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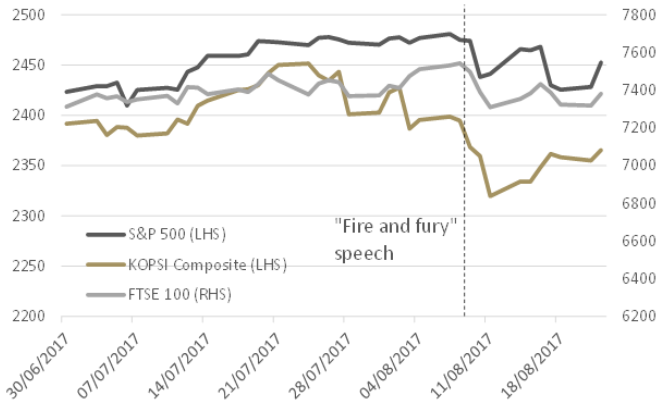
August Update

Global Factors

August has been a tumultuous month for President Trump. North Korea's threats of a military strike on the island of Guam were met with Mr. Trump's own threats of "fire and fury". These tensions prompted an equity market selloff across most developed-nation equity markets, but South Korea, the US, and the UK were particularly hard-hit. Tensions have since eased, and equity markets have reversed most of their losses (Chart 1). Meanwhile, the dismissal of Chief Strategist Steve Bannon, had raised hopes that more mainstream views on trade and US-China relations could be taking hold at the White House. Albeit, recent talk of scrapping NAFTA flies in the face of those hopes.

1.0 Selected Equity Market Indices



Source: Thomson Reuters

Hard economic data remains consistent with a tightening of the Fed Funds rate over coming months. The first estimate of second quarter GDP showed growth of 2.6% on an annualised basis, up from 1.2% three months earlier. Non-farm payrolls increased by 209,000 in July, which was enough to help the unemployment rate fall, to 4.3% from 4.4% in June. Meanwhile, the annual rate of hourly earnings growth held firm at 2.5%.

An Overview

The economy has lost some momentum in the first half of 2017, after a surprisingly-strong performance following the vote to leave the EU. However, this appears to be largely driven by the impact of higher inflation, as opposed to uncertainty about Brexit weighing heavily on households' and firms' spending decisions.

The next few months are pivotal for Brexit negotiations. Despite the current mixed sentiment, the outlook for UK commercial property is in good health. Investors continue to be attracted by its underlying strengths, whilst the higher income returns from UK property look set to remain attractive to investors, many of which have the additional benefit from the current currency discount.

July Top 5

1. Geopolitical tension rises due to Standoff between the US and North Korea.
2. The European economy is accelerating at its best pace in five years as its renaissance continues.
3. London's Walkie Talkie building sold for record-breaking £1.3bn - highest ever price for a single UK building.
4. Prime property values continue to recover from their post referendum loses.
5. The case for regional offices remains solid from both an occupier and investment market perspective.

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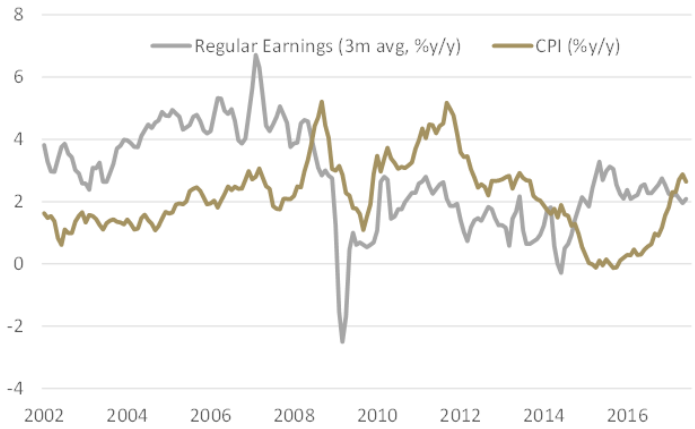
European economies have continued to build momentum. At 0.6%q/q, euro-zone GDP growth picked up in the second quarter, from 0.5%q/q in the first. Encouragingly, the composite output PMI for July points to quarterly growth staying healthy, at around 0.6%, in the early stages of the third quarter.

By contrast, data from the UK economy has been mixed. For example, although quarterly GDP growth did rise in the second quarter, at 0.3%, it was still weaker than what the survey data had been suggesting. The 126,000 jobs created during the three months to June, helped the unemployment rate to fall to yet another multi-decade low, of 4.4%. Unfortunately, despite the erosion of labour market slack, regular pay growth is still subdued. Running at 2.1% in July, it is still below the same month's rate of CPI inflation, implying that real household incomes fell for a 4th consecutive month (Chart 2).

