GVA

RESEARCH

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Economic & property market review

Autumn 2017

Economic Trends

Growth

Political uncertainties continue to cloud the economic outlook, although encouragingly growth picked up a little in Q3, with the preliminary estimate of GDP showing a quarterly rise of 0.4% compared with 0.3% in Q1 and Q2. However, the annual growth rate remained weak and well below the long term trend (see first chart). The manufacturing sector was the main driver of growth at 1% and reversed the weak performance in the previous quarter. Service sector growth was stable at 0.4%.

Confidence surveys

Confidence surveys in October picked up despite continued uncertainty about the economic outlook. The October Markit / CIPS Purchasing Managers Indices average across the services, manufacturing and construction sectors moved back above the long term average after five months of being below average (see second chart).

Inflation and interest rates

The depreciation of Sterling continues to feed into rising inflation, increasing the cost of imports. CPI inflation continued its ascent in September reaching 3.0%, up from 2.9% in August. This is the highest since March 2012, and at the top of the Bank of England's target range.

Although inflation is probably close to peaking, the Bank of England's decision to increase the Base Rate by 25 basis points in November was expected, and is not likely to be the last rise. The Bank is keen to begin raising the Base Rate in order to start 'normalising' it for when the next cyclical downturn occurs.

Given the UK's lacklustre economic growth and Brexit uncertainty, the upward path of interest rates is likely to be gradual. The average Base Rate expectation for Q4 2018 in the latest Treasury comparison of forecasts is 0.65%, and Experian's forecasts suggest 0.75% by Q4 2018 and 1.0% by Q4 2019.

The MPC's initial move has only reversed the precautionary 25 basis point cut that followed the 2016 EU referendum, and the overall impact should be modest. However, the risk to growth would be significantly increased should the MPC raise rates much more aggressively than we (and markets) expect.

Labour Market

Employment growth remains robust. The total number of employees in employment continued to increase in the three months to August, by 94,000. Overall, employment rose by 317,000 from the previous year which has been largely driven by strong growth in full-time employment, up by a remarkable 346,000 whilst part-time employment fell by 29,000.

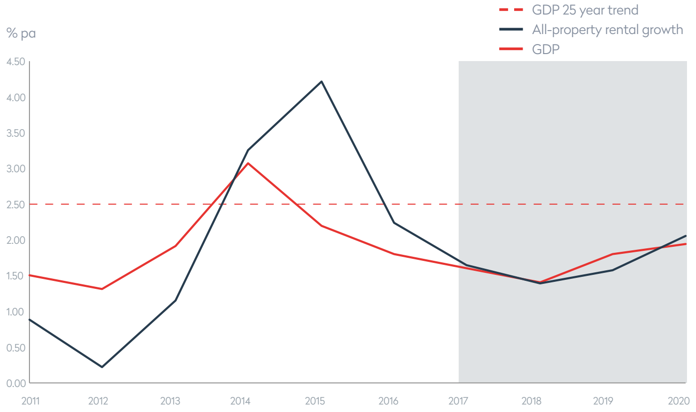
The unemployment rate was unchanged at 4.3% in August, down from 5% a year ago. This is the lowest rate since 1975, but is not feeding through to higher wage growth as would normally be expected. Indeed, real wages fell by 0.3% (including bonuses) compared to the previous year.

Outlook for growth

The biggest risk to economic growth over the coming months is consumer spending, which is being squeezed not only through rising interest rates and declining real wages, but also a lacklustre housing market and a historically low saving ratio.

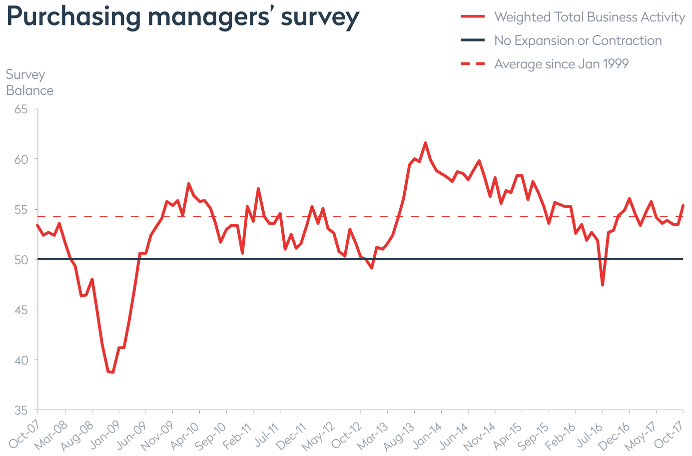
The consensus forecasts show below trend growth of 1.6% for 2017, followed by 1.5% next year (see chart and table). Beyond that, the course that the economy takes becomes increasingly dependent on the outcome of the Brexit negotiations.

