

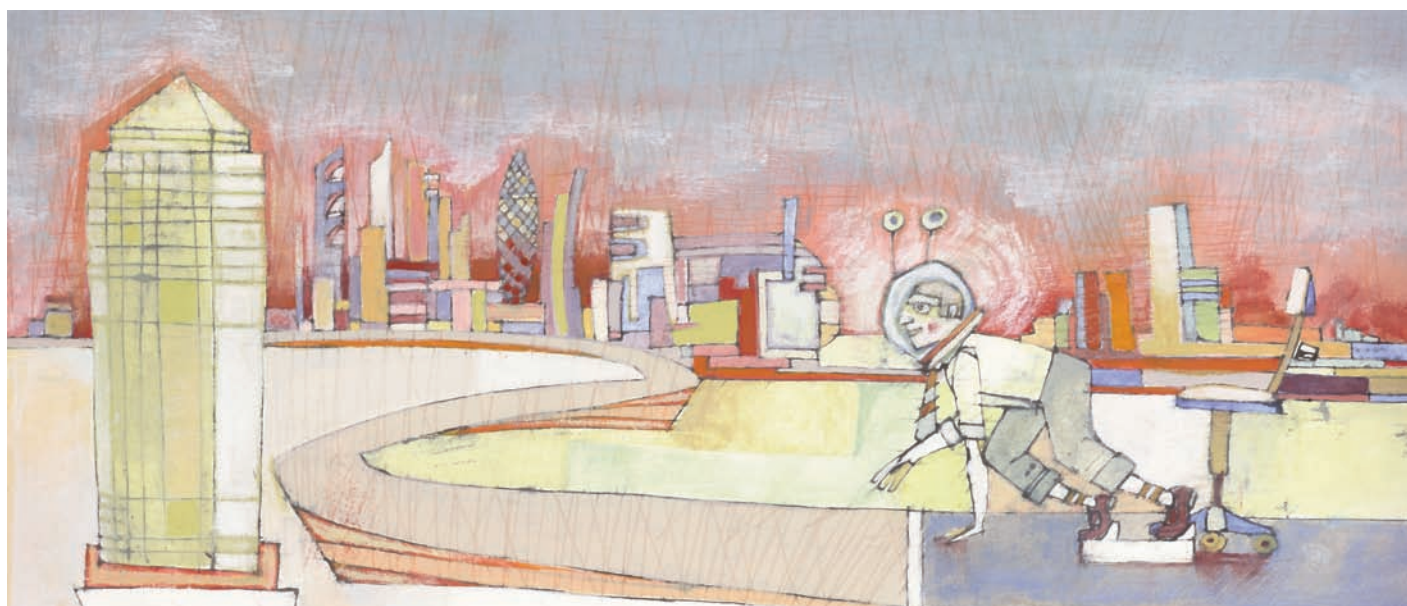
Is commercial property fit for the future?

As the UK economy fell into recession last year, inflationary expectations dived and official interest rates were slashed. More recently, monetary authorities have resorted to more innovative tactics to try and kickstart growth. In a perfect world investors would benefit from an option which combines the relative security associated with bonds now, coupled with the growth potential of equities in a few years time. Commercial property has these attributes and investors can build portfolios which are defensive in the short-term but naturally convert over time to a position to benefit from growth explains Legal & General Property's Head of Research, Robin Martin.

We're all familiar with the fact that different asset classes react differently to inflation. While cash and fixed income securities may offer security when financial markets slide, history has shown that over the longer term many of these investments fail to keep pace with inflation. Alternatively, the returns from 'real' assets such as equities, commodities and commercial property have provided better protection against the wealth eroding effects of rising prices. The asset allocation decision, then, depends

critically on one's view on inflation. And here investors face a particularly tough call. Over the past several years, inflation expectations have moved around substantially. While this volatility has been most pronounced over the short-term, by measuring the difference in yield between conventional and inflation-linked government bonds (figure 1) it is clear that the uncertainty has also spread to the longer-term horizon.

