Mayfair Capital Investment Management

UK Economic and Property Market Update: Q3 2022

PITCH
Property Income Trust For Charities

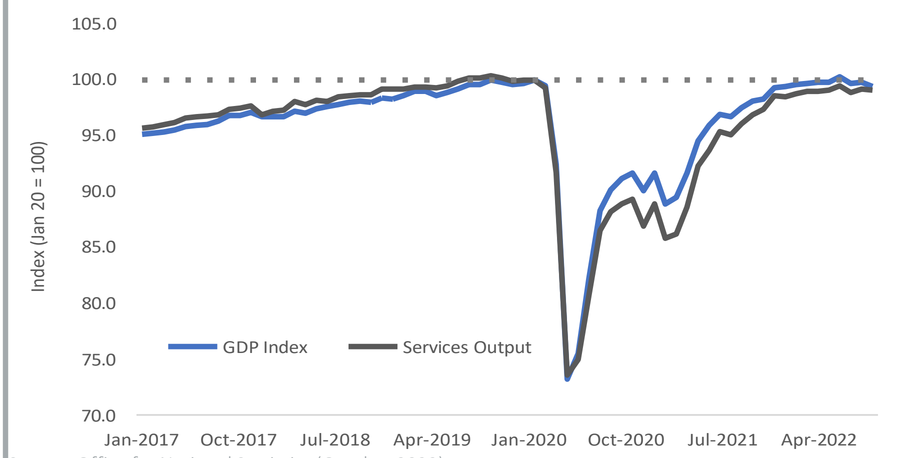
UK Economic Overview:

The 23rd September 2022 is likely to go down in history, following the so-called "Mini-Budget", which announced a £45bn package of tax cuts. This was in addition to the previously unveiled Energy Bill Relief Scheme that capped energy costs for businesses and households and amounted to the largest UK fiscal loosening since 1972.

This sparked a negative reaction from the markets, with sterling collapsing and bond yields rising at an unprecedented rate. This reflects market expectations that this action is likely to lead to more prolonged inflation and therefore, higher interest rates, and that the deterioration in public finances will undermine the UK's long-term growth prospects.

The Bank of England intervened in the turmoil by announcing that it would buy gilts "on whatever scale is necessary" to restore order to the market. This had the effect of reducing the gilt yield to around 4.0% but nervousness returned to the market as the scheme approached the end date. In addition, after just 39 days Kwasi Kwarteng was sacked as chancellor and replaced by Jeremy Hunt, who is likely to announce a raft of measures to try and reassure the markets further.

In the short-term, the freezing of energy costs for households and businesses should support economic activity and limit the inflationary rise in October. However, by increasing consumption, the measures are expected to increase domestic inflation over the medium term. At the same time, currency swings mean that import prices are increasing, adding further inflationary pressures with risks to sterling valuations remaining tilted to the downside given ongoing disagreement regarding Article 16 of the Brexit deal. Externally, the conflict in Ukraine continues to compound upside risks to inflation.



Source: Office for National Statistics (October 2022)

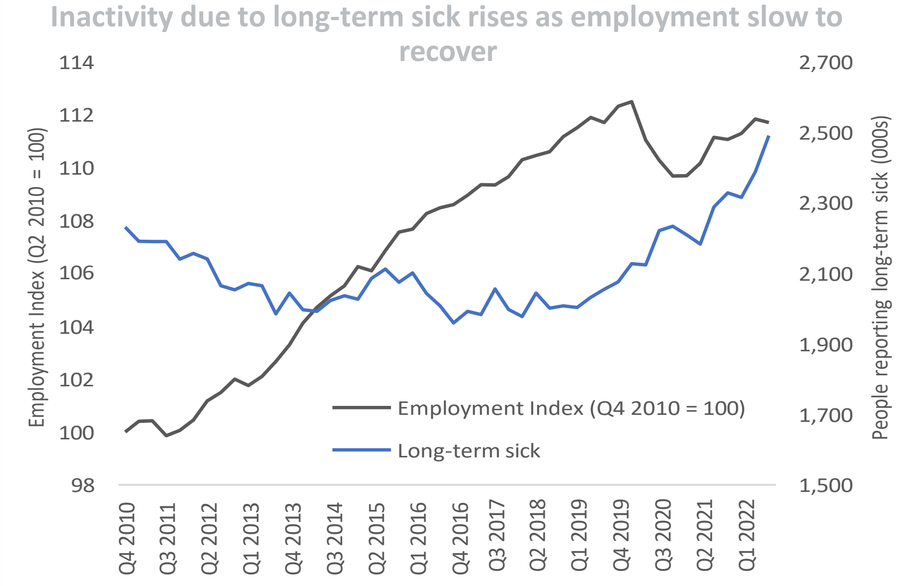
A prolonged period of higher inflation is expected to result in rising interest rates and significant increases in borrowing costs. While UK household balance sheets are in good shape with stable debt levels and record high cash deposits, higher inflation and higher interest rates will create headwinds to consumer spending growth.

