THE BRIEFING

THREE STEPS FORWARD, TWO STEPS BACK

05 MARCH 2025

JON'S BRIEFING

WHILE THE ECONOMIC BACKDROP DETERIORATES THE MARKET SEEMS FINALLY TO BE SHOWING SOME CONCRETE SIGNS OF RECOVERY. AND DESPITE THE POOR FIGURES AND THE ECONOMIC UNCERTAINTY, THINGS ARE LOOKING SLIGHTLY BETTER THAN THE HEADLINES SUGGEST

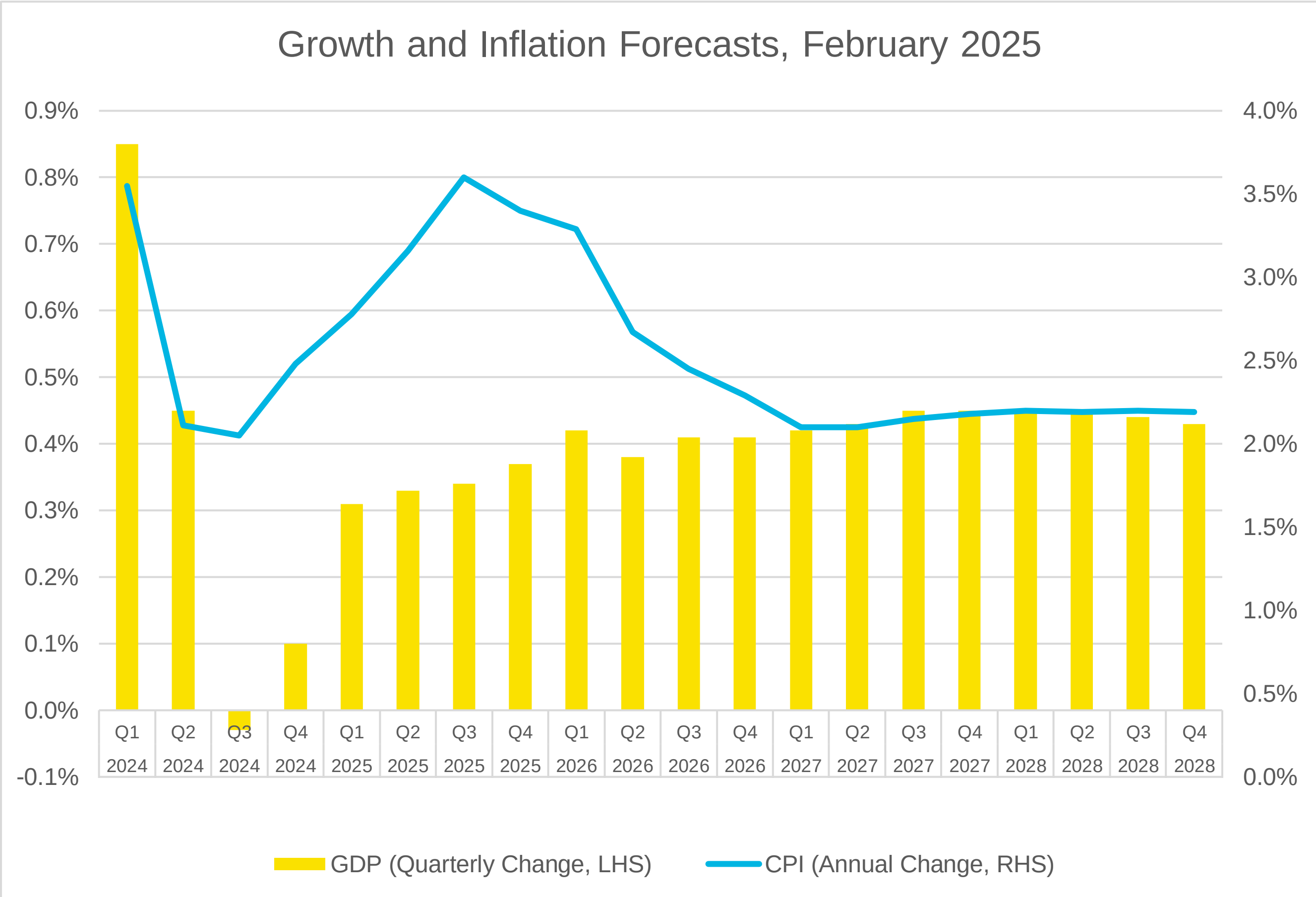
QUICK SUMMARY

- GDP is flatlining but there are signs it might improve in Q1
- Inflation is ticking up, but not enough to derail rate cuts – although current events are unsettling bond markets, which could filter through to property over time
- There has been a minor recovery in investment, although offices are still lagging
- This Is despite office leasing in London and other major cities being robust
- Retail warehousing and industrial remain top of the charts for returns – despite weak leasing figures for the latter
- While house prices continue to tick up, there are vague signs of increasing interest in development – but rental increases are now longer stratospheric

ECONOMIC BACKDROP.

The economic mood music has certainly changed since the middle of last year. GDP was completely flat in Q3 (i.e. growth of 0.0%) and scraped 0.1% in Q4. Manufacturing, which saw a 0.9% fall, erased more healthy figures for services (+0.2%) and construction (+0.5%). This latter figure is the highest for over a year and is perhaps an early indication of a revival in development – although it is unwise to take too much from one quarter.

