RICS

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Economy and Property Market Update

February 2024

Easing inflation and subdued macro environment points to lower base rates as the year wears on

ECONOMICS

Summary

The Bank of England is likely to start cutting interest rates during the second half of the year given the recent moderation in inflationary pressures. The prospect of an easing in credit conditions is now being reflected in the feedback received to the RICS suite of surveys (covering the residential and commercial markets, as well as the construction industry). That said, many significant challenges remain, whether these are around affordability in housing, repurposing of the unviable parts of the commercial property estate, or skill shortages in construction.

Economy

Recent forecasts from both the IMF and the OECD, as well a number of well regarded consultancies, point to a subdued outlook for the UK economy for the best part of this year. That said, a slightly stronger picture is envisaged for 2025. Chart 1 suggests that GDP growth will struggle to reach much more than 0.5% (average for the twelve month period) following the miserly quarter point expansion in 2023.

A key ingredient in driving the macro performance will be the behaviour of inflation. Chart 2 tracks the recent trend in both the headline and core rates; significantly, the latter has made more modest progress than the former since peaking. Even so, the headline measure is likely to continue to fall sharply over the coming months, and could actually hit the 2% target over the spring helped by lower oil and wholesale gas prices. Indeed, the Ofgem energy price cap should drop by around 15% in April. There is rather more debate about what happens beyond this point. One view (put forward by the likes of Capital Economics) is that further declines in utility prices, allied to the more moderate trend in wage growth, will not just sustain inflation around this level but could actually push it closer to zero later this year. The Bank of England is, perhaps understandably, more cautious in its assessment suggesting (in the February Monetary Policy Report), that the headline rate will bounce off its April low and remain above target for much of the next three years.

How the inflation story plays will inevitably have a significant bearing on the timing of interest rate cuts; it will also have ramifications for the spending power of consumers. Interestingly, the Bank of England's Chief Economist recently remarked that 'we do not need to see inflation back to 2% on an underlying basis to begin to reduce the bank rate because we are at a restrictive level'. Chart 3 demonstrates how the mood music around this issue has shifted over the past few months, and that markets are now scaling back their expectations. Notwithstanding the signal provided by Hugh Pill, the inference of the latest money market curve (Feb 7th) is that base rates will not begin to fall until the middle of the year and then perhaps reach 4.5% by the end of 2024 (from 5.25% currently). Crucially, there is also a bigger question mark over how low interest rates will go over the medium term.

Meanwhile, the debate around the fiscal headroom the Chancellor will have to play with in his forthcoming budget continues to rage. Given that softer inflation will weigh on tax revenues, it may not prove to be all that much bigger than was projected back in November.

Chart 1: Growth forecasts for this year remain subdued although a slightly stronger picture is envisaged for 2025

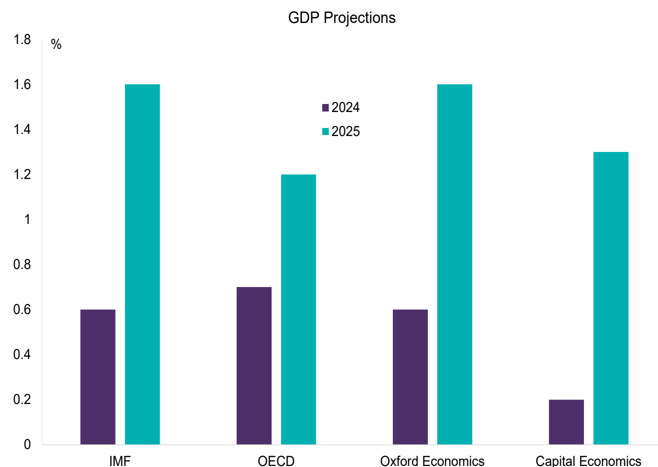


Chart 2: The core measure of inflation is falling more slowly than the headline rate for now

