Research report

EPMR

Economic & Property Market Review

Q3 2012

Economic trends

Declining economic output for the third consecutive quarter was not unexpected but the magnitude of the decline at -0.7% in Q2 was a shock. The extra bank holiday and bad weather no doubt caused much of the decline, but even allowing for this the GDP figure was very weak.

As the first chart shows, the weakest sectors in Q2 were **Construction** (-5.2%) and **Production** (-1.3%). The only positive sectors were **Government and other services** (+0.3%), consistently the strongest sector over the last 12 months, and **Business Services and Finance** (+0.1%) which moved into positive territory (just) after two quarters of decline.

Economic output is now slightly weaker than it was two years ago when the present government came to power, whereas over the previous year output increased by 2.1%, as the economy recovered from the recession. **Public sector net borrowing** over the first quarter of this financial year is actually running at a higher underlying level than it was a year ago, because receipts are growing at a slower rate than the Office for Budget Responsibility (OBR) expected in the March budget, as a result of the recession.

Employment growth, in marked contrast to GDP growth, has surged in recent months, which should be good news for the property market. This increase is difficult to reconcile with an economic recession and suggests that either this is due to special factors such as the Olympics or that GDP data, which is provisional, may be revised up in subsequent months. Unlike the situation a few months ago most of the increase of 182,000 over the latest three month period comprised full time workers (+133,000) rather than part time workers (+48,000).

There was also good news on **unemployment**, with total unemployment falling by 65,000. This brings the rate down to 8.1%, although claimant count unemployment in June actually increased by 6,100, a similar increase to that occurring in May.

Inflation has also provided some good news with further large falls in CPI and RPI inflation (see second chart). CPI inflation has fallen to 2.4% pa in June from 3.5% pa three months ago and a peak of 5.2% pa nine months ago. Similarly RPI inflation has fallen to 2.8% pa from 5.6% pa nine months ago.

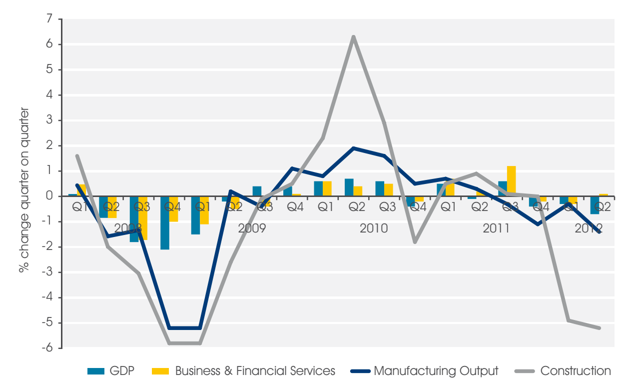
Average earnings growth (excluding bonuses) in May remained weak at 1.8% pa. With inflation at 2.4% pa, earnings growth in real terms remains negative, although much less negative than it has been over the last 12 months (see second chart). Further falls in the inflation rate are likely, and so positive real income growth looks probable in the latter half of 2012. This is good news for the retail sector in particular.

The UK economic outlook, according to the latest consensus view of economists and also the IMF, is noticeably weaker over the short term than it was a few months ago, despite the positive news about employment growth and inflation. Three months ago economic growth was forecast to be 0.6% in 2012 and 1.7% in 2013. The latest figures are 0.1% and 1.4% (see third chart).

The reasons are many: the scale of spending cuts and tax increases at home and throughout much of Europe, plus the lack of decisive positive action required by Eurozone governments to sort out the Eurozone crisis, are the main ones. But also worrying is the economic slowdown in China and in the US.

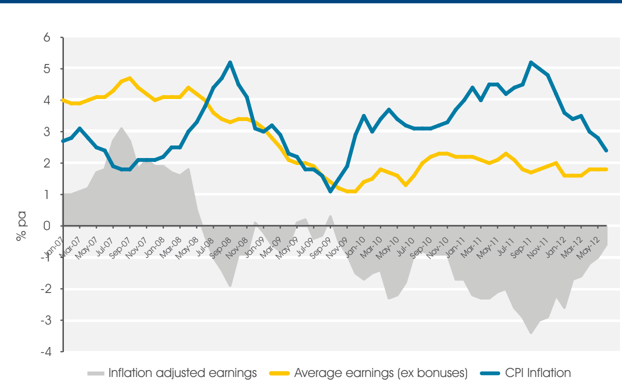
There is also a growing concern over the looming "financial cliff" in the US at the end of the year. Automatic spending cuts and tax increases will occur unless there is political agreement to the contrary. This seems unlikely in a presidential election year with such major differences between Democrats and Republicans.

