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THE NEXT UK RECESSION - NOT IF BUT WHEN?

AUGUST 2019

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RECESSIONS AND THE ECONOMIC CYCLE

Ever since the recession induced by the Global Financial Crisis (GFC) ended in June 2009, investors have been treated to a stream of forecasts warning that another slump is right around the corner. So far, as we are all aware, none of these predictions have been accurate. However, the world economy is now into its 10th consecutive year of expansion and the voices warning of the next downturn are growing stronger and stronger.

Economies have long suffered from booms and busts. Since 1900 the UK economy has experienced 21 years of economic contraction (**see Chart 1**).

In the past, economists claim to have identified three different types of economic cycle. A short run cycle of three or four years associated with holdings of inventories, a medium term cycle of between 7 and 10 years associated with waves of fixed investment, and an ultra-long cycle or Kondratieff wave lasting from 50 to 80 years associated with major technological change such as canals, railways, cars, telephones, and computing and the internet.

This mechanistic approach is the basis for some of the current thinking that the next recession is nearing as the post GFC economic expansion has now lasted ten years. Adopting this type of analysis, the UK commercial property market cycle in the later part of the 20th century and onwards has lasted approximately 16 years, which would see the next market peak in 2022! (**see Chart 2**).

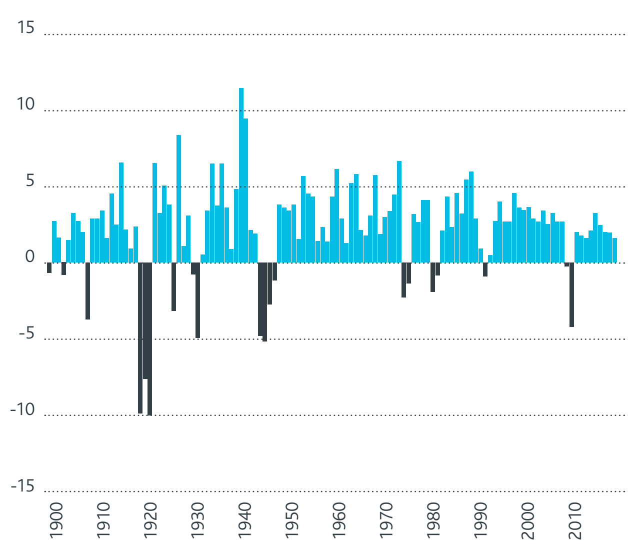
However, it is now recognised that recessions are caused by negative external shocks. The Great Depression of the 1930's was triggered by a fall in USA share prices, which caused a banking crisis and a contraction in credit and money. This was spread around the world by a fixed exchange rate system known as the "Gold Standard" and compounded by protectionism that reduced global trade.

After a 30-year period of relative economic stability, sharply rising oil prices in 1973, and again in 1979, triggered the first recessions since the end of the Second World War.

A third economic contraction in 1990 was triggered by a variety of causes including a decrease in defence spending following the end of the Cold War, a further oil price shock caused by the first Iraq War, and the Savings and Loans Crisis in the USA. In the UK, recession was deepened and pro-longed through the perceived necessity to maintain a high Bank Rate in support of the pound's valuation within the European Exchange Rate Mechanism which the UK had joined in October 1990.

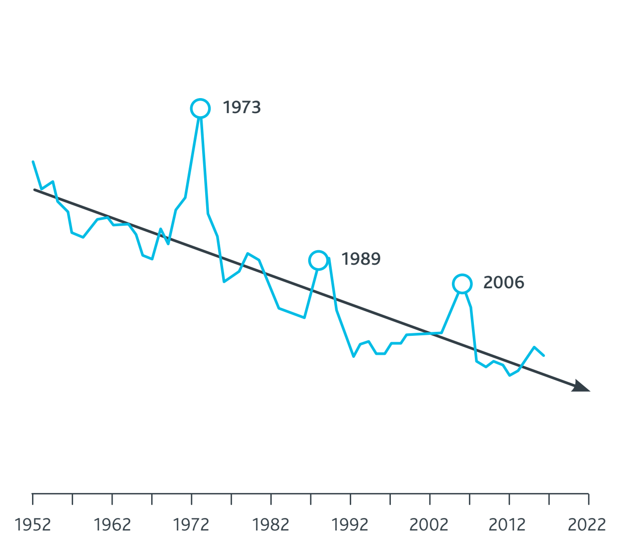
The GFC of 2007 to 2009 had echoes of the 1930's Great Depression. It again started in the USA with a fall in residential real estate prices initiating the failure of Sub-Prime Residential Mortgage Backed Securities issued by under-capitalised banks. The banking contagion spread around the world due to the globalisation of financial markets, but a 1930's style depression was avoided as free trade policies supported the global economy and the G20 countries developed a co-ordinated response to the crisis.

