CLUTTONS
INVESTMENT MANAGEMENT

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Commercial property examiner

Quarter two | 2022

Contents

Foreword

Economic risks

The war in Ukraine continues. Having been repulsed in its attempt to capture Kiev, the seat of government, Russia has now turned to a war of attrition in the south and east of the country. As Ukraine bravely resists the Russian artillery barrages, the possibility exists of the conflict continuing for months if not years. The ramifications for this would seem to be a continuation of elevated commodity prices, particularly grain, gas and oil.

As year-on-year inflation approaches 10%, the Bank of England, the US Federal Reserve and the European Central Bank (ECB) are faced with hard decisions. Raising interest rates too aggressively risks setting off a recession, while doing too little could raise inflationary expectations causing manufacturers and retailers to increase prices and workers to demand higher wages.

The ECB raised interest rates for the Euro Zone by 0.5% this month (July) and the Bank of England is expected to announce a similar increase in August. This will take UK interest rates to 1.75% and markets expect rates to rise further to 2.5% - 2.75% in 2023.

This may not seem high historically. In the 5-years before the Global Financial Crisis (GFC), interest rates occupied a range between 3.75% and 5.75%. However, since March 2009, interest rates have been stuck at 0.5% more or less and during the pandemic were reduced to near zero. Over the past 13-years, commercial and domestic borrowers have adjusted their budgets to match the new normal in borrowing costs.

Climate change and record temperatures

40-degree shade temperatures, heathland ablaze, a village destroyed by wildfire and the London Fire Brigade's busiest day since the Blitz bear witness to the dangers faced by the UK from Global warming. . These events reinforce the headwinds still faced by the move to net-zero.

Rarely has the prospect of a day in an air-conditioned office been more welcoming than it has in the past week. But the UK's infrastructure was not

designed for such heat. Problems faced by commuters included melting tarmac road surfaces, buckled rails, damage to overhead power lines and track side fires. For many office workers, the result was a further uncomfortable stint of working from home in over heated home offices, spare rooms and kitchens.

Investment is needed in the UK's infrastructure and the vehicles that use it to mitigate the effects of inevitable temperature rises and help meet net zero targets. The Department of Transport's plan to decarbonise the entire transport system includes incentivising the production of zero-emission road vehicles which could add £9.7bn to the economy by 2050. Encouragingly, the cost of the batteries they need has already dropped by 85% between 2010 and 2018.

Also included in the plan are safer bike routes and better cycle parking to reduce the demand on trains and buses and decarbonised "last mile" logistics using cargo bikes and electric vans that would further reduce congestion and environmental impacts.

Apart from the economic benefits, the nation's health would be improved through a reduction in air pollution and the more than 28,000 associated deaths each year, as well as bring down the number of fatal road accidents.

Other quicker and more mundane ways to address these problems include painting rooftops a lighter colour which can reduce daytime temperatures by up to 3C and reduce heat-related deaths by up to a quarter. A bank of trees above concrete can reduce temperatures by a remarkable 20C in summer. Bodies of water can have a similar effect, while better building regulations to ensure new homes are properly insulated would make them cooler in the summer as well as warmer in the winter and reduce their associated emissions.

The real estate industry has problems of its own to grapple with in the move to net-zero. In the same month that saw temperatures reach 40C, Axa Investment Managers and Topland Group announced plans to develop two more office towers in the City of London, which together will provide more than 800,000 sq ft of space. Both developers are confident in the demand for buildings with low carbon emissions and modern facilities even if hybrid working becomes more entrenched following the pandemic.

However, there is a growing awareness of the larger carbon footprint of new-builds compared to retro-fits of existing buildings. It is claimed that more than a third of the lifetime emissions of a "typical" office are contained in the embedded carbon from construction.

This number may be exceeded in the 36-storey tower proposed by Axa at 50 Fenchurch Street.

A month earlier, Michael Gove, the Secretary of State for levelling up, housing and communities ordered a public enquiry into Marks and Spencer's plans to demolish and re-develop on the site of its flagship Marble Arch store. Westminster City Council and the Mayor of London had previously accepted the plans. Opponents of the scheme argued that the project would release 40,000 tonnes of CO2 into the atmosphere. The retailer claimed that the new building would use 25% less energy with a maximum carbon payback of 17 years. The debate surrounding refurbishment versus re-development is set to continue.

1. Key take aways

Despite a satisfactory performance by the UK economy so far this year, the risks of a recession are increasing. The annual rate of inflation has increased to 9.4%, the highest rate since 1980-81, causing a cost-of-living crisis. Interest rates have risen from 0.1% in November 2021 to 1.25% and are likely to rise further to 1.75% in early August. The OECD is forecasting that the UK alone among the G7 nations could have zero growth in 2023; and the latest MPC forecasts suggest that that the onset of recession is possible towards the end of this year or early next year.

World stock markets have fallen sharply. The MSCI World Index lost 10.4% in Q2. The NASDAQ which contains the listing of many of the major tech stocks was down 22.0%. Some of these big tech stocks have fallen further. Reacting to falling subscriber numbers, Netflix was marked down 53% and Nvidia, a global leader in artificial intelligence hardware and software, fell 44%. And, Prologis, the largest logistic and warehouse real estate company in the world, suffered a further 27% fall in its share price having fallen 4% in Q1. The FTSE 100, however, with a large representation of oil and commodities stocks only fell -1.8%.

The heat is slowly coming out of the UK commercial real estate market as it faces up to the risks from geo-political events, high inflation, interest rate rises, turmoil in other global financial markets and a cost-of-living crisis. In June, quarterly All Property total returns, as recorded by the MSCI Monthly Index, decreased from 5.6% in March to 3.8%, reflecting an annualised rate of 16.1%.

Year to date performance has already reached 9.6% but we expect that the market will now slow in the second half of the year. Accordingly, we have downgraded our forecast All Property total return for 2022 from 12% to 11%. The momentum built up by retail warehousing and industrials will continue through to the end of the year, but the remaining segments are expected to under-perform the market average. We have also reduced our forecast for 2023 from 7% to 4% reflecting the weaker economic background. The net effect is that the annualised average forecast for the 3-years ending December 2024 is reduced from 8% to 7%.

2. Summary

June's edition of the World Bank's Global Economic Prospects highlights the threats to the world economy from Russia's illegal invasion of Ukraine, high inflation, rising interest rates and slow growth. The report says that the danger of stagflation is considerable – a phenomena that the world has not seen since the 1970's.

