Riverside CAPITAL | THE PROPERTY INVESTMENT PEOPLE

Quarterly Review: Q2 2026

Top Five

- While the global economy has so far weathered the energy shock resulting from the Iran conflict, the prolonged closure of the Strait of Hormuz increases the downside risk to our forecasts. Under our baseline, we still expect global inflation to only rise temporarily with minimal impact on GDP growth. Under our adverse scenario, a continued disruption to energy supply could push the global economy into recession.
- Central London office take-up ticked up in the second quarter, along with space under offer. That led to a further fall in office availability in the capital and a drop in vacancy rates from 8.5% to just 8.0%, the lowest since 2021.
- Coming off two strong quarters, UK investment volumes disappointed in Q2. That was partly driven by a drop back in London office transactions below £2.0bn, a 17% q/q fall. Despite weaker transaction totals, London still saw five large-scale deals above £100m in Q2.
- Regional office activity softened in Q2, with only around 1.2m sq. ft. taken up across the Big Five markets and the South East. That said, for prime office space the evidence from under offers suggests occupier demand remains robust. A limited pipeline will continue to put upward pressure on prime office rents.
- Regional investment trends mirrored the Capital. After a record Q1 for regional offices outside the South East, investment volumes fell 33% on the quarter. Meanwhile, South East office volumes saw little movement, remaining at just £0.2bn. Despite 8% q/q growth in Q2, industrial investment volumes remained well below historical norms. The only sector to show strong growth was retail, where investment rebounded 39% on the quarter, driven by a bumper 76% rise in shopping centre volumes.

1. Economic Overview

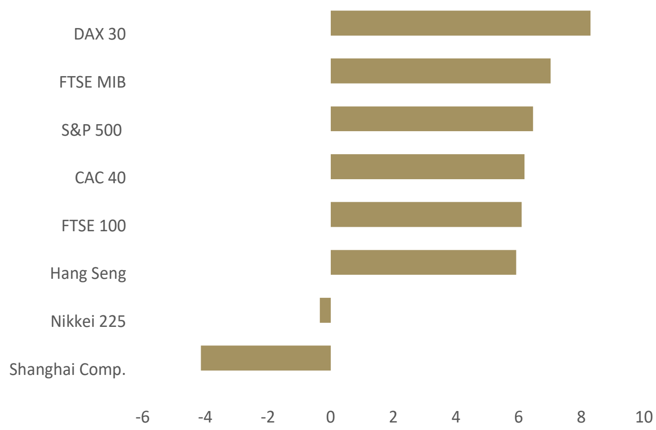
The year continued as it began, with further deterioration of the geopolitical backdrop in the second quarter. While June appeared to bring an end to the conflict in the Middle East, strikes by the end of the month triggered a return to war in the Strait of Hormuz. By late July, ongoing tensions in the Strait and conflict in the Red Sea caused oil prices to jump to $100pb, returning prices back to where they were in mid-May. While the Strait remains blocked, that upward pressure has now eased slightly, leaving prices around $80pb.

Meanwhile, the "Section 122" global tariff imposed by the Trump administration has now expired, giving way to a new regime of tariffs on countries for failing to tackle forced labour. Even so, as these new tariffs will essentially return rates back towards the ~9.5% level seen at the start of the year, we don't expect that will move the dial for global trade. Instead, the Iran war and the AI-driven boom will be the main drivers of the global outlook.

Despite renewed geopolitical uncertainty, equities have broadly seen gains over the past 40 trading days. (See Chart 1.) Most major markets posted positive returns through to the start of August, suggesting investors have continued to look through disruptions caused by the war.

Moves have been uneven across markets though. European equities have generally led gains, with FTSE 100, FTSE MIB, DAX, CAC 40 up around 7%. US equities also continue to post positive returns. While Hang Seng saw solid gains in the last 40 days, Nikkei 225 (Japan) and Shanghai Composite (China) were the only indices to provide negative returns.

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



Source: LSEG

The Iran war has lasted longer than we had initially assumed in our baseline scenario, but the hit to the global economy so far has been much more limited than previously anticipated. Even so, further disruption to energy markets means a tipping point for oil markets could quickly be reached, causing prices to surge above current levels. So far, economies have been relatively shielded by the redirection of one-third of the crude oil that previously flowed through the Strait to pipelines elsewhere in the region and drawdowns in oil inventories, which have cushioned the hit to supply.

Our baseline forecasts, which assumes Brent crude prices fall to $70bp by the end of the year, sees the conflict pushing global inflation to a 3.6% peak in Q4 2026, while GDP growth falls from 3.1% in 2025 to 2.8% in 2026. Although a near term drop back in prices to pre-war levels remains unlikely, we still expect weaker activity to keep second-round inflation effects contained. The experience of the past few months also suggests that a global recession and major monetary tightening cycle is less likely than many initially assumed. Although, we expect some divergence among major economies.

