



MARCH 2024

UK ECONOMIC & REAL ESTATE BRIEFING

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

ECONOMY

"Despite headlines that the UK economy entered a recession in the second half of last year, we doubt this will take the Bank of England's focus away from pay and inflation. Given the mixed signals in the data, the Bank will need to see further evidence of cooling price pressures before it has the confidence to lower interest rates, although we continue to expect this could be as soon as June."

Samuel Duah, Head of Real Estate Economics

The latest GDP data showed that the UK economy entered a mild technical recession in the second half of 2023, with a fall in real GDP by -0.3% q/q in Q4 2023.

The slowdown in economic activity was largely driven by the private sector, with consumer spending softening in the second half of the year. In particular, households appeared to have cut back on discretionary spending as shown by the fall in 'recreation and culture' consumption. This likely reflects the lagged impact of higher interest rates on households.

That said, the recession should be interpreted with caution for a couple of reasons. First, early estimates of GDP data are uncertain and prone to revisions.

Second, it may overstate the weakness in the economy; the size of the falls in GDP means that the economy did not suffer a deep contraction. Other indicators are consistent with a much more resilient economy, such as the unemployment rate, which is at historic lows (see Figure 1). Overall, the news of a recession does not materially change the fact that real GDP growth was positive 0.1% for 2023.

Looking at the timelier Purchasing Managers' Index (PMI) surveys of business activity, the composite measure ticked up in February. While the PMIs are not an accurate predictor of GDP, they support our view that the recession will be shallow and short-lived (see Figure 2). The composite measure continued to receive support from the services sector, while the moderation in

manufacturing output appears to be stabilising. Elsewhere, the survey reported growing optimism regarding the year ahead.

In our view, economic activity will remain muted in the first half of the year. Thereafter, interest rate cuts and improving real incomes will help to generate a recovery.

The weaker GDP data is unlikely to move the dial on monetary policy. Perhaps a greater concern for the Bank of England (BoE) will be the latest developments in the labour market. The ONS recently updated its labour market estimates, after sampling issues led to greater uncertainty around the data. According to the ONS, the unemployment rate stood at 3.8% in Q4, 50bp below the BoE's February projection.

Fig. 1. Unemployment rate (%)

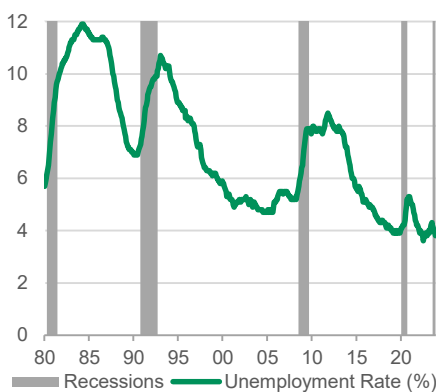


Fig. 2. Economic activity

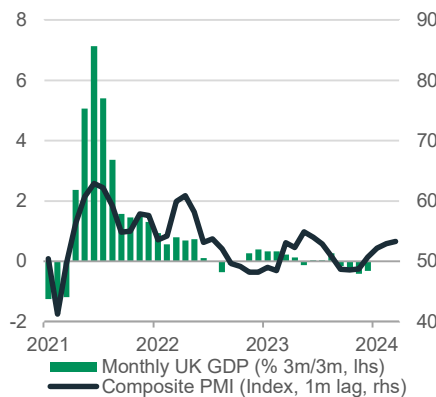
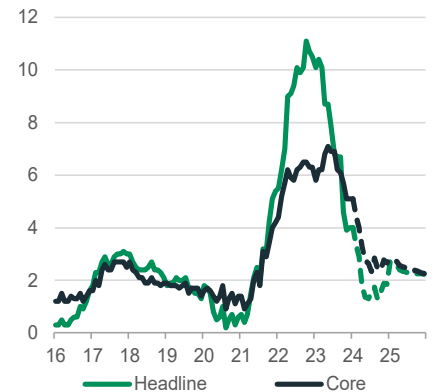


Fig. 3. UK CPI and BNP Paribas forecasts (% y/y)



The concern for the BoE is that the labour market is tighter than previously expected, which could drive up wages and therefore keep inflation above the 2% target.