Stronger than expected performance by the UK economy in May 2022 resulted in growth of 0.5% following a decline of 0.2% in April. Rolling 3-month economic growth, which smooths out some of the volatility in the monthly numbers, amounted to 0.4%. Since the start of the year, output has grown at the annual equivalent of 2.6%.

Year on year CPI inflation increased to 9.4% in June 2022 from 7.0% in March. This is the highest 12-month inflation rate since 1980-81, when its cyclical peak reached 21.0%. Core inflation excluding energy, food, alcoholic drinks, and tobacco is lower at 5.8% and has been falling since it reached 6.2% in April. But even this number is much higher than the 2% target rate.

In its inaugural Fiscal Risks and Sustainability Report, the Office for Budget Responsibility (OBR) reported that UK public debt was on an unsustainable path in the long term.

The MSCI World Index lost 10.4% in Q2 while the FTSE 100 with a large representation of oil and commodities stocks only fell -1.8%. The NASDAQ which contains the listing of many of the major tech stocks was down 22.0% in Q2.

UK REIT share prices shrank by 29% in Q2 and under-performed the wider all share market indices by a wide margin. The losers included the previously top performing logistics and warehousing specialists. In May, Amazon warned that it had over-leased and over-hired in the pandemic, driving down the share price of Segro and Tritax Big Box.

The current property initial / gilt yield gap is 1.97% having decreased by 73 bps over the course of Q2 and 150 bps since the end of 2021. It is now more than three standard deviations below the 10-year average.

The latest Q2 2022 market numbers remain strong but reflect a further slight weakening from Q4 2021 and Q1 2022. The market may be slowly reacting to the headwinds caused by geo-political events, interest rate rises, the turmoil in other global financial markets, elevated inflation and a cost of living crisis.

In Q2, All Property total returns, as recorded by the MSCI Monthly Index, decreased to 3.8% from 5.6% in Q1 2022. And, in the 12-months to the end of June 2022, All Property total returns decreased to 23.7% from 23.9% in the 12-months ending March 2022.

All Property investment volumes, represented by the current value of investment transactions adjusted for capital growth, decreased by 31% in Q1 2022 compared to Q4 2021 and were just 1% above their long run average. Preliminary estimates suggest that investment volumes fell in Q2 but as usual the numbers are likely to be revised upwards in the coming months.

The central forecast from Cluttons' House View model is revised on a quarterly basis to reflect market performance reported in the current year to date. Year to date performance has already reached 9.6% but we expect that the market will now slow in the second half of the year. Accordingly, we have downgraded our forecast All Property total return for 2022 from 12% to 11%. The momentum built up by retail warehousing and industrials will continue through to the end of the year, but the remaining segments are expected to under-perform the market average.

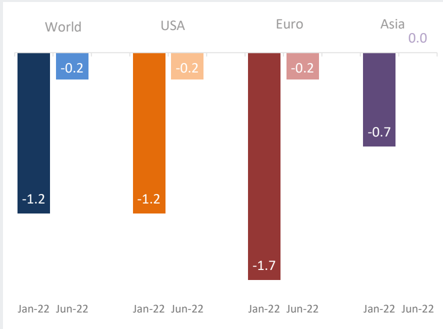
3. The World economy

June's edition of the World Bank's Global Economic Prospects highlights the threats to the world economy from Russia's illegal invasion of Ukraine, high inflation, rising interest rates and slow growth. The report says that the danger of stagflation is considerable – a phenomena that the world has not seen since the 1970's.

Global growth is projected to slow from an estimated 5.7% in 2021 to 2.9% in 2022 and 3.0% in 2023. This is 1.2 and 0.2 percentage points lower for 2022 and 2023 than projected in January 2022. Europe is forecast to fare worse still because of its reliance on Russian gas (see Chart 1.1).

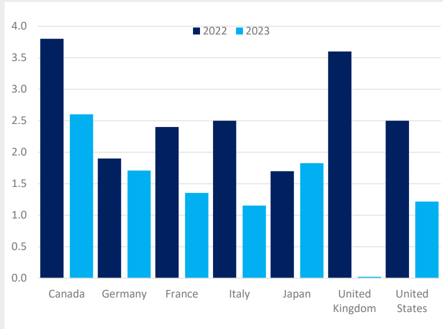
The OECD's Economic Outlook also published in June adds supply chain disruptions resulting from continued shutdowns caused by China's zero-COVID policy to the list of risks. Its forecasts suggest that the UK alone among the G7 group of advanced economies could have zero growth in 2023 (see Chart 1.2).

1.1 2022 growth projections by region



Source: World Bank, Jun 2022

1.2 G7 economies forecast %'age change



Source: OECD, June 2022

4. The UK economy

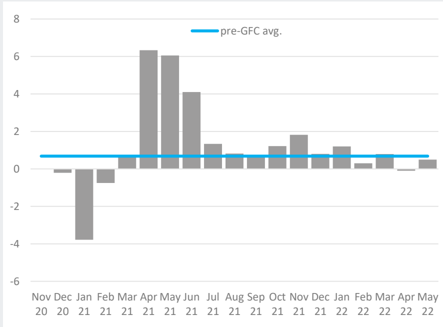
Stronger than expected performance by the UK economy in May 2022 resulted in growth of 0.5% following a decline of 0.2% in April. Rolling 3-month economic growth, which smooths out some of the volatility in the monthly numbers, also amounted to 0.5%. Since the start of the year output has grown at the annual equivalent of 2.6% (see Chart 1.3).

The output of services grew by 0.4% in May as health sector activities grew by 2.1%, mainly because of a large rise in GP appointments, which offset the continued scaling down of the NHS Test and Trace and Covid-19 Vaccination Programmes. Output in consumer-facing services fell by 0.1% in May 2022, driven by a 0.5% fall in retail trade. Manudacturing grew by 1.4% and construction grew by 1.5% representing a seventh consecutive month of growth (see Chart 1.4).

In the post-pandemic era, service sector industries have fared better than manufacturing. Unsurprisingly, given its role in supporting on-line retailing, Logistics has recorded the highest level of growth since February 2019, when Covid first became recognised as a threat. This, of course, supports the strong tenant demand for warehousing and the rapid escalation in "shed" rents (see Chart 1.5).

