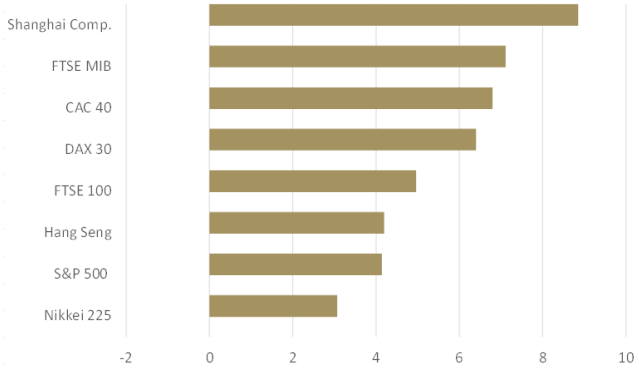
Riverside CAPITAL | THE PROPERTY INVESTMENT PEOPLE

# Update - April 2019

## Global Factors

**Developments in equity markets have been positive over the past month or so (see Chart 1).** In particular, the Shanghai Composite has outperformed. This reflects optimism that a deal will be made to end the US-China trade dispute as well as expectations that policy stimulus will put an end to the slowdown in the Chinese economy. However, it is unclear how well-founded this sentiment is given the fragility of the global economy.

### 1.0 Change in Selected Major Equity Market Indices over 40 Trading Days to 25/04/19 (%)




Source: Refinitiv

**Indeed, following annualised GDP growth of 2.2% in the last quarter of 2018, data from the US generally suggests that growth has further to slow.** In particular, this reflects that last year's fiscal boost is fading and that previous monetary policy tightening continues to drag on growth. Indeed, the weighted average of the ISM manufacturing and non-manufacturing surveys fell to a 19-month low in March. And, although the 196,000 gain in March non-farm payrolls was encouraging, given February's very weak outturn employment growth is on a downward trend. In addition, the March FOMC minutes revealed that officials are concerned about the outlook for core inflation.

## Overview - April Top 5

- Optimism surrounding a possible resolution of the US-China trade dispute has influenced positive developments in equity markets over the past month.
- Despite accelerating wage growth, services inflation remains weak, meaning that the Fed Funds rate will remain on hold for some time.
- The UK economy has grown at low, but positive rates in the first quarter of the year.
- The Brexit extension prolongs uncertainty in the UK property market and, while March investment volumes were 60% higher than February, they were 10% down on the same period last year.
- Despite soft investment volumes and occupier demand for City offices, supply remains constricted, and any fall in rental values is expected to be short lived.

**Notably, underlying services inflation has been persistently weak despite the acceleration seen in wage growth.** As such, it is clear that the Federal Funds Rate will remain on hold for some time.

**In Europe, February's industrial production data suggested that the economy might have performed a little better in Q1 than in Q4 last year.** Even so, the weakness of economic surveys in March suggest that growth won't increase by much. Indeed, the relative resilience of the services sector is not likely to be enough to offset the poor performance of the industrial sector. Given these developments, the expected announcement in June of the terms of the next round of the ECB's Targeted Long-Term Refinancing Operations (TLTROs) looks likely to be more generous than the previous two rounds.

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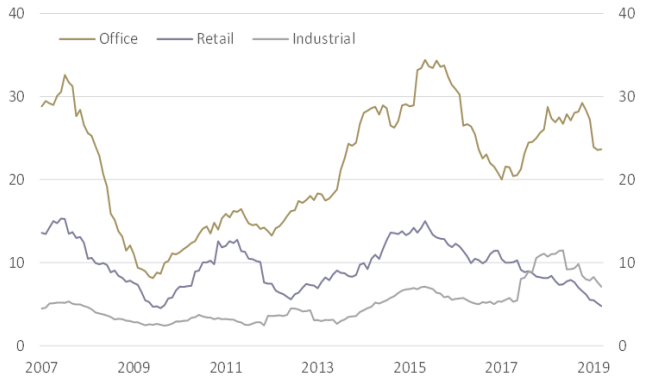
**The UK economy appears to have grown at low, but positive, rates in the first quarter of the year.** Following January's 0.5% expansion, monthly GDP rose by 0.2% m/m in February. This was soft, but still positive given the political uncertainty. To some extent this uncertainty has been reduced, with a no deal Brexit looking less likely following the agreement to extend the Brexit deadline, potentially until 31st October. However, without clarity around future EU-UK relations, consumers and businesses are likely to continue to act cautiously. Indeed, recent strong labour market outturns appear to reflect just that, as businesses choose to hire workers to boost output rather than making longer-term decisions about capital investment. As such, with the MPC's recent comments turning dovish, it is now unlikely that Bank Rate will be raised until later next year.

