CLUTTONS
INVESTMENT MANAGEMENT

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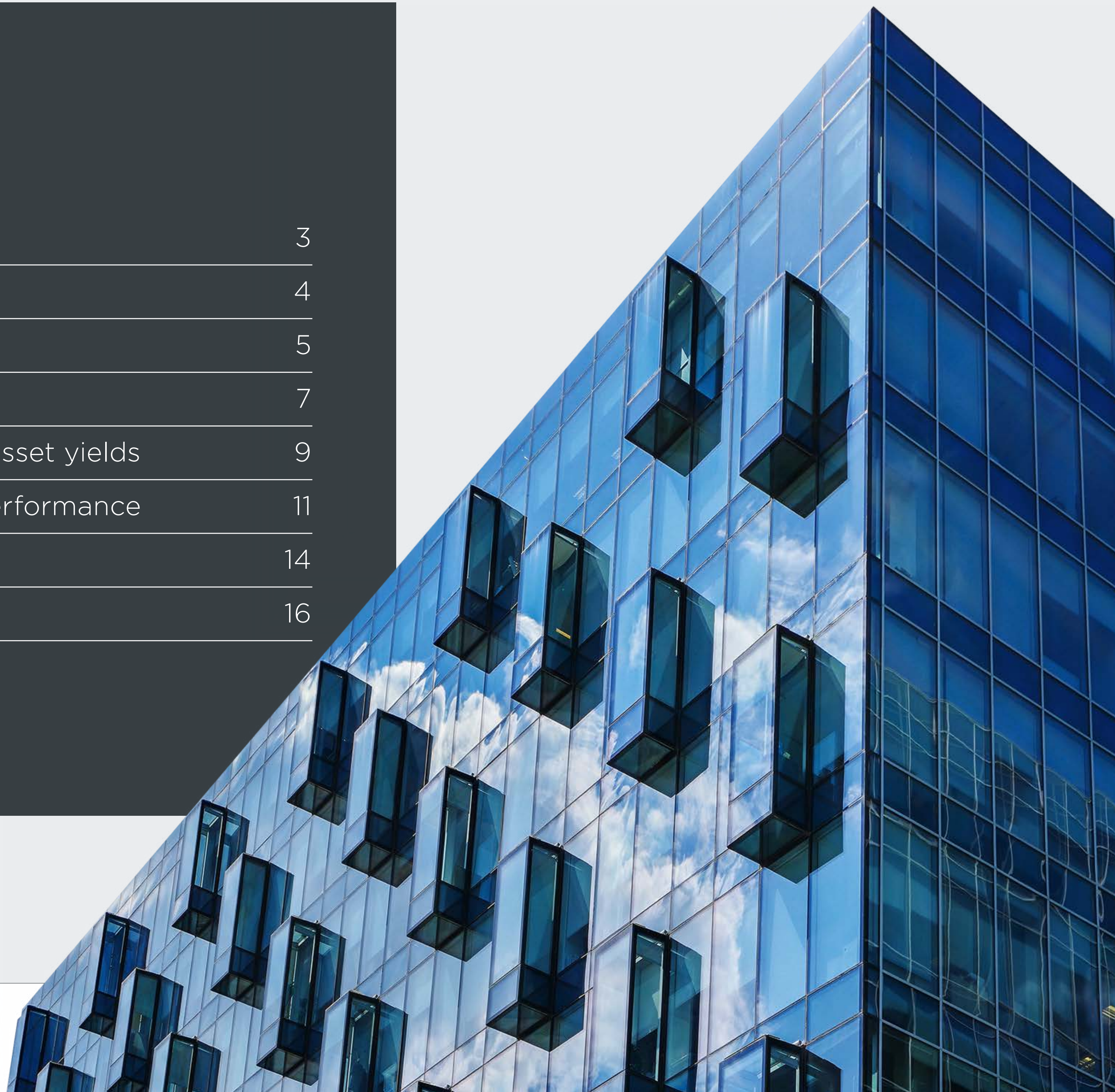
Commercial property examiner

Q2 | 2023

Contents



1. Key take aways

The UK economy has so far just avoided recession but following growth of 0.4% in January, the economy failed to grow at all in February. In the three months to the end of February, the economy grew by just 0.1%. The Monetary Policy Committee's (MPC) latest forecasts published in February suggest that GDP will fall slightly throughout 2023 and into Q1 2024, as high energy prices and interest rates restrict consumer spending.

Following its April meeting, the MPC announced a further rise in base rate to 4.25%. The pricing of UK risk free assets has largely recovered after the UK Government rowed back on its short lived but reckless experiment with unfunded tax cuts. The yield on the 5-15 year gilt index has hardened by 23 bps since the end of last year and 69 bps since September 2022 to stand at 3.51% at the-end of Q1.

In Q1 2023, All Property total returns, as recorded by the MSCI Monthly Index, reflected a rapid improvement in market conditions and increased to 0.2% from -14.5% in Q4 2022. Capital growth was -1.2% in Q1 compared to -15.6% three months earlier. However, in the 12 months to the end of March 2023, All Property total returns decreased to -14.7% from -10.1% in the 12 months ending December 2022.

We expect weak market conditions to persist at least for the first half of 2023. We have therefore maintained our forecast All Property total return for 2023 at -6%. However, if the current short-term improvements in market conditions persist the outcome could surprise on the upside. All Property total returns could recover sharply in 2024 and reach 15% if some of the recent yield de-rates are unwound. Thereafter markets should return towards an equilibrium level. The net effect is that the annualised average forecast for the three years ending December 2025 could be around 5%.

2. Summary

In April's edition of its World Economic Outlook (WEO), the International Monetary Fund (IMF) forecasts that global growth will bottom out at 2.8% this year before rising modestly to 3.0% in 2024. Global inflation will decrease, although more slowly than initially anticipated, from 8.7% in 2022 to 7.0% this year and 4.9% in 2024.

The UK economy has not dipped into recession so far, but after 0.4% growth in January, there was no rise in GDP in February. In the three months to the end of February, the economy expanded by just 0.1%.

The MPC's latest forecasts published in February suggest that GDP will fall slightly throughout 2023 and into Q1 2024, as high energy prices and interest rates restrict consumer spending. However, this is a much shallower profile for the decline in output than in the November report.

Year on year CPI inflation remains stubbornly high and only decreased to 10.1% in March from 10.4% in February. Core inflation excluding energy, food, alcoholic drinks, and tobacco is lower but has shown no change over the month since the end of February. The numbers remain extremely elevated compared to the 2% target rate.

