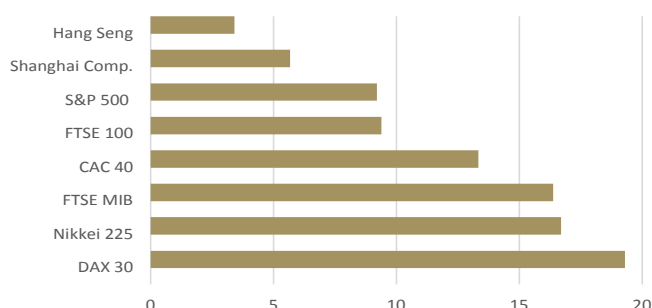


Update
June 2020

Economic Overview

An easing in lockdown restrictions, lower daily infection numbers and improvement in economic data in most developed markets has restored confidence in the equity markets. Indeed, major equity markets have seen a growth in prices in the last month or so (see Chart 1).

1.0 Change in Selected Major Equity Market Indices over the Last 40 Trading Days to 26/06/20 (%)



Source: Refinitiv

Admittedly, there has been a rise in new infections in a handful of US states. But so far, these have mainly been localised and much smaller than the national surge in late-March and early-April that triggered widespread lockdowns. As such, it is unlikely to derail the national rebound evident in the May retail sales figures. Indeed, the 18% m/m rebound in retail sales in May left spending just 8% below February levels. In part, this boost to sales was supported by the \$1200 one-off cash payment made to most adults and the \$600-per-week unemployment insurance supplement. Further, the 2.5 million rebound in payroll employment in May was a welcome surprise, albeit it still left the level of employment almost 20 million below its pre-pandemic peak.

In Europe, recent data also suggests that activity is starting to recover. Indeed, the flash Composite PMI for June rose to 47.5, from 31.9 in May. However, activity remains well below pre-virus levels.

Top 5

- Most major equity markets have continued to see growth over the past month with the further easing of lockdown restrictions;
- Following a 23% fall between February and April, UK retail sales volumes rebounded by 12% m/m in May;
- The commercial property sector was hit hard by a fall in rental collections in March, and the expectation is that June collections could be even lower;
- Occupier demand for London offices was soft, marking a rise in availability and weaker demand for space;
- Over £1 billion in regional assets and £2 billion in Central London was reportedly under offer in May. While this indicates that there should be a pick-up in activity, given uncertainty remains high, regional investment is not expected to recover its H1 losses over the rest of the year.

In addition, the EC euro-zone consumer confidence index rose from -18.8 in May to -14.7 in June, pointing to some recovery in spending. Meanwhile, data suggests that the euro-zone labour market has held up reasonably well given the sharp downturn in economic activity. The euro-zone unemployment rate rose only slightly from 7.1% in March to 7.3% in April. **However, in part this reflects that short-time work schemes have propped up employment. As these schemes end or become less generous, the unemployment rate is likely to rise further.**

The UK economy seems to have turned the corner too. Having fallen by around 23% between February and April, retail sales volumes rebounded by 12% m/m in May. That left sales just 13.1% below their pre-coronavirus level. As non-essential shops re-opened in June, sales are likely to increase further. Meanwhile, the unemployment rate remained at 3.9% in April.

However, as the government has suggested they will increasingly shift the cost of the furlough scheme onto employers from August and end the scheme entirely in October, there is likely to be a rise in unemployment. In response to a weaker outlook for the economy, the Bank of England announced an additional £100bn of quantitative easing in its June meeting.

Property Overview

The commercial property sector has been hit hard by the virus disruption. Indeed, following many landlords reporting a decline in rental collection in March, expectations for June's collection are even lower. As the economy reopens and economic activity gradually picks up over the second half of the year, commercial property activity is expected to improve. That said, with the ban on evicting tenants extended until the end of September, some tenants are likely to maintain their cash reserves rather than pay rent, which will strain the relationship between landlords and tenants further.

For the retail sector, there has been a tentative reopening of stores. While non-essential retail stores were able to open from 15 June, Knight Frank suggest that only around 40-50% of all stores did so in the first week. Even so, this is likely to result in a further improvement in retail sales in June. Nevertheless, with fewer stores open, retailers' revenues are likely to remain weak in the near term, which will lead to more retailers closing stores, seeking CVAs or asking for rental reductions. In fact, Knight Frank suggest some retail landlords are anticipating that rents collected in June could be as low as 10-20%.

The rise in online spending in the face of lockdowns has been encouraging for the industrial sector. Savills report that if online sales were to grow at the same rate for the rest of the year, then an additional 14.9m sq. ft. of industrial space will be needed. However, retailers also account for a large share of take-up. Given they are likely to see weak revenues this year, there is a downside risk to occupier demand. Indeed, a survey from Buck Consultants showed that take-up for industrial is expected to fall by as much as 50% in 2020.

For offices, a decline in employment will reduce the demand for office space this year, but occupiers may be in a healthier position than retail counterparts. This is due to office workers having the ability to work from home and output falling less than the rest of the economy. However, this has also raised questions over the long-term need for some office space. Indeed, some companies such as Google and Facebook have told their staff that they can work from home for the rest of the year, while Twitter has gone as far as to allow employees to do so indefinitely.

