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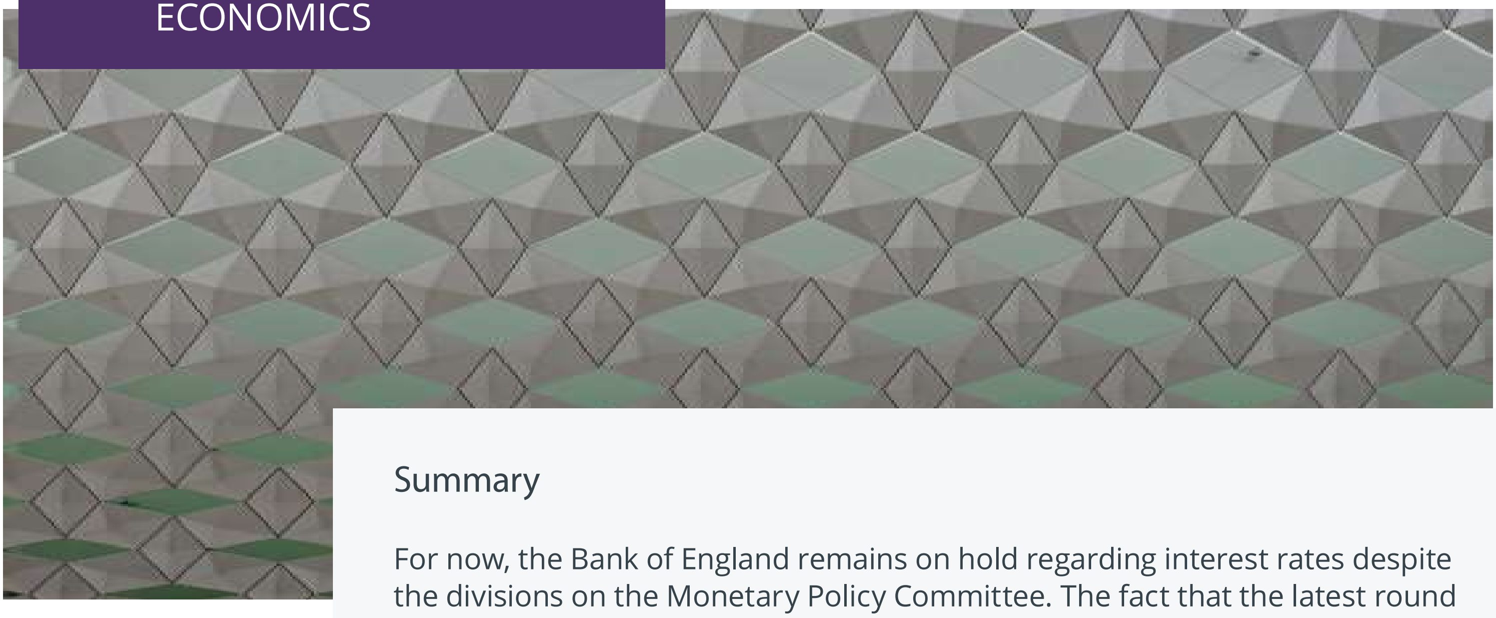
Economy and Property Market Update

August 2026

Flat picture in construction and real estate activity as uncertainty persists

ECONOMICS



Summary

For now, the Bank of England remains on hold regarding interest rates despite the divisions on the Monetary Policy Committee. The fact that the latest round of analysis from the Bank shows inflation still on course to return to the 2% target over the forecast horizon provides some basis for encouragement. That said, the combination of geopolitic uncertainty, domestic political change and the elevated cost of borrowing is weighing on construction sentiment and impacting the level of transaction activity in both the commercial and residential real estate markets.

