

# Economy and Property Market Update

August 2025

Challenging economic outlook remains a drag on real estate and construction

## ECONOMICS

### Summary

Although some of the concerns around tariffs have eased, the macro environment remains a source of uncertainty. The recent 'hawkish' base rate cut from the Bank of England has encouraged money markets to dial down expectations of further easing while considerable speculation is already underway around probable tax increases in the autumn budget. Against this backdrop, feedback from both the real estate and construction industries remains generally subdued.

## Economy

For the first time in its 28-year history, the MPC required a second round of voting at its August meeting to reach a decision on what to do regarding interest rates. The division amongst the nine members of the committee highlights the extent of the ongoing uncertainty regarding the outlook for both economic activity and inflation. In the end, a quarter point reduction in the base rate was sanctioned, as had been anticipated by markets. However, the dissent within the ranks fuelled doubt about the timing of further monetary easing, leading to a strengthening in the pound and a rise in gilt yield. The backdrop to the discussion was inflation currently standing at 3.6%, which is higher than the peak predicted by the Bank of England as recently as May, and upward revisions projected in the latest forecast as highlighted in Chart 1. It is now anticipated (on its central projection) that annual CPI inflation will peak at 4% in September, before slowly edging back to the 2% target by the middle of 2027. Against this backdrop, it is unsurprising that the governor of the Bank, Andrew Bailey, has made clear that 'monetary policy is not on a preset path'.

The economy made a strong start to the year, helped by an uplift in business investment and a jump in exports ahead of the introduction of US tariffs. Moreover, the Q2 increase of 0.3% compared with Q1 suggest that some of the momentum was extended into the spring. That said, there does appear to be increasing seasonality in the GDP data, with firm first halves to a year being offset by weaker second halves. As a result, it remains to be seen whether this trend can be sustained. Significantly, both domestic policy challenges and well-rehearsed global factors look likely to provide headwinds for the economy. Chart 2 shows the Bank of England's profile for GDP measured on a year-on-year basis looking through to 2027. Perhaps unsurprisingly, the forecasts don't differ much from those suggested by the IMF in its recently released analysis of the UK economy. They show a growth rate of 1.4% next year followed by 1.5% in 2027. Once again, the IMF emphasises the need to boost the productivity performance if the growth path is to move onto a higher trajectory.

A more immediate issue is the fiscal equation, with speculation already building about the likely contents of Rachel Reeves' autumn Budget. New research by the National Institute of Economic and Social Research suggests that the Chancellor could be on course to miss her primary fiscal rule by more than £40bn. This is, arguably, at the more pessimistic end of the forecasts, but nevertheless shows the scale of the challenges in managing fiscal policy (Chart 3). The government is also constrained by its second rule which is to ensure debt is falling as a share of national income by 2029-30. With the spending envelope recently agreed for the next three years, it is hard to see how taxes can avoid having to carry most of the burden in filling the budget gap. However, ruling out of increases in the three main sources of revenue (income tax, corporation tax and VAT) is going to make the arithmetic very difficult.

Chart 1: The Bank has revised up its forecast for inflation which is now seen returning to target later than previously anticipated

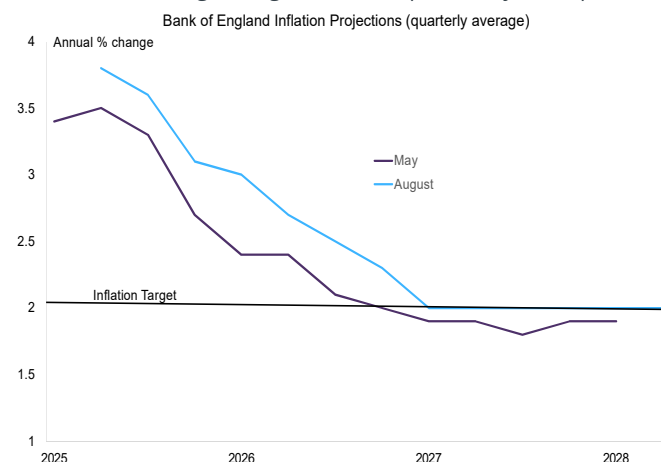


Chart 2: The Bank of England is anticipating only a modest uplift in economic growth over the next few years