However, tepid readings from some of the leading indicators, such as the PMIs, imply continued weak growth; Oxford Economics is now forecasting 1.0% growth in 2025 and 1.5% growth in 2026, down from 17% and 1.8% just a few months ago in September. However, the PMIs are showing some real divergence between services – which was still in slightly expansionary territory in February at 51.1, compared to January's 50.8 – and manufacturing, at 46.9, down from 48.3. Higher input costs and lower global demand appear to be the main issues for the industrial sector.



Source: Oxford Economics

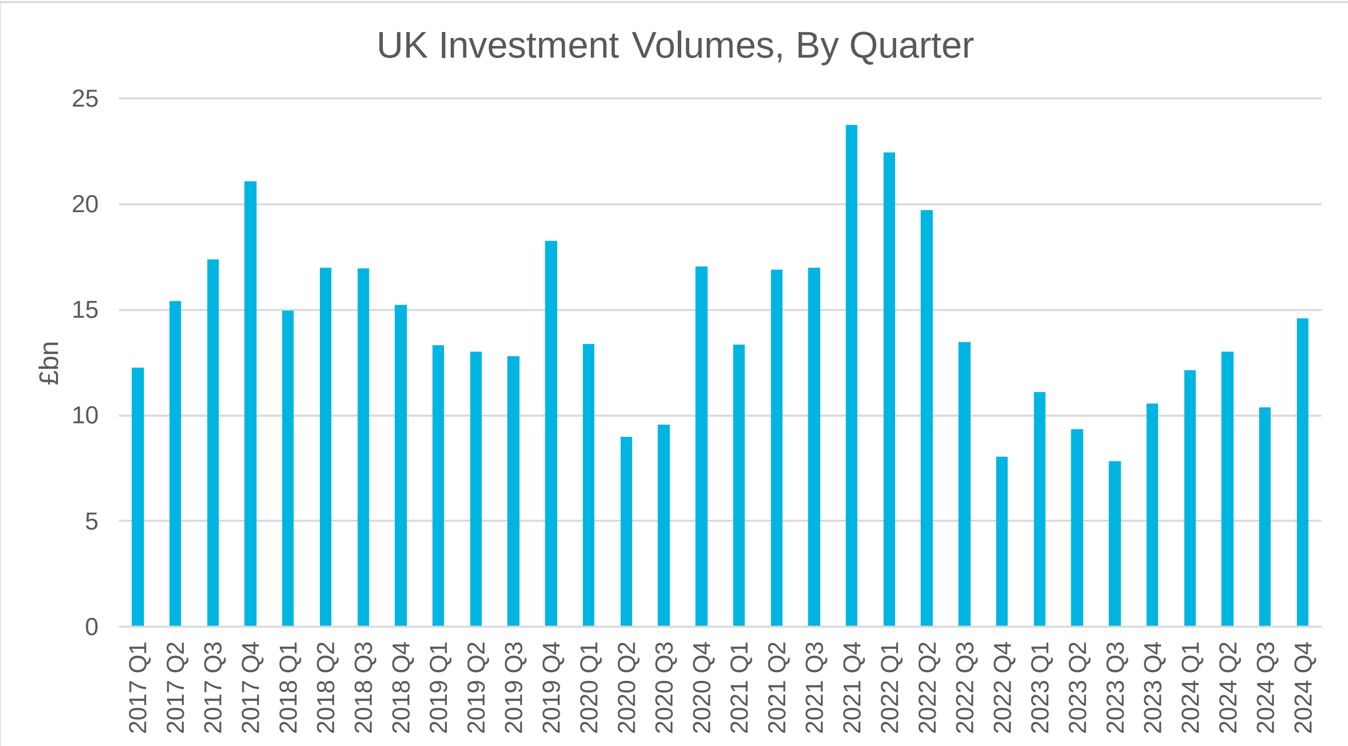
While there are concrete reasons for the slowdown, part of the picture is falling business confidence, which stood as high at +14.4 at mid-year, and now at just +0.2, is the lowest since 2022. The ICAEW (Chartered Accountants' Institute), which publishes this, partly blames weakening demand but also attributes it to a combination of the NIC increases announced during the budget and the increases in the national minimum wage. Having said all that, Oxford Economics argues that the PMIs and confidence surveys have not been good predictors of GDP growth recently. They point to the improved outturn for GDP in December (0.4%) and the strong increase in retail sales in the same month (1.7%) and argue that growth will accelerate over the next few months.

Meanwhile, inflation – as measured by the CPI – stood at 3% over the year to January, up from 2.5% in December. While economists do expect this measure to fall back slightly in February as a result of base effects, the rise in the energy price gap will mean that it will remain above 3% for much of the rest of the year. However, there are some signs that underlying services inflation and private sector wage growth are weakening, which could give the Monetary Policy Committee space to accelerate the rate-cutting cycle. At present, the expectation is that there will be three further cuts to the base rate over 2025, meaning it will end the year at 3.5%.

