INSIGHT

EPMR

Economic & property market review

January 2022

AVISON YOUNG

Summary

- The Omicron Covid-19 variant, which emerged in early December 2021, has spread rapidly through the UK. A higher degree of transmissibility in this variant has led to an average of over 100,000 new cases per day in December and January. However, a lower level of clinical severity in the Omicron strain, combined with high levels of vaccinations and a supporting booster program, has meant that hospitalisations have not risen comparatively. As a result, fewer restrictions were imposed across the UK compared with previous Covid waves, the majority of which were lifted in mid-January.
- In November 2021, the ONS estimates that GDP grew by 0.9% to exceed the pre-pandemic level of February 2020 for the first time by 0.7%, beating consensus expectations and achieving the largest growth since June. Construction and manufacturing output grew by 3.5% and 1.1% respectively, with some easing in the supply chain difficulties that have plagued the sectors in H2 2021. The services sector also reported growth of 0.7%, however this is likely to have receded in December as a high case numbers snagged consumer activity in the crucial festive period.
- CPI inflation increased by 5.4% in the year to December 2021, up on the 5.1% in November and the highest figure since 1992. This figure surpassed consensus expectations, with the strongest upward contributions coming from food prices, furniture and household equipment.

Economic trends

The Omicron Covid-19 variant, which emerged in early December 2021, has spread rapidly through the UK. A higher degree of transmissibility in this variant has led to an average of over 100,000 new cases per day in December and January. However, a lower level of clinical severity in the Omicron strain, combined with high levels of vaccinations and a supporting booster program, has meant that hospitalisations have not risen comparatively. As a result, fewer restrictions were imposed across the UK compared with previous Covid waves, the majority of which were lifted in mid-January.

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Public sector borrowing fell to £17.4 billion in November 2021, £4.9 billion less than the figure recorded in November 2020. Although higher tax revenues helped to support government finances, continuing RPI inflation has pushed up interest repayments on the immense level of government debt, estimated to total £2.3 trillion – the highest level since WWII.

The Markit / IHS purchasing managers indices (PMI) for December achieved a net balance of 53.6, declining down from the 57.6 recorded in November and the lowest figure since February. As it remains in excess of the no-change 50.0 marker, December's number suggests that activity expanded for the tenth consecutive month, albeit with reduced momentum.

All three sectors reported monthly decreases in PMI figures in December despite remaining above the 50.0 marker. Manufacturing reported the least decline and the highest rate of expansion at 57.9 as production, new orders and employment all increased while supply chain difficulties eased slightly. Construction also reported fewer supply issues as well as a reduced rate of material price inflation, delivering a PMI of 54.3 while services decreased to 53.6 due to the concerns around and the impacts of rising Covid cases.

BoE data reported that consumer borrowing grew by £1.2 billion in November, the strongest net borrowing figure since July 2020 and the eighth consecutive month of increased borrowing. Retail sales also increased by 1.2% in November suggest that consumer spending has strengthened along with the wider economy.

Gfk's consumer confidence index decreased to -19 in January from -15 in December, reflecting considerable concerns over cost-of-living increases and Covid-related caution. Combined with lower than expected retail sales figures for December with a monthly decline of 3.7%, it seems likely that retailers in particular will not have an easy start to 2022.

Economic trends

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While the interest rate rise may provide a minor drag to growth, particularly in the high-risk short-term outlook, the positive performance of the economy in November suggests that there is underlying strength in the recovery which will hopefully prove to be resilient

LABOUR MARKET

The employment rate continued to rise in the three months to November 2021, reaching 75.5%. This remains 1.1 percentage points below the level observed in the three months to February 2020 before the pandemic. The majority of this shortfall is attributed to an increase in the economic inactivity rate of 1 percentage point which currently stands at 21.3%.

Employment growth in November 2021 was matched by a corresponding decline in the unemployment rate, decreasing to 4.1% to be just 1 percentage point above its pre-pandemic level.

Although the performance of these labour market indicators paints a positives picture, it is likely that there is some distortion from the size of the labour pool changing. The increase in the economic inactivity rate at the end of the furlough scheme suggests that a considerable portion of employees removed themselves from the labour market rather than become unemployed. Consequentially, both the employment and unemployment rates were partially insulated from the impacts of the scheme ending.

Nonetheless, labour demand continues to outpace supply, with vacancies in December reaching a fresh record of 1.25 million. Pay pressures too are persisting despite a slowdown in the annual nominal growth rate to 3.8% in the November period, although high levels inflation meant that regular pay growth in real terms was 0.0%.

INFLATION

CPI inflation increased by 5.4% in the year to December 2021, up on the 5.1% in November and the highest figure since 1992. This figure surpassed consensus expectations, with the strongest upward contributions coming from food prices, furniture and household equipment.