Against a backdrop of heightened uncertainty associated with recession, governments and monetary authorities across the globe have undertaken unprecedented policy easing – cutting taxes, reducing official interest rates towards 0% and even engaging in 'quantitative easing' (essentially printing money). As a result, the risk is that we may move to a far more inflationary environment once economic growth resumes. Should this be the case, the need



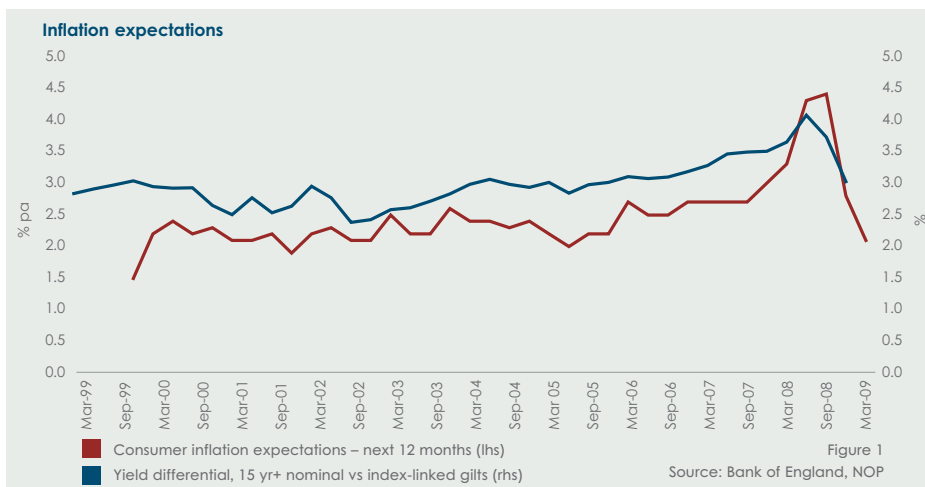
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for investors to hedge against inflation risk will become all the more urgent.

A better deal

At the moment the cost of a conventional hedge against inflation does not come cheap. At 1.00-1.25%, the real yield on medium-term index-linked gilts represents a high cost of insuring against inflation risk. As a result, investors have had a strong incentive to examine other avenues for protecting their portfolios against inflation.

A recent report from EDHEC (“Alternative Investments for Institutional Investors”, EDHEC Risk and Asset Management Research Centre, January 2009) argued that ‘novel’ liability matching solutions, which included commercial property and commodities, could deliver the same degree of inflation-hedging for long-horizon investors, at significantly lower cost than those based purely on index-linked securities or inflation swaps. But how reliable is the inflation hedge from commercial property? To provide an answer, we review the historic record for direct UK commercial property as well as its prospects and the strategies available to investors in commercial property.

Rising rents

Rising property incomes are primarily driven by growth in rents. The most reliable data for commercial property rents comes from the Investment Property Databank (IPD) Annual Index; but their figures only stretch back to 1976. By using several other sources,

we have estimated the figures back to 1973. Figure 2 plots rental growth against RPI inflation. We have chosen 1977 as the starting point for the period over which we assess property’s record as an inflation hedge, since it represented a fairly even point in the cycle, where inflation and rents were broadly in step.

Between 1977 and 2008, rents grew by an average of 4.5% pa, compared to 4.9% pa for RPI inflation. So rents have trailed somewhat behind RPI. But we know that RPI has been boosted, particularly in recent years, by the boom in house prices; the ONS estimate of CPI inflation, which strips this out, comes out around 0.6% pa below the average for RPI since 1989. Assuming that house prices rise more gradually in the future, the record suggests that rental growth will be able to match both RPI and CPI inflation over the long-term. But as figure 2 shows, the property cycle is alive and well!

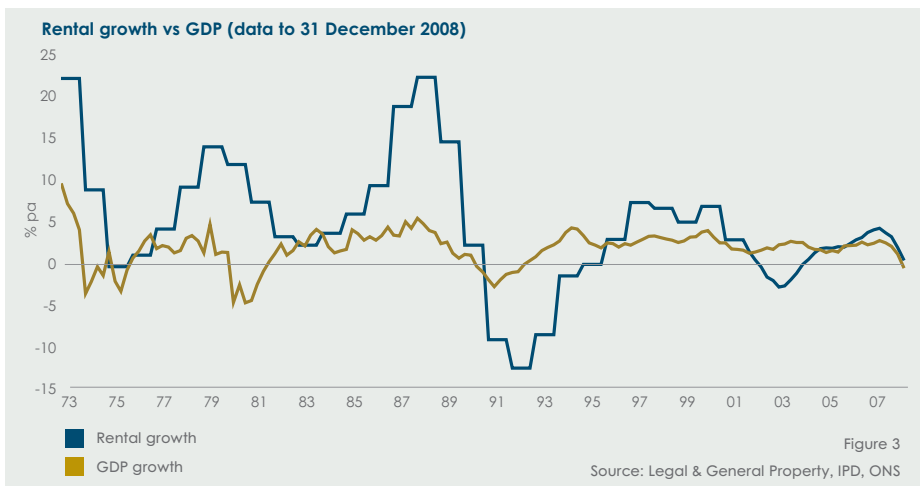
Rental growth has been more cyclical than inflation and at times has deviated quite sharply; two examples being the mid-1970’s and then the late 1980’s/early 1990’s. So timing is important and one needs to consider what is happening in the real economy as well as what is driving inflation when considering property’s potential as an inflation hedge.

