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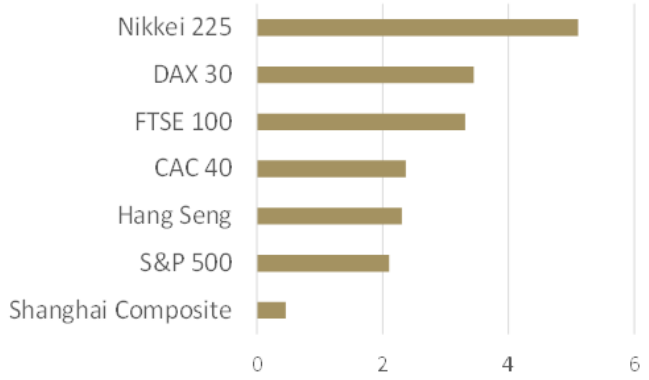
October Update

Global Factors

Global equity markets have seen healthy gains of late. Boosted by rising export prices, Japanese stocks prices rose by 5% over the twenty trading days from October 1st, making the Nikkei the best performer among the major indices. The 4% increase in Germany's DAX30 was helped by healthy domestic and euro-zone activity indicators. Meanwhile, the FTSE 100 rose by just over 3% over the same period (Chart 1).

1.0 Percentage Increase of Selected Equity Market Indices (Last 20 Trading Days, %)



Source: Thomson Reuters

One factor that may be driving the rise in the FTSE 100 is a weak exchange rate. This, in part at least, reflects the fact that progress on the Brexit negotiations has been far from swift. The fifth round of talks between the UK government and the European Union left unresolved issues around the rights of UK and European citizens living abroad, the Northern Irish border, and the size of any divorce settlement. In fact, the EU stated that they did not believe that "sufficient progress" had been made in order to move on to talks about any potential trade deal, or transition period. Realistically, this sets back talks about trade and transition until the European Council's next meeting in December. However, positive words from Angela Merkel gave cause for optimism as she arrived for the start of the two-day summit. Other EU leaders also struck a relatively upbeat note about the possibility of a breakthrough in December.

An Overview

The IMF's latest growth forecasts suggest the global economy could be getting back to normal after a decade of difficulties following the financial crisis. The UK, however, remains stuck in second gear, reflecting the squeeze in consumers' real incomes and the ongoing uncertainty over the Brexit negotiations.

Much will depend on how these negotiations develop, but there are some green shoots of optimism that sufficient progress will be made at the next meeting in December. With the Bank of England becoming significantly more hawkish over UK inflation and spare capacity in the economy diminishing, it seems almost inevitable that rates will rise to 0.5% before the end of 2017.

Despite fears surrounding the outcome of Brexit, London will almost certainly remain a key global financial centre and develop as one of several European hubs for the growing tech sector. Its prime markets will therefore benefit from new domestic wealth generation, as well as attracting wealthy international buyers.

October Top 5

1. Global equity indices hit record highs
2. UK inflation at its highest since April 2012
3. Positive employment data continues to support occupier demand
4. Regional investment activity remains strong
5. In spite of Brexit concerns, London remains the top financial centre in the world

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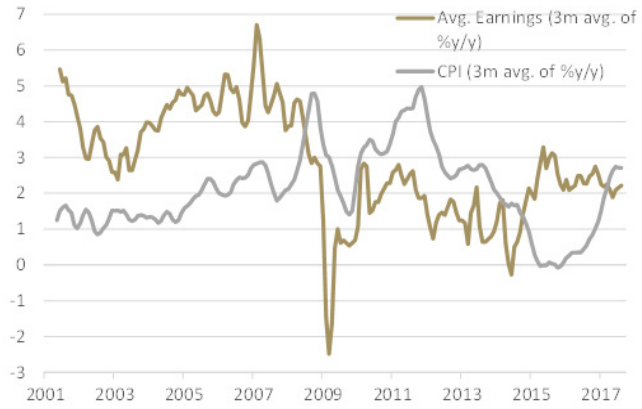
The latest UK economic data emphasises the balancing act that confounds the MPC. For instance, more hawkish members of the Committee will stress that, at 3%y/y in September, CPI inflation is too far above the MPC's 2% target. Similarly, the fact that the unemployment rate, at 4.3%, is at a multi-decade low would suggest that the economy is fairly well placed to handle a reversal of last year's post-referendum monetary loosening. By contrast, more doveish members may be swayed by the fact that, at 2.2%y/y in August, regular nominal pay growth has failed to keep up with consumer prices for the best part of this year (Chart 2). On balance however, the minutes of the last MPC meeting implied a high probability of a Bank Rate hike at the upcoming November meeting.

