Emerging Markets Real Estate Semi-Annual Outlook

CITY OF LONDON
Investment Management Company Limited

November 2018*

Overview

Silver Linings Amidst Softer Growth

Emerging market (EM) real estate equities, measured by either the FTSE EPRA/NAREIT EM or the MSCI EM Real Estate, underperformed EM equities (MSCI EM) and developed market equities (MSCI World) in the first ten months of the year. The fall in Chinese real estate equities contributed to the underperformance. Indeed, EMs face several headwinds. First, Sino-US trade tensions continue to weigh on sentiment. Despite the Democrats taking back the House – which likely means Congressional gridlock for the next two years – President Trump can still impose more tariffs through executive order. Second, Eurozone growth hit a soft patch again, with Q3 GDP slowing to 0.2% qoq from 0.4% qoq in Q2. German GDP growth moderated as trade tensions and slowing Chinese demand hit its export sector and the auto industry. Italy stagnated with zero percent growth, re-igniting recession concerns. Also, the conflict between Rome and Brussels continued to escalate, with the EU rejecting the fiscal budget proposals by the new Italian government. Third, the Chinese growth slowdown was confirmed by recent activity and credit data, affecting both Chinese assets and other EM assets exposed to Chinese demand.

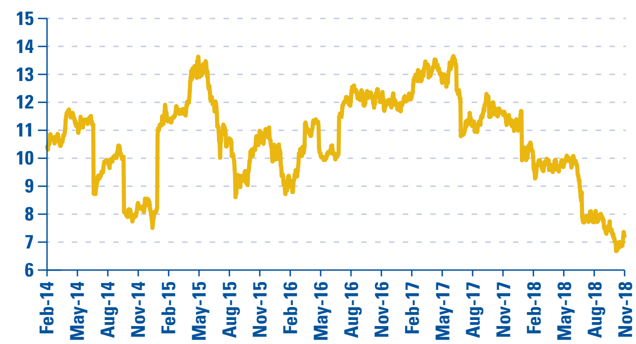
Meanwhile, the Fed is set to continue its monetary tightening despite recent softness in global demand, as the US consumer sector remains healthy. Indeed, personal consumption accelerated to 4% qoq seasonally adjusted annual rate (saar) in Q3, with real disposable income growing at 2.5% annualised rate for a second consecutive quarter. Wage growth just hit a nine-year high in October. 10-year US Treasury yields continue to grind higher against such a backdrop, another headwind for defensive sectors such as real estate. Many EM central banks had to hike interest rates in response to higher US Treasury yields and a strong USD.

Among the dark clouds to softer global growth and the Fed tightening, a few silver linings are appearing. First, excess liquidity due to the Chinese monetary and credit easing may find its way into some Asian real estate markets. The most recent economic commentary by the Communist Party has erased wording about deleveraging or regulatory tightening against the domestic housing market, suggesting regulatory easing at the margin. Second, several countries, e.g. Singapore, Hong Kong, Thailand and Mexico, have managed to avoid sharp monetary tightening this year as they benefit from strong national balance sheets and resilient currencies against the US dollar. That somewhat shields the domestic real estate markets from external pressures. Indeed, real estate prices continue to grow in real terms in those markets. Third, real estate earnings are primarily exposed to the domestic economy and are less vulnerable to elevated trade tensions than export-oriented sectors.

Looking ahead into 2019, we think external headwinds may moderate. For instance, the Fed may hike fewer times in 2019 than in 2018 as the Fed Fund Rate gets closer to the "neutral" level and US growth may moderate as the impact of this year's fiscal stimulus fades. The ECB may continue to maintain an accommodative stance, partly to prevent Italian bond yields from rising to a level that could derail the Eurozone economic recovery.

Against such a backdrop, we believe opportunities will surface in countries and markets with resilient private consumption, supportive (or at least neutral) monetary conditions and/or attractive equity valuations. For instance, Chinese household consumption, which is domestically focused and benefits from potential tax cuts, may prove relatively resilient against trade tensions, supporting the real estate sector. Also, growth in countries like Mexico and Brazil is likely to accelerate in 2019 from the current low base.

Chart 1: EM Real Estate P/E Ratio



Source: FTSE EPRA/NAREIT Index

Market Strategy

The FTSE EPRA/NAREIT EM lost 21.6% in USD terms in the six months until the end of October. Its P/E ratio is trading at 7.2 times (Chart 1) - versus a five-year average of 10.9 times – and is the lowest since 2009. Our country allocation for real estate equities is broadly geared towards a less benign environment for equities, but we have identified opportunities with attractive valuations.

- **Mexico**: We are *overweight* as rising consumer sentiment and stable inflation continue to support the real estate market.
- **Thailand**: We are *overweight* on the back of healthy growth, low inflation and a resilient currency.
- **Hong Kong**: We are *overweight* as the housing sector benefits from tight housing supply and Chinese monetary easing.
- **Malaysia**: We are *underweight* due to housing price weaknesses and economic deceleration.
- **The Philippines**: We are *underweight* due to continued monetary tightening and rising borrowing costs.

We are *neutral* on real estate equities in Brazil and Singapore due to policy uncertainties, as well as China and South Africa due to growth headwinds.

**The publication reflects asset performance up to October 31, 2018, and macro events and data releases up to November 8, 2018, unless indicated otherwise.*

Asia

China

Neutral

Sino-US trade tensions and the Chinese economic slowdown have dented real estate activities. Housing regulations may marginally loosen in 2019.

