

Economy and Property Market Update

May 2025

Downbeat economic outlook but easing in monetary policy to provide some relief

ECONOMICS

Summary

Despite some rowing back in the tariff war, geopolitics continues to cast a shadow over the economic picture in the UK. On top of this, business sentiment has been adversely affected by the increase in NI contributions and uncertainty as to whether more tax increases lie in store. Lower interest rates are, however, providing some support for the real estate sector. Meanwhile, the uplift in construction activity to deliver on the ambitions around both infrastructure and housing is not yet showing sign of materialising.

Economy

To be fair, global events over the past few months have been more significant in influencing the UK macro environment than anything emanating on the domestic front, albeit that the uplift in employer National Insurance contributions announced in the autumn budget has now come into play. At this point, there remains considerable uncertainty regarding how the issue around tariffs will develop. Recently announced trade deals with India and the US are encouraging but not game-changers either in scope or the likely boost to the economy; in the case of the latter, the agreement (covering cars, steel and aluminium) accounts for less than 1% of total UK exports (Chart 1). The 10% baseline tariff on other non-exempt UK exports to the US, announced on April 2, will remain in place.

Meanwhile, the drag from the uncertainty triggered by geopolitical developments continues to be felt in revised economic forecasts which were, in any event, lacklustre. Chart 2 tracks the projections recently released by the Bank of England as well by two private consultancies. Both this year and next, there is little conviction that growth will exceed one per cent which would leave it broadly in-line with last year's outturn. Meanwhile, the updated inflation forecast from the Bank was somewhat less concerning. The near-term profile was lower, reflecting the strengthening in sterling as well as the falls in oil and gas prices in the wake of the US tariff announcements. Looking beyond this, the central bank now anticipates slightly more slack to emerge than previously helping to weigh down on inflation pressures. In terms of the numbers, the February forecast put peak inflation at 3.7% compared with 3.5% in the latest iteration. But more significantly, the key inflation metric is now seen as returning to the 2% target by the beginning of 2027 rather than the end of that year which was a key ingredient of the previous forecast.

That said, it is clear that the Bank is taking a measured approach when it comes to the scope to lower interest rates going forward. The 5 to 4 vote for the quarter point move in May was narrower than expected but also reflected an increasingly divergent range of opinions. It is true that two members of the nine person committee actually wanted a half point cut in rates but, significantly, a similar number wanted the Bank to sit on its hands for now. Chart 3 tracks the mood in the money markets regarding the outlook for base rates over the next five years. It is notable that the more aggressive sentiment has been somewhat curbed but the bet is still that monetary policy will be eased further through the course of this year.

One other specific concern regarding the soft outlook for the economy is how the Chancellor will respond if the Office for Budget Responsibility builds this picture into its own numbers come the autumn. This would inevitably increase pressure to revisit the fiscal rules even though at this point, both Rachel Reeves and the Prime Minister are indicating there is no flexibility on this. The alternatives of a further squeeze on public spending or more tax increases are likely to prove hard to sell and will possibly undermine the economic outlook further.

Chart 1: UK goods exports to the US are a relatively small proportion of total exports

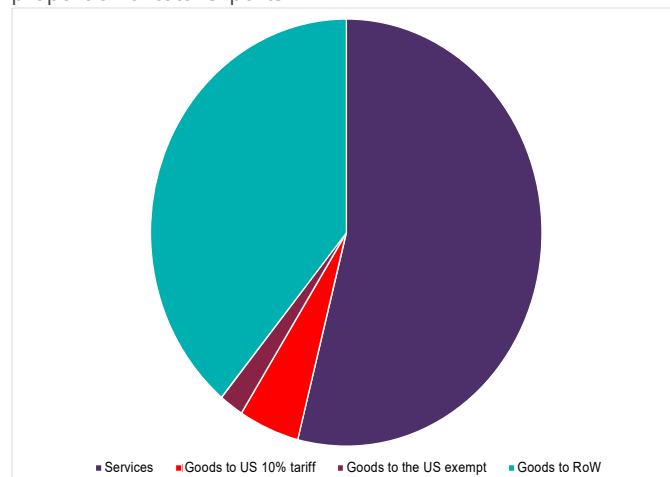


Chart 2: Economic growth will struggle to reach one per cent this year with projections for 2026 little better

