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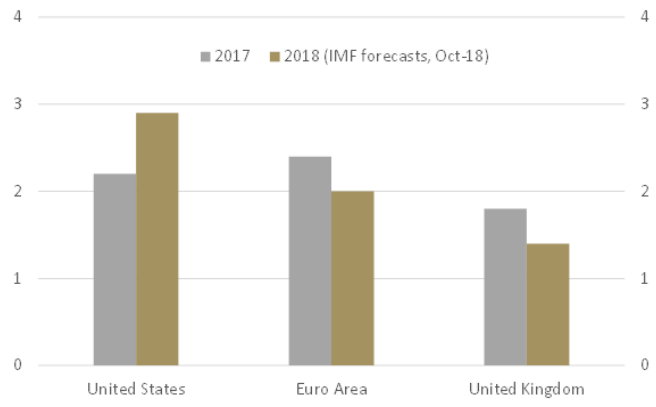
A Review of 2018 and 2019 Outlook

Global Factors

2018 was a year dominated by economic and political events, including escalating US-China trade tensions, Italian political issues, higher US interest rates and, of course, Brexit. Nevertheless, economic growth in the US and Europe is looking to be broadly in line with expectations. The US economy has been particularly resilient, while the Euro Area and the UK economies both appear to have lost some momentum (see Chart 1). Although the UK doesn't look to have performed as well as the Euro Area, against a backdrop of slowing global growth and Brexit-related uncertainty, growth has held up fairly well.

1.0 GDP Growth (% y/y)



Source: IMF Worl Economic Outlook

Indeed, following some weather-related disruption at the start of the year, economic activity in the UK rebounded through the middle of the year. Between January and October, the latest data point available, around 230,000 jobs were created, a similar level to the same period of 2017. In turn, tightness in the labour market intensified, with the unemployment rate falling to 4.1% in October, a near multi-decade low.

An Overview

The UK stands at a fork in the road and deliberations over the coming weeks and months will have a significant impact on our economy. The prospect of a no deal Brexit is spooking investors, but looks unlikely, despite Parliamentary opposition to the current deal Theresa May has agreed with Brussels.

As we look forward to 2019 there will inevitably be headwinds for the sector. However, relative to other income producing asset classes, commercial property remains extremely attractive. The UK's fundamental attractions for international investors remain intact and lack of overall supply and continued strong demand will continue to support the sector for the coming year.

January Top 5

- UK growth has held up well against a backdrop of Brexit-related uncertainty;
- The commercial property sector has brushed off economic and political uncertainty to outperform forecasted expectations at beginning of the year;
- Market fundamentals across the UK remain sound and leasing activity continued to perform positively in 2018;
- The market is expected to remain polarised over 2019. The right assets in the right locations will continue to outperform;
- Investor strategies for 2019 will focus on prime property and, where the risks weigh up, alternative assets.

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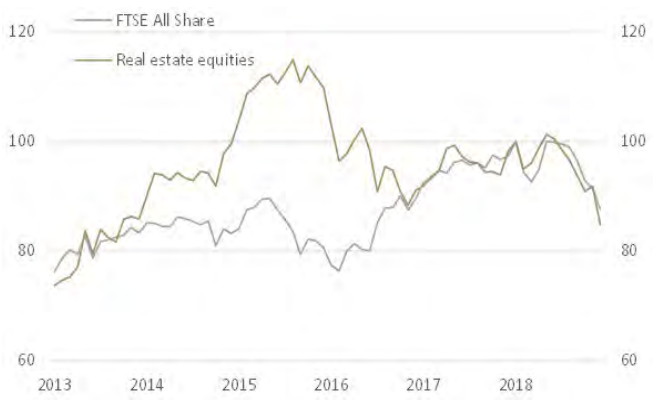
This was enough to push the pace of headline pay growth to 3.3% y/y, from just 2.6% y/y at the start of 2018. Combined with CPI inflation slowing over 2018, this meant that real incomes increased at their fastest rate in almost a year.

Nevertheless, despite reasonable grounds for growth, household spending and business investment have been held back. With little further clarity as to whether, or on what terms, the UK will leave the EU, this uncertainty is likely to continue into the first part of 2019. Indeed, the Monetary Policy Committee is taking a wait-and-see approach until there is more clarity on the future path of economic growth. However, if a Brexit deal is secured, it seems likely that GDP growth will rebound as pent-up demand is released and, as such, the most likely path of interest rates is upwards.