Chinese GDP grew by 6.5% yoy in Q3, in line with market expectations and moderating from the 6.7% growth in Q2 and 6.8% in Q1. That said, Q4 growth faces downside risks. While nominal retail sales held up well at 9.3% yoy in Q3, the value in real terms continued to decelerate. Passenger vehicles sales contracted compared to a year ago and the Caixin services PMI continued its downward trend. Total social financing – a broad measure of credit growth – also reached a historical low in September at 10.6% yoy. The Caixin manufacturing PMI declined to 50.0 in September, the lowest since June 2017, before edging up slightly in October. Fixed asset investment grew by 5.4% yoy for the January-September period, the weakest growth since 1996. In contrast, the export sector was resilient despite the US tariffs on $50 bn Chinese goods implemented in Q3, as the CNY depreciation over the period helped to cushion the impact of the tariffs.

Real estate activity also cooled following a strong performance in H1. Residential property sales contracted by 0.8% yoy in September, compared to 11.0% and 2.8% growth in July and August, respectively. Housing starts (as measured by total floor space) slowed significantly to 17.7% yoy in September from 31.2% in August. Real estate investment (excluding land purchases) contracted compared to a year ago. A bright spot is that home prices remain resilient: the 70-city average home price index accelerated to 8.9% yoy in September from 8.0% in August.

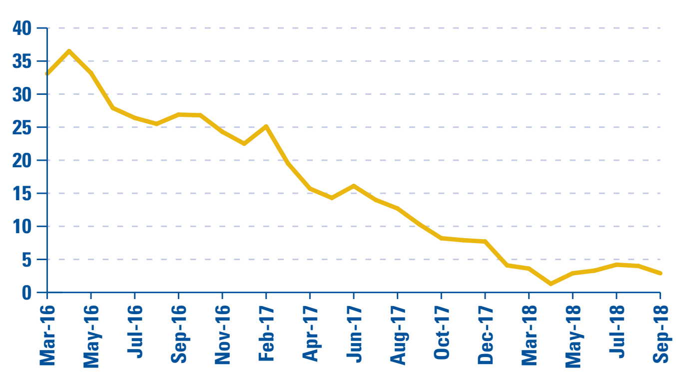
Chinese assets have been volatile recently, driven by the escalating trade and political tensions between the two largest economies in the world. The US government announced a 10% tariffs on $200 bn worth of Chinese goods – effective from September 24 - with the tariff rate set to increase to 25% from January 2019. This is on top of the 25% tariffs announced in August that affected $50 bn of Chinese goods. The Chinese government retaliated with 5-10% tariffs on $60 bn worth of US goods on top of the 25% tariffs on $50 bn of goods that was announced in August. It is possible that the US and China will agree on a deal – and indeed both Presidents are scheduled to meet at the G20 meeting at the end of November - given the negative impact of tariffs on both economies. However, recent rhetoric has been frosty, and there is a significant chance that trade and political tensions may escalate further as there seems a large gap between what the US demands and what China is willing to offer in areas such as technology transfer and ending subsidies to state-owned enterprises.

Although it is challenging to predict how the trade tensions will evolve and whether other areas of economic activity (e.g. FDI) will be affected, it is useful to understand the impact on Chinese growth under various scenarios. If trade tensions de-escalate from the current level, economic growth may slow to around 6.2% yoy in 2019. While this would represent a step down from the 6.8% growth in 2017 and 6.6% forecast in 2018, it may have been already priced in by the equity market, with the MSCI China falling by 18.1% in USD terms in between June and October. However, if trade tensions deteriorate and lead to a trade war where the US imposes 25% tariffs on all Chinese goods while China retaliates with similar tariff rates on all US goods, then the Chinese economy risks growing below 6.0% yoy unless policymakers step up with more aggressive easing measures.

Looking ahead, we expect consumption to perform better than investment and exports. Consumption is relatively isolated from the Sino-US trade tensions and supported by the recent individual income tax reform. Infrastructure investment may re-accelerate on the back of fiscal stimulus as evidenced by the most recent increase in local government bond issuance. The export sector may start to feel the impact of tariffs later this year and in 2019 as more US tariffs get implemented.

Real estate investment may moderate in 2019 due to recent weaknesses in home sales (Chart 2). Also, property developers face margin pressure from local government policies. New home prices face regulatory ceilings in Tier-1 and major Tier-2 cities where housing prices have been a concern for policymakers. In contrast, new home prices in other cities face downside risks as government funding for shanty town redevelopment is fading away. What seems positive at the margin is that, in the most recent economic commentary by the Communist Party, wording about deleveraging or regulatory tightening against the domestic housing market has been erased. Hence regulations on the housing market may become marginally looser in 2019.

Chart 2: China Floor Space of Buildings Sold YTD YoY, %



Source: National Bureau of Statistics of China

Market Strategy: FTSE EPRA/NAREIT China lost 24.3% in USD terms in the six months until the end of October, underperforming FTSE EPRA/NAREIT EM equities by 2.7% points. The Chinese real estate sector is trading at a P/E ratio of 5.6 times. It is 22% discount to that of the EM real estate sector, compared to a long-term average of 30% discount. Valuations look attractive given that the ROE recently reached 18%, the highest in five years. That said, we are *neutral* on China real estate equities, as cheap valuations reflect headwinds from the domestic economic slowdown, Sino-US trade tensions and margin pressures.