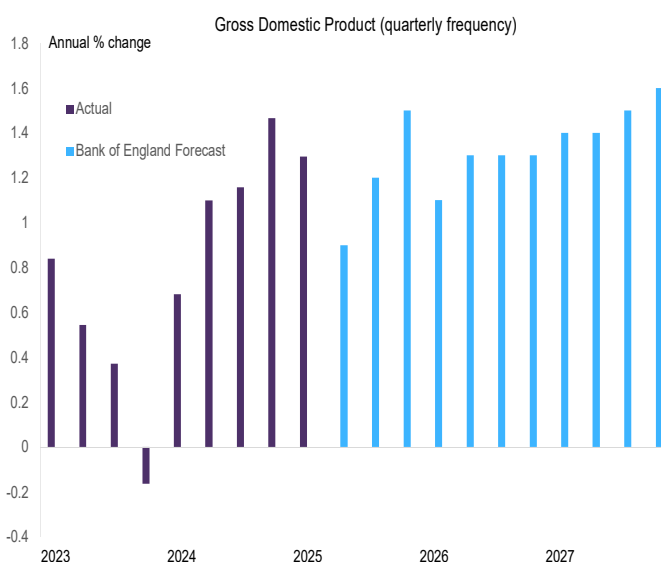
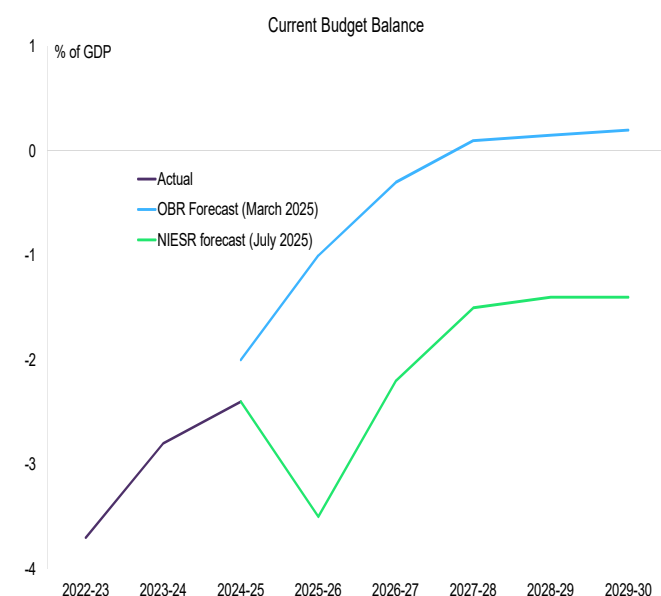


Chart 3: The primary fiscal rule, for the current budget to be in balance by 2029/30, looks likely to be missed as things stand



## Commercial Property

UK transaction activity in the commercial property market fell again in Q2 2025, according to the latest data from Lambert Smith Hampton (LSH). As shown in Chart 4, £8.8 billion worth of property assets changed hands during the quarter - a 6% decline from the previous period and the weakest level recorded since Q2 2023. A closer look at the data suggests that the subdued reading may be linked to the absence of large-scale deals, with no transactions exceeding £400 million recorded for the first time in five years. At the sector level, the recovery in office market performance extended into another quarter, with activity broadly in line with Q1's robust reading. In contrast, the industrial sector remains subdued, with Q2 transaction volumes of £1.5 billion sitting 42% below the five-year average.

This aligns with the latest RICS UK Commercial Monitor, which indicates weak activity nationwide across all three mainstream sectors. While the overall picture appears downbeat, both the RICS survey and LSH data highlight Central London's office market as a pocket of resilience. The former reports strong net balances for occupier demand, while the latter records £1.6 billion in transactions - only slightly below trend and helping to drive the UK's recovery in office performance. The latest data from Savills reinforces this sentiment, showing vacancy rates in London's City and West End falling to 7.4% from a peak of 9.5% in late 2023, though still well above the long-term average of 5.9%. Elsewhere, sentiment on the current stage of the cycle (Chart 5) reveals that, while 35% of respondents view the market as being in an early upturn, 57% still believe it is either in a downturn or at the bottom - two percentage points lower than in the previous quarter. The slight improvement in sentiment may reflect market expectations of imminent interest rate cuts and an easing of trade tensions with the US. Nevertheless, ongoing global geopolitical volatility, coupled with weak domestic growth prospects and impending tax rises, continues to weigh on confidence in the commercial real estate sector.

