CLUTTONS
INVESTMENT MANAGEMENT

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Commercial property examiner

Q2 | 2024

Contents

1. Key take aways

UK economic growth has surprised on the upside since the start of the year and CPI inflation has fallen back to the 2% target rate. The MPC added to the good news by surprisingly voting to cut its base rate by 25 bps to 5.0%. Any further loosening in monetary policy is expected to proceed cautiously.

In the USA and UK stock markets continued their upward trajectory in Q2 supported, particularly in the US, by tech stocks. European and Asian markets disappointed. The share price of logistic warehouse specialist Prologis fell 13.8% and the UK's All Reit index ended the quarter in negative territory. After the quarter ended a series of disappointing results from the big tech companies and weaker than expected US economic data caused a series of market corrections across key global markets.

UK commercial real estate continued its recovery in Q2 as MSCI's All Property total returns increased to 1.7% from 0.6% in Q1 and capital values registered their first positive quarter in the last eight. In the 12 months to the end of June, All Property total returns improved to 1.0% from 0.3% in the year to March.

The property market downturn was generated by increases in the risk-free rate and the cost of borrowing. Consequently, as the first downward movement in base rates since March 2020 was pushed back into Q3, the total return outcome for Q2 2024 was lower than anticipated. However, we expect the market to improve in the second half of the year, although it is likely that All Property returns will undershoot our previous forecast of 7% by at least 50 bps.

1. The General Election

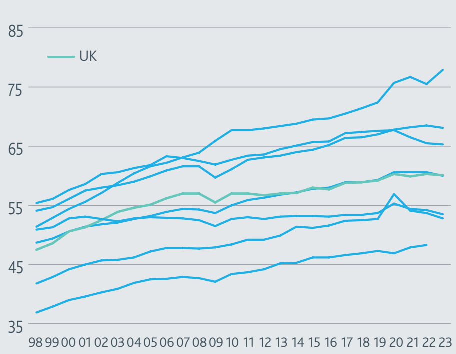
Superficially Labour's crushing victory in the UK's General Election of 4th July has had little immediate impact. Arguably the result was already baked in well before Prime Minister Sunak announced the election on 22nd May in a rain-soaked Downing Street.

The day before the election announcement FTSE All Share Index had closed at 4,584.40; the yield on the FTSE Actuaries 5-15 year gilt index was 4.16%. The day after the announcement, the All Share fell -0.9% to 4543.84 and the gilt yield rose by 12 bps to 4.28%. However, sterling's exchange rate against both the Euro and the Dollar remained steady at €1.17 and $1.27. The day after the votes had been counted the All Share had slipped a further -1.3% to 4,486.08; but the gilt yield had hardened marginally to 4.14%; and the pound had strengthened slightly to €1.18 and $1.28.

It is the medium-term outlook that is more important for the UK economy and real estate. Will the new government be able to improve productivity which has been stagnant since 2009 to the levels achieved in many other western economies (see Charts 1.1 & 1.2); and lift investment, which was falling for a generation before the GFC to match its G7 competitors (see Charts 1.3 & 1.4), to raise the economy's recent weak rate of growth? Can it reboot the gridlocked planning system and "get Britain building again"?

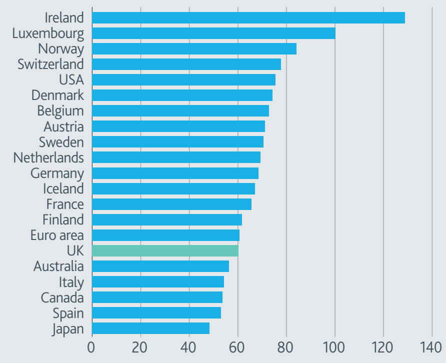
For the world economy, global trade and interest rates it is likely that the more important vote takes place on the 5th November in the USA.

1.1 G7 plus Euro area; GDP per hour worked



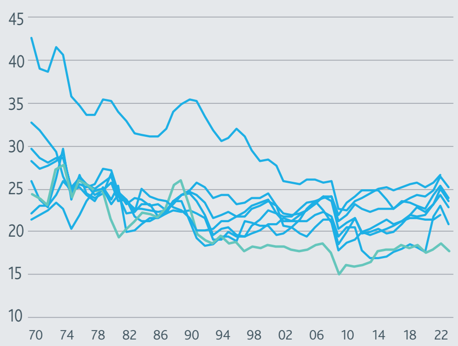
Source: World Bank, Jul 2024

1.2 GDP per hour worked in 2023 ($)



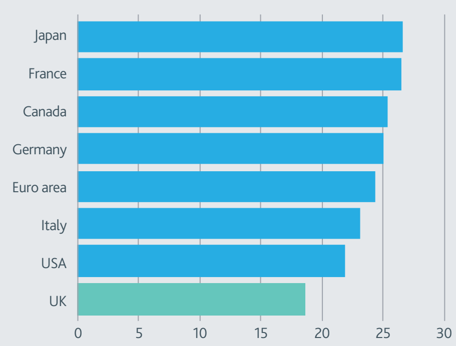
Source: World Bank, Jul 2024

1.3 G7 plus Euro gross capital formation (% of GDP)



Source: World Bank, Jul 2024

1.4 G7 plus Euro gross capital formation (% of gdp)



Source: World Bank, Jul 2024

2. The UK economy

The macro-economic background to this report is finally improving. Since the start of the year the economy has been growing consistently, albeit slowly, and CPI inflation has fallen back to the MPC's 2% target.

