



## Top Five

- The latest activity and survey data suggest that GDP growth slowed in advanced economies in Q2 and the significant tightening in financial conditions is now weighing on credit. Most are likely to fall into mild recessions later this year. Headline inflation is now falling sharply globally, but core rates are proving stickier in most places.
- Central London office demand has continued to fall back. Take-up dropped to 2.0m sq.ft. in Q2, a fall of 7% on the previous quarter and the lowest level for two years. Take-up did better in the City, supported by a large amount of available space. Availability in the City increased to 15.1m sq.ft. in Q2, a 19-year high. By contrast market conditions in the West End remained close to their long run average.
- Office demand has not fared much better outside of the capital. Across the Big Nine regional cities take-up totalled 1.69m sq.ft. in Q1, a drop of 31% on the previous quarter and 16% below the five year average. And closer to London, demand in the M25, M4 and M3 markets has also declined. At 515,000 sq.ft. across the region, take-up in Q2 was 6% down from Q1.
- Demand in other property sectors is also on a downward trend. UK industrial take-up dropped to 3.2m sq.ft. in Q2, around half that seen in the first quarter and much lower than the 12m sq.ft. achieved in Q2 2022. Slowing demand is leading to a steady rise in the industrial vacancy rate, which climbed to 3.4% in Q2, compared to just over 1% in Q2 2022.
- Signs of a recovery in office investment at the start of the year have proved a false dawn. Central London investment volumes came in at £1.17bn in Q2, down from £2bn in Q1 and 56% below the five-year average. Outside of London investment of £580m across the South East and Rest of UK in Q2 represented a marginal improvement over the £530m invested in Q1, but was still down by around 50% compared its long-run average.

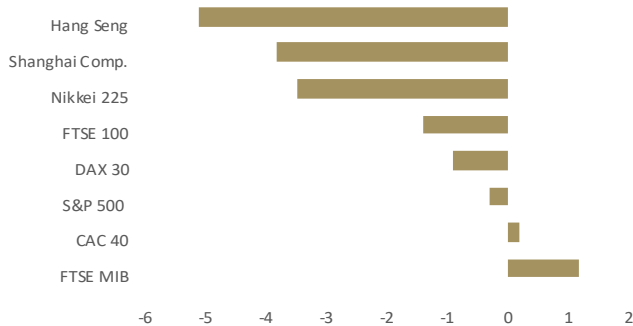
## 1. Economic Overview

The latest activity and survey data suggest that GDP growth slowed in advanced economies in Q2, while in China the reopening rebound seemed to fizzle out in May. For example, the latest PMIs showed manufacturing output fell for the first time in five months in June, while services activity – which had been resilient – slowed too. Meanwhile, the significant tightening in financial conditions is already weighing on credit growth in advanced economies and most are likely to fall into mild recessions later this year. Headline inflation is now falling sharply globally, but core rates are proving stickier in most places.

In the US, the 2.4% annualised gain in second-quarter real GDP growth suggested that higher interest rates are having remarkably little impact on activity. Admittedly, consumption growth slowed to 1.6% q/q annualised and residential investment contracted by 4.2% q/q annualised pointing to some headwinds from tighter policy, but business investment growth accelerated to 7.7% q/q annualised. Nevertheless, disinflationary pressures are beginning to build, with core PCE prices increasing by 3.8% annualised in the second quarter, down from 4.9% in the first.

Meanwhile price and wage inflation are continuing to slow. The employment cost index showed private-sector wage growth slowing to 4.6% y/y in the second quarter, from 5.1% y/y. With core PCE inflation dropping to 4.1% y/y in June, both measures are at their lowest levels in nearly two years. That helps explain why the latest FOMC meeting brought hints that Fed officials are no longer wedded to previous plans for further policy tightening. Even if activity growth continues to hold up a bit better than expected, a run of weaker inflation readings may convince them to shelve plans for further hikes. That helps explain why the S&P 500 has outperformed most other markets over the past 40 days, with the exception of the Italian market (see Chart 1).

