



UK Quarterly Property Snapshot

Aberdeen

The economy

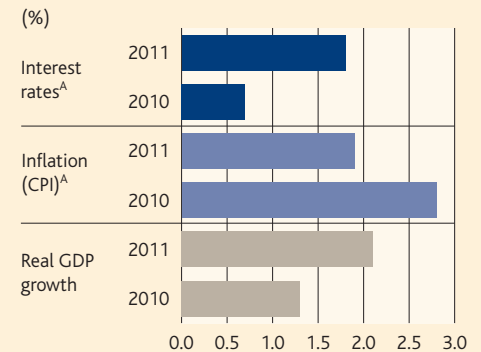
Recent performance

- GDP growth in Q1 2010 was revised up to a quarterly pace of 0.3% from 0.2%. Modest growth reflects the negative impact of a higher VAT rate, the end of the car scrappage scheme and the impact of poor weather in January.
- The largest boost to growth in the first quarter came from a slower pace of destocking, and a rebound in investment, which fell sharply in 2009. Despite sterling's weakness, net exports remain a drag on growth, reflecting a surge in imports. Consumer spending and government consumption contributed very little to GDP growth in Q1 2010.
- According to data to May, the UK economy continued to grow over Q2, and at a firmer pace. Some elements of the economy have performed strongly, including manufacturing output, as exports have climbed on a better global economic climate. However, the larger domestically driven service sector has shown signs of a modest slowdown in recent months.
- Claimant count unemployment has edged down in recent months and job vacancies have strengthened, although private sector employment is still in decline. Consumer confidence and housing market activity has recovered to some degree from the lows of spring 2009. However, high unemployment and a lack of access to credit have limited retail spending levels.
- Inflation continued to run at above the Government's target rate at 3.4% in May, compared to 3.7% in April. Falling food price inflation, and less upward pressure on goods prices, has reduced headline inflation. Spare capacity is pulling inflation down, although has been offset by the impact of a weak sterling for the last 18 months. Pipeline inflation indicators of wage growth and import prices are subdued and point to a near term reduction in inflation pressures.
- Tough measures were announced in the June emergency budget. The budget deficit will be curtailed from £155 billion in 2009/2010 to £37 billion by 2014/15, against the previous government's target of £74 billion.

Outlook

- In the near term, UK growth is likely to be relatively strong and close to the economy's trend rate, underpinned by manufacturing and exports. However, the stimulus from a weaker sterling and the global manufacturing inventory cycle will wane by the end of the year.
- The June budget is reasonably positive for the medium term outlook. Tough measures should help the UK retain its AAA credit rating, as public debt is set to peak at a lower than expected 90% of GDP in the years ahead - a level beyond which economic growth is impaired, according to academic studies. The budget is also positive for investment, with corporation tax to drop 4% in five years' time, to the lowest in the G7. However, aggressive fiscal tightening will damage growth in the short term, and raise the unemployment rate. The pace of budget deficit reduction is 1.4% annually over the next five years, which is higher than the 1.1% seen in the mid-1990s. Deficit reduction in the 1990s was helped by a strong domestic and international growth environment, whereas the growth outlook today is weaker. There are also a number of domestic headwinds present.
- Households have made a modest move to rebuild their balance sheets. However, the current position is tenable only with very low ongoing interest rates. Such low borrowing costs are not sustainable over the medium term if inflation becomes a threat, as we expect. The banking sector also remains in a weakened state. The refinancing is due for a large volume of bank borrowing from the capital markets in the next 12-18 months. Difficult financial conditions mean that banks will be forced to deleverage further, as refinancing is only likely on onerous terms, which will be negative for GDP growth.

Economic forecasts (%)



^A Year end forecasts

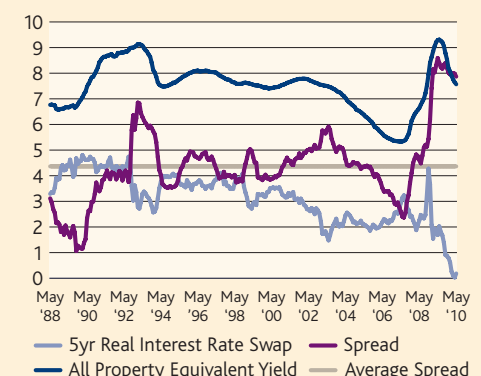
Source: Aberdeen Asset Management, Reuters EcoWin, Consensus Economics