Chart 1 UK economic growth 1900 - 2018



Source: Office for National Statistics

Chart 2 Long run property cycles



Source: MSCI & APR

THE WORLD ECONOMY IN 2019

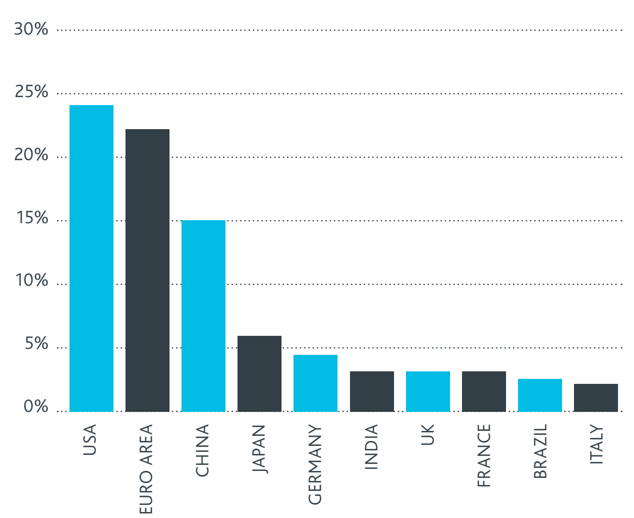
The current world geo-political situation provides some anecdotal evidence that another external shock may be developing. Kristalina Georgieva, Chief Executive Officer at the World Bank said, "At the beginning of 2018 the global economy was firing on all cylinders, but it lost speed during the year and the ride could get even bumpier in the year ahead".

The World Bank estimates that global economic growth in 2018 declined slightly to 3.0% from 3.1% in 2017. At the start of 2019, the World Bank forecast that global economic growth would decline further to 2.9% in 2019. This forecast was downgraded to 2.6% in June reflecting the broad-based weakness observed during the first half of the year, including a further deceleration in investment amid rising trade tensions. As President Trump continues to pursue his America First agenda, global trade growth in 2019 has been revised down a full percentage point, to 2.6% - the weakest since the global financial crisis.

The World Bank expects growth in advanced economies to slow to 1.7% in 2019 and 1.5% in 2020. Growth in emerging market and developing economies is projected to slow to 4.0% in 2019, from 4.3% in 2018, as weaker international trade and investment lead to a deceleration in commodity markets.

The performance of the USA has been critical for the health of the global economy. In 2008, the USA accounted for 24% of global GDP and the next largest national economy was Japan with 8% of GDP. China was the third largest economy with 7% of GDP. The development of the sub-prime mortgage crisis and the onset of a US recession had profound implications for the rest of the world.

Chart 3 Countries with the largest GDP 2017



Source: World Bank

> At the beginning of 2018 the global economy was firing on all cylinders, but it lost speed during the year and the ride could get even bumpier in the year ahead.
>
> **Kristalina Georgieva**
> Chief Executive Officer at the World Bank

By the end of 2017, the economy of the USA had grown by 37% (since 2008) but still represented 24% of the global economy, however, the Chinese economy had trebled in size and represented 15% of the global economy. China's economy is now 2.5 times larger than the Japanese economy which itself represents 6% of the global economy. As an aside the UK represents 3% and the European Union including the UK represents 22% of the global economy (**see Chart 3**).

Consequently, we are now in a multi-centric world where global economic well-being is driven by developments in the USA, China and Europe. Trade wars between the USA and China, and disruption to the EU economy threatened by Brexit, are obvious clear and present dangers. However, the USA is still the most important world economy because of its dominant currency and financial and banking institutions. Hence developments in the USA are paramount.