The IMF's "World Economic Outlook" published In July emphasises the resilience of the global economy as a whole, driven by strong export performance from Asian economies and improving economic activity in the Euro area. However, persistent inflation, particularly in the services sector, provides a continued challenge for global monetary policy makers. In addition, the risks from geopolitical tensions in Ukraine and the Middle East escalating remain.

The IMF is also now more sanguine regarding the outlook for the UK's economy. An improved 2024 growth forecast of 0.8% has been supported by effective monetary policies and a faster-than-expected decline in inflation. However, careful management of interest rates and monitoring of domestic and global risks remain crucial for sustained economic stability.

The latest data from the Office for National Statistics indicates that the UK economy is five months into a steady recovery from a mild "technical recession" in Q3 and Q4 last year. Growth of 0.4% was recorded in May and 0.78% in the last three months to the end of May. In the last 12 months, the economy expanded by 1.5%. At the end of the first quarter that key 12-month metric was just 0.1% (see Chart 2.1).

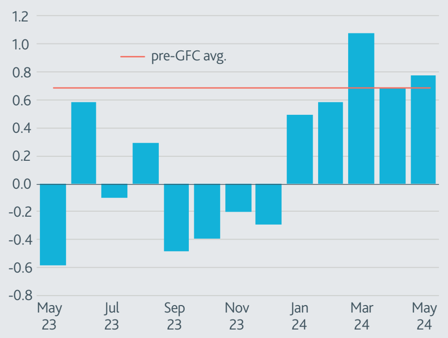
The service sector, which represents 80% of the UK's economy, grew by 1.1% in the three months to May 2024. This is the strongest three-monthly growth rate since December 2021. There was widespread growth across the 14 sub-sectors. Professional, scientific and technical activities was the largest positive contributor to the rise in services output growing by 2.5% in the three months to May 2024. Information technology services grew by 0.7% but financial services contracted by -0.4%.

Manufacturing output shrank by -1.1% in the three months to May 2024. A positive contribution came from pharmaceutical manufacture. But transport, electrical and computer manufacturing together with the refining of petrol and other fuels provided negative contributions as manufacturing continues to struggle in the post pandemic environment (see Chart 2.2).

Construction output is estimated to have fallen by 0.7% in the three months to May 2024 as anecdotal evidence again suggests that continued heavy rainfall in March and April across the UK caused the further delay of planned work.

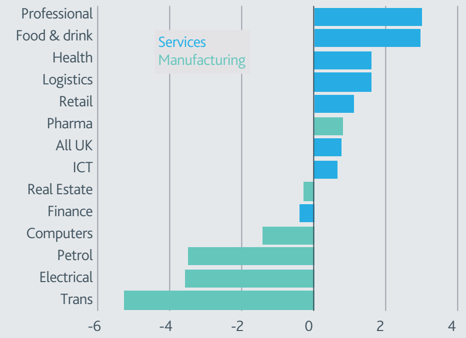
Despite the latest improvement, the UK economy continues to underperform. Although it is now 3.1% above its pre-pandemic level, it is also 5.4% below its potential level based on the assumption that output post March 2020 continued at its post-GFC trend rate. Manufacturing remains -5.8% below its February 2020 level (see Chart 2.3).

2.1 Rolling 3m UK economic growth (%)



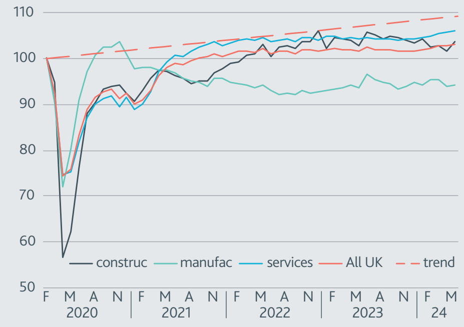
Source: ONS, Jul 2024

2.2 3m economic growth by sector (%)



Source: ONS, Jul 2024

2.3 UK economic growth indices (Feb 2020=100)



Source: ONS, Jul 2024

The MPC's latest forecasts, published at the start of August, confirm that GDP growth has picked up quite sharply so far this year, but highlight that underlying momentum is weaker. Year-on year GDP growth is projected to fall back a little next year before strengthening again over the remainder of the forecast period, to around 1.75% in 2027. This medium-term economic improvement reflects the fading negative impact on growth from past increases in Bank Rate and the market-implied path of forward interest rates i.e. further reductions in base rate anticipated towards the end of the period.

Year on year CPI inflation fell from its recent high of 11.1% in October 2022 to 2.0% at the end of May, but failed to fall back any further in June. Core inflation excluding energy, food, alcohol and tobacco fell from 4.2% in March to 3.5% in June but remains comfortably above its long run average of 2.2%. Service sector CPI inflation peaked at an annual 7.5% in the middle of last year and has only fallen back to 5.7% at the end of June (see Chart 2.4).

