cluttonsim.com

CLUTTONS IM

COMMERCIAL PROPERTY EXAMINER

QUARTER FOUR | 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.

SUMMARY

In November UK economic output declined by 0.4% and year-on-year GDP growth decreased to just 0.5%; the lowest level since June 2012. IHS Market/CIPS survey data suggests that the economy again stagnated in December but hinted at an improvement in confidence post election.

Sterling rose 1% in December but fell back by the same figure in January. This is in the context of a 15% fall in the value of sterling since the middle of 2015 when the prospect of a Brexit referendum first appeared. Any other data to support an immediate improvement in conditions is so far strictly limited.

If global growth fails to stabilise, or if Brexit uncertainties remain entrenched, monetary policy may need to reinforce the expected recovery in UK GDP growth and inflation. Expectations of a 25bp loosening in February or May are now gaining traction.

Weak consumer spending and passive business investment now require increased Government spending.

Regional economic imbalances have become entrenched in the UK. Five of the 10 largest concentrations of high growth industrial activity are located in London. And more than 50% of the largest concentrations in the same activities outside London are located in the South East.

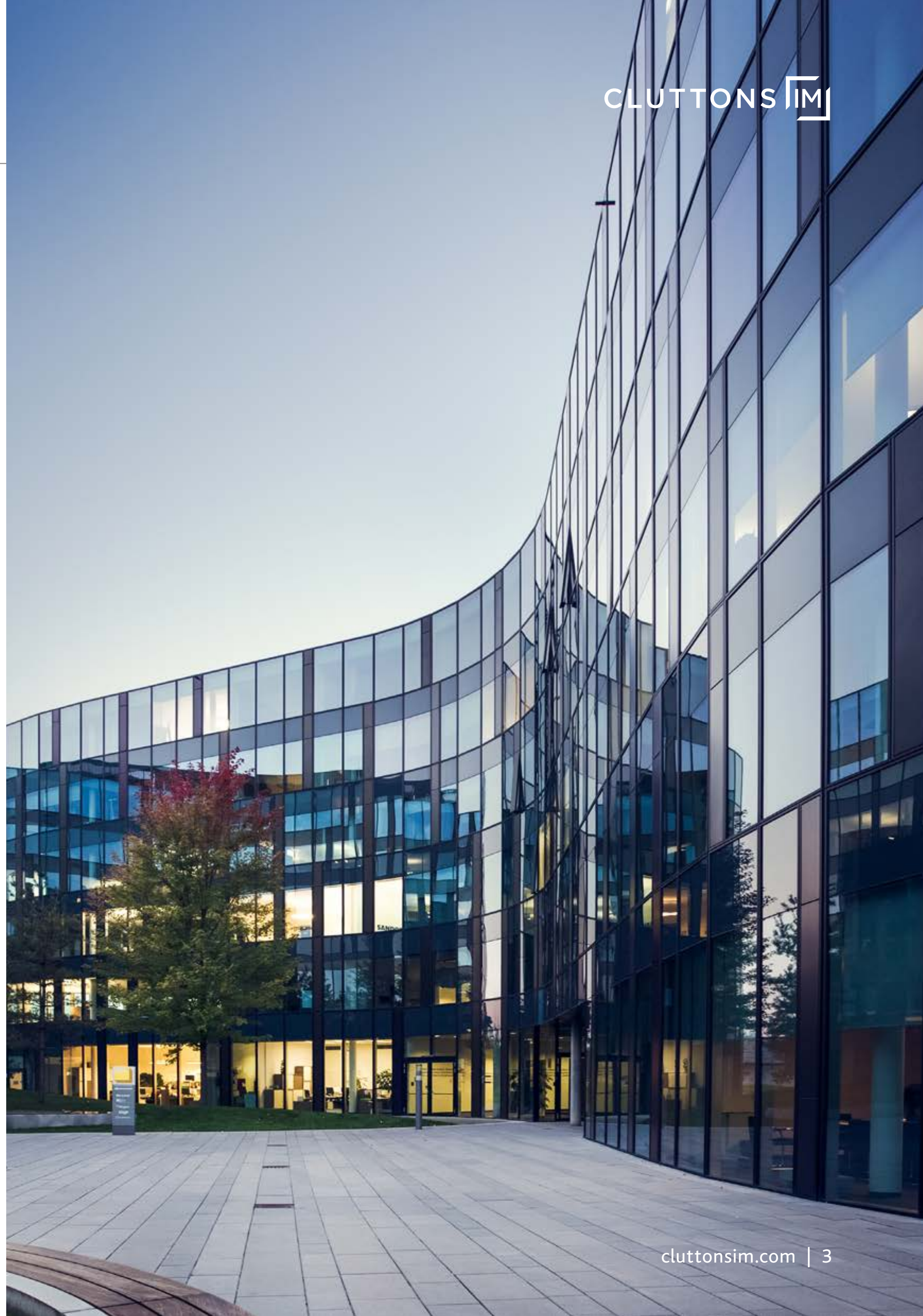
Manufacturing grew by 2.5% in the 3-years to y/e 2018 compared to all UK economic growth of 5.4%. Only one South East location is contained in a list of the locations with the largest concentrations of manufacturing activity.

The property initial / gilt yield gap is currently 4.24%. Overall, this should be supportive of UK real estate asset prices.

There are clear signs that the direction of travel for Retail assets on the one hand, and Office and Industrial assets on the other, is diverging further. All Property capital values decreased by a further -1.% in Q4 2019 as Retail capital values fell by -4.4%. But Office capital values rose by 0.3% and Industrial values increased by 0.7%.

We expect weak property market conditions to continue into 2020 but stabilise in the last two years of the forecast period. As the relatively poor numbers of 2019 drop out, our forecast has increased from an average annualised total return of 3% to 5%.

