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Economics

RICS

Economy will struggle for momentum until Brexit is sorted

UK Economy and Property Market Chart Book

Q2 2019

rics.org/economics

Contents

RICS Survey Release Dates

Frequency	Survey	Period covering	Release date
Monthly	RICS Portuguese Housing Market Survey	April	30-May-19
Monthly	RICS UK Residential Market Survey	May	13-Jun-19
Monthly	RICS Portuguese Housing Market Survey	May	27-Jun-19
Monthly	RICS UK Residential Market Survey	June	11-Jul-19
Quaterly	RICS UK Construction Market Survey	Q2 2019	18-Jul-19
Quaterly	RICS Global Commercial Property Market Survey	Q2 2019	25-Jul-19
Quaterly	RICS UK Commercial Property Market Survey	Q2 2019	25-Jul-19
Monthly	RICS Portuguese Housing Market Survey	June	26-Jul-19
Monthly	RICS UK Residential Market Survey	July	8-Aug-19

Economic outlook

The impasse around Brexit continues to cloud the macro environment even though headline growth in the first quarter of the year proved more resilient than anticipated. Before drawing too much comfort from this, it is worth bearing in mind that a good slug of the uplift was related to stockbuilding as fears heightened that the country might leave the EU without a deal at the end of March. More significantly, the data continues to draw attention to the unbalanced response of the economy to current events.

Business caution visible in capex trend

A striking feature of corporate behaviour over the past few years has been the reluctance of business to commit additional resource to investment spending which has effectively flatlined despite the strength of profitability over the period. How much of this is down to uncertainty about the UK's future trading relationship with both the EU and the rest of the world is hard to gauge but the recent Deloitte survey of Chief Financial Officers (CFOs) provides a few clues.

Critically, it shows that CFOs believe the current climate to be pretty much the worst time to take greater risk onto balance sheets since the Global Financial Crisis. Brexit is noted as the key challenge by contributors alongside uncertainty about the prospects for demand and geopolitical concerns. This has manifested itself in a downgrading of expectations for revenues, rising costs and less accommodative credit conditions. The response, as the report notes, has been 'a drive to raise cash levels' with the indications that this behaviour will continue over the coming quarters.

But hiring continues to grow strongly

While business may be reluctant to commit for the longer term, it is evidently responding to current economic conditions by taking on more labour. The unemployment rate has slipped below 4% for the first time since early 1975 while the employment rate has climbed to the joint highest level on record.

Significantly, vacancy levels are still rising, suggesting that the pressure on the labour market in general and for skilled labour in particular will continue to intensify. Indeed, there are some signs that this is beginning to filter through into a modest upward drift in earnings growth.

At one level, this is to be welcomed given that 'real' wage growth (after allowing for inflation) has been so subdued in recent years and, arguably, contributed to the disconnect in the political world. However, the fundamental challenge is whether it is being backed up by meaningful productivity growth or whether it will ultimately feed through into higher inflation.

Bank of England sends warning shot

Although the Monetary Policy Committee left interest rates unchanged at its May meeting, the tone of comments from Governor Mark Carney were that money markets are being too complacent in their presumption that there will be little change in the base rate over the coming years. A key issue for the Bank remains the tight labour market and the related lack of spare productive capacity across the economy.

That said, there remains a reluctance to be too assertive at this point given the uncertainties surrounding Brexit; the Bank has made no secret of its unease about a 'no-deal' outcome to the ongoing negotiations.

While there is much room for discussion about how such a scenario might play out, the IMF in its recent analysis of the outlook for the UK suggested that it would result in a further loss of output (of around 3 to 4%) compared with a baseline scenario.

Uncertainty slows activity in commercial real estate

Figures from Property Data suggest that investment in the commercial real estate market slipped to the £10bn mark during Q1. This compares with more than £13bn in the same period of 2018 and an average of around £16.5bn in the subsequent three quarters.

The Q1 RICS Commercial Property Survey also reflected this more cautious tone. Although the headline numbers were generally fairly flat, this continues to mask significant divergences in feedback across sectors. While industrials, in general, are eliciting positive feedback, the story in retail is predictably much more downbeat. And not surprisingly, the pain in the latter is particularly acute in secondary locations; results on expectations from the survey point to rents falling in this part of the commercial market by a further 7% over the next twelve months.

Little near term relief in residential

Official data is now showing the headline price trend to be broadly flat with the year-on-year decline in London approaching 4% and the South East posting its first annual drop since 2011. Meanwhile, the Bank of England data on mortgage approvals for house purchases suggests that activity has dipped to its lowest level since the end of 2017.

This is pretty much consistent with the insight being provided through the RICS Residential Market Survey. New buyers remain cautious and the Agreed Sales series, which is a good lead indicator of transactions, is still pointing in a downward direction. Moreover, the negative picture remains particularly acute in the feedback being received from the capital.

Construction workloads being led by housing

Workloads still appears to be growing according to the Q1 RICS Construction and Infrastructure Survey but this is largely due to a positive trend in the residential sector. Developers have turned a little more cautious and are noting rising costs as a challenge, but nevertheless, continue to see opportunities in the market given the commitment to address the housing crisis. The emphasis on trying to encourage the SME sector continues with the recent launch of a new loan guarantee scheme.

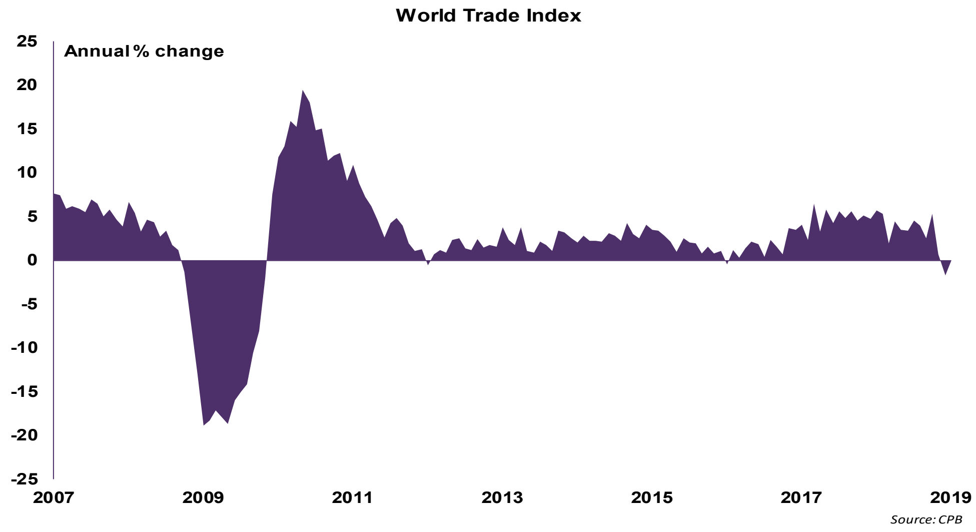
UK Economy

World trade growth has slowed sharply amid an increase in trade tensions between US and China and a decline in business confidence across advanced economies. Estimates compiled by CPB (an economic research institute in the Netherlands) point to a 1% year-on-year fall in global trade volumes in February 2019 (chart 1). Significantly, momentum is expected to continue slowing this year which is likely to have a detrimental effect on UK exports.

