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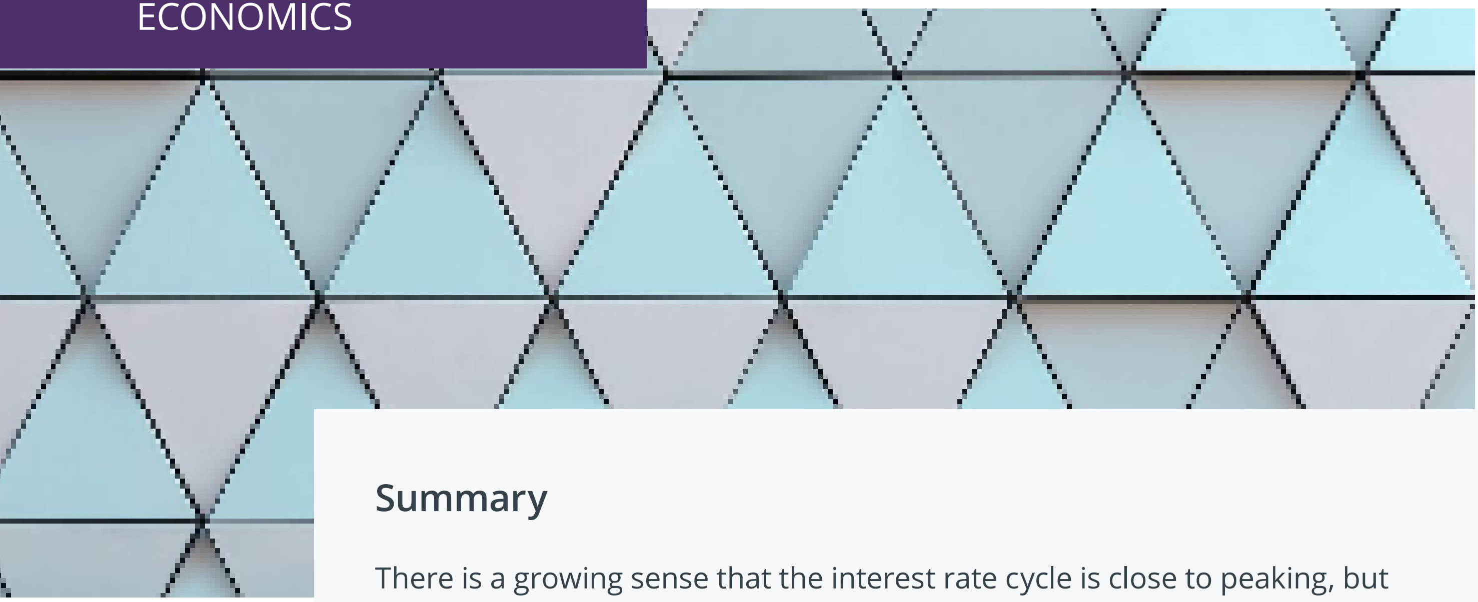
Economy and Property Market Update

February 2023

Light at the end of the tunnel ….but a little way to travel first

ECONOMICS



Summary

There is a growing sense that the interest rate cycle is close to peaking, but financial markets may be running a little ahead of themselves in envisaging an early reversal in the policy stance. The more challenging macro environment is clearly visible in both the commercial and residential sectors, with activity numbers slowing markedly. Meanwhile, infrastructure remains a key area of strength as other parts of the construction industry slow the development pipeline, albeit it only modestly.

Economy

The latest macro forecasts from the Bank of England were a little less gloomy than those released back in November; it now anticipates the economy shrinking by just over 0.5% through the course of 2023 which is not dissimilar to the updated projections from the IMF. This, in part, reflects a reassessment of the outlook for consumption in light of the ongoing strength in the labour market as well as the decline in wholesale energy prices (Chart 1). Alongside this, the Monetary Policy Report from the central bank maps out a relatively encouraging set of forecasts for inflation, projecting the headline rate falling from 10.5% now to 3.9% come the end of this year. By the end of 2024, inflation is expected to ease to 1.4% and to only 0.4% in 2025. That said, a note of a caution was provided in the minutes of the accompanying MPC meeting which firmly suggested that the 'risks to inflation are skewed significantly to the upside'. As an indication of this threat, the Banks own pay survey showed firms expect annual pay settlements to actually rise to 5.7% in 2023 from 5.2% in 2022.

