Commercial Property Market Update

July 2024

KPMG.com.au

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Executive summary

The downturn in the global commercial property market continued into the first quarter of 2024. Investment performance for commercial property has weakened further over the past six months due to the declines in capital values as investors require higher returns to compensate them for increased debt costs and perceived investment risk.

Office sector

- The office sector has been affected the most by a combination of headwinds: the shift to remote and flexible work, uncertain business conditions with rising unemployment and, most of all, high implied capitalisation rates that have sent office values tumbling.
- The office market has not appeared to have bottomed out yet and is likely to experience further capital declines. In calendar Q1 2024, capital growth for office properties was -12.7%, further down from -9.0% half a year ago.
- As a consequence, property funds are limiting the amount that investors can redeem in an attempt to fend off a potential cash crunch.
- The data reveals that location remains a key driver of performance among office assets, with the Brisbane office market appearing comparatively stronger than Sydney and Melbourne, which remain subdued.

Retail sector

- Retail trade figures are currently weak, with real retail turnover growth experiencing negative growth, since the June quarter 2023.
- Retail vacancy has increased to 7.74% in March 2024 from 5.31% in March 2023.
- The weak retail environment is however affecting sub-markets unevenly.
- Cashed-up investors are continuing to actively look for defensive, income-producing investments. With this backdrop, prime retail properties remain in demand resulting in only marginal falls in their total returns. This has also led to a preference for non-discretionary/convenience-based retail properties.
- Neighbourhood centres valued under $50 million are trading well, while the market for larger regional/subregional centres valued at $250 million and above remains largely untested.

Industrial sector

- Despite total returns across all industrial properties falling by 10% over the past 12 months to March 2024, continuing a downward trend from their peak in late 2021, market sentiment suggests that the sector is close to bottoming out. While further minor adjustments may occur, the prevailing view is that the most significant corrections are likely behind us.
- There has been a notable increase in the number of transactions, with the consensus suggesting that the market is in a balanced state, neither overly favouring buyers nor sellers.
- The market remains incredibly constrained for built-form with low vacancy rates. This very limited supply of existing buildings or developed properties available for sale or lease is driving significant increases in market rent for the sector. These rental increases are materially offsetting the implied declines in asset value caused by cap rate decompression.
- New South Wales appears to be more resilient than other sub-markets and remains the only geography that has yet to record a negative total return.

KPMG Commercial Property Uncertainty Index has risen for all individual sectors between the December quarter 2023 and March quarter 2024, with the office sector experiencing the highest level of uncertainty and the industrial sector recording the largest increase in uncertainty over the past six months, mostly likely to the large corrections in asset valuations due to cap rate adjustments.

Economic considerations

- The economy is struggling and has barely grown over the past six months. With subdued growth expected throughout 2024, this is likely to further weigh on performance of commercial property assets.
- Interest rates are key to further market improvement. While inflation is falling, its path to the target remains sticky and volatile, leading to divided market expectations regarding the exact timing of the next rate cut.
- Despite high construction costs, the value of building approvals is growing at a faster pace. This means investors remain optimistic and are actively preparing for a property uptick.

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Executive summary (continued)

Our Outlook

- The short-term outlook for Australia's commercial property market appears to be one of declining fortunes, with tenant demand weak in Office and Retail sectors, while investors are pushing up cap rates in an attempt to increase yields to allow for higher debt costs, inflation and market risk.
- While some individual rates are bucking this general trend, such as the Brisbane Office market and retail properties with certain characteristics, on the whole property values are correcting after an abnormally strong period of investor activity that was driven by low debt costs and post-covid bullishness.
- The likelihood is it will be sometime before the recent peak in real asset values will be achieved again. For many recent investors, they are now facing the headache after the party. Made harder where these investors are crystalising losses through continual marking-to-market valuations.
- For those long-term investors, this current market weakness will just be another blip in their history of holding cyclical assets, while the near-term is also likely to present buying opportunities from those vendors that don't have either the cash flow or balance sheet strength to hold on.

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Key economic events and market conditions

The economy has been a heartbeat away from a recession

The country's gross domestic product rose 0.1% in the first three months of 2024. On an annual basis, the economy grew 1.1%.

The economy also experienced its lowest through-the-year growth since December 2020, primarily caused by higher interest rates and the cost of living.

Concerning retail sales figures

Retail turnover at current prices increased by 0.1% month-on-month between March and April 2024 but recorded negative real growth of -0.4% over the first quarter of 2024. This outcome continues the trend, with six out of the past seven quarters recording zero or negative real growth in retail turnover.

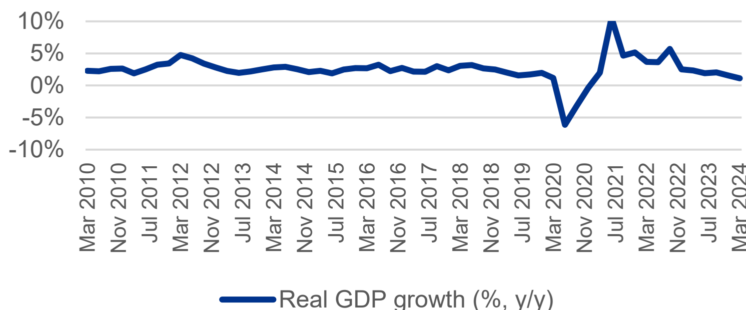
What is more concerning for the industry is the fact that this decline in volumes is occurring in a period of extremely high population growth.

The economic outlook remains uncertain and recent data shows that the process of returning inflation to target is unlikely to be smooth.

While inflation has been tracking down since its peak in the December quarter 2022, its path back to the RBA's target remains sticky and volatile, leading to divided market expectations regarding the exact timing of the next rate cut.

Building cost has also been moderating as a result of the easing of the supply chains and a significant decline across some key construction input prices such as energy and metal commodities. However, the overall measures of construction cost growth are slowing rather than reversing.

