CAPITALISE ON THE FUTURE

Economic & Real Estate Outlook

January 2025

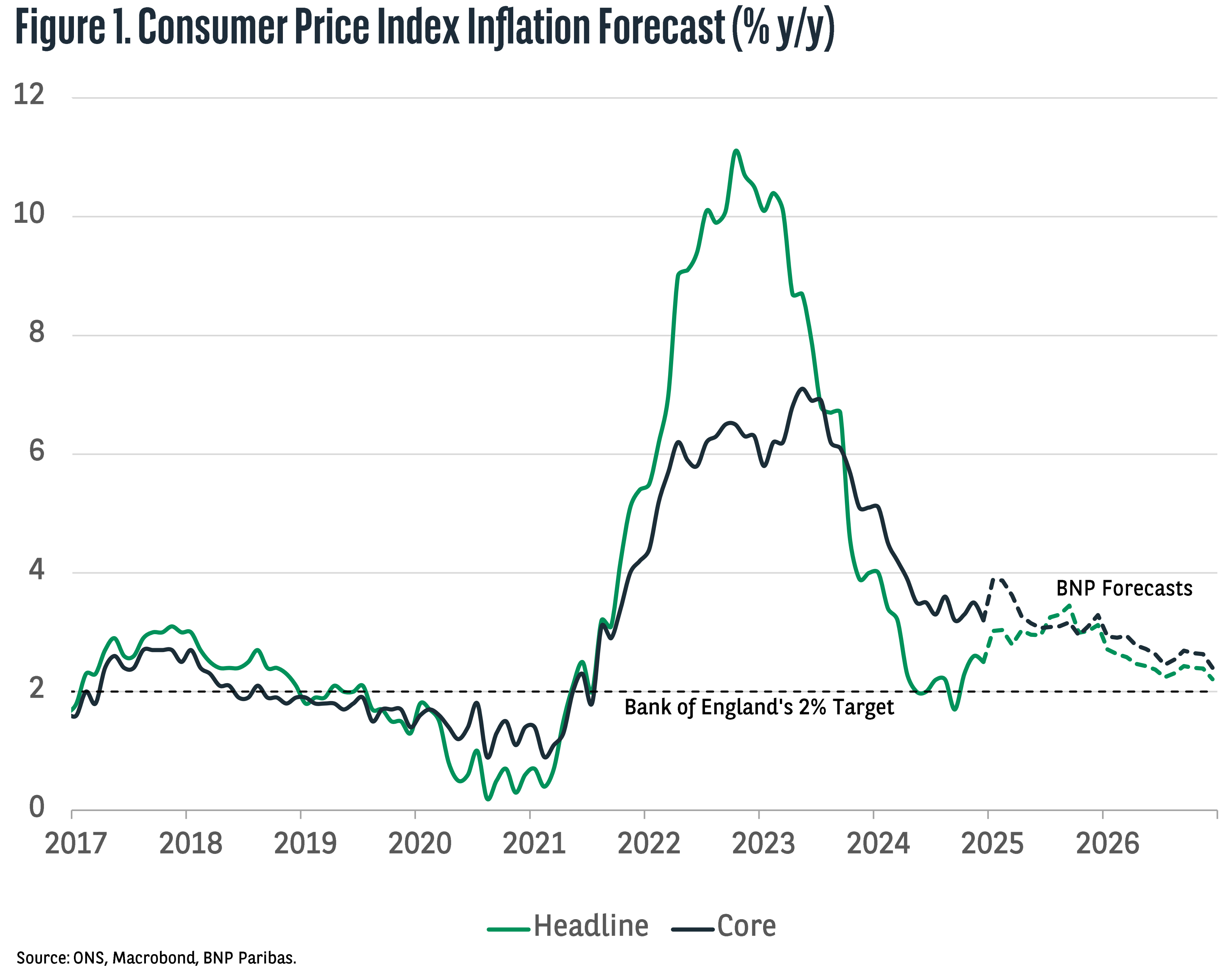
Real Estate for a changing world

Economic Outlook

"We expect sticky inflation, modest growth and a gradual pace of interest rate cuts to characterise the economy in 2025."

Samuel Duah

Figure 1. Consumer Price Index Inflation Forecast (% y/y)



Source: ONS, Macrobond, BNP Paribas.

