cluttonsim.com

CLUTTONS IM

COMMERCIAL PROPERTY EXAMINER

QUARTER THREE | 2019

CLUTTONS IM

We invest in best in class properties for their quality, income security and sustainable growth potential. We believe that a portfolio of properties demonstrating these attributes will produce a consistent, superior investment return over time.

PORTFOLIO
We blend incisive, value-add research with disciplined portfolio construction, selecting those sectors with the best long-term performance prospects.

PERFORMANCE
Our philosophy is perfectly aligned with our clients' objectives as long-term investors in property and best illustrated in our track record of benchmark outperformance over one, three or five year or longer-term time horizons.

ASSET
Our portfolio management is underpinned by a rigorous approach to individual stock selection, with active asset management to protect and enhance asset value whilst driving investment returns.

EXECUTIVE SUMMARY

The performance of the UK economy continues to be underwhelming. UK economic output has been disappointing since the GFC and expectations of the outlook for the next two years are lower still.

Market interest rate expectations are indicative of a 25 bps cut in Bank Rate in Q1 2020 back to 0.5% where it remains until the end of the forecast period. Jon Cunliffe, Deputy Governor of the BoE has recently warned that the current "lower for longer" environment risks more severe economic downturns.

Gilt yields have hardened by a further 37 bps since the end of Q2. The pricing of UK real estate continues to be attractive relative to other asset classes.

Risk and uncertainty are heightened currently and key metrics are indicative of a coming recession.

MSCI data indicates that All Property values contracted in Q3 for the fourth consecutive quarter. the market is differentiated by poorly performing retail assets, stagnant offices and the continued out-performance of industrials. All Property capital values decreased by a further -0.7% as retail capital values fell by -3.1%. But, office capital values rose by 0.2% and industrial values increased by 0.6%.

Office and industrial rental value growth remains positive. South East industrial rental value growth is still strong by historical standards and growth in West End rental values has strengthened.

However, rental values for shopping centres, retail warehouses and shops continue to fall.

August's IPF Consensus Forecast round continues to indicate that 2019 is expected to represent a cyclical trough.

All Property performance expectations for 2019 weakened from 1.8% to 0.9% and expectations for 2020 were reduced to 2.9% from 3.1% in May. Capital values are now expected to shrink by 4% in 2019 and 2% in 2020.

In the medium to long term we continue to expect a slowing global economy and the UK's exit from the EU to entrench the current slow-down in domestic economic growth. This will restrain rental growth and cause yields to soften further. Consequently, we expect a gradual weakening in property values over the next three years. As the outlook has weakened this quarter and the risks appear to strengthening, our three -year forecast has decreased from an average annualised total return of 4% to 3%

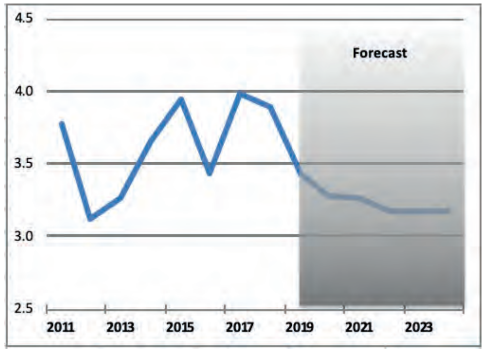
THE UK ECONOMY

The health of the UK's commercial property market is inextricably linked to that of the UK's economy which itself is driven by developments in the world's dominant economies of the USA, China and Europe. In October, the World Bank downgraded its forecast for global growth to the lowest level since 2009/10 (see Chart 1.1).

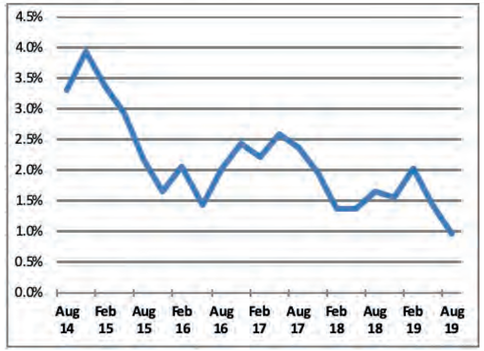
Facing these headwinds, the performance of the UK economy continues to be underwhelming (see Chart 1.2). UK economic output has been disappointing since the GFC and expectations of the outlook for the next two years are lower still (see Chart 1.3).

October's Markit/CIPS PMI survey points to a decline in GDP of 0.1% in the third quarter which means the UK is facing a heightened risk of recession. Cluttons IM's recent opinion piece was headed "The Next UK Recession – not if, but when?". It concluded that the next economic downturn may not arrive this year but is inevitable.