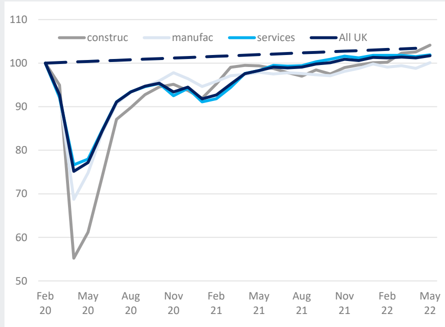
The Monetary Policy Committee (MPC) has been consistently revising its forecasts down. Its UK GDP forecasts published in May 2022 continued this trend and indicated that UK GDP growth is expected to slow sharply over the first half of the forecast period, caused by higher energy prices and the removal of monetary and fiscal policy support in the form of higher interest rates and taxes and cuts to Government spending. It is clear from these forecasts that the onset of recession is possible towards the end of this year or early next year (see Chart 1.6).

1.3 Rolling 3m UK economic growth



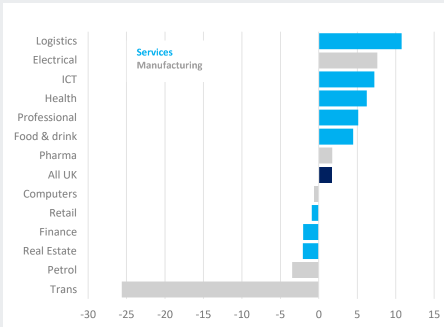
Source: ONS, July 2022

1.4 UK economic growth indices



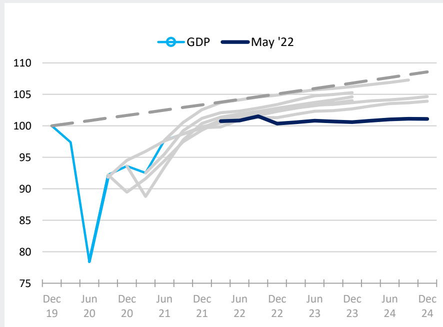
Source: ONS, July 2022

1.5 Post pandemic economic growth by sector



Source: ONS, July 2022

1.6 MPC economic projections



Source: Bank of England, May 2022

5. Other economic indicators

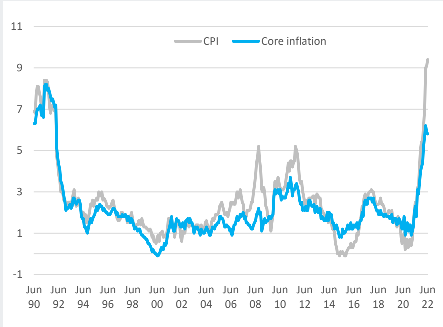
Year on year CPI inflation increased to 9.4% in June 2022 from 7.0% in March. This is the highest 12-month inflation rate since 1980-81, when it reached 21.0% at its cyclical peak. Core inflation excluding energy, food, alcoholic drinks, and tobacco is lower at 5.8% and has been falling since it reached 6.2% in April. But even this number is much higher than the 2% target rate (see Chart 2.1).

Historically, inflation has been caused by over-heating economies and policy makers have responded to high inflation by increasing interest rates to slow economic growth. This led to recessions in 1974-75, 1980–81 and 1991-92 after interest rates were raised to 13% in 1973, 17% in 1980 and 15% in 1990 (see Chart 2.2).

May's MPC forecasts expect inflation to peak at more than 10% in Q4 2022 and remain elevated through 2023 before falling back to the 2% target in the second half of 2024. However, the MPC has consistently underestimated the outlook for inflation (see Chart 2.3). May's MPC meeting confirmed a further 25 bp increase in interest rates to 1.0%. In June, the rate rose again to 1.25%. Although inflation is being generated by factors outside the UK, the Governor of the Bank of England very recently hinted that a 50bp rate rise to 1.75% was likely at August's monetary policy committee meeting.

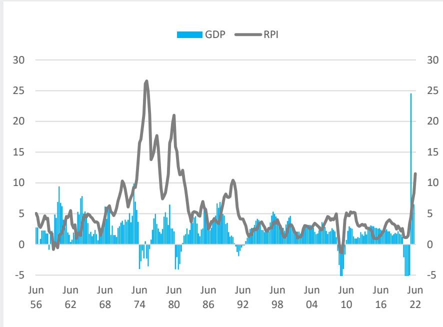
The MPC has suggested that a recession is possible towards the end of this year or early next year. The current jobs' market seems to suggest that there is still some resilience in the economy. Employment has recovered to near pre-pandemic levels and unemployment is at long term low levels (see Chart 2.4).

2.1 CPI inflation



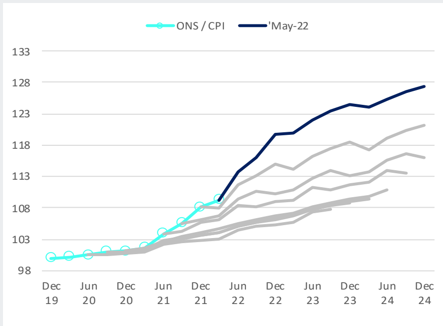
Source: ONS, June 2022

2.2 RPI inflation post WW2



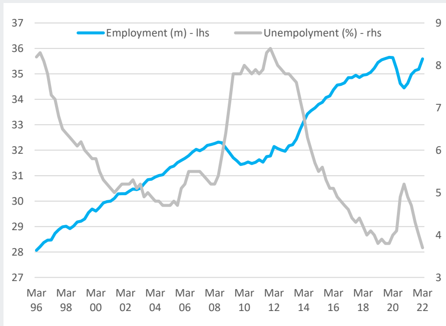
Source: ONS, July 2022

2.3 MPC inflation projections



Source: Bank of England, May 2022

2.4 UK jobs & unemployment



Source: ONS, June 2022

However, pay in real terms has been falling since June 2021 and is now at 2007 levels. This together with sharply higher prices for utilities, petrol and food are the cause of the cost-of-living crisis that will cause consumers to reduce their expenditure and will further slow UK economic growth (see Chart 2.5).