Economy

Geopolitics as well as the domestic political environment are contributing to the ongoing level of uncertainty that is weighing on the economy. This was clearly in evidence at the latest meeting of the Bank of England's Monetary Policy Committee where the vote to keep interest rates on hold (6 to 3) was narrower than previously. This has been subsequently reflected in the upward shift in the money market curve tracking base rate expectations over the next five years (Chart 1). However, it is interesting that both the minutes and the Monetary Policy Report (MPR) provide support for the 'wait and see' approach. Significantly, the minutes indicated that there was greater confidence inflation was on a solid downward path ahead of the outbreak of the confict in the Middle East. Moreover, attention was also drawn to the limited signs, at least to date, of material second-round effects emerging.

This was reflected in the central scenario the Bank produced in the MPR for CPI. Charts 2 shows that on the assumptions that underpin this environment, inflation could dip below to the 2% target by the end of 2027. However it did also produce an 'adverse' scenario which assumes higher energy prices for the entire forecast period with materially larger second-round effects. On this basis, inflation is seen as climbing to a high of 4.5% before beginning to ease but even then, it remains above target through the whole of the Bank's forecast horizon.

In terms of economic activity, output looks to be following the monthly pattern seen since the pandemic in which the economy starts each year strongly and then gradually loses momentum (pointing to problems with the seasonal adjustments). For the whole of 2026, growth of around one per cent looks a reasonable estimate. A key drag on activity remains the household sector where elevated unemployment and the ongoing freeze in most tax thresholds and allowances will exacerbate the relative weakness in labour income. An interesting point as far as the labour market is concerned is that while the headline unemployment rate has begun to stabilise at a little below 5%, the rate for 18-24 year olds continues to climb, hitting an 11-year high of 14.8% (Chart 3). Alongside this, businesses are continuing to feel the pressure stemming higher energy costs as well the various employee-related taxes and regulatory measures. This has pushed the National Accounts measure of corporate pofits share in Gross Value Added to its lowest level in almost 20 years

Meanwhile, there is inevitable speculation around potential changes to fiscal policy with the new prime minister and his Chancellor in place. The next Budget is scheduled for October 28th. Our strong suspicion is that the fragile state of the public finances and a desire to keep the bond markets onside will give the new administration limited room for a more expansionary fiscal stance. Policies announced to date such as the national cap on bus fares and removing VAT on electricity bills for six months are not expensive for the Exchequer but will also have a negligible impact on the economic outlook.

Chart 1: Money markets continue to bet that the next move in base rates is in an upward direction

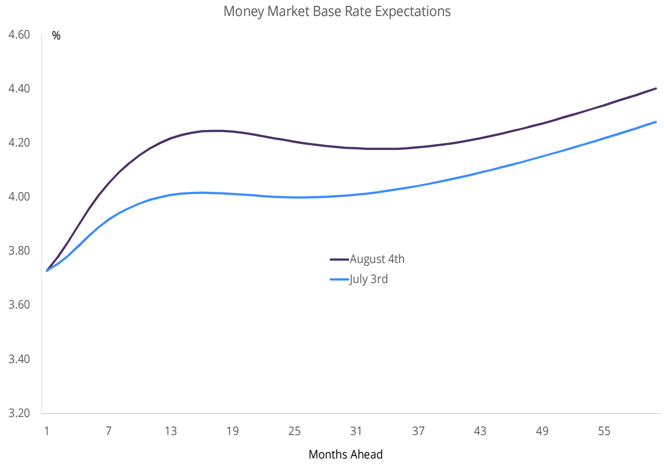


Chart 2: The Bank of England's central scenario for inflation points to it falling to the 2% target by the end of next year

