UK Economic and Property Market Update Q2 2021

A Fund managed by Mayfair Capital

PITCH

Property Income Trust For Charities

UK Economic Overview:

The pace of the UK's vaccination programme and the gradual reopening of the economy are underpinning hopes that we are at the beginning of the end of the pandemic. Risks from new variants and a rising number of cases remain significant, but at present it is expected that the easing of restrictions will go ahead as planned on 19th July.

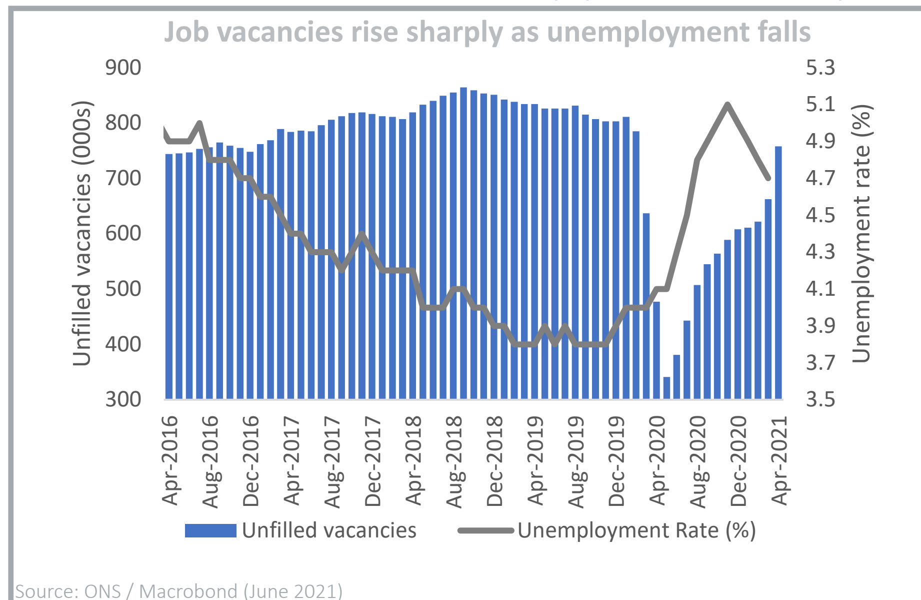
Lockdown restrictions in place during Q1 2021 resulted in a quarterly economic contraction of 1.6%, meaning the UK economy stood around 8.8% smaller than at the end of 2019. Other than Spain, this is the widest gap to pre-crisis GDP among the developed economies. Monthly GDP figures suggest a return to growth in Q2. Expansion of 2.3% in April was followed by more sluggish growth of 0.8% in May. Strong growth in the hospitality sector was counter-balanced by weather-driven declines in the construction sector and weak manufacturing data.

Business leaders remain optimistic. The latest Deloitte CFO survey found that corporate risk appetite continues to strengthen. Most expect to see growth over the next 12 months, with 76% expecting an increase in hiring and 71% planning to increase investment.

Retail sales figures disappointed in May, falling 1.4% month on month. However, it is likely that this reflects a natural slowdown after an initial surge following the re-opening of non-essential retailers in mid-April alongside an increase in households' socialising as restrictions on indoor hospitality eased. In addition, initial indications are that sales in June recorded an improvement.

Overall, consumers still appear cautious. Although May saw the first rise in unsecured borrowing since August 2020, at £0.3bn, this was just a third of the monthly average recorded the year before the pandemic. In addition, the propensity to save persists. Cash in households' bank accounts rose £7.0bn in May. While this is less than the £13.5bn saved per month from February to April, it is ahead of the pre-crisis 2019 average of £4.6bn. Although the tendency to save will have slowed growth in Q2, it could support a greater than expected increase in demand later in the year and enable consumers to spend without increasing borrowings.

Recent labour market data has been robust. May marked the sixth consecutive month of employment growth and the unemployment rate has fallen to 4.7%. Data within the PMI is showing signs of recruitment challenges and the number of job vacancies has increased to close to pre-pandemic levels. This is fuelling concerns about inflation, but the ending of the furlough scheme in September is likely to halt this decline, which should ease inflationary wage pressures.