Consequently, GDP forecasts have been lowered. Our forecasts indicate a contraction of 0.1% in UK economic output next year. For several reasons, risks to growth forecasts remain to the downside, including the risk of rolling electricity blackouts over the winter. These forecasts are against a backdrop of downward revisions to historical GDP growth in 2020 and 2021, which mean the UK economy remains smaller than pre-pandemic. While upward revisions to growth in Q2 means that the UK economy is not yet in recession, sentiment indices, such as the PMI, and monthly GDP data suggest that output shrank in Q3.

A key indicator to watch is the labour market. Latest data indicate some softening in the labour market as employment fell over three months to August and the number of job vacancies fell in September for the fourth consecutive month. However, the supply of labour remains constrained given the shrinking of the UK labour force since February 2020. In part this is due to lower net migration, but it is also being driven by record levels of workers exiting the market citing long-term sick. Over the three months to August an additional 330,000 people became inactive, pushing the unemployment rate down to 3.5%. The continuing labour shortage is underpinning a further acceleration in wage growth and is likely to remain a source of inflationary pressure for some time.

This macro-economic backdrop means that the Bank of England is expected to pursue a more aggressive path of monetary tightening, with interest rate hikes of 100 bps anticipated in November and December. Our current forecasts expect interest rates to peak at 5.00% early in 2023 and to remain at this level for most of the year. It is possible that interest rates will start to trend back downwards from the end of next year if the negative feedback loop from a housing market downturn triggered by higher borrowing costs feeds into the rest of the economy.

16th October 2022



Source: ONS (October 2022)

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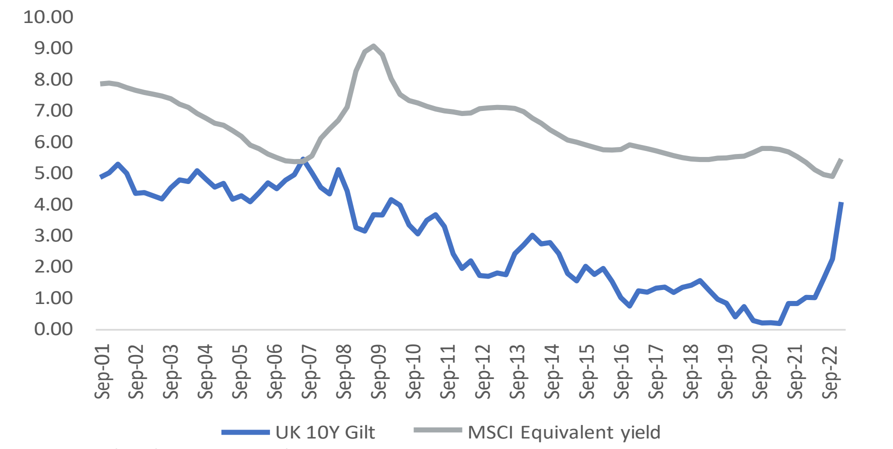
UK Property Market:

In response to a rapidly evolving economic backdrop, the UK property market has lost significant liquidity. Total investment volumes into real estate over the third quarter reached £7.2bn, which reflects a 25% reduction in total volumes relative to the previous quarter, and a 40% reduction relative to Q3 last year. Investment activity in the final quarter may continue to wane whilst the central bank attempts to navigates the economy away from stagflation and a weakening pound.

Performance across all commercial sectors has reversed, with total returns plunging into negative territory over the quarter. The MSCI UK All Property index returned-4.1% over Q3, compared to 3.8% in Q2, driven by a weakening capital market responding to significant outward movement of gilt yields. Over the quarter, all property values have fallen by 5.1%, with industrial values hit the hardest, down 8.1%. In spite of this, all-property rental growth remains positive at 1.0%, although the pace of growth has continued to decelerate over the quarter. It should be noted that valuations lag the market and sentiment points to sharper declines in capital values given the sharp increase in gilt rates. Transactional activity has been limited since the 'mini-budget' but we anticipate further declines in capital values across all sectors as more transactions complete.