As a large oil and gas producer, the US is less exposed to the war disruption than other developed economies. Instead, we expect a strong AI-driven investment cycle and a healthy labour market to keep the US a clear growth leader among major developed markets. That should leave growth to average a solid 2.3% this year and 2.7% in 2027. The combination of a stronger growth profile, falling unemployment and stickier core inflation, which keeps headline inflation above 3% this year, is likely to prompt the Fed to hike. Our baseline assumes that the Fed will push through interest rate hikes this year and next, taking the fed funds target range between 4.25% and 4.50% in 2027.

Thereafter, we are expecting a bursting of the AI bubble which will trigger a major equity market correction by the end of next year. That would weigh on investment and consumption growth, hitting GDP growth in 2028.

The revision to Q1's GDP figure and moderate growth in the second quarter, suggests the euro-zone economy has weathered the energy shock well so far. Even if energy prices remain at their current levels, it is possible that households and firms will reduce their savings rate and keep spending. While our baseline scenario assumes inflation rises back above 3% y/y, the weaker underlying economy, with GDP growth of just 0.7% this year and 0.9% next, means we expect the European Central Bank to pause its tightening cycle, resuming rates cuts next year.

The momentum of the first quarter is unlikely to be sustained in the second in the UK, with an expected tick down in GDP growth from 0.6% in Q1 to 0.4% in Q2. We expect that weakness will continue this year, starting with flat growth (0.0%) in the third quarter. That will leave real GDP growing just 1.0% y/y in 2026 and 2027, a touch below last year's 1.3% y/y.

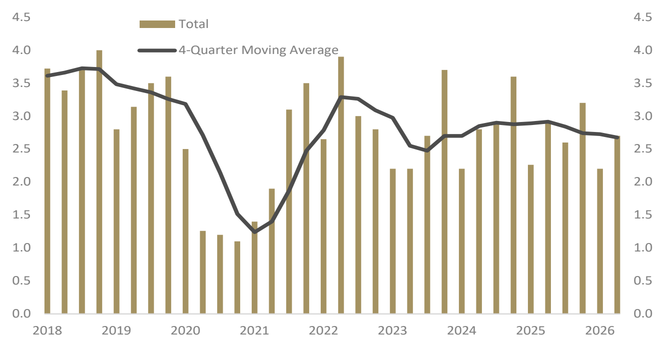
While there are increased risks to our baseline forecasts, we still think that the Bank of England will keep interest rates on hold despite above-target inflation. With weak underlying activity preventing second-round effects from taking hold, we expect interest rates to be cut from 3.75% now to 3.00% by the end of next year as falling fuel prices feeds through to lower inflation. Similarly to the outlook for the euro-zone, much of that will depend on the length of the conflict and how well energy supply can bounce back once an agreement is reached.

2. London

2.1 Occupational Market

Central London office take-up picked up after a disappointing start to the year. CBRE reported 2.7m sq. ft. of space let in Q2. (See Chart 2.) That still left take up 7% below the 10-year average and 14% below Q2 last year.

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



Source: CBRE

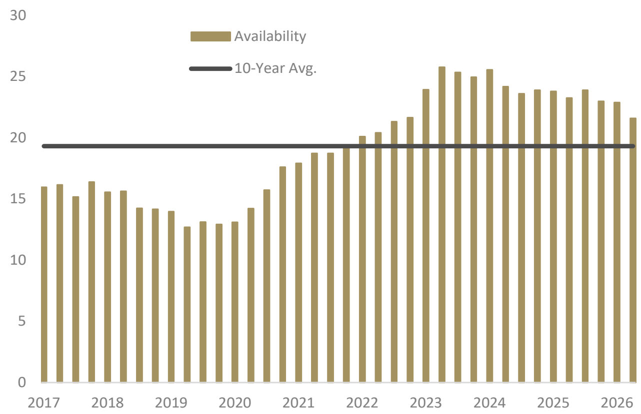
The slump in large deals continued into the second quarter, with transactions exceeding 50,000 sq. ft. falling from eight in Q1 to seven in Q2. More notable was the nature of those large deals. Indeed, two of the four largest deals involved AI companies expanding their London office space. Anthropic took top place with the largest quarterly transaction, taking 158,500 sq. ft. of newly completed space. OpenAI also committed to pre-let 95,500 sq. ft.

Unlike last quarter's unusually low take-up, second hand space rose from 40% of total take-up to 64% in the second quarter. That left the combined share of newly completed space and pre-let activity at just 36%, marking its lowest level since 2020.

