

# Economy and Property Market Update

November 2022

## Macro challenges shift real estate dynamics

### ECONOMICS

#### Summary

The increase in interest rates sanctioned by the Bank of England to try and curb inflation pressures has begun to take its toll on both the residential and commercial property markets. Transaction activity is already beginning to wane and price declines are viewed as likely with further monetary tightening probable over the coming months notwithstanding the more restrictive fiscal stance. For the construction sector, infrastructure is still seen as likely to provide some momentum in what is inevitably going to be a more difficult environment with credit becoming less readily available.

# Economy

Interest rates now stand at their highest level in fourteen years and financial markets are assuming there is further to go before the peak is reached, notwithstanding the recent shift in direction in the fiscal stance. Although there are increasing signs of pressure on the economy, the focus of monetary policy remains geared to tackling the challenge presented by inflation which is expected to average 11% in the final part of this year. Significantly, the latest projections from the Monetary Policy Committee (MPC) suggest that the inflation rate will begin to ease through the course of 2023, albeit remaining well above the target of 2%. However as chart 1 demonstrates, the picture continues to improve through 2024 and beyond according to this analysis; indeed, on the basis of current market interest rates, inflation could fall to close to zero by the end of 2025. Much will depend on how embedded the inflation psychology becomes in the wage bargaining process. And it is worth noting that the minutes of the last MPC meeting did indicate that the risks were viewed to be skewed towards the upside.

Critical to the inflation forecast from the Bank is its assumptions as how economic activity might play out. An important element of this is its judgement that output will fall for eight successive quarters resulting in a peak to trough drop in GDP of around 3%. A key area of uncertainty surrounds the extent to which households will be willing to bolster spending plans in the face of cost-of-living pressures by drawing on past savings and, quite possibly, borrowing more. Some households are clearly better placed (than others) to turn to the 'excess' savings that they were able to accumulate during the Covid pandemic. However, the negative news flow could just as easily encourage consumers to take a more cautious approach to their finances. Recent data (highlighted in chart 2) suggests that the latter force may be proving the more powerful driver with cash deposited by households in bank accounts jumping to £8.1bn in the past month.

For the moment the labour market picture remains remarkably solid with demographic factors, rising inactivity particularly amongst the over 50s and the legacy of Brexit contributing to this (chart 3). This is, however, unlikely to be sustained as consumer demand continues to be reined in and companies begin to adjust to the changing macro picture. Despite ongoing skill shortages in key areas of the labour market, the growing pressure on profits is likely to shift the needle regarding recruitment and result in rising unemployment from current lows.

Chart 1: Inflation expected to fall below the 2% target if current rates persist

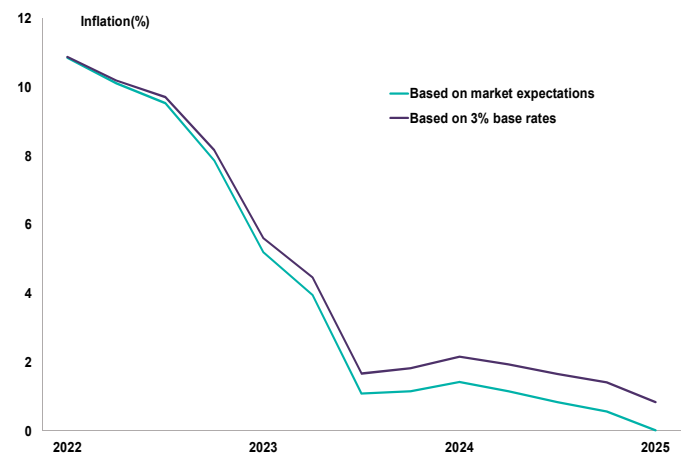


Chart 2: Household savings with the banking sector rose last month which could be indicative of growing caution

