

# Economy and Property Market Update

May 2026

## Energy shock leads to downgrading of economic growth outlook

### ECONOMICS

#### Summary

Expectations for growth this year have been halved, reflecting the recent spike in energy prices and the anticipated second-round effects. Interest rates are now viewed as more likely to rise than fall over the remainder of the year, as inflation remains well above the Bank of England's target. There are already signs that this shift in sentiment is feeding through to real estate markets, with development projections for the next twelve months being scaled back.

# Economy

Predictably, the conflict in the Middle East has begun to weigh on expectations for the economy. While Q1 growth again delivered a typically strong outturn, this can in part be attributed to residual seasonality in the data that has yet to be fully adjusted. A degree of payback has been evident in previous years, and this pattern is likely to be repeated, compounded by the direct impact of higher energy prices alongside heightened geopolitical uncertainty. Most forecasts for the economic outlook point to growth in the region of 0.5% to 0.7% this year, with something close to 1% tentatively pencilled in for 2027. However, at this stage, the risks surrounding these projections are greater than usual.

A key challenge for policymakers is assessing the broader inflationary impact of rising energy costs. In its latest Monetary Policy Report, the Bank of England outlined three possible scenarios to frame this uncertainty (as shown in Chart 1). Scenario A is based on recent market pricing for energy and assumes no second-round effects on wages and pricing behaviour, while Scenario B incorporates higher energy prices alongside limited second-round effects. The most concerning outcome is Scenario C, which envisages elevated energy prices persisting for longer, accompanied by stronger and more sustained second-round effects. Under the first two scenarios, inflation is projected to peak at just over 3.5% before returning to target, most quickly in Scenario A. However, the risks associated with inflation becoming more entrenched are evident in Scenario C, where inflation could potentially exceed 6%.

Given the wide range of possible outcomes, it is not surprising that expectations for the interest rate outlook remain highly uncertain. Most members of the Monetary Policy Committee currently place the greatest weight on Scenario B, although at least a couple appear inclined towards a rate increase in June. The ultimate path will depend in part on how quickly the conflict is resolved; the longer it persists, the greater the risk of second-round effects taking hold. Chart 2 illustrates how interest rate expectations have shifted in recent months, along with the current curve over a five-year horizon. A broadly similar trend is evident in the gilt market, where ongoing political uncertainty is adding to upward pressure on yields. Following the recent local election results, there has been renewed discussion around the scope for further government intervention. Chart 3 highlights two key variables that illustrate the constraints facing policymakers within the existing fiscal framework. Notably, public spending as a share of GDP is close to its highest level since the Second World War. At the same time, debt servicing now accounts for around 10% of total government revenues.

Chart 1: The Bank of England recently outlined three scenarios for inflation in light of the recent jump in energy costs

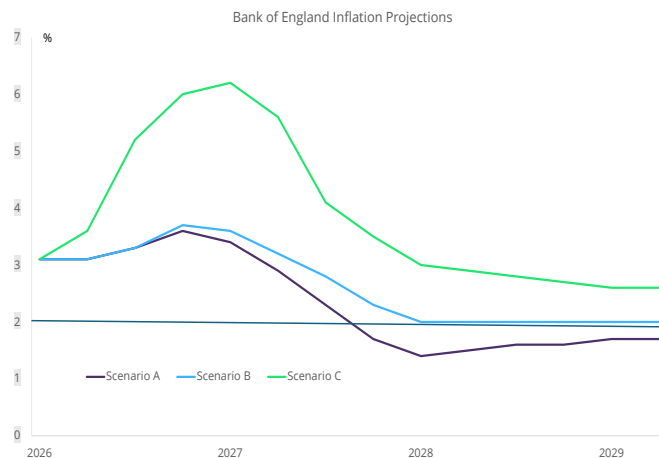


Chart 2: The expectation of higher inflation is now feeding through into money markets view of the outlook for interest rates

