Riverside CAPITAL

THE PROPERTY INVESTMENT PEOPLE

11/16

Quarterly Review: Q3, 2016

November 2016

Inflationary effects on commercial property

The third quarter of 2016 will always be a memorable one as the first full quarter after the referendum vote.

Whilst from a headline news perspective it has been usurped by the US electing a property developer, businessman, and reality TV star as its president, for the commercial property industry, Q3 has given us our first signs of what may be to come over the next couple of years.

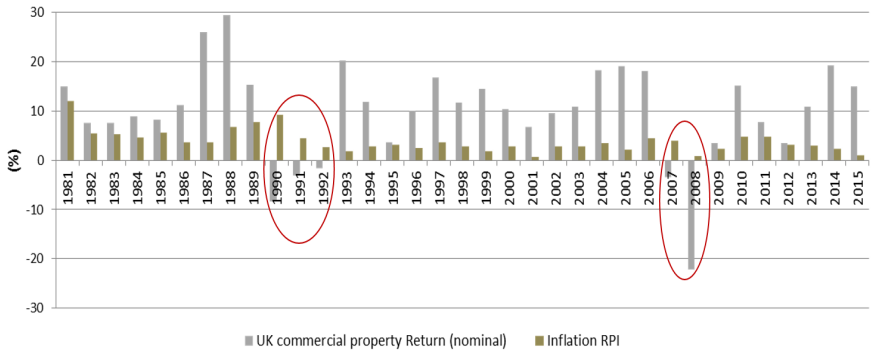
As the quarter unfolded it became clear that inflation would start to move up fuelled by a drop in the value of the pound. The debate as to how quickly this will move, and whether this will be a short spike followed by more normal levels of inflation has begun.

Whatever happens, the one thing that is for sure is that inflation will be higher than that which we have become used to, and the benign inflation figures that buyers of long term assets with inflation linked rent reviews have been using for their appraisals looks set for a boost.

Will these assets be re-rated on the back of this? Maybe, and as owners of a lot of these assets we hope so, but there is also a strong chance that all income producing commercial property assets will do well in an inflationary period.

After all, although statisticians will argue that it is not, many commentators claim that commercial property is correlated to inflation and whilst we will leave that argument for now, what is certain is that commercial property returns have been higher than RPI for every year but 5 in the last 35.

Commercial Property Returns vs Inflation (RPI)

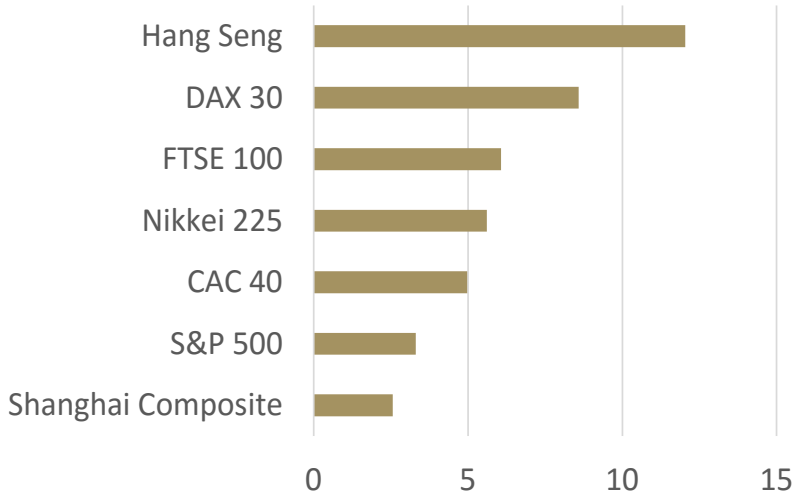


Dominic Wright, Group Chief Executive

Global Macro

Q3 2016 was a positive quarter for markets as volatility across equities and fixed income was markedly lower in comparison to recent quarters. Global markets recovered from the initial shock of the late-June U.K. referendum vote to leave the European Union, as lower bond yields, expectations of additional monetary accommodation, and stable global economic data soothed investor concerns. The Hang Seng was the best performing market thanks to positive policy sentiment from the Peoples Bank of China and investor expectations of further easing.

Chart 1: Selected Equity Market Indicies (Cumulative% in Q3)



Source: Thomson Datastream

The Eurozone's modest growth trajectory continued in the third quarter, unpeturbed by the surprise vote for Brexit. At 0.3%q/q, economic growth was unchanged from the second quarter. The unemployment rate inched down in Q3 and ultra-low interest rates combined with near-zero inflation are continuing to boost consumption. CPI in the Eurozone increased 0.4% year-on-year in September, the highest inflation rate since October of 2014. Early data for the fourth quarter suggests growth remains on an even footing.

