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# IN BRIEF

## UK COMMERCIAL PROPERTY UPDATE AND OUTLOOK

May 2023

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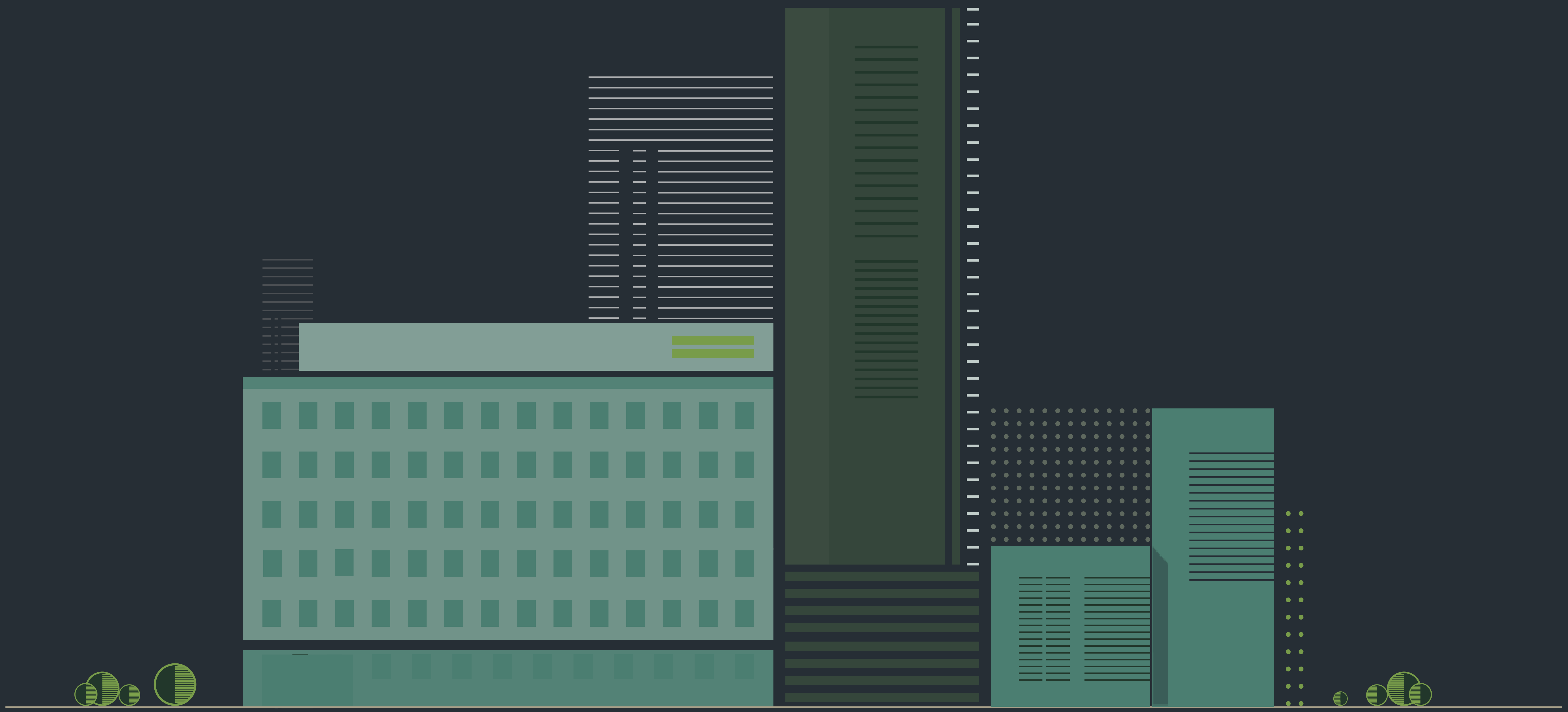

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# MAY UPDATE

All Property quarterly total return continued to trend upwards in April to 1%. After rising substantially over the back-end of 2022 commercial property yields have effectively plateaued since February. However, recent core inflation data surprised on the upside and expectations have turned sharply more hawkish for a substantially higher peak in interest rates. Live investment deals so far appear to be relatively unaffected, but it seems unavoidable now that the previous yield "peak" will now likely be an inflection point before some further outward softening in H2 2023.

