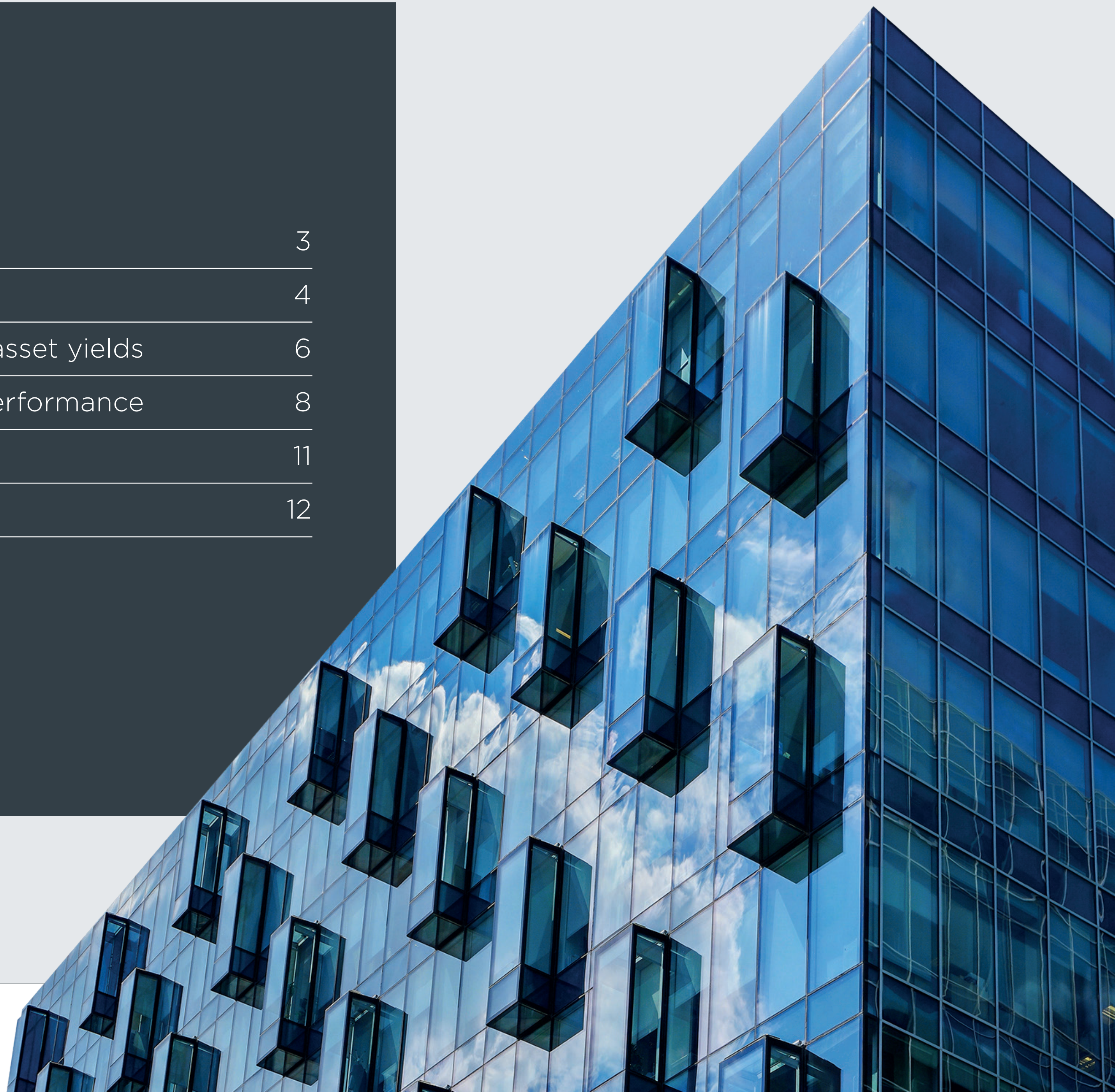
CLUTTONS
INVESTMENT MANAGEMENT

cluttonsim.com

Commercial property examiner

Q4 | 2023

Contents



CLUTTONS
INVESTMENT MANAGEMENT

1. Key take aways

Globally, moderating inflation and steady growth are leading to a soft landing amid rising anticipation of cuts. In the UK, GDP growth remains particularly weak but increased consumer expenditure over the holiday period may save the economy from a second consecutive quarter of negative growth. UK inflation has rapidly reduced to 4.0% year-on-year, but domestic wage rises may delay the point when inflation is once again below the MPC's target 2.0%. Consequently, some commentators are anticipating that interest rates could fall to 3.0% by the end of 2025.

2023 was a good year for equity markets. The MSCI World Index ended the year 17.6% higher and the NASDAQ rose 43.2% driven by investors support for the "Magnificent 7" tech stocks and hopes surrounding Artificial Intelligence. UK REITs enjoyed a strong end to the year suggesting investor confidence in the outlook for UK real estate in 2024 and beyond. The re-pricing of UK gilts delivered total returns of 9.2% in the fourth quarter.

MSCI's All Property total returns decreased to -1.2% in Q4 from -0.2% in Q3 as capital values fell by -2.6%. However, in the 12 months to the end of December, All Property total returns improved to -0.1% from -13.6% in the year to September as weaker numbers from Q4 2022 fell out of the calculation.