Property Overview

For the most part, the commercial property sector has brushed off this economic and political uncertainty and appears to have performed better than many forecasters and commentators expected. Even though property equities got caught up in general financial market weakness over the second half of 2018 (see Chart 2), overall values held up much better. Indeed, CBRE report that all-property total returns in 2018 slowed, but were still a very reasonable 6.3% y/y.

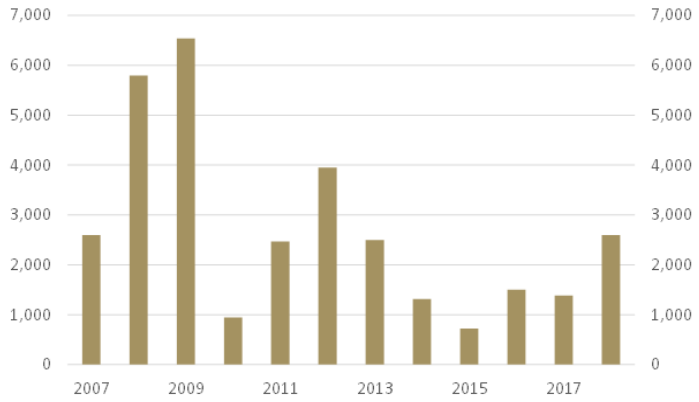
2.0 FTSE All Share and Real Estate Equity Indices (Jan 2018=100)



Source: Thomson Reuters

Admittedly, 2018 was the turning point for retail sector values, with the 2,594 retail store closures during the year not likely to be the last (see Chart 3). However, occupier demand was resilient in both London and the regional office markets. Further, Savills reported that nationwide take-up of logistics property was 32% above 2017 levels. In turn, according to CBRE, all-property rental value growth slowed to 0.5% y/y.

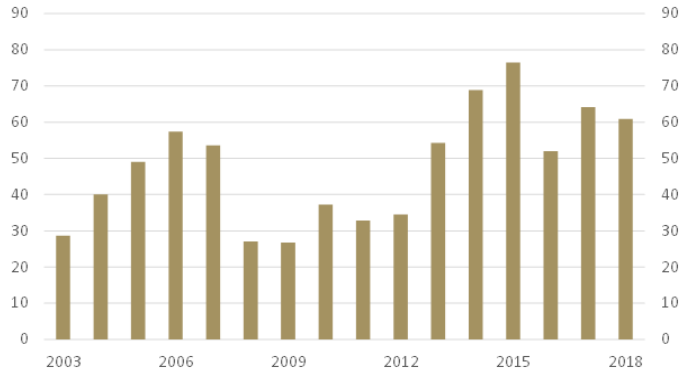
3.0 Retail Store Closures



Source: Centre for Retail Research

In addition, the value of commercial property investment held up surprisingly well. At £61bn, it was only slightly lower than 2017's total (see Chart 4). Indeed, despite the political noise, there was no shortage of large deals. Furthermore, overseas investors' interest in UK property was solid. In fact, overseas investors accounted for over half of the total value of investment and purchases outweighed sales by over £9bn.

4.0 Value of Commercial Property Investment (£bn)



Source: Property Archive

By sector, office investment was the bright spot, with the value of deals completed slightly higher than 2017 totals. Further, demand for assets outside of the traditional office, industrial and retail sectors also held up, accounting for 40% of the total value of deals completed. In contrast, a lack of assets coming to the market held back industrial investment while the value of retail investment was weaker than during the financial crisis. In turn, towards the end of the year there was clear upward movement in retail yields. Indeed, CBRE reported a 10bps increase in retail equivalent yields in December.

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London Property Market

In London, office occupier demand picked up in 2018, with data from CBRE suggesting that office take-up, at 13.7m sq. ft., was higher than in 2016 and 2017. Although flexible offices received a lot of media attention in 2018, take-up was lower than 2017 levels. Meanwhile, the largest share of take-up was attributed to the Technology, Media and Telecommunications (TMT) sector. Going forward, with office-based employment growth set to slow, occupier demand is expected to soften.

