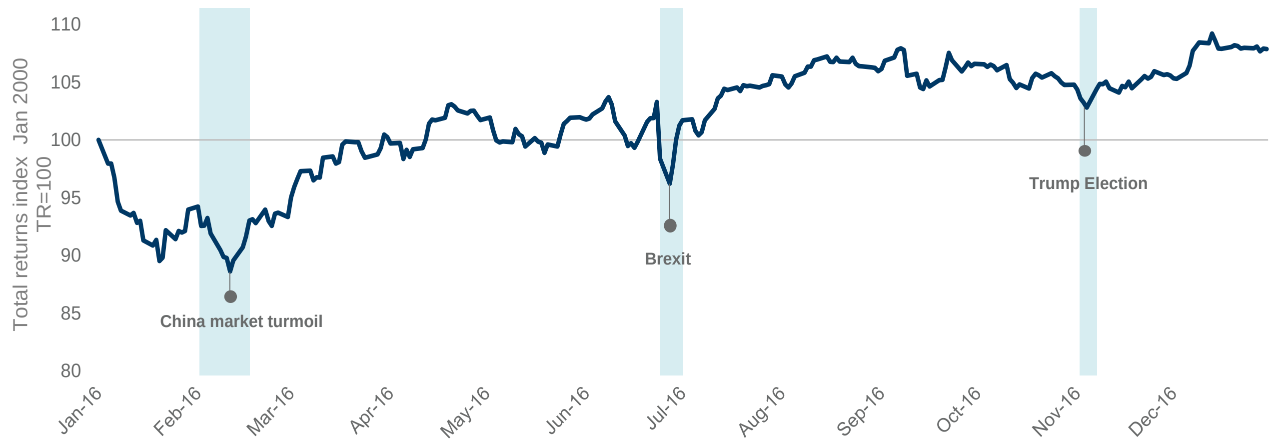
Does increased financial market uncertainty strengthen the case for UK property?

April 2017

2016 threw many challenges at the investment market, as a succession of economic and unexpected political events became harsh realities. The investment market absorbed the shocks well. For each major event; market turmoil in China; a yes vote on the EU referendum; and the election of Trump as US president; the initial impact and recovery in financial markets was quicker than the last.

Equity markets recouped their losses, reaching new highs by year end, while the post referendum falls in UK commercial property values was followed by a swift (albeit small) recovery in values one quarter on. The only outlier was the bond market, where the strong rally in bond yields throughout most of 2016 was interrupted by the prospect of rising inflation given Trump's pledge to deliver an extensive fiscal expansion programme in the US. Despite this, gilt investors still ended up better off with yields down 38bps from the start of the year.

MSCI World Total Return Index, (Jan 2016=100) **Source: MSCI, FT**



2016 will certainly be remembered as the year when politics fought back, while 2017 will be the year that sees the implications of these choices begin to materialise. So what will be the driving forces of investments returns in 2017 and how will UK commercial property fare against the rest?

Historically investment returns have been driven by two key components, economic growth and a continued decline in interest rates. The former has delivered corporate profits, grown dividend payments, supported government debt liabilities and fuelled rental growth for the real estate market, while the latter has driven capital appreciation across the asset classes. However, as we look forward in markets, principal these two features of investment returns are likely to be challenged; by political inertia in the short term and structural changes such as low productivity in the absence of any new innovations, an ageing population and the UK's high debt burden over the long run.

For 2017, we expect a low growth, low returning investment environment to prevail as the economy navigates its way through the Brexit process. However, not all aspects of the investment environment will be the same as before. New dynamics will emerge, monetary policy will be exchanged for fiscal policy as an economic stimulant, worries over deflation will be swapped for concerns of rising inflation while the battle between populism and globalism will deliver pockets of volatility along the way. Against these conditions, investment returns are likely to remain supressed and vulnerable to increased market volatility.

Yet, despite a more volatile marketplace, we believe the case for holding UK real estate remains compelling. Sterling's weakness has made UK property cheaper from an international perspective, while the post-referendum falls in commercial property values has improved the value of UK property relative to equities and bonds, both of which have ended the year on higher values than they were twelve months back.

Increased market volatility should provide interesting opportunities to acquire stock. Segments such as the London office market will be significantly exposed to the political upheaval as occupiers review their plans in light of the future trade arrangements under a Hard Brexit. Such circumstances should provide opportunities for investors to source mispriced investments that offer long term value creation and performance potential.

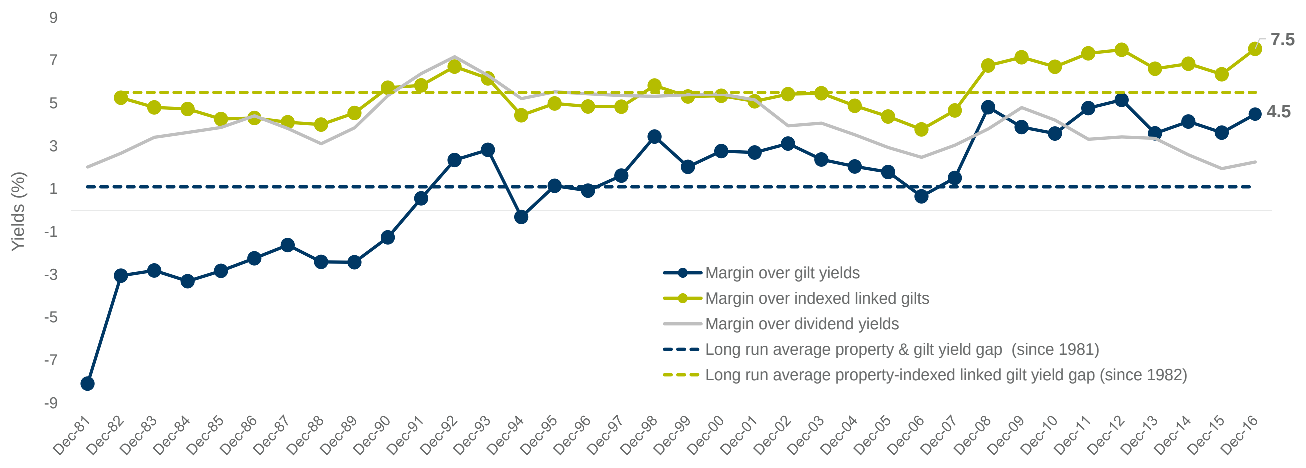
A more balanced monetary-fiscal policy framework should provide good economic conditions for property returns. Sustained economic growth and rising inflation make a favourable backdrop for growth style investments over fixed income investments. The combination of these factors should help necessitate rental growth for commercial property, particularly for segments that are supported by favourable demand-supply dynamics.