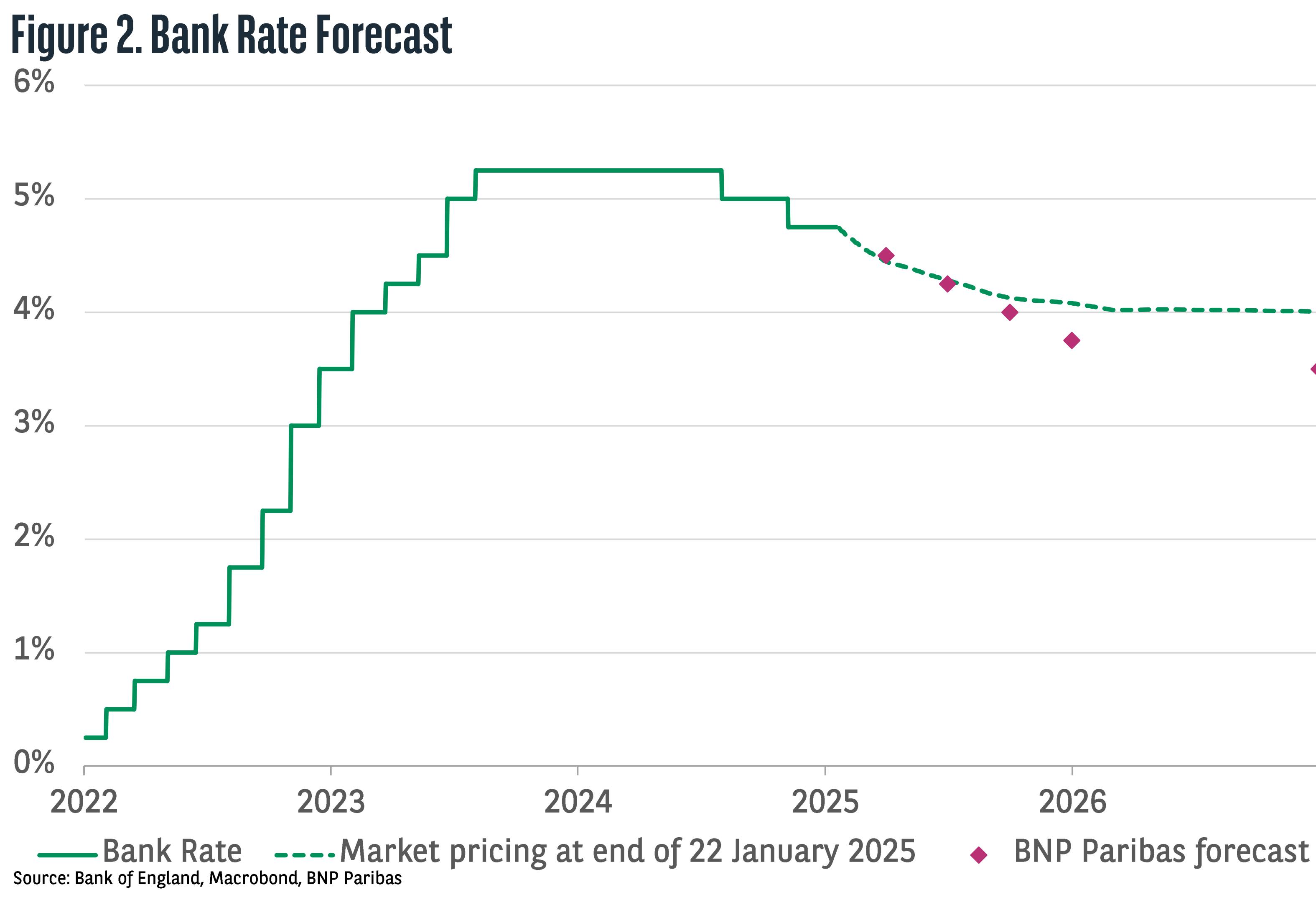
Persistent inflation and gradual interest rate cuts: We expect stickiness in inflation to persist throughout 2025. One reason is that the large falls in energy prices we saw last year are behind us. Admittedly, inflation in the services sector should continue to moderate, but only gradually.

Moreover, new sources of inflation may emerge from US President Trump's trade policies and the Autumn Statement. For example, the Bank of England's (BoE) Decision Maker Panel Survey showed that 54% of firms expected to raise prices in response to the increase in National Insurance Contributions (NICs). Meanwhile, the S&P Purchasing Managers' Index is also signalling price rises. Therefore, on balance, we forecast headline inflation to average around 3% in 2025 (figure 1).

Even though inflation is expected to remain above target in 2025, there is still good reason to expect further interest rate cuts. Cracks are beginning to show in the labour market and economic activity stagnated again in the second half of 2024. Moreover, recent rises in bond yields may lead to additional fiscal consolidation and tighter financial conditions, both of which will be disinflationary.

