INSIGHT

EPMR

Economic & property market review

October 2021

AVISON YOUNG

Summary

- As the UK progresses into the recovery period, the focus is beginning to shift away from Covid case numbers and more toward the composition of the future economy. Several key trends are evolving – many of which are driven by the legacy of the lockdowns and other Covid support measures.
- For August 2021, the ONS estimates that GDP grew by 0.4% to remain 0.8% below the pre-pandemic level of February 2020. Activity was primarily drive by the production sector which achieved an output growth of 0.8%. Service and construction also increased their output by 0.3% and 0.2% respectively. In the same release, GDP growth for July 2021 was revised down to -0.1% from 0.1%.
- Covid-19 vaccinations continue to be administered across the UK, with 79% of the adult population having received two full doses as of 11th October. Although case numbers are at a comparable level to that of December 2020, these are critically not translating into comparable increases in hospitalisations.
- Government borrowing in the financial year to August 2021 is estimated to total some £91 billion. Over FY2020/21 this figure was estimated to be £321 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.

Economic trends

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Covid-19 vaccinations continue to be administered across the UK, with 79% of the adult population having received two full doses as of 11th October. Although case numbers are at a comparable level to that of December 2020, these are critically not translating into comparable increases in hospitalisations. However, public health experts have warned that the lack of exposure to disease during the pandemic, combined with the added threat of Covid, means that the seasonal rise in flu cases over the winter could prove more deadly then usual. In response, vulnerable groups are being offered booster jabs of Covid vaccinations as well as an increased volume of flu inoculations being deployed.

The move into October means that several major government interventions, put in place in response to the pandemic, have now expired. This includes the Coronavirus Job Retention Scheme (CJRS), which had provided an estimated £69 billion of support across 11.7 million employments cumulatively as of 14th September. The stamp duty land tax (SDLT) holiday has also ended following a period of tapering-off.

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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 September achieved a weighted net balance of 55.4, continuing to recede down from the all-time high of 63.3 observed in May and the lowest figure since February. Despite the decrease, the average remains well in excess of the no-change 50.0 marker, signalling that activity continued to expand relative to last month, just at a marginally slower pace than the previous 6 months.

Over the past month, the manufacturing sector achieved a PMI net balance of 57.1, a step down from the previous month's 60.3. This month's figure – the lowest since February – means the industry remains in expansion, but supply chain delays and ongoing material and labour shortages weighed on activity. The construction sector also reported a slowdown in growth, reporting a net balance of 52.6, down from 55.2 in August. Of the three major industries, the services sector was the only one to report an increase in growth rate in September, rising to 55.4 from 55.0, despite prices inflating at the fastest rate since the PMI survey began in 1996.

Gfk's consumer confidence index decreased to -13 in September, down from -8 in August. All components of the index fell as a combined result of rising inflation, supply chain difficulties, tax increases and the ending of the CJRS and other Covid-related government interventions.

BoE data provides a more positive picture in August, with consumer credit increasing by £0.4 billion on net. However, despite interest rates remaining low at an average of 0.29%, household deposits remained high at £9.1 billion, compared to a pre-pandemic average of £4.7 billion over the year to February 2020.

Government announced a further extension to the moratorium on commercial evictions for an additional nine months to now end in March 2022. Commercial tenants are currently facing rental arrears of £6 billion. The extension was welcomed by occupiers at the distain of landlords as tensions between the two heated up ahead of the previous end date of 30th June 2021.

Economic trends

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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'.

The price of natural gas has risen considerably over the past two months as a colder 2020/21 winter depleted reserves more than usual, followed by slow restocking rates over the summer, in part due to a reduced supply from Russia. Additionally, the phasing out of coal power and low wind levels in the Irish sea have meant that natural gas has had less of a buffer in terms of alternative energy sources. The result is soaring gas prices, with an eight-fold increase over just six months during the summer and autumn of 2021. Multiple smaller UK energy companies have gone out of business due to the price surge and energy-reliant businesses are feeling the strain while consumers are partially protected by the price cap.

LABOUR MARKET

In the three months to September 2021, the employment rate increased marginally to 75.3%,, with the unemployment rate continuing to decrease down to 4.5%. While the rising employment rates and declining unemployment rates are positive signs for the labour market, there are wider factors to be considered.

Despite a 207,000 increase in payroll employees between July and September, vacancies topped 1 million for the second consecutive period to achieve a record high of 1.1 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.

Although there have been visible labour supply problems in the construction, manufacturing and agricultural sectors, the shortage is thought to be concentrated within a select group of sectors – typically those with a greater reliance on seasonal and non-permanent employees.

