Lambert Smith Hampton

Property Solutions

Economic & Property Market Bulletin

November 2007

ECONOMIC OVERVIEW

- **Latest GDP data suggest the economy is currently in rude health. However, we expect the credit squeeze to result in slower economic growth in the fourth quarter of 2007 and into next year. GDP growth is to slow to 2% in 2008.**
- **There are no indications that the economy is heading for a significant slowdown or recession, but there is a risk of a downturn depending on the US economy and the risk to inflation due to higher oil prices.**

Economic Growth

There is little evidence as yet that the recent turbulence in the financial markets has had a significant impact on the UK economy. The third-quarter data for GDP shows the economy growing at above-trend rate, with growth at 0.8% during the quarter. On a year-on-year basis this meant that the UK's GDP growth increased by 3.3% – a three-year high. However, growth is expected to slow in the fourth quarter as financial institutions continue to tighten lending both to the corporate sector and to households and as companies and consumers begin to feel the impact of the recent credit squeeze.

The strength of the pound is beginning to take its toll on the production sector. UK factory output declined in September this year by 0.6%, compared to a 0.5% increase in August 2007 according to the ONS. Manufacturing, which accounts for 15% of the economy, is starting to weaken as companies endure record oil prices and the strength of the pound makes their goods more expensive overseas and hurts export prospects.

The consumer sector, which has continued to see growth inspite of rising interest rates is likely to see slower growth as borrowing becomes more difficult, both in terms of personal credit and also mortgage lending.

There is clearly some risk of house prices falling, but these risks are likely to be mitigated by continuing housing supply constraints. The most likely scenario is for a slowdown in the housing market rather than a significant fall in prices.

Inflation

The CPI figure for October shows inflation at 2.1% – up from 1.8% in September. While in general the expectation is that inflation will remain around the Government's target rate, the threat still remains from rising oil prices as well as higher food prices.

Interest Rates

Interest rates were held at 5.75% in November and the expectation is that they will be left unchanged for at least this year given the strength of the economy in the third quarter and the strength of retail sales.

The decision on interest rates is unlikely to be straightforward. On the one hand, the cut in interest rates in the United States to increase liquidity is seen as a signal for interest rates generally to come down. This is especially true since the rise in Sterling, supported by a strong economy and higher interest rates, is beginning to impact on the manufacturing sector. The UK now has the highest rates compared to both the US and the EU. On the other hand, the risk of inflation rising due to a strong economy and rising oil prices, as well as further house price inflation, is likely to deter a cut in interest rates in the next few months at least. The expectation is that the Bank of England will wait for further economic data before taking action. Any evidence of a slow down in economic growth is likely to signal a cut in interest rates next year.

Medium-term Projections

The UK economy appears still to be in rude health despite the credit squeeze in the financial markets, which left Northern Rock in trouble after a run on the bank by depositors. For the moment the expectation is that the UK economy will slow down to around 2% next year. Consumer spending is expected to grow by around 2% and CPI inflation to remain around the Bank of England's 2% target level.

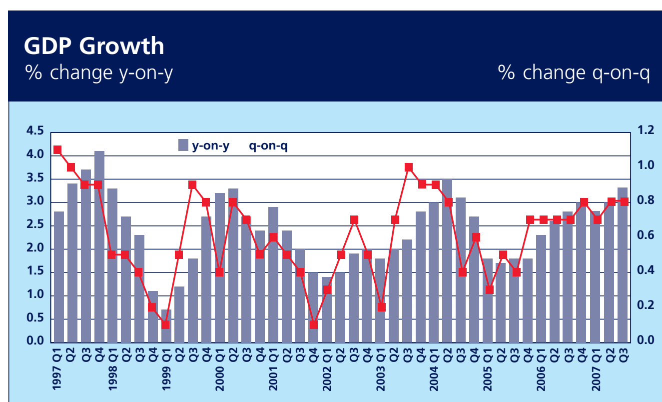
The damage to the US economy from the housing slowdown is intensifying and consumer spending is expected to slow to 1.6% next year. If the credit freeze moves into a full blown banking crisis, the US economy could slip into recession and find itself in a liquidity trap. Although this is unlikely, banking crises are rare but not impossible and therefore should not be entirely dismissed.

