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Quarterly Review: Q3 2023

Top Five

- Activity in advanced economies has generally weakened over the third quarter given the drag from high interest rates. And activity and survey data for October, including the PMIs, suggest that global industrial activity contracted at the beginning of Q4, with forward-looking indicators pointing to further weakness ahead.
- Despite the subdued macroeconomic backdrop, Central London office demand improved somewhat in Q3. Take-up rose to 2.6m sq.ft., a 27% increase on the previous quarter, though it remained 14% below the long-term average. Take-up rose in all submarkets of London, but only in the City did the 31% increase in take-up leave it just above its long-run quarterly average.
- After a weak middle of the year office demand outside of the capital also saw a small recovery in Q3, with out-of-town markets performing relatively well. Take-up totalled 1.87m sq.ft. across the Big Nine cities in Q3, an increase of 15% on the previous quarter. The demand for prime space remains high, but there is evidence that the shift to remote work is now weighing on the need for larger spaces.
- Logistics take-up in the UK was subdued in Q3 at 3.3m sq.ft., down 57% on a year earlier. Of the 13.3m sq.ft. take-up seen so far in 2023, almost half took place in the East Midlands and almost a third in Wales. Falling demand and plenty of new space has pushed the vacancy rate up to 4.6%, not far off the 5.3% recorded just before the arrival of COVID-19 at the start of 2020.
- Against the backdrop of high uncertainty and high financing costs, investment in Central London offices fell for the second consecutive quarter in Q3 by around 3% q/q, to £1.26bn. And after a small recovery in Q2 office investment outside of London resumed its downward trend in Q3, falling to £430m, the lowest since Q2 2020.

1. Economic Overview

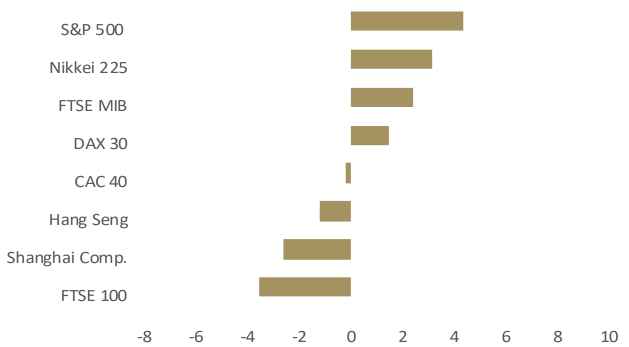
Activity in advanced economies has generally weakened over the third quarter given the drag from high interest rates. Recessions have not yet taken hold in DMs, but that's most likely because of temporary factors. These include households running down the savings accrued thanks to supportive fiscal policy during the pandemic, and producers working off the backlog of orders. This is unlikely to last, especially as the impact from tight monetary policy continues to pass through. Indeed, financial conditions have tightened dramatically and credit growth and lending have generally softened significantly. And activity and survey data for October, including the PMIs, suggest that global industrial activity contracted at the beginning of Q4, with forward-looking indicators pointing to further weakness ahead.

While energy prices picked up and boosted energy inflation a little in many advanced economies over Q3, loosening labour markets have helped core inflation to start to decelerate. As a result, headline inflation has generally fallen, which prompted most central banks in DMs to draw their tightening cycles to a close. While policy rates have almost surely reached their peak, they are expected to remain high for some time still.

In the US, economic activity has been resilient so far and Q3 GDP growth was close to 3.5% annualised. But even so, there is evidence that activity is starting to soften. Indeed, surveys weakened sharply in October and the consensus is that growth will slow over Q4, though it may remain positive. This, together with a loosening labour market and slowing wage growth, should help bring core inflation back to target over the coming quarters.

Despite the 0.2% m/m uptick in core inflation, headline inflation was unchanged in month-on-month terms in October and has broadly been on a declining path. And looking ahead, there's evidence that both goods and services inflation – and shelter price inflation in particular – will edge down further. This will probably prompt the Fed to be one of the first central banks in advanced economies to cut rates next year. The relative strength in the US economy, paired with falling inflation, can help explain why the S&P 500 has outperformed most other markets over the past 40 days (see Chart 1).

