Mayfair Capital Investment Management

UK Economic and Property Market Update: Q1 2021

MAYFAIR CAPITAL
Member of Swiss Life Asset Managers

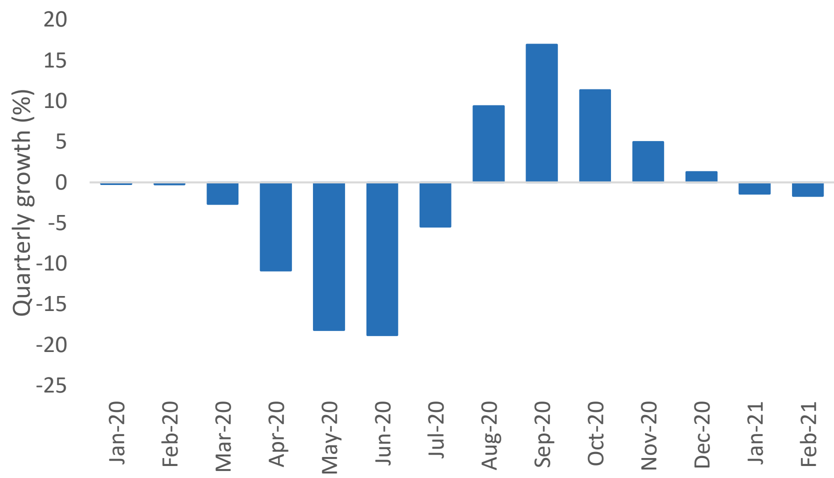
UK Economic Overview:

The UK economy has endured the latest coronavirus wave and associated government restrictions better than had been expected. Q1 GDP contracted far less than in previous lockdowns as more productive output was maintained. This is likely to reflect the extent to which firms have adapted in response to the pandemic. Many retailers now offer click-and-collect, for example, and hospitality firms are set up for take-away and delivery. Office-based companies have systems and IT infrastructure in place to enable full remote working. Construction and manufacturing sites remain open. As a result, many forecasters have upgraded their growth assumptions for the year.

PMI readings recovered strongly in March. All three main sectors were in expansion territory with the critical services sector up to 56.3, its strongest reading since August. Deloitte's UK CFO survey for Q1 showed business optimism at a 14-year high. Hiring and investment plans reached a 6-year high. This was underpinned by the agreed UK/ EU trade deal and a clear vaccine-backed route out of the pandemic.

The UK/ EU trade deal is far from perfect but it nevertheless provides certainty by removing the no-deal risk. In March the UK and EU agreed a Memorandum of Understanding regarding financial services which creates a forum in which to discuss regulatory cooperation. This is an essential precursor to agreeing European market-access rights for the City, although a comprehensive financial services deal remains elusive.

UK GDP: More limited impact from the latest lockdown



Source: ONS/ Macrobond (April 2021)

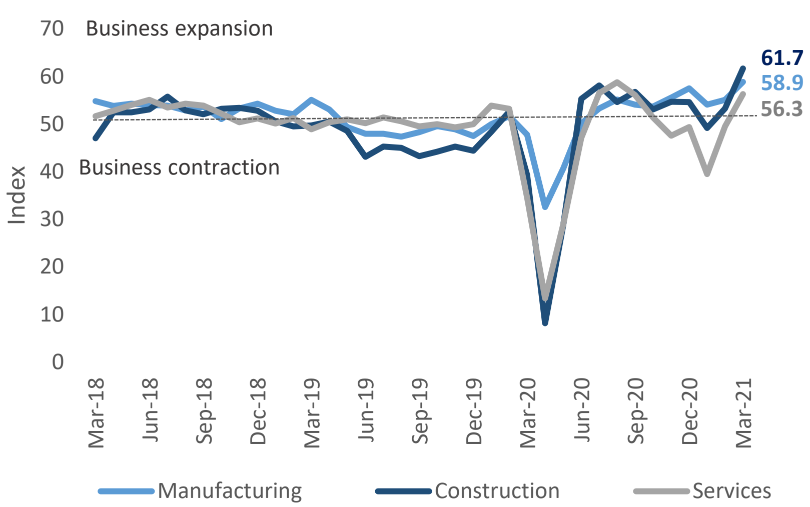
The realities of the Brexit deal have led to border challenges for physical goods. This is notable despite the UK having delayed the implementation of full border checks until 2022. UK firms are adapting fast which, in many cases, involves opening foreign subsidiaries to fulfil orders which would otherwise have been routed through the UK. This will diminish some of the UK's future growth potential. Customs challenges will gradually be resolved but weaker foreign industrial orders may persist.

