RICS

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Economy and Property Market Update

February 2022

More interest rates increases on the way but market sentiment remains upbeat for the time being

ECONOMICS

Summary

Inflation pressures continue to grow leading to a shift in stance from the Bank of England. Despite the hikes in interest rates seen to date and the prospect of more to come, for now it is anticipated that the economy will remain relatively resilient. Consumers are expected to draw heavily on the build-up of savings during the pandemic and business investment is seen picking-up on the back of the tax incentive introduced last year. This is reflected in the feedback provided to recent RICS surveys of the construction sector as well as the commercial and residential markets which generally remain positive.

Economy

Fears around the inflation outlook have intensified over the past few months, and this has been reflected in an upward revision to forecasts. The consensus view is now for a peak in the year-on-year change in the consumer price index (CPI) of more than 7% in April before this key measure of inflation gradually begins to slow, ending 2022 somewhere between 4 and 5%. This profile is to some extent supported by chart 1 which shows just the first hint of a turn in raw material input price inflation which has, historically, been a good lead indicator of the CPI. However, the ongoing political uncertainties in Eastern Europe, which could exert further upward pressure on energy prices, combined with the potential embedding of heightened inflation expectations in wage bargaining, remain key risks.

In light of this, it is not surprising that the Bank of England has begun to strike a more hawkish tone, not just in its decisions, but also in its commentary. At the February meeting of the Monetary Policy Committee (MPC), four out of the nine decision-makers voted in favour of a half point hike (to 0.75%) rather than the quarter point actually sanctioned. It may be that the MPC will take stock at its March meeting (which doesn't have the publication of the Policy Report attached) but unless there is a significant shift in the mood music before then, further tightening is likely in May and more before the year-end. Chart 2 tracking the overnight index swap curve demonstrates how the market view on interest rates has shifted over the past couple of months.

This challenging backdrop will inevitable hit the well-being of households notwithstanding the £9bn package announced by the government to mitigate some of the impact of higher energy costs. Consumers are likely to draw heavily on the estimated £180bn of 'excess savings' accumulated over the past couple of years to help sustain spending through the course of this year. That said, there will inevitably be a strong distributional aspect to this with lower income groups likely to have little in reserve. The economy could, however, also be supported by higher business investment on the back of the two-year 'super-deduction' tax incentive which began in April 2021. This is borne out by the latest Deloitte CFO survey (chart 3) which suggests that the proportion of respondents seeing raising capital expenditure as a strong priority for next twelve months at a series high. Partly because of this, economic growth for the whole of this year is still put at close to 4% before slowing further in 2023.

Chart 1: A tentative signal that the peak in the inflation cycle may be approaching

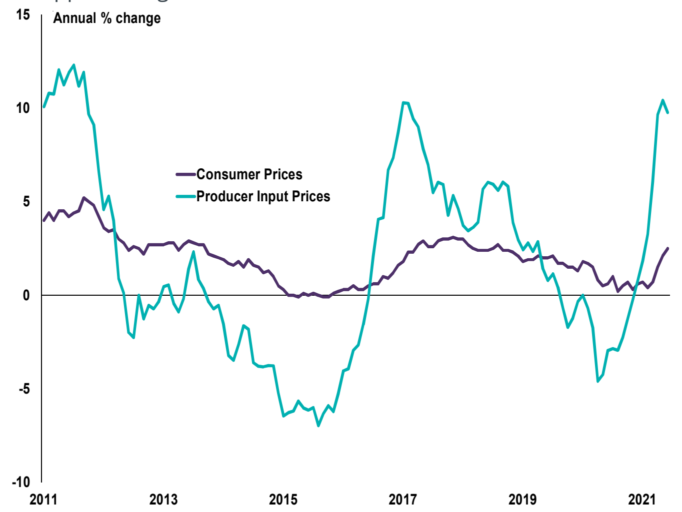


Chart 2: The overnight index swap curve provides a good guide as to how the view on interest rates has changed

