

Economy and Property Market Update

May 2024

Gradual recovery in the economy to be accompanied
by a softer inflation outlook

ECONOMICS

Summary

Interest rates cuts are likely to start over the coming months as the inflation trend continues to moderate. This should provide encouragement both for the construction industry and property markets. RICS survey feedback regarding forward-looking indicators of workloads over the next twelve months are already suggesting a broad-based improvement. Similarly, a more positive view of the residential market is visible at this time horizon, even if new buyer enquiries have recently stalled as mortgage rates backed up. The picture for commercial real estate appears a little flatter but sector trends remain particularly divergent.

Economy

Most forecasts continue to point to a subdued near term outlook for the UK economy. The Bank of England’s latest update almost mirrors the assessment of the OECD with growth of just 0.5% this year followed by something in the region of 1.0% in 2025 (Chart 1). That said, these projections now look to be a little pessimistic, given the stronger-than-expected 0.6% quarterly expansion in GDP the opening stretch of 2024 (the firmest rise since 2021).

Significantly, there is increasing optimism that the macro picture is consistent with inflation falling close to the 2% target over the coming months. Moreover, the Bank’s May projections envisage inflation settling at closer to 1.5% in 2026 (based on market expectations for interest rate cuts over the period).

One potential challenge around any early easing in monetary policy is the perception that the US Federal Reserve may be rather less motivated to move on rates in the near term given the continuing strength of the American economy. However, it would not be without precedence for the two central banks to move into different directions if only for relatively short periods of time as is evident in Chart 2. One potential issue, however, is the inflationary impact of a weaker pound that could result from a divergence in policy. That might be more worrisome if there is still some lingering concerns around the scope for second-round effects emanating from a tight labour market. But, most analysis indicates that it would require a meaningful drop in the value of sterling to shift the mood music around inflation.

Arguably a more significant challenge for policymakers is around how to improve the productivity performance of the economy and, by implication, medium term potential growth. The OECD has noted that more work around supply side reforms without increasing policy churn would be helpful. In particular, it would like to see a focus on addressing ‘economic inactivity and stagnant investment’. Chart 3 shows that although recent government measures including the ‘super deduction’ has helped to encourage business investment (and fuelled a recovery from Covid lows), the impetus appears to be fading.

It is noteworthy that recent data shows economic inactivity approaching the nine and a half million mark (that is people aged between 16 and 64 who are not in employment, who have not been seeking work within the last 4 weeks and/or are unable to start work within the next 2 weeks). By way of comparison, this is around one million more than the level recorded in the final quarter of 2019.

Chart 1: Growth forecasts for this year and next remain relatively subdued albeit they are pointing to a gentle acceleration

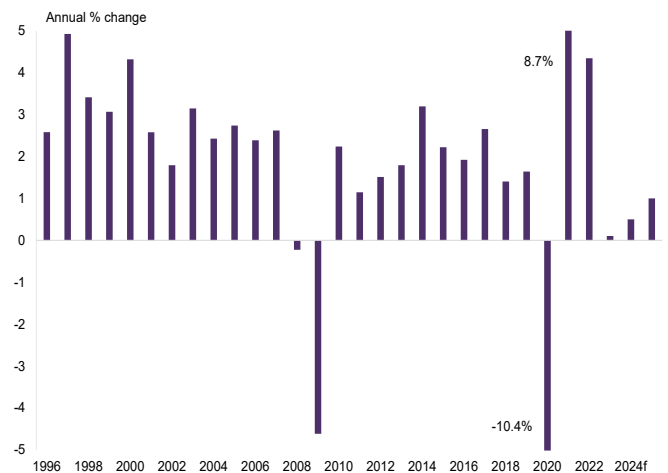


Chart 2: There have been periods of time in the past when the Bank of England and the Fed have diverged on policy

