Recovery expected to pick up in 2025

Kevin McCauley
Head of Strategy & Property Research

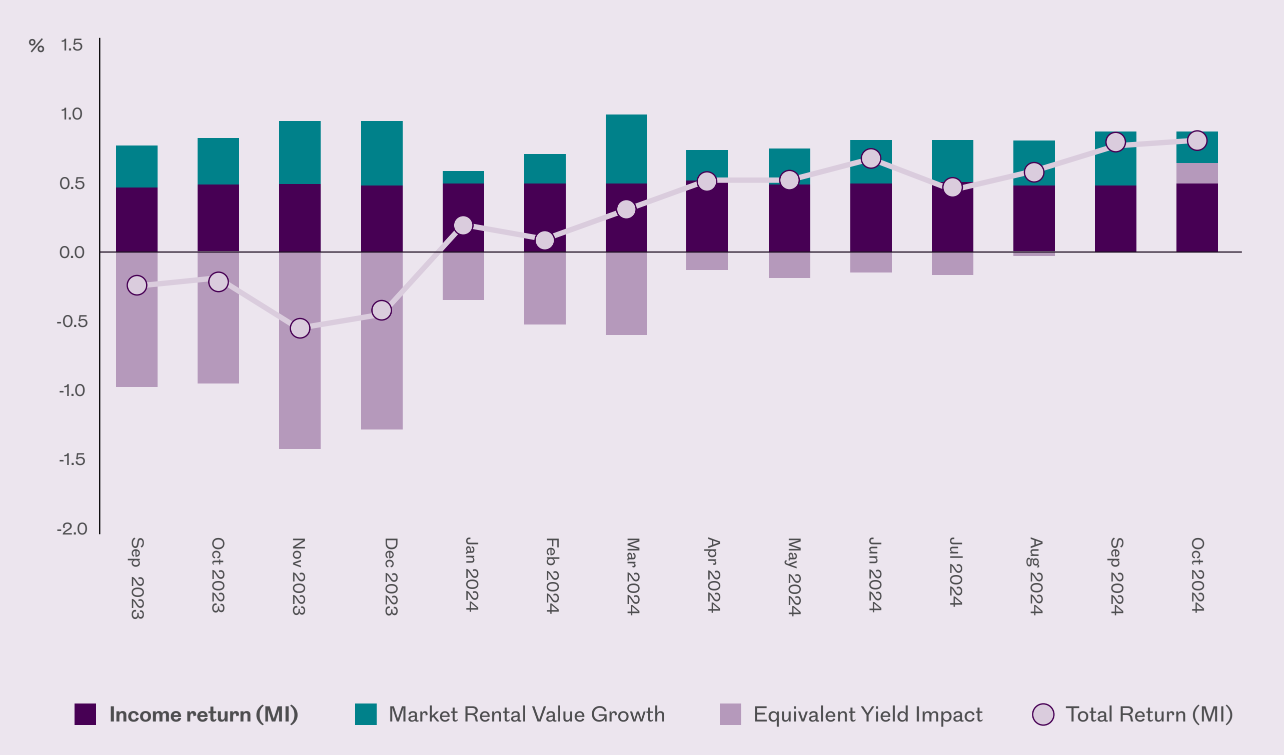
Property

At the start of 2024, we were expecting a recovery in real estate total returns driven by steady income returns, recovering capital values and continued rental growth, supported by a remarkably resilient occupational market.

Much of what we predicted materialised. According to the MSCI UK Monthly Property Index, capital values are marginally positive for the year to October, while they are 0.8% up from April. Total returns turned positive in January and have seen a 4.9% increase for the year to date. Retail with 7.9% total returns led the way, followed by industrial (6.5%) with office the laggard registering -1.0% total returns as capital values fell by 5.6%.

> "As a sector extremely sensitive to changes in the economic cycle, it has been surprising to see the occupational market so strong."