Admittedly, there remains some uncertainty around the official statistics. However, a broader range of indicators, including vacancies and payrolls, also suggest the loosening in the labour market is losing momentum. In turn, wage growth remains stubbornly high. Private sector wage growth, the BoE's preferred measure of labour costs, was 6.2% y/y in Q4 2023. Not only was this above the BoE's projection (6.0%), but it was also much higher than the

3-4% that is consistent with inflation returning to the 2% target on a sustained basis.

On the inflation front, the January's data release bore better news for the BoE. Many expected headline inflation to tick higher in January (4.1% consensus) however, it held steady at 4.0% y/y. Meanwhile, core inflation came in at 5.1% y/y, which was also lower than expected (5.2%). The good news is likely to continue in the coming months as favourable 'base effects' drive inflation lower. Our forecast is that headline inflation will dip below the 2% target in April this year. Core inflation is likely to

remain stickier, dropping below 3% in May but remaining above 2% throughout 2024 and 2025. (See Figure 3.)

Taking stock of what these developments mean for monetary policy, we believe policy rates have now peaked. However, the BoE will need to see more evidence of fading price pressures before it has the confidence to cut interest rates. **On balance, we maintain our view that the BoE will deliver its first rate cut in June, lowering Bank Rate from 5.25% now to 4.25% by end-2024 and 3.00% by end-2025.**

Fig. 4. UK equities correlation to bonds*

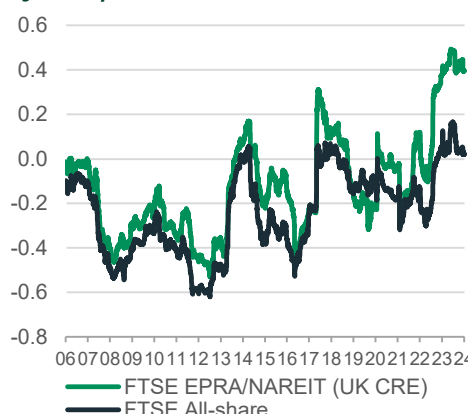


Fig. 5. UK CRE investment volume vs bond volatility

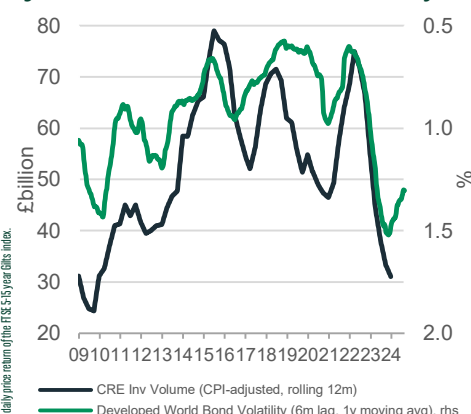
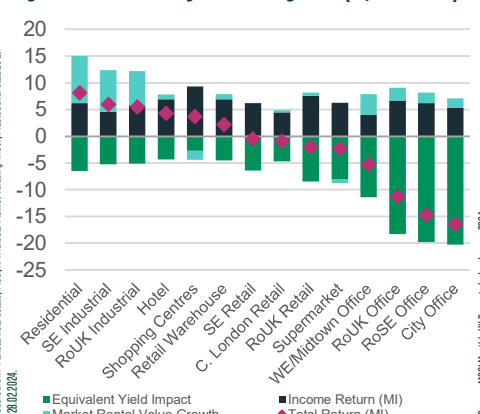


Fig. 6. MSCI returns by market segment (% 12-month)



REAL ESTATE

“Following the year-end rates rally, financial markets have dealt real estate investors a reality check, with 5y swap rates rising c. 40 bps up to 4% over February. This volatility means the market remains highly sensitive to rates movements, but investors remain encouraged by forward-looking economic indicators. We therefore continue to expect resilient prime rental growth expectations to help drive a pick-up in liquidity once Bank Rate is cut in a few months’ time.”