Chart 1: Change in Selected Major Equity Market Indices over the Last 40 Trading Days to 28/08/23 (%)



Source: Refinitiv

In Europe, July's inflation data will have been a disappointment for policymakers as, although headline inflation fell in line with expectations, core inflation was unchanged at 5.5% y/y and services inflation actually increased to its highest ever level. Meanwhile, the unexpectedly strong 0.3% q/q increase in Q2 GDP was largely due to one-off increases in France and Ireland. Excluding those countries, growth would have been close to zero. With the impact of monetary policy tightening still intensifying, euro-zone GDP is still on course to contract in the second half of the year.

In the UK real GDP fell by 0.1% m/m in May, in part due to the extra bank holiday for the King's coronation. It is therefore likely to rebound in June. But the bigger picture is that higher interest rates finally appear to be weighing more heavily on activity. Those parts of output more sensitive to interest rates subtracted 0.1ppts from overall GDP in the three months to May. And July's composite activity PMI is consistent with GDP contracting marginally in Q3.

Despite the easing in UK CPI inflation from 8.7% in May to 7.9% in June and core inflation from 7.1% to 6.9%, the Bank of England went ahead with a 25bps hike at its August meeting. And given strong wage growth and the recent resilience of GDP, another rise can't be ruled out. The slowdown in inflation is also likely to be a drawn out process and rates are therefore set to stay at their peak until the second half of 2024.

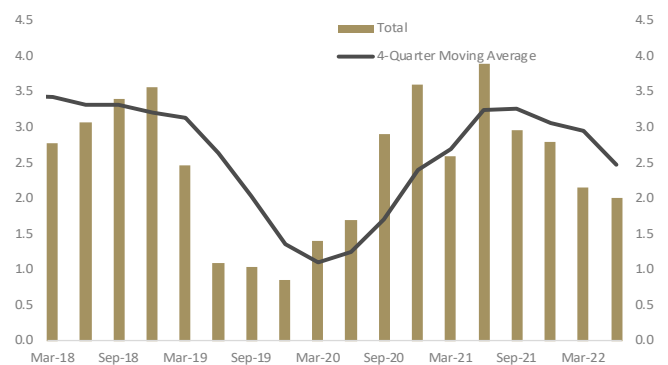
## 2. London

### 2.1 Occupational Market

Central London office demand has continued to slow. According to CBRE, take-up dropped to 2.0m sq.ft. in in Q2, a fall of 7% on the previous quarter and the lowest level for two years (see Chart 2). Office demand is easing on the back of a slowing economy and the ongoing adjustment to remote work. Less prime areas such as the Docklands are also suffering from a flight to quality. Knight Frank reported that take-up in that submarket declined by 36% q/q in Q2, compared to a 5% q/q fall in the West End and a 24% q/q rise in the City.

The rise in the City was helped by four deals of over 50,000 sq.ft. Goodwin Procter was responsible for the largest transaction, taking 89,400 sq.ft. at Sancroft, Paternoster Square. Dentons took 66,400 sq.ft. at One Liverpool Street, while West End demand was supported by Chanel taking 82,700 sq.ft. at 38 Berkeley Square. Notably, all these deals were pre-lets, highlighting continued demand for best-in-class space.

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

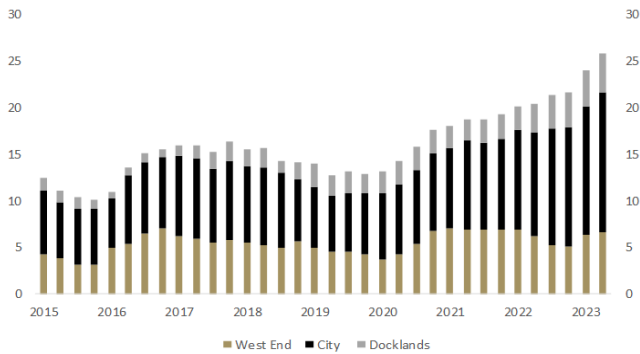


Source: CBRE

Take-up in the City is not being held back by a lack of available space. Knight Frank reported that availability in that region increased to 15.1m sq.ft. in Q2, a 19-year high (see Chart 3). Docklands availability is also at historic highs, having risen 34% over the past year. But the West End has bucked the trend. While availability did increase in Q2, at 6.6m sq.ft. it is close to its long-run average.

