GVA

RESEARCH

EPMR

Economic & property market review

Autumn 2018

Economic Trends

Political rather than economic events continue to dominate the outlook and with no known significant progress on negotiations between the UK and EU, the risk of a no-deal Brexit still lingers. Theresa May suggested she is willing to extend the transition period by another 12 months. This could push the 'cliff-edge' scenario further out to December 2021 and prolong uncertainty for businesses.

Growth

The UK economy continues to show resilience despite continued political and economic uncertainty. According to ONS, UK GDP grew by 0.7% in the three months to August, illustrating a rebound in activity in Q3.

Confidence Survey

The Markit / CIPS Purchasing Managers Indices average across the services, manufacturing and construction sectors eased slightly in September. However, cost pressures persist and activity remains subdued (see top chart). The manufacturing sector saw a mild improvement, although construction activity rose at its slowest pace in six months. Growth in the service sector also slowed slightly.

Labour market

The labour market remains in good shape with the unemployment rate staying at 4%. Overall employment figures came down a little in the three months to August, with the number of people in work falling by 5,000 to 32.4 million. However, compared to a year ago there are 289,000 more people in work. Indeed, earnings growth picked up to 3.1% excluding bonuses, and 2.7% including bonuses, in the three months to August, the largest increase since the financial crisis. This is hopefully the start of much-needed improvements in pay growth following a prolonged period of overstretched household incomes.

Inflation and interest rates

UK inflation resumed its descent in September, following a couple of months of rises. CPI inflation decreased to 2.4% in September, down from 2.7% in August. We expect inflation to gradually decline towards the Bank of England's 2% target by late 2019 (see middle chart).

However, further growth in earnings without a noticeable improvement in productivity could lead to domestic inflationary pressures over the medium term. The Bank of England increased the 'Bank Rate' in August to 'normalise' interest rates although it appears to be the only increase this year. Further rises are likely to be slow and gradual especially with inflation coming in below expectations in September.

Autumn Budget

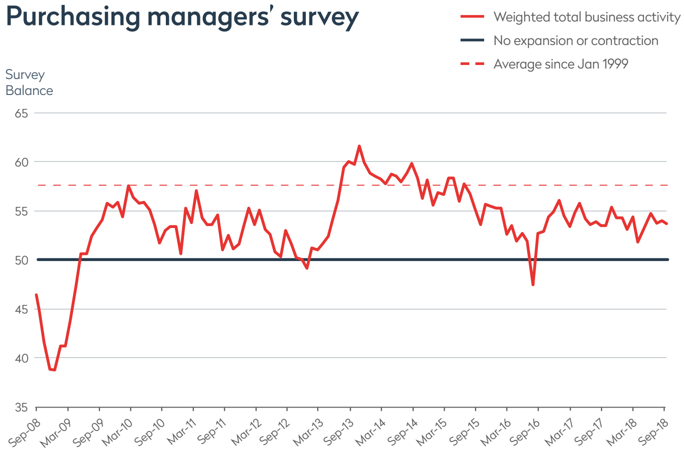
Improved forecasts for growth and tax receipts by the Office for Budget Responsibility (OBR) allowed the Chancellor to deliver a Budget with more giveaways than expected. To support businesses investment on plant and machinery the Chancellor increased the Annual Investment Allowance temporarily from 200,000 to £1 million which covers the amount businesses can spend on equipment including computing, office furniture and integral fittings. Also, investment on new non-residential structures and buildings will be eligible for a 2% capital allowance.

The creation of the £675 million 'future high streets fund' alongside making it easier to gain permission for conversion of commercial to residential will facilitate redevelopment of under-used retail units on the high street. The business rates cut will benefit small and independent retailers although the planned increase in the national living wage in April will put extra pressure on many retailers' cost base.

Outlook for growth

OBR expects GDP for 2018 as a whole to be around 1.3% and this will mark the bottom of the economic cycle (see table). GDP growth is expected to improve to 1.6% in 2019, revised up from the 1.3% predicted in March. However, the outcome of Brexit negotiations will be crucial in influencing the direction that the economy takes, with many commentators suggesting no deal would result in a recession. Free trade arrangements and the free movement of labour will be particularly important. Should the UK leave the EU without a deal then an emergency budget will be held in the Spring to help offset the challenges faced by this scenario.

