RICS

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Economy and Property Market Update

November 2023

Economy to remain slugglish but no interest rate cuts in prospect for a while to come

ECONOMICS

Summary

Inflation, despite falling back from recent highs, remains well above the 2% target, with the Bank of England recently turning a little more pessimistic on its near term trajectory. As a result, interest rates look set to remain on hold for a prolonged period, notwithstanding the weak economy. Against this backdrop, construction output is likely to continue to stagnate into 2024 while activity in both the residential and commercial property markets remains subdued.

Economy

Although interest rates may now have peaked, the Bank of England is clearly intent on avoiding fuelling any speculation that a reversal in their stance on monetary policy is likely any time soon. At the (most recent) early November meeting, the guidance from the Monetary Policy Committee was surprisingly hawkish, with the central message being that policy will remain restrictive 'for an extended period of time'. One element of this approach is a likely desire to avoid a loosening in (market-led) financial conditions which could undermine the fight to reduce inflation.

Significantly, the forecasts from the Bank were more pessimistic than previously. The weaker near-term outlook for activity is reflected in the downgrade to GDP projections for next year, with the economy seen as stagnating before only likely growing by a minimal 0.25% in 2025 (Chart 1). Both of these numbers are at the lower end of the range of other forecasts in the market. Indeed, the IMF, while not anticipating a strong performance, recently pencilled in growth of 0.6% for next year. For inflation, the updated Bank of England analysis points to a raised set of projections; the forecast for final three months of next year is 0.6ppts higher than it had expected in August.

The difficult balancing act the Bank is trying to perform is reflected in the gradual shift in the labour market (Chart 2). A sharp drop in the number of available vacancies and the modest rise in the number of people registered unemployed is indicative of how the sluggish economy is gradually translating into other indicators. And, critically, there are some signs that this is feeding through into an easing in wage growth. Meanwhile, corporate insolvencies are on the rise. In the third quarter, just over 6,200 businesses went bankrupt which, while slightly lower than the Q2 number, was still more than 10% higher than in the same period of 2022.

Chart 3 tracks the shift in interest rate expectations since the end of September. Three points are worth making; first, the more gloomy message from the Bank on the economy has pushed the curve a little lower looking out over the next five years. Second, even allowing for this, there is no sense that a cut in interest rates is likely to be sanctioned much before the middle of next year. And third, the medium-term outlook is likely to be one in which interest rates remain elevated compared with the post GFC environment; since the beginning of 2009, the average level of base rates has been less than 1%.

Chart 1: Bank of England growth forecasts are at the bottom of the range of projections

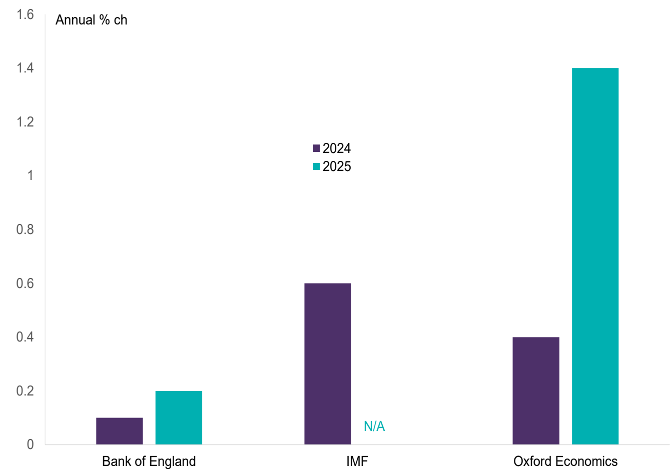


Chart 2: The picture in the labour market is gradually shifting in response to the sluggish economy

