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IN BRIEF

UK COMMERCIAL PROPERTY UPDATE AND OUTLOOK

December 2023

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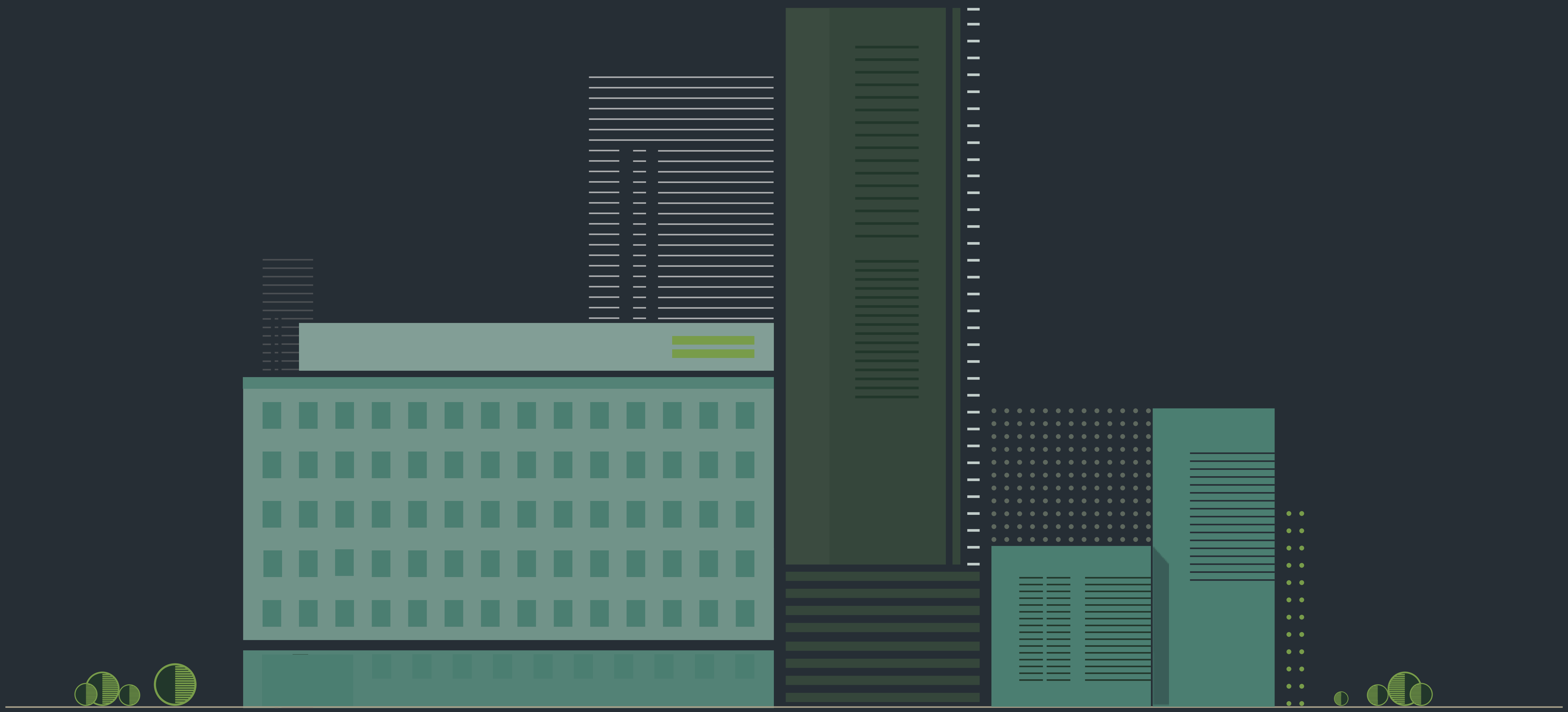

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DECEMBER UPDATE

All Property annual total return jumped again as expected from -7.9% in October to -3.0% in November and could even finish the year back in positive territory. Industrial is once again the outperforming sector as the effects of the late 2022 outward yield shift fall out of the figures. Encouraging December inflation data underlines our position that Q4 2023 will have been the bottom of the investment market and there will be scope for some substantive interest rate cuts from mid-2024. Despite weakness in the real economy, investor confidence is set to pick up next year, with greater depth and competition to the buyer pool.

