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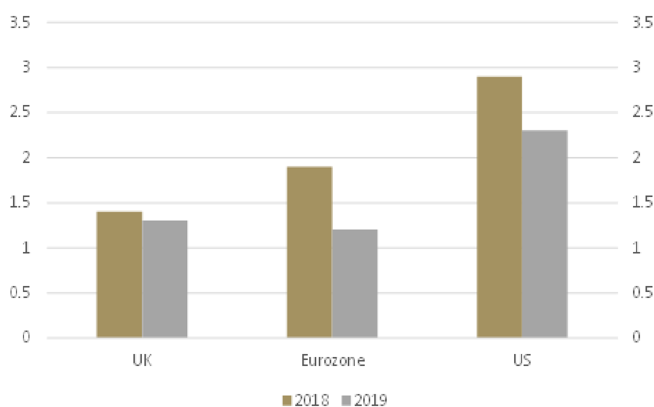
A Review of 2019 and 2020 Outlook

Economic Overview

After a nervous start for the global economy, recession fears eased in H2 2019. This did not prevent asset prices rising inexorably, with global bonds rallying and equity markets hitting new record highs. Despite the worst concerns easing through 2019, central banks remained in loosening mode across the developed world, including the Federal Reserve, ECB and more recently even the members of the Bank of England MPC, and this stance is unlikely to change much in 2020.

GDP growth slowed in Europe, with the euro-zone dragged down by a German economy close to recession and the UK hit by Brexit uncertainties (see Chart 1). By contrast, the US was more resilient, assisted by the Federal Reserve's turnaround on interest rates, leading to three cuts from H2 2019. Looking ahead, the global economy is expected to bottom out in early 2020, with growth recovering thereafter, though the pace of the upturn is likely to be glacial.

2.0 Consensus GDP Growth 2019 (%)



Source: Consensus Forecasts

Top 5

- A historic moment as the UK leaves the EU after 47 years and one month;
- Recession fears eased in 2019 after a nervous start, although asset prices continued to rise;
- UK interest rates remain unchanged at 0.75%;
- Property totals were weighed down in 2019 by Brexit and the crisis in retail, however the December figure was the highest monthly total since 2016, reflecting a surge of post-election optimism;
- Going into 2020, investors are expected to look increasingly for defensive assets with long and secure income streams, though these will be at a premium. The more opportunitic will likely seek assets in the alternative sector that are supported by long-term trends.

In the UK, the year was clouded by Brexit deadlines in both March and October. As noted, economic growth slowed, though the economy continued to create jobs at a healthy rate, albeit that the unemployment rate stabilised at just under 4%. Meanwhile, inflation was below the 2% official target for much of the year, though this was not enough to persuade the MPC to cut rates in 2019. Looking forward, with the general election delivering a decisive majority, Britain will leave the EU on 31st January. But uncertainty is unlikely to dispel, with a December 2020 no deal still not ruled out. This is likely to offset the benefits from the fiscal stimulus expected in the March Budget.

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Property Overview

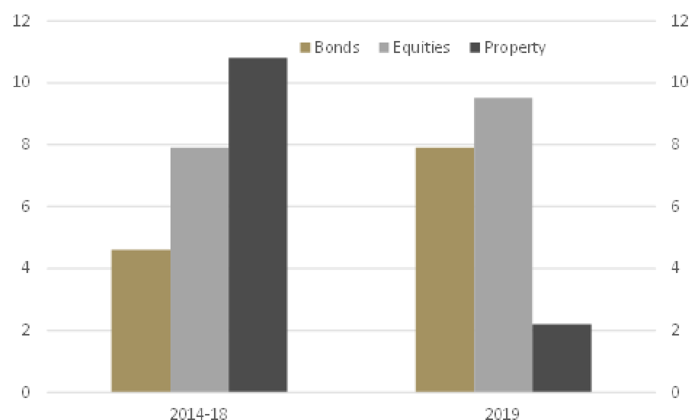
Brexit uncertainty cast a cloud over investor sentiment in 2019 and was reflected in weaker investment totals. Colliers reported that the value of investment totalled £52bn, which was 18% down on 2018. Totals were weighed down by the crisis in retail, which saw severe falls in capital values as investors reduced their exposure, with shopping centre and retail warehouse transactions 80% and 60% below their five-year averages. Nevertheless, the December figure of £9.4bn was the highest monthly total since 2016, reflecting a surge of post-election optimism, though it is too early yet to call a revival.

There were concerns that the market downturn could be amplified by outflows from open-ended property funds, which saw a mass exodus by retail investors. The latest Investment Association data showed there were around £1bn in net outflows in the year to November, although this still did not match the £2bn seen after the 2016 EU Referendum. The large outflows were, in part, due to the downgrade of prospects for retail property over the last year and were also influenced by Brexit and the general election in December. Even though property funds hold significant proportions of cash to guard against withdrawals, several were forced to sell assets to meet redemptions and there were concerns that this could depress the wider market. Nonetheless, the recent volatility may largely reflect political uncertainty, as the anecdotal evidence hints to a reversal after the election.