10-year gilt yields rose by over a percentage point between September and January, partly a result of concerns over the impact of the budget on inflation, partly a result of a rise in bond yields globally as markets anticipated higher inflation after the election of Donald Trump. Over the past month, however, they have fallen by around 50bps, reflecting both the poorer economic news and the implication that the BoE is now in a cutting cycle. 5-year SONIA swaps, the most important data point for lending against property, have followed a similar (albeit rather less pronounced) trajectory.

There are now several conflicting patterns to watch. Falling base rates, relatively tame inflation and weak economic growth should push bond yields down. But at the same time, there are risks around inflation and the supply of government debt is increasing – the public sector is going to borrow more given the evident political trend towards more military spending – typified by the recent relaxation of the German debt brake. This is pushing up yields once again at the time of writing.

INVESTMENT VOLUMES



Some £14.6bn of property changed hands across the UK in the fourth quarter. This was 40.7% higher than Q3 and 37.7% above Q4 2023. It is also the highest total since Q2 2022, two and half years previously. All sectors saw increases on both Q3 and the same quarter in 2024, with industrial and retail (the latter from a low base) leading the increase. Industrial volumes in 2024 overall amounted to £10.3bn, the highest since mid-2022; retail, at £8.4bn, the highest since Q3 2022.

Nevertheless, with the total for 2024 at £50.8bn, it remains one of the worst years in recent history, only outdone by 2023 (£38.8bn) and the pandemic year of 2020 (£49.0bn). But over recent months, sentiment does certainly seem to have improved from almost rock-bottom levels across investment markets. This is probably a combination of a greater certainty around rate falls and a greater confidence that markets have repriced properly. It remains to be seen, though, given the time lags involved in property, how much of this is related to the greater business confidence of mid-2024. Anecdotally, though, funds do appear to be gearing up for higher levels of activity.

It's worth comparing 2024 volumes to the 10-year averages for the various sectors, which highlight the relative popularity of individual segments – demonstrating that for the most part 'beds and sheds' still rule. Hotels are by far the most ahead of their long-term trend, explained by a one-off flurry of deals as well as genuine appetite for a part of the economy that was most hit by Covid and is still in recovery mode. The appetite for residential in no surprise; and retail continues to recover from a base that is structurally much lower than 15 or 20 years ago. Industrial is slightly down, but that reflects a high average skewed by the Covid boom.

Segment	2024 Total	10-year average	Difference
Offices	£9.69bn	£20.05bn	-51.7%
Industrial	£11.40bn	£11.76bn	-3.1%
Retail	£9.41bn	£9.29bn	+1.4%
Residential	£9.14bn	£8.51bn	+7.3%
Hotels	£6.53bn	£4.90bn	+33.3%
Other	£4.63bn	£5.95bn	-22.20%
Total	£50.80bn	£60.46bn	-16.0%

It is offices that is the real outlier – roughly half the typical level of activity. Indeed, if we exclude offices from the overall figures (which are 16% below the 10-year average), then the total is actually 1.7% *ahead* of the average annual volumes since 2015. The reasons for this are well-rehearsed: uncertainty over the return to the office – and what this means about future office demand; a concentration of the office stock in the most accessible locations; and environmental challenges – part of an increasing realisation that offices require a lot of attention if they are to stay relevant (these are all explored in our research piece from last year).

Is this reasonable, though, given the underlying fundamentals? Certainly, there is reason to be worried about some segments of the market – out of town or suburban locations without a strong story, or some second-tier cities. But Central London itself and some other big cities seem robust, albeit rather polarised (see below). Does this mean we are in for a recovery in London offices? Certainly, there has been a flurry of deals in Q1, with Green Street News reporting over a £1bn of transactions in January alone.

Stronger activity here could begin to change one of the side-effects of the office slump, the declining importance of London in the national figures. In 2024, London accounted for just 31% of national investment, compared to a 40% 10-year average and 47% for 2005-2014 period. This does not reflect a waning appetite for the capital; far from it. The problem is that, especially when rated by value, the office sector is (massively) disproportionately weighted to Central London. In contrast, "beds and sheds" are more evenly distributed around the country, even if values remain signifcnatly higher for all sectors in the capital.

Pricing across all sectors is remarkably stable at present, with yields as reported by most advisors barely changing over the past few months. The market is in a “holding pattern” – convinced that rates will decline, but not quite sure when. At various conferences recently 4% has been mentioned as the magic threshold; if nothing changes, that might well happen by the end of the year, although there are plenty of risks to that.