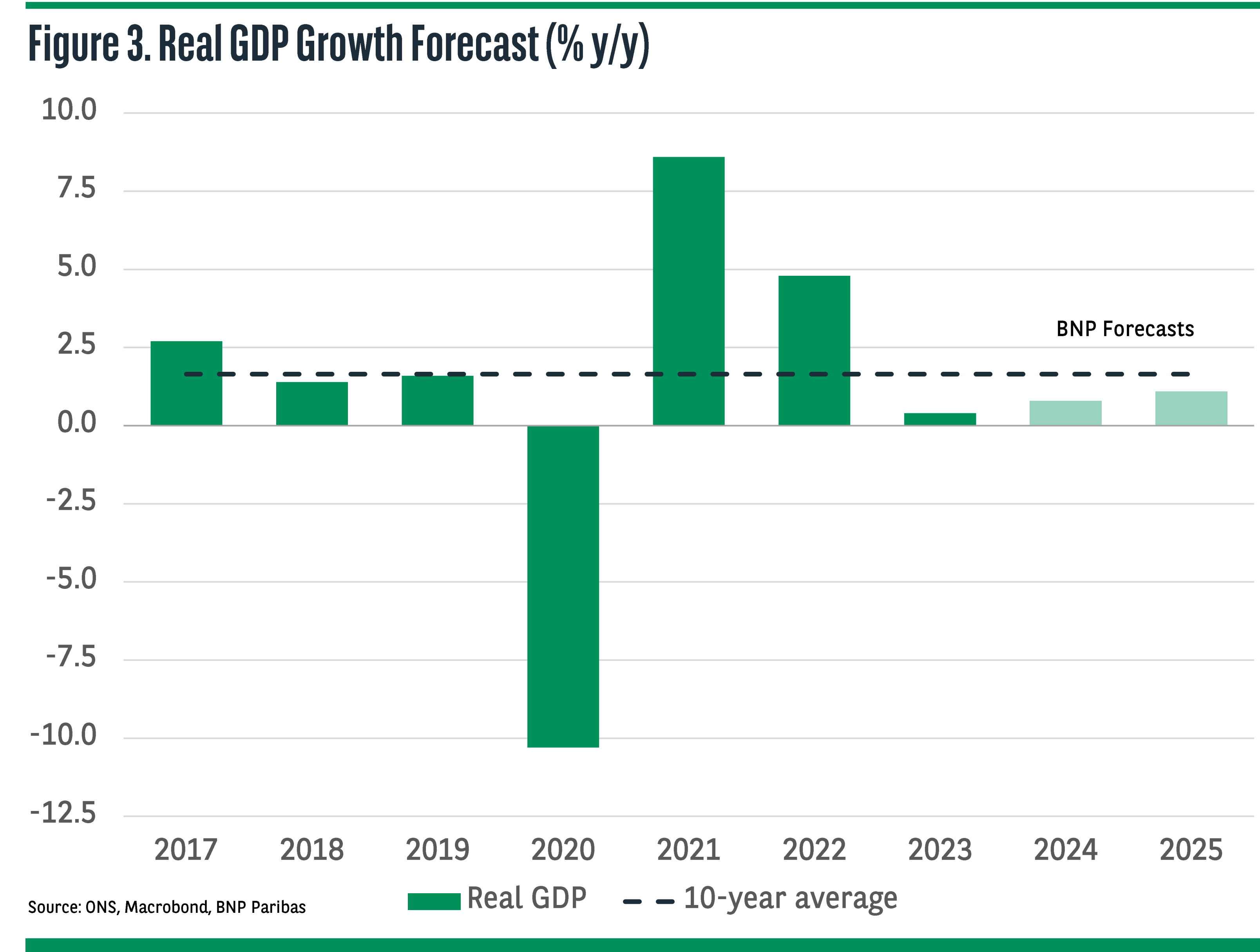
Given the BoE's forward-looking approach, we hold the view that Bank Rate will be cut by 25bps per quarter, to 3.75% by the end of this year. While we consider this to be a gradual pace of easing, it is still faster than what markets are currently pricing in (figure 2). This is one reason why we expect 10-year gilt yields to fall back from their 16-year highs. However, the sticky inflation outlook, Trump administration and concerns around UK government debt sustainability mean 10-year gilt yields are likely to be higher in 2025 than in 2024, on average.

