

Economy and Property Market Update

November 2021

More positive trend in construction and real estate
but rising inflation raises interest rate risk

ECONOMICS

Summary

Concern around rising inflation has heightened over the past few months leading to a shift in expectations around interest rates. For now, the Bank of England (amongst others) continues to view the increase in cost pressures as likely to be temporary, rather than becoming embedded in expectations. Nevertheless, some tightening in monetary policy is still probable if only as a precautionary measure. That said, the scale of any move by the authorities seems unlikely at this point to derail the better tone coming through in parts of the commercial real estate market and the construction sector.

Economy

The key focus of policymakers continues to be on the unfolding inflation story. Supply chain bottlenecks and component shortages are continuing to push up global goods prices while raw material costs are being squeezed higher; Brent crude is hovering around the \$80 per barrel mark compared with \$50 at the start of the year. This is reflected in manufacturers' input price inflation highlighted in chart 1 which now stands in excess of 11%. The measured rate of consumer price inflation remains a little better behaved but it has still pushed above 3% and the recently updated forecast from the Bank of England suggests it will go higher in the near term. Indeed, the latest projections point to inflation reaching 4.5% YoY at the end of the year and approaching 5% in the early part of 2022.

How the picture plays out beyond this remains to be seen. Base effects should gradually become more helpful but labour market pressures are growing, albeit at this point in specific sectors. One concern of the Bank is that this become more broadly based with the inflation psychology becoming more embedded in pay negotiations and settlements. And, as an indication of its unease, its projection for inflation three years out on unchanged rates, is 2.6% (end of 2024). For the record, this is the highest forecast for inflation over this time horizon that it has ever published (Chart 2). As such, it represents a strong signal that some tightening in policy will be required in the year ahead. The decision not to move rates in November was partly down to the majority of decision makers at the Monetary Policy Committee wanting a bit more time to evaluate the impact of the unwinding of the furlough scheme. However, we doubt this is more than a temporary stay of execution.

On a more positive note, the Budget presented the Chancellor with the opportunity to revisit his fiscal numbers in the light of the stronger than anticipated performance of the economy (compared with forecasts made in March). Some of the gain was reflected in the higher spending numbers announced but the remainder was banked and can be seen in the downward projection for debt as a share of GDP (Chart 3). It is now projected to return towards pre-pandemic levels by the middle of this decade. That said, the debt ratio will remain significantly above where it was prior to onset of the global financial crisis. This points to the risk of higher servicing costs as interest rates rise although UK debt has relatively lengthy maturities providing some protection.

Chart 1: Key measures of inflation continue to move upwards

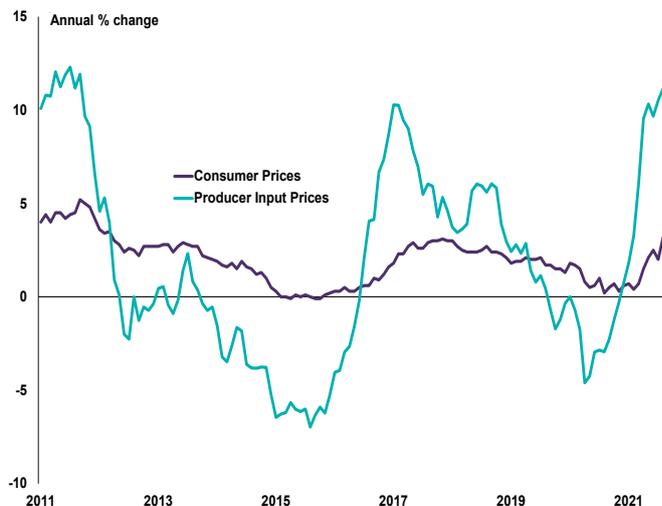


Chart 2: BoE's forecast of where inflation will be in 3 years' time on the assumption of unchanged interest rates

