GVA

RESEARCH

EPMR

Economic & property market review

Spring 2018

Economic Trends

Growth

As in 2017, politics will take centre stage and be the key driver of confidence and economic performance. The second estimate of GDP showed economic growth of 0.4% in Q4, the same rate as in Q3. Growth was driven by the service sector which registered a 0.6% quarterly increase, although the underlying trend suggests the service sector is slowing. Strong performance in the manufacturing sector also contributed to growth whereas the construction sector contracted for the third consecutive quarter.

Confidence surveys

The Markit / CIPS Purchasing Managers Indices average across the services, manufacturing and construction sectors was just above the long-term average in February (see top chart). Growth in the service sector picked up to a four month high, whilst growth in the manufacturing sector fell to its lowest level since June 2017.

Inflation and interest rates

CPI inflation remained at 3.0% in January. Despite being unchanged from December it appears inflation has peaked and the impact of the depreciation of Sterling has started to reduce. We expect inflation to follow a downwards trend in 2018, reaching closer to the Bank of England's target of 2% towards the end of the year.

The Bank of England has signalled earlier and faster rises to the Base Rate to curb inflation from a stronger global economy. The average Base Rate expectation for Q4 2018 in the latest Treasury comparison of forecasts is 0.88%, suggesting a further 25 basis point rise. Given the Bank's 'hawkish turn' further rises this year are very possible.

Labour Market

The unemployment rate increased marginally from 4.3%, a record low level since 1975 to 4.4% in the three months to December. Despite this the UK labour market was buoyant in 2017 and from October to December 32.15 million people were in work, 88,000 more than the three months to September. Compared to the previous year, 321,000 more people were employed, with a significant proportion in full-time employment. The high level of employment growth experienced over the last few years is unsustainable and we expect the rate of growth to moderate in 2018 but remain positive (see middle chart).

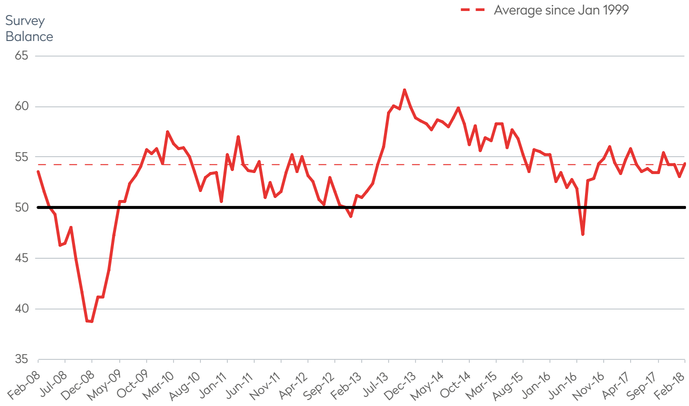
Despite the tight labour market earnings growth has been disappointing, rising by only 2.5% (including or excluding bonuses) in the year between October and December. The shortage of labour supply suggests we should see wage growth rising although the increase will be modest and it will be well into 2018 before wage growth exceeds inflation.

Outlook for growth

A key milestone in the Brexit negotiations was reached near the end of last year, with the EU agreeing to move onto negotiations around future trade relations. However, this phase will be much more challenging and the nature of Brexit and transition towards the final arrangements is still highly uncertain. Whilst there could well be further shocks to arise from the Brexit negotiations these are likely to diminish assuming a withdrawal agreement is reached, possibly in quarter three.

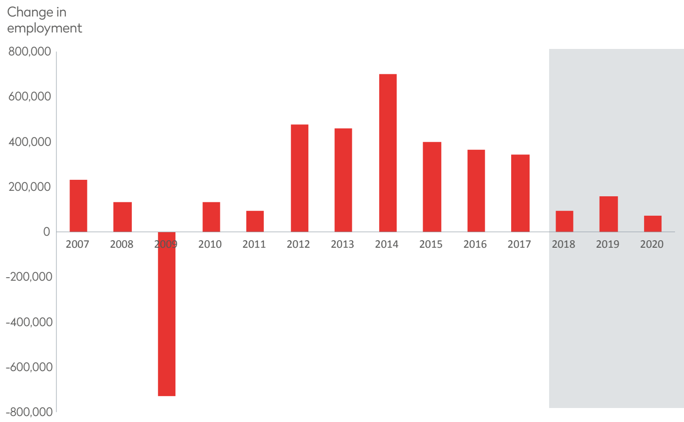
The rising global momentum should fuel growth although uncertainty caused by Brexit will hold back economic growth in the UK, which is expected to be below trend and subdued compared to other major economies. The Treasury consensus forecasts economic growth to slow to 1.6% in 2018 (see table). However, it appears that we are approaching the bottom of this economic cycle, assuming Brexit talks result in a sensible trade deal for the UK.

