INSIGHT

EPMR

Economic & property market review

May 2021

Summary

- The UK is continuing to emerge from the third set of national lockdowns. On 17th May, the second stage of the recovery roadmap was enacted, permitting indoor hospitality and leisure to resume operations once again. The third and potentially final set of relaxations could occur on 21st June at the earliest, although evidence of community transmission of a variant which originated in India has raised questions on if this date will be met.
- Covid-19 vaccinations continue to be administered across the UK, with 38.4 million people having received their at least their first of two doses as of 25th May. In response to the progress in the vaccine rollout, low case numbers and high testing capacities in the UK, the government has permitted international travel to select countries, organised by a traffic light system.
- The ONS reported that GDP grew by 2.1% in March 2021, the fastest growth since August 2020. This positive figure came as schools reopened across much of the UK, but before the first stage of the recovery roadmap had been reached (12th April), meaning the majority of restrictions were still in place. As such, the recovery is expected to be strong as the economy gets back in gear.
- In the annual Budget, the Chancellor focused on balancing short-term economic support with the long-term need to address the hole in public finances. This included a further extension to the Coronavirus Job Retention Scheme (CJRS) to the end of September while waiting until 2023 to increase corporation tax.

Economic trends

The UK is continuing to emerge from the third set of national lockdowns. On 17th May, the second stage of the recovery roadmap was enacted, permitting indoor hospitality and leisure to resume operations once again. The third and potentially final set of relaxations could occur on 21st June at the earliest, although evidence of community transmission of a variant which originated in India has raised questions on if this date will be met.

Covid-19 vaccinations continue to be administered across the UK, with 38.4 million people having received their at least their first of two doses as of 25th May. In response to the progress in the vaccine rollout, low case numbers and high testing capacities in the UK, the government has permitted international travel to select countries, organised by a traffic light system.

Although there are concerns around a rise in infections as the UK moves toward pre-pandemic levels of activity, the majority of the vulnerable population and those who are in close contact with them have been immunised which should help to keep hospitalisation rates low.

In Q1 2021, UK GDP was estimated to have contracted by 1.5% as the third national restrictions reduced activity. This is a significant improvement on the impact of the first Covid lockdown in Q2 2020 which saw GDP decline by 19.5%. Real GDP for Q1 2021 remains 8.7% below its level at the end of 2019.

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Following a significant 5.8% increase in GDP for March, the construction sector is now 2.4% above its pre-pandemic February 2020 level. GDP for the production and service sectors also grew by 1.8% and 1.9% respectively, meaning they remain 1.8% and 7.2% below their February 2020 levels.

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Additional measures announced in the Budget included an extension to the stamp duty holiday until the end of June, with a further continuation through to the end of September for properties worth less than £250,000. The government has also announced a new mortgage guarantee scheme to facilitate high loan-to-value lending for first time buyers.

The Budget also set out restart grants of up to £6,000 and £18,000 per premises for non-essential retail and hospitality venues respectively, alongside some rates relief for smaller companies, although there are questions as to whether this would amount to the £6 billion of relief advertised.

The Budget looked to stimulate inward investment in the UK by creating a 'super-deduction', which allows businesses to claim back 130% of the costs of an investment. It also set out £1 billion of funding for 45 new towns and eight new freeport locations, with the aim of strengthening key logistics markets, as well as several measures concerning green infrastructure development.

Government borrowing in FY2020/21 is estimated to be £300 billion. Despite being the greatest deficit since WWII, the debt interest to revenue ratio is the lowest since records began in 1947 meaning that repayments relative to revenue 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 – which is now estimated at £2.2 trillion – creates a significant vulnerability to even a slight increase in interest rates.

The Markit / IHS purchasing managers indices (PMI) for March achieved a weighted net balance of 61.0, the highest figure since October 2013. As it is well above the no-change 50.0 marker, this indicator suggests that activity significantly expanded relative to the previous month with all three sectors reporting increases. The construction sector reported the greatest expansion in activity, achieving 61.6 in April, with only a slight subsidence from the previous 6-year high of 61.7 the previous month. Manufacturing activity grew for the 11th consecutive month to a decade-high 60.9, while the services sector achieved 61.0, which is the second strongest figure on record, following strong retail sales and the partial reopening of hospitality.

Consumer confidence increased for the fifth consecutive month in May to reach -9, up from -15 in April, driven by strong perceptions of the general economy and a greater willingness to make major purchases, reaching the strongest levels since the pandemic began. This supports the notion of a strong return to activity as restrictions are eased.

The Bank of England (BoE) reported that consumers continued making net repayments of £0.5 billion in March, with a significant £16.2 billion of deposits also made by households, despite historically low rates of interest on these.

Economic trends

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THE BREXIT DEAL

The UK and EU reached a last-minute Brexit deal at the end of 2020, a milestone in the saga that began in June 2016, although not quite the final chapter. This removed a key downside risk for the economy and much of the uncertainty regarding the UK's future relationship with the EU. There is also a potential economic upside from the ability to deploy domestic regulations and other policy tools in order to support growth.

The deal finally brings the removal (or at least large reduction) of Brexit related uncertainty which has delayed decision making for some investors. The long-term relationship between investment in UK real estate and global investment broke down after the referendum, showing it had a direct impact on investment. Uncertainty was a key aspect of this and has affected some groups more than others – particularly non-domestic institutional investors. The removal of this uncertainty, combined with many UK sectors now looking comparatively attractive in terms of pricing and income security, should help provide a real boost to UK investment volumes.

The same removal of uncertainty and economic risk will benefit the housing market. A no-deal would have hit households' real incomes and confidence, both of which are key drivers of housing market activity. Would-be overseas (or to a lesser extent domestic) buyers who were delaying decision making now have more clarity. There will, however, be some additional hurdles for non-UK nationals looking to move to the UK. Positively, there are no plans to change the Tier 1 Investment Visa. This means non-UK nationals can still apply to settle after two years for an investment of £10 million or after three years for a £5 million investment, and after five years for a £2 million investment.