In the December meeting of the BoE's Monetary Policy Committee (MPC), the decision was taken to increase the UK base rate to 0.25%. While domestic inflationary pressures were central to the rate rise, the US Federal Reserve previously tightened their fiscal policy, also in response to high inflation. Without some form of reciprocal action from the BoE, the UK would run the risk of importing more inflation from the US due to the pound weakening and the dollar strengthening.

For the UK property market, the increased base rate means that the cost of debt is no longer as favourable. Around three quarters of UK mortgages have fixed interest rates, hence the increase is unlikely to cause a dramatic wave for many homeowners.

For commercial property, higher rates mean that investors will be looking for higher yields, typically attained through risk or rental growth. Hospitality and retail may serve those with an appetite for risk, particularly as Omicron has not derailed the industry as previous waves, hence reducing the future Covid downside. More risk-averse investors are likely to look toward the industrial sector, hoping to squeeze a few extra 0.1 percentage point drips onto the hardening yields through the strength in rental growth.

Economic trends

OUTLOOK

The improvement of the performance of the UK economy during the latest surge in infections, relative to previous Covid waves, provides hope that future Covid variants (which are likely to decrease in severity) will ease as a major downside risk. Nonetheless, Omicron has caused GDP forecasts for 2022 to be downgraded, with Capital Economics anticipating 4.0% growth.

Higher costs of living, including the increased interest rate, a rise in national insurance taxes and the energy price cap in April, may mean that more of those who left work during the pandemic are more likely to return, providing some relief to the tension currently visible in the labour market.

Conversely, the financial squeeze may mean that consumer expenditure drops, particularly at the lower end of the wealth scale, as high inflation and slowing wage growth compound economic hardships.

Further increases in inflation are anticipate in 2022, with Capital Economics forecasting a peak in excess of 7.0% in April. The interest rate is also expected to be pushed up to 1.25%, with the next increase in February to 0.5%. This would be a headache for the Chancellor ahead of the March 2022 Budget and will likely mean that government spending is limited as a result.

While the interest rate rise may provide a minor drag to growth, particularly in the high-risk short-term outlook, the positive performance of the economy in November suggests that there is underlying strength in the recovery which will hopefully prove to be resilient.

Another point to note is that the majority of the recovery thus far has been sourced through consumer activity and government expenditure – businesses have been relatively quiet. Business investment has lagged in recovery,

11.7% below the pre-pandemic level in Q3 2021. As Brexit and Covid uncertainty ease and being to fade in terms of market impact, there is considerable scope for corporate investment to rapidly increase, injecting a new lease of life into the UK economy. Adding to this potential is the tax super deduction which incentives plant and machinery investments through providing a 130% rebate on the cost.

LATEST CONSENSUS FORECASTS – JANUARY 2022

	2021	2022
Economic growth (GDP)	4.3%	2.2%
Household consumption	5.8%	2.2%
Unemployment rate	4.4%	4.2%
Bank base rate	0.5%	0.8%
CPI - Inflation	4.6%	2.5%
RPI - Inflation	6.3%	3.9%

Source: Consensus Economics

2022 ECONOMIC GROWTH FORECASTS

WORLD
5.9%

UK
6.7%

EUROZONE
5.1%

Source: IMF

KEY STATS

GDP GROWTH

5.5%
Q2 2021

1.1%
Q3 2021

PMI WEIGHTED AVERAGE

57.8%
November

57.6%
December

UNEMPLOYMENT RATE

4.1%
Nov 2021

REAL EARNINGS GROWTH

0.4%
(including bonuses)

0.0%
(excluding bonuses)

