RESEARCH

EPMR

Economic & property market review

Summer 2019

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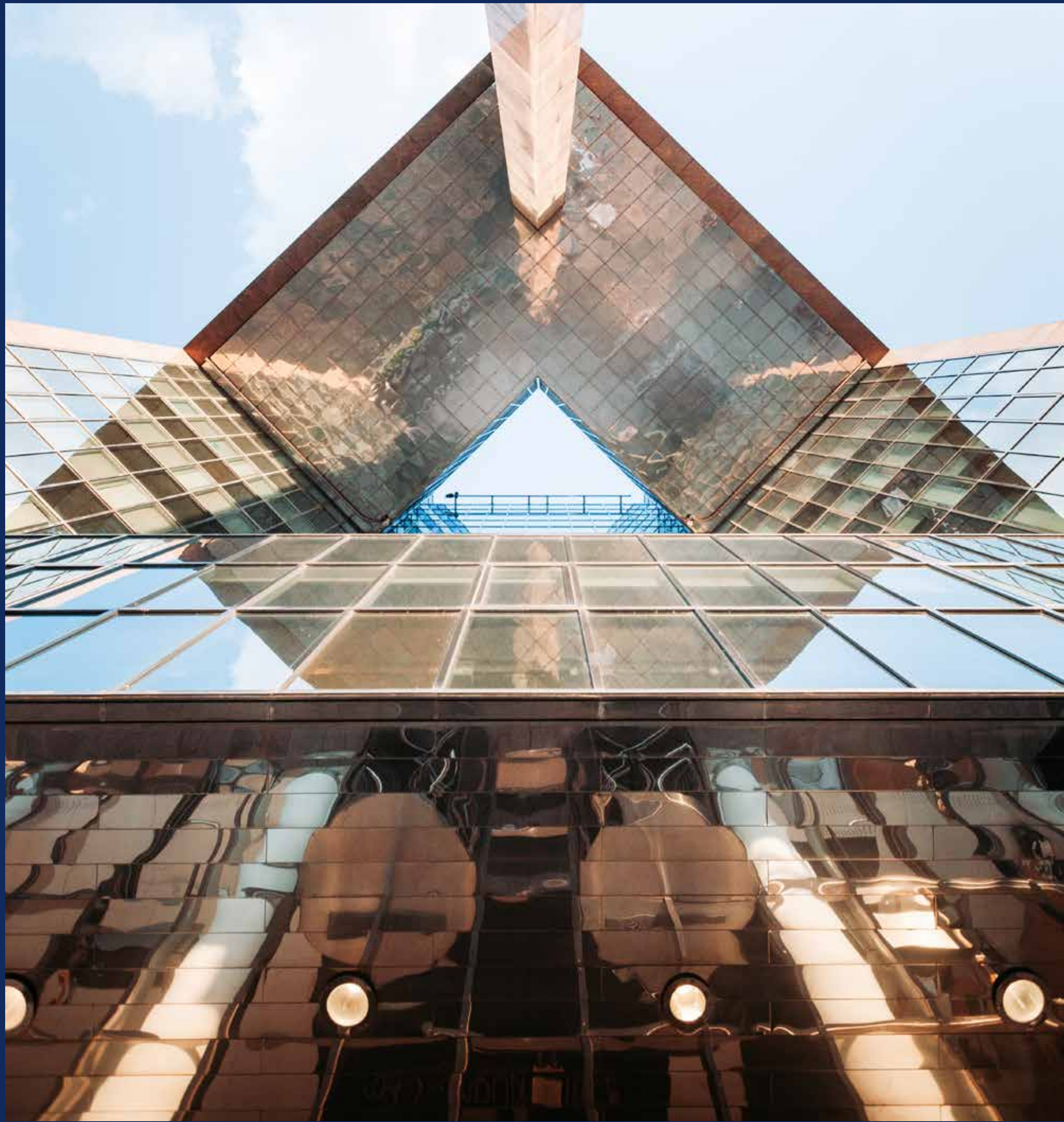


Economic Trends

Uncertainty in the UK economy remains acute and continues to cloud the outlook. The selection of Boris Johnson as the new Conservative Party leader and consequently prime minister was largely expected. Since his appointment the government's stance on Brexit has toughened which continues to further hamper business confidence.

Growth

UK GDP contracted by 0.2% in Q2, the worst performance in six years. This is significantly down from the 0.5% expansion in Q1, which saw activity boosted ahead of the original Brexit date as manufactures stockpiled. Conversely, activity in Q2 was hit by early plant closures by several car manufacturers and reduced demand from those who had previously stockpiled. Activity in the construction sector also reduced whilst the service sector remained effectively flat.