Read more for the most recent occupier and investment updates, economics data and property forecasts.

**1.0%** ▲
All Property quarterly total return, Apr 2023

**4.3%** ▲
10-year bond yield, 30th May 2023

**0.4%** ▲
2023 GDP growth forecast

**6.5%** ▼
2023 CPI inflation forecast

**5.5%** ▲
Market forecast of peak UK Base rate implied by SONIA forward curve

**4.1%** ▲
2023 unemployment rate forecast

# More yield softening to come

All Property quarterly total return continued to trend upwards and reached 1% in April – the second consecutive positive return since July last year. After rising substantially over the back end of 2022 commercial property yields have effectively plateaued since February. Last month we expected an extended period of relative price stability and for All Property yields to progress horizontally over the remainder of the year. At the segment level this would involve the lower-yielding assets such as industrial marginally moving in again while other more opaque secondary assets continue to drift out so that segment relativities re-establish themselves after 2022's volatility.

However, in recent days new core inflation data surprised on the upside and expectations have turned sharply more hawkish for a substantially higher peak in interest rates. The SONIA forward curve implies market expectations of a full 100bps further to go for the Base Rate to reach 5.5% by the end of the year. Economic forecasters have been more conservative in their expectations and have typically put in around a 50bps rise to 5%. Similarly, the 10-year bond yield has moved out again over 50bps in recent days and reduced the gap with the commercial property yield to only 240bps – the lowest since October '22.

Clearly this shift will directly impact the investment market, and more indirectly the occupier market. The timeframe has been extremely short but so far live investment deals appear to be relatively unaffected, though there is certainly increased nervousness reported. Compared with the near-doubling of the cost of debt last year this shift is relatively small, but the situation is precarious since property yields were already below the equilibrium of where they "should" be. In part this can be explained by a section of investors that have been able to lock in long term draw-down facilities at below current debt pricing. These investors can take a medium to long term view and are willing and able to buy key assets at a premium to smaller leveraged investors.

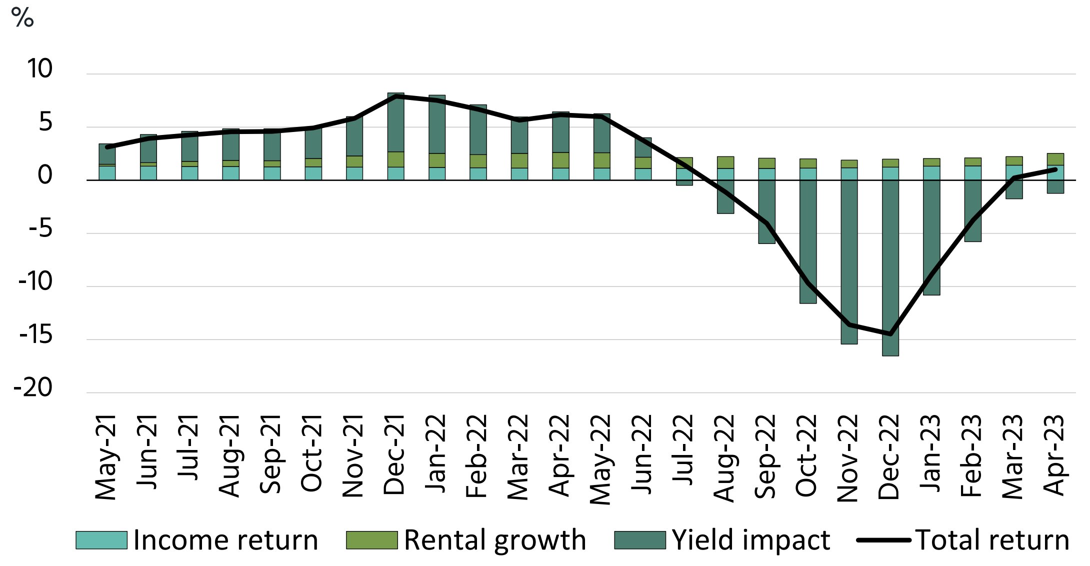
This is still a relevant factor and there remains a weight of global capital seeking a home in UK real estate. However, this further tightening will have created a new, even higher equilibrium yield position with a larger gap over current pricing that is unlikely to be sustainable in all cases. Weaker assets with more vulnerable occupier markets are more likely to be affected than those that are considered a more robust option to place capital and weather the volatility over the medium term. If another bout of increased fund redemptions is triggered there will be further complications. As it stands though, the previous overall yield "peak" will now likely be an inflection point before some further outward softening in H2 2023.