Monetary policy will only be loosened cautiously. As a result, any expectations of sharply higher All Property returns in 2024 are unlikely to be met. Nevertheless, All Property returns could reach 6% in 2024. Prospects for higher levels of performance strengthen in 2025 and 2026 and the annualised average forecast for the three years to the end of December 2026 rises to 8% or more.

2. The UK economy

For the last six quarters, this report has focused on the highest bout of inflation since the early 1980s 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 UK's monetary response saw the base rate rising from near zero to 5.25% in under two years. Inflation eroded the value of wages and savings and high interest rates have increased mortgage costs and reduced consumer expenditure and business investment.

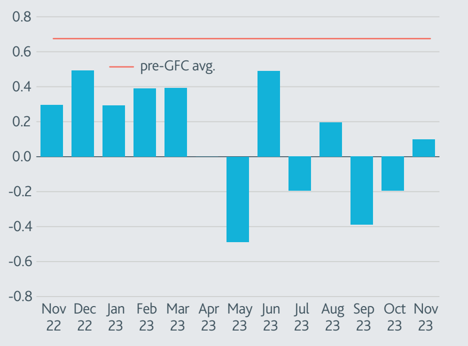
This quarter the narrative is changing. The headlines to the IMF's "World Economic Outlook" published In January indicate that the expectations for 2024 are moderating inflation, and steady growth leading to a soft landing for the world economy. In the UK, CPI inflation peaked at 11.1% in October 2022 and has been on a mostly downward trajectory for the last 13 months. Expectations are now that the Monetary Policy Committee (MPC) will gradually move to ease monetary policy by cutting its base rate.

Since our last report, it has been reported that the UK economy shrunk by -0.1% in Q3. So far, the final quarter of the year is showing little signs of a recovery. Growth in the first two months of the quarter has been flat with a further reduction of -0.29% in October balanced by growth of a similar amount in November (see Chart 1.1). Although the UK economy continues to be 2.1% above its pre-pandemic level, it is still 3.8% below its potential level (see Chart 1.2).

The UK's dominant service sector grew by 0.3% in the three months to November boosted by fewer days of industrial action in the health and education sectors. Over the same period, manufacturing was down -1.3% caused by a broad-based decline across most sectors. Construction decreased -0.1% with the largest downward contribution coming from private new housing. However, the latest figures from the Nationwide Building Society (NBS) shine a ray of light on the sector. In January, UK house prices rose 0.7% month on month and average prices are down just 0.2% compared to a year ago.

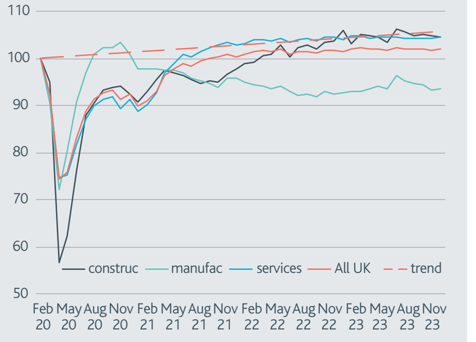
In the post-pandemic economy, service sector industries continue to fare better than manufacturing. The manufacture of petrol and other fuels has now fallen 23.1% since the pandemic first started. However, the worst performing sector continues to be the manufacture of electrical equipment. Information and communications technology (ICT) has grown 17.1% and remains the strongest performing sector (see Chart 1.3). Retail sector output may have grown 7.5%

1.1 Rolling 3m UK economic growth (%)



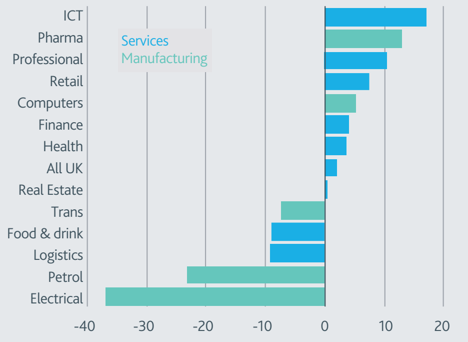
Source: ONS, Jan 2024

1.2 UK economic growth indices (Feb 2020=100)



Source: ONS, Jan 2024

1.3 Post pandemic economic growth by sector (%) Feb 2020-Nov 2023



Source: ONS, Jan 2024

since the onset of the pandemic, however, retail sales volumes have decreased by 5% over the same period (see Chart 1.4).

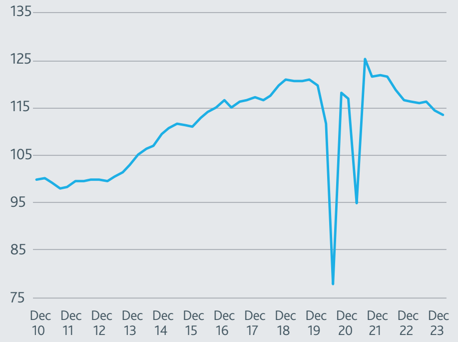
The MPC's latest forecasts, published in February, suggest that GDP growth is expected to pick up gradually during the forecast period, as the impact of increases in Bank Rate diminish. But the forecasts are modest by historic standards as anticipated year-on-year GDP rises are limited to just 0.5% in 2025 Q1, 0.8% in 2026 Q1 and 1.5% in 2027 Q1.