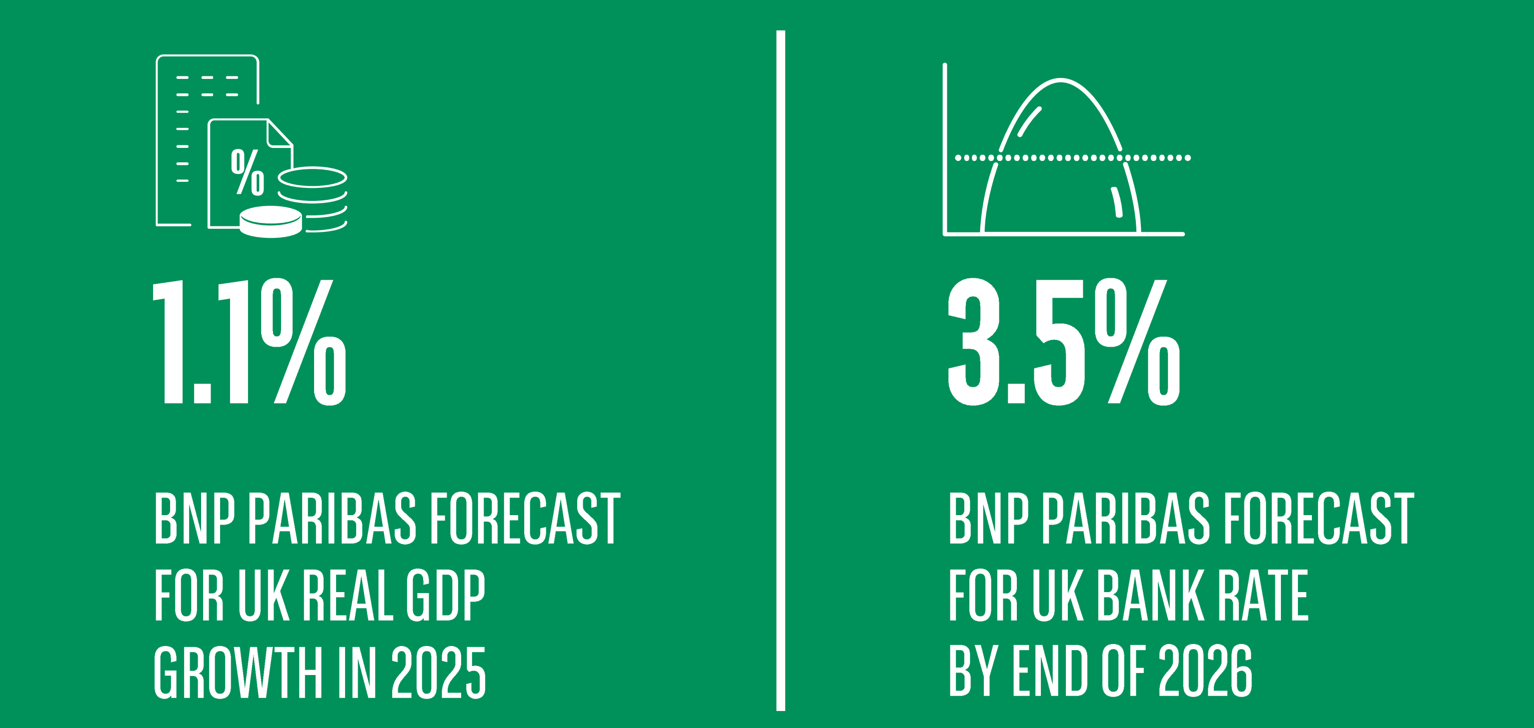
Figure 2. Bank Rate Forecast



Source: Bank of England, Macrobond, BNP Paribas

Government finances under pressure: With the Gilt supply forecast to reach record levels this year, we think the debate around the government's finances will be a recurring one. Having accumulated a significant amount of debt, the government is nearing the borrowing limits of its fiscal rules. Not only this, but the government also faces tight borrowing constraints from bond markets. The combination of high debt levels, weak economic growth and steep borrowing costs means investors remain concerned about the government's ability to service its debt. This could impact the economy in a number of ways.





Firstly, financial markets will be highly sensitive to news or data that could affect the government's finances. As a result, the government will need to tread carefully to avoid an adverse reaction in bond markets. Regardless, we expect a volatile environment for bond yields.

Second, Chancellor Reeves will not be able to rely on debt markets to dig her way out of fiscal difficulties. As a result, she is likely to be faced with a difficult decision: proceed with real-term spending cuts to unprotected departments or raise taxes further. The Chancellor will need to turn spending totals into department allocations in the Spring spending review, making it an important fiscal event in the calendar this year.

Finally, the lack of room to increase borrowing will challenge the government in its pledge to grow the economy. To circumnavigate this, we may see the government lean more heavily on less costly measures to generate growth, such as reforms to planning and pensions.

Modest outlook for economic growth: The government's financial position is just one of many challenges facing the UK economy this year. Domestically, elevated interest rates and rising NICs will also act as headwinds. Meanwhile, external factors such as geopolitical tensions, weak demand from Europe and uncertainty around trade with the US pose additional risks to growth.

Nevertheless, we think that economic activity will regain momentum over the course of 2025, as a combination of factors become more supportive. For one, low unemployment and high savings rates mean that household balance sheets look relatively healthy, and strong wage growth is likely to carry into 2025. While households may continue to exercise caution, these drivers point to a further recovery in consumer spending.

Despite the government's financial circumstances, we still expect it to emerge as one of the main drivers of growth. This view stems from the fiscal stimulus announced in the Autumn Statement, which will provide a boost to demand this year.

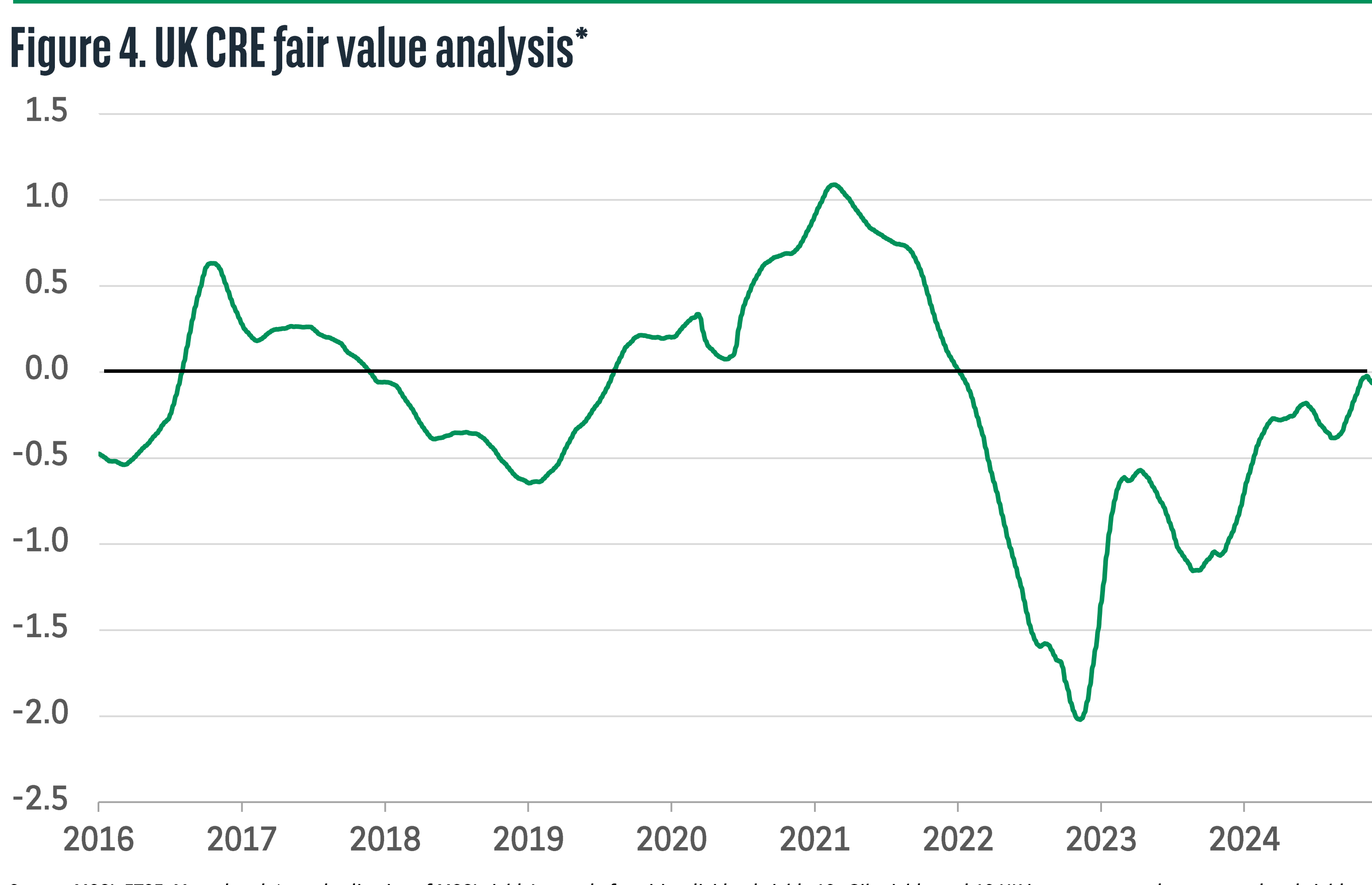
Overall, a challenging economic backdrop means growth is likely to continue underperforming its historic trend. Nonetheless, we expect a marginal improvement from last year, with real GDP growth rising from an estimate of 0.8% y/y in 2024 to 1.1% y/y in 2025 (figure 3).