UK sector growth



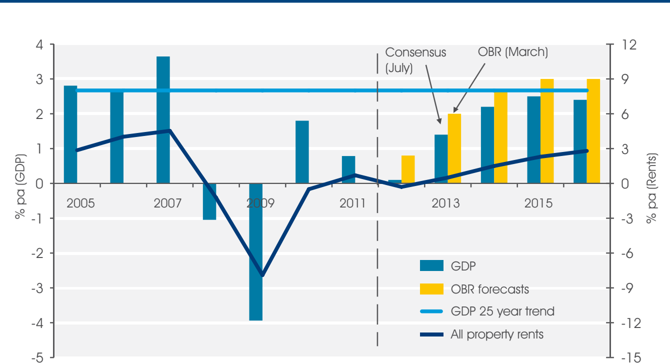
Source: ONS

Earnings & Inflation



Source: ONS

Economic output and all property rents



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

Latest Consensus Forecasts, July 2012

	2011	2012	2013	25 year trend
Economic growth (GDP)	0.7%	0.1%	1.4%	2.7% pa
Private Consumption	-0.7%	0.2%	1.2%	
Employment growth	0.2%	0.7%	0.3%	0.7% pa
Bank base rate (Q4)	0.5%	0.5%	0.7%	
CPI – Inflation (Q4)	4.6%	2.0%	2.0%	
RPI – Inflation (Q4)	5.1%	2.3%	2.6%	
House Price Inflation (Q4)	-0.6%	-1.4%	0.8%	

Source: HM Treasury (compilation of forecasts), GVA

Commercial property market

Recent occupier market trends

The economic backdrop remains challenging for occupiers, but there are some positive trends for occupational demand. The recent robust numbers for employment growth and some mildly encouraging retail sales figures are good examples.

Retail sales volumes were up 1.4% over the three months to June compared with the same three months of 2011. But non-store sales grew by a much stronger 11.8%, highlighting the challenge store-based retailers face to retain market share.

The sharp fall in overall UK construction activity in Q2 highlights the weakness of the development sector, and the level of new construction orders for commercial property remains historically low. Although very little development is coming on stream outside of central London, subdued occupier demand means that vacancy rates are still rising across many UK markets.

In terms of institutionally-held stock, the IPD database shows the office market outside London and the South East as having the highest void rates. This contrasts with central London, where our data shows that the overall office vacancy rate has held steady at around 6% for the last year, well below previous peaks of 9% in 2009 and nearly 14% in 2003.

Overall office take-up has held steady during Q1 and Q2 this year. This can be seen in the first chart, which shows quarterly office take-up in central London and across our 'Big Nine' regional office centres.

The second chart shows short-term rental performance based on the IPD Monthly Index, and illustrates the contrast between the central London (office and retail) market, and the rest of the UK. In central London, growth has remained firmly in positive territory throughout the last two years and has actually accelerated a little in recent months. However across the rest of the UK rental values continue to fall, although at a modest pace.

Outlook for occupier market performance

As the short-term outlook for the UK economy has deteriorated over the last three months, so we have marked down our view on likely rental growth. We expect almost no change to all property average rental values for the rest of this year and in 2013 (see table).

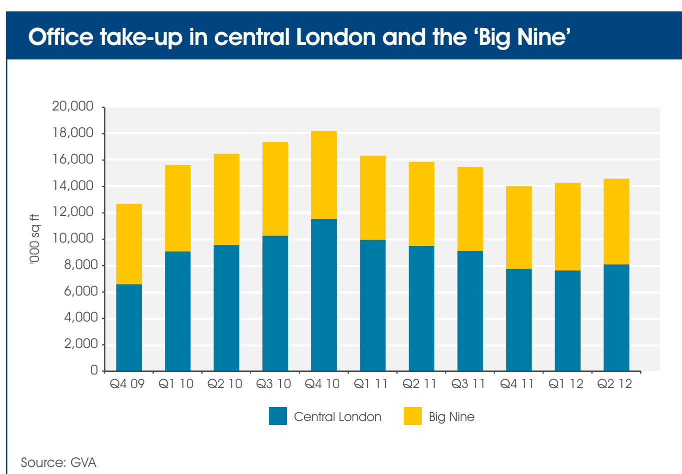
Central London will continue to see more upward pressure on rental values than the rest of the UK, as the third chart illustrates, and rental values should be almost 15% higher than today by the end of 2016. Away from central London, our forecasts suggest that rental values will still be below their 2008 peak at the end of 2016, and only around 6% higher than current levels.