According to GVA, office supply increased in 2018 to 7.7m sq. ft. However, the pipeline post-2020 suggests that supply will reduce, with just 6m sq. ft. under construction, of which 56% is pre-let. Indeed, surveyors in the RICS survey have been reporting declining office development starts for the past three years. Nevertheless, with occupier demand expected to soften, some reduction in the supply pipeline will provide support to rental value growth. However, given that most of the available space is secondhand, some divergence in rental values between secondhand and new office property is also likely.

Investment activity in London in 2018 was 15% higher than a year earlier, totalling almost £30bn. There was no shortage of larger deals supporting investment values, including the sale of Battersea Power Station for Apple's HQ, and the sales of 5 Broadgate and the Fleet Building, all with price tags of more than £1bn. Indeed, investor interest in London commercial property has held up despite the softer outlook for capital values and Brexit-related uncertainties, suggesting that it has not lost its allure.

Regional Property Market

Likewise, office-take up outside of London in 2018 was strong. According to GVA, take-up in the "Big Nine" regions already exceeded 2017 totals in the third quarter. And CBRE data suggest that office take-up in the South East reached a 10-year high. With the supply pipeline restricted, this pushed rents in some areas to record levels. Going forward, RICS surveyors expect this to continue, with office rental value expectations more positive outside of London.

Take-up was also strong in the regional industrial and logistics sector, most notably in the East Midlands, Yorkshire and the North West. Indeed, according to Savills the vacancy rate for logistics property in the East Midlands fell by 160bps in 2018 to just 2.6%.

However, despite solid levels of take-up and a relatively positive outlook, investment activity in the regions appears to have peaked, moderating 23% from 2017 levels to total £31bn in 2018. Nevertheless, this total is still greater than the value of investment in 2016. Looking ahead, demand for prime regional assets is likely to continue, especially from investors who are concerned with overpricing in London. In particular, with the supply pipeline restrictive and rental values less stretched than in London or the South East, there is scope for further rental gains in the rest of the UK.

2019 Outlook

Risk or opportunity?

Looking to the rest of 2019, it's clear that it will be challenging year for both the UK economy and the property sector. Uncertainty will underpin decisions for at least the first quarter of the year. Indeed, investor caution overshadowed the December's Thomson Reuters Asset Allocation Poll, with firms reporting that they were looking to put just 1.6% of their global balanced multi-asset portfolios in UK property, compared to a 2018 average of over 3%. In addition, the risk remains of a no-deal Brexit. But for some investors, these risks will be seen as an opportunity.

Nevertheless, if a Brexit deal is secured, the solid fundamentals of the UK economy suggest that there are reasons to be positive. Indeed, although sentiment has been weak, business investment and household spending are well placed to accelerate when the Brexit fog lifts. And this could see the UK economy growing faster than its peers as the global slowdown strengthens.

Admittedly, with the labour market near full capacity, employment growth is likely to slow. Given the past relationship between employment and occupier demand and the fact that rents look stretched in many markets, rental value growth is also expected to soften relative to 2018. However, at the all-property level, rental values are not forecast to decline. Nevertheless, with valuations looking stretched and interest rates set to rise, it seems that the most likely path for yields is upwards, particularly in the retail sector, which will drag on all-property capital values.

The IPF consensus view is that all-property total returns will end the year around 3% y/y, significantly lower than the 2017 peak of over 10% y/y. Even in the event of a no deal Brexit, the impact on total returns is likely to be mild compared to past crises. Most notably, loan-to-value ratios are much lower than they were during the global financial crisis which would provide a cushion in the event of a downturn in values, preventing investors from being forced to sell by banks as was seen in past crashes.

