CLUTTONS
INVESTMENT MANAGEMENT

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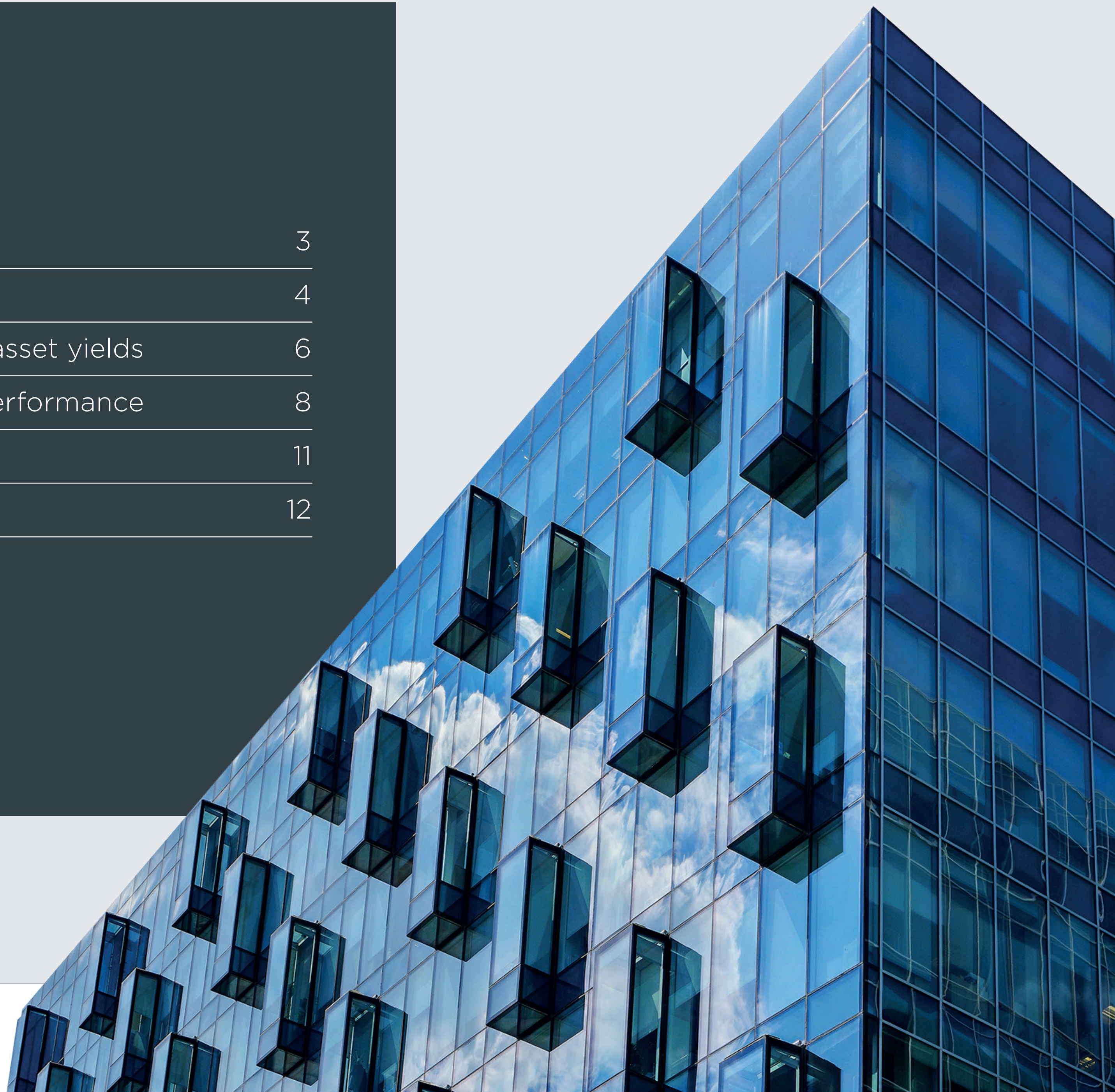
Commercial property examiner

Q3 | 2023

Contents



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1. Key take aways

After revisions to GDP, the UK economy is now estimated to be 2.1% above its pre-pandemic level but remains 3.4% below its potential level. High interest rates will continue to limit any growth in consumer expenditure and will inhibit business investment. Recession remains a possibility, and if not, a further period of below trend economic activity is likely.