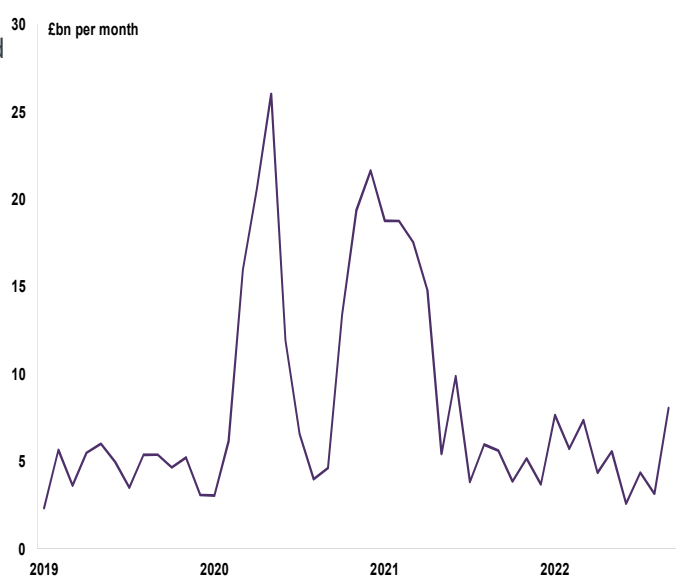
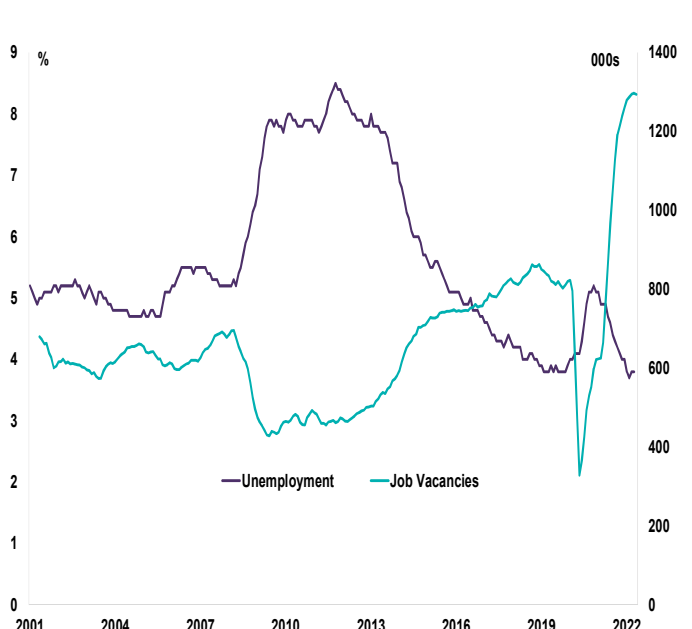


Chart 3: Labour market indicators remain strong for now



## Commercial Property

Concerns over the macro-outlook allied to the recent turmoil in financial markets, albeit that they have settled down more latterly, has set in motion a repricing across commercial property markets. For example, Savills estimate prime West End office yields have climbed from 3.5% in September to 3.75%, high street retail from 6% to 6.5% and industrial multi-lets from 4.25% to 5%. This is also being reflected in the tone of the feedback gathered as part of the Q3 RICS UK Commercial Property Monitor. The Investment Enquiries metric posted a net balance reading of -18% over the last three months compared with +12% in Q2. Within this, the retail indicator fell deeper into negative territory (-39% as against -13% previously) while the reading for offices was -31% after being broadly flat in the previous month period.

Meanwhile, chart 4 suggests that transaction activity slipped to £10.6bn in Q3 which is more than one-third down on the volumes recorded in the previous three month period. Interestingly, Lambert Smith Hampton note that impact was more notable at the larger end of the market. Q3 saw only 24 deals in excess of £100m compared to 38 in Q2 and way down on the recent high of 50 seen Q4 2021.

Underpinning this shift in mood from investors has been greater caution amongst occupiers which is clearly visible in the latest RICS data. Chart 5 shows the tenant demand series in net balance terms disaggregated at a sector level. The office read of -22% needs to be seen in the context of two positive results in the first half of the year but it does now strongly suggest this trend has stalled. Meanwhile, the retail indicator moved further into negative territory and the momentum in the industrial sector has slowed markedly. Availability data as compiled as part of the survey is predictably rising for both offices and retail. Meanwhile, data from Knight Frank provides evidence that this is translating into rising vacancy rates. Indeed, they estimate the vacancy rate now stands at 9.3% for city offices which is the highest level since the start of 2012.

