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Economy and Property Market Update

March 2021

Strong rebound in economy anticipated as restrictions are lifted

ECONOMICS

Summary

Economic activity is expected to recover quickly as lockdown restrictions are lifted. However even the most upbeat forecasters anticipate some long-term scarring from Covid. Commercial real estate will continue to be heavily influenced by the changing patterns of both shopping and working while the residential sector is anticipated to show further resilience aided by the additional government support measures announced in the Budget.

Economy

Although the economy still remains around 10% off its pre-Covid high, the roll-out of the vaccine is fuelling expectations of a strong rebound in activity as the lockdown restrictions are eased over the coming months (chart 1). The Bank of England Chief Economist has even likened the economy to a 'coiled spring' which will be unravelled as households begin to spend the 'excess savings balances' built up through the pandemic.

The measures announced by the Chancellor in the recent budget are seen as likely to add to the momentum of the rebound. In particular, the extended support for business and the furlough scheme will both help to underpin confidence. As a result of the latter in particular, the Office for Budget Responsibility (who independently oversee the impact of government policies on both the economic and the fiscal numbers) envisage that unemployment will rise relatively modestly over the course of the next year, peaking at a high of 6.5% (currently 5.1%). Given the scale of the economic shock, this would be a remarkable outcome when put in a historical context (chart 2).

One risk is that consumers prove more reluctant to run down savings balances than envisaged on concerns around a more challenging jobs market when the furlough scheme expires. Businesses may also be reluctant to commit to capex until the upswing in activity is viewed as sustainable although the 'super-deduction' tax break announced in the budget could prove a powerful incentive to bring forward investment plans.

Another area of challenge for the economy could potentially stem from an uplift in inflation given the scale of the macro policy stimulus. This has been reflected in the recent (global) sell-off in bond markets which has resulted in ten year gilt yields climbing to 0.8% (still a historically very low level) from a nadir of 0.2%. For now least, however, expectations are for no change in base rates.

Chart 1: Bank of England projects a relatively strong rebound in GDP over the next twelve months

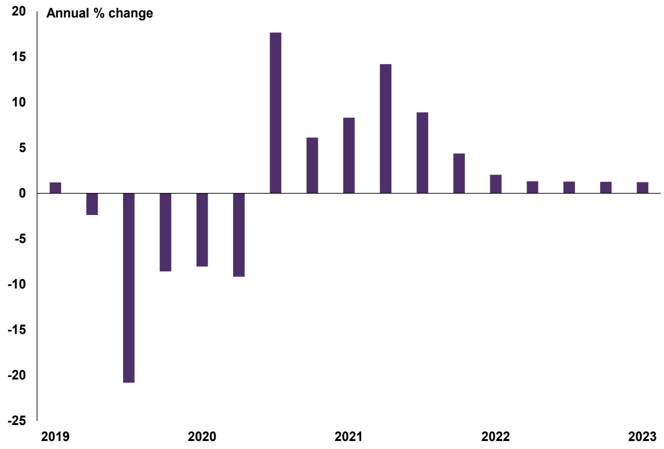
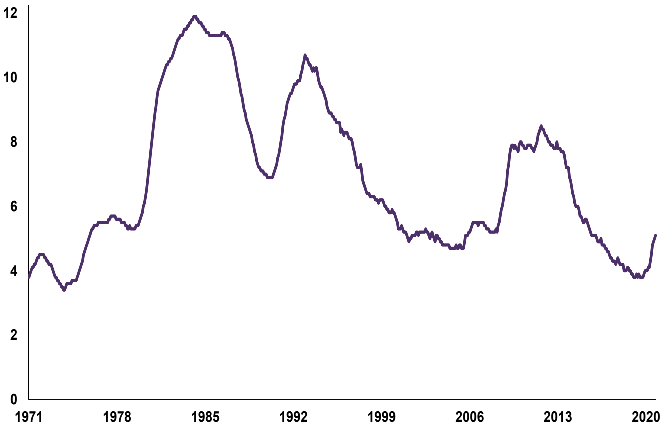


Chart 2: Unemployment remains well below previous recession highs with expectations being lowered as to the likely peak this time around time



Commercial Property

There has been little visible evidence of any upturn in the mood music regarding the outlook for the commercial real estate market, with agents reporting a slow start to year in terms of transactions. This is not altogether surprising given the ongoing macro challenges.

The last (Q4) RICS Commercial Property Monitor showed occupier demand remaining very weak away from the logistics/ industrial segment of the market. Although the indicator capturing investor enquiries was a little more resilient, it also remained in negative territory and displayed a similar sector pattern (chart 3).