Looking ahead over the coming year (Chart 6), prime properties are expected to continue outperforming their secondary counterparts across all three markets tracked in the RICS survey. The most downbeat projections are within the secondary retail space with respective capital value and rental expectations of -2.2% and -2.5% whilst the most solid growth projections are seen within the prime office and prime industrial space. Furthermore, upcoming EPC rule changes mean that 70% of commercial floor space in England and Wales falls below the required standard, putting an estimated £700 billion of real estate at risk of becoming stranded assets, according to Knight Frank. Elsewhere, as has been the case in preceding quarters, activity is expected to remain robust across all the non-mainstream asset classes with the exception of leisure. Unsurprisingly, data centres illustrate the greatest growth prospects with the number of data centres in the UK expected to increase by almost a fifth in the coming years.

Chart 4: Lambert Smith Hampton data shows that quarterly real estate volumes have fallen for second consecutive quarter

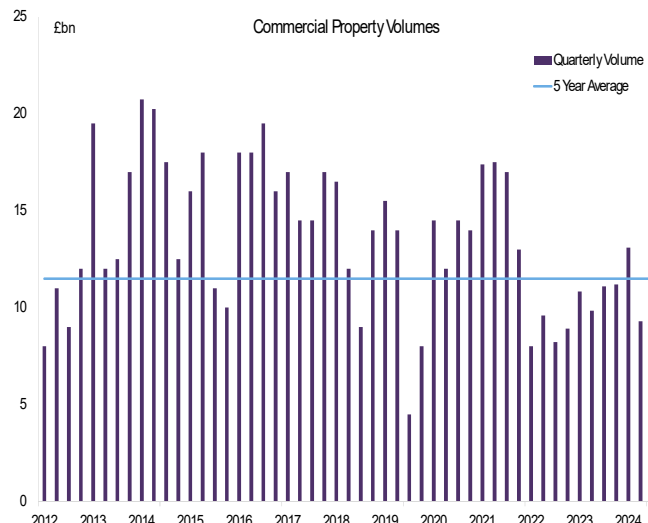


Chart 5: The share of RICS respondents citing the market is in an upturn is gradually edging upward

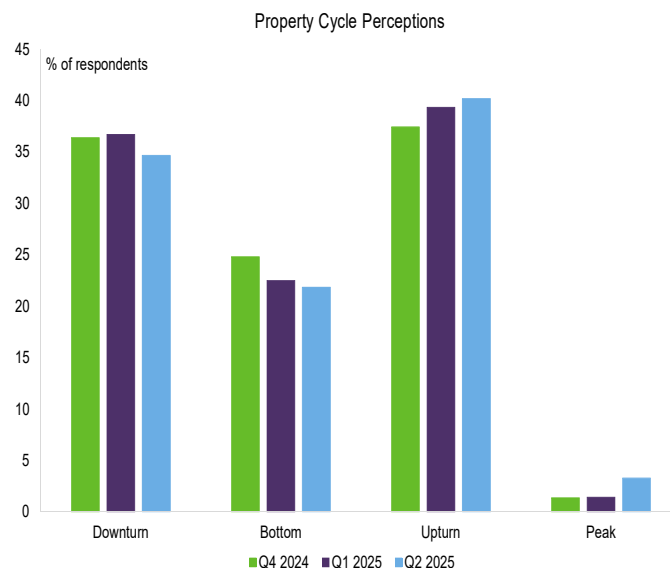
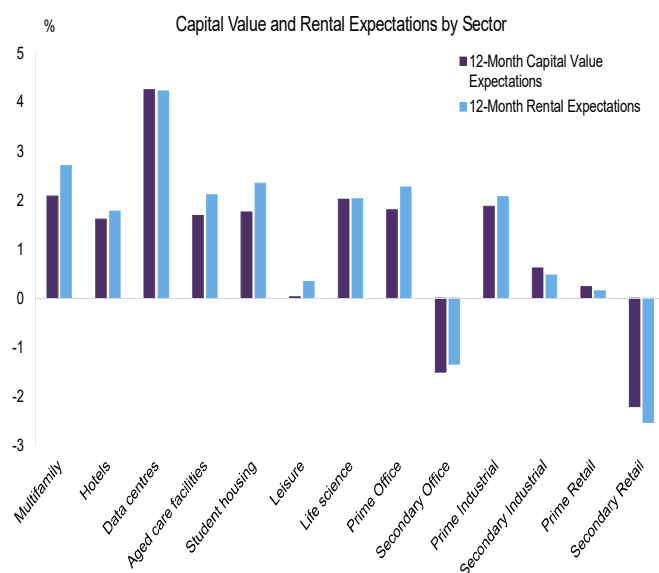