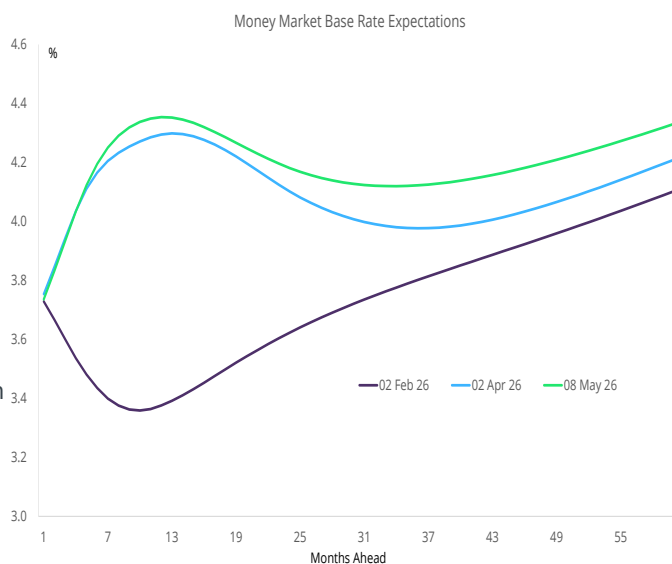
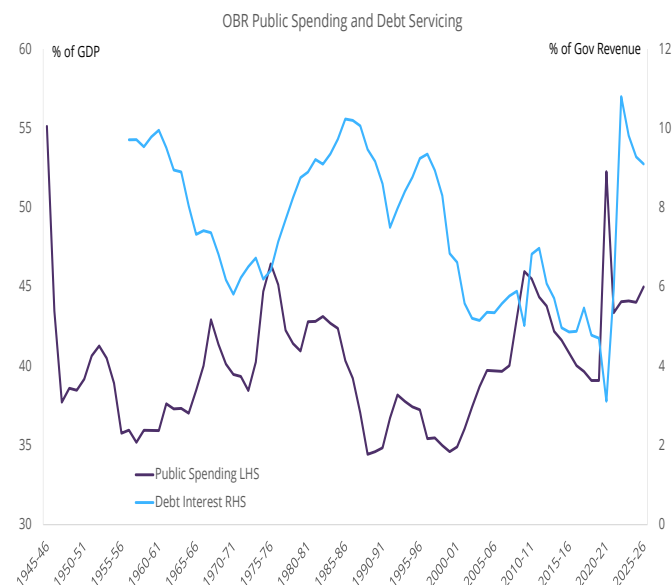


Chart 3: Public spending as a share of GDP is close to an 80 year high (excluding the Covid spike)



# Commercial Property

Data from property consultant Lambert Smith Hampton suggests that transaction activity in the commercial real estate market proved relatively resilient in the first quarter, despite the outbreak of the conflict during this period. Their figures indicate that volumes rose to £10.8bn over the three months, which, although well below the record £21.6bn recorded in the previous quarter, was 16% higher than in the same period of 2025. A notable feature of this performance is the continued momentum in larger deals, with LSH reporting 11 transactions in excess of £200m. However, accompanying commentary highlights the risk that increased uncertainty and a weakening macroeconomic backdrop may weigh on activity in the second quarter.

This aligns with the recently released RICS Commercial Property Monitor, which shows the metric tracking investor enquiries (on a net balance basis) remained broadly stable in Q1, albeit still modestly negative. However, as Chart 4 illustrates, a sharp deterioration in feedback on credit conditions, driven by concerns around the interest rate environment, points to a more challenging outlook for investors should this trend persist.

This shift is already being reflected in the headline RICS capital value expectations series. Chart 5 tracks net balance readings over both three- and twelve-month horizons. In the near term, expectations weakened from -4% to -18%, marking the most negative reading since Q3 2023. Looking further ahead, sentiment has also softened, with expectations moving from marginally positive territory at the end of last year (+6%) back into negative territory (net balance of -11%). Another indicator signalling the risk of a market pullback relates to perceptions of the property cycle. In Q1, 50% of respondents viewed the market as being in the early or mid-phase of a downturn, compared with less than 40% previously. Correspondingly, fewer respondents now consider the market to be at the bottom of the cycle or in the early stages of an upturn.

Chart 6 breaks down twelve-month capital value expectations by sector and highlights the shift from Q4 projections. It is notable that all sectors have seen a downgrade compared with the previous reading, including data centres, which remain the most positively viewed segment of the market. Other areas demonstrating relative resilience include aged care facilities and industrials. By contrast, secondary assets, particularly in the office and retail sectors, continue to be viewed as most exposed to downward pressure on pricing, alongside leisure assets.