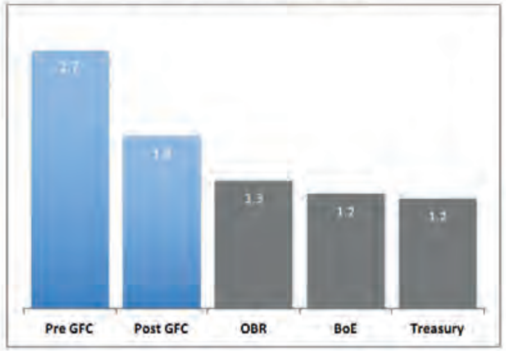
1.1 Economic growth - G4 (China, EU, Japan & USA)



1.2 Economic growth - rolling 12m



1.3 Historic and forecast economic growth rates



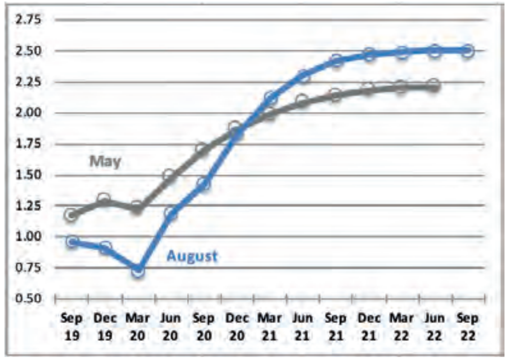
CPI & INTEREST RATES

In its August Inflation Report the MPC noted that growth is expected to remain subdued in the coming quarters as Brexit related uncertainties remain elevated (see Chart 1.4). Consequently, CPI inflation is projected to fall below the 2% target in the short term.

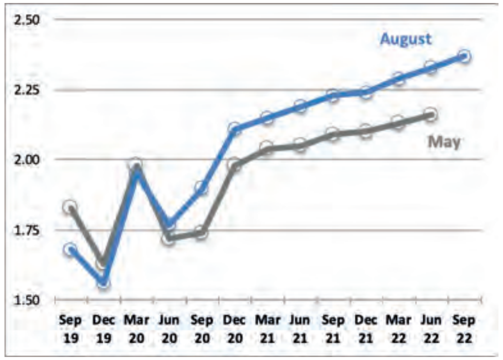
Conditioned on a smooth withdrawal of the UK from the EU, the MPC assumes that Brexit related uncertainties will subside over the forecast period. This decline in uncertainty combined with a looser monetary policy leads to a strong recovery in demand and robust growth rates causing inflationary pressure to build above the 2% target rate by the end of the forecast period (see Chart 1.5).

Market interest rate expectations are indicative of a 25 bp cut in Bank Rate in Q1 2020 back to 0.5% where it remains until the end of the forecast period (see Chart 1.6). Jon Cunliffe, Deputy Governor of the BoE has recently warned that the current "lower for longer" environment risks more severe economic downturns.

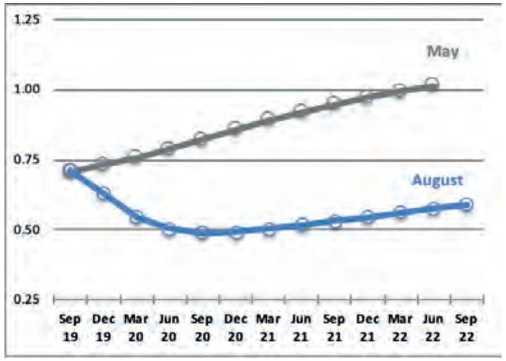
1.4 Bank of England Economic forecasts



1.5 Bank of England CPI forecasts



1.6 Market interest rate expectations



OTHER ECONOMIC INDICATORS

The main contributor to economic growth in the three months to August 2019 was the services sector, which grew by 0.4%.

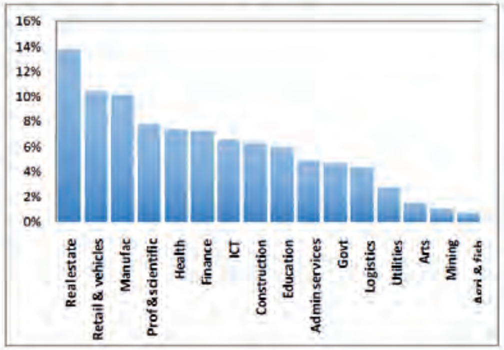
Meanwhile, the production sector fell by 0.4% in the same period, while construction output grew by 0.1%.

The main contributor to services growth in the three months to August was the professional, scientific and technical sector.

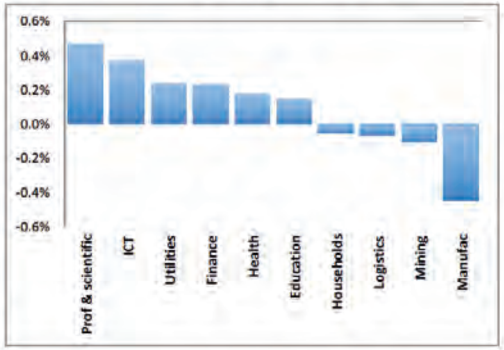
However, the sub-industry that had the largest contribution to economic growth was motion pictures (including TV and music), which has been one of the best performing sectors over the last year.

