Top Five

- Recent resilience in economy activity in many countries in unlikely to last, as higher interest rates squeeze consumers and cut investment. Central banks in the UK, US and euro-zone are set to raise interest rates further over the coming months. But inflation is now showing signs of softening in the US and has likely peaked in the UK, although it won't fall very fast.
- Central London office occupier activity held up well in Q3. But demand is still not matching new supply and as a result availability and vacancy rates saw further gains. At 8.6%, the Central London office vacancy rate is at a 12-year high and 2022 will see the largest amount of space completed since 2017. It should be noted, however, that most of this is sub-prime stock and that prime stock remains in relatively short supply.
- Industrial demand is starting to moderate following a period of record-breaking take-up. The South-East and London also face constraints from a lack of ready-to-occupy space, leading to a steady fall in take-up. The UK industrial pipeline is full, with space under construction increasing in Q3 to another record high, driven by speculative space.
- Take-up across the Big 9 regional office markets ticked-up in Q3, but all of the cities underperformed their 10-year average, with the exception of Manchester. But the Big 9 pipeline is relatively tight compared to London.
- Rising interest rates and a slowing economy are weighing on investor sentiment. Total investment volumes saw a sharp decline in Q3, to their lowest since Q3 2020. Central London office investment stabilised in Q3, but at a level 17% below trend, with London retail and industrial investment falling back. After a strong Q2, Rest of UK office investment dropped back in Q3 to where it was in Q1.

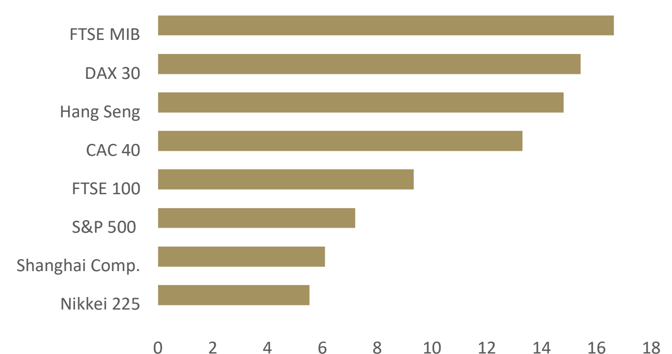
1. Economic Overview

Many of the Q3 GDP releases of early-reporting economies have beaten consensus expectations in the past few weeks, especially in Europe. Not only did energy-crisis-laden Germany grow in Q3, rather than contract as expected, but the economy managed to pick up a little pace compared to the previous quarter. And while it came in close to consensus expectations, GDP in the US and China rebounded in Q3 after contractions in Q2.

However, more recent evidence suggests that this resilience is unlikely to last. China is contending with another wave of virus infections and restrictions, the US economy is bending under the weight of higher interest rates, and the business surveys in the euro-zone point to a bleak few months ahead.

A soft US CPI print in October boosted equities, with the S&P 500 seeing its 15th largest one-day gain since the mid-1960s. Over the past 40 days euro zone markets have seen the largest gains, led by Italy and Germany (see Chart 1). However, those are at risk from as the world economy slips into recession.

Chart 1: Change in Selected Major Equity Market Indices over the Last 40 Trading Days to 07/12/22 (%)



Source: Refinitiv

The 2.6% annualised rise in third quarter US GDP was worse than it looked, with growth in underlying demand grinding to a near-halt. But that economic weakness will soon feed through to disinflation in core services. Indeed, the October CPI report showed that the widespread disinflationary pressure evident in surveys and other private-sector measures is finally feeding through. The 0.4% m/m fall in core goods prices has further to run as easing shortages and the stronger dollar feed through.

The October CPI report makes it more likely that the Fed will slow the pace of tightening to 50bp at the next FOMC meeting in mid-December. Futures markets are also pointing to a lower peak in the fed funds rate next year. Markets did have the peak in rates at 5.14% next June but, post-CPI, that peak is now at around 5%.