Huge fiscal tightening needed to balance the budget



Source: HM Treasury

Spreads on property yields versus interest rate swaps remain close to record levels



Source: Reuters EcoWin, Aberdeen Asset Management

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- Moreover, the growth outlook for the UK's main trading partners has weakened considerably. Southern European economies are accelerating planned reductions in budget deficits, while Germany has also announced a package to curtail spending in 2011. In the short term though, the eurozone economy is benefiting from a sharp upturn in global trading volumes, which will also benefit the UK. The key balancing act for the Government and for the Bank of England (BoE) will be to avoid a double-dip recession. Even though headline inflation will stay elevated, due to a higher VAT rate in 2011, the BoE is likely to keep interest rates low as fiscal measures take effect. We do not expect another recession, although growth is expected to slow next year.
- A sustained period of very expansionary monetary policy will result in stronger inflation over the medium term, as the BoE will err on the side of caution in withdrawing excess liquidity. By 2012, a reduced drag from fiscal tightening will help growth to pick up to above trend. Strong growth and rising inflation will necessitate the withdrawal from unconventional policy measures, leading to continued volatility in economic growth for some time to come.

Property market overview

Recent performance

The pace of increase in capital values has slowed sharply during summer 2010. The capital uplift in June was just 0.5%, the smallest increase since August 2009. Transaction volumes have fallen since the final quarter of 2009. Although demand generally remains robust, investors have become more cautious about secondary stock let to weaker tenants with shorter lease expiries, perhaps reflecting concerns about the fragility of the economic recovery. Investors have become more risk averse across all asset classes, as can be seen, for example, in the rise in corporate bond spreads. Although overseas purchasers have remained active, particularly for central London property, the rapid pick up in capital values in the UK, compared to continental Europe over the past years, has weakened its relative attraction, as has the strengthening of sterling against the euro. Inflows into the retail funds have also slowed over the past quarter.

Although rents continue to fall, the pace of rental decline is far slower than it was a year ago. Rents are falling at an annualised 1.5%, compared to 12% a year ago. Nevertheless, over the past quarter, the pace of improvement has weakened, reflecting the anaemic nature of the economic recovery.

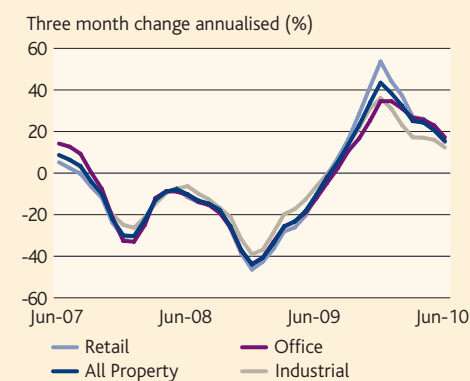
Retail

- The pace of rental decline has continued to slow, with the annualised rate falling from 9% in spring 2009 to less than 2% currently. Rental levels are rising in central London, although falling more sharply in the provincial markets. Completion levels for both shopping centres and retail warehousing have fallen to all time lows, and this lack of new supply is aiding the stabilisation of vacancy rates. Retail sales have held up a little better than expected, helped by record low interest rates, as retailers have had some success passing on higher costs while simultaneously squeezing suppliers. Nevertheless, a further rise in VAT and dramatic cuts in public spending do not augur well for the resumption of retail rental growth, especially in the regions where the pain from cuts in public spending will be more pronounced.
- Yields across all retail segments fell slightly over the quarter. However, the pace of decline has slowed substantially from previous quarters. Yields on some prime standard shops and most types of retail warehouses have stabilised, with some indications over the last few weeks that they may now be drifting upwards a touch.

Offices

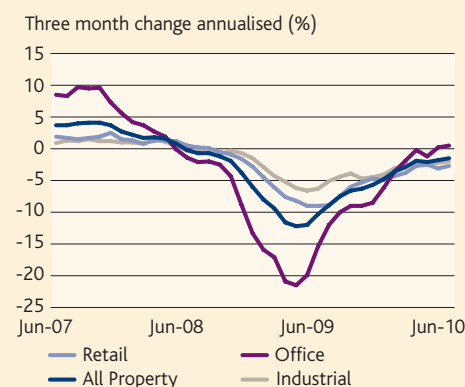
- The office sector has been the fastest sector to recover: rents were falling at a quarterly annualised rate of 22% in April 2009 and are now rising at 0.5% on the same basis. Rental growth in central London has resumed, growing at an annualised rate of over 5% in the three months to May. Central London rents were falling at an annualised pace of over 30% in spring 2009. Prime rents in the City are now rising