An element of recessionary fear is now starting to creep back into markets. After growing by 17.3% in H1, the MSCI World Index, with large and mid-cap representation across 23 developed markets, lost 2.7% in Q3 and all bar one of the world's major equity markets also posted losses in Q3. The pricing of UK risk-free assets is once again under pressure and the yield premium for holding risky property assets in the UK has been squeezed down.

MSCI's All Property total returns decreased to -0.2% in Q3 from 1.0% in Q2 as capital values fell by -0.7%. In the 12 months to the end of September. All Property total returns edged up to -13.6% from -16.9% in the year to June as weaker numbers from Q3 2022 fell out of the calculation.

After a strong start to 2023, expectations of a return to weaker market conditions in the second half look to be justified, as inflation remains stubbornly high, and the path of interest rates continues upwards. Consequently, our forecast All Property total return for 2023 remains at -6.0%. The prospects of an immediate improvement in All Property returns in 2024 continues to be limited. It is likely that any stronger recovery will be delayed until 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 2.0%.

2. The UK economy

The highest bout of inflation since the early 1980s has been caused by the dislocation to supply chains resulting from Covid pandemic lock downs and subsequently by an escalation in energy prices following Russia's invasion of Ukraine. The monetary response in the UK has seen the base rate rising from near zero to 5.25% in under two years.

Inflation has eroded the value of wages and savings and high interest rates have increased mortgage costs and reduced business investment. Escalating building costs have caused the cancellation of the northern leg of HS2 north of Birmingham, a critical piece of infrastructure designed to promote the "levelling up" programme and support broader economic development.

Since our last report, the UK economy has benefitted from trend levels of growth in June, shrinking output in July and another lacklustre recovery in August (see Chart 1.1). After revisions to GDP from updated survey data and seasonal adjustment reviews, the UK economy is now estimated to be 2.1% above its pre-pandemic level but remains 3.4% below its potential level (see Chart 1.2).

The UK's dominant service sector grew by a meagre 0.1% in the three months to August, while manufacturing was up 1.7% and construction increased by 0.9%.

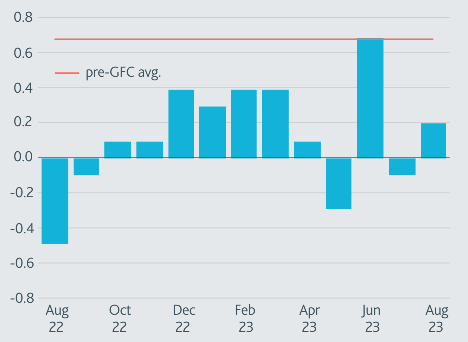
In September, Nationwide Building Society announced that all regions recorded annual house price falls in Q3. The rate of decrease in average house prices increased from -3.8% in July to -5.3% in September. Nevertheless, Q3's improvement in construction output came from increases in both new work, and repair and maintenance.

In the post-pandemic economy, service sector industries continue to fare better than manufacturing. The manufacture of petrol and other fuels has fallen 18.9% since the pandemic first started. However, the worst performing sector is the manufacture of electrical equipment. Information and communications technology (ICT), however, has grown 18.1% and remains the strongest performing sector.

Employees in the health sector, rail network and some parts of the bus and air transport network all undertook industrial action for parts of August. However, despite the industrial action, not all these sectors saw a decline in August (see Chart 1.3).

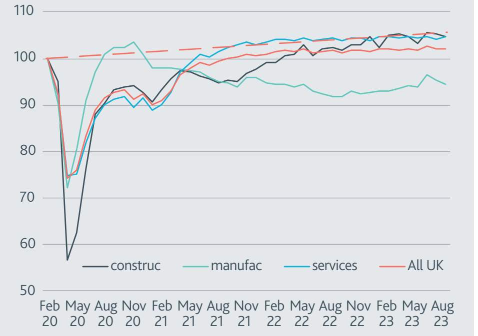
The MPC's latest forecasts published in August suggest that GDP growth is expected to remain below pre-pandemic rates in the medium term.