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

+0.3% ▲	**-93bps**	**1.5%** ▲	**1.6%** ▼	**3.75%** ▼	**3.7%** ▼
Industrial annual total return, November 2023	Drop in 10-year bond yield Oct '23 – 15th December '23	2025 GDP growth forecast	2025 average CPI inflation forecast	End-2025 Bank Rate forecast	End-2025 10-year government bond yield forecast

Industrial annual return turns positive and regains top sector position while the latest inflation figure comes in under expectations

All Property annual total return jumped again as expected from -7.9% in October to -3.0% in November as the base effects of the sharp upturn of property yields in late 2022 continue to fall out of the figures. UK commercial property may yet produce a positive annual return for 2023, but it will effectively be around zero. Net yield softening (notably for offices) will have offset positive income return and rental growth (notably for industrial).

Valuation yields for **industrial** and **retail** have been remarkably stable over 2023, with only some slight softening in secondary markets. In contrast, **office** yields have repriced more actively over the second half of 2023, softening 85 basis points in the six months over May to November. This has been particularly acute for London City offices, which are the worst performing segment over 12 months at -18.4% on the chart overleaf. Meanwhile industrial segments have worked their way from the lower-performing area on the right to a relatively stronger position on the left. Indeed, UK industrial has reclaimed its outperformer status and was the first sector to post a positive annual total return in November of +0.3%.

Headline CPI inflation slowed to 3.9% in November from 4.6% in October, with core inflation and domestic services inflation components coming in under expectations. The MPC maintained the Bank Rate at 5.25% in December and continued to stress the need for restrictive policy for an extended period. However, the markets are increasingly factoring in some substantive Bank Rate cuts in the second half of 2024 and particularly in 2025 to support the economy. This has been reflected in 10-year government bond yields, which fell from 4.7% in October to 3.8% as at 15th December and will likely ease further.

Intensified geopolitical risk aversion and the corresponding investor hiatus means that Q4 investment transactions were low and will likely prove to have been the bottom of the market in this cycle. Yields in the direct market should have softened around 25bps but valuers are under pressure to maintain LTV covenants so this will likely lag into 2024 or may be smoothed off altogether.

Despite weakness in the real economy, investor confidence is set to pick up over 2024, with greater depth and competition to the buyer pool. Pension funds, which were largely absent in 2023, will likely make a comeback. Current key sellers are the defined benefit pension funds seeking to de-risk and meet outstanding payout obligations. Into 2024 retail funds will likely face further redemptions and look to make some sales as household investors divest to pay down mortgage debt. Local authorities under financial pressure will also likely need to sell assets to free up capital. And further consolidation is likely in the REIT market.

Lower interest rates in 2024/25 could provide a boost for property returns, not only on the financing side, but also by giving occupiers more confidence and ability to invest in their business operations. The mitigating factor is that property yields are still below where the monetary fundamentals suggest they should be, and this will limit yield compression and upside returns over the medium term.

+0.3%▲

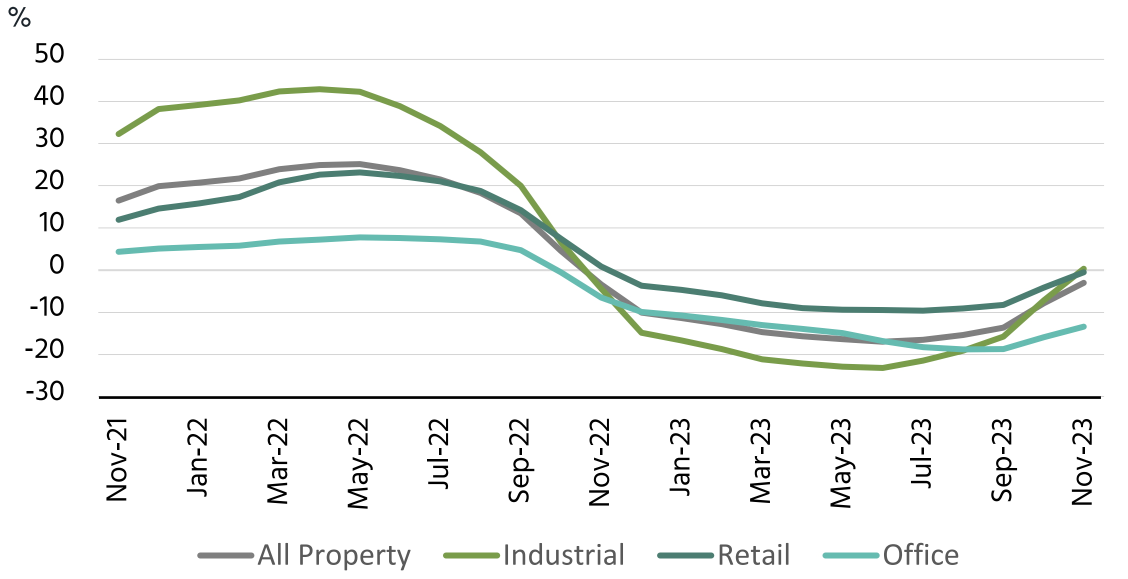
Industrial annual total return, November 2023