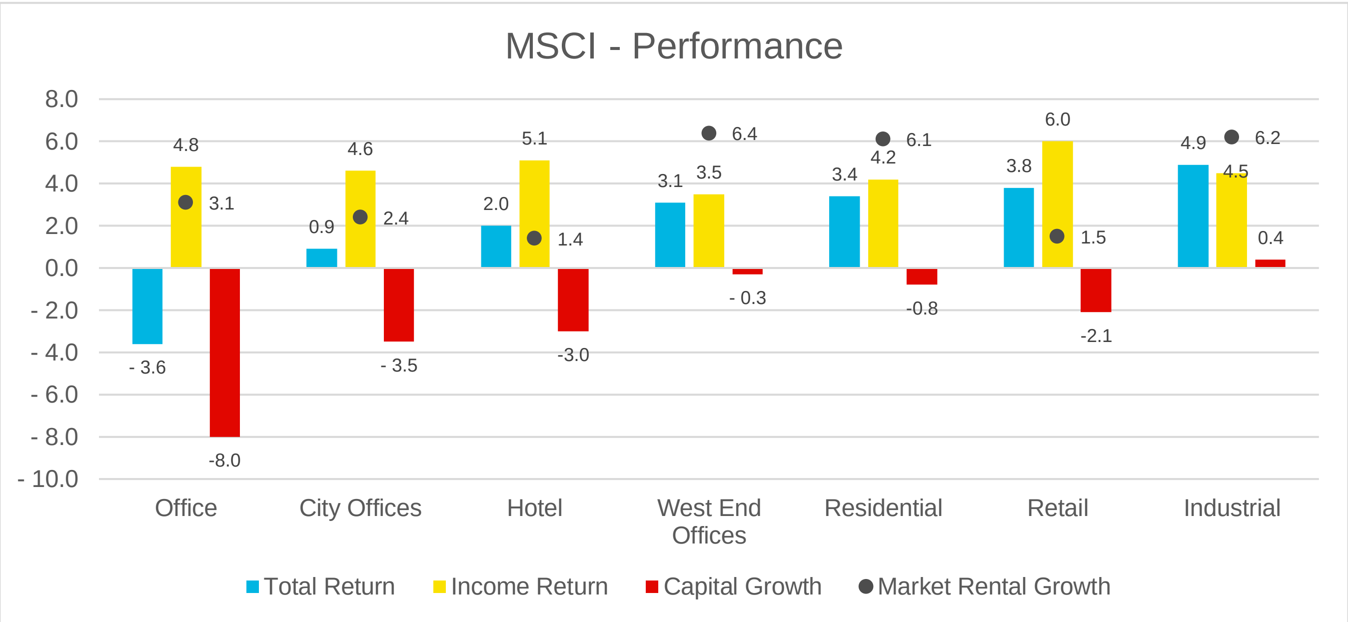
On the fundraising side, 2024 represented a low ebb for real estate, with PERE reporting just $1.13bn raised globally over the year. This is the third consecutive year of declines, representing a 50% fall from the peak. This does not look great for the short-term prospects, but anecdotally interest in real estate is beginning to rise (from a low base). If 2025 does indeed see this trend reverse, then it could auger a much-improved 2026.

RETURNS - MSCI

MSCI's UK Real Estate Index shows similar trends – in terms of the popularity of different sectors at least. Industrial tops total returns (4.9%), followed by retail (3.8%), residential (3.4%) and Hotels (2.0%). Offices is in distant last place and the only segment with negative total returns (-3.6%). It's worth noting that every sector apart from Industrial (+0.4%) is still seeing negative capital growth; retail's high return figure is because of the strength of income returns (6.0%); i.e. it has much higher yields because of the scale of recent capital value readjustments.

But capital growth is by far the worst for offices; over the past year the segment lost 8% of its value, compared to 3.0% for hotels, the next worse performer here. What is remarkable, though, is the difference in market rental growth. At 3.1%, it is higher than retail and hotels, suggesting that the fundamentals are relatively good. So why the sharp fall? Perhaps it is a reflection of the uncertainty and polarisation outlined above, but it's more likely due to the global negativity towards offices. This, in turn, is a reflection of the US experience, which for various reasons - higher structural vacancy, greater tendency to work from home - has been rather worse than on the side of the Atlantic.

Having said that, the performance of Central London offices has been somewhat better, with total returns of 0.9% in the City and 3.1% in the West End, driven by lower levels of capital losses. The market still looks a little sceptical, then, about these locations - but much less sceptical than the segment as a whole.