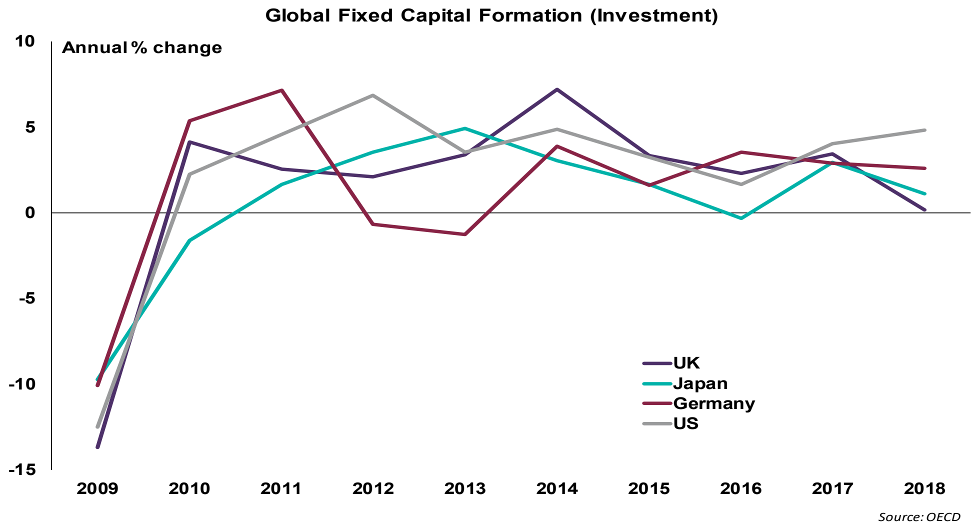
At the same time, UK economic growth could remain sluggish through the rest of the year on the back of Brexit uncertainty and a decline in investment. Business investment fell in every quarter of 2018 with the annual change in gross capital fixed formation (the acquisitions and creation on new assets) last year lower in the UK than in any other G7 country (chart 2).

The sluggish trend in business investment is now feeding through to productivity. Annual growth in output per hour is expected to slip further from 0.5% in 2018 to 0.2% in 2019, putting the UK's productivity performance well behind the average of all other advanced economies (chart 3).

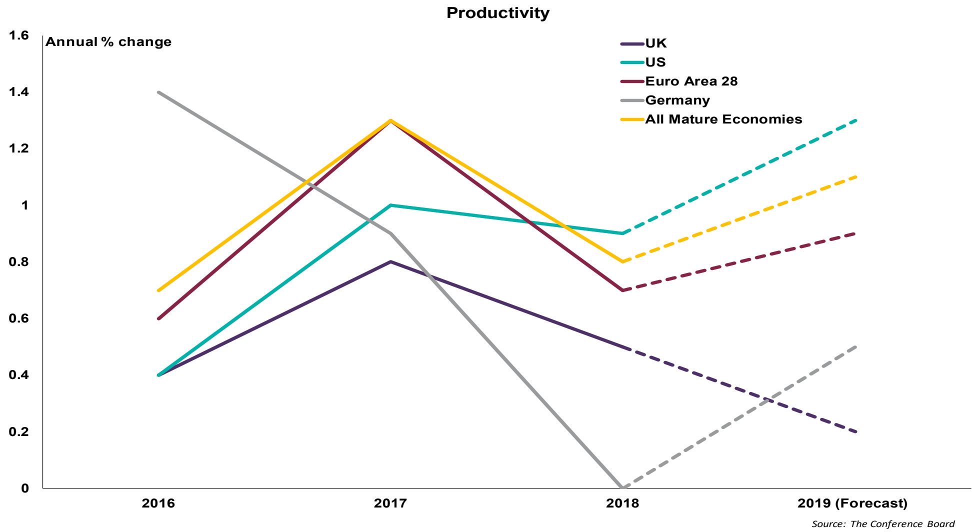
1. World trade growth has slowed significantly



2. Investment in the UK is lower than in other G7 countries



3. Productivity remains a key challenge



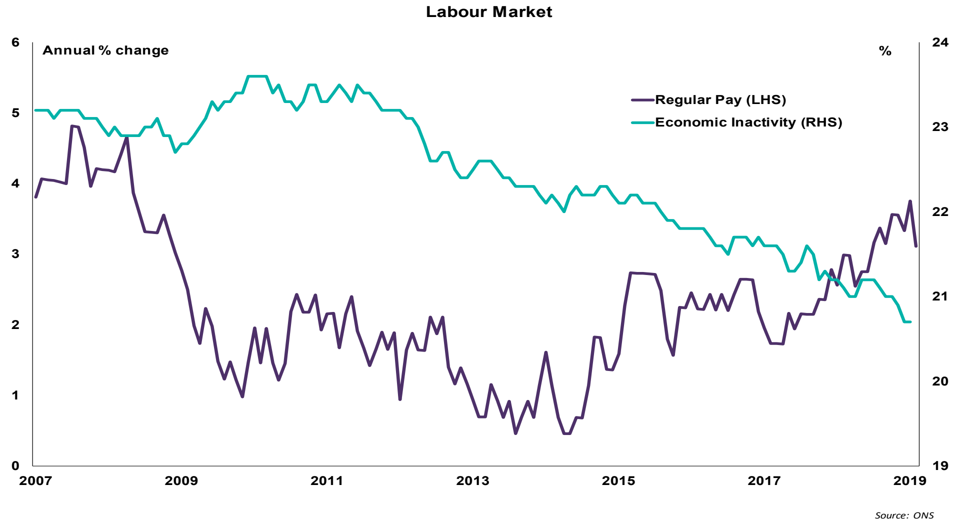
UK Economy

In the labour market, employment growth remains strong driven by an increase in labour force participation. The inactivity rate (the proportion of the population not in the labour force) slipped to 20.7% in January 2019, a record low (chart 4). Pay growth, however came in at 3.1% on a year-on-year basis, the weakest in five months. Nonetheless, we think that this is likely to be an aberration and the tight labour market should see wage growth staying close to the 3.5% mark for the remainder of the year.

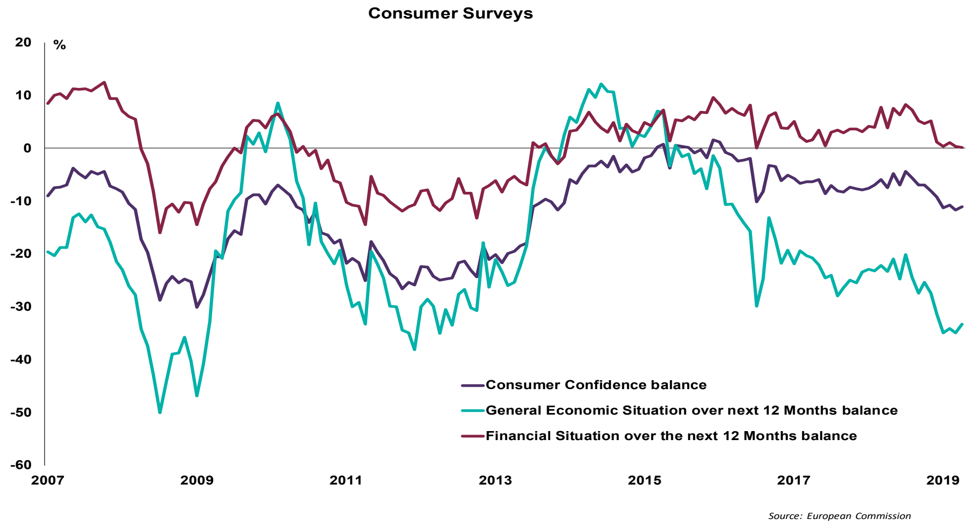
Meanwhile the European Commission's measure of consumer confidence is still close to its lowest point in over five years, driven by fears over the performance of the UK economy. That said, perhaps on the back of strong employment growth numbers, consumers remain slightly more positive about their own financial situation over the coming twelve months (chart 5).

