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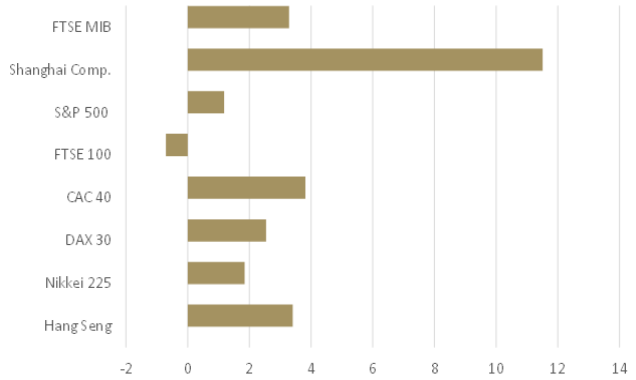
Update - March 2019

Global Factors

Global stock markets have continued to recover after performing poorly at the turn of the year. The exception has been the FTSE 100 which has taken a hit as the result of recent Brexit turmoil (see Chart 1). However, the fact that equity markets are generally lower than a year ago highlights the relative weakness of economic data. In turn, forecasters have been cutting their expectations for global growth. A recent example is the OECD which now expects global growth of 3.3% y/y this year, and 3.4% y/y in 2020.

1.0 Change in Selected Major Equity Market Indices over 20 Trading Days to 20/03/19(%)



Source: Refinitiv

In the UK, Brexit has been clouding the economic picture and uncertainty is looking likely to continue for the next few months or more. But Brexit aside, for now the UK economy is holding on. In particular, the fact that monthly GDP growth picked up by 0.5% m/m in January, pulling the annual rate up to 1.4% from just 1% in December was a reassuring sign that the economy has recovered somewhat from the weakness at the end of last year.

Overview

British politics has faced another turbulent month as investors attempt to digest a constantly shifting set of possible outcomes. With the deal deadline now extended to April 12th, uncertainty remains. Will the date of departure be extended again, or will May's deal finally be accepted at the 3rd attempt? Above all, the key questions now are: will the UK leave the European Union at all? And if so, with a deal.... or with no deal and no transition period in place?

March Top 5

- Expectations that the US Fed is unlikely to raise interest rates any time soon has seen risk assets, particularly equity markets, rally in 2019 thus far;
- The UK economy has recovered somewhat from the weakness at the end of last year as GDP growth picked up by 0.5% in January, pulling the annual rate up to 1.4% from just 1% in December;
- Continued uncertainty around Brexit has seen investors adopt a 'wait and see' approach to making decisions. Subsequently, overall volumes are down on the same point last year;
- Investment levels are expected to pick up once the Brexit fog lifts particularly in the regional markets where occupational conditions remain supportive;
- Supply continues to fall, with a limited development pipeline and generally strong occupier demand resulting in supply constraints being experienced across the market.

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Nevertheless, the UK economy is not likely to grow as strongly as last year. Indeed, even though the all-sector Markit/CIPS PMI rose in February to 51.4, from a weak 50.3 in January, it still only points to GDP growth stagnating in the first quarter. This is consistent with the Chancellor's decision at the Spring Statement to revise down his forecasts for GDP growth this year to 1.2% y/y, from 1.6% previously. However, encouragingly for the UK's economic prospects, this downward revision was almost offset by some upward revisions in later years.

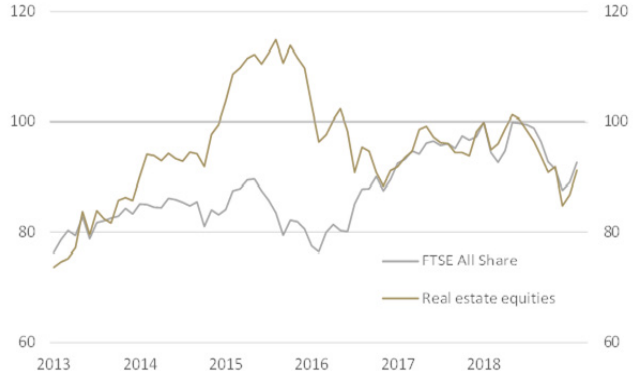
In the US, early indicators suggest that economic activity has slowed in the first quarter. This was expected given that the fiscal stimulus which boosted growth last year is fading. In particular, the labour market has suffered. In February, there was an increase of just 20,000 non-farm workers, compared to an average gain over the previous six months of over 230,000 workers per month. In addition, CPI inflation softened to 1.5% y/y in February, continuing the general slowing seen since the middle of last year from almost 3% y/y. Slower growth and lower inflation are consistent with the Federal Reserve leaving interest rates on hold for an extended period.