Commercial Real Estate Outlook

"With volatility on the rise, 2025 is likely to show only a muted uptick in investment activity. Even so, pricing dislocation means stock-selective investors can still unlock historic value and income growth this year."

Charlie Tattersall

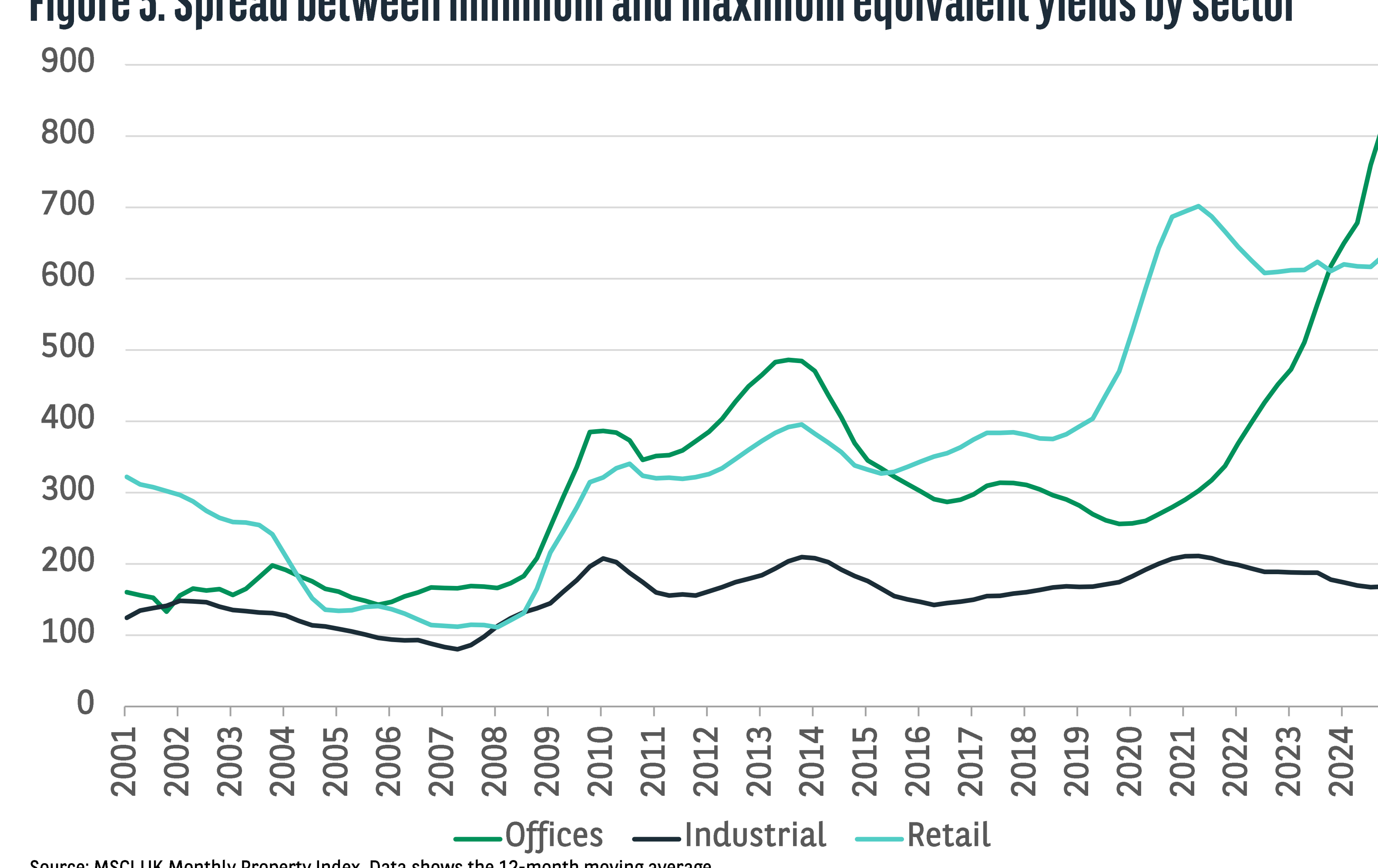
Figure 4. UK CRE fair value analysis*



Source: MSCI, FTSE, Macrobond. *standardisation of MSCI yields' spread of equities dividend yields,10y Gilt yields, and 10 UK investment-grade corporate bond yields