This could help to explain the latest outturn for retail sales (chart 6). The ONS retail trade index suggests sales picked-up sharply by 6% on an annual basis in March 2019, the strongest result for this series in more than two years.

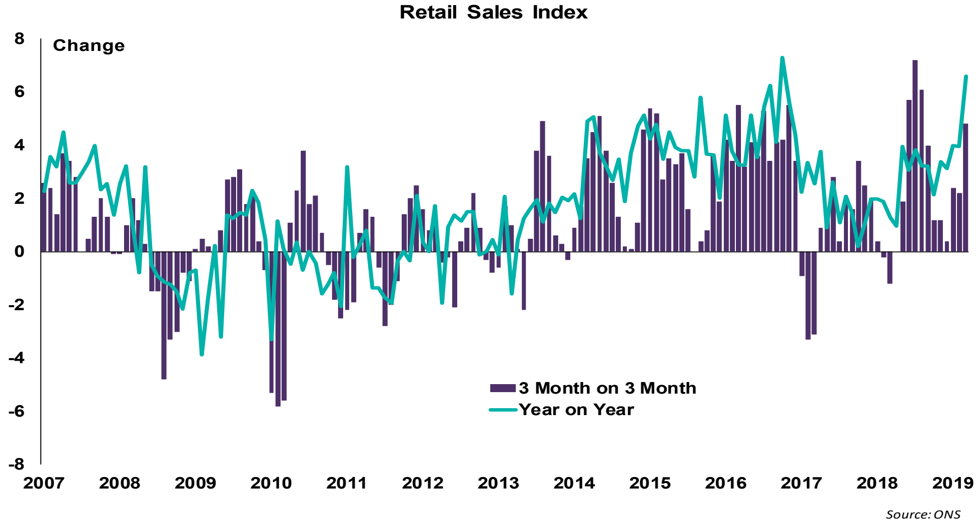
4. Inactivity continues to fall sharply



5. Consumer confidence is at a five-year low



6. Retail sales have increased in the latest results



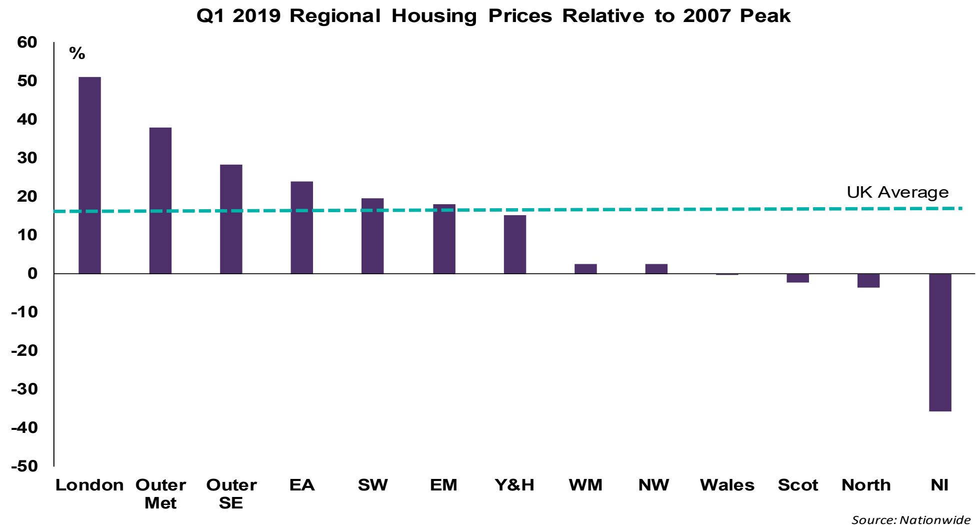
Housing Market

According to the Nationwide Building Society Q1 2019 data, house price growth is the strongest in Northern Ireland with prices rising by 3.3% on a year-on-year basis. In comparison, prices in London fell by 3.8%. This result is not entirely surprising taking into account that whilst affordability has become particularly stretched over the years in London and the South East, prices in Northern Ireland are still more than 35% below their 2007 peak (chart 7).

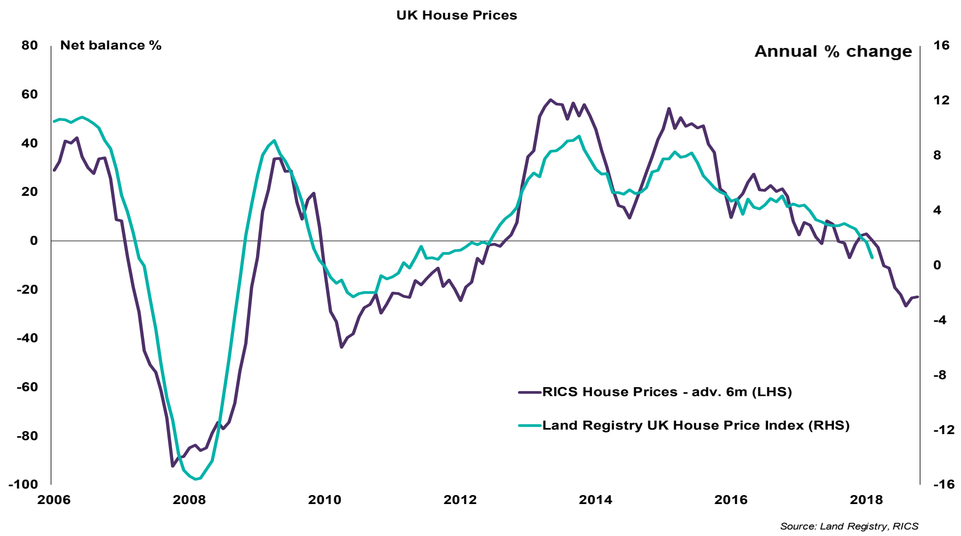
In the RICS survey, the headline price balance has slipped into negative territory over the past five reports driven by particularly downbeat price trends in London and South East (chart 8). This series is a good lead indicator of the official measure of house price growth and suggests that national price inflation will soften further as we move through this year.

The picture across the lettings market is a little firmer. Headline near term rent expectations remain positive, with the RICS series suggesting UK private rents will rise modestly over the coming twelve months (chart 9).

