

# Economy and Property Market Update

May 2022

## Recession fears grow as interest rates rise to combat accelerating inflation

### ECONOMICS

#### Summary

A further worsening in the inflation environment is increasing pressure on the Bank of England to tighten monetary policy. This is leading to a downgrading of growth expectations with the economy widely anticipated to flirt with outright recession over the next eighteen months. For now, both the real estate sector and construction appear to be displaying a considerable degree of resilience but some shift in tone would not be a surprise as the macro newsflow continues to deteriorate.

## Economy

The shift in the tone regarding the economic outlook has been quite dramatic as inflationary pressures continue to worsen. The Bank of England in its latest update acknowledged that the economy will flirt with recession in the coming quarters and, indeed, it anticipates precious little growth over the coming years, a point highlighted in Chart 1. High frequency data around the household sector emphasises the impact of recent developments with the closely watched GfK measure of consumer confidence falling to its lowest level since the global financial crisis.

The tightening in policy is viewed as likely to gradually begin to reverse the adverse trend in inflation but the Bank assumes that the CPI measure will hit a high of 10% first and then only return to the 2% target by the middle of 2024. Perhaps inevitably against this backdrop, it is projected that the labour market will begin to soften as the economy falters and that as a result, the talk of skill shortages that currently prevails will give way to rising unemployment which could climb towards the 5.5% area (from under 4% at present).

In the face of these headwinds, one area of potential support for the economy could come from the corporate sector which has amassed a huge cashpile through the pandemic. The sum involved is equivalent to 50% of investment in a “normal” year. Whether business will feel minded to put this capital to work in such hostile macro conditions is open to question but it is a plausible scenario with the appropriate incentives. This raises the question of whether the government will intervene to encourage such a response; the current 130% super-deduction capital allowance on qualifying plant and machinery investments which runs until next March may be extended or replaced with a not dissimilar measure.

Significantly, although the Chancellor made a commitment to lower debt as a share of GDP in the autumn budget (from 2024 onwards), it is likely that this laudible goal will be subsumed by events. And critically, as Chart 2 from the April IMF Fiscal Monitor demonstrates, while the level of UK public debt is not low at around 90% of GDP, there appears to be more room for a budget stimulus than many other countries.

In terms of the interest rate outlook, the downbeat analysis from the Bank has fuelled speculation that the tightening in policy may not need to be quite so pronounced as previously envisaged. Chart 3 tracks how money market sentiment has shifted around the May meeting of the Monetary Policy Committee. That said, there remains considerable uncertainty as to the effectiveness of monetary policy in combatting cost-driven inflation, highlighting the potential upside risk on interest rates.

Chart 1: The Bank of England forecast projects a very weak outlook for GDP growth

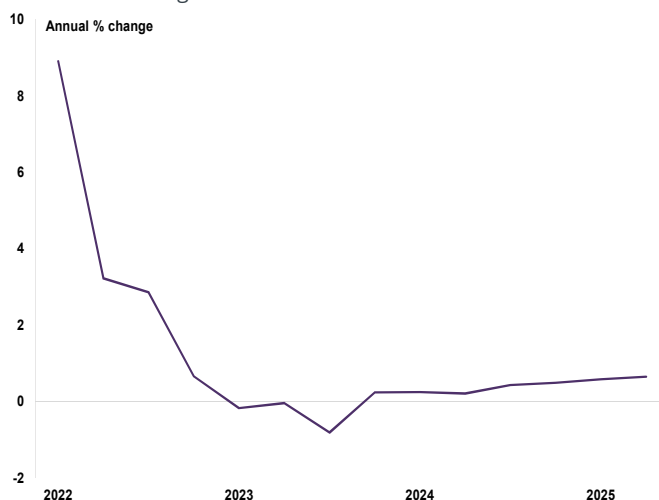


Chart 2: IMF numbers suggest that the UK has more room for a fiscal stimulus than many other countries

