RESEARCH

Carter Jonas

ALL PROPERTY BRIEFING

Q2 2019

PROPERTY PERFORMANCE SUMMARY

	RENTAL VALUES		CAPITAL VALUES		
	Quarterly Change	Annual Change	Quarterly Change	Annual Change	Date
COMMERCIAL					
Office	0.4%	1.9%	-0.2%	1.0%	June 2019
Industrial	0.8%	3.4%	0.5%	5.8%	
Retail	-0.8%	-3.9%	-2.4%	-9.5%	
RESIDENTIAL					
Greater London	-0.9%	1.0%	-1.7%	-4.4%	May 2019
UK	-0.2%	1.6%	0.8%	1.2%	
RURAL					
Arable (England & Wales)	-	-	-1.5%	-2.6%	June 2019
Pasture (England & Wales)	-	-	0.4%	-0.5%	

Figure 1 Latest change in capital values

Source: MSCI Monthly Index (commercial); Homelet (residential rental values); Land Registry (residential capital values); Carter Jonas (rural, England & Wales only)*

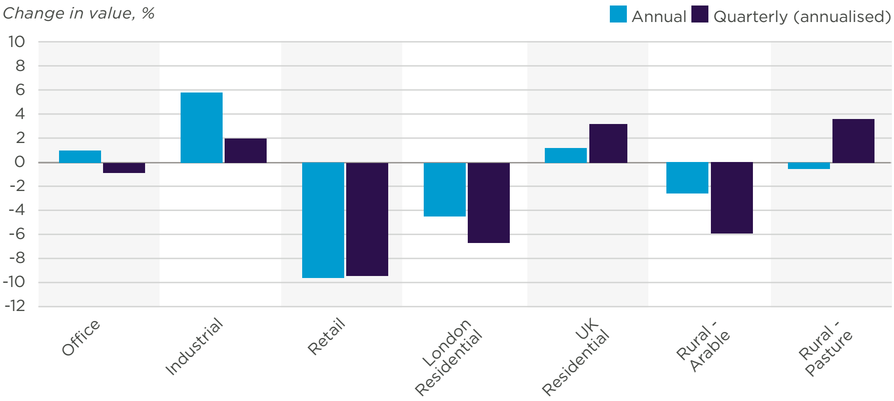
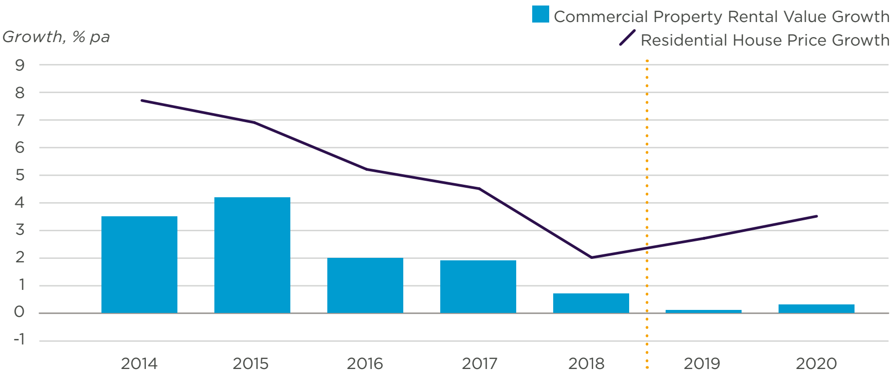


