CLUTTONS
INVESTMENT MANAGEMENT

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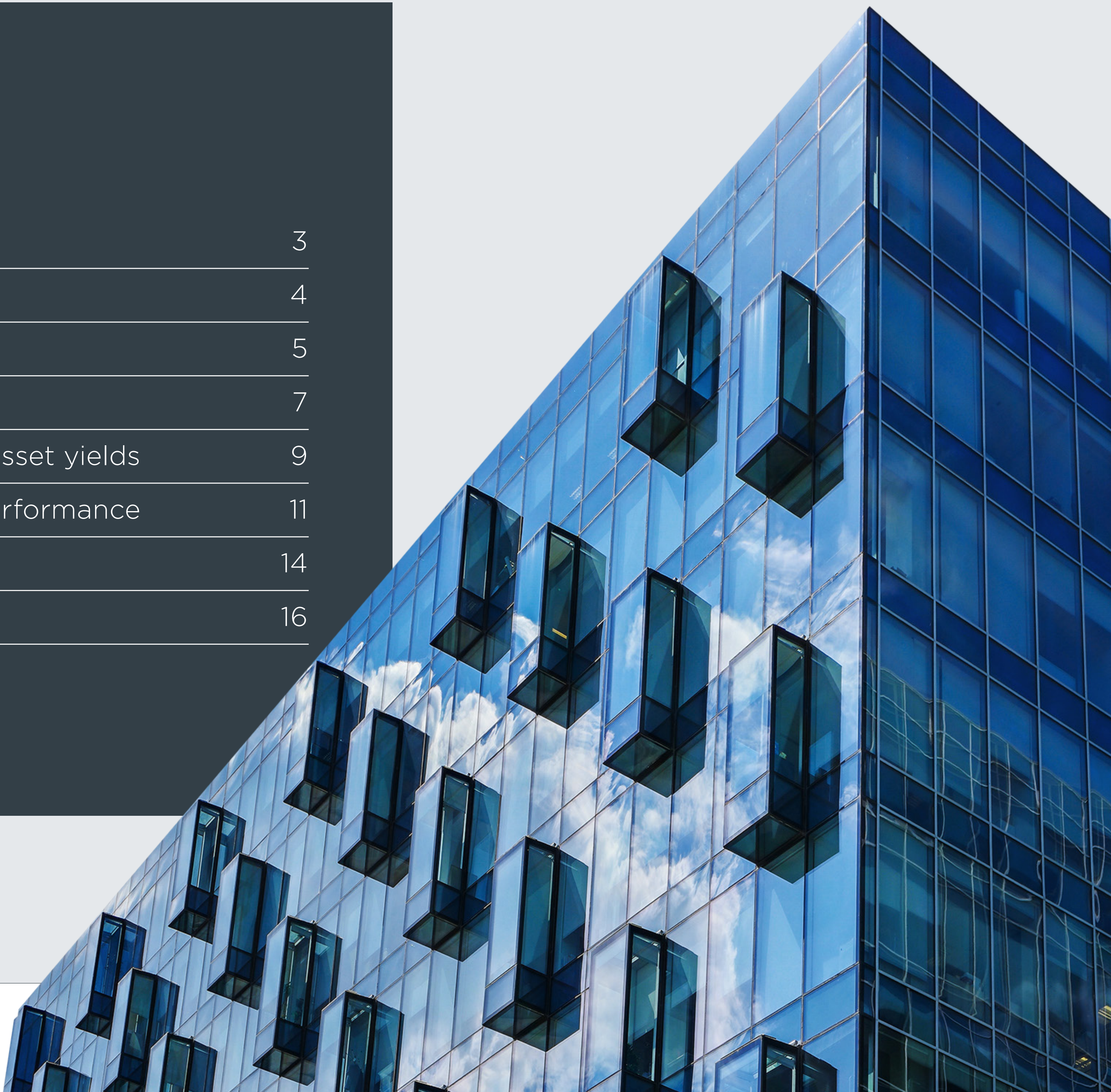
Commercial property examiner

Summer | 2023

Contents



1. Key take aways

A combination of sharply higher inflation and interest rates has created a cost of living crisis that has held back the UK economy. Following a lack of growth in the three months to February, the economy shrank by -0.1% in the three months to May. The MPC's latest forecasts published in August suggest that the economic outlook has weakened slightly since the previous set of forecasts. GDP growth is expected to remain below pre-pandemic rates in the medium term as spare capacity and unemployment rise.

Following a further 25 bp increase in the base rate in August, the Bank of England has overseen fourteen consecutive rises in its base rate to 5.25%, up from 0.1% in March 2020. Interest rates were last at this level in March 2008 when the UK slid into its last major economic downturn. The pricing of UK risk-free assets is once again under pressure as the Bank of England struggles to bring inflation back towards its target level of 2.0%. The yield on the 5-15 year gilt index has softened by 94 bps since the end of the first quarter and now stands at 4.45%.

In Q2 2023, All Property total returns, as recorded by the MSCI Monthly Index, increased to 1.0% from 0.2% in Q1. Capital values fell by just -0.4% in Q2 compared to -1.2% three months earlier. However, on an annual basis, All Property total returns decreased to -16.9% in the year to June, down from -14.7% in the 12 months ending in March, as stronger numbers from Q2 2022 fell out of the calculation.

It now seems likely that UK inflation and interest rates will stay higher for longer. Consequently, expectations of a sharp recovery in All Property returns in 2024, have been trimmed back from 15% to 7% and any stronger recovery delayed until 2025 or 2026. The net effect is that the annualised average forecast for the three years ending December 2025 could be just 2%, representing a 3-percentage point downgrade from Q1's three-year forecast.

2. Summary

In July's edition of its World Economic Outlook (WEO), the International Monetary Fund (IMF) forecast that global growth will fall from an estimated 3.5% in 2022 to 3.0% in both 2023 and 2024. The forecast for 2023 is modestly higher than predicted in the April 's WEO but it remains weak by historical standards.

A combination of sharply higher inflation and interest rates has created a cost of living crisis that has held back the UK economy. Following a lack of growth in the three months to the end of February, the economy shrank by -0.1% in the three months to the end of May.

The MPC's latest forecasts published in August suggest that the economic outlook has weakened slightly since the previous set of forecasts. GDP growth is expected to remain below pre-pandemic rates in the medium term as spare capacity and unemployment rise.

Year on year CPI inflation remains stubbornly high by historical standards but finally fell through the 10% barrier as it decreased to 7.9% in June from 10.1% in March. Core inflation excluding energy, food, alcoholic drinks, and tobacco is lower but has increased since the end of March. The numbers remain extremely elevated compared to the 2% target rate.