Investment volumes have been low in recent quarters. And the increased reluctance to dispose of assets and a slowing supply pipeline of new development raises the possibility of another summer of low transaction activity while the market waits it out. Meanwhile, the current situation will certainly dent occupier sentiment and amplify risk aversion. Business insolvencies are at their highest since the GFC, with commercial property defaults and void rates ticking up. Occupiers will nevertheless still need accommodation and the narrow focus on quality and sustainability will continue. Moreover, the ongoing lack of suitable development supply will continue to underpin prime rents while some secondary markets will suffer.

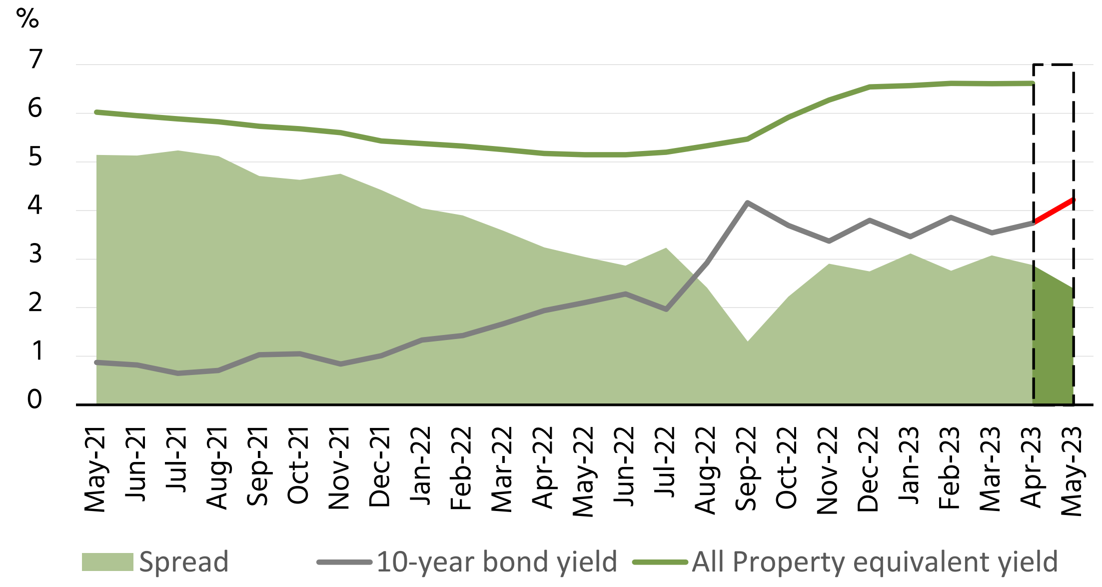
**1.0%** ▲
All Property quarterly total return, Apr 2023

**4.3%** ▲
10-year bond yield, 30th May 2023

**All Property quarterly total return and components**
Source: MSCI, Gerald Eve




**All Property yield and spread over bond yield**
Source: Gerald Eve, MSCI, Bank of England



# UK property segments

**12-month return to April 2023**
Source: Gerald Eve, MSCI

# UK economy

UK GDP fell 0.3% month-on-month in March but the quarterly increase of 0.1% in Q1 is reflective of an economy continuing to flatline, as it has been doing for the past year now. This is set to continue into Q2, with increases in business and consumer sentiment and activity offset by the disruption of lingering industrial disputes and the impact of the extra bank holiday to mark the King's coronation. Oxford Economics currently forecasts 0.4% GDP growth in 2023 and a weak 1.3% recovery in 2024 weighed down by increased fiscal tightening. However, at the next iteration these figures are highly likely to be revised downwards again, given the very recent publication of the April inflation data and the associated increase in interest rate expectations.

