



INSIGHT

EPMR

Economic & property market review

March 2022

AVISON
YOUNG



Economic trends

Across 2021, UK GDP grew by a record 7.5% according to the ONS, beating expectations and the highest rate of growth since WWII. In the three months to January 2022, GDP grew by 1.0% which suggests that the Omicron variant slowed but did not derail growth. The quarterly index figure suggests that the economy remains 0.4% below the pre-pandemic level in 2019 due to the 9.4% decline observed over 2020. However, due to differences in methods, the monthly GDP index reports that the economy has in fact above the pre-pandemic level.

December saw output from the construction sector grow by 1.1% on a m-on-m comparison, while the production sector achieved 0.7% and the services sector expanded by 0.8%. The January figures benefited from the rapid peak for Omicron cases which led to the government reversing the 'plan B' restrictions sooner than expected.

Following a considerable surge in cases over the festive period, peaking at a record 273,000 new infections in a single day on 4th January, the rate of transmission of the virus has significantly decreased and continues to trend downward. As a result of the downward trend and the decreased severity of infections as a result of vaccinations and the nature of the dominant Omicron variant, Covid-related restrictions have been reduced across the UK, and ended in England.

However, while the Covid risk appears to be ebbing at present, this has coincided with the outbreak of war between Russia and Ukraine. This caused sharp rises in commodity prices and the imposition of sanctions on Russia. It is too early to accurately judge the economic impact of the war, although typically high energy prices act as a brake on growth.

Public sector spending was lower than tax receipts in January 2022, resulting in a £2.9 billion surplus for the month – something which often happens in January and July, but most months will probably see a deficit this year. 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 January achieved a net balance of 59.9, up from the 54.2 recorded in January, driven by strong figures for services and construction. This was the highest reading since June 2021.

The services sector PMI jumped from 54.1 in January to 60.5 in February, probably reflecting the rollback of Covid restrictions. The construction sector increased from 54.1 to 60.5 m-on-m, while the manufacturing sector recorded a more subdued rise from 57.3 to 58.0.

BoE data reported that consumer borrowing grew by £0.1 billion in December, which was down on the December figure, although a slowdown in borrowing between December and January is common. This marked the eleventh consecutive month of increased borrowing.

GfK's consumer confidence index decreased to -26 in February from -19 in January, reflecting considerable concerns over cost-of-living increases and Covid-related caution. On a more positive note, retail sales volumes picked up in January, rising 1.9%, marking an improvement on December's 4.0% fall. This was buoyed by spending on home improvements, perhaps reflecting the surge in Omicron in January encouraging DIY projects as alternative to going out.

Economic trends



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.

LABOUR MARKET

The employment rate continued to rise in the three months to January 2022, reaching 75.6%. This remains 100 basis points below the level observed in the three months to February 2020 before the pandemic. This is largely due to a higher inactivity rate than pre-pandemic.

Employment growth in January 2022 was matched by a corresponding decline in the unemployment rate, decreasing to 3.9%, which is below its pre-pandemic level. This indicates a tight labour market, which could act as a brake on growth going forward.

Although recent labour market indicators paint a positive 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.

Nonetheless, labour demand continues to outpace supply, with vacancies in December reaching a fresh record of 1.3 million. Pay growth appeared to peak in the Summer of 2021, and stands at 3.8% in nominal terms, but is negative in real terms, which is why concerns are growing on a household income squeeze this year.

INFLATION

CPI inflation increased by 5.5% in the year to January 2022, up on the 5.4% in December and the highest figure since 1992. This figure surpassed consensus expectations, with the strongest upward contributions coming from Transport and Housing and utility bills.

In the March meeting of the BoE's Monetary Policy Committee (MPC), the decision was taken to increase the UK base rate to 0.75%. While domestic inflationary pressures – and inflation expectations – were central to the rate rise, the MPC would have been conscious that the US Fed is now tightening policy. 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 increased risk or rental growth. Hospitality and retail may serve those with an appetite for risk, although for consumer-facing property the household income squeeze is fast replacing Covid as a major risk to the outlook. More risk-averse investors are likely to look toward the industrial sector, hoping to squeeze a few extra 0.1 percentage point drips into 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 and above expectations inflation has caused GDP forecasts for 2022 to be downgraded, with Oxford Economics anticipating 3.7% growth. There is also now the growing risk to growth presented by the war in Ukraine.