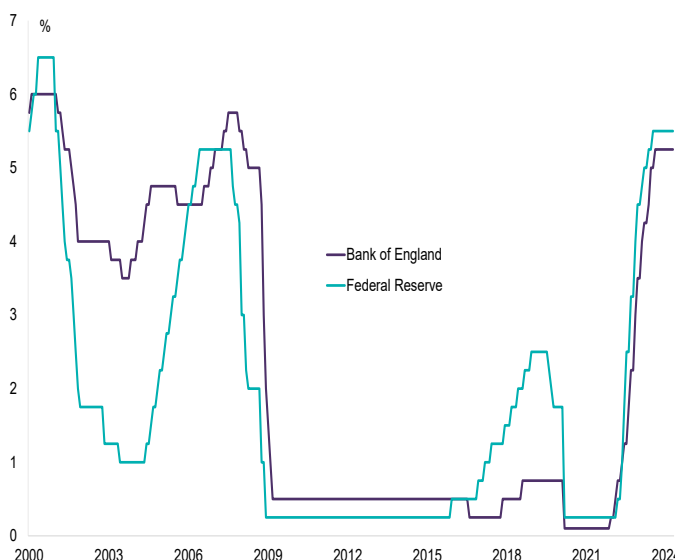
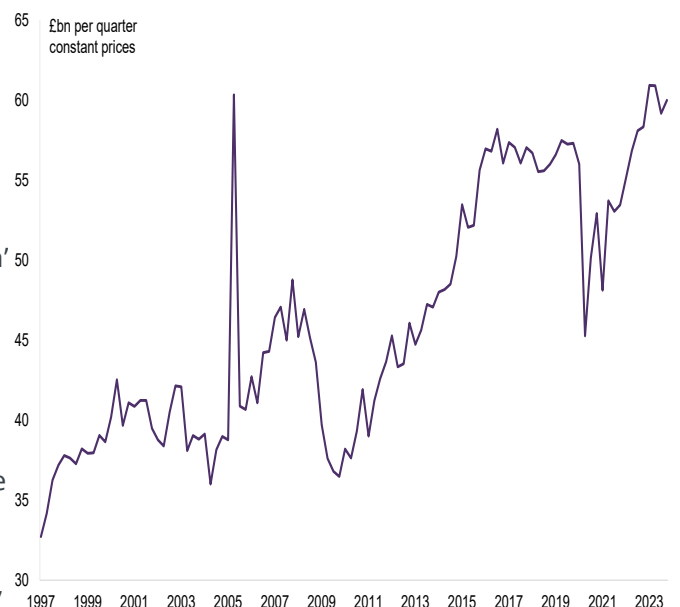


Chart 3: Business investment has rebounded from Covid lows but the underlying trend is only indicative of modest growth



Commercial Property

Commercial real estate investment volumes fell by 9% in Q1 when compared to the previous quarter, with a reported £4.8bn worth of assets trading hands during the opening three months of the year. Moreover, the latest figures continue a persistently weak trend evident over the past eighteen months, during which real estate investment levels have been well below the 15-year average (as evidenced in Chart 4). Further emphasising the narrative of a market struggling for momentum, the number of transactions also exhibited a marked decline in Q1, falling 19% from last quarter to 1536 (marking the slowest quarter for activity since 2009). This is in line with the latest findings from Bayes Business School, who reported that new loans for commercial property hit a decade-low last year amidst the backdrop of weak GDP growth, falling property prices and increased debt costs.

Nevertheless, the latest data from the RICS Commercial Property Monitor does present some more encouraging signs for the market. Indeed, a combined 38% of respondents now feel conditions are consistent with the early stages of an upturn (rising noticeably from a share of 24% last time). Moreover, for the beleaguered office sector, a net balance of +6% of respondents cited an increase in occupier demand in Q1, representing the first positive reading since early 2022. That said, when breaking this figure down, the improvement was entirely driven by a significant upward movement within the Central London office market, where the net balance rose from +3% in Q4 2023 to +40% in Q1. All other regions across the country have reported either a flat or marginally negative trend in office tenant demand. The sector is increasingly becoming a two-tier market, as best-in-class assets perform considerably better than their secondary counterparts. Likely contributing to this divide, 52% of respondents noted there has been an increase in the number of office tenants downsizing over the past year.

Looking at the next twelve months, many of the more alternative commercial real estate asset classes continue to be viewed as likely to deliver solid returns. This includes data centres, student housing and life sciences in particular, all of which display comfortably positive capital value growth projections. By way of contrast, leisure appears to be lagging somewhat, recording negative expectations for both rents and capital values (albeit only marginally so) as shown in Chart 6. When considering the archetypal asset classes, the divergence between prime and secondary properties remains clear. This is most apparent across the office and retail sectors, where projections remain downbeat for secondary markets over the year ahead, as structural challenges continue to weigh on the outlook.

