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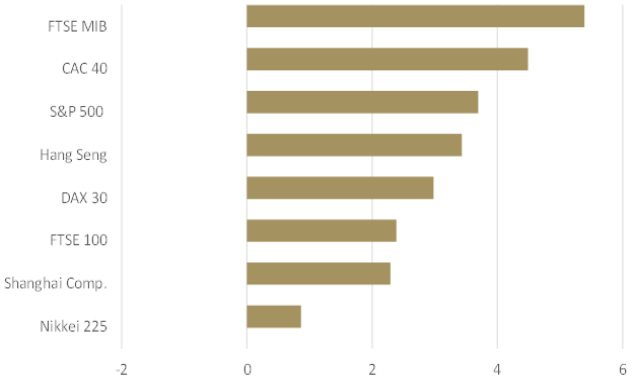
Update - June 2019

Global Factors

Equity market performance has been stronger in recent weeks (see Chart 1). Of note, the market reaction to the protests in Hong Kong has been small. Meanwhile, hopes that interest rate cuts by the Federal Reserve will prevent the US economy from weakening have supported the S&P 500. However, given the soft outlook for the global economy, the bigger picture is that equity markets in general are not likely to see sustained improvements.

1.0 Change in Selected Major Equity Market Indices over the Last 20 Trading Days (%)



Source: Refinitiv

In the UK, early readings on how the economy has performed in the second quarter have been disappointing, supporting the view that the boost to GDP growth in Q1 was temporary. Indeed, monthly GDP contracted by 0.4% m/m in April. Admittedly, the composite PMI picked up slightly in May, but even so it points to economic growth doing little better than stagnating. Data on the consumer side also suggests that there has been some reversal in activity in Q2. Indeed, employment growth has been softening since the start of the year and retail sales increased by just 2.3% y/y in May, down from a peak of over 6.7% y/y in March.

Overview - June Top 5

- UK GDP growth in Q1 proved to be temporary, with early readings on how the economy has performed in the second quarter looking disappointing.
- Wage growth has held up, which is expected to feed through to higher inflation and Bank Rate rises next year.
- The UK commercial property market slowdown continues to be driven by the retail sector.
- Investor demand in regional office markets has held up well, and the outlook for rental growth in regional cities is solid.
- Industrials continue to be the top performing traditional sector, with rental value growth expected to be greater than other traditional sectors for the next five years.

Encouragingly, however, wage growth has held up, which is expected to feed through into higher inflation and entice the MPC to raise Bank Rate next year. However, the MPC was more dovish at its June meeting, highlighting that there are downside risks to growth given increasing concerns about the global trade war and the increased chance of a no deal Brexit.

Similarly, there have been no signs from euro-zone industrial production or timelier survey measures that economic growth improved in Q2. In addition, European inflation expectations have fallen sharply. In turn, after markets failed to react to the more dovish tone of the June monetary policy press conference, the ECB stepped up its policy communication in a speech. This highlighted that the ECB remained ready to cut interest rates and relaunch its quantitative easing programme.

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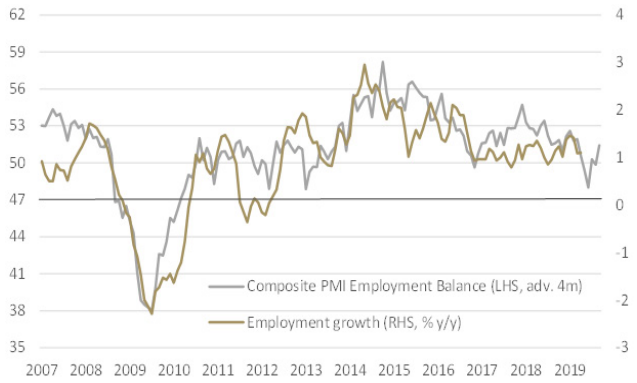
In the US, recent data has been slightly more positive. Indeed, retail sales grew by 0.5% m/m in May and previous months were revised higher. Together, this suggests that real consumption grew by 4% annualised in Q2. Further, industrial production increased in May, reversing the small decline seen in April. In turn, it was unsurprising that the Federal Reserve did not cut interest rates at its June meeting. That said, with fiscal stimulus fading, a further escalation in the US/China trade tensions seeming likely and global growth soft, the prospect of interest rate cuts are becoming increasingly likely. In fact, at its June meeting, Federal Reserve official's median interest rate forecast showed that, for the first time since the projection was published in 2012, a majority of officials now expect interest rates to fall.

Property Overview

Data over the last month have provided further evidence that the UK commercial property market is slowing. Indeed, surveys point to UK employment growth, an indicator of occupier conditions, slowing further (see Chart 2).

2.0 Composite PMI Employment and Employment Growth



Source: IHS Markit, Refinitiv

The slowdown continues to be driven by the retail sector. Indeed, data from CBRE show that retail capital values fell by 0.6% m/m in May, while capital values saw small gains in the office and industrial sectors. Weakness in the retail sector was also the main reason why the May IPF consensus downgraded its forecast for all-property returns to 1.8% y/y this year, compared to 2.4% y/y in the February survey. In fact, the IPF consensus expect retail returns to fall by almost 4% this year, while office and industrial returns are expected to slow, but stay positive, at 2.4% and 7.2% respectively.

Consistent with the subdued outlook for the commercial property sector, investor sentiment was soft in May. Indeed, preliminary data from Colliers showed that only £1.4bn worth of deals were completed, less than half of April's total and 75% lower than May 2018.

Nevertheless, although it is clear that the struggles in the retail sector are not over, there have been some positive developments. Specifically, in early June, legislation was introduced that confirms that business rate revaluations will occur every three years instead of five, linking the cost of business rates more closely to the current value of the property.

