

# Economic & Property Market Review

UK

Quarter 1 2008

# Economic Trends

## Economic Overview

Provisional Q4 UK **economic growth** indicates that in Q4 only a gradual economic slowdown was underway. Growth was a slightly below trend 0.6%, or 2.3% annualised, compared with annualised growth of 3% in Q3, 3.2% in Q2 and 3.1% in Q1. The equivalent eurozone figures for Q4 were somewhat weaker, at an annualised 1.6%, and in the USA growth was a very weak 0.6% annualised.

There are two key areas where the slowdown was most evident. One was **Business Services & Finance**, where annualised growth slowed from close to 5.5% in Q3 and Q2 to 2% in Q4, reflecting the problems in the financial sector caused by the credit squeeze. The other was the slowdown in **retail sales** volumes, where growth slowed from over 5% in Q3 and Q2 to 2.1% in Q4, although over the 3 months (November - January) growth was a slightly stronger 2.3%. The **manufacturing** sector continued to show weak growth and in Q4 output shrank by nearly 1% annualised.

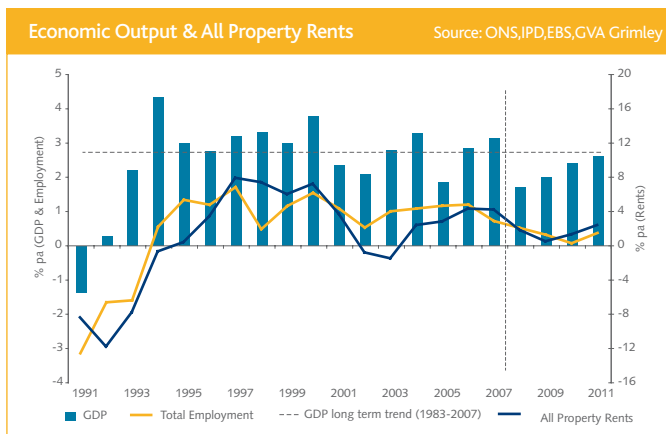
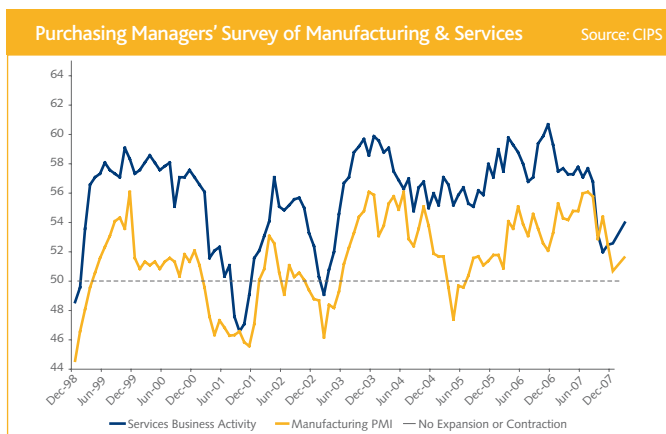
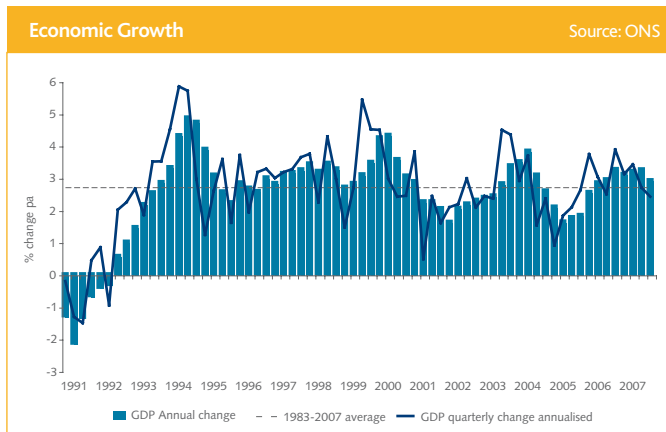
## Outlook

With a weakening economy, interest rates need to fall quickly and noticeably, as they have done in the USA, to prevent the slowdown turning into a major downturn. But short term inflation concerns (the Bank of England's main focus), from higher energy and food prices and a weakening pound, will delay and lessen reductions in interest rates. This is likely to cause a major economic slowdown this year, which would drive inflation down anyway! A fiscal stimulus to lessen the extent of the downturn, as recommended by the IMF, seems unlikely as Government finances leave no room for a reduction in taxation or increased expenditure.