Portfolios which are under-weight to Retail will out-perform and UK real estate, with a yield of 5% and a 420bp premium to the risk-free rate, continues to be an attractive investment proposition by comparison to other asset classes.



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THE UK ECONOMY

The health of the UK's economy is driven by developments in the world's dominant economies of the USA, China and Europe. Estimated UK economic growth of 1.3% in 2019 bares comparison to that prevailing in the Eurozone and other advanced economies (see Chart 1.1); although this may be too optimistic.

As a result of a US-China Phase 1 trade deal, lower likelihood of a no-deal Brexit and supportive monetary policy from central banks, there are now signs that global growth may be stabilizing, though at subdued levels (see Chart 1.2).

In November economic output declined by 0.4% and year-on-year GDP growth decreased to just 0.5%; the lowest level since June 2012. But a widely espoused view is that the UK economy should benefit from an uplift following the re-establishment of a majority government after the general election and the smooth passage of the EU Withdrawal Bill. IHS Market/CIPS survey data suggests that the economy again stagnated in December but hinted at an improvement in confidence.

Chart 1.1 Economic growth rates 2019 (est)

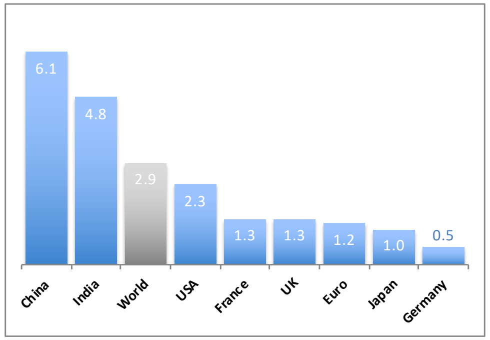


Chart 1.2 World economic growth forecasts

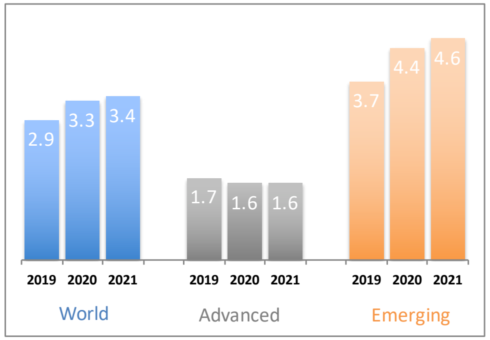
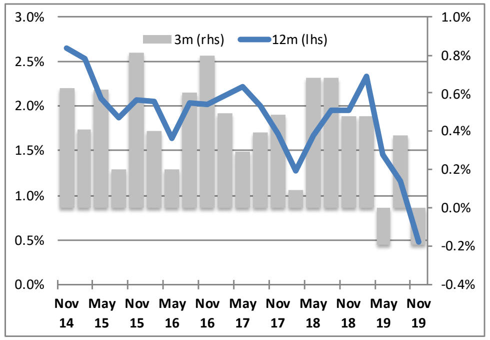


Chart 1.3 Economic growth - rolling 12m



CPI & INTEREST RATES

In its November Inflation Report the MPC noted that agreement on the terms of the UK's withdrawal from the EU and the Political Declaration are expected to remove some of the uncertainty facing businesses and households. Accordingly, the MPC projects that UK GDP growth will pick up during 2020 (see Chart 1.4).

The MPC expects that inflationary pressures are projected to lessen in the near term. In the second half of the forecast period, domestic inflationary pressures are expected to build as demand grows. Based on market interest rate expectations, CPI inflation is projected to rise to slightly above its 2% target towards the end of the forecast period (see Chart 1.5)

Market interest expectations at the time of November's report were indicative of little change to base rate in 2020. However, if global growth fails to stabilise or if Brexit uncertainties remain entrenched, monetary policy may need to reinforce the expected recovery in UK GDP growth and inflation (see Chart 1.6). Expectations of a 25bp loosening in February or May are now gaining traction.

Chart 1.4 Bank of England Economic forecasts

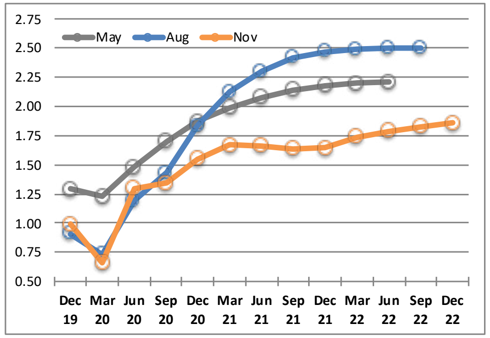


Chart 1.5 Bank of England CPI forecasts

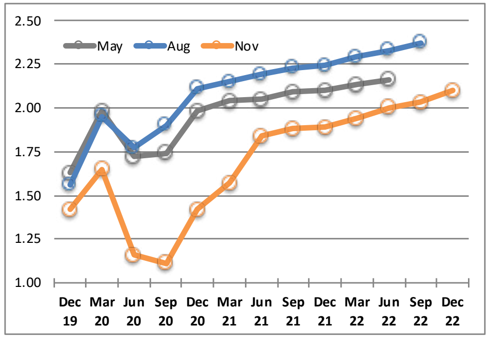
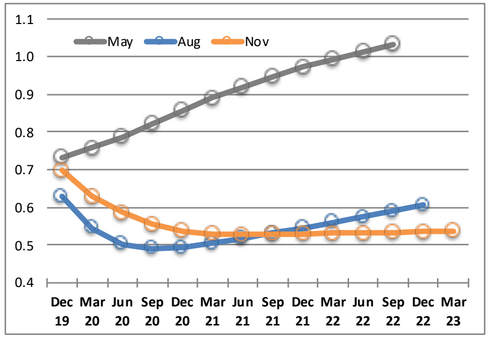


Chart 1.6 Market interest rate expectations



OTHER ECONOMIC INDICATORS

Household consumption remains relatively subdued and has been at or below its trend rate of growth for 11 out of 12 quarters since September 2016. (see Chart 1.7). The GfK Consumer Confidence Index increased 3 points in December, but the overall trend remains downwards.

