

EPMR

Economic & Property Market Review

UK

Q3 2010



GVA Grimley



In this issue

- Recently published economic data has been very positive, but further improvement is unlikely in the short term due to the severity of planned spending cuts. Occupier demand will improve slowly, with positive rental growth returning in most sectors/locations by 2012.
- As the recent downward yield movement comes to a halt and rental growth remains subdued, we expect All Property total returns this year of 13%, reducing to 7-8% pa in 2011 and 2012.

Economic trends

Economic growth rebounded in Q2 spectacularly (see first chart), no doubt reflecting the previous government's fiscal stimulus and weak Q1 figures. Provisional official figures show growth in Q2 was 1.1%, nearly double the quarterly trend rate of growth (0.6%). This contrasts with well below trend growth of 0.3% in Q1, no doubt adversely affected by extreme weather conditions and VAT increasing back to 17.5%.

Sector growth was well balanced with manufacturing output increasing by 1.6%, business services and finance by 1.3%, Government and other services by 0.9% and the service sector as a whole (76% of the economy) also increasing by 0.9%. Retail sales volumes were also up by a similar amount in Q2 (1.3%). Perhaps the most surprising statistic of all was construction output, where growth was a barely believable 6.6% compared with -1.6% in the previous quarter!

Further good news came with the latest **employment statistics**. Employment increased by 160,000 in the three months to May, as the second chart shows, and unemployment fell on both the International Labour Organisation basis and the Claimant Count basis. However, the rise in employment was driven by a rise in part time workers more than offsetting a fall in full-time workers. Similarly, the fall in claimant count unemployment was partly offset by an increase in people claiming other benefits, and the increase in people recorded as 'long term sick' was more than double the fall in Claimant Count unemployment.

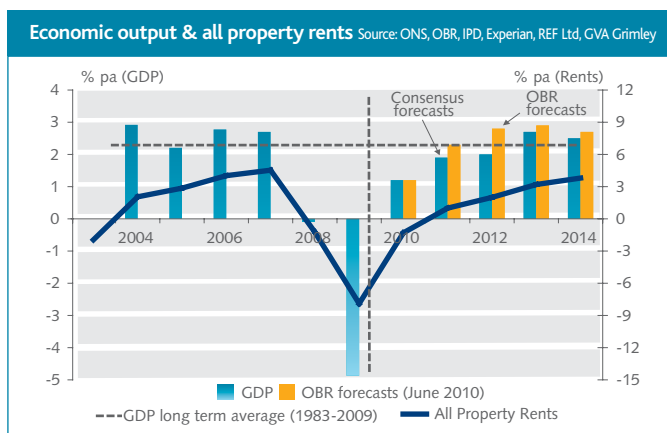
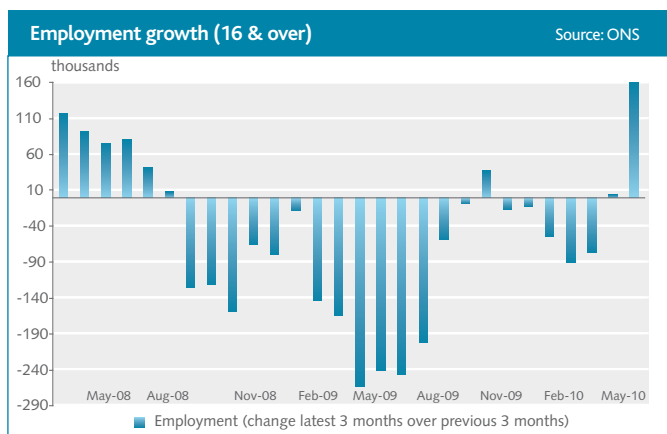
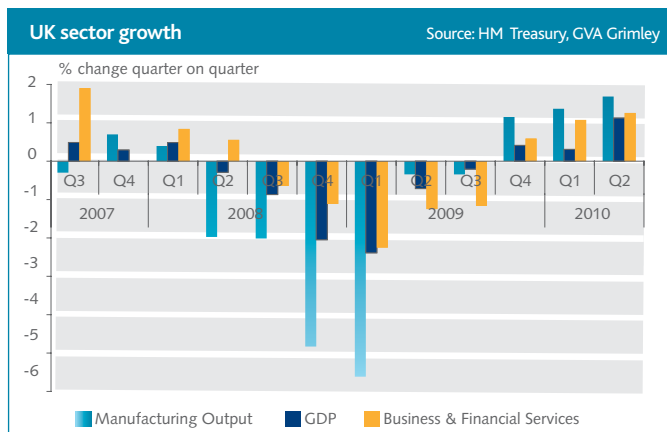
To what extent will the stronger economic upturn in Q2 be affected by the June **Emergency budget**? The government has opted for very large spending cuts and to have them sooner rather than later. In addition there are significant tax increases. This is planned to reduce the budget deficit to just 1.1% of GDP by the end of this parliament.