In June, the largest upward effects to inflation came from restaurants and hotels, and transport. In the longer run, petrol and transport-related costs have been an important influence on the falling rate of inflation but in the last year petrol prices rose from 143p per litre 12-months ago to 146p this June. The largest downward effect came from clothing and footwear. Housing and household services also made a large negative contribution to CPI helped by cheaper gas and electricity prices this year compared to a year ago.

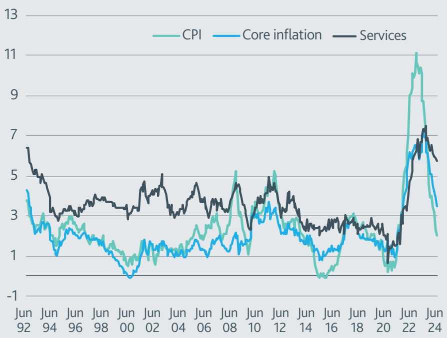
Petrol and transport-related costs made the largest upward contribution to the rate of inflation in 2021 and 2022 but are now an important influence on the falling rate of inflation together with utility costs as Ofgem's price cap continues to be cut (see Chart 2.5).

Food price inflation has fallen from a high of 19.2% since March 2023 to 1.5% in June this year and is now lower than the annual increase in real regular pay. However, the affordability issue remains. Since February 2020 real wages have shrunk by -0.4% but food prices have risen by 30.0% (see Chart 2.6).

Indications of persistent inflationary pressures monitored by the MPC include the labour market, wage growth and services price inflation. The annual rate of increase in real pay decreased to 2.3% in May from 2.6% in April and points towards a weakening in inflationary pressures. But the strength of economic activity since the start of the year and the persistence of services inflation had suggested a reduction in base rates may be delayed. Nevertheless, the rate setting committee felt there was enough economic slack to justify a cut in base rate by 25 bps to 5.0% having previously maintained base rate at 5.25% for the last 12 months.

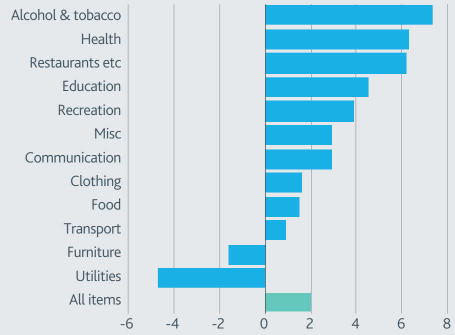
The projections for CPI inflation in this month's Monetary Policy Report are for an increase from the 2% target to around 2.75% at the turn of the year. CPI inflation then falls back to 1.7% in two years' time and to 1.5% in three years.

2.4 CPI inflation (%pa)



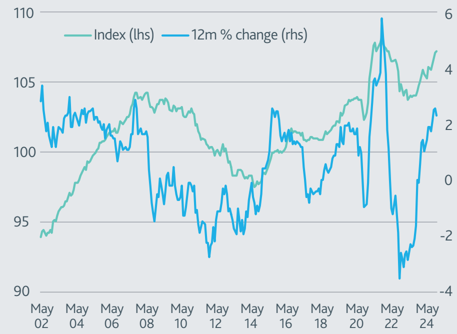
Source: ONS, Jul 2024

2.5 Inflation by sector (%) year to June 2024



Source: ONS, Jul 2024

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



Source: ONS, Jul 2024

3. Stock markets, interest rates & asset yields

Despite strong corporate earnings and cautious optimism regarding inflation and interest rates, markets slowed in the second quarter of 2024. The MSCI World Index, with large and mid-cap representation across 23 developed markets, slowed from gains of 9.9% in Q1 to 2.8% in Q2. The potential of Artificial Intelligence continued to encourage investment but geopolitical tensions weighed on sentiment.

The FTSE 100 rose 2.7% in Q2 but some volatility was evident, with the index rising to 8,446 in May before ending the quarter on 8,154. The S&P 500 increased by 4.8% in Q2 2024, and the NASDAQ grew by a further 9.2%% driven once again by strong performance in tech stocks. European and Asian markets had a disappointing second quarter. The Euro Stoxx 50 index grew by less than 0.1% while the Shanghai Composite Index fell by -1.4%, and Japan's Nikkei fell by -1.9% (see Chart 3.1).

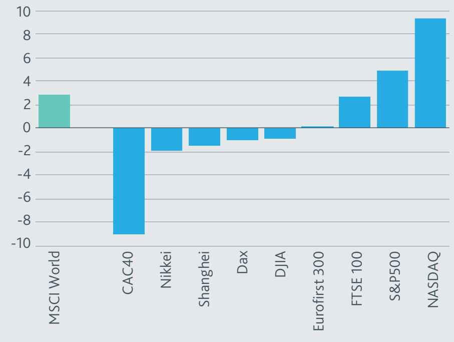
The "Magnificent 7" all showed further gains in Q2 with Nvidia, the manufacturer of the chips that power AI applications, up a further 36.7% and Apple up 22.8% following the introduction of Apple Intelligence for iPhone, iPad and Mac. Investors in Prologis, the largest logistic and warehouse real estate company in the world, had a poor quarter as it announced continued subdued customer demand and the share price shrank -13.8% (see Chart 3.2).

