



AUGUST 2011

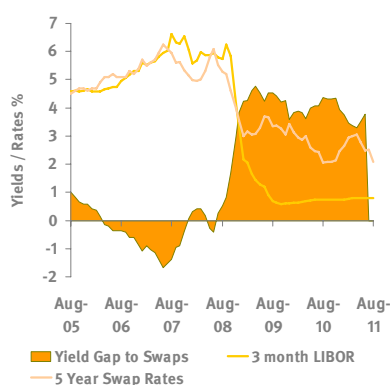
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators

Lending rates and property yield gap



Source: Knight Frank Research, FT, IPD

- The UK base rate remained unchanged in August, which was generally expected. The Swiss and Japanese central banks have intervened to halt the appreciation of the Franc and the Yen.
- There is now widespread discussion on whether we may now see more QE in the UK, which has been publicly called for by the Business Secretary. However, similar QE speculation this time last year came to nothing.
- The Sovereign debt crises have resulted in a small rise in the Pound against the Euro and the greenback. Sterling is trading at €1.15, compared to €1.11 a month ago, and \$1.64, up from \$1.59.

Economic overview

- The first estimate of Q2 GDP growth was 0.2%. Many analysts had cut their forecasts both for the quarter and the full year ahead of the figures.
- Debate continues on whether the government should consider a 'plan b' on fiscal retrenchment. Appearing to waver on public spending cuts might prompt short sellers to target Sterling.
- On a more positive note, inflation declined in June to 4.2%, down from 4.5%. There was also a small increase in average pay levels.
- The rate of unemployment in the three months to May was 7.7%, although this is a time lagged indicator, which will probably rise again in the near-term.

Key economic indicators

	% / Value	Change
CPI **	4.2	↓
Retail sales (volumes) **	0.4	↓
Unemployment *	7.7	→
Base Rate	0.5	→
£ : \$	1.64	↑
£ : €	1.15	↑
FTSE 100	5,584.5	↓

Source: NS, FT, BoE.

All figures as at 3 Aug, except * end May and ** June. Currencies are the spot rate. FTSE is index value.

Property performance

Borrowing yield gap*	377 bps	↑
Risk yield gap**	327 bps	↓
Investment purchases (2011)	£18.18 bn	
of which, from UK institutions	27.9%	
All Property void rate	9.7%	↓
	Initial yield	20yr average
Retail	6.0%	6.3%
Office	6.2%	7.3%
Industrial	7.0%	8.0%

Key performance indicators

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 2011

- As has been the case for some time now, the IPD capital growth figures remain just about in positive territory; largely thanks to the Offices sector.
- Both Retail and Industrial recorded further month-on-month declines in rental values.
- Central London property appears to be gaining from the uncertainty in the global economy, with overseas investors regarding it as a 'safe haven'.
- Transaction volumes for January to June totalled £16.3 bn, compared to £15.0 bn for the equivalent period in 2010.

Commercial Research

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Summertime Blues

- Eurozone crisis, US debt ceiling, bank redundancies, and weak manufacturing figures. The flow of bad news has been relentless.

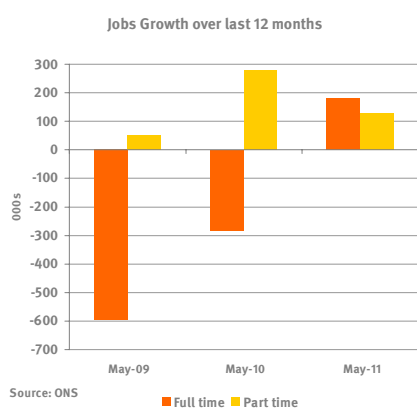


- It is tempting to note it is August – silly season. The US debt ceiling controversy was mostly reported as though a default was imminent, right up to the inevitable compromise. While in the UK the PMI / Markit Services index rose in August, defying the gloomy sentiment.

- Nevertheless, we can not blame it all on sensationalism. Equity markets overlooked Washington's debt compromise and plummeted in response to poor manufacturing data that was released on the same day. Ten year Gilt yields are 2.75%, suggesting investors have their riot shields up.
- What does this mean for commercial property? On the face of it one would expect a re-enforcement of the existing biases within the market – target prime, Central London, and parts of South East with a good track record.
- After all, if investors are getting more risk averse it is difficult to see anyone other than the brave venturing into the murkier parts of the secondary and tertiary markets.
- For instance, the market for retail property in secondary locations needs root-and-branch reform; including a large amount of stock switching to other uses. One would need a very compelling reason and long-term horizons, to enter such a market.

- Nevertheless, there is the danger of all secondary commercial property being tarred with the same brush. After all, the term secondary covers a vast array of property, some of which in a rising market often gets passed off successfully as being prime.
- Such 'only-just-secondary' assets acquired during the periodic bursts of pessimism can appear canny purchases six months later. Sentiment changes rapidly, which creates opportunities.
- However, this pre-supposes the volatile financial markets are just a case of the Summertime blues. Property has ongoing debt problems to work out, and a chilly economy would discourage investors from being adventurous. Safer to wait and see if the financial markets bounce in September (as they have done so often before) before making any big decisions.

Employment



- The number of people in employment in the UK has been gradually rising since early 2010, however this has been driven mainly by part-time and temporary jobs. In difficult times companies seek flexibility, and the unemployed have to make do.

- This is something of a mixed blessing. It is better people are earning than jobless, but full time jobs are more likely to generate stronger economic growth.
- Therefore it is encouraging that the latest Labour Force Survey shows that in the twelve months to May the economy created 180,000 full time jobs compared to 129,000 part time. Let us hope this continues.

KNIGHT FRANK COMMENTS

The flow of bad news has been daunting this Summer. Even if there is a positive outcome to a problem – the raising of the US debt ceiling, for instance – the financial markets appear to overlook it and find something else to worry about.

In the Spring, we were hopeful that the recovery occurring in the London property market was spreading, but the on-going sovereign debt crisis is hitting sentiment. August is a month when the news tends to be gloomy. September will be a better time to take stock of the situation.