Year on year CPI inflation has fallen for 12 out of the last 14 months from its recent high of 11.1% in October 2022 to 4.0% at the end of December. Disappointingly, as far as hopes of immediate cuts to base rates are concerned, it remains twice the 2.0% targeted by the MPC and rose from 3.9% in November. December's "tick" upwards was caused by an increase in tobacco duty announced in the Government's Autumn Statement. Core inflation excluding energy, food, alcoholic drinks, and tobacco remains stubbornly high (see Chart 1.5).

Petrol and transport-related costs made the largest upward contribution to the rate of inflation in 2021 and 2022 but now continue to fall year on year. Food price inflation has fallen from a high of 19.2% since March this year to 8.0% in December but is still more than four times the 1.8% annual increase in real regular pay. High growth in the cost of energy and food continues to cause hardship, and, out of necessity, a reduction in household spending elsewhere. The single highest contributor to the cost of living crisis is now Alcohol and Tobacco which may have put a further dent in some household budgets over the Christmas and New Year holiday (see Chart 1.6).

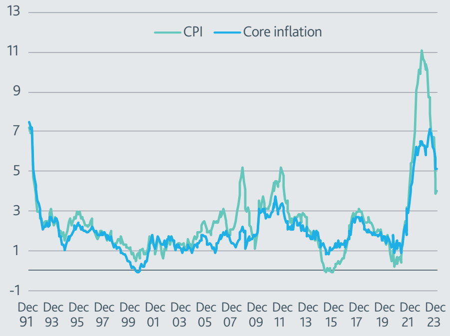
February's MPC forecast suggests that further reductions in CPI inflation will be slowed by domestic price and wage rises. CPI inflation is expected to decrease to around 2.75% by the end of this year. However, the forecast based on implied forward market interest rates suggests that it then remains above target over nearly all the remainder of the forecast period and only falls below 2% in 2027 Q1.

1.4 Index of retail sales volumes (Dec 2010 = 100)



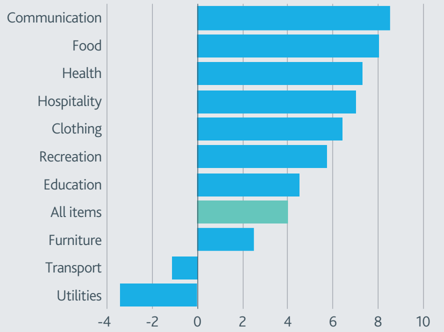
Source: ONS, Jan 2024

1.5 CPI inflation (%pa)



Source: ONS, Jan 2024

1.6 Inflation by sector (%pa) year to December 2023



Source: ONS, Jan 2024

3. Stock markets, interest rates & asset yields

Markets shrugged off any residual recessionary fears in the last quarter of 2023. The MSCI World Index, with large and mid-cap representation across 23 developed markets, gained 6.6% in Q4 and ended the year 17.6% higher than at the outset.

All bar one of the world's major equity markets also posted gains in 2023. The solitary exception was the Shanghai Composite which fell 3.7%. Despite China recording year-on-year macro-economic growth of 5.2% in 2023, the market's poor performance in Q4 reflected investors' concerns regarding a growing real estate crisis. Elsewhere in Asia, Japan's Nikkei index ended the year up 28.2%.

London's FTSE 100 index continued to underwhelm. It is dogged by a low exposure to the tech sector and a reluctance from businesses to list in London when more aggressive valuations are available elsewhere. (see Chart 2.1).

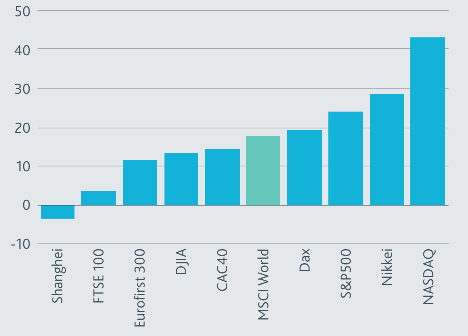
The NASDAQ, which contains the listing of many of the major tech stocks including the so called "Magnificent 7", rose 13.4% in Q4 and ended the year 43.2% higher supported by hopes surrounding the growth of Artificial Intelligence. Shares in Nvidia, a global leader in artificial intelligence hardware and software, posted annual price growth of almost 240%. The share price of Prologis, the largest logistic and warehouse real estate company in the world, grew 18.3% (see Chart 2.2).

UK REIT share prices enjoyed a strong end to the year, and after rising 18.0% in Q4 out-performed the wider all share market index in 2023. Poor prospects for the London office market continued to weigh on the share price of Great Portland and Derwent London. As might be expected, the industrial and logistics specialists fared better last year. The share price of Segro, the logistics and warehousing specialist, rose 16.1% and Big Box was up 21.9%. More surprisingly the retail specialists, Hammerson, ended the year 19.3% higher and Shaftesbury Capital shares finished 2023 29.7% higher (see Chart 2.3).

