

FAIRWAY

C A P I T A L



Prime Central London
Residential

MARKET COMMENTARY

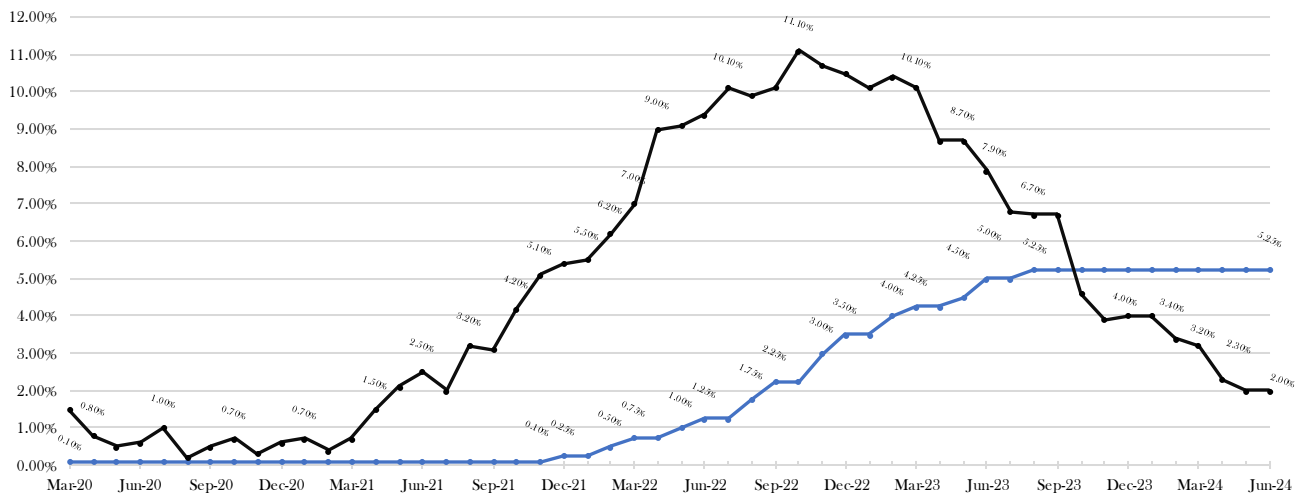
30th June 2024

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THE GLOBAL ECONOMY: The global economic outlook predicts steady GDP growth of 3.2% in 2024 as the global recovery tries to take hold (*IMF, The World Economic Outlook Update, Jul-24*). While the impacts of a prolonged period of monetary tightening take affect and inflation continues to decline across major economies, it does so against a backdrop of political uncertainty with 70+ global elections scheduled this year. As we move past the half year mark, we've already seen several key states cement their political futures, including Russia, India, Mexico and the U.K. (in July). The outlook continues to differ across countries, with weaker growth in many advanced economies, especially in Europe, and strong growth in many emerging market economies such as China and India. India is catching up on China's spot as the largest emerging market as share prices soar and earnings growth by Indian companies have pushed India to represent just under 20% of the MSCI emerging markets Index, behind Taiwan and China at 25% (*FT, Jul-24*). Overall, risks to the outlook remain balanced, but some near-term risks have gained prominence, such as a lack of progress on services disinflation and price pressures emanating from renewed trade and geopolitical tensions. The world will also be keeping a close eye on the US Elections in November, and although Harris has closed the gap, Trump remains ahead in opinion polls).

THE UK ECONOMY: The new Labour government has taken the reins on the UK economy, with the worst of the 'cost of living crisis' now behind us. Keir Starmer and his Cabinet's number one priority is to kickstart economic growth and have set an ambitious target to achieve the highest sustained growth in the G7 over the next decade. PWC are expecting 1% GDP expansion this year but according to projections, on its current trajectory the UK will likely fall short of its 10-year target, being the third fastest-growing economy behind the US and Canada. However, there are signs economic activity is gaining momentum as UK business activity expanded at a faster rate than its G7 peers in Q1 and London is poised to be the fastest growing region in 2024 (*PWC UK Economic Outlook, Jul-24*). Whilst election uncertainty has been removed, it likely won't be until we move past the autumn budget that we see the policy clarity needed for consumer confidence to return and household spending hesitancy to wane.