Under offers saw a marginal increase in Q2, totalling 4.1m sq. ft. That pushed the total 17% above the 10-year quarterly average of 3.5m sq. ft. according to CBRE. The City accounted for the largest share of those under offers. Meanwhile, the largest unit was in the Docklands, where PwC has agreed to take 358,000 sq. ft. Once again, the majority of under offers remained either for new spaces or pre-lets, suggesting that occupiers continue to seek higher quality offices.

The second quarter saw another drop in London office availability. Totals ticked down from 22.9 m sq. ft. to 21.6 m sq. ft. according to Knight Frank, leaving levels close to the 10-year average. (See Chart 3.) That caused Central London vacancy levels to drop from 8.5% last quarter to just 8.0% in Q2, the lowest since 2021.

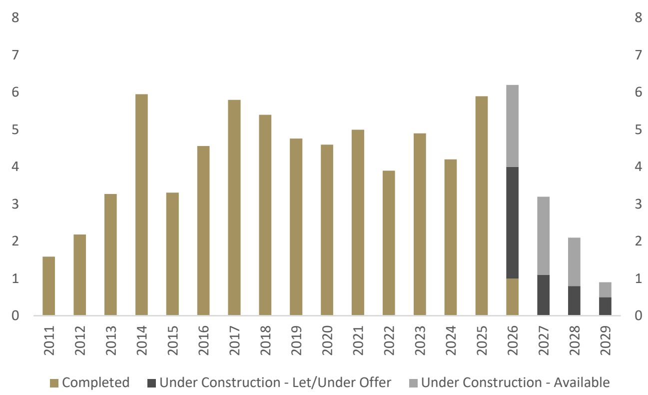
Chart 3: Central London Availability (M. Sq. Ft.)



Source: Knight Frank

CBRE reported that Central London development completions totalled 1.1 m sq. ft. in Q2, with around 3.8m sq. ft. under construction with the earliest possible completion date of Q3 2026. That would leave completions to top 6m sq. ft. this year, beating last year's eight year high. (See Chart 4.) Thereafter, the pipeline will drop back markedly, falling well below historical averages. While that likely reflects developer caution, totals are expected to rise closer to the time as demand for prime office space remains robust.

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



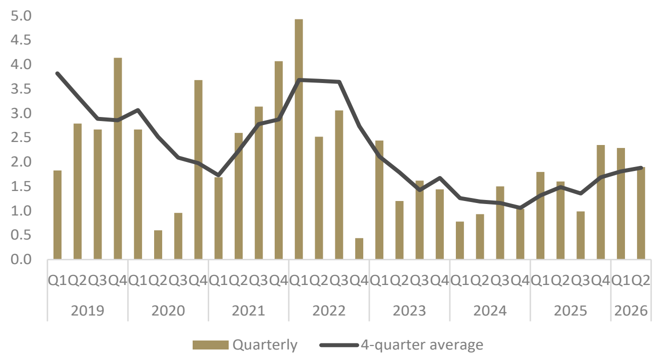
Source: CBRE

2.2 Investment Market

While the first quarter appeared resilient in the face of war in the Middle East, the impact of the ongoing conflict is starting to show in the quarterly transaction figures. Indeed, Central London investment volumes ticked down from £2.3bn in Q1 to just £1.9bn in Q2, a 17% decline on the quarter. (See Chart 5.)

Despite weak headline figures, Lambert Smith Hampton (LSH) report London accounted for 75% of total UK investment, leaving the share only 5 percentage points below trend.

Chart 5: Central London Office Investment (£bn)



Source: Lambert Smith Hampton

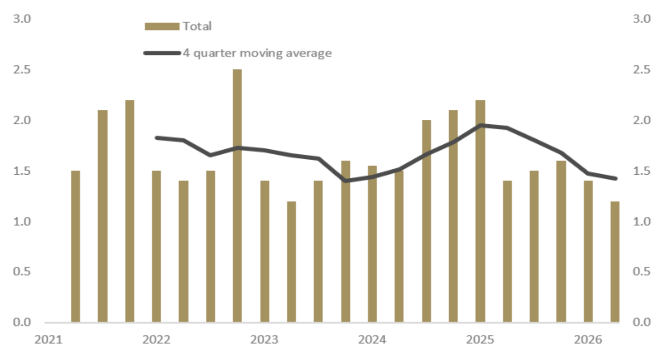
Large-scale deals remained key to London volumes, with five deals above £100m in Q2. Of these, the largest was Barclays' £750m freehold acquisition in Canary Wharf, marking the biggest London office deal in four years and made up 40% of total Central London investment volume. Despite the hit to investment sentiment resulting from the Iran war, prime office yields in Central London offices held steady in Q2 at 3.75%.

