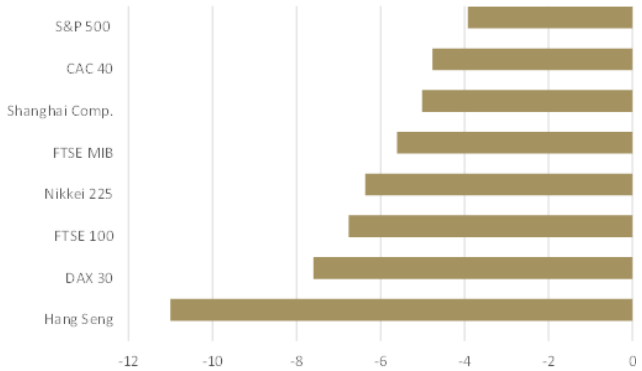
Riverside CAPITAL | THE PROPERTY INVESTMENT PEOPLE

Update - August 2019

Global Factors

Over the past month, equity markets have generally performed poorly amid softness in global growth, political concerns and trade tensions (see Chart 1). These concerns have also raised expectations of more global monetary policy easing, which has pushed down government bond yields.

1.0 Change in Selected Major Equity Market Indices over 40 Trading Days to 26/08/2019 (%)



Source: Refinitiv

Recent moves have seen 10-year government bond yields fall below 2-year government bond yields in some advanced economies; in other words, the yield curve has inverted (see Chart 2). This has increased talk in markets of an impending recession as, in the US, an inverted yield curve has been a good predictor of recession in the past. However, for other advanced economies, an inverted yield curve has been a less reliable warning indicator. What's more, it provides little information about the timing of a future downturn and can be distorted by factors other than market expectations for monetary policy. Nevertheless, the inversion of yield curves does provide a signal that the pace of global growth could decelerate.

Overview - August Top 5

- The proroguing of Parliament has been the topic on everyone's lips this week, as Boris escalates his Brexit strategy.

- UK growth slowed in the first half of the year, but is showing signs of improvement in Q3.

- Commercial property investment volumes saw some improvement in July, boosted by the alternative sectors.

- Despite a slowdown, direct property has generally performed better than open ended property funds since the EU referendum vote.

- Following the worst start to the year in over a decade in the leisure sector, more cautious investor behaviour following the delay to Brexit is putting upwards pressure on yields.

1.0 10-Year less 2-Year Government Bond Yields (Bps)

Source: Refinitiv

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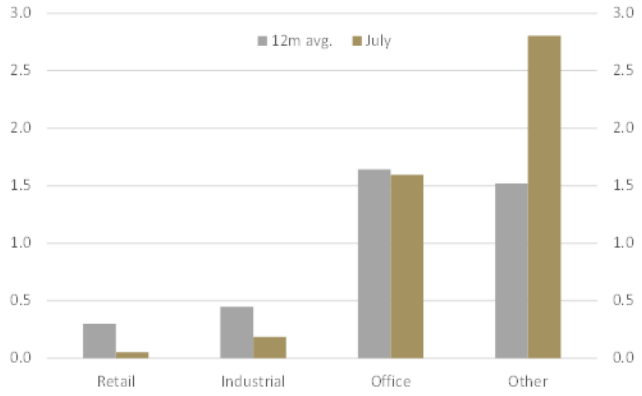
In Europe, after GDP grew by just 0.2% q/q in Q2, economic indicators suggest that growth has remained subdued so far into Q3. In particular, the flash euro-zone composite PMI was 51.8 in August, up slightly from 51.5 in July, but still consistent with weak economic growth. In addition, political concerns have grown, with the Italian Prime Minister resigning. Given sluggish economic growth, price pressures are unlikely to build. Indeed, the account of the ECB's July meeting showed that there was broad support for further policy easing in September and possibly a change to the inflation target.

In the US, trade tensions, concerns about the slowdown in global growth and about the still-low level of core inflation and wage growth prompted the Federal Reserve to cut the federal funds target to 2.00% to 2.25% at its July meeting. However, continued strength in consumer spending and a pick-up in core CPI inflation to 2.2% y/y in July, suggest that the real economy shows few signs of imminent recession. Nevertheless, with markets pricing in more than 100bps of easing, it's possible that the Federal Reserve will cut interest rates further, if only to avoid disappointing market expectations.

