Top Five

- Recessions in advanced economies were avoided last year and so it looks like they will commence a little later than initially envisaged. But the full force of monetary tightening is yet to be felt and contractions are still likely in the US, UK and euro-zone.
- Central London occupier activity is starting to cool as the economy slows, with office take-up in Q4 10% below its 10-year average. That drop in demand is leading to a rise in availability, particularly of second-hand space. And a lot of new space is set to hit the market in 2023, which will push up vacancy further.
- Bucking the trend, industrial demand ticked-up in Q4, with the South East seeing the most deals. But a drop in take-up over the second half of last year helped South East availability to improve. A strong supply response is also easing market tightness, with a doubling of under construction and completed buildings over the year.
- Slowing office demand was also evident outside of London. Take-up in the South East fell 27% q/q in Q4 and was 28% below the five-year average. UK regional office availability was stable in Q4, but as with London there is a sizable pipeline with 3.4m sq.ft. due to be completed in 2023, of which 60% is speculative.
- Total investment volumes had a very weak end to the year, as rising interest rates, a slowing economy and concerns around capital values all hit investor sentiment. Investment volumes in Q4 were down around 60% y/y. Within that total London office investment has seen a particular large decline, with just a handful of small deals totalling £300m and down 93% on a year earlier.

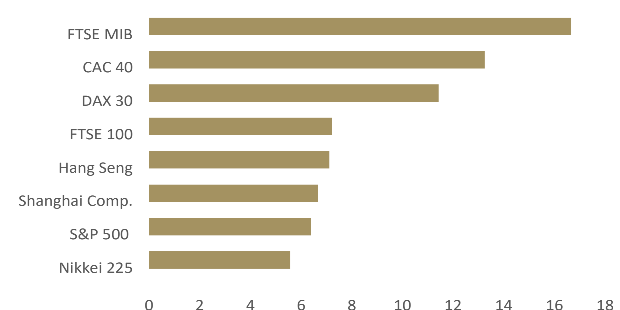
1. Economic Overview

A raft of strong data out of the US have poured cold water on the idea that its economy has tumbled into recession at the start of 2023. And this comes after GDP data revealed that the euro-zone and UK economies (narrowly) avoided outright contraction in Q4. In addition, there has been a clear turnaround in the business surveys and further evidence that, if anything, labour markets have tightened in the past couple of months.

Accordingly, it looks like recessions in advanced economies will commence a little later than initially envisaged. But they are unlikely to be avoided. After all, the full force of monetary tightening is yet to be felt. Higher interest rates have weighed heavily on credit growth and the latest bank lending surveys generally point to further falls in demand for loans and tightening of credit conditions for firms and households, which are consistent with even weaker credit growth. This is likely to take its toll on activity in the months ahead. And to the extent it doesn't, that will just raise the risk that monetary policy is kept tighter for longer.

In the US, there was an unexpectedly large increase in payroll employment in January, and retail sales and manufacturing output data were unquestionably strong too. Even allowing for some reversal in February, the economy will probably avoid a recession in the first quarter. That brightening outlook helped the S&P 500 make some gains over the past 40 days, although the rise of 6.4% meant it underperformed most other countries (see Chart 1).

Chart 1: Change in Selected Major Equity Market Indices over the Last 40 Trading Days to 16/02/23 (%)



Source: Refinitiv

That might reflect that with the impact of higher rates and tighter credit conditions still gradually mounting, a modest decline in GDP in the second and third quarters is likely, which will be accompanied by a modest rise in the unemployment rate too. And even under those circumstances, there is a risk that rather than just hiking rates by 25bp in March, the Fed might follow that with another hike at the early May FOMC meeting too.

The second estimate of Q4 GDP in the euro-zone was unchanged, with growth slowing from 0.3% q/q in Q3 to 0.1% q/q, leaving the economy 2.4% above its pre-covid level and 1.9% larger than in Q4 2021. Growth slowed in most of the larger countries and output contracted in Germany and Italy. The euro-zone labour market remains in rude health, with employment growing by a stronger-than-expected 0.4% q/q in Q4. But here are clear signs in the money and credit data, and in the Q4 bank lending survey that past monetary tightening is starting to bite. That drag is set to intensify in the coming months and a recession is likely in the first half of 2023.

