RESEARCH

PROPONOMICS – MACRO VIEW

MARCH 2016

NEGATIVE INTEREST RATES

A quarter of global GDP now comes from countries with negative interest rates, a situation that is transforming assumptions on yields and returns. German government bond yields are negative up to 8 years income, and Swiss bonds up to fifteen years, leaving these traditional safe havens for global investors in the red. What will this mean for UK property?

Negative rates

Negative interest rates will **encourage international investors to further diversify portfolios**

As a popular market for cross-border investors, **UK property will probably benefit**

British banks could **fill up with foreign money, resulting in increased lending**

Were the Brexit threat to end this June, **yield compression for property may follow**

While negative rates in the UK are unlikely, Britain's commercial property market will feel the repercussions from what central banks are doing abroad. The UK has long been a focus of cross-border property investment. Moreover, the countries that have adopted negative rates are wealthy, have large pension funds, and are ageing. Their institutional investors need to regularly deploy incoming funds, and have target returns to meet; while the UK is a relative economic bright spot in Europe.

Indeed, as we argue below, a changed rate environment could, once the Brexit issue is settled, open a door to commercial property yields hardening further.

The search for yield

In the context of negative yields across large swathes of the global bond market, pricing for UK commercial property looks competitive. As a result we see the new rate environment intensifying the search for yield by cross-border property investors, with the UK, and London in particular, a logical beneficiary. Britain has a growing economy, rental growth is in evidence in a range of markets, and exchange rate fluctuations can be hedged.

Growing supply pressures are improving the prospects for a rent increase at review, and high build costs are deterring construction. This suggests we will see tight supply for some time, improving the chances that rental growth will continue.

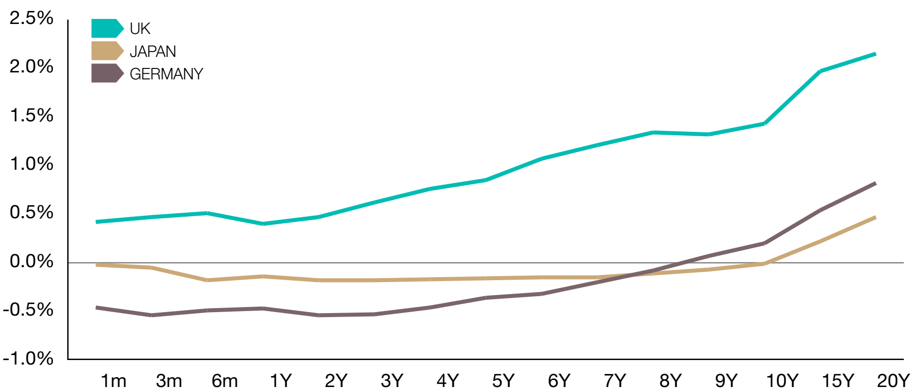
Different countries, different motives

Looking around the world, countries that have negative interest rates fall into two camps. The first camp, which includes the Eurozone and Japan, are trying to fend off deflation and spark growth. The second camp consists of Switzerland, Denmark, and Sweden; who adopted negative rates to prevent capital flight from the Eurozone leaving their currencies uncompetitive, and asset prices inflated.

For investors in the Eurozone and Japan, deploying money in the UK

FIGURE 1

Underwater – 10 year bond yield curves



Source: Thomson Reuters

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For the latest news, views and analysis on the world of commercial property, visit Commercial Briefing or @KF_CommBrief offers a useful hedge against economic uncertainty at home. For UK property, the fact yields today are comparable with or lower than in 2007 is irrelevant, given the interest rate environment is so different, especially for many overseas investors.

Turning to the countries in the second camp – Switzerland, Denmark, and Sweden – these are deliberately diverting capital away from themselves via negative rates, and some of it will end up in the UK. We do not see the UK being similarly pressured into going negative, as it is a much bigger economy and thus in a better position to absorb the inflows.

The lure of Britain

Consequently, we believe negative rates elsewhere will push international money towards the UK. Some Eurozone investors will prefer the bird in the hand of a UK recovery that is underway, to the bird in bush that the ECB's QE programme finally works. Similarly, some Japanese investors, who have now seen many QE programmes, may decide their money might be better deployed abroad.

Turning to the domestic economy, the very reality of negative rates overseas kicks the idea of a UK interest rate rise deep into the long grass, as there would be a risk of making exporters uncompetitive. Moreover, with rate levels so different between the UK and the neighbouring Eurozone, British banks could fill up with foreign capital, bringing them under pressure to lend more. This could create further momentum in the property market.

Brexit brake

So given the above, why is foreign capital not flowing in apace right now? The answer is that the possibility of a Brexit is hanging over the UK economy. The uncertainty has hit equity prices and the pound exchange rate, and pushed down Gilt yields.

Our view is that in the run-up to the EU referendum a share of property demand will go into a holding pattern, awaiting the poll's outcome. Viewed in the light of negative rates, we believe that if the Brexit threat is removed in June, the second half of the year will not only see the 'holding pattern' property demand come in to land, but also the arrival of more refugee money from the negative rate nations.

The political uncertainty has to end first, but property yields could be hardening by year end.

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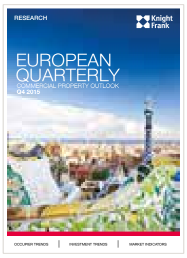

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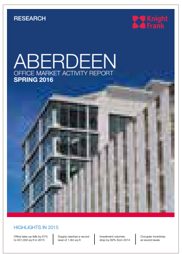

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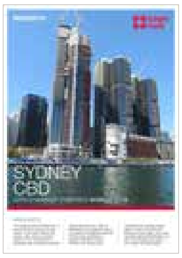

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