Figure 2 Key property forecasts

Source: Land Registry, MSCI, Experian, REFL, Carter Jonas



RENTAL VALUES

- There continues to be strong differentiation between the main commercial property sectors. **Industrial property** remains the strongest performing sector, with average annual rental value growth of 3.4% (MSCI Monthly Index, June 2019), although growth has decelerated in recent months. Growth during the three months to June 2019 was only 0.8% or 3.2% on an annualised basis.
- Rental value growth in the **office sector** was 1.9% pa in June 2019, slightly higher than the 1.7% pa recorded a year previously. There is relatively little differentiation between London, the South East and the regional markets.
- The **retail sector** continues to struggle across the board. Average rental values have been falling continuously for the last 12 months, and are now 3.9% below their June 2018 level.
- Overall, we expect little change to average **all-property commercial rental values** this year and next (see Figure 2), with a continued modest rise in office and industrial rental values being offset by falling values for the retail sector.
- Within the **residential sector,** rental value growth has slowed a little but remains in positive territory, increasing by 1.0% in Greater London and 1.6% across the UK during the 12 months to May 2019 (Homelet).

CAPITAL VALUES

- **All property commercial** capital values are now declining, by 0.7% during the three months to June 2019, according to the MSCI Monthly Index. Annual values are also falling, by 1.2%. However strong sectoral differences are evident (see Figure 1).
- Average **UK house prices** increased by 0.8% over the three months to May 2019, and remain 1.2% higher than a year ago. Prices in London however are falling, by 4.4% over the last year, with a 1.7% decline over just the last three months. We expect prices to rise at a little under 3% at the UK level this year (see Figure 2), however price reductions are likely to occur in the London market.
- In England and Wales' farmland market, average **arable land values** reduced further during Q2 2019, by 1.5% over the quarter and 2.6% during the last 12 months. **Pasture land values** were broadly stable this quarter, increasing by 0.4%, however values remain down by 0.5% annually.

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ECONOMIC OUTLOOK

- The **politics of Brexit continue to cause immense uncertainty,** holding back decision-making across the household and business sectors, impacting on house buyer sentiment and commercial occupier demand.
- Concerns are now rising over the outlook for the global economy, and growth appears to be slowing in the EU. **The IMF has recently downgraded its forecasts for 2019, projecting 3.3% for the global economy,** down from 3.6% in 2018, and just 1.3% for the Euro area (down from 1.8% in 2018).
- **The UK economy has held up well so far in 2019, with growth of 0.5% in Q1** (see Figure 3), above the 10-year average. This was largely due to stockpiling and activity brought forward in anticipation of the missed March 29 Brexit date. Growth has since slowed somewhat, with GDP for the three months to April reaching 0.4% and falling further to 0.3% in the three months to May. Slowing global growth plus the ongoing domestic uncertainty means that UK growth is set to be below trend for the rest of this year, and will at best match 2018's lacklustre performance (see Figure 4).
- **The UK's workforce has risen by 354,000 employees over the last year** (to May 2019), according to the ONS, and the labour market is becoming increasingly tight. The unemployment rate has dropped to 3.8%, the lowest since 1974, and the employment rate is 76.0%, 0.1 percentage points lower than the previous three months and the first quarterly decrease since June to August 2018. Wage growth has now responded, accelerating to 3.4% pa, well ahead of CPI inflation (1.9%).
- Employment growth is forecast to slow significantly over the next year. **With earnings growth now outpacing inflation, the real spending power of households is rising and household consumption accelerated in the first three months of the year.** CPI inflation is likely to bottom out this year (see Figure 4), although a 'no deal' Brexit scenario in October would probably mean a much sharper rise in inflation than current forecasts suggest.
- **The base rate is likely to remain at 0.75% until political certainty increases,** but the path will then be upwards, assuming a deal is reached with the EU this year, as the Bank of England will want to 'normalise' rates.