Purchasing managers' survey

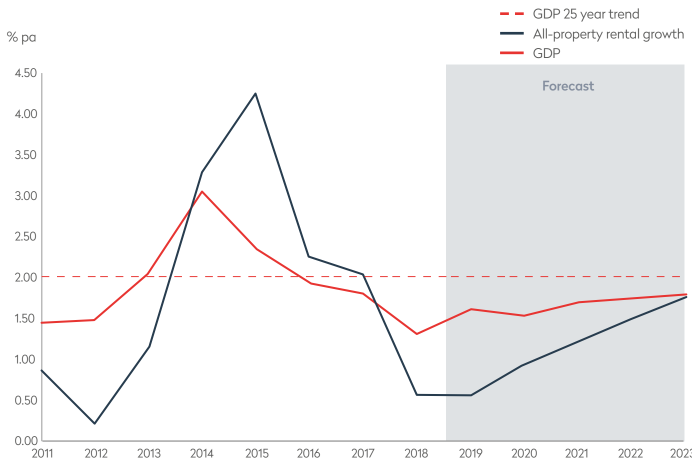


Source: Markit & CIPS

Inflation and wage growth

Source: Experian, HM Treasury Consensus

GDP and all-property rental growth forecast



Source: Experian, HM Treasury Consensus, MSCI, REFL, GVA

Latest Office for Budget Responsibility forecasts, October 2018

	2018	2019	25-year trend
Economic growth (GDP)	1.3%	1.6%	2.5% pa
Household consumption	1.3%	1.2%	
Employment growth	1.2%	0.8%	0.7% pa
Bank Base Rate (Q4)	0.75%	1.06%	
CPI – Inflation (Q4)	2.6%	2.0%	
RPI – Inflation (Q4)	3.5%	3.1%	

Source: OBR (Compilation of forecasts, GVA)

Occupier market

Supply

UK commercial construction activity peaked well below the long-term average and continues in a downward trend. The annual level of new construction orders for retail, office and industrial has now fallen for three consecutive quarters (see top chart).

The Markit/CIPS construction activity survey, covering all construction activity, decreased slightly from 52.9 in August to 52.1 in September. Housebuilding and commercial construction continued to increase at a good pace, albeit slower than in August. The subdued economic conditions in 2018 have been a drag on many companies according to the survey.

In the regional office markets there are concerns that build cost inflation is impacting on scheme viability and therefore the appetite for speculative development. Whilst completions in London's office market are expected to peak in 2019 totaling 7.1 million sq ft.

Demand

Take up for **Central London office** totalled 3.9 million sq ft in Q3, up 6% on the five-year average. Although the uncertain economic climate is not adversely affecting take-up, it is weighing on occupier decisions and the willingness of smaller companies to take space without awareness of the future of their business. TMT & Creative occupiers made up 34% of take-up in the quarter, followed by Financial Services at 18%. However, excluding the deal to Facebook which accounted for 18% of take-up for Q3, the Financial Services sector dominated take-up at 28% followed by the TMT & Creative sector. Indeed, three of the top five transactions over 100,000 sq ft were from the Financial Services sector. The co-working sector continued its expansion making up 13% of take-up, although slowing in pace compared to previous quarters.

Take up in the 'Big Nine' **regional office markets** for the first three quarters of the year totalled over 8 million sq ft, well positioned to break last year's record of 10 million sq ft. Take up activity in Q3 exceeded the average by 64%, with record activity across the out-of-town markets. The public sector remains very active with take up in the regional market during Q3 at almost double the long term average. Encouragingly, some exceptional deals have also come from the private sector. The combination of healthy demand and tight supply continues to put pressure on net effective headline rents which increased at 4.3% per annum.

The high street continues to suffer from the structural shift towards online shopping. This has adversely affected **retail** property performance, with average rental growth falling further into negative territory to -0.9% in the 12 months to September. The budget announced small retailers with rateable value below £51k will see their bill cut by a third. Although this is good news for small and independent retailers it will not provided any insulation for retail chains who have been particularly struggling to compete with online shopping.

On the other hand, the structural changes within the retail sector have been positive for the **industrial** sector. So far this year there has been a record level of take-up by retailers in the big shed market, with a fairly even split between ecommerce, pure play retailers and third party logistics, many serving retail contracts. According to the latest RICS Commercial Property Market Survey demand continued to increase for industrial units, although at a slower pace. Our latest forecasts show industrial rents are expected to increase by 3.7% in 2018 as a whole, before slowing to 3% next year. The looming Brexit deadline presents significant challenges to the sector including agreement on the movement of goods, the costs of tariffs and the availability of labour.

