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Commercial property examiner

Quarter one | 2022

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Foreword

The last 15 years have not been short of events. In that space of time, we have been through the Great Financial Crisis (GFC), Brexit and COVID-19. The latest crisis to afflict people, economies and markets is Russia's unprovoked invasion of Ukraine.

During the GFC, UK All-Property values fell by more than 40% but subsequent crises have had limited impact on the progress of the market. Reversals have been quickly corrected and since the bottom of the market in June 2009, capital values have grown by 60%. Falls in retail values of 6% and increases in industrial values of 183% illustrate a by now well-known structural adjustment to the UK's commercial real estate market.

The report that follows highlights how Putin's aggression will lead not only to appalling loss of life and destruction of Ukraine's cities, towns and infrastructure but will also have ramifications for people far away from the war zone caused by sharply higher commodity prices.

In the UK, high inflation coupled with low growth in real earnings and tax rises in April, will decrease real livings standards by 2.2% in 2022-23 – their largest financial year fall on record – and not recover their pre-pandemic level until 2024-25. In Sri Lanka, record levels of inflation together with food and fuel shortages have led to civil unrest and the declaration of a national emergency.

The latest Monetary Policy Report was published on 5th May when the MPC raised rates by 0.25% to 1.0%; their highest level since 2009. Thereafter the MPC is expected to move cautiously on rate rises for fear of further weakening UK economic activity. However, a recession in the UK now appears to be a possibility.

In the USA, the Federal Reserve also met in the first week of May. The economy is running hot, and the Fed is trying to slow it down before widespread price pressures become even more of a problem. It lifted interest rates in March for the first time since 2018, by a quarter of a percentage point, and has now announced a further rate rise of 0.5% to a target rate of between 0.75% and 1.0%.

At these levels the risks to commercial property valuations from rising interest rates are limited. But at some point, the increasing cost of capital will restrain the prices that investors are prepared to pay. A recession would be more damaging to property valuations.

Office occupancy

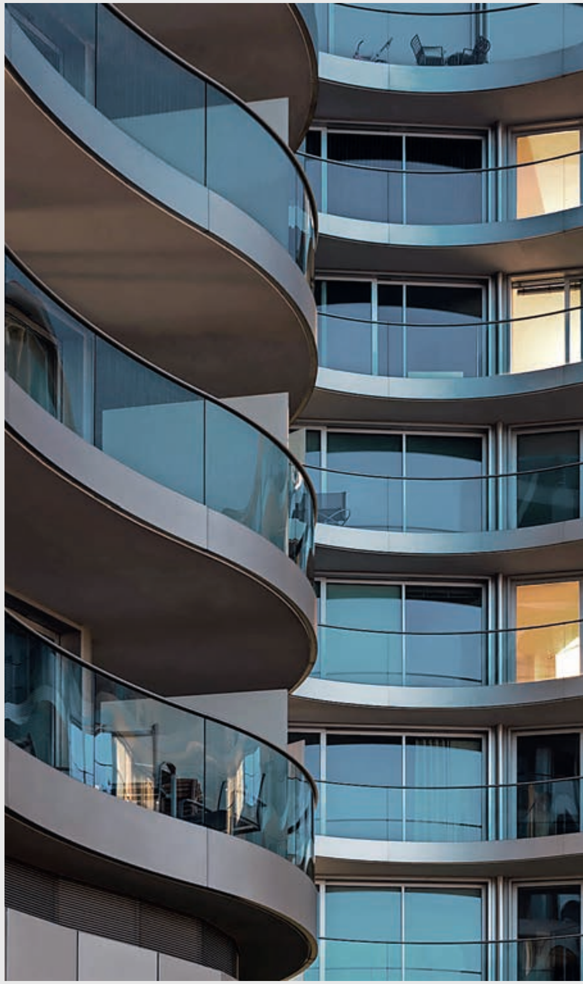
Despite Jacob Rees-Mogg, Minister for Brexit Opportunities and Government Efficiency, remonstrating civil servants for working from home, it is clear that Covid has rapidly accelerated a move towards remote working patterns. According to Remit Consulting, the highest average office occupancy level of 23.3% was recorded in November 2021 after pandemic restrictions and working from home guidance had been first lifted and before their reinstatement after the emergence of the Omicron variant.

Google's mobility reports are indicating that following the removal of all pandemic restrictions, Central London workplace searches had reached 60% of pre-pandemic levels by the end of March. But the "return to work" may already have plateaued. Tube travel into central London midweek has steadied at between 60% and 67% of pre-Covid levels, with a significant rise only on Thursdays, much favoured by the "three-day hybrids".

Staff at Stephenson Harwood, a City of London law firm, already have the option of working remotely for two days a week. Now they have been offered the opportunity to work from home permanently, in exchange for a 20% cut in pay. At the end of April. Airbnb announced that staff can work from anywhere they want without having to take a pay cut. Again, in April, a pilot programme involving more than 3,000 workers at 60 companies across Britain taking part in a four-day working week trial was announced. The scheme will run from June to December. Businesses are prepared to adopt a shorter working week with no loss of pay while aiming for productivity gains. The move to flexible patterns of work is gaining momentum and poses as big a threat to the office sector as on-line retailing does to physical shops.

The performance data indicates that secondary office buildings let on shorter leases are being left behind. It is commonly held now that prospective office occupiers are focused solely on Grade A energy efficient space and more secondary space is in danger of being left stranded.

Lower levels of office occupancy especially in Central London means that there are fewer office workers visiting shops, restaurants cafes and bars. In addition, visits to the UK from Overseas are a fraction of their previous levels. Before the pandemic, London was by far and away the leading centre of attraction for international tourists visiting the UK. Oxford Street is now struggling to retain its destination status and retail rental values in Central London have fallen 18% since the start of the pandemic.



Key takeaways

Russia's invasion of Ukraine will have major implications for the world economy and has raised the possibility of a UK recession. Higher commodity and energy prices will weigh heavily on the UK economy. Higher inflation will erode real incomes and consumption, further reducing future GDP growth which recorded growth of just 0.1% in February. Year on year CPI inflation increased to 7.0% in March 2022 from 5.4 % in December 2021. This is the highest CPI 12-month inflation rate since March 1992. Interest rates have been increased to 1% from 0.25% at the start of the year and there are expectations of further increases during 2022 to 1.25%.

The MSCI World Index has fallen 1.7% in Q1. Major markets have all fared worse. Japan's Nikkei Index is down 3.4%, the Eurofirst Index is down 5.7% and the NASDAQ down 9.1%. Some big tech stocks have fallen further. Meta (aka Facebook) and Netflix are down 33.9% and 37.8% respectively. And, Prologis, the largest logistic and warehouse real estate company in the world, has suffered a 4% fall in its share price despite strong performance by the sector in global real estate market.

The UK's commercial real estate market continues to post strong performance numbers, seemingly oblivious to the risks from geo-political events, interest rate rises and the turmoil in other global financial markets. In Q1, All Property total returns, as recorded by the MSCI Monthly Index, might have decreased to 5.6% but that still reflects an annualised rate of 23.9%. In the 12-months to the end of March 2022, All Property total returns increased to 23.9% from 19.9% in the 12-months to the end of December 2021.

All Property total returns could now reach 11% or more in 2022. However, we have reduced our forecast for 2023 from 9% to 7%. The net effect of raising 2022's forecast and easing back on the outlook for 2023 is that the annualised average forecast for the 3-years ending December 2024 remains at 8%. However, it should be noted that the latest forecasts were put together before the MPC's latest Monetary Policy Report indicating the possibility of recession in Q4 2022 or 2023.

Summary

April's edition of the International Monetary Fund's (IMF) *World Economic Outlook* is subtitled *War Sets Back the Global Recovery*. The report records that Russia's unprovoked invasion of Ukraine has triggered a costly humanitarian crisis and demands a peaceful resolution. Not surprisingly, the IMF also finds that economic damage from the conflict will contribute to a significant slowdown in global growth in 2022 and add to inflation.

Weaker than expected performance by the UK economy in February 2022 resulted in growth of 0.1% following growth of 0.8% in January. Rolling 3-month economic growth, which smooths out some of the volatility in the monthly numbers, amounted to 0.7%. This represents one of the weakest periods since the start of the recovery from the first pandemic shock.

Year on year CPI inflation increased to 7.0% in March 2022 from 5.4% in December 2021. This is the highest CPI 12-month inflation rate since March 1992, when it stood at 7.1%. The MPC now expects 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.

The latest forecasts by the Office for Budget Responsibility (OBR) were published, in the shadow of the Russian invasion of Ukraine, in March's *Economic and fiscal outlook*. The OBR noted that higher global energy prices will weigh heavily on the UK's economy. Higher inflation will erode real incomes and consumption, further reducing GDP growth over the forecast period. The MPC's May forecasts imply that the onset of recession is possible towards the end of this year or early next year.

The MSCI World Index has fallen 1.7% in Q1 2022. Major markets have all fared worse. Japan's Nikkei Index is down 3.4%, the Eurofirst Index is down 5.7% and the NASDAQ down 9.1%. Some big tech stocks have fallen further. Meta (aka Facebook) and Netflix are down 33.9% and 37.8% respectively. And, Prologis, the largest logistic and warehouse real estate company in the world, has suffered a 4% fall in its share price despite strong performance by the sector in global real estate market.

In April 2022 the NASDAQ fell a further 13.3%. The worst decline since October 2008 when Lehman Brothers collapsed.

UK REIT prices fell by 2.7% in Q1 2022. Segro and Big Box, specialising in logistics units, fell by 6.3% and 2.9% respectively as the growth in online retail sales slows post pandemic. Shaftesbury, central London retail, Hammerson, Shopping centres, and Unite, Student housing, were all in positive territory as they benefitted from the removal of the last pandemic restrictions on social gatherings.

The current property initial / gilt yield gap is 2.7% having decreased by 77 bps over the course of Q1 and is now more than one standard deviation below the 10-year average (see Chart 4). However, the yield gap still remains high by longer run standards.

The UK's commercial real estate market continues to post strong performance numbers, seemingly oblivious to the risks from geo-political events, interest rate rises and the turmoil in other global financial markets. In Q1, All Property total returns, as recorded by the MSCI Monthly Index, might have decreased to 5.6% but that still reflects an annualised rate of 23.9%.