CPI INFLATION

5.4%

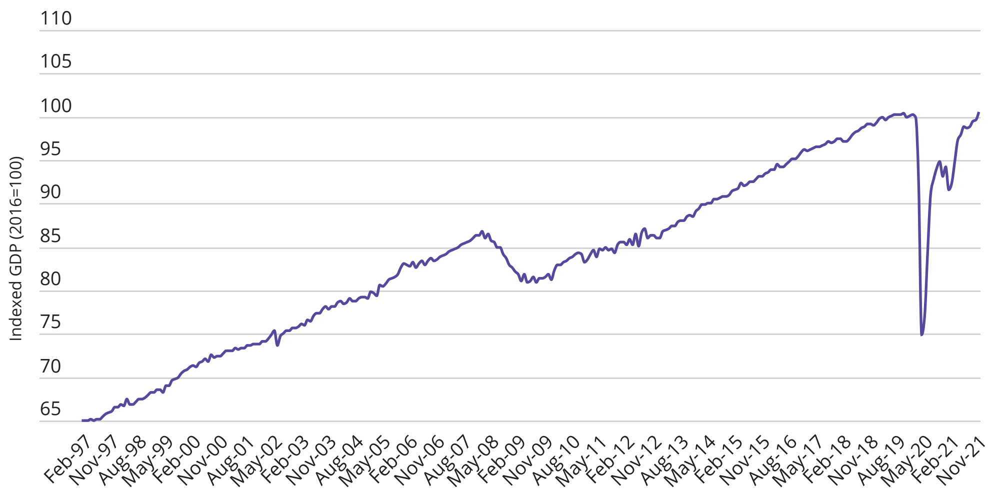
BANK RATE

0.1%

Economic data

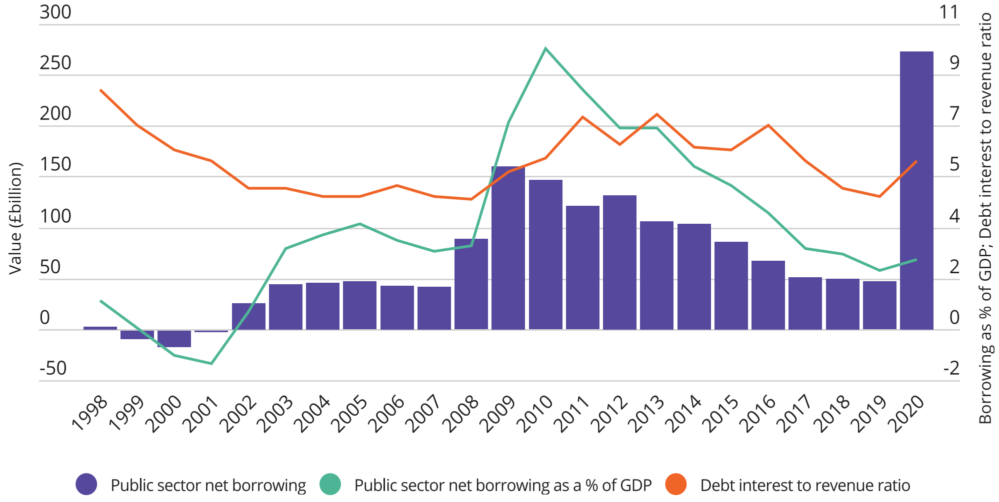
MONTHLY GDP

Source: ONS



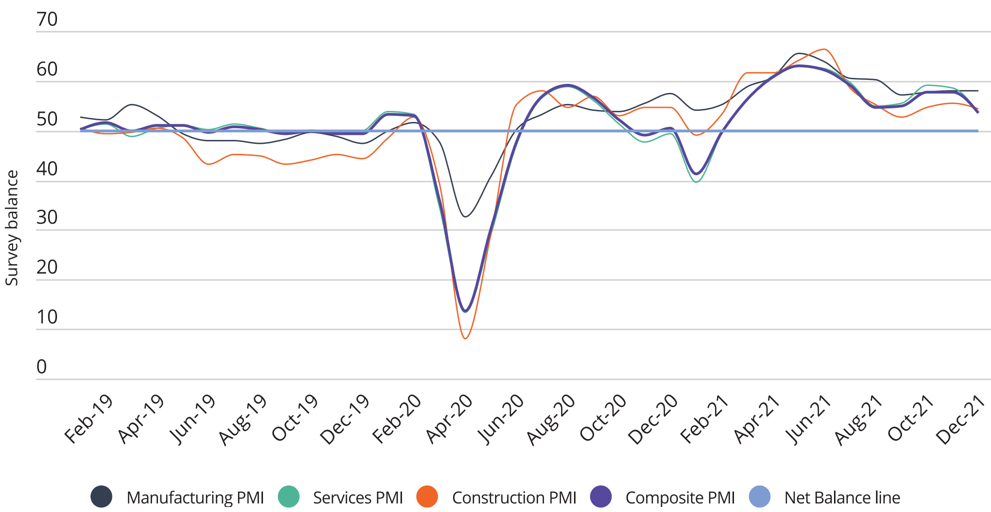
PUBLIC SECTOR NET BORROWING EXCL. PUBLIC SECTOR BANKS

Source: ONS