Chart 2 puts the revised projected downturn for the economy in a historical context. Significantly, the profile now envisaged is much shallower than in previous recessions with output getting back to the earlier peak sooner than on those occasions. However, it is also noteworthy that concerns are increasing about the trend rate of growth the economy is capable of delivering going forward. Key reasons for this are the ongoing disappointing productivity performance and the weakness in labour participation. On the former, Chart 3 paints a dismal picture of the contribution of business investment which appeared to recover smartly from the Global Financial Crisis but then flatlined from around the middle of the last decade. Moreover, the impact of the 'investment super-deduction' (introduced by Rishi Sunak in April 2021 and ending in March) appears to have been relatively modest. Meanwhile, ill health and early retirement (amongst other things) appears to be squeezing labour supply.

Money markets have interpreted the signalling from the Bank in a very clear way; that base rates are at or very close to their peak. Indeed, there is even a suspicion that they could be heading down by the year end. Twelve month money is now available at less than 4% (the current base rate) which compares with around 4.75% as recently as December. The threat of domestic inflation pressures lingering for a little longer (as overall CPI inflation falls) may be a reason why these expectations prove too sanguine. Much attention will be paid to the Chancellor's forthcoming budget (March 15th) with Jeremy Hunt needing to balance the pressure to provide a boost for the economy (with the general election at most two years away) against maintaining the rebuilt economic credibility of the government after the turmoil of last autumn.

Chart 1: Wholesale gas prices (Henry Hub) have fallen sharply in recent months

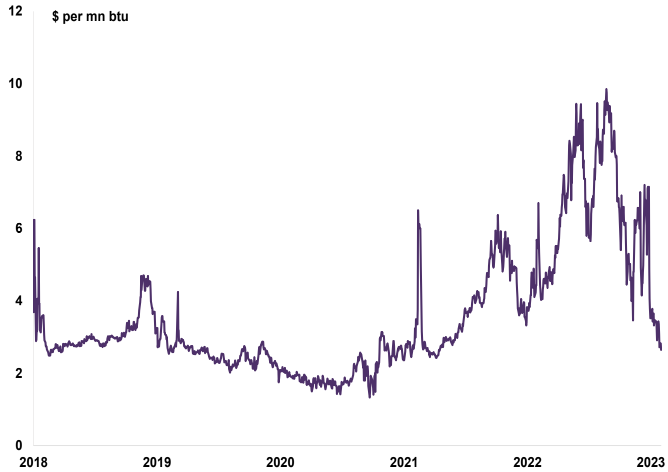


Chart 2: The current downturn in GDP will be shallower and shorter than past recessions

