AVISON YOUNG

RESEARCH

EPMR

Economic & property market review

Winter 2018/19

Economic Trends

The UK remains engulfed in economic and political uncertainty as we approach the official exit date for Brexit. It is unlikely that a deal will be reached until the eleventh hour as Theresa May struggles to get a deal through Parliament. We are increasingly expecting some reworking with the likelihood of a short extension to the exit date.

Growth

UK GDP grew by 0.3% in the three months to November 2018, indicating a slowdown in activity in Q4 2018 compared to 0.6% GDP growth in Q3 2018 (see first chart). Manufacturing has been a drag on economic growth driven by poor performance from car production and pharmaceuticals.

Confidence Survey

The Markit / CIPS Purchasing Managers Indices average across the services, manufacturing and construction sectors dropped to a two and half year low in January, only just above the crucial 50 no-change value (see middle chart). Brexit-related uncertainty weighed on spending decisions by businesses and willingness to take on new projects across the service, construction and manufacturing sectors. The manufacturing sector noted a sharp rise in stockpiling of raw materials and finished goods amid concerns over Brexit-related disruptions, although this was offset by a slowdown in output and new orders.

Labour market

The labour market continues to thrive with the employment rate reaching 75.8%, the highest since records began in 1971. The number of people in work from September to November 2018 reached 32.5 million, up by 141,000 people compared to the previous three months and 328,000 more than the previous year. Indeed, majority of the rise in employment was from full-time work. The recent improvement in pay growth continued with real earnings increasing by 1.1% excluding bonuses and by 1.2% including bonuses. This is the largest annual increase since 2016 (see bottom chart).

Inflation and interest rates

CPI inflation fell to 2.1% in December 2018, down from 2.3% in November and its lowest level in nearly two years. The lower inflation reflects the decline in oil prices and introduction of the new energy price cap.

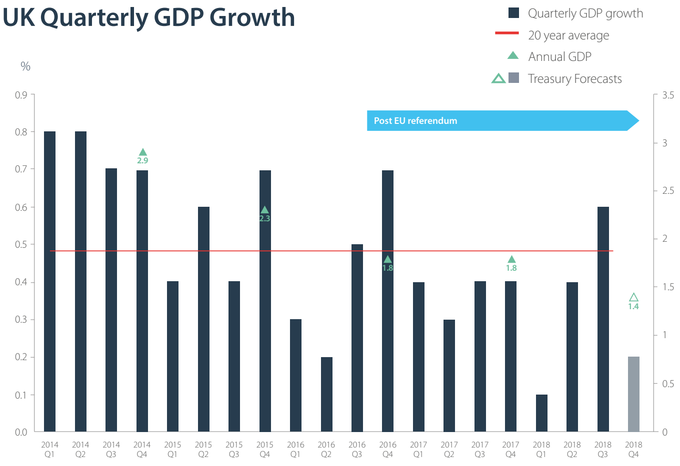
The Bank of England voted unanimously to keep the 'Bank Rate' on hold in February amid Brexit uncertainty and mounting pressure from a global slowdown. However, there is a strong likelihood of a gradual increase in the 'Bank Rate' should the UK reach a deal with the EU. The Bank of England will also be closely monitoring earnings growth and the potential risk of it feeding into higher inflation. However, in the event of a no-deal we expect the Bank of England to cut the 'Bank rate' in order to support the economy.

Outlook for growth

At the tail-end of 2018, business confidence had diminished in advance of the looming exit date. We expect GDP growth to be weak in 2019, particularly in Q1 with business activity and investment continuing to be subdued. Although we expect the pressure on households to ease as real earnings improve, it is unlikely to boost growth significantly as consumers have sustained high spending through borrowing in recent years and sentiment about the economic outlook has also deteriorated which could lead to households reducing their spending.