Chart 4: CoStar data shows CRE investment volumes started the year on a weak footing

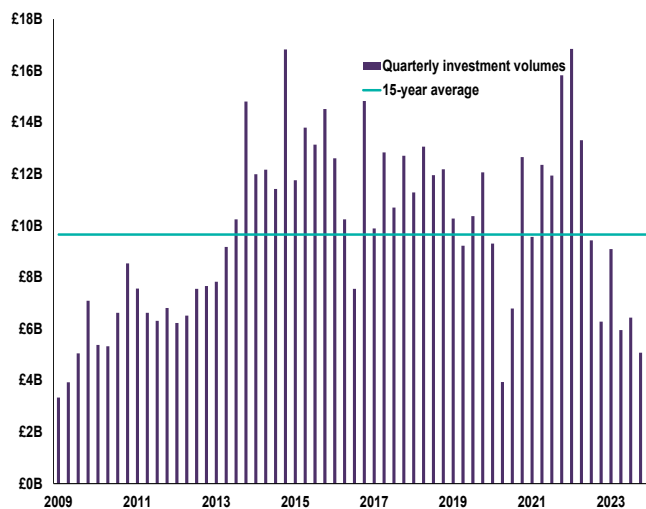


Chart 5: A rising share of respondents to the RICS UK CPM do now sense that the market has shifted to the early stages of a recovery

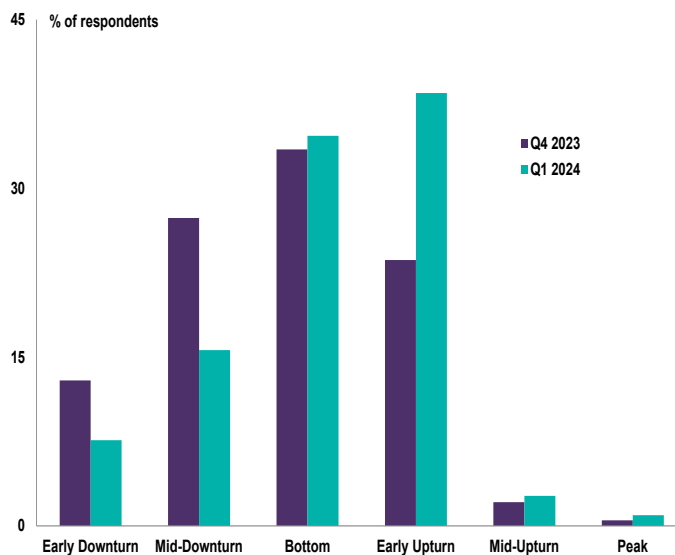
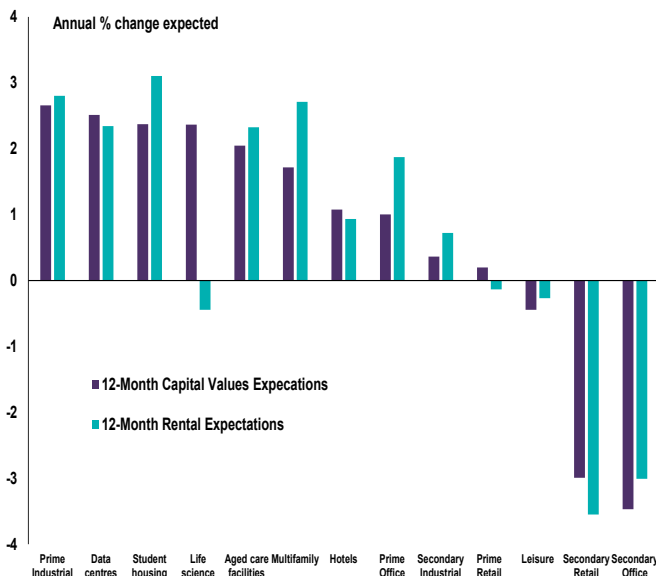


Chart 6: RICS member's twelve-month projections for rents and capital values remain downbeat across secondary office and retail



Residential Property

Tentative signs of an improving tone to the housing market have given way to a more cautious mood of late on the back of a modest uplift in mortgage rates. This is evident in the most timely house price data; the Nationwide Building Society index has now declined modestly for two successive months while the Halifax measure was broadly flat in April after a 0.9% drop in March. Alongside this, the latest RICS New Buyer Enquiries series was effectively unchanged (net balance of -1%) breaking a run of three consecutive small increases. Chart 7 tracks this metric against Bank of England data capturing the number of mortgage approvals (per month) on a year on year percentage comparison. The RICS series, with a three month lead, points to a flattening in the recovery in activity through the spring/early summer.

