UK Economic and Property Market Update: Q2 2022

A Fund managed by Mayfair Capital

PITCH
Property Income Trust For Charities

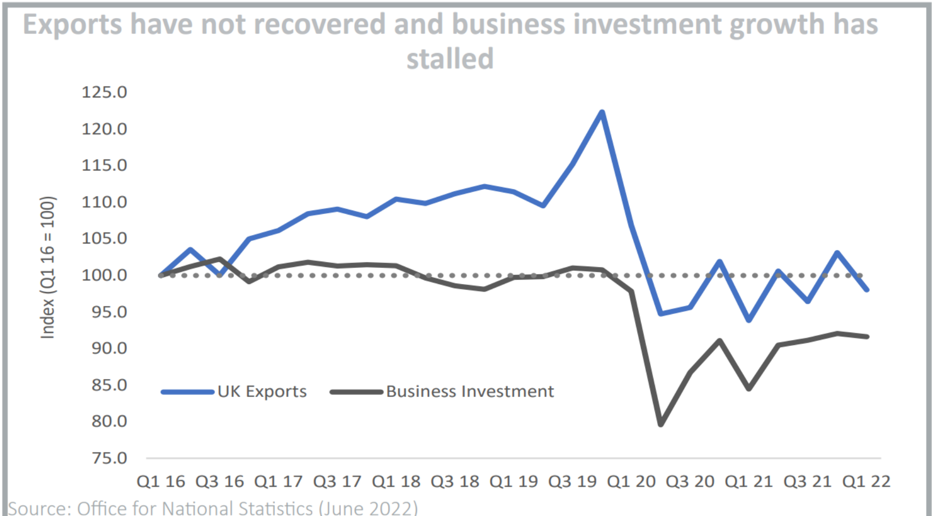
UK Economic Overview:

Inflation and the cost-of-living crisis dominated economic discourse in Q2 2022. Consumer prices continued to increase with annual CPI reaching 9.1% in May 2022. Further rises are anticipated in coming months as food prices do not yet fully reflect the increases in agricultural commodity prices, and an additional 40% rise in utility prices is expected in October.

Despite this upward trend, the fall in core inflation from 6.2% to 5.2% suggests inflationary pressures are not yet becoming more persistent. Assuming this remains the case, a weaker economy driven by the squeeze on households' disposable incomes, means inflation should be trending down by year-end. However, our forecast that CPI will stand at 7.0% at the end of 2022 and average 4.9% next year indicates it will remain well above the Central Bank's target during this period.

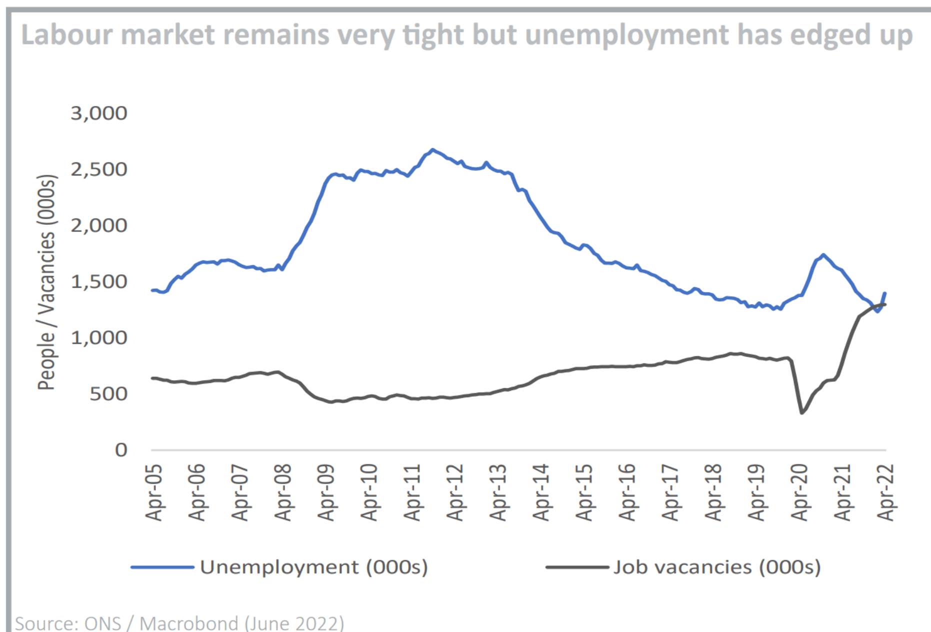
In addition, inflation risks remain skewed to the upside. There are signs that pay settlements are increasing, suggesting a de-anchoring of inflation expectations, and political developments are having an impact. A harder line on the Northern Ireland protocol is likely to weaken the pound further, adding to inflationary pressures from imports, and any further fiscal support, while supportive of economic growth, will also be inflationary.