Chart 1: Change in Selected Major Equity Market Indices over the Last 40 Trading Days to 16/08/23 (%)



Source: Refinitiv

Meanwhile, the euro-zone economy contracted by 0.1% q/q in Q3. The region's October PMIs are the lowest among the major advanced economies and, together with the latest activity data, they point to a further contraction in Q4. Despite the economic weakness, the labour market in the euro-zone remains very tight, albeit showing the first tentative signs of loosening. This should help bring wage growth back to levels consistent with the ECB's 2% inflation target.

Indeed, headline inflation has continued to fall sharply on the back of lower energy and food inflation, settling at 2.9% y/y in October. Despite the fact that inflation is expected to fall back to target over the next couple of years, the ECB probably won't start cutting until late 2024, and tight monetary policy will continue to take a toll on activity.

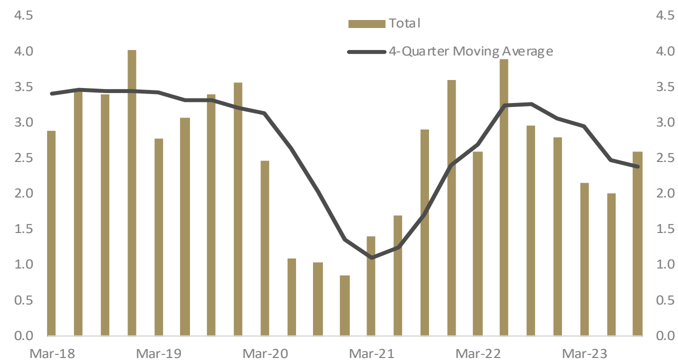
In the UK, after a barely noticeable contraction in GDP in Q3 (by 0.02%), activity in September rose by 0.2% m/m. But the October PMIs are consistent with a contraction, and subdued activity data from retail spending, as well as money and credit data, support this view. The coming weakness should help loosen the labour market, and there are signs that wage growth has now peaked and should continue to slow gradually. This in turn will push down inflation, which has generally been on a downward trend and fell to 4.6% in October. Similar to the ECB, the Bank of England will probably refrain from cutting rates until late 2024 to make sure that inflation is reined in.

2. London

2.1 Occupational Market

Despite the subdued macroeconomic backdrop, Central London office demand improved somewhat in Q3. According to CBRE, take-up rose to 2.6m sq.ft., a 27% increase on the previous quarter, though it remained 14% below the long-term average. (See Chart 2.) Knight Frank reports that two-thirds of these deals were for prime spaces, confirming that the "flight to quality" is still very much the driver of transactions. Take-up rose in all submarkets of London, but only in the City did the 31% increase in take-up leave it just above its long-run quarterly average. Indeed, both in the Docklands and West End take-up remained 21.8% and 28.5% below the long-term trend, respectively.

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

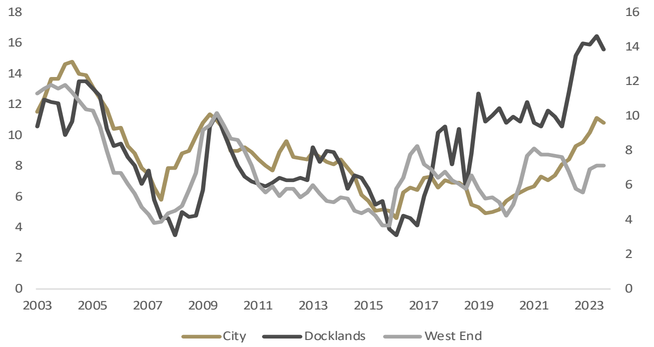


Source: CBRE

Among the five deals above 50,000 sq.ft. in Central London, four of them took place in the City, including the biggest one which was Kirkland & Ellis taking an additional 173,800 sq. ft. at 40 Leadenhall Street. Other notable deals include ICE Futures exercising 126,700 sq.ft. of option space at Sancroft, Paternoster Square in the City, and John Lewis taking 108,500 sq.ft. at 1 Drummond Gate in the West End.

