

# CAPITALISE ON THE FUTURE

Economic & Real Estate Outlook

January 2024



**BNP PARIBAS  
REAL ESTATE**



BNP PARIBAS GROUP 

Real Estate for a changing world

# Economic Outlook

**In the near-term, firms and households will continue to face economic headwinds. However, an improved inflation outlook means that interest rate cuts appear to be on the horizon. This will provide a much needed boost to the economy after a year of stagnation.**



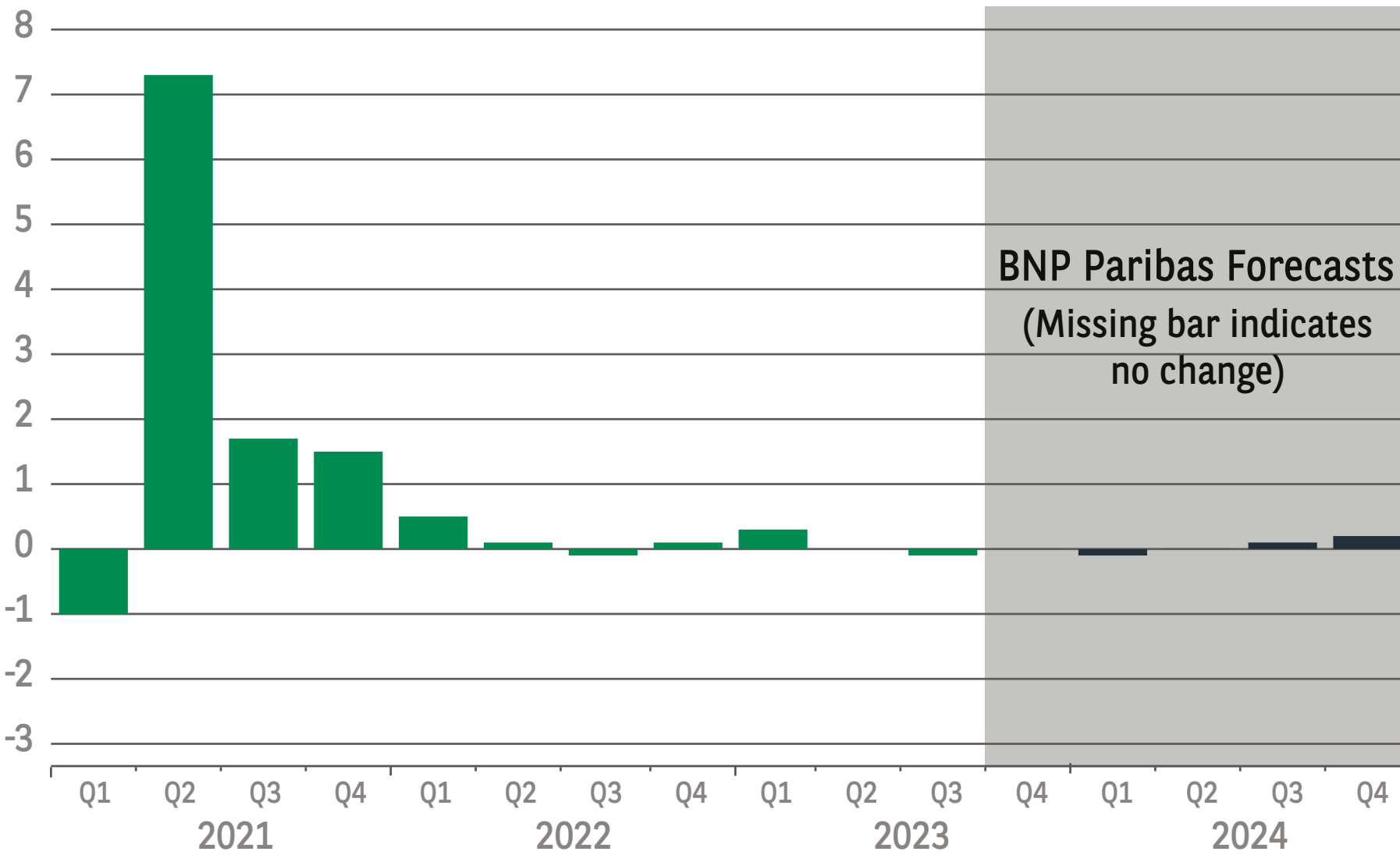
The outlook for households will vary depending on their personal circumstances. Further declines in inflation will mean that real wages rise in 2024. However, there are 1.5 million households due to refinance their mortgages this year, who will feel much worse off as they move onto higher mortgage rates.