Total returns weaken



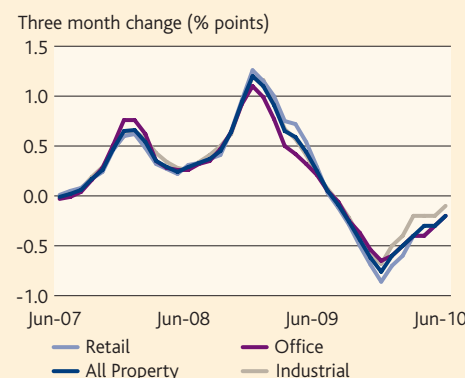
Source: IPD Monthly Index, June 2010; Aberdeen Asset Management

Rental values stabilise



Source: IPD Monthly Index, June 2010; Aberdeen Asset Management

Inward yield shift slows sharply



Source: IPD Monthly Index, June 2010; Aberdeen Asset Management

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rapidly, reaching £52 per square foot compared to the low point of £42 a year ago. Vacancy rates in central London have fallen for three successive quarters, and the fall in prime availability has been even more pronounced. Large new floorplates are in particularly short supply, with development levels remaining exceptionally low. Take up has been running at above the long term average in central London over the past year, although this is expected to drop back over the summer. In the South East and Rest of UK segments, take up levels have been much lower than the long term average, and availability rates have not fallen. Rental values continue to decline, albeit at a much slower pace.

- Prime yields have stabilised over the past quarter, after falling dramatically over the previous year. In the City and West End, prime yields stand at 5.5% and 4.25% respectively.

Industrial

- Industrial rents fell by 2% on an annualised basis over the three months to June 2010. Although demand has remained subdued and availability is at record levels, the pace of rental decline has continued to slow. Although overall availability levels have continued to rise, availability of prime, newly constructed property has fallen in all regions of the UK, reflecting the fact that completion levels have fallen sharply. Prime yields have been stable over the last quarter.

Sector prospects

Outlook

A total return of 12% is projected for 2010, a slight downward revision from our last forecast of 16% in the spring. This assumes an acceleration of the anticipated slowdown, with a weaker capital return over the remainder of the year, as investor demand weakens and further investment stock comes onto the market. Investor risk aversion has increased in recent weeks, reflected in widening credit spreads and the fall in the equities market. The sharp rise in sterling against the euro has also eroded some of the attractiveness of UK property to overseas investors.

Nevertheless, we are not expecting a sharp decline in capital values. Despite a fall of over 150 basis points in property yields over the past year, there still exists a substantial yield premium of property yields over the yields on most other asset classes compared to the long term average. Property looks attractive from an income perspective as a consequence. This is particularly the case against the low risk asset classes: nominal government bonds (where yields have fallen recently), index-linked government bonds and cash.

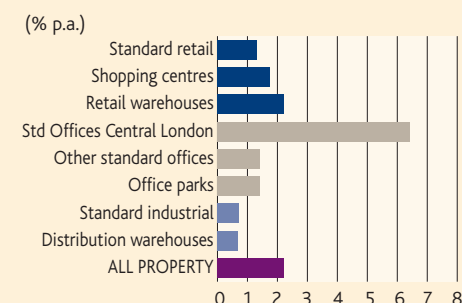
The pace of rental decline is expected to continue to slow over the course of the year, as economic growth gradually resumes and demand continues to slowly recover, while development completions remain very subdued. Rental growth is only projected to occur in the London office market, and this will be concentrated at the prime end of the market.

The assumption of a faster slowdown means our forecasts for 2011 have been revised up marginally. Due to the sluggishness of the economic recovery, hindered by large cuts in public spending and tax increases, any interest rate rises in 2011 will be modest, meaning property yields will continue to look attractive, and should not rise substantially. The weakening of total returns in 2011 would be similar to the correction experienced in 1995, which also followed a sharp bounce in capital values in the preceding two years.

For 2012, we project a renewed improvement in total returns, aided by gradually improving occupier market conditions. Nevertheless, rising interest rates and bond yields will mean downward pressure on property yields will be minimal after 2012 onwards.