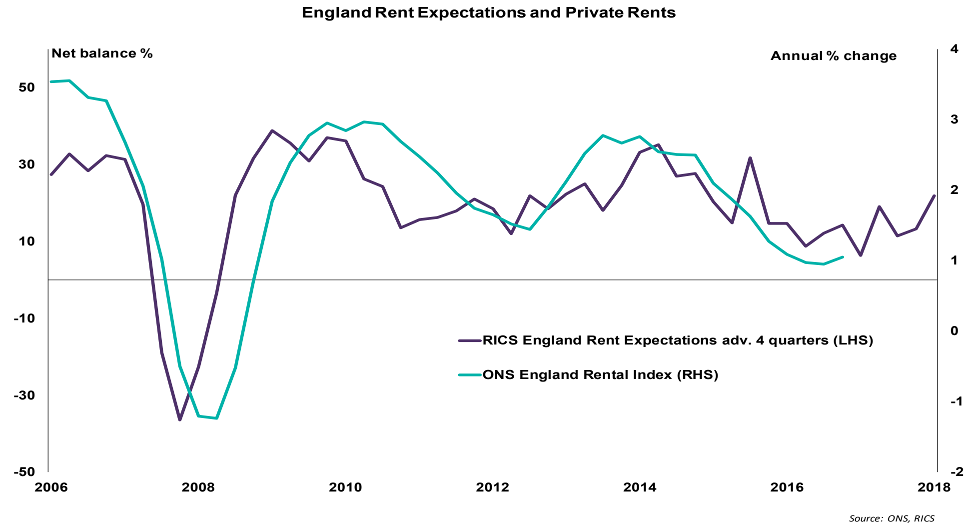
7. Affordability is particularly stretched in London and the SE



8. House price growth looks likely to soften further



9. Rents are still expected to rise modestly



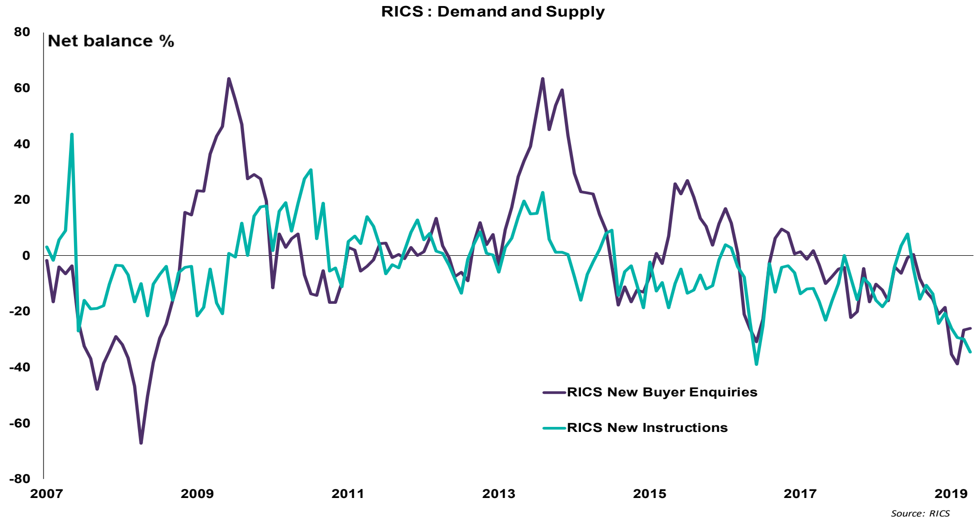
Housing Market

Chart 10 shows that feedback to the RICS Housing Market Survey continues to point to subdued activity nationally. New buyer enquiries (an indicator of demand) have declined for seven successive reports. Alongside this, new instructions, capturing the flow of properties being listed on the sales market, have also deteriorated.

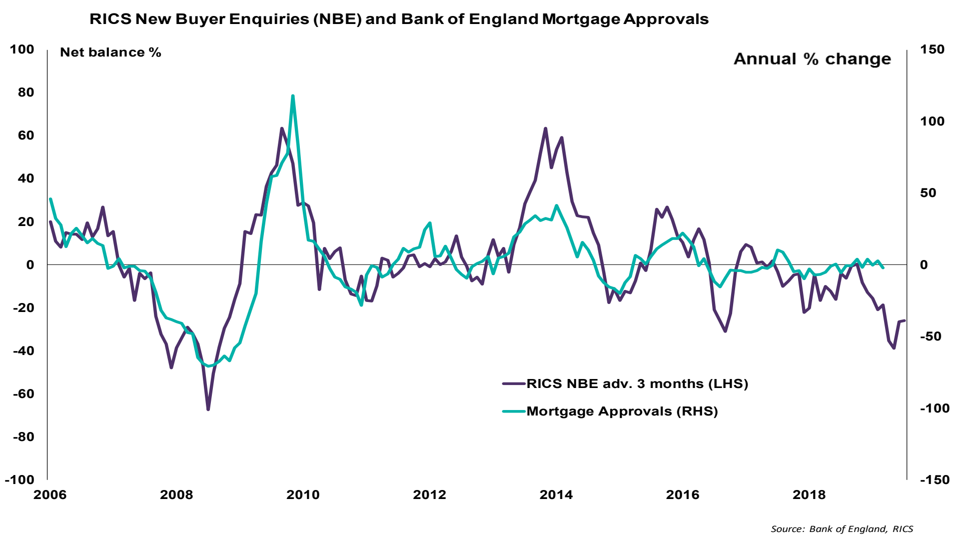
Mortgage approvals (estimated by the Bank of England) have held pretty steady at around the 64,000 mark in the last six months (notwithstanding the 4.6% month-on-month fall in March). However, with RICS indicators suggesting an ongoing softening trend in buyer appetite, it remains to be seen whether this resilience in transactions activity persists (chart 11).

Following the subdued trend in buyer demand, the RICS Agreed Sales indicator is also consistent with a decline in activity. Looking ahead, momentum is envisaged to continue slowing over the coming three months, although expectations of the twelve-month horizon are a little more optimistic (chart 12).

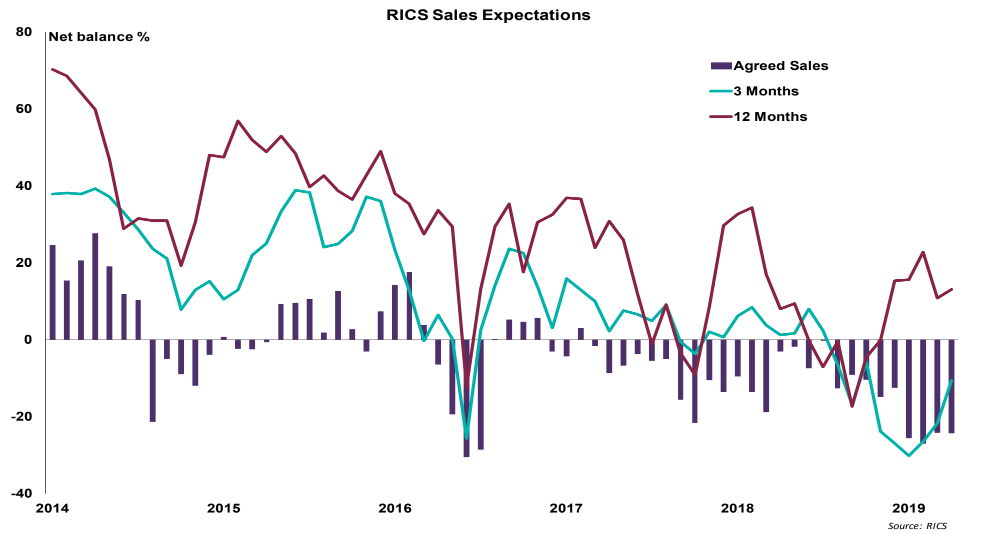
10. RICS indicators on demand and supply are both negative