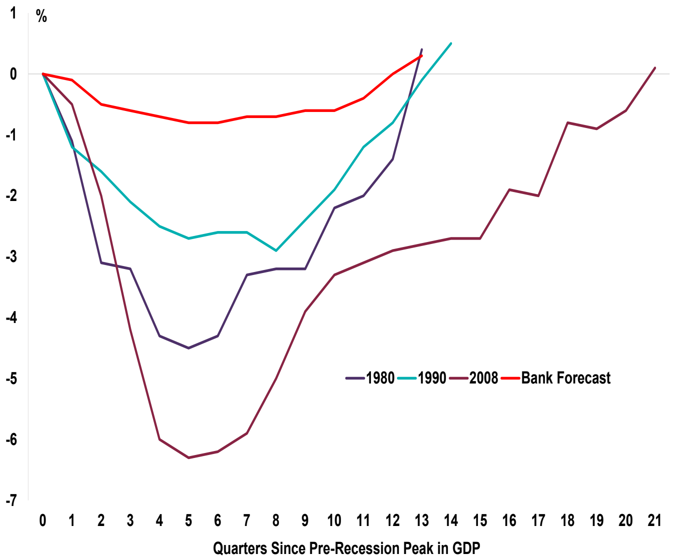
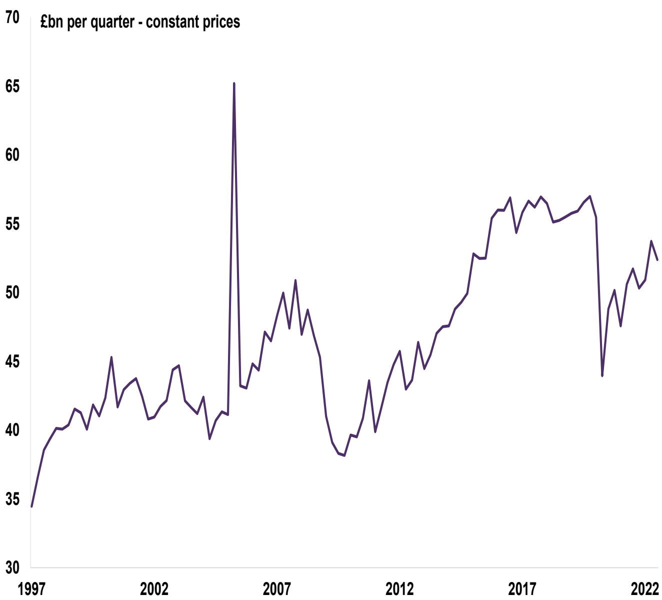


Chart 3: Business investment in real terms has failed to get back to pre-Covid levels despite the boost from the 'super-deduction'



Commercial Property

Activity in the commercial property market in the final quarter of 2022 was unsurprisingly hit by the turmoil unleashed following the 'mini-budget', with transaction volumes slumping to just £7.3bn according to Lambert Smith Hampton (Chart 4). This represents the lowest figure since Q2 2020. Significantly, LSH suggest that there were only ten deals in excess of £100m. In terms of sectors, it is offices that appear to have been most under pressure with sales of only £1.3bn during the period, close to the low recorded in the aftermath of the GFC.

This softer tone is also visible in feedback to the RICS Commercial Property Monitor, with the net balance metric for investment enquiries in Q4 slipping to -30%. Within this figure, the reading for both offices and retail continued to weaken (-39% and -48% respectively) and there was also a noticeable turnaround regarding industrials/logistics. In the first quarter of 2022, the net balance reading for investment enquiries in this sector stood near a historic high of +62% but it slipped to +7% in Q3 and turned negative in Q4 (-9%). This chimes with data showing that values in this sector have been scaled back aggressively in recent quarters; CBRE numbers point to a drop of some 20% between the second and fourth quarters of the year. Meanwhile, Chart 5 suggests that the pressure on prices is unlikely to abate just yet; the RICS investment enquiries reading has historically captured turning points in the market with a lead of a couple of quarters.

Looking out over the course of this year, RICS members' projections for both capital and rental values diverge quite markedly by sector (Chart 6). Student housing, aged care facilities, data centres, prime industrial and multifamily are seen as likely to deliver the strongest (or most resilient) performances. Life Sciences is another segment of the market viewed as having a positive outlook; indeed, a recent survey by the British Property Federation put it at the top of the list in terms of returns likely to be delivered over the next twelve months. Significantly, according to the RICS Monitor, the occupier market is generally anticipated to continue to show greater strength than the investment market (as has been the case in recent quarters) helped by the somewhat less negative economic outlook discussed previously. This is highlighted by stronger expectations for rental than capital growth (or more modest drops) in all sectors included in the survey.

