Derivatives

Property Derivatives Market Overview
June 2009

UK IPD swaps

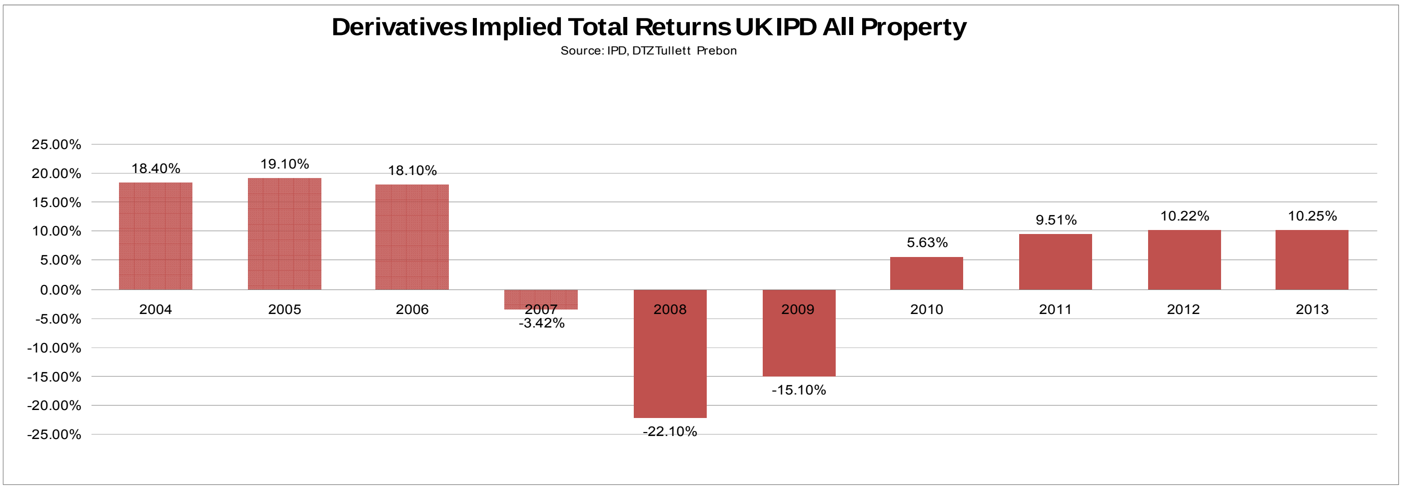
In our Property Week article, we mentioned the vast array of sport taking place over the next few months. In fact, the UK commercial property swaps market has mirrored another fine English institution – Glyndebourne. June has seen the market achieve a tranquillity and calm not seen this year, or last for that matter!! Prices have been remarkably stable.

The entire curve has drifted higher, particularly the front end, suggesting an improvement in sentiment. However, a look at DTZ's Money into Property report would soon provide a reality check. The mid price of the 2009 contract is currently -15.1%, which with the index already down 10% to the end of May and therefore seven months remaining, seems high. Admittedly the monthly valuation cuts appear to be stabilising, but still the macro-economic outlook is actually worse today than it was a year ago.

One reason for the 2009 contract moving higher is the demand for outperformance structured notes. For anyone benchmarked to IPD and who does not wish to tie up their cash for long periods, these products still make perfect sense. Inevitably, as more of these are bought, so the price moves higher.

The 2010 contract has also rallied. Uncertainty still surrounds 2010. The current price implies a total return for 2010 of around the 5% mark. Assuming a yield of 7%, that's a further 2% fall in capital values. It's very hard to call what is going to happen in 2010 and as such this contract has the potential to be volatile.

Beyond 2010, swap prices are not a great deal different from June 1st. There is certainly more activity in the shorter maturities, but there is liquidity beyond 2011.



Contract	Price as at 1/06/2009	Price as at 24/06/09
Dec 09	-16.75%	-15.1%
Dec 10	-7.00%	-5.3%
Dec 11	-1.25%	-0.60%
Dec 12	1.75%	2.00%
Dec 13	3.00%	3.25%