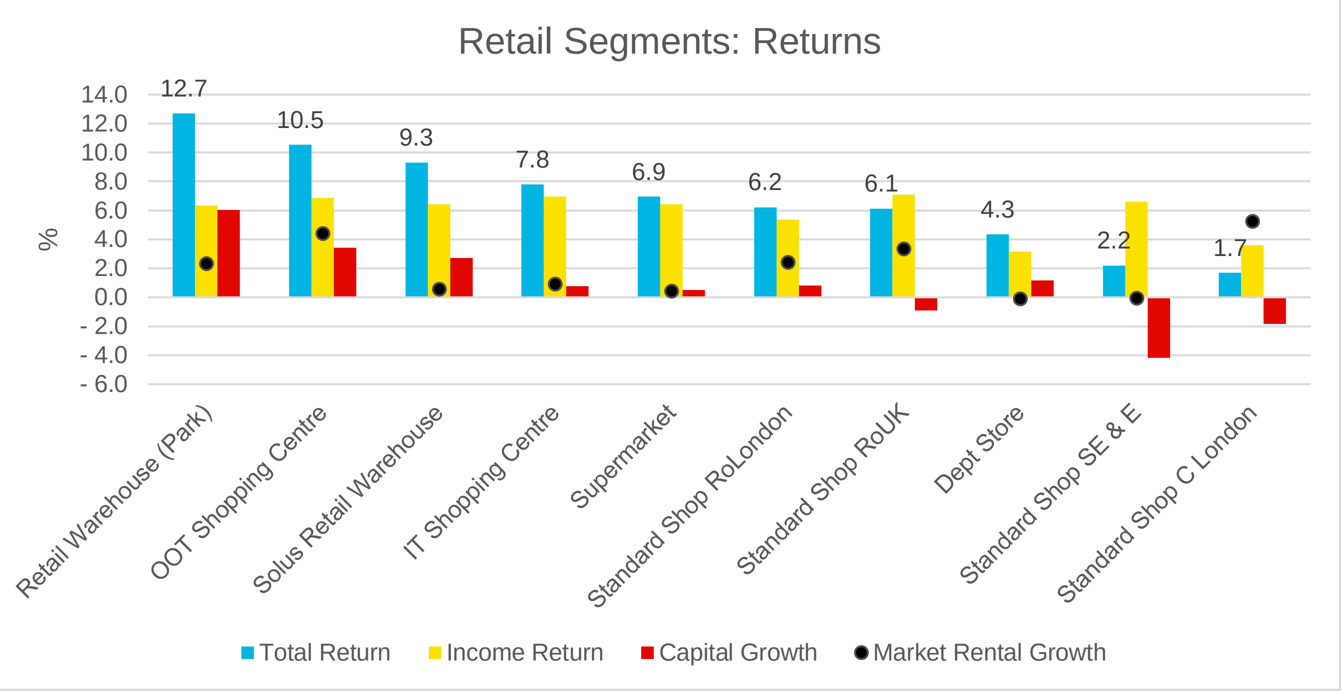


Source: MSCI

Given the stabilisation of values and the slightly improved outlook, the IPF's regular consensus forecasts show a marked improvement in returns in 2025 and beyond – even if the hierarchy hasn't' changed. These are shown in detail at the bottom of this document.

RETAIL

Given retail's recent renaissance, it's perhaps time to dig into some of the differences within the segments – it's a very varied sector.



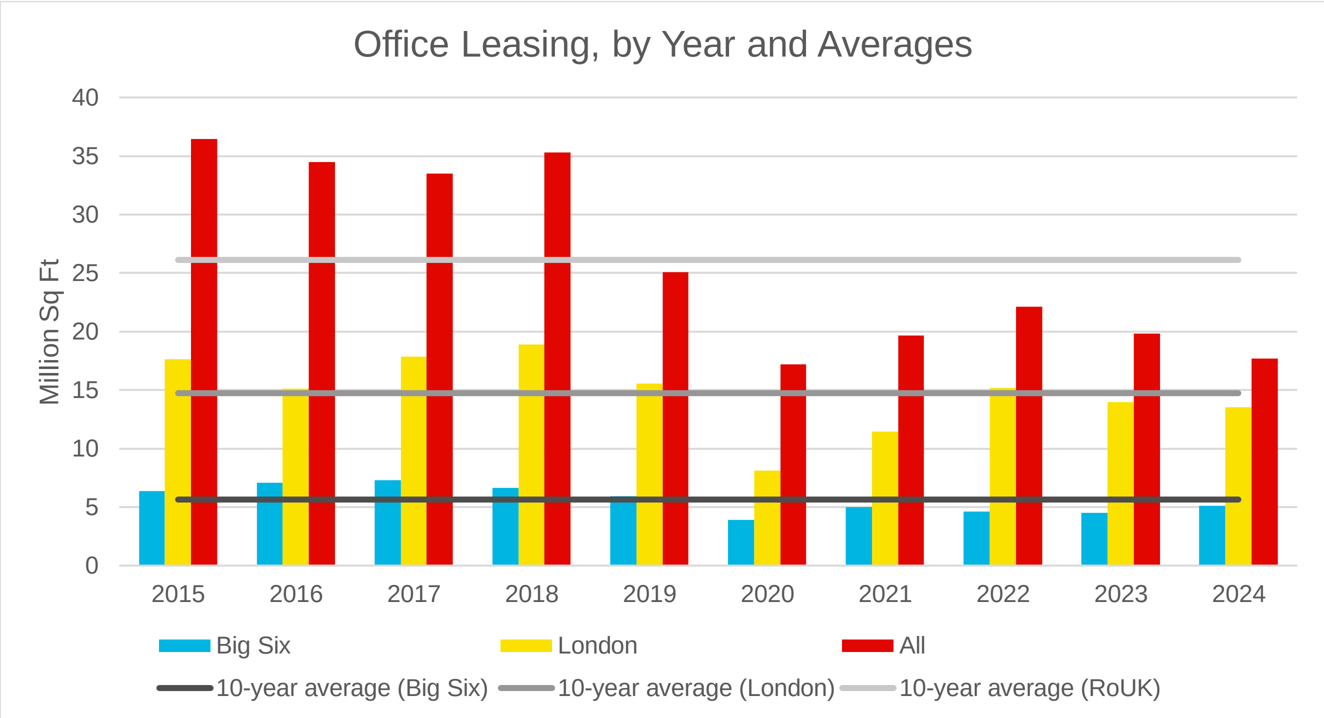
Source: MSCI

Retail Warehousing (in parks, that is) is still by far the strongest performer of almost any property segment, with a total return of 12.7% - much higher than industrial - off the back of strong capital growth and high-ish income returns. Out of Town Shopping Centres are not far behind, but here it is driven mostly by income returns (as a result of such strong value corrections over recent years). The strength of supermarkets and standard shops is also a story of income, as capital growth here is basically zero. The worst performers are standard shops in London and the South East - somewhat puzzling as the former has high income returns and the latter the strongest rental growth in the entire sector. Does that suggest that high street retail is next in line for a renaissance, particularly given what might be happening to retail sales?

