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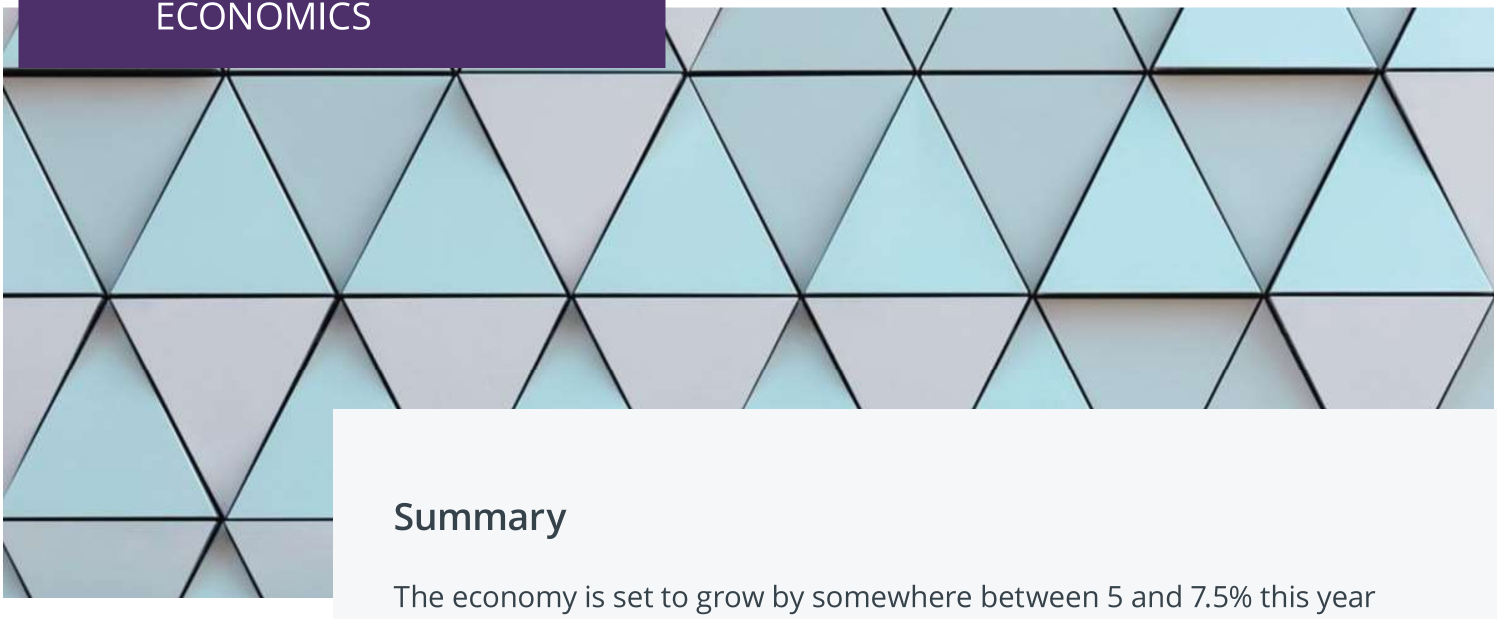
Economy and Property Market Update

May 2021

Sharp rebound in economy expected to gather pace over coming months

ECONOMICS



Summary

The economy is set to grow by somewhere between 5 and 7.5% this year creating a generally favourable environment for real estate as interest rates remain at rock bottom levels into 2022. Structural challenges will continue to depress some parts of the commercial property market but investment activity elsewhere will gain further momentum. Private housing and infrastructure will lead the acceleration in output growth in the construction sector.

Economy

The economic outlook has brightened with the successful rollout of the vaccination programme. Reflecting this, growth projections are being revised upwards with the IMF now expecting a 5.3% increase for this year compared with 4.5% back in January. Most other forecasters are even more upbeat with the Oxford Economics consultancy projecting growth of 7.5% to be followed by a further strong performance (5.5%) in 2022.

