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IN BRIEF

UK COMMERCIAL PROPERTY UPDATE AND OUTLOOK

September 2022

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SEPTEMBER UPDATE

All Property total return continued its sharp downward trajectory and turned negative in August. Unsurprisingly this was driven by negative yield impact as the radical turn in the investment market starts to feed its way into valuations yields in earnest. Outward yield shift in the direct market has been significant, most notably since the gilt market has been engulfed in recent turmoil. Many investment deals underway have now faltered as buyers wait on the sidelines for some stability. Meanwhile sell-side pressures are likely to build in the second half of the year. There is a two-page special on the economy in this edition.

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

-1.1% ▼
All Property quarterly total return, August 2022

£6.3bn ▼
Q3 UK commercial property investment

1.03 ▼
Record low USD/GBP exchange rate

4.61% ▲
Recent peak UK 10-year government bond yield

£45bn ▲
Proposed tax cuts in the recent 'fiscal event'

£65bn ▲
Bank of England spending to buy up long-dated UK gilts

Total return turns negative

The latest property data is to August 2022 and does not yet reflect the impact of the drastic rise in government bond yields and precipitous fall in the value of sterling immediately following the chancellor's 'fiscal event'. Nevertheless, quarterly All Property total return continued its sharp downward trajectory and turned negative in August. Unsurprisingly this was driven by negative yield impact as the radical turn in the investment market starts to feed its way into valuation yields in earnest. The sector at the sharp end with the lowest yields is industrial and this has been where the most significant turnaround in performance has occurred. Nevertheless, the negative effects have been felt across all sectors all the way up the risk curve.

Outward yield shift in the direct market has been significant, most notably since the gilt market has been engulfed in recent turmoil. Prime industrial yields, after typically softening around 50bps in Q2, are estimated to have moved out a further 100bps in Q3 in the largest quarterly shift certainly since the global financial crisis and potentially on record. Many investment deals underway have now faltered as buyers wait on the sidelines for some stability. The Q3 investment volume fell to only £6.3bn and Q4 is set to be similarly impacted.

In terms of sellers, the recent pension funds crisis will have brought some assets to market. Additionally, funds with mixed assets have seen a fall in the value of gilts and equities. The relatively slow-moving, illiquid and valuation-lagged property component of the portfolio now appears overweight (even accounting for recent yield softening). Consequently we could see outflows of the most liquid, good quality assets to rebalance positions. Meanwhile some occupiers with significant corporate debt on their balance sheet have investigated sale-and-leaseback options. These kinds of sell-side pressures are likely to build in the second half of the year.

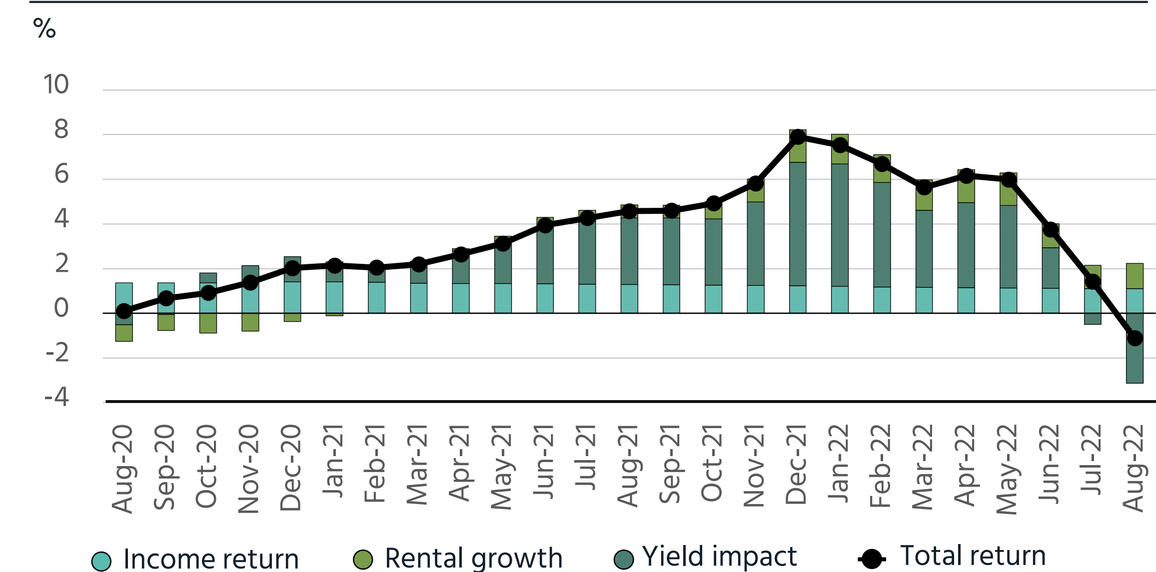
Sales resulting from banking distress are not yet evident, but these types of transactions are also likely over the next six months. The main risk concerns refinancing on assets acquired within the last two years. These will have not accumulated sufficient positive yield impact and rental growth to cover the significant hike in the all-in cost of debt based off where markets believe base rates will be into next year. With a margin of 150bps over SONIA, this puts lending rates at over 7%, considerably more than current prime property yields. Banks are better capitalised now than during the financial crisis, but the system could be tested by a large volume of non-performing loans.

