RICS

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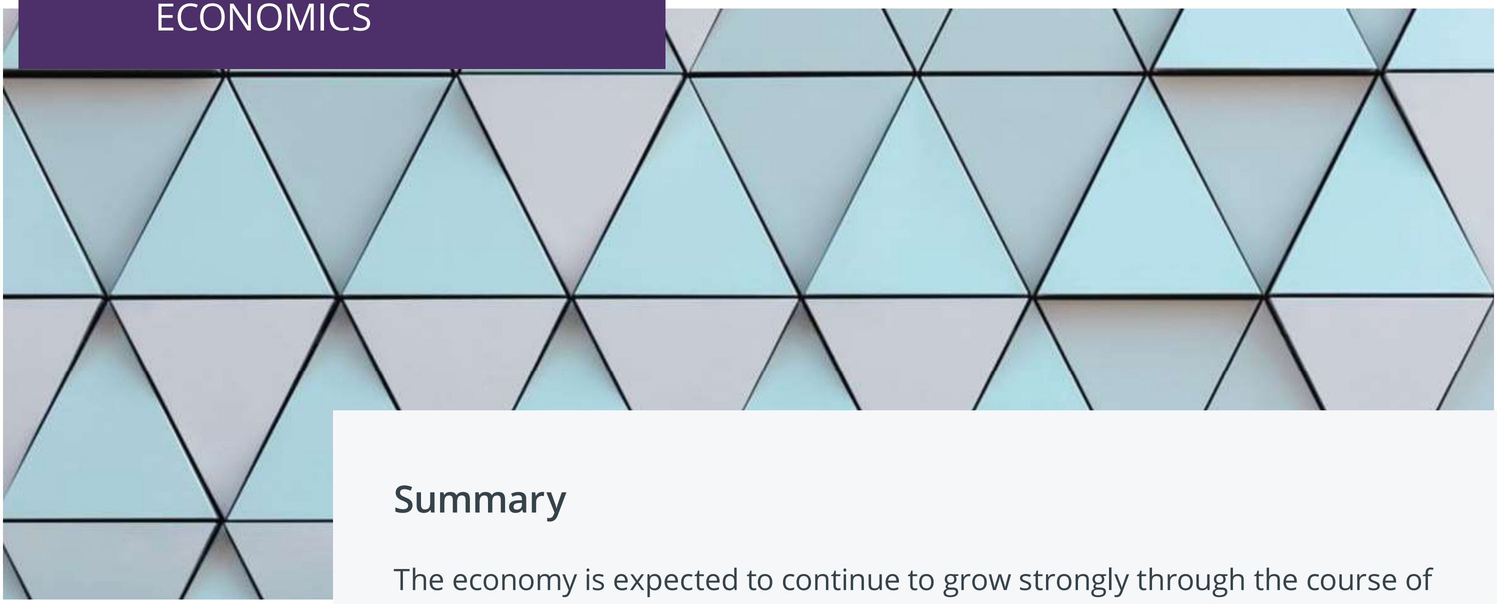
Economy and Property Market Update

August 2021

Stronger economy underpinning better tone to both construction and real estate

ECONOMICS



Summary

The economy is expected to continue to grow strongly through the course of this year and next. Higher inflation becoming embedded in expectations is the key risk, but for now, markets and the Bank of England remain relatively sanguine. Construction activity is benefiting from a number of big infrastructure projects and the strength of the housing market. Meanwhile, sentiment towards commercial real estate is improving but there remains a significant divergence in performance between highly prized industrial units and out of favour retail.

Economy

Although there has been some loss of momentum in a number of high frequency macro indicators over the past month, the broader outlook appears little changed. Significantly, the Bank of England left its projection for economic growth for this year at 7.25% in its August Monetary Policy Report and actually made a small upgrade to the 2022 projection to 6%.

The consumer is widely expected to play a key role in supporting economic activity over the remainder of this year as households run down savings balances accumulated during the course of lockdowns. However, the macro picture is likely to be more balanced in 2022 as companies take advantage of the temporary tax credit announced in the Budget to accelerate their investment programmes. Significantly, a growing proportion of Chief Financial Officers captured in the Deloitte quarterly survey (Chart 1) believe that it is currently a good time to take risk onto balance sheets.

Perhaps unsurprisingly given recent inflation indicators (highlighted in Chart 2), the Bank of England has acknowledged that its previous projection for consumer prices was too sanguine. Its last forecast (three months ago) envisaged a peak for inflation at 2.5% but it has now revised this to 4%. Despite the upgrade, it continues to take the view that inflation will gradually return to the 2% target within the forecast period; the headline rate is expected to peak in the first quarter of next year.