Chart 4: UK Commercial Property investment volumes fell sharply in Q4 (data from Lambert Smith Hampton)

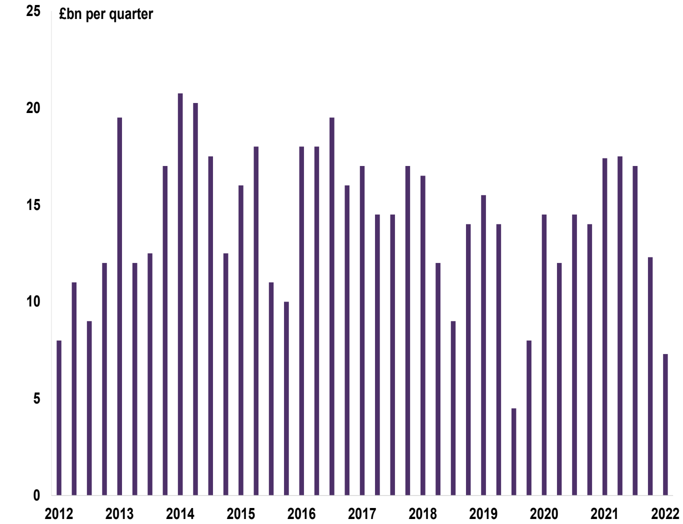


Chart 5: The RICS Investment Enquiries metric suggests pricing will remain under pressure over the coming quarters

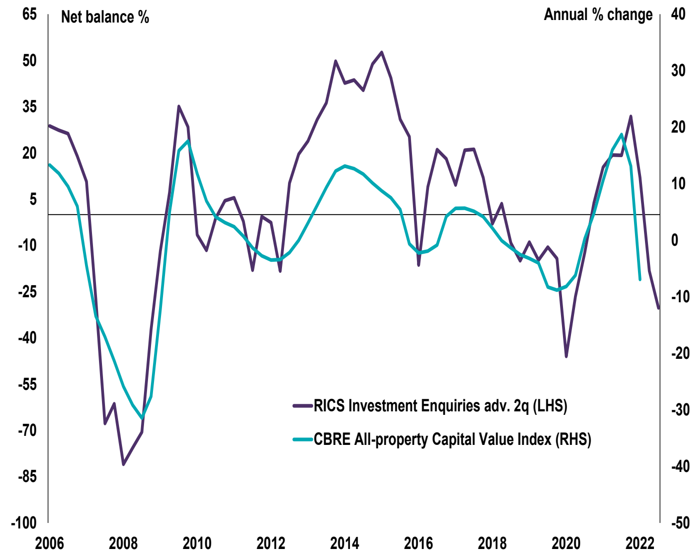
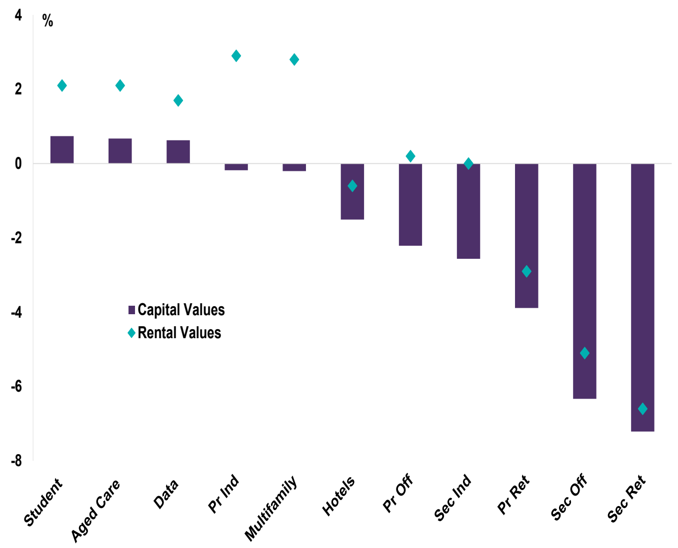


Chart 6: Respondents to the RICS Monitor show a preference for alternatives over the next year in terms of expectations