11. Mortgage approvals look likely to slip



12. Activity is expected to remain subdued in the coming 3 months



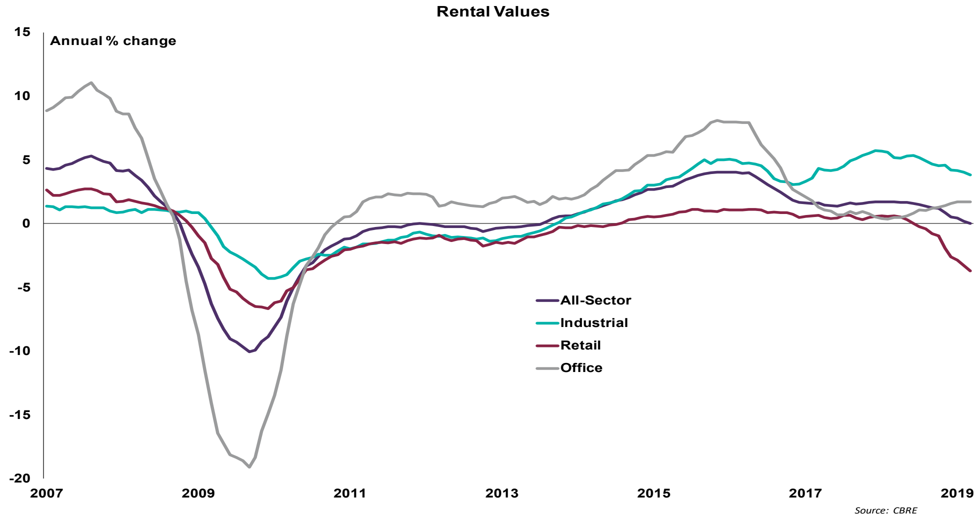
Commercial Property Sector

In the UK commercial property market, the troubles of the retail sector remain a key feature where rental values are now declining at the fastest pace since the financial crisis (chart 13).

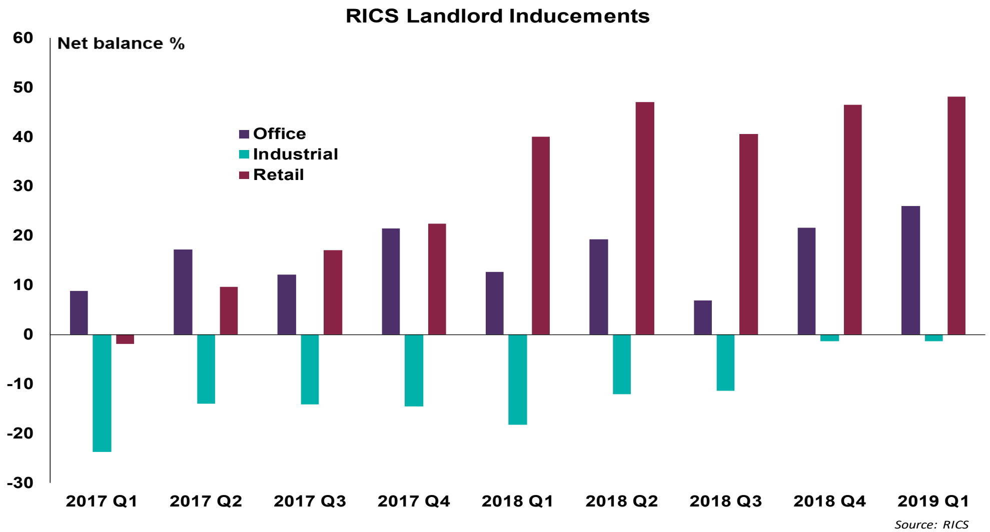
According to PWC, a record number of 2481 stores disappeared from UK's top 500 high streets in 2018, 40% higher than the number in 2017. This chimes with the feedback to the RICS survey, where a rise in the availability of retail space has prompted landlords to increase the value of incentive packages on offer to tenants sharply over the past year (chart 14).

As a result of a particularly downbeat outlook for rental values in the retail segment, the RICS headline rent expectations net balance has edged down slightly to -9% in Q1 2019, from -7% previously, pointing to a moderation UK rental value growth over the coming quarters (chart 15). Office rents are, however, projected to hold steady whilst rents in the industrial/logistics sector are expected to continue rising firmly.

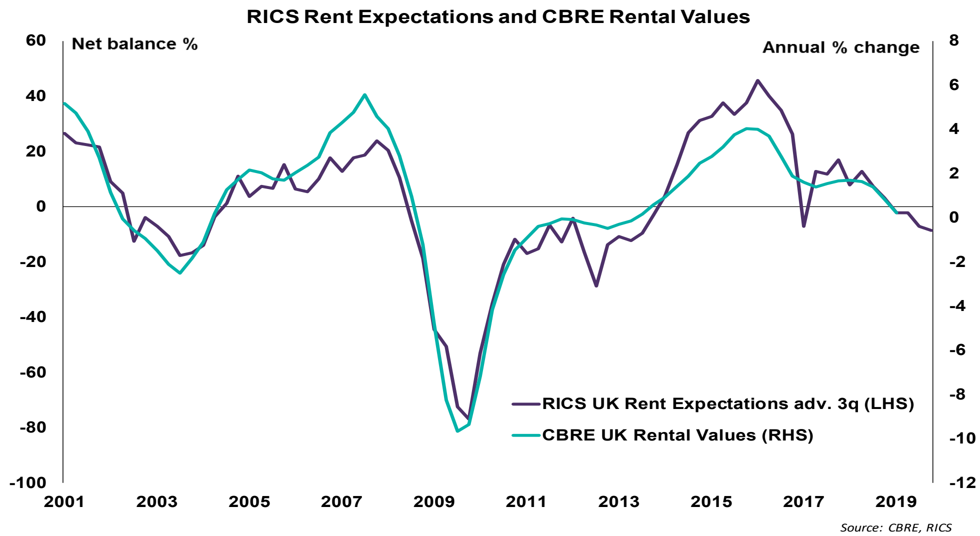
13. Rental values are falling in the retail sector



14. Landlord inducements have increased sharply in the retail



15. Growth in rental values is likely to soften at the headline level



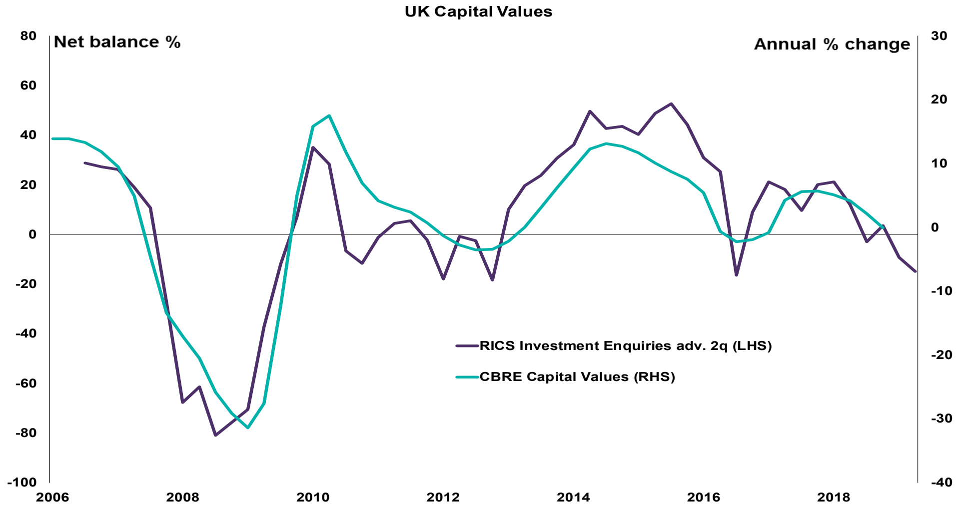
Commercial Property Sector

Shown in chart 16, RICS headline investment enquiries have slipped slightly over the previous two reports pointing to a slightly negative trend in UK capital values in the coming quarters. On a sector level, RICS indicators suggest that although investor demand has slipped significantly in the retail portion of the market, appetite for industrial properties remains solid.

