Morgan Stanley

INVESTMENT MANAGEMENT

Mid-Year Outlook

CRE Bright Spot within Murky Macro Backdrop

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The current macroenvironment is volatile and uncertain with growth expected to moderate and diverge. Within this macro backdrop, real estate looks durable and downside-protected, particularly in sectors that are supported by long-term structural trends. Several factors suggest this is an attractive time to invest in real estate: meaningful downward re-pricing (20 to 25% across regions) which enables an attractive entry basis, positive core returns across regions for the past four quarters suggesting the market has bottomed and the next up cycle has begun, and significantly lower new supply due to the pullback in construction starts which will be supportive of fundamentals.

Macroeconomic Environment

Global growth is forecasted to be lower due to tariffs, policy uncertainty and elevated geopolitical tensions. In the US, Morgan Stanley Research expects a step down in real GDP growth due primarily to tariffs and immigration restrictions. While elevated policy uncertainty and a weaker USD may result in marginal capital shifts away from the US, structural growth drivers (technology, AI, deregulation, demographics) and the size and diversity of the broader US economy and capital markets remain compelling and supportive of investment performance. Europe's growth is expected to accelerate, albeit from a low base, helped by fiscal stimulus from increased defense spending, lower inflation and lower interest rates. Asia's macro story remains mixed and divergent based on each country's dependence on trade and strength of domestic demand. Japan, Australia and India are expected to remain relatively resilient; Korea will likely be moderately impacted given its trade orientation, and China is expected to continue its deflationary growth path.

Generally, central banks around the world have begun to lower interest rates, reacting to slower growth and softer inflation. Given the relative strength of recent macro data (e.g., resilient labor market and consumer) and expectations for lingering inflation in the US, Morgan Stanley currently expects the Fed will remain on hold throughout 2025 but aggressively cut interest rates in 2026. In Europe, already falling inflation, soft economic activity, and an appreciating euro may support further interest rate cuts. In Japan, MS Research expects the BOJ to keep policy rates static through the end of 2026 due to slower growth, moderating inflation, and an appreciating yen. Lower interest rate expectations across most countries should be positive for real estate yields and values leading to increased levels of capital flows and transaction activity.

Commercial Real Estate Market

Real estate fundamentals remain relatively resilient for high quality assets in preferred sectors and specifically markets supported by long-term structural tailwinds, including residential (supported by housing shortages and demographic shifts), industrial (supported by supply chain reconfiguration and e-Commerce), senior living (supported by aging populations) and hotels (supported by accelerating global tourism and a propensity to spend on experiences vs goods). Occupier locational and asset-level preferences continue to narrow, leading to wider performance dispersion, requiring a more targeted investing approach.

Transaction activity is expected to increase, albeit off low levels, due to a more constructive real estate market outlook and greater availability of more cost-effective debt financing. Selective situations with ongoing seller pressure to deleverage could lead to more distress and create interesting opportunities to deploy capital into recapitalizations and structured credit investments (more likely in Europe). MSREI believes that the next several years will represent an attractive investing vintage as real estate markets typically experience above average returns following periods of downward re-pricing.

RESIDENTIAL

The residential sector generally remains attractive with compelling fundamentals mostly driven by housing shortages, particularly in Europe. Short term stimulus from the recently passed tax bill and healthy wage growth in the US, fiscal stimulus in Europe and a sustained wage growth cycle in Japan are all supportive of rent growth, particularly given the for-sale market remains unaffordable and out-of-reach for many buyers.

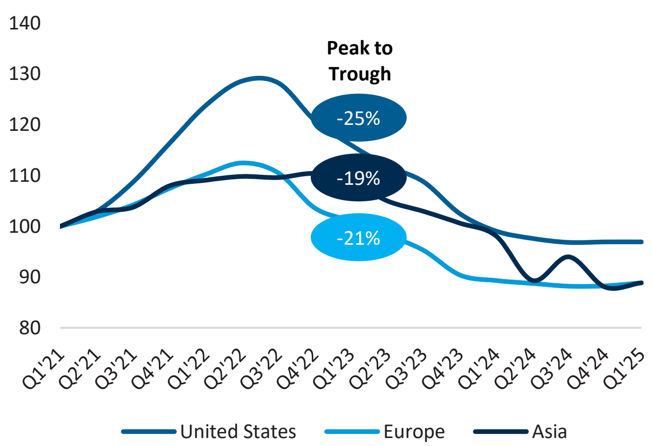
As an extension, student housing offers strong fundamentals in many markets, particularly for high quality, well-located assets proximate to leading colleges that are less impacted by a pullback in international students and/or Federal funding grants. Resilient, counter-cyclical enrollment demand, generally moderating supply and a favorable yield profile support attractive risk-adjusted returns.

