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INVESTMENT MANAGEMENT

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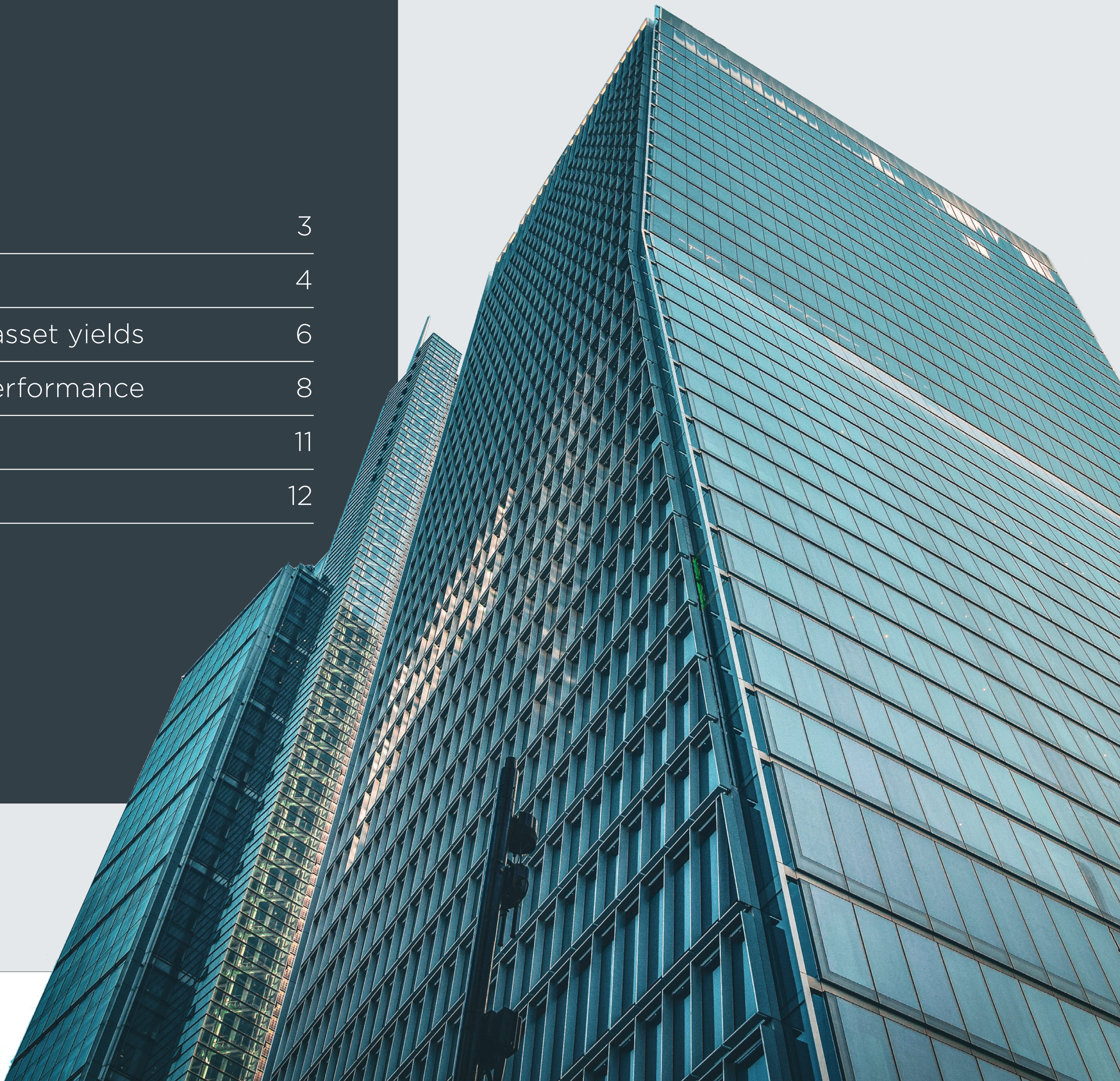
Commercial property examiner

Q1 | 2024

Contents



1. Key take aways

At the end of Q4 2023, the UK entered the mildest of “technical” recessions after suffering from two consecutive quarters of falling output. Output shrank by just -0.1% in Q3 and -0.3% in Q4. Since the turn of the year, there have been signs of an improvement. Growth of +0.3% was recorded in January and a further +0.1% in February. However, the latest forecasts for the rest of the year suggest that the UK’s economy will continue to limp along.

2023 was a good year for equity markets and the first quarter of 2024 continued in the same vein. The MSCI World Index ended the quarter 9.9% higher. Although the NASDAQ rose 9.0%, tech stocks had mixed fortunes. Nvidia continued its spectacular run but Tesla and Apple disappointed. After a strong 2023, UK REITs had a poor start to the year suggesting that investor confidence in the outlook for UK real estate is volatile.

UK commercial real estate showed signs of recovery in Q1 as MSCI’s All Property total returns increased to 0.6% in Q1 from -1.2% in Q4 although capital values fell by a further -0.8%. In the 12 months to the end of March, All Property total returns improved to 0.3% from -0.1% in the year to December.