Cyclical pressures are compounding on the ongoing structural shift in office demand as organisations grapple with the implications of the post-Covid hybrid working environment. Chart 6 shows the results to an additional question included in the Q3 RICS UK Commercial Property Monitor around the likely scaling back in the office footprint. Perhaps unsurprisingly given the results, around 85% of respondents also indicate they are seeing some repurposing of office space.

Chart 4: UK Commercial Property investment volumes fall sharply in Q3 according to Lambert Smith Hampton

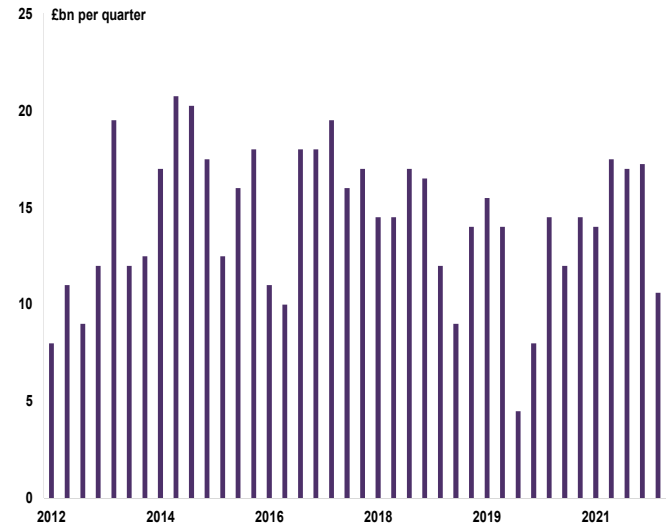


Chart 5: Occupier demand metrics softened for offices and retail in Q3 according to the RICS survey while industrials slowed

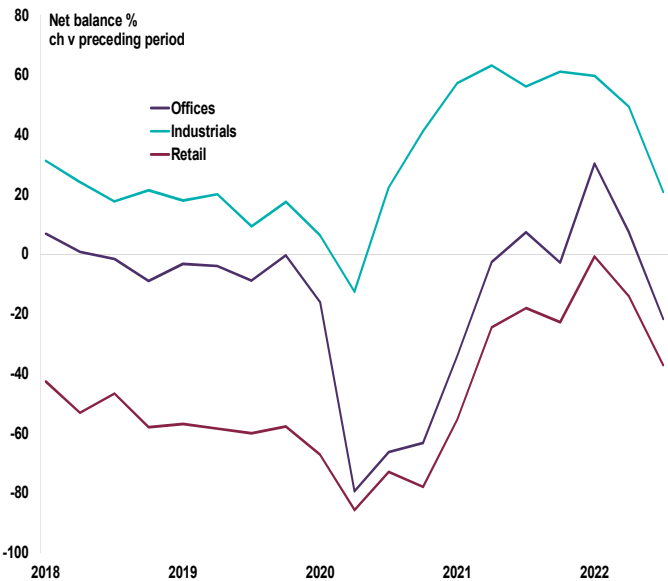
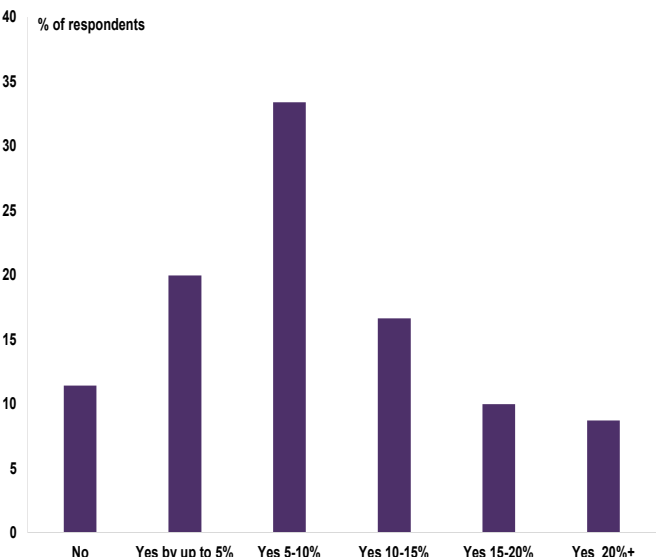