February's MPC forecasts suggest that headline inflation will continue to decrease. CPI inflation is projected to fall sharply to just under 4% by the end of 2023. It also expects that continued weakness in the economy alongside a continuing reduction in energy price inflation will reduce domestic inflationary pressures and inflation will decline to below the 2% target in the medium term.

The MSCI World Index gained 7.7% in Q1 2023 although it was a long way from recouping the 17.3% lost in 2022. All bar one of the world's major equity markets also posted strong gains in Q1. The NASDAQ led the way as investors decided that tech stocks had been oversold.

UK REIT share prices again under-performed the wider all share market index in Q1. The All REIT index fell -3.1% but all of the major property companies fared better. The share price of Segro rose by a modest 0.5%. Other industrial specialists performed better, including Big Box, London Metric and Big Yellow. Poor prospects for the London office market and UK retail property, continued to weigh on the share price of Derwent London, British Land and Land Securities.

The pricing of risk-free assets has recovered since the ill-fated mini-budget. The yield on the 5-15 year gilt index has hardened by 69 bps since September last year, and by 23 bps since the end of last year to stand at 3.51% by the-end of Q1.

As risk free rates fell back and property yields rose, the property initial / gilt yield gap increased by 120 bps from less than 0.25% in September to 1.4% in December. In Q1 it subsequently increased by a further 32 bps to 1.7%. However, by the standards of the last 16 years, property continues to look as if it is priced above fair value.

In Q1 2023, All Property total returns, as recorded by the MSCI Monthly Index, reflected a rapid improvement in market conditions and increased to 0.2% from -14.5% in Q4 2022. Capital growth was -1.2% in Q1 compared to -15.6% three months earlier. However, in the 12 months to the end of March 2023, All Property total returns decreased to -14.7% from -10.1% in the 12 months to the end of December 2022.

All Property investment volumes, represented by the current value of investment transactions adjusted for capital growth, decreased by 40% in Q4 2022 compared to Q3 and were 53% below their long run average. Preliminary estimates suggest that investment volumes in Q1 2023 rose sharply by 51% against this very low base but remained 30% below the long run average.

As the path of interest rates continues to be upwards, we continue to expect weak market conditions to persist at least for the first half of 2023. We have therefore maintained our forecast All Property total return for 2023 at -6%. However, if the current short-term improvements in market conditions persist the outcome could surprise on the upside.

On the assumption that inflation and interest rates peak later this year we expect All Property total returns to recover sharply in 2024 and could reach 15% if some of the recent yield de-rates are unwound. Thereafter markets should return towards an equilibrium level. The net effect is that the annualised average forecast for the 3-years ending December 2025 could be around 5%.

3. The World & UK economies

In April's edition of its World Economic Outlook (WEO), the International Monetary Fund (IMF) forecasts that global growth will bottom out at 2.8% this year before rising modestly to 3.0% in 2024. Global inflation will decrease, although more slowly than initially anticipated, from 8.7% in 2022 to 7.0% this year and 4.9% in 2024 (see Chart 1.1).

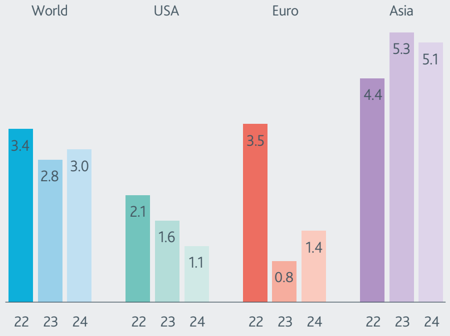
Tentative signs in early 2023 that the world economy could achieve a soft landing have receded amid stubbornly high inflation and the recent failures of Silicon Valley Bank and Credit Suisse. Although inflation has declined as central banks have raised interest rates and food and energy prices have come down, underlying price pressures are proving sticky. Risks to the outlook are now heavily skewed to the downside, with the chances of a hard landing having risen sharply.

Emerging market and developing economies are already growing strongly. The slowdown is concentrated in the advanced economies, especially the euro area and the United Kingdom, where the annual rate of growth is expected to fall to 0.7% and –0.3%, respectively this year before rebounding to 1.8% and 2.0% in 2024 (see Chart 1.2).

The UK remains trapped in an economic limbo resulting from Brexit, Covid, rising energy prices and Russia's war in Ukraine. It has so far just avoided recession but following growth of 0.4% in January, the economy failed to grow at all in February. Growth in construction was offset by falls in services and production. In the three months to the end of February, the economy grew by just 0.1% (see Chart 1.3).

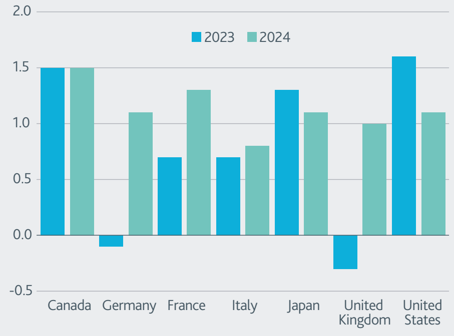
The largest contributors to the negative growth in services in February 2023 were education and public administration. These falls were partially offset by growth in health and social work. Production output fell for the second consecutive month in February driven by a decline in the demand for electricity, gas, steam and air conditioning and the manufacture of chemicals and electrical equipment. The construction sector benefitted from an increase in repairs and maintenance rather than new build. Various factors were cited as an explanation for this differential performance including industrial action in the health, education and rail industries and, of course, the weather as February turned out to be unusually dry and mild (see Chart 1.4).