Falling inflation and a weak economy suggest that monetary policy will start to be loosened in the second half of the year. While expectations of sharply higher All Property returns in 2024 are unlikely to be met, they could reach 7% 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. The risks to this forecast are judged to be balanced between a more benign outlook for the economy, inflation and interest rates and turbulence caused by geopolitical downside risks.

2. The UK economy

Many of the themes explored in last quarter's report continue into 2024. High inflation 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, is receding. Expectations remain that the tightening of UK monetary policy, represented by base rate rising from near zero to 5.25% in under two years, will gradually start to be reversed. This should ease the pressure on real estate markets through a reduction in the cost of debt and a reduction in capitalisation rates.

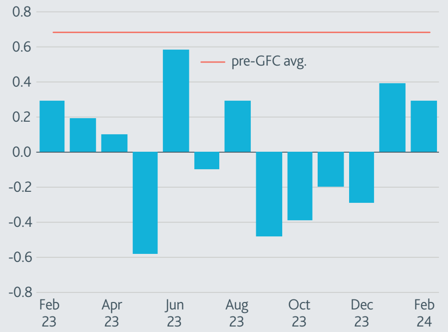
The headlines to the IMF's "World Economic Outlook" published In April indicate that the global economy has been surprisingly resilient. Inflation is expected to decline steadily. In the UK, inflation continues on a downward trend and expectations persist that the Monetary Policy Committee (MPC) will initiate an easing in monetary policy by cutting its base rate later on this year. However, the IMF's forecast for global economic growth over the next five years is the "lowest in decades". The institution is also forecasting UK economic growth of just 0.5% this year driven largely by an increase in population. GDP per head is expected to stagnate as the productivity problem has still to be grasped.

Since our last report, it has been reported that the UK economy has entered a shallow technical recession. Output shrank by -0.1% in Q3 and -0.3% in Q4. However, the economy showed some signs of a recovery in the first two months of the first quarter. Growth of 0.3% was recorded in January and a further 0.1% in February. In the last six months, the economy has grown by a meagre 0.1% (see Chart 1.1).

The UK's dominant service sector grew by 0.2% in the three months to February. "Professional, scientific and technical activities" was the largest positive contributor to the rise in service sector output, rising by 1.1% in the three months to February 2024. Over the same period, manufacturing increased by 1.2% caused by a broad-based improvement across most sectors. Construction decreased by a further -1.0% with the largest downward contribution coming from new infrastructure work. Anecdotal evidence suggests that heavy rainfall across the UK caused the delay of much planned work. Despite the latest improvement, the UK economy continues to underperform and although it is now 2.0% above its pre-pandemic level, it is also 4.3% below its potential level (see Chart 1.2).

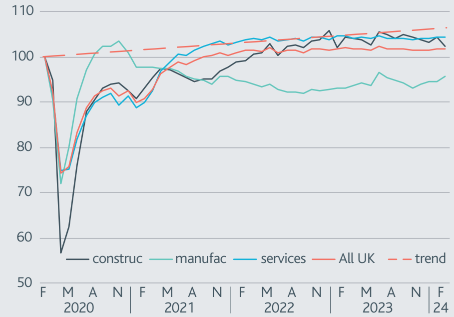
In the post-pandemic economy, service sector industries continue to fare better than manufacturing. The manufacture of petrol and other fuels has now fallen

1.1 Rolling 3m UK economic growth (%)



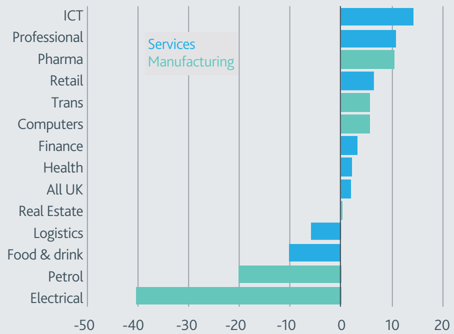
Source: ONS, Apr 2024

1.2 UK economic growth indices (Feb 2020=100)



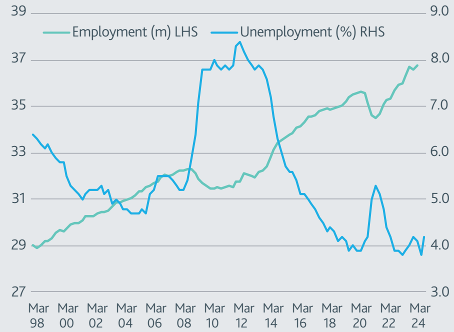
Source: ONS, Apr 2024

1.3 Post pandemic economic growth by sector (%) Feb 2020-Feb 2024



Source: ONS, Apr 2024

1.4 UK jobs & unemployment



Source: ONS, Jan 2024

20.3% 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 14.4% and remains the strongest performing sector since February 2020 (see Chart 1.3).

