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Quarterly Review: Q1 2023

Top Five

- Q1 GDP releases have confirmed that the major economies avoided recession at the start of the year and some of the more recent survey data suggest that this resilience continued into Q2. But monetary indicators confirm that policy is becoming a stronger headwind to economic activity and that suggests the major economies will struggle to grow in the months ahead.
- Central London occupier activity had a slow start to the year, with office take-up in Q1 down 35% q/q. West End demand is partly being constrained by a tight market, but that is not the case in the City where availability has doubled since 2020. The pipeline for 2023 is at a 20-yer high, which suggests vacancy rates will see a further rise.
- Office demand also fell back in regions outside of London. Take-up in the M25, M3 and M4 markets dropped back 55% q/q in Q1, and beyond the South East take-up in UK regional markets totalled 1.1m sq.ft. in Q1, which was 22% below the five-year average.
- Demand in other property sectors also lost momentum in Q1, with industrial take-up falling to its lowest level since the start of 2021. That said, demand is still elevated relative to its pre-pandemic level. The strong supply response to rocketing demand is helping to ease industrial market conditions. Availability across the UK has more than doubled since Q2 2022.
- The office investment data showed early signs of confidence that the worst of the property downturn is behind us. Central London investment volumes staged a strong recovery in Q1, with the majority of deals occurring in March. That said, the recovery in investment was not matched in the Rest of UK, and retail and industrial investment also fell back in Q1.

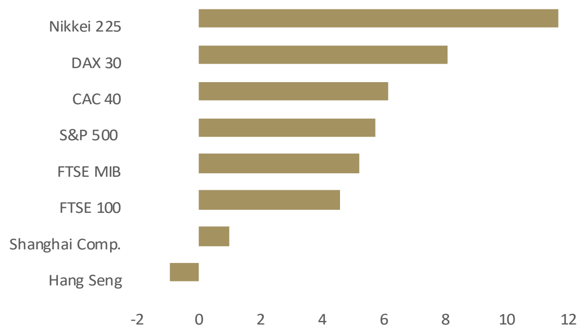
1. Economic Overview

Q1 GDP releases have confirmed that the major economies avoided recession at the start of the year and some of the more recent survey data suggest that this resilience continued into Q2. The composite PMI output index for developed economies rose from 52.6 to 53.7 in April, suggesting not only that growth has remained positive but that it has accelerated. However, it is worth noting that the PMIs have been the most optimistic of the survey indices lately and others such as the US ISM and the euro-zone EC Economic Sentiment Indicator have broadly flatlined at levels consistent with little or no growth. Additionally, monetary indicators confirm that policy is becoming a stronger headwind to economic activity and that suggests the major economies will struggle to grow in the months ahead.

In the US, solid gains in retail sales and manufacturing output in April indicate that the economy remains resilient to the impact of higher interest rates and tightening lending standards. That said, real consumption growth is still likely to slow quite sharply in the second quarter and the latest survey evidence points to a renewed slump in manufacturing output.

Meanwhile, the April CPI data showed the three-month annualised rate of core CPI services (excluding shelter) inflation edged down to 4.0%, half the rate it was 12 months earlier. That was greeted enthusiastically by markets, with bond yields falling and equities rallying. The S&P 500 is up over 5% over the last 40 days, although that performance trails gains in France, Germany and Japan (see Chart 1 overleaf). Easing inflation and a new policy statement from the Fed suggests the fed funds rate has now peaked at 5.00% to 5.25%.

Chart 1: Change in Selected Major Equity Market Indices over the Last 40 Trading Days



Source: Refinitiv

In Europe, the second estimate of Q1 GDP confirmed that the euro-zone economy stagnated over the winter. GDP was confirmed to have grown by 0.1% q/q in Q1 after falling 0.1% in Q4 which is better than the recession that many forecasters were anticipating, but still a meagre performance. And the national breakdowns that have been published so far suggest that domestic demand probably contracted in Q1 with GDP boosted by net exports. At a country level, Germany remained the laggard, whereas Italy and Spain recorded strong growth of 0.5% q/q and France lay in between.

Surveys for April generally pointed to a rise in activity, which suggests the euro-zone may have avoided a contraction in GDP in Q2. But beyond that an increasing drag from higher interest rates means renewed contractions in activity are more likely than not later this year.

The UK economy contracted by 0.3% m/m in March and grew by just 0.1% q/q in Q1 as a whole, meaning the economy dodged a recession. However, lower real household incomes and high interest rates are still acting to dampen activity.