THE SITUATION IN THE USA

President Trump's policy initiatives have had mixed effects. The 2017 tax cuts seem to have had a limited but positive impact on economic growth in the USA which is estimated to have improved from 2.2% in 2017 to 2.9% in 2018.

GDP growth is robust. Unemployment is nearing a 50-year low. And the stockmarket is up by a whopping 50% since 2016. Yet, for all the positive economic news, there is no shortage of hand-wringing on Wall Street about a looming recession. But precisely when will it strike?

In December 2018, the overall strength of the economy caused the US Federal Reserve to announce a ninth consecutive rise in interest rates since late 2015, from 2.25% to 2.5%. However, responding to Trump's trade wars and rising interest rates the Dow Jones declined 5.6%, the S&P500 was down 6.2% and the NASDAQ fell 4%, making 2018 the worst year for stock markets since 2008.

Since the start of the year, Trump's USA has threatened Mexico with tariffs, cancelled preferential trading rules with India, proposed a widening of the range of Chinese imports subject to a 25% tariff to include virtually every item coming from China, and banned supplies manufactured by Huawei, China's own tech giant. In the Middle East, the USA has blamed Iran for attacks on oil tankers near the coast of the UAE and in the Strait of Hormuz, and a US military surveillance drone has been shot down by Iranian forces.

In its June meeting, the Federal Open Market Committee warned about "uncertainties" to the economic outlook and suggested that interest rates may have to be reduced later on this year. Futures contracts have changed from pricing in the probability of rate increases at the start of the year to implying multiple rate cuts.

THE SITUATION IN THE UK

Domestic politics seems to provide the biggest downside risk facing the UK economy as Brexit continues to dominate the news. Indeed, the whole sorry saga drags on with the likelihood of providing an outcome that is unsatisfactory to both Leavers and Remainers. Businesses and investors alike are haunted by uncertainty. Will the UK join Mauritania as only the second country seeking to trade with the rest of the world solely on World Trade Organization (WTO) terms, continue trading with it's closest neighbours as full members of the EU, or perhaps the Government will actually conclude the "easiest trade deal in history" with the remaining 27 EU states.

In the UK, the economy grew by a lacklustre 1.5% in the year to December 2018 but increased to 1.8% in the year to March 2019 as the business sector built stock levels to protect itself from the deleterious effects of a no deal Brexit at the end of March. Brexit day has been postponed to Halloween, at the earliest, and the expectation is that economic activity will once again slow in the middle months of the year as inventory levels are run down.

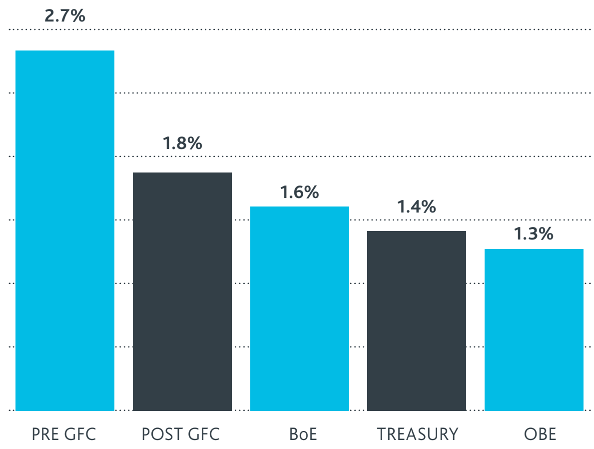
Monthly data released by National Statistics indicates that the UK economy contracted by 0.4% in April 2019 but expanded by 0.3% in May. Rolling three-month growth was 0.3% in May, the second consecutive month of slowing growth after 0.5% in March.

Rolling 3-month growth in the UK's dominant service sector has slowed notably since July 2018 when it reached 0.8%. Growth in the 3 months from March to May 2019 was 0.3%. Rolling 3-month growth in manufacturing slowed to 0.1% and 3-month growth in construction slowed from 1% in April to 0% in May.

The latest forecasts suggest that the UK economy remains mired in this pattern of low growth for at least the next 3 years (**see Chart 4**).

The MPC maintained the bank rate at 0.75% in its June meeting and noted that downside risks to growth have increased. Globally, trade tensions have intensified and, domestically, the perceived likelihood of a no-deal Brexit has risen. Increased Brexit uncertainties have put additional downward pressure on UK forecast interest rates and led to a decline in the sterling exchange rate.

