UK ECONOMIC AND INVESTMENT BRIEFING
AUGUST 2017

Economic
- UK GDP expanded 0.3% in Q2, up from 0.2%. The majority of growth came from the service sector.
- Inflation fell unexpectedly in June for the first time in nine months to 2.6% from a four-year high of 2.9%.
- The fall in inflation casts doubt over a rate hike later this year.

Investment
- The UK investment market continues to defy expectations, posting H1 2017 investment volumes of £26.17bn, 24.4% above the long-term average.
- Across H1 2017, Overseas investors deployed significant capital into UK real estate, acting as substantial net investors and accounting for 50.6% of total UK investment volumes, rising to 74.7% in the capital.
- Based on MSCI's latest June Monthly Index, All Property total returns stood at 4.8% for H1 2017, a substantial improvement on the 0.2% registered for H2 2016.

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UK ECONOMIC UPDATE

UK GDP expanded 0.3% in Q2, up from 0.2% in the first quarter. Year-on-year growth slowed to 1.7% from 2%.

The majority of growth came from the service sector, which rebounded to grow 0.5%, following a 0.1% expansion at the start of the year. Construction and manufacturing fell 0.9% and 0.5% respectively.

The second quarter GDP estimate was just below the Bank of England’s (BoE) expectations of 0.4% growth but was in line the consensus view. The BoE this week revealed its latest outlook on the economy. Mark Carney, the governor of the bank talked about how the forecasts factored in a large amount of uncertainty about the eventual shape of the UK’s economic relationship with the EU.

The BoE forecasts assume a smooth Brexit transition, with Mark Carney also stating at the press conference that he has not seen any material evidence that businesses think otherwise.

The new forecasts reflect the deterioration of the economic outlook as rising inflation outpaces wage growth, restricting consumer spending. Economic growth of 1.7% is expected this year and 1.6% in 2018, down from 1.9% and 1.7%. The downgrades to growth were enough for the Monetary Policy Committee to keep interest rates on hold.

Last month the International Monetary Fund also downgraded its UK growth forecast for the first time since the aftermath of last year’s Brexit vote. The fund also now expects GDP to expand 1.7% this year from an earlier estimate of 2% made in April.

Having warned of an immediate hit to the UK economy following last June’s referendum result, the IMF was forced to change course on its outlook, reversing almost all of its initial post-referendum downgrades from October as evidence showed consumer spending was holding growth. But rising inflation, encouraged by the weaker pound, is now beginning to squeeze household spending.

Inflation has risen rapidly since the EU referendum in June last year, when the consumer prices index was 0.5%. The Brexit vote triggered a sharp fall in the value of sterling which has driven up the cost of imported goods.

However, recent figures show inflation fell unexpectedly in June this year for the first time in nine months to 2.6% from a four-year high of 2.9% in May, the rate was largely expected to be unchanged. The fall was mainly driven by lower petrol and diesel prices, reflecting weaker global oil prices. Fuel prices fell by 11.1% between May and June, compared with a 2.2% rise over the same month a year earlier.

Despite the fall, inflation at 2.6% is still well above the BoE’s 2% target. Looking ahead inflation is expected to average 2.8% for 2017, stagnate in 2018 before it begins to fall to 2.4% in 2019 – still above target.

The fall in inflation cast’s doubt over a rate hike later this year. Even if inflation does recover, the decision to raise rates still hinges on the growth outlook. BoE governor Mark Carney has said that the Bank needs to see stronger investment and a recovery in wage growth before tightening policy. BNP Paribas expect no rate hike this year; one in 2018 and two rate hikes in 2019.

“The fall in inflation casts doubt over a rate hike later this year.”
UK INVESTMENT UPDATE

The UK investment market continues to defy expectations, posting H1 2017 investment volumes of £26.17bn, 24.4% above the long-term average. Following a solid Q1, Q2 2017 recorded an improved performance, with total volumes rising by 9.9% despite the significant boost provided by the £1.15bn sale of the Leadenhall Building in the previous quarter.

Industry benchmarks illustrate a continually improving outlook for UK real estate following the declines witnessed post-referendum. Based on MSCI’s latest June Monthly Index, All Property total returns stood at 4.8% for H1 2017, marking a substantial improvement on the 0.2% registered for H2 2016.

The industrial sector remains an outperformer: the Standard Industrial and Distribution Warehouse sectors recorded total returns of 9.2% and 7.4% respectively across H1 2017. Investor interest in the sector also appears to be picking up pace as the year progresses with industrial investment volumes rising 11.6% from Q1 to Q2.

Across H1 2017, overseas investors deployed significant capital into UK real estate, acting as substantial net investors and accounting for 50.6% of total UK volumes, rising to 74.7% in the capital. Asia Pacific investors, particularly Hong Kong and China-based firms, remain the most prevalent. Whilst diversification into other sectors and UK regions is slowly picking up traction, the office sector and especially Central London offices remain the key targets, a trend which seems set to continue post-H1 2017 as evidenced by Hong Kong investor LKK Health Products Group’s recent agreement to acquire 20 Fenchurch Street (The Walkie Talkie) for a record-breaking £1.28bn, reflecting just a 3.4% yield.

2017 is also starting to show signs of a potential softening in the net sell position of domestic investors. Whilst UK institutions and Property companies still stand at a net sell position overall, the level has reduced slightly from Q1 to Q2 2017. For both UK institutions and property companies, Q2 2017 marked the strongest quarter for UK investment post-referendum, with volumes standing at 2.04bn (+24.4% on Q1) and 3.17bn (+25.8% on Q1) respectively.

Typically operating a more diverse UK real estate investment strategy than their overseas counterparts, competition in the capital and a hunt for higher returns continues to orchestrate a drive for alternatives and a regional focus from these investor types.

"Overseas Investors accounted for 50.6% of total UK investment volumes over H1 2017, rising to 74.7% in the capital."