Figure. 1 Bank of England base Rate vs CPI Inflation (Mar-20 -Mar-24)



Sources: ons.gov.uk, (Jul-24), bankofengland.co.uk (Jul-24)

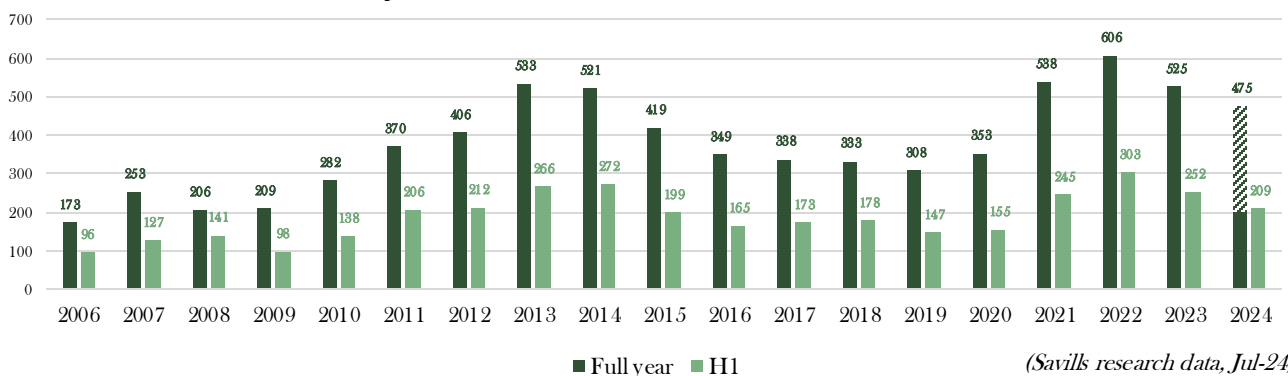
INFLATION: Inflation fell to the target 2% in May of Q2 for the first time in 3 years. This time last year, UK inflation was at 7.9% and appeared to lag against its global peers with the US at 3.0% and 5.5% in the Eurozone. The divergence has now narrowed as the impacts of the Bank of England's 13 consecutive rate hikes have come into effect with the U.S at 3.0% and Eurozone at 2.5% (*Trading Economics, Jul-24*). It's expected headline inflation will hover around 2% for the remainder of the year. While core goods inflation is at its lowest level since April 2022, and energy disinflation has done much of the heavy lifting in the return to target, services inflation remains elevated at 5.7%, driven by high wage growth. However, as the labour market cools off and labour cost inflation simmers towards the end of the year, services inflation is expected to fall back to target (*PWC UK Economic Outlook, Jul-24*).

INTEREST RATES: According to Capital Economics, by the middle next year, 20 of the world's 30 major central banks will be cutting interest rates (*Capital Economics, Jul-24*). The Swiss National Bank led the charge in March and followed with its second rate cut in June to 1.25%. Canada became the first G7 nation to cut rates in June reducing interest rates by 25bps to 4.75%. The ECB also cut rates for the first time in 5 years in Q2, lowering its record high rate by 25bps to 3.75% in June. Markets are pricing in a further 40bps of rate cuts across the year for the Eurozone (*Reuters.com, Jun-24*). The U.S Fed and the Bank of England have held off any rate cuts so far, but it is expected that September cuts may well be on the agenda for both. Financial markets have priced in around 100 basis points of cuts by the BoE over the next 12 months and by the end of 2027 expect rates to settle around 3.4%. According to PWC, the UK economy has felt around $\frac{3}{4}$ of the cumulative impact of the base rate rises and it will take 12-18 months before the effects of monetary loosening are reflected in GDP figures (*PWC UK Economic Outlook, Jul-24*). The Fund will be looking to capitalise on the extended window of opportunity to purchase unmodernised stock before competition invariably returns when the cost of borrowing decreases.

