UK | RESEARCH & FORECAST REPORT

REIF IN BRIEF

Q4 2018

ECONOMIC OUTLOOK

Despite a welcome uptick in GDP growth in Q3 (0.6% q/q vs 0.4% q/q in Q2), it has been widely agreed by economic forecasters that 2018 will see the slowest expansion of GDP since the global financial crisis. Business investment has slowed significantly, while government investment is forecast to have declined this year. Although real wage growth returned earlier this year and the unemployment rate fell further, household consumption slowed as consumers remain cautious about their spending decisions. Economic forecasts beyond 2018 are difficult, given the continued Brexit uncertainty. The Office for Budget Responsibility currently predicts growth of 1.6% y/y in 2019 and 1.4% in 2020 while Capital Economics (2.0% y/y in 2019 and 2.2% y/y in 2020) and Oxford Economics (1.7% y/y in 2019 and 2.0% y/y in 2020) are more optimistic.

CPI inflation currently stands at 2.4%, still above the BoE's inflation target, but down from 3.1% a year ago, while RPI inflation has been in a very narrow range of between 3.3% and 3.6% since February. Under the assumption of some form of a Brexit deal, CPI inflation should move back towards the Bank of England (BoE) target next year. However, a "no deal" Brexit could push inflation back above the 3% mark, thanks to another sterling devaluation and associated increase in import costs. The future path of interest rates remains uncertain too and also depends on the future relationship between the EU and the UK. However, we don't expect a change in the Bank Rate when the BoE's Monetary Policy Committee meets for a final time this year on 20th December.

ALL PROPERTY FORECASTS

Annual all-property returns are expected to slow to 5.0% by year end and to weaken to 3.5% in 2019, but we forecast a re-acceleration thereafter. Total returns will be driven by income return (4.6% in 2018 and 4.9% in 2019) as capital growth (0.3% in 2018) turns negative in 2019. The retail sector will see the largest drop in capital values, with capital growth expected at -6.7% in 2018 and -3.9% in 2019. Industrial continues to be the standout performer by a wide margin.

Equivalent yields have been on a downward trajectory since 2009. However, the pace of yield compression has slowed and all-property equivalent yields are predicted to end 2018 a modest 4bps lower than in 2017 before moving out modestly in 2019. We expect a continued, gradual softening over the forecast horizon, led by the retail sector.

Rental growth will be maintained in 2018, but is predicted to slow to 0.6% y/y by the end of the year, down from 2.3% y/y last year and the weakest performance since 2012. Strong rental growth is maintained across the industrial sector, especially for assets in London and the South East. In contrast, rents are falling in the retail sector, with the exception of standard shops in London, where marginal growth is maintained. All-property rental growth is set to turn negative in 2019, before stabilising in the year thereafter.

Investment volumes in 2018 are down around 12% compared to the same period last year, following slightly disappointing October and November figures. However, transaction volumes have surpassed the £50bn mark for the sixth year running. The retail sector, especially shopping centers, attracted only limited capital. Hence, the sector is on course for its worst year since 2000 in terms of investment volumes. Other sectors recorded slowdowns too, but by no means to the same extent as the retail market. Foreign demand for commercial property remains healthy, with overseas cash accounting for over 40% of all investment. Asian capital continues to make up the largest share, followed by European and US investors.

Retail: Retail sales volumes enjoyed a strong summer, buoyed by the football World Cup, a royal wedding and exceptionally warm weather. However, the trend has slowed in recent months, with sales volumes rising just 0.4% in the three months to October, down from 2.3% in the three months to July. Part of the weakness in October is likely a result of consumers holding off on purchases ahead of "Black Friday". That said, latest consumer confidence figures from GfK suggest that sentiment remained subdued in November, with the index dipping to a one-year low. Nonetheless, with continued real wage growth and falling oil prices, there should be some scope for consumer spending growth to gather momentum.

Retail investment volumes in 2018 are on course to reach the lowest level since 2000, down around 50% from 2016 and 35% from 2017. Shopping centres traded particularly poorly with only a very limited number of transactions taking place. Rents fell across all main retail segments in Q3, according to the latest MSCI index.