In the UK, core services inflation fell further than the Bank of England had anticipated, from 6.8% in December to 6.4% in January. Private sector regular pay growth was a bit stronger than expected, but the Bank will have been reassured to see the three-month annualised rate and the core services CPI both fall sharply. That implies there may not need to be many further interest rate hikes.

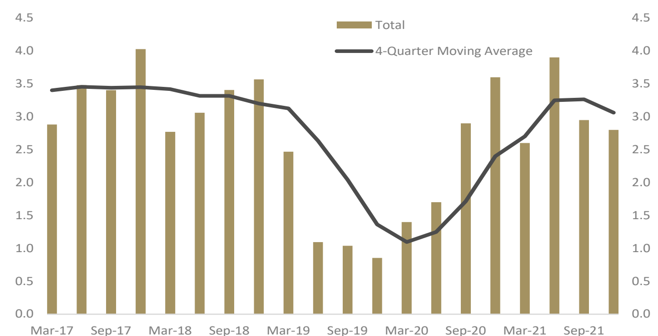
That said, the moderation in inflation comes against the background of economic resilience in the UK and a stronger global backdrop. And if there is one lesson to learn from the US, where seasonally-adjusted core CPI has accelerated again, it's that it won't be a smooth path back to the 2.0% inflation target. Moreover, with the UK unemployment rate unchanged at 3.7% in December, the labour market remains exceptionally tight. This perhaps means inflation is falling for other reasons aside from the tight labour market, such as a reduction in short-term inflation expectations.

2. London

2.1 Occupational Market

Central London occupier activity is starting to cool as the economy slows. According to CBRE, office take-up in Q4 totalled 2.8m sq. ft., a decline of 5% on the Q3 total (see Chart 2). That level of demand was 10% below the 10-year average. Both the City and West End saw take-up of around 1.2m sq. ft. But whereas demand in the City is 10% below its 10-year average, demand in the West End continues to outperform and is close to 20% above that average. West End demand was led by a 155,400 sq. ft. deal by GSK for The Earnshaw, WC1. In the City, the largest deal in the quarter was for 319,000 sq. ft. at 2 Aldermanbury Square, EC2 by Clifford Chance.

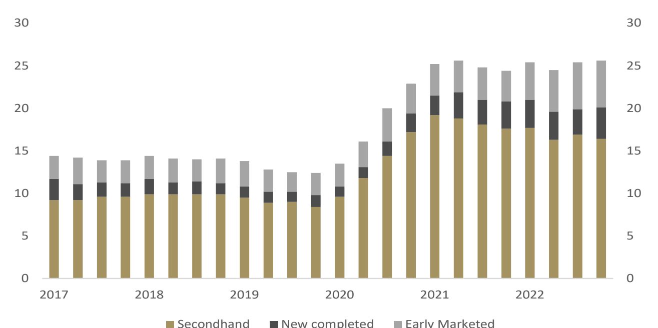
Chart 2: Central London Office Take-Up (M. Sq. Ft.)



Source: CBRE

Demand continues to be concentrated on high quality buildings, with the three largest deals in Q4 all pre-lets for space under construction. The search for quality also means there is a lot of second-hand space on the market. Total availability increased to 25.7m sq. ft. in Q4, matching the previous high seen since 2021. And 64% of that space was second-hand (see Chart 3).

