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IN BRIEF

UK COMMERCIAL PROPERTY UPDATE AND OUTLOOK

August 2022

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AUGUST UPDATE

All Property quarterly total return fell sharply again in July to only 1.4%, which was its lowest value since October 2020. This downward trend in property performance was not unexpected, set against rising debt costs and a deteriorating economic outlook that is mired in uncertainty. However, it was a larger fall than anticipated. There has been a marked shift in sentiment over the past three months that has unambiguously resulted in a buyer's market for investors but presents a more complex picture on the occupier side.

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1.4% ▼	4.1% ▲	0.3% ▼	18.6% ▲	23.3% ▲	13.5% ▲
All Property quarterly total return, July 2022	SONIA implied base interest rate forecast, March 2023	Oxford Economics 2023 GDP forecast	Citigroup peak CPI inflation, forecast Jan 2023	Raw materials input price inflation, July 2022	Construction cost inflation, July 2022

Total return drops sharply in July

All Property quarterly total return fell sharply again in July to only 1.4%. This was its lowest value since October 2020 and the first quarterly negative yield impact since August 2020. This downward trend in property performance was not unexpected, set against the deteriorating economic outlook that is mired in uncertainty that has created a shift in sentiment for commercial property, particularly for investors, since May this year. Nevertheless, valuations-based measures such as MSCI tend to lag and this drop is arguably quicker than anticipated, which demonstrates the magnitude of the impact.

There has been a marked shift in capital markets over the last three months, due principally to rising interest rates and debt costs as inflation has spiralled upwards. Ultra-low commercial property yields have become unsustainable as deficit financing cannot be supported for long, and all-in debt costs have effectively doubled in the last 12 months. Risks on the magnitude of interest rate hikes remain to the upside and forward-looking financial market interest rate benchmarks such as SONIA suggest continued increases this year and a Bank rate of over 4% by early 2023, which could narrow the buyer pool further up the risk curve.

Monthly MSCI data are volatile, but the July figures suggest that lower-yielding industrial yields moved out the most, with distribution warehouses adding 13bps. Meanwhile, already heavily discounted shopping centres moved out only 1bp. However, this is early days and direct data from the prime industrial market suggests prices have already dipped by 75bps or more.

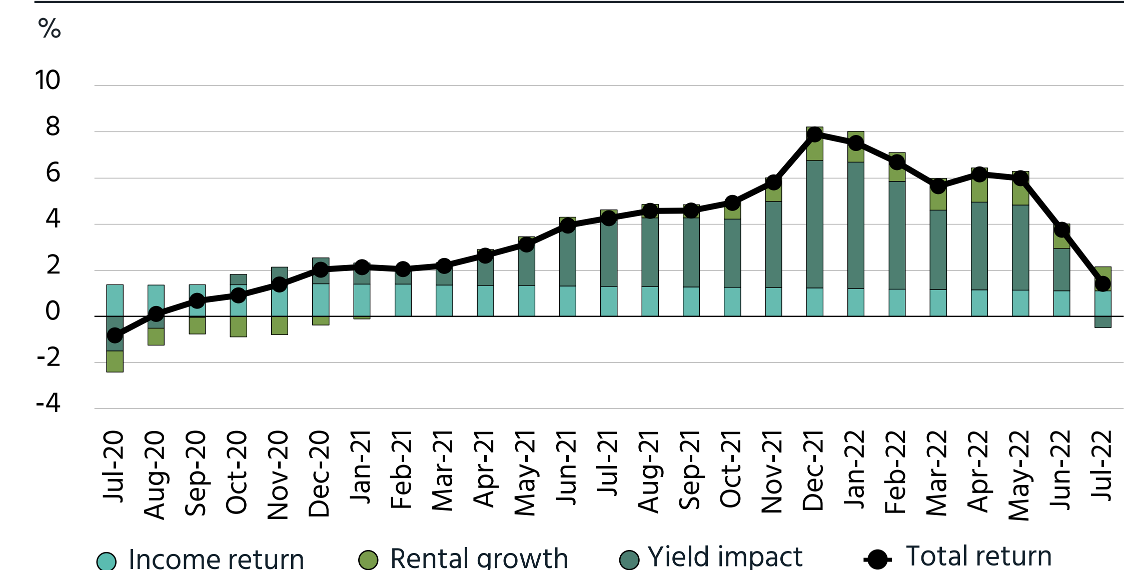
There are currently far fewer buyers in the commercial property investment market, and those with genuine conviction are therefore able to benefit from lower prices and far less competition to secure stock. Furthermore, such buyers have a great deal of choice and they can focus their attention on properties they really want to own, meaning best-in-class assets are the most liquid. Liquidity across commercial property remains inconsistent and so vendors need to be careful to adopt the right marketing strategy and maintain an open mind on pricing.