1.1 Rolling 3m UK economic growth (%)



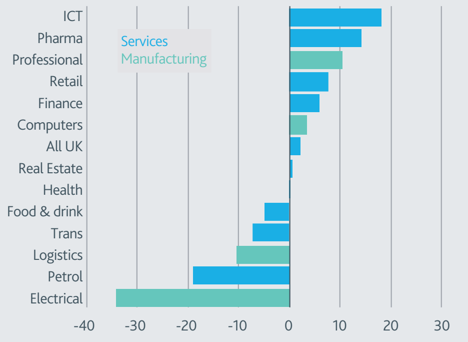
Source: ONS, Oct 2023

1.2 UK economic growth indices (Feb 2020=100)



Source: ONS, Oct 2023

1.3 Post pandemic economic growth by sector (%)



Source: ONS, Oct 2023

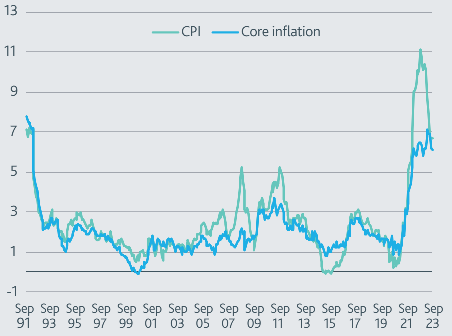
Year on year CPI inflation remains high by recent historical standards. Having fallen through the 10% barrier in April, it has declined by just 10 bps to 6.7% in September from 6.8% in July. Core inflation excluding energy, food, alcoholic drinks, and tobacco remains stubbornly high as well. The numbers remain extremely elevated compared to the headline 2.0% target rate and it is uncertain whether the Government will meet its target of halving inflation by the end of the year (see Chart 1.4).

High growth in the cost of energy and food continues to cause hardship, and, out of necessity, a reduction in household spending elsewhere. An ONS survey suggests that around two-thirds of adults in Great Britain are spending less on non-essentials because of the rising cost of living. The survey also revealed that 52% of adults said their overall cost of living had increased in September compared with a month earlier.

Petrol and transport-related costs made the largest upward contribution to the rate of inflation in 2021 and 2022 but are now falling year on year. Food price inflation has fallen from a high of 19.2% since March this year but remains the single highest contributor to the cost of living crisis (see Chart 1.5).

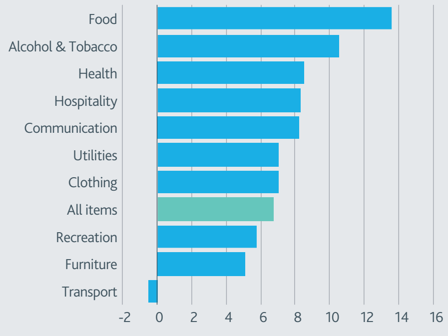
August's MPC forecast suggests that CPI inflation is expected to decrease to around 5.0% by the end of the year, owing to lower energy prices and reduced food and core goods price inflation.

1.4 CPI inflation (%pa)



Source: ONS, Oct 2023

1.5 Q3 Inflation by sector (%pa)



Source: ONS, Oct 2023

3. Stock markets, interest rates & asset yields

Some recessionary fear is now starting to creep back into markets. After growing by 17.3% in H1, the MSCI World Index, with large and mid-cap representation across 23 developed markets, lost 2.7% in Q3.

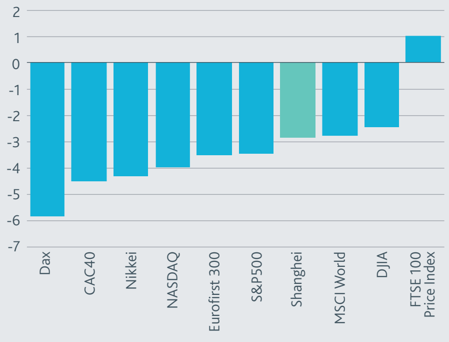
All bar one of the world's major equity markets also posted losses in Q3. The FTSE100 was the solitary exception, benefitting in the short term from its low exposure to ICT. Recent disappointment in the City over Arm Holding's decision to list on the NASDAQ reflects the problems in attracting tech stocks to the UK' s major market (see Chart 2.1).

The NASDAQ, which contains the listing of many of the major tech stocks fell 4.0% in Q3 as its constituents enjoyed mixed fortunes. Shares in Netflix, Apple and Microsoft fell and Nvidia, a global leader in artificial intelligence hardware and software, which had posted 50%-plus price growth earlier in the year, rose by a relatively meagre 2.8%. The share price of Prologis, the largest logistic and warehouse real estate company in the world, fell -8.5% (see Chart 2.2).