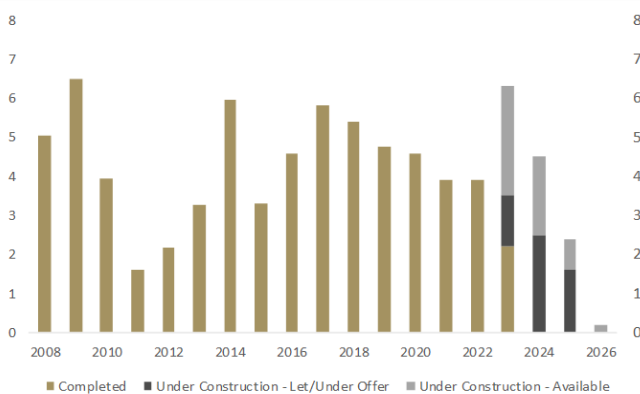
A substantial pipeline will prevent any reduction in office availability over the next couple of years. According to CBRE over 6m sq.ft. of space has either been or is set to be completed in 2023, the highest since 2009 (see Chart 4). A substantial amount of space is also due to be completed in 2024, with around 2m sq.ft. of that still available.

Chart 3: Central London Availability (M. Sq. Ft.)



Source: Knight Frank

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



Source: CBRE

Retail sales volumes have been resilient, with a 0.7% m/m rise in June following a 0.1% m/m gain in May. However, unusually warm weather in June supported sales and with consumer confidence falling back in July due to higher interest rates it's too soon to conclude that the rebound will be sustained.

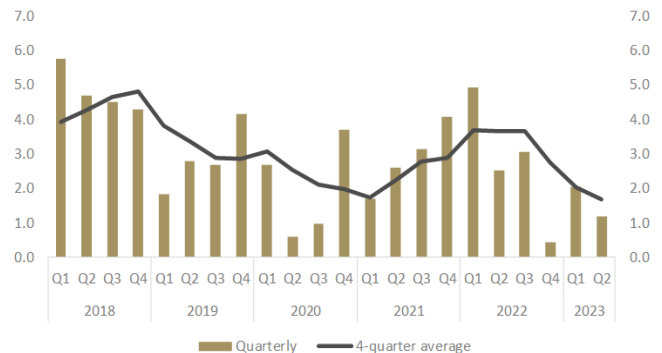
The recent strength in sales and recovery in international tourism has supported retailer demand in the West End. Savills reported a further decline in the prime West End retail vacancy rate to 11.1% in Q1, from 12.2% a year earlier. Larger units are back in demand thanks to a revaluation of Business Rates. That helped encourage HMV back to its 16,000 sq.ft. flagship store on Oxford Street, while Footaslym took 20,000 sq.ft. at 73-85 Oxford Street.

## 2.2 Investment Market

Signs of a recovery in central London office investment at the start of 2023 petered out in Q2. Lambert Smith Hampton reported investment of £1.17bn, down from £2bn in Q1 and 56% below the five-year average (see Chart 5). And monthly data from CBRE do not point to any improvement over the quarter, with just £330m transacted in June. Investor sentiment will have taken a hit from renewed pressure on office capital values. MSCI reported City office values fell 2.8% m/m in June, compared to a 1.1% m/m decline in April and May.

Key transactions in Q2 included Mitsui Fudosan UK buying 10-15 Newgate Street for £315m from Shimao Group, a Singaporean investor's £54m purchase of 215 Great Portland

Chart 5: Central London Office Investment (£bn)



Source: Lambert Smith Hampton

Retail investment across the UK has been on a downward trend. Lambert Smith Hampton reported investment of £780m in Q2, the lowest amount since Q2 2020. Within that total, shops and shopping centre investment was particularly poor. There were also relatively few deals within London, as despite a decent level of occupier demand, a lack of available stock is curtailing retail investment. Bond Street dominated the market, including private Guatemalan buyers buying Alexander McQueen's 27 Old Bond Street for £143m.

