RESEARCH

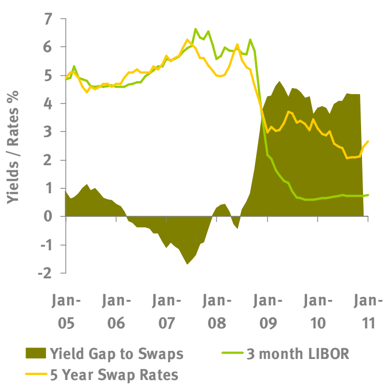
JANUARY 2011
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators

Lending rates and property yield gap



Source: Knight Frank Research, FT, IPD

- The last two months have seen investors turn against Gilts with remarkable speed, considering confidence in the strength of the recovery is fairly low.
- In contrast, commodities have been on the rise, with WTI oil trading at over $89.00 a barrel, up nearly 10% on three months ago. Food stuffs are on the rise also, which will probably push up inflation.
- The volume of hot money on the move is becoming an increasing concern, particularly for emerging market nations. The surge commodity prices may well be hot money driven.
- With Gilts on the slide, equities are unsurprisingly on a rising tide, albeit on low trading volumes. The FTSE 100 finished 2010 at 5,899.9, up 9.0% on the start of the year.

Economic overview

- Inflation continues to edge up, with many commentators warning CPI could reach 4%.
- This creates headaches for the Monetary Policy Committee, as rising inflation is coinciding with a bottleneck of economic challenges over the next few months.
- The effect of the VAT increase will be softened by the January sales, though price rises are inevitable. Moreover, the public sector cuts are already biting. 83,000 public sector jobs were shed in the first nine months of 2010, and there is probably worse to come.
- The MPC is divided on what to do next, with Adam Posen voting for more QE, while Andrew Sentence continues to call for a rise in the Base Rate.
- Fortunately, the rally in the £ has lost steam, and we view cheap Sterling as being a key element to the UK economy successfully navigating 2011.

Key economic indicators

	%	Trend
CPI *	3.3	↑
Retail sales *	1.1	↑
Unemployment **	7.9	↑
Base Rate	0.5	→
£ : $	$1.55	↓
£ : €	€1.19	↑
FTSE 100	3.0	↑

Source: NS, FT, BoE.
All figures as at 7 Jan, except ** end Sept, * end Nov.
Currencies are the spot rate.

Property performance

Key performance indicators

Borrowing yield gap*		433 bps →
Risk yield gap**		356 bps ↓
Investment purchases (2010)		£31.27bn
All Property void rate		9.8% →
	Initial yield	20yr average
Retail	6.1%	6.3%
Office	6.5%	7.3%
Industrial	7.3%	8.0%

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 November 2010

- Capital growth increased by just 0.11% month-on-month in November, according to IPD. Retail saw the strongest growth, while the industrial index is still falling.
- Rental value growth was just about positive, but only thanks to growth for offices. Industrial is still recording significant declines.
- The void rate remained steady at 9.8%. Office void rates continued to rise, which probably reflects on-going supply increases in the smaller city centres and out-of-town markets.
- Investment purchases finished the year at £31.3 bn, up from £23.7 bn in 2009. With more corporate recovery stock expected to come to the market, and a strong wall of money, we expect sales to rise again in 2011.

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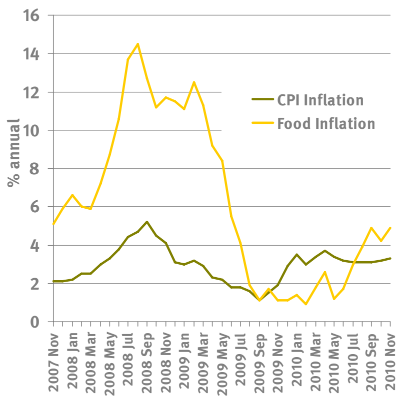
The Base Rate dilemma

- So the market embarks upon the New Year with an air of trepidation, and it would take a brave person to argue that we should actually be more upbeat.

CPI inflation vs Food inflation

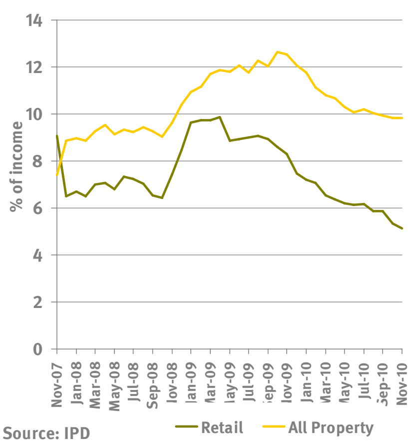


Source: Office of National Statistics

- The economy must negotiate a series of rapids, in particular the VAT rise, an intensification of the public sector cuts, and the impact on exports of the debt crisis in the Eurozone. And the banks will continue to deleverage.
- Meanwhile, inflation creeps higher, despite the fact that there is clearly spare capacity in the economy – unemployment is on the rise again. Why is this spare capacity not bringing inflation into line?
- Partly the increase is down to the volatile items in the CPI basket, particularly food stuffs, where there are global and speculative pressures. Rising fuel prices will probably add to this going forward.
- This commodity-driven inflation could fall away suddenly. This is why even now some are still calling for QE2, seeing the deflationary threats as the greater concern.
- However, even if commodity prices drop back, it is not clear that this alone will quickly dampen inflation, as we need to consider the nature of the spare capacity that is emerging.
- More public sector workers will be coming to the job market, but are their skills easily transferable to future growth areas of the economy? Also, decades of public policy encouraged Whitehall to shift civil service jobs to the UK's unemployment black spots, which is about to prove counter-productive.
- This could leave us with a situation where spare capacity is in the wrong part of the country, and skills shortages exist alongside rising unemployment. Consequently City traders, or techies with TMT firms, will find their skills in high demand as the economy gains momentum, driving up wage bargaining power.
- This is why you can have rising inflation and rising unemployment – and that is before we come to the not-so-small matter of the £200 bn the Bank of England has already printed, plus the VAT rise.
- The MPC may soon feel obliged to make a token statement on inflation, with possibly a 25 bp rise in the base rate. But the committee is doubtless conscious of how dependent those public sector-exposed areas of the country are upon cheap mortgage repayments to keep heads above water.
- Given this, we believe monetary policy will remain focused on supporting the economy, leaving inflation largely unchecked. Commercial property will feel the benefit as the year progresses, as investors move out of cash and look to spread risk. Also, finance is re-emerging, albeit for certain favoured sections of the market. Nevertheless, tenant risk remains high, which will make pricing a keen source of debate.

Retail looks to 2011

IPD Voids - All property vs Retail



Source: IPD

- For the High Street, commentators are decidedly bearish, and even if the Christmas trading figures are good sentiment will probably not shift hugely. Speculation is rife on who will be next into administration.
- Interestingly, the lowest void rate of the three property sectors is for retail, according to IPD. The pre-packs have helped the figures – arguably artificially distorting them. And Pound shops have provided some upside.
- However, the figures are backwards looking - voids will inevitably rise, but at least they will start from a low base. Also, and importantly, it remains to be seen just how sharply consumers will actually rein in spending.

KNIGHT FRANK COMMENTS

The first editions of the trade press for this year appear slimmer than usual, due to fewer advertisements. The industry appears to be in wait-and-see mode on 2011.

The first half will not be easy, as we experience another aftershock from the crisis of 2008. However, investors are on the sidelines, anxious to deploy cash and viewing the absence of the banks as an opportunity. The period of aftershocks, is probably closer to the end than the beginning.

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