The more positive sentiment is also visible in a range of other indicators including the IHS Markit/CIPS PMI series for both manufacturing and services, as well as the KPMG/REC jobs reports. The latter points to vacancies for permanent employment opportunities rising at the fastest rate in the survey's 23 year history. Significantly, the latest Deloitte CFO survey shows the appetite from business to take risk onto balance sheets standing at its highest level since the middle of the last decade (chart 1).

It is likely consumer spending will be the main driver of the initial stage of the recovery, fuelled by excess savings built up during the lockdowns, which are estimated to amount to around 8% of GDP (£170bn). However, the temporary investment tax credit (announced in the budget) should provide some balance supporting an uplift in capex as the year wears on.

Inflation is, meanwhile, likely to move above the 2% target on the Bank of England's own analysis (chart 2) with oil price-related base effects and the increase in the utilities tariff cap driving the CPI higher. The key question for the authorities will be how sustained this trend proves to be. Rising raw material costs, 're-opening' inflation, some labour shortages and the introduction of Brexit-related non-tariff barriers from January next year present upside risks. However, for now, money markets are putting more faith in subdued wage settlements exerting a stronger influence on medium term inflation. This suggests base rates are likely to remain on hold through the course of this year, although some modest tightening is certainly plausible in 2022 if the economic recovery maintains the trajectory envisaged.

Public debt is likely to remain above 100% of GDP for the time being (chart 3) with measures to repair the fiscal picture only beginning to kick-in during 2023 with the hike in corporation tax. The low level of servicing costs continues to provide space to address this challenge.

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

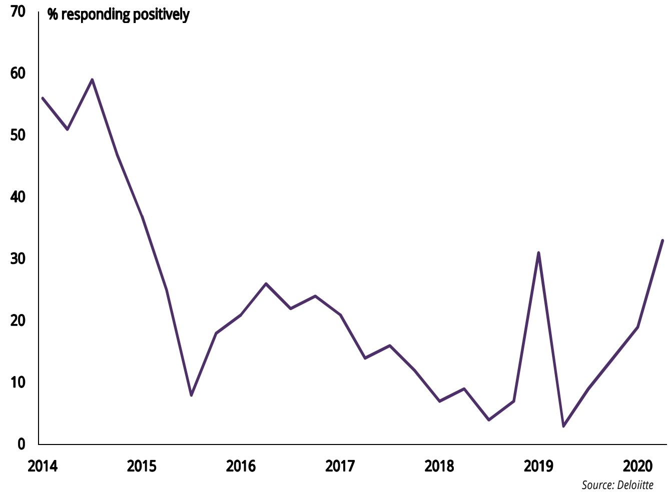


Chart 2: The Bank of England expects inflation to climb towards 2.5% over the coming months before slipping back