Higher costs of living, including the interest rate hike, a rise in national insurance taxes and the energy price cap increase in April, may mean that more of those who left work during the pandemic are more likely to return, providing some relief to tight conditions in the labour market. Conversely, the financial squeeze may mean that consumer expenditure drops, particularly at the lower end of the wealth scale.

Further increases in inflation are anticipated in 2022, with Bank of England forecasting inflation to reach 8.0% in Q2 and perhaps go higher. The interest rate is also expected to be pushed up to 1.00% according to Oxford Economics, following March's increase to 0.75%.

The interest rate rise – and the anticipated further increase in the base rate, up to 1.00% later this year – may provide a minor drag to growth, particularly in the high-risk short-term outlook. However, the war in Ukraine is currently emerging as the leading downside risk, as it has already pushed up commodity prices and further disruption to supply chains is expected.

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, and is 10.4% below the pre-pandemic level in Q4 2021. As Brexit and Covid uncertainty ease and begin 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 incentivises plant and machinery investments through providing a 130% rebate on the cost.

However, this also comes with the caveat that the uncertainty caused by the Ukraine war could encourage a 'wait and see' attitude among firms towards investment.

LATEST CONSENSUS FORECASTS – FEBRUARY 2022

	2022	2023
Economic growth (GDP)	4.3%	2.0%
Household consumption	5.9%	2.1%
Unemployment rate	4.3%	4.2%
Bank base rate	1.1%	
CPI - Inflation	5.4%	2.7%
RPI - Inflation	7.0%	4.1%

Source: Consensus Economics

2022 ECONOMIC GROWTH FORECASTS



WORLD
4.9%



UK
5.0%



EUROZONE
4.4%

Source: IMF

KEY STATS

GDP GROWTH

▲ 1.0% ▲ 1.0%
Q3 2021 Q4 2021

PMI WEIGHTED AVERAGE

53.6% ▼ 54.2%
December January

UNEMPLOYMENT RATE

3.9%
Jan 2022

REAL EARNINGS GROWTH

0.1% -1.0%
(including bonuses) (excluding bonuses)

