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Quarterly Review: Q4 2023

Top Five

- Activity in advanced economies broadly softened in Q4 given the continued drag from high interest rates. And the latest survey data suggest that, while the major developed economies will narrowly avoid a recession, their economic growth will generally disappoint in 2024.
- Despite the subdued macroeconomic backdrop, Central London office demand improved once again in Q4. Take-up rose to 3.4m sq.ft., which represented a 30% increase on the previous quarter, though on an annual basis take-up fell in 2023 as a whole and was below the long-term average.
- In line with the usual seasonal pattern, office demand in the South East picked up in the final quarter of 2024 and take-up in the M25, M3 and M4 markets rose 65% q/q. Demand continued to be concentrated in high quality, smaller offices in prime locations. Nevertheless vacancy rates, particularly in the M4 markets, remained high.
- Big box logistics take-up in the UK accelerated in Q4, with just under 6.1m sq.ft. of let, compared to take-up of 4.6m sq.ft. in Q3. Demand was concentrated in the East Midlands, with almost half of all take-up in 2023 in that region. But a strong supply response in recent years meant the vacancy rate also increased to 5.1%, up from around 2% a year earlier.
- Against the backdrop of uncertainty and high financing costs, investment in Central London offices fell for the third consecutive quarter by around 20% q/q, to £1.3bn in Q4. But office investment outside of London rebounded in Q4. The total of £1bn across the South East and Rest of UK was double the Q3 figure.

1. Economic Overview

The ongoing drag from high interest rates meant activity in advanced economies generally slowed over Q4. And the latest evidence, including PMI surveys, suggested that while developed markets should avoid recessions, global growth will generally undershoot consensus expectations in 2024.

There are a couple of reasons why this is the case. For one, monetary policy should remain a drag on growth in 2024. Admittedly, the pass-through of interest rates to activity is proving to be weaker than in previous cycles. But higher interest rates have already caused bank lending to slow sharply. And higher policy rates are gradually feeding through to debt service costs. As income growth slows in the year ahead, rising interest payments are set to eat up a larger share of household incomes.

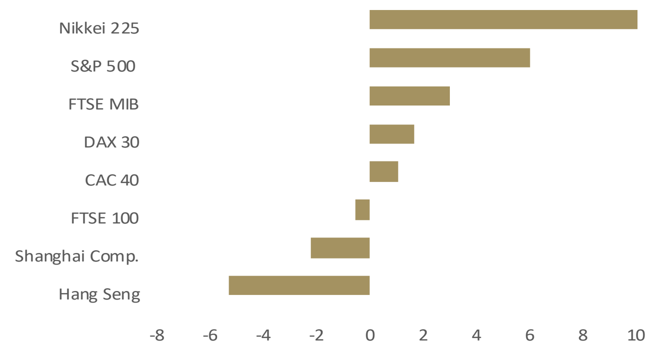
As a result, consumer demand will slow. All else equal, lower inflation should help boost income growth in real terms. But the trend decline in job vacancies and softening of hiring intentions suggest that employment growth is likely to weaken further in the quarters ahead. And with labour markets loosening, nominal average income growth should ease too.

In the US, economic activity has held up better so far and Q4 GDP growth should be close to 1.9% annualised, though this represents a marked slowdown from 4.9% in Q3. Part of this resilience was due to strong consumption growth, but that is unlikely to last as the boost from households' excess savings accumulated during the pandemic are exhausted.

The lagged impact of past monetary tightening will continue to feed through for the next few quarters, pushing US GDP growth well below potential. But, given the prevalence of fixed-rate debt the economy is set to narrowly avoid a recession. And as core PCE inflation is on track to return to the 2% target around mid-2024, the Fed is likely to cut interest rates by 25bp at every meeting this year from March onwards. The easing in financial conditions that has already begun – as expectations of Fed easing build – will flip the monetary impulse from a strong headwind to a tailwind in the second half of next year.

The relative strength in the US economy, paired with falling inflation, helps explain why the S&P 500 has outpaced most other markets over the past 40 days (see Chart 1). Part of the outperformance was also due to the exuberance surrounding AI, with the US expected to be one of the economies that will benefit the most from it.

Chart 1: Change in Selected Major Equity Market Indices over the Last 40 Trading Days to 09/02/24 (%)



Source: Refinitiv

Meanwhile, the euro-zone economy stagnated in q/q terms in Q4 and surveys suggest that it remained subdued in January. The weakness in economic activity is weighing on firms' hiring intentions. Indeed, the January employment PMI pointed to jobs growth grinding to a halt in the coming months. But even so, the labour market still looks tight, with the unemployment rate at a record low and the vacancy rate only slightly below its 2022 peak. This will contribute to keeping wage growth high by past standards this year, though income growth has already started to slow on the back of declining inflation and should continue to do so.