One consequence of higher UK interest rate expectations has been a rally in the pound against the dollar. Sterling rose against the US dollar, from $1.28 in late August to $1.35 towards the end of September.

Over the last 12 months, we have benefitted from locking in on historically low swap rates, providing our investors with the best all-in borrowing rates available. Our house policy on the majority of our deals is to lock in on debt at the point of draw-down for the duration of the loan. In the majority of circumstances, this provides investors with certainty above all else and allows us to see through property-specific business plans. With volatility surrounding swap rates and indications of a likely interest rate hike, our policy to provide certainty seems prudent. Most importantly, this policy will ensure that further equity calls are mitigated.

2.0 Average Earnings and CPI



Source: Thomson Reuters

European data has also been mixed. August's retail sales figures showed that euro-zone retail sales contracted by 0.5% in August, bringing the annual rate down from 2.3% in July to 1.2%. This contrasts with the signals coming from the Composite PMI. At 56.7 in September, the PMI was higher than the previous two readings of 55.7; and suggests that the economy will have sustained its momentum in Q3.

Property Overview

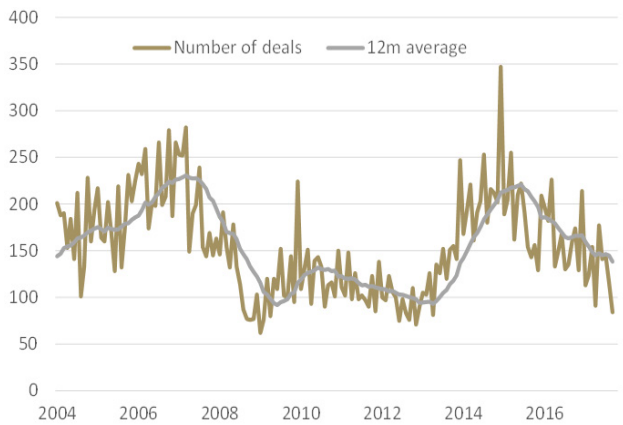
The latest employment data suggests that occupier demand should be well-supported during the next two or three quarters. Granted, the 94,000 increase in employment during the three months to August was roughly half the increase seen in July. That cut the rate of employment growth slightly, from 1.2%y/y to 1.0%y/y. Nevertheless, based on the past relationship, the latest reading for employment growth is in line with subdued, but positive rates of rental growth.

Meanwhile, in aggregate, the value of commercial property deals in September stood at £3.7bn, down by 13%m/m. **Even so, it was enough to bring the Q3 total to £12.1bn, which is around a tenth higher than both Q3 of last year and the average for third quarter totals since 2003.**

Breaking the investment data down by sector and buyer-type highlights that broader market trends have been little changed. Indeed, in line with the 12-month average, 45% of deals by value were in the office segment. Meanwhile, overseas investors made net purchases of UK commercial property amounting to £790m, a figure not too dissimilar to what has been typical over the last year or two.

Nevertheless, patchy liquidity still seems to be a defining feature of the investment market. For example, despite the fact that the average number of deals inked each month has steadily fallen since 2015, September's total of 84 was 40% lower than its 12-month average (Chart 3). Yet, the fact that large deals are still being signed could mean that low deal volumes are a result of the lack of stock for sale, rather than soft investor demand.

3.0 Number of Commercial Property Deals per Month



Source: Property Archive

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The lack of stock availability has helped push up the price of "alternative" sectors, specifically long income assets allied with good covenants. Investors have understandably been attracted by the property recovery and rental income in a low-yield world. And with demand outstripping supply in prime locations, we have taken the opportunity to sell one of our holdings, a Pure gym in the Nine Elms area, having exceeded our investment target during the life span of the investment.

