RESEARCH

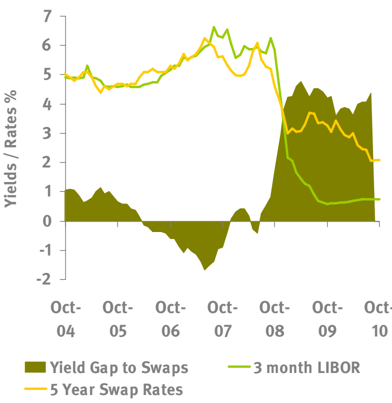
OCTOBER 2010
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators

Lending rates and property yield gap



Source: Knight Frank Research, FT, IPD

- The borrowing yield gap increased in August, as the fall in the five year Swap rate outpaced further yield compression. Despite an uptick in September, Swaps are at the time of writing back to the August level, so at record lows.
- This reflects the sharp contraction in Gilt yields, as debt investors appear to have priced in a bearish outlook for some time to come. Speculators are probably also buying in anticipation of a possible extension of the QE programme.
- Interestingly – perhaps, oddly – the rise in Gilt prices has coincided with a rally for equity markets, albeit off low volumes. Debt and equity investors seem to be betting on different outcomes.

Economic overview

- The Q2 GDP figure remained unchanged at 1.2% on the second revision. There was a slight downwards revision of the contribution from inventories, suggesting the economy is slightly healthier than previously supposed.
- Nevertheless, there is a broad consensus that the economy is only likely to record weak growth in the near-term. To this backdrop the MPC left the official rate unchanged at 0.5%.
- Inflation remaining steady at 3.1% complicates matters for the MPC. So far the surplus capacity in the economy is not proving as effective a brake on inflation as many had expected.
- Retail sales, for instance, did increase at a slower pace in August. However, earlier this year some commentators were predicting far less from consumers by now. Non-food retail sales have held up well.

Key economic indicators

	%	Trend
CPI *	3.1	→
Retail sales *	0.4	↓
Unemployment **	7.8	↓
Base Rate	0.5	→
£ : $	1.59	↑
£ : €	1.14	↓
House Prices: Halifax *	2.6	↓
House Prices: Nationwide *	3.1	↓

Source: NS, FT, BoE, Halifax, Nationwide.
All figures as at 7 Oct, except ** end July, * end Sept.

Property performance

Key performance indicators

Borrowing yield gap*		436 bps ↑
Risk yield gap**		477 bps ↑
Investment purchases (YTD)		£21.81bn
of which, from UK institutions		36% →
All Property void rate		10.1% ↓
	Initial yield	20yr average
Retail	6.1%	6.3%
Office	6.5%	7.3%
Industrial	7.2%	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 February 2010

- Capital growth managed a paltry 0.11% increase month-on-month in August, according to IPD. It is worth remembering that IPD is a basket of properties of varying quality, as there remains a big difference between prime and secondary in the market
- On a more positive note, rental value growth is now only just negative at 0.03%, largely thanks to growth for offices.
- Moreover, voids remained steady at just over 10%, despite recent increases in the number of buildings in the IPD portfolio. This suggests the occupier market may be in better shape than supposed.
- All three sectors recorded some yield compression, though for retail and industrial the rate of decline has lost momentum in recent months.

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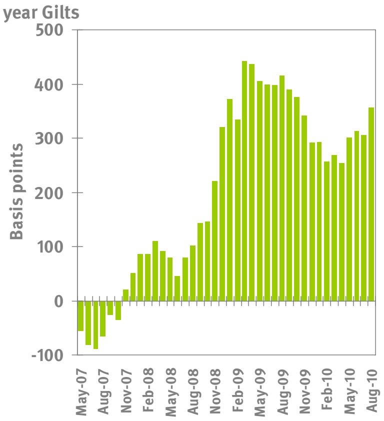
To QE, or not QE?

