GVA

RESEARCH

EPMR

Economic & property market review

Summer 2018

Economic Trends

Growth

Economic growth in the UK has been below trend but steady since the EU referendum. However, estimates for the first quarter of 2018 showed GDP growth slowed to a feeble 0.1%, down from 0.4% in Q4 2017 and the weakest growth since Q4 2012. A slowdown in activity in the construction sector was the largest drag on growth whilst the service sector remained the largest contributor to growth. Adverse weather conditions were partly to blame and we expect better performance in Q2.

Confidence Survey

The Markit / CIPS Purchasing Managers Indices average across the services, manufacturing and construction sectors improved in April however at a lesser degree than we had hoped (see first chart). Construction activity moved back into positive territory and the service sector experienced a modest rebound from the 20-month low in March.

Inflation and interest rates

The impact of the depreciation of Sterling on prices has diminished and CPI inflation fell to 2.4% in April, down from 2.5% in March. Having peaked in November at a high of 3.1%, the rate has dropped back to the lowest level since March last year.

Prior to the release of the Q1 economic growth figures a May Bank Rate rise was near certain. However, in light of the weaker than expected performance, the Monetary Policy Committee voted to keep the Bank Rate at 0.5%. We still expect a rate rise later this year but it is likely to be gradual. The average Bank Rate expectation for Q4 2018 in the latest Treasury comparison of forecasts is 0.76%, although further disappointing data could further delay the decision.

Labour market

The UK labour market has been the upside story with unemployment falling to 4.2%, down from 4.6% last year and the lowest since 1975. From January to March 2018 around 32.3 million people were in work, 197,000 more than Q4 2017 and 396,000 more than the previous year. Full-time employment accounted for around 64% of the annual increase.

With little spare capacity left in the UK nominal pay accelerated ahead of inflation to 2.9% (excluding bonuses) and by 2.6% including bonuses. The squeeze on households appears to be easing and we expect real wages to continue to grow in 2018 (see middle chart).

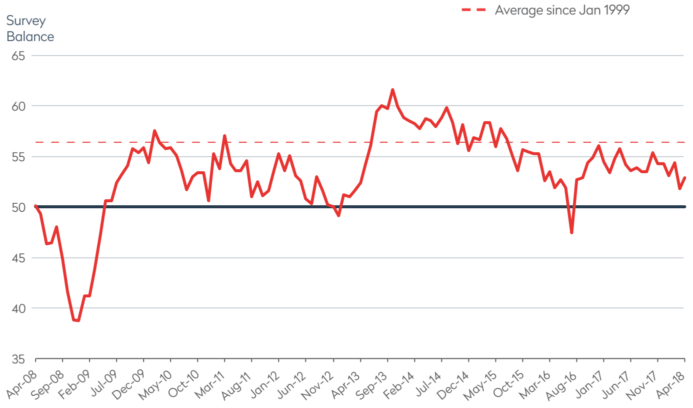
Outlook for growth

Within a year, the UK will have officially left the EU and the 21-month transition period means the UK is not likely to experience the 'cliff-edge' scenario next year.

However, the UK government is yet to agree on a model which can replace the customs union. In reality any future arrangements will require time and perhaps new technology to implement. Nearly two years after the referendum there is still little clarity over what the Brexit deal will look like, and we expect business activity and investment to remain subdued until there is more certainty, hopefully in the autumn.

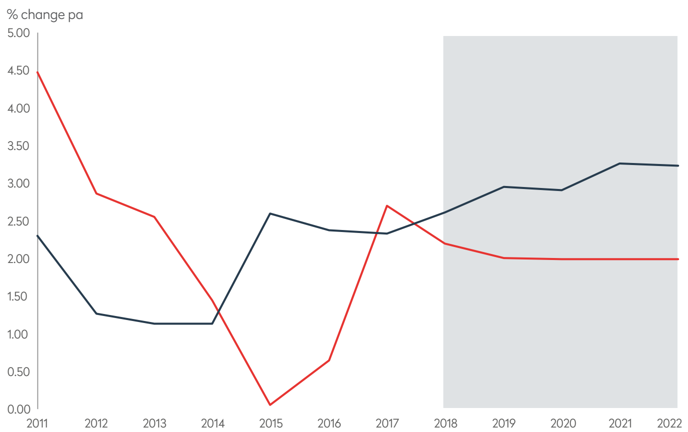
The Treasury consensus forecasts have downgraded economic growth from 1.7% in 2017 to 1.4% in 2018 and similar below trend growth is expected in 2019 (see table). 2018 appears to mark the bottom of the cycle, however this is assuming Brexit negotiations result in a positive trade deal for the UK. Assuming the economy remains resilient we expect the property market will track annual growth closely at 1.5% per annum over the next two years.

