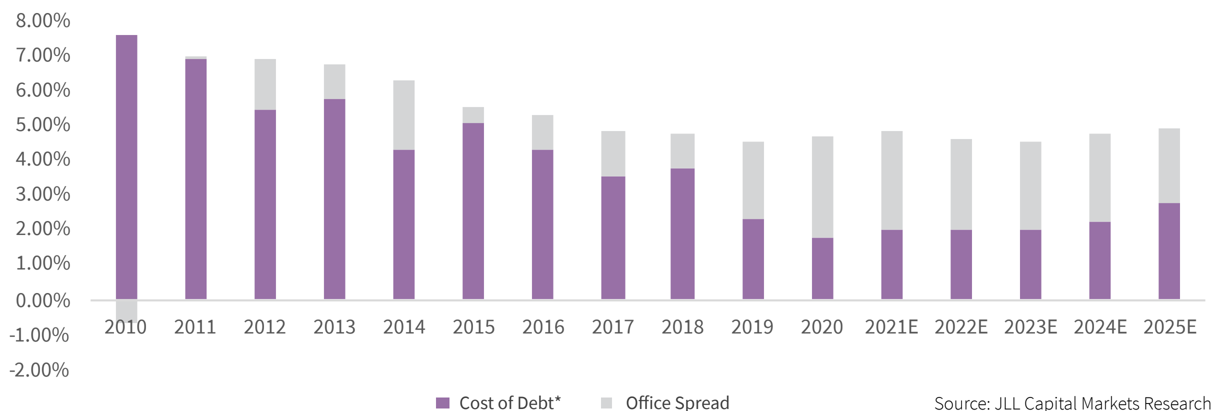
Publicly available information on debt market pricing is limited in Australia, so we have historically adopted corporate bond market pricing as a proxy for the cost of debt. The BBB-rated corporate bond yield moved out by 100 basis points from 1.81% in February 2020 to 2.89% in April 2020 reflecting the potential economic impact of COVID-19. The resilience of the Australian economy and expectations of a low interest rate and inflation environment has led to a sharp reduction in the BBB-rated corporate bond yield to 1.49% in January 2021.

What could happen to Sydney office yields?

Australian prime office yields were largely unchanged in 2020 as the prime grade office sector displayed its defensive characteristics. The price discovery journey was relatively short with liquidity returning to the office sector in 3Q20. A number of benchmark sales were recorded across different geographies highlighting that prime grade assets with strong covenants and long WALEs were proving resilient.

The Sydney CBD prime equivalent yield range sits between 4.38% and 5.00%. The spread between office yields and the real risk-free rate (implied risk premium) is wider than historical benchmarks. However, the softer leasing market conditions and potential for higher vacancy is expected to see yield decompression for assets with income risk in the short-term. JLL projects the Sydney office market will start to recover in late 2021 and prime equivalent yields are forecast to compress to 4.25% to 4.75% by the end of 2022.

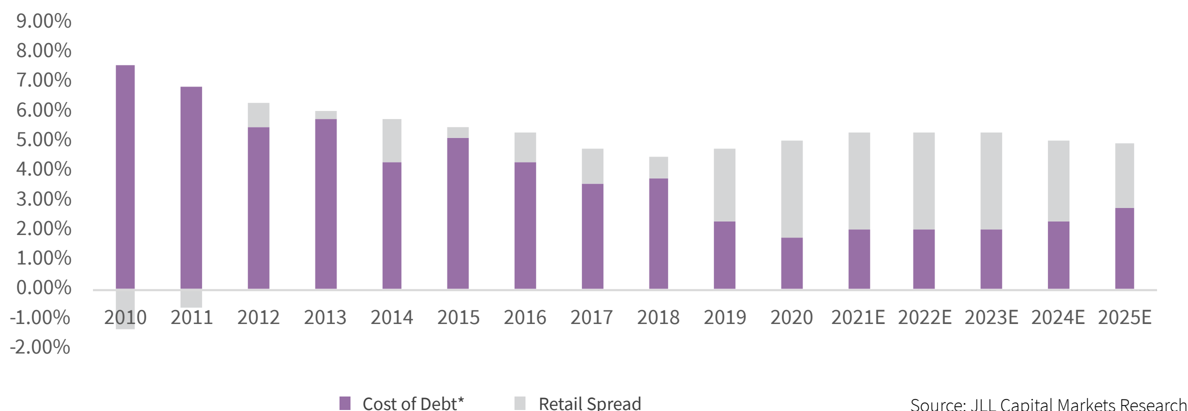
Figure 17: Sydney Office Yield Spread (%)



Source: JLL Capital Markets Research

Sydney retail yields have expanded 50bps over the past two years, increasing the spread over financing cost to 330bps. We expect mild yield compression by 2025.

Figure 18: Sydney Regional Shopping Centres Yield Spread (%)



Source: JLL Capital Markets Research

06
Japan

Economy and Bond Yields

The Japanese economy contracted by about 4-5% in 2020. While the economy was 8.3% weaker year on year in 2Q2020, preliminary estimates showed a mild 3% qoq recovery in 4Q2020. This implies that two-thirds of the 'lost GDP' caused by the pandemic has already been recovered and fundamentals remain intact. Economists expect GDP to recover back to the previous peak by end of 2021.

IMA Asia expects Japan's economy to expand by 2.5% in 2021 and 1.3% in 2022, driven by a recovery in consumer spending and exports. The government launched a massive fiscal stimulus package worth JPY 73 trn, equivalent to 14% of GDP. The 2021 starting budget is 4% higher than 2020's initial budget and more supplementary spending may be added to stimulate the economy. We expect the Bank of Japan to keep the current quantitative easing policy for 2021 or longer, until the economy recovers to pre-COVID levels. We expect monetary policy to be one of the most accommodative in Asia Pacific.