The investment market is undoubtedly a buyer's one, whereas the occupational market is more complex. Consumer sentiment is at a record low, business indebtedness is elevated from Covid, and the effective interest rate is rising. Insolvencies have trended sharply upwards of late, but this may still turn out to be a shakeout from the subdued period of insolvencies during Covid where there was significant government support. However, in many occupier markets rents have already either dropped substantially (retail) or occupier demand continues to outstrip supply (industrial). Development has also become challenging against the backdrop of build cost inflation, product availability and high land values which has helped keep supply constrained.

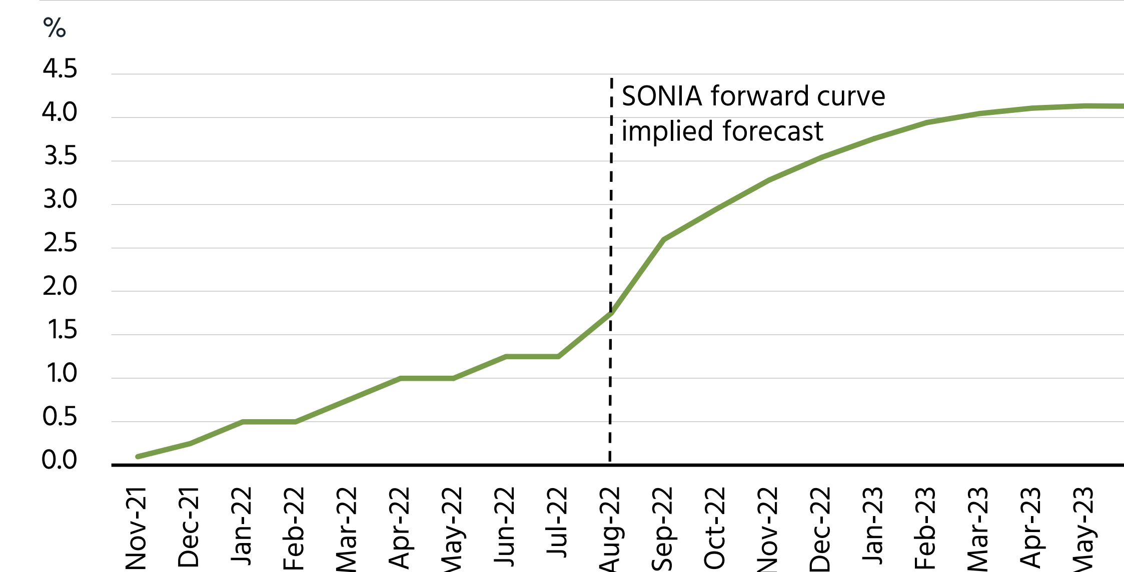
1.4% ▼
All Property quarterly total return, July 2022