Chart 1: GDP growth

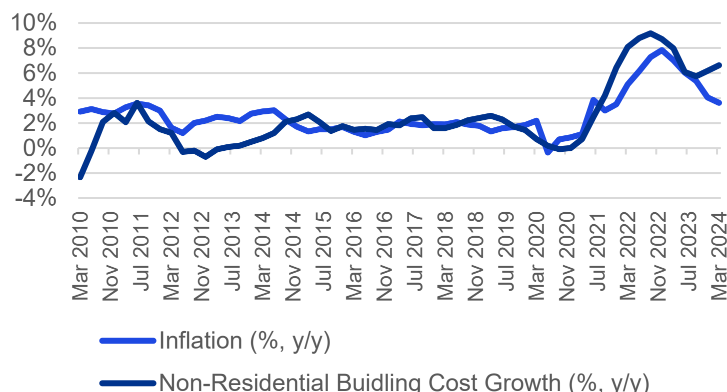


Source: KPMG, ABS, Haver

Chart 2: Retail turnover

Source: KPMG, ABS, Haver

Chart 3: Inflation and building costs



Source: KPMG, ABS, Haver

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The labour market is at a turning point

The latest data reveals that the labour market is returning back to its natural level, albeit slowly. The easing of the labour market will hopefully lead to faster completion times. The population boom has helped correct some of the imbalances in the labour market. The seasonally adjusted unemployment rate increased to 3.9% by the end of Q1 2024. The rate at which new jobs are added to the economy is now similar to pre-pandemic levels.

Wages growth in the construction sector, previously exceeding the national average, has now fallen to be in line with national wages growth.

Completions yet to catch up with large backlogs

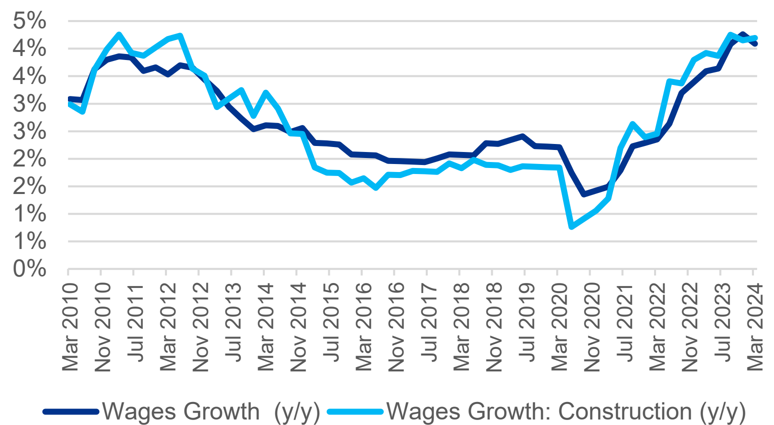
High construction costs have led to project delays before completions or cancellations as developers re-evaluated, as revealed by the ABS.

Despite this, the value of building approvals is growing at a faster pace than the value of work commenced, and the value of work completed. This suggests that some developers and investors maintain optimistic about the long-term demand for commercial property by proceeding with approvals, anticipating that current challenges will eventually subside, and the market will recover.

Chart 4: Labour market

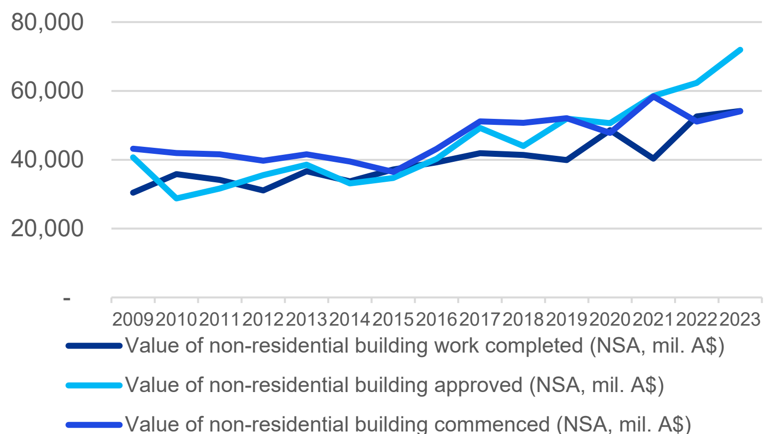
Source: KPMG, ABS, Haver

Chart 5: Wages growth



Source: KPMG, ABS, Haver

Chart 6: Construction activity by stages



Source: KPMG, ABS, Haver

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Statistics show stable lending market but market feedback suggests increased nervousness

There seems to be an uncomfortable balance in the finance market for commercial property – lending data suggests although the finance sector still has a willingness to provide and maintain funding support to commercial property investors, however this is coming with tighter lending criteria. Despite this cautiousness, there does not appear to be any evidence that financiers are 'calling in' existing loans nor of significant levels of covenant default.

Financial stress levels for commercial real estate currently low but show signs of picking up

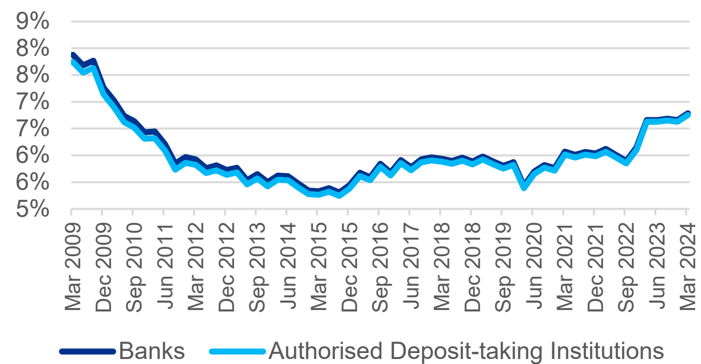
The share of non-performing commercial real estate loans from banks has increased slightly from the same time last year. However, non-performing rates on commercial property have remained steady and still far below the levels seen during the GFC, in part reflecting conservative lending practices among banks operating in Australia.

Lenders shifting away from offices

The share of office exposures in total commercial property exposures has continued to decline, dropping from 32% in early 2021 to 28% in Q1 2024 due to the increasing risks in the office sector.

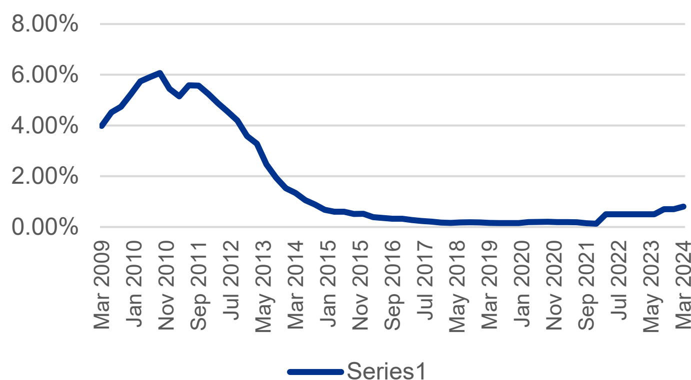
Industrial assets are still being viewed by lenders as safer investments, increasing from 16% to 18% over the year in Q1 2024.

