Mayfair Capital Investment Management

UK Economic and Property Market Update: Q1 2019

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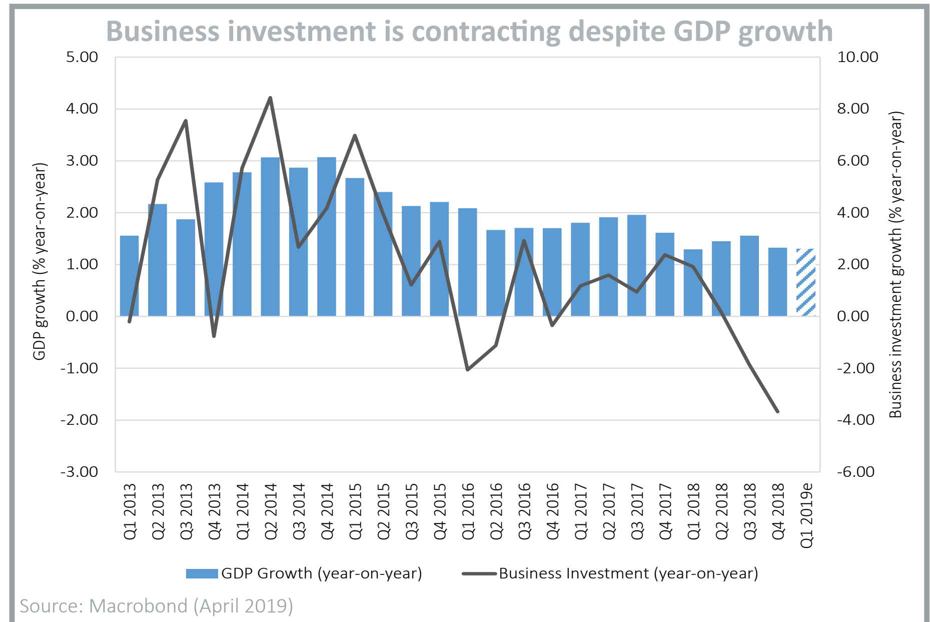
UK Economic Update

UK GDP grew by 1.4% in 2018, the slowest rate since 2009. Growth of just 0.2% was recorded in Q4. Quarterly GDP growth of 0.3% to end-February 2019 is an improvement but is still poor by historical standards. Growth is being fuelled by government spending and consumer consumption with business investment impacting negatively.

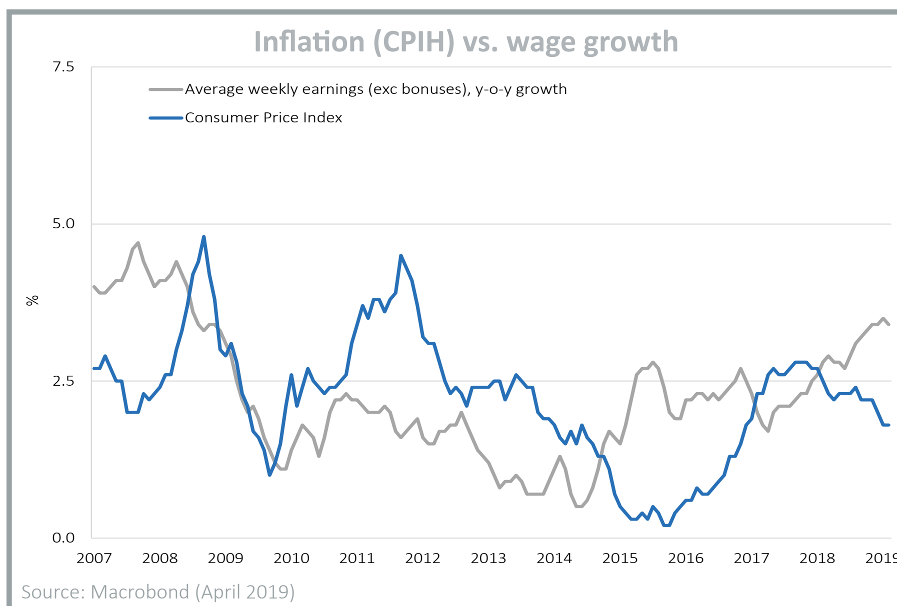
Business investment fell 3.7% in 2018 as firms delayed or shelved non-essential spending. In part this reflects a broader global economic slowdown but mainly it was due to the lack of clarity regarding the UK's future trading relationships. March PMI readings for the services and construction sectors indicated contraction. UK services recorded falling new orders for the third consecutive month with political uncertainty blamed. Overall the UK PMI reading in March was neutral due to expansion in the manufacturing sector. This was attributed to manufacturers ramping up production and stock-piling ahead of the 29 March, rather than underlying strength.