Chart 6: RICS data suggests businesses are looking to scale back the office footprint by around 10% over the next year



## Residential Property

Negative news flow around the outlook for the housing market has continued to grow notwithstanding the easing in volatility in the financial markets. The latest RICS Residential Market Survey shows the current price trend is now flatlining (broadly consistent with the hard data) and that buyers enquiries are falling sharply at a headline level (chart 7). Significantly, this is also being reflected in the twelve-month expectations metrics; the forward-looking sales series posted a reading of -42% (net balance) in October, little changed from the previous two months numbers which represents the worst run of results since the series began a decade ago. For pricing, the outlook has deteriorated markedly with a net balance of -42% anticipating price declines (compared to -18% in September and +3% in August).

Judging what this will actually mean for the market is inevitably highly speculative given the uncertainty as to how high interest rates will need to rise to contain inflation and how this eventually plays out in the labour market. Consensus forecasts currently appear to be centring around a 10% average decline in prices but with a larger fall-off in activity. Chart 8 shows the extent of recent mortgage rate increases based on data provided by the Bank of England. It is noteworthy that 2 and 5 year overnight money has fallen sharply over the past few weeks but it is unlikely that this will be fully reflected in lending rates. Meanwhile, the latest measure of affordability (mortgage payments as a share of take home pay) for first-time buyers produced by the Nationwide Building Society climbed to 34% in Q3 which is above the long run average (29%) and the highest figure since the GFC. As has been well discussed elsewhere, around 90% of mortgages are fixed rate products so the impact of the rising cost of borrowing will inevitably be felt over time. Estimates suggest around 300,000 fixed term products end per quarter, peaking at 370,000 in Q2 of next year; the total for the whole of 2023 could be around 1.5 million.

Meanwhile, the challenges in the sales market are exacerbating the strength of rental demand while supply of lettable property continues to lag some way behind. The latest RICS data, highlighted in chart 9, shows how is being reflected in rent expectations. Respondents to the Residential Survey contest that the shift in the tax and regulatory environment has played a critical role in driving this imbalance, which according to the most recent Zoopla data, is resulting in rents on new lets seeing double digit increases.

Chart 7: The latest readings for the RICS Price Balance and New Buyer Enquiries highlight the shift in tone in the housing market

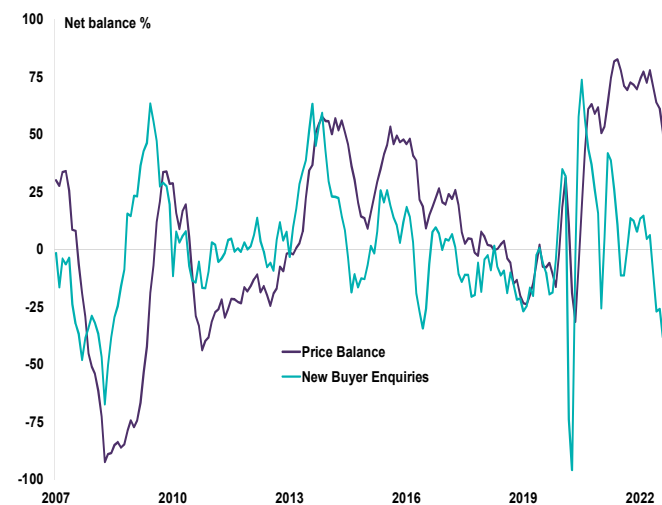


Chart 8: Bank of England data shows how sharply mortgage rates have risen over the past few months