GDP and all-property rental growth forecast



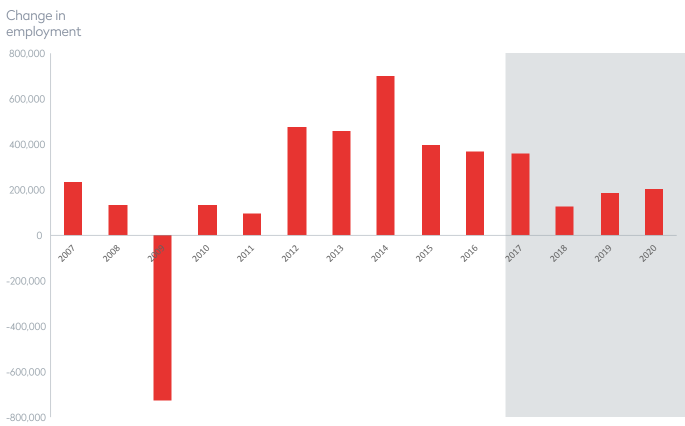
Source: Experian, HM Treasury Consensus, MSCI, REF, GVA

Purchasing managers' survey



Source: Markit & CIPS

Full time equivalent employment forecast



Source: Experian

Latest consensus forecasts, October 2017

	2017	2018	25-year trend
Economic growth (GDP)	1.6%	1.5%	2.5% pa
Private consumption	1.6%	1.1%	
Employment growth	1.2%	0.5%	0.7% pa
Bank Base Rate (Q4)	0.39%	0.65%	
CPI – Inflation (Q4)	3.0%	2.4%	
RPI – Inflation (Q4)	4.0%	3.2%	

Source: HM Treasury

Occupier market

Supply

The annual level of new construction orders across the retail, office and industrial sectors has fallen for the fourth consecutive quarter (see first chart). With continued occupier uncertainty and rising costs for imported materials, we expect the decline to continue into next year.

The Markit / CIPS construction activity survey, covering all construction activity, moved back above the crucial 50 no-change threshold in October, following September's fall. However, growth was mainly driven by house building whilst activity in both commercial and civil engineering declined.

Demand

Central London office take-up for Q3 2017 totalled 2.4 million sq ft, up 10% on the previous quarter. This brings take-up for the year to 6.7 million sq ft, 6% up on the corresponding period last year. Some significant deals, including Deutsche Bank, Boston Consulting Group and Spotify, have ensured that take-up for the year remains robust. However, underlying demand is relatively subdued, particularly for smaller buildings. There is currently 10.4 million sq ft available across central London, an increase of 22% over the last year.

Four large deals to the Government Property Unit have lifted Q3 take-up to the highest quarterly total on record across the 'Big Nine' **regional office markets.** The deals in Cardiff, Leeds and Liverpool are the largest ever in these cities and Birmingham's is the largest deal in a decade. The total amounted to well over a million sq ft, almost half city centre take-up for the quarter. Along with Edinburgh's GPU deal in Q2 total take-up for the year is expected to rival the levels witnessed at the peak of the market in 2015. Underlying demand is also robust, especially in the city centres, although the out-of-town market has dropped off slightly from its recent consistent level.

The **industrial** sector remains highly active and according to the latest RICS Commercial Property Market Survey it saw tenant demand rise by 28% in Q3 together with a marked decline in availability. This is reflected in rental growth, with average industrial rental values increasing by 4.9% in the 12 months to September (IPD monthly index), the fastest rate of growth since June 2016 and well above the all-property level.

Challenging conditions for the consumer are likely to amplify profitability concerns of physical **retail** stores. However, we are now seeing some online-only brands investing in bricks-and-mortar flagship stores and selling directly to consumers, the latest being Microsoft which will open its first UK store on London's Regent Street. Average all-retail rental values grew by just 0.1% in the three months to September (IPD Monthly Index), and this weak growth is broadly reflected across the main retail subsectors.