Headline inflation fell to 2.8% y/y in January, as lower food and core inflation offset gains in energy inflation. This should prompt the ECB to deliver its first rate cut in Q2, most likely in April, and to bring its deposit rate from 4% to 2.75% by end-2024.

In the UK, real GDP may have contracted in Q4 2023, but the outlook for activity has improved. January's services PMI is consistent with a decent rebound in non-retail services output at the start of this year. And while retail sales volumes fell by 2.5% in 2023, January's rise in consumer confidence pointed to an improvement in sales volumes at the start of 2024. The market is now pricing in interest rate cuts from June, which should also support spending.

2. London

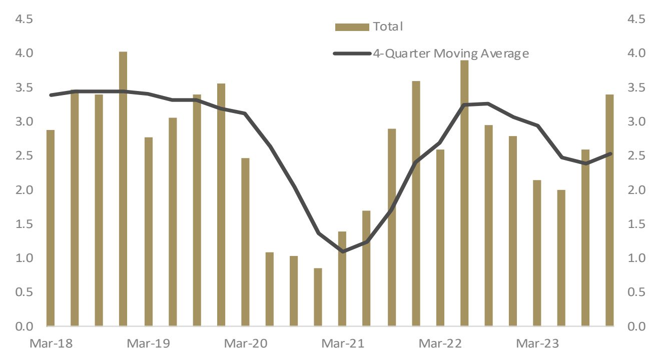
2.1 Occupational Market

Despite the subdued macroeconomic backdrop, Central London office demand improved further in Q4. According to CBRE, take-up rose to 3.4m sq.ft., a 31% increase on the previous quarter (see Chart 2). However, the yearly figures suggest that take-up fell 16% y/y to 10.5m sq.ft., below the 10-year average. The most notable deal was HSBC taking 540,600 sq.ft. of space at Panorama St Paul's, as part of its plans to exit Canary Wharf.

Tenants continued to value quality over quantity. Knight Frank report that prime office spaces accounted for 84% of the take-up deals throughout the year.

Take-up in the City outshone other submarkets relative to trend, totalling 1.2m sq.ft. in Q4. Meanwhile, take-up in the West End was up 7% on the long-term average level, while the other submarkets underperformed with below-trend take-up.

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

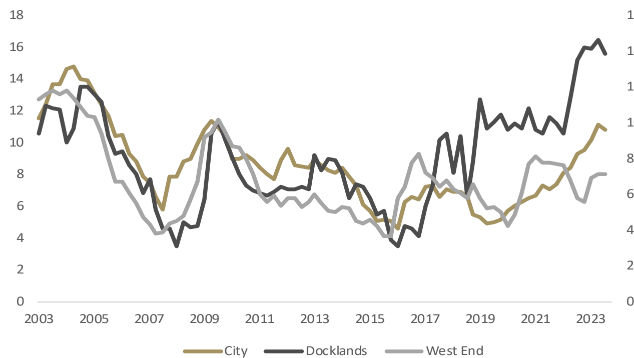


Source: CBRE

Despite overall increased take-up, availability rose by 5% quarter-on-quarter to 26.1m sq.ft., well above the long-term average of 16.9m sq.ft.. The increase pushed up the Central London vacancy rate to 9.1% in Q4 from 8.5% in Q3.

But there are differences within Central London. In Q3, availability in both the City and the Docklands remained very high by past standards, with vacancy rates of 10.8% and 15.6% respectively. Meanwhile, the West End is faring a bit better, with the vacancy rate slightly above past standards at 7.1%. (see Chart 3).

Chart 3: Central London Vacancy Rates (%)



Source: Knight Frank

Availability was supported by completions that totalled 4.3m sq.ft. in 2023 in Central London. The largest scheme to complete in Q4 2023 was Blossom Yard & Studios in Central East London. And the substantial pipeline will help keep office availability high over the next few years. There was a total of 12.9m sq.ft. under construction across Central London at the end of the year (see Chart 4). Of that, 6.7m sq.ft. is set to be completed in 2024 and only 38% of the total space under construction was pre-let or under offer at the end of Q4.

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

Source: CBRE

The notable 3.2% m/m fall in retail sales volumes in December meant that retail activity fell by 0.9% q/q in Q4. Throughout 2023, retail sales declined by a sizeable 2.8% y/y – suggesting that higher interest rates have weighed on high streets. While consumption will remain weak in the first half of 2024, interest rate cuts and the further boost to real household incomes from falling inflation will support a recovery in real consumer spending over H2 2023.