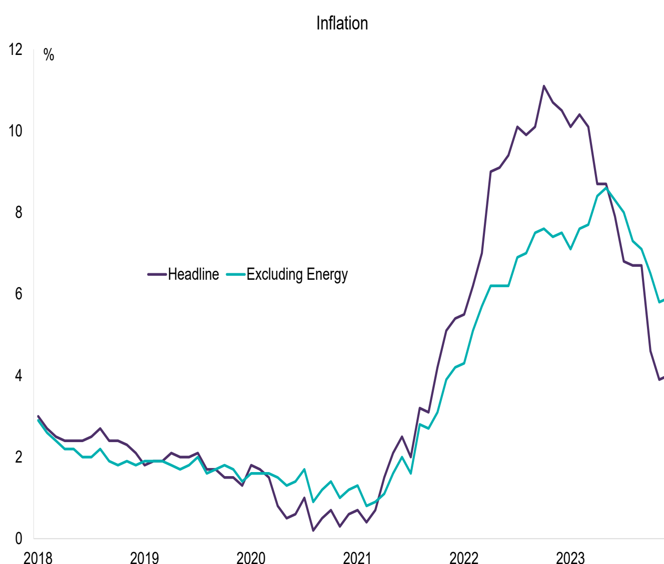
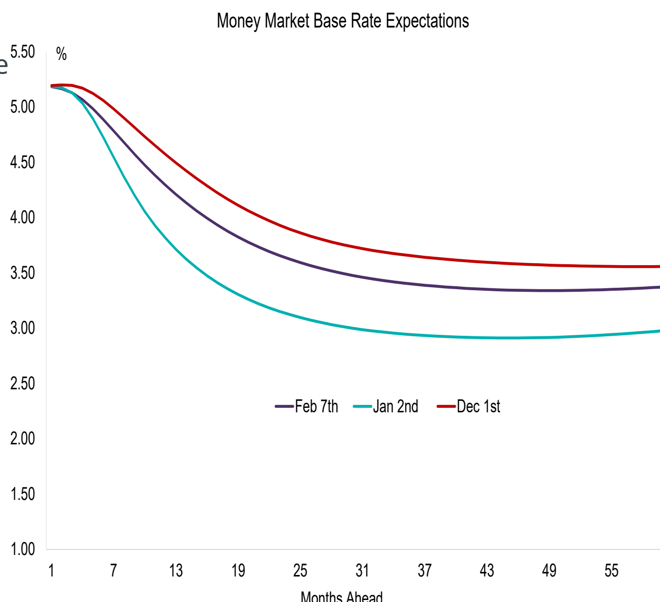


Chart 3: Interest rate expectations have eased a little but remain elevated



Commercial Property

Transaction activity picked-up in the final quarter of the year with £10.2bn of property assets changing hands in the three month period (as highlighted in Chart 4). This represents a 14% increase on the preceding quarter and the first £10bn plus outturn since Q3 2022. Stronger activity at the larger end of the market was primarily responsible for this improvement with the number of deals over £100m up 37% on Q3. Despite this, the latest numbers from CBRE are not indicative of a material change in pricing, with the All-Property equivalent yield estimate remaining around the 6% mark.

The latest RICS Commercial Property Monitor also paints a somewhat mixed picture, with the headline metrics for both occupier and investment demand still in negative territory to a greater or lesser extent. However, as Chart 5 demonstrates, the proportion of respondents seeing the real estate market in a downturn has fallen and the share perceiving it to either be at the bottom of the cycle or (more encouragingly) in the early stages of an upturn has increased. This shift is in part linked to increased confidence that interest rates will begin to fall through the course of the year; in the Q3, a net balance of -44% were reporting a tightening in credit conditions but this improved to just -5% in the latest iteration of the survey. It is arguably also significant that around two thirds of respondents now believe the market is around fair value despite the prevailing level of gilt yields.

Chart 6 shows the response to the forward looking questions regarding the outlook for both rents and capital values at a twelve month time horizon. In truth, the story is little different from last quarter with the so-called alternative assets including multifamily, student living, life sciences and aged care continuing to be viewed as the likely stronger performers. Once again, the marked polarisation between best in class and the rest is particularly visible in the case of the office sector and, albeit to a lesser extent, retail.