The uncertainty caused by Brexit and the global economic slowdown has caused the most prolonged slump in business investment in 17 years. The British Chamber of Commerce said business spending in the UK was due to decline by 1.5% in 2019 and by 0.1% in 2020 as companies lacked the confidence to invest in plant, machinery and computing (see Chart 1.8).

Austerity has resulted in government spending declining from 23% of GDP in 2009 to 21% at the end of 2018 (see Chart 1.9). But reduced consumer spending and passive business investment now requires increased Government spending. It is expected that March's budget will announce a £20bn increase in spending on infrastructure health, policing and education.

Chart 1.7 Household expenditure quarterly growth

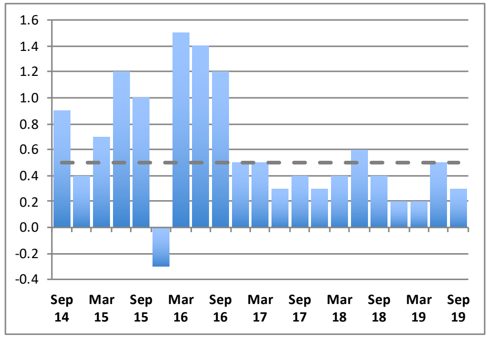


Chart 1.8 Business investment quarterly growth

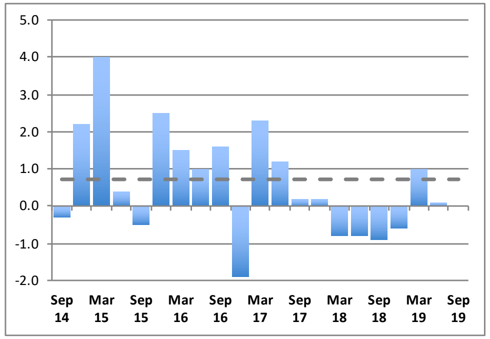
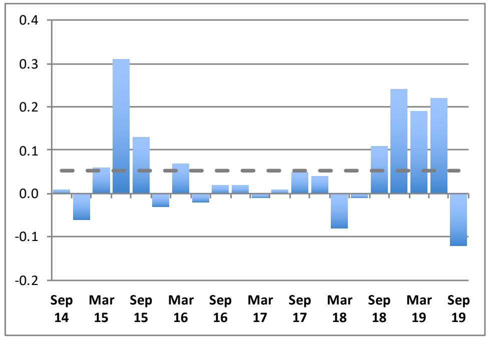


Chart 1.9 Government spending quarterly growth



REGIONAL ECONOMIC INDICATORS

Regional economic imbalances have become entrenched in the UK. GVA per head is a widely used measure indicating the economic well-being of an area and enabling comparison with other areas (see Chart 1.10).

The fastest growing sectors of the UK economy in the last 3 years have been Information and Communication, Professional Scientific and Technical activities including legal, architecture, accounting, engineering advertising and other professional services which both grew by 13% or more in the last 3 years. Five of the 10 largest concentrations of such activities are located in London. And more than 50% of the largest concentrations outside London are located in the South East. (see Chart 1.11).

In the same three years manufacturing grew by 2.5% compared to all UK economic growth of 5.4%. Only one South East location is contained in a list of the locations with the largest concentrations of manufacturing activity (see Chart 1.12).

Chart 1.10 Regional GDP per head

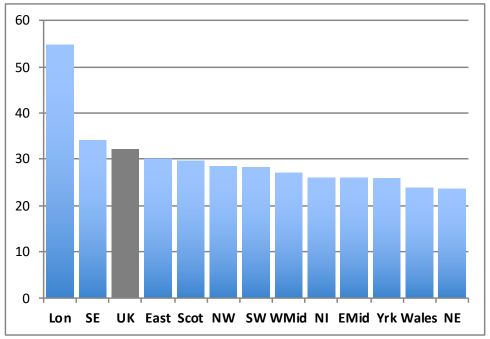


Chart 1.11 Info, Comms, Science and Tech

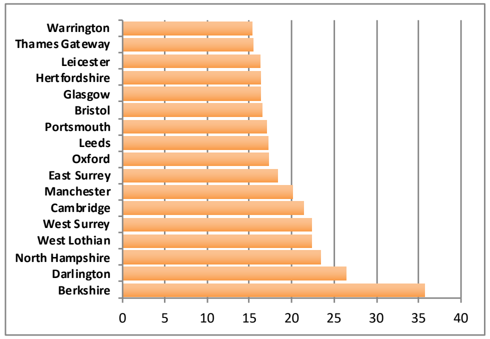
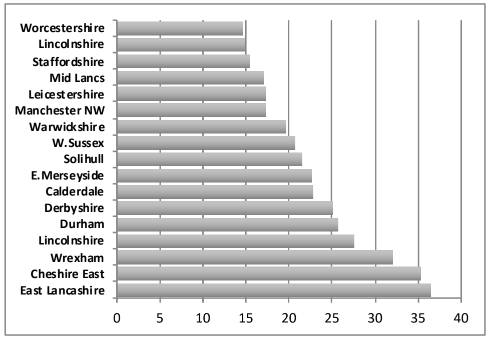


Chart 1.12 Manufacturing



INTEREST RATES AND ASSET YIELDS

Gilt yields have softened by 35bps since the end of Q3 (see Chart 2.1). But across all major economies central bank monetary policy remained loose as global growth slowed, and gilts ended the year 42bps lower than they were at the outset.

