Riverside CAPITAL

THE PROPERTY INVESTMENT PEOPLE

02/16

End of Year Review 2015

2015 global market review

2015 started the year on a positive note, as oil prices continued to fall and the ECB launched a QE programme that was much larger than markets had expected. Against this backdrop, many markets around the world hit record highs. Monetary easing and additional fiscal stimulus from China gave risk assets a further shot in the arm.

The start of summer saw a sharp shift in sentiment, as volatility hit a level not seen since the depths of the financial crisis. A wave of selling hit markets around the world in August, propelled by fears that China's economic slowdown was turning out to be worse than feared. Market concerns were compounded when the Chinese government allowed its currency to depreciate. This prompted fears that China was on the brink of a much larger devaluation and for many confirmed the view that the country was headed for a hard landing.

2015 was notable as the year in which the US Fed finally announced its first rate change in nine years. In a widely anticipated move, the US Fed raised interest rates by 25 basis points and stated that it would continue on a gradual course of monetary tightening as long as inflation and economic growth allowed.

After several years of seemingly uninterrupted growth, 2015 ended on a weak note with growing concerns that the global economy is slowing. Global economic growth, at 2.6 per cent, was below trend and the weakest since the financial crisis (2009). The slowdown stemmed from emerging economies, where growth of 3.5 per cent was not only well below the 2001–08 average of six per cent but, also fell short of the 4.9 per cent achieved in the aftermath of the financial crisis.

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Moving forward, monetary policy divergence will be the key theme for 2016. Major central banks face a number of challenges as they take different paths to meet their inflation targets amid turbulence in emerging markets and slumping oil prices.

Geopolitics will remain at the top of everyone's agenda as political risk remains alive and well in both emerging and developed economies. The ever-growing migrant crisis in Europe shows no sign of easing, whilst the continued conflict in the Middle East also remains a concern and could escalate at any point. Finally, closer to home, the referendum on the fate of the UK's membership of the European Union is likely to cause bouts of short-term volatility.

UK economic overview

The UK economy expanded 0.5 per cent in the final months of 2015 as expected, but for the year as a whole, growth was down markedly. Official figures show GDP grew 2.2 per cent last year after a 2.9 per cent rise in 2014, with the slowdown occurring against the backdrop of a waning global economy.

Whilst GDP figures demonstrate that the recovery remains fragile, government data show that no economy in the G7 has grown faster than Britain since 2010.

Looking ahead, the pace of economic growth is unlikely to change much from here, with a range of surveys and indicators suggesting that growth will be maintained at close to 2.5 per cent despite recent financial market volatility.

London and the South East will continue to lead the recovery, as has been the pattern for many years, but all other UK regions should also register positive real growth of around 1.6–2.5 per cent per annum in 2016, according to the PWC UK economic outlook.

Mid-way through 2015, with the recovery gathering momentum, it looked like we were heading for a return to a more normal monetary policy and expectations were high that the UK would follow the US in raising rates. However, it now appears that any thought of a rise is firmly on the backburner with Governor Mark Carney reiterating that any decision would "depend on economic prospects, not the calendar".

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At the start of 2015, Inflation was forecast to average around 1.5 per cent for the following 12 months. Instead, we saw headline inflation turn negative for the first time since 1959 as energy prices tumbled and the pound strengthened.

Analysts expect inflation to pick up towards the end of 2016 and recover to around one per cent, but low rates of money and credit growth, combined with falling oil prices, will ensure that headline inflation will remain well below the BoE's two per cent target.

Potential dangers to the UK economy

Chancellor George Osborne recently suggested there was a "dangerous cocktail of threats" facing the UK economy. The Chancellor cited slower growth in China, increasing tensions in the Middle East and falling oil prices as potential headwinds faced by Britain in 2016.Whilst the UK recovery is exposed to downside global risks, specifically a slowdown in China, there is plenty to be positive about. Britain remains among the fastest-growing major advanced economies and consumers will continue to benefit from low oil prices as well as falling unemployment and recent signs of stronger earnings growth.

As we move into 2016, it is very likely that we will see further bouts of volatility and uncertainty, domestically and internationally. From a UK perspective, there are two specific situations that could cause volatility to spike in the near future.

Will 2016 see a rise in interest rates?

The US finally raised interest rates in December 2015, for the first time in almost a decade. A 0.25 per cent move up in the Fed funds rate set a marker that the Bank of England's rate setters will be measured against.

