UK Economic and Property Market Update: Q4 2021

A Fund managed by Mayfair Capital

PITCH
Property Income Trust For Charities

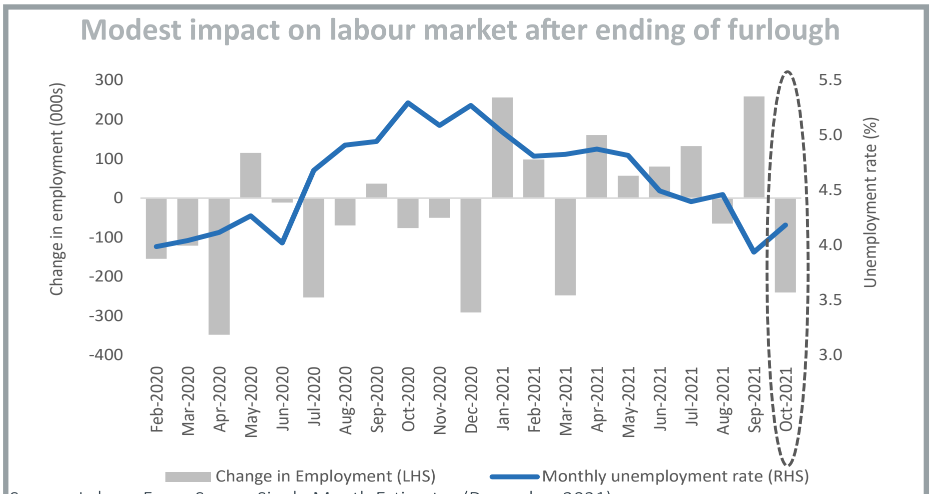
UK Economic Overview:

The UK economy experienced a disappointing final quarter of the year. Early data suggests that ongoing labour and material shortages continued to weigh on the recovery. GDP growth in October was just 0.1% over the month, falling below consensus expectations of 0.4%. While the services sector continued to grow, manufacturing output was unchanged and construction output fell 1.8%.

Sentiment for November is slightly more positive. While PMI indices cited product shortages and supply disruptions as key factors supressing manufacturing activity, looser travel restrictions were proving helpful for services exports and consumer confidence increased for the first time since July 2021.

Data in the labour market suggested the fallout from the ending of the furlough scheme on the 30 September 2021 was weaker than feared. Employment fell 240,000 in October and unemployment rose by 75,000. However, weekly data indicated that unemployment was falling again by the end of October and a rise in the PAYE measure of company payrolls in November suggest that the labour market was strengthening once again.

The discovery of Omicron at the end of November, however, means that once again we face significant disruption across the economy. The "Plan B" restrictions imposed in early December will have a smaller impact than previous lockdowns but when combined with more cautious consumer behaviour are still likely to result in economic contraction in the final month of the year.



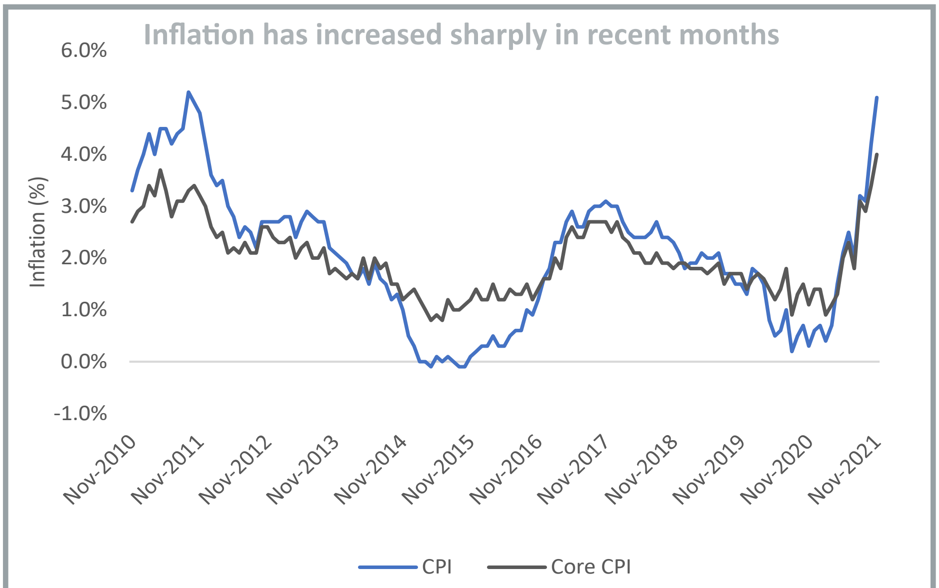
Source: Labour Force Survey Single Month Estimates (December 2021)

Current conditions mean that the outlook remains uncertain. Further restrictions appear unlikely but the number of hospital admissions in the coming weeks will be closely monitored. A more uncertain backdrop means the outlook for consumers and businesses may also be less supportive of growth this year. Household balance sheets remain in good shape but headwinds to consumer spending are strengthening given the impact of higher taxes, increasing prices, and rising interest rates.