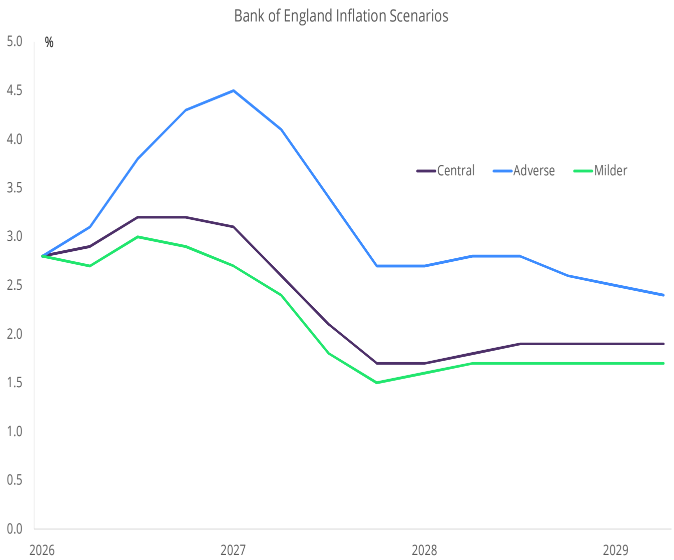
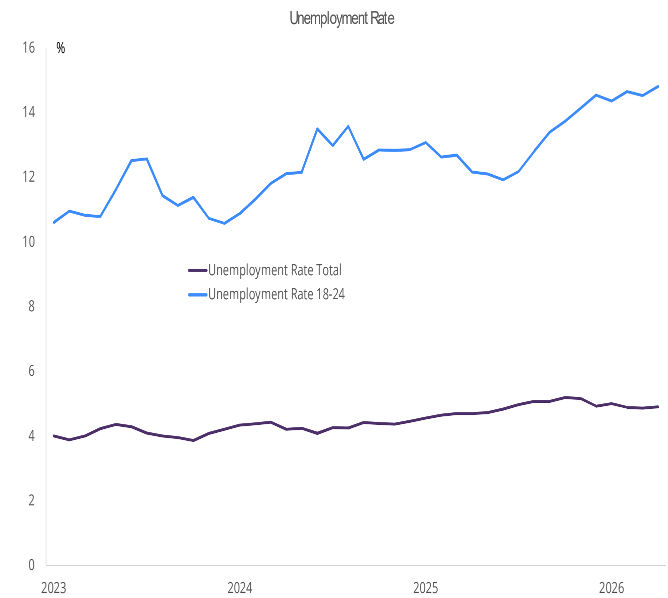


Chart 3: Unemployment has risen particularly sharplyn for those under the age of 25



Commercial Property

Activity in the commercial real estate sector in Q2 held up relatively well in Q2 in headline terms in the face of both geopolitics and the impact on energy costs as well as domestic political turmoil. Charts 4 shows quarterly transaction numbers from Lambert Smith Hampton (LSH) which estimate that volumes between April and June fell just short of the £10bn mark. That said, a significant share of activity was at the top end of the market with saw 24 £100m-plus deals together accounting for 62% of total volume. This suggests the underlying picture was a little flatter which chimes the results of the latest RICS Commercial Property Monitor. Accordsing to feedback received in the survey, a net balance of -8% respondents reported a drop in investment enquiries compared to the preceding period. Caution was also captured in the insights provided around the occupier side of the market where the net balance reading was also negative (-5%).

One feature of the RICS data is the regional dimension to the results. On the investment side of the market, the net balance for the enquiries metric in London was largely unchanged at +1% which compares with -16% elsewhere across the South, -13% in the Midlands and -13% in the North. The respective figure for the occupier market are +11% for London and then -17%, -5% and -9%. This does appear to chime with Knight Frank data showing office take-up in London and vacancy rate falling.

That said, the broader picture is still one in which market participants appear to be waiting for more visibility before commiting to deals. Chart 5 shows the results to the question from the RICS survey regarding the perceptions of respondents as to the point the CRE market is in the cycle. The feedback is not very different from that received in the first three months of the year; it is noteworth that in the final part of last year, 27% of contributors suggested that the market was in the early phase of an upturn compared with 21% in both the first and second quarters of this year.

LSH data suggests that the living sector saw the leading share of Q2 investment, with volume of £4.0bn which was broadly in line with the five-year quarterly average. The strength of this segment of the commercial property market is also evident in the forward-looking metrics from the RICS survey. Chart shows, in net balance terms, an average of the 12 months expectations results for rents and capital values. Once again, the results are markedly polarised between prime and secondary assets, particularly regarding office and retail. Data centres remain the standout in terms of projected performance while multifamily (living) as well as aged care facilities and life sciences are also maintaining a positive trend. Predictably given what was noted above, the picture for London prime offices is solid with expectations for both rental and capital values being revised upwards.