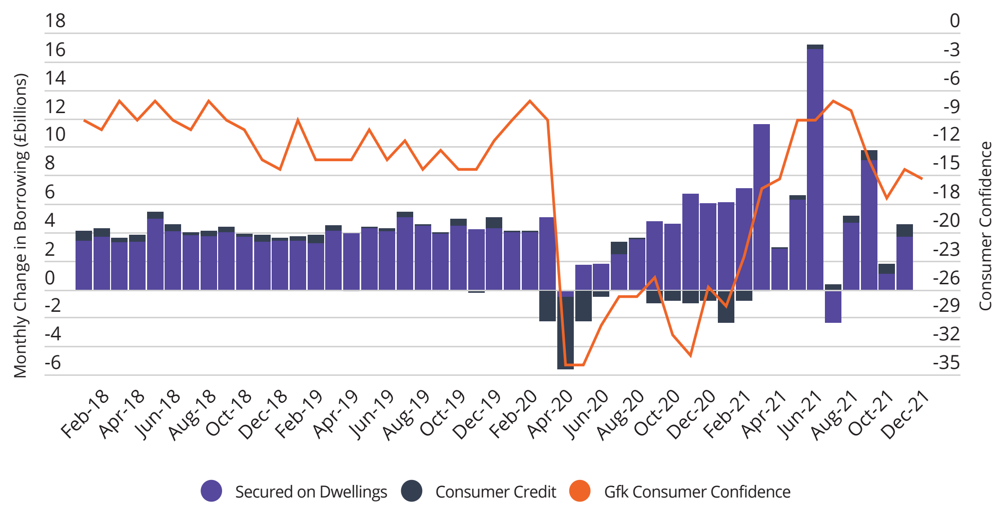
PURCHASING MANAGERS' SURVEY

Source: Markit & CIPS



CONSUMER CREDIT AND CONFIDENCE

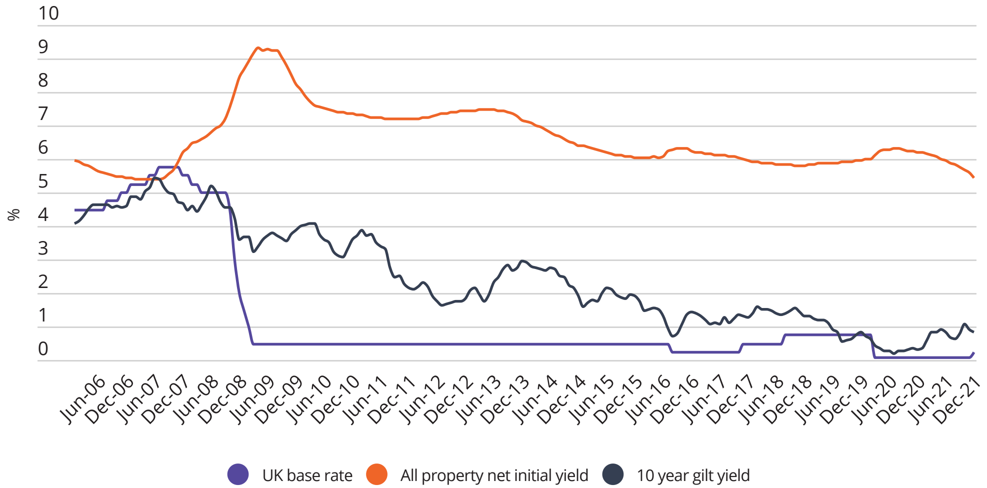
Source: Bank of England



Economic data

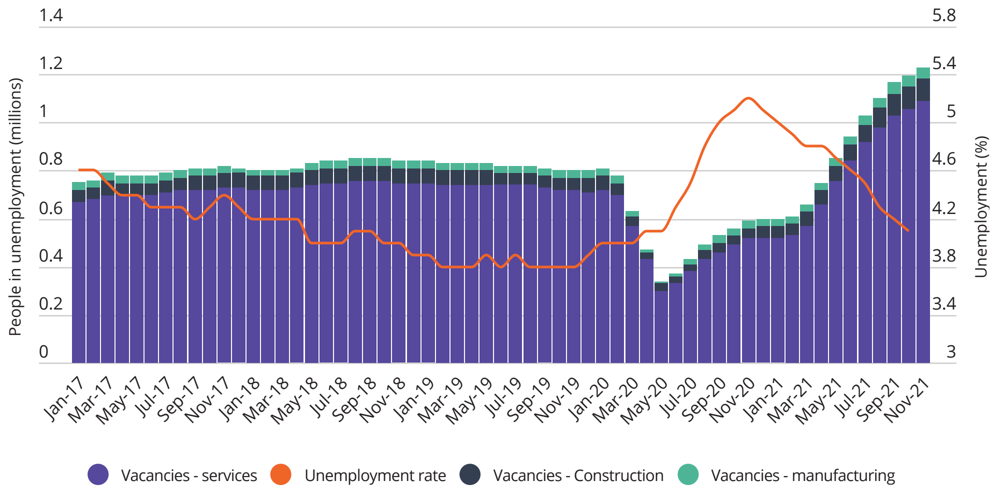
UK NET INITIAL YIELD VS GILTS VS BASE RATE