As take-up increased, availability fell by 1.6% to 25.36m sq.ft. in Q3, causing the vacancy rate to edge lower to 9.9%. Despite the decline – the first in two years – availability was still close to an 18-year high and almost twice as much as the 16.7m sq.ft long-term average. The fall was driven by a 2.4% drop in City availability to 14.75m sq.ft. and by a 4.9% decline in availability in the Docklands, to 3.91m sq.ft.. In both submarkets availability remains very high by past standards, with the City vacancy rate now at 10.8%, still 3.9 ppts above its long-term average. (See Chart 3.) Conversely, in the West End the uptick in availability left the vacancy rate in line with past standards, at 7.1%.

Chart 3: Central London Vacancy Rates (%)



Source: Knight Frank

A substantial pipeline will probably 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 expected to be completed in 2023, the highest since 2009. (See Chart 4.) Looking ahead, a substantial amount of space is also due to be completed over the next few years, particularly in 2024, which will result in an additional 6m sq.ft. of available space.

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

Source: CBRE

The 0.3% m/m fall in retail sales volumes in October means that after contracting by 1.0% q/q (which was revised down from -0.8% q/q) in Q3, retail activity remained weak at the start of Q4. That suggests higher interest rates are taking a toll on real consumer spending. Low consumer confidence in October and the lagged drag from high interest rates mean that retail sales will likely remain subdued over the coming quarters.

But even so, Savills reports that there has been some strong momentum in leasing activity across Central London in Q3, especially on key retail streets. This has pushed down vacancy in the West End, with the rate falling for the fifth consecutive quarter to 6.5%, down almost 300 bps on the previous quarter.

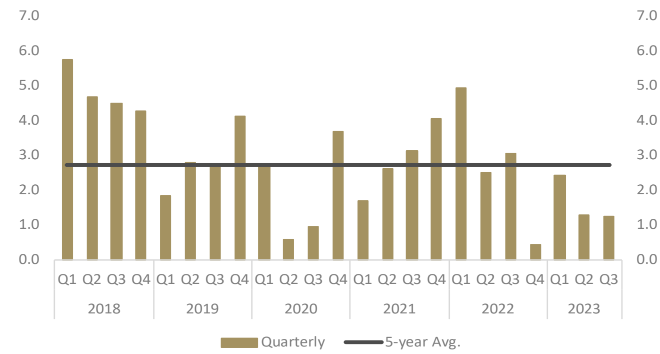
Notable deals include PSG and Dr Martens both securing units on Oxford Street East. And as the festive season approaches, retail property should benefit from international tourism over the fourth quarter.

2.2 Investment Market

Against the backdrop of high uncertainty and high financing costs, investment in Central London offices fell for the second consecutive quarter in Q3 by around 3% q/q, to £1.26bn. This left it around 50% lower than both the same period in the previous year and the 5-year quarterly average. (See Chart 5.) And monthly data from CBRE point to continued weakness in Q4 as well, with only £98m transacted in October, down 91% on the long-term monthly average of £1.1bn.

Lambert Smith Hampton reports there were only two deals above £100m in Central London, namely UBS's £240m acquisition of Bloom, Clerkenwell and the £206m purchase of Lion Plaza by a Vietnamese Consortium.

Chart 5: Central London Office Investment (£bn)



Source: Lambert Smith Hampton

But Central London retail investment bucked the trend with total volumes of £263m, roughly in line with historic standards. That strength was mainly attributable to Aviva's £115m purchase of an additional 50% stake in the Bentall Centre in Kingston upon Thames.