Chart 7: Bank loan exposures to commercial property (share of total assets)



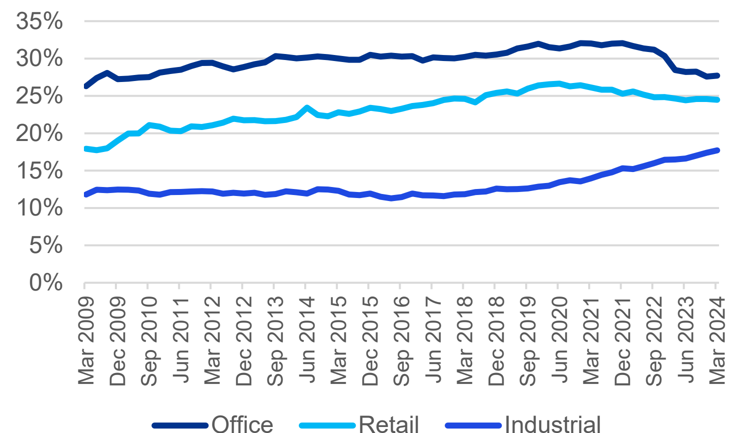
Source: KPMG, APRA, Haver

Chart 8: Non-performing rate* (share of banks' commercial property exposures)



Source: KPMG, APRA, Haver
Note: *Data reported as impairment rate prior to 2022

Chart 9: Exposures of different commercial property segment (share of total commercial property exposures)



Source: KPMG, APRA, Haver

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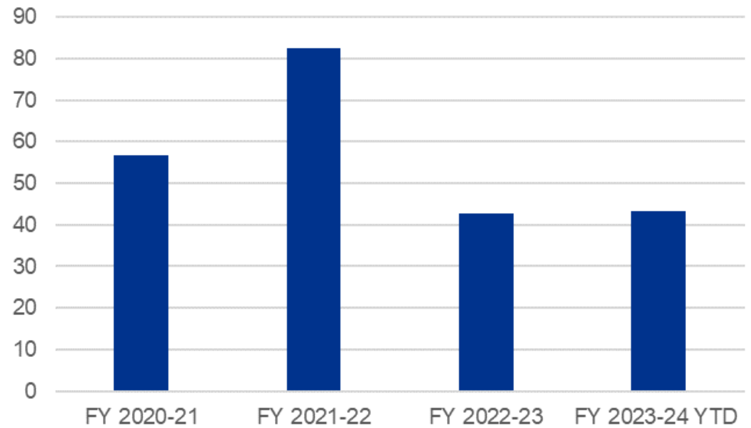
Foreign investor demand for commercial real estate yet to recover from FY22 levels

The value of commercial investment proposals approved from July to December 2023 reached $86.7 billion.

This translates to a quarterly average value of commercial investment proposals of $43.4 billion for this financial year, which is little changed compared to the $42.9 billion quarterly average recorded in FY23 and half of the figures recorded in FY22.

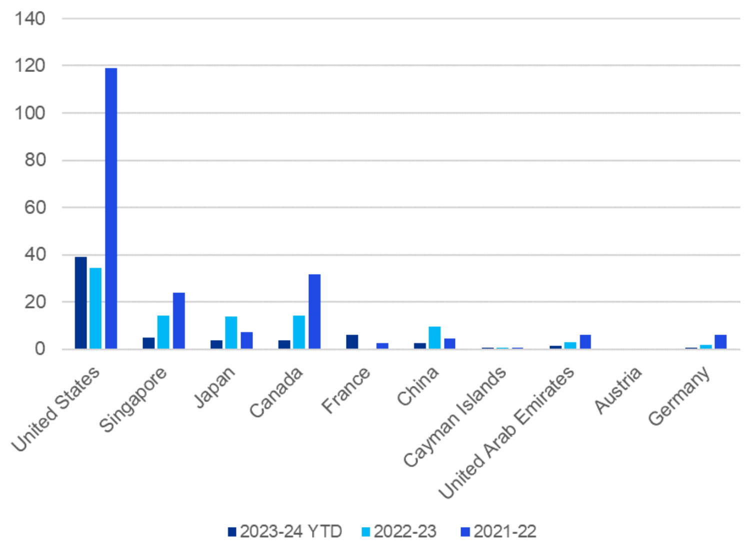
The United States remains the largest source country for approved commercial investment proposals. Notably, mid-year investment from the US has already surpassed the total amount for the full previous year.

Chart 10: Quarterly average value of foreign investment proposals for commercial real estate ($ billion)



Source: KPMG, Commonwealth Treasury

Chart 11: Sources of foreign investment proposals for commercial real estate ($ billion)



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Key economic forecasts

AUSTRALIA	Dec-23	Jun-24	Dec-24	Jun-25	Dec-25	Jun-26
Consumption	2.1%	1.1%	0.8%	0.3%	0.2%	0.6%
Business investment	9.1%	5.5%	1.4%	0.8%	2.1%	2.4%
Housing investment	-4.4%	-1.6%	-1.4%	0.6%	2.9%	3.3%
Government	3.4%	4.2%	2.6%	1.7%	1.6%	1.6%
Exports	6.6%	3.3%	2.0%	4.2%	5.5%	4.9%
Imports	6.5%	5.5%	3.5%	0.7%	0.5%	1.6%
GDP	2.0%	1.4%	1.4%	2.0%	2.4%	2.2%
Headline CPI	4.0%	3.8%	3.3%	3.0%	2.7%	2.8%
WPI	4.1%	4.1%	3.5%	3.4%	3.3%	3.3%
Real WPI	0.0%	0.3%	0.1%	0.4%	0.5%	0.6%
Current account balance*	1.8%	0.1%	0.7%	0.4%	0.1%	0.0%
Government budget*	-1.7%	-2.2%	-2.3%	-2.2%	-2.0%	-1.9%
RBA cash rate*	4.35%	4.35%	4.35%	3.85%	3.28%	3.25%
10-year government bond*	4.5%	4.1%	3.8%	3.6%	3.5%	3.4%
AUD/USD*	0.65	0.67	0.69	0.70	0.71	0.73
Terms of trade	-3.1%	1.0%	-4.1%	-6.2%	-6.4%	-4.7%
Employment	3.1%	2.5%	1.0%	0.3%	0.7%	0.6%
Unemployment rate*	3.7%	4.2%	4.3%	4.5%	4.6%	4.7%
Dwelling price	-0.2%	0.0%	0.8%	2.0%	2.6%	2.9%