The office sector returned -1.6% over the third quarter, compared to 1.7% in Q2. Negative returns have been driven by regional and South-Eastern offices, as capital values have fallen by 3.2% and 3.3%, respectively. The sector recorded 0.4% rental growth and, while growth has been mostly consistent across the segments, regional offices marginally outperformed with 0.7% growth over the quarter. London offices are perhaps the least vulnerable, as the pace of outward yield movements has been moderate relative to other segments and may benefit from international capital looking to benefit from currency swings. Despite rising cost pressures, occupier demand across London remains strong. Demand is expected to remain focused on prime, Grade A, ESG-rich stock, of which there is modest availability. The rest of the office sector is looking particularly exposed to a weakening economic outlook which may cause distress in the occupier market.

Sharp rise in gilt yields will impact pricing



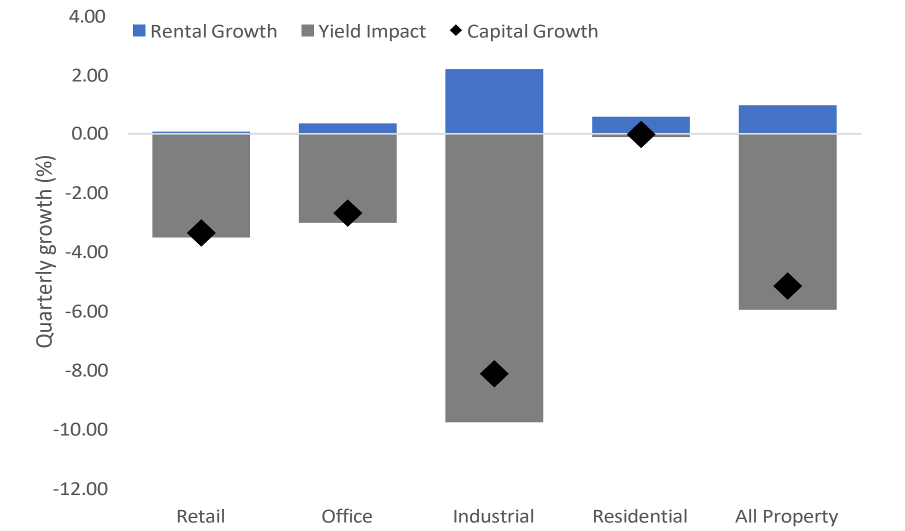
Source: Macrobond; MSCI Quarterly Digest Q3 2022

Given the strength of yield compression in the industrial sector in recent years, it is most vulnerable to the sharp movement in gilts. Therefore, perhaps unsurprisingly, the industrial sector experienced the weakest performance relative to the other commercial sectors. Over the quarter, industrials returned -7.3% with capital values declining by 8.1%, driven entirely by yield decompression. In spite of this, structural drivers continue to increase occupational demand for storage, supporting modest rental growth of 2.2% during Q3. Although occupier demand is moderating, low levels of vacancy persist, and the development pipeline will be constrained by rising construction costs. For this reason, modest rental growth is still anticipated.

Since the re-opening of physical retail after the pandemic, all-retail returns have been skewed by retail warehousing which was the clear winner in both the capital and occupier markets. This success has dissipated over Q3, with retail warehousing returns below all-retail, at-2.1% and-1.9%, respectively. Capital loss has been consistent across the segments, with value declines of -3.3% overall. This has been driven by yield softening, albeit this trend has been observed since Q2 at first mention of a recession. A worsening outlook on the cost of debt and mortgage rates will continue to limit household's disposable income and hence, spending. As a result, leisure-based retail such as restaurants and shopping centres have the weakest outlook. Conversely, convenience and value retail should be more resilient, particularly well-located supermarkets, where spend is considered more mandatory.

While the investment market responds to significant policy announcements, price corrections are expected and will cause a dampening of investor sentiment and liquidity. If GDP contracts next year as currently forecast, distress in the occupier market may prevail and limit rental growth. During these conditions, stock selection and having a disciplined thematically-based investment strategy will be crucial.

Capital declines driven entirely by capital markets



Source: MSCI UK Quarterly Fund Index (September 2022)