Market Monitor: Q1 2020

Alpha Real Capital

Summary

Inflation

- Annual UK CPI rose 0.1% to 1.5% over the quarter but declined by 0.2% against February 2020. The increase at the beginning of the quarter was driven by increases in transport prices and the subsequent decrease was mainly due to the weakening prices of clothing and fuel.
- Annual UK RPI increased by 0.2% to 2.6% over the quarter after rising prices of groceries outweighed the decrease in clothing and fuel. The lower weighting of fuel in RPI compared to CPI contributes to the higher quarterly increase in RPI.
- UK inflation expectations have significantly declined over the quarter across the curve. This is primarily driven by investors' negative outlook due to Covid-19.

Bond yields

- Real Gilt yields have decreased across the curve with the largest decrease in medium term Gilts. This decrease reflects the negative investor sentiment driven by the Covid-19 pandemic and a move towards 'safe' assets.
- Nominal Gilt yields have significantly decreased across the curve, by up to 55bps, mainly driven by lower inflation expectations.

Credit spreads

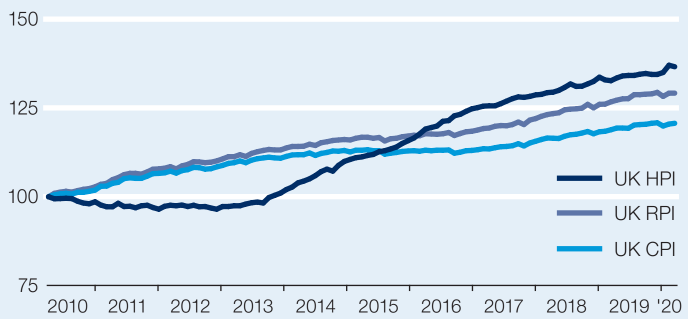
- After initial volatility in February, investment grade credit spreads substantially widened in March, with spreads for single A rated bonds increasing by 50bps over the quarter. This was driven by investors' response to the increased credit risk from Covid-19.

Macro picture

UK CPI (y/y)	1.5%
UK RPI (y/y)	2.6%
Dec 2040 nominal gilt yield	0.8%
March 2040 real gilt yield	-2.1%
UK GDP (y/y)	1.4%
UK BOE base rate	0.1%

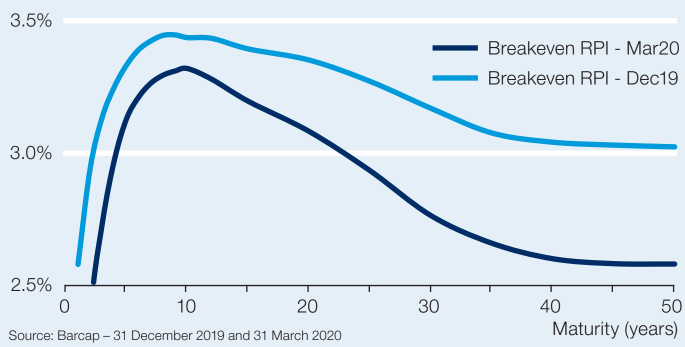
Sources: ONS, Barcap, 31 March 2020 or latest published figures

RPI, CPI and HPI historical returns



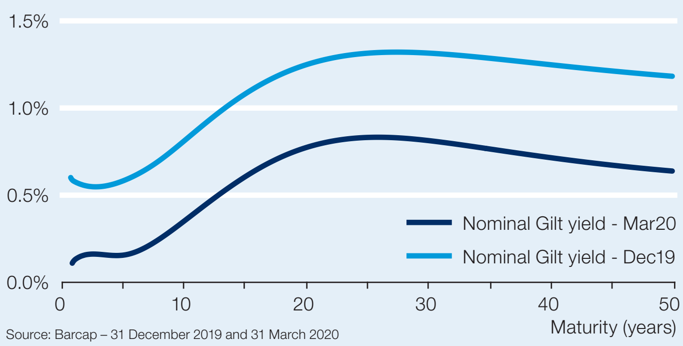
Source: Thomson Reuters, ONS – 30 march 2020

RPI swap rate



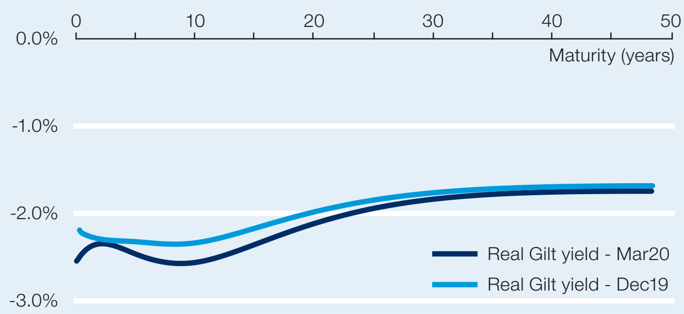
Source: Barcap – 31 December 2019 and 31 March 2020

