GVA

RESEARCH

EPMR

Economic & property market review

Summer 2017

Economic Trends

Political rather than economic events continue to dominate the outlook. Whilst the unexpected general election result has added further uncertainty for occupiers and investors, the potential implications are nowhere near on the scale of last year's EU referendum.

Growth

Economic growth in second half of 2016 was resilient following the EU referendum result (0.5% in Q3 and 0.7% in Q4). However, growth in Q1 2017 slowed to just 0.2%, the weakest performance since Q1 2016. Household spending, a key driver of growth, was particularly weak and the latest retail sales figures suggest that spending has slowed sharply.

Confidence surveys

The uncertainty following the general election result has contributed to a fall in confidence as shown by the June Markit / CIPS Purchasing Managers Indices. This measure of confidence across the services, manufacturing and construction sectors revealed a slowdown from the previous month, but remains above the 50 mark indicating expansion and the average across the three sectors is just shy of the long term average (see chart 1).

Inflation and interest rates

Whilst exporters have welcomed Sterling's fall of roughly 13% against the Euro and US Dollar, the boost in export sales has been minimal. Inflation is rising as the devaluation of Sterling continues to increase the cost of importing goods. CPI fell unexpectedly to 2.6% in June, down from 2.9% in May but is likely to rise again in the coming months, and should still peak at circa 3% by the end of this year (see chart 2).

Higher inflation has divided the Monetary Policy Committee (MPC), and last month three members voted to raise the base rate. Given weak consumer spending, restrained wage growth and the uncertain political and economic outlook, it appears unlikely that rates will rise this year. However, the level of uncertainty surrounding the path of interest rates has increased.

Labour Market

The UK labour market has further strengthened as unemployment rate fell to 4.5%, its lowest level since 1975, and down from 5% the previous year. The total number of employees in employment rose by 175,000 between March and May compared with the previous three months and by 324,000 from the previous year. The increase in employment over the past year has been largely driven by the growth in full-time employment, up by a remarkable 364,000.

Despite the high proportion of workers in employment, any rise in wages has been offset by inflation. Real wages fell by 0.6% (excluding bonuses), compared to the previous year. Inflation is likely to rise further this year placing increased pressure on household spending. Given the uncertainties surrounding Brexit and the tightness of the labour market, the rate of job creation is likely to slow in the second half of the year, and wage growth will remain muted.

The Government's legislative programme

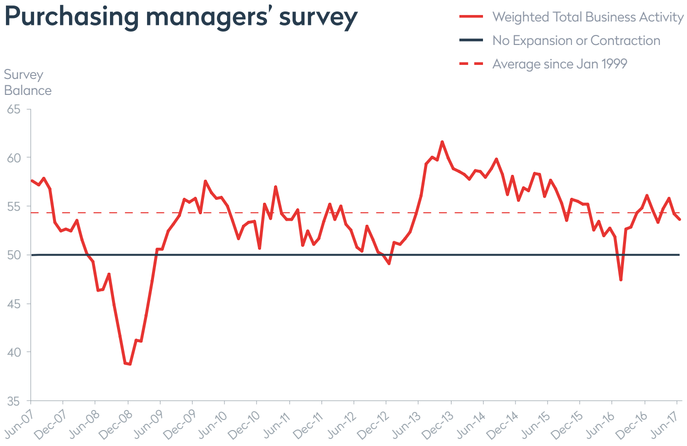
The Queen's speech was inevitably light on new policy initiatives, with a focus on Brexit. However, it did include new legislation to further increase the National Living Wage to 60% of median earnings by 2020, having already increased to £7.20 per hour from £6.50 per hour last year. This will be a further cost burden to businesses, at a time when general inflation, and the cost of imported goods in particular are also rising.

