Top Five

- Economic activity has weakened, with the latest PMIs suggesting the euro-zone has fallen into recession, with the UK set to follow suit. However, there have been growing signs that we are at the turning point in global inflation.
- Central London office occupier activity had a good first half of the year. Strong demand however failed to prevent a further rise in availability, and the office supply pipeline remains full with next year's total completions estimated to be the highest since 2003.
- Even as the economy has slowed, industrial demand in the UK has so far held up. The boost to take-up primarily occurred outside the South-East and London. However, that reflects a lack of supply rather than demand and developers are now responding to tight market conditions. Speculative space under construction is at its highest since at least 2012.
- In contrast to Central London, regional office markets have seen a slowdown in take-up in recent months. And unless activity picks-up markedly in the second half of the year 2022 is on track to see a lower level of take-up than in 2020. But regional industrial occupier activity was robust and accounted for over 80% of total UK industrial take-up in Q2.
- Total UK investment volumes dropped back for the second quarter in a row in Q2, and office investment was at its lowest since 2020 Q4, driven by a sharp fall in Central London office investment. In contrast, Rest of UK office investment recovered from a very weak Q1 to reach the largest quarterly figure since the end of 2018.

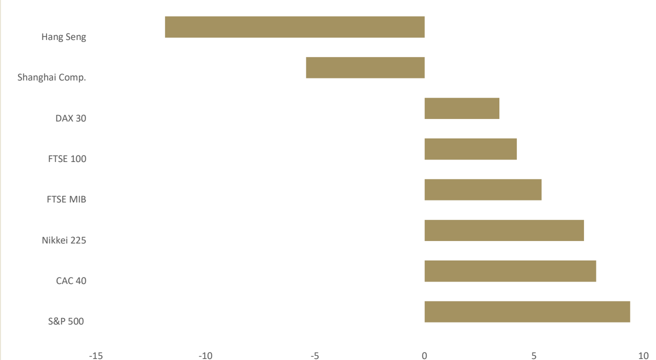
1. Economic Overview

August's flash PMIs suggest that global activity has weakened considerably, and, at face value, suggest that the euro-zone has fallen into recession. What's more, the forward-looking components of the PMIs point to further falls in output ahead.

That said, there have been growing signs that we are at the turning point in global inflation. The one bit of good news from the PMIs was the further evidence that supply chain disruptions are easing in advanced economies. Moreover, shipping costs are down both in year-on-year and level terms, while product shortages have alleviated as softer demand and fewer bottlenecks have opened up spare capacity.

Building disinflationary pressures in the US have given a boost to equity markets, with the S&P 500 seeing largest gain over the past 40 days (see Chart 1).

Chart 1: Change in Selected Major Equity Market Indices over the Last 40 Trading Days to 24/08/22 (%)



Source: Refinitiv

But price indices are still high by historical standards. And the recent renewed surge in European natural gas prices suggests that inflation in Europe will stay higher for even longer. Accordingly, we expect central banks to press on with tightening policy in the coming months despite the weak outlook for activity.

In China, the economic rebound following the hit from lockdowns looks to have petered out in July. And despite increased policy support, growing headwinds will continue to weigh on the economy during the remainder of the year. Vast swathes of industry are at risk of shutting down if the recent energy crunch in some areas spreads. What's more, global demand for Chinese exports is likely to weaken amid rising living costs elsewhere and a reversal in pandemic-induced shifts to consumption patterns.

A 0.9% annualised fall in US GDP in the second quarter was partly due to a huge drag from inventories and doesn't mean the economy is currently in recession. And after a year-long contraction in real disposable incomes, the sharp declines in energy prices over recent weeks are finally providing some relief. For example, consumer prices were unchanged in July and there's a good chance that prices will fall outright in August. Alongside continued strong employment growth, it is likely that the drop in retail gasoline prices to below $4 per gallon, from a peak of above $5, helped drive a solid rebound in real disposable incomes in both July and August.

The second estimate of euro-zone GDP in Q2 confirmed that the economy grew at a decent pace in the first half of the year. However, the construction sector is already shrinking and looks set to suffer as the ECB tightens. And the timelier activity surveys for the economy as a whole have taken a marked turn downwards.