**Interest rates and inflation** - although UK base rates have been reduced to 5.25% (still high compared to US and eurozone levels, even though our inflation is lower), 3 month LIBOR has fallen from a very high 6.5% before Christmas to 5.7% currently, although the decline has reversed a little over the last month. 5 year Swap rates (a key interest rate for the property investment market) have also reduced noticeably, from over 6% last Summer to around 5% currently, although there has been a slight reverse in the last month and risk premiums have increased at least 30 basis points over the same period according to our recent survey of bank lending.

**Economic growth** is set to be much weaker in 2008 judging by the closely watched CIPS/RBS monthly business activity purchasing managers' index which has fallen noticeably over the last six months (see chart). However, although the slowdown is marked, so far the index is recording higher figures than in 2003 or 2001, suggesting continued economic expansion.

Recent economic forecasts expect the housing market and consumer spending to weaken further and employment growth, which has been strong in recent years, is expected to drop below trend. The occupier market and rental growth will clearly weaken further in 2008 and 2009. UK economic growth, according to the latest consensus forecasts, is expected to weaken in 2008 to 1.7% compared with 3.1% in 2007. Growth nearer 1.5% in 2008 is now looking more likely, with the consensus view expecting a slow improvement to 2% in 2009 and further improvement to a close to trend 2.6% in 2011.



### Latest Consensus Forecasts, February 2008

Source: HM Treasury compilation, GVA Grimley

	2007	2008	2009	Long-term average
Economic growth (GDP)	3.1%	1.7%	2.0%	2.7% pa (1983-2007)
Private Consumption	3.2%	1.7%	1.7%	
Employment growth	0.7%	0.5%	0.3%	0.4 - 0.6% pa
Bank base rate (Q4)	5.6%	4.8%	4.7%	
CPI - Inflation (Q4)	2.1%	2.3%	2.0%	
RPI - Inflation (Q4)	4.2%	2.6%	2.6%	

# Commercial Property Overview

## Overview of recent performance

All Property rental growth has continued to slow, to 3.35% year-on-year in January, compared with 3.9% pa three months previously (IPD Monthly Index). However, rents only increased by 0.5% over the three months to January, equivalent to 2.2% annualised (down from an annualised 4.1% pa three months ago). This suggests that further weakening is likely in the year-on-year rate.

The largest contribution to this slowdown has been the central London office market, and although year-on-year growth remains strong at 11.4% pa in the City and 15.4% pa in the West End / Midtown, this hides a much sharper slowdown over the last few months. This is most apparent in the City, where rents only increased by 0.7% over the three months to January, the annual equivalent of just 2.6%. In the West End / Midtown, rents increased by a much higher 2.5% over the three months (an annual equivalent of 10.2%, still well below the year-on-year rate).

Rental growth has also continued to slow noticeably in the retail sector, reaching 1.7% year-on-year in January, down from 2% pa in October 2007 and a peak of 4.2% pa in February 2006.

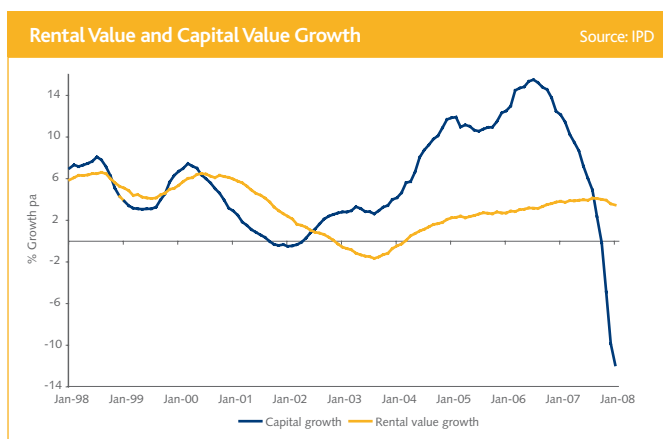
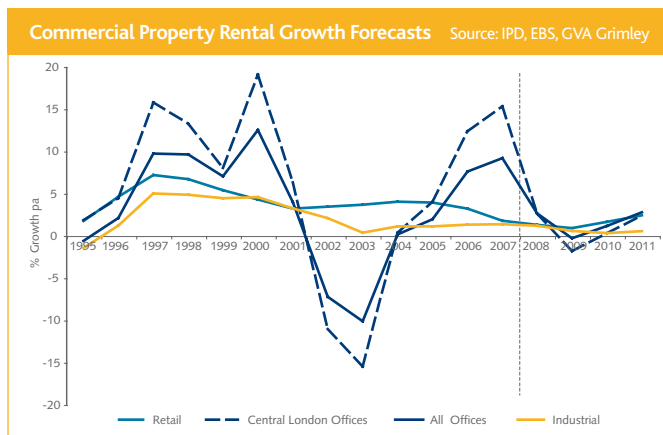
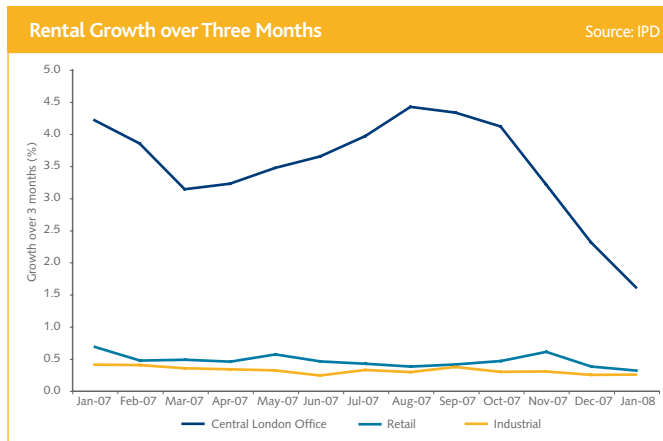
Rental growth in the industrial sector remains very subdued at 1.2% pa in January, slightly slower than the 1.4% pa reported three months ago.

