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Recession fears are much exaggerated

Policy-makers have to be incompetent for recession to occur

Recession mongering has been around for over a year

Newspaper headlines have become tiresome with their constant references to "recession". It needs to be emphasized that the recession mongering began in the middle of last year and has so far been wrong. In its July 1997 *Economic Review* the National Institute drew attention "to the magnitude of the contractionary forces already in place"; it went on to say that, with "the prospect of further tightening of monetary and fiscal policy", an estimate could be made of "a 25% chance of a fall in output during next year" and "a 15% chance that average output is lower in 1998 than in 1997". In fact, demand and output have continued to rise since last summer. A particularly telling refutation of the recession-mongers' pessimism is that base rates have risen further since last summer, but unemployment has fallen significantly. Last month the unemployment rate (on the claimant-count basis) was 4.6%; in July 1997 it was 5.5%.

Last three recessions all due to policy response to very high inflation

If the recession mongers were wrong last year in their forecasts for 1998, why should they receive so much publicity this year in their forecasts for 1999? More fundamentally, what is the justification for a recession in the UK at present? All three recessions of the last 25 years were a response to unacceptably high inflation and were due to deliberate policy decisions. The 3% drop in gross domestic product in the year to the third quarter 1975 was needed to deal with an inflation rate which (on the retail price index) peaked at 27%; the 4% slide in GDP between the fourth quarters of 1980 and 1981 was meant to curb inflation of over 20%; and another 4% decline in the 18 months to the first quarter of 1992 was required against an inflation rate of over 10%. But today inflation on the RPIX measure (i.e., retail price excluding mortgage costs) is 2.5%, bang in line with the Government's target. Quite simply, on policy grounds a period of falling output is not needed. Policy-makers would be incompetent if they allowed a recession to develop.

The counter-argument is that policy-makers may prove ineffective in dealing with "global deflationary forces". But the pessimists must be specific. The Japanese economy has behaved strangely in 1998, with domestic demand falling over 4% in real terms, and this has hit the world economy as a whole. Otherwise the world economy has performed much as expected, with demand in the USA recording above-trend growth and in Europe roughly trend growth. As the pound is not tied to the euro, the Bank of England can react to a genuine deflation threat by a large cut in interest rates. The pound's recent fall to under 2.80 DM has been welcome, but the foreign exchange market's response was disproportionate to a small drop in interest rates. If interest rates were lowered to the 5% - 6% area in the next few months, the pound would tumble and above-target inflation would again become a problem.

Risk of big exchange rate fall if interest rates tumble

Professor Tim Congdon 19th October, 1998

Summary of paper on

"Equities vs. property: a long-run investment perspective"

Purpose of the paper

Considered as an asset class for investment insitutions, commercial property has under-performed equities for almost a generation, but now yields 4% a year more. This research paper asks whether property's under-performance has been due to an adverse yield shift compared with equities or to other influences.

Main points

* **If a gross (i.e., tax free) fund had invested in the stocks included in the FT all-share index in 1972 and always re-invested income, the investment would have been worth 14.8 times the initial sum at the end of 1997. By contrast, if the money had been put in representative commercial property, it would have been worth 7.3 times the initial sum. (See p. 3.)**

* **Property's under-performance was consistent from one cycle to the next. A few years of out-performance occurred in late-cycle conditions, helped by upward rent reviews after strong demand for space in booms. (See pp. 6 - 7.)**

* **In the early 1980s property typically gave a lower yield than equities, but the recognised industry benchmark (prepared by the Investors Property Databank) shows that property now yields about 4% a year more than equities. (See pp. 8 - 9.)**

* **The rise in the yield on property reduced capital values, whereas the fall in the equity yield led to capital gains. The change in capital values due to this adverse yield shift explains some of property's under-performance.**

* **However, even without the adverse yield shift, property would have under-performed because rents grew more slowly than dividends. (See pp. 10 - 11.)**

This research paper was written by Professor Tim Congdon, with help from Mr. Brendan Baker in the preparation of the data and charts. It will form the subject of a presentation to the IPD Investment Strategies Conference in Brighton on 27th November.

Equities vs. property: a long-run investment perspective

Does the adverse yield shift explain property's under-performance?

Dividends and rents two main forms of capital income in market economies

Dividends and rents are the two principal forms of income on capital in modern market-based economies, and both tend to rise in the very long run at roughly the same rate as nominal gross domestic product. The behaviour of the two asset classes with claims on these incomes - equities and commercial property - is fundamental to all investment decisions. Assuming that the two asset classes have similar initial yields, a reasonable expectations would be that they achieve much the same sort of long-run total return. Further, because there is some uncertainty about income growth as well as volatility in their capital values, they need to give a higher return than government bonds and cash. Historically, they have indeed done better than these relatively safe assets.