Confidence Survey

The Markit / CIPS Purchasing Managers Indices average across the services, manufacturing and construction sectors moved back into the positive territory in July. However, it remains subdued coming in only slightly above the crucial 50 no-change level. Both manufacturing and construction survey remained in the contractionary phase as businesses held back on activity amid ongoing political uncertainty, a wider global slowdown and unwinding stock levels ahead of the original Brexit date.

Labour market

The UK labour market remains buoyant with low levels of unemployment. However, the UK unemployment rate increased slightly to 3.9%, but remains lower than the recorded 4% a year ago. The number of people in employment totalled 32.81 million from April to June 2019, up 1.3% compared to year ago. The increase in employment has mostly been driven by the rise in number of full-time workers. At the same time, real earnings increased by 1.8% (including bonuses) and 1.9% (excluding bonuses).

Inflation and interest rates

CPI inflation remained steady at 2.0% in June and in line with the Bank of England's target for the second month in a row. However, there is a risk of inflation rising as the recent fall in Sterling and stronger wage growth feeds through. The Bank of England unanimously voted to hold interest rates at 0.75% at the latest MPC meeting. The outcome of Brexit will largely determine whether the Bank goes ahead with gradual albeit limited increases in the base rate or cuts rates ahead of a no-deal Brexit. Indeed, some traders are pricing in over 50% chance of a rate cut by December. However, a smooth Brexit could spur the Bank to increase rates more quickly.

Outlook for growth

The outlook for UK economic growth continues to be dominated by political and Brexit-related matters. Despite Boris Johnson's government ramping up preparations for a no-deal we believe this is most likely a negotiating tactic to make no-deal a credible threat. Ultimately, the prime minister aim is to get a Brexit deal however, in the short-term this is likely to have a knock-on effect on the economy as business confidence takes a hit and uncertainty remains. This comes at a time where global factors are less favourable, with escalating global trade tensions and slowdown in global economic potentially adding further stress to the UK economy.

The Treasury consensus has now downgraded its 2019 forecast for economic growth to 1.3% and remained at 1.4% for 2020.

LATEST CONSENSUS FORECASTS, JULY 2019

	2019	2020	25-year trend
Economic growth (GDP)	1.3%	1.4%	2.5% pa
Private consumption	1.6%	1.5%	
Employment growth	1.0%	0.4%	0.7% pa
Bank Base Rate (Q4)	0.82%	1.08%	
CPI – Inflation (Q4)	1.8%	2.1%	
RPI – Inflation (Q4)	2.5%	2.9%	

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

2019 ECONOMIC GROWTH FORECASTS

UK
1.3%

WORLD
3.2%

EUROPEAN UNION
1.6%

Source: HM Treasury and IMF

KEY STATS

- 0.2% ▼
Q2 GDP growth

PMI INDEX WEIGHTED AVERAGE

JUNE 49.5 ▲ JULY 50.6

UNEMPLOYMENT RATE

3.8%

REAL EARNINGS GROWTH

1.4% (INCLUDING BONUSES)

1.7% (EXCLUDING BONUSES)