## Property Overview

**After a soft start to the year, investment activity improved in March.** According to data from Property Archive, the total value of commercial property deals was £3.5bn. This was 60% higher than in February, but 10% lower than the March total for last year. The total was boosted by the £1.1bn deal by Citigroup to purchase the building they occupy at Canary Wharf from AGC investors. In turn, there was some stabilisation in office investment (see Chart 2). However, there was no change to the downward trend underway in the value of industrial and retail deals completed.

### 2.0 Total Value of Investment Deals Completed (Annual Total, £bn)




Source: Refinitiv

**This softness in UK commercial property investment is likely to continue.** For one, the extension of the Brexit deadline further prolongs uncertainty. But more importantly, the fact that rental value growth is slowing and yields are picking up in the retail sector, and to a lesser extent for office property, suggests that pricing will become more of a constraint to investment activity.

**Indeed, the CBRE monthly index for March showed that, at the all-property level, capital values declined by 0.2% m/m, with values down by 0.6% in Q1.** The decline in capital value growth was mainly driven by the retail sector, with the office and industrial sectors still posting modest monthly gains. Recent news on the retail sector highlights that any improvement is still a way off, with Debenhams going into administration in early April and British Land continuing to reduce its retail exposure by selling its 12 superstores from its joint venture with Sainsbury's.

**Nevertheless, there have been some bright spots in the investment market.** In particular, over the past year alternative investment has held up well, accounting for over 30% of the total value of investment deals completed. This could provide some indication that investors are willing to look through the Brexit turmoil, especially in sectors that are less connected to the economic cycle and where supply shortages are more acute.

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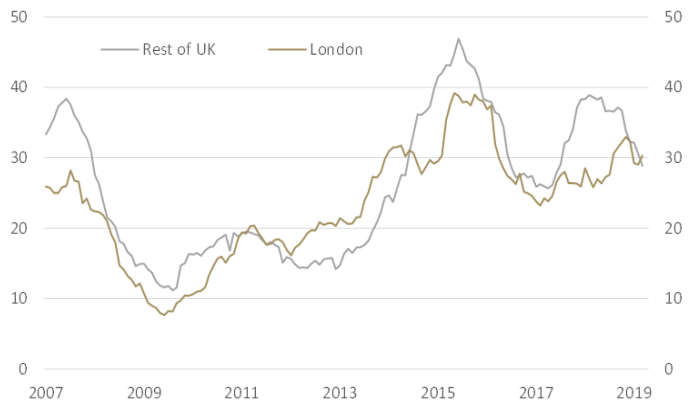
## London Property Market

**Data from Property Archive show that the value of investment in London was £2.7bn in March, above the 12 month average of £2.5bn.** This total was boosted by the Citigroup deal, but also included the joint venture between Unibail-Rodamco-Westfield, the Public Sector Pension Investment Board and QuadReal Property Group to build a £670m private rented sector scheme adjacent to Westfield Stratford City, as well as a £160m student accommodation deal by a joint venture between Greystar Real Estate Partners and Allianz Real Estate. In turn, although there was some softness in investment activity in London earlier this year, this appears to have stabilised (see Chart 3).

### 3.0 Total Value of Investment in London and the Rest of the UK (Annual Total, £bn)




Source: Property Archive

Meanwhile, Savills report that the performance of the London retail market, outside of Bond Street, is continuing to worsen. Indeed, the West End vacancy rate was 3.2% in Q1 2019, up from 2.9% a year earlier. And Central London prime rental values fell by 5.1% y/y over the first quarter, compared to growth of 1.1% y/y a year earlier.

