2017...The Year So Far

September 2017

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Bear: Well, that was a pretty long summer, wasn't it Bull? The weather has been rubbish, the markets have been quiet and to make matters worse, X Factor is already back on our TV screens.

Bull: It's depressing, isn't it? Although I'm more of a 'Strictly' fan myself. That said, this year's line-up hardly makes for compelling viewing, does it? They say the programme involves celebrities but who on earth are these people they've got this year?

Bear: No idea. And to make matters worse, there's no Len Goodman head-judging this year. How will the British public survive the autumn without hearing his catchphrases? "It's a 10 from Len"… "Pickle my walnuts"…"Seven".

Bull: Easily, and Bear, you seriously need to get out more! You'll soon be telling me that it's reassuring to have Simon, Louis and Sharon back on our screens. After fourteen series, surely the British public have suffered enough from X Factor?

Bear: Well, I've heard recent similar whisperings said about us two. Only last week I overheard someone in the kitchen saying that the idea of us debating the comings and goings of the UK property market was surely past its sell by date. They even went on to say that it was time for us to retire… and for good.

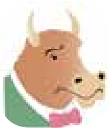
Bull: Rubbish. Let them gossip, I say!

Bear: Well, I must confess that I was starting to think that St Bride's were thinking along a similar line. They usually call us straight after their Annual Seminar in June, don't they? When July and August both passed without even a WhatsApp message, I started preparing myself for the worst.

Bull: They can't get rid of us that easily! They need our years' of experience. Plus they also need someone to take the blame when their predictions go wrong... however rare that is of course!

Bear: That goes without saying! You only have to cast your eyes back at our January 2017 predictions to see that we've still got what it takes.

Economic and Political



Bull: Absolutely. When it comes to our economic and political predictions we've nailed it, haven't we? We said that the UK Government would serve the Article 50 notice by the end of March. Did they? Yes they did. And with a whole day to spare!

Bear: So very true. And we were wise enough to say that Brexit negotiations would be lengthy and difficult.

Bull: A nice, cheeky early understatement there Bear! MPs have just launched an inquiry into the state of Brexit negotiations after the latest round ended in recriminations about a lack of progress. What was the latest update again? Oh yes. "No decisive progress" has been achieved and there are now concerns on both sides that time is running out to resolve the issue by the March 2019 deadline.

Bear: That's why Theresa May is being urged to better prepare for a "no deal" scenario. There is now genuinely the prospect of the UK having to leave Europe without a deal and trade under WTO regulations.

St Bride's January Predictions for 2017 A Reminder

1	The UK will serve Article 50 by the end of March 2017
2	No European Nationalist Party will win control in 2017
3	UK GDP growth will be higher than forecast by the OBR
4	Interest rates will not increase by the end of 2017
5	The British and Irish Lions will lose the series 3-0 to the All Blacks
6	Total Returns for 2017 will be 2.5%
7	Prime yields will see little change over 2017
8	The Alternatives Sector will continue to increase its share of all property investment in the UK
9	2017 investment volumes will better those of 2016
10	Industrials will be the best performing commercial asset class

Source: St Bride's Managers

Bull: Very true, especially as no European Nationalist Party has won control in Europe this year, just like we predicted back in January. Macron defeated Le Pen in France, Rutte defeated Wilders in the Netherlands whilst Angela Merkel has just won four more years at the top in Germany. All these election results point towards a long, long winter of Brexit negotiations.

Bear: Well, I just hope they make some progress… and quickly. According to the latest round of surveys, the UK economy is losing momentum. In fact, it has made its slowest start to a year since 2012. Did you know that the UK economy only grew at an annualised rate of 1% in the first six months? That's less than half the average growth rate of about 2.5% in the years running up to the EU Referendum. To make matters worse, the Eurozone has grown twice as fast.