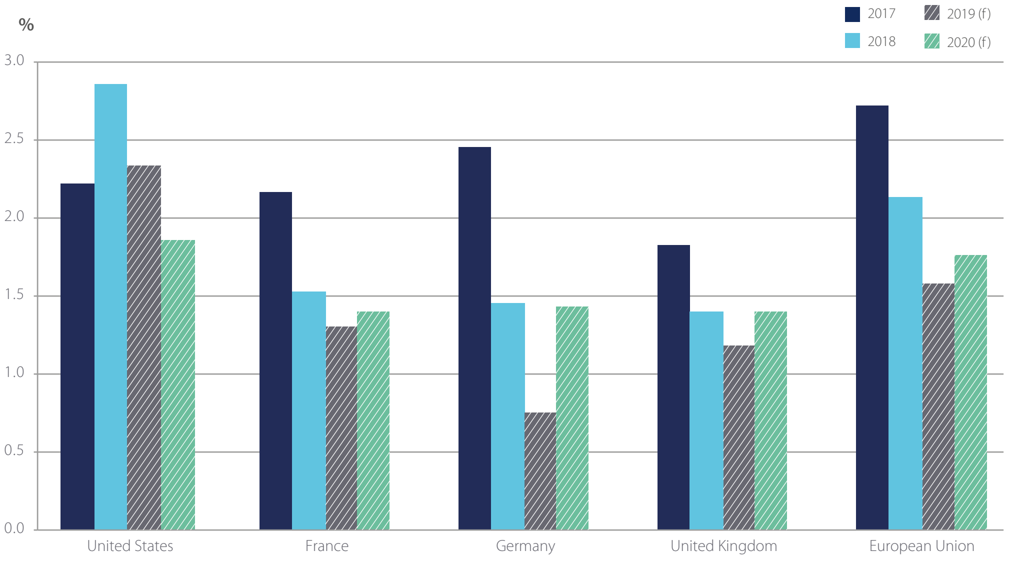
CPI INFLATION

2%

BANK RATE

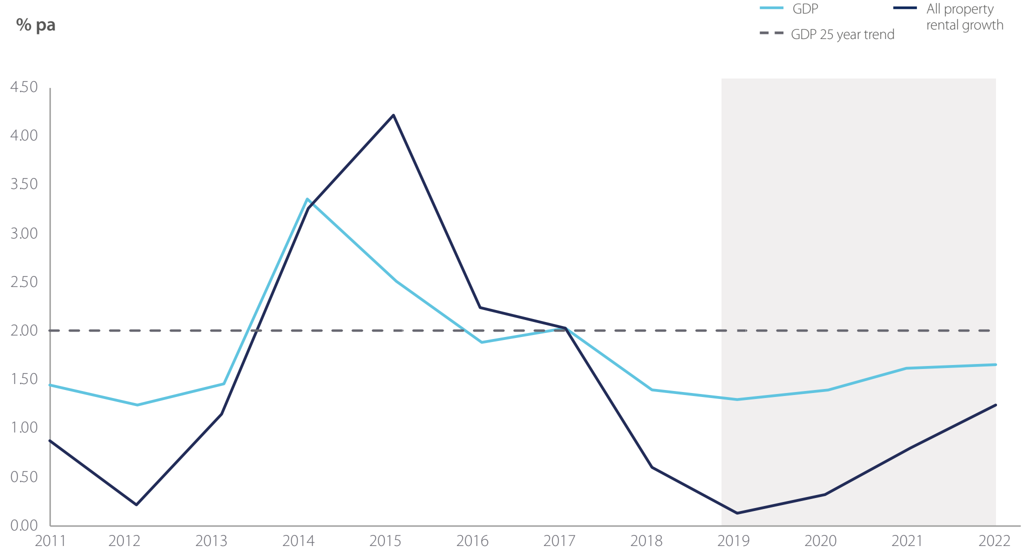
0.75%

GLOBAL ECONOMIC GROWTH



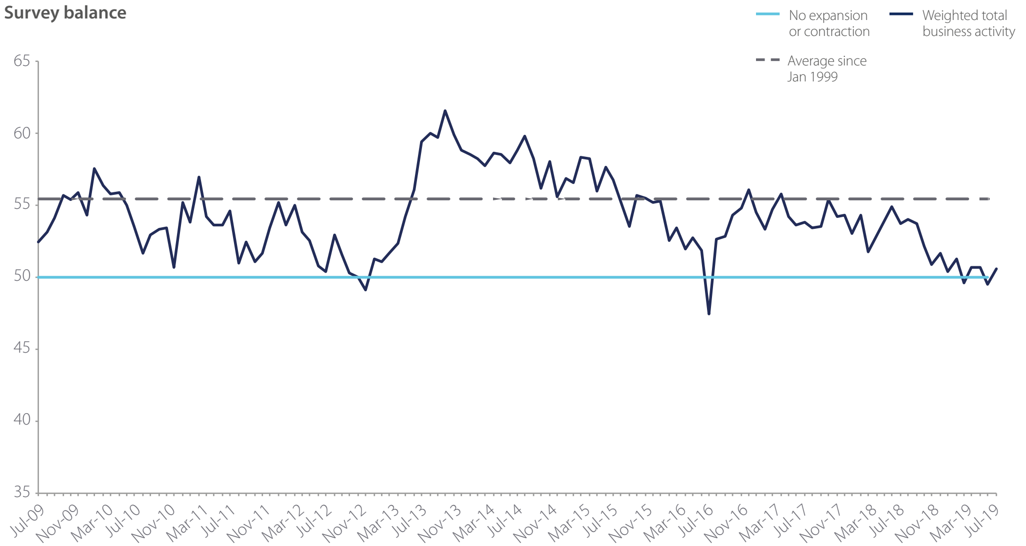
Source: IMF

GDP AND ALL-PROPERTY RENTAL GROWTH FORECAST



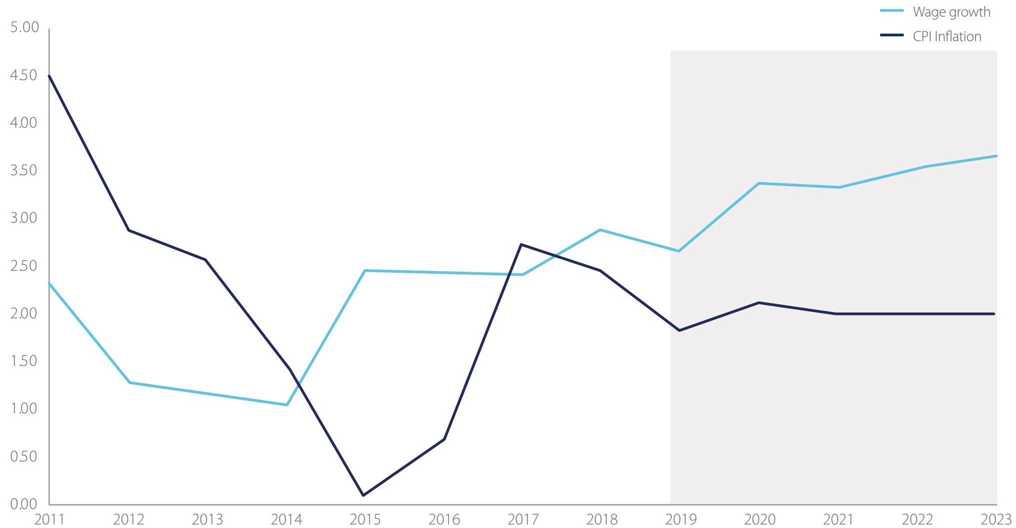
Source: Experian, HM treasury consensus, MSCI, REF and Avison Young

PURCHASING MANAGERS' SURVEY



Source: Markit & CIPS

INFLATION AND WAGE GROWTH



Source: Experian, HM treasury consensus

Occupier market

Supply

The annual level of new construction orders across the retail, office and industrial sectors picked up in Q1, but remain well below the 20-year trend (see chart). In the office sector, whilst availability has risen over the year it remains constrained for grade A and under-construction stock. In fact London, Birmingham and Manchester account for 87% of all construction stock across our ten key cities. Availability is also constrained in the industrial sector whilst the retail sector saw the largest rise in availability amid the ongoing structural change in the sector.

Demand

Real estate demand continues to hold up well underpinned by a resilient economy and a strong labour market. The **Central London office** market saw strong leasing activity during the quarter, well above the long term average with take-up reaching 3.0 million sq ft. Financial Services dominated tenant demand in Q2 2019 making up 30% of take-up for the quarter, followed by serviced offices which accounted for 15% of take-up.

Take-up has also been strong across the **Big Nine regional office** markets during Q2, with activity heavily skewed towards larger deals, city centre markets and the 'modern' sectors of flexible workspace and TMT. Flexible workspace deals totalled over 600,000 sq ft in Q2, which is already similar to the annual totals in the previous two years. Large deals across flexible workspace, TMT and consumer services meant it accounted for almost 80% of activity over 5,000 sq ft. In stark contrast there was very little activity by the public sector, finance and particularly professional services sectors.

