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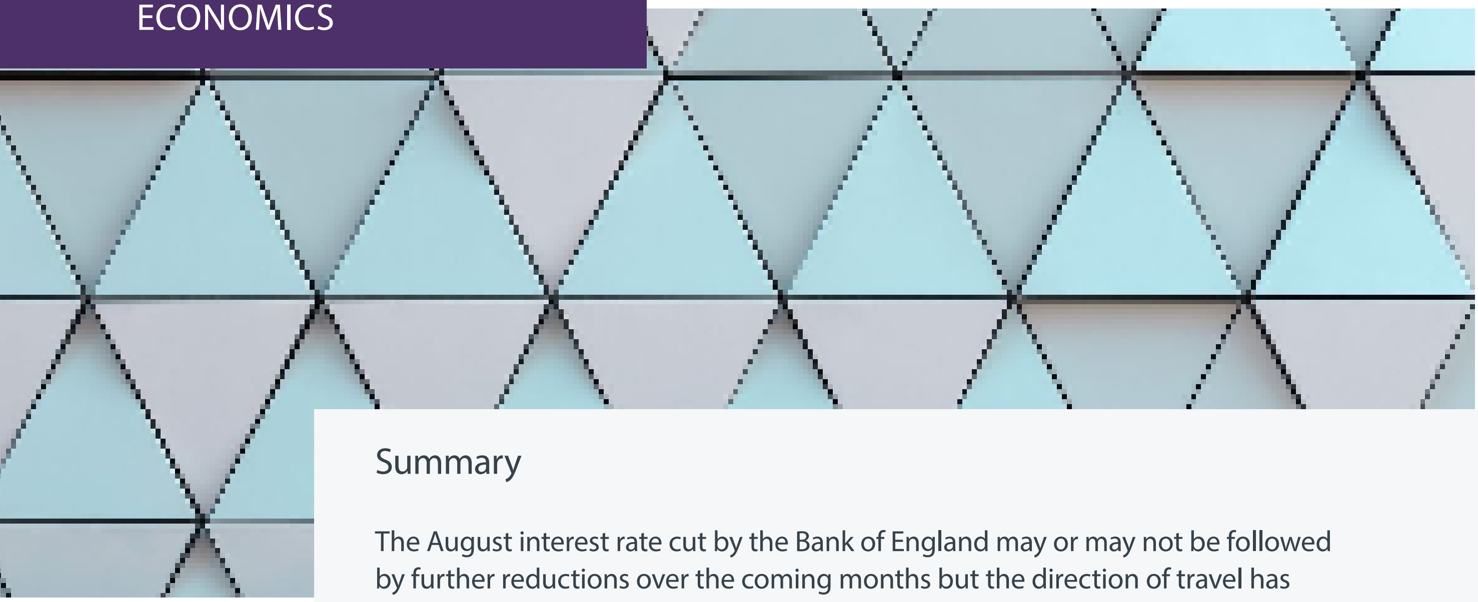
Economy and Property Market Update

August 2024

Turn in interest rate cycle should help support real estate and construction

ECONOMICS



Summary

The August interest rate cut by the Bank of England may or may not be followed by further reductions over the coming months but the direction of travel has now shifted and this will help support economic activity through the back end of this year and into 2025. The RICS Construction Monitor continues to highlight financial constraints as the key impediment to activity demonstrating the significance of this signal for the building industry. Alongside this, forward looking indicators point to a likely modest uplift in activity in the residential sector while polarisation between asset performance will remain a major feature in the commercial real estate market.

Economy

The decision by the Bank of England to lower the base rate to 5% at the beginning of August was a reflection of growing confidence that the medium term outlook for inflation is likely to be consistent with the 2% target set by the government. However, it was clear from accompanying comments by Andrew Bailey that that it would be premature to assume that further cuts will follow in quick succession. He noted "We need to put the period of high inflation firmly behind us and we need to be careful not to cut rates too much or too quickly". That said, Chart 1 tracks the central expectation of the Bank regarding the headline inflation rate and demonstrates the belief that after a near term bounce, it will settle within the comfort zone of the monetary authority.

