RESEARCH

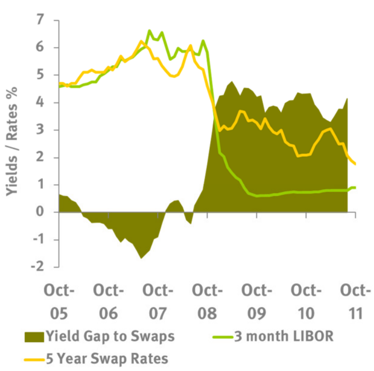
OCTOBER 2011
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators

Lending rates and property yield gap



Source: Knight Frank Research, FT, IPD

- The Bank of England surprised markets by announcing a bigger-than-expected £75 bn increase in the QE programme. The decision has proved controversial, with some commentators suggesting the move may be excessive.
- This occurred as fears grew over the strength of banks in the Eurozone. There is now a growing expectation that Greece will default, turning attention to the impact on capital levels for banks holding its debt.
- The Pound unsurprisingly fell against the US dollar, but remained steady against the Euro.
- Despite the general risk adversity in the financial markets, the price of Gold fell sharply in October, dropping below $1,700 per ounce. This may suggest investors believe that after a long 'bull run' Gold is now in late cycle.

Economic overview

- Inflationary pressures continue to build within the economy, with the CPI index rising to 4.5% in August. The RPI index increased to 5.2%. The figures have been cited as evidence to criticise the expansion of the QE programme.
- Unemployment at 7.9% remains high, but not as elevated as in the early 90's recession. The rate of unemployment throughout this downturn has undershot expectations.
- In a recent speech, the Chancellor of the Exchequer announced a programme of 'credit easing', whereby the government would support lending to small businesses. This is a welcome measure but may only become a working reality by the time the economy is through the present slowdown.
- The Markit PMI index for Services recorded a surprise increase in September. However, the PMI indices have been weak over the summer months suggesting a low Q3 GDP figure.

Key economic indicators

	%	Trend
CPI *	4.5	↑
Retail sales *	0.0	→
Unemployment **	7.9	→
Base Rate	0.5	→
£ : $	$1.56	↓
£ : €	€1.16	→
FTSE 100	5,303	↓

Source: NS, FT, BoE.
All figures as at 7 Oct, except ** end Jul, * end Aug.
Currencies are the spot rate. FTSE is index value

Property performance

Key performance indicators

Borrowing yield gap*		415 bps ↑
Risk yield gap**		387 bps ↑
Investment purchases (2011)		£23.0 bn
of which, from UK institutions		29.4%
All Property void rate		9.7% ↑
	Initial yield	20yr average
Retail	6.0%	6.3%
Office	6.1%	7.3%
Industrial	7.0%	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 August 2011

- The IPD All Property capital growth index was barely positive at 0.07% on a month-on-month measure. This leaves the index very close to double-dip territory.
- It should be remembered that IPD is a wide-ranging basket of properties of varying qualities, and there is significant variation in performance within the IPD portfolio.
- Certainly, offices are still recording capital value growth, compensating for declines for retail and industrial. Within those two sectors there is difference in performance according to location.
- Investment volume reached £6.3 bn for Q3 compared to £8.2 bn for the equivalent period in 2010. Transaction volumes have decreased as the year has progressed – the opposite of what occurred in 2010.

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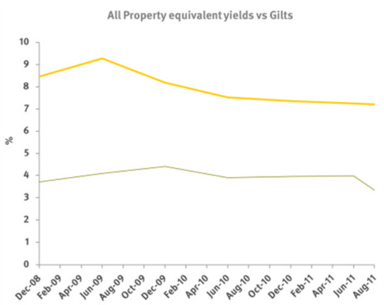
The smell of QE in the morning