Property yields continued to move upwards in January, with the equivalent yield on the IPD Monthly Index rising by 13 basis points, to stand at 6.3%. However, the rate at which yields are rising has eased, having shifted upwards by nearly 30 basis points in both November and December.

The total upward movement since the peak of the investment market in Spring 2007 has now been more than 90 basis points. With rents rising by less than 2% over the same period, the result has been a fall in capital values of 13.5%, wiping out all of the increase that has occurred over the last two years.

The year-on-year All Property total return fell to -7.6% in January, a marked turnaround from the +11.1% pa recorded just six months ago, and a peak of 21.6% in July 2006. During the three months from November to January, the total return was -8.6% (-30.3% annualised).

The rapid deterioration in commercial property market performance has been reflected in a sharp reduction in investment transactions. According to Property Data, transactions in Q4 2007 totalled £7.1 billion, compared with £16.3 billion in Q3, and a quarterly average of £15.3 billion from Q3 2005 to Q3 2007. Transactions in January 2007 total only £1.4 billion.



**All Property Rental Value Growth Forecasts**

	2007	2008	2009	2010	2011
Consensus Forecasts	(actual)				
Maximum	-	3.7%	2.0%	2.9%	-
Minimum	-	-2.5%	-6.1%	-1.7%	-
Average	-	1.1%	0.5%	1.4%	-
GVA Grimley	4.6%	1.7%	0.4%	1.2%	2.3%

## Occupier Market Outlook

With a marked slowdown in UK economic growth expected in 2008, as well as lower employment growth than in recent years, we anticipate a corresponding slowdown in the rate of rental growth across the UK commercial property sector, with All Property rents forecast to rise by less than 2% this year, compared with 4.6% in 2007 and 4.2% in 2006. This would be the slowest rate of growth since the last downturn in the market in 2002/03.

This will be most apparent in the central London office market. With the ongoing problems in the global financial sector we anticipate a fall in demand for space, as some firms shed jobs and others cancel expansion plans, and this will coincide with the peak of the development cycle in the City of London. Clearly, this will have a marked effect on rental growth prospects, and we believe that a fall in rental values in the City over the next two years is now almost inevitable (probably in 2009).

The West End office market will be insulated from this to a certain extent, both because of a more diverse demand base, and a more restricted supply pipeline. The impact should also be felt less in the regional markets which are less reliant on financial services, and where most, although certainly not all, major city centres have a relatively restricted supply pipeline. Overall, we expect UK office rents to increase by around 2.5% this year.

With consumer spending expected to continue slowing this year, the outlook for the retail occupier market is inevitably rather weak. All retail rents increased by around 1.8% in 2007, but we expect a weaker 1.3% in 2008, followed by under 1% in 2009, which should mark the bottom of the cycle. The industrial sector saw rents rise by a subdued 1.4% in 2007. A very modest weakening in 2008 is expected (1.2%).