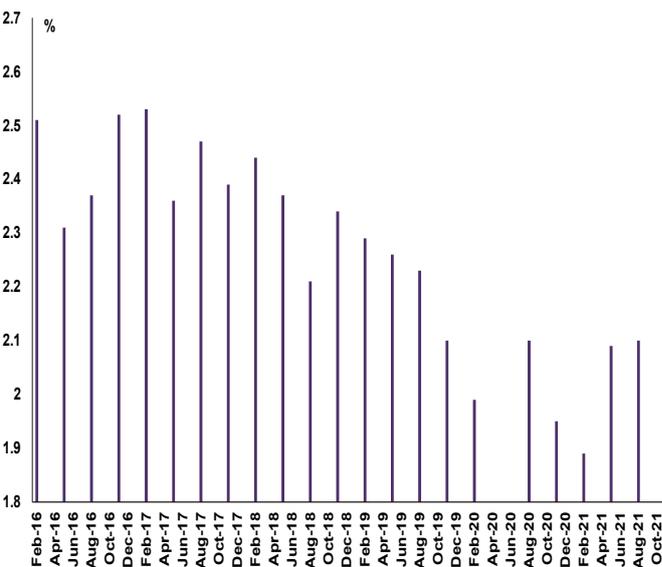
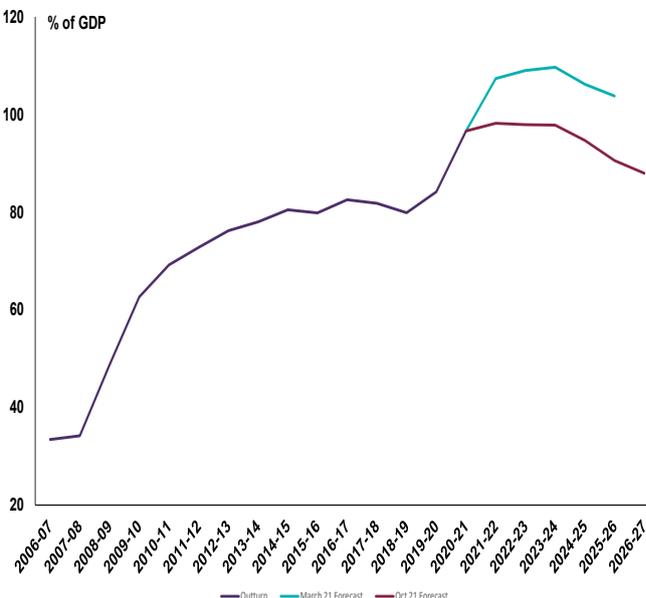


Chart 3: The Office for Budget Responsibility scaled back its expectations regarding the growth in public debt in the Budget



Commercial Property

Hard data shows investment transactions (in terms of deal value) are now running ahead of 2019 levels and are only slightly below when viewed from the perspective of deal numbers. This is clearly evident in Chart 4 which also demonstrates the importance of activity in logistics and retail parks in driving this performance. Indeed, in the last twelve months, industrial transactions have accounted for more investment volume than any other sector (31% of the total.) London offices, which used to be the dominant subsector, have a share of activity over this period of 16%. Unsurprisingly against this backdrop, transaction yields in industrials continues to slip to new lows with the latest Property Data figures showing them approaching the 3.5% area.

The generally more positive mood regarding the outlook for the commercial real estate market is also very visible in the results of the Q3 RICS UK Commercial Property Monitor (CPM). Around two-thirds of respondents now view the market to be in the early or mid phase of the upturn in the cycle. As Chart 5 shows, this is the highest proportion taking this view since the back end of 2015. Meanwhile, less than one in five contributors to the survey still see the market in a downturn. This tone is also captured in the more forward looking indicators, with the 12 months expectations metric for capital values climbing in net balance terms from +1% (in Q2) to +11% which is actually the best headline reading since the early part of 2018.

