Economic update

Persistent inflation drives rate expectations higher

Economic discourse was dominated by inflation in the second quarter. CPI proved stickier than anticipated, with core inflation rising to 7.1%, the highest level in over 30 years in May. Both CPI and core inflation trended downwards in June, and this is expected to continue due to the fall in utility prices in July and further easing in food price inflation. However, price pressures appear to be increasingly domestically generated, as accelerating wage growth, underpinned by the shrinking of the labour force, manifests in increasing prices for domestic services.

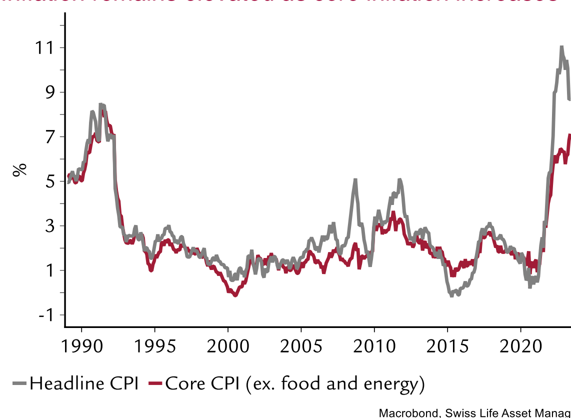
Currently, there are few signs that the labour market is loosening. As at May 2023, the number of job vacancies had fallen every month for the last 12 months but remained almost a third higher than pre-pandemic levels and employment has continued to rise. This has supported further growth in wages, which are rising 6.5% year-on-year, well above the level consistent with the Bank of England's 2.00% inflation target.

A weaker economy will be necessary to reduce demand and cool the labour market and wage growth. Consequently, the market's interest rate expectations have risen. The Monetary Policy Committee (MPC) raised interest rates by 50 bps in June to 5.00% and while it did not commit to raising rates further, it reiterated that continued evidence of persistent pressures would require further tightening. We expect interest rates to peak at 5.50% this year and remain at this level into 2024, with scope for modest monetary policy loosening from Q2 2024.

The 10-year government bond yield has risen sharply, reflecting higher inflation and interest rate expectations, standing at 4.43% (4 July '23). It is likely to remain elevated over the short-term due to a combination of persistent deficits in government spending and Quantitative Tightening (QT) resulting in an increased supply of gilts.

Despite the tightening monetary policy, the UK economy is appearing resilient. GDP rose 0.2% in April driven by growth in the services sectors. While output declined 0.1% in May, this was partly due to the extra bank holiday, with underlying growth more positive than this suggests.

Inflation remains elevated as core inflation increases



Macrobond, Swiss Life Asset Managers

As the impact of the bank holiday unwinds in June, growth could be stronger. This expectation is further supported by the flash UK composite PMI, which has softened over the quarter, but remains consistent with growth.

However, further monetary tightening is expected to weaken the economy and we are anticipating a mild recession in H2 2023. Households' real incomes are already being squeezed by inflation and this will be compounded by higher borrowing costs for mortgaged homeowners. Increased debt costs and weaker consumer demand are also creating challenges for businesses resulting in increasing insolvencies. In May, the number of registered company insolvencies was 40% higher than the same month in 2022 and almost 90% above May 2019.

In 2024, we expect global headwinds and monetary policy tightening to continue to dampen growth. We anticipate that the UK economy will expand 0.4%, but there is a risk that interest rates rise more than anticipated, and further weaken GDP growth. Geopolitical risks also remain skewed to the downside. Inflation is expected to decline but remain above the MPC's target due to a higher energy price environment and relatively tight labour market. It is also expected to be more volatile than over the last decade due to several factors, including the impact of climate change on food price inflation. This will limit the MPC's ability to decrease rates significantly. Consequently, we expect a higher interest rate environment, relative to the post-GFC period, to persist in the medium-term.

PITCH
Property Income Trust For Charities

Property market update

Has the recovery of performance run out of steam?

