RESEARCH

EPMR

Economic & property market review

Spring 2019

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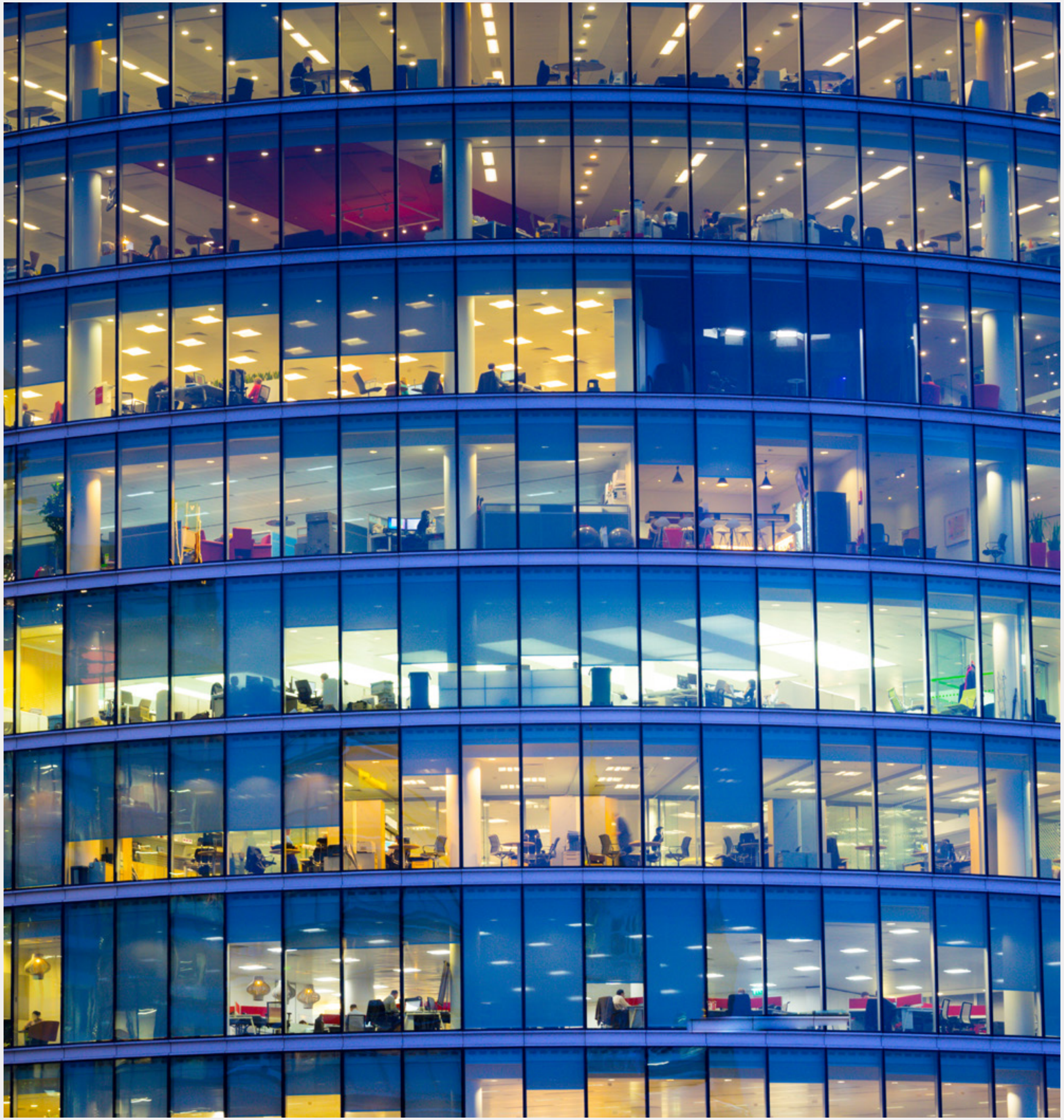


Economic Trends

UK economic growth remains subdued as the drawn-out process to leave the EU has left the UK engulfed in a prolonged period of uncertainty, now well beyond the 'official' exit date. Whilst the delay suggests the likelihood of a disorderly exit from the EU is reduced the risk still remains. In the short-term the persistent uncertainty continues to weigh on business decisions in both the manufacturing and services industries and can often come with significant costs.

Growth

UK GDP growth increased to 0.5% in Q1 2019, up from 0.2% in the previous quarter. Forward looking indicators of GDP growth are downbeat amid a backdrop of a slowing global economy and Brexit-related uncertainty. The British Chamber of Commerce's quarterly economic survey found the percentage of service firms reporting an increase in export sales fell to the lowest level in a decade, whilst manufacturing firms also reported a decline to the lowest level since 2016.