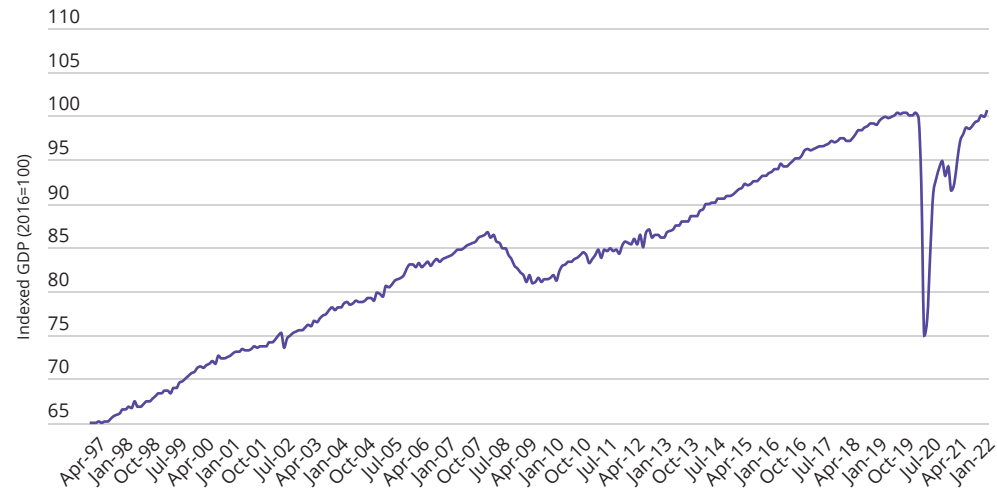
CPI INFLATION BANK RATE

5.5% 0.75%

Economic data

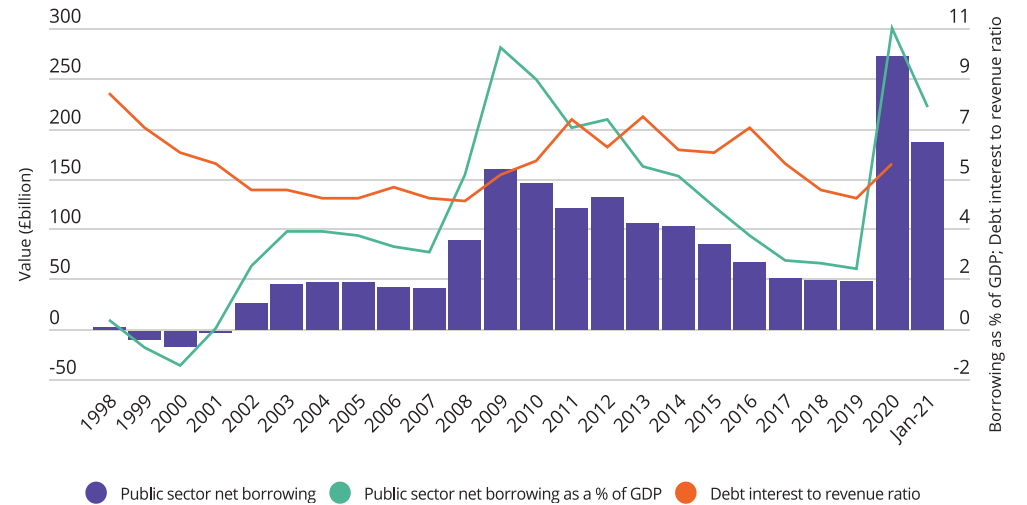
MONTHLY GDP

Source: ONS



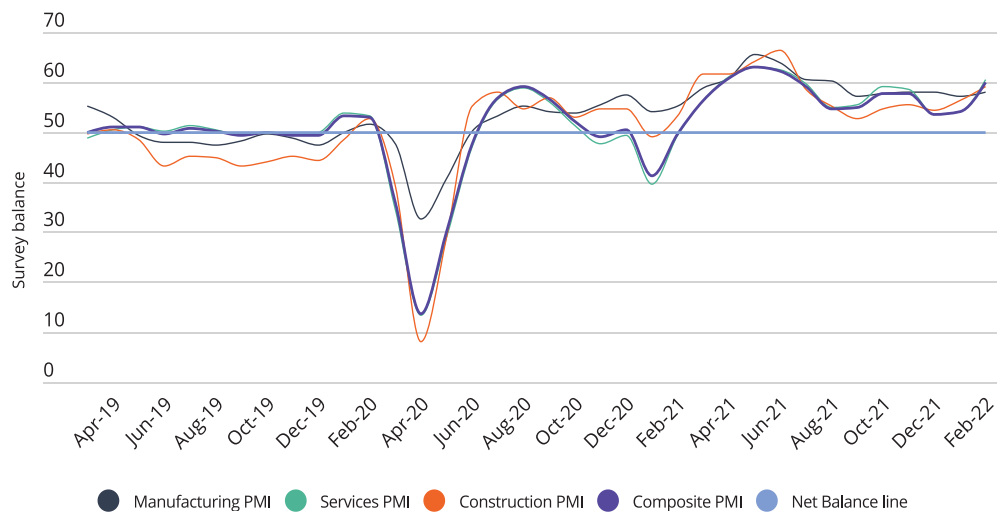
PUBLIC SECTOR NET BORROWING EXCL. PUBLIC SECTOR BANKS

Source: ONS