The latest 25bps rise in interest rates from 4.25% to 4.50% was widely expected. More of a surprise was an upward revision to the Bank of England's GDP forecasts, which mean it is no longer forecasting a recession. That improvement is due to stronger global activity, a sharp fall in energy prices and the fiscal support in the Spring Budget. But while the risks have decreased, a recession later this year is still a possibility. After all, the full drag from higher interest rates has yet to be felt and with their savings depleted stretched consumers will be looking to decrease spending.

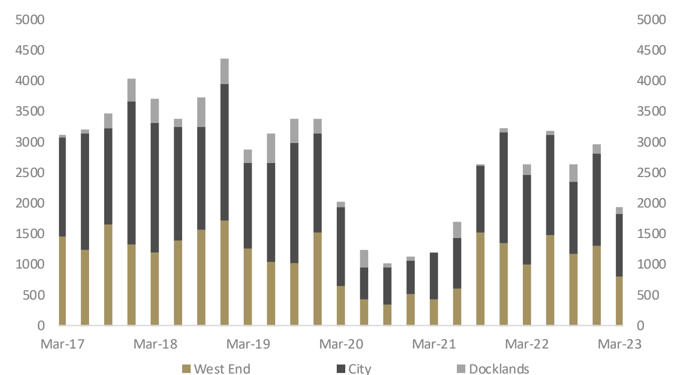
2. London

2.1 Occupational Market

Central London occupier activity had a slow start to the year. Take-up totalled 1.94m sq.ft in Q1 according to Knight Frank, a decline of 35% q/q on Q4 and the lowest level of demand since Q2 2021 (see Chart 2). The West End, City and Docklands all saw a decline in take up, with the West End seeing the largest fall of 39% q/q to 800m sq.ft. Office demand is easing as concerns about a future recession are leading some firms to cut their workforces. The ongoing shift to working from home will also be leading firms to reassess their space requirements.

City demand was supported by TikTok taking 139,400 sq.ft. at Verdant, 150 Aldersgate Street. And in the West End Pimco Europe took 106,100 sq.ft. at 25 Baker Street, and there was a 83,100 sq.ft. deal at 3 Sheldon Square for Virgin Media.

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

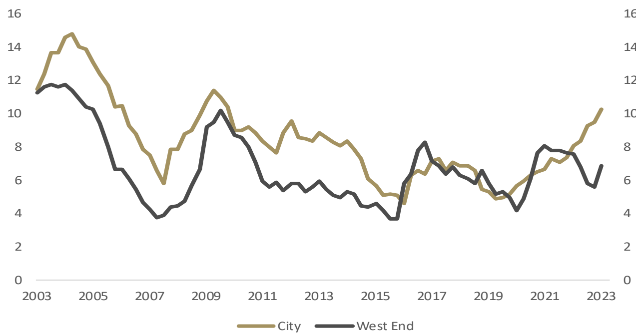


Source: Knight Frank

The relatively large drop in West End take-up in Q1 will in part reflect a tight market. Availability has been flat at close to 6m sq.ft. since the end of 2020, in contrast to the City which has seen availability double to close to 14m sq.ft since 2020. That is evident in vacancy rates. At 6.9% the West End vacancy rate is close to its average since 2002, whereas the City vacancy rate reached 10.3% in Q1, a 14-year high (see Chart 3 overleaf).

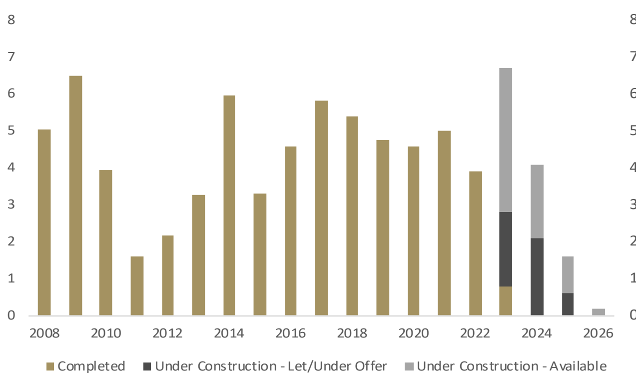
The moderation in office demand has occurred at the same time as a significant amount of new space is set to enter the market. According to CBRE there was 12.1m sq.ft. of office space under construction across central London, with over half of that due for completion in 2023 (see Chart 4 overleaf). If all that space does complete this year, it would be a 20-year high. Of that pipeline, 42% was let or under offer by the end of the quarter.

