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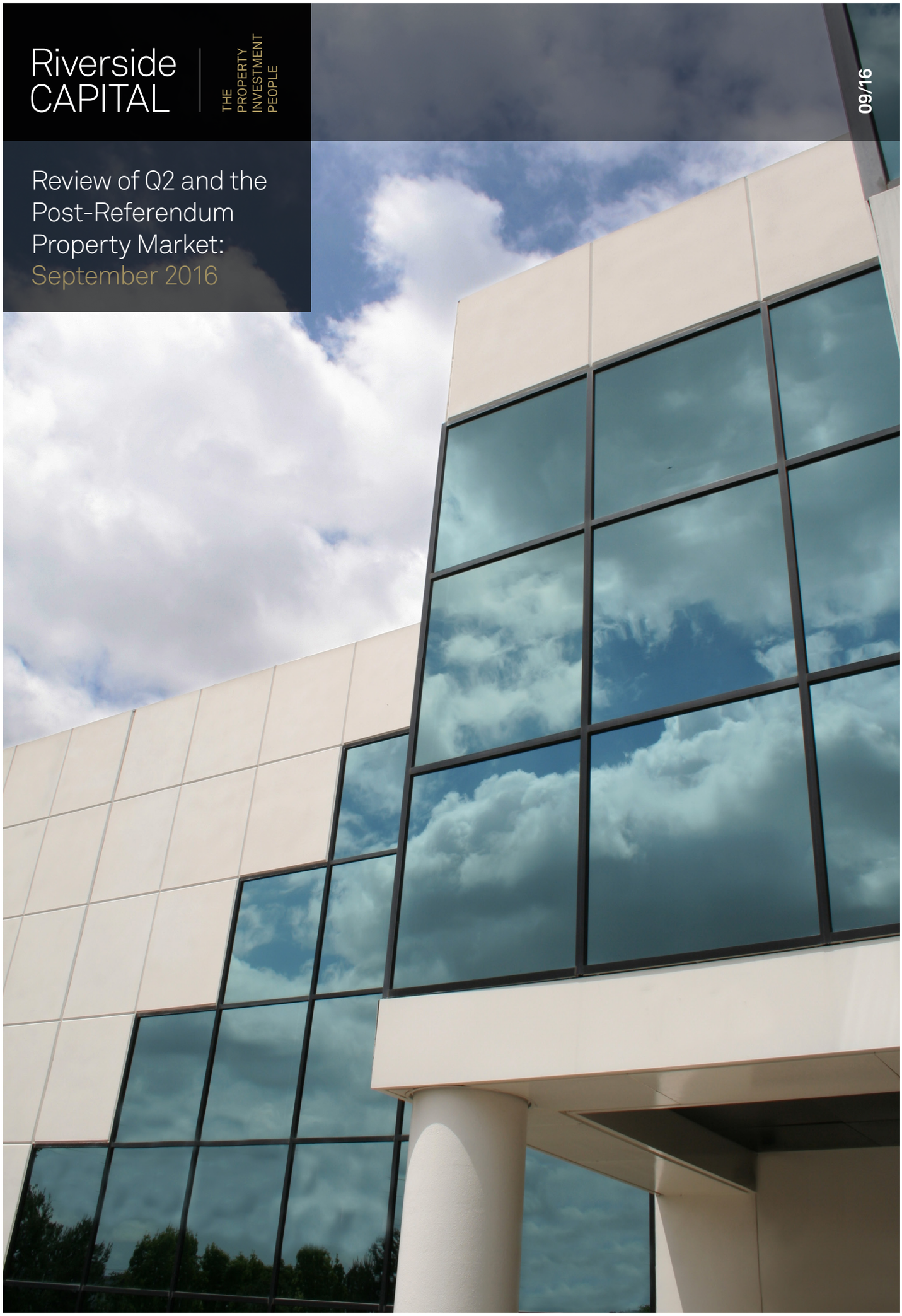
THE PROPERTY INVESTMENT PEOPLE