Euro-zone GDP posted a small expansion in Q3, and most of the data for September showed that the economy ended the quarter on a high note with retail sales and industrial production both rising on the month. Auto production has increased particularly rapidly since March as global semiconductor shortages have eased. But the rebound in car production will not be enough to offset the declines in output in other industrial sectors in Q4. And the construction sector – which accounts for just over 5% of output – is already in recession. As in the US, euro-zone inflation edged back in November, from 10.6% to 10.0%.

In the UK, about half of the 0.6% m/m fall in real GDP in September and half of the 0.2% q/q decline in Q3 as a whole was caused by the one-off reduction in the number of working days due to the extra bank holiday for the Queen's funeral. But after stripping that out, real GDP still declined in Q3 and that likely marks the start of a recession.

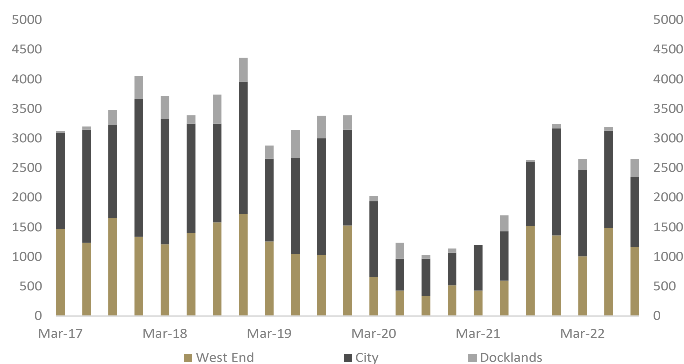
In his Autumn Statement, the Chancellor, Jeremy Hunt, appears to have pulled off the tricky task of reassuring the financial markets of the government's fiscal discipline, while also managing not to deepen the recession. The overall tightening in fiscal policy means that interest rates may not need to be as high as otherwise over the next five years. But with most of the fiscal tightening not taking place until 2025/26, the Bank of England will still need to raise interest rates over the next six months to reduce inflation from 11.1% to the 2% target.

2. London

2.1 Occupational Market

Central London occupier activity held up well in Q3. According to Knight Frank total take-up edged down to 2.65m sq.ft., a level unchanged from a year earlier (see Chart 2). There was an even split in demand between the City and West End, while the 300,000 sq.ft. take-up in the Docklands was the largest in three years. That was supported by a 50,273 sq.ft. lease by Boston Consulting Group at Cargo, 25 North Colonnade. The largest deal in Q3 was in the West End with a 213,995 sq.ft. lease by Blackstone at Lansdowne House, followed by a 60,601 sq.ft. lease in the City at Premier Place by Jane Street Group.

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

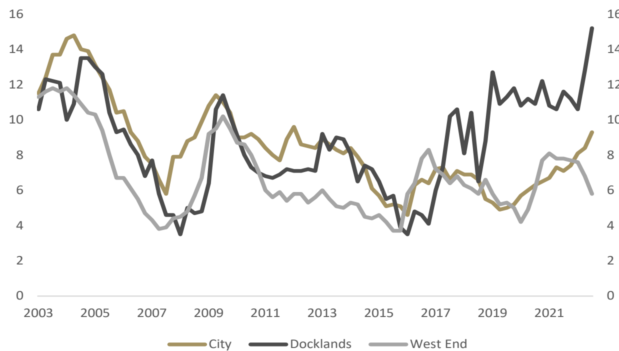


Source: Knight Frank

But as was the case in the previous quarter, demand is not matching new supply and as a result availability and vacancy rates saw further gains. Indeed, at 8.6%, the Central London office vacancy rate is at a 12-year high. But there is a notable divergence between the submarkets, with West End vacancy recently trending down (see Chart 3). There is also a divergence between prime and sub-prime space, with the vast majority of space available being lower quality. Prime space remains in relatively short supply.

London office markets are set to loosen further as weakening demand, due to a decline in employment, runs up against a substantial pipeline. Knight Frank reports that 2022 will see the largest amount of space completed since 2017. And 2023 is set to exceed that with over 6m sq.ft. under construction, the majority of which is speculative (see Chart 4).