Investments based on rents have under-performed in last 25 years

On this basis, equities and property should be seen as twins who engage in close and constant rivalry for the affections of investment institutions. However, that is not their relative status in the present UK investment scene. Instead equities are the dominant member of the family of investment assets, while property is the poor relation. In terms of total return, property has under-performed equities for many years. There have been occasional intervals of out-performance, but these have usually lasted only a few quarters at the end of the upturn phase of the business cycle. (See pp. 6 - 7.)

and are regarded as an unsatisfactory asset class by investment institutions

Analysis of the data shows that the under-performance began in the 1970s. In the 25 years to 1997 a gross fund (i.e., a tax-exempt fund such as a pension fund or charity) which invested in the FT all-share index and retained all the income would have increased in value by 14.8 times; if it had instead invested in a representative sample of commercial property, as monitored by Investment Property Databank, it would have increased in value by 7.3 times. Expressed in terms of the compound annual total return, equities gave 11.4% and property 8.3%. As comprehensive and reliable data on property returns are not available before the 1960s, it is difficult to demonstrate any medium-term period in which property did better than equities. Not surprisingly, property is deemed to be the also-ran in institutions' asset allocation decisions.

Has property's under-performance been due to an adverse yield shift?

But property does have its supporters. Some institutions have significantly different weightings in property from the norm. For example, the property weighting in life insurance companies' non-unit-linked assets (i.e., in the main life fund) at the end of 1996 was 12.2% for Legal & General and 10.8% for AXA Equity & Law, but for Abbey Life it was 0.7% and for Allied Dunbar nil. (The life industry average was about 8%, according to figures based on DTI returns and compiled in NTC Publications' *Insurance Pocket Book.*) One argument urged by property's defenders is that it has suffered unfairly in recent decades from a change in investment fashion, which has pushed up the yield on property and lowered the yield on equities. Of course, the rise in yields has depressed commercial property values and, hence, total returns, whereas the fall in yields has had the opposite effect in equities. It is sometimes claimed that

- without this adverse yield shift (see p. 8) - the returns on property would have at least matched those on equities.

The purpose of the research paper in the following pages is to review this claim. The approach is to decompose the returns on the two asset classes into three elements,

- the income received,

- the effect of increases (or decreases) in income on capital value, and

- the effect of changes in the yield basis on the capital value.

Answer is "no, slower growth of rents than dividends also responsible"

The key numbers are set out on pp. 10 - 11. The analysis shows that the adverse yield shift was not the only influence explaining property's under-performance, in either the 25-year or ten-year periods to 1997. (This is shown readily if the black segments of the two bars on both p. 10 and p. 11 are deleted. When the black segments are taken away, equities still beat property by a wide margin.) As the effect of income received was more or less neutral in both periods, equities' out-performance stemmed from a persistent difference in the growth rate of the income streams as well as from the yield shift.

and property has other drawbacks

In short, equities out-performed property not only because of a change in fashion, but also because dividends had a consistently higher growth rate than rents. Indeed, a fair comment might be that institutions' increasing aversion to property in the late 1980s and 1990s was justified by the unsatisfactory results of rent reviews. Their aversion to property was re-inforced by traditional worries such as the high management costs of in-house commercial property departments, by the illiquidity of property as an asset class, and by surprise declines in valuations as leases ran out and new tenants could not be found without incurring substantial refurbishment costs.

Higher yeield on property argues that it should now out-perform

Of course, the past is not an infallible guide to the future. The adverse yield shift could be interpreted as largely a consequence of institutions' changed attitude towards property. But is this change in attitude now complete? Could it be taken further? Or is there a possibility that it could be reversed? Much depends on assessments of the adequacy of the current differential between equity and property yields. With this differential now at about 4% (i.e., 400 basis points), it is obvious that property returns will out-perform equities over most investment horizons unless,

- dividends continue to rise faster than rents, and/or

- the excess of the property yield over the equity yields increases further.

Much depends on tax policy towards capital incomes

Much depends here on larger social and political trends. A crude generalization is that Conservative governments have been good for dividend growth and bad for rental growth, whereas Labour governments have been bad for dividend growth and good for rental growth. The Conservatives have usually altered the tax system to make it more friendly towards dividend distributions, whereas Labour has discouraged dividends not only by reversing the Conservatives' tax changes, but also by direct dividend restraint. Meanwhile the Conservatives have generally (but not always) removed - or at any rate watered down - planning restrictions, and so stimulated more building. Crudely, the more factories, offices, shops and warehouses are built, the slower the rate of increase in rents.

Labour Party has typically been more obstructive of new development than the Conserviative, tending to raise rents

On the other hand, Labour has typically been anti-development, leading to space scarcities and so to rapid rental growth. Examples are Mr. George Brown's ban on London office building in the 1960s and, until the mid-1980s, the hostility of the Labour-controlled London boroughs to office development. Both Mr. Brown's ban and the reluctance of Labour boroughs to give planning consents on new offices made the owners of already-existing London office buildings much richer than they would otherwise have been. (It is not clear that Mr. Brown, or the Labour councillors of Camden and Southwark, understood quite what they were doing. Ironically, when rate-capping forced the Labour-controlled London boroughs to accept new development in the 1980s, and the flow of new consents in the Square Mile also increased in response to the threat from Docklands, a record amount of new office space was constructed. In the early 1990s rents and site values in the City of London collapsed.)

and has already attacked dividends

Arguably, New Labour under Mr. Blair has been behaving according to Old Labour form. The main measure in the present Government's first Budget was an attack on dividend distributions to pension funds. Advance corporation tax is now to be abolished altogether, which will depress the growth rate of dividends. Meanwhile the planning regime is being tightened. For example, planning consents for large out-of-town retail developments are being restricted, in order to preserve the character of town centres. With the gradual absorption of much of the empty office and industrial space created during the boom of the late 1980s, most types of commercial property can now expect a resumption of rental growth.

