

Institutional Investment in Property

The outlook for the UK economy continues to reflect the expectations of the Office for Budget Responsibility that the recovery will be weaker than the recoveries of the 1980s and 1990s as a result of the effects of fiscal consolidation, the relatively slow easing of tight credit conditions and ongoing private sector deleveraging. The latest Monetary Policy Committee (MPC) forecasts are shaped by a further fall in household's purchasing power and weakening consumer confidence. In the view of the MPC the continuing squeeze on households' real incomes is likely to weigh on demand, especially over the next year or so. However, the recovery in the world economy has continued to support UK growth as has the considerable stimulus from monetary policy and the current level of sterling.

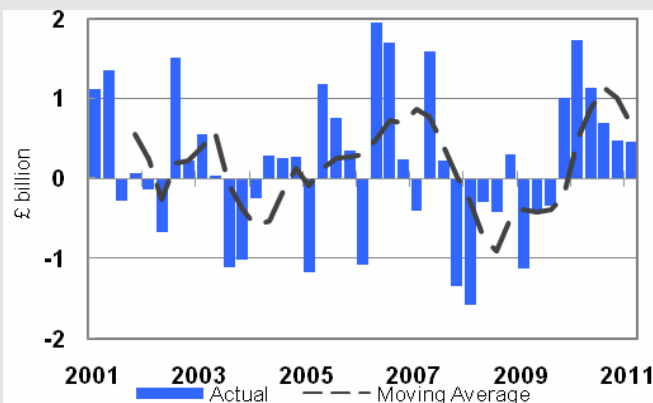
Investment in UK property Q1 2011 (£ millions)

	Pension Funds	Insurance Companies	Unit Trusts ¹	Total
Purchases	679	407	265	1,351
Sales	162	691	41	894
Net Investment	517	-284	224	457

1. Includes Investment Trusts

In April, the PMI index constructed from surveys of the services, manufacturing and construction industries pointed to stronger economic growth in June but at an insufficient pace to lift growth in the second quarter close to that seen in Q1. The survey data suggests that the rate of economic growth will have decreased to 0.3% in Q2 from 0.5% in Q1. The surveys suggest a broad-based slowdown across the construction, manufacturing and services sectors over Q2 as a whole compared to the rates seen in the opening quarter. Downturns in the forward looking indicators suggest that this weakness could extend into Q3. Across all three sectors, new orders rose at the slowest rate for six months and business optimism in construction and services ebbed.

Net institutional investment in property



Source: National Statistics

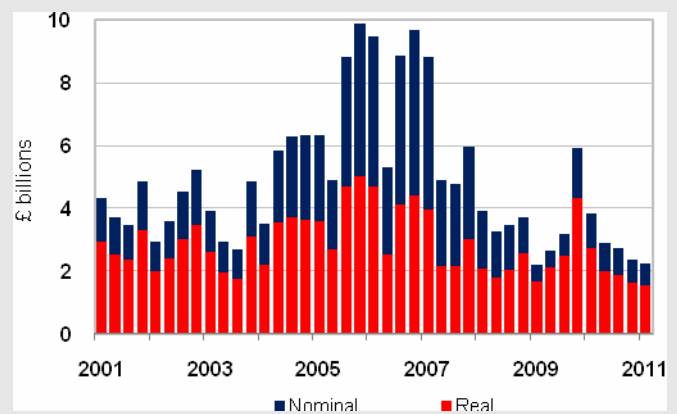
The commercial property market weakened ever so slightly over the course of Q2. Capital values as measured by the IPD Monthly index increased by 0.4% in Q2 compared to 0.6% in Q1. This is the lowest rate of growth since the recovery started in September 2009. Total returns decreased to 2.1% in Q2 from 2.3% in Q1. Total returns in the 12 months to June decreased to 9.1% from 10.7% in the 12-months to March.

In Q1 net investment in commercial property decreased for the fourth consecutive quarter as institutions acquired property assets worth £1.4 billion and recorded sales of £894 million. As a result, net investment in Q1 was £457 million compared to £483 million in Q4 2010. In the 12 months to March, net investment by institutions amounted to £2.8 billion compared

with net investment of £4.0 billion in the 12 months to December 2010 and £2.0 billion in the 12 months to March 2010.