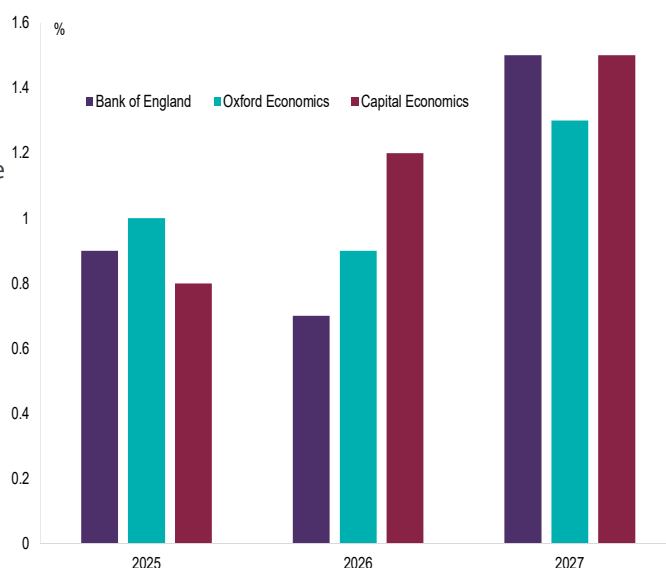
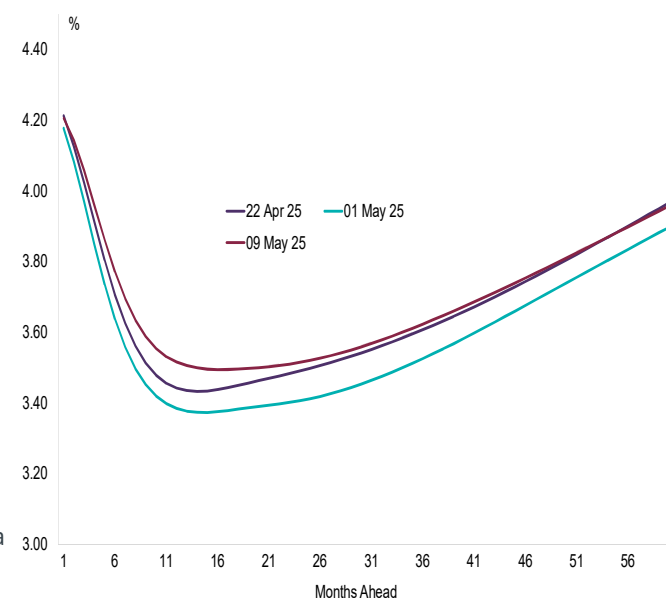


Chart 3: Money markets, while still anticipating further interest rate cuts, are more circumspect than they were



Commercial Property

The latest data from Lambert Smith Hampton indicates a sharp decline in UK commercial real estate activity between Q4 2024 and Q1 2025. As shown in Chart 4, investment volumes equated to £9.3 billion in Q1, marking a significant 36% decrease from the previous quarter. A breakdown of the data shows that offices were the only sector to exhibit a quarter on quarter increase with the figure rising by 10% to £2.4bn and marking the best reading in circa two years. While the total value of transactions fell sharply, the number of deals declined more moderately, down 16% quarter-on-quarter, bringing it in line with the five-year quarterly average.

Feedback from the Q1 RICS UK Commercial Property Monitor continues to reflect a relatively subdued market, with domestic tax changes, economic uncertainty, and global trade policy all contributing to a generally cautious tone. That said, some encouragement can be drawn from the growing share of respondents that now perceive the market to be shifting into an upturn phase of the cycle, with this figure rising (very modestly) to 39%, up from 37% last quarter.

Supporting this slightly more optimistic outlook, the net balance for credit conditions moved out of negative territory in Q1 despite the turmoil in financial markets, rising to +3% from -7% last quarter. This shift likely reflects the suspicion that further interest rate cuts are on the way as highlighted earlier. Alongside this, the investment enquiries metric has seen a small uplift of late. Indeed, according to the Q1 feedback to the RICS Commercial Property Monitor, the net balance moved into marginally positive territory (+4%) for the first time since Autumn 2023. Offices and industrial properties led this improvement, with the net balance for the former rising from -11% to +1%, while the reading for industrials increased from +8% to +18%. With respect to trends in capital values reported by CBRE, a growth rate of 1.7% was registered for offices in Q1, while the comparable rate stands at 2.3% for industrials (Chart 5). Even so, the former index still stands around one-quarter down on its high water mark.

Looking ahead over the next twelve months (Chart 6), capital value expectations remain (just about) positive across all three prime markets tracked in the RICS survey, with the strongest outlook for offices and industrial. The gap between prime and secondary assets persists, however, most notably in the office sector. Across the broader landscape, nearly all alternative asset classes covered in the RICS monitor, except leisure, show solid capital value expectations. Data centres, aged care, student housing, and multifamily assets continue to promise the strong outlook as has been the case over the past several quarters.