4.1% ▲
SONIA implied base interest rate forecast, March 2023

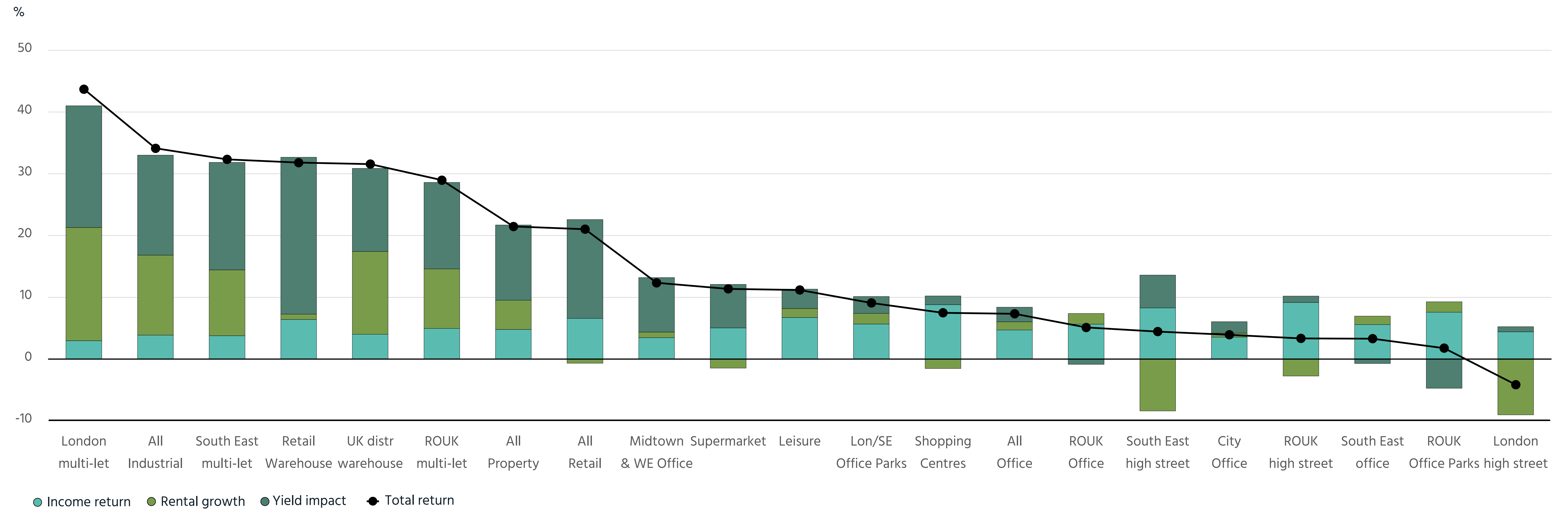
All Property quarterly total return and components
Source: MSCI



Bank base interest rate
Source: Bank of England, Chatham Financial



UK property segments



UK economy

UK GDP fell 0.6% month-on-month in June and Oxford Economics has cut its forecast for annual GDP growth for 2023 again by a further 0.5 percentage points to just 0.3%. Unlike several other commentators, including the Bank of England, Oxford Economics does not yet forecast a recession. However, the consumer sector is already in recession and is expected to be a drag on GDP until at least mid-2023, though this seems optimistically mild.

Retail sales were 5.8% lower in June than a year earlier. Both food and non-food retailing was down but sales of household goods have been particularly affected, with a near-18% drop in June. Online spending has fallen commensurately and the proportion of online retail sales has settled at around 25% post-Covid.

Real incomes are expected to fall by more than 5% between Q1 2022 and Q1 2023. In principle households could take on new credit and spend some excess saving accumulated during the pandemic. However, the saving ratio is already very low and even if it falls to its lowest ever level next year it will not be sufficient to stop consumer spending contracting.

UK CPI inflation rose to 10.1% in July, a 40-year high. Various other business input cost measures are similarly into double digits. The wholesale prices of gas and oil have come off their recent highs but there is still momentum across a wide range of global goods and sectors. And nevertheless the jump in energy futures means the energy price cap is set to rise by around 80% in October and 20% in January. Some forecasters, such as Citigroup, expect UK CPI inflation to peak at over 18% by January 2023.

The Bank of England raised the base interest rate to 1.75% in August. The MPC has adopted a significantly more hawkish and aggressive stance to try to stop inflation from becoming entrenched in domestic prices and wages. The SONIA forward curve has repeatedly edged out as the market re-evaluates future scenarios and it now implies base rates of over 4% by Q1 2023. However, the MPC rate-setting still lags the US Federal Reserve and sterling has continued to fall sharply as a result.