In recent days investor confidence has been shaken by disappointing results from the major tech firms suggesting the high expectations placed on AI may not be realised immediately. This has been compounded by news of a rise in the US unemployment rate and lower than expected payroll data raising recessionary fears. Market instability may continue until the Federal Reserve moves to cut rates which will in turn put pressure on UK and European central banks.

The UK's All REIT index again under-performed the wider all share market in Q2. The merger of London Metric Property and LXi REIT, was completed in March 2024 creating the UK's fourth-largest REIT with a combined portfolio valued at £6.2 billion. Despite substantial cost and operating synergies, stronger income longevity and security, and a more resilient capital structure, the share price ended the quarter down -4.8%.

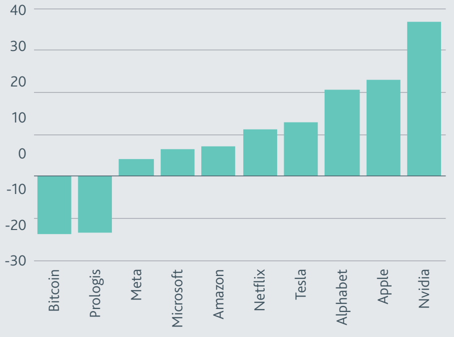
As the decision to finally start loosening monetary policy was pushed back into Q3, continued concerns regarding the outlook for the UK's listed commercial real estate companies resulted in valuation downgrades across the sector. Companies specialising in London offices, student accommodation, shopping centres, retail parks, West End shopping as well as industrial and logistics had their share price marked down. Only British Land, Derwent London and Big Yellow

3.1 3.1 World stock markets in Q2 2024 (%'age growth)



Source: Yahoo Finance, Jul 2024

3.2 Tech & other selected stocks in Q2 2024 (%'age growth)



Source: Yahoo Finance, Jul 2024

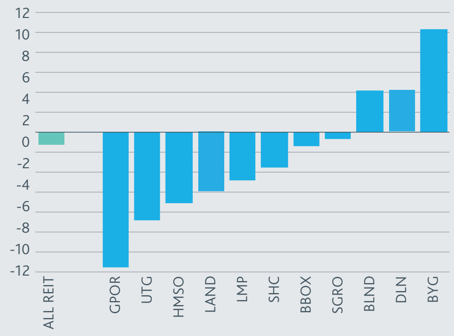
Group ended the quarter with a higher share price (see Chart 3.3).

A recovering economy and stubborn core and service sector inflation have put pressure on the pricing of UK risk-free assets since the start of the year. The yield curve moved higher in both Q1 and Q2 as concerns returned that the MPC may not move to raise rates as soon as expected. The yield on the 5-15 year gilt index softened by a further 24 bps in the second quarter and now stands at 4.19%. This is reflected in the total return performance on the FTSE Actuaries 5-15 year gilt index in Q2 of -0.93%. However, over the last 12 months, the gilt index has provided total returns of 6.84% and Q2's yield is actually 26 bps lower than it was in June 2023. (see Chart 3.4).

As risk free rates rose in Q2, there was no change in the All Property initial yield. Consequently, the property initial / gilt yield gap decreased by 24 bps to 1.37%.

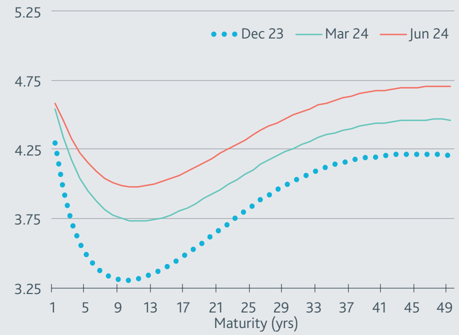
By the standards of the last 16 years, when base rates were less than 1% for much of the time, property continues to look as if it is priced above fair value. However, comparison with earlier cycles when base rates hovered around 5% and the yield gap was nearer to 200 bps suggests that property valuations may be nearing the bottom of their range. At the All Property level, capital values stabilised in April, after falling for 21 consecutive months, before strengthening in May and June (see Chart 3.5). Despite the shrinking yield gap, direct property continues to offer a competitive income return compared to other UK asset classes (see Chart 3.6).