The MPC increased the Bank Rate by 25bps as expected to 4.5% at its May meeting. The guidance implied that this could be the peak of the current cycle and that further tightening would only occur if there were more upside surprises in the data for activity, inflation, and wages. In due course the headline CPI inflation data for April came in at 8.7%. While this marks a notable fall from the 10.1% recorded in March as the global energy prices base effects fall out of the figures, it was much higher than expected. The troubling driving force was the rise in core inflation in April, driven by the tight labour market, private sector wage growth and services sector inflation.

With unemployment still near historic lows and the prospect of the energy price cap falling from £2,500 to £2,074 in July consumer sentiment improved again in April. Retail sales also increased 0.4% in April and were at their highest since October 2022. This surprising optimism may prove short-lived, however, given the persistence of price rises and the prospect of even higher mortgage rates that haven't yet had their full impact.

The SONIA forward curve (in essence, a market forecast for the Base Rate) pushed out to around 5.5% by the end of this year. Forecasters have typically been more conservative, pointing to a further 50bps rise, but they are tellingly less confident to call the peak this time. The 10-year government bond yield has shifted out to around 4.3% in recent days and hundreds of fixed rate mortgage products have been pulled from the market, reminiscent of the period after last September's problematic "mini Budget". We await further data and updates but recent talk of rate-cutting in 2024 now look premature.

**0.4%** ▲
2023 GDP growth forecast

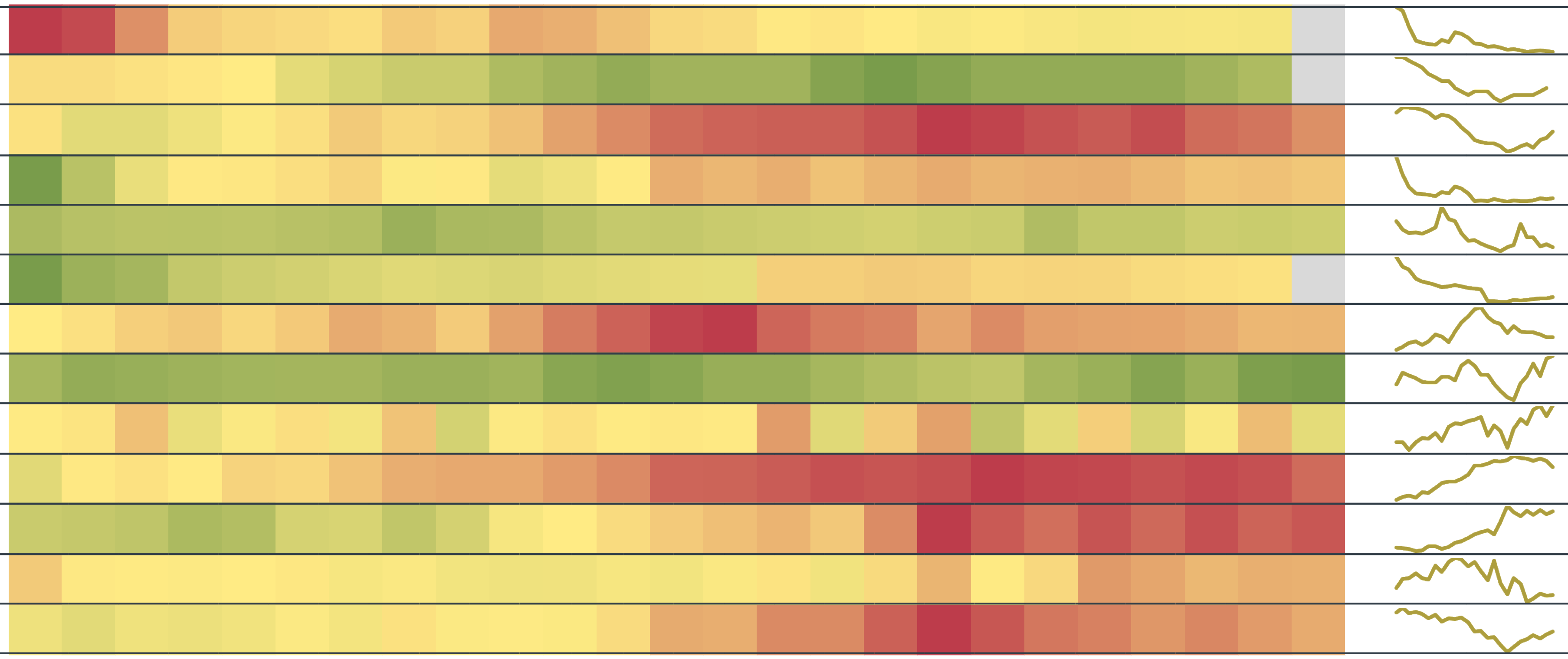
**4.1%** ▲
2023 unemployment rate forecast