Looking at the deal more specifically, the free trade agreement which came into effect on January 1st critically means trade in goods will continue to be tariff and quota free. Although, the movement of goods will now face customs, rules of origin, and some regulatory checks. These will cause short term disruption and delays but should be largely mitigated by the UK government's plans to phase in full border controls over six months.

From a real estate perspective these aspects of the trade deal are most relevant to the retail and industrial sectors and are a far better outcome than a 'no-deal' or a deal with tariffs and quotas would have been. Businesses face less supply chain and operating disruption but will experience delays and some additional costs and bureaucracy.

Our departure from the EU single market also means that the cross-border provision of some services will be affected by new barriers to trade. Significantly, there remains some uncertainty around aspects of financial services where agreements on 'financial equivalence' still need to be 'firmed up'. As negotiations continue on 'equivalence', a degree of uncertainty for firms in affected sub-sectors will remain and it is beginning to seem less likely that ultimately a deal will be reached. In the meantime, the lack of equivalence likely contributed to £5.7 billion worth of share trading being displaced from London to the EU in January. Amsterdam was the primary recipient of this activity, jumping to the pole position of European share trading ahead of London, the historic leader (CBOE Europe). It's important to remember this actually represents a small piece of the city's revenue but there are concerns we could see a kind of 'creep' where activity and business gradually moves from London. A counter point is that if we do not agree financial equivalence it would give us more scope for deregulation.

The restrictions end of free movement and the right to work in the UK for EU citizens will have an impact with some sectors more exposed than others. The new income thresholds mean that businesses with a high reliance on a low paid migrant workforce will face challenges coming to terms with the new landscape, particularly when compounded with the impacts of Covid-19. For example, 70% of London's hospitality workforce were born outside the UK and 75% of those are from the EU (PwC). 30% of London's construction workforce are from the EU and the NHS has a similarly high exposure. The new points-based system is much more restrictive than EU free movement rights and will disproportionately affect these sectors with obligation-heavy and expensive burdens that present a structural challenge to operating models, particularly in construction.

LABOUR MARKET

In the three months to March 2021, LFS employment rose by 84,000 – the first increase since March 2020 – while the unemployment rate fell slightly to 4.8%. Although the unemployment rate may be an underestimate and is forecast to increase further – Capital Economics anticipates a peak of 6.0% in 2022, (improved from 6.5% previously) – the figure is well below where it could have been without the significant and ongoing government intervention.

While the reopening of retail and other areas of the economy will help employment across the UK, the expiry of the CJRS in the end of September will likely cause an increase in joblessness during the recovery. Similarly, although the redundancy rate continued to decline in the January to March period to 5.5 per 1,000 employees, down from the 14.2 peak between September to November, vacancies remain subdued at 657,000 in February to April, 16.3% down on a year previous. These figures show that significant challenges remain despite the labour market beginning to convalesce.

Economic trends

Real earnings growth achieved 3.1% for total pay, and 3.6% for regular pay for January to March. This is only a small decline from the two-decade growth rate peak observed in the November to January period, as pay continues to rebound from the contractions observed during 2020. Although the data suggests that there is strong underlying growth, the job losses incurred over the past year are likely to have skewed pay growth upward to some extent also.

INFLATION

CPI inflation increased to 1.5% in April, up from 0.7% in March. Inflationary pressure was predominantly sourced from rising transport costs while clothing and fuel pump prices provided deflationary off-setting.

Suggestions of a rapid recovery bring with them risks of inflation above the BoE's 2.0% target, particularly if households splash their Covid-savings cash in 2021. However, the longer-term picture sees recovery pressures subside and a stronger pound. This means that high levels of inflation are unlikely to persist into 2022, albeit with the 2.0% target not being consistently met until 2023.

The BoE Monetary Policy Committee (MPC) voted once again to maintain 0.1% interest rates in May 2021 and suggested that this would likely continue to be the case for some time (years rather than months). This 'lower for longer' approach toward interest rates, which has been adopted in the UK and internationally, seeks to achieve growth through greater levels of productivity-enhancing activity in the market, by encouraging increased business and consumer spending. Following significant increases during 2020, the MPC also decided to maintain the rate of asset purchases and the total program remains at £895 billion.

OUTLOOK

GDP forecasts for 2021 are cautiously optimistic, with Consensus Economics expecting 4.2% for the year. The critical factor remains the alleviation of Covid-19 impacts.

The recovery roadmap for easing restrictions in England, which has been largely mirrored in the other UK nations, has continued at the fastest pace set out through its first two stages as social distancing and the vaccine rollout keep cases low. The earliest date for a potential final stage of the easing is 21st June, when all social distancing measures could be removed.

Efficacy of the vaccines against variants of Covid poses a downside risk to recovery as well as the possibility of a rise in the infection rate as restrictions are eased. These emphasise the rapid rollout of immunisations across the UK and the globe in order to reduce the chances of further variants mutating.

With the Brexit deal signed, a considerable downside risk to the UK economy has been significantly reduced. There remain, however, gaps and questions around the specifics of the agreement and impacts of the deal (positive or negative) are likely to take time to materialise.

International tensions remain high amongst key players, with several complex global issues continuing without resolve. Although these are generally being retained in the political sphere at present, there is a notable potential for one or more of these topics to seep into economic domains through sanctions, trade wars or state violence.