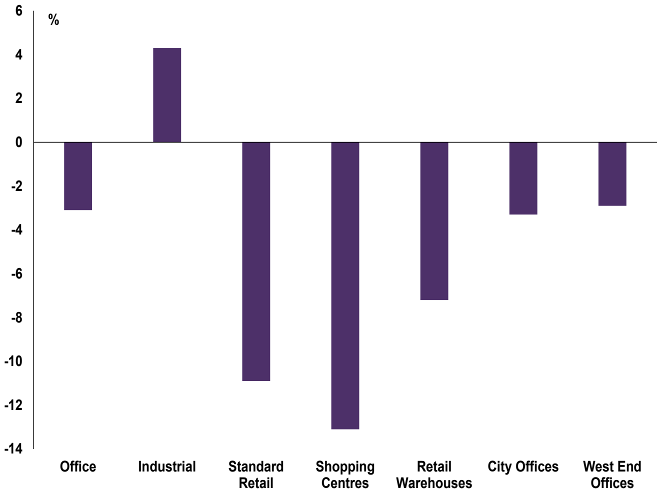
The latest valuation data (February) shows aggregate rental and capital values essentially unchanged since the start of the year, but this masks individual sector dynamics. Reflecting the ongoing attraction of well located logistics/industrial property, the CBRE data suggests that initial yields in this segment of the market are continuing to edge lower and now stand just a little above 4%.

Forward looking metrics from the RICS Monitor were also generally downbeat, with projections for the both prime and secondary retail, as well as hotels, strongly negative. Significantly this is also evident in the latest consensus forecasts from the IPF which have 'all Property' capital values posting a decline of 2.5% in 2021 but much bigger drops envisaged in standard retail (10.9%) and shopping centres (13.1%) as shown in chart 4.

The recent rise in bond yields has raised concerns about the implications for valuations in the real estate market. Critically, the spread against property yields remains large. Moreover, comfort may be drawn from feedback to the last RICS survey which suggested that, at a national level, around two-thirds of respondents viewed the market as fair value (with only 20% seeing it as dear). Strikingly, even in central London the percentage of contributors now seeing the market as stretched has slipped to around one-third; as recently as the first half of 2019, this share stood at three-fifths.

Chart 3: RICS Tenant Demand and Investor Enquries metrics remain in negative territory away from logistics

Chart 4: IPF Consensus Forecasts for capital values by sector point to further price falls this year



Residential Property

The announcement in the Budget of an extension to the Stamp Duty break alongside the forthcoming guarantee around high LTV lending (due to take affect from next month) has eased concerns about a 'cliff-edge' drop in transaction volumes. On a seasonally-adjusted basis, HMRC shows property sales exceeding 120k in both December and January which are the largest monthly numbers since 2007.

The February RICS Residential Market Survey shows the lockdown slowing the flow of new instructions onto the market. New Buyer Enquiries also slackened over the month albeit to a lesser extent (chart 5). As a result, the Sales to Stock ratio has resumed an upward trend that typically in the past has been consistent with higher house price inflation.

This message is also evident in the near term (3 months) price expectations series which has turned around from a net balance reading of -12 in January to +11. On a 12 month view, the results for price expectations show a positive net balance reading of 46, the highest figure since February last year. Given the existing affordability issues, the prospect of a further period of price inflation demonstrates the importance of addressing the ongoing shortage of supply. Planning reform, which the government is focused on, alongside supporting a sustainable and inclusive recovery in the economy, are key elements in encouraging the private sector to increase the pipeline of new build. But a holistic approach is required to ensure that policy is designed to deliver across tenures.

The rental market is also higlighting similar issues with RICS data showing tenant demand remaining firm while landlord instructions continue to weaken. This imbalance is being reflected in higher rent expectations (chart 6). At the twelve month time horizon, rents are projected to rise by around 2.5% nationally. London expectations are lagging behind the national picture, and now signal a broadly flat trend.

With the restrictions in place as a result of the lockdown, a repeated theme running through the anecdotal feedback is the desire amongst homeowners for more space and green, rather highly urban, locations. This is reflected in a widening gap in price expectations collated through the survey between and one and four bedroomed homes.

Chart 5: Both RICS New Buyer Enquiries and New Instructions indicators have slipped back since the begining of the year

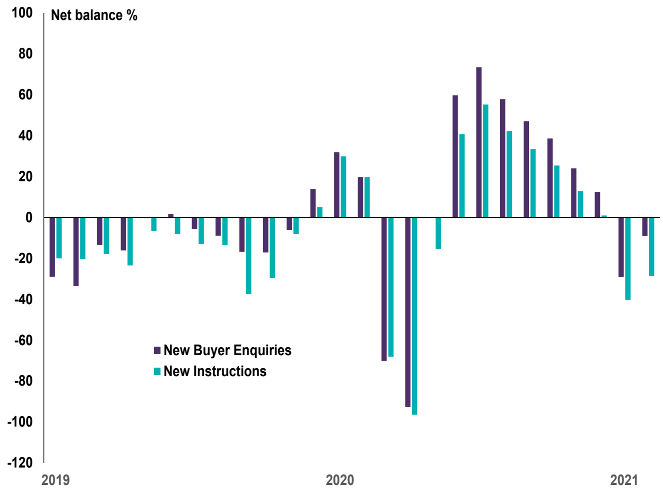
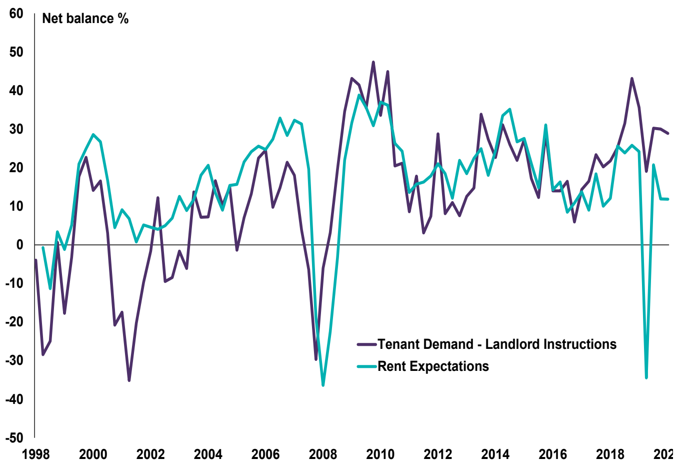


