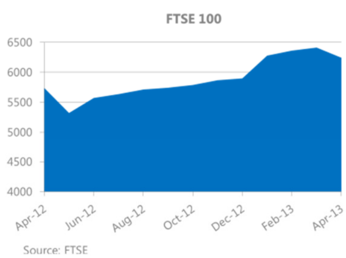
RESEARCH

APRIL 2013
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators



- The Bank of England left policy unchanged at its April meeting. Recent meeting minutes point to a split in the Monetary Policy Committee between a minority who favour more QE, and a majority preferring no chance.
- UK Gilt yields have edged downwards in recent weeks, possibly reflecting a view that more QE is inevitable. Although possibly in pushing yields lower the markets may ironically be persuading the MPC majority that Gilts are as low as they need to be.
- The FTSE 100 has mirrored other global stock markets by falling in April. However, the price of gold – which normally benefits during times of investor caution – has also fallen.

Economic outlook

- The third reading for Q4 UK GDP saw no change at minus 0.3%. Repair shutdowns in the North Sea impacted the figures in 2012. Signals on whether we shall see a negative Q1 output figure, creating a technical recession, are decidedly mixed.
- For instance, survey evidence suggests a continuing pattern for the UK of steady output from services firms, but weakness for industrial output. The PMI index for services pointed to growth in March, but was still negative for manufacturing.
- The government's austerity programme has suffered two major blows. Unemployment, one of the few indicators that has been improving lately, increased in February – edging upwards to 7.9%. Also, the IMF suggested that the UK should keep open the option of loosening fiscal policy in the future.

Key economic indicators

	% / Value	Change
CPI *	2.8	→
Retail sales (volumes) *	-0.5	↓
Unemployment **	7.9	↑
Base Rate	0.5	→
£ : $	1.52	↑
£ : €	1.17	↓
FTSE 100	6,243.7	↓

Source: NS, FT, BoE.
All figures as at 18th Apr, except * end Mar. ** end Feb. Currencies are the spot rate. FTSE is the index value.

Property performance

Key performance indicators

Borrowing yield gap*		526 bps ↑
Risk yield gap**		506 bps ↑
Investment purchases (2013)		£9.27 bn
All Property void rate		12.2% ↑
	Initial yield	**20yr average**
Retail	6.2%	6.2%
Office	5.9%	7.1%
Industrial	7.3%	7.8%

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 March 2013

- IPD 12 month total returns are starting to pick-up again. On the all property index they increased from 2.35% in January to 2.55% in March. The increase was thanks to improved income returns for retail and industrial.
- While capital values are still falling on the IPD measure, there is evidence of deceleration. The month-on-month decline averaged minus 0.20% in Q1 2013, versus minus 0.38% in Q4 2012 and minus 0.36% in Q3.
- Total investment in UK commercial property was £9.0 bn in Q1 2013, compared to £7.3 bn, for Q1 2012 according to Property Data. The figures benefited from strong increases in investment in shopping centres and leisure property.

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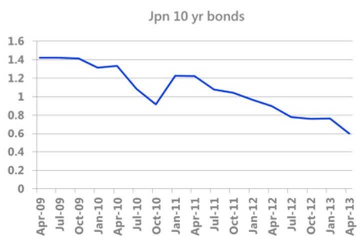
Japan’s QE and UK property

- Early April saw the Bank of Japan announce plans to double the country’s monetary base in order to hit a 2% inflation target. Good luck to them getting inflation to stop rising at 2%, but that is another debate.



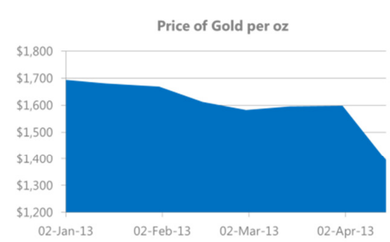
Source: Bloomberg

- In our globalised economy, this seemingly distant event merits examination regarding the prospects for UK property. After all, how many of us in early 2007 imagined the growing signs of distress in the US sub-prime residential mortgage market would lead to a huge slump in value for UK commercial property?
- A number of commentators are now predicting institutional money will soon be on the move out of Japan, in search of higher yields, with a range of different investments set to benefit. If true, this could provide an energy shot for the global economy.
- A word of caution is necessary. The Japanese economy has failed to respond to QE before, though what is being proposed is much bigger than previous attempts.
- Also, there is a difference between asking “will this kick-start the Japanese economy?” and “will this prompt money to move overseas?” The latter is arguably easier to achieve, particularly if Japanese investors doubt the likelihood of a domestic economic revival.
- So what does this mean for UK property? There probably will be a small amount of resulting direct investment from Japan, but with more coming indirect via funds.
- However, where we believe the effect of Japanese QE may be greater could be availability of finance; possibly through an improvement in debt availability via the carry trade.
- This would build on the tentative signs we are seeing of a revival in the property debt market. US banks have been showing interest in restarting CMBS issuance in Europe. The markets we would expect them to show the most interest in are Germany, the Nordics, and the UK.
- Consequently, by year end we could be looking at more carry trade finance, the early stages of a CMBS revival, plus banks being slightly closer to working down past excesses and more Basel compliant. The debt market could feel a more normalised place, which for secondary property in particular, could make a significant difference.
- Lately, we have seen some encouraging signs of investors looking at the better end of secondary. Indeed, the latest Knight Frank secondary yield guide even reported selected incidences of yields hardening – usually for ‘good’ secondary.
- Nevertheless, there is still much that could potentially derail the recovery. As a bad news story, the Euro crisis refuses to die; and the UK economy continues to struggle to achieve more than pockets of growth.
- However, the recent tumble for the price of gold suggests that investors are sceptical on the outlook for safe havens, who have enjoyed years of rising prices.
- Whether the Bank of Japan will rescue the Japanese economy is another matter. Yet, they may have taken an important step in reviving the availability of investment finance in the global economy, which UK property could benefit from. For the global crisis, the long dark night began with the US housing market; the sunrise of recovery could be starting in the East.

Knight Frank Comments

Since the last Market Outlook there has been no shortage of bad news, with Cyprus bringing the Euro crisis back to life, and UK unemployment – one of the few economic indicators that had been going right for George Osborne – starting to rise again. However, to this backdrop of fresh gloom, the price of gold – the uber safe haven – has sunk. Investors are looking at the global economy and asking, is this the last burst of bad news before we enter the next cycle?

Is this suspicion of the gloom, and raised expectations on the outlook, justified? After all, we have had so many false dawns in recent years. A lot of stimulus has now been injected into the global economy, such as the $85 bn of QE the Federal Reserve is pumping into the US; which is to be joined by more stimulus from the Bank of Japan. This comes at a time when corporate cash balances are bloated, and savers are punished for holding money in the bank. We see gold’s new pain as a sign money is on the move, and expect property to gain.



Source: World Source Council