BNP PARIBAS REAL ESTATE

Real Estate for a changing world

RESEARCH

FEBRUARY 2023 UK ECONOMIC & REAL ESTATE BRIEFING

EXPERT, DATA-DRIVEN ANALYSIS OF THE UK'S LATEST ECONOMIC AND REAL ESTATE MARKET TRENDS.

ECONOMY

"Growth forecasts have been revised upwards following upside surprises to economic data so far this year. That said, we still expect GDP to contract by 0.8% this year, followed by weak growth of 0.7% in 2024. The recession will be shorter and less painful than initially predicted six months ago, but the reality is that the full impact of higher interest rates is yet to be felt in the wider economy."

Samuel Duah, Head of Real Estate Economics

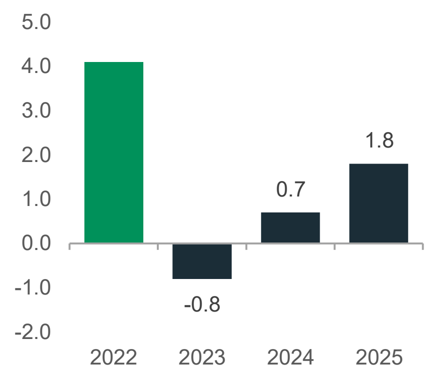
Recent reports of key macroeconomic data in the UK continues to be encouraging. Following the high level of borrowing in December, the latest release of public finances shows an unexpectedly-high level of surplus in January (£5.42bn). With the government set to discontinue its energy support scheme in March, the public finances are likely to continue to improve. In its recent outlook the Bank of England (BoE) now believes that the UK economy will likely experience a shallower and shorter downturn that it had predicted in the second half of 2022. Finally, in recent days we have seen considerable political efforts to solve one of the last elements of Brexit negotiations; the Northern Ireland protocol.

All these are contributing to an improvement in consumer and business confidence. The latest survey data from S&P Global points to a significant improvement in the January reading of Consumer Confidence (-38); up seven points from the previous month, and six points from six months ago. For Business Confidence (53) this is above the break-even point (50) for the first time since June last year (fig. 1). These soft data points are supported by hard data on inflation (showing signs of weakening) and the outlook for the Bank rate. The prevailing mood is one of cautious optimism for the months ahead.

As such most forecasters have revised up their outlook over the next two years for UK economic activity. However we continue to expect negative GDP growth for the UK in 2023 (-0.8%) as a whole, albeit softer than we had previously forecasted. For 2024 (+0.7%) we see a positive, but weak expansion in economic activity (fig. 2). Therefore over the next two years our central view is that UK GDP will be more or less flat. Together with continued elevated inflation levels, which is not expected to fall below the 2% target rate until mid-2024, the UK economy is expected to remain in stagflation mode over the next two years. What is important is that the quarterly profile of the outlook suggest a shorter and shallower recession than had been predicted six months ago.

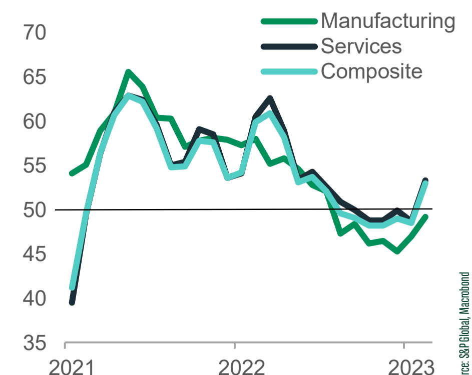
One key reason for projected sustained weakness of the economy is the long pass-through of the successive interest rate rises thus far. The nature and structure of the UK financing market is such that increases in interest rates have a direct impact on consumer spending, but the nature of the effect can take longer to come through as fixed-rate finance contracts come to an end. Over 85% of regulated UK mortgage finance is fixed-rate, with a sizeable proportion at the short end and needing refinance over the next twelve months (fig. 3). This will be done at a higher and prevailing market rate, thereby reducing household disposable income.