In terms of the economic prospects, GDP projections for this year are grativating towards the one per cent area partly due to an upward revision to historical data for Q1 and evidence of strong momentum being sustained into Q2. The 2025 consensus forecast is currently nearer 2% with solid real income gains and rising consumer confidence (Chart 2) supporting a consumer led upswing in activity. One potential drag on household spending power will be the impact of tighter fiscal policy with the ongoing freeze in most tax thresholds weighing on disposable income growth. More generally, concerns have risen in recent weeks about a potential slowing in the American economy with greater discussion about the scope for a recession in the light of the latest jobs report; this would inevitably have implications for the UK. At this point, and to be clear it is a developing story, our judgement is that while the risk of a hard landing in the US has increased, it is still a relatively small probability. We would also note that the recent employment numbers may have been adversely impacted by Hurricane Beryl.

Returning to the UK, a key plank of the new government's economic policy is lifting the long run trend rate of growth. Boosting productivity will be a key element of this which will, in turn, require a step up in business investment. The latest data, highlighted in Chart 3, demonstrates a positive post-covid bounce (it is now back above the post-97 trend line) but the long run share of investment within GDP has remained broadly stable over the past thirty years. Meanwhile, fiscal challenges have already seen Rachel Reeves acknowledge the difficulties around the government delivering on its own investment programme which, as set out in Jeremy Hunt's last set-piece statement, was far from ambitious.

Chart 1: The Bank of Englands updated forecast for inflation envisages a temporary move back above the 2% target

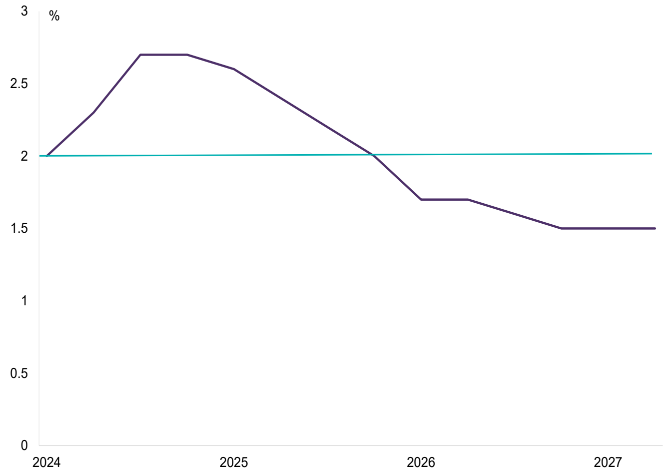


Chart 2: The GfK measure of consumer confidence is pointing to a significant improvement in sentiment

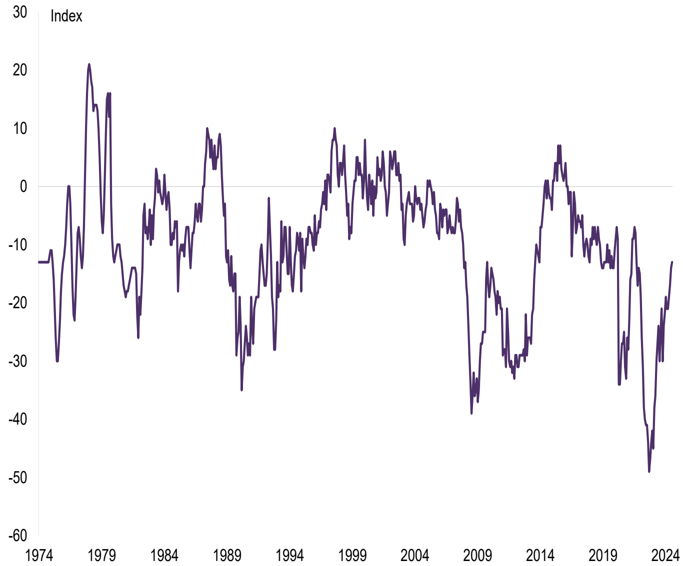


Chart 3: Business investment has rebounded from Covid lows and is now running above the post-1997 trend but more is needed

Commercial Property

The latest data monitoring turnover in the commercial real estate market is pointing to a modest uplift in activity. Figures from Lambert Smith Hampton (LSH) captured in Chart 4 suggest that around £11bn of property assets changed hands during Q2, up 12% on Q1 and the strongest outturn since Q3 2022. Transactional activity has also improved - while Q2 volume was 8% below the five-year quarterly average, the number of recorded deals was actually 5% above average for the period. Meanwhile numbers from CBRE tracking pricing are consistent with the emergence of a more stable trend indicating little change in capital values (at an aggregate level) since the back end of last year. Both datasets predictably reflect significantly divergent patterns at a sector level with LSH highlighting investment across several of the living sectors, once again, playing a major role in driving overall volume.