The low level of development activity means that the supply of high quality space is already diminishing. As economic recovery gets a firmer footing in the second half of our five-year forecast period, the demand for quality space will increase.

Other factors will add to supply pressures and are storing up a future market imbalance. The high number of lease expiries, the looming April 2018 deadline after which it will probably not be possible to lease a building with an EPC rating below 'E', and the need for retailers to adapt their offer in a world increasingly influenced by internet sales are just three reasons why we think demand for prime space will rise significantly as we emerge from recession.

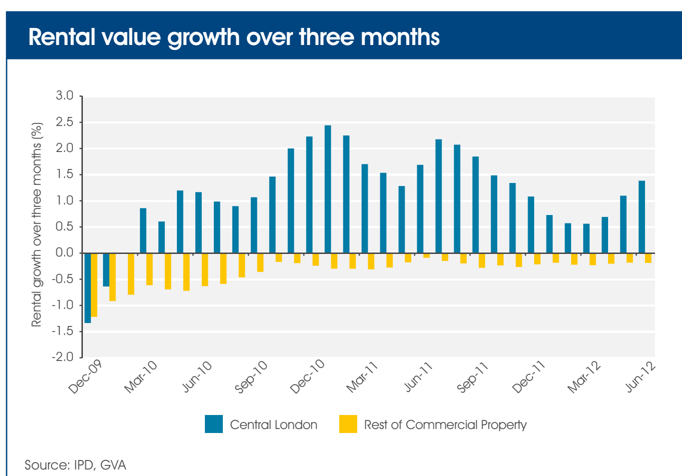
As the gap between London, the South East, and the rest of the UK continues to widen, the market will become increasingly segmented, both by location and asset quality.

Office take-up in central London and the 'Big Nine'



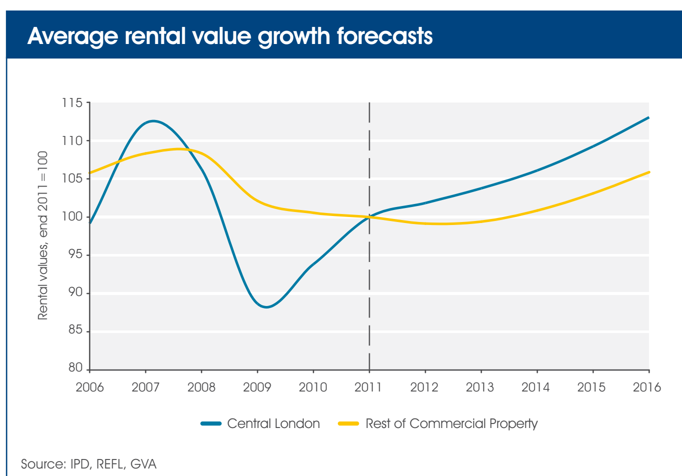
Source: GVA

Rental value growth over three months



Source: IPD, GVA

Average rental value growth forecasts



Source: IPD, REFL, GVA

All property rental growth forecasts

	2012	2013	2014	2015	2016
Consensus					
Maximum	0.3%	2.3%	2.5%	-	-
Minimum	-3.0%	-1.3%	-1.5%	-	-
Average	-0.9%	0.4%	1.3%	-	-
GVA (July)	**-0.3%**	**0.5%**	**1.5%**	**2.3%**	**2.8%**

Investment market commentary

Recent investment performance

The level of commercial property transactions has stabilised at around £7.5 billion per quarter, as the first chart illustrates. Overseas investors have remained highly active in the UK market. Q2 saw more than £4.5 billion purchased by overseas investors. This accounted for more than 60% of total market activity.

Taking properties sold into account, the net increase in overseas holdings during Q2 was more than £2.5 billion, the highest quarterly increase since 2009. Over the 12 months to June 2012, overseas investors have increased their exposure to UK commercial property by an impressive £7 billion (source: Property Data).

Strong overseas interest in the London market is buoying overall demand. In general, transaction levels are being held back by the scarcity of debt finance, the lack of quality product and by high levels of investor uncertainty.

Average all property yields as monitored by the IPD Monthly Index shifted upwards in June for the eighth consecutive month. This has driven a modest fall in capital values of -2.1% between October 2011 and June 2012, reversing the trend seen throughout most of 2010 and 2011. The change in the level of all property capital values over the last decade is illustrated in the second chart.

Yields at the very prime end of the market held broadly steady during Q2, but elsewhere they continued to soften, and so the gap between prime and secondary property widened further. However, yields are difficult to quantify in some markets due to low transaction volumes. The total all property return for the first six months of 2012 was 1.2% (IPD Monthly Index), well below the year-on-year figure for June of 4.8%.