We expect further corporate insolvencies as the recession deepens, with importers and those overleveraged most at risk. Some industrial occupiers who arguably overstretched during the pandemic when conditions were more favourable are handing back space, but this is still relatively rare. In many occupier markets rents have already either dropped substantially (retail) or vacancy and defaults are extremely low and not expected to increase substantially (industrial). Some developers who bought land relatively recently, even with pre-lets attached, will now struggle to make the development work and are looking to sell. This should further help keep the supply side constrained. However, longer term developers backed with US money and/or with locked in construction costs will still stack up financially and are likely to continue.

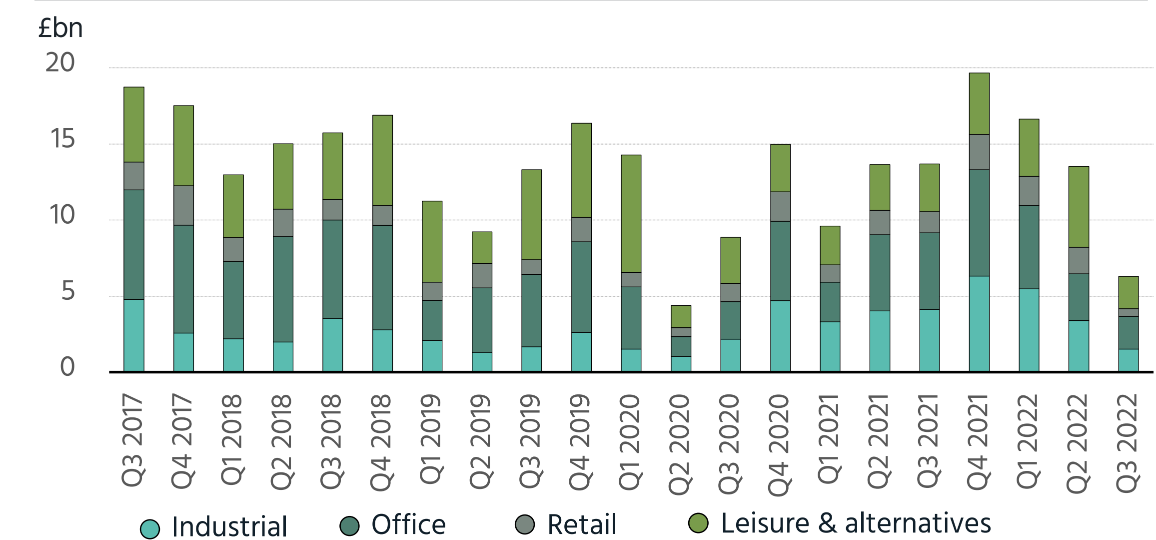
-1.1%▼
All Property quarterly total return, August 2022