The "Repeal Bill" will withdraw the European Communities Act 1972 and transfer EU law on to the UK statute book. However, little clarity was provided around the direction of key areas such as immigration and trade. Increased cross-party consensus will be required in order to pass the huge volume of Brexit legislation, and this could mean a greater level of transparency and debate during the process, which would be a positive development. A "softer" approach to negotiations may emerge, and the needs of the UK's businesses now appear to be higher up the political agenda.

Outlook for growth

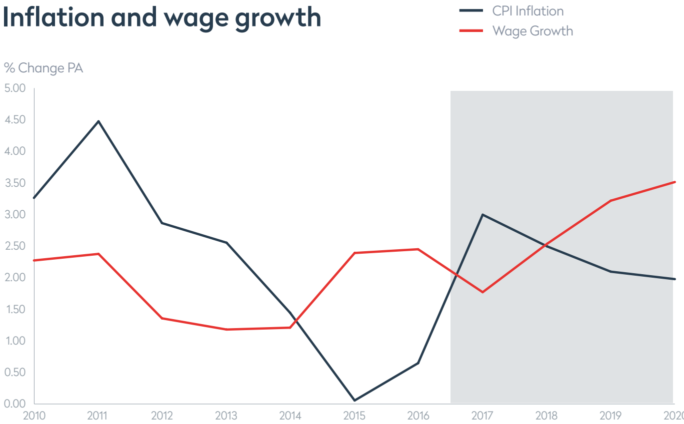
Consensus forecasts now suggest growth of 1.6% for 2017, followed by 1.4% next year, well below trend (see table). However, the actual course that the economy takes is highly dependent on the outcome of Brexit negotiations, particularly around trade and the free movement of labour.

Purchasing managers' survey



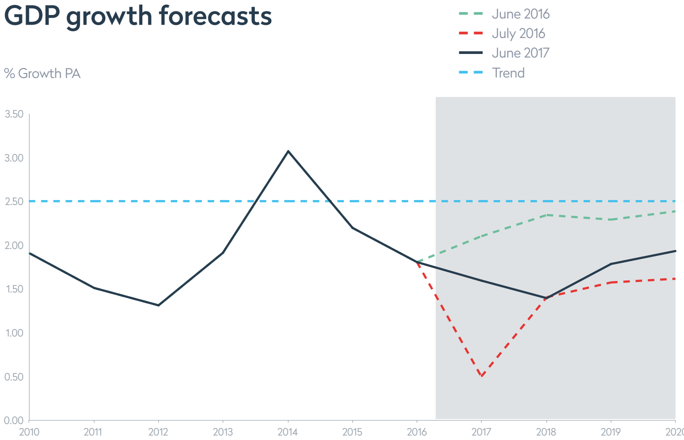
Source: Markit & CIPS

Inflation and wage growth



Source: Experian, HM Treasury Consensus

GDP growth forecasts



Source: HM Treasury Consensus, Experian, GVA

Latest consensus forecasts, June 2017

	2017	2018	25-year trend
Economic growth (GDP)	1.6%	1.4%	2.5% pa
Private consumption	1.7%	1.0%	
Employment growth	0.7%	0.3%	0.7% pa
Bank Base Rate (Q4)	0.33%	0.46%	
CPI – Inflation (Q4)	3.0%	2.5%	
RPI – Inflation (Q4)	3.9%	3.3%	

Source: HM Treasury (Compilation of forecasts, GVA)

Occupier market

Demand

Central London office take-up for Q2 2017 totalled 2.1 million sq ft, 3% up on the previous quarter. This brings take-up for the first half of the year to 4.1 million sq ft, which is down 22% on the second half of 2016, but marginally up on the corresponding period in 2016.

The first half of the year has seen no change to prime rental levels across most central London submarkets, whilst rent free periods have continued to push out. However, there are exceptions. In the West End, record rents have been achieved in Soho and Covent Garden and evidence of 'super-prime' rents being achieved in the core markets of Mayfair and St James's.