## Regional Property Market

**In contrast, the deceleration in regional investment activity which started in the fourth quarter of last year continued in March.** Less than £1bn worth of deals were completed in the month, the lowest since 2013. Admittedly, the monthly data can be volatile. But looking at the activity over the last year makes it clear that investor interest towards the regions has waned (refer back to Chart 3).

**The latest agency reports, however, show that the fundamentals supporting regional office markets remain positive in many parts of the country.** Indeed, data from Knight Frank show that, although South East office take-up was weak in the first quarter at just 0.85m sq. ft., the tight supply conditions remains supportive of rental value growth. In fact, the vacancy rate fell to 6.4% in Q1, compared to a recent peak of 7.5% in the second quarter of last year. (see Chart 4). Further, Savills report that Birmingham office availability in the first quarter of 2019, at 1.9m sq. ft., was at the lowest levels since the records begun. Meanwhile, take-up was just below 0.2m sq. ft., around 50% above the same quarter of last year and the long-term average.

### 4.0 South East Office Vacancy Rate (%)


Source: Knight Frank

## Sector Spotlight

### London Offices

**Over the start of 2019, there appears to have been some caution towards the London office market, particularly in response to Brexit uncertainty.** In turn, Knight Frank data show that West End prime office yields have risen around 25bps and now sit in a range of between 3.5% and 3.75%. This compares to City prime office yields of between 4.25% and 4.5%.

**Occupier demand was also soft in the first quarter, with Central London office take-up just 2.7m sq. ft. according to CBRE.** This was 7% lower than Q1 2018, as well as being a bit below the first quarter average over the past 10 years. More than 30% of take-up was supported by business services, of which more than half was attributed to the flexible office sector.

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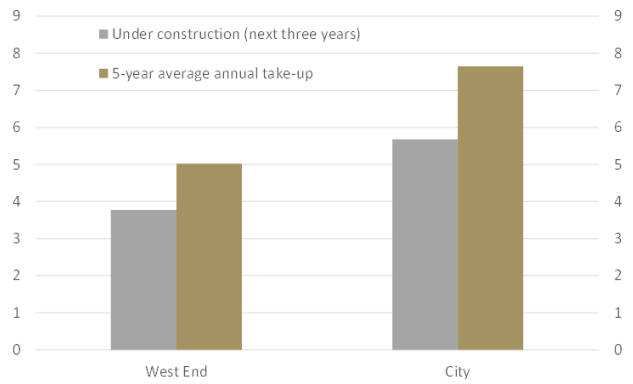
**With Brexit uncertainty likely to continue for another six months or so, occupier demand is expected to remain soft.** However, measures of London office-based employment do not suggest that demand is about to fall away sharply. Indeed, the labour market data for Q4 2018 showed that office-based employment in London grew by over 4% y/y, compared to just 1.4% y/y nationally. In addition, a recent survey from Knight Frank highlights that the number of Brexit-related moves have been low this year, with 46 business moves recorded up until mid-March compared to around 300 over 2017 and 2018.

**Further, it is encouraging that the level of supply in the Central London office market appears pretty limited.** Indeed, the vacancy rate was just 6.1% in the fourth quarter of 2018, well below its recent peak at the end of 2017 of 7.3%. And the balance of surveyors from the RICS Commercial Market survey expecting an increase in London office development starts has been in negative territory for the past three years. Looking ahead, conditions are likely to remain restrictive. Indeed, assuming similar levels of take-up to recent years, the current amount of space under construction does not appear sufficient to meet demand (see Chart 5).

## 5.0 Average Quarterly Take-Up (000s Sq. Ft.)




Source: Knight Frank

**As such, although the latest IPF Consensus forecasts show that the average expectation is for Central London office rental values to fall this year, any decline is expected to be short-lived (see Chart 6).** Indeed, over the next five years rental value growth is expected to average 1.4% y/y per year in the West End and 0.9% y/y in the City of London.

## 5.0 Average Quarterly Take-Up (000s Sq. Ft.)


Source: Knight Frank

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