Research report

EPMR

Economic & Property Market Review

Expo edition 2012

GVA

Economic trends

Recent Chartered Institute of Purchasing and Supply survey data suggests that **economic growth** was weak in Q2 but that, contrary to ONS figures, output did not contract (see first chart). The survey also shows a marked improvement in August following a poor July. This suggests that ONS data will show positive output growth in Q3, helped by Olympic visitor event payments which are counted by ONS as all occuring in Q3.

Employment data shows an accelerating surge in growth in 2012 (as the second chart shows) which is very hard to reconcile with an official recession in output terms! In fact, over the latest three month period (May – July) employment increased by 236,000. This is the second strongest three month growth in the last 20 years, which is astonishing and good news for the property sector. However, only 43% of this growth was in full time jobs, 57% was in part-time jobs and 22% of total growth was self-employment.

The downside to strong employment growth when output growth is weak is that **productivity** falls, which is bad news for international competitiveness. Recent data shows that in 2011, on an output per worker basis, UK productivity was 20 percentage points lower than the other G7 nations. Since 2007, the last year before the recession started, growth of UK output per hour and per worker has been much weaker than in the US, Japan and Canada, but broadly similar to other major European economies. In the first half of 2012 UK productivity appears to have weakened further.

Inflation continues to edge downwards (CPI inflation was 2.5% pa in August and RPI inflation was 2.9% pa), but is still higher than income growth, although the gap has narrowed dramatically over the last 12 months. Earnings growth excluding bonuses was 2% pa in July, much the same growth rate as it has been for the last 18 months.

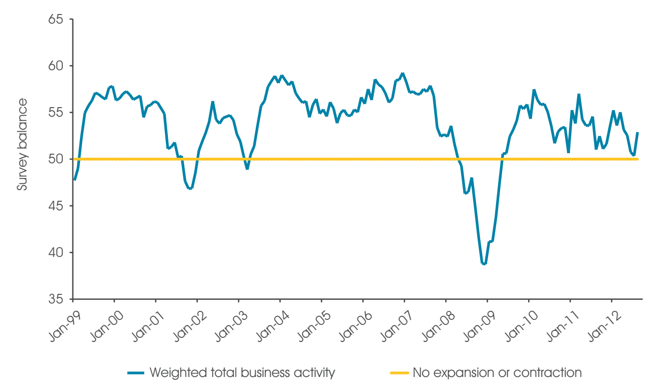
Although this means that **income growth** is still just negative in real terms, it could move into positive territory over the next few months if current trends continue, which would be good news for the retail sector. However the rise in food prices, due to the drought in the US and rising worldwide energy prices, may push inflation higher and delay the move back to positive real income growth, last experienced over four years ago.

The **UK economic outlook** remains weak in the short term (see third chart and the table below). This is due to numerous factors – negative real income growth, severe austerity policies in the UK and throughout Europe (which this financial year are contributing to an increase in the UK budget deficit and government borrowing), a weakening world economy and fears about the looming 'fiscal cliff' in the US which could cause a US recession in 2013.

Although the **Eurozone** crisis is far from being resolved, the recent positive action by the European Central Bank to buy, without limit, government bonds of at-risk countries in the Eurozone is a major step in the right direction and exceeded market expectations. This is arguably the first step towards doing whatever is necessary to support the euro, which will inevitably mean not just monetary union but fiscal and eventually some form of political union, although this will take years to achieve.

However like all good news in the Eurozone there is a sting in the tail of the ECB's new policy. First, countries must request help which is tantamount to admitting failure and second, strict austerity policies will be imposed which could weaken economic growth further in countries such as Spain and Italy and hence in the Eurozone as a whole. This would adversely affect UK exports and UK economic growth.