1998 will see out-performance by property

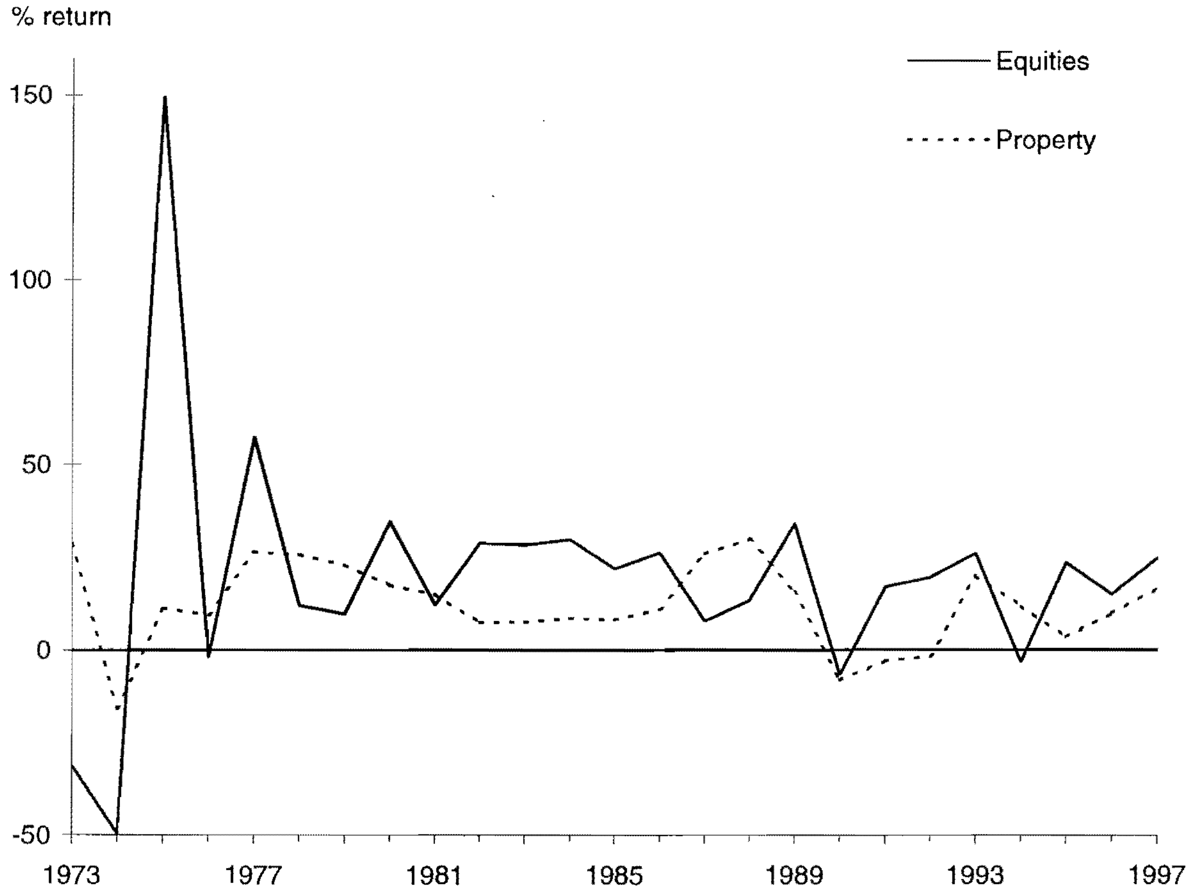
1998 has already seen a marked change in the pattern of dividend and rental growth. In the year to the end of September the dividends paid by companies in the FT all-share index fell by over 3%. (See p. 14 of our *Portfolio Strategy* publication.) By contrast, according to Investment Property Databank's *Monthly Index*, the rental value of all institutionally-held property increased by 6.4% in the year to July. Total returns on property this year are likely to be about 15% and certainly above 10%. At the time of writing (15th October) the FT all-share is down on its value at December 1997 by more than its dividend yield. Unless equities bounce strongly in the next few weeks, total returns could be negative for the year as a whole. As property tends to out-perform equities in late-cycle conditions (see p. 6), the 1998 figures may not be particularly remarkable. But the wide income differential in favour of property and the relatively poor prospects for dividend growth suggest that its familiar late-cycle out-performance may be followed, unexpectedly, by a period of out-performance extending over at least one business cycle and perhaps longer.

which may be the start of a medium-term trend

Property's almost continuous under-performance

Property did well only in late-cycle conditions

Chart shows the total return in % p.a. on equities in the FTSE all-share index and commercial property, as recorded by Investment Property Databank, using annual data, between 1973 and 1997.