Investment market outlook

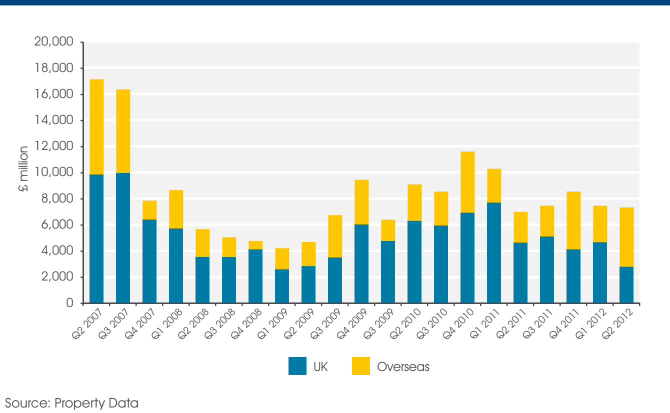
In the central London market, rental growth will continue to have a positive impact on performance over the next two years. But the relatively strong growth rates seen last year are unlikely to be repeated in the short term. Away from central London and parts of the South East, rental growth is likely to remain elusive in most markets. However, we expect the rate of inflation to continue slowing and this will help performance when viewed in real terms.

We expect average capital values to fall in the second half of this year, by a similar amount to the first six months, taking the figure for 2012 to around -4%. The income side is producing a healthy return of almost +6% pa, and so we expect total returns of nearly +2% for the whole of 2012.

Our central view is for little change to either rental or capital values next year, with a total return of +5.6% forecast. But we are clearly in very uncertain times and the IPF consensus forecasts reflect this, with views ranging from +4.4% to -2.0% for this year and a range nearly as wide for next year (as the table shows).

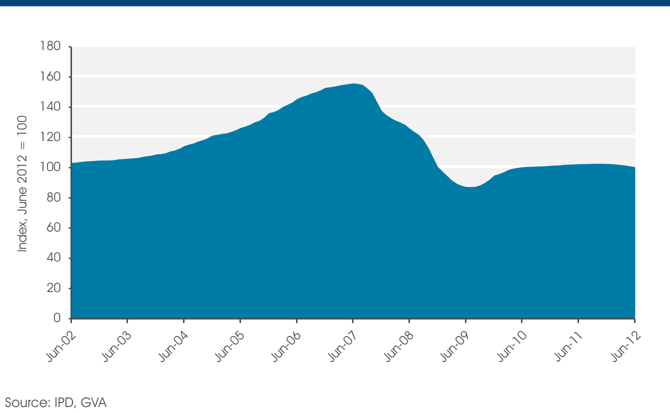
The market will continue to be polarised. Prime assets, particularly those with long leases and strong covenants, as well as quality assets in central London, will continue to attract strong investor demand but supply will be limited. At the secondary / tertiary end of the market, supply will be steadily fed to the market as banks work their way through their distressed asset portfolios and pricing will need to be realistic to attract buyers.

Value of investment transactions



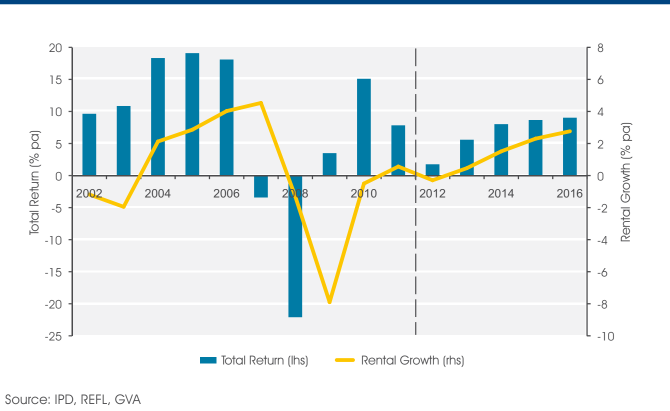
Source: Property Data

All property capital values



Source: IPD, GVA

Forecasts for rents and returns



Source: IPD, REFL, GVA

All property total returns forecasts

	2012	2013	2014	2015	2016
Consensus (May)					
Maximum	4.4%	8.5%	10.3%	-	-
Minimum	-2.0%	3.3%	5.8%	-	-
Average	1.4%	6.0%	7.8%	-	-
GVA (July)	**1.8%**	**5.6%**	**8.0%**	**8.7%**	**9.0%**

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