0.3% ▼
Oxford Economics 2023 GDP forecast

23.3 % ▲
Raw materials input price inflation, July 2022

18.6% ▲
Citigroup peak CPI inflation, forecast Jan 2023

13.5% ▲
Construction cost inflation, July 2022

The monthly monitor

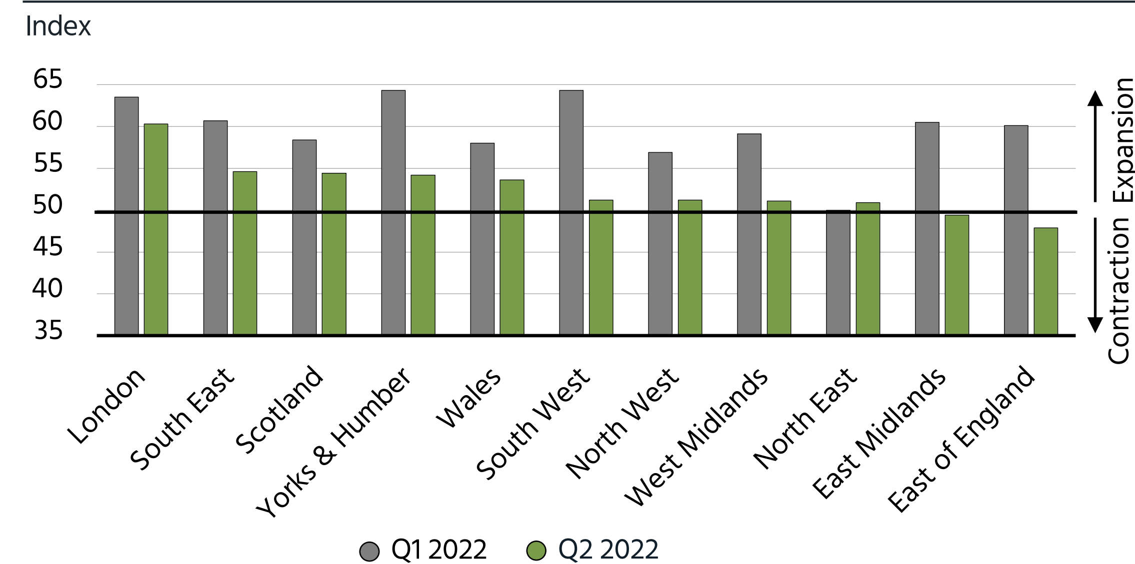
Source: Bank of England, IMF, ONS

Months: Jul-20, Aug-20, Sep-20, Oct-20, Nov-20, Dec-20, Jan-21, Feb-21, Mar-21, Apr-21, May-21, Jun-21, Jul-21, Aug-21, Sep-21, Oct-21, Nov-21, Dec-21, Jan-22, Feb-22, Mar-22, Apr-22, May-22, Jun-22, Jul-22