We take a straightforward view, which is that rents are a function of the relative demand for and supply of property. Demand comes from growth in the economy and supply from the delivery of new and refurbished space. The two periods mentioned above when rental growth showed a particularly different trend to that in RPI coincided with major swings in the economy (figure 3); the mid-1970’s saw two recessions (in 1973 and 1975) whilst in the second period the UK experienced the classic ‘boom-and-bust’ which led to a long recession during 1990-91. But it is also clear that there is a substantial lag between movements in the economy and movements in rents; while in the early 1990s economic growth bottomed out in 1991, rents took a further year before they hit their low point. Furthermore, it wasn’t until 1996 that rental growth rose above the rate of GDP growth.

Trends in the construction of new space are key to explaining this lag; when the economy is growing and rents are rising, developers commence new schemes in anticipation of strong demand from



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occupiers; since those schemes take time to complete, space is often delivered just when the economy has peaked and demand is slowing, putting pressure on rents. The clearest example of this was the late 1980's/early 1990's; construction output peaked in 1989 just over a year after the economy and conversely troughed in 1992, some 18 months after economic growth had bottomed out. So trends in construction help to explain why rental growth sometimes lags behind GDP growth and inflation. And more broadly, while property rents have generally matched inflation, trends in the economy and the lags introduced by the construction cycle tend to determine the timing of rental growth.

Where now for rents?

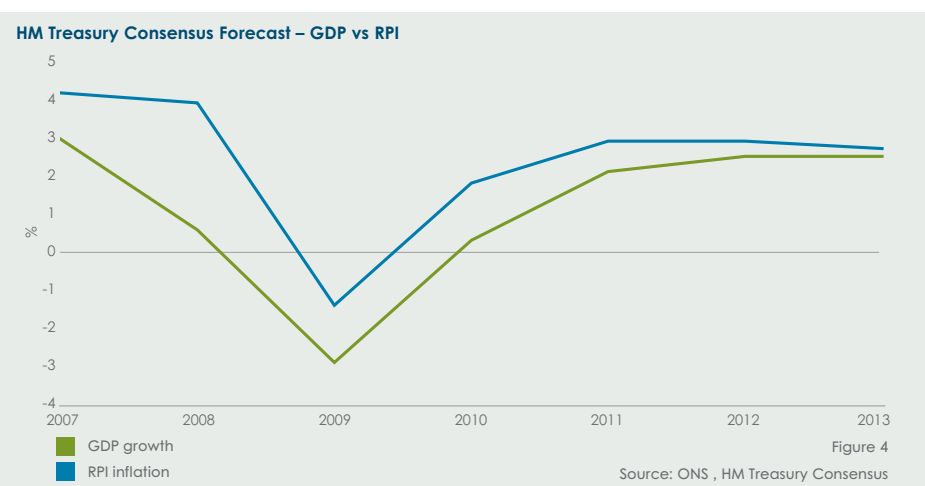
There's little doubt that the short-term outlook for the economy during 2009 and 2010 is very difficult, which will bear down on demand for property. On the supply side, while there was a substantial volume of new space delivered during 2006-7, the scale of this was nowhere near as big as in the late-1980's and indeed development activity has been cut back sharply. While there may be excess supply in certain parts of the market over the next several years, our view is that the hit to rents in this cycle will not be as severe as in the last recession.

A return to an inflationary environment?

