Market in Minutes

August 2010

Tentative economic recovery will intensify competition for assets in prime markets

Competition for assets in prime markets set to intensify

- Following the softening in prime yields seen in some sectors last month, July was characterised by lack of activity with only one sector reporting any movement.
- West End offices saw a hardening in prime yields of 25bps to 4% and is now only 50bps above its 2007 peak.
- However, this 'holding' is not expected to continue. We expect to see a divergence in prime yield movements between sectors based on differing perceptions of risk. For example, further softening has been mooted for industrial multi-lets, high street retail and M25 offices. In contrast, for those sectors where the property/market fundamentals remain strong, such as West End and City offices, further hardening is expected.
- Some investors are already starting to revisit their portfolio in order to release capital for reinvestment in prime assets in target sectors. This, together with the re-entry of UK Institutions (net investment was up 17% to date for 2010), means that competition for 'prime' assets looks set to intensify generating further downward pressure on yields in some sectors.

Prime equivalent yields

	Jul-09	Jun-10	Jul-10
West End Offices	5.75%	4.25%	4.00%
City Offices	6.25%	5.25%	5.25%
Offices M25	7.25%	6.25%+	6.25%+
Provincial Offices	7.00%	6.00%	6.00%
High Street Retail	6.00%	4.75%+	4.75%+
Shopping Centres	7.25%	6.00%	6.00%
Retail Warehouse (open A1)	6.50%	5.25%	5.25%
Retail Warehouse Park (restricted)	8.25%	6.25%	6.25%
Foodstores	-	4.50%	4.50%
Industrial Distribution	7.25%	6.50%	6.50%
Industrial Multi-lets	7.75%	6.25%+	6.25%+
Leisure Parks	8.75%	7.00%	7.00%
Regional Hotels	7.25%	7.00%	7.00%

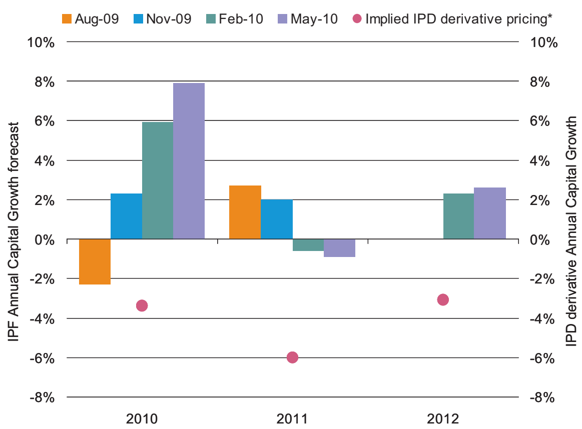
Source: Savills

Note: In some sectors initial yield pricing is becoming more relevant than equivalent yields. This particularly applies to retail warehousing and hotels where the figures indicated above are net initial yields. The +/- against the figures in the table above reflects the expected direction of movement in yields over the next 3 months.

Investor confidence waning

- The negative newsflow surrounding the strength of the economic recovery and upcoming public sector job cuts is dampening wider investor confidence.
- IPF consensus forecasts have reported a steady increase in capital growth for 2010, currently standing at 7.9%. However, 2011 forecasts have gone from 2% growth as predicted at the end of 2009 to a fall of 0.9%. Declining confidence is also being priced into the derivatives market with total return swaps implying a fall in capital values of 6% next year.
- Whilst there is going to be downward pressure on average values next year it will not be universal. The growth in employment in Q2, the largest quarterly increase since 1989, points to some resilience in the private sector, which will help provide some reassurance to investors.

Confidence in 2011 returns declining



Source: IPF; Morgan Stanley

Note: 2010 implied derivative pricing for 2H10*

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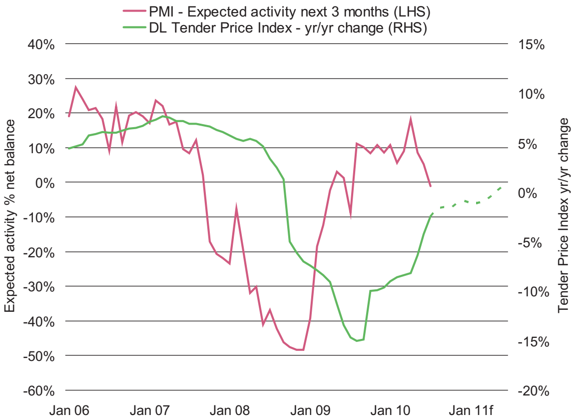
Market in Minutes

Development expectations back in negative territory

- Savills commercial development activity index, measuring expectations over the next three months, dropped into negative territory in July for the first time since July 2009.
- This negative outlook was attributed to lack of development funding and concerns surrounding the strength of occupational demand due to proposed public sector job cuts.
- However, it does suggest that for those developers with funding in place, now may be a good time to secure contracts before tender price growth returns.
- Tender prices have lagged expectations suggesting that the fall in confidence will temper the current upturn in prices. Forecasts from Davis Langdon suggest that positive growth will not return until 2011.

Expectations dampening tender price growth

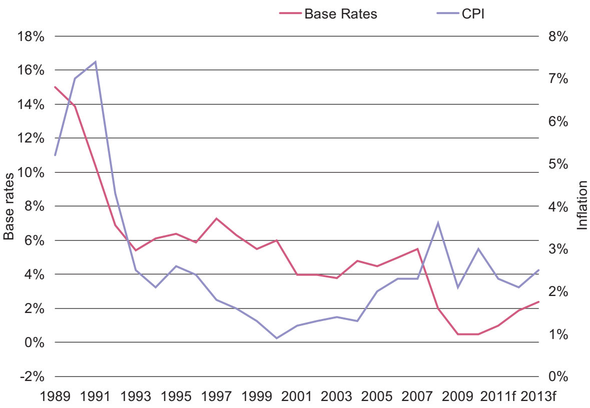


Source: Savills; Davis Langdon TPI

'Choppy recovery' on the cards

- The outlook for the UK economy took a maritime theme this month with Mervyn King saying that the economic recovery will be 'choppy' with references to headwinds (bank balance sheets; fiscal positions) and tailwinds (continuing monetary stimulus; earlier depreciation of Sterling).
- The August inflation report downgraded previous GDP forecasts for 2011 to 2.5-3%. While the outlook may not be as positive as previous estimates suggested, it is still in positive territory.
- The real issue is inflation and keeping this in check while supporting economic recovery by keeping interest rates low. The BoE suggested that inflation will remain above the 2% target until the end of 2011, falling back once the effects of price level shocks, such as the the rise in VAT, drop out of the 12 month comparison. As a result they will hold interest rates at historically low levels until the economic recovery becomes more robust.

Interest rates to remain low despite inflation



Source: Bank of England; ONS; Consensus Economics

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