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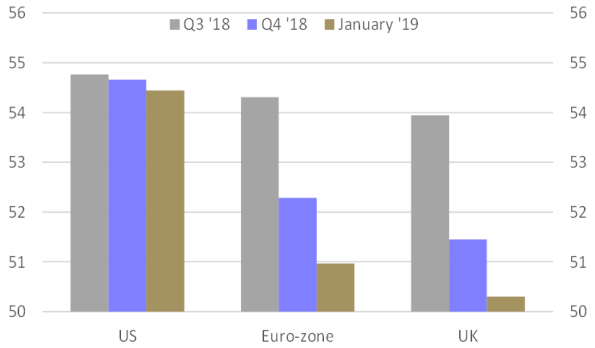
Update - February 2019

Global Factors

Since the New Year, global financial markets have rallied, but economic indicators have remained worsened across the major economies (see Chart 1). As a result, most forecasters now expect the world economy to slow over the next two years, with the euro-zone, US and China leading the downturn. In this context, global trade growth is likely to slow, regardless of whether there is an escalation in the US-led trade war.

1.0 Markit Composite Purchasing Managers Index (Averages)



Source: Thomson Reuters

Weaker economic activity is also likely to subdue core inflation, so the major central banks are expected to be more cautious about normalising monetary policy. Market expectations of Fed rate hikes in the US have been revised sharply downwards over the recent past and some are projecting rate cuts as early as next year. ECB and BoJ are now expected to keep rates unchanged, missing out on the current tightening cycle altogether, while The Bank of England has issued more doveish guidance on UK interest rates.

February Top 5

- The world economy is looking likely to slow over the next two years, with the US and China leading the downturn;
- Despite the prospect of Brexit at the end of March, there is still little further clarity as to the terms on which the UK will leave the EU. If a deal is secured, however, it seems likely that growth will revive;
- Industrial remains the most robust commercial sector, benefiting from the rise of online spending and increased need for storage;
- Solid demand is further eroding avilability in the regions;
- Hotel capital values rose by almost 5% in 2018 and total returns were an impressive 9.2%.

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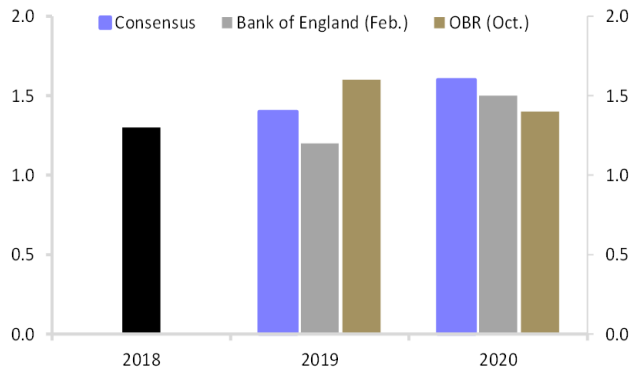
UK economic growth eased in late 2018, as temporary factors that fuelled growth during the summer faded and Brexit uncertainty weighed on demand. But the labour market has remained solid, with employment growing at an annual rate of 1.0% at the end of last year. Headline average wage growth has also climbed to a post-financial crash peak, which, given that CPI inflation has declined to close to its 2% target, implies rising real incomes.

With Brexit looming at the end of March, there is little further clarity as to the terms on which the UK will leave the EU. With a reasonable prospect of a delay, this uncertainty could continue well into this year, so there is limited upside to GDP growth relative to a below-par 2018 (see Chart 2). As noted, the Monetary Policy Committee is also taking a cautious approach. Nonetheless, if a Brexit deal is secured, it seems likely that growth will revive and, as such, the most likely path of interest rates is upwards from the current lows.

2.0 UK GDP and Forecasts (y/y%)

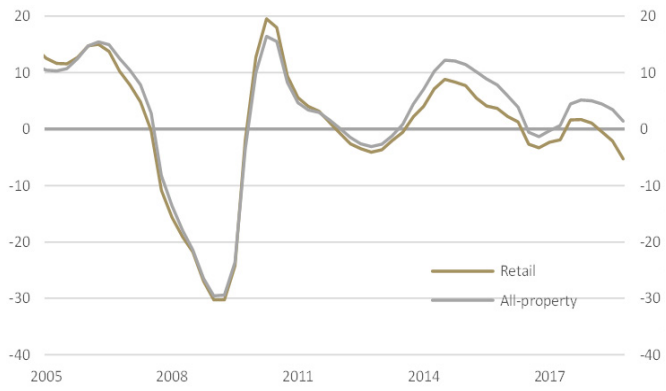


Source: Thomson Reuters

Property Overview

The latest MSCI figures for late 2018 highlighted a sharp (though not entirely unexpected) deterioration in the retail sector. A hit to retail rents, combined with an increase in equivalent yields, meant that capital values declined by 5% in this sector last year – the worst performance in a decade. (see Chart 3). Total returns for the year were also negative for the first time since the Global Financial Crisis.