Further, we also disposed of another asset (acquired as part of a corporate transaction); a Premier Inn Hotel in Camberley, reflecting a net initial yield of 4.97%. The yield achieved demonstrates the continuing growth in the budget hotel sector, driven largely by the strength of the Premier Inn and Travelodge Hotel covenants, and bodes extremely well for our existing holdings within this sector.

As things stand, with Bank Rate looking set to rise sooner than most had expected, it is hard to envisage property yields falling much further. **As such, the muted rates of rental growth should mean that capital values are unlikely to make significant gains over the next few quarters.**

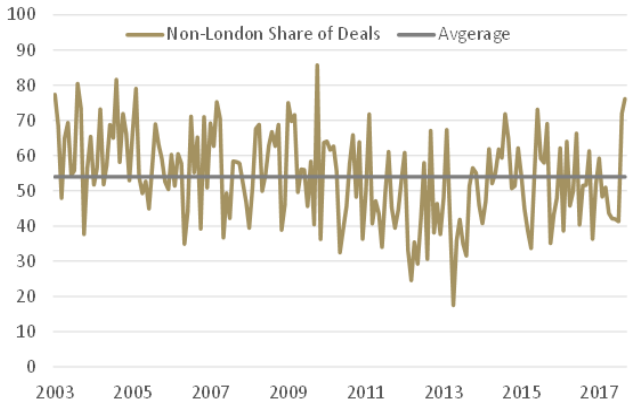
Regional Property Market

There has been little by way of regional property data released over the last month. However, the available data points were broadly positive. The latest data on regional employment – which is for July – shows that the number of people employed is higher than a year prior in the majority of UK regions. This bodes well for both occupier demand and rental value growth. That said, modest falls were recorded in the East Midlands (-1.6%), the East (-0.4%), Wales (-0.6%) and Northern Ireland (-0.8%).

Regional investment activity has been fairly strong of late. The £2.9bn worth of non-London properties exchanged during September was 8% below August's reading, which compares positively with the 13% fall seen when London is included. What's more, representing three quarters of the monthly total, the share of non-London deals was significantly above the average of 54% seen since 2003 (Chart 4).

While still too early to have a full picture of the third quarter data, preliminary releases indicate that prime yields outside of the capital have held firm. Regional office yields were unchanged over the quarter, at 5.25% according to CBRE. Meanwhile, CBRE also reported that yields of prime regional assets also held firm across the board in September.

4.0 Non-London Share of Commercial Property Investment Deals (%)



Source: Property Archive

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Sector Spotlight - London Offices

London serves not only as a gateway to Europe for global investors, but also a gateway to the world for European businesses looking to expand and invest overseas. Britain's departure from the trading bloc has led to some politicians and economists predicting London will lose its pre-eminent status as a financial centre, but there are few signs of that happening yet.

The Global Financial Centres Index (GFCI), which ranks 92 financial centres, put London at the number one spot, despite fears that the City will be less attractive to financiers in the wake of Brexit. London's score fell by only two points this year. New York's, the runner up, fell by 24 amid uncertainty about Trump's views on free trade.

In another recent survey by the Tokyo-based Mori Memorial Foundation, the UK's capital was deemed the world's most attractive city to companies and talent for the tenth year running. Global cities were appraised across five different categories: Economy, R&D, Cultural Interaction, Liveability, Environment, and Accessibility.

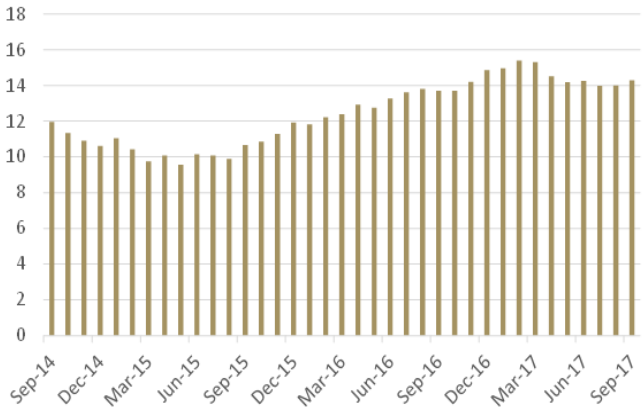
London has received further support from the likes of UBS, who this week declared that "regulatory and political clarifications" have made it "more and more unlikely" that the bank will move its previously proposed 1,000 jobs away from the city following Brexit. Original fears of 1000's of City jobs in jeopardy are now easing, with numerous bank executives now guiding that numbers will be in the hundreds rather than the thousands (Financial Times).

