Perspectives

UK Economic & Property Market Commentary

Q1 2024

Economic update

UK economy returns to growth

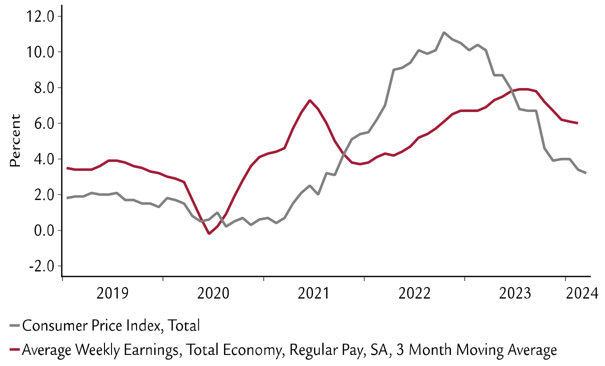
Momentum in the UK economy improved in the first quarter of 2024 after falling into a mild recession during H2 2023. Economic growth of 0.3% and 0.1% was recorded in January and February, respectively. Consequently, we expect to see a return to growth overall in the first quarter.

The Bank of England voted to keep interest rates unchanged in Q1 but minutes from their March meeting laid the groundwork for the first interest rate cut. For the first time since September 2021, none of the Monetary Policy Committee (MPC) members voted to raise rates and the minutes suggested a rate cut was consistent with current guidance. In addition, the Governor of the Bank of England stated in an interview after the meeting that the MPC doesn't need annual growth in wages and services CPI to fall sharply before a rate cut, but simply confidence that it's heading in the right direction.

The latest inflation data indicates that it is moving in the right direction for a rate cut, falling to 3.2% in March. The decline has been relatively widespread across most of the major categories and core inflation has also reduced from 5.1% in December to 4.2% in March. This was primarily driven by core goods inflation, but core services inflation also softened from 6.4% to 6.0%. Most of the decline occurred in February, with a more modest decline in March, raising the risk that recent falls in inflation may start to stall. However, a further decline is anticipated in April despite the latest risk to oil prices, due to the falls in producer price inflation and the Ofgem energy price cap in April.

Labour market data also appears to be becoming more supportive of a rate cut. Employment fell sharply in February, pushing the unemployment rate up to 4.2%. However, labour market data remains relatively volatile, and it may be wise not to rely too heavily on one month's data. Furthermore, while wage growth is easing, the decline is modest and overall growth remains strong with private sector earnings excluding bonuses standing at 6.0% in February. Nevertheless, wage growth is anticipated to slow further, with leading indicators such as the REC UK Report on Jobs pointing to lower demand consistent with

Inflation and wage growth is easing



Sources: Macrobond, Swiss Life Asset Managers. Last data point: 02/2024

slowing wage growth. Considering comments from the MPC and inflation and labour market data, we believe there is scope for interest rate cuts from June 2024 and have pencilled in five cuts by year-end. This is expected to enable gilt yields to fall from their current levels into the mid-3.0%'s. That said, uncertainty is high and the pathway for interest rates will ultimately be determined by inflation, where there are both upside and downside risks.

Our expectations for the UK economy in 2024 are relatively muted. While our forecasts are anticipating growth in all four quarters, the economy is forecast to expand just 0.1%. Conditions remain challenging for UK businesses manifesting in a high number of insolvencies and while consumer confidence is returning, the rollover of fixed-rate mortgages onto higher rates is likely to drag on consumer spending growth. The net giveaway of £13.9bn in the March budget provides potential upside to growth expectations this year but fiscal policy is still being tightened and will probably require new tax hikes after the election.

The election is one of the geopolitical events that will influence the medium-term outlook. While the impact of the UK election on the economic outlook is likely to be relatively modest, other geopolitical risks are more material. This includes an escalation of the conflict in the Middle East and Eastern Europe. These risks, and others, will be influenced by the outcome of the US election and resulting foreign and trade policy. Close monitoring of global events and policies will be required.