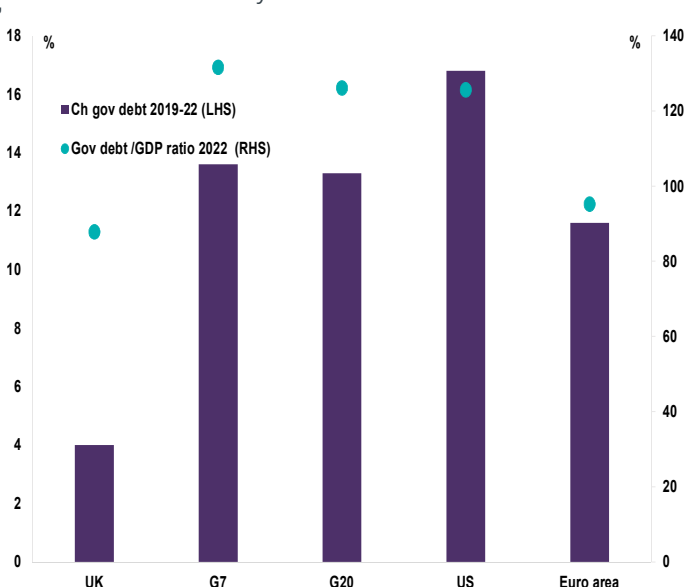
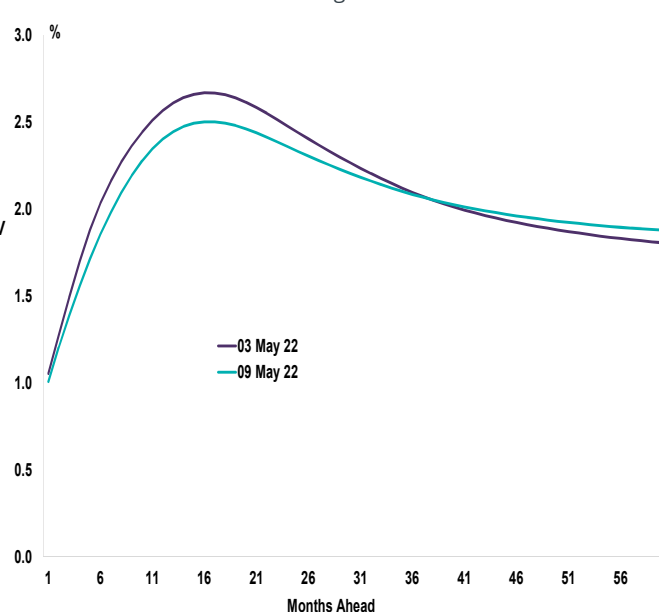


Chart 3: Interest rate expectations edged down after the gloomy assessment from the Bank of England



## Commercial Property

Sentiment towards real estate continues to improve despite the increasing macro and geopolitical concerns. Significantly, the Q1 RICS Investment Sentiment Index rose to +18%, its best read since the early part of 2017. Meanwhile, the Occupier Sentiment Index recorded a more substantive gain compared with the final three months of 2021, jumping from +4% to +16%. These trends are demonstrated in Chart 4 and also reflected in data from CBRE showing capital values (in aggregate) rising by 3.9% over the period and yields continuing to edge lower.

Inevitably, there continues to be a strong sector skew to the performance of the market with industrials/logistics still keenly sought after even at higher prices while data centres and multifamily are also still attracting considerable interest. But alongside this, there are now signs emerging of an improving picture for parts of the office sector and even retail. The RICS occupier demand metric for the former shows a positive net balance of +30%, while the comparable figure for the whole of the retail sector is -1% (the least negative result since the early part of 2017).

Significantly, the better tone to the retail numbers is evident both in Savills data tracking yield developments and in the CBRE data on pricing. In the former, the latest insights show high street retail yields slipping from 6.75% last year to 6.25% currently, with retail warehouses dropping to 4.75%. Shopping centres in general remain a little more challenging with Savills numbers putting the average yield unchanged at 7.5%. Chart 5 shows the RICS Investment Enquiries series for the aggregated retail sector against CBRE capital values. Of course, none of this is to downplay the ongoing structural and occupational issues besetting parts of the sector, while the macro risks remain significant with discretionary spending likely to come under increasing pressure this year (as a result of the uplift in inflation). It does, nevertheless, still point to some light at the end of the tunnel.

Meanwhile, the latest numbers on investment activity in the sector show transaction were firm in the first three months of the year (Chart 6) driven by industrials/logistics and central London offices. Quarterly volumes were up 43% compared with same period of 2021 although deal numbers showed a more modest gain (10%). The twelve month rolling average of activity has now climbed back to where it was in the early part of 2019.

