



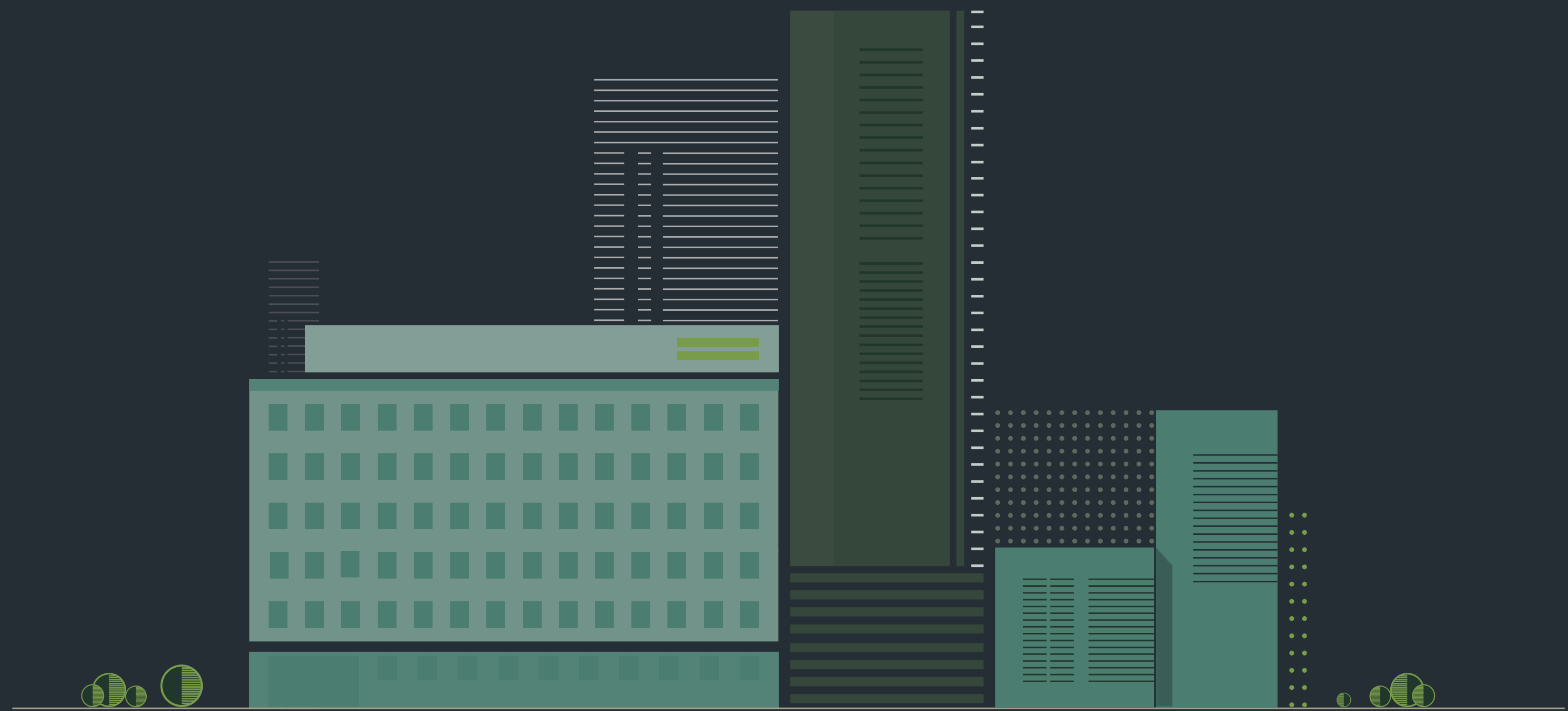
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# IN BRIEF

## UK COMMERCIAL PROPERTY UPDATE AND OUTLOOK

May 2024

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## MAY UPDATE

UK commercial property quarterly total returns edged back into positive territory in March and April as valuation yields near their peak. There is increased depth to the buyer pool, but investment transaction volumes remain relatively muted while there is ongoing lack of suitable stock available. However, sellers may return in (moderately) increased numbers to take advantage of the lack of competition if pricing is not expected to materially improve over the short term. Performance in 2024 will remain muted but there is potentially more scope for stronger returns in 2025.