-93bps

Drop in 10-year bond yield Oct '23 – 15th December '23

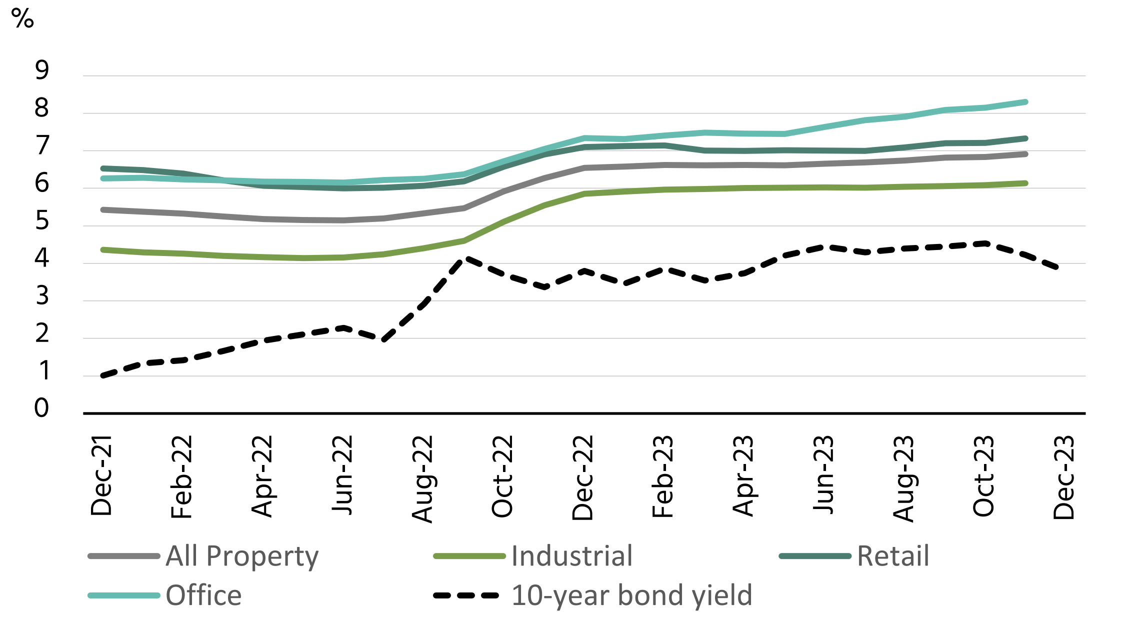
Annual total return by sector

Source: MSCI



Equivalent yields by sector and 10-year bond yield

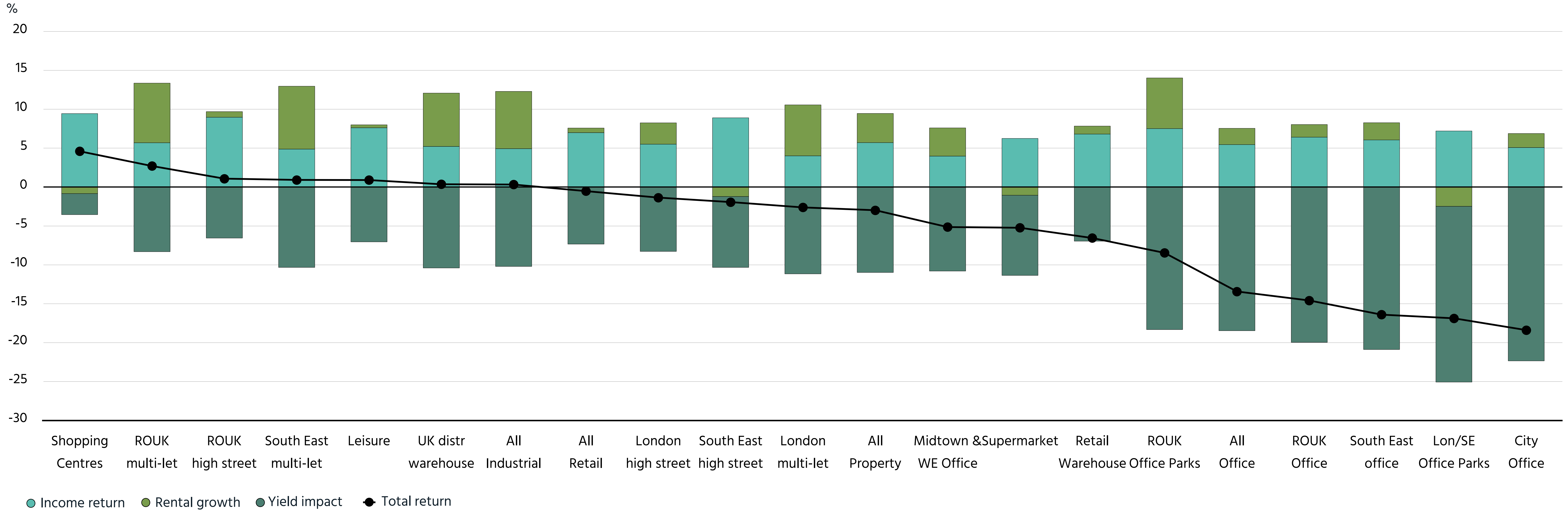
Source: MSCI



UK property segments

12-month return to November 2023

Source: Gerald Eve, MSCI



UK economy

The final quarter got off to a weak start and UK GDP fell by 0.3% month-on-month in October, losing all ground gained over the previous two months. The breakdown showed that all three of the major sectors shrank for the first time since July. The monthly national accounting data have been noisy over 2023 and GDP is likely to have modestly increased again in November. But with more industrial action planned over December and January, this time from junior doctors, the path will continue to be bumpy.

Forward-looking survey data improved again in December and moved into moderately expansionary territory for services firms, though manufacturing weakness has persisted. The combination of high interest rates and strong growth in wage costs have contributed to rising financial stress, with corporate insolvencies increasing over 2023 to rates not seen since the financial crisis, though they remain well below the magnitude of that period.

Oxford Economics has increased its annual GDP forecast for 2024 from 0.4% to 0.5% on the back of some small giveaways announced in the Autumn Statement. Notably, the rate of employee national insurance contributions will be cut from 12% to 10% from January 2024. This is in the context of a significant fiscal policy tightening over the next several years, which will dampen output generally. A gradual recovery is forecast, however, with GDP growth of 1.5% pencilled in for 2025.

Headline CPI inflation slowed to 3.9% from 4.6% in October, with core inflation and domestic services inflation components coming in under expectations. Most of the decline in headline inflation this year has been driven by energy-related base effects, which are now in the past. However, the data suggest that the upward pressures from a tight labour market and strong pay growth are beginning to fade.

The MPC maintained the Bank Rate at 5.25% in December and continued to stress the need for restrictive policy for an extended period. However, this language is more of a policy tool to try prevent financial conditions from loosening prematurely while inflation is still above target. Oxford Economics forecasts a 50bps cut to support the economy by year-end 2024 and for the Bank Rate to fall to 3.75% by end-2025. This could even prove conservative and the broadly more dovish outlook has been reflected in 10-year government bond yields, which fell from 4.7% in October to 3.8% as at 15th December.