ALL PROPERTY FORECAST SUMMARY

	DEC-17	DEC-18	DEC-19	2018 - 2022
ERV Growth (% pa)	2.3	0.6	-0.3	0.6
Equivalent Yield (% eop)	5.7	5.6	5.7	5.8 (2022)
Capital Growth (% pa)	5.2	0.3	-1.3	0.1
Total Return (% pa)	10.2	5.0	3.5	5.0

Source: Colliers International, MSCI

RETAIL FORECAST SUMMARY

	DEC-17	DEC-18	DEC-19	2018 - 2022
ERV Growth (% pa)	1.4	-1.9	-2.5	-1.5
Equivalent Yield (% eop)	5.6	5.8	5.9	6.0 (2022)
Capital Growth (% pa)	1.7	-6.7	-3.9	-2.6
Total Return (% pa)	6.9	-1.9	1.6	2.9

Source: Colliers International, MSCI

OFFICE SUMMARY

	DEC-17	DEC-18	DEC-19	2018 - 2022
ERV Growth (% pa)	1.5	0.8	-0.1	0.9
Equivalent Yield (% eop)	5.8	5.7	5.8	5.8 (2022)
Capital Growth (% pa)	3.6	1.4	-1.0	0.8
Total Return (% pa)	7.9	5.5	3.1	5.0

Source: Colliers International, MSCI

LOGISTICS & INDUSTRIAL FORECAST SUMMARY

	DEC-17	DEC-18	DEC-19	2018 - 2022
ERV Growth (% pa)	5.3	4.2	2.5	3.2
Equivalent Yield (% eop)	5.7	5.3	5.3	5.5 (2022)
Capital Growth (% pa)	13.9	10.5	1.9	3.4
Total Return (% pa)	19.6	15.5	6.5	8.1

Source: Colliers International, MSCI

Standard shops in Central London (-0.4% q/q) saw rents decline for the first time since the end of 2009, while standard shops in Rest of UK and shopping centres experienced particularly sharp drops in market rental value growth. Subdued consumer confidence and structural changes in the retail sector including an increasing importance of online retail will no doubt provide ongoing challenges to high street shops.

It was therefore welcome that the Chancellor (Philip Hammond) acknowledged the struggles the sector is currently facing. Our latest forecasts suggest that rents for standard shops in Central London will have increased by just 0.5% y/y in 2018, down from 5.2% in 2017.

Rental growth will not be maintained, however, as we expect declines of -1.5% y/y in 2019 and -0.5% y/y in 2020. Outside of London, rents are predicted to drop at a sharper rate, with standard shops in Rest of UK predicted to record a decline of -3.0% y/y in 2019, before slowing slightly to -2.0% in 2020. Over the 2018-2022 forecast horizon, negative rental growth is expected across all retail segments with the exception of Central London standard shops. Shopping centres and retail warehouses (both -1.9% pa) will see the largest drops in rents.

All-retail total returns are expected to show a decline of -1.9% y/y in 2018, down from +6.9% y/y in 2017, with income returns of 5.1% not sufficient to offset negative capital growth of -6.7% (0.3% residual). Capital growth will remain in negative territory until 2022, but positive income returns (5.6%) will lead to a reappearance of total return growth in 2019 (1.6%). Over the five-year forecast horizon, all-retail total returns are expected to average 2.9% pa.

Offices: Demand for London office space remains strong. Overall vacancy continued to decline while pre-letting activity reached its highest quarterly total for four years. Nevertheless, London Offices Grade A absorption fell, as scarcity of product impacted upon transaction levels. The vast majority of available space in London now constitutes second-hand product. Outside of London, strong leasing activity continues to limit office supply across all grades. There are reports of office take-up in Manchester reaching a record high of 1.5 million sq ft by the end of 2018. Prime rents across the CBDs have all topped £30 psf and are predicted to show further upward movement in the coming years.

Despite slowing from 1.5% y/y in 2017 to 0.8% y/y, all-office MSCI rental growth is predicted to remain in positive territory by the end of 2018. That said, rental growth will turn slightly negative in 2019 (-0.1% y/y). The decline in 2019 will be driven by rent reductions across most London markets, led by Midtown (-2.0% y/y). Meanwhile, Rest of UK, Rest of London and South East will sustain positive rental growth over the 2018-2022 period.

Overseas capital continues to dominate the London office market, with foreign investment breaking through the £10bn mark for the fifth time in six years and accounting for almost three quarters of all investment. UK institutions have been more cautious over the past few years, with investment volumes failing to reach £1bn for the third year in a row. However, having been a net seller throughout most of the past years, UK institutions are a net buyer of offices in Q4 for only the third time over the past 11 quarters.