LATEST CONSENSUS FORECASTS – MAY 2021

	2021	2022
Economic growth (GDP)	4.2%	5.6%
Household consumption	4.3%	6.6%
Unemployment Rate	6.6%	6.0%
Bank base rate	0.1%	0.1%
CPI - Inflation	1.5%	2.0%
RPI - Inflation	2.5%	2.9%

Source: Consensus Economics

2021 ECONOMIC GROWTH FORECASTS

EUROZONE
6.4%

WORLD
6.0%

UK
5.3%

Source: IMF

KEY STATS

GDP GROWTH

▲ 1.3%
Q4 2020

▼ 1.5%
Q1 2021

PMI WEIGHTED AVERAGE

56.9%
March

▲ 61.0%
April

UNEMPLOYMENT RATE

4.8%
March

REAL EARNINGS GROWTH

3.1%
(including bonuses)

3.6%
(excluding bonuses)

CPI INFLATION

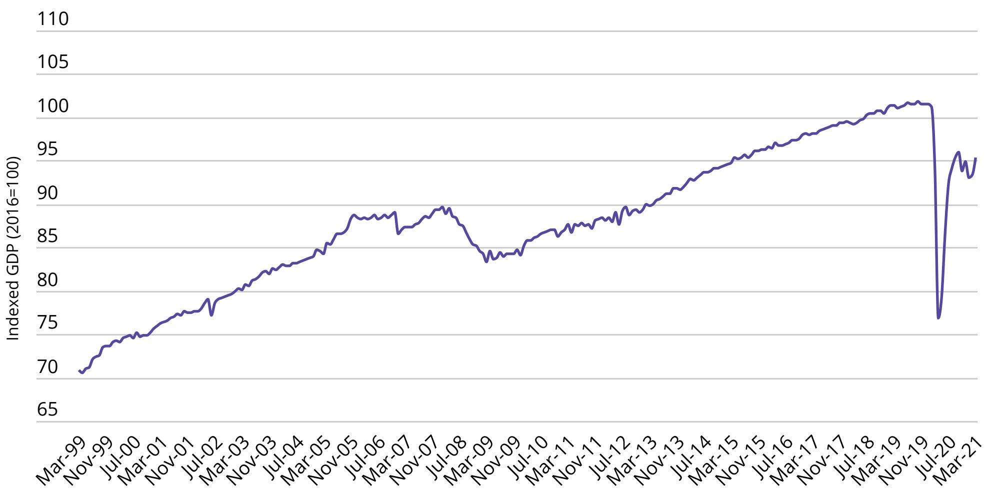
1.5%

BANK RATE

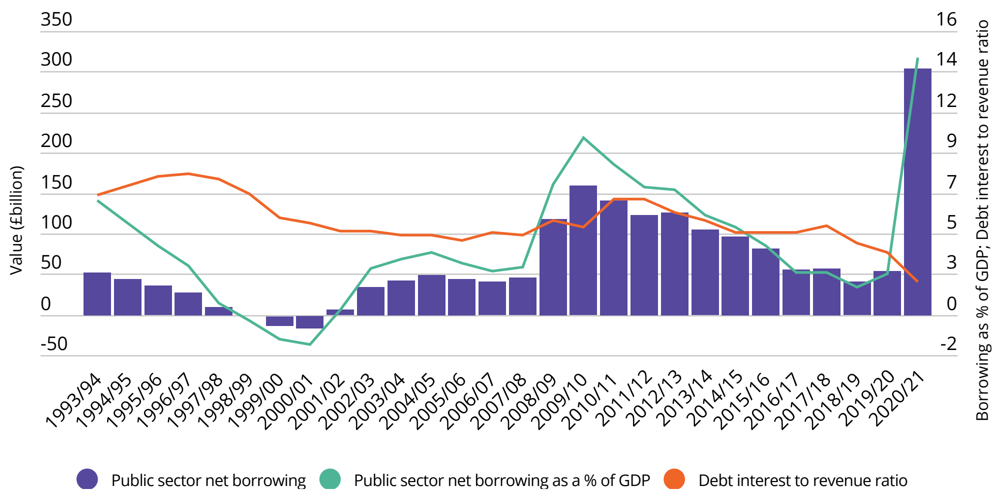
0.1%

Economic data

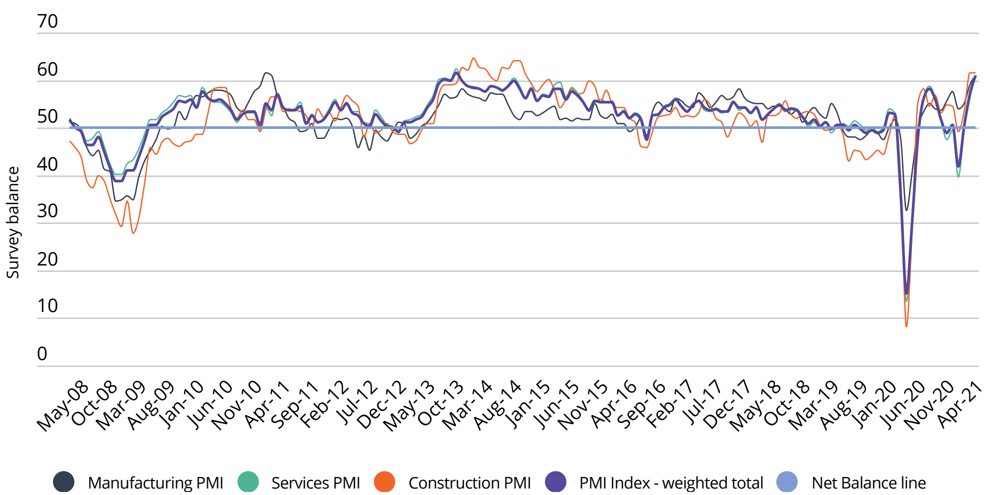
MONTHLY GDP Source: ONS



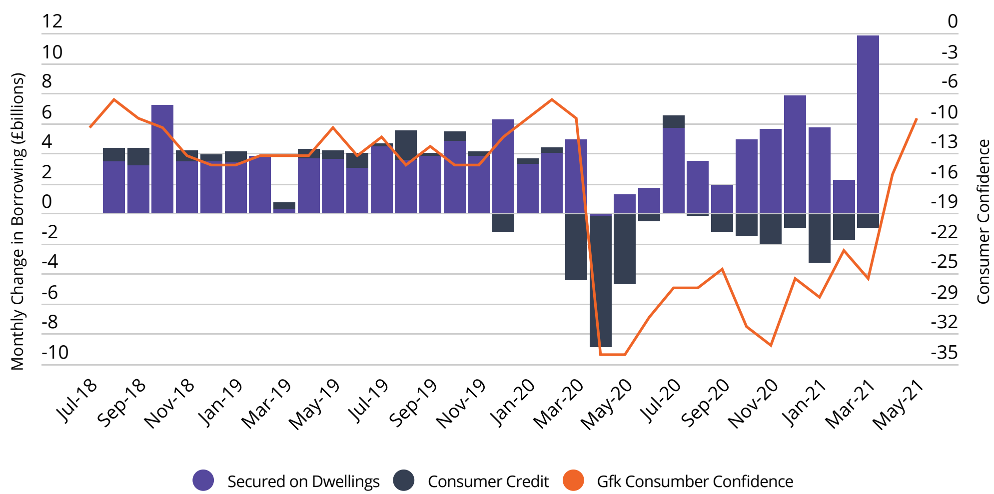
PUBLIC SECTOR NET BORROWING EXCL. PUBLIC SECTOR BANKS Source: ONS



PURCHASING MANAGERS' SURVEY Source: Markit & CIPS



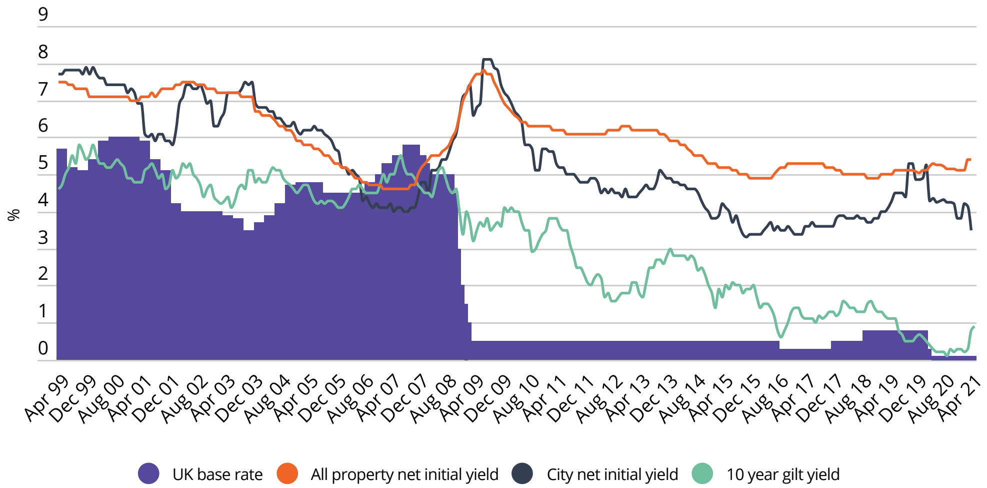
CONSUMER CREDIT AND CONFIDENCE Source: Bank of England



Economic data

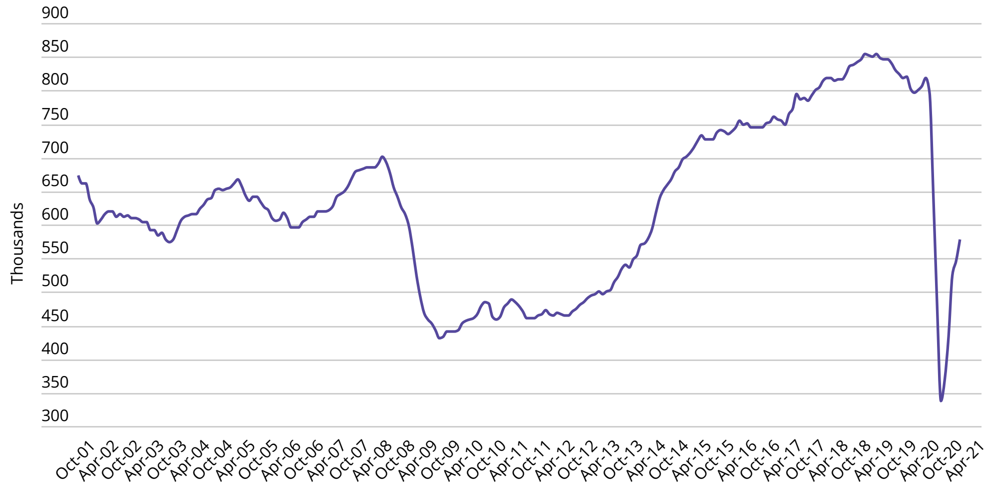
UK NET INITIAL YIELD VS GILTS VS BASE RATE

