INSIGHT

EPMR

Economic & property market review

December 2021

AVISON YOUNG

Summary

- In response to evidence of community transmission of the Omicron variant, the UK government has reintroduced measures targeted at reducing the rate of infection. The 'Plan B' measures include mandatory face coverings and vaccine certificates for indoor venues, as well as advice to work from home where possible, coming into effect between 10th and 15th December.
- In October 2021, the ONS estimates that GDP grew by 0.1% and remains 0.5% below the pre-pandemic level of February 2020. Service output grew by 0.4%, now reaching its pre-pandemic level. Alongside this, production output decreased 0.6% in October 2021, with electricity and gas dropping by 2.9%, while construction decreased by 1.8%.
- CPI inflation increased by 4.2% in the year to October 2021, up on the 3.1% in September and the highest figure since 2011. The rise in the energy price cap caused 0.7 percentage points of the increases, while transport, restaurants and hotels provided additional upward momentum and most other sectors also experienced price growth. The latest figure exceeded the BoE 3.9% expectation and means that the inflation is now double the BoE's 2.0% target.

Economic trends

The emergence of the Omicron Covid-19 variant has caused the largest ripple across the global economy since the initial downturn at the beginning of the pandemic in March 2020. At the time of writing, it remains unknown as to whether the Omicron variant is more transmissible, severe or resistant to current vaccinations.

In response to evidence of community transmission of the Omicron variant, the UK government has reintroduced measures targeted at reducing the rate of infection. The 'Plan B' measures include mandatory face coverings and vaccine certificates for indoor venues, as well as advice to work from home where possible, coming into effect between 10th and 15th December.

Additional 'Plan C' restrictions are also in discussion within government. Full lockdown restrictions seem unlikely at this stage; there isn't the public support for such measures, nor the budgetary capacity to provide the fiscal support to protect the economy. A more likely scenario would be restrictions on group sizes, as were in place previously – although introducing these a week before Christmas would be politically challenging (the new measure currently expire on 20th December, hence they need to be renewed or increased by 18th).

Another alternative to a full-scale lockdown would be targeted measures applying to unvaccinated individuals. Several such interventions were imposed in Europe, with Austria and Germany restricting those who have not been inoculated to only essential activities and travel.

Vaccine mandates have also been introduced in some countries, however again there is a significant political and ethical disincentive for this. In the UK, 81% of the population have received two doses of the inoculation, with 37.8% having received an additional booster dose as well.

In October 2021, the ONS estimates that GDP grew by 0.1% and remains 0.5% below the pre-pandemic level of February 2020. Service output grew by 0.4%, now reaching its pre-pandemic level. Alongside this, production output decreased 0.6% in October 2021, with electricity and gas dropping by 2.9%, while construction decreased by 1.8%.

Public sector borrowing fell to £18.8 billion in October 2021, £0.2 billion less than the figure recorded in October 2020 but still £7.2 billion more than in October 2019. This figure fell faster than expected in October due to the end of the furlough scheme and the strong recovery of tax receipts.

Total public debt is estimated at £2.2 trillion, the highest figure since WWII. However, the debt interest to revenue ratio is currently the lowest rate since records began, meaning the repayments relative to government income are the most affordable they have ever been. This is due to the ultra-low interest rate environment, with the BoE maintaining the 0.1% record low level since March 2020. Although this reduces the fiscal impact, the immense scale of public debt creates a significant vulnerability to even a slight increase in interest rates.

The Markit / IHS purchasing managers indices (PMI) for November achieved a net balance of 57.6, marginally down from 57.8 in October. As it remains in excess of the no-change 50.0 marker, this figure suggests that activity expanded for the ninth consecutive month and with additional momentum.

Despite continuing to report strong growth, the services sector drove the decline in the headline PMI in November, declining down to 58.5 from 59.1. The momentum in the sector was sourced in part from export sales as travel restrictions eased internationally, hence there may be a downturn in activity in December as governments enact travel restrictions in response to the Omicron variant and rising cases, as well as other domestic measures. Construction achieved a PMI of 55.5 in November, up from 54.6 previously, as new business surged up and supplier delays eased. Manufacturing also increased to 58.1 from 57.8, even as input prices experienced the greatest increase on record.

Gfk's consumer confidence index increased to -14 in November from -17 in October. The improvement came as a result of a jump in the major purchases index which indicates how willing consumers are to buy high-value items, as well as slight gains in personal and general economic outlooks.

BoE data reported that consumer borrowing grew by £2.2 billion in October, down from £9.9 billion in September and the second lowest monthly figure since June 2020. This was primarily due to a slowdown in lending secured on dwellings, reflecting the reduced impetus in the housing market following the expiry of the Stamp Duty Land Tax (SDLT) holiday.

Economic trends

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Covid is back at the top of the agenda for deciding the future of the UK economy

The UK government has released a strategy for achieving net zero by 2050 ahead of hosting the COP26 climate Summit in Glasgow at the end of October. Included in the strategy are £650 million in grants for electric vehicles and charging points, funding toward up to 90,000 domestic ground source heat pumps and £120 million to develop small modular nuclear reactors. There have also been discussions of changes to tax structures to better align to achieving climate targets, with the Treasury highlighting the difficulties from 'the erosion of tax revenues from fossil fuel-related activity'.

