BNP PARIBAS REAL ESTATE

RESEARCH

DECEMBER 2023

UK ECONOMIC & REAL ESTATE BRIEFING

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

ECONOMY

"The measures announced in the Autumn Statement will provide modest support to the economy at a time when growth has slowed to a standstill. This reinforces our view that the Bank of England will keep Bank Rate at 5.25% until mid-2024."

Samuel Duah, Head of Real Estate Economics

Leading up to the release of the Autumn Statement (22nd November), the Office for Budget Responsibility (OBR) gifted Chancellor Hunt a better set of borrowing projections than in March, primarily driven by a boost to tax revenues from higher inflation. Factors such as persistently high inflation and growing debt sustainability concerns led many commentators to expect a relatively benign Autumn Statement. Indeed, there was plenty of speculation that the Chancellor would save the additional fiscal headroom and announce a series of giveaways in the Spring budget in 2024. However, Chancellor Hunt turned this idea on its head with surprise tax cuts, now shifting the narrative from fiscal prudence to economic growth. In doing so, he spent almost all of the additional headroom given to him by the OBR (fig. 1).

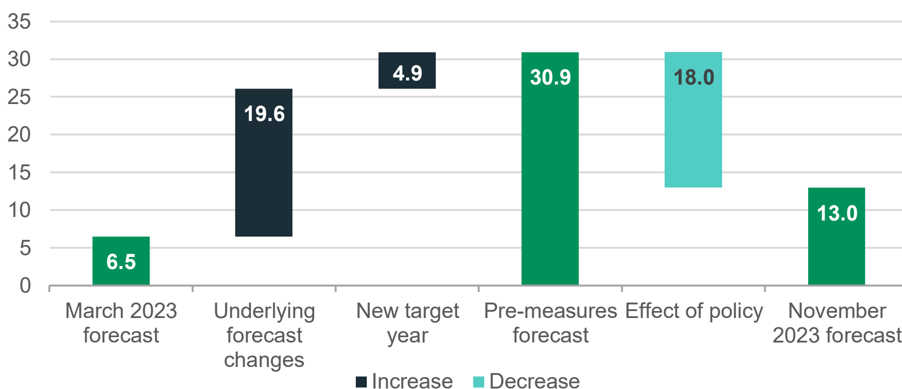
This turn of events will have major implications for policy in the years to come. In particular, the announcement of tax cuts will squeeze spending on public services. The OBR now projects real spending on public services to be around £19bn lower than in March. (fig. 2) This will present challenges to the Government over the next few years as pressures to support public services mount.

As a result, the Government will need to either proceed with spending cuts or raise revenues by hiking taxes. Alternatively, the Government could change the fiscal framework to allow for higher borrowing. However, this could risk damaging its credibility. Overall, the Government will be forced to make a difficult decision to address this shortfall in public services spending at some point in the coming years.

An additional risk could emerge from the OBR's economic forecasts. Indeed, the fiscal watchdog's projections for economic growth were much more generous than those of the Bank of England (BoE) (fig. 3). If the UK economy were to grow in line with the BoE's forecasts instead of the OBR's, the real economy would be approximately 3% smaller by the end of 2026, eliminating the current fiscal headroom.

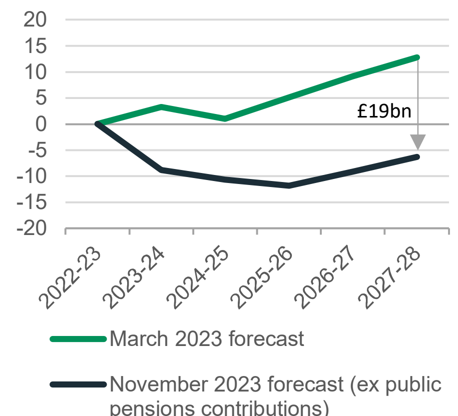
The bottom line is that headroom against the fiscal targets is likely to remain tight and in turn constrain fiscal policy.

Fig. 1. Underlying debt falling headroom: changes since March (£bn)



Source: OBR, data as at 30.11.2023.