Source: MSCI monthly index, Bank of England



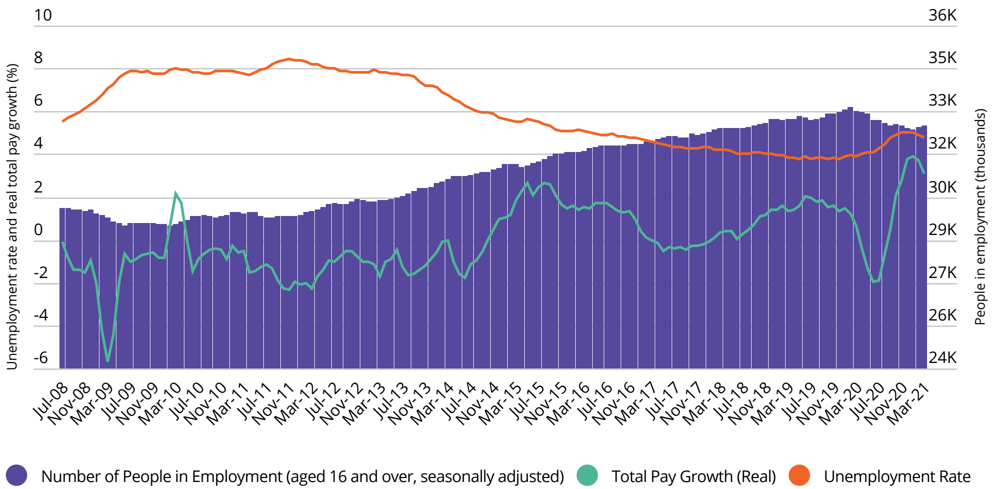
VACANCIES

Source: ONS



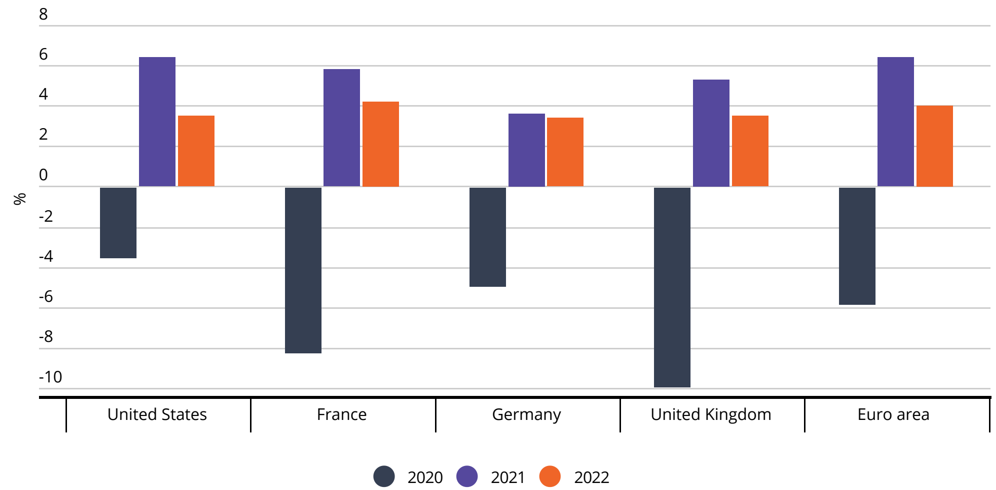
EMPLOYMENT AND AVERAGE WEEKLY EARNINGS

Source: ONS



GLOBAL ECONOMIC GROWTH

Source: IMF



Summary

- Central London office take-up totalled 1.3 million sq ft in Q1 2021, the highest figure since Q1 2020 but still 46% below the 10-year quarterly average. Across the Big Nine cities, total take-up during Q1 amounted to 783,400 sq ft in the city centres and 676,100 sq ft out-of-town, 41% and 14% below respective ten-year averages.

Occupier market

Central London office take-up totalled 1.3 million sq ft in Q1 2021, the highest figure since Q1 2020 but still 46% below the 10-year quarterly average. Over the quarter, Linklaters' acquisition of 20 Ropemaker Street, EC2, was the largest transaction at 307,200 sq ft. The only other 100,000 sq ft deal in Q1 was Google taking 134,900 sq ft at 286 Euston Road, NW1. In the development pipeline, there is 12.7 million sq ft under construction, with 3.9 million (31%) of this space pre-let.

Total take-up during Q1 across the Big Nine cities amounted to 783,400 sq ft in the city centres and 676,100 sq ft out-of-town, 41% and 14% below respective ten-year averages. The largest deal of the quarter was the 133,100 sq ft transaction of B3, Thorpe Park in the Leeds out-of-town market by Lowell Group. In the city centres, DLA Piper's 83,000 sq ft lease of City Square House in Leeds was the largest transaction, followed by 44,700 sq ft at The Spark, Newcastle, acquired by Womble Bond Dickinson.

The reopening of non-essential retail in England on 12th April and the subsequent further relaxations on 17th May have led to noticeable increases in mobility and spending around the UK. High frequency CHAPS payment data has remained at 99% of its pre-pandemic February 2020 level in the two weeks to 29th April, while overall footfall reached 77% of the equivalent week in 2019.

While reopening will undoubtedly help to ease some of the pain currently being felt in the retail sector in particular, the significant structural adjustment occurring across the sector is still ongoing as consumers spend more online and less in store. So far in 2021, there have been an estimated 25,150 retail job losses from 9 major retailers collapsing, affecting circa 1,660 stores. These figures do not include smaller businesses, which have also been hit hard.

Lockdown-induced physical store closures and the need for vulnerable groups to shelter accelerated the uptake of online retailing, even in previously hard to reach demographics and markets, such as grocery shopping. Internet sales achieved a new peak in January, accounting for 36.4% of all retailing during the third national lockdown before subsiding slightly to 32.8% in March and then 29.4% in April. The considerable progress made in advancing the supporting infrastructure and in improving public attitude toward online retailing will persist even once physical stores can reopen; hence the outlook is positive for the e-commerce market.

The recent expansion of online retailing has been largely at the expense of physical stores. This trend is demonstrated by the recent spending spree of several pure-play online retailers purchasing insolvent high street brands without purchasing their physical sites. The failed Arcadia Group's Topshop, Topman, HIIT and Miss Selfridge have been purchased by online retailer Asos for £330 million, while Burton, Dorothy Perkins and Wallis have been acquired by Boohoo who also recently bought the Debenhams chain. All of these deals have been for the brands and websites only, excluding the 408 physical stores and cutting approximately 24,000 jobs.

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 this looks set to continue. The RICS commercial property survey for Q1 2021 illustrates this strong performance, with expectations strongly positive for capital values, rental growth, occupier demand and investment inquiries for both prime and secondary industrial assets over the coming 12 months. This is in stark contract to the office and retail sector outlooks, which both remain negative despite some improvement over Q1.