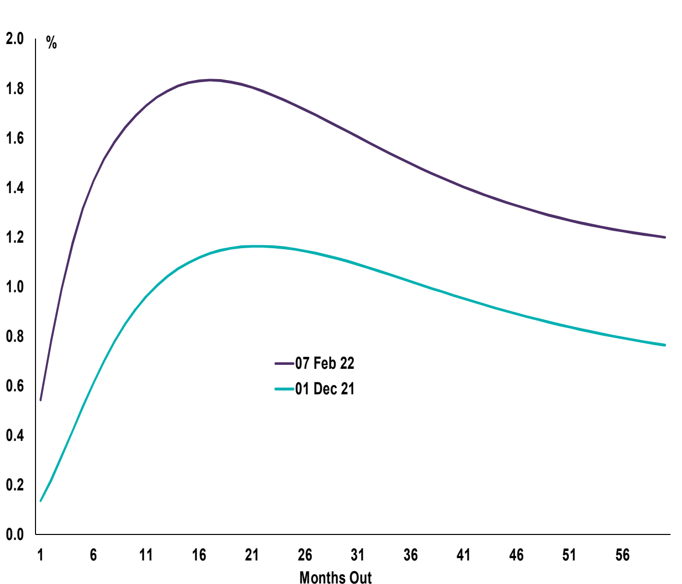
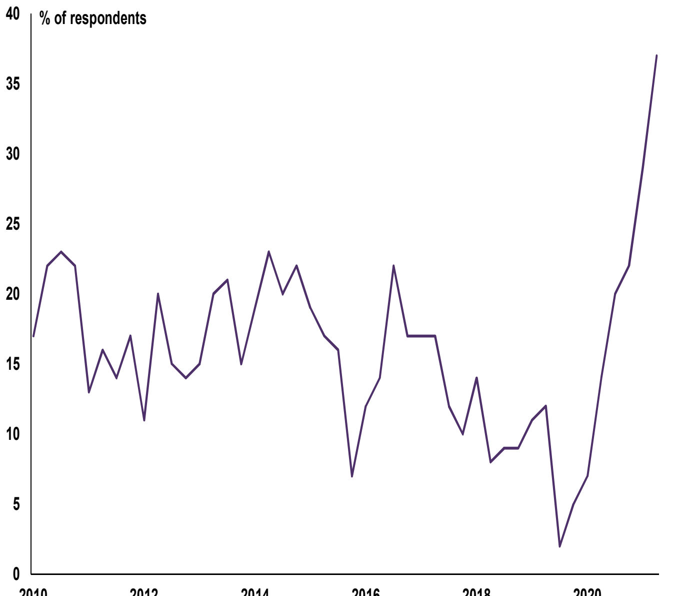


Chart 3: Deloitte CFO Survey - Increasing capital expenditure is a strong priority for 'your' business over the next 12 months



Commercial Property

After falling by 13% in 2020, overall transaction volumes grew 24% last year to stand 9% above 2019 levels. This strong performance was fuelled by solid growth in logistics and retail parks and the bounce in shopping centres from historic lows (chart 4). Significantly, while logistics accounted for nearly one-third of investment activity in the past twelve months (compared with an average of nearer 10% over the previous ten years), the share taken up by central London office has slipped from around one-quarter (over the same period) to 15%.

The more positive mood regarding investment in real estate is also being reflected in pricing. The December MSCI numbers show the IPD all-property capital value index is up 3.5% on the month and 13.9% higher than a year earlier. Logistics continued to be a particularly strong performer recording a rise of more than 30% over the course of the past twelve months. Feedback to the latest RICS Commercial Property Monitor, meanwhile, showed sentiment amongst property professionals remaining resilient in the face of the spread of the Omicron variant of Covid during the period in which the fieldwork was conducted.

Chart 5 tracks the RICS Investment Enquiries series against the CBRE all-property capital value index with the former advanced two quarters; it suggests the current rate of growth will be sustained through much of this year. Inevitably, there is still a pronounced sector skew in the insight being received with regard to firmer expectations for industrials/ logistics, data centres, multifamily and aged care facilities. Significantly,the perception of respondents regarding the valuation of the market (in aggregate) is still broadly supportive; around two-thirds view it as being fair value which should help provide some protection in face of the shift in mood regarding the outlook for interest rates.