August's MPC forecasts suggest that headline inflation will decrease to 5% by the end of the year owing to lower energy prices and reduced food and core goods price inflation. CPI inflation is expected to return to the 2% target by Q2 2025.

The MSCI World Index gained 7.1% in Q2 2023 and 14.9% in H1. It has now nearly recouped the 17.3% lost in 2022. The FTSE100 fell -1.2% while the top performing Nikkei was up 19.0% and the NASDAQ, which contains the listing of many of the major tech stocks, was up 15.4%% as the prices of big tech stocks raced ahead again.

UK REIT share prices again under-performed the wider all share market index in Q2. The All-REIT index fell -7.1% but many of the major property companies fared worse. Poor prospects for the London office market weighed down the share price of Derwent London and British Land and Great Portland. The industrial and logistics specialists were also not immune to the downward trend in pricing.

Following a further 25 bp increase in the base rate in August, the Bank of England has overseen fourteen consecutive rises in its base rate to 5.25% from 0.1% in March 2020. Market expectations are that interest rates will peak at more than 6.0% in the middle of next year.

The pricing of UK risk-free assets is once again under pressure as the Bank of England struggles to bring inflation back towards its target level of 2.0%. The yield on the 5-15 year gilt index has softened by 94 bps since the end of the first quarter.

As risk-free rates rose sharply in Q2, the property initial / gilt yield gap decreased by 87 bps to 0.85%. By the standards of the last 16 years, property continues to look as if it is priced above fair value.

In Q2 2023, All Property total returns, as recorded by the MSCI Monthly Index, increased to 1.0% from 0.2% in Q1. Capital values fell by just -0.4% in Q2 compared to -1.2% three months earlier. However, In the 12 months to the end of June 2023, All Property total returns decreased to -16.9% from -14.7% in the 12 months ending March as stronger numbers from Q2 2022 fell out of the calculation.

All Property investment volumes, represented by the current value of investment transactions adjusted for capital growth, increased by 61% in Q1 2023 compared to Q4 2022 when rising risk-free rates drove All Property capital values down 15.6%. Despite this increase, Q1 transaction volumes remained 20% below their long run average. Preliminary estimates suggest that investment volumes in Q2 2023 fell by -43% compared to Q1 2023 and were 54% below the long run average.

As inflation remains stubbornly high and the path of interest rates continues upwards, we expect a return to weaker CRE market conditions in the second half of 2023. Our forecast All Property total return for 2023 remains at -6%; this reflects a stronger H1 than expected but weakening conditions in H2.

It now seems likely that UK inflation and interest rates will stay higher for longer. Consequently, expectations of a sharp recovery in All Property returns in 2024, have been trimmed back from 15% to 7% and any stronger recovery delayed until 2025 or 2026. The net effect is that the annualised average forecast for the three years ending in December 2025 could be just 2%, representing a 3-percentage point downgrade from Q1's 3-year forecast.

3. The world & UK economies

In July's edition of its World Economic Outlook (WEO), the International Monetary Fund (IMF) forecasts that global growth will fall from an estimated 3.5% in 2022 to 3.0% in both 2023 and 2024. The forecast for 2023 is modestly higher than predicted in April 's WEO but it remains weak by historical standards as the rise in central bank policy rates to fight inflation continues to weigh on economic activity (see Chart 1.1).

However, the balance of risks to global growth remains tilted to the downside. Inflation could rise if further shocks occur. An intensification of the war in Ukraine could again lead to a spike in world food prices. And further policy tightening by central banks could see the return of the financial sector turbulence that required the rescue of Silicon Valley Bank, Credit Suisse and others earlier in the year.

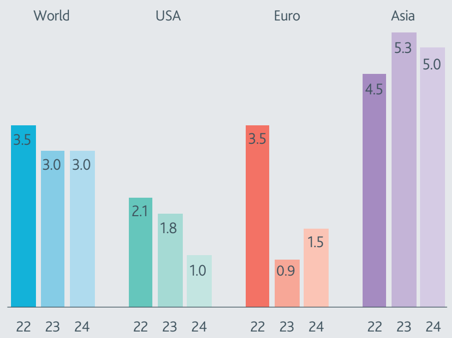
Growth in emerging market and developing economies is projected to be broadly stable at 4.0% in 2023 and 4.1% in 2024. But growth in the United Kingdom is projected to decline to 0.4 % in 2023, and only rise to 1.0% in 2024. Meanwhile, growth in the euro area is projected to only reach 0.9% in 2023, before rising to 1.5% in 2024 (see Chart 1.2).

The UK's post-Covid recovery has petered out since the first quarter of 2022. Brexit may or may not have reduced the medium or long-term potential rate of economic growth, but a combination of sharply higher inflation and interest rates have created a cost of living crisis that has held back the UK economy. Following a lack of growth in the three months to the end of February, the economy shrank by three months to the end of May. (see Chart 1.3).

THE UK's dominant service sector shrank by -0.2% in the three months to May, while manufacturing grew by 0.3% and construction was -1.3% lower. It seems likely that house builders perceived a drop in affordability for their product as mortgage costs rose sharply and cut back on development. In July, Nationwide Building Society announced that average house prices had fallen by 3.8% on the year, representing the biggest drop since July 2009. The UK economy is just 0.2% above its pre-pandemic level and -4.7% below it's potential level (see Chart 1.4).

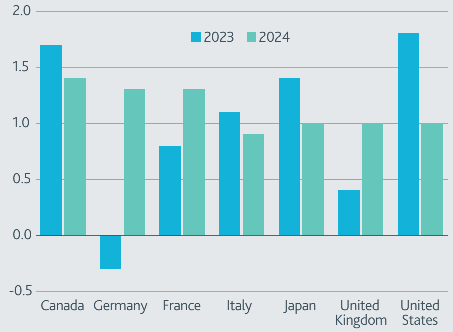
In the post-pandemic economy, service sector industries continue to fare better than manufacturing. The manufacture of petrol and other fuels has fallen 18.2%

1.1 2023 gdp growth projections by region (%)