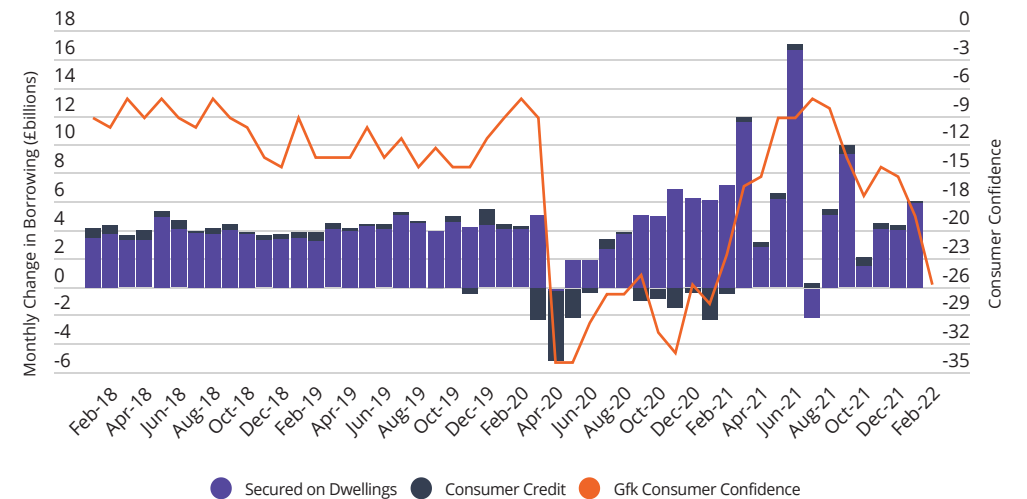
PURCHASING MANAGERS' SURVEY

Source: Markit & CIPS



CONSUMER CREDIT AND CONFIDENCE

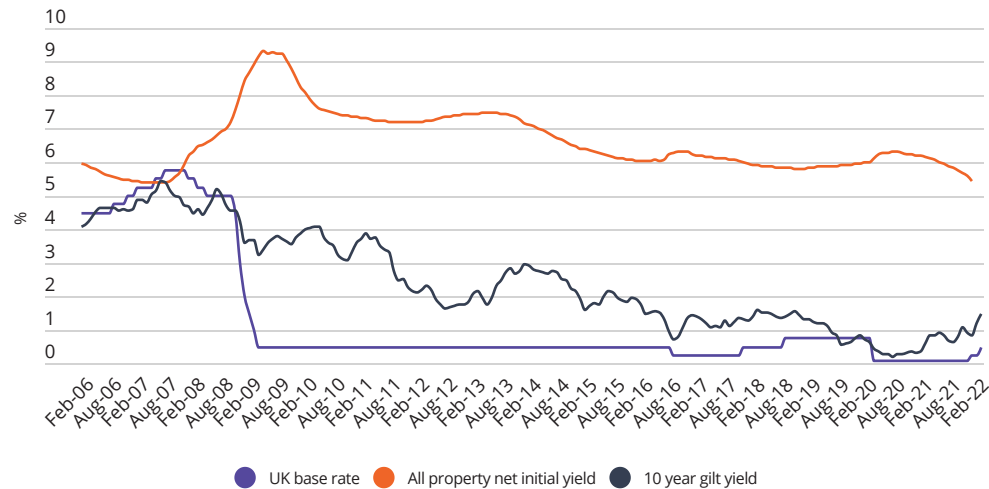
Source: Bank of England



Economic data

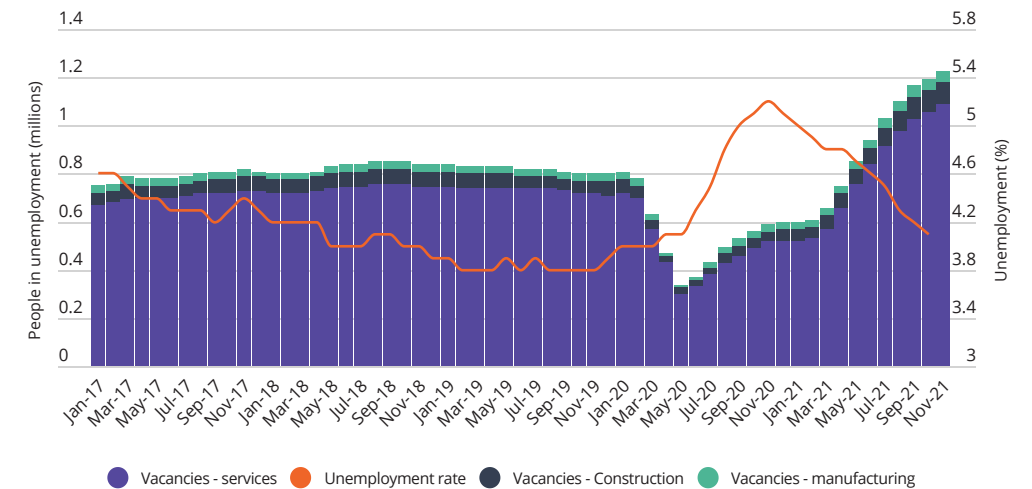
UK NET INITIAL YIELD VS GILTS VS BASE RATE

