RESIDENTIAL RESEARCH

UK RESIDENTIAL MARKET FORECAST

FORECAST OVERVIEW

As we move into the second month following the UK's EU referendum, economic indicators are beginning to provide some insight on the future direction of the economy.

Headlines August 2016

The outlook for the economy appears bumpy, but with lower risk of a economic crisis

The post-referendum housing market has slowed in terms of sales, and price growth has weakened

Property taxes have had as big an impact on the prime markets as the referendum

We will be reviewing our forecast in full in the autumn

Recent PMI data reflected the reality that the UK is going to experience a bumpy ride over the next few quarters. That said the outlook seems less tumultuous than was initially expected. While a recession for the UK seems a real possibility, what appears less likely is an economic crisis, as was being suggested in the days following the referendum.

But just because the worst of the original Brexit predictions for the economy haven't transpired it doesn't mean the property market is guaranteed a smooth ride.

House purchases are a big commitment, and even if the wider economy holds up the property market can still underperform. The extent of this underperformance depends on where you are. In essence the lower the price point, the stronger current market conditions. This trend points to the fact that the prime market slowdown is part of a wider story than just Brexit. Higher stamp duty for the £1m+ sector has led to an easing in sales at this level since late 2014.

This slowdown has been reinforced by the introduction of the additional rate of Stamp Duty in April this year, and Brexit has compounded the situation. As we discuss below, while prime market sales are down a fifth year-on-year they haven't collapsed. During July, £1m+ sales across the UK were equal to levels seen in 2011 and 2012.

It doesn't seem likely that we will see a notable improvement in the short-term, August is expected to be quiet, following seasonal patterns, but September will be a pivotal month and will give an indication of the autumn selling season. For this reason we have decided to wait until the autumn before reviewing our forecast, which was last updated in March.

Knight Frank Residential Market Forecast

	2015 (actual)	2016	2017	2018	2019	2020	2016-2020
Mainstream residential sales markets							
UK	4.2%	3.9%	4.1%	3.5%	3.1%	4.0%	20.0%
London	12.1%	5.0%	4.5%	3.0%	3.0%	2.5%	19.3%
North East	2.3%	2.5%	2.5%	2.5%	2.0%	3.0%	13.1%
North West	0.6%	2.0%	2.0%	2.5%	2.5%	3.0%	12.6%
Yorks & Humber	0.4%	2.0%	3.0%	3.0%	2.5%	3.0%	14.2%
East Midlands	3.6%	4.0%	3.5%	3.0%	2.5%	4.0%	18.2%
West Midlands	1.5%	3.5%	3.5%	3.0%	2.5%	4.0%	17.6%
East	2.3%	4.5%	4.0%	4.0%	3.5%	4.5%	22.3%
South East	6.7%	4.0%	4.0%	4.0%	3.0%	4.5%	21.2%
South West	3.8%	4.0%	4.0%	3.5%	3.0%	4.0%	19.9%
Wales	0.7%	3.5%	3.0%	2.5%	2.5%	3.0%	15.4%
Scotland	-2.0%	1.5%	2.5%	2.5%	2.5%	3.0%	12.6%
Prime residential sales markets							
Prime Central London East*	4.5%	5.0%	5.0%	4.5%	4.5%	5.0%	26.4%
Prime Central London West**	-0.6%	-2.0%	0.0%	3.0%	4.0%	5.0%	10.2%
Prime Outer London	3.1%	4.0%	4.0%	4.0%	5.0%	5.0%	24.0%
Residential rental markets							
UK	2.5%	2.2%	2.3%	2.3%	2.5%	2.6%	12.5%
Prime Central London East*	1.5%	2.5%	3.0%	3.5%	3.0%	3.0%	15.9%
Prime Central London West**	0.2%	1.0%	2.0%	3.0%	3.0%	3.0%	12.6%
Prime Outer London	0.6%	2.0%	2.5%	3.0%	3.5%	3.5%	15.4%

Source: Knight Frank Research
*City & Fringe, Islington, Southbank, King's Cross and Riverside
**Notting Hill, Kensington, South Kensington, Chelsea, Knightsbridge, Belgravia, Hyde Park, Marylebone, Mayfair, St John's Wood

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Mainstream UK residential market

Buyer demand eased in July, according to RICS, but this was matched by a downturn in new instructions from vendors. This signals a slowdown in transactions during the month, but also indicates that the status quo of imbalance between demand and supply in the market is being maintained, serving to underpin prices.

