Research report

EPMR

Economic & Property Market Review

Q2 2012

Economic trends

Economic output shrank 0.2% in Q1 following a 0.3% fall in Q4 2011 – a technical recession, but very different in scale from the start of the 2008 recession when output shrank by 3.2% over the first two quarters. The fall in output in Q1 was a surprise as it was contrary to recent survey evidence which has been positive. The big surprise was the **3% decline in construction output**, (subsequently revised down to a 4.8% decline) which is notoriously volatile according to official figures, and prone to frequent, often large, revisions.

Even if GDP figures are revised up, more in line with recent survey evidence, they are still likely to show a very weak performance over the last 18 months as chart 1 shows. Current figures show zero overall growth. Particularly worrying is the **decline in Business services and finance** (29% of total economic output) over the last six months, as this sector is usually the main driving force of an economic upturn. The only main sector to show consistent growth in every quarter over the last 12 months has been **Government and other services,** where output increased by 0.2% in Q1!

The economic upturn, since the last recession ended in mid 2009, has been exceptionally weak, despite an encouraging start in late 2009 and early 2010. As a result the last recession and its aftermath have been worse even than the great depression of the early 1930s, as the second chart shows. A return to peak output levels recorded in Q1 2008 is not now likely until mid 2014, nearly seven years later.

The main explanation for the exceptionally weak upturn over the last 18 months must be the severity of the government's austerity programme, introduced to overcome the ballooning budget deficit. The eurozone crisis is also often blamed, but this seems hard to square with a 12% rise in UK exports to the eurozone in 2011.

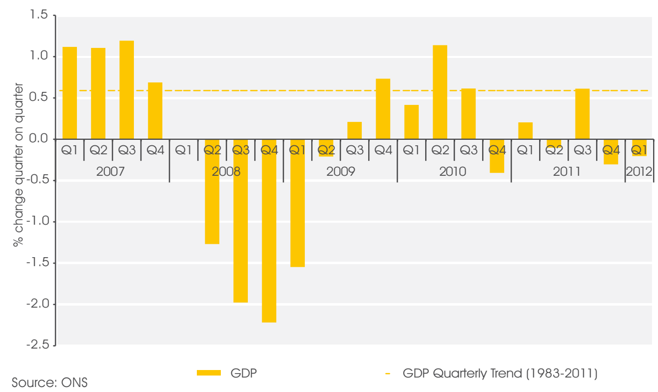
Persistently high overall inflation is also a factor as it is currently much higher than wage inflation, meaning **a steep fall in incomes in real terms**, which not surprisingly adversely affects consumer spending. CPI inflation in March was 3.5% and RPI inflation was 3.6% (down from 5.2% and 5.6% respectively six months ago), whereas annual wage inflation in March was just 0.1%. Even if general inflation reduces further, as the Bank of England expects, it will be some time before income growth becomes positive in real terms.

Employment growth, of major importance to property occupier demand, has been mildly encouraging over the last six months, as employment increased by 120,000, after falling by 105,000 over the previous six months. However, the details are more worrying as recent growth was entirely driven by an increase in employees working part time, many of whom couldn't find a full time job. Full time employment actually decreased.

The economic outlook will inevitably be weak in the short term, as the third chart shows, although an improvement is expected in the latter part of 2012, with a further improvement thereafter. But with 90% of the government's spending cuts still to come (according to RBS), with the eurozone crisis still a long way from being solved, and the eurozone economy stagnated, the UK upturn will continue to be weak and drawn out. This will affect the outlook for occupier demand and rental value growth.

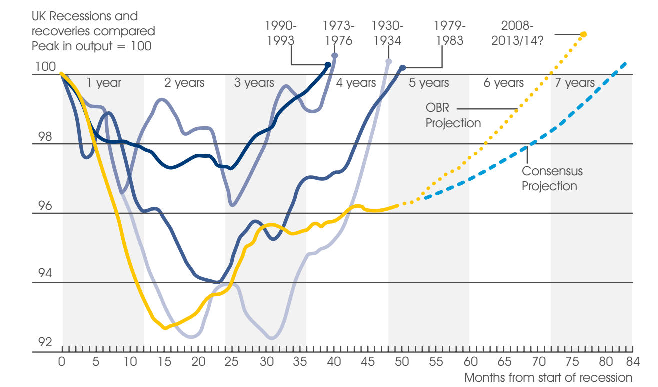
With Greece in a state of political paralysis and increasingly likely to exit the euro, and with growing public anger in the eurozone over austerity policies, the outlook is very uncertain. The main encouraging sign is the strengthening US economy which is now growing at an annual rate of over 2%.