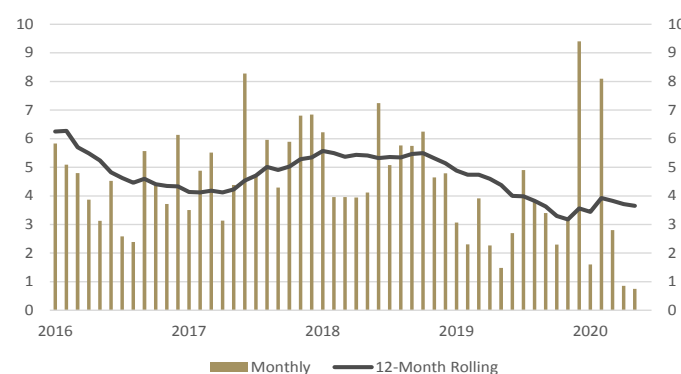
Student accommodation may also fare worse than usual during this period. In "normal" downturns, there is usually a surge in student numbers as employment prospects are perceived to be weaker, giving the sector some counter-cyclical characteristics. However, it could be different this time, with the sector facing serious headwinds in the short term from the coronavirus.

With most students released from university early and summer business effectively cancelled, many landlords have suffered an income hit. Further ahead, there are downside risks to occupancy in 2020-21. For one, if distancing rules mean teaching is required to move online, students could defer offers feeling this will diminish their student experience, which could push occupancy rates up. When combined with ongoing restrictions on travel, demand from international students, a lucrative and key segment of the market, could fall even more sharply. Additionally, uncertainties around Brexit add to concerns around demand from EU students. Nevertheless, as teaching returns to normal, this is likely to support demand for beds, reinforced by deferred places from the previous year.

Meanwhile, a slump in revenues in the leisure sector will accelerate the number of CVAs and closures this year. While restaurants and pubs are expected to open in July, they will remain hamstrung by social distancing. In fact, UK Hospitality report that the leisure industry is likely to see about 30% of normal revenues under a 2m distancing rule, rising to 60-75% under a 1m rule. Anecdotal evidence suggests that even a 1m distancing rule will leave many restaurants and pubs unprofitable and so, there is likely to be a rise in closures this year.

Given that the lockdown reduced viewings and uncertainty was high, it is unsurprising that investment in May failed to reach £1bn for the second consecutive month, with just £750m worth of deals completed. In turn, on a 12-month rolling average basis, investment transactions were 20% lower than a year ago (see Chart 2).

2.0 Monthly Investment (£bn)



Source: Colliers

Consistent with supermarkets having fared relatively well during the lockdown, the largest deal of the month was a portfolio sale of Sainsbury's stores to Supermarket Income REIT for £100m. Preliminary numbers for the first two weeks of June suggest that May was the low point for investment in 2020. With social distancing measures being eased and economic activity improving, investment is likely to gradually rise in H2. Nevertheless, with concerns around pricing resulting in assets being withdrawn from the market, as well as investor caution, transaction activity is likely to be subdued compared to previous years.

CBRE report that capital values fell at a slower pace in May. On a month-on-month basis, all-property capital values fell by 1.1% compared to the 2.1% decline in April. While yields stabilised, rents fell by 0.5% m/m, after declining by 0.2% m/m in the previous month. As expected, the retail sector, which has suffered the most from the lockdown, saw rents drop by 1.7% m/m in May, although this was slower than the 3.6% fall in values in April. Meanwhile, office and industrial saw values decline by 0.6% m/m and 0.2% m/m respectively, slower than the 1% m/m drop that both saw the previous month.

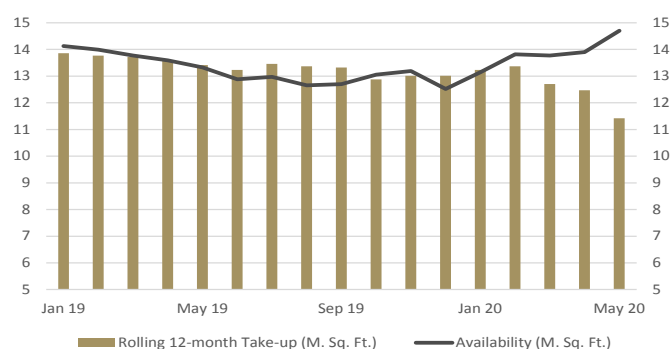
At an all-property level, falling capital values combined with slightly softer income returns resulted in annual total returns falling to minus 0.6%, from minus 1.6% from March. Looking ahead, investor caution will lead to further yield increases in the near term. In turn, values and returns are likely to remain negative in 2020.

London Property Market

CBRE reported that at just £90m, Central London office transactions were down 20% m/m in May, after what was already an extremely weak April.