3.3 UK Reit price movement in Q2 2024 (%'age growth)



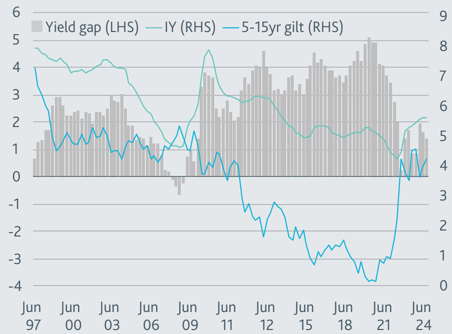
Source: Yahoo Finance, Jul 2024

3.4 Gilt yield curve (%)



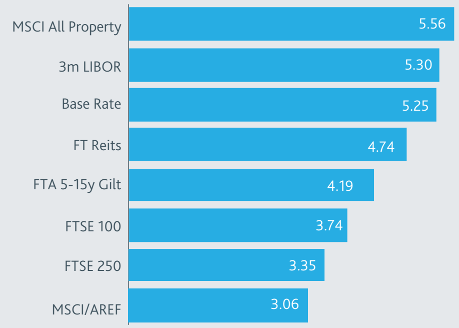
Source: Bank of England, Jul 2024

3.5 Property IY – Gilt yield gap (%)



Source: MSCI & Bank of England, Jul 2024

3.6 UK asset yields Q2 2024 (%)



Source: MSCI & Bank of England, Jul 2024

4. Commercial property market performance

In Q2, All Property total returns, as recorded by the MSCI Monthly Index, increased to 1.7% from 0.6% in Q1. Capital values rose by 0.2% compared to a fall of-0.8% three months earlier. Property equivalent yields softened by less than 1 bp but nevertheless contributed to a -0.4% fall in valuations. All Property market rental value growth remained stable at 0.8% in Q2. Second quarter income returns amounted to 1.5% (see Charts 4.1 & 4.4).

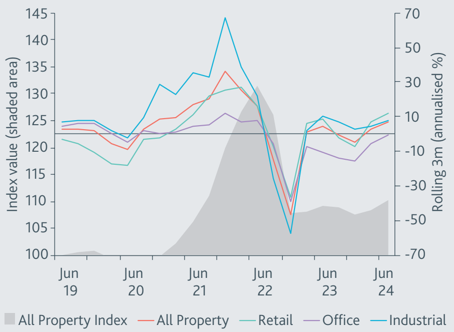
Over the course of the second quarter, office rental value growth decreased to 0.4% from 0.8% in Q1, while Q2 industrial rental value growth increased to 1.3% from 1.1% a quarter earlier. Retail rental value growth was 0.2%. Market rental values for shopping centres and retail warehouses strengthened but rental values for the traditional high street shop segments deteriorated (see Charts 4.2 & 4.5).

In the 12 months to the end of June 2024, All Property total returns increased to 1.0% from 0.3% in the 12 months ending March. Year-on-year capital growth also improved to -4.7% in June from -5.3% in March but still remained negative. Property equivalent yields have softened by 41 bps in the 12 months to June and contributed to a 7.7% drop in valuations over the course of the last 12 months. All Property rental values increased year-on-year by 3.6% and income return amounted to 5.9%.

In the last month equivalent yields have started to harden across all three sectors. Any downward adjustment movement has been limited for offices and industrials, but the retail sector has benefited from a much stronger re-rate of 12 bps. The implication of this, particularly for offices, is that working from home, the associated reductions in occupancy footprint and the cost of retro-fitting secondary offices to meet the latest ESG standards are now reflected in valuations (see Charts 4.3 & 4.6).

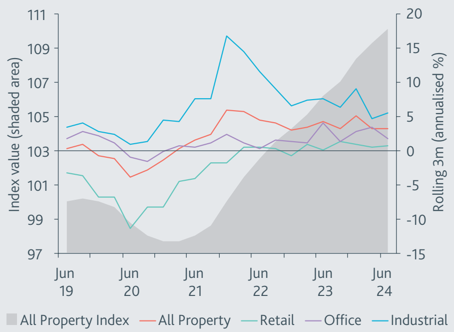
Tables 5.1 – 5.5 contain further performance data for UK commercial real estate in Q1 2024.