Beyond the short-term, the consensus expectation is that the monetary and fiscal easing currently being brought to bear will eventually lead to a recovery in the UK

economy that will also feed through into a pick-up in inflation; the HM Treasury consensus for February 2009 (the latest medium-term view) put GDP growth in 2012-13 at 2.6% pa and RPI inflation at 2.9% pa (figure 4). In that environment, demand for commercial property should improve and with supply less of an issue than in the last recession, this should feed through into rents relatively quickly, enabling property to perform the role of an inflation hedge.

But there are huge risks around this forecast. The impact of falling asset prices, credit restrictions and a large amount of spare capacity could all contribute to a medium-term deflationary spiral. Conversely, massive monetary and fiscal easing could prove highly effective in stimulating the economy, setting off a bout of inflation that government may tolerate for a number of years for fear of choking of the recovery.



And we could yet see a return to 'stagflation'; in one scenario, concern over the public finances could see a sell-off in gilts alongside a run on sterling, which would push up both imported inflation and risk-free interest rates in the absence of any improvement in the real economy.

Bond-like protection, equity-like opportunities

We've already explored the history of rental growth, which leads to a long-term increase in property incomes. But the contracts used to lease space also provide some downside protection; UK leases are relatively long and generally have upward-only clauses which protect against reductions in rent. Even in the depths of the early 1990's recession, IPD data show that property incomes remained in positive territory, despite the sharp reduction in market rents, reflecting this downside protection (figure 5). So property incomes combine much of the defensiveness of a bond with the potential for growth offered by an equity.

The combination of defensive and growth characteristics for commercial property mean that as an asset class it has the capacity to perform better than equities in a deflationary world and better than bonds in an inflationary scenario; as such, it provides some protection against either scenario relative to some of the alternatives. But there is no doubt that the stagflation case would prove more problematic; we have already seen that

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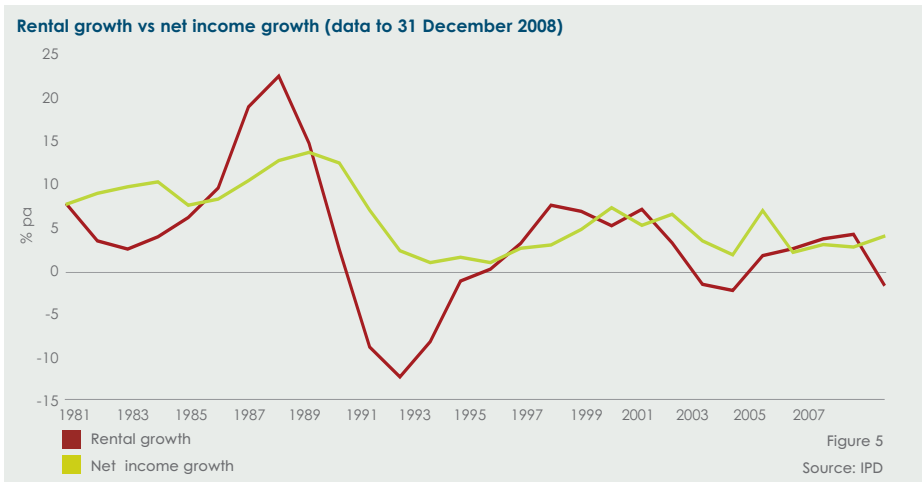
property relies on growth in the economy to support rental and income growth. Without that, property's inflation-hedging characteristics are likely to prove weaker than has been the case in the past.

Made-to-Measure Strategies

That's the picture at the asset class level. But since investors buy specific properties, not the asset class itself, it is possible to tailor portfolios to investors' specific expectations for the economic backdrop. Individual properties differ in their defensive and growth characteristics; a defensive asset will have a long lease to a stable tenant, ensuring that income will be steady and reliable. A growth property, on the other hand, contains less certainty with regard to the stability of lease payments and may, for example, be an older building with a low income which has the potential to earn significantly more following a refurbishment. Such properties are more sensitive to the rental cycle.

To illustrate, figure 6 shows the difference in capital performance between defensive (defined simply as those with more than 15 years still on the lease) and growth properties (those with less than 5 years) in the South East office market since the early part of this decade. When rents fell in 2002-3 in the wake of the technology bust, there was significant outperformance for defensive properties relative to growth stock. As rents started to pick up, the growth stock saw the best performance. More recently, as rents have come under pressure, the outperformance of defensive stock has re-emerged.