Real regular pay grew by 3.4% in the year to August 2021, while total pay (including bonuses) grew by 4.0%, both of which represent continued decline from the June peak. Although these factors are also influenced by other factors, such as the low growth observed in mid-2020 and the laying-off of lower-paid staff resulting in a higher average wage, they are likely to be primarily the result of the aforementioned difficulties in the supply of labour.

Although the expiry of the CJRS at the end of September – impacting around 1.3 million furloughed employments – will likely drive the rate of joblessness up, the resulting unemployment will be unlikely to immediately ease labour market difficulties. 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. Capital Economics forecasts that unemployment will rise to a peak of 5.0% in Q1 2022.

INFLATION

CPI inflation increased by 3.1% in the year to September 2021, down marginally from 3.2% in August. Restaurants and hotels provided some deflationary pressure in the period but almost all other areas of the economy reported positive price growth. Further, the restaurant and hotel impact can be largely written off as a base effect due to last year's Eat Out to Help Out scheme, active across August 2020, distorting current trends by exacerbating restaurant prices.

September's figure came in between the consensus forecast of 3.2% and the BoE's forecast of 3.0%. Although it represented a decrease from the previous month, deflation was primarily caused by the artificial decrease in restaurant and hotel prices and hence there is little evidence to suggest that the underlying inflationary pressure has subsided.

Looking ahead, a 12.0% rise in fuel prices is likely to drive CPI inflation up to 4.0% in October, according to analysis by Capital Economics. Beyond this, Capital Economics expects inflation to peak at 5.0% in April 2022. These levels are in excess of the BoE target of 2.0%, and hence may stimulate an early than anticipated hike of the base interest rate.

Economic trends

The BoE Monetary Policy Committee (MPC) has provided some suggestion that they may increase the base rate before the end of the year, should the inflationary trend continue. This would be contrary to the 'lower for longer' approach that was already coming into effect prior to Covid. The slowdown in GDP growth in August also provides an argument to avoid rates increasing, as higher interest typically discourages spending – counter to the direction of travel needed for continued economic recovery. Government would also be keen to avoid interest rates rising, with the massive public debt accrued over the pandemic leaving state finances vulnerable to even minor increases in interest, while higher (relative to the past 20 years) levels of interest could help raise tax revenue without having to directly increase taxation.

The BoE decision around the base rate will likely be driven by their view on whether the supply-side drivers are becoming baked-in, hence requiring a demand correction. Although supply constraints are currently present in the majority of global economies, they are more severe in the UK due to the compounding impact of Brexit and the pandemic. Government is acting to attempt to reduce the risk of permanent supply chain restructuring through easing the transition into the post-Brexit economy via temporary visa schemes for in-need sectors, however uptake has been low thus far.

OUTLOOK

GDP forecasts for 2021 are continuing to grow in optimism, with the October Consensus Economics survey expecting 6.9% for the year – the highest figure anticipated thus far. Conversely, views over 2022 have become less favourable, declining to 5.1% for the year.

Covid continues to play high on the agenda for deciding the future of the UK economy. Case numbers are at the highest level observed since July, although hospitalisations have remained at a manageable level so far. Booster doses of the Covid vaccine and an increased scale of the flu immunisation program are being deployment to try and keep hospitals operating over winter without becoming overwhelmed.

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, the likelihood of a jump in interest rates is very low, however a smaller near-term rise is becoming increasingly probable.

LATEST CONSENSUS FORECASTS – OCTOBER 2021

	2021	2022
Economic growth (GDP)	6.9%	5.1%
Household consumption	4.2%	6.6%
Unemployment rate	4.9%	4.9%
Bank base rate	0.2%	0.4%
CPI - Inflation	2.3%	3.3%
RPI - Inflation	3.6%	4.7%

Source: Consensus Economics

2021 ECONOMIC GROWTH FORECASTS

WORLD 6.0%

UK 5.3%

EUROZONE 4.4%

Source: IMF

KEY STATS

GDP GROWTH

-1.4% Q1 2021

5.5% Q2 2021

PMI WEIGHTED AVERAGE

55.6% August

55.4% September

UNEMPLOYMENT RATE

4.5% September

REAL EARNINGS GROWTH

4.7% (including bonuses)

3.4% (excluding bonuses)