* = values at end of period

Global[4]	Annual GDP Growth[1]			Unemployment Rate[2]			Average Annual Inflation[3]		
	2023	2024	2025	2023	2024	2025	2023	2024	2025
World[5]	**3.2**	**3.1**	**3.2**				**5.9**	**3.8**	**1.8**
Euro Area	0.5	0.7	1.6	6.5	6.5	6.4	6.2	2.9	2.0
UK	0.1	0.5	0.9	4.0	4.5	4.9	6.9	2.3	2.0
US	3.4	1.2	2.1	3.8	4.4	4.3	3.8	2.4	2.0
Brazil	2.9	1.8	2.2	7.5	6.9	6.9	4.6	4.0	3.8
China	5.2	5.0	4.7	5.1	5.2	4.9	0.2	1.0	1.6
India	7.7	6.6	6.7	7.5	7.5	7.4	5.6	5.3	4.9
Indonesia	5.0	5.1	5.2	5.3	6.4	6.6	3.6	2.7	2.4
Japan	1.9	0.9	1.1	2.5	2.4	2.3	3.0	2.4	1.8
Singapore	1.1	2.3	2.9	2.0	2.3	2.0	4.8	2.9	2.5
South Korea	1.3	2.3	2.5	2.8	3.2	3.1	3.6	2.7	2.0
Taiwan	1.3	3.1	2.6	3.4	4.0	3.9	2.1	2.3	1.8
Vietnam	5.0	5.8	4.1	2.4	3.1	3.3	3.3	3.2	4.0
Australia	2.0	1.4	2.4	3.7	4.3	4.6	5.1	3.3	2.9
New Zealand	0.6	1.2	2.4	4.0	4.1	3.2	5.8	3.9	3.5

[1] GDP growth calculated as (GDP q1-q4 t/GDP q1-q4 t -1) [2] Estimated unemployment rate at end of year [3] Estimated average inflation though the year [4] Source: NIESR

[5] Growth calculated on PPP-weighted basis

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The KPMG Commercial Property Uncertainty Index

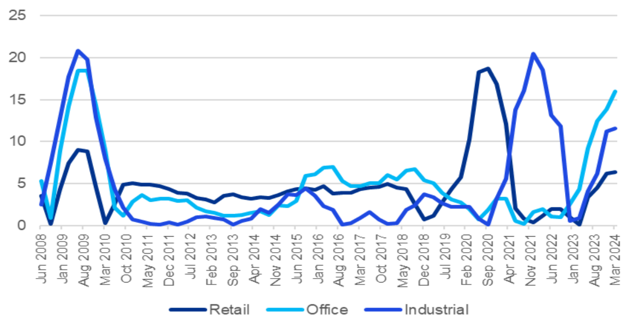
Introduction

The KPMG Commercial Property Uncertainty Index provides insights into the unpredictability and potential risks associated with investing in office, industrial and retail property.

An asset that produces consistent fair returns should generate a stable, low uncertainty index. Where an index spikes it signals investors are expecting, or are reacting to, significant changes in market conditions.

Chart 12 presents the KPMG Commercial Property Uncertainty Index for the industrial, office, and retail sectors between Q2 2008 and Q1 2024.

Chart 12: KPMG Commercial Property Uncertainty Index



Historical performance

The three commercial property sectors experienced sharp spikes in uncertainty during the period of the Global Financial Crisis (2008–2010), reflecting a range of factors including variability in economic conditions, reduced access to finance at higher costs, and reduced investor sentiment.

As the global and domestic economy settled and finance markets returned to 'normal' trading conditions, the uncertainty index for the three commercial property sectors in Australia largely stabilised during the decade between 2010 and 2020.

Another period marked by spikes in uncertainty occurred from 2020 – the time of the global coronavirus pandemic – although different to the GFC period, there has not been a synchronous timing of the spikes in uncertainty for three different commercial property sectors.

The retail sector's spike in uncertainty in early 2020 can be attributed to the health policy response to the global pandemic which included widespread lockdowns and a material shift in the purchasing behaviour of consumers. Non-essential retail stores experienced closures, and there was a significant pivot towards ecommerce as customers shifted to online shopping due to the restrictions and safety concerns.

As the initial wave of the pandemic subsided and the economy began to reopen, the retail sector started to recover. This recovery was likely due to a combination of factors, including adaptation to safety protocols, government stimulus and pent-up demand.

Industrial properties, especially those related to logistics and warehousing, initially fared better than retail because they supported the increased demand for ecommerce. However, as the pandemic continued, supply chain disruptions and the changing dynamics of global trade (such as trade tensions or changes in manufacturing locations) might have led to increased uncertainty in 2021.

Uncertainty in the office sector spiked much later. Initially, many businesses swiftly adopted remote work arrangements out of necessity. As the immediate crisis of the pandemic began to stabilise, companies and employees alike started to re-evaluate their need for physical office space and consider hybrid or fully remote work models. As a consequence, the future demand for office space has become uncertain.

Recent performance

The KPMG Commercial Property Uncertainty Index has risen for all individual sectors between the December quarter 2023 and March quarter 2024.

A combination of persistent inflation, rising government bond yields and retail lending interest rates, combined with broader geopolitical tensions and global economic concerns have collectively been weighing on investor sentiment.

From an individual sector perspective, the sector with the highest uncertainty rating is the office sector, increasing 3.5 index points to now sit at 15.9 – the highest uncertainty rating since December 2009.

The uncertainty index for the industrial property sector increased the most in the past six months by 5.4 index points to 11.6. This happened amidst the worst of the corrections in industrial, with total returns across all industrial properties falling by 10% over the past 12 months to March 2024.

The retail sector recorded the smallest increase of the three commercial property sectors, up 1.8 uncertainty index points to be 6.4 at the end of the March 2024 quarter – slightly higher than its long-term average of 4.5.

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Retail property sector

Space conditions

The past year has seen a noticeable uptick in vacancy rates as retail trade has been subdued and pressures from inflation are impacting business profit margins.

The vacancy rates for the whole retail sector increased by 240 basis points over the past 12 months.

However, prime and super and major regional retail properties are more resilient to the economic slowdown, with the vacancy rates increasing by 100 basis points and 140 basis points respectively. Notably, secondary retail properties have seen a significant 440 basis points increase in vacancy rates.

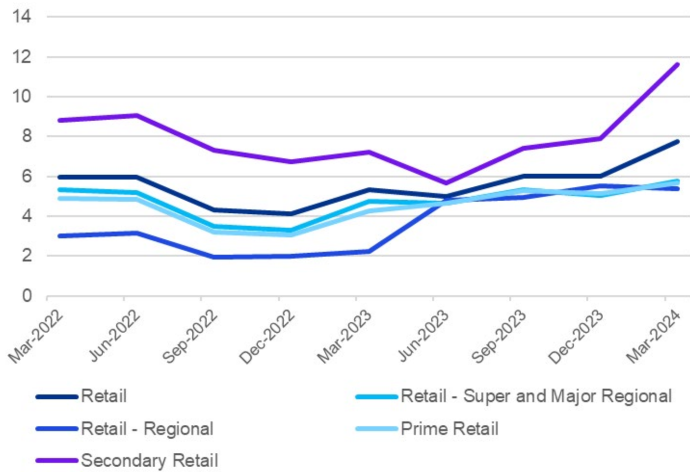
Asset pricing

Investors are demanding a higher return for retail property in general due primarily to higher capital costs.