The current property initial / gilt yield gap has therefore decreased to 4.24% but remains more than 1 standard deviation above the 10-year average (see Chart 2.2). The gap has widened sharply since September 2018 as the pricing of UK commercial real estate has weakened. Overall, this should be supportive of UK real estate asset prices.

The accommodative low interest rate policy encouraged a disconnect between mainstream equity markets and the economies associated with them. The total return on the FTSE 250 rose to 28.9% and the FTSE 100 total return amounted to 17.3%. Although UK Reit total returns rose to 30.8%, values in the underlying direct commercial real estate market fell as retail assets began to be heavily marked down (see Chart 2.3).

Chart 2.1 FT Gilt 5-15 yr yield

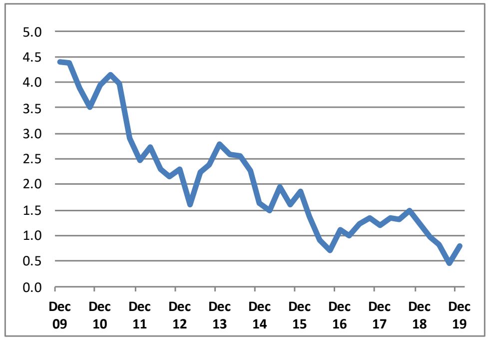


Chart 2.2 Property IY - Gilt yield gap

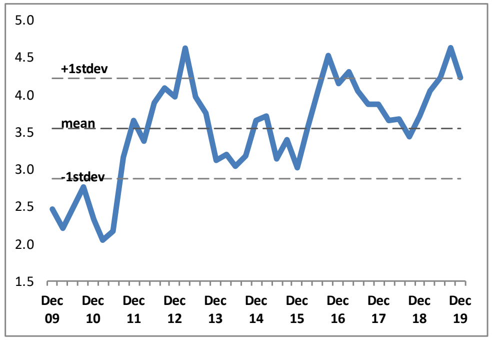
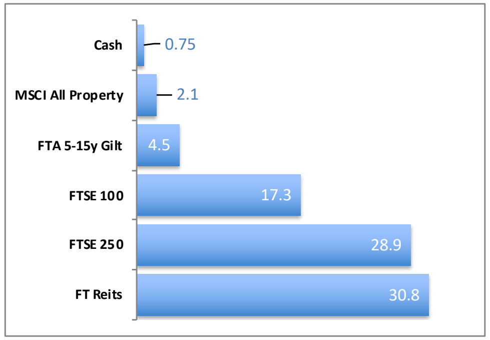


Chart 2.3 UK asset total return 2019



RISK AND UNCERTAINTY

Brexit, Trump's trade wars and the rise of populism were all cause for concern in Q3 2019. However, Q4 witnessed a UK general election and escalating conflict in the Middle East involving the bombing of an oil refinery and the assassination of a general. The UK Uncertainty Index (see chart 2.4), based on the volume of articles from 10 UK newspapers regarding policy uncertainty, rose sharply.

The shape of the yield curve was highlighted in Q3 with discussions centred around its use as a key recession indicator. Typically, the 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 (see Chart 2.6). But in December the yield curve reverted to a more typical flatter shape albeit with the rate on 1-year gilts equal to the rate on 5-year gilts.

Chart 2.4 UK uncertainty index

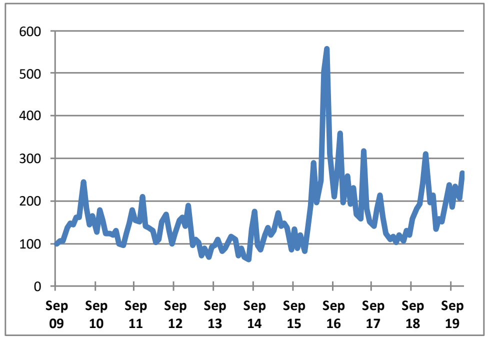


Chart 2.5 Gilt yield curve

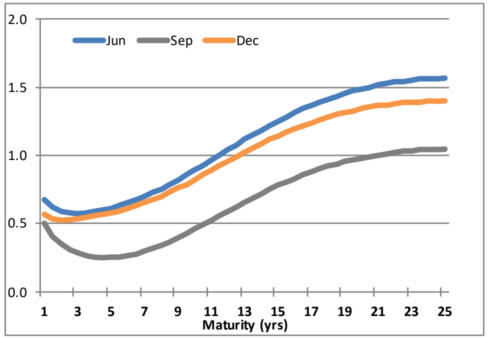
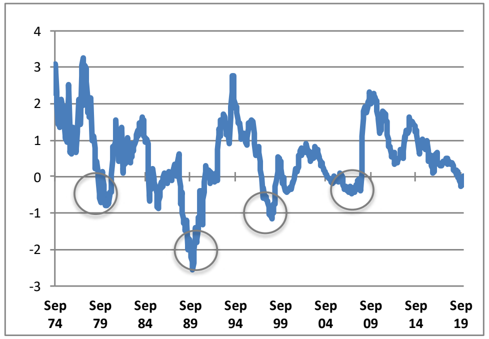


Chart 2.6 Yield curve inversion



MSCI DATA

The performance of private real estate as monitored by MSCI has been weakening since December 2017. MSCI data indicates that at the All Property level total returns continued to fall back in Q4. But there are clear signs that the direction of travel for Retail assets on the one hand, and Office and Industrial assets on the other, is diverging further.

All Property capital values decreased by a further -1.0% as Retail capital values fell by -4.4%. But Office capital values rose by 0.3% and Industrial values increased by 0.7%.

Uncertainty in the wider economy causes businesses to delay investment and decline to take on additional business space. Accordingly, All UK Property rental value growth continues to be weak, decreasing -0.2% in Q4. Office and Industrial rental value growth, however, remains positive. But rental values for Shopping Centres, Retail Warehouses and Shops continue to fall.