Financing Costs for Investors

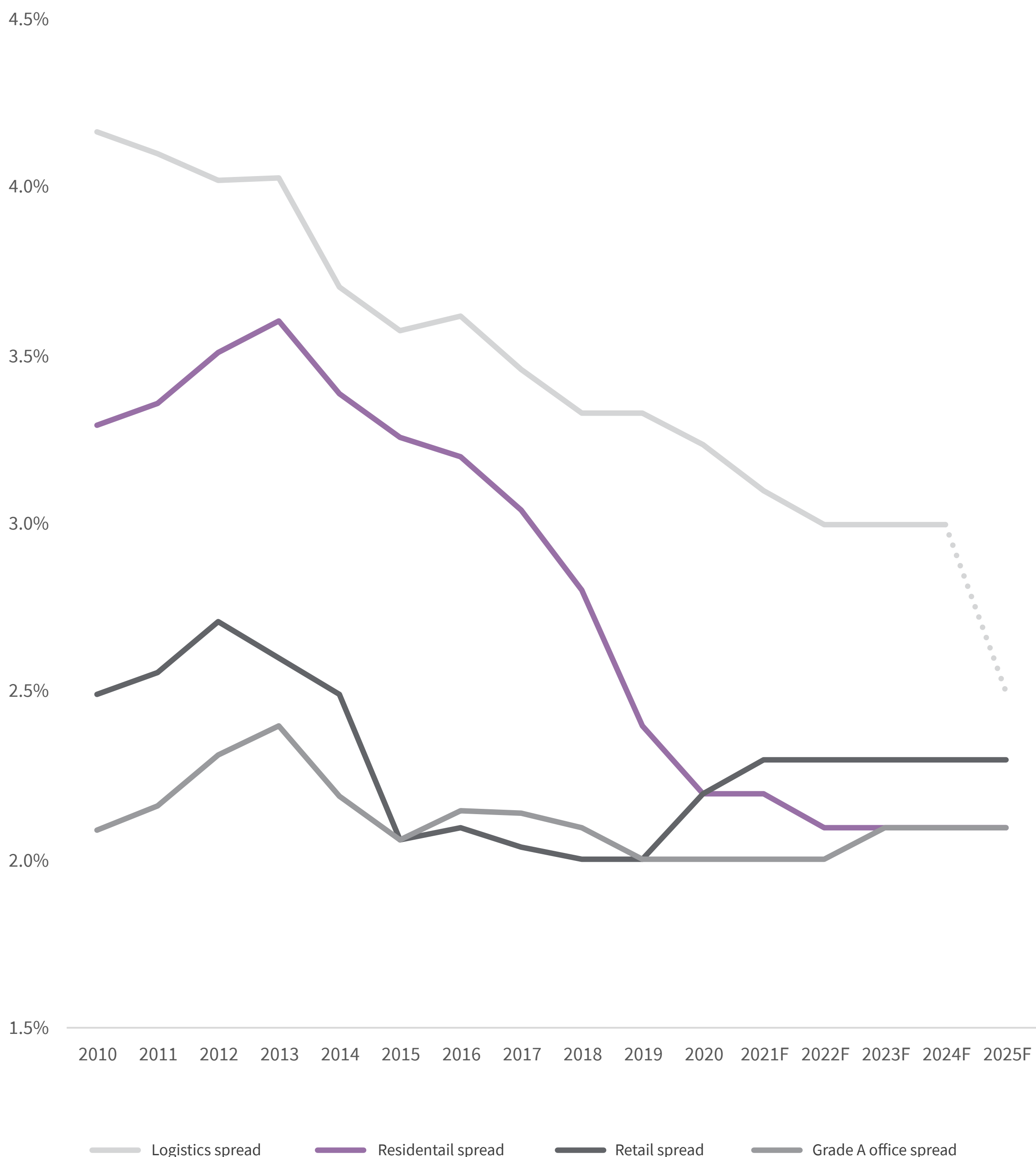
The Bank of Japan has adopted quantitative easing from 2013. Since 2016, it has maintained a negative policy rate. With deflation accelerating to 1.2% yoy in Dec 2020 and expectations of no inflation in 2021-2022, we expect the negative interest rate policy to be maintained for the next 3-5 years.

Financing Costs for Investors

Over the last ten years, yields for retail and multifamily assets have compressed to converge with office yields to sit just 200 – 220 bps above the cost of debt. The sharpest compression was experienced by the multifamily sector, of 100bps in the last 3 years as more investors took interest in the sector given the large stock and scalability, diversification benefits and tight supply-demand dynamics. The retail sector experienced some yield expansion in 2020 due to structural uncertainties.

Over the next 5 years, we expect funding costs and asset yields to remain relatively stable as Japan's growth outlook is unlikely to change materially. However, there is potential for yields for high quality, modern logistics assets to compress a further 50-80 bps over the next few years given strong fund flows into the sector and the large yield gap between logistics and other asset classes.

Figure 19: Japan Office, Retail, Multifamily and Logistics Yield Spreads



Source: JLL Capital Markets Research

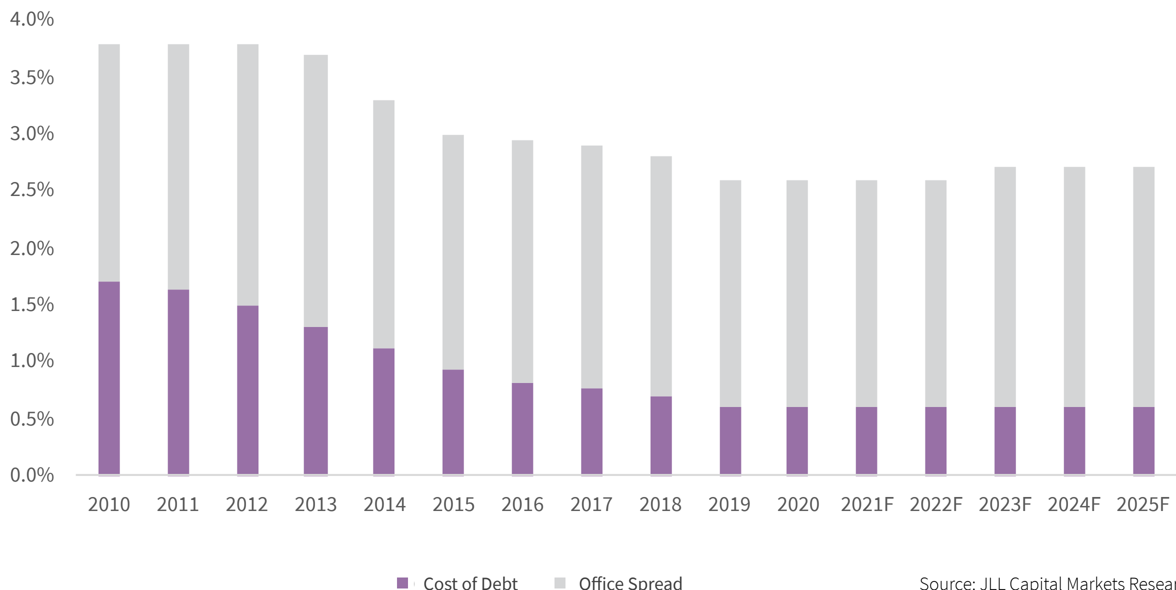
What Could Happen to Tokyo Prime Office Yields?

Prime office yields have hovered about 200-220bps above the cost of debt in Tokyo for the last 10 years.

