RESEARCH

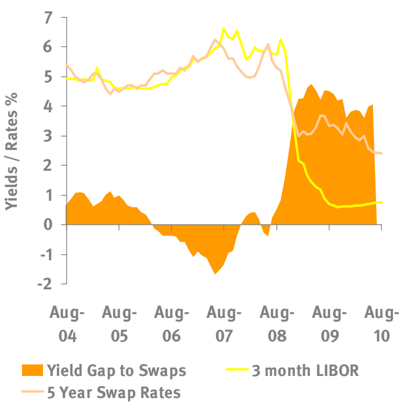
AUGUST 2010
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators

Lending rates and property yield gap



Source: Knight Frank Research, FT, IPD

- For the 18th consecutive month, the base rate will remain stuck at 0.5%. Surprisingly strong Q2 GDP growth of 1.1% and rising core inflation (see right) are still not enough to convince the MPC as a whole that an upward move is warranted.
- We'll have to wait for the minutes to see if anyone else has joined Andrew Sentance in his call to increase the base rate. But, with the dawning of the Government's new era of austerity, it's hard to be confident that strong growth can be maintained. With inflation not yet an overriding concern, a rate rise still looks too risky a manoeuvre.
- This view would seem to be supported by 5 year swap rates which, having risen to 3.0% just 4 months ago, were down to 2.4% by 5 Aug.

Economic overview

- CPI fell to 3.2% in June, while core inflation headed in the other direction, rising from 2.9% to 3.1%. The BoE has maintained its view that inflation is more likely to move down than up, but is now tempering this with statements that the inflationary outlook is "highly uncertain".
- Unemployment fell again in the 3 months to May. The private sector is rebounding - but will it be at a fast enough rate to cancel out the impending loss of public sector jobs?
- Sterling has seen a small improvement recently. This is perhaps more due to a weakening in other currencies than a comment on sterling itself, but it feels good to be back on the right side of the $1.50 threshold.
- The consumer measures of house prices and retail sales look less cheerful, however, and unfortunately this is likely to be a continuing theme.

Key economic indicators

	%	Trend
CPI *	3.2	↓
Retail sales (volumes) *	1.3	↓
Unemployment **	7.8	↓
Base Rate	0.5	→
£ : $	1.59	↑
£ : €	1.21	↑
House Prices: Halifax ^	4.9	↓
House Prices: Nationwide ^	6.6	↓

Source: NS, FT, BoE.
All figures as at 4 Aug, except ** end May, * end Jun, ^ end Jul.

Property performance

Key performance indicators

Borrowing yield gap*		407 bps ↑
Risk yield gap**		364 bps ↑
Investment purchases (2010)		£15.93bn
of which, from UK institutions		37% →
All Property void rate		10.1% ↓
	Initial yield	20yr average
Retail	6.2%	6.3%
Office	6.6%	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 June 2010

- Capital growth continues to creep up (emphasis on the word "creep"). June saw the lowest monthly change, at 0.47%, since the first increase last August.
- Nonetheless yields are still moving in and, with swaps and gilt yields trending downward, the borrowing and risk yield gaps have both widened. Albeit the former is somewhat theoretical these days.
- IPD's rental measure fell by a negligible amount in June (-0.05%), nudging ERV decline in the first 6 months to only -0.8%.
- The total return in H1 was 9.6%. This would be cause for optimism for substantial returns this year had the number of investment transactions not halved in July. It could merely be the traditional summer slump, but there is perhaps sufficient uncertainty in the wider economy to give us pause.

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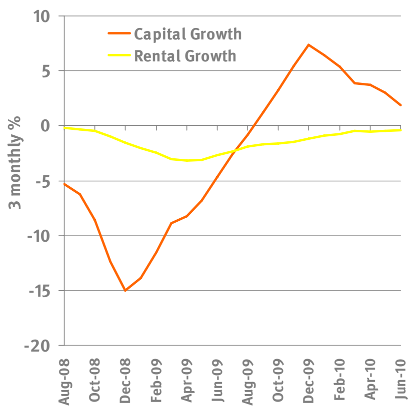
Why all the doom-mongering?