In Q4 softening Retail yields caused a -2.9% fall in capital values and Retail rental value growth contributed a further -1.7% decline. Office and Industrial yields have now stabilised and consequently the initial yield on MSCI's monthly index has decreased marginally from 5.09% in Q3 to 5.06% at the end of Q4.

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 but we expect it to play out further in the next year.

Chart 3.1 Total returns by sector

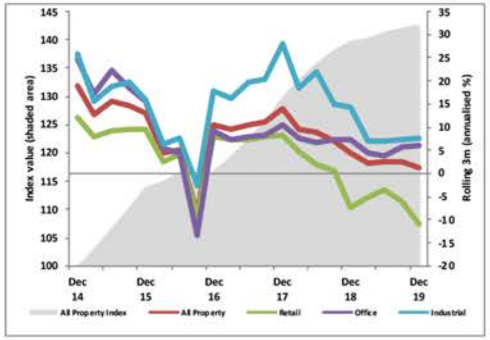


Chart 3.2 MRV growth by sector

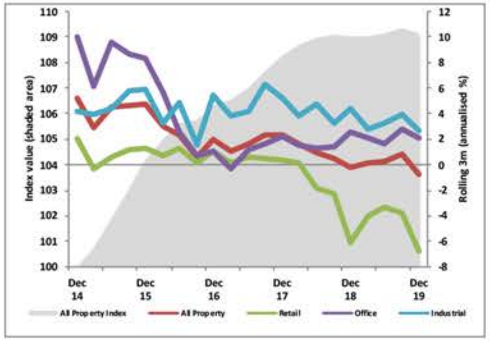


Chart 3.3 Initial yield by sector

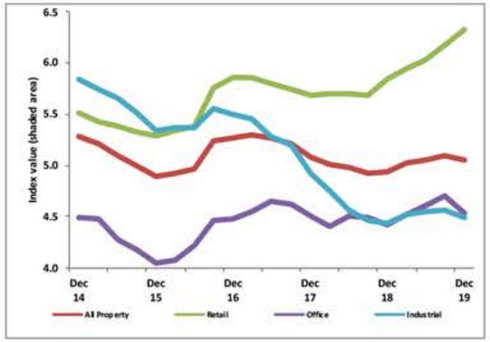


Chart 3.4 Total returns by segment (Q4 annualised)

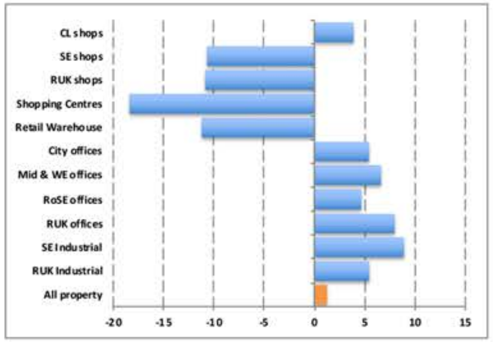


Chart 3.5 MRV growth by segment (Q4 annualised)

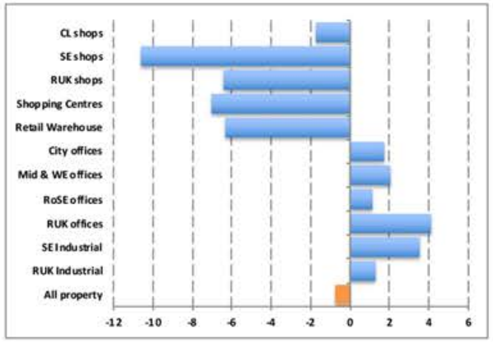
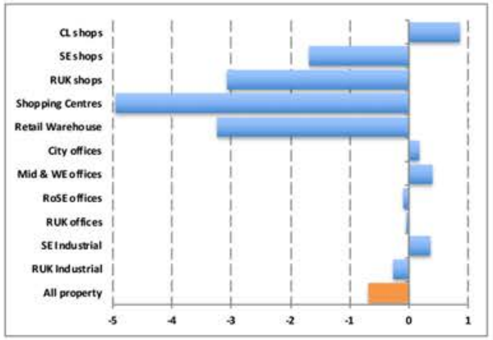


Chart 3.6 Yield impact (Q4)



MSCI DATA COMMENTARY

Despite the negative impact of Retail property on balanced portfolios, investors can still find positive returns across the Industrial and Office sectors. There is also increasingly 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.

Table 3.16 compares a range of strategies from Prime / Low Yield to Short Lease from broad property types. The number for each strategy and property type is quarterly total return relative to the All Property average overlaid with a heat map. Under-performance is reflected in shades of red and over-performance in shades of green.

Whilst most strategies involving Retail property underperformed in Q4, Low Yield and Long Lease Shops continued to outperform relative to the All Property average. The best performing strategies were provided by Secondary / High Yield and Short Lease Industrials and Secondary / High Yield Rest of UK Offices.

3.11 Total returns

	Dec	3m	6m	12m
All Property	0.1	0.3	1.0	2.1
Retail	-1.2	-2.8	-4.3	-6.4
Office	0.6	1.5	2.9	5.0
Industrial	0.6	1.9	3.7	7.2
Annualised				
All Property	1.1	1.3	1.9	2.1
Retail	-13.0	-10.9	-8.5	-6.4
Office	6.9	6.1	5.9	5.0
Industrial	7.9	7.7	7.4	7.2

3.12 Capital growth

	Dec	3m	6m	12m
All Property	-0.3	-1.0	-1.7	-3.1
Retail	-1.7	-4.4	-7.4	-12.1
Office	0.2	0.3	0.5	0.2
Industrial	0.2	0.7	1.2	2.3
Annualised				
All Property	-4.0	-3.9	-3.3	-3.1
Retail	-18.6	-16.5	-14.2	-12.1
Office	2.0	1.2	1.0	0.2
Industrial	3.0	2.8	2.5	2.3

