



Fundamentals:

Commercial property: the return of rental growth



Commercial property rents are rising, buoyed by stronger tenant demand and a shrinking supply of space. This is taking over from yield compression as the key source of capital growth.



Commercial property prices have risen nearly 20% since the start of 2014. But the pace of growth

has slowed in recent months. In this edition of Fundamentals, Rob Martin, Research Director, LGIM Real Assets, looks at what is driving the market and how conditions may evolve in the coming months.

OCCUPIERS EXPANDING

Demand for commercial property space from tenants is tightly linked to developments in the wider economy. Business expansion and job creation creates the demand for more and better space. **Figure 1** demonstrates how the demand for office and logistics space (two of the major constituents of the market) has fared in recent years. While take-up (the

volume of space leased by tenants) improved in the period to 2007, the Global Financial Crisis (GFC) led to a sharp drop in GDP and a contraction in occupier demand. The market impact was exacerbated by occupiers releasing surplus space to the market. While there was a bounce in take-up in 2010, the euro zone crisis weighed heavily on business confidence and take-up fell back once more in 2011-12. More recently, there has been a progressive improvement in the volume of space being leased by companies. While this has not permeated the whole market to the same degree, and retailer space appetite in particular has remained relatively weak, this has marked a significant improvement in demand.

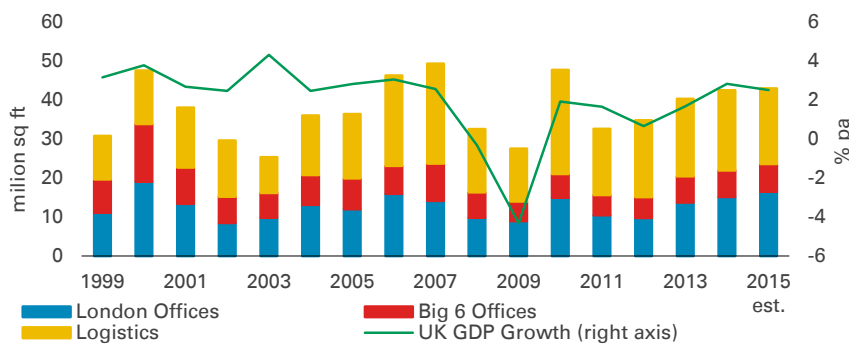
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Figure 1. Take-up



Note: Big 6 office markets are Manchester, Birmingham, Leeds, Glasgow, Edinburgh and Bristol

Source: Property Market Analysis LLP, UK National Statistics, LGIM

LIMITS ON SUPPLY

Conditions in the occupier markets have also been supported by changes on the supply side. Since the GFC, the overall volume of construction activity taking place has dropped sharply. Official data on construction orders show that activity in the five years to Q2 2015 was the weakest for 30 years (**Figure 2**). Not only have new buildings not been built but the existing stock of buildings is also increasingly suffering from underinvestment, meaning it is less suitable for modern occupier requirements.

Another factor which has become increasingly important is the pressure on commercial property supply from the conversion of space to other uses. A recent report prepared by CBRE for the British Council for Offices estimated that around six million square feet of office space in England had been converted from office to residential use in 2014 under Permitted Development Rights, which remove the need for planning permission; this is broadly equivalent to the entire office stock of Oxford. Proposals have recently been announced to extend these rights more broadly to include the conversion of industrial buildings and to allow the demolition of

redundant buildings. This is a useful ingredient in boosting housing supply but clearly has a corresponding effect in reducing the supply of commercial property.