Demand for modern **industrial** space is highly driven by e-commerce, manufacturing and logistics companies. The e-commerce sector was by far the most acquisitive during the first half of the year, accounting for almost 50% of take-up of the big-shed market. Overall, the market remains resilient with average industrial rental values increasing by 3.3% in the 12 months to June, well above the office and retail sector although growth has slowed over the last year (MSCI Monthly Index).

The latest 'UK Commercial Property Market Survey' stated tenant enquiries continue to rise for industrial space whilst availability continues to dwindle. Consequently, we expect further solid near term rental growth albeit below the high 3%.

The stress in the **retail** sector continues with the UK's British Retail Consortium reporting a 0.3% increase in retail sales in July, the lowest July figure since records began in 1995. The combination of rising import costs, higher business rates and the changing nature of shopping patterns to online has resulted in subdued performance in the retail property sector with average rental growth falling further negative to -4.1% in the 12 months to June (MSCI Monthly Index). According to RICS, availability has increased to the highest level since Q2 2009 whilst landlords continue to increase the value of incentive packages to retail tenants.

Outlook for rental growth

The annual rate of growth for all-property declined to just below zero in the 12 months to June, largely due to the drag from the retail sector (MSCI Monthly Index). We expect all-property rental growth to remain largely flat for the remainder of this year. In the industrial sector, rental growth will remain robust and above inflation, albeit slower than the previous two years at just below 3%. We expect rental growth for prime stock in the office sector to remain resilient whilst secondary stock is likely to see flat to negative growth.