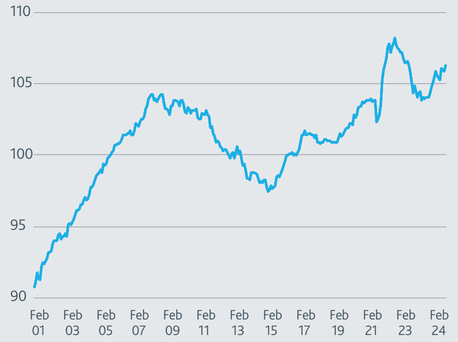
The MPC's latest forecasts, published in February, suggest that GDP growth is expected to pick up gradually during the forecast period, as the impact of increases in Bank Rate diminish. But the forecasts are modest by historic standards as anticipated year-on-year GDP rises are limited to just 0.5% in 2024, 0.7% in 2025 and 1.4% in 2026. The OBR reported in March's Economic and Fiscal Outlook that it expects output growth to pick up to 0.8% in 2024 but its assumed trend rate of growth is now as low as 1.67% a year.

The latest improvement in economic output appears to be driven by a 125,000 increase in workforce jobs since September 2023 where the largest individual increase came from the transport and storage sector, possibly caused by the demands of on-line retailing. However, the latest unemployment numbers are showing an increase from 3.8% to 4.2% in January, above pre-pandemic levels. Further impetus to economic growth is provided by the recent growth in real pay which is also now above pre-pandemic levels and could have stimulated the latest increase in retail sales volumes (see Charts 1.4, 1.5 & 1.6).

Year on year CPI inflation has fallen for 12 out of the last 17 months from its recent high of 11.1% in October 2022 to 3.2% at the end of March. This number is below the MPC's forecast published in February. Core inflation excluding energy, food, alcohol and tobacco also fell from 5.1% in December to 4.2% in March. This was slightly higher than markets anticipated, and caused some discussion that a possible June interest rate rise could be delayed. But if April's inflation figures show another fall, a June cut is still a possibility. (see Chart 1.7).

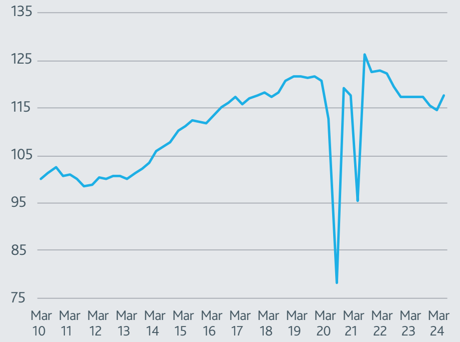
Petrol and transport-related costs made the largest upward contribution to the rate of inflation in 2021 and 2022 but are now an important influence on the falling rate of inflation together with utility costs as Ofgem's price cap continues to be cut. Food price inflation has fallen from a high of 19.2% since March 2023 to 4.0% in March this year. In March, the price of bread and meat actually fell and the only food types still seeing an increase in inflation are vegetables, hot beverages and soft drinks. Nevertheless, food price inflation is still almost twice the 2.1% annual increase in real regular pay and continues to drain the spending power of many (see Chart 1.8).

1.5 Real pay index, sa (May 2005=100)



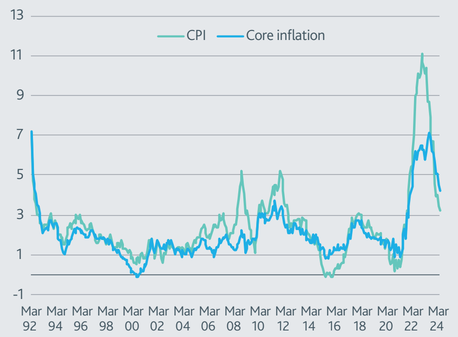
Source: ONS, Feb 2024

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



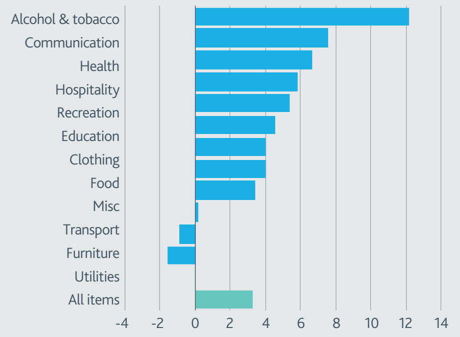
Source: ONS, Apr 2024

1.7 CPI inflation (%pa)



Source: ONS, Apr 2024

1.8 Inflation by sector (%) year to March 2024



Source: ONS, Apr 2024

3. Stock markets, interest rates & asset yields

Markets continued to perform strongly in the first quarter of 2024. The MSCI World Index, with large and mid-cap representation across 23 developed markets, gained 9.9% in Q1.

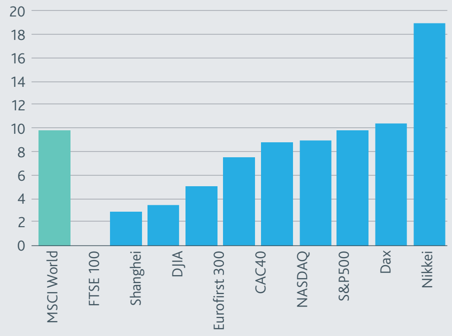
All of the world's major equity markets also posted first quarter gains. The laggards were the UK's FTSE 100 and the Shanghai Composite which recovered from a poor 2023 as state backed investors poured billions into domestically focused funds. Elsewhere in Asia, Japan's Nikkei index ended the quarter up 18.9% (see Chart 2.1).