The latest agency figures suggest that office occupier demand improved in the third quarter. CBRE data show that, despite a very poor August, during which only 0.5m sq.ft. of office space was leased, the quarterly total reached 3.4m sq.ft. Not only was that figure 3% larger than in the second quarter, but it also represented a 10% improvement on the figure typically seen during Q3.

A breakdown of the take-up figures by submarket was also pretty positive. For instance, take-up rose on a quarterly basis in the main City, West End and Midtown submarkets. In addition, the 1.5m sq.ft. leased in the West End was the highest reading on record.

That said, healthy leasing activity was not enough to match the increase in the office stock brought on by the delivery of new schemes. The amount of space available for letting increased from 13.9m sq.ft. in August, to 14.3m sq.ft. in September. (Chart 5.) A 400,000 sq.ft. rise in availability is not negligible but, when looked at in relation to the size of the stock, it only pushed the availability rate up marginally, from 6.2% to 6.3%.

5.0 Central London Office Availability (M Sq.Ft.)



Source: CBRE

Reflecting a much more active development pipeline, the deterioration in availability was centred in the City submarket. Between August and September, City availability rose by 5%, whereas in the West End, the rise was limited to 1%. Elsewhere, Midtown and Docklands availability were unchanged, and the volume of space available in the Southbank area fell by 4%.

Prime Central London office rental values are a little lower than last year. On a three month annualised basis, prime office rents fell by 1.8% in September. Meanwhile, capital values rose by 2% on the same basis, implying that yield compression more than reversed the drag from rents.

Meanwhile, retail market occupier demand has softened slightly during the first half of this year. Figures from the Local Data Company highlight that, primarily driven by a contraction in demand from chains and multiples, 85 more stores have closed than opened during the first half of the year. However, the fall in London net openings was broadly in line with the national trend. And given that retail rents in London stand at some two thirds higher than their post crisis trough, London tenants faced the largest increases in business rates this year, the size of that fall is not too alarming. **In any event, Greater London's retail vacancy rate rose only marginally, from 7.4% to 7.5%, leaving it as the lowest rate nationally** (Chart 6).

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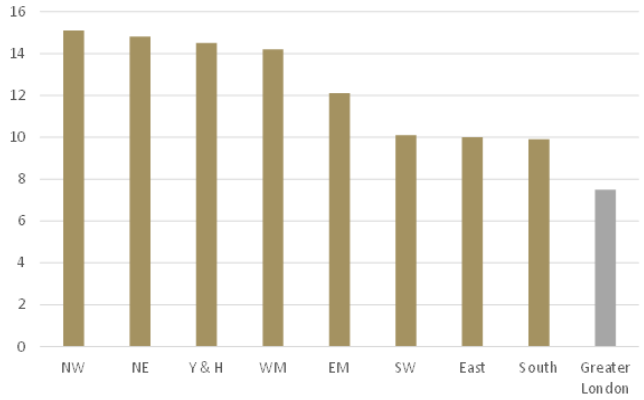
6.0 Retail and Leisure Vacancy Rate (%)



Source: LDC

Although all-sector investment activity has been a little subdued recently, the bigger picture is that London assets are still proving attractive to investors. Granted, the outlook for rental value growth in both the retail and office sectors is fairly subdued, particularly compared with the double-digit rates of growth seen as recently as mid-2016. Nevertheless, with investor demand holding up and availability still below the levels consistent with falling rents, we suspect that the short-term prospects for London's property market are on solid foundations. **Yet, as interest rates and property yields begin to rise, the income component of returns will be the key driver of property returns.**

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