CURRENCY: FX markets across 2024 continue to be determined by disinflation fuelled rate cuts, suppressed but steady economic growth, and a changing global political landscape. The results of the general election provided little volatility in sterling, given markets had already priced in a Labour victory. However, the pound has since climbed against the dollar, rising to \$1.28 and is the strongest performing currency against the dollar this year, up 0.3% (*Yahoofinance.com, Jul-24*). At the beginning of July, the euro also slumped to its lowest level against the pound in nearly two years (€1.19) as traders compared the political stability in Britain to that of its neighbour France and the ECB cut rates for the first time. The comparative timing and the extent of rate cuts between major central banks will play a key role in driving FX moves this year as foreign investment is detracted from lower interest rate environments.

TRANSACTIONS: Sales have continued to remain elevated by historic standards, driven by core underlying demand for best-in-class product. Compared to the record-breaking year in 2022 where we saw 606 sales, volumes have dropped off slightly as some prime buyers adopted a wait-and-see approach in the run up to the election. However, transactions still remain higher than pre-pandemic levels. There were 209 sales in the first half of the year, which although is 17% less than last year, is still 42% higher than H1 in 2019. The £5-15m market remains the most liquid part of the market accounting for 86% of sales in H1. Above £30m, there were just 6 sales in H1, which is more likely a factor of the distinct lack of stock at this level than it is of buyer activity. Nonetheless, there have been some significant trophy home sales so far this year including an £82m house in Chelsea to a US buyer and a £72m house in Mayfair. The sale of these trophy homes at the top end of the market provides a strong indication of investors continued confidence in London (*Savills data, Jul-24*).

Figure 2: H1 sales > £5 million in London from 2006 - 2024



TAX CHANGES: Labour have already confirmed they will increase the SDLT for overseas buyers of UK property by 1%, but when compared on the global stage against the likes of Singapore (60%) and Hong Kong (30%), London still ranks competitively. The move to abolish the non-dom tax regime in April 2025 has provided some with a reason to pause on any immediate decisions, but the long-term impact of this on London's allure to wealthy overseas is likely to be trivial. Most prime central London buyers, and sellers, do not have non-dom status and demand from domestic and other international purchasers continues to be resilient, partly because of the value on offer in a historical context (PCL values remain 18.5% below its March 2014 peak). There are 68,800 registered non-doms in the country, only c. 37,000 of which currently claim the remittance basis tax status, representing a mere 0.05% of the population (*The Independent, Apr-24*). Uncertainty around what policy changes the new labour government may or may not introduce will ultimately not fully dissipate until their Autumn budget (now scheduled for 30th October) but this provides the Fund with an extended buying opportunity to take advantage of.

DEMAND: Fundamental imbalance of supply and demand across PCL continues to underpin the market, particularly for turn-key product, which is simply few and far between. Demand for flats are coming back strong and represented 53% of sales above £5m in the first half of the year, compared with 45% last year and only 28% in 2021 (*Savills data, Jul-24*). This gives a strong indication of the level of overseas demand as foreign buyers in search of a London pied a terre are typically more flat-focused in their criteria. On the flip side, domestic buyers who propped up the market during peak COVID (2021) were predominantly house buyers. However, the PCL market does remain price-sensitive as the autumn budget looms and decisions around key areas of government policy still require clarity. There remains a unique dislocation in the market with little competition for unmodernised stock as buyers are put off by construction risk and high borrowing costs, while premium stock in prime locations still trades at a premium. The highest proportion of sales above £5m took place in Belgravia, Mayfair, Kensington, and Chelsea accounting for 50% of total (*Savills, Prime London House Prices Q2-2024, Jul-24*).

