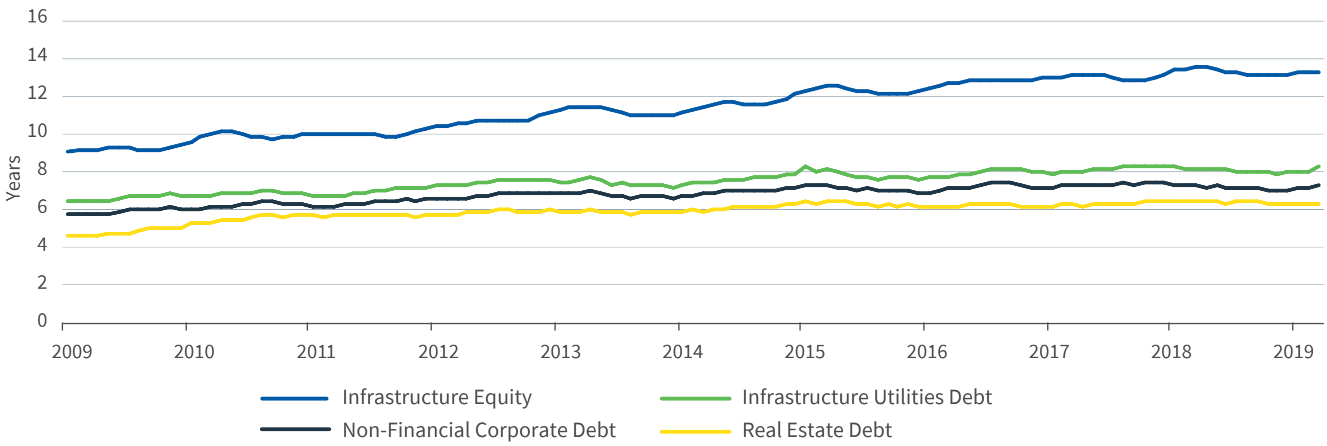
Update on drivers in Real Assets

Q2 2019

Long duration real assets could appreciate amid lower long-term rates

- Fears of a potential global economic slowdown have put interest rate rises on hold.
- Longer duration assets (infrastructure debt and equity, real estate long income) should capture the higher capital gain if long-term rates fall but are quite insensitive to short-term rates.
- Despite higher leverage in infrastructure versus real estate, most borrowers have fixed rate long-term debt. Real estate borrowers should capture the benefit of lower rates on income return more quickly.

Figure 1. **Asset Class Duration**

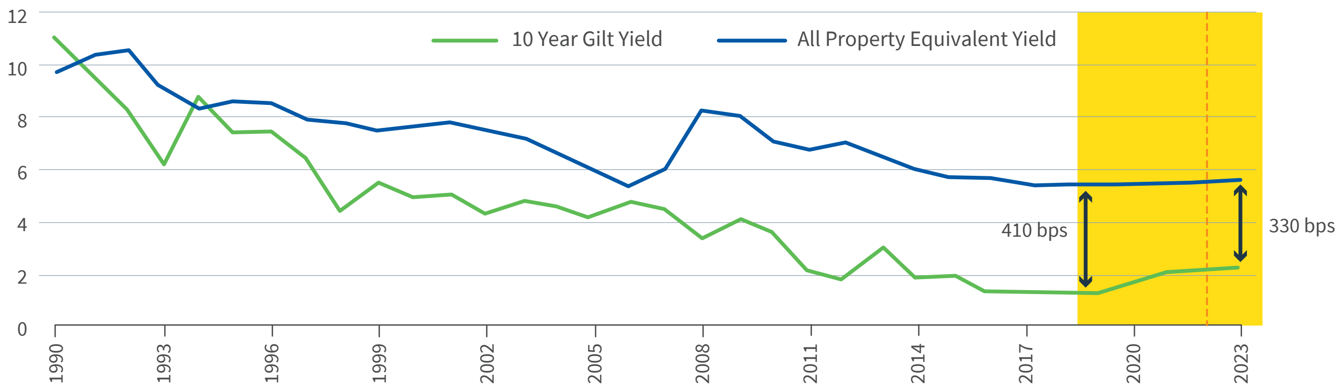


Sources: EDHEC infrastructure, Bank of America Merrill Lynch, Aviva Investors, June 2019

UK forecast assumptions: lower bond yields to extend the real estate cycle

- In late 2018, we expected interest rates to start rising and demand for real estate to be subdued. This narrative has changed in 2019, with expectations that central banks may be forced to keep rates on hold for longer or even cut again as economic growth slows.
- Lower interest rates will extend the real estate cycle: even at current levels, real estate yields are significantly above government bond yields.
- Real estate pricing is attractive compared to a host of other income-producing asset classes. With the outlook for interest rates now more supportive, investors can now find positive total returns in several areas across the UK.

