OAK INVESTMENT MANAGEMENT GROUP

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Brexit and Real Estate

If General de Gaulle had not lost a popular referendum in France in 1969 (by a margin of 52/48) maybe the Britain would not have been admitted finally into the EEC in 1973. Britain had tried to join twice in 1963 and 1967. De Gaulle sensed with his intimate knowledge of the British from his wartime sojourn in London and North Africa that they could not belong to his vision for European co-operation. Maybe it was their merchant-nature, their pragmatism or their ruthlessness. Certainly, all of these characteristics were on display when the UK voted to leave the European Union on 23rd June 2016.

Economically speaking, the EEC/EU had served the UK well between accession in 1973 and the financial crash of 2008 but then the block has failed to recover its GDP, its vivacity and its allure for UK voters. Unlike other European countries the community / Union was never a political project - so when the tangible economic argument was lost in the minds of the people, all the political irritants that had been boiling away for over forty years came to the fore. 'Taking back control' - the slogan of the leave campaign was predominantly a political not an economic argument.

Now that the people of the UK have made a political decision (decision is derived from the Latin to cut), the economic question of free market access comes back to the fore. On what basis may goods and services be sold to and from the European continent? The UK is exposed as never before since (perhaps even including) the time of Napoleon to 'fortress' Europe that has mercantilism in its DNA - and which the UK found so restrictive when it was part of the EU.

Mercantilism is the belief that trade generates wealth and is stimulated by the accumulation of profitable balances, which a state body should encourage by protectionism. This is an anathema to free trade and a laissez faire economy that the UK has championed fairly uninterruptedly since the agricultural and industrial revolution starting in the late 18th century. As the UK was not one of the six founding members of the EEC, the UK latterly sought to insert this into the EEC/EU ethos by championing the single market, resisting state intervention and encouraging EEC/EU wide competition. But the Common Agricultural Policy (CAP), which accounts for 40% of the total spend of the EU budget and capitalised at 4%, is a 1 trillion euro barrier to entry for developing countries to export their agricultural products to the EU demonstrates fairly well that substantial transformation of EU mercantilism was never really up for discussion or reform.

Now the question is to what extent the EU will seek to adopt an analogous policy for financial matters as in one fell swoop the prime champion of laissez faire economy has left and that there would accrue substantial benefits to the other centres of finance across Europe (Dublin and Luxembourg for fund administration; Paris and Frankfurt for banking) of imposing a tariff for passporting rights on their erstwhile fellow member. There is no doubt that fortress Europe will punish the fortress as much as

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the island that now floats beside it. As with CAP, any protectionism is economically sub-optimal, but like CAP it might be politically unacceptable to allow a non-member access on the same basis as a member of the European Union. It is clear that the partial or total exclusion of the City of London from automatic financial passporting or the imposition of a tariff will be devastating on jobs located in the City of London. This will have a noticeable impact on GDP growth prospects for the UK, and particularly on the economy of London.

It is clear that the departure of the UK from the European Union will have profound impact on both the UK and the EU. Real Estate values largely correlate with the prospects for GDP growth in each area. Such is the fast moving nature of the events that are unfolding as well as the laboriously slow nature of the structural changes that are happening that it will be hard to get a clear idea of which way GDP in these respective blocks are heading.

It is the belief of the pro-business centre right leaning faction of the Conservative party that led the charge for Brexit that free from the rules and regulations of the EU the UK could grow more outside it. It is the belief of all who voted to remain that these outlined benefits would not materialise and that the costs of breaking away would be profound, with a large negative impact on GDP. Of course, we cannot map out a parallel universe and examine both outcomes empirically – the UK has voted to leave so we need to examine the implications for real estate in the UK and the rest of the European continent.

UK Sterling. Without the shock absorber of an independent currency the real economic adjustments required as a result of the referendum vote would have been extremely difficult. As it is, UK sterling has depreciated against all currencies since the result of the referendum became known. If this is a permanent feature then imports will become more expensive and exports will become cheaper. More importantly for the present circumstances of the global market, this depreciation will import inflation from other countries. Almost all other countries are desperate to import inflation and in some cases have deliberately tried to manipulate their currencies lower for this end this is a welcome impetus to get the economic engine of recovery moving. It is not clear to what extent this depreciation of UK sterling will counter-veil the freeze on foreign as well as domestic investment while the profound political questions begin to be addressed.

UK Interest Rates. It has long been known that in the event of a Brexit the Bank of England had the capacity to lower interest rates. The ECB currently holds interest rates at 0.0% in the UK the base rate is 0.5%. This allows scope (without going into negative territory) of a 0.5% rate decrease to stabilise the economy. It is also important to note that the US is very likely to hold off rate rises for the rest of the year as well. This will flood the market with liquidity but again to what extent financial institutions pass this on to the real economy as opposed to using it to buffer their own financial position remain to be seen.

UK Territorial Integrity. Fears of a break-up of the UK are slightly over-stated. First, Wales voted with England for Brexit. Secondly, there is no doubt that a poll of Northern Ireland would result in the province wishing to stay a part of the UK. Thirdly, Scotland's independence bid is not as simple as it sounds.