Nominal Gilt yield forward curve



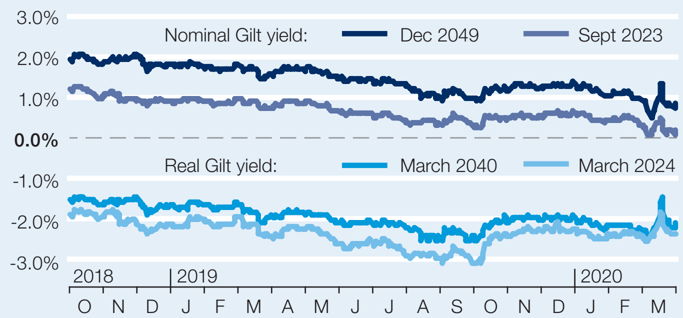
Source: Barcap – 31 December 2019 and 31 March 2020

Real Gilt yield forward curve



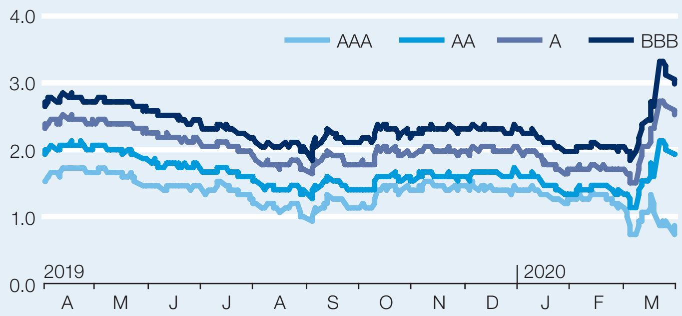
Source: Barcap – 31 December 2019 and 31 March 2020

Historical nominal and real yields



Source: Barcap – 31 March 2020

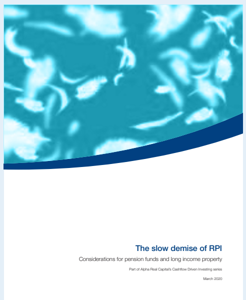
UK credit spreads



Source: S&P Capital IQ 10 year non-financial bonds – 31 March 2020

The slow demise of RPI – considerations for pension funds and long income property

In response to the well documented proposal to align RPI with CPIH, the Treasury launched a consultation at the most recent budget to assess the change further. Whilst the Treasury's focus is mostly on index-linked gilt markets, the impacts of a change on the long income property market should not be ignored.



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Key takeaways

- As a result of underlying issues in the calculation of RPI, several official bodies, including the Treasury, appear to support an alignment of RPI methodology to that of CPIH between 2025 and 2030.
- The proposed move is being interpreted as a transfer of value from those who hold RPI-linked securities, to issuers of RPI-linked securities. The most prominent example of this is a transfer of value from pension schemes to the UK Government.
- The proposed alignment of RPI to CPIH has already been partially reflected in traditional gilt and swap markets, although the impact on long income property is harder to quantify.
- For RPI-linked long income property, the potential outcomes as a result of an alignment will depend on the terms within the lease and range from a full convergence of rental uplifts to CPIH, to no change at all.
- Post the various announcements, long income assets continue to be marketed with RPI-linked rent reviews. A review of the lease terms is recommended to check the position in terms of convergence and for pricing any adjustments accordingly.
- Pension schemes with RPI-linked liabilities shouldn't see any deterioration in funding level, but those with CPI-linked liabilities will be impacted if they are currently using RPI-linked assets to hedge their liabilities.
- The government launched a consultation at the most recent budget which is open until late August 2020 to shed more light on the potential impact, with the results expected in 2021. Although their focus is on index-linked gilt holders, the outcomes of the consultation remain very relevant to long income property investors.

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Your contacts at Alpha Real Capital

Hugo James
Partner, Head of Long Income
+44 (0)207 391 4729 hugojames@alpharealcapital.com

Tom Benham
Director, Long Income
+44 (0)207 391 4731 tbenham@alpharealcapital.com

Scott Gardner
Partner, Institutional Capital
+44 (0)207 391 4723 scottgardner@alpharealcapital.com

Adam Hayes-Newington
Institutional Business Development
+44 (0)207 391 4561 adamhayes-newington@alpharealcapital.com

Alpha Real Capital

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