Investors wishing to protect against deflation should go overweight on long-let properties to safe tenants where the income will be secure if rents fall. Equally, those focusing on the risks of inflation can go long on riskier assets in cyclical parts of the market which will benefit from an early upswing in the economy. There is also an option which can provide protection against stagflation; properties let on long



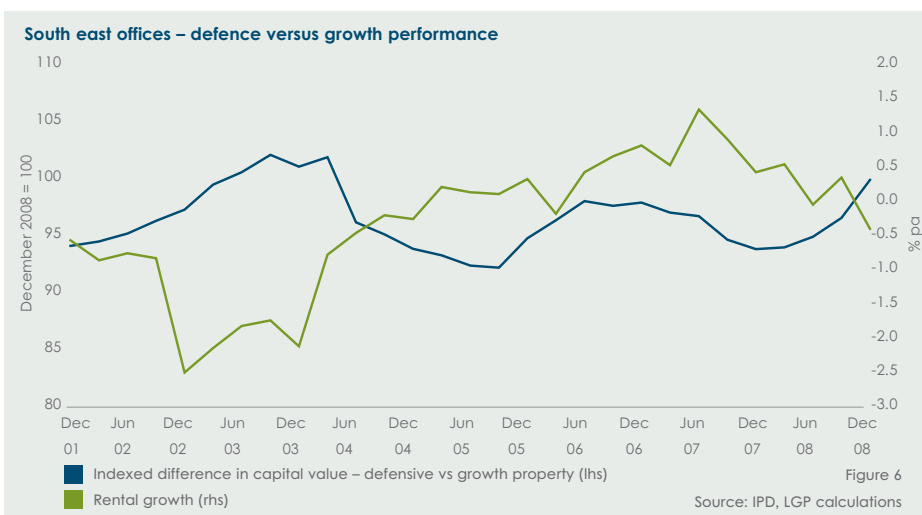
index-linked leases to strong tenants provide much of the inflation security of an index-linked gilt.

As leases shorten, assets naturally become increasingly dependent on growth and sensitive to the state of the occupier market for their investment return. Using this life-cycle attribute of property, investors can create portfolios which are defensive in the short term but that will naturally convert over time to be positioned to benefit from growth without bearing transaction costs. This 'convertible' characteristic of property is one of its distinctive characteristics versus most other asset classes.

A balanced outlook

Commercial property has had a good record of matching inflation over the long term, though the rental cycle is very much driven by the prevailing supply / demand

dynamics and a return to stagflation would threaten this performance. While conditions in occupier markets are likely to remain difficult in the short term, an eventual recovery in the economy should feed through into property rents. However, there are very major risks around a consensus-style view of the economy, both on the upside and downside; the blend of defensive and growth characteristics for property provides some protection against either scenario. Furthermore, the specific features of the asset class mean that investors can tailor their portfolios around their expectations for the investment landscape, and benefit from the life-cycle experienced by individual properties to build portfolios which naturally convert over time from being defensive to a position where they can benefit from growth.



Market Overview

Governments and monetary authorities across the globe have now orchestrated a swift, synchronised and solid policy response to the banking crisis which brought the financial system to its knees last year. While the global backdrop remains weak, recent economic data have started to show some tentative signs policy measures may be starting to take effect.

In response to slower consumer spending, stalling business activity and rising unemployment, the world's major monetary authorities have been slashing official interest rates towards zero and quantitative easing (essentially printing money) is now underway in the US and the UK. We believe that growth will begin to recover later this year, supported by an improving housing market, lower energy prices and easing credit conditions driven by these aggressive policy responses. However, while growth will be roughly aligned across developed economies, equity market performance remains a function of how significantly the cyclical downturn has already been priced in.

Equity Overview

UK Signs of improvement?

After declining -7.2% in February, the UK equity market rose 2.8% (as tracked by the FTSE All Share price index) during the month of March. As economic growth slows and unemployment rises, people have reduced their spending and company profits remain under significant pressure. However, falling mortgage rates, a combination of lower energy prices and a weaker pound and improvements in household balance sheets have begun to support the UK economy.

Recent economic data appear to be showing tentative signs of stabilisation and it seems possible that the UK economy undergoes a gradual recovery beginning later this year.

While risks remain that policymakers fail to stop unemployment rising or that households decide to rebuild their savings more quickly than expected, we believe the outlook for the UK economy will be supported by improving manufacturing activity and improved confidence over the next few months.

US Printing a recovery

With official interest rates essentially at 0%, the Federal Reserve (Fed) has taken innovative steps to attempt to get credit markets functioning normally and help households and businesses obtain loans again.