In the first quarter, pension funds invested a further £517 million and have been net investors for the last sixteen quarters. Total investment by pension funds in the 12 months to March amounted to £1.9 billion compared to £1.7 billion in the 12 months to December 2010 and £1.6 billion in the year to March 2010. Life companies were net sellers for the second consecutive quarter. Net disinvestment in Q1 amounted to £315 million. In the 12 months to the end of March disinvestment amounted to £85 million compared to investment of £788 million in the 12 months ending December 2010 and disinvestment of £565 million in the year to March 2010. Property Unit Trusts were net investors for the sixth consecutive quarter in Q1 as the Association of Real Estate Funds continued to report net cash inflows. They invested £170 million in Q1 and £780 million in the 12 months to the end of March compared with investment of £1.4 billion in the 12 months ending December 2010.

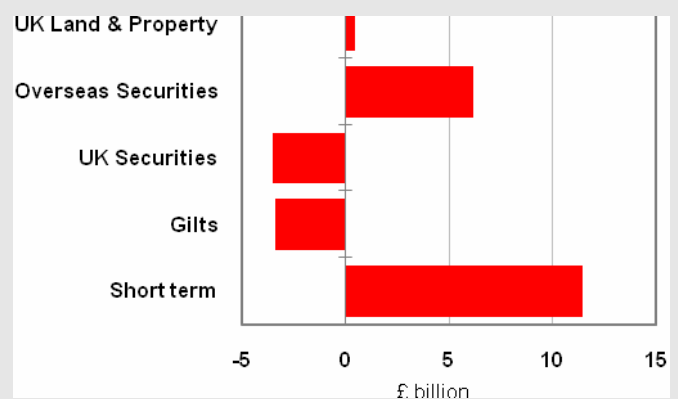
Property market liquidity



Source: National Statistics & Fletcher King

Total institutional investment grew by £17.0 billion in Q1 having previously grown by £16.4 billion in Q4 2010. In addition to the net investment of £457 million in UK Property noted above, institutions also made net purchases in Q1 amounting to £6.2 billion of overseas equities and increased their holdings of cash and other short term instruments by £11.5 billion. However, they sold £3.4 billion of UK government gilts and £3.5 billion of UK equities.

Net institutional investment by asset type, Q1 2011



Source: National Statistics

Interest rates hold the key

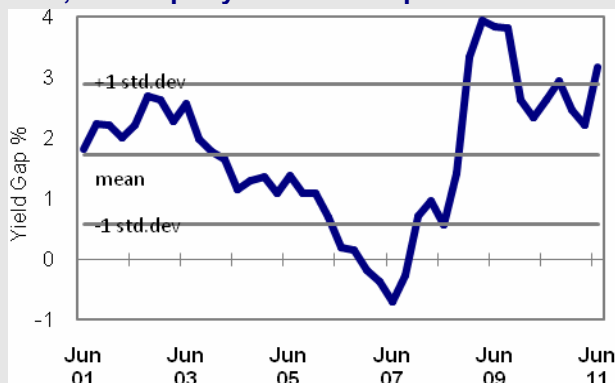
Confidence in the outlook for the commercial property market has been gently improving in the last 12 months. Since June 2010 the All Property total return for calendar 2011 implied by the 2011 Swap price has increased from 1.5% to 7.0% at the end of June 2011. Since November 2010 the IPF's All Property Consensus forecast for 2011 has increased from 5.2% to 6.3% in May 2011. Back in June 2010, the 2011 derivatives contract was implying an annual fall in values of approximately 6% and the IPF's Consensus forecasts were suggesting that capital values would decrease by at least 2% in 2011. In fact in the first half of 2011, capital values have increased by 1%.

It is easy to understand the reasons for this earlier pessimism. Economic growth and low interest rates were seen as the key supporters of property pricing levels. But it was expected that fiscal consolidation would result in weak economic growth. While an early increase in base rates was seen as inevitable because of persistently high inflation.

An increase in base rates would add the burden of increased mortgage interest costs to the plight of households where higher-than-expected inflation was already squeezing disposable income. Already weak levels of consumer spending would be reduced further. Increasing base rates would also drive gilt redemption yields higher and erode the property risk premium. Higher interest rates could also see the banks abandoning their policy of "delay and pray" as mortgagors became unable to continue servicing their already distressed loans. Any large increase in property receiverships and forced sales would undermine pricing levels especially of secondary property.