Confidence Survey

The Markit / CIPS Purchasing Managers Indices average across the services, manufacturing and construction sectors moved just above the crucial 50 no-change threshold to 50.7 in April, up from 49.6 in March. Growth slowed in the construction sector whilst activity moved back into the positive territory for the service and manufacturing sectors, albeit demand remains subdued.

Labour market

The UK labour market remains robust with the unemployment rate at 3.9%, the lowest since 1974. The total number of employees in work between December 2018 and February 2019 rose to 32.7 million, an increase of 457,000 compared to a year ago. Employment growth has been largely driven by full-time employment. With little spare capacity left in the UK labour market, this has started to feed into higher pay growth with real earnings increasing by 1.5% excluding bonuses and by 1.6% including bonuses.

Inflation and interest rates

CPI inflation remained muted in March at 1.9%, unchanged from February and remains below the Bank of England's 2% target for third month in a row. The Bank of England is likely to keep the 'Bank Rate' on hold in the near term amid Brexit uncertainty and heightened concerns about a global slowdown. The Bank of England downgraded its economic growth forecast and suggested there is a 25% chance of a recession, even if there's a smooth Brexit.

Outlook for growth

The UK remains engulfed in economic and political uncertainty following the extension on the exit date for Brexit. We expect GDP growth to be weak in 2019, particularly in the first half with business activity and investment continuing to be subdued. However, the slowdown in economic growth is not unique to the UK, suggesting there are other global factors at play too which have been a drag globally. The Treasury consensus forecasts economic growth at 1.3% for 2019, before picking up to 1.5% in 2020.

LATEST CONSENSUS FORECASTS, APRIL 2019

	2019	2020	25-year trend
Economic growth (GDP)	1.3%	1.5%	2.5% pa
Private consumption	1.5%	1.4%	
Employment growth	0.8%	0.4%	0.7% pa
Bank Base Rate (Q4)	0.90%	1.17%	
CPI – Inflation (Q4)	1.9%	2.1%	
RPI – Inflation (Q4)	2.7%	2.9%	

Source: HM Treasury (Compilation of forecasts, Avison Young)

2019 ECONOMIC GROWTH FORECASTS

UK
1.3%

WORLD
3.3%

EUROPEAN UNION
1.6%

Source: HM Treasury and IMF

KEY STATS

0.5% ▲
Q1 GDP GROWTH

PMI INDEX WEIGHTED AVERAGE

MARCH **49.6** ▲ APRIL **50.7**

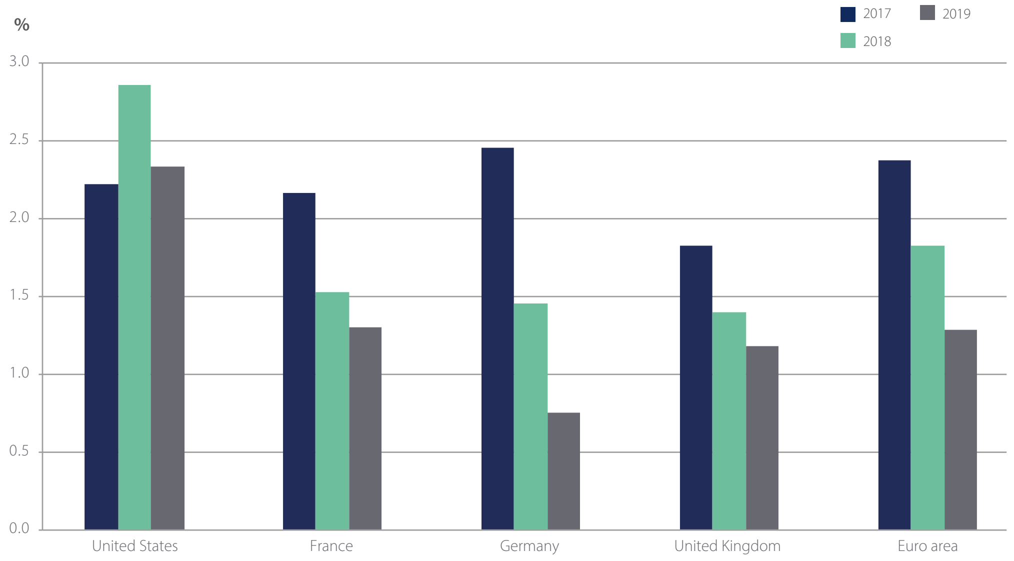
UNEMPLOYMENT RATE
3.9%

REAL EARNINGS GROWTH
1.5% (INCLUDING BONUSES)
1.6% (EXCLUDING BONUSES)