Accordingly, yields moved out last year as investment in commercial property slowed. As reported by CBRE, all-property equivalent yields rose by 21bps in 2019, largely due to the downturn in the retail sector. Prime regional shopping centre and prime high street yields increased by around 75bps and 50bps in 2019. On the other hand, yields for the industrial and office sector remained stable last year. Despite this, CBRE reported that capital values fell 3.2% last year at an all-property level due to declines in retail, while values for the industrial and office assets grew by 2.5% and 2.1% respectively.

As a result, UK commercial property saw relatively weak returns in 2019. CBRE reported that all-property total returns totalled 2.2% in 2019, which was the lowest since 2012. By contrast, returns for other assets fared better. Total returns for equities (9.5%) and bonds (7.9%) were significantly higher than property last year, which was not the case in the five years to 2018 when real estate comfortably outperformed (see Chart 2).

2.0 Returns for Bonds, Equities and Property (%)



Source: Refinitiv, CBRE

London Property Market

Investment activity was subdued across the UK, including West End and City offices last year. According to Savills, West End investment values totalled £5.1bn in 2019, 33% below down on 2018. Similarly, the City activity in 2019 was 32% below the previous year and totalled £8.2bn. But both markets reported a significant increase in activity in December, which could be a sign of optimism after the UK's general election, though as noted one strong month's data is not enough to call an upturn.

The London office occupier market experienced a mixed year in 2019. Despite a 16% drop on a very strong 2018, West End take-up was 3.8m sq. ft in the year to November, surpassing the 10-year average of 3.5m sq. ft. Savills expects an annual total of 4.2m sq. ft. and report that 1.7m sq. ft. was under offer at the end of 2019, 12% up on the average for the past two year, which could provide a boost to take-up in Q1 2020.

The vacancy rate in the West End remained at 4%, as office supply fell from 4.8m sq. ft. at the start of the year to 4.5m sq. ft. in November, according to Savills. This resulted in an increase in office grade A rents by 3% to £79 per sq. ft. over the same period. However, supply is expected to be constrained next year, which would apply further pressure on rents.

In contrast, City offices remained comparatively robust. City office take-up was 6m sq. ft. in the year to November and Savills estimates that the year-end was around 6.4m sq. ft. This would mean that take-up would be 11% above the 10-year average. Active demand in 2020 remains positive and was indicated by the willingness of tenants to pre-let significant amounts of space last year. Flexible office providers continued to account for a significant proportion of City of London take-up, at 26% in 2019 as well as a 17% share in the West End (see Chart 3).

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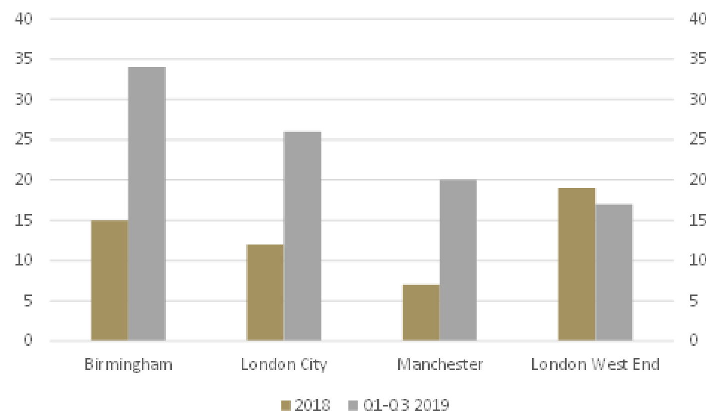
3.0 Flexible office take up as a % of total



Source: Savills

4.0 Logistics Take-Up (M Sq. Ft.)

Source: Savills

Nevertheless, Savills reports that supply increased from 6.7m sq. ft. at the start of year to 6.9m sq. ft. in November, and that the vacancy rate in the City rose from 4.9% to 5.2% over that period. As the market tipped slightly more in favour of tenants, grade A city office rents fell to £63.30 per sq. ft., from £64.66 per sq. ft. during 2019.

Regional Property Market

In 2019, regional office take-up was weaker than in 2018, but still in line with 10-year average. According to Avison Young, take-up in the “Big Nine” regions fell 19% from a strong 2018 to 8.8m sq. ft. in 2019. The supply of regional offices remained constant in 2019, with 5.8m sq. ft. under construction, of which 56% has been pre-let. Cushman & Wakefield reported that the vacancy reduced from 7.3% at the start of the year to 7% by the end of Q3. And, as there is a lack of speculative space in the development pipeline, vacancy rates are expected to stay relatively low.

Notably, flexible office providers took a higher proportion of space in some of the regional markets. In Birmingham and Manchester in the year to Q3 2019, the share of flexible space in take-up was twice as high as in previous years, at 34% and 20% respectively (see Chart 3).

