Riverside CAPITAL

THE PROPERTY INVESTMENT PEOPLE

04/16

# Quarterly Review
## Q1, 2016

## Hedging your bets against inflation

**Riverside Capital CEO, Dominic Wright, addresses the inflation debate and the role of commercial property in abating the effects.**

Protecting the real value of income streams remains a challenge, and in the US, BlackRock has joined Pacific Investment Management (Pimco) in recommending that investors seek an inflation hedge. Whilst deflation continues to be a concern across the Euro-zone and Japan, the US & UK appear to be moving in the opposite direction and we don't think it will be long before prudent UK investors begin to prepare their portfolios in the same way as our American cousins.

The UK's March inflation data provided a positive surprise, with both the headline and core rates of CPI coming in above consensus and hitting their highest levels in 15 months. The core inflation measure - watched closely by the Bank of England - also rose, hitting 1.5 per cent, its strongest since October 2014 and above all forecasts in a Reuters poll.

It is still very difficult to forecast any significant inflation. However, the effect of falling oil prices has started to fade, and a weaker currency is likely to start to start to push up the cost of imported products over the coming months. In addition, there are increasing wage pressures reinforced by the National Living Wage.

Given the data, the trajectory of UK inflation has started to change and it is very possible that we will see higher inflation later this year.

There are not many better ways of achieving an inflation hedge than through investing in Commercial property, and in particular those commercial properties that are let on long leases and which have rent reviews linked to one or other of the main inflation indexes. As always, any meaningful exposure to direct commercial property is difficult to achieve due to the lot sizes involved and the Riverside Capital direct investment platform enables private investors from around the world to access these types of opportunities.

*Dominic Wright, Group Chief Executive*

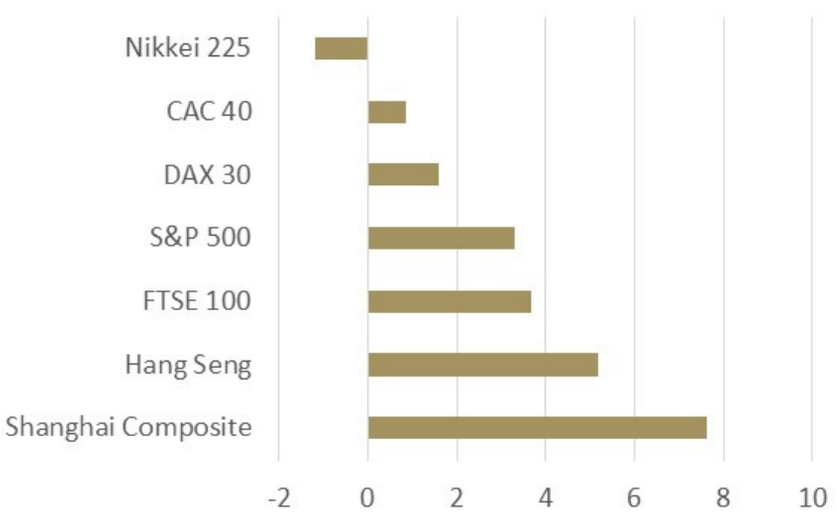
## Global Macro

**US economic data are painting a mixed picture.** For instance, weak trade figures and a fall in motor vehicle sales seem consistent with a weak outturn for Q1 GDP of just 1% annualised. That said, non-farm payrolls posted a robust gain of 215,000 in March. But this has yet to translate into wage pressures, average hourly earnings growth was unchanged at 2.3%y/y. And while, at 0.3%, the annual rate of headline inflation is still subdued, core inflation is somewhat higher at 2.3%. In all, this may well push the Fed into action sooner than markets expect.

**Similarly, in the Euro-zone, some positive data was balanced by softer surveys.** Euro-zone unemployment edged down from 10.4% to 10.3% in March, while retail sales volumes growth reached 2.4%y/y, thanks to a boost from low oil prices. By contrast, composite PMI measures suggested that Q1 GDP Euro-zone GDP would be below Q4's 1.5%y/y figure.