Additional questions were included in the survey to gauge some of the structural changes impacting the office sector as a result of the pandemic. Critically, some 66% of respondents still believe office space is essential for an organisation to operate successfully. Alongside this, 76% of contributors reported that they are seeing a relative increase in demand for flexible and more local workspaces. Significantly, the allocation of space per desk has increased according to 69% of contributors. Meanwhile, almost nine in ten real estate professionals report seeing some re-purposing of office space for other uses as highlighted in chart 6.

Chart 4: Property Data figures shows commercial real estate activity has now climbed back above the 2019 level

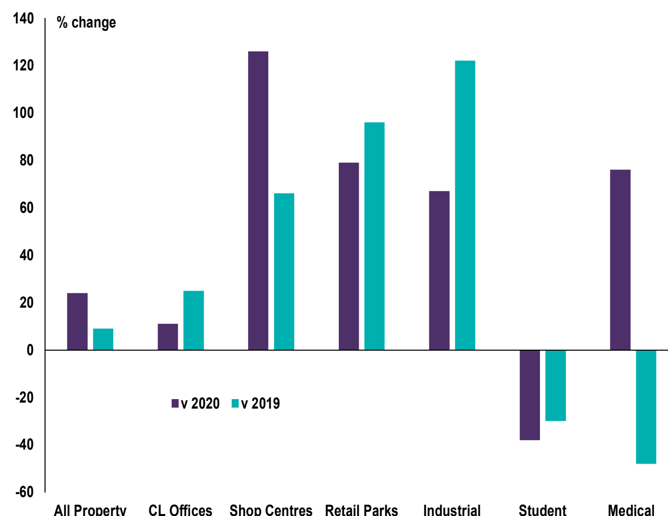


Chart 5: The RICS Investment Enquiries metric suggests capital values will post strong growth over the coming quarters

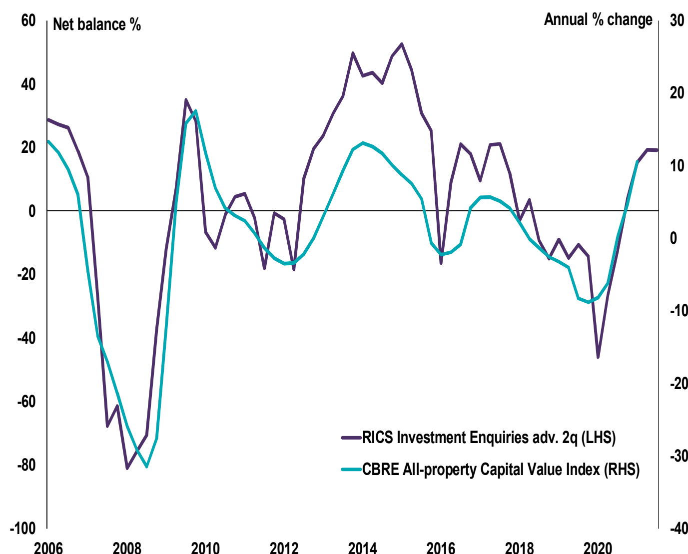
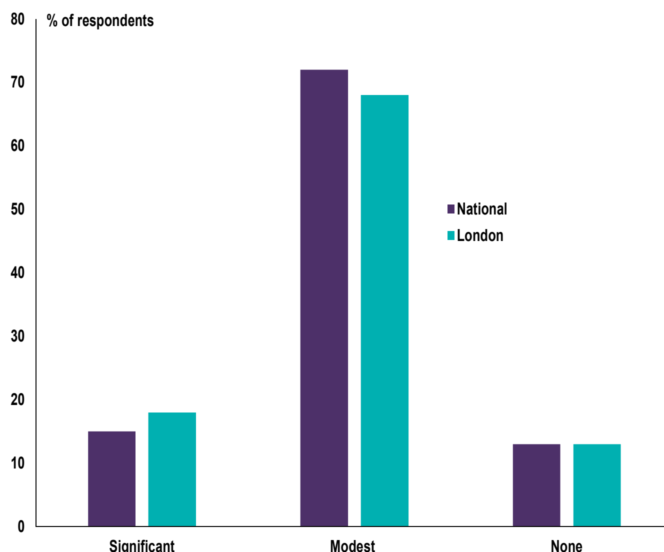