Liquidity improved last year: Despite another turbulent year for global markets, UK commercial real estate (CRE) market conditions improved in 2024. Q4 2024 was the investment market's busiest final quarter since 2021, helping annual CRE investment volume to rise 23% y/y to £50bn, marginally above our £48bn forecast. Driving this was improved availability of acquisition finance and a 63% rise in inward investment from US-based buyers, who increased their market share to 25%, in line with 2021's record high. Prime pricing also stabilised, and, in all the main sectors bar offices, capital value growth was positive. Analysis of average equivalent yields against yields on UK equities, corporate bonds and gilts suggests, at a macro level, that UK commercial real estate came close to fair value last year (figure 4).

Figure 5. Spread between minimum and maximum equivalent yields by sector



Source: MSCI UK Monthly Property Index. Data shows the 12-month moving average.

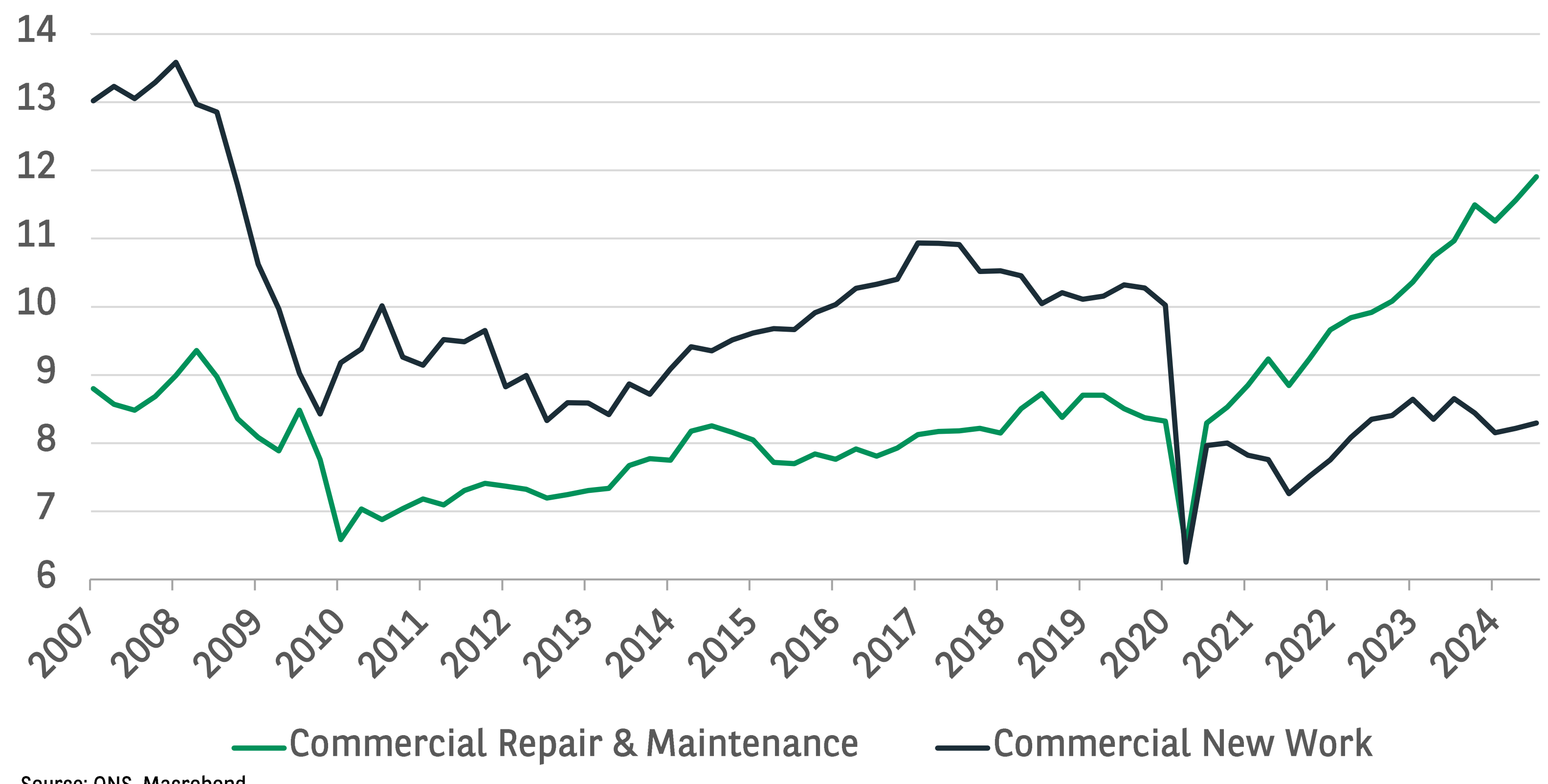
Interest rates - from rally to reality check: That said the path of recovery from here will not be easy. Last January. investors were looking forward to a robust market rally, driven by 100 bps of base rate cuts and greater political stability. Since then, markets have been dealt a reality check. Bank Rate did fall, but swap rates still ended 2024 higher on account of higher global inflation, geopolitical volatility, and the impact of the Government's Autumn Budget.