Outlook for rental growth

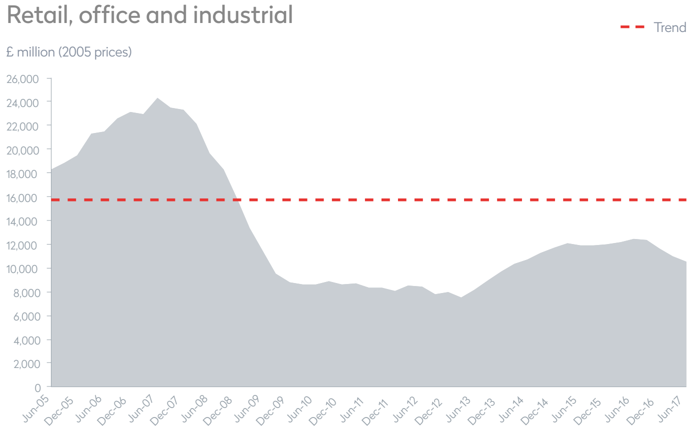
All property rental growth appears to have picked up pace in recent months (see third chart), boosted by strong performance in the industrial/distribution sector. The annual rate of growth increased to 1.8% in September, following a modest slowdown to 1.4% in May, but remains below the 2015 peak of 4.3%.

We expect all property rental growth to be 1.7% for 2017 as a whole (see table), decelerating a little to 1.4% in 2018, in line with continued occupier uncertainty and below-trend economic growth.

We expect rental growth in the industrial sector to remain above 4% pa over the next two years as etailing, parcel delivery and discount retailers all continue to drive demand for both large distribution warehouses and smaller units in multi-let estates. However, the retail and office sectors are likely to see rental growth rates below CPI inflation.

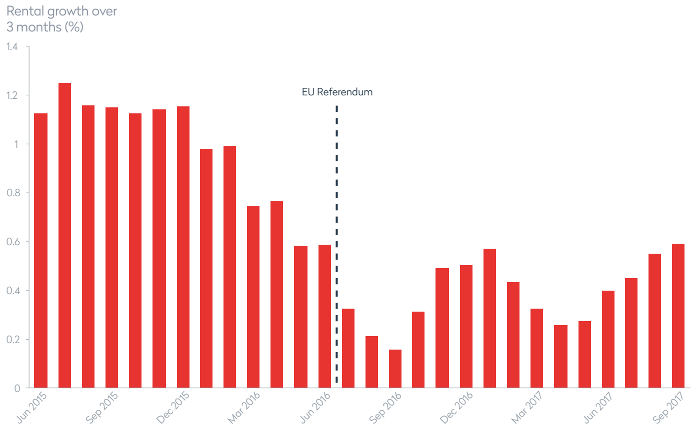
Annual new construction orders (development activity)

Retail, office and industrial



Source: ONS, GVA

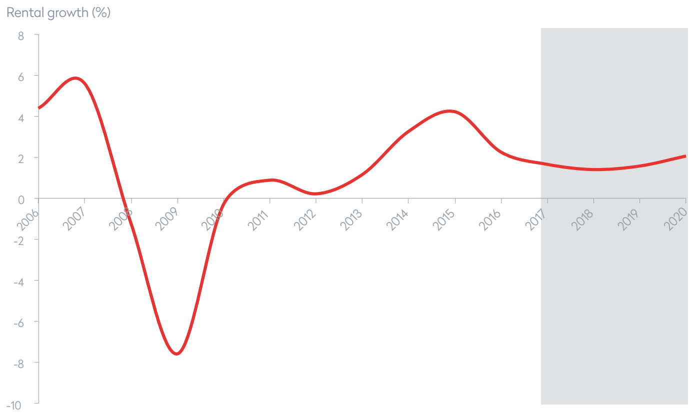
Average quarterly rental growth



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 (September 2017)			
Maximum	1.6%	1.6%	1.8%
Minimum	-1.0%	-1.1%	-1.4%
Average	0.9%	0.2%	0.6%
GVA (October 2017)	**1.7%**	**1.4%**	**1.6%**

Source: IPF, REFL, GVA

Investment market outlook

Investor demand

Investment activity in the UK commercial market has been resilient and investors remain pragmatic as the UK continues to be viewed as a stable "safe haven" global property market.

Purchases in Q3 totalled circa £16 billion, the highest quarterly figure since Q4 2015, with £57 billion transacted over the last 12 months. Overseas investors have accounted for 51% of total purchases by value so far this year, and Far Eastern buyers have been particularly active, accounting for circa 40% of the value purchased by overseas investors.

Recent performance

All-property equivalent yields have continued to move downwards and have now returned to their pre-referendum level of 6.1%, as the middle chart illustrates. All property capital value growth has accelerated in recent months according to the IPD Monthly Index, with values rising by 0.6% in the three months to September compared with 0.4% over the previous three months, with rental value growth and downward yield shift both contributing.