**6.5%** ▼
2023 average CPI inflation forecast

**5.5%** ▲
Market forecast of peak UK Bank Rate implied by SONIA forward curve

**The monthly monitor**

Source: Bank of England, IMF, ONS



| | Latest month |
|---|---|
| GDP annual growth | 0.3% |
| Unemployment rate | 3.9% |
| Consumer confidence | -30.0 |
| Retail sales growth | -3.1% |
| Retail sales % online | 25.2% |
| Manf output growth | -1.3% |
| Brent crude (USD/bbl) | 80.33 |
| Gold (USD/oz) | 1,990 |
| FTSE-100 | 7,871 |
| CPI inflation | 8.7% |
| 10-year bond yield | 3.7% |
| EUR/GBP | 1.14 |
| USD/GBP | 1.26 |

Two-year trend Latest month

# Spotlight on...decarbonising the UK energy sector

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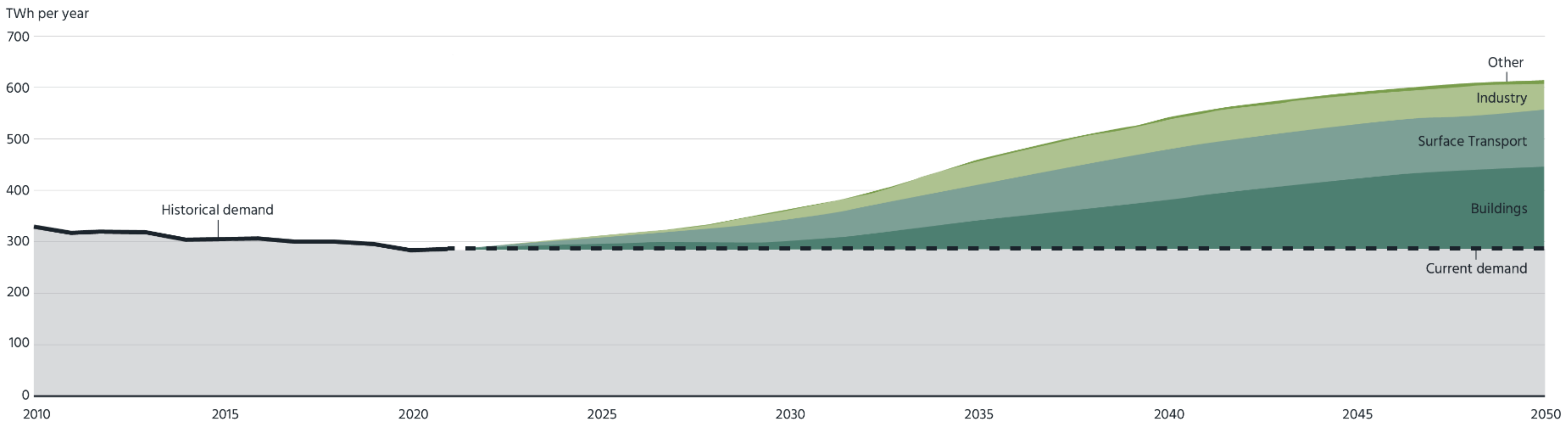
### The UK's path to net zero will significantly increase demand for low-carbon electricity

If the UK is to meet its 2050 net zero target, carbon emissions must fall in all sectors and at a faster rate than over the last 30 years. This will involve the electrification of transport, industry and, importantly, buildings. The Committee on Climate Change's Balanced Net Zero Pathway for the UK estimates that demand for low-carbon electricity will increase by 50% by 2035 and double or even treble by 2050. Decarbonising the energy system is therefore crucial and will require significant investment.