Purchasing managers' survey



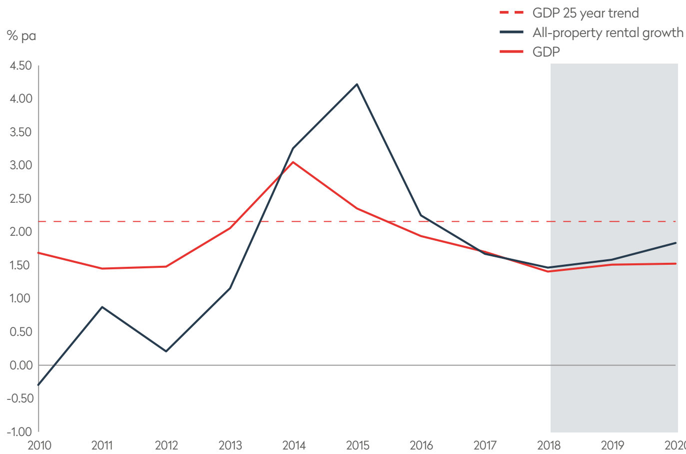
Source: Markit & CIPS

Full time equivalent employment forecast



Source: Experian

GDP and all-property rental growth forecast



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

Latest consensus forecasts, February 2018

	2018	2019	25-year trend
Economic growth (GDP)	1.6%	1.5%	2.5% pa
Private consumption	1.2%	1.3%	
Employment growth	0.6%	0.4%	0.7% pa
Bank Base Rate (Q4)	0.88%	1.23%	
CPI – Inflation (Q4)	2.4%	2.1%	
RPI – Inflation (Q4)	3.3%	3.2%	

Source: HM Treasury (Compilation of forecasts, GVA)

Occupier market

Supply

The annual level of new construction orders across the retail, office and industrial sectors resumed its decline and fell to the lowest level in almost four years (see first chart). The level of new orders remains subdued amid an uncertain outlook. In the office sector, 'permitted development rights' have continued to drive the rate of conversion of office space into residential uses and available office stock is now constrained in a number of city centre markets.

The Markit/CIPS construction activity survey, covering all construction activity increased to 51.4 in February, up from 50.2 in January. Commercial construction activity took an upturn and expanded at its fastest rate since May 2017.

Demand

Central London office take-up for Q4 2017 totalled 2.8 million sq ft, up 13% on the previous quarter. This brings take-up for 2017 to 9.5 million sq ft, 1.5% up on the 2016 total. The largest deal of the quarter was a 310,000 sq ft pre-let to Dentsu Aegis followed by a 300,000 sq ft deal to the Department for Communities and Local Government whilst two of largest deals in the City were both to WeWork. 68% more new space was delivered in 2017 compared to 2016, however the majority was pre-let and only 35% is still available. Prime rents in central London are now 0.3% up on the same time last year, although growth has only occurred in a handful of submarkets whilst most have remained static.

Take-up for 2017 amounted to over 10 million sq ft for the first time across the 'Big Nine' **regional office markets**. 2017 was also the year that serviced office / co-working deals soared in the regional office markets, totalling 635,000 sq ft. This accounted for 9% of all activity over 5,000 sq ft and compares to an average over the previous five years of 87,000 sq ft pa. There are still Government Property Unit deals to complete in the first phase of the government's relocation and the recent industrial strategy has committed to further phases and more jobs moving from London. We expect public sector deals and co-working office space to continue to drive demand.

The **industrial** sector was the best performer during 2017 with its success underpinned by the strength of e-tailing and the logistics market. Strong occupier demand and limited availability has sustained robust rental growth (see middle chart), with average industrial rental values increasing by 4.9% in the 12 months to January, well above the office and retail sector (IPD Monthly Index). The importance placed on 'last-mile' delivery will continue to support demand and rental growth for industrial assets through 2018.