The era of cheap money ended, with a rapid escalation of interest rates as Central Banks struggled to control soaring inflation. The Bank of England has overseen fourteen consecutive rises in its base rate to 5.25%, from 0.1% in November 2021. A combination of rapidly falling levels of CPI inflation and disappointingly slow UK macro-economic growth has encouraged expectations that interest rates have now peaked. However, any reduction in base rate may not be as fast as hoped for.

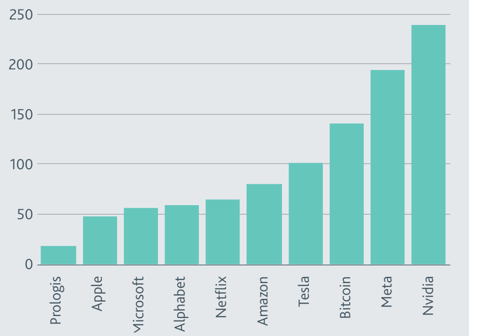
February's MPC forecast suggests that monetary policy needs to be restrictive for an extended period of time until the

2.1 World stock markets in 2023 (%'age growth)



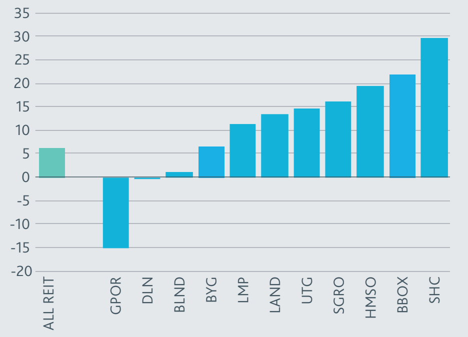
Source: Yahoo Finance, Jan 2024

2.2 Tech & other selected stocks in 2023 (%'age growth)



Source: Yahoo Finance, Jan 2024

2.3 UK Reit price movement in 2023 (%'age growth)



Source: Yahoo Finance, Jan 2024

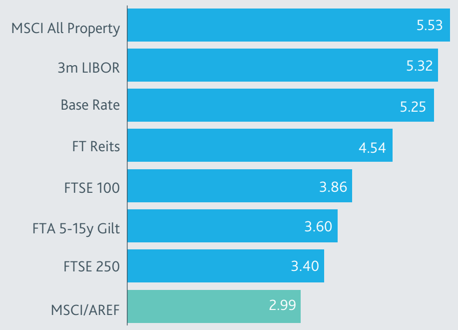
risk of inflation becoming embedded above the 2% target dissipates. However, the MPC remains prepared to loosen monetary policy if the state of the economy requires. The conditioning path for interest rates underlying the MPC's latest forecasts suggests a possible cut of 25 bps in Q1 this year, with base rate falling to 4.0% by 2025 Q1, and 3.25% by 2026 Q1. Some commentators, however, are anticipating rates of 3.0% by the end of 2025.

The pressure on the pricing of UK risk-free assets has now eased as the Bank of England is expected to slowly reverse its tightening of monetary policy. The yield on the 5-15 year gilt index hardened by 95 bps in the fourth quarter and now stands at 3.60%. This is reflected in the total return performance on the FTSE Actuaries 5-15 year gilt index in Q4 of 9.2% (see Chart 2.4).

December's month end gilt yield curve reflects the money markets belief that the medium-term trajectory for inflation and interest rates is downward. However, the longer-term outlook reflects the mantra of "higher for longer". (see Chart 2.5).

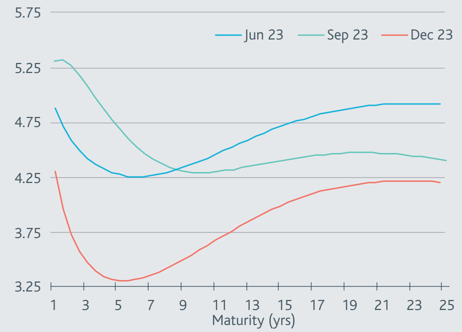
As risk free rates decreased in Q4, the All Property initial yield rose by a further 10 bps in Q4. Consequently, the property initial / gilt yield gap increased by 106 bps to 1.91%. By the standards of the last 16 years, when risk free rates fell from 5.0% in 2008 to less than 0.5% in 2020, property continues to look as if it is priced above fair value. This period may now come to be seen as an anomaly. A fairer comparison may be with earlier cycles when the yield gap was nearer to 200 bps. On this basis, property valuations, having fallen more than 24%, may be nearing the bottom of their range (see Chart 2.6).

2.4 UK asset yields Q4 2023 (%)



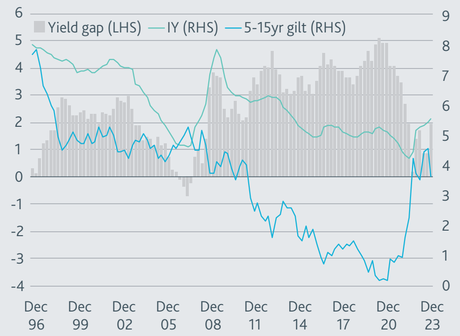
Source: Yahoo Finance & MSCI, Jan 2024

2.5 Gilt yield curve (%)



Source: Bank of England, Jan 2024

2.6 Property IY – Gilt yield gap (%)



Source: MSCI & Bank of England, Jan 2024

4. Commercial property market performance

In Q4, All Property total returns, as recorded by the MSCI Monthly Index, decreased to -1.2% from -0.2% in Q3. Capital values fell by -2.6% compared to -1.6% three months earlier. Property equivalent yields softened by a further 17 bps and contributed a -3.6% fall in valuations. All Property rental value growth increased to 1.2% in Q4 from 0.8% in Q3. Fourth quarter income returns amounted to 1.4% (see Charts 3.1 & 3.4).