Capitalisation rates have risen at a faster rate in the past 12 months and the increases have been consistent across subsectors.

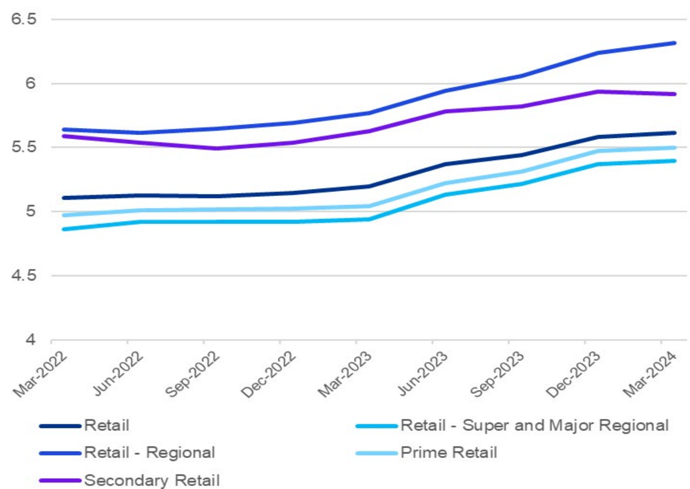
The increase is the largest for regional shopping centres, climbing by 0.54 percentage points over the last 12 months to 6.32% in Q1 2024.

Chart 13: Vacancy rates across retail property subsectors (%)



Source: KPMG, MSCI/PCA

Chart 14: Capitalisation rates across retail property subsectors (%)



Source: KPMG, MSCI/PCA

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Retail property sector

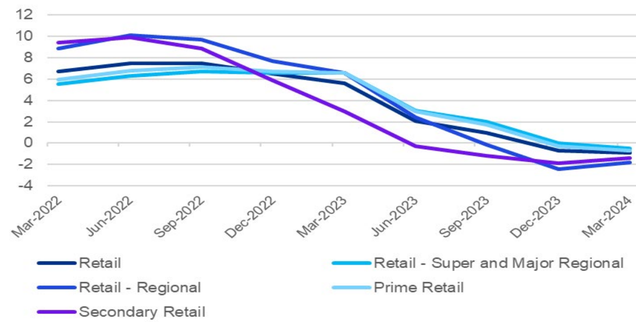
Investment performance

Investment performance has continued to deteriorate for retail property over the past four quarters as investors require higher returns to compensate them for increased debt costs and perceived investment risk, with the sector as a whole recording negative returns in the past six months.

Despite this overall decline, not all retail properties have been affected equally. Super and major regional shopping centres, along with prime retail properties, have managed to record the lowest falls in total returns due to the strong growth in income. This resilience could be attributed to their scale, location, and the diversity of their tenant mix, which may offer a buffer against market fluctuations. Additionally, there's an increasing preference for neighbourhood and non-discretionary retail properties.

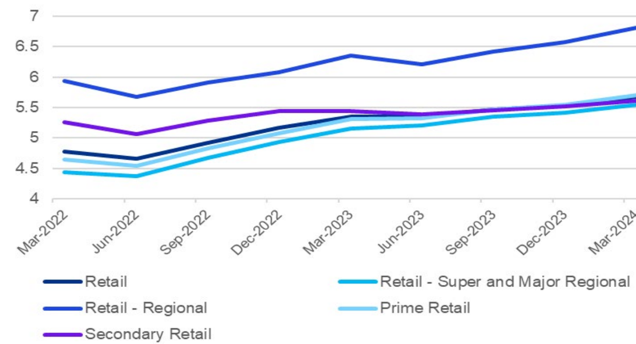
Conversely, smaller regional centres and secondary retail properties have not fared as well. These properties typically have a less diverse tenant base and are more vulnerable to shifts in consumer behaviour and the competitive pressures of the retail market. The decrease in returns for these properties could reflect a combination of factors, including a decline in foot traffic, increased vacancies, and tenants renegotiating lease terms in search of lower rents, which collectively diminish the revenue potential for investors.

Chart 15: Total returns across retail property subsectors (%)



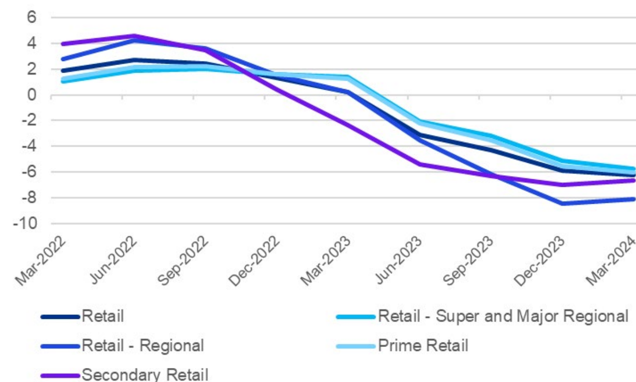
Source: KPMG, MSCI/PCA

Chart 16: Income returns across retail property subsectors (%)



Source: KPMG, MSCI/PCA

Chart 17: Capital returns across retail property subsectors (%)



Source: KPMG, MSCI/PCA

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Office property sector

Space conditions

While the University of Sydney's Transport Opinion Survey (TOPS) revealed a decrease in remote working among Australian workers (down to 22% in March 2024 from 27% a year prior) the vacancy rates for office ticked up to 7.9%, by 60 basis points from the previous quarter, and 120 basis points from the previous year.

In March 2024, among the capital cities of Sydney, Melbourne and Brisbane, staff in Melbourne work from home more than workers in other cities, with 29% working at home, meaning a higher vacancy rate for Melbourne offices.

Office quality appears as a key differentiator for rental growth, with rental growth evident for A-grade, with subdued growth (if any) displayed for lower-grade stock. However, the average vacancy rates over the past 12 months for premium CBD Office, Grade A CBD Office and Grade B Office was roughly similar, at around 8%.