Chart 4 Historic & forecast economic growth rates



Source: ONS, BofE & OBR

In the MPC's view, underlying growth in the UK weakened slightly in the first half of 2019 and CPI is likely to fall below the 2% target later this year. Nevertheless, the MPC noted that a limited tightening of monetary policy with a path for Bank Rate that rose to around 1% by the end of the forecast period remained appropriate based on its assumption of a smooth Brexit. However, this month (July), the economist Dr Gertjan Vlieghe of the MPC suggested in a speech in London that rates could be reduced to "near-zero" in the event of a no-deal Brexit.

In its Fiscal risks report published in July 2019, the Office of Budget Responsibilty (OBR) considered that a no-deal exit from the EU could result in a year-long recession with real GDP declining by 2% by the end of 2020, a fall in the value of the pound against the US dollar of 10%, unemployment rising from 3.8% to 5%, house price falls of 10% by mid-2021 and a cut in Base rate to 0.25%. It is worth noting that for the purposes of its modelling, the OBR used the least severe of the IMF's two no-deal Brexit forecasts.

REAL ESTATE AND THE ECONOMY

The current macro-economic situation and its outlook is paramount for investors in UK real estate because the health of the UK's commercial property market is inextricably linked to that of the UK's economy. The returns to commercial property correlate strongly with current GDP growth; the returns to other assets do so weekly at best (**see Table 1**).

Table 1 Asset correlations with GDP

	Property	Equities	Gilts	T-Bills
GDP	60%	15%	-14%	5%

Source; MSCI, ONS & FT.com

A downturn in the UK commercial real estate market would be consistent with the domestic macro-economic environment described above. For a number of quarters, the RICS has included views on the current stage of the property cycle in its quarterly Commercial Property Market Survey. In Q1 2019 the Survey reported that 52% of respondents considered that the UK market was in the early to middle stages of a downturn. In London, 63% of contributors agreed that the market was in a downturn although 14% now feel that conditions are now stabilising.

The key link is through rental value growth. Open market rental values quickly adjust lower in periods of recession or economic weakness, and recover, albeit with a lag, as the economic cycle turns up (**see Chart 5**). Open market rental values in turn feed through into capital values. This movement is compounded by the behaviour of yields, which tend to respond in a lagged fashion to rental signals.

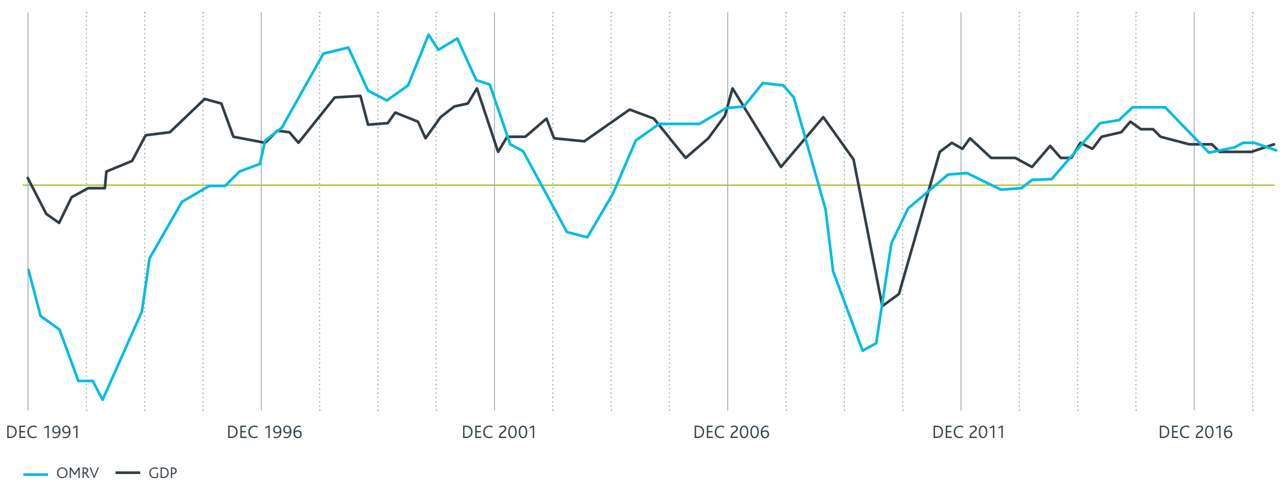
Once the UK withdrew from the ERM in 1992, allowing interest rates to be cut, the economy recovered strongly. The commercial property market's recovery from the slump was equally robust. In the eight years between 1992 and the end of 2000, capital values grew by 41% or 4.4% a year. The market had to wait until 1994 for the trough in the rental cycle but thereafter rents themselves grew by 41% or 5% a year between the end of 1994 and 2000.