Economic data has been relatively mixed over the quarter. GDP contracted in April as higher fuel prices constrained manufacturing growth and services output declined. Sentiment indices suggested the outlook was weakening as the Purchasing Managers' Index for services fell to its lowest level since October 2020 in May and consumer confidence fell to record lows. However, GDP growth was more resilient than expected in May, recording expansion of 0.5%. Manufacturing and Construction increased by 1.4% and 1.5% over the month, respectively. Consumer-facing services remained weak as households continued to rein in their retail and entertainment spending, with output declining 0.1% over the month, but non-consumer facing services were more resilient, expanding 0.5%.



Source: Office for National Statistics (June 2022)

Tentative signs that there are the beginnings of an easing in the labour market, suggests further challenges for consumer spending ahead. Employment fell in April and remains below pre-pandemic levels, while unemployment rose to 4.2%. That said, the market remains very tight, with high levels of job vacancies. This should support further earnings growth, albeit likely below inflation.



Source: ONS / Macrobond (June 2022)

Elsewhere in the economy, data indicates a slowing of momentum. The UK is lagging the rest of the G7 in terms of trade recovery post-pandemic and while business investment has improved, it has stalled in recent months. Both these trends have been attributed to Brexit concerns but with rising political uncertainty and taxes as a % of GDP at their highest level since the end of World War II, this is also likely to be a headwind to corporate spending.

Economic developments are being closely monitored by the Bank of England. After a rise of 25 bps in June, interest rates stand at 1.25%, their highest level since early 2009. Comments from the Committee have been increasingly hawkish, in particular noting a willingness to act "forcefully" in the event of any indications of persistent inflationary pressures. Consequently, markets are pricing in a 50 basis points increase in August and for interest rates to reach 3.0% by H1 2023, which is broadly in line with the 30-year average.

Under our base case scenario, it is expected that tighter financial conditions will lead to the UK falling into a temporary recession, with growth of just 0.4% next year, before recovering in 2024. This assumes no further escalation in the conflict in Ukraine, however, and therefore, the combination of this uncertainty alongside domestic risks, such as more prolonged inflation, more widespread UK industrial action and political changes, the risks to our GDP growth forecasts are firmly skewed to the downside. The risk of a stagflation scenario where the overshoot of inflation is higher and more persistent, requiring more aggressive monetary tightening and triggering a deeper recession remains plausible.

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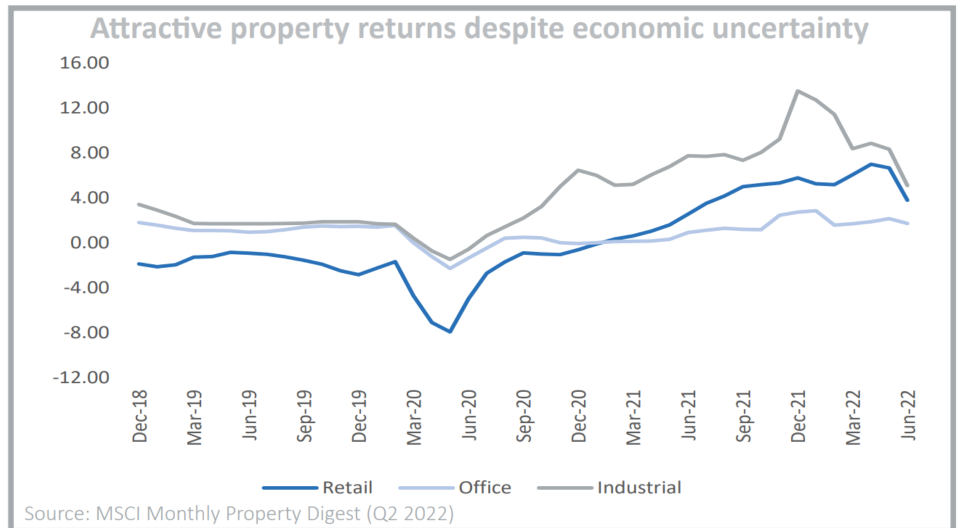
UK Property Market:

The real estate investment market is driven largely by business and consumer sentiment. The ongoing uncertainty caused by current geopolitical events and rising inflation can be expected to impact investor behaviour as businesses navigate through this period. The latest corporate sentiment survey of Chief Financial Officers (Deloitte) has provided reassurance that businesses remain focused on growth and, although investment volumes have declined to £6.5bn over the second quarter, the number of transactions has remained broadly unchanged.

Performance across all sectors has showed signs of slowing over the second quarter in response to a weakening economic outlook. Over the period, the MSCI All Property Index returned 3.8%, compared to 5.6% in Q1, and the capital growth rate has roughly halved as values increased 2.3%. Capital value growth continues to be driven by the industrial sector and retail warehousing segment, albeit at a slower pace and, despite rental growth remaining in positive territory at 1.1%, the pace of growth has decelerated across most segments.