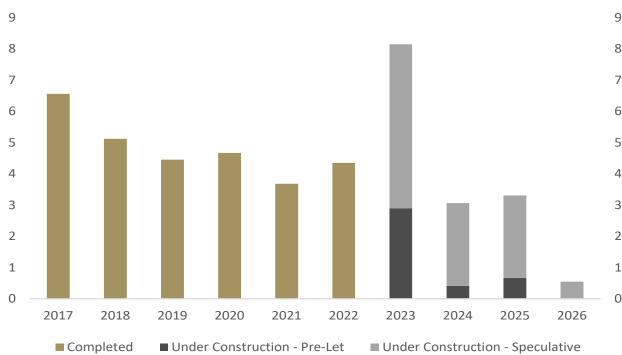
Chart 3: Central London Office Availability (%)



Source: CBRE

London availability is set to rise further as firms cut workforces in response to the recession this year. At the same time, a lot of new space is expected to hit the market in 2023. Knight Frank reports that after 4.35m sq. ft. of completions in 2022, over 8m sq. ft. is in the pipeline for delivery in 2023 (see Chart 4). And around two-thirds of that are speculative developments.

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



Source: Knight Frank

The cost-of-living crisis is weighing on retail sales. Sales volumes did rise 0.5% m/m in January, but that only partly reversed December's 1.2% m/m fall and it leaves sales down by 0.7% over the whole festive period. And that weakness is set to continue, with consumer confidence dropping back in January and the impact of rising interest rates yet to be fully felt.

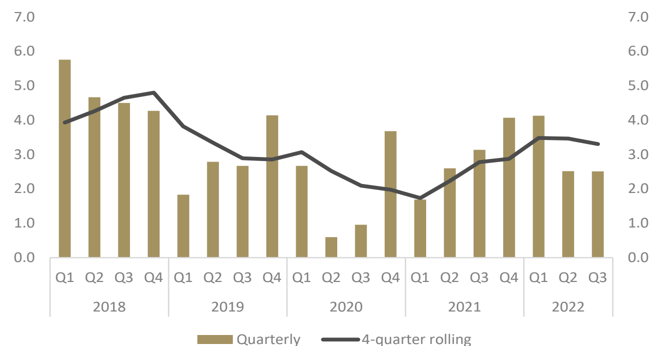
In London, CBRE reported that retail letting requirements in Q4 were lower than in Q3, but there was an increased variety of demand from occupiers including increases in health and beauty, and household good retailers. And significant adjustments to business rateable values following the Autumn Statement are leading to increased demand for retail space.

2.2 Investment Market

Total investment volumes had a very weak end to the year, as rising interest rates, a slowing economy and concerns around capital values all hit investor sentiment. Colliers reported that just £3.2bn was invested in commercial property in November and December, compared to a five-year average of £14.7bn.

Lambert Smith Hampton reported investment volumes in Q4 were down around 60% y/y. Within that total London office investment has seen a particular large decline with just a handful of small deals which totalled £300m, down 93% on a year earlier (see Chart 5).

Chart 5: Central London Office Investment (£bn)



Source: Lambert Smith Hampton

Total retail investment did better in Q4, with a slight increase in Q4 to £1.6bn. That total was helped by a large London deal, namely Fenwick's £430m sale and leaseback agreement of its flagship store on New Bond Street with Lazari investments.

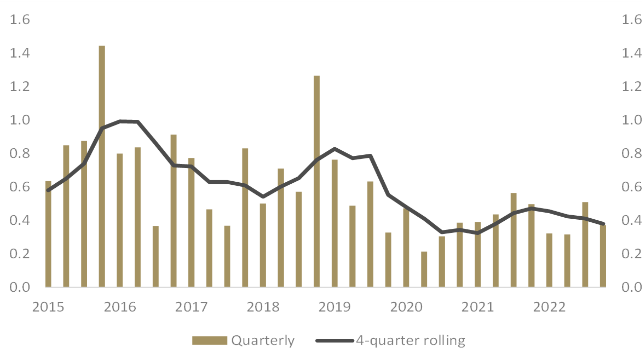
CBRE reported that industrial investment across the UK dropped 59% q/q in Q4 to £1bn. But 10% of that total was accounted for by the £99.2m purchase of Thames Gateway, Dagenham by Boreal IM.