First, Scotland cannot reach out for any bilateral relations with either the EU or with other countries for the simple fact that those countries do not wish to give credence to a separatist movement when they have ample of these within their own borders. Secondly, the UK effects a fiscal transfer to Scotland of £15 billion per annum which, if they were independent, and managed to secure taxing powers over North Sea oil they cannot plug with the current price of oil. Thirdly, if they were to re-apply and get membership of the European Union they would be a richer member and in line with the pro-rata contribution of the UK could expect a bill of approximately £1.5 billion per annum to Brussels. Fourthly, they have only recently had a referendum if they lose a new one they won't be able to have another for a generation. Fifthly, when re-applying to join the EU like all new members Scotland would have to accept to the promise to use the euro one day (which would not be popular with the voters). And therefore, sixthly they are still reliant on pound sterling for the foreseeable future. All-in-all the lack of room for manoeuvre is not as big as they would wish.

UK Residential Real Estate. The second largest asset class in the country (after human labour) is residential real estate. This is indistinguishably both a prime mover as well as a prime derivative of GDP. In other words, on the one hand rising house prices make people spend more as well as when people earn more they spend more money on residential real estate. What we know is the very likely interest rate cut will ease the burden on some £1.4 trillion lent on residential real estate in the UK. If a full 0.5% is taken off the base rate (i.e. the base rate goes to zero) there is some £7 billion per annum fiscal stimulus that will go into the pocket of home owners across the country.

But any emergency decrease of interest rates by the Bank of England (like those before) is clearly not aimed at existing asset owners, it is aimed at getting banks to lend more into the economy and get economic activity going. Although banks are well capitalised as a result of, *inter alia*, implementation of Basel III rules there are several bottlenecks that are not only related to Brexit. First, banks have still not recovered from the Great Recession of 2008. RBS is completely and Lloyds Banking Group is partially owned by the taxpayer. Secondly, their managements with living memories of what happened in 2008 are risk averse and are not readily lending. As a result, given more liquidity they are more likely to soak it up than to lend it out in an uncertain environment.

A welcome boost to house buying and selling activity would be the abolition of SDLT rates that have been ratcheted up as well as spun into a complicated progressive formula by George Osborne. A flat, low rate would cushion a weak market and support new entrants into the market more than an interest rate deduction. Arguably, a tax cut in this area would increase the tax take because with residential tax take on transfers at 15% for expensive properties we are at the high end of the Laffer curve. A tax cut could easily be justified on a popular basis as we are likely to see a large fall in tax take on this very shortly if no action is taken anyway.

Housing throughout the UK is a restricted commodity that is hemmed in by multiple planning restrictions not easily unravelled, new supply is expensive, awkward and slow to come online (at least for areas where people wish to live). As a result, the broad pricing of residential property is underpinned by strong domestic (i.e. non-global) demand.

UK Commercial Real Estate. The London commercial real estate market is the biggest in Europe. It is in fact, bigger than the next 15 European cities combined. This is a result of unbridled expansion of financial services from the 'big bang' orchestrated by Margaret Thatcher in 1986. This thirty year

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march has seen the bulking out of the historic City with the expansion into Canary Wharf and the Southwark. This market is most at threat from occupier demand shock caused by the UK's departure from the European Union, and if it is frozen out of the EU market. However, London financial market is also global in its nature and it cannot be regarded solely as a financial hub solely for the European Union. Any transfer of offices from the City of London to other European cities will be a slow process. It is more likely to express itself in lost new opportunities rather than by an exodus of occupiers. It is also easy to imagine a future UK government resorting to the various techniques of the Thatcher government to win and retain occupiers for what is after all a vast real estate financial services complex. A serious competitive advantage of a UK government could be the minimisation of corporate as well as personal taxes throughout the country.

Outside London we are likely to see a jump in yielding assets, as investment in built real estate as well as development pipeline slows. Investment activity will slow down as the new balance of occupier demand is assessed. The fundamentals of the UK regional markets are strong and have a great deal less exposure to the EU headwinds than London.

An interest rate cut to zero percent would also buffer corporate balance sheets of real estate companies throughout the UK that own commercial property to the tune of £750 million (with approximately £150 billion outstanding). This is unlikely to have a significant impact as interest rates are already so low and many commercial facilities are already hedged.

The Negotiation. Of course there are complicated issues to navigate but it is not beyond the collective wit of Europe's leaders to reach an accommodation with a newly economically independent country of the European continent. Put simply, the European Union is losing approximately £11 billion in net contributions to their budget. This was set to rise after a Cameron inspired cut and freeze on contributions in 2013. Beyond a vindictive political process it is quite clear that a general arrangement between the UK and the EU will look something along these lines:

UK wants	EU wants
Tariff free access to sell financial services	Tariff free access to sell goods
Control of general migration to UK	Re-coup £11 billion lost in membership dues
Retain the territorial integrity of the UK	Prevent other countries of the EU from leaving

The EU will never take kindly to a rich (albeit small), developed and competitive polity on its doorstep - creating an alternative narrative for its members. The UK will always be in the long shadow of the behemoth of an EU with well over 400 million citizens. But it is possible to co-exist and be strong trading partners whilst assuaging the fears of both polities. The fact that this could not have been done within the framework that had been built up over the preceding sixty years is an indictment of all political leaders involved as well as the system that exuded such rigidity in the face of change.

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