Source: MSCI monthly index, Bank of England



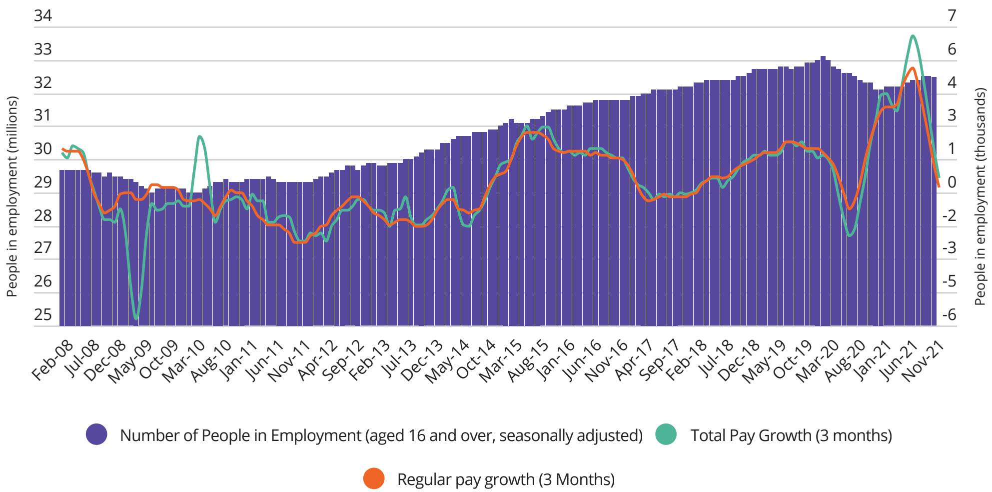
VACANCIES

Source: ONS



EMPLOYMENT AND AVERAGE WEEKLY EARNINGS

Source: ONS



GLOBAL ECONOMIC GROWTH

Source: IMF

Summary

- Office rental value growth has been modest, with 1.1% over 2021. However, the removal of the work from home guidance from the government – hopefully the last time that this measure is required – means that occupiers are likely to have a larger appetite for office space, helping to bolster rental growth.
- The Big Nine office markets delivered a strong finish to the year, bringing total take-up for 2021 to 8.2 million sq ft, 5% down on the ten-year average but 42% up on 2020. Q4 take-up was the highest quarterly total for more than three years, led by the second largest deal across the big nine on record: HM Revenue & Customs taking 465,000 sq ft at Pilgrim's Quarter in Newcastle city centre. There were other large deals across the cities, often sourced from technology companies such as Roku (115,000 sq ft) in Manchester, Fanduel (58,000 sq ft) in Edinburgh and the University of Bristol (74,000 sq ft).
- Central London's office lettings market returned to something resembling normality in the latter half of 2021, boosting end-of-year take-up to 8.7 million sq ft – which is a 71% uplift on the volumes seen in 2020, albeit 9% below the long-term average for annual activity.

Occupier market

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Having hit the long-term average for space let in Q3, we have subsequently seen an end-of-year flurry of lettings, with Q4 figures showing that just shy of 3.1 million sq ft has transacted. This figure represents a 28% increase against the five-year average – and is even reflective of a 21% increase on typical pre-pandemic quarterly volumes as companies begin to shake off Covid-induced uncertainty and look instead towards the critical role that offices will play in the future of working.

Overall retail footfall across the UK has not recovered to pre-pandemic levels, and has in fact lost considerable ground over the festive period due to Omicron, declining from around 15% below 2019 levels in November to 19% in December.

December retail sales figures declined by 3.7% month-on-month as early Christmas shopping in November and the Omicron variant dragged expenditure below consensus expectations. Online sales, however, only fell by 0.3%.

The ongoing shift online is continuing to drive structural changes in the retail sector, although rental data suggests that the trend may be plateauing with annualised growth of -3.1% in December – the highest figure since January 2019. Additionally, 2021 saw the fewest number of retailers going bust since before 2007 with the least number of stores impacted since 2017.

The industrial market continues to deliver record levels of growth with total returns over 2021 achieving 38.4% following rental growth of 8.9%. Take-up of Grade A space over 100,000 sq ft surpassed 49 million sq ft. In a similar scenario to last year, e-commerce continued to dominate the occupier market.

There is unlikely to be a slowdown in demand for big box space across all UK regions in 2022, due to the continued shift in consumer behaviours. With online retail sales forecast to continue growing there will be requirements for even more industrial units to meet demand.

Occupier market

OUTLOOK

The removal of the 'Plan B' restrictions and guidance in late January is a considerably positive step forward for business activity and real estate. While Covid remains a threat, the size of the downside risk it poses is declining as variant severity combined with high vaccination rates means its impact on people and the economy is likely to be declining.

This is considerably positive news for the real estate sector, where those who have faired the pandemic storm well may now be on the hunt for new spaces across sectors.

In the residential sector, 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 in 2022. Although this will be at more moderate levels than we have seen so far.

HOUSING MARKET

House price growth in the UK remained strong in Q4 despite the initial tapering of the Stamp Duty Land Tax (SDLT) holiday at the end of June and the final tapering in September. Nationwide reported 10.4% growth for 2021, the highest level for a calendar year since 2006. This puts the average UK house price at £254,822, compared to £229,819 at the same time last year.