- Last week, the Chancellor said fears that public spending cuts might derail the economy were unfounded, as the cuts will be phased in over several years. Mr Osborne also pledged to back any future request from the MPC for another tranche of QE money.
- On the face of it, the two statements appear contradictory, but they are not. The situation is highly fluid and visibility so low that growth could fall or rise. So policymakers have to be ready to move in either direction.
- This raises the question, how effective will another round of QE be? Especially as the jury is still out on how much impact the previous rounds had. Much depends on what we expect from QE.
- If it is to get the banks lending again, then there is not much reason for optimism. The weaker banks will probably just use the money to shore up their balance sheets and roll back further the process of working out their bad loans. As the cynics would say, "a rolling loan gathers no loss".
- The flipside to this is that not all banks are weak, and some are gearing up for the next business cycle. Yet, these institutions are currently wondering how much of their operations they should keep in the UK, given the threatened regulatory crackdown. Until the banks know where they stand on regulation, why would they start expanding in Britain in a big way?
- So is QE ineffective? I would say the early stages of QE did have a big impact, but it was on investor sentiment not bank lending. The combination of low interest rates and Gilt purchases punished investors for holding cash, forcing them into the economy to get a decent return. On this level QE gave a defibrillator shock to the economy in 2009 and got money flowing around the system again.

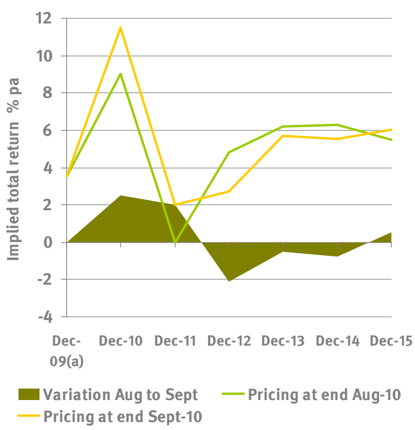
All property initial yield - premium/discount to 10 year Gilts



- Herein lies the danger of another bout of QE – it may persuade investors the emergency measures are no longer a defibrillator but a life support machine. Then they will remain camped in Gilts, and risk averse – the opposite of what the economy needs.
- Ten year Gilt yields are currently sub-3% while inflation is steady at 3.1%. Add some better-than-expected economic news, and investors might start looking for a higher return. After all, the economic news lately has not been a one-way street. The latest UK CIPS-Markit Services index was stronger than expected, while Chinese manufacturing appears to be flexing its muscles again.
- If left alone, the natural tides of the market could yet flush investors into the economy without help from the Bank of England.
- Turning this to the property world, the gap between property yields and Gilts is becoming temptingly large, at a time when indicators suggest the occupier market never sank as deep as was expected. The pessimism in the market for secondary stock could be an opportunity for those brave enough to look past the gloomy economic headlines, and with the experience necessary to sort the wheat from the chaff.

Property derivatives

Derivatives pricing: implied total returns



Source: Morgan Stanley

- Following the slump in confidence on the outlook for 2011 over the Summer months, the derivatives market has seen a recovery in faith in prospects for next year. Having hit the floor in July, total return pricing for 2011 is up to 2.0% now, though this compares unfavourably to the 5.0% seen back in the Spring.
- The outlook for this year has also improved, and now back into double-digits, at 11.5%. In contrast, the medium-term outlook has dulled slightly.
- On balance, it looks like the derivatives market has decided the gloom of July and August was overdone, and is now re-pricing. A timely reminder of how quickly sentiment can change direction.

KNIGHT FRANK COMMENTS

Currently there is not much confidence out there. But then we all knew it would be a long march back from the wilderness the market found itself in during 2008 and early 2009.

It is also worth noting that there are indicators suggesting the gloom is being overdone. It would be fairer to say the indicators are mixed but leaning towards the downside; not completely bad. For those prepared to cast the die, times like this can offer opportunities, but do note the gambling analogy.

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