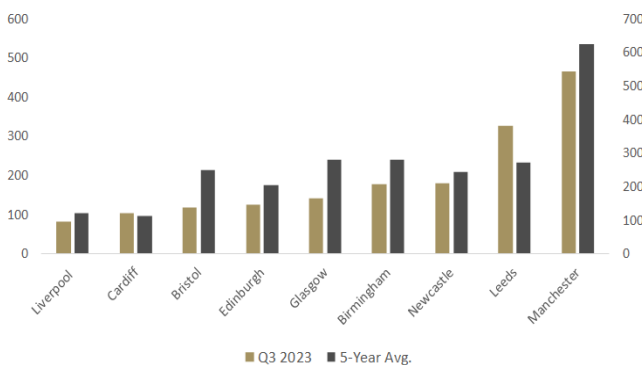
### 3. Rest of UK

#### 3.1 Occupational Market

After a strong end to the year office demand has since dropped back in regional office markets. Avison Young reported take-up of 1.69m sq.ft. across the Big Nine cities in Q1, a drop of 31% on the previous quarter and 16% below the five year average. Of the nine cities, only Leeds and Cardiff saw take-up above average, with Leeds the strongest performer (see Chart 6). At the other end of the spectrum, Glasgow and Bristol saw take-up at 41% and 45% below average respectively.

Key deals in Q1 included Lloyds Banking Group taking 124,400 sq.ft. at 11-12 Wellington Place, Leeds and QA's acquisition of 45,180 sq.ft. at Lousia Ryland House, Birmingham.

Chart 6: Big Nine Regional Cities Office Take-Up

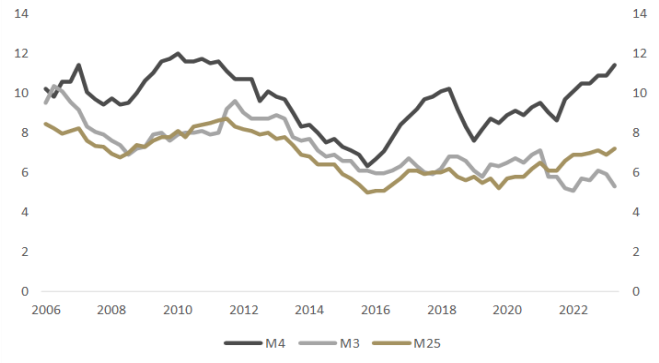


Source: Avison Young

Closer to London, Knight Frank also reported a slowdown in demand in the M25, M4 and M3 markets. At 515,000 sq.ft. in total across the region, take-up in Q2 was 6% down from Q1, driven by a 27% fall in the M3 market. But after a very weak Q1, there was a modest recovery in the M4 market, with take-up rising 32% q/q to 193,000 sq.ft. Key transactions in Q2 included Moderna taking 145,000 sq.ft. at Harwell Campus, Didcot. And LGC acquiring 45,243 sq.ft. at the Priestley Building in Guildford.

Availability in the South East office markets has been fairly stable in recent months. Knight Frank reported total availability across the M25, M4 and M3 markets of 18.1m sq.ft. in Q2, up from Q1, but unchanged from the end of 2022. That said, the M4 region is something of an outlier. While vacancy rates have been fairly stable in the M25 and M3 markets, in the M4 region they rose to 11.4%, a 12-year high (see Chart 7).

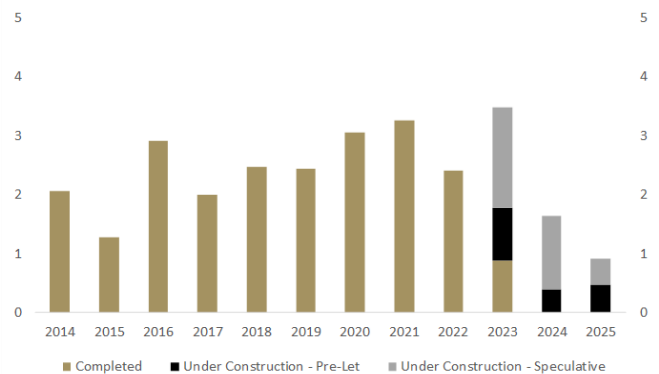
Chart 7: M25, M4 and M3 Office Vacancy Rates (%)



Source: Knight Frank

The regional pipeline is also healthy. Avison Young reported that 3.47m sq.ft. of space has or will be completed in 2023 across the Big Nine cities. And of that total around half is still available, a little higher than previous years but not markedly so (see Chart 8). Glasgow and Manchester have the most space under construction at over 1m sq.ft. each.

