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How UK residential rents behave in a downturn

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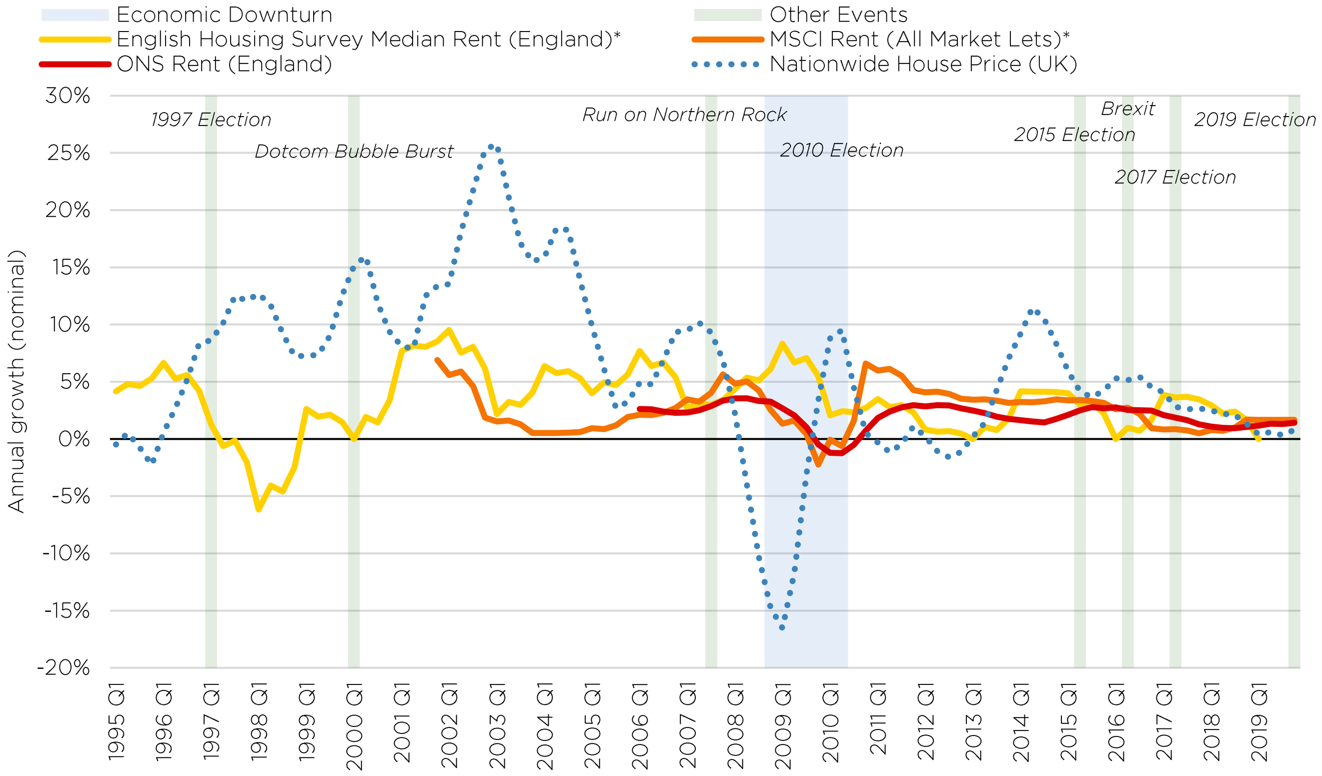
Rents in the last downturn

The coronavirus pandemic will have a substantial negative impact on the UK economy. Consensus among economic forecasters is that the UK will experience a severe economic contraction in Q2 2020, with recovery following once restrictions are lifted. In this note we look back to see how residential rents and tenant demand have changed in previous periods of uncertainty.

The three sources of rental data we have looked at show that over the last 25 years, residential rents have been much less volatile than house prices. Following the Global Financial Crisis, rents exceeded their pre-downturn peak within two years according to both ONS and MSCI. Nominal rental growth has averaged between 2-3% per annum over the past 15 years, in line with income growth.

Comparing the MSCI residential rents index to other sectors suggests that residential was the most resilient property asset class during the Global Financial Crisis. Residential rents fell by -2.2% to their trough at the end of 2009, compared with -13.5% for offices, -5.4% for retail and -4.6% for industrial.

Figure 1 Nominal rental and house price growth



*Interpolated annual data

Source English Housing Survey, Nationwide, ONS, MSCI

This stability was underpinned by more consistent levels of demand than found in the sales market. There was a significant fall in the number of new buyer enquiries following the run on Northern Rock in the lead up to the last recession. This coincided with the period of house price falls reported by the Nationwide House Price Index.

In contrast to buyer demand, residential tenant demand never fell. During late 2009 and early 2010 there was a period where demand grew more slowly compared with the preceding few quarters, but the RICS survey reported a consistent net balance of +20 respondents seeing rising tenant demand.

Overall the data shows that residential tenant demand is considerably more consistent and robust compared with the more volatile level of demand in the sales market.

