RICS

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Economy and Property Market Update

May 2023

Recession fears ease but significant challenges persist

ECONOMICS

Summary

Economic newsflow remains generally resilient which has led the Bank of England to upgrade its growth forecast. However, concerns over inflation remain undiminished at this point which could yet lead to a further interest rate hike. At the very least, an early reversal of recent monetary tightening seems implausible. Significantly, real estate markets appear a little more settled than previously albeit activity indicators remain relatively subdued.

Economy

The continued resilience of macro data is clearly visible in the latest (May) economic forecasts from the Bank of England. Chart 1 compares the profile for GDP growth in its most recent analysis against what was anticipated back in February. The Bank now expects the economy to expand by 0.25% this year (rather than contract) and while the projection for 2024 only shows output rising modestly once again, the economy is still predicted to be 2% larger at the end of next year when set against expectations in the last forecast.

Alongside this, the Bank has now become a little more cautious about the likely easing in inflation pressures. Back in February, its estimates had inflation falling to the 2% target in the second quarter of 2024. Now, the Bank doesn't see the headline measure getting there until the early part of 2025. Meanwhile, a key area of concern is that a higher rate of core inflation (which will not respond as readily to a fall in energy costs) is steadily becoming more firmly embedded. To the extent this might be happening, it is arguably a result both of higher wages (albeit the rate of increase still lags the headline inflation rate as shown in Chart 2) and some price gouging. For now, the labour market remains tight even if there are a few signs it may be fraying around the edges. Employment rose by a further 182k in the first quarter but a sizable drop in inactivity (linked to student numbers) resulted in a slight rise in the unemployment rate (to 3.9%). Significantly, the number of people registered as long term sick continues to increase highlighting a more fundamental problem regarding labour supply.

A further challenge lies with the prospect of a significant tightening in credit conditions in the wake of the recent wave of bank failures primarily in the US. Responses to questions regarding credit availability in both the RICS Commercial and Construction Monitors are certainly consistent with the picture becoming a little more restrictive (albeit not dramatically).

Chart 3 shows money market expectations for base rates in the light of recent events. The latest increase in policy rates to 4.5% was widely viewed as likely to be followed by at least a temporary pause in the tightening cycle. That said, the signal from the money markets is that it may be premature to call the peak just yet. That could change if the impact of previous moves starts to manifest itself more powerfully, possibly through the delayed impact on households as they refinance mortgages on higher rates. Even so, it is implausible that the Monetary Policy Committee will shift its focus to active consideration of interest rate cuts for some time to come. To get to that stage, it will likely need to see inflation fall much lower, wage growth easing back, and evidence that labour market conditions have loosened sufficiently. This is unlikely to emerge until well into 2024.

Chart 1: Bank of England's May profile for GDP growth shows significant uplift compared with February

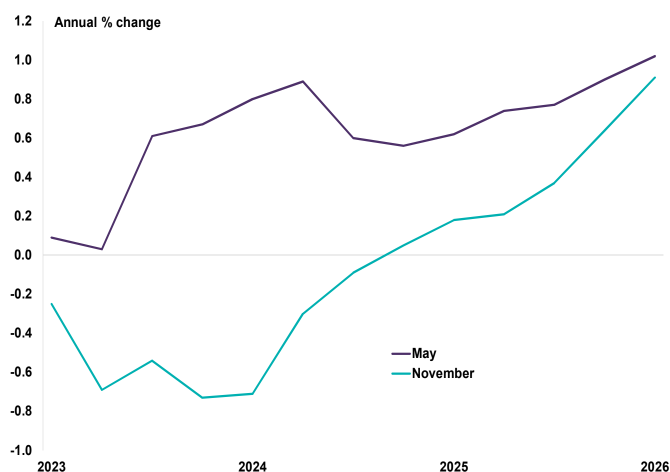


Chart 2: Inflation continues to outstrip wage growth even more so in the public than in the private sector