Chart 8: Big Nine Office Markets Development



Source: Avison Young

CBRE reported a sharp decline in UK industrial take-up in Q2. At 3.2m sq.ft. take-up was around half that seen in the first quarter, and compares to 12m sq.ft. achieved in Q2 2022. Of that take-up, 24% was located in London & South East, and 35% in the East Midlands.

Avison Young report that key big box deals in Q2 included 598,000 sq.ft. at Sergo Park, Coventry for Syncreon Technology (UK) Ltd., and 500,000 sq.ft. at Rockingham Gateway, Corby for Ceva Logistics.

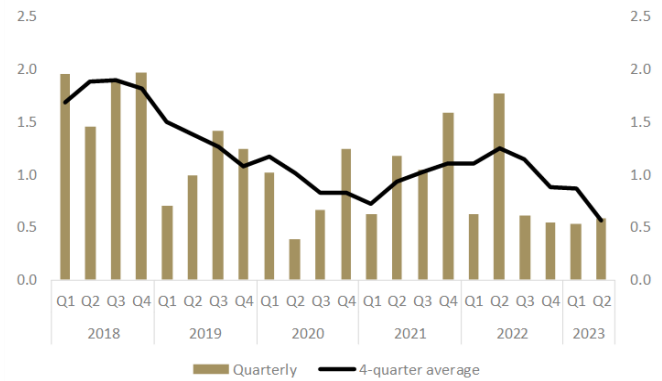
The fall back in industrial occupier demand has been accompanied by rising availability. Total available space was 32.3m sq.ft. in Q2. While that was unchanged from Q1, availability has more than doubled compared to a year ago. The vacancy rate has been on an upward trend since Q3 2022 and, at 3.4% in Q2 it has tripled from a rate of just over 1% in Q2 2022.

The hotel market continues to perform well, with the 'staycation' trend supporting regional markets, while the return of international travellers has boosted London. Savills report that London hotel revenue per available room in the first five months of 2023 was 21.6% above the same period in 2019, driven by a 28% increase in average daily rates.

### 3.2 Investment Market

Office investment outside of London remained subdued in Q2. Lambert Smith Hampton reported investment of £580m across the South East and Rest of UK in Q2, a marginal improvement over the £530m invested in Q1, but around half the average from 2016 (see Chart 9). Key deals in the quarter included CBREs IM's £73m purchase of Halo in Bristol from Tesco Pension Fund and Glade Capital paying £35m for Vastern Road, Reading from abrdn.

Chart 9: Rest of UK and Rest of South East Office Investment (£bn)



Source: Lambert Smith Hampton

Industrial investment totalled £1.85bn in Q2, up from £1.34bn in Q1. But that represented a marked slowdown from 2022, when volumes averaged £3bn a quarter. Within that total big box investment totalled £1.15bn in H1 2023. This was concentrated in the North West, which accounted for £538m of the total. By contrast, London & South East and the West Midlands both saw investment of around £120m.

Key industrial deals in H1 included £74m for Wembley180 to Covent Garden IP Limited from DWS Group, and £43.5m for 360 at Logistics North in Bolton to Amazon from Aviva Investors.

Hotel investment across the UK has also slowed, in the year to June investment volumes were down 60% compared to 2022. The largest deal in May was £40m for Travelodge Gatwick Airport to Blacksand Real Estate from Arlo Holdings. While in June the biggest transaction was the £4.5m sale of Riverside Hotel, Kendal to Interesting Hotels Group from South Lakes Hotels Limited.

### For more information:

Please contact Sarah White;

[sw@rivercap.co.uk](mailto:sw@rivercap.co.uk)