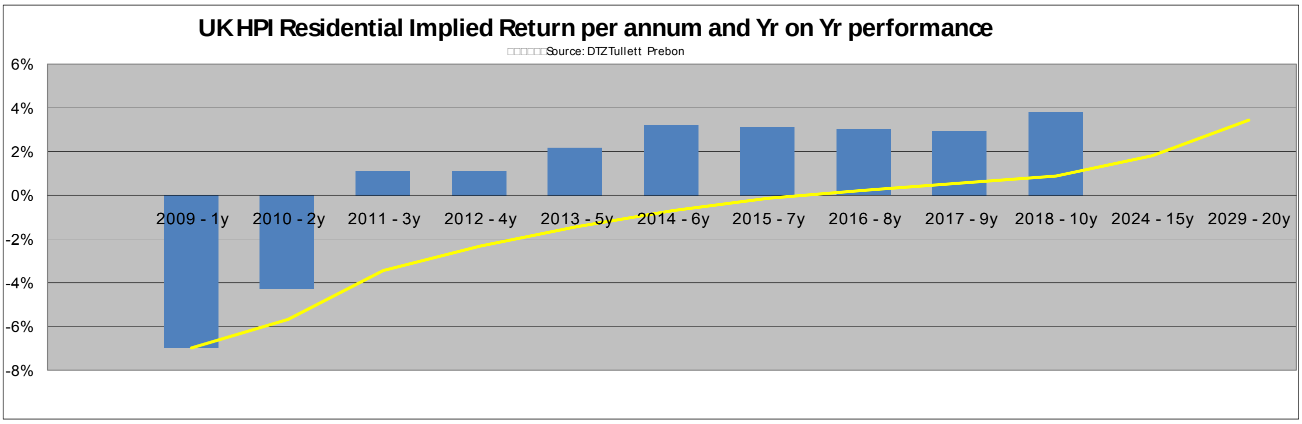
UK Residential Market

The non-seasonally adjusted HBOS house price index is **up** 1.5% so far this year. With all the doom and gloom surrounding house prices and the economy this is something of a surprise. When the monthly data is released, HBOS always suggest looking at the data over a period of months to get a clearer picture of what is really happening, than to go on just one month's results. Well, this year's results have been fairly topsy-turvy but after 6 months, to be up 1.5% has certainly impacted residential derivative prices.

As recently as the beginning of April prices were suggesting the index would be 20% lower in Dec 2009 from Dec 2008. Now, the mid is 93, indicating a 7% fall over that period. The 2y contract (Dec 08-Dec 10) has rallied even more. In mid March the mid price was 72, or a 28% fall in the index. Today the mid is 88, or a 12% decline.

Contract (Dec 08 -	Price as at 1/04/2009	Price as at 24/06/09
Dec 09 / 1y	80	93
Dec 10 / 2y	72	88
Dec 11 / 3y	73	89
Dec 12 / 4y	74	91
Dec 13 / 5y	76	93
Dec 15 / 7y	81	99
Dec 18 / 10y	95	109

These prices now make interesting reading and support the theory that derivative markets tend to 'overshoot' physical markets. But where now? These prices imply the index should bottom out some time next year, followed by a slow recovery. With unemployment levels, interest rates and mortgage availability all extremely difficult to predict in the current environment, so too are derivative prices!!



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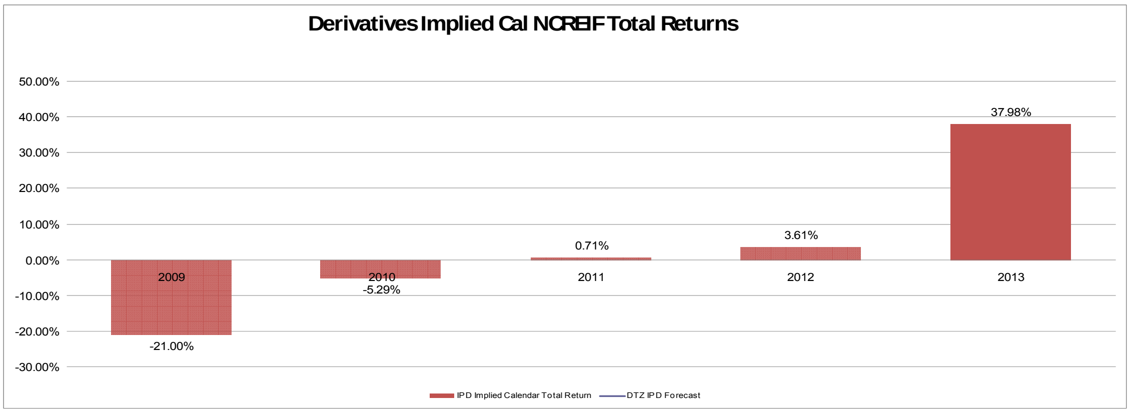
US Property Swaps

Just as in the UK, commercial property swaps appear to have stabilised slightly this month. The overall feeling of a full blown recovery is still quite a way off though, and the swaps prices are still quite negative, even compared to the underlying. Worries still persist over rental declines and tenant defaults. In the derivatives market, particular interest remains in Dec 09 NCREIF, which has remained at a mid of -21%, and the dec 10, also relatively stable at -13.50. The table shows the total returns for the next five calendar years, and how the derivatives market is not expecting a positive return until 2011.



There is some light to be glimpsed at the end of the tunnel, as evidence emerges that investors are returning to the market. One such example involves RCG Longview signing a contract with Deutsche Bank AG to purchase Worldwide Plaza, a Manhattan office tower that was part of an ill-fated portfolio of skyscrapers acquired by developer Harry Macklowe at the top of the market.

This month also witnessed the launch of the US IPD Index. With ten years of historical data in the US, and a wide berth of valuations, it will be interesting to see how the market reacts to the index moving forward. There have already been prices on the IPD index at similar levels to the NCREIF, and data will be released on an annual and quarterly basis.

RPX – US Residential

The RPX composite increased for the first time since the peak in June 2007, a recent report by Radar Logic showed. The increase of 1.2% for the month of April, whilst encouraging, should be viewed with caution as there is an element of seasonality in the figures. US house prices are 33% down from their peak with the RPX derivatives market implying a further 17% fall to the trough. Despite US home sales unexpectedly falling 0.6% in May, there has on the whole been a mirroring of the improved sentiment in the UK in the physical market, and hopes are high for this to start to trickle down into the derivatives volumes. This was reflected in the RPX curve which has rallied over the last week in the longer end. The 2yr traded at 155.75 in the last couple of days, and further buying interest was seen in this maturity. The 3 and 4 year have also rallied, the latter now with a mid of 165.

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