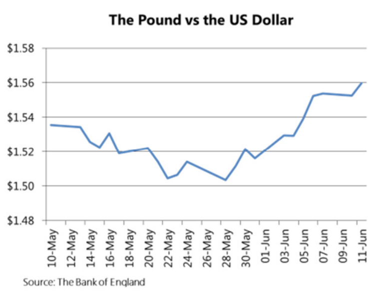
RESEARCH

JUNE 2013
UK MARKET OUTLOOK

Commercial property review
Knight Frank

Financial indicators



- The Bank of England Monetary Policy Committee (MPC) left policy unchanged in June. Next month Mark Carney takes over as Governor. Officials of the US Federal Reserve have suggested publicly that they are considering 'tapering' off their QE programme.
- The prospect of an end to QE prompted a sell-off in global financial markets, inevitably with those investments that benefited the most from QE in the forefront. Emerging market bonds and currencies have come under pressure, as well as US and UK government bonds.
- UK ten year gilt yields have risen to 2.2%, up from 1.8% a month ago, having dipped below 1.7% in April. This effectively takes gilt yields back to where they were at the start of the year. The pound has also gained against the US dollar, climbing from just over $1.50 in late May to $1.56 currently.

Economic outlook

- Economic think tank, NIESR, estimates that the UK economy grew by 0.6% in the three months to the end of May. This suggests the recovery is strengthening, given the second reading of Q1 GDP was 0.3%.
- The latest PMI indices also point to improved conditions. The PMI index for UK manufacturing came in at 51.3 – a reading of over 50 indicates expansion. The Services PMI read at 54.9 in May, up from 52.9 in April. This is the best reading for services in 14 months.
- The unemployment rate was unchanged at 7.8%, and this indicator has only seen marginal change since last summer. The level of employment has also stabilised at 71.5%. We would expect unemployment to come under pressure later in the year.
- **Key economic indicators**

	% / Value	Change
CPI *	2.4	↓
Retail sales (volumes) *	0.5	↑
Unemployment *	7.8	→
Base Rate	0.5	→
£ : $	1.56	↑
£ : €	1.18	→
FTSE 100	6,340.1	↓

Source: NS, FT, BoE.
All figures as at 11th June, except * end Apr..
Currencies are the spot rate. FTSE is the index value.

Property performance

Key performance indicators

Borrowing yield gap*		540 bps ↑
Risk yield gap**		524 bps ↑
Investment purchases (2013)		£13.85 bn
All Property void rate		12.2% ↑
	Initial yield	**20yr average**
Retail	6.3%	6.2%
Office	5.9%	7.1%
Industrial	7.3%	7.8%

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 April 2013

- The IPD capital growth index saw a month-on-month decline of 0.04% in April, which on rounding is effectively no change. In a continuation of established trends, offices were the best performing sector, and retail the worst. We expect the index to begin to rise again in the coming months.
- The City of London office market continues to see growing interest from the technology sector, with Amazon taking a 190,000 sq ft building on Holborn Viaduct, which follows Salesforce.com taking space in the Heron Tower. This coincides with office deals in Manhattan by Yahoo! and Facebook.
- Total investment in UK commercial property has reached £13.8 bn so far this year, compared to £13.3 bn, for the same period of 2012, according to Property Data. The volume of activity has decelerated in Q2 though, following a strong Q1.

Commercial Research
James Roberts, Head of Commercial Research
+44 (0)20 7861 1239
james.roberts@knightfrank.com

www.knightfrank.com
Knight Frank LLP is a limited liability partnership registered in England with registered number OC305934. Our registered office is 55 Baker Street, London, W1U 8AN, where you may look at a list of members' names

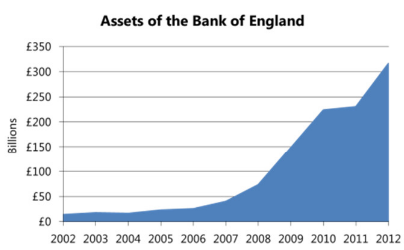
JUNE 2013

UK MARKET OUTLOOK

Commercial property review

Eyes turn to Carney

- Six months ago the arrival of Mark Carney at the Bank of England was expected to mark a new phase of loose monetary policy. However, the arrival of the new Governor may now prove to be something of a non-event.