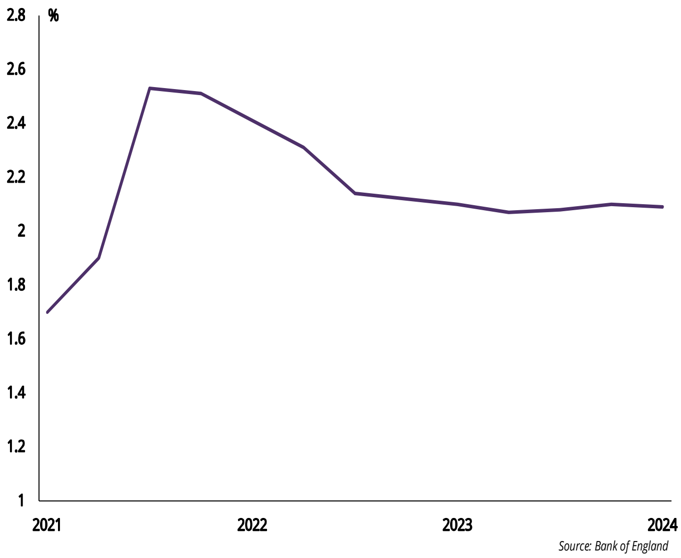
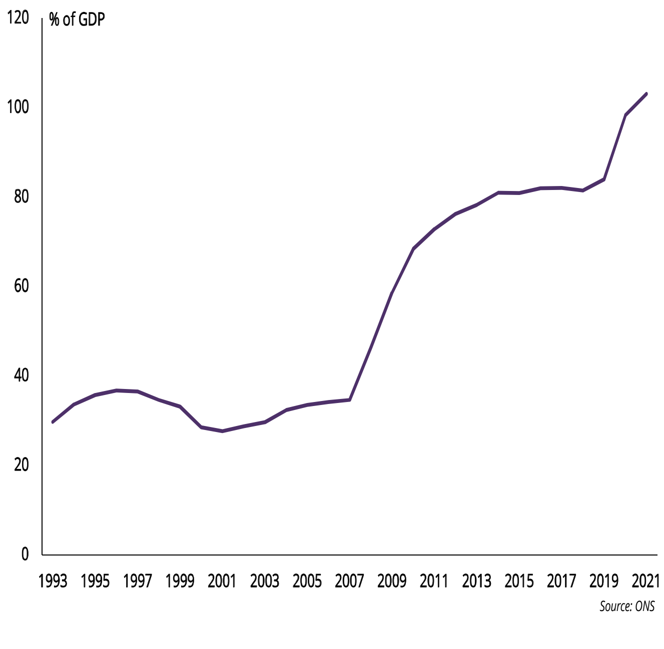


Chart 3: Public sector debt is likely to peak at around 104% of GDP



Commercial Property

Better news on the economy over the past few months has helped lift the mood in the real estate sector, with the RICS Commercial Property Sentiment Index climbing from -25 to -11 in the first quarter of the year (its best reading since the final three months of 2019). Total investment activity according to Lambert Smith Hampton was £11.2bn over the period. While down on the strong transaction number recorded in the run-in to the end of last year, it is only 13% below the five year quarterly average.

Significantly, the stark sector narrative continues to be clearly visible across the investment numbers, with PropertyData showing industrial/logistics accounting for more than £3bn of the investment spend over the quarter, the third highest quarterly total devoted to this segment of the market since their records began (chart 4).

The sector trends are also very much to the fore in the RICS data with Q1 numbers showing occupier demand continuing to fall sharply for retail and, to a lesser extent, for offices but rising solidly for industrial/logistics; the net balance reading of +57% for the latter (which reflects momentum rather than a level) was the most positive reading since the early part of 2015. Within retail, the pressure remains most intense on shopping centres with the latest CBRE data suggesting rental values have declined by more than 13% over the past twelve months.

Forward looking indicators from the RICS survey suggest this trend is likely to persist. Chart 5 shows the most recent expectations for rents over the next twelve months. Alongside this, the Q1 survey included an additional question aimed at estimating the length of time it would take for revenues from an asset class (on average) to return to pre-COVID levels. Retail in general was put at 5+ years with shopping centres at the upper end of the range. Meanwhile, the projections for leisure hotels were slightly more favourable in terms of the recovery path than for business hotels.

In terms of the future of the office, a recent study from Morgan Stanley bears out the prospect of a hybrid model emerging with their analysis pointing to an expectation of a three-two day blend between office and home working. Feedback to the RICS survey (chart 6) suggests that a scaling back in the office footprint by around 12% over the next two years is plausible and would be consistent with more home work and some de-densification of space.