The NASDAQ, which contains the listing of many of the major tech stocks including the so called "Magnificent 7" rose 9.0% in Q1. Shares in Nvidia, a global leader in artificial intelligence hardware and software, posted further price growth of 82.5% after growing almost 240% in 2023. However, the price of Tesla dropped -29.25% as e-car sales disappointed and Apple shares fell -10.9% as Samsung regained its position as the top smart phone manufacturer. The share price of Prologis, the largest logistic and warehouse real estate company in the world, shrank -2.3% (see Chart 2.2).

UK REIT share prices enjoyed a strong 2023 but a -3.6% price fall in Q1 under-performed the wider all share market index. Poor prospects for the London office market continued to weigh on the share price of Great Portland, Derwent London, British Land and Land Securities. Although Big Yellow fell -12.9%, other industrial and logistics specialists including Segro and London Metric fared better. The retail specialists, Hammerson and Shaftesbury Capital continued to out-perform in Q1 after a strong 2023 (see Chart 2.3).

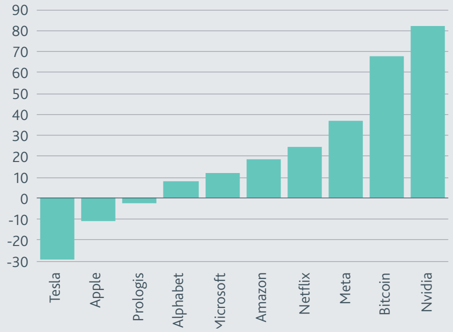
The era of cheap money ended in 2022 and 2023 with a rapid escalation of interest rates as Central Banks struggled to control soaring inflation. The Bank of England has overseen fourteen consecutive rises in its base rate to 5.25%, from 0.1% in November 2021. A combination of rapidly falling levels of CPI inflation and disappointingly slow UK macro-economic growth has encouraged expectations that interest rates have now peaked. The MPC is on record as being prepared to loosen monetary policy if the state of the economy requires and as noted above, economists are forecasting rate cuts later this year, although the date

2.1 World stock markets in Q1 2024 (%'age growth)



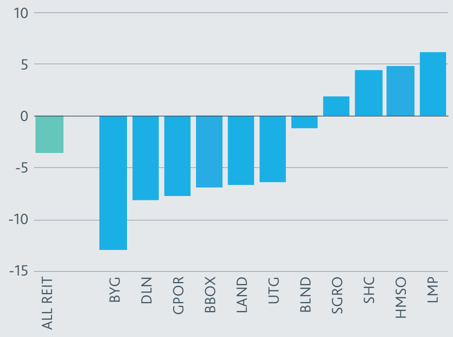
Source: Yahoo Finance, Apr 2024

2.2 Tech & other selected stocks in Q1 2024 (%'age growth)



Source: Yahoo Finance, Apr 2024

2.3 UK Reit price movement in Q1 2024 (%'age growth)



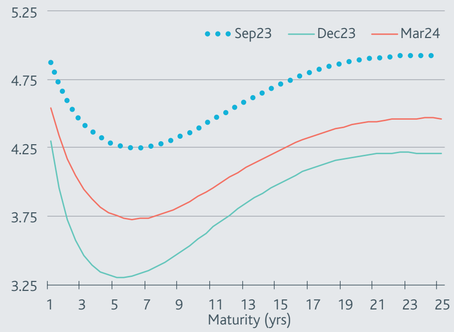
Source: Yahoo Finance, Apr 2024

of the first cut remains finely balanced. The OBR reported In March that it expected Bank Rate to fall this year from its current peak of 5.25% to 4.2% in the final quarter of 2024.

A weak economy and falling inflation rates have eased the pressure on the pricing of UK risk-free assets since the middle of last year but the yield curve moved higher in Q1 as sticky wage data and the worsening geopolitical landscape raised concerns that the Bank may not move to raise rates as soon as expected. The yield on the 5-15 year gilt index softened by 35 bps in the first quarter and now stands at 3.95%. This is reflected in the total return performance on the FTSE Actuaries 5-15 year gilt index in Q1 of -1.54%. It is likely that this short-term shift in the outlook for interest rates simply reflects the volatility of expectations. Nevertheless, gilt yields at the end of Q1 were 50 bps lower across most maturities than in September 2023 (see Chart 2.4).

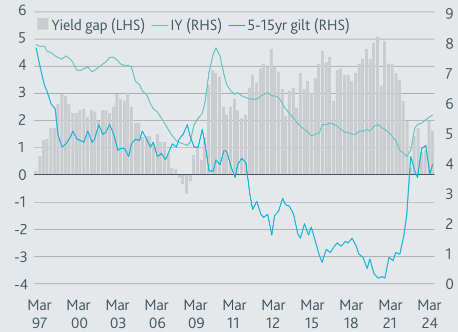
As risk free rates rose in Q1, the All Property initial yield increased by just 3 bps. Consequently, the property initial / gilt yield gap decreased by 32 bps to 1.61%. By the standards of the last 16 years, when risk free rates fell from 5.0% in 2008 to less than 0.5% in 2020, property continues to 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 25%, may be nearing the bottom of their range (see Chart 2.5). Direct property also offers a competitive income return compared to other UK asset classes (see Chart 2.6).