In the 12-months to the end of March 2022, All Property total returns increased to 23.9% from 19.9% in the 12-months ending December 2021. All Property investment volumes, represented by the current value of investment transactions adjusted for capital growth, increased by 56% in Q4 2021 compared to Q3 2021 and were 44% above their long run average. Preliminary estimates suggest that investment volumes fell in Q1 2022 but as usual the numbers are likely to be revised upwards in the coming months.

23.9%

In the 12-months to the end of March 2022, All Property total returns increased to 23.9% from 19.9% in the 12-months ending December 2021.

Open-ended property funds that were once again closed to redemptions in Q1 2020 have mainly re-opened. Data to the end of February 2022 suggests redemptions are again on the increase and assets under management are shrinking.

The strength of the commercial property market's post-pandemic recovery has surprised on the upside and the forecast path for rental values continues higher driven largely by the strength of industrial and logistic rents and their increasing weight in the index. However, the pace of growth in capital values should weaken as higher inflation and interest rates give investors cause for concern. Of course, an economic recession, which now appears a possibility, would cause a fall in rents and capital values.

The central forecast from Cluttons' House View model is revised on a quarterly basis to reflect historic market performance. At the All-Property level we expect capital values to improve for the remainder of the forecast period. All Property total returns could now reach 11% or more in 2022. However, we have reduced our forecast for 2023 from 9% to 7%. The net effect of raising 2022's forecast and easing back on the outlook for 2023 is that the annualised average forecast for the 3-years ending December 2024 remains 8%. However, it should be noted that the latest forecasts were put together before the MPC's latest Monetary Policy Report indicating the possibility of recession in Q4 2022 or 2023.

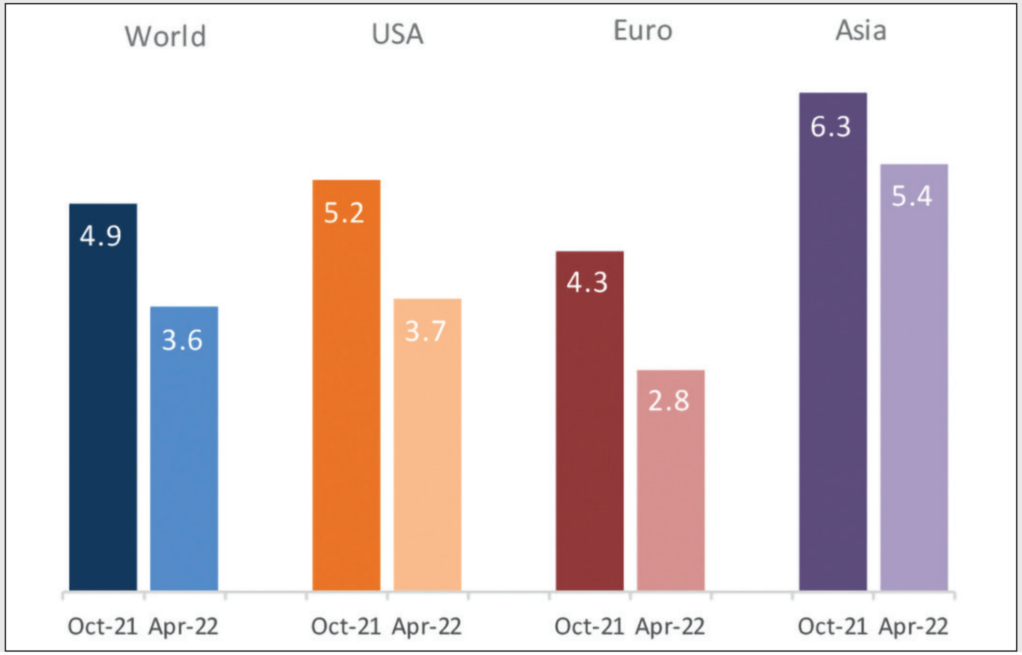
The World economy

April's edition of the International Monetary Fund's (IMF) *World Economic Outlook* is subtitled *War Sets Back the Global Recovery*. The report records that Russia's unprovoked invasion of Ukraine has triggered a costly humanitarian crisis and demands a peaceful resolution. Not surprisingly, the IMF also finds that economic damage from the conflict will contribute to a significant slowdown in global growth in 2022 and add to inflation.

Global growth is projected to slow from an estimated 6.1% in 2021 to 3.6% in 2022 and 2023. This is 0.8 and 0.2 percentage points lower for 2022 and 2023 than projected in January 2022. Beyond 2023, global growth is forecast to decline to about 3.3 percent over the medium term (see Chart 1.1).

War-induced commodity price increases and broadening price pressures have led to 2022 inflation projections of 5.7% in advanced economies and 8.7% in emerging market and developing economies – 1.8 and 2.8 percentage points higher than projected last January.

1.1 2022 growth projections by region



The UK economy

Weaker than expected performance by the UK economy in February 2022 resulted in growth of 0.1% following growth of 0.8% in January. Rolling 3-month economic growth, which smooths out some of the volatility in the monthly numbers, amounted to 0.7%. This represents one of the weakest periods since the start of the recovery from the first pandemic shock (see Chart 1.2).

The main contributor to the recovery from February 2020 to February 2022 was human health and social work activities. However, the health sub-sector acted as a drag on growth in February 2022 as the free-testing regime ended. Growth in consumer-facing services of 0.7% in February was driven by a 33% increase in travel agency as pandemic travel restrictions eased. Tourists from the UK can now visit Portugal, Italy and Greece without a vaccination certificate. Visitors to the UK no longer have to complete a passenger locator form, supply COVID-19 test results or quarantine on arrival whether vaccinated or not.

Manufacturing fell by 0.4% in February 2022. This was driven by contractions of 5.4% in the manufacture of cars and 4.3% in the manufacture of computers. Shortage in the supply of semi-conductors remains an issue for these sectors.

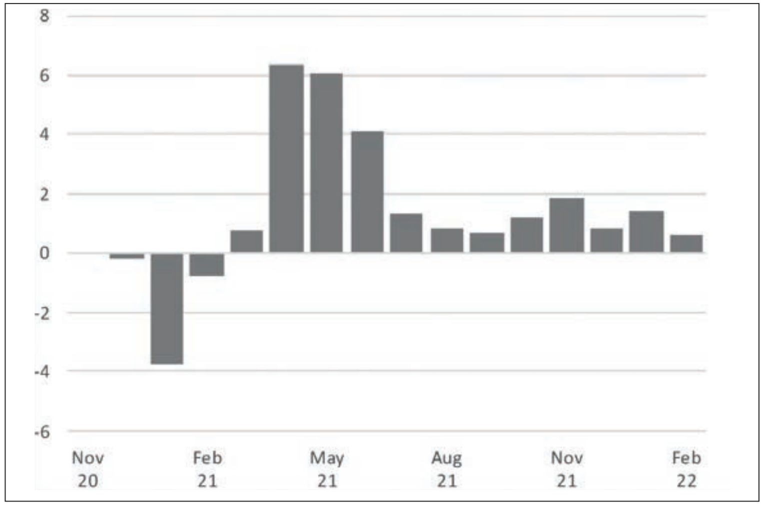
Output and is now 1.5% above its pre-Coronavirus level but remains 3.5% below its potential level based on trend rates of growth. Service sector output is now 2.1% above its pre-Coronavirus pandemic level in February 2020, while construction is 1.1% above and production is 1.9% below (see Chart 1.3).

The latest forecasts by the Office for Budget Responsibility (OBR) recorded first and foremost, that Russia's peremptory actions in Ukraine are a human tragedy. However, the OBR also noted that the conflict also has major repercussions for the global economy. A fortnight into the invasion, gas and oil prices peaked over 200% and 50% above their end-2021 levels respectively. Prices have since fallen back but remain well above historical averages.

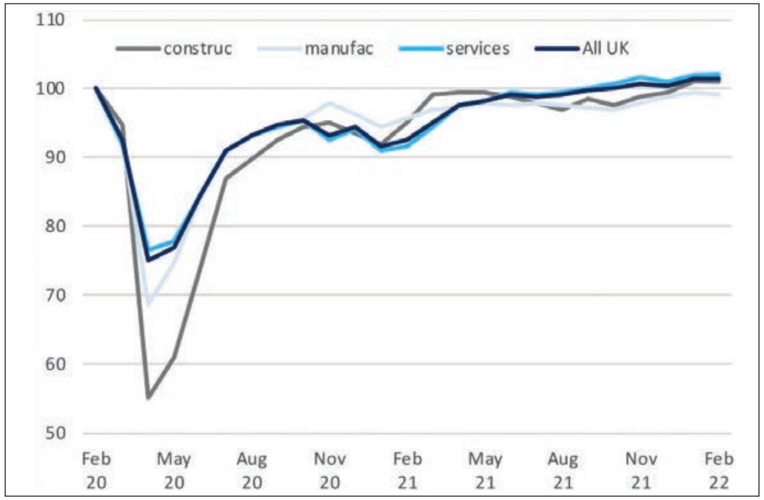
The UK is a net energy importer with a high degree of dependence on gas and oil to meet its energy needs. Higher global energy prices will weigh heavily on its economy. Consequently, the OBR expects increased petrol and energy bills to push inflation sharply higher.

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

1.2 Rolling 3m UK economic growth



1.3 UK economic growth indices



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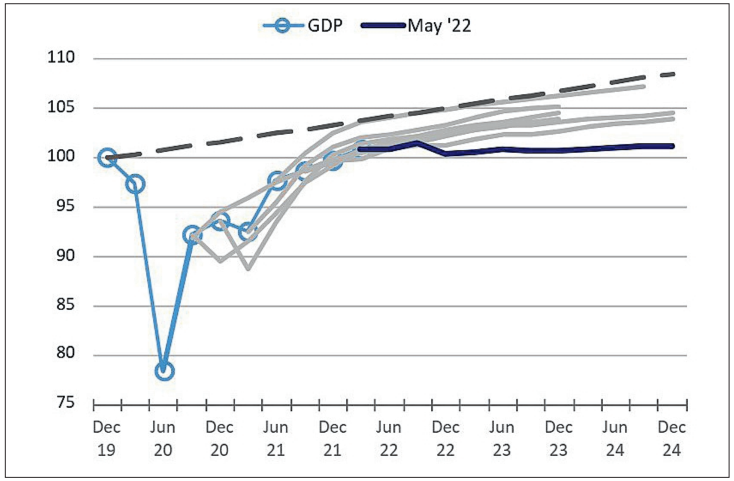
to slow sharply over the first half of the forecast period, caused by higher energy prices and the removal of monetary and fiscal policy support in the form of higher interest rates and taxes and cuts to Government spending. It is clear from these forecasts that the onset of recession is possible towards the end of this year or early next year (see Chart 1.4).

