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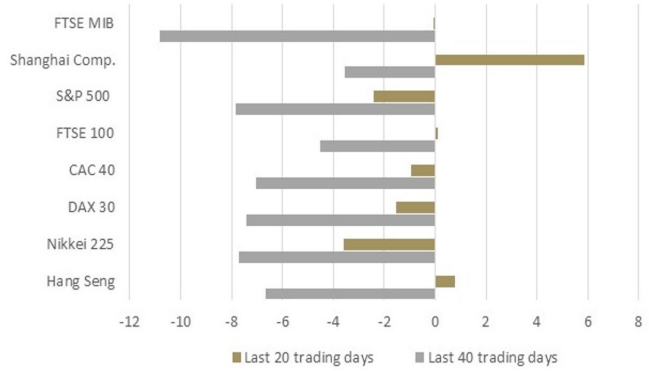
Update - November 2018

Global Factors

The weak sentiment that was evident in equity markets in October has continued into November. Mounting concerns about the pace of growth spurred fresh declines in stocks around the world, wiping out yearly gains for the S&P 500 and causing further falls across global markets. What started as a selloff in shares of high-flying technology companies bled into other corners of the financial markets, as investors drove down prices for everything from shares of retailers and energy companies to oil and bitcoin. The so-called FAANG companies (Facebook, Apple, Amazon, Netflix and Google) whose rises helped drive stock markets to record highs have all suffered sharp losses in recent weeks. Each is down more than 20% from its year high. Whilst economic data remains positive, for now it seems that volatility is set to remain elevated.

1.0 Change in selected major market indices over the last 20 trading days from 20/11/2018



Source: Thomson Reuters

Whilst the UK economy looked strong in Q3, the outlook for 2019 is being complicated by the lack of clarity about whether, or on what terms, the UK will leave the EU. With the latest draft Brexit deal resulting in a raft of Cabinet resignations, the possibility of a "no deal" Brexit looks to be about 50/50. On the flip side, the chances of the UK staying in the EU have also risen.

An Overview

The UK Cabinet finally gave a green light to Theresa May's Brexit deal, paving the way for the UK Parliament to vote on the agreement on December 10. More clarity on the final relationship is needed, and uncertainty remains high. There are still big hurdles ahead which could yet mean that the negotiations go down to the wire, but this is an important step forward. In spite of the stream of political noise from the Brexit negotiations, 2018 investment volumes and the sheer number of deals are clear testaments to the ongoing confidence in the core fundamentals of UK commercial property. With the risks around Brexit being viewed in a wider global context, the UK continues to offer relative value compared with other core markets, while continuing to benefit from its enduring reputation as a safe haven for international capital.

November Top 5

- Global share markets tumble amid fears the rise of big tech is over;
- Brexit reaches 'decisive moment' as the EU turns its attention to the future relationship;
- Commercial property inflows in 2018 are on target to reach circa £60bn: the sixth year running that volumes will break through the £50bn mark;
- Central London take-up remains strong, with under offers 20% above their 10-year average;
- Outlook for logistics occupier demand appears solid, with the share of retail sales made online now standing at 18%, compared with just 9% in 2009.

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It is difficult to estimate the impact a "no deal" outcome could have on the economy, not least because it would still be in the EU's interest to take steps to minimise the economic fallout. In the most extreme case, however, in which flights were grounded, contracts subject to renegotiation and supply chains seriously disrupted etc., the UK might well suffer a mild recession in 2019. However, any economic damage to the UK economy is likely to be short-lived. Policy-makers would step up to cut interest rates and loosen fiscal policy and businesses would adapt. Lost output would then be largely made up in the later stages of 2019 and early 2020. In turn, any hit to property yields and rental expectations would likely to be reversed as economic activity recovers.