For businesses, the early stages of Q4 bought a perceived increase in political risk arising from the implementation of the Northern Ireland protocol. Alongside further pandemic-driven uncertainty this could dampen appetite from businesses to increase capital expenditure. This would mark a clear shift in sentiment. At the end of Q3 2021, the Deloitte CFO survey suggested that CFOs were putting more emphasis on raising capital expenditure over the next 12 months than at any time in the history of the survey. Although this has not yet been reflected in GDP figures.

In contrast to the downside risks to GDP, Omicron represents upside risk to our inflation forecasts. In early December, there were tentative signs that product and labour shortages may be easing. Chinese exports had been growing strongly and some producer prices in China as well as shipping costs were starting to fall. There is risk that Omicron halts these trends and adds further inflationary pressure as restrictions boost demand for goods over services, making current shortages worse. Our view is that the period of higher inflation will still be temporary, but it is likely to be stickier than previously expected. Consequently, we have increased our CPI forecast for 2022 from 3.0% to 3.7%.

The changing outlook is having a significant impact on monetary policy. The jump in inflation to 5.1% (CPI) in November combined with the positive data from the labour market resulted in the Monetary Policy Committee (MPC) raising interest rates for the first time in three years to 0.25% in December. Minutes from the meeting were more hawkish than anticipated, with the MPC focused on the upside inflation risks from Omicron. With inflation anticipated to remain elevated for at least the first half of 2022, we continue to expect a rise this year. However, if high inflation does prove transitory and starts to trend back down in the second half of the year, as expected, any interest rate rises should be modest. This is aligned with the guidance provided by the MPC, but the more hawkish tone to their commentary suggests the risk that rates rise more quickly than anticipated has risen.



Source: ONS / Macrobond (December 2021)
* Core inflation excludes energy, food, alcohol and tobacco

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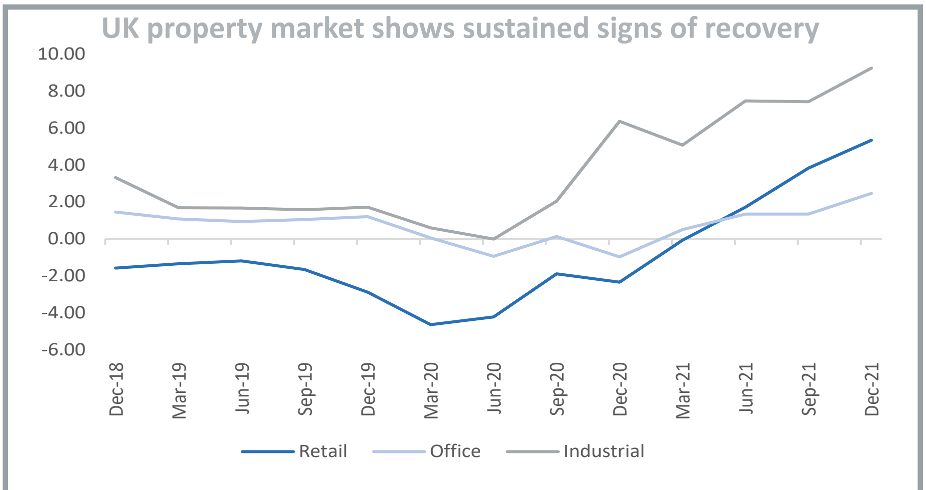
UK Property Market:

The investment market recovery was sustained throughout Q4, with total volumes reaching £17.4bn over the quarter compared to £16.3bn in Q3. Volumes were predominantly driven by the office sector which transacted over £6.7bn, surpassing that of Q3 which reached £4.5bn. All-property capital growth reached 4.5% over the quarter, reflecting the continued yield compression as rental growth remains subdued.

MSCI UK All Property returned 15.4% over the year to December with capital values up 10% over the same period. After a period of subdued growth, all-property rents are beginning to show some signs of improvement, with values up 1.0% over the quarter compared to 0.5% in Q3. This slow recovery of rental growth is forecast to continue into next year with yield movements showing signs of stabilisation. Sustained build cost inflation and material shortages will continue to limit growth in all sectors, highlighting the importance of targeting prime assets for rental growth performance.