UK rates have now been at a record low for six years, and opinions are still divided as to when they are expected to rise. The Centre for Economics and Business Research predicts it will not change till the summer, whilst money markets are even less optimistic, implying that the first increase will come in January or February 2017. To put this in context, in the summer of last year, a rate rise was considered likely by the end of 2015.

Whilst a rate rise at some point almost seems inevitable, the eventual path of rates is perhaps more important. The BoE's quarterly Inflation Report (November 5) captured market predictions, suggesting a notional rate of 1.1 per cent by the end of 2016, 1.7 per cent by the end of 2017, and 2.3 per cent by the end of 2018.

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The long-term risk is that the BOE leaves it too long to raise interest rates and then slams on the brakes when inflationary pressures start to appear. Over the past seven years, the UK has become used to rock-bottom borrowing costs; nobody is quite sure what the reaction will be to a tightening of policy.

A Possible Brexit

Withdrawal poses a key risk to recovery

Voting to leave the EU would have significant risks for the wider UK economy, according to Société Générale. The French banking giant claimed that a Brexit would lead to slower economic growth for at least the next decade, while the pound would slip in value.

Although many business lobby groups have come out in support of the UK remaining in the EU, there is a clear split in the City. Those that are anti-Brexit see the advantages of a huge consumer market and export perks with a market that represents the majority of UK trade, while others say the bureaucracy and strict regulation is limiting the potential of British businesses.

A date has yet to be set but, whatever the outcome, it is likely to cause higher levels of volatility and has the potential to dent future growth prospects. The IMF stated that the "uncertainty associated with the outcome of the planned referendum on EU membership could weigh on the UK's outlook".

UK commercial property – review of 2015

- 2015 will be defined as the year in which we saw a significant increase in trading volumes in the regions and confirmation that rental growth for offices and industrial units had spread outside London.
- Whilst total returns fell short of the highs of 19.7 per cent for 2014, commercial property continues to benefit from strengthening investor demand and a supportive economic backdrop.

Another year of double-digit returns

- 2015 was a strong year for UK commercial real estate, with total unleveraged returns of 14 per cent, according to the latest CBRE Monthly Index.

Whilst total returns fell short of the highs of 19.7 per cent for 2014, commercial property continues to benefit from strengthening investor demand.

- Over 2015, capital values grew by 8.3 per cent. The sector with the strongest capital value appreciation was Offices at 12.8 per cent, followed closely by the Industrial sector at 11.2 per cent.
- More significantly, All Property rental values grew by four per cent in 2015, the highest growth rate since the recession.

	All Property	Office	Retail	Industrial	Other
Total Return	14.0%	17.7%	9.6%	17.7%	15.9%
Capital Value Growth	8.30%	12.80%	3.80%	11.20%	9.60%
Rental Value Growth	4.00%	8.00%	1.10%	5.00%	3.20%

Source: CBRE UK Monthly Index Snapshot: Annual 2015

- As an asset class, UK commercial property performed extremely well against equities and gilts. The FTSE 100 was down -1.3 per cent, whilst UK gilt total returns were 1.08 per cent (down from 11.86 per cent in 2014).

	2015 returns (%)	
Asset Class	Capital growth	Total return
All property	8.30	14.00
UK equities (FTSE 100)	-4.90	-1.30
Gilts (5-15yrs)	-2.20	1.0
UK corporate bonds	-3.50	0.70
Global equities	2.90	4.90

Source: CBRE UK Monthly Index, Datastream

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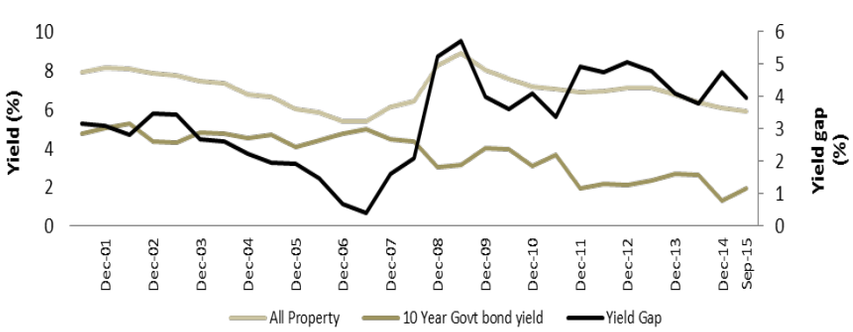

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The current yield gap is approximately two per cent, which is slightly lower than the ten year average of 2.4 per cent.

