UK MARKET OUTLOOK FEBRUARY 2014

Emerging markets fallout – what it means for UK property

Lately we have seen a run of good news for the UK economy which has lasted long enough to underwrite a recovery for the commercial property market. However, a concern is the distant thunder of an economic storm overseas. The bad news for emerging markets keeps running, and given China's growing importance it is not encouraging to hear talk of yet another liquidity crunch.

The market in a minute

IPD capital growth index up 1.52% m-on-m in Dec 2013 – best since Mar 2010

Offices capital growth index up 2.47% in Dec m-on-m, vs 1.39% in Nov

Retail up 0.90% in Dec, vs 0.42% in Nov, but still slowest growing sector

Investment volume for January 2014 was £1.1 bn*

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** Based on Property Data figures*
*** Based on the IPD monthly capital growth index*

This beckons the question, has commercial property escaped from the Euro crisis frying pan, just to tumble into an emerging markets fire? After all, stock markets in the West have been falling in response to events in Asia and the Southern hemisphere in recent weeks, suggesting the fallout is now reaching us. Given this, it is worth examining how the UK commercial property market responded to the events of 1997-1998, the time of the Asian and Russian financial crises. An analysis of this period, with consideration of what has changed since then, suggests UK property is well positioned to continue recovering, and may even benefit.

The Asian Financial Crisis began in the Summer of 1997, yet the IPD capital growth index continued to rise throughout the second half of that year. Doubtless events closer to home appeared more important to property investors, and there was probably a time lag effect. In January 1998, when Indonesia and South Korea took IMF loans, the pace of growth for the IPD index slowed sharply, but it continued to rise.

The UK property sector needed proof the crisis was drawing closer to home before paying serious attention, and the IPD index increased through much of 1998. However, in August Russia moved into crisis, which in turn dragged under the hedge fund Long Term Capital Management (LTCM) in September; just as the panic spread to Latin America. November saw the IPD capital growth index finally turn negative for a single month. It grew again in December, then saw one more negative month in January 1999 (a decline so small it hardly shows up on a graph). The index then resumed growth.

Untangling how much impact the 1997-1998 emerging markets crisis had on UK property is difficult. However, it is noteworthy that

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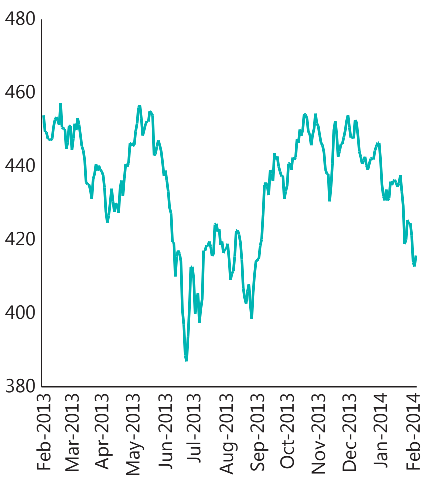
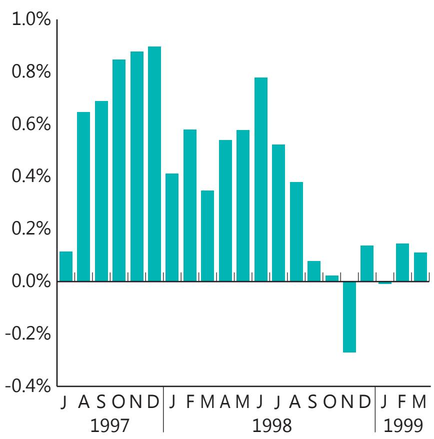
FIGURE 1
MSCI emerging Asia equities index



Source: Thomson One

FIGURE 2
IPD capital growth m-on-m during Asia / Russia crises



Source: IPD

the crisis had to draw much closer to home, and in particular enter the mainstream of the western financial system via LTCM's collapse, in order to solicit a relatively small fall in values. The emerging markets did not carry enough weight seventeen years ago to immediately impact the UK real estate market, and investors had to be concerned that the crisis was turning systemic and global in order to take money off the table, albeit only briefly.

This is perhaps the main source of concern about the current bout of emerging markets volatility – today they have more economic clout than in 1997-1998. Emerging markets investors own a string of trophy assets in London, although there would probably be a queue of buyers if they wanted to sell. Also, one could debate the nature of that increased influence. In leasing markets, firms from emerging markets are not generally big occupiers in the UK; even in London there are few who occupy more than 20,000 sq ft of office space. Investing in UK commercial property could be seen as a way to limit exposure to the emerging markets downturn, via purchasing rental income that is largely backed by western businesses.

Where emerging markets are exercising more influence in the global economy is through their purchasing of western government bonds. With QE in its final days in the US, and probably the UK, bond yields have softened in the last year, creating a dilemma for emerging markets investors on what to do with the capital released as their western bonds mature. Repatriating the money now does not look attractive, while UK commercial property is re-priced.

In their involvement in UK commercial property, emerging markets investors are looking more like long-term, strategic players. They are funding development, forming joint ventures with UK companies, and spreading into the regions. The UK economic upturn and problems at home are all the more reason to redeploy money from maturing bonds into commercial property here.

The lesson from 1997-1998 was that only evidence the crisis was starting to look systemic caused UK property values to wobble. Yet many commentators believe emerging markets are better positioned today than seventeen years ago, given more of their debt is denominated in local currencies. UK commercial property could well benefit from the volatility in emerging markets.

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