Purchasing managers' survey



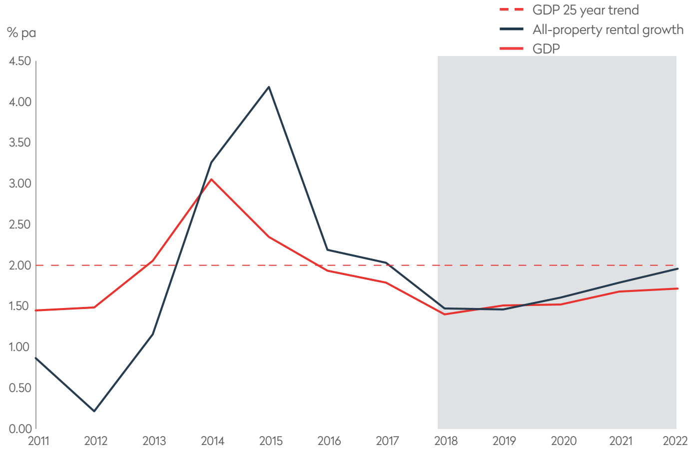
Source: Markit & CIPS

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 consensus forecasts, May 2018

	2018	2019	25-year trend
Economic growth (GDP)	1.4%	1.5%	2.5% pa
Private consumption	1.1%	1.5%	
Employment growth	0.7%	0.5%	0.7% pa
Bank Base Rate (Q4)	0.76%	1.14%	
CPI – Inflation (Q4)	2.2%	2.0%	
RPI – Inflation (Q4)	3.2%	3.0%	

Source: HM Treasury (Compilation of forecasts, GVA)

Occupier market

Supply

The commercial development pipeline continues to be limited as developers remain cautious amid the uncertain economic outlook. The Markit / CIPS construction activity survey, covering all construction activity, fell below the crucial 50 no-change threshold in March following the snow disruptions. In April it moved back above 50 to 52.5 although this was mostly driven by residential work with only a modest rise in commercial building.

Demand

Central London office take-up for Q1 2018 totalled 2.5 million sq ft, 11% down on the previous quarter, and 5% down on the five-year quarterly average of 2.6 million sq ft. The lack of supply particularly for larger units and good quality stock has constrained take-up and will continue to support rental levels. Indeed, with high demand, we have seen cases where tenants have missed out on their first choice of building, and in order to not repeat the same mistake, have become more flexible on rents. This was the second quarter of rental increase after five successive quarters of negative or no growth. Central London prime rents are now 2.1% up on the same time last year, although performance has varied considerably between submarkets.

Take up in the 'Big Nine' **regional office** markets totalled 1.4 million sq ft during Q1 2018, up 13% on the 10 year quarterly average. As in 2017, a large proportion of demand came from Government Property Unit deals and co-working office space. With low supply the largest deals continue to be pre-lets but there have been several speculative construction announcements this year including Atlantic Square and Cadworks in Glasgow and 100 Embankment in Manchester. Average regional office rental growth is likely to remain steady at just over 1% pa over the next two years before picking up a little.

The divergence in rental performance in the industrial and retail sectors continues. **Industrial** fundamentals remain robust, underpinned by demand from the logistics and 'last-mile' delivery. Average industrial rental values rose by 4.9% in the 12 months to April, well ahead of the 1.9% all-property average rental growth. Average industrial rental growth is projected to slow slightly to around 4% pa by the end of the year, although growth is more likely to exceed this than to undershoot.

Whilst the industrial sector continues to benefit from the structural change towards online shopping it has been at the expense of high street **retail**. The rising number of retailers in administration and Company Voluntary Arrangements continues to have an adverse impact on rental growth which has practically flatlined over the last year. In the 12 months to April 2018 average retail rental values increased by only 0.2%, well below the all-property average. In line with the challenging climate we do not expect rental growth to pick up, with secondary stock more vulnerable to declines in values.