£6.3bn▼
Q3 UK commercial property investment

All Property quarterly total return and components
Source: MSCI

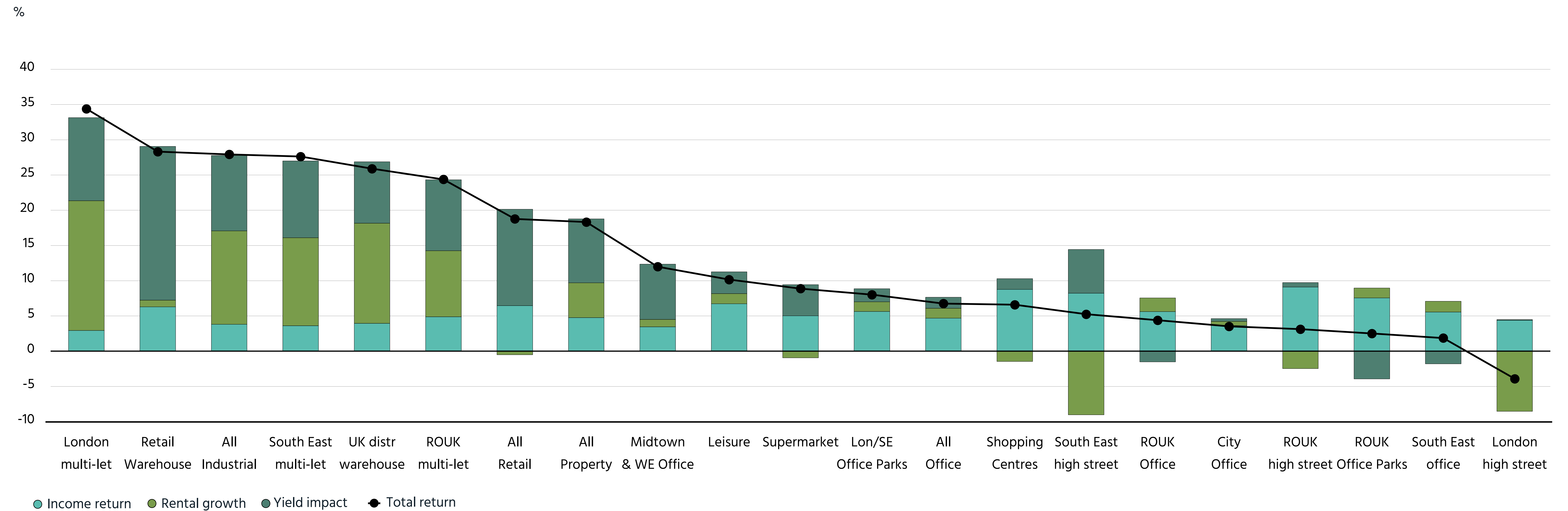


UK quarterly commercial property investment volume by sector
Source: Gerald Eve, Property Data



UK property segments

12-month return to August 2022
Source: MSCI



UK economy

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UK GDP edged up 0.2% month-on-month in July after a 0.6% fall in June due principally to the extra Platinum Jubilee bank holiday. Further volatility will have been introduced via the extra bank holiday for the Queen's state funeral in September. Essentially though the economy has no momentum and Oxford Economics expects GDP to fall slightly in Q3 overall and do no better than stagnate over the next 12 months. Other commentators, including the Bank of England, suggest quite plausibly that the economy might already be in recession. September's UK flash PMIs continued on a downward trend, with the services sector joining manufacturing in reporting contracting activity.

The foremost current economic news story, however, is the new chancellor's recent Growth Plan 'mini budget', featuring £45bn of tax cuts in the largest fiscal loosening since 1972. This included reversing this year's rise in the rate of employee national insurance contributions, abandoning the planned rise in corporation tax, and scrapping the 45% top rate of tax for the highest earners.

The chancellor claimed the package would boost the UK's medium-term growth rate, but most commentators disagree. The economy has no spare capacity and they have instead determined that the measures will simply have a bigger impact on demand and inflation and will likely trigger a more aggressive monetary policy response to offset it. The usual independent OBR modelling was absent but the implication for most observers is that it would potentially require tighter fiscal policy in future years to help repair government finances. Perversely, in all this would weigh on GDP growth, which is now broadly expected to be weaker than previously forecast in 2023 and 2024. The proposed 2.5% GDP growth target is widely considered to be totally unachievable from this position.

The money markets were similarly unconvinced and the lack of accountability and credibility of the UK government's long-term fiscal plans rapidly caused 10-year government bond yields to rise as high as 4.61%, which was the highest since 2010. The value of sterling also fell precipitously to a record low $1.03 against the US dollar. The Bank of England was required to step in, initially stating that there will be a 'significant policy response' (i.e. even higher future interest rates) and subsequently to stem the gilt market crisis with its £65bn guarantee to buy up long-dated gilts and stop bond yields rising further.

