RESEARCH

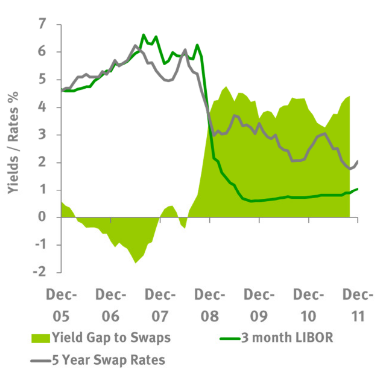
DECEMBER 2011
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators

Lending rates and property yield gap



Source: Knight Frank Research, FT, IPD

- Once again, the Bank of England left the base rate unchanged at 0.5%, although the ECB cut rates by a further 25 bps. They also announced measures to increase funding to banks, given the falling levels of liquidity.
- UK gilt yields have been hovering close to, and at times have matched, German bunds, underlining the depth of investor concern over the Euro area debt crisis, and worries about the economic outlook.
- Investors may also be pricing in further QE for the UK to follow when the release of the current tranche completes in February 2012.
- The FTSE 100 has been trading mostly between the 5,100 and 5,500 marks in the last month, with events in the Euro area dictating sentiment.

Economic outlook

- In the current environment economic predictions can quickly find themselves overtaken by events. This is demonstrated by the latest consensus of UK GDP forecasts (see table below).
- The consensus points to 1.0% growth this year and 1.1% in 2012, both of which are already looking on the high-side. The OECD is predicting the UK to move into technical recession in Q4 of this year and Q1 of 2012.
- That said, it is possible for the economy to contract in Q1 of 2012, and the full year growth figure exceeds that 1.1% consensus – it all depends on the strength of the post-recession rebound.
- The Q3 GDP figures for the UK were ahead of consensus, as were those for the US. This is a timely reminder that the actual figures can and do exceed analysts' expectations on a regular basis.

November consensus forecasts (%)

	2011	2012	2013	2014	2015
GDP	1.0	1.1	2.1	2.3	2.4
CPI	4.5	2.7	2.0	2.2	2.3
RPI	5.3	3.3	2.6	3.2	3.6
Base Rate	0.5	0.8	1.2	2.1	3.1

Source: HM Treasury Consensus, Nov 2011

Property performance

Key performance indicators

Borrowing yield gap*		442 bps ↑
Risk yield gap**		429 bps ↓
Investment purchases (2011)		£26.5 bn
All Property void rate		10.2% ↑
	Initial yield	20yr average
Retail	6.0%	6.3%
Office	6.1%	7.3%
Industrial	7.0%	7.9%

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 October 2011

- The IPD Capital Growth index achieved negligible growth in October. However, the chances of a double-dip for values have risen considerably.
- We believe a double-dip would be focussed on poor quality secondary, fringe locations and tertiary stock, as investors seek the steady income of prime and better quality secondary.
- That the capital growth index has made it this far into 2011 – despite the economic slowdown – without turning negative shows property has proved more resilient than many expected, possibly reflecting fewer tenant insolvencies comparative to previous recessions. However, we expect more retailers to go down the pre-pack route come January.

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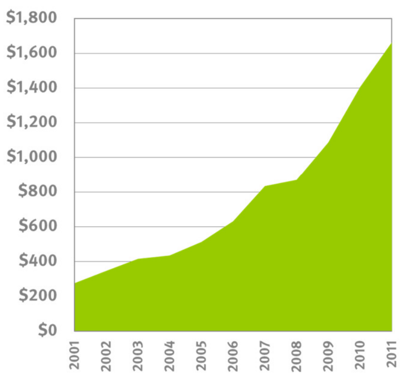
Obituary: The Safe haven

- Sovereign debt for Western economies was once viewed as being as safe as it gets in the investment world. Now the list of once proud nations who have lost their triple A status reads like a war memorial. Last week, Standard & Poor's warned that memorial may need a bigger plaque when it placed six triple A Euro area nations on credit watch.

One troy ounce of Gold bullion



Source: World Gold Council

- This leaves investors with a serious dilemma, as the array of supposed safe havens for them to flee to in times of uncertainty is narrowing fast. Weight of money has pushed the few better-regarded sovereigns – none of whom presently could be called 'safe' per se – down to sub-3% yields for 10 years income. Moreover, central banks are now lifting the draw bridge on investors via QE, or in Switzerland's case an exchange rate ceiling.

- Moreover, a recent *Financial Times* article described some countries like the UK which investors are decamping to, as winners of a 'least ugly contest'. If correct, this would make the current 2.1% yield on 10 year gilts (versus 4.8% inflation) a house of cards in the long-term, particularly once the economy moves into better times.

- Precious metals have ballooned in price in recent years, but that is a source of concern in itself. Gold, which offers no yield, has risen 80% in price since 2007. This also could be a case of weight of money in a 'least ugly contest'.

- That leaves the painful option of cash in the bank. Given that much of the UK looks dependent on printed money and ultra-low interest rates until the global economy moves into an upswing, cash is almost the Kamikaze option for investors.

- Investors must now re-assess concepts of risk and safety, and accept that safety barely exists in today's markets. There is only the choice between degrees of risks ranging from medium-risk upwards. More QE, possibly from February or March, will keep this the case.

- Commercial property has typically been thought of as being a recovery-play investment. However, in a world where parking money in government debt and reaping the coupon is dwindling as an option, property also deserves a re-assessment.

- A building let to a good covenant UK PLC, is probably a safer bet than much sovereign debt these days. We would argue that tenant covenant will be a major influence on how attractive investors will view a building on the market in 2012.

- Yes, there is further tenant distress to come – particularly in retail – but careful asset selection should protect the investor. The extent of the due diligence conducted will separate the winners from the losers among 2012 investors.

- Also, property offers the potential for further upside via asset management, and that is not something that should be dismissed lightly. The economic news is very dark at present, yet it was much darker in December 2008, and twelve months later yields were falling in central London. Anyone brave enough to have predicted that in December 2008 would certainly have been laughed at.

KNIGHT FRANK COMMENTS

Sovereign debt is not what it used to be, and there is a growing chance that the financial markets will lose patience with the Euro area governments and force a break-up. Investors need to put money somewhere, and gilts, treasuries, and bunds have sub-inflation yields. Inflation is edging down now and will do so for the next few months, but the Bank of England is printing money which bodes ill for the long-term outlook. Since 2007 forecasters have mostly underestimated the strength of inflation, and the flood of money into gilts is turning into a form of QE in itself.

The current period of uncertainty for sovereign debt looks set to continue, and we see 2012 as a year global investors will be looking around for alternative places to put money which deliver steady and relatively secure income. Commercial property let to blue-chip tenants is an option we expect to rise up the agenda, particularly those assets with distant rent reviews which will be best placed to achieve income uplift when the economic recovery takes hold.

Prime Yields vs Gilts

Source: Knight Frank/Financial Times