2.0 Wage and Inflation



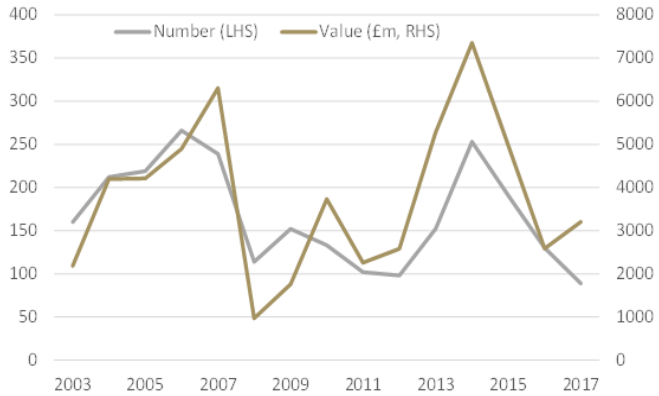
Source: Thomson Reuters

With UK GDP growth failing to pick up substantially, and wage growth still muted, monetary policy should stay very loose in the short-term. And even when the rate tightening cycle starts, most probably in the first half of 2018, a very gently rising path for Bank Rate seems like the most likely scenario.

Property Overview

Generally speaking, investment market activity eased in July. The £3.2bn worth of commercial property transactions marked a 39%m/m fall. To be fair, a month-on-month fall of that magnitude is not abnormal for the time of year, nor was July's total especially low for that month (Chart 3). However, the total number of deals fell much more dramatically, from 130 in July 2016 to 89 this year, implying a sharp drop in market liquidity.

3.0 Value of Commercial Property Deals (£bn per year)



Source: Property Archive

The upshot is that the total value of transactions was almost certainly flattered by a couple of very large deals. Indeed, despite falling from £51m in June, the average implied deal size of £36m was still about 20% above the 12-month average. Moreover, the combined value of the five largest transactions in July made up just shy of two-thirds of the total, almost double the long-term average of 35%.

The latest data from CBRE highlighted that prime capital values continued to recover from their post-referendum losses. However, a large portion of the 3.3%y/y increase seen in July can be attributed to a 9% increase in industrial capital values. By contrast, capital appreciation in the office market as close to 2%, while retail capital values were broadly flat on the year.

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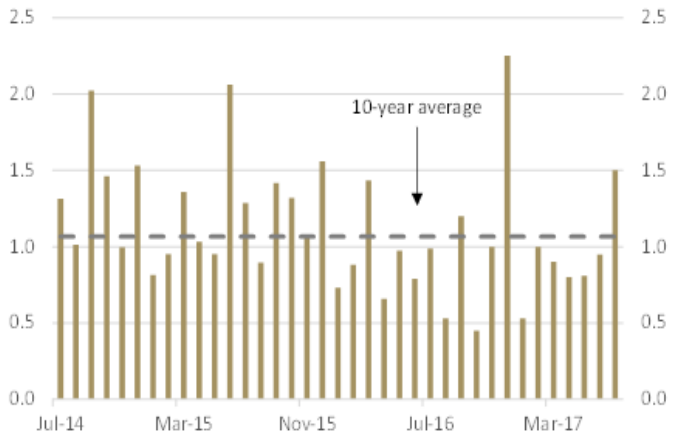
London Property Market

The latest office occupier market data suggest that the balance between supply and demand has improved of late. Granted, at 1.3m sq.ft. in July, central London office leasing activity was 17% lower than in June. Yet, the monthly total was 26% above the 10-year average of just over 1m sq.ft. In turn, this was enough to help office availability edge lower, by about 1%, to 14m sq.ft. This marked the 4th consecutive month of muted falls in availability (Chart 4).

4.0 Central London Office Take-Up (million sq.ft. per month)



Source: CBRE

According to CBRE, financial sector occupiers accounted for 58% of office lettings in July. The largest amongst these was Deutsche Bank's 550,000 sq.ft. pre-let, agreed at 21 Moorfields. Meanwhile in August, and in keeping with their recent expansion, deals by co-working firm WeWork have also been announced in two peripheral office locations: Hackney (143,000sq.ft.) and Shoreditch (240,000sq.ft.).

With some of the largest investment deals for July signed in the capital, it is no surprise that London accounted for the lion's share of investment activity. In fact, by value, 60% of all deals were inked in London, considerably above the 46% average seen since 2003. The largest of these, LandSec's disposal of the Walkie Talkie building in the City, was agreed for a reported £1.3bn, reflecting an initial yield of 3.4%.

Regional Property Market

Like at the national level, regional investment activity was soft in July. Compared to the average seen over the preceding 12-month period, the value of deals completed was 16% lower. And the softness was fairly broad-based, the notable exceptions being the South East and North West, where July's figures were 14% and 103% higher than their respective 12-month averages.

A new benchmark for regional hotel yields was set in August. Standard Life Assurance acquired a Premier Inn for £26.55 million, or Net Initial Yield of 4.12%. The auction for the hotel sent prices far higher than expected and underlines current confidence in the budget hotel market.