Consumer expenditure represents 60% of the UK economy when measuring GDP by expenditure. There is a direct link between inflation and consumer expenditure. As inflation rises so consumer expenditure growth slows (see Chart 1.5). As explained by the OBR, higher inflation will erode real incomes and consumption, further reducing GDP growth over the forecast period. Lower growth in real earnings combined with tax rises in April 2022, will decrease real livings standards by 2.2% in 2022-23 – their largest financial year fall on record – and not recover their pre-pandemic level until 2024-25.

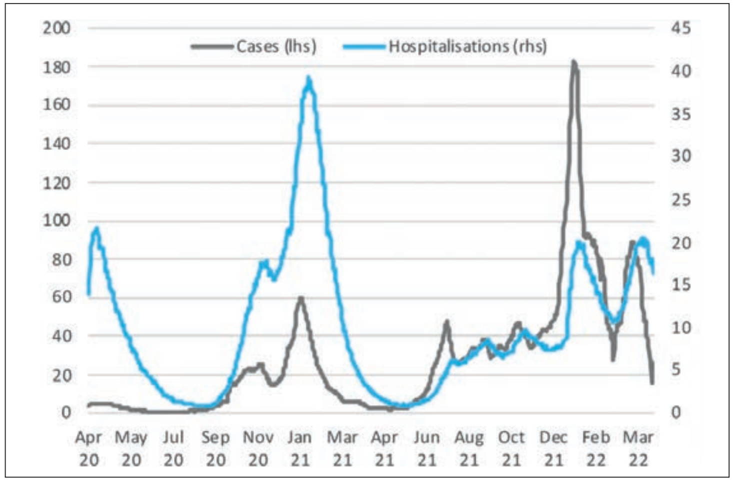
The Omicron variant of COVID-19 caused cases and hospitalisations to spike over Christmas 2021 and the new year. Face masks and the NHS Covid Pass became mandatory and office workers were once again asked to work from home. Thankfully, the risks from COVID-19 have now diminished. All restrictions have once again been lifted as well as access to free virus testing (see Chart 1.6). The next phase of the pandemic is living with Covid.

1.4 MPC economic projections



1.5 Inflation & consumer expenditure

1.6 Covid in the UK



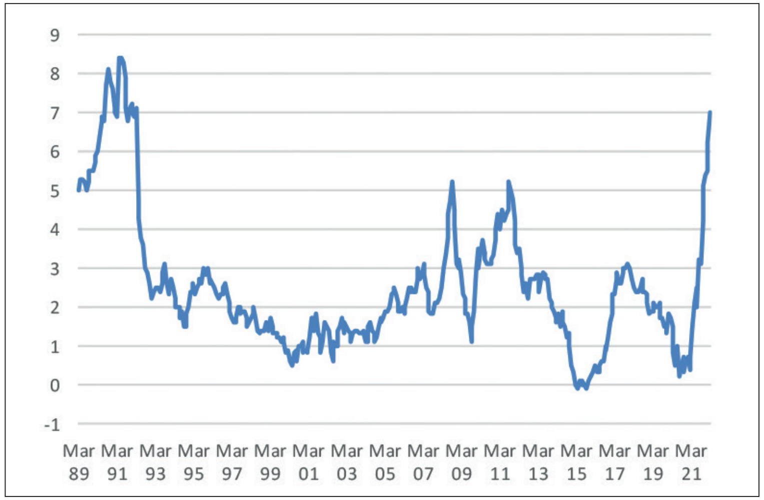
Other economic indicators

Year on year CPI inflation increased to 7.0% in March 2022 from 5.4% in December 2021. This is the highest CPI 12-month inflation rate since March 1992, when it stood at 7.1%. In the early 1990's year-on-year inflation peaked at 8.1% and interest rates were increased to 14.875% triggering a 5-quarter recession when the economy declined 2.1% (see Chart 2.1).

The principal drivers of this burst of inflation remain the same as last quarter. The largest contribution to the annual inflation rate again came from Housing and household services (Utilities) as a result of price rises for gas and electricity following the increase in the energy price cap on 1st October 2021. Transport cost inflation has been driven by increases in the price of motor fuels and second-hand cars. Average petrol prices of 160.2p per litre compare with 123.7p per litre a year earlier. A shortage of new cars and a pandemic preference for private over public transport have increased used car prices.

The Russian invasion of Ukraine will lead to further large increases in energy and commodity prices. 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 2.2). May's MPC meeting confirmed a further 25 bp increase in interest rates to 1.0% and suggested that a recession is possible towards the end of this year or early next year.

2.1 CPI inflation

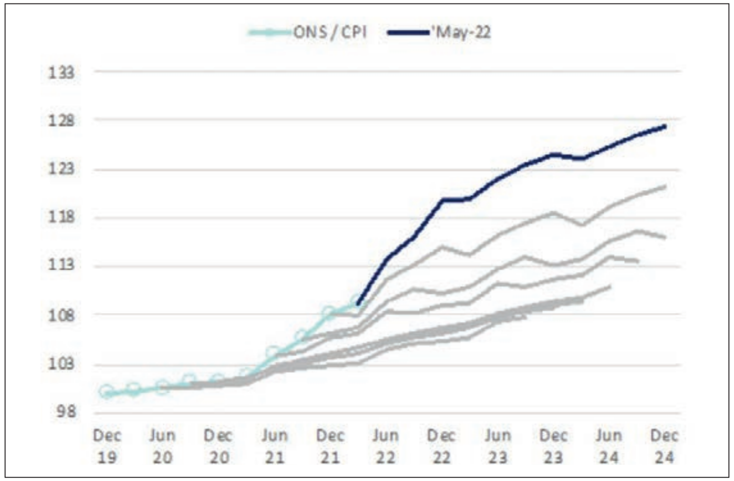


Remit Consulting estimate that in the week after the removal of working from home guidance, national office occupancy levels reached 17%. Google's Community Mobility Reports indicate that office occupancy rates and the profitability of hospitality and retail businesses serving office centres are likely to have improved since the removal of all pandemic restrictions. At the end of March 2022, the number of searches for workplace destinations in the UK's biggest business centres and conurbations across the UK had increased after the removal of Plan B restrictions. In Central London, activity levels were nearer 60% of pre-pandemic levels by the end of March (see Chart 2.3).

But the "return to work" may have plateaued. Tube travel into central London midweek has steadied at between 60% and 67% of pre-Covid levels, with a significant rise only on Thursdays, much favoured by the "three-day hybrids". Law and finance firms are reporting offices at between 30% and 60% of capacity. This, of course, has implications for the outlook for office rental values.

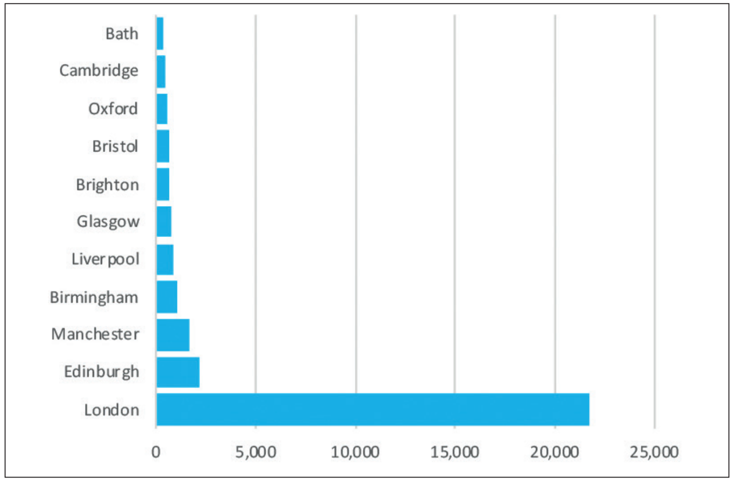
Before the pandemic, London was by far and away the leading centre of attraction for international tourists visiting the UK (see Chart 2.4). Tourists were routinely sighted towing large suitcases to accommodate their shopping up and down Oxford Street. Today visits to the UK from Overseas are a fraction of their previous levels (see Chart 2.5). Oxford Street is struggling to retain its destination status and retail rental values in Central London have fallen 18% since the start of the pandemic.

2.2 MPC inflation projections

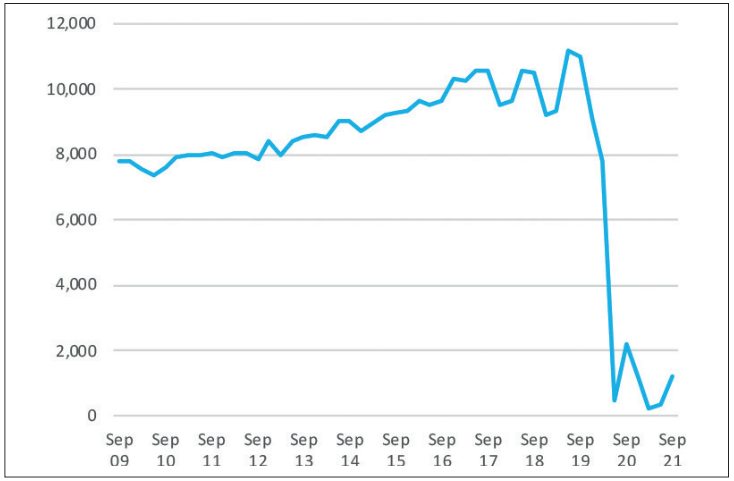


2.3 West End workplace searches

2.4 International visitors in 2019 by City ('000s)



2.5 Visits to the UK from overseas ('000s)



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Interest rates and asset yields

In 2021, stock markets across the world reached record highs as Central Banks maintained their ultra-loose policy stance in support of Covid hit economies and governments continued with pandemic stimulus programmes. The MSCI World Index with large and mid-cap representation across 23 developed markets gained 23.6% in 2021.

