Euro Area Market Monitor: Q4 2019

Alpha Real Capital

Summary

Inflation

- Euro Area (EA) inflation was 1.3% in December 2019, up from 1.0% and 0.8% in November and September respectively. The largest contributors were food, alcohol and tobacco closely followed by services. This is expected to reduce post the festive season.
- Short term EA inflation is forecasted to remain around current levels (1.0-1.3% y/y) and further upside is expected to be limited as economic growth in 20/21 is predicted to be low.
- Looking forward, one-year EA HICP forecast remains approximately 1% with the five year forecast at 1.1%.

Bond yields

- European government bond yields have marginally improved from their Q3 historic lows on the back of slightly improved economic data and geo-political events. An improvement in European manufacturing data as well more certainty regarding Brexit has driven these events.
- Low rates, strong demand for safe-haven investments and the quest for yield is expected to remain the fundamental drivers for fixed income markets in Q1 2020.

Credit spreads

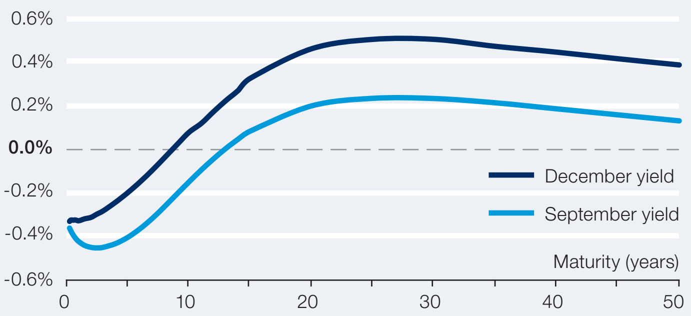
- Investment grade credit spreads have increased slightly since the summer tightening, however, remain compressed since the start of the year. Over the course of the year they have tightened on the back of improved manufacturing data.
- The cost of raising debt in Euros has persistently been cheaper in major markets since 2014, with Euro to GBP and Euro to USD spreads increasing further in Q4 2019. This is a trend that is expected to continue.

Macro picture

EA GDP (y/y)	1.3%
ECB marginal lending rate	0.25%
EA December Inflation	1.3%
Netherlands CPI (y/y)	2.7%
Germany CPI (y/y)	1.5%
Ireland CPI (y/y)	1.3%

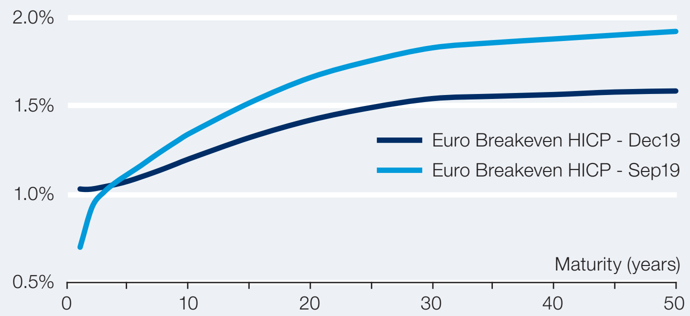
Sources: Eurostat, ONS, Barcap, Reuters, FT.com, December 2019 or latest published figures

EURO nominal swap yields forward curve



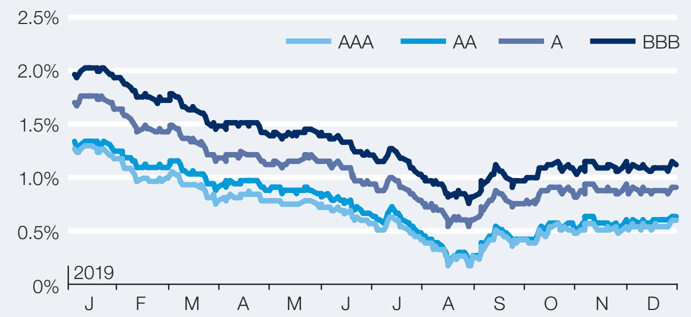
Source: Barcap – September 2019 and December 2019

EURO HICP swap rate forward curve



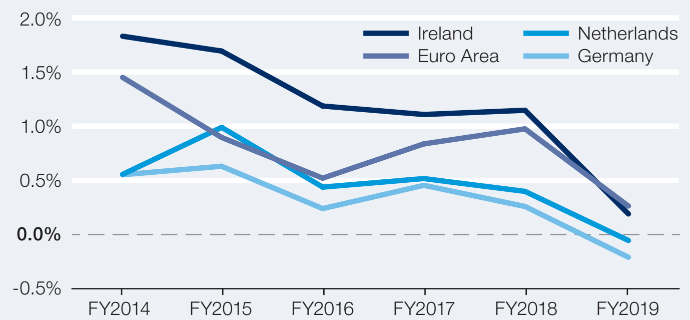
Source: Barcap – September 2019 and December2019

EURO historic 10-year credit spreads



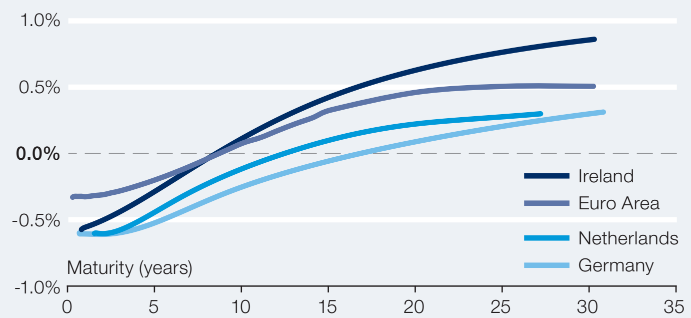
Source: S&P Global, Thompson Reuters December 2019

Historic 10 year nominal Government bond yields



Source: S&P Global – December 2019

Nominal bond yield forward curves



Source: Barcap – December 2019

Economic indicators

Avg. annualised GDP rate	1-year	3-year	5-year	10-year
Germany	0.60%	1.53%	1.70%	1.26%
Ireland	1.70%	8.15%	11.30%*	5.24%
Netherlands	1.90%	2.75%	2.45%	0.92%
Euro Area	1.90%	2.20%	2.10%	0.80%

Avg. annualised CPI	FQ4 2019	1-year	3-year	5-year	10-year
Germany	1.50%	1.40%	1.60%	1.10%	1.30%
Ireland	1.30%	0.90%	0.60%	0.30%	0.60%
Netherlands	2.70%	2.60%	1.90%	1.30%	1.60%
Euro Area	1.60%	1.50%	1.70%	1.10%	1.50%

* Ireland had a 26.3% spike in GDP in 2015 due to revised figures taking into consideration foreign investment

Source: Eurostat, S&P Global – December 2019

European commercial ground rents as a compelling fixed income alternative

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 pickup 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.

European Long Income Property

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.

Recently, Alpha has launched 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.

Other white papers are available to download at **alpharealcapital.com/news**

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For more information about Alpha Real Capital LLP, its funds and key personnel visit: www.alpharealcapital.com

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