3.13 Income return

	Dec	3m	6m	12m
All Property	0.0	0.0	1.3	3.9
Retail	0.0	0.0	1.6	4.7
Office	0.0	0.0	1.2	3.6
Industrial	0.0	0.0	1.2	3.6
Annualised				
All Property	0.0	0.0	2.6	3.9
Retail	0.0	0.0	3.2	4.7
Office	0.0	0.0	2.4	3.6
Industrial	0.0	0.0	2.4	3.6

3.15 Net initial yield

	Dec	3m	6m	12m
All Property	5.0	5.1	5.1	4.9
Retail	6.3	6.2	6.0	5.8
Office	4.5	4.7	4.6	4.4
Industrial	4.5	4.6	4.5	4.4

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	-2.8	-0.9	-0.8	0.6	-1.9
Shopping Centres	-3.3	-4.2	-3.4	-3.4	-1.8	-2.8
Retail Warehouses	-2.4	-2.6	-4.1	-1.4	-1.2	-2.5
Central London offices	0.9	0.3	0.5	1.0	0.8	0.1
RoSe offices	1.0	0.4	0.4	1.2	1.1	0.3
RUK offices	1.2	1.6	0.8	1.0	1.2	1.5
Industrials	1.2	1.6	1.4	1.3	1.1	1.7

INVESTMENT BY SECTOR

Investment in Central London offices increased by 14% to £2.8bn in Q4 from £2.5bn in Q3 but there has been a reduction in transactions of 38% in the 12 months to year ending December 2019.

Net investment in Q4 decreased for Rest of UK offices and Shops but increased for Industrials, and more surprisingly Shopping Centres and Retail Warehouses albeit in thin trading conditions.

Chart 3.7 Rolling 12m investment by sector (£bn)

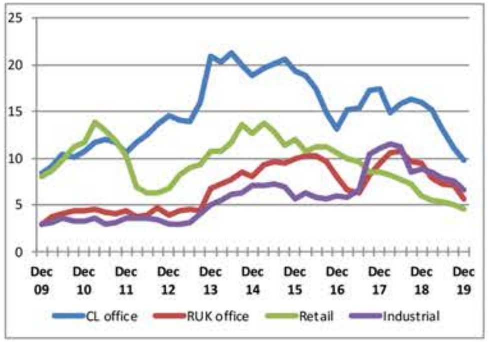
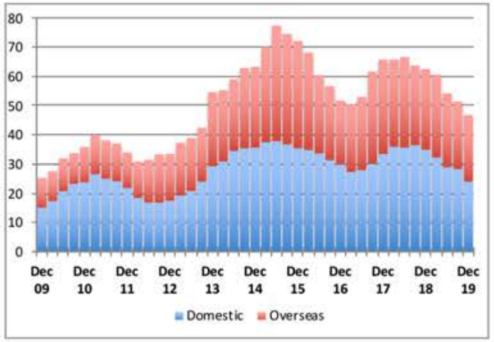


Chart 3.8 Rolling 12m investment by investor type (£bn)



INVESTMENT BY INVESTOR TYPE

Domestic and overseas investors together bought commercial property in Q4 2019 worth £12.68bn compared to purchases of £13.54bn in Q3. As the General Election result removed some of the uncertainty associated with the market, the amount of overseas money flowing into UK property increased in Q4 2019.

However, year on year inflows to the UK from overseas in Q4 are 17% down on the levels achieved 12 months ago. Over the same period, UK based investors decreased their purchases of UK real estate by 31%.

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 The Investment Association property funds under management to fall since Q4 2018 (see Charts 3.9 and 3.10).

In the year to September 2019, £1.09 billion has been withdrawn from property funds by retail investors due to concerns regarding performance and liquidity. Indeed, these concerns materialised in December when the M&G Property Portfolio again suspended redemptions.

Chart 3.9 Property Funds under management (£mn)

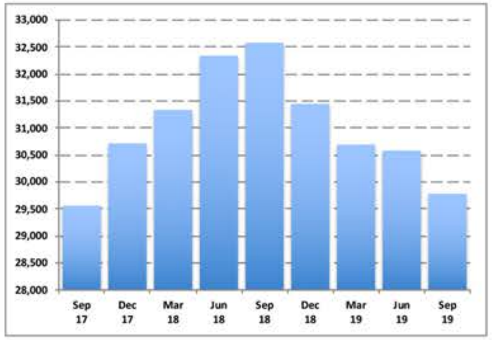
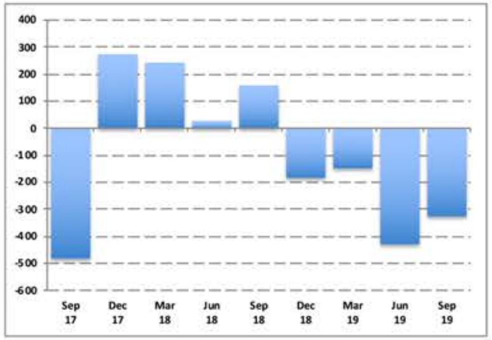


Chart 3.10 Property funds' net sales to retail investors



IPF CONSENSUS FORECASTS

November 2019's forecast round continues to indicate that 2019 is expected to represent a cyclical trough but the outlook for 2020 has weakened in successive quarters.

All Property performance expectations for 2020 weakened from 2.9% to 2.5% and expectations for 2021 were reduced to 4.9% from 5.6% in August 2019. Capital values are now expected to shrink by a further 2% in 2020 and stabilise in 2021.

At the segment level the outlook for Retail property in 2020 has weakened further. The outlook for Offices and Industrials has strengthened.

The 5-year outlook has decreased slightly. November's annualised average forecast is 3.9%; down slightly from 4% in August. The medium-term outlook has again improved for Offices and Industrials but deteriorated for all types of physical Retail.

