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Letter from America

April 2015

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Now that Spring is in the air, we are starting to see signs of the US core investment markets bouncing back to life. We, at St Bride's Managers US, are still very much in buying mode and (but don't tell anyone), our top-tip is city center retail.

Richard Saunders

I have been living in Connecticut and working in New York now for nearly 25 years but it was only on a recent trip to see my parents in Eastbourne that we finally came to terms with the fact that the UK and the US seem destined to remain an ocean apart in both language and perspective.

By way of an example… the vigorous coaching imposed on the "Brit" James Corden for his role as anchorman for The Late Late Show in the US. CBS insisted that he learnt American and cautioned him on using words such as ***squiffy*** and ***knackered*** which are not really understood on this side of the Atlantic. Going the other way, it is the case with real estate jargon too, with expressions such as *estoppels*, *eminent domain* and *condominium ownership* which leave the British chartered surveyor all befuddled.

My second wake-up call came from an English businessman who expressed his concern at the current strength of the GBP v the Euro. Come on, Man!! Apologies, I mean wakey, wakey old chap. Where is your perspective?

It's not about the pound. It's all about the dollar and its impact on interest rates. After all, it has gained 22% in the past 12 months against a basket of major currencies. In this regard, the currency markets were more volatile than usual in March in response to the Fed's statement that they had dropped the word ***patient*** from its policy statement. Immediately afterwards, Ms Yellen announced that that did not mean they would be impatient.

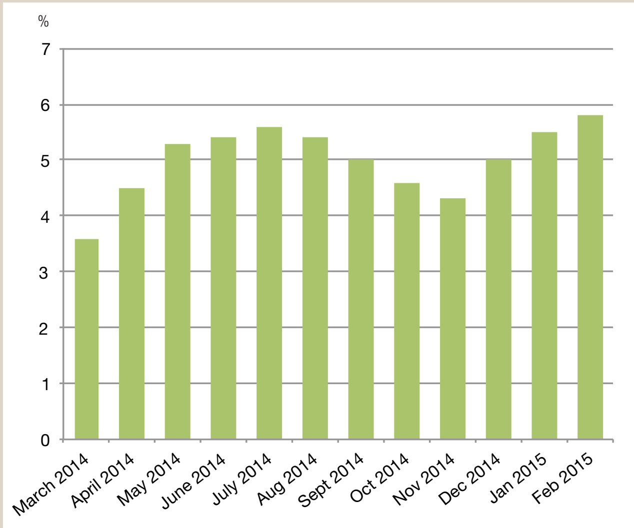
In my view, the Fed will end up being forced to remain patient throughout the balance of the year. And meanwhile, talk of even lower rates in the UK, Denmark, the Eurozone and Japan will inevitably continue to boost the dollar further without the US even lifting a finger.

The impacts are the usual suspects… a) the cost of American exports will become more expensive, b) companies who draw on overseas' earnings will see profits falter and c) US tourism will fall.

The hawks meanwhile point to a plummeting unemployment rate and the assumption that consumer spending must have been helped by the billions of dollars saved from lower gas prices. The latter is seen as having a particularly significant impact in a country where something like 70% of the GDP is driven by consumer spending. The argument continues that this must all be good for the US economy and in turn will drive inflation upwards to the Fed's medium term goal of 2%, a figure not reached for the last 34 months and which is currently at 1.4%.

There are more than just a few problems which are converging to highlight the fragile confidence of the US consumer. The first is that wage growth is at a standstill; secondly, housing starts are down; thirdly manufacturing growth is at its slowest in two years and fourthly, especially if the last three months' figures are anything to go by, retail sales on a year-on-year basis are falling! It all adds up to consumers looking to save, not spend. And as the chart below illustrates, the savings rate rose to 5.8% in February, the highest level since December 2012. Not illustrated is that households are also using savings to pay down debt.

US Savings Rates



Source: U.S. Bureau of Economic Analysis

Already this year, the US economy is showing ominous signs of faltering. Growth in Q^4 2014 was revised downwards from 2.6% to 2.2% and do not be surprised if economic growth in Q^1 2015 is less than half this rate. And rising interest rates, with an accompanying stronger dollar, will only accentuate our problems. So in my book, until Europe, Japan and the UK show signs of raising their interest rates, why should we?