Energy prices are currently playing a critical role in pushing up the inflation rate but over the medium term, a bigger risk lies with growing evidence of labour shortages in key sectors which might drive wage rates upwards. A key point will be the closure of the furlough scheme (end of September) and what this means in terms of job losses with the unemployment rate currently standing at 4.8% (way down on expectations earlier in the pandemic). The risk is that higher inflation gradually becomes more embedded in expectations.

Some ‘modest tightening’ in monetary policy is likely according to the Bank of England but the gilt market appears to be comfortable that this will be of relatively limited magnitude; Chart 3 shows that yields have retraced some of the increases seen in the early part of the year despite the newsflow around inflation. Alongside this, the signal from the Bank is that the quantitative easing programme will in all probability run its course through till the end of the year.

Chart 1: The Deloitte CFO survey shows an increasing appetite from business to take risk onto balance sheets

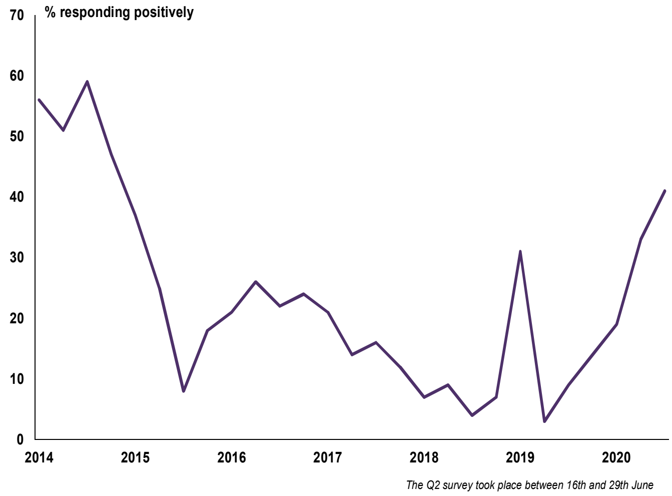


Chart 2: Measures of inflation have picked-up sharply over recent months

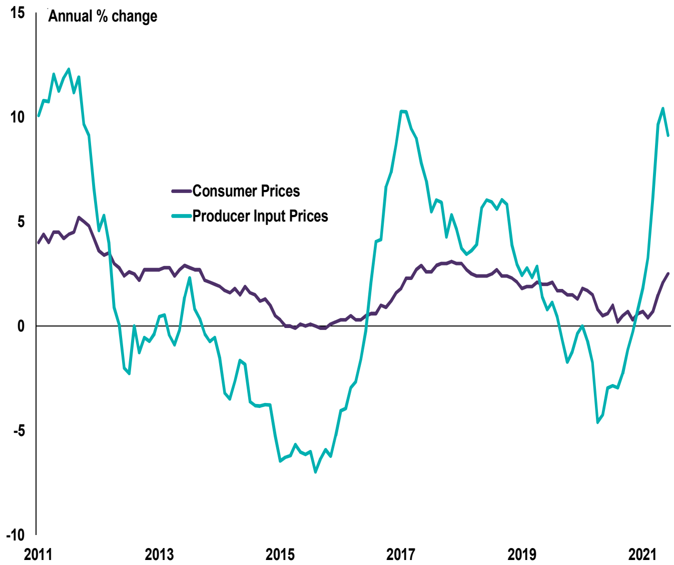
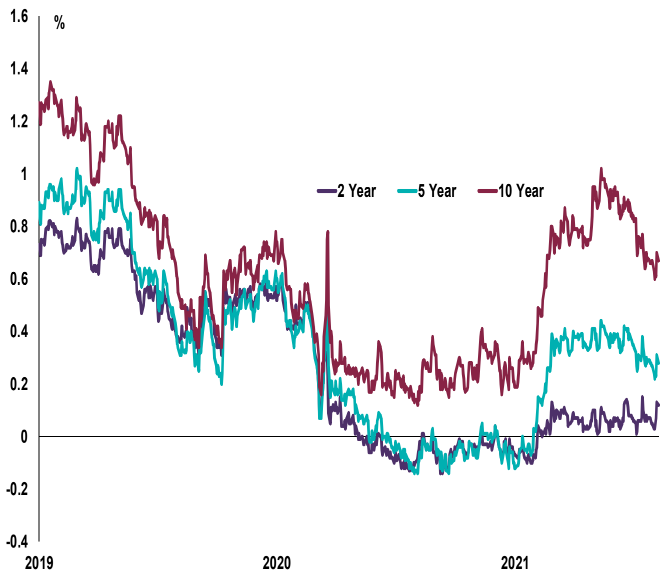