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<p><b>0.9%</b> ▲</p> <p>Quarterly All Property total return, April 24</p>	<p><b>51bps</b> ▲</p> <p>Increase in All Property equivalent yield, Jan 23 – Apr 24</p>	<p><b>2.0%</b> ▲</p> <p>2025 GDP growth forecast</p>	<p><b>2.2%</b> ▼</p> <p>2025 average CPI inflation forecast</p>	<p><b>3.5%</b> ▼</p> <p>End-2025 Bank Rate forecast</p>	<p><b>3.5%</b> ▼</p> <p>End-2025 10-year government bond yield forecast</p>
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# Back to positive quarterly total returns

UK commercial property quarterly total returns have edged back into positive territory for the first time since August 2023, with +0.6% and +0.9% in March and April. Yield impact has been the main driver of return volatility over the past 24 months, and it is the recent slowing of outward yield shift that has led to these positive figures.

There has been a gradual erosion of capital values at the All Property level over January 2023 to April 2024, captured by a 51bps increase in the equivalent yield. This follows the initial rapid repricing of 108bps in Q4 2022 when the outlook for interest rates became significantly more hawkish. This subsequent more gradual shift in yields, particularly over the past 12 months, has been most notable for offices which have pulled away from the other sectors. The higher interest rate environment dovetailed into the sector's unique occupancy and sustainability issues. However, this too has now mostly run its course and the office valuation yield outward shift has slowed.

For retail and industrial assets, the bottom of the direct investment market when yields last softened was arguably back in Q4 2023. Sentiment was at its most fragile and beset with geopolitical concerns. Buyer intentions have improved as anticipated in 2024, and various potential investors have adopted a more positive (though cautious) stance. Pricing in the direct market also commensurately improved somewhat early in 2024, but these movements have effectively been smoothed over by valuations yields, which have simply drifted out very gradually so far over 2024 and should now be near their peak.

Investment transaction volumes remain relatively muted while there is ongoing lack of suitable stock available. There are few sellers at this point in the cycle, given the expectation that interest rates will become more accommodating and pricing will likely improve.

Market expectations as to the future path of interest rates (and thus the cost of capital and asset prices) has been varied over the past six months. This is best captured in the forward SONIA curve. After a prolonged stretch of reflecting the "higher for longer" BoE mantra, the forward curve fell back as it became apparent that there was potential scope to cut rates sooner and faster than previously anticipated. However, a mixed picture for inflation and output globally has meant that the curve has become somewhat flatter again over the first half of 2024.

Some sellers that have so far held off entering the market in the expectation that lower interest rates were set to improve asset pricing by the end of the year may now be encouraged to act. Prices may not change by much in the short term and the advantage of bringing assets to market now is that competition is relatively low. Consequently, there is some potential for an increase in investment transactions over the coming quarters, albeit still within the context of a relatively low volume market.

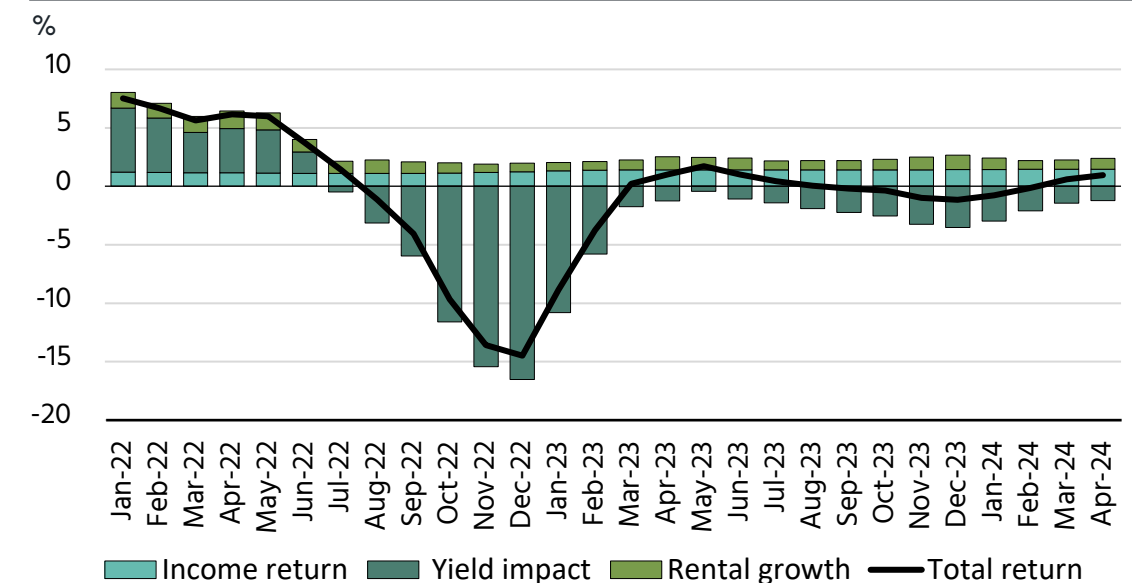
There is scope for only limited inward yield movement over the medium term, which should cause total returns to continue to trend upwards. The 10-year bond yield has oscillated over recent months as the outlook has alternated, but broadly the spread with property yields continues to be relatively narrow.