Chart 4: A worsening in the credit environment has typically been associated with a weaker trend in investor enquiries

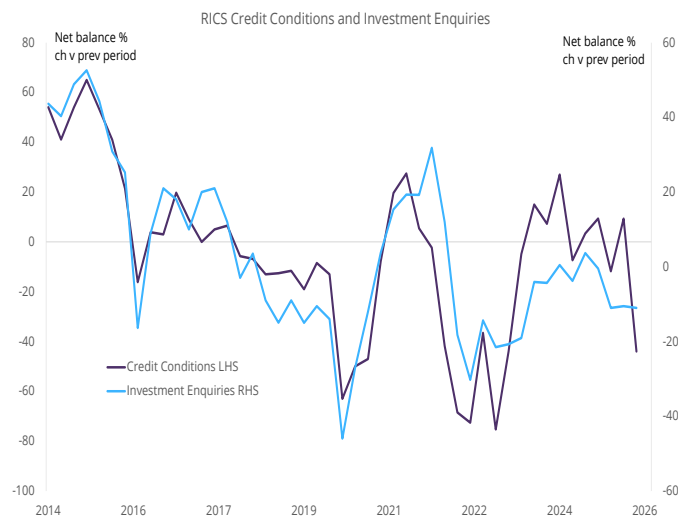


Chart 5: RICS metrics capturing headline capital value expectations are in negative territory

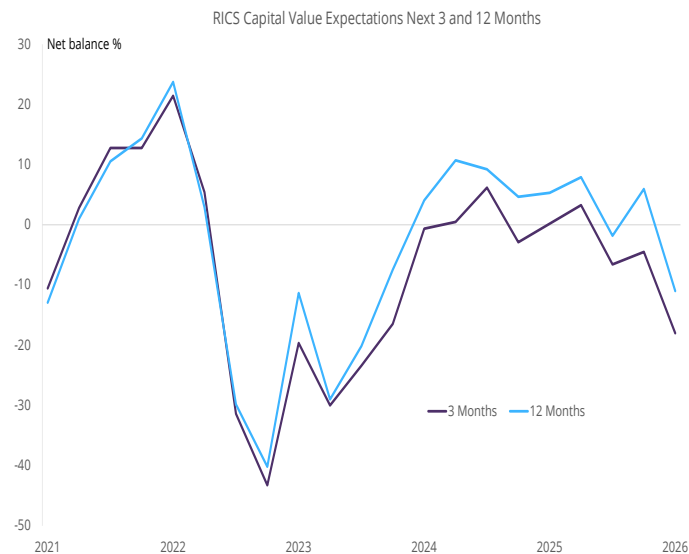
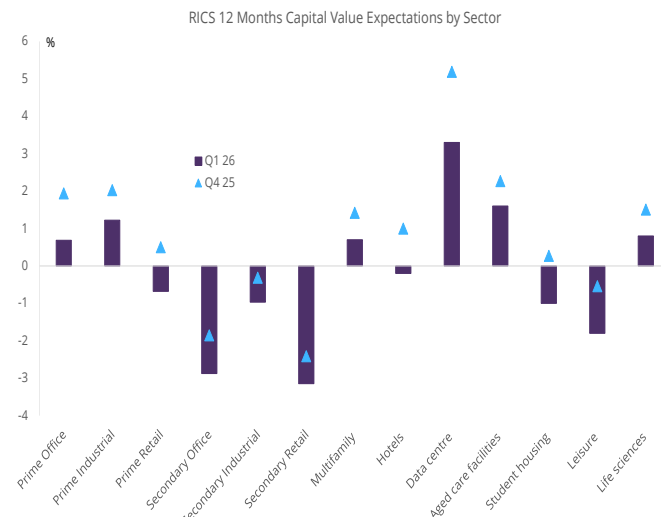


Chart 6: Capital values expectations have been lowered across all sectors but Data Centres remain most resilient



# Residential Property

Sentiment in the housing market has turned markedly more negative since the onset of the conflict in the Middle East, reflecting increased macroeconomic uncertainty and the repricing of mortgage products at higher rates. One of the clearest indicators of this deterioration is the RICS New Buyer Enquiries series, which, as Chart 7 shows, has fallen sharply in recent months. The chart also illustrates the relationship between this metric and housing transactions (measured on an annual basis). In the absence of a resolution to the conflict in the near term, activity in the sales market appears likely to come under further pressure. That said, there remains a clear regional divergence, with feedback from the south of England, including London and East Anglia, generally more negative than from the north, as well as Scotland and Northern Ireland.

For now, the main measures of house prices continue to show a degree of resilience. The Nationwide Building Society index is currently 3% higher than a year ago, the Land Registry series is up 1.2%, and the Halifax index stands at +0.4%. However, the key price indicators from the RICS survey, which tend to lead the official data, have begun to weaken. Chart 8 tracks four principal series, all of which are, to varying degrees, trending downwards. Even so, material falls in nominal house prices typically occur only in the context of significant economic disruption, characterised by rising unemployment and increased levels of distressed selling. At present, most economic forecasts remain in positive territory, albeit less robust than previously, and unemployment is expected to rise only modestly from current levels.