CPI INFLATION
1.9%

BANK RATE
0.75%

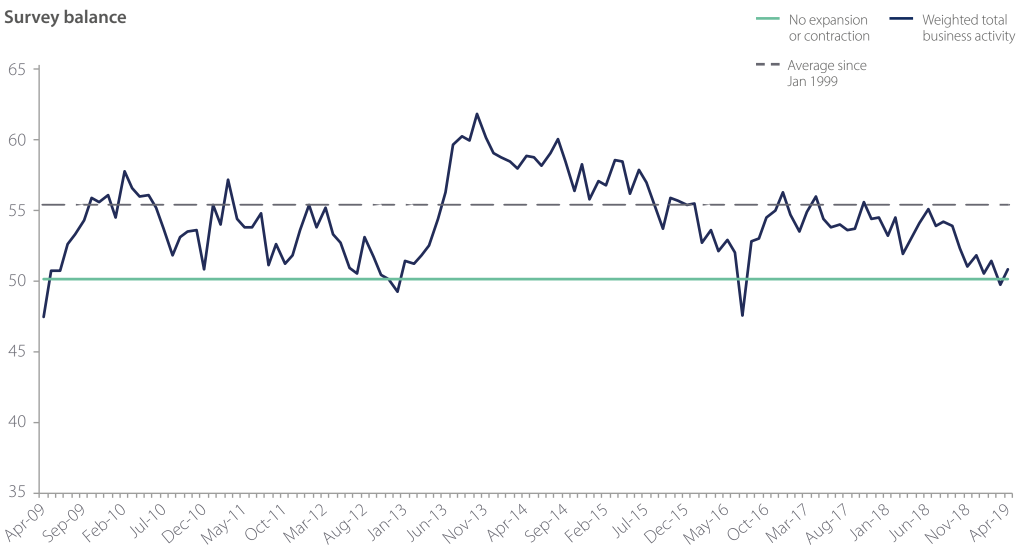
GLOBAL ECONOMIC GROWTH



GDP AND ALL-PROPERTY RENTAL GROWTH FORECAST

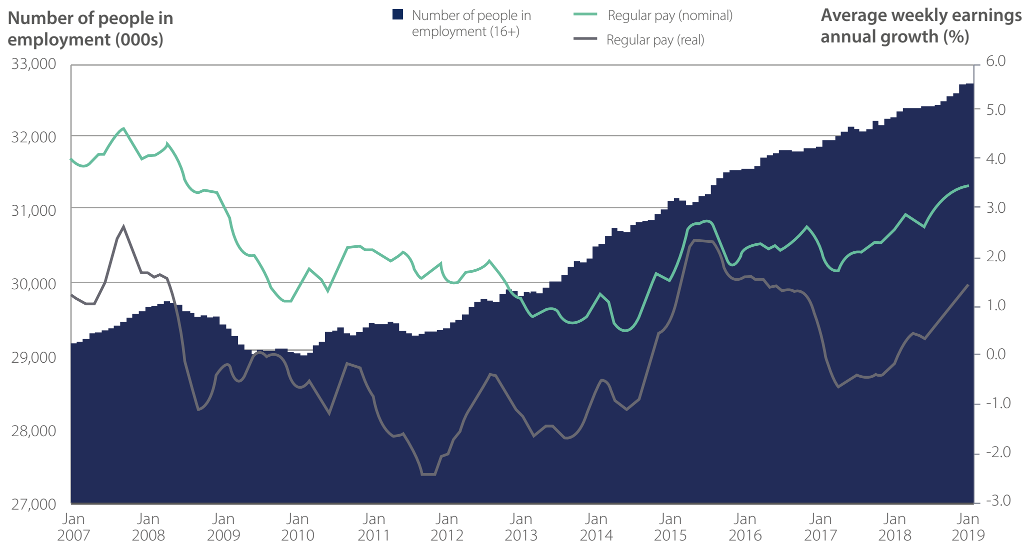
Source: Experian, HM treasury consensus, MSCI, REF and Avison Young

PURCHASING MANAGERS' SURVEY



Source: Markit & CIPS

EMPLOYMENT AND AVERAGE WEEKLY EARNINGS ANNUAL GROWTH RATES



Source: ONS

Occupier market

Supply

The annual level of new construction orders across the retail, office and industrial sectors ticked up slightly at the end of Q4 2018, although remains 4.7% down on the 12 months previous following four consecutive quarters of falls. The Markit/CIPS construction activity survey increased to 50.5 in April, up from 49.7 in March and above the neutral 50 threshold for the first time since January. However, the growth was predominately driven by house building with commercial construction activity continuing to decline, albeit at slower rates than the previous month.