UK Economic Forecasts - August 2017

	2017	2018	2019	2020	2021
GDP Growth (%)	1.6	1.5	1.6	1.8	1.9
CPI (%)	2.7	2.6	2.2	1.9	1.9
Unemployment Rate (%)	4.5	4.7	4.8	4.8	4.8

Source: HM Treasury

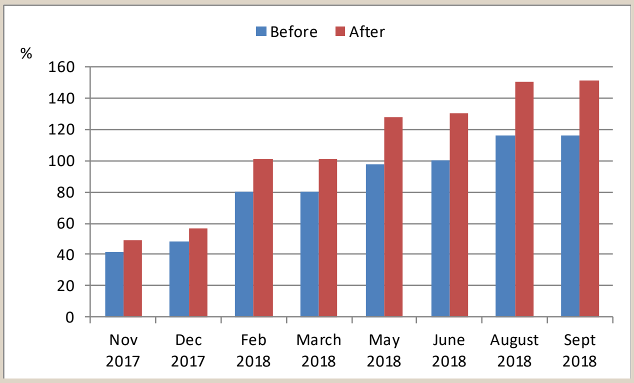
Bull: So are you telling me that our prediction that UK GDP growth will be higher than forecast by the OBR will be wrong? I accept that the UK is currently behind its peers in Europe and the US, but the UK GDP growth is not that bad and has averaged about 1.7% so far this year. Remember that the OBR forecast GDP growth of 1.4% for 2017 at the start of the year.

Bear: I think we'll be proved correct, but the UK economy is really only treading water and that's not great news, is it?

Bull: The numbers may well suggest that's the case, but unemployment at 4.3% is at a level unseen since the mid-1970s. Joblessness has hit a 42-year low according to the Office for National Statistics, who have also confirmed that the number of people in work has risen by 379,000 since the Referendum. That's not the definition of an economy treading water in my book.

Bear: But wages are failing to keep pace with inflation, hurting consumption which is a key driver of the UK economy. It's far from rosy out there and there is now a genuine prospect of an interest rate rise later this year. Markets currently ascribe a 50% chance of a hike in November and a rate hike is fully 'priced' by next February.

Market Pricing of an interest rate hike before and after minutes of the September 2017 MPC meeting were released



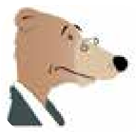
Source: Bloomberg

Bull: Well, I am sticking with our prediction that there won't be a rate rise this year. Raising interest rates at a time when real wages are falling risks unleashing forces that The Bank of England won't be able to handle. There's a real risk to consumers, who are already struggling to keep up.

Bear: But inflation remains a problem. Prices have risen at an alarming rate, fuelled by the fall in the pound since the Referendum. The Consumer Price Index hit 2.9% in August and the MPC now expects the rate to peak above 3% in October, much higher than initially estimated. I can see why The Bank would want to put a lid on rising inflation through tightening the cost of borrowing.

Bull: But wage growth hasn't fed through yet to help cushion the blow of higher interest rates. The current spike in inflation may also dissipate without intervention anyway. As the impact from the expected drop in sterling dissipates, inflation should begin to fall of its own accord.

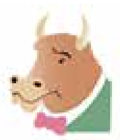
Sporting Predictions



Bear: Only time will tell Bull, but I am preparing myself for the fact that we will have got our interest rate prediction wrong come January 2018. We'll be able to add it to the list along with our British and Irish Lions rugby prediction and our prediction that Andy Murray would win Wimbledon.

Bull: I don't think there's any shame in getting those two predictions wrong. I think the whole world expected the Lions to lose to New Zealand, even if our 3-0 prediction was perhaps a bit harsh. I can't believe there were many, if any, people who predicted a series draw.

Bear: Fair point.



Bull: And as for Sir Andy, he was doing okay until his dodgy hip got the better of him in the quarter-finals at Wimbledon. He's basically been out of action ever since. You shouldn't forget that we got the 2016/2017 Premier League champions correct (Chelsea), the Six Nations winners correct (England) and our prediction about the Test cricket series between England and South Africa was spot on too.