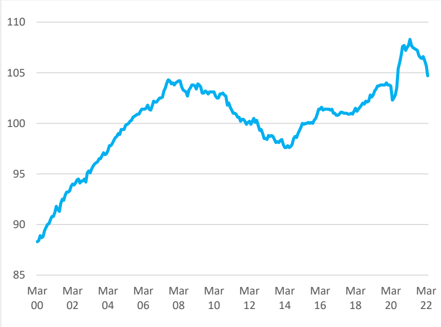
In its inaugural Fiscal Risks and Sustainability Report, the Office for Budget Responsibility (OBR) reported that a retreat from global economic integration caused by the Russian invasion of Ukraine and the US-China tariff war, higher energy prices and long-term fiscal pressures from an aging population and the loss of existing motoring taxes in a decarbonising economy leaves public debt on an unsustainable path in the long term (see Chart 2.6). Future governments will have difficult decisions to make on the balance between taxation and spending. This also feeds into the current Tory leadership contest between Liz Truss, promoting unfunded tax cuts and increased borrowing, and the more cautious ex-Chancellor, Rishi Sunak.

The latest quarterly GDP data to the end of Q3 2021 for the English regions plus Wales released in May suggests that the Government has a long way to go to make good on its "levelling up" promises. London is the only region to have experienced any positive economic growth since the end of 2019 (see Chart 2.7).

In May, the ONS also released annual estimates of GDP in 2020 for UK local areas and city regions. It provides a more granular view of economic activity across the UK albeit at a distance of twelve months or more.

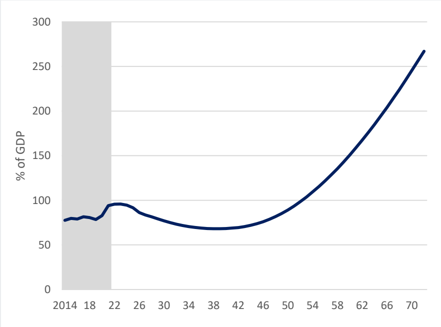
Across a selection of the UK's largest and/or fastest growing city regions, the West End and City of London together with Manchester and Cardiff enjoyed the largest annualised rate of growth in the 10-years ending 2020. Birmingham, Bristol, Edinburgh and Glasgow, four of the UK's "Big 6" regional cities, were included in a cluster of northern cities that underperformed the UK average (see Chart 2.8).

2.5 Real pay index (sa)



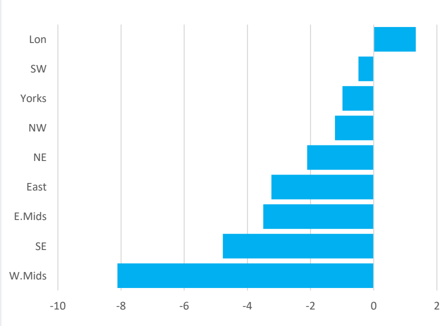
Source: ONS, June 2022

2.6 Long term projections for public sector debt



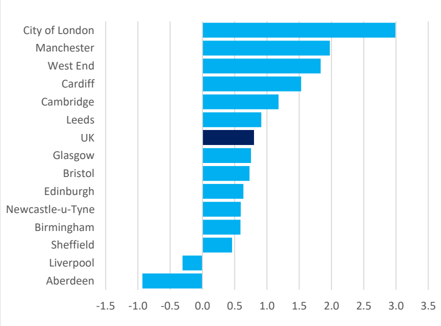
Source: OBR, Jun 2022

2.7 Post pandemic regional economic growth



Source: ONS, May 2022

2.8 Economic growth by city 2010-2020



Source: ONS, May 2022

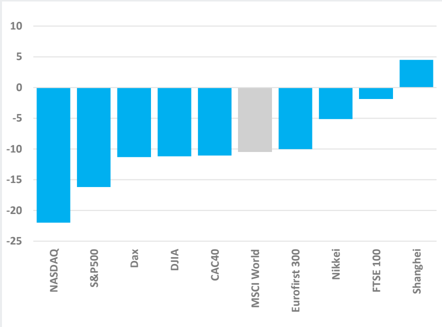
6. Interest rates and asset yields

In Q2, stock markets across the world fell sharply. The MSCI World Index with large and mid-cap representation across 23 developed markets lost 10.4% while the FTSE 100 with a large representation of oil and commodities stocks only fell -1.8% (see Chart 3.1).

The NASDAQ which contains the listing of many of the major tech stocks was down 22.0% in Q2. Some of these big tech stocks have fallen further. Reacting to falling subscriber numbers, Netflix was marked down 53% and Nvidia, a global leader in artificial intelligence hardware and software, fell 44%. And, Prologis, the largest logistic and warehouse real estate company in the world, suffered a further 27% fall in its share price having fallen 4% in Q1. Perhaps the least surprising of these numbers was the deflating of the digital currency bubble represented by Bitcoin's 56% slump (see Chart 3.2).

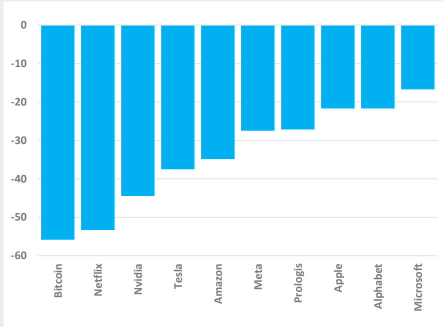
UK REIT share prices shrank by 29% in Q2 and under-performed the wider all share market indices by a wide margin. The losers included the previously top performing logistics and warehousing specialists. In May, Amazon warned that it had over-leased and over-hired in the pandemic, driving down the share price of Segro and Tritax Big Box. Investment banking analysts voiced a more cautious outlook for the London office market and UK retail property sending the share price of Hammerson, Great Portland, Derwent London, British Land and Land Securities falling (see Chart 3.3).

3.1 World stock markets in Q2 2022



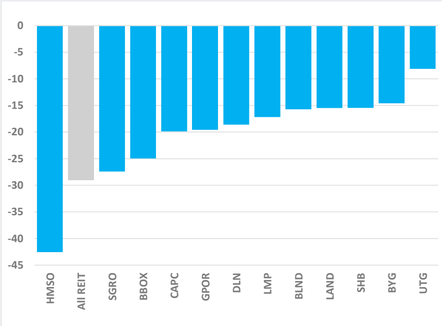
Source: Yahoo Finance, July 2022

3.2 Tech & other selected stocks Q2 2022



Source: Yahoo Finance, July 2022

3.3 UK Reit price movement in Q2 2022



Source: Yahoo Finance, July 2022

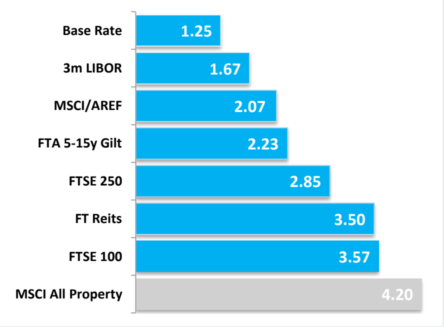
Risk free assets have continued their rise from the historic low yields prevailing during the Covid years. The yield on the 5-15 year gilt index hardened by a further 63 bps in Q2 to 2.23%. It has now risen 128 bps since the start of the year from 0.95%. Consequently, the total return performance on the UK Gilts Actuaries Index in Q2 was -4.3% (see Chart 3.4).