As Jon Cunliffe implies above, the monetary tools available to stimulate a low inflation / low interest rate economy are limited. In such circumstances it is of concern that the path of business investment in the last two years has been downward as uncertainty weighs on firms' capital spending is worrying (see Chart 1.9).

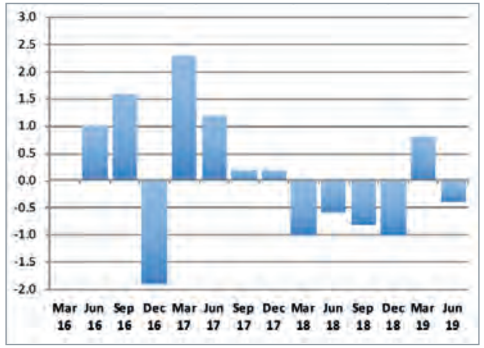
1.7 UK industrial sectors ranked by size (%)



1.8 Industry contributions to All UK economic growth



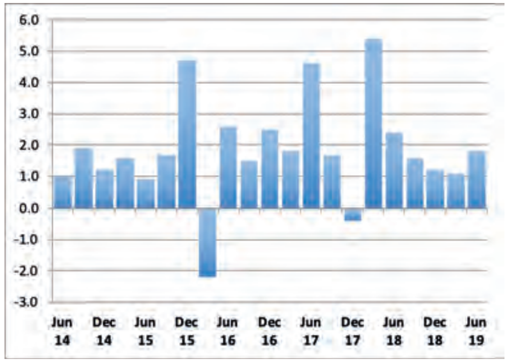
1.9 Business investment quarterly growth



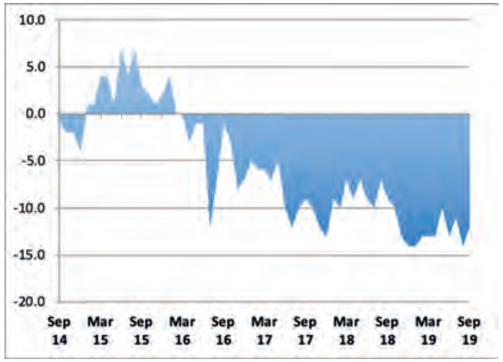
Household consumption has been revised down in the first two quarters of 2019 and all available evidence suggests that consumer spending remains relatively subdued (see Chart 1.10). The GfK Consumer Confidence Index increased 2 points in September, but the overall trend remains downwards (see Chart 1.11).

Limited monetary tools, reduced consumer spending and passive business investment will require a more Keynesian approach to economic policy from the Government than it has demonstrated since 2010. But the latest figures from the ONS indicate that Government borrowing increased by more than 20% as Whitehall carried out preparations for a "no-deal" Brexit. This may restrict future plans to spend on public services and infrastructure projects to support the post-Brexit UK economy.

1.10 Household expenditure quarterly growth (%)



1.11 Consumer Confidence



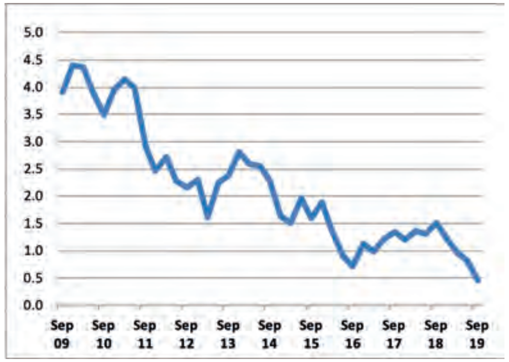
INTEREST RATES & ASSET YIELDS

To reinforce the "lower for longer" theme, gilt yields have hardened by a further 37 bps since the end of Q2 (see Chart 2.1). UK long nominal rates have not been this low in the past 200 years. In Germany the 30 year bund yielded minus 0.27% in August.

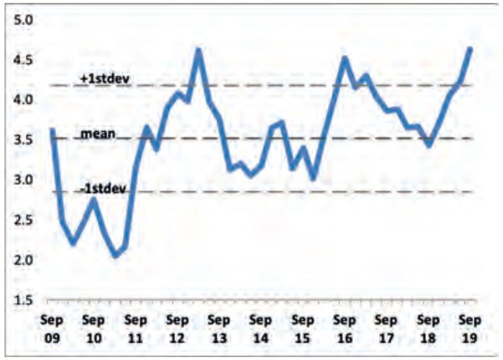
The current property initial / gilt yield gap has therefore increased to 4.63% and remains more than 1 standard deviation above the 10- year average (see Chart 2.2). The gap has widened by 120 basis points since September 2018. Arguably, this provides a strong floor under UK real estate asset prices. In June 2007 at the outset of the last downturn, the yield gap had reversed; property yields were 4.6% and gilt yields 5.3%.

