RESIDENTIAL MARKET UPDATE

Knight Frank

JANUARY 2010

WHERE NEXT FOR THE MARKET IN 2010?

"The housing market ended 2009 in much better heart than it started the year. Prices have risen, sales volumes have at last begun to hit respectable levels and access to mortgage finance has widened to more than just the affluent and equity rich. However, the economy and the state of the public finances still hold risks for the market, while the upcoming election has the potential to be a significant turning point."

Liam Bailey, Head of Residential Research, Knight Frank

"One of the main features in the housing market last year, was a notable imbalance between strong demand on the one hand and weak supply of property on the other, this imbalance helped push prices higher last year."

Current market conditions

Average house prices rose almost 6% during 2009. On a seasonally adjusted basis the majority of this growth took place between May and August, with the rate of price growth slowing considerably in November and December.

Market growth has been reflected in sales volumes as well as prices. While total sales in 2009 fell 13% compared with 2008, there has been a steady recovery from the low point reached in January last year. This improvement in sales volumes was evidenced by a 58% year-on-year increase in November.

The mortgage market saw a similar recovery through 2009, with the number of approvals for house purchases in sterling rising to a 19-month high in October. Improved conditions in the wholesale money markets have resulted in a widening range of available mortgage products, in particular a slow recovery in higher loan-to-value and high-income-multiple loans.

Despite the wide spread between LIBOR rates and the Base Rate, the decision by the Bank of England to maintain the Base Rate at 0.5% in January will help to maintain low mortgage rates. In November the average standard variable rate mortgage stood at 3.98%, admittedly up from the low of 3.82% research in April, but still substantially below the average of 6.34% last November.

The cost of fixed-rate mortgages hit a low point last May, with typical three and five-year rates reaching 4.3% and 4.8% respectively. More recently, future inflation concerns have contributed to upwards pressure on rates, with the three and five-year rates settling at 4.8% and 5.7% respectively in recent months. The average two-year rate has actually moved in the opposite direction, hitting 4.1% in November, down from 4.5% in August.

One of the main features in the housing market last year, was a notable imbalance between strong demand on the one hand and weak supply of property on the other, this imbalance helped push prices higher last year. Latest data from RICS suggests that this market imbalance is beginning to ease. On a seasonally adjusted basis, new buyer enquiries are running at half the level they hit during the summer, whereas new instruction volumes are at their highest level since the middle of 2007. Thanks to relatively high sales volumes in November and December, stocks of available properties remain around 20% lower than a year ago.

Market outlook

It is impossible to provide an outlook for the housing market that does not recognise the fact that 2010 is an election year. Economic policy in the UK, in particular decisions on how to

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repair the state of the public finances, is effectively on hold until the election is out of the way.

What does this mean for the housing market? Ignoring the negative impact this policy drift is having on the gilt markets, and potentially on the strength of Sterling, the main impact will be to make the upcoming election a more important factor than usual on market activity and sentiment.

Despite the received wisdom that elections tend to lead to market inertia in the weeks before polling day due to rising consumer uncertainty, a study of historic data reveals that this almost never actually occurs. The difference this time is that, firstly, a hung parliament is a distinct possibility for the first time in decades and, secondly, there is considerable anticipation that the post election budget will contain substantial tax and spending changes. We might assume that some buyers at least will be likely to delay potential purchases as the election approaches.

The main economic influences on the market are likely to be relatively benign. The Bank of England will be under pressure to maintain the UK base rate at 0.5%, at least until the election – despite the likelihood of rising inflationary pressures in the economy. This is only possible of course if the state of the public finances do not lead to a Sterling crisis that forces the Bank’s hand to push rates higher.

Most commentators expect the rate of CPI to substantially exceed 2% in the next few months, as fuel costs rise and following the increase in the rate of VAT from 15% to 17.5% at the turn of the year. The bank has already signalled that it is relaxed about the medium and longer term inflation outlook.

Our housing market forecast, for 3% price falls in the UK in 2010, is predicated on a sluggish economic recovery and further unemployment growth, especially from the public sector. Despite this prognosis we would reject the more negative market forecasts (some suggesting 20% or more price declines in 2010).

Mortgage lending is likely to keep rising as banks continue to rebuild their balance sheets. In addition, with base rates likely to remain low, we expect the price of mortgages to remain relatively low.

On the supply side, new-build completions are still running far below government targets – 115,000 completions in 2009 compared with a target of 240,000. New-build starts are edging higher but it will take some time before the industry is able to deliver units at its pre-crash peak rate (175,000 units in 2007).

Taking the above factors into account, our central forecast is that house price growth will slip in 2010, with prices at the end of the year being between two and four per cent lower than today. Over the longer term, the weak recovery will continue to hold growth back, but we still expect house prices to be around nineteen per cent higher at the end of 2014 than they are today.

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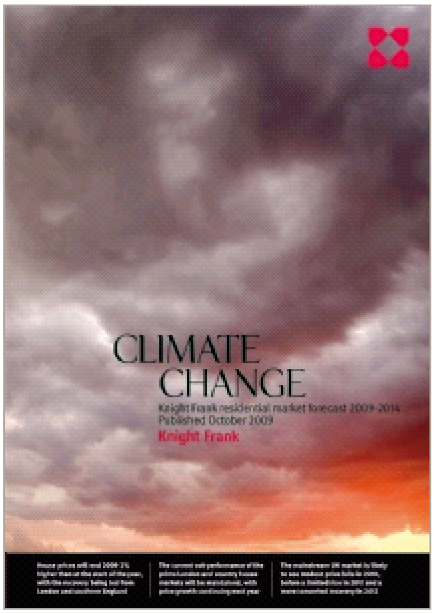

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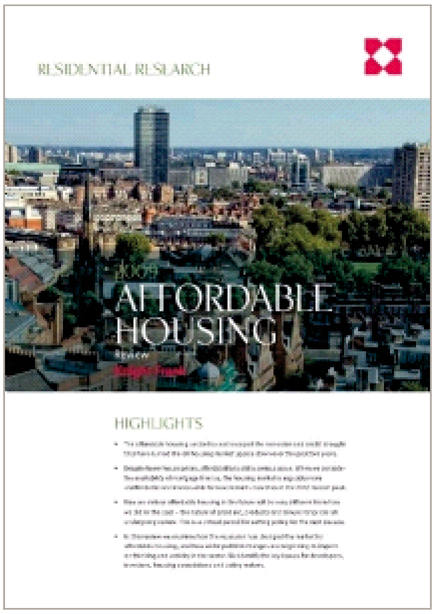

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