Residential Property

The latest data tracking the number of mortgages being approved by lenders shows a further sharp drop, with the December figure of 35,600 the lowest since January 2009 (excluding the pandemic period). As recently as the third quarter of last year, mortgage activity for new homes was running close to double that number. For now, actual transactions data is displaying a good deal more resilience, with the December figure of close to 102k little different from where it was in Q3. This has fuelled some speculation that cash buyers may be playing a bigger role in the market. While there may be something in this, we are not wholly convinced. First, it would be reasonable to see a significant lag between a trend emerging in mortgage lending data and it being visible in HMRC (or Land Registry) transactions. Second, Chart 7 highlights the strong relationship between the RICS newly agreed sales net balance and the HMRC data (year-on-year change); it suggests that the latter will weaken sharply during the first half of this year.

Meanwhile, most, but not all, measures of house prices indicate that they are now falling. The Nationwide and Halifax indices, which are based on mortgage approvals, show falls of 3.2% and 4.3% respectively since August and the Rightmove index signals a drop in asking prices of 2.3% from its peak. By way of contrast, the official index has merely plateaued but not only does this come out somewhat later (the latest ONS data is still for November) but, as with HMRC, it is based on completions. Chart 8 shows the RICS price balance metric, advanced by six months, is a reliable lead indicator of the official house price dataset. That said, we remain of the view that the extent of the decline in residential prices will be relatively modest thanks, in part, to the ongoing strength of the employment picture which will limit the fallout from potential distressed sales. Also, recent moves in the bond market point to a modest downward repricing of mortgage finance.

The latest RICS lettings data (Chart 9) continues to highlight the imbalance between demand and supply and the impact this is having on expectations for further rental growth. The latest Zoopla data puts annual rental growth as still in excess of 12% nationally although they do see this slowing to the 4 to 5% area by year end (on the back of stretched affordability). Respondents to the most recent RICS survey envisage Build to Rent only making a modest contribution to filling the shortfall in the supply of rental property, with just 8% suggesting it will play a significant role.

Chart 7: The RICS agreed sales balance suggests data on completed transactions will drop sharply over the coming months

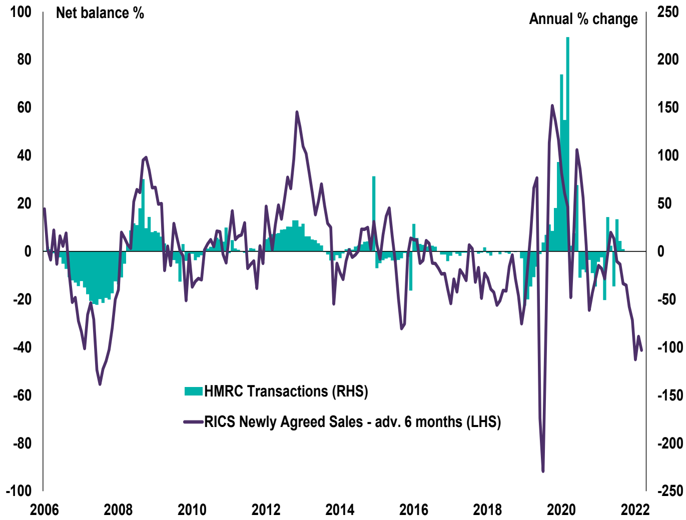


Chart 8: The headline RICS price measure indicates that the official house price series will follow other indices lower