1.03 ▼
Record low USD/GBP exchange rate

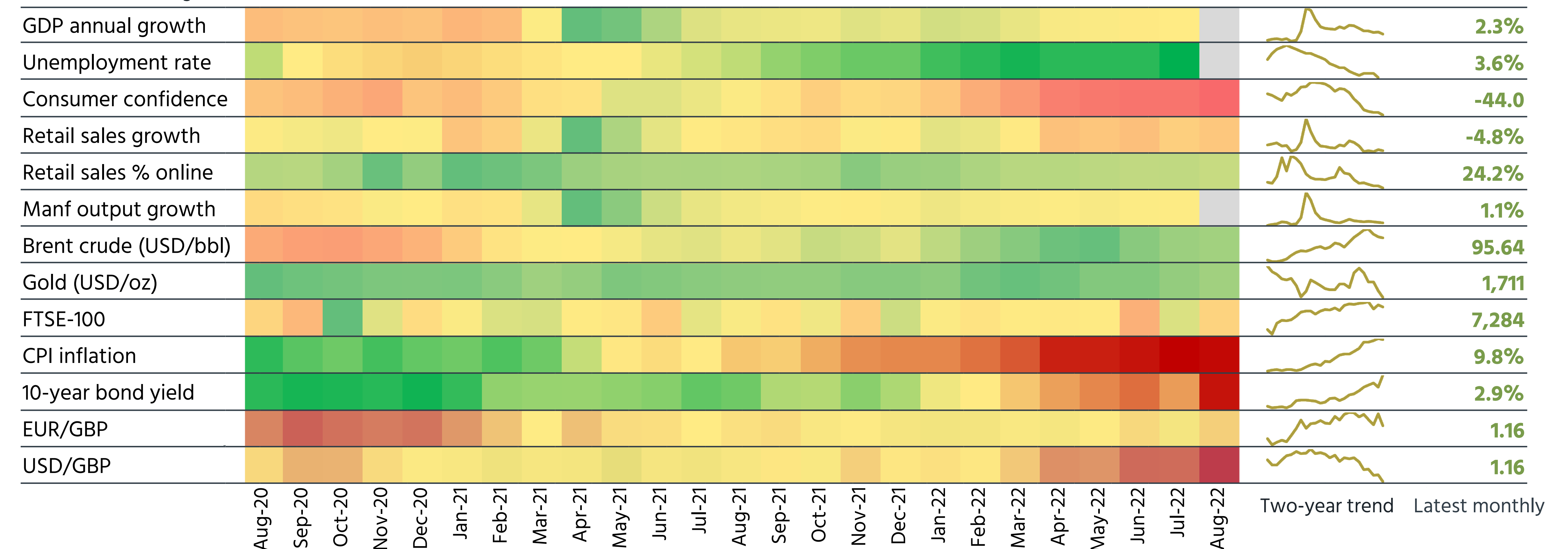
£45bn ▲
Proposed tax cuts in the recent 'fiscal event'

4.61% ▲
Recent peak UK 10-year government bond yield

£65bn
Bank of England spending to buy up long-dated UK gilts

The monthly monitor

Source: Bank of England, IMF, ONS



UK economy

The Bank Rate was raised by 50bps to 2.25% in September before the chancellor's mini budget. The Bank has so far not signalled an intervention to raise rates further before the next scheduled meeting of the monetary policy committee on the 6th of November. However the markets may again force its hand if the pound falls to below parity with the US dollar and/or if credit rating agencies downgrade UK sovereign debt, which is a possibility.

Recent media rounds suggest the government is doubling down on its proposals, though the prime minister and chancellor have now met with the OBR. Fiscal policy remains unpredictable and there is the risk that the government could do something similarly destabilising. Consequently there is a built-in higher interest rate risk to gilt yields now, which are hovering around 4%.

The SONIA forward curve has moved out aggressively over the past two months and in recent days has implied a Bank Rate of over 6%in 2023. Around a thousand mortgage products were temporarily pulled as lenders reassess and reprice amid the uncertainty. Mortgage rates above 4% are expected to breach affordability for the UK housing market. Rates of up to 6% or more would destabilise it considerably, with a substantial increase in arrears, defaults and repossessions. This could lead to a potential 10-15% fall in the average UK house price, which would mean a drop in value of around a quarter in real terms.