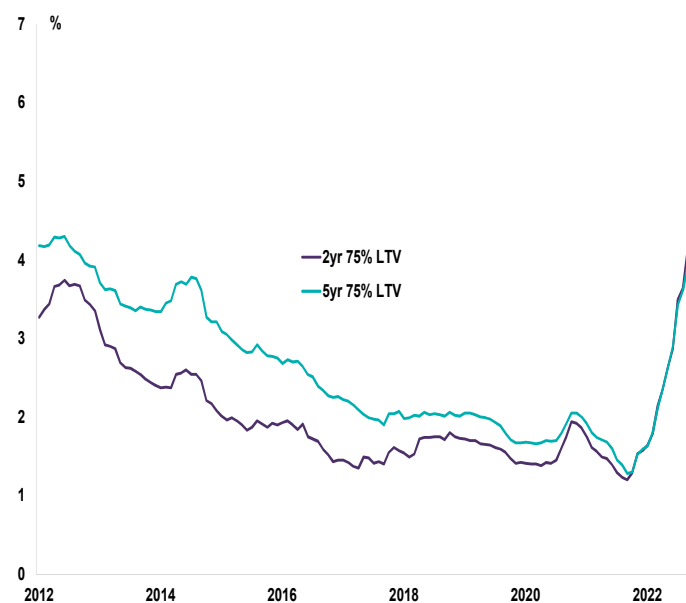
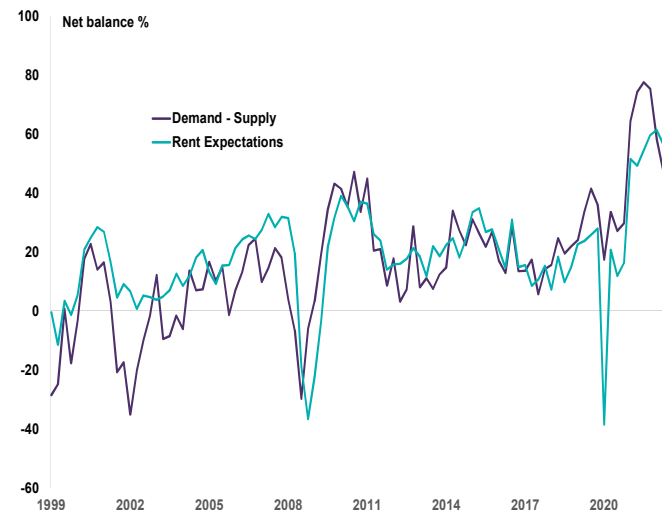


Chart 9: RICS lettings data show demand hugely exceeding supply and rent expectations still very strong



## Construction

The cost and availability of building materials continue to be viewed as major challenges for the construction industry with around four-fifths of respondents to the Q3 RICS Construction Monitor identifying these issues as limiting activity. Some comfort may, however, be drawn from the latest BEIS data on costs (chart 10); this shows that the annual inflation rate of construction materials was 16.7% in September 2022, which is a 3rd consecutive fall from the recent peak of 26.8% in June. However, this rate of increase will inevitably continue to be a source of discomfort particularly for SME contractors on fixed price contracts. This is partly captured in the headline profit margins metric from the RICS dataset. It suggests that a net balance of 23% of respondents saw a contraction in margins and that the pressure appears to be intensifying (-15% in previous three month period).

The latest official data for construction output indicates that it is around 6% up on a year ago and 2.5% above pre-pandemic levels. But the workload momentum does now appear to be slowing according to the RICS sentiment data, to a greater or lesser extent, pretty much across the board. New Business Enquiries while still positive in net balance terms are showing the least positive reading since the Q4 2020 while hard numbers tracking new construction orders (ONS) appears to be slipping. Against this backdrop, the more subdued trend in the forward-looking workload indicators captured in the Monitor is unsurprising. Little change is anticipated in residential and commercial development while infrastructure is left to drive activity (chart 11).

Despite this prospect, concerns continue to be expressed about the challenges associated with recruitment. The number of employees in construction is now higher than it was prior to the pandemic but, significantly, there has been a material fall in self-employment in the sector (20% down on the 2019 peak). The Q3 RICS Monitor shows that shortage of labour continues to be reported by around three-quarters of respondents with lack of skilled trades and professionals cited by an even higher proportion. Meanwhile, upskilling the existing labour force is perceived to be the most immediate route to lifting productivity levels in the industry according to feedback garnered as a result of an additional question included in the last survey. The full results are shown in chart 12. Other areas of particular focus include greater investment in data and digitalisation and improving procurement and supply chain management.

