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INVESTMENT WEEK

investmentweek.co.uk 12 October 2020

Property investors remain cautiously positive amid value and income decline

By Mike Sheen

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UK property investors have begun to see signs of improvement in the market amid heavy writedowns of rental and capital values in their underlying holdings, but both open-ended and closed-ended vehicles face an uphill battle against blows dealt to portfolios by the ongoing coronavirus pandemic.

The total return offered by all UK property is expected to contract by 7.4% by the end of 2020, according to the Investment Property Forum's (IPF) *UK Property Consensus Forecasts*, with average rental value and capital value growth expected to fall by 5% and 11.7% respectively.

In terms of capital value, the IPF forecasts the greatest declines within retail, shopping centres and retail warehousing with falls of 20.4%, 28.3% and 20.9% respectively.

Retail and shopping centres are also the worst hit on retail values, which have contracted 10.8% and 13.4% respectively.

It is a difficult environment for open-ended UK property funds, which have only just begun to end suspensions after being given the all-clear by the Royal Institution of Chartered Surveyors in September when it recommended a "general lifting" of material uncertainty on the valuation of most UK real estate assets.

However, analysts from Investec noted in an October update on UK real estate investment companies that closed-ended property funds "have been far from immune to developments, with NAVs under pressure and many suffering sharp de-ratings".

Amid this "extraordinary economic backdrop", according to Investec, AEW UK REIT is the only investment company to have maintained its dividend with a yield of 10.7%. However, the trust is still trading on discount to NAV of 16.7%, according to Association of Investment Companies data.

Gerry Frewin, manager of Threadneedle UK Property, which reopened on 17 September, said the second quarter of this year in particular was "dominated by capital and rental value falls", and "inevitable challenges to rental income in the wake of government intervention".

However, according to Frewin, "these trends appear to have subsided" as the economy has begun to adapt to the pandemic, with the pace of capital value declines "markedly" easing.

Retail bears brunt

Going forward, Frewin said there will be "significant sector divergence" on rental income and rental value growth, with retail in particular bearing the brunt of social distancing measures.

He added: "As government lockdown control measures are eased, sentiment in both the investment and occupational markets is likely to improve… excluding retail."

Similarly, manager of the Ediston Property Investment Company (EPIC) Calum Bruce said the "structural challenges" within the retail market have been "accelerated by the Covid-19 pandemic", with rental value and capital value coming under pressure.

However, he noted a divergence in the outlook within retail depending on the location of property, with out-of-town retail holdings performing well compared to city- or town-based equivalents.

Bruce said this was particularly true of retail warehousing, where EPIC allocated 61% of its portfolio at the end of June, according to its latest factsheet, with town-based rents having been historically too high for some time.

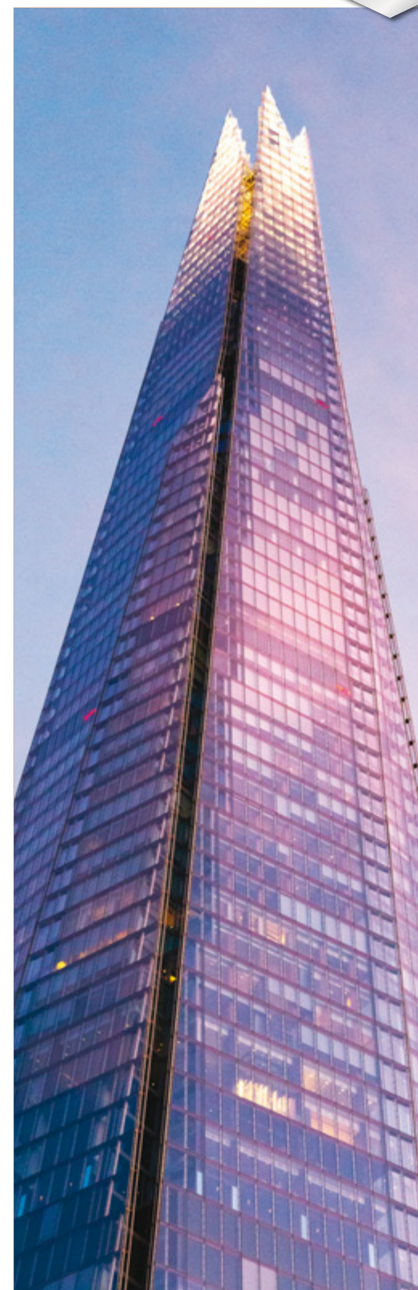
Bruce explained: "There are real advantages to being out of town versus being in town. They are easy to get to, they are cheaper for retailers to occupy, there is more space, parking is free, and it has actually helped support online sales through click and collect."

