

# UK Investment Commentary

## August 2008

### Investment summary

- Just over one year after the sub-prime market crisis erupted in the United States, triggering financial market turmoil around the world, global financial markets remain fragile. Meanwhile policy trade-offs between economic growth, inflation and financial stability are becoming increasingly difficult, in the UK and indeed for many national economies.
- The continuing slowdown in UK GDP output has done little so far to dampen rising inflation, principally because inflation is being driven by rising prices for world commodities. Since 2003, oil prices have quadrupled, metal prices have tripled and food prices doubled.
- Forecasts by the International Monetary Fund reveal that its current expectations are for UK growth to fall below trend, albeit recording growth of 1.6% in both 2008 and 2009. This compares with forecasts of 1.3% and 1.7% across the Euro Area over the period and just 0.5% and 0.6% in the United States.

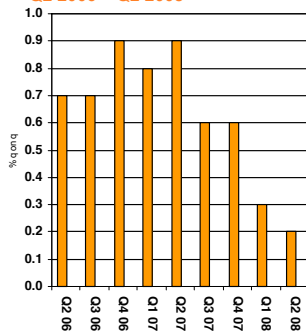


### Property summary

- The correction in the commercial property investment market continues unabated with total returns to property falling to -14.9% over the 12 months to June. On a monthly basis, property returns fell by -1.5% in June, with the pace of downward re-pricing apparently resuming to the rate witnessed at the beginning of the year.
- All Property rental value growth slowed to 2.1% in the 12 months to June, relative to 2.5% in May. Viewed over the last three months, All Property rental growth slipped into negative territory for the first time since September 2003, recording virtually flat growth of -0.04%. Retail is the only sector to have experienced positive rental growth over the last three months, albeit marginal, recording 0.1%.
- On an annual basis, the industrial sector has emerged the as lead performing sector in the current market with total returns over the last 12 months of -13.2%, while returns for offices declined by -14.6% over the period. Retail is now the poorest performing sector with total returns of -16.0 % over the 12 months to June, following a sharp fall of 1.9% in the month of June alone.

Figure 1

**Quarterly change in GDP**  
Q2 2006 – Q2 2008



Source: National Statistics

### Economic overview

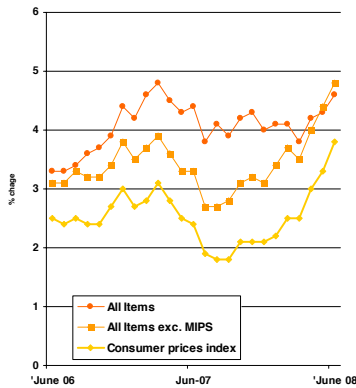
#### Growth — annual GDP growth falls well below trend

- According to provisional figures from National Statistics, GDP growth slipped to 0.2% during Q2 2008, the lowest quarterly growth since Q1 2005. The reduced levels of growth over the last two quarters have brought the annual rate down to 1.6%, the lowest since Q2 2005 and some way below the economy's trend rate of circa 2.5%.
- Key to the slower growth during Q2 was the weak showing from the construction sector, where output fell by -0.7% in the quarter, its largest fall since Q3 2005. The sector has been particularly affected by a large fall in housing starts associated with the higher cost of finance and the downturn in the market, albeit partly offset by public infrastructure spending.
- Output from the services sector increased by 0.4% in Q2, although the annual rate of growth was only 2.1%, its lowest level since Q4 1992. More specifically, output from Financial & Business Services, traditionally a key area of growth in the UK economy, slipped to 0.1% in Q2, the lowest since Q2 2002.