RISING RENTS

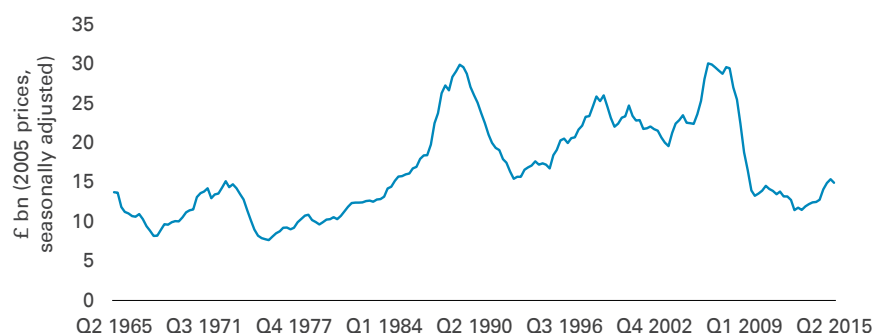
The combination of stronger demand and shrinking supply has helped to rebalance market conditions. Since peaking in mid-2010, the volume of available (i.e. vacant) office and industrial space across the UK has fallen by 28%. The situation is more pronounced for the best quality space; as rents fell during the GFC and afterwards, a number of tenants took the opportunity to upgrade to newer buildings. With so little construction in recent years, the availability of new buildings has fallen sharply. In Birmingham for instance, the available volume of new office space has more than halved

(-55%) since 2009.

Conditions have generally been weaker in the retail sector. With the exception of London, modest consumer spending growth and the structural changes in the way people shop have led many retailers to reappraise their business models and shrink the volume of space they occupy. The result has been a relatively high overall vacancy rate that has been little changed since peaking in 2013. While the vacancy rate for 'prime' units in town centres has come down substantially, we maintain our view that stock selection in the retail sector is critical to rental prospects. The themes we focus on heavily are to target locations which benefit from the long-term shift to leisure spending e.g. family restaurants, cinemas etc. and those in which retailers are still able to trade profitably.

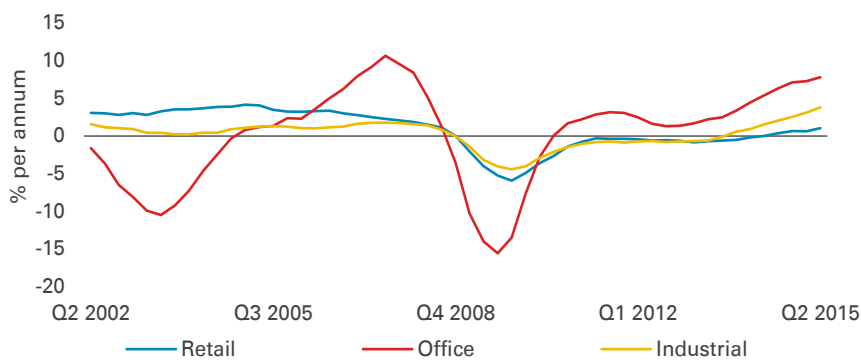
These trends are manifesting themselves in the rates of rental growth being achieved. Office rental growth has strengthened significantly over the past 18-24 months and industrial property is also now achieving healthy rates of growth (**Figure 3**). Conversely, retail rents have largely remained unchanged. At the same time, rental growth has started to spread beyond London; while

Figure 2. UK Commercial Property Construction Orders



Source: UK National Statistics

Figure 3. Rental growth



Source: MSCI (IPD Quarterly Index)

rents in London were up by 9% in the year to Q2 2015, rents outside the capital grew by 2% and are trending upward.

Our projection is for rents to continue to grow over the coming three years. Across the sectors, LGIM is expecting growth to average 2.8% annually from 2016-18, nearly double the rate experienced over the past 5 years (1.5% pa). We see growth continuing to be strongest for the office and industrial sectors; while there is likely to be some recovery for retail rents, we expect this to be relatively muted.

