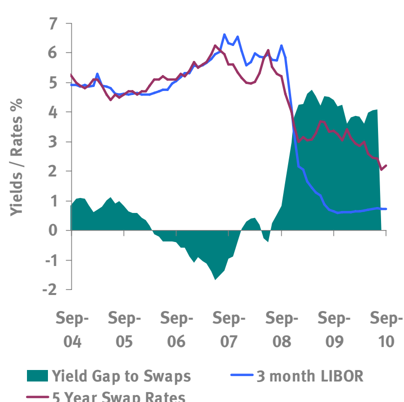
SEPTEMBER 2010
UK MARKET OUTLOOK
Commercial property review

Knight Frank

Financial indicators

Lending rates and property yield gap



Source: Knight Frank Research, FT, IPD

- Mervyn King will have breathed a sigh of relief last month. July's inflation figures showed only a marginal drop in CPI to 3.1%, which means he is still having to write monthly letters to the Chancellor explaining why inflation is more than 1% over target.
- Importantly, though, core inflation dropped from 3.1% to 2.6%, while core goods inflation fell even more dramatically to just 1.2%. All of which gives support to the MPC's stance that inflation is not of sufficient concern to warrant fiddling around with the base rate and jeopardising economic recovery.
- The market has acknowledged the likelihood that rates will stay low for some time yet, with 5 year swap rates steadily falling and down at 2.18% by 9 Sep.

Economic outlook

- The latest round of independent forecasts collated by the Treasury paints, on the surface, a pretty rosy picture. Slow but reasonable growth this year of 1.3%, then a steady dawdle back up towards trend by the end of the forecast period.
- Inflation starts off at racy, but not alarming, pace before gradually calming down to where it should be. And healthy growth combined with benign inflation means a return to familiar levels for the base rate.
- So, all very reassuring on the face of it. But, as I've covered before, this average of independent views disguises the murky world of dissent that lies beneath.
- With a double dip still possible, several forecasters are predicting annual growth of less than 1% next year - which would make 2011 a fifth consecutive year of poor performance - while others run as high as 3.4%, representing a phenomenal recovery.
- Importantly, though, whether despondent or madly optimistic, the one thing all agree on is that everything is better than it was. Recovery is just a question of pace.

Economic forecasts

	2010	2011	2012	2013	2014
GDP	1.3	2.0	2.2	2.4	2.4
CPI	2.9	2.4	1.8	2.0	2.2
RPI	4.2	3.4	2.7	3.0	3.2
B/Rate	0.5	1.0	1.9	2.8	3.4

Source: HM Treasury Consensus, August 2010

Property performance

Key performance indicators

Borrowing yield gap*		408 bps ↓
Risk yield gap**		432 bps ↑
Investment purchases (2010)		£17.82bn
of which, from UK institutions		36% →
All Property void rate		10.2% ↑
	Initial yield	20yr average
Retail	6.2%	6.3%
Office	6.7%	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 July 2010

- The rate at which capital growth, well, grew slowed yet again in July with a monthly change of just 0.21%.
- With rental decline now almost negligible – a fall of only -0.05% for the second month in a row – and income still trundling along at a fairly healthy rate, everything has combined to see total returns continue to grow. The year to July has produced 10.5%.
- Net investment continues to be driven by the UK institutions and overseas buyers. The number of transactions and total monetary volume of July and August added together barely equalled that of June alone, but quarter end fillips and the passing of summer may mean September fares better.
- IPD's void rate did increase for the first time since October, though only marginally. It did rise on both retail and offices, however, so it may be something to keep an eye on.

