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CEO Insight: US investors shift their focus to Japan

For European investors, Japan can be the perfect alternative to their domestic crisis.

Japan is currently experiencing a visitor boom, with more than two million foreign tourists and businesspeople arriving in June - the last time this figure was surpassed was just before the start of the pandemic. Among those arriving were real estate investors from the United States. Back home, the commercial real estate recession has left many investors in the red. But these investors are showing how crisis works. Instead of burying their heads in the sand, they are looking for attractive opportunities elsewhere. They are not sitting out the downturn, but have found Japan as an alternative investment destination.

The data speaks for itself: while vacancy rates in major U.S. cities such as Manhattan and San Francisco are 20% and 32%, respectively, only 6% of office space in Tokyo's central districts is vacant. Subsequently, U.S. pension funds and real estate developers are selling their office properties at a discount and buying Japanese offices. As a result, transaction volume in the first quarter of 2023 more than doubled year-on-year to more than $4 billion, according to JLL. "Almost any other office market in the world would trade places with Tokyo in a heartbeat," Calvin Chou, head of Asia Pacific for Invesco Real Estate, told The Wall Street Journal.

For these investors, several factors point to a market with high stability and manageable risk. In 2022, for example, the investment volume of foreign investors increased by 12%, and the share of foreign investors in transactions of more than 10 billion yen (70 million euros) was 44%. These features attract foreign investors: The home office is a fading model in Japan. According to Nomura, more than 62% of employees return to the office every day. The economic recovery continued in the second quarter, with more than 80% of large companies expecting growth in the next 12 months. Inflation, relatively low anyway, is already falling, while the stock market has recently hit 33-year highs. And banks are happy to lend to investors because the Bank of Japan is not making money more expensive.

Japanese residential real estate is at least as attractive as office space. Large Asian investors have been particularly active recently. They are also targeting Japan to increase their capital. Yields have recently been close to 4%. The interest rate differential between the yen and the euro significantly increases the return if a foreign investor hedges the entry rate for the long term. The foreseeable, probably sharp upward correction of the yen promises an additional plus for both residential and office real estate. This makes Japan an extremely attractive investment target for European investors.

The J-REIT market, by far the largest in Asia with a market capitalization of $120 billion and a market share of 50%, even in 2022, a difficult year for listed REITs, shows only a slight negative total return of 4.8%, while Singapore in second place and Hong Kong in third place do much worse with losses of 11.9% and 23.4% respectively. The hotel and the residential sectors outperformed the J-REIT benchmark.

Japan's strong performance can be explained by major differences with Europe. European property prices rose sharply during the Corona period due to monetary easing, while in Japan they rose slightly during the pandemic. When consumer prices surged in 2022, many Western countries tightened monetary policy in rapid steps, triggering a correction in property prices. However, the Bank of Japan has maintained its accommodative monetary policy, so the risk of property prices falling due to higher interest rates is low.

This remains true even after the slight correction in monetary policy at the end of July. The yield on 10-year government bonds is now allowed to rise to 1%, up from 0.5%, before the Bank of Japan intervenes. But Governor Kazuo Ueda has said that 1% is unlikely to be reached. In fact, the highest 10-year rate since then has been 0.65%. This means that the cost of capital in Japan remains low. A real turnaround in interest rates is unlikely until wages start to rise sustainably, says economist Kazuo Momma, a longtime executive director at the Bank of Japan.

But recent income data do not support an imminent rate hike. In June, nominal wages were up 1.8% from a year earlier, but after accounting for a 2% increase in hours worked, hourly earnings fell 0.2%. Hence, Europe's real estate investors need not fear a sudden interest rate turnaround in Japan but should overcome their shock paralysis and put their hearts into their hands. Japan will reward them.

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