Chart 3: Central London Office Vacancy Rates (%)



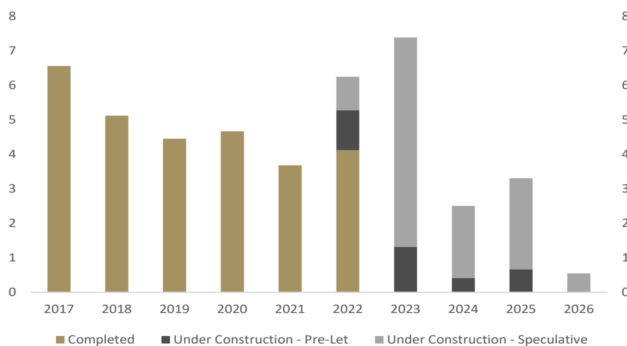
Source: Knight Frank

2.2 Investment Market

Rising interest rates and a slowing economy are weighing on investor sentiment. Total investment volumes saw a sharp decline in Q3 according to Lambert Smith Hampton, with the £10.59bn invested the lowest since Q3 2020. All sectors saw a fall, with total office investment declining for the third month in a row to £3.33bn.

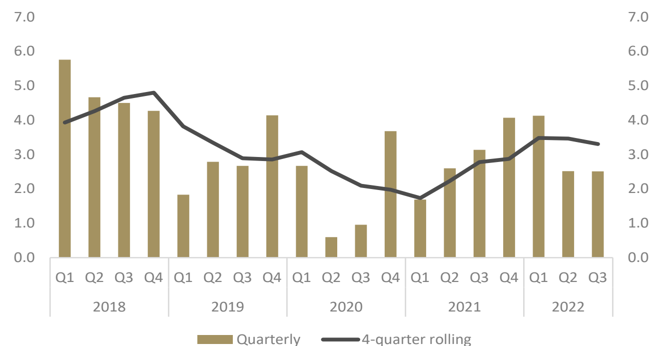
After a large drop in Q2, Central London office investment stabilised in Q3 at £2.51bn. (See Chart 5.) But that was only due to TCorp's £809m purchase of 21 Moorfields from Land Securities. Otherwise it was a subdued quarter, with volumes 17% below trend and just eight deals above £100m.

Chart 4: Central London Development Pipeline (M. Sq.



Source: Knight Frank

Chart 5: Central London Office Investment (£bn)



Source: Lambert Smith Hampton

High inflation is weighing on consumer spending, with retail sales volumes down by 4.5% since January. But the London retail sector has been stable in recent quarters. Google Mobility data shows footfall in Greater London has been steady since the start of the year, although still down 25% compared to its pre-pandemic average. That is reflected in retail vacancy rates, which according to CBRE have remained unchanged at 10.2% in Greater London in the year to Q3 2022, slightly under the UK average of 11.5%.

Industrial demand is starting to moderate following a period of record-breaking take-up. The South East and London also face constraints from a lack of ready-to-occupy space. That is leading to a steady fall in take-up in the region. Following a 27% q/q drop in take-up in Q2, CBRE reported take-up of 1.25m sq.ft. in Q3, down a further 22% q/q.

Central London retail investment also fell back in Q3, with Knight Frank reporting £513m worth of deals, from just under £1bn in Q2. That total was split evenly between the West End and Midtown markets, with no activity reported in the City. In the West End, NFU Mutual acquired 51-54 Long Acre for £32m. Yields were once again stable at 2.75% on Bond Street and 3.5% on Oxford Street. That compares to 6.25% for Prime UK High Street.

After an average of £1.9bn over the first two quarters of the year, Knight Frank report that industrial investment in London and the South East dropped back to £1.3bn in Q3. But at around £5bn transactions YTD are 19% ahead of last year. Prologis UK acquired two properties from Schroder's Capital in Park Royal and Watford for a total of £200m.

Hotel transactions have been strong so far in 2022 at £2.4bn, driven by London. To date £900m has been invested in London, including Crimson Hotels' £130m acquisition of the Trafalgar Square Hotel in August.