Figure 2

### Inflation rates

June 2006 - June 2008

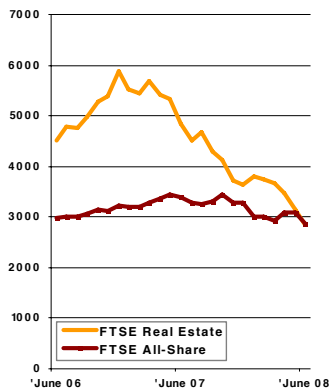


Source: National Statistics

Figure 3

### Share performance

June 2006 - June 2008

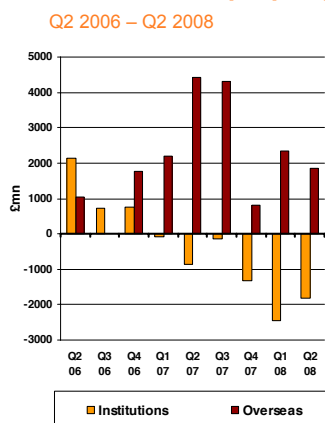


Source: FT

Figure 4

### Net institutional investment in property

Q2 2006 - Q2 2008



Source: Property Data

## Inflation — inflation at highest level since early 1990s

Continuing increases in energy and food prices have contributed much to the UK's headline rate of inflation in recent months. In the month of June alone, CPI inflation increased by 0.7%, having increased by 0.6% in May and 0.8% in April which amounted to the sharpest monthly increase in seven years. On an annual basis, CPI inflation increased to 3.8% in June, the highest annual increase since July 1992. The Bank of England is expecting inflation to move beyond 4% in the coming months although commentators anticipate that the affects of the slowdown should help to bring rates down in 2009.

## Interest rates — the MPC is performing a difficult balancing act

In their July meeting, the Monetary Policy Committee (MPC) voted to hold interest rates at 5.00%. This is the third month in a row that rates have remained at this level, with the last rate change comprising a quarter point cut last April. Despite a more pronounced slowdown being underway, the MPC's priority is to keep inflation under control. Currently, the risks to growth and inflation are counterbalancing each other and, consequently, rates have been held in check in the hope that the economic downturn will, itself, help to clamp down on surging prices. As long as external price shocks remain unabated, commentators expect the MPC to risk a more prolonged economic stagnation by keeping rates at their current level for the time being.

## Property investment overview

### Share performance — equity markets suffer

June saw a rapid deterioration in equity market sentiment, following the brief recovery in the spring. The recent problems have stemmed from looming fears over poor earnings growth and inflation risks as oil prices have reached new record highs. In particular, financials suffered from worries over further write-downs while housebuilders were beset by the slump in the housing market. The FTSE All-Share is currently -8.5% down on the month, and trading at 2.9% below its previous low on 17th March. Nevertheless, the downturn in the fortunes of property shares has been deeper and more prolonged. In the month of June alone property shares lost -9.5% of their value and, taken over the last 12 months, share values have dropped by over 40%, reflecting the steep fall in investor sentiment for property since the onset of the credit crunch in July 2007.

### Institutional investment — overseas investors are now key to activity

According to latest figures from Property Data, just over £5bn was invested in commercial property in Q2 2008, a 70% decline on the equivalent period in 2007. The steep fall in investment volumes is a clear reflection of the turbulence in commercial property pricing, in addition to the cost and availability of finance effectively freezing debt-backed investors out of the market. Having been key to the strong performance of UK investment market in recent years, the UK institutions have emerged as clear net dis-investors over the last year, with -£1.8bn of dis-investment in Q2 2008. However, net investment by overseas investors continues to offset institutional sales, totalling £1.8bn during Q2 2008.

### All property

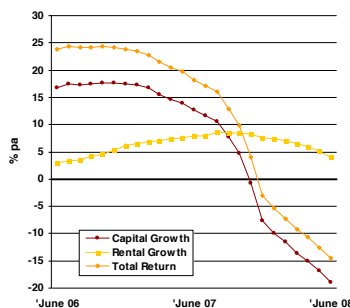
All Property total returns have fallen steeply over the last year, recording -14.9% in the 12 months June. The pace of re-pricing has also accelerated again in recent months, following a gradual easing of the rate decline in the first four months of 2008. Indeed, over the three months to June, All Property total returns recorded -2.7% (compared with -2.0% in the three months to May), indicating a possible 'double-dip' in investor sentiment is occurring, driven by renewed outward yield movement. Initial yields moved out by 16 basis points in June, to 5.7%, taking them to their highest level since June 2005.

The steep fall in property values has led to the sector's outperformance by gilts and equities over the 12 month and three year periods. Nevertheless, over the last 10 years, property remains the lead performing sector, with average annual total returns of 9.9%, compared with 3.5% for equities and 5.3% for gilts.