Chart 3: The gilt market, particularly for longer maturities, has recovered some of its earlier losses despite the rise in inflation



Commercial Property

The improvement in the macro picture as the economy reopens is now feeding through both into sentiment and hard data when it comes to commercial real estate. The Q2 RICS Commercial Property Monitor recorded a net balance reading of +16% for the headline tenant demand indicator (compared with -5% in the previous quarter). Similarly, the aggregated RICS Investment Enquiries metric climbed from +4% to +15%. Chart 4 provides some historic perspective on this improvement in the feedback received from RICS members.

CBRE data provides a broadly comparable message with both the all-property rental index and the capital value index picking up to a greater or lesser extent; the latter has seen a stronger rebound but it is still 8% away from its 2018 high. That said, divergent sector trends continue to be hugely significant beneath the headline numbers.

Chart 5 shows the RICS (3 month) retail rent expectation series measured against CBRE hard data (with the former advanced four quarters). Both have improved somewhat over the latest quarter with the CBRE indicator picking up sooner than might have been anticipated from past experience (albeit still declining on a year on year comparison). Significantly, the twelve month point estimate projections collated as part of the RICS survey still imply significant pressure on secondary retail rents and provide only a small amount of comfort for even the prime segment of the market.

Expectations over the next year amongst survey respondents are strongest, predictably, in industrials, followed by data centres, aged care facilities and multifamily. Savills have noted that industrial take-up was the second highest on record at 25.1m sq. ft. in H1, only slightly down on the peak of 28.1m sq. ft. in H2 2020 and that, as a result, the vacancy rate in this sector has slipped to a new low of 4.4%.

Investor interest in the capital has picked up in Q2 according to the RICS indicators (London has been a little slower in the recovery than other parts of the country) with the improvement being most evident in offices. In another sign of the improving mood, a growing share of respondents now view the market to be in the upturn phase of the cycle. Chart 6 shows the share taking this view has climbed to around 60% with a significant decline in those seeing the market in a downturn or bottom phase.

Chart 4: RICS indicators demonstrate the improvement in both tenant demand and investor enquiries

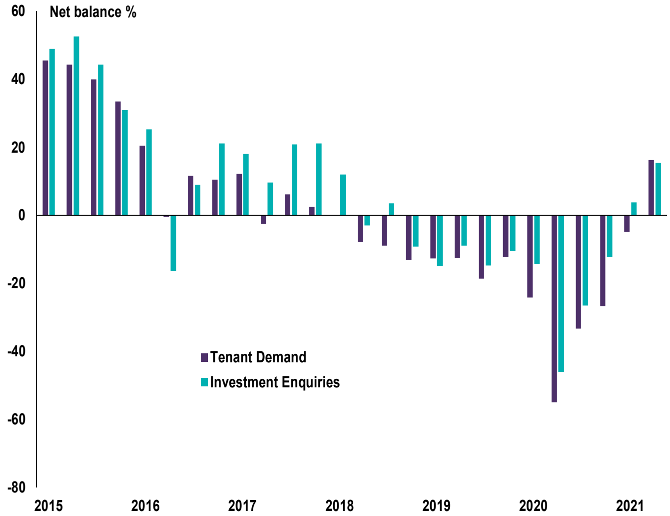


Chart 5: The picture regarding retail remains downbeat albeit a little less so than previously