Chart 4.1 IPF All Property forecasts y-by-y (Nov 19)

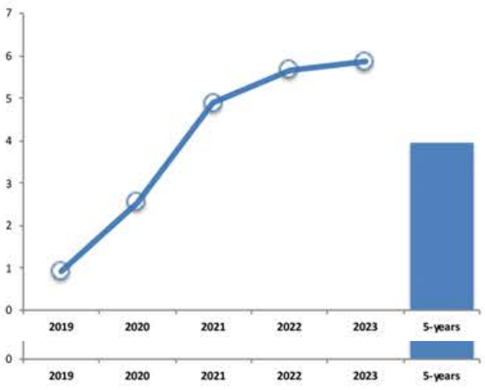


Chart 4.2 MRV growth by sector

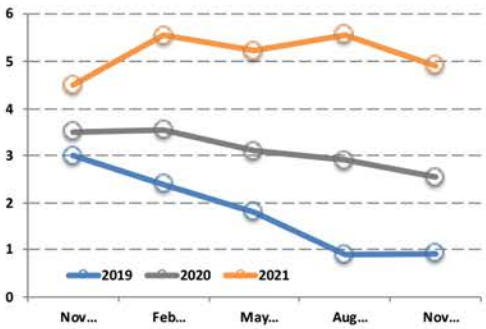


Chart 4.3 IPF 2020 forecasts by sector (Nov 19)[1]

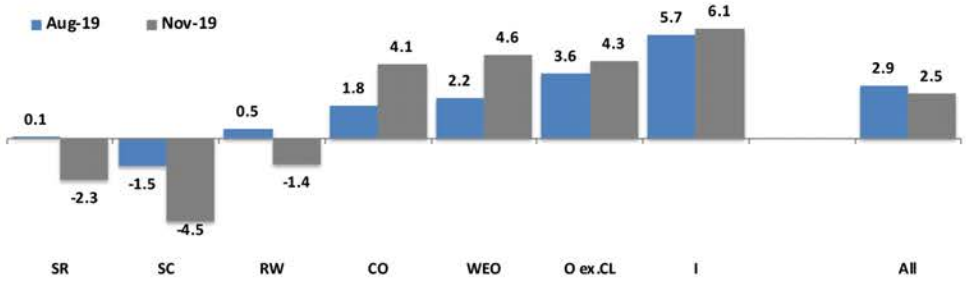
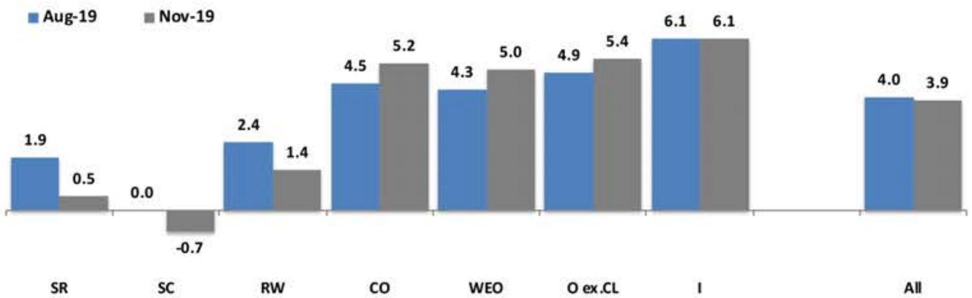


Chart 4.4 IPF 5-year forecasts by sector (Nov 19)



CLUTTONS IM HOUSEVIEW FORECASTS

A slowing global economy, increasing trade tariffs and uncertainty surrounding the UK's exit from the EU - and latterly a general election - have brought domestic economic growth to its lowest level for 7 years. This has restrained rental growth and caused yields to soften.

But the outlook is now brighter. There is a tentative trade agreement between the USA and China, the IMF are cautiously optimistic regarding the outlook for the world economy, the general election has delivered the prospect of stable government to the UK and the UK will be leaving the EU on 31st January.

Expectations immediately post-election were of an improvement in the economy and markets. Sterling rose 1% in December 2019 but fell back by the same figure in January 2020. This is in the context of a 15% fall in the value of sterling since the middle of 2015 when the prospect of a Brexit referendum first appeared. Any other data to support an immediate improvement in conditions is strictly limited.

Withdrawing from the EU was the easiest part; and that took 3 ½ years. However, the biggest uncertainty for UK business remains. Namely, what will be its future terms of trade with Europe and the rest of the world after the transition period has expired at the end of this year. The Government has decided to hardwire this deadline. Expect the rhetoric and talk of risks to rise substantially in the second half of the year.

Consequently, we expect the weak property market conditions to continue into 2020 but stabilise in the last two years of the forecast period. As the relatively poor numbers of 2019 drop out, our forecast has increased from an average annualised total return of 3% to 5%.

These numbers assume a market weight in Retail. Portfolios which are under-weight to Retail will out-perform. and UK real estate, with a yield of 5% and a 420bp premium to the risk-free rate, continues to be an attractive investment proposition by comparison to other asset classes.

