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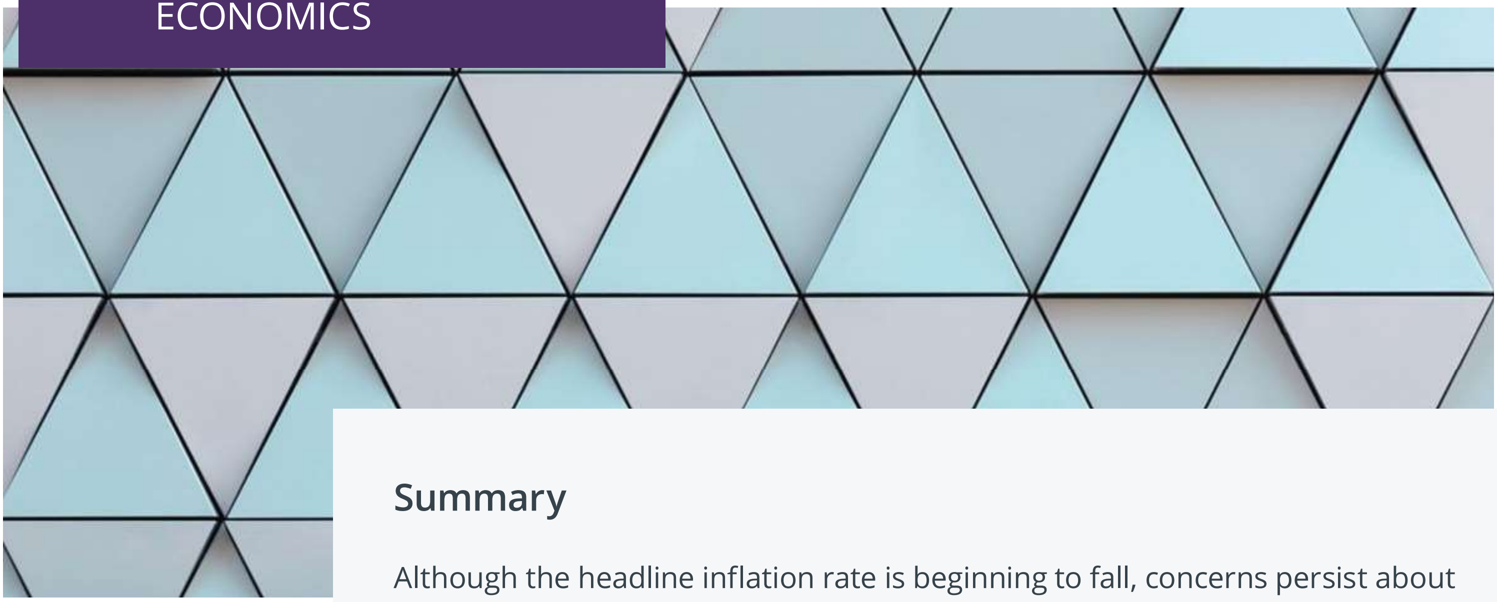
Economy and Property Market Update

August 2023

Interest rates likely to remain at an elevated level for some time to come

ECONOMICS



Summary

Although the headline inflation rate is beginning to fall, concerns persist about the core measure which could remain a little more troublesome. This is fuelling expectations that interest rates will stay close to current levels through well into next year. Feedback around commercial real estate points to the subdued trend persisting while the resilience in the residential sector is seen as likely to fade somewhat. However, construction activity is still expected to grow over the coming year led by workloads in the infrastructure sector.

Economy

The Bank of England may be nearing the peak of the rate tightening cycle following the latest quarter point hike, but the guidance it provided in the accompanying communication suggests it would be premature to anticipate an early reversal of recent moves. This is being reflected in the response from money market which is captured in Chart 1. Significantly, while fears about how high rates could go has eased, the first cut is not anticipated until the second half of next year. Moreover, even over the medium term the cost of money is seen as settling at a much higher level than households and businesses have grown accustomed to. Critically, the Bank's commentary indicates that the base rate will need to remain "sufficiently restrictive for sufficiently long to return inflation to the 2% target".