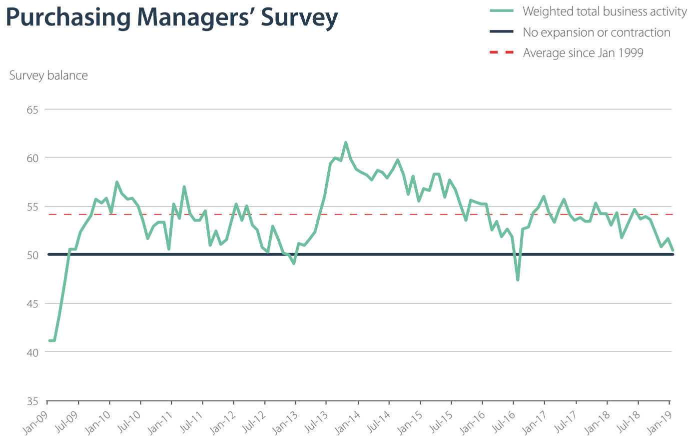
Economic growth remains muted and we do not expect growth to pick up at least until next year given the mounting pressures from home and abroad. The wider slowdown of the global economy will add pressure, with the deceleration of the Chinese economy, and the trade tariffs imposed by the US, being the most noteworthy but not the only factors in an increasingly subdued outlook for growth. The Treasury consensus forecasts have downgraded economic growth from 1.7% in 2017 to 1.4% in 2018, remaining around the same level in 2019 (see table).

UK Quarterly GDP Growth



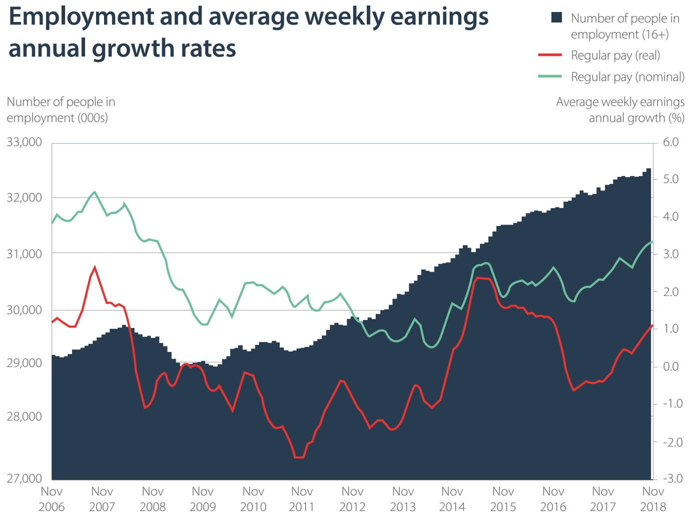
Source: ONS & HM Treasury

Purchasing Managers' Survey



Source: Markit & CIPS

Employment and average weekly earnings annual growth rates



Source: ONS

Latest Consensus Forecasts, January 2019

	2018	2019	25-year trend
Economic growth (GDP)	1.4%	1.4%	2.5% pa
Private consumption	1.6%	1.4%	
Employment growth	0.9%	0.6%	0.7% pa
Bank Base Rate (Q4)	0.78%	1.09%	
CPI – Inflation (Q4)	2.3%	1.9%	
RPI – Inflation (Q4)	3.2%	2.9%	

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

Occupier market

Supply

The annual level of new construction orders across the retail, office and industrial sectors continued to decline in Q3 2018, reaching a five-year low (see first chart). Brexit-related uncertainty has restricted construction output in sectors where high investment is required upfront in return for a long term income stream such as commercial real estate. Indeed, orders from the infrastructure sector are likely to be the main driver of construction activity in 2019.

The Markit/CIPS construction activity survey, covering all construction activity, decreased from 52.8 in December to 50.6 in January. All three areas of construction output deteriorated in January however, commercial construction was the weakest performing area. Political uncertainty and a tepid economic outlook has been a particular drag on commercial construction activity which declined for the first time in ten months.

Build cost inflation and future economic uncertainty are continuing to restrict new development in the regional office market, and grade A availability (consisting of brand new stock and second hand grade A) across the Big Nine office market is at a record low.