Performance in the office sector has been consistent over the second quarter, returning 1.7% compared to 1.5% in Q1. The sector achieved rental growth of 0.1% and, while there was little spread across the segments, growth was marginally stronger in London. Capital growth was slightly more polarised, with values increasing 1.4% in the West End, yet declining -0.1% in the City; this has been driven by inward yield movement in the former, and outward movement in the latter.



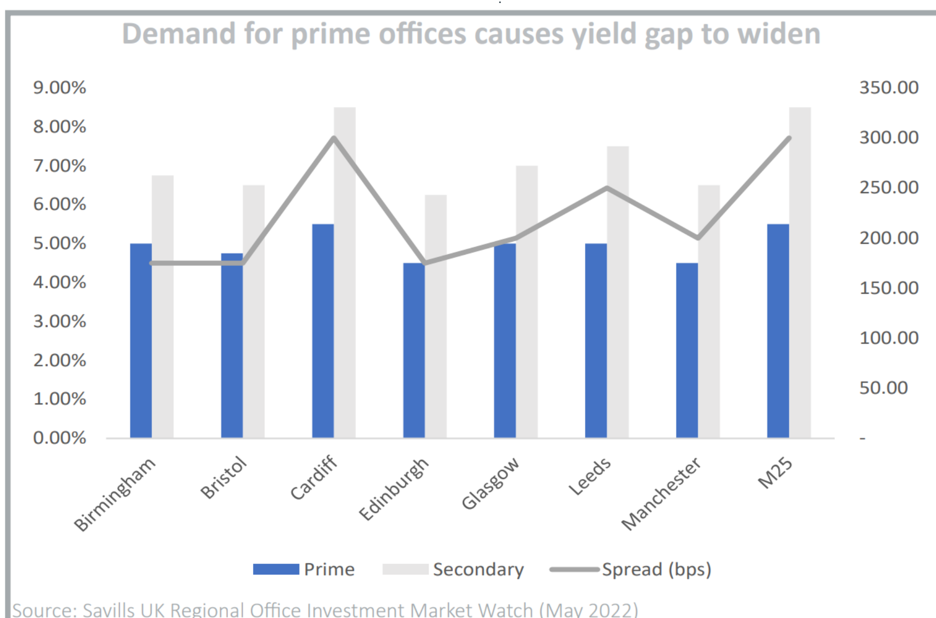
Source: MSCI Monthly Property Digest (Q2 2022)

Across each segment, significant polarisation is being experienced as demand focuses almost exclusively on prime, grade A stock. As a result, the yield gap has widened as occupier demand targets best-in-class space and will pay premium rents to secure this. In Greater London and the South-east, grade A rents were 53% above Grade B and C rents, which is being echoed across other markets particularly outside of London where commuters seek well-connected assets to avoid rising fuel costs.

The industrial market continues to outperform, despite the pace slowing rapidly. Industrials returned 5.1% over the quarter which reflects 40% slowdown from Q1. Capital values are up 4.2% quarter-on-quarter, characterised by a continued supply-demand imbalance, and yields have remained stable even for secondary estates. Rental growth has been consistent across the sector, with values increasing 2.7%, and is forecast to continue as rising construction costs put delays on the development completions. Several factors unsurprisingly, caused a drag on performance including the rise in fuel, with costs now reaching a 30+ year high, and continued disruptions across the supply chain. Large businesses are anticipated to be most resilient to the resulted margin squeezes, and operators may choose to increase their urban logistics space requirements as higher rents may be offset by lower transport costs.

MSCI all-retail has performed well over Q2 with returns reaching 3.8% and capital values increasing by 2.3%. Performance continues to be skewed by retail warehousing, which outperforms all other segments, returning 5.2% and experiencing capital value growth of 3.7% driven by continued yield compression over the period. Rental growth has been poor across the sector at just 0.1%, with retail warehousing the outperformer recording 0.3% growth. The current fall in real incomes, driven by both rising inflation and a rise in National Insurance has forced households into cautious spending behaviour. Coupled with rising energy, manufacturing, and staff costs, the outlook for retail operators looks challenging. Budget and food-based operators are likely to be most defensive, as well as luxury retailers who target an affluent consumer base.

The uncertain economic outlook will have undoubtedly affected investor confidence, which combined with a higher interest rate environment may put upward pressure on yields. Nevertheless, opportunities for rental growth are still apparent, particularly in prime, well-connected locations with strong market fundamentals. Supply-demand imbalances also remain favourable for living sectors, with the PRS segment anticipated to prove relatively resilient and continue to deliver impressive income returns.



Source: Savills UK Regional Office Investment Market Watch (May 2022)