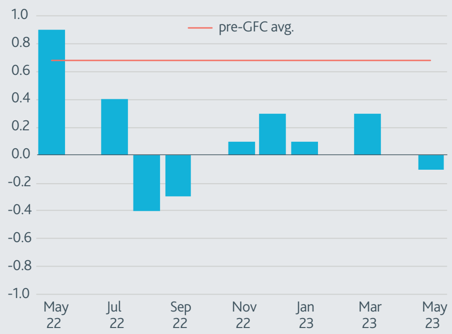
Source: IMF, Jul 2023

1.2 G7 economies forecast, annual percentage change



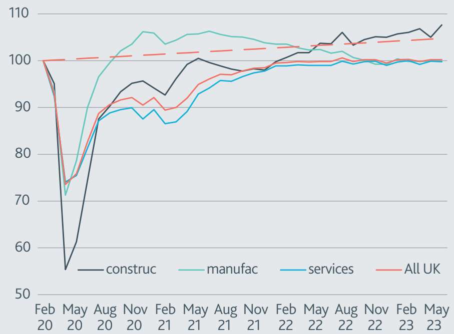
Source: IMF, Jul 2023

1.3 Rolling 3m UK economic growth (%)



Source: ONS, Jul 2023

1.4 UK economic growth indices (Feb 2020=100)



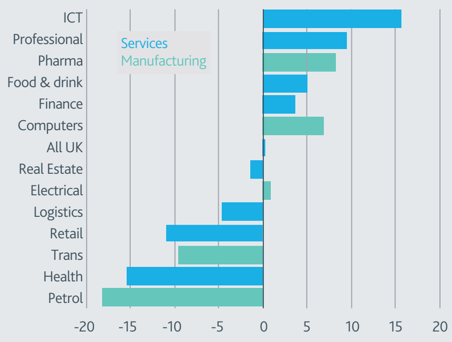
Source: ONS, Jul 2023

since the pandemic first started but Information and Communications Technology (ICT) has grown 15.7%. The Food and Drink sector has recovered from the threats posed by successive Covid lockdowns and is now 5.0% larger. The growth in on-line sales has not fully compensated for the decline in physical sales and the retail sector is 11.0% smaller post-pandemic. The bank holiday for the new King's coronation seems to have reduced output in manufacturing and construction but boosted arts, entertainment, and hospitality. The health, rail, and education sectors together with the civil service all saw industrial action in May 2023 which restricted growth. There is also anecdotal evidence that rail network industrial action had an adverse impact on footfall for the retail and hospitality sectors (see Chart 1.5).

The MPC's latest forecasts published in August suggest that the economic outlook has weakened slightly since the previous set of forecasts in May. GDP growth is expected to remain below pre-pandemic rates in the medium term (see Chart 1.6).

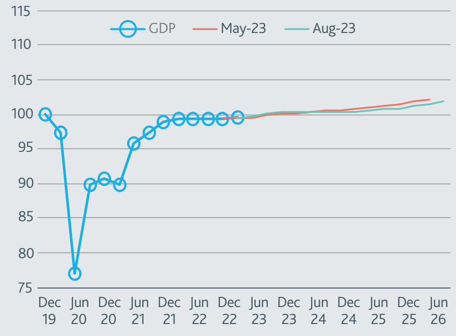
The latest Monetary Policy Report comments that: *"The labour market remains tight but there are some indications that it is loosening. The Labour Force Survey (LFS) unemployment rate rose to 4.0% in the three months to May and the vacancies to unemployment ratio has been falling since mid-2022, although the latter still remains above its 2019 Q4 level. In the MPC's August projection, the unemployment rate is projected to rise to just under 5% by 2026 Q3. Both aggregate spare capacity and unemployment increase by somewhat more in the Committee's latest projections than in the May Report, reflecting the weaker path of GDP."*

1.5 Post pandemic economic growth by sector (%, Feb '20-May '23)



Source: ONS, Jul 2023

1.6 MPC economic projections (Dec 2019=100)



Source: Bank of England, August 2023

4. Other economic indicators

Year on year CPI inflation remains stubbornly high by historical standards but finally fell through the 10% barrier as it decreased to 7.9% in June from 10.1% in March. Core inflation excluding energy, food, alcoholic drinks, and tobacco is lower but has increased since the end of March. The numbers remain extremely elevated compared to the 2% target rate and the Government looks unlikely to meet its target of halving inflation by the end of the year (see Chart 2.1).

High growth in the cost of energy and food continues to cause hardship, and, out of necessity, a reduction in household spending elsewhere. ONS figures show that food, gas, and electricity prices continue to rise rapidly compared with last year. The cost of food staples has risen more than indulgent goods. Olive oil is up more than 50% in the last five years, and canned tomatoes are priced 45% higher, while dry spaghetti has increased by 39%.

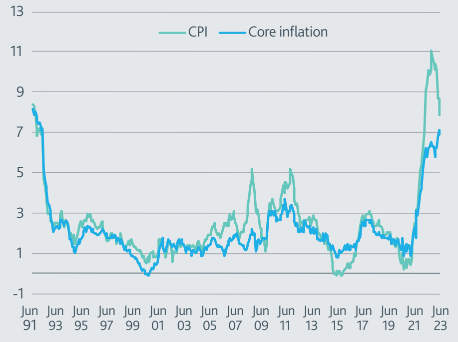
Petrol and transport-related costs made the largest upward contribution to the rate of inflation in 2021 and 2022. However, transport costs made the largest downward contribution to annual CPI inflation in June as petrol prices have fallen from £2.00 to nearly £1.40 per litre (see Chart 2.2).

August's MPC forecast suggests that CPI inflation is expected to decrease to around 5% by the end of the year, owing to lower energy prices and reduced food and core goods price inflation (see Chart 2.3).

The latest Monetary Policy Report comments that: *"An increasing degree of slack in the economy and declining external cost pressures lead CPI inflation to return to the 2% target by 2025 Q2 and to fall below target in the medium term, but to a lesser degree than projected in the May Report. The Committee continues to judge that the risks to the modal forecast are skewed to the upside, but by less than in May. Taking account of this skew, mean CPI inflation is 2.0% and 1.9% at the two and three-year horizons respectively."*

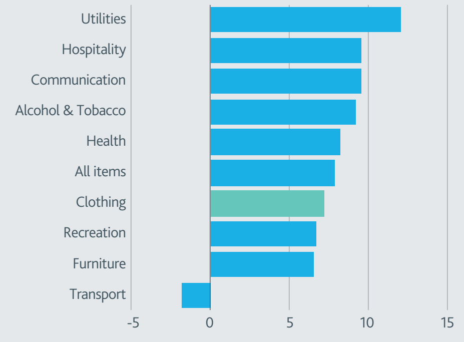
Talk continues from the IMF, economists and newspapers regarding the likelihood of recession. In the UK at least this is crudely defined as two consecutive quarters of declining output. In the USA, they take a more holistic approach to the definition. The Business Cycle Dating Committee decides when 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 that the economy is on the brink of a typical recession characterised by failing businesses, job losses and mass unemployment (see Chart 2.4).