By and large, anecdotal media coverage of big business views on Brexit has been negative, such as that of car manufacturers and financial institutions. However, the official statistics reveal a more sanguine picture, at least until the mid-point of 2018. While fixed capital formation from businesses slipped by 7% in Q2, it was nonetheless 3% above the five-year average, implying ongoing confidence to invest in spite of heightened political uncertainty.

In the US, the first estimate of GDP growth for the third quarter suggests that the economy grew at 3.5% annualised. This reflects some slowdown from the 4.2% annualised rate in Q2, with there being signs that higher interest rates are beginning to have a greater impact.. The first data for the fourth quarter suggest that the manufacturing sector continues to slow, reflecting the stronger dollar and slowing global growth, particularly in China. Meanwhile, CPI inflation picked up to 2.5% y/y, mostly reflecting higher gasoline prices. At its November meeting, the FOMC reaffirmed its plans to continue raising interest rates.

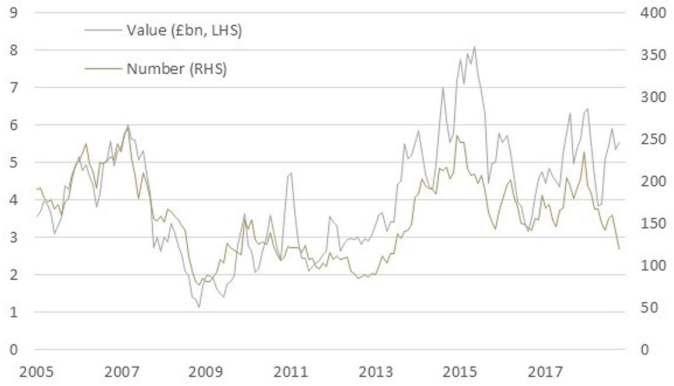
Property Overview

The latest data show that capital value growth for UK commercial property slowed in the third quarter. This slowdown is set to continue. Indeed, although employment growth picked up to 1.1% y/y in Q3, from 0.9% y/y a quarter earlier, this is still consistent with further moderation in all-property rental value growth in coming quarters. However, with the supply pipeline generally limited, outright falls in rental value growth seem unlikely.

Property Archive data for October show that commercial property investment was £5.5bn, similar to the previous two months. This has meant that the value of investment so far over 2018 has been on par with the same period in 2017. Volumes in 2018 are on target to reach circa £60bn, 35% above the ten-year annual average. This will be the sixth year running that volumes will break through the £50bn mark.

With a number of +£200m deals across all of the traditional sectors, the market was characterised by a very low number of deals, suggesting a lack of availability in the market (see Chart 2). Just 103 deals were completed in October, much lower than the 15-year average of around 160 deals.

2.0 Value and number of completed investment deals (3m moving average)



Source: Property Archive

Investment in October was above its 12-month average in the office, leisure and hotel sectors. In particular, leisure investment was strong, boosted by the sale of the NEC in Birmingham. There was also an increase in retail sector investment compared to previous months. This was driven by the sale of Highcross Leicester Shopping Centre by Hammerson plc.

Nevertheless, retail sector consolidation still has some way to go. Over the first 10 months of the year, the Centre for Retail Research suggest that 2,875 stores have been affected by retail closures. This is twice the number of closures seen last year. Indeed, the RICS Commercial Market Survey for Q3 showed that the balance of 39% of surveyors reported that the availability of retail property continued to increase.

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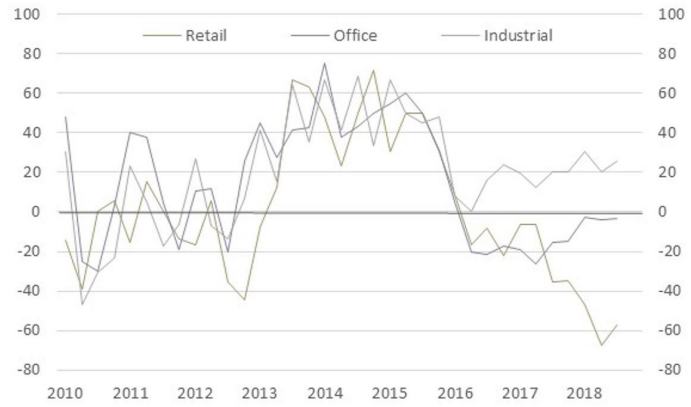
London Property Market