Demand

Central London office take-up for Q4 2018 totalled 3.5 million sq ft, up 42% on the long term average. This brings take-up for 2018 to 12.8 million sq ft, up 30% on the long-term average. The TMT & Creative sector made up the majority of take-up for Q4 at 22%, followed by Serviced Offices at 18%. Prelets continued to dominate particularly the City market with acquisitions by Interpublic Group at 135 Bishopsgate, EC2 and Jane Street Capital at Premier Place, EC2. Availability fell to 10.8 million sq ft for Q4 2018, down 10% on the 10-year average. Strong leasing activity and a continued lack of development supply caused the fall, despite rising tenant-offered space. The Central London vacancy rate currently stands at 5.6%.

2018 was another record year of take-up across the **'Big Nine' office** markets, amounting to 10.7 million sq ft, compared to last year's previous best of 10.1 million sq ft. Both city centre and out-of-town activity were 30% up on the long term average. 2018 was another strong year of take-up from Central Government, and the banking sector, with some of the largest deals, had a record year, after two fairly quiet years. The lack of prime stock continues to impact on headline rents with net effective rent across the Big Nine cities now at £26.03 psf, an increase of 4.1% over the past 12 months and 30% over five years.

The **retail** market had a particularly weak year, with multiple Company Voluntary Arrangements (CVAs) and store closures resulting from the on-going cost pressures and structural shift towards online shopping, which now accounts for 20% of total retail sales. Despite many retailers starting seasonal discounts early in attempt to overcome the pre-Christmas slump, overall sales volume decreased by 0.2% in the three months to December 2018 and by 0.9% when compared to the previous month. The backdrop of rising business rates, diminishing consumer confidence and change in consumer shopping habits have all negatively impacted retail property performance, with average retail rental growth declining by 2.5% in the year to December 2018 (MSCI monthly index).

The fundamentals in the **industrial sector** have remained resilient despite the uncertainty caused by Brexit. Activity continues to be underpinned by the strong demand from online shopping and 'last-mile' delivery. Online retailers, such as Amazon will continue to grow and demand space to fulfil e-commerce orders and 'last-mile' deliveries. As a result, average industrial rental growth remains robust at 4.1% in the 12 months to December, well ahead of the all-property average of 0.7% (MSCI monthly index).

Outlook for rental growth

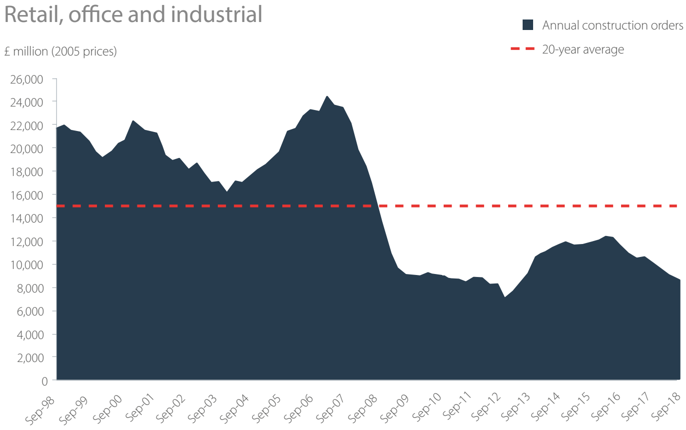
All-property rental growth has slowed over the course of 2018 with weak retail property performance being a particular drag (see third chart). The annual rate of growth for all-property declined to 0.7% in December 2018, down from 1.9% a year earlier (MSCI monthly index).

We expect the squeeze on mid-market retailers to continue into 2019, and consequently the 'polarisation' of the retail market will continue. We anticipate average rental values to decline by at least 5% considering the headwinds that continue to face the UK retail market. We expect average UK rental growth in the industrial sector to continue to outperform the retail and office market, although below the circa 4% pa growth seen in the previous three years.

Consequently, we expect all-property rental growth to be 0.4% for 2019 as a whole (see table), in line with continued occupier uncertainty and below-trend economic growth.