While most news coming out of the US has revolved around the election, the economic data has been consistent with another rate hike. Non-farm payrolls rose by 156,000 in September and whilst the unemployment rate rose, this was maginal, to 5% from 4.9% a month earlier. Average hourly earnings rose by 0.2%m/m, bringing the annual rate to 2.6%, a sixth-month high.

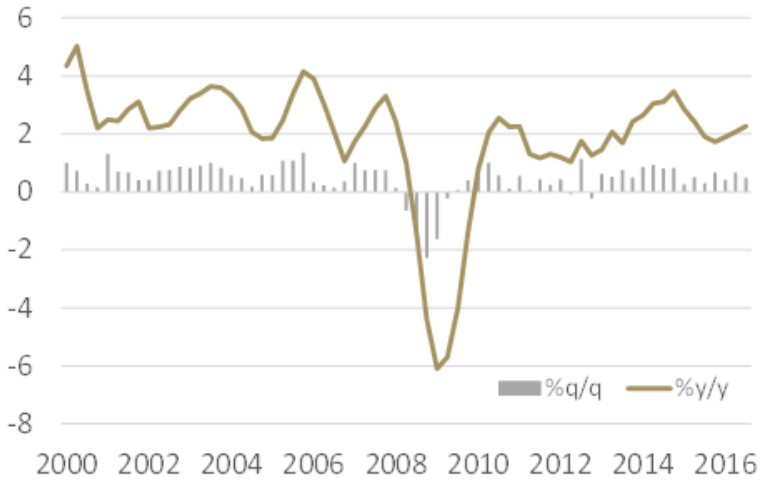
Although the Fed will probably hike rates sooner, rather than later, most other major central banks are likely to continue to hold their loose monetary stance. Indeed, with modest growth and muted inflationary pressures, the ECB is unlikely to pare back the asset purchase programme or raise rates any time soon. Meanwhile, the Bank of Japan could well cut rates further into negative territory by 10bps, to push them to minus 0.2% before year-end.

The majority of major central banks are likely to continue to hold their loose monetary stance for the foreseeable future.

UK Economy

In line with the positive survey data which preceded it, the preliminary estimate for Q3 GDP painted a solid picture of the state of the UK economy. At 0.5%, quarterly GDP growth was only slightly weaker than the second quarter's rate of 0.7%. That said, growth was unbalanced, with the expansion primarily driven by the services sector. Early indications from the latest PMIs suggest that this may continue to be the case in the short-term.

Chart 2: Real GDP Growth



Source: ONS

Meanwhile, less timely official figures suggest that the drivers of household spending have been resilient to the referendum outcome so far. Although job creation fell back, from 173,000 in the three months to July to 105,000 in August, the annual rate of employment growth held firm at 1.8%. Moreover, average regular earnings growth picked up a little, from 2.2% in July to 2.3% in August. That should help to support real incomes as imported inflation rises. That said, with employment already high, and employment intentions weakening, job creation is very likely to slow.

UK equities performed well against a more stable domestic political backdrop following the EU referendum. The UK's Consumer Prices Index (CPI) rose by 1% in the year to September, significantly higher than the 0.6% rise recorded in the year to August, according to the latest figures released by the ONS. The CPI last reached 1% in November 2014. The impact of Sterling's depreciation will continue to affect our domestic inflation as the cost of imports will rise accordingly. The world's worst performing currency of 2016, Sterling is now worth 20% less against the US dollar than it was prior to 23 June.

While weaker employment growth and rising inflation should erode household's real incomes over the next year or so, loose monetary policy, as well as a boost to exports, and less restrictive fiscal policy mean that a dramatic slowdown in economic activity is unlikely next year.

Less restrictive fiscal policy means that a dramatic slowdown in economic activity is unlikely next year.

