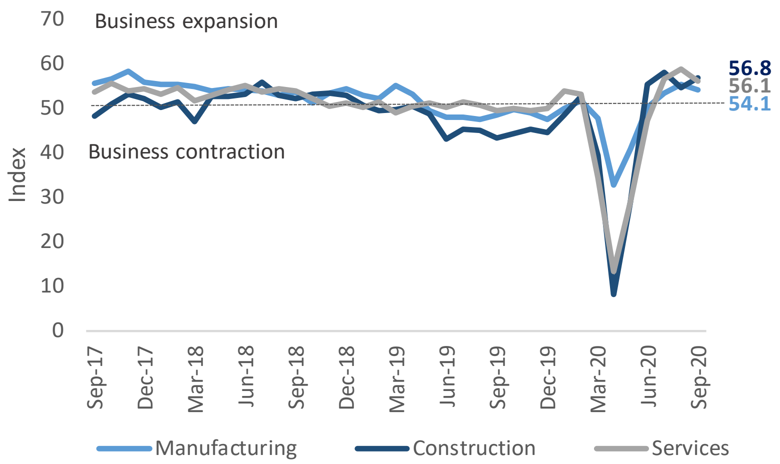
UK Economic Overview

The UK has been the worst-performing major developed economy this year. In Q2, GDP fell by 20%, much more than had been projected. Whilst activity has improved in the third quarter, the recovery is happening relatively slowly compared to other European economies. As a result, we are currently forecasting UK GDP to fall -8.9% overall this year before a 7.4% rebound in 2021, meaning that the economy will not reach its pre-coronavirus level until 2022.

Consumer spending has improved significantly in Q3 and now exceeds pre-coronavirus levels but non-retail consumption, which includes travel, transport and leisure, is recovering far more gradually, which is dragging on performance. The recently imposed 10 pm curfew and delayed reopening of some hospitality activities will further hurt these sectors. Retail spending is unevenly spread. Online retail has been the biggest beneficiary, peaking at 33% of all retail sales in May before falling back to 27% in August, representing 52% growth year-on-year. Clothing and footwear and department store trade remains well below previous levels.

PMI readings confirm that economic activity is expanding but concern among business leaders remains extremely high. The UK composite reading fell in September after expanding in July and August. All sectors continue to shed jobs. In the all-important services sector, the rate of job losses is persistently high and operating expenses are increasing. Whilst the UK unemployment rate rose to 4.5% in the three months to August, this undercounts the true picture. As the furlough scheme unwinds and is replaced by the less attractive work support scheme, we expect unemployment to rise significantly with knock-on impacts on consumer spending.

UK PMI indices: Rising optimism despite job losses



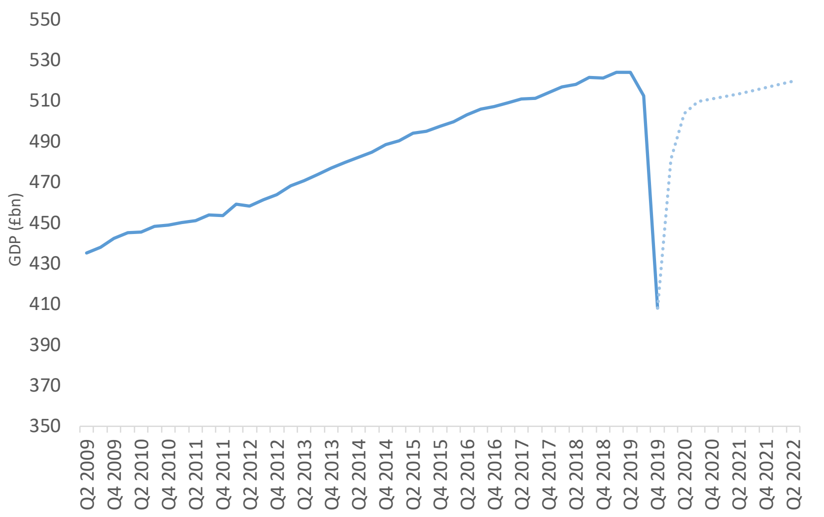
Source: IHS Markit/ Macrobond (October 2020)

Data from Google indicates that UK mobility levels are improving but still lag behind other European countries, particularly for work-related mobility. Many UK office employees, particularly those in London and the largest cities, are still working from home much of the time. This is set to continue with the government encouraging those who can work from home to do so, which constrains related economic activity such as travel or lunch expenditure. Work-related mobility is unlikely to improve meaningfully until the coronavirus is tamed, either through a vaccine or a functioning test and trace system.

UK inflation (CPIH) equated to just 0.2% in August, its lowest level in nearly 5 years, as a result of falling fuel and recreational prices and the government's "Eat Out to Help Out" scheme. We expect a deflationary environment to persist for some time whilst the UK economy operates below full capacity. This limits the scope for interest rate rises in the near future.

The UK is entering a second wave of the coronavirus. Regional lockdowns are already in place and as cases rise, more widespread restrictions should be expected. Additional government measures to mitigate the second wave will have a major bearing on the short-term UK outlook. Another major short-term risk is the end of the UK's transitional period from the EU on 31 December. In our view, a deal will be reached comprising a narrow trade agreement with the details negotiated in the future, but this will not be formalised until the last-minute meaning prolonged uncertainly. Nevertheless, an acrimonious exit on WTO trading terms is a high risk and this would be damaging to the economy. The economic risks are thus skewed to the downside.

