Market monitor – Q4 2018

Alpha Real Capital

Summary

Inflation

- Annual UK CPI fell 0.3% to 2.1% over the quarter, continuing the downward trend since August 2018. The decline was supported by falling road fuel prices and air fares
- Annual UK RPI fell by 0.6% to 2.7% over the quarter, falling below 3% for the first time since January 2017. The fall was greater than CPI due to air fares having a larger weight in RPI than CPI
- As expected from the above UK inflation expectations fell significantly at the very short end of the curve over the quarter (see chart)

Bond yields

- Real Gilt yields largely fell at the short end, reflecting a lower path of future cash rates, whilst longer dated bonds remained broadly flat over the quarter
- Nominal Gilt yields decreased across the curve, which has supported by lower real yields at the short end and reduced inflation expectations at the long end

Credit spreads

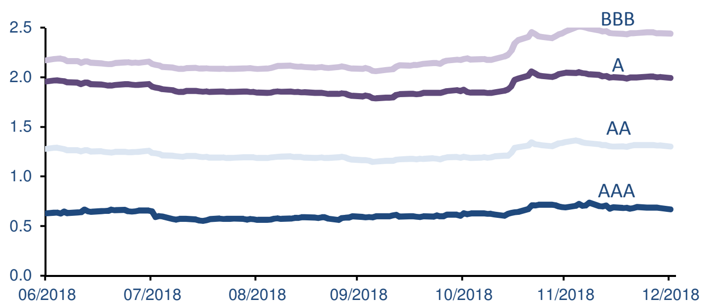
- Investment grade credit spreads widened across the board over the quarter in a reversal of recent trends, with higher-quality corporate bonds generally outperforming their lower-quality counterparts. The widening can be partly attributed to a softening of global GDP growth expectations

Macro picture

UK GDP (y/y)	1.5%	**UK RPI (y/y)**	2.7%
UK BOE base rate	0.75%	**UK CPI (y/y)**	2.1%
March 2024 real gilt yield	-2.1%	**March 2040 real gilt yield**	-1.7%

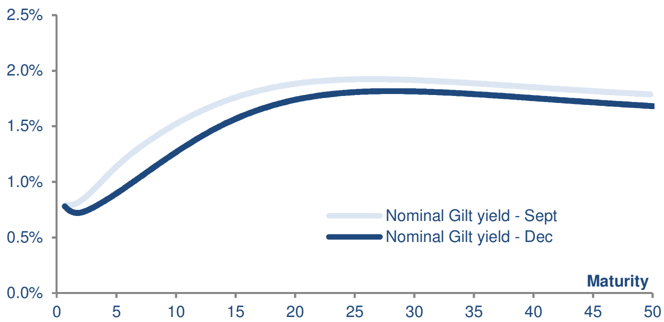
Sources: ONS, Barcap, Reuters, FT.com, 31 December 2018 or latest published figures

UK credit spreads



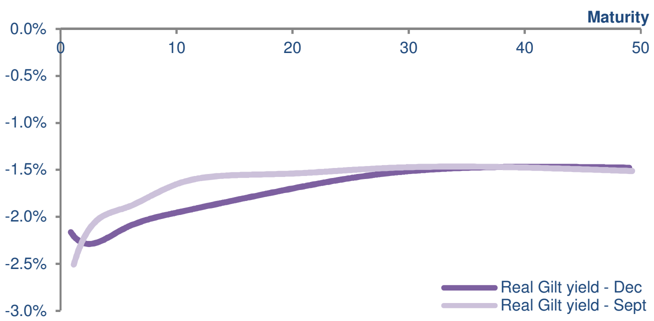
Source: Thompson Reuters, IBOXX non-financials +15 year indices

Nominal Gilt yield forward curve



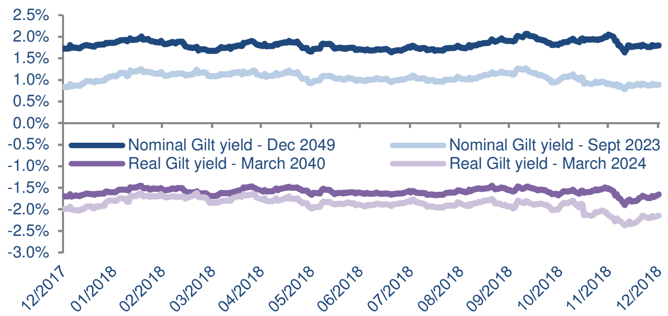
Source: Barcap – 30 September and 31 December 2018

Real Gilt yield forward curve



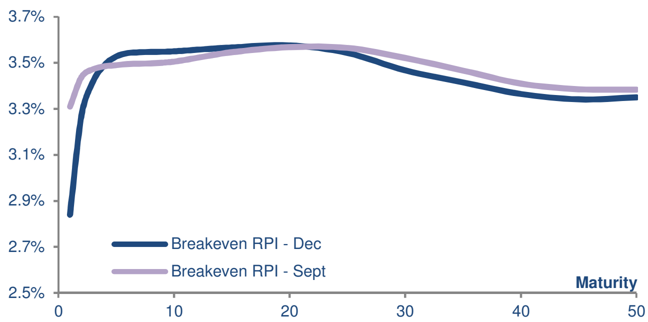
Source: Barcap – 30 September and 31 December 2018

