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February Update

Global Factors

Politics will remain one of the key risks facing financial markets in 2017. Over the next year, we will see France, the Netherlands and Germany all go to the polls. These elections have the potential to significantly raise levels of volatility across the globe.

The Fed is expected to raise rates in the months ahead as long as the economy continues to grow above trend. Trump's spending plans are expected to boost economic growth, as well as inflation, which could force the rate rise. It is likely that the bulk of any Fed moves will come in the second half of the year.

Global Inflation is on the up and the UK is no exception. January saw a significant rise in inflation, as the ONS stated that retail prices rose 1.8% compared with a year ago, the most since July 2013 and up sharply from December's 0.9%. The slower-than-expected ascent toward 2% doesn't, however, mean the consumer is going to have it easy this year. Economists were quick to re-state their view that energy costs and a weaker pound mean inflation is still primed to accelerate.

The current base rate is expected to remain at 0.25% until 2019 at the least. If we see no change over this period then there will have been no change for over 10 years. This, however, is in stark contrast to Bond yields which have moved upwards as inflation expectations have increased. 10 year gilt rates have gone from 0.65% in Sept to 1.22% in Dec. **With inflation set to rise further we have locked in rates at 3.3% and 3.8% for our DPD and Traveldoge investments repectively, and will continue to do so for future opportunities where possible.**

Contrary to the Treasury's pre-referendum warnings of recession, the UK was the fastest growing economy in the G7 in 2016 and is not yet showing any signs of a slowdown. The solid 0.6% expansion in UK GDP in the fourth quarter of last year provided further evidence that the vote to leave the European Union has so far had little discernible adverse effect on the UK economy.

An Overview

The UK economy and property markets have proved more resilient to the referendum result than many had thought. In an environment of solid economic growth and low interest rates, property will continue to be an attractive proposition.

February's Top 5

1. Global inflation is on the rise and set to accelerate in the UK.
2. The UK has confounded expectations, being 2016's fastest growing G7 economy.
3. UK investment inflows likely to soon fall back to 10 year average.
4. National office take-up was strong in Q4 2016.
5. Downside demand risks in central London are overstated.

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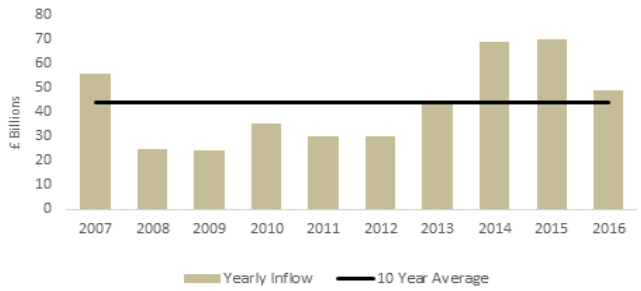
Property Overview

Investment inflows for 2016 were £49bn (Chart 1.0).

1.0 UK Investment Market Activity



Source: Property Archive

Following a record-breaking year in 2015, investment levels fell to their lowest since 2012, but shall remain above their 10-year average. Having seen a strong end to the year it is evident that the uncertainty caused by the EU referendum had a big part to play.

The UK market continued to receive support from overseas buyers, reflecting the impact of a lower pound and the transparency and liquidity that the UK offers. Despite an initial pause for breath, London's long term growth story remains unchanged by the vote. The UK economy continues to surprise on the upside, giving us little reason to believe that demand from investors, foreign or domestic, is about to dry up. Central London, in particular, has witnessed significant capital inflows since the referendum. Far Eastern investors remained the major overseas investor in 2016 at 27% (£7.4bn) followed by the US at 13% (£3.7bn). The interest from overseas remains high with assets looking increasingly attractive in exchange rate terms alone.

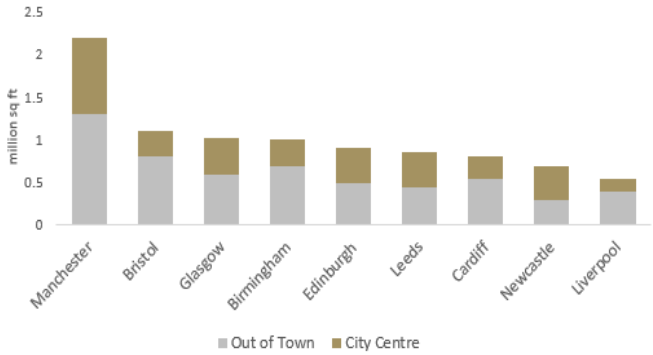
The UK fell into second place behind Germany in a ranking by Real Capital Analytics (RCA) of Europe's most active markets for commercial real estate investment, marking the first time Germany had occupied the top spot since 2012. London, however, was still Europe's biggest city market, with almost 20% more investment than nearest rival, Paris. The UK also accounted for half of the top 10 single property deals by value, in spite of the slide in overall investment volumes.