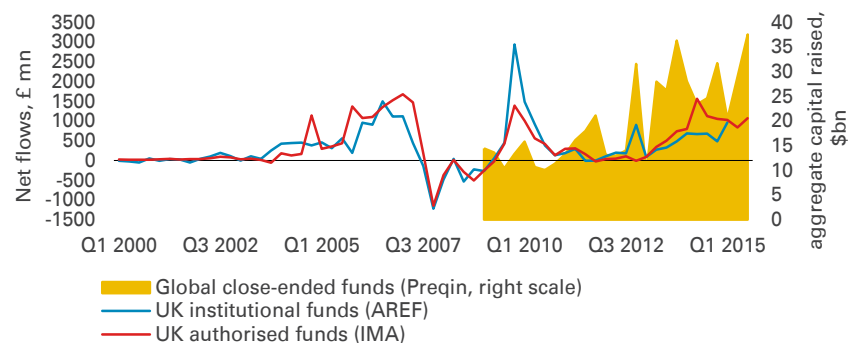
MARKET MOOD SWINGS

While the occupier markets are in increasingly good shape, sentiment among a number of investors has become more measured over the summer and the market has seen a more even balance of buyers and sellers since the start of the summer. Anecdotally, a number of open-ended property funds serving UK clients have seen smaller net inflows, coinciding with a number of early cycle purchasers meeting their return targets and bringing stock to the market. The result has been a slowdown in the rate of yield compression. While valuation yields as measured by the IPD monthly index have

continued to fall as recent deal information is incorporated by appraisers, the more timely CBRE 'benchmark' yields have been unchanged since May 2015.

How should we interpret this? Does it presage a reversal in yields, which would drag on property prices? Let's start with capital flows. While the data readings for UK funds focused on institutional clients are published with a considerable lag, the more timely data for authorised funds do not point to a sharp slowdown in flows (Figure 4). At a global level, if anything the underlying trend has been towards greater levels of fundraising. While these close-ended fund data readings are likely to reflect higher risk / return strategies, it is consistent with LGIM's experience that there remains a large volume of capital seeking exposure to property.

Figure 4. Property Capital Flows



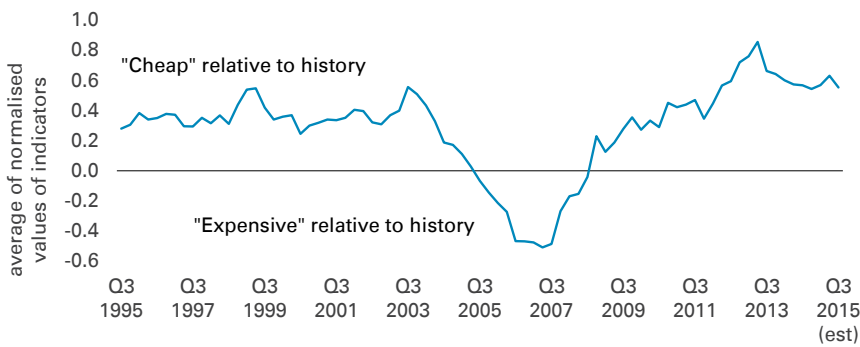
Source: Investment Management Association (IMA), Association of Real Estate Funds (AREF), Prequin

VALUATIONS

Broader risk asset markets have been volatile over the summer. What implications does this have for property? The most obvious impact is that the pricing of different asset classes has shifted. Equity and credit prices have fallen, with a resultant upward movement in yields. That rise has put some downward pressure on the yield arbitrage from property. We include these and a number of other metrics in a composite basket of indicators against which to judge the relative value of property. While that composite has weakened somewhat as a result of the recent volatility, the absolute position remains above average (Figure 5).

What is not in doubt is that in absolute terms, property yields are below long-term averages, as are those for many other asset classes. What explains this is the exceptionally low interest rate environment. A lot of attention is focusing on the precise timing of the lift-off in US Federal Reserve rates and any corresponding move by the Bank of England. Given the longer horizons over which property investments are underwritten, we focus more on the overall pace of tightening and

Figure 5. Composite Relative Value Measure



Source: CBRE, Thomson Reuters, LGIM

the level to which rates are likely to move in the longer term.

The Bank of England has consistently signalled that the pace of tightening will be gradual and dependent on economic data. More fundamentally, the level to which rates will return in the long term is likely to be lower than historic averages. The Bank has indicated that whereas the 'neutral' level of policy rates may have been 5% in the past, this may now be closer to 3%. Market expectations are consistent with a very muted interest rate cycle (figure 6). LGIM's analysis of trends in property rental growth and depreciation indicates that UK property yields are now broadly in line with fair value if one assumes policy rates at 3% (not their current 0.5%). While such calculations are inevitably uncertain, they imply that property yields can absorb the amount of rate normalisation that is likely to be the central case for many investors.