Chart 4.5 Cluttons House View - 2020 relative total returns (%)

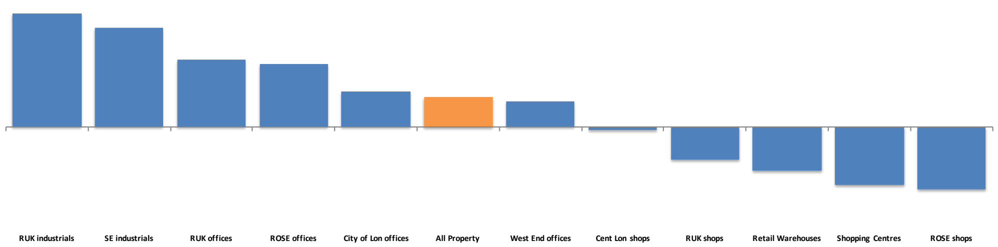
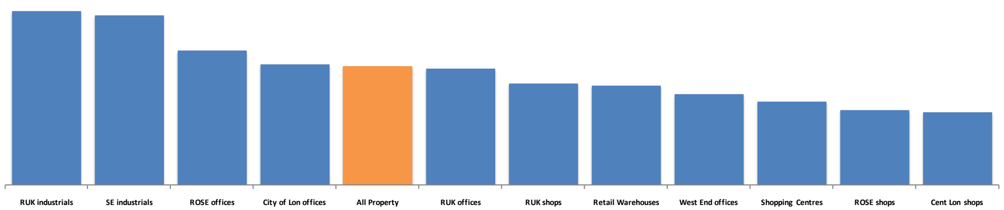


Chart 4.6 Cluttons House View - 2020-2022 relative total returns (%)

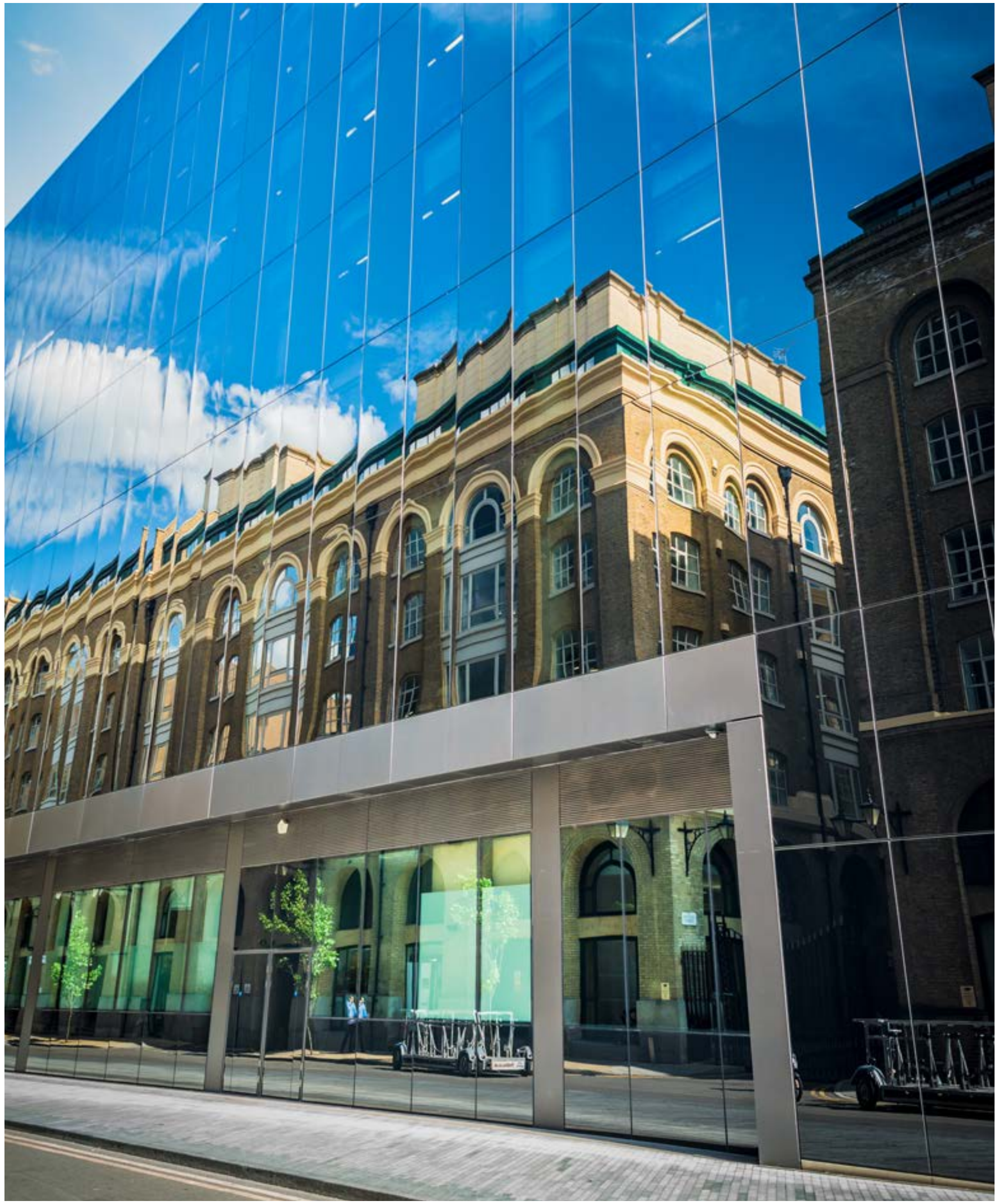


CLUTTONS IM OPINION

Sentiment has improved since the turn of the year with a majority government creating much needed certainty and providing a potential stimulus to UK economic growth. However, a number of headwinds remain to reach even trend levels of economic growth and this will continue to feed into relatively weak market conditions as we move through 2020, increasing the prospect of an interest rate cut.

The performance of UK real estate continues to weaken at All Property level, but this is being driven almost entirely by the continuing decline in Retail capital and rental values with the Office and Industrial sectors recording positive returns in the final quarter of the year. Sector allocation remains key and those portfolios under-weight to Retail will continue to out-perform the UK average.

The prospect of a more stable political environment in the UK, at least in the short-term, together with a positive initial/gilt yield gap and relatively attractive income profile, should ensure that real estate continues to remain an attractive investment proposition when compared to other asset classes.



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GLOSSARY

IPF FORECASTS BY SECTOR

SR	Standard Retail
SC	Shopping Centres
RW	Retail Warehouse
CO	City Offices
WEO	West End Ofices
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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