In the year to February 2021, MSCI data reflects a similar story with the industrial sector delivering 3.2% rental value growth compared to -0.6% and -8.0% for office and retail respectively. Industrial was also the only sector to record positive capital value growth at 11.5% compared to -4.7% and -9.6% for office and retail. Subsequently, industrial yields hardened to 5.1% in February, while office and retail softened to 6.5% and 7.3% respectively.

OUTLOOK

We are hopefully consumer spending will help drive economic recovery in the short term. The government are also hoping to increase corporate expenditure to fuel growth through the 130% tax super-deduction on business investments.

Occupier market

Client feedback tells us that several notable office occupiers have set provisional return to office dates in Q2 2021. Broadly, we expect to see a serious return of activity in the office leasing market in H2 2021. Although the return to office is anticipated to be strong once public health concerns are sufficiently reduced, there will be a sustained increase in the level of home working relative to before the pandemic. This trend, as well as companies looking to cut costs, will likely result in further grey sub-let space coming to market as occupiers look to reduce their footprints.

The restart grants, limited rates relief and most significantly the extension of the CJRS, alongside potential consumer expenditure increases from savings accrued during the past year, mean that retail may finally experience some positivity having reopened on 12th April with strong retail sales reported. However, it is anticipated that e-commerce will retain a sizeable share of activity post-Covid and it seems likely that physical store retailing will continue to bear the brunt of the structural shift in the economy and consumer behaviour over the medium-term.

Retail's loss is industrial's gain, however, with Capital Economics estimating 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.

An important outcome from the Brexit deal will be the ongoing negotiations around the equivalency of financial service operations. If the UK does not achieve a favourable outcome – i.e. UK firms do not gain EU equivalency – then UK locations will be less appealing for companies looking to do business with the EU.

HOUSING MARKET

The housing market continues to show considerable strength across the UK as the extended Stamp Duty Land Tax (SDLT) holiday fuels activity. Nationwide reported an annualised growth rate of 5.4% in March 2021, down slightly from the 6.9% in February. Transaction volumes have surged to the highest figure on record at 190,980 in March, attributed to the rush to complete before the former SDLT holiday deadline of 31st March.

Mortgage borrowing totalled £11.8 billion in March – the strongest figure since at least 1993 when the series began – with 82,700 mortgage approvals also taking place, up from 73,000 in February but below the recent peak of 103,100 in November 2020.

We expect momentum in the housing market to continue through to the end of the SDLT holiday on 30th June as the most overt Covid impacts recede and more regular economic activity begins to return.

Following the expiry of the holiday and the government moratorium on evictions, wider macro-economic factors will return as the primary drivers of the housing market. Although these factors could weigh on the UK housing market over 2021 and beyond, we are cautiously optimistic that the economic recovery will be strong enough to support continued house price growth albeit at much more moderate levels.

> "While reopening will undoubtedly help to ease some of the pain currently being felt in the retail sector in particular, the significant structural adjustment occurring across the sector is still ongoing as consumers spend more online and less in store.