BRINGING IT ALL TOGETHER

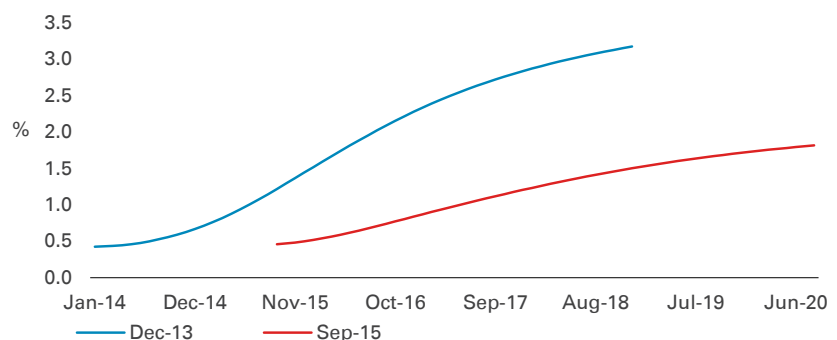
We are sketching a picture of a more balanced property investment market. Yields are now consistent with the level we would see them at once rates have normalised and without the expectation of above average

rental growth. That puts the focus of return generation on yield and rental growth, the fundamentals drivers of property return. Property has long been subject to boom and bust. If anything, we interpret the recent moderation in transactional activity as a positive, as it reduces the potential for momentum to propel the market into overvaluation and eventual correction.

Within the market, there are some fascinating trends emerging. The structural pressures on retailing are forcing a range of locations to redefine their function or risk becoming obsolete. The restructuring of the retail supply chain is creating demand for new, state-of-the-art logistics facilities. Within the business space sectors, the progressive concentration of growth and employment into a smaller

number of cities is creating opportunities, as is the potential for renewed and expanded transport infrastructure to rewrite the UK's economic geography. Lastly, there is the potential for rented residential property, be it student accommodation, general needs housing or retirement housing, to form a material share of UK institutional investor allocations to property. The recent phase of supernormal returns in property appears to be behind us. Going forward, returns will be founded more on economic than financial drivers.

Figure 6. Market Short-term Interest Rate Expectations (OIS swap curve)



Source: Bank of England, Thomson Reuters

Market overview:

Global risk appetite returns

Global investment markets staged a recovery in October. Having suffered their most significant falls for four years over the summer, most risk assets delivered strong gains during the month. Investors became more sanguine following promises of greater stimulus from around the world, most notably in China and Europe. Emerging market assets were the primary beneficiaries of this improvement in sentiment, but returns were also strong across equity and credit investments in developed markets. In a similar vein, commodity prices rebounded somewhat, although low inflation and unemployment rates continued to provide a strong tailwind for global consumers. UK and US government bonds were the only major asset class to see negative returns, although European bond prices remained firm.

UK

Chinese state visit takes the limelight

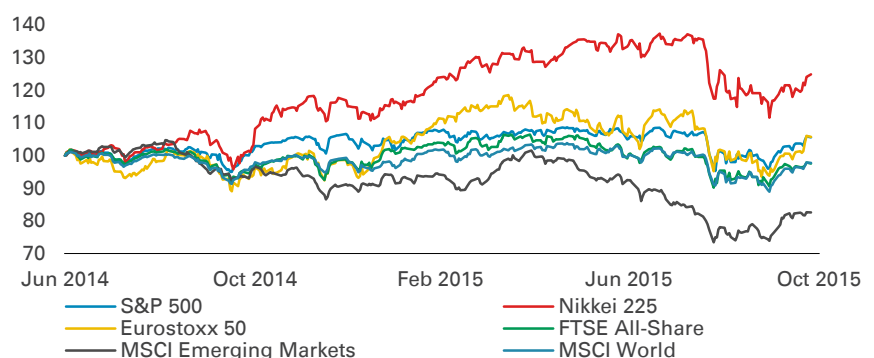
The state visit of Chinese Premier Xi Jinping to the UK made headlines over the month, and Chancellor George Osborne continued to promote stronger financial ties with the world's second largest economy. Domestic economic data readings over the month were somewhat weaker than expected, with growth for the third quarter of the year falling to 0.5%, having been 0.7% in the second quarter. The slowdown was driven by lower growth in the construction sector and outright contraction in the manufacturing sector. However, the consumer remained at the heart of the UK economic recovery, with the combination of low unemployment and low inflation feeding through into higher real domestic wages.