This is also being reflected in the occupier market, with the CBRE all-property rental value index edging up in recent months and, in the process, posting its first annual gain since the early part of 2019. Tenant demand remains particularly firm in the industrial sector, with the RICS CPM recording a net balance of +56% for this indicator; this is marginally down from the +63% posted in Q2 but is still consistent with a strong appetite to take-up space. Meanwhile, as Chart 6 illustrates, the picture regarding offices is beginning to improve as the demand metric moved back in positive territory (albeit only marginally) and the availability measure eased back a little. Disaggregating the data a little further does point to some improvement in the numbers for London but this comes after hefty falls previously with the jury still out as to how the hybrid model of working will impact big city office usage. The headline retail indicator for occupier demand, while still negative in Q3, was the least so since Q3 2017.

Chart 4: Property Data figures show the extent of the rebound in commercial real estate activity this year

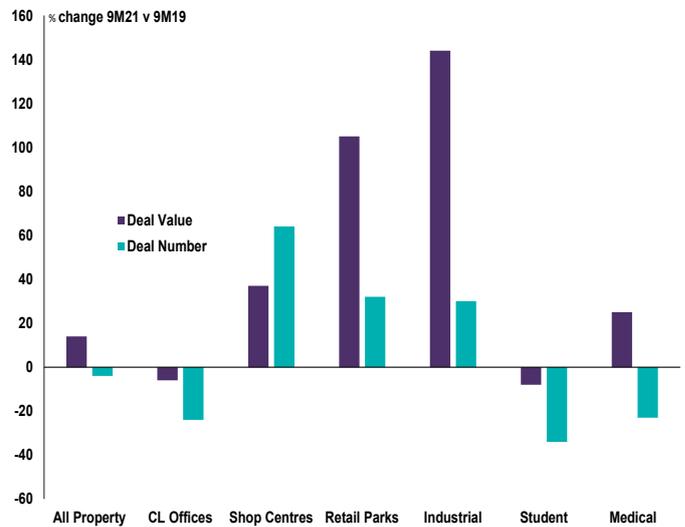


Chart 5: The rising share of respondents to the RICS Commercial Property Monitor who view the market in an upturn phase

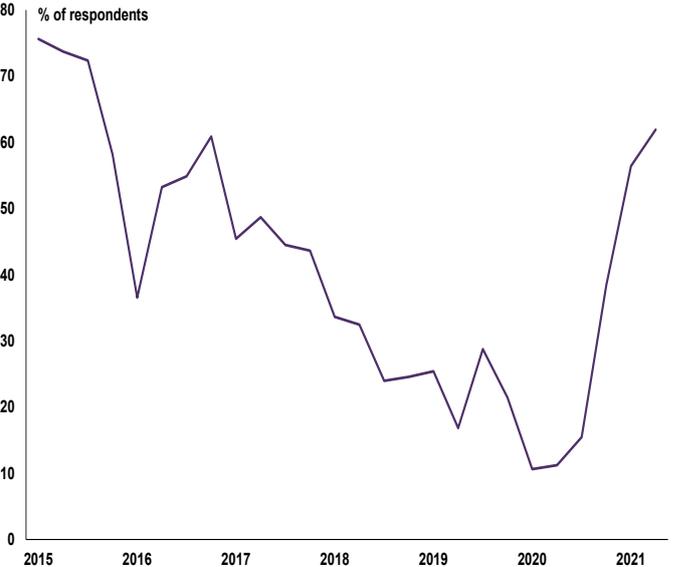
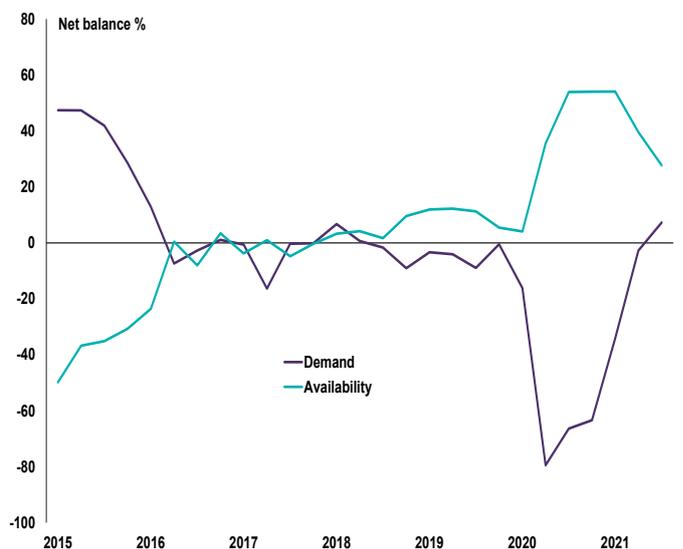