1.1 2022 gdp growth projections by region (%)



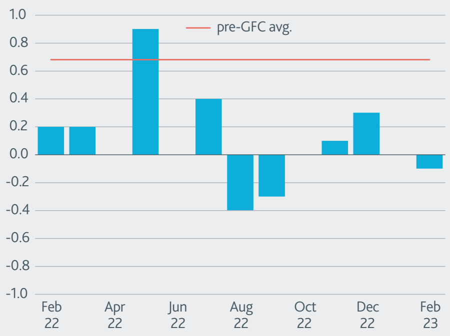
Source: IMF, Apr 2023

1.2 G7 economies forecast %'age change



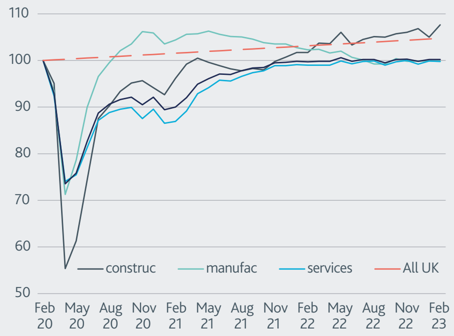
Source: IMF, Apr 2023

1.3 Rolling 3m UK economic growth (%)



Source: ONS, Apr 2022

1.4 UK economic growth indices (Feb 2020=100)

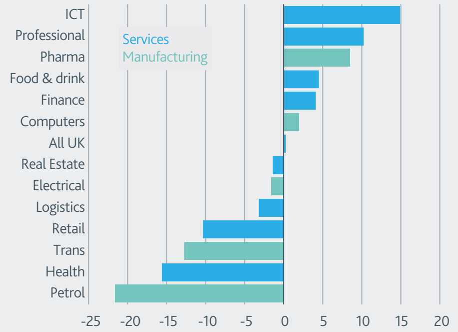


Source: ONS, Apr 2023

At last, the UK's economy is larger than it was in February 2000 but by just 0.2%. The manufacture of petrol and other fuels has fallen since the pandemic first started but ICT has grown 14.9%. Generally, service sector industries have fared better than manufacturing. The Food and Drink sector has recovered from the threats posed by successive Covid lockdowns and is now 4.5% larger. The growth in on-line sales has not fully compensated for the decline in physical sales and the retail sector remains 10% smaller post-pandemic. The direct impact of the strikes can be seen in rail and postal services and in health and education. One in nine businesses were directly or indirectly affected by industrial action, with three in 10 of those businesses reporting that they were unable to fully operate as a consequence (see Chart 1.5).

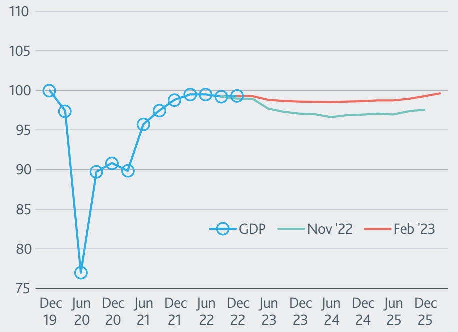
The MPC's latest forecasts published in February 2023 suggest that GDP will fall slightly throughout 2023 and into Q1 2024, as high energy prices and interest rates restrict spending. However, this is a much shallower profile for the decline in output than in the November report, reflecting stronger consumption as wholesale energy prices decline and the ongoing strength of the labour market. Nevertheless, growth is expected to remain well below pre-pandemic rates (see Chart 1.6).

1.5 Post pandemic economic growth by sector (%)



Source: ONS, Apr 2023

1.6 MPC economic projections (Dec 2019=100)



Source: Bank of England, February 2023

4. Other economic indicators

Economists expected inflation to fall below 10% in March for the first time since last summer. But year on year CPI inflation remained stubbornly high and only decreased to 10.1% in March from 10.4% in February. Core inflation excluding energy, food, alcoholic drinks, and tobacco is lower but has shown no change over the month since the end of February. The numbers remain extremely elevated compared to the 2% target rate (see Chart 2.1).

High growth in the cost of energy and food is causing hardship and out of necessity a reduction in household spending elsewhere. ONS figures show that gas and electricity prices continue to rise rapidly compared with last year, and most adults in Great Britain are reporting using less fuel in their homes because of the rising cost of living.

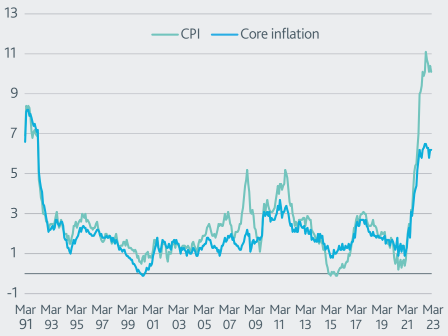
The largest upward contributions to the annual inflation rate in March came from electricity, gas and other household fuels and food and non-alcoholic drinks. Petrol and transport-related costs made the largest upward contribution to the rate of inflation in 2021 and 2022. However, its contribution has now fallen and it was one of the smallest contributors to rising prices in March as petrol prices have fallen from £2.00 to less than £1.50 per litre (see Chart 2.2).

February's MPC forecasts suggest that headline inflation will continue to decrease. The direct contribution of energy prices to CPI inflation is expected to fall steadily towards zero throughout 2023 and to turn negative in the medium term. There also continue to be signs that other global price pressures are falling back. Domestic cost pressures, however, remain elevated. Services CPI inflation rose to a 30-year high of 6.8% in December, as nominal annual private sector regular pay growth increased to 7.2%.

CPI inflation is projected by the MPC to fall sharply to just under 4% by the end of 2023. It also expects that continued weakness in the economy alongside a continuing reduction in energy price inflation will reduce domestic inflationary pressures and inflation will decline to below the 2% target in the medium term (see Chart 2.3).

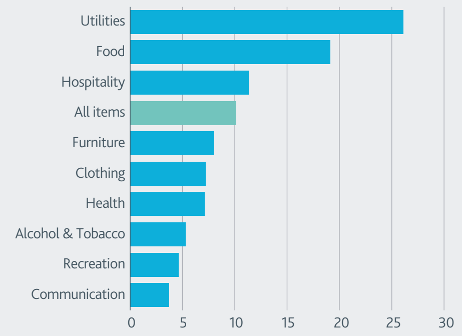
Talk continues from the IMF, economists and newspapers regarding the likelihood of recession. In the UK at least this is crudely defined as two consecutive quarters of declining output. In the USA, they take a much more holistic approach to the definition. The Business Cycle Dating Committee decides when a recession begins and ends based on multiple criteria, including employment and industrial production. Looking at employment in the UK, it is far from clear