The full impact of higher interest rates on businesses is also yet to be felt. As more businesses refinance at higher rates, profits will come under increasing pressure. This will have several implications. Firms may decide to save on labour costs, which points to further increases in unemployment this year. It will also weigh on business investment and raises the risk of a rise in bankruptcies.

Fiscal policy has returned to the spotlight after a surprise spending splurge in the Autumn Statement and the announcement of a date for the Spring Budget. Pre-election giveaways will provide some near-term support to demand, but the bigger picture is that the overall fiscal stance remains a drag on growth.

<sup>1</sup> Financial Conduct Authority

**CHART 1. STAGNANT ACTIVITY IN 2024 | UK GDP GROWTH FORECASTS (% Q/Q)**

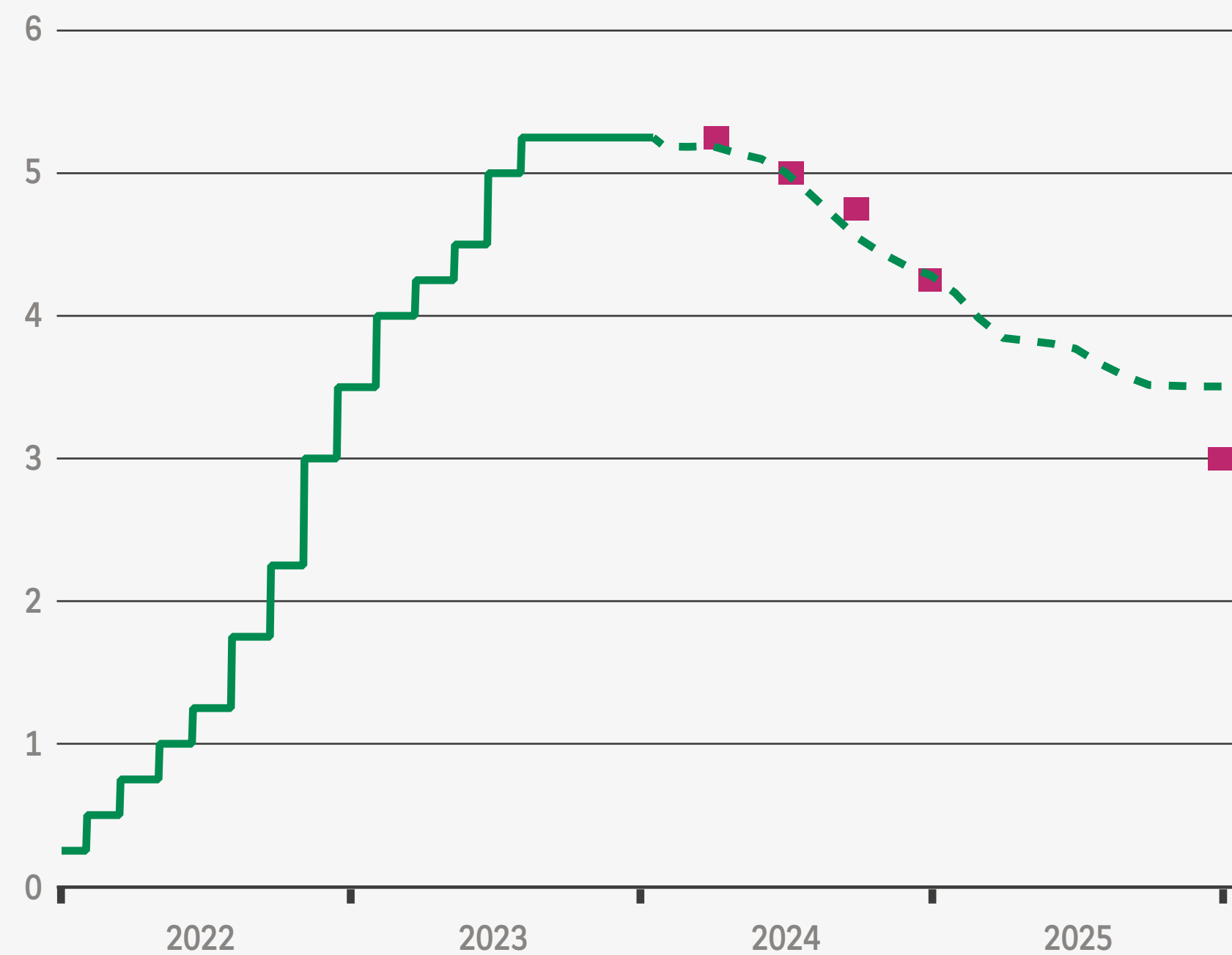


Sources: Macrobond, BNP Paribas

While a General Election this year will help to clear some of the political uncertainty that hangs over the UK economy, the future government will be confronted with a tricky fiscal position. This could force the government to either cut spending, raise tax revenues or risk credibility by changing the fiscal framework.

Overall, the stagnation in economic activity seen in recent quarters is likely to carry into the first half of this year. (See Chart 1.) As the lagged impact of higher interest rates offsets the boost from reduced cost of living pressures, we expect economic growth to be more or less flat for the year as a whole. Thereafter, falling interest rates should help growth to recover to around 1% y/y in 2025.

## CHART 2. INTEREST RATE CUTS ON THE HORIZON BANK RATE FORECAST (%)



Sources: Macrobond, BNP Paribas

— Market Expectations  
-■- BNPP Markets 360 forecast

**3%**

**BNP PARIBAS FORECAST  
FOR UK BANK RATE  
BY END OF 2025**

Optimism around the outlook for inflation has grown in recent months, following a run of below-expectation data releases. Admittedly, services inflation is likely to remain sticky due to tightness in the labour market. Despite the recent loosening, conditions remain relatively tight compared to the past decade. Furthermore, there is a lag between labour markets loosening and wage growth slowing. Nonetheless, inflation will continue to decline. We think that headline inflation may even temporarily dip below the Bank of England's (BoE) 2% inflation target in the middle of the year reflecting favourable base effects and continued declines in core