Purchasing managers' survey

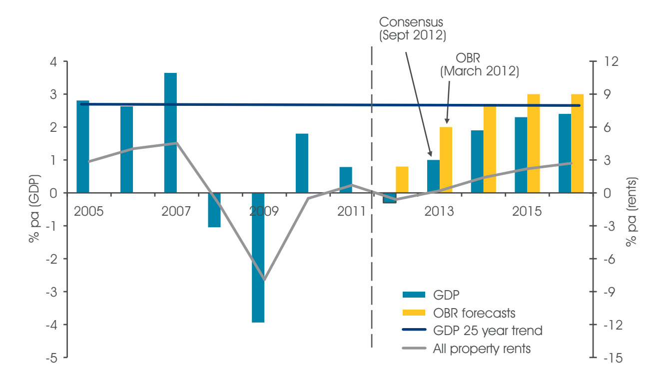


Source:CIPS, Markit

Employment (aged 16 & over)

Source: ONS

Economic output and all property rents



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

Latest consensus forecasts, September 2012

	2011	2012	2013	25 year trend
Economic growth (GDP)	0.7%	0.3%	1.0%	2.7% pa
Private Consumption	-0.7%	-0.2%	1.1%	
Employment growth	0.2%	1.0%	0.3%	0.7% pa
Bank base rate (Q4)	0.5%	0.5%	0.5%	
CPI – Inflation (Q4)	4.6%	2.2%	2%	
RPI – Inflation (Q4)	5.1%	2.7%	2.5%	
House Price Inflation (Q4)	-0.6%	-0.9%	0.3%	

Source: HM Treasury (compilation of forecasts), GVA

Commercial property market

Recent occupier market trends

Average all property rental values fell slightly during the first eight months of 2012 and are now 0.3% lower than at the start of the year (IPD Monthly Index, August). Behind the all property figure, the market remains polarised geographically. Average rental values for central London offices have increased by 2% since the start of January and central London retail rents are an impressive 3.7% higher.

This is in marked contrast to falling rental values across much of the rest of the mainstream market. Outside London and the South East/East of England, average shopping centre rental values are 2.5% lower than at the start of the year. Average office rental values are 1.2% lower and industrial rents have fallen by a similar 1%.

The market is also heavily polarised by asset quality. IPD figures reveal a stark contrast between the prime and more secondary ends of the spectrum. For example, the highest quality 25% of UK shopping centres in the index saw rental values rise by 0.6% in the first half of this year. In contrast, the most secondary 25% saw a fall of 3.1%.

These performance differentials are repeated across a range of sectors, though to varying degrees. Even in the central London office market, where overall rental growth is fairly strong relative to the market overall, rental values on secondary assets have fallen during the first half of the year.

Outlook for occupier market performance

In the short term rental values are likely to continue to fall at the all property level and we expect 2013 to see little change in the overall figures, as the table below suggests. In central London, the rate of growth is likely to moderate next year but we forecast that rental values will be almost 15% higher than today by the end of 2016.

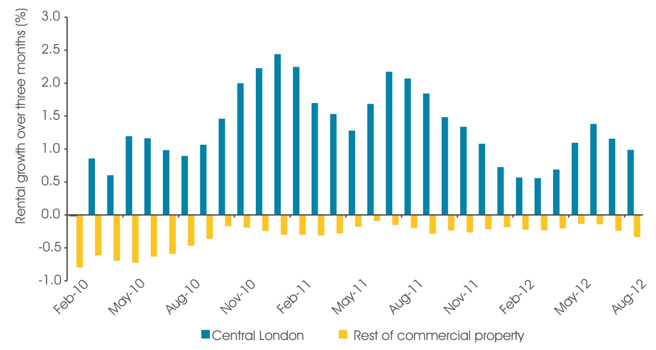
In the regional markets the rate of decline should ease next year but the return to growth will be slow. Indeed, outside central London rental values will still be below their 2008 peak at the end of 2016 and are forecast to be only around 6% higher than current levels, as the third chart shows.