2.1 CPI inflation (%pa)



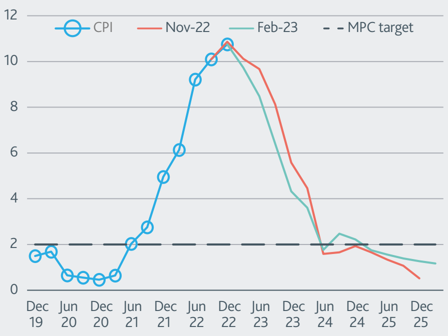
Source: ONS, Apr 2023

2.2 Inflation by sector (%pa)



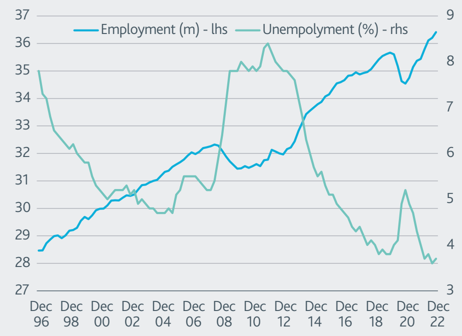
Source: ONS, Apr 2023

2.3 MPC inflation projections (%pa)



Source: Bank of England, February 2023

2.4 UK jobs & unemployment



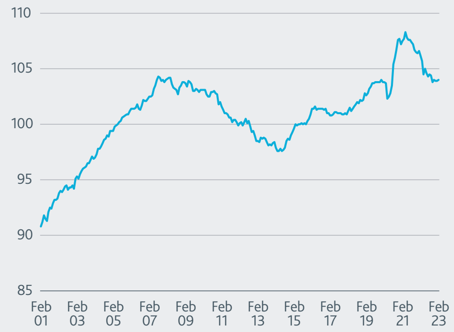
Source: ONS, Apr 2023

that the economy is on the brink of typical recession characterised by failing businesses, job losses and mass unemployment (see Chart 2.4).

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

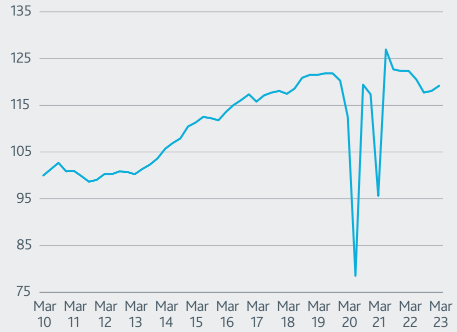
The fortunes of the retail sector remain mixed. Retail sales volumes (the amount of goods bought) fell by 0.9% in March 2023 following on from a rise of 1.1% in February. Sales volumes are still 0.9% below the pre-COVID-19 level of February 2020. However, in terms of value spent, retail sales have risen 12.7% over the same period (see Chart 2.6).

2.5 Real pay index (May 2005=100)

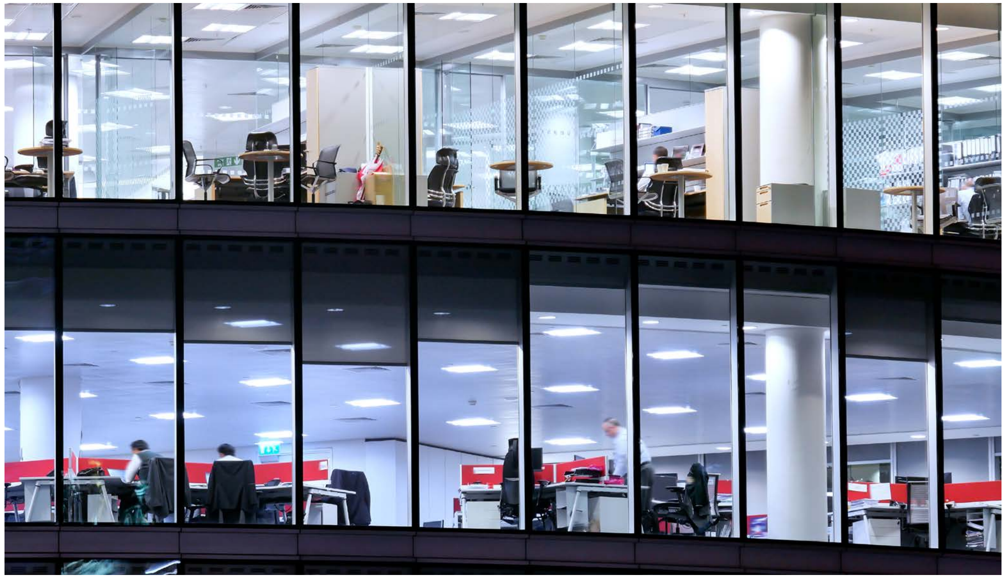


Source: ONS, Apr 2023

2.6 Index of retail sales volumes (Jan 2009=100)



Source: ONS, Apr 2023



5. Stock markets, interest rates & asset yields

In 2022 financial markets posted the heaviest losses in asset markets since the global financial crisis. In Q1 2023 the markets rebounded.

The MSCI World Index with large and mid-cap representation across 23 developed markets gained 7.7% in Q1 2023 although it was a long way from recouping the 17.3% lost in 2022. All bar one of the world's major equity markets also posted strong gains in Q1. The NASDAQ led the way as investors decided that tech stocks had been oversold (see Chart 3.1).

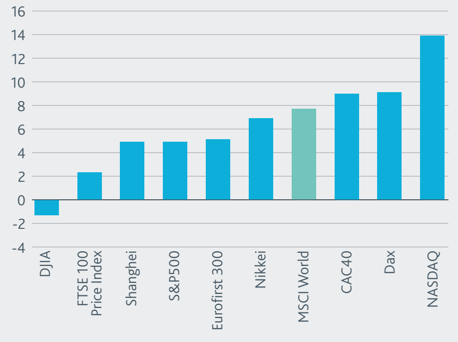
The NASDAQ, which contains the listing of many of the major tech stocks, was up 13.9% in Q1 as the prices of big tech stocks raced ahead again. Shares in Nvidia, a global leader in artificial intelligence hardware and software, rose 90.1% as the open source Chat GPT amassed over 100 million monthly users. Meta, previously known as Facebook, rose 76.1%. Prologis, the largest logistic and warehouse real estate company in the world, enjoyed a 10.7% rise in its share price as real estate markets staged a slight recovery (see Chart 3.2).

UK REIT share prices again under-performed the wider all share market index in Q1. The All REIT index fell -3.1% but all of the major property companies fared better. The share price of Segro, the logistics and warehousing specialist, rose by a modest 0.5%. Other industrial specialists did better including Big Box, London Metric and Big Yellow. Poor prospects for the London office market and UK retail property, continued to weigh on the share price of Derwent London, British Land and Land Securities although Great Portland managed a 2.4% uplift (see Chart 3.3).

The era of cheap money has ended with the rapid escalation of interest rates as Central Banks struggle to control soaring inflation. The Bank of England has overseen eleven consecutive rises in its base rate to 4.25% from 0.1% in March 2020. Interest rates were last at this level in October 2008 shortly after the collapse of Lehman Brothers triggered the GFC.