2.4 Gilt yield curve (%)



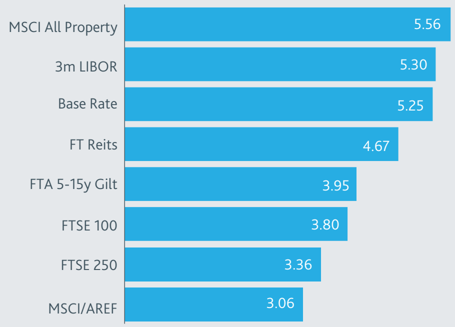
Source: Bank of England, Apr 2024

2.5 Property IY – Gilt yield gap (%)



Source: MSCI & Bank of England, Apr 2024

2.6 UK asset yields Q1 2024 (%)



Source: Yahoo Finance & MSCI, Apr 2024

4. Commercial property market performance

In Q1, All Property total returns, as recorded by the MSCI Monthly Index, increased to 0.6% from -1.2% in Q4 2023. Capital values fell by -0.8% compared to -2.6% three months earlier. Property equivalent yields softened by a further 7 bps and contributed to a -1.4% fall in valuations. All Property rental value growth decreased to 0.8% in Q1 from 1.2% in Q4 2023. First quarter income returns amounted to 1.5% (see Charts 3.1 & 3.4).

Over the course of the first quarter, office rental value growth increased to 0.8% from 0.7% in Q4 2023, while Q1 industrial rental value growth decreased to 1.1% from 2.2% a quarter earlier. Retail rental value growth was 0.1%. Market rental values for shopping centres fell back further but rental values for all other retail segments improved (see Charts 3.2 & 3.5).

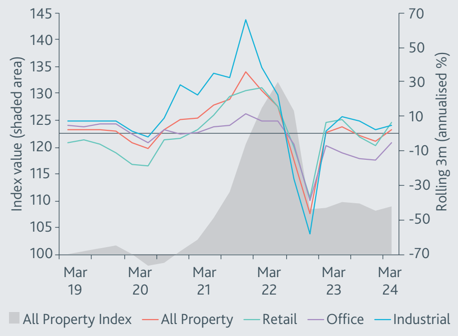
In the 12 months to the end of March 2024, All Property total returns increased to 0.3% from -0.1% in the 12 months ending December 2023.

Year-on-year capital growth also increased to -5.3% in March from -5.6% in December 2023. Property equivalent yields have softened by 45 bps in the 12 months to March and contributed to an 8.3% drop in valuations over the course of the last 12 months. All Property rental values increased year-on-year by 3.9% and income return amounted to 5.8%.

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).

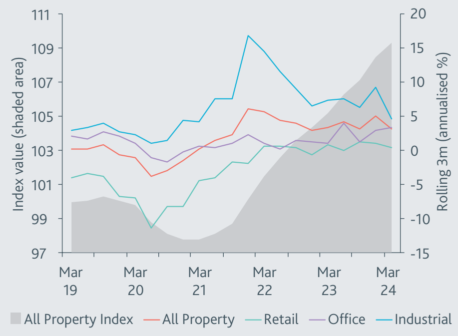
Tables 4.1 – 4.5 contain further performance data for UK commercial real estate in Q1 2024.