Capital values are now 0.5% higher than the previous pre-referendum peak. All property capital value growth accelerated to 4.5% in the 12 months to September and the annual total return has improved accordingly reaching 10.4%, compared with a low of 2.6% towards the end of 2016.

Performance is now heavily polarised according to sector, with industrial performing exceptionally well and capital values rising by an impressive 12.2% over the 12 months to September. In contrast, the office sector saw values rise by 3.1% and retail values increased by just 1.4%.

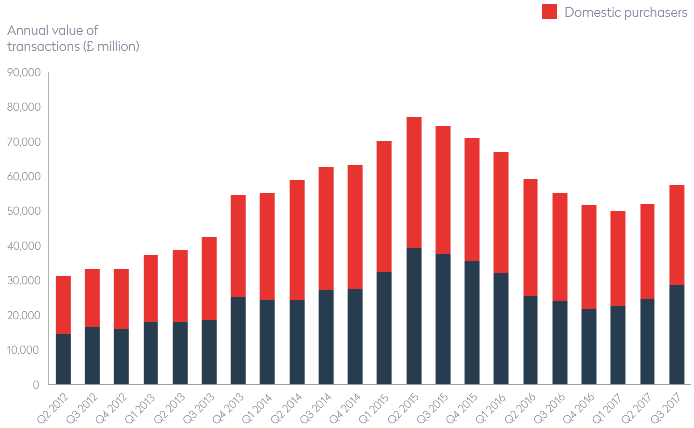
Outlook

The huge global demand for high quality real estate looks set to continue, with commercial property one of the few options available to investors seeking secure income. The weight of money looking to invest in the UK significantly exceeds the available opportunities, and with few sellers and falling development, there is little possibility of investment supply increasing.

Rising interest rates combined with slowing consumption and lacklustre GDP growth would normally suggest an upward movement in property yields. But the continued high level of global demand for quality UK commercial property, combined with a very limited supply of available assets, means a significant upward shift in property yields is unlikely. Indeed, for quality property in selected high-demand sectors, such as distribution and multi-let industrial, yields could well fall further.

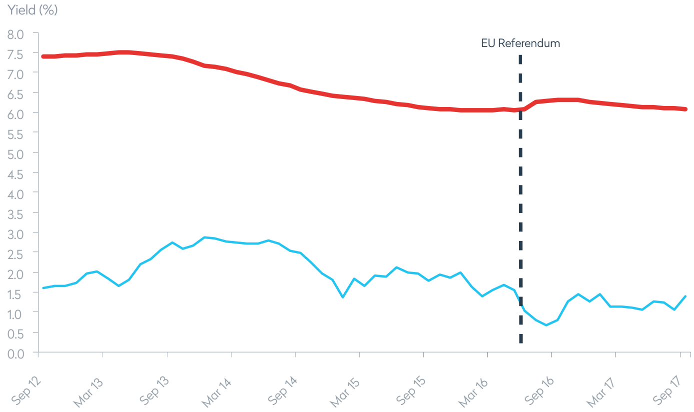
As long-term interest rates rise, the gap between property and gilt yields will decrease. However, 10-year gilt yields are still only circa 1.3% whilst the all property equivalent yield is 6.1% (IPD Monthly Index). This is a historically wide margin, so there is plenty of scope for this to narrow without unduly affecting property's attractiveness.

Annual investment transactions



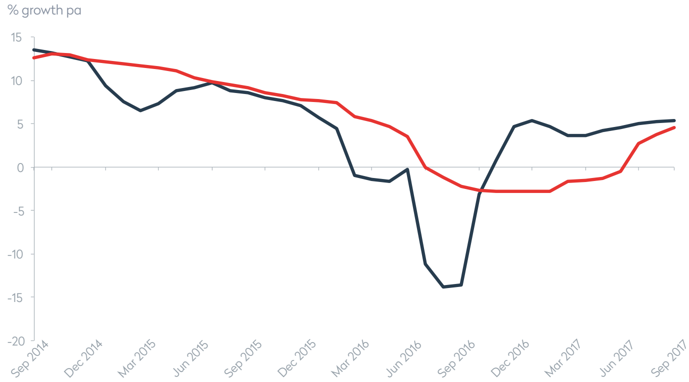
Source: Property Data

All property equivalent yield



Source: IPD Monthly Index, Bank of England

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
Linkedin/gvauk
@gvaviews

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