UK Economic and Property Market Update: Q1 2022

A Fund managed by Mayfair Capital

PITCH

Property Income Trust For Charities

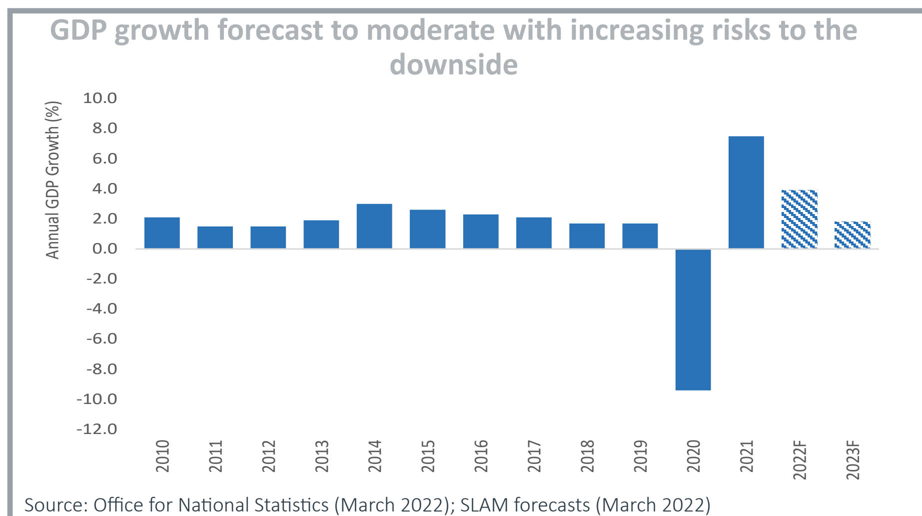
UK Economic Overview:

The first quarter has been a tale of two halves, split by the invasion of Ukraine by Russia in February. A humanitarian crisis first and foremost, this has also resulted in significant changes to the economic outlook for 2022, at home, and globally.

As the quarter began, the UK economy was showing clear signs of a recovery from a weak finish to 2021 following the emergence of the Omicron variant in November. GDP increased by 0.8% in January driven by growth in consumer facing services, such as retail and leisure, and an increase in construction output. Growth slowed in February, but the service sector was robust, and PMI data suggests the service sector has expanded further in March.

Much of the optimism in the start of the year has since faded given the onset of war in Ukraine. While the UK economy has a relatively low exposure to Russia, higher commodity and energy prices are anticipated to exacerbate existing inflationary pressures. This will have a significant impact on household finances, and therefore, consumer spending and GDP growth.

CPI, as well as core inflation, are both already running at a 30 year high, with the former hitting 7.0% in March, and the latter sitting at 5.7%. As expected, a 9.9% increase in fuel prices was a significant contributor to the rise but there were also strong price increases across food and drink, restaurant and hotels and furniture/household equipment. These can be attributed to ongoing supply chain issues as well as the conflict in Ukraine. A further increase is anticipated in April due to the 54% rise in utility prices, which is forecast to add an additional 1.6 ppts. Consequently, inflation is expected to peak at over 8% in April but will remain elevated. Additional inflationary pressures may also arise from current labour shortages in the UK – job vacancies remain at record highs and there are 655,000 fewer workers in the UK than in February 2020 – as well as further supply chain disruption due to the war and renewed lockdown restrictions in China.