There is currently an unusually long lag in transactional activity data from Land Registry but mortgage approvals are a good indicator of activity and they have held up well so far following the end of the Stamp Duty holiday. The number of mortgage approvals for house purchase fell 0.2% in November but were still ahead of their 2014-19 average. Overall in 2021 transaction levels will be by far the highest we have seen since the Global Financial Crisis.

Although we expect the market to cool somewhat next year, the latest RICS Residential Market Survey and internet searches suggest buyer demand ticked up in December, having receded over the previous two months (although still high). 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 removal of the 'Plan B' restrictions and guidance in late January is a considerably positive step forward for business activity and real estate

KEY STATS

ANNUAL ROLLING VALUE OF NEW CONSTRUCTION ORDERS

£11.3 billion

Q4 TAKE-UP LEVELS

CENTRAL LONDON OFFICES

3.1m sq ft

'BIG NINE' REGIONAL OFFICES

3.5m sq ft

ANNUALISED AVERAGE RENTAL GROWTH

ALL PROPERTY

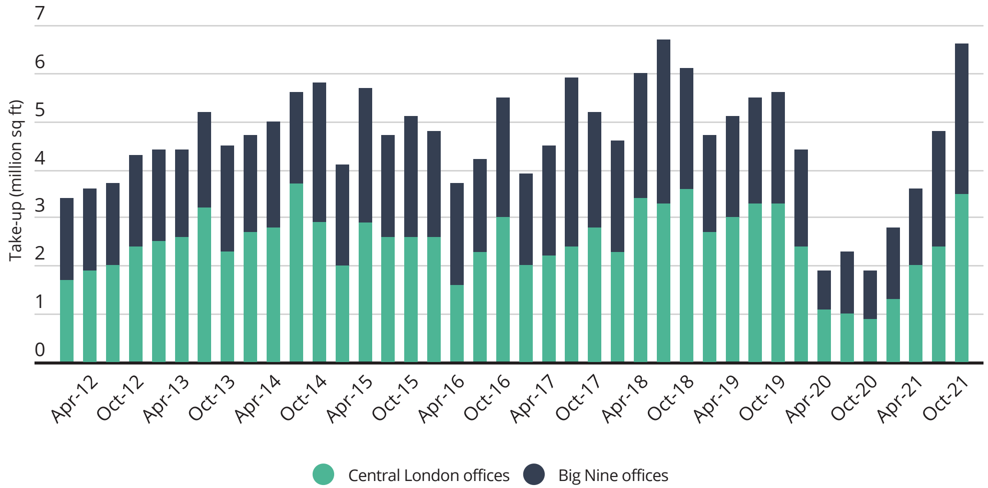
1.2%

INDUSTRIAL	RETAIL	OFFICES
8.9%	-3.1%	1.1%

Occupier market data

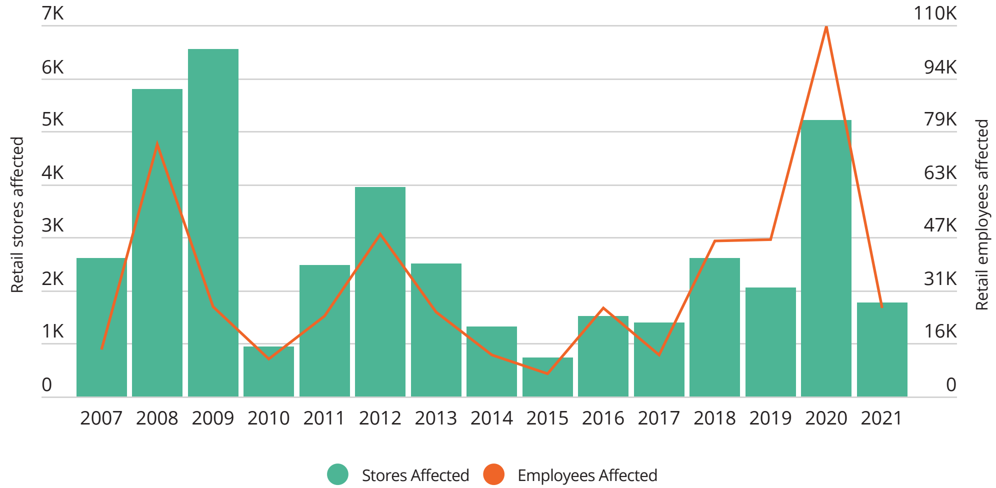
BIG NINE & CENTRAL LONDON TAKE-UP

Source: Avison Young



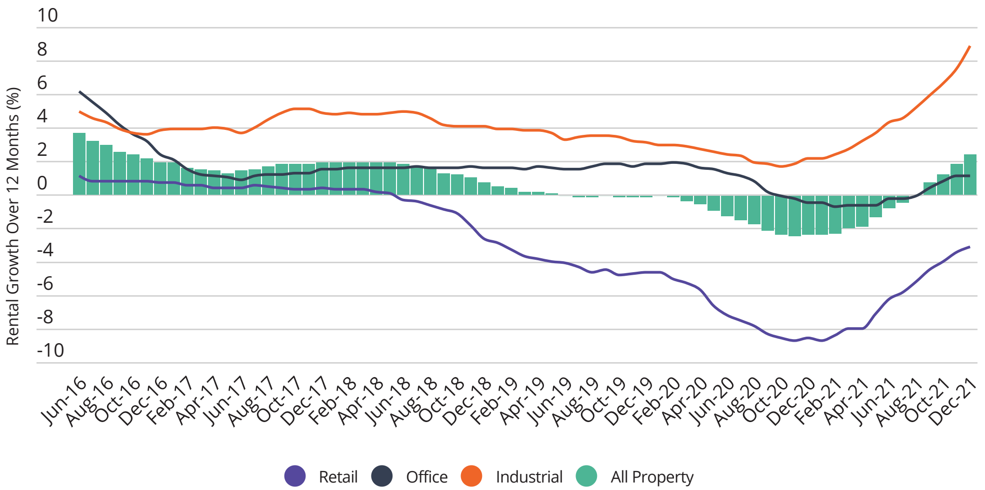
FAILING RETAIL COMPANIES

Source: Centre for Retail Research



AVERAGE ANNUAL RENTAL GROWTH

Source: MSCI Monthly Index



Summary

- Capital values for the UK office market have reported a modest 0.3% growth over the course of 2021. Although this means that values remain below their pre-pandemic levels, there is evidence of an upward trend in growth, with December reporting the greatest monthly increase since the onset of the pandemic.
- Sentiment in the regional office investment market remains relatively upbeat. Volumes for the Big Nine office markets recovered to £2.6 billion during 2021, compared to £1.7 billion in 2020 and 8% up on the ten-year average.
- Well-located, good quality assets with a strong tenant base continue to receive good levels of interest in the regions, particularly those that meet net zero carbon commitments and fulfil expectations for positive rental growth. While the number of deals slowed towards the end of the year, the figures were boosted by the largest deal of the year: owner occupier NatWest's purchase of the £292 million One Hardman Boulevard, Manchester.