Chart 6: Alternative asset classes are expected to continue their strong performance according to the RICS Commercial Monitor



## Residential Property

Over recent months, there has been much discussion as to the impact of the ending of the stamp duty break on the housing market. Predictably, most indicators suggest the change in the tax regime only led to a temporary dip in activity and that this has now reversed. This is clearly evident in Chart 7 which shows the recent path of HMRC residential transactions on a seasonally adjusted basis. Having hit a recent high of almost 178k in March, volumes slipped to just 65k in April before recovering back to around 93k in June. That said, the latest feedback to the RICS Residential Market Survey does raise the question of the resilience of buyer appetite. The most relevant metric in the survey, New Buyer Enquiries, shows a negative reading in the July report when measured in net balance terms. Although only modestly so, the cautious signal indicates that other factors may now be weighing on the confidence of potential home buyers.

These likely include a softening in the employment picture and a slowing in wage growth alongside uncertainty about possible changes to taxation in the autumn budget. Meanwhile, despite the recent cut in the base rate, the messaging from the latest Bank of England meeting has fuelled a debate about how much further the cost of money is likely to be lowered, with forward looking indicators scaling back projections somewhat. These factors will probably continue to offset more supportive regulatory changes that have been announced by the government including a lifting in the proportion of new mortgages that lenders can issue at 4.5 times above borrowers' incomes from 10 to 15% of their loan book. Alongside this, the mortgage guarantee scheme, which effectively provides protection for lenders offering 95% LTV loans, has been made permanent; since its introduction it has supported the completion of 53,000 mortgages with 86% of those issued to first-time buyers. Chart 8 reflects the subdued near term outlook for the market, showing national sales expectations (in net balance terms) at both the three and twelve month time horizons.

In terms of the rental market, the outlook has changed little. Supply of rental property remains constrained on the back of relatively high mortgage rates and both past and forthcoming changes to the tax and regulatory regimes (Chart 9). Indeed, the headline RICS measure of landlord instructions moved deeper into negative territory in the latest quarter when measured in net balance terms, with the reading of -31% being the worst since the Covid era. Meanwhile, demand for private rental property continues to grow albeit rather more modestly than was previously the case. Against this backdrop, it is unsurprising that the underlying trend in rents remains in an upward direction. Significantly, a net balance of +25% of RICS respondents see further gains in rents levels as very likely over the coming months. Furthermore, looking further out, the perception is that rents could increase by in excess of 25% over the next five years, adding to the pressure on affordability.

Chart 7: Residential transactions have stabilised after the expiry of the stamp duty break

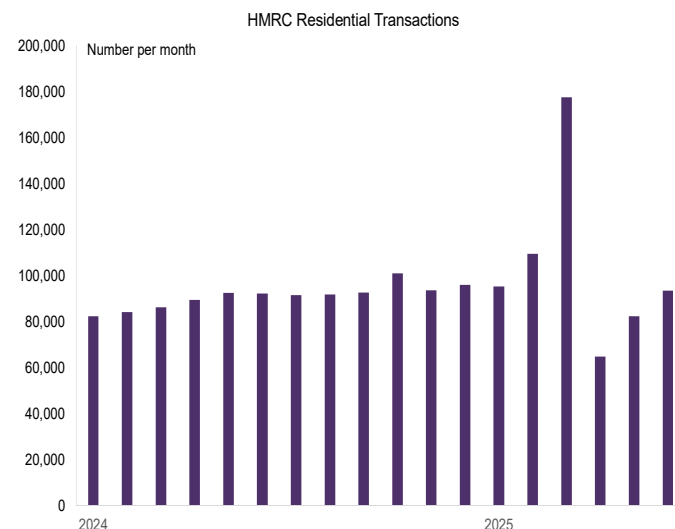


Chart 8: Sales expectations are now fairly flat according to the latest RICS survey