Demand

Q1 2019 was quieter than normal as occupiers and investors who could hold off their decisions until after the now redundant 29th March Brexit date, did so. Take-up for **Central London offices** totalled 2.7 million sq ft for Q1 2019 which was 33% below Q4 2018 but was in line with the short-term average. Despite subdued overall transaction volumes, occupier demand continues unabated for the best market supply, of which transport connectivity is an essential component. The most active sectors accounted for around 70% of all take-up for Q1 2019. Financial Services serviced offices both accounted for 20% of take-up with TMT & Creative accounting for 15% and Government Services at a further 13%. Central London prime rental levels increased by 0.78% on a rolling annual basis for Q1 2019, and were unsurprisingly largely stable on a quarterly basis as subdued prime supply, kept a hold on rental figures.

Take up in the **'Big Nine' regional office** markets totalled 2 million sq ft in Q1 2019, 4% down on the ten year quarterly average. Given that Q1 is traditionally the quietest quarter and in light of the political uncertainty, this is an encouraging start to the year. Sectoral activity was dominated by the private sector: professional, financial and consumer services, while for the first time in two years there has been very little activity by the public sector. With the steady level of take-up and relative caution amongst occupiers there has been no movement in headline rents during Q1, although a number of cities are expecting rental growth this year.

The challenges in trading conditions in the **retail market** are likely to continue this year with retailers suffering from structural shift towards online shopping, higher labour costs and declining footfall. In 2018, the number of retailers entering CVAs soared with an increasing number being larger companies with multiple stores. 2019 is on track to be a record year for CVAs and most likely the eye of the storm. This continues to have an adverse impact on retail property performance, with average retail rental growth falling deeper into negative territory to -3.6% in the 12 months to March (MSCI Monthly Index).

In stark contrast to that of the retail market, performance in the industrial sector remains resilient in 2019. According to the latest RICS Commercial Property Market Survey tenant demand for industrial space continued to rise steadily. However, occupiers are starting to look at non-prime locations where labour availability and rents provide lower cost solutions. In addition to this, as demands on last mile delivery intensify it is influencing changes in logistic networks. Strong occupier demand and limited availability has sustained robust rental growth, with average industrial rental values increasing by 3.8% in the 12 months to March, well above the office and retail sector (MSCI Monthly Index).

Outlook for rental growth

The retail property sector shows no signs of improvements given the structual changes facing high street retailers, with average retail rental growth to remain negative for at least the next two years. We expect average rental growth to continue for the industrial sector in both prime and secondary markets, albeit at a slower pace compared to the 4% achieved over the few years. In the office sector we anticipate average growth to remain steady at circa 1%, however there is a more substantive divide between prime and secondary with the latter likely to experience slightly negative growth.

All-property rental growth has slowed further at the start of 2019. The annual rate of growth for all-property declined to 0.2% in the 12 months to March (MSCI Monthly Index). We expect all-property rental growth to turn negative to -0.2% for 2019 as a whole given the drag from the retail sector (see table).

ALL PROPERTY RENTAL VALUE GROWTH FORECASTS

	2019	2020
IPF Quarterly Consensus (February 2019)		
Maximum	1.4%	2.0%
Minimum	-1.0%	-1.0%
Average	0.0%	0.2%
(May 2019)	-0.2%	0.2%

Source: IPF, REFL, Avison Young)