**As a result, equity markets have begun to show signs of diverging.** Chinese stocks have rebounded strongly, as growth fears have eased. Meanwhile, Japanese stocks suffered from the effect of a stronger yen. Meanwhile, the weak, but positive, performance of French and German equity markets reflected soft economic data.

**Chart 1: Selected Equity Market Indices (% change from trough, latest = 14th April 2016)**



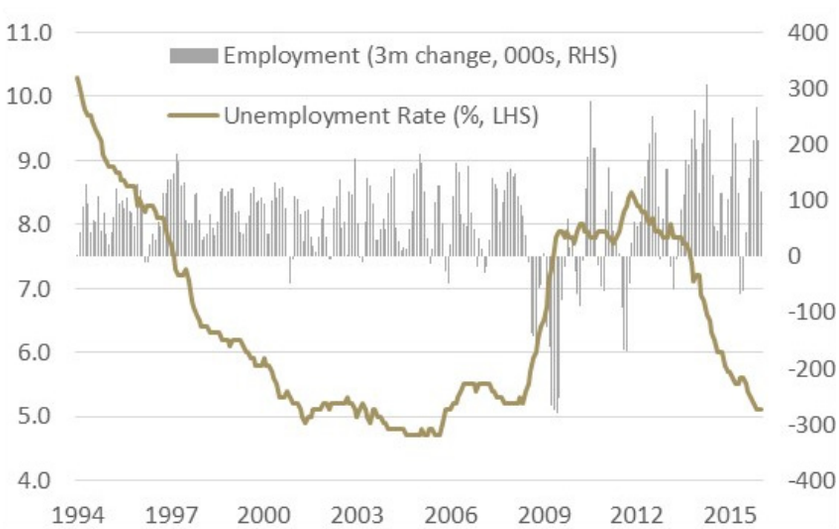

Looking ahead, divergent monetary policy is likely to be a feature of the economic landscape for some time.

## UK Macro

**As global growth fears have receded somewhat, March was a calmer month for UK financial markets.** Over the last four weeks, the FTSE 100 rose by 3.6%, and 10-year gilt yields have been broadly flat at around 1.45%. That said, the UK is not quite out of the woods. Sterling's 11% decline on a trade-weighted basis is slightly larger than relative interest rates or inflation expectations would imply, suggesting that Brexit concerns are still a factor.

**Recent data for the labour market and retail sales suggest that conditions in the real economy are healthy.** Over the three months to January 116,000 jobs were created, and the unemployment rate stood at 5.1%. (See Chart 2) With employment at historically high levels, it is unsurprising that January's increase in jobs was the smallest since August 2015. Retail sales volumes growth was still healthy despite dipping in February, to 3.8%y/y from 5.4%y/y a month earlier. And there is little reason to think that that dip is anything other than the normal volatility in the data.

**Chart 2: UK LFS Emplyment Change and Unemployment Rate**




**However, weaker sentiment and survey data suggest that activity is unlikely to strengthen sharply in the near term**. Over the first three months of the year, the weighted average of the services, manufacturing and construction PMIs fell to 53.0 from 55.3. Similarly, business and consumer confidence indicators were also slightly weaker. In the absence of further financial stress, this suggests that even though Brexit concerns have not made a dent in the hard data, the uncertainty around the referendum may be weighing down on business and consumer sentiment.

**In light of the uncertainty surrounding the referendum, and in the absence of an inflationary shock, the MPC is likely to refrain from raising interest rates by more than 25bps this year.** Even with the impact of lower oil prices fading, CPI inflation ticked up only marginally in March, to 0.5%y/y up from 0.4%y/y a month earlier.