In Europe, recent developments do nothing to change the bigger picture that growth in the bloc is slowing. The final composite PMI for February increased slightly to 51.9, from 51 in January. But this is consistent with quarterly growth in the first quarter of 0.2% at best. Further, at its March meeting the ECB stepped up its monetary stimulus, launching a third round of Targeted Long-Term Refinancing Operations (TLTROs) and strengthening its interest rate guidance. In addition, the ECB downgraded its forecasts for euro-area growth this year to 1.1% y/y, from 1.7% y/y.

Property Overview

The UK commercial property is gradually slowing, pulled down by the poor performance of the retail sector. Admittedly, property equities have improved on the back of the recovery in broader equity markets (see Chart 2). But economic fundamentals, and the fact that yields are starting to rise, indicate that rental and capital value growth will soften further this year. In particular, the retail sector is still working through its excess supply of property. As such, store closures and downward pressure on retail rents are expected to continue. Indeed, the Centre for Retail Research suggest that, over the first two months of the year, 266 retail stores have been closed.

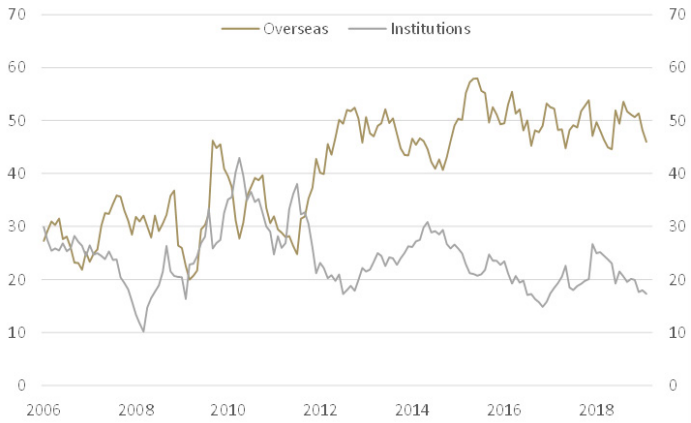
2.0 FTSE All Share and Real Estate Equity Indices (Jan 2018=100)



Source: Refinitiv

Recent developments in the investment market are consistent with this outlook. In February, the value of deals completed according to Property Archive totalled just £1.5bn. Some of this weakness reflects Brexit-related uncertainty which has seen investors taking a 'wait and see' approach to making decisions. However, the underlying trend in investment activity since October last year has been downward. And overseas investors no longer appear indifferent to the impact of Brexit, with the overseas share of purchases falling below 50% after holding up well over most of the post-EU referendum period (see Chart 3).

3.0 Share of Investment Purchases (%, 6m Average)



Source: Property Archive

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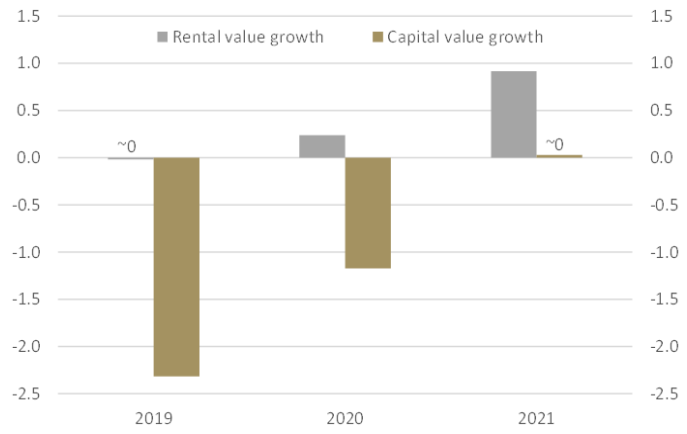
The February IPF Consensus survey showed that the consensus expectation is for rents to stagnate this year. And combined with an expected upward movement in yields, all-property capital values are forecast to fall by 2.3% y/y this year. This view has been downgraded since November, partly as forecasters have taken on board the substantial drop in retail values in the fourth quarter of 2018. Nevertheless, 2019 is expected to be the cyclical low for the property market (see Chart 4). Indeed, by 2021 the consensus expectation is for no change in all-property capital value growth.

4.0 All-Property IPF Consensus Forecasts (% y/y)



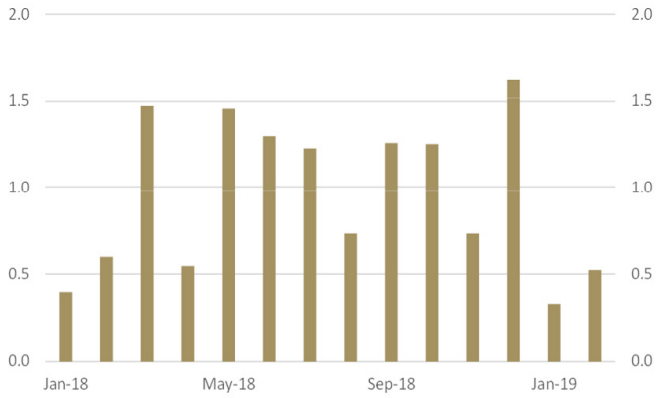
Source: IPF Consensus

London Property Market

Most of the weakness in investment activity so far over 2019 has been caused by the London property market. In fact, the value of deals in London has been less than 40% of the total value of investment in the UK. This is in contrast to the recent trend which has seen investment activity in the Rest of the UK slow more than in London.