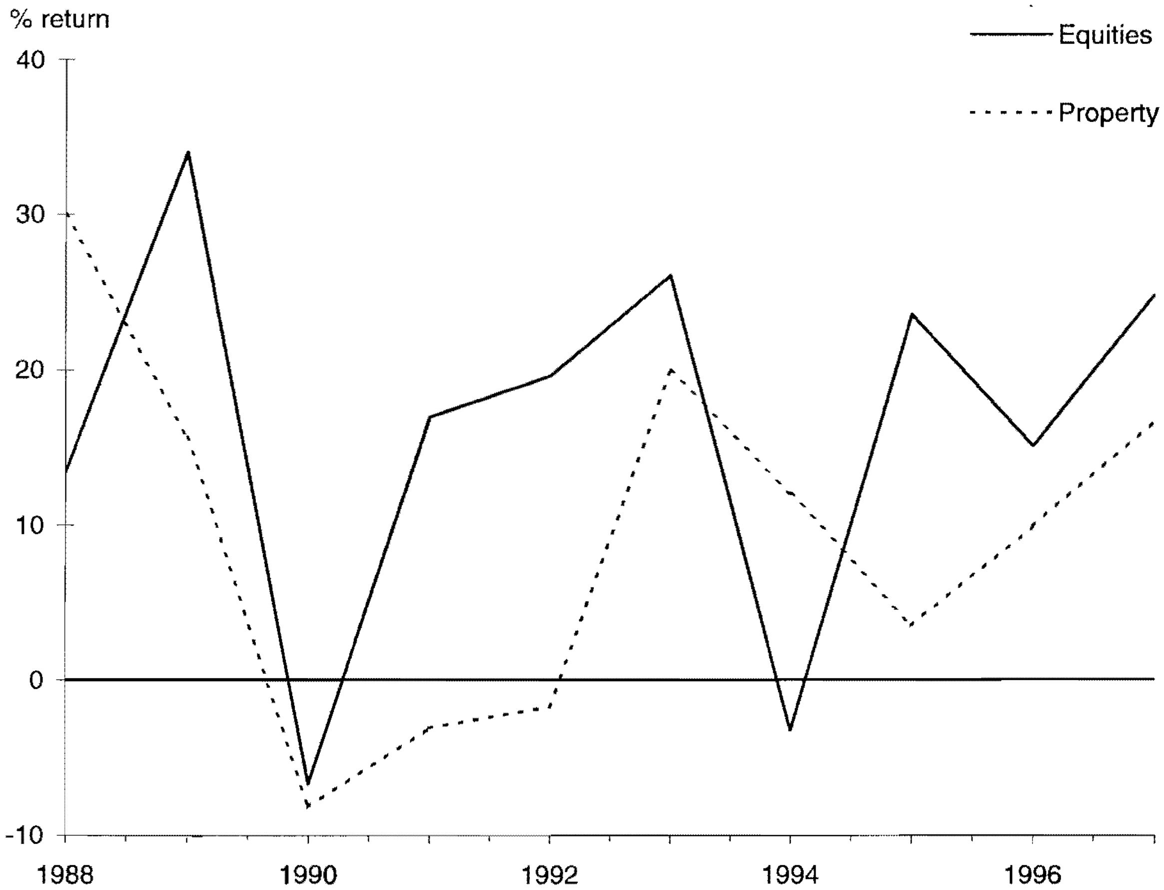
Sources: Financial Times *and Investment Property Databank*

In the late 1970s commercial property was an important asset class for investment institutions. Many life insurance companies had property holdings whose value was similar to, or even larger, than that of their equity holdings. The property assets of all UK pension funds at the end of 1979 were £5.8b., 16.9% of total assets and almost half the size of their UK equity holdings. Since then property has under-performed equities almost continuously, with the only exceptions being in the year or two coinciding with the peak of economic cycles. These peaks usually see excess demand for space and rising rents, which boost property values, while increases in interest rates undermine bond and equity markets. Pension funds' property assets were only 4% of total assets at the end of 1996.

Property still the underdog

In last decade property out-performs only twice

Chart shows the total return in % p.a. on equities in the FTSE all-share index and commercial property, as recorded by Investment Property Databank, using annual data, between 1988 and 1997.