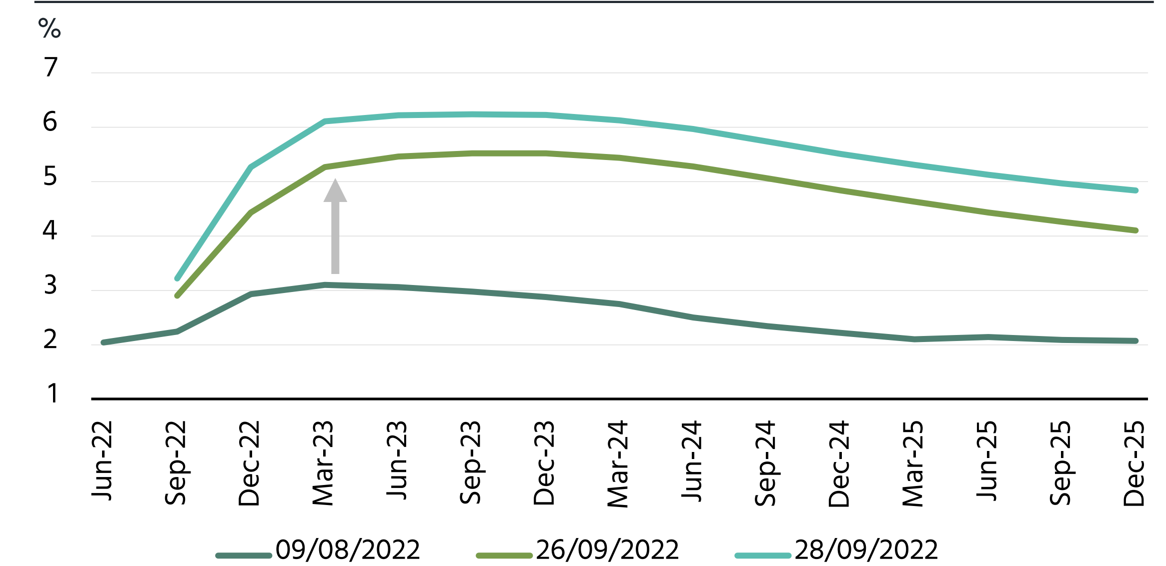
The impact on disposable incomes and household consumption could be considerable. GfK consumer confidence had already fallen to another successive record low in September as households continue to contend not only with the prospect of sharply rising mortgage payments but also food prices and energy bills. This increased pessimism is despite the expectation of a modest improvement on the back of the government's £150bn package to freeze household bills for two years at the new October rate of a typical £2,500 per household per year.

The consumer sector remains in recession and retail sales fell by a further 1.6% in August. All types of spending in food and non-food stores were down, but household goods have been particularly affected, with sales more than 17% lower compared with a year ago. Despite the overall fall in retail sales, the online component as a percentage also fell in August to 24.2% - the lowest since before the pandemic in 2020.

Turning to inflation specifically, annual CPI inflation eased fractionally but remained extremely elevated at 9.8% in August. This figure is composed of two main elements – firstly the exogenous component in the form of global energy prices stemming from geopolitical events that have destabilised supply chains and increased costs. The final capped increase in UK energy prices will come in at the beginning of October and oil prices have fallen for the last five weeks from a high of over $120 per barrel to around $85 per barrel. Notwithstanding the offsetting fall in sterling against the dollar overall headline inflation is thus likely to be at or near its peak.

The other, more concerning component for the Bank of England are the domestic sources of inflation, particularly second-round effects from the labour market. This component would undoubtedly be exacerbated by the proposed fiscal stimulus, but it will take some time to see how it will play out. Consequently the magnitude and duration of domestic inflation and the required policy response is mired in uncertainty. On the flipside the weaker housing market and likely accompanying recession means that the Bank could pivot back to cutting rates sooner (i.e. late 2023). In the US the Fed is still hawkish, meaning the dollar will remain strong and sterling is likely to remain undervalued for the foreseeable future.

SONIA forward curve/implied market forecast of the Bank Rate
Source: Chatham Financial



Spot end-day exchange rate, US $ into sterling
Source: Bank of England

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.