inflation. However, this is likely to be short-lived as energy base effects fade in the latter half of the year. Ultimately, we expect headline inflation to be around 2% by end-2024 and end-2025, while core inflation will be closer to 2.5% at end-2024 before falling towards 2% by end-2025.

The improving inflation outlook means interest rate cuts could soon be on the horizon. But before the BoE begins to normalise policy, we think there are three boxes that need to be ticked. The first is a sustained decline in inflation, with both headline and core returning close to or below 3%.

Second, evidence of a more material easing in wage growth. In particular, the BoE will want to be sure that the rise in the National Minimum Wage in April doesn't lead to a resurgence in wage pressures. Third, analysis of the fiscal position. The MPC will want to incorporate the fiscal policies announced in the Autumn Statement as well as those due to be announced in March.

Bringing this together, we think the BoE will start cutting rates in June. Our forecast is for Bank Rate to fall to 4.25% by end-2024 and 3% by end-2025 (See Chart 2).



# What does this mean for occupier markets?

In the near term, an uncertain geopolitical backdrop and the lagged impact of high interest rates may dampen leasing demand overall. Recent survey data points to lacklustre hiring intentions<sup>2</sup>, while in housing markets affordability constraints are likely to continue to weigh on transaction volume despite the onset of a mortgage price war.

**Beyond 2024 though, the economy will become more supportive.** A recovery in consumer spending will underpin occupier demand for the retail sector, and firms will require more industrial space to manufacture and store this additional inventory. Economic tailwinds will stretch to the office sector too.

As a recovery in economic activity leads to employment growth and higher profits, firms will be more likely to expand their office footprint. This will also boost residential demand from prospective buyers and tenants.