Historical nominal and real yields



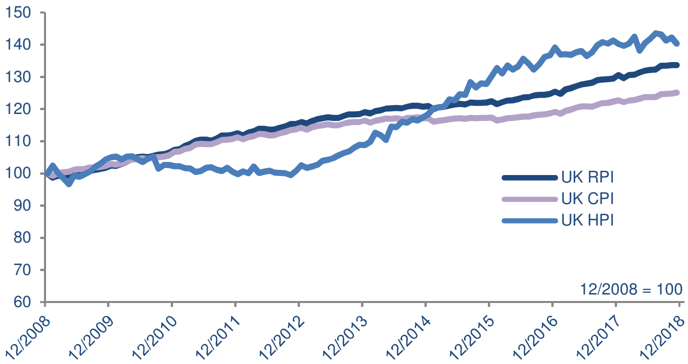
Source: Barcap

RPI swap rate



Source: Barcap – 30 September 2018 and 31 December 2018

RPI, CPI and HPI historical returns



Source: Thomson Reuters, ONS

Lifetime Mortgages – Addressing historical concerns

Alpha Real Capital LLP ("Alpha") is creating a new fund (the "Fund") for defined benefit pension schemes to invest in UK lifetime mortgages ("Lifetime Mortgages"), an equity release product regulated by the Financial Conduct Authority ("FCA") which offers investors an attractive risk-adjusted return as compared to other long-dated assets.

Background

Lifetime Mortgages allow homeowners aged 55 years and older to realise a portion of the equity in their property while still retaining 100% ownership and the right to reside there, rent free, for the rest of their lives. There are no required monthly payments with interest typically fixed and rolled-up/accrued into the mortgage balance, full repayment only becomes due when the last borrower either dies or moves into long-term care.

Evolution of the equity release sector

The equity release sector has matured considerably over the last 20 years. The troubled products of the past are no longer offered and today, Lifetime Mortgages (introduced in 1997) represent over 99% of the market[1] (the other 1% being Home Reversion Plans[2]). Lifetime Mortgages include safeguards for customers that were introduced by the Equity Release Council (formerly Safe Home Income Plans or SHIP), the industry body for the equity release sector established in 1991. The Equity Release Council consists of over 290 member firms and 870 individuals, including providers, regulated financial advisors, surveyors and other professionals[3], with each member agreeing to follow a strict code of conduct and safeguard the interests of homeowners:

- Borrowers have the right to remain in their property for life;
- Borrowers have the right to transfer their mortgage to another eligible property;
- Borrowers must receive advice from an FCA regulated financial advisor to assess their financial situation and determine their suitability for a lifetime mortgage as compared to other options;
- Borrowers must engage a solicitor to explain the risks and benefits of the plan, evidenced by a signed solicitor's certificate; and
- Borrowers benefit from a 'No Negative Equity Guarantee' whereby they (or their estate) will never owe more than the net proceeds from the sale of their home

Further protections were put in place in 2004 when Lifetime Mortgages, along with other UK residential mortgages, became subject to statutory regulation by the Financial Services Authority (replaced by the FCA in 2013). While the new regulations required that residential mortgages be arranged and/or originated by an authorised party, the Equity Release Council further imposed that no direct consumer-to-lender Lifetime Mortgage originations were allowed. Instead, customers were required to use a regulated financial advisor who would also act as a broker/intermediary between the customer and Lifetime Mortgage lender throughout the mortgage application process.

Confidence in the sector has attracted companies such as Aviva and Legal & General to become the largest suppliers and funders of Lifetime Mortgages, together originating £1.7 billion (56% of the market) in 2017[4]. In addition, Nationwide Building Society, Santander, The Co-operative Bank and Virgin Bank are all marketing Lifetime Mortgages to their customers.

Conclusion

The UK equity release sector has evolved considerably since the first product was introduced over 50 years ago. Through regulatory reform, product development and the introduction of customer safeguards, Lifetime Mortgages have become the fastest growing segment of the UK mortgage market while generating the fewest registered complaints across all home finance products. They have also become a preferred investment for insurance companies and are now being offered by high street lenders to their customers. With broader market acceptance, attractive yields and long-dated cashflows, Alpha views Lifetime Mortgages as an appealing opportunity for defined benefit pensions schemes seeking long-dated assets.

[1]Equity Release Council Autumn 2018 Market Report
[2]Home Reversion Plans allow customers to sell all or part of their home to a scheme provider while still retaining the right to remain there, rent free, until they die or move into long-term care.
[3]Equity Release Council Autumn 2018 Market Report, [4]Legal & General and Aviva's Annual Reports and Accounts 2017

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