UK REIT share prices again under-performed the wider all share market index in Q3. The All-REIT index just about maintained par over the quarter. Poor prospects for the London office market continued to weigh on the share price of Derwent London but British Land and Land Securities enjoyed a modest improvement in prices. The industrial and logistics specialists fared better this quarter. The share price of Segro, the logistics and warehousing specialist, rose slightly by 0.4% but Big Box was up 11.8% and London Metric's price rose 4.0% (see Chart 2.3).

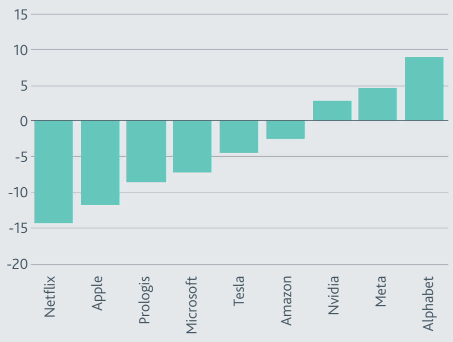
The era of cheap money has ended, with a rapid escalation of interest rates as Central Banks struggle to control soaring inflation. Following a further 25 bp increase in the base rate in August, the Bank of England has paused it's rate rising in September. Even so, it oversaw 14 consecutive rises in its base rate to 5.25%, from 0.1% in November 2021. Interest rates are expected to peak at around 5.5% before falling back, although any sudden rise in oil prices due to the current situation in the Middle East would change this picture.

2.1 World stock markets in Q3 2023 (%)



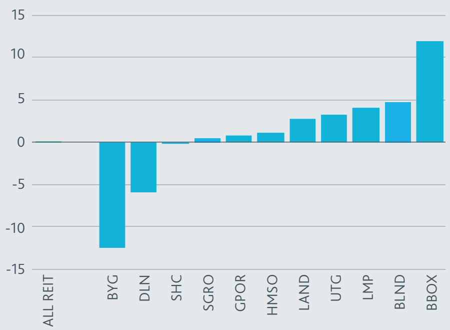
Source: Yahoo Finance, Oct 2023

2.2 Tech & other selected stocks Q3 2023 (%)



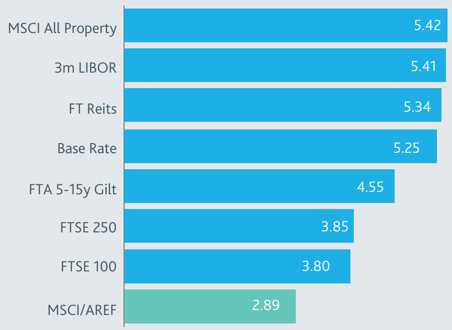
Source: Yahoo Finance, Oct 2023

2.3 UK Reit price movement in Q3 2023 (%)



Source: Yahoo Finance, Oct 2023

2.4 UK asset yields Q3 2023 (%)



Source: Yahoo Finance & MSCI, Oct 2023

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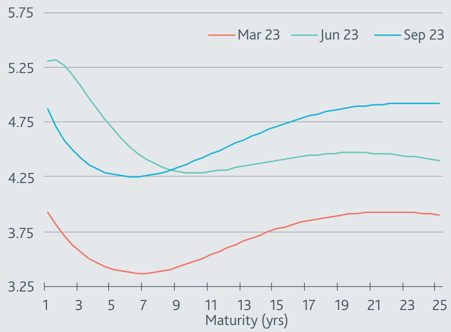
The pricing of UK risk-free assets is once again under pressure as the Bank of England struggles to bring inflation back towards its target level of 2.0%. The yield on the 5-15 year gilt index softened by a further 10 bps in the third quarter and now stands at 4.55%. The total return performance on the FTSE Actuaries 5-15 year gilt index in Q3 was 0.33%, a big improvement on the -6.0% posted in Q2 when yields rose 94 bps (see Chart 2.4).

The money markets continue to believe that the short-term trajectory for inflation and interest rates is downward, as rates will have to come down to support a weakening economy. However, the longer term outlook reflects the mantra of "higher for longer". (see Chart 2.5).