CIM's paper earlier this year arguing for Pension Funds to increase their allocation to real estate, demonstrated that in the last 20 years, real estate as an asset class has provided better returns than equities at a much-reduced level of risk. A key factor in real estate's relatively low volatility is the key contribution to total returns made by income (see Chart 2.3); 70% of real estate's overall performance comes from income.

2.1 FT Gilt 5-15 yr yield (%)



2.2 Property IY - Gilt yield gap (%)



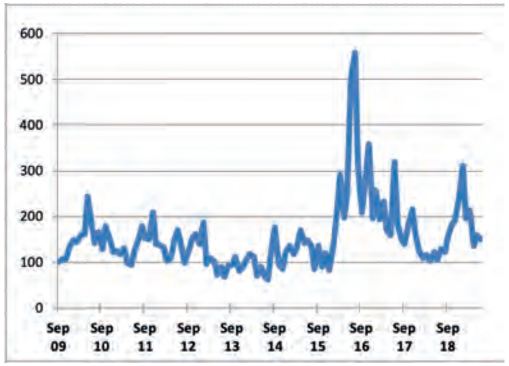
2.3 Asset yields (%) (Sep 19)

RISK & UNCERTAINTY

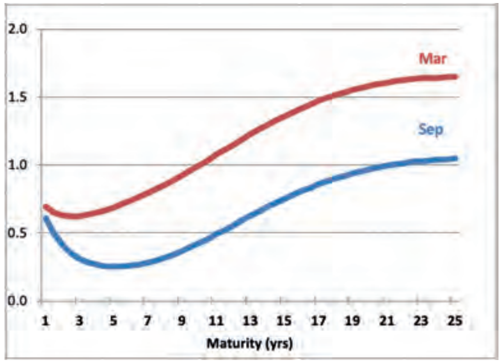
Brexit, Trump's election, the rise of populism and discussions concerning the Thucydides trap on Radio 4's Today programme suggest that political risk has heightened in recent years. The Global Economic Policy Uncertainty Index (see Chart 2.4) seeks to quantify this political risk. The UK index is based on the volume of articles from 10 UK newspapers regarding policy uncertainty.

A key recession indicator, discussed in recent months, looks at the yield curve. Typically, this curve flattens when bond investors anticipate a slowdown and indicates imminent recession when long term rates are lower than short-term rates (see Chart 2.5). Yield curve inversion has been a reliable indicator of previous recessions including the GFC; the dot.com bust & US recession; the Lawson boom / bust & ERM; and the early 1980's experiment with monetarism (see Chart 2.6).

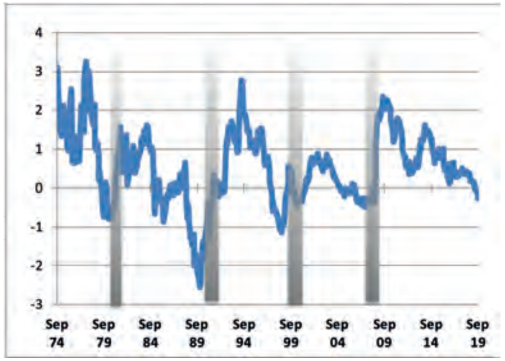
2.4 UK uncertainty index



2.5 Gilt yield curve (%)



2.6 Yield curve inversion



MSCI DATA COMMENTARY - PT. 1

The performance of private real estate as monitored by MSCI has been weakening across all sectors of the market since September 2018. MSCI data indicates that All Property total returns continued to fall back as values contracted in Q3, for the fourth consecutive quarter.

The market is differentiated by poorly performing retail assets, stagnant offices and the continued out-performance of industrials.

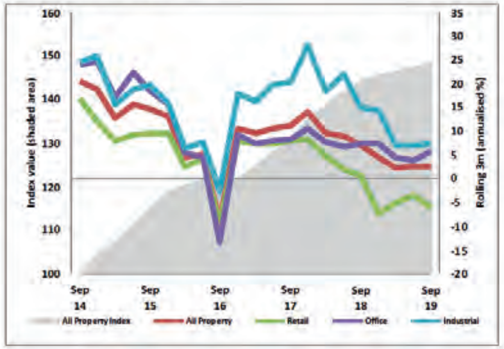
All property capital values decreased by a further -0.7% as retail capital values fell by -3.1%. But, office capital values rose by 0.2% and industrial values increased by 0.6%.

MSCI DATA COMMENTARY - PT. 2

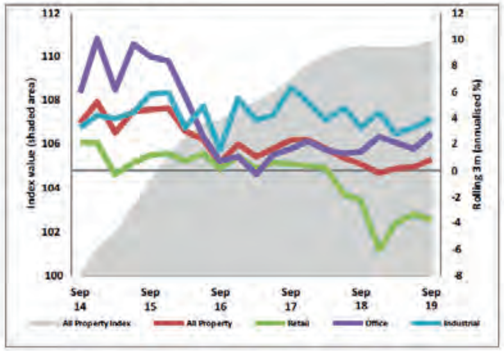
All UK property rental value growth continues to be very weak. Rental values increased by a barely perceptible 0.2% in the year to September. Office and industrial rental value growth remains positive. South East industrial rental value growth is still strong by historical standards and growth in West End rental values has strengthened. However, rental values for shopping centres, retail warehouses and shops continue to fall.