Figure 5

**Office market performance**

June 2006 - June 2008

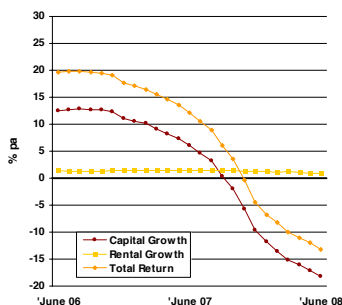


Source: IPD

Figure 6

**Industrial market performance**

June 2006 - June 2008

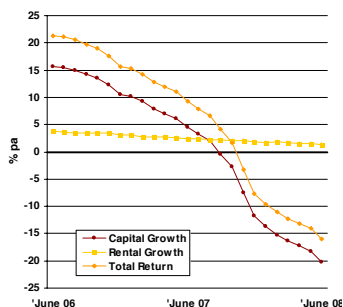


Source: IPD

Figure 7

**Retail market performance**

June 2006 - June 2008



Source: IPD

**Sector overview****Office market**

Provisional figures from National Statistics reveal that service sector output growth was 0.4% in Q2, an encouraging increase on the 0.3% growth in Q1. However, Financial & Business Services output increased just 0.1% in Q2, the lowest since Q2 2002. Furthermore, June's UK CIPS Report on Services also revealed a sharp drop in the business activity index from 49.8 to 47.1, the second consecutive month below the 50 mark, and indicative of a contraction in the sector, moving forward.

On an annual basis, total returns to offices fell to -14.6% in June, having recently been replaced by industrial as the lead performing sector. Rental growth has steadily declined during the first half 2008, recording marginally negative growth in each of the last three months. The recent fall resonates with the lower projection for Financial and Business Services (FBS) output growth. Nevertheless, over the 12 month period, rental growth stands at 4.0%, and offices comprises the only sector showing real rental growth on an annual basis. Furthermore, the key occupational markets outside central London appear in good health.

**Industrial market**

Production industry output declined -0.5% in Q2, with the annual rate of growth slipping to -0.8%. Within the production industries, the main constituent, manufacturing, saw output fall by -0.4% in Q2, offsetting the equivalent rise in the first quarter and, on an annual basis, output was down by -0.4%. With the current slowdown in domestic and global demand, the relative fall in the value of Sterling has not yet provided a boost to the competitiveness of UK manufacturing and exports although this advantage is expected to be a more significant moving forward.

Industrial total returns were -13.2% over the 12 months to June and, in the current market, the sector has emerged as the strongest performing sector over recent months. Income returns have risen to 6.2% on annual basis, and remain the strongest of the sectors. Tenant demand continues to be driven by distributors seeking warehousing, storage and assembly rather than production. Average rental growth in the sector has been very consistent, albeit unremarkable, over the last few years but has declined gradually in recent months to stand at 0.9% over the 12 months to June.

**Retail market**

Official retail sales figures from National Statistics reveal that May's sudden and unexpected 3.5% surge in retail sales was reversed by June's record -3.8% fall. However, set against ever gloomier consumer confidence surveys, sales are nevertheless up 2.2% compared with 12 months ago, which was prior to the credit crunch. Further evidence reveals differences in fortunes exist between retailers, with homewares struggling while fashion sales are proving more resilient.

Total returns in the retail sector were -16.0% over the 12 months to June. High Street retail is the best performing sub-sector, returning -12.6% over the period, while Retail Warehouses, once the stellar performer of commercial property, is the poorest performing retail sub-sector, returning -18.7%. In the month of June, Retail total returns were down by -1.9%, the largest fall of the main sectors on a monthly basis. This was fuelled by the pronounced fall in returns experienced by Shopping Centres, where returns were down by -4.7% in the month of June alone, reflecting the strong 35 basis point outward yield shift in the sector.

**Newmark Knight Frank Contacts:**

**Richard Sexton**  
Partner,  
Global Business Development  
125 Park Avenue  
New York, NY 10017  
Tel. 212.372.2124  
RSexton@newmarkkf.com

**Peter Kozel**  
Executive Managing Director  
Research and RE Strategies  
125 Park Avenue  
New York, NY 10017  
Tel. 212.372.2455  
PKozel@newmarkkf.com

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