Hong Kong

Overweight

Hong Kong housing prices may remain resilient in 2019 on the back of persistently tight supply as well as liquidity looking for safe havens.

Hong Kong's housing market has been remarkably resilient this year. Housing prices rose by 14% yoy in September, slightly moderating from the 17% growth in July. The Centa-City Leading Index (a leading indicator of housing prices) moderated marginally to 184 in October from the historical peak of 189 in August. Admittedly several headwinds face the Hong Kong market, including global trade slowdown, rising Sino-US trade tensions as well as the gradual Fed rate hikes. For instance, the 3-month Hong Kong interbank rate (HIBOR) generally follows the US LIBOR given the fixed exchange rate regime and has risen to 2.1% as of end-October, the highest since 2008. HSBC Hong Kong increased the prime lending rate by 12.5bps to 5.125% in September, the first time since 2005, though the magnitude of the increase was smaller than expected. Consensus expects GDP growth to moderate to 2.7% in 2019, from a strong 2017 (3.8%) and 2018 (3.6% forecast), largely due to a slowdown in global trade.

However, several positive factors continue to support the Hong Kong housing market. First, land supply remains tight. Measures announced by the government in the October Policy Address (e.g. increasing conversion of agricultural land to residential land) seem too incremental to resolve the problem of land shortages. Second, liquidity – on the back of Chinese monetary easing since the summer – may seek safe havens and find its way into Hong Kong properties in 2019, offsetting the tightening effect of the Fed rate hikes and higher HIBOR. Indeed, the past three years have seen an expansion of the Hong Kong monetary base, as capital inflows from mainland China on the back of the Chinese stimulus following the 2015 stock market crash largely offset capital outflows elsewhere. Third, headline inflation came in at 2.7% yoy in September, compared to the 3-month HIBOR rate of 2.1%, resulting in a negative real interest rate, implying the attractiveness of investing in properties. Meanwhile, the unemployment rate was 2.8% in September, the lowest in 20 years. A robust labour market supports wage growth and inflation, suggesting that the low real interest rate environment is likely to remain.

Market Strategy: FTSE EPRA/NAREIT Hong Kong, which includes a few Hong Kong-listed Chinese names, lost 14.8% in USD terms in the six months until the end of October, outperforming FTSE EPRA/NAREIT EM equities by 6.8% points. The Hong Kong real estate sector is trading at a P/E ratio of 4.2 times, or 39% discount to that of the EM real estate sector. Valuations look attractive, and the ROE reached 13%, the highest in five years. We *overweight* Hong Kong real estate equities as the recent Chinese monetary easing provides support to Hong Kong housing prices, while tight housing supply remains.

Singapore

Neutral

A good track record of government policies suggests that the latest cooling measures are likely to dampen the recent rebound in housing prices.

Unlike many other governments in the world, the Singaporean government has effectively prevented a housing price bubble from forming since the Global Financial Crisis. The government launched eight rounds of cooling measures between 2009 and 2017, including imposing Additional Buyer's Stamp Duty (ABSD) on permanent residents and foreigners, tightening the limits on loan-to-value (LTV) ratios and capping the tenure of mortgages. During that period, housing prices in Singapore decelerated from 15% yoy in 2009 to nearly zero in 2012, followed by outright contractions between 2013 and 2017.

That said, housing prices saw a significant rebound since mid-2017, reaching 10% yoy in Q2 this year, on the back of strong economic and income growth. The government subsequently launched in July the ninth round of cooling measures since 2009 out of concern about potential "euphoria" of the real estate market. The latest measures include raising the ABSD by another 5% points and reducing the LTV ratio by another 5% points. We think those measures are pre-emptive, since the cumulative rise in housing prices over the past ten years in Singapore is relatively limited, and Singaporean banks generally enjoy robust balance sheets with low loan-to-deposit ratios and limited exposure to the real estate sector. The latest cooling measures are likely to lead to a moderation in housing price growth, given the effectiveness of similar measures in the past decade. Indeed, the number of new home transactions in the first three quarters of the year has gone down by 17% versus the same period in 2017.

Meanwhile, the Singaporean economy is growing slightly above potential. GDP growth is set to rebound in Q3 (preliminary 4.7% qoq saar) after a weak Q2 (1.2%). The Monetary Authority of Singapore (MAS) tightened monetary policy in October as core inflation reached a four-year high of 1.9% yoy in August. More specifically, the MAS increased the "slope" of the nominal effective exchange rate policy by around 1% per year (according to various analyst estimates) following an estimated increase of 50bps in April. However, we expect the tightening cycle to be very gradual given the risk of a global trade slowdown and its impact on Singapore. Indeed, consensus expects GDP growth to moderate to 2.7% in 2019, compared to forecast 3.2% this year.

Market Strategy: FTSE EPRA/NAREIT Singapore lost 15.2% in USD terms in the six months until the end of October, outperforming FTSE EPRA/NAREIT EM equities by 6.4% points. The Singaporean real estate sector is trading at a P/E ratio of 9.6 times, or 34% premium to that of the EM real estate sector (versus the long-term average of 0% premium). We are *neutral* on Singaporean real estate equities as housing prices and transactions are likely to slow on the back of the latest government measures.

Philippines

Underweight

The central bank is likely to continue hiking interest rates due to rising and above-target inflation, and this is set to weigh on real estate equities.