1.5% ▲
2025 GDP growth forecast

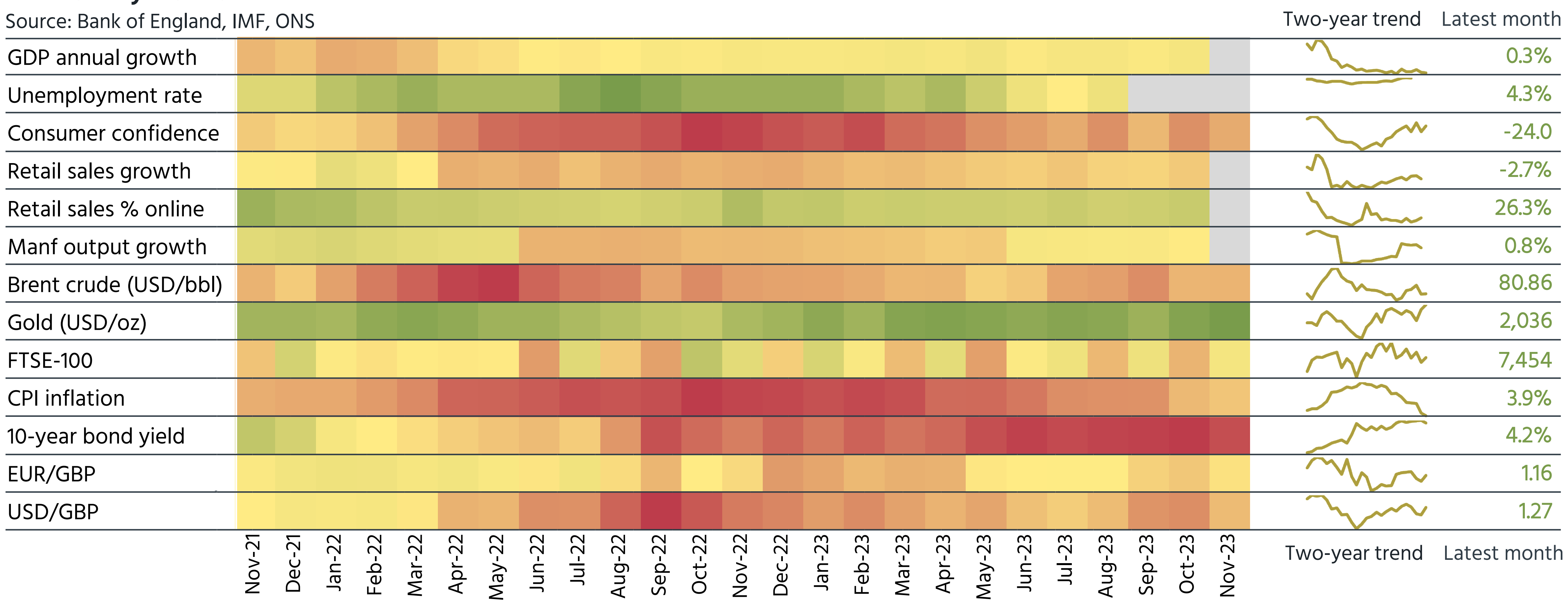
3.7% ▼
End-2025 10-year government bond yield forecast

1.6% ▼
2025 average CPI inflation forecast

3.75% ▼
End-2025 Bank Rate forecast

The monthly monitor

Source: Bank of England, IMF, ONS



Outlook

Interest rates have peaked at 5.25% and monetary policy will probably turn out be able to be more accommodating from late-2024 than currently signalled. But the upside potential for property returns will be limited, given that current commercial property yields continue to be below where the monetary fundamentals suggest they should be. All Property annual total return is set to be effectively zero in 2023, with positive returns from industrial and retail driven by income return (and rental growth in the case of industrial) while office returns suffer some significant losses through outward yield shift. Annual property returns should continue to trend upwards thereafter as yields discontinue any softening (notably for offices) and rental growth comes back in line with the economic recovery.

The resilience of the **Industrial** occupier market will continue to appeal to investors and has maintained yield pricing in the prime markets. Rental growth may have cooled, but this is from very strong rates in 2021/22. Void rates and default rates are likely to continue to rise and peak in 2024, but well below previous downturns. We remain relatively upbeat on the sector and expect nominal rental growth to remain positive.

In contrast, **retail** and **offices** have more structural problems to contend with. **Office** prime/secondary polarisation is set to intensify as alternative working practices allied with EPC obstacles continue to negatively impact occupancy and investment demand for secondary space. Meanwhile households and retailers are in for another challenging year. The significant fall in capital value for retail assets 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, December 2023 forecast
Source: Gerald Eve, MSCI

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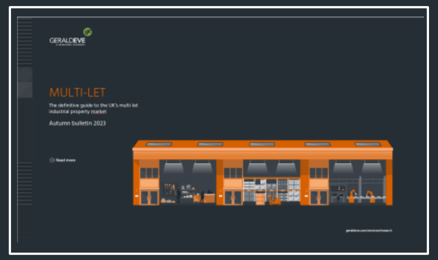

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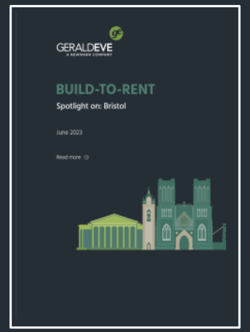

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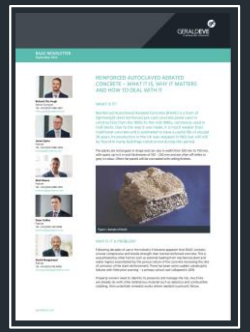
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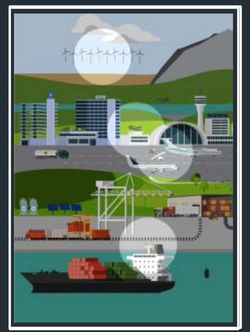
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