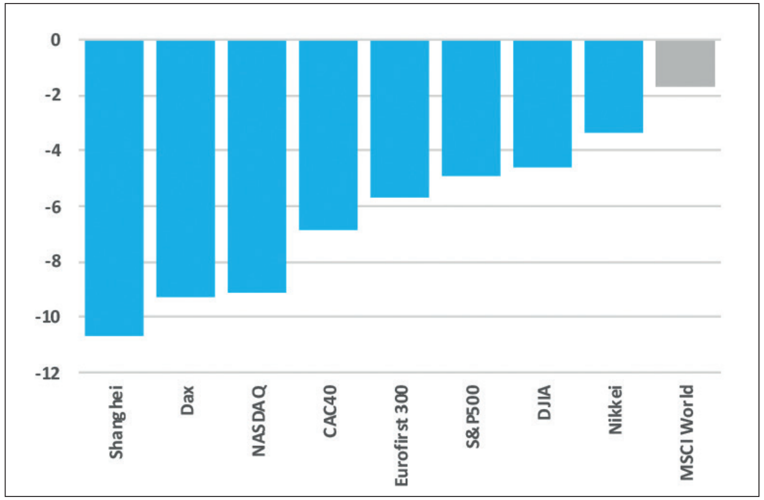
Since the turn of the year, Central Banks have turned their attention to the fight against inflation. In the USA, the Fed announced a rate rise of 0.5% to a target rate of between 0.75% and 1.0%. Officials estimate that the neutral interest rate that neither aids nor constrains inflation is 2.4%. In the UK, the MPC have raised interest rates four times since December last to 1.0% and have also announced an end to Quantitative Easing. Future maturities from the Bank of England's gilt and corporate bond portfolios will no longer be re-invested; and a programme of corporate bond sales should fully unwind the position by the end of 2023. A decision will be taken later on in the year whether to start selling its portfolio of gilts back into the market.

The MSCI World Index has fallen 1.7% in Q1. Major markets have all fared worse. Japan's Nikkei Index is down 3.4%, the Eurofirst Index is down 5.7% and the NASDAQ down 9.1%. In London the FTSE100 was stable by comparison as prices grew by 1.8% producing total returns of 2.9% (see Chart 3.1). Some big tech stocks have fallen further. Meta (aka Facebook) and Netflix are down 33.9% and 37.8% respectively. And, Prologis, the largest logistic and warehouse real estate company in the world, has suffered a 4% fall in its share price. (see Chart 3.2).

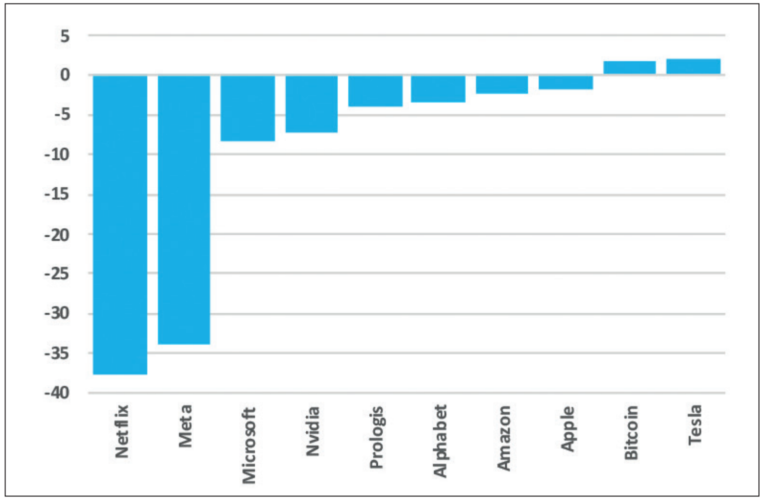
UK REIT share prices grew by 26% in 2021 and outperformed the wider all share market indices. The top performers in the year all focused on logistics and warehousing. However, UK REIT prices fell by 2.7% in Q1 2022. Segro with a portfolio of logistics assets and Big Box, which develops and invests in logistics assets of more than 500,000 sq ft. fell by 6.3% and 2.9% respectively. Big Yellow Group, a provider of self-storage units, fell 10.0%. The share price for REIT's with exposure to industrial assets has come under pressure as the growth in online sales slows post pandemic. According to the IMRG Capgemini Online Retail Index, UK online retail sales fell by more than a quarter year-on-year in March.

Shaftesbury, central London retail, Hammerson, Shopping centres, and Unite, Student housing, were all in positive territory as they benefitted from the removal of the last pandemic restrictions on social gatherings (see Chart 3.3).

3.1 World stock markets in Q1 2022



3.2 Tech & other selected stocks Q1 2022



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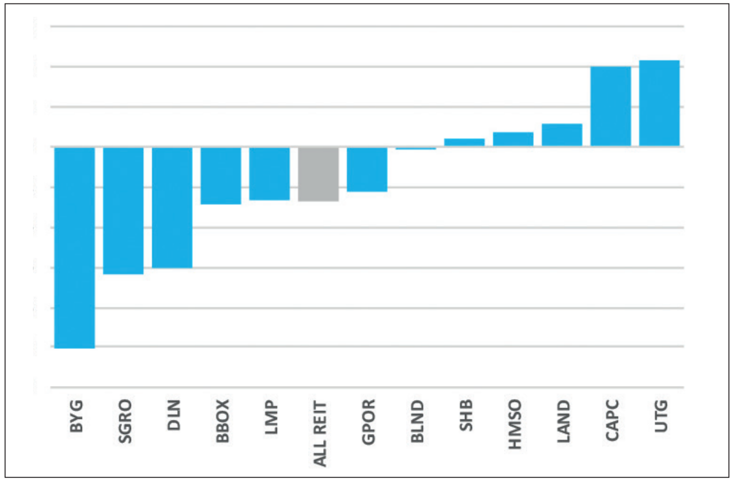
Risk free assets have begun to rise from the historic low yields prevailing during the Covid years. The yield on the 5-15 year gilt index hardened by 65 bps in Q1 2022 to 1.60% from 0.95% at the end of Q4 2021. Consequently, the total return performance on the index was -4.8% (see Chart 3.4). Market expectations of future interest rates have increased by 75 bps at the shorter end of the yield curve and by 65 bps for longer maturities. At 1.43%, the yield on 5-year gilts is at its highest since the end of 2014 (see Chart 3.5).

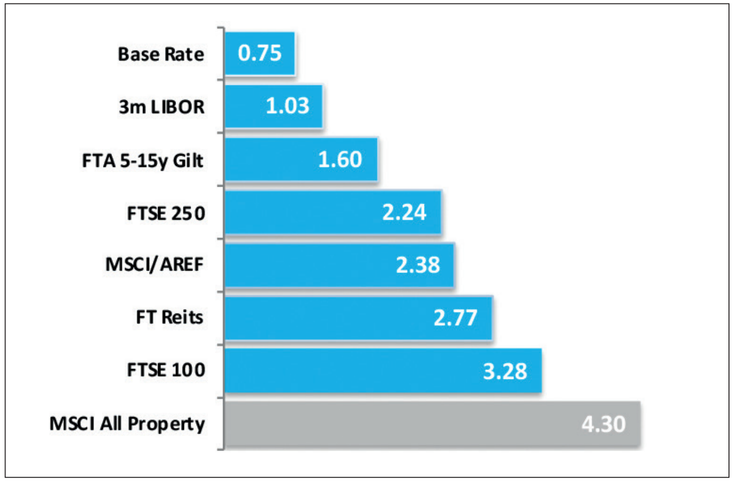
The current property initial / gilt yield gap is 2.7% having decreased by 77 bps over the course of Q1 and is now more than one standard deviation below the 10-year average (see Chart 3.6). However, the yield gap still remains high by longer run standards. In the months before the GFC, the yield gap briefly turned negative. And, of course, in the 1980s the reverse yield gap was an established feature of the UK market.

QE by central banks and the prevailing low cost of debt, albeit now rising, has resulted in unprecedented levels of liquidity in global markets. This liquidity and the level of property yields relative to the risk-free rate and the yield on other risky assets will continue to provide protection to UK real estate asset prices. Lower yielding industrial and logistics assets, however, will need to benefit from continued growth in rental values. Generally, for the retail and office sectors the yield gap is much higher.