ALL PROPERTY RENTAL VALUE GROWTH FORECASTS

	2019	2020
IPF Quarterly Consensus (May 2019)		
Maximum	1.0	1.1
Minimum	-1.2	-0.9
Average	-0.2	0.1
Avison Young (August 2019)	0.1	0.3

Source: IPF, REFL, Avison Young)

KEY STATS

ANNUAL ROLLING VALUE OF NEW CONSTRUCTION ORDERS

£9.8 billion

Q1 TAKE-UP LEVELS

CENTRAL LONDON OFFICES

3m sq ft

'BIG NINE' REGIONAL OFFICES

2.34m sq ft

ANNUALISED AVERAGE RENTAL GROWTH

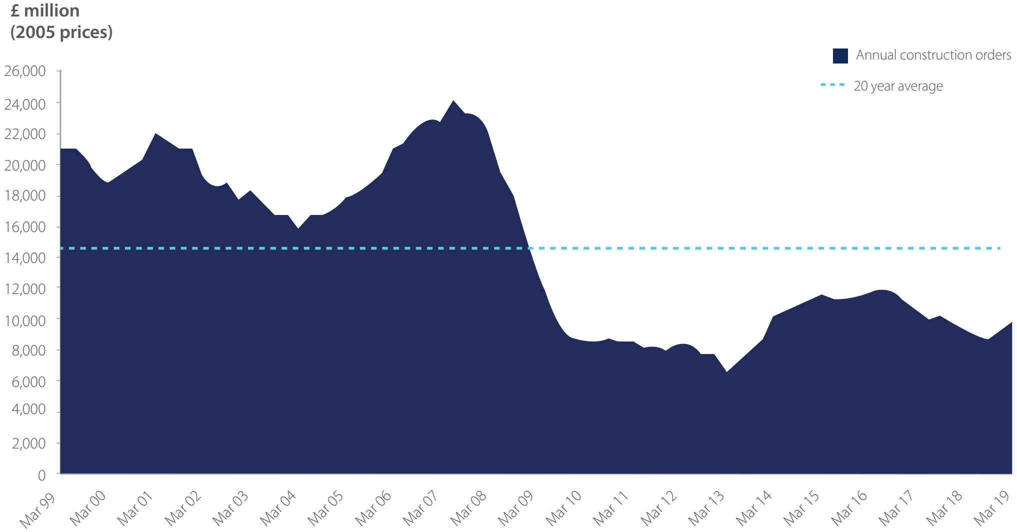
ALL-PROPERTY **0%**

OFFICES **1.5%**

RETAIL **-4.1%**

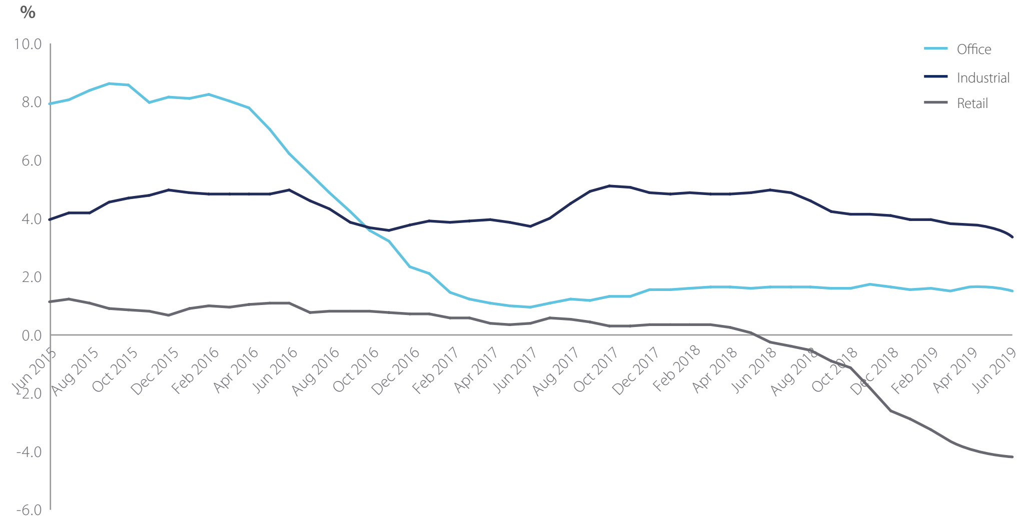
INDUSTRIAL **3.3%**

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



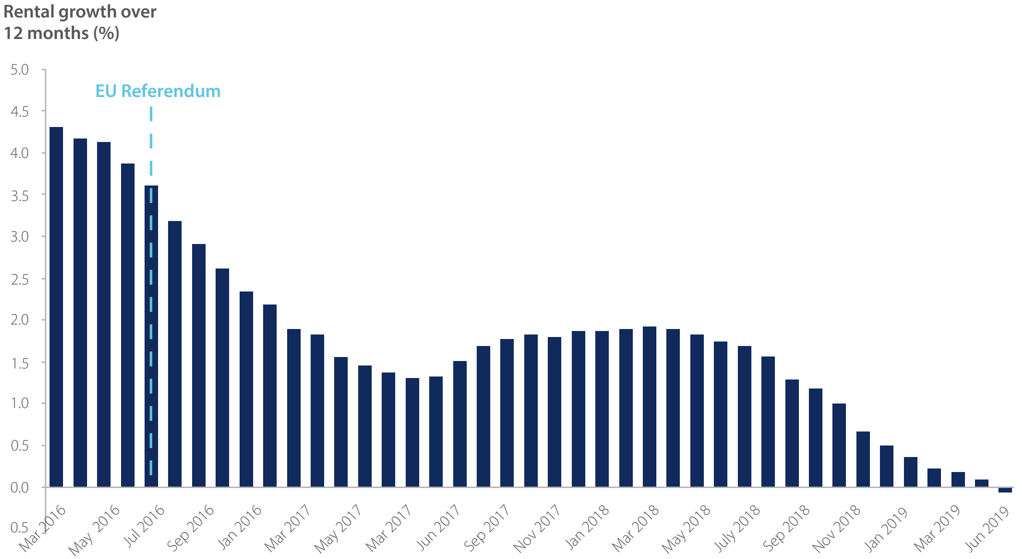
Source: ONS, Avison Young

AVERAGE ANNUAL RENTAL GROWTH



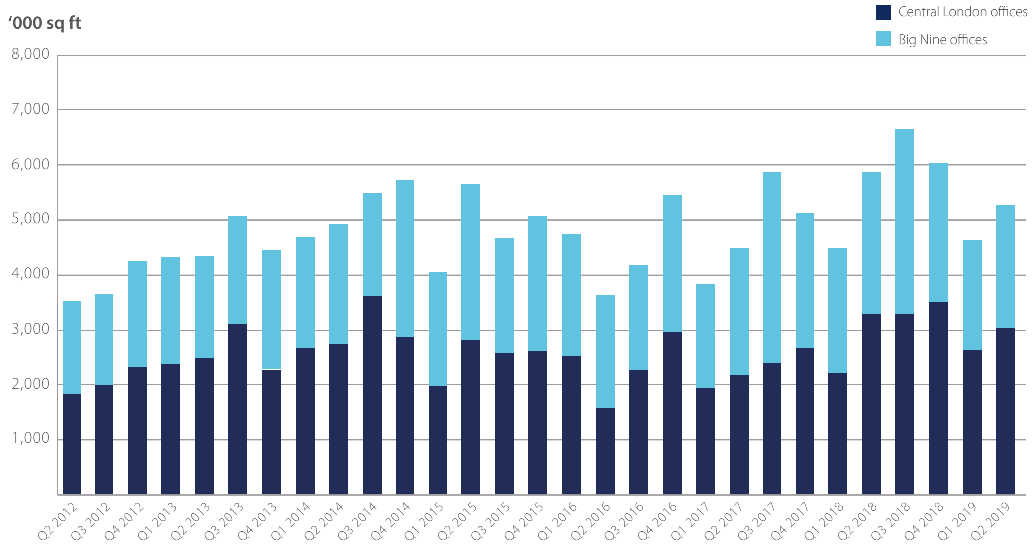
Source: MSCI Monthly Index

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

Investor demand

Weakening economic sentiment and political uncertainty related to Brexit has contributed to a slowdown. Activity in H1 has been notably down as investors remain cautious and delay purchasing decisions.

Investment volumes cooled to circa £19 billion during H1 2019, down 32% compared to H1 2018. Consequently, rolling annual transactions value dropped to circa £53 billion, the weakest in two years. The gloomy sentiment towards the retail investment market has deepened with the annual transactions down circa 50% on the five year average.

Overseas investors continue to benefit from the materially weakened currency, accounting for 53% of all transactions in the 12 months June. US investors dominated activity in Q2 totalling almost £2.3 billion, the highest level since 2015. However, this increase by US investors was offset by a reduction in activity from both Far Eastern and European investors. Overall, there has been a notable decrease in rolling annual activity from both UK institutions and overseas investors by 18% and 21% respectively compared to a year prior.

Recent performance

Average all-property equivalent yields have begun to drift upwards to 5.9% in June 2019 compared to 5.8% a year ago. Average yields have increased the most in the retail sector, by over 30 basis points (MSCI Monthly Index). However, the industrial and office sectors are also showing signs of upwards pressure.

Annualised average capital value growth for all-property has now turned negative to -1.2% in the year to June 2019. This is predominantly driven by the sharp falls in the retail sector of -9.5% in the 12 months to June (MSCI Monthly Index). Average capital value growth remains positive for the industrial and office sector at 5.8% and 1% respectively. This combined with diminishing all-property rental growth has resulted in all-property total return falling to 4% in the 12 months to June 2019, down from 11% a year ago.