3.1 Total returns (%) by sector



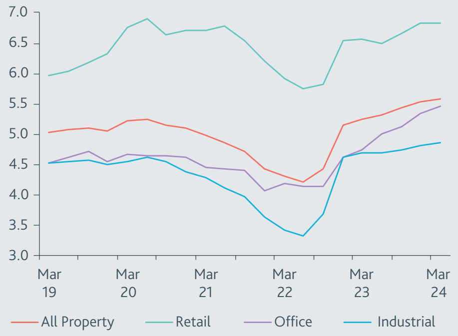
Source: MSCI, Apr 2024

3.2 MRV growth (%) by sector



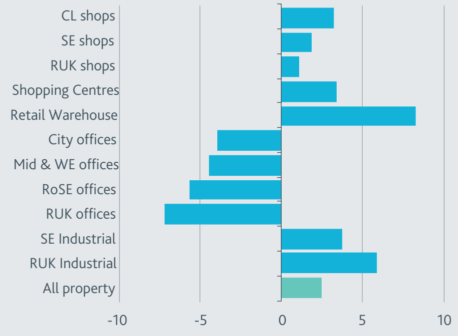
Source: MSCI, Apr 2024

3.3 Initial yield (%) by sector



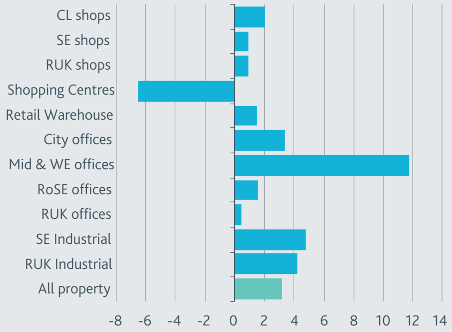
Source: MSCI, Apr 2024

3.4 Total returns (%) by segment – Q1 2024 annualised



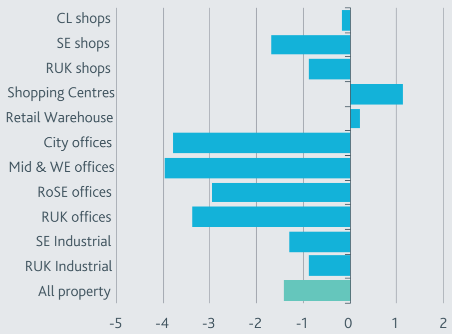
Source: MSCI, Apr 2024

3.5 MRV growth (%) by segment – Q1 2024 annualised



Source: MSCI, Apr 2024

3.6 Yield impact (%) - Q1 2024



Source: MSCI, Apr 2024

4.1 Total returns (%)

	March	3m	6m	12m
All Property	0.3	0.6	-0.6	0.3
Retail	0.8	1.5	-0.3	1.1
Office	-0.4	-1.4	-5.4	-11.5
Industrial	0.4	1.1	1.6	5.9
Annualised				
All Property	3.9	2.5	-1.1	0.3
Retail	10.1	6.3	-0.7	1.1
Office	-4.4	-5.5	-10.6	-11.5
Industrial	5.3	4.4	3.3	5.9

Source: MSCI, Apr 2024

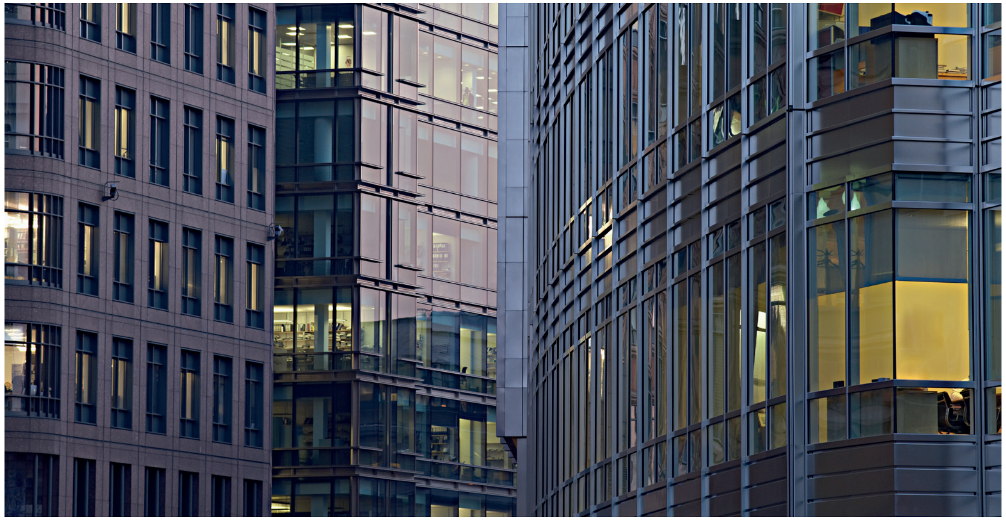
4.2 Capital growth (%)

	March	3m	6m	12m
All Property	-0.2	-0.8	-3.4	-5.3
Retail	0.2	-0.2	-3.8	-5.6
Office	-0.9	-2.8	-8.2	-16.3
Industrial	0.0	-0.2	-0.8	0.8
Annualised				
All Property	-2.0	-3.3	-6.6	-5.3
Retail	2.7	-0.9	-7.4	-5.6
Office	-9.9	-10.9	-15.6	-16.3
Industrial	0.1	-0.6	-1.7	0.8

Source: MSCI, Apr 2024

4.3 Income return (%)

	March	3m	6m	12m
All Property	0.5	1.5	2.9	5.8
Retail	0.6	1.8	3.5	7.1
Office	0.5	1.5	2.9	5.7
Industrial	0.4	1.2	2.5	5.0
Annualised				
All Property	6.0	6.0	5.9	5.8
Retail	7.2	7.3	7.2	7.1
Office	6.0	6.0	5.9	5.7
Industrial	5.2	5.1	5.0	5.0



4.4 ERV growth (%)

	March	3m	6m	12m
All Property	0.5	0.8	2.0	3.9
Retail	0.1	0.1	0.3	0.6
Office	0.7	0.8	1.5	2.8
Industrial	0.5	1.1	3.4	6.9
Annualised				
All Property	6.1	3.2	4.1	3.9
Retail	1.4	0.4	0.7	0.6
Office	8.6	3.3	3.1	2.8
Industrial	6.7	4.6	6.8	6.9

Source: MSCI, Apr 2024

4.5 Net initial yield (%)

	March	3m	6m	12m
All Property	5.6	5.5	5.4	5.2
Retail	6.8	6.8	6.6	6.6
Office	5.5	5.3	5.1	4.7
Industrial	4.8	4.8	4.7	4.7