Fig. 2. UK real GDP forecasts (% y/y)



Source: BNP Paribas Real Estate, *European Market Outlook Q1 2023*

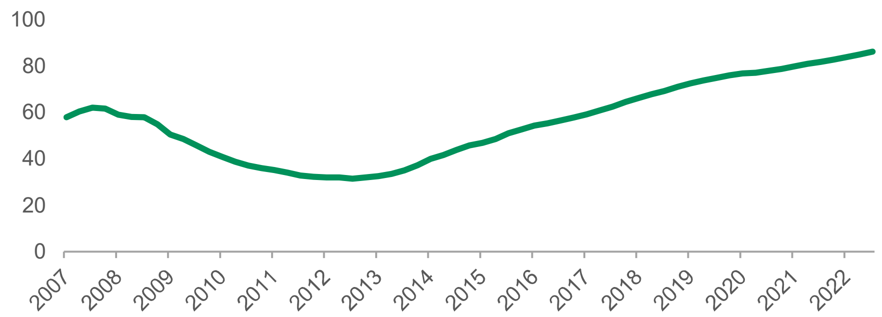
Fig. 1. UK PMI's



Source: S&P Global, Macrobond

The picture is similar for businesses. The subdued consumer and business spending is what will weigh on the economy in general in the months and quarters ahead. For commercial real estate, the elevated level of interest rate will continue to push up yields in 2023, even if at a reduced rate than in 2022.

Fig. 3. UK mortgages, percentage of outstanding balance that is fixed-rate (regulated)



REAL ESTATE

> **"It is still too early to call the end of yield decompression. While the global economic backdrop has undoubtedly improved and headline inflation has surprised to the downside, core inflation is stubbornly high and job markets remain tight across developed markets. However, real estate data flow continues to point to low supply, a moderation in value decline and increasing liquidity."**
>
> *Charlie Tattersall, Associate Director, Capital Markets Research*

Liquidity and pricing discovery has continued to improve in the last month. In London, Chinachem's headline-grabbing acquisition of One New Street Square from Landsec for £349.5m – a yield of c. 4.7% - has also provided crucial evidence of pricing for prime London offices with strong green certifications, as well as demand from international investors. Furthermore, news that Kering is in advanced discussions to sell Alexander McQueen's Bond Street flagship store for a sub-3.00% yield (or £6,800 per sq ft) shows the continued reputation of super-prime Central London retail as a safe haven for investors.

Perhaps the most reassuring however is the agreed sale of Tesco Pension Fund's Halo in Bristol to CBRE IM for £75m. This represents a c. 5.50% yield, ahead of the £70m / 5.75% asking price as well as our 5.75% prime benchmark yield for regional offices. The sale of the Grade A building, let to Osborne Clark and Deloitte and with an Outstanding BREEAM rating and WiredScore Platinum certification, may prove to be a crucial bellwether of returning liquidity outside London. It is also crucial evidence of the premium investors are attributing to strong sustainability and tech credentials.

Transactions like these will help persuade more investors to prepare for the beginnings of a recovery in values later this year. Indeed, we are confident that at least £2.5bn of Central London office assets will transact in Q1 – almost triple the volume in the previous quarter (fig. 4). Moreover, they are promising in that they suggest prime office yields have (at worst) flat lined since the end of last year, providing important evidence of a clear trend observable in MSCI's average market returns data (fig. 5).

Of course, these examples are from the very top end of the market and not reflective of the wider sector. Real estate as an asset class is undoubtedly facing some key challenges – both macroeconomic and regulatory – that will have a material impact on the trajectory of asset values this year for all but the very best-in-class.