Although there are mounting signs of distress in the US real estate market, this is not currently a significant feature in the UK domestic market. Although there are some parallels between two, the lessons learnt and the changes implemented in the wake of the GFC means that the loans linked commercial property are generally in better shape with the aggregate loan to value ratio less than half the level reached at that time.

Chart 4: Lambert Smith Hampton data shows investment activity picked-up modestly in the final quarter

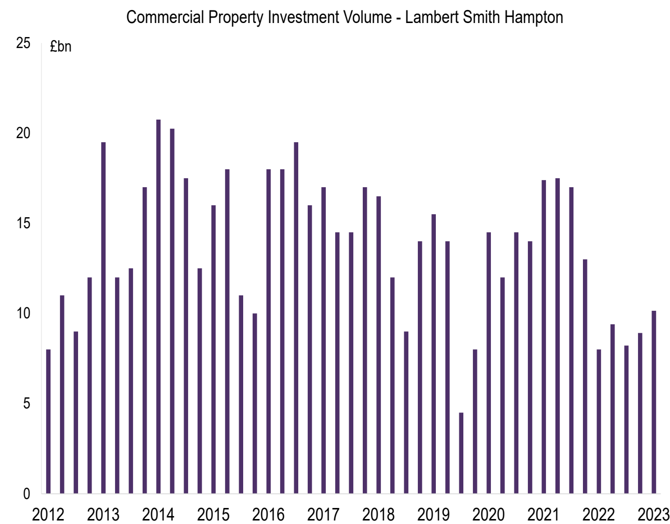


Chart 5: The RICS Commercial Monitor shows more respondents believing the market has now reached the bottom of the cycle

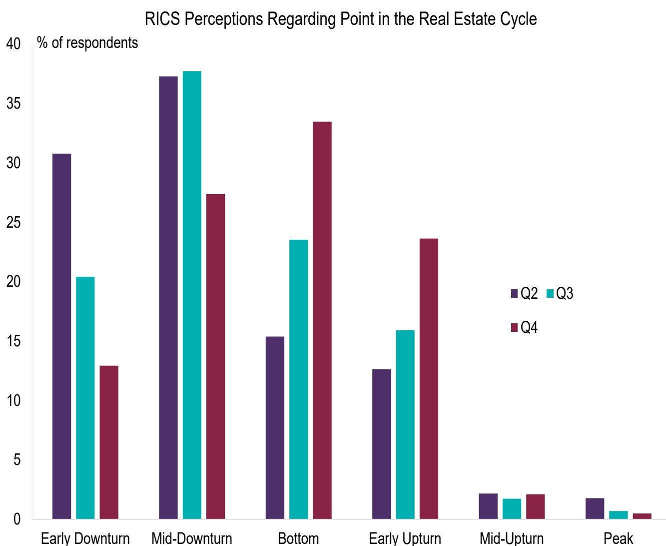
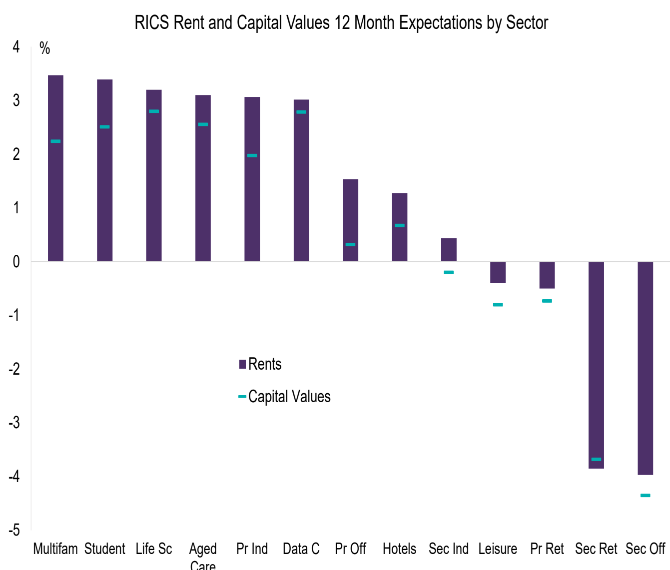


