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Economy and Property Market Update

August 2022

Further deterioration in macro outlook clouds prospects for real estate

ECONOMICS

Summary

Interest rates are now being hiked aggressively with more to come to combat accelerating inflation. A likely resulting recession could see the economy shrink by more than two per cent according to the Bank of England. A shift in sentiment is begining to filter into real estate markets although pricing generally remains resilient for now despite the uplift in borrowing costs. Meanwhile, in the construction sector, the immediate challenge remains the availability and cost of both building materials and labour rather than a drop in demand. That said, growth in workloads could begin to slow towards the back end of the year if projections for economy prove accurate.

Economy

The signal from the Bank of England at its August meeting was unambiguous with the base rate being raised by 0.5% to 1.75%. The Monetary Policy Committee (MPC) also hinted that it was minded to begin gilt sales of £10bn per quarter from the end of September revving up the contribution of quantitative tightening to the policy shift. Ensuring that longer-term inflation expectations are anchored at the 2% target is now the clear focus of its actions. But it is also significant that the latest Monetary Policy Report, attached to the interest rate announcement, acknowledged that the 'risks around the MPC's projections... are exceptionally large at present' emphasising just how uncertain the outlook is.

Inflation, which currently stands at 9.4%, is set to climb towards the 13% area through the second half of the year (on the basis of the Bank's analysis) partly because of the uplift in the energy cap. Chart 1 tracks how the headline rate of CPI inflation has in the recent past been led by the behaviour of commodity prices (measured in sterling terms). The degree to which the inflation trend begins to reverse in 2023 and beyond will depend, at least to an extent, on how embedded the inflation psychology becomes in the wage bargaining process. The central projection is for inflation to begin to ease from the second quarter of next year but it is not until the second half of 2024 before it begins to close in on the target.

Against this backdrop, it is highly unlikely that the top of the interest rate cycle has been reached; indeed, the Bank's projections are built on at least a further one percentage point tightening in the monetary dial. However, as chart 2 demonstrates, the precipitous decline in the GfK consumer confidence indicator highlights the risks to the economy as households begin to rein in spending in the face of the cost of living crisis. Significantly, while 'the general economic situation' remains the key driver of this drop in consumer sentiment, the readings on 'personal financial situation' are also now deteriorating. Savings balances are already being rundown in response to these conditions but even with this buffer, a recession looks inevitable; the key question is how deep it proves to be. The Bank envisages there being a decline in GDP of around 2.2% and that it will be spread over the five quarters.

The fact that labour shortages are still pretty visible across the board as highlighted in chart 3 (with vacancy levels exceeding the one million mark) might seem a little incongruous with all the speculation around a recession but most forecasts do see the picture beginning to turn later in the year. Indeed, a gradual rise in the unemployment rate towards the 6% area is a key element in the Bank's thinking.

Chart 1: Raw materials and energy continue to drive consumer price inflation higher

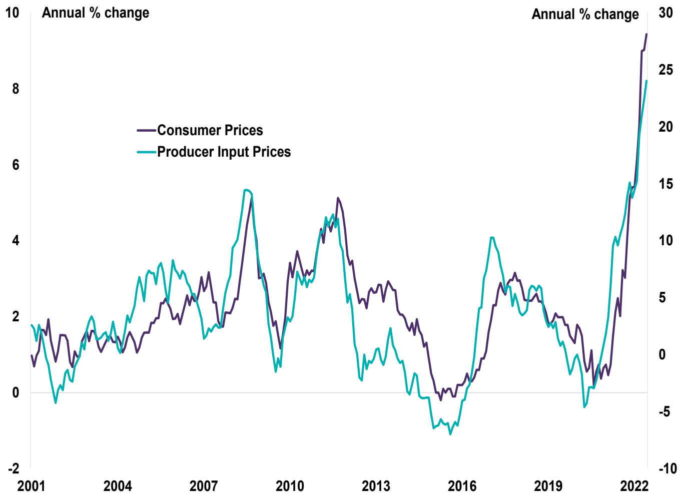


Chart 2: The collapse in consumer confidence highlights the very real challenge facing policymakers