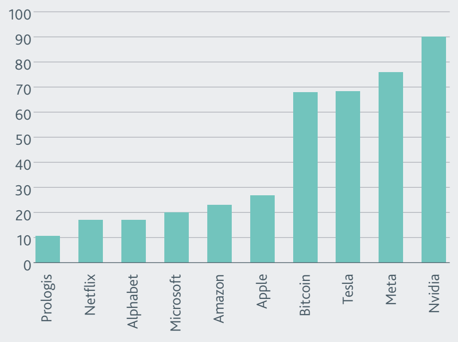
The pricing of UK risk free assets has largely recovered in the wake of the mini-budget. The yield on the 5-15 year gilt index has hardened by 23 bps since the end of last year and 69 bps since September 2022 to stand at 3.51% by the-end of Q1 as the money markets clearly believe that the long term trajectory for inflation and interest rates is now downward. Consequently, the total return performance on the FTSE Actuaries 5-15 year gilt index in Q1 was 2.8%. Since the end of last year, the MPC has announced two further increases in the base rate, taking the current rate to 4.25% (see Chart 3.4).

3.1 World stock markets in Q1 2023 (%)



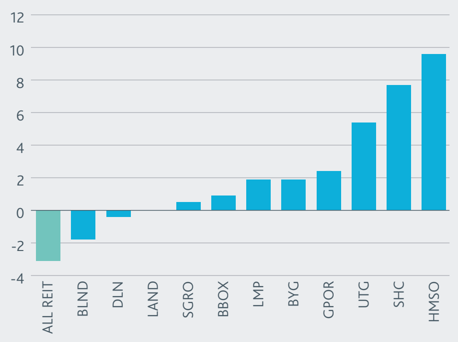
Source: Yahoo Finance, Apr 2023

3.2 Tech & other selected stocks Q1 2023 (%)



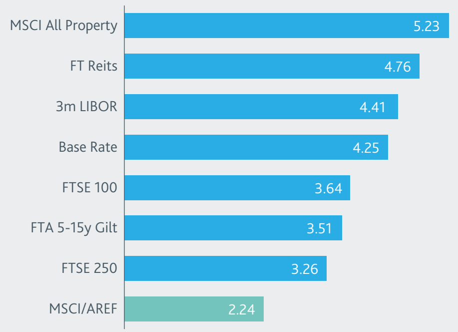
Source: Yahoo Finance, Apr 2023

3.3 UK Reit price movement in Q1 2023 (%)



Source: Yahoo Finance, Apr 2023

3.4 UK asset yields Q1 2023 (%)

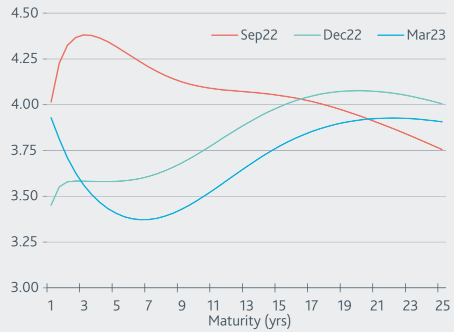


Source: Yahoo Finance & MSCI, Apr 2023

In the last six months Chancellor Jeremy Hunt and Prime Minister Rishi Sunak have restored a degree of order to financial markets The current shape of the yield curve suggests that the markets clearly believe that the medium term trajectory for inflation and interest rates is now downward. Market pricing now implies that interest rates will now peak at close to 5.0% in November (see Chart 3.5).

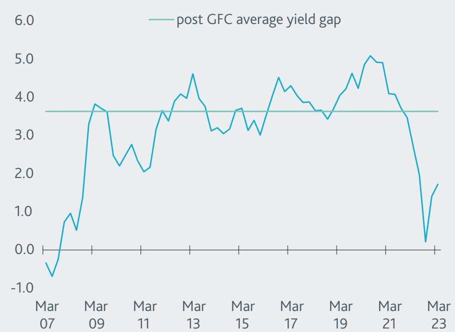
As risk free rates fell back and property yields rose, the property initial / gilt yield gap increased by 120 bps from less than 0.25% in September to 1.4% in December. In Q1 it subsequently increased by a further 32 bps to 1.7%. However, by the standards of the last 16 years, property continues to look as if it is priced above fair value. The last time the asset class was valued at this level was on the eve of the GFC when a banking crisis triggered a decline in All Property capital values of 40% (see Chart 3.6). Sharp upwards movements in risk free rates have certainly triggered a correction in the pricing of commercial real estate but the latest commercial property market indices featured below suggest that the analogy with the GFC may not be entirely accurate.

3.5 Gilt yield curve (%)



Source: Bank of England, Apr 2023

3.6 Property IY – Gilt yield gap (%)



Source: MSCI & Bank of England, Apr 2023

6. Commercial property market performance

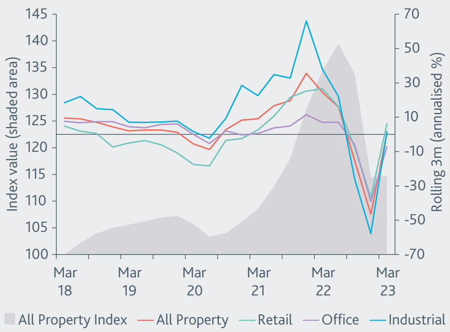
In Q1 2023, All Property total returns, as recorded by the MSCI Monthly Index, reflected a rapid improvement in market conditions and increased to 0.2% from -14.5% in Q4 2022. Capital growth was -1.2% in Q1 compared to -15.6% three months earlier. Property equivalent yields softened by 7 bps and contributed a -1.7% fall in valuations. All Property rental value growth increased very slightly to 0.8% in Q1 from 0.7% in Q4. Q1 income returns amounted to 1.4% (see Charts 4.1 & 4.4).

Over the course of the first quarter, office rental value growth remained at 0.3% as it was in Q4, while industrial rental value growth increased to 1.8% from 1.6% in Q4. All Retail rental value growth increased to 0.2% from -0.2% in Q4. Market rental values for shopping centres and South East shops continued to fall back, whilst rental values for central London and Rest of UK shops and retail warehouses drifted higher (see Charts 4.2 & 4.5).