UK Residential

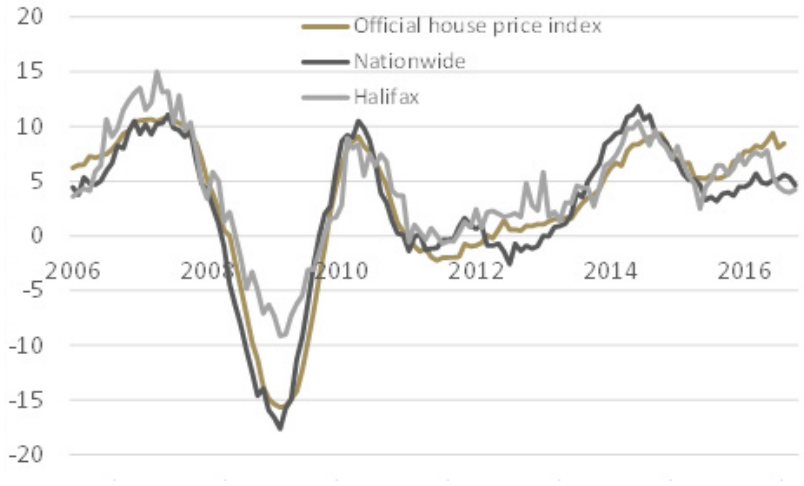
The September 2016 RICS Residential Market Survey results show new buyer enquiries increased for the first time since February, albeit the pick-up was only modest. Alongside this, new instructions to sell slipped further, with the lack of supply firmly underpinning prices at the headline level. What's more, price expectations rose at the three and twelve month horizons, although both indicators remain softer when compared to the start of the year.

Moreover, the mortgage data shows few signs of an imminent rise in housing transactions. Data from the BBA suggests that in September around 38,300 loans were approved for house purchase, down by 15% compared to a year earlier. That said, this softening was already underway before the referendum, probably because of the stamp duty surcharge for investors and second home buyers introduced in April.

These factors mean that house price pressures have eased but price growth has stayed positive. The official house price index for August showed that the annual rate of house price growth has slowed, to 8.4% from 9.4% in June. Meanwhile, more timely measures of house prices, like the Halifax and Nationwide series suggest that house price growth had slowed to around 5.3% by the end of September.

House price pressures have eased but price growth has stayed positive.

Chart 3: Official House Price Index growth by Region (% y/y)



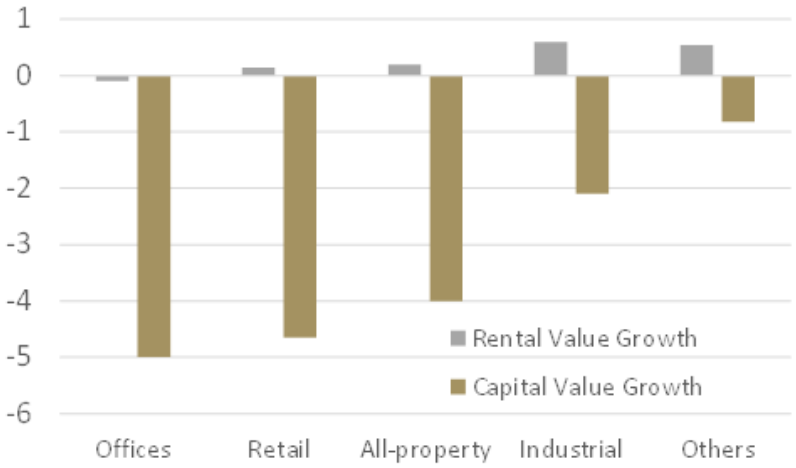
Source: ONS/Land Registry, Halifax, Nationwide

Limited transaction activity and high prices should take further wind out of the market's sails. Nevertheless, with the economy holding up well, house price growth is unlikely to dip into the red.

UK Commercial

Data from CBRE suggested that, in the quarter since the referendum, all-property capital values fell by 4%. At 5% and 4.6% respectively, the office and retail sectors both took a bigger hit than the all-property average. Meanwhile, at 2% and 0.8%, the decline in capital values recorded in the industrial and others sectors was more modest. However, occupier market conditions have held up comparatively well. In fact, prime rental values rose during the third quarter than the major property sectors. The single exception was the office sector, where rental values fell by 0.1%q/q.