Chart 4: Investment volumes have fallen back again in the opening quarter of 2025 according to Lambert Smith Hampton

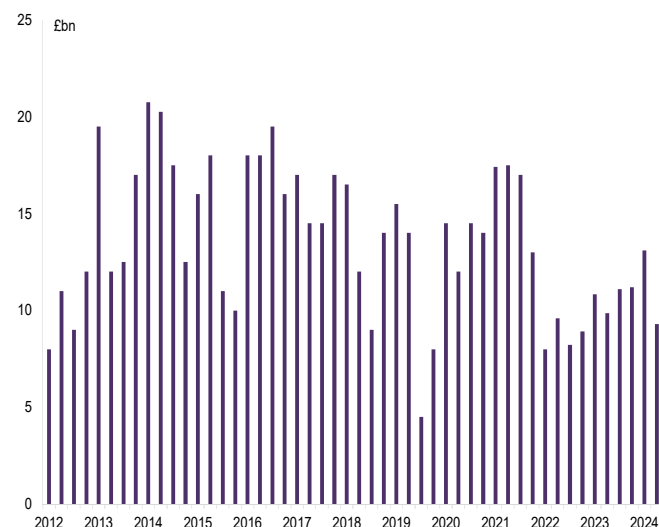


Chart 5: CBRE data shows that total returns on a quarterly basis have eased slightly but remain in positive territory

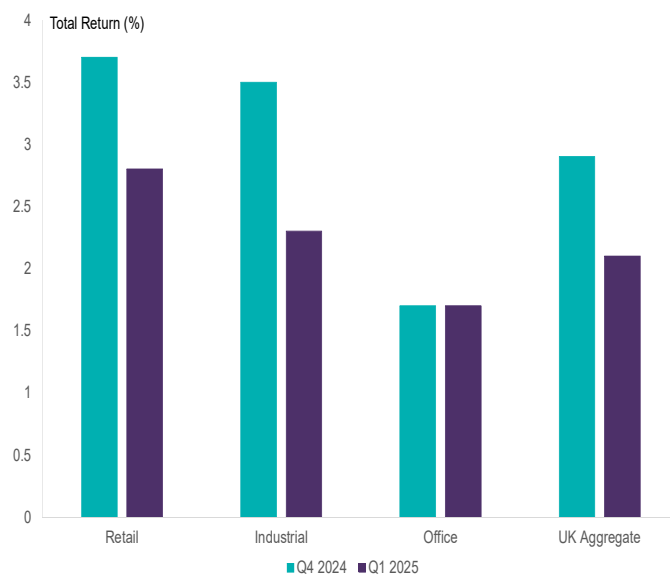


Chart 6: The outlook for alternative assets remains most positive looking forward



Residential Property

The most recent data has been pretty consistent in pointing to a slowing in activity (and a flattening in pricing) in the residential market. The critical issue is whether this is largely a reflection of the termination of the stamp duty break at the end of March or a response to a shift in the economic backdrop. If it were to be the latter, it is not hard to identify reasons why this might be the case including the deterioration in the geopolitical climate following the announcement of the new tariff regime by President Trump and the worsening in domestic business sentiment as the higher National Insurance contributions become applicable. That said, our sense is that the softer trend in the residential sector has more to do with the aftermath of the run-up in activity as buyers sought to take advantage of the tax advantage of purchasing a property before expiry of the tax benefit.

Chart 7 tracks the RICS New Buyer Enquiries and Sales Agreed metrics. From this, it is evident that the former began to turn negative in February as the timeline to completing on a property purchase ahead of the ending of the fiscal incentive became more demanding. Moreover, HMRC numbers capture the sharp jump in completed sales at this point. The average number of monthly transaction between November and January was just over 95,000, however in February, this climbed to just shy of 110,000 and then in March to nearly 180,000.

While it would be wrong to understate the macro risks to the market, it is noteworthy as highlighted in Chart 8 that the RICS forward looking indicators (one year out) remain relatively resilient. One important reason for this is the scope for further interest rate cuts over the course of the year, notwithstanding the slightly more cautious than anticipated outcome to the May meeting of the Bank of England (as discussed earlier). Alongside this, the short end of the gilt market has already begun to reflect the prospect of more accommodating monetary conditions paving the way for the introduction of more competitive mortgage products. It is possible that deeper disruption to the global trading environment could threaten the softer landing still largely built into most forecasts; inevitably such an outcome would be more damaging for the housing market but at this point, we view this prospect as a tail risk.