Chart 6: Expectations for the next twelve months are stronger for alternative real estate assets



Residential Property

Evidence is emerging of a better tone to the residential market. Projections of further price declines this year have given way to indications of a flatter trend if not a return to modest gains. This is exemplified by the turnaround in the Nationwide house price index which captures data at mortgage approval stage (Chart 7). The Rightmove 'ask' price index also appears to be turning albeit after posting a more modest drop. The Land Registry measure, in contrast, is still heading down but this is partly because the data is released in a less timely fashion and also as it reflects the price at completion stage (so tends to be a lagging signal). Alongside this, the RICS House Price metric (which measures sentiment but is a good leading indicator of turning points) has improved from a net balance reading of -68% last August to -18% in January.

Meanwhile, there are also signs of an uplift in activity. Bank of England data on mortgage approvals for new house purchases has climbed from 44k in September to close to 50.5k in the latest (December) release. This pattern is also evident in the RICS New Buyer Enquiries data which recorded a net balance of +7% in January; this is first time since the early part of 20222 that this series has shown a positive result (Chart 8). The growing confidence of respondents to the survey is, moreover, visible in the forward looking indicator for sales; the twelve month sales expectations series has risen particularly sharply in recent months.

While the sales market appears to now be exhibiting a more stable trend, the feedback around the lettings market is still challenging. The growth in tenant demand (captured in the RICS survey in net balance terms) does seem to be losing momentum although still remains in positive territory. However, landlord instructions are continuing to fall (Chart 9). The modest closing in the gap does point to slowing in the pace of rental growth from the double digits increases recorded on new lets over the past twelve months but still suggests that they will likely run ahead of wage gains.

Higher interest rates are resulting in more borrowers falling into arrears. Data from UK Finance shows homeowner mortgages in arrears increased by 7% to 93,680 compared to the previous quarter. More significantly, buy-to-let mortgages in arrears increased 18 per cent to 13,570 on the same basis. That said, a total of just 1,040 were repossessed in Q4 2023. This compares with nearly 2,000 in Q4 2019 before the onset of the pandemic.

Chart 7: House prices appear to be turning the corner according to the most timely indices

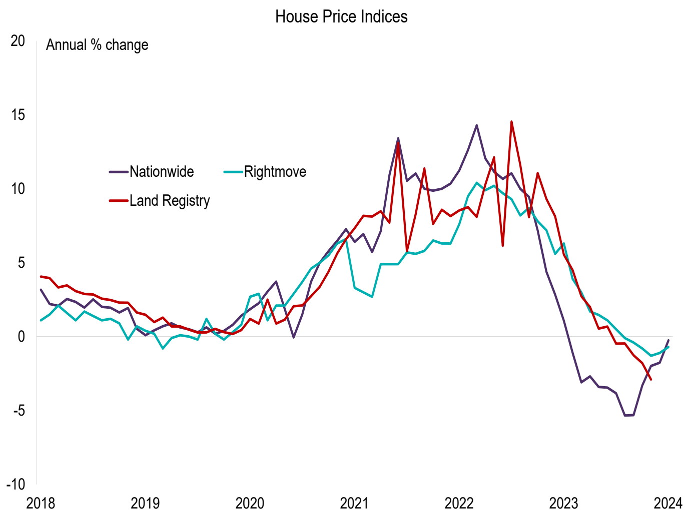


Chart 8: Forward looking activity indicators from the RICS survey are pointing to an upturn in sales