This behaviour is typical of the more closed market conditions prevailing 25 years ago. However, faster and heavier global capital flows have increased the sensitivity of the domestic UK real estate market to external financial shocks.

In mid-2007 the nascent crisis in the USA's residential real estate market very quickly spread to UK commercial property prices. UK commercial property prices started to fall in June 2007. The first falls in UK open market rental values were coincident with the onset of recession in Q2 2008. By that time, All Property capital values had fallen by 19% and yields had softened by 105bps.

The principal driver in this collapse in capital values appears to have been the withdrawal of support for the UK market from overseas investors. Net investment in UK commercial real estate by overseas investors amounted to £7.3bn in Q2 2007. This fell by 71% to £2.1bn in Q2 2008 as international banks responded to losses in the USA by limiting the availability of credit worldwide.

Chart 5 All property OMRV & GDP



Source: ONS & MSCI

FORECASTING THE NEXT UK RECESSION

Given the illiquid nature of direct real estate portfolios, advance notice of a downturn in the market can be critical. As we have discussed above, macro-economic performance can be a key leading indicator. But traditional GDP data is published after a lag of at least some weeks. For example, the First Estimate of GDP for January to March 2019 was published on 10th May. The timeliest estimates of economic growth are published monthly but these numbers can be volatile.

Economists are therefore constantly looking to develop leading indicators for the economy. Claudia Sahm, an economist at the Federal Reserve, has developed a new method for predicting economic downturns. Ms Sahm argues that when the three-month average unemployment rate is at least 0.5 percentage points above its minimum from the previous 12 months, the economy is in a recession. This simple measure, it turns out, has correctly called every recession in America since 1970. In January 2008, for example, Ms Sahm's index warned of the coming Great Recession. The index had also flashed red in early 2001, amid the bursting of the dotcom bubble. Today, conditions are considerably less dire. With unemployment 0.07 percentage points below its minimum of the past year, the "Sahm recession indicator" suggests that the chance of a downturn occurring in the next year is just 10%.

The slope of the yield curve, which plots interest rates on short- and long-term government bonds, has long been considered one of the most reliable barometers of economic health. Typically, this curve steepens when investors are more bullish on the economy, and expect higher growth and rising interest rates, and flattens when they anticipate a slowdown.

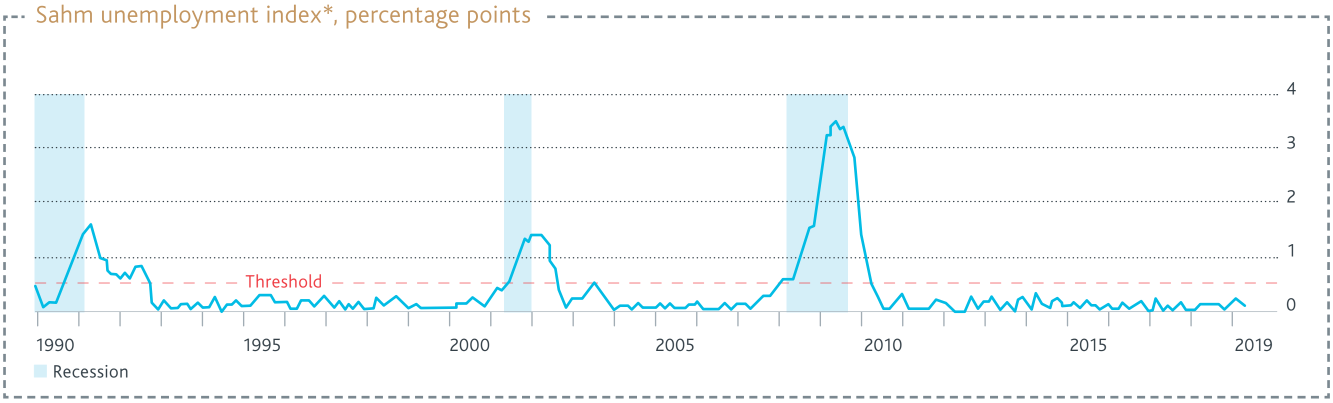
The Economist's "R-word index", measures the prospects for a future downturn based on the number of times that newspapers publish the word "recession". This spikes when recessions are on the minds of traders and the financial journalists who write about them.