Bear: I am still gutted that Usain Bolt didn't bring the curtain down on his phenomenal career with any gold medals at the London Stadium.

Bull: Yep, I agree. Age gets us all in the end! Anyway overall, compared to our 2016 sporting predictions, we've done remarkably well.

January 2017's Sporting Predictions

Competition	Prediction	Winner
Six Nations	England	England
The Premier League	Chelsea	Chelsea
The Lions vs New Zealand	New Zealand (3-0)	Drawn Series (1-1)
Cricket Test Series vs South Africa	England	England
Usain Bolt Gold Medals	Three	None
Wimbledon	Sir Andy	Roger Federer

Source: St Bride's Managers

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Bear: That's good news that we've done well with sporting predictions because I am not that convinced we'll do that well with our property predictions. I know there are still over three months to go, but I can already foresee us getting a couple of our five property predictions wrong.

Bull: You are so negative Bear. I actually feel quite relaxed. Dare I say it, a tad smug about what we predicted back in January. Take prime property yields for example. We predicted that they would see little change over 2017 and they remain on track to have done just that.

Bear: It depends on what your definition of 'little change' is though.

Bull: Well, according to CBRE's latest Yield Sheet, there has been very little change since December 2016. Yields for Prime High Street Retail, Prime Shopping Centres and Prime Retail Warehouses have all remained unchanged since December 2016. The same applies for West End Offices and Regional City Offices. That's five of the nine sub-sectors we specifically listed out.

Prime UK Property Investment Yields

Sector	Prime Yield December 2016 (% pa)	Prime Yield September 2017 (% pa)
High Street Shops	4.00	4.00
Shopping Centres	4.65	4.65
Retail Warehouses	4.75	4.75
West End Offices	3.75	3.75
City Offices	4.25	4.00
Regional Cities Offices	5.25	5.25
Distribution	5.00	4.85
Industrial Estates (Greater London ex Heathrow)	5.00	4.50
Industrial Estates (ex Greater London)	5.25	4.75

Source: CBRE

Bear: So should I assume that the remaining sub-markets/sectors have seen some yield change?

Bull: Yes they have. Prime City Office yields are now 4.00%, down from 4.25%. And of course there is everyone's current favourite tipple...industrial properties. This is where the biggest change has been over the last nine months. Prime yields for Greater London Industrial Estates are now 4.50%. That's 50 basis points lower than they were at the start of the year.

Bear: Did you just say 4.50% for an industrial estate in Greater London?

Bull: Yes I did. 4.50% but with an expectation that they could be even lower by the end of this year. For the first time ever, reflecting stronger rental growth prospects and ongoing structural change in shopping patterns, the rolling annual average transaction yield for industrial is lower than for retail, at 5.80% and 6.09% respectively.

Bear: I don't believe it!

Bull: It's true. How many example transactions do you want me to list out? Capita Industrial bought Wates Way Industrial Estate in Mitcham, South London over the summer. They paid £20.5m, equating to a net initial yield of 3.80%. Boundary Park in Hemel Hempstead was sold by to a Cambridge College for £14.10m (4.31% NIY). I could go on.

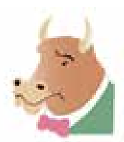
Bear: But what on earth is driving this level of pricing? I know that we predicted industrials would be the best performing commercial asset class in 2017, but not even you Bull would have envisaged this level of pricing, would you?

Bull: You're probably right Bear, but there's a perfect storm out there. Strong occupier demand is resulting in rising rents and it looks as though this trend will continue. There are also constraints to new supply, whether it be rising construction costs or competition for land from alternative uses. And of course there's a huge weight of capital looking for a home at a time when there is limited stock to buy. Throw all this into the pot and it's no wonder industrials have performed really well.

Bear: Relatively speaking.

Bull: Of course, but standard industrial and distribution warehouses continue to seriously out-perform MSCI's index, with 3.9% and 3.3% annual rental growth, and 8.8% and 7% annual capital growth, respectively.