4.1 Total returns (%) by sector



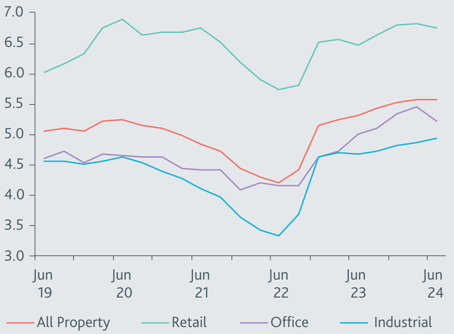
Source: MSCI, JuL 2024

4.2 MRV growth (%) by sector



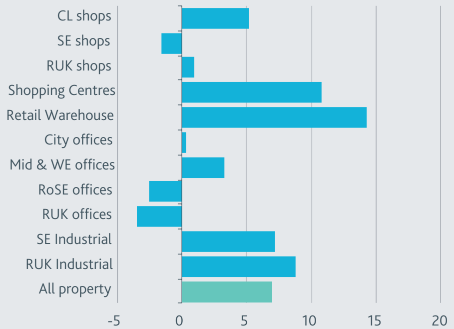
Source: MSCI, JuL 2024

4.3 Initial yield (%) by sector



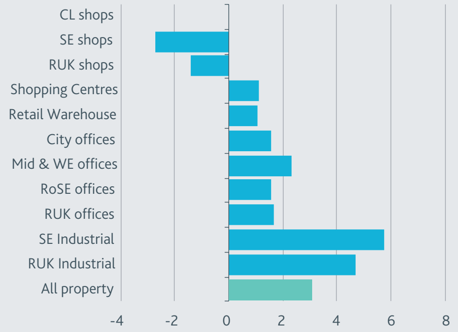
Source: MSCI, JuL 2024

4.4 Total returns (%) by segment – Q2 2024 annualised



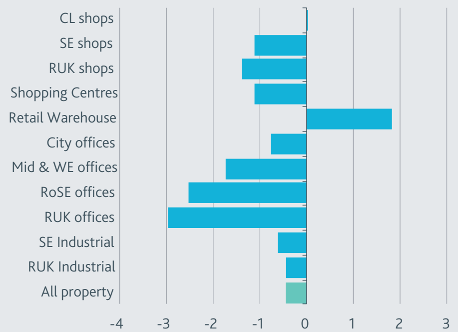
Source: MSCI, JuL 2024

4.5 MRV growth (%) by segment – Q2 2024 annualised



Source: MSCI, JuL 2024

4.6 Yield impact (%) - Q2 2024



Source: MSCI, JuL 2024

5.1 Total returns (%)

	July	3m	6m	12m
All Property	0.7	1.7	2.3	1.0
Retail	1.2	2.8	4.4	1.9
Office	-0.1	-0.2	-1.6	-9.1
Industrial	0.7	1.9	3.0	5.3
Annualised				
All Property	8.1	7.0	4.7	1.0
Retail	15.7	11.7	8.9	1.9
Office	-0.9	-0.8	-3.2	-9.1
Industrial	8.6	7.8	6.1	5.3

Source: MSCI, Apr 2024

5.2 Capital growth (%)

	July	3m	6m	12m
All Property	0.2	0.2	-0.6	-4.7
Retail	0.6	1.0	0.8	-4.9
Office	-0.6	-1.6	-4.4	-14.2
Industrial	0.3	0.6	0.5	0.3
Annualised				
All Property	2.0	1.0	-1.2	-4.7
Retail	8.1	4.1	1.6	-4.9
Office	-6.6	-6.3	-8.6	-14.2
Industrial	3.3	2.5	0.9	0.3

Source: MSCI, Apr 2024

5.3 Income return (%)

	July	3m	6m	12m
All Property	0.5	1.5	2.9	5.9
Retail	0.6	1.8	3.6	7.2
Office	0.5	1.4	2.9	5.8
Industrial	0.4	1.3	2.5	5.0
Annualised				
All Property	6.0	6.0	6.0	5.9
Retail	7.2	7.3	7.3	7.2
Office	6.0	5.9	6.0	5.8
Industrial	5.1	5.1	5.1	5.0

5.4 ERV growth (%)

	July	3m	6m	12m
All Property	0.3	0.8	1.6	3.6
Retail	0.1	0.2	0.3	0.8
Office	0.1	0.4	1.3	2.3
Industrial	0.6	1.3	2.5	6.3
Annualised				
All Property	3.8	3.1	3.2	3.6
Retail	0.8	0.7	0.5	0.8
Office	1.8	1.7	2.5	2.3
Industrial	7.4	5.4	5.0	6.3

Source: MSCI, Apr 2024

5.5 Net initial yield (%)

	July	3m	6m	12m
All Property	5.6	5.6	5.5	5.3
Retail	6.8	6.8	6.8	6.5
Office	5.2	5.5	5.3	5.0
Industrial	4.9	4.8	4.8	4.7

Source: MSCI, Apr 2024

5. Investment in property

Weak market conditions have reduced liquidity in the market. However, ever optimistic investment agents can finally argue with some justification that the market has finally turned a corner and investors should once again be looking selectively to increase their allocations. The office sector is now alone in recording continuing decreases in capital values over one, three, six and twelve months. But even in the office sector yields have stabilised, as noted above.

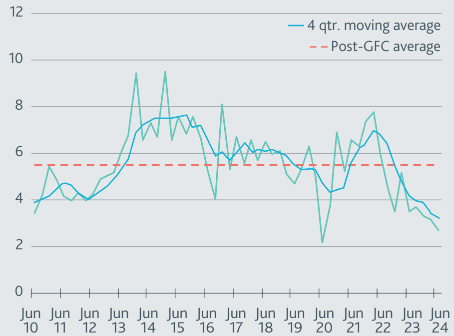
Nevertheless, All Property investment volumes, represented by the current value of investment transactions adjusted for capital growth, decreased by -5% in Q1 2024 compared to Q4 2023. Q1 2024 transaction volumes were -43% below their long run average. Preliminary estimates suggest that investment volumes in Q2 fell by a further -15% and were 51% below the long run average. As usual the latest numbers for Q2 are likely to be revised in the coming months (see Chart 6.1).

Retail made up 46% (by number) of investment transactions in Q1; offices represented a further 23% and industrials made up the remaining 32%. Retail, office and industrial investment volumes so far recorded in Q2 are all lower than in Q1 (see Chart 6.2).

Having increased in Q3 and Q4 2023, Central London office investment volumes returned to their recent trend and declined by 24% in Q1 2024 compared to Q4 2023. Q1 2024 transaction volumes were -64% below their long run average. Preliminary estimates suggest that investment volumes in Q2 decreased by -27% and were 74% below the long run average (see Chart 6.3).