Feedback to the Q2 RICS UK Commercial Property Monitor paints a not dissimilar picture. Chart 5 tracks respondents' perceptions as to where the property market is in the cycle and to provide some comparison, we have included the results for the past four quarters. For the record, the share suggesting the market is now in an upturn phase has climbed to its highest level since the early part of 2022. It is also noteworthy that the proportion viewing the real estate market as being expensive, to a greater or lesser extent, has slipped to its lowest level since 2017. That said, the metric designed to track the trend in investment enquiries is still fairly flat (net balance reading of -4%). As one might expect, the sector numbers do show contrasting fortunes with (amongst the mainsteam areas) industrials still reporting positive momentum while office and retail enquiries remain negative. Even so, for the former, the last result of -9% (net balance) compares with a recent low of -39%.

Looking forward, insights provided to the RICS Commercial Property Monitor continue to show likely further outperformance by some of the alternative assets and by prime over secondary in the mainstream domain (Chart 6). So, data centres are at the top of the pile followed by living in its various forms and prime industrial. Within office, the divergence in projections between prime and secondary remains stark; the former is viewed as likely to see a further uplift in both capital values and rents. This preference for better quality is also visible in data from Savills which shows that over the past few years, around 15% of office space in outer London alone has been converted to residential or removed; the comparable figure for inner London is 6%.

Chart 4: Activity in the second quarter was the strongest since Q3 2022 according Lambert Smith Hampton

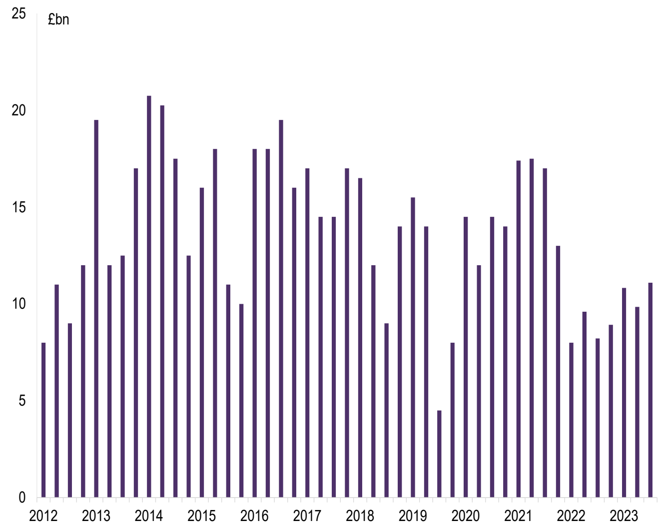


Chart 5: An increasing share of respondents to the RICS survey believe the market cycle is begining to turn upwards