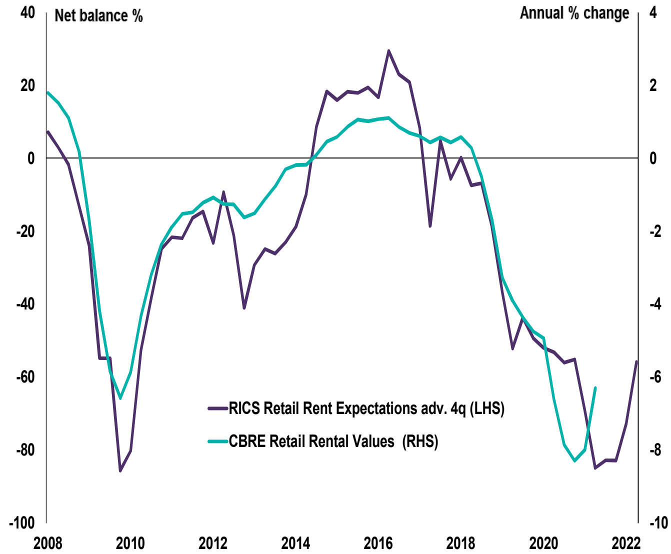
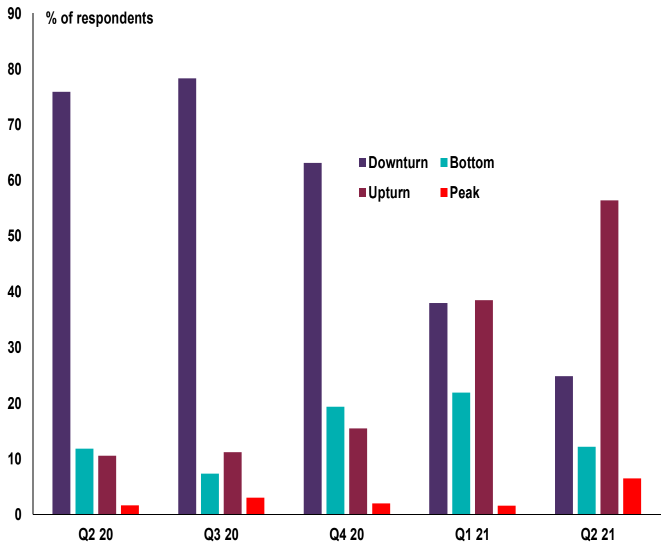


Chart 6: The shift in mood is clearly visible the rising share of respondents who view the market to now be in an upturn phase



Residential Property

The number of monthly property transactions jumped to a record high of 198,240 in June ahead of the tapering of the stamp duty break. To put this in some perspective, the average monthly volume of sales (HMRC seasonally adjusted) over the past sixteen years has been a little under 100,000. Aside from the 183,830 transactions registered in March of this year, the previous high was 149,510 in December 2006. The latest (July) RICS Residential Market Survey suggests activity may slow a little over the coming months but the new buyer enquiries indicator is, at this point, only slightly down on where it was previously.

The imbalance between demand and supply remains a feature of both the sales and lettings markets and continues to underpin current prices and rents, while also fuelling expectations about the direction of travel. The RICS indicator for new sales instructions to agents has now been in negative territory for six out of the last seven months after turning positive through 2020. Chart 7 tracks the headline RICS Price Balance metric against the Land Registry measure of house prices with a six month lead while Chart 8 shows the RICS Rent Expectations series with the ONS Private Rent Index (four quarter lead). In both cases, the RICS indicator is actually pointing to further increases over the coming months and this is also evident in the twelve months expectations data collected through the survey.

The challenge around the rental market is, if anything, viewed as more problematic with feedback pointing to both tax changes and the regulatory environment as disincentives to landlords expanding portfolios. Significantly, rent expectations are now strongly positive in all parts of the country having been a little softer in London during the height of the pandemic.

Another theme that is clearly visible in the sales market is the outperformance of housing higher up the price range. Rightmove data (Chart 9) shows that over the past year, properties seen as being at 'the top of the ladder' have registered increases in 'ask' prices of more than double those targeted at first time buyers. This trend is also evident in the RICS dataset with price expectations at both the twelve month and five year time horizons stronger for three and four bedroomed homes than for smaller properties.

Chart 7: RICS sentiment data suggests house price inflation will remain elevated over the coming months

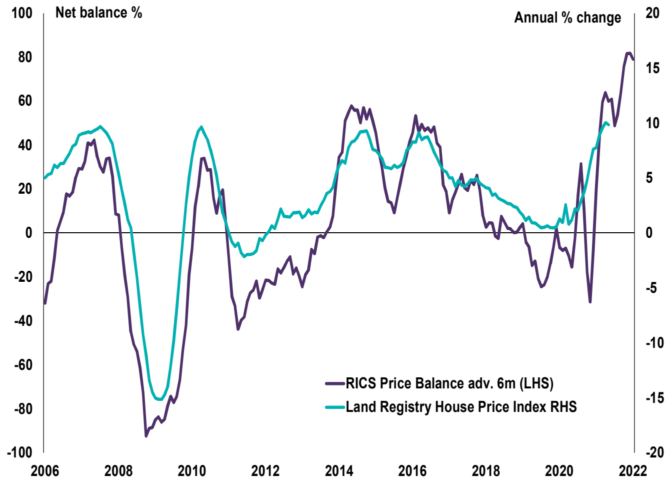


Chart 8: RICS sentiment data is pointing to a sharp acceleration in private rents