Fig. 2. Change in real DEL spending from 2022-23 (£bn)



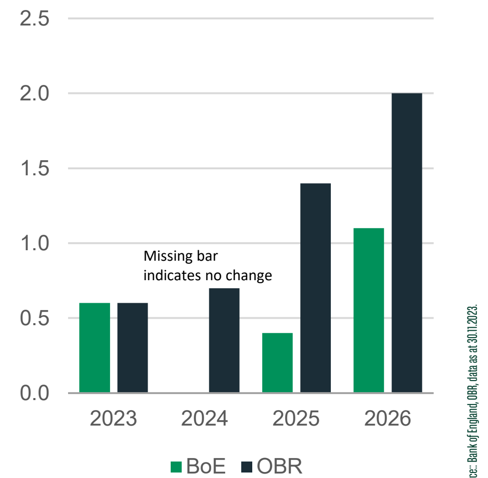
Source: OBR, data as at 30.11.2023.

Taking a closer look at the economic impact of the Autumn Statement, the OBR expects the announced measures to provide a modest but lasting increase to the supply side of the economy. This is largely driven by the Government's efforts to support business investment and boost labour supply. The OBR also expects a modest uplift to near-term demand, primarily reflecting the reduction in National Insurance Contributions which are due to take effect in January 2024.

As a result, these supportive measures reduce the risk of the UK economy entering a recession in the coming quarters. They also cast greater uncertainty over the inflation outlook. At this stage, it is unclear to what extent the inflationary impact of greater demand will be offset by the increase in labour supply.

Putting the Autumn Statement into the context of current economic conditions, Chancellor Hunt's announcement was set against a backdrop of stagflation. GDP growth slowed to a standstill in Q3 and, at 4.6% y/y in October, headline inflation remains stubbornly high. The measures set out by the Chancellor will provide some near-term support to economic activity, while the impact on inflation is less certain. Admittedly, the modest improvement to near-term growth skews the risks to the timing of the anticipated rate cuts in 2024 to later in the year. Nevertheless, the outlook for monetary policy remains largely unchanged, and we continue to expect the BoE to cut rates from the middle of 2024.

Fig. 3. Real GDP Growth Forecasts (%y/y)



REAL ESTATE

> **"The Autumn Statement contained some welcome announcements for real estate, but the reality of where we are in the cycle is that investors' main concerns remain the outlook for inflation and swap rates. The good news is that these are now on a downward trajectory. Combined with the likelihood of increased bank-led disposals next year, this is starting to give investors confidence that the moment to switch back into acquisition mode is approaching."**
>
> *Charlie Tattersall, Associate Director, Capital Markets Research*

The Autumn Statement presented a number of favourable measures for the commercial real estate (CRE) industry. Key points include:

- Making permanent the 'full expensing' policy enabling companies to claim corporation tax relief on the full cost of investments in plant, machinery, and equipment.
- Commitments have been made towards investment in Life Sciences, AI, and electric vehicles manufacturing.
- The Small Business rate multiple has been frozen for another year, with an extension of the relief scheme for small retail, hospitality, and leisure businesses.
- There are also various measures intended to expedite the planning process for major infrastructure and commercial applications.

These measures represent welcome support for businesses and, consequently, leasing demand for CRE. Furthermore, the attempts to reform the planning system will likely be encouraging for investors and developers who often find themselves frustrated with bureaucracy.

However, it is important to scrutinise the detail. Much of the announced funding for key manufacturing sectors such as electric vehicles, life sciences, and clean energy, as well as additional funding for Levelling Up projects, will not be available until 2025. Moreover, the full expensing scheme was already in place and not due to expire until 2026. These measures, while positive, may not have a significant influence until after the next General Election. Indeed, the muted immediate impact on bond markets and UK REITs when compared with the effects of the latest inflation data and Bank Rate decision demonstrates clearly that macroeconomic fundamentals matter more to investors (fig. 4).

In short, the measures announced did relatively little to alter the underlying real estate investment outlook for the remainder of this year and the near term. And while acquisitions and disposals remain challenging, particularly in office markets, there is a growing consensus that values in sectors with the most resilient fundamentals are close to reaching a floor (fig. 5). This is aided by debt costs that are on the other side of the peak and trending lower. Combined with inflation-beating rental growth forecasts in certain sectors (fig. 6) and more landlords grappling with potentially insurmountable funding gaps, the flow of investment opportunities