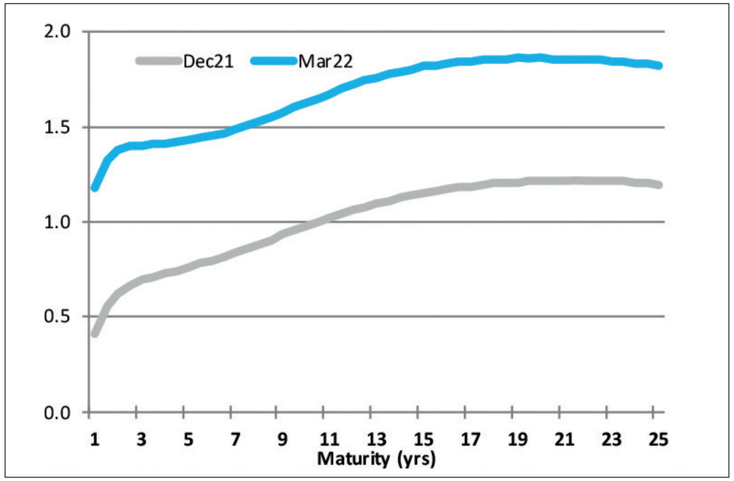
3.3 UK Reit price movement in Q1 2022



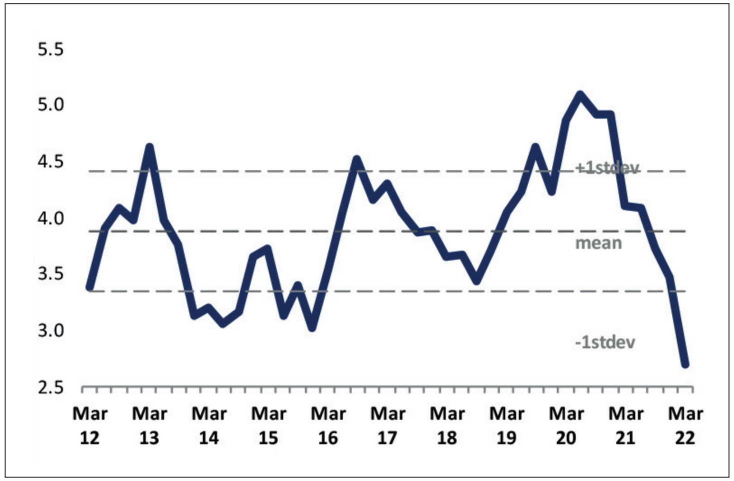
3.4 UK asset yields Q1 2022



3.5 Gilt yield curve (%)



3.6 Property IY - Gilt yield gap

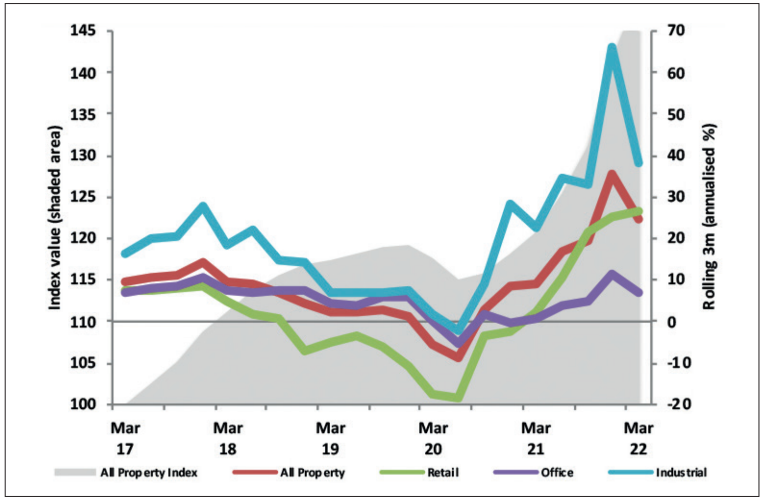


Commercial property market performance

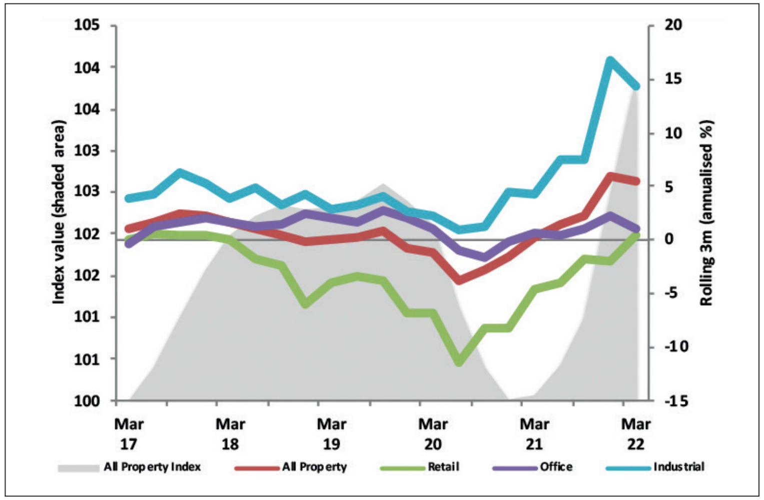
The UK's commercial real estate market enjoyed a spectacularly strong final quarter of 2021 driven by the industrial sector and retail warehousing. As suggested in last quarter's Examiner, unexpectedly strong performance from West End and Midtown offices in Q4 2021 has indeed proven a one-off correction as uncertainty surrounds the post-Covid outlook for offices. The latest Q1 2022 market numbers remain strong but reflect a slight weakening in the first three months of the year.

In Q1 2022, All Property total returns, as recorded by the MSCI Monthly Index, decreased to 5.6% from 7.9% in Q4 2021. As previously noted, Q4 2021 was the highest quarterly return generated at the All-Property level since the end of 2009 when the market was in the early stages of recovery following the GFC. So, any improvement on that number was always going to be challenging. Capital growth was 4.4% in Q1 2022 compared to 6.6% in Q4 2021. Property equivalent yields hardened by 18 bps and contributed a 3.4% uplift to valuations. All Property rental value growth decreased very slightly to 1.4% in Q1 2022 from 1.5% in Q4 2021. Q1 2022 income returns amounted to 1.2% (see Charts 4.1 & 4.4).

4.1 Total returns by sector



4.2 MRV growth by sector



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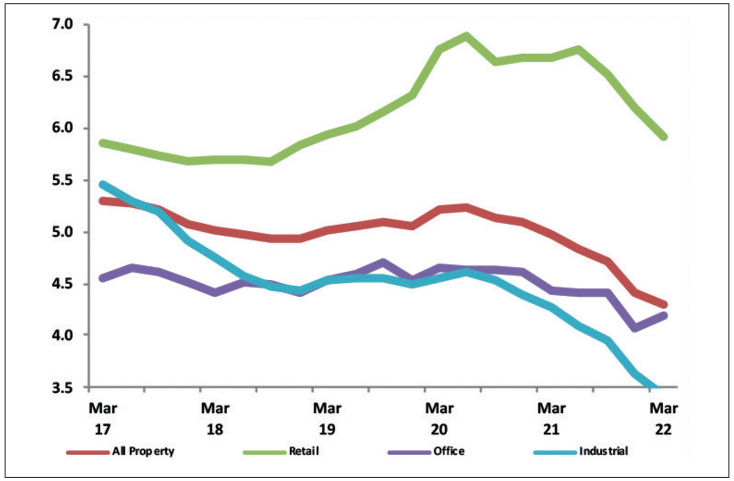
Over the course of the first quarter, office rental values decreased by 0.3% from 0.6% in Q4 2021, while industrial rental value growth decreased to 3.4% from 4.0% in Q4 2021. Retail rental value growth was just 0.1%. Retail warehousing rental values grew by 0.7% but rental values for Shopping Centres and Rest of UK shops continued to slip. And Central London retail rental values suffered a further fall of 3.0% (see Charts 4.2 & 4.5).

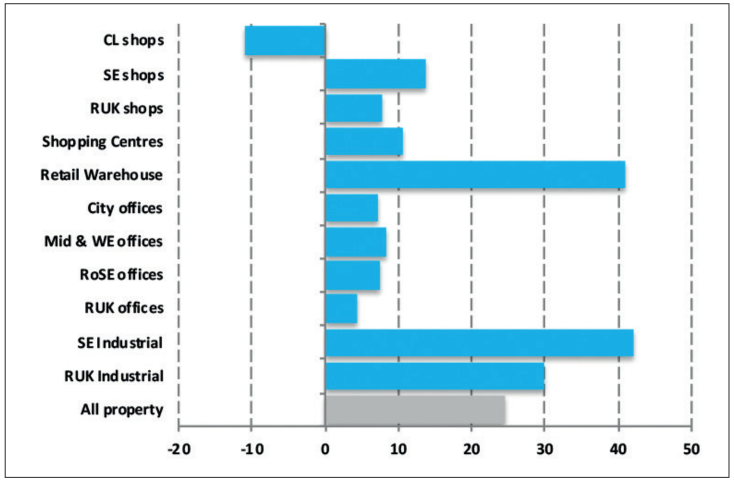
In the 12-months to the end of March 2022, All Property total returns increased to 23.9% from 19.9% in the 12-months ending December 2021. Year-on-year capital growth was 18.0% in March 2022 compared to 13.9% in December 2021. Property equivalent yields hardened by 87 bps in the 12-months to March and contributed a 14.4% uplift to valuations. All Property rental values increased year-on-year by 3.8% and income return amounted to 5.3%.

Strong investment and occupier demand for industrials has pushed up rental values and driven yields down to 3.4% and approaching 2.5% for last mile logistics in London. The yield gap between industrials and retail and office assets continues to expand to the 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).

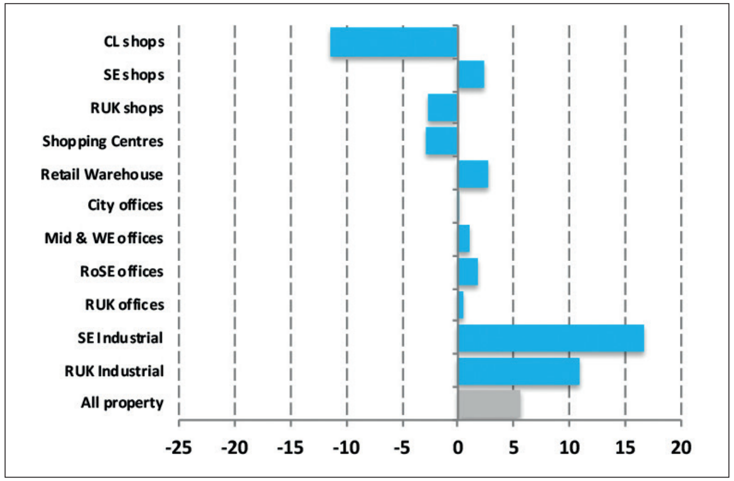
4.3 Initial yield by sector



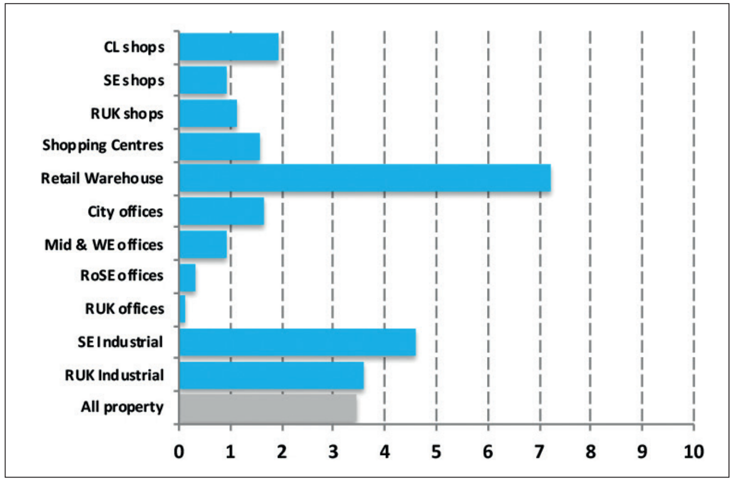
4.4 Total returns by segment (Q1 annualised)



4.5 MRV growth by segment (Q1 annualised)



4.6 Yield impact (Q1)



Occupier demand for industrials, however, is driving rental growth of 11.4% year-on-year and 14% at a quarterly annualised rate in Q1 2022. For the moment, after adding back the income, investors can reasonably anticipate total returns of 15% or more. This suggests that the re-rating of industrial assets may have further to run.

Industrial assets now represent 44% of the monthly index and many traditional balanced funds will still be over-weight in retail and office and under-weight in industrial. The drive to re-balance will add further liquidity to the sector.