Chart 6: The RICS Monitor also shows an improving picture in the office sector with tenant demand metric now in positive territory



Residential Property

In the wake of the expiry of the tapered stamp duty break at the end of September, it was not surprising that official data collated by HMRC showed another large rush in activity to complete before the deadline. Although some revision to the latest estimate is probable, it is currently indicated that 161k transactions took place in the final month before the tax perk was fully removed. More significantly, it implies that a hefty 1.562million sales were completed in most recent twelve month period which is an the upper end of the historic range (see chart 7).

Looking forward, there are some encouraging signs from the monthly RICS Residential Market Survey that the drop off in activity may not be as dramatic as might have been expected. The closely watched New Buyer Enquiries indicator, which tends to lead mortgage activity, increased in October after a few softer months (net balance of +10%). Meanwhile, the near term Sales Expectation series recorded the same result. Interestingly, the twelve-month Sales Expectations net balance was close to zero which also suggests that respondents are not anticipating the (underlying) volume of activity to change very much over the period. However, one ongoing challenge remains the level of new instructions being received by agents. The latest data shows another drop (net balance of -20%) which has contributed to pushing the average stock on agents books on the RICS measure back towards historic lows. And, with the number of appraisals down on where they were a year ago, it remains questionable whether this trend will be reversed anytime soon.

The lack of stock may not just inhibit activity going forward but could also contribute to further price growth; the headline RICS price balance is still showing a very strong reading (Chart 9) and twelve month expectations are also elevated. The shift in tone regarding interest rates has the potential to influence sentiment towards residential purchases although it remains to be seen whether the increase over the coming months is sufficient to do so. The strong employment picture allied to the high proportion of existing borrowers on fixed rate mortgages provides a good basis for not anticipating a material near term impact on the market. Consultancy, Capital Economics, have estimated that Bank Rate would have to rise to over 2%, and mortgage rates to more than 3.2%, for affordability to deteriorate enough to risk a correction.

Chart 7: HMRC property transactions over the past twelve months has been near previous highs

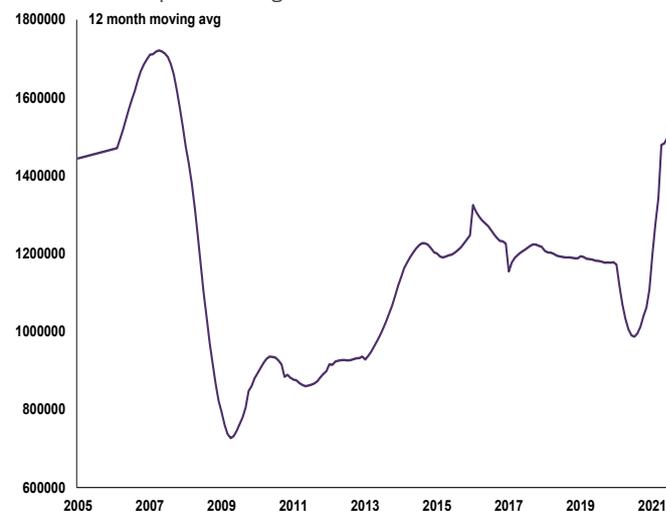


Chart 8: RICS sentiment data is pointing to a stable trend in underlying levels of activity in the housing market