**0.9%** ▲  
Quarterly All Property total return, April 24

**51bps** ▲  
Increase in All Property equivalent yield, Jan 23 – Apr 24

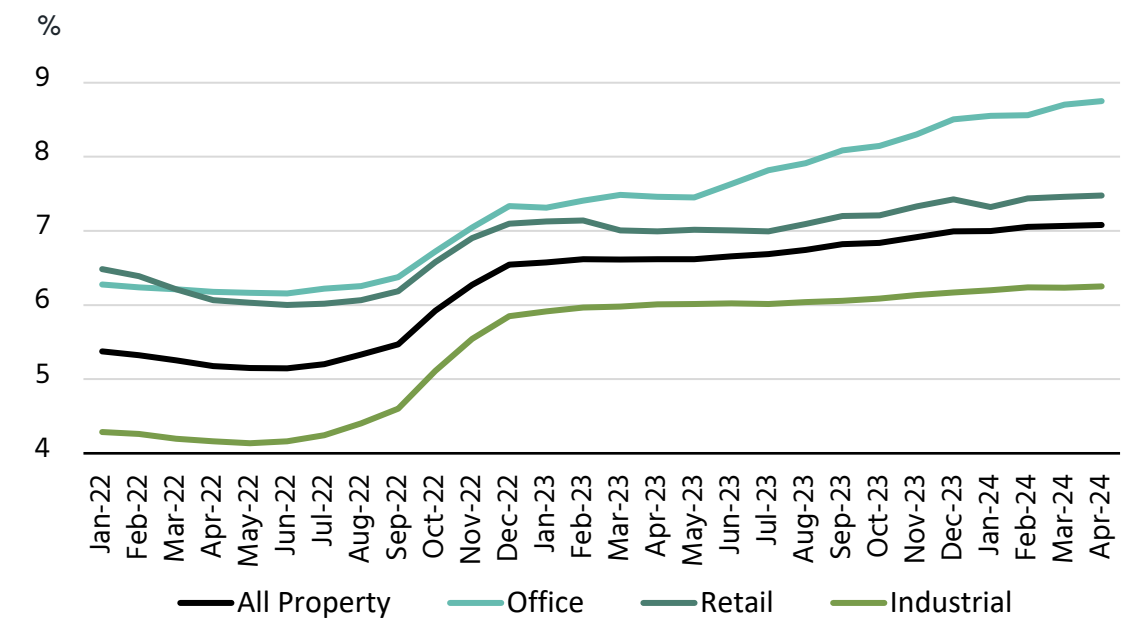
## Quarterly total return and components