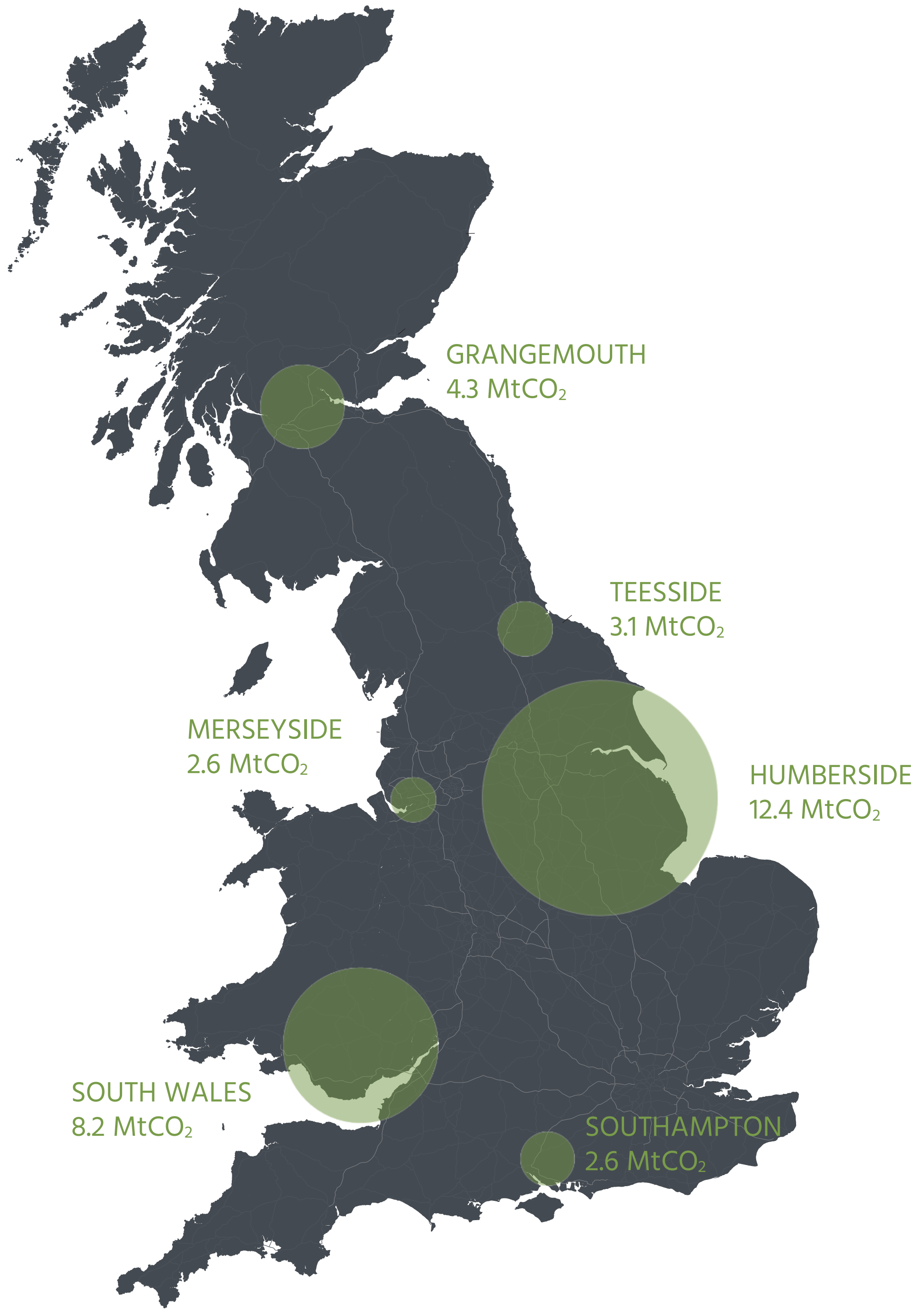
### Areas with greatest carbon emissions are likely to see the greatest inward investment