Outlook

Brexit will continue to play a pivotal role in investment decisions during the second half of the year and with the possibility of no-deal rising we do not expect activity to recover in Q3. Despite this, there remains a large weight of global money ready to invest, particularly for best assets with long dated income and secure covenants.

Escalating trade tension and worsening global economic outlook combined with Brexit uncertainty has driven UK 10-year gilt years to below 0.5% in August. UK commercial real estate continues to look attractive for investors as UK government yields fall to record-lows. The gap between the property and government yields in June was just under 500 basis points, this has now widened as government yields continue to harden.

Q2 VOLUMES BY REGIONS

- London **£3.7 billion**
- East of England **£230 million**
- East Midlands **£640 million**
- North East **£119 million**
- North West **£290 million**
- Scotland **£614 million**
- South East **£628 million**
- South West **£290 million**
- Wales **£53 million**
- West Midlands **£360 million**
- Yorks & Humber **£193 million**
- Northern Ireland **£59 million**

KEY STATS

ANNUAL ROLLING INVESTMENT TRANSACTIONS VALUE

£53 billion

Q2 VOLUMES BY INVESTOR TYPE

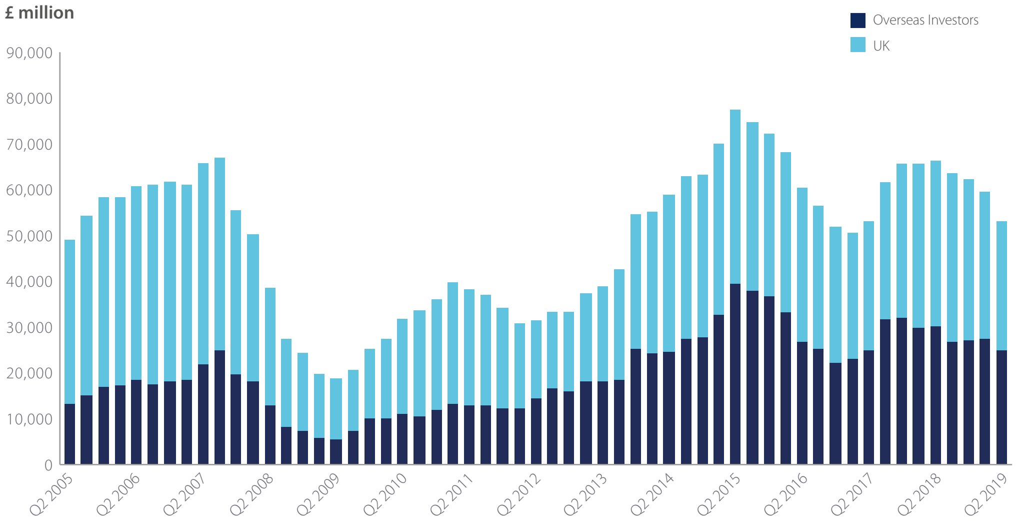
OVERSEAS INVESTOR	UK INSTITUTION	UK PROPERTY COMPANY
52%	13%	19%

ALL-PROPERTY EQUIVALENT YIELDS

5.9%

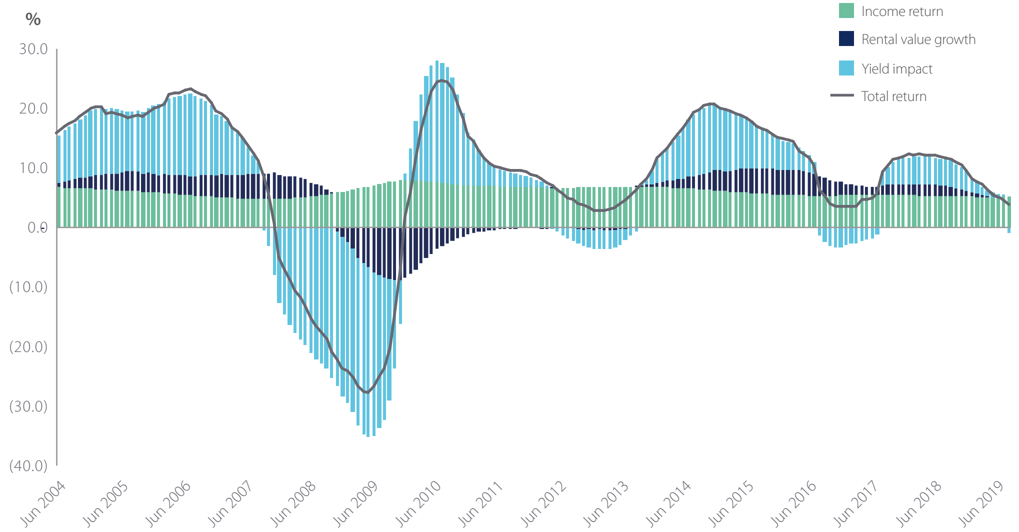
ANNUALISED ALL-PROPERTY TOTAL RETURN	ANNUALISED ALL-PROPERTY CAPITAL GROWTH
4%	-1.2%