Germany's chancellor for the past 16 years, Angela Merkel, has stepped down. Following a vote in the Bundestag, the German parliament, Olaf Scholz of the centre-left Social Democrats party will take on the leadership in a coalition with the Greens and Free Democrats. The move is likely to bring a harder line on Germany's relationship with China and Russia despite a potential cost to businesses, while strengthening ties with the US.

LABOUR MARKET

In the three months to October 2021, the employment rate increased marginally to 75.4%, with the unemployment rate continuing to decrease down to 4.3%. While the rising employment rates and declining unemployment rates are generally positive signs, there are wider factors to be considered which suggest that the labour market may be in danger of overheating.

Despite a 160,000 increase in payroll employees in October, vacancies topped 1 million for the third consecutive period to achieve close to 1.2 million. Labour shortages – which have been exacerbated by the pandemic driving alterations in the composition of the economy and the turbulent exit from the EU – are seriously impacting business performance in multiple sectors. Early indicators suggest the unemployment rate is coming down rapidly, at 4.0% in September and 3.5% (or around 1.1 million individuals) in the last week of the month – lower than the pre-pandemic level – suggesting there may not be enough slack in the labour market to satisfy demand.

There is the added concern of the approaching mandate for health and adult social care workers to be vaccinated. At present, estimates suggest that around 10% of NHS staff and around 5% of adult social care workers are unvaccinated. Both of the sectors have considerable staff shortages already which are likely to become severe in response to the vaccine requirements.

Real regular pay grew by 2.2% year-on-year in the three months to September 2021, while total pay (including bonuses) grew by 3.1%, both of which represent continued decline from the June peak. These figures are relatively low considering the labour shortages, potentially reflecting the squeeze many businesses continue to feel as a result of the pandemic, and the comparatively well-off position of household savings.

The expiry of the CJRS at the end of September impacted some 1.1 million furloughed jobs. Although the full extent of the impacts are still unknown at the time of writing, initial suggestions are that the majority of these employments will be maintained with only a minority being made redundant. The government's additional funding for apprenticeships and training may curb increases chronic unemployment levels as a consequence of Covid and aid the restructuring of the post-pandemic economy. The current staff shortages require a more immediate solution or risks provoking an inflation-wage spiral as labour demands drive up pay, exacerbating the pre-existing supply-driven price rises.

At present, the impact to businesses from the new restrictions seems likely to be minor. Although masks and vaccination passports made add some operational headaches potentially with some extra costs, the main downside from these will be consumer confidence. As such, we don't expect an uptick in redundancies or hiring freezes at present, although further restrictions could change this.

Economic trends

INFLATION

CPI inflation increased by 4.2% in the year to October 2021, up on the 3.1% in September and the highest figure since 2011. The rise in the energy price cap caused 0.7 percentage points of the increases, while transport, restaurants and hotels provided additional upward momentum and most other sectors also experienced price growth. The latest figure exceeded the BoE 3.9% expectation and means that the inflation is now double the BoE's 2.0% target.

These higher-than-anticipated figures, combined with the labour market outlook, suggest that the BoE's Monetary Policy Committee (MPC) may have been leaning toward raising the interest rate at their next meeting in mid-December. However, the emergence of the Omicron variant, combined with the underperformance of GDP relative to expectations, has complicated the decision further.

It seems likely that, should the 'transitionary' perception of the current levels of inflation persists, then the MPC will leave rates as they are. Rate hikes are long-term levers which will not have a tangible impact on the market for several months, thus are likely not to be able to help alleviate the current surge in price growth. It therefore seems probable that the MPC will not risk stifling long-term growth by raising rates as we enter another period of considerable uncertainty just to solve a short-term issue. Hence we expect the base rate to be held for the remainder of 2021, with a possible rise in Q1 or Q2 in 2022.

This is good news for the government, as the scale of public debt means that even a slight rise interest rates would significantly increase debt maintenance costs. If rates are held until Q2 2022, then there will be a greater scope for additional spending in the March budget, which may be particularly useful considering the prospect of further restrictions coming into force.

OUTLOOK

Forecasts remain contingent on how the pandemic and the Omicron variant develops. For now, markets are likely to take a precautionary stance and react in line with the re-introduction of covid restrictions.

GDP figures for 2022 are less favourable with the Confederation of British Industry cutting their predictions for GDP growth down from 6.9% to 5.1%. With 'Plan B' now in place, consumer confidence has been knocked back and presents the real possibility of a contraction in output in December. Any more restrictions imposed by the government will reduce the UK's economic recovery further.

Covid is back at the top of the agenda for deciding the future of the UK economy. Case numbers are now doubling every 2 to 3 days and the country is bracing for one million cases by the end of December. New hospitalisations have remained at a manageable level so far, helped by the vaccination and subsequent booster programmes. Increased scale of the flu immunisation will also ease pressure on hospitals operating over winter.

The inflation and labour market narratives are having an increasing influence over the UK economy, through material realities and expectations. With waning momentum in the recovery effort, and the reinstated restrictions, the likelihood of a jump in interest rates is low until Q2 2022. For the property sector, this means that prospective purchasers of domestic and non-domestic property can continue to take advantage of the low borrowing costs. However, higher supplier prices mean that the business environment is more restricted, particularly for new businesses and those with low margins. Hence there may be a reduced appetite for smaller spaces over the coming year as viable business models become harder to distil.