Rising inflation and monetary tightening are weighing on the outlook for the Filipino economy and its asset performance. CPI has continued its rise that started in late 2015 when it recorded negative headline rates. It has risen to 2.2% yoy by end-2016, to 2.9% yoy by end-2017 and, most dramatically, to 6.7% yoy in October 2018 after accelerating every month in 2018. It is now significantly above the central bank's 2-4% target range. Price pressures have broadened out beyond the food, transport and utility categories in recent months, suggesting increasing demand-led pressures. The government announced some reforms which targeted food prices, but the bulk of the policy response will have to come from the central bank. BSP has tightened its policy rate by 150bps this year, with the September meeting delivering the last 50bps so far. Elevated oil prices and the impact of the latest typhoon on food prices could drive inflation higher. The BSP recently acknowledged the persistent, broader and sharper-than-expected acceleration in CPI. Therefore, we expect aggressive monetary tightening to continue for the next 12 months until headline inflation slows back to the target range of 2-4%, which may not come until the end of 2019.

The Philippine housing market already saw signs of cooling before the monetary tightening started in Q2, and this is likely to continue. Indeed, the country's real estate price index slowed to 2.1% yoy in Q1, from 5.7% in Q4 2017. Prices in the Makati Central Business District, the leading financial and business district in Manila, grew at 10% yoy in Q2, also moderating from previous periods.

Meanwhile, economic activity slowed again after a bumper first quarter but remains at very healthy levels. Q3 GDP grew by 6.1% yoy, below expectations and moderating from 6.2% yoy in Q2. Fixed investment and private consumption slowed while net exports remained a drag. Also, pledges of foreign investment are currently at their weakest level since 2010, a development that could weigh on potential growth. This likely reflects the erratic and autocratic ruling style of President Duterte, which while not disrupting technocratic policymaking, is deterring foreign investors.

Market Strategy: FTSE EPRA/NAREIT Philippines lost 4.0% in USD terms in the six months until the end of October, outperforming FTSE EPRA/NAREIT EM equities by 17.6% points. The Philippine real estate sector is trading at a P/E ratio of 20.6 times. It is equivalent to a 185% premium to that of the EM real estate sector, substantially above the long-term average of 108%. We are *underweight* the Filipino real estate equities due to expensive valuations as well as monetary tightening that may increase the borrowing costs of households and developers.

Thailand

Overweight

Housing prices are accelerating on the back of strong economic growth and low inflation.

GDP growth in Thailand has continued to exceed expectations, rising by 4.6% in Q2 against an expected 4.4%. The expansion was broad-based, with private consumption, investment and export growth accelerating in Q2. Forward-looking indicators are also strong, with consumer confidence rising to a five-year high in August and business sentiment in positive territory since May. Economic growth for 2018 is expected to accelerate to 4.4% from 3.9% in 2017, before moderating to 3.9% in 2019.

This comes against a backdrop of tepid inflation, with headline CPI rising by just 1.2% yoy in October and core prices up 0.8%. Price rises are at the lower end of the Bank of Thailand's (BoT) 1-4% target range, prompting it to leave the key policy rate at 1.5% at its September meeting. Two of the seven monetary policy committee members voted for a 25bp rate rise, in an attempt to "curb financial stability risks" due to concerns over rising household debt and loosening credit standards. The first hike could come in Q4, but policy accommodation is only set to be "gradually reduced".

Strong economic growth – the highest in five years – and benign inflation foster a significant pickup in the housing market. Housing prices in all the three segments – single-detached homes, townhouse and condominium – significantly accelerated this year after bottoming out in H2 2017, growing by 7.1% yoy, 6.5% yoy and 6.4% yoy, respectively, in August. Credit conditions are also improving. For instance, mortgage lending accelerated to 7.2% yoy at the end of H1, compared to 6.1% and 5.6% at the end of H2 and H1 2017, respectively.

Thailand's external positions remain robust, though external uncertainties remain. The current account is expected to post a 9.0% of GDP surplus this year, supported by a continued recovery in tourist inflows and the strong trade surplus. However, downside risks remain from reduced exports given slowing global growth, baht strength (up 5.0% yoy on a real effective basis) and rising imports due to the higher oil price. Overall, the substantial current account surplus makes Thailand less vulnerable than other EMs to tightening global liquidity.

Market Strategy: FTSE EPRA/NAREIT Thailand lost 7.9% in USD terms in the six months until the end of October, outperforming FTSE EPRA/NAREIT EM equities by 13.7% points. The Thai real estate sector is trading at a P/E ratio of 14.7 times. It is equivalent to a 103% premium to that of the EM real estate sector, above the long-term average of 42%. The high premium is supported by its high ROE of 16.8%, close to 5-year high. We are *overweight* Thailand real estate equities on the back of strong economic growth, low inflation and housing price acceleration.

Malaysia

Underweight

Weaker growth and a renewed decline in consumer sentiment weigh on the Malaysian housing market.

Malaysia's Q2 GDP disappointed: the economy slowed to 4.5% yoy from 5.2% in Q1, underperforming consensus expectations. Temporary factors - such as the transition following the general election in May and disruptions in the export sector – played a role too, but should fade going forward.