LEASING MARKETS

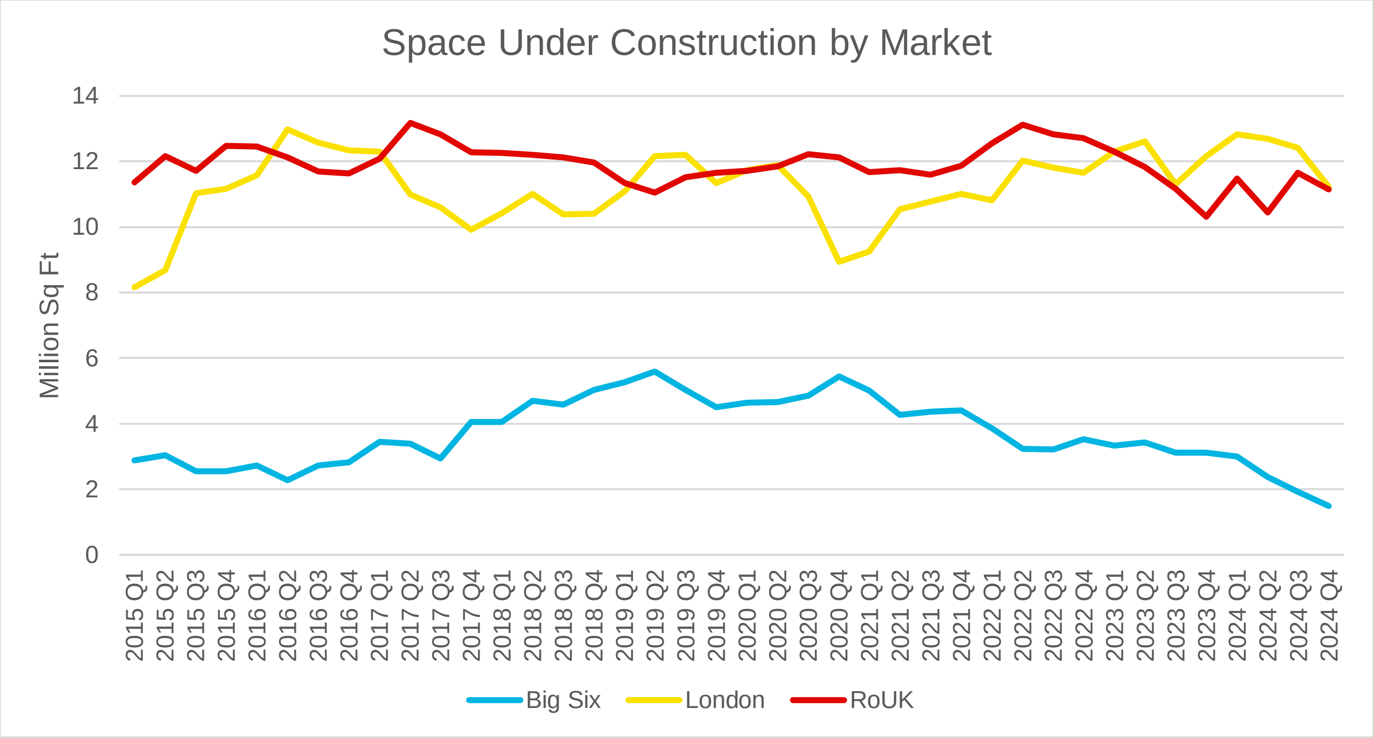
Going back to the office market, the geographical polarisation is backed up by the fundamentals in the various markets. The chart below shows office leasing in different locations – Central London, the Big 6 (Manchester, Birmingham, Glasgow, Edinburgh, Leeds and Bristol) and the rest of the country. For the major urban office markets, volumes were hit hard but have returned to close to their 10-year average.

For the rest of the country (the green bar), the story is different – it has not recovered and remains well below trend. Of course, there are individual markets within this that are doing well (Cambridge for example), but the trend is obvious. The office market is increasingly polarised and given that most investors concentrated on London (above all) and then the other major cities (to a much lesser extent), it can't be long before this story hits home and investment regains at least some proportional interest.