In the recession of 2008 -09 economic output was reduced by 6.4% whereas in 1990-91 output fell 2.5%. Between December 1990 and June 1995 rents fell by 22%. It might have been reasonable to expect rents to fall by the same amount if not more given the severity of the most recent downturn. But the rental market has been more resilient and between April 2008 and November 2010 rental values only decreased by 11%.

Chart 1; The Property-Gilt Yield Gap



Source: IPD & Fletcher King

The retail sector in particular is struggling in the current economic climate. A squeeze on real take home pay and a public sector pay freeze has resulted in the first sustained fall in real earnings since the 1920's. Weak high street sales and the continuing growth of internet sales have seen an increase in the number of retail business failures increasing shop vacancy rates. The Local Data Company report a vacancy rate across the UK of 14.5%. Nevertheless shop rents only declined at the annualised rate of -1.0% in Q2 compared to -2.3% in Q1.

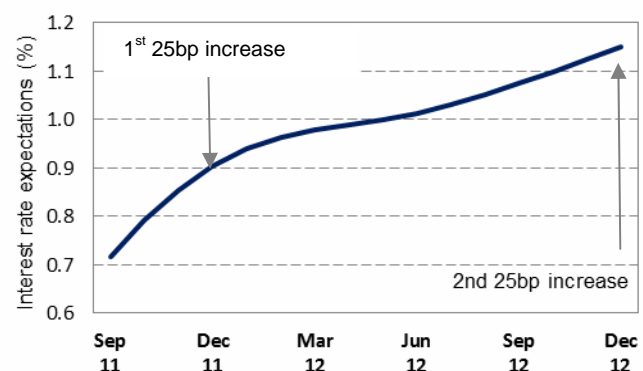
The office sector is experiencing mixed fortunes. In Q2 Central London rental values grew at an annualised rate of 6% but South East and Rest of UK office rental values both decreased at an annualised rate of -1%. Although it has slowed in 2011,

quarterly Central London office take-up has been running at the long term trend rate or better since September 2009. Across the whole of Central London the vacancy rate is now less than 7%. In the major regional centres office take-up has been below the long run trend level in each of the last three years and the vacancy rate is 16% or more.

The industrial and distribution market still suffers from record amounts of available space. But some of this is of poor quality and the supply of new build space is limited. Government policy is aiming to re-balance the UK economy away from domestic led consumer expenditure towards manufactured exports. This policy has been helped by the relatively low sterling exchange rate and the continued recovery of the global economy. This may help the market for industrial space as manufacturers occupy a significant 30% of industrial property. But the slow domestic economy will limit the demand for industrial space from distributors, retailers and business service operators.

The prospects of rental value growth may be negligible but the pricing of commercial property reflects this. Despite a recovery that has seen the average All Property initial yield harden by 165 basis points and the equivalent yield harden by 203 basis points since the market trough, property yields are still high relative to gilt yields (see Chart 1).

Chart 2; Short End Yield Curve



Source: Bank of England

Weak UK economic data has recently seen gilt yields reverse their increases of earlier in the year. Inflationary concerns and fears of an imminent increase in the base rate have been replaced by a view that monetary policy may need to stay loose for much longer than expected to support the economy in a time of fiscal consolidation. Market interest rate expectations now suggest that the first quarter point increase in interest rates will be delayed until December 2011 with the next quarter point tightening in December 2012 (see Chart 2). Capital Economics are forecasting that the 10-year gilt yield which is currently 3.1% will harden to 2.75% and that base rates will remain at 0.5% until 2013.

In the last 12 months the performance of the commercial property market has surprised on the upside. Despite the weak performance of the UK economy rental values have proved more resilient than expected. The yield gap between property yields and gilts remains at historically high levels. It reflects the lack of rental growth but also puts a floor under current property prices. If gilt yields harden or the economy performs better than expected commercial property total returns could even exceed current expectations. On the down side, there are still very real dangers to the economy and the financial system from potential Euro-zone sovereign defaults and the stalled Congress negotiations surrounding the need to increase the debt ceiling of the USA, spending cuts and tax increases.