2.1 CPI inflation (%pa)



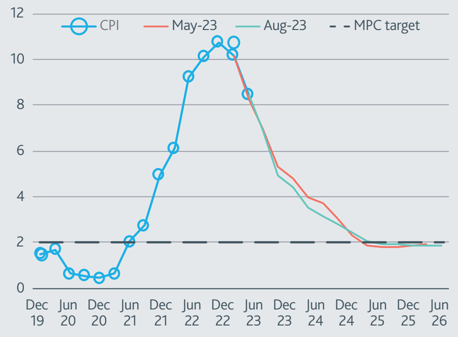
Source: ONS, Jul 2023

2.2 Inflation by sector (%pa, 12m to June '23)



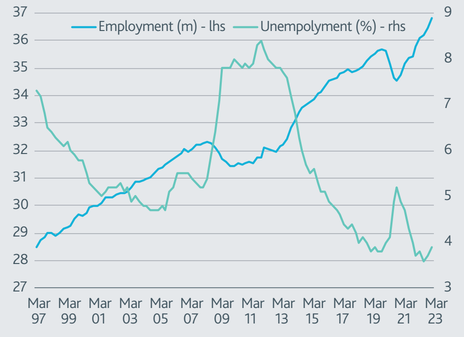
Source: ONS, Jul 2023

2.3 MPC inflation projections (%pa)



Source: Bank of England, August 2023

2.4 UK jobs & unemployment

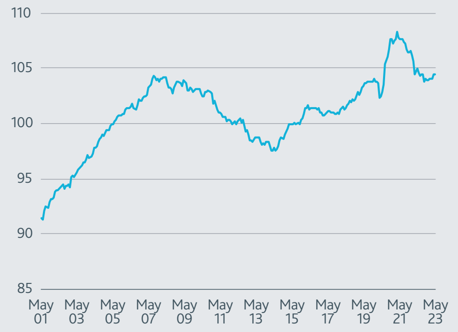


Source: ONS, Jul 2023

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).

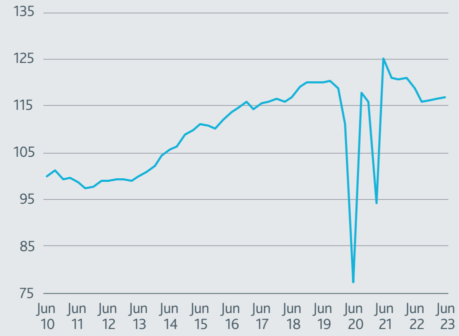
The fortunes of the retail sector remain mixed. Retail sales volumes (the amount of goods bought) rose by 0.5% in Q2, following on from a rise of just 0.1% in the first quarter. Sales volumes are still 1.4% below the pre-COVID-19 level at the end of 2019. However, in terms of value spent, retail sales have risen 14.0% over the same period (see Chart 2.6).

2.5 Real pay index (May 2005=100)

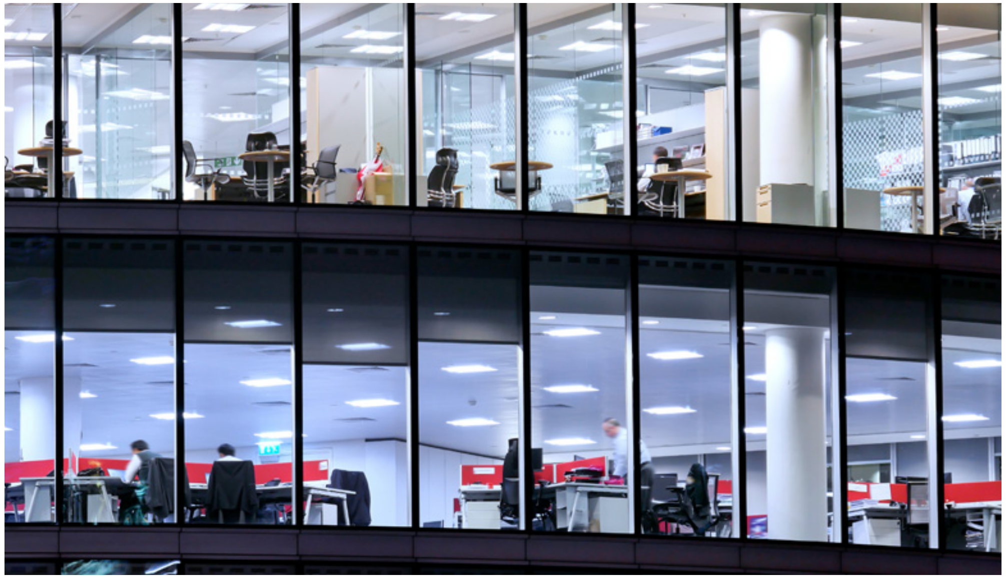


Source: ONS, Jul 2023

2.6 Index of retail sales volumes (Jun 2010 =100)



Source: ONS, Jul 2023



5. Stock markets, interest rates & asset yields

In 2022, financial markets posted the heaviest losses in asset markets since the global financial crisis. Since the start of this year markets have performed as if the fears of recession have been completely discounted.

The MSCI World Index, with large and mid-cap representation across 23 developed markets, gained 7.1% in Q2 2023 and 14.9% in H1. It has now nearly recouped the 17.3% lost in 2022. All bar two of the world's major equity markets also posted strong gains in Q1. The FTSE100, being one of the exceptions, suffered as market pricing fell -1.2%. The Nikkei led the way with growth of 19.0%. Underlying macro-economic conditions are very different in Japan. Core consumer price inflation is 3.3% and the Central Bank has just opted to maintain its benchmark interest rate at -0.1% (see Chart 3.1).

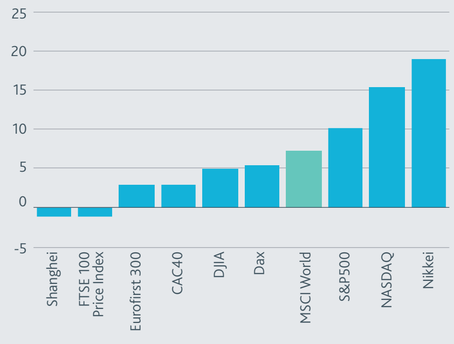
The NASDAQ, which contains the listing of many of the major tech stocks was up 15.4%% in Q2 as the prices of big tech stocks raced ahead again. Shares in Nvidia, a global leader in artificial intelligence hardware and software, rose a further 52.3%. Microsoft has integrated Chat GPT into Office 365 and Apple is developing its own large language model. Meta, previously known as Facebook, rose 35.4%. But the share price of Prologis, the largest logistic and warehouse real estate company in the world, fell -1.7% as US core real estate funds recorded four consecutive quarters of falling valuations for the first time since December 2009 (see Chart 3.2).

