Real Estate for a changing world

UK ECONOMIC & INVESTMENT BRIEFING
APRIL 2019

Economic

- The European Council has given the UK a flexible extension until 31 October 2019. The UK will participate in European parliamentary elections in May or leave at the end of May.
- So this essentially means there is a new cliff edge date, however the UK has already stated it is prepared to participate in the May elections.
- With the news of a potential 'No Deal' falling the British Pound VIX - which is a measure of market volatility fell dramatically.

Investment

- The number of available commercial properties listed for purchase eased. Consequently UK commercial real estate transaction figures came in at £10.4 billion (down about a third on the five year quarterly average). Sales volumes in the non-traditional sectors outperformed in Q1 2019, outpacing the traditional sectors for only the second time since the series began.
- Overseas investors were the largest buyer group across the UK in Q1, transacting £4.8 billion (accounting for just under half of all commercial transactions). Investors from Asia Pacific were the most active, transacting £1.2 Billion.

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UK ECONOMIC UPDATE

New exit date

The European Council has agreed to extend UK's membership of the EU until 31 October 2019. The European Council offered the UK a flexible extension with the option to leave earlier if Parliament approves the withdrawal agreement.

The UK will participate in European parliamentary elections in May or leave at the end of May. So this essentially means there is a new cliff edge date, however the UK has already stated it is prepared to participate in the May elections.

With the news of a potential 'No Deal' falling the British Pound VIX - which is a measure of market volatility fell dramatically (see chart below).

How does the VIX work?

Traders will buy options (a type of derivative) in order to safeguard themselves from any downside risk when they foresee a possible market fall. As they begin to increase purchases of these options the implied volatility rises, which in turn will increase the VIX.

The latest delay to Brexit has also prompted investors to sell British gilts. British 10-year gilt yields rose by 20 basis points, reaching 1.19% (April avg), pushing the spread over the equivalent German bund to approx 95 basis points. The difference between British and German bond yields is at its widest in almost two-and-a-half years.

In the past investor interest in bonds has driven prices up and therefore sending yields down. With investors seeking to benefit from more accommodative central banks government bond yields around the world have reached all time lows.

Low yields are good news for the government as this means it is cheaper to borrow, but lower bond yields is also an indication that investors are not confident about growth prospects.

Recently the demand for gilts has gone down. Markets are moving towards the notion that we are headed towards a much 'softer' Brexit which translates into not much of threat to the UK economy. This has then led the market to believe that the Bank of England will deliver at least one interest rate hike this year. As interest rates rise, investors are unlikely to hold onto government bonds as they are able to get a higher return elsewhere.

But it's not all about Brexit...

German government bond yields have more or less hovered around 0% for most of this year. The US Treasury yield has also been trending downwards. We saw yields peak back in October last year.

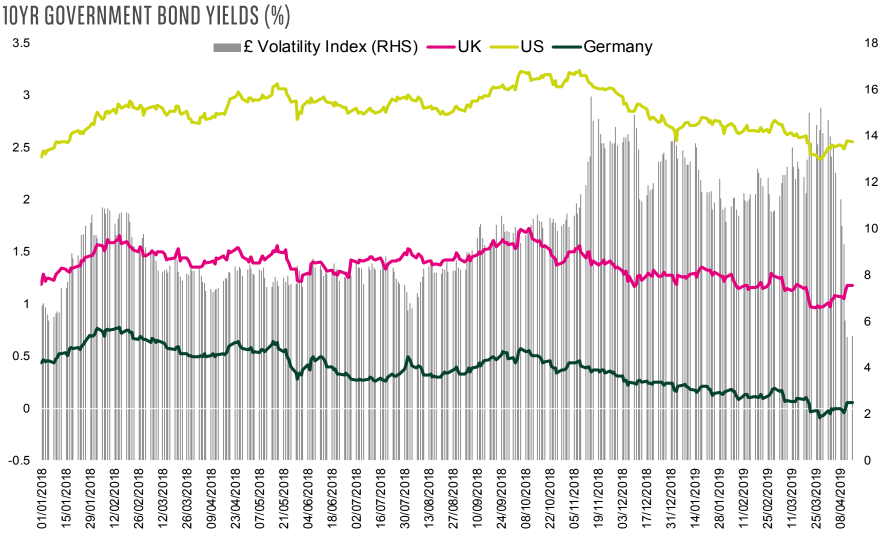
So what has changed?

The Federal Reserve has changed its stance on interest rates, with markets now attributing 90% probability of a rate cut this year. While in the euro area risks to the economic outlook are rising, with monetary policy normalisation policies on hold. All in all signs of a sychronised global slowdown have risen coercing investors seeking security in government bonds therefore sending yields even lower.

Looking ahead as central banks around the world are likely to maintain their accomodative monetary policies, bond yields will remain lower for longer.

"The latest delay to Brexit has prompted investors to sell British gilts. British 10-year gilt yields rose by 20 basis points."