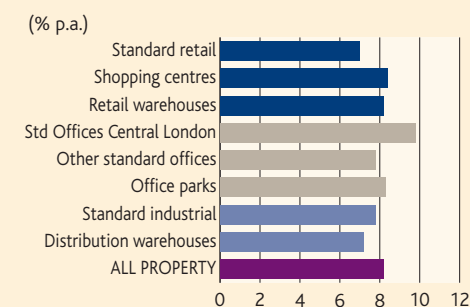
A five year annualised 'All Property' total return of 8.2% is forecast, based on pricing at the end of June 2010. The majority of this (approximately 6.5%) will be delivered by income return, with the remainder aided by some rental growth concentrated mainly at the back end of the forecast period.

Five year annualised rental growth (to June 2015)



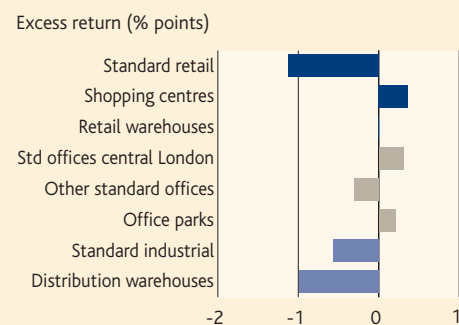
Source: Aberdeen Asset Management

Five year annualised total returns (to June 2015)



Source: Aberdeen Asset Management

Market pricing over five year horizon relative to benchmark



Source: Aberdeen Asset Management

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Over the next five years, the best performing sector is projected to be central London offices, driven by much stronger rental growth than in any other segment, which will be concentrated in the next three years. Prime rents are already rising sharply, while even average rents are starting to increase after falling at a pace of as high as 30% in spring 2009. Availability of Grade A space is diminishing rapidly and completion levels will be exceptionally low over the next three years. South East offices are also projected to outperform, aided by a historically high yield, and recovering rental growth at the prime end in the medium term, off a very low base in historic terms.

The standard shop sector is projected to be one of the worst performers, particularly outside London and the South East, where development has been more modest in recent years. Standard shops have a substantially lower yield than most other segments. In the past, this has been compensated for by much stronger rental growth. However, in the future, strong rental growth is much less likely due to a combination of the further growth of internet shopping, supermarkets' continued expansion into non-food, a further rise in VAT, rising interest rates and the current record level of retail vacancy rates. The provincial office market is also expected to perform poorly, hindered particularly by the large cuts in public sector spending.

Investment policy

The table below shows Aberdeen's recommended positions, relative to benchmark, in order to achieve outperformance over a five year period.

Sector	Strategy
Standard retail	Underweight
Shopping centres	Neutral
Retail warehouses	Neutral
City offices	Overweight
West End offices	Neutral
Rest of South East offices	Neutral
Rest of UK offices	Underweight
Office parks	Neutral
Industrial	Underweight
Other	Underweight

Source: Aberdeen Asset Management

Important information

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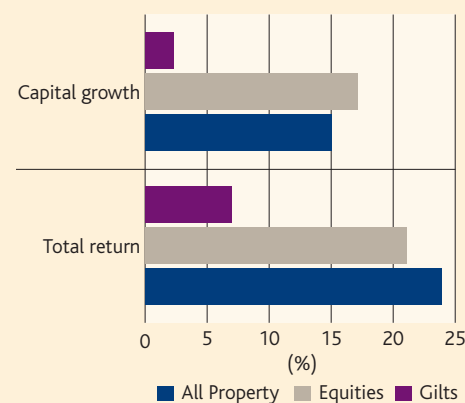
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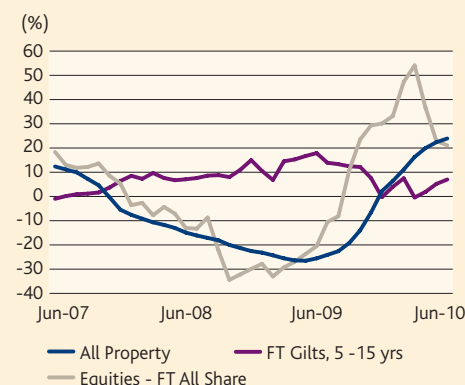
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Asset classes – 12 month total return and capital growth (to end June 2010)



Source: Aberdeen Asset Management, IPD

Asset classes – 12 month rolling total return (to end June 2010)



Source: Aberdeen Asset Management, IPD

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