UK REIT share prices again under-performed the wider all share market index in Q2. The All-REIT index fell -7.1% but many of the major property companies fared worse. Poor prospects for the London office market continued to weigh on the share price of Derwent London and British Land. Great Portland, which had avoided a downgrade in Q1, suffered from a drop of -18.1% in Q2. The industrial and logistics specialists were not immune to the downward trend. The share price of Segro, the logistics and warehousing specialist, fell by -6.6%. Oher industrial specialists fared little better. Big Box was down -10.7% and London Metric's price fell -5.8% (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. Following a further 25 bp increase in the base rate in August, the Bank of England has overseen fourteen consecutive rises in its base rate to 5.25%, from 0.1% in March 2020. Interest rates were last at this level in March 2008 when the UK slid into its last major economic downturn.

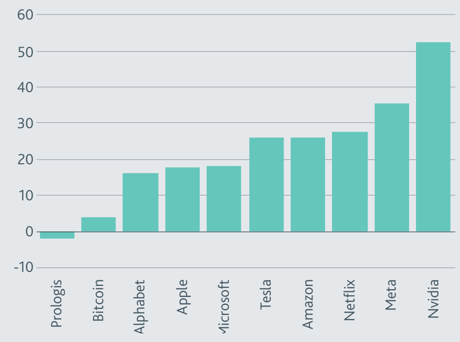
The pricing of UK risk-free assets is once again under pressure as the Bank of

3.1 World stock markets, change in Q2 2023 (%)



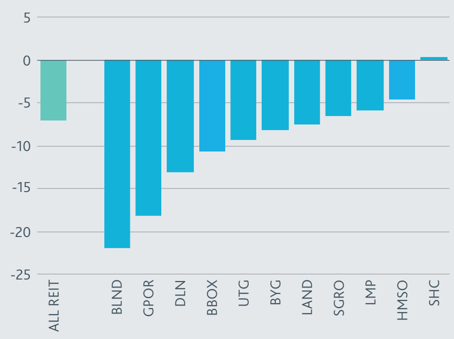
Source: Yahoo Finance, Jul 2023

3.2 Tech & other selected stocks, change in Q2 2023 (%)



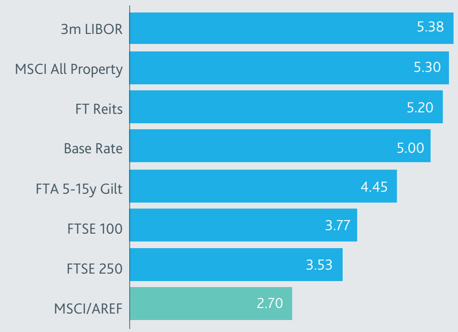
Source: Yahoo Finance, Jul 2023

3.3 UK Reit price movement in Q2 2023 (%)



Source: Yahoo Finance, Jul 2023

3.4 UK asset yields Q2 2023 (%)



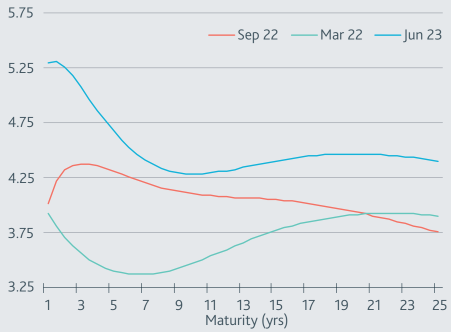
Source: Yahoo Finance & MSCI, Jul 2023

England struggles to bring inflation back towards its target level of 2.0%. The yield on the 5-15 year gilt index has softened by 94 bps since the end of the first quarter and now stands at 4.45%. Consequently, the total return performance on the FTSE Actuaries 5-15 year gilt index in Q2 was -6.0% (see Chart 3.4).

The money markets continue to believe that the short-term trajectory for inflation and interest rates is downward as they did three months ago, albeit from a much higher starting point. This inverted yield curve, in which long term bonds pay lower rates of interest than short-term, is often seen as a harbinger of recession. It does not itself cause a recession, rather, it is an implicit forecast that rates will have to come down sharply to support a weakening economy (see Chart 3.5).

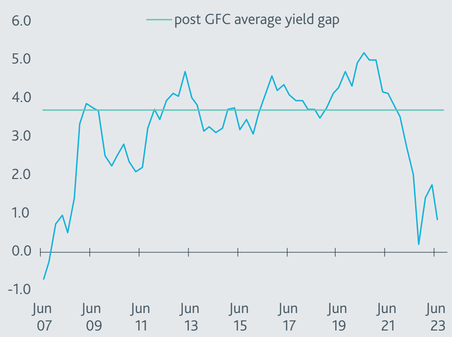
As risk-free rates rose sharply in Q2, the property initial / gilt yield gap decreased by 87 bps to 0.85%. By the standards of the last 16 years, property continues to look as if it is priced above fair value. The last time the asset class was valued at this level was on the eve of the GFC when a banking crisis triggered a decline in All Property capital values of 40% (see Chart 3.6). It is now quite possible that the latest sharp upwards movement in risk-free rates may trigger a further correction in the pricing of commercial real estate.

3.5 Gilt yield curve (%)



Source: Bank of England, Jul 2023

3.6 Property IY – Gilt yield gap (%)



Source: MSCI & Bank of England, Jul 2023

6. Commercial property market performance

In Q2 2023, All Property total returns, as recorded by the MSCI Monthly Index, increased to 1.0% from 0.2% in Q1. Capital values fell by just -0.4% in Q1 compared to -1.2% three months earlier. Property equivalent yields softened by 7 bps and contributed a -1.1% fall in valuations. All Property rental value growth increased very slightly to 1.0% in Q2 from 0.8% in Q1. Q2 income returns amounted to 1.4% (see Charts 4.1 & 4.4).

Over the course of the second quarter, office rental value growth increased to 1.0% from 0.3% in Q1, while quarterly industrial rental value growth remained at 1.8%. Retail rental value growth was 0.2% for the second consecutive quarter. 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 once again drifted higher (see Charts 4.2 & 4.5).