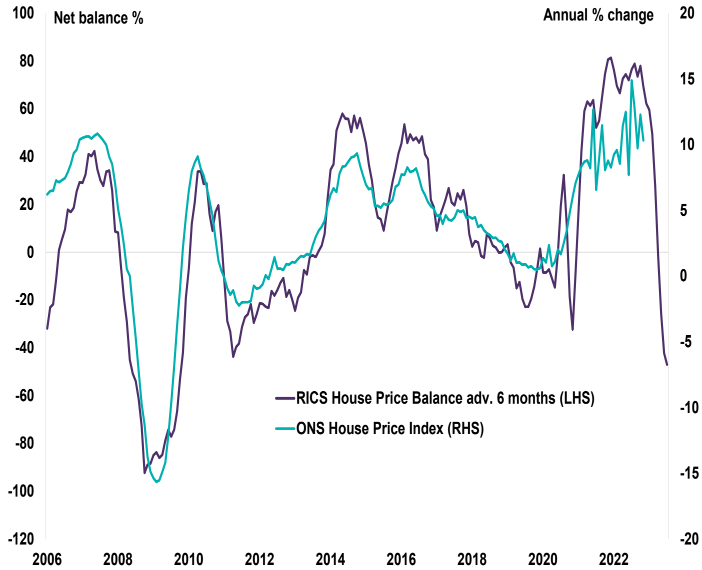
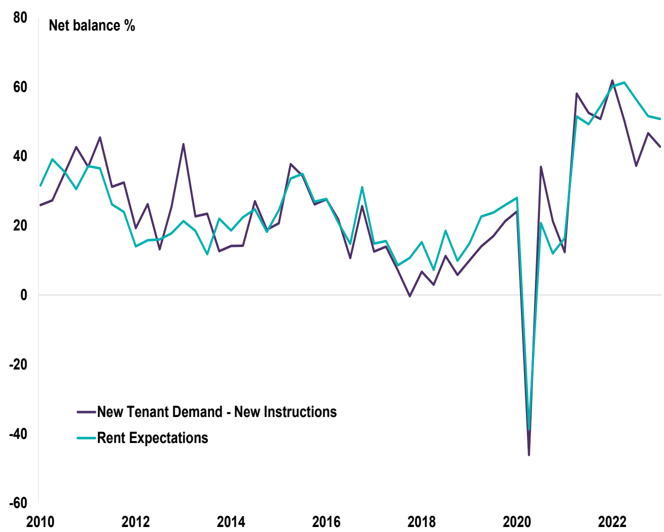


Chart 9: RICS lettings data show demand continuing to exceed supply and rent expectations still very strong



Construction

Official data on construction activity points to a broadly flat trend during the second half of last year, leaving total output just over 2% higher than pre-pandemic levels (January 2020). The RICS headline workloads metric, which is captured in net balance terms, tells a broadly similar story with the latest reading standing at -1%. This stable picture does, however, mask significantly divergent trends at a sector level. While the feedback around infrastructure remains generally upbeat (net balance of +22% against +32% in Q3), the shift in the mood music around the housing market is beginning to manifest itself in the private residential workloads indicator (-13% compared with +17% previously).

Looking forward, a broadly similar trend is expected to persist as highlighted in Chart 10. Further growth in infrastructure workloads will be supported by ongoing commitments to HS2 and Hinkley Point C amongst other projects. Meanwhile, recent trading statements from the major housebuilders suggests a modest scaling back in completions. Reflecting all of this, the latest forecast from the Construction Products Association suggests that total output will decline by close to 5% this year even with a rise in infrastructure output of between 2 and 3%. Issues around recruitment remain significant for the sector, even with the prospect of a more subdued year for workloads (Chart 11). The RICS Monitor shows a net balance of +15% of respondents anticipating increasing employment over the next twelve months, although it is worth noting this is the lowest positive reading since Q3 2020. Shortages remain pretty consistent across the 'trades' with more than 50% of respondents referencing challenges regarding hiring. Meanwhile, the story is not dissimilar when it comes to quantity surveyors and other professional.

Increasing concerns about financial constraints alongside the suspicion that profit margins will continue to be squeezed (net balance -26% vs -23% in Q3 and -14% in Q2) is also captured in the RICS Monitor. Against this backdrop, it is perhaps unsurprising that the underlying trend is one of rising corporate insolvencies in the sector; the latest data shows a year-on-year increase of 11%. The bulk of the insolvencies are amongst specialist contractors (around three-fifths), many of them smaller businesses who will have been working on fixed price contracts. The decline in output away from infrastructure suggests that the peak for this cycle has yet to be reached. Predictably, a relatively small share of the total number of insolvencies is amongst civil engineering businesses.