Areas with the highest carbon emissions are the obvious targets for emissions reductions. In the UK, this includes legacy industrial locations such as Humberside, South Wales and Grangemouth. Reducing emissions from these locations will be key if the UK is to meet net zero targets and is likely to draw in significant investment. Locations which can not only decarbonise but also capitalise on the switch to low-carbon energy production will particularly benefit. Offshore wind is seen as the backbone of low carbon electricity production in the UK, and so coastal locations are likely to be a key focus.

**Electricity demand in the Balanced Pathway**
Sources: BEIS, CCC




**UK INDUSTRIAL CO2 EMISSIONS HOTSPOTS**




$MtCO_2$=million tonnes of carbon dioxide ($CO_2$) emissions per year

# Outlook

**The forecasts have been carried over from the April release until the new projections from our economics provider are made available. The recent increase in interest rate expectations means that while the sector relativities will be broadly maintained, the outlook will be revised downwards in our next update, notably for 2023. In 2022 the various property segment yields concertinaed together so as this is unwound the lowest-yielding property assets (industrial) will outperform the more thinly traded higher-yielding segments (retail) as they re-establish appropriate yield relativities.**

**Industrial** still sits relatively favourably amongst the other major property sectors. There is a significant global weight of capital targeting the sector that has driven some yield compression in the direct market. Strong prime rental growth momentum has been maintained into 2023 across many regional markets in spite of the increased headwinds for occupiers. Void rates may rise somewhat over the short term but rental growth will remain positive for this fundamentally robust asset class that is relatively well placed to contend with the current economic slowdown.

In contrast, **retail** and **offices** have more structural problems to deal with. **Office** prime/secondary polarisation is set to intensify while new development is restricted and new working practices continue to negatively impact occupancy of secondary space. Tenant demand will remain subdued over the medium term while the global economy faces ongoing challenges. The significant capital value falls for **retail** property over the last several years should provide a small offsetting cushion in the form of relatively greater income return.

**Total return and components by sector, April 2023 forecast**

Source: Gerald Eve, MSCI

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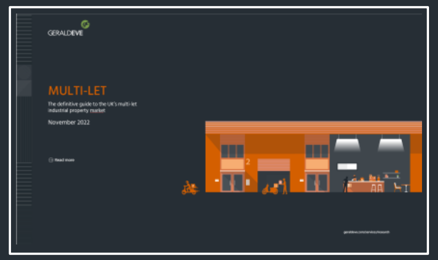
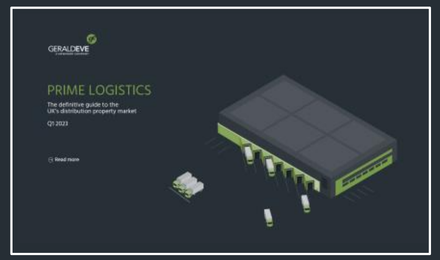
## Further Insight

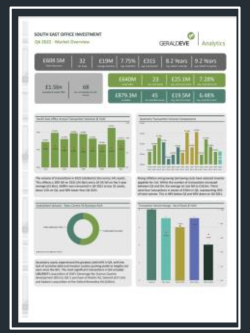


Multi-Let
December 2022



Prime Logistics
Q1 2023

London Markets
Q1 2023



South East Office Investment
Q4 2022

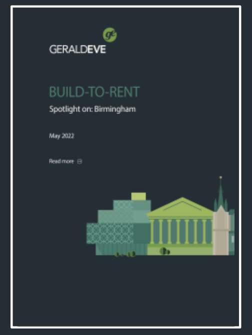
Carbon Offset Contribution - London Benchmarkg
August 2022


MEES - EPC uprating
April 2023


Rating update -
April 2023

Whole life carbon Optioneering
July 2022


Sustainable estate of the future
April 2023



Birmingham BTR
May 2022

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