Still, the economy faces a few headwinds and growth will likely remain weak in H2. First, despite PM Mahathir Bin Mohamad's visit to China in August, the new Malaysian government has suspended – and is likely to permanently cancel - a handful of Chinese-backed projects in oil pipelines and railways (e.g. the East Coast Rail Link), which are worth $23 bn in total, or about 7.0% of Malaysian GDP. This may weigh on capex spending and business sentiment. Second, the removal of the GST and the re-imposition of fuel subsidies have opened a hole in the fiscal budget. The government seeks to contain the fiscal deficit by reintroducing the Sales and Services Tax (SST, effective on September 1) and cutting public investments, the latter of which weighs on long-term productivity growth. Third, the Consumer Sentiments Index significantly pulled back in Q3 to 107.5 from the post-election peak of 132.9 in Q2. The decline took place despite low inflation and a rise in real consumption, suggesting that political uncertainty weighs on consumer sentiment. Fourth, Malaysia is an open economy and closely integrated into the regional supply chain led by China. Malaysian exports and business supply chains are likely to be negatively affected if trade tensions between China and the US continue to escalate and Chinese growth slows as a result. Consensus expects 5.0% yoy growth in H2 and 5.1% for the whole year, a meaningful step down from 5.9% in 2017.

The housing market in Malaysia continues to slow. Housing price increases per square-metre have slowed to 4.1% yoy in Q1, the slowest since 2009. The PropertyGura Market Index, a leading indicator of the housing market, shows that the asking prices of Malaysian properties declined in Q3 on a yoy basis. Meanwhile, headline CPI inflation eased to 0.2% yoy in August while core CPI inflation dipped into negative territory (-0.2% yoy). The removal of GST and the reintroduction of fuel subsidies have contributed to low inflation.

Market Strategy: FTSE EPRA/NAREIT Malaysia lost 20.8% in USD terms in the six months until the end of October, outperforming FTSE EPRA/NAREIT EM equities by 0.8% points. The Malaysian real estate sector is trading at a P/E ratio of 11.8 times. It is equivalent to a 64% premium to that of the EM real estate sector, above the long-term average of 26%. We are *underweight* Malaysia real estate equities due to economic growth deceleration and continued weakness in the housing market.

Latin America

Brazil

Neutral

Jair Bolsonaro won Brazil's presidency, a development welcomed by the markets, but his ability to implement reform remains in doubt.

Right-wing populist Jair Bolsonaro has delivered a strong victory in the October general election, taking 46% of the vote in the first round and 55% in the second. Bolsonaro's Social Liberal Party (PSL) also boosted its standing in Congress, raising the number of its deputies from eight to 52 (10% of total) and making it the second-largest party in the Chamber of Deputies. The Workers' Party (PT) remained the largest single party with 56 deputies (11%), and both right and left camps gained relative to 2014, at the expense of the non-aligned centrist parties. As Bolsonaro promises market-friendly programs, his victory has emboldened markets and driven a 30% rally in dollar terms in Brazil's equity market since early September.

Nevertheless, risks remain high. Congress is extremely fractured with 30 parties represented, the two largest of which command only 10-11%. To achieve a 50% majority and push through simple bills, Bolsonaro would have to unite all 12 right-of-centre parties and garner several centrist and/or leftist votes also. Bills requiring constitutional change, such as the pension reform, require a 60% majority, implying an even greater need for outreach and consensus building: all right-wing parties combined represent only 82% of that requirement. The risk is that Bolsonaro, who is a notoriously divisive figure, grows weary of tedious congressional negotiations and adopts a more authoritarian style of ruling (by issuing presidential decrees, for example, a common practice). Eventually, this could make Brazil face a choice between democracy and inclusion or economic reform.

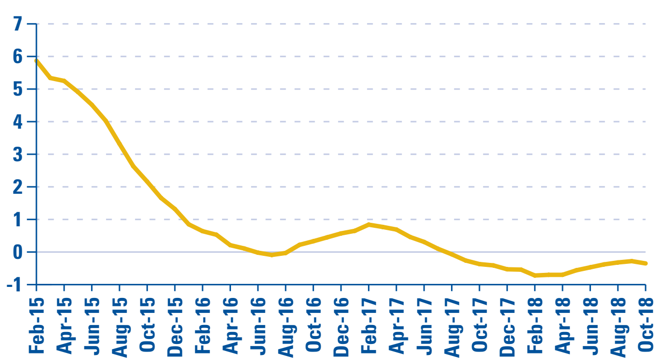
Another risk is his lack of government experience, particularly in economic and fiscal issues. The economic outlook thus largely depends on the prospects for and the ideas of Paulo Guedes, Bolsonaro's University of Chicago-trained economic adviser. While Guedes is expected to maintain the freeze on public spending – which was initiated by President Temer - and retain Ilan Goldfajn at the helm of the central bank, he has also advocated more controversial policies, such as the introduction of a "flat tax" of 20% which is considered regressive and fiscally costly. Also, Guedes is under investigation for corruption and if he were not able to assume office due to this, it could represent a serious setback for the market's positive disposition towards Bolsonaro.

Worsening economic conditions represent an additional headwind to the economic recovery. In Q2, sequential GDP growth picked up to 0.2% qoq, but the annual outturn dropped from 1.2% yoy in Q1 to 1.0% yoy in Q2. Quarterly gains were mostly driven by an acceleration of government consumption and a build-up of inventory, suggesting that it may not be sustainable. Industrial production has swung wildly in Q3, accelerating to 4.2% yoy in July before slowing to 1.6% yoy in August and contracting by 2.0% in September. Consensus expects 1.4% GDP growth this year and 2.3% in 2019, indicating a very gradual recovery after a real GDP contraction of 3.5% in both 2015 and 2016.