US

Investor focus returns to timing of Fed tightening

Having been expected to raise rates as recently as early August, the Federal Reserve ultimately kept short-term borrowing costs unchanged at their September meeting. However, with fears over emerging market growth easing, talk of the first US rate hike returned in October. In addition, core consumer prices (which do not include food and energy) rose by 0.2% over the month, which was more than had been expected, even if overall price levels fell given a continued drop in gasoline prices. Boosted by lower prices at the pump, the picture for the domestic US consumer remained robust and US homebuilder confidence moved to a 10-year high.

Figure 1. Global equity markets



Source: Bloomberg L.P. chart shows price index performance in local currency terms

EUROPE

Draghi reiterates dovish mantra

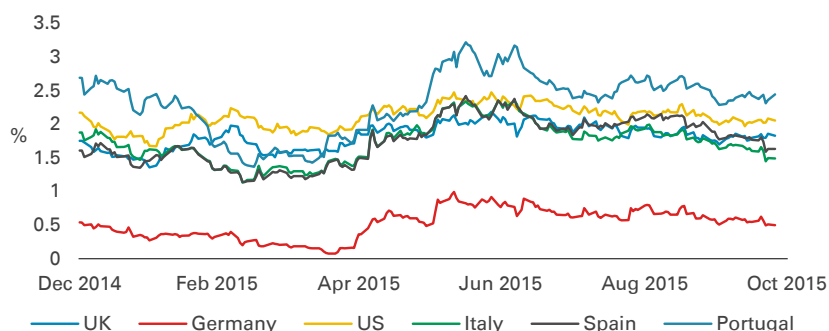
With overall European price levels registering slight falls over the month, European Central Bank head Mario Draghi reiterated his statement that he would do “whatever it takes” to promote continued stability in Europe, both in terms of price levels and overall economic growth. This prompted renewed speculation that an increase in the current rate of euro zone quantitative easing was likely before the end of the year. Having been slowly gaining ground against the US dollar since the first quarter of the year, the euro weakened sharply in response. From a political perspective the major news over the month was the election of a Conservative majority in Poland, while Catalonia made further strides towards independence in regional elections.

JAPAN

Weak data spurs stimulus hopes

Growth and inflation in the Japanese economy remained subdued, leading to speculation that the Bank of Japan will increase the level of stimulus being applied to the economy. However, with the effectiveness of the Prime Minister’s policy of monetary stimulus now being called into question – a 30% decline in the yen has failed to result in lasting consumer price inflation – investor focus moved to the issue of fiscal stimulus as the best future means of promoting growth and lifting the country out of deflation.

Figure 2. 10-year government bond yields



Source: Bloomberg L.P.

ASIA PACIFIC/EMEA

Chinese central banks cuts interest rates

Asian and emerging markets led the rebound in risk assets in October following China’s unexpected decision to cut interest rates as the country looks to manage their economic slowdown. The Chinese authorities also reduced the reserve requirement for banks in a bid to boost domestic liquidity. China’s growth for Q3 was announced at 6.9% although the headline figure was driven by a robust consumer sector, while the manufacturing sector and fixed asset investment both remained weak. The Chinese property market was a bright spot, with prices rising in the majority of provinces.

FIXED INCOME

Divergent government bond performance

Having returned to favour in unison over the summer months as greater risk aversion drove investors into safe haven assets, government bond prices diverged in October. UK and US government bonds weakened modestly, while European bond prices remained firm. Gilts and treasuries saw selling pressure as continued domestic

economic strength put investor focus back on the timing of interest rate hikes, with yields rising accordingly. Strength in European government bonds was driven by the dovish statement from Mario Draghi, and peripheral bonds – most notable Spain and Italy – outperformed core German bunds.

