RESIDENTIAL RESEARCH

UK RESIDENTIAL MARKET FORECAST

HOUSING FORECAST OVERVIEW

With the tax treatment of housing undergoing further reform, we gauge the net impact on demand and pricing from recent and future changes.

Headlines August 2015

The cumulative impact of recent and future reforms to Stamp Duty, mortgage interest relief for investors, CGT and IHT will take some time to work through the UK housing market

Cumulative growth in UK prices will total a little over 18% in the five years to the end of 2019

While political risk for the prime London market has fallen, affordability constraints will limit price growth in the near term

UK rents and prime central London rents will rise 2.2% and 3.5% respectively in 2015

The risk that UK interest rates rise more rapidly than expected or that the global economy suffers a notable slowdown in activity remain the biggest risks to the UK housing market

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"One of the most notable changes is the Chancellor's move to equalise the tax treatment of companies and individuals."

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The UK economy provides a relatively positive backdrop for the housing market. Most forecasters expect GDP to rise by upwards of 2.5% this year. In line with this outlook, the latest data from the Knight Frank/Markit House Price Sentiment Index confirms that an increasing majority of households are expecting house prices to continue to rise over the next 12 months.

The ability of households to continue to bid house prices higher will be influenced by a range of factors, which we summarise overleaf in our Risk Monitor, not least recent and planned changes to the tax system which directly impact on property.

Last month's "emergency budget" allowed George Osborne to tweak a number of taxes, just as previously announced reforms were coming in to effect.

The creation of an additional nil-rate band for IHT from 2017, benefitting owners with property valued up to £2.35m, should act to add to demand for property. However this uptick in demand should be at least partly offset by the innovation that downsizers will see property equity "ring fenced" for the future.

Changes which could weigh on demand include the restriction of buy-to-let mortgage interest tax relief to basic rate income tax, which is being phased in from 2017. In addition anecdotal evidence suggests that last December's Stamp Duty reforms are impacting on activity and trading above £2m.

One of the most notable changes which could have an impact in central London is the Chancellor's move to equalise the tax treatment of companies and individuals. First we saw the introduction of the additional rate of Stamp Duty (don't buy through a structure), followed by ATED (if you insist you will pay for the privilege), and now IHT reform which undermines for many the final benefit for maintaining structured property ownership.

Despite the pace of tax change, our view remains that it is interest rates and economic performance which will shape the outlook for prices and demand.

Knight Frank Residential Market Forecast August 2015

(Prime Central London updated October 2015)

	2014	2015	2016	2017	2018	2019	2015-2019
Mainstream residential sales markets							
UK	7.2%	3.5%	2.5%	3.0%	4.0%	4.0%	18.2%
London	17.8%	3.5%	4.0%	5.0%	5.5%	5.5%	25.8%
South East	10.6%	5.0%	3.0%	3.5%	5.0%	5.0%	23.4%
South West	8.0%	4.0%	2.5%	3.0%	4.5%	4.0%	19.3%
East Anglia	9.8%	4.5%	3.0%	3.5%	4.5%	5.0%	22.2%
East Midlands	6.0%	3.5%	2.0%	2.5%	4.0%	4.0%	17.0%
West Midlands	6.8%	3.5%	2.0%	2.5%	4.0%	4.0%	17.0%
North East	4.4%	3.0%	2.0%	2.0%	3.0%	3.5%	14.2%
North West	3.8%	3.0%	1.5%	2.0%	3.5%	3.5%	14.2%
Yorkshire & Humber	1.5%	3.0%	2.0%	2.0%	3.5%	3.5%	14.8%
Wales	1.4%	3.0%	2.0%	2.5%	4.0%	4.0%	16.5%
Scotland	4.2%	3.5%	2.5%	3.0%	4.0%	4.0%	18.2%
Prime residential sales markets							
Prime Central London	6.7%	1.0%	2.0%	5.0%	5.0%	6.0%	19.3%
Prime Outer London	10.5%	3.0%	5.5%	5.0%	5.0%	5.0%	25.8%
Residential rental markets							
UK Mainstream	2.0%	2.2%	2.3%	2.3%	2.4%	2.4%	12.1%
Prime Central London	4.0%	3.5%	3.3%	3.3%	3.0%	3.0%	17.1%
Prime Outer London	0.5%	4.0%	3.3%	3.0%	2.8%	2.8%	16.8%

Source: Knight Frank Residential Research

RISK MONITOR

10 9 8 7 6 5 4 3 2 1

HIGHEST RISK — LOWEST RISK

Knight Frank's residential market Risk Monitor provides our latest assessment of key risks to the UK's residential markets. Our risk score, out of a maximum 10, is based on two assessment, firstly our view of the likelihood of the described scenario occurring, and secondly the potential market impact. Both these elements are scored from one (low) to five (high), collectively contributing to our combined Risk Score. Our measure of risk is deliberately narrow – namely the risk that house prices could under perform our central forecast scenario.