Tables 5.1 – 5.5 contain further performance data for UK commercial real estate in Q4 2021.

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 with new tools to segment the market in addition to traditional approaches that dissect assets by sector and geography as noted above.

5.1 Total returns	Mar	3m	6m	12m
All Property	2.9	5.6	14.0	23.9
Retail	3.4	6.1	12.2	20.8
Office	0.9	1.7	4.5	6.7
Industrial	4.2	8.4	23.0	42.3
Annualised				
All Property	41.1	24.5	29.9	23.9
Retail	49.7	26.6	25.9	20.8
Office	11.0	7.0	9.2	6.7
Industrial	63.1	38.0	51.4	42.3

5.2 Capital growth	Mar	3m	6m	12m
All Property	2.5	4.4	11.3	18.0
Retail	2.9	4.4	8.7	13.0
Office	0.5	0.6	2.1	1.8
Industrial	3.8	7.4	20.7	36.8
Annualised				
All Property	34.8	19.0	24.0	18.0
Retail	40.8	18.9	18.1	13.0
Office	6.0	2.3	4.3	1.8
Industrial	57.3	33.1	45.8	36.8

5.3 Income return	Mar	3m	6m	12m
All Property	0.4	1.2	2.4	5.1
Retail	0.5	1.6	3.3	7.0
Office	0.4	1.1	2.3	4.8
Industrial	0.3	0.9	2.0	4.2
Annualised				
All Property	4.8	4.7	4.9	5.1
Retail	6.5	6.5	6.7	7.0
Office	4.7	4.6	4.7	4.8
Industrial	3.8	3.8	4.0	4.2

5.4 ERV growth	Mar	3m	6m	12m
All Property	0.8	1.4	2.8	3.8
Retail	0.2	0.1	-0.3	-1.8
Office	0.1	0.3	0.9	1.2
Industrial	2.0	3.4	7.5	11.4
Annualised				
All Property	10.1	5.6	5.8	3.8
Retail	2.0	0.5	-0.7	-1.8
Office	1.7	1.1	1.7	1.2
Industrial	26.4	14.4	15.6	11.4

5.5 Net initial yield	Mar	3m	6m	12m
All Property	4.3	4.4	4.7	5.0
Retail	5.9	6.2	6.5	6.7
Office	4.2	4.1	4.4	4.4
Industrial	3.4	3.6	4.0	4.3

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 Q4 2021. 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. Prime low yield shops and secondary Shopping Centres are the best "other" retail strategies but their performance relative to the whole market remains negative. All office strategies across the Central London, South East and Rest of UK markets are in negative territory. As questions surrounding the future demand for space in a post-Covid business environment hang over the future for offices, secondary buildings let on shorter term leases in particular are being left behind in performance terms.

5.6 Performance by strategy relative to All Property average Q4 2021

	Low Yield	High Yield	High Rent	Low Rent	Long Lease	Short Lease
Shops	-3.8	-5.7	-5.6	-3.8	-2.8	-6.0
Shopping Centres	-5.3	-3.8	-4.9	-5.3	-1.7	-6.6
Retail Warehouses	0.3	2.1	0.7	0.3	1.0	1.5
Central London offices	-3.1	-5.4	-3.7	-3.1	-4.0	-4.9
RoSe offices	-3.1	-8.0	-4.1	-3.1	-3.5	-6.0
RUK offices	-3.9	-8.6	-4.1	-3.9	-3.9	-6.2
Industrials	7.2	4.3	7.9	7.2	3.6	7.2

Investment in property

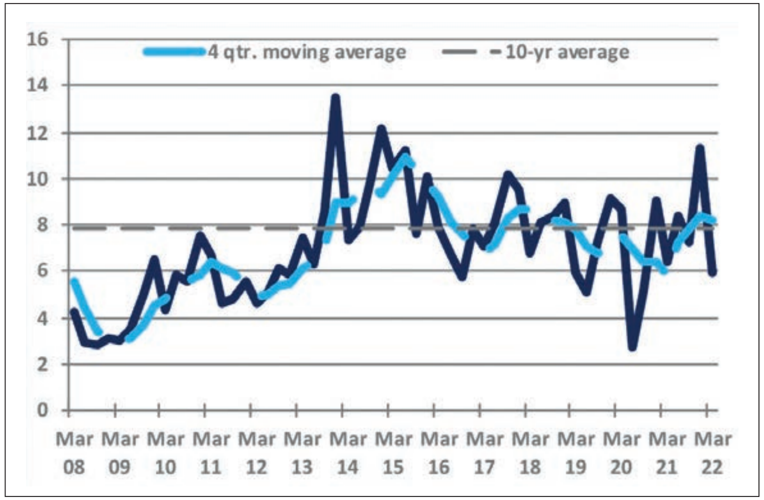
High levels of investor liquidity and a search for yield in the continuing hyper-low interest rate environment has driven allocations to real estate. A re-surgent economy following the easing of lockdown restrictions earlier in the year and a strong performance by commercial real estate has encouraged higher levels of investment activity. On a relative basis, the UK remains highly attractive from a yield perspective compared to many other global real estate markets.

All Property investment volumes, represented by the current value of investment transactions adjusted for capital growth, increased by 56% in Q4 2021 compared to Q3 2021 and were 44% above their long run average. Preliminary estimates suggest that investment volumes fell in Q1 2022 but as usual the numbers are likely to be revised upwards in the coming months (see Chart 6.1).

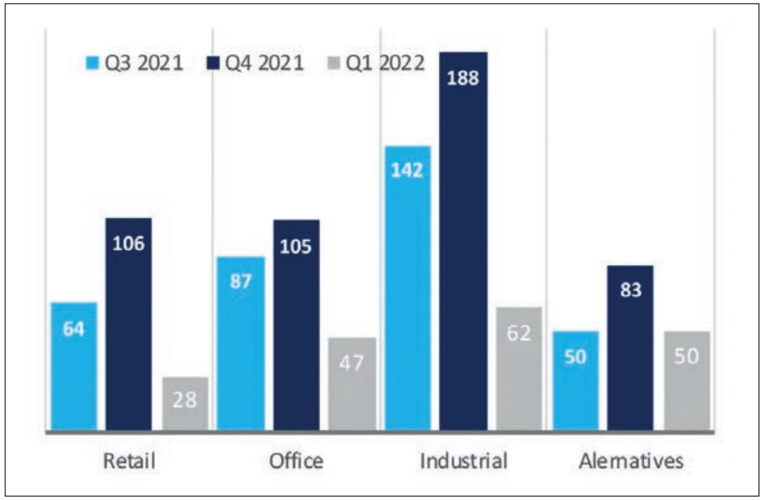
Industrials made up 26% by value of investment transactions in Q4 2021; Central London offices represented a further 19% and Alternatives including Medical Facilities, Car Showrooms, Residential and Student Accommodation made up another 17%. Across all sectors of the market, investment volumes were higher in Q4 2021 than in Q3 (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 have shown signs of improvement since March last year (see Chart 6.3).

6.1 All property investment volumes (£bn)



6.2 Investment transaction nos. by quarter

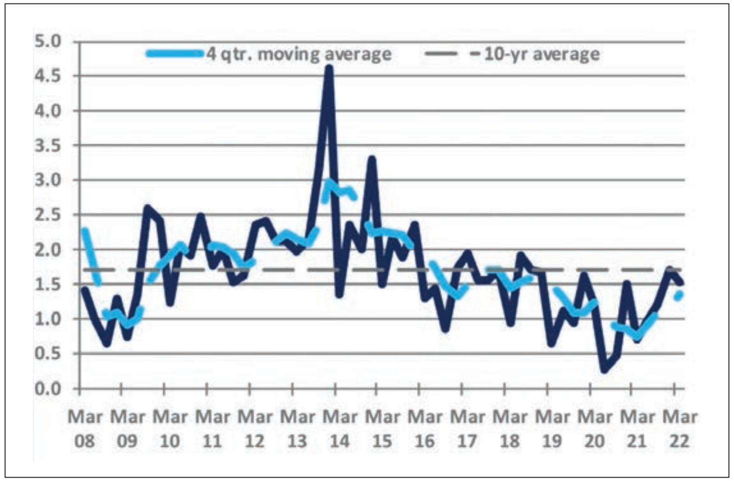


Transaction numbers across Central London increased strongly in Q4 2021 but the City Fringe, Docklands and Southbank markets were thinly traded. In Q4 2021 the City of London accounted for 21% of all Central London office transactions while the West End represents 57% of such transactions (see Chart 6.4).

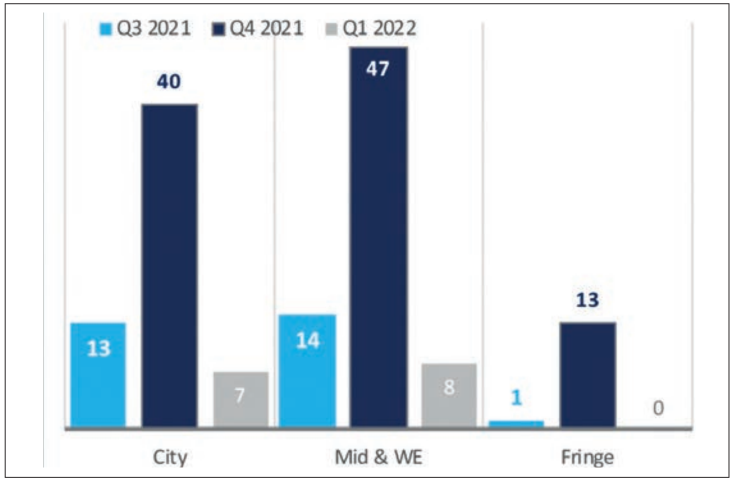
Continued talk of a large amount of overseas capital targeting Central London offices may well be accurate but this capital is only being deployed slowly (see Chart 6.5). This may be thro ugh a lack of suitable assets for sale or residual concerns surrounding the medium-term risks. High inflation, rising 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 February 2022 suggests redemptions are again on the increase and assets under management are shrinking (see Chart 6.6).