Inflation jumped from 2.9% yoy in May to 4.2% yoy in June in the wake of the trucker strikes and has accelerated to 4.6% in October, just above the Brazilian central bank's 4.5% inflation target for 2018. So far, the Copom council has left the Selic rate unchanged at 6.5% throughout the year, looking through the inflation rise. Indeed, the Q3 Inflation Report stressed that inflation expectations remained well contained. The sharp appreciation in the real since early September also supports the case for delaying monetary tightening. Still, consensus expects the tightening cycle to start in 2019, for the central bank to achieve the lower inflation target of 4.25% in 2019. The actual timing of an interest rate hike depends largely on the progress in fiscal reform under Bolsonaro's government.

The housing market has been stagnating since the country exited the recession in 2016. Housing prices stalled in nominal terms since mid-2016 (Chart 3), implying contraction in real prices over the past two years due to weak demand. Indeed, the 20-city average housing price contracted by 0.28% yoy in September.

Chart 3: Brazil Average Housing Price YoY, %



Source: The Institute of Economic Research Foundation (FIPE)

Market Strategy: FTSE EPRA/NAREIT Brazil gained 0.1% in USD terms in the six months until the end of October, outperforming FTSE EPRA/NAREIT EM equities by 21.7% points. The Brazilian real estate sector is currently generating negative earnings. Its P/B ratio is running at 1.2 times, substantially higher than the 5-year average of 0.9 times. It stands in sharp contrast to the P/B ratio of the EM real estate sector whose P/B ratio is trading below its historical average. Therefore, we are *neutral* on Brazil real estate equities as we think the potential economic benefits from the Bolsonaro victory are largely priced in. Progress on fiscal reform – which has significant market consequences – remains to be seen.

Mexico

Overweight

Accelerating credit growth, stable inflation and subsiding political uncertainty are set to support consumer sentiment and the housing market.

Mexico, Canada and the US have recently made substantial progress in renegotiating NAFTA. All three parties have endorsed a deal called "the United States–Mexico–Canada Agreement" (USMC). Such an agreement, if implemented, will represent a key win for the Mexican government and local businesses. Aspects of the agreement that are most relevant for Mexico include: 1) for a car to be qualified as duty free, 75% of its content has to be made in the US/Mexico, up from 62.5% under NAFTA, and 40% of the car should be made by workers earning at least $16 per hour and 2) the deal has a 16-year sunset clause and will be reviewed after six years, which is less stringent than the five-year sunset clause that was previously proposed. Those terms are expected to require only marginal adjustments by Mexican car manufacturers as just a handful of car models are affected by the changes. Even if some car exporters no longer qualify for duty-free trade, the average WTO most-favoured-nation tariff on Mexican car exports to the US is only 2.5%.

Meanwhile, we expect a rebound in economic activity in H2 2018 after a 0.2% qoq contraction in Q2 due to a decline in agricultural production. First, the Business Confidence Index rebounded in Q3 and stayed above 50.8 after reaching 48.7 in June. Second, the IGAE monthly GDP proxy grew by 3.3% and 1.7% yoy in July and August, respectively, suggesting a GDP growth rate of around 2% qoq saar. Consensus expects 2.1% and 2.2% growth in 2018 and 2019, respectively, up from 2.0% in 2017. We expect that Andrés Manuel López Obrador's (AMLO) victory in the July presidential election and the progress in the trade deal may continue supporting business and consumer sentiments. AMLO's preference of using referenda brings uncertainty, though, as evidenced by the recent cancellation of building a new airport in Mexico City following a referendum where only 1% of the electorate participated.

Housing prices accelerated to 8.7% yoy in Q1 after moderating to 5% in mid-2017. Credit conditions have been supportive, with mortgage lending accelerating to 8.8% yoy in July after the trough of 8.1% in January. Rising housing prices and credit growth took place in spite of high interest rates, suggesting robust demand in the housing market.

Market Strategy: FTSE EPRA/NAREIT Mexico lost 23.6% in USD terms in the six months until the end of October, underperforming FTSE EPRA/NAREIT EM equities by 2.0% points. The Mexican real estate sector is trading at a P/E ratio of 8.0 times. It is equivalent to an 11% premium to that of the EM real estate sector, compared to the long-term average of 3%. We are *overweight* Mexico real estate equities on the back of improving business sentiments, accelerating economic growth, rising housing prices and continued credit expansion.

Emerging Europe and Africa

South Africa

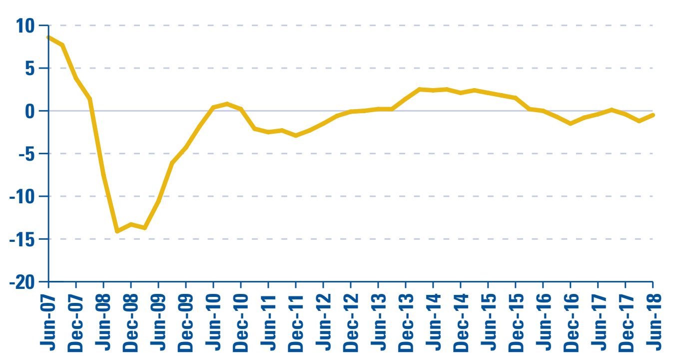
Neutral

Cheap real estate equity valuations reflect weak growth, elevated inflation and persistent fiscal problems.