Market expectations of future interest rates have increased by 50 bps at the shorter end of the yield curve and by 80 bps for longer maturities. At 1.93%, the yield on 5-year gilts is at its highest since the end of 2014. Based on the conditioning path for Bank Rate published by the Bank of England, markets now expect rates to rise further to 2.5% - 2.75% in 2023 (see Chart 3.5).

The current property initial / gilt yield gap is 1.97% having decreased by 73 bps over the course of Q2 and 150 bps since the end of 2021. It is now more than three standard deviations below the 10-year average. However, the yield gap remains high by longer run standards. In the months before the GFC, the yield gap briefly turned negative. And, of course, in the 1980s the reverse yield gap was an established feature of the UK market (see Chart 3.6).

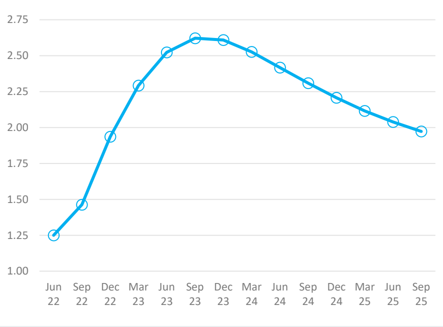
Real estate capital valuations are now starting to be buffeted by headwinds. Firstly, the interest rate on commercial loans charged at 200 bps plus over the Sterling Overnight Index Average (SONIA) has now climbed to 3.2% or more. Secondly, asset valuations achieved using a discounted cash flow approach, with the discount rate representing a margin over the risk free rate, will see a downwards correction. For the moment, the industrial sector in particular which has an average MSCI initial yield of just 3.3%, also benefits from market rental growth currently running at 12.5% in the year to June.

3.4 UK asset yields Q2 2022



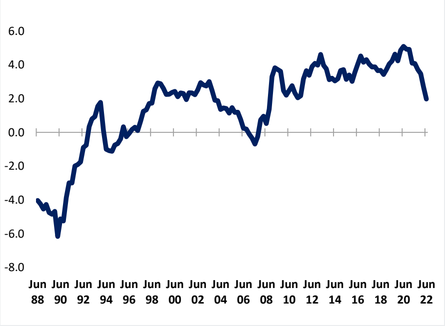
Source: Yahoo Finance & MSCI, July 2022

3.5 Market expectations for base rate (%)



Source: Bank of England, May 2022

3.6 Property IY - Gilt yield gap



Source: MSCI & Bank of England, July 2022

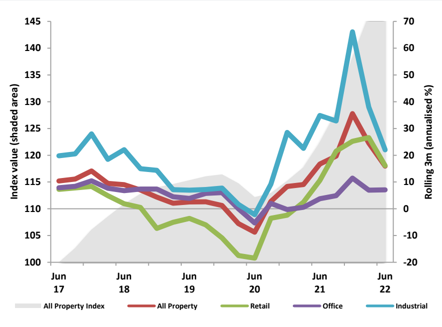
7. Commercial property market performance

The latest Q2 2022 market numbers remain strong but reflect a further slight weakening from Q4 2021 and Q1 2022. The market may slowly be reacting to the headwinds caused by geo-political events, interest rate rises, the turmoil in other global financial markets, elevated inflation and a cost-of-living crisis.

In Q2, All Property total returns, as recorded by the MSCI Monthly Index, decreased to 3.8% from 5.6% in Q1 2022. Capital growth was 2.6% in Q2 compared to 4.4% in Q1 2022. Property equivalent yields hardened by 11 bps and contributed a 1.8% uplift to valuations. All Property rental value growth decreased to 1.1% in Q2 from 1.4% in Q1 2022. Q2 income returns amounted to 1.1% (see Charts 4.1 & 4.4).

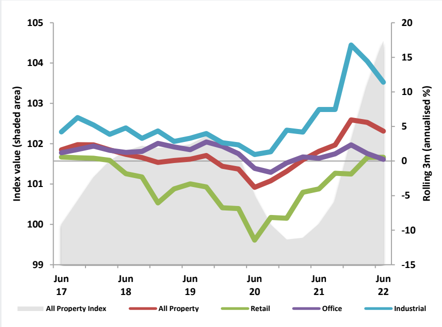
Over the course of the second quarter, office rental value growth decreased to 0.1% from 0.3% in Q1 2022, while industrial rental value growth decreased to 2.7% from 3.4% in Q1 2022. Retail rental value growth increased slightly from 0.1% in Q1 2022 to 0.2% in Q2. Retail warehousing and Shopping Centre rental values grew by 0.3% and 0.1% respectively but rental values for Rest of UK shops continued to slip. And Central London retail rental values increased by 1.0% having fallen by more than 9% in the last 12-months (see Charts 4.2 & 4.5).