One notable development in recent years has been an improvement in affordability in the more expensive parts of the country. Chart 9 presents the Nationwide Building Society First Time Buyer House Price to Earnings ratio (HPER) back to the early 1980s. The figures for London are particularly striking, with the HPER now at 7.5, compared with a peak of over 10 a decade ago. Meanwhile, the latest RICS rental market indicators point to a continued imbalance between demand and supply, with the latest survey conducted ahead of the introduction of the new Renters' Rights Act. Against this backdrop, rents are expected to continue rising, broadly in line with inflation over the coming year.

Chart 7: Weaker RICS New Buyers Enquiries are pointing to a drop in transaction activity

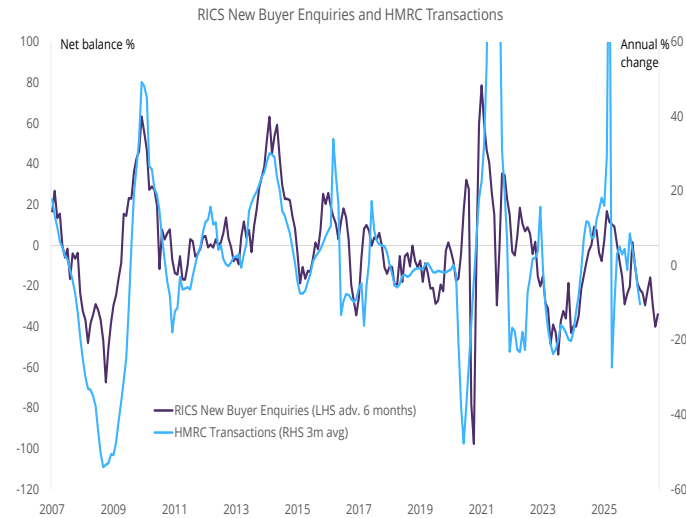


Chart 8: RICS house price metrics have turned negative

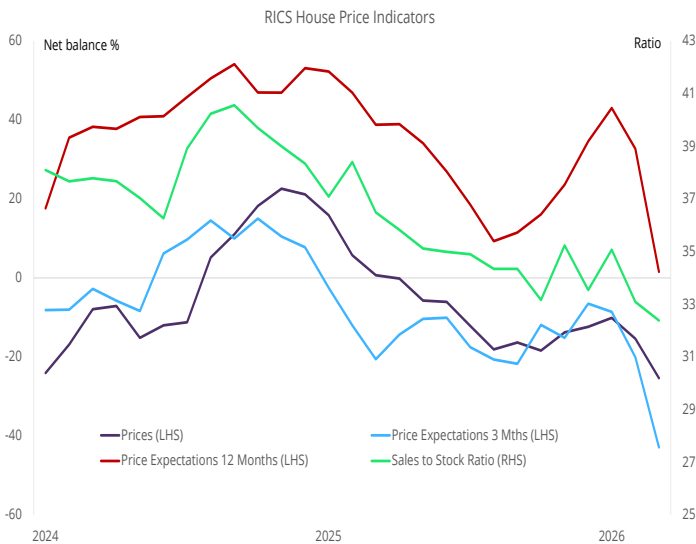
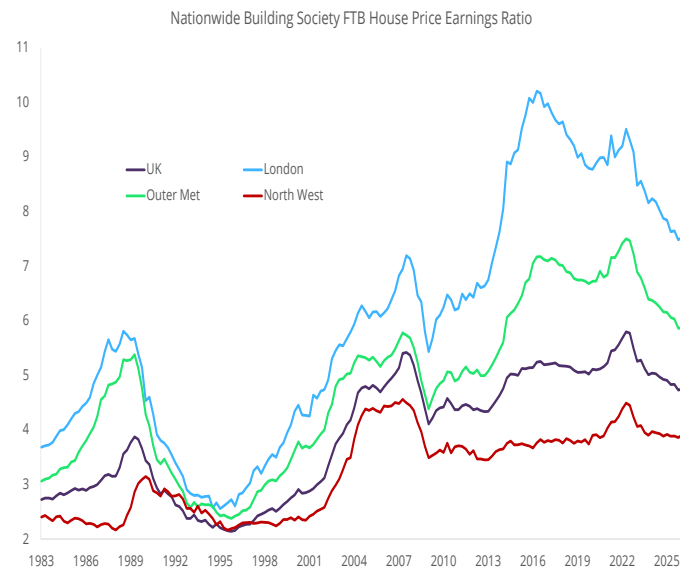


Chart 9: The biggest improvement in affordability has been in London



# Construction

Official data on construction output point to a broadly flat trend at present. However, ongoing concerns regarding data quality (including the underestimation of costs, the resulting overestimation of volumes, and survivor bias) continue to cast doubt on its reliability as a guide to underlying industry conditions. The Q1 RICS Construction Monitor provides further evidence suggesting that a more cautious interpretation may be warranted.