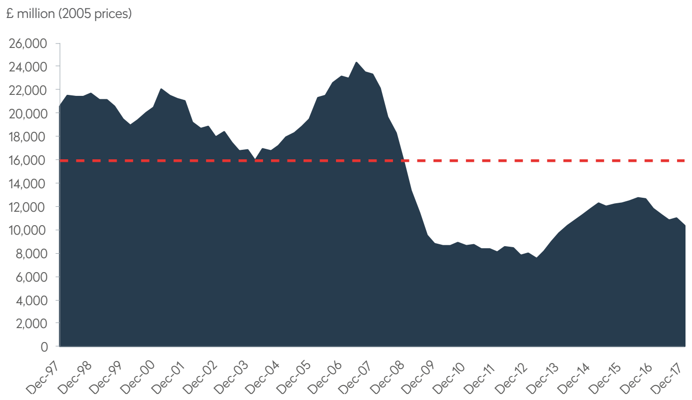
Outlook for rental growth

Average annual all-property rental growth has remained steady at 1.9% in 2018 so far, up from 1.3% recorded in May 2017 (IPD Monthly Index). The strength of the industrial/distribution sector has held the average up. We expect limited supply and strong demand from etailing, parcel delivery and discount retailers will continue to support average rental growth at above 4% pa over the next two years for the industrial sector. However, the retail and office sectors are likely to see average rental growth rates below CPI inflation.

We expect average all property rental growth to be 1.5% for 2018 as a whole and in 2019 (see table). The lack of supply is likely to insulate pressures arising from the continued occupier uncertainty and below-trend economic growth.

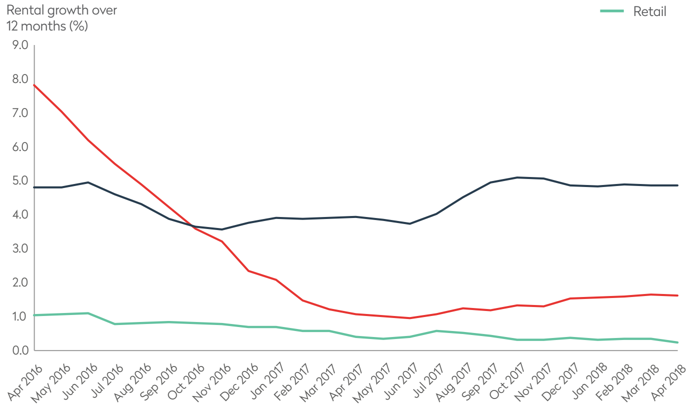
New construction orders (development activity)

Retail, office and industrial



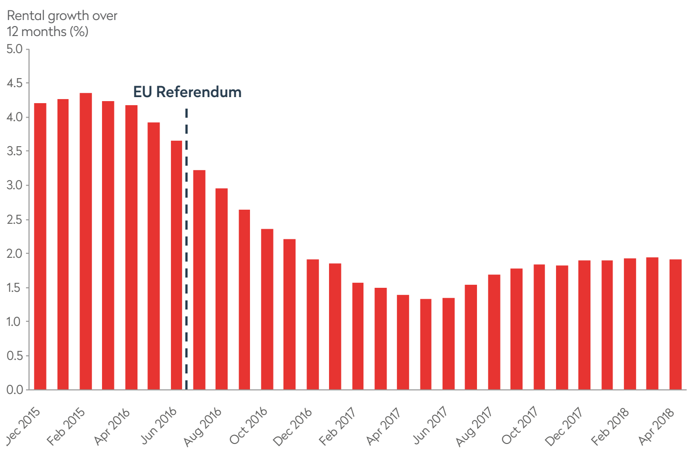
Source: ONS, GVA

Average annual rental growth



Source: IPD Monthly Index

Average all-property annual rental growth



Source: IPD Monthly Index

All-property rental value growth forecasts

	2018	2019
IPF Quarterly Consensus (May 2018)		
Maximum	1.9%	2.0%
Minimum	0.2%	-0.6%
Average	1.0%	0.6%
GVA (May 2018)	**1.5%**	**1.5%**

Source: IPF, REFL, GVA

Investment market outlook

Investor demand

Investor appetite for UK commercial property remains robust although the lack of buying opportunities is curtailing transactions.

Annual investment transaction value for the UK commercial market levelled off at £65 billion in the 12 months to Q1 2018 (see first chart). Total quarterly transactions amounted to £12.7 billion, down from £18 billion in Q4 2018 and around 3% lower than the corresponding figure last year.