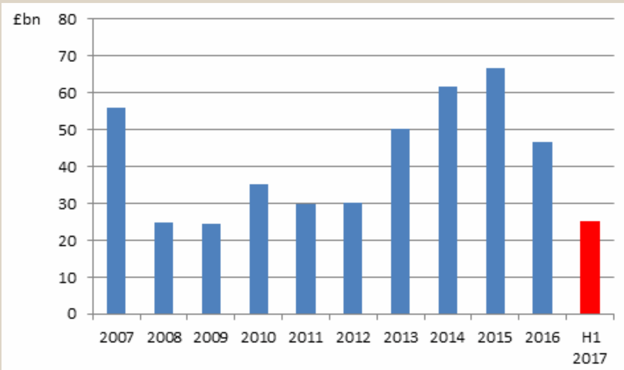
Bear: Well it sounds like we'll get our industrial performance prediction right then. But what about our prediction that 2017 investment volumes would better those of 2016? All I keep hearing about is a lack of stock to buy. Plus, of course, we had the small matter of a General Election to act as a handbrake on volumes.



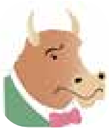
Bull: It's quite difficult to say as so much of the year's trading is done in Quarter 4. But if you take the investment volume figures up to the end of June 2017, just over £25bn had been traded. The first half of 2016 saw investment volumes of £21.68bn. So the signs are encouraging that we will be proved right. There was also very little sign of the traditional summer lull this year. £4.1bn worth of commercial property deals were completed in August.

Bear: That's encouraging to hear, although I suspect the Cheesegrater and Walkie-Talkie deals have helped. These two landmark skyscrapers both sold to Chinese buyers for more than £1bn each.

UK Investment Volumes 2007 – 2017



Source: LSH, Property Data, Property Archive



Bull: Of course they will have helped, but despite an element of uncertainty still remaining in the market, there remains a substantial weight of money looking for UK property, from both domestic and overseas buyers alike.

Bear: Well, from what I've read recently, the tap has been well and truly turned off in China.

Bull: What makes you say that?

Bear: Have you had your head buried in the sand all summer? Back in August, as part of their ongoing efforts to regulate overseas investments by Chinese companies, China's State Council published a set of investment guidelines providing the most clarity on outbound investments since late 2016 when they first started clamping down on so-called "irrational" or "non-genuine" investments. Property now sits in the restricted bracket, alongside investments in hotels, film studios, entertainment and sports clubs.

Bull: Oh yes. I remember. But if the previous measures implemented by the Chinese authorities are anything to go by, the impact could be pretty immaterial.

Bear: Why do you say that?

Bull: Well, according to Real Capital Analytics, buyers from mainland China have comprised only 1% of volumes so far this year.

Bear: So perhaps the more relevant question is whether these tighter controls will filter through to impact on Hong Kong investors, given they have made up 31% of this year's market?

Bull: Indeed. It's probably too early to tell although I did read recently that a Hong Kong billionaire has just acquired Aldwych House in London's Midtown for around £250m. Hong Kong investors still seem to be highly acquisitive. What I do know though is that there are still far more buyers than sellers at present and London currently looks comparatively cheap for the overseas investors.

Hong Kong and Chinese Investment in London's Commercial Property Market

Source: Real Capital Analytics

Bear: Sorry? London. Cheap? They were two words that I didn't expect to hear in the same sentence ever again. Come again Bull.

Bull: I know it sounds strange but despite the record prices currently being paid here, the UK is actually not as expensive as many of the other global cities. For example, prime office yields in some of the world's largest cities are considerably lower than London - Munich, Paris, Hong Kong and Tokyo are all significantly keener for example. Only New York of the major global cities at 4.75% currently offers a higher prime office yield than London.

Global Cities Prime Property Yields

City	Prime Office Yields % pa
London (City)	4.00
Hong Kong	2.75
Munich	3.00
Paris	3.00
Zurich	3.00
Madrid	3.25
Tokyo	3.25
New York	4.75

Source: Knight Frank/ Savills

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Bear: And I suppose you are going to mention the impact of currency?