In October, London commercial property investment was £2bn, 14% above its 15-year average levels. The total was partly boosted by the £475m sale of the London Executive Offices portfolio to Celvam Management. This positive outturn adds to the improving investment trend. In the 12 months to October investment has totalled £30.8bn, making it the strongest 12-month period since before the EU referendum.

City investment turnover across October saw eight transactions totalling £853.15m, the third highest monthly turnover in 2018 to date. Total investment volume for the year now stands at £9.47bn. This is 7.6% up on the same period in 2017, where only £8.8bn had transacted and the highest turnover recorded to the end of October. Furthermore, we are entering traditionally the most active period of the year for City investment. The 5-year average investment volume for the final two months of the year is £3.68bn.

Across London, the balance of surveyors in the Q3 RICS Commercial Market Survey reported that demand in the industrial sector was higher than in the retail and office sectors (see Chart 3). Nevertheless, office occupier demand appears to have held up well so far over 2018, with a balance of just 3% of surveyors reporting that demand is falling, compared with 15% at the end of last year.

3.0 Surveyors reporting a rise in demand (% net balance)



Source: RICS Commercial Market Survey

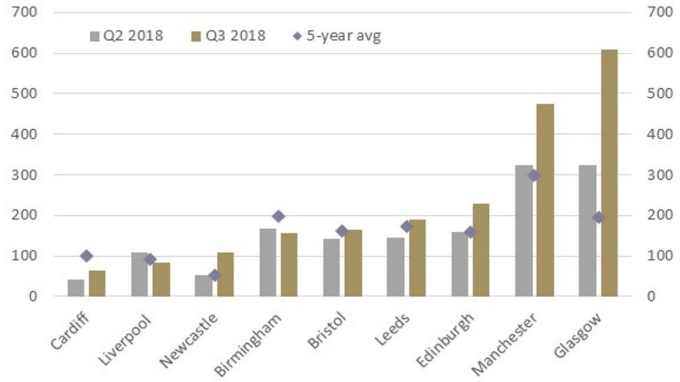
This is consistent with agency reports. For example, CBRE report that central London office take-up in October was stable at around September's level of 1.25m sq. ft. In turn, the vacancy rate fell from 6.9% to 6.3%, the lowest since the second quarter of 2016.

The outlook for take-up is also still strong, with under offers 20% above their 10-year average. Granted, this measure has been declining steadily since June 2018. However, with the supply pipeline constrained, particularly in the West End, the outlook for the market is still positive.

Regional Property Market

In the rest of the UK, office take-up was also solid in the third quarter. According to GVA, in the main regional cities, take-up totalled 2m sq. ft., around 40% higher than the level of take-up recorded in both Q1 and Q2. Take-up was above its five-year average in most cities, but was boosted in particular by two large deals – the letting of Buchanan Wharf in Glasgow to Barclays and the letting of Enterprise City in Manchester to Booking.com (see Chart 4).

4.0 Office take-up in the big nine cities (000s sq. ft.)

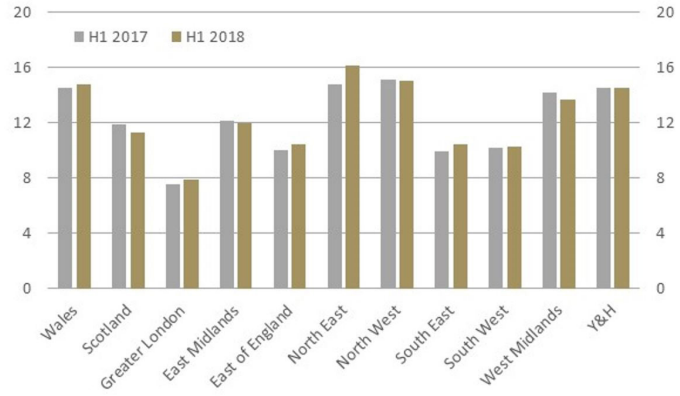


Source: GVA

Healthy levels of office take-up appear slightly more positive than the picture of occupier demand painted by office-based employment which, on a four-month rolling basis, has slowed from 1.6% y/y at the end of last year to only 1% y/y.