Chart 4: Resilient activity in Q2 supported by a number of big transactions

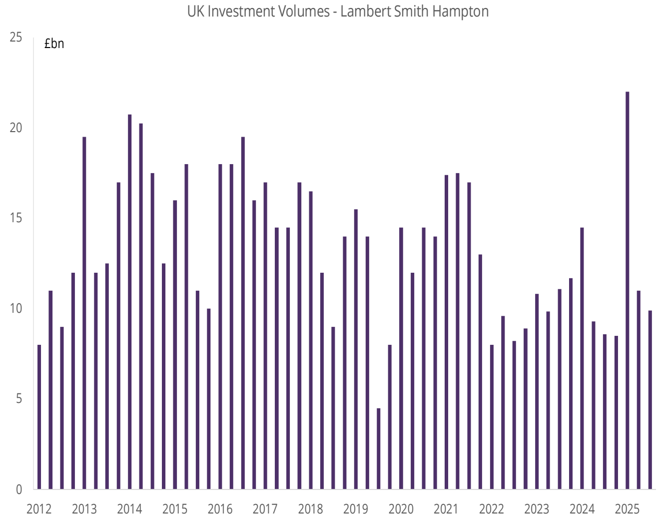


Chart 5: RICS metrics on perceptions regarding point in the CRE cycle remain cautious

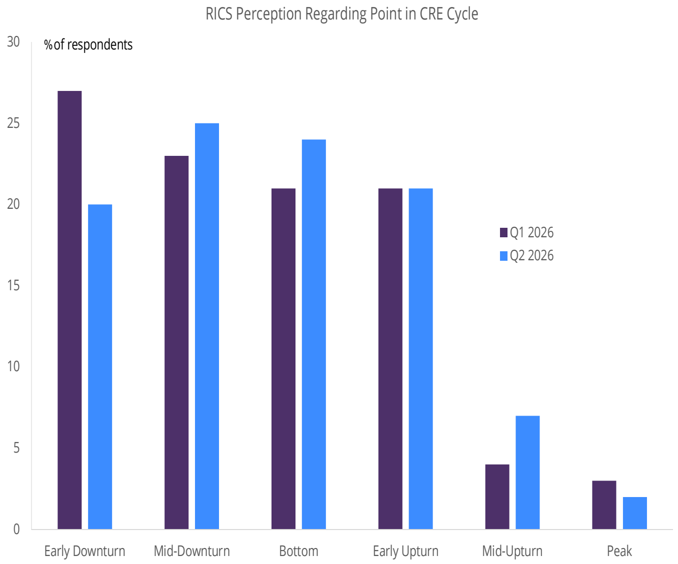
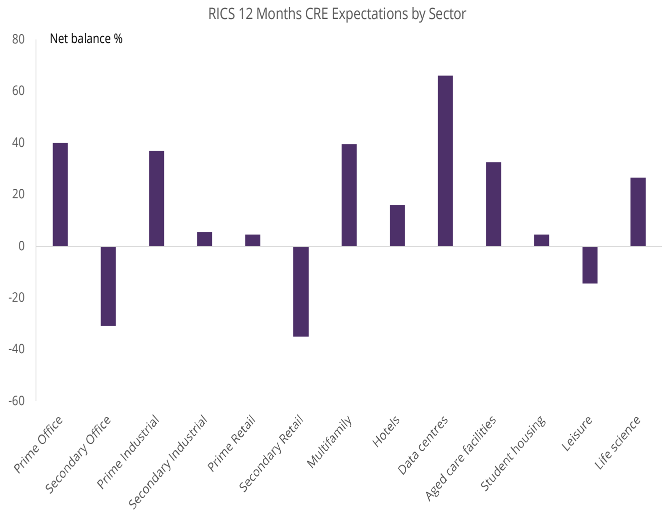


Chart 6: Sentiment regarding the outlook is still most positive for data centres, prime offices, industrial and multifamily



Residential Property

Most indicators of residential property transactions suggest that activity has been subdued this year. HMRC data provides the most complete, albeit lagging guide, Between January and June (the most recent data point), completed sales were 3.8% down on the same period of last year. Bank of England figures capturing the number of mortgage approved tells a broadly comparable story. Meanwhile, RICS metrics designed to track new buyer interest and new sales agreed paint a similar picture as highlighted in Chart 7.