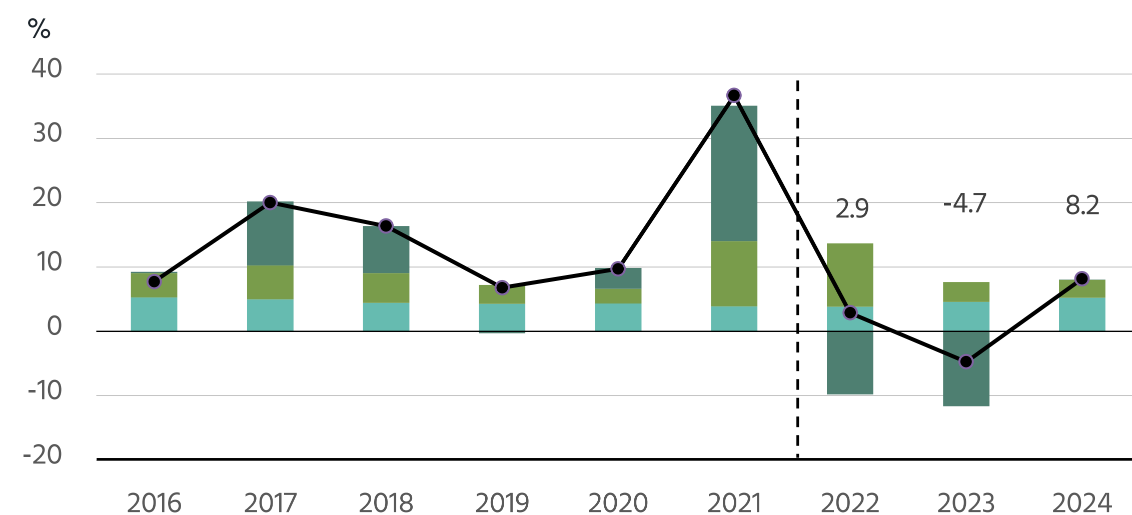
Industrial is expected to continue to outperform the other sectors in 2022, though outward yield shift in H2 will dampen total return to only 2.9%. We expect a return to 'normal' rates of rental growth from 2023 as the market absorbs record levels of reversion. Since income return is relatively low and if interest rates keep rising there is the prospect of a negative annual return in 2023 for the first time since 2012.

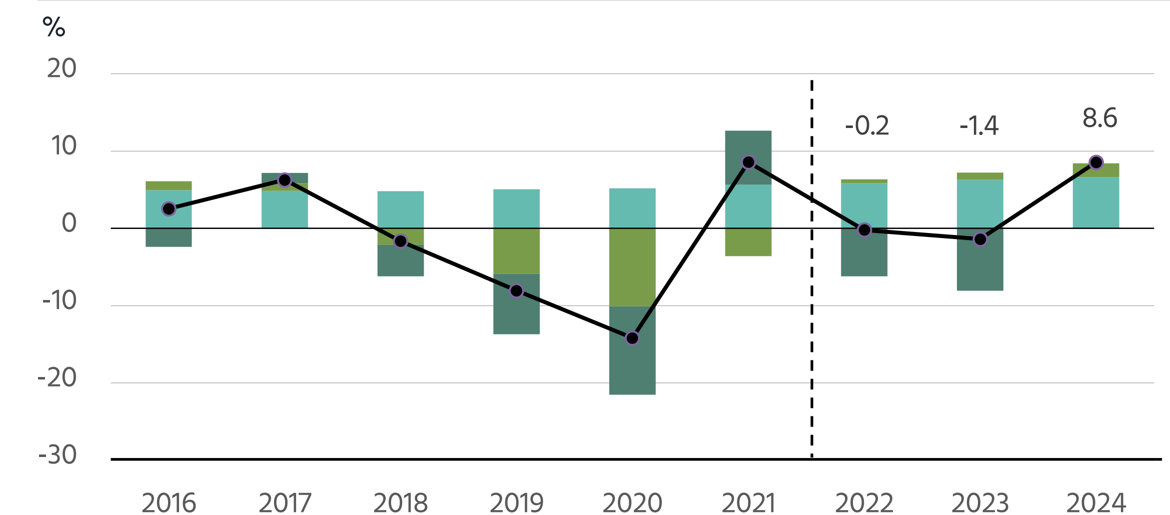
The **office** market is polarised between the highly desired and undersupplied best-in-class stock versus the rest. This is set to persist since development timescales will be pushed out by high cost inflation and lack of availability of materials. There may still be some upward rent inertia at the 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.