LATEST CONSENSUS FORECASTS – NOVEMBER 2021

	2021	2022
Economic growth (GDP)	6.9%	4.7%
Household consumption	4.2%	6.2%
Unemployment rate	4.8%	4.8%
Bank base rate	0.3%	0.6%
CPI - Inflation	2.3%	3.3%
RPI - Inflation	3.7%	5.1%

Source: Consensus Economics

2021 ECONOMIC GROWTH FORECASTS

WORLD
5.9%

UK
6.7%

EUROZONE
5.1%

Source: IMF

KEY STATS

GDP GROWTH

▲ 5.5% Q2 2021

▲ 1.3% Q3 2021

PMI WEIGHTED AVERAGE

57.8% October

▼ 57.6% November

UNEMPLOYMENT RATE

4.8% Q3 2021

REAL EARNINGS GROWTH

3.1% (including bonuses)

2.2% (excluding bonuses)

CPI INFLATION

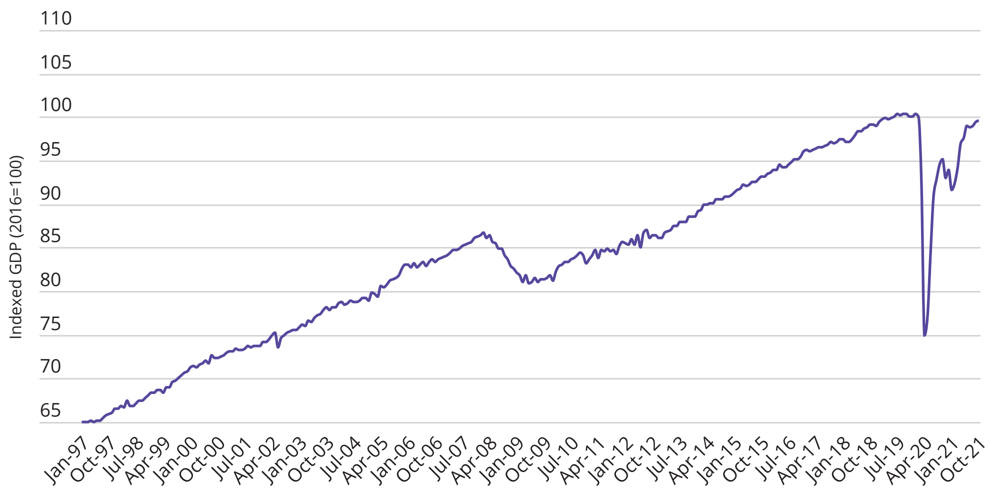
4.2%

BANK RATE

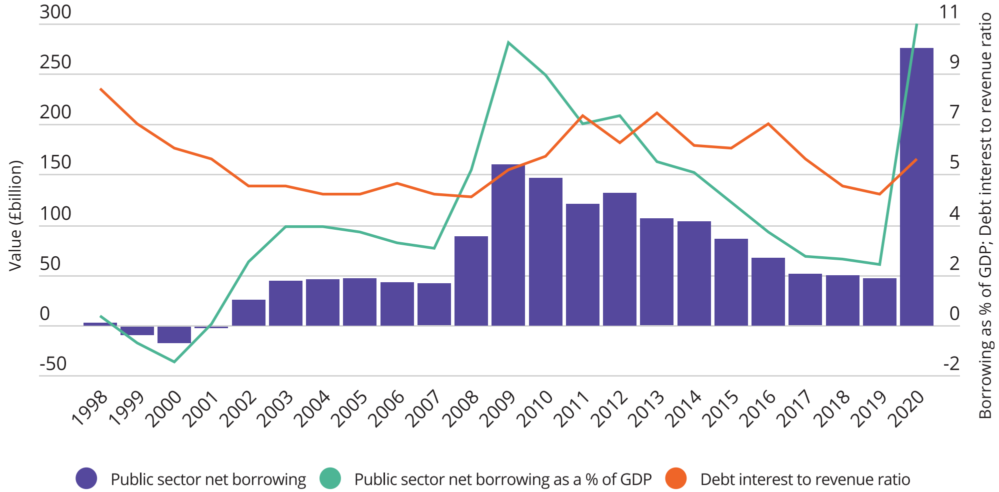
0.1%

Economic data

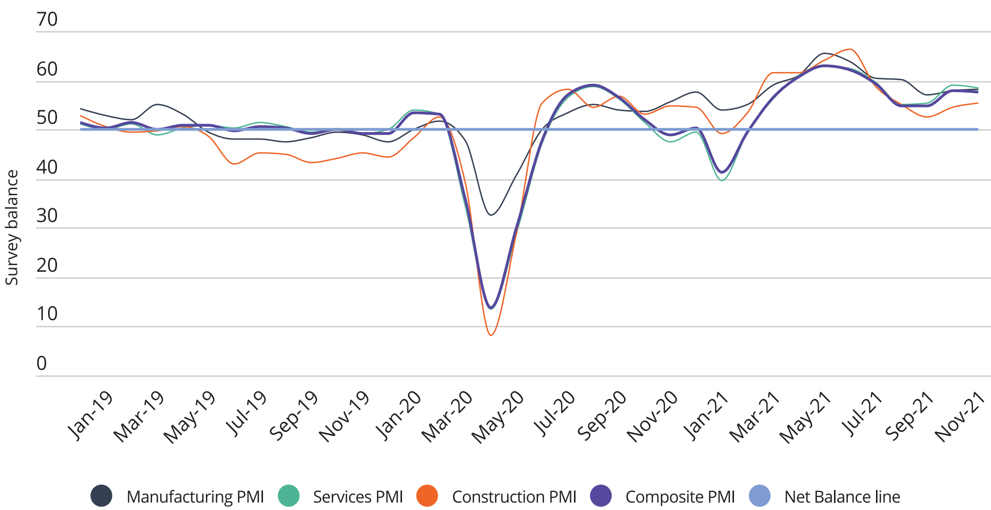
MONTHLY GDP Source: ONS



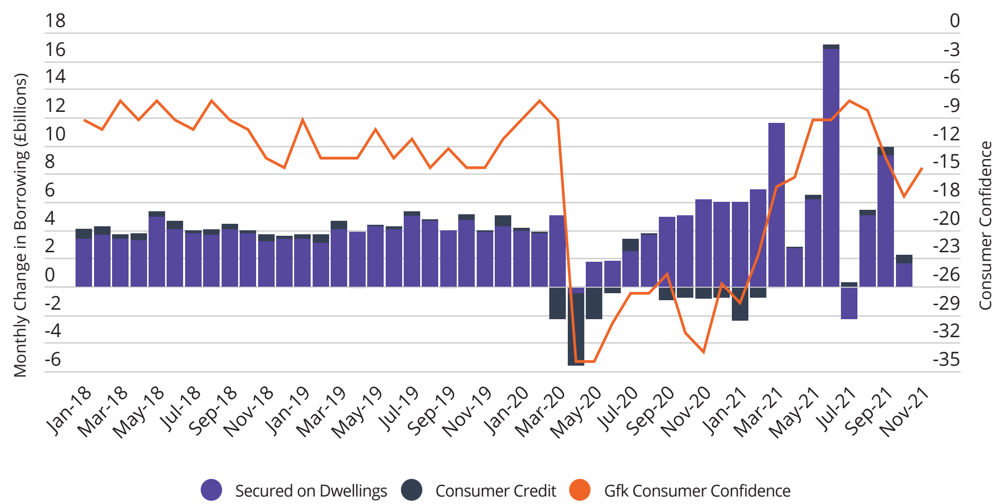
PUBLIC SECTOR NET BORROWING EXCL. PUBLIC SECTOR BANKS Source: ONS



PURCHASING MANAGERS' SURVEY Source: Markit & CIPS



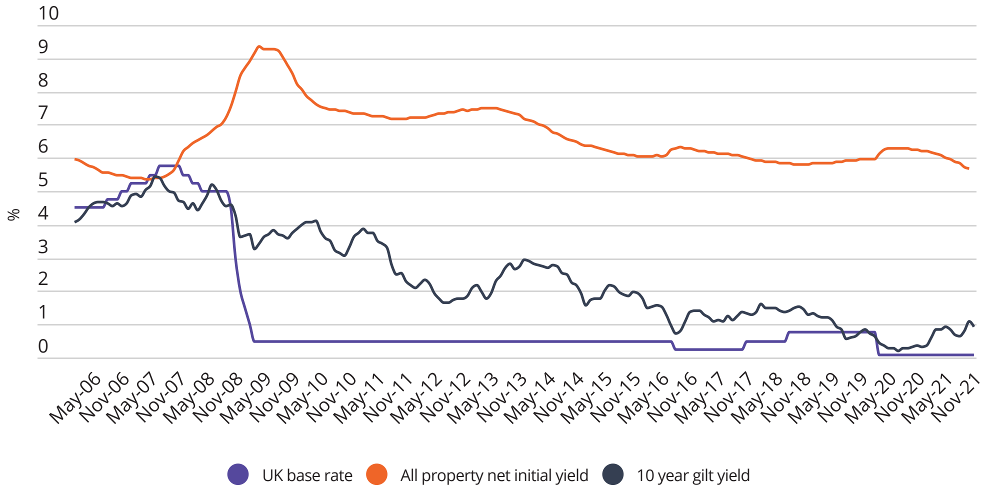
CONSUMER CREDIT AND CONFIDENCE Source: Bank of England



Economic data

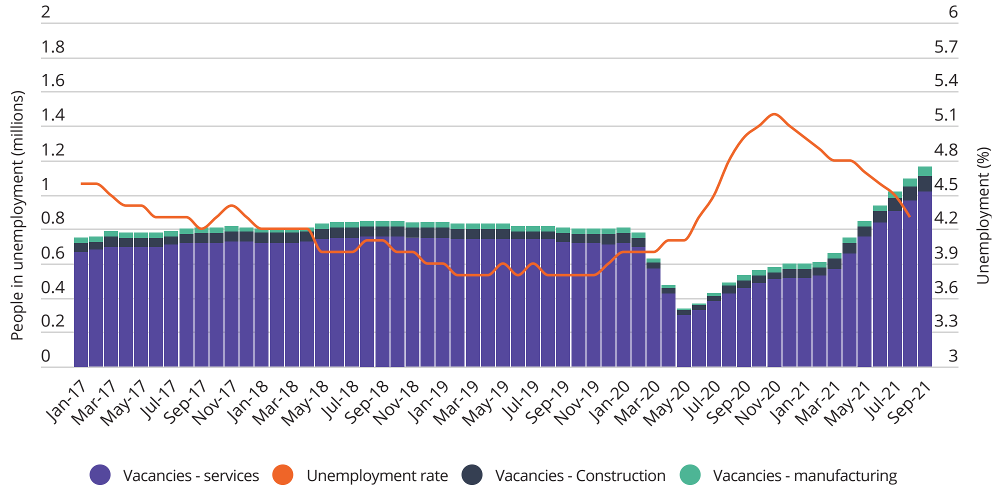
UK NET INITIAL YIELD VS GILTS VS BASE RATE

