Market monitor – Q2 2019

Alpha Real Capital

Summary

Inflation

- Annual UK CPI rose 0.1% to 2.0% over the quarter, stopping the downward trend since August 2018. The slight uplift was driven by an increase in prices across the hotel/restaurant sector as well as the recreation and culture sector
- Annual UK RPI rose by 0.5% to 2.9% over the quarter. The increase was due to less aggressive discounting in the clothing and footwear sector compared to 2018, which has a larger weight in RPI than CPI
- Despite the increase in RPI over the quarter, UK inflation expectations have declined over the quarter at the longer end of the curve (see RPI swap rate chart)

Bond yields

- Real Gilt yields have decreased over the medium term and marginally over the long term, reflecting a lower path of expected future cash rates. The decline is largely driven by the effect of recent Brexit and political uncertainty on investor sentiment
- Nominal Gilt yields also decreased across the curve, driven by reduced real yields at the short end and inflation expectations at the long end

Credit spreads

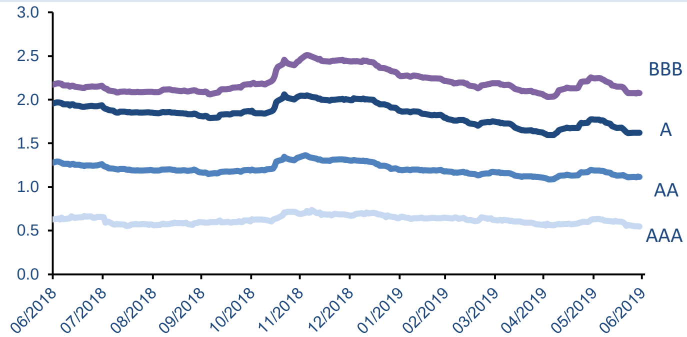
- Investment grade credit spreads have slightly narrowed across the board after a widening in April/May due to a lag in pricing when Real Gilt yields decreased

Macro picture

UK GDP (y/y)	1.8%	**UK RPI (y/y)**	2.9%
UK BOE base rate	0.75%	**UK CPI (y/y)**	2.0%
March 2024 real gilt yield	-2.5%	**March 2040 real gilt yield**	-2.0%

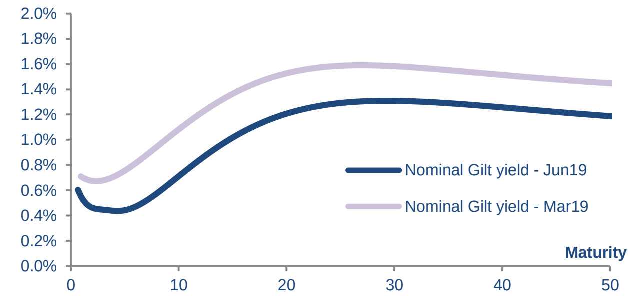
Sources: ONS, Barcap, Reuters, FT.com, 30 June 2019 or latest published figures

UK credit spreads



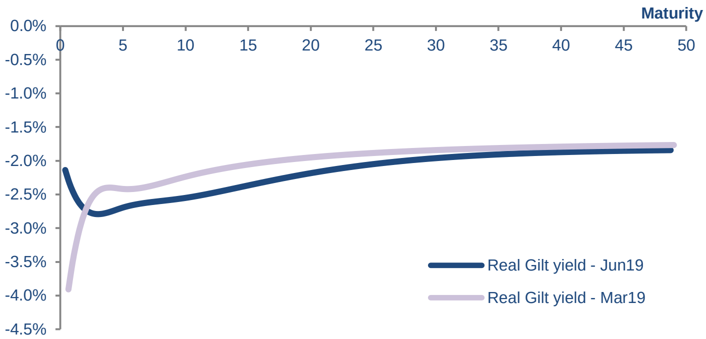
Source: Thompson Reuters, IBOXX non-financials +15 year indices – 30 June 2019

Nominal Gilt yield forward curve



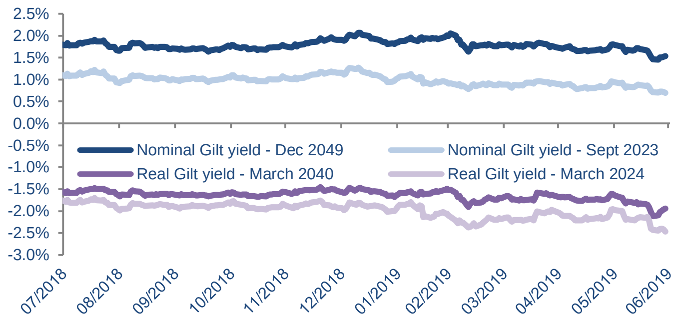
Source: Barcap –31 March 2019 and 30 June 2019