Key economic data
Source: ONS, BoE, HM Treasury comparison of independent forecasts

	Latest data	Date	2019 (forecast)	2020 (forecast)
Annual GDP growth	1.5%*	May' 19	1.4%	1.4%
CPI inflation	1.9%	June 2019	1.8%	2.1%
Base Rate	0.75%	June 2019	0.9%	1.19%
Unemployment rate	3.8%	Mar' 19-May' 19	4.0%	4.1%
Employment growth	1.1%*	Mar' 19-May' 19	0.8%	0.4%
Average earnings growth	3.4%	Mar' 19-May' 19	3.1%	3.1%

** latest quarter on corresponding quarter of previous year*

Figure 3 Quarterly economic growth
Source: ONS

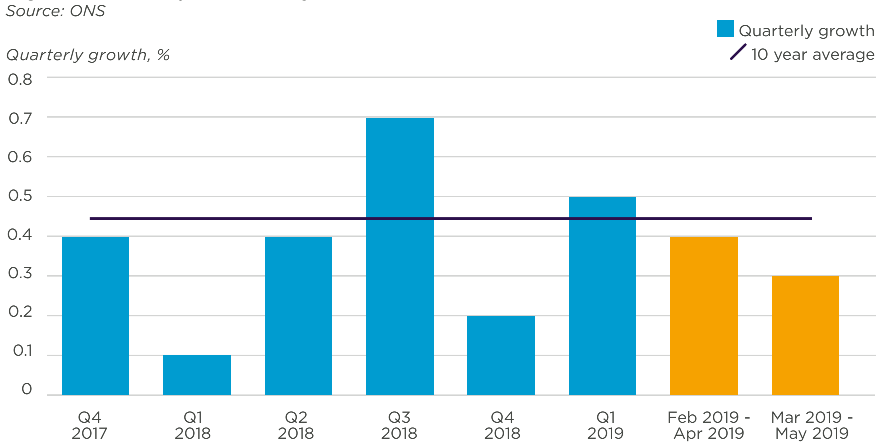
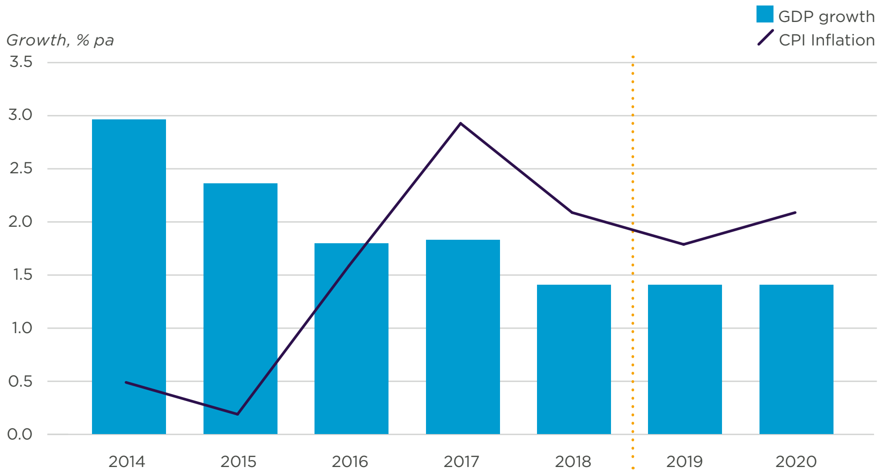


Figure 4 Economic growth and inflation
Source: ONS, HM Treasury Consensus Forecasts



CONSTRUCTION ACTIVITY

- **Latest data on construction output suggests a stabilisation of development activity in both the commercial and residential sectors.** Overall output for the three months to May 2019 was unchanged on the previous quarterly period. Private commercial construction was up by 2.2%, while private residential and all repairs and maintenance were both down (-0.2% and -0.5% respectively).
- **Over the last year, UK construction output grew by 2.9%** (3-month rolling total for March to May 2019 compared with the same period a year ago), driven by increases in both new work and repair and maintenance. Whilst new housing work increased by 7.9%, new commercial activity declined by 4.9%.
- **Housing construction activity has increased slightly over the 12 months to March 2019, with close to 170,000 units completed in England during the period.** Q1 2019 saw completions totalling just over 40,000, while the number of starts increased from over 35,000 in Q4 2018 to 38,290 in Q1 2019. Figure 5 illustrates the slowdown in housing completions over the last four years.
- Data on the value of new commercial construction orders (a proxy for development activity) also suggests that **new private commercial development continues to be affected by demand uncertainty and higher costs.** The value of new orders had been falling steadily for the last two years, however, during Q1, new orders actually increased by 3.7% compared with the same quarter in the previous year. This is the first annual increase since Q4 2016 (see Figure 6).