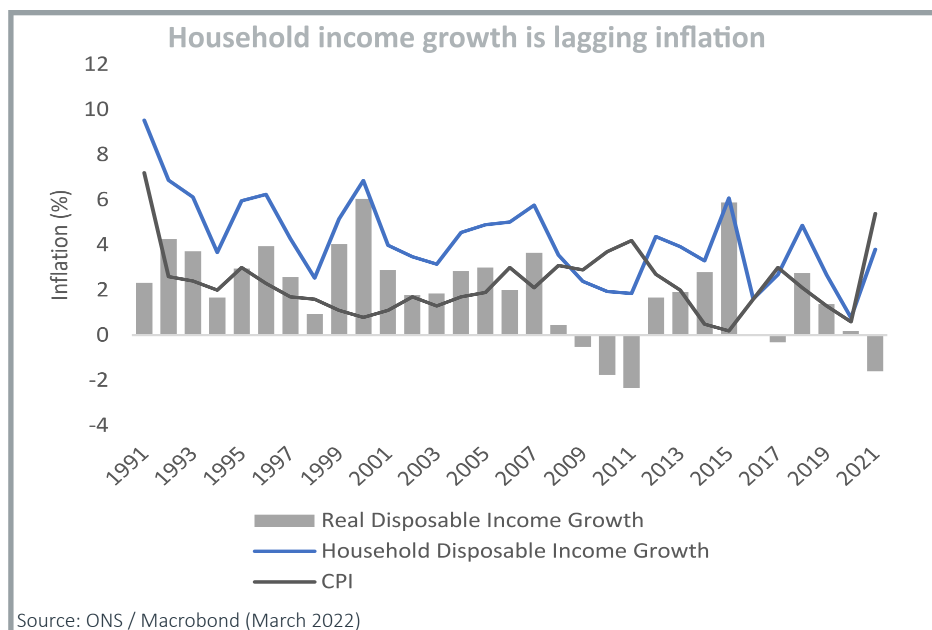


Source: Office for National Statistics (March 2022); SLAM forecasts (March 2022)

The sharp increases in inflation, and particularly energy costs, will have a negative impact on household disposable incomes and therefore, the outlook for consumption growth has weakened. The Spring fiscal statement announced measures for 2022/23 that add up to £18.2bn of support for households but this doesn't completely offset the hit to real disposable incomes. The Office for Budget Responsibility (OBR) forecasts that with the package announced in March real household disposable incomes will fall 2.2% in 2022/23, the largest decline on record. Against this backdrop, it is no surprise to see consumer confidence falling in March as well as a strong increase in credit card debt in February.

The Monetary Policy Committee (MPC) increased the base rate by 50bps over the first quarter to 0.75%. The minutes from the latest meeting in March were noticeably less hawkish than in February, as the MPC acknowledged the downside risks to GDP growth and the need to balance these with the expectation of more persistent inflation. This suggests that it is unlikely that the MPC will increase monetary tightening more than had originally anticipated and will rather continue with the modest tightening outlined previously. Gilt rates have risen given the expectation of rising interest rates but are expected to remain at low levels relative to history. That said the risk that interest and gilt rates rise more sharply than we envisage is increasing.

Under our base case scenario, we anticipate a worsening growth and inflation mix with UK GDP growth revised down from 4.2% to 3.9% this year, and price rises in 2022 overall forecast to average 6.7%. Growth is still being driven by consumer spending growth due to forecasts of rising employment, increased borrowing, and the drawing down of excess savings built up by higher income households. However, uncertainty is high and downside risks to our forecasts are increasing. In particular, the likelihood of a stagflation scenario triggered by the emergence of a price-wage spiral that results in overtightening by the central bank has risen.



Source: ONS / Macrobond (March 2022)

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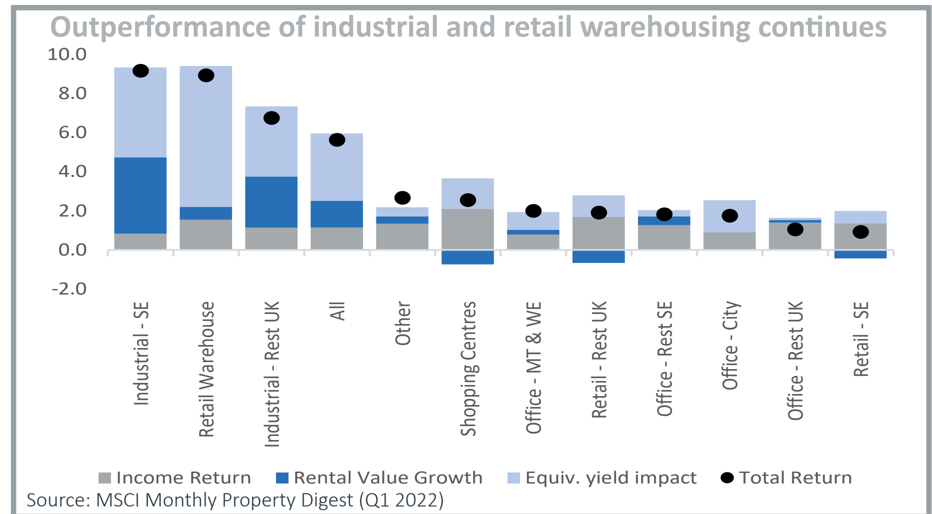
UK Property Market:

Geopolitical events do not yet appear to be having a negative impact on appetite for UK real estate. Following a strong end to the year in 2021, momentum has been sustained into Q1 2022, with volumes reaching £12.8bn, reflecting an increase of almost 34% year-on-year. With interest rate rises expected to remain modest, real estate should continue to present a compelling investment opportunity for those seeking income.

UK real estate performance has also remained robust. The MSCI UK All Property Index returned 5.6% over the first quarter, with capital values up 4.4% over the same period. Capital growth has been driven almost entirely by the industrial sector and retail warehousing segment, which saw values rise by 7.4% and 7.3%, respectively. All-property rental growth has remained in positive territory, with rents increasing 1.4% over the quarter but remains polarised across the segments.