Despite COVID 19, there has not been a significant exodus of large office tenants. We expect more occupiers to adopt flexible working arrangements over the next few years, and gradually make minor adjustments to their office footprint. There could be some erosion in net office absorption, but the magnitude and speed are unpredictable. Prime office vacancies are still very low in Tokyo and should cushion this impact somewhat.

As we expect interest rates to remain relatively stable over the next five years, we think Tokyo prime office yields could stay flattish till 2025. There is a risk of marginal yield expansion should rental prospects become more negative in 3-5 years' time.

Figure 20: Tokyo Office Yield Spread



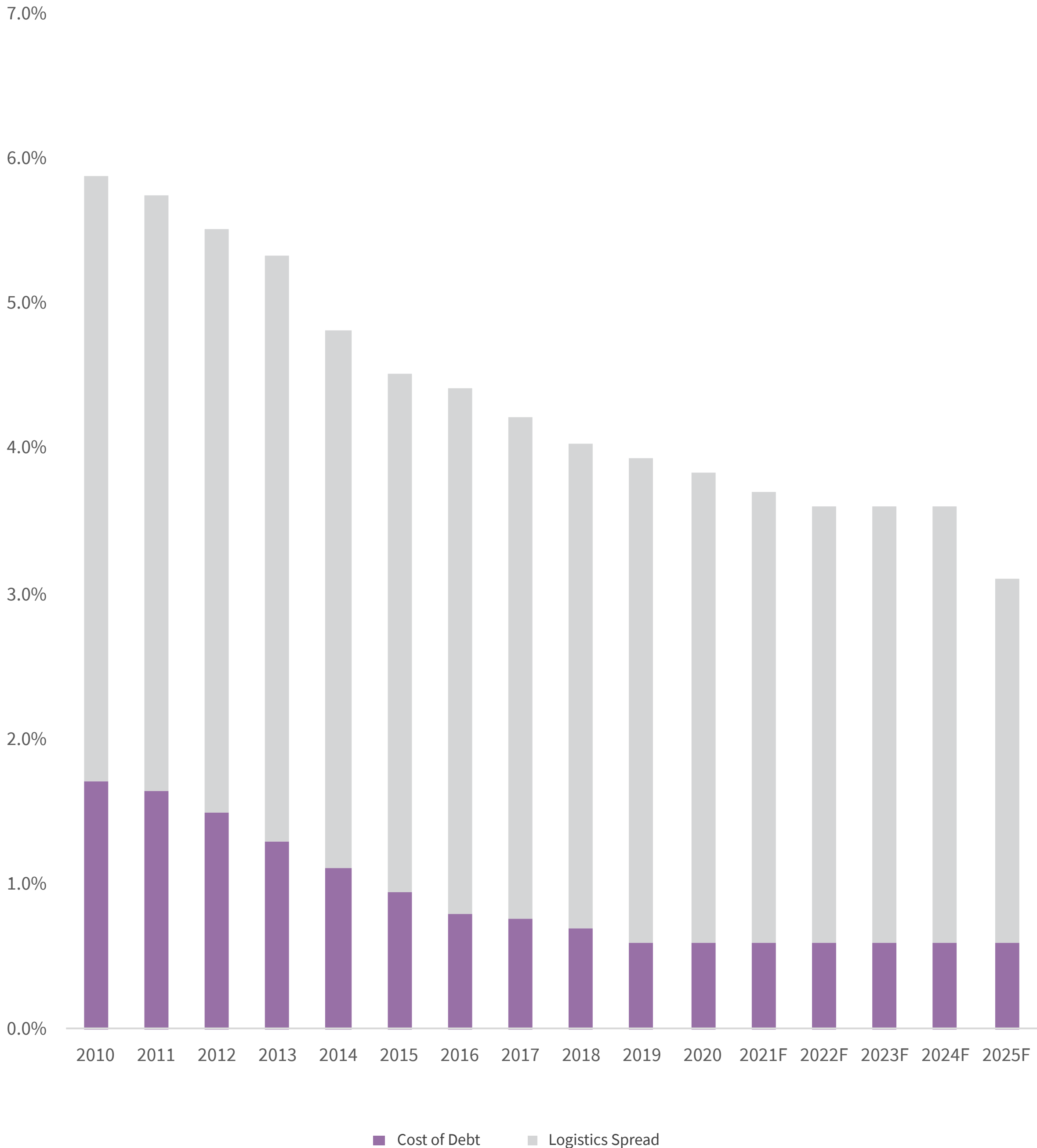
Source: JLL Capital Markets Research

What Could Happen to Tokyo Logistics Yields?

Prime logistics yields have compressed 80bps in the last 7 years as e-commerce adoption gradually grew and demand for logistics expanded. We expect demand for logistics space to remain strong over the next few years. Government statistics indicated e-commerce sales grew over 15% year on year in 2020 while offline retail has contracted. While upcoming logistics supply in 2021-2023 is high, over 90% of the supply has been pre-committed.

In 2020, over USD 15bn of new logistics and data centre funds have been raised in Asia Pacific, a sharp increase over the last 5 years. We expect investment demand for logistics to grow and yields to compress further.

Figure 21: Tokyo Prime Logistics Yield



Source: JLL Capital Markets Research

07
Singapore

Economy and Interest Rates Outlook

Singapore's economy contracted by 5.4% in 2020, as construction and services output fell by 36% and 7% respectively. Manufacturing expanded by 7% due to rising global demand for pharmaceutical and IT exports. COVID 19 immunisation has commenced and is expected to be completed in 2021. While this could help lift business travel and meetings in the medium term, such as the World Economic Forum, tourism is not material as it contributes just 4% to Singapore's GDP.

Consensus amongst economists indicate GDP growth of 5-6% in 2021 and 3-4% in 2022. In 2020, business investment commitments rose 13% to SGD 17.2bn, as global companies committed more in electronics, chemicals, and IT projects. Key growth drivers include financial services and information and communications, which grew 1-2% in 2020 and could expand by 3-5% in 2021. Policy changes to encourage more family offices, setting up of digital banks and fintech that were introduced in 2020 should boost employment over 2021-2025. Technology companies continue to grow rapidly in Singapore, including new entrants from China, Korea and Japan.

Borrowing costs for institutional investors' acquisitions of commercial real estate fell by over 130bps in 2020. Some REITs were able to finance new asset purchases with debt costing 1.35-2.0% in 4Q2020, compared to 2.7-3.5% in 4Q2019. The extremely low rates were the result of two key factors, in our view. Firstly, global interest rates and bond yields have fallen significantly as central banks loosened monetary policies to support economies amid COVID 19. Secondly, the Singapore dollar has strengthened against the USD and currencies of other trading partners, compressing SGD 10Y bond yields.