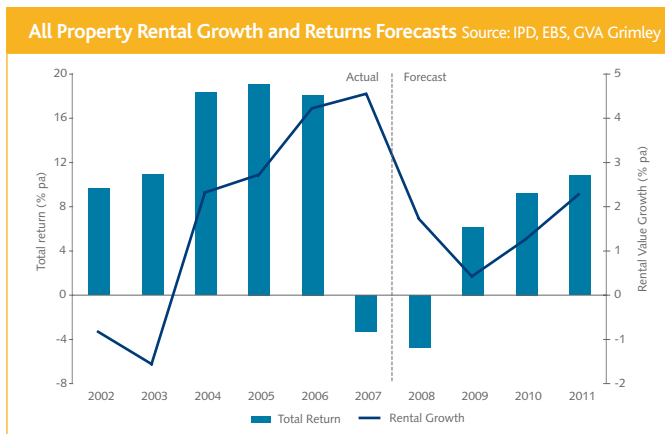
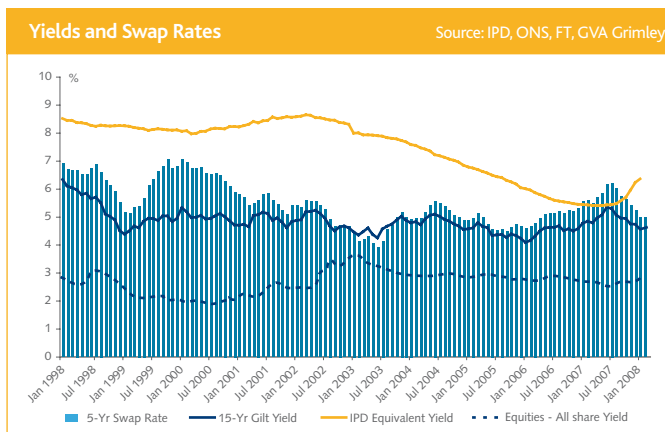
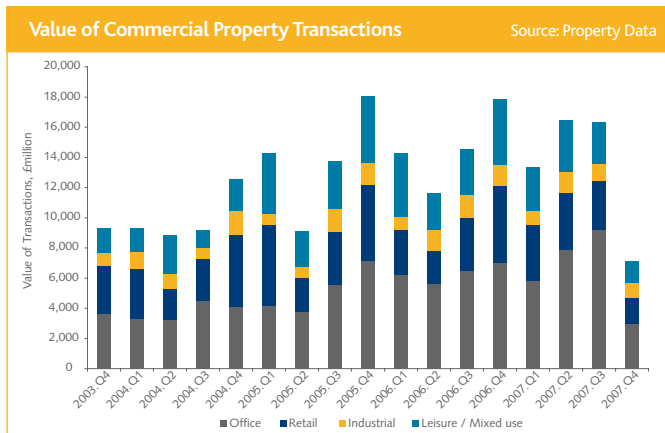
## Investment Market Outlook

The slowing rate of rental growth across the commercial property sector and expectations of relatively lacklustre occupier market performance over the next 2-3 years is clearly not well timed in terms of the prospects of recovery in the property investment market. However, the overall pricing of commercial property is now beginning to look more attractive.

Whilst commercial property yields have been rising since the summer, gilt yields and 5-year Swap rates have been falling, reversing the trend seen during 2006 and the first half of 2007. The IPD equivalent yield fell below 5.4% in the summer, and has since risen to 6.3% in January. 15-year gilt yields peaked in the summer at around 5.4%, and have since fallen steadily to around 4.7% (mid February). 5-year Swap rates have also fallen over the same period, as described earlier, to around 5%.

The next two years will clearly be very challenging for the commercial property investment sector. With All Property rents expected to rise by less than 2% this year, and some further upward movement in yields, we expect total returns from commercial property to be around -5% in 2008, compared with -3.4% in 2007 (IPD Annual Index). However, 2009 should see the All Property return rise above 6%, despite the expected very subdued rental growth performance, and 2010 should see a return in excess of 9%, as investor confidence returns, and the rate of rental growth begins to pick up.

However, sentiment remains a major factor, and markets are seldom completely rational, particularly at times of significant correction. With this in mind, there must inevitably be a degree of uncertainty attached to our forecasts.



All Property Returns Forecasts					
	2007	2008	2009	2010	2011
Consensus Forecasts	(actual)				
Maximum	-	1.5%	13.1%	12.8%	-
Minimum	-	-8.1%	0.1%	5.9%	-
Average	-	-2.6%	6.5%	8.4%	-
GVA Grimley	-3.4%	-4.8%	6.2%	9.2%	10.8%