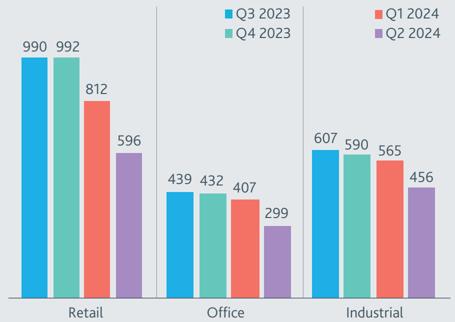
Midtown and West End made up 85% (by number) of Central London office investment transactions in Q1 2024; Fringe offices represented a further 8% and City offices made another 8%. City and Fringe office investment volumes so far recorded in Q2 have seen a strong improvement in Q2 whilst interest in Midtown and West End offices appears to be weakening (see Chart 6.4).

6.1 All property investment volumes (£bn)



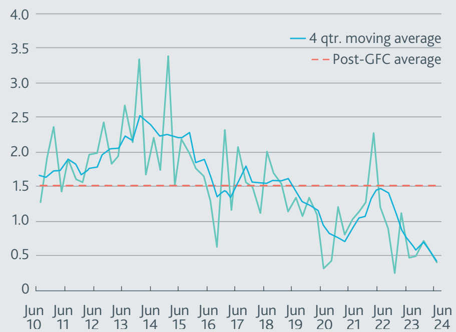
Source: CoStar, MSCI & APR, Jul 2024

6.2 UK investment transaction nos. by quarter



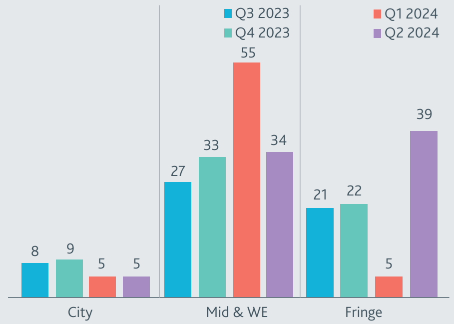
Source: CoStar, MSCI & APR, Jul 2024

6.3 Central London office investment volumes (£bn)



Source: CoStar, MSCI & APR, Jul 2024

6.4 Central London Office transaction nos. by quarter



Source: CoStar, MSCI & APR, Jul 2024

6. Outlook & house view

The expected recovery in the UK's commercial property market during the first half of the year was much weaker than expected. It is only the very latest data releases that are showing any signs of stabilisation and recovery. Consequently, after February's Investment Property Forum (IPF) consensus forecasts reflected greater optimism, May's average total return forecasts for 2024 have been cut to 5.5%. In addition, the outlook for 2025 has weakened to 8.7% from 9.0% (see Chart 7.1).

The IPF consensus view from May is that 2024 will be characterised by stabilisation rather than recovery. With UK commercial real estate currently offering a net initial yield of 5.6%, the 2024 outlook remains neutral for All Property capital values but negative for retail and offices. However, a return to more robust levels of capital growth in the years thereafter seems likely. The annualised total return average forecast over the three years to 2026 is 7.5% and 7.4% for the five years to 2028 (see Chart 7.2).

Respondents to the IPF Consensus Forecast Survey expect to see positive total returns in 2024 for all segments but the numbers imply that negative total returns will continue for offices outside Central London. The outlook for City and West End offices has also weakened. Shopping Centres and Retail Warehouses are the only sectors that have not seen the consensus outlook weaken (see Chart 7.3).

The maximum total return forecast for 2024 remains +10.2% whist the minimum forecast has only changed slightly to +1.6% from +1.5% in February. The forecast range for 2025 has decreased to 5.5%, with a maximum of +11.9% and a minimum of +6.4% (see Chart 7.4).

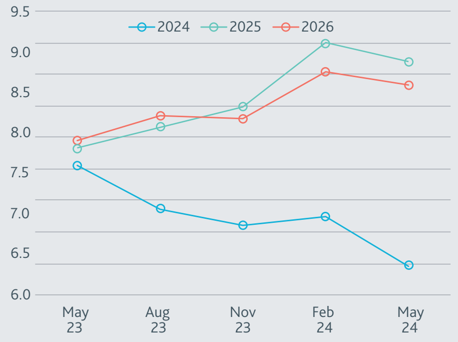
The central forecast from the House View model is revised on a quarterly basis to reflect the changing macro-economic outlook and the current performance of commercial real estate.

Monetary policy was loosened this month, but any further loosening will only proceed with caution. The MPC confirmed in its latest report that,

"Monetary policy will need to continue to remain restrictive for sufficiently long until the risks to inflation returning sustainably to the 2% target in the medium term have dissipated further."

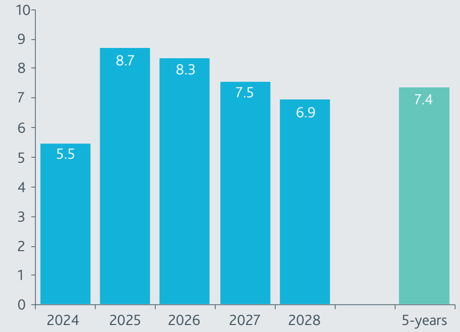
A new mantra quoted in the press conference that followed release of August's Monetary Policy Report posed the question, "one and done or more to come?". At this moment in time, it seems likely that any further lowering of interest rates that will be limited in 2024 but gather pace thereafter.