Over the next 5 years, we expect a moderation of these two factors and a slight increase in borrowing costs of around 50bps in Singapore, but it is likely that borrowing costs in 2025 would still be some 100bps lower than 2019-levels, aligned with expectations that global interest rates could stay low in the near term.

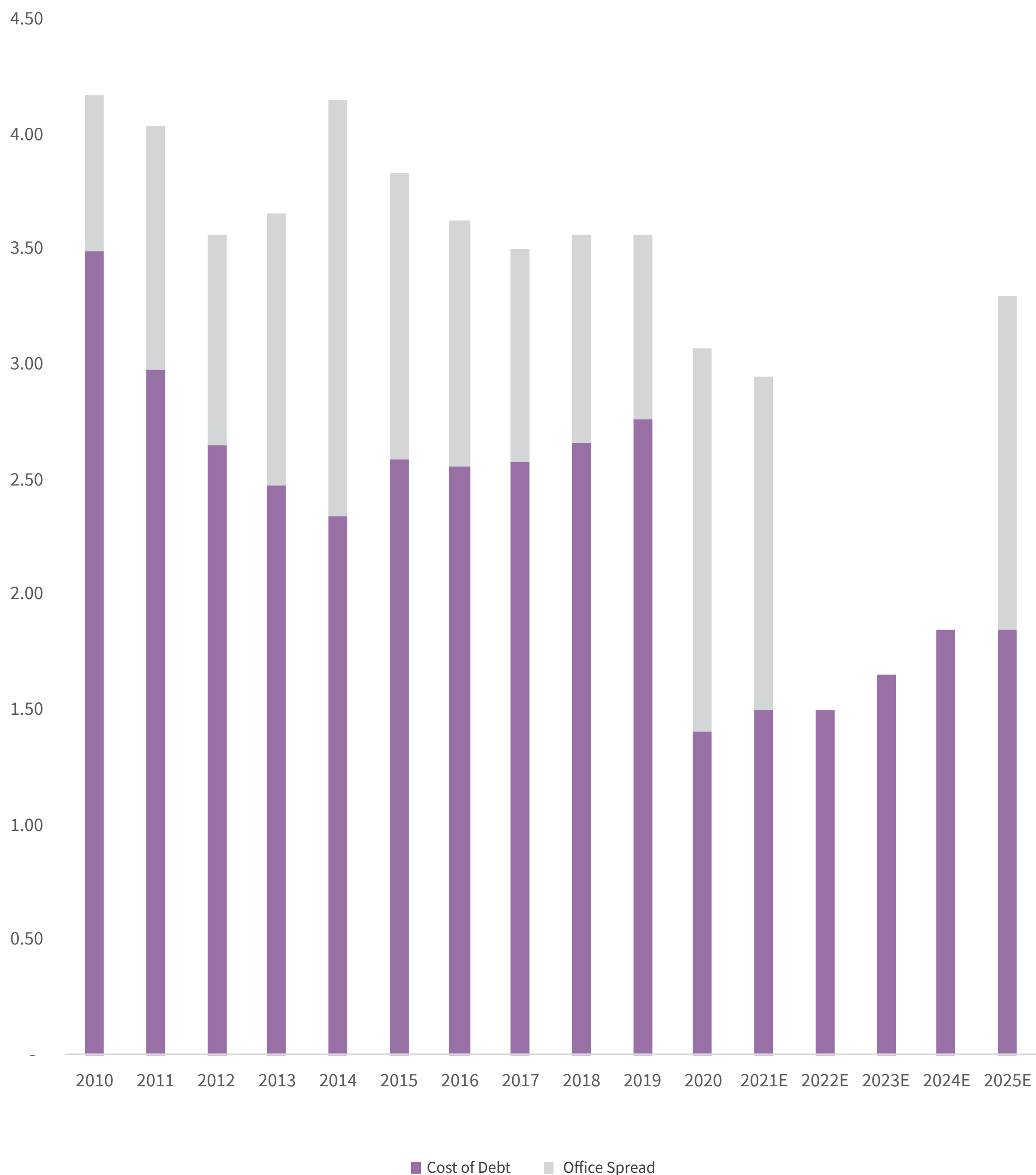
Financing Costs for Investors

While interest rates fell by over 130bps in 2020, office yields compressed by just 50bps. The yield spread widened potentially as uncertainties about the relevance of the office remained. Travel restrictions and COVID19 also limited investors' ability to resume acquisitions. The withdrawal of older offices for redevelopment in Singapore will cut average net office supply in 2021-2025 to just 0.5 msf annually, below the 0.6 msf of anticipated annual net absorption.

Thus, we expect office rents to remain under pressure in 2021 but recover significantly in 2022-2025.

Over 2021-2025, we expect borrowing costs for institutional investors to rise moderately by 30-50 bps. Over 2015-2019, office yields have maintained a 100bps spread over borrowing costs. We expect office yields in 2025 to be close to 4Q2020 levels.

Figure 22: Singapore Office Yield Spread (%)