Source: MSCI



## Equivalent yield by sector

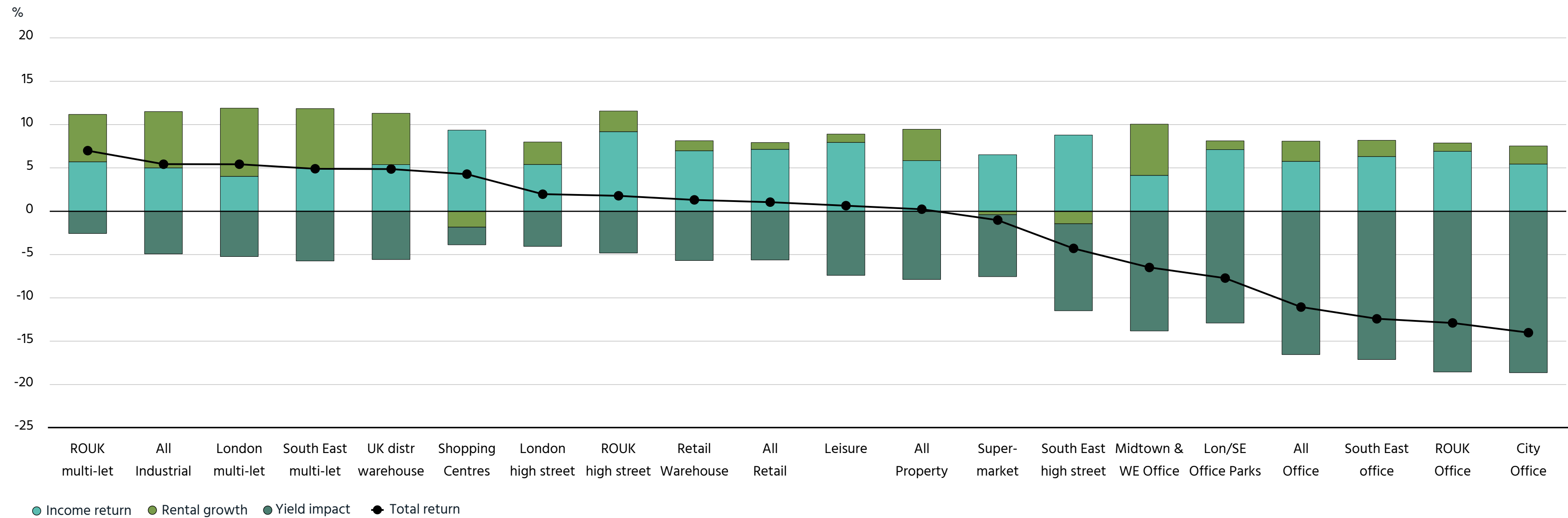
Source: MSCI



# UK property segments

## 12-month return to April 2024

Source: Gerald Eve, MSCI



# UK economy

UK GDP increased by a surprisingly large 0.4% month-on-month in March, which took the Q1 2024 quarterly growth estimate to 0.6%. This will have more than offset the modest falls in output during the second half of 2023. The early Easter this year and the pause in health sector industrial action will have had a positive impact. In contrast, the unusually wet weather hampered construction activity, and this is also one potential reason behind the sharp fall in UK retail sales in April. This has added to the evidence that GDP growth is likely to slow somewhat in Q2. Nevertheless, the overall forecast for 2024 UK GDP growth has been revised up to 0.9%, with 2% still pencilled in for 2025.

CPI inflation came in at 2.3% in April, down from 3.2% in March, which is only fractionally above the BoE's 2% target. This should edge down further over the coming months, with base effects continuing to exert downward pressure and the Ofgem energy price cap set to drop by 7% in July. However, core inflation remains sticky, and the second-round effects of high pay growth resulted in a higher-than-expected services inflation figure for April. Consequently, the first base interest rate cut is likely to be in August this year rather than in June. Oxford Economics has reined in its expectation of 75bps of cuts in 2024 to 50bps, with the Bank Rate ending the year on 4.75%.

The consumer outlook for H2 2024 is cautiously optimistic. Wages are growing in real terms following the sharp fall in inflation. And strengthening confidence suggests this will translate into spending growth, notwithstanding the lagged impact of past interest rate rises (notably relating to fixed-rate mortgages) that will weigh on activity. The 2p cut in National Insurance and freeze in fuel duty in the March Budget only slightly mitigated the fiscal tightening that will take place over the medium term. A continued freeze in most tax thresholds and allowances will negatively impact post-tax real wages and limit the recovery irrespective of the outcome of the July General Election.

Business survey data are broadly positive and are consistent with domestic recovery and export market stability becoming more firmly entrenched. Encouragingly, manufacturing indicators have switched back into growth territory to join services firms. Interest rates and wage costs remain elevated and thus companies, particularly the smaller firms, are likely to remain under financial stress for much of 2024. However, these pressures are far less acute than during the global financial crisis, and the current cyclical peak in insolvencies should be much lower than during that period.