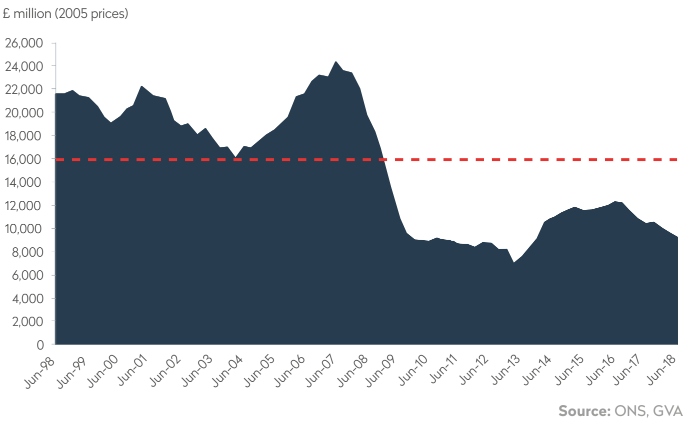
Outlook for rental growth

All-property average rental growth has significantly slowed since Q1 2018 amid a subdued economic environment (see middle chart). In the 12 months to September, all-property rental growth slowed to 1.4%, down from 1.6% in August (IPD Monthly Index).

We expect all property rental growth to be 0.6% for 2018 as a whole (see table), and remain stable in 2019 in line with continued occupier uncertainty and below-trend economic growth. The retail property sector has a particularly poor outlook whilst forecasts for the industrial sector remain above inflation.

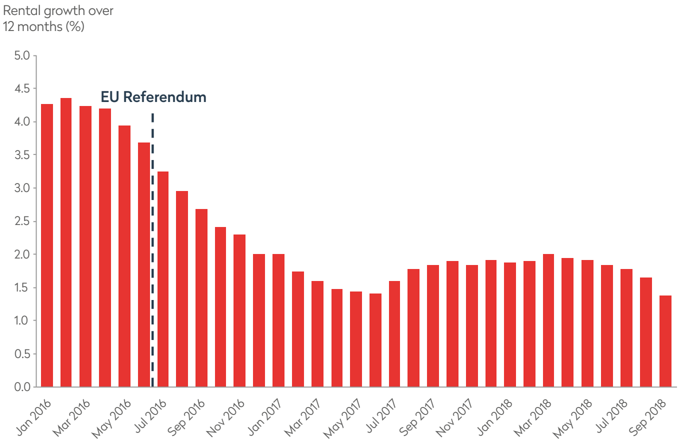
New construction orders (development activity)

Retail, office and industrial



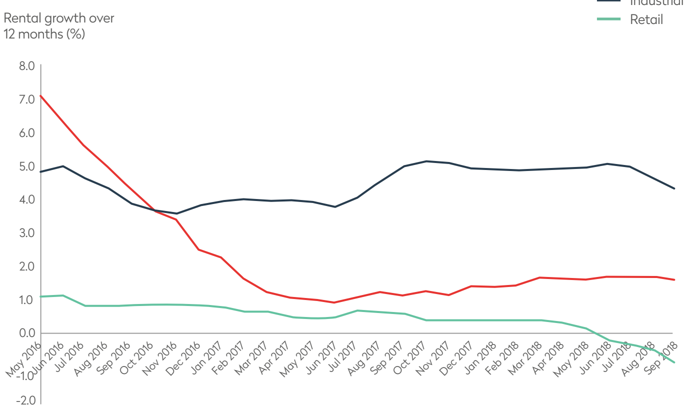
Source: ONS, GVA

Average all-property annual rental growth



Source: IPD Monthly Index

Average annual rental growth



Source: IPD Monthly Index

All-property rental value growth forecasts

	2018	2019
IPF Quarterly Consensus (September 2018)		
Maximum	1.8%	1.6%
Minimum	0.1%	-1.0%
Average	0.9%	0.4%
GVA (November 2018)	**0.6%**	**0.6%**

Source: IPF, REFL, GVA

Investment market outlook

Investor demand

Demand for UK commercial property remains strong despite continued lack of clarity over Brexit. Circa £15 billion of UK commercial property was transacted in Q3, up 9% on Q2 and in line with the five-year average. Whilst total annual transactions value has clearly decreased in 2018 this has been partly a supply issue with a lack of investment stock on the market. Indeed, supply has decreased in all sectors with the exception of the retail sector.

Overseas investment accounted for 42% of total value in the 12 months to Q3 2018. However, this has come down from last year's peak of circa £32 billion to £26 billion.

Recent performance

Average all-property equivalent yields have modestly hardened to 5.8% in September 2018, down from 6.1% a year ago (IPD Monthly Index). However, there is a large divergence between assets with average industrial yields now significantly below office and retail yields (see middle chart). Average all-property capital values rose by 0.4% in the three months to September, and by 4.4% year-on-year (IPD Monthly Index). The slowdown in rental and capital growth has brought the all-property annual total return to 9.9%, down from this year's peak at 11.3% in March (see bottom chart).

