

UK Commercial Property

Dec09 contract reaches flat, as improved sentiment is built on shaky ground

It would have been unfathomable just six months ago, but after a sustained period of strong rallying, the price of the dec09 contract reached 0% this week. This followed this month's strong IPD number (1.63%) and further positive sentiment that the market is set to continue in a similar vein of investment inflow and a stabilising occupier market. This is ratified in the investment market by Goldman Sachs' statement that they have raised \$6.3bn for Real Estate investment with UK as their 'most wanted', and Savills forecasting that there is an estimated £530m of commercial property for sale in central London, with £7.5bn of money competing for it. In the occupier market, Land Securities, Britain's biggest property company, announced the end of "across the board" rent concessions and vacancy rates reduced to 7.2% (CBRE). And, with DTZ stating this month that, 'we expect to see Central London rents rise, on the back of tight supply,' things are looking up for landlords.

This positive news from the world of real estate comes in the same month that unemployment hit 7.9%, actual Government debt is forecast at £3.2 and the Office of National Statistics released quarterly forecast figures confirming that the UK was still in the grip of recession ('public enemy number 1'), with the economy set to contract by a further 0.4% in Q3, the first time on record we have witnessed 6 consecutive monthly contractions. This seems a rather perverse scenario as the recent rally is not based upon sound fundamentals, merely an influx of buyers seeking better returns than alternative investments (interest rates held at 0.5%, gilts at 3.6%) and taking advantage of historically low prices. In addition, we have overseas investors looking to make currency plays and banks reluctant to foreclose on covenant breaches, which is constricting supply further.

So, what of the derivatives market? See below for updated pricing for the UK IPD All property, Total Return Swap.

Figure 1. IPD All property Swap Prices (31/07/09 – 30/10/09)

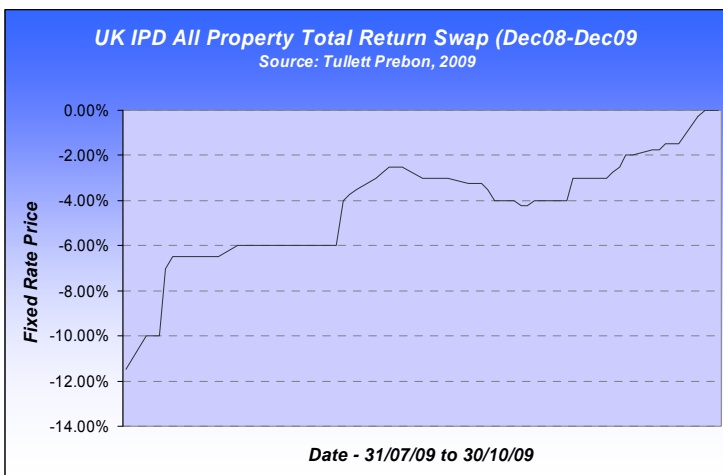


Figure 2. IPD All property Swap Prices (30/09/09)

(Source Tullett Prebon)

Contract Dec 08 – Dec XX	Price at 30/10/2009	Price at 15/10/09	Price at 30/09/2009
Dec 09	-0.0%	2%	-4.0%
Dec 10	5.3%	4%	2.7%
Dec 11	5.5%	5.5%	4.75%
Dec 12	5.8%	6.25%	6.0%
Dec 13	6%	6.6%	6.25%

Figure 1. shows how the Dec09 contract has rallied in the last 3 months from it's value of -11.5% at the end of July to it's current level at 0%. Figure 2. shows how, although the short end pricing has rallied strongly, longer dated contracts have fallen from their mid-month pricing on the back of mid-term economic uncertainty.

It is also worth noting that there has been increased activity and confidence in the European investment market. CBRE reported that European investment was at €17.3bn during Q3, up 34% from the previous quarter. There was also a landmark purchase in Paris by LaSalle this week, as Le Bleriot building was

bought for €100m. This improved news in the French market has not manifested itself significantly in the French IPD pricing, with a meagre 50bps increase during the month in the dec09 contract currently at -8.5% mid. With the French economy out of recession, European real estate significantly up, and bearing in mind what we've seen in the UK market, perhaps herein lies an opportunity?

UK Residential Property

Has the recent rally slowed?