Take up across the **'Big Nine' regional office** markets picked up in Q2 compared to the first quarter, 4% above the five-year average. For the first half of the year, finance, professional and business services have accounted for a significant proportion of activity at 55%, above the five year average of 50%.

Brexit uncertainty has dampened occupier confidence, leading to a slowdown in enquiry levels in some cities. Over half of city centre office take up across the regions has been in Edinburgh and Manchester. Large deals have returned to the 'Big Nine' markets, such as the Government Property Unit agreeing 189,000 sq ft deal in Edinburgh, Distrelec (a Swiss distribution company) choosing Manchester for European headquarters and Burberry moving staff from London to Leeds.

The **industrial** sector remains buoyant with average rental values increasing by approximately 4% over the 12 months to May, well ahead of the all-property average (IPD Monthly Index). Average quarterly rental growth remains at 1% in May. The structural change in the retail market towards etailing, parcel delivery and discount retailers continues to drive demand for the logistics sector in particular.

The **retail** sector will continue to face challenges throughout 2017 as rising prices and falling real wages place pressure on household spending. Retail sales volumes are likely to flatten in the weaker economic outlook, amplifying the challenge faced by physical retail stores to remain profitable against online retailers. Network consolidation by retailers will continue to favour profitable prime retail locations.

All-retail rental values were stable in the three months to May (IPD Monthly Index), a picture broadly reflected across the main retail subsectors.

Supply

UK commercial construction activity appears to have peaked at well below the long-term average, with the annual level of new construction orders for retail, office and industrial now having fallen for three consecutive quarters (see first chart).

The Markit/CIPS construction activity survey, covering all construction activity, continues to indicate expansion at 54.8 in June, although down from 56.0 in May. Increased uncertainty over future occupier demand and rising costs from the weak pound are contributing to lower speculative development activity.

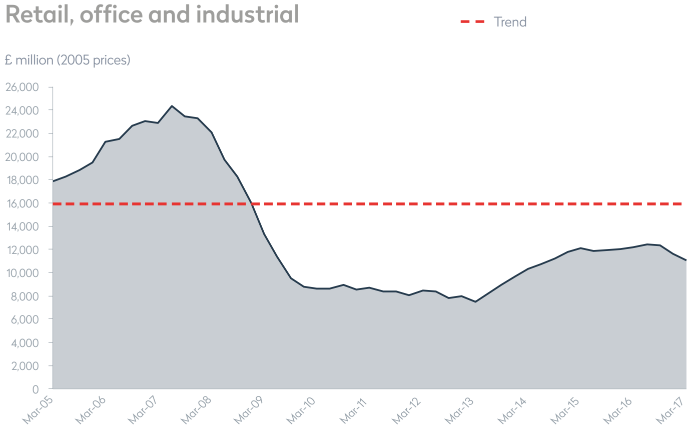
Outlook for rental growth

The pace of all property rental growth had been slowing prior to the EU referendum, and the immediate impact of the vote led to a sharper slowdown. Despite bouncing back over the last few months of 2016, rental growth has slowed this year from 0.6% in the three months to January to 0.3% in the three months to May. The annual rate of growth was 1.4% in May, compared with 3.9% a year ago and a peak of 4.3% in autumn 2015.

We forecast all property rental growth of 0.9% for 2017 as a whole, followed by a similar rate in 2018 (see table and chart 3), as the subdued development cycle continues to support rental values against a backdrop of further political and economic uncertainty ahead.