The Q1 2019 Deloitte CFO Survey indicates that corporates are prepared for turbulence. Around 44% are prioritising defensive strategies compared to 31% a year ago. The amount of cash being held is at a record high. This preparedness is consistent with the Bank of England's agents surveys which show that 80% of companies say they are ready for a no-deal Brexit. A no-deal Brexit remains a real risk so it is reassuring that corporates are treating it as such.



Source: Macrobond (April 2019)

One short-term upside of uncertainty has been to encourage investment in labour, which is more flexible than capital expenditure. Employment remained at a 45-year low of 3.9% in February. Staff shortages are evident in many sectors leading to upwards wage pressure. With inflation holding at 1.8% so far this year, real wage growth is accelerating. This has bolstered consumer spending – up 6.7% in March on a volume basis (i.e. net of inflation) – despite uncertainty and a subdued housing market keeping consumer confidence low. UK households have now been net borrowers for nine consecutive months and they could be vulnerable if the economy deteriorates.



Source: Macrobond (April 2019)

In terms of forecasts, our base case scenario assumes that a no-deal Brexit will be averted and a deal reached. Should that occur we anticipate GDP growth of 1.3% this year and next. Inflation is expected to remain below target in 2019 at 1.9%. This will alleviate pressure for an interest rate rise and we believe that the Bank of England is unlikely to alter its monetary policy until there is more clarity on the future direction of the UK.

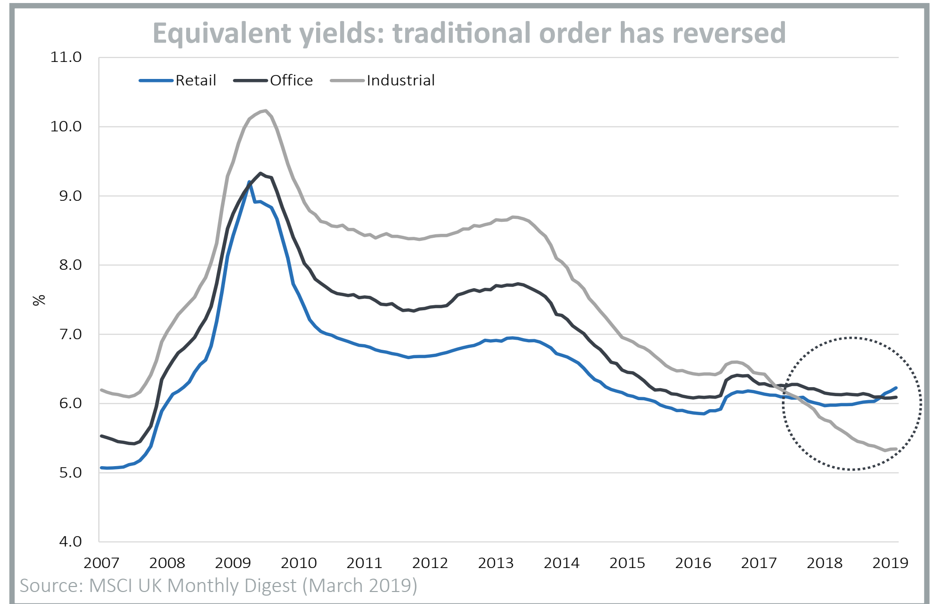
The date for the UK's departure from the EU has been moved back to 31 October and thus the fog of uncertainty will endure for the foreseeable future. Once a deal is reached, it should herald a slow and steady improvement in the economic climate. The UK economy has strong underlying potential and our forecasts imply UK growth for the next two years could exceed that in the Eurozone if some of this is realised. While interest rates may increase under this scenario, we continue to anticipate a low interest rate environment over the medium term. Slower global growth is also expected, which will constrain UK growth. This slowdown is expected to be modest but the UK is exposed should political or economic shocks cause this slowdown to occur more rapidly than we anticipate.

UK Property Market Update

The real estate investment market has mirrored the economy with Brexit uncertainty weighing on activity in Q1. Since summer 2016, quarterly investment volumes have averaged £15.8bn, but just £8.8bn traded in Q1 2019. Investment in retail assets has fallen particularly sharply as a growing number of retailer failures and CVA activity compounds wider macro-economic concerns. However, office investment has also declined, reflecting weaker activity in Central London and fewer large ticket transactions.

