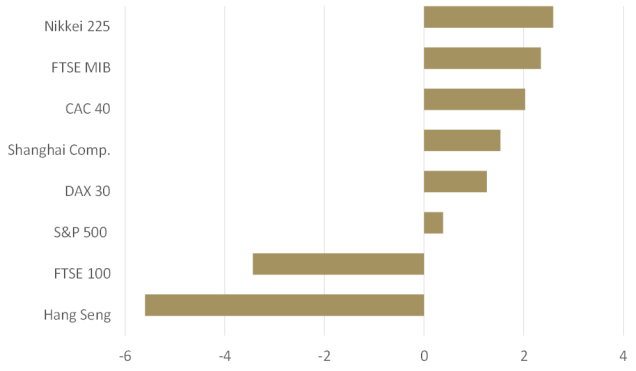
Riverside CAPITAL | THE PROPERTY INVESTMENT PEOPLE

Update - September 2019

Global Factors

Over the past month, financial markets have regained some composure after the upheaval related to trade tensions between the US and China and recession fears in the US in early August. Indeed, in the US, UK and Canada, long-dated government bond yields have risen by more than short-dated bond yields in recent weeks meaning that their yield curves are no longer inverted, thereby easing recession fears. Meanwhile, most equity markets have held up well given the weak global economic outlook (see Chart 1).

1.0 Change in Selected Major Equity Market Indices over the Last 40 Trading Days to 23/09/19



Source: Refinitiv

In the UK, with monthly GDP rebounding by 0.3% m/m in July, the economy appears to have gathered some pace following the 0.2% q/q contraction in Q2 and should avoid a recession before October's planned Brexit at least. What's more, Q3 GDP growth will receive a boost from car plants staying open in August when they are usually shut. Meanwhile, with inflation dropping back below the Bank of England's 2% target in August, there was never much chance that the MPC would raise interest rates from 0.75% at its September meeting.

Overview - September Top 5

- With monthly GDP rebounding, the UK economy has gathered some pace following the Q2 contraction, avoiding a recession before October's planned Brexit at least.
- Property investment activity has been supported by alternative investment, but has still been 30% lower over 2019 so far than the same period in 2018.
- Rental value growth continues to be dragged down by the retail sector. However, the growth of CVAs is slowing, which should limit further rental value falls.
- Whilst central London office take up has been slow in 2019 after a strong 2018, the proportion of pre-let space is above average, supported by flexible office providers.
- Central London office rental value growth will slow a bit further this year, but will be better than many expected at the start of the year.

Nonetheless, unless there is a no deal Brexit, the Bank of England should buck the global trend of looser monetary policy in the coming quarters.

Indeed, other advanced economy central banks are undertaking monetary policy easing. Despite the jump in core inflation in August, the Federal Reserve voted to cut its key policy interest rate by an additional 25bps at its September meeting to between 1.75% and 2.00%. Looking ahead, it appears that the Federal Reserve is less sure about the future path of interest rates. Indeed, while one third of the Federal Open Market Committee is projecting another rate cut before year-end, close to another third disagreed with the most recent cut. For what it's worth, federal funds futures suggest that the market expects the Federal Reserve to cut rates once more in December to between 1.50% and 1.75%.

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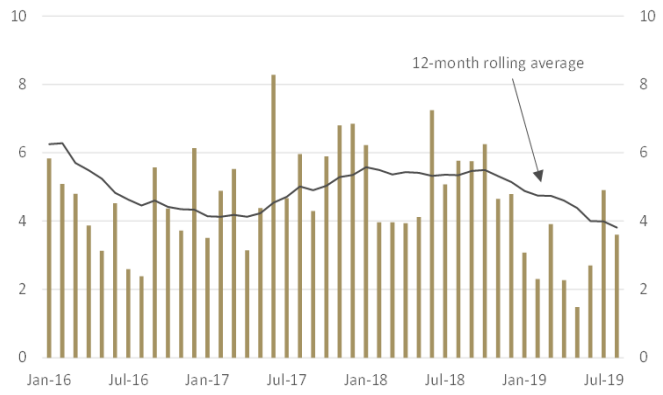
Similarly, in Europe, with growth weakening in Q2 and the euro-zone composite flash PMI for September falling to a 75-month low of 50.4, it was expected that the ECB would cut their key interest rate by 10bps to -0.50% in September. What's more, Mario Draghi appears to have locked the ECB into QE for several years beyond his time in office. Even so, this package is unlikely to reboot economic growth or boost inflation. Indeed, the euro-zone's key problems are its exposure to the global manufacturing downturn, the related industrial recession in Germany and the chronic malaise in Italy's economy, none of which can be solved by ever-looser monetary policy.