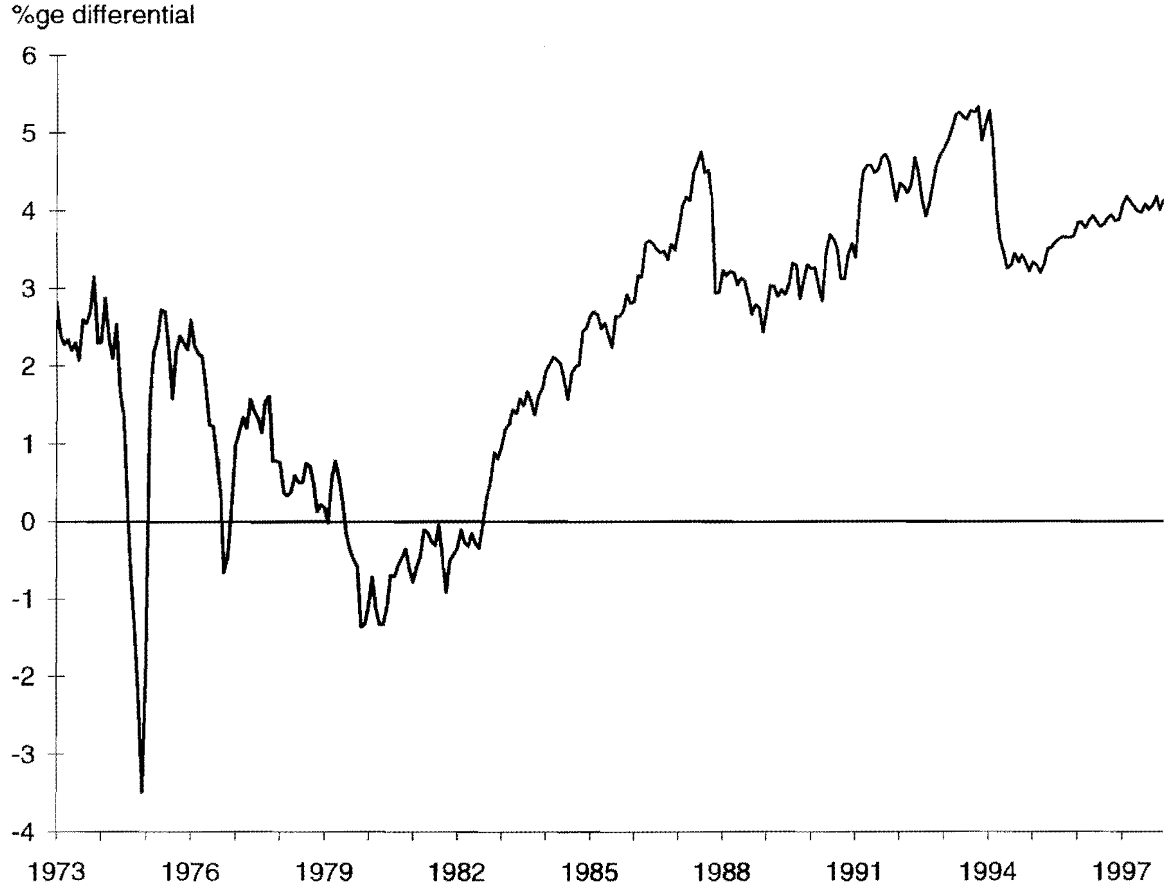
Sources: Financial Times *and Investment Property Databank*

Property did particularly badly in the early 1990s, with negative total returns in 1990, 1991 and 1992. Capital values fell, perhaps because of the over-supply of space from the boom of the late 1980s. Institutional investors' disillusionment with property is illustrated by their reaction to this traumatic period. Instead of buying up cheap assets, they disinvested. According to data from the Office for National Statistics, pension funds were net sellers of commercial property of £325m. in 1994, £16m. in 1995 and £735m. in 1996. (By contrast, they were net buyers of £948m. in 1980, £847m. in 1981 and £983m. in 1982, when property values were much lower.) However, they became net buyers again in 1997. Insurance companies also bought over £1b. of commercial property last year.

Adverse yield shift against property

Investor disillusionment behind rise in property yields

Chart shows the differential between the commercial-property rental yield, as measured by Hillier Parker, and the dividend yield on the FTSE all-share index, monthly data.



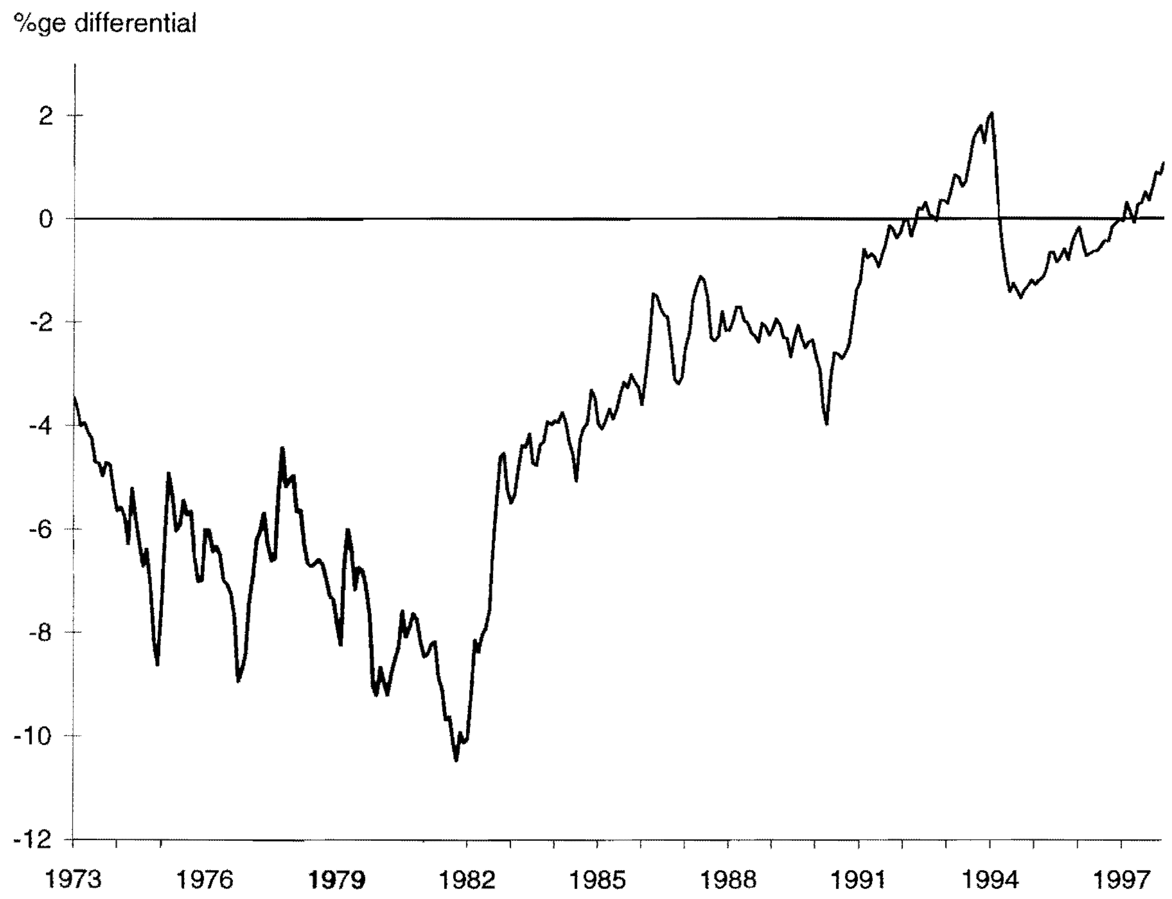
Sources: Financial Times *and Hillier Parker*