3.0 Capital Value Growth (y/y %)



Source: MSCI

And this is unlikely to be the end of the bad news for retail. According to the Centre for Retail Research, almost 2,600 stores were closed last year. In addition, the latest RICS survey suggests a net balance of 46% of surveyors are still reporting rising availability. So while improving income growth should bring some uplift to retail fundamentals longer term, the correction in retail values is expected to continue through this year and next.

Other sectors, however, have held up much better. Outside of retail, capital values increased in 2018, albeit at a slower rate. Industrial remains the most robust commercial sector. It continues to benefit from the rise of online spending and the increased need for storage. Indeed, online retail accounted for 30% of total industrial take-up last year, compared with negligible amounts before 2015. Although take-up may not be sustained at current levels, demand for industrial property is expected to remain healthy.

The value of commercial property investment declined last year, with annual total purchases 7% lower than a year earlier at around £60bn. Despite ongoing political concerns, there was no shortage of large deals. Furthermore, overseas interest in UK property held up well, accounting for over half of the total investment. But activity was notably weaker in Q4 and in preliminary figures for 2019. So, with Brexit uncertainty continuing and capital values under pressure, there appears limited prospect of a rebound in investment this year.

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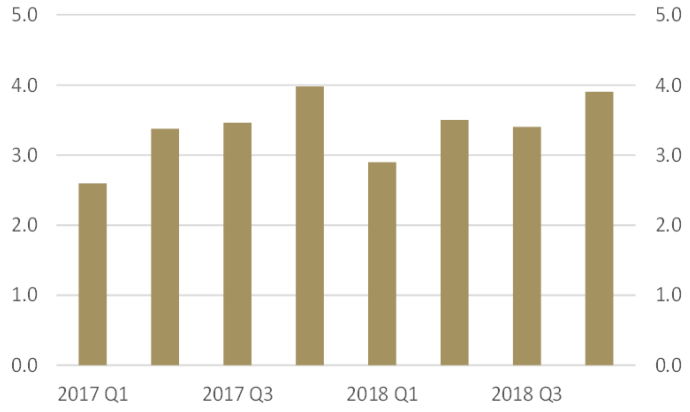
London Property Market

Demand for Central London offices remained buoyant last year. CBRE report that Central London office take-up was 3.9m sq. ft. in the fourth quarter (see Chart 4). In turn, the total for 2018 was stronger than in each of the previous two years. But take-up has been overstating the strength of occupier demand, with the rise of flexible office space in particular acting to weaken this link. Slower-than-expected rental growth in the capital tends to support this view of more subdued underlying demand.

4.0 Central London Office Take-Up (m sq. ft.)



Source: CBRE

With the labour market near full capacity and Brexit looming, it seems unlikely that such strong levels of take-up will be sustained in London. Indeed, CBRE data show that under offers have already dropped around 30% from their peak in the Q2 2018. In addition, although partly reflecting Brexit-related uncertainty, the latest RICS survey reported a decline in office occupier demand.

Central London office completions hit decade-highs in 2017-18, but strong demand and pre-letting meant that vacancy rates continued to edge lower. The current pipeline suggests that 2019 will also see further net additions to supply, but thereafter completions will slow sharply. This is in line with the RICS survey reporting declining office development starts for the past three years. With occupier demand expected to soften, a reduction in the supply pipeline will provide support to rental value growth over the medium term.

During 2018, investment activity in London was 15% higher than a year earlier, totalling almost £30bn. This comparison masks a deterioration in the more recent figures, however, with the 12 month rolling total slowing sharply since the autumn. This mirrors a weaker national trend. But it also suggests that Brexit-related uncertainties will continue to dampen investor interest, at least in the short-term.

