RESEARCH

PROPONOMICS

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BREXIT MEANS REMAIN

The phase one UK/EU agreement contains suggestions that a soft Brexit may be ahead. If that is the case, more capital will target UK property in 2018.

Headlines

The phase one agreement on Brexit contains hints that the final deal could closely resemble the Single Market / Customs Union

Many of the darker predictions for the post-EU UK economy were based on a hard Brexit scenario

In 2017, market sentiment towards UK property has been more pessimistic than the statistics justify

If the news in 2018 continues to point towards a soft Brexit, we would expect more investors to look at UK property

JAMES ROBERTS
Chief Economist

"In the context of a UK property market where some had assumed a 'cliff edge' exit was a strong possibility, signs that a 'soft Brexit' might be the final outcome could have significant implications."

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Last week, the UK government and the EU reached an outline agreement on phase one of the Brexit talks that will allow negotiations to advance to phase two: the trade talks. The UK, based on the suggestions within last week's statement, could be moving towards a system of maintaining regulatory alignment to the European Single Market and the Customs Union after Brexit. In the context of a UK property market where some had assumed a 'cliff edge' exit was a strong possibility, signs that a 'soft Brexit' might be the final outcome could have significant implications.

As part of the agreement on the North-South Irish border, the UK has pledged that even if no trade deal is reached it will maintain "full alignment with the rules of the [EU's] Internal Market and the Customs Union". It has also promised "the same unfettered access for Northern Ireland's businesses to the whole of the United Kingdom internal market". This suggests that the UK and EU's preferred outcome for a future UK trade agreement, is one based on regulatory alignment.

The UK maintaining regulatory alignment with the Single Market and Customs Union would allow the EU to wave the need for border controls and continue to offer British firms free market access. However, as a face-saver for the Brexiteers, all this would be dressed up as a free trade agreement, not formal membership of either the Single Market or the Customs Union.

Given the signs of compromise, the likelihood of a 'hard Brexit' – where the UK leaves the Single Market and Customs Union, defaulting to WTO rules – has shrunken considerably, in our view. Indeed, David Davis, the UK Brexit negotiator said in a recent interview that the odds of such outcome had "dropped dramatically". The widely quoted Oliver Wyman forecast for 75,000 post-Brexit job losses for UK financial firms and their support industries assumes a default to WTO rules.

Brexit in name only

Accepting that nothing is certain until we see the final deal, there is a growing possibility that the UK is heading for a Brexit in name only. So what would be the consequences for the UK economy and real estate?

FIGURE 1
2017 recovery – USD to GBP

Source: Thomson Reuters

The Brexit process has inevitably dampened the UK economy in 2017 due to the sheer uncertainty it has created. Last week's agreement has reduced the likelihood of the worse case scenario, but not eliminated it entirely. This means that some of the geo-political risk hanging over the UK has dissipated, but there are still plenty of Brexit-related issues left to resolve. We have no idea what the regulatory alignment will look like, and whether businesses will view it as an effective replacement to being in the EU. Inevitably, defining alignment will be politically controversial in the UK.

Overall, the phase one Brexit deal will in the short-term have a positive but limited impact on the economy, and the commercial property market. It will help cast doubt on the worst case scenarios that have been weighing on sentiment, but there is not enough detail on the more important final deal to create a definitive turning point; at least for now.

However, both the economy and the real estate market could now see expectations on the long-term outlook begin to gradually improve if more evidence emerges confirming that a soft Brexit is probably going to be the final outcome.

Turning point ahead

At present in the property market, there is a huge gap between sentiment, which is very cautious, and the statistics, which in most property markets are steady, if not improving. After an 18 month bombardment of Brexit gloom and political uncertainty, statistics like unemployment at a 42 year low, or the City of London office market vacancy rate falling, barely make an impression.

However, if the view that we are heading for a soft Brexit is confirmed by the details of the trade talks during 2018, then the statistics could start to overshadow the gloom in investors' minds. Far from collapsing in 2017, office take-up in Central London is in line with long-term average levels, while supply fell by nearly 1 million sq ft in Q3 2017 on a quarter-on-quarter comparison. If the default to WTO rules that underpins the darker Brexit job loss figures does not happen, the case for investors re-entering the market will grow.

This presents the cautious investor with a dilemma. The Brexit uncertainty will only truly end when the final deal is agreed, but from an investment perspective, by then it will be too late. Those who pre-empt the starting pistol will have already bought the best assets by the time May and Juncker shake hands on the final agreement. An old saying in real estate is "the turning point is either six months away or six months ago", and the investment market may be approaching one of those unseen changes of direction.

This will also be true in the occupier market. If landlords become less concerned about Brexit, they will soon rein back the generous incentive packages on offer at present. While the pundits have fretted over financial sector demand for offices, the tech sector has been out taking space, which has reduced choice for tenants activating searches in 2018.

Both for investors and occupiers 2018 could be a year when delaying limits options.

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James Roberts
Chief Economist
+44 20 7861 1239
james.roberts@knightfrank.com

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