Whilst the UK remains a strong target for inflows, the main problem facing investors is sourcing suitable stock. **Given the lack of availability of high quality properties, we see this as a good market to dispose of some of our assets that have hit their investment targets.** There is a very strong interest in purchasing property in supply-constrained markets with long income and good covenants. The UK's continued safe haven appeal for investors is driven by high levels of transparency and stable legal structures and there will be opportunities arising over the next 18 months, thanks to the changing business climate.

Regional Property Market

GVA data shows that office market take-up up from the Big Nine regional office markets was healthy in the closing quarter of 2016 (Chart 2.0). In aggregate, take-up in the Big Nine markets jumped from around 1m sq.ft in the third quarter to almost 1.7m sq.ft. That left take-up more or less unchanged from the closing stages of 2015.

2.0 Office Take-up in the Big Nine (2016)



Source: GVA Worldwide

Looking ahead, regional markets have looser links to the fate of the financial sector than London, and the economy looks set to perform better than most forecasters thought in the run up to the referendum. Regional office occupier market prospects therefore look relatively strong.

At £1.7 billion, investment activity in the regions was subdued in January, seeing an overall fall of around 30% m/m. That said, the softening was less marked than in the capital. Key deals included Lone Star's purchase of the Project Ultrabox industrial portfolio for a reported £280m.

London Property Market

Despite the perception that London's economic fortunes are most exposed to the Brexit vote, indicators of occupier demand conditions in London have held up. Take up levels exceeded initial estimates, hitting 11.39m sq ft, just 10% below the long term average.

London-based businesses will see a sharp rise in rates from April 2017, but firms in the Midlands and north will be largely unaffected or see a reduction. The last time new rates were set was 2010. The latest revaluation is drawn on figures from 2015 and rents in London have skyrocketed in that period. Average increase in rates payable will range from as little as 4% in Docklands and 5% in Knightsbridge to 46% in Farringdon and 67% in Kings Cross.

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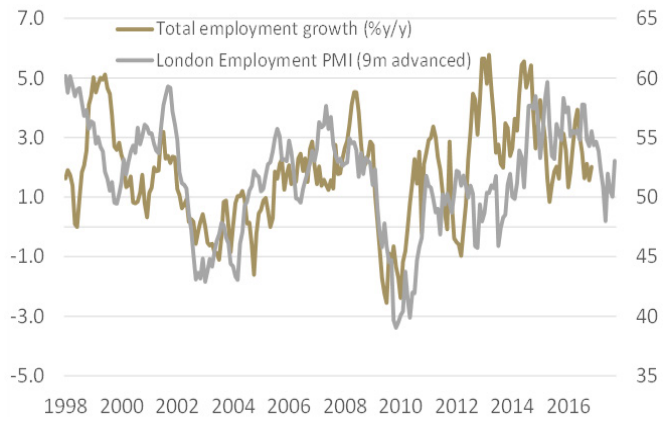
Sector Spotlight - London Offices

The vote to leave the European Union has created a great deal of volatility and uncertainty for the UK. Given that we are still in the early stages of the Brexit process this uncertainty is set to continue in 2017. After an initial pessimistic outlook for the UK economy, however, data has in fact surprised on the upside, and whilst growth is expected to slow, London's employment PMI for December is consistent with total employment growth, hovering around the 2% mark over the next nine months (Chart 3.0).

3.0 London Employment



Source: Thompson Datastream, CIPS/Market

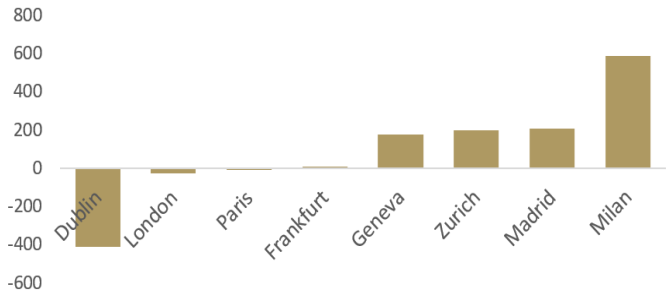
Location and quality will be crucial determinants of how individual properties perform in the year ahead given the emerging impacts of Brexit on the market in the longer term. The London office market is entering the post EU referendum world at a time when office vacancy levels across Central London are at historic lows. While it is likely that demand for London office space will weaken over the next 12-18 months, the undersupply of available floor space should help underpin the market.