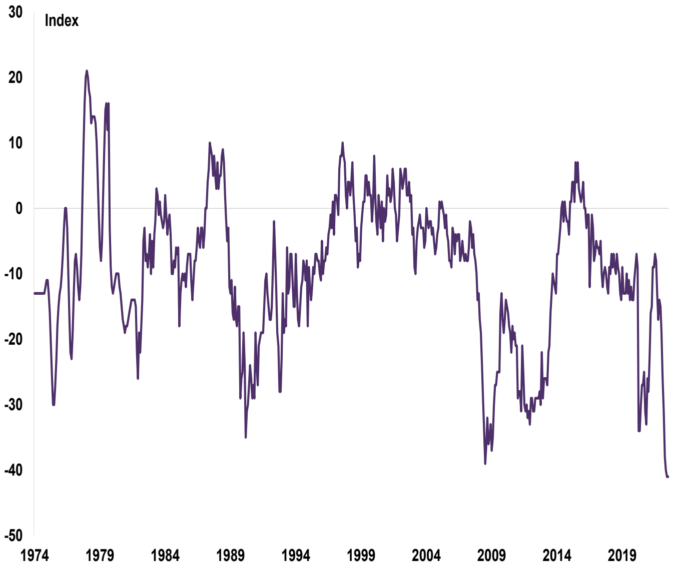
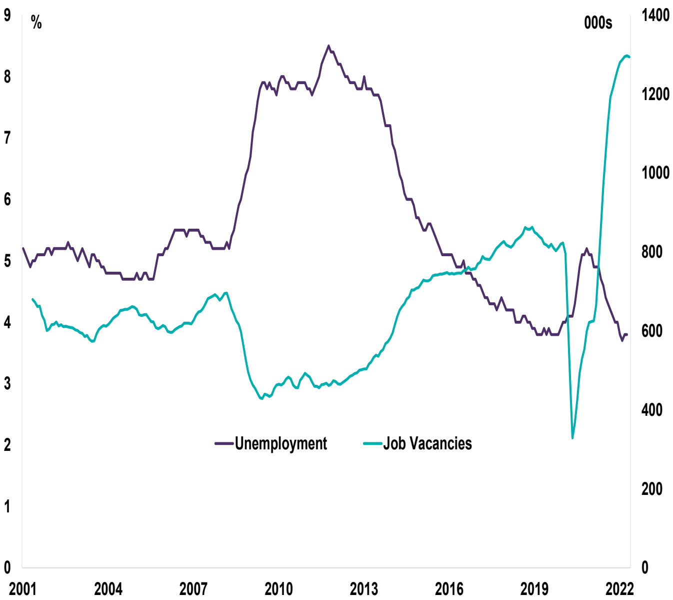


Chart 3: Labour market indicators remain strong for now



Commercial Property

Despite the increasingly challenging macro environment, feedback to the Q2 RICS Commercial Property Monitor was still on balance positive with the headline metric capturing both occupier and investor sentiment coming in at +6 compared with +17 in the preceding three month period. Inevitably, however, the headline number continues to mask significant diverengence in performance at a sector level. The industrials/logistics segment of the market remains particularly strong as highlighted in chart 4 despite seeing prices rise on average by in excess of 60% over the past couple of years according to CBRE data. Significantly, the CBRE numbers also point to the vacancy rate in this area slipping to just 1.18% (reflected in RICS 'availability' indicator).

Meanwhile the insights provided by RICS members for prime offices remains reasonably upbeat for now. Both capital values and rents are projected to post further increases, albeit modestly so, over the course of next twelve months. Moreover, this picture is pretty consistent across the country. Predictably, a number of alternative sectors also continue to be viewed positively in the RICS survey including datacentres, multifamily and care facilities. However, there are some signs of a stalling in the rebound in the retail sector which, given the pressure on household budgets in the wake of the cost of living crisis, is not altogether surprising (chart 5).

Hard data tracking investment volumes so far appear to be showing a resilient trend. Numbers from Colliers suggest that activity in the first half of this year reached around £30bn which compares with £27.5bn in the same period of 2021 and a five year average of just under £26bn. Significantly, cross border capital has so far accounted for around one-half of all the activity this year.