Chart 4: RICS Investor and Occupier Sentiment Indices strengthened in Q1

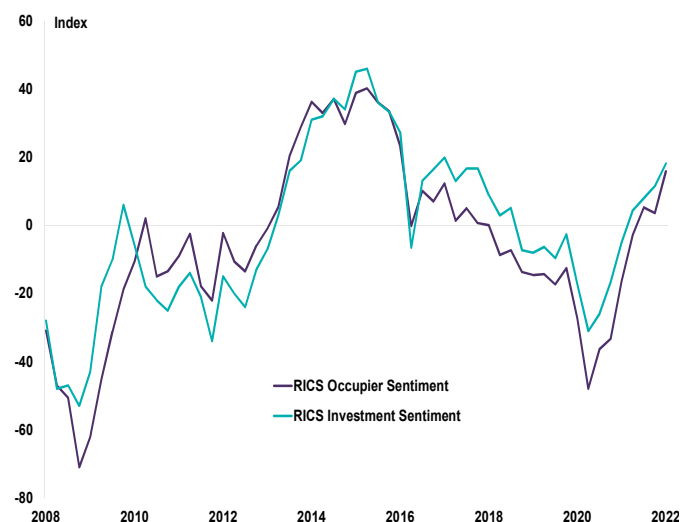


Chart 5: The RICS Retail Investment Enquiries net balance typically has a 2 qtr lead over the CBRE Retail Capital Value index

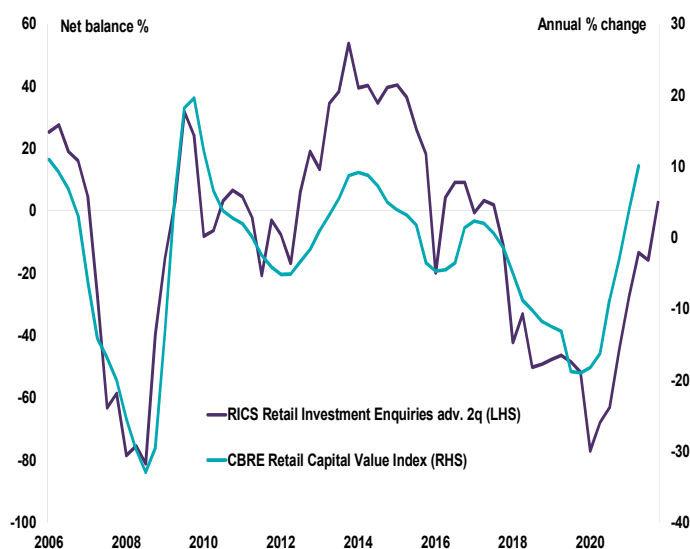
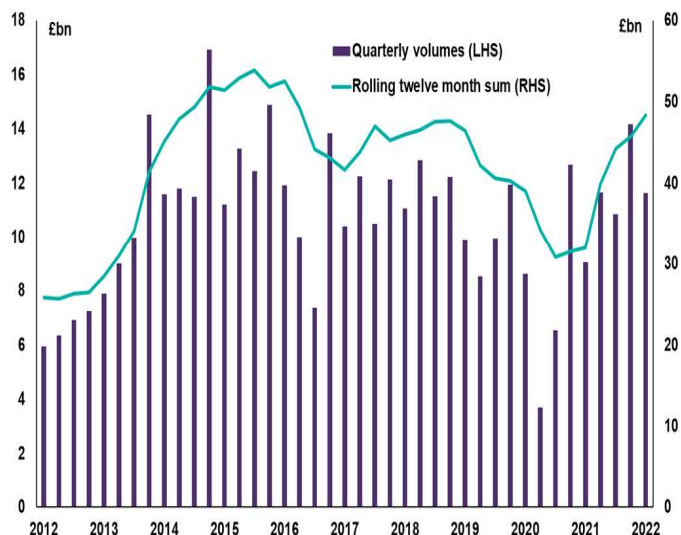


Chart 6: PropertyData's indicator of deal volume shows a firm trend in Q1



## Residential Property

In the face of the ominous warnings about the outlook for the economy and the hit to consumer confidence, housing market indicators remain resilient for the time being. Both the Nationwide and Halifax price indices continue to post double-digit annual gains, albeit in the case of the former, there does appear to be some slowing in momentum. Meanwhile, the Zoopla and the RICS measures of buyer interest are still showing broadly positive trends. The RICS New Buyer Enquiries series is shown in Chart 7 in net balance terms. While the reading is down from the stamp duty break fuelled numbers recorded over much of the past two years, it is still pointing to solid levels of appetite from potential purchasers. Whether this is the lull before the storm remains to be seen.