In the UK, underlying growth slowed in the first half of the year, but there have been some signs of improvement in Q3. Admittedly, survey data only showed a slight pick-up. But, surveys have been negatively affected by uncertainty around Brexit. Indeed, the hard data have generally been stronger than consensus expectations. In particular, the consumer side of the economy has held up well, with retail sales growing by 3.2% y/y in July. Further, CPI inflation increased to 2.1% y/y in July, from 2% y/y in June. With stronger pay growth and recent falls in the pound expected to boost inflation next year, unless there is a no deal Brexit, it seems likely that the Bank of England will resume interest rate increases next year. That said, with the EU appearing unwilling to remove the Irish backstop, expectations of a no deal Brexit have increased.

3.0 Value of Investment Deals (£bn, Monthly)



Source: Property Archive, Colliers

In part, this reflects the bleak rental value outlook for the retail sector, which is likely to mean that retail yields will need to increase further to entice buyers to the market. Indeed, CBRE data show that retail equivalent yields increased by a further 5bps in July, while rental values fell by 0.2% m/m. However, office and industrial yields are also showing signs of upwards pressure. In fact, Knight Frank data show that prime yields for some City of London offices are around 25bps higher than at the end of last year.

At the all-property level, with yields rising, and rental value growth slowing, capital values fell in July for the third consecutive month. That said, recent data from Morningstar showed that direct property has generally performed better than open-ended property funds since the EU referendum vote in 2016. Over the three years to June, UK open-ended funds generated an average annualised return of 4.4%, while all-property returns in the MSCI quarterly index averaged over 6%.

PropertyOverview

Following a subdued first half of the year, there was some improvement in UK commercial property investment volumes in July. Colliers report that around £4.6bn of deals were completed, up from £2.7bn in June. Investment activity was boosted by the alternative sectors, which accounted for more than 60% of the total (see Chart 3). This echoes recent agency reports which have highlighted that, over the past year, the alternatives sector has grown to be the largest sector in the UK commercial property investment market. Nevertheless, investment activity is likely to remain weak over the rest of the year.

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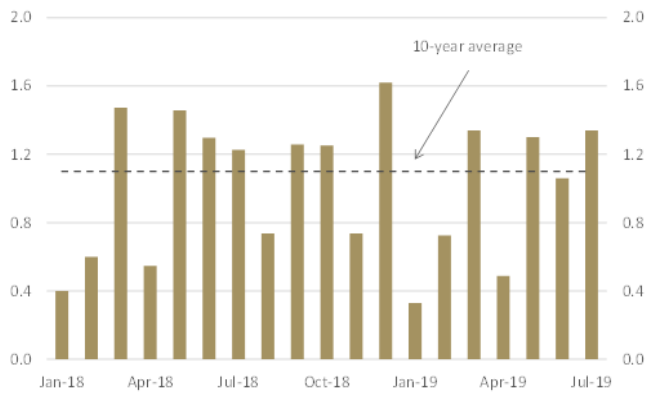
London Property Market

CBRE data show that Central London office take-up in July stood at 1.3m sq. ft., above the 10-year average of 1.1m sq. ft. (see Chart 4). Together, the creative industries and business services each accounted for around one third of take-up. However, an increase in supply saw the Central London vacancy rate increase slightly to 4.4%. There was also an 8% m/m reduction in the amount of space under offer in July to 3.8m sq. ft., although this was still above the 10-year average and should support take-up levels in coming months.

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



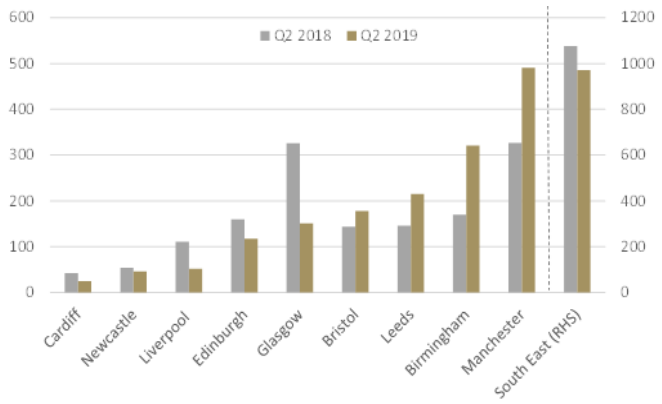
Source: CBRE

Meanwhile, the retail sector in Central London is showing signs that it is catching up to the Rest of UK, with retail rental values falling on an annual basis in both the City of London and West End in July. With reports such as House of Fraser extending its administration period until August next year continuing to hit the headlines, it seems that retail rental value falls will continue for some time, both in London and in the Rest of UK.