Despite 4 million fewer workers being furloughed in January compared to the first lockdown in April 2020, unemployment remains relatively low. Quarterly unemployment actually fell by 20 basis points to 4.9% in February. In March the Office for Budgetary Responsibility revised down its peak UK unemployment forecast to 6.5%. Households have amassed an estimated £180 billion of savings during the pandemic according to the Bank of England. The latest YouGov/ CEBR survey finds consumer confidence at its strongest since August 2018. With the vaccination roll-out proceeding rapidly and over 31 million people receiving the first dose by the end of March, a consumer-spending backed economic rebound commencing in Q2 appears likely.

We believe Q2 UK economic growth will outperform all other major industrialised countries. Overall we anticipate GDP growth of 5.3% in 2021 and 4.3% in 2022. If correct, this would make the UK the fastest growing large western economy next year. 10-year gilts yields rose to 0.8% at the end of Q1 compared to 0.4% at end-Q4 2020 as markets priced in rising post-pandemic inflation. We still foresee a relatively benign short-term inflationary environment. Annual inflation was 0.7% to March according to the ONS. Despite a rapidly growing economy, we expect inflation to average 1.4% this year and 1.6% in 2022.

In the near term, local elections in May will create some domestic political uncertainty, particularly in Scotland if the SNP perform as well as expected on a pro-second independence referendum platform. If the SNP gain a majority and try to unilaterally force a second referendum it could trigger further uncertainty, although it is far from certain that they would seek to do so. We see this as the a major short-term economic risk.

UK PMI: Business activity is expanding



Source: IHS Markit/ Macrobond (April 2021)

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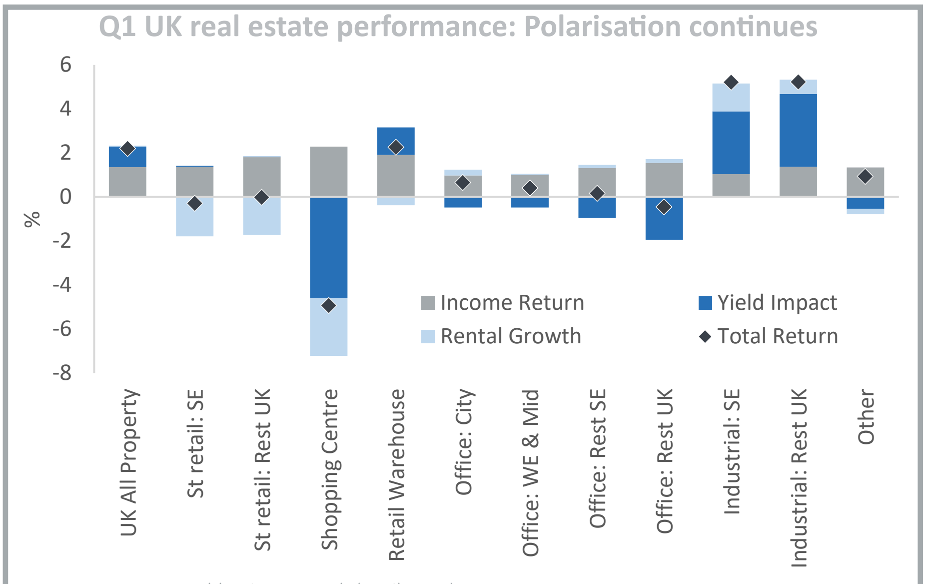
UK Property Market:

UK real estate investment volumes amounted to £8.9 bn in Q1, a 13% reduction on the first quarter last year and 19% down on the five-year Q1 quarterly average. Activity over the last 12 months has been concentrated on industrial and residential property with volumes up 71% and 43% respectively compared to the previous year. Retail volumes fell by 48% whilst office volumes were broadly comparable. The market has been constrained by uncertainty, a lack of quality stock and restrictions on international and domestic travel. We expect volumes to grow throughout 2021 in line with the wider economy.

The UK All Property quarterly total return was 2.2% in Q1. Annual returns reached their highest level since March 2020. This reflects improving economic fundamentals, a clear path to reopening retail and offices and the attractive spread of property yields over gilts which is at an all-time high.