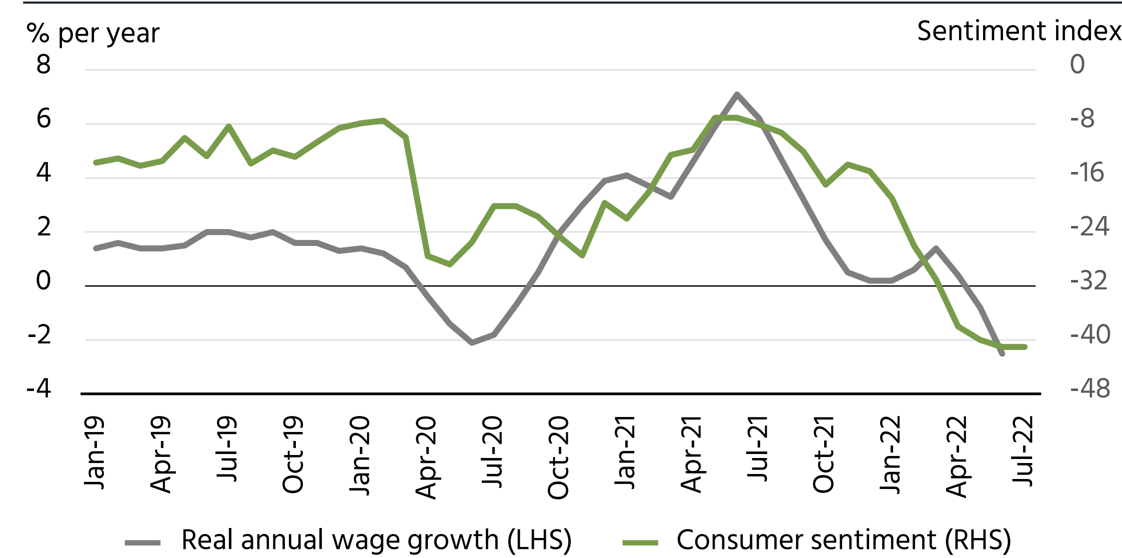
Indicator	Two-year trend	Latest figure
GDP annual growth		1.9%
Unemployment rate		3.8%
Consumer confidence		-41.0
Retail sales growth		-3.1%
Retail sales % online		25.3%
Manf output growth		1.4%
Brent crude (USD/bbl)		97.80
Gold (USD/oz)		1,766
FTSE-100		7,423
CPI inflation		10.1%
10-year bond yield		2.0%
EUR/GBP		1.19
USD/GBP		1.22

Spotlight on... UK businesses and households

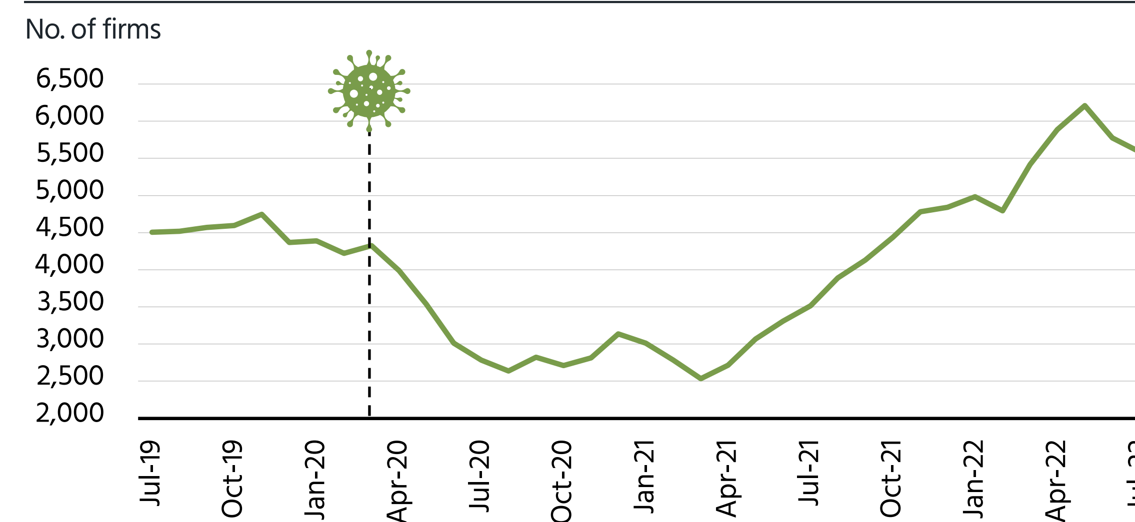
Business activity index by region
Source: Natwest regional PMI



