RESEARCH

UK MARKET OUTLOOK AUGUST 2015

STRONG ENOUGH FOR RATE RISES

A rise in UK interest rates is drawing closer, but few in the property industry appear greatly concerned. This probably reflects the fact that commercial property, like the UK economy, is strong enough take a base rate increase in its stride.

The market in a minute

All property capital growth index rose by 0.7% in July m-on-m, which is down on the 0.9% reported for June*

Industrial saw the highest capital growth (1.2%), and retail the lowest (0.2%)*

12 month total return fell again to 16.2%*

Investment volume from January to July was £38.4 bn, up from £30.1 bn for the same period of 2014**

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

Normally a rise in interest rates signals that the UK economy has moved into a period of excess, and the Bank of England has decided it is time to rein back inflationary pressures. So it is unusual to find widespread discussion on when interest rates will rise at a time when inflation is largely absent, and could stay that way for some time.

However, this rate increase is different. It is a sign the UK economy, like the US, is getting near to the day it can throw away the crutches of very low interest rates. Indeed, UK policymakers now want the safety net of higher rates. Should we hit another economic crisis, the Monetary Policy Committee (MPC) will thus have the option of cutting rates before resorting to printing money. Parts of Europe presently have negative interest rates, and were some fresh disaster to unfold, they would have little choice other than to plunge further into the minus figures, or print money. All this increases the UK's safe haven credentials.

This probably explains why at present the commercial property industry seems to be so little concerned about the approach of higher interest rates. When presenting to clients on the UK market one is more likely to be asked about the impact of the EU in/out referendum, or even the Chinese slowdown, than a rate rise. We live in a world of hedges and swaps which soften the impact of rate rises, and the Bank of England is giving lots of guidance to prevent firms and households from being wrong-footed. So while the cost of debt will rise, most borrowers will be ready for the change.

JAMES ROBERTS
Chief Economist

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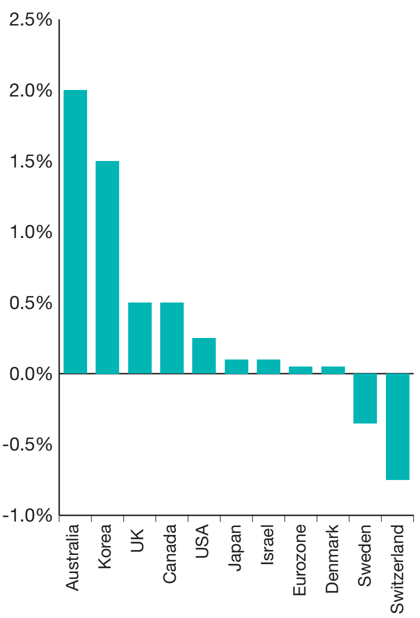
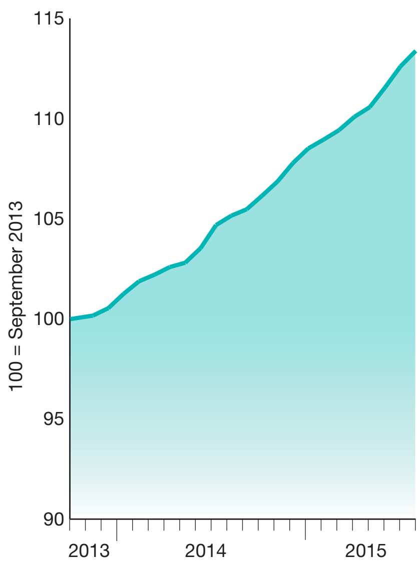
FIGURE 1
Various Central Bank Policy Rates



Source: Thomson Reuters

FIGURE 2
IPD All Office Rental Growth Index



Source: IPD

The Bank's guidance is that rates will rise gradually over a long period, and there are very good reasons for this gradual strategy. Financial institutions hold lots of Gilts, so big and sudden losses on bonds could reopen systemic uncertainties initially. Also, thinking back on those countries where rates are negative or nearly zero, if UK rates move too far ahead, then carry trade money will flood into British banks, with the risk of creating a future lending bubble.

Moreover, the MPC's view of the UK economy (that it will soon be robust enough to withstand higher rates) is probably true of commercial property. IPD's capital growth index has been rising month-on-month for 27 consecutive months now, and while that could be weight of money rather than a reflection of underlying health, other indicators support an upbeat view. For instance, IPD's rental growth index has risen for 24 months in a row, and not just thanks to central London offices. South East offices have recorded rental growth on the IPD measure for 27 months running now, and the pace appears to be accelerating.

Nevertheless, the impending rate rise will have some impact, particularly on those households who do not adequately prepare or are still financially stretched. Retail is still commercial property's lagging sector, and there probably will be some slowdown in consumer spending when rates rise. While industrial property is arguably more exposed to retail spending than ever before due to e-commerce, tighter purse strings may send more shoppers online in search of bargains, and thus offer logistics a degree of support through the rate rise.

As of the end of July, the IPD all retail rental index was up a tepid 0.6% on a year ago, while the office index had increased 7.8% over the same period. Unfortunately, a rise in interest rates will probably have the most impact in the property sector which has benefited least from the new market cycle. It is just as well the MPC are guiding that there will be a gradual rise in rates.

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