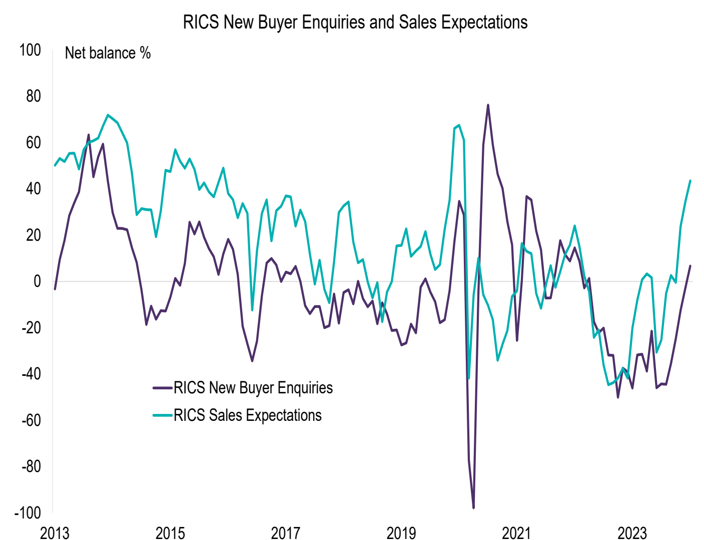
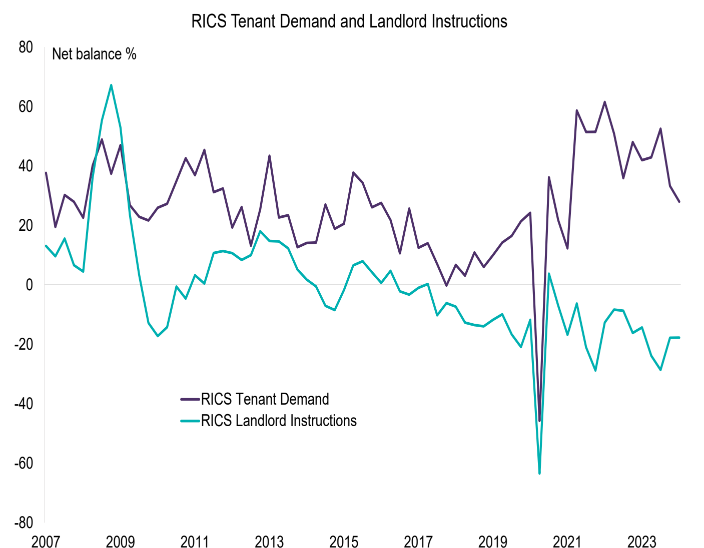


Chart 9: The growth in tenant demand using the RICS metric is slowing but still running ahead of new instructions



Construction

Official data around construction comes out with something of a lag and is indicative of a mixed picture. The latest reading (covering November) shows output 0.9% higher than a year ago and 5.8% above the pre-pandemic level of January 2020. Year-on-year changes in new activity at a sector level are captured in Chart 10. This suggests that commercial and other public work are recording gains while private housing and industrial are posting significant declines. That said, the latest RICS sentiment data on current workloads paints a slightly different picture in signalling a modestly positive trend in infrastructure while being more downbeat on commercial. Another area of contention is highlighted by the Construction Products Association who continue to draw attention to (what they see as) the overestimation of private housing repair and maintenance output; their judgement is that the deflator in this area in particular is being underestimated.

Meanwhile, construction material prices were dipping into the year end, a point illustrated by Chart 11. However, the most recent numbers only extend to December before the disruption to Red Sea shipping took hold. This is likely to begin to become visible as more timely data is published, reflecting if nothing else the sharp jump in freight prices (one measure of this has already climbed by around 250%).

Nevertheless, feedback to the RICS survey suggests that respondents generally hold a positive assessment of the outlook with the net balance for workloads expectations particularly strong in infrastructure. This is despite concerns about some high-profile projects. At the same time, forward-looking views are also upbeat, albeit to a lesser degree, when it comes to private non-residential workloads (Chart 12). One area of concern still evident is around profit margins, which are viewed as likely to remain under some pressure. This is also consistent with feedback to the question regarding the major impediment to activity at the present time. Close to two-thirds of respondents identified financial constraints while just over half reference planning and regulation. Alongside this, skill shortages remain a challenge even if the acute pressure has lessened somewhat on the back of the softer trend in activity. That said, around one half of contributors are still reporting difficulties in hiring quantity surveyors.