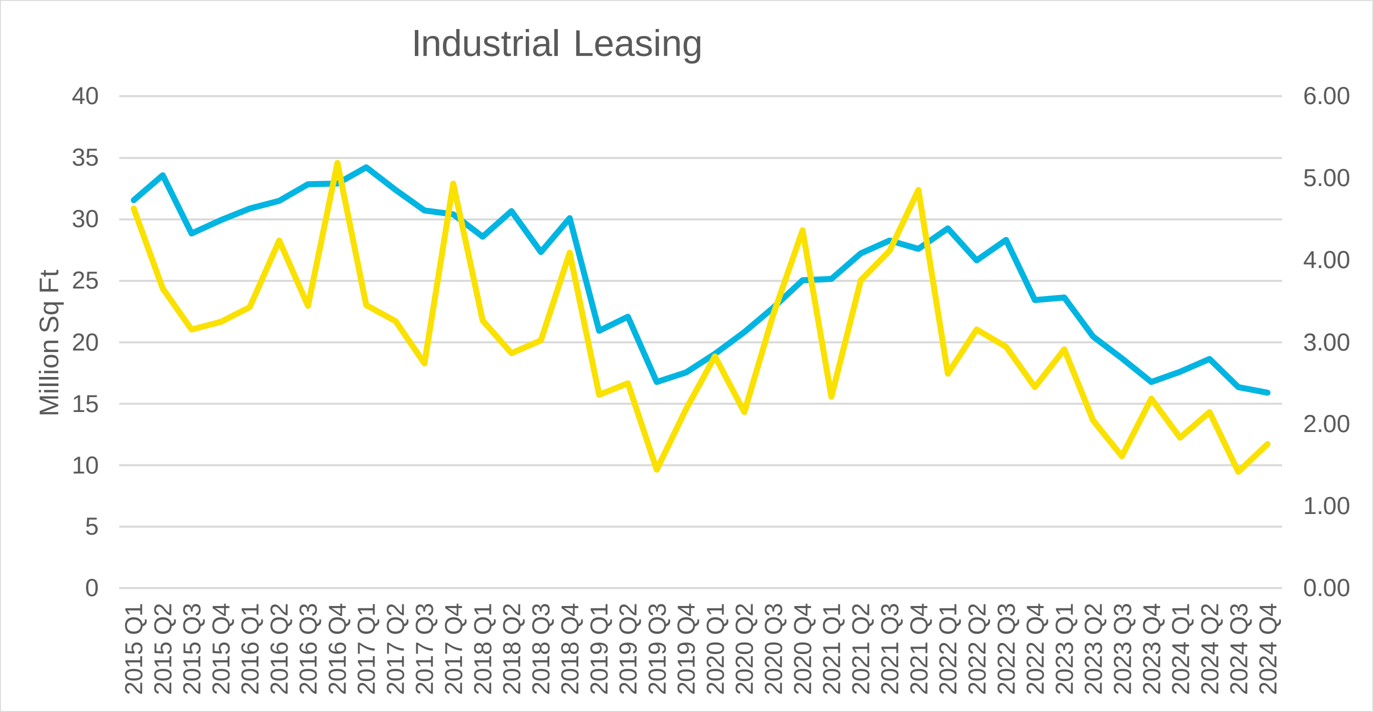
Source: CoStar

Now here's the weird thing. Leasing has obviously held up better in the big six than in the rest of the country. But look at what's happened to construction volumes – they've collapsed in the major cities but have held firm in London and the rest of the UK. Indeed, the space under construction in the 'big six' is the lowest it has been for over a decade. This would suggest that the regional cities are walking into a supply shortage and that there's going to be a real need for development. Of course, the problem is that with rents rather lower than in London, viability is more challenged by construction cost rises – but how to explain the relatively robust figure for the rest of the UK?



Source: CoStar

The buoyancy of the office leasing market (at least in certain locations) stands in contrast to the industrial segment. While this is still very much in demand among investors, leasing activity does seem to have slowed down substantially, as the graph below shows. However, there are all sorts of reasons – from greater inventories to the continued increase in online shopping – for believing that this is a cyclical pause not a structural downshift.