Chart 10: The RICS Construction Monitor suggests infrastructure will be the only area seeing workloads grow over the next year

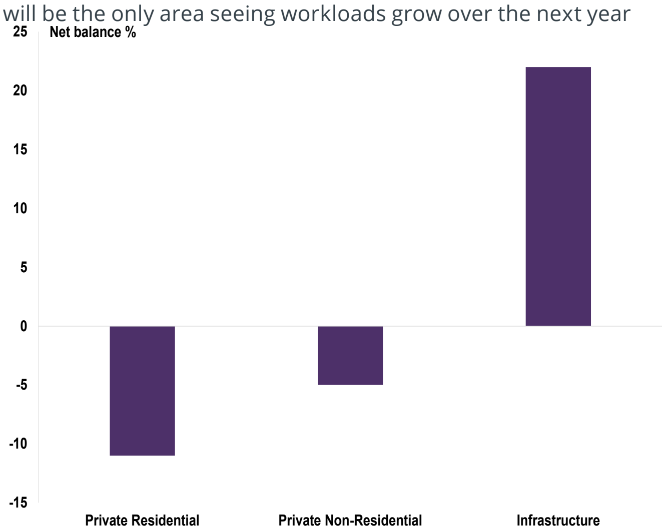


Chart 11: The RICS Construction Monitor continues to point to labour, material and finance issues as obstacles to development

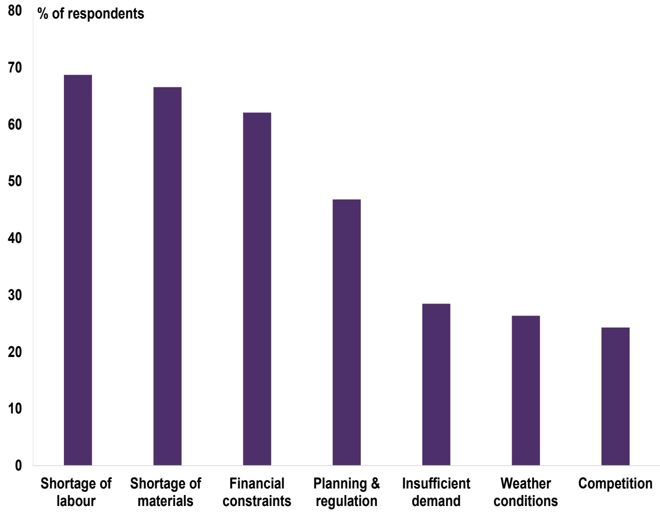
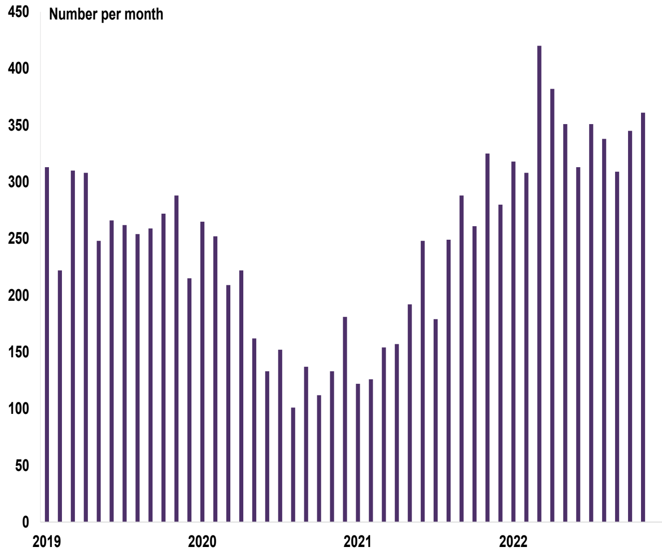


Chart 12: The number of insolvencies in the construction industry has increased by 11% over the past year



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