Chart 2 highlights the recent improvement in the headline inflation number which has slipped back below 8% but it also draws attention to what appears to be a more resilient trend in the 'core' figure (which excludes energy, food, alcohol and tobacco). This is also reflected in the still strong trend in wage growth; regular pay is currently showing a year on year gain in excess of 7% led by the private sector and, in particular, the finance and business services segment (around 9%). However, there are some signs emerging of the tight conditions in the labour market beginning to ease. The number of vacancies has fallen by close to 300k to just over one million from the high watermark. As a result, the number of unemployed people per vacancy has edged up to 1.3 in recent months. Alongside this, public expectations for inflation in 12 months' time have slipped to 4.3%, according to the monthly survey conducted by Citi and YouGov.

Unsurprisingly, the Bank's latest macro forecasts envisage a weaker profile for GDP than was assumed when it last updated its numbers back in May. For next year, it is now pencilling in just 0.5% (down from +0.75%) with the 2025 projection put at only 0.25% (from +0.75% previously); by any stretch of the imagination this is an anaemic profile for the economy (Chart 3). Against this backdrop, the Bank is predictably judging that unemployment will edge higher but interestingly, the central scenario is still only assuming a move towards the 5% area by the middle of 2026.

So far, the incoming newsflow on activity is still a little mixed. July's composite PMI fell to a six-month low of 50.8 from 52.8 in June, signalling only a marginal rise in private sector activity. On the other hand, mortgage approvals increased to an eight-month high according to the latest numbers. Meanwhile, the headline GfK consumer confidence index retreated a little over the past month and remains in negative territory but significantly less so than at the start of the year. In addition, the component tracking whether this is a good climate to make 'major purchases' is showing a broadly similar picture.

Chart 1: Interest rate expectations have softened a little but remain above where they were in June

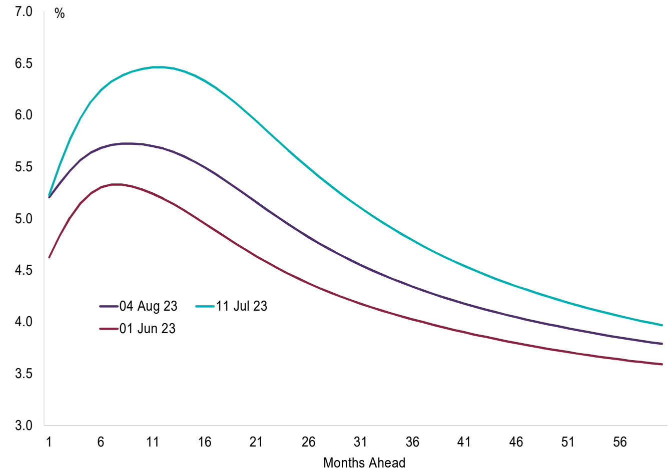


Chart 2: The headline inflation rate is now falling sharply but the core rate remains more stubborn

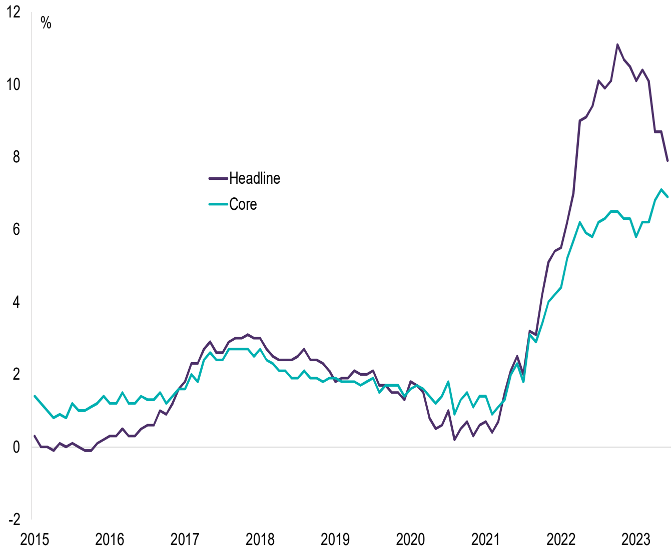
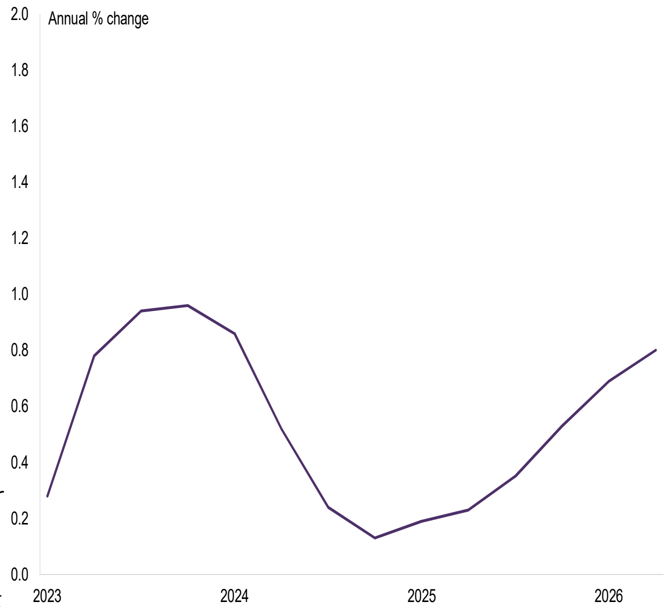