The market decline in Q3 is wholly attributable to yield impact of - 0.8% as Rental Value Growth was limited. Yields continue to gradually soften; the initial yield on MSCI's Monthly Index has increased from 5.06% in Q2 to 5.09% at the end of Q3.

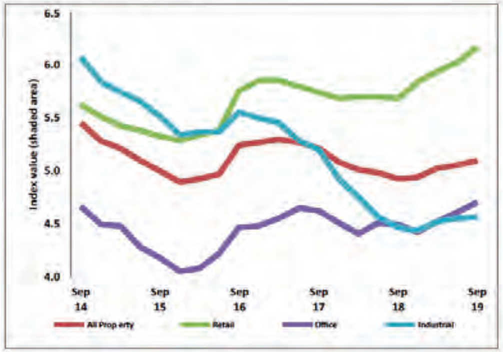
3.1 Total returns by sector



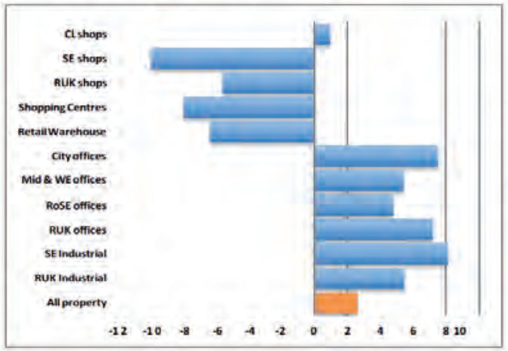
3.2 MRV growth by sector



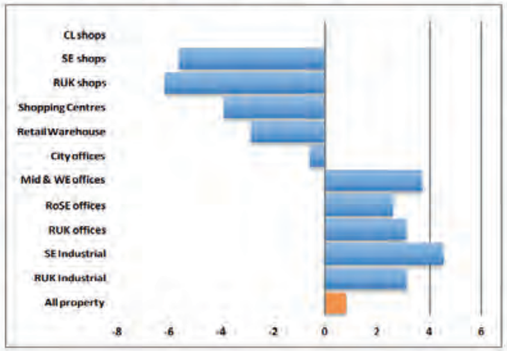
3.3 Initial yield by sector



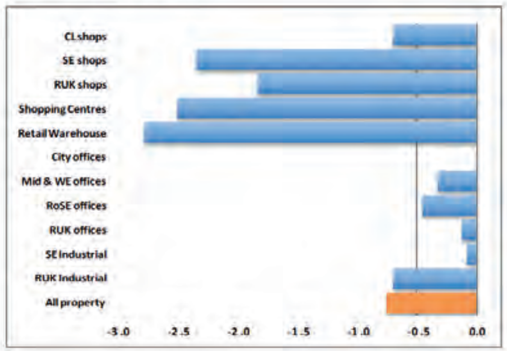
3.4 Total returns by segment (Q3 annualised)



3.5 MRV growth by segment (Q3 annualised)



3.6 Yield impact (Q3)

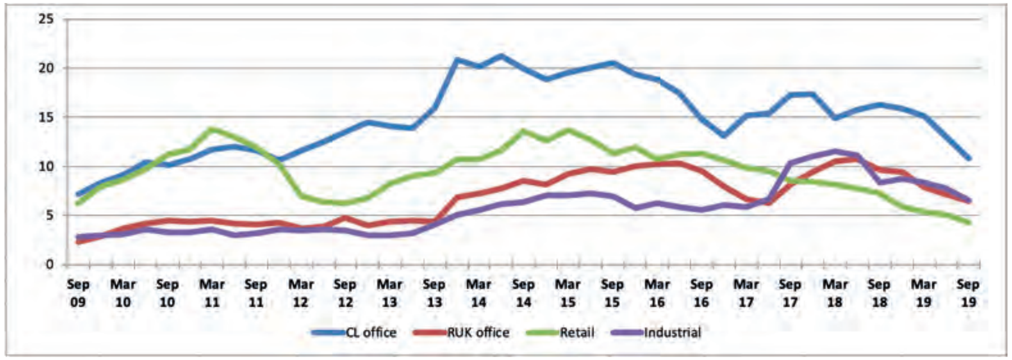


INVESTMENT BY SECTOR

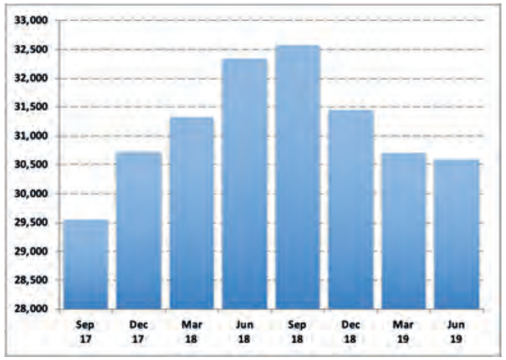
Investment in Central London offices decreased by 20% to £2.3bn in Q3 from £2.8bn in Q2 and there has been a reduction in transactions of 34% in the rolling 12-months ending September 2019 compared to the 12-months ending September 2018.

