july 2013

investment bulletin

Fletcher King

CHARTERED SURVEYORS

Institutional Investment in Property

July's preliminary estimate indicates that economic growth increased to 0.6% in Q2 2013 from 0.3% in Q1. The largest contribution to growth in Q2 came from services which grew by 0.6%; manufacturing increased by 0.4% having fallen 0.2% in Q1 and construction was estimated to have increased by 0.9% compared with Q1 when output was at its lowest level since Q1 2001. The peak to trough fall of the economic downturn in 2008/09 is now estimated to be 7.2%. Growth of 1.4% in the last year, however, is below the economy's trend rate of growth and at the end of the second quarter GDP remains 3.3% lower than the pre-financial crisis peak in Q1 2008.

This more welcome economic news is supported by other recent surveys.

In June, the British Retail Consortium reported that UK retail sales values were 1.4% higher on a like-for-like basis compared with June 2012. Online sales were up 14.1% compared with June 2012, when they had risen by 12.1%. The BRC commented that, "June's figures represented a strong performance from the UK's retailers, with very respectable overall growth across all categories and confirm that the retail recovery is continuing."

The Nationwide House Price Index indicated that prices rose by 0.4% in Q2 and are 1.4% higher than the same quarter in 2012. London prices are now 5% above their 2007 peak. Amongst the English regions, the South of England and the Midlands continued to outperform the North of England.

As the macro-economic background showed some tentative signs of improvement the commercial property market enjoyed its first quarter of increasing prices after enduring six consecutive quarters of decreasing prices. Capital values as measured by the IPD Monthly index rose by0.2% in Q2 compared to a decline of -0.6% in Q1. Total returns increased to 1.9% in Q2 from 1.1% in Q1 and total returns in the 12 months to June increased to 4.1% from 2.5% in the 12-months to March.

In Q1 institutions continued to put money into the commercial property market acquiring property assets worth £1.2 billion and recording sales of £939 million. Net investment in Q1 of £224 million compared to net investment of £624 million in Q4. Only once since the start of the market recovery in Q4 2009 have quarterly net inflows into the asset class been lower. In the 12 months to March, net investment by institutions amounted to £1.64 billion compared with net investment of £1.73 billion in the 12 months to December.

In the first quarter, pension funds invested a further £134 million and have been net investors for the last twenty four quarters. Total investment by pension funds in the 12 months to March amounted to £1.7 billion compared to £1.9 billion in the 12 months to December and £1.3 billion in the year to March 2012. Life companies continued to be sellers although net disinvestment in Q1 amounted to just £40 million. Total disinvestment in the 12 months to the end of March amounted to £947 million compared to disinvestment of £985 million in the 12 months ending December and a net disinvestment of £165 million in the year to March 2012. Property Unit Trusts were net investors for the fourteenth consecutive quarter and invested £98 million in Q1. Net investment in the 12 months to the end of March amounted to £358 million compared with net investment of £275 million in the 12 months ending December and £490 million in the year to March 2012.

Total institutional investment expanded 54% to £16 billion in Q1 from £10 billion in Q4. Institutions made net investments in Q1 of £16.0 billion in cash and other short term instruments, £3.5 billion in UK gilts and £224 million in UK Property as noted above but were net sellers of £840 million in overseas equities and £5.0 billion in UK equities.

What risks do rising bond yields pose to the commercial property market?

In an effort to resuscitate a moribund economy battered by recession, bank failures, a reluctance to lend and government austerity, UK monetary policy has been exceptionally loose. Bank base rates have been 0.5% since March 2009 and the Bank of England has bought £375 billion of gilts through its asset purchase programme (quantitative easing or QE) in an attempt to keep longer term interest rates low and prompt some degree of lending from banks desperate to repair their balance sheets.

The expectation is that as the economic recovery gathers pace, short term interest rates will rise as base rates are increased from the current low levels. Longer term rates will also increase as the Bank faces up to its biggest challenge of unwinding its long gilts position.

Theory suggests that risky assets such as equities and commercial property should be valued by reference to the risk free rate which is taken as the rate offered by benchmark government bonds; Treasuries in the USA and gilts in the UK. As the risk free rate rises so should the yield on equities or property leading to falling capital values.