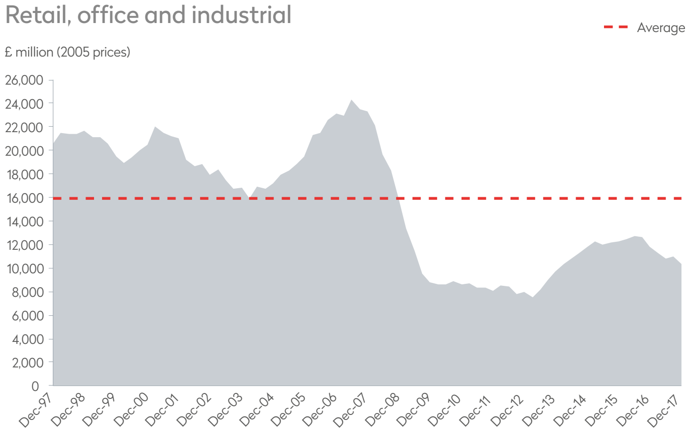
The **retail** sector struggled through 2017 as falling real wages squeezed household budgets and structural changes within the sector continued to place pressure on physical stores. 2018 will see a similar trend continue although some pressure may ease as inflation begins to ease.

Outlook for rental growth

All-property rental growth for 2017 performed somewhat better than expected at 2.2% (IPD Quarterly Index), but below-inflation growth and occupier uncertainty will continue into 2018 (see bottom chart). We expect rental growth to soften to 1.5% this year (see table), with the supply shortage and strength of the industrial sector supporting stronger growth in that market. However the nature of Brexit and its impact on occupier demand is clearly hard to predict.

Annual new construction orders (development activity)

Retail, office and industrial



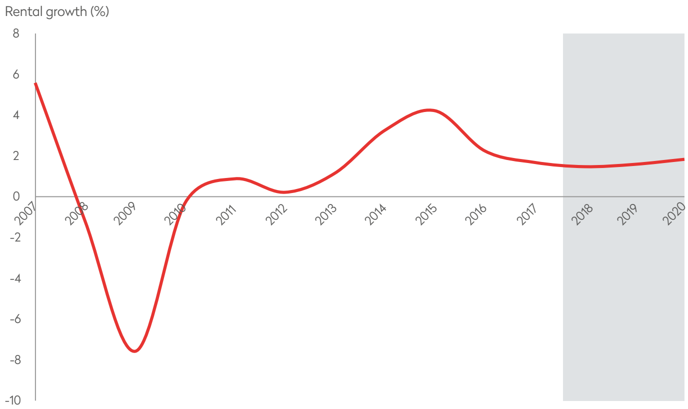
Source: ONS, GVA

Average quarterly rental growth

Source: IPD Monthly Index

All property average rental growth forecasts

Retail, office and industrial



Source: IPD Annual index, REFL, GVA

All property rental value growth forecasts

	2017	2018	2019
IPF Quarterly Consensus (February 2018)			
Maximum	-	2.0%	2.1%
Minimum	-	-0.9%	-0.7%
Average	-	0.8%	0.8%
GVA (March 2018)	**2.2%**	**1.5%**	**1.6%**

Source: IPF, REFL, GVA

Investment market outlook

Investor demand

The UK economic backdrop has not been favourable since the EU referendum but this hasn't altered the strong fundamentals of the UK market and investment activity in the UK commercial market remained buoyant in 2017.

Investment transaction value climbed to £65.4 billion in 2017 with Q4 adding over £18 billion to the total, an increase of circa 25% compared to Q4 2016 (see top chart). Although the annual total was below the 2015 peak it represents a 26% increase on the 2016 total.

The huge weight of global money has supported this strong investment activity. Overseas investors have accounted for circa 50% of transactions, with Far Eastern buyers accounting for 41% of overseas purchases. UK real estate will remain a 'safe haven' asset and the recent Budget announcement to charge Capital Gains Tax (CGT) on UK commercial property owned by overseas vehicles from April 2019 is unlikely to reduce its attractiveness. Indeed the increase in CGT will merely align the UK with the rest of the world.

Recent performance

The average all-property equivalent yield moved downwards throughout 2017 and has fully reversed the upwards jump following the EU referendum. It now stands at 5.9%, the lowest level since November 2007 (IPD Monthly Index). Capital values are now 3.1% above the pre-referendum level with average all-property capital growth picking up pace to 5.5% in the year to January (see middle chart). During the same period, the all-property annual total return was 11.2%, a marked improvement on the 2.7% a year ago (see bottom chart).

