First State Investments
Colonial First State Global Asset Management

Monthly strategy update

June 2018

Trend global growth is likely to continue to be supported by very low unemployment levels, corporate profit growth and Government fiscal stimulus which is mainly been driven by developed countries. Whilst seasonality and weather impacted the March quarter global GDP growth, anecdotally the June quarter global GDP growth reaccelerated back towards long term trend levels. However, risks are increasing in developing country economies with the stronger USD, rising United States (US) interest rates and also will likely experience the greatest impact from any escalating trade war. The United States (US) more protectionist policies on trade with the introduction of trade tariffs has to date been very much targeted and they are unlikely to be enough to derail current trend global GDP growth. Whilst risks remain around a more pronounced trade war between the US and China to date the talk of a third round of tariffs has yet to be implemented. The US Government review of the US auto sector is not expected to be completed until February 2019, which depending on the outcome may also lead to further targeted trade tariffs on auto imports. The US Federal Reserve continues to lead the way on interest rate normalisation with most other central banks continuing with their existing extraordinarily aggressive accommodative monetary policies. With global inflationary expectations building there is increasing pressure on developed country central banks to start the process of interest rate normalisation. A lack of willingness to start this process raises the risk of a forced accelerated future path to interest rate normalisation which could derail the developed country lead global economic recovery.

Direct property fundamentals generally speaking remain solid with occupancy rates in most markets remaining very high with market rental rates continuing to rise. The rising market rental rates are supporting current cash flow growth and the future underwriting of cash flow growth. The late cycle supply response has commenced in many markets, however, in the major cities with high barriers to entry where development is difficult and very expensive, the newly completed developments are being absorbed with direct property fundamentals remaining solid. Required returns for direct property remains very low which continues to support very high direct property valuations. Demand for high quality buildings in the major cities remains strong. A Hong Kong property company during the month purchased 5 Broadgate a premium grade office building located as part of the Broadgate office complex in central London. The 13 storey building totalling 710,000 (sqf) was completed in 2015 and is fully leased to UBS until 2035. The groundscraper design has high external solid area with the stainless steel façade creating high thermal mass for efficient internal temperature control whilst still allowing for natural light penetration, its roof area also contains one of the largest concentrations of solar panels in London. The building sold for £1bn which equates to circ. £1,400 (sqf) and a yield of 3.95%. The building is slightly under-rented with UBS subject to annual rent increases based on the United Kingdom Retail Price index within a range of 0-4%. The sale is further transactional evidence that direct property valuations remain elevated.

The publicly traded landlords continue to trade at a discount to direct property private market values. With the healthy direct property fundamentals sector cash flows and dividends are expected to continue to grow with some excess returns also flowing from completed developments. Given the valuation discrepancies with the private property market, the publicly traded land lords are being proactive in returning capital to shareholders mainly via share buybacks. Merger and acquisition activity also continues as private equity funds and others take advantage of the discounted valuations. The sector total return dispersions remain high with pricing anomalies prevalent particularly with regard to shopping malls and shopping centres where occupancy rates remain high and the cash flows remain very stable. Although the future cash flow growth will likely be moderate as eCommerce continues to gain market share in most countries, however, overall retail sales continue to grow given the healthy global economic back drop. We are expecting slightly elevated volatility in the shorter term as the market gains more certainty around the future of US trade policy with bouts of higher volatility over the medium term as the expectations of the rate of change of interest rate normalisation continues to ebb and flow. The team's focus remains on through-the –cycle valuations and allocating capital into specific landlord opportunities whilst minimising overall concentration risk.

The US Federal Reserve Open Market Committee (FOMC) raised interest rates by 0.25% to a range of 1.75%-2.0% with expectations for two more rate rises this year. Employment growth continues to be strong with 223k non-farm payrolls jobs in May. The unemployment rate fell further to 3.8% with participation falling -0.1% to 62.7%. Average hourly earnings increased 2.7%. The employment growth continues to benefit apartments and single family housing with market rental growth accelerating and growing faster than real GDP growth as occupancies remain very high. Headline inflation for May increased 2.8% (yoy) with core inflation increasing 2.2% (yoy) which is in-line with the FOMC's target rate. The employment growth is also benefitting the household sector finances which has flowed onto retail sales for May up 5.9% (yoy), this marked turn around in retail sales will benefit the shopping mall and shopping centres particularly in the coastal cities where the jobs growth is more pronounced and the average wages are higher.

The West Coast office markets continue to remain robust particularly in San Francisco where tenant demand remains strong. The industrial markets also remain very strong with tenant demand particularly for logistical warehousing continues to outstrip new supply with market rental rates rising rapidly. The strategy[1] has a 42.5% exposure to the US, with concentrations in coastal city and Sun Belt apartments and single family residences in Los Angeles and Florida, "A" grade office buildings in Los Angeles, San Francisco and Seattle, and business exchange data centres, industrial warehouses and hotels nationally.

The Bank of England left interest rates unchanged at 0.5% and is maintaining its current balance sheet through the reinvestment of bond maturities. Inflation in May fell to 2.4% (yoy) and is expected to continue to fall with the sterling bouncing off its lows reducing imported inflation for the large services based economy. The fall in inflation will likely take some pressure off household finances which could lead to improving retail sales which increased 3.9% (yoy) in May due to favourable weather conditions. Non-store sales were the main driver which increased 16.2% (yoy), which continues to be a headwind for shopping mall fundamentals with the high percentage market share of on-line retail sales. The unemployment rate for April remained at 4.2% in April the lowest level since 1975 with wages increasing 2.8% (yoy) encouragingly above inflation. Property fundamentals remain benign with occupancy rates remaining at high levels and cash flows are very stable. Market rental growth is flat across the office and retail markets, although logistical warehousing fundamentals continue to be very strong benefitting from eCommerce. The strategy has a 3.9% exposure in UK in student accommodation.