Chart 4: Industrial investment acivity remains firm despite the wider challenges for real estate

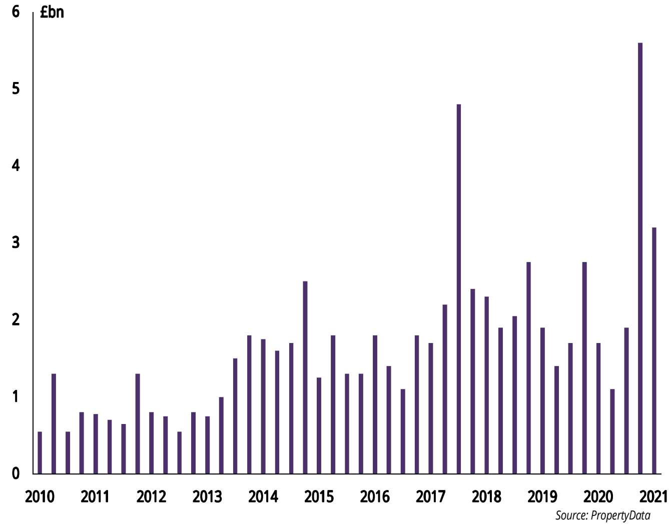


Chart 5: Prime industrials are likely to see the strongest rental growth over the next twelve months according to the RICS survey

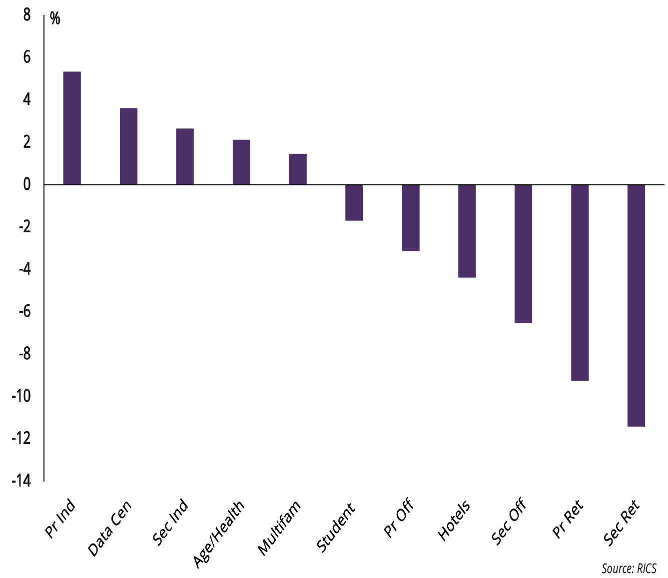
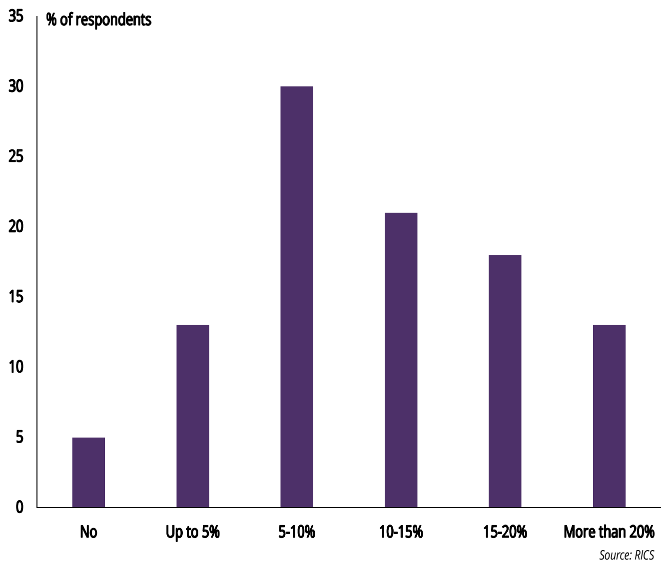


Chart 6: Feedback around the scaling back of the office foorprint point to an average reduction of around 12%



Residential Property

This has clearly been a most unusual period for the housing market. In the midst of a record peacetime GDP contraction, residential prices have surged, driven by behavioural changes, i.e., the desire for more space given lockdown and working from home, low interest rates and the stamp duty break.