In the 12 months to the end of March 2023, All Property total returns decreased to -14.7% from -10.1% in the 12 months ending December last. Year-on-year capital growth decreased to -18.8% in March from -14.2% in December. Property equivalent yields have softened by 136 bps in the 12-months to March and contributed to a 23.5% drop in valuations. All Property rental values increased year-on-year by 3.6% and income return amounted to 5.0%. It is likely that these year-on-year numbers will weaken further next quarter as strong returns in Q2 2022 fall out of the calculation.

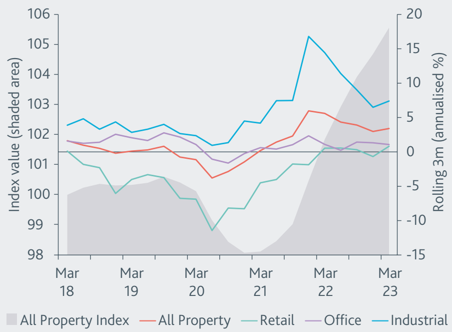
Strong investment and occupier demand for industrials has driven yields down to 3.3% and approaching 2.5% for last mile logistics in London at the top of the market. The sharp increase in the benchmark risk free rate and borrowing costs together with doubts surrounding the sustainability of high levels of rental value growth has led to a re-appraisal of value in this sector of the market in particular (see Charts 4.3 & 4.6).

4.1 Total returns (%) by sector



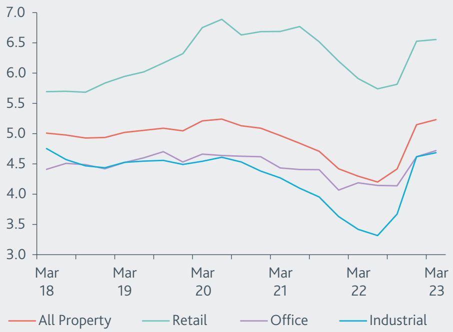
Source: MSCI, Apr 2023

4.2 MRV growth (%) by sector



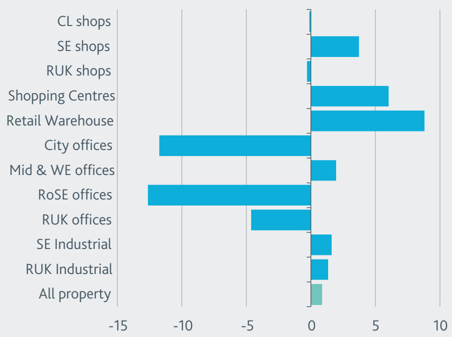
Source: MSCI, Apr 2023

4.3 Initial yield (%) by sector



Source: MSCI, Apr 2023

4.4 Total returns (%) by segment – Q1 2023 annualised

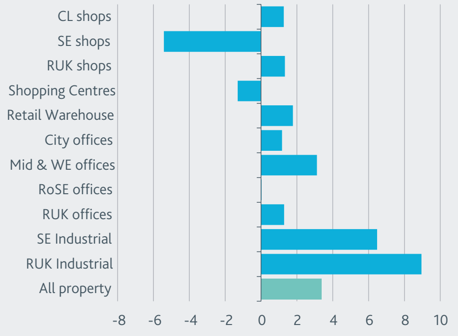


Source: MSCI, Apr 2023

Tables 5.1 – 5.5 contain further performance data for UK commercial real estate in Q1 2023.

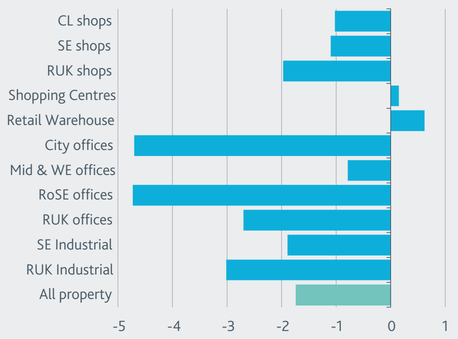
In Table 5.6, we have adopted the factor approach to real estate by segmenting the market firstly by use and secondly by a key characteristic i.e. yield, rent or lease length. The numbers presented are the 3-month total return relative to the MSCI All Property average for Q4 2022. A heat map has been used as a visual aid to pick out the under-performing segments in red and out-performing segments in green.

4.5 MRV growth by segment – Q1 2023 annualised



Source: MSCI, Apr 2023

4.6 Yield impact (%) – Q1 2023



Source: MSCI, Apr 2023

5.1 Total returns (%)

	Mar	3m	6m	12m
All Property	0.7	0.2	-14.3	-14.7
Retail	1.3	1.5	-9.5	-7.8
Office	-0.5	-1.8	-13.3	-13.2
Industrial	1.1	0.4	-19.1	-21.2
Annualised				
All Property	8.9	0.9	-26.5	-14.7
Retail	17.2	6.1	-18.1	-7.8
Office	-6.3	-7.1	-24.8	-13.2
Industrial	13.7	1.5	-34.5	-21.2

Source: MSCI Apr 23

5.2 Capital growth (%)

	Mar	3m	6m	12m
All Property	0.2	-1.2	-16.6	-18.8
Retail	0.8	-0.2	-12.5	-13.5
Office	-1.0	-3.1	-15.5	-17.3
Industrial	0.7	-0.8	-21.0	-24.3
Annualised				
All Property	2.9	-4.6	-30.4	-18.8
Retail	9.5	-0.9	-23.4	-13.5
Office	-11.2	-12.0	-28.6	-17.3
Industrial	8.1	-3.4	-37.5	-24.3

Source: MSCI Apr 23

5.3 Income return (%)

	Mar	3m	6m	12m
All Property	0.5	1.4	2.7	5.0
Retail	0.6	1.7	3.3	6.4
Office	0.4	1.3	2.5	4.9
Industrial	0.4	1.2	2.3	4.1
Annualised				
All Property	5.9	5.8	5.4	5.0
Retail	7.1	7.0	6.8	6.4
Office	5.5	5.5	5.2	4.9
Industrial	5.2	5.0	4.6	4.1

Source: MSCI Apr 23

5.4 ERV growth (%)

	Mar	3m	6m	12m
All Property	0.4	0.8	1.6	3.6
Retail	0.0	0.2	0.0	0.2
Office	0.2	0.3	0.6	1.0
Industrial	0.7	1.8	3.4	8.6
Annualised				
All Property	4.3	3.4	3.2	3.6
Retail	0.5	0.8	0.1	0.2
Office	2.0	1.1	1.2	1.0
Industrial	9.1	7.4	6.9	8.6

Source: MSCI Apr 23

The third quarter last year saw a complete reversal of the trends that have prevailed for most of the last 5 years. All industrial segments underperformed while parts of the office, shop and shopping centre segments outperformed. This pattern was repeated in Q4 but is unlikely to continue in the same analysis next quarter.