Ms Sahm's unemployment measure has some advantages over its peers. It shows clear delineations between periods of recession and growth. It also appears to detect few, if any, false positives. Where her recession indicator falls short is on timeliness. The ability to anticipate a recession is far more useful than knowing when you are in one. The yield curve predicted both the 2001 and 2008 recessions about a year in advance, and the R-word index ticked up at about the same time. The unemployment-based measure, on the other hand, would have given investors a head-start of just a few months (see charts from The Economist below headed "Warning Signs"). Today, the yield curve suggests that a recession may be imminent and America's leading newspapers are discussing recessions more often than at any point since 2012.

Campbell R. Harvey is a finance professor at Duke University's Fuqua School of Business and a research associate at the USA's National Bureau of Economic Research, which among other things provides the official start and end dates of expansions and contractions. He maintains one of the more rigorous models for analysing the potential for a future economic contraction.

In a recent YouTube discussion, Harvey cited four signals warning of an impending recession. One is the Duke-CFO Global Business Outlook survey, which this month found that

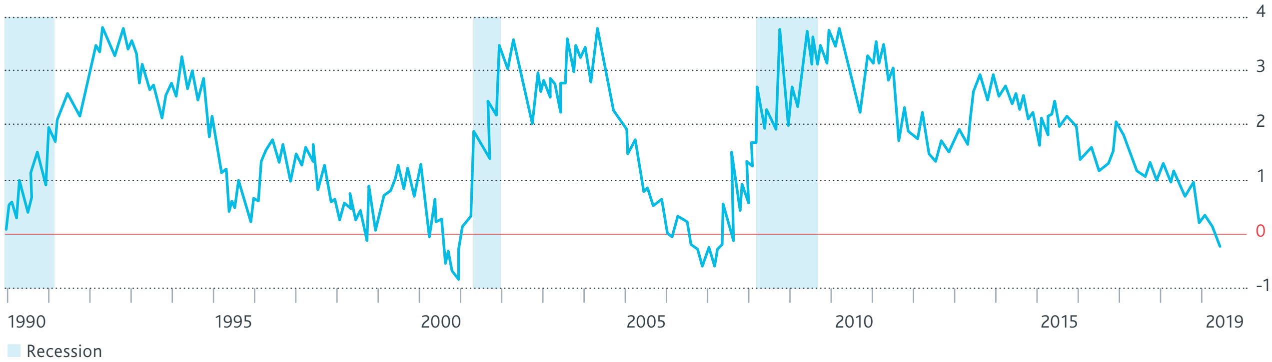
WARNING SIGNS | UNITED STATES



Sources: The Federal Reserve Bank of St. Louis; US Treasury. *Washington Post, New York Times*
*The difference between the three-month average unemployment rate and the minimum from last year
† In the *Washington Post* and *New York Times*

WARNING SIGNS | UNITED STATES

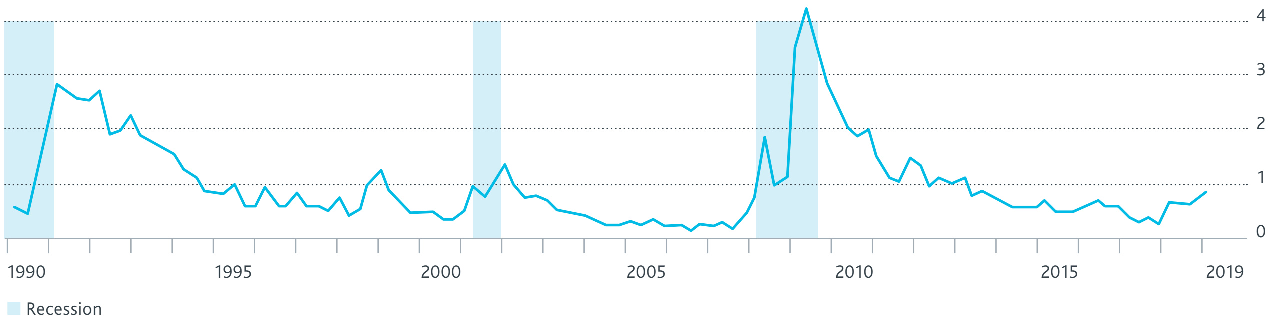
Difference between ten-year and three-month Treasury yields, percentage points