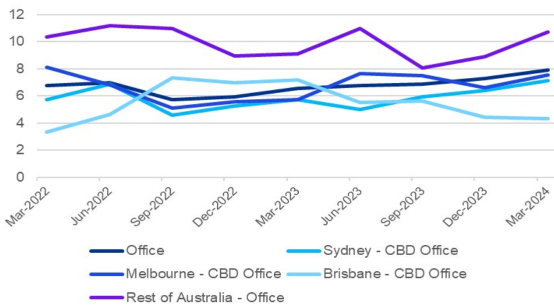
Asset pricing

We have been witnessing a consistent rise in capitalisation rates for the office sector since June 2022.

Melbourne offices recorded the largest increase in capitalisation rates across all the capital cities, increasing by 75 basis points over the year to 5.6% in March 2024.

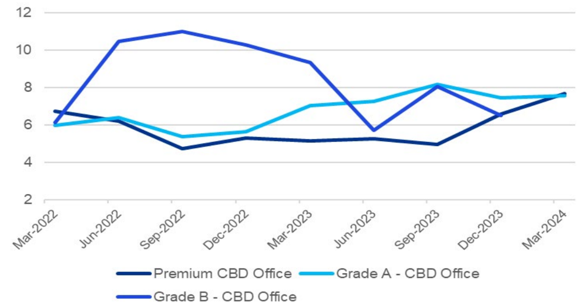
This increase has been particularly pronounced among lower-grade buildings, in which B-grade offices have seen their capitalisation rates surge by 90 basis points in December 2023 relative to the previous year.

Chart 18: Vacancy rates across office property by location (%)



Source: KPMG, MSCI/PCA

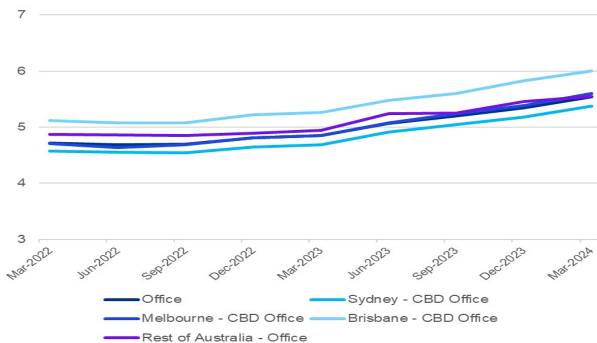
Chart 19: Vacancy rates across office property by quality (%)



Note: The data for Grade B – CBD Office is not reported in Q1-2024

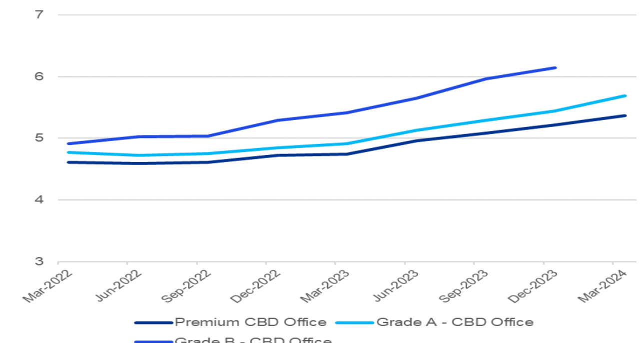
Source: KPMG, MSCI/PCA

Chart 20: Capitalisation rates across office property by location (%)



Source: KPMG, MSCI/PCA

Chart 21: Capitalisation rates across office property by quality (%)



Note: The data for Grade B – CBD Office is not reported in Q1-2024

Source: KPMG, MSCI/PCA

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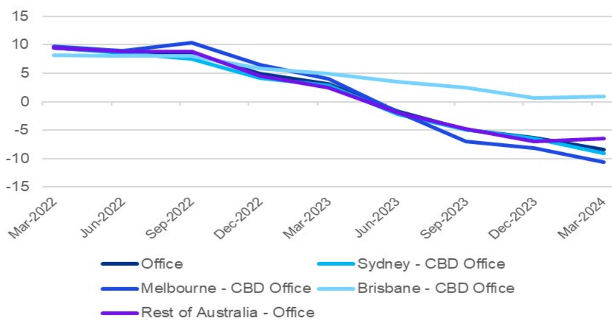
Office property sector

Investment performance

Total returns for office across multiple CBDs have been negative for the last four quarters, except for Brisbane. The Brisbane CBD rental market is relatively strong, primarily due to a surge in demand from large corporations and government entities, coupled with a scarcity of available space. This strong demand against limited supply has led to a decrease in vacancies; an outlier in this market. As a result, income returns from office properties in Brisbane are notably higher than those in Sydney and Melbourne, with a significant margin of 100–110 basis points.

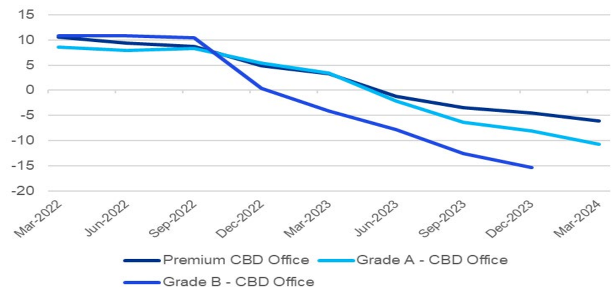
Office quality appears as a key differentiator for asset performance with premium CBD recording the lowest loss, underscoring their appeal to investors and their ability to retain value, notwithstanding the Premium sector remaining largely untested.

Chart 22: Total returns across office property by location (%)



Source: KPMG, MSCI/PCA

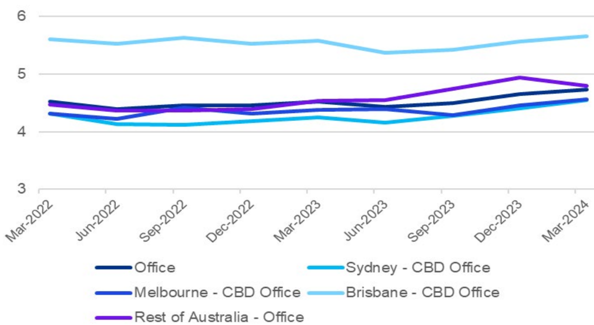
Chart 23: Total returns across office property by quality (%)



Note: The data for Grade B – CBD Office is not reported in Q1-2024

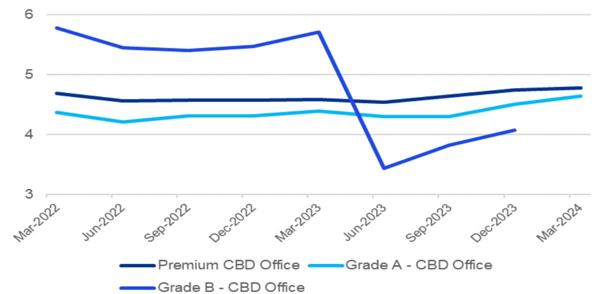
Source: KPMG, MSCI/PCA

Chart 24: Income returns across office property by location (%)



