RESIDENTIAL MARKET UPDATE.

Knight Frank

JUNE 2011
MARKING TIME.

"Prime London property prices hit a new high in May but the performance of the wider UK housing market was less buoyant, especially in the North, marking a further polarisation in price growth across the country. But there are unlikely to be any sudden or sharp drops in prices while interest rates remain benign and supply is constrained."

Gráinne Gilmore, Head of UK Residential Research, Knight Frank

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UK housing market

House prices climbed by 0.3% in May, more than offsetting April's 0.2% decline. The annual fall in prices also eased to 1.2% from 1.3% in April. But the monthly price data has proved volatile, falling in four of the past 12 months and then rising again.

The smoother, quarterly, price data shows a more positive picture, with a 0.6% rise in the three months to May compared to the previous three-month period. This is the third consecutive monthly rise after seven months of falls or stagnation in prices.

But the uncertainty over the economic outlook is still acting as a dampener on confidence among buyers.

Official data published late last month confirmed that the economy expanded by just 0.5% in the first three months of the year. This was only enough to make up for the 0.5% drop in gross domestic product (GDP) in the final quarter of 2010 and confirmed that there has been little, if any, underlying economic growth in the UK since October last year.

Surveys from the manufacturing, construction and service sectors have also been disappointing, with output from British factories falling in May for the first time since the recession began in 2008. The growth in the dominant services sector, which accounts for more than three quarters of economic output, also slowed by more than expected in May.

The downbeat economic data indicates that interest rates are likely to stay at a record low of 0.5% for some months to come.

The Bank of England seems to be growing increasingly conscious of rising inflation – which hit 4.5% in May, the highest level since September 2008 and far above the Bank's inflation target of 2%. The rise in prices is not only putting the Bank under the microscope, but is also placing households under pressure as their bills rise despite muted wage growth.

Yet there is little room for manoeuvre to raise rates while the economic landscape looks so bleak. When more positive economic data emerges however, borrowers will have to prepare for rates to rise.

Low interest rates may be a boon for homeowners, but they are providing scant relief for home buyers who are still being hampered by the seizure in mortgage lending.

The number of mortgages approved for house purchases fell to 45,166 in April, down from 47,557 in March and marking the lowest number of monthly approvals this year. This may, in part, have been due to the rise in stamp duty for homes worth more than £1 million, which came into effect in early April

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as some buyers may have been tempted to bring their house purchase forward to avoid paying the new 5% tax.

While the number of mortgage deals on the market has risen in recent months, lenders are still demanding hefty deposits. Deals which offer to lend up to 90% or even 95% of the value of a home come with large fees and heavy caveats and in some cases require a guarantor. Some house builders, spurred by the lack of finance, are creating their own mortgage deals in a bid to kick-start the market.

Our forecast for a 6% drop in prices in the mainstream UK market this year followed by a 6% rise next year factors in a rate rise to 0.75% before the end of the year, as well as the effects of the public sector spending cuts. If interest rates remain on hold until 2012 however, the fall in prices may be smaller, followed by a more modest bounce-back next year.

In the longer term, there are worries over the government's localism bill, which will mark the biggest shake-up in the UK's planning regime in more than half a century. While details of the planning changes are trickling out, there is still a lack of clarity which some fear will further hamper house-building, which last year fell to the lowest level since the mid 1950s.

Housing market activity

The latest national housing market survey from RICS showed that new instructions rose sharply in April as the good weather and plentiful bank holidays around May Day and the Royal Wedding prompted homeowners to dip their toes back into the market.

Sales also picked up during the month, and agents are expecting a further improvement in sales in the coming three months.

But the Council of Mortgage Lenders (CML) lowered its forecast for housing transactions this year from 860,000 to 840,000. This would mark a fall from 886,000 transactions last year, and is far below the long-term average of 1.2 million. However the CML is forecasting that transactions will rebound next year to 900,000, taking sales back to 2008 levels.

As mortgage funding remains constrained, the rental sector is becoming more prominent as those who can not get a foot on the property ladder or who are waiting to re-enter the market choose to rent a home instead.

Demand for rental property is continuing to exceed supply in many parts of the country, driving up achievable rents. Data from RICS showed that demand from tenants rose at the fastest pace since early 2009 in May. The proportion of properties let out to individuals in the private rented sector also soared to the highest level in nearly two and a half years.

Rents in the prime London market are at a record high, rising by nearly 17% over the last year.

Prime market performance

The contrast between the prime London market and the mainstream UK market has become even more pronounced as the appetite for prime property in the capital among overseas buyers drove prices to a new high.

The average price of prime London property rose by 1.4% in April, taking the annual increase to 8.4%. Prices are now 1.3% higher than they were at their previous peak in March 2008.

While Asian buyers account for the majority of new-build sales, European and US buyers are taking advantage of the favourable exchange rate to buy existing homes. The weakness of sterling means that they can clinch prime properties at a discount of more than 15% compared to late 2007 despite the jump in prime property prices since then. French, Greek, Italian and Swiss buyers accounted for 16% of sales in the first three months of the year.

This demand shows no sign of abating, signalling that prices in the prime London market will continue to grow. Our forecast is for 3% growth in prices this year.

Demand in London is also trickling out to the country, with counties surrounding the capital seeing renewed interest from buyers.

This reflects the divide between prices in the North and South in the first quarter, with average values of prime country houses in the North of England and Scotland dipping while prices in the South rose by 0.5%.

Our forecast for the prime market outside London is that prices will remain stable this year.

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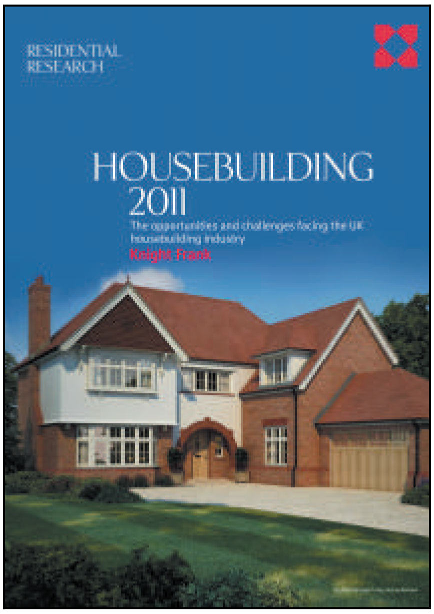

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