3. Rest of UK

3.1 Occupational Market

Full regional office data for Q2 are still emerging. Early evidence for the Big Five markets (Birmingham, Bristol, Edinburgh, Leeds and Manchester) and the South East from Cushman & Wakefield points to weakness in the second quarter. Total office take-up amounted to 1.2m sq. ft., representing a 14% q/q fall, leaving take-up at its lowest level since 2023. (See Chart 6.)

Chart 6: Big 5 and South East Office Take-up (M. Sq. Ft.)



Source: Cushman & Wakefield

The weak quarter partly reflected a lack of large occupier deals, with just one transaction exceeding 50,000 sq. ft. across those regions. While activity remained subdued, 475,000 sq. ft. of new office space completed, with 188,000 sq. ft. on the market across the Big Five and South East. Even so, available stock ticked down in Q2. That 1% fall in stock left vacancy rates at 10.5%, marking the fifth consecutive quarterly decline.

According to Cushman & Wakefield, Q2 take-up across the South East totalled 574,886 sq. ft., a 19% q/q fall. Office availability edged up marginally to 20.9m sq. ft., nudging vacancy rates to 11.7%. That was partly off the back of delivery of 400,000 sq. ft. of new space onto the market.

The office development pipeline remains limited in the South East. While Cushman & Wakefield reports that approximately 1.6m sq. ft. is under construction, 30% is either pre-let or under offer.

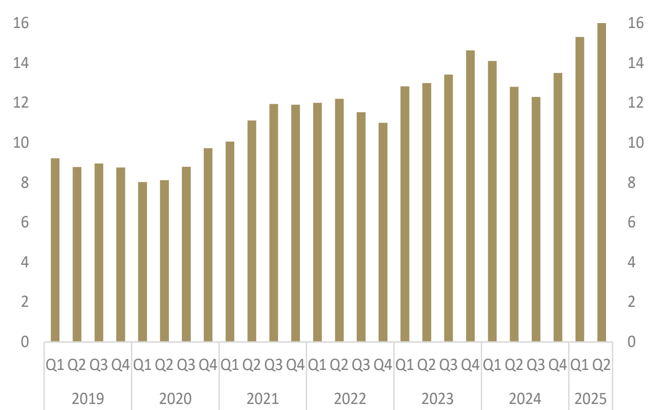
Regional occupier demand remains focused predominantly Grade A office buildings. Deals under offer suggest that this is likely to remain the case in the near term, squeezing availability for prime office space. With limited development pipeline and constrained supply, robust demand will continue to put upward pressure on prime rents over the rest of this year. As occupiers continue to look to Grade A space, a relatively large volume of secondary stock remains on the market.

Outside the office sector, CBRE reported UK logistics take-up slowed in the second quarter, totalling 5.2m sq. ft. That left availability of completed units to tick up, boosting the vacancy rate to 7.1%. Regionally, the East Midlands continued to dominate activity, accounting for 46.5% of total take-up.

3.2 Investment Market

Continuing the trend of the previous quarter, South East office investment volumes performed poorly, with just £0.2bn transacted in Q2. (See Chart 7.) That came despite a boost from British Land's £150m acquisition of Life Science REIT's labs.

Chart 7: Big Nine Office Availability (M. Sq. Ft.)



Source: Avison Young

UK regional office purchases outside of the South East did not sustain Q1's momentum, falling back 33% in Q2 from the four year high of £612m. (See Chart 7 again.) That left volumes at just over £400m, 18% below trend. As in London, regional prime office yields saw little movement, with the above sale of The Lincoln in Manchester confirming the 25bps outward move in yields in the previous quarter.

Industrial investment saw little improvement on the previous quarter, coming in at £1.5bn. While that was still an 8% quarterly tick up from Q1, volumes remained 35% below trend. That mainly reflected a low number of transactions, with total deals amongst the lowest on record. Instead, total volumes were boosted by large-scale deals. Indeed, average lot-size stood at £32m, the third largest on record. Distribution warehouses drove the overall improvement this quarter, with volumes almost double Q1's eight year low. Industrial prime yields remained steady in Q2, although global political uncertainty will put them under some upward pressure according to LSH.

Reversing much of the drop last quarter, retail volumes jumped 39% q/q to £1.7bn. This left volumes just 6% below the five-year quarterly average, despite the number of deals coming in 8% lower than the previous quarter. The drop in shopping centre volume to the lowest level since Q1 2025 meant much of the sector's rebound was driven by retail warehouses, which came in at £1.0bn.

The resilience of retail volumes is set to continue in the second half of this year, partly supported by headline shopping centre deals according to LHS. Indeed, several assets have come onto the market, including Metro Centre, Gateshead. While sentiment has been knocked, prime retail yields were broadly stable in Q2.

For more information:

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