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June Update

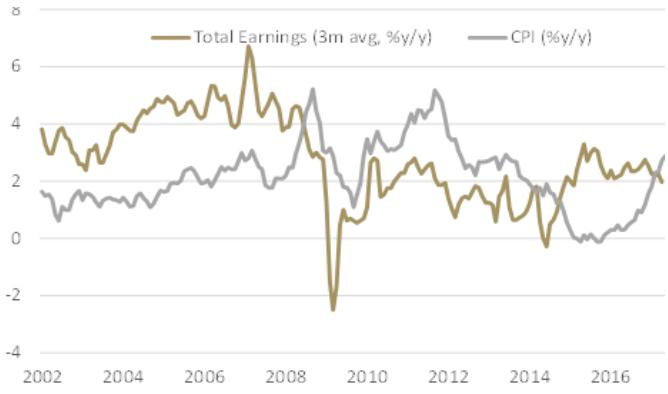
Global Factors

The logic behind June's snap general election was for Theresa May to go into the Brexit negotiations with a stronger hand. The loss of the Conservatives' parliamentary majority therefore now looks to have been a miscalculation. As things stand, the Tories are in the process of negotiating a deal with the Democratic Unionist Party to secure their support for a minority Conservative government.

Markets had a fairly mixed reaction to the election result. Sterling fell by 2% against the dollar on the day following the vote. Meanwhile, due to the supportive impact of a weaker exchange rate on UK companies' foreign-denominated income, the FTSE 100 rose by 1%. 10-year gilt yields, however, have been fairly stable, hovering around 1%.

Labour's stronger-than-expected showing has partly been attributed to its promise of a looser fiscal stance. As a result, it has been argued that the election result could signal the end of austerity. But even if the Conservatives were to follow Labour's tax and spending plans, the cyclically adjusted budget deficit would still tighten by around 0.5% over the next parliament. In other words, fiscal policy would still be acting as a drag on growth.

1.0 Average weekly earnings and CPI inflation



Source: Thomson Reuters

An Overview

With face-to-face talks with the EU having begun, it is still unclear whether or not the General Election result, which clearly weakened Theresa May's negotiating mandate, will lead to a softening in the Government's Brexit stance.

The prospect of a prolonged period of domestic political uncertainty and risks weighing on economic activity, coupled with the strong performance of the economy and the resilience of the property market following the EU referendum – widely regarded as a bigger shock – suggests that the scale of the threat may be limited.

June Top 5

1. Brexit negotiations back in focus as Conservative party lose their parliamentary majority
2. Negotiations underway to form 'confidence-and-supply' relationship with the Democratic Unionist Party (DUP)
3. Real income contracts as inflation hits 2.9% in May, the highest level since September 2013
4. Amazon announced its largest ever acquisition with the take-over of Whole Foods in a $13.7bn deal
5. Discount supermarkets continue to outperform and gain market share

Meanwhile, the most recent economic data reinforced fears that the exchange rate-led rise in inflation has begun to erode real household incomes. In April, average weekly earnings growth slowed to 2.1%y/y, slightly lower than the annual rate of CPI inflation of 2.4%. And with May's CPI reading rising further, to 2.9%, real incomes are contracting (Chart 1). That said, the PMIs suggest that the inflationary pressures in the pipeline are now starting to ease, and that the squeeze on real incomes will not persist for very long.

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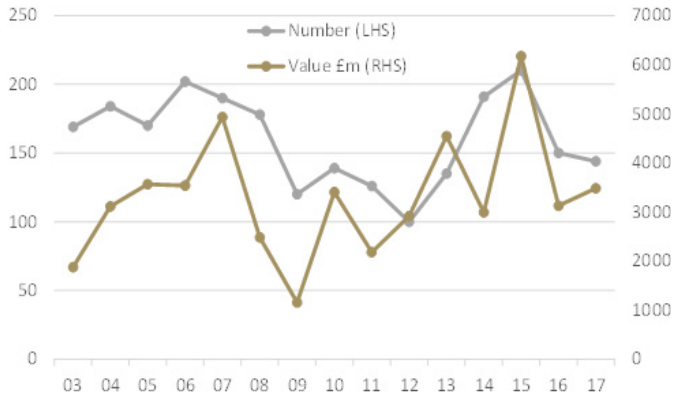
Another surprise was delivered by June's MPC meeting. Of the Committee's eight members, five voted for no change but three voted for a 25bp hike. That struck a much more hawkish tone than in previous meetings. The minutes revealed that those voting for higher rates were concerned about the faster-than-expected rise in CPI inflation, the continued erosion of labour market slack, and perhaps the prospect of looser fiscal policy. However, the big picture is that, even if interest rates do increase over coming months, there leaves little prospect for a sharp tightening in monetary policy.