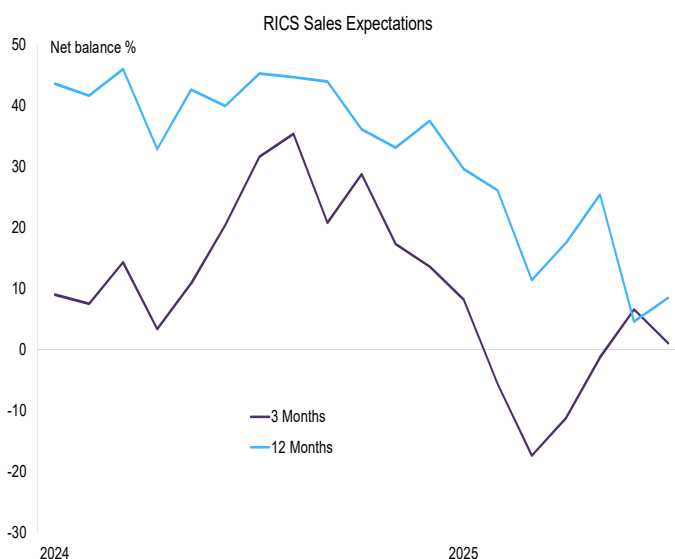
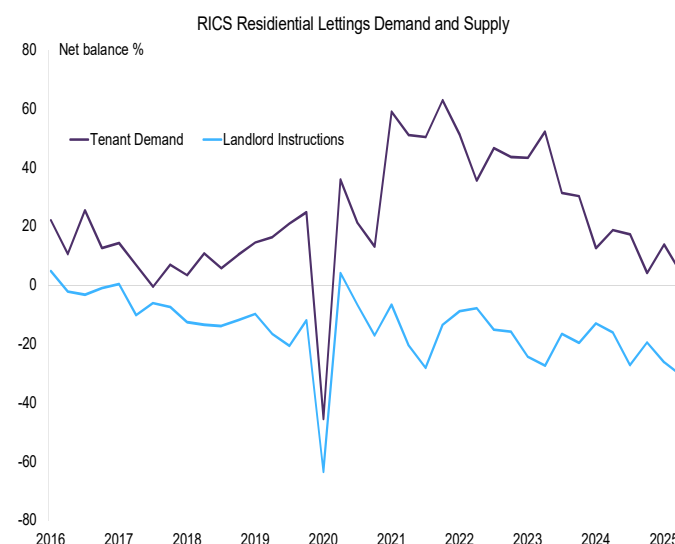


Chart 9: RICS sentiment data shows new instructions of residential lets to agents continuing to decline



## Construction

The latest ONS data points towards an increase in output of more than 1% in the second quarter. However we would continue to caution about the quality of this series. The Construction Products Association highlights two particular issues; first, the data appears to underestimate costs, so when removing price from the nominal numbers, it overestimates volume and second, there may be a survivor bias in the contractor survey because of a rise in insolvencies. A more cautious assessment of the industry picture aligns with the latest feedback to the RICS survey where a Q2 net balance for workloads of -3% follows a -1% in Q1. The breakdown by sector is captured in Chart 10 which shows that workloads in infrastructure appear to be the only segment of the industry showing growth; all other areas are either flat or negative in net balance terms. For the record, the insight provided from S&P Global survey, which is released monthly and does have a tendency towards greater volatility, is more downbeat still.