KEY STATS

ANNUAL ROLLING VALUE OF NEW CONSTRUCTION ORDERS

£9.7 billion

Q1 TAKE-UP LEVELS

CENTRAL LONDON OFFICES

1.3m sq ft

'BIG NINE' REGIONAL OFFICES

1.5m sq ft

ANNUALISED AVERAGE RENTAL GROWTH

ALL PROPERTY

1.9%

OFFICES	RETAIL	INDUSTRIAL
-0.6%	8.0%	2.7%

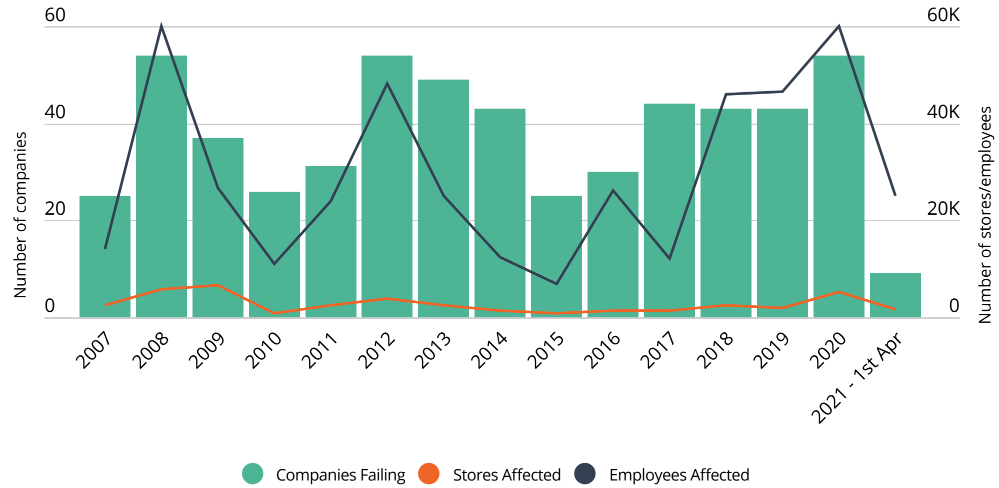
Occupier market data

BIG NINE & CENTRAL LONDON TAKE-UP

Source: Avison Young

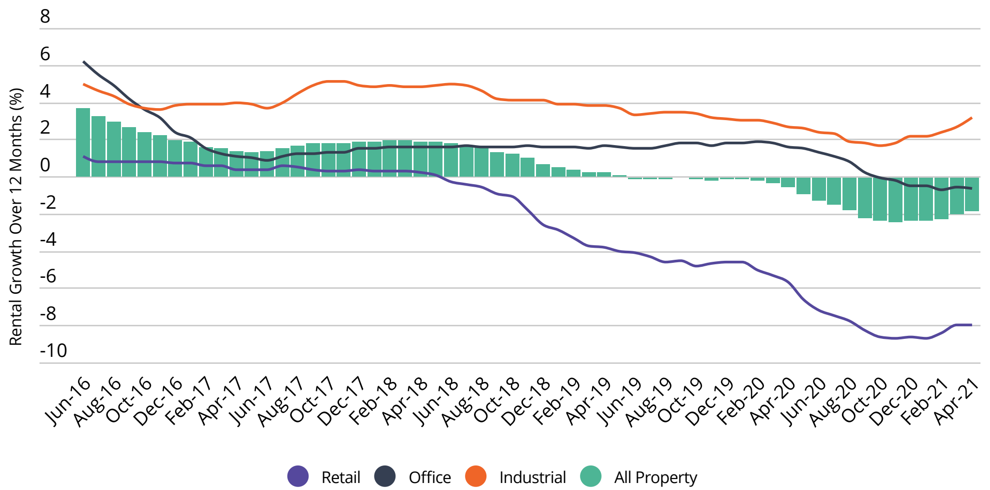
FAILING RETAIL COMPANIES

Source: Centre for Retail Research



AVERAGE ANNUAL RENTAL GROWTH

Source: MSCI Monthly Index



Summary

- In the investment market, provisional transaction volumes for Q1 2021 are £10.7 billion, 24% below the 5-year quarterly average (Property Data). This is the lowest Q1 figure since 2012, with the third set of national restrictions weighing on transactions.
- Effective vaccine rollout across the UK and will be the key driver of economic performance in the near term. Our progress so far, and the boost in consumer activity seen in our Cities Recovery Index following the 12th April and 17th May lockdown easing, gives hope for a strong economic recovery over Q2 & Q3.

Investment market

In the investment market, provisional transaction volumes for Q1 2021 were £10.7 billion, 24% below the 5-year quarterly average (Property Data). This is the lowest Q1 figure since 2012 with the third national restrictions weighing on transactions.

The office and retail sectors saw investment volumes decline quarter-on-quarter in Q1 and are under their 10-year quarterly averages by 57% and 53% respectively. While industrial investment declined from the record-high £5.6 billion in the previous quarter, Q1 2021 accrued £3.3 billion which remains 93% above the 10-year average for the sector. The only sector to report a quarterly increase was the alternatives & mixed used sector, which registered a 10% increase to total £3.8 billion – 10% above the 10-year average.

Central London investment volumes in Q1 2021 totalled £2.2 billion, 38% below the 10-year quarterly average and a decline from the strong end to 2020. The largest transactions of the quarter were 45-50 Holborn Viaduct, EC1, purchased by CBREGI for £265 million and 66-73 Shoe Lane, EC4, by Wing Tai Properties for £255. Activity was centred in the West End and Midtown where £970 million and £754 million was transacted respectively, 78% of the quarterly total.

Following a strong finish to 2020, positive sentiment continues in the Big Nine office investment markets. Several large deals have completed since the start of the year and others are under offer. While total volumes for Q1 amounted to £177 million, 69% down on the ten-year average, Q2 volumes have already surpassed this figure.

As a result of the challenges within the commercial real estate market, all property average capital value growth remains negative at -0.6% in the year to April 2021, compared to -6.5% a year previously (MSCI Monthly Index). All property equivalent yields declined marginally in April to 6.1%, driven primarily by the industrial sector.

Investment market

OUTLOOK

The continuation of fiscal support measures announced in the Budget, policy support for investment, the progressing vaccine rollout and the roadmap for easing restrictions suggest that economic recovery will begin to gather momentum in Q2 2021.

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.

In the near-term, there could be considerable scope for investments for those with the capital and appetite for the increased risk. There may be further opportunities in from structural shifts that have occurred or been accelerated in the last year.

Effective vaccine rollout across the UK and will be the key driver of economic performance in the near term. Our progress so far, and the boost in consumer activity seen in our Cities Recovery Index following the 12th April and 17th May lockdown easing, gives hope for a strong economic recovery over Q2 & Q3.

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Q1 2021 VOLUMES BY REGIONS

- London **£3.0 billion**
- South East **£950 million**
- North West **£740 million**
- South West **£498 million**
- Yorks & Humber **£405 million**
- West Midlands **£351 million**
- East Midlands **£307 million**
- East of England **£307 million**
- Scotland **£255 million**
- Northern Ireland **£128 million**
- Wales **£122 million**
- North East **£124 million**