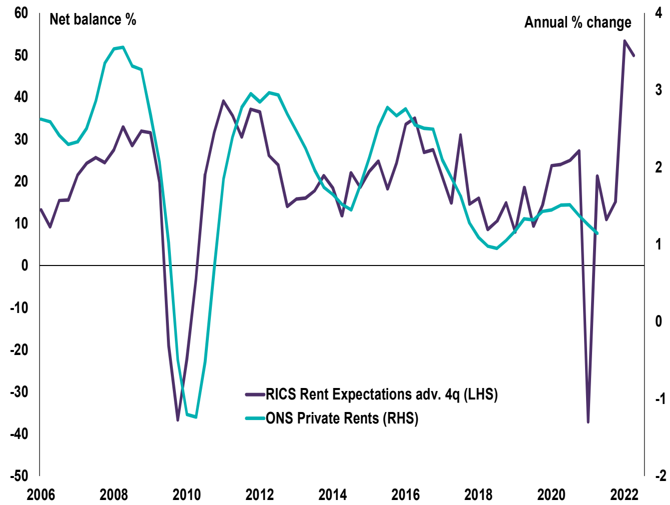
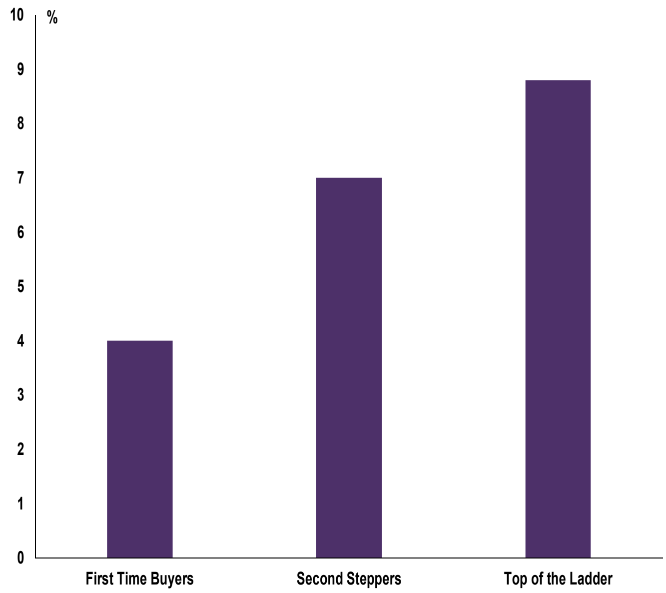


Chart 9: Rightmove 'ask' prices shows that larger, more expensive properties have seen the biggest price rises over the past year



Construction

The latest ONS construction data shows that output is now pretty much back to where it was prior to the onset of the pandemic. However, sector level numbers demonstrate a clear divergence between infrastructure and private housing including R&M (which are well above pre-COVID levels) and commercial and industrial (which remain someway lower). The key projects driving infrastructure work at present are Thames Tideway, Hinkley Point C and HS2.

A key obstacle for the construction industry is addressing ongoing challenges in securing building materials. Chart 10 shows that shortages in this area are the main concern at the present time (cited by over 80% of respondents to the Q2 RICS Construction and Infrastructure Monitor). However, issues around labour are also on the rise (64% report shortages) with skilled trades like bricklayers and carpenters topping the list. Although a little lower than this in terms of responses, finding qualified professionals such as quantity surveyors is also becoming more problematic.

The rise in new business enquiries highlighted in the latest RICS Monitor (with the net balance indicator climbing from +29% to +50%) suggests that the growth in workloads will remain firm running into 2022. The latest forecasts from the Construction Products Association (Chart 11) tells a similar story with total output projected to rise by more than 6% in 2022 following an increase of around 14% this year. Infrastructure is viewed by the CPA as likely to remain the strongest area of growth with a 23% increase in output this year followed by a 10% rise next.

Supporting a buoyant construction sector will see headcounts rise despite challenges around recruitment. Feedback from RICS members suggests a net balance of over 40% anticipate employment continuing to increase over the next twelve months.