Chart 6: The imbalance between the RICS Tenant Demand and Landlord Instructions metrics is consistent with rising rents in the private lettings market



Construction

The latest construction data shows that output increased by 0.9% in January, but still remains 2.6% below the February 2020 level (chart 7). Significantly, the level of new work is still 6.4% down on where it was before the onset of the pandemic, while repair and maintenance work is, according to the official data, 4.5% higher.

The more timely IHS Markit/CIPS UK Construction Purchasing Managers' Index recorded a positive set of results in February with the headline reading climbing to 53.3 from 49.2 in January. The strongest area of growth continued to be residential work, though the speed of growth slowed slightly. Most notably, the vaccine rollout appear to be fueling confidence about the outlook with the business expectations component of the dataset jumping to its highest level in five years.

The Q4 RICS Construction Monitor (C&I) shows infrastructure as the sector most likely to show the strongest growth in workloads over the next twelve months, followed by private residential (chart 8). This pattern is broadly consistent with the levers being pulled by government to support economic recovery. More detail, for example, was provided in the Budget around the establishment of the UK Infrastructure Bank which amongst other things will be able to deploy £12 billion of equity and debt capital and be able to issue up to £10 billion of guarantees. This is expected to fund £40 billion in infrastructure investment.

In terms of the sector more generally, access to finance remains the most cited obstacle to development although the proportion of RICS respondents identifying this factor has dropped from over 80% at one point in 2019 to just over a half. Meanwhile, concerns around access to skills have also lessened somewhat with greater focus on the supply and cost of materials.

Chart 7: Official construction data show the rebound in activity is being led by R&M with new build still below pre-pandemic levels

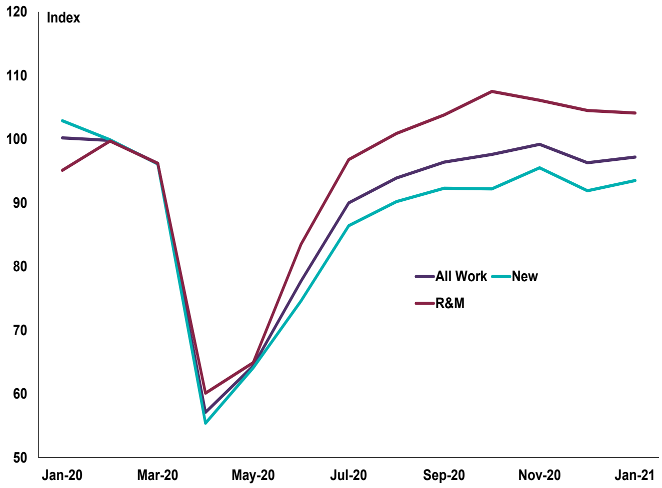
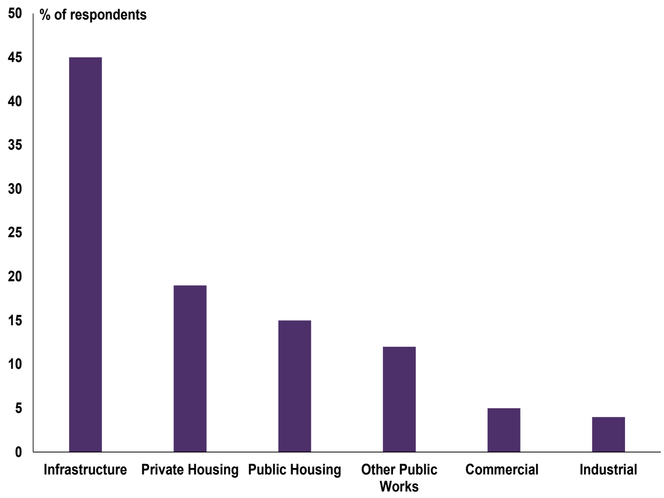


Chart 8: The RICS C&I Monitor shows respondents viewing infrastructure as posting the strongest growth over the next 12 months



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