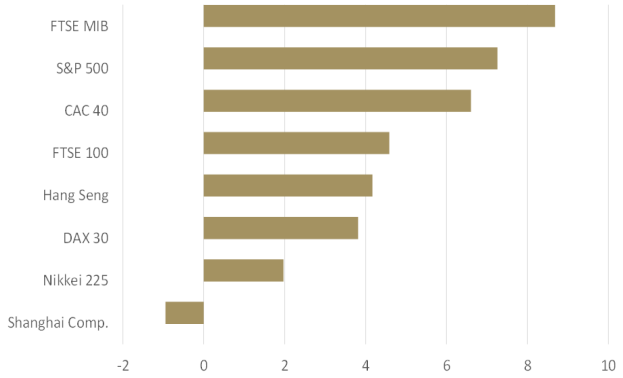
Riverside CAPITAL | THE PROPERTY INVESTMENT PEOPLE

Update - July 2019

Global Factors

Globally, equities have edged higher on expectations of monetary easing, most notably the belief that the US Federal Reserve will cut interest rates in July. This is despite weaker global economic growth, continued political concerns and trade tensions. In particular, the S&P500 and FTSE MIB have benefited (see Chart 1). Nevertheless, the Shanghai Composite continued to underperform.

1.0 Change in Selected Major Equity Market Indices over 40 Trading Days (%) to 25/07/2019



Source: Refinitiv

Economic indicators suggest that UK economic growth stalled in Q2, reversing some of the pre-Brexit boost in Q1. Admittedly, the composite PMI remained in negative territory in June, suggesting that GDP may have contracted. However, data on the consumer side was more encouraging. In particular, retail sales rebounded by 1% m/m, after contracting in the previous two months. Consistent with softer economic activity in Q2, just 28,000 jobs were created in the three months to May, continuing the deceleration in employment growth that began in January this year. That said, the labour market remained tight. In turn, the unemployment rate stayed at its lowest level since 1974 of 3.8% and wage growth held up.

Overview - July Top 5

- Boris Johnson's arrival at the top job raises the chances of a no deal Brexit.
- Spending sprees under the new admistration are likely to be accompanied by a rise in borrowing/ loosening of fiscal policy.
- Brexit has continued to drive a weaker sentiment, affecting the UK commercial property market.
- In spite of a slowdown, property assets continue to perform better than real estate equities.
- Regional office markets have seen a significant improvement, after being hit by uncertainty earlier in the year.

Despite his hard-line stance on the campaign trail, there is no way of knowing how Boris Johnson will handle Brexit. But it's going to be turbulent and the chances of a no deal Brexit (and a general election and/or a Labour government) are surely higher now than they've ever been. Whatever happens, a loosening in fiscal policy appears to be baked into the cake. Any spending spree by the new administration will probably be accompanied by a rise in borrowing, which could breach the current fiscal rule, especially if there is a no deal Brexit. However, fiscal rules are made to be broken, so this shouldn't prevent tax cuts and more spending.

Signals from the US economy have been mixed. On the one hand, the labour market has been resilient, consumption growth appears to have picked up and inflation has held up. Meanwhile, a deal has been agreed on the US debt ceiling, removing any threat of a US debt default and allowing increased federal spending. On the other hand, survey indicators suggest GDP growth has slowed further. In addition, trade tensions and softness in the global economy remain cause for concern. In any case, the Federal Reserve still appears to want to push ahead and cut interest rates, likely as soon as the July meeting.

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In Europe, economic indicators suggest that quarterly GDP growth has probably been slightly stronger in Q2, following its 0.3% q/q expansion in Q1. But this hides differences within the bloc. Indeed, France appears to be doing a bit better, while Germany and Italy lag behind. However, the French economy has been boosted by fiscal stimulus, partly due to concessions made to the "gilets jaunes" protestors, which are not expected to be continued.

The outlook for euro-zone GDP growth and inflation is weak. In turn, at its July meeting, the ECB strengthened its forward guidance, stating that interest rates are likely to "remain at present or lower levels at least through the first half of 2020." In addition, the ECB kept open the prospect of further policy easing of some type. The bigger picture is that European interest rates are likely to remain very low for some time yet.