Chart 3: Central London Office Vacancy Rate (%)



Source: Knight Frank

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



Source: CBRE

Retail sales volumes dropped 0.9% m/m in March, although that weakness was in part due to unusually wet weather. Higher interest rates are still set to weigh on sales this year, but with consumer confidence rebounding in April that suggests the worst of the declines in sales volumes are now in the past.

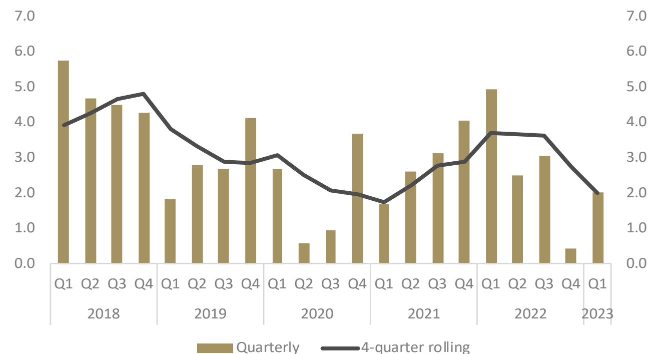
Savills reported a slight rise in Oxford Street retail vacancy in the final quarter of last year, but that was due to the closure of American style candy stores by Westminster council. The prime West End vacancy rate (Oxford Street, Bond Street and Regent Street) was 11.3% in Q4, unchanged from Q3 but down from 12.9% in Q4 2021.

2.2 Investment Market

Following a very weak end to last year, central London office investment volumes staged a strong recovery in Q1. According to Lambert Smith Hampton transactions totalled £2.03bn, up from £440m in Q4. (see Chart 5). CBRE reported a similar rise and showed that the majority of those transactions occurred in March, which may indicate growing investor belief that the worst of the office capital value falls are now behind us. It is worth noting that March was also the month that SVB collapsed in the US, which seemingly has had little impact on UK investor sentiment.

Key transactions in Q1 included St Katherines Docks in the City, which sold for £395m to City Developments, and 1 New Street Square, which sold for c£350m to Chinachem Group.

Chart 5:Central London Office Investment (£bn)



Source: Lambert Smith Hampton

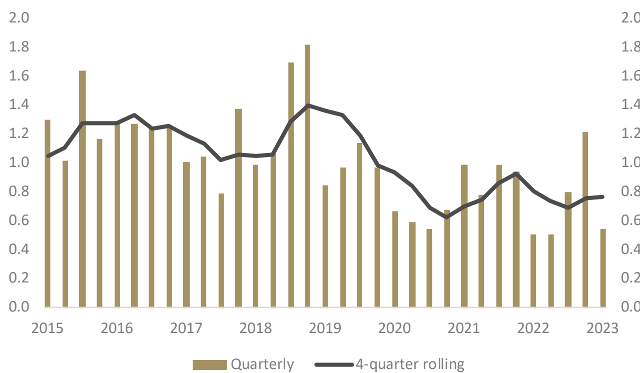
Retail investment across the UK edged back in Q1 according to Lambert Smith Hampton, to £1.28bn from £1.60bn in Q4. Colliers report that a strong March at £1bn helped drive that total, including a £140m unit shop sale at 27 Old Bond Street and a £59m sale of a retail warehouse in Croydon to DTZ investors.

3. Rest of UK

3.1 Occupational Market

Office demand also fell back in regions outside of London. Knight Frank reported that after a strong end to 2022, take-up in the M25, M3 and M4 markets dropped back 55% q/q to 547,000 sq.ft. in Q1, although the four quarter rolling average ticked up for the second quarter in a row (see Chart 6). The largest deal in the quarter was for 36,211 sq.ft. in Evolution Business Park, Cambridge for Nyobolt, followed by a 30,309 sq.ft. deal at Brennan House, Farnborough for

Chart 6: M25, M3 & M4 Take-Up (M. Sq. Ft.)