10YR GOVERNMENT BOND YIELDS (%)



Source: Macrobond

UK INVESTMENT UPDATE

Asset owners wait & see

The major theme of Q1 2019 was an easing in the number of available commercial properties listed for purchase. Consequently UK commercial real estate transaction figures came in at £10.4 billion, about a third below the five-year average quarterly volume. Uncertainty was the defining characteristic of capital markets in Q1 2019, with the investment environment looking unclear beyond the nominal Brexit deadline of 29 March 2019 (which after being delayed twice this year, now stands at 31 October 2019).

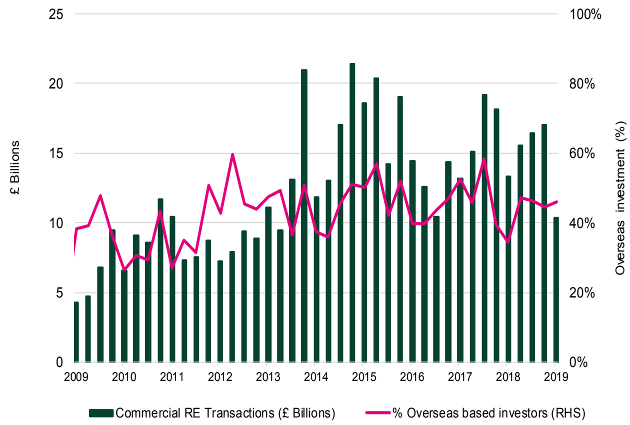
Typically the number of larger transactions determine the strength of the quarterly volumes; this quarter the > £100 million segment experienced a ~£2.2 billion shortfall on the previous three year quarterly average. The Investment Committees governing portfolios housing large assets generally exercise a cautious attitude to risk and it is unsurprising they opted to place divestment and tactical disposal plans on hiatus. Had assets been less tightly held this quarter, we expect that transaction volumes would have been broadly in line with recent history as there are active potential purchasers that are looking beyond the near-term uncertainty and placing more consideration on market fundamentals.

Potential buyers favourably rate the fundamentals

Underpinning the UK commercial real estate investment thesis is the (long-term) liquidity, transparency and comparatively favourable economic fundamentals. Employment growth has been trending upwards and wages continue to outpace the rate of inflation, improving the assumed security of covenant on office and prime quality retail assets. The pound has been trading at a discount to its long-term average and continues to attract international investor interest to the property market; while a further Sterling depreciation in the short-term may be expected, the long-term assessment from international investors remains positive.

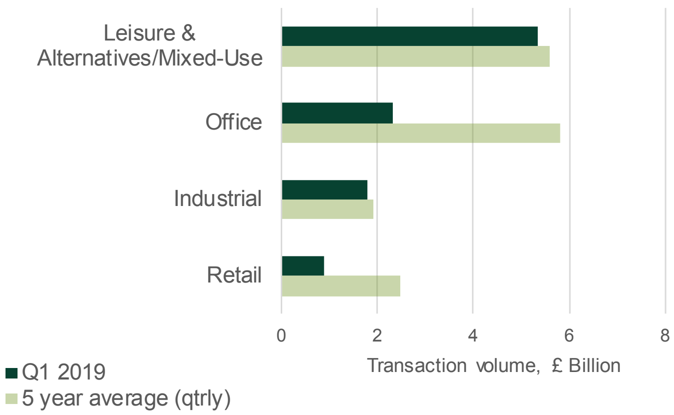
In fact, overseas investors remained proportionally at the average in Q1 2019 (46% of quarterly investment volumes), investing £4.8 billion into the UK commercial real estate market. Overseas based investors have acquired (on a net

Commercial Property Transactions & Overseas Investors



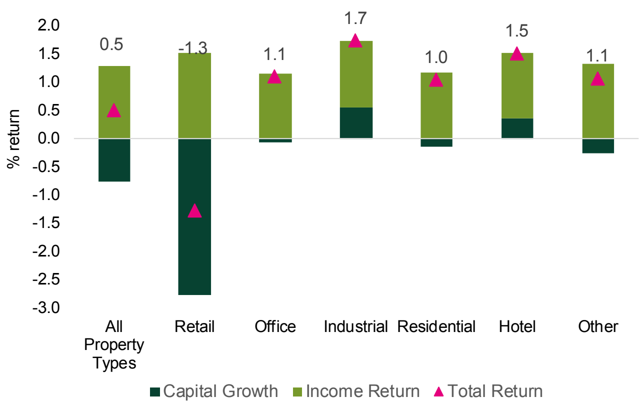
Source: Property Data

Q1 2019 Commercial Property Transactions, by sector



Source: Property Data

Total Returns Q1 2019



Source: MSCI

basis) ~£118 billion of UK commercial real estate since 2000 to 2018. Demand is not confined to overseas investors, a developing trend continued into Q1 2019 as quoted property companies remained net buyers for the sixth consecutive quarter.