He added EPIC has seen marked signs of improvement in rental collection in recent months, which has allowed the trust to continue to distribute as much as possible to investors.

Bruce said: "We have seen some progress in rent collections since lockdown ended and restrictions were eased.

"We have seen some solid rent collection numbers across the portfolio, with a positive increase in each quarter. A number of tenants have moved back to quarterly payments, and some of the tenants we had put on repayment plans have started to make payments in accordance with that.

"There is a bit more normality resuming in the regularity and frequency of rental payments, which is positive."



UK property forecast for 2020

	Rental value growth (%)	Capital value growth (%)	Total return (%)
Office	-3.5	-8.8	-4.9
Industrial	0.4	-3.5	0.8
Standard Retail	-10.8	-20.4	-16.4
Shopping Centre	-13.4	-28.3	-23.4
Retail Warehouse	-9.6	-20.9	-16.0
All Property	-5.0	-11.7	-7.4

Source: IPF UK Property Consensus Forecasts (Investec)

Five top funds focusing on the UN's Sustainable Development Goals: page 12

Dambisa Moyo
Market strategist

For decades investors have advocated for emerging markets as an asset class, and for some exposure to emerging market equities, in particular, as part of a global diversified portfolio.

Asset managers have believed they would generate outsized returns for the unit of risk that they would take. However, that reality has not materialised, at least over the past decade and furthermore, strong returns are unlikely to appear in the foreseeable future. In essence, not only are emerging markets returns likely to be subdued going forward, but also economic and political risks across the asset class are rising.

There are at least four reasons emerging market equities are unattractive. Firstly, a history of disappointing returns relative to a compelling narrative.

Emerging market equities have underperformed. They have underperformed relative to other stockmarket indices and relative to EM bonds.

The MSCI Emerging Market index has returned annualised average returns of just 2.5% over the past ten years, compared with the 13.6% average annual return of the S&P 500 since the start of 2010. Meanwhile, over the same period, emerging market debt returned 5.53%, according to the JP Morgan Emerging markets bond index (EMBI), which tracks the performance of hard currency emerging market sovereign debt.

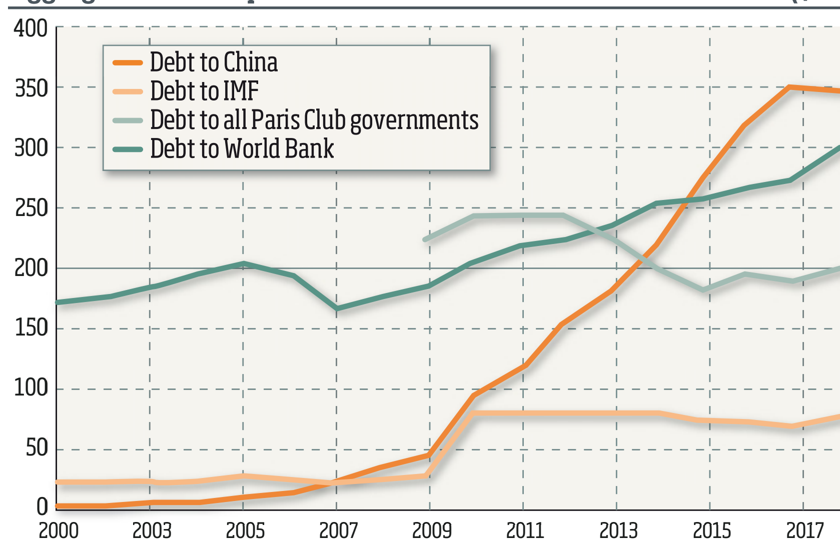
Furthermore, the emerging market equity performance is also observable at a sector level, with emerging markets equities underperforming US in information technology, healthcare, consumer discretionary and industrials in dollar terms since 2013, according to BNP Paribas.

