Viewpoint

Marc Mogull

Prime bricks and mortar no longer looks so solid

If you can keep your head when all about you are losing theirs, you have misunderstood the severity of the situation. That's the joke doing the rounds on the trading floors of London, New York and Hong Kong. Markets have been wildly volatile, US sovereign debt downgraded and new rumours about struggling eurozone members abound. But what does all this mean for property investors?

Prime property has been a solid performer for the past two years due to its attractive income attributes, but also because of expectations that fundamentals would strengthen on the back of improving economies and lack of new supply. The latter belief has been severely shaken, as markets now realise that European growth is less robust than pre-August equity market valuations implied. There is little confidence in policy makers' ability to cut debt, stabilise markets and encourage growth.

Lower economic growth expectations mean lower employment and, ultimately, lower rental growth. We may like to think that in the financial crisis prime property pricing has been underpinned by real estate's attraction as a hard asset (ie inflation hedge). But rises in values have stalled since Q4 2010, even as gold prices have continued rising, highlighting the weakness of that argument.

Investors weren't just buying 'gold with a yield' in property; they were buying a growth story. They bought the theory that lack of development finance and waves of lease expiries meant severe impending supply shortages. They bought agents' consensus forecasts that City office rents would grow more than 50% from 2010 to 2014.

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Collapsing equity markets have shifted perceptions of market fundamentals, rather than the fundamentals themselves. European property markets may not face the same oversupply threat as US markets, but they can be shaken just as strongly by severe, sustained bouts of low demand.

Acceptance of lower European economic growth forecasts will cause rental growth forecasts to be cut in all markets and it will be harder to justify yields below long-term averages on the basis of future rental growth. Historically low interest rates may forestall a mean reversion of prime yields, but the risk to prime investors has risen in past weeks.

Given volatility in equity markets and minimal fixed-income returns, investors will probably sit on their hands for now. They will accept that lower returns on prime assets are inevitable once capital growth is taken out of the total return equation.

This is a risky approach. Prime may appear a safe port in the storm, but these assets remain disproportionately exposed to interest rate rises; a move from 5-6% will have a far greater impact on value than from, say, 8-9%, and affords less scope to offset market reversals via active management.

Retail investors will, in time, lose their appetite for property as returns fall. Institutional investors will also cut their exposure as the 'denominator effect' kicks in and they sell property to keep their exposure in line with percentage targets, in the face of a shrinking overall investment portfolio.

The UK may still benefit from 'capital flight' from the eurozone and Middle East, but the Continent will have to look inward for capital, as the world takes fright from fears about the single European currency. Property investors in the US are much more focused on the euro than they are on European property market fundamentals.

We've come to the end of the inevitable bounce following the post-2008/2009 downturn. Investors will take one of three paths: balking at minimal capital appreciation and low cash yields, they may take their profits; they may shift to higher yielding assets (despite the greater challenges in sustaining income), in an effort to preserve the returns of 2010/2011; or they'll act like the frog in the pot as the heat starts rising – do nothing until interest rates rise and prime yields start to normalise.

There are no easy answers and few alternative investment attractions. The resilience of prime property cash flows seems very enticing – but prime property values may not be equally resilient.

Marc Mogull is managing partner of Benson Elliot and chairman of the Urban Land Institute's UK National Council