Property was attractive to investment institutions in the 1960s and 1970s, because rents were expected to rise at least in line with the inflation rate. Equities were regarded as less reliable, with dividend growth held back by incomes policies. Property yielded more than equities in the early 1970s, but the differential became negative for a few years in the early 1980s. With the scrapping of dividend restraint and the achievement of low inflation under the Thatcher Government, equities were re-rated. Between 1982 and 1987 the property/equity yield differential rose steadily, and for the last decade has typically been between 3% and 4%. As both rental and dividend growth ought in the long run to track nominal GDP, the usual justifications for the differential are property's management costs and relative illiquidity.

Gilts now yield less than property

Collapse in expectations of inflation and rental growth

Chart shows the differential between all-property rental yield, as measured by Hillier Parker, and the yield on long-dated medium-coupon gilts, monthly data.



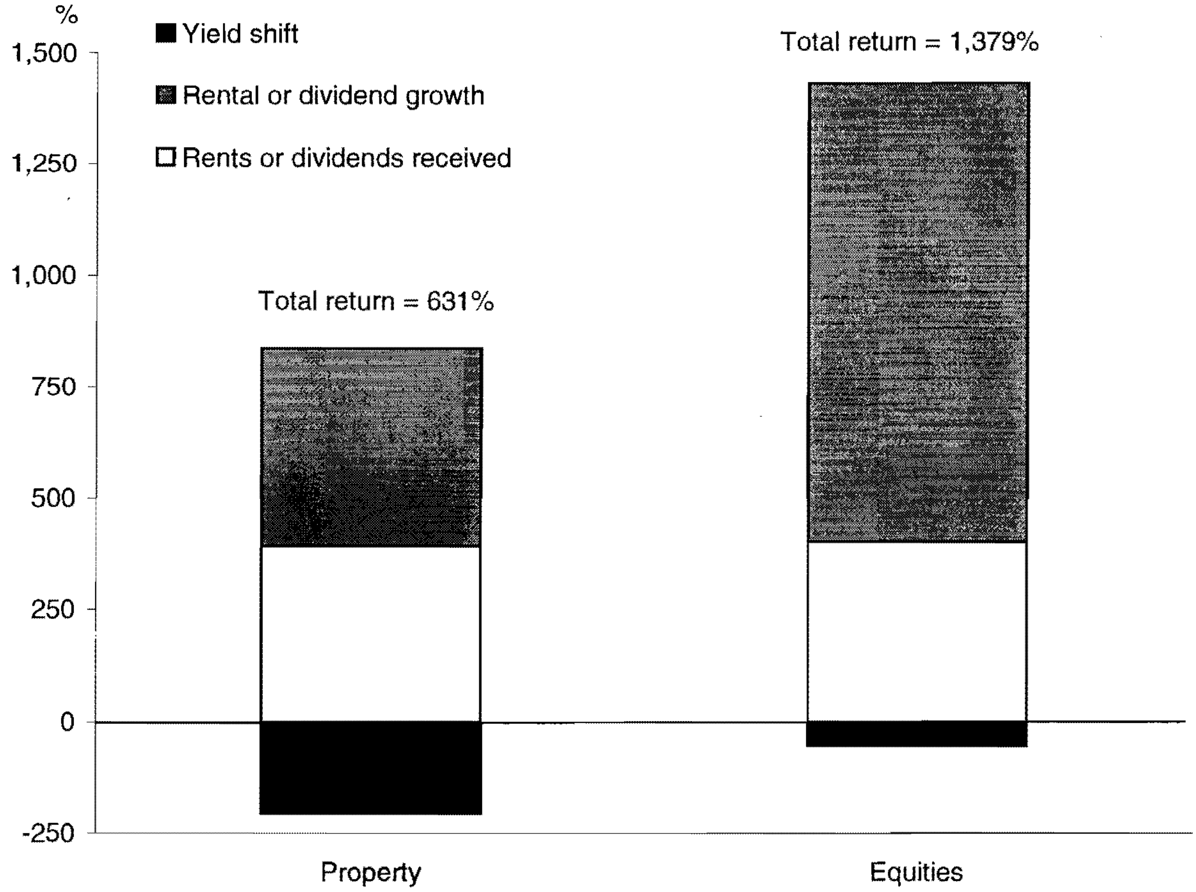
Sources: Financial Times *and Hillier Parker*