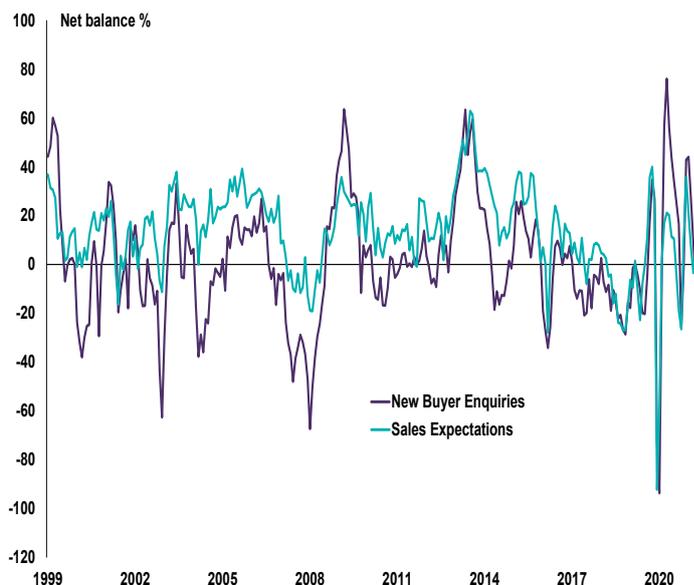
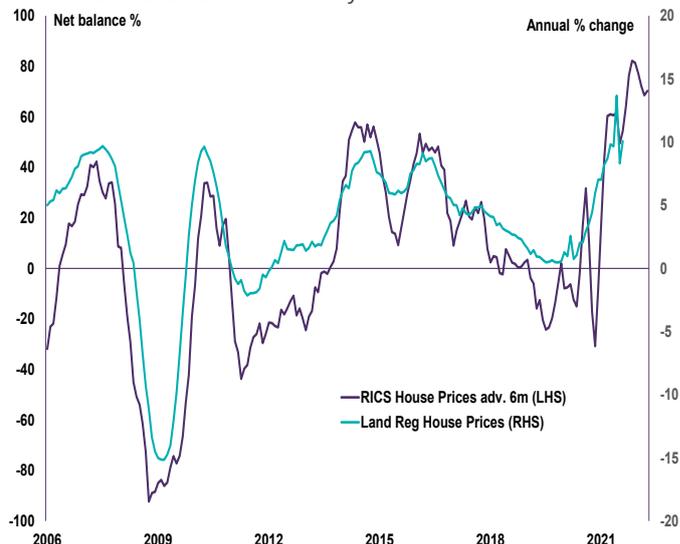


Chart 9: RICS key price indicators suggests house price inflation will remain elevated into the new year



Construction

Official data suggests that while construction output is currently around 10% up on a year ago (August numbers), it still around 3.5% lower than in the summer of 2019. The ONS often ends up revising this dataset and it would not be a surprise to see the current picture upgraded over the coming months. This is because, looking across the sectors, it shows sharp falls in output in new build private housing and r&m over the past quarter; this seems inconsistent with much of the anecdotal insight. Indeed as Chart 10 highlights, feedback to the the Q3 RICS Construction Monitor shows infrastructure and private residential seeing the strongest uplift in workloads at the current time.

Major challenges for the industry are presented both by the rising costs of materials and issues around labour and skills. In the latest RICS Monitor, around 90% of respondents identified availability of materials as a problem. Against this backdrop, UK construction materials annual price inflation in the 3 months to September 2021 was put at more than 22% according to BEIS. The fastest inflation rates remain in primarily imported products such as timber (& timber-related products) & steel (& steel-related products). Feedback to the RICS survey suggests that the biggest difficulty on the labour front is around the recruitment of skilled trades but that there also appears a renewed scarcity of quantity surveyors; over half of respondents noted this which is the highest reading since the first three months of 2019.

These pressures are also evident in the RICS metric designed to capture the current trend in profit margins, which remains in negative territory (-11% net balance). Looking forward, respondents suggest the increase in construction costs, on average, will continue to outstrip the likely rise in tender prices (Chart 11).

That said, a strong reading for the RICS New Business Enquiries indicator (+54% net balance after a +50% reading in Q2) suggests the activity trend will be upbeat into the New Year. Updated forecast for industry output from the Construction Products Association are contained in Chart 12. These suggest that activity will increase by close to 5% in 2022 after a 14% rise this year. Within this, infrastructure is likely to remain at the forefront, posting another 10% increase in output with industrial work rising by nearer 8%. Repair and maintenance is likely to contribute a smaller share of the work after a strong 2021.