However, there are a number of major challenges to development that will significantly restrict the amount of new supply being delivered over the next few years. Firstly, **higher costs are here to stay.** The government's index of non-residential 'new work' remains over 40% above 2019 levels, and recent events in the Middle East have highlighted again how fragile the global supply of crucial commodities still are.

Moreover, development finance costs remain in excess of 7% even for fully pre-let developments. To illustrate the scale of the challenge, our appraisal of a typical office development suggests new building remains unviable in all but the most core Central London submarkets. This is still the case even when land value is set to zero. In Birmingham, for example, prime rents need to grow another 66% before developers can reach returns hurdles.

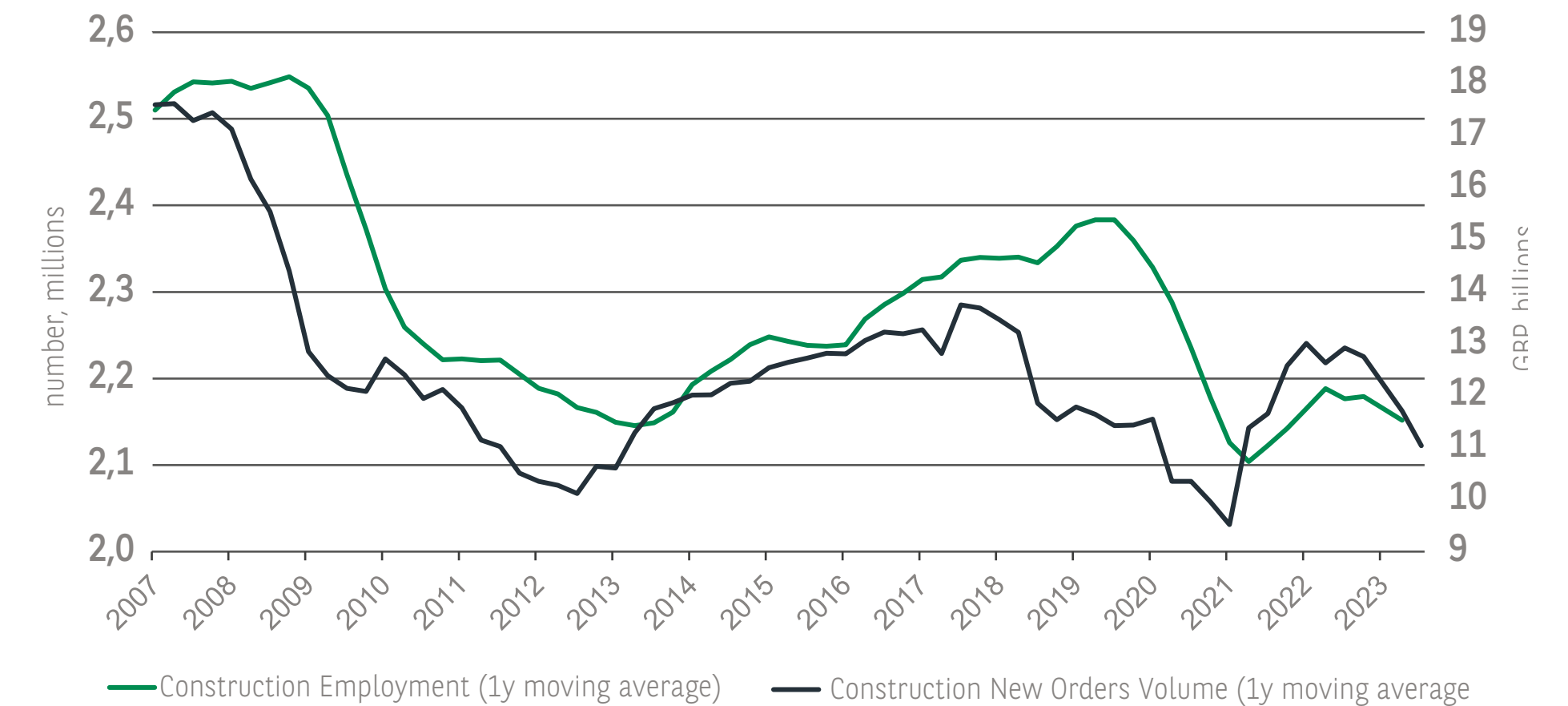
Secondly, **the construction industry has shrunk** since 2019. Indeed, employment levels have not recovered since the Global Financial Crisis in 2007/8. This is partly why the value of new constructions orders was down 15% y/y in Q3 2023 (13% below the 10y quarterly average) and 42% below 2006 levels (See Chart 3).