Chart 3: The Bank of England's projection for year on year growth in GDP over the forecast horizon remains very subdued



Commercial Property

Transaction activity remained subdued in the second quarter with data from Lambert Smith Hampton suggesting that it only amounted to £7.4bn. To put this in some context, that figure is 11% lower than the weak number recorded in the previous three month period and a hefty 41% below the (quarterly) five year average (Chart 4). The office sector was the main drag on the latest data with ongoing uncertainty about the implications of hybrid working and the cost of remediation to meet sustainability requirements contributing to the softer tone.

This pattern is also evident in the latest RICS Commercial Property Monitor. Chart 5 captures the occupier demand metric in net balance terms for the three main CRE sectors looking back to the final part of 2022. Although the retail demand indicator is still most deeply in negative territory, the Q2 reading was little different from Q1. For offices, there is clear evidence that the improvement reported in the early months of this year has been reversed.

That said, the picture around offices remains rather more nuanced with best in class assets continuing to change hands at relatively aggressive yields while also commanding premium rents. The most recent RICS dataset highlights the extent of the polarisation in its forward looking indicators. For example, prime office capital values are seen as being broadly unchanged over the course of the next twelve months according to respondents to the survey while secondary assets are viewed as likely to post a further decline in prices of in the region of 5%. The projections for rents are not dissimilar with prime offices anticipated to record a modest rise with the rest of the market facing rather more downward pressure; the central view is now for a further fall of 4% in the latter. Feedback to the survey, meanwhile, shows the appeal of alternative assets remains solid with expectations for rental growth particularly strong for housing related products (BTR, student) even if the scope for capital gain has diminished.

The generally cautious mood around real estate is clearly captured in the RICS indicator focused on where the market currently is in the cycle (Chart 6). Around 70% of respondents perceive the market to be in the downturn phase with another 15% seeing it as being at the bottom. However, it is noteworthy that despite another round of tightening from the Bank of England, three-fifths of contributors view the market as offering fair value. This arguably reflects, in part, the sharp drop in headline capital values (around 20% according to CBRE) that has already taken place.

Chart 4: Lambert Smith Hampton data shows investment numbers remained soft in Q2

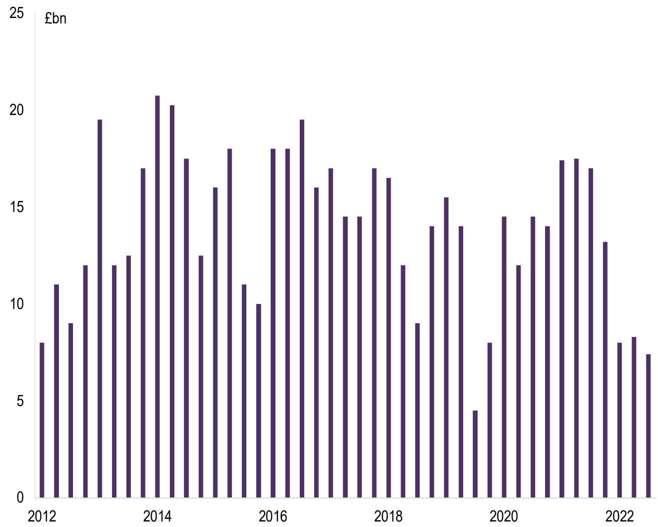


Chart 5: The RICS Commercial Monitor indicates tenant demand for office space has retreated in recent months