Chart 10 tracks workloads by sector in net balance terms for the final three months of last year and the first quarter of 2026. Unsurprisingly, the latest results are more downbeat, primarily reflecting concerns linked to the conflict in the Middle East. The deterioration is most pronounced in private housing, aligning with recent trading statements and results from major housebuilders. By contrast, infrastructure and other public works continue to demonstrate greater resilience.

Feedback from the latest RICS survey indicates that financial pressures have intensified across the sector in recent months, partly reflecting broader geopolitical developments. This is most clearly captured in the credit conditions metrics, which assess both recent trends and expectations over the next three and twelve months. As shown in Chart 11, while there was only a modest deterioration in credit conditions during the first quarter, respondents have become significantly more pessimistic about the outlook. At the twelve-month horizon, the latest reading shows a net balance of +42% of contributors expecting conditions to worsen, marking the weakest result since Q3 2022.

Alongside this, financial constraints have emerged as the primary barrier to increased activity, cited by around two-thirds of respondents. Planning and regulation rank as the second most significant constraint, despite the passage of the Planning and Infrastructure Act, with concerns around delays at the Building Safety Regulator frequently highlighted.

Despite these pressures, it is notable that the number of construction insolvencies is currently trending downwards, notwithstanding the inherent volatility in this data (Chart 12). Whether this improvement can be sustained in the face of recent headwinds remains uncertain. With the RICS forward-looking indicator for profit margins moving further into negative territory (net balance of -27% compared with -12% previously), the outlook appears increasingly challenging.

Meanwhile, the challenge facing the government in meeting its target of delivering 1.5 million new homes over the course of the current parliament continues to intensify. The RICS metric assessing expectations for residential workloads over the next twelve months now points to a broadly flat outlook (net balance of -1%), down from +14% at the end of last year and +26% following the 2024 general election.

Chart 10: RICS construction workload indicators have softened during Q1



Chart 11: Credit conditions are now seen as worsening significantly through the course of this year

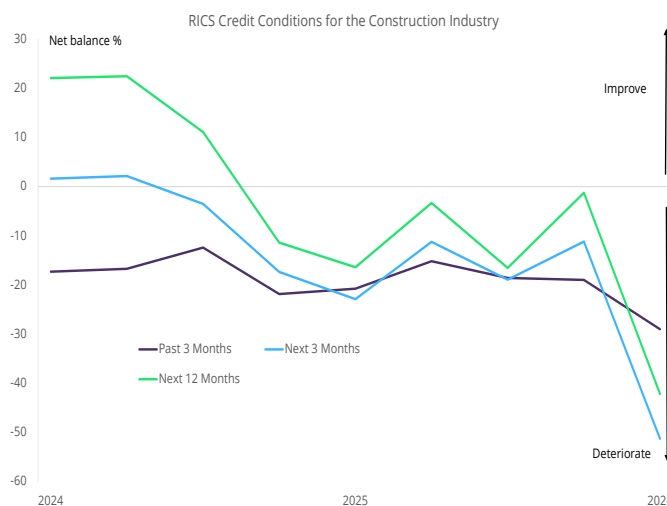
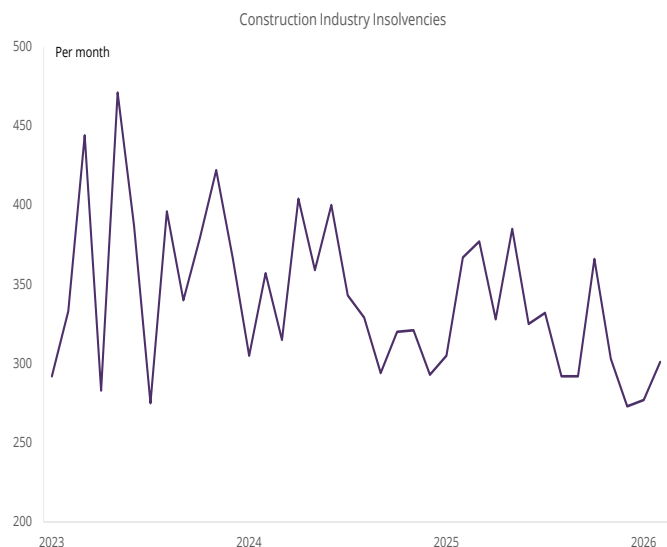


Chart 12: The number of insolvencies in the construction industry is trending downwards but this is unlikely to be sustainable



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