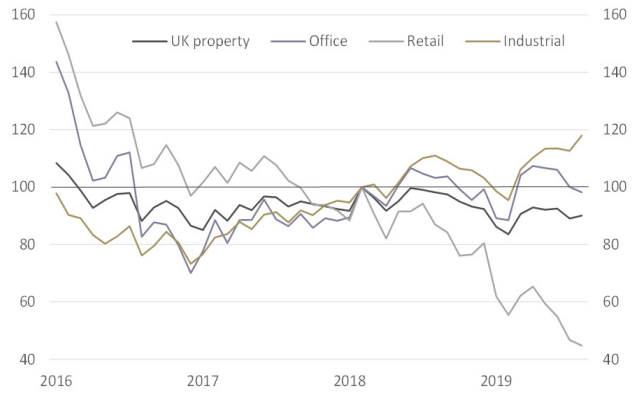
Property Overview

At the halfway point in the year, there have been clear signs that weak sentiment, driven by uncertainty about Brexit, is affecting UK commercial property investment. Indeed, Colliers reported just over £2bn worth of deals were completed in June. This compares to around £7bn a year ago. In turn, investment over the first half of the year was more than 40% lower than the same period of 2018. Preliminary data for July suggest that there has been some improvement, albeit this would still not bring investment to levels seen a year earlier.

All-property capital values declined on an annual basis in both May and June. Weakness in the retail sector continues to be the main driver, with retail rental values falling and yields well above their levels a year ago. Indeed, the sector continues to struggle, with data from the Centre for Retail Research showing that 932 retail stores have been closed this year. Nevertheless, if store closures were to continue at the same rate for the rest of the year, a total of 1,864 stores could be closed by year-end, less than the 2,594 stores closed last year. However, there are also signs of slowdown in the office sector. Indeed, CBRE data showed that office rental value growth stalled in June. Further, office yields have risen since the start of the year, mostly in the City of London. The industrial sector continues to outperform. Even so, the pace of yield compression in the industrial sector has reduced, albeit yields remain near historically low levels.

Nevertheless, in general, property assets continue to perform better than real estate equities. Indeed at the start of June, the FTSE EPRA Nareit UK was down 10% y/y compared to the start of 2018, driven by the fact that the retail sub-index was over 50% lower (see Chart 2).

2.0 FTSE EPRA Nariet UK Indices



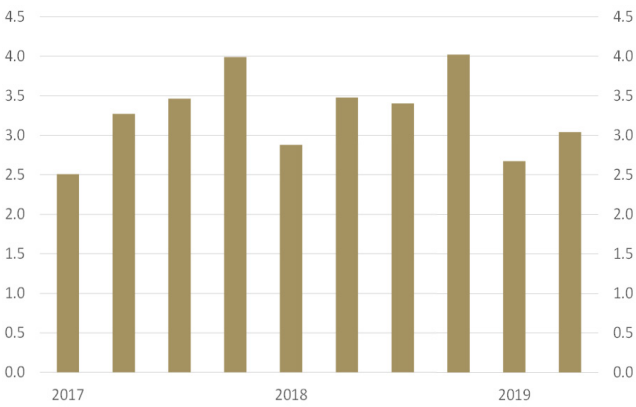
Source: Refinitiv

In contrast, the industrial sub-index was 17% higher. Although declines in real estate equities have overstated the actual movement in commercial property asset values in the past, they may provide an indication that capital values have further to fall.

London Property Market

Data from CBRE show that just 3m sq. ft. of office space was taken in Central London in Q2, 13% lower than the same period last year (see Chart 3). In particular, this reflected weaker take-up in the City of London, where occupiers have become wary, notably as a result of the increased risk of a no deal Brexit.

3.0 Central London Office Take-Up (M Sq. Ft.)



Source: CBRE

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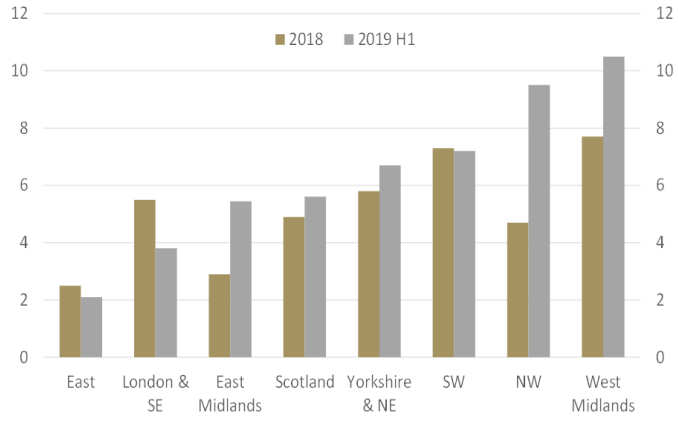
Prime West End retail property continues to outperform retail property elsewhere. Indeed, Savills report that the vacancy rate across Bond, Oxford and Regent Street ticked down to 3% in Q2. Although prime yields are higher than a year ago in Q2, at 2.75% for Bond Street, this compares to average UK prime high street retail yields of 5%.