FIXED INCOME

Credit spreads move tighter

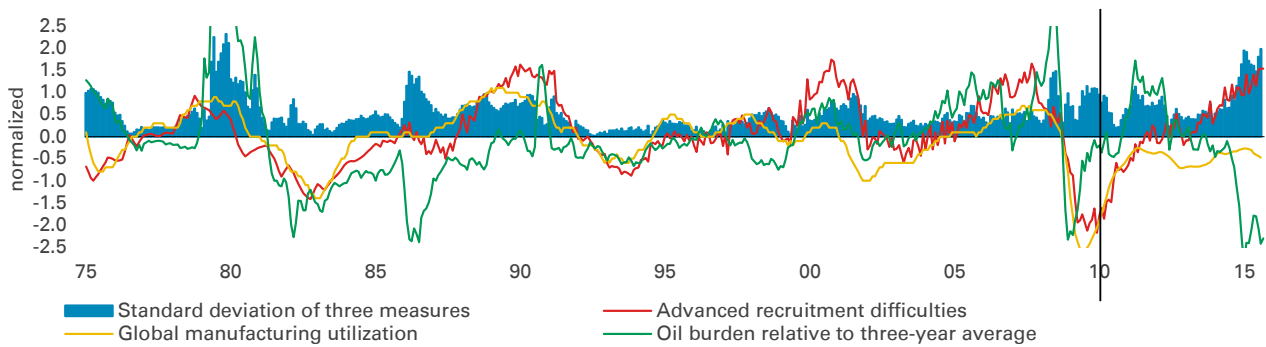
Following the sharp widening in spreads over government bonds during the summer months, credit markets staged a recovery in October. This was driven by three main factors. First, global growth fears started to fade and commodity prices moved higher. Second, central banks across the globe kept short-term interest rates on hold. Third, issuance levels in the corporate sector remained relatively contained, with companies having already issued a significant amount of debt over the summer months in the anticipation that interest rates would rise.

Snapshot:

Play your cards right

In Bruce Forsyth's hit TV show "Play your cards right", contestants had to predict whether the next card would be higher or lower. As investors, we need to predict the next move in inflation – higher or lower – and how central bankers will respond to it. Uncertainty about the inflation outlook is arguably the highest today since 1979. This is because different drivers of core inflation are heading in different directions.

Figure 1. Drivers of our core inflation model are moving in different directions



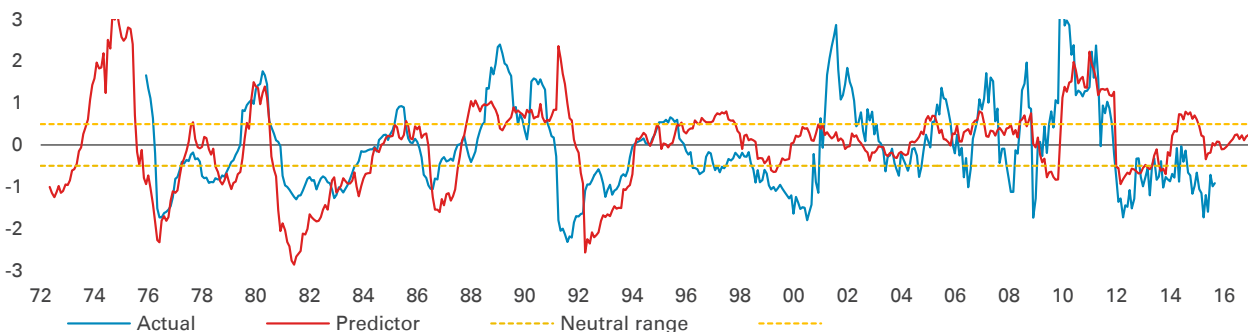
Source: Macrobond, LGIM estimates, EViews

Unemployment has fallen surprisingly fast in advanced economies in recent years, helped by ageing populations. So firms' recruitment difficulties are at elevated levels. Historically, this has led to higher wages and prices. However, thanks to overinvestment in China, global manufacturing capacity utilisation rates remain below average, and have fallen further in recent months, putting downward pressure on goods prices. On top of this, commodity prices have collapsed, due to a revolution in US oil production and weaker Chinese demand. The divergence between these three core inflation drivers is the highest in 36 years (**Figure 1**).

On top of this, we've had large currency swings. The dollar and the pound have been strong, while the euro and the yen have been weak. This makes the current environment unusually difficult for policymakers and investors when it comes to forecasting inflation.

