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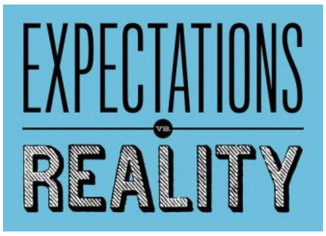

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Forward Guidance and Real Estate

Forward guidance is the policy of credibly and consistently indicating where a central bank will set base interest rates in the future. The policy is a spawn of behaviourial economics and one based on the belief that peoples' expectations are as important as anything else in informing their behaviour. It is the opposite of reading backward looking data and adjusting interest rates accordingly.

Forward guidance's main message is to the capital markets, which is only vicariously (and with a time lag) transmitted to the underlying or 'retail' market. In the real estate market, for example, the quoted price of financing is a form of 'forward guidance' from a lending bank on the margin that they expect to be able to make between the wholesale and retail market. Only if a bank had misread the economic climate dramatically, there is extreme volatility or margins are extremely thin will forward guidance have a dramatic impact on the 'retail' market. None of these apply currently.

Forward guidance on interest rates now, therefore, only makes a marginal difference to real estate. The biggest area that it has an impact is in the pricing of hedges (or swaps) that are wholly dependent on the movement in interest rates. Even in this area much of the expected volatility has been stripped out and a real estate user of hedges cannot realistically expect much profit or loss from forward relying on or analysing forward guidance from a central bank.

Interest rate is an indication of how much demand for money there is in market place. This is something in ordinary (and optimal) circumstances in a free and fair market a central bank should be an observer of. This is because first the central bank only indirectly provides liquidity to the market through the small number of market participants, secondly, though fundamental it constitutes a small block of a vastly multiplied pool of capital and thirdly, there is fundamental time lag before their actions are felt in the retail market.

In recent years central banks around the world have sought to subsidise the very financial intermediaries that they use. But in the long term the only sustainable role is to play honest broker maintaining relatively stable circumstances for growth and stability. But there are weaknesses in the congruence model. A central bank will always be under huge political pressure to favour loose monetary policy over fiscal discipline. Whatever their statements whatever there models that they parade or factors they espouse inflation rising will always be more welcome than interest hikes.

It is a peculiar time to introduce forward guidance which would *prima facia* be more powerful a tool to loosen the shadow market rather than to reign them in i.e. to forward guide interest lower rather than higher, especially in these extraordinary times. Ultimately, forward guidance can be considered trying to double play the market. The value of a feint is high as if the capital markets believe that the interest rates will go down and they go up or vice versa the belief itself will have the desired affect by the central bank. However, this is indisputably a power game doomed to failure.

Nicholas Frankopan is the Managing Director of Oak Investment Management Group pan-European real estate investment manager. To contact the author please email nfrankopan@oakimg.com or learn more about the group at www.oakimg.com.