KEY STATS

ANNUAL ROLLING VALUE OF NEW CONSTRUCTION ORDERS

£9.3 billion

Q1 TAKE-UP LEVELS

CENTRAL LONDON OFFICES

2.7m sq ft

'BIG NINE' REGIONAL OFFICES

2m sq ft

ANNUALISED AVERAGE RENTAL GROWTH IN MARCH

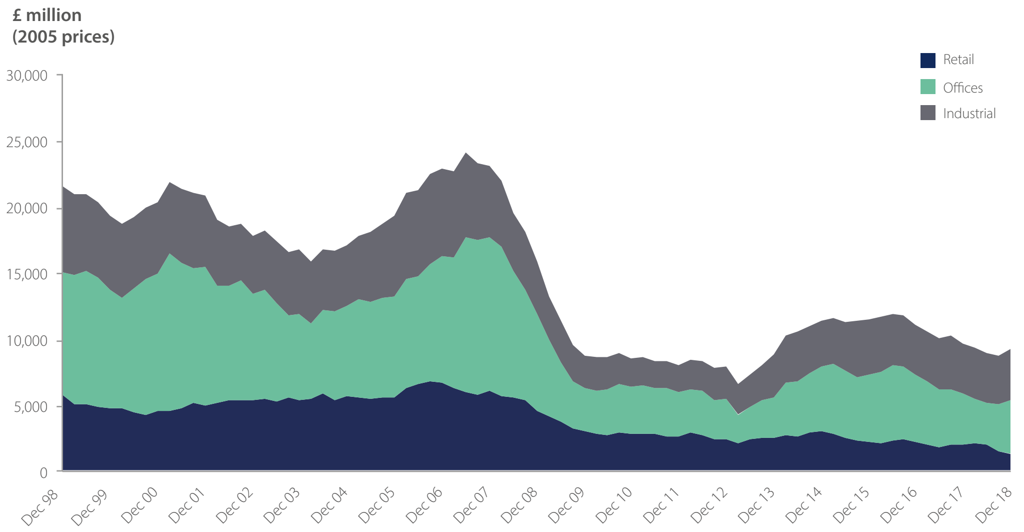
ALL-PROPERTY **0.2%**

OFFICES **1.5%**

RETAIL **-3.6%**

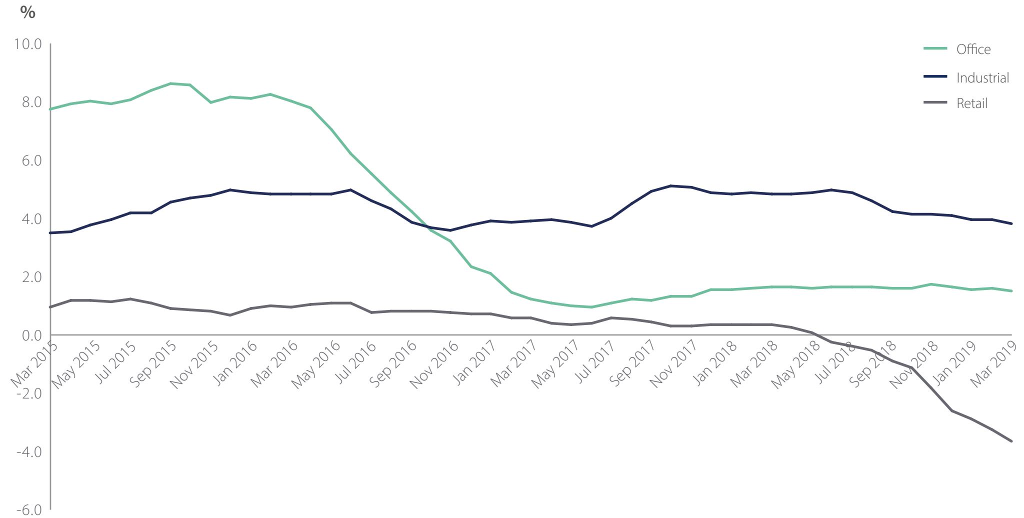
INDUSTRIAL **3.8%**

NEW CONSTRUCTION ORDERS (DEVELOPMENT ACTIVITY) RETAIL, OFFICE AND INDUSTRIAL



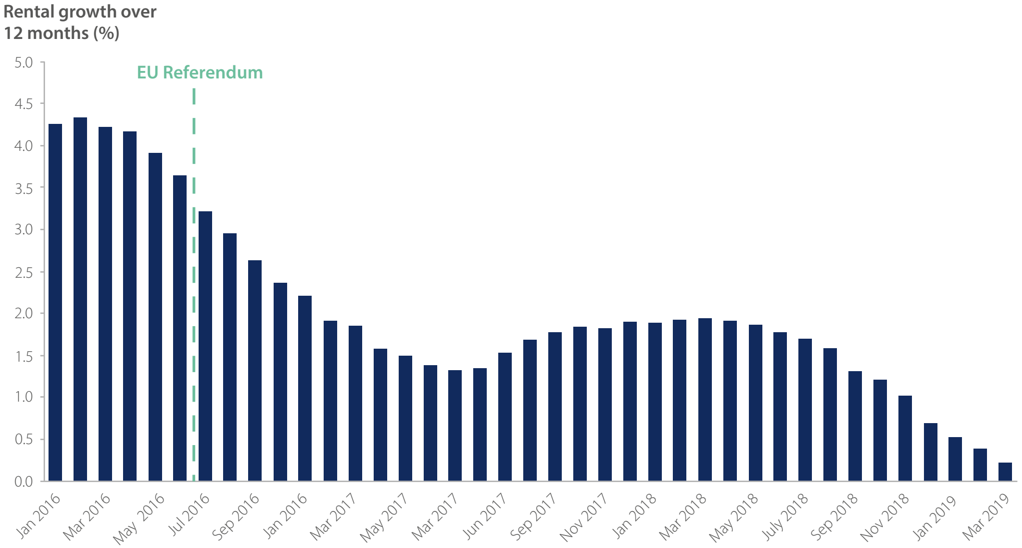
Source: ONS

AVERAGE ANNUAL RENTAL GROWTH



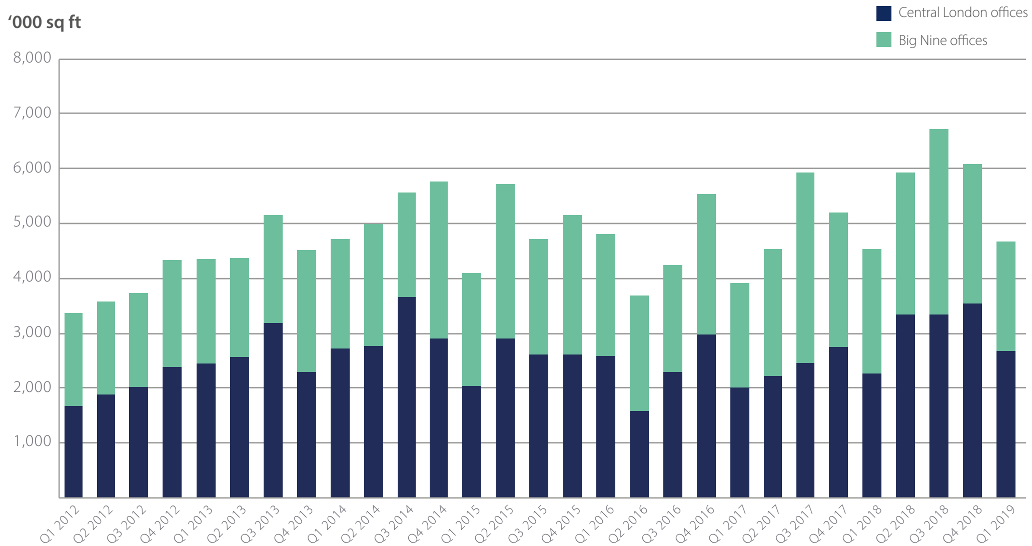
Source: MSCI Monthly Index

AVERAGE ALL-PROPERTY ANNUAL RENTAL GROWTH



Source: MSCI Monthly Index

QUARTERLY OFFICE TAKE-UP IN CENTRAL LONDON AND THE 'BIG NINE'



Source: Avison Young

Investment

The UK economic backdrop has been far from favourable with some investors holding off buying or selling in the run-up to the original Brexit date. The continued uncertainty and downturn in sentiment has translated into materially reduced activity during the first quarter of 2019.

Annual investment transaction values for the UK commercial market totalled circa £59 billion in the 12 months to end Q1 2019, with purchases in Q1 totalling £10.4 billion, the lowest quarterly figure since Q3 2013. Total overseas investment value has now levelled off following the post-referendum surge, however it remains a significant proportion of activity, accounting for 46% of all transactions.

Recent performance