Sources: The Federal Reserve Bank of St. Louis; US Treasury. *Washington Post, New York Times*
*The difference between the three-month average unemployment rate and the minimum from last year
† In the *Washington Post* and *New York Times*

WARNING SIGNS | UNITED STATES

Number of news articles† mentioning "recession", '000

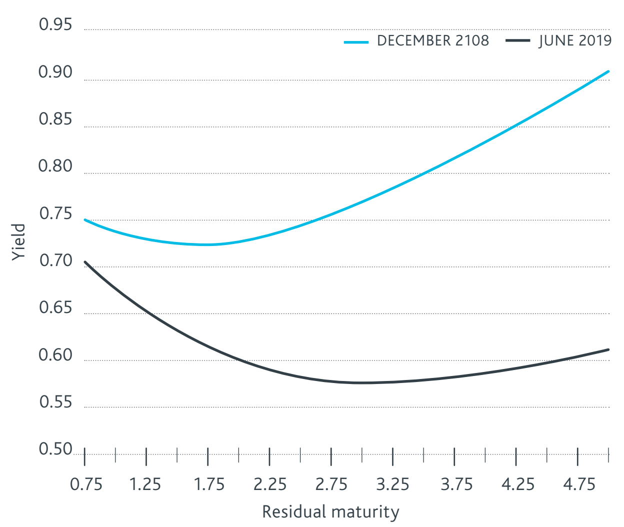


Sources: The Federal Reserve Bank of St. Louis; US Treasury. *Washington Post, New York Times*
*The difference between the three-month average unemployment rate and the minimum from last year
† In the *Washington Post* and *New York Times*

more than two-thirds of corporate chief financial officers expect that a recession will be underway by the end of 2020. His second factor is "the realisation of anti-growth protectionism," or tariffs and rising trade-war tensions; the third is market volatility, which he notes frequently gives false signals, but has generally been on the rise for the past few months.

The last, and most important of Harvey's four recessionary signals, is the yield curve, or the schedule of bond yields based on maturity dates. His focus is on the five-year Treasury bond yield, which is now lower than the yield on three-month Treasury bill. According to Harvey's research, when this inversion - short-term rates being higher than long-term rates - lasts for a full quarter, or 90 days, then a recession will occur in 12 to 18 months. Inversion occurred on March 7 and earlier this month we crossed the 90-day threshold. Thus, all four of the conditions for a future

Chart 6 UK short term yield curve



Source: Bank of England

recession in Harvey's model have now been met. The flattening out or inversion of the yield curve is also the case in the UK (**see Chart 6**).

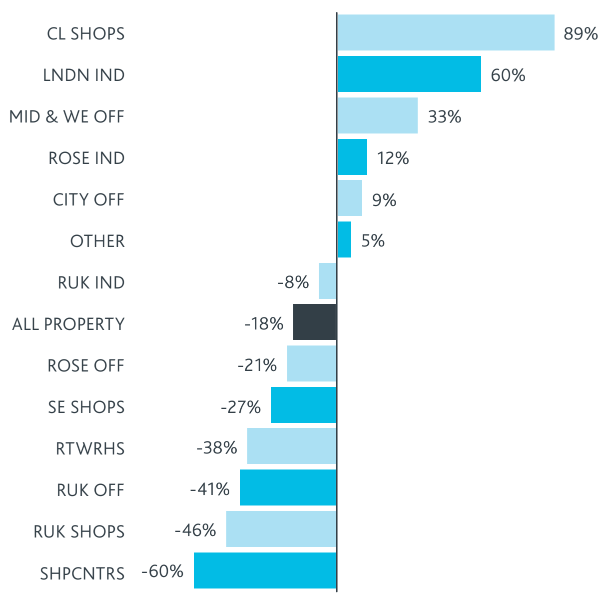
UK REAL ESTATE'S RESPONSE TO RECESSIONARY THREATS

The genesis of the next economic downturn will originate from either (1) an external shock; (2) collapsing asset prices; (3) rising interest rates; (4) trade protection; or (5) a combination of all of the above. Whether the event is in the USA, Europe or China, the internationalisation of capital markets means it will quickly impact UK real estate.