Official data show the average quoted rate for a two-year fixed-rate mortgage (75% loan-to-value ratio) has climbed to 2.35% (prior to the last interest rate rise) compared with 2.11% in March and 1.29% six months ago. Moreover, the spread between the benchmark mortgage rate and the two-year OIS rate (a good proxy for the cost of wholesale funds) in April was just 19bp, well below its 105bp average in the second half of the 2010s. Given the more risky environment, lenders are likely to increase this adding to the cost of mortgage finance.

Meanwhile, the feedback to the RICS survey suggests that rental demand is continuing to rise very strongly leading to a growing gap with available supply. The result of this is further upward pressure on rent expectations (which are at an all-time high for the series) as shown in Chart 8. Whether this is sustainable as the cost of living squeeze intensifies is open to question but the imbalance between demand and supply suggests that it might well be.

The consensus view on the housing market is for modest price gains over the next few years (despite the economic climate) but a flatter trend in transactions. The risk of something more deleterious lies in the possibility that a more significant rise in interest rates is needed to bring inflation under control. In these circumstances, it is conceivable that unemployment will rise beyond the 5.5% area projected by the Bank of England leading to greater pressure on homeowners. Chart 9 shows how an uplift in repossessions has in the past impacted on house prices. However, after the experience of the early 1990s, it is implausible that the government wouldn't intervene (as it has done subsequently) to ameliorate the fallout.

Chart 7: The RICS New Buyer Enquiries series remain positive for now

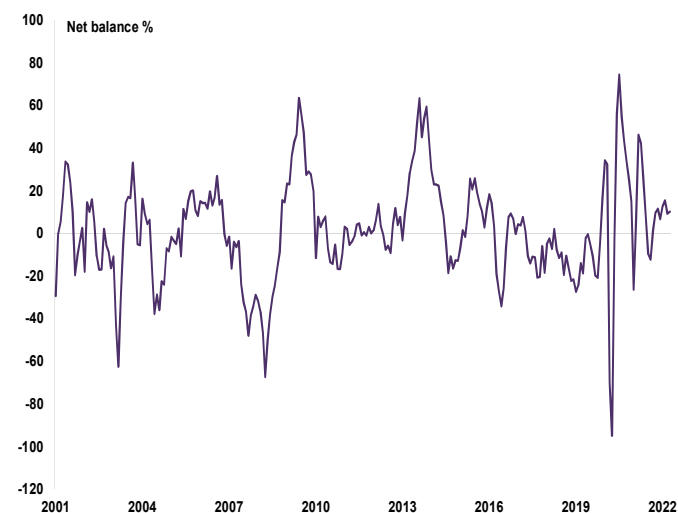


Chart 8: The imbalance between demand and supply in the rental market is driving the RICS Rent Expectations series

