RESEARCH

UK MARKET OUTLOOK FEBRUARY 2015

THE NEW YIELD LANDSCAPE

Last week saw Sweden's Riksbank become the latest central bank to announce a negative interest rate, joining the Eurozone, Denmark and Switzerland. At the time of writing ten year bond yields are now at or below 0.5% for Austria, Denmark, Germany, Japan, The Netherlands, Sweden, and Switzerland. Suddenly the yields on UK commercial property look huge, particularly if you are an overseas investor, beckoning the question, how will a normal spread be restored?

The idea that bond yields and interest rates could sharply increase is unlikely for the foreseeable future, so the other alternative – property yields fall – feels a more probable option.

However, there is a third, and more bearish scenario, which is the gap stays the same or perhaps even widens as bond yields go lower, as arguably the spread is there due to risk levels. Central banks are printing money because they are concerned about the outlook, and the spread reflects the greater risks involved in holding an asset like property, that does best in a rising economy, during tentative times.

Also, deflation threatens to create its own bizarre economics in Europe. If inflation is minus 0.33% in Switzerland and a 10 year bond yields 0.05% there is still a spread of 38 bps for anyone who is feeling cautious.

There is of course no correct size for the spread, which is dictated by how bearish or bullish the market has become. At a time when there is talk that Greece may yet crash out the Euro it is unsurprising that some are prepared to accept negligible yields on safe haven bonds, but that is unlikely to continue indefinitely. If investors can find a recovery to ride they will do so, particularly when it is in a G7 nation. Also, one has to wonder at the pressure that will build on those in bonds to take profits and redeploy it elsewhere as we get further into the latest round of QE.

To this backdrop the UK offers an established economic recovery, and a property market where discussion on

The market in a minute

All property capital growth index rose by 0.4 % in January m-on-m, vs 1.1% in December*

Offices saw the highest capital growth (0.7%), and retail the lowest (0.1%)*

12 month total return edged down to 18.9%*

Investment volume for January 2015 was £3.1 bn, unchanged on Jan 2014**.

* Based on IPD figures
** Based on Property Data figures

JAMES ROBERTS
Chief Economist

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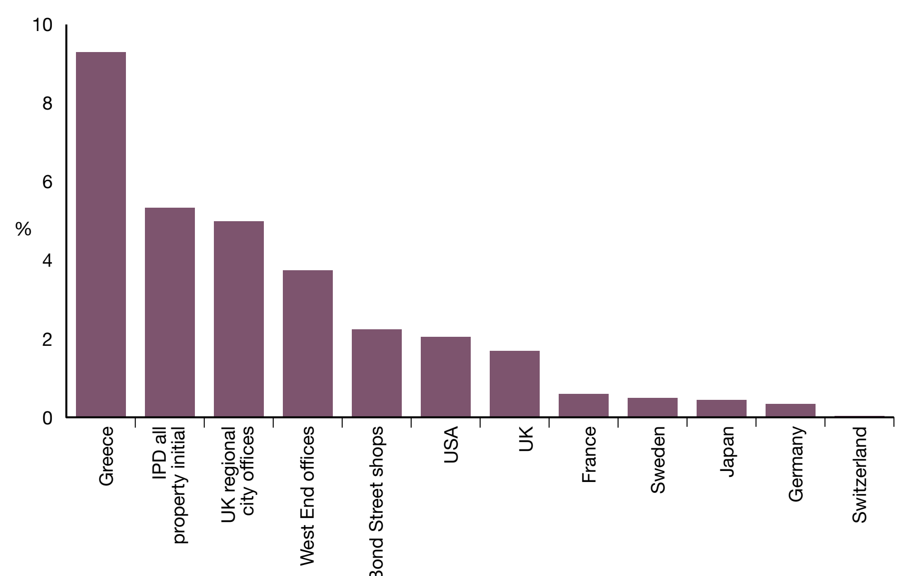
FIGURE 1
Commercial property yields vs 10 yr sovereign bonds



Source: Thomson Reuters, IPD, Knight Frank Research

the impact of bad debts has almost disappeared. Prices have been rising for 21 months on the IPD measure, and rental growth is re-emerging outside of central London.

Money is being printed in the Eurozone (and Denmark and Sweden), but it can travel where it likes in the EU to be invested. Similarly rates on the continent can be set at levels intended to strong arm bankers into lending, but they can lend abroad rather than at home. For some European investors and lenders, UK property could look a safer bet than domestic markets, as there are probably further road bumps ahead for the Eurozone.

Yes, the exchange rate is not in the favour of a Euro buyer looking at the UK. However, while the pound has been steadily strengthening against a range of currencies for some time foreign investment volumes in London are still high, probably thanks to currency hedging. Plus there is the prospect of receiving rent payments in an appreciating currency, and a lesson of recent years has been portfolio diversification has advantages.

So we believe a QE boost for UK property could be around the corner.

This beckons the question where will this money go in the UK?

While there are well publicised examples of foreign money now heading into the regions, overseas investment is typically less comfortable deploying beyond London and we should expect the capital to be the main target. Foreign money has accounted for the majority of investment in the central London market for seven of the last ten years, and 2015 looks set to extend the trend towards international dominance. While regional yields may be higher than those in London, the finance environment for those coming in from abroad makes the numbers work in the capital, and there is little reason to expect this to change suddenly.

Thus we could be looking at another year where central London is a difficult market for the typical British fund to buy into. For UK investors the regions should now be at the top of the agenda.

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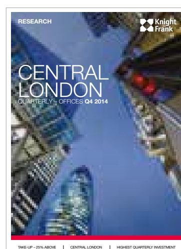

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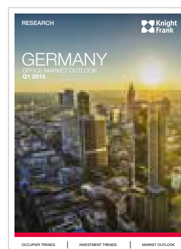

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