CPI INFLATION

3.1%

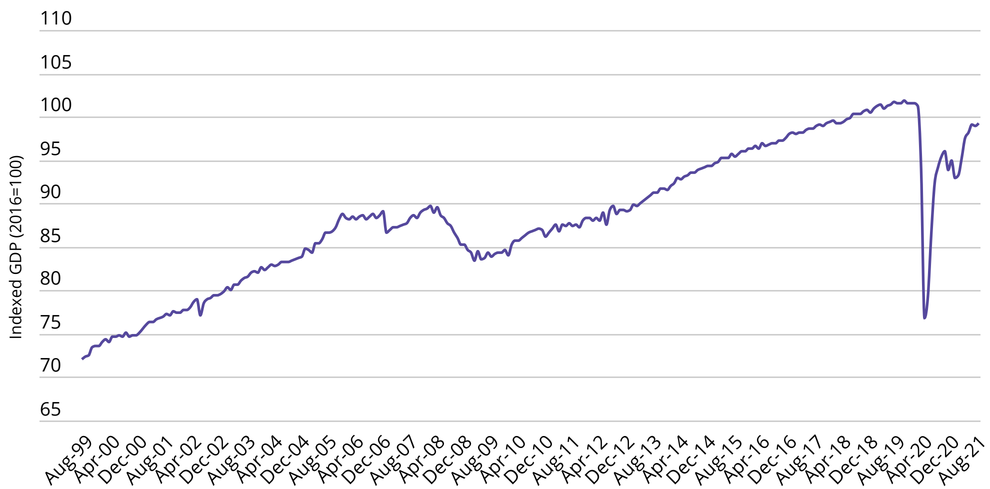
BANK RATE

0.1%

Economic data

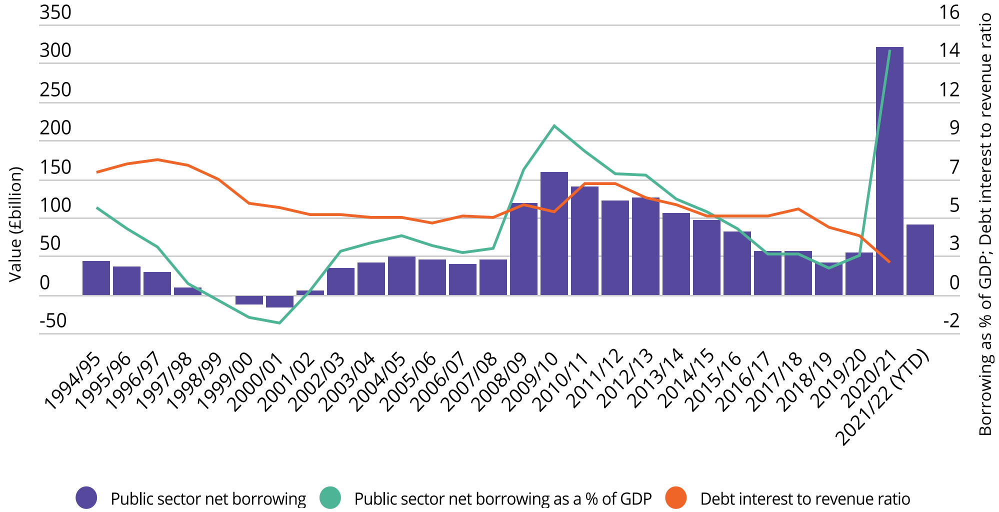
MONTHLY GDP

Source: ONS



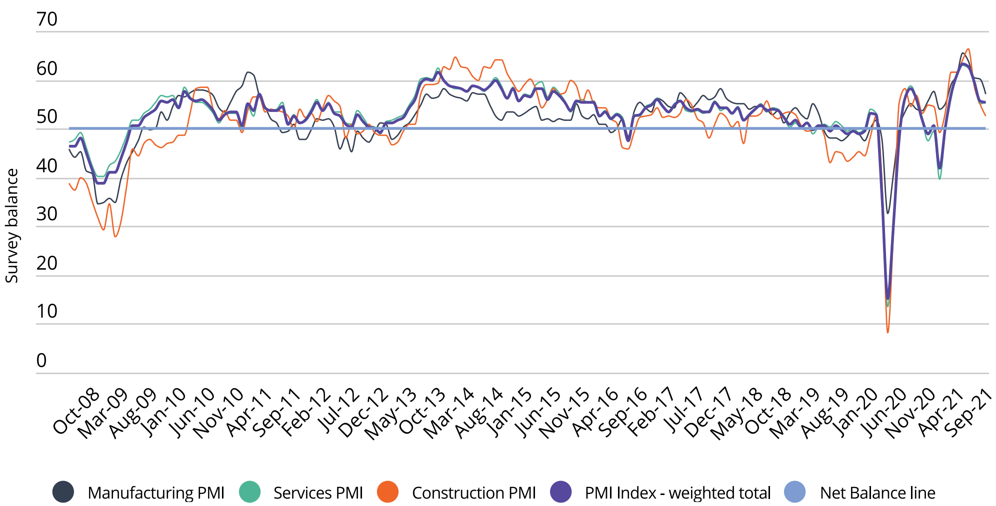
PUBLIC SECTOR NET BORROWING EXCL. PUBLIC SECTOR BANKS

Source: ONS



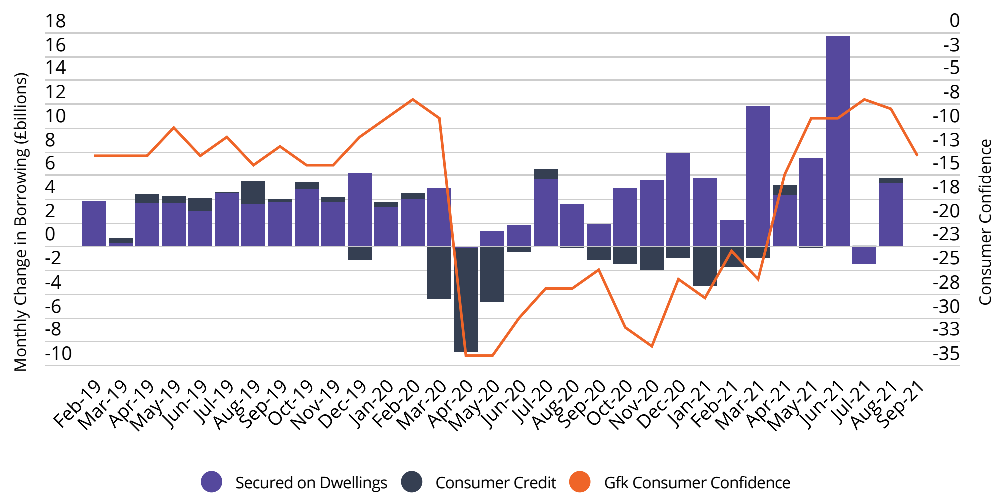
PURCHASING MANAGERS' SURVEY

Source: Markit & CIPS



CONSUMER CREDIT AND CONFIDENCE

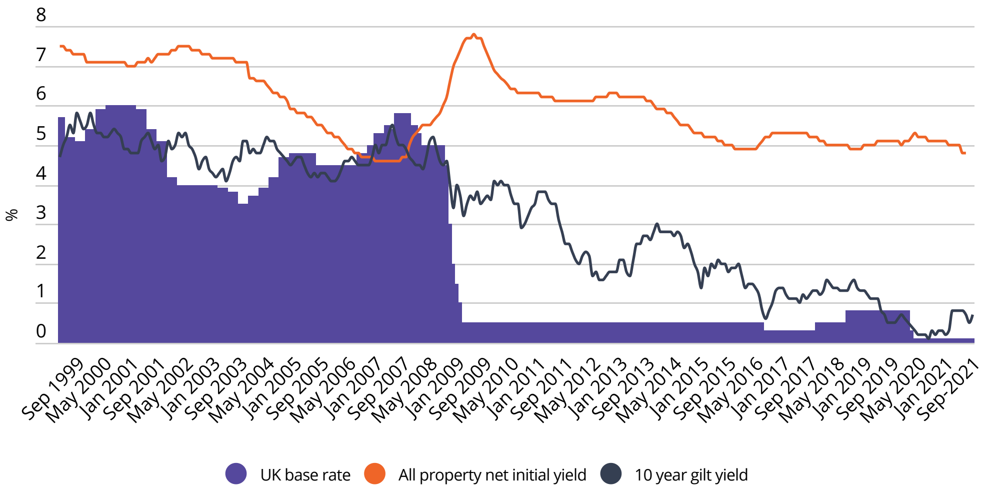
Source: Bank of England



Economic data

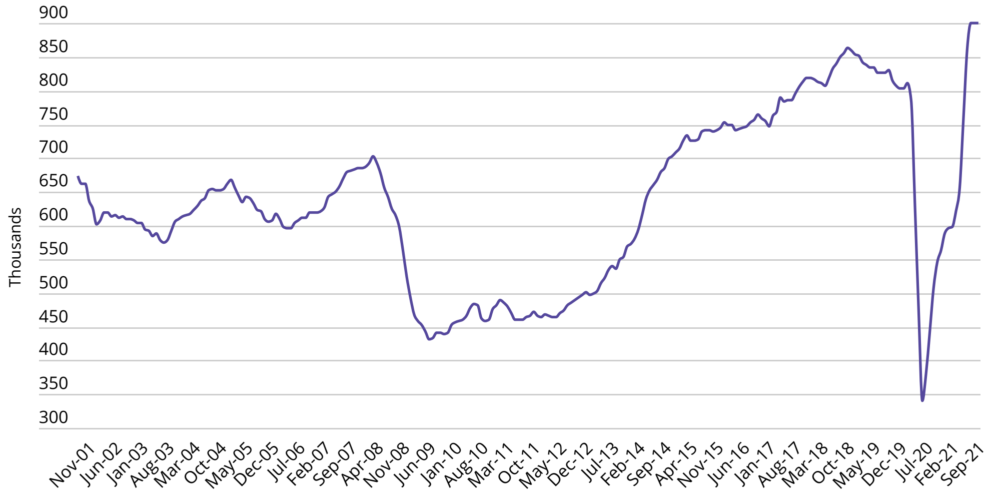
UK NET INITIAL YIELD VS GILTS VS BASE RATE

Source: MSCI monthly index, Bank of England



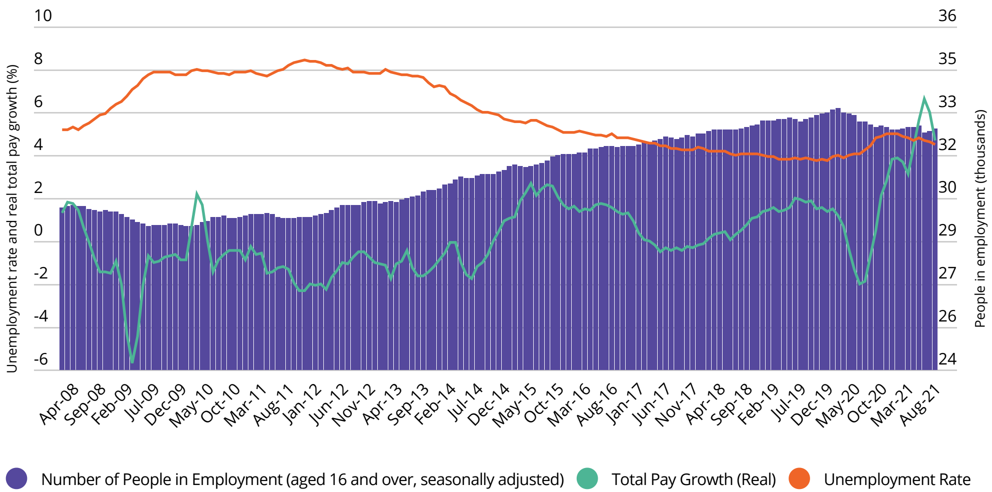
VACANCIES

Source: ONS



EMPLOYMENT AND AVERAGE WEEKLY EARNINGS

Source: ONS



GLOBAL ECONOMIC GROWTH

Source: IMF

Summary

- Central London office take-up totalled 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.
- 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.

Occupier market

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Retail sales in August recorded a 0.9% decline in volume – the fourth consecutive monthly decrease despite a strong return to pre-pandemic levels in the period following the 12th April relaxation in restrictions. Food, non-food and non-store retailing all saw month-on-month declines in August, contributing to the slower growth over the wider economy.

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 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.