Adding to this is an acute shortage of planning staff. Even if the government legislates to address planning delays, the fact that the number of public sector planners is c. 25% below 2009 levels<sup>3</sup> will constrain new development and delay refurbishments to address net zero and environmental/ESG targets.



<sup>2</sup> CFO Survey Q4 2023, Deloitte UK  
<sup>3</sup> State of the Profession 2023, Royal Town Planning Institute (RTPI)

**CHART 3. UK CONSTRUCTION NEW ORDERS AND CONSTRUCTION EMPLOYMENT SINCE 2007**



Source: ONS, Macrobond

# What about the investment market?

The upshot is that both demand and supply-side structural forces will play a larger role in driving rental value growth than changes in underlying economic conditions, with strong risks to the upside on account of huge issues for developers. This informs our divergent outlook for rental value growth across sectors.

Higher interest rates have led to a significant repricing in commercial real estate and more expensive debt. Some office markets have seen capital value declines of over 30% since Q2 2022.

The almost complete absence of price discovery for most of the year and a reluctance by banks to push under-performing assets into the market has meant investment volume fell to its lowest annual level since 2010 last year.

Thankfully, however, there are clear signs we are approaching a window of opportunity where investors can lock in historically attractive income returns. The year-end rates rally brought outward prime yield shift to a halt (See Chart 4), and the recent completion of the long-trailed

20 Old Bailey acquisition by Sinar Mas Land for £240m, a c. 6.1% yield, may prove to be the line in the sand many office investors are looking for.

That said, those hoping for a rates rally-driven tide that lifts all boats may prove disappointed. Firstly, yield compression is likely to remain limited. The resilience of economic activity to higher interest rates seen over recent quarters has led many to believe that rates will need to remain higher to keep a lid on inflation.

Indeed, we expect 10-year gilt yields will be around 3.5% to 3.7% over the next couple of years, compared to yields of below 1% for much of the past decade. Moreover, with property's risk premium over gilts remaining narrow by historic standards, any further declines in gilt yields are more likely to translate into a restoration of the premium over risk-free rates, rather than an actual compression in property yields. As a result, investors will need to work harder on their current portfolios to achieve the strong rental growth on offer in a supply-starved environment. This will mean a more pronounced flight to quality and continuing divergence in prime and secondary performance.