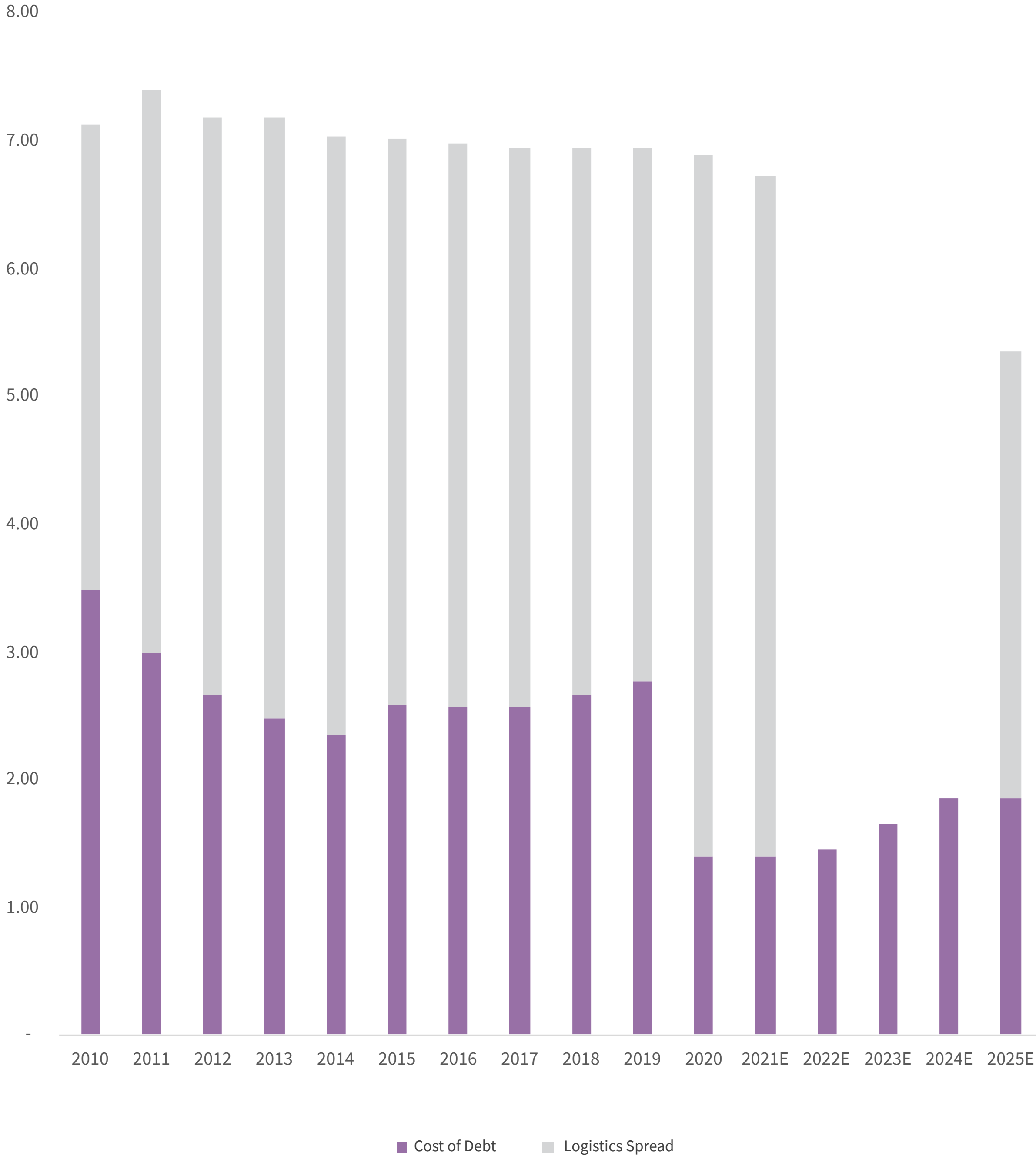


Source: JLL Capital Markets Research

What Could Happen to Singapore Logistics Yields?

Logistics and industrial yields have steadily compressed over the last 10 years. In 4Q19, logistics yields had narrowed to 420 bps above the cost of debt, higher than the 100 bps average for office assets. We think this premium of 320 bps is justified, to account for the shorter land tenure for industrial assets (c. 150 bps) and lower rental growth prospects (say 150 bps). In 2025, we think logistics yield spreads could still be 250 bps higher than office spreads due to these shortcomings. That would imply that logistics yields could rest about 50-150 bps lower in 2025, compared to 4Q20 levels.

Figure 23: Singapore Logistics Yield Spread (%)

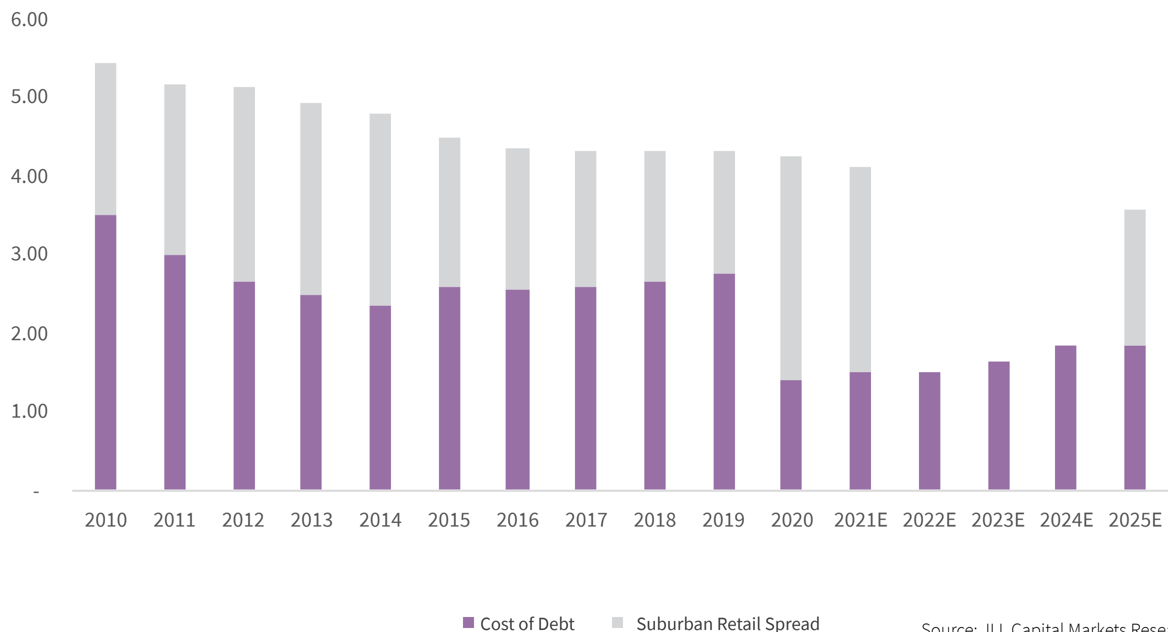


Source: JLL Capital Markets Research

What Could Happen to Singapore Retail Yields?

Suburban retail yields had compressed to just 160 bps above borrowing costs, higher than the 100 bps for office yields, mainly due to investors' reservations about structural changes that may affect the sector's long term rental growth outlook. Suburban retail assets in Singapore are extremely resilient, enjoy constrained supply and tenant sales in 4Q20 have ecovered to close to 4Q19 levels. In 2025, we expect retail yields to still stay 160 bps above the cost of debt, which could imply about 50 bps compression from 4Q20 to 4Q25.

Figure 24: Singapore Suburban Retail Yield Spread (%)



Source: JLL Capital Markets Research

08
Hong Kong

Economy and Interest Rates Outlook

The Hong Kong economy is estimated to contract by 5.9% in 2020. The retail, tourism and hospitality sectors were severely impacted by the pandemic. Stringent containment measures inevitably stifled a wide range of businesses, notably F&B. Inbound tourism, which contributes to about 30% of Hong Kong's retail sales, was effectively shut off in most of 2020 and visitor arrivals were at a minimal, down more than 99% from 2019. In December 2020, the PMI index dropped to 43.5, down 13% from the previous month, also reaching a low since April 2020, reflecting poor business sentiments, especially on the trade front. In December 2020, overall unemployment rate surged 6.6%, a 16-year high.