Key development indicators
Source: MHCLG, IHS Markit/CIPS, ONS

	Q2 2019	Q1 2019	Q4 2018	5-year average
Quarterly construction output growth (Q/Q-1)	+0.0%***	+1.0%	-0.5%	+0.9%
Annual construction output growth (Q/Q-4)	+2.9%***	+2.8%	+0.3%	+3.8%
Construction PMI*	47.4	49.9	53.1	53.8
Quarterly housing construction starts (England)	-	38,290	35,410	38,703
Quarterly housing completions (England)	-	40,190	47,740	37,154
Commercial property - annual growth in new construction orders**	-	+3.7%	-11.6%	-0.2%

** Quarterly average. > 50 indicates expansion compared to the previous period, <50 indicates contraction*
*** Rolling 12-month average*
**** Latest data as at May 2019; quarterly growth refers to the rolling 3-month growth of Mar-May 2019 against Dec-Feb 2019; annual growth refers to the rolling 3-month growth of Mar-May 2019 against Mar-May 2018*

Figure 5 Annual Change in housing completions
Source: MHCLG, Carter Jonas

Growth, % pa (12-month rolling average)

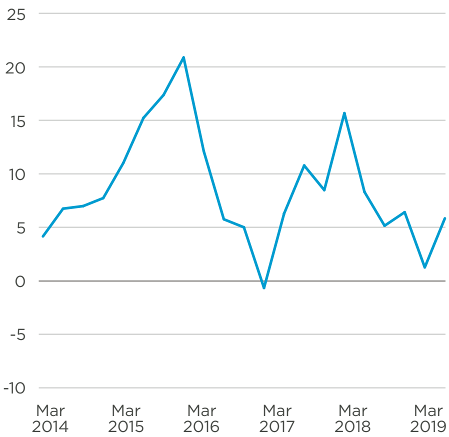
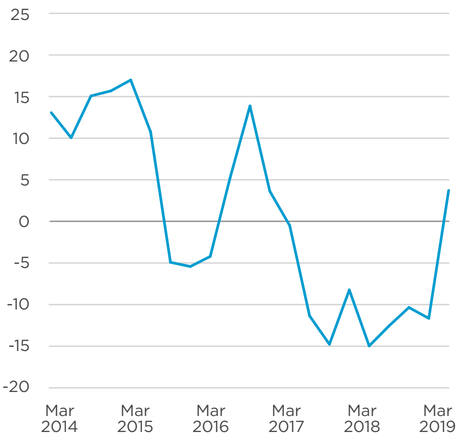


Figure 6 Value of new commercial construction orders
Source: ONS

Growth, % pa (12-month rolling average)



OCCUPIER MARKET TRENDS

OFFICE

- Brexit uncertainty has undoubtedly held back decision making and adversely impacted occupier demand. However, there is evidence that the ongoing uncertainty has benefitted the labour market, as firms have lacked the confidence to invest and have instead hired workers. This has been supportive of occupier demand.
- Rents are likely to plateau in some submarkets and fall modestly in others in 2019. However, central London rental growth should resume next year as supply shortages begin to bite and the path to Brexit becomes clearer.
- For the South East and regional offices, the key issue is a shortage of quality stock rather than a lack of demand. Many city centres will see little or no speculative space completed this year, and, where speculative stock is coming through (in Birmingham, for example), this is helping to address a long-term supply shortage, and will quickly be taken up. Against this backdrop, prime rents in key city centre locations are likely to see a modest rise over the next year.

