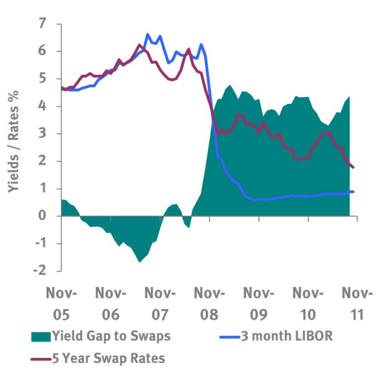
NOVEMBER 2011
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators

Lending rates and property yield gap



Source: Knight Frank Research, FT, IPD

- Given the heightened instability in the global financial markets, and potential threats to growth, the Bank of England unsurprisingly left the base rate at 0.5%.
- The ECB cut rates by 25 basis points, confirming that policy makers are now moving back towards supporting growth.
- UK gilt yields remain at historic (and sub-inflation) lows. In the global financial markets the UK is currently seen as a safe haven, reflecting the Bank of England's supportive policies and use of QE.
- Interestingly, in the last two weeks the FTSE 100 has been relatively stable, perhaps suggesting investors view the bad news as priced in now.

Economic outlook

- The first estimate of UK GDP was better than expected, at 0.5%. Encouragingly, it was driven by a strong performance from services – which is 75% of the economy.
- This concurs with US and Japanese Q3 GDP figures, which were also ahead of expectations.
- Nevertheless, recent survey evidence points to a cooling of the UK economy in October. This doubtless reflects sinking confidence given the flow of bad news from the Eurozone.
- Interestingly, Sterling has remained stable against major international currencies, despite the announcement of more QE, again reflecting a view abroad that the UK is a safe haven.

Key economic indicators

	% / Value	Change
CPI **	5.0	↓
Retail sales (volumes) **	0.6	↑
Unemployment *	8.1	↑
Base Rate	0.5	→
£ : $	1.61	↓
£ : €	1.17	↑
FTSE 100	5,545.4	↑

- Source: NS, FT, BoE.
- All figures as at 11 Nov, except * end August and ** September. Currencies are the spot rate. FTSE is index value.

Property performance

Key performance indicators

Borrowing yield gap*		434 bps ↑
Risk yield gap**		430 bps ↑
Investment purchases (2011)		£24.6 bn
All Property void rate		10.0% ↑
	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 September 2011

- The IPD Capital Growth index continued to grow in September on a month-on-month basis, by a tepid 0.08%, confirming that confidence remains low.
- As in previous months, offices were the main driver of growth, although the industrial index also turned positive.
- The Rental Growth index, however, hit zero. A further increase for offices was outweighed by further falls for the other two sectors.
- Offices being the main support for the IPD figures appears to be an established trend. This is consistent with earlier comments on the importance of the service sector to the economy at present.

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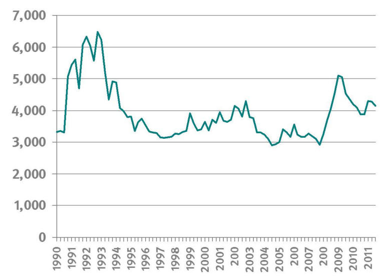
Remember the ERM crisis?

- "We have driven our economy into the sand; we approach 3 million unemployed; our businesses have gone under by the hearse-load; there is a horrendous worsening of living standards; we are losing world market share and continue to run a huge deficit". So thundered former-cabinet minister, Lord Ridley, in 1992, after Sterling left the Exchange Rate Mechanism.

Company Insolvencies in England & Wales



Source: The Insolvency Service

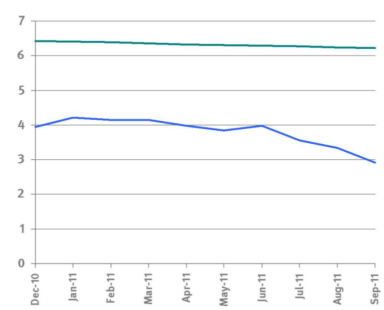
- It would be tempting to conclude we are in the same situation now. However, there are important differences, which have implications for property investors. This merits working through Lord Ridley's comments and benchmarking against today.
- "We have driven our economy into the sand". The Q3 2011 GDP first estimate was higher than expected at 0.5%; although Q4 is expected to see slower growth. However, in 1992 the UK was in the eye of the economic hurricane (as in 2008). Today the UK is on the periphery of the crisis.
- "We approach 3 million unemployed". At the time of writing unemployment stands at 2.6 million, although new figures this week are expected to show a further rise. However, the total workforce is bigger today – the rate of unemployment is 8.1% in 2011, compared to 10.1% in 1992.
- "Our businesses have gone under by the hearse-load". In 1992, 24,400 companies went into liquidation in England and Wales, compared to 16,600 in the twelve months to September 2011.
- "There is a horrendous worsening of living standards". Today we hear a lot about squeezed consumer incomes. Yet, in late 1992 CPI inflation was 2.6%, but the base rate was 6.9%, resulting in high real terms mortgage repayments. In 2011, we have the opposite – 5.0% inflation, and 0.5% base rate.
- "We are losing world market share and continue to run a huge deficit". In 1992 the balance of payments deficit was 2.1% of GDP, but the IMF is forecasting 2.7% for 2011. However, in 1992 the problem was getting worse – the deficit increased by 71% compared to 1991. This year the situation is improving – data for the year-to-date show a 29% fall
- While in numbers we have seen the worst recession and slowest recovery on record, QE has spared us the worst ravages. This has kept companies afloat, more people in work, and mortgage repayments low.
- The implications for property are that we have not seen demand tank the way it did in the early to mid-90s, thanks to more tenants remaining solvent. Occupier demand is down, but has not evaporated.
- Consequently, a QE protected economy has spared the occupier market from the extremes seen in the 1990s. At a time when property yields are high compared to cash and gilts, this could draw more interest towards commercial property.

KNIGHT FRANK COMMENTS

Another month passes without real progress on the Eurozone crisis. It is now only a matter of time before the financial markets lose patience with the politicians and impose their own solution, as in 1992. However, interestingly after it left the ERM, the UK never looked back – moving into a long period of sustained growth. For all the gloom-mongering on the effects of a Euro break-up, if effectively managed it could be the best solution, as it will end the uncertainty, which is the real threat to growth.

Property now lives in a twilight zone of uncertainty, although many of the fundamentals behind it appear sound. Demand is subdued, but has not evaporated, supply is manageable due to lack of development, tenant default rates have not spiralled as feared. It is amazing to think the UK is today regarded as a safe haven by bond and currency investors. With high yields and steady income streams, could property be next to gain safe haven status?

IPD Initial yields vs 15 yr Gilts



Source: IPD