Components of total return (%) - All Sectors



Source: MSCI Monthly Index October 2024 . Past performance is not a reliable indicator of future results.

As we approach 2025, the prevailing consensus is that an economic recovery is underway. This recovery is being facilitated by central banks beginning to reduce interest rates, which has in turn bolstered investor sentiment in property. Consequently, investors are increasingly seeking opportunities to deploy capital in order to capitalise on this cyclical turning point.

Against this backdrop, the pace and strength of the recovery will depend on the speed at which the Bank of England cuts interest rates, the strength of the economic recovery, property market fundamentals, and the growing influence of net zero carbon on investor and occupier decision making.

> "The limited supply of new, high-quality space has driven significant rental growth."

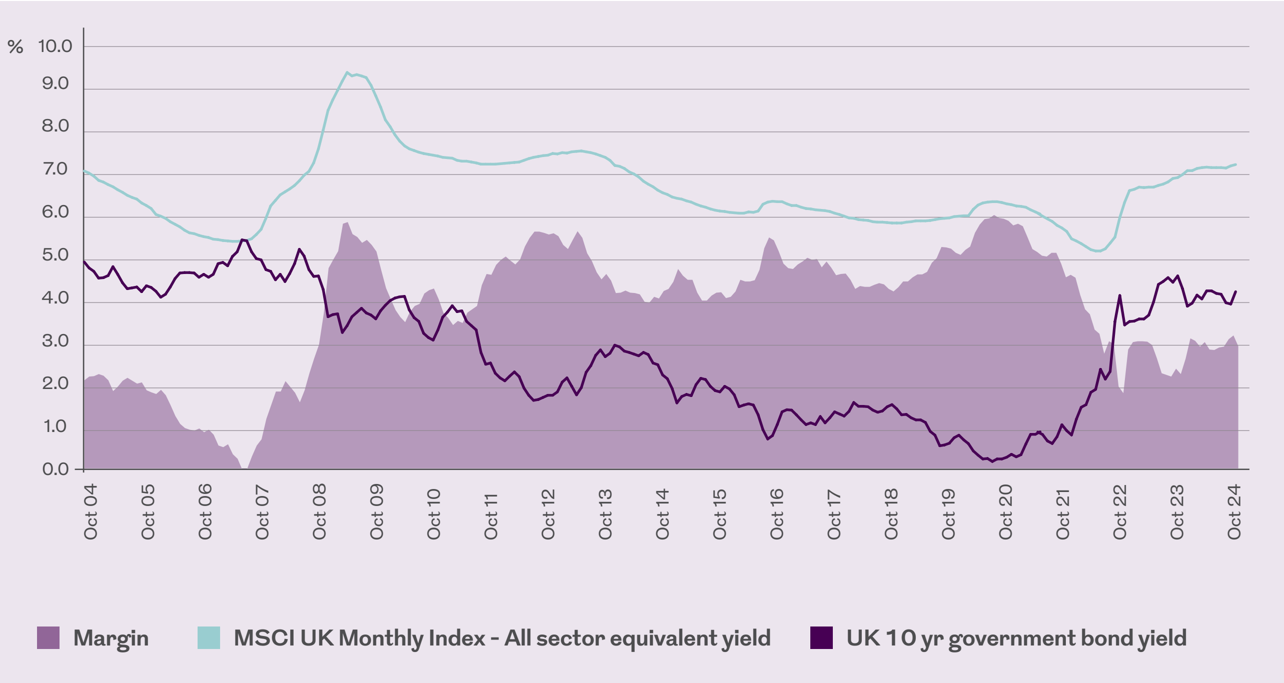
Interest rate tightening cycle has ended

August saw the first drop in borrowing costs for more than four years, with a further cut in November to 4.75%. However, the pathway to more cuts in 2025 has been complicated by an expansionary budget compared with previous plans, which financial markets have interpreted as potentially inflationary. With the gap between the risk-free rate and property yields relatively narrow, if gilt yields remain high, it could impact or slow the recovery in capital values.