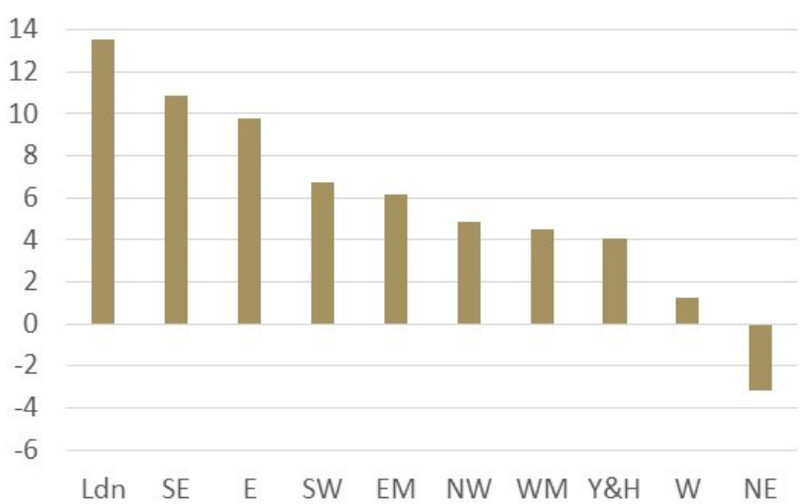
As global growth fears have receded somewhat, March was a calmer month for UK financial markets.

## UK Residential

**An imbalance between active supply and demand continues to characterise the housing market.** Nevertheless, according to Land Registry data, annual national house price inflation slowed from 6.5% in January to 6.1% in February.

**That said, house price inflation trends showed the usual regional divergence.** While house price growth strengthened in London and the East Midlands, it weakened in the North East, and Wales.

**Chart 3: House Price Growth (% y/y)**




**However, the market now appears to be cooling again with London leading the way.** For one thing, mortgage approvals fell by 0.3%m/m in February. Moreover, the balance of surveyors reporting a rise in buyer enquiries fell from 22% in January, to 3% in March. In London, the comparable figures were 33% and minus 58%. And with house prices already so high, house price inflation is likely to slow as the year progresses.

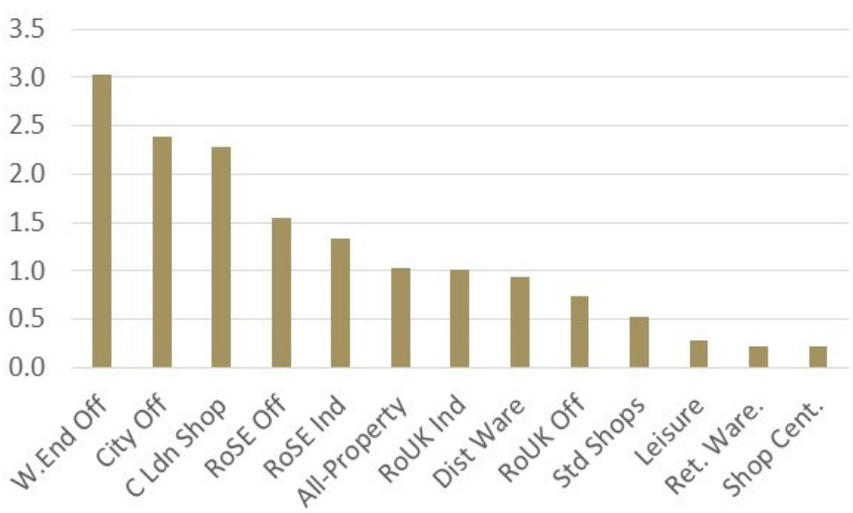
House price inflation trends showed the usual regional divergence.