The challenge around affordability remains a key drag on the market highlighted by respondents to the most recent RICS Residential Market Survey. It is also a theme picked up in a recent report from Nationwide. This suggests that nearly half (49%) of prospective first-time buyers (those looking to buy in the next five years) have delayed their plans over the past year with the most commonly cited reason being that house prices are still too high (53%). Meanwhile, 41% said that elevated mortgage costs were preventing them from buying. The RICS data continues to indicate that both activity and prices will be somewhat higher in 12 months time (Chart 8). Even so, this uplift is likely to be limited with transactions for the whole of 2024 probably close to the 2023 figure (of 1.02m). Savills updated forecast is 1.05m.

As far as the lettings market is concerned, the gap between the RICS indicator measuring (the change in) tenant demand and landlord instructions is narrowing. This is also being reflected in more modest expectations around rental growth (in net balance terms). This is clearly demonstrated in Chart 9. Affordability is increasingly a significant constraint on the market, but, with the supply indicator having been in negative territory in every quarter bar one since 2017 (and likely to remain so), the trend in rents is not about to go into reverse. Meanwhile, the subdued picture in terms of Build to Rent development suggests that a meaningful uplift in stock is unlikely to emerge from this source in the near term; the number of homes under construction is down 6% compared with Q1 2023.

Chart 7: The New Buyer Enquiry series suggests the growth in mortgage approvals will continue to slow over the coming months

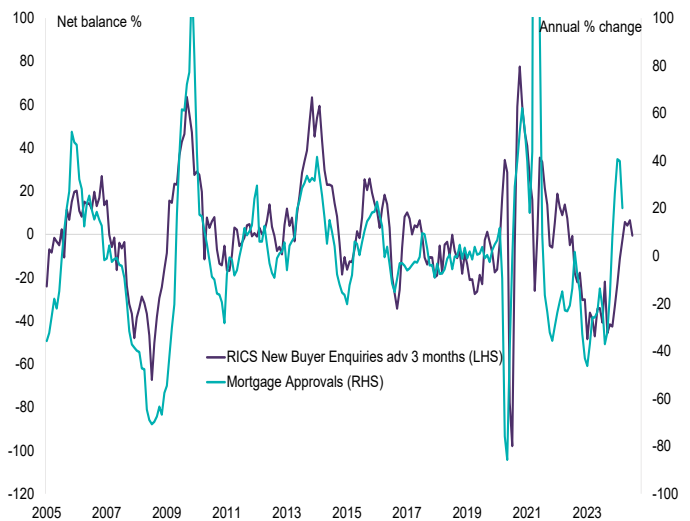


Chart 8: RICS 12 Months Expectations indicators still point to a gradual uplift in both activity and prices later in the year

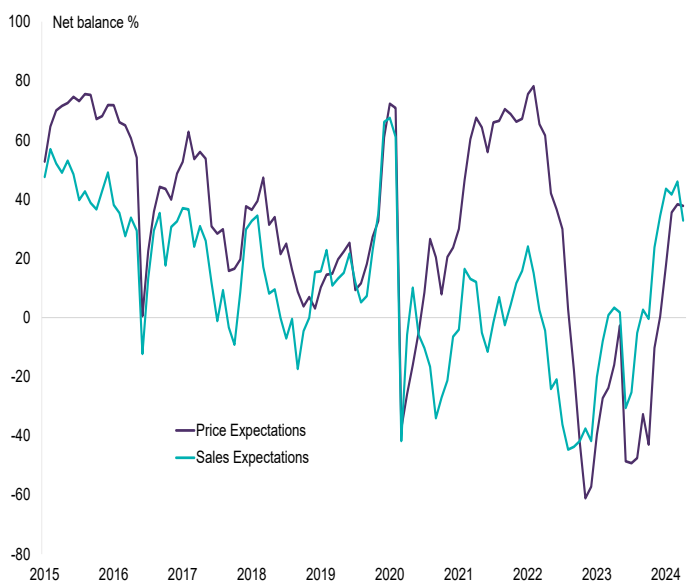
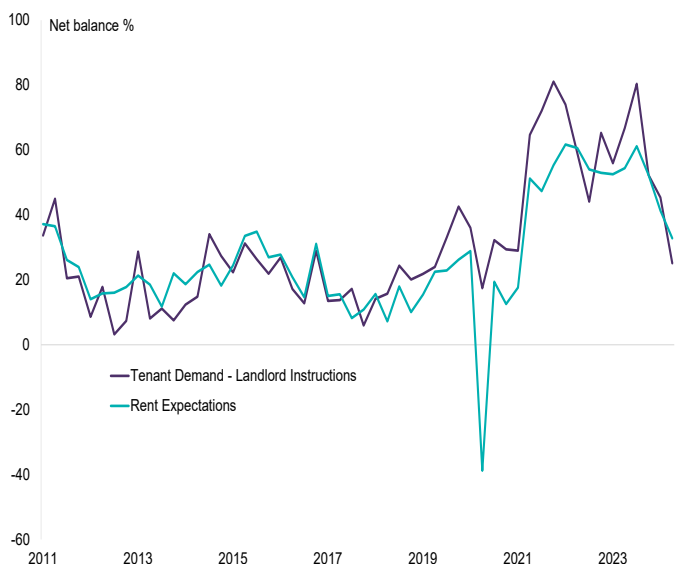