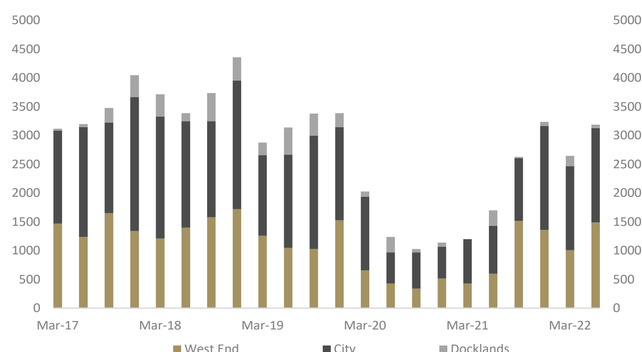
The 0.6% m/m drop in GDP in June in the UK was mostly due to the adverse effect of the extra Jubilee bank holiday. Even so, the GDP figures confirmed that the economy contracted by 0.1% q/q in Q2 as a whole. Admittedly, unlike those in the euro-zone and the US, the UK PMI stayed above the boom-bust level of 50.0. But with the latest surge in wholesale gas prices set to boost inflation even further above the 10.1% it reached in July, it is probably only a matter of time before the activity PMIs start ringing the recession alarm bell. However, given the strength of recent earnings and retail spending data, the Bank looks set to deliver a second 50bps interest rate hike in September.

2. London

2.1 Occupational Market

Central London occupier activity had a good first half of the year. Knight Frank data indicated that Central London office take-up rose to 3.2m sq. ft. in Q2, although still means that underlying demand is slightly below its pre-pandemic averages (see Chart 2). Take-up in the City totalled 1.64m sq. ft., with the largest deal a 218,630 sq. ft. lease by Kirkland & Ellis at 40 Leadenhall Street. This was followed by a 75,897 sq. ft. deal in the same building. In the West End, take-up was 1.49m sq. ft., with a 220,000 sq. ft. lease in Paddington Square by Capital International the largest deal.

Chart 2: Central London Office Take-Up (M. Sq. Ft.)



Source: Knight Frank

Strong demand, however, failed to prevent a further rise in availability to 20.41m sq. ft. And the vacancy rate inched up to 8.3%, which is the highest since 2010. Moreover, the office supply pipeline remains full according to CBRE, with next year's total completions estimated to be the highest since 2003. Moreover, of the 7.1m sq. ft. set to be completed next year, around 75% of it is still available (see Chart 3).

The retail sector will be hit by the cost-of-living crisis. Indeed, surging inflation and higher interest rates have pushed consumer confidence to a record low, and that means consumer spending and retail volumes are likely to contract in the coming quarters. And even after demand recovers, there will also be ongoing structural challenges, in particular the permanent leakage of high street demand to online. This share has trended steadily down since last year, but at the current 25% of sales it remains several points above its long-term trend. As pandemic effects recede, the share is likely to stabilise before drifting upward again over the long-term. That said, retail property is emerging steadily from its long slump and rents are finally starting to rise.

Chart 3: Central London Development Pipeline (M. Sq. Ft.)

Source: CBRE

Even as the economy has slowed, industrial demand has so far held up. However, according to CBRE, the boost to take-up primarily occurred outside the South-East and London. Indeed, take-up there dropped back by 27% q/q in Q2 to 1.6m sq. ft. However, agents report that is not due to a moderation in demand. Rather, a lack of available space has constrained the market. That said, developers are responding to tight market conditions, with speculative space under construction increasing to 2.8m sq. ft., the most since at least 2012.

2.2 Investment Market

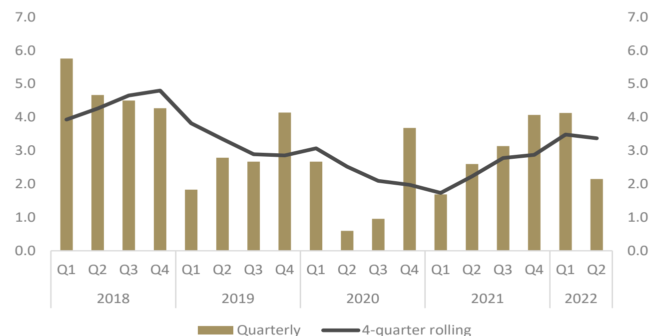
According to Lambert Smith Hampton, total UK investment volumes dropped back for the second quarter in a row in Q2, falling to £15.7bn from £16.7bn in Q1. That said, volumes are still high by past standards. Indeed, £32.4bn is the highest H1 total since 2015. Within the total, office investment dropped back to £4.4bn, the lowest amount since 2020 Q4.

It was a sharp drop in Central London office investment which drove that decline, almost halving from £4.13bn in Q1 to £2.15bn in Q2. (See Chart 4.) There were only six deals in excess of £100mn in Q2, compared with 14 in Q1. That said, while not counted as an office deal, Derwent London plan to develop the £239m purchase of the Moorfield Eye Hospital site into a business campus.

