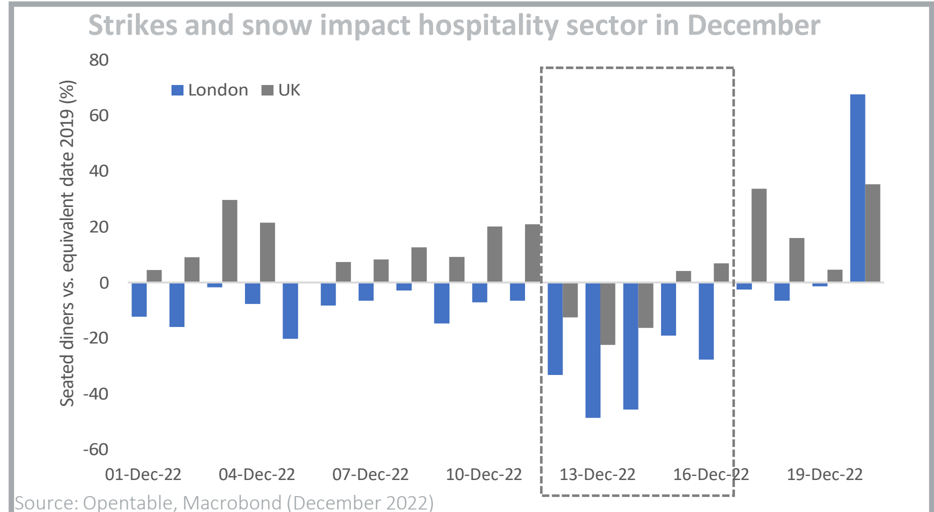
UK Economic Overview:

The final quarter has proved challenging for households and businesses as they grapple with cost inflation in excess of 10%, and higher borrowing costs, following the rise in interest rates to 3.50% in the most rapid period of monetary policy tightening in any cycle since the late-1980s. Economic indicators suggest this has pushed the UK economy into recession in Q4. The composite PMI has sat consistently below 50, the level indicating growth, UK exports remain lacklustre, and retail sales figures weak. Flash PMIs released in December pointed to contraction of 0.1% in Q4 2022, but snowfall and increased strike action in December may have reduced output further. This is already visible in high frequency data related to the hospitality sector.



Strikes and snow impact hospitality sector in December

Source: Opentable, Macrobond (December 2022)

The labour market remains tight but there have been signs of cooling labour demand in Q4 2022. Job vacancies fell for the sixth consecutive month in November and unemployment rose for the first time since February 2021. The latter was primarily driven by an increase in the labour supply as people came out of retirement. This may be a sign that cost-of-living pressures are starting to encourage some back to the job market.

Challenging conditions will persist in 2023. The OBR is forecasting two years of sharp contractions in households' disposable income due to higher energy bills and mortgage payments. In addition, unemployment is expected to rise as the economy weakens, putting further pressure on incomes. While households accumulated considerable savings during the pandemic, the record low level of consumer confidence suggests they will continue to be cautious and are unlikely to deplete savings to support consumption.

Similarly, the outlook for business investment is weak as higher borrowing costs encourage more to pay down debt. Forecasts from the CBI suggest business investment could be 9% below pre-pandemic levels by end-2025 citing a lack of action from the government to encourage investment and address skills and labour shortages, as well as the impasse in relation to the Northern Ireland protocol.

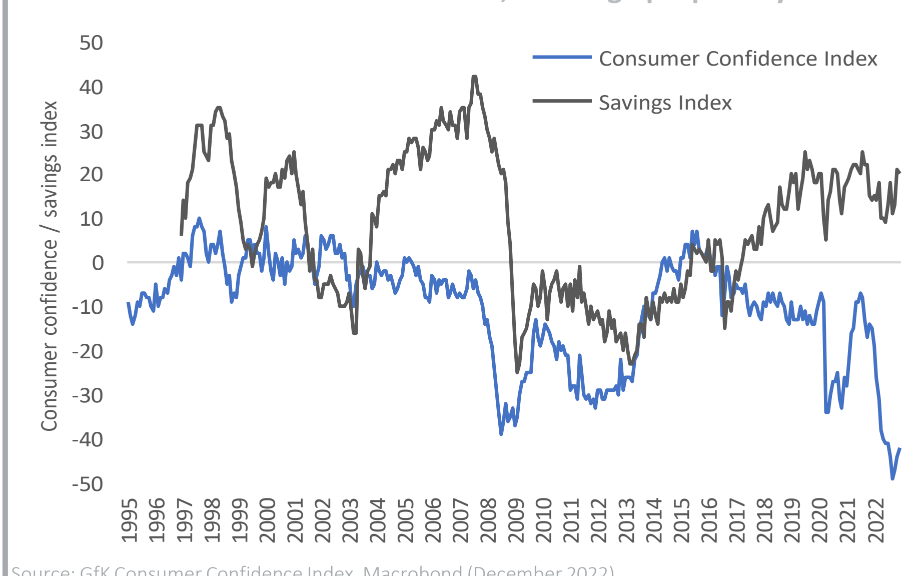
Consequently, the outlook for economic growth in 2023 has softened. Swiss Life Asset Managers expects five quarters of negative growth from Q3 2022 and is forecasting that the UK economy will contract by 1% next year.