UK GDP growth



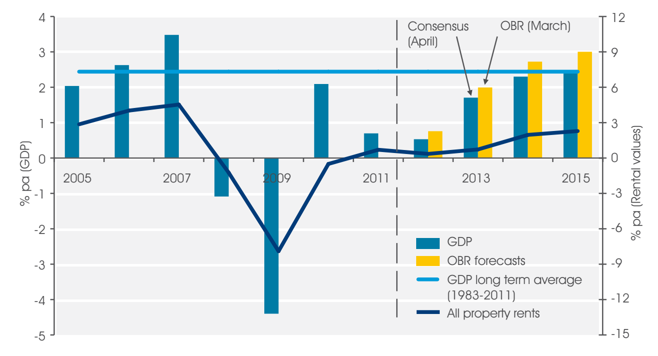
Source: ONS

The profile of recession and recovery



Source: NIESR, OBR, HM Treasury

Economic output and all property rents



Source: ONS, Treasury, OBR, IPD, REFL Ltd, GVA

Latest Consensus Forecasts, April 2012

	2011	2012	2013	Long-term average
Economic growth (GDP)	0.7%	0.6%	1.7%	2.4% pa (1983-2010)
Private Consumption	-0.7%	0.5%	1.4%	
Employment growth	0.2%	-0.2%	0.2%	0.4 - 0.6% pa
Bank base rate (Q4)	0.5%	0.5%	0.75%	
CPI – Inflation (Q4)	4.6%	2.3%	2%	
RPI – Inflation (Q4)	5.1%	2.6%	2.7%	
House Price Inflation (Q4)	-0.6%	-1.1%	1.2%	

Source: HM Treasury (compilation of forecasts), GVA

Commercial property market

Recent occupier market trends

Occupier demand remains subdued across most of the commercial property market although the latest RICS UK Commercial Market Survey suggests that demand has stabilised (a balance of +3 in Q1 2012 compared to -11 in Q4 2011). The survey suggests that demand for space fell in retail, remained stable for office space and increased for industrial space.

Construction activity remains low and new orders during Q4 2011 fell 2.5% from the previous quarter, and 14.1% for the year. The value of new construction orders in real terms for retail, office and industrial property fell 15.7% during Q4 2011.

Although new construction activity is low across the UK as a whole, the last quarter saw 15 schemes start on site in central London, meaning there is now 9.6 million sq ft under way. 2.6 million sq ft of speculative development is due to complete across central London during 2012.

1.7 million sq ft was let during Q1 2012 in central London, 26% down on the five year quarterly average. Once again, the TMT subsector drove demand, accounting for 25% of take up during the quarter, with F&BS accounting for just under 10%. The GVA prime rent index recorded an increase in central London rents of 2.7% during Q1.

Take up across the UK's nine largest regional office markets during Q1 totalled 1.6 million sq ft, in line with average. However, an increased level of occupier requirements means we expect higher take-up over the coming quarters. Prime headline regional office rents were broadly stable in Q1, but average rents continued to fall, although they appear to be levelling off. Average retail and industrial rental values saw a decrease of -0.2% and -0.3% respectively in Q1 (IPD Monthly Index).

Outlook for occupier market performance

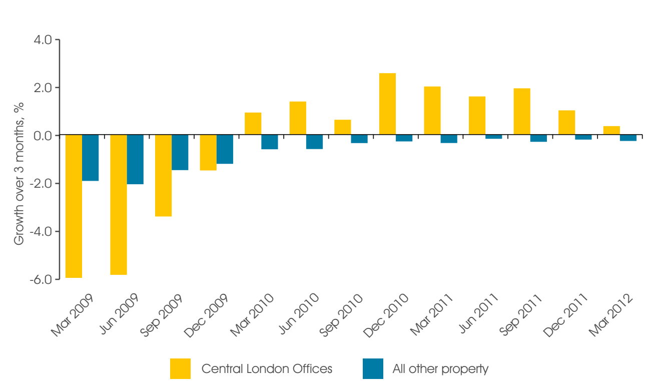
The April Markit/CIPS survey of Purchasing Managers in the construction sector produced a reading of 55.8, ahead of the 50.0 which indicates that activity is flat (although down on the 21 month high of 56.7 recorded in March). The survey suggests a continued recovery in construction activity, which will be a welcome boost after the ONS reported that construction output contracted by 4.8% during the first quarter of the year.