It is worth bearing in mind that the negative reading extend back to the April 2025 stamp duty changes. However, the pressure on the market has been exacerbated by this years war in Iran; as an example, the average two year fixed rate mortgage has climbed by a full percentage point from a low of less than 4% in February. As noted earlier, the Bank of England is currently split on the case for a base rate increase (which could put further upward pressure on the cost of money), but the fact that its cental scenario shows inflation heading back to target over its forecast horizon provides some reason for positivity. The RICS survey also captures members views looking forward a year and in the latest report, there does appear to be a very modest imporovement in sentiment about the outlook.

Recent reports on pricing in the housing market tell a similar tale. A flat picture is evident in the Lloyds measure of house prices (recently rebranded from Halifax) which chimes with the message from the alternative Nationwide house price index. The RICS headline price indicator (measured in net balance terms) remains stuck in negative territory. Chart 8 tracks the RICS dataset against the Nationwide house price series with the former advanced six months to demonstrate its leadership properties. This suggests that pricing in the market will remain subdued through the second half of the year in the absence of any material policy changes. Official data tracking prices contines to show the appartment segment of the market struggling more than houses. This is paricularly marked in London where, on average, transacted flat prices are around 9% lower than three years ago.

Meanwhile there has been little relief for the lettings market with the Renters Rights Act now bedding in. Although some caution is required in the read through from the RICS new landlord instructions series to the actual supply of rental properties, the former continues to point to drop in properties coming to the market with, if anything, a slight worsening in the picture over the past three months. Chart 9 shows the RICS three month rent expectations series against the ONS private rent series. Notwithstanding the more restrictive regulatory environment, it suggests that the pressure on rents is likely to remain in an upward direction in the near term.

Chart 7: Key RICS activity indicators remain subdued for now

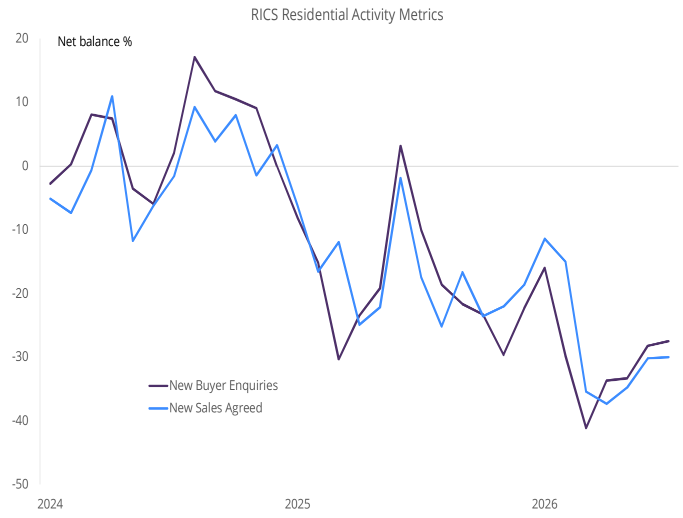


Chart 8: The RICS house price series is a good lead indicator of house price inflation suggesting the flat picture will persist