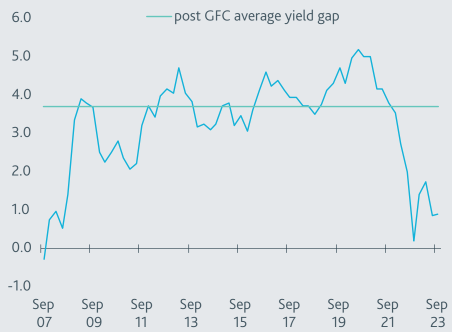
As property yields rose by slightly more than risk-free rates in Q3, the property initial/gilt yield gap increased, but by less than 2 bps to 0.87%. By the standards of the last 16 years, property continues to look as if it is priced above fair value. The last time the asset class was valued at this level was on the eve of the GFC when a banking crisis triggered a decline in All Property capital values of 40% (see Chart 2.6). All Property capital values have fallen 3.1% this year and 17.1% in total since June 2022.

2.5 Gilt yield curve (%)



Source: Bank of England, Oct 2023

2.6 Property IY – Gilt yield gap (%)



Source: MSCI & Bank of England, Oct 2023

4. Commercial property market performance

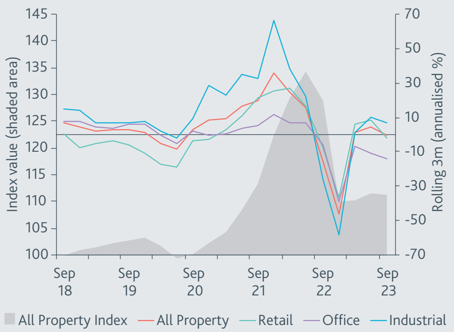
In Q3, All Property total returns, as recorded by the MSCI Monthly Index, decreased to -0.2% from 1.0% in Q2. Capital values fell by -0.7% compared to -0.4% three months earlier. Property equivalent yields softened by a further 7 bps and contributed a -1.0% fall in valuations. All Property rental value growth decreased to 0.8% in Q3 from 1.0% in Q2. Q2 income returns amounted to 1.4% (see Charts 3.1 & 3.4).

Over the course of the third quarter, office rental value growth decreased to near zero from 1.0% in Q2, while quarterly industrial rental value growth decreased to 1.5% from 1.8% a quarter earlier. Retail rental value growth was 0.3%. Market rental values for retail warehouses and shops in Central London, the South East and Rest of the UK all rose but shopping centre rents continued to fall back (see Charts 3.2 & 3.5).

In the 12 months to the end of September 2023, All Property total returns were -13.6%, marking an improvement from -16.9% in the 12 months ending June. Year-on-year capital growth also increased to -18.2% in September from -21.2% in June. Property equivalent yields have softened by 135 bps in the 12-months to September and contributed to a 22.6% drop in valuations. All Property rental values increased year-on-year by 3.4% and income return amounted to 5.6%.

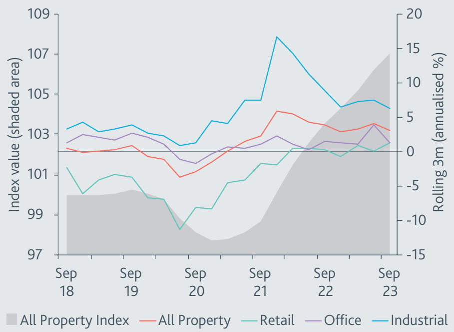
Yields continue to soften across all three sectors but office valuations are coming under increasing pressure. Working from home remains more popular in the UK than the rest of Europe, businesses are trimming their occupancy footprint and there is an increasing awareness of the cost of retro-fitting secondary offices to meet the latest ESG standards (see Charts 3.3 & 3.6).