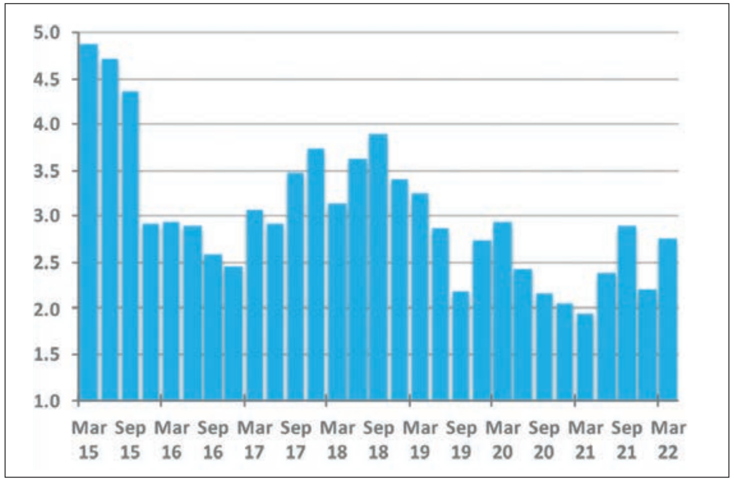
6.3 Central London office investment volumes (£bn)



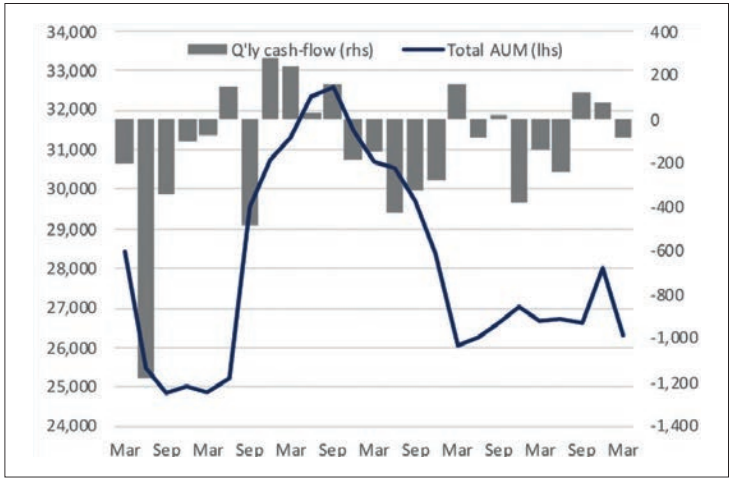
6.4 Central London office Investment transaction nos. by quarter



6.5 Overseas investment in Central London offices (£bn)



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



Outlook

February'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 8.2% from 7.7% in November and the outlook for 2023 has weakened to 6.3% from 6.5% (see Chart 7.1). From 2022 onwards, year-on-year total return forecasts decrease to 5.5% in 2026 with an annualised average over the next 5-years of 6.6% (see Chart 7.2).

Respondents to the IPF Consensus forecasts continue to strongly favour Industrials and Retail Warehouses. There has also been an improvement in the prospects for West End offices reflecting the improvement in performance numbers for this segment seen at the end of Q4 last year (see Chart 7.3).

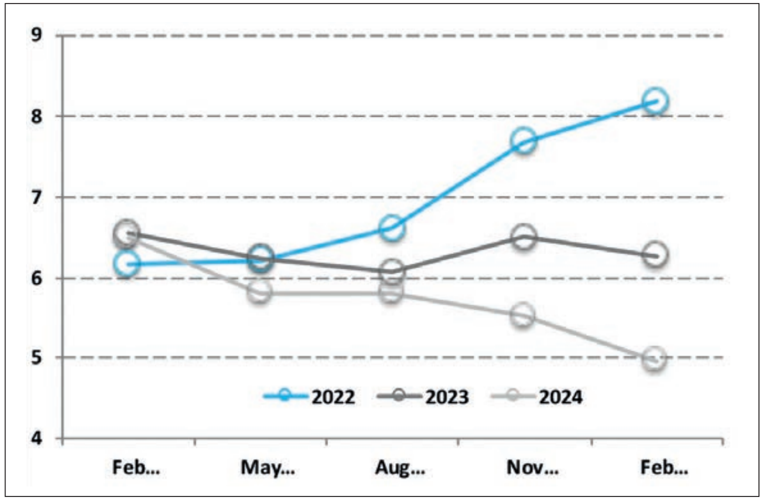
As the effects of Covid on the economy recede and we move into a post pandemic environment, the range of forecasts has narrowed, reflecting a reduction in risk. Total return forecasts for 2022 range between +13.0% and +4.8%. The forecast range for 2023 has reduced from 7.2% in November 2021 to 6.8% in February 2022, with a maximum of 10.0% and a minimum of 3.2% (see Chart 7.4).

The MPC's latest economic forecasts noted above continue to be revised down and are weaker than those produced three months earlier. The OBR's latest Economic and fiscal outlook also reports a worsening picture driven by the Russo Ukrainian war and higher commodity prices. The strength of the commercial property market's post-pandemic recovery has surprised on the upside and the forecast path for rental values continues higher driven largely by the strength of industrial and logistic rents and their increasing weight in the index. However, the pace of growth in capital values should weaken as higher inflation and interest rates give investors cause for concern.

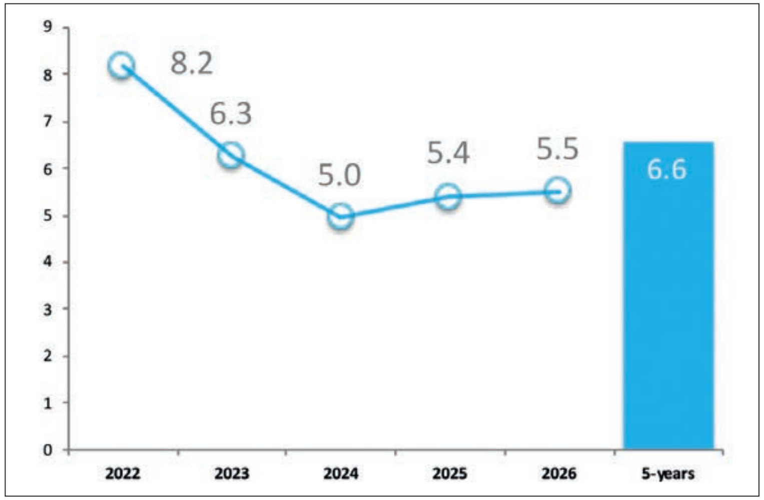
June 2021 represented the bottom of the cycle for All Property rental values and rental values should recover their pre-pandemic levels by the end of Q2 2022. Capital values, having surpassed their pre-pandemic levels in Q4 2021, are now expected to follow a slightly less elevated path (see Charts 7.5 & 7.6).

Of course, an economic recession, which now appears a possibility, would cause a fall in rents and capital values.

7.1 IPF forecast evolution (Feb 22)



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



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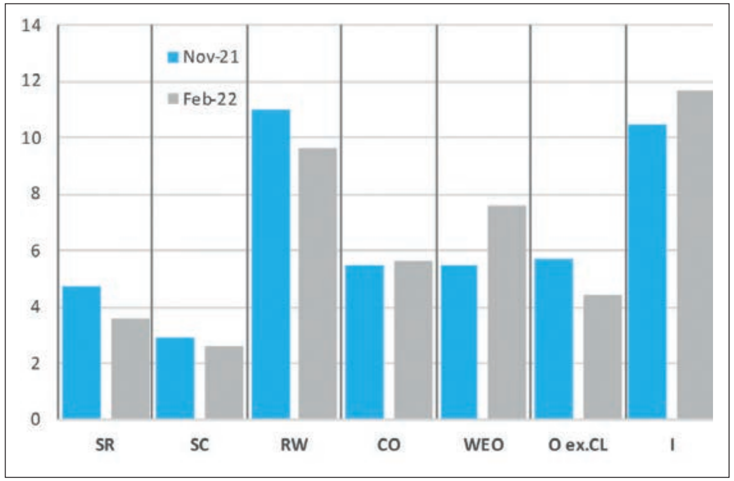
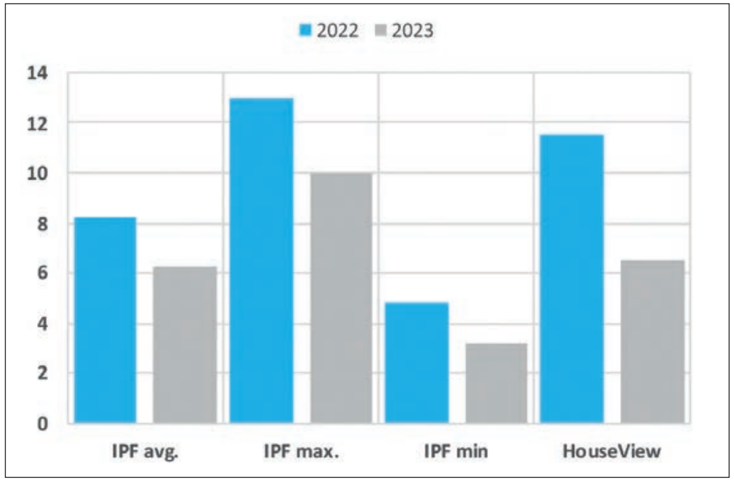
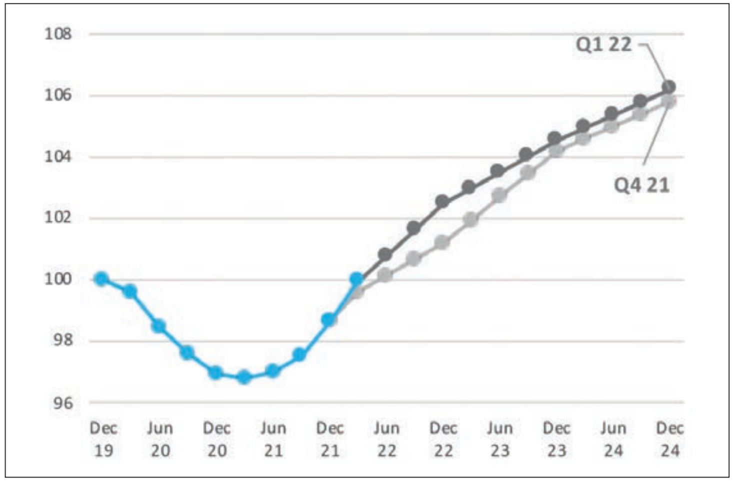
7.3 IPF 2022 forecasts by sector Feb 22 v Nov 21