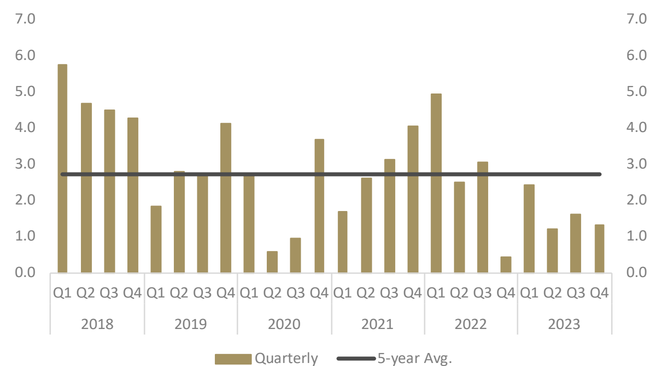
CBRE reported that there was a substantial rebound in the net change in Central London store openings and closings in Q4, to +17. Within that, Oxford Street performed particularly well. Vacancy rates also continued to fall. In Q4 the Central London rate fell to 10%, the lowest level since 2019.

2.2 Investment Market

Investment in Central London offices fell by 20% q/q in Q4 to £1.3bn, according to Lambert Smith Hampton. This figure was about half of the 5-year quarterly average (see Chart 5). The total investment figure for 2023 stood at £6.6bn – which was not only a 40% reduction from the 2022 number, but also the lowest annual investment volume recorded since 1999 according to CBRE.

Lambert Smith Hampton reported that there were only four deals above £100m in Central London in Q4, the most notable being UBS's £221m purchase of Bloom from HB Reavis.

Chart 5: Central London Office Investment (£bn)



Source: Lambert Smith Hampton

Meanwhile, Central London retail investment ticked up in Q4 to £188m. But that still left activity for the year at just £795m, well below historic averages. Key deals in the quarter included Fast Retailing purchasing its recently opened Uniqlo store in Long Acre for £115m and 175-179 Oxford Street being sold to a private family for £34m.

3. Rest of UK

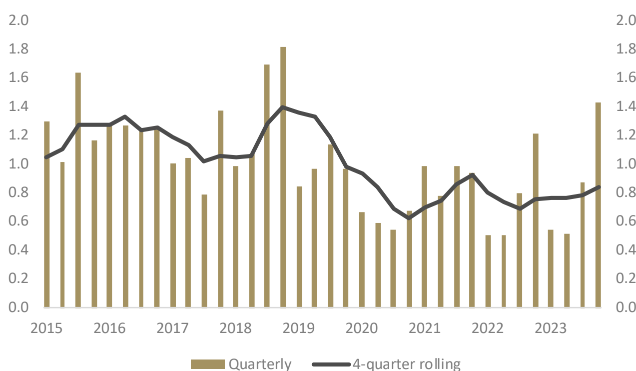
3.1 Occupational Market

In line with the usual seasonal pattern, office demand in the South East picked up in the final quarter of 2024. Knight Frank reported that take-up in the M25, M3 and M4 markets rose 65% q/q to 1.44m sq. ft, the highest since the end of 2018 (see Chart 6). That was driven by a doubling in take-up in both the M4 and M3 markets.

Demand continues to be concentrated in high quality, smaller offices in prime locations. Of the 54 markets in the South East, Knight Frank reports that just six accounted for 50% of total take-up. And 74% of deals last year were for 10,000 sq.ft. or less, with the average deal of 10,400 sq.ft. the smallest since records began in 1992.

Key South East deals in Q4 included Lonza taking 184,500 sq.ft. at Thames Valley Park, Reading, Wood Plc occupying 119,424 sq.ft. at 400 Longwater Avenue, Reading and BioNtech taking 79,995 sq.ft. at 1000 Discovery Drive, Cambridge. Outside of the South East, Dyson took 66,300 sq.ft. at 1 Georges Square, Bath and Harbour Energy leased 35,400 sq.ft. at Prime Four Business Park, Aberdeen.

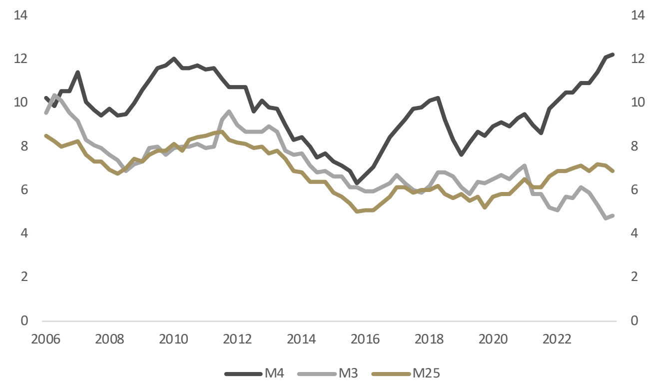
Chart 6: M25, M3 and M4 Take-Up (000s Sq.Ft.)(000s



Source: Knight Frank

The jump in demand in the final quarter of last year failed to bring South East vacancy rates down. Knight Frank report that vacancy increased in the M4 and M3 markets, with only a marginal fall in the M25 market to 6.9%, which was high by past standards (see Chart 7). Loose markets are also evident in the rest of the UK. CBRE report that availability in the 10 cities outside of London and the South East rose to 19.1m sq.ft. by the end of 2023, the highest since records began in 2000.