The rise in overseas investment fuelled by the depreciation of Sterling has shown signs of moderating since the EU referendum. In the opening three months of 2018, the value of overseas investment in the UK commercial real estate market fell to £4.7 billion, down 31% from a year ago and the lowest level since Q3 2016. However, UK investor interest was up 29% in Q1 2018 compared to last year.

Recent performance

Yields remain under downward pressure across many parts of the market, including some secondary properties with shorter leases. This reflects the high desirability of UK commercial real estate and limited supply. In April, the average all-property equivalent yield edged further down to 5.9%, the lowest level since October 2007 (IPD monthly index). The industrial and regional office sectors have been the key drivers of this trend.

Average capital values were up 5.6% in the 12 months to April, and around 3.9% above the pre-referendum level (IPD monthly index). The all-property annual total return was 11.3% in April, a large improvement from 4.1% last year, although the rate has come down slightly from February when it peaked at 11.5%.

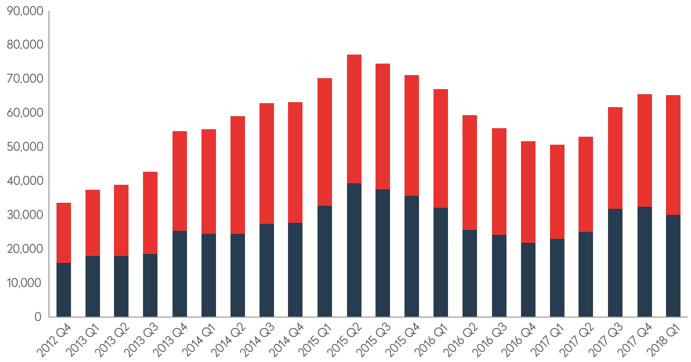
Outlook

Industrial properties remain one of the most sought after real estate investment in the UK. Demand for regional and central London offices is also high but limited supply has restricted activity in the market. Assets with long-term secured income remain robust and continue to be highly sought after, whilst the lack of supply is encouraging investors to look at opportunist properties with a higher risk profile.

The positive interest for UK real estate will continue and high quality stock is likely to trade at a premium, with retail being the exception. The rise in administrations and Company Voluntary Arrangements amongst retailers is likely to shrink the rental income stream from retail assets and investors will be looking for a discount on deals.

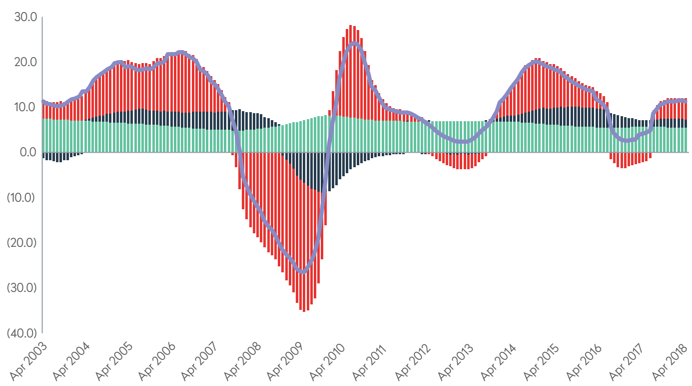
Although all-property equivalent yields continue to harden and long-term interest rates are rising, the gap between commercial real estate and gilts will remain wide. 10-year gilt yields are still only circa 1.5%, a 440 basis-point gap with the all-property equivalent yield (see bottom chart).

Annual investment transactions



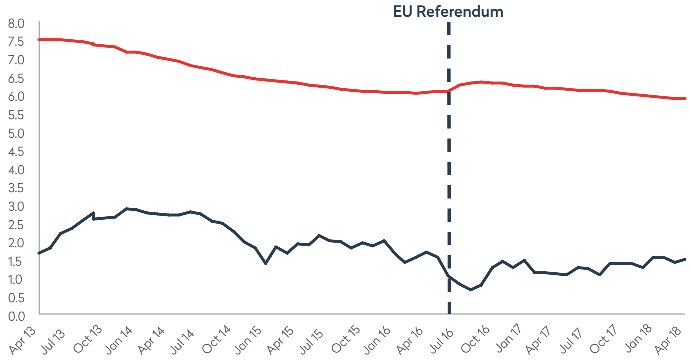
Source: Property Data

All-property equivalent yield



Source: IPD Monthly Index

All-property equivalent yield



Source: IPD Monthly Index

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