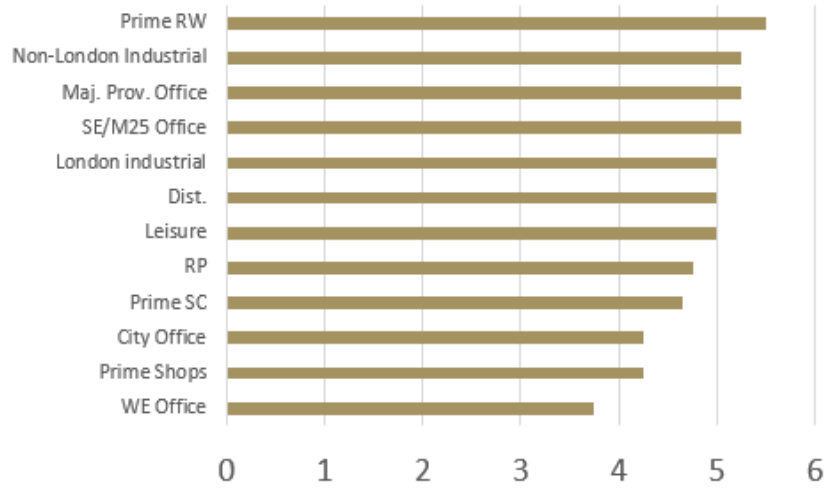
Chart 4: Q3 2016 Prime Rental and Capital Value Growth (% q/q)



Source: CBRE

With rental values broadly unchanged, this implies that the bulk of the capital value adjustment has come from rising yields. The fact that prime yields in the office and retail segments are generally lower than in the other sectors highlights that there has been a negative relationship between the starting level of yields and the correction in capital values.

Chart 5: Prime Equivalent Yields (%)



Source: CBRE

Occupier market conditions have held up comparatively well, with prime rental values rising across most property sectors.

Encouragingly, the RICS commercial survey showed that investor and occupier sentiment both showed signs of improvement in the third quarter. In line with stronger demand and less availability, the rental growth expectations net balance improved, to 13% from -7% in the second quarter. Similarly, both the investment enquiries and capital value expectation net balances also rose, from -16% and -21% to 9% and 17% respectively. Together, these factors give weight to the idea that the majority of the post-referendum adjustment is probably behind us.

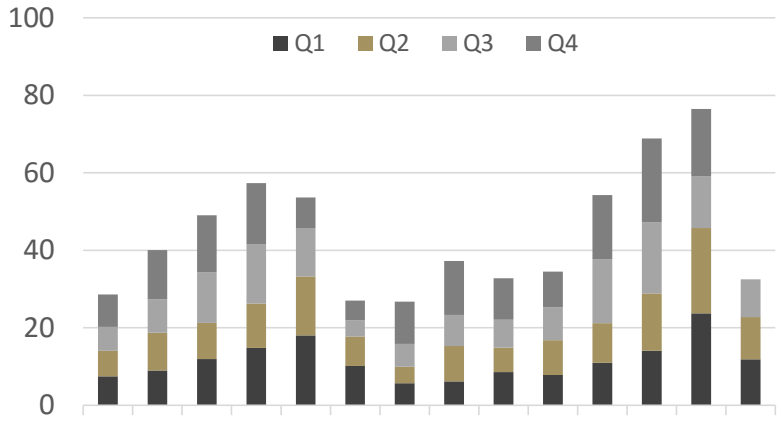
Given that the economy looks to be on a solid footing, and that any tightening of monetary conditions is likely to be slow and gradual, the improvement in occupier and investor sentiment mean that commercial property seems likely to be well supported over the coming months.

The improvement in occupier and investor sentiment means that commercial property seems likely to be well supported over the coming months.

Investment

At £9.7bn in the third quarter, the total value of commercial property investment was weaker than the third quarter in the three preceding years. (Chart 6) The weakness seen in Q3 was entirely driven by the dismal July and August outturns of less than £2.3bn per month. That said, at £5.2bn September was a very strong month.

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



Source: Property Archive

In line with the trend observed over the last few months, investment activity has primarily been driven by overseas investors. On the other hand, institutions have now strung together six consecutive months of net disposals of UK commercial property assets. Overseas investors now represent 58% of the UK investment market.

The most recent data showed that there was £3.4bn of investment activity in October, down by a third compared to September. However, this latest figure was not abnormally weak (or strong) for the time of year, and was less dependent on a small number of very large deals. The value of the top five deals fell by 22%m/m, and the implied average lot size fell back into line with the average seen over the last year, at £27.6m. This suggests that the market is nearing more normal levels of liquidity.

A sectoral breakdown of the data shows that October's slowdown was evenly-spread. Investment activity in the office sector roughly halved from a month earlier, while the industrial sector saw activity decline by 15%m/m. By contrast, however, at £1.2bn and £0.3bn respectively, the retail sector and mixed-use schemes were the only segments to see an improvement in activity.

Since the referendum, we have seen capital values adjust. This, along with the effects of lower interest rates and a weaker exchange rate should help drive improvements in investor and occupier sentiment over coming months. Yet, with activity still lumpy, the recovery in investment activity is likely to be volatile.

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