Prospects for the world economy, however, remain positive despite the recent turbulence in the credit markets. Growth is expected to be around 4.7% in 2008. Rapid expansion in China continues to underpin global growth. But the Chinese economy is beginning to be overheated with inflation running at 6.5% in August. As monetary policy is tightened economic growth is forecast to grow at 9.5% and 9.2% in 2008 and 2009 respectively.

Overall, so far the recent credit crunch appears to have bruised the various economies rather than hurt them, but there is a clear risk that the economy could slow substantially.

GDP Growth

% change y-on-y — % change q-on-q



Source: Office for National Statistics (ONS)

Medium-term Year-End Economic Forecasts

% change per annum

	2006	2007	2008	2009	2010	2011
GDP	2.70	2.80	2.40	2.40	2.50	2.50
Base Rates	5.00	5.75	5.25	5.00	5.00	5.00
Inflation (CPI)	2.30	2.40	2.00	2.00	2.10	2.10
Inflation (RPI)	3.20	4.00	2.80	2.60	2.60	2.90
Consumer Spending	2.00	2.50	1.90	2.00	2.50	2.50

Source: HM Treasury, NIESR

PROPERTY MARKET OVERVIEW

- **The investment market has seen an adjustment, but at present there is little evidence to suggest that the occupier market is set for a downturn.**
- **Total returns are to slow down sharply this year and next year, but to recover from 2009.**

Rental Growth

The commercial property market is becoming polarised between the occupier and investment markets, with the former continuing to show signs of growth and the latter beginning to slow down. Occupier-demand remains healthy and, if anything, has strengthened in 2007. The latest IPD data show rental growth at 3% in 2007 to the end of October 2007.

The office market continues to lead with rental growth of 6.7% so far this year. Our analysis of key markets around the UK shows activity levels are up on last year. In Central London take-up totalled some 9.7m sq ft and at this rate we expect the outturn for the year to be 13m sq ft. While the City market remains somewhat more vulnerable to the recent financial turbulence, the West End and Mid Town markets remain buoyant, benefiting from a broader occupier-base.

Elsewhere in the UK, our M4 Corridor report showed positive growth in Hammersmith and strengthening demand in the Thames Valley markets such as Reading (town centre), Slough and Maidenhead. The South Wales and South West markets have also experienced strong demand. In Cardiff, we have seen good levels of take-up with the city having seen its first rise in rental values to £20.00 per sq ft in several years.

The Northern markets, too, have seen strong activity. In Manchester take-up is expected to be similar to last year, while in Glasgow the market is expected to see around 700,000 sq ft of take-up by the end of this year – the highest ever. The city appears to have shed its legacy as an industrial city with the influx of financial and business services and is catching up fast with other key regional cities. Prime rental values in Glasgow have increased to £27.50 per sq ft – similar to Bristol and Edinburgh and only marginally below Manchester and Birmingham.

The driving force behind rental growth has been the rapid decline in the supply of Grade A space. While development is taking place, some markets such as Glasgow will continue to see an acute shortage of new space until 2009. The recent credit squeeze means that banks will become more cautious in lending money. Developers will also become more discerning in their choice of schemes, with some projects going on the back burner in the short term. This may not be such a bad thing, since it is likely to stave off the risk of an over-supply in the office market in the medium term.

In the retail market, we are on course to see 2% growth in rents in 2007. The consumer sector has proven to be more resilient than expected. With interest rates likely to come down from next year, we may well see rental growth at least similar to this year. With the economy expected to grow at trend rate from 2009, we expect rental growth to pick up to around 2.6% per annum, although this is below what we have seen in recent years.

