RESEARCH

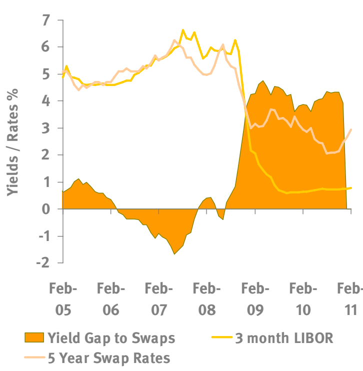
FEBRUARY 2011
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators

Lending rates and property yield gap



Source: Knight Frank Research, FT, IPD

- Concerns are now growing on inflationary pressures both in the UK and global economies. This has resulted in a bumpy ride for Sterling, due to conflicting messages on growth, plus rising inflation.
- Gilt yields have continued their drift upwards, probably driven more by expectations on interest rates than confidence in the strength of the recovery. Ten year Gilt yields stood at 3.86% last Friday. Three months ago they were below 3.00%.
- The FTSE 100 has since the beginning of the year largely hugged the 6,000 mark, reflecting the general mixed messages on the UK economy. This is in contrast to the major US indices which have recorded growth since the start of January.

Economic overview

- The first estimate of Q4 GDP caught everyone by surprise, with a reading of minus 0.5%. Many commentators have suggested the figure may be revised upwards in the coming months.
- Also, the Markit PMI survey indices pointed to a rebound in activity in January, particularly for the key Services sector.
- Despite the economic slowdown, inflation increased sharply in December, reaching 3.7%. With the price of Oil clearing $100 per barrel, and the VAT increase, it is expected inflation will continue rising.
- Retail sales were flat in December compared to the same time in 2009. There was a sharp rise in non-store retail sales, reflecting an increase in online shopping. Non-food store retailing held up well also.

Key economic indicators

	% / Value	Trend
CPI *	3.7	↑
Retail sales (volumes)†	0.0	→
Unemployment **	7.9	↑
Base Rate	0.5	→
£ : $	1.61	↑
£ : €	1.19	→
FTSE 100	5,997.4	→

Source: NS, FT, BoE.
All figures as at 4 Feb, except ** end Nov, * end Dec, † end Dec. Figures for currencies and FTSE are the value

Property performance

Borrowing yield gap*		393bps ↓
Risk yield gap**		341 bps ↓
Investment purchases (2011)		£3.1bn
of which, from UK institutions		14%
All Property void rate		9.8% →
	Initial yield	20yr average
Retail	6.1%	6.3%
Office	6.4%	7.3%
Industrial	7.2%	8.0%

Key performance indicators

Source: IPD, FT, Property Data, Knight Frank Research
*5 yr Swap rates to All Property initial yield
**Gilt redemption yield to All Property equivalent yield
IPD and matching data as at end December 2010

- IPD Capital growth figures, on the month-on-month measure had an encouraging finish to the year. All the three sectors were in the black in December, with Offices still leading the charge.
- Offices will probably continue to be the preferred sector, given it is recording positive rental growth, albeit weighted towards London.
- The overall picture for 2010 was a strong start to the year, which gradually slowed to a crawl. On a twelve month comparison, total returns peaked in July at 24.2%, then fell back to 14.5% by December.

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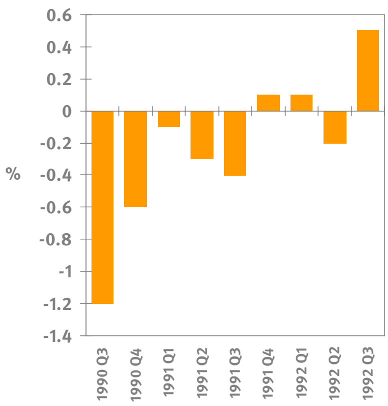
Back in the red

- What interesting times we live in. Two weeks ago we had the shock Q4 GDP figures. Last week saw punchy survey figures for January. This week we await the Bank of England's interest rate decision with more interest than usual. Despite the depressing GDP figures there is serious discussion that the MPC may finally take the base rate out of holding pattern.

UK GDP Growth - The early 90s recession

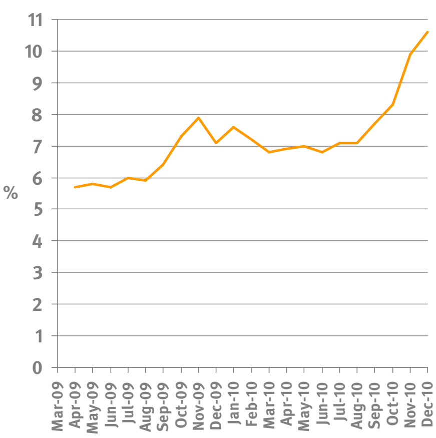


Source: Office of National Statistics

- Tightening monetary policy just after disappointing GDP figures appears odd on the face of it. While the Office of National Statistics estimates that growth would have been 'flatish' but for the snow, the figures would still have been worse than expected. The consensus forecast was for modest growth of 0.2%.
- Also, financial markets were bumpy in December, as the Eurozone debt crisis continues to unfold, which has hit earnings for the key FBS sector.
- However, some are dismissing the Q4 figures as a blip, as occurred in Q2 1992, after the UK exited the early 90s recession. There are even predictions of a rebound in Q1.
- The January Markit PMI indices highlighted a sharp improvement in Services and continued growth for Manufacturing, lending weight to these forecasts. Let us hope the rally lasts.
- Moreover, inflation is proving unresponsive to the spare capacity in the economy, as shown by the marked increase in the CPI measure in December. The minutes for last month's MPC meeting suggests the balance of opinion edged slightly towards hawkishness.
- Nevertheless, a question mark hangs over the strength of the recovery, as we can only read so much into one month's survey evidence. In particular, the breakdown of the Markit PMI survey for Services – the largest sector of the economy – showed that while new business increased strongly, the jobs measure is still negative. This needs to change if the private sector is to counterbalance the public sector job losses.
- Also, the MPC is concerned with weak bank lending. As we are keenly aware in property, the banks are still deleveraging and will continue to do so for some time to come.
- While the MPC may now feel the need to make a statement on inflation, and increase rates sooner rather than later, this will probably be a one-off. Growth is occurring but not over a broad base, and fundamentals are not yet in place. In particular we need to see consistent full time private sector employment growth and more bank lending before the economy can move out of the current period of ultra-lax monetary policy.

Online Retail

Internet as % of total retail sales by value



Source: Office of National Statistics

- Retail sales figures point to a strong Q4 for online shopping, which in December accounted for 10.6% of sales by value, up markedly on the 7.1% figure recorded a year earlier.
- A recurring theme in our recent logistics research notes was growing interest in warehouses from retailers in general, including online firms like Amazon.
- Online usually works better for some goods than others, and shopping centres have evolved into a mixture of retail and leisure. Nevertheless, online retailing looks like an area to watch for logistics property demand.

KNIGHT FRANK COMMENTS

It is hard to know which way we should be looking. A poor set of GDP figures is followed by open discussion on whether the Base Rate should rise. These things do not normally happen at the same time.

But QE has changed the rules. The situation is fluid and sooner rather than later the market will make a collective decision on whether 2011 will be a good year or not, then things will move quickly. It is right (and safest) to be cautious, though we should not rule out the pendulum swinging towards risk.