In addition to their traditional role of providing short-term liquidity to financial institutions, the Fed has also developed the tools to provide liquidity to borrowers and investors in key credit markets directly and is purchasing longer-term securities such as the debt of government-sponsored enterprises (GSEs).

The extent of recent efforts should start having effect, however, we believe credit market conditions will remain difficult for some 18 months as banks move to re-coup losses and rebuild their capital base. Crucially, the US housing market needs to improve. For once house prices begin to stabilise, banks can quantify their losses and resume lending again.

US equities rose 7.9% (tracked by the FTSE All-World North America price index in sterling) in March after falling -9.5% during February.

EUROPE German cars sell

As lending conditions have deteriorated, access to trade credit has become prohibitively expensive and as a result global trade came to an abrupt halt and continues to struggle. While this caused significant issues for the world's second largest exporter, Germany, very recent car sales data has been strong suggesting that the government's policy response has been effective. We expect the recession to last through 2009 before a recovery in 2010 takes place.

The European Central Bank (ECB) aggressively reduced official interest rates during the end of 2008, and continues to reduce them in 2009 (albeit slower than its peers in the UK and US). Given how far manufacturing activity has fallen, it appears likely that the ECB will need to continue to reduce rates (to as low as 0.5%) and may follow suit with the US and UK, undertaking quantitative easing in order to stimulate growth.

European equities, as measured by the FTSE AW – Developed Europe (ex UK) Price Index, rose 8% in March after declining -10.2% during February.

Major Equity Markets – Total Returns £ 2008/2009



Figure 1

Source: Datastream, FTSE indices shown

Equity Overview Contd.

JAPAN

Signs of strength

After declining significantly in February, the Japanese equity market strengthened towards the end of the period to close 0.8% higher during the month of March (as measured by the FTSE AW-Japan price index in sterling).

Economic data in Japan has remained very weak during 2009. Housing investment and house prices both remain in decline, business fixed investment has deteriorated and consumers have reined back spending even further. As Japan's major trading partners economies have slowed, exports have also suffered and industrial production has slumped.

In March, Japanese equities strengthened as signs that the global economic backdrop may be stabilising emerged. Investors sought comfort from the extent of recent government stimulus plans and monetary authorities' rapid, coordinated policy easing.

ASIA / EMERGING MARKETS

Cheap cars for Chinese farmers

Since the end of last year, the dramatic decline in the availability of trade finance and the consequences this has for global trade has weighed on Asian equity markets. The Baltic Exchange Dry Index (a common barometer for global trade volumes) collapsed towards the end of 2008 and while it has risen significantly from its lows in December, it remains some 90% below where it was mid-2008.

As global trade begins to stir again, there have been improvements in export data and industrial production data in Korea and Thailand. There have also been signs of economic strength from three out of the four BRIC countries (Russia remains the exception). In March, the Chinese government announced it would subsidise cars and motorcycles in rural areas and forecast GDP growth for 2009 to be as high as 8%.

Equity markets rallied during March. As a whole the market moved 14.6% higher during the month (as measured by the Asia Pacific Ex Japan price Index), with the best returns coming from South Korea, Indonesia and China. The rally came following positive economic news from across the globe, notably out of the US where banking liquidity programs and quantitative easing appears to be taking effect. While stocks have risen from technically oversold levels, further gains may subside as companies take measures to rebuild their balance sheets and consumers move to replenish their savings throughout many developed economies.

Fixed Income

After falling to record lows in December, US Treasury bond yields rose from 2.2% to 3% during the March quarter of 2009. UK ten-year gilt yields rose sharply from 3.0% to 3.6% during the same period of time. This was largely on the prospect of an unprecedented increase in new issuance to fund the recapitalisation of the UK banking system and the worsening budget deficit. European government bond yields rose slightly (from 3.0% to 3.1%) as the prospect of ratings downgrades for smaller European markets and the debt levels of Western European banks continued to unsettle investors.

Credit markets endured another volatile quarter. The prospect of a sharp rise in credit defaults overhangs the market, while cyclical sectors are particularly vulnerable to ratings downgrades. However there was strong demand for new issues, particularly in non-cyclical areas such as healthcare.