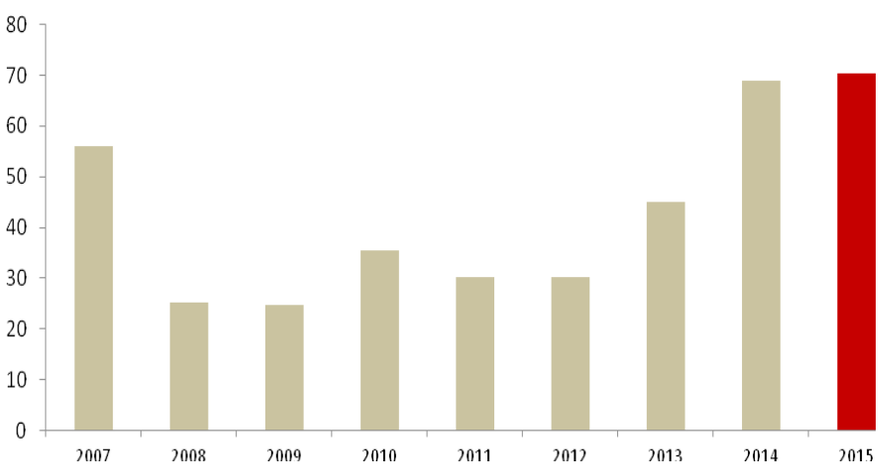
FTSE 100 Dividend Yield (Dec 2015) 3.98%	Equivalent Yields (%) Dec 2015
All property	5.90
Prime offices - City	4.00
Prime offices - SE	5.25
Prime offices: Major provincial	5.25
Prime distribution unit	5.00
Hotels: Prime regional	6.25
Prime shops	4.00
Good secondary shops	6.50

Source: CBRE UK Monthly Index, Datastream

Investment inflows hit nine year high

- A record amount of money flowed into UK commercial property in 2015. Investment inflows for the year were £70.4bn according to Property Archive, up 2.2 per cent from 2014 (£69bn).

UK investment market activity – 2007 to 2015 (£bn)



Source: Property Archive- December 2015

- The record figures were driven by overseas investors, who accounted for over 52 per cent of all total UK investments, the highest level seen to date. US investors were the largest overseas investor for the second consecutive year at 32 per cent, followed by the Far East at 23 per cent.
- In 2015 (to Q3), 32 per cent of transactions (by value) outside London have attracted foreign buyers from 31 different countries—a noticeable increase in the diversity of investors.

A record amount of money flowed into UK commercial property in 2015. Investment inflows for the year were £70.4bn.

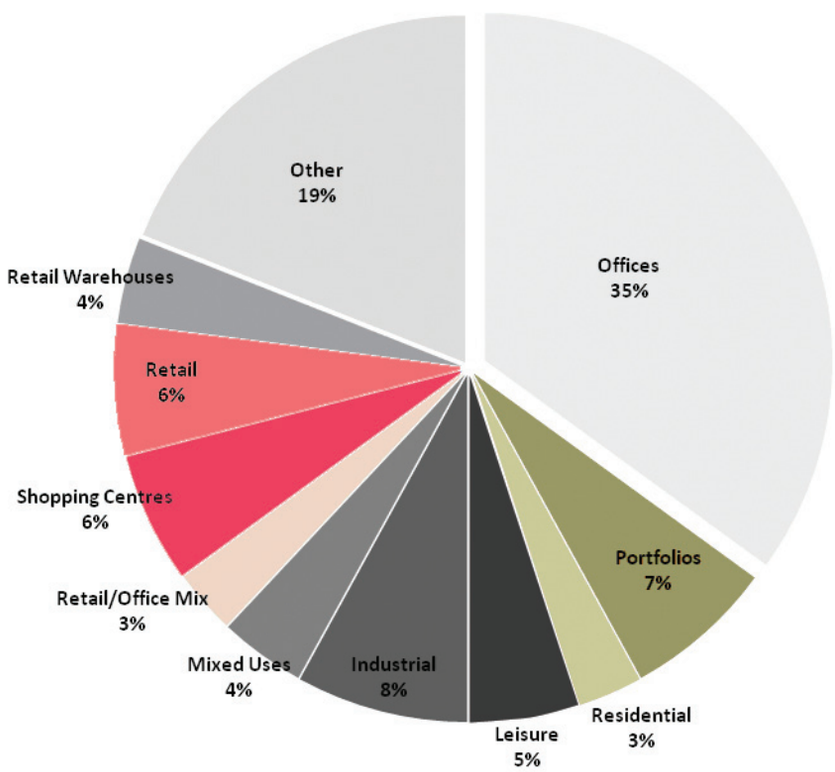
Overseas investment diversifies away from London

- Foreign investment has not historically been a significant part of the UK market outside central London, making up only around 20 per cent of acquisitions according to CBRE. However, in recent years, foreign investment outside London has increased.
- In 2015 (to Q3), 32 per cent of transactions (by value) outside London have attracted foreign buyers from 31 different countries—a noticeable increase in the diversity of investors.