There is increasing bad news for the high street. Retail sales at stores open at least 12 months fell 3.3% in April, according to the British Retail Council, the biggest monthly drop since March 2011, with retailers blaming the bad weather. Clinton Cards, the UK's largest card retailer with over 750 stores, has gone into administration. However, according to Retail Economics, retail spending is forecast to increase by 1% due to the Olympics.

Internet retailers are expected to increase their share of the UK retail market from 11% with the sector likely to grow faster than the rest of the retail market over the coming year. It is therefore probable that internet retailers will once again make up a large bulk of take up in the distribution market.

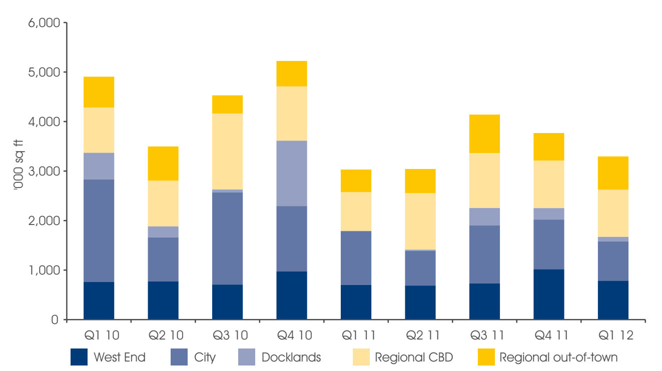
At the all property level, we have downgraded our forecasts for rental value growth in 2012 and 2013, to 0.3% and 0.6% respectively. Growth is likely to stay well below 3% pa throughout our five-year forecast period, as the table shows, with falls in real terms. As the bottom chart illustrates, there should be a rebalancing of rental performance, as the relatively strong rate of rental growth in central London starts to slow and the regional markets begin to see a small rise in rental values (in nominal terms at least).

Average rental value growth over three months



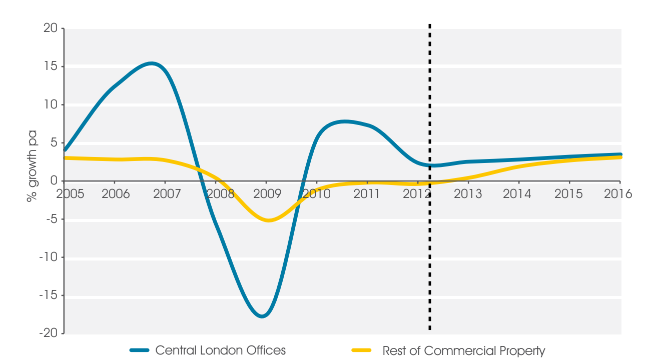
Source: IPD, GVA

Office take-up – central London and key regional centres



Source: GVA

Average rental value growth forecasts



Source: IPD, REFL, GVA

All property rental value growth forecasts

	2012	2013	2014	2015	2016
Consensus (February)					
Maximum	1.2%	2.4%	3.1%	-	-
Minimum	-2.7%	-1.6%	-1.5%	-	-
Average	-0.8%	0.6%	1.5%	-	-
GVA (April)	**0.3%**	**0.6%**	**1.7%**	**2.4%**	**2.7%**

Investment market commentary

Recent investment performance

The level of commercial property transactions has averaged £7.6 billion per quarter over the last year, according to figures from Property Data. £7.3 billion was transacted in Q1, down slightly from £8.6 billion recorded in Q4 2011 (see first chart). Transaction levels are being boosted by an increasing number of loan sales.

The polarisation between prime and secondary property continues. Demand for prime remains very strong, although transactions are now taking a little longer to complete. Continued robust demand and a shortage of supply mean that prime yields have held broadly steady during the first four months of 2012, and we have seen some downward movement in selected markets.

However, in the secondary market investor demand remains weak. We would highlight concerns over the occupational market, especially the difficulties in agreeing lease renewals and reletting vacant property, plus falling headline rents. Indeed, some secondary buildings are now regarded by investors as almost unlettable. As a result, the trend in secondary yields is upwards, and this is reflected in the IPD results for Q1 2012, which show a continued widening in the prime versus secondary yield gap.