The end of the tax holiday will, in all probability, cool the market somewhat. However, previous examples of expiring temporary stamp duty reductions point to only a short term drop in transactions and a more modest impact on pricing before both return to underlying trends. Significantly, it is evident from similar performances in other countries that the resilience of the market is being driven by more than this single issue. It is also clear the government remains fully committed to supporting homeownership and has demonstrated this with the introduction of the new guarantee scheme aimed at boosting riskier 95% LTV mortgages.

Chart 7 shows after briefly rising relatively sharply last year, the subsequent strength of demand for homes has resulted in the inventory of unsold stock on estate agents books heading south once again. The impact of this on expectations is clearly visible in chart 8 which captures the anticipated change in both prices and sales over the next twelve months. Tellingly, while the RICS net balance indicator for the former continues to accelerate to stand not far off a series high, the latter is pointing to only modest growth in activity. Moreover, it is expected by respondents to the RICS survey that the robust price trend will be sustained beyond this period. The five year projection (taking an average of the last three months readings) is consistent with price growth in excess of 20%, highlighting the prospect of a further deterioration in housing affordability.

This message is also coming through in the RICS private rental metrics. Chart 9 shows RICS Rent Expectations, reflecting a widening imbalance between the demand and supply indicators, as likely to materially drive up private rents.

While it may be simplistic to assume that higher supply numbers alone can redress the affordability issue, particularly in a low interest rate environment, an uplift in delivery does have a role to play. Planning reforms as outlined in the recent Queen's Speech are likely to provide part of the answer although it is critical, especially with regard to permitted development rights, that quality and safety are not compromised.

Chart 7: The inventory of residential property on estate agents' books has fallen sharply after briefly picking up

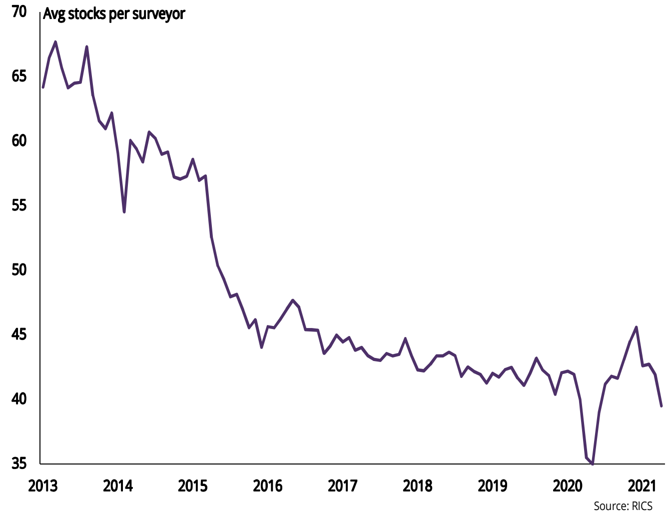


Chart 8: The latest survey shows a further acceleration in 12 month price expectations with sales expectations more subdued