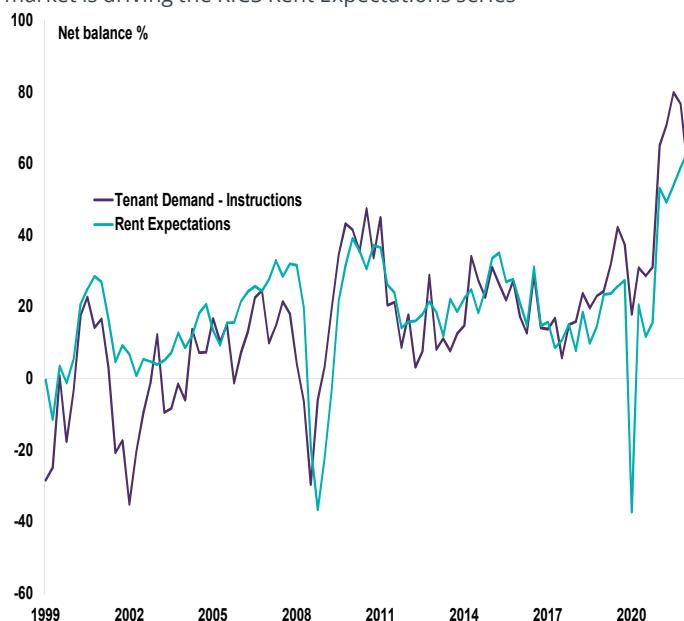
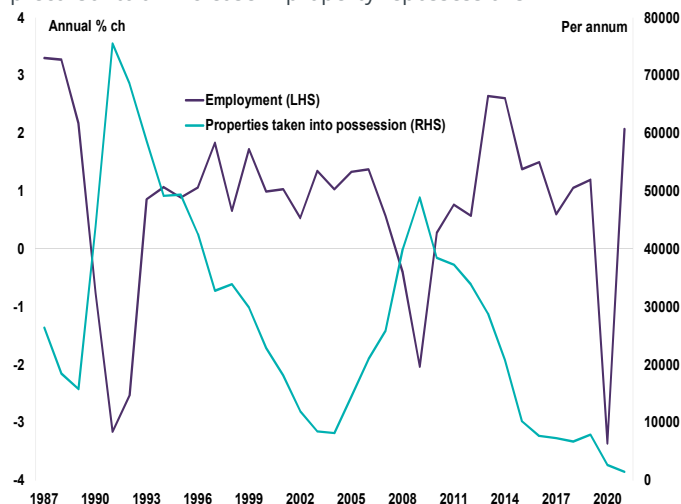


Chart 9: A sharp rise in unemployment has in the past been a precursor to an increase in property repossessions



## Construction

Official data tracking construction output shows healthy gains through the first quarter of the year with the volume of activity now almost 4% above its pre-pandemic level (February 2020). This is also reflected in RICS current workloads data (measured in net balance terms and shown in Chart 10). What is particularly striking about the latter is the broad based nature of the growth. While sentiment is particularly positive about infrastructure unsurprisingly, it is evident that the mood around development in the commercial space has gained some momentum in recent quarters. Significantly, this is also reflected in the forward looking metrics for workloads with strongly positive expectations in the feedback around both residential and non-residential activity.

The generally upbeat tone is also reflected in the monthly S&P Global/ CIPS PMI for the construction sector with the headline result for activity coming in at 58.2 (well above the flat trend signalled by a read of 50). The expectations series from this survey also remains positive suggesting that for now at least, the sector doesn't appear unduly concerned by the interest rate hikes sanctioned or some of the downbeat macro commentary. Meanwhile, the most recent forecasts from the Construction Products Association show output expected to grow by 2.8 % this year (down from 4.3% previously) and by 2.2% in 2023.

At the present time, a key concern for the industry is rising building costs as material prices continue to soar; official data shows them to be 25% higher than a year ago. For some parts of the sector, access to construction products also continues to be a challenge. In addition, there are ongoing issues around labour scarcity with the issue around recruitment quite widespread. This is highlighted in Chart 11 which shows the proportion of respondents to the Q1 RICS UK Construction Monitor who report shortages in each of these areas. Evidently, a healthy proportion of businesses are looking to increase investment in workforce development and training in response.

Chart 12 shows projections for both tender prices and construction costs over the next twelve months and suggests that while activity may remain resilient, at this point there is no suggestion that pressures linked to supply chains and labour will ease materially. This is also evident in the RICS indicator looking at expectations for profit margins over the next twelve months, which remains broadly flat.

Chart 10: The RICS Q1 Construction Monitor shows a broad-based growth in workloads

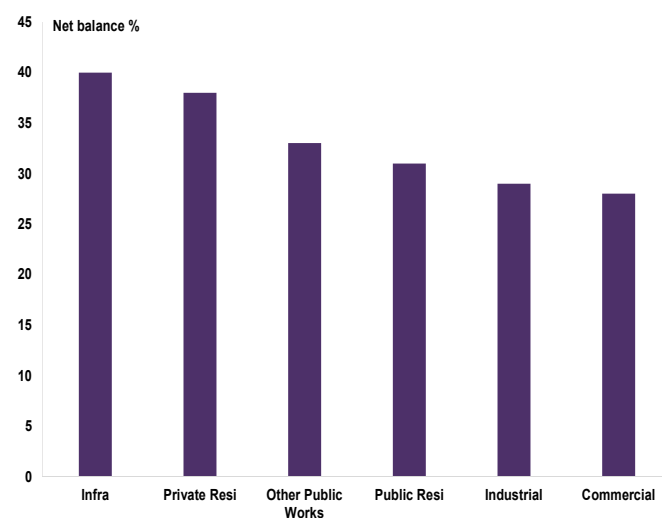


Chart 11: Significant shortages of skills continue to be reported in the RICS Monitor across a wide range of disciplines