Despite this, workload expectations remain solid over a twelve-month time horizon with the latest net balance of +17% in the RICS UK Construction Monitor unchanged from the previous quarter. Chart 11 provides a sectoral breakdown of the projections with infrastructure, continuing to show the greatest likely growth in activity over the coming year (net balance of +34%). Within private residential and private non-residential, activity is expected to be more modest with respective net balances of +15% and +9%. Meanwhile, employment expectations over the coming year remain firm (+16% net balance), despite April's employers' National Insurance hike.

Financial constraints remain a key barrier to construction activity, cited by 61% of respondents to the RICS UK Construction Monitor (Chart 12). While the recent base rate cut and the prospect of further reductions may help ease some financial pressures, persistent economic headwinds, sluggish growth prospects, and sticky inflation suggest this will likely remain a significant challenge for businesses. Elsewhere, planning and regulatory challenges were also cited by 61% of survey participants as barriers to activity. The introduction of the Planning and Infrastructure Bill, aimed at streamlining local decision-making by cutting red tape, is a step in the right direction to support construction activity. However, anecdotal remarks from respondents to survey suggest it might take a little while for its impact to be felt.

Labour shortages also remain an ongoing issue, cited by 39% of respondents - still significant, but notably lower than the elevated levels seen throughout 2021. Problems regarding labour shortages are also highlighted in a recent report by McBain which estimate that the UK will need 225,000 more skilled workers by 2027 in order to address the long-standing issue of an ageing workforce within the construction industry. Specifically, the RICS results still point to a particular challenge around the recruitment of quantity surveyors.

Chart 10: Downturn in activity across the board according to latest data from RICS Construction Monitor



Chart 11: Twelve-month expectations remain positive for all sectors according to the latest RICS survey

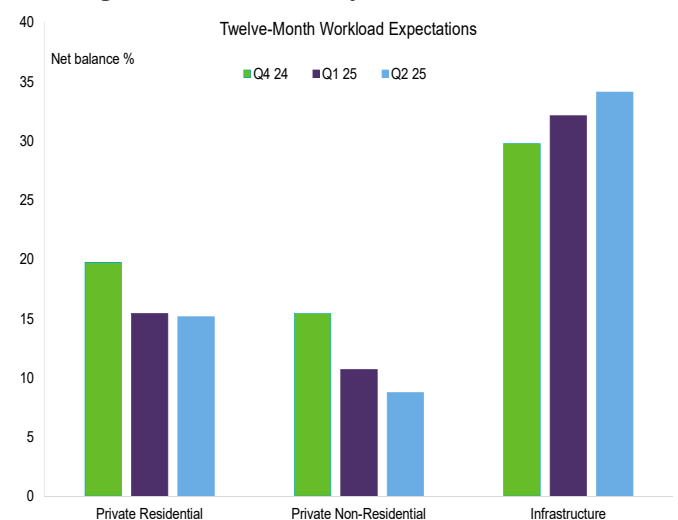
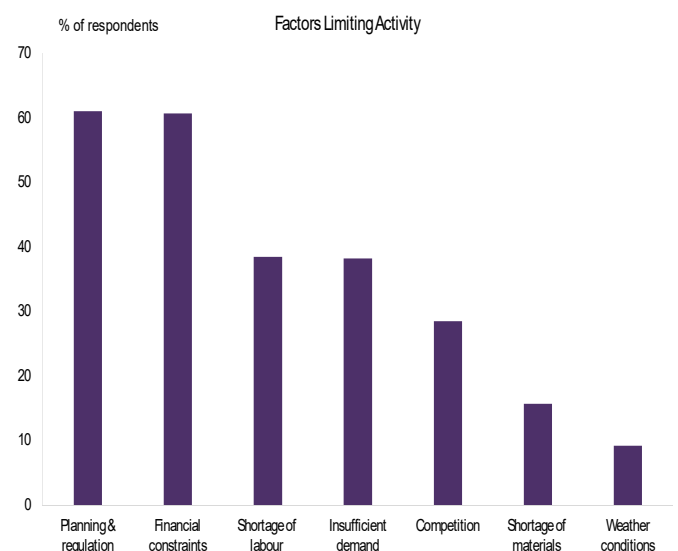


Chart 12: Financial constraints and planning and regulation now joint most cited barriers to construction activity





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