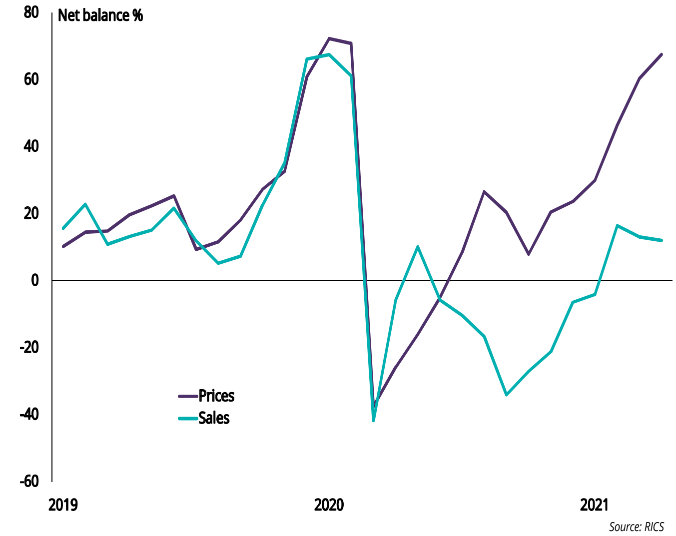
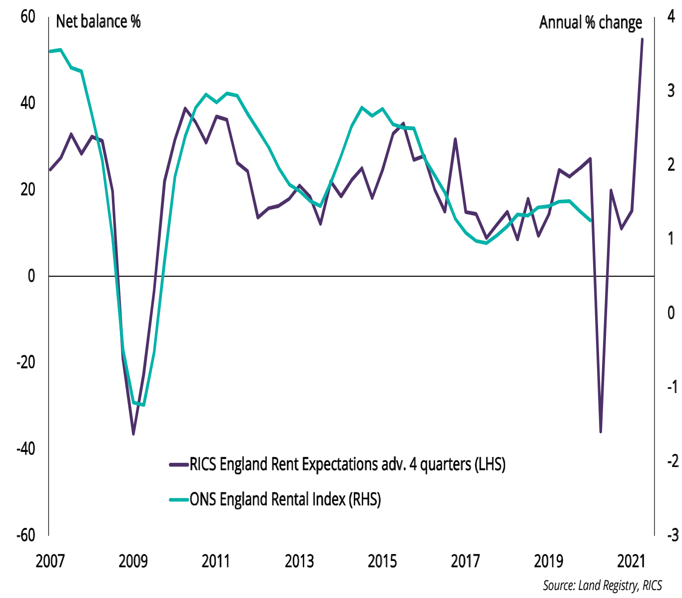


Chart 9: The imbalance between the RICS Tenant Demand and Instructions indicators points to sharp rise in private rents



Construction

The latest ONS construction data shows that output is now picking up smartly with the March number 5.8% higher than February and 6% up on the same month in 2020. Chart 10 looks at how construction output has changed over the past fifteen months, covering the period of the pandemic. Repair and maintenance (in aggregate) stands out as the key area of strength followed by (new) infrastructure work and housing. Commercial output, unsurprisingly, remains more challenging.

This is a trend also coming through very vividly in the Q1 RICS Construction and Infrastructure Monitor. Significantly, the 12 months expectations data shows workloads are anticipated gathering momentum across all sectors although the net balance readings point to private residential leading the way. Updated forecasts from the Construction Products Association (CPA) suggest industryoutput may grow by close to 13% this year followed by around 5% expansion in 2022. Within this, the CPA are envisaging infrastructure output climbing by almost 30% over 2021 and even the laggardly private commercial sector to post a gain.

Chart 11 suggests that the rebound in activity across the sector is likely to see headcounts rise and, more notably, the start of a reversal of the trend that has seen an erosion of profit margins. Against a background of rising raw material costs, any improvement in terms of profitability is likely to be modest but feedback received from RICS respondents does at least suggest that some of the pressure around skill shortages may have eased a little.

Critically, the fear of a race to the bottom in terms of pricing does not appear to be manifesting itself in the results to the RICS Monitor. More than 80% of respondents indicated that they are not receiving tenders/bids below realistically prepared cost estimates. In addition, where there was any evidence of this behaviour, contributors typically suggested the pricing was within 5% of costs.

Alongside this, the RICS survey also sought to gauge the potential hit to productivity from any change in work practices linked to COVID. When this question was asked in the wake of the onset of the pandemic (Q2 2020), the average loss of productivity was viewed at being around 16%. It is evident that the industry has quickly learnt to adapt to the new environment with the latest results putting the loss at just 5% (chart 12).