Source: MSCI monthly index, Bank of England



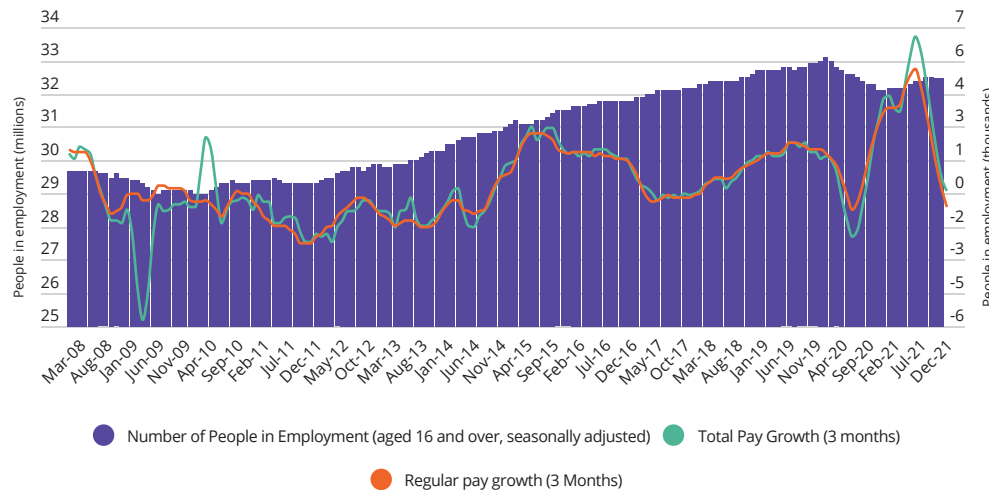
VACANCIES

Source: ONS



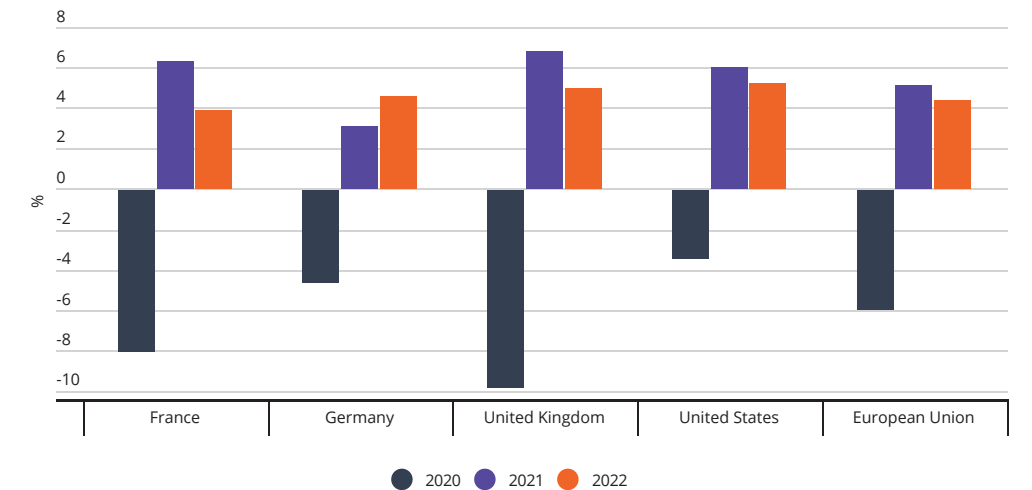
EMPLOYMENT AND AVERAGE WEEKLY EARNINGS

Source: ONS



GLOBAL ECONOMIC GROWTH

Source: IMF





Property market

The final quarter of 2021 saw the property market continue to maintain momentum through to the close of the year, despite Covid headwinds. Leasing and purchasing transaction volumes recorded strong year-on-year gains in 2021, as well as generally impressive final quarter figures.

Rolling investment volumes across the market in the year to Q4 2021 totalled £51 billion, exceeding the 10-year average for the second consecutive period. This performance was driven primarily by increased domestic investment which totalled over £30 billion for the first time since Q1 2019, while overseas activity receded slightly to £26 billion.

OFFICES

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.

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.

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.

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.

Property market

RETAIL

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.

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.

INDUSTRIAL

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.

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.

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.

“
While Covid remains a threat, lower severity of infections combined with high vaccination rates means its impact on people and the economy is likely to be declining, reducing the downside risk it poses.