Knight Frank reported £4.18bn worth of retail investment in Q2, a 157% q/q rise from Q1. And Q1 prime retail yields for Bond Street and Oxford Street remained unchanged compared to the previous quarter at 2.75% and 3.5%, respectively.

Overseas tourists and hotel demand should also see a further recovery. After all, in April, overseas visitor numbers were still 40% below their pre-COVID-19 level. Admittedly, many countries are struggling with their own high rates of inflation, which may cut overseas visits. But a weak pound should partly offset that impact.

Chart 4: Central London Office Investment (£)



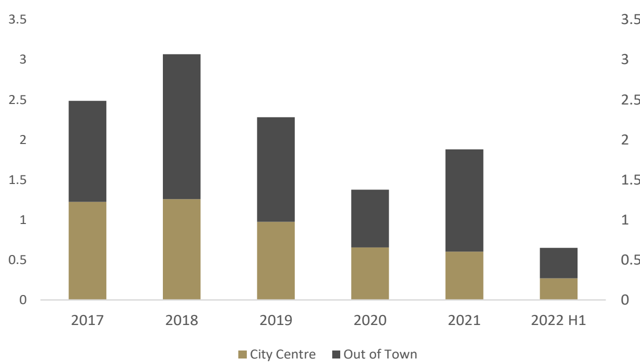
Source: Lambert Smith Hampton

3. Rest of UK

3.1 Occupational Market

Regional office markets have seen a slowdown in take-up in recent months. According to Avison Young, take-up in the 10 major South East submarkets fell by 4.3% q/q in Q2 to 317,000 sq. ft. That leaves take-up down 30.5% y/y, and unless activity picks-up markedly in the second half of the year 2022 is on track to see a lower level of take-up than in 2020 (see Chart 5). That weakness in demand likely reflects a faltering economy and labour market and the shift to working from home.

Chart 5: South East Office Take-Up (M. Sq. Ft.)



Source: Knight Frank

Key transactions in Q2 included TechData taking 51,764 sq. ft. at Maplewood, Basingstoke and Labcorp taking 16,477 sq. ft. at B5 Foundation Park in Maidenhead.

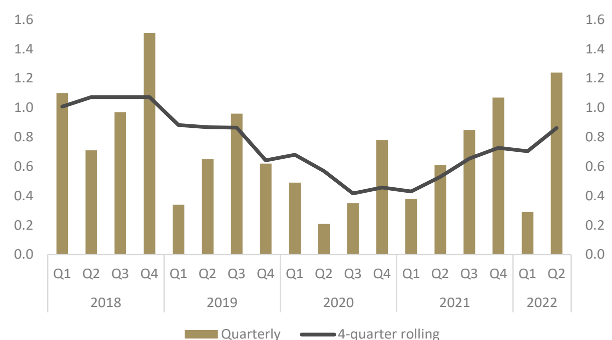
Regional industrial occupier activity accounted for over 80% of total UK industrial take-up in Q2, with 39 deals completed. The West Midlands had a particularly strong quarter, with take-up reaching 3.5m sq. ft. across 14 deals. That take-up was mostly made up of speculative and BTS space, with third party logistics taking up 43% of the space. Meanwhile the North West more than doubled Q1's take up levels, and Yorkshire and the North East also saw a significant increase in take-up.

Strong performance has led to a robust supply response. Space under construction increased to a record high of 33.1m sq. ft., up 17% from Q1. The increase was driven by BTS construction, with speculative space holding steady. The East Midlands had the most space under construction at end Q2, at around 10.3m sq. ft. split evenly between BTS and speculative projects. At the other end of the spectrum the South West had under 1m sq. ft. of space under construction.

3.2 Investment Market

According to Lambert Smith Hampton, Rest of UK office investment recovered from a very weak Q1 to reach £1.24bn, the largest quarterly figure since the end of 2018. (See Chart 6.) The headline deal was Blackstone's £182m acquisition of Colmore Plaza, Birmingham. Investment in the South East office market also ticked up, but the rise to £530m was less impressive.

Chart 6: Rest of UK Office Investment (£bn)



Source: Lambert Smith Hampton

Rest of UK industrial investment had another strong quarter in Q2, rising to £970m. That marks the third consecutive quarter of investment close to £900m, compared to an average of £500m from 2016 to 2021. The largest single asset deal was Realty Income's £105m purchase of a Tesco distribution hub in Avonmouth.

For more information:

Please contact Sarah White;

sw@rivercap.co.uk