Net investment in Q2 decreased across all other market segments with the exception of Rest of UK offices, where quarterly investment was up 31%. Perhaps most surprising was the continued decline in industrial transactions from £1.9bn in Q1, to £1.2bn in Q2 and £815mn in Q3. We suspect that this caused by a lack of assets available for sale rather than a flight from the sector.

3.7 Rolling 12m investment by sector (£bn)



3.8 Property Funds under management (£mn)



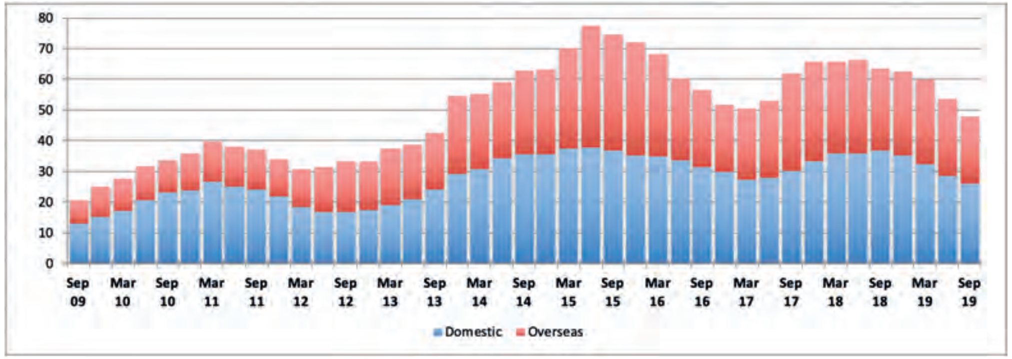
INVESTMENT BY INVESTOR TYPE

Domestic and Overseas investors together bought commercial property in Q3 2019 worth £10.76bn compared to purchases of £9.04bn in Q2. Unsurprisingly, given the uncertainties caused by Brexit, the amount of money flowing into UK property from overseas has been declining since September 2018.

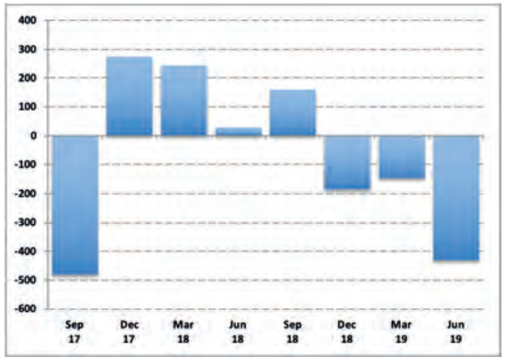
Year on year inflows to the UK from overseas in Q3 are 28% down on the levels achieved 12 months ago. In contrast UK based investors increased their purchases of UK real estate by 45% in Q3; the first quarter on quarter increase this year.

Shortly after the referendum in 2016 Standard Life, Aviva, M&G, Henderson and Columbia Threadneedle suspended redemptions from their open ended property funds. Fear of a similar outcome in the event of a disorderly Brexit, has caused Investment Association Property funds under management to fall since Q4 last year (see Charts 3.9 and 3.10).

3.9 Rolling 12m investment by investor type (£bn)



3.10 Property funds' net sales to retail investors (£mn)



Retail property continues its journey of transition as rents rebase to lower levels reflecting the shift in consumer behaviour and rise in e- commerce. It is not yet clear how much further this process has to run or where retail rents will settle. One possible outcome is that secondary assets values will be severely discounted relative to prime assets. But until this rebasing is complete it is difficult to judge fair value for retail assets.

Investors, however, can still find positive returns across the industrial and office sectors but stock selection and geographical spread will be paramount. There also remains a flight to alternative sectors, where attractive long-term income streams can be secured but stringent checks on underlying tenant covenant will need to be carefully assessed to mitigate tenant default risk.

Investors need to adjust their expectations to a lower return environment in the short term, whilst bearing in mind that there remain downside risks even to these lower projected levels of return.

Whilst most strategies involving retail property underperformed in Q3, low yield and long lease shops out performed relative to the All Property average. The best performing strategy was provided by high rent rest of UK offices.