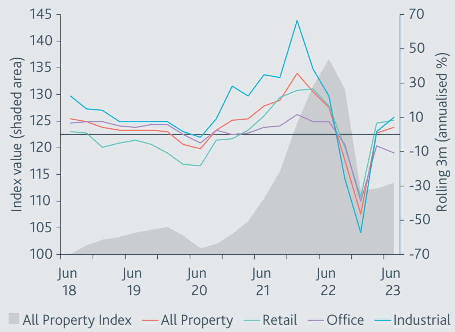
In the 12 months to the end of June 2023, All Property total returns decreased to -16.9% from -14.7% in the 12 months ending March as stronger numbers from Q2 2022 fell out of the calculation. Year-on-year capital growth decreased to -21.2% in June from -18.8% in March. Property equivalent yields have softened by 151 bps in the 12-months to June and contributed to a 26.4% drop in valuations. All Property rental values increased year-on-year by 3.6% and income return amounted to 5.1%.

Strong investment and occupier demand for industrials had 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 led to a re-appraisal of value in this sector of the market. Office valuations are coming under pressure now. Working from home remains more popular in the UK than the rest of Europe, businesses are trimming their occupancy footprint and there is an increasing awareness of the cost of retro-fitting secondary offices to meet the latest ESG standards (see Charts 4.3 & 4.6).

Tables 5.1 – 5.5 contain further performance data for UK commercial real estate in Q2 2023.

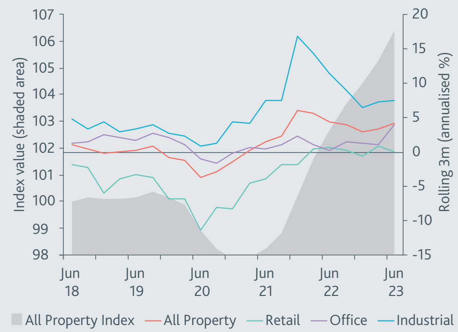
In Table 5.6, we have adopted the factor approach to real estate by segmenting the market firstly by use and secondly by a key characteristic i.e., yield, rent or lease length. The numbers presented are the 3-month total return relative to the MSCI All Property average for Q1 2023. A heat map has been used as a visual aid to pick out the under-performing segments in red and out-performing segments in green.

4.1 Total returns (%) by sector



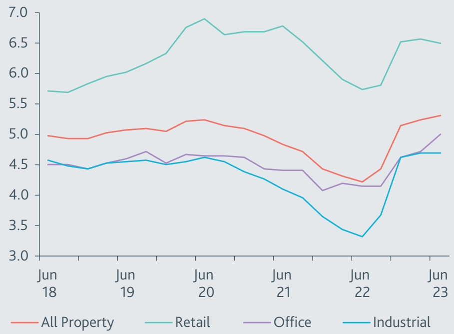
Source: MSCI, Jul 2023

4.2 MRV growth (%) by sector



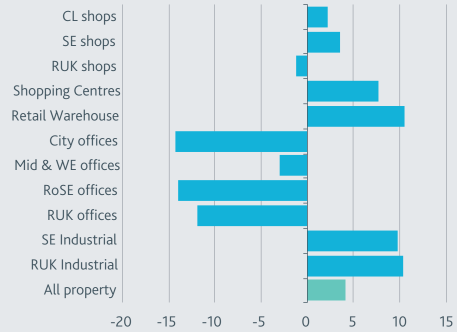
Source: MSCI, Jul 2023

4.3 Initial yield (%) by sector



Source: MSCI, Jul 2023

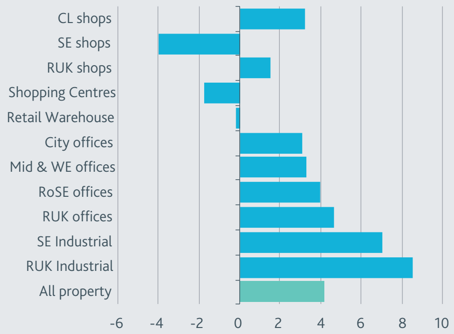
4.4 Total returns (%) by segment – Q2 2023 annualised



Source: MSCI, Jul 2023

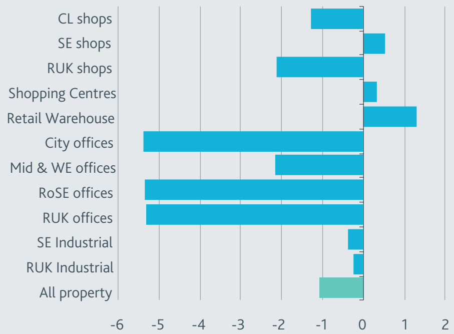
The first quarter of this year witnessed a re-emergence of industrial outperformance. Shopping centre and retail warehouse segments are continuing to outperform. High yielding, short lease offices are now coming under pressure together with Rest of UK offices.

4.5 MRV growth by segment – Q2 2023 annualised



Source: MSCI, Jul 2023

4.6 Yield impact (%) – Q2 2023



Source: MSCI, Jul 2023

5.1 Total returns (%)

	Jun	3m	6m	12m
All Property	0.0	1.0	1.2	-16.9
Retail	0.5	2.0	3.5	-9.5
Office	-1.8	-2.8	-4.6	-17.0
Industrial	0.7	2.4	2.8	-23.2
Annualised				
All Property	0.0	4.1	2.5	-16.9
Retail	6.1	8.1	7.1	-9.5
Office	-19.6	-10.8	-9.0	-17.0
Industrial	8.2	10.0	5.7	-23.2

Source: MSCI, Jul 2023

5.2 Capital growth (%)

	Jun	3m	6m	12m
All Property	-0.5	-0.4	-1.6	-21.2
Retail	-0.1	0.3	0.0	-15.2
Office	-2.2	-4.1	-7.1	-21.1
Industrial	0.3	1.2	0.3	-26.5
Annualised				
All Property	-5.4	-1.5	-3.1	-21.2
Retail	-0.8	1.0	0.1	-15.2
Office	-23.8	-15.4	-13.7	-21.1
Industrial	3.1	4.8	0.7	-26.5

Source: MSCI, Jul 2023

5.3 Income return (%)

	Jun	3m	6m	12m
All Property	0.5	1.4	2.8	5.3
Retail	0.6	1.7	3.4	6.6
Office	0.4	1.3	2.7	5.1
Industrial	0.4	1.2	2.5	4.4
Annualised				
All Property	5.7	5.7	5.7	5.3
Retail	6.9	7.0	7.0	6.6
Office	5.4	5.4	5.4	5.1
Industrial	4.9	4.9	5.0	4.4

Source: MSCI, Jul 2023

5.4 ERV growth (%)

	Jun	3m	6m	12m
All Property	0.3	1.0	1.9	3.6
Retail	0.2	0.0	0.2	0.1
Office	0.3	1.0	1.2	1.9
Industrial	0.6	1.8	3.7	7.6
Annualised				
All Property	3.7	4.2	3.8	3.6
Retail	2.0	0.0	0.4	0.1
Office	3.8	3.9	2.5	1.9
Industrial	7.3	7.6	7.5	7.6