Investment market

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Across 2021, almost £12 billion was invested into London offices. While this is 15% behind the ten-year average for annual volumes, it nevertheless represents a 50% uplift against activity in 2020 and comes in 29% ahead of 2019 investment as global capital once again found its way to London's shores despite travel restrictions pervading much of the year.

Retail investment is also performing well with £1.0 billion in December, the highest monthly total since October 2016, while 2021 as a whole was the greatest annual figure since 2017. This was primarily due to retail warehouse transactions, which have proved more resilient over the course of the pandemic in terms of value and footfall. Retail capital value growth finished the year on a high with 7.0% across 2021, however values remain below their pre-pandemic levels.

Investment volumes for distribution industrial assets are rivalling the strength of the occupier markets. At the end of 2021, total investment volumes surpassed £11 billion across the UK. Overseas investors were particularly attracted to the UK industrial scene. Foreign money was responsible for 57% of total volumes, up from the 55% recorded last year, with US investors accounting for the highest share. Industrial stock reported a staggering 32.7% growth in capital values over 2021.

Investment market

OUTLOOK

The industrial sector is expected to continue to compress yields to their lowest point, while office and retail work to shape new requirements of space following the ongoing structural changes. High quality assets in all sectors will continue to attract capital, particularly those with the strong sustainability accreditations which are fast becoming a fundamental requirement for top properties and even lower grade stock.

> "The industrial sector is expected to continue to compress yields to their lowest point, while office and retail work to shape new requirements of space following the ongoing structural changes

Q3 2021 VOLUMES BY REGIONS

- London **£5.1 billion**
- South East **£2.1 billion**
- East of England **£1.1 billion**
- West Midlands **£8.8 million**
- Scotland **£3.3 million**
- York & Humber **£4.4 million**
- East Midlands **£3.3 million**
- South West **£2.2 million**
- North East **£2.2 million**
- North West **£1.4 million**
- Wales **£2.2 million**
- Northen Ireland **No data**