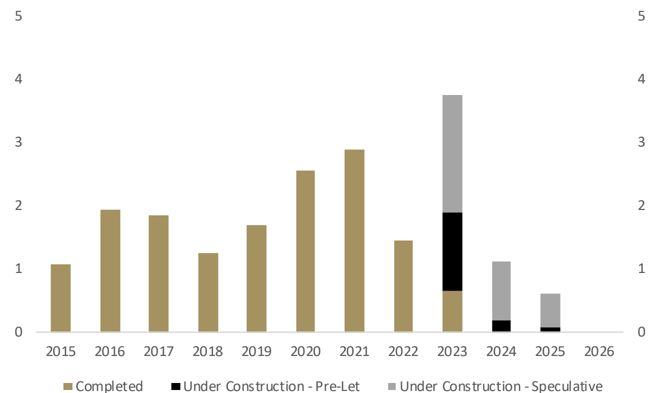
Source: Knight Frank

Despite the drop in take-up, markets in the South East tightened a bit in Q1. The vacancy rate in the M25 and M3 regions declined to 6.9% and 5.9% respectively, and held steady at 10.9% in the M4 region.

Beyond the South East, CBRE reported that take-up in UK regional office markets totalled 1.1m sq.ft. in Q1, which was 22% below the five-year average. The largest deal by some distance in the first quarter was for 124,400 sq.ft. at 11 & 12 Wellington Place in Leeds for Lloyds Banking Group. After that Birmingham dominated, with three large deals in the quarter, including 45,200 sq.ft. in Louisa Ryland House for QA.

Availability in the UK regional markets was stable in Q1, ending the quarter at 18m sq.ft., which is a fall of 2% y/y. But easing demand will soon by met by a wave of new supply. At the end of Q1 there was 4.8m sq.ft. of office space under construction (see Chart 7). And of that space 3.1m sq.ft. has an earliest completion data of 2023, high compared to the 10-year average of 1.5m sq.ft.

Chart 7: UK Regional Office Markets Pipeline (M. Sq.



Source: CBRE

CBRE report that across the UK industrial take-up dropped back in Q1 to 6.6m sq.ft., from just over 8m sq.ft. in Q4. That was the lowest level of demand since the first quarter of 2021, but is in line with the average of 6.2m sq.ft. recorded in 2019 before the arrival of COVID-19. In Q1 30% of take-up occurred in London and the South East, and 36% in the East Midlands.

Avison Young report that key deals in Q1 included 610,000 sq.ft. in Mulberry Logistics Park in Swadlincote for TPN, and 456,735 sq.ft. in PLP & Crewe Commercial Park for TK Maxx.

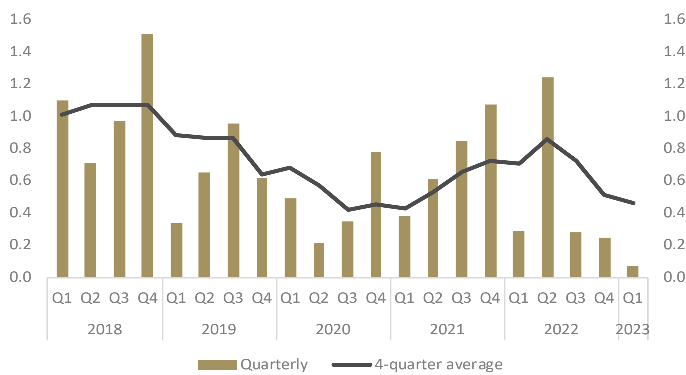
A substantial supply response is helping to ease industrial market conditions. Availability across the UK has more than doubled since Q2 2022, to 32.3m sq.ft. in Q1. That said, while the vacancy rate increased to 2.7%, that is still historically low. And the construction boom is now losing steam, with the 42.9m sq.ft. of space under construction in Q1 more-or-less unchanged from the previous quarter.

The hotel market continues to perform well, with the 'staycation' trend helping occupancy recover from the impact of COVID-19. At the national level, Avison Young report that occupancy is down 3% compared to its 2019 level, in large part due to London which continues to suffer from lower business travel. But it has risen above that benchmark in Birmingham, Edinburgh, Manchester and Newcastle.

3.2 Investment Market

The recovery in Central London office investment was not matched in the Rest of UK. Lambert Smith Hampton reported investment of just £70m in Q1 down from £250m in Q4 2022 (see Chart 8). But Rest of South East did better with £450m invested, up from £320m in Q4 and the highest amount since Q2 2022. Key deals in the quarter include £268m for 2 Ruskin Square, Croydon to the Pension Insurance Corporation and £75m for Westbrook Centre, Cambridge to UBS.

Chart 8: Rest of UK Office Investment (£bn)Ft.)



Source: Lambert Smith Hampton

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