Economic & Property Market Commentary

A Fund managed by
Swiss Life Asset Managers UK

Q4 2023

Economic update

UK economy remains subdued.

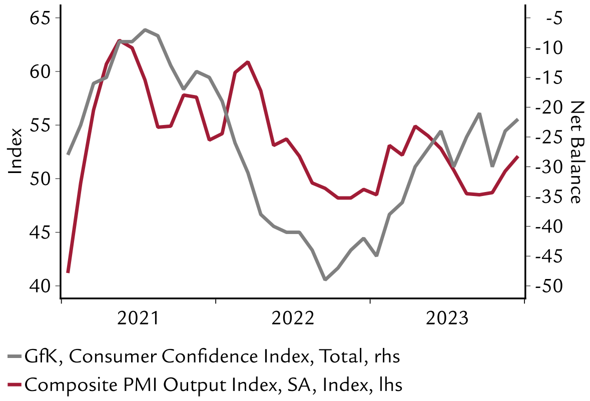
UK economic growth is likely to have been stagnant in the final quarter. The economy contracted in October but saw modest growth during November. This mirrored the improving composite Purchasing Managers' Index (PMI), which rose above 50, indicating growth, in November for the first time since July and increases the chances that the economy avoided recession in 2023. The PMI increased further in December driven by more positive sentiment in the services' sector and the GfK consumer confidence survey, also saw improvements, albeit this remains at relatively low levels. Consequently, we expect economic growth in Q4 to be at least flat overall.

Despite a better-than-expected end of 2023, the outlook remains subdued. Geopolitical risks arising from potential escalations in conflicts in Ukraine and the Middle East remain high and at home, the full effects from higher interest rates are yet to be felt. As more fixed-rate mortgages expire in 2024, more homeowners will be exposed to higher debt costs, which will continue to suppress real consumer spending. In addition, households' cash deposits have increased sharply, suggesting some households are choosing to save more, given the more attractive savings rates on offer.

Inflation has continued to edge down during Q4 reaching 4.0% in December, due to the swing in utilities' inflation and a continued slowdown in food price inflation. While these are largely controlled by external factors, further falls in services CPI and slowing wage growth suggests that domestic price pressures are also receding. Over the three months to October, the three-month annualised rate of average earnings growth fell from 2.4% to -1.2% due a fall in bonus payments. For pay excluding bonuses, the annualised growth rate slowed from 5.3% to 2.0%.

This reflects a marginal loosening in the labour market. Although employment has continued to increase, an increase in labour supply has also been reported. In October, labour supply exceeded its pre-pandemic level for the first time. This kept the unemployment rate unchanged at 4.2%. Despite weak economic growth and declining inflation, the Bank of England kept interest rates on hold at

Improving economic sentiment towards end-Q4



Sources: Macrobond, Swiss Life Asset Managers

5.25% in December. The minutes of the meeting revealed a continued hawkish stance from the Monetary Policy Committee ('MPC'). Three members continued to vote for a rate hike, and several comments pushed back against the prospect of near-term interest rate cuts. These included a continued belief that further tightening may be necessary if there was evidence of more persistent inflationary pressures and that monetary policy was likely to be restrictive for an extended period. The MPC downplayed the softer-than-expected wage and inflation releases noting that it was too early to conclude that these were on a firmly downward path. A prudent statement given the marginal rise in the December inflation figure.

Our forecasts suggest modest economic growth is expected next year, pencilling in GDP expansion of 0.4%. Inflation is forecast to continue to trend downwards but will not return to the Bank of England target until 2025. Nevertheless, we see scope for interest rates cuts from mid-2024 and have pencilled in four 25 bps cuts in the second half of the year. Geopolitics are likely to cast a shadow over markets next year, both external and domestic. There may be several bigger policy changes announced in the March budget in advance of a UK election. However, while this may bring volatility to financial markets in the short term, the economic influence is likely to be overstated as Labour's fiscal plans are not dramatically different from the incumbent government and therefore, sweeping policy changes are considered unlikely.

Swiss Life Asset Managers

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Property Income Trust For Charities

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Property market update

A mixed picture in the final quarter.