09/16

Review of Q2 and the Post-Referendum Property Market: September 2016



Global Macro overview

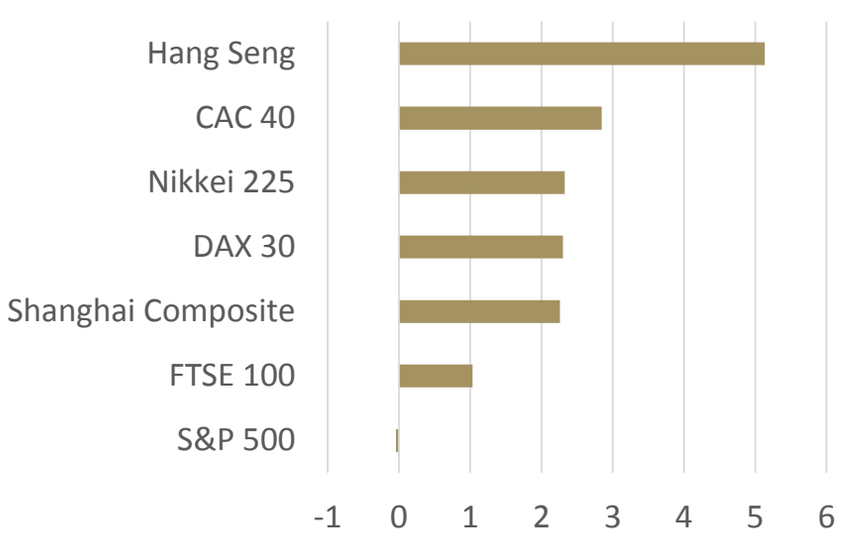
Euro-zone economies have shown little sign of improvement (or deterioration) since the UK's vote to leave the EU. Indeed, headline inflation was unchanged at 0.2%y/y in August. Meanwhile, at 10.1% in July, the unemployment rate was also unchanged from a month earlier. And while the composite PMI saw a marginal improvement, rising from 53.2 in July to 53.3 in August, the forward-looking aspects of the index, such as those relating to new orders and employment intentions, were less rosy.

Meanwhile, the first estimate of US GDP growth for the second quarter disappointed, at 1.2% annualised. This was considerably below the consensus estimate of 2.6%. In addition, downwards revisions to the last few quarters mean that GDP growth is now expected to end the year at 1.5%, rather than our previous forecast of 2%. Moreover, headline inflation is below 1% and may yet ease on the back of softer energy prices.

Therefore, a sharp tightening of monetary policy seems a distant prospect. For example, even though a rate hike is likely later in the year, the poor run of data Stateside means that the prospects of a September rate rise by the Fed have diminished. Meanwhile, muted economic growth and low inflation mean that the Bank of Japan and the ECB will probably cut their already negative policy rates by 10bps or so over the next few months.

Equity markets have responded positively to the prospect of looser monetary policy. Indeed, major European markets have risen over the last 20 trading days. Yet, the Hang Seng index posted the strongest gain, at 5%.

Chart 1: Selected Equity Market Indices (% change last 20 trading days, latest = Sep 7 2016)



Source: Datastream

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UK Economy

Contrary to some of the worst prognoses, UK financial markets have held up fairly well since June's referendum. Granted, sterling is down by around 10% on a trade-weighted basis. But the Bank of England has cut Bank Rate to 0.25% and restarted its asset purchase programme. In turn, 10-year gilt yields have fallen close to record low levels, at around 0.6%. This goes some way to explaining the fact that equity markets have surpassed their pre-referendum levels; the FTSE 100 is now 7% above, and the more domestically focused FTSE All-Share is 6% higher.

While July's PMIs pointed to much weaker growth, the data for August so far suggest that the initial drop may prove to have been an overreaction. For instance, in the immediate wake of the EU referendum result, the manufacturing PMI dropped, from 52.4 in June to 48.3 in July. However, those losses were more than made up in August, as the index jumped to 53.3. Similarly, both the construction and service sector PMIs largely recovered July's losses in August, bringing the composite PMI back above its pre-referendum level.

Chart 2: CIPS/Markit Composite PMI

Source: Markit Economics

Moreover, claimant count and retail sales data have provided further encouraging post-vote signals. Indeed, after two months of increases, July's claimant count figures showed a 9,000 drop. And July's good weather, as well as solid household fundamentals – like low unemployment and interest rates, meant that retail sales growth rose from 4.3%y/y in June to 5.9%y/y in July.

Nevertheless, given the usual volatility in the data, it is probably still too soon to sound the all clear. **Yet, the MPC as well as the Treasury are more likely to loosen monetary and fiscal policy than tighten it over the coming months. Given that, we are probably on the cusp of a period of slower growth, rather than all-out recession.**

MPC and the Treasury are likely to loosen monetary and fiscal policy over the coming months.