Theresa May shed some light on the UK's priorities for the Brexit negotiations in January and confirming that the UK will not remain in the single market. Since then, several large financial institutions have reiterated their intentions to relocate jobs to mainland Europe. The extent of the financial services exodus will depend on whether or not deals can be struck to gain access to Europe via 'passporting' rights.

The prospect of financial institutions shifting jobs away from the UK does pose a risk to the UK economy, as well as commercial property markets. However, there are good reasons to take their threats with a dose of scepticism:

- Firstly, relocating part of a bank's operations is not a costless endeavour. From a property perspective, finding new office space or expanding footprints at existing locations will not be straight forward. Supply conditions in the most obvious destinations are comparably tight in relation to London (Chart 4.0). This would imply that a positive demand shock, arising from jobs moving from the UK, is likely to drive up rental values in Dublin, Frankfurt, and/or Paris.
- Secondly from a cost perspective, a move would almost certainly be disadvantageous. Indeed, at 20%, the UK's corporate tax rate is considerably lower than in France (33%) or Germany (30%). The Chancellor has also made clear that a lowering of UK corporate tax rates could be on the cards.
- Attracting high flying bankers to make the move away from the UK may also prove difficult as a bonus cap of up to 200% of base salaries is still in place across the ECB's jurisdiction. This, in turn, is likely to increase resistance to a move.

4.0 Vacancy Rates (Deviation from Long-Term Avg.) BPS



Source: Capital Economics

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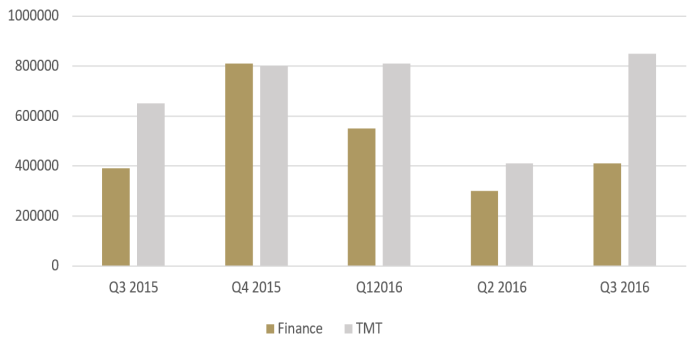
Where will demand come from?

The banking and finance sectors are most likely to be affected by Brexit, particularly if the UK does not retain the ability to 'passport' financial services into the EU. Some banking functions – particularly those trading in Euro denominated assets, will be most vulnerable to a relocation to financial centres such as Paris, Frankfurt or Dublin.

The market, however, has been moving away from finance for some time. Between 2007-11, finance dominated take-up levels, accounting for 23%. The last five year period (2012-16) however has seen this share diminish to 17%, with the Tech sector now dominating (Chart 5.0).

5.0 Central London Office Take-Up: Finance vs Technology, Media and Telecoms (TMT)



Source: BNP Paribas Real Estate

Looking at the Q4 2016 deals and active searches, it is apparent that demand from technology and creative firms has held up well since the referendum. As well as the Apple deal at Battersea Power Station, Snapchat is set to almost triple its current presence in London, having agreed terms to occupy 20,000 sq. ft. of space in Shaftesbury Avenue. Expedia has also signed for an extra 154,000 sq. ft. of space in Clerkenwell.

Even some of the active office searches for non-tech firms are for their digital businesses, as shown by HSBC's requirement for its digital arm. **We see Brexit as accelerating the pivot away from finance in the London economy, with tech supporting office demand.**

Brexit will pose uncertainties for London but it also presents a number of opportunities. According to a post-Brexit survey of over two hundred senior US tech executives, London ranks as Europe's leading destination for technology and financial services and is the best city in which to build a European operation. **These factors, along with the talent pool, legal systems, business friendly time zone and established markets, will ensure Central London's continued attractiveness to investors across the globe.**

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