The biggest takeaway for UK CRE in 2025, in our view, is that hoping for rate cuts to boost investment liquidity and pricing is misguided. Recent bond market turmoil only highlights this further and strengthens our view that we are now unlikely to see material prime yield compression this year.

Record yield spreads across sectors: However, while the market may take some time to digest the implications of the new US government and reassesses economic expectations, this does not necessarily mean investors cannot find value. The impact of COVID-19 and higher interest rates has forced a historic reassessment of risk and opened up considerable yield spreads across the risk curve. This is the case not only at an all-sector level but also within specific sectors (figure 5).

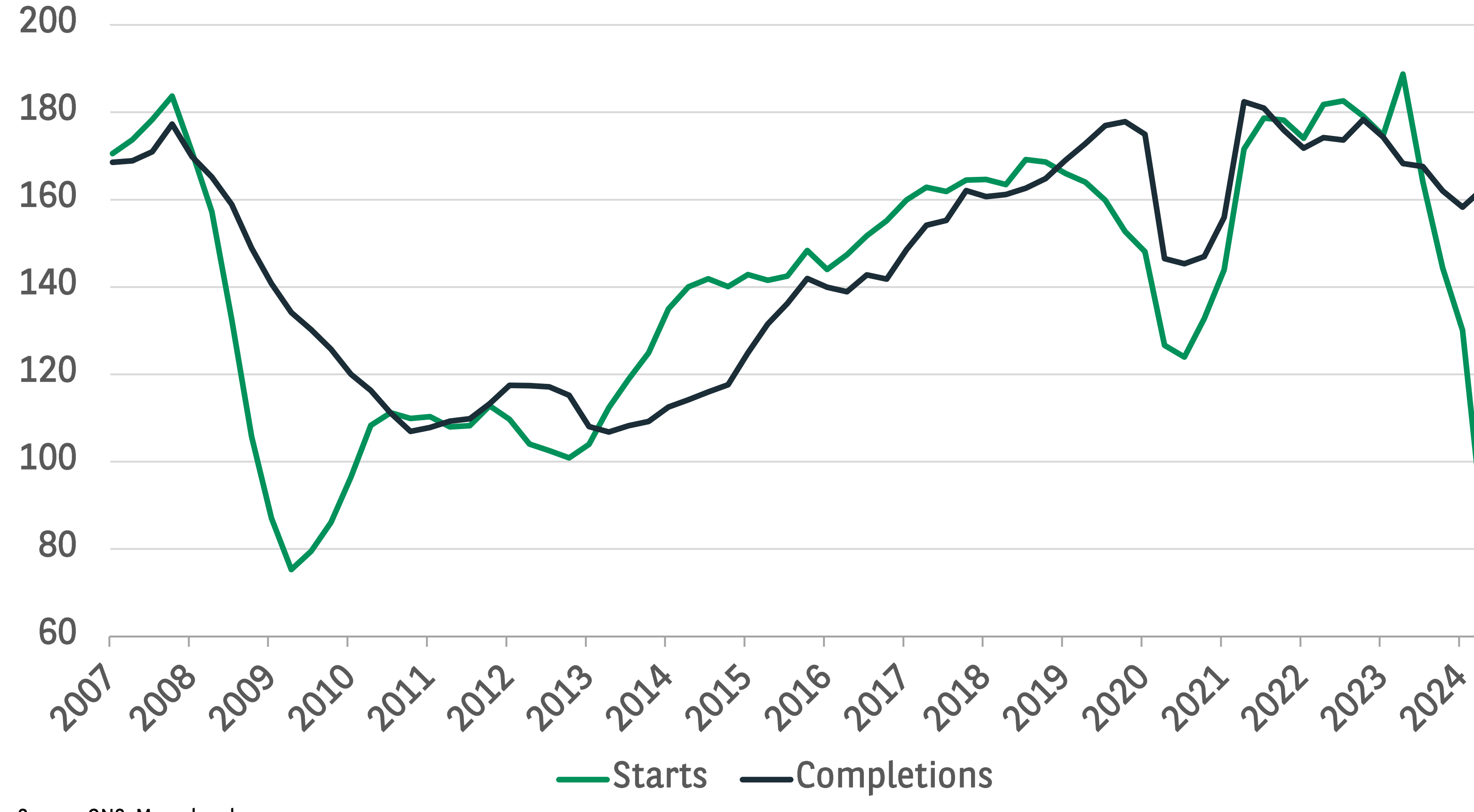
Colliding with this is a resilient leasing market that shows few signs of the oversupply that preceded historic market downturns. Grade A commercial space continues to be in short supply, but even at a wider market level we are now seeing overall vacancy rates peak or even trend lower in prime locations, such as

Figure 6. UK commercial construction volume by type of work (constant prices, £bn)



Source: ONS, Macrobond.

Figure 7. England Housebuilding (thousands, rolling annual)



Source: ONS, Macrobond.

the City Core and Midtown office markets in London and certain regional industrial markets.

