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Update - March 2018

Global Factors

On balance, global economic news-flow has had a positive tone over the past few weeks. An index by the University of Michigan showed that US consumer confidence reached a 14-year high in March and industrial production jumped by 1.1% m/m in February. Meanwhile, surveys suggested that US GDP growth in the first quarter is more likely to surprise on the upside than to disappoint, as did February's 313,000 rise in non-farm payrolls. In any event, the Fed's decision to raise interest rates by 25bps in March rarely looked to be in any doubt.

Meanwhile, the euro-zone recovery shows little sign of running out of steam. Admittedly, industrial production did fall sharply in the opening weeks of the year, posting a 1% m/m drop, but that is likely to prove temporary. By contrast, employment growth rose by a solid 1.6% y/y in February. Finally, both the PMI and economic sentiment surveys suggest that economic growth is more likely to have accelerated than to have cooled in the first quarter. As a result, the ECB is edging closer to ending its asset purchases.

In the UK, the Chancellor delivered the first of his new-look (policy-free) Spring Statements in the second week of March. And, with the major talking point being the Office of Budget Responsibility's reluctance to acknowledge the economy's recent better-than-expected performance, it was as dull as promised. That said, the incoming data has not been overwhelmingly positive. So, despite March's CPI data appearing to provide firm evidence that inflation has now peaked, few were surprised that the MPC elected to keep rates on hold at their latest meeting.

Arguably, the bigger surprise was the apparently fairly smooth agreement of a transition deal between the UK and the EU, which leaves the Northern Ireland border issue as work in progress, but allows the UK to negotiate trade deals with other countries during the transition. The latter is something that Brexit proponents have argued is key, as it will bring forward the date when the UK starts to reap some of the rewards of leaving the EU.

Despite plenty of positive news, equity markets have recently lost a bit of their shine. The major indices typically fell by between 4% and 8% during the first two weeks of February and have since struggled to make good those losses (see Chart 1).

An Overview

Market volatility jumped once again as the US threatened to start a trade war with China, before tensions eased following reports that they were willing to renegotiate trade imbalances.

Brexit talks took a big step forward as the EU confirmed that a 21-month transition period would begin from next March. The agreement was a welcome development, providing some reassurance for UK businesses that trading arrangements with the EU are likely to be unchanged until the end of 2020.

Going forward, this should help to provide support for commercial property pricing, as companies can return to considering real estate strategies within their decision making processes.

March Top 5

1. UK and EU agree terms for Brexit transition period
2. UK will be able to negotiate, sign and ratify its own trade deals during the transition period
3. The high street experiences casualties, with Maplin and Toys R Us both going into administration
4. Strong start to the year for regional property
5. City letting market remains in robust shape

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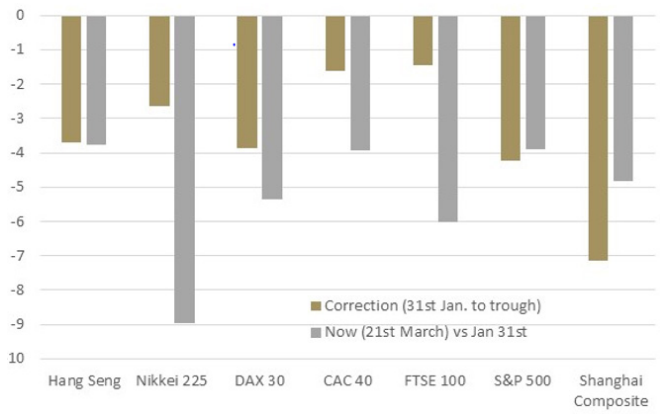
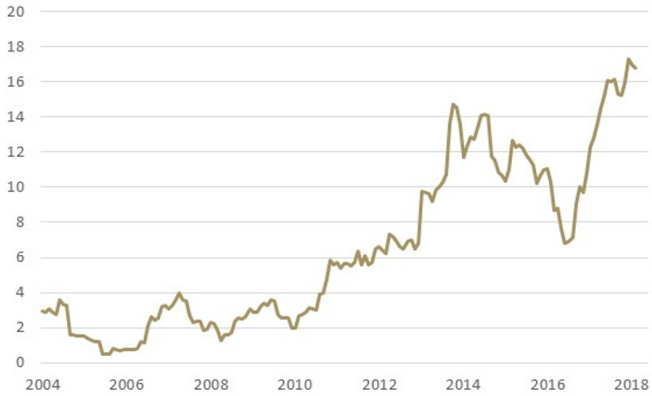
1.0 Changes in Selected Major Equity Market Indices (%)



Source: Thomson Reuters

2.0 Investment in Alternative UK Property Assets (12m Rolling Total, % of All Investment)



Source: Property Archive

Property Overview

The total value of deals completed during February was £3.5bn. Whilst this was down by £1.9bn compared to January, the total invested in the first two months of the year is still 7% ahead of the same period of 2017. January's total was boosted by the inclusion of the huge £1.6bn deal for Apple's new HQ in Battersea.