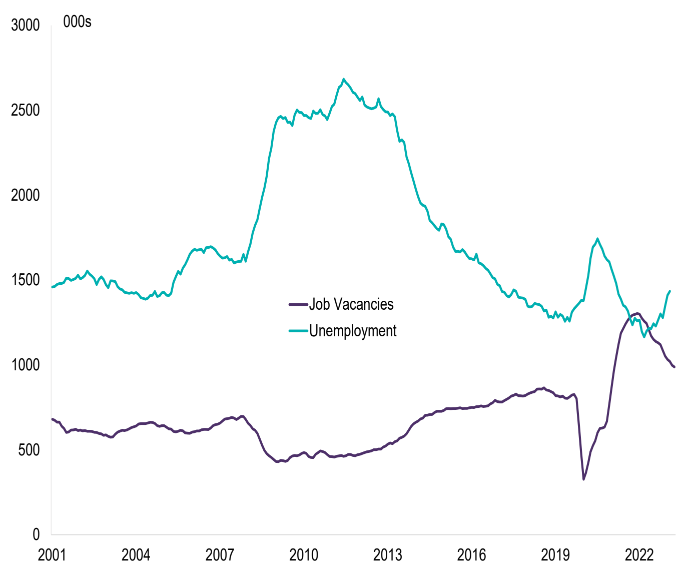
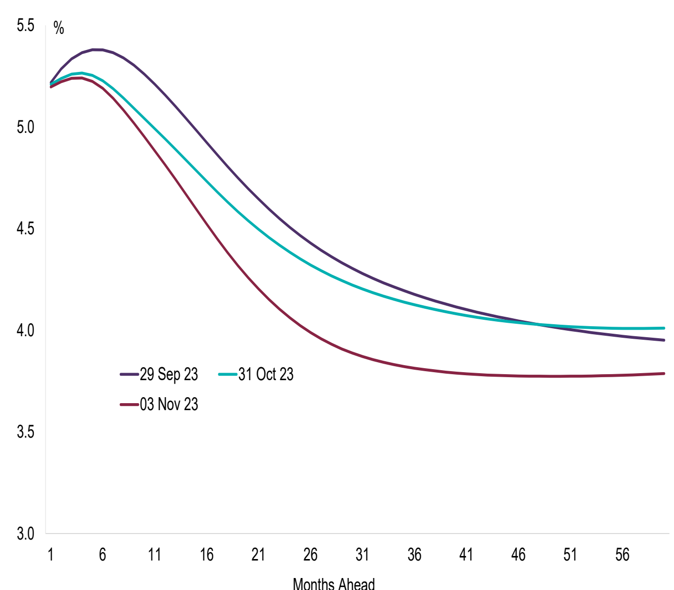


Chart 3: Interest rate expectations have eased a little but remain elevated



Commercial Property

Transaction activity remained soft in the third quarter, with data from Lambert Smith Hampton suggesting that only £7.9bn of UK property assets changed hands during the period (Chart 4). This was 8% down on Q2's already weak outturn, 35% below the five-year quarterly average, and the lowest since the pandemic impacted period of Q2 2020. However, one slightly more positive aspect to the data was a pick-up in the actual number of transactions which rebounded 25% on the second quarter outturn. Interestingly, of the main sectors, retail volumes appeared the most resilient in Q3, hitting a five-year high of £1.9bn, while offices remain under greatest pressure.

Despite this, yield data from CBRE suggests a turnaround in the retail sector has yet to begin in earnest. At a headline level, the equivalent yield is continuing to drift upwards and now stands at 7.2% which compares with just over 6.5% at the beginning of the year. For offices, the comparable numbers also point to a rise in yields of around 75bps, although the picture appears more resilient in central London.

Meanwhile, the story emerging from the latest RICS Commercial Property Monitor is also fairly downbeat. Chart 5 captures the investor demand metric in net balance terms for the three main CRE sectors, looking back to the start of 2022. The negative picture for retail (in general) still appears very visible but the turnaround in office demand as well as the flattening trend in the appetite to acquire industrial space is also visible. This broad pattern is also replicated in the indicator designed to measure changes in the availability of real estate for sale. Meanwhile, close to 60% of respondents to the latest survey suggest the CRE market at an aggregated level is in a downturn phase of the cycle, with a further 25% believing it to be at the bottom of the cycle; the figures from the Q2 survey were 68% and 15% respectively.

Chart 6 shows the projected capital gains for different asset classes from respondents to the survey. Predictably, it is the non-traditional areas of the market which are seen as likely to deliver the strongest returns. Sectors such as aged care facilities, student housing, life sciences and data centres are all in this category and, interestingly, the twelve-month projections have been upgraded in each instance compared to the Q2 results. By way of contrast, capital values across the leisure sector are anticipated to come under downward pressure. The same is also true for secondary office and retail.