Meanwhile, 4,370 construction firms in the UK went out of business in the year to November 2023, a rise of 7.0% on a year ago with the biggest impact on smaller specialist sub-contractors. The likelihood is that this rising trend will persist for a while yet.

Chart 10: The latest official data shows R&M work growing most strongly with new private housing under most pressure

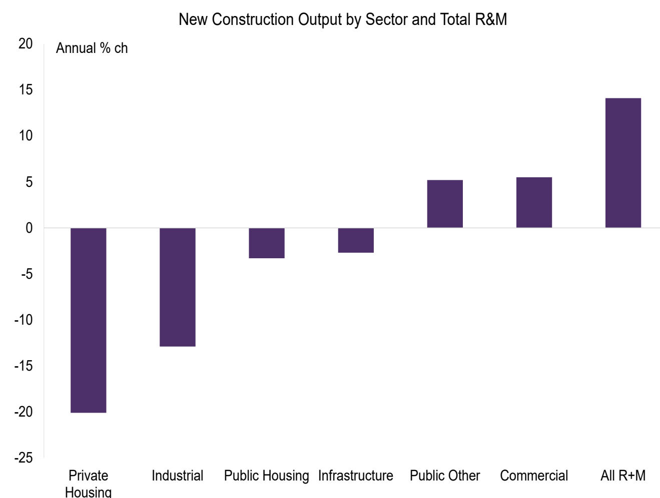


Chart 11: Construction material prices were falling prior to the onset of the disruptions to Red Sea shipping

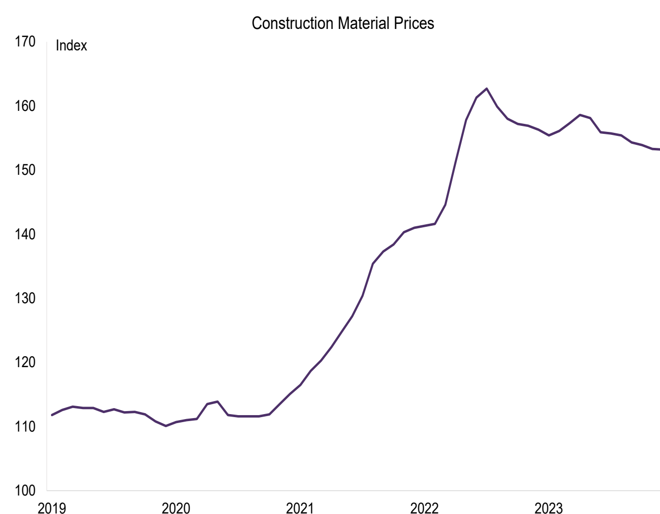
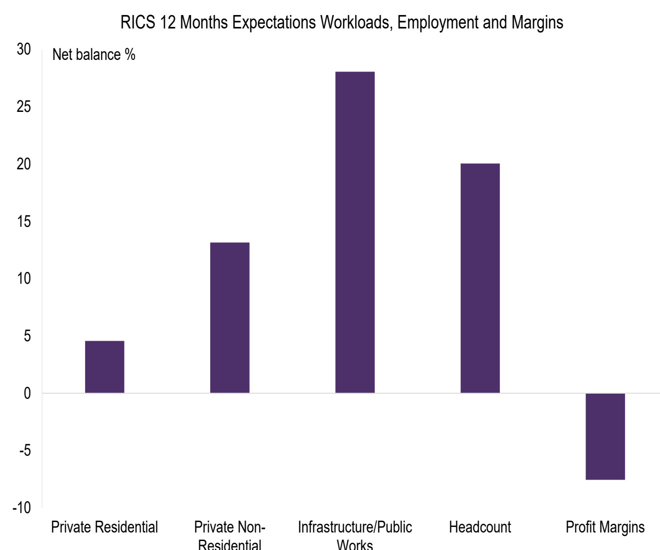


Chart 12: The latest RICS Monitor continues to show infrastructure workloads growing most strongly



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