Source: MSCI monthly index, Bank of England



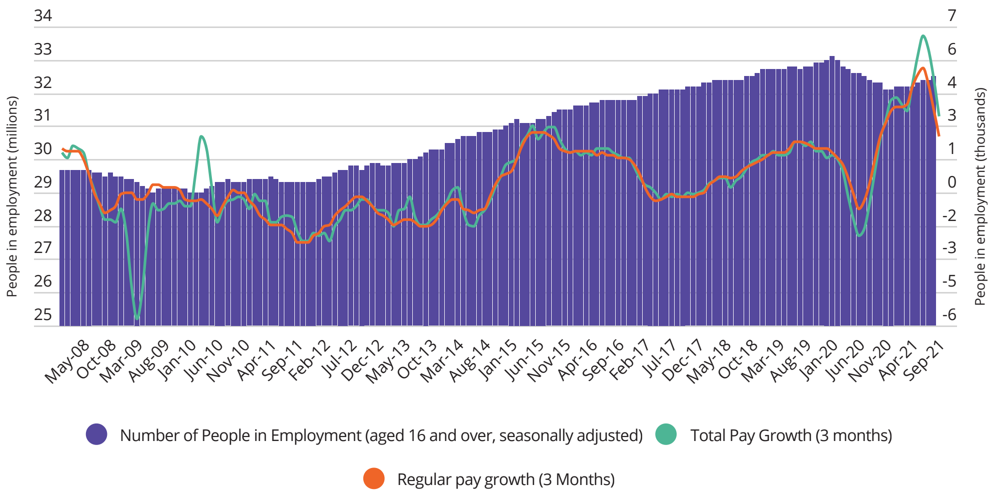
VACANCIES

Source: ONS



EMPLOYMENT AND AVERAGE WEEKLY EARNINGS

Source: ONS



GLOBAL ECONOMIC GROWTH

Source: IMF

Summary

- Total take-up during Q3 across the Big Nine cities amounted to 2.3 million sq ft, 10% up on the 10-year average and by far the highest demand since the pandemic began. There was a particular improvement in the out-of-town markets, which accounted for 1.1 million sq ft, compared to 1.2 million sq ft in the city centres.
- Retail sales increased by 0.9% in October, the first month-on-month increased since April 2021. This figure was above consensus expectations and was also held back by the impact of the fuel crisis at the end of September which reduced fuel purchasing in October.
- The share of sales which took place online also increased for a third consecutive month to 26.3% - a figure likely to be pushed up further at the end of 2022 as consumers take precautions around the new variant. Initial indicators suggest that the annual Black Friday sale reported strong overall transaction numbers despite physical store volumes being down, providing further evidence of the strength of the e-commerce sector and the wider restructuring of the retail market. So far in 2021, there have been an estimated 24,755 retail job losses from 13 major retailers collapsing, affecting circa 1,687 stores. It is worth noting that these figures do not include smaller businesses, which have also been hit hard.

Occupier market

Central London office take-up totalled 2.4 million sq ft in Q3 2021, 1.1% above the 10-year quarterly average. This was anchored by the completion of 11 deals above the 50,000 sq ft mark – the highest quarterly volume of large lettings since the end of 2019. Facebook's 310,000 sq ft deal at 1 Triton Square, NW1, was the largest of the quarter, while Travers Smith committed to a 158,000 sq ft pre-let at Stonecutter Court, EC4.

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Increasing demand for warehousing and logistical space in light of the e-commerce boom has provided considerable momentum in the industrial market across 2020 and into 2021. There has been a record level of occupational activity for big box warehousing during the first half of the year, continuing the momentum gathered in the second half of 2020. Take-up of large grade A warehouses (>100,000 sq ft) amounted to 25.4 million sq ft during H1 2021, 71% up on the five-year, six-monthly average and a staggering 46.1 million sq ft of take-up over the past 12 months.

In the year to October 2021, MSCI data reflects a similar story with the industrial sector delivering 6.6% rental value growth compared to 0.8% and -4.0% for office and retail respectively. Industrial remains the only sector to record positive annualised capital value growth at a staggering 25.3%, the strongest figure on record, compared to -2.4% and 2.4% for office and retail. Subsequently, industrial yields hardened to 4.7% in October, while offices and retail also declined marginally to 6.4% and 6.8% respectively.

Occupier market

OUTLOOK

The government advice that employees should work from home where possible will considerably impact office occupancy numbers, which have been gradually increasing since the alleviation of the previous lockdown restrictions in Q2 2021. Although this may delay some end of year transactions, we don't expect there to be a significant impact on rents or take-up figures for key office markets over the medium-term.

The latest set of restrictions should not have a considerable impact on retail and hospitality trading directly, however detrimental impacts are more likely to surface through downgraded consumer confidence in both the economic and public health picture. Initial data from early December suggests that public attitudes haven't shifted much as a result of Omicron, but rising case numbers and new restrictions may change this.

Household savings continue to be elevated relative to pre-Covid levels. Although these are not being explicitly felt in retail sales volumes, we expect these will be deployed in deposits for houses in 2022. This will add momentum into the market and allow further house price growth on top of the considerable appreciation observed in 2021.

E-commerce appears to have retained around a 25% to 26% share of retail sales, considerably up on the pre-Covid level, which may still be pushed up further in the unlikely event of another hard lockdown being imposed. While this will continue to push painful restructuring in the retail sector, the industrial market is sweeping up the spoils.