KEY STATS

ANNUAL ROLLING VALUE OF NEW CONSTRUCTION ORDERS

£18.6 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

2.4%

INDUSTRIAL



8.9%

RETAIL



1.1%

OFFICES



-3.1%

Property market Occupier data

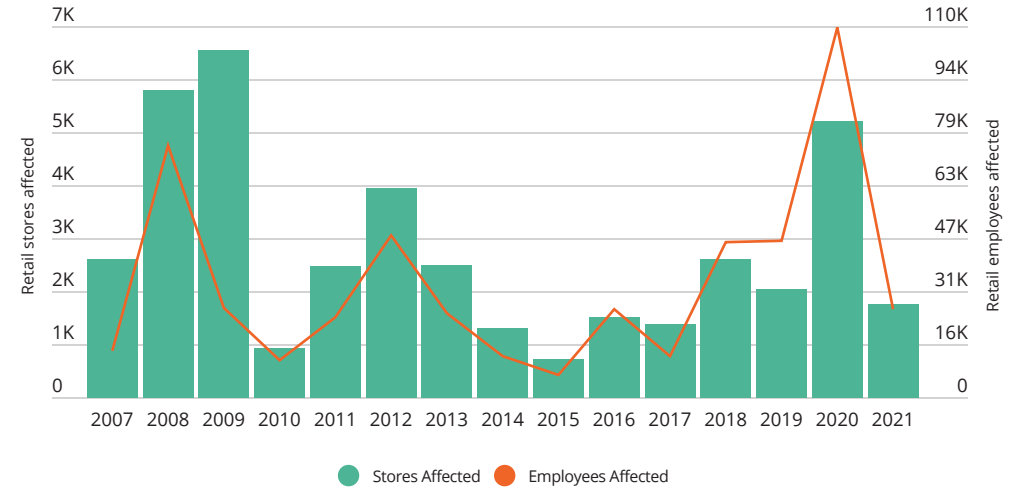
BIG NINE & CENTRAL LONDON TAKE-UP

Source: Avison Young



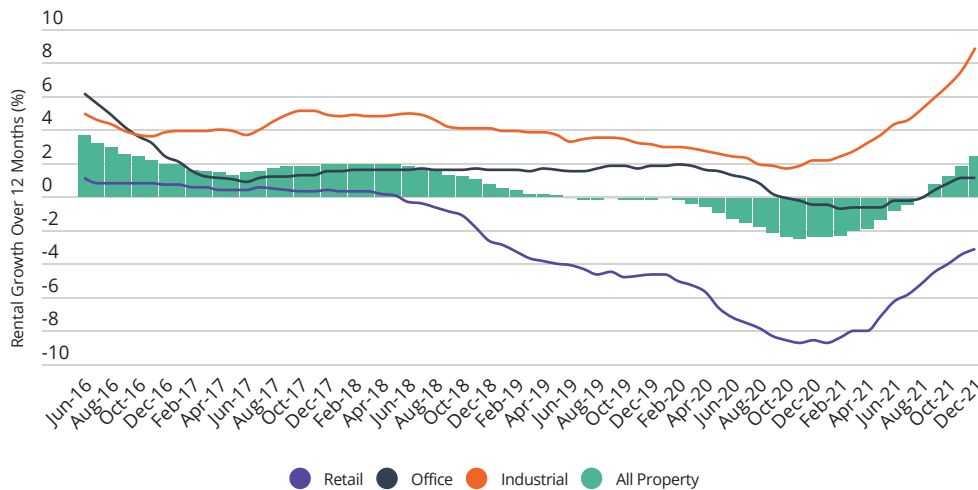
FAILING RETAIL COMPANIES

Source: Centre for Retail Research



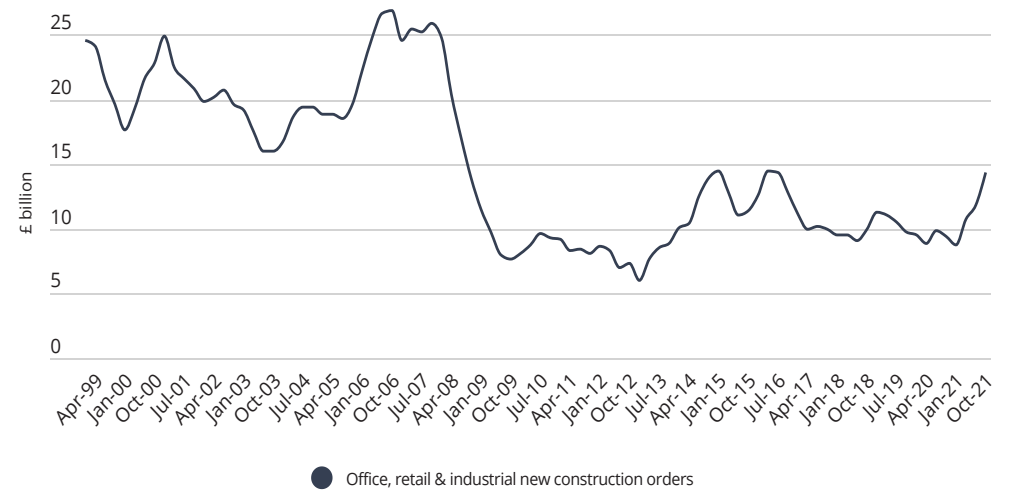
AVERAGE ANNUAL RENTAL GROWTH

Source: MSCI Monthly Index



NEW CONSTRUCTION ORDERS RETAIL, OFFICE AND INDUSTRIAL

Source: ONS



Property 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, lower severity of infections combined with high vaccination rates means its impact on people and the economy is likely to be declining, reducing the downside risk it poses. This is considerably positive news for the real estate sector, where those who have fared the pandemic storm well may now be on the hunt for new spaces across sectors

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.

In the residential sector, the economic backdrop, low (albeit increasing) 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.

Across all sectors, the increasing costs of living and of doing business mean that disposable incomes and margins are being squeezed. As a result, market activity may also be hindered as people and businesses look to contain costs, at least until inflationary pressures subside in a significant way. This may act as a drag to rental values in particular, as shorter-term transactions are more likely to be buffeted by these headwinds.