Chart 6: A high proportion of respondents to the RICS survey are seeing evidence of offices being repurposed to some extent



Residential Property

House sales ended last year on a resilient note with HMRC data showing that there were just over 100k of transactions in December (when measured on a seasonally adjusted basis). To put this into some context, it is pretty much in line with the run rate prior to the onset of the pandemic but comes after a stellar year for activity (chart 7); in the first three-quarters of 2021, sales were averaging 135k per month. Significantly, feedback to the January Residential Market Survey points to a degree of confidence that this trend can be sustained with a net balance of +22% expecting an increase in sales over the next three months (the highest reading since last March). Although the lack of new instructions continues to be viewed as a potential obstacle to activity, one encouraging theme emerging from the latest report is an upturn in the number of appraisals being undertaken; the net balance which gauges the trend in relation to the comparable period twelve months earlier came in at +3%, the first time this series has been above zero since June 2021.

Meanwhile, there appears to be little relief in store in terms of pricing, at least in the near term. Notwithstanding the strong gains experienced through the past couple of years, both the RICS headline price balance indicator and the twelve month expectations measure are running at or close to series highs. Charts 8 tracks the first of these metrics against the Land Registry price series and highlights the underlying momentum that persists. Significantly, the RICS price balance readings are firm for all parts of country, and while London still lags, it is no longer the outlier it previously was. Higher mortgage rates are gradually likely take some of the heat from the market but in the absence of the economy taking a bigger hit, it points to a slower rate of house price inflation rather than anything more material.

The demand supply imbalance is just as prevalent in the lettings market (as in sales) and is evident in data both from RICS (chart 9) and Zoopla numbers. The latter suggest that national rental demand was up 76% in January compared with the same period between 2018-21. Rental growth on new lets was 8.3% in the fourth quarter of 2021 (compared with a year earlier) according to Zoopla. And the RICS rent expectations series shows a net balance of +59% of respondents anticipating further rental growth which, once again, is a series high.

Chart 7: HMRC property transactions over the past twelve months has been near previous highs

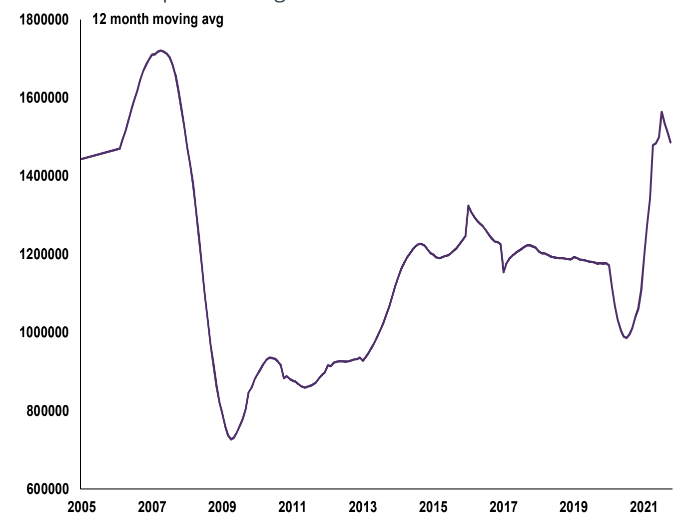


Chart 8: The headline RICS price balance indicator suggests price inflation will remain firm over the coming months