One sign of caution that is emanating from the latest RICS Commercial Monitor is the increasing proportion of respondents who now view the market to be in a downturn phase of the cycle. Chart 6 shows how this has jumped from less than one-quarter in Q1 to over 50% in the latest survey, taking it to its highest share since the final three months of 2020. Despite this, our suspicion is that the downside threat to the market is relatively limited even with the challenge presented by rising interest rates and a weakening economic outlook. In particular, we would draw comfort from the relatively limited build up of debt and development compared with some past real estate cycles.

Chart 4: Key indicators of the industrials/logistics market from RICS Commercial Property Monitor

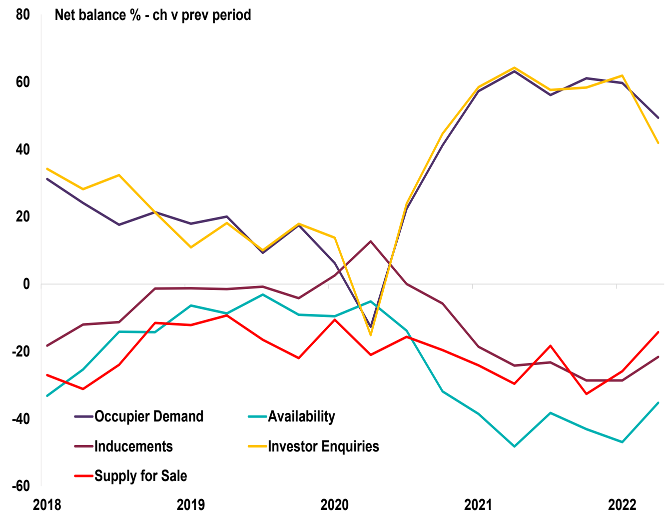


Chart 5: The RICS Retail Investment Enquiries net balance suggests the recovery in retail prices is set to slow

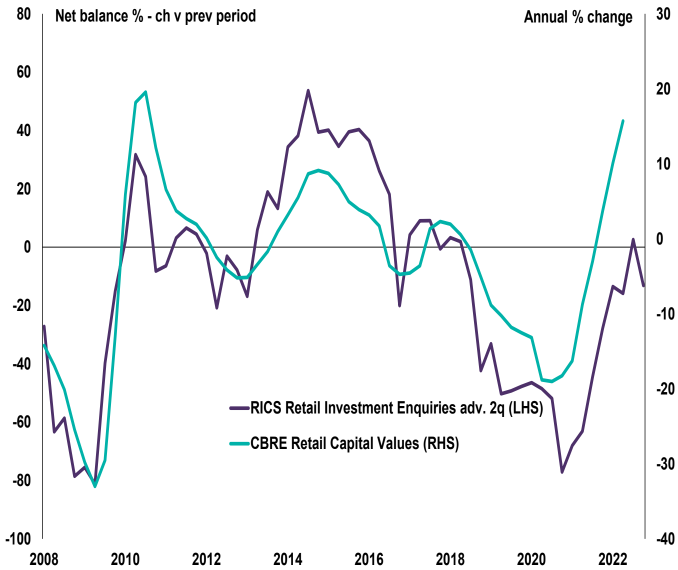
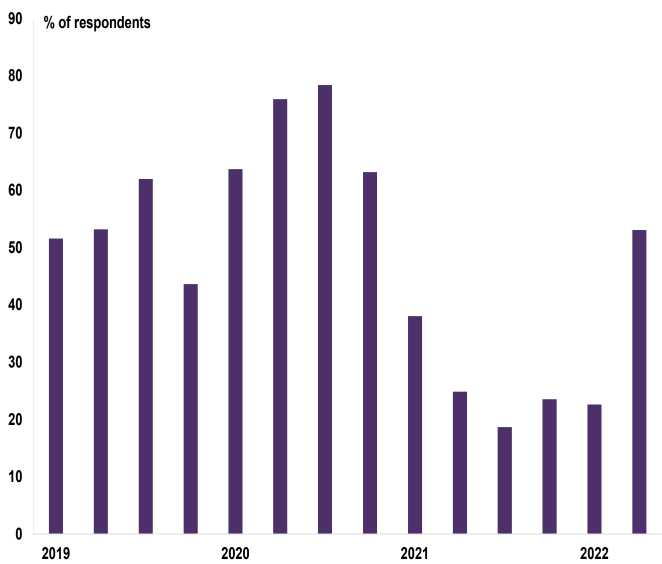