All-property equivalent yields have edged up slightly to 5.9% amid weak economic outlook and stress in the retail property sector. Consequently, all-property average capital value growth has reduced sharply to 0.3% in the year to March 2019 (MSCI monthly index), down from 5.6% a year earlier. The downward movement in capital values was particularly pronounced in the first quarter of 2019, with average all-property capital values falling by 0.8% in the three months to March, compared to a decline of 0.2% in the previous three months. Falling rental value growth and softening of yields contributed the annual total return reducing to 5.6% in 12 months to March, compared to 11.4% a year ago.

At sector level, the trends seen in 2018 continue with retail performance continuing to deteriorate. Average capital values in the retail sector declined by 8.2% in the year to March, compared to positive growth in the industrial and office sector at 1.7% and 9.3% respectively. However, it is worth noting that capital value growth and, in turn total return has reduced across all three sectors.

Outlook

Brexit will undoubtedly continue to play a large role in short- term investment decisions and we expect activity to remain weak in the first half of 2019 or until there is greater clarity on Brexit. However, investors are unlikely to shy away from a transparent and liquid market, particularly for long-term investments.

The key question many investors will be contemplating is not whether to invest in the UK but when to invest. If the uncertainty dissipates, then we expect to see a resumption in investment decisions. However, for those opportunistic investors with long-term confidence in the UK market will find more opportunities creeping up in a less congested market.