Source: MSCI, Jul 2023

5.5 Net initial yield (%)

	Jun	3m	6m	12m
All Property	5.3	5.2	5.1	4.2
Retail	6.5	6.6	6.5	5.7
Office	5.0	4.7	4.6	4.1
Industrial	4.7	4.7	4.6	3.3

Source: MSCI, Jul 2023

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	-0.9	-0.8	-0.6	-0.9	-1.0	-0.1
Shopping Centres	0.6	-0.1	0.8	0.6	0.6	-1.3
Retail Warehouses	1.3	2.5	2.3	1.3	1.3	1.9
Central London offices	0.1	-3.1	0.2	0.1	-0.7	-2.9
RoSe offices	-0.5	-5.2	-3.0	-0.5	-1.2	-4.6
RUK offices	-2.4	-3.4	N/A	-2.4	-2.4	-3.3
Industrials	-0.7	1.6	0.5	-0.7	0.2	0.6

Source: MSCI, Apr & Jul 2023

7. Investment in property

All Property investment volumes, represented by the current value of investment transactions adjusted for capital growth, increased by 61% in Q1 2023 compared to Q4 2022 when rising risk-free rates values drove All Property capital values down 15.6%. Despite this increase, Q1 transaction volumes remained 20% below their long run average. Preliminary estimates suggest that investment volumes in Q2 2023 fell by -43% and were 54% below the long run average. As usual the latest numbers are likely to be revised in the coming months (see Chart 6.1).

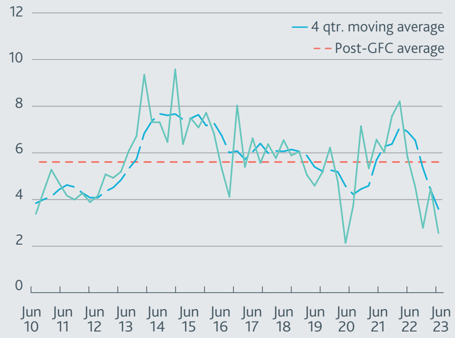
Retail made up 33% (by number) of investment transactions in Q2 2023; offices represented a further 17% and industrials made up the remaining 50%. Retail and office investment volumes so far recorded were lower in Q2 2023 than in Q1, but industrial transaction numbers were sharply higher (see Chart 6.2).

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). Reduced office investment transactions levels are not London specific but characteristic throughout Europe and the US. As noted above, investors have two principal concerns. Firstly, growing vacancy levels due to remote working patterns; and secondly, future refurbishment costs to meet ESG criteria.

Overall transaction numbers in Central London office markets increased in Q2 2023 compared to Q1 and Q4 2022 but remain below the levels achieved in Q3 last year before a period of turbulence in financial markets. In Q2, transactions in the Mid-Town and West End markets represented 67% of transactions, while fringe markets on the edges of the City, Docklands and Southbank comprised 26% and the City only numbered 8% (see Chart 6.4).

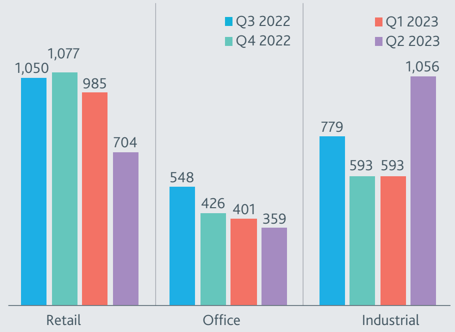
As interest rates rose, there was an expectation that liquidity in the form of debt would be sucked out of the real estate market. From the borrower's perspective, floating rate loans would quickly become unaffordable and renewal of fixed rate loans agreed five years ago would be on far less favourable terms. From the lender's perspective, a market where valuations remain under pressure represents an obvious risk requiring loan to value ratios to be trimmed and rent – interest cover to rise. However, the data available so far on bank lending to real estate does not yet support this pessimistic view. Bank lending fell during the pandemic years but has since steadily increased (see Chart 6.5).

6.1 All property investment volumes (£bn)



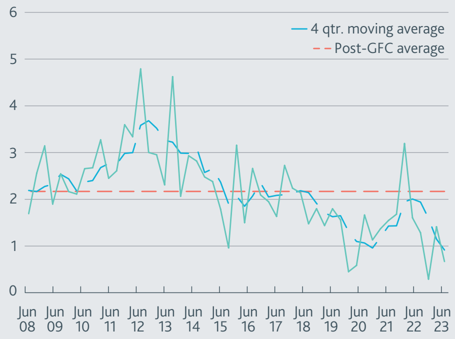
Source: CoStar, MSCI & APR, Jul 2023

6.2 Investment transaction nos. by year



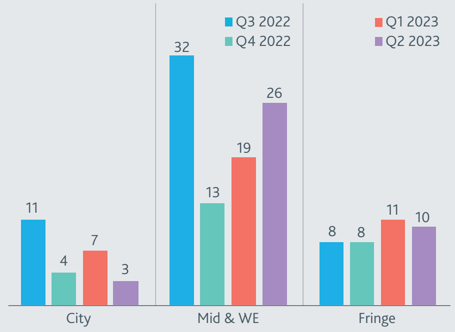
Source: CoStar, MSCI & APR, Jul 2023

6.3 Central London office investment volumes (£bn)



Source: CoStar, MSCI & APR, Jul 2023

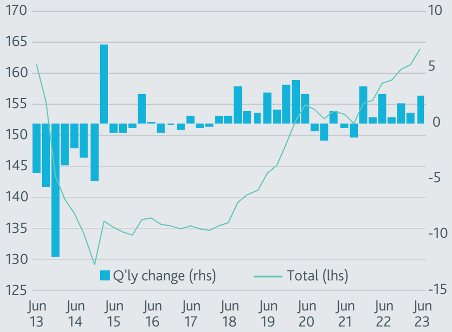
6.4 Central London office Investment transaction nos. by year



Source: CoStar, MSCI & APR, Jul 2023

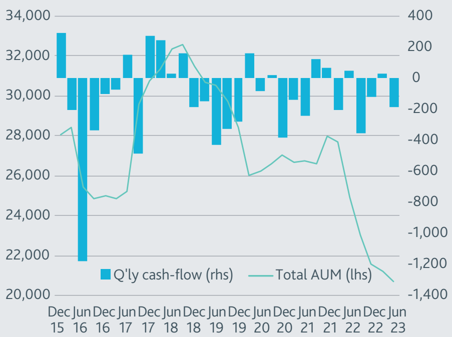
In the last six years, property funds have regularly faced demands for redemptions from retail investors. Data to the end of June 2023 indicates that the sector has suffered from quarter-on-quarter net redemption demands since mid-2018. Retail investment vehicles have been overwhelmed by calls for redemptions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

6.5 Bank lending to property (£bn)



Source: Bank of England, Jul 2023

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



Source: Investment Association, Jul 2023

8. Outlook & House View

Increasing risk-free rates and the weak economic outlook continue to be reflected in May's Investment Property Forum (IPF) consensus forecasts. However, forecasters are more optimistic than they were in February and further back in November. Total return forecasts for 2023 have been increased to 2.4% from 0.6% in February 2022. The outlook for 2024 has strengthened to 7.1% from 6.6% (see Chart 7.1).