Firstly, the industry as a whole is now having to grapple with looming Minimum Energy Efficiency Standard (MEES) deadlines regarding minimum EPC ratings. While data is still patchy, analysis of the governments EPC register suggests just under 8% of Inner London's commercial building floorplate will be unlawful to let from April this year on account of being rated F or G. With only c. 23% currently fully compliant with proposed MEES legislation (Grades A+, A, and B), large swathes of the market are arguably at a tipping point of obsolescence risk. This will only exacerbate the gap between prime and secondary values that traditionally widens during economic downturns.

Secondly, real estate continues to face persistent headwinds from rising interest rates and inflation. Uncertainty has reduced considerably, but sentiment over the path of interest rates in the short term has shifted in recent weeks, particularly in the US on account of recent upside surprises in inflation data and jobs growth. Core inflation in Europe also remains stubbornly high, and market expectations for the peak policy rate have increased from c. 3.2% in mid-January to c. 3.8%.

Fig. 4. Central London office investment (£bn)

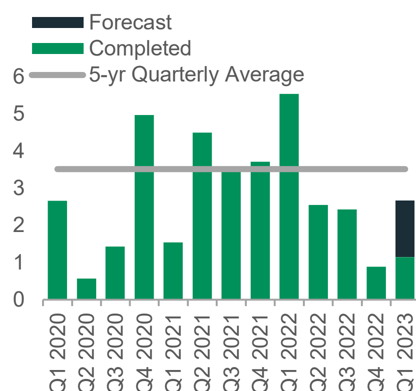
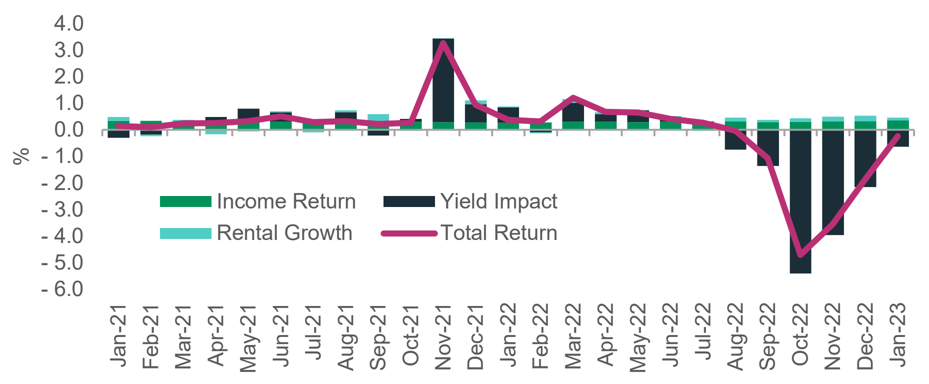


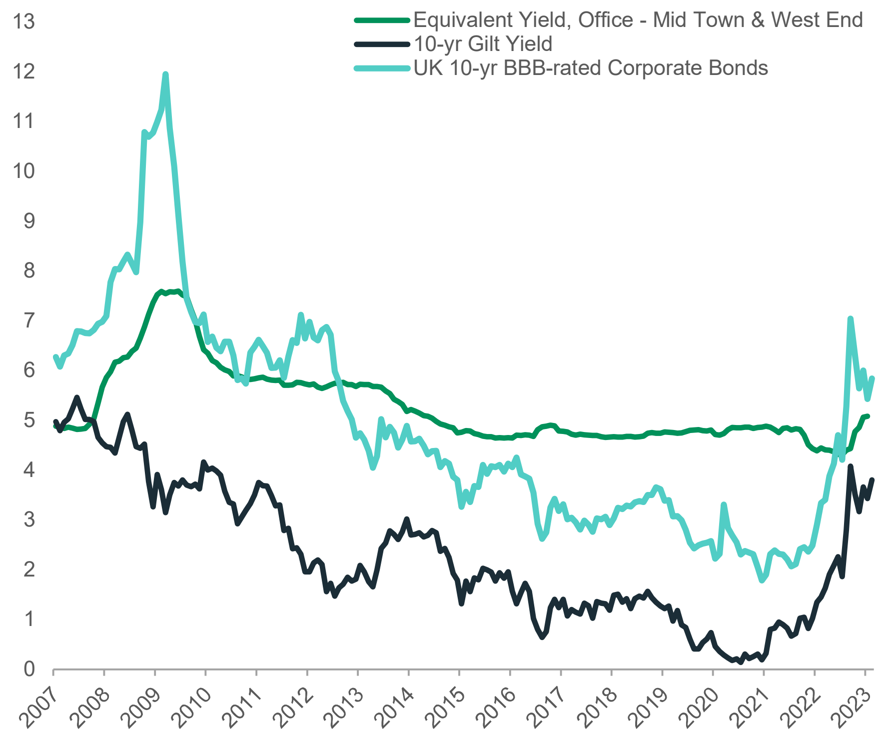
Fig. 5. Components of Central London office returns (% m-o-m)