Support offered by the improving economic backdrop

Property has had to contend with a relatively weak economic environment in the past two years with estimated growth of 0.3% and 1.0% in 2023 and 2024 respectively. As a sector extremely sensitive to changes in the economic cycle, it has been surprising to see the occupational market so strong, with many sectors seeing occupational demand close to long-term averages. Having rebounded in 2024, the UK economy is forecast to grow more robustly in 2025 with Oxford Economics latest forecast suggesting around 1.5%. We anticipate this will translate into stronger occupational demand and higher rental growth in 2025 and beyond.

The gap between property yields and the risk-free rate has narrowed



Source: MSCI Monthly Index October 2024 and Macrobond

Watch property market fundamentals

In a typical property market cycle, weak economic growth leads to reduced leasing activity. Due to the inherent delays in the development cycle, this situation results in an increase in supply as new space becomes available precisely when demand is at its weakest.

This has occurred to some degree this cycle. For instance, in the logistics sector, an increased number of speculative developments were completed as interest rates rose and leasing demand weakened, resulting in higher supply. Conversely, while supply has also risen in the office and retail sectors, the main contributing factor has been the return of second-hand space to the market.

The limited supply of new, high-quality space has driven significant rental growth. For instance, prime West End office rents have increased by 14.8% over the past two years and 47.6% over the past four years. High construction costs and elevated interest rates have curtailed speculative development, preventing the usual response to rising rents, namely development starts. We expect strong rental growth to continue until this situation changes.

Net zero carbon stays centre stage

In terms of investors and occupiers, we are seeing differentiated demand characteristics. They are now focusing on a building's lifecycle carbon footprint, including embedded carbon, energy and water efficiency, potential for on-site renewable energy, and end-of-life carbon impacts. This is notably challenging for the office sector, where retrofitting buildings for net zero carbon is being scrutinised for cost-effectiveness. As a result, there is increased obsolescence and a reduction in property values to account for this. Additionally, the demand for office space is declining outside the central business districts of major UK cities, which is accelerating the falls in capital value.

Implications for our strategy

In our view, the outlook for property in 2025 remains positive. Economic growth is expected to sustain occupational demand, which is having a strong end to 2024. Combined with a shortage of quality space, we think this will likely drive rents higher. A cutback in speculative development starts will ensure that there is not much additional supply of new space adding to the upward pressure on rents.

Investor demand and risk appetite have risen, boosting competition for assets and is starting to drive prices higher albeit slowly. We expect this trend to intensify in 2025. Following the general election, the UK is considered relatively more stable than other large European economies, which will appeal to investors. As a result, we expect international investors to renew their appetite for UK property.

We anticipate that all property total returns will average 7.0% annually over the next five years, driven by some yield compression and rental growth. Certain sectors are expected to outperform this average. Among these are the industrial and living sectors, which are supported by strong fundamentals, particularly a limited supply. This suggests a strategy to focus investment on build-to-rent, healthcare, and industrial sectors.

Following the challenges of the pandemic and the disruptions caused by ecommerce, the retail sector is anticipated to exhibit robust total return performance. As consumer confidence improves, low inflation and high earnings growth are expected to enhance spending power, subsequently boosting retailers' sales. Retail parks and shopping centres, particularly those of higher quality and with dominant catchment areas, are poised to benefit from this recovery.

The office sector outlook is mixed. We expect values to decline until late 2024, potentially into 2025, then stabilise. Central business districts in major UK cities are likely to perform best due to limited development and renewed investor interest. Outside major cities, we anticipate continued value declines and repurposing of office space for residential, hotels, and self-storage uses.

Important information

Investment risks

Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested. Changes in currency exchange rates may affect the value of these investments.

Important information

For professional clients/qualified investors only, not suitable for retail investors.
This is a marketing communication.

