The UK has recently seen some positive macro factors, such as stronger employment and rising real wages, but alongside easing inflation, a cooling housing market and more moderate economic growth. While these mixed economic messages have resulted in a somewhat hesitant response from the Bank of England (BoE) over tightening monetary policy, the consensus still expects interest rates to rise this year.

Given this expectation, this paper looks at the potential implications of rising interest rates for the UK real estate market by assessing the nuanced relationship between bond and property yields and looking at recent experience in the US market. Our analysis suggests that interest rate rises and increases in bond yields do not automatically have a linear impact on property yields, and that market-specific factors can provide support to capital values during such periods.

Transition to “new normal” for interest rates

There has been much speculation about the frequency with which rate rises will occur, underscored by the health of the UK economy and inflation above the Central Bank’s 2% target. We expect the BoE to pursue a strategy of policy normalisation, involving a gradual transition towards a comparatively lower “new normal” for interest rates. Since the start of 2017, five-year interest rate swaps in the UK have remained between 0.5% and 1.5%, implying that markets do not expect rates to return to higher levels deemed to be “normal” before the financial crisis.

Lessons from the US

In the US, where interest rates have been rising since late 2015, and at a more rapid pace than anticipated in the UK, current market expectations on US long-term rates still remain low relative to pre-financial crisis levels. That said, the spread between US and UK bond yields is now at its highest since 2008.
Looking at the correlation between property yields and interest rates more closely, arguably asset-class-specific factors can often impact the outcome. This more nuanced relationship is shown by the recent experience of the US property market, following the Fed’s initial rate hike in December 2015. Comparing prime yields for New York offices against 10-year US treasury bonds as an example, rising interest rates have so far not caused any major detrimental impact to US property yields, although the yield spread between the two has narrowed.

**Correlations 1998 - 2017**

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<th>MSCI All Property Equivalent Yields (%)</th>
<th>Prime All Property Net Initial Yields (%)</th>
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<tr>
<td>10-year gilt yields</td>
<td>0.47</td>
<td>0.33</td>
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<tr>
<td>Bank rates</td>
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<td>10-year gilt yields</td>
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<td>0.30</td>
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<td>Bank rates</td>
<td>0.14</td>
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Regression analysis estimating the relationship between bond yields and property yields shows broadly similar trends to the correlation data. In fact, gilt yields and bank rates have historically accounted for less than 50% of the shift in MSCI property yields. This type of analysis alone, however, oversimplifies a complex relationship that cannot be easily explained without considering other drivers of property values.

**Property values supported by macro and market fundamentals**

Rising interest rates typically occur during periods of economic growth (or expectations of this) and higher inflationary pressures. Real estate assets tend to perform well in such environments, as occupier confidence increases and businesses expand, providing support to rental growth and therefore boosting commercial property values. Certain occupiers may also be committed to inflation-linked leases, which means rental income will grow at least in line with inflation, supporting overall returns.

**Capital value growth and 10-year gilt yields**

Source: MSCI Monthly Index, May 2018.
Looking back at the impact of rising gilt yields on property capital values since 1989, in nearly all of the seven periods where bond yields have risen by at least 100bps, property values have also appreciated, supported by modest levels of rental growth. Whilst economic downturns in the early 1990s and 2008 reversed this growth, in all other cases property values have held steady or continued to rise, while yields have typically flattened out. This relationship highlights the impact of rental growth and market-specific demand and supply fundamentals as key drivers of property values.

**Healthy risk premium priced into UK property**

Given the relative pricing of property to government bonds – the risk-free rate – the current pricing gap relative to history is also an important factor influencing future property performance. The yield spread between property and benchmark 10-year gilts moderated during 2017, as long-term bond yields have priced in rising interest rate expectations. However, this spread, at the all property level, remains significantly above the historical average by 75bps, with a healthy risk premium of 420bps priced in (as at March 2018).

**Property yield spread over UK 10-year gilts (bps)**

Source: IPD Quarterly Index March 2018.

The current risk premium is more or less the same across each of the major sectors, as average property yields have recently converged. This is largely reflective of structural change driven by e-commerce growth affecting the retail and industrial sectors, driving pricing for the two in opposite directions. The strength of the industrial sector, supported by accelerating rental growth and significant yield compression, has seen the industrial spread move to just 10bps above its long-term average. The retail spread by comparison is 140bps higher than its long-term average. Given the re-rating in market yields is driven by long-term structural drivers, this relationship is likely to persist going forward. No matter which sector, bond yields will need to rise significantly before UK real estate becomes relatively unattractive, although the currently wide risk premium is likely to narrow over the next few years.

**UK real estate a global asset class**

As UK property becomes an increasingly global asset class, the volume of global capital flows is also likely to distort the impact of domestic monetary policy changes. Central London offices, and more recently both regional offices and industrial assets, have become key targets for international investors looking to diversify outside of their home countries into ‘safe-haven’ assets in markets backed by strong structural trends.
Recent Sterling appreciation may cool international capital flows to a certain extent, but it remains over 18% down versus the Dollar when compared to the last 30 years. UK real estate also offers a wealth of advantages, including diversification,

transparency – ranked first globally according to JLL’s Transparency Index 2018 - and relative value versus other global assets. With global capital flows at near record highs, investor interest in core UK cities should help to prevent significantly higher property yields over the medium term.

**Mitigating the impact of rising interest rates**

We expect future total returns for UK property to be increasingly driven by income return and rental growth, with the prospects for capital growth arising from further yield compression more unlikely. Careful consideration during the property selection process, as well as effective active asset management, will be fundamental in driving rental growth, supporting property values and overall returns. M&G Real Estate’s investment strategy is to target both core and value-add opportunities within sectors and markets, which stand to benefit from above-average rental growth. Our build-to-core development approach has sought to take advantage of the current lack of high quality assets across much of the UK, at a time of resilient occupational demand. Should interest rates rise in line with current market expectations, we believe these fundamentals will support rental growth and capital values across our portfolio.

**Recent developments within the M&G Real Estate portfolio**

**Office Sector**

**Location:** The Grid, Glasgow  
**Size:** 280,000 sq ft  
**Type:** Speculative  
**Rental Growth Drivers:**  
- Grade A vacancy 2.1%  
- Flexible office space  
- Gold WELL certification

**Residential Sector**

**Location:** Port Street, Manchester  
**Size:** 135 PRS units  
**Type:** Speculative  
**Rental Growth Drivers:**  
- Young affluent population  
- Close to Piccadilly train station  
- Communal rooftop garden

**Retail Sector**

**Location:** Selly Oak Retail Park  
**Size:** 190,000 sq ft  
**Type:** Pre-let  
**Rental Growth Drivers:**  
- Affluent catchment market  
- Food anchored  
- Improved public realm

**Industrial Sector**

**Location:** Klinger Park, Sidcup  
**Size:** 105,000 sq ft (14 units)  
**Type:** Part-speculative  
**Rental Growth Drivers:**  
- Supply and demand imbalance  
- Access to M25 / Central London  
- Generous yard and eave height

Source: M&G Real Estate 2018.
Summary

Despite much speculation over the pace with which interest rates will rise, we expect the next moves by the BoE to be gradual. Market-implied estimates would suggest the UK will transition towards a comparatively lower “new normal” for interest rates over the next five years.

However, statistical analysis on historical data suggests there is not a linear relationship between property and bond yields. With supportive occupier market fundamentals in most sectors, we would not expect modest, gradual rises in interest rates to lead to a significant increase in property yields. A focus on sectors and assets with the greatest scope for income growth, alongside proactive asset management and taking selective development risk, will help cushion any impact of rising rates and aid investment performance.

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