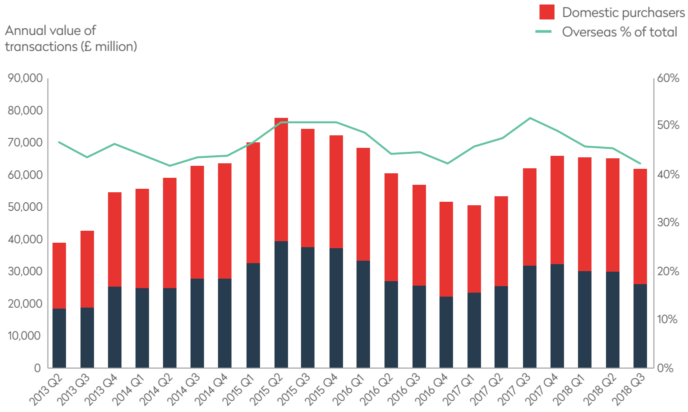
Outlook

Investors continue to scale back their retail exposure as the sector continues to struggle from a combination of higher costs associated to increased taxes and input costs as well as the structural shift towards online shopping. On the back of this, retail yields continue to move out whilst capital values are expected to remain negative over the next two years.

However, there remains a compelling story for industrial investment which is largely driven by strong occupier demand, good income streams, a lack of available standing stock and limitations to speculative development. We expect the downward pressure on yields to continue in 2019, albeit at a slower pace. The appetite for alternatives also remains robust.

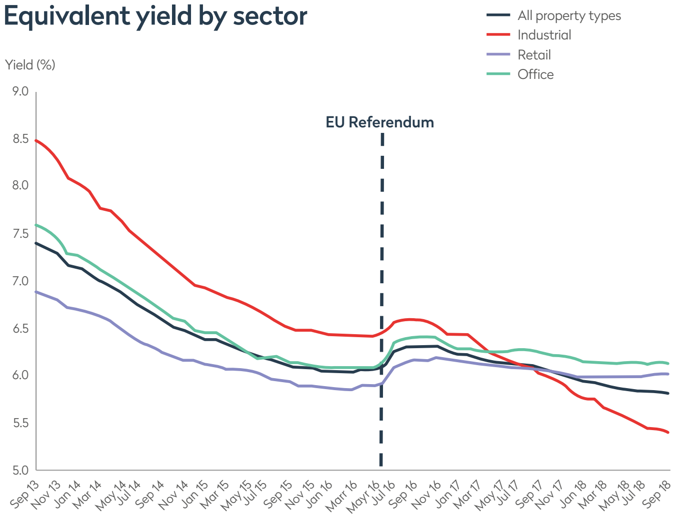
Overall, the UK commercial property market will remain attractive with the exception of retail. The global weight of money against a limited supply will keep yields low for many assets. The Bank Rate remains historically low and we expect further rises to be slow and gradual. As a result, the gap between commercial real estate and gilts will remain wide.

Annual investment transactions



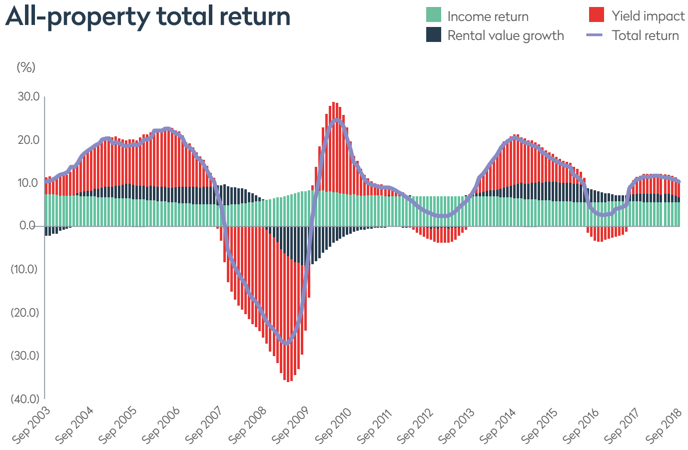
Source: Property Data

Equivalent yield by sector



Source: IPD Monthly Index

All-property total return



Source: IPD Monthly Index

Research enquiries
Amerita Vassaramo
020 7911 2510
amerita.vassaramo@gva.co.uk

GVA
65 Gresham Street, London EC2V 7NQ

Linkedin/gvauk @gvaviews

Created: 11/18 **Ref: 11819**