4.1 Total returns by sector



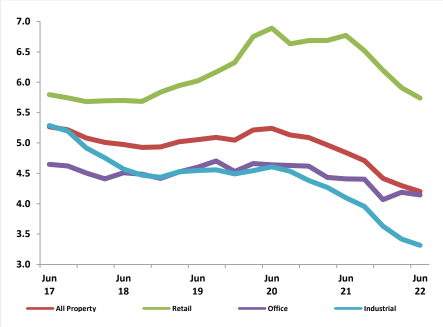
Source: MSCI, July 2022

4.2 MRV growth by sector



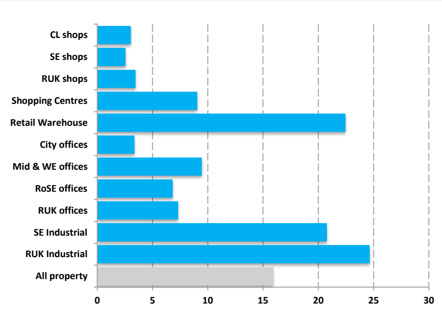
Source: MSCI, July 2022

4.3 Initial yield by sector



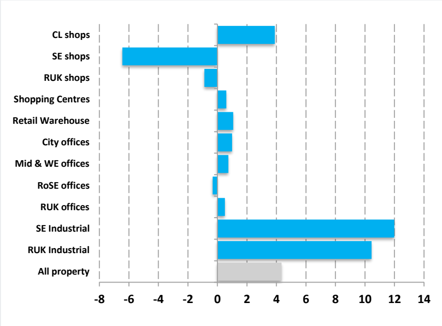
Source: MSCI, July 2022

4.4 Total returns by segment (Q2 annualised)



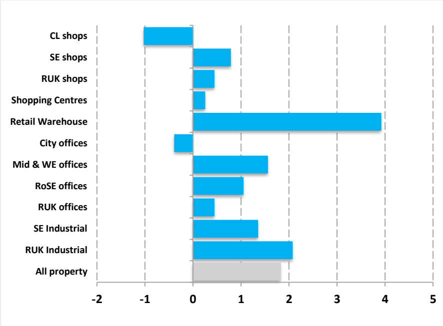
Source: MSCI, July 2022

4.5 MRV growth by segment (Q2 annualised)



Source: MSCI, July 2022

4.6 Yield impact (Q2)



Source: MSCI, July 2022

In the 12-months to the end of June 2022, All Property total returns decreased to 23.7% from 23.9% in the 12-months ending March 2022. Year-on-year capital growth was 18% in in March 2022 and 18% again in June 2022. Property equivalent yields hardened by 81 bps in the 12-months to June and contributed a 13.6% uplift to valuations. All Property rental values increased year-on-year by 4.5% and income return amounted to 4.9%.

Strong investment and occupier demand for industrials has pushed up rental values and driven yields down to 3.3% and approaching 2.5% for last mile logistics in London at the top of the market. The yield gap between industrials and retail and office assets has reached a point where investors might be tempted to look for value in the office, shop and shopping centre sectors just as has previously been seen in retail warehouses (see Charts 4.3 & 4.6).

Occupier demand for industrials, however, is driving rental growth of 12.5% year-on-year and 11.4% at a quarterly annualised rate in Q2. For the moment, after adding back the income, investors can reasonably anticipate total returns of 14% or more. But an element of caution is creeping into the market as interest rates continue to rise and the economic outlook weakens. Annecdotal evidence indicates that there is a growing spread bewteen prices being offered and the prices sought by vendors.

Tables 5.1 – 5.5 contain further performance data for UK commercial real estate in Q2 2022.

5.1 Total returns

	Jun	3m	6m	12m
All Property	0.7	3.8	9.6	23.7
Retail	0.6	3.7	10.1	22.3
Office	0.4	1.7	3.4	7.6
Industrial	1.1	5.1	13.9	38.8
Annualised				
All Property	9.3	15.9	20.1	23.7
Retail	7.8	16.1	21.2	22.3
Office	5.3	7.1	7.0	7.6
Industrial	13.4	22.0	29.8	38.8

Source: MSCI

5.2 Capital growth

	Jun	3m	6m	12m
All Property	0.4	2.6	7.2	18.0
Retail	0.1	2.3	6.8	14.7
Office	0.1	0.6	1.1	2.7
Industrial	0.8	4.2	11.9	33.7
Annualised				
All Property	10.9	14.9	18.0	13.9
Retail	1.6	9.5	14.1	14.7
Office	0.6	2.3	2.3	2.7
Industrial	9.7	17.9	25.3	33.7

Source: MSCI

5.3 Income return

	Jun	3m	6m	12m
All Property	0.4	1.1	2.3	4.9
Retail	0.5	1.5	3.1	6.7
Office	0.4	1.1	2.3	4.7
Industrial	0.3	0.9	1.8	3.9
Annualised				
All Property	4.5	4.5	4.6	4.9
Retail	6.1	6.1	6.3	6.7
Office	4.7	4.6	4.6	4.7
Industrial	3.5	3.5	3.7	3.9

Source: MSCI

5.4 ERV growth

	Jun	3m	6m	12m
All Property	0.4	1.1	2.4	4.5
Retail	0.2	0.1	0.3	-0.7
Office	-1.1	0.1	0.3	1.2
Industrial	1.1	2.7	6.3	12.5
Annualised				
All Property	5.2	4.3	5.0	4.5
Retail	2.0	0.5	0.5	-0.7
Office	-0.0	0.1	0.3	1.2
Industrial	1.1	2.7	6.3	12.5

Source: MSCI

5.5 Net initial yield

	Jun	3m	6m	12m
All Property	4.2	4.3	4.4	4.8
Retail	5.7	5.9	6.2	6.8
Office	4.1	4.2	4.1	4.4
Industrial	3.3	3.4	3.6	4.1

Source: MSCI

Factor investing or "smart beta" involves targeting quantifiable characteristics or "factors" that can explain differences in asset returns. This smart beta approach can be used to identify characteristics of real estate that drive out-performance and identify new asset allocation strategies based on factors. Such an approach offers real estate investors new tools to segment the market in addition to traditional approaches that dissect assets by sector and geography.

In Table 5.6, we have adopted the factor approach to real estate by segmenting the market firstly by use and secondly by a key characteristic i.e. yield, rent or lease length. The numbers presented are the 3-month total return relative to the MSCI All Property average for Q1 2022. A heat map has been used as a visual aid to pick out the under-performing segments in red and out-performing segments in green.

Consistent with our analysis in this report, each of the Retail Warehouse and Industrial segments are out-performing. Offices have now joined Shops and Shopping Centres in negative territory as questions surrounding the future demand for space in a post-Covid business environment hang over the sector.

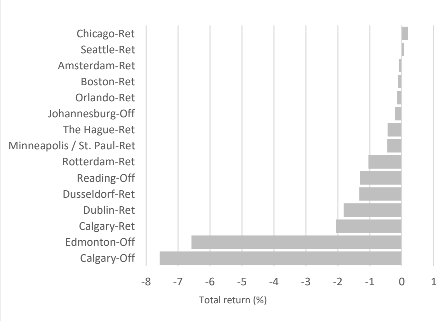
In May, MSCI published the performance numbers for the world's largest real estate markets in 2021. Total returns ranged from -7.6% for Calgary offices to 53.9% for Los Angeles industrials. The themes playing out in UK commercial real estate of retail and office under performance and industrial out performance are visible around the world. The office and retail sectors in cities across North America, Europe and Africa prop up the 2021 performance league table while industrials are the top performers particularly in the UK and USA (see Charts 5.7 and 5.8). The best performing retail market was Adelaide, where total returns of 13.6% were achieved. And San Diego was the best performing office market with total returns of 19.0%.