The South African housing market has been tepid since the Global Financial Crisis. Housing prices in real terms have stagnated since 2010 (Chart 4), as housing price growth only keeps pace with inflation. The underlying reasons are weak economic and household income growth. Indeed, annual GDP has decelerated from 3.3% in 2011 to 1.3% in 2017. South Africa's economy entered recession in Q2 as GDP contracted by 0.7% qoq saar following a 2.6% fall in Q1. The decline in Q2 was broad-based. Even excluding the volatile agricultural sector, quarterly economic activity was flat. Manufacturing also contracted and with the Barclays PMI in September falling to its lowest level since July 2017, the outlook for the sector in H2 is lacklustre. Market consensus forecasts GDP to slow to 0.7% in 2018, before recovering moderately to 1.8% in 2019. The unemployment rate remains high and is forecast to rise to 27.7% in 2019, weighing on household consumption.

Headline inflation rose to 4.9% yoy in September and has diverged from core inflation (4.2% yoy) as a result of rising food prices. Throughout the period of accelerating inflation, the South African Reserve Bank (SARB) left its key policy rate unchanged at 6.5%. However, there was a hawkish tilt at its September meeting. And recent rand weakness (-10% in real effective terms since February) is set to push headline CPI close to the upper end of the SARB's 3-6% target range. Therefore, consensus expects a rate hike in 2019 despite weak growth outlook. Further rand depreciation may call for more rate hikes.

Chart 4: South Africa Real House Price Index, YoY %



Source: Federal Reserve Bank of Dallas

Meanwhile, the government faces the challenge of boosting economic activity without blowing out the already elevated fiscal deficit. In September, President Cyril Ramaphosa announced a series of measures: 1) reallocate 3% of GDP of the budget towards areas of higher social impact such as job creation, health and education; 2) set up an infrastructure fund with the private sector worth 8% of GDP (ZAR400 bn) and 3) reform in the mining, telecoms, tourism and agriculture sectors. However, the Medium Term Budget Policy Statement (MTBPS) in October failed to announce more details about those initiatives. The MTBPS revised down its growth estimates and revised up the fiscal deficit and debt for the next two years, as Finance Minister Mboweni failed to announce any new fiscal revenue initiatives. As a result, the government seems content to "kick the can down the road" and delay addressing the fiscal problem, until the ruling African National Congress (ANC) delivers a decisive victory in the coming general election (due between May and August 2019) and gives President Ramaphosa a strong mandate to launch ambitious reforms. However, time is running out for the government to fix the fiscal problems, as S&P and Fitch Ratings already assigned the country's external sovereign debt sub-investment grades, while Moody's assigned Baa3, only one notch above the junk grades.

Another concern for the electorate and investors is land reform. It has the potential to reduce high levels of inequality, with the top 10% of earners now accounting for over two-thirds of national income. The ANC is seeking to address long-established grievances regarding land redistribution. Easy gains could be made given that land purchased by the government makes up 10% of the total and 70% of the state-owned land remains unused.

President Ramaphosa has sought to assuage fears of a Zimbabwe-style land grab as investors have expressed concern about this policy. He stated in August that any change to the constitution would need to uphold the principle that "prohibits the arbitrary deprivation of property and holds that expropriation is possible in the public interest subject to just and equitable compensation." It is perhaps this latter part that leaves investors concerned. The Joint Constitutional Review Committee, tasked with gauging views nationally, is due to publish its findings in November. This leaves little time to pass constitutional changes before the 2019 election. Uncertainty over the plan is thus likely to linger.

Market Strategy: FTSE EPRA/NAREIT South Africa lost 29.2% in USD terms in the six months until the end of October, underperforming FTSE EPRA/NAREIT EM equities by 7.7% points. The South African real estate sector is trading at a P/E ratio of 8.1 times. It is equivalent to a 12% premium, similar to its long-term average. We are *neutral* on South Africa real estate equities despite undemanding valuations. Fiscal and political uncertainties are clouding the outlook for South African assets.

KEY ECONOMIC AND FINANCIAL INDICATORS *(All data shown are as at October 31, 2018 unless otherwise stated)*