Today, with interest rates in all advanced western economies at record low levels, some bond market veterans are drawing parallels with the situation in 1994. What will happen, they ask, when the Federal Reserve decides it has done enough to stimulate the economy of the USA? Could there be another shock?

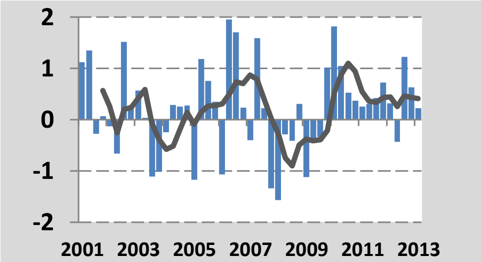
At the beginning of the nineties economic recovery was very slow and the banks were recovering from a financial crisis. Indeed, the poor performance of the USA's economy had cost President George H.W. Bush the White House. The central bank's key policy

Investment in UK Property
Q1 2013 (£m)

	Pension Funds	Insurance Companies	Unit Trusts	Total
Buy	309	599	255	1,163
Sell	175	607	157	939
Net	134	8	98	224

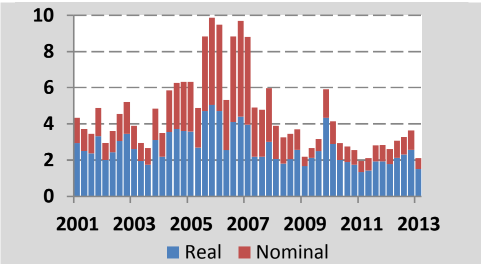
Source: National Statistics

Net Institutional Investment in Property (£billion)



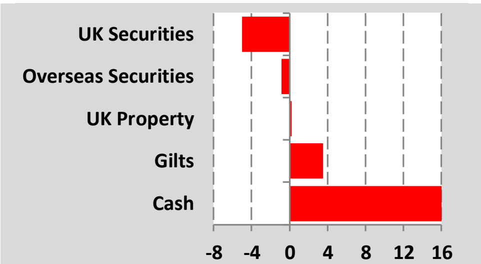
Source: National Statistics

Property Market Liquidity (£billion)



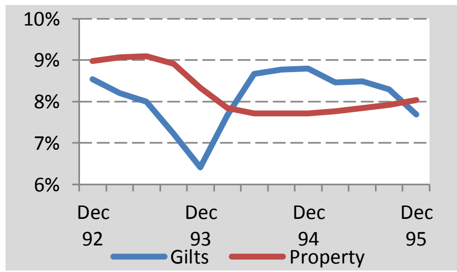
Source: National Statistics & Fletcher King

Net Institutional Investment (£billion) Q1 2013
By asset type



Source: National Statistics

Gilt & property yields 1993-95



Source: IPD & Financial Times

july 2013

investment bulletin

had been a long period of low interest rates, designed to nurture a recovery for the banking system and the housing market.

In his State of the Union address in January 1994, President Bill Clinton laid out a compelling argument that the US economy was finally beginning to wake up. “Auto sales are way up. Home sales are at a record high. Millions of Americans have refinanced their homes. And our economy has produced 1.6m private sector jobs in 1993, more than were created in the previous four years combined.”

On February 4, 1994, the Federal Reserve unexpectedly raised rates and kept tightening through the year, as the US economic recovery picked up pace and the central bank decided to guard against the risk of future inflation. The sharp, unexpected rise in interest rates wrecked the value of bond portfolios, hedge funds blew up, banks plunged into the red and the resulting shockwaves even hurt the equity market, which reversed a strong start to end down on the year.

The situation in the UK was similar. The economy was enjoying a period of strong growth as it recovered from the recession of 1991. Output grew by 4.0% in the year to March 1994 and by the end of the year it was growing at 5.3% year on year. In March the Bank of England cut base rates from 5.4% to 5.1% but as the recovery grew stronger base rates were increased to 5.6% in October and 6.1% at the end of the year. Gilt prices were influenced by the market for US Treasuries and possibly also reflected fears of future monetary policy tightening. The yield on 5-15 year gilts softened from 6.4% at the start of the year to 8.8% in December.