Increasing appetite for the alternative sector

- The record figures (2015) were supported by increasing investment in alternative property assets (+50 per cent year-on-year).
- Offices continued to be the most sought after sector with 35 per cent of the overall inflows, whilst "Other" represented 19 per cent of the overall total, confirming evidence that there has been a significant move away from the traditional main sectors.

UK Investment 2015: by sector



Source: Property Archive - December 2015
(Other: motor related, hotels petrol stations, pubs, student accommodation, nursing homes, medical, educational)

Despite the slower rate of growth in Q3, forecasts suggest that GDP growth will be close to 2.4% in 2015

Riverside Capital Outlook for 2016 & beyond

Polarised returns over 2016: high single digit returns still expected

Over the last three years, the UK commercial property market has delivered high double-digit total returns. Whilst the economic backdrop and low interest rate environment will remain supportive, we forecast that returns will moderate from 2016 but still offer very healthy high single-digit returns.

Given where we are in the current cycle, returns will also become polarised across different regions, sub-sectors and asset classes. The best market returns will be achieved by real estate which is in the right location and which best suits occupiers' requirements.

The capital growth and income offered by the UK real estate market will continue to make this asset class look attractive relative to others and will help to drive private and institutional inflows into the market.

Return to fundamentals: investors set to focus on income

The income producing potential of various property asset classes is expected to be top of investors' agendas in 2016 and the emphasis will now shift to the actual performance of underlying assets.

Going forward, we foresee that performance will be driven by improved real estate fundamentals. Future returns are going to be increasingly reliant on income yield and rental growth, which historically have always been the main drivers of returns.

UK GDP growth, falling oil prices and increased levels of employment are expected to boost both corporate and consumer confidence and should underpin the fundamentals and values of UK real estate.

Rental growth is now positive across all sectors, driven by stronger tenant demand and a shrinking supply of space.* Legal & General expects rental growth to average around three per cent annually from 2016 to 2018, nearly double the rate experienced over the past five years (1.5 per cent per annum). Office and industrial sectors are predicted to see the most rapid growth.

With the supply of available property constrained and increasing competition amongst occupiers, rental growth will take over from yield compression as the key source of capital growth.

**Since peaking in mid-2010, the volume of available office and industrial space has fallen by 28% and is more pronounced for the best quality space.*

The capital growth and income offered by the UK real estate market will continue to make this asset class look attractive.

The interest rate environment will remain supportive for All Property capital values

With CPI inflation close to zero and nominal wage pressures muted, it is likely that we will see looser monetary policy for longer (money markets are now not pricing in a rise until 2017), which is a positive for property valuations.

Historically, property prices have not been that strongly correlated with short-term interest rates: long-term interest rates are more important. In most cases, UK commercial property has continued to perform well during periods when interest rates have been increased, according to a report by M&G investments.

Property will remain comparatively attractive

Commercial property yields have compressed significantly over the last few years as investors compete for limited stock. The relative pricing against other asset classes is an important driver of real estate returns and currently the gap between commercial property and UK gilts remains high.

The forecast UK property income yield for 2016 is 5.2 per cent; this is 3.3 per cent greater than ten-year gilts, 1.4 per cent above the current FTSE 100 yield and significantly higher than the rate of return on cash (Dec 2015).

In a low yield world, commercial property remains a compelling investment.

Overseas inflows set to remain high

The UK commercial real estate market has experienced (increasingly) high transaction volumes over the last two years. The latest forecast (Jan 2016) from global real estate advisor CBRE suggests that total investment in UK commercial property is now likely to moderate, with 2016 seeing a similar volume to 2015 (£70bn).

In a low yield world, rising rental growth is a key attraction for income-seeking investors. Quality commercial property continues to yield more than other comparable assets available to investors.

As we move forward, the origins of foreign capital will likely change. Asian investment inflows have been higher than the ten year average, with countries like Singapore and Taiwan becoming more important, according to CBRE.

European and US investors have withdrawn a little capital over the last year, potentially due to strength in sterling. Investment from the Middle will continue; however, it is more likely to come from private wealth rather than sovereign wealth, given the latter is suffering from the low oil price.

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