SUPPLY: There remains a significant supply shortfall in PCL, and the development pipeline has contracted 70% over the last decade, meaning the delivery of new units to the golden postcodes remains constrained. According to Knight Frank, the pipeline of homes with a blended value of £3,000 per square foot and above either with planning, under construction or recently completed, has shrunk from some 3,350 units ten years ago down to 1,114 currently (*Knight Frank Residential Development Update, Jun-24*). Supply is only tightening and with new planning restrictions across Westminster restricting the supply of new homes above 200 sq m, buyers will be forced to the second-hand market in search of such assets, where best-in-class product commands a premium. In the first half of the year, 192 sales (92% of sales above £5m were in the second-hand market (*Savills data, Jul-24*). However, Knight Frank are reporting their planning team are seeing increasing opportunities emerging for office to residential conversion due to a slight relaxation in planning restrictions, so the Fund will be monitoring these opportunities closely.

PRICES: Annual price growth adjusted marginally in Q2 falling -0.4% and is -0.9% down over the past year, as political uncertainty hampered buyer decision making. With most of the uncertainty behind us now, PCL represents a good ‘buy’ opportunity for many as the main agents expect growth to remain flat for the remainder of the year as buyers digest the impacts on their tax positions following policy clarity from the new government. This buying window won't last long as significant recovery over the next 5 years is expected (see figure 3 below). JLL have earmarked PCL to be one of the best performing markets over the next 5 years as buyer confidence returns (*JLL, PCL Q2 2024, Jul-24*).

Figure. 3: Main agents 5-year PCL Residential Forecasts

Company	2023	2024	2025	2026	2027	2028	5-year Compounded
Savills	-0.80%	0.00%	3.50%	6.00%	4.00%	4.00%	18.66%
Knight Frank	-2.10%	-1.00%	3.00%	4.00%	4.50%	5.00%	16.36%
Strutt & Parker	-1.00%	2.50%	2.50%	2.50%	2.50%	2.50%	12.50%
JLL	-3.00%	0.00%	3.50%	5.00%	5.50%	4.50%	19.81%
Chestertons	-1.50%	1.80%	4.50%	3.00%			9.57%
Hamptons	-2.50%	1.50%	5.00%	7.50%			14.57%
AVERAGE	-1.82%	0.80%	3.67%	4.67%	4.13%	4.00%	18.44%

*Savills 'Prime Central London' - Forecasts (Jan-24), Knight Frank UK Housing market forecasts, PCL (May-24), S&P 'PCL Price Forecast' - Best Case (Spring-24), JLL Central London Residential Forecasts: 2024-28 (May-24), Chestertons Property Forecasts 2024 (Dec-23). *2026 Chestertons forecast from Dec-21 publication, Hamptons - Autumn Forecast 2023 - London (Nov-23).*

PRIME AGENTS:

Stuart Bailey, Head of Super Prime Sales, Knight Frank:

“The top end of the London market will be flat in terms of pricing during 2024. Though a 10 out of 10 property will still command a 10 out of 10 price (as confidence is not that far below the surface). For upward pressure on pricing in 2025, the clear election result needs to be coupled with a reduction in services inflation, swap rates, and interest rates, ideally later this summer.”

James Gow, Head of London Agency, Strutt & Parker:

“Proposals to scrap the non-dom tax regime and end the use of offshore trusts to avoid IHT may deter some buyers in the prime and super-markets, but they won't make a material difference. These markets remain highly desirable...London which retains its status as a global capital city will continue to attract buyers for its arts, history, culture, education as well as being a major centre for business, for decades to come.”