A combination of rising yields and falling rental values means that all property capital values have fallen over the last six months, by 1.1% between October 2011 and April 2012 (IPD Monthly Index). Year-on-year capital growth has turned negative, at -0.6% in April.

A positive message is that commercial property is providing healthy income returns of 6% per annum, so properties with secure income streams remain desirable investment opportunities. There also remains a significant positive gap between property yields and gilt yields, as the second chart shows.

Investment market outlook

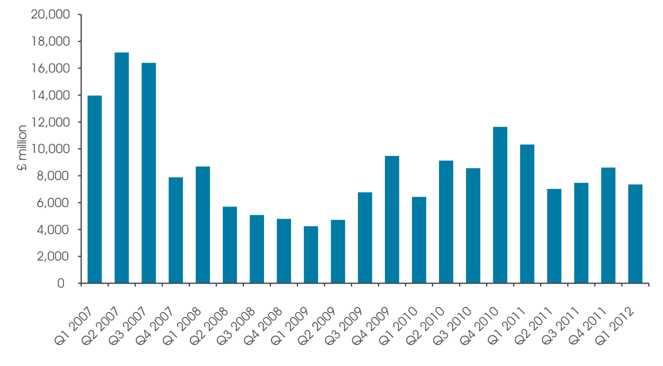
Prime supply will remain restricted, although there is uncertainty over the speed at which distressed secondary assets will be brought to the market. The banks continue to hold large quantities of distressed assets, but they are at very different stages of working through them. We think that a steady flow of properties will continue to come to the market.

The last three months have seen a weakening of the outlook for economic growth and hence occupier demand. In view of the direct impact of this on rental growth, plus the indirect effect on investor confidence, we have revised downwards our view of the likely total return for 2012.

We think that a combination of broadly flat rental values and an upward movement in yields will mean a fall in all property capital values of around 4% for 2012 as a whole. However, an income return of 6% should mean a positive total return, which we forecast at 2.4%. However, performance will be stronger in the London markets this year. We forecast an all property return of more than 6% for next year, although this is almost entirely from income, with capital values expected to be broadly flat.

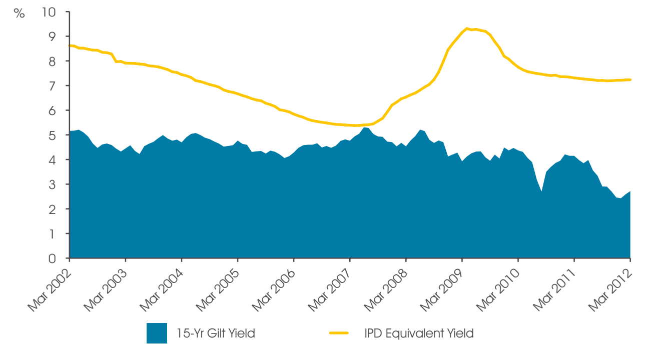
The gap between prime and secondary yields is likely to widen further, with prime yields holding broadly stable, but secondary continuing to move out.

Value of property transactions



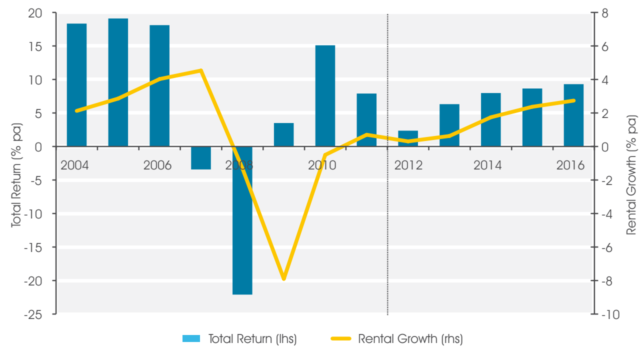
Source: Property Data, GVA

Property and gilt yields



Source: IPD, FT, GVA

Forecasts for rents and returns



Source: IPD, REFL, GVA

All property total returns forecasts

	2012	2013	2014	2015	2016
Consensus (February)					
Maximum	6.0%	13.5%	12.1%	-	-
Minimum	-3.9%	1.5%	4.9%	-	-
Average	1.6%	6.4%	7.8%	-	-
GVA (April)	**2.4%**	**6.3%**	**8.0%**	**8.7%**	**9.3%**

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