Chart 4: Lambert Smith Hampton data shows investment numbers remained soft in Q3

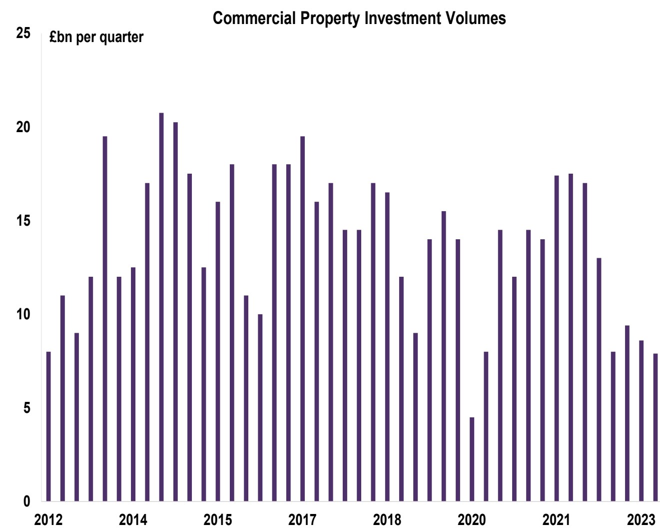


Chart 5: The RICS Commercial Monitor shows that investment enquiries remain soft particularly for offices and retail

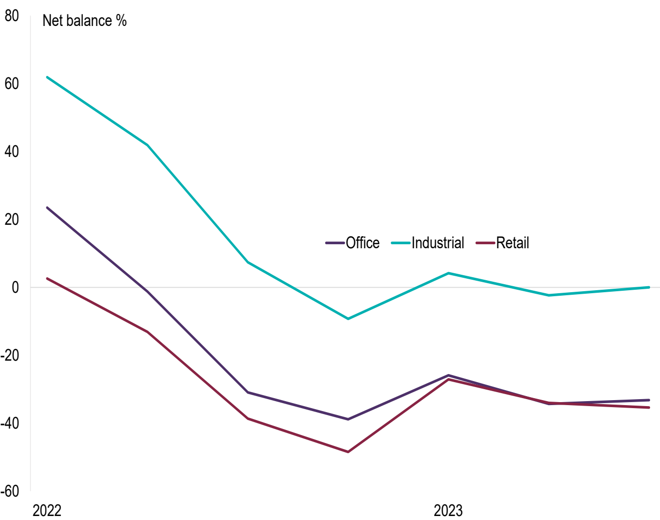
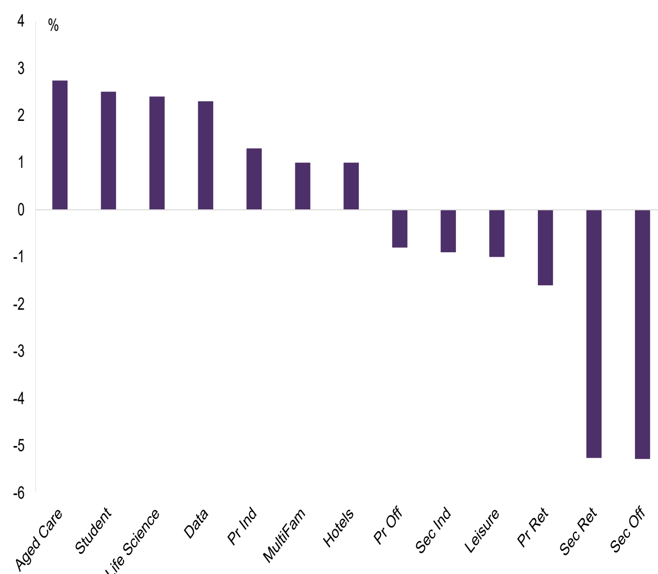


Chart 6: Capital value expectations for the next 12 months according to respondents to the RICS Monitor



Residential Property

The latest activity numbers from the residential market continue to trend downwards. Mortgage approvals in the most recent release stand at just over 43,000 which is the lowest figure since the start of the year. And, while the more complete HMRC data for residential transactions shows a small improvement compared to the spring, it is still consistent with an annual run rate below the one million mark (compared to 1.27m last year). Even so, the October RICS Residential Market Survey does provide some reason for concluding that the bottom is not far off (Chart 7). The key New Buyer Enquiries metric is still in negative territory (in net balance terms) but less so than previously. The -28% number as against -37% is actually the best read since May. This pattern is also evident in other indicators. The Newly Agreed Sales result of -25% compares with -35% in September, while three month Sales Expectations stands at -20% v -22%.

Price related datasets continue to display a greater degree of resilience, at least for now. Indeed, the latest reports from both the Nationwide Building Society and Halifax actually suggest that prices rose by around one per cent in October. This means that house prices (on the Nationwide measure) are now just 4.6% below their summer 2022 peak (5.4% previously). Chart 8 suggests that notwithstanding the stronger result last month, the pressure on the market is not yet about to abate. The headline RICS Price Balance is -63% as against -67% in each of the previous two months. And the twelve-month Price Expectations metric still remains deeply in negative territory at -43%. However, constrained supply, supportive labour market conditions, and generous lender forbearance may be factors that limit the downside from here.