This is a financial promotion and is not investment advice. Telephone calls may be recorded.
For further information please see our Privacy policy at **www.rlam.com**

The views expressed are those of Royal London Asset Management at the date of publication unless otherwise indicated, which are subject to change, and is not investment advice.

Bloomberg® is a trademark and service mark of Bloomberg Finance L.P. (collectively with its affiliates, “Bloomberg”). Barclays® is a trademark and service mark of Barclays Bank Plc (collectively with its affiliates, “Barclays”), used under license. Bloomberg or Bloomberg’s licensors, including Barclays, own all proprietary rights in the Bloomberg Barclays Indices. Neither Bloomberg nor Barclays approve or endorse this material or guarantees the accuracy or completeness of any information herein, or makes any warranty, express or implied, as to the results to be obtained therefrom and, to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith.

This document is private and confidential and only for use by “permitted clients” in Canada. This document is for information purposes only and is not intended as an offer or solicitation to invest. This document does not constitute investment advice and should not be relied upon as such. Royal London Asset Management Limited is authorized to provide investment services in Canada under the International Adviser Exemption. Royal London Asset Management’s principal place for business is in the United Kingdom, and it is not registered as a manager in the provinces of Alberta, British Columbia, Ontario, and Québec.

Issued in December 2024 within Europe (ex-Switzerland) by FundRock Distribution S.A. (“FRD”) the EU distributor for Royal London Asset Management Limited. FRD is a public limited company, incorporated under the laws of the Grand Duchy of Luxembourg, registered office at Airport Center Luxembourg, Level 2, 5 Heienhaff, L-1736 Senningerberg, Luxembourg, and registered with the Luxembourg trade and companies register under number B253257. FRD is authorized as distributor of shares/units of UCIs without making or accepting payments (within the meaning of Article 24-7 of the 1993 Law), as updated from time to time. FRD is authorised and regulated by the Commission de Surveillance du Secteur Financier (CSSF). Portfolio management activities and services are undertaken by Royal London Asset Management Limited, 80 Fenchurch Street, London, EC3M 4BY, UK. Authorised and regulated by the Financial Conduct Authority in the UK, firm reference number 141665. A subsidiary of The Royal London Mutual Insurance Society Limited.

For Switzerland: Copies of the Memorandum and Articles of Association,the Prospectus, KIIDs and the annual and semi-annual reports of the fund may be obtained free of charge from the fund’s representative in Switzerland, ACOLIN Fund Services AG, Leutschenbachstrasse 50, CH-8050 Zurich. The Paying Agent in Switzerland is Banque Cantonale Vaudoise, Place StFrançois 14, CH-1003 Lausanne.

Issued in December 2024 within Switzerland and the UK by Royal London Asset Management Limited, 80 Fenchurch Street, London, EC3M 4BY. Authorised and regulated by the Financial Conduct Authority, firm reference number 141665. A subsidiary of The Royal London Mutual Insurance Society Limited.

Contact us

For more information about our range of products and services, please contact us.

Royal London Asset Management has partnered with FundRock Distribution S.A, who will distribute its products and services in the EEA. This follows the United Kingdom's withdrawal from the European Union and ending of the subsequent transition period, as UK Financial Services firms, including Royal London Asset Management, can no longer passport their business into the EEA.

Royal London Asset Management
80 Fenchurch Street
London EC3M 4BY

For advisers and wealth managers
bdsupport@rlam.co.uk
+44 (0)20 3272 5950

For institutional client queries
institutional@rlam.co.uk
+44 (0)20 7506 6500

For any queries or questions coming from EEA potential investors, please contact:
Arnaud Gérard, FundRock Distribution S.A. Airport Center Luxembourg, Level 2, 5 Heienhaff, L-1736 Senningerberg, Luxembourg +352 691 992088 arnuad.gerard@fundrock.com

For further information, please visit **www.rlam.com**

We are happy to provide this document in Braille, large print and audio.