Without doubt, the biggest external shock facing the UK economy at present is Brexit. Since June 2015 when David Cameron's last Government was elected with a Manifesto promise of an EU referendum, year-on-year overseas net investment in UK commercial property has fallen 42% from £39bn in the 12 months to June 2015 to £23 billion in the year to June 2019.

The market response has, so far, not been catastrophic. Nevertheless, year-on-year total returns have declined from 16.8% in June 2015 to 4.7% at the end of May 2019, and year-on-year rental value growth has declined from 4.1% to 0.3%. The IPF Consensus Forecast for year-end 2019 is 1.8% and the annualised 5-year average is 4%. By comparison the All Property market average total return over the last 10-years has been an annualised 10%. However, there are considerable down-side risks as the odds on a "no-deal" Brexit must be shortening with Boris Johnson's recent appointment as Conservative party leader and prime minister.

Chart 7 Capital Value growth June 2007 – May 2019



Source: MSCI

Investors in direct property assets must have long-term time horizons. Given the illiquidity of the asset class, they invest through the cycle. To hedge against any downside it is vital to be in the right segments of the market. During the GFC, All Property values fell 44% but 10 years later the values of Central London shops, City and West End offices, and London and South East industrials have surged passed their pre- GFC highs. Other market segments have not fared so well (**see Chart 7**).

On receiving an advance warning of a recession and the associated downturn in the commercial real estate market, property fund managers should:

(1) strategically review the hold/sell decisions around non-performing assets;
(2) ensure there are clear asset management plans to maintain the net income from the portfolio;
(3) if debt is held in the portfolio review whether there is the potential to reduce the loan to value through early repayment from sale proceeds, and;
(4) consider the timing of counter cyclical re-investment to take advantage of asset miss-pricing as the market weakens.

CONCLUDING REMARKS

Economies have long suffered from booms and busts. In the past, economists claim to have identified short, medium and long run economic cycles. However, it is now recognized that recessions are caused by negative external shocks.

At the end of 2017, the economy of the USA represented 24% of the global economy, the EU represented 22% and the Chinese economy represented 15% of the global economy. Consequently, we are now in a multi-centric world where global economic well-being is driven by developments in the USA, China and Europe. However, the USA is still the most important world economy because of its dominant currency and financial and banking institutions. Hence developments in the USA are paramount.

In its June meeting, the Federal Open Market Committee warned about "uncertainties" to the economic outlook and suggested that interest rates may have to be reduced later on this year. Futures contracts have changed from pricing in the probability of rate increases at the start of the year to implying multiple rate cuts.

In the UK, domestic politics seems to provide the biggest downside risk facing the economy as Brexit continues to dominate the news. The latest monthly data released by National Statistics indicates that the UK economy contracted by 0.4% in April 2019 but expanded by 0.3% in May. And the latest forecasts suggest that the UK economy remains mired in this pattern of low growth for at least the next 3-years.

The OBR is now warning of a year-long recession with effect from the fourth quarter of 2019 in the event of a no-deal Brexit at the end of October.

The health of the UK's commercial property market is inextricably linked to that of the UK's economy. Given the illiquid nature of direct real estate portfolios, advance notice of a downturn in the market can be critical.

A range of indicators now appear to be warning of a recession in the USA which would pose a threat to global economic health. The inversion of the yield curve suggests that a recession may be imminent and America's leading newspapers are discussing recessions more often than at any point since 2012. More than two-thirds of corporate chief financial officers expect that a recession will be underway by the end of 2020. Anti-growth protectionism is on the rise, championed by President Trump and equity market volatility has been on the rise for the past few months. However, unemployment in the USA suggests that the chance of a downturn occurring in the next year is just 10%.

The next economic downturn may not arrive this year but it is inevitable. Whether the trigger is in the USA, Europe or China, the internationalisation of capital markets means it will quickly impact UK real estate.

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