We expect the challenges in the retail sector to continue as asset values remain depressed but these are underpinned by the structural change affecting this market. There is continued investor appetite for long income deals with 10 year plus leases. Assets like PRS, hotels and industrial remain in high demand.

Q1 VOLUMES BY REGIONS

- London **£4.4 billion**
- East of England **£570 million**
- East Midlands **£170 million**
- North East **£190 million**
- North West **£290 million**
- Scotland **£330 million**
- South East **£790 million**
- South West **£190 million**
- Wales **£60 million**
- West Midlands **£360 million**
- Yorks & Humber **£420 million**
- Northern Ireland **£28 million**

KEY STATS

ANNUAL ROLLING INVESTMENT TRANSACTIONS VALUE

£59 billion

Q1 VOLUMES BY INVESTOR TYPE

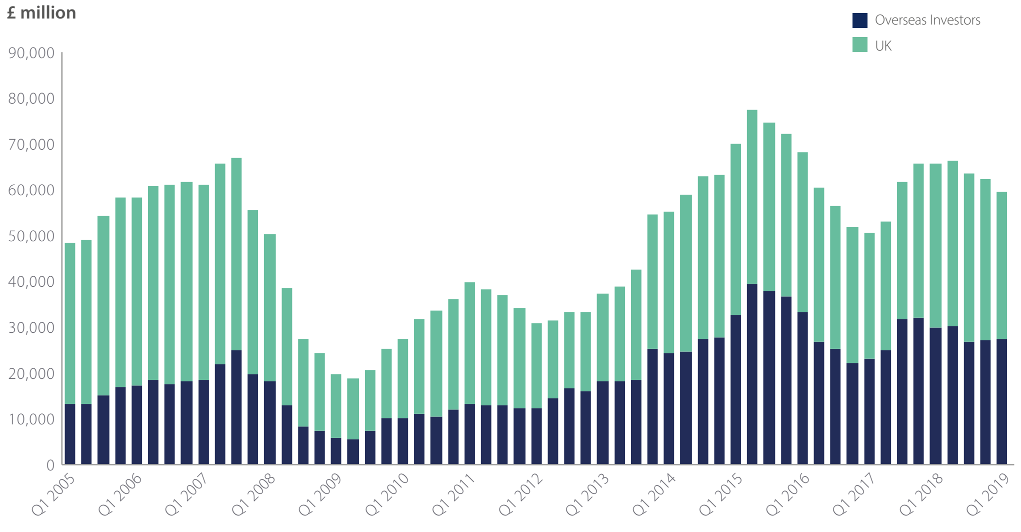
OVERSEAS INVESTOR	UK INSTITUTION	UK PROPERTY COMPANY
46%	**17%**	**25%**

ALL-PROPERTY EQUIVALENT YIELDS

5.9%

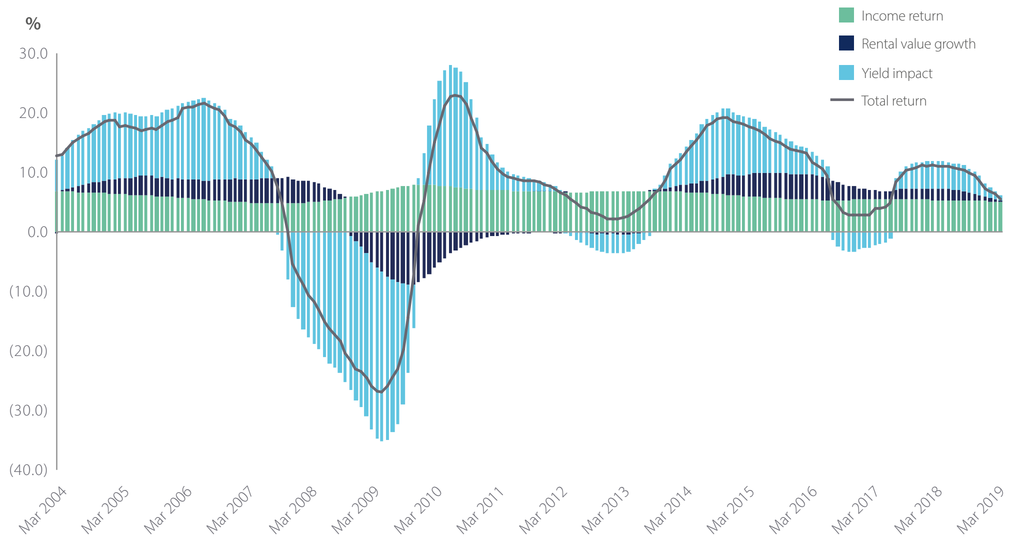
ANNUALISED ALL-PROPERTY TOTAL RETURN	ANNUALISED ALL-PROPERTY CAPITAL GROWTH
5.6%	**0.3%**