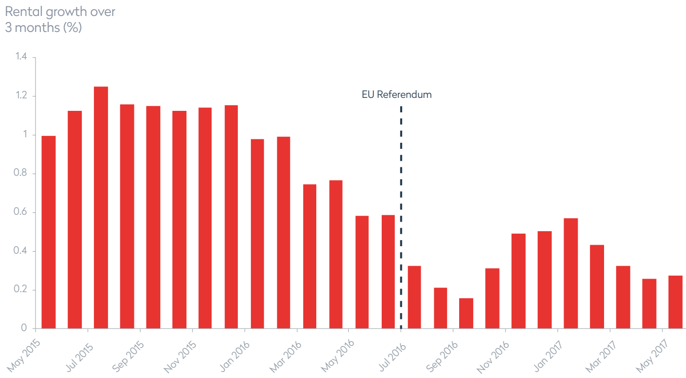
Annual new construction orders (development activity)

Retail, office and industrial



Source: ONS, GVA

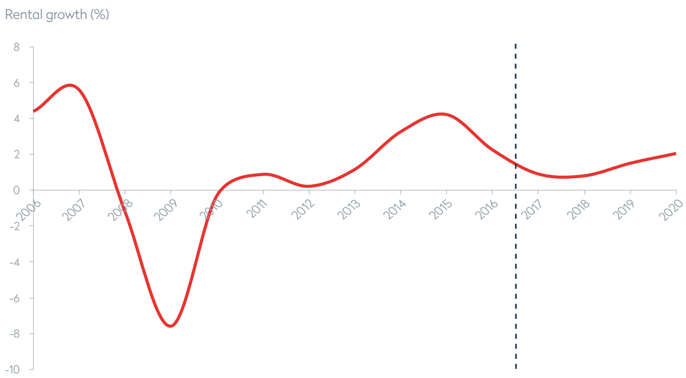
Average quarterly rental growth



Source: IPD Monthly Index

All property average rental growth forecasts

Retail, office and industrial



Source: IPD Annual index, REFL, GVA

All property rental value growth forecasts

	2017	2018	2019
IPF Quarterly Consensus (May 2017)			
Maximum	1.5%	1.6%	2.2%
Minimum	-1.0%	-1.1%	-1.0%
Average	0.6%	0.3%	0.7%
GVA (July 2017)	**0.9%**	**0.8%**	**1.5%**

Source: IPF, REFL, GVA

Investment market outlook

Investor demand

The heightened political uncertainty and continued lack of clarity over the UK's negotiating position on Brexit is not having a significant impact on sentiment and there is perhaps a sense that the market has developed a certain "shock fatigue". Some investors have adopted a 'waiting to see' approach to Brexit and others are pricing in the increased risk apparent in the leasing market.

Defensive stock remains highly sought after but we are also seeing strong investor demand in higher-risk sectors such as secondary industrial. We continue to see a high level of demand from a wide range of UK buyers including private individuals, local authorities and institutional investors. The retail funds, who have now built up considerable cash reserves, are particularly active.

There remains a huge weight of global money looking to invest in UK property and overseas buyers still see the UK as a highly attractive proposition. Indeed, 52% of the total purchases by value so far this year have been by overseas investors, who have increased their UK property exposure to the tune of £5 billion. Far Eastern buyers have been particularly active, accounting for circa 40% of the value purchased by overseas investors in H1 2017, with European and US buyers accounting for 25% and 15% respectively.

Circa £12 billion of UK commercial property was transacted in Q2, very similar to Q1, with £50 billion transacted over the last 12 months, as the first chart illustrates. Whilst this is clearly well below the market peak of nearly £80 billion pa in mid-2015, it represents a more 'normalised' level, a little above the average of the last 15 years, although recent volumes have been supported by some particularly large transactions.

Recent performance

Following last year's EU referendum, average all-property equivalent yields moved upward by nearly 25 basis points. As the second chart shows, this has reversed over the last six months, with average yields now approaching pre-referendum levels, although they are now stabilising. Capital value performance reflects this. All property values fell by less than 4% immediately after the referendum, and a year on have recovered much of that lost ground, standing at just 1.3% below their June 2016 level (IPD Monthly Index).

Average all-property capital values rose by just over 1% in the three months to May 2017, the equivalent of 4.2% pa, according to the IPD Monthly Index (although the year-on-year rate is still reflecting the post-referendum fall, as the third chart shows).