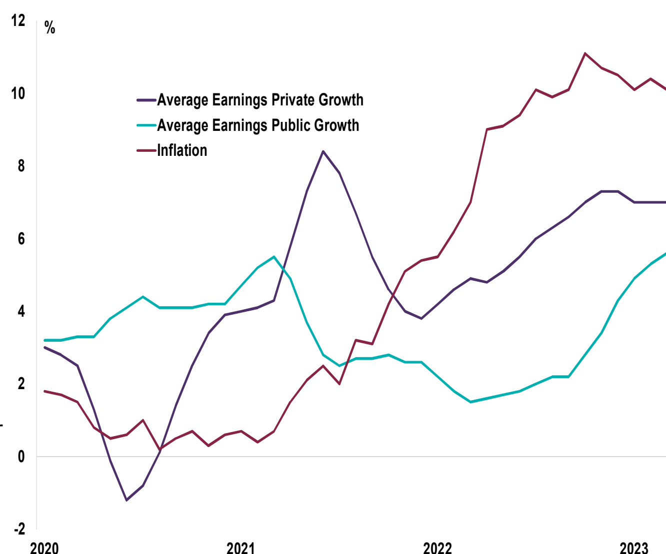
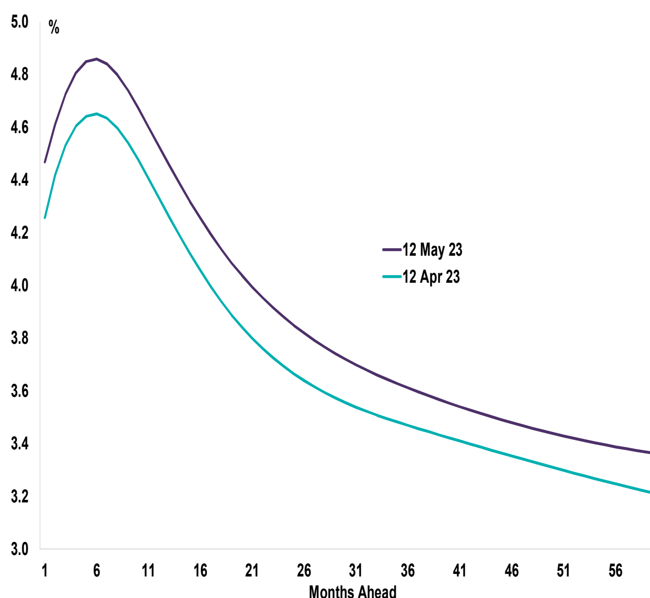


Chart 3: Money market interest rate expectations point to at least one more hike over the coming months



Commercial Property

Transaction activity may have picked up in Q1 but, as CoStar data demonstrates in Chart 4, it remains relatively subdued on a historical comparison, with the volume of sales amounting to just over £7bn. This chimes with the results of the latest RICS Commercial Property Monitor, which shows the investment enquiries sentiment metric still in negative territory, albeit the net balance of -14% represents an improvement on the -30% recorded in the final part of last year. Significantly, the headline RICS indicator measuring occupier demand is now broadly stable, with the picture in the three mainstream sectors either a little more positive than previously or less negative.

The slightly better tone to the market is also visible in price and rent data. Capital values at an aggregate level have now risen for two months in succession (according to CBRE), while the rental value trend remains solid. Significantly, while the former is still almost 18% down on where it was a year ago, the latter is 4% higher. It is noteworthy that the biggest reduction in values over the period is still being attributed to the industrial sector, with a drop of around 27%. The retail sector was the only area to see a fall in yields in Q1 which may in part reflect the substantial adjustment that has already taken place in that segment of the market.

In the RICS survey, around 75% of respondents took the view that the market is either still in a downturn or at the bottom of the cycle. However, as Chart 5 shows, there has been a shift in perception with more viewing the market closer to the floor and around 20% actually suggesting it is the early phase of an upturn.

Looking ahead, expectations for returns for real estate show two distinct trends. First, there is a polarisation between the best in class and the rest, as reflected in diverging projections between prime and secondary assets. Interestingly in this regard, Savills note that in the City, 92% of take-up this year has been of Grade A quality, of which 61% was recently comprehensively refurbished/developed. In addition, they point out that over half of Q1 take-up was in buildings with a BREEAM rating of 'Excellent' or 'Outstanding'. Second, there continues to be a stronger interest in those areas of real estate which traditionally have been bundled up as alternative assets. This is clearly evident in Chart 6 which shows projections for both rents and capital values over the course of the next twelve months.

Chart 4: CoStar data shows investment activity remained relatively subdued in the first quarter of the year