3. Rest of UK

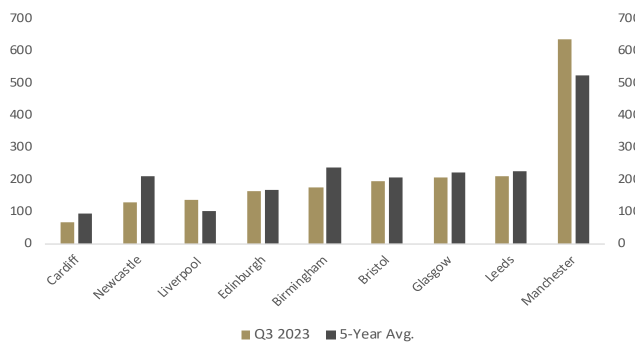
3.1 Occupational Market

After a weak middle of the year office demand outside of the capital saw a small recovery in Q3, with out-of-town markets performing relatively well. Avison Young reported take-up of 1.87m sq.ft. across the Big Nine cities in Q3, an increase of 15% on the previous quarter. But of the nine cities, only Manchester and Liverpool saw take-up above the five year average (See Chart 6.) By contrast, Newcastle and Birmingham saw take-up significantly below that benchmark.

The demand for prime space remains high, but there is evidence that the shift to remote work is now weighing on the need for larger spaces. City centre deals for 25,000 sq.ft. or over accounted for just 22% of all transactions over the past year, compared to an average of 40% in the five years before the arrival of COVID-19.

Key city centre deals in Q3 included Lloyds Bank taking 59,896 sq.ft. at 6 Brindleyplace, Birmingham, Arden University occupying 42,944 sq.ft. at 2 Hardman Street Manchester and BT taking 39,688 sq.ft. at The Plaza, Liverpool. Meanwhile out-of-town deals included Rheinmetal taking just over 62,000 sq.ft. at Aztec West in Bristol and the Department of Education occupying 50,143 sq.ft. in Napier Court, Liverpool.

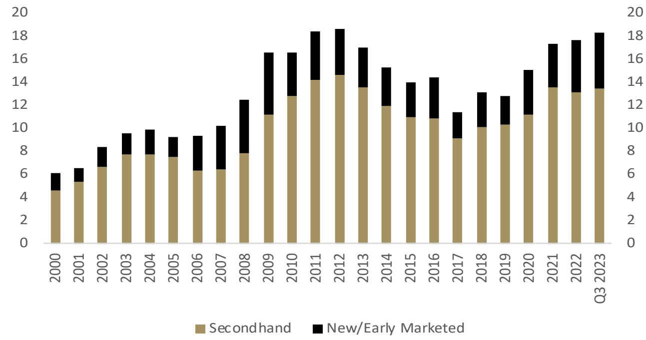
Chart 6: Big Nine Regional Cities Office Take-Up



Source: Avison Young

Despite the slight rise in take-up, CBRE reported a further increase in UK markets office availability in Q3. At just over 18m sq.ft. availability is close to the record high seen in 2012. (See Chart 7.) Vacancy rates are particularly high in Glasgow (10.8%) and Manchester (10.2%).

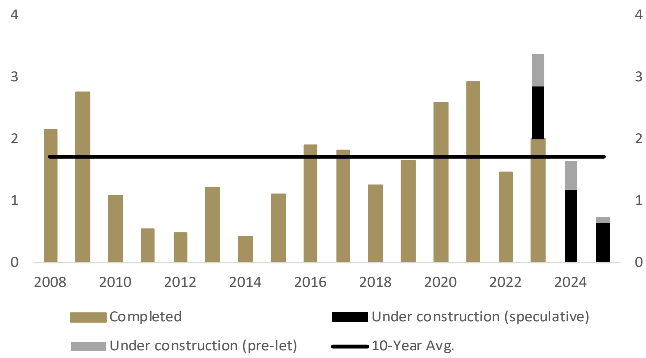
Chart 7: UK Markets Availability (M. Sq. Ft.)Ft.)