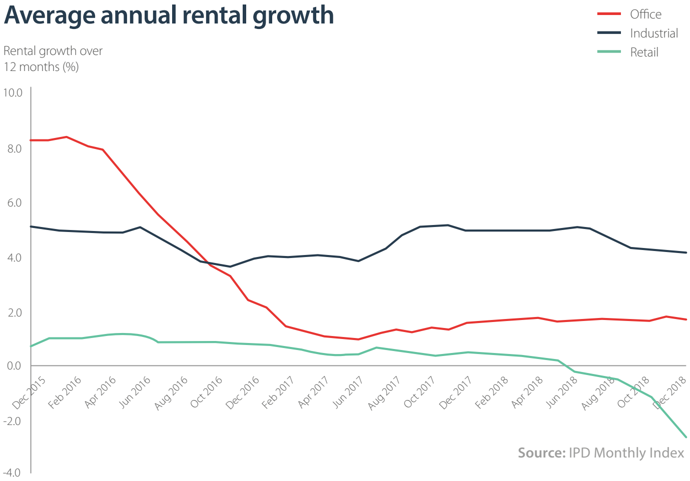
New construction orders (development activity)

Retail, office and industrial



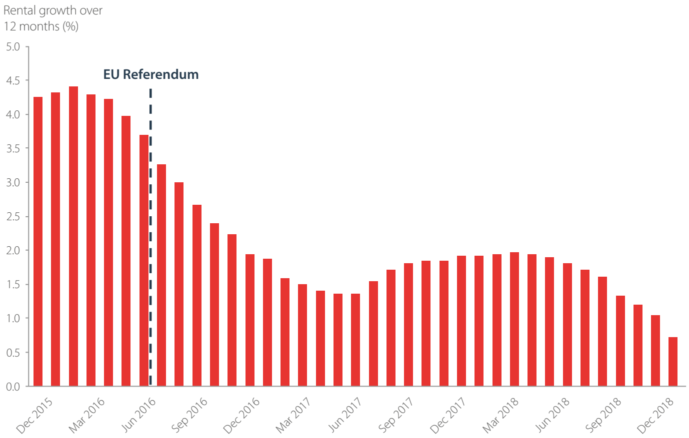
Source: ONS, Avison Young

Average annual rental growth



Source: IPD Monthly Index

Average all-property annual rental growth



Source: MSCI Monthly Index

All-property rental value growth forecasts

	2018	2019
IPF Quarterly Consensus (December 2018)		
Maximum	1.7%	1.5%
Minimum	0.2%	-2.0%
Average	0.8%	0.2%
Avison Young (February 2019)	**0.4%**	**0.4%**

Source: IPF, REFL, Avison Young

Investment

Investment activity remained robust in 2018 despite political and economic uncertainty intensifying. Annual investment transaction value for the UK commercial market totalled circa £62 billion in 2018 (see first chart), with purchases in Q4 totalling £16.7 billion, the highest quarterly figure in 2018.

Following a modest start to the year in Q1 2018, overseas investments remained steady at circa £7.5 billion per quarter for the remaining three quarters. Overall, overseas transactions accounted for around 44% of total purchases in 2018, down from 49% in 2017. Foreign investors were particularly active in the London office market, boosted by a surprisingly resilient occupational market, cheap currency and relatively attractive yields in comparison to other Tier 1 global cities. Indeed, they dominated investment in the City accounting for 74% of total investment for Q4 2018 alone. In the 'Big Nine' regional cities overseas investment cooled slightly, falling to 24% of total volumes during 2018, compared to 38% for the past three years.

Recent performance

All-property equivalent yields have stabilised at around 5.8% following a period of downward movement (see middle chart), although yields appear to be edging upwards amid weak economic outlook and stress in the retail property sector. As a result, all-property average capital value growth has lowered to 2.1% in the year to December 2018 (MSCI monthly index), down from 5.5% a year earlier. The downward movement in capital values was more pronounced in Q4, with average all-property capital values falling by 0.2% in the three months to December, compared to a growth of 0.4% in the previous three months. Falling rental value growth and softening of yields contributed the annual total return reducing to 7.5% in 2018, compared to 11.4% in 2017.

Performance is heavily polarised according to sector, with industrial yields well below those of offices and retail, supported by the structural change and strong rental growth in the logistics sector. Average capital value growth in the industrial sector reached 12% in the year to December 2018, compared to 2.5% in the office sector and a 5.7% capital value decline in the retail sector. However, it is worth noting that capital value growth and, in turn total return has reduced across all sectors.

