RESEARCH

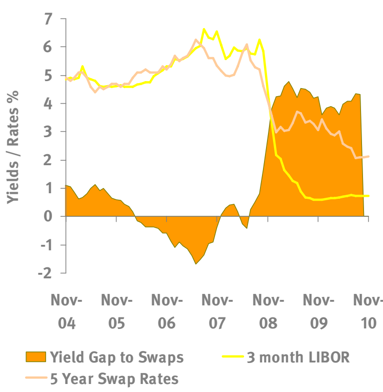
NOVEMBER 2010
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators

Lending rates and property yield gap



Source: Knight Frank Research, FT, IPD

- The Bank of England's Monetary Policy Committee kept the base rate on holding pattern, and shied away from more QE at its latest meeting.
- Financial markets had expected co-ordinated action with the Fed in the US, which has embarked on a $600 bn QE2 programme. However, better-than-expected Q3 UK GDP figures called into question the necessity of further stimulus.
- The Chancellor of the Exchequer has since warned of 'choppy waters' ahead, and repeated his support for further QE. However, it will be interesting to see in future MPC meetings whether other committee members now adopt Andrew Sentance's hawkish view on inflation.

Economic overview

- CPI inflation appears to have 'flat-lined' at 3.1%, just above the 3.0% ceiling set for the MPC. Recent increases in food and other commodity prices and the impending VAT increase are expected to push headline inflation higher .
- The first estimate for Q3 GDP growth was 0.8%, down on the 1.2% seen in Q2, but more than double the consensus forecast figure of 0.4%.
- The Unemployment rate continues to edge lower, though employment figures suggest a shift to part-time and temporary employment has occurred.
- Worth noting is the rally for equities. The FTSE 100 has risen 8.2% in the two months to 5 Nov 2010, compared to the 5.6% increase in the same period of 2009.

Key economic indicators

	%	Trend
CPI *	3.1	→
Retail sales (volumes)†	0.5	↓
Unemployment **	7.7	↓
Base Rate	0.5	→
£ : $	1.62	↑
£ : €	1.16	↑
House Prices: Halifax *	1.2	↓
House Prices: Nationwide *	1.4	↓

Source: NS, FT, BoE.
All figures as at 5 Nov, except ** end Aug, * end Oct, † end Sept

Property performance

Key performance indicators

Borrowing yield gap*		431 bps ↓
Risk yield gap**		393 bps ↓
Investment purchases (2010)		£24.46bn
of which, from UK institutions		35% ↓
All Property void rate		9.9% ↓
	Initial yield	20yr average
Retail	6.1%	6.3%
Office	6.4%	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 June 2010

- According to IPD, capital growth was up 0.17% in September, month-on-month, which was better than the 0.11% recorded in August, but still marginal. A 0.25% rise for Retail counterbalanced a slight fall for Industrial.
- Initial yields hardened modestly for Offices and Retail, but softened for Industrial. Offices were the only sector to record month-on-month rental growth on the IPD measure. Central London offices are mostly the driving force behind this.
- In general, commercial property in London is outperforming the rest of the UK by most measures. Outside of London, buyer interest remains selective and biased towards low risk prime assets.

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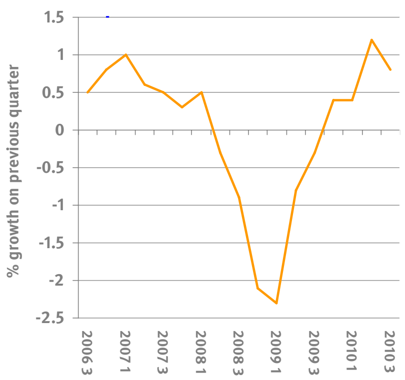
In the absence of QE

- The surprisingly strong Q3 GDP figures derailed hopes of another wave of Quantitative Easing from the Bank of England last week. This is probably for the best, as it spares Britain the displeasure of our emerging market trading partners, some of whom view QE2 in the US as little more than competitive devaluation.

UK GDP Growth - % on previous quarter

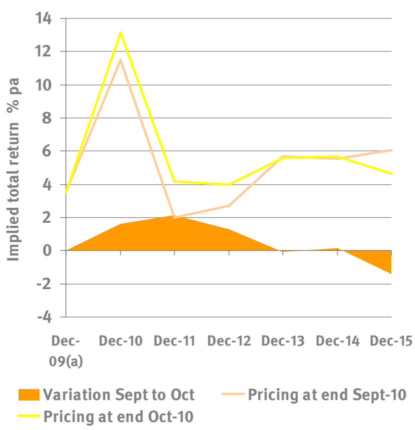


Source: Office of National Statistics

- However, this beckons the question, what are the prospects for the UK economy in 2011 in the absence of QE? After all, we are now faced with a major fiscal squeeze, but no new printed money as a counterbalance. Moreover, debt availability, while improving, is still low.
- Arguably, we are a lot better off, as there is stronger momentum in the economy, which is a bird in the hand. In contrast, we have no idea how well QE2 would have worked. There was even speculation that much of the money would be invested in emerging markets where higher returns are on offer.
- Moreover, certain indicators of particular relevance to commercial landlords are improving. The latest UK insolvency figures show company bankruptcies are down 5% quarter-on-quarter and 14% year-on-year.
- This should ease concerns on 'distress' issues facing commercial property, which lag the turning point for the wider economy. Moreover, it improves the prospect of re-awakening demand for secondary investment stock, which outside of Central London, is minimal.
- Turning to the Labour market, the number of people in employment rose by 178,000 in the three months to the end of August, while the number of unemployed dropped by 20,000.
- Admittedly, a lot of the increase was for part-time and temporary staff. However, inevitably employers seek flexibility when taking on staff early in a cycle. After a time lag the full-time figures will pick-up.
- Nevertheless, the public spending cuts will bite next year, and this is keeping property investors nervous, particularly on regional markets. Yet, the proposed cuts – 490,000 jobs between now and 2015 – seem a manageable sum for the private sector to counterbalance.
- Consequently, now could be the time to look at regional property that does not tick quite enough boxes to qualify as prime – the section of the market which will probably re-open next once confidence returns.
- This is at odds with the more bearish views on the economic outlook, but so was Q3 GDP coming in at twice the level analysts expected. And the same thing happened with the Q2 figures. With the probability of a double-dip recession receding, the downside risks appear far less daunting now than six months ago. Time to move along the risk curve.

Property derivatives

Derivatives pricing: implied total returns



Source: Morgan Stanley

- The rebound in confidence this Autumn for near and medium-term pricing continues in the derivatives markets. This might reflect higher trading volumes.
- Back in the Summer months, the implied total return for December 2011 had plummeted to 0.0%, but now it has leapt back up to 4.2%. Confidence in 2012 has also picked up in October, rising to 4.0% from 2.7% in September.
- In contrast, derivative investors are taking a more bearish view of 2015, suggesting the markets are now bringing forward the recovery to sooner rather than later, but viewing the middle of the decade as the end of the cycle.

KNIGHT FRANK COMMENTS

We entered October expecting the Bank of England to run the printing presses. Then it turned out the economy is doing better than we thought. However, the bears are undaunted and see the public spending cuts as the chink in the recovery's armour.

Reflecting the gloomy sentiment, yield has been in demand lately. However, with the pace of economic growth at odds with the bearish view, the question arises, is Andrew Sentance right? Is it the time to worry about inflation…?

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