5.5 Net initial yield (%)

	Mar	3m	6m	12m
All Property	5.2	5.1	4.4	4.3
Retail	6.6	6.5	5.8	5.9
Office	4.7	4.6	4.1	4.2
Industrial	4.7	4.6	3.7	3.4

Source: MSCI Apr 23

5.6 Performance by strategy relative to All Property average Q4 2022 (%)

	Low yield	High yield	High rent	Low rent	Long lease	Short lease
Shops	2.6	6.8	7.2	2.6	0.9	5.5
Shopping Centres	5.6	0.9	6.5	5.6	5.9	3.5
Retail Warehouses	-0.3	4.4	0.4	-0.3	0.1	1.2
Central London offices	4.7	0.9	5.9	4.7	4.3	2.8
RoSe offices	1.9	-1.5	0.8	1.9	0.9	1.2
RUK offices	-0.7	-1.7	-0.9	-0.7	0.4	-0.6
Industrials	-8.9	-0.6	-8.3	-8.9	-5.3	-6.7

Source: MSCI, Jan & Apr 2023

7. Investment in property

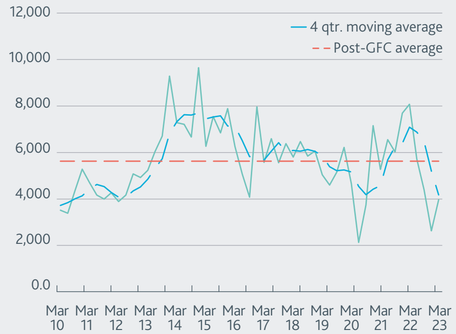
All Property investment volumes, represented by the current value of investment transactions adjusted for capital growth, decreased by 40% in Q4 2022 compared to Q3 and were 53% below their long run average. Preliminary estimates suggest that investment volumes in Q1 2023 rose sharply by 51% against this very low base but remained 30% below the long run average. As usual the latest numbers are likely to be revised in the coming months (see Chart 6.1).

Retail made up 47% (by number) of investment transactions in Q1 2023; offices represented a further 22% and industrials made up the remaining 31%. Across all sectors of the market, investment volumes were lower in Q1 2023 than in Q4 2022 (see Chart 6.2).

Central London offices traditionally dominate UK real estate investment representing 27% of the UK's real estate investment market over the last 22 years. Investment volumes have been on a declining trend since December 2013. Despite some signs of an improvement since March 2021 investment volumes remain below long run average levels (see Chart 6.3).

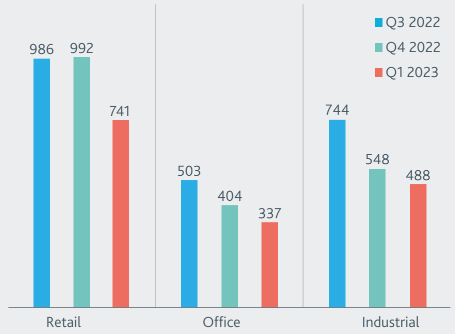
Transaction numbers in Central London office markets increased in Q1 2023 compared with Q4 2022 but are below the levels achieved in Q3 last year before the period of turbulence in financial markets. In Q1 transactions in the fringe markets on the edges of the City, Docklands and Southbank represented more than 50% of transactions while the City only numbered 13% and West End 35% (see Chart 6.4).

6.1 All property investment volumes (£bn)



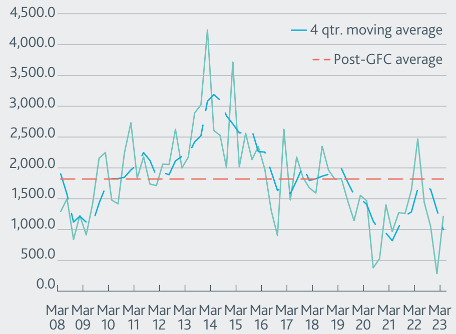
Source: Property Data, MSCI & APR, Apr 2023

6.2 Investment transaction nos. by year



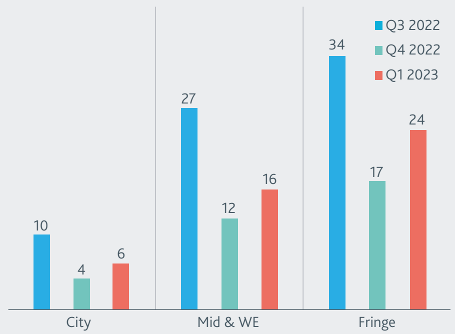
Source: Property Data, Jan 2023

6.3 Central London office investment volumes (£bn)



Source: Property Data, MSCI & APR, Jan 2023

6.4 Central London office Investment transaction nos. by year

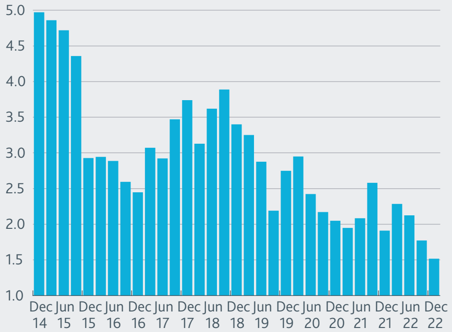


Source: Property Data, Jan 2023

Overseas' Central London investment volumes have been declining for the last five quarters. The surge in activity in 2021 can be put down to the release of pent-up demand after pandemic lockdown restrictions were lifted. The sudden fall in value of the pound triggered by "Trussonomics" did not usher in a wall of overseas' capital targeting Central London offices. The value of sterling has largely recovered since but investment in Central London offices by overseas investors has not (see Chart 6.5).

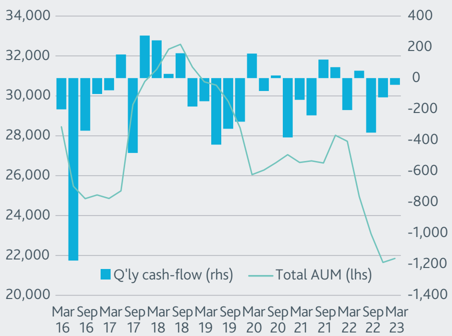
In the last six years, property funds have regularly faced demands for redemptions from retail investors. Data to the end of February 2023 indicates that the sector has suffered from quarter on quarter net redemption demands since mid-2018. Retail investment vehicles have been overwhelmed by calls for redemptions and have been forced to suspend trading in their units, but also to sell some assets to meet repayments. Redemption demand also spread to the institutional open diversified core market last September as falling gilt prices forced pension funds to increase liquidity levels (see Chart 6.6).