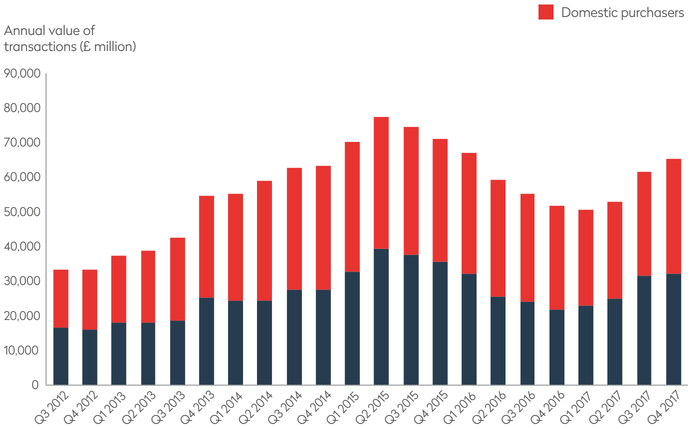
Prime industrial stock has been the success story of 2017 owing to the strong occupational performance plus its secure long dated income characteristics. The shortage of stock has led to premium prices as investors seek to acquire relatively defensive assets with reasonable income returns. Average industrial capital values increased by 15% in 2017 and yields continued to move downwards to 5.8% in January (below the all-property average), compared to 6.4% at the end of last year. As a result average industrial total returns were an impressive 20.1% (IPD Monthly Index).

Outlook

Investor demand for high quality real estate will remain strong, although limited available opportunities could curb the level of investment activity. We expect the average all-property total return to slow significantly in 2018 as we do not expect significant yield movement, and rental growth will remain subdued. The industrial sector is likely to outperform, in line with stronger rental growth expectations, with particularly strong investor interest in the last mile delivery sector, and should achieve close to a double-digit return.

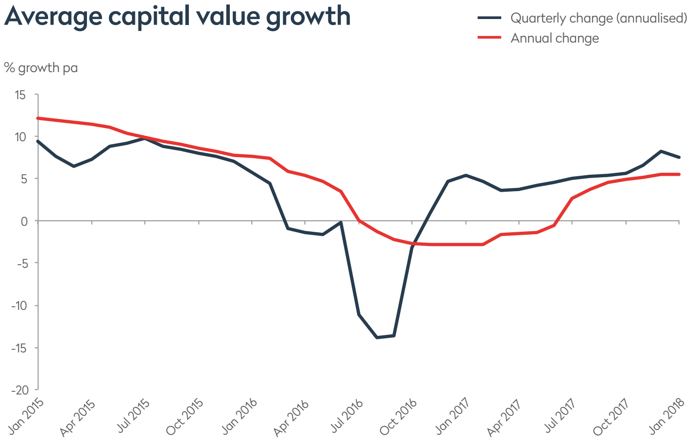
Although rising interest rates will reduce the gap between gilt yields and all-property equivalent yields a little, the gap will remain historically wide and so commercial property will continue to look attractive.

Annual investment transactions



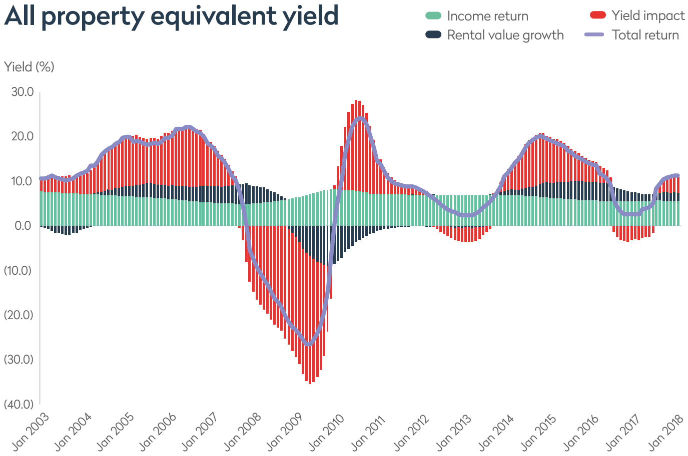
Source: Property Data

Average capital value growth



Source: IPD Monthly Index

All property equivalent yield



Source: IPD Monthly Index

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