Source: MSCI, Apr 2024

5. Investment in property

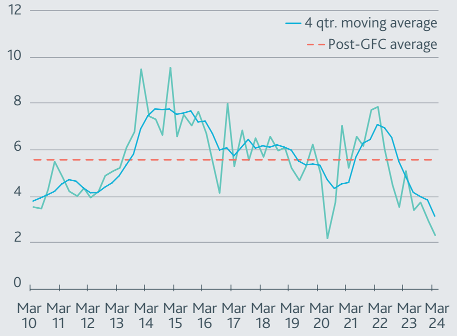
Weak market conditions have reduced liquidity in the market. All Property investment volumes, represented by the current value of investment transactions adjusted for capital growth, decreased by -22% in Q4 2023 compared to Q3 2023. Q4 2023 transaction volumes were -47% below their long run average. Preliminary estimates suggest that investment volumes in Q1 fell by a further -21% and were 58% below the long run average. As usual the latest numbers for Q1 are likely to be revised in the coming months (see Chart 5.1).

Retail made up 51% (by number) of investment transactions in Q4 2023; offices represented a further 22% and industrials made up the remaining 27%. Retail, office, and industrial investment volumes so far recorded in Q1 are all lower than in Q4 2023 (see Chart 5.2).

Central London office investment volumes reversed a recent downward trend and increased by 35% in Q4 2023 compared to Q3 2023. Nevertheless Q4 2023 transaction volumes were 57% below their long run average. Preliminary estimates suggest that investment volumes in Q1 decreased by -23% and were 67% below the long run average (see Chart 5.3).

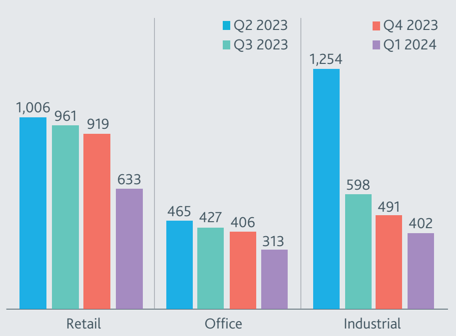
Midtown and West End made up 48% (by number) of Central London office investment transactions in Q4 2023; Fringe offices represented a further 37% and City offices made up the remaining 15%. City and Fringe office investment volumes so far recorded in Q1 are lower than in Q4 2023 whilst Midtown and West End offices are seeing a strong improvement in interest (see Chart 5.4).

5.1 All property investment volumes (£bn)



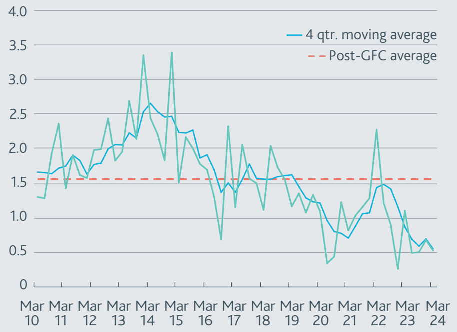
Source: CoStar, MSCI & APR, Apr 2024

5.2 UK investment transaction nos. by quarter



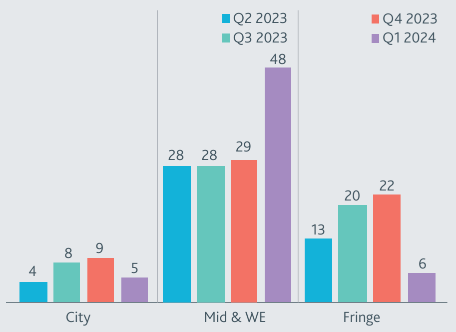
Source: CoStar & APR, Apr 2024

5.3 Central London office investment volumes (£bn)



Source: CoStar, MSCI & APR, Apr 2024

5.4 Central London Office transaction nos. by quarter



Source: CoStar & APR, Apr 2024

6. Outlook & house view

After a quarter where the UK's commercial real estate market showed some signs of improvement, February's Investment Property Forum (IPF) consensus forecasts are reflecting greater optimism in the outlook. Average total return forecasts for 2024 have been increased to 6.3% from 6.1% in November and the outlook for 2025 has strengthened to 9.0% from 8.0% (see Chart 6.1).

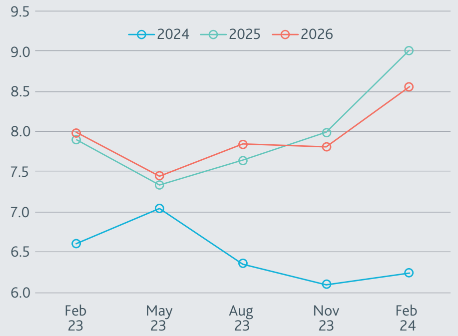
The IPF consensus view is that 2023 will have marked the bottom of the cycle. With UK commercial real estate currently offering a net initial yield of 5.6%, the outlook remains largely neutral for capital values in 2024. However, a return to robust levels of capital growth in the years thereafter seems likely. The annualised total return average forecast over the three years to 2026 is 7.9% and 7.6% for the five years to 2028 (see Chart 6.2).