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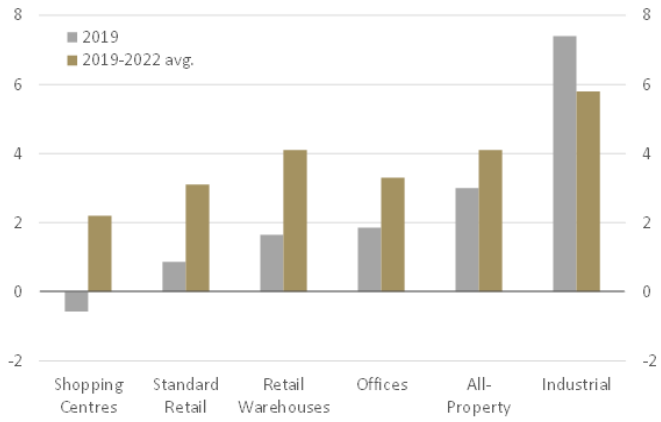
However, in 2019, the market is expected to remain polarised, with the retail sector underperforming while the industrial sector sees the highest returns. Nevertheless, the underperformance of retail is not expected to last. Indeed, by 2022, the IPF consensus believe that industrial and retail warehouses are set to outperform (see Chart 5). However, industrial property is not likely to see the rates of return of recent years. Indeed, the current historically low-level of industrial yields seems to imbed unrealistic expectations of future rental value growth. As such, it seems likely that industrial yields will rise over the coming years as investors reconsider pricing.

5.0 Total Return Forecasts (% y/y)



Source: Property Archive

As yields have compressed, a shift to alternatives has also been a feature of this cycle. This move reflects that, despite the higher risks associated, the prospects for many alternative assets are supported by urbanisation, demographic trends and an ageing population. According to the PWC/ULI European property survey, alternatives are likely to remain a key feature of the real estate market, with 60% of respondents already investing in alternatives and 66% wishing to increase their holdings in 2019. Of alternatives, investors currently have the highest exposure in hotels and student housing. And going forward, student housing is on the top of the wish-list. Nevertheless, given yields have fallen to low levels in many alternative sectors, investors need to be careful that pricing fully accounts for the inherent level of risk.

The outlook is also for investment activity to soften slightly in 2019. To some extent this will reflect investors holding fire until the outcome of Brexit becomes clearer and, at the margin, some overseas demand may be dampened by the introduction of the capital gains tax for foreign investors. However, more importantly, with valuations stretched and interest rates set to rise, investors are likely to act more cautiously about bidding yields lower. In particular, investment activity in the retail sector is likely to remain slow, albeit there could also be an increase in opportunistic buyers who seek distressed assets available at a discount.

However, there are reasons to expect that investor interest will not drop away completely. For one, according to the latest INREV survey, investors expect to deploy at least €72bn worth of capital, or dry powder, this year, well up from the €51bn that was expected in 2018.

True, compared to UK government bonds and equities, UK commercial property looks slightly more expensive than a year ago. But, recent yield movements mean that the UK market is likely to maintain its appeal to overseas investors. Indeed, at 3.57%, all-property prime yields are still higher than in countries like Germany and France. And over the last year, movements in prime UK yields have been smaller than other European yields (see Chart 6). As such, if relative pricing was attractive enough to support demand for UK assets a year ago year, the fact that European yields have fallen in relation to the UK should support UK investment activity in 2019. In turn, it seems likely that the 2018 tendency of investors, particularly from Asia, buying big assets at yields that are low, but still higher than continental Europe, will continue, especially if sterling stays weak.

Going forward, student housing is on the top of the wish-list

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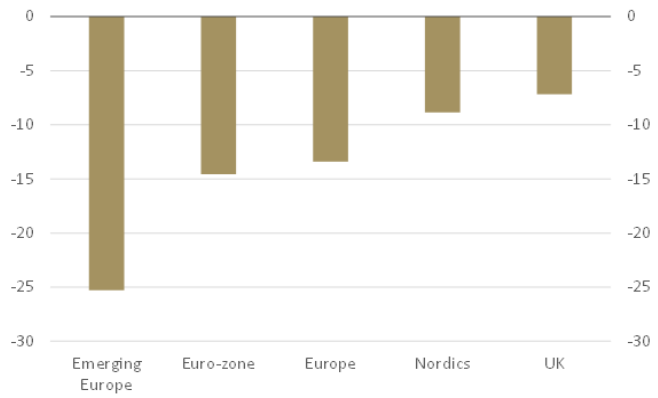
6.0 Change in Prime All-Property Yields over the Past Year (Bps)



Source: Various agents

Indeed, at this late stage of the cycle, investors are likely to be more selective, taking a longer term view, concentrating on assets with secure income, those that have higher income returns or those with healthy rental prospects. As such, some continuation of investor strategies which focus on prime property and, where the risks weigh up, alternative assets seems likely.

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