IMPERIUM CAPITAL

momentum

Build up not out

Global Matters Weekly

1 August 2022

– **Richard Stutley, CFA**

Congratulations to England's Lionesses, who beat Germany yesterday to win Euro 2022, the country's first major trophy at senior level since 1966.

I met with one of our underlying global listed property managers last week and I thought some of the discussion points were worth repeating here. Until such time that we all live in the metaverse, what is happening with physical space remains important, with implications for investors beyond dedicated property buyers.

From a sector perspective, we discussed the supply outlook for industrial/logistics space, following Amazon's announcement earlier this year that they plan to mothball several new warehouse projects and sublet excess space. Amazon front-loaded securing new space in the immediate aftermath of the pandemic, to ensure they did not run into capacity issues further down the line, and now they are refining their plans. Despite Amazon's size, the impact of this change is expected to have only a modest impact on the supply of logistics space[1]. Is there scope to double or triple existing space by building premises up and not out? As unlikely as it sounds, Prologis have tried exactly this in Japan, but the fact that the initiative appears to have run out of steam suggests the build costs are uneconomical at present.

In terms of global listed property fundamentals, data tends to be less timeous compared to other asset classes, but we can nonetheless make certain observations based on what we have seen so far this year: rental growth is accelerating for most property types, led by industrial and apartments, which are enjoying close to record rental growth[2]. Driving that strong rental growth is ultra-low vacancies: vacancy rates are now at historic lows in several sectors, with the exception of offices[3]. Taken together, demand-and-supply dynamics are leading to lower vacancies, higher rents, and higher prospective earnings.

Debt is a great way to ruin a good investment.

Debt is a great way to ruin a good investment (the business may endure, but your ownership will not). Property companies are lowly levered by historical standards[4] and that debt is extremely easy to service[5] at present. Interest coverage ratios have improved across the vast majority of companies[6], rather than just at the headline level, hence there is less risk of contagion from a reasonable-sized cohort of distressed companies. What about rising interest rates? Companies have extended the maturity of debt[7], buying them time should we be about to enter a prolonged period of higher interest rates. They also have access to more diversified sources of financing (primarily public debt markets and other non-bank lenders, like private equity debt funds) and are therefore less reliant on the traditional banking sector.

With regards to inflation, looking at the average company's cost base[8], they are relatively insulated from rising costs of goods and services. Instead, taxes are the biggest part of costs, which are linked to property prices, which in turn are linked to demand and supply. If demand strength is leading to increases in your costs, then it stands to reason that you can pass those costs on in the form of higher rents.

Overall, fundamentals look good in our assessment. However, armed with this information alone, one still does not know whether global listed property is a good investment. Critically, a reasonable amount of the deteriorating macroeconomic outlook appears to be in the price (2.4 standard deviations cheap on the basis of price to book9), although prices are still some way above crisis troughs like in Q1 2020. Further rises in real interest rates would pose a challenge to the sector, as would a derating on par with those kinds of crises, but the asset class looks reasonable value from a top-down perspective today, with more opportunities for active managers under the surface.

Sources: [1] "the amount of space that Amazon is expected to sublease equates to 0.2% of total industrial inventory and would increase available supply growth from 2.6% to 2.8% in 2022". Catalyst Fund Managers Quarterly Fund Commentary 2022 Q2. [2] CoStar, NAREIT. Data as of 2022:Q1. [3] CoStar, NAREIT. Data as of 2022:Q1. [4] S&P Capital IQ Pro, NAREIT T-Tracker®. [5] S&P Capital IQ Pro, NAREIT T-Tracker®. [6] S&P Capital IQ Pro, NAREIT T-Tracker®. [7] FactSet, NAREIT, Federal Reserve Economic Data (FRED), Raymond James research. [8] Catalyst Fund Managers. 9S&P Global Property USD Total Return Index, as seen on Bloomberg. Daily data from 15/04/2013 to 28/07/2022. Trimmed mean excluding top and bottom 10% of observations.

The **Marketplace**

- Global equities rose 3.6% last week
- The Federal Reserve Systems' fourth rate hike this year raised interest rates by 75bps to 2.5%, as forecast
- Brent crude rose 6.6% over the week to $110.01 a barrel
- Gold rose 2.2% to $1765.94 per ounce

Market **Focus**

US

- US equities rose 4.3% last week, driven by Oil, Gas, Metals and Miners, while Social Media and Retail lagged
- As forecasted, the Federal Reserve System raised interest rates by 75bps for the second month to 2.5%. Jerome Powell suggested a similar move is possible in September, but it will depend on the data. The chair added that rates are "in the range" of what the Federal Open Market Committee (FOMC) considers neutral, and the pace of hikes will slow further out
- US Gross Domestic Product (GDP)for Q2 fell 0.9% (vs an expected increase of 0.5%); Treasury Secretary Yellen said, "We need to see a slowdown. The labour market is extremely tight and may be the source of some inflationary pressure."
- US New Home Sales for June was 590k (vs 660k forecast), Pending Home sales fell 8.6% (vs a forecasted decline of 1.5%).