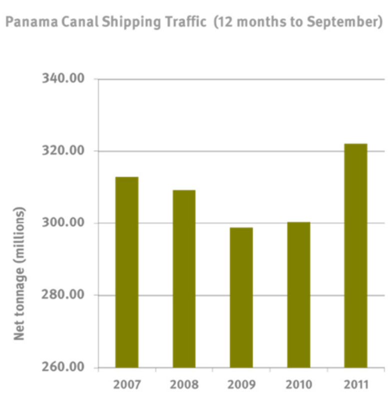
- A tree line that previously bristled with hostile gunfire is swept with bright orange flames. Before it stands Mervyn King, dressed in camouflage fatigues and an old fashioned US cavalry Stetson. Overhead the jets that delivered his £75 bn air strike against a threatening recession soar back into the clouds. Far bigger and sooner than expected – King's QE has 'shocked and awed'.



Source: IPD

- QE2 is now a reality, though the similar name to a stately liner is deceptive. The printing presses have run at a time when CPI inflation is 4.5%, and rising. Hardly a Japanese-style deflationary scenario; with the risk that an inflationary aftermath will follow.
- QE is a fiery weapon. Why else has inflation been above expectations through a prolonged period of debt famine and high unemployment?
- So where does this leave commercial property? Unsurprisingly, Sterling declined against the Dollar on the QE news, and so far this UK property cycle has been principally driven by foreign (often Dollar-pegged) money. This is particularly true for prime assets, the type of stock you would most expect to be in demand in times of uncertainty.
- Moreover, this economic crisis has been rumbling on for four years now, which is starting to break the traditional 'bear market' rules.
- Such a long period of uncertainty has inflated the prices of accepted 'safe haven' investments to, in some cases, historic highs. Gold is now losing ground suggesting investors view the price as having peaked. The Swiss have intervened to halt the rise of the Franc against the Euro. While QE by its nature makes long-dated gilts unattractive.
- So with the steady income stream from rents, and yields offering a healthy premium over bank interest, property should in theory be in a position to benefit. However, as we have been cautioning for some time, the benefit will not be universal.
- The first phase of the QE programme in Q1 2009, was quickly followed by a rebound for the Central London office market, led by the main financial districts – the City and Mayfair & St James's.
- Evidence of a rebound in the wider UK was more tentative, and much of the bounce in capital values recorded by IPD for the wider UK was in anticipation that the recovery would spread.
- In reality, the situation outside of the capital is very patchy. The M4 corridor has a TMT / infrastructure story, Cambridge has science, and Aberdeen has its oil economy links. However, anywhere traditionally associated with the public sector and consumer boom-oriented industries is struggling.
- However, it is a mistake to overlook the UK regional cities; most of whom in their CBDs offer a similar (albeit on a smaller scale) range of tenants to the capital. A building let to PwC or HSBC in a regional city has the same covenant as the HQ in London; but offers a higher yield. Moreover, as genuine prime becomes harder to find in the capital, a look further afield becomes logical.

Logistics faces the future



Source: Panama Canal Authority

- Recent years have seen a major artery of world trade, the Panama Canal, struggle to cope. Ships carrying goods and commodities between Asia and the West queue up to transit the canal. Over a third of the world's ships are too large for the 97-year-old locks.
- In the year to September 2011 the canal handled a record volume of shipping tonnage – 322 million tons (up 7% on a year earlier).
- However, recent months have seen progress on an expansion project – a new lane of super-sized locks. The summer saw concrete poured on the new lock foundations. Last month an order was placed for tug boats to manoeuvre ships out of the new locks.
- Around the world port facilities are being expanded in anticipation of larger ships and a speedier flow of world trade. The UK will surely be affected. Food for thought when thinking about logistics real estate.

KNIGHT FRANK COMMENTS

Was more QE necessary? When considered in the light of the inflation figures, it seems a surprising step. On the other hand, a major threat is the draining away of confidence, and the Bank of England has now given us reason to suppose there may be some upside ahead.

Unsurprisingly, the temptation for an investor to sit on cash is very high, but the Bank of England is determined to make this a painful option. The same is occurring across the Atlantic with Operation Twist. In the new investment world being a Bear means you get clawed rather than do the clawing. Standby for a buy cycle driven by the stick not the carrot?