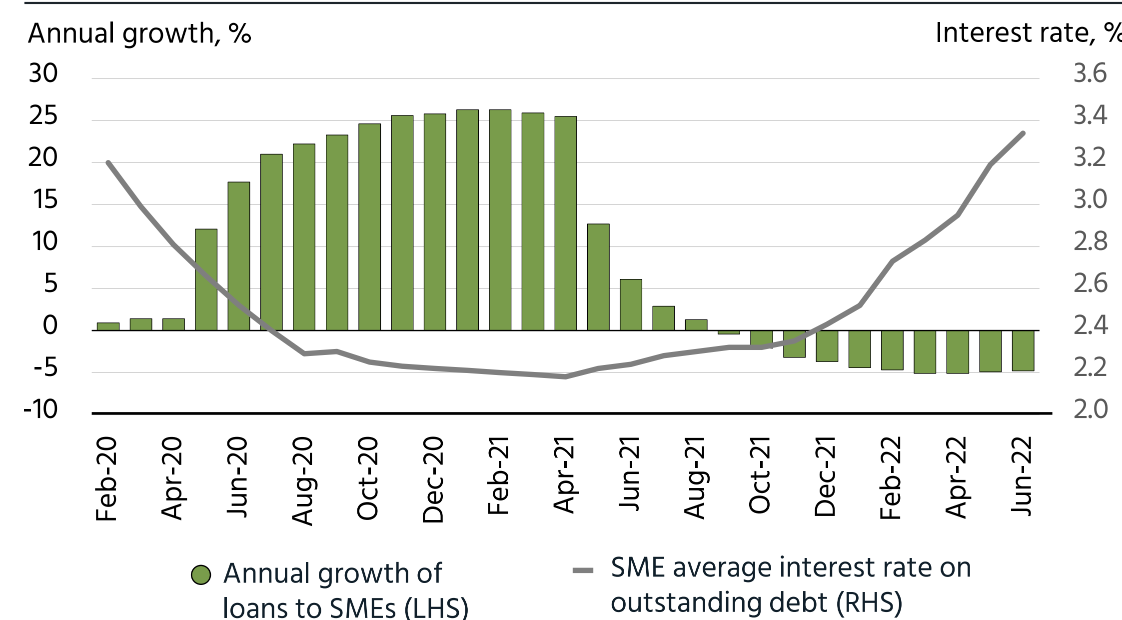
Real wage growth and consumer sentiment
Source: ONS, Trading Economics



UK rolling quarterly business insolvencies
Source: ONS



Lending volume to and interest rate for SMEs
Source: Bank of England



The prospect of high and sustained inflation and an uncertain and worsening economic backdrop has negatively impacted business confidence and new business demand across the UK. Firms in all regions reported significantly increased costs for goods and services in Q2. London continued to outperform the other UK regions in terms of output and employment growth. Two out of the 12 regions saw new business fall in June, the most since the lockdowns in early 2021, whilst the remaining areas all saw growth of new business slow. More regions are set to fall below 50 and into contraction in Q3.

Nominal wage growth has fallen behind the rise in the cost of living and real annual wage growth in June trended down to below the rate during the pandemic. Its rate of decline and expected deterioration can explain UK consumer sentiment, which continues to sit at a record low.

Data from the Bank of England show that SMEs took on a significant amount of new debt over the pandemic. Around 70% of this was from non-government lenders and consequently the effective SME interest rate has been rising. Quarterly insolvencies have been trending sharply upwards also but the tick down in the last two months suggests this may still turn out to be a shakeout from the subdued period of insolvencies during Covid where there was significant government support.

Outlook

We expect outward yield shift in H2 to more than offset the inward yield undershoot in H1 across various property segments. As such, we forecast a net negative overall annual yield impact in 2022. The direct market will likely correct quite quickly but in 2023 we see some potential further valuations-based yield softening in H1 since valuations lag market pricing. This would generate a negative annual total return in 2023.

Industrial is expected to continue to dominate in 2022, though outward yield shift in H2 will dampen total return to 11%. Performance will be driven by rental growth in 2022 but we expect a return to 'normal' rates of rental growth from 2023 as the market absorbs record levels of reversion. Since income return is relatively low and if interest rates keep rising there is the prospect of a negative annual return in 2023 for the first time since 2012.