Europe

- European equities returned +2.8% last week, driven by Basic Resources, Oil, Gas while Retail and Telecom lagged
- European Consumer Price Index (CPI) for July year-on-year was 8.9% (vs 8.6%), causing the Euro to continue to decline to levels not seen since 2005.
- German Gross Domestic Product (GDP) for Q2 was flat (vs 0.1% estimate)
- German Information and Forschung (IFO) Business Climate Index for July was 88.6 (vs 90.2 forecast).

UK

- UK equities returned +2% last week
- The Conservative leadership battle for Prime Minister narrowed to Liz Truss and Rishi Sunak
- The Bank of England is expected to increase interest rates by 0.5% to 1.75% this week, its biggest hike since 1995.

Asia/Rest of The World

- Global emerging market equities rose 0.4% over the week
- Chinese equities fell 3.7% over the week
- Chinese Manufacturing Purchasing Managers Index (PMI) for July was 49 (vs 50.4 estimated) lower due to lockdown
- Japanese equities fell 0.8% over the week
- Australia Consumer Price Index for Q2 was 1.8% (vs 1.9% forecast), June retail sales 0.2% (vs 0.5% estimated).

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Asset Class/Region	Currency	Currency returns			
		Week ending 29 July 2022	Month to date	YTD 2022	12 months
Developed Market Equities					
United States	USD	4,3%	9,2%	-12,8%	-5,6%
United Kingdom	GBP	2,0%	3,5%	5,3%	12,0%
Continental Europe	EUR	2,8%	8,0%	-10,9%	-6,0%
Japan	JPY	-0,8%	3,7%	-1,2%	3,1%
Asia Pacific (ex Japan)	USD	0,2%	0,0%	-15,6%	-18,8%
Australia	AUD	2,3%	5,7%	-4,7%	-2,5%
Global	USD	3,6%	7,9%	-14,2%	-9,8%
Emerging markets equities					
Emerging Europe	USD	1,1%	0,5%	-76,9%	-77,2%
Emerging Asia	USD	-0,3%	-1,3%	-18,3%	-21,4%
Emerging Latin America	USD	7,0%	4,3%	3,7%	-12,4%
BRICs	USD	-0,6%	-3,6%	-20,0%	-26,5%
China	USD	-3,7%	-9,5%	-19,7%	-29,5%
MENA countries	USD	1,2%	5,0%	3,7%	10,0%
South Africa	USD	0,0%	0,3%	-7,1%	-12,1%
India	USD	3,2%	8,3%	-6,4%	3,0%
Global emerging markets	USD	0,4%	-0,2%	-17,8%	-21,2%
Bonds					
US Treasuries	USD	0,3%	1,7%	-7,4%	-8,2%
US Treasuries (inflation protected)	USD	2,0%	4,5%	-5,6%	-4,0%
US Corporate (investment grade)	USD	0,5%	3,2%	-11,6%	-12,5%
US High Yield	USD	1,5%	5,9%	-9,1%	-8,0%
UK Gilts	GBP	0,8%	2,8%	-12,2%	-14,1%
UK Corporate (investment grade)	GBP	1,2%	3,5%	-11,2%	-13,0%
Euro Government Bonds	EUR	2,0%	4,2%	-8,6%	-10,7%
Euro Corporate (investment grade)	EUR	1,3%	4,7%	-7,7%	-9,3%
Euro High Yield	EUR	1,2%	5,1%	-10,1%	-10,1%
Japanese Government	JPY	0,4%	0,7%	-2,4%	-3,0%
Australian Government	AUD	2,4%	3,7%	-6,9%	-9,9%
Global Government Bonds	USD	1,0%	1,9%	-12,5%	-15,6%
Global Bonds	USD	1,1%	2,1%	-12,5%	-15,4%
Global Convertible Bonds	USD	0,9%	3,0%	-18,5%	-22,0%
Emerging Market Bonds	USD	2,7%	4,0%	-23,7%	-25,2%

Source: Bloomberg. Past performance is not indicative of future returns

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Asset Class/Region	Currency	Currency returns			
		Week ending 29 July 2022	Month to date	YTD 2022	12 months
Property					
US Property Securities	USD	4,9%	8,9%	-13,7%	-3,5%
Australian Property Securities	AUD	3,9%	11,9%	-16,2%	-4,3%
Asia Property Securities	USD	2,5%	-0,7%	-5,1%	-12,2%
Global Property Securities	USD	3,8%	6,8%	-13,9%	-9,6%
Currencies					
Euro	USD	-0,3%	-2,7%	-10,4%	-14,2%
UK Pound Sterling	USD	1,2%	-0,1%	-10,1%	-12,9%
Japanese Yen	USD	2,0%	1,8%	-13,7%	-17,8%
Australian Dollar	USD	0,5%	1,0%	-4,1%	-5,7%
South African Rand	USD	0,9%	-2,3%	-4,3%	-12,6%
Swiss Franc	USD	0,9%	0,2%	-4,3%	-4,8%
Chinese Yuan	USD	0,1%	-0,7%	-5,8%	-4,3%
Commodities & Alternatives					
Commodities	USD	4,5%	0,9%	24,2%	33,2%
Agricultural Commodities	USD	5,5%	-2,3%	6,5%	18,1%
Oil	USD	6,6%	-4,2%	41,4%	44,7%
Gold	USD	2,2%	-2,4%	-3,5%	-3,6%
Hedge funds	USD	0,5%	0,5%	-4,6%	-4,3%

Source: Bloomberg. Past performance is not indicative of future returns

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