UK Real Estate update

The return of inflation?

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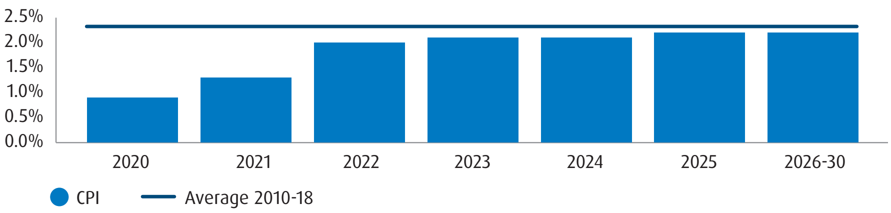
Inflation rates are currently low, but some commentators have expressed concern that the major easing in monetary policy now occurring, could re-ignite inflationary pressures in the future. Property can be seen as a hedge against inflation. Will this be the case in the coming years?

Inflation back on the agenda

It may seem perverse to be writing about inflation at a time when the annual CPI is 0.5% and consensus market forecasts, as indicated below, are for a prolonged period of below average inflation. There has been a dip into negative gilt rates and the economy, hit by lockdown, is predicted to see a recession this year.

UK CPI Consensus Forecasts – per cent per annum



Sources: Consensus Economics Jun-20, Apr-20, ONS

Key Risks

Our review and outlook is a marketing communication providing an overview of the recent economic and property market environment. It should not be considered as advice or a recommendation to buy, sell or hold investments. Nor is it investment research and has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of its dissemination.

The value of investments and income derived from them can go down as well as up as a result of market or currency movements and investors may not get back the original amount invested.

The value of directly held property reflects the opinion of valuers and is reviewed periodically. These assets can also be illiquid and significant or persistent redemptions may require the manager to sell properties at a lower market value adversely affecting the value of your investment.

In March 2020, a material uncertainty clause was imposed by valuers due to the impact of coronavirus on property performance.

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However, Central Banks across the globe have initiated a dramatic easing in monetary policy with indications that this will not be accompanied by fiscal austerity. So are conditions in place for a resurgence of inflation over the medium-term? A recent paper from the Institute of Economic Affairs (IEA)* has flagged the prospect.

The case for higher inflation

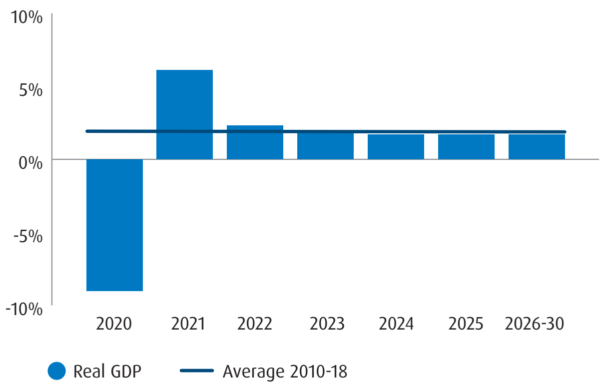
Consensus expectations are for inflation to edge higher, but Bank of England data shows the most hawkish external forecaster predicting only 2.5% by mid-2023.

So, the return of inflation is not a mainstream view, but we live in uncertain times. The IEA report is a discussion document and reflects the opinion of its authors, not the Institute. The writers believe that in the UK, money supply will expand by 7.5%-15% in the year to late-2020/early-2021. Latest Bank of England data shows M3 up 9.1% year on year versus 1.1% in December 2019.

The authors believe that this will be inflationary. They argue that money supply growth will exceed trend GDP growth, causing inflationary problems in 2-3 years' time, as economies recover. They provide no estimate for the UK but argue that without policy tightening, inflation could reach double digits in the US, but money supply growth there has been significantly higher.

The case may be further weakened for the UK by the caveat that after a short-term mini-bounce in 2021 as industries re-open, consensus forecasts are for a fairly average economic performance, as indicated below. Also, while monetary policy is a blunt instrument, the Bank of England's focus has traditionally been on containing inflation and any signs of an upturn could lead to a swift policy switch.

UK Real GDP Consensus Forecasts – per cent per annum



Sources: Consensus Economics Jun-20, Apr-20, ONS

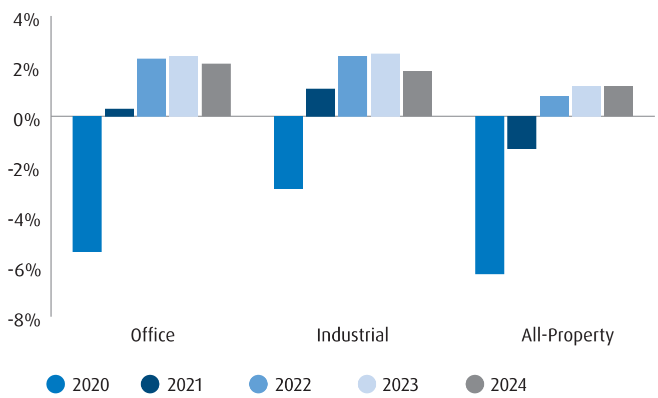
Property as an inflation hedge

Investors have been favouring long income, index-linked assets in large part due to low yields elsewhere, but it may be an appropriate strategy for those property investors wishing to limit the risk from an upturn in inflation.

However, the perception of property as an inflation hedge stems more from its perceived ability to secure income growth through rental uplifts and long-term contracted income streams.

Both of these factors are looking less comforting at present. The coronavirus measures have made rent collection more difficult and leasing terms are being re-written. An economy in lockdown may experience rental growth by exception and a heightened risk of business failure. Lockdown has borne disproportionately on the retail and hospitality sectors. There are now signs of lockdown easing, and while retail may still experience structural problems, investors elsewhere in property could see rental growth returning, as indicated by the consensus forecasts produced by the Investment Property Forum (IPF), below, in late-May 2020.

IPF Consensus Rental Growth Forecasts – per cent per annum



Source: IPF May-20

Both the easing of monetary policy and the cost of any normalisation would seem likely to keep interest rates "lower for longer". This could benefit property given its relatively favourable yield compared with gilts.

Based on past data, the link between inflation and property out-performance is not assured as we have noted in earlier reports. We have advised clients not to let concerns about inflation dominate decision-making. Think about market fundamentals, growth prospects, timing, and the impact of

*Institute of Economic Affairs, Inflation – the Next Threat?, written by Juan Castaneda in collaboration with Tim Congdon, Jun-20

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Brexit as well. Our advice in our last update, back in 2016 to those concerned about inflationary pressures was:

- Look to link rents to inflation
- Focus on the protection of the income stream
- Frequently review rents as inflation accelerates
- Invest in areas of restricted supply

This remains our view.

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