Chart 6: RICS data shows a rising share of respondents to the survey see the market in a downturn phase of the cycle



Residential Property

Signs of a softening in demand are beginning to emerge. First, mortgage approvals as captured by the Bank of England slipped (on a seasonally adjusted basis) to just under 64,000 in June which is lowest level since the same month of 2020 when the housing market was recovering from the shut down at the start of the pandemic. Moreover, it leaves approvals below the pre-pandemic average of 66,000 a month. Meanwhile, the RICS New Buyer Enquiries metric has now fallen for three successive months (net balance -25% in July) albeit this retreat follows eight consecutive monthly increases previously (see chart 7). And third, the HMRC Residential Property Transactions series is showing a provisional reading for June of 95,420 which is the weakest number since last November.

For now, pricing remains relatively resilient although there does see to be some easing in the momentum of price growth. The latest Halifax house price index puts the annual growth rate at 11.8% with the Nationwide series a touch below at 11%. Significantly, the latest RICS headline net price balance indicator is still at +63% which, while down from recent highs, remains elevated in a historical context.

Chart 8 tracks the RICS series against the Nationwide data with a six month lead for the former, and suggests house price inflation is unlikely to fall away too rapidly despite the increase in mortgage rates. That said, the twelve months price expectation series gathered through the monthly RICS survey is pointing to a greater loss of momentum although not at this point falling prices. The latest net balance results for this indicator stands at +30% down from +37% last month and a high in February of +78%.

A key reason why the feedback around the outlook for pricing is still holding up is the ongoing issue around supply. New instructions are broadly flat according to the RICS numbers after an extended period of decline which is reflected in the sales to stock ratio remaining not far off historic highs. This is also evident in the Rightmove data.

Meanwhile, the upward pressure on rents remains intense with rent expectations not far off recent highs (chart 9). Tenant demand continues to grow firmly, albeit a little less so than previously, while the RICS landlord instructions series is still stuck in negative territory. Respondents to the RICS survey point to changes in the tax regime and the regulatory environment as having an adverse impact on supply to the sector.

Chart 7: The RICS New Buyer Enquiries series is now in negative territory and reflecting the drop in mortgage approvals

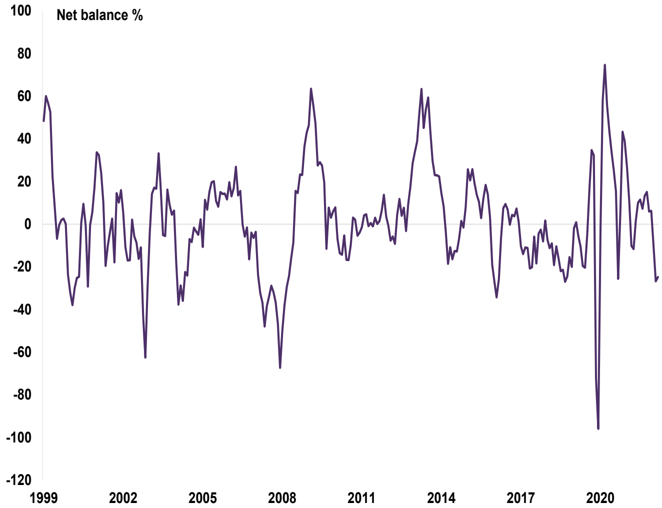


Chart 8: The RICS price balance series typically leads house price inflation by six months