5.6 Performance by strategy relative to All Property average Q3 2021

	Low yield	High yield	High rent	Low rent	Long lease	Short lease
Shops	-3.0	-3.8	-5.0	-3.0	-2.3	-3.8
Shopping Centres	-3.2	-3.8	-5.0	-3.2	-2.5	-4.3
Retail Warehouses	3.0	3.8	4.0	3.0	2.3	4.0
Central London offices	-2.4	-3.6	-3.4	-2.4	-2.7	-3.7
RoSe offices	-2.1	-3.5	-3.3	-2.1	-2.3	-3.1
RUK offices	-2.7	-4.0	-2.8	-2.7	-2.3	-4.2
Industrials	4.2	2.1	4.4	4.2	1.8	5.6

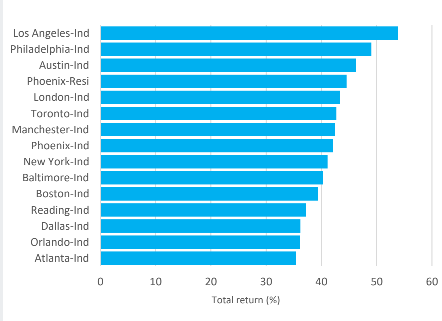
Source; MSCI Quarterly Digest Q1 2022

5.7 MSCI Global cities in 2021 - bottom 15



Source: MSCI, July 2022

5.8 MSCI Global cities in 2021 - top 15



Source: MSCI, July 2022

8. Investment in property

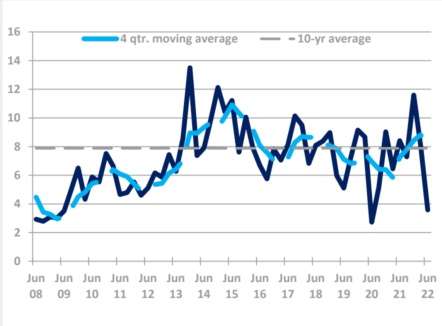
All Property investment volumes, represented by the current value of investment transactions adjusted for capital growth, decreased by 31% in Q1 2022 compared to Q4 2021 and were just 1% above their long run average. Preliminary estimates suggest that investment volumes fell in Q2 but as usual the numbers are likely to be revised upwards in the coming months (see Chart 6.1).

Industrials made up 27% by value of investment transactions in Q1 2022; Central London offices represented a further 29% and Alternatives including Medical Facilities, Car Showrooms, Residential and Student Accommodation made up another 19%. Across all sectors of the market, investment volumes were lower in Q1 2022 than in Q4 2021 (see Chart 6.2). However, there is a seasonality to this data that reflets the pressure in Q4 on fund managers to complete transactions and fulfil asset allocation mandates before year-end.

Central London offices traditionally dominate UK real estate investment representing 28% of the UK's real estate investment market over the last 22 years. Investment volumes which have been on a declining trend since December 2013 had shown signs of improvement since March last year although the volumes reported so far for Q2 are disappointing (see Chart 6.3).

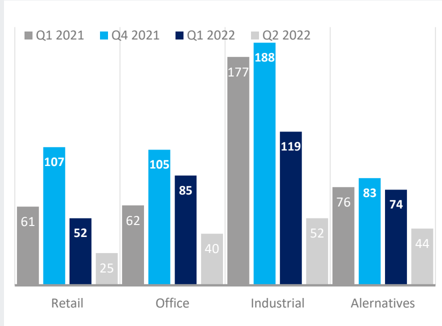
Transaction numbers in the City of London increased strongly in Q1 2022 but decreased in the West End and Midtown markets. The City Fringe, Docklands and Southbank markets were again thinly traded. In Q1 2022, the City of London accounted for 57% of all Central London office transactions while the West End represents 43% of such transactions (see Chart 6.4).

6.1 All property investment volumes (£bn)



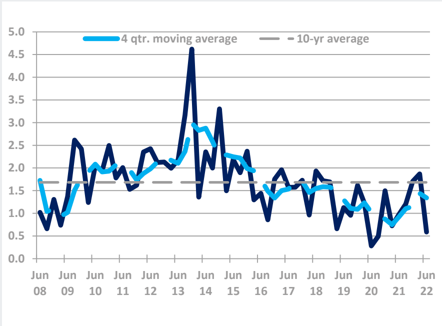
Source: Property Data, MSCI & APR, July 2022

6.2 Investment transaction nos. by quarter



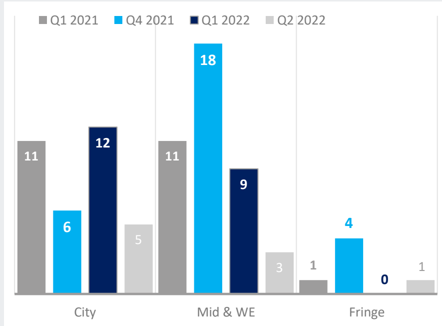
Source: Property Data, July 20222

6.3 Central London office investment volumes (£bn)



Source: Property Data, MSCI & APR, July 2022

6.4 Central London office Investment transaction nos. by quarter

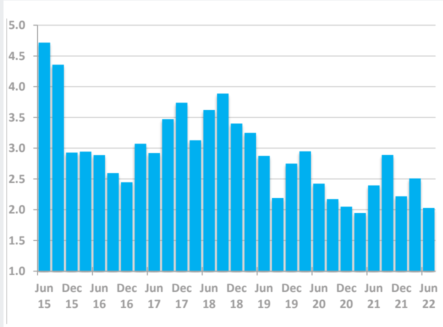


Source: Property Data, July 2022

Continued talk of a large amount of overseas' capital targeting Central London offices may well be accurate but this capital is only being deployed slowly (see Chart 6.5). This may be through a lack of suitable assets for sale or residual concerns surrounding the medium-term risks. High inflation, rising bond yields and the geo-political uncertainties caused by Russia's war in Ukraine will increase any tendency to delay decisions.