3. Rest of UK

3.1 Occupational Market

Slowing office demand was also evident outside of London. Avison Young reported that take-up in the South East fell 27% q/q in Q4 to 371,000 sq.ft., which is 28% below the five-year average (see Chart 6). And a large part of that demand was due to a single deal in Weybridge, with 115,000 sq.ft. taken by Haleon (GSK) at Brooklands Business Park. The next largest deal was for 23,000 sq.ft. at Exchange House, Milton Keynes for Policy Expert.

Chart 6: South East Office Take-Up (M. Sq. Ft.)



Source: Avison Young

And looking at the wider UK, CBRE reported that take-up in UK regional markets - the largest 10 cities outside of London and the South East - totalled 1.7m sq.ft. in Q4, pushing the total for the year to 5.4m sq.ft., up 12% on 2021. Key deals in the final quarter included 139,200 sq.ft. at 20 Brandon Street, Edinburgh for BlackRock and 54,500 sq.ft. at Trevelyan Square, Leeds for Leeds Trinity University.

UK markets office availability was stable in Q4 at 19m sq.ft., which represents a 4% increase over the year. But in line with London there is a sizeable pipeline. After 1.5m sq.ft. of space was completed in 2022, there is currently 3.4m sq.ft. due to be completed in 2023, of which 60% is speculative.

Industrial demand ticked-up in Q4 according to CBRE. Take-up totalled 8.1m sq. ft., although that compares to an average of 11.1m sq. ft. per quarter in the year to Q2 2022. Within the total South East take-up totalled 2.6m sq. ft. in Q4 across 10 deals, the largest contribution of any region.

Across 2022 around half of industrial take-up in the South East was for speculative developments, with third party logistic occupiers accounting for 34% of all deals. The drop in take-up over the second half of the year is helping South East availability to improve, up 74% y/y to 51m sq.ft. A strong supply response is also helping to ease market tightness, with a doubling of under construction and completed buildings over the year.

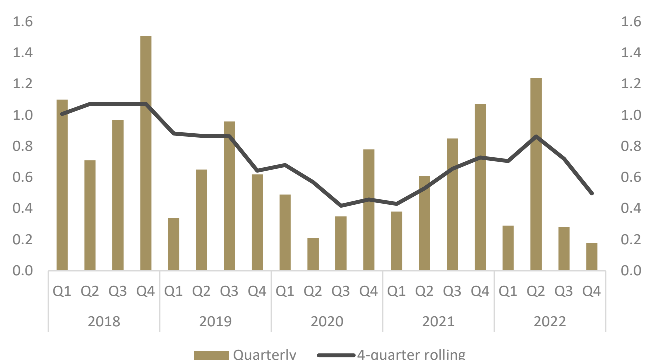
Outside of the South East, Yorkshire and North East saw the largest industrial take-up in Q4. CBRE reported 1.9m sq.ft. of take-up across four deals. But the largest deal in Q4 was in Manchester, with 167,480 sq.ft. taken in Trafford Park for Supreme Imports. Other key deals included 150,935 sq.ft. in Leicester for XPO, and 111,237 sq.ft. in Knowsley for Castore.

The UK industrial vacancy rate ticked-up in Q4 to 2%, from 1.58% at the end of 2021. And although ready-to-occupy space increased by 35% over the year, at 10.1m sq.ft. that still only represents three months of supply at current levels of take-up. The East Midlands, Yorkshire and the North East had the most space under construction at the end of Q4, with Scotland having the smallest pipeline.

3.2 Investment Market

In line with London, Rest of UK office investment saw a sharp contraction in Q4. Just £180m was transacted, an 83% drop from a year earlier (see Chart 7). By contrast, Rest of South East Office investment held up at £320m, essentially unchanged from Q3 and down a relatively modest 37% y/y. Key deals in the region included a £91m for Gunnels Wood Road, Stevenage by UBS/Reef and £85m in Cambridge Science Park by Cadillac Fairview/Stanhope Plc.

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



Source: Lambert Smith Hampton

CBRE reported that outside London key industrial deals in Q4 included Farmfoods, Warrington for £32.1m by Leftfield, and £31.3m for Poundland, Wolverhampton by Boreal IM. Both deals had a net initial yield of around 5%.

For more information:

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