3.1 Total returns (%) by sector



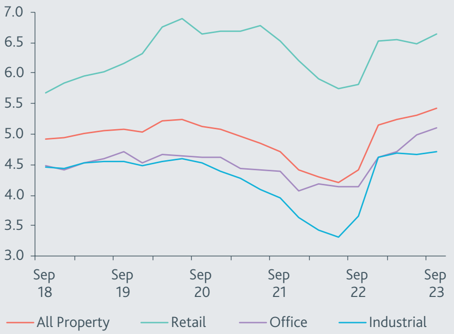
Source: MSCI, Oct 2023

3.2 MRV growth (%) by sector



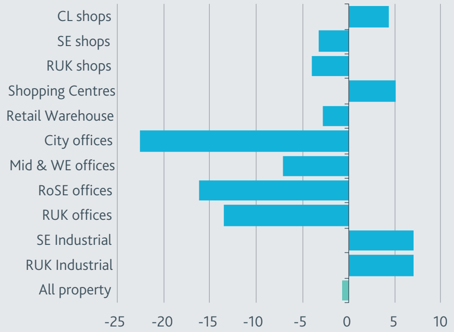
Source: MSCI, Oct 2023

3.3 Initial yield (%) by sector



Source: MSCI, Oct 2023

3.4 Total returns (%) by segment – Q3 2023 annualised



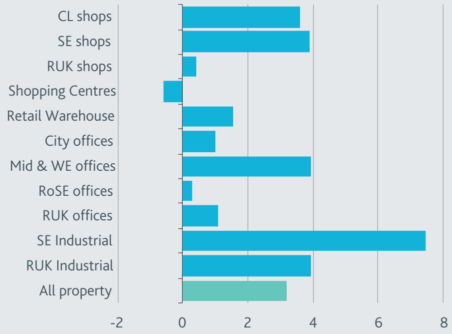
Source: MSCI, Oct 2023

Tables 4.1 – 4.5 contain further performance data for UK commercial real estate in Q3 2023.

In Table 4.6, 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 three-month total returns relative to the MSCI All Property average for Q2 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.

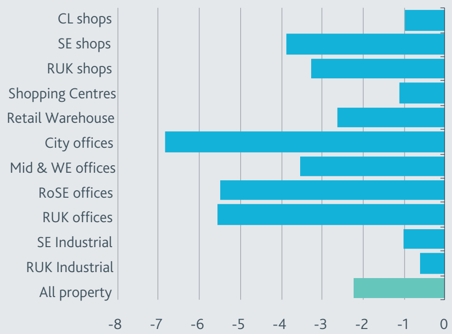
Industrials have returned to outperformance. Shopping centre and retail warehouse segments are also continuing to outperform. Offices representing all factors and segments are under pressure.

3.5 MRV growth by segment – Q3 2023 annualised



Source: MSCI, Oct 2023

3.6 Yield impact (%) – Q3 2023



Source: MSCI, Oct 2023

4.1 Total returns (%)

	Sep	3m	6m	12m
All Property	-0.2	-0.2	0.8	-13.6
Retail	-0.8	-0.5	1.4	-8.2
Office	-1.3	-3.7	-6.4	-18.9
Industrial	0.6	1.7	4.2	-15.7
Annualised				
All Property	-2.8	-0.7	1.7	-13.6
Retail	-9.6	-2.1	2.8	-8.2
Office	-15.0	-14.1	-12.5	-18.9
Industrial	7.8	7.0	8.5	-15.7

Source: MSCI, Jul & Oct 2023

4.2 Capital growth (%)

	Sep	3m	6m	12m
All Property	-0.7	-1.6	-1.9	-18.2
Retail	-1.4	-2.2	-2.0	-14.2
Office	-1.8	-5.0	-8.9	-23.0
Industrial	0.2	0.5	1.7	-19.6
Annualised				
All Property	-8.0	-6.1	-3.9	-18.2
Retail	-15.5	-8.6	-3.9	-14.2
Office	-19.4	-18.7	-17.1	-23.0
Industrial	2.8	2.0	3.4	-19.6

Source: MSCI, Jul & Oct 2023

4.3 Income return (%)

	Sep	3m	6m	12m
All Property	0.5	1.4	2.8	5.6
Retail	0.6	1.7	3.4	6.9
Office	0.4	1.4	2.7	5.3
Industrial	0.4	1.2	2.4	4.8
Annualised				
All Property	5.7	5.7	5.7	5.6
Retail	7.0	7.0	7.0	6.9
Office	5.4	5.5	5.5	5.3
Industrial	5.0	4.9	4.9	4.8

Source: MSCI, Jul & Oct 2023

4.4 ERV growth (%)

	Sep	3m	6m	12m
All Property	0.3	0.8	1.8	3.4
Retail	0.1	0.3	0.3	0.3
Office	0.0	0.3	1.3	1.9
Industrial	0.6	1.5	3.4	6.9
Annualised				
All Property	3.6	3.2	3.7	3.4
Retail	1.3	1.3	0.6	0.3
Office	0.4	1.3	2.6	1.9
Industrial	7.1	6.2	6.9	6.9

Source: MSCI, Jul & Oct 2023

4.5 Net initial yield (%)

	Sep	3m	6m	12m
All Property	5.4	5.3	5.2	4.4
Retail	6.6	6.5	6.6	5.8
Office	5.1	5.0	4.7	4.1
Industrial	4.7	4.7	4.7	3.7