7.1 IPF Consensus forecast evolution (%)



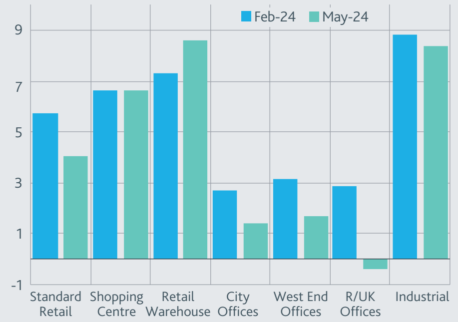
Source: IPF, May 2024

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



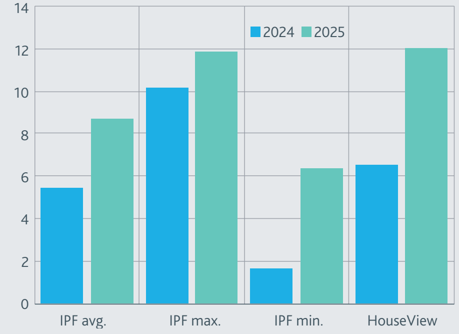
Source: IPF, May 2024

7.3 IPF 2024 total return forecasts by sector May 24 v Feb 24 (%)



Source: IPF, May 2024

7.4 UK commercial total return forecast range (%)



Source: IPF, APR & Cluttons, Jul 2024

This property market cycle is inextricably linked with movements in the risk-free rate and the cost of borrowing. The first cut to base rate was pushed back into Q3 and although the total return outcome for Q2 2024 is an improvement on the results posted in the first quarter it was lower than expectations. Consequently, although we expect the market to improve in the second half of the year, it is likely that All Property returns will undershoot our previous forecast of 7% by 50 bps or more. As we said last quarter, any stronger recovery will be delayed until 2025 or 2026 (see Chart 7.5).

The dominant themes that have shaped the performance of commercial real estate in the last few years have been the growth of online retailing and the development of remote and hybrid working models. These are structural changes that will not be reversed.

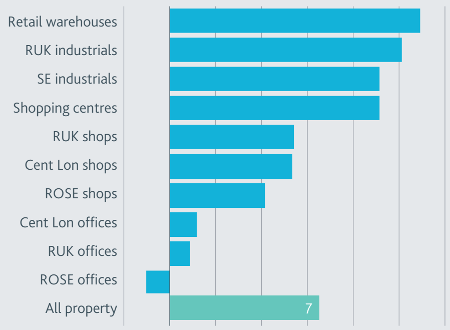
A positive outlook for distribution centres is driven by continued growth in online shopping, along with the need for efficient supply chain management, which is expected to sustain high demand for logistics space. Investment in smart logistics and automation technology could further enhance the attractiveness of this sector. Market rental value growth that was running at an average annual rate of 2% prior to the GFC, recently peaked at more than 12%.

A growing trend towards flexible office spaces and co-working models, is reshaping the office sector. Office valuations have been likened to "melting ice cubes". But this generalisation ignores a split in the market. Prime office locations in major cities are likely to remain in demand, especially those offering high-quality amenities and flexible working environments. However, secondary locations may struggle with higher vacancy rates.

Shopping centres have faced significant pressures with declining footfall and increasing vacancy rates. Larger centres with a strong mix of retail, dining, and entertainment have fared better than smaller, less diversified ones. The sector's future depends heavily on its ability to adapt and diversify. Centre's that can integrate a mix of retail, leisure, and experiential components are more likely to succeed. Investment in refurbishments and rebranding could help attract more visitors. Land Securities recently paid £120m to increase its stake in Bluewater Shopping Centre to 66% as part of a strategy to grow investment in major retail destinations (see Chart 7.6).

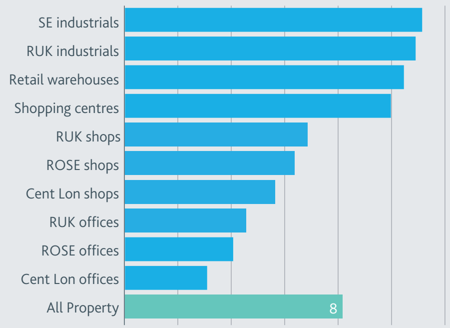
As usual there are a number of caveats regarding uncertainty surrounding our central forecast. Upside risks involve a more favourable outlook for the economy, inflation, and interest rates, along with improved liquidity as investors see the recent price drops as an immediate buying opportunity. Downside risks include economic instability, a potential resurgence in inflation and a global trade war should former President Donald Trump return to the White House. Since the start of Israel's conflict with Hamas the oil price has been relatively stable. A general escalation of this conflict into a regional war between Israel, Iran and various Lebanese factions would test this stability.

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



Source: APR & Cluttons, Jul 2024

7.6 Cluttons House View - 2024-2027 relative total returns (%)



Source: APR & Cluttons, Jul 2024

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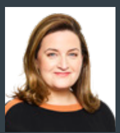

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