RESEARCH

PROPONOMICS – MACRO VIEW

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BOND BEARS AND PROPERTY

Money is on the move again, with some commentators calling an end to the long bull market for government bonds. What will this mean for property?

Headlines

Gilt yields have softened markedly in recent weeks, mirroring price movements for the bonds of other comparable economies

The black swan events of Brexit and Trump's election have not repelled investors from risk assets

UK property yields are unlikely to follow bond yields and soften, as the spread is very high

The UK looks less of an outlier in the global economy and investment is flowing back into real estate

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Chief Economist

"A UK property market that was viewed as on the brink of a precipice on the 24th of June, has seen gated funds re-open, while overseas buyers are actively pursuing and buying assets."

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Received wisdom prior to this year was that markets hate uncertainty, and that black swan events will send investors out of risk/growth assets and into the safety of bonds. However, Brexit and President-elect Trump's shock win have cast doubt on this age-old assumption. Equity markets are up, bonds have sold off, and the yield curve is steepening. A UK property market that was viewed as on the brink of a precipice on the 24th of June, has seen gated funds re-open, while overseas buyers (particularly from Asia) are actively pursuing and buying assets.

Investors are preparing for growth and inflation, and despite Brexit and the US election, risk appetite is re-emerging; with the FTSE all share index trading over 6.5% higher than pre-referendum. The spread between the two year and ten year Gilt yield is often seen as a gauge of investor sentiment. A narrow spread is viewed as evidence investors are risk averse, and in June to September the gap predictably contracted on the referendum vote and its aftermath. However, October and November saw the spread leap out to levels comparable with pre-referendum (see figure 1).

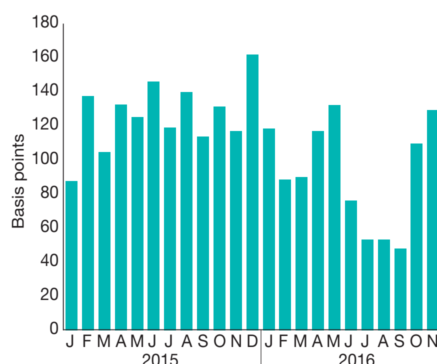
Moreover, a range of data has cast doubt on the downbeat narrative for the UK economy post-Brexit. While performance has been far from spectacular, it has also failed to match the expected gloom. Business investment in the UK grew by 0.9% quarter-on-quarter in Q3 2016, only slightly down on the Q2 figure of 1.0%. This sits well with anecdotal evidence of firms continuing to invest in the UK, ranging from Apple taking a new European HQ at the Battersea Power Station in London, to the foreign takeovers of UK tech firms like Skyscanner and Arm Holdings.

Critically, the longer that the predicted Brexit slowdown takes to materialise, the more consumers and investors will doubt it is ever going to happen, and return to business as usual. This could lead to a self-fulfilling prophecy of spending and investment supporting the GDP figures and shoring up market values. Arguably this is already happening.

With investors leaving the air raid shelter of bonds, Gilt yields (and effectively the market interest rate) have moved up, beckoning the question: what happens to property yields? Rule of thumb logic suggests they would soften too, but the reality is that too many factors shape property yield levels to allow such simplifications to hold true.

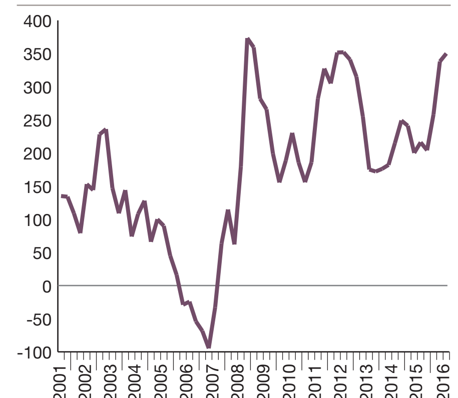
Firstly, the data does not point to a strong correlation between bond and property yields. For instance, in 2013, 10 year

FIGURE 1
Ten year / Two year Gilt yield spread



Source: Thomson Reuters

FIGURE 2
City office / 10 year Gilt yield spread



Source: Knight Frank / Thomson Reuters

Gilt yields softened by well over 100 bps, while Central London office yields were mostly stable, and even hardened towards the end of that year. For much of 2008, bond and property yields were on a divergent course with the former hardening and the latter softening. In both examples, the wider macro-economic environment, financial market dynamics, and perceptions of the outlook for property more than outweighed the level of gilts when it came to pricing real estate.

Moreover, debt has played less of a role in this cycle than the previous one, which should mean that pricing is less sensitive to interest rate movements.

Secondly, the current spread offered by commercial property yields over bonds is huge by historic standards. Even taking into account 10 year Gilt yields moving out to over 1.4% at the time of writing, City prime office yields still offer a spread of over 280 bps, compared to a long term average of 200 bps. As figure two shows, pre-2008 that spread rarely exceeded 150 bps, and there is even precedent for it turning negative.

Thirdly, increasingly it is events beyond our shores that are shaping investor demand for UK property.

A lot of Chinese money is looking at UK real estate, reflecting concerns over a possible devaluation of the renminbi. Expectations of rising interest rates in the US are sending money in dollar-pegged nations in search of overseas investments. The ECB has warned on potential vulnerability in parts of the Eurozone banking system, at a time the euro is strong against the pound.

Moreover, whether people are right or wrong to believe property is an inflation hedge, the perception is there, and capital will head towards UK real estate for that reason. Also, if money is displaced from bonds by softening yields, it has to go somewhere else.

The UK's Brexit risk looks less daunting in an increasingly volatile global economy, where political risk appears to be spreading to more countries – standby for Italy's referendum this weekend. The UK economy's resilience in Q3 is reducing fears of a Brexit downturn, and re-opening the property market to overseas capital. It may be a case of the rest of the world has joined the UK in raising the uncertainty level, but Britain now appears less of an outlier than back in June, and property looks set to benefit.

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