RESEARCH

UK MARKET OUTLOOK JANUARY 2015

Knight Frank

The market in a minute

All property capital growth index grew by 1.0 % in December m-on-m, vs 0.8% in November*

Offices saw the highest capital growth (1.7%), and retail the lowest (0.5%)*

12 month total return edged down to 19.3%*

Investment volume for 2014 was £61.7 bn, vs £54.5 bn for 2013**

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

JAMES ROBERTS
Chief Economist

"Some retailers are already faced with the rent collar working against them resulting in above inflation increases, and the number in this situation will grow in 2015."

Follow James at @KF_JamesRoberts

For the latest news, views and analysis on the world of prime property, visit Commercial Briefing or @KF_CommBrief

DISINFLATION OR DEFLATION?

UK inflation hit 0.5% on the CPI measure in December, almost ruling out an interest rate rise in 2015. We are clearly in a significant period of disinflation (prices still rise but the rate of increase slows) and we could even see outright deflation (prices fall). What will this mean for property?

Traditionally deflation has been viewed as economic quicksand. It is something that was assumed could only occur in the darkest of circumstances, and would have two consequences:

1. People would stop spending because the dreadful economic news scares them into belt-tightening, but as a result they grease the downwards slope of deflation. This is what Keynes called "the paradox of thrift".
2. As the price fall gains momentum, consumers have double the reason not to spend. Why buy today what will be cheaper tomorrow? This 'buyers strike' further contributes to the downwards spiral.

However, as David Smith in The Sunday Times has been pointing out in recent weeks, the current situation is not as simple as the above suggests.

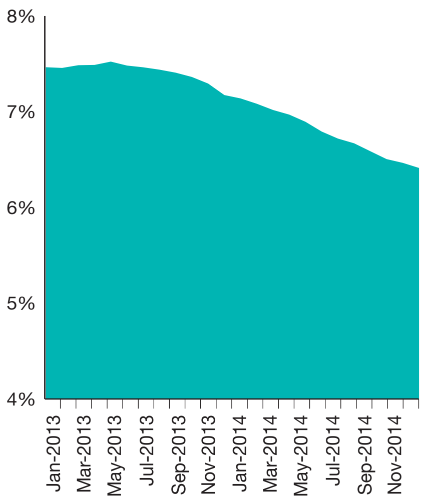
Some purchases one has to make in order to stay alive, such as food and fuel. Given these cannot be economised away or delayed, such price falls become good news. Money not spent at the petrol pump or on groceries becomes money that can be spent elsewhere.

Critically, in a country like the UK that surplus money will get spent. Whereas consumers in many Asia-Pacific countries have a high propensity to wisely save any extra cash, John Bull is fortunately not that frugal; and with interest rates so low, what would be the point in saving? This is why talk of a 'Japanisation' of the economy is overdone. There are cultural differences between the British and the Japanese which mean that more money in shoppers' pockets in the UK will be spent on other goods and services.

Critically, the deflationary spiral also normally assumes an economy in a desperate situation – which is why there is concern in Europe – but the UK is achieving good levels of growth. So the risk of "paradox of thrift" is low, thanks to falling unemployment and positive news on GDP.

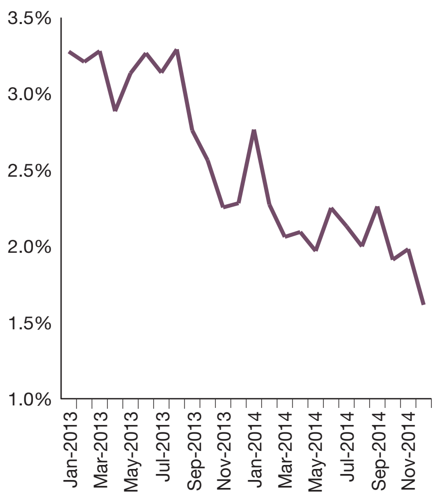
What will all this mean for commercial property? Let's start with the bad news, then look at the good.

FIGURE 1
IPD Equivalent Yields



Source: IPD

FIGURE 2
12 month RPI inflation



Source: ONS

The new era of very low inflation is clearly not good news for tenants holding an RPI linked lease. Speaking in very broad brush strokes, many such leases in the retail sector are collared at 1.0% to 2.0%. With RPI at 1.6% and falling, some retailers are already faced with the rent collar working against them resulting in above inflation increases, and the number in this situation will grow in 2015.

While superficially this situation is good news for the landlord, the opposite could be true if it pushes frail retailers into administration, or prompts another wave of lobbying for monthly rents or even rent holidays. It may also encourage retailers to deliberately push customers towards non-store distribution, such as the internet, in order to further downsize on the high street. Particularly in regard to the banks' high street networks this could be a concern.

So what's the good news?

The general boost to the economy from lower fuel and food bills is self-evident. In effect, the commodity exporting nations have been draining off ever larger sums of money from countries like the UK for several years, and now some of that gets rolled back. Ten of billions of pounds that would have been paid to trade partners now stays in the country, and is invested in productive capital or new employment. Thus occupier markets will gain.

Also we need to consider the yield and interest rate environment, particularly in the context of an increasingly international capital markets environment.

Rates are now very unlikely to rise in the UK this year, which given that property capital values are rising, creates a benevolent scenario for the real estate debtor.

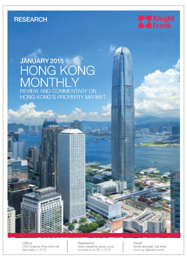
Furthermore rates are negative in the Eurozone, Switzerland and Denmark, while 10 year bond yields are sub-1% in France, Germany, and again Switzerland. This should result in more cash looking for a high yielding home in 2015, and real estate tends to perform best in an economy that is growing. Forecasters generally expect the UK to outperform most large advanced economies (particularly those in Europe), so that makes British commercial property appear attractive.

Consequently, more foreign money targeting UK commercial property in 2015 looks an increasingly likely scenario. This should make for an interesting year in the commercial market, as a dismal year for the FTSE in 2014 could result in more domestic money favouring property unit funds.

"Consequently, more foreign money targeting UK commercial property in 2015 looks an increasingly likely scenario."

RECENT MARKET-LEADING RESEARCH PUBLICATIONS

Paris Office Market Report - Q4 2014



Hong Kong Monthly - January 2015

Central London Retail Report - Winter 2014

Global Capital Markets Q1 2015

Knight Frank Research Reports are available at **KnightFrank.com/Research**

COMMERCIAL RESEARCH
James Roberts
Chief Economist
+44 20 7861 1239
james.roberts@knightfrank.com