OAK INVESTMENT MANAGEMENT GROUP

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ECB, Negative Interest Rates and Real Estate

The ECB is trying to battle huge deflationary pressure in the Eurozone. Spooked by 0.5% inflation so far in 2014 as well as first quarter growth of only 0.2% the ECB is trying to get banks in the region to lend. It has made the unprecedented step of applying negative interest rate to foster lending. On the one hand this is clearly good for the real estate market as cost of funding will remain low on the other hand this leaves a great deal of capital value compression in the short to medium term.

In simplest terms the ECB wants to encourage risk taking. This is much harder to enculturate since the economic crisis of that started in 2007/2008. Even though the capital markets have broadly recovered and government bond borrowing rates are under control the Eurozone market participants still remember this recent traumatic period; especially between 2010-2012. Since market participants are not *automons* but people with memories it is unlikely that this is going to be dispelled quickly. In all likelihood it will do so quickly, ahead of the average and thus will be part of a new cycle.

Other asset classes in the economy are generally much more responsive than real estate. Real estate has one of the longest cycles within the asset class spectrum. Investment product often stocks out in good times as supply rushed against natural constraints, and demand dynamics naturally snowball until they come to an abrupt end. This is why real estate is either symptomatic or an underlying cause of boom and bust in the wider econmy.

As a result it looks like the right thing to do is accept the ECB's invitation to invest, whilst paying as much attention as possible to fundamentals. Fundamentals in real estate consist of broadly three important areas, first, the specification of the real estate concerned for the short to medium term; secondly, the demand for that specification in different economic climates; and thirdly, the income profile of the contract as specified.

All of these fundamentals need to be adequately analysed and any risks emanating from these need to be mitigated. Broadly speaking income at the point at which interest rates start to rise (or to normalise) will become more valuable, and the capital value will become less valuable. The key to playing the macro-economic environment correctly is to ascertain when this might happen, and adjusting a real estate positioning accordingly. Knowing when to withdraw from the ECB's open invitation to invest (or lock up liquidity) and instead producing live cashflows from these assets or switching to yielding assets will be the determinant of alpha in the next cycle. However, all the indications and pronouncements are that this switch will not happen for quite some time. The long lived economic decisions of real estate investing are decidedly in favour of entering the market. Nonetheless, having sufficient liquidity to buffer future volatility or heightened cost of borrowing has never been a problem.

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