3. CONSTRUCTION COSTS

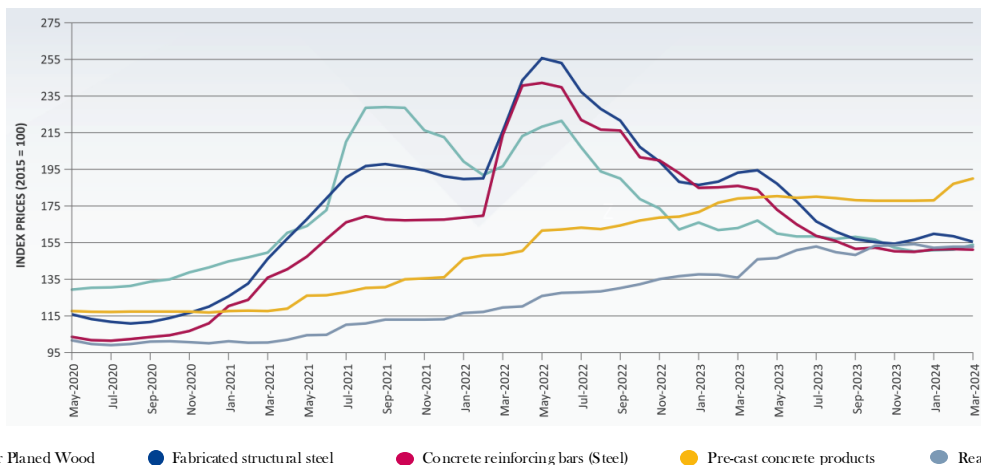
Tender prices in Q2 2024 rose by 0.3% compared to Q1, resulting in an annual growth of 2.1%. This represents a continued reduction in the rate of annual price inflation when compared to Q2 2023 (*Martin Arnold, Summer Newsletter, Jun-24*). This easing in tender prices comes as a result of several factors, including the stabilisation in supply chains and subsequent predictability of material availability, a cooling labour market, and improvements in market sentiment following clarity in the political landscape. While construction costs do remain elevated, inflation is stabilising, and contractor pricing has become more consistent compared to last year.

Across 2023, total construction activity (output) contracted -6.8% compared with 2022. A smaller contraction of -2.2% is now forecasted for 2024, followed by a recovery of 2.1% in 2025 and 3.6% in 2026 driven by expectations of an economic rebound and rate cuts, which have boosted demand. Some segments of the industry will fare better in 2024, such as commercial refurbishments, which will continue to grow and support workloads. However, much like last year, private residential new starts and repair and maintenance & improvement will remain subdued this year (-4% growth) as they remain the most exposed to higher cost pressures, higher borrowing costs, and the uncertain political landscape, which directly impact clients’ investment plans (*G&T, Market Update, Q2-24, Jun-24*).

In the aftermath of the pandemic and the outbreak of war in Ukraine, construction material prices climbed 19.8% in 2021 and 10.9% in 2022. However, material price inflation appears to be stabilising after the BEIS All-Work index receded by -2.2% in the year to March 2024, driven by falling wholesale energy prices, improvements in supply chains, and stagnating demand. Falling iron ore prices, have dragged steel prices lower with Rebar at £694/T in May, -3.1% lower than Feb-24 and down from £1,170/T at its peak in Jul-22 (*G&T, Market Update, Jun-24*). Imported timber has also seen significant declines in prices, although much like steel, were the most heavily inflated materials across 2021 and 2022 (see Figure 4). However, as disinflation slows there are signs that material price falls are now bottoming out. The effects of high energy costs have kept some materials, such as concrete and cement, high as commodity prices remain 38% above pre-pandemic levels. Heightened geopolitical tensions, particularly in the Middle East pose the biggest risk to commodity prices.

The labour market remains tight, but signs of softening are appearing as spare capacity in the market emerges. However, Brexit left a significant gap in labour supply for the construction industry with a projected shortfall of around 225,000 workers by 2027 (*The Telegraph, Jul-24*). 43% of contractors are reporting low or very low availability for project labour and office staff resources, with 71% expecting no change in availability over the next 12 months, according to Gardiner & Theobald’s Main Contractor Survey (Jul-24). In order to achieve its ambitious house building delivery targets it has set itself, Labour are going to have to throw free movement back into the equation if it is to resolve the structural labour shortages that currently exist.

Figure 4: BEIS Price Indices of Construction Materials (Mar-22 to Mar-24)



Source: Gardiner & Theobald, Q2-24 Market Intelligence, Jul-24.

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