Major Bond Markets – Total Returns £ 2008/2009



Figure 2

Source: Datastream

Snapshot

Consumer confidence

Consumer confidence is extremely depressed in the developed world. This reflects rising unemployment and falling asset prices. US consumer confidence has failed to improve in recent months. Does this mean that consumer spending will continue to contract at a rapid pace? We're not sure. Historically, consumer spending has recovered even though consumer confidence has remained depressed.

Take the early 1990s for example (figure 1). Consumer spending was falling in early 1991 but grew by 3% around a year later even though consumer confidence remained depressed. We believe this reflects two factors.



First, the change in consumer confidence appears to be as important as the level. If consumers move from being optimistic to being pessimistic, they will undoubtedly cut spending. For example, instead of buying branded toothpaste with extra features such as 'whitening' or 'sensitive' they might buy a supermarket's own brand value range. If they remain depressed, they will continue to buy the cheaper product. But will they continue to cut spending? Will they no longer clean their teeth? There are obviously some limits to how often consumers can retrench spending.

Second, we need to take into account the availability of credit. Consumer confidence is a good proxy for the demand for credit. If consumers are feeling optimistic they will be more willing to take on debt. But if banks are unwilling to lend, spending might be weak even if consumers want to spend. For example, their car loan application might be refused.

Figure 2 shows the results of a simple model of consumer spending based on the level and change in consumer confidence and a measure of credit availability (the willingness of banks to provide consumer durable loans). Given the recent uptick in credit availability, this model suggests consumer spending growth can return to positive territory, even if consumer confidence remains at low levels.



UK Forecast

More optimistic than the market

UK Economy		Price Inflation (HICP)		GDP (Growth)		10 Yr Gilt Yields		Base Rates		\$/£		£/Euro	
		Average 2009	Average 2010	Average 2009	Average 2010	End 2009	End 2010	End 2009	End 2010	End 2009	End 2010	End 2009	End 2010
Market participants forecasts		%	%	%	%	%	%	%	%	%	%	%	%
High		3.60	2.70	-1.30	2.00	4.60	5.10	1.00	n/a	1.75	1.78	0.99	1.00
Low		0.30	0.70	-4.10	-0.30	2.75	2.75	0.00	n/a	1.30	1.35	0.73	0.67
Median		1.00	1.30	-3.30	0.40	3.08	3.34	0.50	n/a	1.50	1.59	0.87	0.80
Last month median		1.00	1.60	-2.70	0.70	3.15	3.83	0.50	0.50	1.50	1.58	0.87	0.82
Legal & General Investment Management		1.30	1.90	-3.00	1.60	2.75	3.50	0.50	0.50	n/a	n/a	n/a	n/a

Source: Bloomberg and LGIM estimates

Amidst the current volatile environment, the table has been altered to extend the range of forecasts to capture a greater sample size. This now reflects more up-to-date adjustments. The forecasts above are taken from Bloomberg and represent the views of between 20-40 different market participants (depending on the economic variable). The 'high' and 'low' figures shown above represent the highest/lowest single forecast from the sample. The median number takes the middle estimate from the entire sample.

We spent most of last year more pessimistic on the outlook for the global economy than most market participants. However, as the world has spiralled into recession, economists have wound back their forecasts, and we now find ourselves largely in-line with consensus. The exception, however, is in regards to the UK economy.

This month the median forecast from a Bloomberg survey of market participants shows the UK contracting -3.3% in 2009 and picking up only slightly in 2010 (at 0.4%). Alternatively, we anticipate a recovery of the magnitude of 1.6% for 2010 following a decline of 3% this year.

The severity of the decline in inventory data has been worse than we expected. However, as we anticipated, global production and trade have begun to stabilise and we believe that economic data should continue to surprise the market with its strength over the summer. We still believe, though, that it is too early to conclude that the modest improvements we are now seeing in the availability of credit will flow on to a self-sustaining recovery. Our view is that the recovery will depend critically on domestic demand picking up (which should be shown through better home and car sales), improving labour market conditions and further gains from financial markets.

Authorities across the globe continue to respond to the global downturn with force. As a result of massive amounts of policy stimulus in conventional and innovative ways, there has been a dramatic shift in interest rate expectations since last year. In December 2008, the median market participant expected official interest rates to remain as high as 3% during 2009 while we expected rates to fall to 1%. Today, nearly every market participant agrees that rates will remain at 0.5% this year while the Bank of England (BOE) continues on its path of quantitative easing.

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