Q3 2021 VOLUMES BY REGIONS

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

KEY STATS

ANNUAL ROLLING INVESTMENT
TRANSACTIONS VALUE

£52.1 billion

Q4 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%

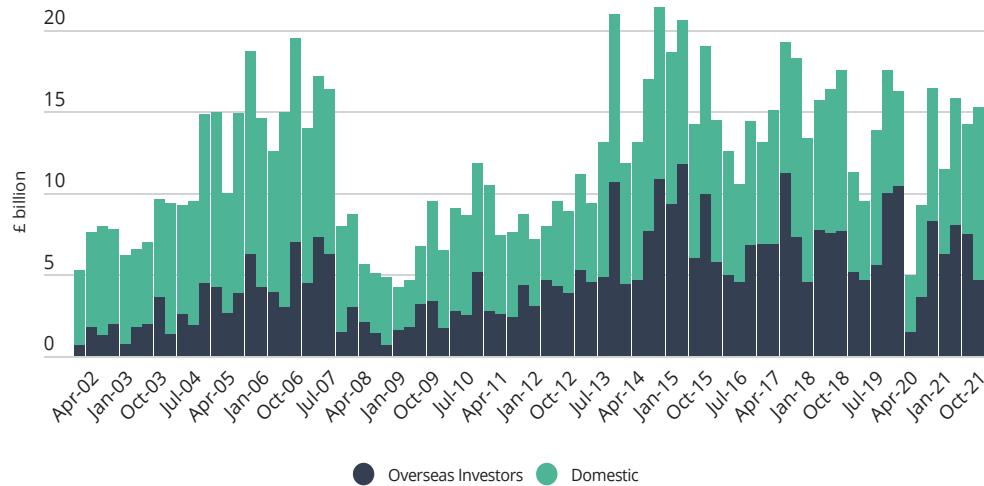
ANNUAL ALL PROP CAPITAL GROWTH

5.3%

Property market Investment data