Plus, with the days of strong yield driven capital growth firmly behind us, and heightened political uncertainty increasing market volatility, investors will be reliant on strong income returns to deliver consistent investment performance. Property's high and stable income return relative to the income returns on other asset classes will be beneficial to investors. We expect commercial property to deliver an income return of 4.5%p.a. over the next five years, compared to c.3.5 %p.a. and 1.5%p.a. on equities and bonds respectively. Moreover, the heterogeneous nature of real estate (by sector, geography, quality, income stream and lease length) gives investors opportunities to gain exposure to longer length income streams and investments with a higher than average yield.

In a world of low returns where the risks of achieving a given level of return is rising, focussing on alpha to deliver performance will be essential. This is where property can offer more opportunities than other asset classes. Traditional assets classes (equities and gilts) offer little in the way of active management, except to buy when undervalued and sell well. Property provides these opportunities and far more, from re-structuring leases, light refurbishments and extensions to large-scale developments, the number of asset management options available to investors should assist in the delivery of above market returns.

Property's relative yield advantage is still wide enough to absorb any rate hikes. With deflationary concerns pushed to one side and unconventional monetary policy measures having run their course, a return to a steeper yield curve now looks more plausible. This will be a good setting for equity investors, but less promising for bond investors who will have to come to terms with the value of their investments falling as yields soften. Property should be less affected from rising interest rate expectations. Property's current yield premium to fixed income investments of 450bps is exceptionally higher than its long run average yield premium, providing enough scope for gilt yields to rise before an outward shift in property yields is necessary to correct the property to gilt yield risk premium (see chart overleaf).

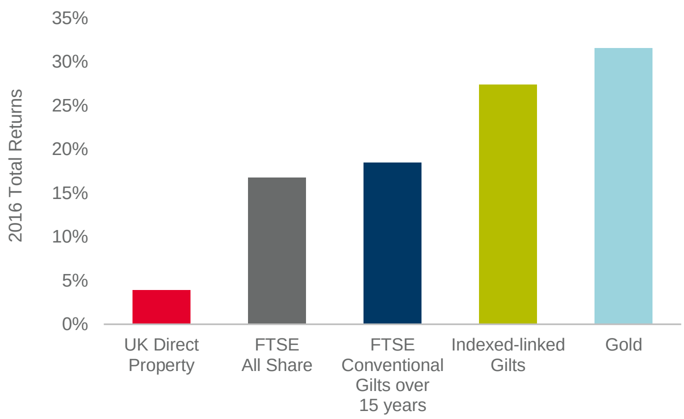
Yield gap between All Property equivalent yield and other asset class yields, Source: IPD, Bloomberg



The chart above review's property's yield premium against other asset classes (10 year gilt yields, indexed linked gilt yields and dividend yields) since 1981. During this time, there have only been three other occasions where the property - gilt yield margin (property's traditional yield comparator) has been higher than it is currently (in 2008, 2011 and 2012 respectively), suggesting that property looks significantly undervalued. Assessing the current yield premium between property and 10 year gilts against its long run average (of 110bps, a proxy for property's fair value level) could be viewed as slightly misleading, given the high inflation environment in the 1980's and its impact on bond yields. A comparison of property's current yield premium to indexed linked gilts against its long run average eliminates this issue. Either way, on both measures, there is still considerable scope for the yields on fixed income investments to move out by more than 200bps from its year end position, before fair value is reached. Most consensus forecasts predict 10 year gilt yields to settle in the region of 2-3% by 2020, even if this were to happen, this would still leave enough room for property yields to fall in the medium term.

There aren't many occasions where UK property has underperformed both equities and gilts in a given year. When it has happened, it has generally corresponded with an economic recession, which is an event that we do not foresee in the short term. The hybrid nature of commercial property (possessing both bond and equity characteristics) should in theory mean that property delivers a return that is between both asset classes; instead 2016 saw equities and gilts charge ahead delivering returns in excess of 15%, while property trailed behind with a sub 4% return for the year. The relative performance differential between the asset classes needs to adjust at some point; and so given that market fundamentals should remain supported by moderate economic growth prospects in the near term and property's relative pricing and income return prospects offer an appealing returns profile in an environment where income is set to become the principal component of performance, strengthens the case for investing in UK property.

2016 Investment Returns Source: Bloomberg, FTSE, MSCI



"Favorable currency movements and a mixed monetary-fiscal policy set against the current political backdrop should provide interesting mispriced investment opportunities in UK property."

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