Regional Property Market

In regional markets, office take-up was mixed in the second quarter. Compared to a year ago, take-up fell in the South East, but increased in many of the big nine regional cities (see Chart 5). In particular, take-up was strong in Manchester and Birmingham. Serviced office providers boosted take-up in both these cities over H1 2019, accounting for 23% and 47% of take-up respectively. In fact, Savills note that serviced office providers took more space in the top regional cities in H1 2019 than they did over the whole of 2018.

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



Source: Avison Young, Knight Frank

Regional property supply remained tight in Q2 and, looking ahead, the pipeline appears constrained. Indeed, Avison Young report that there is 1.3m sq. ft. of space under construction in the South East, down from the 2016 peak of 4m sq. ft.. Meanwhile, Knight Frank data show that there is 5.4m sq. ft. under construction in the big nine regional cities. Given the average annual level of take-up over the past five years, this represents less than one years' worth of supply.

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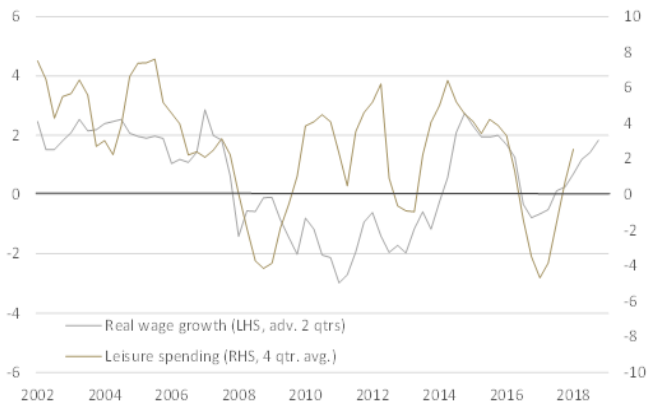
Sector Spotlight - Leisure

At the start of 2019, leisure equivalent yields fell to their lowest level since their 2007 trough, as low government bond yields and low yields on traditional commercial property drove investor appetite for higher yielding sectors. However, in Q2, more cautious investor behaviour following the delay to Brexit has put upward pressure on yields.

At the same time, monthly growth in leisure rental values has been subdued. In a large part this has reflected weakness in occupier turnover, with rents in the sector often linked to occupier performance. Although demand for many types of leisure is trending upwards, leisure is a diverse sector and some leisure units are facing weak occupier demand, with, for example, restaurant chains struggling. Indeed, data from the Local Data Company show that there was a net closure of 749 leisure units in 2018, compared to 67 units in 2017. In turn, the MSCI leisure vacancy rate increased to 11.3% in Q2, from 8.2% a year ago.

Nevertheless, there have been some signs that demand for leisure is improving. Indeed, spending on leisure has picked up since late last year. Further, with real wages continuing to grow at a solid pace, leisure spending is likely to hold up (see Chart 6). That said, consumer sentiment is also an important determinant of willingness to spend. Since the initial Brexit deadline in March, sentiment has deteriorated and is unlikely to improve until after Brexit-related uncertainty is removed.

6.0 Leisure Spending and Real Wage Growth (% y/y)



Source: Refinitiv

Going forward, the fundamental shift in consumer preferences towards experiences will continue to support leisure property. Indeed, with leisure less affected by the increase in the online share of consumer spend, the sector is not expected to suffer to the same degree as bricks and mortar retail.

That said, leisure yields are likely to continue to increase, driven by higher interest rates if a Brexit deal is secured or repeatedly delayed, or the initial disruption if there is a no deal Brexit. However, leisure yield rises aren't likely to be as steep as in other property sectors. This reflects that, at this late stage of the cycle, with income returns high and rental prospects healthy, investor interest in well-located leisure property is likely to hold up. In turn, over the next five years or so, leisure property is expected to perform well compared to traditional property assets.

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