In the industrial market, the expected fall in interest rates should also help the manufacturing sector and, therefore, demand for industrial space. The distribution market is heavily dependent on the consumer sector and retailing and the improvements in both as economic growth accelerates from 2009 should help to increase demand. The distribution sector is likely to benefit significantly from the rise in internet shopping, which is expected to drive demand for more warehousing and storage space. The improvements in trade and the significant growth in countries such as China and India, will further increase the flow of goods and will again improve demand for distribution and storage space.

Investment Yields

While the fundamentals in the occupier market remain sound and we expect further growth, the investment market has continued to see an adjustment. Property was the star performer during 2000-2006. However, performance has been entirely yield-driven. The intense competition for investment product saw yields falling to an all-time low, not only for prime assets but across the board. However, the market has seen a correction and we have seen a significant outward shift in yields in the last quarter. The adjustment, though expected, has been quicker and sharper than anticipated. The IPD data shows yields moving out from 4.57% in June to 4.71% in October. The adjustment has been evident in all three sectors of the market, with retail and industrial seeing the largest shifts. We anticipate yields softening further in the next few months, then stabilising from mid-2008 onwards in response to lower interest rates.

Total Returns

The outward shift in yields has already had a significant impact on capital values and total returns. The IPD monthly data shows total returns of -1.5% during the month of October. For the calendar year 2007, total returns were 1.8%.

In light of recent evidence we have downgraded our total return forecast for the sector as a whole to 1.0% this year, with the office market outperforming. For next year, we are expecting total returns of -2.7% and as yields stabilise from 2009 we anticipate returns will recover to 6.5% and 7.7% in 2009 and 2010.

The Investment Market

The impact of lower returns is already evident in the investment market. According to our quarterly *UKIT Report* published in late October, the total volume of transactions in the first three quarters of 2007 was £39bn. This compares with £47bn in the same period last year. The market is expected to slow down further in the months ahead. We have already seen institutional investors reducing their exposure to the sector. However, on the positive side, we are beginning to see the return of debt-investors to the market, particularly those with funding in place, as yields shift out and the prospects for a fall in interest rates improve. The turbulence in the equity markets is also likely to serve as a reminder of the volatility of the stock market, reinforcing property's benefits as an investment medium. Among all the doom and gloom which currently characterises much of the media covering the property market, it is important to bear in mind that the slowdown in the investment market has been an inevitable consequence of an overheated market and that the fundamentals of the occupier market in terms of demand and supply remain healthy.

Mike Thatcher and Ezra Nahome Investment
United Kingdom House, 180 Oxford Street
London W1D 1NN
Tel: +44 (0)20 7198 2000 Fax: +44 (0)20 7198 2210
E-mail: mthatcher@lsh.co.uk and enahome@lsh.co.uk

Dr Arezou Said Head of Research
United Kingdom House, 180 Oxford Street
London W1D 1NN
Tel: +44 (0)20 7198 2000 Fax: +44 (0)20 7198 2001
E-mail: asaid@lsh.co.uk

Details of other Lambert Smith Hampton research material can be viewed on our web site at http://www.lsh.co.uk

© Lambert Smith Hampton November 2007.

This document is for general informative purposes only. The information in it is believed to be correct, but no express or implied representation or warranty is made by Lambert Smith Hampton as to its accuracy or completeness, and the opinions in it constitute our judgement as of this date but are subject to change. Reliance should not be placed upon the information, forecasts and opinions set out herein for the purpose of any particular transaction, and no responsibility or liability, whether in negligence or otherwise, is accepted by Lambert Smith Hampton or by any of its directors, officers, employees, agents or representatives for any direct, indirect or consequential loss or damage which may result from any such reliance or other use thereof.

All rights reserved. No part of this publication may be transmitted or reproduced in any material form by any means, electronic, recording, mechanical, photocopying or otherwise, or stored in any information storage or retrieval system of any nature, without the prior written permission of the copyright holder, except in accordance with the provisions of the Copyright Designs and Patents Act 1988.

Warning: the doing of an unauthorised act in relation to a copyright work may result in both a civil claim for damages and criminal prosecution.

Lambert Smith Hampton

Property Solutions

www.lsh.co.uk