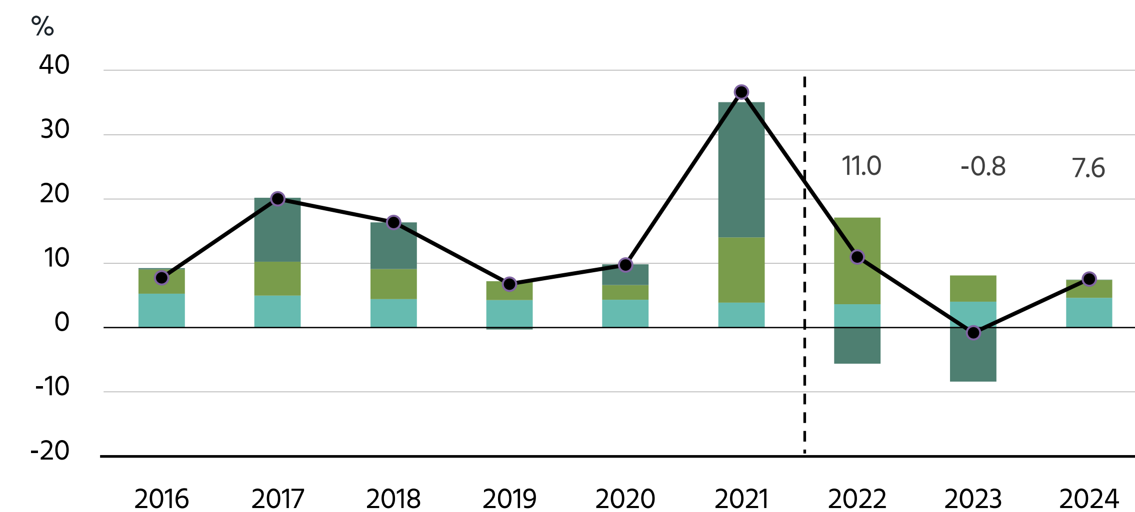
The **office** market is polarised between the highly desired and undersupplied best-in-class stock versus the rest. This is set to persist since development timescales will be pushed out by high cost inflation and lack of availability of materials. There may still be some upward rent inertia at the prime end in London but broadly a slowdown in occupier activity is expected over the medium term as the global economy weathers a challenging period.

UK households are facing real challenges and the **retail** sector is now in recession. However, the significant value falls for retail property over the last several years should cushion the sector somewhat from further negative pressures. Income will be the key driver of performance and retail assets benefit from high income return, though there is considerable risk.