Despite the significant rally in bond markets and tightening credit spreads we've seen so far this year, uncertainty over peak interest rates combined with quantitative tightening will put further upside pressure on fixed income yields. While we maintain our forecast of a 4.25% peak Bank Rate in the UK, 10-year gilt yields have risen 27 bps in February to 3.70% at the time of writing, while UK BBB-rated corporate bonds of the same maturity currently yield 5.7% (fig. 6). Not only will rising risk-free rates adversely impact property yields, but high investment-grade bond yields also represent a historic opportunity for investors to lock in attractive, liquid income streams at a time of improving overall economic sentiment. This means investors don't necessarily have to look to 'alternative' asset classes such as real estate to unlock attractive income yields.

That said, the ability for real estate investor's to capture rental growth is a key differentiator that will continue to attract investment this year, particularly given the continuing structural lack of supply of future-proof space across the sectors. For this reason, employment growth and leasing market data will be watched closely as we approach peak interest rates and head into the shallow downturn.

Fig. 6. UK real estate and bond yields (%)



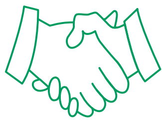
Source: Macrobond, MSCI UK Monthly Property Index January 2023. Data as at 27.02.2023

"The economic backdrop continues to evolve. On the one hand, markets have been boosted by the early signs of recovery in consumer sentiment and business activity, while sharply falling energy and fuel prices bring down headline inflation. However, with core inflation (excluding volatile items such as food and energy) still uncomfortably high, private sector wage growth still rising and labour markets still historically tight, the outlook is still complicated to forecast. The current perception of central banks' abilities to tame price rises means they must be seen to act by tightening policy. This is why forecasts of peak interest rates have crept upward in the last few weeks, and partly why bond yields have risen. The significance for real estate is that financial markets are still reacting to higher interest rates, meaning we have not seen the end of price corrections just yet.

"Nevertheless, the prevailing sentiment amongst real estate investors remains one of cautious optimism. Growth forecasts have been reassessed to reflect a less painful and shorter downturn than first envisaged. This should translate into a more positive outlook for leasing in a market where demand is quickly coalescing around a low supply of future-proof Grade A buildings. The fast-approaching MEES deadlines will only serve to exacerbate this and accelerate the polarisation between the performance of prime and secondary assets and drive a re-weighting of portfolios this year."

Etienne Prongué, CEO, BNP Paribas Real Estate UK

KEY FACTS & FIGURES



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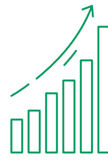
No. of Central London office investment deals in Q1 23 so far – more than in the whole of Q4 22



+37bps

Rise in the UK 10-year Gilt yield since 1st February – highest level since October

4.0%

Forecast for prime West End office yields at end of 2023, up 15 bps on today's 3.85%

-0.8%

Yield shift's impact on capital values in January (Dec 22: -4.1%)

+38.6%

Growth in the price of insulating materials over 2022

10.1%

January 23 UK CPI y/y increase (Dec 22: 10.5%)

Source: BNP Paribas Real Estate, MSCI Monthly UK Property Index January 2023, Macrobond. Economic data is as at 28.02.2023

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