3.11 TOTAL RETURNS

	Sept	3m	6m	12m
All Property	0.2	0.6	1.3	2.9
Retail	-0.8	-1.5	-2.4	-5.5
Office	0.5	1.4	2.4	5.3
Industrial	0.6	1.7	3.5	8.9
ANNUALISED				
All Property	2.0	2.6	2.6	2.9
Retail	-9.2	-6.0	-4.8	-5.5
Office	6.4	5.7	4.8	5.3
Industrial	8.1	7.2	7.1	8.9

3.12 CAPITAL GROWTH

	Sept	3m	6m	12m
All Property	-0.3	-0.7	-1.3	-2.3
Retail	-1.3	-3.1	-5.5	-11.1
Office	0.1	0.2	0.0	0.6
Industrial	0.3	0.6	1.1	3.9
ANNUALISED				
All Property	-3.2	-2.6	-2.6	-2.3
Retail	-14.8	-11.8	-10.6	-11.1
Office	1.5	0.9	0.0	0.6
Industrial	3.1	2.3	2.2	3.9

3.13 INCOME RETURN

	Sept	3m	6m	12m
All Property	0.4	1.3	2.6	5.3
Retail	0.5	1.6	3.2	6.3
Office	0.4	1.2	2.4	4.7
Industrial	0.4	1.2	2.4	4.8
ANNUALISED				
All Property	5.3	5.3	5.3	5.3
Retail	6.5	6.5	6.4	6.3
Office	4.9	4.8	4.8	4.7
Industrial	4.8	4.8	4.8	4.8

3.14 ERV GROWTH

	Sept	3m	6m	12m
All Property	0.1	0.2	0.3	0.2
Retail	-0.2	-0.9	-1.8	-4.3
Office	0.2	0.7	1.1	2.2
Industrial	0.3	1.0	1.8	3.6
ANNUALISED				
All Property	0.9	0.8	0.5	0.2
Retail	-2.6	-3.7	-3.5	-4.3
Office	2.6	2.8	2.2	2.2
Industrial	3.2	4.0	3.6	3.6

3.15 NET INITIAL YIELD

	Sept	3m	6m	12m
All Property	5.1	5.1	5.0	4.9
Retail	6.2	6.0	5.9	5.7
Office	4.7	4.6	4.5	4.5
Industrial	4.6	4.5	4.5	4.5

3.16 Performance by strategy relaltive to All Property average Q3 2019

	Low Yield	High Yield	High Rent	Low Rent	Long Lease	Short Lease
Shops	0.1	-3.8	-0.8	-2.2	0.1	-1.8
Shopping Centres	-3.6	-3.5	-4.2	-1.7	-1.4	-3.2
Retail Warehouses	-1.6	-2.0	-2.4	-1.5	-0.8	-1.8
Central London offices	0.5	-0.1	0.1	0.6	0.5	-0.1
RoSe offices	0.7	-0.1	0.8	1.0	0.7	0.6
RUK offices	0.8	-1.1	2.5	0.3	0.6	0.2
Industrials	1.2	1.7	1.5	1.0	1.1	1.5

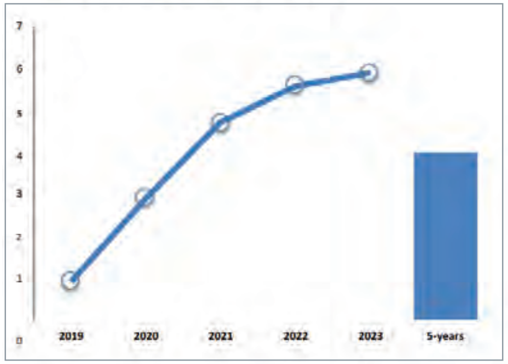
IPF CONSENSUS FORECASTS AUGUST 2019

August's forecast round continues to indicate that 2019 is expected to represent a cyclical trough. All Property performance expectations for 2019 weakened from 1.8% to 0.9% and expectations for 2020 were reduced to 2.9% from 3.1% in May. Capital values are now expected to shrink by 4% in 2019 and 2% in 2020.

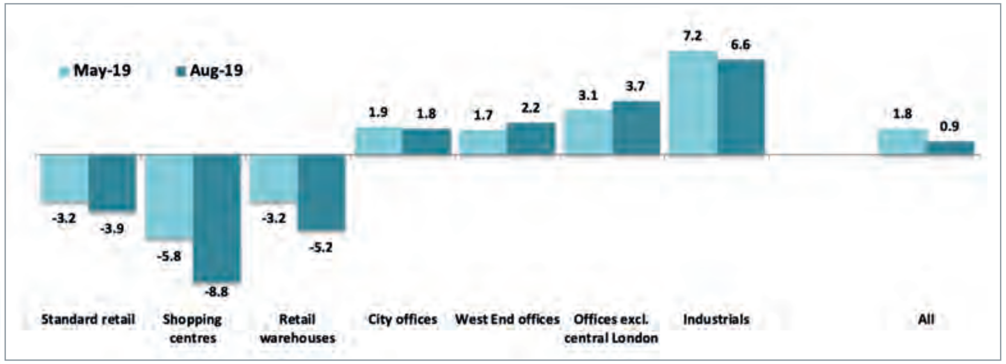
At the segment level the outlook for retail property in the last three months of the year has weakened further. The outlook for offices and industrials is stronger.