The relationship between gilt and property yields is strongly influenced by expectations for inflation and rental growth. Assuming a strong covenant and a fully rack-rented property (i.e., one where the contractually-agreed rents are in line with market conditions), and ignoring changes in the yield level, the total return on commercial property is given by the rental yield plus the growth rate of rents. Until the 1990s rents moved ahead with inflation. Logically, property had a consistently lower yield than conventional gilts, whose income is fixed. Despite property's setbacks in recent years, a reasonable medium-term expectation is for gradual increases in rents in line with nominal GDP. If so, property ought to continue to yield less than gilts. Instead it yields 1% - 2% more, which appears anomalous.

Yield shift not the only culprit

Property under-performance partly because of slower income growth

Chart shows contribution to total return from income received, income growth and yield changes for commercial property and equities in the 25 years to 1997.



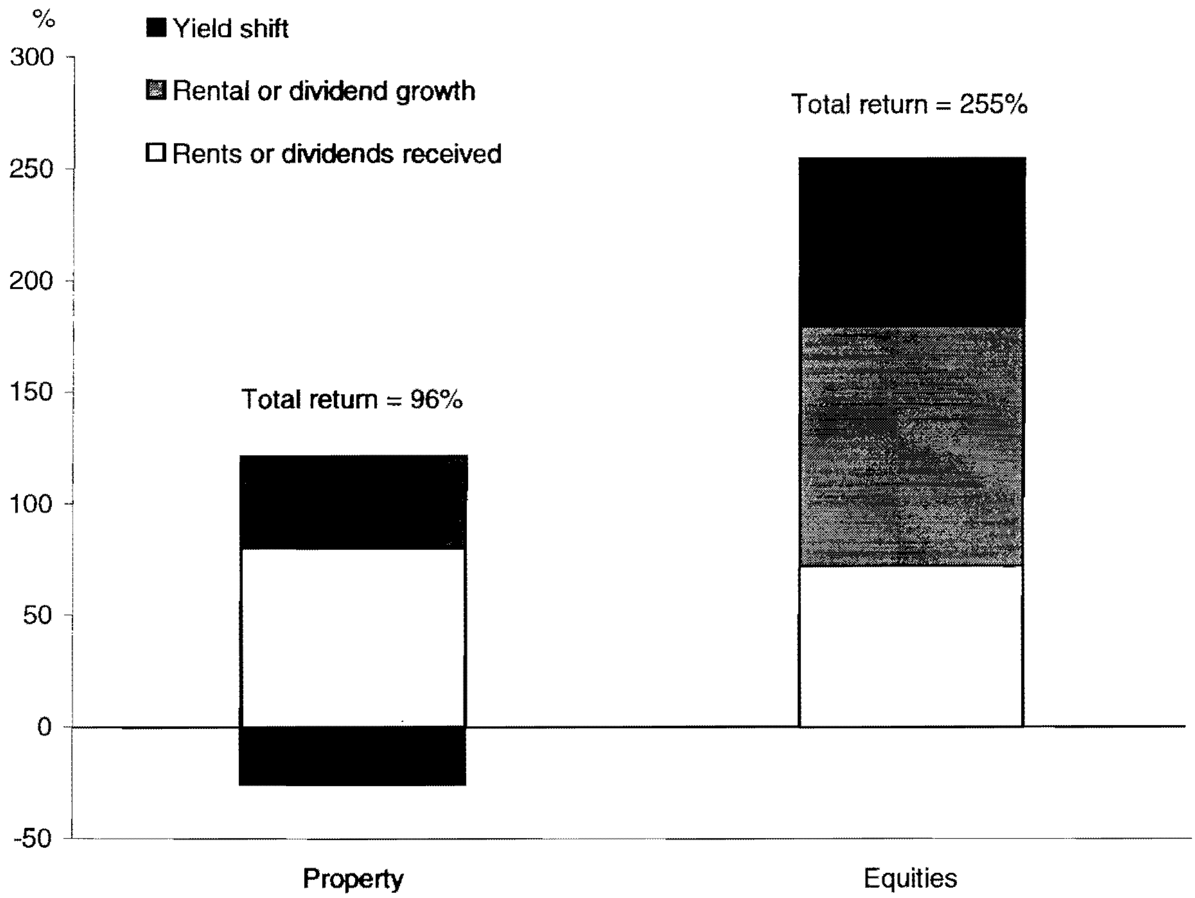
Sources: Financial Times *and Investment Property Databank*

Total returns on any asset can be decomposed into three elements - income received (i.e., rents on property, dividends on equities), income growth and the yield change. (With income static and a fall in yield, or with income rising and yield static, there is evidently a capital gain.) Supporters of property as a destination for institutional funds argue that its under-performance relative to equities since the late 1970s has been due to an adverse yield shift, as discussed on p. 8. The chart shows that, when the last 25 years is considered, this claim is incorrect. If the effect of yield changes is taken away (i.e., if the bottom segment of the bar is ignored), equities have still beaten property by a wide margin. Equities were of course massively boosted in the 1980s by the ending of dividend restraint.