While overseas buyers have remained net investors, their market share has fallen. With the exception of the Middle East, capital inflows have slowed from all regions and in particular from Asia Pacific and Europe. Capital from these regions accounted for 60% of overseas investment last year, compared with just 20% so far in 2019. We expect this capital to return to the UK if some of the Brexit uncertainty is resolved.

Real estate performance echoes the subdued investment market. MSCI All Property total returns* slowed to 0.5% in Q1 2019, down from 1.1% in Q4 2018 and 2.3% over the equivalent period last year. This is being driven by price softening across most segments. Consequently, with the exception of SE industrial, capital growth was absent from the market. Pricing has weakened most notably in the retail sector. Over the last 12 months, equivalent yields have diverged and retail yields are now above industrial and office yields, reversing the traditional order.



Source: MSCI UK Monthly Digest (March 2019)

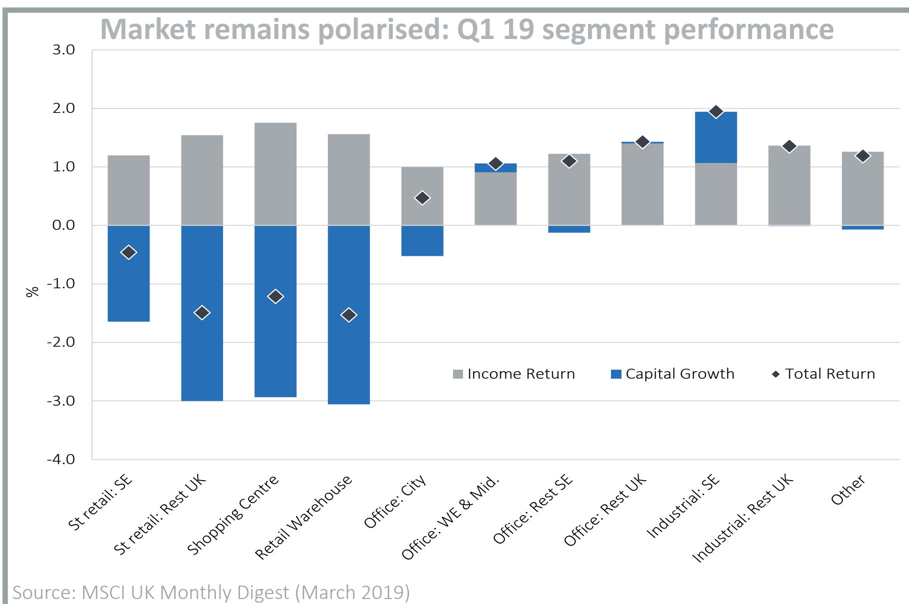
Offices returned 1.1% in Q1 2019 as capital values softened 0.1%. Rest of UK offices outperformed returning 1.4% in Q1. London City was the weakest office segment, recording a quarterly total return of 0.5%. Rents increased in the City (+1.3%) and Rest of UK (+0.8%) but were largely flat elsewhere. Pricing is holding firm in the SE and regional markets but has softened in the City. This has driven the underperformance.

The industrial sector remains the strongest performer of the traditional sectors, returning 1.7% in the first quarter. However, this is down from 3.4% in Q4 2018. Capital values increased but the pace of growth has slowed from 2.2% to 0.6%. This is due to the absence of yield compression in Q1 as rental values have continued to rise steadily. Capital values were flat across the Rest of UK and therefore, the South East outperformed, returning 1.9% in Q1 compared with 1.4% across the rest of the UK.

Structural changes and retailer distress continues to drive negative investor sentiment towards the retail sector. Retail returned-1.3% in Q1 2019 as values declined 2.8%. This has been driven by a combination of rent and yield softening. Retail rents have been falling since April 2018 and are down 3.6% cumulatively since then but we believe there is some way to go before a floor is found. Central London retail, solus units and supermarkets have proved most resilient to date, with shopping centres, retail fashion parks and standard retail outside London recording the greatest falls in value.

A further moderation in real estate performance is anticipated but the outlook remains highly uncertain. In light of a more subdued property market and potential for increased volatility, we continue to invest with a long term view, using our thematic approach to identify assets and locations that will remain in demand from occupiers.

* All MSCI performance data sourced from the March monthly digest.



Source: MSCI UK Monthly Digest (March 2019)

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