Anecdotal evidence suggests that investor interest in alternative property is on the rise. And defining "alternative" as anything except offices, retail, industrial, hotels and leisure, it accounted for almost £1 in every £6 invested in 2017 – a record high (see Chart 2).

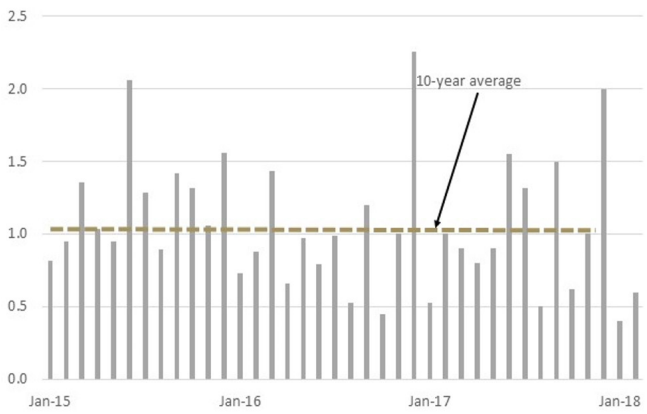
On the occupier side, the main news over the past few weeks has focussed on the continuing problems in the retail sector. Toys R Us and Maplin both went into administration, while Carpetright warned investors that it was in danger of breaching its loan covenants. There have also been reports of troubles at New Look.

It is tempting to see such developments solely as further evidence of the damage being wrought on the retail sector by the ever-growing influence of online sales. Yet not all retailers are in decline, suggesting that specific problems with the management of these companies must also be playing some role. That said, it seems more likely than not that we have yet to see the full impact of changing consumer habits on the retail property sector.

London Property Market

CBRE reported that office take-up in central London has made a subdued start to the year. Take-up totalled just 0.4m sq. ft. in January and just 0.6m sq. ft. in February, both well below the 10-year average of 1m sq. ft. per month (see Chart 3). **Yet the amount of space under offer in February was about a third higher than normal, pointing to a healthy level of underlying occupier demand.**

3.0 Take-Up in Central London Office Markets (Million Sq.Ft.)



Source: CBRE

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This positive "under offer" data seems consistent with other indicators. Regional business surveys, such the Markit regional PMI, suggest that activity in London is growing at a similar pace to, if not faster than, the rest of the UK. London has also punched above its weight in terms of job creation.

In the year to January, UK employment grew by 1.3% - employment in London rose by 2.9%.

On the investment side, there has been some concern that the Chinese HNA Group Co. is reportedly trying to sell two office buildings in Canary Wharf in order to cut its debt levels. But this appears to be a one-off rather than the start of a mass-outflow of Chinese money.

Indeed, Hong Kong developer, Nan Fung, recently acquired the Regent Quarter office complex for £300m, reportedly paying £20m over asking price to beat off the competition. Of course, that could be seen as a worrying sign of "irrational exuberance", but there are few other signs that cracks are appearing in the capital's commercial property market.

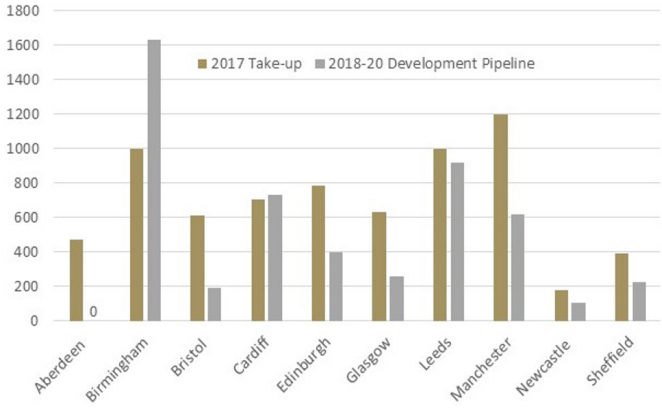
Regional Property Market

Regional property markets have made a strong start to the year. According to Knight Frank, take-up in the 10 largest city markets, excluding London, totalled over 7m sq.ft. in 2017, roughly 25% higher than what has been typical over the past decade. In a year when the economy appeared to be losing momentum, that implies a healthy level of occupier confidence.

Reports that many occupiers are increasingly cost conscious should bode well for occupier demand outside London and the South East this year. Limited supply pipelines should also mean that landlords benefit from competition for the best available space in the form of rising rental values, as well as decent levels of income security. In nine of the 10 largest UK regional city markets (Birmingham being the exception), the development pipeline out to 2020 is equal to, or less than, last year's take-up, and considerably smaller in most cases (see Chart 4).

The hunt for income, particularly in the face of the current Brexit unknowns, saw increased investor appetite for UK hotels in 2017. Cost pressures, as well as a lack of opportunity, also pushed growing numbers of hotel investors out of London and into the regions last year. According to Savills, investment activity in the hotels sector reached £5.4bn in 2017, a figure that was roughly a third higher than in 2016. All of that increase was driven by a rise in activity in the regions.