Central London office take-up also got off to a weak start of the year. At just 0.5m sq. ft. in February according to CBRE, take-up was around 13% lower than the same time last year (see Chart 5). Availability remained stable, but the space available is disproportionately secondhand. As such, concerns about a possible oversupply of secondhand space have not reduced.

5.0 Central London Office Take-Up (M Sq. Ft.)



Source: CBRE

Going forward, economic fundamentals suggest that underlying demand for London offices this year will remain subdued. Over 2018, London office-based employment grew at around 2% y/y, a faster pace than over 2017. But with the labour market near full capacity, office-based employment and therefore occupier demand is expected to soften.

However, although the consensus expectation is that central London rental value growth will slow, the range of IPF Consensus forecasts highlight the uncertainty around this path. Indeed, for offices in the city of London, the most pessimistic forecasters expect rents to decline by 7.5% y/y this year, while the more optimistic expect them to rise by 2.6% y/y.

Regional Property Market

On a more positive note, the latest RICS Commercial Property Market Survey highlighted that occupier demand is generally holding up better outside of London, particularly in the industrial sector. Of course, there are differences in industrial performance across regions given their different fundamentals. In fact, Carter Jonas note that prime industrial rents grew 6.9% in 2018 in the South East and 3.2% in the Midlands, but just 1.6% and 0.5% respectively in the East and the South West/Wales.

This is consistent with a recent report commissioned by the British Property Federation into the warehousing needs of the UK. This report highlighted the importance of the West Midlands for its national logistics function and the fact that the South East is key to providing last mile delivery for London due to its shortage of appropriate land.

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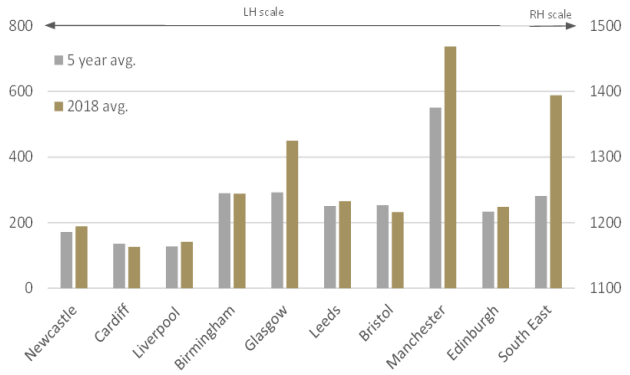
Sector Spotlight

Regional Offices

Investor appetite for regional offices held up relatively well in 2018. However, heading into 2019 there have been clear signs that investors are taking a more cautious approach as they await more clarity on the Brexit outcome. Nevertheless, once the Brexit fog clears, occupier conditions appear supportive of a pick-up in investment activity.

Indeed, data from Avison Young and Knight Frank show that, in 2018, average take-up per quarter in the regions was generally above its five-year average (see Chart 6).

6.0 Average Quarterly Take-Up (000s Sq. Ft.)



Source: Avison Young, Knight Frank

In particular, take-up in Glasgow and Manchester was robust, boosted by a number of large deals including Barclays' 470,000 sq. ft. deal at Glasgow's Buchanan Wharf and Booking.com taking 225,000 sq. ft. of space at Manchester Goods Yard. These large deals highlight the willingness of companies to locate in regional cities to take advantage of, for example, lower occupancy and labour costs. In addition, commentators note that flexible office providers are also likely to take a large amount of space this year. In turn, so long as economic fundamentals remain solid, occupier demand is likely to hold up.

But importantly for rental values, so far the supply response to these solid fundamentals has been muted. In the South East, strong take-up meant that the vacancy rate fell to 6.6% in the fourth quarter of 2018, below even its pre-crisis low of 6.9%. And space under construction, at 0.9m sq. ft., is almost half of what it was one year ago.

Of the Big Nine cities, most have less than 2.5 years' worth of supply when accounting for current availability and speculative space under construction. Manchester stands out as one exception, with more than four years' worth of supply.

Overall, given generally tight supply and no worrying signs from economic fundamentals, rental value growth in regional office markets is likely to outperform London markets in coming years. However, within the regions, rental values outside of the South East appear to have more scope to rise as rental values appear less stretched.

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