Commercial Property

After a subdued April, there were signs of improving liquidity as figures for May showed that there was an increase in investment market activity. At £3.5bn, the latest reading marked a 20%m/m rise over the previous month (Chart 2).

2.0 Number and value of deals completed in May of each year



Source: Property Archive

May's figures gave some encouraging signs that the market's reliance on a small number of large deals may be easing. Over recent months, investment activity has been characterised by a heavy reliance on a few, very large deals. That suggests that the muted levels of activity reflect a limited supply of assets for sale, rather than a lack of investor demand. Encouragingly, after five months of sitting above the 12-month average, the implied average lot size fell, from £42m in April to £25m. Similarly, the combined value of the five largest deals fell by 38%m/m. That could be a sign that liquidity is beginning to improve.

A breakdown of the data also highlights some other encouraging features. overseas investors continued to drive the market with net purchases of £922m, roughly in line with the levels seen over the last two years. UK institutions also made net purchases worth £155m, one of only three positive readings over the previous twelve months, indicating a higher level of confidence in the market for the month of May.

That said, the election result is widely perceived as a knock to the sector's confidence. A Property Week survey highlights that a number of market participants expect a slowdown in deal making. Yet, puzzlingly, the same survey showed that a majority of respondents did not expect deals that they were working on to be affected. As such, it is plausible that any slowdown in investment activity will be modest. From an anecdotal perspective, since the EU referendum, we have also seen an increasing level of interest in UK commercial property from our underlying investor base.

London Property

Data from CBRE also showed that London's office occupier markets are showing some signs of improvement. At 0.8m sq.ft in May, take up rose by 8%m/m. This helped bring availability down for the third consecutive month, to 14.3m sq.ft. And with space under offer up by 6% over the month, at 3.8m sq.ft., there is little reason to believe that occupier demand is about to dry up.

Some have also speculated that the inconclusive election result will lead the Government to pursue a softer approach to Brexit, with more emphasis on protecting jobs than controlling immigration. But although it is still very early days, with negotiations now underway, there has been little to suggest that either side have altered their negotiating positions.

Regional Property

There has been little by way of hard data regarding the regional property markets. However, the investment market figures suggest that activity levels in the regional property markets picked up slightly in May. In aggregate terms, the share of non-London investment rose from 36% in April, to 49% in May. This was driven by a particularly strong showing in the North West, Yorkshire & the Humber, and the South West where the value of deals agreed was higher than the average seen over the previous twelve months.

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Sector Spotlight - Retail

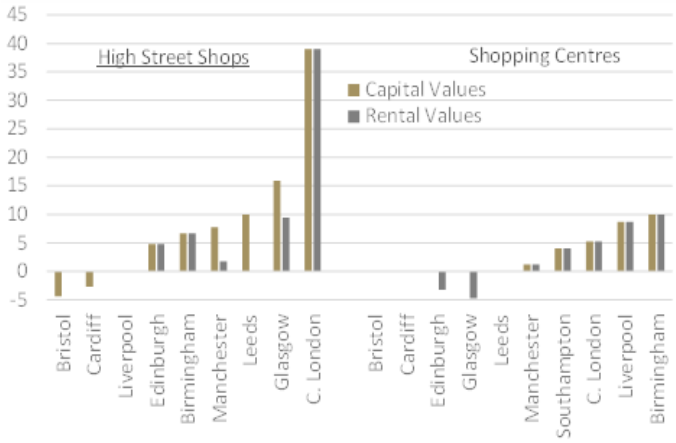
The remainder of 2017 is expected to be a challenging year for retailer's margins. Import and operational costs are all experiencing upward pressures whilst consumers are starting to feel the effects of ongoing political uncertainty, stagnating wage growth and rising inflation, which reached 2.9% in May, its highest level since September 2013.

Agents, however, report that retail rental values have risen or remained unchanged during the twelve months to March. On a simple unweighted basis, prime high street rental value growth averaged 6.9%y/y. This was driven, mainly, by the 39% increase recorded in central London high street shops. Meanwhile, prime shopping centre rents rose in half of the ten locations in CBRE's coverage, rising by 2.9%y/y on an unweighted average basis.

The prime yield picture has been a little more mixed. Over the last four quarters, high street shop yields fell by 25bp in Glasgow and Manchester, and 50bp in Leeds. By contrast, prime yields rose by 25bp in both Bristol and Cardiff. Meanwhile, on an annual basis, prime shopping centre yields rose by 25bp in Edinburgh and Glasgow, but were unchanged elsewhere.