Investors seek diversification

Uncertainty in the financial markets continued to constrain activity into the second quarter. Higher financing costs have been restrictive for debt-backed buyers, who, as a result, have been less active. Investment volumes into traditional property sectors reached £3.3bn, reflecting a 53% slowdown from Q1, and 66% below the long-term average for Q2. Meanwhile, investment into alternative property sectors displayed greater resilience. In particular, investment into the living sectors (including BtR and healthcare), which increased quarter-on-quarter by 5%, as investors recognised attractive structural tailwinds, and sought to gain greater portfolio diversification. We expect investors will continue to consider alternative investment strategies into H2 2023, particularly in response to a shifting economic environment.

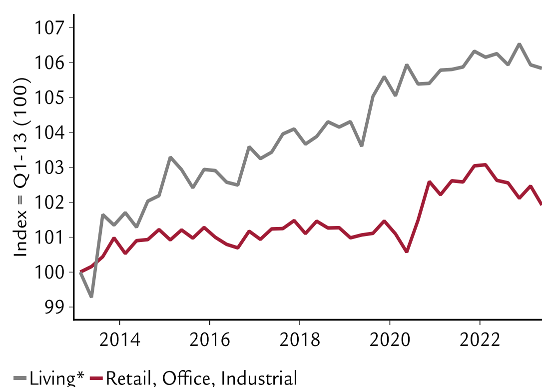
All-property: Slow and steady, for now

Over the second quarter, the MSCI All Property Monthly Index returned 1.0%. Although performance showed a modest recovery from Q1 where all-property returned 0.2%, momentum reduced over the quarter as economic uncertainty failed to improve. Over the period, capital values for all-property declined by 0.4%. The most significant falls were experienced in the month to June, particularly for offices, where values declined by 2.2%. MSCI All Property rents have shown more resilience, increasing 1.0% over the quarter. Although a valuable insight to the market, the Index masks polarisation on both an asset and sector level, highlighting the continued relevance of careful stock selection and income diversification

Offices: Super prime, and the rest

The office sector has been the main drag on property performance over Q2, with each office segment recording a negative return. Over the period, all-offices returned -2.8%. This has been driven by a -4.1% capital value decline as yields continue to move outwards whilst investors consider how much risk they are willing to tolerate. In contrast, rental values edged up 1.0%, compared to 0.3% over the previous quarter, and may be a reflection of improving office occupancy. Whilst still early days and far from pre-pandemic levels, the occupier market is demonstrating signs of a shift back towards office-centric working. We expect this trend to materialise in stable rental growth over the medium-term. However, this will be concentrated on assets which are being redefined as 'super prime'.

Quarter-on-quarter investment growth for UK living



Source: RCA (Jun-23)
*Hotel, Apartment, Senior Housing & Care

Industrials: Reliable for performance

The turnaround in performance witnessed over the first quarter has continued into the second, as all-industrial returned 2.4% compared with 0.4% over Q1. Contributions to the quarterly total return have been equal between income return and capital growth of 1.2%. The industrial sector recorded the strongest quarterly rental growth relative to other sectors, after rents increased 1.8%; performance has been broadly consistent across the South East (1.7%) and Rest of UK (2.1%). New supply is expected to be delivered over the second half of the year and, whilst this may apply some upwards pressure on vacancy rates, an oversupply relative to demand is not expected and rental growth performance is expected to show resilience.

Retail: Benefitting from high yields

Retail performed well, returning 2.0% over the quarter, driven by income return, which contributed 1.7% compared to capital values edging up just 0.3%. This is especially true for shopping centres which returned 1.9%, despite capital values declining 0.4%. Whilst pricing drifts outwards, favourable lease structures, often with index-linked uplifts, are supporting overall performance. Pricing for some retail segments may offer opportunities despite a more subdued rental growth outlook, as yields remain well above the risk-free rate. As such, investment activity is focused on segments where consumer spend has demonstrated resilience to increasing cost pressures. These include supermarkets, discount-anchored retail parks and convenience grocery. Performance of the retail sector will continue to be distorted by these segments.