Inflation is anticipated to trend downwards over the next year. November inflation data indicated a broad easing of underlying inflationary pressures. Global food prices are falling, suggesting food price inflation should start to decline in 2023 and a combination of negligible rises in producer prices, a sharp fall in shipping costs, and the build-up of excess inventory, points to a rapid decline in core goods CPI in 2023. Furthermore, while energy prices remain elevated, they are currently falling and are not forecast to increase significantly. Therefore, their contribution to inflation will fade. Domestic services inflation is likely to be slower to fall as wage pressures remain. However, the labour market is easing, which should dampen wage growth in 2023.

Despite the downward trend, inflation is expected to remain well above the central bank's target. Inflation forecasts are highly uncertain but Swiss Life's current projections suggest CPI could end 2023 around 4%.

The Bank of England is likely to remain concerned about inflation in the short-term and we anticipate an increase in the base rate to 4.00% during Q1 2023. However, if economic and labour market data softens further, we expect the MPC to end its tightening cycle by Q2 and keep rates stable for the remainder of the year.

While there is more clarity around the outlook today than at the start of Q4 2022, significant downside risks remain. Geopolitical risks remain elevated due to the conflict in Ukraine and increasing tensions in Iran and China. While energy supplies appear secure this winter, countries will need to replenish their stocks next year, keeping prices elevated. If combined with a sharp increase in demand from China, LNG prices could be volatile, keeping inflation above the central banks' target rates for longer.

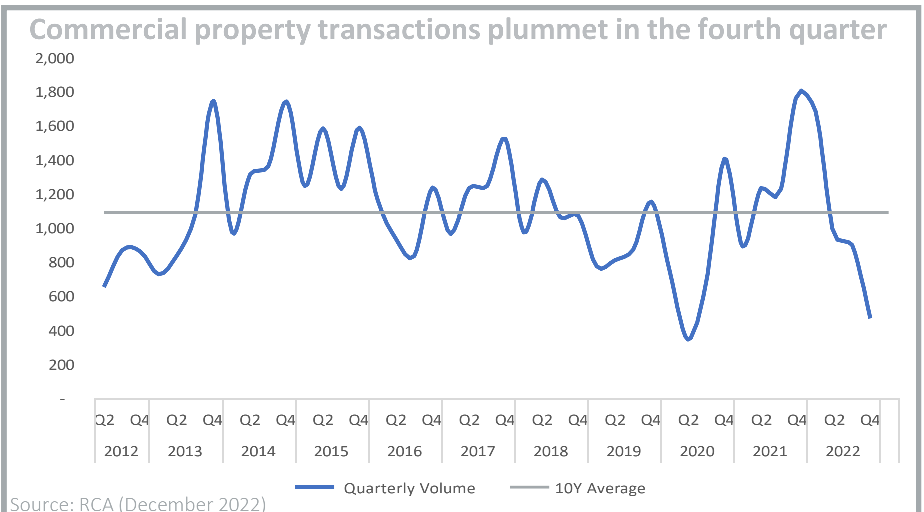


Consumer confidence at record lows, with high propensity to save

Source: GfK Consumer Confidence Index, Macrobond (December 2022)

UK Property Market:

We entered the final quarter of 2022 dealing with the consequences of the Government's 'mini-budget', the effects of which both the Bank of England and succeeding Government have worked hard to reverse. Over the quarter, 10-year Government bond yields peaked at 4.6%, putting upwards pressure on property yields and causing capital values to plummet. As a result, commercial property lost significant liquidity, with volumes reaching £4.7bn, just half that of Q3 and 24% down year-on-year, as investors sought to determine fair value.