We expect high debt and construction costs, along with persistent labour shortages, to keep construction starts low this year. We also think the post-pandemic trend of older stock being refurbished and repositioned will continue (figure 6). Therefore, we continue to project robust prime rental growth over the next year, one of the key calls from our 2024 Outlook.

Stock selection key to achieve historic returns: In this environment, focusing on mispriced assets, local leasing market fundamentals and driving yields through income growth will be key to unlocking value, but the level of opportunity will vary widely depending on sector focus.

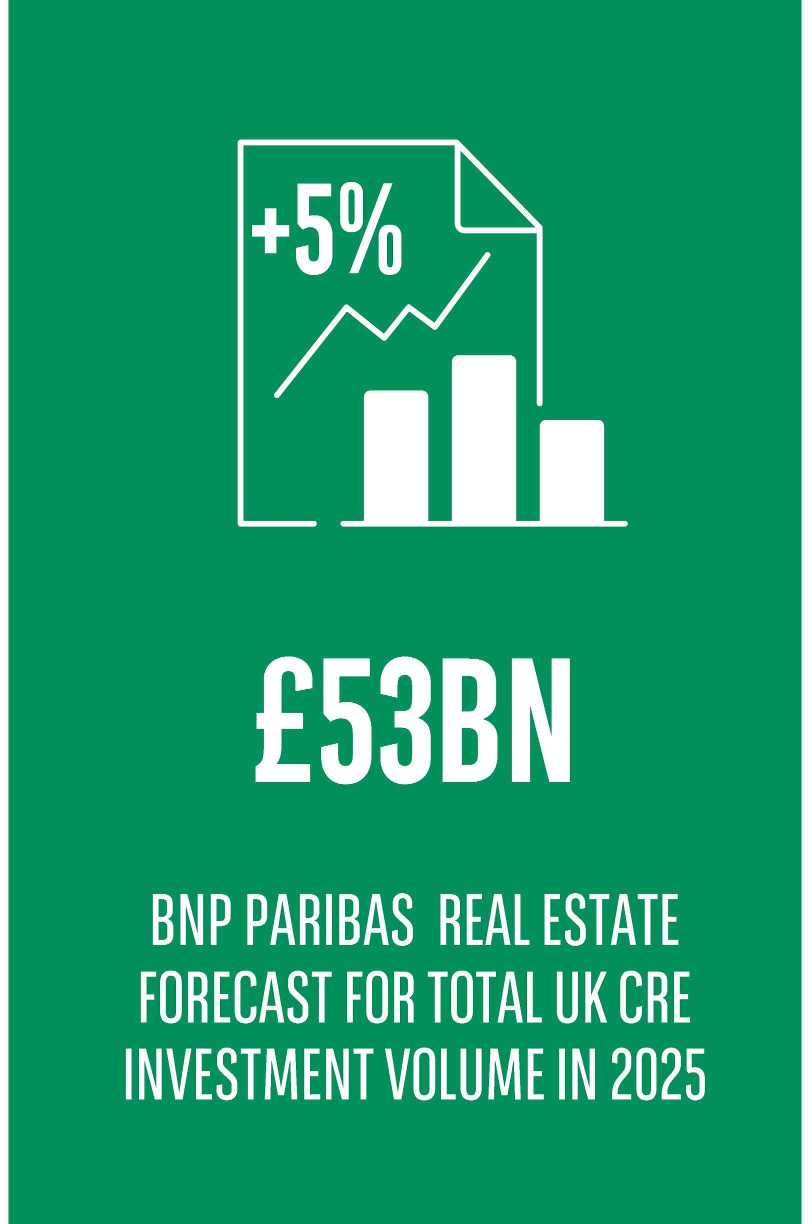
For offices, those able to overcome high construction costs can realise very strong rental growth, while prime yields in some supply-constrained regional markets are at historic highs. This provides a potentially compelling opportunity to achieve value-add returns on fundamentally core or core-plus quality assets. However, significant capex requirements and refinancing needs mean there is a persistent buyer-seller expectations gap. Unless there is a substantial drop in interest rates, or a global change in risk perception, we think the recent low levels of office volume are likely to continue this year.

Industrial & Logistics was again the largest sector last year. The sector is now the global institutional sector of choice, but recent manufacturing sector weakness, moderating rental growth and a low risk premium cloud the outlook. Even so, yields remain stable in the face of long-term investor convictions, and the potential for reversion in urban logistics estates near urban conurbations remains considerable. The rapid growth of the data centre market is also likely to weigh on the supply of industrial land.

This year, we think assets most exposed to the consumer economy will be the most favoured. While many businesses grapple with higher costs and trade uncertainty, rising real incomes and continued growth in savings means household spending on services and goods remains robust. This gives many consumer-facing businesses at least some protection from inflation, which in turn can pass on to rents. Indeed, last year's investment data shows that investors are increasingly targeting resilient, well-located retail schemes, particularly high-footfall shopping centres and retail parks.

As for the living sector, the long-term trends underpinning the investment rationale have only intensified over the last year (figure 7). Questions over affordability in some markets are justified, but overall, the sectors closer correlation to wage growth and consumer confidence, combined with high mortgage rates for first-time buyers, remain attractive in today's environment.

We expect these consumer-focused market segments to be strong drivers of the ongoing investment market recovery this year, but the result of the long shift into a new economic paradigm has resulted in significant pricing dislocation in every sector. In our view, this has created a compelling opportunity to benefit from mispricing.



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