Over the course of the fourth quarter, office rental value growth increased to 0.7% from 0.3% in Q3, while Q4 industrial rental value growth increased to 2.2% from 1.5% a quarter earlier. Retail rental value growth was 0.2%. Market rental values for retail warehouses and shopping centres rose but rents for shops in the South East and Rest of the UK continued to fall back (see Charts 3.2 & 3.5).

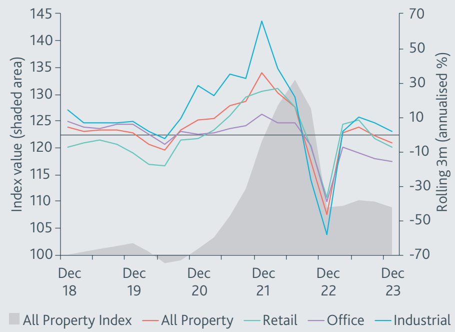
In the 12 months to the end of December 2023, All Property total returns were -0.1%, marking a huge improvement from -13.6% in the 12 months ending September as the weak result from Q4 2022 fell out of the calculation. Year-on-year capital growth also increased to -5.6% in December from -18.2% in September for the same reason. Property equivalent yields which softened by 108 bps in Q4 2022, have softened by a further 45 bps in the 12 months to December 2023 and contributed to an 8.7% drop in valuations over the course of 2023. All Property rental values increased year-on-year by 3.9% and income return amounted to 5.7%.

Yields continue to soften across all three sectors, but office valuations are coming under increasing pressure. The principal drivers for office rents continue to be working from home causing businesses to trim their occupancy footprint and an increasing awareness of the cost of retro-fitting secondary offices to meet the latest ESG standards (see Charts 3.3 & 3.6).

Tables 4.1 – 4.5 contain further performance data for UK commercial real estate in Q4 2023.

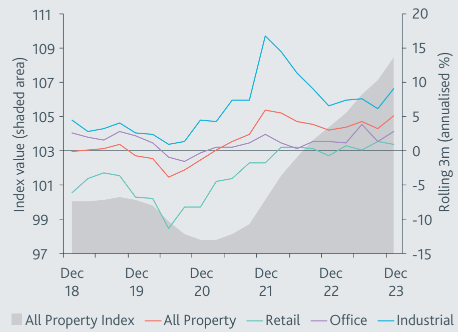
In Table 4.6, we have adopted the factor approach to real estate by segmenting the market firstly by use and secondly by a key characteristic i.e. yield, rent or

3.1 Total returns (%) by sector



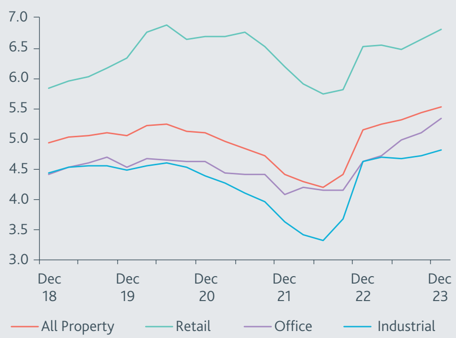
Source: MSCI, Jan 2024

3.2 MRV growth (%) by sector



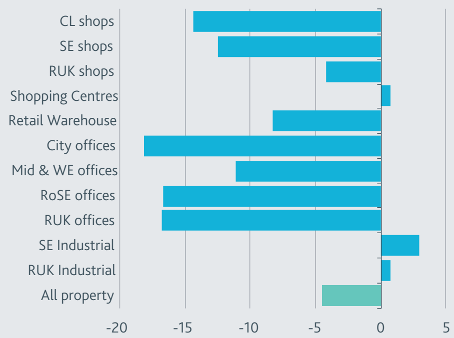
Source: MSCI, Jan 2024

3.3 Initial yield (%) by sector



Source: MSCI, Jan 2024

3.4 Total returns (%) by segment – Q4 2023 annualised

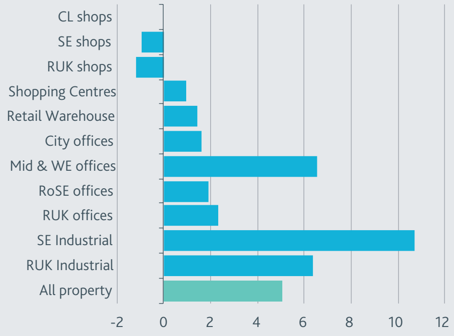


Source: MSCI, Jan 2024

lease length. The numbers presented are the three-month total returns relative to the MSCI All Property average for Q4 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.