Capital Economics estimates that the e-commerce boom could increase industrial demand by around 15% over the next decade. Combined with restricted supply across the UK, this means that both capital values and rents are likely to continue to rise in the industrial market. Rising shipping costs and supply chain difficulties may also encourage reshoring of processing and production, providing a potential further boost to the industrial sector over the medium-term.

HOUSING MARKET

House price growth in the UK remained strong in Q3 despite the initial tapering of the SDLT holiday at the end of June. Nationwide reported 10.3% year on year growth in the quarter, the same as in Q2. This puts the average UK house price at £247,535, compared to £224,337 at the same time last year.

Transactional activity has also remained strong, despite a dip in July also attributed to the reduction in the SDLT holiday. The most recent figures for August show 98,300 transactions, 20.8% higher than the same time last year and a 32% rebound from July's figures. Over the past 12 months, transaction levels have been the highest we have seen since the Global Financial Crisis and 25% above the 2019 total.

Although we expect the market to cool somewhat in the final quarter of the year, the latest RICS Residential Market Survey and internet searches suggest buyer demand ticked up in September having receded over the previous two months. Zoopla have also reported higher than typical demand for the time of year.

Another factor which will help support price growth is very limited supply. According to the RICS survey, the number of homes per surveyor at its lowest level on record except for the housing market shutdown in Q2 2020.

With the unwinding of the SDLT holiday, we expect wider macro-economic factors to return as the key drivers of the housing market. Our near-term economic outlook is broadly positive although supply chain pressures and inflation are posing an increasing risk.

The economic backdrop, low mortgage rates and a continuation of demand resulting from reassessment of housing needs will support continued house price growth and transaction levels. Although this will be at more moderate levels than we have seen so far.