The 5-year outlook remains at an annualised average forecast of 4.0%. The medium term outlook has improved for offices and industrials but deteriorated for all types of physical retail.

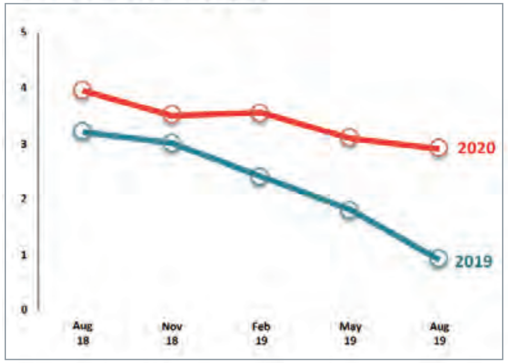
4.1 IPF All Property forecasts y-by-y (Aug 19)



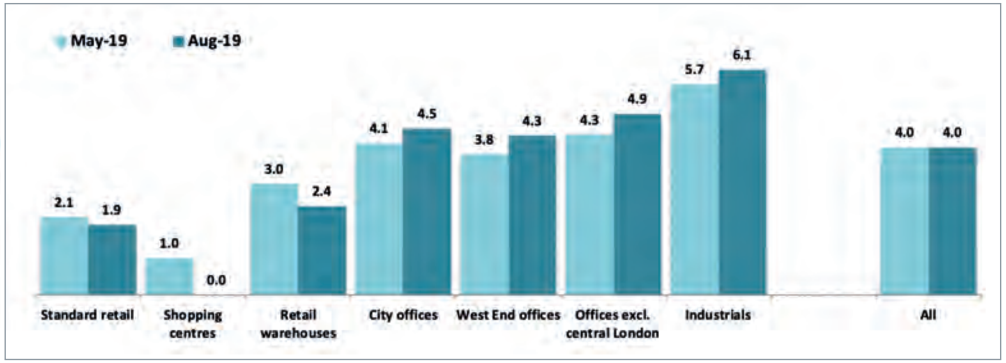
4.3 IPF 2019 forecasts by sector (%)



4.2 IPF forecast evolution (Aug 19)



4.4 IPF 5-year forecasts by sector (%)



CLUTTONS IM HOUSE VIEW FORECASTS

In the medium to long-term we continue to expect a slowing global economy and the UK's exit from the EU to entrench the current slow-down in domestic economic growth. This will restrain rental growth and cause yields to soften further. Consequently, we expect a gradual weakening in property values over the next three years. As the outlook has weakened this quarter and risks appear to be strengthening, our three-year forecast has decreased from an average annualised total return of 4% to 3%.

With effective investment management, it should be possible to mitigate these heightening risks both absolutely and relative to other asset classes, as UK real estate continues to be an attractive investment proposition by comparison to these other asset classes.

4.5 Cluttons House View - 2019 relative total returns (%)

CLUTTONS IM OPINION

Economic indicators suggest that a technical recession may now be avoided this year. However, recessionary pressures continue to abound, with the Government facing a lack of flex in both monetary or fiscal policy to stimulate economic growth. This is having a negative impact on capital values and overall returns.

Very few sub-sectors are now forecasting a prospective total return above the All Property average. With prospective returns of just 3%- 4% p.a. over the next three years, sector allocation will be of key importance to investors but so too will individual stock selection.

Despite this, real estate remains an attractive investment proposition due to the extent of the current gilt-yield gap and the desire across the global markets for secure income streams. Those portfolios holding high quality stock on durable income profiles and with limited exposure to retail will continue to perform best.

4.6 Cluttons House View - 2019-2021 relative total returns (%)

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GLOSSARY

1. IPF FORECASTS BY SECTOR

SR	Standard Retail
SC	Shopping Centres
RW	Retail Warehouse
CO	City Offices
WEO	West End Offices
O ex CL	Offices excluding Central London
I	Industrials

DATA SOURCES

Macro-Economic Background

1.1 International Monetary Fund
1.2 ONS
1.3 ONS, OBR, BoE and HM Treasury
1.4 Bank of England
1.5 Bank of England
1.6 Bank of England
1.7 ONS
1.8 ONS
1.9 ONS
1.10 ONS
1.11 ONS
1.12 ONS

INTEREST RATES & ASSET YIELDS

2.1 FT
2.2 FT & MSCI
2.3 FT & MSCI
2.4 POLICYUNCERTAINTY.COM
2.5 BANK OF ENGLAND
2.6 BANK OF ENGLAND

CRE PERFORMANCE

All tables and charts MSCI Forecasts

4.1 Investment Property Forum
4.2 Investment Property Forum
4.3 Investment Property Forum
4.4 Investment Property Forum
4.5 Alexander Property Research (APR)
4.6 APR

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