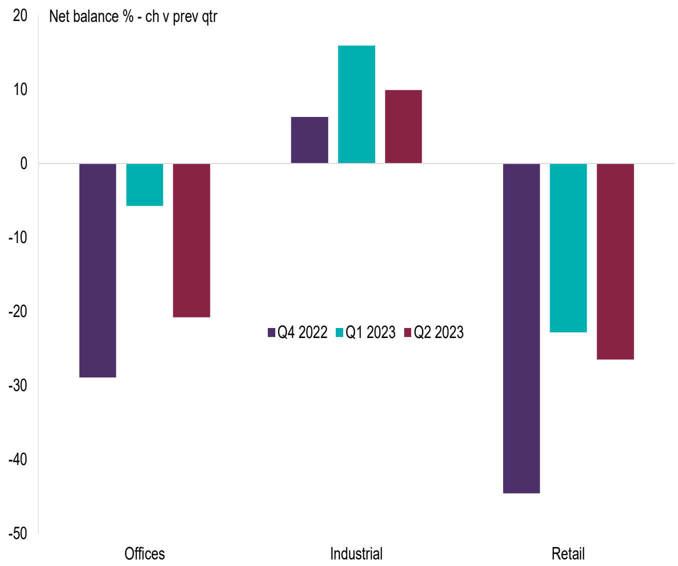
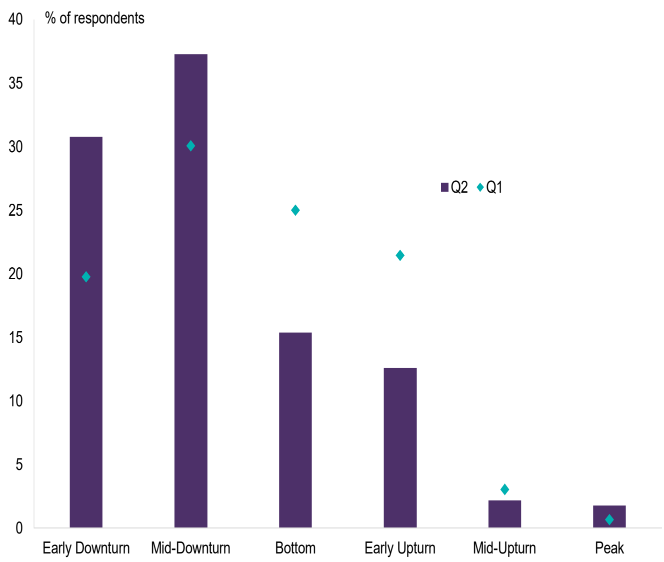


Chart 6: Respondents to the RICS Monitor perceive the CRE market to be more embedded in the downturn phase of the cycle



Residential Property

Recent activity data for the housing market has shown a degree of resilience in the face of the sharp rise in the cost of money. Monthly mortgage approval have actually ticked up to their best level since October last year while HMRC transaction numbers have also edged higher in recent months. However even with some better mortgage deals coming onto the market as fears have eased as to where the likely peak in base rates will be, there are justifiable concerns as to whether the firmer trend can be sustained. Chart 7 tracks the RICS New Buyer Enquiries series against the mortgage approvals data provided by the Bank of England. The former has been advanced six months and suggests that the rebound in activity is likely to falter in the second half of the year. This tone is also captured in other RICS metrics including both the 3 and 12 months Sales Expectations series where the latest readings (in net balance terms) are -45% and -25% respectively.

Predictably, indicators designed to capture affordability in the market appear increasingly stretched. Data from the Nationwide Building Society shows mortgage payments as a share of take home pay to now stand at 39% on average which compares with just 27% in 2020; the last time it reached this level was back in the third quarter of 2008. One response to this has been the extension of mortgage terms with the most common length for a secured loan now in the range of 31 to 35 years. Five years ago, the typical mortgage term was 21 to 25 years. This will help mitigate the prospect of a significant rise in arrears and, indeed, repossessions as will the forbearance agreed to in the government's Mortgage Charter. Even so, it is still likely that prices will soften a little further in the near term, a point demonstrated by Chart 8. But with these initiatives making a significant increase in distress sales less likely, it is unsurprising the consensus view is still for the peak to trough price decline to be in the region of 10% in nominal terms.

Meanwhile, the picture in the rental market remains very different with demand still very strong and supply remarkably constrained. The latest reading for the RICS New Instructions series shows the numbers of properties coming to the lettings market declining for the twelfth consecutive quarter, and at the fastest pace since the start of the covid pandemic. Inevitably against this backdrop, private rents are continuing to grow strongly and feedback around the outlook provides little comfort that the upward pressure is likely to ease anytime soon (Chart 9).