KEY STATS

ANNUAL ROLLING INVESTMENT TRANSACTIONS VALUE

£41.1 billion

Q1 VOLUMES BY INVESTOR TYPE

OVERSEAS INVESTORS

47%

UK PROPERTY COMPANY

23%

UK INSTITUTIONS

10%

ALL PROPERTY EQUIVALENT YIELDS

6.1%

ANNUAL ALL PROP TOTAL RETURN

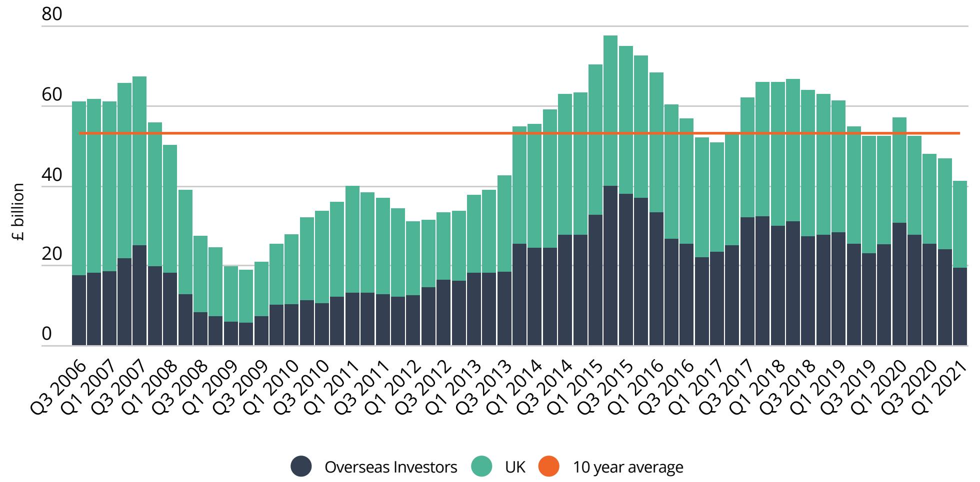
5.2%

ANNUAL ALL PROP CAPITAL GROWTH

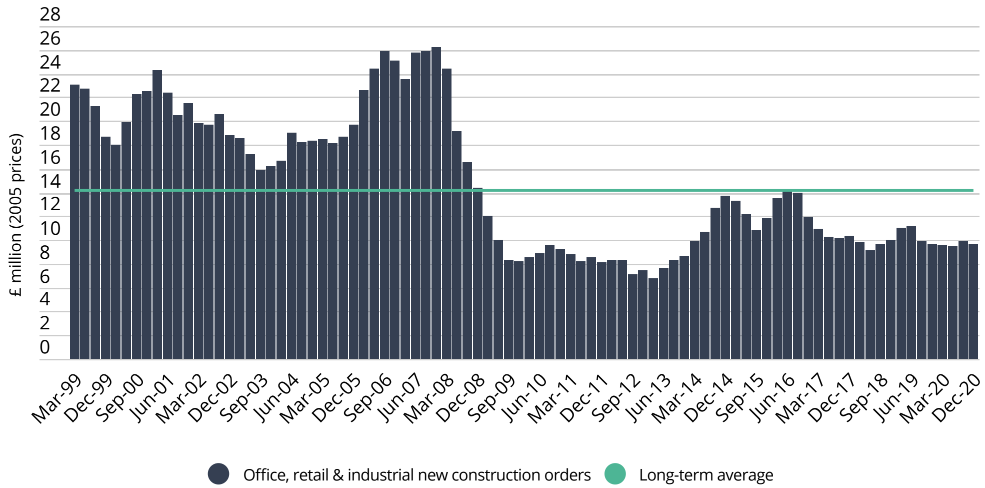
-0.6%

Investment market data

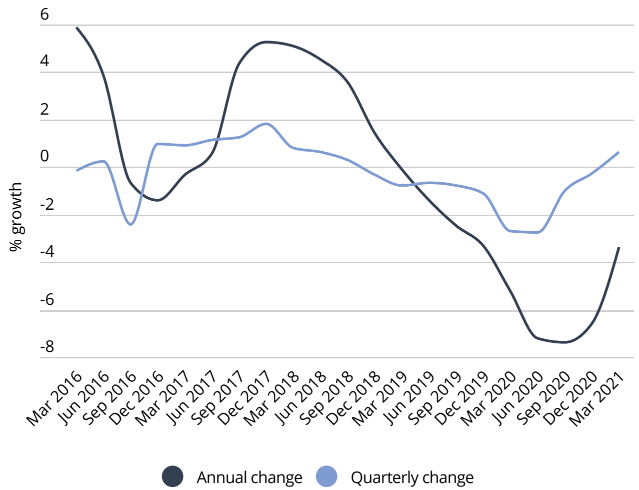
ROLLING ANNUAL INVESTMENT TRANSACTION VOLUMES Source: Property Data



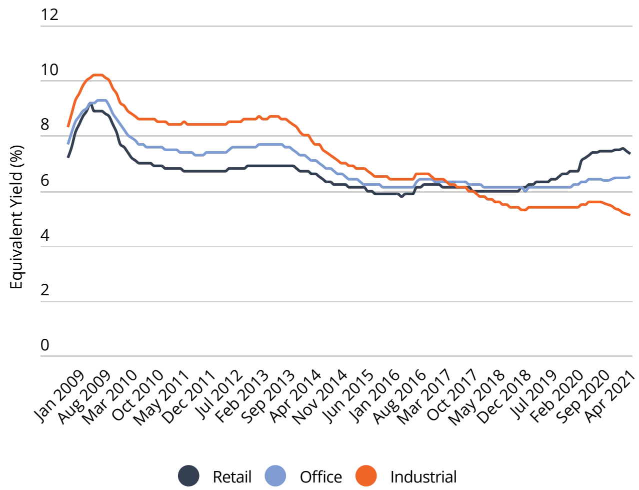
NEW CONSTRUCTION ORDERS RETAIL, OFFICE AND INDUSTRIAL Source: ONS



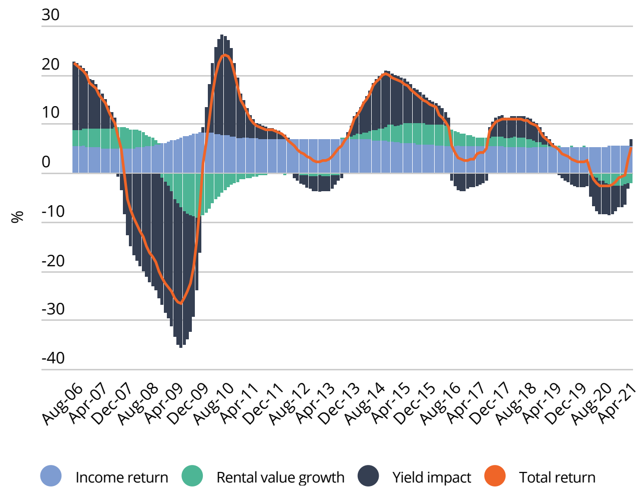
ALL PROP AVERAGE CAPITAL VALUE GROWTH Source: MSCI



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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