Real Gilt yield forward curve



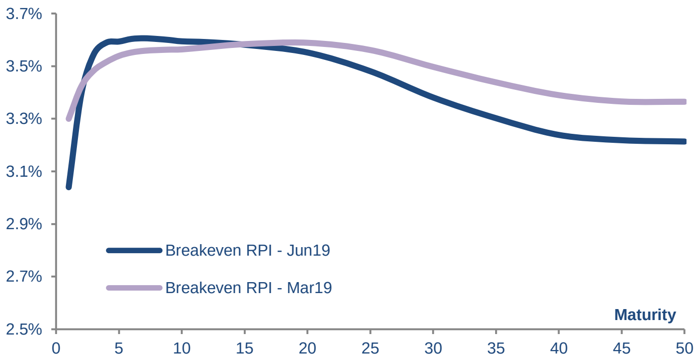
Source: Barcap – 31 March 2019 and 30 June 2019

Historical nominal and real yields



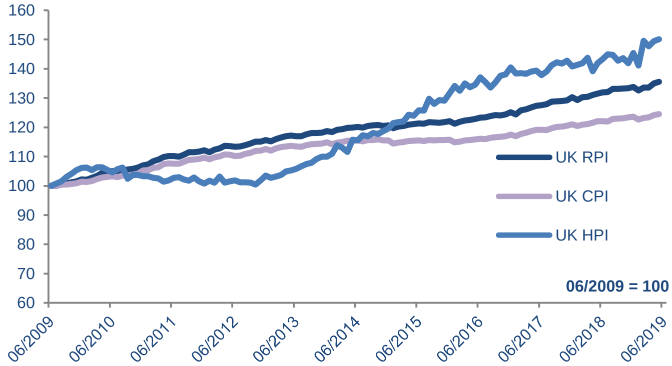
Source: Barcap – 30 June 2019

RPI swap rate



Source: Barcap – 31 March 2019 and 30 June 2019

RPI, CPI and HPI historical returns



Source: Thomson Reuters, ONS – 30 June 2019

European Long Income Property

A combination of low European government and corporate bond yields and an uncertain macroeconomic environment have led institutional and other real money investors to seek alternative sources of long-dated secure income to meet their liabilities.

Alpha believe European Long Income Property, including ground rents, income strips and other long lease property, can specifically meet these income requirements by providing an attractive risk-adjusted return whilst complementing the existing matching and growth assets held.

Why invest in European Long Income Property?

Attractive risk-adjusted return – potential to deliver a significant net yield pick-up over government and corporate bonds (with comparable credit quality) and an attractive risk-adjusted return.

Income security – the investor (freeholder) typically has first ranking title in the event of tenant default, which is underpinned by the property value and/or income overcollateralisation and/or the credit quality of the tenant. Further, the contractual cashflows have lower letting risk compared with traditional real estate on shorter leases, meaning cashflows are more predictable and secure over the long run.

Inflation protection – the majority of Long Income Property targeted by Alpha have rent reviews that are linked to inflation, providing inflation protection to the rental income received and also to the underlying freehold capital value. The inclusion of a rent review floor or catchup provisions (e.g. no negative rent reviews) in a lease can help protect performance in a low or negative inflation environment. Conversely, the inclusion of a cap can reduce the ability to track inflation in highly inflationary environments. The cap does however act as an important feature to enhance the credit and long-term sustainability of an investment by preventing the rent from increasing higher than the earnings of the underlying operating business.

Duration – institutional and other real money investors with long-dated liabilities, can use the long-dated inflation-linked cashflow streams to match their liabilities. Further, in the long-run, Long Income Property yields tend to trend in line with changes in government bond yields, providing a natural interest rate.

Low volatility – the inflation-linked income stream and defensive nature of the asset, typically results in lower expected volatility (from an income and capital perspective) through market cycles, compared to traditional real estate. At a time of macroeconomic uncertainty, returns driven by income rather than capital value growth, offers an attractive, lower-risk alternative option for investors.

Portfolio diversification – investors gain access to different return drivers versus liquid and traditional real estate assets, helping to enhance investors portfolio diversification and provide a lower range of expected outcomes. Sufficient diversification is possible with opportunities across alternative and core real estate sectors and geographies.

Large pool of freehold properties – the Eurozone has a large pool of freehold, owner-operated (over 69%), high quality, income generating assets that are well-suited to Long Income Property. This, coupled with owner-occupiers' increasing acceptance of Long Income Property as a way to release capital tied up in real estate as part of an efficient capital structure, helps provide a large supply of investment opportunities.

Conclusion

Due to the current low yield environment, coupled with Europe's large pool of owner-occupied income generating assets and increasing acceptance of Long Income Property as an efficient source of capital, now is an opportune time for investors to consider this emerging asset class.

In the coming months Alpha will be launching the European Long Income Fund ("ELIF"). ELIF will focus on asset backed, secure inflation-linked income streams through commercial ground rents, long lease property (e.g. sale and leasebacks) and income strip structures throughout Europe to capitalise on the advantages explained above.

Contact

For the full publication please visit: www.alternativerealcapital.com/media/

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