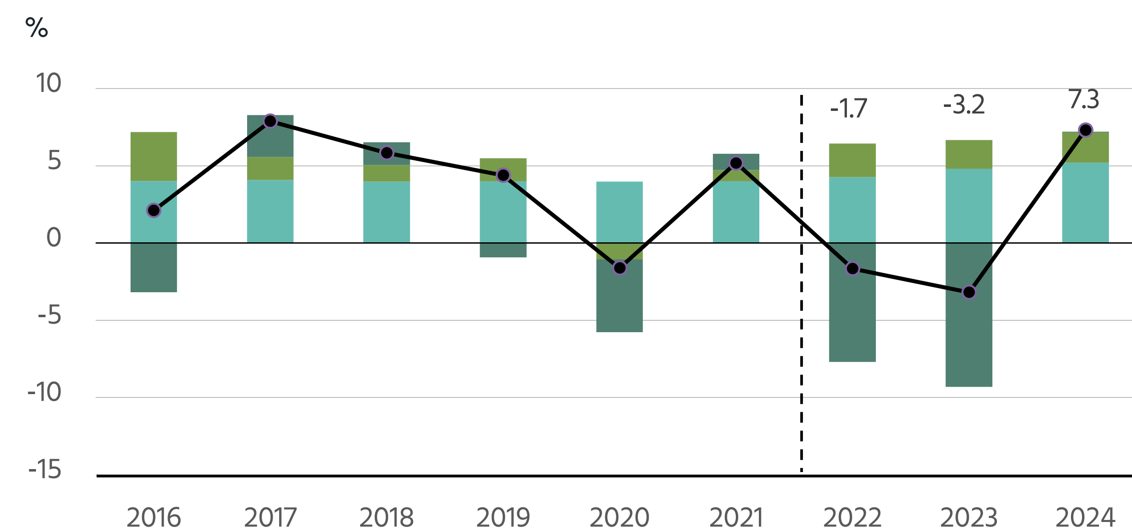
UK households are facing significant challenges and the **retail** sector is now in recession. However, the significant value falls for retail property over the last several years should cushion the sector somewhat from further negative pressures. Income will be the key driver of performance and retail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

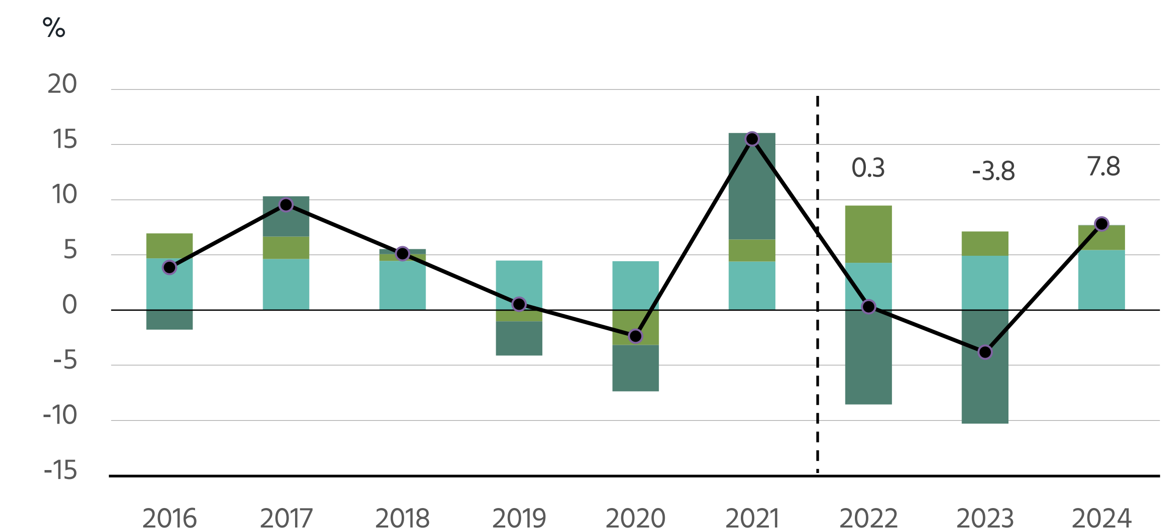
Total return and components by sector

Source: Gerald Eve, MSCI









Income return · Rental growth · Yield impact · Total return

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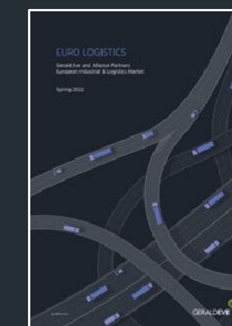

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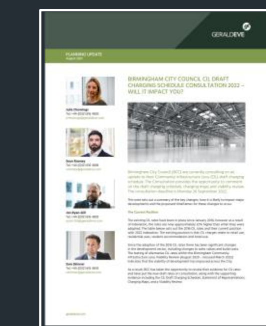

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