Chart 9: The gap between the RICS metrics measuring (the change) in tenant demand and landlord instructions is closing



Construction

Official data continues to point to a fairly flat trend in construction activity at an aggregate level; this largely chimes with the feedback received in the Q1 RICS Construction Monitor. The headline reading for industry workloads came in at zero in net balance terms, signalling a generally stable trend in Q1. That said, this does mark an improvement compared to the net balance of -8% returned in the previous quarter. Chart 10 demonstrates that respondents to the survey are seeing the emergence of a more positive (or less negative) picture in all sub-sectors, with the shift in feedback around private housing particularly notable.

The improvement in sentiment more generally is likely to have been supported by the better tone regarding the credit environment. Feedback to the survey shows a growing belief that credit conditions will become more accomodating, particularly looking forward over the course of the next year (net balance +22% vs +11% in the final three months of last year). Interestingly, there also appears some realism that a shift in policy is unlikely in the very near term, with a net balance of just +2% anticipating any easing over the next quarter.

Meanwhile, for now at least, there appears to be little evidence that events in the Middle East are leading to renewed pressure on building material prices. The most recent data shows the headline index of costs to be around 2% down on where it was a year ago (Chart 11). It is worth bearing in mind that only around 25% of materials used in UK construction are imported, and, of those, two-thirds come from the EU. This helps to explain some tentative signs that the profits cycle in the construction industry may be in the process of turning around. Chart 12 tracks the twelve months expectations results, in net balance terms, from the RICS survey, not just for margins, but also for headcounts and aggregate workloads. For the first of the metrics (profits), the Q1 result represents the best reading in two years.

That said, the number of companies becoming insolvent in the construction industry is still edging upwards. Moreover, despite the less negative tone to the responses this quarter, the RICS Monitor still shows financial constraints to currently be the biggest impediment to activity. Alongside this, shortages of skilled labour remain an ongoing problem, with this continuing to be reflected in rising wage costs; the expectations are that this trend will persist into 2025.

Chart 10: RICS data on current workloads shows that feedback around all segments of the construction industry has improved



Chart 11: Construction material prices are continuing to soften despite ongoing wars in Ukraine and the Middle East

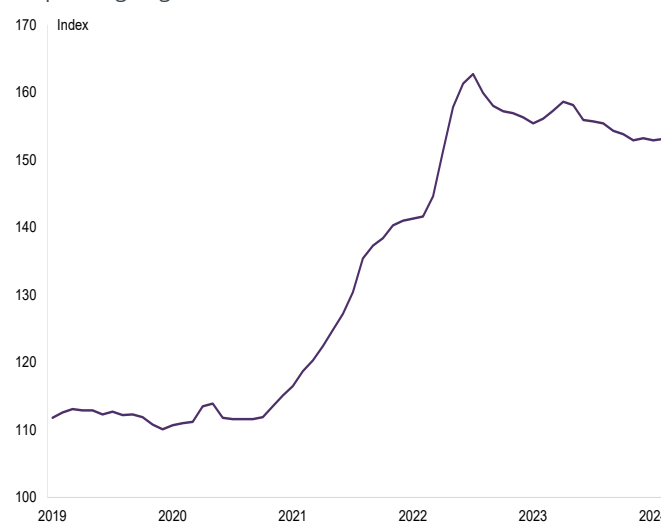


Chart 12: Insight from respondents in the latest survey points to a gradual improvement in key indicators over the next year



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