The differentiation in performance by quality is more likely to increase than decrease. The current low level of development activity - illustrated in the second chart using data on the value of new construction orders - means that shortages of quality space will become increasingly apparent as economic recovery eventually gathers pace.

At the same time the quality of space will become more important, whether this is office occupiers demanding more flexible buildings or the need for retailers to adapt their offer in a world increasingly influenced by internet sales.

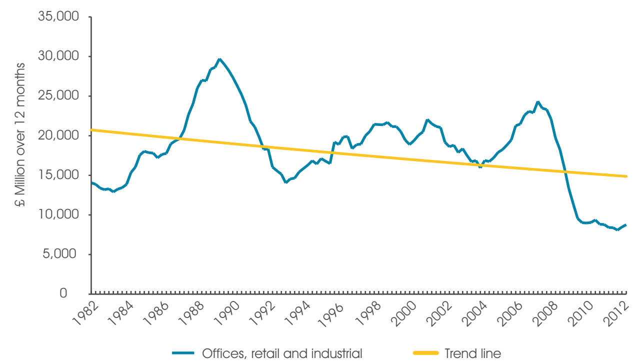
At the same time, it will become more difficult to let secondary stock. The April 2018 deadline after which it will probably not be possible to lease a building with an EPC rating below 'E', and the retrenchment of occupiers from secondary locations are just two reasons for this.

Rental value growth over three months



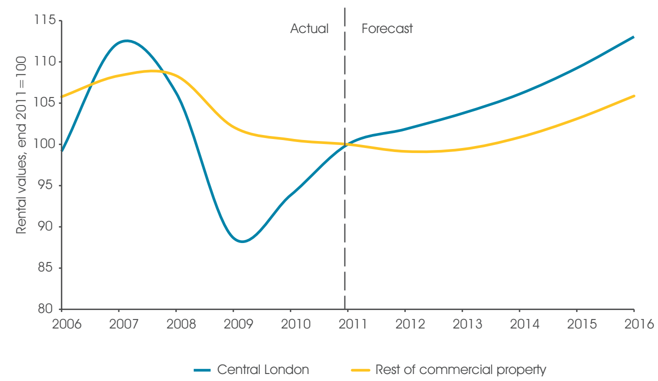
Source: IPD, GVA

New construction orders (2005 prices)



Source: DTI, GVA

Average rental value levels



Source: IPD, REFL, GVA

All property rental growth forecasts

	2012	2013	2014	2015	2016
Consensus (August)					
Maximum	0.3%	2.1%	3.7%	-	-
Minimum	-3.0%	-3.0%	-1.2%	-	-
Average	-0.8%	0.0%	1.2%	-	-
GVA (September)	**-0.5%**	**0.3%**	**1.4%**	**2.2%**	**2.7%**

Investment market commentary

Recent investment performance

Strong overseas interest in the London market continues to buoy overall investor demand. During the first eight months of 2012 Property Data has recorded transactions across the UK totalling £19.7 billion, slightly below the £21.9 million recorded for the same period last year. Transaction levels are still being held back by the scarcity of debt finance, the lack of quality product and by high levels of investor uncertainty.

So far 51% of this year's transactions by value (£10.2 billion) is accounted for by overseas investors, who increased their overall exposure to the UK market by £6 billion over the period.

Average all property yields have now shifted upwards for ten consecutive months (IPD Monthly Index, August). Although this shift has been relatively modest at just under 20 basis points, the investment market now appears to be in a 'double-dip', at least at the all property level. But this time around the extent of the upward shift should be very limited, unlike the major upward yield shift seen in 2007 and 2008.

Again, the all property figures do not tell the whole story and yields at the very prime end of the market have held broadly steady in recent months. As a result the gap between prime and secondary property widened further.

The first chart shows the movement in average all property yields over the last decade. It also shows the gap with gilt yields which has widened significantly over the last year. This is mainly due to falling gilt yields which are currently around 2.2% (15-year gilts). This almost unprecedentedly low level is the result of high investor demand for 'safe' assets as well as the Bank of England's quantitative easing programme.