As far as the private rental market is concerned, the picture has not changed materially since the February Economy and Property Market Update. Supply continues to shrink while demand is still growing at a moderate pace. This imbalance continues to drive rents higher with expectations that this pattern will continue (Chart 9). Indeed, forward looking data from the RICS survey is still consistent with somewhere between 20 and 25% growth in rents over the next five years. Respondents to the RICS survey continue to point the uncertainty surrounding the Renters Right Bill as well as the consultation around the required EPC for rented homes as likely continuing to act as a drag on supply.

Chart 7: RICS New Buyers Enquiries and Sales Agreed metrics have begun to fall

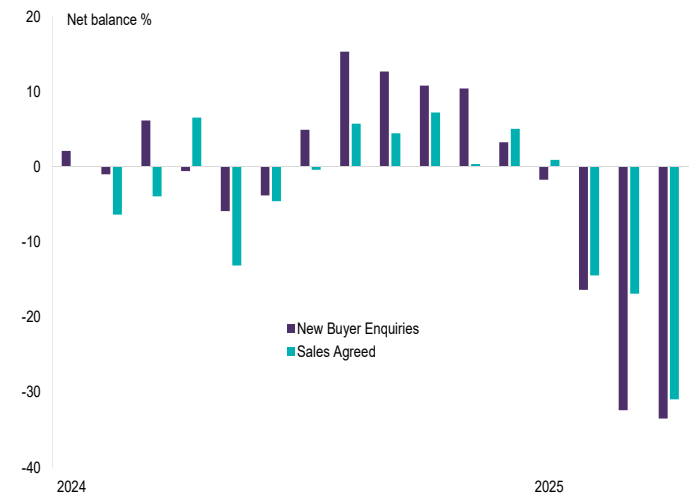


Chart 8: One year out, RICS Price and Sales Expectations remain more positive

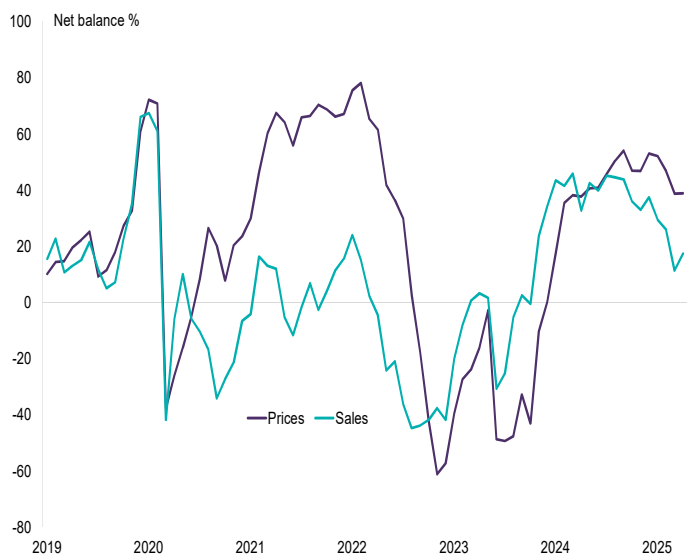
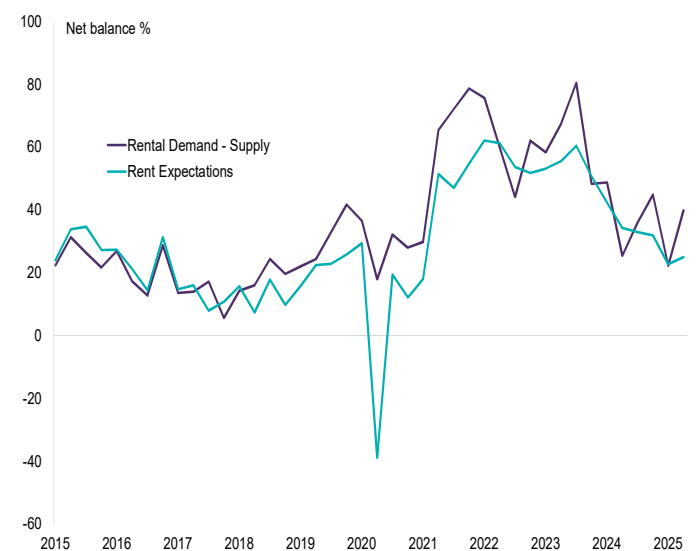


Chart 9: RICS data shows the imbalance between rental demand and supply to still be significant



Construction

The latest data from the ONS continues to show a broadly flat trend in UK construction activity. While output is estimated to have grown by 0.4% in February 2025, following 0.3% growth in January, there was no overall increase in the three months to February. This subdued picture is echoed in the latest RICS UK Construction Monitor, where the headline workloads net balance came in at -1%. A sectoral breakdown (Chart 10) reveals that infrastructure remains the most resilient area, with a net balance of +13% of respondents reporting an increase in workloads, extending a prolonged positive trend seen in recent quarters, in contrast to the stagnant or slightly negative trends reported across other sectors.