The magnitude of the **spending cuts and tax increases** should please the markets and prevent a run on the pound and a rise in gilt yields. It should also keep interest rates lower for longer. However, there is a substantial risk that the fragile economic recovery will be threatened in the short term (2011 particularly), especially with cut-backs planned in many Eurozone countries, our main export market.

Economic growth will decelerate in the second half of this year and remain weak in 2011. This will have knock-on consequences for occupier demand and rental growth. Particularly threatened will be the north, Wales and Scotland, where public sector cuts will hit hardest as public sector employment is greater – in some local authorities well over 50% of total employment.

The large increase in VAT, in addition to employment cuts in the public sector, must affect **retail spending and the retail property sector**. It will also affect lower income groups most. So secondary shopping/town centres in the north, Scotland and Wales are likely to be the worst affected. However, until the VAT increase is introduced in January 2011, retail spending is likely to be boosted.

The short term outlook is worrying, but in the longer term (the latter part of this parliament) the benefits of a lower budget deficit should become apparent with stronger economic growth (see third chart). The economy should then be in a better position to face future challenges such as the rising costs of an ageing population and the next economic downturn/recession.



Latest consensus forecasts, July 2010 Source: HM Treasury Experian, GVA Grimley

	2009	2010	2011	Long-term average
Economic growth (GDP)	-4.9%	1.2%	1.9%	2.4% pa (1983-2009)
Private Consumption	-3.2%	0.5%	1.4%	
Employment growth	-1.8%	-0.6%	0%	0.4 - 0.6% pa
Bank base rate (Q4)	0.5%	0.6%	1.6%	
CPI – Inflation (Q4)	2.1%	2.7%	2.4%	
RPI – Inflation (Q4)	0.6%	3.1%	3.5%	
House Price Inflation (Q4)	3.4%	3%	2.9%	

Commercial property market

Recent occupier market trends

Occupier demand fell in Q2, according to the latest RICS Commercial Market Survey, with a balance of -10% of respondents reporting a fall in sales and letting activity over the quarter (see first chart). This reverses the modest rises reported over the previous three quarters and shows that demand remains fragile, with uncertainty resulting from the Budget highlighted as a key factor. In the office sector, our monitoring of key UK markets reflects this, with a sharp drop in take-up in Q2 reversing the rises seen over the previous three quarters (see second chart).

The RICS survey also points to a continued increase in available space in Q2, with a balance of +19% of respondents reporting a rise (see first chart). This is broadly the same rate as in the previous two quarters, but is a much slower rate of increase than was being reported in late 2008 and early 2009. Central London offices have been bucking the national trend. Our monitoring of the central London office market shows that the vacancy rate fell from a peak of 9% of stock in Q2 2009 to 8.4% in Q1, although remaining at this rate in Q2.

Average central London office rents rose for the second consecutive quarter in Q2, by 1.4% (calculated from IPD Monthly Index), a significant turnaround from the low point of -10.1% in Q1 2009. In contrast, rental values continue to see modest falls across most of the rest of the market, as the third chart shows. This rental cycle is certainly very flat given the severity of the economic recession. A relatively constrained level of speculative development and subdued rental growth during the previous upturn, a more resilient labour market, and the support provided to the banking sector have all doubtless contributed to this trend.