Chart 7: The RICS New Buyer Enquiries series is signalling a renewed fall in mortgage activity over the coming months

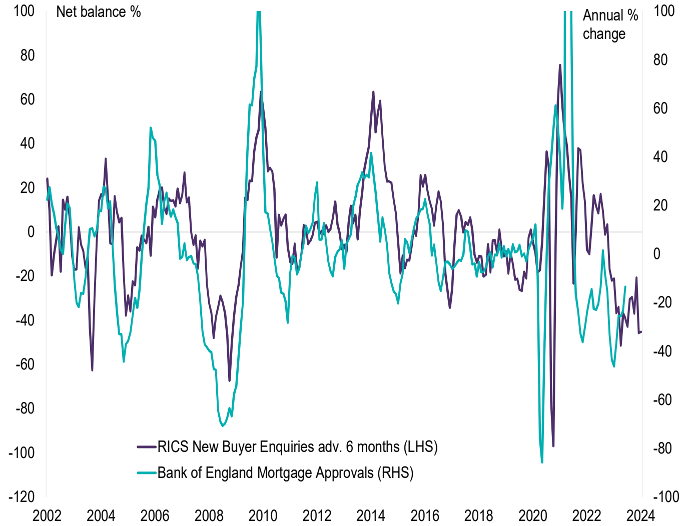


Chart 8: The RICS House Price Balance suggests the very modest decline to date has further to run

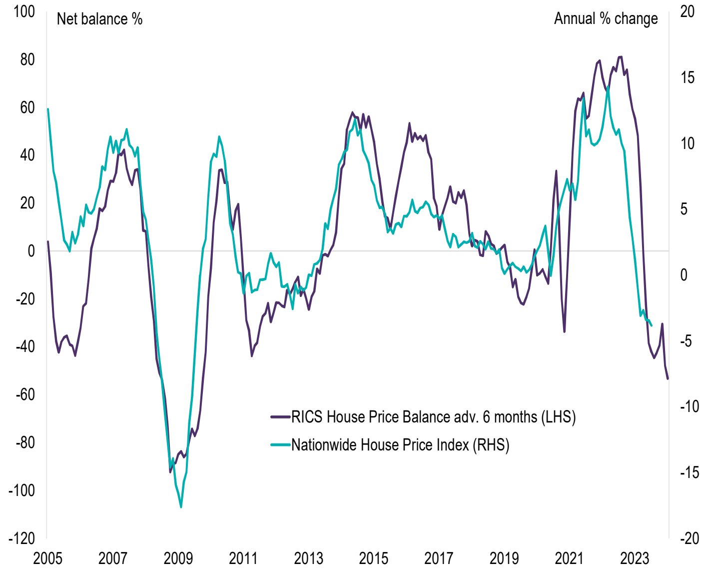
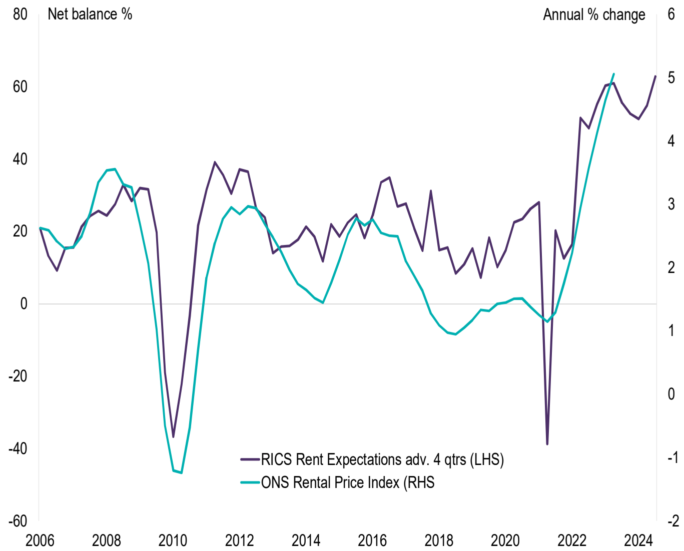


Chart 9: The RICS metric on rental expectations points to further upward pressure on rents as demand outstrips supply



Construction

Official data on construction activity is pointing to an essentially flat picture at an aggregated level, however this masks significantly divergent trends at a sector level. Most notably as highlighted in Chart 10, private housing output appears to be around 15% lower than a year ago. The contrast to this is provided by the infrastructure component which is showing a broader similar gain over the same time period thanks to HS2, Hinkley Point and the Thames Tideway. This has been sufficient to counter delays and cancellations to some roads projects as well as work stopping at Euston station. Meanwhile as might be expected, industrial related work is continuing to grow while commercial development is trending a little lower.