Regional industrial and logistics demand held up. Savills reported 26.3m sq. ft. of space was taken last year, though this was slightly down from an exceptionally strong 2018 (see Chart 4). The Midlands witnessed robust demand once again, chiefly in build-to-suit schemes. Nevertheless, there was also a pick-up in supply in the regions, most notably in the East Midlands, Yorkshire & Humberside, South West and East of England and this resulted in a 39bps rise in the national vacancy rate to 6.65%.

2020 Outlook

In 2020, the UK commercial property market is expected to see a slight improvement. However, the UK economy is expected to be slow moving with just 1.1% GDP growth according to Consensus Economics. Given this and the challenges still facing retail, any property recovery is likely to be muted.

As the UK attempts to negotiate a trade deal by December 2020, uncertainty about future arrangements will linger throughout the year. This, and the subdued outlook for returns, are expected to affect the level of exposure firms will want to the UK property. December’s Thomson Reuters Asset Allocation Poll reported that firms have reduced the proportion of their global portfolios that they want in UK property from 3.1% on average in 2017-2018 to about 2% by end-2019 (see Chart 5).

5.0 Thomson Reuter's Poll - Property Allocation (%)

Source: Thomson Reuter

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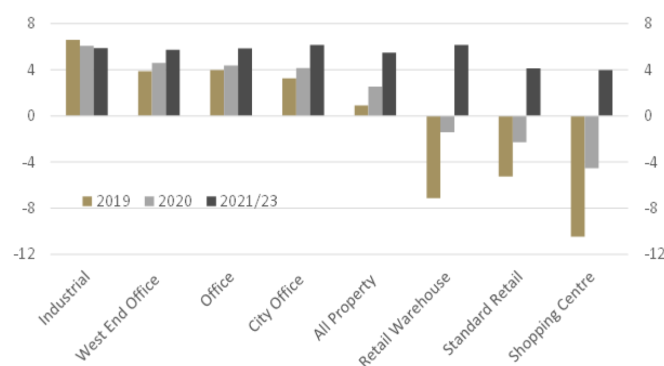
Recent indicators suggest that the UK economy has remained subdued, notably a fall in GDP of 0.3% m/m in November and a drop to 1.3% y/y in the December inflation rate. The latter was well below the Bank's 2.0% inflation target and the Monetary Policy Committee is likely to consider cutting rates from 0.75% to 0.5% at their January meeting. True, a cut would potentially make UK property more appealing in relative terms, but given the underlying uncertainties, any impact on yields is likely to be marginal.

This weaker outlook for the economy will likely restrain rental growth. Rental values are expected to fall slightly in 2020, albeit less so than in 2019. According to the latest IPF Consensus survey, all-property rental values are expected to decline by 0.2% y/y this year. And the main reason for this is a 3.6% y/y decline in retail rental values.

This drop is offset by better prospects for industrial and office rents, which are predicted to grow by 2.3% y/y and 1% y/y in 2020, albeit both slightly slower rates than last year. It is worth noting that the IPF survey was taken before the election when EU withdrawal remained highly uncertain, though, as noted, this unease has now been replaced by concerns about future trading arrangements.

The latest IPF Consensus view is that all-property total returns will be 2.5% in 2020, which is higher than the estimated year-end for 2019, but still low by historical standards. The retail sector is expected to weigh on all-property returns in 2020 once again, with returns predicted to be negative until at least 2021 (see Chart 6).

6.0 IPF Total Return (%)



Source: IFA

In this cycle, historically low yields have pushed investors from traditional sectors, such as retail and office, and towards alternative assets, such as residential, healthcare and student housing. As long-term demographic trends support the underlying demand for these assets, this trend is expected to continue. Indeed, PWC and Urban Land Institute reported that respondents rank retirement and assisted living, co-living and student accommodation highly for investment prospects in their Emerging Trends Europe Survey 2020. In fact, many respondents deemed 'anything related to a bed' as a good defensive strategy against political and economic headwinds, although this interest has meant that yields are now at new lows in many alternative sectors. As a result, investors are likely to have pricing concerns going forward, even for these assets.

A weak outlook for returns does not bode well for investment, with transaction expected to remain close to the subdued levels of last year. In part, this will reflect investor caution on whether the UK could fall hit a cliff-edge after trade negotiations, which are likely to drag for most of the year. And, concerns over the pricing of assets will remain at the forefront of discussions, as stretched valuations deter investors from bidding prices higher.

Most notably, investment in the retail sector is expected to remain very weak, though this could also provide for opportunistic investors seeking deep discounts. But there may be other reasons not to be too gloomy. For one, the INREV investment intention survey for 2020 reports that investors plan to invest €98bn in real estate globally, up from the €72bn expected in 2019. And within that the UK remains in the top three preferred European destinations for investors.

Indeed, investors will go into 2020 with a little more optimism than in the previous year. Given the uncertain environment, investors are expected to look increasingly for defensive assets with long and secure income streams, though these will be at a premium. Those seeking higher returns are likely to turn to assets in the alternative sector that are supported by long-term trends.

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