Source: KPMG, MSCI/PCA

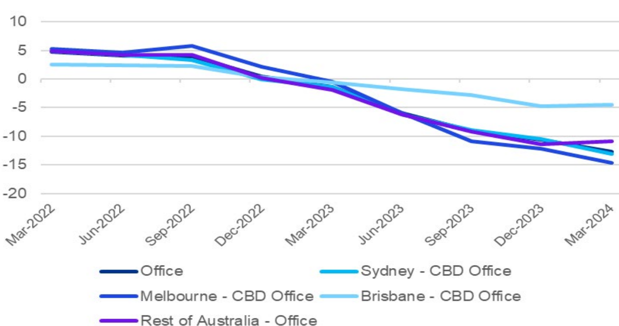
Chart 25: Income returns across office property by quality (%)



Note: The data for Grade B – CBD Office is not reported in Q1-2024

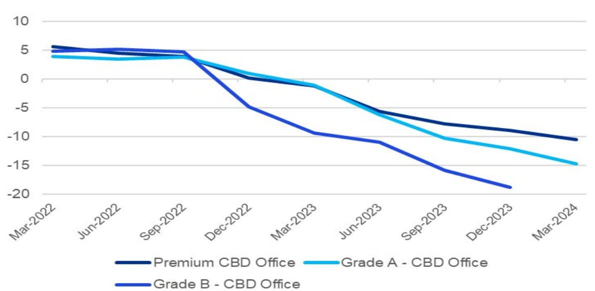
Source: KPMG, MSCI/PCA

Chart 26: Capital returns across office property by location (%)



Source: KPMG, MSCI/PCA

Chart 27: Capital returns across office property by quality (%)



Note: The data for Grade B – CBD Office is not reported in Q1-2024

Source: KPMG, MSCI/PCA

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Industrial property sector

Space conditions

Industrial property markets across all surveyed locations are exhibiting exceptionally low vacancy rates despite the economic headwinds. Although the vacancy for industrial properties picked up in the December quarter last year to 1.3%, looking through this volatility the vacancy rate for industrial remains quite low, at approximately 1%.

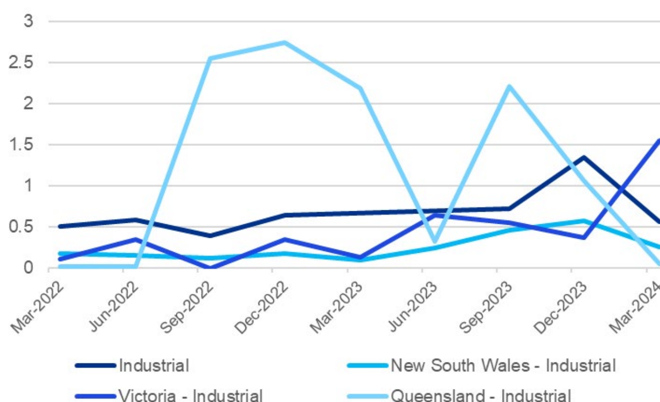
The situation in New South Wales stands out where it has sustained vacancy levels below 1% for the last two years due to its particularly tight supply, which may catalyse more strategic reallocations of space by companies to optimise operational efficiency and cost-effectiveness across the country.

Asset pricing

Capitalisation rates have increased consistently for industrial properties in the past 12 months by more than 100 basis points, currently sitting at 5.2% in the March 2024 quarter as higher interest rates continue to weigh on asset valuations.

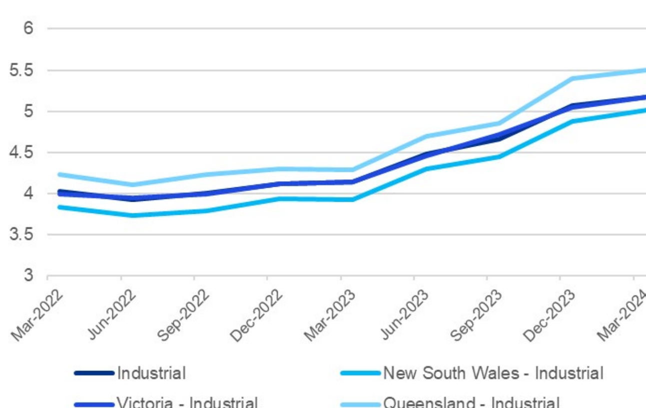
Across the three state-based primary east coast markets, capitalisation rates have increased the most for Queensland properties, rising by 120 basis points over the past 12 months to sit at 5.5%.

Chart 28: Vacancy rates across industrial property by location (%)



Source: KPMG, MSCI/PCA

Chart 29: Capitalisation rates across industrial property by location (%)



Source: KPMG, MSCI/PCA

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Industrial property sector

Investment performance

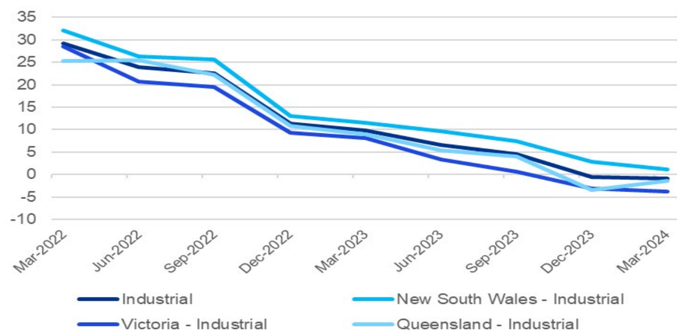
Total returns across all industrial properties by location have fallen by 10% over the past 12 months to March 2024, and have continued to trend down after having peaked in late 2021. Despite this acute and recent market correction, the sector is now displaying signs of stabilisation, and is attracting a considerable wave of capital searching for logistics and industrial product, driven by an increased understanding of the long-term structural tailwinds driving growth in the sector and with forecast stability in debt markets.

New South Wales appears to be more resilient than other sub-markets and remains the only market that has yet to record a negative total return.

In contrast, industrial properties in Victoria and Queensland have experienced losses for two consecutive quarters due to the sharp fall in valuation since the June quarter 2023.