Despite Brexit concerns, Property Data estimates that net investment into the UK by overseas investors reached more than £3 billion in Q1 2019, up from £1.1 billion in the previous quarter. Consequently, overseas investment made up more than half of the total value of investment purchases in Q1 2019 (chart 17).

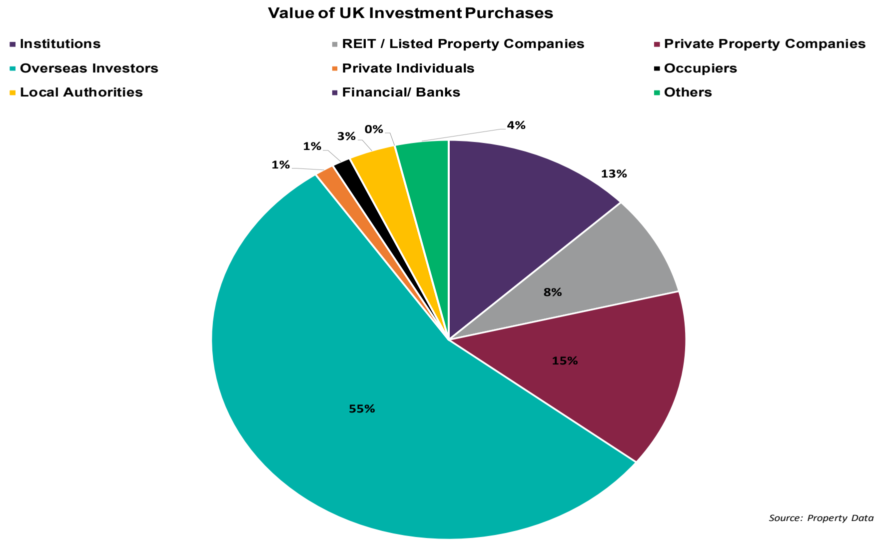
Looking ahead however, whether the UK retains its position as a major investment hub is still open to question. In the RICS survey, the share of contributors expecting an increase in firms relocating (at least some part of their business) from the UK over the next two years in response to Brexit has risen noticeably over the past quarter (chart 18).

16. Investment enquiries have dipped slightly



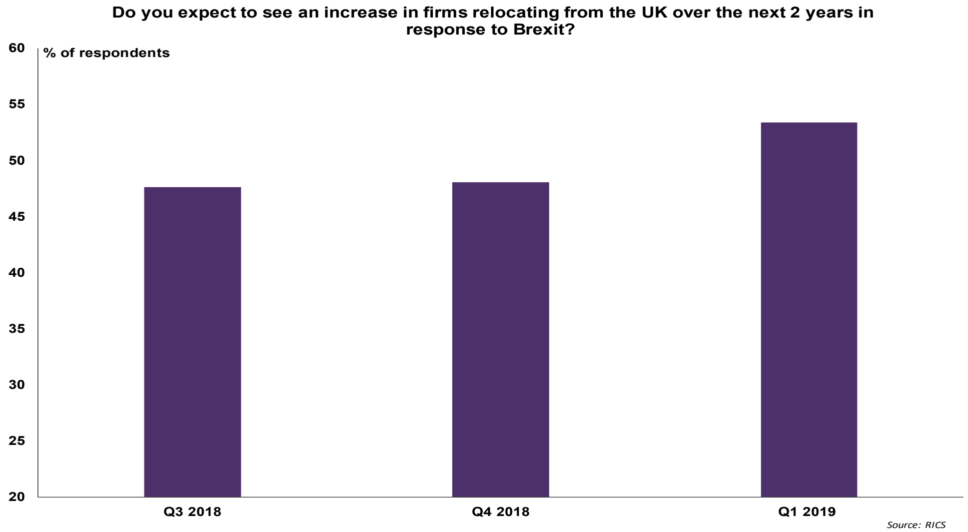
Source: CBRE, RICS

17. Overseas investment in the UK is still strong



Source: Property Data

18. Some relocations are expected to occur in response to Brexit



Source: RICS

Construction Sector

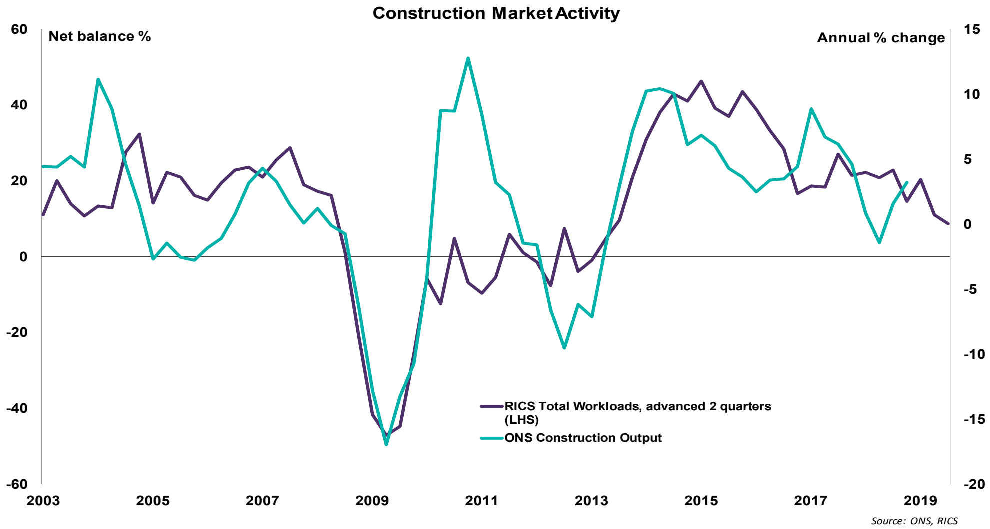
The latest estimates by ONS suggest that the volume of new construction orders slipped in the second half of 2018 (chart 19). New planned projects have fallen to their lowest levels in six years which points to a rather downbeat outlook for the construction industry as far as potential future activity is concerned.

This is consistent with the feedback to the RICS UK Construction Market Survey. The headline new workloads net balance has eased to +11% in Q1 2019 from +20 in Q4 2018, suggesting that total output growth is likely to moderate slightly as the year advances (chart 20).

Still, behind the headline figures, the RICS survey suggest that workloads across the private housing sector are continuing to rise, outstripping all other segments of the industry. Indeed, a net balance of +21% in the latest survey is close to the average of the past two years suggesting that activity remains solid in this area (chart 21).