February's IPF Consensus forecasts predicted an All Property total return of 2.1% in 2021, held back by retail. Following a -6.3% fall in 2020, capital values grew by 0.8% in Q1 according to MSCI, driven by industrials and slowing retail capital loss. There was wide performance divergence between and within sectors but we expect capital values to advance across most sectors over 2021. However, because the pandemic has served to accelerate structurally-driven change, polarisation will become more pronounced. Clear winners and losers will emerge across segments, locations, and assets.



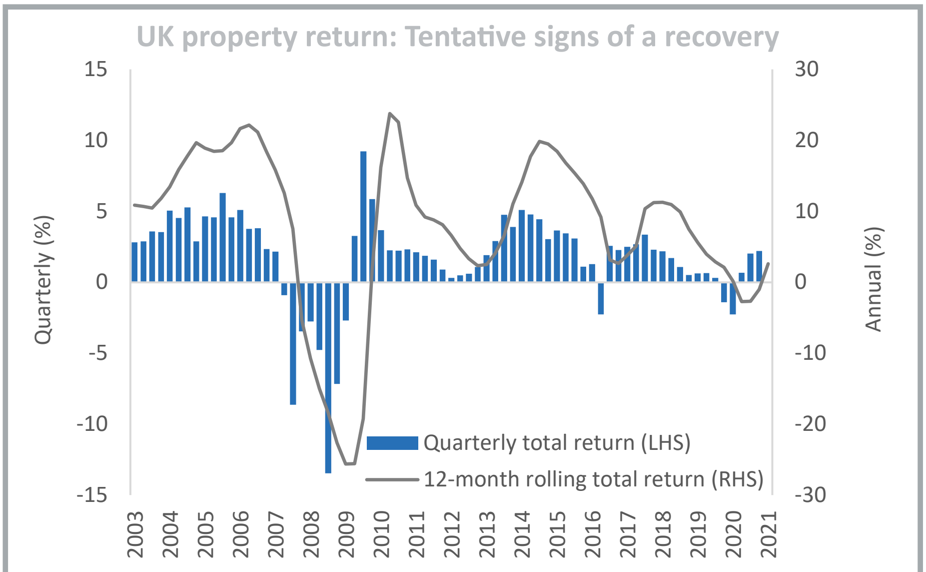
Source: MSCI UK Monthly Digest March (April 2021)

Based on the MSCI monthly index, offices returned 0.1% over Q1 with capital loss of -1.1%. City offices recorded the highest total return of all office segments. Occupational activity was limited, with take-up in the City and West End offices down 54% and 76%, respectively, compared to Q1 2020. It was a similar story in regional markets. In our view low take-up is a reflection on the inability of occupiers to re-occupy space, rather than a fundamental lack of demand. Due to the pandemic, occupiers are reassessing their space needs to reflect greater home-working which is likely to reduce short-term aggregate demand. Demand will converge on the best assets in the best markets, where supply is limited. This will cause rapid performance divergence between prime and secondary assets and locations. Relatively high office yields compared to European markets creates scope for compression, especially for good quality London stock.

The industrial sector continued its strong performance into 2021, returning 5.2% over the first three months of the year. Take-up of big box warehouseses (> 100,000 sq ft) was 34% above the long-term average at 8.8 m sq ft according to Savills. Vacancy rates of 5.4% were at their lowest level since 2016 as supply across prime markets remained constrained. Online spending growth and supply chain recalibration should sustain demand this year.

Retail remains weak with the sector returning 0.6% in Q1 despite robust retail warehousing performance of 2.3%. Retail warehousing capital value loss has been slowing and was positive on a monthly basis in March. This may imply the segment has levelled out, dependent on tenant line-up and income profile this will vary significantly between assets. Shopping centre values were down -4.9% over Q1. Lifted lockdown restrictions and high savings ratios should support sizeable consumer 'revenge spend' in Q2 and beyond. Physical retail and leisure facilities in affluent locations should see a strong trading boost. For weaker assets and locations, high vacancy and limited demand will require landlords to consider repurposing.

As restrictions ease, the effects of the pandemic recede and Brexit fades, we believe the UK property market is well placed to see a strong recovery in 2021 which may outperform market expectations. Polarisation means stock selection is more important than ever requiring a thematically-based investment strategy to target winning assets.



Source: MSCI UK Monthly Digest March (April 2021)