Figure 2. **10 year Gilt vs. IPD All Property Yield**

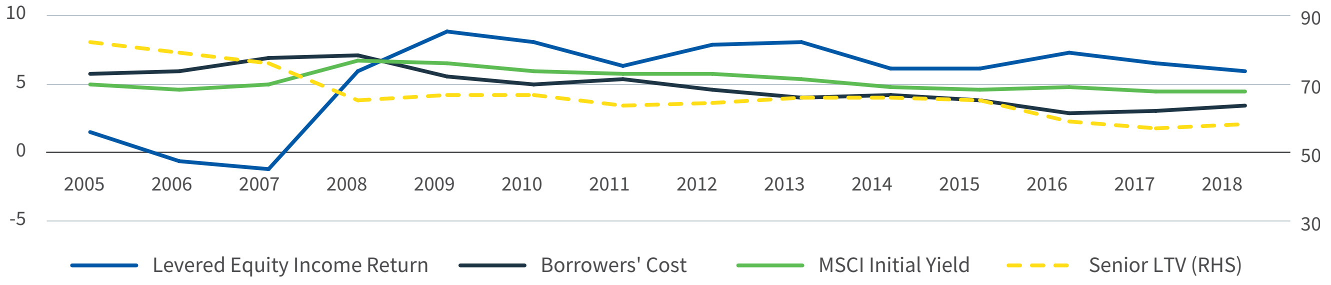


Source: Thomson Reuters Datastream, Aviva Investors, April 2019

But conservative lending at senior level has reduced interest rate sensitivity

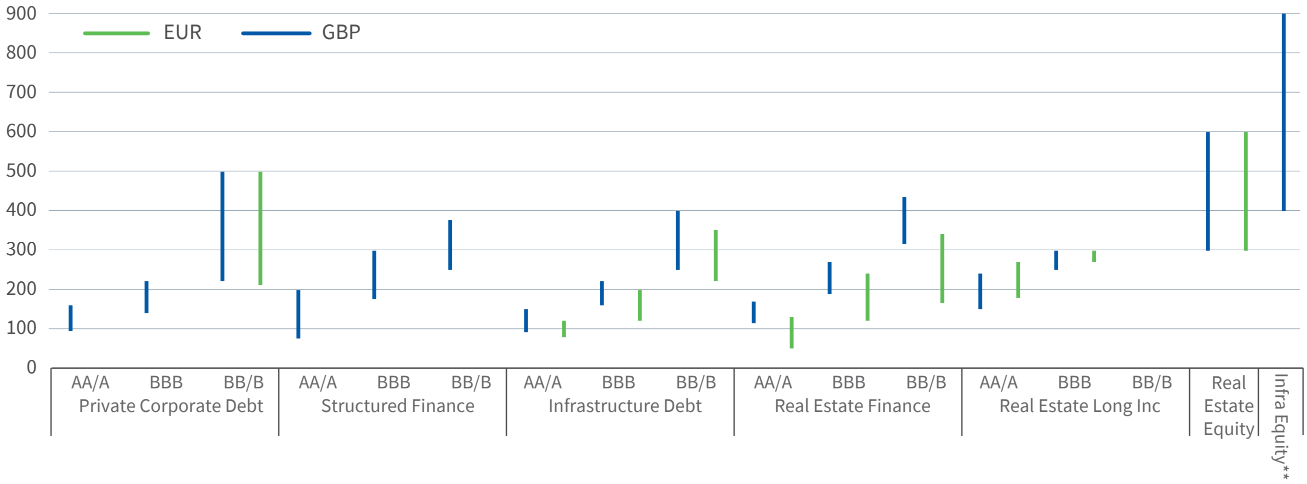
- Over recent years, lower borrowing costs have not translated into higher profit for commercial property investors, due to yield compression and more conservative lending terms, i.e. lower loan-to-value ratios (LTV).
- If senior LTVs had stayed unchanged in the last 10 years, the levered equity income return would be around 25 per cent higher today. We expect leverage to continue to be used relatively conservatively even if rates decline further.

Figure 3. **Borrowers' Cost and Equity Income Return**



Note: Leveraged equity income return calculated based on MSCI Yield and the Borrowers' Cost from the CASS Commercial Real Estate Lending Report 2018. Corporate tax has been ignored. Source: CASS Commercial Real Estate Lending Survey, Aviva Investors, May 2019

Indicative spreads p.a.*



*Additional yield above comparable government bonds **High quality Unlevered Infrastructure Equity.

Source: Aviva Investors (for illustrative purposes only). All data as at June 2019. The future returns and opinions expressed are based on Aviva Investors internal forecasts and should not be relied upon as indicating any guarantee of return from an investment managed by Aviva Investors nor as advice of any nature.

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