That said, inflation expectations are increasing. CPI rose to 2.1% in May, exceeding the Bank's target rate for the first time since July 2019. This was driven by energy price rises as well as supply and demand distortions arising from recent lockdowns.

One sector that has seen a significant rise in costs is the construction sector. Supply chain disruption has driven the costs of raw materials up sharply. Input cost inflation was at a record high in the June construction PMI and the latest ONS figures suggest construction costs are up more than 8.0% year-on-year.

Rises in inflation are forecast but the period of higher inflation should be transitory given the spare capacity within the UK economy. In addition, the withdrawal of fiscal support will lower rates of consumption and we expect monetary normalisation discussions to intensify from 2022. Nevertheless, inflation risks are at their highest since 2008 and this issue as well as monetary policy responses are being closely monitored.

We are forecasting GDP growth of 6.1% this year driven by rebounding domestic demand. Growth is expected to slow in 2022 due in part to base effects, but also structural issues including a slower recovery in trade flows following Brexit.

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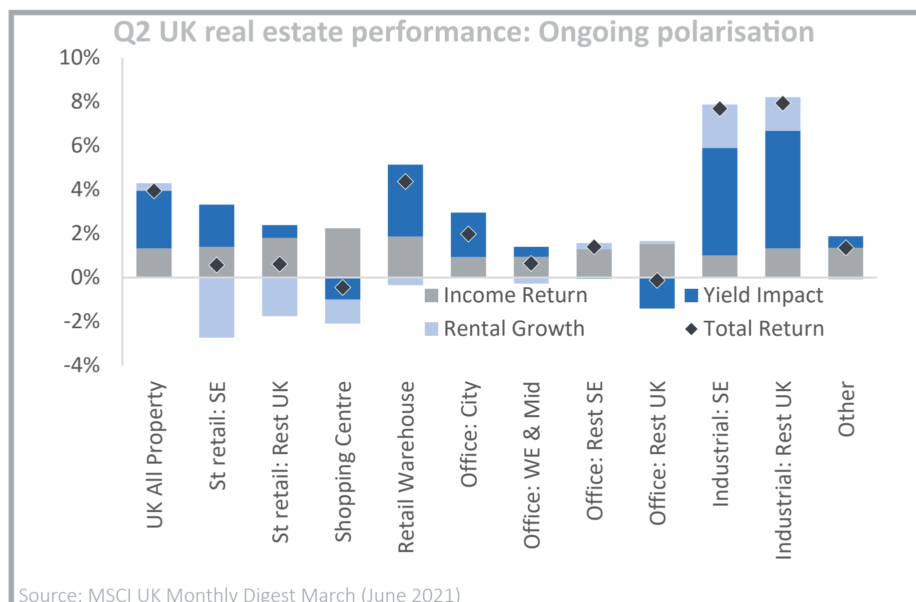
UK Property Market:

Preliminary data indicates investment volumes picked up in Q2 with total volumes amounting to £12.4m, 49% above Q2 2020 and 3% above the 10 year quarterly average. Investment activity over the year to date is up 24% over the same period last year. Liquidity is expected to further improve over the year as international travel restrictions relax and overseas investors can more easily access the market.