19. New orders have slipped recently

20. Momentum looks likely to slow



21. But private housing activity is still solid

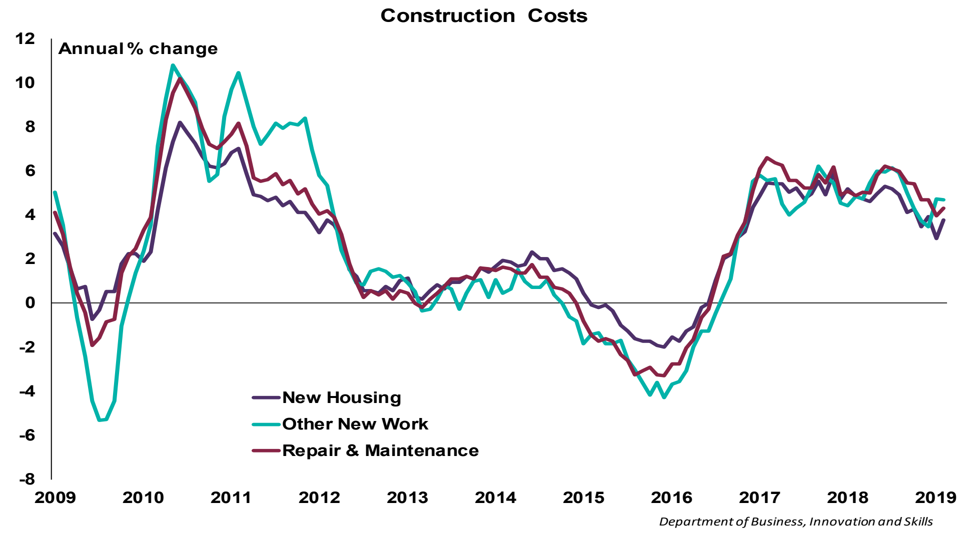
Construction Sector

According to government statistics, costs of building materials are still continuing to rise firmly (chart 22). Notably, the price of cement on an annual basis increased by 4% in Q1 2019, the highest in almost four years. This is significant particularly given the ongoing capacity constraints across the industry alongside concerns about the potential impact of Brexit on construction supply chains.

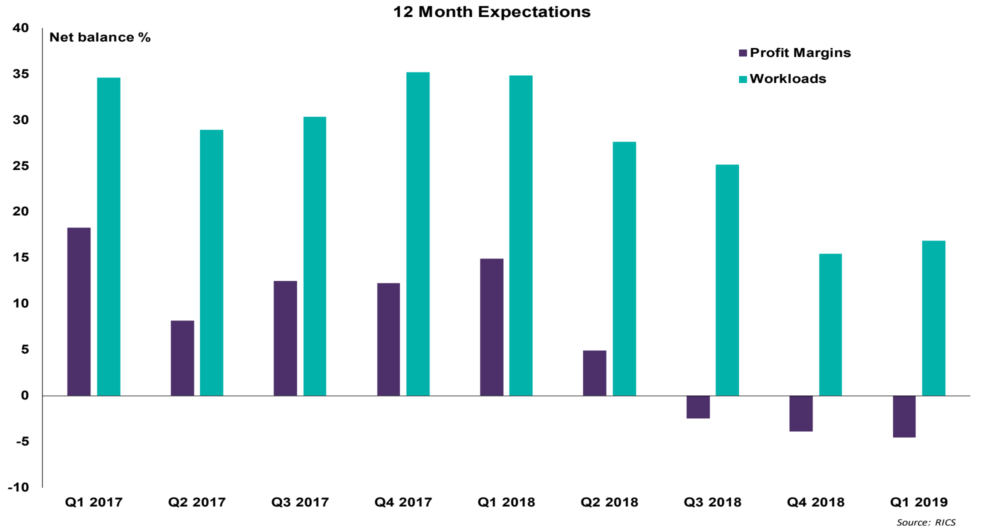
This could help to explain why expectations for profit margins have deteriorated in the RICS survey over the last three quarters. Contributors expect profit margins to slip marginally in the coming twelve months even though total workloads are still expected to rise in the same timeframe (chart 23).

Meanwhile, contributors continue to report a shortage of skilled labour with the deficiency particularly acute in the quantity surveying profession (chart 24). Lack of skilled labour has consistently been reported as one of the major impediments to future market activity. Crucially, a likely drop in net immigration in response to Brexit could further exacerbate the current shortage.

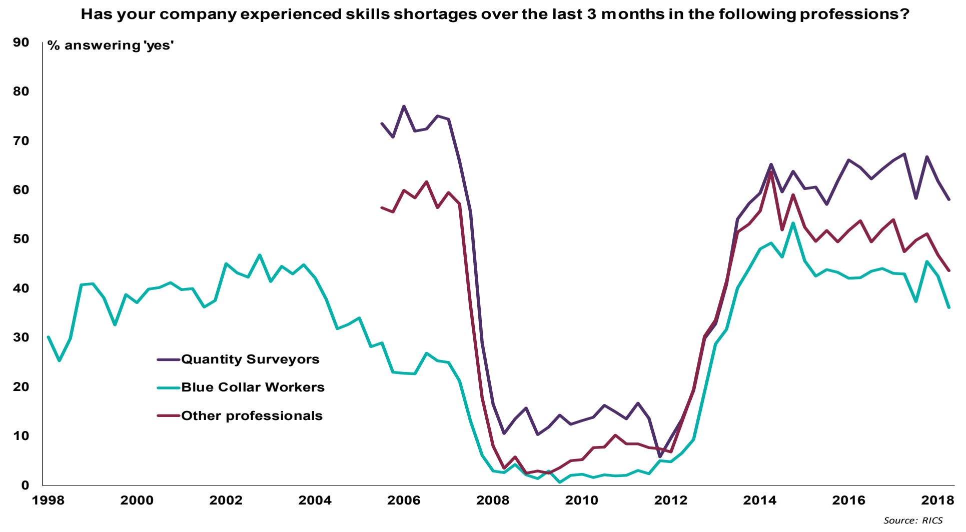
22. Material costs are still rising firmly



23. Expectations for profit margins are broadly flat



24. Skill shortages remain elevated



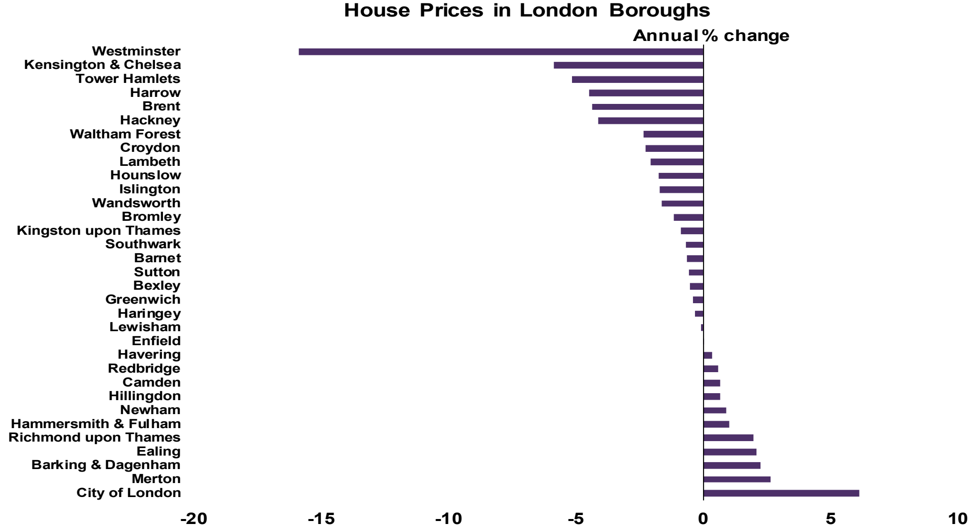
London

The UK Land Registry estimates that house prices across London have been falling for almost a year. Looking at the price trends across London boroughs, this appears to be stemming from sharp price declines in prime Central London areas like Westminster and Kensington and Chelsea, although price momentum also appears to be falling in areas like Hackney and Harrow (chart 25).