Looking forward, feedback to the Q2 RICS Construction Monitor suggests that workloads in the private residential sector will be fairly flat over the next twelve months. A net balance of just +1% of respondents anticipate an increase in activity (rather than a decrease) which compares with +9% in Q1. Predictably, the insights provided around infrastructure continue to show a more buoyant picture with the net balance at +27%, little changed from the previous survey. The result for private non-residential was also similar to Q1 at +12%.

When it comes to the near term challenges for the industry, a wide range of factors continue to be cited in the latest RICS survey including material costs, despite some signs that the price trend of key commodities is easing. Meanwhile labour related issues also remain very much to the fore with skill shortages highlighted by two-thirds of contributors compared with almost 80% previously. In addition, financial constraints are viewed as an increasingly significant obstacle; participants now see little reason to anticipate an early reversal of the more restrictive lending environment (Chart 11). Reflecting this, a slightly larger number of respondents still expect profit margins to narrow over the next year rather than widen (net balance -13%). This concern is also visible in the latest data around insolvencies.

One interesting theme emanating from the survey is around investment intentions demonstrated in Chart 12. With recruitment issues still a headache (even if a little less than in previous quarter), there is an expectation spending on workforce development will continue to increase and (in net balance terms) at a roughly similar pace to Q1. The positive read for investment in fixed assets, equipment and software remains more modest.

Chart 10: Official data points to a striking contrast between infrastructure work and private housebuilding over the past year

Chart 11: The latest RICS Monitor shows contributors not anticipating a material easing in credit conditions

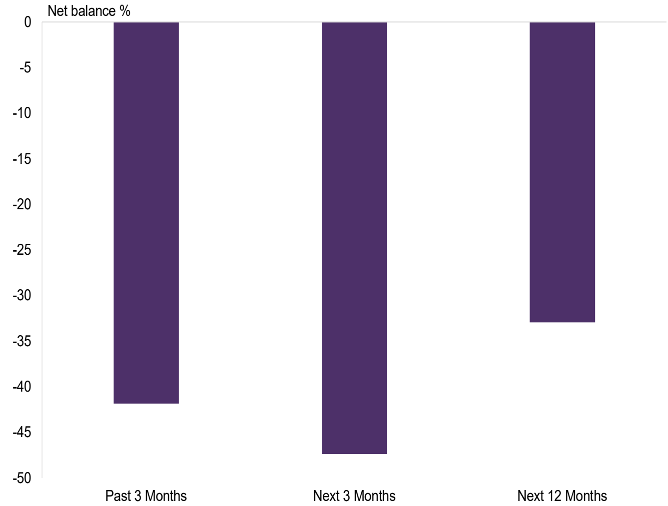
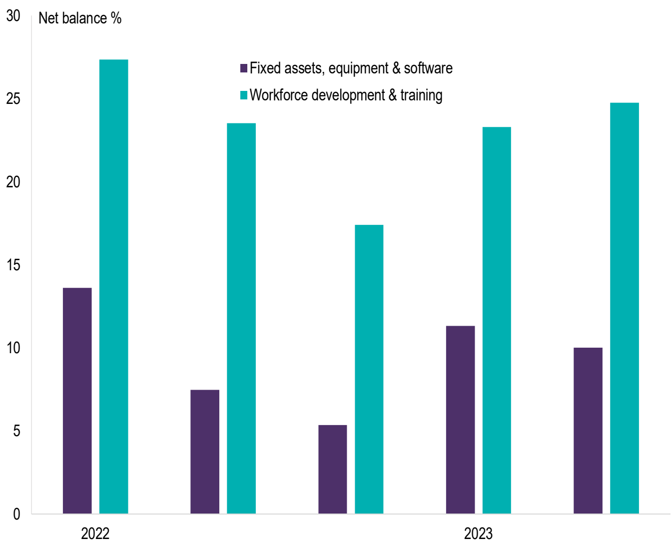


Chart 12: Feedback from the survey continues to point to a focus on investment in workplace development and training



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