Regional Residential

July's RICS housing market survey indicated that some of the initial Brexit shock has started to ease. The new buyers enquiries balance rose, from minus 36% in June to minus 27%. Similarly, the new sales instructions balance increased from minus 45% to minus 33%. **Nevertheless, with the net balances still negative, these indicators are still signalling a slowdown in transactions.**

Moreover, mortgage credit softened further in July. Indeed, the Bank of England data showed that there were around 60,900 mortgage approvals for house purchase, down 5%m/m. That said, it would be misleading to attribute all of that weakness in approvals to the referendum. Indeed, approvals were already on a downward trajectory due, in part, to the stamp duty surcharge and the high level of house prices.

Chart 3: Mortgage Approvals per Month (000s)

Source: Bank of England

Since the referendum, the evidence on house prices has been mixed. For instance, the Halifax index fell by 1% July, and by 0.2% in August. That took the quarterly rate of growth to 0.7%, a four-year low. However, the Nationwide reported two consecutive monthly increases, of 0.5% and 0.6% in July and August respectively.

Although some of the worst of the referendum shock may now be behind us, activity will take time to recover. Even so, the next few quarters are more likely to generate a further slowdown in house price inflation than a slump.

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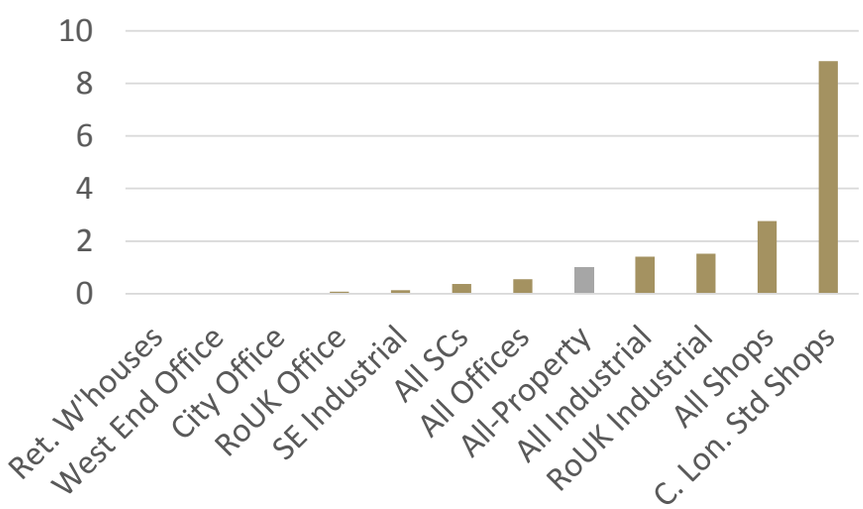
UK Commercial

The latest comprehensive agency data refers to the second quarter, reflecting the pre-referendum state of the market. It shows that prime all-property rental values edged up, rising by 1%q/q. Yet, that figure was skewed by a strong showing in prime retail shops, with central London retail rents surging by 8.9%q/q, and the all-shops average rising by 2.8%q/q. By contrast, rental values rose by less than 1% in the most of the main sub-markets. **Nevertheless, the big picture is that prime all-property rental value growth has slowed in annual terms to 5%.**

Prime all-property rental value growth has slowed.

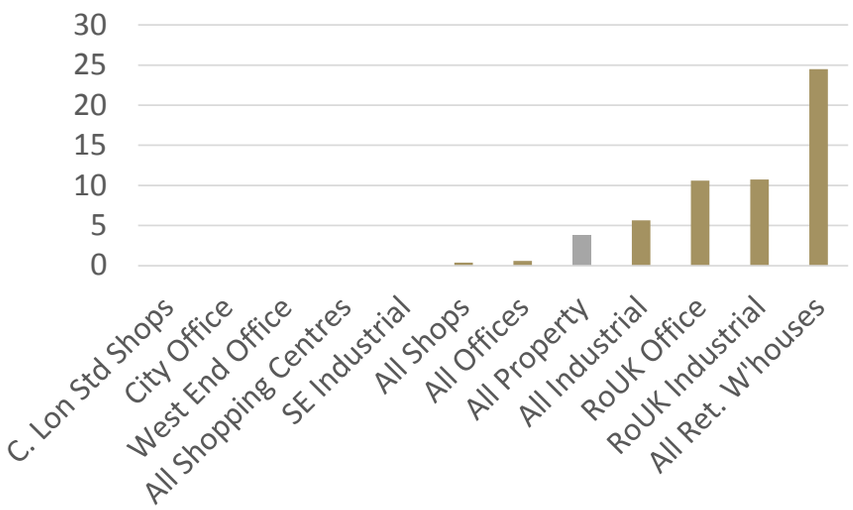
Chart 4: Q2 2016 Prime Rental Value Growth (% q/q)