**2.0%**▲

2025 GDP growth forecast

**3.5%**▼

End-2025 10-year government bond yield forecast

**2.2%**▼

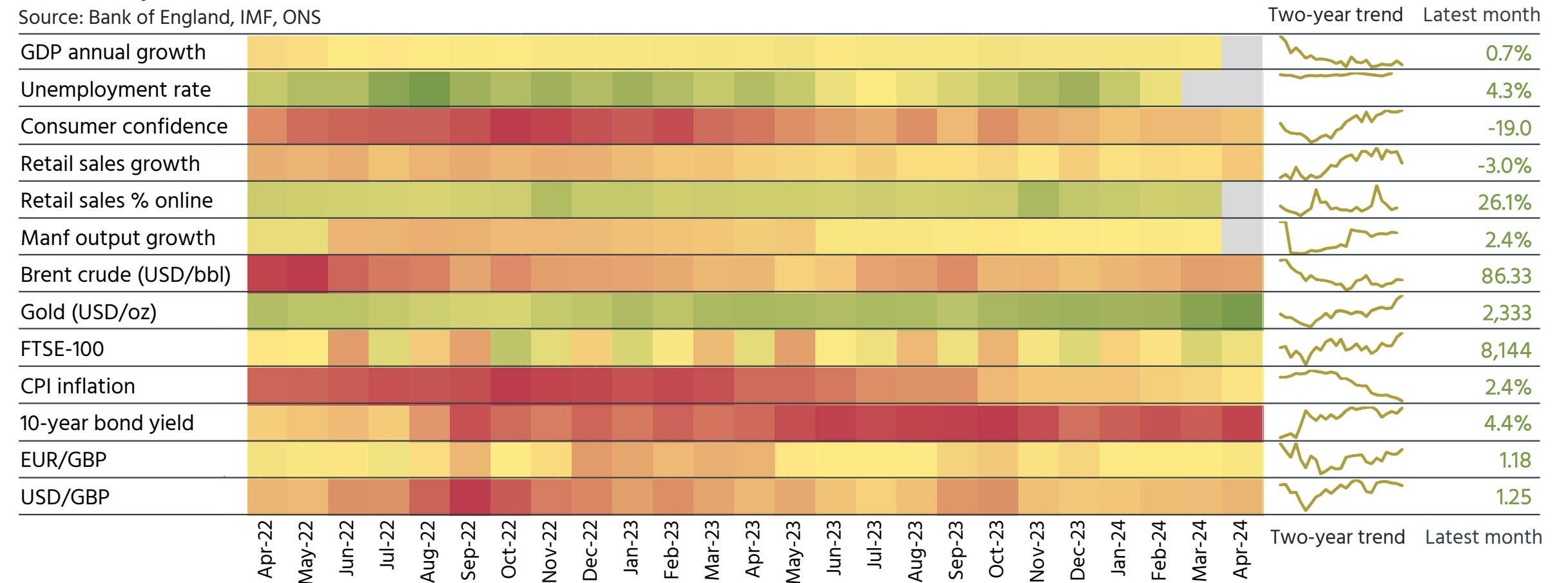
2025 average CPI inflation forecast

**3.5%**▼

End-2025 Bank Rate forecast

## The monthly monitor

Source: Bank of England, IMF, ONS



# Outlook

With interest rates having peaked at 5.25% and expectations of cuts starting in August, the cost and availability of debt should continue to become more accommodating. But the upside potential for property returns will be limited, given that current commercial property yields continue in the main to be below where the monetary fundamentals suggest they should be. The outlook is cautiously optimistic and annual property returns should trend upwards over the medium term – notably in 2025 when there may be some small scope for inward yield shift.