The office sector recovery continued over the quarter with investments returning 2.5% compared to 1.4% in Q3. Capital values over the quarter showed modest signs of improvement at 1.3%, driven mostly by outward movement of yields as rental growth increased by just 0.1% over the quarter; forecasts predict rental growth recovery to continue as office job levels improve. There was divided performance across the sector, with yields hardening in the West End and regions, whilst remaining flat elsewhere. Occupier demand in regional cities has surpassed the 10-year average, demonstrating the segments resilience to homeworking. This is likely a combined outcome of cheaper space, shorter commuting times, and typically less adaptable occupiers. Across the sector, however, office buildings that offer a modern, flexible, and amenity-rich space are expected to prove resilient to changing working practices.

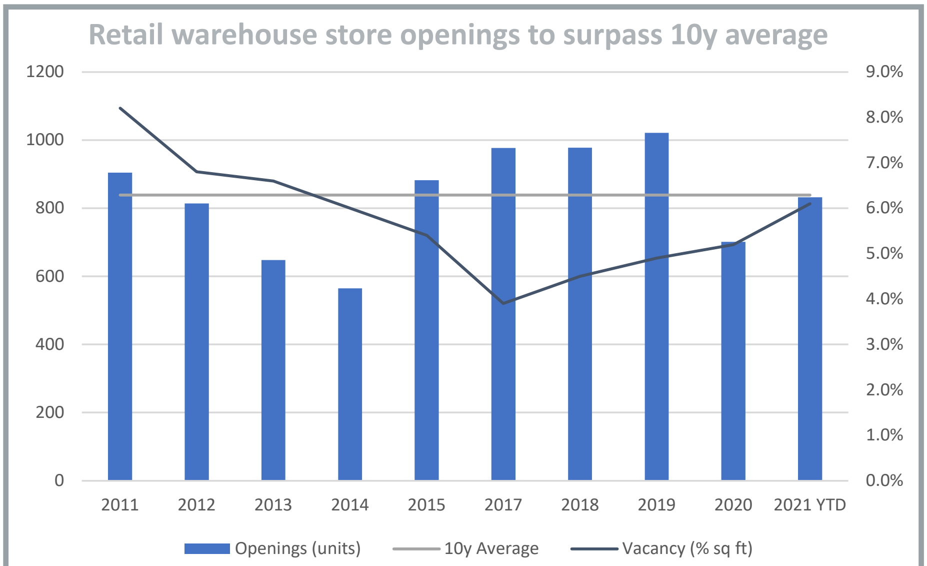


Source: MSCI Quarterly Property Digest (Q3 2021) (Dec-21 figure 3m to Nov-21)

Industrials returned 9.2% over the quarter, showing a consistent rise quarter-on-quarter over the year and this has been a key driver of all-property returns. Capital value growth continued to out-perform at 8.1% over the quarter which has almost entirely been driven by contraction in yields. Occupational activity has contributed to a record low vacancy rate of 3.7%, as take-up of “big box” units (> 100,000 st ft) is set to surpass 50 m sq ft in 2021. The rise of e-commerce seen over the pandemic has been the key driver for demand for industrial space. Although the development pipeline has increased to accommodate demand, many projects are facing delays due to ongoing supply chain issues and rising construction costs. Over the short to medium term, it is anticipated that a lack of available space will support rental growth, but as institutional demand becomes less discerning, there is a risk of mispricing.

Performance for the retail sector continued to rebound, returning 5.3% over the quarter, compared to 3.8% in Q3, and marking the third consecutive quarter of positive capital growth. Although capital values for the sector rose 3.6% in Q4, this was almost entirely driven by retail warehousing where values increased by 6.0% over the period, roughly ten times the rate of other retail segmets. Overall, capital growth performance was driven mostly by yield compression as rental values declined -0.6%. Within the retail warehousing segment, operators with a value-oriented focus continue to dominate market activity. In particular, food-based operators have accounted for a third of all new openings over 2021. Lidl has been the most active operator over the year, opening 53 new stores equating to 908,400 sq ft, helping drive new unit openings over the 10-year average for the first time since the 2019.

Whilst both occupational and investment recovery continued over the quarter, performance in 2022 is likely to be weaker as a softer economic background combined with structural factors may mute transactional activity. Rising interest rates may also put pressure on property yields although any increases are expected to be modest.



Source:Savills (2021)