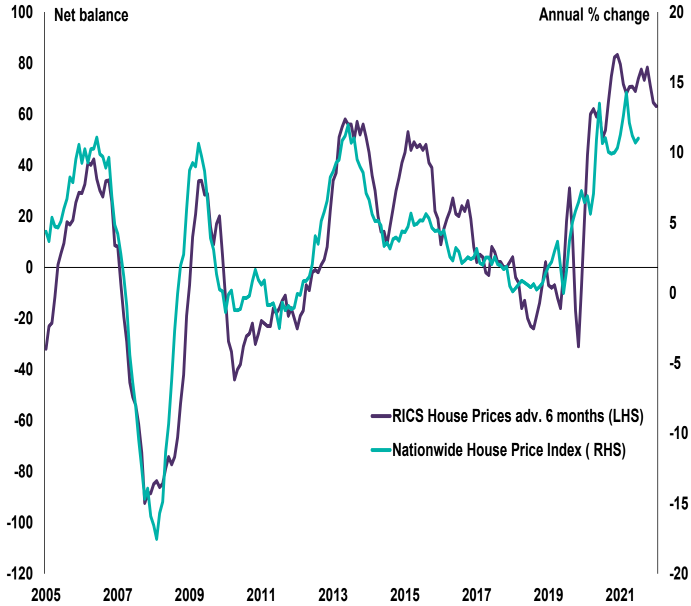
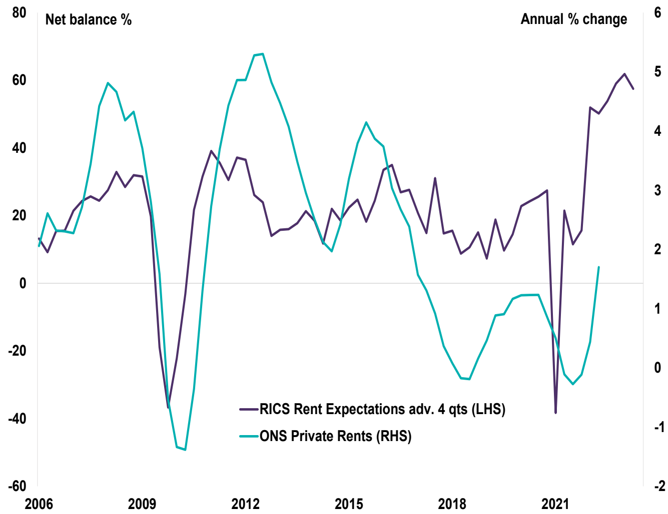


Chart 9: RICS Rent Expectations data points to a sharp rise in private rents



Construction

The most recent official data for the sector (May) shows output some 5% up over the past twelve months and around 3.5% higher than in January 2020 (pre pandemic level). Inevitably, there is considerable volatility on a month by month basis particularly at a sector level. Nevertheless, when looked at over the last two and a half years, the key drivers of the growth in output have been private housing rm&i (+20%), industrial (+18%), and infrastructure (+13.5%). By way of contrast, commercial output has fallen (-21%) over the same period.

In terms of forward looking indicators, the Q2 RICS Constructions Monitor suggests that workloads will continue to grow over the next twelve months albeit at a somewhat lesser pace than currently (chart 10) in response to the more downbeat economic climate. Within this, infrastructure is viewed as likely to see the fastest momentum on the back of a number of significant projects that are currently under way (HS2, Thames Tideway Tunnel and Hinkley Point C). The Construction Products Association is now projecting output to grow by 2.5% this year slipping to 1.6% next year. For infrastructure, the comparable numbers are 8.5% and 3.8%.

Although macro uncertainty is a growing concern, feedback to the RICS survey suggests that the more immediate challenges for the industry still revolve around building materials and labour. ONS data shows prices (on average) for the former have climbed by in excess of 26% over the past year while construction wage inflation is now above 8%. Chart 11 indicates that around 80% of respondents cite the availability of materials as a current problem with a similar share highlighting labour shortages. This compares to around 15% who identified lack of demand as an issue.

The impact of rising costs is already beginning to manifest itself in some areas of the industry with insolvencies picking up smartly (chart 12). The risk is that this trend could become even more visible in a tougher economic environment; financial constraints are viewed as an increasing obstacle for the sector (54% of respondent cited this factor which is the highest number since Q4 2020) with credit conditions anticipated as deteriorating materially over the second half of the year. Interestingly, however, feedback to the survey suggests that respondents see tender price inflation accelerating so that, on balance, it could come close to matching further gains in construction costs.