Property market update

Stabilising property returns

Investment market: Slow start into 2024

Investment activity started off slowly in the new year. Over the first quarter, total volumes declined to £7.6bn, marking a 25% decline from Q4 2023, and down 53% on the long-term average for the same period. However, despite volume data suggesting activity has continued to weaken into 2024, the count of properties traded over this period is aligned with the quarterly average for the previous six. This indicates the decline in transaction volumes is more a function of capital value declines, as opposed to a further weakening in liquidity. Although activity has been moderate into 2024, investor sentiment and therefore transaction volumes are expected to pick up somewhat this year given the improving economic landscape.

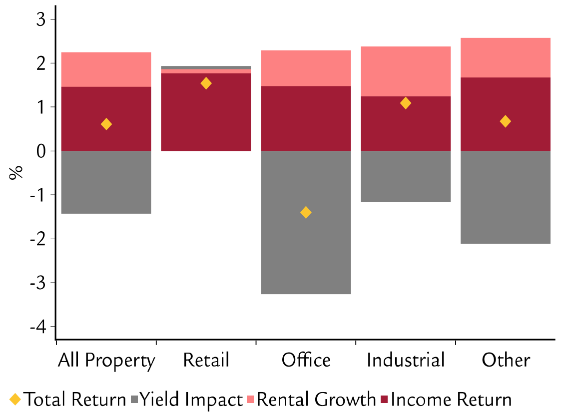
All-property: Returns turn positive

Over the first quarter, the MSCI All-Property Monthly Index returned 0.6%, marking the first reading since August last year where the three-month total return was positive. Once again, the all-property segment was held back by weak performance from the office sector which continues to suffer from weak investor demand. Consequently, offices were the only sector to achieve negative returns over Q1 driven by -2.8% decline in capital values; MSCI equivalent yields moved outwards 20 basis points while rents grew 0.8%. As we move further into 2024, all-property total returns are expected to remain positive as property valuations stabilise. However, increasing corporate insolvencies are posing a downside risk to rental growth, and with liquidity risk premiums already historically low, capital growth performance is unlikely to come from yield compression. Strategies targeting higher income returns should therefore be in focus.

Offices: Risky business

Offices were the weakest performing amongst the property sectors, returning -1.4% over the first quarter. Despite being the only sector to record negative returns driven by persistent capital value declines, the slowdown has shown signs of moderating in Q1: Over the three-months to March, capital values declined 2.8% compared to 5.5% during the three months to December 2023. Sentiment for the sector remains marred by impacts from working from home as the resulting shift in spatial requirements feeds slowly into tangible occupier demand. Consequently, demand is concentrated in the UK's largest most connected and vibrant markets, while smaller peripheral markets suffer; this is evidenced by robust take-up for Grade A in the 'Big-Six' markets.

Improving picture for quarterly property returns



MSCI Monthly Property Index (March 2024), Macrobond, Swiss Life Asset Managers UK

Occupier led performance for industrials

The industrial sector returned 1.1% over Q1, supported by capital values declining 0.2%, the least negative performance of all sectors, while income returned 1.2%. Analysing monthly data suggest valuations may soon return to growth, as values declined -0.1% in January, and were flat during February and March, edging closer towards positive territory. Capital values have been broadly stable as negative yield impact has been counteracted by 1.1% rental growth. In fact, the occupier market is performing relatively well despite the news that corporate insolvencies have risen to their highest level since the Global Financial Crisis: A recent occupier survey showed 93% respondents expect to take the same or more space in 2024. The report also cited access to power as one of the highest priorities amongst occupiers given the shift towards electrification and should therefore be a consideration during stock selection.

Retail: Positive sentiment for warehousing

The retail sector outperformed all other property sectors over Q1, returning 1.5%. Total returns have been supported by strong income returns of 1.8% while capital values declined 0.2% over the period. Retail warehousing continues to support overall performance, the only segment to record positive capital value growth over the period (0.3%), driven by modest rental growth of 0.4% and 4 basis points of inward movement of MSCI equivalent yields. Sentiment for retail warehousing is positive given favourable structural tailwinds, particularly for food-anchored schemes as demand for this type of product will remain inelastic irrespective of disruptive events. The outlook for retail will be supported by falling inflation, although pressures on household incomes have not yet fully abated.