In the retail sector, the rest of the UK has fared slightly worse than Greater London. LDC report that vacancy rates for retail property have been increasing across the country, but at 7.9% they are far lower in Greater London (see Chart 5).

5.0 Retail Vacancy Rates (%)



Source: LDC

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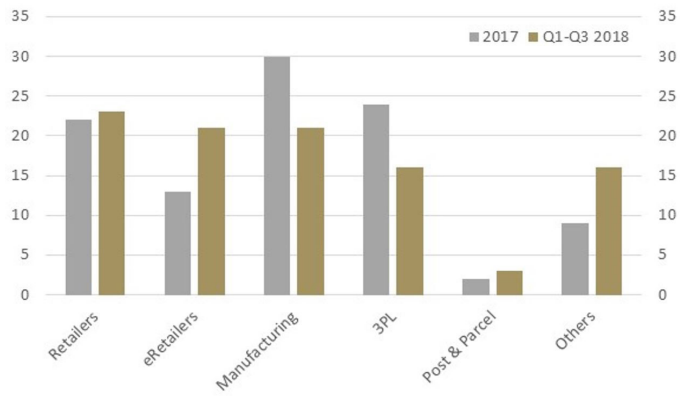
Sector Spotlight

Logistics

Logistics property performed well compared to other commercial sectors in the third quarter. Annualised total returns were 16% for distribution warehouses and 21% for standard industrial, well above the all-property average.

Cushman and Wakefield report that third quarter take-up was strong across the industrial sector, totalling 6.5m sq. ft.. This was 43% higher than in Q3 last year, but 17% lower than the five-year average. Of this total, the logistics sector accounted for a substantial proportion of activity and its share was greater than in previous years (see Chart 6). For example, 3rd party logistics accounted for 24% of total take-up, compared to 16% in 2017. In contrast, the share of take-up accounted for by the manufacturing sector was just 21%, compared to 30% in 2017. In addition, eRetailers take-up in Q3 was boosted by the deal for 360,000 sq. ft of space near Haydock by Amazon.

6.0 Share of Industrial Take-Up by Sector (%)



Source: Cushman and Wakefield

The outlook for logistics occupier demand also appears solid. For one, real wage growth has been positive for the past six months which should start to flow through into stronger rates of consumer spending growth. Further, there has yet to be any slowdown in the share of retail sales made online – which now stands at 18%, compared with just 9% in 2009.

However, the imbalance between logistics supply and demand, which has boosted rental value growth, appears to be easing. According to CBRE, the amount of Grade A logistics space available has increased to 14 months' worth of take-up, from just eight months a year ago.

Meanwhile, availability of secondhand space is equivalent to 16 months take-up. Further, the amount of speculative space under construction in the industrial sector reached a post-GFC high of 10.5m sq. ft. in Q3, suggesting that the supply pipeline is strong.

Investor demand for industrial property has also started to slow, albeit from high levels. So far over 2018, industrial investment has totalled around £5.6bn, 40% lower than over the same period of 2017. This is consistent with the fact that, after many years of compression, prime industrial yields have started to stabilise. They currently range from around 4.4% in London to 5.25%-5.5% in other regional areas.

In turn, total returns are expected to moderate given the stronger supply pipeline and as a result of an expected increase in yields as interest rates and bond yields rise. But even so, logistics returns are expected to continue to outperform other commercial property sectors for some time yet.

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