Chart 10: The rate of price growth of building material is beginning to slow but remains well in double digits

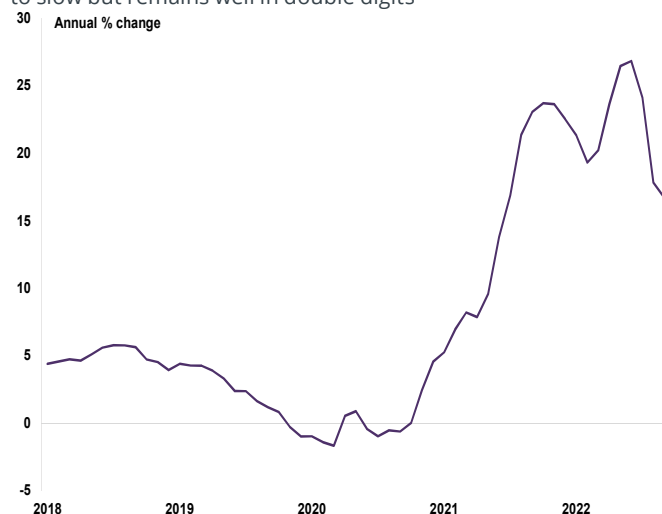


Chart 11: Twelve month workload expectations show the key role infrastructure is likely to play over the next year

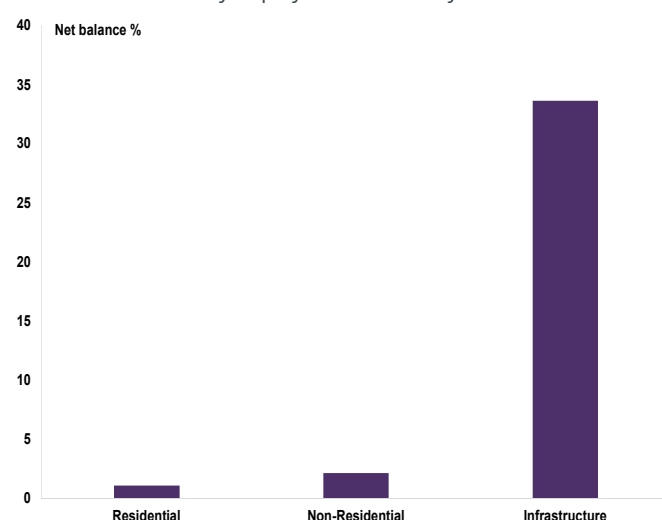
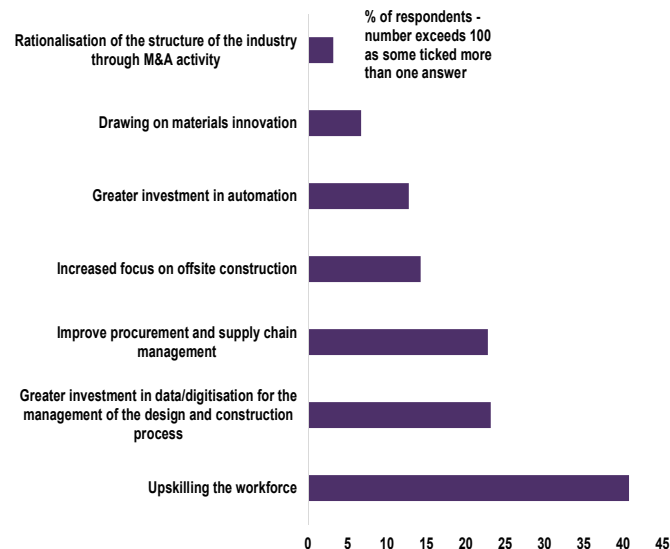


Chart 12: Upskilling the workforce is viewed as the key approach to lifting productivity over the next twelve months



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