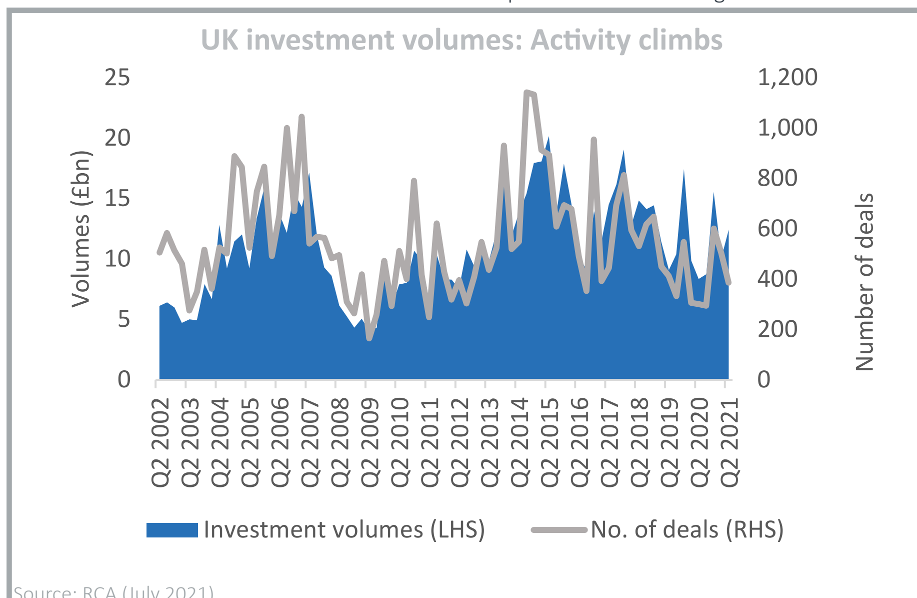
MSCI UK All Property has returned 6.2% over the year to date. Quarterly capital growth of 2.6% has been primarily driven by a contraction in yields, as rental growth at an All Property level has been marginal. The recovery in UK property will likely continue over the second half of the year, suggesting performance for the year should be strong.

Industrials' stand out performance continued into 2021. Total returns of 7.8% over the last quarter contributed to a return of 13.4% in the first half of the year. Capital values have risen 10.9% over the last six months as yields hardened and rental values grew 2.9%. Occupational activity set another record as "big box" (> 100,000 sq ft) take up over the first half of the year reached 24.4 m sq ft, up 82% on the long term H1 average, according to Savills. The strength of occupier demand has contributed to the lowest vacancy rate on record of 4.2%. Supply is expected to struggle to keep up with demand in the short to medium term. Global supply chain disruption is limiting the availability of necessary materials and causing build cost price inflation. This is expected to cause delays to developments which could lead to further yield compression in the near term.



Source: MSCI UK Monthly Digest March (June 2021)

Offices returned 0.9% in Q2 as capital values fell-0.3% over the quarter as the impact of rising yields outweighed the limited rental growth. There was a divided performance across segments as yields hardened in the City and West End but moved out elsewhere. City offices were the strongest performing office segment and recorded positive capital growth as values rose 1.0%. Occupiers are increasingly withdrawing surplus secondary space from the market reflecting increased confidence. In the City and West End, Grade A space represented 90% and 85% of total take up respectively over the first half of the year. As occupiers reassess their space requirements, we expect them to converge on the best space able to satisfy evolving requirements. With a high number of lease expiries and breaks in the coming years we expect to see occupiers relocate to modern, well-connected, flexible, amenity-rich accommodation with strong ESG credentials.



Source: RCA (July 2021)

Retail saw positive returns for the second consecutive quarter, returning 2.5% in Q2 driven by a recovery in retail warehouses, which returned 4.4%. Retail capital values rose 0.7% in Q2 down-0.5% on the year to date with shopping centres the most impacted. Capital values declined across the sector, except for retail warehouses, which rose 2.5%. Improving occupational demand within this segment is underpinning demand from investors and drove inward yield shift of 203 basis points over the quarter. Optimism is returning to the sector as the economy opens and restrictions ease. There was a shift back towards physical retail in May, with online sales falling 4.2% month-on-month. However, online penetration remains significantly above pre-pandemic levels and we expect this to persist. As many as one third of UK retail premises are either vacant, not producing income, or occupied on only a short-term basis according to Colliers. With many of these assets likely to be obsolete, investors will need to focus on repurposing opportunities.

The return to positive capital and rental growth at an all property level, supports the proposition that we are at the start of a recovery within the property market. As the pace of economic growth increases over the second half of the year and the final restrictions end, this should support occupational demand and underpin further improvements in property performance.