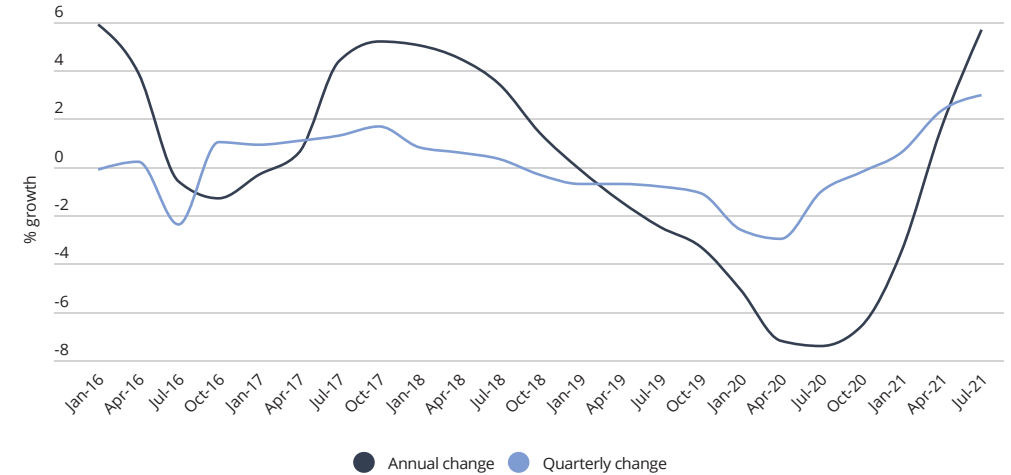
ROLLING ANNUAL INVESTMENT TRANSACTION VOLUMES

Source: Property Data



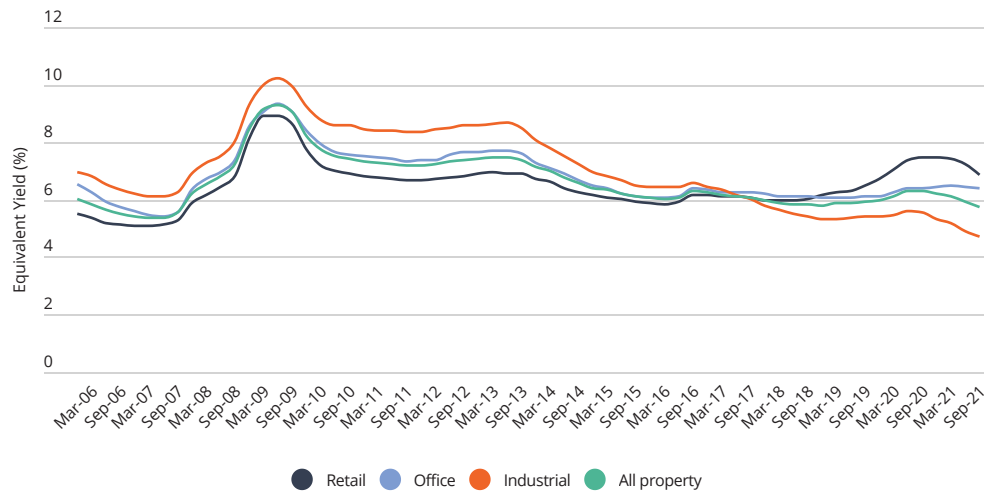
ALL PROP AVERAGE CAPITAL VALUE GROWTH

Source: MSCI



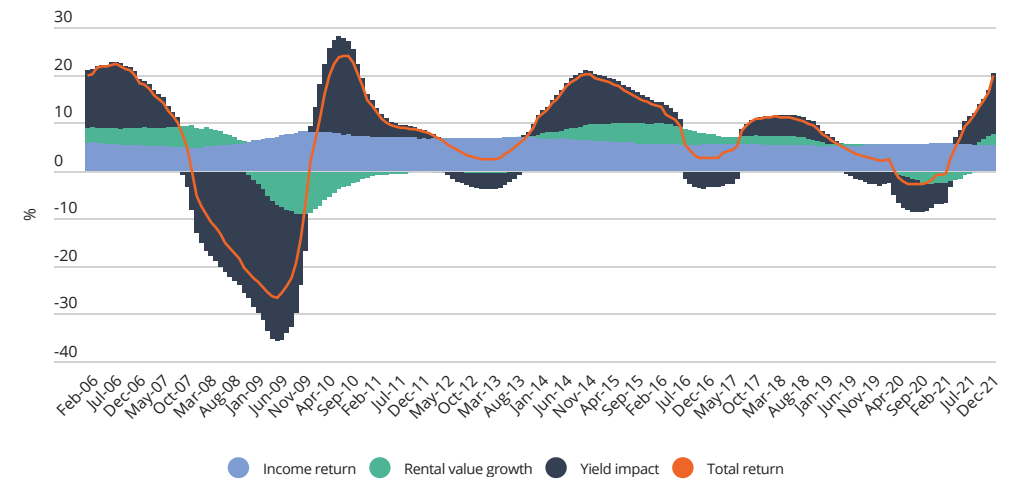
AVERAGE EQUIVALENT YIELDS

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