Historic and projected GDP growth: Slow recovery



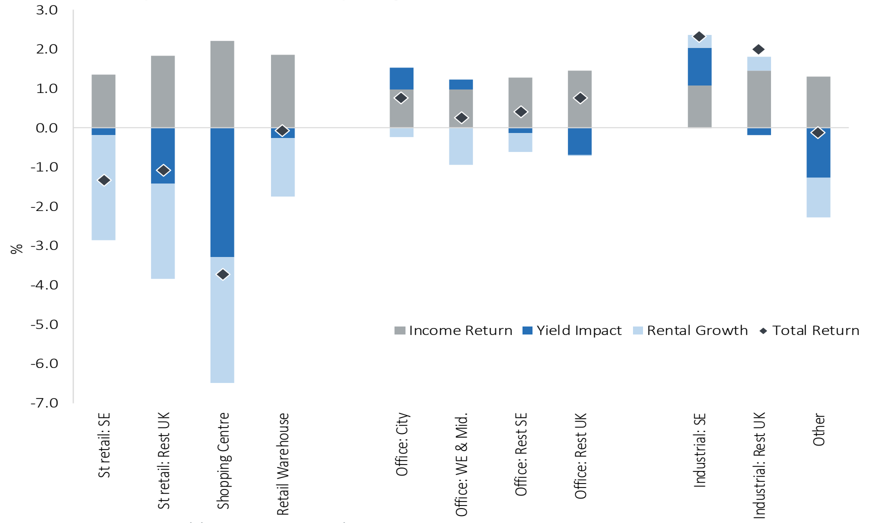
UK Property Market

Investment activity remained muted in Q3 with total volumes amounting to £7.5bn, a reduction from the £7.9bn recorded in Q2, although there may be a lag in recording all Q3 sales. Investment volumes for the year to date are down 17% compared to the same period last year. In September, the RICS recommended lifting material valuation uncertainly clauses on all UK real estate, excluding some assets valued with reference to trading potential. However, rising coronavirus cases and government restrictions will prolong uncertainly and may suppress investment volumes regardless.

According to the latest (August) IPF UK consensus forecast, UK All Property returns will equate to -7.4% in 2020 with capital declines of -11.7%. Based on the MSCI UK monthly index to September, UK all property returns were -3.0% over the year to date implying significantly worsening performance over the remaining few months of the year. Performance is highly nuanced. Industrials have returned 2.1% over the year to date, offices have returned -0.9% and retail has returned -10.2%. Within those main sectors there is also marked variation within segments.

Logistics has been a major beneficiary of the acceleration in online spending which has supported strong industrial returns. Occupational logistics activity in Q3 was record-breaking for the second consecutive quarter, with JLL reporting the highest ever level of prime take-up. We expect the UK's long-term online penetration rate to settle much higher than it was pre-pandemic and to continue to rise. This will mean elevated logistics demand supporting rental value growth.

Q3 performance by segment: Polarisation widens



Source: MSCI UK Monthly Digest September 2020

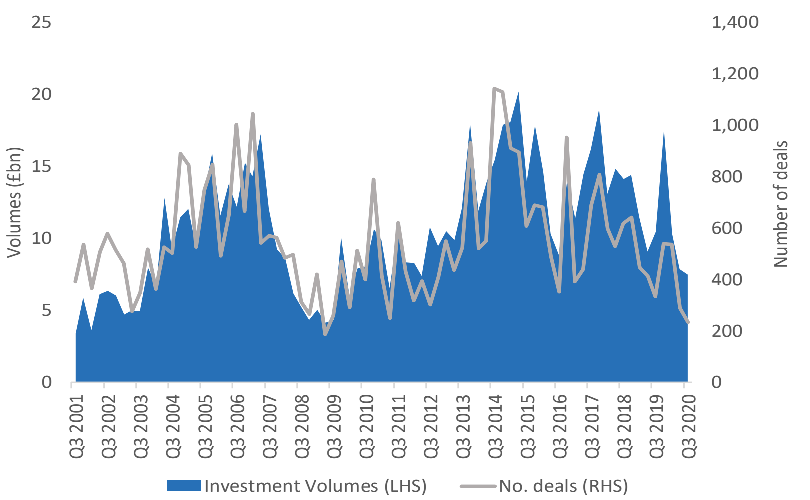
Office capital values are down -4.4% so far this year, although the rate of value loss is slowing. Offices remain under-occupied and Q3 take-up has been weak. Activity is likely to remain low as some occupiers with imminent lease events elect not to renew until re-occupation is possible and look to flexible leasing models to fulfil short-term demand. None of this changes our fundamental view on the future of offices. Repeated surveys show that the optimal solution for most employees is flexibility, with a mix of office and home-based working preferred rather than just one or the other. Offices will remain essential to enabling idea creation, innovation, collaboration, training and company showcasing. Occupiers will take less total space and they will be more selective, favouring the best quality only. This requires landlords to be more selective and deliver higher service standards.

Retail in all locations is under severe pressure due to cyclical and structural trends which have been accelerated by the pandemic. Capital values are down -2.7% on the quarter to September and -14.8% on the year to date with shopping centres most adversely impacted. As with all sectors though, the detailed story is mixed with some retailers such as discounters, supermarkets and local shops capturing higher trade levels. In the future, we believe consumers will visit physical stores more tactically, with trips being focused and targeted. For landlords this means that performance will be more variable depending on local considerations. Covenants will become harder to assess and there will be rising pressure to agree turnover-based rents.

Recent events have led to renewed interest in the living sector on account of its strong pandemic performance and its long-term potential. This reflects the significant need for modern accommodation across the aged care, later living and build to rent markets, combined with its reliable, non-discretionary income, low turnover and operational costs. Investor appetite for living stock will remain strong, despite its relatively low income returns.

In the current environment, real estate should remain attractive to investors for its income. However, accelerating structural changes mean clear winners and losers will emerge. Investors must apply renewed focus to their stock selection and asset management plans to ensure they are favourably positioned.

UK investment volumes: Activity reduces



Source: RCA (October 2020)