Over-supply of space held back returns

Too much space build in the boom of the 1980s

Chart shows contribution to total return from income received, income growth and yield changes for commercial property and equities in the 10 years to 1997.



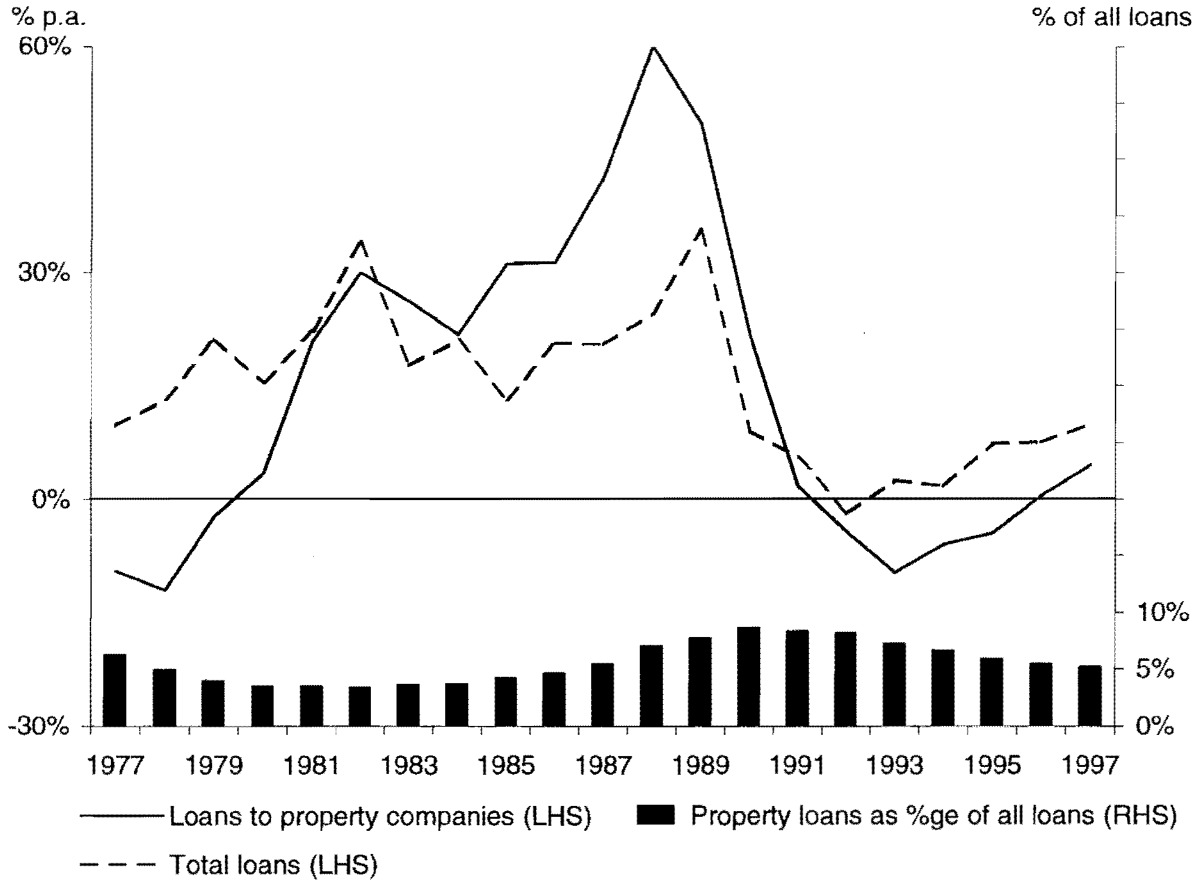
Sources: Financial Times *and Investment Property Databank*

The chart here follows the same procedure as that on the previous page, but over a shorter 10-year period. In this period the yield shift was vital in explaining equities' out-performance of property. As property started the period with a higher running yield, the contribution of income alone was favourable to property. On the other hand, dividend growth was much faster than rental growth, with rents restrained by the over-supply of space from the building boom of the late 1980s. Overall the net effect of income received and income growth would have been equity out-performance, to the extent of 3% - 4% a year. The actual out-performance was much greater, at about 6% a year, with the extra 2% - 3% a year due to the conjunction of rising property yields and falling equity yields.

No over-heating in today's property market

Property loans only 5% of all UK bank loans

Line chart (LHS) shows annual percentage growth rates of lending to property companies and total lending to UK residents. Bar chart (RHS) shows the value of commercial property loans as percentage of all bank loans



Source: Bank of England

Long-term investment institutions are the dominant holders of UK equities, but they are only one kind of player in the commercial property market. Other investors include unquoted property companies, foreign investors and owner-occupiers, and many of these leverage their stake by bank borrowing. The cycles in property valuation partly reflect banks' attitudes towards lending to the sector. The chart identifies three distinct phases of bank involvement - retrenchment from the early 1970s' boom in the late 1970s, enthusiasm from 1980 to 1990 (when property loans grew on average by 30% a year) and retrenchment again from 1990. Whereas in 1990 property loans were almost 10% of banks' total loans, the figure today is down to under 5%. Commercial property does not suffer at present from undue leverage and speculative over-heating.