As the risk free rate soared, any reaction from the UK commercial property market was non-existent (see chart). The All Property initial yield hardened from 8.3% at the start of the year to 7.7% in December and the property equity yield gap shrank from +1.9% to -1.1%.

The question today is whether low interest rates, signs of stability in the housing market and improving jobs data are a prelude to a stronger rebound for the economy this year and an increase in interest rates.

Markets are justifiably nervous about a rate sell-off. Bond investors have never seen a major central bank exit QE and react instantly on any clue as to when the central bank might finally signal its intention to wind down QE.

Ben Bernanke, Federal Reserve chairman, sparked a sharp sell-off in financial markets and a spike in bond yields in May when he suggested that the Fed would start to "taper" its $85bn a month in bond purchases as the US recovery gathers pace. Subsequently, however, he used an appearance before the House of Representatives to reassure financial markets that his own plans to scale down monetary stimulus were not "on a pre-set course", and would depend on the health of the economy.

In its July meeting the Monetary Policy Committee expressed concern at the "surprising" rise in UK government bond yields that followed Bernanke's remarks. In April, markets had not been expecting rates to go up until late 2016; by the time the MPC met in July, that **had** been brought forward to mid-2015.

The MPC were keen to dampen expectations that interest rates were set to rise and took the unusual step of issuing a statement to financial markets warning them that interest rates were unlikely to rise. Developments in the UK’s economy, while broadly positive, had not been enough to warrant such an upward move in the near-term path of Bank Rate.

UK 5-15 year gilt yields softened from 1.5% at the end of April to 2.2% at the end of June. The UK’s commercial property market is today much more sophisticated and transparent than it was in 1994 and the market did see a slight reaction to the spike in gilt yields. The All Property initial yield softened by 10 bps, from 6.3% at the end of April to 6.4% at the end of May. But the reaction didn’t last long and had been reversed by the end of June.

It is possible that a future spike in bond yields induced by a strengthening economic recovery, a rise in short term rates and an exit from QE, could drive property yields higher and values down but at present this is unlikely. The spread between the All Property initial yield and 5-15 year gilts is currently 410 bps and is more than double the ten year average. As the economy strengthens and investors can start to see a time when rental growth eventually returns to the market, they may in any event accept a smaller risk premium.

The real risk to the property market from bond yields is if there is panic and the move to higher interest rates is explosive. But Central Banks are aware of this risk. They have issued warnings about the prospect of higher long-term bond yields and the risk that a sharp jump will inflict capital losses on bond holders and financial institutions.

Citing the 1994 experience in a speech on long-term interest rates, Mr. Bernanke says the central bank provides far more clarity about its policy intentions and could act to stem a sudden rise in rates. Mark Carney, the new governor of the Bank of England, is known to favour “forward guidance”. A policy that would see the MPC promise to keep interest rates low until the economy meets specific targets.

What the central banks wants to see is a period where long-term rates go up first, as the economy improves, before it raises the cost of short-term borrowing. That way banks and other financial firms can still make money by borrowing cheaply and lending it out at higher rates. Most of all, it wants the shift to higher rates to come slowly.

Fletcher King

CHARTERED SURVEYORS

CONTACT

Fletcher King
61 Conduit Street
London
W1S 2GB

www.fletcherking.co.uk

020 7493 8400

OUR SERVICES

Fletcher King Property Fund Managers and Chartered Surveyors provide a wide range of real estate services:

- Investment
- Fund Management
- Asset Management
- Landlord & Tenant
- Valuation
- Rating
- Transactions
- Development

FUND MANAGEMENT & INVESTMENT CONTACTS

For further information, please contact:

Richard Goode
e: RichardGoode@fletcherking.co.uk
t: 020 7458 0633

David Mayes
e: DavidMayes@fletcherking.co.uk
t: 020 7458 0624

Paul Morris
e: PaulMorris@fletcherking.co.uk
t: 020 7458 0645