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KEY STATS

ANNUAL ROLLING VALUE OF NEW CONSTRUCTION ORDERS

£11.3 billion

Q3 TAKE-UP LEVELS

CENTRAL LONDON OFFICES

2.4m sq ft

'BIG NINE' REGIONAL OFFICES

2.3m sq ft

ANNUALISED AVERAGE RENTAL GROWTH

ALL PROPERTY

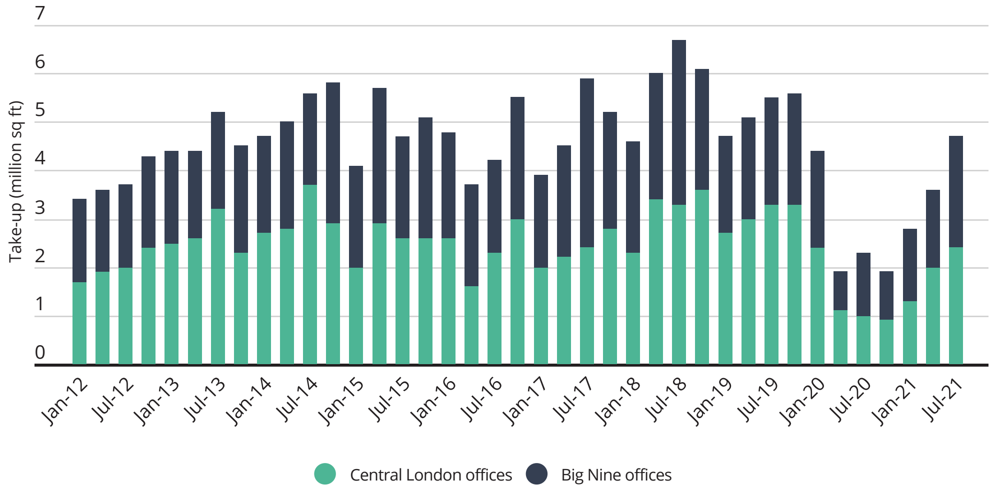
1.2%

INDUSTRIAL	RETAIL	OFFICES
6.6%	-4.0%	0.8%

Occupier market data

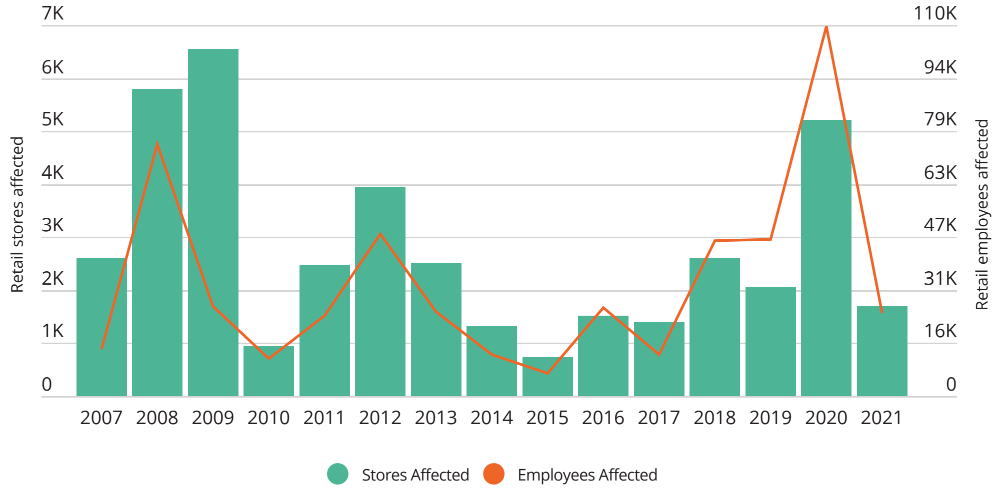
BIG NINE & CENTRAL LONDON TAKE-UP

Source: Avison Young



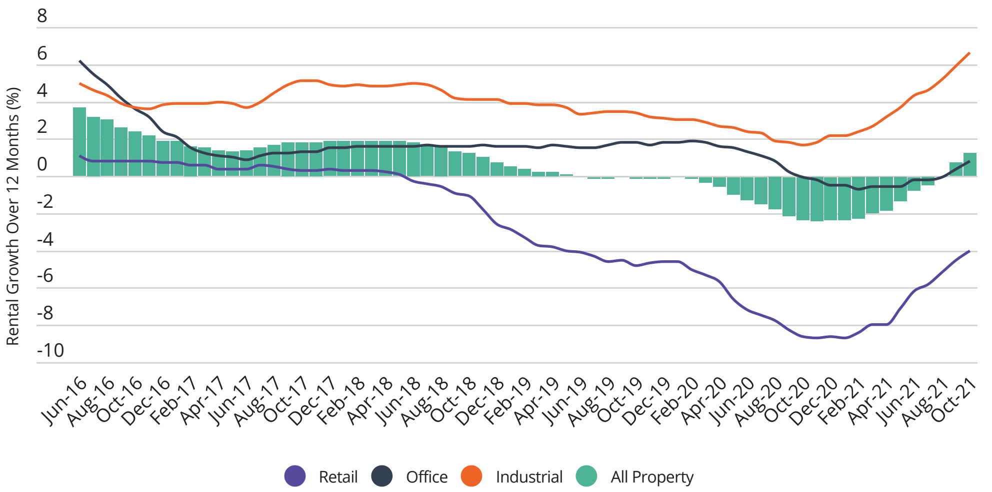
FAILING RETAIL COMPANIES

Source: Centre for Retail Research



AVERAGE ANNUAL RENTAL GROWTH

Source: MSCI Monthly Index



Summary

- Central London investment volumes in Q3 2021 totalled £3.1 billion. This is almost three times the overall investment compared to this point last year, boosting the 12-month rolling average office investment in London to nearly £12 billion – the highest figure since mid-2019. Among the largest transactions of the quarter were Times Square, EC4, purchased by Generali for upwards of £450 million and Deka's acquisition of 8 St James' Square, SW1, for £220 million.
- Confidence in the regional office investment market remains robust with activity over the past 15 months performing above the long-term average – a strong performance given the recent conditions. Total investment volumes during Q3 amounted to £753 million, 26% up on the ten-year average of £599 million.

Investment market

In the investment market, provisional transaction volumes for Q3 2021 were £13.2 billion, 7% below the 5-year quarterly average (Property Data). This is a declined from the £15.8 billion transacted in the previous quarter, with the office, retail and industrial sectors all reporting a quarter-on-quarter decline. Despite this, industrial volumes remained 62% above the quarterly average, further demonstrating the strength of the current market. In the year to Q3 2021, the majority of investment came from overseas investors, accounting for 52% of the total.

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Confidence in the regional office investment market remains robust with activity over the past 15 months performing above the long-term average – a strong performance given the recent conditions. Total investment volumes during Q3 amounted to £753 million, 26% up on the ten-year average of £599 million.

Annual all property capital value growth achieved 8.8% in the year to October 2021, driven primarily by the continued surge in industrial values. All property equivalent yields hardened in October to 5.7%, primarily due to the industrial sector again although declines were observed across the sectors as the property market edges closer to pre-Covid levels of risk.

Investment market

OUTLOOK

The majority of respondents of the annual INREV investor survey suggested they had not significantly changed their investment plans for 2021 as a result of Covid-19. Capital Economics also forecast positive total returns for UK commercial property in 2021, albeit at a modest level.

Industrial stock is expected to continue to drive returns on the all property level for the UK, while restructuring in the office and retail sectors weigh on capital growth for the remainder of 2021 at least

Property investors in particular tend to take the long view of situations, hence the reintroduction of fairly small-scale restrictions will likely not disrupt many transactions already in the pipeline. However, the Omicron variant remains a relatively unknown quality, hence adding an increased degree of risk which may push some to delay signing agreements in the short-term.

> "Confidence in the regional office investment market remains robust with activity over the past 15 months performing above the long-term average – a strong performance given the recent conditions

Q3 2021 VOLUMES BY REGIONS

- London **£4.6 billion**
- South East **£1.2 billion**
- East of England **£938 million**
- North West **£758 million**
- East Midlands **£579 million**
- York & Humber **£438 million**
- West Midlands **£438 million**
- Scotland **£420 million**
- South West **£385 million**
- Wales **£103 million**
- North East **£62 million**
- Northen Ireland **No data**