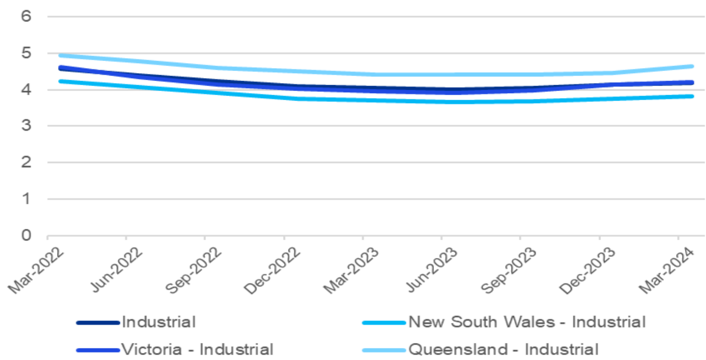
Income returns nevertheless remain stable. The stability in income returns is due to the relatively robust underlying fundamentals. Factors such as a resilient economy and a low vacancy rate help maintain a steady flow of rental income and play a pivotal role in limiting the losses from asset valuations caused by cap rate decompression.

Chart 30: Total returns across industrial property by location (%)



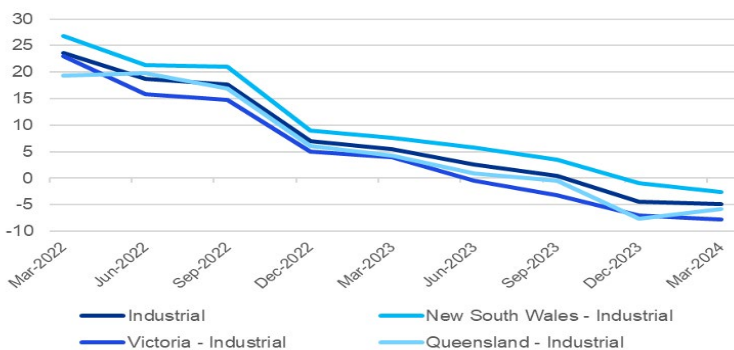
Source: KPMG, MSCI/PCA

Chart 31: Income returns across industrial property by location (%)



Source: KPMG, MSCI/PCA

Chart 32: Capital returns across industrial property by location (%)



Source: KPMG, MSCI/PCA

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Technical appendix

What is uncertainty?

Uncertainty in a financial asset and from an investment return perspective is defined as the conditional volatility of a disturbance that is unforecastable from the perspective of economic agents, which include investors.

An economic disturbance is an event or action that reduces the predictability of the future net cash flows from income producing assets, like commercial property.

If an economic disturbance alters the perception an investor has of an asset's ability to earn a predictable return in the future (usually, in some context, to the return it has earned in the past) then the value an investor places on that asset will change; and where that information is not fully transparent across all participants in the market, there is likely to be an increased variance in (investor) valuations.

There can be a wide variety of shocks that alter investor expectations, but where changes occur rapidly (i.e. more volatility) the record of the past necessarily contributes less to predictions about future income. Volatility, which is a well-known indicator for measuring asset price risk, is conventionally measured as the standard deviation of asset returns.

Increases in uncertainty can depress hiring, investment, or consumption if households or investors are subject to fixed costs, are risk averse, and/or if financial constraints tighten in response to higher uncertainty.

What does the KPMG Commercial Property Uncertainty Index measure?

The KPMG Commercial Property Uncertainty Index tracks the variability of total returns from real estate properties. These returns are calculated based on the MSCI and Property Council of Australia Property Index (MSCI/PCA Property Index). This MSCI/PCA Index reflects the overall returns from direct real estate investments that are not leveraged, taken from one property valuation to the next, and considers only those properties that are completed and available to rent.

The Uncertainty Index does not break down how much of the uncertainty in the market is due to changes in property values (capital returns) versus rental income (income returns). Instead, it provides a measure of the overall level of uncertainty linked with the total returns from property investments.

Properties that yield steady and reasonable returns are typically associated with a lower score on the Uncertainty Index, indicating a stable market environment. Conversely, a spike in the Index suggests that investors are either anticipating, or responding to, significant shifts in the market. An increase in the Index value is an indicator of rising uncertainty in the investment environment, while a decrease suggests the opposite.

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Technical appendix (continued)

How is the KPMG Commercial Property Uncertainty Index calculated?

The KPMG Commercial Property Uncertainty Index has been constructed using total returns within a stochastic volatility model framework; an approach similar to that applied to measure stock market volatility. The stochastic volatility model treats volatility as a random process that evolves over time as opposed to treating it as constant or deterministic.

The Uncertainty Index value calculated using a stochastic volatility model tells users whether total returns of commercial property is more volatile in the current period, compared with previous periods (i.e. the index value is higher in period t than in period t-1) or less volatile (i.e. the index value is lower in period t than in period t-1).

A consistently low index number would indicate that the returns from the property market are stable and less variable. This stability could be due to a robust underlying demand for property or economic stability. In such a case, investors might lower their hurdle rates, as the risk associated with investing is perceived to be lower, and hence, they can accept lower returns for the reduced risk.

A moderate or high index number indicates a more volatile investment performance. In a volatile and uncertain investment environment, adopting a 'wait and see' approach can be advantageous. Volatility can lead to rapid and unpredictable changes in investment values. By waiting, investors can avoid making decisions that might result in significant losses due to unforeseen market movements. Uncertainty often implies a lack of information or the presence of conflicting information. Delaying investment decisions allows for the collection and analysis of additional data, leading to more informed decision-making. Alternatively, investors might also want to adjust their hurdle rates higher in such scenarios to compensate for the increased risk.

How is the stochastic volatility formula applied in the KPMG Commercial Property Uncertainty Index?

The key idea behind stochastic volatility models is that the latent volatility cannot be directly observed; instead, it must be inferred from the returns data. To achieve this, we firstly estimate the square of total returns, y_t, using a conditional mean equation:

$$\mathrm{y_t} = \mu + \sigma_t \epsilon_t \quad (1)$$

We then model the evolution of the variance term, σ_t^2, over time using a standard stochastic volatility process (see Harvey et al, 1994):

$$\log(\sigma_t^2) = \alpha + \beta \log(\sigma_t^2) + \omega \eta_t \quad (2)$$

where ϵ_t and η_t are iid $N(0,1)$ random variables.

The stochastic volatility parameters α, β and ω are then estimated by casting (1) and (2) into a state-space form using a Kalman Filter.

We then define the measure of uncertainty as:

$$\mathrm{U_t} = \sqrt{E(\sigma_t^2)}$$

References

Harvey A, Ruiz E, Shepard N. 1994. Multivariate Stochastic Variance Models. *Review of Economic Studies* 61: 247-264

Jurado K, Ludvigson S, Ng S. 2015. Measuring Uncertainty. *American Economic Review* 105: 1177-1216.

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