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 down to plateau at 25.5% in July and August – still well in excess of the 19.1% in pre-pandemic February 2020. 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.

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 September 2021, MSCI data reflects a similar story with the industrial sector delivering 5.9% rental value growth compared to 0.4% and -4.5% for office and retail respectively. Industrial remains the only sector to record positive annualised capital value growth at a staggering 24.0%, the strongest figure on record, compared to -2.7% and 0.4% for office and retail. Subsequently, industrial yields hardened to 4.7% in September, while offices and retail also declined marginally to 6.4% and 6.9% respectively.

Occupier market

OUTLOOK

Client feedback tells us that several notable office occupiers have set provisional return to office dates in Q3 2021. Combined with the positive figures observed in both the London and Big Nine markets, these figures support the view that the office leasing market is returning to serious levels of activity in H2 2021.

However, rising case numbers pose a threat to gradually improving office occupancy statistics, with government and private work-from-home advise a possibility should the trend continue to progress. While such policies would compound the effects, there will be a sustained increase in the level of home working relative to before the pandemic regardless. This may result in further grey sub-let space coming to market as occupiers look to reduce their footprints.

Although many were hopeful that the savings accrued by consumers during the pandemic would be deployed to boost the recovery through consumer spending, the latest retail sales data suggests this is unlikely to materialise, at least in the short-term outlook. The performance of our UK Cities Recovery Index has also been largely flat in over the autumnal months, suggesting that activity is unlikely to have increased substantially following the slower August growth.

E-commerce appears to have retained around a 25.5% share of retail sales now, considerably up on the pre-Covid level. 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.

While there are questions around the direct relationship between inflation and property, there are several of indirect impacts that may materialise should the CPI continue to track upward at a considerable rate, particularly when combined with the current labour market picture. The most prominent of these is likely to be felt in the retail sector. An interest rate rise due to high inflation levels, combined with higher prices and slower wage growth would weigh on consumer spending. Taken with the supply chain and distribution difficulties resulting in stock shortage, this could amount to greater pressure on physical retailing by pushing consumers online to more well-stocked alternatives at cheaper prices. An additional knock-on effect would be felt in the industrial sector, further fuelling the rapid growth observed in the sector over the past two years.