With UK house prices running away with themselves in recent months, the recent Nationwide and Land Registry numbers (+0.4% and +0.9% respectively) may suggest that things are slowing to a more sustainable level. The Halifax HPI number, due out next week will be telling. We continued to receive mixed messages this month – roaring for the bears in blue corner we have with the negative unemployment and GDP figures, Hometrack reporting a reduction in new property instructions and the foreboding presence of interest rate rises towards the end of next year. Julian Crush of Fitch summed this mood up in stating, “Fundamental indicators, including limited mortgage availability and stretched affordability, point towards a period of stagnant growth at best, or at worst a double-dip contraction. U.K. house prices could fall 30 percent from their October 2007 peak, and are currently down just 13 percent.”

In stark contrast to this, and bolstering the bulls in the red corner were the British Banking Association reporting a 72% increase in mortgage completions (year on year), HSBC's Martijn van der Heijden, who said, “There is a new optimism among buyers that house prices will not fall any further” (and so committed £500m to 90% LTV mortgages) and Liam Bailey, head of residential research at Knight Frank, who boldly forecast that, “By 2014, London prices will be 38% higher than today while the national gain will be 19%.”

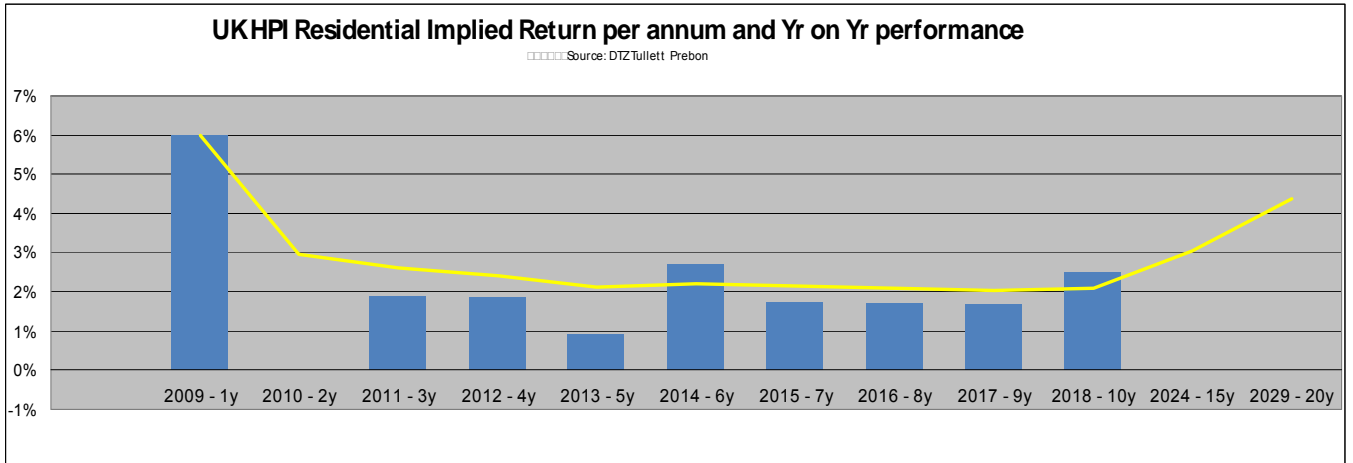
This heavyweight contest has ended a split decision with HPI derivative pricing showing very little change during the month. Following the Halifax HPI figure of 1.79% (non-seasonally adjusted) on the 6th month, where prices jumped 300-400bps across the curve, things have remained rather static. The 1y and 2y contracts are at 106%, with a modal increase of 2% per annum down the curve to the 10y contract priced at 123%. If this very recent activity seems uneventful, consider the 1y contract price of 94% mid at 31/07/09, a full 12% rally in 3 months! Fig. 3 compares HPI pricing at 31/07/09 with 30/10/09, whilst Fig. 4 shows implied annual returns at current pricing.

With pricing over the last week remaining generally static, we wait with baited breath for next week's Halifax HPI number.

Contract Dec08-	Price as at 31/07/2009	Price as at 30/10/2009
Dec 09 / 1y	94	106
Dec 10 / 2y	89	106
Dec 11 / 3y	90	108
Dec 12 / 4y	91	110
Dec 13 / 5y	93	112
Dec 15 / 7y	100	116
Dec 18 / 10y	112	123

Fig 3. HPI forward contract prices, 31st July 09 v 30th Oct 09. (Source Tullett Prebon)

Fig 4. Halifax HPI Forward Contract Prices (30/09/09)



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