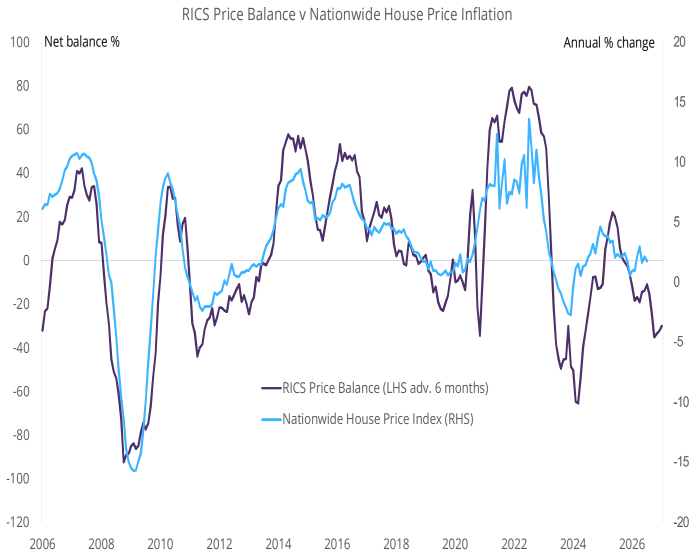
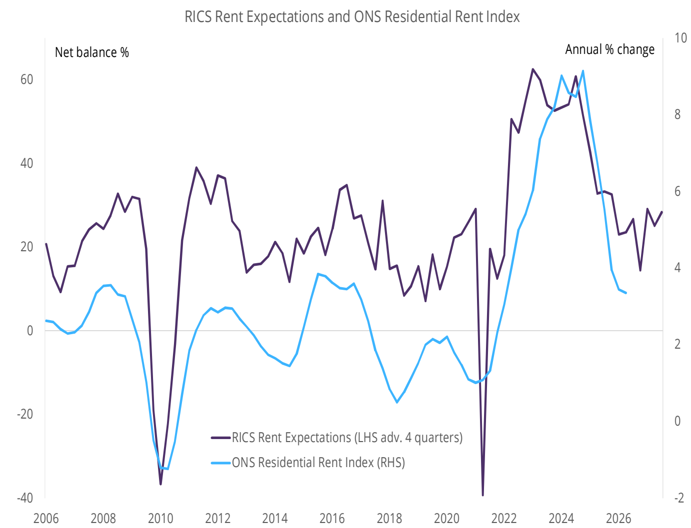


Chart 9: The demand supply imbalance in the private rented sector remains a key issue



Construction

Official data shows construction output is currently tracking around two per cent down than a year ago. While we and many others have cautioned about placing too much weight on the ONS numbers, the latest RICS sentiment data paints a not dissimilar picture. Q2 workloads were marginally negative compared with the preceding period with a net balance reading of -4% (this is the share of respondents reporting a drop in activity as against those indicating a rise when set against Q1). Other surveys assessing the current health of the construction industry including the S&P PMI also tell a similar story.

Chart 10 disaggregates the headline RICS workloads data looking at the feedback at a sector level, again in net balance terms. What is particularly striking is the divergence between the private and public sectors with the readings for the former negative in all three sub-components. Most notable is the downbeat picture in private housing activity which is also reflected in many other insights capturing this part of the development industry. NHBC, which covers approximately 70% of new house building, reported 19,045 new homes registered in the private sector in Q2, which was 5% lower than a year ago. Meanwhile, Barratt Redrow struck a cautious tone in its latest trading update stating that that due to current economic conditions, it would limit new land investment. As has been the case for a while, infrastructure continues to be the area reporting the strongest postive momentum with energy, water and communications driving activity.

Viability remains a particular concern for housebuilders particularly those operating in London and the South-East of the country. The Home Builders Federation, in recent analysis, estimate that build costs have jumped by around £76,000 over the past five years amounting to more than 20% of an average home's value (when allowing for materials, taxes, levies and regulatory compliance). Chart 11, once again drawing on feedback for the RICS Construction Monitor, shows that financial constraints continue to be the number one obstable to workload activity at the present time followed by planning and regulation. This is also captured in metrics tracking pfofit margin which remain stuck in negative territory.