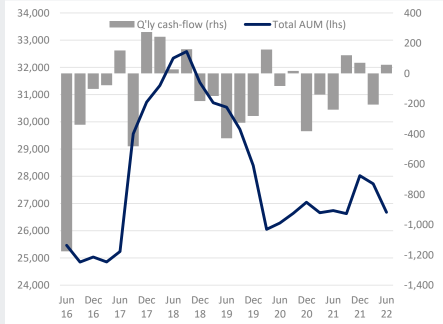
In the last six years, property funds have regularly faced demands for redemptions from retail investors. In 2016, the Brexit referendum resulted in the closure of open ended funds. And in the last two years, the lethargic performance of the UK economy and the continued uncertainties surrounding Brexit have resulted in an almost continuous outflow of money from open-ended property funds. Open-ended property funds that were once again closed to redemptions in Q1 2020 have mainly re-opened. Data to the end of May 2022 suggests that sales of units have picked up so far in Q2 after redemptions amounting to £206m in Q1 2022 (see Chart 6.6).

6.5 Overseas investment in Central London offices (£bn)



Source: Property Data, July 2022

6.6 Property funds AUM & cash-flow (£m)



Source: Investment Association, July 2022

9. Outlook

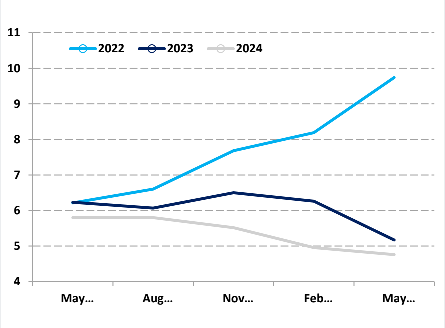
May's IPF consensus forecasts reflect an increasingly positive view on the outlook for UK real estate values as the sector recovers from the effects of pandemic lockdown. Total return forecasts for 2022 have been increased to 9.7% from 8.2% in February. The outlook for 2023 has weakened to 5.2% from 6.3% (see Chart 7.1).

Year-on-year total return forecasts decrease to 4.8% in 2024 before staging a small recovery in the last two years of the forecast period with an annualised average over the next 5-years of 6.0% (see Chart 7.2).

Respondents to the IPF Consensus forecasts continue to strongly favour Industrials and Retail Warehouses. There has also been a small improvement in the prospects for City of London offices and Shopping Centres (see Chart 7.3).

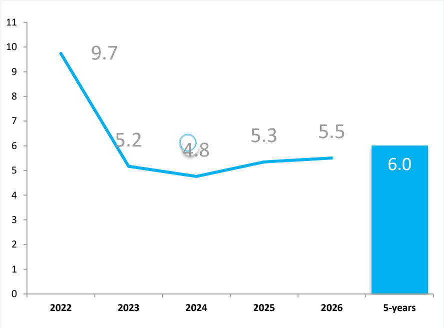
As inflation increases causing interest rates to rise and uncertainty surrounding the economy grows, the range of forecasts has widened, reflecting an increase in risk. Total return forecasts for 2022 range between +14.5% and +4.3%. The forecast range for 2023 has increased from 7.2% in February to 8.1% in May, with a maximum of 10.0% and a minimum of 1.9% (see Chart 7.4).

7.1 IPF forecast evolution (May 22)



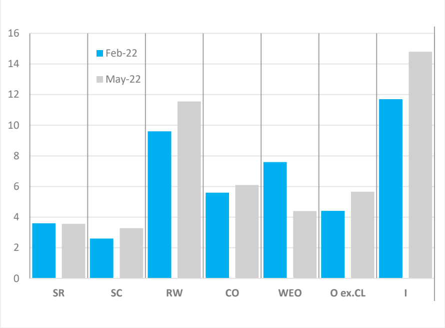
Source: IPF, May 2022

7.2 IPF All Property forecasts y-by-y (May 22)



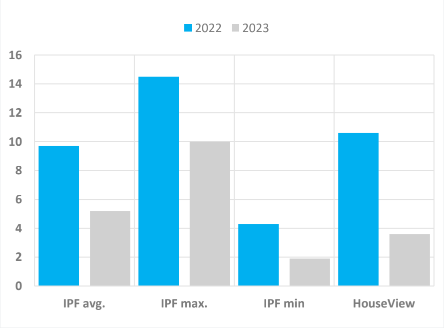
Source: IPF, May 2022

7.3 IPF 2022 forecasts by sector May 22 v Feb 22



Source: IPF, May 2022

7.4 UK commercial total return forecast range

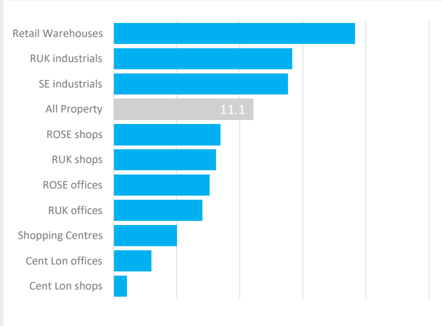


Source: IPF & Cluttons, May & July 2022

The central forecast from Cluttons' House View model is revised on a quarterly basis to reflect market performance reported in the current year to date. Year to date performance has already reached 9.6% but we expect that the market will now slow in the second half of the year. Accordingly, we have downgraded our forecast All Property total return for 2022 from 12% to 11%. The momentum built up by retail warehousing and industrials will continue through to the end of the year, but the remaining segments are expected to under-perform the market average (see Chart 7.5).

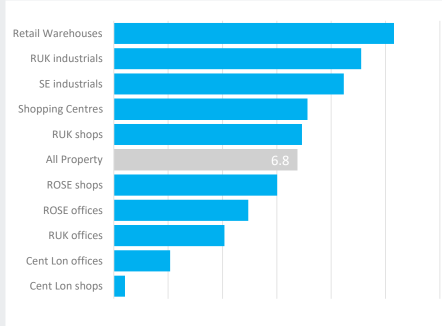
We have also reduced our forecast for 2023 from 7% to 4% reflecting the weaker economic background. The net effect is that the annualised average forecast for the 3-years ending December 2024 is reduced from 8% to 7%. After years of under-performance Shopping Centres and Rest of UK Shops are providing an 8% income return which provides some resilience in the later years of the forecast model (see Chart 7.6). However, the usual caveats regarding uncertainty surrounding this central forecast remain.

8.5 Cluttons House View - 2022 relative total returns (%)



Source: IPF, APR & Cluttons, July 2022

8.6 Cluttons House View - 2022-2024 relative total returns (%)



Source: IPF, APR & Cluttons, July 2022

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