Source: CBRE

The rise in availability was driven by an increase in new and early marketed space. Indeed, 3.4m sq.ft. of space is due to enter the market in 2023, almost double the long term average. (See Chart 8.) But that level of new supply is not set to last, with just 1.6m sq.ft. of space under construction and set to be completed in 2024.

Chart 8: UK Markets Pipeline (M. Sq. Ft.)Pipeline (M.



Source: CBRE

CBRE reported that logistics take-up in the UK remained subdued in Q3 at 3.3m sq.ft., down 57% on a year earlier. The non-food retail sector took the most space in Q3, followed by third-party logistics. Of the 13.3m sq.ft. take-up seen so far in 2023, almost half took place in the East Midlands and almost a third in Wales.

Avison Young report that key big box deals in Q3 included 661,348 sq.ft. at Castle Mound Way, Rugby for Sainsbury's and 628,943 sq.ft. at DRIFT, Daventry for Zara.

Not surprisingly, as demand has fallen back availability has surged. Total available space increased to 36.3m sq.ft. in Q3, up 25% on Q2 and 155% on the low recorded in mid-2022. At 4.6% the vacancy rate is now not far off the 5.3% recorded just before the arrival of COVID-19 at the start of 2020.

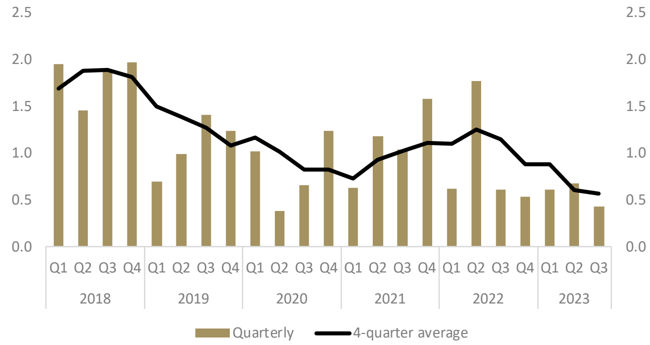
Developers have responded quickly to the loosening in market conditions. From 43m sq.ft. in Q1 2023, the amount of space under construction had declined to 27m sq.ft. by Q3, a two-year low.

The regional hotel market continues to recover from COVID-19. Knight Frank report that at 81.3% in July occupancy was at its highest since September 2019. But upscale hotels have seen less of an improvement, with occupancy plateauing at 77.6% in July. That is an indication that cost-of-living pressures are still weighing on the luxury market.

3.2 Investment Market

After a small rise in Q2, office investment outside of London resumed its downward trend in Q3. Lambert Smith Hampton reported investment of £430m across the South East and Rest of UK, the lowest since Q2 2020 when lockdowns disrupted activity. (See Chart 9.) The largest deal in the quarter was Praxis purchasing Brindleyplace, Brimingham from Hines for £125m, representing an initial yield of around 12-13%. Other deals in the quarter were all under £40m, including the Citi Private Bank purchasing 1 Sovereign Street in Leeds for £38.5m from Artmax.

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



Source: Lambert Smith Hampton

Lambert Smith Hampton reported that retail investment in the UK has been the most resilient amongst other sectors in Q3. Indeed, volumes reached a 5-year high of £1.9 bn which left them 36% above trend. But investments were boosted significantly by the £650m sale of the ASDA supermarket portfolio by Realty Income Corporation.

After a slight recovery in Q2 industrial investment dropped back to £1.9bn in Q3. That is in line with the average seen in the three years prior to the COVID-19 lockdowns. Distribution warehouses made up £1.3bn of the total, including JD.com's £180m purchase of Apollo & Phase 2 Ansty Park, Coventry from Canmoor/Goldman Sachs.

Build-to-Rent volumes were also subdued in Q3 at £320m, with the largest deal being Aviva Capital Partners/ Moda's acquisition of a 4-acre site in Digbeth, Birmingham, where 1,000 units are planned.

For more information:

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