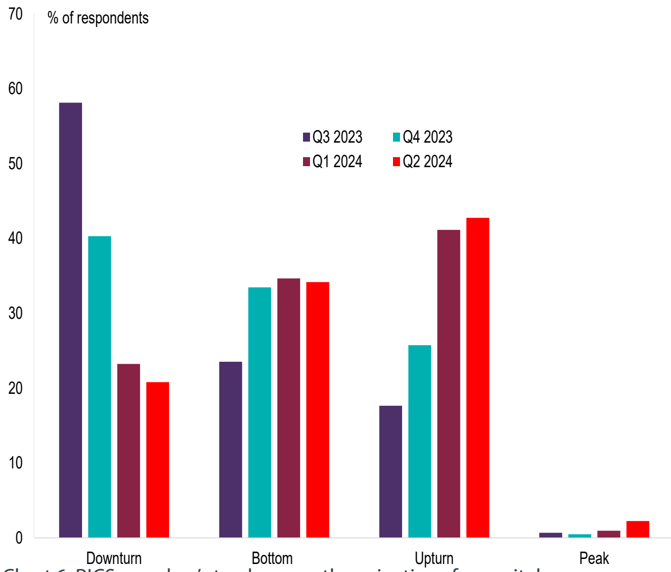
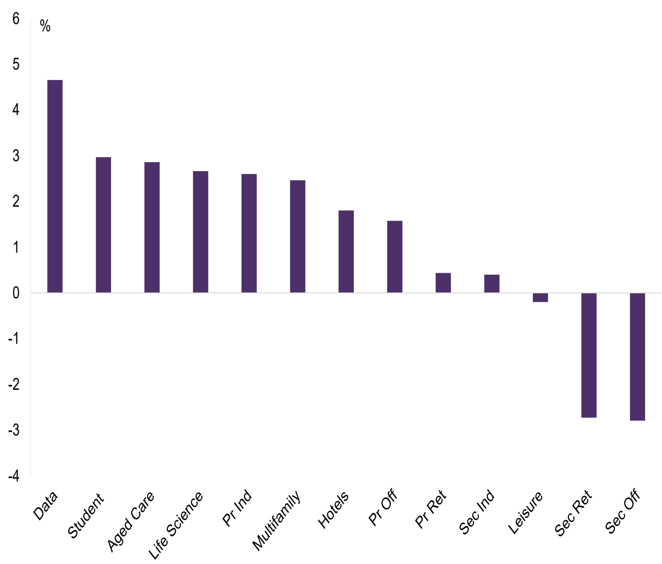


Chart 6: RICS member's twelve-month projections for capital values remain more positive for alternative assets



Residential Property

Early signs pointing towards an improvement in the condition of the UK residential property market continue to emerge, albeit at a relatively modest rate. With further loosening of monetary policy anticipated as we progress through the back end of 2024, a certain degree of cautious optimism can be seen with the market expected to exhibit more stability in the coming months. This is supported by recent house price data such as the Nationwide house price index, in which the annual growth rate climbed to 2% in July marking the fastest rate of growth in 18 months. Meanwhile, the Rightmove, Land Registry and Lloyds indices (Chart 7) show house prices rising at an annual rate of 2.3%, 0.4% and 1.6%, respectively. Whilst the RICS house price (sentiment) metric remains in negative territory (-19% net balance), it is significantly improved from the deeply negative figures seen in the latter stages of 2023.

An important sign that the tone does appear to be shifting can be seen in the RICS metric tracking new buyer enquiries with the net balance moving into positive territory (+2%), up from -7% and -6% in May and June (Chart 8), respectively. This is further reinforced by the expectations indicators in the latest RICS report. The net balance for the 3-month outlook stands at +30% which is the best reading since the onset of the pandemic in 2020. Shift in tone likely partly reflects the focus of the new government on boosting housing development alongside the recent quarter point base rate cut. That said, significant challenges lie ahead in delivering on the ambitions around planning reform and it is far from clear whether the Bank of England will follow the August move with further easing over the coming months but, even so, the policy mix is becoming more supportive for the sector.

Meanwhile, as far as the lettings market is concerned, tenant demand appears to have cooled over recent months, but the lack of new supply is exacerbating the challenges as evidenced in Chart 9. Against this backdrop, rents have risen to record highs with Rightmove data showing rents outside of London are currently 7% higher than they were the same time last year, albeit marking a slim slowdown in the growth rate. The principal driver behind the mismatch between supply and demand of rental properties is dwindling supply of rental properties with Zoopla showing that the supply of homes available for rent remains a third lower than pre-pandemic levels because of low investment from landlords in the market as a result of rising costs, falling tax relief and altering regulations. Reflecting this, the RICS rent expectations indicator is pointing to further increases over the next twelve months despite the affordability constraints.