How this all plays out in terms of industry profitability remains to be seen but there is little conviction from the RICS Monitor that it will materially improve despite the strength of activity. The forward looking net balance indicator remains modestly in positive territory at +12% (as against +9% in Q1). However the point forecasts for the next year, which are highlighted in chart 12, suggest that rising construction costs will be a major drag on the sector's financial wellbeing with higher material costs being the critical issue.

Chart 10: Shortage of materials and labour are the two key challenges for the industry according to the RICS C&I Monitor

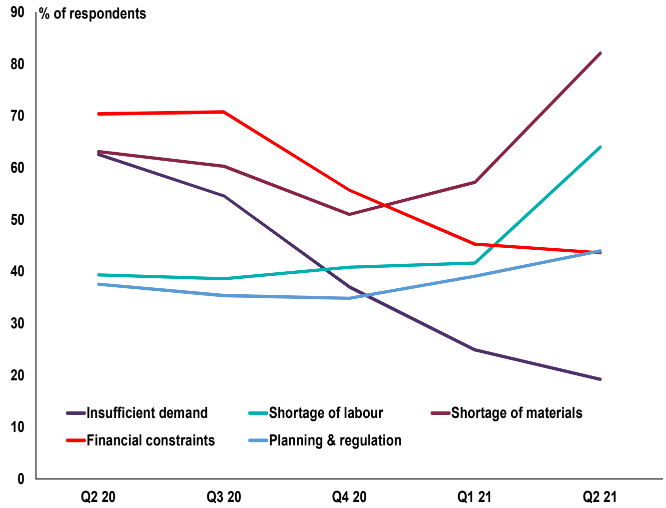


Chart 11: The Construction Products Association continues to forecast strong growth in output through next year

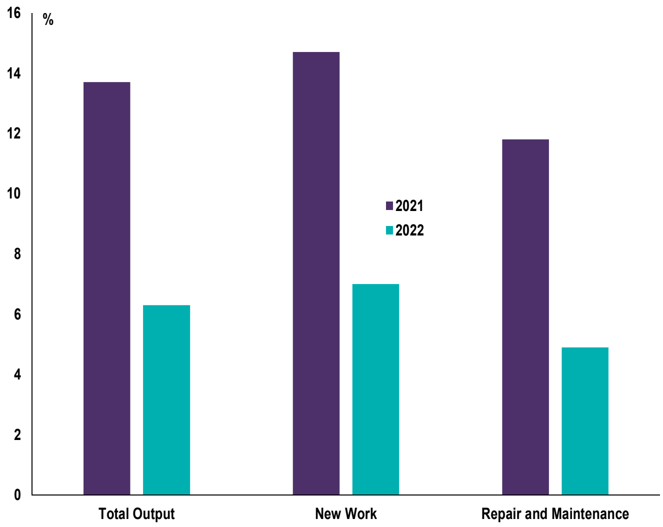
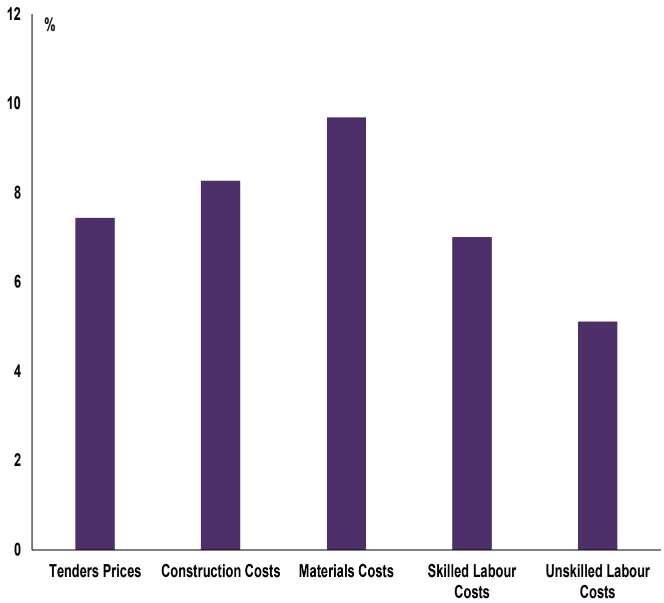


Chart 12: RICS respondents are projecting the increase in construction costs to exceed tender prices over next year



What's the forecast?

Anderson Wilde & Harris, Chartered Surveyors, have a practiced eye on the prevailing conditions in the property markets.

We are members of the RICS and we are experts in all aspects of real estate. But, just as important, we keep a weather eye open to ensure that our clients get the best advice available in changing economic times.

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