In addition, data from the Bank of England show that, even as capital values decline, banks and building societies remain less exposed to the commercial property sector than in the past. In fact, in May property debt accounted for just 6.8% of the total loan book, compared to over 11% in the lead up to the financial crisis (see Chart 3).

3.0 Lending to Property as a Share of the Total Loan Book (%)

Source: Bank of England

London Property Market

Investor demand in the Central London office market also softened in May. Savills reported that, at the beginning of June, there were only 20 office properties worth £750m openly marketed in the City of London, compared to 35 properties totalling £3.7bn a year ago. Meanwhile, the value and number of investment transactions completed in the West End in May was the lowest since January this year.

Indeed, there are signs that uncertainty about the outlook is feeding into occupier conditions. For example, Carter Jonas report that in some cases it is possible to negotiate rental discounts of between 2.5% and 5%. In turn, the IPF consensus expect very limited office rental value growth in Central London this year and next (see Chart 4). Nevertheless, from 2021 a recovery in rental value growth is in prospect, in a large part reflecting that the office supply pipeline further out is more constrained.

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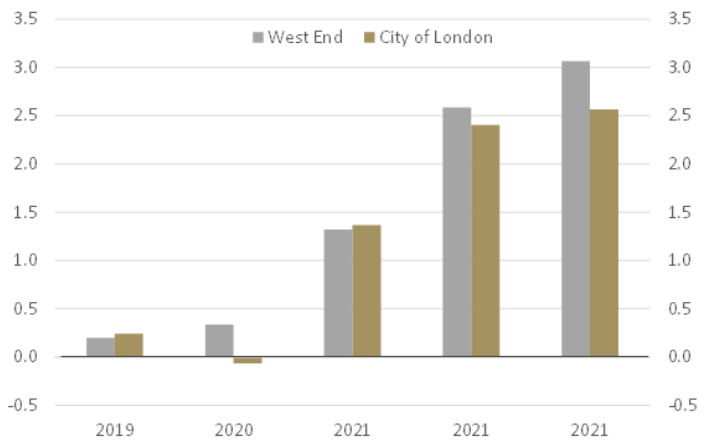
4.0 South East Office Vacancy Rate (%)



Source: IPF

Regional Property Market

In contrast to the Central London office market, investor demand in the regional office markets has generally held up. Indeed, Knight Frank data show that office yields in the South East and main regional cities have been stable at around 5% and 4.75% respectively. This reflects that the outlook for rental value growth in regional cities is solid, supported by tighter supply pipelines.

However, regional retail yields have generally increased more quickly than in London. This has started to encourage opportunistic buying. For example, in May, the New River and Pimco joint venture purchased four retail parks in Scotland and the Isle of Wight for a 9.8% initial yield.

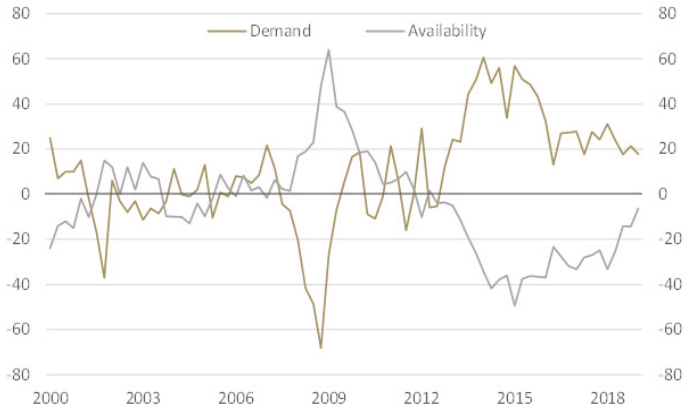
Sector Spotlight

Industrials

Total returns in the UK industrial sector were almost 14% in the first quarter of the year. Admittedly, this is down on the recent peak of over 20%. But, even so, industrial continues to be the top performing traditional sector.

The slowdown in total returns reflects that rental value growth is softening. Indeed, the gradual increase in supply is starting to reduce the shortage of industrial property. In fact, RICS surveyors reported that availability fell at the slowest rate in six years in Q1 (see Chart 5). Further, Cushman and Wakefield data show that speculative completions are set to surpass the 2016 peak this year.

5.0 RICS Surveyors Reporting Rising Industrial Demand and Availability (% Net balance)



Source: RICS

That said, it was a soft start to the year for industrial take-up, with Cushman and Wakefield reporting that just 6.5m sq. ft. of space was taken, compared to over 10m sq. ft. in the previous quarter and also in Q1 2018. However, this appeared to reflect heightened Brexit uncertainty and a lack of stock on the market. Indeed, there have been no signs that RICS surveyors have seen a fall in demand for industrial property (see Chart 5). In turn, although rental value growth is expected to slow a bit further, it is expected to be greater than in the other traditional sectors over the next five years or so.

The stronger rental growth prospects for industrial property are a key reason why there has been no upward pressure on industrial yields over the past six months, unlike in the office and retail sectors. Indeed, yields appear to have stabilised around record low levels. In May, Savills reported that prime industrial distribution yields were 4.25%, compared with 4% for industrial multi-lets. However, it seems unlikely that yields will fall further. Indeed, data from Property Archive show that industrial investor demand has been softening since early 2018 (see Chart 6).

6.0 Value of Industrial Investment (Annual Total, £bn)

Source: Property Archive

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Nevertheless, stronger rental value growth prospects meant that, even though industrial yields are unlikely to be immune from the impact of rising interest rates and bond yields once the MPC increases Bank Rate next year, the impact on capital value growth will be partly offset. In turn, industrial total returns are expected to continue to outperform other traditional sectors over the next five years.

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