Fig. 4. UK FTSE EPRA/NAREIT Index, Price Return, GBP

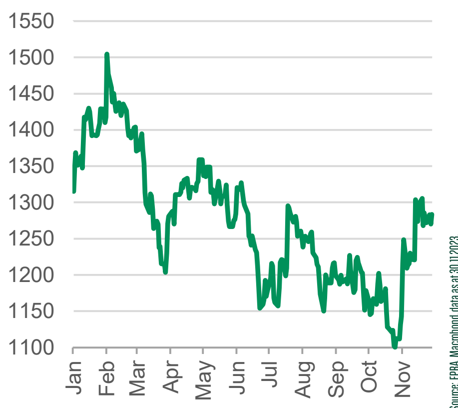


Fig. 5. Capital growth since June 2022

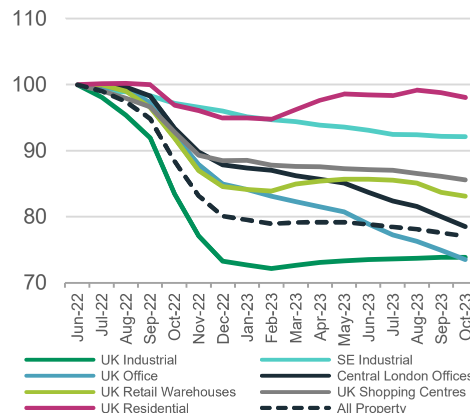
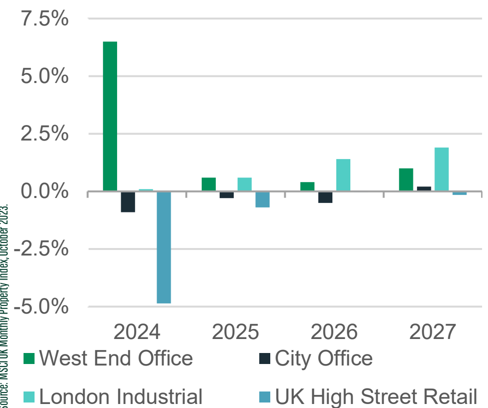


Fig. 6. Real prime rental growth forecasts 2024-27



is set to increase. The latest Real Estate Allocations Monitor, published by Hodes Weill and Cornell University, reports an encouraging conviction amongst global institutions that 2024 will provide a strong vintage year for returns.

Finally, possibly less noticed, but potentially more consequential, were the pledges to reform financial services, particularly pension funds and insurers who make up a significant portion of the UK CRE's traditional investor base. The present system is discouraging ownership of risk assets such as CRE by pension funds, who have been penalised financially for finding themselves in surplus on account of higher fixed income yields. When those schemes do explore buy-out options, risk assets most often cannot be part of the transaction, so pension funds are forced to divest out of their real estate portfolios. Therefore, the announced reduction to the surplus tax rate, pooling of local government pension schemes and further assurances on legislating to bring in Solvency II reforms for insurers may help stem the current outflows of UK institutional capital from direct CRE and contribute positively to an investor universe that has become increasingly reliant on overseas buyers in recent years.

Again though, these announcements will have little short-term impact, and much uncertainty remains with a General Election due within the next year. For now, with gilt yields still high, the portfolio denominator effect still in play and funding positions strong, UK institutional investors will continue to de-risk and remain net sellers of CRE. This makes maintaining the UK real estate markets' attractive fundamentals crucial for attracting global investor capital.

"The Autumn Statement contained direct and indirect implications for our real estate markets – pledges to reform planning and extend business rates relief schemes are of course welcome. However, the reality is there are more pressing issues at hand for investors: onerous debt costs, falling asset values, and an uncertain economic outlook.

"Looking ahead to 2024, these factors will remain a challenge to investors and continue to shape the real estate outlook, but I am confident there will be exciting opportunities for those able to deploy capital. There is growing confidence that the worst elements of a 'hard landing' scenario for the economy following the rate hike cycle can be avoided. As inflation continues to fall, this will pave the way for the Bank of England to start cutting interest rates. In turn, it will help to bring us closer to price discovery and the conditions needed to sustain a recovery in economic growth and real estate activity."

Etienne Prongué, CEO, BNP Paribas Real Estate UK

KEY FACTS & FIGURES

4.6%

Annual headline CPI inflation rate in October, down from 6.7% in September.

0.0%

Q3 2023 real UK GDP growth.

4.0%

5y swap rate at the end of November, down from 4.4% a month earlier.

+13.4%

UK FTSE EPRA/NAREIT index price return since end of October.

-2.7%

UK CRE capital value growth in the six months to end of October 2023 (previous six months: -10.4%).

+2.1%

Average annual prime West End office rental growth forecast, after inflation, 2024-2027.

Sources: BNP Paribas Real Estate, Bank of England, ONS, MSCI, data as at 30.11.2023.

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