6.5 Overseas investment in Central London offices (£bn)



Source: Property Data, Jan 2023

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



Source: Investment Association, Apr 2023

8. Outlook & House View

Increasing risk free rates and the weak economic outlook continue to be reflected in February's IPF consensus forecasts. However, forecasters are slightly more optimistic than they were three months ago. Total return forecasts for 2023 have been increased to 0.6% from -0.1% in November 2022. The outlook for 2024 has strengthened to 6.6% from 6.1% (see Chart 7.1).

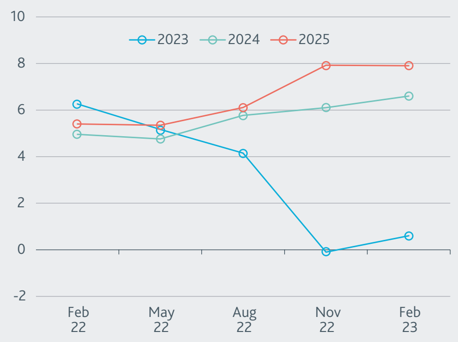
The IPF consensus view remains that values will continue to drift down in 2023 although the pace of decline is now expected to slow. This year will, however, mark the bottom of the cycle with year-on-year total return forecasts increasing to nearly 7% in 2024 and 8% in the years thereafter. The annualised average over the next 5-years ending 2027 will be 5.9% (see Chart 7.2).

Respondents to the IPF Consensus forecasts expect to see retail warehouses and industrials once again produce positive returns in 2023 but the outlook for all other segments remains negative. Nevertheless, the outlook has strengthened for all sectors except for Rest of UK offices, which are potentially more exposed to weak domestic economic growth. But sentiment remains weakest for City of London and West End offices as overseas investors remain absent from the market (see Chart 7.3).

Interest rates continue to rise and economic growth remains limited, however, risk free rates have fallen back as noted above. Consequently, the range of forecasts has narrowed, reflecting a perceived decrease in risk. Total return forecasts for 2023 now range between +5.3% and -8.3%. In comparison the forecast range for 2024 has increased to 14.7%, with a maximum of 14.8% and a minimum of 0.1% (see Chart 7.4).

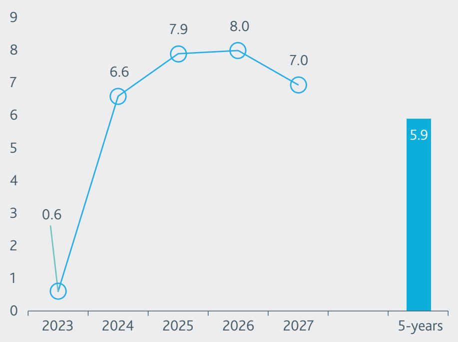
The central forecast from the House View model is revised on a quarterly basis to reflect the changing macro-economic outlook and the current performance of commercial real estate. As the path of interest rates continues upwards, we continue to expect weak market conditions to persist at least for the first half of 2023. We have therefore maintained our forecast All Property total return for 2023 at -6%. However, if the current short-term improvements in market conditions persist the outcome could surprise on the upside (see Chart 7.5).

7.1 IPF forecast evolution



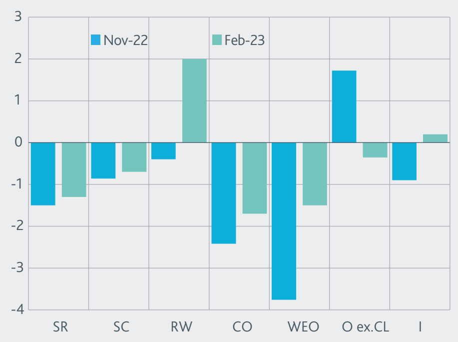
Source: IPF, Feb 2023

7.2 IPF All Property forecasts y-o-y (%)



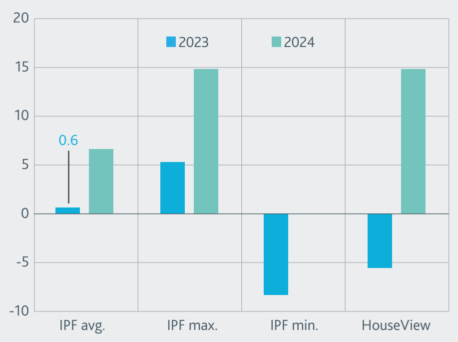
Source: IPF, Feb 2023

7.3 IPF 2023 forecasts by sector Feb 23 v Nov 22 (%)



Source: IPF, Feb 2023

7.4 UK commercial total return forecast range (%)

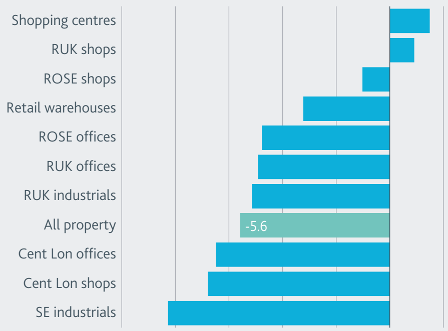


Source: IPF, Feb 2023

On the assumption that inflation and interest rates peak later this year, we expect All Property total returns to recover sharply in 2024 and could reach 15% if some of the recent yield de-rates are unwound. Thereafter markets should return towards an equilibrium level. The net effect is that the annualised average forecast for the three years ending December 2025 could be around 5%.

After years of under-performance, Shopping Centres and Rest of UK Shops are providing an 8% income return, which provides some resilience in the face of a continued de-rate of the asset class this year (see Chart 7.6). The usual caveats regarding uncertainty surrounding our central forecast remain including a more benign outlook for the economy, inflation and interest rates and an improvement in liquidity as investors believe that the sudden downward adjustment in pricing now presents an immediate buying opportunity.

7.5 Cluttons House View – 2023 relative total returns (%)



Source: IPF, APR & Cluttons, Apr 2023

7.6 Cluttons House View – 2023-2025 relative total returns (%)

Source: IPF, APR & Cluttons, Apr 2023

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