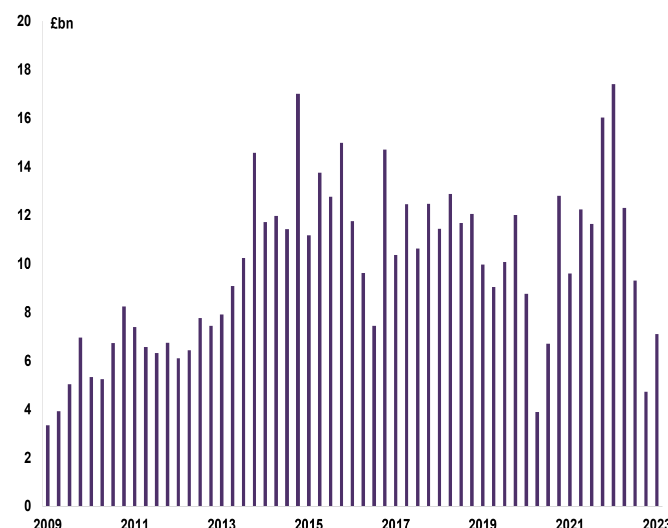


Chart 5: The RICS Monitor shows a rising share of contributors viewing the real estate cycle more advanced in the downturn

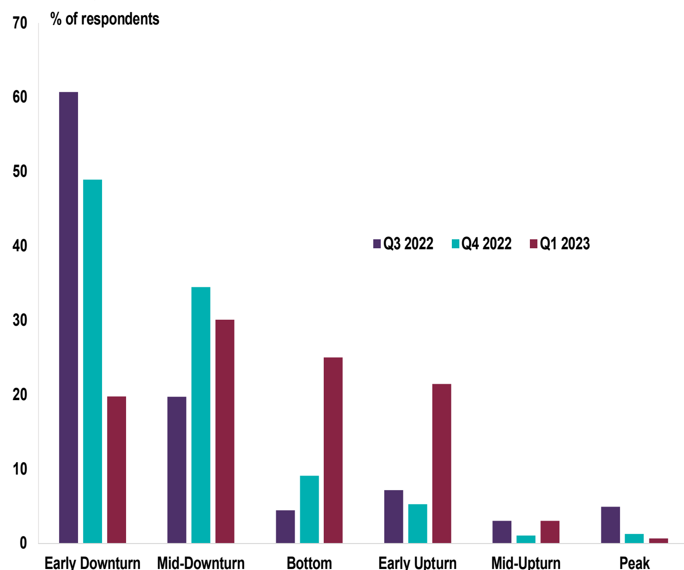
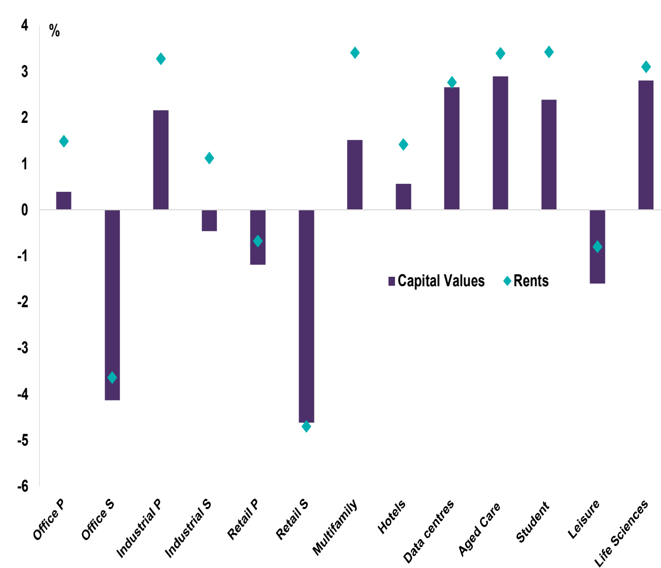


Chart 6: Respondents to the RICS Monitor show a preference for prime and alternatives in terms of 12 months expectations



Residential Property

Some signs are emerging of a more stable picture in the residential market. Charts 7 shows both a modest rise in new mortgage approvals in March as well a flatlining in actual completion numbers as reported by HMRC. The increase in the former at least in part likely reflects a fall in mortgage rates over the past few months, but, to provide some context, the March figure of 52,000 is still some way below the pre-pandemic average. Moreover, data from the RICS Residential Market Survey casts doubt as to whether the better trend in activity can be sustained, particularly given the little room for any further lowering in borrowing costs in the face of latest Bank of England action.

Significantly, the key new buyer enquiries metric actually slipped further back into negative territory in April, when captured on a seasonally adjusted basis (net balance of -37% as against -30% previously). Alongside this, as highlighted in Chart 8, the newly agreed sales indicator and the 3 months sales expectations series continue to send cautionary messages. However, there does appear to be a slightly more positive trend in the 12 months sales expectations series which has now, albeit only modestly, turned positive.