ROLLING ANNUAL INVESTMENT TRANSACTION VOLUMES



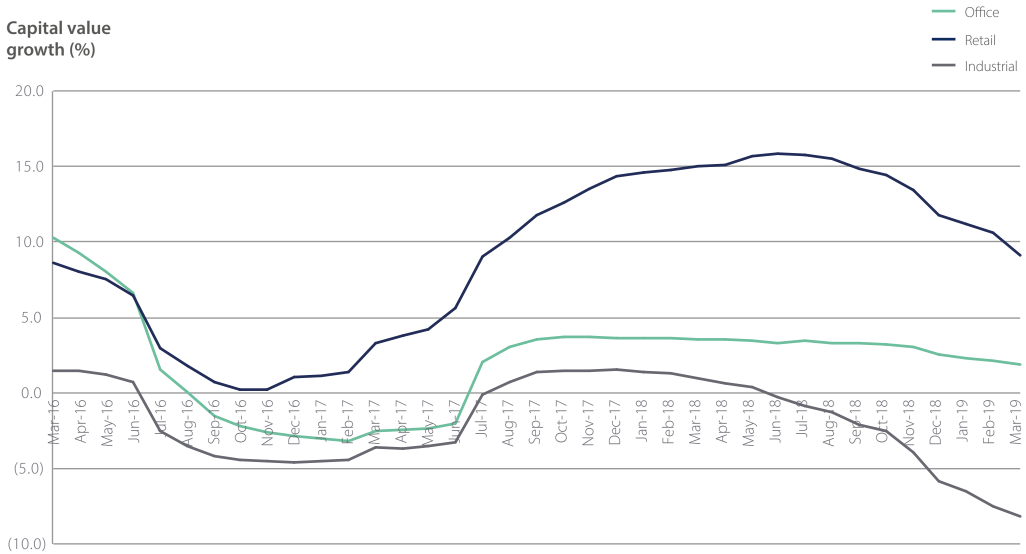
Source: Property Data

ALL PROPERTY ANNUAL TOTAL RETURN



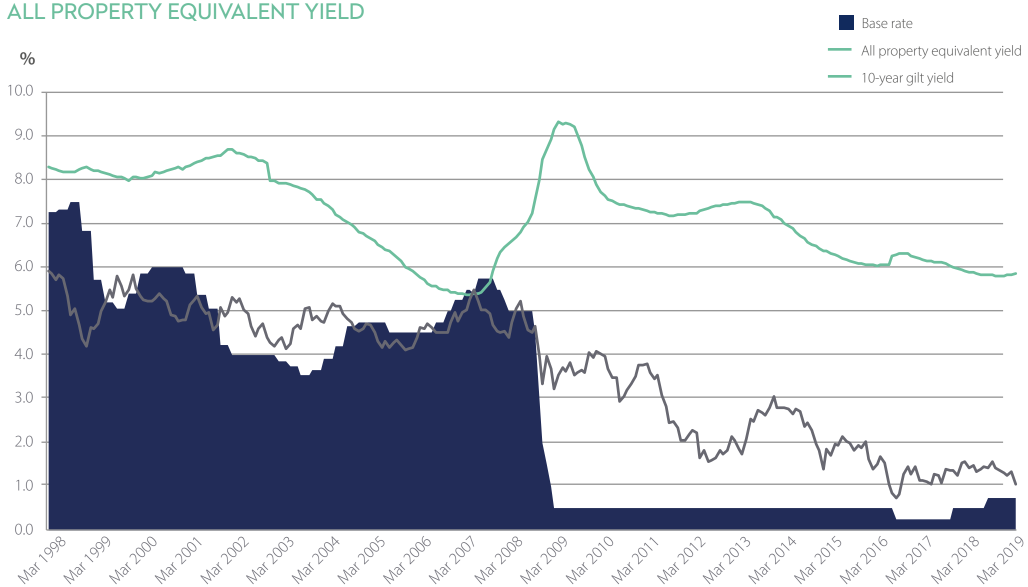
Source: MSCI Monthly Index

ANNUALISED CAPITAL VALUE GROWTH BY SECTORS



Source: Property Data

ALL PROPERTY EQUIVALENT YIELD



Source: MSCI monthly index, Bank of England

Should you wish to discuss any details within this update please get in touch.

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