Charlie Tattersall, Associate Director, Capital Markets Research

Recent macroeconomic data has not been particularly helpful for UK commercial real estate (CRE) investors. Stronger-than-expected inflation, jobs data and economic growth in the US, alongside a slightly tighter-than-expected UK labour market, have sent the 10y gilt yield back to early December levels, unravelling the gains from the strong year-end rally.

While our base case for Bank Rate cuts remains unchanged, the mixed data flow does mean there are upside risks to this forecast, and that investors’ strategic focus will remain on the trajectory of interest rates. Indeed, analysing the correlation between stocks and bond returns shows that UK REITs’ correlation to bond markets is at a record high (see Figure 4). As long as the volatility in financial markets continues, investment activity will remain muted. That said, now we are at peak rates, there are signs that conditions are easing (see Figure 5).

In turn, CRE investment data does continue to point to the beginnings of recovery. MSCI’s latest monthly index (January)

pointed to resilient rental growth and moderating capital value falls. Moreover, 18 months of outward yield shift means some market segments are offering decade-high income returns, particularly retail and core regional office markets (see Figure 6). Combined with projections for the end of capital value decline this year, this represents more evidence of the attractiveness of today’s pricing.

In Central London, following the 50% q/q uptick in investment volume last quarter, early signals this year suggest momentum in the capital’s investment market continues to build. While our in-house data on actual transactions so far this quarter provisionally suggests £0.7bn of Central London assets has changed hands, the number of deals currently under offer suggests total Q1 volume may record a second consecutive q/q increase. Key imminent deals, such as the sale of 55 St James’ Street, SW1 are likely to further improve price discovery and give investors further confidence of underlying liquidity.

However, residential continues to be the

most dynamic and liquid sector. Not only does the most up-to-date data for 2023 show a 7.6% y/y increase in Build-to-Rent investment (BtR) activity, but volume for Q1 2024 to date has already surpassed the Q4 2023 total (see Figure 7). The final Q1 figure is likely to be significantly higher once large deals like the distressed £1.3bn Nine Elms sale goes through. Buoyed by persistent housing affordability issues and a lack of supply exacerbated by planning red tape, strong, inflation-beating rental growth projections are likely to keep investor demand for the Living sector and all its subsectors, such as Single-Family Rental (SFR), strong. This includes student housing; Unite’s recently announced FY23 results highlighted 7.4% like-for-like rental growth over the previous 12 months and upgraded rental growth expectations for the 2024/25 academic year to at least 6%.

The risk of a rise in distressed sales remains hotly debated, with the system risk to the banking system a key question. We are beginning to see more high-profile bank-led sales process, such as the recent sale of 5 Churchill Place, E14 or the Nine Elms sale,

but the reality is that banks are very reluctant to take poorly performing assets on to their balance sheets. Indeed, UK banks' write-offs of non-performing loans to real estate companies remain minimal compared to the post-GFC period (see Figure 8). As for systemic risk, while non-negligible, UK banks' exposure to commercial real estate as a share of total lending is less than half what it was in 2009, suggesting any risk can be contained. With debt costs poised to end the year lower and liquidity beginning to return, many borrowers with imminent refinancing deadlines are opting to either source gap financing or put in more equity to cover any losses.

In short, the UK CRE market, much like monetary policy, continues to wait for clearer evidence that 2023's challenges are behind it. While financial market volatility means this has not happened yet for some sectors, it remains the case that those able to overcome these obstacles and deploy capital are likely to reap the rewards of inflation-beating rental growth in the years to come.