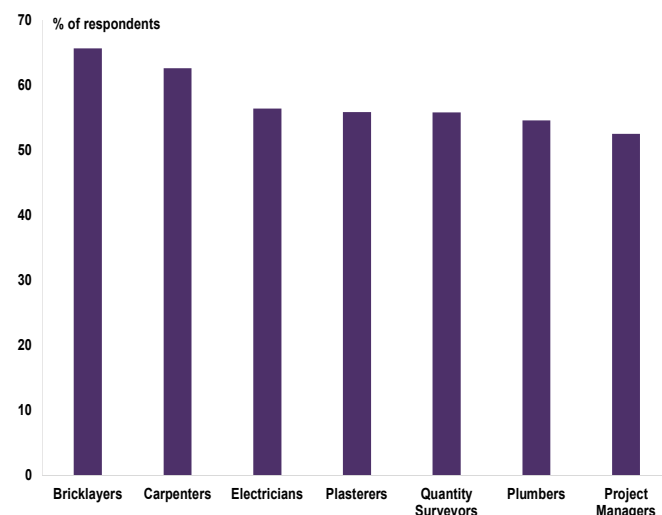
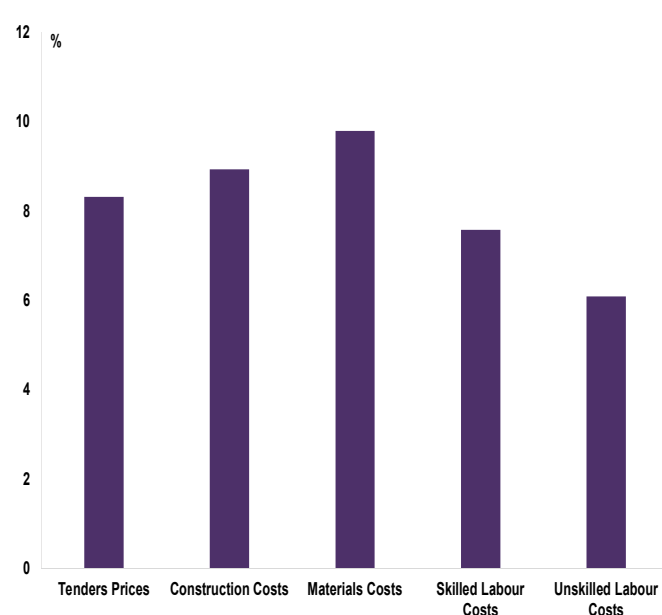


Chart 12: Feedback to the RICS Construction Monitor on 12 month expectations for tender prices and costs



## TRUSTED EXPERTS IN Central London Property

[awh.co.uk](http://awh.co.uk) [admin@awh.co.uk](mailto:admin@awh.co.uk)

For specialist property advice call 0800 071 5517

Complex Commercial Valuations  
Residential Valuations  
Valuations for Tax  
Lease Extensions  
Full Building Surveys  
RICS Homebuyer Reports  
Project Management  
Property Management  
Rights to Light

For enquiries about the Economy and Property Update and the use of the charts,  
please contact:

Simon Rubensohn

Chief Economist

[srubensohn@rics.org](mailto:srubensohn@rics.org)

Tarrant Parsons

Senior Economist

[tparsons@rics.org](mailto:tparsons@rics.org)

## Delivering confidence

We are RICS. Everything we do is designed to effect positive change in the built and natural environments. Through our respected global standards, leading professional progression and our trusted data and insight, we promote and enforce the highest professional standards in the development and management of land, real estate, construction and infrastructure. Our work with others provides a foundation for confident markets, pioneers better places to live and work and is a force for positive social impact.

Americas, Europe, Middle East & Africa

[aemea@rics.org](mailto:aemea@rics.org)

Asia Pacific

[apac@rics.org](mailto:apac@rics.org)

United Kingdom & Ireland

[contactrics@rics.org](mailto:contactrics@rics.org)



[rics.org](https://www.rics.org)