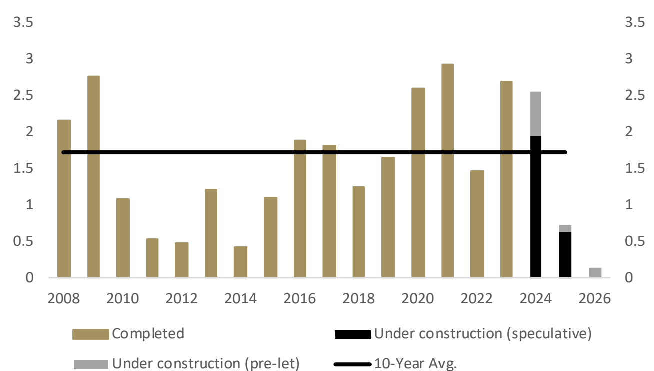
Chart 7: M25, M3 and M4 Vacancy Rates (%)



Source: CBRE

The rise in UK market availability was driven by an increase in new and early marketed space. In 2023, 2.7m sq.ft. of space was completed, of which 60% was pre-let or under offer (see Chart 8). Construction delays meant that was less that was expected, but that also suggests 2024 is set for a similarly large amount of completions, of which the large majority is speculative.

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



Source: CBRE

Avison Young reported that big box logistics take-up in the UK accelerated in Q4, with 6.1m sq.ft. of space let, compared to take-up of 4.6m sq.ft. in Q3. Over 2023 as a whole, third-party logistics took the most space at 8.7m sq.ft, around 45% of all demand. Demand was concentrated in the East Midlands, with almost half of all take-up in 2023 in that region.

The rise in take-up in Q4 was helped by Amazon taking 2.25m sq.ft. at the SEGRO Logistics Park in Northampton. Elsewhere, 621,000 sq.ft. was let to a confidential tenant at Panattoni Park in Aylesford.

Despite the rise in demand, a significant rise in construction in recent years kept availability high in Q4. CBRE reported availability of 37.8m sq.ft., up marginally from Q3. The vacancy rate also increased to 5.1%, up from around 2% a year earlier.

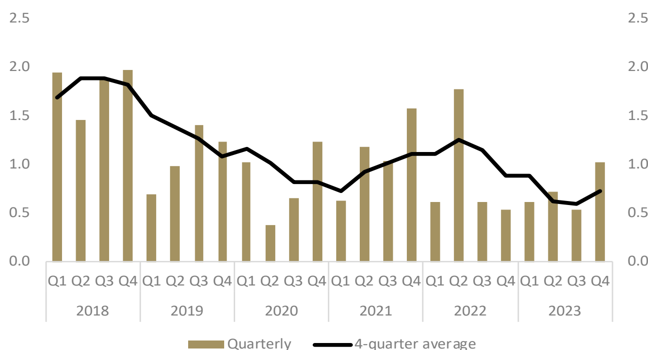
Developers are responding to the loosening in market conditions. From 43m sq.ft. in Q1 2023, the amount of space under construction halved to 21.4m sq.ft. by Q4.

Resilient local demand, helped by the soaring cost of foreign holidays and a recovery in international travel is supporting the regional hotel market. Knight Frank reported that occupancy was up seven percentage-points in the year to September 2023. Golf and Spa hotels have outperformed, with a 46% surge in Average Daily Rate (ADR) since 2019.

3.2 Investment Market

Office investment outside of London rebounded in Q4. Lambert Smith Hampton reported investment of £1bn across the South East and Rest of UK, double the Q3 figure (see Chart 9). The total was boosted by NatWest's sale of One Hardman Boulevard, Manchester to Parthena Reys for around £250m, and HMRC's purchase of 1 Ruskin Square, Croydon from Schroders for £115m.

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



Source: Lambert Smith Hampton

Retail investment saw above-trend activity in Q4, rising to £1.6bn. There were further moves in the supermarket space, with a 55 store Asda portfolio being sold for £400m to Macquire Asset Management. Shopping centres are also seeing a rising volume of transactions. There were 10 deals in Q4, the largest being the sale of Churchill Square in Brighton to Ingka Centres from Abrdn for £347m.

After booming during the pandemic, industrial investment is now coming back to earth. Total transactions of £1.2bn in Q4 was 51% under its five year average. An absence of large transactions is weighing on the total, with the largest of only six deals being Aviva investors £102m purchase of Leicester Distribution Park from Blackrock.

For more information:

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