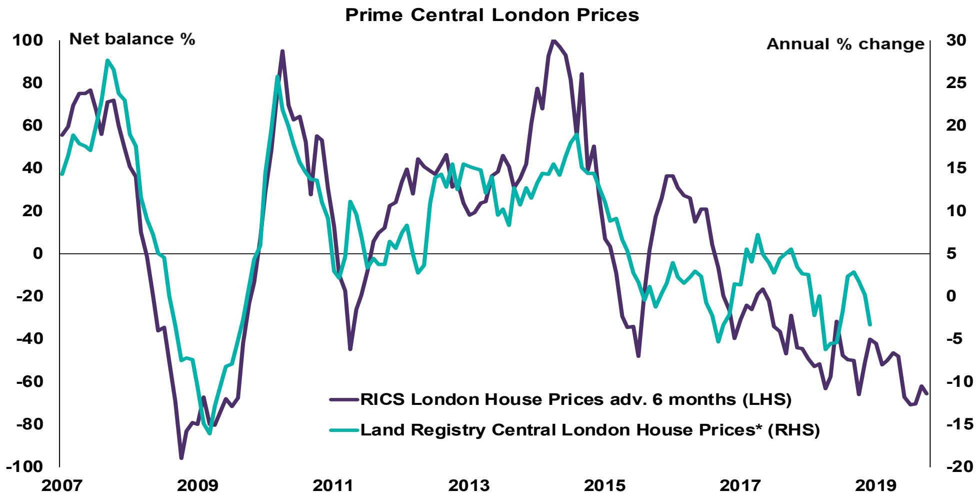
In the RICS Housing Market Survey, the London series (which mainly captures prices trends across prime areas) has remained in negative territory for two years. The net balance came in at -66% in April 2019 pointing to a further decline in prices over the coming months (chart 26).

Turning to the commercial property market, feedback to the RICS survey suggests investor demand for Central London offices has cooled somewhat in Q1 2019 (net balance easing to -13% from -6% in Q4 2018). This points to a broadly negative trend in London office capital values over the course of the year (chart 27).

25. House prices have fallen in most London boroughs



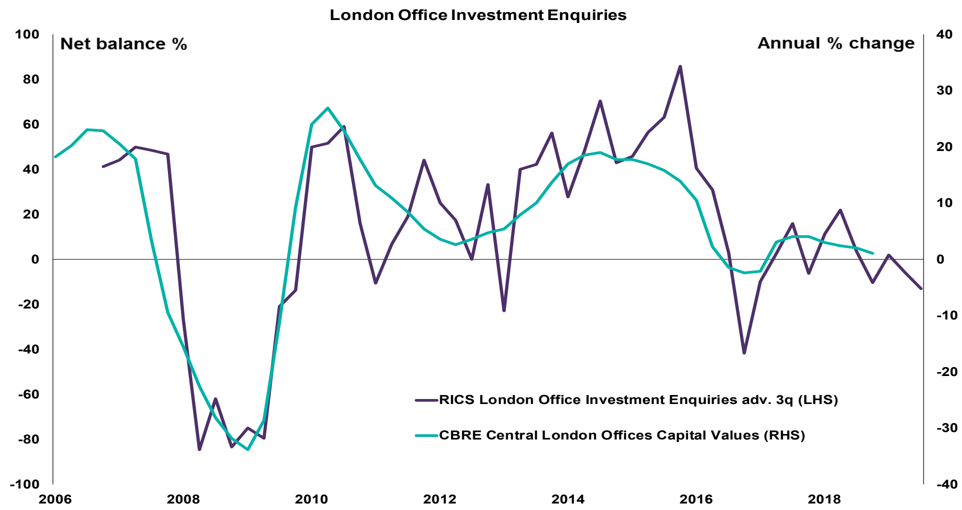
26. Prices in prime boroughs look likely to drop further



*Average prices of Kensington & Chelsea, Hammersmith & Fulham, City of Westminster boroughs

Source: Land Registry, RICS

27. Investor appetite for London offices has pulled-back slightly



Source: CBRE, RICS

Market Surveys & Reports

Why the RICS surveys?

“The RICS poll - considered one of the most reliable guides to movements in house prices.” **Financial Times**

“The RICS survey - the best short-term lead indicator of house prices and activity in our view.” **Goldman Sachs**

“The RICS Survey has been a good leading indicator for the direction of and inflection points in the IPD index, and therefore the UK commercial property market overall.” **Morgan Stanley**

“The RICS Commercial Property Survey is an excellent predictor of future IPD total returns.” **North Row Capital**

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  http://www.rics.org/hong-kong-residential-market-survey

The Economics Team

Kisa Zehra, Economist
kzehra@rics.org +44 (0)20 7695 1675

Simon Rubinsohn, Chief Economist
srubinsohn@rics.org +44 (0)20 7334 3774

Jeffrey Matsu, Senior Economist
jmatsu@rics.org +44 (0)20 76971644

Sean Ellison, Senior Economist
sellison@rics.org +65 68128179

Tarrant Parsons, Economist
tparsons@rics.org + 44 (0)20 7695 1585

Janet Guilfoyle, Surveys Administrator
jguilfoyle@rics.org +44 (0) 20 7334 3890

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United Kingdom RICS HQ
Parliament Square, London SW1P 3AD
United Kingdom
t +44 (0)24 7686 8555
f +44 (0)20 7334 3811
contactrics@rics.org
Media enquiries pressoffice@rics.org

Ireland
38 Merrion Square, Dublin 2,
Ireland
t +353 1 644 5500
f +353 1 661 1797
ricsireland@rics.org

Europe
(excluding UK and Ireland)
Rue Ducale 67,
1000 Brussels, Belgium
t +32 2 733 10 19
f +32 2 742 97 48
ricseurope@rics.org

Middle East
Office G14, Block 3,
Knowledge Village,
Dubai, United Arab Emirates
t +971 4 446 2808
f +971 4 427 2498
ricsmenea@rics.org

Africa
PO Box 3400, Witkoppen 2068,
South Africa
t +27 11 467 2857
f +27 86 514 0655
ricsafrica@rics.org

Americas
One Grand Central Place,
60 East 42nd Street, Suite 2810,
New York 10165 – 2811, USA
t +1 212 847 7400
f +1 212 847 7401
ricsamericas@rics.org

South America
Rua Maranhão, 584 – cj 104,
São Paulo – SP, Brasil
t +55 11 2925 0068
ricsbrasil@rics.org

Oceania
Suite 1, Level 9,
1 Castlereagh Street,
Sydney NSW 2000. Australia
t +61 2 9216 2333
f +61 2 9232 5591
info@rics.org

North Asia
3707 Hopewell Centre,
183 Queen's Road East
Wanchai, Hong Kong
t +852 2537 7117
f +852 2537 2756
ricsasia@rics.org

ASEAN
10 Anson Road,
#06-22 International Plaza,
Singapore 079903
t +65 6635 4242
f +65 6635 4244
ricssingapore@rics.org

Japan
Level 14 Hibiya Central Building,
1-2-9 Nishi Shimbashi Minato-Ku,
Tokyo 105-0003, Japan
t +81 3 5532 8813
f +81 3 5532 8814
ricsjapan@rics.org

South Asia
48 & 49 Centrum Plaza,
Sector Road, Sector 53,
Gurgaon – 122002, India
t +91 124 459 5400
f +91 124 459 5402
ricsindia@rics.org