Economic & Property Market Commentary
Swiss Life Asset Managers UK

September 2023

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Property Income Trust For Charities

Economic update

Impact of higher interest rates starts to be felt over Q3

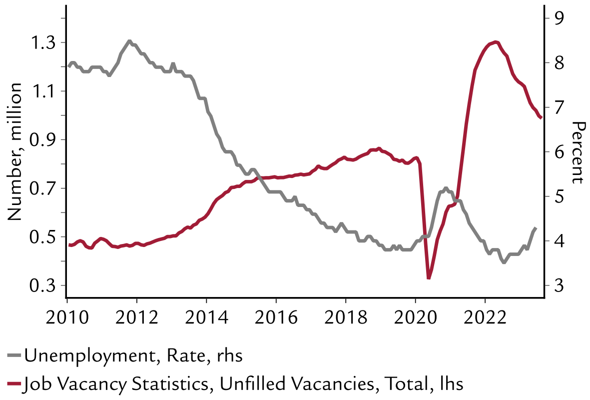
Economic sentiment shifted over the quarter as inflation trended downwards and data pointed to a slowing momentum in GDP growth. The economy contracted 0.6% in July, with declines across most sectors. While modest growth (+0.2%) was recorded in August, this was supported in part by temporary factors, such as fewer strike days. Data releases for September suggests the economy contracted and PMI figures are consistent with a contraction in Q3 due to weakening demand arising from cost-of-living pressures and higher borrowing costs.

There are few signs of an improvement in Q4. While inflation has been falling, it remains elevated, and many households are still to face a sharp rise in costs when refinancing a fixed-term mortgage. In addition, while business investment surprised to the upside in H1 2023, it is unlikely to be sustained in H2. In recent weeks, the Bank of England have warned of a growing risk of corporate defaults as the share of companies experiencing debt-servicing stress increases, and the number of companies entering insolvency remains high. Nevertheless, business surveys remain resilient, and the risk of continued rising borrowing costs has declined. This may mean that any pullback on corporate spending will be relatively modest.

The weakness in the economy is starting to be felt in the labour market. Unemployment has edged up to 4.3%, and the number of job vacancies fell below one million for the first time since July 2021. Forward looking indicators suggest this trend will be maintained. The flash PMI employment balance fell to a 32-month low of 46.6 in September suggesting that firms' demand for labour is declining, and the REC/KPMG permanent employment balance has fallen to its lowest level since the GFC, consistent with modest falls in employment by the end of the year.

Inflation fell to 6.7% in August, down from 7.9% at the end of Q2. Rising petrol prices added inflationary pressures but were outweighed by a drop in food and drink inflation. Core inflation declined from 6.9% in July to 6.2%. Falls were recorded in both core goods and services inflation, reversing the rise experienced since March. Upside risks remain. There is still little evidence of an easing in wage growth, despite tentative signs of loosening in the labour market and the recent rise in oil price means that inflation is not expected to fall significantly in September and may increase. However, the fall in the Ofgem utility price cap in October should reverse this, with a downward trend anticipated throughout the final quarter of 2023.

Tentative signs of loosening in the labour market



The soft inflation number in August combined with signs of loosening in the labour market and slowing economic momentum meant the Bank of England narrowly voted to keep interest rates unchanged in September. Although the Monetary Policy Committee (MPC) statement did not rule out further increases if there was a reversal of the inflation trend, our base case is for interest rates to stay at their current level into the second half of 2024. This aligns with additional MPC guidance that rates will stay sufficiently restrictive for sufficiently long.

Our current forecasts anticipate a modest UK recession in H2, resulting in growth of 0.2% in 2023. Inflation is expected to trend downwards but remain above the Bank of England target during 2024. Easing inflation should support a return to economic growth from Q1 2024 by bolstering consumer spending power, although we expect economic expansion in 2024 to remain modest at 0.3%. Falling inflation combined with weaker economic growth is anticipated to provide some scope for interest rate cuts from H2 2024. However, structural trends in the macroeconomic environment mean that it is unlikely that interest rates will fall back to the levels seen in the last decade.