Some may argue that valuation metrics today make emerging markets attractive. For example, the price-to-book ratio of the MSCI EM index relative to that of the MSCI World index is near the lows last seen in 2003. However, the broader picture, especially the economic outlook, is foreboding.

Secondly, emerging market economic fundamentals are weakening.

Even before the 2020 global pandemic hit in earnest, growth prospects across the emerging markets and, in particular, large economies such as Brazil, Russia and South Africa, were markedly deteriorating. Emerging market and developing economies' growth was recorded at 3.7% at the end of 2019, despite the World Bank's forecast of 4.4% at the start of the year. With Covid-19 in full swing, emerging economies are expected to contract by 3% in 2020, with Brazil's GDP falling 9%, South Africa's by 8% and Russia's by 6.6%.

Aggregate external public debt owed to different offical creditors ($bn)



As at 25 September 2020. Source: Lazard

Emerging Markets Performance How key fixed income and equity indices performed the week of 25-Sep-2020

Benchmark	1wk	MTD	YTD	1yr	3yr5yr	5yr	10yr
MSCI Emerging Markets index	-4.42	-3.72	-3.29	7.72	1.49	8.58	2.50
JP Morgan EMBI Global Diversified index	-1.87	-1.89	-0.55	1.36	3.46	6.03	5.53

Source: Lazard Asset Management

* Yearly data is annualised

Beyond the GDP collapse on the back of the pandemic, emerging markets are exposed to the long-term structural effects of deglobalisation – including further harm to trade and FDI (foreign direct investment).

Specifically, global trade growth has flatlined in the past decade at around 3%, and according to McKinsey Global Institute the share of goods produced around the world and traded across borders has fallen sharply, from 28.1% in 2007 to 22.5% in 2017. In terms of FDI, the UN Conference of Trade and Development (UNCTAD) noted FDI to developing economies stalled in 2019 compared with the previous year at $695bnn.

Thirdly, sovereign balance sheets in emerging markets are increasingly stretched.

According to a stress test by Absolute Strategy, an independent research firm, 37% of the sovereign issuers in the JP Morgan EMBI could be at risk of default in the coming year.

Already, in the advent of the pandemic, many debtor emerging countries have negotiated a debt standstill. In April 2020, the G20 countries agreed to a debt service standstill until the end of 2020. Given the on going health and economic challenges, it is likely that emerging economies will seek an extended debt moratorium, if not an outright debt cancellation.

More generally, sovereign emerging market debt is moving from being an economic issue to being an un-hedgeable geo-political risk. China has become the largest creditor to the developing world – overtaking both the World Bank and Paris Club of International Government creditors in 2013.

Many market participants contend that China has been buying distressed debt of sovereign emerging nations on the secondary market, in order to build influence. In past periods of debt stress – think Argentina, Mexico and Russia – creditors would extend maturities and renegotiate debt coupons.

However, there is evidence China prefers to take land access and natural resources in exchange for debt forgiveness, placing greater stress on emerging country public finances.

Finally, the prospects for significant emerging market equity returns will be further hampered by ever-more encroaching governments.

Given the precarious political, economic and social environment, governments are likely to get bigger.

Ballooning welfare payments will increase government debt and deficits, but governments will also come under pressure to act as an arbiter of capital and labour in challenged emerging economies.

Higher taxes, tighter regulation and ever more protectionist policies will likely play a greater role in their agendas. More government intervention introduces risks that make it harder to value assets and extract dividends, leading to portfolio uncertainty.

We look back on a period of low returns, an immediate outlook of low growth, and a volatile future in which political risk is in the ascendent. Taken together, this spells fewer bright prospects for emerging market equity investments, not more.

Dambisa Moyo is a global economist and author