**CHART 4. YIELD COMPRESSION IN A WORLD OF PERMANENTLY HIGHER RATES IS LIKELY TO BE LIMITED...**

**PRIME LONDON OFFICE & 10Y GILT YIELDS (PLUS LATEST BNPP FORECASTS)**



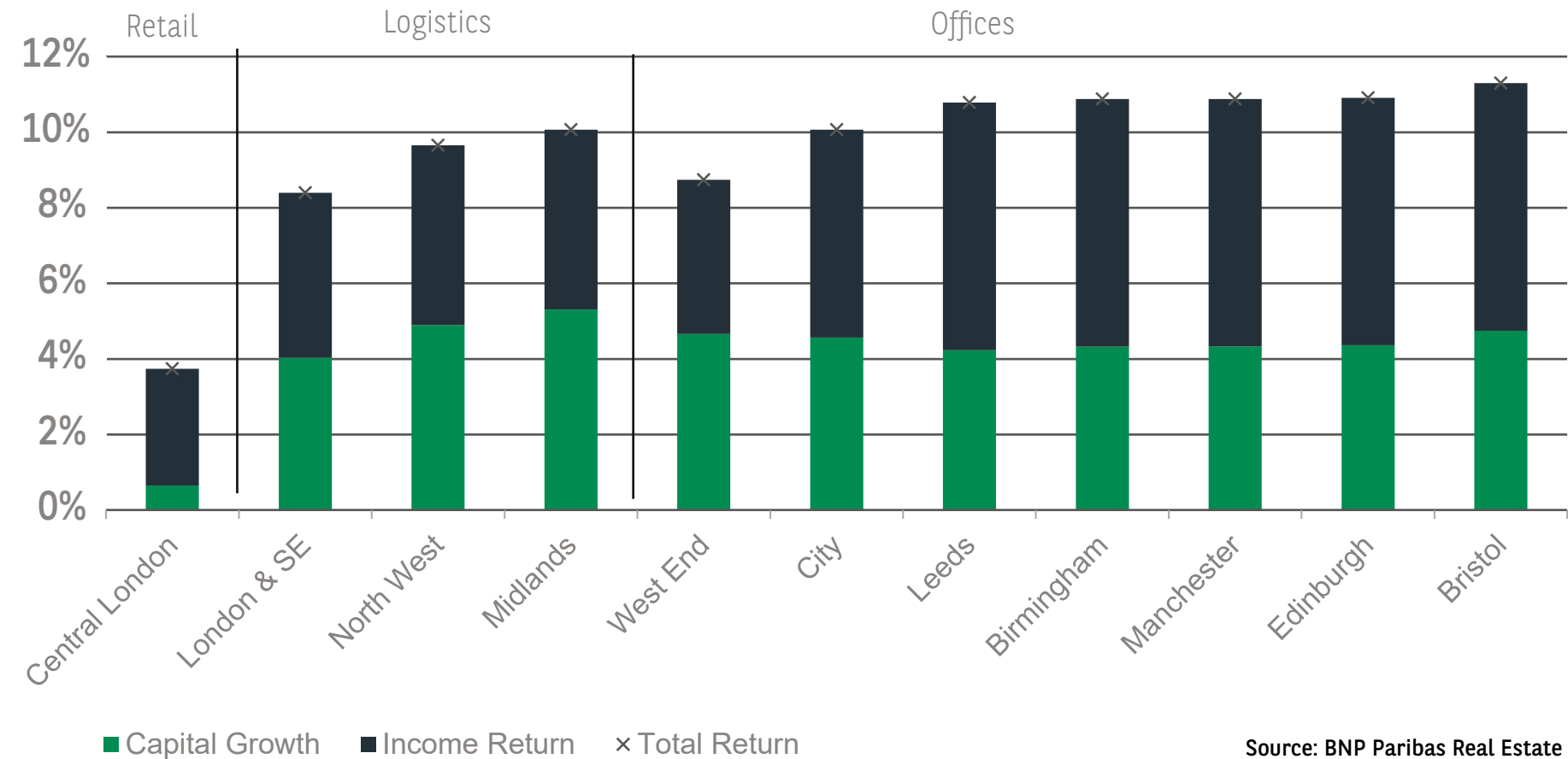
Sources: BNP Paribas Real Estate, BNP Paribas, Bank of England, Macrobond. Recessions shaded in grey.

In turn, this means refinancing risk will remain a threat over 2024 and beyond. Those older assets on the wrong side of energy efficiency preferences and without a 'reason to be' in the modern economy may then get stuck in the doldrums, acting as a drag on valuations in the rest of the market. On the flip side, those landlords of fundamentally good-quality assets that are approaching onerous refinancing deadlines can access gap financing or reach forbearance agreements and avoid crystallising painful value write-downs.

While this reduces the systemic risk to the market, it will also mean sourcing investment stock will remain challenging.

Nevertheless, the robust occupier market backdrop means there is a strong investment rationale for UK real estate today. As inflationary pressures continue to fade, market expectations of lower interest rates will become more deeply embedded, and price discovery will accelerate. The result is that 2024 is likely to prove a good vintage year for those able to invest (See Chart 5).

**CHART 5. PRIME COMMERCIAL PROPERTY FORECASTS (% PER ANNUM, 24-28)**



Source: BNP Paribas Real Estate



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