		Macroeconomic Data													Market Performance and Forecast					
		% change on year ago																		
		Annual Real GDP	Quarterly Real GDP QoQ*	Industrial Production	Consumer Price Index	Broad Money (M2/M3) ***	Budget Balance % of GDP 2018F**	Current Account Balance	Unemployment Rate	Currency vs $ 2018 Latest	Currency vs $ 2017 Year ago	Short-Term Interest Rates	10-Year Government Bond Yield	Sovereign Rating S&P	% FTSE EPRA/NAREIT EM Capped Index****	Stock Market (FTSE EPRA/ NAREIT) US$	Change Since 12/31/2017 US$	Change Since 12/31/2017 Local	Dividend Yield	2018 P/E Forecast**
		%	%	%	%	%		$ Bns	%			%	%		%	%	%	%	%	
Overweight	HONG KONG	3.5	-0.8	1.6	2.7	4.3	2.2	41.5	2.8	7.8	7.8	2.1	2.5	AA+	n.a.	3273.59	-14.3	-14.0	4.8	10.6
	MEXICO	2.6	3.6	0.2	5.0	10.1	-2.3	-26.5	3.6	19.9	18.9	8.4	8.9	BBB+	8.47	95.82	-15.5	-12.6	8.6	9.7
	THAILAND	4.6	4.0	-2.6	1.2	4.9	-2.8	38.3	1.0	32.8	33.1	1.0	2.8	BBB+	10.65	9754.73	-9.1	-7.6	2.8	15.4
Neutral	BRAZIL	1.0	0.8	-2.0	4.5	8.5	-7.2	-14.5	11.9	3.7	3.3	6.2	10.2	BB-	7.54	1084.78	-11.8	-0.6	2.7	25.0
	CHILE	5.3	2.8	-3.2	3.1	7.2	-2.5	-3.6	7.2	682.0	628.3	2.7	n.a.	A+	1.81	4277.91	-23.7	-13.8	2.1	16.9
	CHINA	6.5	6.4	5.8	2.5	8.3	-3.6	67.8	3.8	6.9	6.6	1.1	3.5	A+	20.00	4345.00	-16.6	-10.6	6.3	5.9
	GREECE	1.8	0.8	1.4	1.1	6.8	0.6	-3.4	19.0	1.1	1.2	0.1	4.2	B+	0.50	655.00	-19.4	-14.3	n.a.	n.a.
	INDIA	8.2	-11.8	4.3	3.8	10.0	-3.5	-49.5	n.a.	72.5	64.5	6.3	7.9	BBB-	2.43	549.86	-41.0	-31.6	2.3	18.8
	INDONESIA	5.3	16.8	9.0	3.2	6.1	-2.3	-24.2	5.1	14880.0	13517.0	6.2	8.5	BBB-	6.08	1246.45	-38.6	-31.3	3.1	10.9
	POLAND	5.1	4.0	2.8	1.7	7.9	-1.8	-0.1	5.7	3.8	3.6	2.0	3.2	A-	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	SINGAPORE	2.6	4.7	-0.2	0.7	3.5	-0.3	64.6	2.1	1.4	1.4	1.7	2.5	AAA	n.a.	2713.07	-13.6	-10.4	5.6	14.5
	SOUTH AFRICA	0.4	n.a.	1.3	4.9	6.9	-3.9	-47.6	27.5	14.3	14.0	7.4	n.a.	BB	17.45	2620.96	-25.8	-11.5	9.5	10.5
	TAIWAN	2.3	10.7	1.5	1.7	3.3	-0.8	84.5	3.7	30.4	30.2	0.7	0.9	AA-	0.17	n.a.	n.a.	n.a.	n.a.	n.a.
	TURKEY	3.1	3.7	1.7	24.5	22.3	-2.5	-51.1	10.8	5.5	3.8	25.5	18.5	B+	1.08	628.83	-57.3	-36.9	9.4	3.8
	UAE	0.8	n.a.	n.a.	3.4	8.4	1.3	27.5	n.a.	3.7	3.7	2.6	n.a.	AA	2.68	4225.93	-4.5	-4.5	8.1	7.0
Underweight	MALAYSIA	4.5	6.4	2.2	0.3	6.1	-3.2	11.2	3.4	4.2	4.2	3.2	4.1	A-	7.42	1764.82	-29.4	-27.3	4.5	14.5
	PHILIPPINES	6.0	n.a.	8.8	6.7	9.7	-2.8	-4.5	5.4	53.0	51.4	4.9	7.7	BBB	13.72	5804.85	-15.7	-10.1	1.3	20.1
	USA	3.0	3.5	5.1	2.3	8.0	-4.0	-442.9	3.7	1.0	1.0	2.8	3.1	AA+	tba	5768.20	-1.0	-1.0	4.3	31.5

*Note: S&P credit rating shown is long-term foreign currency rating. *% change in GDP on previous quarter, annual rate. **Bloomberg consensus forecast. ***M3 is used. M2 is used if M3 is unavailable. ****as of August 31, 2018.*

†Any forecasts are based on Bloomberg consensus forecasts, where available, and assumptions. Actual results may vary from any such statements or forecasts. Past performance is no guarantee of future results.

**Key Criteria*

Source: Bloomberg, City of London Investment Management

CITY OF LONDON
Investment Management Company Limited

Contacts

Macroeconomic Analysis

Michael Hart, London Office
Phone: 011 44 207 711 1558
E-Mail: michael.hart@citlon.co.uk

Lyndon Barreto, CFA, London Office
Phone: 011 44 207 711 1551
E-Mail: lyndon.barreto@citlon.co.uk

Mike Liu, CFA, London Office
Phone: 011 44 207 860 8318
E-Mail: mike.liu@citlon.co.uk

London Office
77 Gracechurch Street
London EC3V 0AS
United Kingdom
Phone: 011 44 20 7711 0771
Fax: 011 44 20 7711 0772
E-Mail: info@citlon.co.uk

Philadelphia Office
The Barn, 1125 Airport Road
Coatesville, PA 19320
United States
Phone: 610 380 2110
Fax: 610 380 2116
E-Mail: info@citlon.com

Seattle Office
Plaza Center
10900 NE 8th Street, Suite 1519
Bellevue, WA 98004
United States
Phone: 610 380 2110

Singapore Office
20 Collyer Quay
10-04
Singapore 049319
Phone: 011 65 6236 9136
Fax: 011 65 6532 3997

Dubai Office
Unit 2, 2nd Floor
The Gate Village Building 1
Dubai International Financial Centre
P.O. Box 506695, Dubai, United Arab Emirates
Phone: 011 971 4 249 8402
Fax: 011 971 4 437 0510

Website

www.citlon.co.uk
www.citlon.com