Source: CoStar

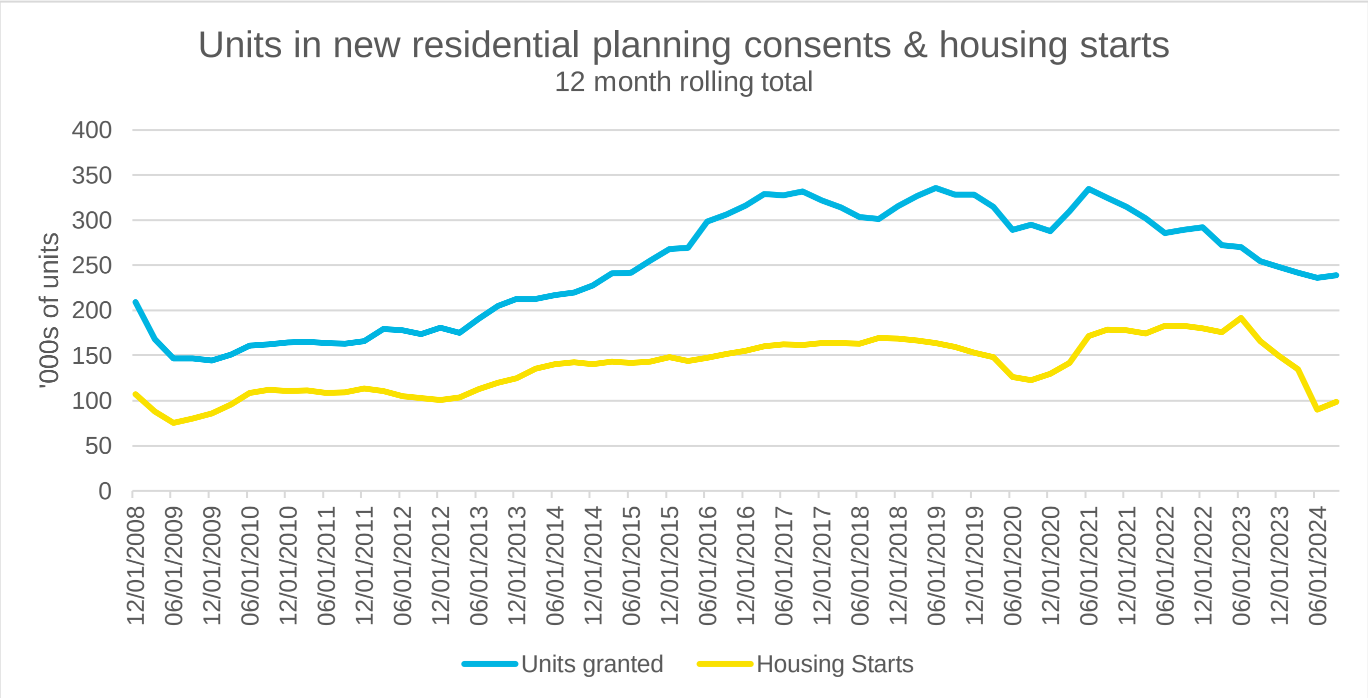
HOUSING

According to nationwide, prices rose again in November after falling slightly in January. The average, at £270,493, was some 3.9% ahead of February 2023. But this conceals some significant regional differences - price growth in all the Midland and Northern regions is above 4%, while in London and the South East it is below 3%. This reflects the greater affordability pressures higher rates have produced in the South.

The ups and downs of the bond market have had an impact on mortgages, though, with the average rate up a few basis points over the past few months. The average 2-year and 5-year fixed rate deal rates now stand at 4.6% and 4.2% respectively - only slightly lower than a year ago, although quite a bit below the 'bump' seen in the middle of the year. Perhaps unsurprisingly, mortgage approvals fell back slightly over the year.

Meanwhile, private rents - as measured by National Statistics - rose by 0.4% in January, the lowest figure since 2022. This is equivalent to an annual increase of 4.9%, more in line with the more modest figures in some other more timely indices. (London was even lower at 0.3%). Although it is only one month, it does confirm the general picture for rents - still rising, and ahead of inflation, but the era of 10%+ increases is over.

On the development side, there are signs that activity is increasing. Q3 was the third quarter in which housing starts rose, admittedly from a very low base. The number of units consented over the previous 12 months rose slightly in the third quarter, for the first time since 2022. On the other hand, the number of planning applications overall – both received, decided and granted – fell in Q3. Molior's measure of London housing units applied for did rise at the end of the year however, so it doesn't seem unreasonable that the Q4 figures (yet to be released) might show a reversal in the trend.



Source: National Statistics

OUTLOOK

In summary, while there are plenty of risks out there – not least the trade war that seems to be kicking off at the time of writing – the statistics do seem to imply an inflection point, or a potential inflection point, in many areas. It's easy to be gloomy given the geopolitics and the issues around the UK economy, and the probability that gilt yields will remain elevated has risen over the past few days and weeks, potentially keeping upward pressure on yields. But 2025 should be the year in which *selected* office and retail locations recover, and where development starts to happen again – at least in residential. This will no doubt come as a relief to a government focussed on providing new housing, even if that 3 million figure still looks like a stretch.

APPENDIX

ECONOMIC FORECASTS (OXFORD ECONOMICS)

Year	GDP Growth	CPI Inflation	House Prices	10-year gilt
2023	0.4%	7.3%	0.4%	4.0%
2024	0.9%	2.5%	1.3%	4.1%
2025	1.0%	3.2%	3.1%	4.5%
2026	1.5%	2.7%	1.3%	4.2%
2027	1.7%	2.1%	2.9%	3.7%
2028	1.8%	2.2%	4.3%	3.4%
2029	1.7%	2.1%	5.2%	3.4%

IPF CONSENSUS FORECASTS - COMMERCIAL PROPERTY RETURNS

	Rental Value Growth				Capital Value Growth				Total Returns			
Sector	2024	2025	2026	2024/28	2024	2025	2026	2024/28	2024	2025	2026	2024/28
Office	0.7	1.1	1.9	1.7	-2.6	2.0	2.5	1.2	2.5	7.2	7.6	6.3
Industrial	3.8	3.3	3.2	3.2	3.6	5.4	4.6	3.9	8.2	10.0	9.1	8.4
Standard Retail	0.6	1.1	1.4	1.2	-0.3	2.9	2.5	1.8	4.8	8.0	7.6	6.8
Shopping Centre	-0.5	0.2	0.9	0.6	-1.5	0.8	0.6	0.0	5.7	8.0	7.7	7.1
Retail Warehouse	0.9	1.5	1.7	1.5	0.3	3.2	2.4	1.8	6.7	9.6	8.7	8.1
West End Office	1.9	2.2	2.6	2.5	-0.4	4.1	4.1	2.8	3.8	8.5	8.4	7.0
City Office	0.5	0.9	2.0	1.7	-2.9	2.2	2.9	1.3	1.8	7.0	7.7	6.1
All Property	2.0	2.0	2.2	2.2	0.8	3.5	3.2	2.4	5.9	8.8	8.4	7.6

MONTAGU EVANS

70 ST MARY AXE

LONDON

EC3A 8BE

WWW.MONTAGU-EVANS.CO.UK