PropertyOverview

Colliers report that the value of property investment in August was £3.6bn, almost 40% lower than the total in the same month of last year. In turn, even after July's reasonable rise, investment activity so far over 2019 has been 30% lower than over the same period of 2018 (see Chart 2).

2.0 Value of Investment Deals Completed (£bn per month)



Source: Property Archive, Colliers

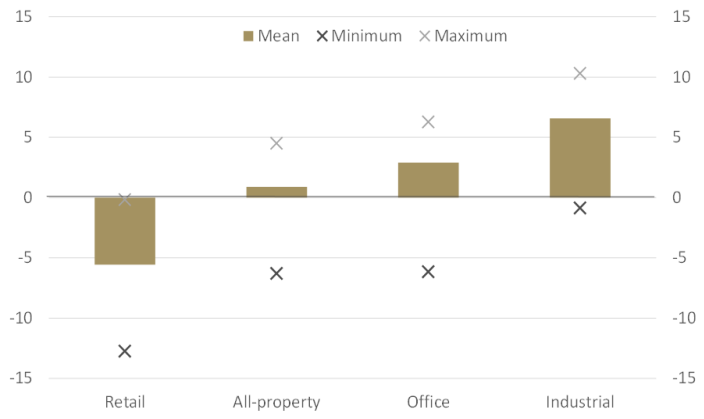
Investment activity was supported by alternative investment, with DWS's purchase of the Vita student portfolio for £600m and Schroders and Octopus forming a joint venture to develop retirement homes worth £400m. In addition, the value of office investment held up at similar levels to the 12-month average. However, retail and industrial investment was subdued.

Consistent with the softness in investment activity, CBRE report that all-property yields increased by 12bps over the past year, mostly driven by rises in the retail sector and City of London offices. With little rental value growth to speak of, all-property capital values fell by 1.7% y/y in August.

Rental value growth continues to be dragged down by the retail sector. That said, reports suggest that the growth in CVAs appears to be slowing, which could limit further rental value falls. This is consistent with ONS data which shows that there have been nine store retailer CVAs (including shops, food and beverage) over the year to Q2, down from 12 in the year to 2018 Q3. However, with CVAs lowering the overall market rent and there being no guarantee that those retailers who have entered into a CVA will avoid insolvency, it seems unlikely that retail rental values have found their trough.

The weak outlook for the retail sector was the main driver of the downward revision in August by the IPF Consensus for 2019 all-property returns to 0.9% y/y, from 1.8% y/y in the May survey. Nevertheless, there was a wide range of uncertainty around these forecasts, with the outcome of Brexit likely to be an important determinant of total returns going forward. In fact, the minimum and maximum forecast for all-property returns this year was minus 6.3% and 4.5% respectively, an exceptionally wide spread (see Chart 3).

3.0 2019 Total Returns Forecasts (% p.a.)



Source: IPF Consensus

London Property Market

London employment growth fell by 0.6% y/y in August, the first decline since early 2012. Although employment data can be volatile, there has been a clear downward trend in annual employment growth since the beginning of the year.

However, more encouragingly, the September EY Financial Services Brexit Tracker suggested that, over the past three months, there was a slowing in the number of Brexit-related job relocation announcements from financial services firms. In part, this likely reflected that most firms had already completed any staff movements ahead of the original March Brexit deadline.