Meanwhile, the October RICS data provides the first sign that rental demand may be slowing in the face of elevated rental costs. Now to be clear, the net balance of +33% (on a seasonally adjusted basis) is still consistent with tenant demand growing strongly but as Chart 9 highlights, this is lowest number since the early part of 2021. Alongside this, landlord instructions fell at a slower pace in the latest survey, suggesting a narrowing in the gap between fresh demand and supply. That said, the Rental Expectations indicator remains firmly in positive territory (+53% v +61% last quarter. The latest forecast from Zoopla shows rental growth slowing from 9% this year to 5-6% in 2024.

Chart 7: The RICS New Buyer Enquiries series is pointing to a more stable trend in transaction activity

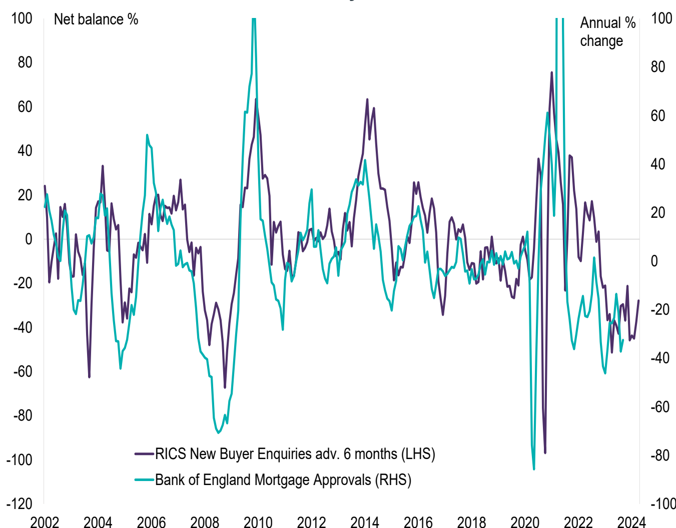


Chart 8: The RICS House Price Balance is still pointing to further price weakness over the coming months

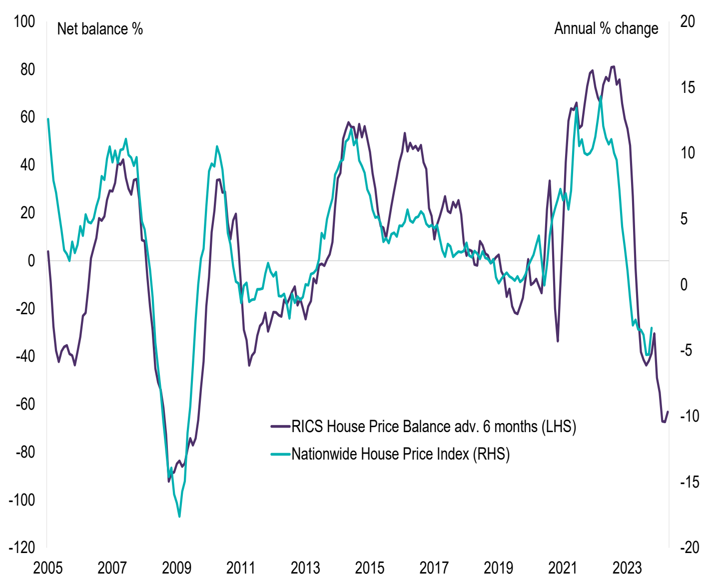
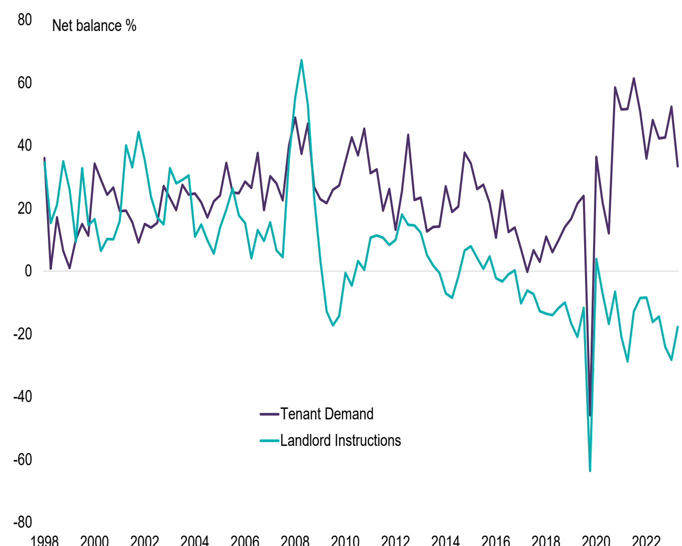