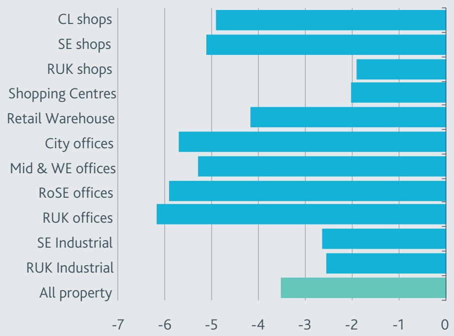
Industrials returned to outperformance last quarter supported by improved performance from shops, shopping centres and retail warehouses. Offices representing most factors and segments continue to act as a drag on performance at the All Property level except for a slight outperformance by low yielding / prime Central London offices

3.5 MRV growth (%) by segment – Q4 2023 annualised



Source: MSCI, Jan 2024

3.6 Yield impact (%) - Q4 2023



Source: MSCI, Jan 2024

4.1 Total returns (%)

	Dec	3m	6m	12m
All Property	-0.4	-1.2	-1.3	-0.1
Retail	-0.5	-1.8	-2.4	1.0
Office	-1.1	-4.1	-7.7	-11.9
Industrial	0.0	0.5	2.2	5.1
Annualised				
All Property	-5.0	-4.6	-2.7	-0.1
Retail	-6.2	-7.2	-4.7	1.0
Office	-12.0	-15.4	-14.8	-11.9
Industrial	-0.5	2.1	4.5	5.1

Source: MSCI, Oct 2023 & Jan 2024

4.2 Capital growth (%)

	Dec	3m	6m	12m
All Property	-0.9	-2.6	-4.1	-5.6
Retail	-1.1	-3.5	-5.7	-5.6
Office	-1.5	-5.5	-10.2	-16.6
Industrial	-0.4	-0.7	-0.2	0.1
Annualised				
All Property	-10.3	-9.9	-8.0	-5.6
Retail	-12.5	-13.4	-11.0	-5.6
Office	-17.1	-20.1	-19.4	-16.6
Industrial	-5.2	-2.7	-0.4	0.1

Source: MSCI, Oct 2023 & Jan 2024

4.3 Income return (%)

	Dec	3m	6m	12m
All Property	0.5	1.4	2.8	5.7
Retail	0.6	1.7	3.5	7.0
Office	0.5	1.4	2.8	5.5
Industrial	0.4	1.2	2.4	5.0
Annualised				
All Property	5.8	5.8	5.8	5.7
Retail	7.1	7.1	7.1	7.0
Office	6.0	5.8	5.6	5.5
Industrial	4.9	5.0	5.0	5.0

Source: MSCI, Oct 2023 & Jan 2024

4.4 ERV growth (%)

	Dec	3m	6m	12m
All Property	0.4	1.2	2.0	3.9
Retail	0.2	0.2	0.6	0.8
Office	0.3	0.7	1.0	2.3
Industrial	0.7	2.2	3.7	7.6
Annualised				
All Property	5.5	5.1	4.1	3.9
Retail	2.0	0.9	1.1	0.8
Office	3.8	2.9	2.1	2.3
Industrial	9.0	9.1	7.6	7.6

Source: MSCI, Oct 2023 & Jan 2024

4.5 Net initial yield (%)

	Dec	3m	6m	12m
All Property	5.5	5.4	5.3	5.1
Retail	6.8	6.6	6.5	6.5
Office	5.3	5.1	5.0	4.6
Industrial	4.8	4.7	4.7	4.6

Source: MSCI, Oct 2023 & Jan 2024

4.6 Performance by strategy relative to All Property average Q4 2023 (%)

	Low yield	High yield	High rent	Low rent	Long lease	Short lease
Shops	-0.8	-0.1	0.3	-0.8	-0.5	-0.2
Shopping Centres	-1.8	0.8	0.8	1.8	0.2	-2.5
Retail Warehouses	-1.1	0.4	-1.4	-1.1	-0.7	-1.0
Central London offices	0.0	-2.4	-0.9	0.0	-0.7	-1.8
RoSe offices	-2.7	-4.4	-3.2	-2.7	-3.7	-6.8
RUK offices	-2.2	-4.1	-4.0	-2.2	-0.4	-4.7
Industrials	0.4	1.7	0.8	0.4	0.9	1.1

Source: MSCI, Jan & Feb 2024

5. Investment in property

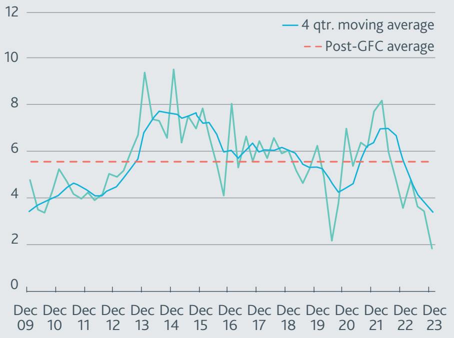
Weak market conditions have reduced liquidity in the market. All Property investment volumes, represented by the current value of investment transactions adjusted for capital growth, decreased by 6% in Q3 compared to Q2. Q3 transaction volumes were 38% below their long run average. Preliminary estimates suggest that investment volumes in Q4 fell by a further -48% and were 68% below the long run average. As usual the latest numbers for Q4 are likely to be revised in the coming months (see Chart 5.1).