Chart 10: R&M is showing the strongest increase in output since the beginning of 2020 followed by infrastructure

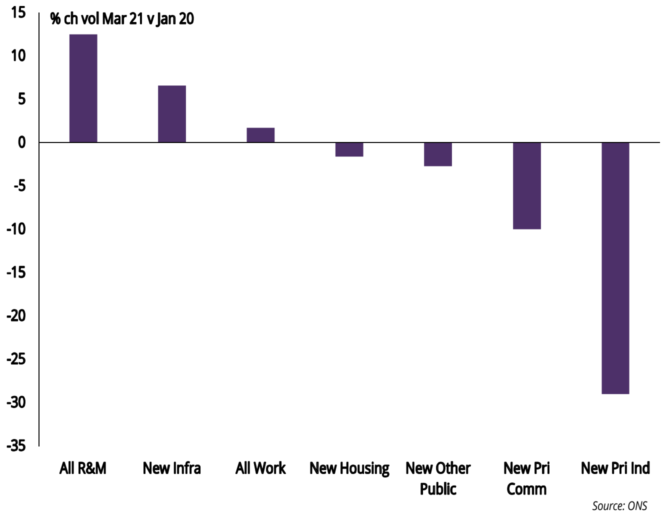


Chart 11: Both headcount and profit margins are expected to show some growth over the next 12 months

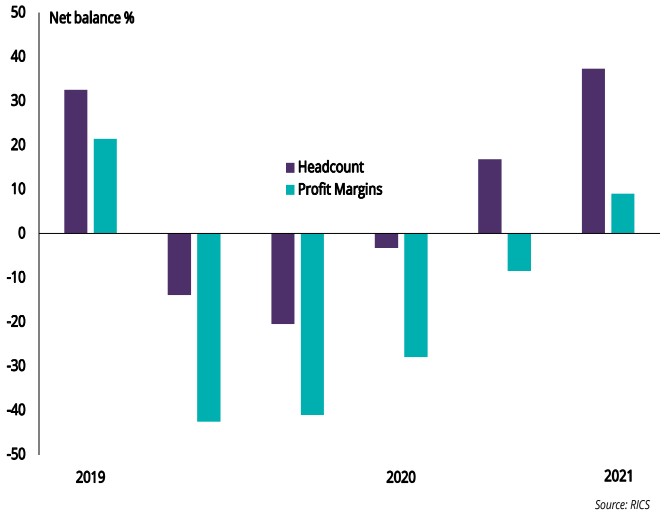
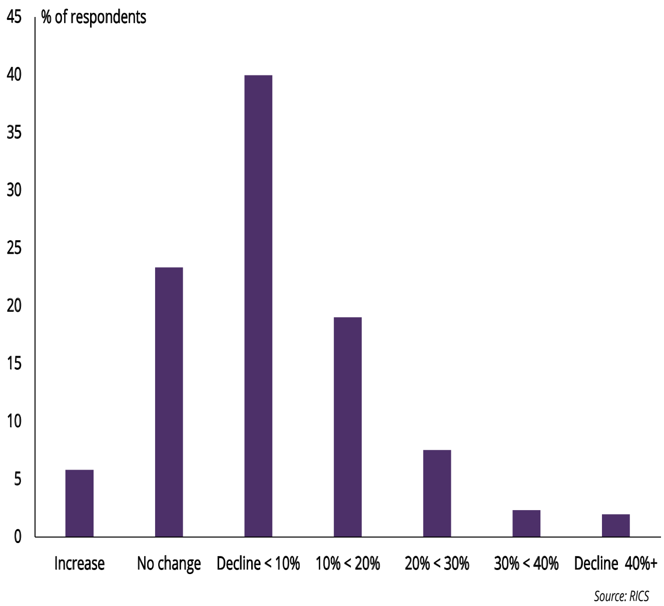


Chart 12: The hit to productivity as a result of changing work practices in response to COVID is now put on average at 5%



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

Simon Rubinsohn
Chief Economist
srubinsohn@rics.org

Tarrant Parsons
Economist
tparsons@rics.org

Sean Ellison
Senior Economist
sellison@rics.org

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Americas, Europe, Middle East & Africa
aemea@rics.org

Asia Pacific
apac@rics.org

United Kingdom & Ireland
contactrics@rics.org