EU Referendum: The UK votes to Leave

Research – Market implications

The UK has voted by 52% to 48% to leave the European Union.

Although a significant proportion of the laws and regulations that apply in the UK come from the EU, some of the key drivers of property markets rest with UK policy makers. The most important of these is the UK economy, although it is of course affected by conditions around the rest of the world.

Almost all economic forecasts of a Brexit predicted that the effects on the UK economy would be negative. They forecast higher costs of trade for businesses, which would reduce trade, leading to lower economic growth, and ultimately impacting on wage levels and standards of living.

The immediate short-term effect has been sharp downward movements in financial markets, pressure on the pound and negative sentiment towards property market shares (although not close to the levels seen following the GFC). That said, Mark Carney has given a considered statement outlining the Bank of England's ability to support financial stability; which appears to have calmed markets a little. Notably he has pointed out that the capital requirements of our largest banks are now 10 times higher than before the financial crisis, with the banks stress-tested against economic scenarios considerably worse than the current one. Moreover, as a backstop to support the functioning of the markets, the Bank of England stands ready to provide more than £250bn of additional funds through its normal market operations – he has signalled a potential drop in rates and further QE. The Bank of England is also able to provide substantial liquidity in foreign currency if required.

Considerable concern is being raised regarding both UK Government debt and the UK's large current account deficit. Whilst it is legitimate to worry, we should remember that the global economy remains in a low-growth environment, with the global supply of capital looking for a home still substantial. The UK is also not unique in terms of a volatile political environment. Indeed we should not forget that the country has fundamental strengths not common to most nations, notably strong legal institutions, the English language, the time zone, and good business and financial regulation. The global flight to safety has seen yields on US Treasuries, German Bunds and UK Gilts all fall.

We will have to wait and see what the medium- to long-term effects are, and a current unknown is the potential for contagion. Broadly, however, they are very much dependent on:

(i.) The trade agreements the UK agrees with the rest of Europe and the rest of the world; and
(ii.) UK domestic policy, with the hope of the Leave campaign that the economy will flourish without the shackles of European regulation, law making and the UK subsidising poorer-performing countries.

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The Bank of England has sought to calm markets with assurances around the health of the financial sector and the Central Bank's willingness to act as a backstop.

Global flight to safety has seen UK Gilt yields fall.

The broad impact on UK property sectors

It has been repeatedly said during the referendum campaign that there will be uncertainty in at least the short-term and greater volatility in financial and property markets if the UK votes to leave. Although a truism, it is a truism for a reason. Most property markets tend to have lower levels of transactions before a major vote, whether an election or a referendum, and that has been the case this time.

The key to how property markets will be affected after the short-term is whether the general public, property owners and investors have a clear and certain vision of what UK policy is.

- For construction, businesses will be seeking to understand how to maintain and indeed strengthen their workforces, being highly reliant on European and international skills and workers.

- For investors, the immediate question will be around current pricing and future rental / capital growth. A depressing of economic indicators will impact sentiment. However, it will take a while to reach a new market equilibrium, given that the market is not characterised by debt (as in 2008), and there will be few sellers wishing to crystallise losses.

- For the residential sector, this means what will happen to interest rates, bank lending and the government's policies to stimulate housing supply and demand.

- For the commercial property sector, this means businesses and consumers having the confidence to invest and spend, which depends on them being convinced that the medium-term economic outlook is positive that the economy will continue to grow, and that their jobs are secure.

- For the rural sector, the key industry is farming, and this means having a clear vision of whether there will be a replacement for the Common Agricultural Policy and what levels of payments it will provide; secondary to this is the level of regulations it will impose, with many farmers' hope being that they will be significantly lower.

"Activity levels had slowed substantially in the run up to the EU Referendum. We now wait to see if the decision of UK voters will result in investors seeking to return to the market, either for safety and / or for opportunity"

Stephanie McMahon

Head of Research,
Strutt & Parker

Agriculture

Some of the most significant impacts of the decision will be felt on farms, due to the high dependence of farmers' incomes on direct payments through the Common Agricultural Policy (CAP). The decision will delight significant numbers of farmers, as polls had consistently shown strong farmer support for the leave campaign. In brief:

- In the short-term, if the value of sterling falls, the UK's exports will be become more attractive to buyers which will support demand for them, which is positive.
- The decision will end British farmers' inclusion in the Common Agricultural Policy (CAP) and raises a large number of questions about the future direction of agricultural policy and the impact on farm profitability.
- We expect that a British agricultural policy will replace the CAP, with very different policies in England, Scotland, Wales and Northern Ireland. Farmers across the UK would welcome a clear, concise, jargon-free farming, food and environmental policy that makes their role clear. The policy should also include measures to help farmers manage risk and price volatility better, which is one of the most damaging things affecting UK farmers' businesses at present.
- Important elements of the replacement policy are the level of payments that are made to farmers, what farmers have to do to receive the payments, and the payments system.
- The level of support that UK farmers will receive and the terms of any trade deals struck with the EU and the rest of the world are the two most important factors affecting farm profitability. Profitability will be maintained, or could even improve, if the level of support is continued at current levels, something the Leave campaign suggested during the referendum campaign and, if a trade deal does not liberalise trade significantly, which would expose UK farmers to competition with imports from low cost producers around the world.
- There is also an opportunity to review the way the farming sector is regulated, with many farmers feeling that the sector has been over-regulated and burdened with red tape.
- Furthermore, it creates a significant opportunity to reform the way farmers are paid. The payment systems, in England and Scotland in particular, are complicated, bureaucratic and have led to delays in payments to farmers in recent years. This is a significant opportunity to change the payments system so that it is simple, quick and accurate, and deal with other gold-plating of laws and regulations.
- We would expect the new agricultural policies of the four countries' policies to continue diverging. For example, we expect the English agricultural policy to be much more supportive of the growing of genetically-modified crops than policies in Wales and Scotland.
- There is also the issue of how to deal with global issues such as climate change and environmental protection, areas previously regulated by the European Union.
- Until we have more clarity on payments, we recommend that any new farm tenancies or Contract Farming Agreements should include a clause reserving the right to review the terms in view of any change in levels of support.