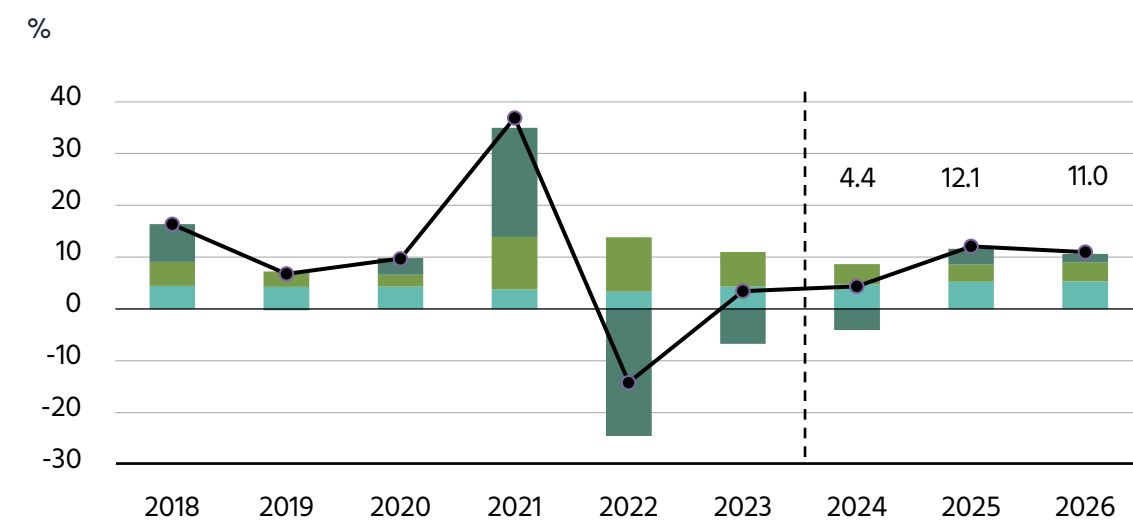
The resilience of the **Industrial** occupier market will continue to appeal to investors and continues to support prices that having corrected in late-2022 now remain relatively robust. Rental growth may have cooled, but this is from very strong rates in 2021/22. Void rates and default rates are likely to stop rising in 2024 and remain below previous downturns, which will sustain positive rental growth.

**Office** prime/secondary polarisation is set to continue as alternative working practices allied with EPC obstacles continue to negatively impact occupancy and investment demand for secondary space. For **retail**, eroded real incomes and the elevated cost of debt should begin to turn a corner but households and retailers are nevertheless in for ongoing challenges. The significant rise in retail yields and reset of rents over the last several years that has so negatively impacted capital values should provide a small offsetting cushion in the form of relatively greater income return.

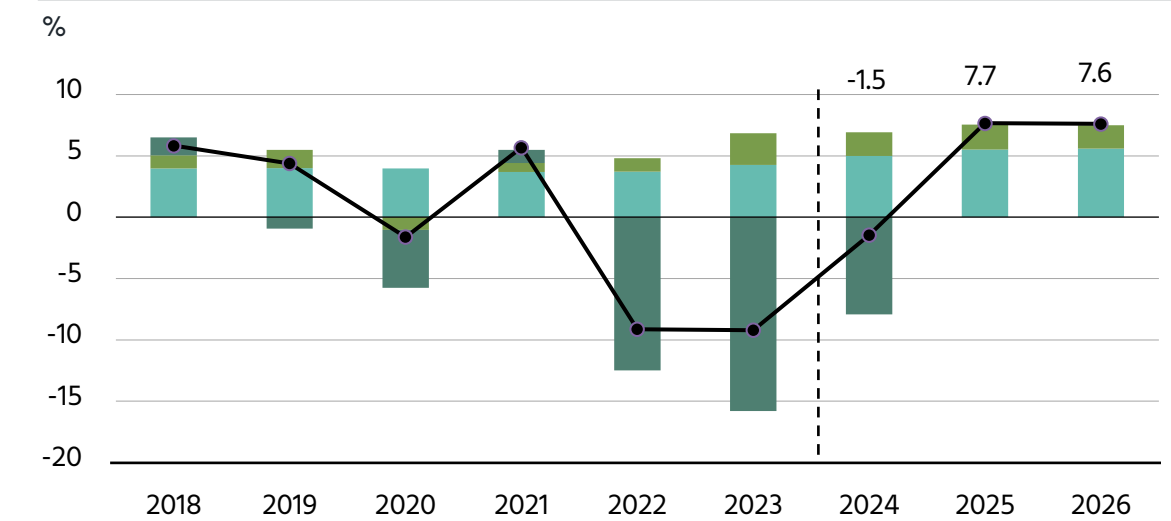
**Total return and components by sector, May 2024 forecasts**