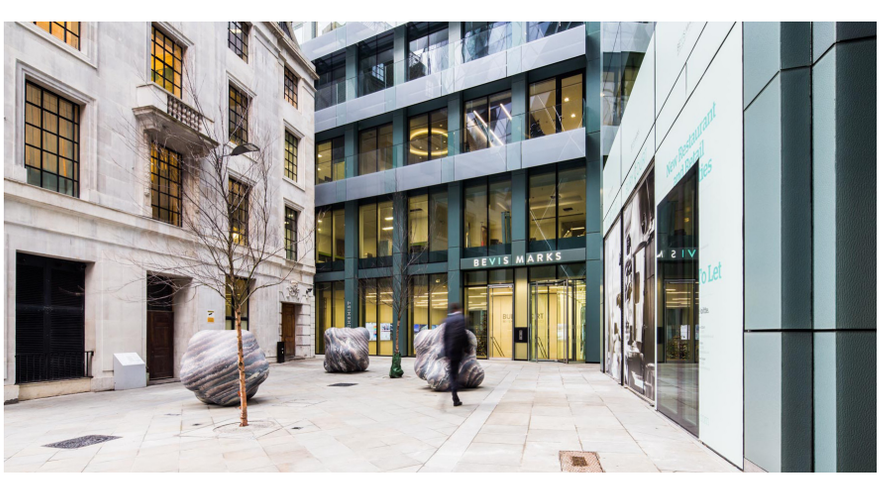
## UK Commercial

**On the back of healthy demand and shortages of space, UK commercial property rents had a solid start to the year.** The data for the latest three month period show that all-property rents rose by 1% compared to the previous three months. This brought the annual rate to 4.4%.

**Rental values grew fastest in and around the capital, while retail rents languished.** On a quarterly basis, the heftiest gains were recorded in London's office markets and Central London retail, where rental growth ranged between 2.3%q/q and 3%q/q. Rental growth was also solid in the South East, where office and industrial rents rose by 1.5%q/q and 1.3%q/q respectively. By contrast, retail rents outside of London have only recently started to show signs of improvement. For instance, over the last quarter, standard shop and retail warehouse rental growth held steady at 0.5%q/q and 0.2%q/q respectively. And even though shopping centre rental growth picked up, from 0%q/q to 0.2%q/q, it remained the weakest subsector.

**Chart 4: Rental Value Growth (% q/q)**



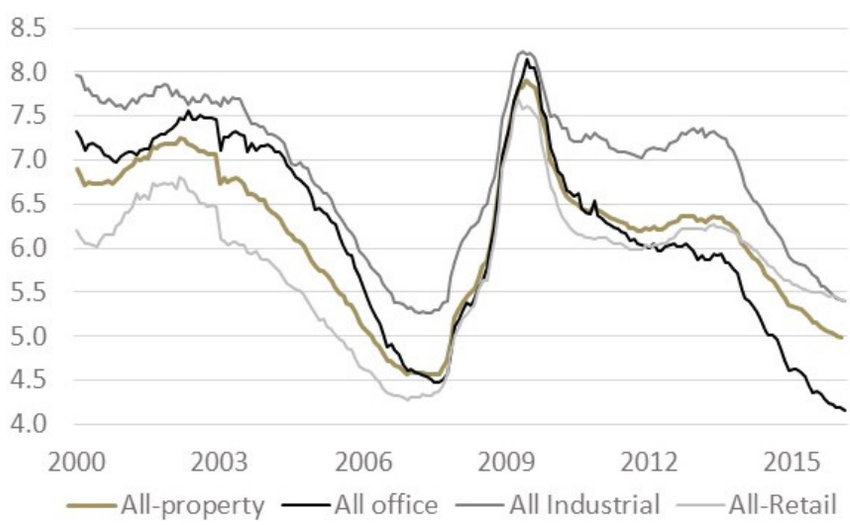




On a quarterly basis, the heftiest gains were recorded in London's office markets and Central London retail, where rental growth ranged between 2.3%q/q and 3%q/q.

**Meanwhile, all-property yields are fast approaching their floor. But this masks significant divergence between sectors and locations.** At the all-property level, initial yields fell by about 5bps over the last three months, to reach 5%. They are currently still some 40bps above the 2007 low. By contrast, at 4.2%, all-office yields are 30bps below their pre-crisis low, and within that average, pricing in Central London's office markets is by far the most stretched. The contrast is starker in the retail sector where the all-retail average is 110bps above its pre-crisis trough, while in London retail yields are 65bps below the equivalent benchmark.

All-property yields are fast approaching their floor. But this masks significant divergence between sectors and locations.