Retail made up 49% (by number) of investment transactions in Q3 2023; offices represented a further 22% and industrials made up the remaining 29%. Retail, office, and industrial investment volumes so far recorded in Q4 are all lower than in Q3 (see Chart 5.2).

Central London office investment volumes decreased by 8% in Q3 compared to Q2. Q3 transaction volumes were 68% below their long run average. However, preliminary estimates suggest that investment volumes in Q4 increased by 26% and were 60% below the long run average (see Chart 5.3).

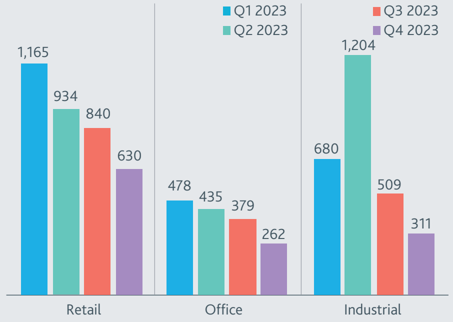
Midtown and West End made up 50% (by number) of Central London office investment transactions in Q3 2023; Fringe offices represented a further 33% and City offices made up the remaining 17%. City and Fringe office investment volumes so far recorded in Q4 are lower than in Q3 whilst Midtown and West End offices are seeing some improved interest (see Chart 5.4).

5.1 All property investment volumes (£bn)



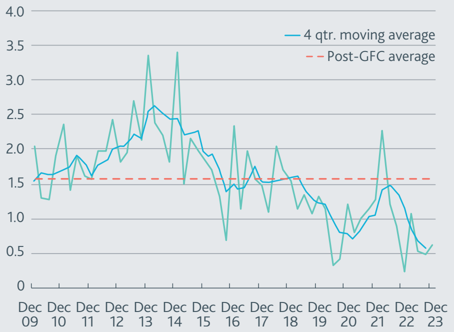
Source: CoStar, MSCI & APR, Jan 2024

5.2 UK investment transaction nos. by quarter



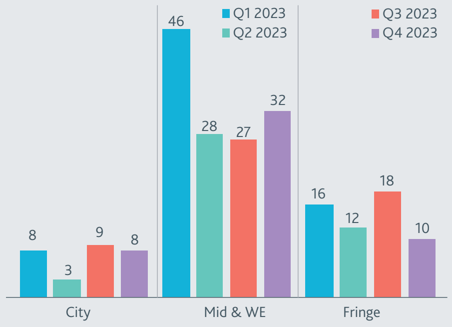
Source: CoStar & APR, Jan 2024

5.3 Central London office investment volumes (£bn)



Source: CoStar, MSCI & APR, Jan 2024

5.4 Central London Office transaction nos. by quarter



Source: CoStar & APR, Jan 2024

6. Outlook & house view

After another year where performance has been driven by increasing risk-free rates and weak economic conditions, November's Investment Property Forum (IPF) consensus forecasts are at last showing some light at the end of the tunnel. Contributors are slightly more pessimistic regarding the outlook for 2024 but are more sanguine for 2025 and 2026. Average total return forecasts for 2024 have been reduced to 6.1% from 6.4% in August. However, the outlook for 2025 has strengthened to 8.0% from 7.7% (see Chart 6.1).

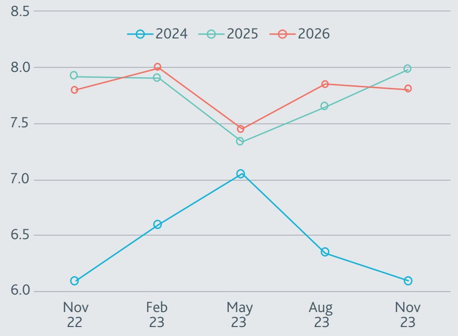
The IPF consensus view is that the year just gone will mark the bottom of the cycle. With UK commercial real estate currently offering a net initial yield of 5.5%, the outlook remains largely neutral for capital values in 2024. However, a return to modest levels of capital growth in the years thereafter seems likely. The annualised total return average forecast over the three years to 2026 is 7.3% (see Chart 6.2).

Respondents to the IPF Consensus forecast survey expect to see positive total returns in 2024 for Industrials and all retail segments but the outlook is slightly more pessimistic compared to the August survey. Sentiment remains weak for Central London and Rest of UK offices (see Chart 6.3).

The maximum total return forecast for 2024 has now decreased to +8.4% from +8.9% whist the minimum forecast has also slipped to +0.4% from +1.3%. The forecast range for 2025 has increased to 12.1%, with a maximum of +15.8% and a minimum of +3.7% (see Chart 6.4).

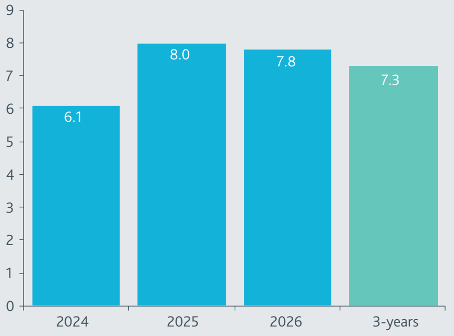
The central forecast from the House View model is revised on a quarterly basis to reflect the changing macro-economic outlook and the current performance of commercial real estate. The outcome for 2023 surprised on the upside. Our expectations of a return to weaker market conditions in the second half of 2023 did not materialise as risk free rates hardened in anticipation of cuts to bank base rate in early 2024.