The combination of rising rents and broadly flat prime yields meant that, in most segments, capital values rose in line with rents (Chart 3). That left London high street shops comfortably leading the pack, with capital values 39% higher than a year before. By contrast, shopping centre capital values in Edinburgh and Glasgow fell to sit 3.2% and 4.8% respectively below their level from a year prior. Similarly, prime high street capital values in Bristol and Cardiff are 4.3% and 2.7% below the same benchmark.

3.0 Q1 2017 prime capital and rental growth (%y/y)

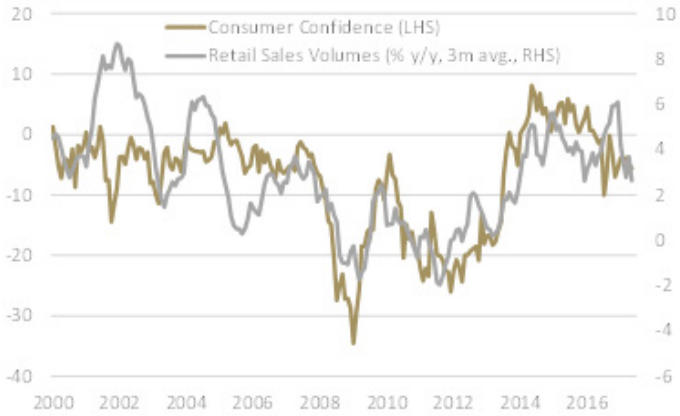


Source: CBRE

The fact that retail rents have held up or increased is consistent with the fact that consumer confidence and retail sales have proved to be resilient. After a brief dip after the EU referendum, the consumer confidence reading has averaged minus 4.5% during the ten months between August and May. That is somewhat above the survey average of minus 8.6%. Similarly, on an annual basis, retail sales volumes growth was 4.2%y/y in the three months to May. That compares positively to the average rate of 2.7%y/y.

However, there is some evidence that the squeeze to households' real incomes is tempering both sentiment and the rate of retail sales growth. Indeed, both measures have edged down over the last two or three months (Chart 4).

4.0 Consumer confidence and retail sales volumes



Source: Thomson Reuters

Despite potential headwinds all retail segments will not fare equally and there are a few potential bright spots. In the supermarket segment, for instance, intense competitive pressures have weighed on the performance of the sector over recent quarters. However, some operators look set to benefit from the current environment. There is a case to be made that as the price of imported staples increases, consumers will substitute in favour of discounters. Indeed, according to data from Kantar World Panel, Sales at Aldi rose by 19.8% and at Lidl by 18.3% in the 12 weeks to 21 May (see chart 5), while the UK's big four supermarkets, Tesco, Sainsbury's, Asda and Morrisons, collectively grew by just 1.6%.

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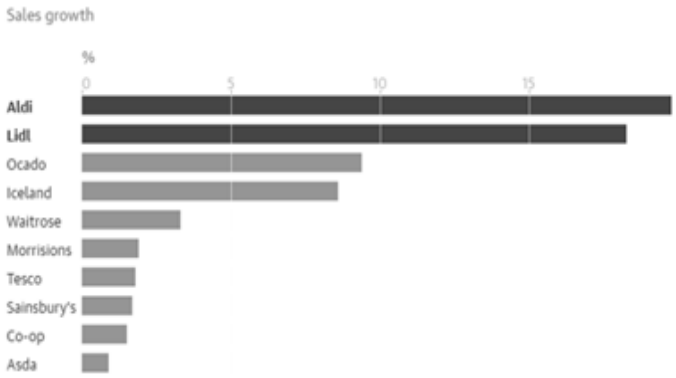
5.0 Aldi and Lidl's sales rose at the fastest rate since 2015, taking their joint market share to 12%



Source: Kantar World Panel

Aldi has now overtaken the Co-Op to become Britain's fifth biggest supermarket by market share (7%), while Lidl (5%) is closing in on Waitrose for seventh place.

Meanwhile, the weakness of the exchange rate could entice foreign visitors to spend more time and money in the UK. And, given that the capital receives roughly a quarter of all arrivals and revenues from tourism, retail rental values in central London should hold on to most of their recent gains.

In terms of significant transactions in the sector, Amazon - the worlds most powerful online retailer - announced its largest ever acquisition earlier this month with the take-over of Whole Foods Market in a $13.7bn deal.

Amazon has long had ambitions to move into the grocery business and launched its food delivery service, Fresh, in the US 10 years ago. It introduced the service in the UK last year after signing a wholesale deal with British supermarket, Morrisons.

Whilst Whole Foods' store portfolio in the UK runs to only nine outlets, UK supermarket brands such as Tesco and Sainsbury's will be very wary of the threat now posed by Amazon to the industry once they have overhauled the business.

For further information please contact:

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

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

www.rivercap.co.uk