Fig. 7. UK Build-to-Rent (BtR) & Private Rented Sector (PRS) Investment Volume by quarter

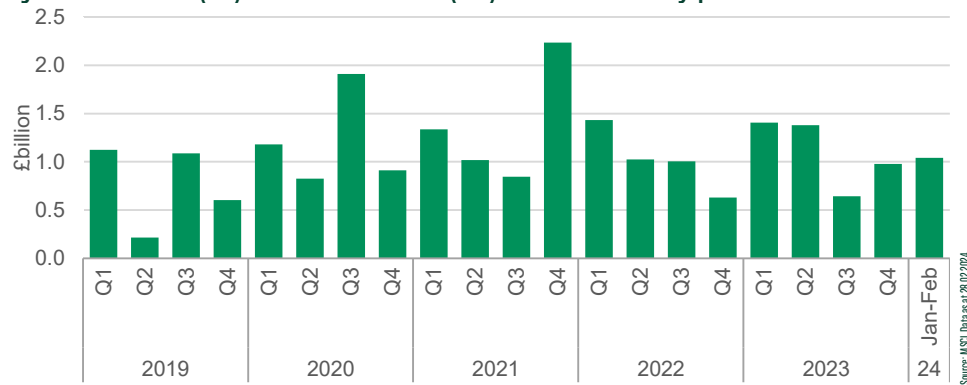
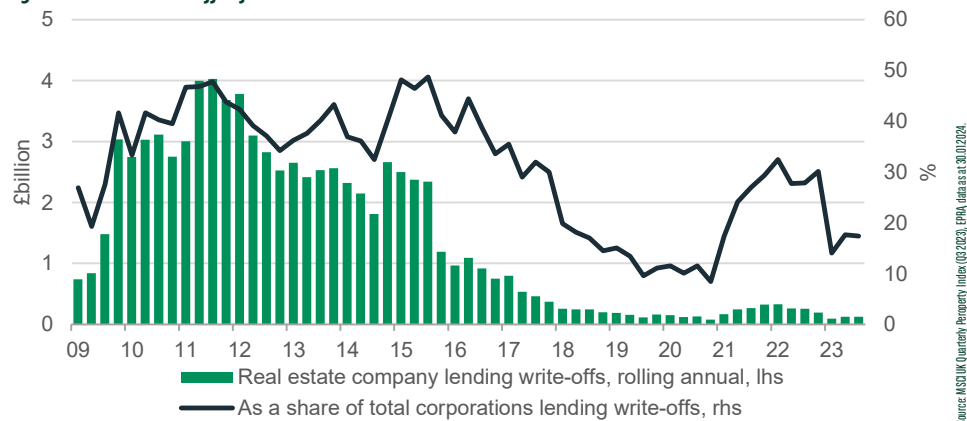


Fig. 8. UK banks' write-offs of real estate loans



“Recent data has confirmed that the worst of the economic stagnation we have endured over the last 12 months is behind us. The economy went into recession at the end of last year, but the latest indicators already point to increasing business activity and industrial production, real income growth, and recovering house prices. Job listings data also suggests accelerating business expansion, and services sector optimism is improving. This is an important signal for leasing demand picking up later this year.

“This has come with heightened inflation fears, exacerbated by the crisis in the Red Sea. Nevertheless, if current forecasts for falling core inflation and slowing wage growth are accurate, the Bank of England should still be able to initiate a long-awaited rate cutting cycle next quarter.

“Real estate markets are already responding. Our data shows London office liquidity is gradually recovering, demand across the residential segments is intensifying, and recent shopping centre deals are providing retail price discovery in a complicated market. Furthermore, a recent flurry of industrial M&A and share placing activity is another indicator that investors are positioning to benefit from the imminent trough in pricing.

“Navigating this fast-moving environment successfully requires financial fluency and unrivalled access to financial markets. As the only real estate advisor to be part of one of the world’s pre-eminent financial services groups, we are ideally placed to add value for our clients in a pivotal year for UK real estate.”

Etienne Prongué, CEO, BNP Paribas Real Estate UK

KEY FACTS & FIGURES

3.00%

BNP Paribas forecast for Bank Rate at end of 2025.

-0.3%

Real GDP growth in Q4 2024, the second consecutive quarterly contraction.

4.0%

5y SONIA swap rate at end of February, up from 3.6% a month ago.

£45bn

FY2024 UK CRE investment volume forecast, an 19% increase on 2023.

7.1%

BNP Paribas Real Estate forecast for prime UK office total return in 2024.