ROLLING ANNUAL INVESTMENT TRANSACTION VOLUMES



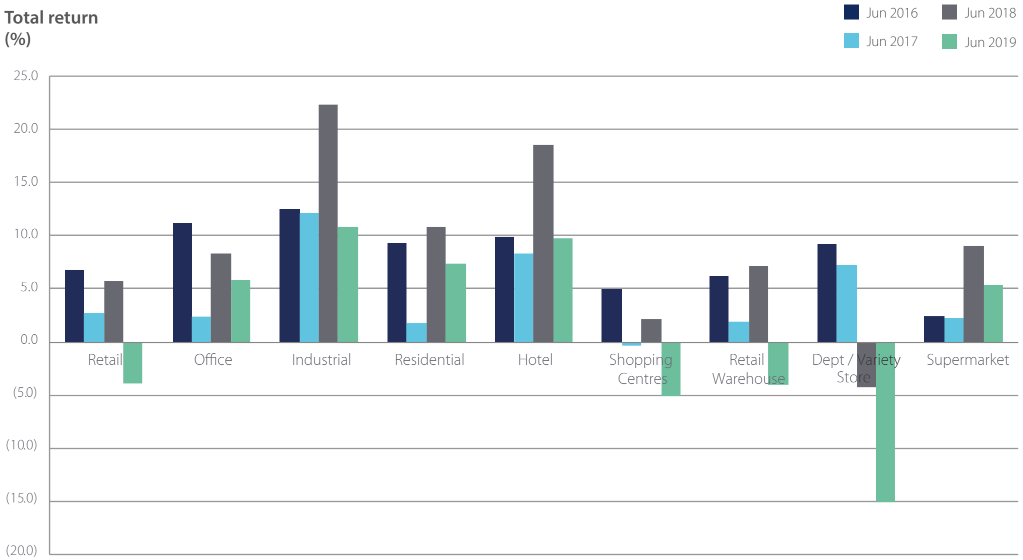
Source: Property Data

ALL PROPERTY ANNUAL TOTAL RETURN



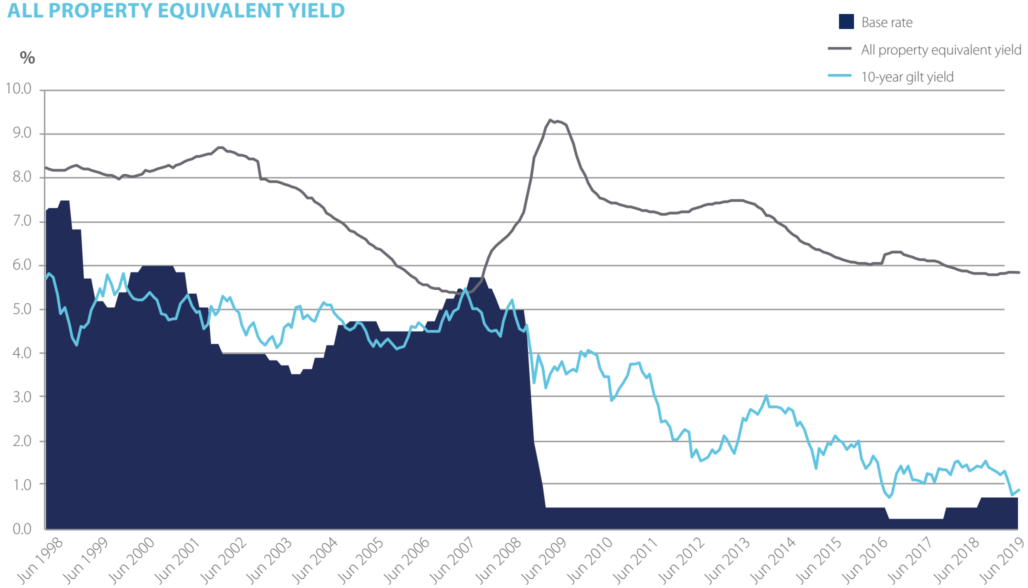
Source: MSCI Monthly Index

UK ANNUALISED TOTAL RETURNS BY SECTOR



Source: MSCI Monthly Index

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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