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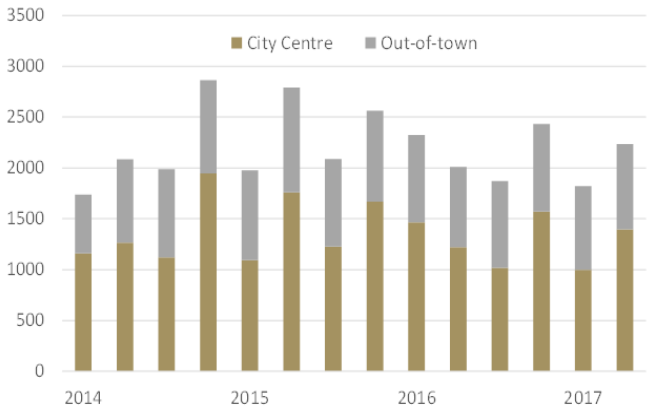
Sector Spotlight - Regional Offices

Office leasing activity picked up in the main regional office markets during the second quarter. Data from GVA shows that, taken together, town centre and out-of-town office take-up rose, from 1.8m sq.ft. in the first quarter to 2.2m sq.ft. (Chart 5). Yet most of that improvement came from a 40%q/q rebound in office leasing activity in the main town centre markets. And while out-of-town office locations also saw an improvement, it was muted by comparison, rising by just 1.8%q/q.

5.0 Big 9 Office Market Take-Up by Submarket (000s sq.ft. per quarter)

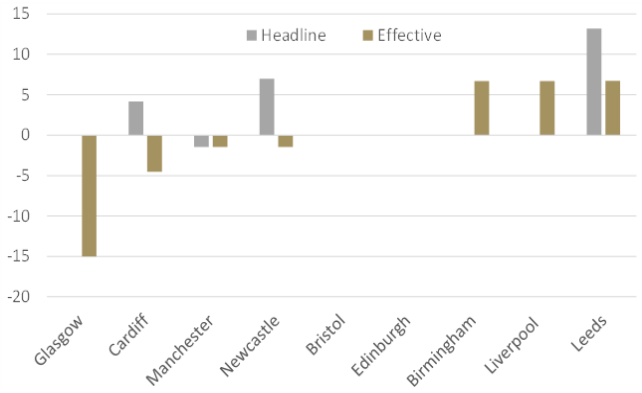


Source: GVA

Moreover, much of the improvement was driven by activity in Edinburgh and Manchester city centres. Indeed, at just under 450,000sq.ft. and 300,000sq.ft. respectively, these markets were the only major cities to record leasing activity above their five-year averages, of 150,000sq.ft. and 250,000sq.ft. However, at least some of the strength of tenant demand in Edinburgh can be attributed to some very large lettings to government entities, which may not necessarily be repeated in the near future.

Despite the improvement in demand for city centre offices, prime rental trends appear mixed (Chart 6). For instance, headline prime rents have only increased in three of the big nine markets over the last four quarters: Cardiff, Newcastle and Leeds. Meanwhile, Manchester has seen prime headline rents fall, and the remaining markets saw stable rents. However, the picture changes a little when the impact of rent-free periods and other incentives are taken into account. Effective office rents rose by just under 7%y/y in Birmingham, Liverpool and Leeds. By contrast, on the same basis, they fell in Glasgow, Cardiff, Manchester, and Newcastle. Rents were unchanged in Bristol and Edinburgh in both headline and effective terms.

6.0 Big 9 City Centre Office Rental Growth (%y/y)



Source: GVA

Despite the relative stability in rents, falling yields have supported capital value growth. Data from CBRE shows that prime equivalent yields fell by around 5bps in the non-London office markets during the three months to July. That is consistent with healthy levels of investor interest. According to the RICS survey for the second quarter, the office investment enquiries net balance indicated rising enquiries in the South and North, while with a reading of 0% in the Midlands, investor demand held firm.

A full a sectoral breakdown of the regional investment activity is unavailable. However, there have been a handful of notable office deals outside the capital over recent months. In July, for instance, Milton Park in Abingdon and No. 1 Spinningfields in Manchester were each sold for a reported £200m. Moreover, Ærium bought an office in Cardiff for £51m. More recently, in August, smaller deals have been reported, including UBS' purchase of Quartermile 2 in Edinburgh, for £28.5m, and Picton's acquisition of a Bristol city centre building for £23.1m.

Looking ahead, the case for regional offices is solid from both an occupier and investment market perspective. With supply pipelines generally smaller than in the capital, and less exposure to the fall-out from any potential loss of financial service passporting rights stemming from Brexit, regional office rental growth is expected to outperform most property sectors. In addition, the fact that regional office yields are currently look high relative to London means that, as monetary policy begins to normalise, the size of expected yield rises and thus downward pressure on capital values, will be comparatively small in the regions.

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