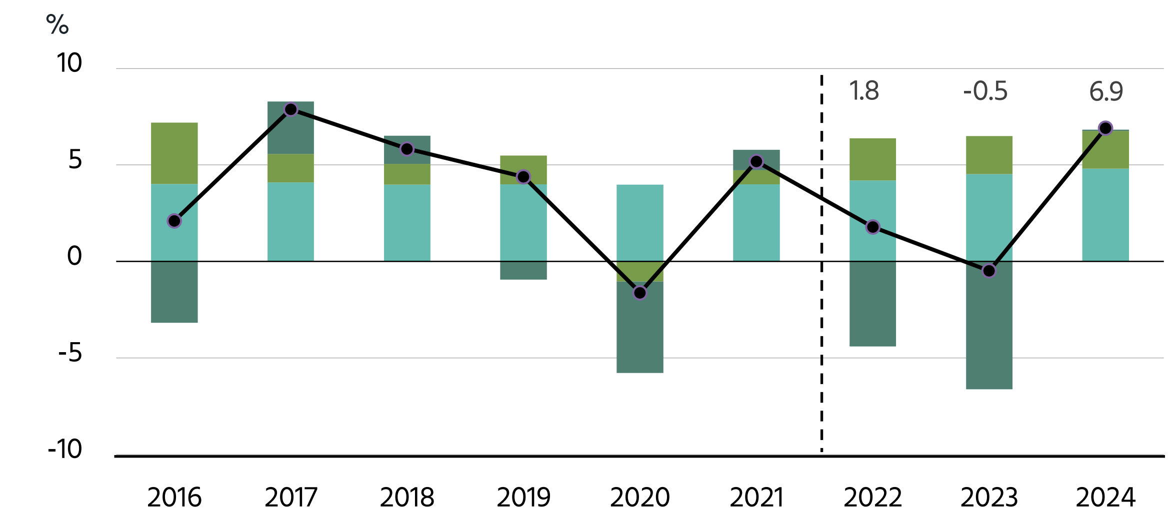
Total return and components by sector

Source: Gerald Eve, MSCI

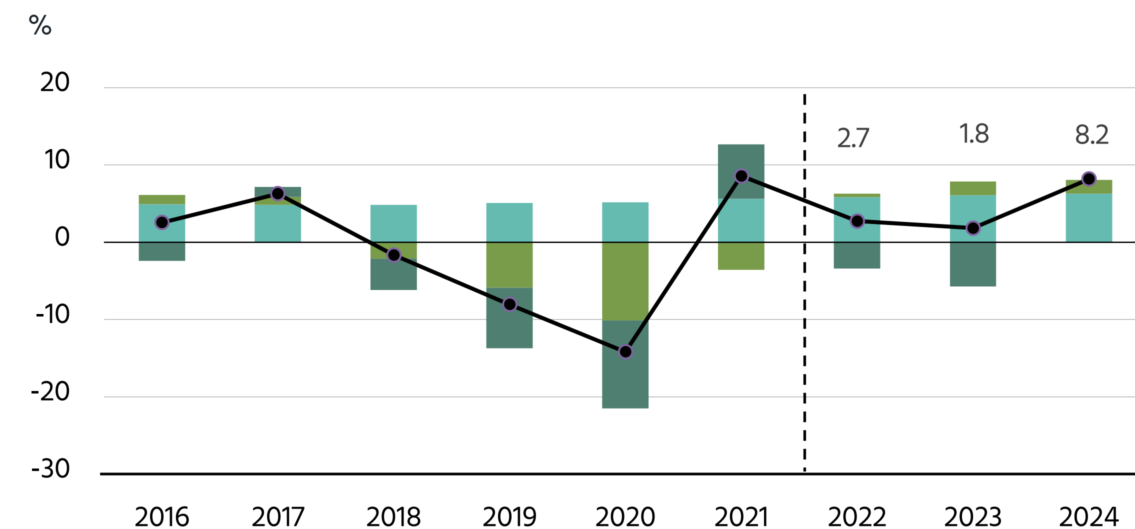
Industrial



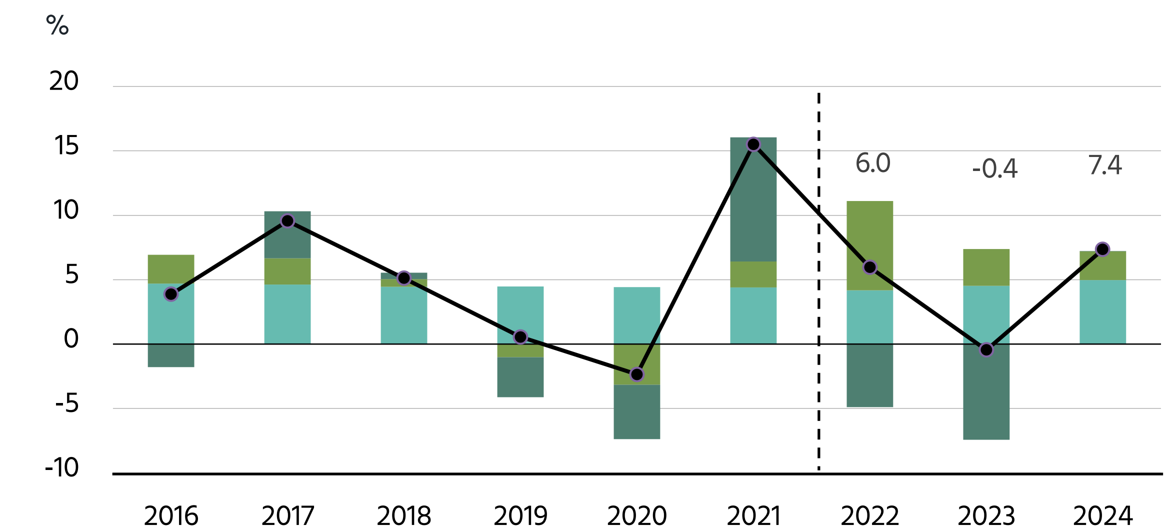
Office



Retail



All Property



Income return · Rental growth · Yield impact · Total return

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