Investment market: A quarter of two halves

Transaction volumes over the final quarter followed a similar trend seen in the wider economy: starting off slow as weak momentum from Q3 continued into October, followed by an improving picture later in the quarter. Investment volumes in Q4 reached £6.3bn, reflecting a 22% decline from Q3, and 45% decline from the same period last year. That said, monthly data shows activity was heavily backloaded, as values continued to fall, and could suggest an increasing alignment between buyers and sellers' expectations. In October, investment volumes were just £1.2bn, the weakest monthly performance in over 13 years. By November, this had more than doubled to £2.9bn, and momentum was sustained into December.

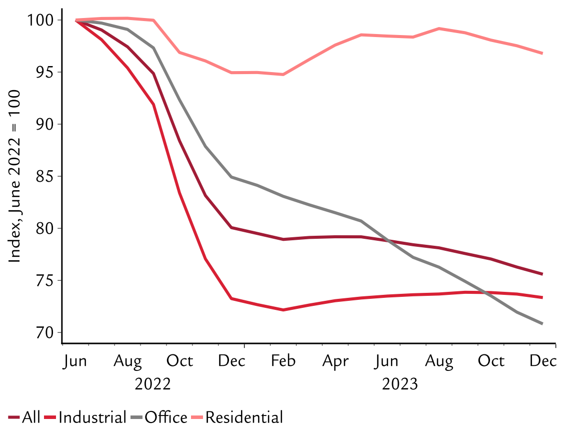
All-property: Offices hold back performance

Over the final quarter, the MSCI All-Property Monthly Index returned -1.2%, marking a 100-basis point slowdown from Q3. This was driven by an acceleration in capital value declines from -1.6% to -2.6%. This was driven by a poor performance in the office sector, which saw declines of 5.5%, widening its underperformance relative to the wider market. Compared with their peak in June 2022, all-property capital values have declined 24.4%, with office values down 29.2%. With interest rates expected to have stabilised and potential for interest rate cuts in 2024 in response to easing inflation, we expect property values to stabilise during the first quarter, before starting their recovery. However, there will remain significant polarisation between sectors and prime and secondary assets.

Headwinds continue for offices

Offices returned -4.1% in Q4, driven by capital loss. Risks surrounding the office sector mean that performance is likely to remain weak this year. In Q4, performance between London markets showed significant polarisation: West End offices returned -2.9%, the least negative of all office segments, while those in the City returned -4.9%, the weakest. Despite this divergence, prime yields are expected to stabilise in London most quickly given the stronger fundamentals, meanwhile the risk of further outward yield movement remains greatest for regional offices. Across all markets, the flight to quality continues, as businesses remain focused on attracting their staff back into the office. Consequently, take-up of new stock remains solid. This is providing some competitive tension for rental growth, but only at the super-prime end of the sector.

Capital value performance since June 2022



Source: MSCI Monthly Index. Last data point: 12/2023

Industrials lead the way

The industrial sector outperformed its peers once again, returning 0.5% over the three months to December. Overall performance can be attributed to less negative capital returns (-0.7% q-o-q) relative to other property sectors, supported by rental growth of 2.2% and more modest outward yield shift. National vacancy rates remain below the long-term average as occupiers remain active despite slow economic growth. Looking ahead into 2024, occupier demand will be supported by businesses' efforts to strengthen supply chain resilience by holding greater levels of inventory. As such, we expect moderate prime rental growth for under-supplied regional markets.

Retail: Not yet out of the woods

Over Q4, the retail sector returned -0.6%, echoing the quarter-on-quarter slowdown evident across other property sectors. Although income growth performance was relatively strong, returning 1.7% over the period, total returns were once again held back by negative valuations, which declined 3.5%: yields continued to drift outwards, while rents only edged up 0.2%. Performance will be supported by falling consumer price inflation; however, households still face significant financing burdens which will limit any recovery in sales volumes. High street retail remains plagued with store vacancies, limiting any potential for rental growth. However, some segments have shown resilience, namely supermarkets and retail parks, particularly those located in mixed-use, convenient locations, and able to service online orders.