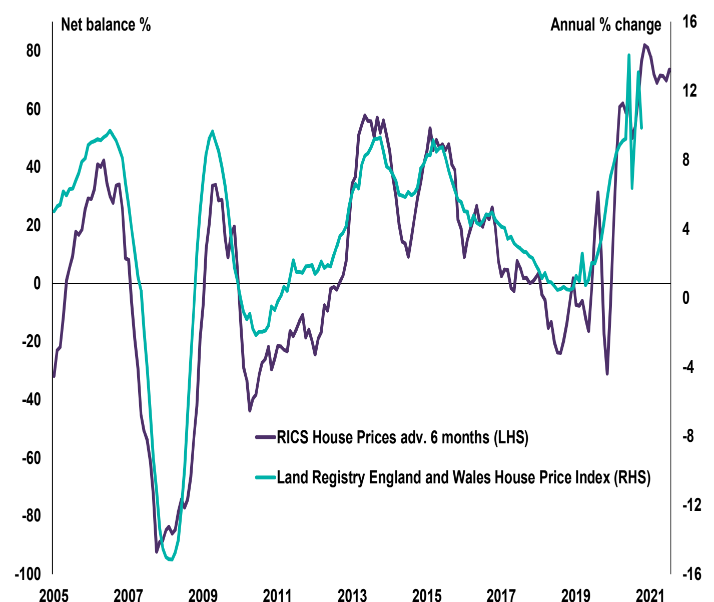
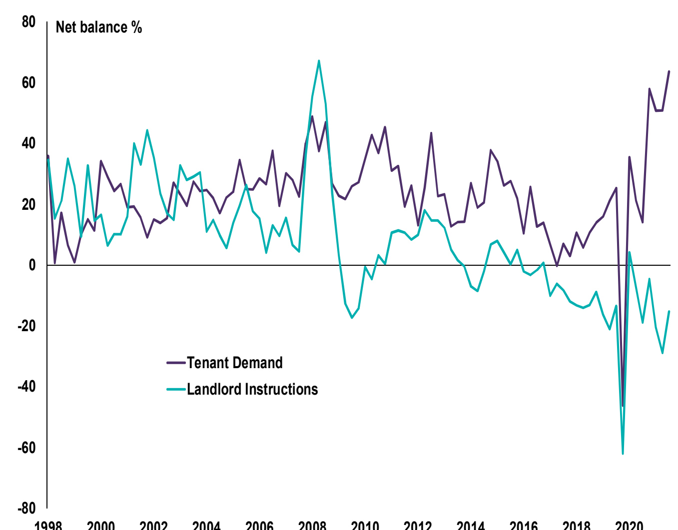


Chart 9: The gap between the RICS tenant demand and new landlord instructions indicators continues to widen



Construction

If the feedback to the latest RICS Construction Monitor is anything to go by, sentiment generally remains positive across the sector with workloads rising particularly strongly in infrastructure and private residential. Chart 10 shows the workloads readings by sector and demonstrates the upbeat trend across all parts of the industry. A broadly similar message is evident in the January IHS Markit/ CIPS Construction PMI which recorded its twelfth consecutive positive reading, as the commercial component climbed to a six month high.

Forward looking indicators covered by the RICS survey paint an encouraging picture of the outlook, despite some of the ongoing macro challenges. New business enquiries remain strong while the one year out workload expectations numbers are firmly in positive territory in net balance terms. This broadly chimes with the latest forecasts from the Construction Products Association, which envisages industry output rising by a further 4.3% this year (following the 13% increase in 2021).

While the RICS survey does point to headcount continuing to climb (net balance of +44%), it also highlights potential challenges around recruitment. Chart 11 graphs the proportion of respondents reporting shortages across a range of skills and suggests the issue is not confined to one or two areas. Indeed, one likely consequence of this is the need to pay higher wages, with the RICS survey projecting skilled labour costs rising by more than 7% over the course of 2022.

The other big concern that comes back loud and clear in the survey surrounds access to, and the cost of, building materials. 80% of respondents highlighted these issues as obstacles to activity. Data from BEIS shows the inflation rate of construction materials currently still stands at more than 20% (chart 12) although it has slowed very modestly over the past couple of months. The highest rates of inflation are in timber (and related products) and steel (and related products) with annual price rises of between 47%-60%. Against this backdrop, it is not surprising that the RICS profit indicators continue to lag the recovery in workloads. The margin outlook is captured in a net balance format with the latest number a little more positive than in Q3, albeit that only 10% more respondents anticipate an increase rather than a decrease in 2022 (previously +2%). However, the somewhat tentative nature of any uplift in profitability is evident in the assumption that tender prices will struggle to keep pace with construction costs.