Rising yields and declining rental values have driven a fall in capital values, which are now 2.8% below their recent peak towards the end of last year. The change in the level of all property capital values over the last decade is illustrated in the second chart. The total all property return for the first eight months of 2012 was 1.6% (IPD Monthly Index), whilst the year-on-year figure to August was 3.9%.

Investment market outlook

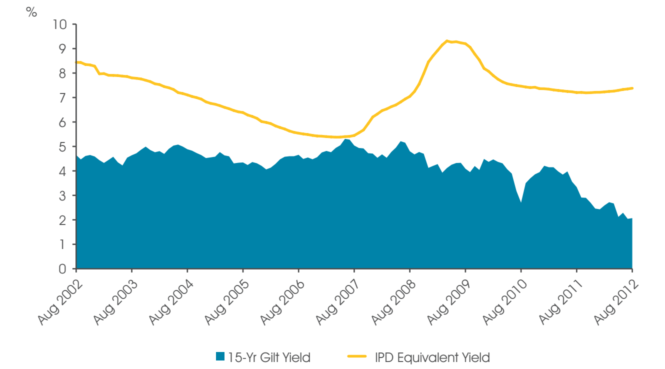
We expect average all property capital values to finish the year around 4% lower than at the start. With the income return approaching 6% pa, our forecast for total returns is 1.7%.

For 2013 our central view is for little change to either rental or capital values at the all property level. Adding in the income element we forecast a total return of 5.3%. However we are in very uncertain times and the IPF consensus forecasts reflect this, with views for 2013 ranging from 8.7% to 1.2% (as the table shows).

Beyond 2013 returns should rise further to 8-9% pa as rental growth begins to feed through across a broader section of the market and the current modest upward yield movement reverses.

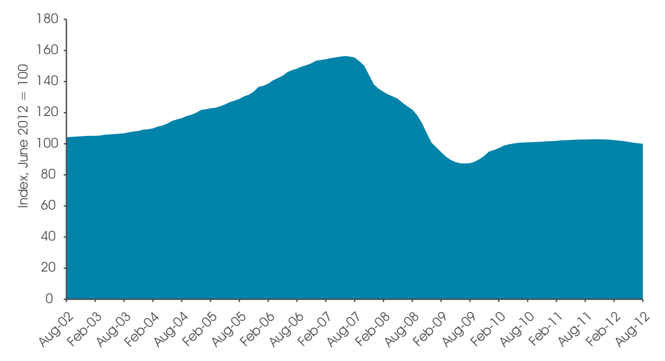
Investor demand for prime assets will continue to be strong. However much of the supply will be at the more secondary / tertiary end of the market as banks work their way through their distressed asset portfolios.

Property and gilt yields



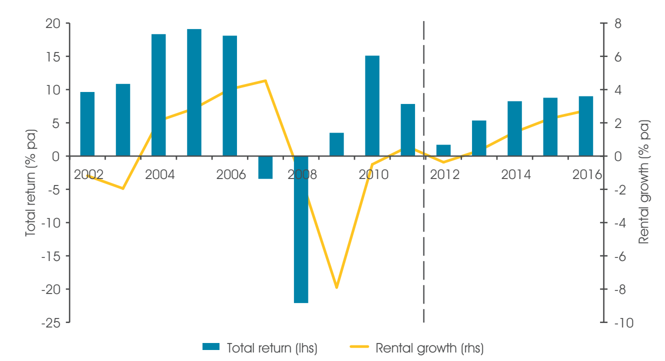
Source: IPD, FT, GVA

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 (August)					
Maximum	6.2%	8.7%	14.5%	-	-
Minimum	-2.0%	1.2%	4.2%	-	-
Average	1.1%	5.0%	7.7%	-	-
GVA (September)	**1.7%**	**5.3%**	**8.3%**	**8.8%**	**9.0%**

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