6.1 IPF Consensus forecast evolution (%)



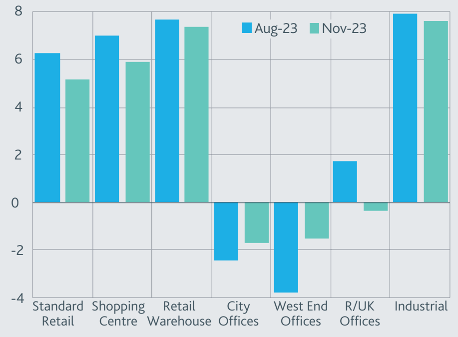
Source: IPF, Nov 2023

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



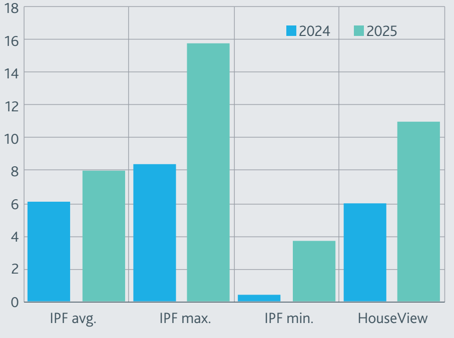
Source: IPF, Nov 2023

6.3 IPF 2024 total return forecasts by sector Nov 23 v Aug 23 (%)



Source: IPF, Nov 2023

6.4 UK commercial total return forecast range (%)



Source: IPF, APR & Cluttons, Jan 2024

It now seems likely that monetary policy will loosen resulting in a gradual lowering of interest rates that will be limited in 2024 but gather pace thereafter. Expectations therefore of sharply higher All Property returns in 2024 are unlikely to be met. All Property returns in 2024 could reach 6% but may be lower if the market persists in penalising those sectors where rental values continue to fall back or higher if yields stabilise across all segments. It is, however, likely that any stronger recovery will be delayed until 2025 or 2026 (see Chart 6.5).

Strong market rental value growth will remain characteristic of the industrial and logistics sector. 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 expected to provide an 8.0% income return, which provides some resilience in the face of any continued de-rate of these retail segments. The net effect is that the annualised average forecast for the three years to the end of December 2026 could rise to 8% or more (see Chart 6.6).

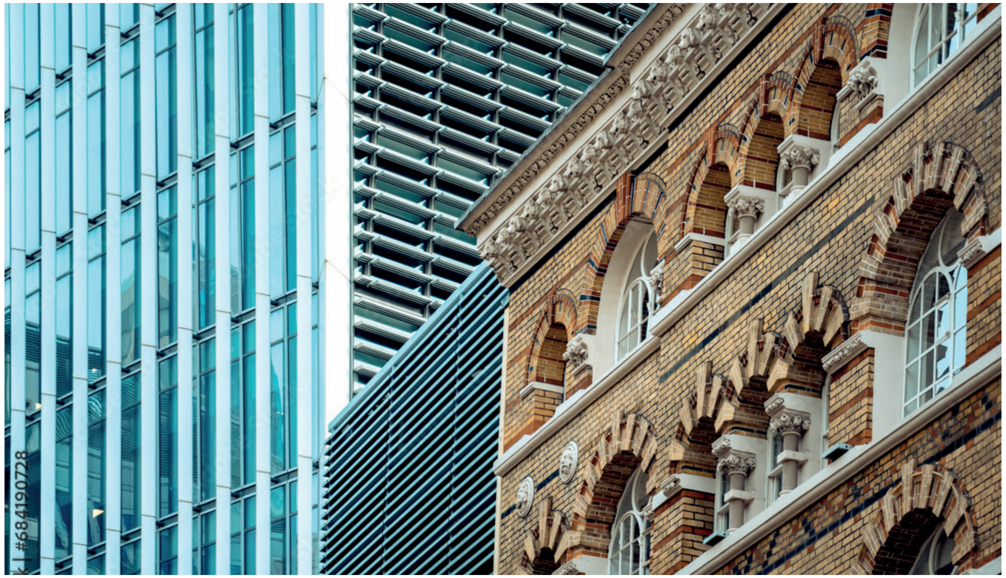
The usual caveats regarding uncertainty surrounding our central forecast remain including a more benign outlook for the economy, inflation and interest rates and an improvement in liquidity as investors believe that the sudden downward adjustment in pricing now presents an immediate buying opportunity.

6.5 Cluttons House View - 2024 relative total returns (%)

Source: APR & Cluttons, Jan 2024

6.6 Cluttons House View - 2024-2026 relative total returns (%)

Source: APR & Cluttons, Jan 2024



CLUTTONS
INVESTMENT MANAGEMENT

CLUTTONS
INVESTMENT MANAGEMENT

cluttonsim.com

For further details contact:

Jamie McCombe
Head of investment management
+44 (0) 20 7647 7234
jamie.mccombe@cluttonsim.com

Grainne Gilmore
Director of research and insight
+44 (0) 20 7647 7142
grainne.gilmore@cluttons.com

Researched on behalf of Cluttons Investment Management by Alexander Property Research.