Bull: You beat me to it. I know it has been pedalled out a lot recently, but the impact of currency has been significant. The cold reality is that sterling's battering has been really helpful for new overseas investors. Over the last 15 months, sterling has fallen 7.5% against the US dollar, 13% against the Euro and 7.8% against the Chinese RMB. Sterling's depreciation has undoubtedly acted as a driver for overseas investors when it comes to making their investment decisions.

The Devaluation of Sterling Since June 2016

£1	21 June 2016	21 September 2017	Change %
$US	1.46	1.35	(7.5%)
€	1.30	1.13	(13.0%)
CBY	9.66	8.90	(7.8%)

Source: www.xe.com

Bear: And I suppose London remains a 'safe-haven' despite what Brexit might entail. This, coupled with the depth, liquidity and transparency of the market, means London will remain extremely attractive destination for overseas investors going forward.

Bull: Absolutely. Irrespective of what David Davis and his team finally negotiate, this is not going to change. I am, however, slightly worried about the fact that prime office rents in the West End have fallen for three consecutive quarters and rents have also been marked down in the City. The investment market could be in for a bit of a bumpy ride, especially if Brexit negotiations continue to go as badly as they appear to have gone so far.

Bull: I think the fact that approximately £38bn is reportedly targeting London office investments at present says it all though, doesn't it?

Bear: Probably. But what about domestic investors? Have they been active this year? I've read a lot recently about the emergence of the Local Authorities and how they have been taking advantage of cheap and flexible funding from the UK Treasury to buy commercial properties all over the country.

Bull: That's right. They have been one of the big news stories over the last twelve months or so. And they continue to be acquisitive, especially in the context of the last couple of years.

Bear: What do you mean by that?

Bull: Local authorities invested £142m in UK property in 2015, equating to 0.6% of the whole market. In 2016 they invested £1.3bn. That equated to a whopping 815% increase. According to *The Times,* £878 million was invested in the first five months of 2017, suggesting a full year figure approaching £2.1 billion!

Bear: Blimey. What have they been buying?

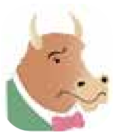
Bull: It really varies. All sectors, all lot sizes, all locations. One of the most recent acquisitions was Warrington Borough Council buying Birchwood Park for £200m!

Bear: Wow. But the rumours I've heard are that they have been over-paying for properties, inflating the investment market. What did Baroness Wheatcroft say again? Something along the lines of being prepared to believe that local authorities know a lot about social housing, but not being convinced that they had any knowledge of the Mercedes showrooms or ferry terminals that they have been buying. Ouch! It all sounds very risky to me.

Local Authority Commercial Property Investment Volumes in 2016

Most Active Councils	Volumes
Spelthorne	£394m
Surrey Heath	£104m
Canterbury	£80m
Portsmouth	£78m
Stockport	£75m
Others	£569m
Total	£1.3bn

Source: Savills



Bull: There are risks, of course there are. Given that most of the property acquisitions being made by these Local Authorities have been 100% debt-funded, the councils, and ultimately the UK Treasury, are exposed to immediate losses should property values fall. Time will tell if their current buying spree ends in tears, but given the arbitrage they are enjoying and the need for them to raise money to deliver essential local services, it's not hard to see why they are investing in property so heavily at present.

Bear: I suppose so, and I particularly like the idea of the Local Authorities investing in their own area. Whilst many have declared that they will buy anything and anywhere, Leeds City Council, for example, announced that they will only looks at buying properties in Leeds.

Bull: What's their thinking behind that?

Bear: They really want to be the catalyst in stimulating their local economy. Their strategy also makes sense because in addition to generating income from the yield arbitrage, from 2020, councils will keep 100% of local business taxes, compared with just 50% now. Local councils are therefore incentivised to promote growth and development in their areas to expand their business tax base.