As far as pricing is concerned, all the main data sources continue to point to relatively modest falls to date. Chart 9 shows the RICS house price balance against the Nationwide index with a four month lead. Similar to the activity numbers, there are some early signs of a more stable trend coming through. That said, a key challenge remains one of affordability both in terms of the house price earnings metric and, increasingly, in terms of ongoing financing costs. As regards the former, the Q1 figure from Nationwide stands at 6.4, which is down from a recent high of 6.9 but remains well above the long run average of 4.7. For the latter, the most recent share of mortgage costs as a share of take home income reached 37% (its highest level since Q3 2008). Against this backdrop, a renewed discussion is beginning around how to improve access to the market including the launch of a no-deposit mortgages.

Meanwhile, the strength of the lettings markets shows no sign of abating, with demand remaining strong and supply still constrained. Indeed, respondents to the RICS survey continue to point to tax and regulatory changes as hampering supply. The result of this imbalance is that the RICS Rent Expectations series is not far off historic highs in net balance terms.

Chart 7: Bank of England and HMRC data suggest that residential transaction levels may now have bottomed

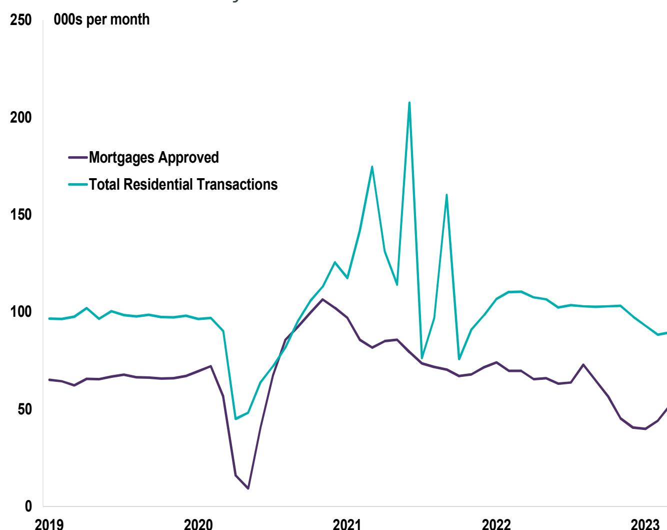


Chart 8: RICS data points to an improving trend in sales activity looking in 2024

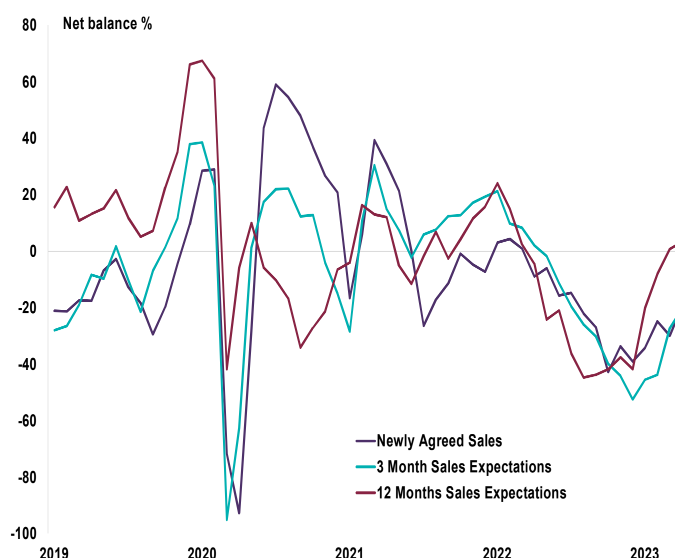
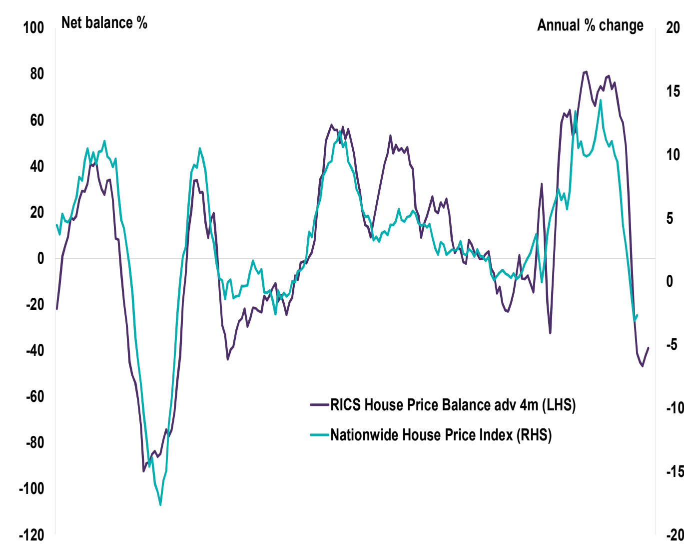


Chart 9: Price data from both the RICS (4 month lead) and Nationwide suggest the picture may also be steadying



Construction

The latest official data on construction activity points to a gently rising trend in output, despite the macro challenges, with total activity just over 6% above pre-pandemic levels (January 2020). Meanwhile, the Q1 RICS Construction Monitor also shows a modest improvement in workloads during the first three months of the year. Significantly, as Chart 10 highlights, this pattern is visible to a greater or less extent in all sub-sectors, with the notable exception of private residential which remains in negative territory. Unsurprisingly, infrastructure workloads continue to show the strongest momentum and, drilling down a little further, this picture is particularly marked in energy related areas.