The IPF consensus view remains that values will continue to drift down in 2023 although the pace of decline is expected to slow. This year will, however, mark the bottom of the cycle with year-on-year total return forecasts increasing to more than 7% in 2024 and the years thereafter. The annualised average over the five years to 2027 is 6.4% (see Chart 7.2).

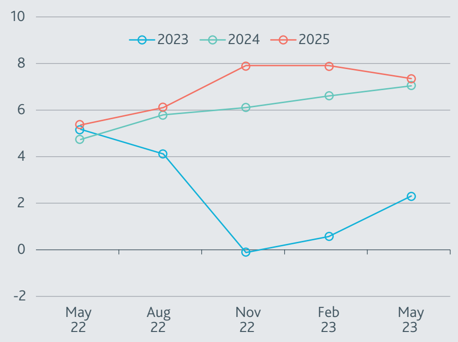
Respondents to the IPF Consensus forecast survey expect to see positive returns in 2023 for all sectors except City offices and Rest of UK offices. Shopping Centres and Retail Warehouses are expected to perform better than Industrials. The outlook has recently weakened for Rest of UK offices, which are potentially more exposed to weak domestic economic growth, and sentiment remains weak for City of London offices (see Chart 7.3).

Although interest rates continued to rise and economic growth remained limited, it is likely that May's Consensus forecasts reflected the fall in risk-free rates in Q1 as markets reacted to a more orthodox approach to management of the UK's economy. Consequently, the range of forecasts has increased on the upside and seen no change on the downside. The maximum total return forecast for 2023 has now increased to +6.2% whist the minimum forecast remains -8.3%. The forecast range for 2024 has decreased to 11.6%, with a maximum of 11.8% and a minimum of 0.2% (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. The outcome for Q1 and Q2 surprised on the upside. However, as inflation remains stubbornly high and the path of interest rates continues upwards, we expect a return to weaker market conditions in the second half of 2023. Our forecast All Property total return for 2023 remains at -6% but this reflects a stronger H1 than expected together with weakening conditions in H2 (see Chart 7.5).

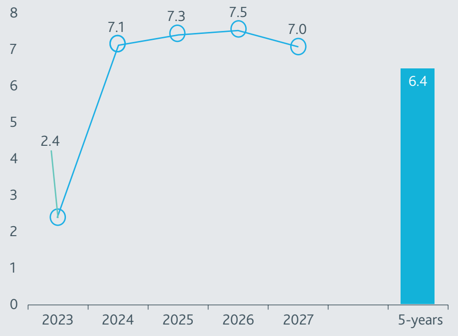
It now seems likely that UK inflation and interest rates will stay higher for longer. Consequently, expectations of a sharp recovery in All Property returns in 2024, have been trimmed back from 15% to 7% and any stronger recovery delayed until

7.1 IPF forecast evolution (%)



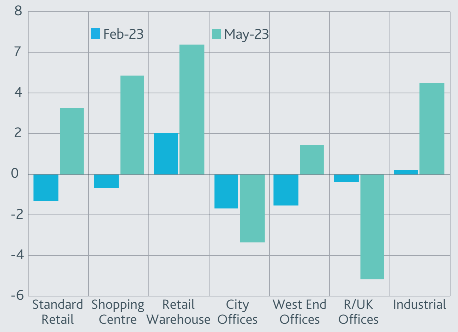
Source: IPF, May 2023

7.2 IPF All Property forecasts y-by-y (Total Returns, %, Median)



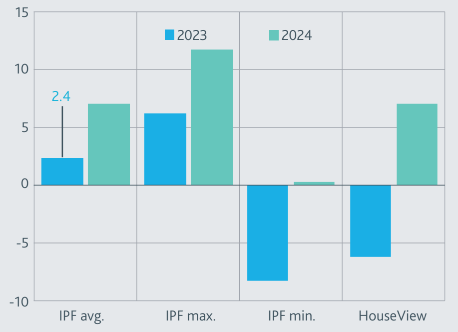
Source: IPF, May 2023

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



Source: IPF, May 2023

7.4 UK commercial total return forecast range (%)

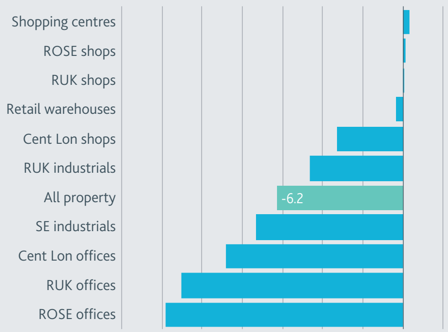


Source: IPF, May 2023

2025 or 2026. The net effect is that the annualised average forecast for the three years to the end of December 2025 could be just 2%, representing a 3 percentage point downgrade from Q1's three year forecast.

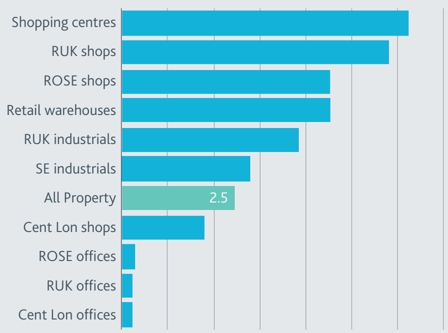
Strong market rental value growth remains characteristic of the industrial and logistics sector. But despite the yield de-rate in Q4 last year, the sector remains keenly valued and at risk from the recent increase in risk free rates. Investors are increasingly aware of firstly, the threat to vacancy rates posed by working from home and, secondly, the cost of retro-fitting offices at risk of being stranded by tougher rules surrounding ESG. However, 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 (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: APR & Cluttons, July 2023

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



Source: APR & Cluttons, July 2023

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