- Given that we've had nearly double-digit returns in H1 alone, it may seem odd that the prevailing sentiment is on the gloomy side.
- But actually price growth has been slowing steadily throughout 2010.

3 monthly trends in capital/rental growth

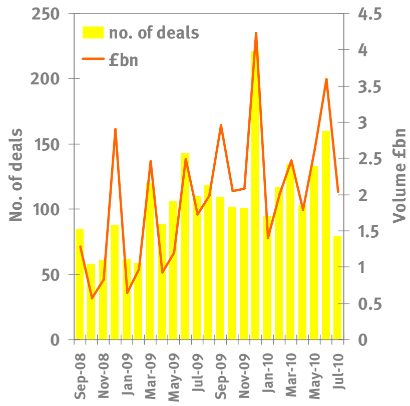


Source: IPD

- This chart uses 3 monthly figures, which strip out the volatility of single month results but still show more timely trends than annualised data.
- There are two quite clear turning points. Aug 09 was heralded as the first month to yield a positive capital growth figure since the downturn, but this had been on the cards since the start of that year. 12 months on, and the orange line switches direction again.
- Meanwhile, transaction levels have rebounded somewhat. (It's interesting to note the upswings in the final month of each quarter and particularly each December, with the push to use allocations.)
- However, the number of deals completed in July halved from the June level, and is back to late 2008 levels. We'll be kind and say the data for July may not yet be complete but, even if more data feeds through, it's clear volumes will still be well down.
- Interestingly, prices are now broadly on a par with where they were at the end of 2008.

Therefore the value of deals done in July is comparatively healthy – although still 45% below that of June.

Commercial property investment volumes



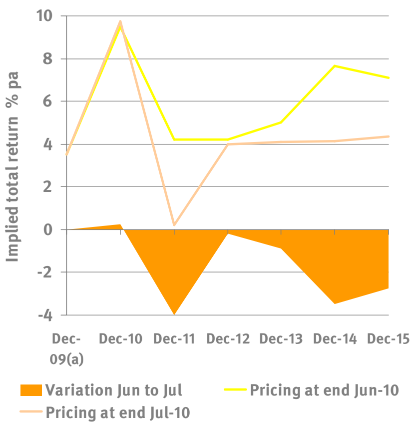
Source: Property Data

- It would be a gloomy (though not uncommon) projection indeed to suggest we won't hit double digits this year, but the evidence does suggest that H2 is going to be a lot quieter.

Property derivatives

- Derivatives pricing has taken a decided turn for the worse in recent weeks.
- While still reasonably upbeat for this year's outcome, an anticipated total return of 9.8% in 2010 is below that of many independent forecasts. (Not to mention that the total return in only the first 6 months of this year is already at 9.6%.)
- More significant is the distinct drop in pricing for 2011. A change in sentiment from June's suggested 4.2% to pricing of just 0.2% by the end of July represents the biggest monthly revision in a year.
- Last time, it was a 4% improvement in recognition of the rebounding investment market and that 2009 was likely to provide a better result than previously anticipated. Now, implied capital growth of -7.0% next year indicates that a reversal in fortune is expected.

Derivatives pricing: implied total returns



Source: Morgan Stanley

- Of equal concern is the decline in pricing for the latter part of the period. Currently, the derivatives market is suggesting an average annual return of just 4.4% for 2012 through to 2015. Property's long term average is 10.8%.

KNIGHT FRANK COMMENTS

Well, goodness, that all sounds very downbeat. Just as well most of you are on holiday and not reading this anyway.

The summer period always makes for a difficult time to call the market, and indeed the economy. The general absence of activity might simply be restored in September, but could it be the start of a trend?

Perhaps the point here is just to provide evidence to explain why sentiment is now veering to the negative. It's not only because we're British and we don't like to be happy for too long a period. Although, of course, that may still be a factor.