INDUSTRIAL

- Occupier demand in the industrial and distribution sectors is underpinned by strong fundamentals, and take-up remains buoyant as retailers and their third party logistics partners adapt to growing online demand. However, uncertainty has been affecting the decision-making process for some occupiers.
- There remains a severe shortage of well-located sites for distribution use, and also urban sites suitable for last mile delivery, waste recycling and open storage.
- The online retail distribution sector now requires highly bespoke warehousing solutions, and this is leading more occupiers to purchase sites and develop their own buildings. Developers are therefore cautious about large speculative schemes, although less so for small to medium-sized schemes. However, there were some significant starts in 2018 and so far in 2019, and developer interest for speculative new build is becoming more evident across a number of markets.
- The sector will remain relatively immune to the effects of Brexit and, as supply continues to exceed demand, industrial rental growth will continue to outperform. However, the rate of growth will continue to decelerate as pricing begins to reach its limit in the current market.

RETAIL

- Despite wages now rising in real terms, the GfK consumer confidence index remains in negative territory (currently -13 in June 2019). While there are concerns surrounding the economic uncertainty in the UK, personal finance continues to be a major worry. This will act as a brake on consumer spending over the next year.
- Debenhams going into a pre-pack administration earlier this year was clearly unwelcome, if not unexpected, news. Furthermore, Arcadia's plans to restructure their business, both in the UK and the US, will add additional pressure on the sector. Given the headwinds facing retail property, more retailers will inevitably seek rent reductions, go into administration, or become online-only.
- Although rental values are falling across much of the retail sector, it is a mixed picture, with prime shopping centres and high street locations showing some resilience. Worryingly, Debenhams is the key anchor tenant in a number of shopping centres and a key driver of footfall in many high streets. The business was already proposing to close nearly a third of its outlets, a figure that could well increase, with potentially adverse effects on those locations.
- Increased certainty over the direction of Brexit would provide a boost to consumer confidence, and rising real incomes will provide a much needed shot in the arm. However, the ongoing structural changes will continue to have a far more powerful impact on the high street for many years to come. Rental values are likely to fall across most of the sector over the next 12 months, although central London and selected top-tier shopping centres should prove resilient.

RESIDENTIAL

- At the start of the year, Brexit uncertainty had deterred vendors from marketing their properties, meaning that the supply of properties for sale was unusually tight. However, over the last two months there has been a very modest rise in demand and supply of new stock has held steady, according to the latest RICS Residential Market Survey (June 2019).
- Much of the sentiment surrounding the housing market over the last 6-12 months seems to be a lack of buyers and depressed demand, and recent transaction volumes reflects this. Over the last six months, there have been around 3% fewer transactions each month, on a rolling annual basis.
- According to UK Finance, Q1 2019 saw around 3% fewer approved mortgage loans as the same quarter over the last few years, at just below 170,000. The data suggests that home movers, rather than first time buyers, are retreating slightly as mortgages to this group are down 4% over the same period last year, with no change from first time buyers.
- Real earnings growth and the strong labour market will be supportive of the housing market, and we expect further modest house price growth for the UK as a whole this year, probably exceeding inflation. However, further modest price falls in London are likely, given affordability constraints.

RURAL

- Buyers remain keen to acquire for the right price, however the low volume of available stock has subdued activity. According to the Farmers Weekly land tracker, 66,960 acres were publically marketed between January and June 2019, a 22% reduction on the same period last year. This was largely due to an extremely slow start in Q1, where only 4,500 acres were marketed.
- The pricing of assets continues to be very much location dependent, and those with good access routes are attracting strong interest. However, while uncertainty remains, in some cases buyers are unwilling to commit to large capital investments.
- While land values have dipped since the EU referendum in 2016, the general consensus is that values are unlikely to fall significantly. Brexit is currently affecting activity, however the key fundamentals of owning farmland in the UK will not change regardless of when, and how, the UK leaves the bloc.