3. Rest of UK

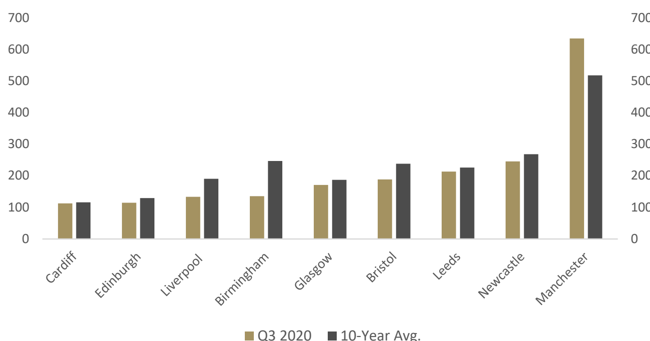
3.1 Occupational Market

Take-up across the Big 9 regional office markets ticked-up in Q3 to 1.9m sq.ft. according to Avison Young. But all of the cities underperformed their 10-year average, with the exception of Manchester with over 630,000 sq.ft. transacted. (see Chart 6). That performance was driven by two of the biggest out-of-town deals in Q3. A 43,029 sq.ft. deal at Skelton House for Yourgene Health and a 18,852 sq.ft. transaction at Mulberry House for the NHS. Newcastle also performed relatively well with 133,000 sq.ft. transacted, led by a 18,000 sq.ft. deal at 13 Trinity Park for Tarmac Trading.

Regional office markets will be not immune to the hit from the recession, but tend to be less cyclical compared to London. The long-term structural effects are also likely to be less of a drag, with the potential to work remotely generally lower thanks to shorter commutes and a sector mix that is less favourable to homeworking.

The Big 9 pipeline is also relatively tight compared to London. A total of 4.1m sq.ft of developments are expected to complete between 2023 and 2025, a third below what was completed in a single year in 2009.

Chart 6: Big 9 Office Take-Up (M. Sq. Ft.)



Source: Lambert Smith Hampton

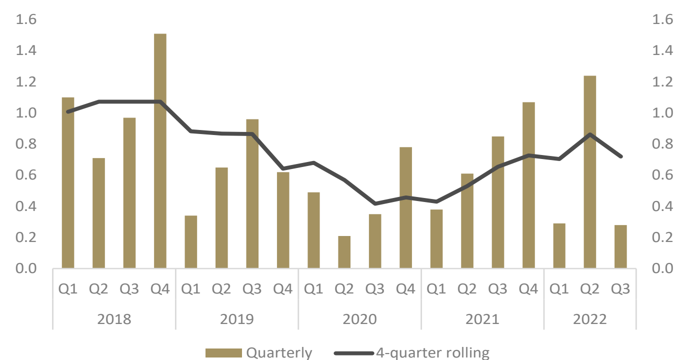
Regional industrial occupier activity dropped back in Q3, although remains above the 10-year average. CBRE reported that year-to-date the West Midlands has seen the largest share of take-up at 21.6%, followed by Yorkshire & North East at 19.4%. Key deals in Q3 included 981,042 sq.ft. in Nuneaton by Rhenus Logistics and 161,900 sq.ft. in Huyton by Yodel.

The UK industrial vacancy rate ticked-up in Q3 to 1.32% from 1.18%, due to a rise in ready-to-occupy space. The pipeline is full, with space under construction increasing 8% q/q to 35.7m sq.ft. in Q3, another record high. The rise was driven by speculative space, with build-to-suit seeing only a marginal increase. The East Midlands had the most BTS and speculative space under construction, with Scotland the least.

3.2 Investment Market

After a strong Q2, Lambert Smith Hampton reported a sharp fall in Rest of UK office investment to £276m in Q3, the lowest since Q2 2020 (see Chart 7). That figure included £105m by PIC for First Street North, Manchester.

Chart 7: Rest of UK Office Investment (£bn)



Source: Lambert Smith Hampton

For more information:

Please contact Sarah White;

sw@rivercap.co.uk