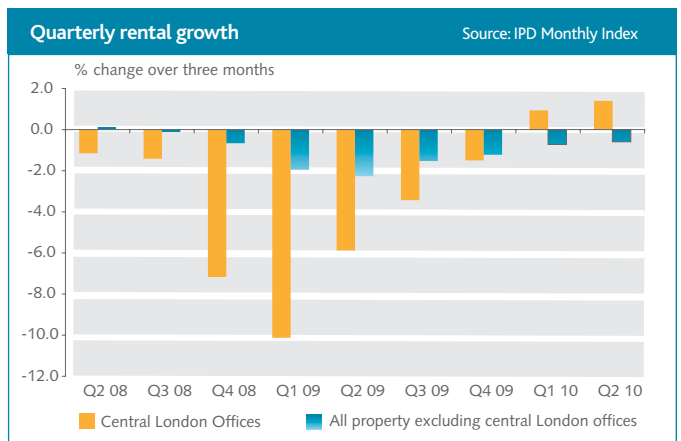
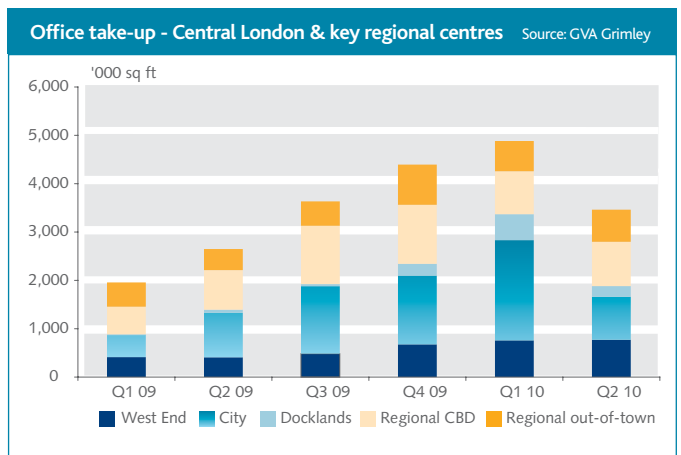
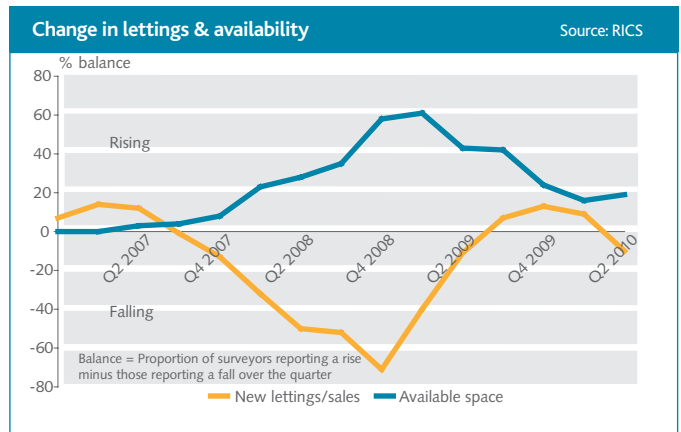
Outlook for occupier market performance

We expect recovery in the commercial property occupier markets outside central London offices to be a gradual one. Below-trend economic growth, a sluggish pick-up in private sector employment and major public sector job losses will mean a subdued outlook for occupier demand over the next few years.

We forecast that All Property rental values will see a total decrease of -1.3% during 2010. However, more than half of this should already have occurred, with the IPD Monthly Index showing a fall of -0.8% during the first six months of the year. Average central London office rents should continue to rise, and are forecast to finish the year more than 3% higher than at the start, with prime rents seeing a higher increase. In contrast, the rest of the commercial property market is likely to experience further modest falls.

Next year, we expect All Property average rental growth of 1% but there is again likely to be a significant variation. Central London offices are forecast at 5%, with regional offices at 1-2%, while in the retail and industrial markets a further modest fall is likely.

Beyond 2011, rental growth should begin to accelerate as the unprecedented fall in development activity feeds through to supply shortages and occupier demand starts to recover with economic growth rising back towards trend.



All property rental value growth forecasts

	2010	2011	2012	2013	2014
Consensus (May)					
Maximum	0.8%	-4.4%	5.1%	-	-
Minimum	-6.9%	-1.3%	1.1%	-	-
Average	-1.6%	-1.4%	2.9%	-	-
GVA Grimley	-1.3%	1.0%	2.0%	3.2%	3.8%

Recent investment performance

The downward yield movement that has driven the strong performance of prime and good quality secondary property over the last year appears to be coming to a halt. The All Property equivalent yield fell very marginally from 7.57% in May to 7.53% in June (IPD Monthly Index). This was the smallest move since August 2009, and underlines our view that the market is now levelling off.

As yields have begun to level off, so capital value growth has slowed noticeably. The IPD Monthly Index reports that capital values increased by 1.9% in the three months to June, compared with 3.9% in the three months to March and 7.4% in the three months to December 2009. Falling rental values detracted just -0.4% from capital value growth in the three months to June compared with -2.7% a year ago.

Although capital growth is now slowing (as the three-month figures show) the year-on-year figure has continued to rise sharply, reaching 15% pa in June compared with 7.6% pa in March. This largely reflects the sharp increases in values seen in mid-2009, and the year-on-year figure will almost certainly peak over the next month or two, after which we expect it to drop rapidly back to single figures.

£8 billion of commercial property was transacted in the three months to June, according to Property Data, compared with £5.9 billion in the three months to March and the highest figure since October-December 2009 (see first chart). However, the level of transactions is now reducing, largely in response to a significant reduction in available stock, although a cooling in investor demand has also had an effect. As a result, we expect a lower level of transactions to be reported in Q3.