Chart 7: House prices appear to be gaining momentum according to various indices

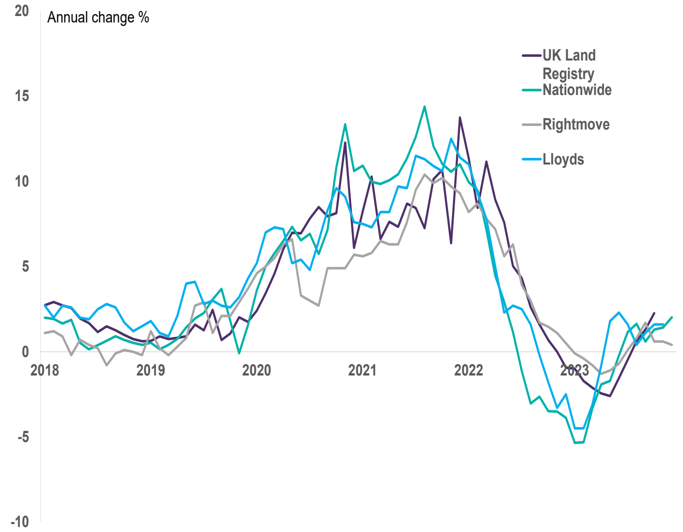


Chart 8: RICS New Buyer Enquiries and 12 month Sales Expectations both trending upwards

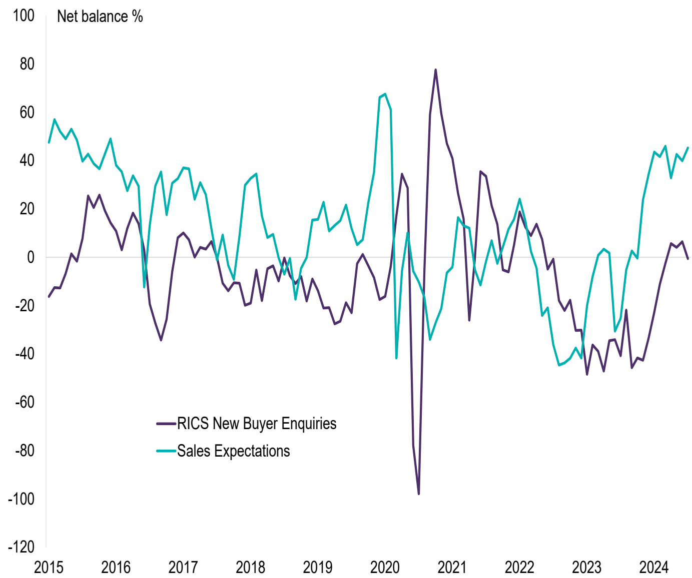
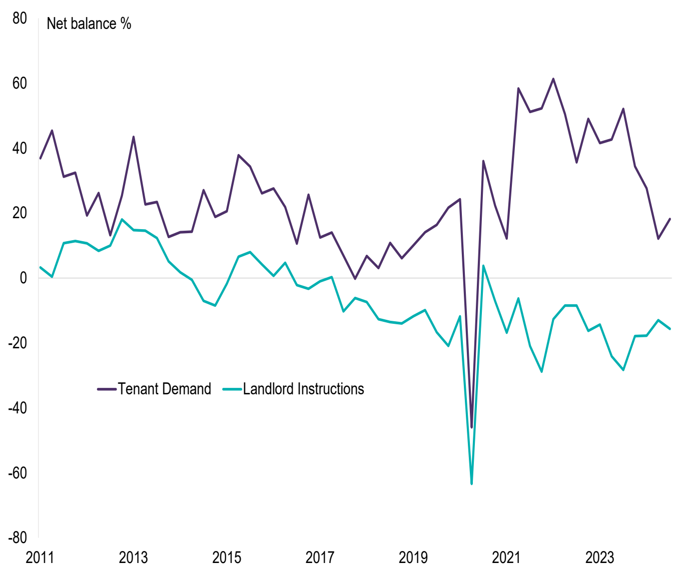


Chart 9: Tenant Demand appears to be moderating whilst Landlord Instructions remain deeply negative



Construction

The official measure of construction output continues to be viewed as requiring caution in intepretation with a suspicion by industry analysts that it has been overestimating volumes over the past couple of years. For the record, the latest data shows output around one percent higher than where it was in the same month of 2023 but still down on the peak. The concern about these figures has increased focus on sentiment surveys such as the S&P Construction PMI and RICS UK Construction Monitor. The former does suggest that a positive trend in activity has begun to emerge in recent months but feedback to the latter (which has a significantly larger sample) is a little more circumspect as highlighted in Chart 10; this indicates that workloads have been flat for the past two quarters. Disaggregating the RICS activity number shows infrastructure remains the one area seeing positive momentum at the present time.