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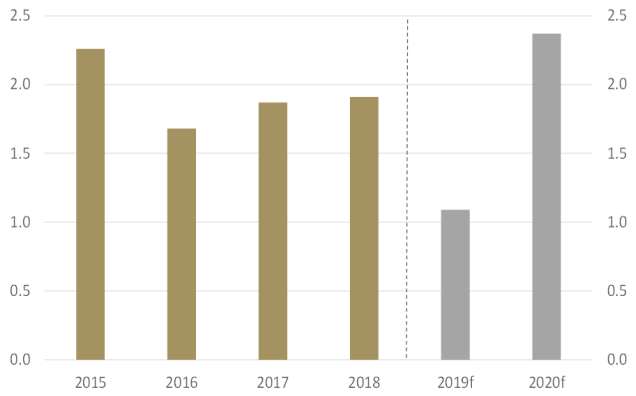
The tracker has also recorded just 1,000 job moves amongst the large investment banks since June 2016, compared to earlier estimates by financial services firms that there could be more than 10,000. However, EY also note that there remains a possibility that around 7,000 more jobs could still be relocated from the UK to Europe in the near future.

Regional Property Market

Turning to regional property markets, Knight Frank reported that, in early September, regional shopping centres yields increased by a further 25bps-50bps, with challenged local schemes continuing to yield the highest at 10.50%. In turn, it is no surprise that CBRE forecast shopping centre completions to almost halve this year compared to last year.

However, in 2020, the completion of Edinburgh St James is expected to boost supply (see Chart 4). Notably, this scheme includes mixed-use space, something which is expected to be more common in new retail developments. In addition, other major regional schemes, such as the West Midlands Designer Outlook in Cannock, are expected to come to market. In the current environment, the boost to supply will likely put further downward pressure on retail rental values.

4.0 Shopping Centre Development Completions

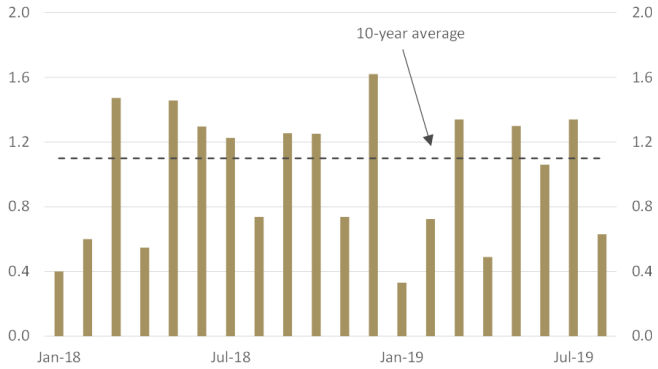


Source: CBRE

Sector Spotlight - London Offices

After a solid 2018, Central London office take-up has been soft so far this year. This continued in August, with CBRE data showing that take-up was just 0.6m sq. ft., well-below the 10-year average of 1.1m sq. ft. (see Chart 5).

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



Source: CBRE

That said, within this total, the proportion of pre-let space was above average. In addition, take-up continued to be supported by flexible office providers. Cushman and Wakefield report that, over the first half of 2019, 1.2m sq. ft. of flexible office space was taken. If flexible office take-up continues at a similar pace for the rest of the year, the full year total would be similar to 2018, albeit down from 2017 levels.

However, softness in office take-up is consistent with signs that office-based employment growth may have peaked, which would be expected to weigh on office occupier demand. In particular, the number of office-based job vacancies have declined since April this year, and, in August, were 6% lower than a year ago (see Chart 6).

6.0 Office-Based Job Vacancies (000s)(Incl.

Source: ONS

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Admittedly, Central London vacancy rates suggest that office occupier conditions are particularly tight. Indeed, data from Knight Frank show that vacancy rates in Q2 were just 5.1% in the West End and 4.9% in the City of London. But, the low rates of vacancy are at odds with the current low rates of office rental value growth. This could reflect that the large share of take-up by flexible offices is distorting vacancy rates. Indeed, flexible office providers generally do not operate at full capacity on opening, but any unoccupied space would not be considered vacant. Furthermore, it likely reflects that the bargaining power of landlords is particularly weak, with the risk of a no deal Brexit in the back of tenants' minds. In turn, landlords appear unable to increase office rents even in a tight market.

On balance, it seems likely that Central London office rental value growth will slow a bit further this year, but will be better than many expected at the start of the year. Indeed, in the February IPF Consensus survey, the mean expectation was for Central London office rental values to fall this year. However, the August survey was much more optimistic, with forecasts of 0.8% y/y and 0.5% y/y for the West End and the City of London respectively.

For further information please contact:

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