Respondents to the IPF Consensus Forecast Survey expect to see positive total returns in 2024 for all segments but the outlook is weaker for Central London and Rest of UK offices (see Chart 6.3).

The maximum total return forecast for 2024 has now increased to +10.2% from +8.4% whist the minimum forecast has also improved to +1.5% from +0.4%. The forecast range for 2025 has decreased to 6.2%, with a maximum of +11.4% and a minimum of +5.2% (see Chart 6.4).

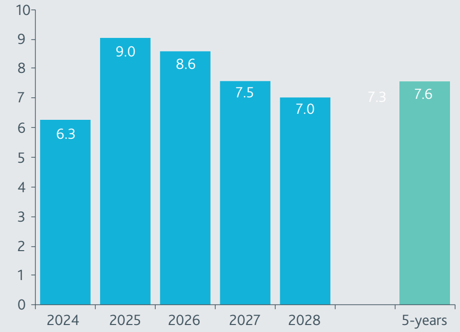
The central forecast from the House View model is revised on a quarterly basis to reflect the changing macro-economic outlook and the current performance of commercial real estate. The total return outcome for Q1 2024 is an improvement on the results posted in Q4 and Q3 2023 and we expect the market to improve further moving forwards.

6.1 IPF Consensus forecast evolution (%)



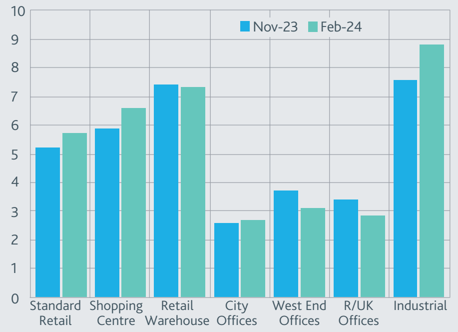
Source: IPF, Feb 2024

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



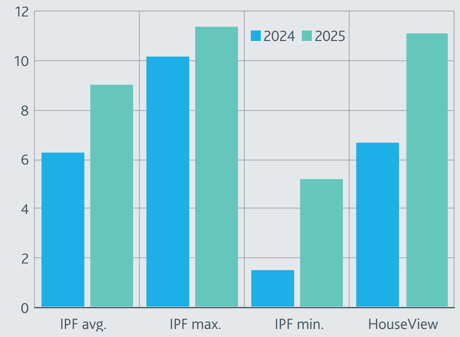
Source: IPF, Feb 2024

6.3 IPF 2024 total return forecasts by sector Feb 24 v Nov 23 (%)



Source: IPF, Feb 2024

6.4 UK commercial total return forecast range (%)



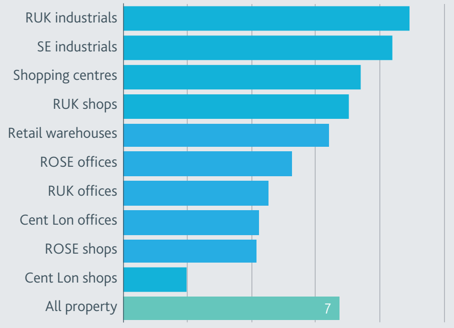
Source: IPF, APR & Cluttons, Apr 2024

It now seems likely that monetary policy will loosen in the second half of the year 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. Consistent with the latest IPF Consensus forecast, we now think All Property returns in 2024 could reach 7%. It is, however, likely that any stronger recovery will be delayed until 2025 or 2026 (see Chart 6.5).

The industrial and logistics sector now represents more than 30% of the institutional investment market and is therefore a key driver of All Property performance. In the medium-term robust levels of market rental value growth should remain characteristic of this sector Secondary office are at risk of being stranded by tougher rules surrounding ESG. In the last 12 months there is a 12%'age point gap between capital growth for high yielding / secondary and low yielding / prime Central London offices. 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 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).

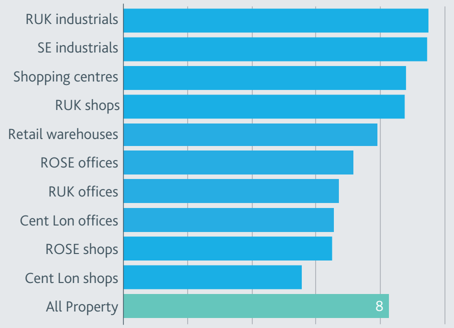
As usual there are a number of caveats regarding uncertainty surrounding our central forecast. Upside risks include a more benign outlook for the economy, inflation and interest rates and an improvement in liquidity as investors believe that the downward adjustment in pricing now presents an immediate buying opportunity. Downside risks include economic instability and a renewed inflation episode caused by an escalation of Israel's war with Hamas and the continuation of Russia's invasion of Ukraine.

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



Source: APR & Cluttons, Apr 2024

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



Source: APR & Cluttons, Apr 2024

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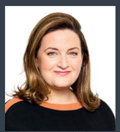

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