Within the entire living sector, senior housing perhaps demonstrates the most compelling fundamentals, supported by aging demographics (US 75+ population growing at 4% per annum over the next five years), cyclical post-COVD recovery in occupancy, low supply and attractive yields. While aging populations/longevity is a global theme, MSREI believes the US

DISPLAY 1

Real Estate Values Re-Priced

Gross Asset Value Appreciation Index, Q1'2021 = 100

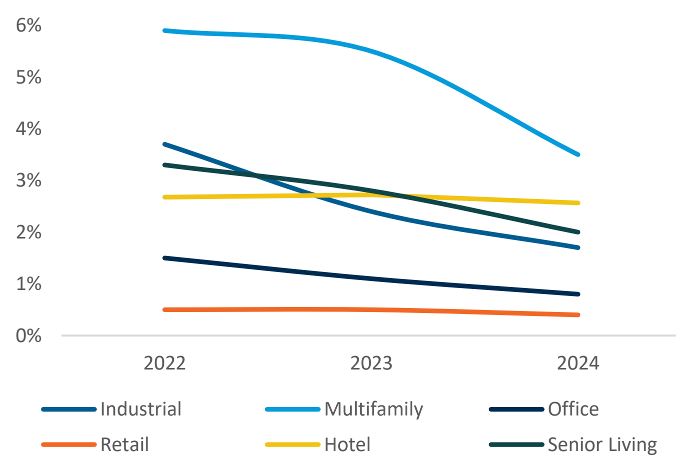


Source: ANREV, INREV, ODCE, data as of May 2025

DISPLAY 2

Reduced Supply Supports Fundamentals

U.S. Space Under Construction (% of Stock)



Source: Costar, MSREI Strategy, data as of April 2025 presents the best investment opportunities largely due to supportive cultural norms and a friendlier regulatory environment.

INDUSTRIAL

The industrial sector is the most impacted by tariffs, trade negotiations and supply chain shifts. In the short term, fundamentals are slowing as occupiers have stalled decision making in response to changing tariff policies and geopolitical risks, particularly in port markets levered to global trade flows.

Over the long-term, supply chain reconfiguration and the restructuring of global trade patterns will likely shift the type and location of industrial demand. Likely “winners” include US onshoring markets that have an existing manufacturing ecosystem, proximity to the end customer, cheap and plentiful energy and a decent supply of labor. In Asia, the shift in manufacturing from China should benefit India (where manufacturing is expected to quadruple over the next ten years). Additionally, Japan (automobiles, robotics, and biotechnology) and Korea (semiconductors and precision manufacturing) should see a step-up in manufacturing growth and derivative industrial demand. While reshoring / nearshoring in Europe has lagged behind the US due to the early implementation of stimulus, tax benefits and tariffs, catalysts for Europe are clearly in-place. Higher defense spending, renewable energy investments, and efforts to regionalize production in critical sectors like defence, pharmaceuticals and medical supplies support industrial demand.

Additionally, continued growth in eCommerce sales fueled by demographics, AI adoption and higher penetration rates should lead to incremental demand, particularly for infill assets in locations with lower supply risk.

HOSPITALITY

The hotel market globally remains relatively strong, supported by rising tourism, increased international travel and the recovery of group demand. This increase in long term travel demand can be attributed to growing income levels and higher travel rates among the millennial generation (largest age cohort), who generally prefer to spend on experiences vs goods. Near-term consumer weakness and heightened geopolitical risks may slow fundamentals in the near term, favoring markets with diverse demand drivers and lower supply risk, e.g., Europe and Japan.

OFFICE

Office take-up had been improving for well-located, high-quality assets but may slow due to macro uncertainty and more moderate job growth. MSREI expects the trend of demand consolidation into the best buildings to continue, pushing up rents in the best assets. Markets and assets with strong tenant demand and lower capital expenditure requirements (e.g., Japan) are likely to outperform.

RETAIL

The retail sector is generally back in favor given higher yields, reset rents and low/negative supply growth in many markets. Higher goods inflation in the US and generally moderating growth may slow demand in the near-term.

Conclusion and Strategy Implications

Real estate is a relative bright spot within an uncertain macro backdrop. Positive income growth, low supply and the expectations for lower interest rates create an attractive investing vintage over the next several years. MSREI believes that investment performance will diverge within and across sectors, based on the location, quality and specific attributes of each asset, requiring a selective investment strategy, local market expertise and asset management capabilities.

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