Source: MSCI, Jul & Oct 2023

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

	Low yield	High yield	High rent	Low rent	Long lease	Short lease
Shops	-0.8	0.5	-1.2	-0.8	-0.3	-0.4
Shopping Centres	-1.2	-0.4	0.4	-1.2	1.0	-0.5
Retail Warehouses	0.9	2.1	1.8	0.9	1.6	1.0
Central London offices	-1.3	-4.9	-0.7	-1.3	-2.9	-3.7
RoSe offices	-2.4	-8.3	-2.4	-2.4	-4.8	-4.8
RUK offices	-4.3	-4.0	-1.6	-4.3	-4.2	-3.4
Industrials	1.4	2.4	1.7	1.4	1.3	2.2

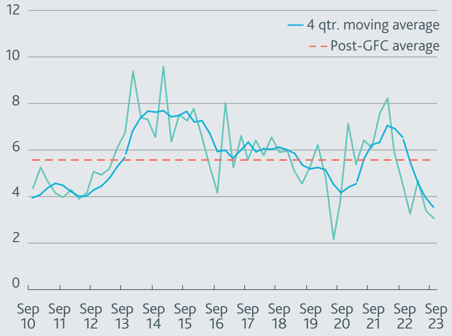
Source: MSCI, Jul & Oct 2023

5. Investment in property

Weak market conditions have reduced liquidity in the market. All Property investment volumes, represented by the current value of investment transactions adjusted for capital growth, decreased by 28% in Q2 compared to Q1. Q2 transaction volumes were 40% below their long run average. Preliminary estimates suggest that investment volumes in Q3 fell by a further -9% and were 45% below the long run average. As usual the latest numbers are likely to be revised in the coming months (see Chart 5.1).

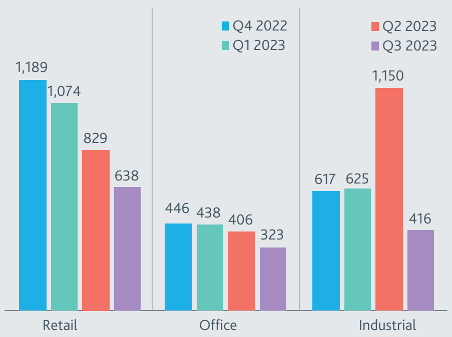
When looking at retail, offices and industrial sectors, retail made up 46% (by number) of investment transactions in Q3 2023; offices represented a further 23% and industrials made up the remaining 30%. Retail, office, and industrial investment volumes so far recorded in Q3 are all lower than in Q2 (see Chart 5.2).

5.1 All property investment volumes (£bn)



Source: CoStar, MSCI & APR, Oct 2023

5.2 UK investment transaction nos. by quarter



Source: CoStar, MSCI & APR, Oct 2023

6. Outlook & house view

Increasing risk-free rates and the weak economic outlook continue to be reflected in August's Investment Property Forum (IPF) consensus forecasts as contributors are once again turning more pessimistic. Total return forecasts for 2023 have been decreased to 1.1% from 2.4% in May. The outlook for 2024 has weakened to 6.4% from 7.1% (see Chart 6.1).

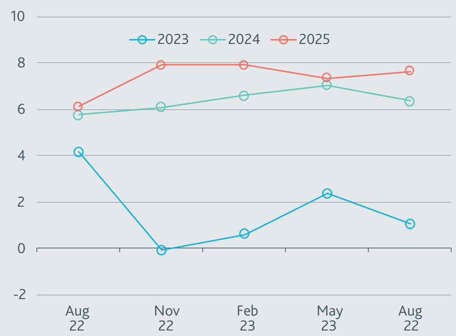
The IPF consensus view remains that values will continue to drift down in 2023 although the pace of decline is expected to slow. This year will, however, mark the bottom of the cycle with year-on-year total return forecasts increasing to more than 6.0% in 2024 and 7.0% or more in the years thereafter. The annualised average over the five years to 2027 is 5.4% (see Chart 6.2).

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 6.3).

