UK Economic Update

UK GDP grew by 0.3% in the three months to August, following a 0.2% contraction in Q2 2019. Growth was attributable to stronger services sector performance, in particular knowledge-based professional, scientific and technical services. Manufacturing sector output deteriorated over the period despite receiving a boost from car production restarting after the April shutdown. Whilst this data suggests that the UK will avoid a technical recession in Q3 2019, forward looking indicators are weighted to the downside at present.

The composite PMI reading in September fell further into contraction territory with the construction, manufacturing and service sectors all reporting falling activity. Performance would have been even worse had it not been for renewed stock-piling activity in the manufacturing sector ahead of the current 31 October Brexit deadline. A growing proportion of businesses in all sectors reported falling employment.

Global growth is slowing but the UK's deceleration is predominantly due to Brexit-related nervousness which is deterring private investment. ONS data for Q2 2019 indicated a 1.4% fall in business investment year-on-year, with ICT expenditure especially weak. The latest Deloitte UK CEO survey shows an intense focus on cost control which is at its highest ever recorded level. One-third of UK CFOs have now reported high or very high uncertainty for four consecutive quarters, an unprecedented level of persistence. Capital expenditure is being curtailed and 70% of CFOs expect hiring to fall over the next 12 months which implies weaker near-term employment and wage growth.

The UK’s labour market and retail spending have been resilient over the last three years despite the uncertainty, but the latest data suggests this may be changing. Over the three months to August the UK’s unemployment rate rose by 10 bps to 3.9% and the number of job vacancies fell to their lowest level in nearly two years. Real wage growth remains strong, at 1.9% in August, but retail spending is moderating. Monthly retail sales volume growth was flat in September following a decline in August. On a rolling three month basis, sales volumes were up just 0.6% compared to the previous quarter. More cautious household spending habits reflect weakening consumer confidence measures.

The economic outlook remains highly uncertain and much will depend on the outcome of political wrangling in the UK and Europe over the next few weeks. Our base case is that GDP growth will be modest but positive, equivalent to 1.3% in 2019 and 1.1% in 2020. This will support a continuation of the relatively benign inflation environment in the short-term. A further devaluation of Sterling has the potential to result in an inflation spike but under current conditions it is thought this would short-lived.

The Bank of England has issued increasingly dovish comments and has implied that it may cut interest rates should Brexit uncertainty persist in the context of a weaker global economy. Consequently, the next Base Rate movement may well be a cut early next year. Even if this does not materialise, the low interest rates, low inflation environment appears set to persist, which should continue to be supportive of real estate pricing.
UK Property Market Update

Property market liquidity reduced over the summer but there is no sign of distress in the market. Instead buyers and sellers are choosing to sit on the side lines due to growing uncertainty about the Brexit outcome. PMA recorded 292 commercial property transactions over Q3 2019 totalling £8.9bn, which is 34% below the 10 year quarterly average. Assets that are trading include alternatives and non-retail, good quality assets with long leases to strong covenants. Pricing for these assets has remained robust. For poorer quality assets with shorter income or perceived capex risk, appetite from buyers is thin. Where there is interest, there is a widening gap between the aspirations of buyers and sellers.

Local authorities have been active in the market but an increase in their financing costs may alter their asset pricing. This will impact those segments where they have been the most prominent investors. Overseas capital has been less active but could increase, particularly if there is clarity around Brexit. Sterling has proved volatile and further currency movements may provide opportunities in the short term.

The MSCI All Property UK (monthly) Index suggests the annual total return at the end of Q3 2019 had slowed to 2.9%, down from 7.5% at the end of 2018, with capital values falling 2.3% year-on-year. Headline numbers continue to be skewed by weak retail sector performance. Across most other segments, capital values have been more stable. Performance of alternative sectors remains robust. The MSCI Monthly Index recorded quarterly returns of 3.0% and 1.4% in residential and Other, respectively.

Offices returned 1.4% over Q3, based on the monthly index. This was marginally higher than Q2, reflecting an improved performance in London, following several strong prime transactions. Capital values increased across the office sector, except for the South East where the impact of rising yields offset positive rental growth. Rental increases in the Rest of UK segment continue to support capital values. Rents grew 0.8% over the quarter in this segment, reflecting the lack of Grade A supply in many cities.

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The MSCI Monthly Index recorded an industrial total return of 1.7% in Q3. Values increased by 0.6% due to rental increases of 1.0%. This masks a diverging trend between the South East and Rest of UK. Although rental growth is similar in both, pricing movements in the Rest of UK market have offset this, resulting in modest capital value loss of 0.1% over the quarter. In contrast, yields in the South East have been stable and capital values have increased 0.9%. This may reflect that investors are anticipating weaker rental growth in the regions given current rental values, a development response in some areas or concerns about the manufacturing sector.

All retail segments recorded a negative return over Q3, according to the MSCI Monthly Index. All retail returned -1.5% in Q3 with capital values falling 3.1%. On an annual basis, capital and rental values are down 11.1% and 4.3% respectively. Further declines are anticipated in the short term but during 2020 we anticipate some improvement for select retail warehouses as the market is rebased.

Away from the retail sector, many of the underlying property fundamentals are in good shape. Relative pricing is attractive, leverage is at low levels and there are acute shortages of good quality space. These factors should support capital values but performance over the short-term will be determined by domestic and international geopolitical developments.