On the supply side, the latest RICS Construction Survey showed that commercial workloads in London and the South East improved in Q2, with a net balance of 10% respondents reporting that workloads rose, compared to 10% reporting that workloads fell in Q1. However, construction activity has softened since its recent peak in 2015, where a net balance of almost 70% of respondents reported rising workloads, suggesting that the supply pipeline is more constrained.

Regional Property Market

Turning to regional markets, there has been a notable increase in industrial vacancy rates in H1 this year (see Chart 4). In particular, data from Savills show that vacancy rates in the West Midlands increased from 7.7% to 10.5% in 2019 H1, and from 4.7% to 9.5% in the North West.

4.0 Industrial Vacancy Rates (%)



Source: Savills

This provides some indication that supply is increasing, consistent with estimates that speculative supply of UK industrial property is set to surpass its 2016 peak this year. However, in the North West, East Midlands and Scotland industrial take-up was also noticeably weaker in H1, suggesting that in some cases increased vacancy may also reflect softer demand conditions.

Sector Spotlight

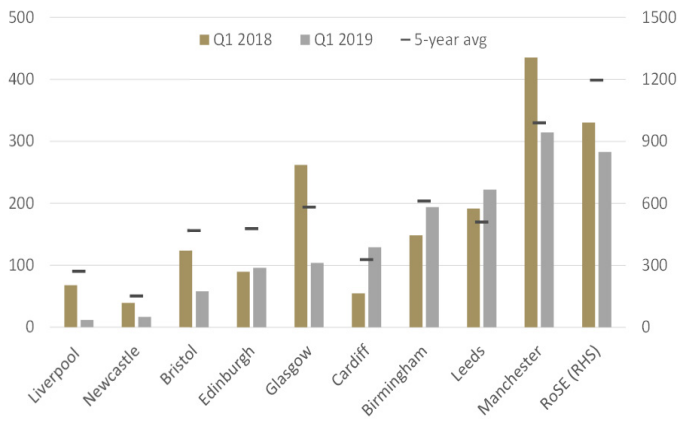
Regional Offices

There appears to have been some improvement in investor sentiment towards regional office markets in June, which had been hit by Brexit uncertainty earlier in the year. Colliers reported that £410m worth of office deals took place regionally in June, around 40% higher than in May. This included the largest deal of the month – the purchase of an office building in Birmingham's Priority Court for £149m by Gulf Islamic Investments.

This likely reflects that the fundamental factors supporting regional offices, such as the tighter supply pipeline, are still in place. In fact, data from Avison Young and Knight Frank suggest that most main cities have less than one years' worth of supply based on the previous five-year average annual take-up.

Admittedly, at the start of the year, regional office take-up was generally weak, both compared to a year ago and compared to the five-year average (see Chart 5).

5.0 Regional Office Take-Up (000s Sq. Ft.)



Source: Avison Young, Knight Frank

Nevertheless, there are indications that take-up will improve. For one, so far over 2019, employment growth, as an indicator of occupier demand, has been stronger for most regions than the 2018 average. Further, nowcasts of regional GVA, which provide a lead on official estimates of economic activity, point to GVA growth picking up in the South West and South East, as well as Yorkshire and the Humber (see Chart 6). However, regional GVA nowcasts for Q1 suggest signs of some slowdown in occupier demand in the North and the West Midlands.

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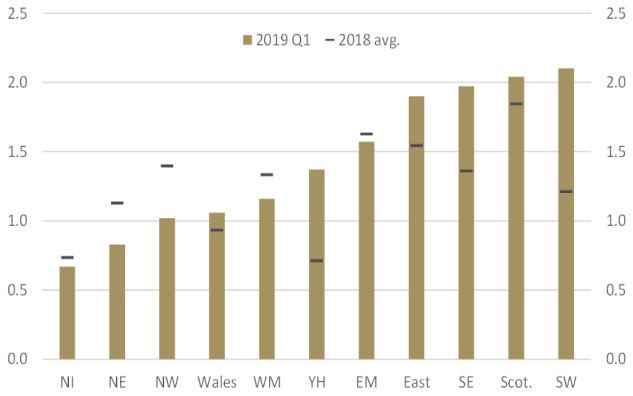
6.0 Nowcasts of Regional GVA (% y/y)



Source: Koop, McIntyre, Mitchell and Poon (2018)

In turn, it is no surprise that, unlike in the City of London, regional office yields have held broadly steady in recent months. That said, if a Brexit deal is secured and the Bank of England resume interest rate hikes, regional office yields are expected to rise as longer-term interest rates increase. However, given their higher starting point, they are not likely to rise as much as in Central London. Combined with the stronger rental value growth prospects in the regions, regional office markets are expected to outperform those in Central London over the next five years or so.

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