The markets (sort of) agree. They are showing a less than a 50:50 chance of interest rates rising by September. And if not by then, well let's not forget that we have Halloween, Thanksgiving, Black Friday and the Christmas Holidays all following on in quick succession. Are we really going to want to slow down consumer spending at the height of the spending season? I don't think so. So in my view, this means there is only a 50:50 chance of interest rates rising before 2016.

If I am correct, this would be positive for property. Yields on prime leased properties in the US are currently between 4.00%-4.50% in the major cities for the main asset types. And this provides a handsome yield gap to 10 Year Treasuries, the Dow Jones Index and the S&P 500, all of which are hovering around 2.00%.

On top of this, and not a moment too soon in my book, total return hurdle rates have become much more realistic too. Target Core unlevered returns are now typically 6-7%; Core Plus/Value Add returns are 8-10%; and for taking risk associated with high vacancy and construction, target returns of 12-15% are the new 20%.

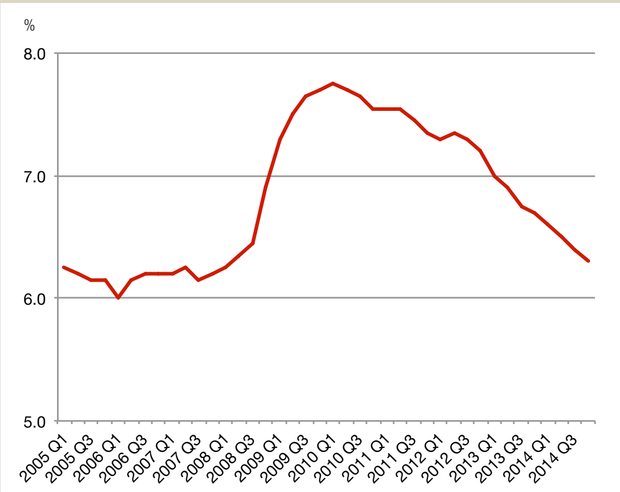
Of course, just as in the UK, the make-up of the total return expectation will vary depending on the type of investor. Some will want more income than capital and some will want the exact opposite.

So back to patience/impatience. Was it impatience that lost England the 6 Nations' Championship? You see, we can have a view now as we can watch the games stateside. We enjoyed the many references to basketball which followed the final score which prompted the question again about perspective and language. The approach was repeated when the New York Times started covering the Cricket World Cup all wrapped up in a way we could understand with analogies to baseball.

This, in turn, has gotten (even I dislike that word) me thinking about how many sportspeople might be competing in US sports from the countries where St Bride's and our Alliance members have offices. Perhaps to our collective surprise, Spain and Australia deke (I will leave you to check exactly what that means) it out at the top. Spain has five players in the NBA with Pau and Marc Gasol arguably the best known, who play for the Chicago Bulls and Memphis Grizzlies respectively.

Australia's highest paid sports star is Andrew Bogut who plays basketball for the Golden State Warriors while a further three of their top 10 earning sports people play basketball or baseball in the US. This pips the UK who will give us Frank Lampard and Stephen Gerrard in the next few months for our soccer. Whoops! I mean football.

US Retail Vacancy Rates



Source: CoStar Group Inc,; PPR; Pension Real Estate Association

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Richard Saunders

Curiosity Corner

- The shape of the US real estate market is being driven by two particular age cohorts, the 20-30 year olds and the baby boomers (55 years plus). Together they represent 54% of the population.
- Both are demanding hip, entertainment-driven, urban living environments.
- In chasing the demographics, retailers now want city center sites as fast as they can get them… but (surprise, surprise) there is a woeful shortage of space. It is our top tip for investment.
- Office vacancy rates remain stubbornly high at about 17.5% in Washington DC, just over 16% in both Chicago and Los Angeles, 14.5% or so in Boston, close to 10% in New York, and just under 10% in San Francisco. We generally consider markets to be in equilibrium at about 10%.
- Office floor plates are getting even larger and individual space allocations have been driven down from 1/400 sq ft in 1985 to 1/165 sq ft today. They are forecast to fall to 1/135 sq ft in the next few years.
- According to JLL, law firms downsized by 17% last year and other sectors are likely to follow suit. This will affect take-up volumes and impact on rental growth.
- Our contrarian investment option is the DC office market. Cap rates/ yields are 1.00-1.25% higher than in our six other World Cities in the US and DC has one of the fastest population growths amongst Millennials in the country.
- And is there still value to be found here? You bet. After all… We are the Big Country and the Land of Opportunity. There are always deals to do… even little ones like merging Heinz and Kraft.

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