+6.7%

BNP Paribas Real Estate forecast for prime UK office rental growth in 2024.

Sources: BNP Paribas Real Estate, MSCI, Bank of England, ONS, data as at 29.02.2024.

CONTACTS

PROPERTY DEVELOPMENT • TRANSACTION • INVESTMENT MANAGEMENT • PROPERTY MANAGEMENT • VALUATION • CONSULTING



Etienne Prongué
Chief Executive Officer UK
+44 (0)20 7338 4112
etienne.prongue@realestate.bnpparibas



Samuel Duah, PhD CRE
Head of Real Estate Economics
+44 (0)7968 906225
samuel.duah@realestate.bnpparibas



Charlie Tattersall
Associate Director, Capital Markets Research
+44 (0)7818 539188
charlie.tattersall@realestate.bnpparibas



Sam Hall
Property Economist
+44 (0)7909 487568
sam.hall@realestate.bnpparibas



BNP PARIBAS REAL ESTATE

EUROPE

FRANCE
Headquarters
50, cours de l'Île Seguin - CS 50280
92650 Boulogne-Billancourt cedex
Tel.: +33 1 55 65 20 04

BELGIUM
Avenue Louise 235
1000 Brussels
Tel.: +32 2 290 59 59

GERMANY
Goetheplatz 4
60311 Frankfurt
Tel.: +49 69 2 98 99 0

IRELAND
57 Adelaide Road,
Dublin 2
Tel.: +353 1 66 11 233

ITALY
Piazza Lina Bo Bardi, 3
20124 Milan
Tel.: +39 02 58 33 141

LUXEMBOURG
Kronos building
10, rue Edward-Steichen
2540 Luxembourg
Tel.: +352 34 94 84
Investment Management
Tel.: +352 26 06 06

NETHERLANDS
Antonio Vivaldistraat 54
1083 HP Amsterdam
Tel.: +31 20 305 97 20

POLAND
Prime Corporate Center
Grzybowska 78
00-844 Warsaw
Tel.: +48 22 653 44 00

PORTUGAL
Avenida da República, 90
Piso 1, Fracção 1
1600-206 Lisboa
Tel.: +351 939 911 125

SPAIN
C/ Emilio Vargas, 4
28043 Madrid
Tel.: +34 91 454 96 00

UNITED KINGDOM
10 Harewood Avenue
London NW1 6AA
Tel.: +44 20 3993 3562

MIDDLE EAST / ASIA

DUBAI
Emaar Square
Building n° 1, 7th Floor
P.O. Box 7233, Dubai
Tel.: +971 44 248 277

HONG KONG
63rd /F, Two International Finance
Centre,
8 Finance Street, Central,
Hong Kong
Tel.: +852 2909 8888

SINGAPORE
Pte Ltd 20 Collyer Quay,
#17-04
Singapore 049319
Tel.: +65 8189 2762

BNP Paribas Real Estate UK
10 Harewood Avenue
London NW1 6AA
Tel.: +44 (0) 2039 933 562

KEEP UP-TO-DATE WITH
BNP PARIBAS REAL ESTATE'S NEWS,
WHEREVER YOU ARE



www.realestate.bnpparibas.co.uk
#BEYONDBUILDINGS

© BNP PARIBAS REAL ESTATE ADVISORY & PROPERTY MANAGEMENT UK LIMITED. ALL RIGHTS RESERVED. No part of this publication may be reproduced or transmitted in any form without prior written consent by BNP Paribas Real Estate UK. The information contained herein is general in nature and is not intended, and should not be construed, as professional advice or opinion provided to the user, nor as a recommendation of any particular approach. It is based on material that we believe to be reliable. While every effort has been made to ensure its accuracy, we cannot offer any warranty that it contains no factual errors. The information contained herein should therefore not be relied upon for any purpose unless otherwise agreed with BNP Paribas Real Estate UK and BNP Paribas Real Estate UK shall have no liability in respect of the same.



**BNP PARIBAS
REAL ESTATE**

Real Estate
for a changing
world