It is likely that August's Consensus forecasts reflected the further rise in risk-free rates in the summer as markets reacted to the prospect of interest rates remaining higher for longer. Consequently, as the year-end approaches the range of forecasts has consolidated around a more pessimistic outlook. The maximum total return forecast for 2023 has now decreased to +4.5% whist the minimum forecast has improved to -7.1%. The forecast range for 2024 has decreased to 7.6%, with a maximum of +8.9% and a minimum of +1.3% (see Chart 6.4).

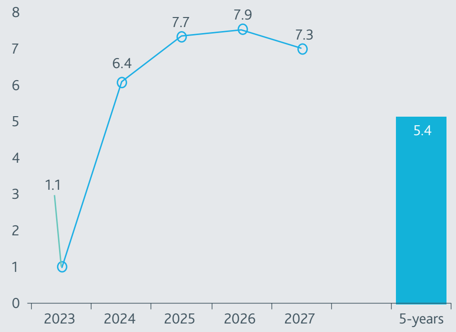
The central forecast from the House View model is revised on a quarterly basis to reflect the changing macro-economic outlook and the current performance of commercial real estate. The outcome for the first half of 2023 surprised on the upside. However, our expectations of a return to weaker market conditions in the second half of 2023 looks to be justified, as inflation remains stubbornly high, and the path of interest rates continues upwards. Consequently, our forecast All Property total return for 2023 remains at -6.0% (see Chart 6.5).

6.1 IPF Consensus forecast evolution (%)



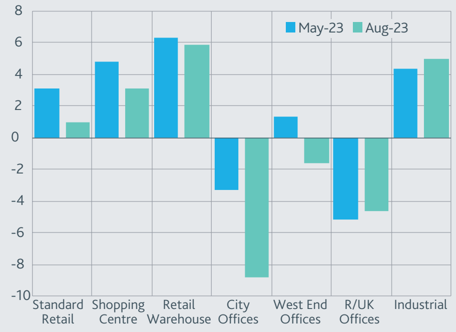
Source: IPF, Aug 2023

6.2 IPF All Property consensus forecasts y-by-y (%)



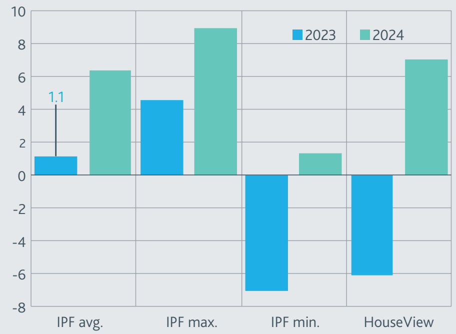
Source: IPF, Aug 2023

6.3 IPF 2023 total return forecasts by sector May 23 v Feb 23 (%)



Source: IPF, Aug 2023

6.4 UK commercial total return forecast range (%)

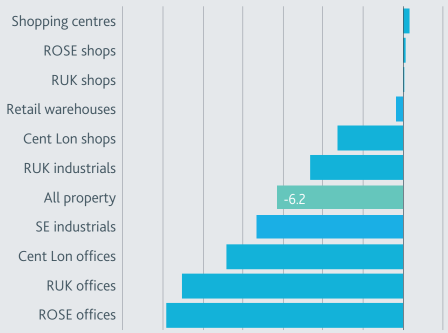


Source: APR & Cluttons, Oct 2023

It now seems likely that UK inflation and interest rates will stay higher for longer. Expectations of an immediate improvement in All Property returns in 2024 continue to be limited. It is likely that any stronger recovery will be delayed until 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 2.0%.

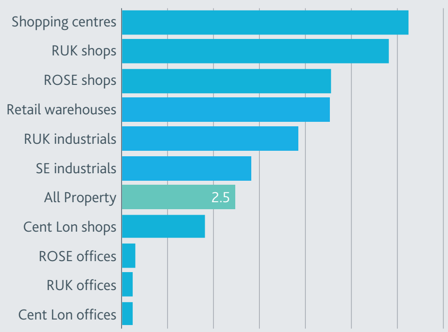
Strong market rental value growth remains characteristic of the industrial and logistics sector. But despite the yield de-rate in Q4 last year, the sector remains keenly valued and at risk from the increase in risk free rates. Investors in offices are increasingly aware of firstly, the threat to vacancy 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 8.0% income return, which provides some resilience in the face of a continued de-rate of the asset class (see Chart 6.6). 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.

6.5 Cluttons House View - 2023 relative total returns (%)



Source: APR & Cluttons, Oct 2023

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



Source: APR & Cluttons, Oct 2023

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