RESEARCH

UK MARKET OUTLOOK APRIL 2015

Knight Frank

WHEN WILL INTEREST RATES RISE?

With the inflation rate at zero the base rate is not expected to rise soon. However, we are forecasting an increase to come next year, probably in the summer. What will this mean for commercial property?

The market in a minute

All property capital growth index rose by 0.8 % in March m-on-m, which is double February's figure*.

Offices saw the highest capital growth (1.4%), and retail the lowest (0.2%)*.

12 month total return fell to 18.3%*.

Investment volume for Q1 2015 was £16.1 bn, up from £11.7 bn in Q1 2014**.

* Based on IPD figures
** Based on Property Data figures

At present the UK stands on the brink of deflation, although few expect this to last very long. The disappearance of inflation is mostly due to volatile commodity prices, such as oil which began falling last summer. A lot of the fuel we use is purchased on forward contracts so that suggests we may be looking at the autumn or even the winter before the oil price effect drops out of the inflation figures. Note in figure 1 that the sharpest fall in domestic fuel inflation has been in recent months.

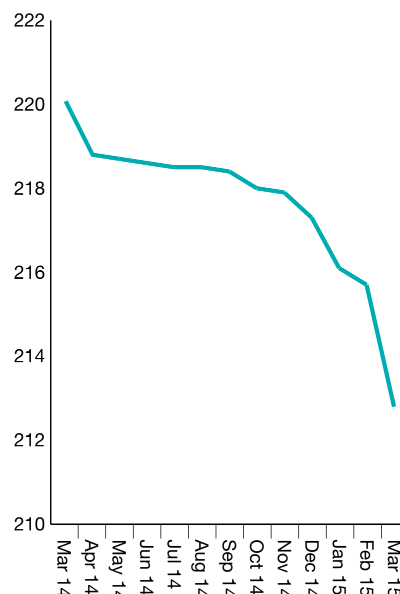
How quickly inflation picks up once the commodities effect subsides is inevitably a source of debate. Even excluding food, fuel, tobacco and alcohol, CPI inflation stands at 1.0% (and falling), which is well below the Bank of England's 2.0% target. On the other hand, services inflation stands at 2.4%, pointing to stronger inflationary forces in some parts of the economy.

Moreover, the Bank of England may want to see inflation exceed target before raising rates, as arguably there is no reason to act until it does. So if we assume the effect of commodity price falls do not drop out of the figures until towards the end of the year, then add on some time for inflation to get back to target, the day the base rate increases is probably well into next year.

Once we get into 2016, then another reason to delay a rate rise surfaces. As the Bank of England begins hinting that an increase is coming, the financial markets will then do the job for them and bond yields float upwards. Debt gets more expensive, and a strengthening currency becomes a threat to the outlook.

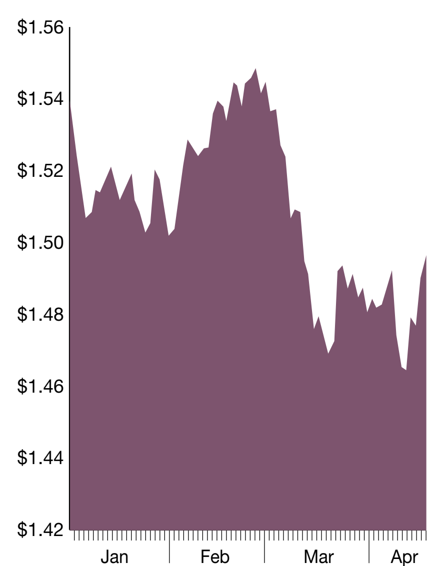
For these reasons we see the base rate rise timeline stretching well into next year.

FIGURE 1
Electricity, gas and other fuels inflation index



Source: ONS

FIGURE 2
US$:£ Sterling rate



Source: Bank of England

JAMES ROBERTS
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"The first interest rate rise will be less about addressing inflationary pressures, and more about symbolism"

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The first interest rate rise will be less about addressing inflationary pressures (unless commodities surprise and rebound), and more about symbolism. Ultra-low interest rates were meant to be an emergency measure, but they are now becoming the norm. This raises the question, if we are living permanently on emergency measures, what are our options if there is another emergency? Consequently, we see the gap between the first and second rate increase as being a wide one. Once the symbolic step of moving rates one step out of emergency territory has occurred, we are left with good reasons for not going further for some time after.

Two reasons for a return to inaction are compelling. Firstly, the speed of recovery is much slower for production industries than services, and until the Eurozone (our largest trading partner) is out of the woods the Bank needs to continue to support this weaker sector of the economy. Secondly, banks hold a lot of government bonds, and a sudden upwards movement in bond yields could reawaken the whole issue of debt availability.

So for commercial property we believe the impact of a base rate rise looks manageable as it is still some way off, and in our view is likely to be introduced gradually.

However, inevitably there will be an impact, as the wide spread for commercial property yields over Gilts in the long-term is going to narrow. The closing of the gap in our opinion will be partly property yields compressing, but mostly from bond yields rising. As a consequence some of the shine is going to come off of the case for UK prime property investment next year, creating more pressure on buyers to move up the risk curve in search of value.

Therefore, we see investors becoming more selective, and looking for angles to add value to an asset, such as leveraging upcoming infrastructure projects or moving an asset to mixed-use.

Also, as we have seen in the US, the prospect of an impending interest rate rise should push up the currency. On both sides of the Atlantic there is a growing expectation that US money is going to be targeting European real estate this year. Similarly, as the UK draws closer to its first rate rise, investor interest may begin to switch from the domestic property market to overseas opportunities.

All of the above comes with the caveat that two years ago most people were assuming interest rates would have risen by now.

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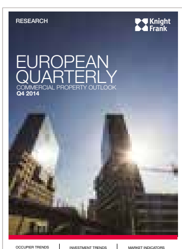

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