Source: Capital Economics

Meanwhile, prime all-property yields stood at 5.4%, or 4bps higher than three months ago. Yet this also masked some sectoral divergence. In turn, with rental value growth slowing and yields holding fairly steady, prime all-property capital value growth lost steam in the second quarter, to stand at 5.8%y/y.

Chart 5: Q2 2016 Quarterly Prime Initial Yield Shift (bps)



Source: Capital Economics

Unsurprisingly, however, the caution around the economic outlook for the UK had an impact on commercial property. While post-referendum data is scarce, what we do have all point to a deterioration in market conditions after the vote. For example, in the latest RICS survey –¬ conducted shortly after the referendum – occupier demand fell and availability rose. In addition, CBRE reported a 3.3% fall in capital values in July. Yet, the fact that the fall that was similar in size across most sectors suggest that July's falls may prove to be a knee-jerk reaction. Indeed, provisional reports for August suggest that capital values have fallen by a much more modest 0.5%.

Anecdotally, there is some evidence to suggest that occupiers are still active, and the fall in the pound and the looser monetary environment have helped underpin investor demand. As such, provided that the economy does not lapse back into recession, the commercial property market is likely to undergo a small adjustment rather than a sharp downturn.

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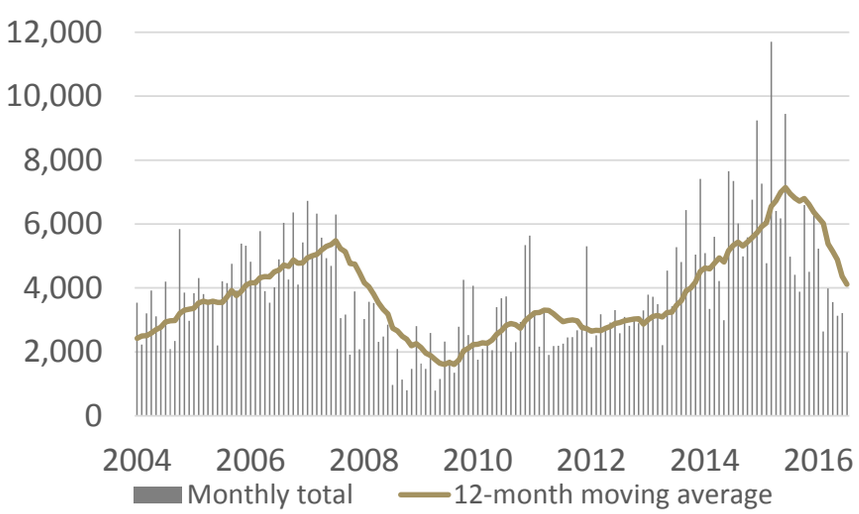
Investment

At just under £2bn, commercial property investment fell by 38%m/m in July. Certainly, part of the weakness is down to Brexit. For example, as several deals fell through in the wake of the referendum result. Moreover, even adjusting for the seasonality in the data, July's figure was weak in both number and value terms. Yet, activity had already been moderating for some time. After a surge in alternative investment and some exceptionally large deals in 2015, a slowdown seemed inevitable.

Chart 6: Value of Commercial Property Deals (£m) - Property Archive



Source: Property Archive

A sectoral breakdown of activity reveals that the traditional – office, retail and industrial – sectors accounted for the bulk of activity. The industrial sector saw a 58%m/m rise, to £263m. By contrast, at £858m, office sector investment fell by 20%m/m. With deals worth £587m, activity was also weaker on a monthly basis in the retail sector, down by 48%.

That said, foreign investors were net buyers of UK property once more in July. Granted, foreign investors made fewer net purchases over the three months to July than in any period since 2012. Yet, that was almost entirely down to net disposals worth £575m made in June; in July, they made net purchases worth £331m.

Admittedly, it is hard to assess whether July's investment activity figures will set the tone for the next few months. However, a weaker pound and lower interest rate environment, as well as the rapid formation of a new government following David Cameron's resignation, should go some way to support investor demand for UK property.

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