HOUSING MARKET

House price growth in the UK remained strong in Q3 despite the initial tapering of the Stamp Duty Land Tax (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 following the tapering of 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.

KEY STATS

ANNUAL ROLLING VALUE OF NEW CONSTRUCTION ORDERS

£11.3 billion

Q3 TAKE-UP LEVELS

CENTRAL LONDON OFFICES

2.0m sq ft

'BIG NINE' REGIONAL OFFICES

1.6m sq ft

ANNUALISED AVERAGE RENTAL GROWTH

ALL PROPERTY

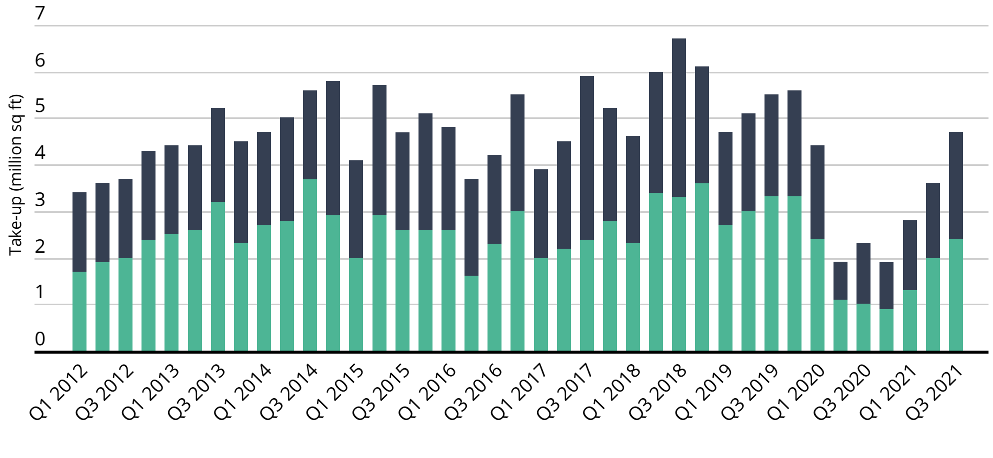
-0.4%

INDUSTRIAL	RETAIL	OFFICES
4.6%	-5.8%	-0.2%

Occupier market data

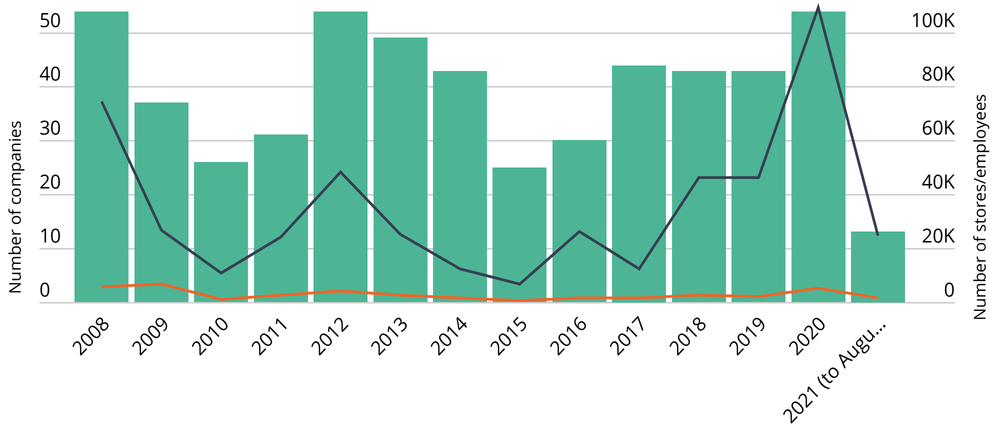
BIG NINE & CENTRAL LONDON TAKE-UP

Source: Avison Young



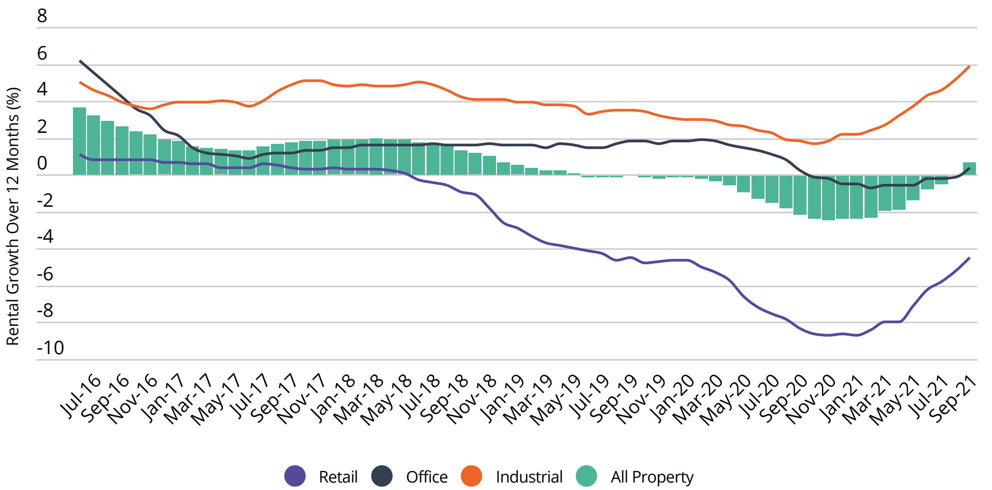
FAILING RETAIL COMPANIES

Source: Centre for Retail Research



AVERAGE ANNUAL RENTAL GROWTH

Source: MSCI Monthly Index



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Summary

- In the investment market, provisional transaction volumes for Q2 2021 were £13.7 billion, 1% below the 5-year quarterly average (Property Data). This is a considerable improve on the Q1 figure which was the lowest volume reported for the period since 2012 at £11.4 million.
- All three of the industrial, office and retail sectors saw an increase in investment volumes in Q2 2021 compared to Q1. Against the 5 year quarterly average, Q2 volumes for industrial were up 54%, while office and retail both down by 1%.
- Central London office investment volumes in Q2 2021 totalled £1.7 billion, 58% below the 10-year quarterly average and a decline from the strong end to 2020. The largest transactions of the quarter were One Braham, purchased by Union Investment for £468 million and Suntec's acquisition of The Minster Building for £353 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.

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.

Annual all property capital value growth achieved 7.6% in the year to September 2021, driven by the continued surge in industrial values. All property equivalent yields hardened in September 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.