KEY STATS

ANNUAL ROLLING INVESTMENT TRANSACTIONS VALUE

£52.1 billion

Q1 VOLUMES BY INVESTOR TYPE

OVERSEAS INVESTORS

31%

UK PROPERTY COMPANY

38%

UK INSTITUTIONS

15%

ALL PROPERTY EQUIVALENT YIELDS

5.4%

ANNUAL ALL PROP TOTAL RETURN

19.9%

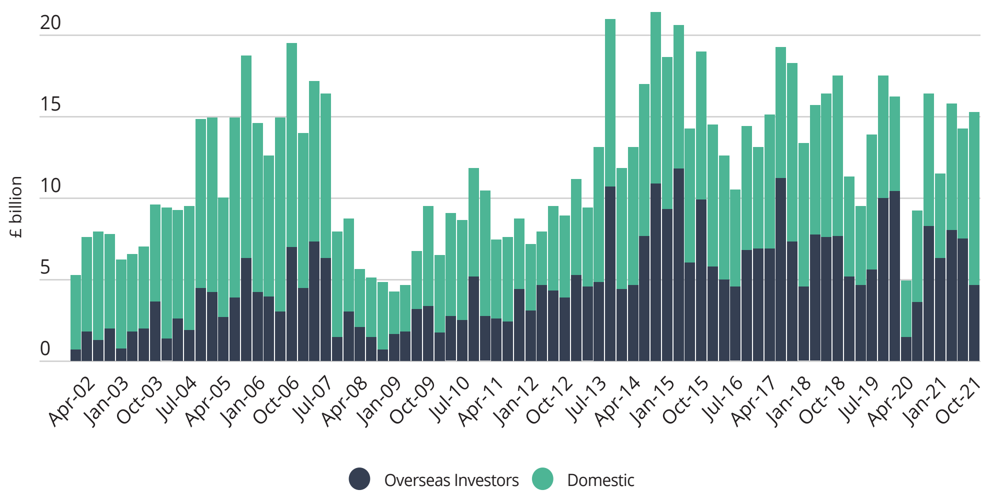
ANNUAL ALL PROP CAPITAL GROWTH

5.3%

Investment market data

ROLLING ANNUAL INVESTMENT TRANSACTION VOLUMES

Source: Property Data

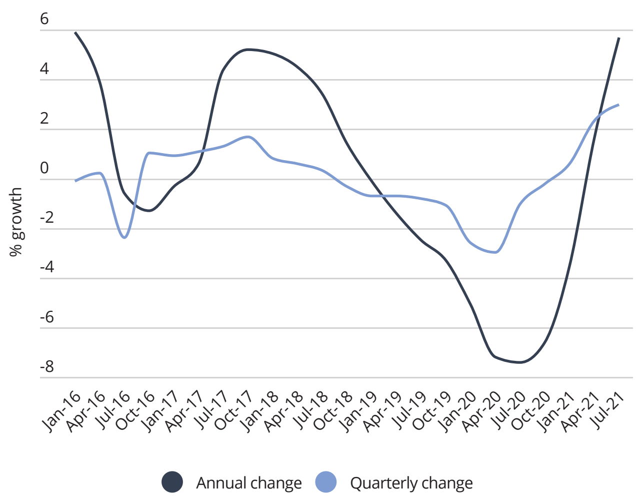


NEW CONSTRUCTION ORDERS RETAIL, OFFICE AND INDUSTRIAL

Source: ONS

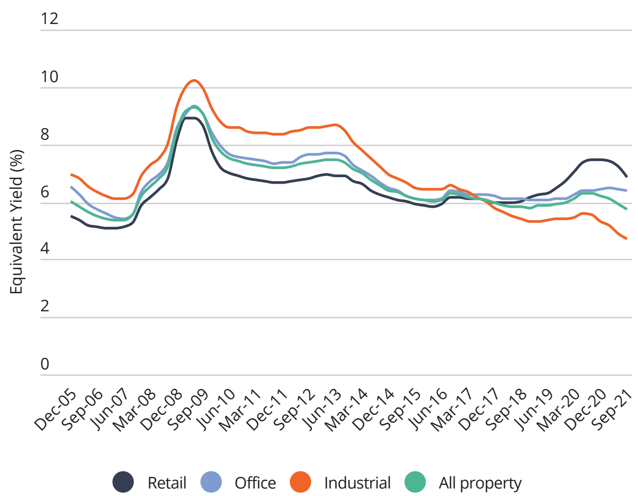
ALL PROP AVERAGE CAPITAL VALUE GROWTH

Source: MSCI



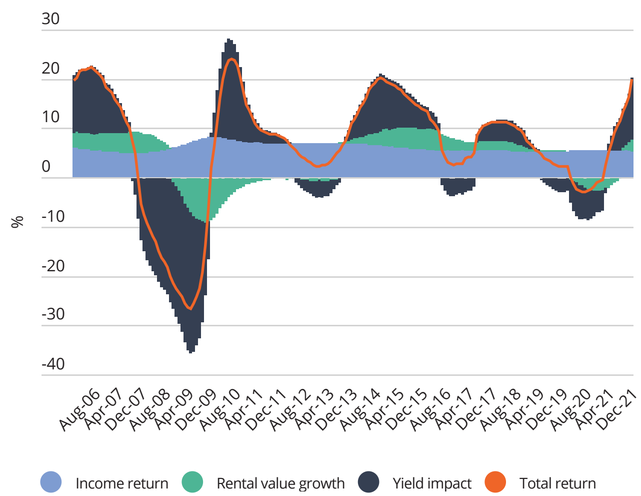
AVERAGE EQUIVALENT YIELDS

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

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