Despite this, the latest data from the Insolvency Service suggests that the picture in the industry has begun to stabilise (see Chart 12). There were 3,805 construction insolvencies in the 12 months to June, 0.4% lower than in the year to May and 4.6% lower than a year ago. Whether this better trend can be sustained will, in part, depend on events in the Middle East and how this plays out on building material costs and supply chains. The most recent projection from the RICS Construction Monitor is that materials costs will rise by a further 7% over the next twelve months.

Chart 10: RICS construction workload indicators highlight a striking divergence between the public and private sectors

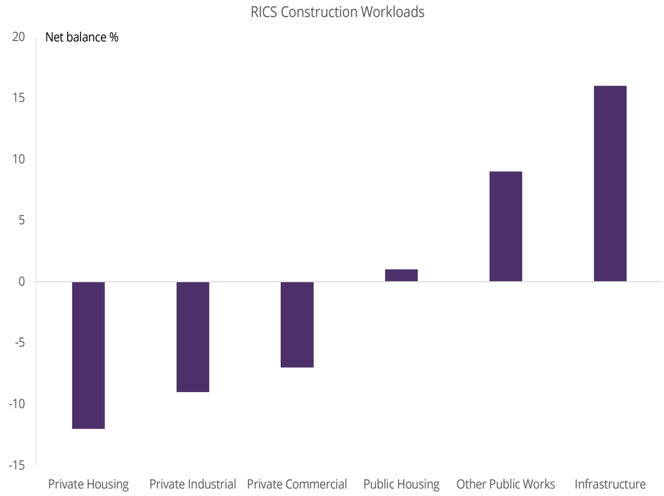


Chart 11: Financial constraints remain the number one barrier to activity

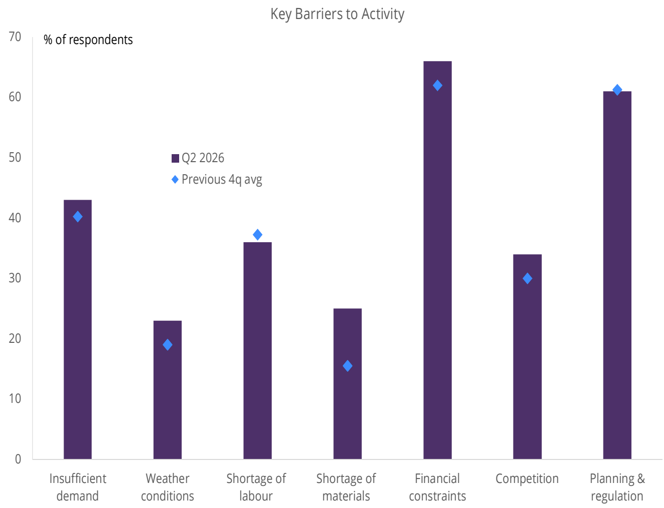
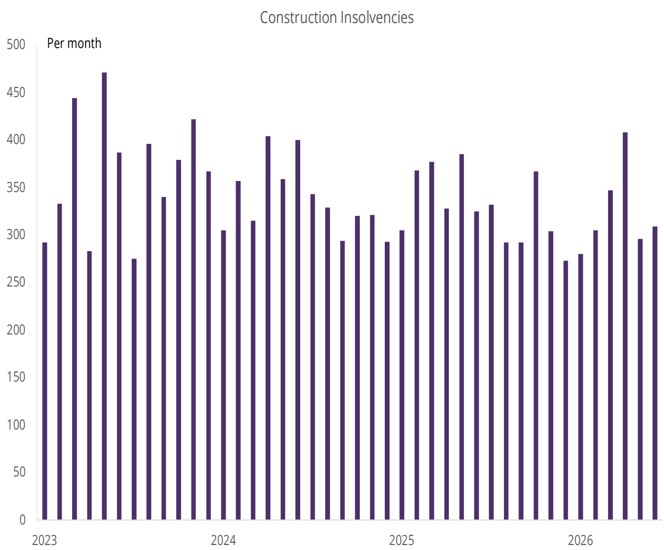


Chart 12: The trend in the number of insolvencies in the construction industry is edging downwards for now



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