However, there were signs of a pick up, notably in the external trade. Merchandise trade gathered pace towards the end of 2020. Aggregate trade value increased by 2.6% y-o-y in Oct-Nov, with imports rose by 2.9%, and total exports grew by 2.3%. Specifically, trading activities with Singapore and China showed growth compared to last year, recording at 4.2% and 1.8%, respectively.

For 2021, Hong Kong is expected to rebound in the 4-4.5% range, then moderating to 2-3% annually in 2022-2025. While such a recovery profile appears modest at best, upside potential could come from deepening integration with China of which the economy has firmly embarked on a growth path. In addition, fiscally, the Hong Kong Government is still sitting on a reserve of about USD 110 bn (close to two years of public expenditure). This can be directed to investing in infrastructure projects and other pro-growth programs.

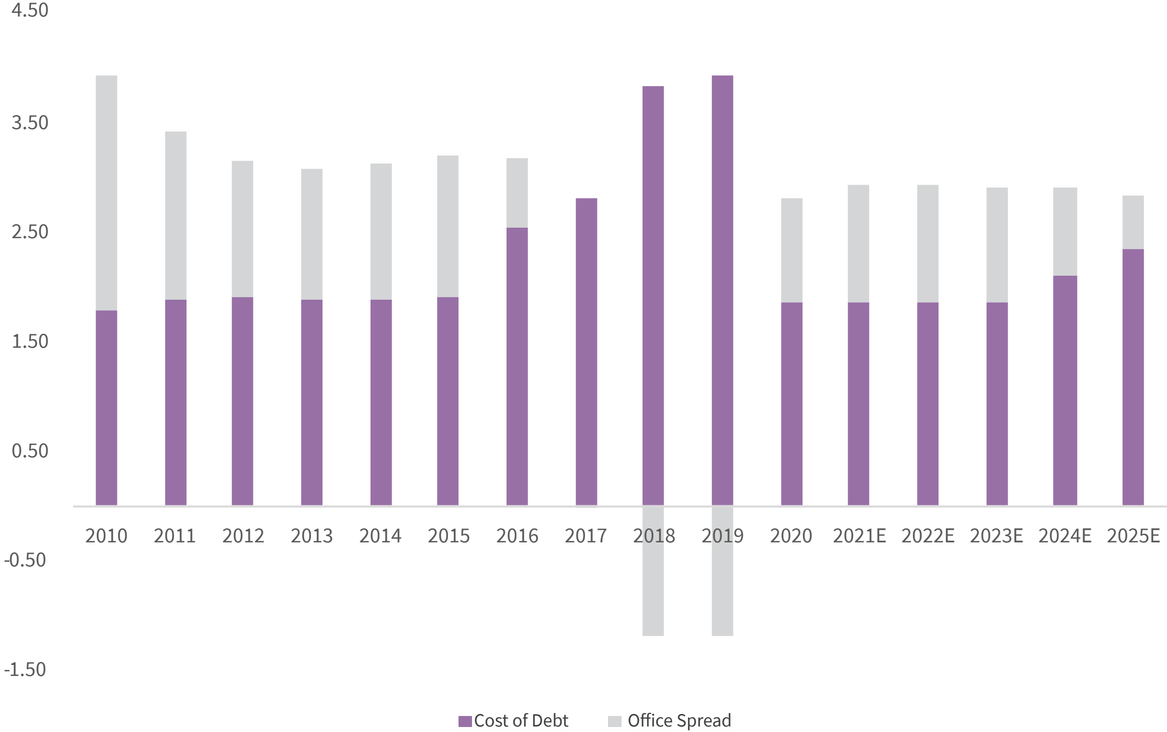
Borrowers continued to benefit from plentiful liquidity. Notably, "unlimited QE" as a monetary response to COVID-19 has brought borrowing rates to extremely low levels. As the 10-year US treasury yield dropped from close to 2% in 2019 to as low as 0.5% during 2020, local interbank rate HIBOR came down by more than 200 bps during the year, and hovers today at 0.25% (3-M). Together with a spread of 100-150bps for borrowers with good credit rating, actual financing cost is currently around 1.3-2%. While 10-year bond yields recently rose to 1.2-1.3% and the HIBOR is likely to rise moderately in tandem, considerable liquidity in the Hong Kong banking system will likely keep any spike in the HIBOR well in check.

What Could Happen to Hong Kong Prime Office Yields?

Despite a 208bps compression in the 3M HIBOR, Grade A office yields expanded marginally by 6bps as investors' raised the risk premium for office assets to account for rising uncertain geopolitical tensions and potential changes in the way offices are used after COVID-19. Occupier demand has been subdued and downsizing activity has been prevalent in the city. Office vacancy rate reached a 16-year high of 8.9% as at the end of 2020 and rents dropped by 18.9% during the year.

Looking ahead, office rents are forecast to drop further by 9.4% in 2021 and embark on a moderate recovery subsequently once the pandemic is under control. Office Yields have widened by 30bps in the last four years and likely more than accounted for the sectoral risks and anticipated increase in interest rates. We expect office yields to move within a confined range in 2021-2025 as modestly improving medium-term prospects offset an expected 50bps rise in financing cost.

Figure 25: Hong Kong Office Yield Spread (%)