In an endorsement of the long term outlook, the largest sales this quarter were made outside the traditional property classes; the Grange Hotel Portfolio transacted for ~£1.0 billon, while Canadian Pension Fund PSP and QuadReal entered into a JV for £500 million in a build-to-rent project at Westfield Stratford. The PSP/QuadReal JV with Unibail-Rodamco-Westfield illustrates that overseas investors are motivated to obtain scale in the UK property market and will move up the risk curve into new and alternative/non-traditional sectors to obtain it.

Overseas investors were the largest buyer group across the UK in Q1, transacting £4.8 billion (accounting for just under half of all commercial transactions). Investors from Asia Pacific were the most active, transacting £1.2 billion.

Near term returns impacted by Brexit

The MSCI All Property Total Returns were comparatively soft this quarter at 0.5%. While retail had the overall largest negative impact on the all property index (-1.3% retail total return, driven by a -2.8% deterioration in retail capital values), the total returns for the remaining asset classes were also soft (albeit positive), ranging from ~50-60% below their 5 year quarterly average. To put this in context, the observations recorded immediately after the Brexit referendum were acutely negative (All Property Index recorded a -2.3% drop, followed by a bounce-back in the following quarter), in Q1 2019 total returns have held up much better by comparison. With the FTSE & Sterling Volatility indices (VIX) indicating a degree of relief flowing through investment markets, we can expect total returns to claw back some lost ground in the remainder of 2019, however downside risks to this outlook remain tied up with Brexit.

KEY ECONOMIC & PROPERTY METRICS

April 2019

IPD Net initial yields	Current*	1m ago	Difference
All Property	5.02	5.01	0.01
Retail	5.94	5.92	0.02
Office	4.52	4.52	0.00
Industrial	4.53	4.51	0.02
Residential	3.69	3.78	-0.09

IPD Capital growth (%)	Current	1m ago	Difference
All Property	-0.23	-0.32	0.09
Retail	-0.94	-1.10	0.16
Office	0.03	-0.06	0.09
Industrial	0.23	0.20	0.03
Residential	-0.27	0.14	-0.41

IPD Total Returns (%)	Current	1m ago	Difference
All Property	0.20	0.10	0.10
Retail	-0.43	-0.60	0.17
Office	0.42	0.32	0.10
Industrial	0.63	0.58	0.05
Residential	0.12	0.53	-0.41

Economic (%)	Current	1m ago	Difference
UK GDP**	0.2	0.7	-0.47
EU GDP**	0.3	0.3	-0.01
US GDP**	0.5	0.8	-0.29
UK RPI	2.4	2.5	-0.10
UK CPI	1.9	1.9	0.00
US CPI	1.9	1.5	0.36
EU HICP	1.6	1.6	0.02

Rates (%)	Current	1m ago	Difference
BoE policy rate	0.75	0.75	0.00
ECB key interest rate	0.00	0.00	0.00
US Fed rate	2.50	2.50	0.00
SONIA	0.70	0.71	0.01
EONIA	-0.36	-0.37	0.01
SHIBOR	2.49	2.58	-0.10
TONAR	-0.06	-0.05	-0.01
UK 5YR swap	1.06	1.31	-0.25
US 5YR swap	2.26	2.55	-0.28
EU 5YR swap	0.01	0.17	-0.16

10YR Bond yields (%)	Current	1m ago	Difference
UK	0.97	1.27	-0.30
France	0.32	0.57	-0.25
Germany	0.01	0.06	-0.05
US	2.57	2.67	-0.10
Japan	-0.04	-0.02	-0.02

Equity dividend yields	Current	1m ago	Difference
All share	4.22	4.29	-0.07
Financial	4.32	4.24	0.08
Non-financial	4.19	4.30	-0.11
FTSE EPRA REIT's	4.33	4.22	0.11

Exchange rates	Current	1m ago	Difference
EUR per GBP	1.16	1.17	-0.01
USD per GBP	1.30	1.33	-0.03
MYR per GBP	5.32	5.41	-0.09
SGD per GBP	1.76	1.80	-0.03
CNY per GBP	8.74	8.90	-0.15
JPY per GBP	144.23	148.04	-3.81
HKD per GBP	10.23	10.44	-0.21
KRW per GBP	1481.84	1496.41	-14.57

Volatility	Current	1m ago	Difference
FTSE 100 Volatility Index	12.85	13.49	-0.64
S&P 500 Volatility Index	13.71	14.78	-1.07
Eurostoxx Volatility Index	15.27	13.59	1.68

Commodites	Current	1m ago	Difference
Brent $/bbl	66.01	61.87	4.14
Gold $/oz	1295.40	1319.15	-23.75

**The latest level date of reference refer to the previous month highlighted on the top right, unless stated otherwise.

*Quarterly GDP - compared to the previous quarter

Sources: Macrobond, MSCI, BNPPRE