Chart 10: RICS Q3 Construction Monitor shows current workload momentum strongest in infrastructure and private housing

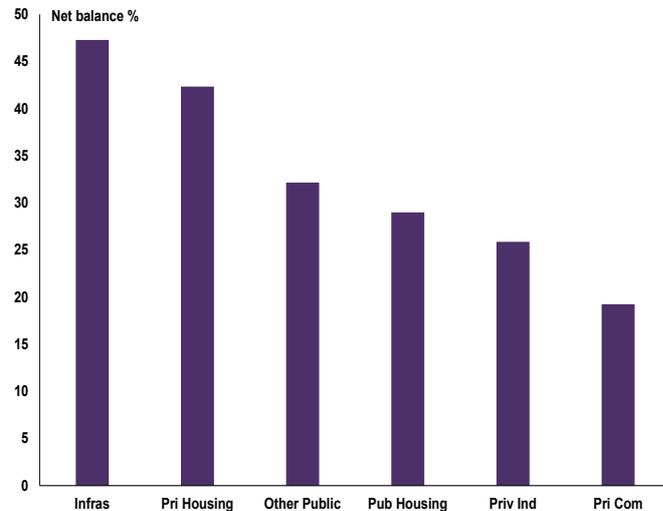


Chart 11: Twelve month expectations provided by respondents to the RICS survey suggest that profits will remain under pressure

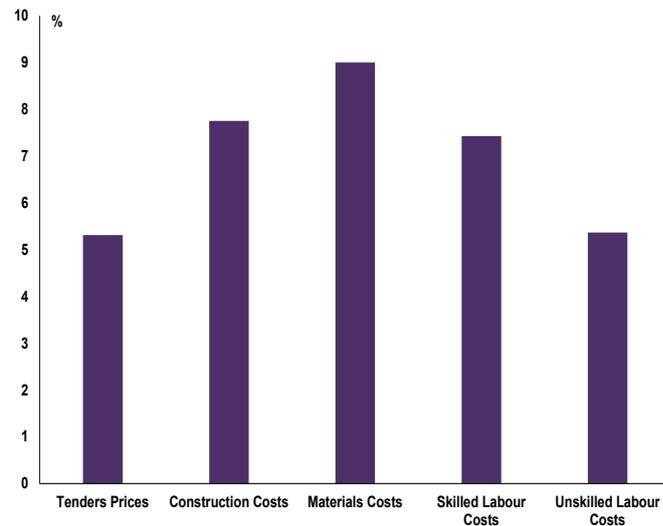
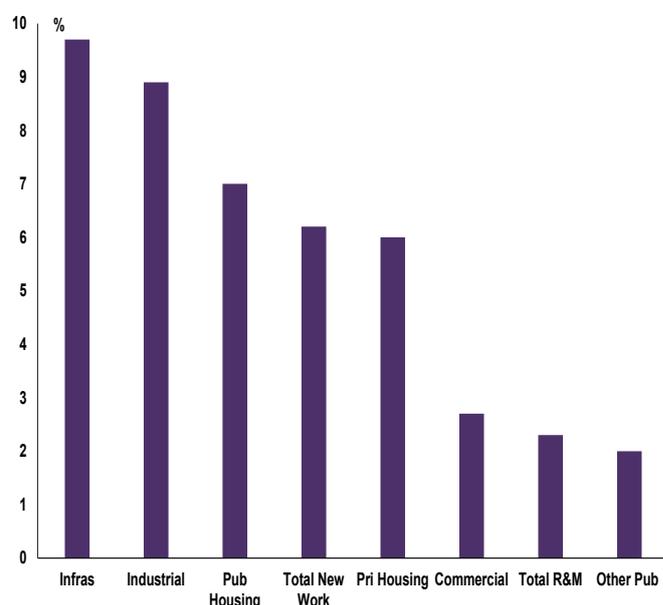


Chart 12: The Construction Products Association’s forecasts show infrastructure and industrial work likely be most buoyant in 2022



What's the forecast?



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