Significantly, even before the announcement of a rate cut by the Bank of England, a net balance of 22% of RICS respondents were anticipating an easing in credit conditions as it impacts the construction industry over the course of the next twelve months. This might, in part, help to explain why the workload expectations metrics are more upbeat than current trends (Chart 11). Significantly, although the net balance reading for infrastructure remains the most robust at this time horizon, the readings for private residential and non-residential are gaining strength. One factor that may have contributed to the former is the heavy focus of the incoming Labour government on housebuilding and the reinstating of local targets.

When it comes to barriers to development, it is noteworthy that the latest RICS survey suggests that financial constraints are still the major challenges but that this is followed by planning which is another area of focus for new administration (Chart 12). 58% of respondents highlighted this issue (planning) which is the highest figure since prior to the onset of covid. Shortage of skills and labour more generally remain areas of concern albeit they have eased somewhat over the past year, arguably reflecting the more challenging environment for building. That said, almost half of contributors draw attention to difficulties in sourcing quantity surveyors while a further 40% signal issues in recruiting other construction professional. Partly as a result, the survey continues to indicate that there is currently greater focus on workforce development and training rather than investment in fixed assets, equipment and software.

Chart 10: The headline RICS workloads metric has been unchanged for the past couple of quarters

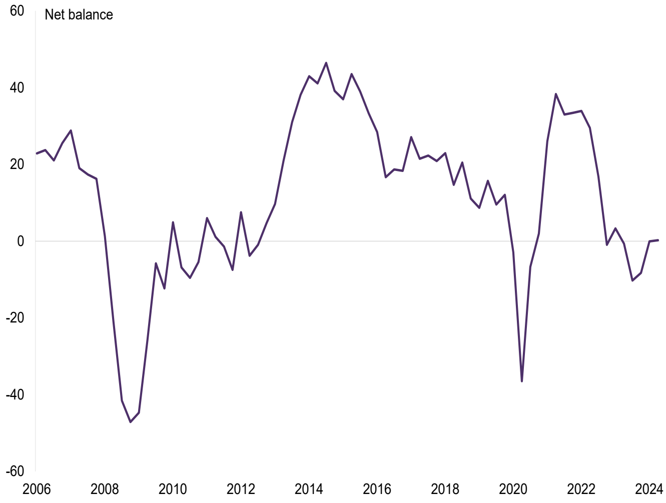
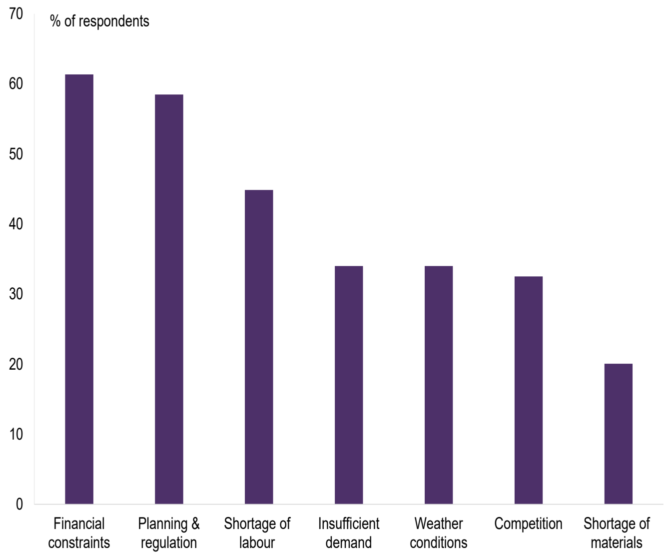


Chart 11: 12 Months Workloads Expectations from the RICS survey shows a noticable shift in sentiment around residential

Chart 12: Financial constraints still remain the main challenge for the sector followed by planning and regulation



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