Farmland market and prices:

- The impact on the farmland market depends largely on how quickly the UK government reveals its intentions for a replacement agricultural policy and trade agreements, as the market depends on certainty, and buyers will be more reluctant to invest.
- Until there is greater certainty, the decision is likely to have a negative effect on the UK land market at a time when prices are already under pressure because of falls in farming profitability.
- Farmers remain the largest buyer of farmland in the UK, so any changes in income as a result of changes to the payment system will have an impact.

Industrial

As we have previously stated, even if we experience a slowdown in consumer retail spend, the structural shift towards online purchasing is likely to ensure that e-commerce logistics and distribution continue to experience growth. As such, we anticipate that the demand for this type of space will be relatively unimpaired, although the depth of that demand may thin.

Manufacturing growth has been soft recently, and uncertainty around trade agreements would influence new plant investment in the short-term. For those who do not trade internationally, it will be local markets and economic activity which will have most effect. For those who do trade internationally, most importantly with the EU, the trade settlement will be key and restricted access to the single market will certainly impact.

In May 2016, the Sheffield Political Economy Research Institute, an inter-disciplinary department within Sheffield University, published research outlining where most regional impact for the trade of goods would be felt. Although some regions have higher exports in absolute terms, others have greater levels of EU dependency. The report concluded that "The Southern English regions and the North West export most goods in absolute terms to the EU but, paradoxically, those regions that tend to export fewer goods, such as the North East, South West and Northern Ireland, are more reliant on the EU insofar as EU countries are the destination of a greater proportion of their goods exports". We would anticipate that these regions will be those which experience most volatility as trade agreements are negotiated. They will also be required to shift their focus to global markets resulting in further uncertainty. In the short to medium-term, UK manufacturing is likely to slow its investment in capital goods and services, including property[1].

Office

The UK has benefitted over the last few decades from its position as the springboard into the EU for many global companies – according to the government, in 2012 the UK benefitted from 43% of inward investing HQs into key European centres. This has included R&D, pharmaceuticals, banking and legal services.

For inward investors the likelihood is that they will hold off decision making until more is known about the process and timetable of exit from the EU. For those already located within the UK, the fundamentals of business are unchanged; it remains a safe world financial centre, it uses one of the world's business languages, it has a good time zone for businesses, and it is an attractive cultural centre.

In the longer-term, greater change is likely. Several high profile corporates have stated an intention to leave the UK in the event of an exit, although any such moves are likely to be slow given the need to exercise break clauses. Most impact will be felt in sectors where trading outside of the Union becomes disadvantageous, for example retail banking and euro trading. London is the financial centre, but the UK's other centres of financial services activity such as Edinburgh, Glasgow and Leeds will also suffer. Job losses in the two Scottish centres will of course intensify demand for another independence referendum, given the country's pro-EU stance. Occupiers, such as law and professional services who have historically supported EU trading HQs, would follow their clients. Core investment banking and associated services are likely to be less affected.

A further concern will be the ability to attract and retain the best of the global talent.

[1] http://ukandeu.ac.uk/wp-content/uploads/2016/05/UK-regions-the-EU-and-manufacturing-exports-research-paper.pdf

Retail

Although the short-term may show relatively few immediate changes to high street trading, retailers are going to be aware of impacts coming from several directions. Firstly, as time moves on, consumption is likely to be curtailed as UK shoppers seek to understand what this will mean for them. Much of the run up to the vote has focused on the potentially dire economic forecasts, and it is likely that spend will be down through lack of confidence and nervousness over the future. Should that nervousness extend to the residential market, the additional goods bought through house moving will also see a decline.

Secondly, the effect of currency fluctuations on their import costs and the export value of their goods – they will no doubt seek to withhold these costs from the consumer for as long as possible, however, they will at some point inflate pricing and impact demand. Finally, if immigration levels slow, retailers will potentially experience a challenge around both recruitment – the UK is at 5.1% unemployment and the depth of replacement labour market is not there – and consumption.

Residential

The residential market effectively splits into three: the prime central London (PCL) mainstream market, the London new build market and the UK domestic market.

There are two outcomes for PCL; one is the flight to quality driving demand for safe haven assets. The other is uncertainty resulting in a continuation of lower transaction volumes. Both outcomes have their merits. We anticipate in the short-term that dampened market demand and a lack of market supply will result in PCL property prices remaining stagnant over the remaining quarters of 2016. However, London in general, and PCL more specifically, remain a ‘safe-haven’ for foreign investors and, so long as the outlook for the UK economy remains positive, we anticipate price growth will return to a strong level in the medium/long-term.

The London new build market will experience interest with international investors seeking to take advantage of the weakness of the pound. The property fundamentals of location, quality and length of ownership will prevail.

The UK domestic market will be impacted by purchaser sentiment and the UK economic outlook. The likelihood of price increases in construction may well reduce supply levels and have the unintended consequence of putting further upwards pressure on prices even whilst demand levels soften.

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