Let's take the UK for example. Assuming the oil price stabilises at \$50, headline inflation is expected to converge with core inflation in 2016 as the large drop in petrol prices falls out. But it is possible that there are further, 'second-round' effects from cheaper commodity and import prices still to come. If core inflation remains subdued at around 1%, then overall inflation will remain well below the Bank of England's 2% target, leaving them in no rush to raise rates (**Figure 2**).

Figure 2. Our UK core inflation predictor is dipping down in 2016 due to falling import prices



Source: Macrobond, LGIM estimates, EViews

This makes us even more positive on the UK consumer outlook. Given tight labour market conditions, a longer period of low inflation and interest rates will boost households' purchasing power. Low conviction on interest rates and high conviction on growth remains our central view on the UK economy (see 'Beyond Goldilocks', Fundamentals February 2015).

UK forecast:**In for a pounding?**

UK economy	Price inflation (CPI)		GDP (growth)		10-year gilt yields		Base rates		\$/£		£/€		
	2015 %	2016 %	2015 %	2016 %	2015 %	2016** %	2015 %	2016* %	2015	2016**	2015	2016**	
Market participants' forecasts													
High	1.10	2.00	2.80	3.00	2.25	2.80	0.50	1.00	1.59	1.76	0.77	0.79	
Low	0.00	0.00	2.30	1.50	1.80	1.80	0.50	0.50	1.44	1.38	0.66	0.65	
Median	0.10	1.30	2.50	2.40	2.02	2.35	0.50	0.75	1.54	1.54	0.72	0.70	
Last month median	0.20	1.50	2.60	2.40	2.15	2.58	0.50	1.25	1.54	1.52	0.70	0.69	
Legal & General Investment Management	0.10	1.20	2.50	2.40	2.10	2.65	0.50	1.00	n/a	n/a	n/a	n/a	

Source: Bloomberg L.P. and LGIM estimates

*Forecasts are for end of Q2 2016

**Forecast for end of 2016

"You work in the City? I'm going on holiday next month – should I get my dollars / euros now or later?". It's a question commonly asked of any market commentator*.

Forecasting short-term currency moves is notoriously difficult – but having a medium-term view on sterling vs the US dollar plays a key part in our portfolio hedging strategies. We look at a variety of factors: growth, inflation and interest rates as well as valuations, current account balances and politics.

At a macro level, we look at consumer prices in the UK compared to those overseas, a measure usually referred to as purchasing power parity, or PPP. In the short term, this is a very poor indicator. But over three and five years it exerts a strong gravitational pull. We can see this on a historic basis: over the past 50 years, the UK has had higher inflation than other developed markets and sterling has therefore generally weakened. Sterling then collapsed in 2008 during the financial crisis – falling by far more than PPP suggested it should. This eventually fed through to the sterling rally over the last 18 months or so. So that 'oversold' tailwind has now disappeared.

External deficits also matter – namely the current account, which combines your trade balance (exports minus imports) with your investment income. The UK is running an enormous current account deficit of around 5% of GDP – the highest it's ever been. Investment income has been hit in recent years as the problems in the euro area and in commodity-related sectors have depressed the returns of UK assets held overseas. This is unlikely to recover swiftly while commodities remain under a cloud, and the trade deficit is likely to remain under pressure, not least because of the gains in the pound since 2013.

Finally back to that Economics 101 and interest rates. Irrespective of who raises rates first (and we believe it will be the Fed), we expect US rates to rise further. In part this is because of the UK's greater sensitivity to interest rates – a greater proportion of UK mortgages are variable than in the US, meaning rate rises bite much faster.

The combination of the lack of valuation support, a large current account deficit and a growing interest rate differential could prove toxic for sterling, suggesting that it could see a material fall against the US dollar over the next three years – particularly given heightened political uncertainties as the EU referendum approaches.

*The answer is naturally "Just don't buy it at the airport, the rates will be dreadful."

The forecasts above are taken from Bloomberg L.P. and represent the views of between 20–40 different market participants (depending on the economic variable). The 'high' and 'low' figures shown above represent the highest/lowest single forecast from the sample. The median number takes the middle estimate from the entire sample.

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