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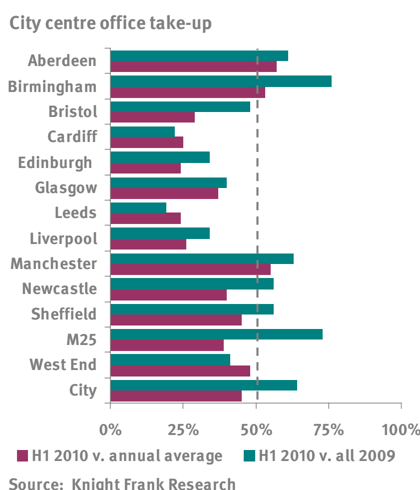
Anarchy in the UK

- Today's trade union congress calling for the public to participate in acts of civil disobedience on the streets of Britain has given me a cheap excuse for a song reference.
- Cheap or not, though, state spending in the UK is 53.4% of GDP (the EU average is 50.4%) and, as we all know, the proportion of the economy dependent on the public sector varies substantially around the country. The issue of public sector cuts and their resultant impacts on the property market is weighing heavily.
- We've covered before how much of a rebound has been seen in the London markets, most obviously though not exclusively in the office sector. Admittedly some of this recovery has been expressed in an improvement in rents, which has yet to be seen outside of the South East. Perhaps surprisingly, though, this year to date has not been as torrid for many of the regional office markets as one might think.
- This chart looks purely at the take-up of city centre office space. The data is only taking on board the first half of 2010, and is set against two comparables – each city or market's medium term annual average and, as things have not been very average of late, total annual take-up during last year.

City centre office take-up



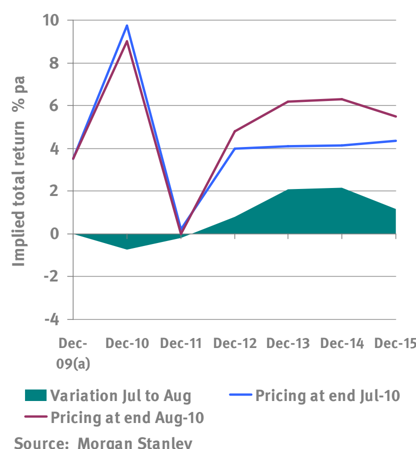
Source: Knight Frank Research

- What we'd be looking for is, hopefully, the maroon lines to have passed the 50% point, indicating they're on track for a typical annual result. Failing that, the 50% point on the turquoise lines, indicating they should perform at least as well as they did last year.
- It's a mixed bag, but there are a few surprises. Taken together, the markets have already reached 39% of their average and half of their 2009 level. In the main, then, we're on track.
- Three markets have exceeded the half way point of their average already. Not London, not the South East, but Aberdeen, Birmingham and Manchester. All 3 cities are far ahead of their 2009 level, as too are the M25 and City markets, and Newcastle and Sheffield – the latter two being among those often highlighted as being dependent on the public sector. Instead, among the laggards are cities which we would perhaps more closely associate with the financial sector – Edinburgh, Glasgow, Leeds.
- All this is not to imply that the markets will be unaffected by the cuts to come. But in many cases it will be on the back of a stronger performance than might be expected. 2011 may prove to be a challenging year for many, but 2010 is looking in reasonably good shape.

Property derivatives

- Derivatives. Hmm. There was a time when I was going to delete the month-on-month comparisons because so little changed it barely registered on the graph. Not so in recent months.

Derivatives pricing: implied total returns



Source: Morgan Stanley

- Those of you who weren't on holiday when last month's report came out may recall me discussing the implications of pricing in a return of 9.8% when the first half of the year had already produced 9.5%. Now we're another 1% better off, while derivatives pricing has dropped back to 9.0%. Hmm indeed. There's clearly some folk out there who are feeling very negative about what the next few months may bring.
- On the upside, though, there's been a bit of a boost in sentiment towards the medium-term. Not a vast improvement, as returns hovering around 6% are not going to enable us all to take early retirement.
- But medium-term pricing has been on a predominantly downward trend for some time, so a couple of percent swing in the other direction may in fact represent more optimism for the future than my little turquoise knoll can convey.

KNIGHT FRANK COMMENTS

I confess I'm in a minority, but I think we're going to find that 2010 will have been a pretty good year for property performance. Returns are already in double digits, with 5 months still to be calculated. A derailment is possible but, I don't believe, likely this year. Priced on average at 35% below peak, property still looks quite attractive both on its own merits and relative to other asset classes. Things may be slowing down, and there are plenty of downside risks to next year, but we should take care not to be too gloomy just yet.

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