Bull: That does sound sensible, as long as they pay the right prices!

Bear: Totally agreed. Anyway, what about the UK institutions? In January we forecast that UK property would deliver a total return of 2.5% in 2017. The institutions need a better return than that so I assume they are looking elsewhere for their returns?

Bull: You are quite right. UK institutions are persistently searching for sustainable, inflation-proofed returns but understandably they are finding these returns hard to secure across all the asset types. However from an income perspective, property remains attractive. In 2016 property delivered an income return of 4.90%. Government bonds are still currently hovering between 1.00%-1.50%, more than 300bps below the property income return, whilst we all know how little cash offers at present.

Relative Income Returns

Asset Type	Income Return (% pa)	Margin to Property (% pa)
All Property Income Return	4.90	-
10 Year Government Bond	1.30	3.60
UK Base Rate	0.25	4.65
FTSE All Share Dividend Yield	3.46	1.44

Source: FT, IPD

Bear: Fair enough. But where is the perceived value in the UK property market for the domestic institutions at present?

Bull: Industrials, plus alternative sectors such as student accommodation and healthcare.

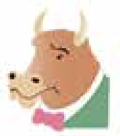
Bear: That's good news. Are the alternative sectors continuing to increase in popularity, just as we predicted back in January?

Bull: Absolutely. At £2.2bn in Q2 2017, the alternative sectors recorded their highest quarterly volume since Q2 2015. Half of this was student accommodation, including Liberty Living's £460m purchase of the Union State portfolio.

Bear: It's entirely understandable though, isn't it? Quite rightly investors are focusing on assets that derive returns from domestic population growth, urbanisation and demographic change. It's also good to see the private rented sector finally starting to see some significant institutional investment…and not just in London.

Bull: Indeed. Another area of strong focus from the UK institutions is the long-dated, strong covenant, income-backed assets. It is hardly surprising that these assets, with long-term predictable and stable cash flows, have been so in demand of late.

Bear: So are the institutions not looking at value-add then?



Bull: Some are, especially those properties offering genuine asset-management angles. Not just through expected rental growth or clever lease renewals but through refurbishments, extensions development etc. Location remains key though.

Bear: Okay. So where does this leave us for the rest of 2017? And please don't say 'Keep Calm and Carry On'!

Bull: Well, I think the one property prediction we are likely to end up getting wrong is our Total Return forecast. According to the most recent IPF Consensus Forecast, UK commercial property is now expected to deliver 6.7% in 2017.

Total Return Forecasts - September 2017

	2017 Total Return (%)	2018 Total Return (%)	2017-2021 Total Return (%)
IPF Consensus	6.7 (4.8)	4.1 (4.1)	5.4 (5.2)
IPF Maximum	8.5 (7.5)	7.8 (6.1)	8.2 (7.3)
IPF Minimum	3.5 (0.6)	0.2 (-0.7)	2.8 (3.1)

Source: IPF. Forecasts in brackets are May 2017 comparisons.

Bear: But I bet the quid pro quo to this increased optimism is a lowering of expectations in 2018 and beyond.

Bull: You are so annoying Bear…but I hate to admit you are right. Whilst the 2018 forecast average total return is virtually unchanged at 4.1%, the 2019 forecast has fallen to 4.6% from 4.9% last quarter, having been 5.8% at the start of the year. Total returns projections for 2020 and 2021 have also reduced over the last three months. Even so, the five year consensus forecast at 5.4% looks pretty creditable.

Bear: So if you had to sum up how you expect the rest of 2017 to play out in exactly twenty words, what would you say?

Bull: "More of the same. More buyers than sellers. Limited stock. Aggressive pricing for prime assets. Occupational demand to hold up". That's twenty words!

Bear: You are so annoying…especially when I have to agree with almost every word you said.

Bull: On that note then, let's call it a day and reconvene in January to see how we ultimately faired with our predictions for 2017 and to discuss what lies ahead in 2018.

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