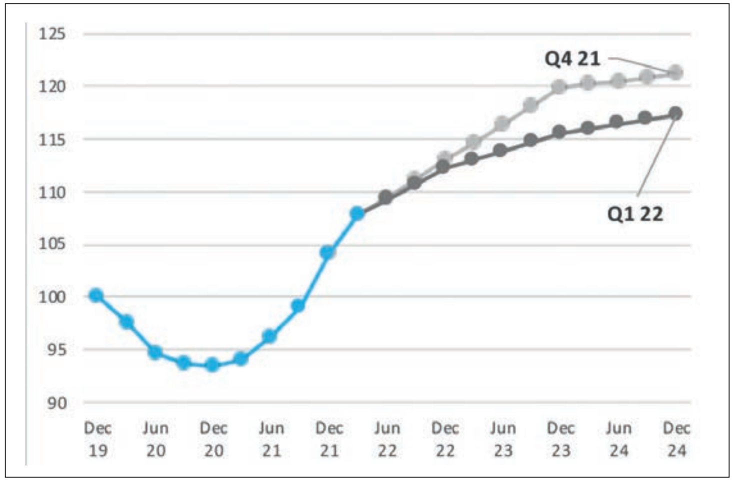
7.4 UK commercial total return forecast range



7.5 Rental value forecasts



7.6 Capital value forecasts



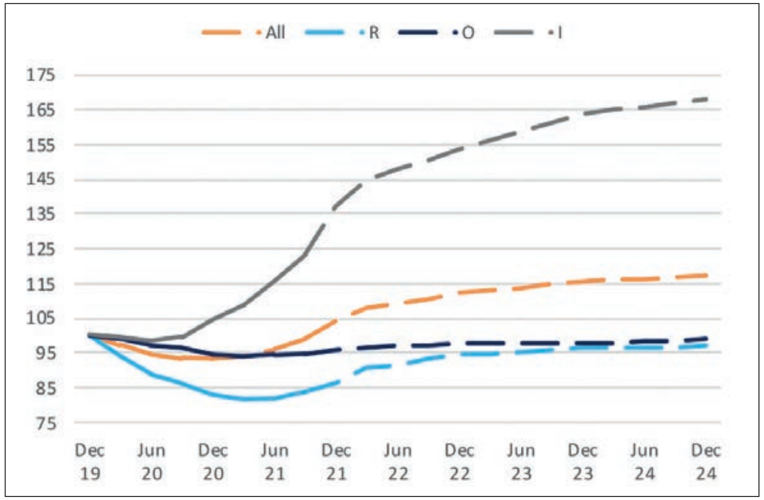
House view

The central forecast from Cluttons' House View model is revised on a quarterly basis to reflect historic market performance. We continue to be more optimistic than the consensus view and expect capital values at the All Property level to improve for the remainder of the forecast period. All Property total returns could now reach 12% or more in 2022. However, we have reduced our forecast for 2023 from 9% to 7%. The net effect of raising 2022's forecast and easing back on the outlook for 2023 is that the annualised average forecast for the 3-years ending December 2024 remains 8%. However, the usual caveats regarding uncertainty surrounding this central forecast remain and it should be noted that the latest forecasts were put together before the MPC's latest Monetary Policy Report indicating the possibility of recession in Q4 2022 or 2023.

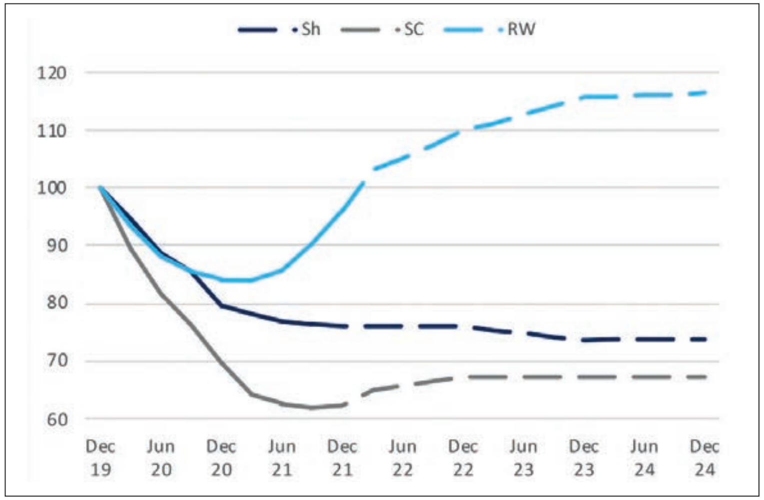
At the All Property level, we expect capital value growth to be positive. Market conditions have been improving throughout 2021 but we expect these trends to slow (see Charts 8.1 – 8.4) from the high levels posted in the fourth quarter of 2021. Geo-political uncertainty has now been added to the risks to this outlook in addition to persistently high inflation and increasing interest rates.

Retail assets, with the exception of Retail Warehouses, have borne the brunt of the downturn, but we expect them to show some signs of stability in 2022. Industrials will provide upside protection from the downside risks inherent in holding offices and retail (see Charts 8.5 & 8.6). If, however, affordability becomes an issue for logistic occupiers, especially in the most expensive locations, they will not be prepared to chase rents higher, and yields may de-rate.

8.1 3-sector capital value forecasts



8.2 Retail segments capital value forecasts



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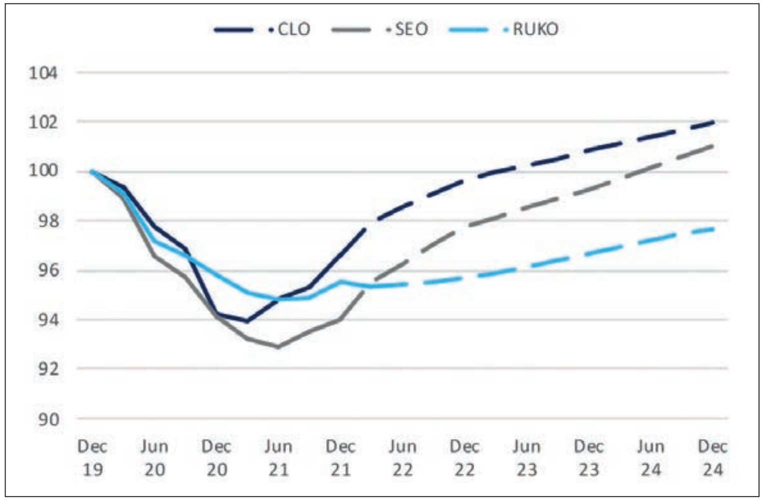
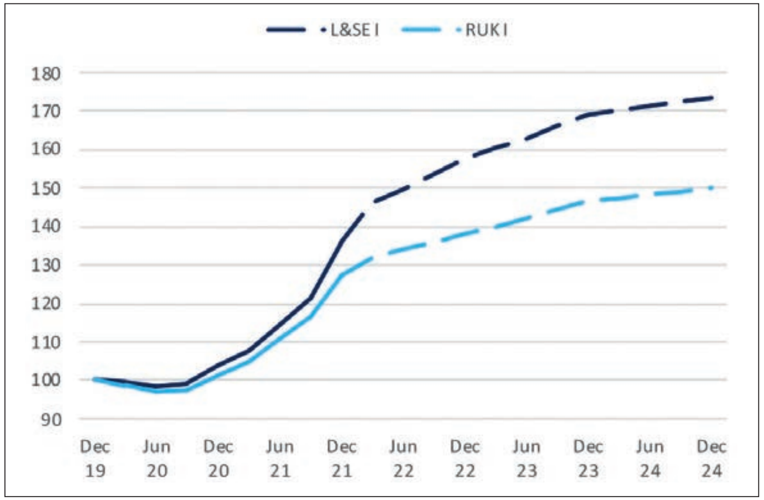
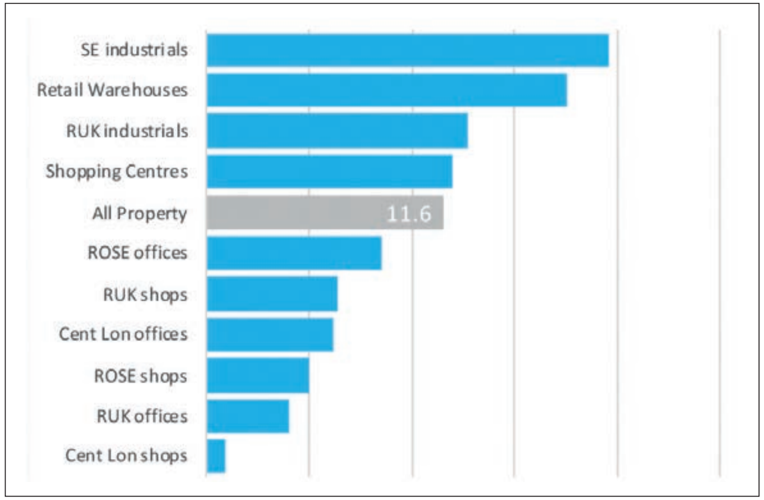
8.3 Office segments capital value forecasts



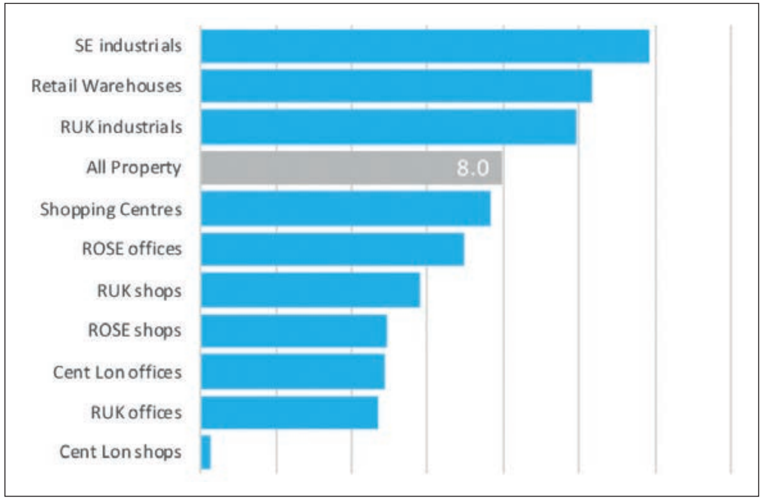
8.4 Industrial segments capital value forecasts



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



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



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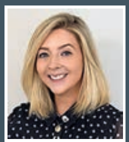

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