The European Central Bank (ECB) left interest rates unchanged at -0.4% but did target reduced asset purchases down to €15 billion per month in the September quarter and zero at the end of the year. The Norges Bank of Norway left interest rates at 0.5% but will likely start raising rates in the second half. The Swiss National Bank left rates unchanged at -0.75%. Inflationary expectations have increased in Europe with CPI increases in May for Romania 5.4% (yoy), Germany 2.2% (yoy), Spain 2.1% (yoy), France 2.0% (yoy), Netherlands 1.7% (yoy), Poland 1.7% (yoy), Finland 1.0% (yoy) and Switzerland 0.8% (yoy). May retail sales are also improving with Poland 6.1% (yoy) and Denmark 3.9% (yoy). Germany the world's third largest exporter saw exports for April increase 9.3% (yoy) with imports rising 8.2% (yoy). US trade policy remains a risk for Germany with 9.0% of its exports going to the US. Overall, the European economies are continuing to grow and improve and with inflationary expectations rising the ECB will likely have to start raising interest rates from extraordinary low levels. European direct property valuations remain very over inflated, although real estate fundamentals are also improving with economic growth. The stronger office markets are Central Paris, Madrid, Amsterdam and Frankfurt. Retail sales growth is also benefitting the shopping centres across France, Spain, The Netherlands and Central Europe and the logistics markets are improving driven by increased tenant demand although barriers to entry remain low. The strategy has a 16.8% exposure to Europe with concentrations in data centres in Paris, Amsterdam and Frankfurt and "A" grade offices Madrid and Paris and apartments in Berlin and Finland.

The Bank of Japan (BoJ) left rates unchanged at -0.1% and maintained their quantitative easing programme. Interest rates in Japan are expected to remain low for an extended period of time with inflation in May only 0.7% (yoy) and BoJ core measure only increasing 0.3% (yoy), a long way from the 2.0% target. Importantly for the manufacturing based economy, industrial production for April increased 2.6%. Exports for May increased 8.1% (yoy) and imports 14.0% (yoy) with a combination both price and volume growth. The private sector in Japan continues to perform well which is supporting economic growth. Japan does remain exposed to any US trade policy changes with the US being their largest export market at 19.0%. The private sector growth continues to benefit the central Tokyo office market with vacancy rates remaining very low in May at 2.7% and market rents increasing 6.5% (yoy). Shopping centre fundamentals are also improving particularly in Tokyo where inbound tourism continues to grow with the number of visitors doubling in the large five years to over 13 million. The central Tokyo Ginza district is getting the greatest benefit with market rents increasing 14.1% (yoy). The regional areas are also experiencing growing market rents. Although the regional shopping centres are more exposed to eCommerce, these areas have aged populations that are conservative and slow to adopt eCommerce and credit card use is low in Japan. The logistics market has been modernising with the increase in the development of modern logistical warehousing, the new supply is putting a ceiling on market rental growth. The strategy has a 13.9% exposure to Japan with concentrations in central Tokyo skyscrapers and logistical warehousing.

The strategy is focused on high quality urban infill assets in high barrier to entry markets in the world's most bustling cities. The strategy has a 19.4% exposure to premium and "A" grade office buildings, with concentrations in Seattle, San Francisco, Los Angeles and Tokyo. The strategy has a 17.4% exposure to shopping centres, with concentrations in the major Metropolitan Statistical Areas (MSAs) in the US, Canada, Hong Kong, China and Australia. The strategy has a 26.3% exposure to residential buildings, with concentrations in apartments and single family housing in Los Angeles, the US Sun Belt Region, Finland and Berlin, and student accommodation in London, Sheffield and Bristol. The strategy has a 12.6% exposure to hotels and all-inclusive resorts in the US, Europe and the Caribbean. The strategy has a 10.8% exposure to logistical warehousing in the US and Japan. The strategy has a 6.3% exposure to data centres in the major US MSAs, as well as in London, Paris, Amsterdam and Frankfurt. The strategy's cash flows are very secure, underpinned by contracted rental income streams with a weighted average lease term of 3.4 years, including the strategy's 39.0% exposures to shorter dated residential leases and hotels. Additionally, positive rental reversions of 5.9% are driving embedded cash-flow growth. Given the strategy's exposure to very high quality assets in high barrier to entry urban locations, we see minimal risk to the projected three year dividend compound annual growth rate (CAGR) of 11.2%.

Developed country sovereign bond yields decreased in June. The US 10-year Treasury yield was flat at 2.85%; the German 10-year Bund yield fell to 0.30%; the 10-year UK Gilt yield rose to 1.28%; the Japanese 10-year Government Bond yield was flat at 0.04%; and the Australian 10-year CGS yield fell to 2.61%. The 10-year Canadian Bond yield fell to 2.17%.

In US dollar terms, the global property securities market returned approximately 1.6% in June, giving the sector a 0.1% year-to-date return.

[1]The strategy refers to a composite of CFSGAM/FSI global real estate securities funds.

The strategy's one year total return expectation is currently 11.9%, versus our screened investment universe's total return expectation of 4.3%. The strategy's cash weighting is 0.9%. The strategy's discount to Net Asset Value is -12.6%, with look-through gearing at 27.7%. The interest coverage ratio is 7.0 times, with an average debt maturity of 5.1 years. The number of stocks held increased to 42, with non-benchmark exposure at 19.8% and active share at 74.4%.

Source: All data is sourced from CFSGAM/FSI and Bloomberg and are expressed in local currency unless otherwise stated.

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