Alongside this, forward looking metrics from the survey are also painting a more upbeat picture compared with the Q4 results. The net balance reading for infrastructure, looking out over the next twelve months, now stands at +31% as against +22% in the last iteration of the questionnaire. The comparable figures for private residential development are +9% as against -11%, while for private non-residential they are +15% versus -5%.

That said, meaningful challenges around both material costs as well as labour and skills continue to overhang the industry. Looking first at material costs, there is some good news with the year-on-year increase slowing to under 9% from a peak that approached 30%. Nevertheless, the direction of travel is still upwards, albeit more modestly. Moreover, the RICS Monitor still highlights significant concerns about this issue. At the same time, contributors to the survey remain particularly vexed by the scale of labour shortage in general and more pertinently, the difficulties in hiring skilled labour. Chart 11 shows something in the region of 80% of respondents viewing this as a factor hampering development plans.

Increasing concerns about financial constraints is another message that is evident in the survey, with the credit environment remaining tough. That said, the RICS metric designed to capture payment delays continues to rise only fairly modestly. The latest data on insolvencies in construction is captured in Chart 12. After a sharp increase in the early part of last year, the trend did look to have stabilised, however the March reading does represent a new high. The majority of contractors becoming insolvent have been the smaller specialist businesses where the vulnerability to fixed price contracts in the face of rising costs has been most acute.

Chart 10: The RICS Construction Monitor shows workloads rising to some extent in most sectors away from private housing

Chart 11: Labour shortages and skills in particular continue to be key areas of concern according to RICS respondents

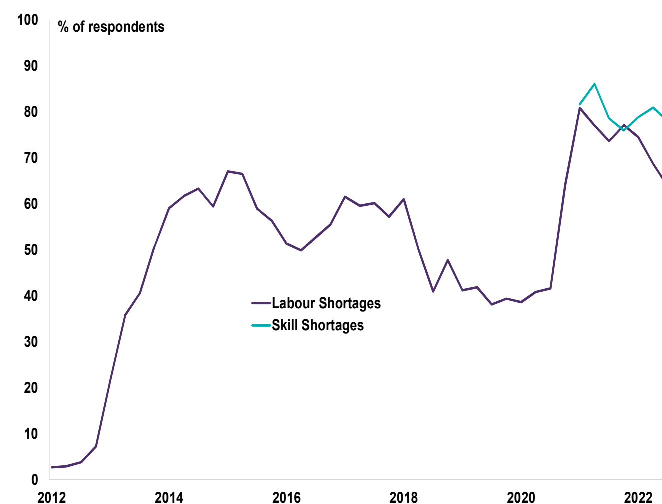
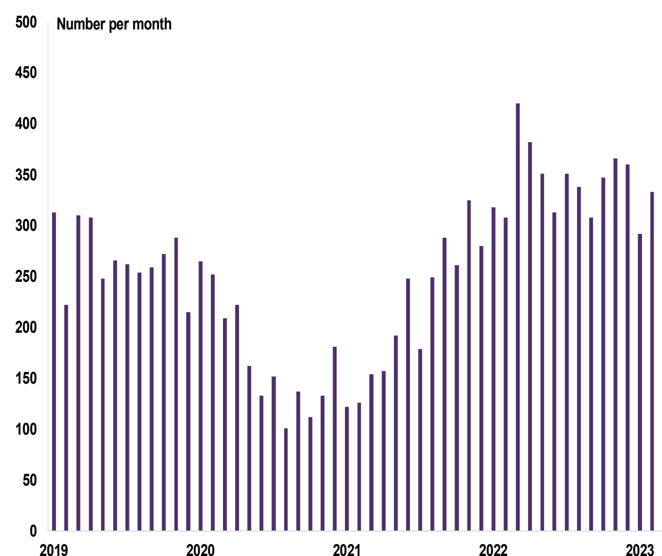


Chart 12: The number of insolvencies in the construction industry has increased by 6.5% over the past year



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