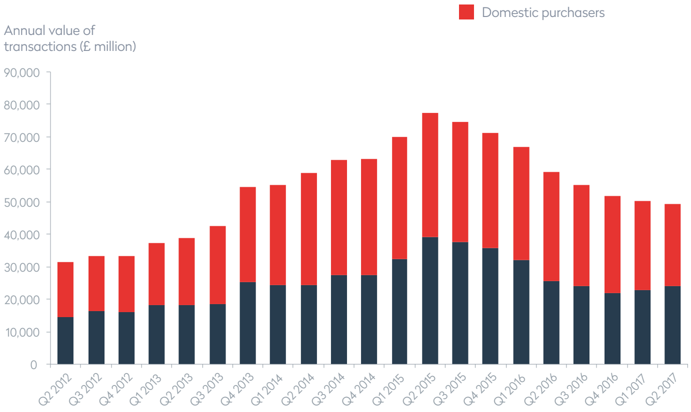
Outlook for returns

The latest annual total return is 4.2%, up from a low of 2.6% at the end of last year, and this will continue to increase in the coming months as the post referendum numbers drop out of the figures.

Looking further ahead to 2018, there are a range of uncertainties including a potential rise in interest rates, the emergence of the Brexit deal, and the impact on business and consumer confidence. This will all be key in shaping the direction of the investment market.

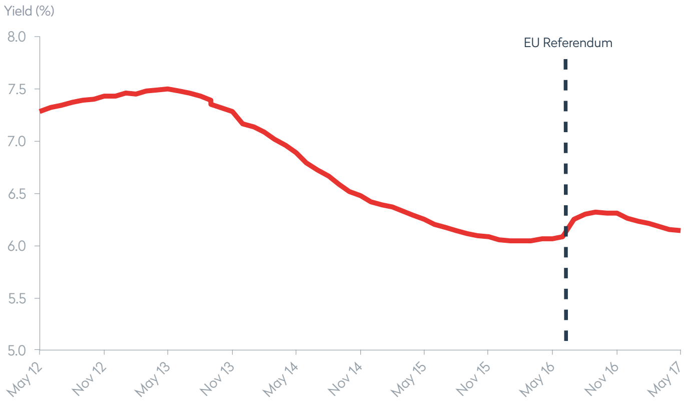
We do not anticipate much further downward yield movement given the headwinds facing the UK. However, the weight of money and relative scarcity of supply will continue to be supportive of yield levels, particularly for quality defensive stock. The UK will remain a relatively stable "safe haven" global property market and UK commercial property will continue provide an attractive income return in a low growth, low interest rate environment.

Annual investment transactions



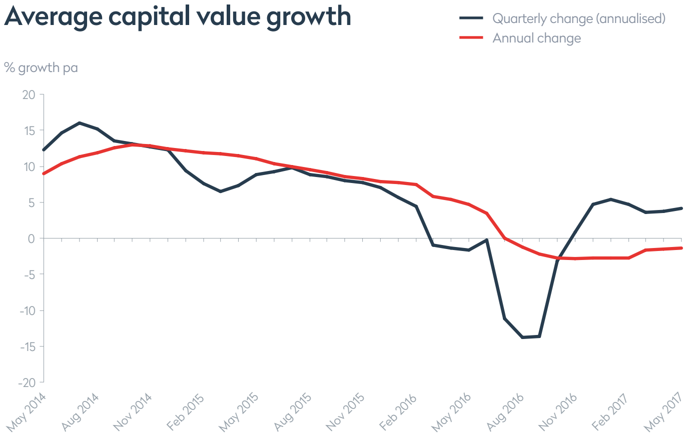
Source: Property Data

All property equivalent yield



Source: IPD Monthly Index

Average capital value growth



Source: IPD Monthly Index

Research enquiries
Daniel Francis
020 7911 2363
daniel.francis@gva.co.uk

GVA
65 Gresham Street, London EC2V 7NQ

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