**Chart 5: Initial Yields (%)**



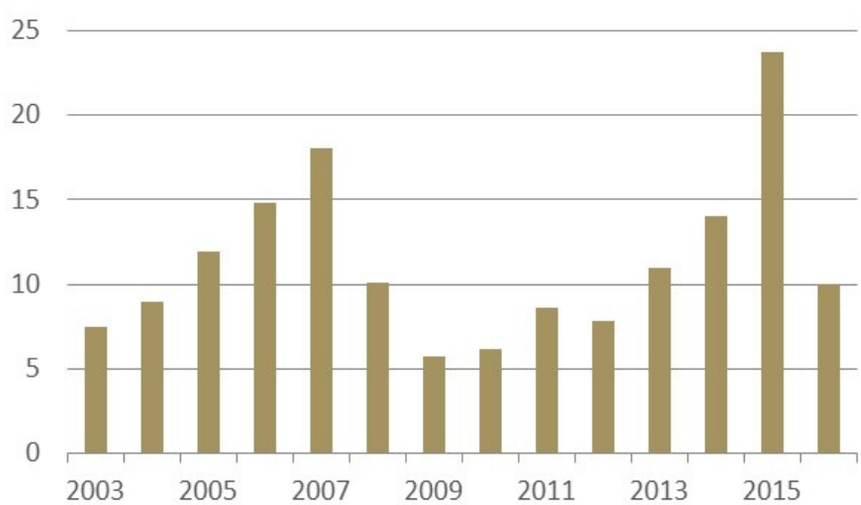

**With yield compression slowing to a crawl and rental growth stable, capital value growth has also slowed.** Indeed, all-property capital value growth dipped to 1.4%q/q, from 2%q/q one quarter earlier. Nevertheless, reflecting the strength of rental growth in London and the South East, capital value growth trends were polarised. The best two performing sectors were in London, with West End and London retail capital growth standing at almost 3% over the quarter. At the other end of the spectrum, the main retail subsectors saw capital values grow by 1%.

**Nevertheless, the short term outlook is generally positive, but not without risks.** The relatively healthy outlook for the economy combined with low interest rates should support both rental values and valuations. That said, the uncertainty around Brexit could weigh on tenant and investor confidence therefore delaying some transactional activity, at least until after the referendum vote.

## Investment

**As financial market volatility subsided, commercial property investment activity picked up in March.** At just shy of £3bn, the value of transactions completed in March rose by 29% compared to February's 58-month low, leaving the Q1 total at an solid, if unspectacular, £10bn. (See Chart 6) Moreover, the rise in investment in March was larger in value terms than in volume terms and, as a result, the average lot size rose by 65%m/m, to £28.5m. And despite falling short of the 12-month average, this is above the long-run average of £24.5m. That suggests that February's exceptionally weak numbers primarily reflected a temporary lack of liquidity.

**Chart 6: Value of Commercial Property Deals in Q1 of Each Year (£bn)**




**Furthermore, there was little evidence to suggest there has been a rise in risk aversion.** Despite the referendum-related uncertainty, net purchases from overseas investors have held up well. In fact, with net purchases of £1.1bn of UK assets, foreign investors were the most active buyers. With pricing looking far more stretched in London than elsewhere, a shift in sentiment would be most notable in the capital. However, the share of investment transacted in Central London stood at 37% which is roughly in line with the long-term trend.

**On a sectoral basis, the first quarter's moderation in activity has been most notable in the traditional office, retail and industrial sectors.** At £3.9bn, £2.3bn and £0.9bn respectively, the value of deals signed in the traditional sectors was lower than a quarter earlier and also lower than the long-term average. By contrast, accounting for £400m and £780m investment in alternative sectors like leisure, and mixed-use schemes outstripped last quarter's total.

Despite the referendum-related uncertainty, net purchases from overseas investors have held up well.

**In all, the latest data gives weight to the idea that Brexit fears played only a minor role in February's slump in investment activity.** That said, as the referendum edges closer, we expect investment activity to be relatively subdued before picking up slightly in the second half of the year.

## For further information please contact:

Sarah White
Head of Marketing
+44 (0)20 7297 4480
sw@rivercap.co.uk

Jaspal Phull
Head of Research
+44 (0)20 7297 4480
jp@rivercap.co.uk

**www.rivercap.co.uk**