Chart 9: The growth in tenant demand using the RICS metric is still strong but less so than previously



Construction

Although official data shows construction output being broadly flat in recent months, it still remains just over 2% higher than a year ago. This trend is also captured in the Q3 RICS Construction Monitor which reports the net balance of respondents indicating a drop in workloads slipping from -1% to -10% over the past three months. Significantly, the feedback from respondents to the survey demonstrates increasing pressure on private residential development as housebuilders slow the pace of work in response to a drop in site visits and reservations (net balance -26%). The contrast to this downbeat picture is the more resilient insight being received regarding infrastructure, albeit that even the positive number for the latter is less so than in Q2. Perhaps unsurprisingly against this backdrop, the Construction Products Association are forecasting little change in the overall volume of output over the course of 2024, with new work slightly down and repair and maintenance slightly higher (Chart 10).

Financial constraints are now viewed as the major challenge for the industry, a point highlighted in Chart 11. This, in part, reflects the feedback from a net balance of 38% of respondents that saw a further worsening in credit conditions over the last quarter (following the 42% reading in Q2). Labour supply is still seen as an important issue but the contrast with a year ago (when it and material shortages were the most cited factors hampering activity) is significant.

The skill deficiency is still fairly broadly based but, for the time being, appears more marked in so called 'white-collar' areas, with roughly half of respondents identifying difficulties in recruiting quantity surveyors. The demographic challenge of an ageing workforce points to the skills issue becoming even more potent as the industry gradually begins to gain some renewed traction. Meanwhile, official data on building material costs shows the headline index to have fallen by almost 2% over the past twelve months. However, the level of material prices still remains elevated, some 40% higher than in January 2020.

Inevitably in an environment when corporate cashflows are under pressure, the results to the questions around investment intentions have continued to soften, although they are still pointing to an increase, rather than a decrease, in spend as demonstrated in Chart 12. But, one consequence of this shift is that only around one-third of respondents anticipate an increase in productivity over the course of the next year.

Chart 10: Forecasts for construction output from the Construction Products Association points to a flat picture in 2024

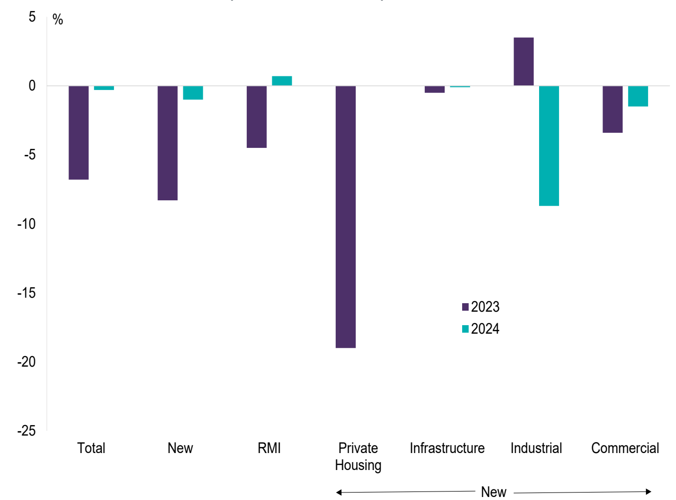


Chart 11: The latest RICS Monitor shows financial challenges as the biggest issue for the construction industry at present

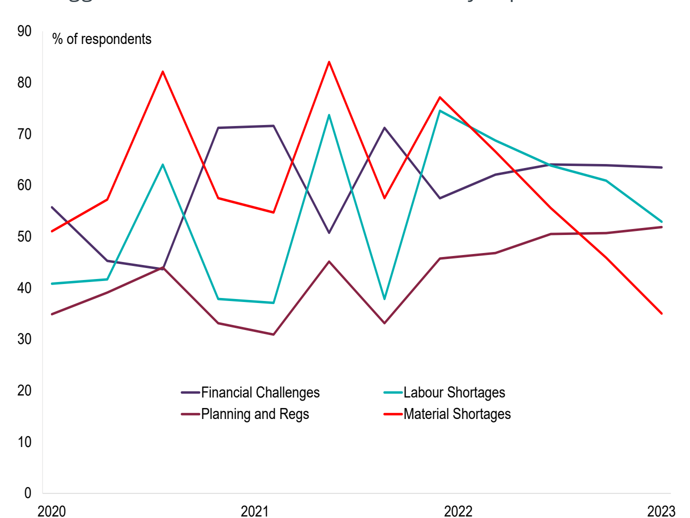


Chart 12: Feedback from the survey continues to point to a focus on investment in workplace development and training

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