Table 2 Net balance of increase/decrease in tenant demand and new buyer enquiries from the RICS survey

	Tenant demand	New buyer enquiries
Northern Rock to end of the GFC	+32	-5
10-year average	+22	+2
15-year average	+24	+1
20-year average	+24	0

Source RICS

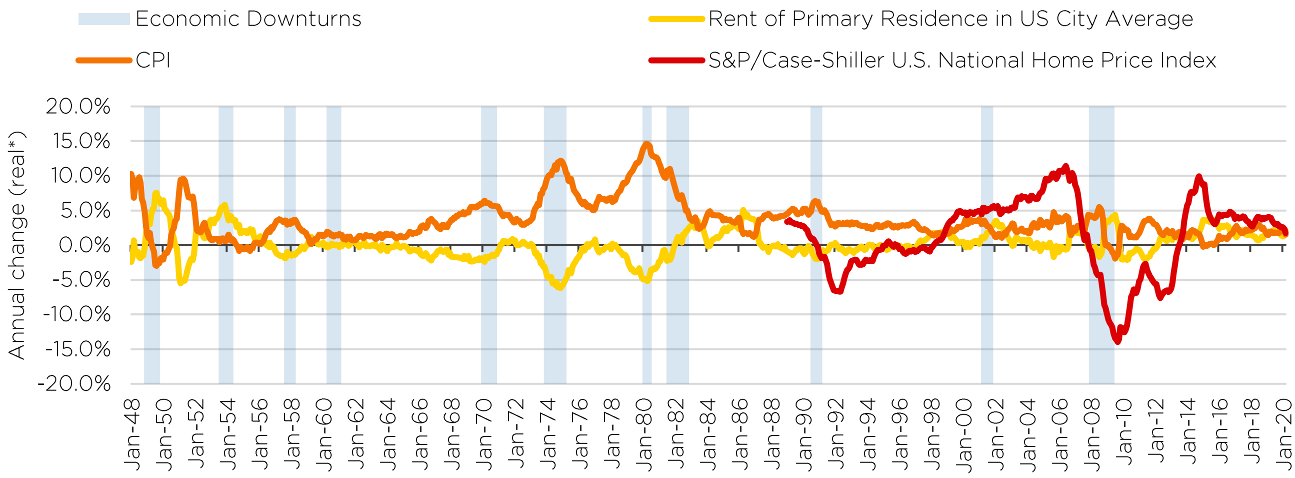
What can we learn from other markets?

Consistent rental value data is only available for the UK for the last 20 years. However, data is available for a longer time period for the US rental market, and can give a wider indication of what has happened to rents in other economic downturns. Over the past 50 years, the *Rent of Primary Residence in US City Average* index has seen real compound annual growth of 0.2%pa.

In the 2007/09 downturn, rents peaked in August 2007 and fell by -1.9% in real terms to their trough in July 2008. However, growth rapidly returned and by the end of the downturn, rents were 2.3% higher than their pre-recession peak. In the 2001 downturn, rents were not negatively affected, and rose by 2.3%, while in the 1990s recession, rents fell by -1.4% between May 1990 and January 1991.

In the 1970s and 1980s, deeper real falls were seen in the US, but this was driven by periods of very high inflation. Even with inflation running at 12-14% per annum, rents only fell by -6%.

Figure 2 Real rental growth in US cities during economic downturns



Source Federal Bank of St Louis, S&P Dow Jones Indices (*constant 2019 prices)

The outlook for rental growth

In the long term, the outlook for rental growth will be linked to what households can afford. While we may see short-term fluctuations in rental values as local levels of supply and demand shift, growth over the next five years will be linked to the state of the economy and the strength of income growth. Therefore, we anticipate that any falls in rents will be smaller than those in capital values and are likely to return to growth at an earlier stage.

When we published our forecasts in November 2019, our rental growth estimates were predicated on income growth of c.3.0% per annum over the next five years. We expected this to feed through to overall rental growth of 15.4% for mainstream UK rents between 2020 and 2024.

A weaker economy will have a detrimental impact on income growth, highlighted by the recent spike in unemployment, which increased by 69% between March and April to 2.1 million. Despite this, Oxford Economics' current baseline forecast, published on 28th April 2020, expects incomes to fall by only 1.6% this year. On a more positive note, this fall in income growth is forecast to be followed by a rebound of 5.4% and then annual average growth of c.3.0% until 2024. This results in total income growth over the next 5 years being only 2% lower than the forecasts we published in November 2019.

The gloomier outlook for incomes will have an impact on how rents are likely to perform compared with our previous forecasts. The capacity for rental growth as we come out of the lockdown, especially in mainstream markets, will be hampered by slower income growth. Taking into account the revised income growth forecasts suggests that we are likely to see rents rise by 13.6% by the end of 2024.

Table 2 Oxford Economics income growth forecasts

	2020	2021	2022	2023	2024	5 yr
8th August 2019	2.6%	3.0%	3.0%	3.0%	3.0%	*15.6%*
28th April 2020	-1.6%	5.4%	3.1%	2.8%	3.1%	*13.4%*

Source Oxford Economics

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