# CREFC: late cycle but there is still more to go; CREFC: 'known unknown' risk to capital values

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**Geopolitics is less important than the phase of the cycle that the market is in, delegates at last week's CREFC Spring conference heard, which is near universally agreed to be 'late cycle' in the majority of Western EMEA jurisdictions, with asset pricing and sourcing deal opportunities the twin largest obstacles for many investors.**

Richard Dakin, former MD at Lloyds Banking Group's CRE BSU division responsible for legacy loan book de-leveraging, reminded delegates that although EMEA transaction volumes were down year-on-year in 2016 – to €255bn – levels remained high by 10-year historical averages. "CRE is still seen as an attractive asset class for investors and this is likely to continue for the next few years given the search for yield," said Dakin, MD at CBRE Capital Advisors. There has been, Dakin said, a notable transition in the primary investment motivation for investors, a conclusion drawn from a recent global investor sentiment survey of approximately 2,000 global real estate investors. "In 2017, there was a switch towards a strong rise in income-related motivations for investing. The importance of yield came much more into people's thought processes, rather than just looking for capital growth."

Dakin added: "Asset pricing remains one of the biggest obstacles to deals. There is plenty of capital out there but finding the opportunities is getting more difficult across the regions."

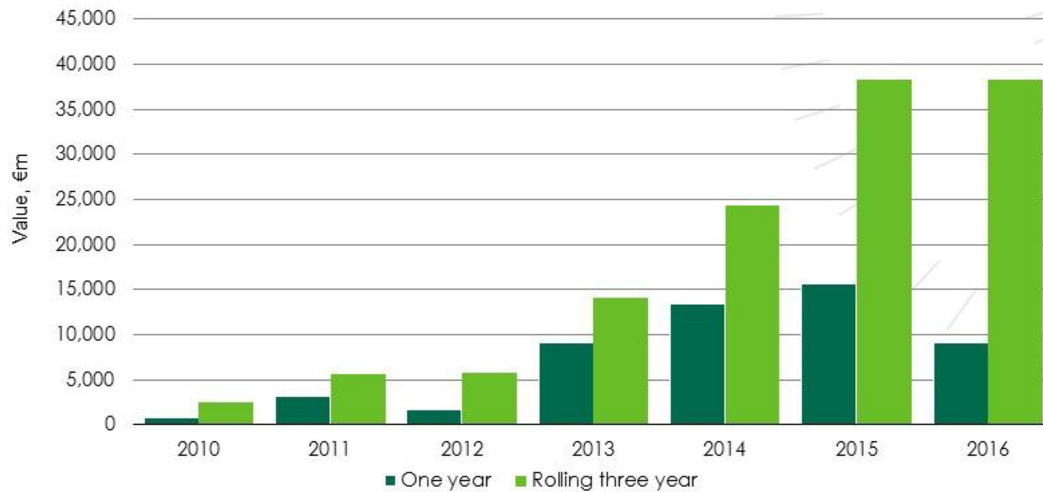
The search for yield – a perennial theme over the years at CREFC conferences – was continuing to push liability-driven investors such as pension funds and insurance companies into alternative fixed income sectors. Real estate debt has formed an "important part" of that move into alternatives, Dakin continued, as evidenced by fundraising levels for European debt funds over the last five years. (See chart below)

"Investors are targeting the much wider than average gap to government and corporate debt," Dakin added. Paul Jayasingha, global head of real assets at Willis Towers Watson, who advises pension funds on real estate strategies, returned to the theme in a later panel discussion. "Traditional core real estate has been squeezed. Pension funds have been investing in more alternatives such as long leases, real estate debt and infrastructure. There is approximately €2 trillion of UK pension fund liabilities which are maturing and there are not enough index-linked gilts today to satisfy that de-risking. So, pension funds have to look at these alternative areas, where investors are paid to take the illiquidity risk."

By comparison, US investor interest in real estate debt is coming from a slightly different perspective. "US pension funds seem to be more interested in the UK" said Jon Rickert, investment director at GAM. "There is a broad view that values are softening. Investors are more risk-off today than one to two years ago and therefore like the downside protection from credit."

## Worldwide central bank unwinding of QE poses "known unknown" risk to capital values

Worldwide central banks unwinding of the "mountains" of central bank held government and corporate debt, acquired through years of global Quantitative Easing, remains a significant "known unknown" risk to capital values in the coming years.




Trevor Williams, the former chief economist at Lloyds Bank Commercial Banking and a current visiting Professor at the University of Derby, told delegates at CREFC's conference last Thursday that a 'false market' had developed in global fixed income markets. "One of the reasons why gilt yields are under downward pressure is that central banks have buying them up. You therefore have an artificial market. At the same time, there are regulations which require institutional investors to hold so-called 'safe assets' in the form of government debt so there is competition for what is left. But the rules say you have to hold safe assets as part of your portfolio. So, you have a false market."

The regulations Williams is referring to are the rules set by central banks which govern investments by riskiness and duration. Investors like pension funds and insurance companies need to offset risky assets with 'safe assets', as government debt is classified. In certain situations, insurance companies which continue to collect need capital from investors need to keep buying bonds regardless of the price, driven by the requirement to hold a certain proportion of their portfolio in 'safe assets'.

Eventually, though not expected in the near-term, central banks will start offloading their mountains of corporate and government debt. "We don't know what will happen when central banks start unloading their gilts and bonds. It is the known unknown. To some extent, there is a risk on capital values, as a result of this. But we are going to be in the holding pattern for a while as there are no signs of the central banks unloading anytime soon, nor a stampede to raise interest rates, there is no need to because global inflation remains very low.

"The problem is there is a savings glut, particularly in the EM world. But the real issue is this: there isn't enough assets to soak up the liquidity which is out there and this is leading to over-pricing of all sorts of assets. And risky assets that we don't really understand. And we don't know how this is going to play out."

Nevertheless, the near-term macro picture remains bright, despite a raft of political headwinds. Williams summarised the picture for CREFC delegates:

"The political backdrop consists of:

- An unpopular US president (if you believe the opinion polls) who is threatening economic nationalism and protectionist policies. This has not converted into policies yet (though Donald Trump did repudiate the Trans-Pacific Partnership) but the rhetoric is not one of free trade;

- Russian adventurism;

- Populism threats subsiding, with Germany and Italy next on the radar;

- China has a property-related credit bubble. Not surprising about the Chinese outflows, but there are rules around this; and

- Continuous problems in the Middle East where there are four wars raging."

Notwithstanding the geopolitics and uncertainties around medium-term unravelling of Quantitative Easing, global GDP is expected to rise faster this year than last year both for matured and maturing economies, driven by low oil prices, loose worldwide monetary policy, plentiful liquidity and a return to growth in key world economies.

Williams told delegates: "Always and forever, if oil prices are low it boosts consumption. It reduces firms' costs, it reduces their input costs. There are more consumers than producers. So, low oil prices always boosts the world economy and keeps inflation low. We are in that nice sweet spot and it is predicted to stay there.

"We also have loose monetary policy. The disincentive to save caused by very low interest rates is still in place. Record low rates in the UK, record low rates in the euro area, record low rates in Japan. Only the US has started to reverse its ultra-low interest rate policy. We also have plentiful liquidity provided by central banks. No central bank has reversed their policy yet so they are all sitting on mountains of debt that has been taken out of the market and pushing liquidity into it.

"Also, there has been a return to growth in key economies. The recession in Russia is over, the recession in Brazil is over. That turnaround alone is sufficient to improve global growth. But on top of that loose monetary policies and low oil prices are boosting all economies. I don't think the cycle will end this year or next. But it will end one day."