The picture is a little more upbeat looking out over the next twelve months however, with expectations positive across all three main categories, with infrastructure projected to see the strongest expansion in activity (Chart 11). Although workload expectations for both the private residential and private non-residential sectors remain in expansionary territory, the Q1 RICS survey results show sentiment has weakened slightly for a second consecutive quarter. The net balance for private residential declined from +20% to +15%, while for private non-residential it has eased from +15% to +11%. Despite the recent increase in employer National Insurance contributions, employment expectations remain firm over the year ahead, even if the net balance dipped slightly from +18% to +15%. However, concerns over the financial landscape, as it specifically relates to the construction industry, have intensified. Indeed, the surveys credit conditions metrics deteriorated at each time horizon tracked, posting a net balances of -23% for the next three months and -16% over the twelve-month horizon.

In keeping with this, the RICS survey continues to highlight financial constraints as the most significant impediment, with 63% of respondents reporting a negative impact on their activity. Reflecting this cautious outlook, the Construction Products Association has revised down its UK construction growth forecast for 2025 to 1.9%, citing weak consumer and business confidence, high inflation, and subdued economic prospects as key drivers of the downgrade. Elsewhere, planning and regulation remains another frequently cited barrier to business operations according to 60% of participants in the recent RICS survey. Planning reforms proposed under changes to the Planning and Infrastructure Bill may see this figure fall in the coming quarters as the government sets out to boost housebuilding in order to achieve their target of 1.5 million new homes within this parliament. However, any impact is likely to be gradual, with labour shortages posing a major obstacle to achieving this goal as reflected by anecdotal comments left by respondents to the RICS Construction Monitor.

Chart 10: RICS construction workload indicators remain subdued across all sectors away from infrastructure



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

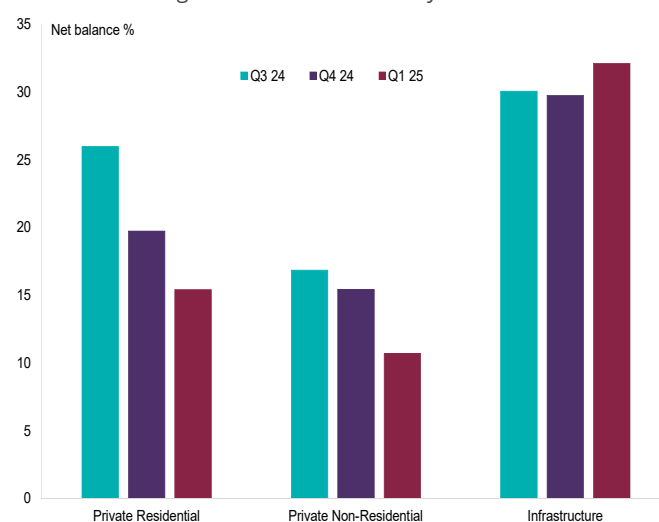
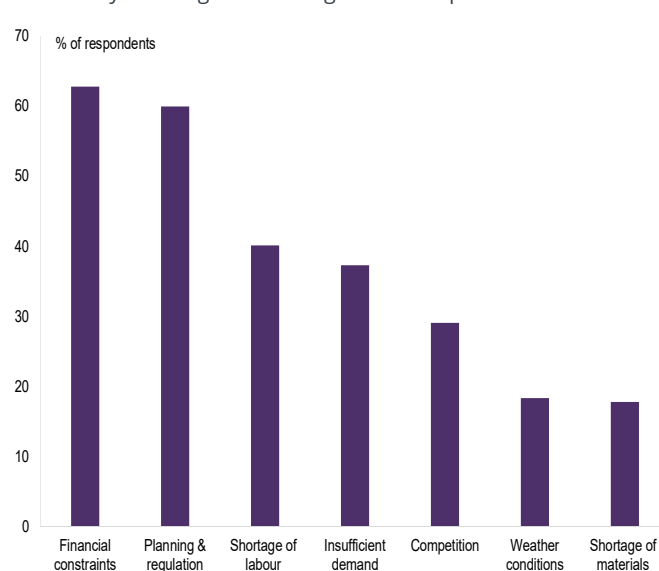


Chart 12: Financial constraints and planning and regulation remain key challenges according to RICS respondents



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