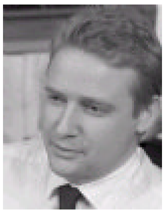
RESIDENTIAL MARKET UPDATE

Knight Frank

SEPTEMBER 2010
AUSTERITY STARTS TO BITE



"The long-expected housing market slowdown is beginning to be felt as the number of sales fall and stock levels rise. Prices have managed to remain relatively resilient over the summer, but the early evidence from the autumn market is that vendors are having to reassess asking prices following strong growth during the first half of 2010."

Liam Bailey, head of residential research, Knight Frank

"The growth in supply has been matched by slowing demand from new applicants, which has dipped by around 12% in the two months from June to the end of August."

Economic update

On a positive note the UK's provisional estimate of GDP growth for the second quarter of 2010 has been revised upwards to 1.2% (quarter on quarter). But the composition of this growth, with a heavy reliance on inventory building, has not dissuaded the markets that the economic recovery is anything other than fragile.

These concerns have fed into the money markets, which have revised down their interest rate forecasts. In mid-August, expectations for the UK overnight interest rate in 12 months' time were about 1%. By early September they had dropped back to 0.75%.

Economic weakness

UK gilt yields also fell sharply during August and there is now a growing sense that the fears around ongoing economic weakness in the UK, if not necessarily a full-blown double-dip recession, have led the markets to believe that the Bank of England base rate will be left on hold for a prolonged period.

The pound remained relatively stable against the euro over the past month, reflecting the market's equally-negative view of the outlook for both economies. There was a slight weakening against the dollar over the same period, which appeared to reflect the attitude of the market to plans for a more rapid tightening of fiscal policy in the UK than in the US.

Fiscal tightening

With the economy growing, but with the main round of fiscal tightening still to come, the outlook for wage and employment growth across the economy remains weak. It is likely that unemployment will rise in the final quarter of 2010 and through at least the first half of 2011, before the private sector is able to absorb the job losses in the public sector.

Housing market update and outlook

August is never the easiest month to assess market conditions because the summer slowdown in activity often hides wider trends. Taking a longer-term view, however, shows that price growth has been slowing since late spring. The Nationwide's UK index reported annual house price growth of around 10% in May this year. Since then the rate has dropped steadily, slipping below 5% in August.

In terms of market activity, the number of estate agents reporting an increase in sales instructions rose from a net balance of 28% in June to 34% in July, according to the latest RICS survey data. This confirms our own experience in London and the prime regional markets, with new sales instructions rising from at least the first quarter of the year.

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This growth in supply has been matched by slowing demand from new applicants, which has dipped by around 12% in the two months from June to the end of August.

With supply increasing and demand beginning to slow, the volume of available stock per estate agency office has risen from 11 months' worth to 12.5 months' worth in July, according to RICS.

Creating opportunities

Rising supply has the beneficial effect of creating opportunities for new entrants to the market because vendors have to become more competitive to secure sales. These new entrants are, however, not likely to find a mortgage sector that will allow them to easily access the housing market. The volume of mortgage approvals for house purchases has remained almost static at around 45,000 per month since the start of 2010.

Although the banks and the government are publicly championing the need to see credit opened up to a wider group of buyers, they are still very conscious of the need to minimise risk. Behind the façade of attractive headline mortgage rates, lending criteria - particularly for first-time buyers - remain tough.

Existing borrowers could also soon be affected. The industry recently examined the potential for not only restricting new 'interest-only' loans, but forcing existing interest-only borrowers to revert to repayment mortgages at the end of their initial term.

Huge shock

This would be a huge shock to many borrowers for whom the credit crisis has so far been a once-in-a-lifetime opportunity to enjoy mortgage rates of close to zero. In fact, the risks to the housing market if this were to happen suggest that full implementation of this policy is unlikely. However, the main point to note is that lenders seem to be increasingly worried about the potential of further house price falls and are therefore looking at ways to cut risk by increasing the rate of loan repayments.

Last October we forecast that house prices in the UK would fall by around 3% in 2010. We have revised that figure marginally to 3.3% in the light of evidence from the first half of the year.

There is no doubt that the market is in a less healthy state than it was this time last year. However, the continuation of low interest rates is insulating it to a significant degree. The real test is likely to be in 2011 when we have the potential for a potent cocktail of public sector job losses coinciding with rising interest rates.

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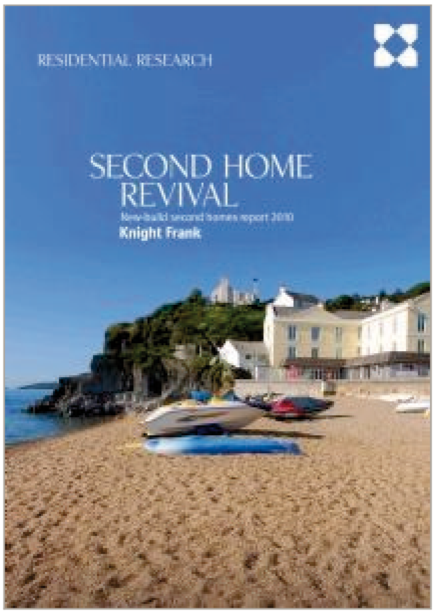

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