Chart 10: The RICS Q2 Monitor suggests infrastructure workloads will see the strongest growth over the next 12 months

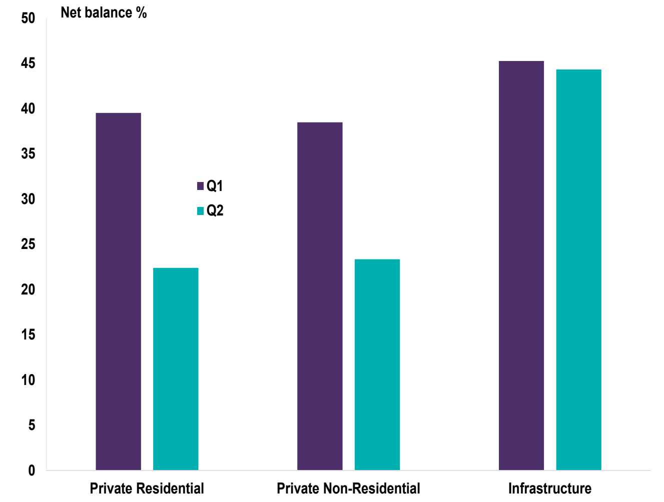


Chart 11: Factors cited as limiting output in Q2 RICS Q2 Construction Monitor

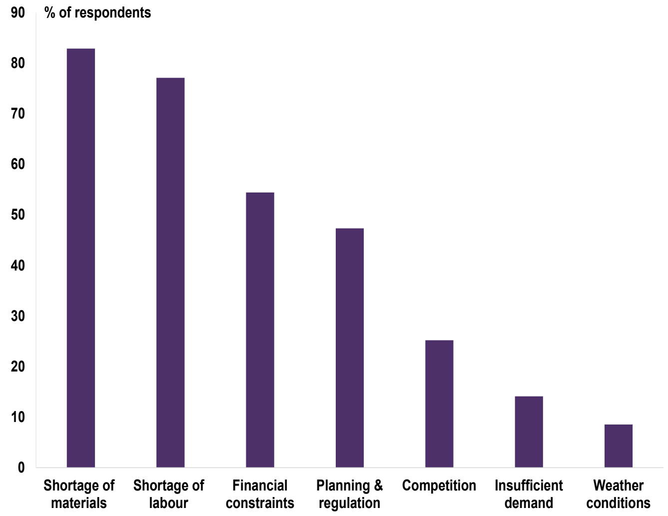
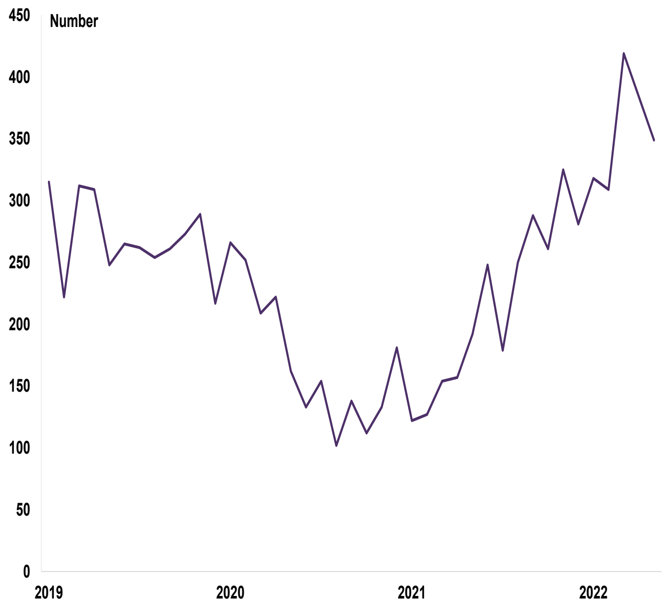


Chart 12: The underlying trend in insolvencies in the construction sector is on the rise



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