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UK Commercial Market in Minutes
Is "uncertainty" really the word of the year?

April 2017

Prime yield hardens again, but might there be an election spike?

■ The Savills All Sector Prime Yield hardened again last month to 4.75%. This makes March the seventh consecutive month of prime yield hardening, and brings the All Sector yield back to its pre-referendum level.

■ Increasing levels of global insecurity have driven a steady shift towards income-producing assets all over the world, and the UK's unique lease structure is still seen as offering a safe haven in times of volatility. Nowhere is this more true than in the London office market, where the first quarter of 2017 saw a record level of nearly £5bn of transactions, 84% of which were to non-domestic investors. Many of these investors, while they accept that occupational risk has increased due to Brexit, still see the UK as comparatively safe in a global context.

■ With the announcement of a snap general election in June it is arguable that uncertainty in the UK has risen once again. However, the story around transactional activity and pricing in general election years is far from conclusive.

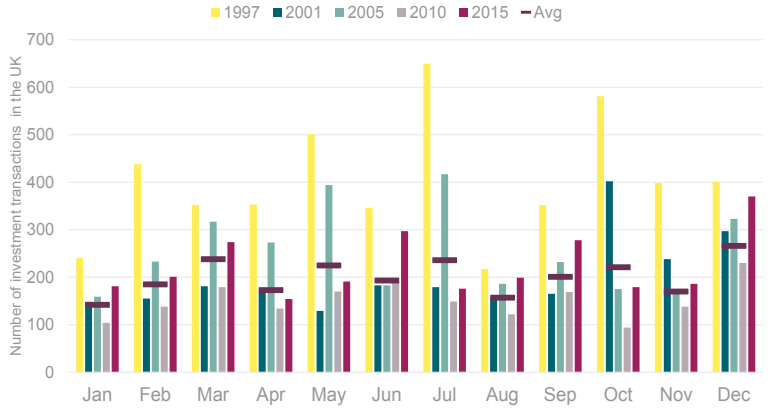
■ As Graph 1 shows, in three of the last five election years there was less than normal activity in the investment market in May and June. However, this tended to be compensated for by more activity in the second half of the year.

■ There is a similar story when it comes to pricing. In 1997, 2010 and 2015 our All Sector Prime Yield ticked up by around a quarter of a point in May/June. However, in all three years it reverted to its pre-election levels within three months of the election date.

■ So, perhaps all we can say about elections and the market is that sometimes they have a short-term effect on confidence, but this doesn't last. Indeed, June 2017 may be a good time to buy.

GRAPH 1

Election years - less investment activity in May & June is compensated for by more in Q3 and Q4



Graph source: Savills

TABLE 1

Prime yields

	Mar 16	Feb 17	Mar 17
West End Offices	3.00%	3.25%	3.25%
City Offices	4.00%	4.00%	4.00%
Offices M25	5.00%	5.25%↓	5.25%↓
Provincial Offices	5.00%	5.25%↓	5.25%↓
High Street Retail	4.00%	4.00%↑	4.00%
Shopping Centres	4.25%	4.50%	4.50%
Retail Warehouse (open A1)	4.75%	5.25%	5.25%
Retail Warehouse (restricted)	5.75%	5.75%	5.75%↓
Foodstores	5.00%	5.00%	5.00%
Industrial Distribution	4.75%	5.00%	5.00%↓
Industrial Multi-lets	4.75%	4.75%	4.50%↓
Leisure Parks	5.00%	5.00%	5.00%
Regional Hotels	5.50%	5.25%	5.00%

Table source: Savills

If uncertainty is not affecting prime yields, what about secondary?

■ If domestic uncertainty is not having an appreciable effect on prime yields, then perhaps it should be more noticeable in secondary and tertiary (i.e. short income) deals?

■ Graph 2 looks at the spread between our national prime and secondary yield indices, which has now widened from its recent low of 316bps to 355bps. Given that this is a larger spread than the long-term average of 326bps, it does point to a mix of increased caution around secondary assets and enthusiasm for prime assets. However, it also perhaps puts into context the degree of risk that investors think the UK is facing (i.e. significantly less than in the early 1990s recession or the global financial crisis (GFC).

■ We would concur with this view, as this latest shock is not likely to be amplified by credit issues or global contagion.

■ A similar story prevails outside London, with the spread between prime and secondary yields in the regional office markets being wider than average, but significantly narrower than during the GFC.

■ Looking ahead, we do expect to see weaker investor demand for short-income deals as concerns about demand and rental growth rise, and a greater degree of caution applied to their evaluation. This will in turn lead to a rise in secondary yields until they start to look cheap in relation to the occupational risk. However, the ceiling for secondary yields this cycle is definitely lower than it was in 2007-2012, though the highest returns will once again be from turning short-income into long-income.

For the economy as well as the property market, confidence is everything

■ With the news that the IMF has revised its forecast for UK GDP growth in 2017 up from 1% to 2%, it might seem that economic uncertainty is over. However, a number of measures are starting to point to rising tensions in household finances.

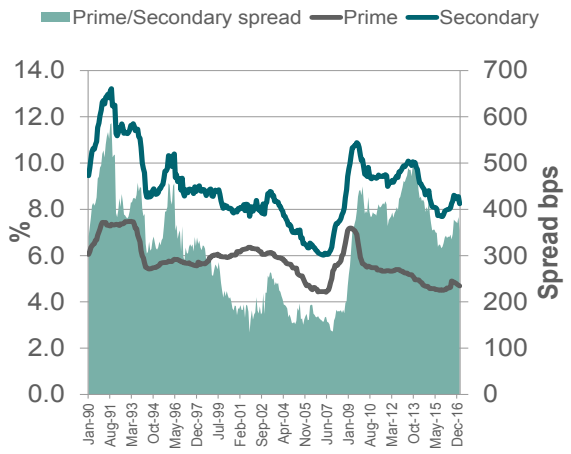
■ While some surveys are pointing to the fact that the inflationary impact of sterling's devaluation may already have peaked, other factors such as rising utility bills are expected to push CPI close to 3% over the summer.

■ With wage growth not likely to keep in step with inflation, a key question for the UK economy is how shoppers will continue to fund spending. Household savings ratios are now at their lowest ever level and the Financial Policy Committee has recently started to make worried noises about the level of unsecured borrowing that is going on.

■ As Graph 3 shows, while consumers remain reasonably relaxed about their own economic situation, they are much more pessimistic about the general economic situation. However, a downturn in the latter has often preceded one in the former, so a slowdown in household spending is starting to look increasingly likely. ■

GRAPH 2

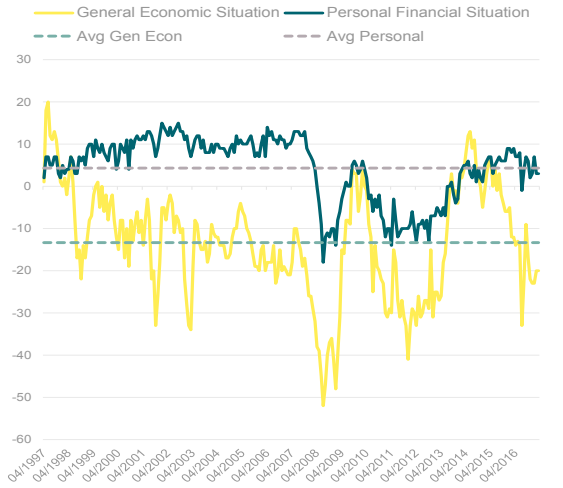
The spread between prime and secondary yields has widened



Graph source: Savills

GRAPH 3

Are consumers in denial?



Graph source: Savills from GfK data

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