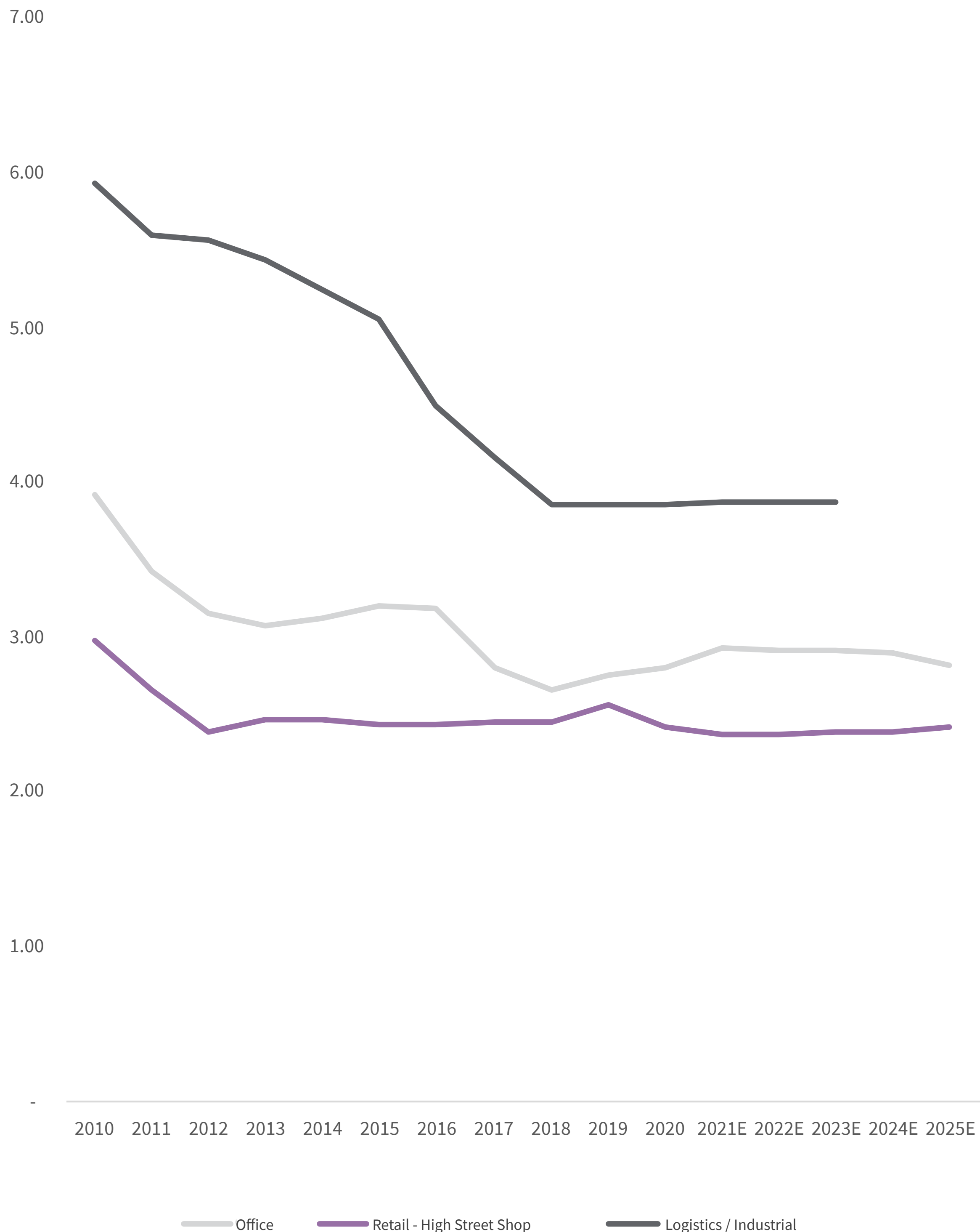


Source: JLL Capital Markets Research

What Could Happen to Hong Kong Logistics Yields?

Prime warehouse yields remained flat in 2020 as there was a lack of transactional evidence. But at 200bps spread over cost of debt, logistics yields are much higher than office or retail yields. Potentially this yield gap could narrow by 2025, allowing logistics yields to compress 100-150bps from here.

Figure 26: Hong Kong Office, Retail and Logistics Yields (%)



Source: JLL Capital Markets Research

What Could Happen to Hong Kong Retail Yields?

The pandemic brought the retail and tourism sectors to a standstill. Investors began to front-run the potentially bottoming sector following periods of low infections in Hong Kong, yet the pandemic situation was volatile throughout the year with several waves of resurgence. As vaccination programmes are gradually rolled out, expectations that travel could resume partially started to rise.

Retail rents are forecast to grow mildly by 3.2% in 2021 and yields are expected to further compress if tourist arrivals start to increase in 2H2021.

High street shop yields compressed by 15bps in 2020 but yield spreads over financing cost are 60bps wider than in 2016, as investors priced in uncertainties associated with the sector. As a result, we expect retail yields to remain relatively stable even amidst and increase in interest rates.

Figure 27: Hong Kong High Street Retail Yield Spread (%)

Source: JLL Capital Markets Research

09
Korea

Economy and Interest Rates Outlook

In 2020, Korea's GDP contracted by 1.1%, the first contraction since 1998. The Bank of Korea (BOK) expects growth to bounce back by 2.5-3% in 2021 and 2022. COVID-19 outbreak took a heavy toll on the economy. Export volume declined by 4.6% while the import volume plummeted by 12.7% in 2020, moderated by a surge in activity in 2H2020. December's export amount was the sixth largest in volume in Seoul's history, and the nation's trade balance stayed in the black for the eighth straight month.

In May 2020, the BOK lowered its benchmark interest rate to a record low 0.5% in the face of economic uncertainty, and it held this rate unchanged amid the prolonged COVID crisis. Since the rate cut, 10-year government bond yield has hovered around 1.3-1.8% range. Economists expect the monetary policy to remain dovish for the most of 2021. The spread between 3-year and 10-year government bond yields has widened as a result of the government's recent announcement of expansive policy. Given low benchmark interest rate, 3-year government bond yield reached 0.95% in 4Q20, down 46 bps year on year.

Borrowing rates for senior loans fell just 20 bps in 2020, despite a 80bps cut in BOK benchmark interest rates, as banks and lenders took a conservative stance and raised their risks premia. As a result, we expect senior loan rates to rise by just 20 bps by 2024, even if BOK benchmark interest rates were to start rising from 2022 and revert back to 2019 levels by 2024.

What Could Happen to Seoul Prime Office Yields?

Despite the pandemic, Seoul office yields compressed by 17bps on average in 2020 due to lower borrowing costs and relatively stable office market demand-supply dynamics. In 2015-2019, office yields have remained 130 bps above borrowing costs on average. From 2021, we expect the yield spread to narrow slightly as institutional investors continue to compete aggressively for core office assets and the stock of available opportunities remains scarce. This will offset the anticipated 20bps increase in borrowing costs and allow cap rates to remain stable.