4.0 Office Take-Up and Development Pipelines in the UK City Office Markets (000 Sq. Ft.)



Source: Knight Frank

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Sector Spotlight - London City Offices

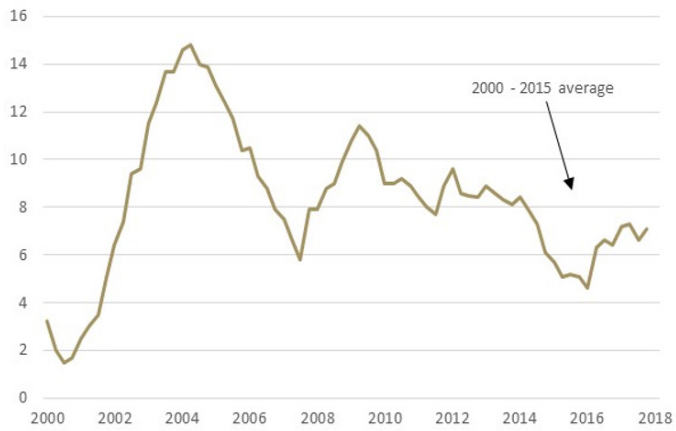
City of London investment volumes hit £12.64bn in 2017. This was 56% higher than the 2016 turnover, 57% up on the 10-year average and the highest figure on record, according to Savills.

Asian buyers remained the largest investor group, accounting for 52% of total turnover, significantly ahead of their nearest rivals, European buyers (14%) and UK buyers (12%). The City of London continues to attract a wide array of investors, driven by the status and stability of the market. This is clearly shown by the fact that 28 different nationalities acquired City real estate in 2017.

Opinion about the outlook for the City office market is polarised. According to the IPF Consensus survey conducted in February, at one end of the spectrum, the most pessimistic forecaster currently expects rental values to be almost 15% lower in 2022 than they are today. However, at the other end of the spectrum, the optimists envisage a rental value-driven rise in City office capital values over the same period of as much as 22%.

To date, the available evidence appears to favour those sitting towards the optimistic end of the spectrum. For one thing, the City office vacancy rate currently stands at 7.1%. While that is up from the lows of 4.6% seen two years ago, it is comfortably below the average level seen between 2000 and 2015 of 8.5% (see Chart 5).

5.0 City Office Vacancy Rate

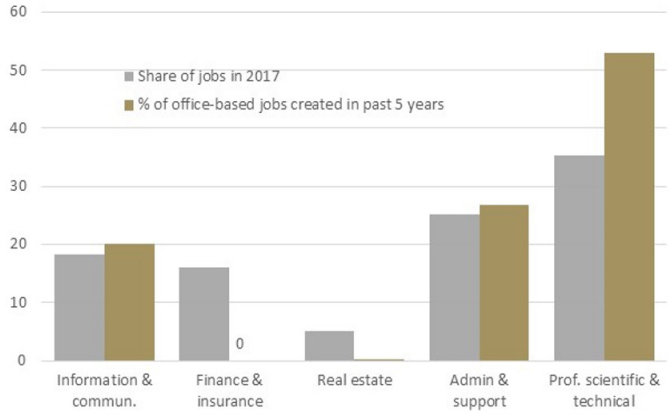


Source: Knight Frank

The letting market in the City continues to be in robust shape, with several significant transactions either completing or going under offer in the final quarter of 2017. Whilst the serviced office sector, with WeWork being the obvious standout, continues to grab the headlines, demand continues to come from a wide variety of sectors.

London is still yet to see many jobs leave as a result of the vote to leave the EU. Whilst a case can be made that Brexit, and/or the gradual normalisation of monetary policy, has the potential to deliver an adverse shock to the financial sector, it is striking that, as a driver of occupier demand, the financial sector has been punching below its weight for some time now (see Chart 6).

6.0 Office-Based Jobs in London by Main Sector



Source: Thomson Rueters

In fact, over the past five years, the number of financial sector jobs in London has stagnated, while a wider measure of office-based jobs has risen by 385,000. For reference, in the previous five-year period, financial services accounted for one-in-five new office-based jobs in London. The implied broadening in the occupier base in the City should reduce the risks faced by investors in this market segment.

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The lack of options for occupiers seeking larger units remains. Looking at the future pipeline, there is currently 8.5 m sq. ft. under construction due to complete within the next three years; however, 42% has already been committed according to Knight Frank. Further, they report that active demand requirements currently stand at a healthy 4.5m sq. ft., implying that, in the absence of a shock, deficient demand is unlikely to be a major issue for the City.

Despite the associated volatility with Brexit, investors have shown that they are willing to buy into the solid fundamentals and relative value available from London real estate, and we expect them to continue to do so. Indeed, as the outcome of Brexit and the current political uncertainty become clearer, an improving confidence in the underlying occupier markets will support pricing for both prime and, increasingly, for more opportunistic assets.

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