KEY STATS

ANNUAL ROLLING INVESTMENT TRANSACTIONS VALUE

£52.1 billion

Q1 VOLUMES BY INVESTOR TYPE

OVERSEAS INVESTORS

52%

UK PROPERTY COMPANY

29%

UK INSTITUTIONS

9%

ALL PROPERTY EQUIVALENT YIELDS

5.7%

ANNUAL ALL PROP TOTAL RETURN

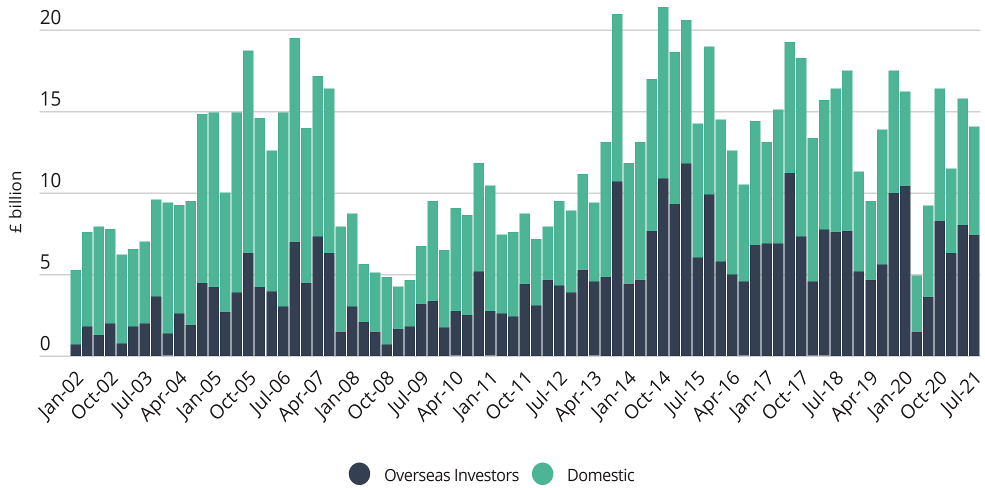
14.7%

ANNUAL ALL PROP CAPITAL GROWTH

8.8%

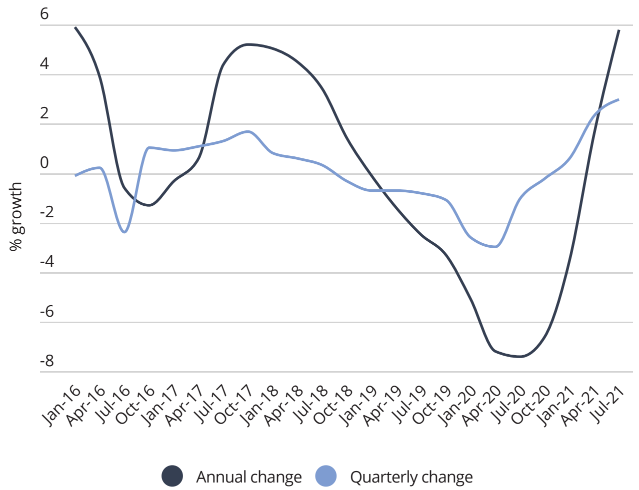
Investment market data

ROLLING ANNUAL INVESTMENT TRANSACTION VOLUMES Source: Property Data

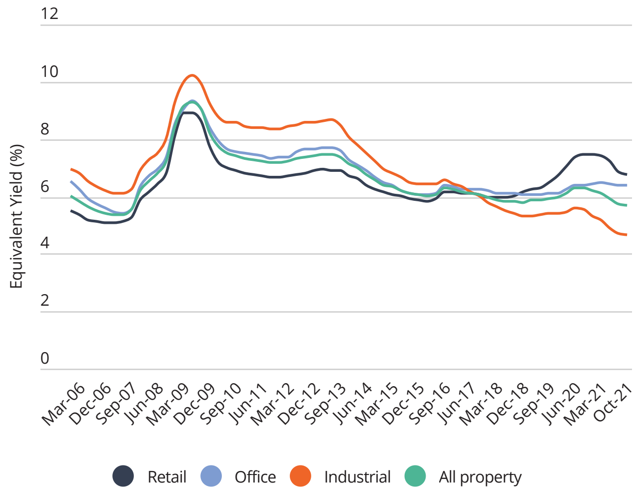


NEW CONSTRUCTION ORDERS RETAIL, OFFICE AND INDUSTRIAL Source: ONS

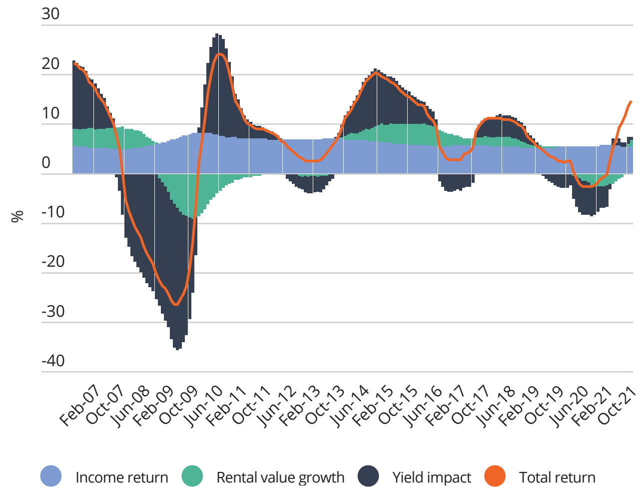
ALL PROP AVERAGE CAPITAL VALUE GROWTH Source: MSCI



AVERAGE EQUIVALENT YIELDS Source: MSCI Monthly



ALL PROPERTY ANNUAL TOTAL RETURN Source: MSCI Monthly



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

James Roberts
Director, Insight
+44 (0)20 7911 2580
james.roberts@avisonyoung.com

Joshua Rose-Nokes
Associate Director, Insight
+44 (0)20 7911 2566
joshua.rose-nokes@avisonyoung.com

Kiran Patel
Senior Insight Analyst
+44 (0)20 7911 2625
kiran.patel@avisonyoung.com

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