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Property market update

Quiet quarter for investment activity

Investors seek signs of stabilisation

Uncertainty over pricing has continued to suppress investment activity over the third quarter. Accordingly, investors have spent the quarter seeking signals of market stabilisation through the monitoring of economic developments, monetary policy announcements and their implications on the outlook for 10-year government bond yields. Investment into commercial property therefore continued to weaken from Q2, with total volumes falling to a record-setting £2.6bn, reflecting a -71% decline from Q3 last year, and down 25% on the long-term quarterly average. Despite muted activity, surveys into investor sentiment suggests an improving outlook, and with the latest policy announcement by the Bank of England keeping base rates unchanged, transaction activity in the final quarter may begin to pick up.

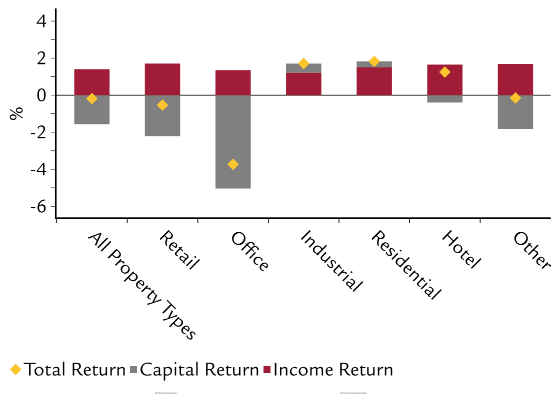
All-property: Flat quarterly returns

Over the third quarter, the MSCI All Property Monthly Index returned -0.2%. Negative quarterly performance on an all-property level can be explained by the 1.4% income return being netted off by capital values declining -1.6% over the period. Quarterly performance marks a considerable slowdown from Q2, where all-property returned 1.0%, and can mostly be attributed to the current turmoil facing the office sector. Despite varied performance across the sectors, all-offices acted as the main drag to overall returns, achieving -3.7% total return; in contrast, living and industrial assets were most robust. Despite a stagnant performance over the quarter, early indications of market stabilisation and improving sentiment may support activity going into Q4.

Offices: Another slow quarter

The office sector achieved a disappointing -3.7% total return over Q3, as capital values suffered a -5.0% decline whilst income returns were broadly stable. Although rental growth has remained positive, recording 0.3% growth over the quarter, external analysis suggests performance is being supported by increasing lease incentives, which landlords are offering to maintain headline rents. The same analysis suggests that passing rents have seen a sharp decline, whilst vacancy rates have edged up to 22.0%, the highest level since MSCI records began. Despite well documented headwinds to the sector, performance is expected to become increasingly nuanced and asset-specific, which will be masked by the MSCI Monthly Index.

Capital value declines restricting quarterly returns



Industrials: Outperforming, once again

Relative to other commercial sectors, industrials performed well over Q3, returning 1.7%. After witnessing sharp capital value declines from July 2022 to end-February 2023, stabilising yields have allowed capital growth to re-enter positive territory, recording a 0.5% increase quarter on quarter. This moderate recovery has been most pronounced for industrials compared to other commercial sectors. The sector remains fundamentally well-positioned to structural shifts which continue to support demand. This is reflected in the most recent RICS Commercial Property Indicator, which suggests the net balance of occupier demand for industrial space remains positive (+10% q-o-q) whilst negative for both offices and retail, (-20% and -27% q-o-q, respectively). Over the medium term, such performance is expected to materialise in stable rental growth, sector liquidity, and capital value resilience.

Retail: Subdued outlook

The retail sector returned -0.5% over Q3. Each segment recorded negative returns apart from shopping centres, as quarterly income returns of 2.2% was enough to outweigh capital values declining -1.0%. Each segment recorded capital value declines over the quarter, driven by outward yield movement ranging between 10-25 basis points; the largest exception was shopping centres, where, according to MSCI, net initial yields compressed by 15 basis points. The worst hit retail segments were regional high street and retail warehousing, where capital values declined -2.8% and -2.4%, respectively. Whilst the outlook for the retail sector is subdued, household disposable incomes and therefore consumer spending may show signs of improvement as inflation continues to fall.