Source: Gerald Eve, MSCI

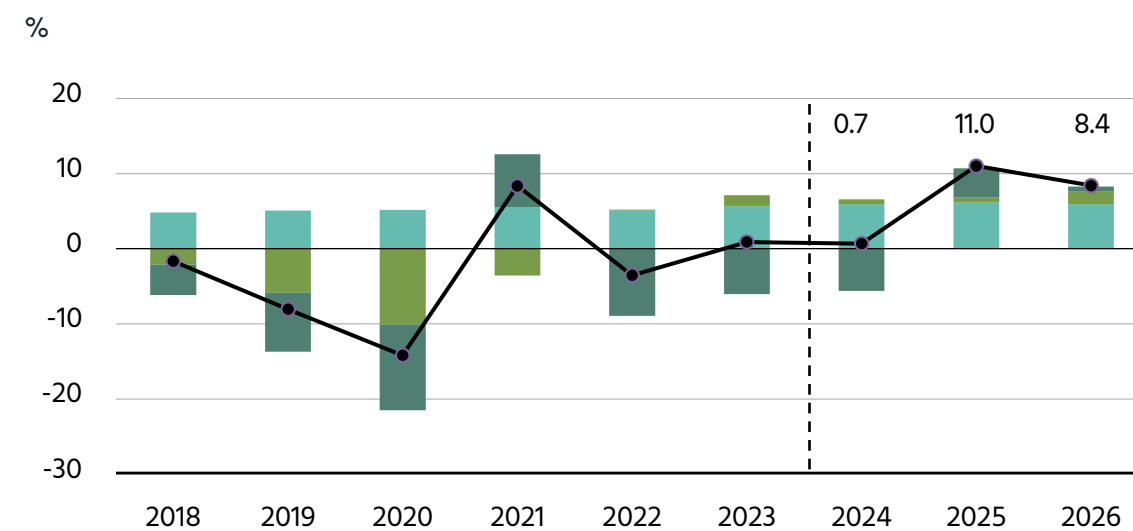
### Industrial



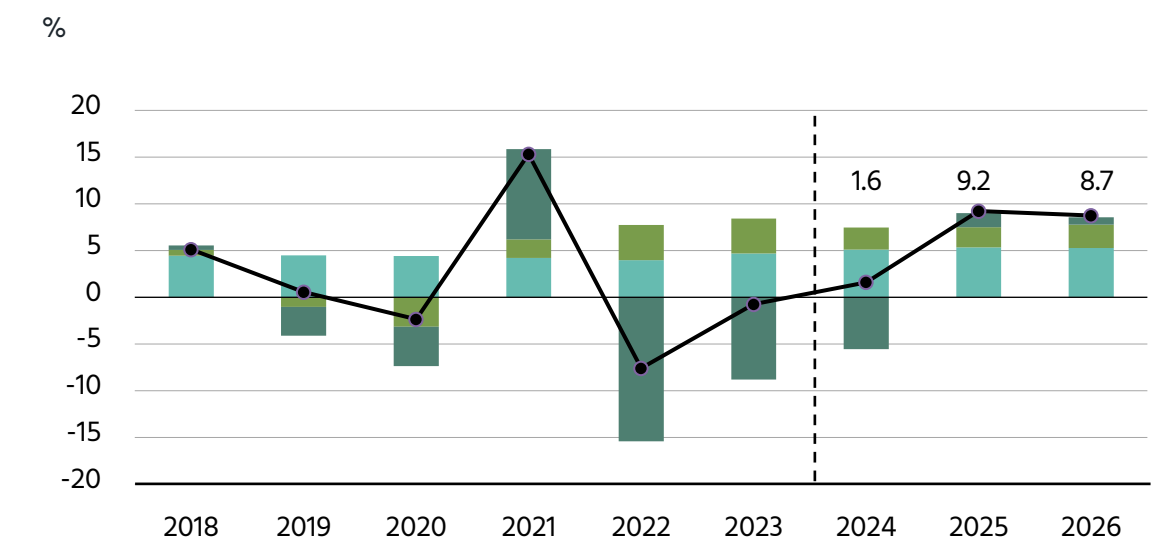
### Office



### Retail



### All Property



Income return Rental growth Yield impact Total return

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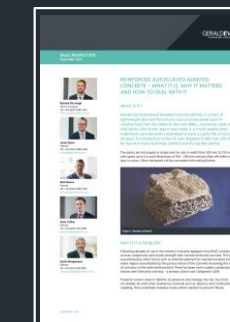
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