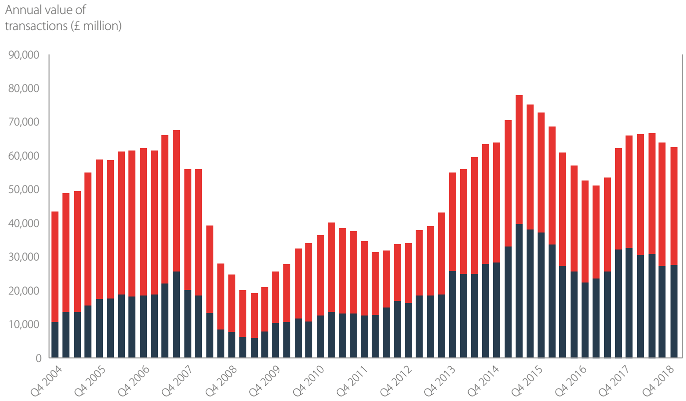
Outlook

As we approach the official Brexit date, many investors will opt for the 'wait and see' approach and hold off on transactions in the first quarter of 2019. However, there remains a large weight of global money ready to invest in the UK property market.

Industrial assets will remain highly sought after with rental growth holding up, although to a lesser extent than the last few years. Continuing with the trend, we expect the industrial sector to be amongst the few sectors with positive capital gains in 2019. Likewise, assets in the alternative sectors with long dated income will trade as demand is underpinned by demographics or technology and is fairly insensitive to Brexit.

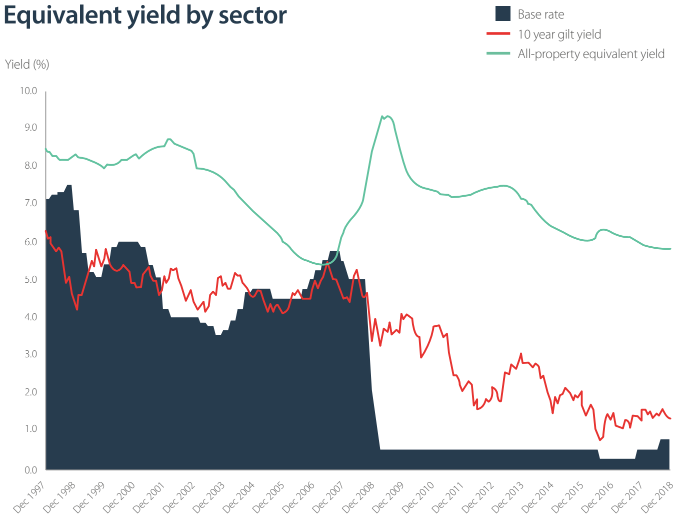
Many investors will be looking to reduce their exposure to the retail sector, as even those retail assets with 15-year leases no longer provide a guaranteed income stream since many retailers may still have a high risk of entering CVAs in the meantime.

Annual investment transactions



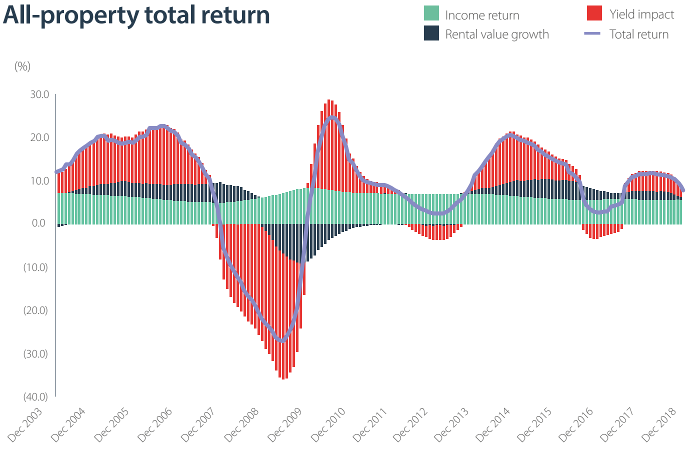
Source: Property Data

Equivalent yield by sector



Source: MSCI monthly index, Bank of England

All-property total return



Source: MSCI Monthly Index

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