Performance in the office sector has tapered from last quarter, returning 1.7% compared to 2.5% in Q4. Rental growth has remained largely stable at 0.3%, increasing 20bps over the quarter. Capital values overall rose 0.6% compared to 1.3% in Q4, indicating yields have been relatively stable over Q1. The outlook for offices remains uncertain. Employment levels have been used in the past to forecast rental growth, but as remote working becomes more embedded, this may be a less reliable indicator as occupiers require less space per employee. That being said, take-up activity is recovering across the UK, with demand focused on Grade A stock as occupiers become increasingly conscious of ESG requirements and staff wellness. For example, of the 1.4m sq ft that is currently under-offer across London, 65% is Grade A, which is significantly up on the long-term average of 53%. This reinforces the prediction that performance will become progressively polarised across the sector.

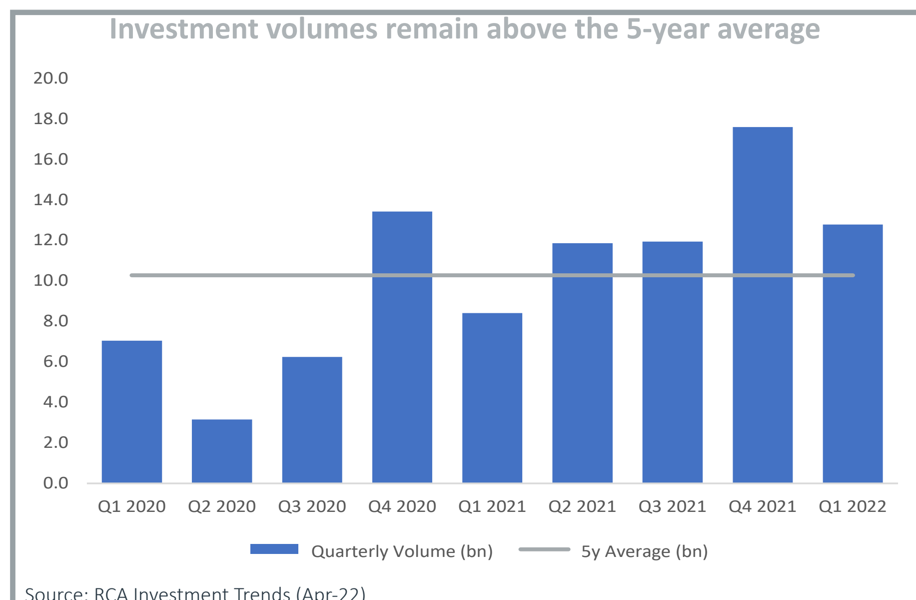


Source: MSCI Monthly Property Digest (Q1 2022)

Industrials returned 8.4% over the first quarter and continues to outperform. Capital values are up 7.4% quarter-on-quarter, with South-Eastern industrials outperforming the rest of UK, recording growth of 8.3% and 5.6%, respectively. Rental growth has been consistent across the sector, rising 3.4% over the quarter but is marginally down on last quarter, which saw rents grow by 3.6%. Forecasts for 2022 predict rental growth to continue as supply struggles to keep pace with the unabated occupier demand, particularly in the south-east where high land values may restrict development opportunities. Rising prices and supply chain challenges will be exacerbated by geopolitical tensions and further constrain the development pipeline across all locations. Investment activity may be hindered by a lack of sellers, as investors choose to hold assets where rental growth is being delivered. This imbalance between investor demand and supply is predicted to drive further yield compression over the short-to-medium term.

Performance in the retail sector has been driven by the continued success of the retail warehousing segment. Over Q1, all-retail achieved a total return of 6.1% compared to the retail warehouse segment which returned 8.9%. Additionally, capital values rose by 4.4% across the sector, compared to a 7.3% increase for retail warehousing alone and rents have remained in negative territory for all segments apart from retail warehousing which recorded a growth rate of 0.7% over the quarter. With consumer headwinds in the form of declining real incomes, and cost-of-living increases, the outlook for retail has weakened. As such, the forecast for rental growth is subdued and the pace of yield compression seen last year is not expected to be sustained.

Although UK property is still forecast to return 8.7% this year, there are growing downside risks to rent and yield expectations posed by rising inflation, higher interest rates and a weaker economic backdrop. Tenant risk has also increased due to the inability of some occupiers to pass on these cost increases, causing margins to reduce. Consequently, performance will continue to be characterised by significant polarisation both between and within sectors. High quality assets in segments with resilient occupier demand are expected to offer opportunities to outperform.



Source: RCA Investment Trends (Apr-22)