Figure 28: Seoul Prime Office Yield Spread

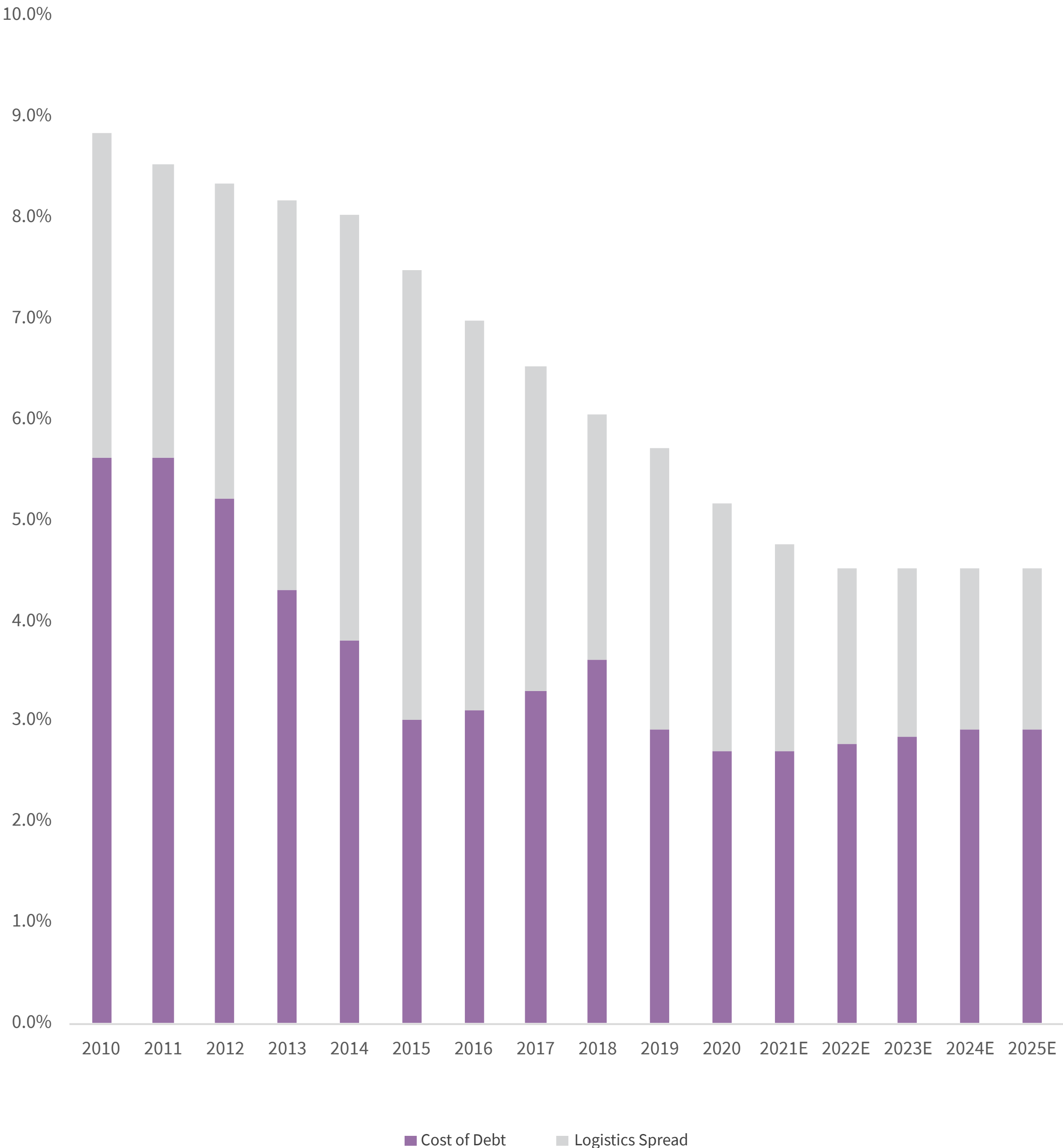
Source: JLL Capital Markets Research

What Could Happen to Korea Logistics Yields?

Over the last five years, Seoul logistics yields have compressed by 200 bps, significantly more than the average 50 bps movement in other Asia markets. This was driven primarily by strong structural demand tailwinds, increase in the share of global institutional tenants and improved tenant income profiles. Logistics yield spreads over office yield and cost of debt now sit at 100 bps and 250 bps respectively.

Over the next 5 years, we expect logistics yields to compress by 50-70bps. While supply of new completions is high, we expect this to be absorbed as demand for modern logistics assets remains strong. Institutional investors' appetite for quality logistics assets continue to increase and the Seoul market is core target market for these funds given its high cash on cash yield and compelling e-commerce adoption rates. Due to strong competition for logistics assets, some investors have recently moved up the risk curve, taking on development projects or forward purchases.

Figure 29: Seoul Capital Area logistics Yield Spread



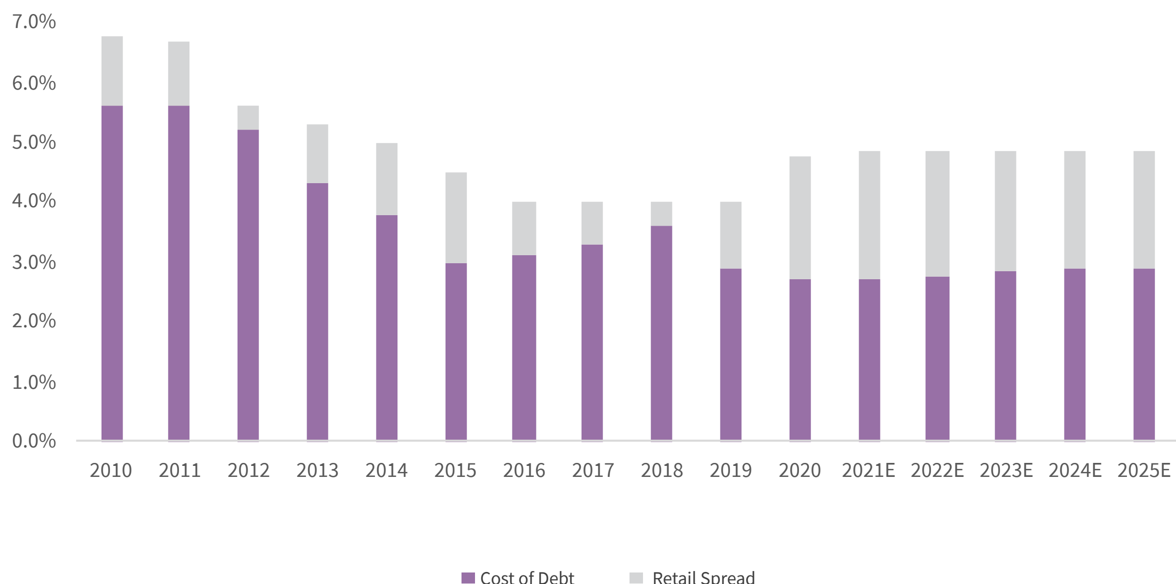
Source: JLL Capital Markets Research

What Could Happen to Korea Retail Yields?

In 2020, Seoul's prime shopping mall retail yields expanded by 75bps as the rental outlook was severely impacted by the pandemic. Prior to the COVID-19, heightened uncertainties for retail demand had already affected the sector and yield compression for retail assets lagged that for office and logistics assets since 2016.

Nevertheless, premium Seoul retail malls have delivered resilient performance. Relative to the global peers, retail mall stock per capita is low and retail malls have pivoted towards entertainment and experiential trades that continue to draw foot traffic and new retail brands. Hence, we expect retail mall sales to rebound once the economy recovers and we expect retail yields to remain stable till 2025 even amidst a 20bps increase in borrowing costs.

Figure 30: Seoul Retail Shopping Mall Yield Spread



Source: JLL Capital Markets Research

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