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Q3 2021 VOLUMES BY REGIONS

London
£4.2 billion

South East
£1.2 billion

East of England
£847 million

North West
£754 million

West Midlands
£431 million

Scotland
£420 million

South West
£380 million

East Midlands
£341 million

York & Humber
£298 million

Wales
£103 million

North East
£62 million

Northen Ireland
No data

KEY STATS

ANNUAL ROLLING INVESTMENT TRANSACTIONS VALUE

£50.5 billion

Q1 VOLUMES BY INVESTOR TYPE

OVERSEAS INVESTORS

51%

UK PROPERTY COMPANY

29%

UK INSTITUTIONS

9%

ALL PROPERTY EQUIVALENT YIELDS

5.7%

ANNUAL ALL PROP TOTAL RETURN

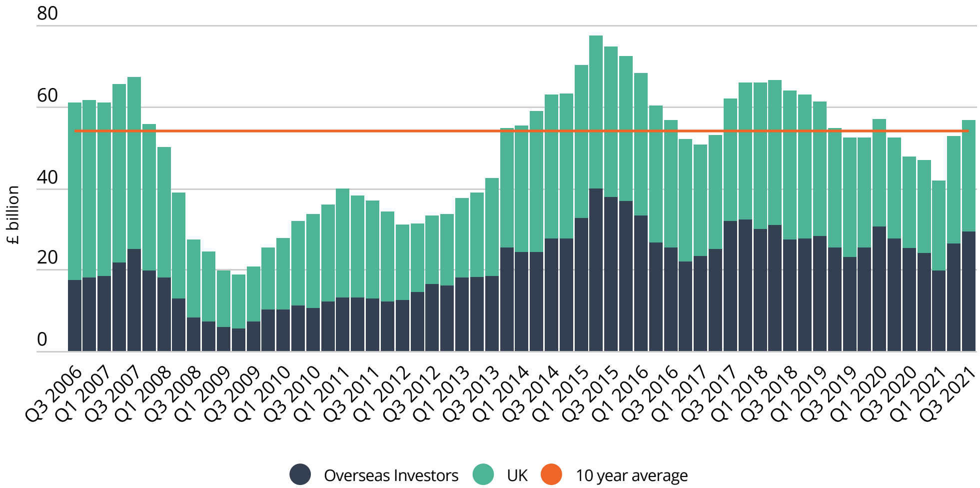
13.4%

ANNUAL ALL PROP CAPITAL GROWTH

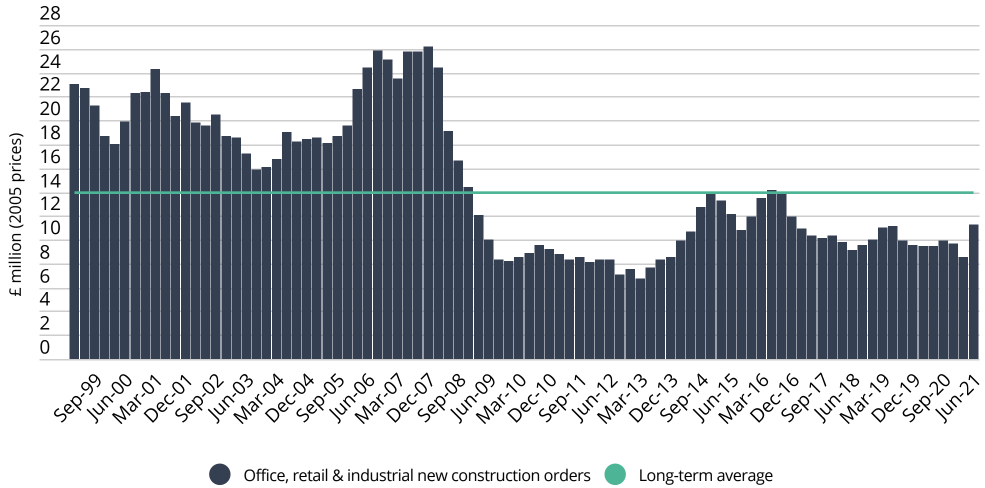
7.6%

Investment market data

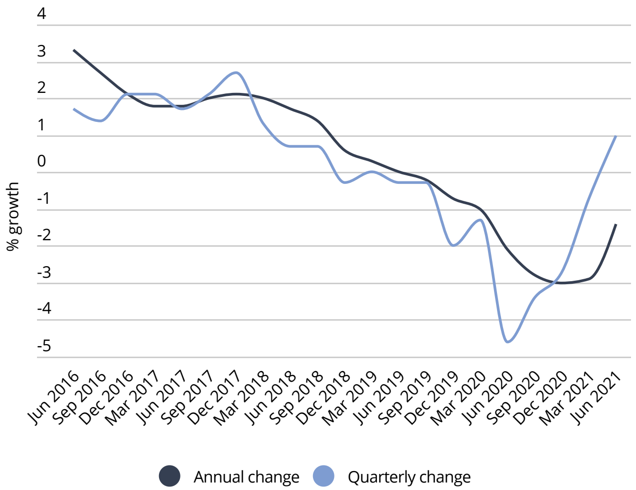
ROLLING ANNUAL INVESTMENT TRANSACTION VOLUMES Source: Property Data



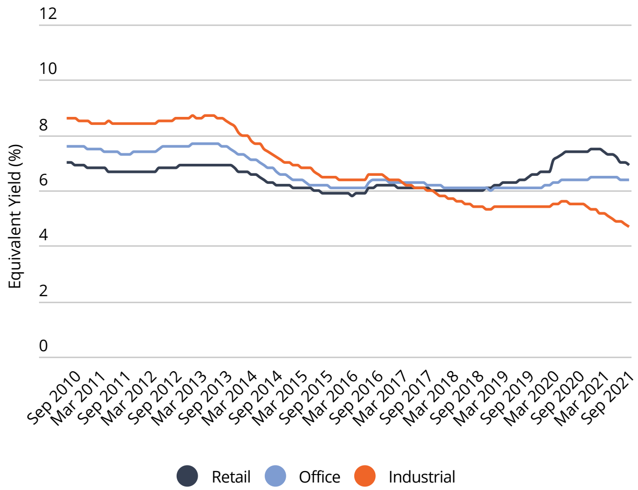
NEW CONSTRUCTION ORDERS RETAIL, OFFICE AND INDUSTRIAL Source: ONS



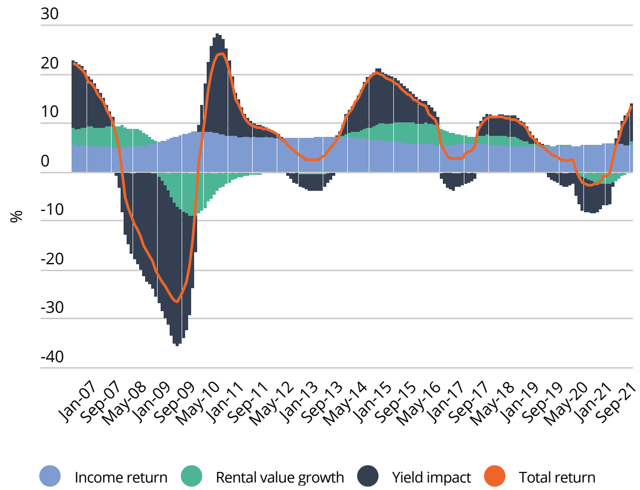
ALL PROP AVERAGE CAPITAL VALUE GROWTH Source: MSCI



AVERAGE EQUIVALENT YIELDS Source: MSCI Monthly



ALL PROPERTY ANNUAL TOTAL RETURN Source: MSCI Monthly



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