All-office total returns are expected to slow to 5.5% by the end of 2018, comprised of 1.4% capital growth and 4.1% income return, down from 7.9% in 2017. South East and Rest of UK offices are set to outperform with total returns of 7.7% and 7.3%, respectively. The West End, Midtown and the City of London will see a weaker performance with total returns of 3.6%, 5.4% and 5.5%, respectively. With yields moving out and capital growth turning negative, income return will be the only source of total return growth in 2019. Consequently, all-office total returns are predicted to slow to 3.5%.

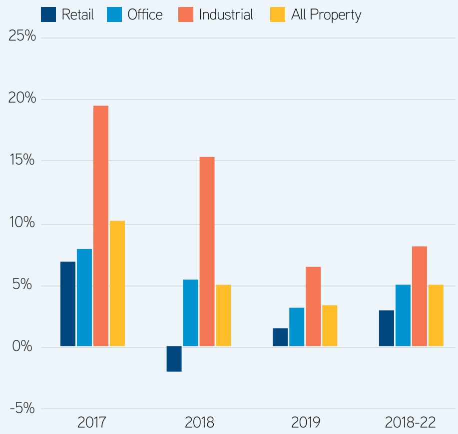
Logistics & Industrial: Output in the production sector rose 0.8% q/q during Q3, following two consecutive quarters of contraction. However, latest PMI data from IHS Markit points to a subdued performance of the manufacturing sector in Q4. Although the headline PMI improved from October's 51.1 to 53.1 in November, export orders fell for a second month running and companies reported that Brexit uncertainty, exchange rate volatility and a slowing economy weighed on confidence regarding the outlook. Moreover, part of the increase in demand was attributed to the build up of stocks in response to supply-chain uncertainties and may therefore only prove temporary.

At 7.5% y/y, London saw the strongest growth in industrial market rents, according to the Q3 MSCI/IPD index, followed by the South East at 6.3% y/y and the North East at 6.2%. Rental growth was much weaker in the East Midlands (1.9% y/y) and West Midlands (2.1% y/y) and remained flat in Scotland. Wales recorded the strongest acceleration with rents increasing at 3.6% y/y, up from 1.6% y/y in Q2.

At 15.5% y/y total returns growth, the industrial sector remains the standout performer across the commercial property universe in 2018. Although total returns will slow to 6.5% in 2019 and 6.4% in 2020, industrial will continue to outperform the other traditional sectors. Positive capital growth (1.9% in 2019 and 1.7% in 2020) will be maintained over the forecast horizon.

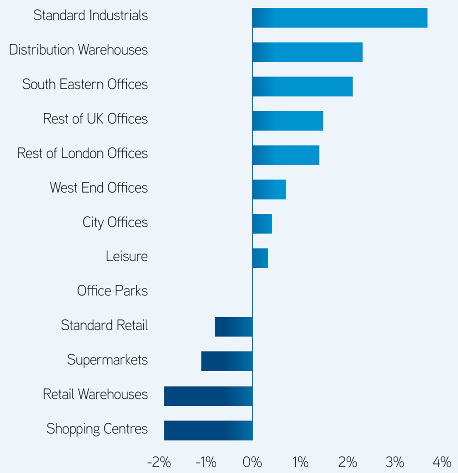
As is the case with the other sectors, the outlook heavily depends on the future relationship between the EU and the UK and our forecasts are based on the assumption that there will be some form of agreement. A deal would bring greater certainty and potentially unlock requirements that are currently on hold. A 'no deal' could on the one hand lead to opportunities linked to stockpiling, but on the other hand adversely affect the sector through the impact of downsizing, business relocations and supply chain shifts. In either case, the real domestic supply economy may prove resilient, as it has since the vote to leave in 2016.

CHART 1: **TOTAL RETURN**



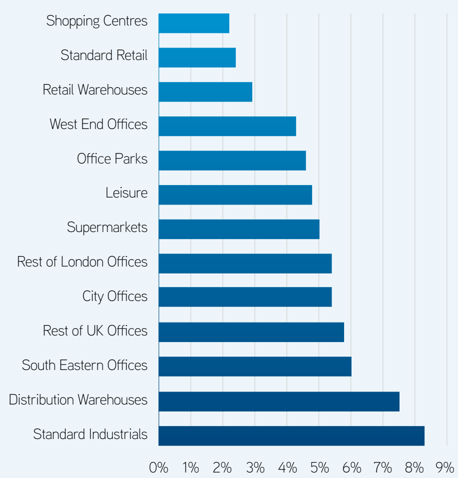
Source: Colliers International, MSCI

CHART 2: **ERV GROWTH 2018-22**



Source: Colliers International, MSCI

CHART 3: **TOTAL RETURN 2018**



Source: Colliers International, MSCI

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