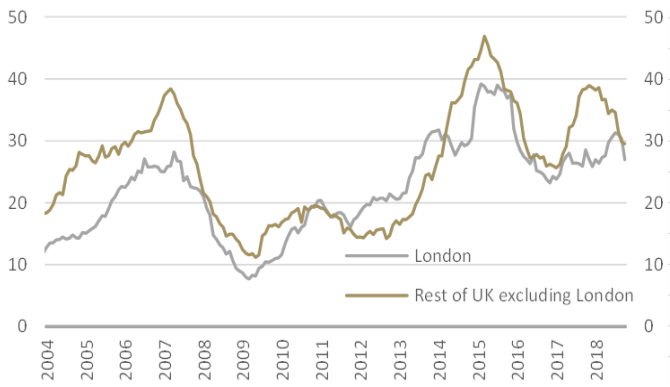
Regional Property Market

According to GVA, in the Big Nine regional cities, office take-up totalled 1.74m sq. ft. in Q4, with Manchester particularly strong. Overall, regional take-up in 2018, at 6.7m sq. ft., was just 1% lower than 2017 levels. Solid demand has further eroded availability. Of the Big Nine cities, only Newcastle has more than one year's worth of supply based on average take-up. Once speculative construction is added, the picture worsens somewhat, but, even then, on average there is just 1.4 years' worth of supply. This is consistent with the latest RICS survey which suggests that office availability is tighter outside of London.

In the South East, office take-up in 2018 was over 30% higher than in 2017, boosted by the 1.8m sq. ft. of space leased in the fourth quarter. In turn, the office vacancy rate fell to 6.6% of stock, which was its lowest since 2016. Further, space under construction in the South east stood at just 0.9m sq. ft., well below the 2017 average of 2.2m sq. ft..

Despite relatively positive occupier fundamentals, investment activity in the regions slowed sharply last year, declining 23% to total £31bn (see Chart 5). While Brexit may bring a further deceleration in the near term, regional markets remain attractive to investors. Not least because, with supply tight and valuations less stretched than in London, there is more scope for rental gains in the rest of the UK.

5.0 Value of Commercial Property Investment (£bn, 12m rolling)



Source: Property Archive

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Sector Spotlight

Hotels

The hotel market has performed strongly over recent years boosted by the global economic recovery and strong tourist inflows. In the UK, this has been reinforced by the benefits of the steep sterling depreciation after the EU Referendum. Although there are more challenges ahead from a slower global economy, Brexit and competitive pressures, performance is expected to remain healthy.

Hotel capital values rose by almost 5% in 2018 according to MSCI, and total returns were an impressive 9.2%. Meanwhile, the value investment in hotels has held up better than other commercial sectors over recent months. But demand fundamentals point to a slowdown. UK visitor arrivals declined over the first three quarters of 2018, as the boost from a weaker pound faded. (See Chart 6). There is unlikely to be a significant pick up given the current economic backdrop.

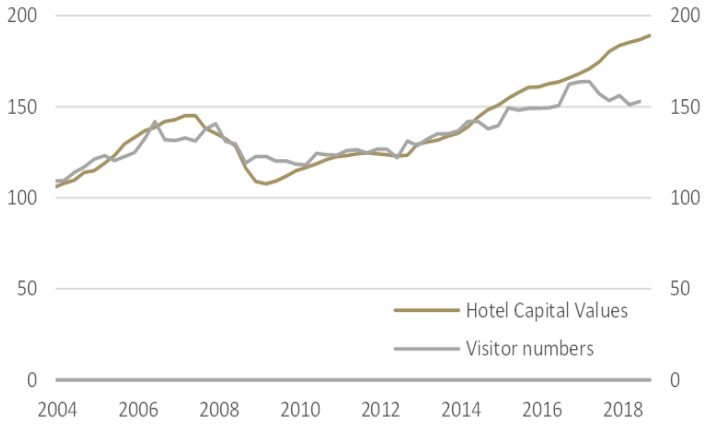
The hotel supply pipeline appears solid, particularly outside of London. At the margin, the prospects for more retail-to-hotel conversions as vacant shop space is released will also bolster supply. With occupier demand expected to soften, this pipeline is expected to keep a lid on hotel rental value growth.

The sector faces other challenges. Operators are likely to see more intense competition from online disruptors, such as Airbnb, than other property sectors. These will be reinforced by pressures on staff costs caused by a rise in the UK minimum wage.

Looking forward, we expect hotel yields to edge higher, as UK policy rates are tightened after Brexit. With rental prospects subdued, the implication is modest annual declines in capital values over the medium term. As a result, we expect hotel returns to average around 3% a year over the next five years.

As with any sector in times of uncertainty, there will be winners and losers. Astute asset selection and shrewd asset mangement will deliver strong returns from the right opportunities.

6.0 UK Visitor Numbers and Hotel Capital Value Index (2000 Q4 =100)



Source: MSCI, Thomson Reuters

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