Meanwhile, occupier demand for offices was also soft in May. Take-up was just 220,000 sq. ft., marginally less than the month before. Meanwhile, availability increased by 6% m/m due to a pickup in second-hand availability (see Chart 3).

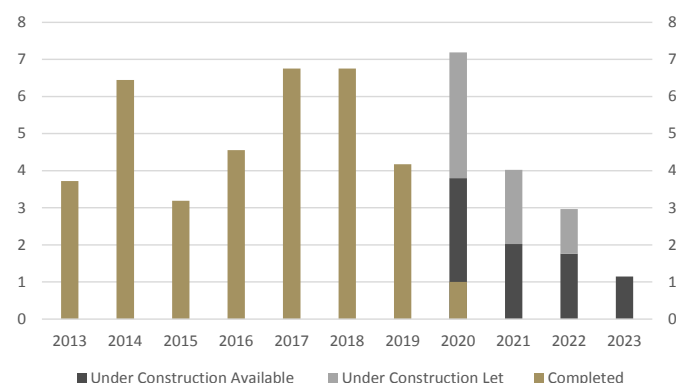
3.0 Central London Office Take Up and Availability



Source: Colliers

This marked rise in availability, combined with weaker demand, caused the vacancy rate to increase further in May to 4.8%, from 4.6% in the previous month. And vacancy is likely to increase further, as supply increases and demand remains weak. Indeed, the recent Deloitte Crane Survey reported that completions will rise from 4.2m sq. ft. in 2019 to around 8.2m sq. ft. in 2020 (see Chart 4).

4.0 Central London Offices Pipeline (M. Sq. Ft.)



Source: Deloitte

Regional Property Market

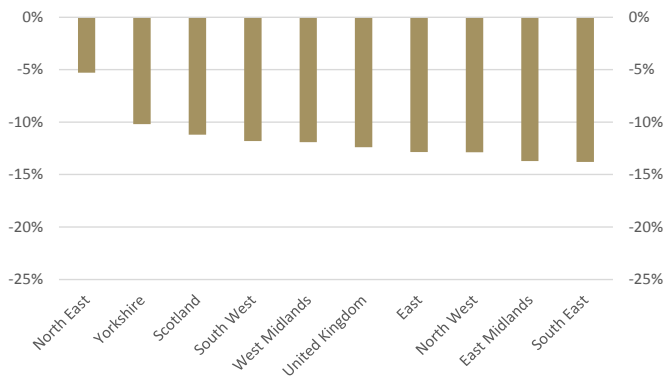
Regional investment took a significant hit in March and April when compared to the year before. As reported by Colliers, investment in the regions fell by 47% y/y in those months, whereas the fall in Central London was 38%. However, over £1 billion in regional assets and £2 billion in Central London was reportedly under offer in May. While this indicates that there should be a pick-up in activity, given uncertainty remains high, regional investment is not expected to recover its H1 losses over the rest of the year.

Admittedly, there have been reports that some Central London occupiers are looking to increase their regional presence or take space in the regions for the first time to reduce their office density to adhere to social distancing. However, this would require businesses to make additional hires or relocate workers. And as uncertainty about the outlook for the economy remains high, this is a commitment that many occupiers are likely to be unwilling to make in the near term.

According to Knight Frank, the main increases in regional yields in June were for regional high streets and shopping centres. They increased by a further 25bps m/m to 6.25-6.50% and 7% respectively. In the near term, with retail rental prospects weak and risk aversion high, there is likely to be further upward pressure on retail yields in the regions.

Aside from retail, another sector where yields are likely to rise substantially is leisure. Parts of the sector, notably pubs and chain restaurants, were already struggling before the virus outbreak. Indeed, the number of pubs has been decreasing steadily for several decades and this has disproportionately affected the regions, particularly the South East, East Midlands and North West (see Chart 5).

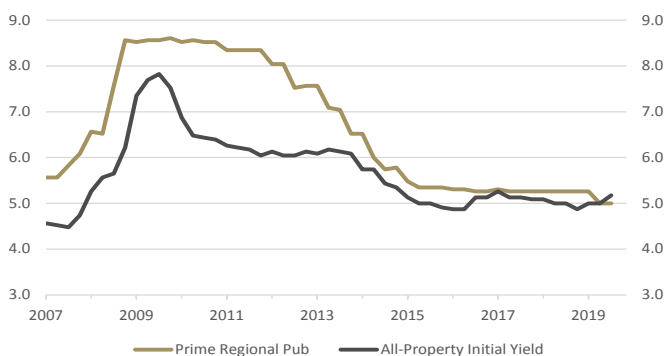
5.0 Decline in Pubs 2010 - 2019 (%)



Source: ONS

Pubs in the regions could be better placed to deal with social distancing measures as they are likely to be larger and have more access to outdoor spaces, which would allow them to operate closer to normal levels, at least for the summer months. Nevertheless, many pubs are still unlikely to be profitable under social distancing measures, so there is likely to be a rise in closures in the regions. In turn, regional pub yields are likely to be at their nadir (see Chart 6).

6.0 UK Regional Pub and All-Property Yield (%)



Source: CBRE

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