Chart 10: The RICS Q4 Construction Monitor shows a broad-based growth in workloads

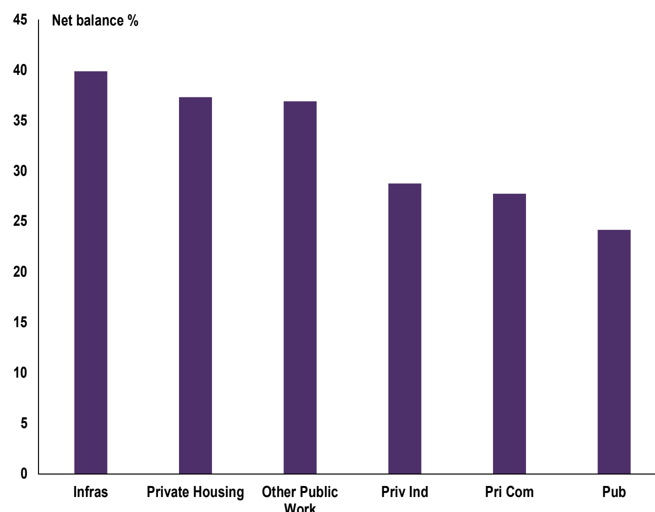


Chart 11: Significant shortages of skills are being reported in the RICS Monitor across a wide range of disciplines

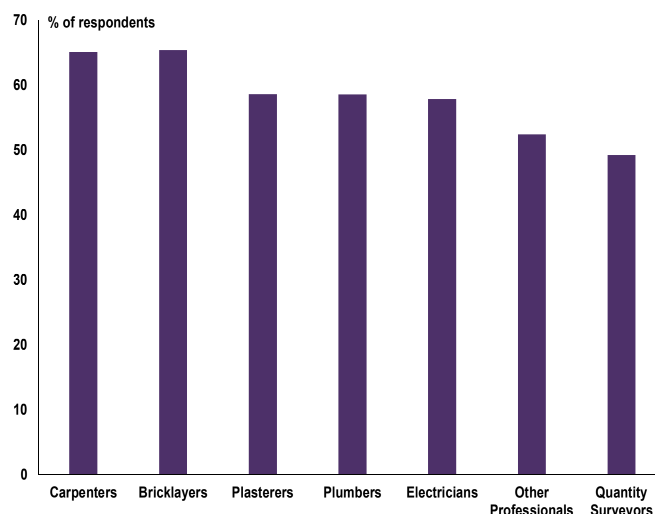
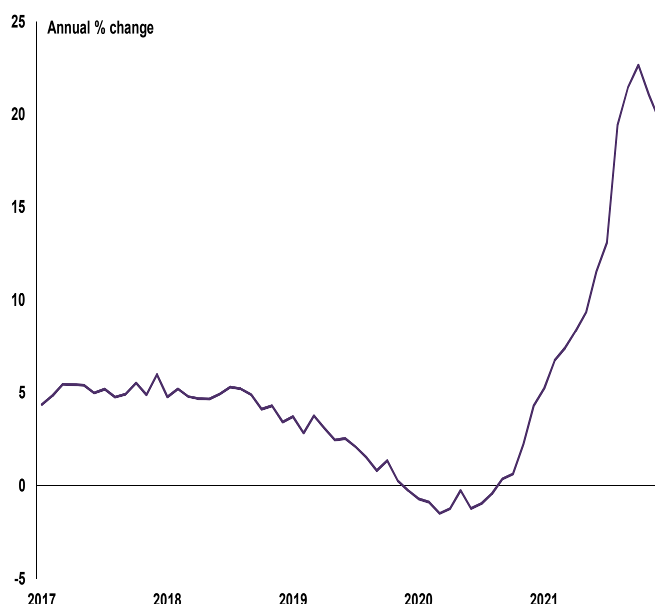


Chart 12: Construction materials inflation is running at around 20% according to BEIS data



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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