RISK	SCENARIO	IMPACT	UK			PRIME LONDON		
			LIKELIHOOD	IMPACT	RISK SCORE	LIKELIHOOD	IMPACT	RISK SCORE
INTEREST RATES	The Bank of England raises base rates more rapidly than expected	Our expectation is that the UK base rate will rise to 0.75% in the first half of 2016. A more rapid rise would translate into higher mortgage rates, putting pressure on current borrowers, and reducing the ability of new buyers to purchase at current prices. Rising rates are likely to make alternative investments more attractive, and could prompt investors to look less favourably on relatively low yielding property investments.	1	5	6	1	4	5
GLOBAL ECONOMY	The UK economy is hit by weaker global activity	While the UK economy continues to outperform most developed markets, a key risk to future growth is renewed weakness in the global economy. Deflation and political turmoil in the Eurozone remain potent issues and risks a downturn there. Emerging markets, including China, have seen an economic reversal more recently, which could be reinforced by the withdrawal monetary stimulus.	3	3	6	3	2	5
EU REFERENDUM	The prospective referendum causes economic uncertainty	The possibility of the UK leaving the EU could cause a level of uncertainty in the market from the day a referendum is announced. This will likely gather pace in the run-up to polling day, weighing on activity on all parts of the market. We will monitor the polls to assess the risks associated with the final result as the date of the referendum approaches.	3	2	5	3	2	5
MACRO PRUDENTIAL POLICY TOOLS	The Bank of England imposes restrictive mortgage policies	The Bank of England is increasing the use of macro-prudential measures to help manage risk in the UK housing market. These efforts have mainly been expressed as regulations limiting higher-risk lending. The Financial Policy Committee is seeking additional powers to intervene in the market to control loan to value ratios and debt to income ratios. These measures could weigh on mortgage availability as lenders become more cautious.	1	4	5	1	3	4
GEO-POLITICAL CRISIS	Worsening crisis in Crimea or Syria feeding a wider economic fall-out	EU restrictions on Russian investments have focussed on a small group of individuals, and without a noticeable increase in the scale of the crisis it is difficult to see how this will expand to more significant restrictions. The prime London market would face some risk from this scenario. The growing Middle East crisis, centred on Syria, could easily damage global economic conditions by disrupting world trade, harming the London residential market.	3	2	5	3	2	5
DOMESTIC ECONOMY	Economic weakness leads to sharply lower economic growth	The Bank of England has increased its forecast for GDP growth this year from 2.5% to 2.8% , with a forecast of 2.6% and 2.5% in 2016 and 2017. The outlook for the economy is broadly upbeat, with initial signs that productivity is rising, a crucial factor for a sustainable economic recovery. However the plans to address the UK's large deficit – spending cuts – are likely to weigh on growth.	2	3	5	2	3	5
NEW BUILD SUPPLY	Housing supply exceeds demand	Outside London and some regional hot-spots this is a non-issue in our view. In most areas the real issue is undersupply, a factor which has helped underpin price growth. This problem is likely to be exacerbated in the short-term as uncertainty is introduced on schemes currently in planning by the Government's new rules on 1% rent cuts for social housing. At a macro level it is almost impossible to imagine new-build delivery ever outpacing demand for housing in London, however in some hubs around the edge of central London this issue is worth watching.	1	3	4	2	3	5
POLITICAL RISK	New property taxes and restrictions on non-resident buyers	While the Mansion Tax has disappeared as an immediate threat to the £2m+ market, those claiming that political risk has ceased to be an issue for the prime markets would do well to remember that the Conservatives, both since the recent election and as part of the coalition have been one of the most active parties on property taxes.	2	1	3	2	3	5
CURRENCY RISK	The pound strengthens against the US dollar	After falling from a 2007 high of \$2.10 to a 2009 low of \$1.36, the pound/US dollar rate has remained relatively constant between \$1.50 and \$1.70. Our forecast is based on the assumption that the rate will remain below \$1.75 to the end of our forecast period. The impact of the recent weakening of emerging market currencies could pose an additional risk to the London market.	2	1	3	2	3	5

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