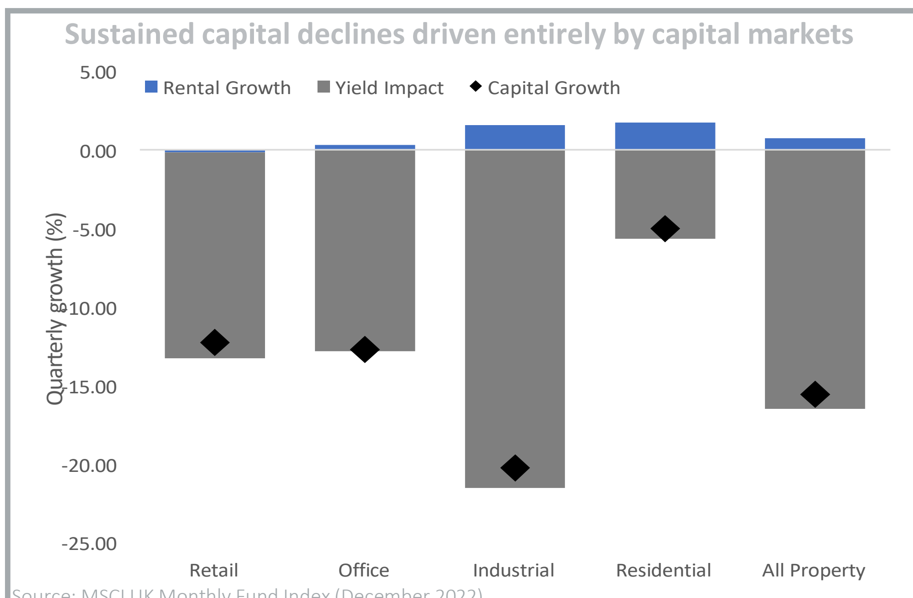


Source: RCA (December 2022)

Over the quarter, the MSCI UK All Property Index returned-14.5%, compared to-4.1% during Q3, marking a significant slowdown in performance. This was almost entirely driven by the substantial 15.6% fall in capital values given the 108-basis point outward yield movement at an all-property level. Performance across the sectors has been felt disproportionately, with those that saw the sharpest capital gain over the last 12-months experiencing the sharpest correction. In spite of this, rental growth has managed to remain largely positive, with all-property rents increasing by 0.7% over Q4. As we enter 2023, preserving and generating income will become the focus as the UK grapples with a recession.

The office sector returned-11.7% over Q4 and, unlike Q3 when negative returns were driven by specific regions, weak performance has been felt almost uniformly across the segments. Capital values have fallen by 12.7% due to outward yield shift as rental growth managed to stay marginally positive at 0.3%. Rental growth is likely to enter negative territory next year as occupational demand softens, particularly for secondary assets. Good quality assets with strong ESG credentials will be most resilient over the medium term as this is likely to be where occupier demand will remain focused and occupancy rates in these buildings are likely to be higher. There remains a severe shortage of modern buildings that offer best-in-class amenity and strong ESG credentials, particularly in the largest regional cities. Consequently, these assets will be able to deliver resilient income returns and potential for income growth.

From an occupational perspective the industrial sector remains buoyant, but the capital market has weakened over Q4, returning-19.4% compared with-7.3% during Q3. Capital loss has been significant this quarter, with values falling 20.3% entirely due to outward yield shift of 125-basis points. Rents edged up 1.6% over the quarter. This divergence between capital and occupational markets has been most pronounced for industrials, following a recent run of significant yield compression leaving the sector exposed to sharp swings in the gilt market. The occupational outlook remains robust, however, and there are likely to be opportunities in the market. Although the sector is vulnerable to weaker conditions for retailers, long-term structural changes supporting demand, persist, and there continues to be a shortage of suitable stock to meet this need, therefore the prospect for rental growth remains.



Source: MSCI UK Monthly Fund Index (December 2022)

Over the quarter, the retail sector returned -10.8%, in line with the office sector. Performance has been supported by a relatively high income return, at 1.6%, and less severe capital losses in some segments. However, in our view, short-term resilience and weaker capital losses do not signal an investment opportunity for the sector overall. The outlook continues to weaken in tandem with both the economic outlook and cost of living crisis, which will undoubtably stretch consumer spending for the most part of next year. Despite this, the fallout from failing retailers is expected to be less severe compared with previous recessions, as businesses have been hardened as a result of the pandemic; operators with an omni-channel presence are expected to show most resilience.

The fourth quarter has been characterised by significant price corrections in the capital markets. Valuation falls have been deep but whether they completely reflect market sentiment remains in question, particularly in sectors where transactional evidence has been limited. As we enter an economic recession and period of more sustained higher interest rates, pricing may continue to adjust, particularly in response to a weaker occupational outlook.