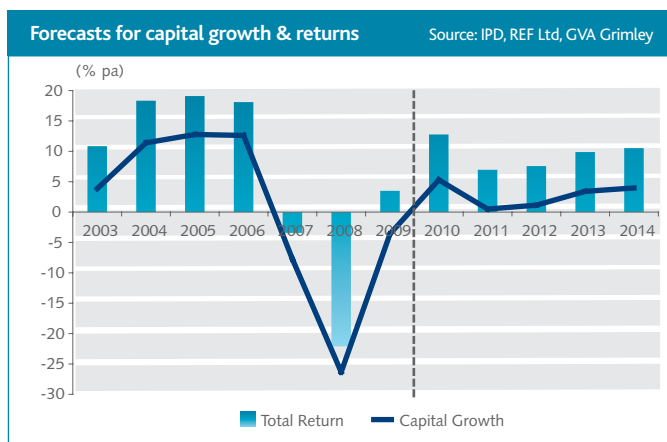
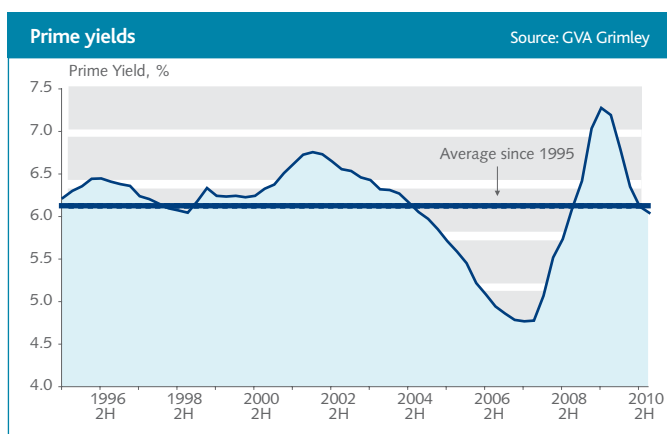
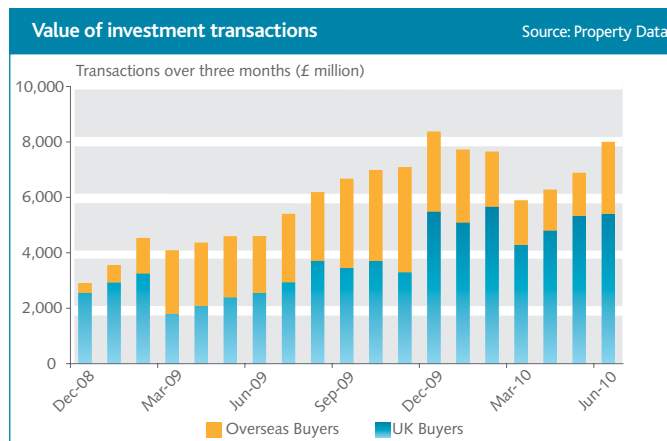
Investment market outlook

With the downward movement that has occurred over the last year, property yields have moved back to a level broadly in line with the average over the last 15 years (see second chart). Taking into account the subdued outlook for rental growth across most of the market, a further significant downward movement in property yields looks hard to justify. However, there does remain a substantial gap between property yields and gilt yields and borrowing costs, which continues to create opportunities for investors focussing on income rather than capital growth.

With the subdued outlook for the economy and rental growth, yields for good quality secondary property could well come under increased pressure to move upwards. At the same time, there could also be some further selective downward move in prime yields. As a result, we are likely to see a widening gap between prime and good quality secondary property yields, although the extent and timing is hard to predict.

We have moderated our forecasts for All Property returns this year to just under 13%, considerably below the current year-on-year figure of 23.9%, and the risk to this outlook is now to the downside. Property derivatives are certainly suggesting a lower outcome this year, of below 10%.

2011 and 2012 are likely to see All Property returns of around 7-8% pa. Subdued rental growth and a relatively flat yield profile will limit capital growth until higher rental growth begins to feed through toward the end of our forecast period. Our five-year forecasts for capital growth and returns are shown in the third chart.



All property total returns forecasts

	2010	2011	2012	2013	2014
Consensus (May)					
Maximum	19.5%	11.4%	15.3%	-	-
Minimum	10.7%	-3.5%	4.7%	-	-
Average	15.3%	6.0%	9.5%	-	-
GVA Grimley	12.8%	7.0%	7.6%	9.9%	10.5%