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COMMERCIAL PROPERTY INVESTMENT

- **Many investors have paused activity due to the ongoing Brexit impasse, and few investors are under pressure to sell.** Consequently, activity fell markedly in Q2, with £8.8 billion of commercial property transacted. This compares with £10.8 billion in Q1 2019 and £15.6 billion in Q2 last year (see Figure 7), and was the lowest figure since Q3 2016, immediately after the EU referendum.
- **Overseas buyers have maintained their share of UK purchases.** During the 12 months to Q2 2019, overseas investors acquired £23.3 billion of assets in the UK. This accounted for 45% of the total investment volume, with the proportion increasing to 62% in Greater London. Far Eastern buyers have been the most active across the UK so far this year, particularly in Greater London.
- **The all-property equivalent yield has edged up slightly over the last three months**, according to the MSCI monthly index, standing at 5.87% as at June (see Figure 8). There are notable differences across the sectors, with average retail yields now seeing sustained upward movement, whilst industrial and office yields have been virtually flat so far this year.
- The gap between gilt and property yields remains historically wide, with 10-year gilt yields currently at around 0.7%.
- **Annual all property total returns peaked in early 2018 at around 11% and have fallen steadily to 4.0% pa as at June 2019 (MSCI Monthly Index).** With yields now moving upwards modestly and all property rental growth only just in positive territory, returns have further to fall. This is also evidenced by returns performance in the second quarter of 0.6%, just 2.4% on an annualised basis.
- With Prime Minister Boris Johnson's firm commitment to leave the EU on 31 October, the risk of a 'no deal' Brexit has probably increased. However, there is little to suggest that a major pricing correction would occur in this event. **Whilst investment volumes will remain subdued until certainty increases, market activity is likely to increase again when the UK leaves the EU, irrespective of the terms.**

Key investment indicators
Source: Property Data, MSCI, FT, Carter Jonas

	Q2 2019	Q1 2019	Q4 2018	5-year average
Quarterly commercial transactions	£8.8 bn	£10.8 bn	£17.1 bn	£15.6 bn
All property annual rental growth	0.2%	0.3%	0.7%	2.2% pa
All property annual total return	4.0%	5.6%	7.5%	5.5% pa
All property equivalent yield (MSCI Monthly Index)	5.87%	5.86%	5.81%	6.1% pa
10-year gilt yield	0.7%	1.0%	1.3%	1.4%

Figure 7 Quarterly Investment Transactions
Source: Property Data, Carter Jonas

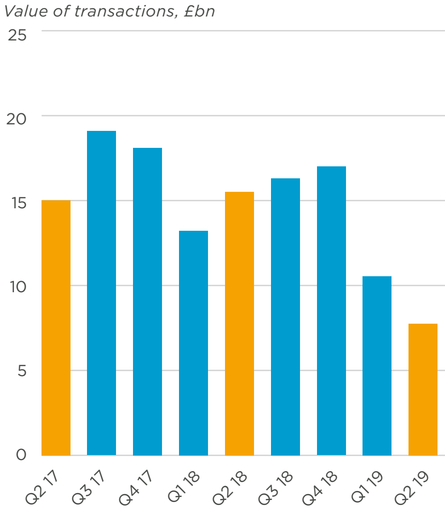
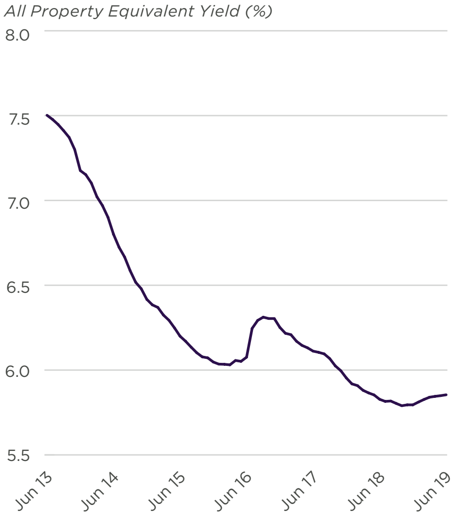


Figure 8 Commercial Property Yields
Source: MSCI Monthly Index



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