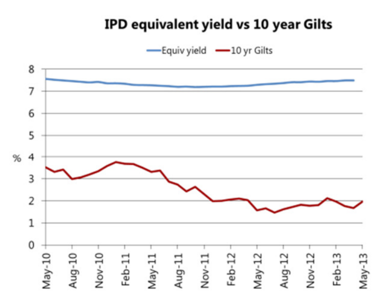
Source: The Bank of England

- In the US, Federal Reserve officials are now talking about the time when they begin 'tapering off' bond purchases, and yields have moved upwards. US ten year bonds are trading at 2.2% at the time of writing compared to 1.9% a month ago. In June, the ECB, the Bank of England, and the Bank of Japan, all left policy unchanged.
- Major western central banks are holding back from more stimulus. Indeed the majority of the Bank of England MPC has voted down Governor Mervyn King, who personally has favoured QE in recent months. So Carney arrives at Threadneedle Street when the majority view is 'wait and see'.
- Caution among policymakers arises from signs of tentative improvement in the economy, at least in the US, Japan, and UK. In the Eurozone bond yields are moving closer to convergence again (albeit still with a long way to go), a welcome sign of normalisation.
- So unless there is a sudden deterioration in the economic news, or a fresh bout of financial crisis, the opening phase of Carney's governorship may look like much of final stages of King's tenure. Month after month of no change for the base rate at 0.5%, and no additional QE.
- If a benign economic scenario unfolds, Carney's first opportunity to make an impact on policy will come further down the line – perhaps in 2015 – and then as a hawk not a dove. If the economy manages a slow recovery in the next 18 to 24 months, the task will arise of unwinding QE.
- While it is possible that political pressure and fear of causing another recession results in the printed money remaining in circulation, interest rates will have to return to normal levels. This will have implications for commercial property.
- Rising interest rates will mean new property loan defaults, suggesting that even if lending improves in 2014, it may take another hit the following year. It is also a compelling reason for banks to sell or force the sale of assets in 2014, in order to clear the decks ready for the next wave of repossessions.
- However, let us not forget that asset sales are not the only way to reduce the debt mountain. With an improving economic backdrop one would expect more money to flow into private equity and opportunity funds. In turn, this suggests more money buying debt at a discount from the banks.
- Moreover, before we get to the interest rate rise we need to see a protracted economic recovery, which in itself will generate a wave of fresh direct property investment. A next round of loan defaults may arrive into a very different property market.

Knight Frank Comments

At the time of writing the financial markets are in another volatile period, with both equities and bonds falling in value at the same time. This is because the global economy is undergoing another gear change, this one shifting money out of pricy emerging markets assets. We believe the next gear change will see that money transfer back to the West, where six years of bear markets have pushed prices low for a range of assets.

The next big challenge facing developed economies is unwinding QE, but that is not something that we expect to occur this year or next. In the meantime, commercial property is an asset class that has undergone a big price correction, but an economic recovery should improve occupier demand, which will attract investor interest. If the Q2 GDP figures show growth, interest in property outside of London will increase, and in London the market focus is shifting towards development. This side of the distant interest rate rises, the outlook appears favourable.



Source: Datastream/IPD

Commercial Research

www.knightfrank.com

© Knight Frank LLP 2013

This report is published for general information only. Although high standards have been used in the preparation of the information, analysis, views and projections presented in this report, no legal responsibility can be accepted by Knight Frank Research or Knight Frank LLP for any loss or damage resultant from the contents of this document. As a general report, this material does not necessarily represent the view of Knight Frank LLP in relation to particular properties or projects. Reproduction of this report in whole or in part is allowed with proper reference to Knight Frank Research.