Economic update

Resilient growth but increasing uncertainty

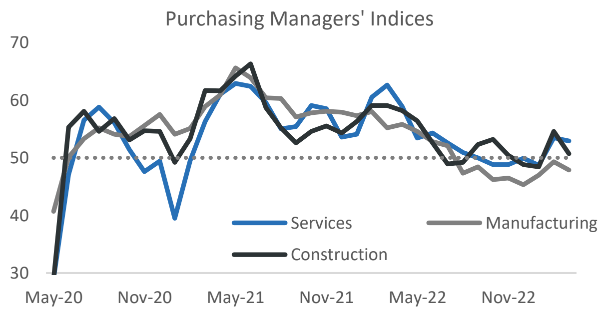
This was a quarter of two halves for the UK economy. Better than expected data at the start of the year meant sentiment was turning more positive. However, the collapse of SVB and take-over of Credit Suisse, had a somewhat sobering effect. Nevertheless, the UK economy continued to demonstrate more resilience than anticipated. GDP growth in Q4 2022 was revised upwards as household spending outperformed previous estimates and the household savings rate increased. This suggest that households' balance sheets were in a better position at the start of the year.

This appears to have translated into continued resilience in early 2023. GDP growth in January surprised to the upside, with growth of 0.4% recorded. This was in part due to fewer strikes than in December, resulting in a bounce-back in transport output, but also showed continued robust household consumption. An increased number of strikes in February had a negative impact on GDP, but there were still signs of resilience. Consumer-facing services reported improving growth driven by the retail trade. This aligns with the rise in the services Purchasing Managers' Index, which rose above 50, indicating expansion, in February for the first time since August 2022, and has remained at this level during March.

Currently, we are still anticipating a mild recession in H1 2023 in the UK. While our GDP forecasts have been revised upwards, we continue to expect the UK economy to contract 0.3% this year. Output from the manufacturing and construction sectors declined in January and sentiment suggests that manufacturing output has remained subdued throughout the quarter. In addition, businesses continue to report a challenging operating environment, and unlike household spending data, estimates of business investment growth in Q4 2022 have been revised down sharply.

Inflation data has become less positive over the quarter. Prices had been trending downwards but rose unexpectedly in February from 10.1% to 10.4%. Core inflation also increased, with rises in both core goods- and core services-inflation, and food inflation rose to a record high

PMI for Services and Construction indicate expansion



Source: S&P Global, Macrobond (April 2023)

of 18.3%. Wage growth remains elevated due to the tight labour market. Although there are tentative signs wage growth may be easing in January, more data is required to determine if this is a trend.

The rise in inflation could be expected given the more resilient economy, but it means the outlook for monetary policy is more uncertain. This has been exacerbated by the stress in the banking system, which is expected to result in a tightening of credit conditions.

This tightening may ease pressure on the Bank of England, and mean interest rates do not need to rise much further. Currently, we expect interest rates to peak at 4.50%, but if the economy continues to show more resilience than expected and inflation proves stickier, then rates could move higher. Conversely, it is plausible that tighter credit conditions dampen activity and inflation, preventing further interest rate hikes.

In conclusion, sentiment has weakened over the quarter, but the economy continues to show some signs of resilience. The outlook has become more uncertain, particularly regarding monetary policy, but we continue to anticipate a mild recession in the first half of 2023 as rising interest rates and persistent inflation dampen household spending. Under this scenario, 10-year gilts are expected to trend broadly sideways from their current position over the medium-term, settling around 3.25%.

Property market update

Values stabilising, but there is significant polarisation

Investment volumes begin their recovery

Last year, real estate performance was impacted by economic instability, surging inflation and rising interest rates, all of which led to valuation declines and a loss of liquidity in the capital market. Investment activity in the first quarter has undoubtably reflected some nervousness given the uncertainty around the strength of the financial market, with total volumes reaching £5.1bn. Although down on the long-term average by over 50%, volumes have picked up from Q4, increasing 3.7% month-on-month. As values recover, income will drive total return performance over the short-term, so we expect sectors with strong occupier fundamentals to remain in favour and correct most quickly.

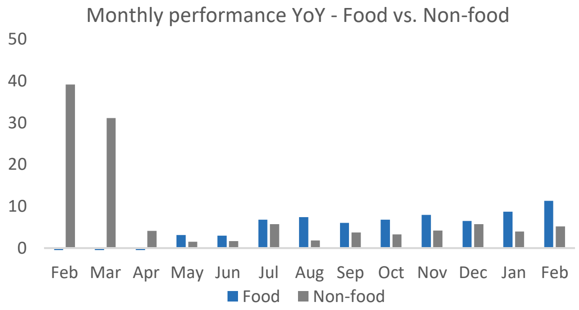
All-property: Slow but steady start to 2023

Over the first quarter, the MSCI All Property Monthly Index returned 0.2%, compared to -14.5% over Q4. The improved performance has been driven by less-severe capital movements, as values declined 1.2% quarter-on-quarter, compared with -15.6% in Q4, whilst income returns remained broadly level. This illustrates the pace at which values corrected at the end of last year due to a significant outward yield shift at an all-property level and suggests values and yields may now be starting to stabilise. Rental values have increased 0.8% over Q1, with most segments recording positive growth. The exceptions were South-East retail and Shopping Centres which saw rental declines of 0.7% and 0.3%, respectively, and regional offices where rental values were unchanged.

Offices: re-defining Grade A

The office sector is facing several headwinds to performance, given the significant changes to occupiers' requirements for specification, amenity provision and ESG credentials, all of which are causing investors to redefine the definition of 'Grade-A'. According to the MSCI Index, the sector returned -1.8% over Q1, with values declining 3.1%, due to increasing yields. In contrast, rental values increased 0.3%, with strongest growth recorded in the West End, where rents increased 0.8%. It is true, however, that the Index will be masking significant polarisation of performance between assets which satisfy the new definition of 'Grade A', and the rest. Falling availability of best-in-class stock and a slow pipeline is expected to put upwards pressure on rents in London and the 'Big Six' markets, but stranding and void risks are significant for assets which do not meet modern requirements.

Sustained food retail volumes despite record inflation



Source: Knight Frank, Retail Sales Dashboard (Feb 2023)

Industrials remain in favour

All-industrials returned 0.4% over Q1, compared with -19.4% over Q4. This considerable turnaround was driven by a swift -20.3% correction in capital values over Q4, which moderated to declines of just 0.8% over Q1. Structural demand drivers continue to support the growth of the occupier market, causing investment activity to focus on the sector. Ongoing transactional activity during a period of low liquidity has helped guide portfolio valuations, and in-turn, caused buyer and seller price expectations to move into alignment most quickly. Rental growth, particularly in the regions, have continued their steady pace, with rents increasing 1.8% quarter-on-quarter. The outlook for rental growth remains promising despite the upcoming rates revaluation, particularly in the regions where new supply is expected to be modest relative to demand.

Green shoots for retail

Retail reported the strongest total return for the "traditional" sectors in Q1, returning 1.5% over the period. Alternative sectors also performed strongly, such as Residential, which recorded a return of 2.9%. Retail warehousing outperformed the other retail segments as capital value increased 0.5% over the quarter, and income returns have remained resilient. Retail warehousing was the only segment outside alternatives to record an uplift in capital values. The outlook for the retail sector is largely driven by consumer spending which continues to surprise on the upside, particularly for value and food operators which continue to see strong year-on-year sales volumes. From the highs of nearly 38%, the share of e-commerce as a proportion of total retail spend has declined to 25%, another promising sign for physical retail, especially for stores in convenient, mixed-use locations.