Mortgage rates remain near record-lows, and, as illustrated by the recent rate cut, the narrative from the Bank of England is largely concerned with monetary loosening rather than tightening. Unlike the aftermath of the financial crisis, mortgage lenders remain keen to lend, mitigating worries about rising rates in the short-term. Those with access to equity will find their mortgage servicing costs remain low for now. However, in the medium-term any second-round effects from Brexit, such as rising inflation due to the weak pound, could mean a reversal in the movement of rates – which would have the potential to affect mortgage borrowers, especially the most highly leveraged.

Initial data shows that residential prices held up in the first month post-Brexit, with price growth remaining just above 5%, according to Nationwide, similar to the level seen at the end of June. The market remains regionalised, and price performance is also likely to become increasingly aligned to capital values, given the new stamp duty regime introduced by the former Chancellor.

Prime London residential market

As with the wider UK economy, the decision to leave the European Union has provided a backdrop of short-term uncertainty that is affecting behaviour in the prime central London property market. Early indications suggest the Brexit vote is reinforcing existing pricing trends and viewing the referendum in the context of the preceding two-year period is helpful.

In June 2014, annual growth in prime central London was 8.1%, the last peak before a period that saw growth fall steadily to -1.5% in July 2016. Despite widespread media coverage devoted to the referendum and its potential impact on house prices, the primary factor curbing demand in prime central London remains stamp duty.

Over the past 18 months vendors had already begun to adapt to the new pricing environment and in many cases Brexit has been a trigger to make overdue reductions to asking prices.

It is too early to say whether these reductions are likely to result in higher transaction levels. There is no uniform picture across London and the situation is compounded by thin trading during the seasonal summer lull.

Across prime central London, while the number of new prospective buyers was down slightly in the first two quarters of 2016, compared to the same period in 2015, strong viewing figures give some confidence regarding future sales volumes, which are currently down by around 15% year-on-year.

Prime Country residential market

The impact of the referendum on the prime country property market should not be viewed in isolation. Other policy decisions, especially tax, as we discuss above, have also affected the market. Partially as a result average prices remain 13.7% below their previous market peak according to our Prime Country House Index.

As such, it is important not to overstate the impact of the vote. In the wake of the referendum, transactions in the prime country market have largely continued while the number of viewings conducted is only slightly behind the same period last year. Unsurprisingly there has been evidence of renegotiation around pricing in some instances.

The fundamentals of the market show little sign of changing with low mortgage rates and an imbalance between supply and demand, especially in prime town and city locations, helping to underpin pricing.

The primary drivers of the prime country market are also largely unaffected – with schools, lifestyle and financial reasons remaining a draw – and these will continue to drive sales.

Prime Scottish market

The EU vote was the fourth major political event within the last two years in Scotland, following the Independence Referendum in 2014, the UK General Election in 2015 and the Scottish Parliamentary Elections in 2016. The introduction of the Land and Buildings Transaction Tax added another layer of uncertainty to the prime market last year.

There is likely to be continued uncertainty in the short-term as the country waits for a firmer plan on how the UK, and Scotland, will proceed both politically and economically, now that the UK has voted to leave the EU.

UK rental market

Rental growth within Greater London has been slowing since the summer 2015. During August 2015 mainstream market annual rental growth peaked at 4.3%, before slowing to 3% in June this year. This moderation can be partially explained by the Help-to-Buy initiative which reduced some demand for rental product as first time buyers moved into the owner-occupier sector.

Official data on the market highlights notable regional variations in terms of rental performance. The South East has not experienced a recent slowing in rental growth, and is currently experiencing a higher increase in rents than London with annual growth in June at 3.4%. This points to the ongoing resilience of demand within this region.

While other regions in England experienced minimal changes, Scotland and Wales have seen a steep reduction in the rate of annual rental growth. However, rental growth remains positive in each region except Wales.

Early anecdotal evidence following the referendum confirms that interest from investors for PRS development remains in place, particularly in London. Despite this, actual evidence of development activity is focussed on schemes which were active prior to the vote. The “wait and see” attitude noticeable across the wider property market is a clear trend within the PRS sector.

Prime London rental market

Rental values declined 3.6% in the year to July in prime central London, due to higher stock levels and a degree of uncertainty surrounding the EU referendum result.

There are parallels between the lettings and sales markets because the Brexit vote has reinforced the existent pricing trends rather than alter market fundamentals.

Demand has been relatively flat since the start of the year due to uncertainty surrounding the state of the global economy, particularly in the financial services sector, which contributed towards a slowdown in rental value growth from its last peak of 4.2% in May 2015.

While the number of new registrations of prospective tenants fell 6.8% year-on-year in the three months to the end of June, the number of new tenancies agreed rose by 3% over the same period, with viewings up by 16%.

Despite the three-month decline in the number of new prospective tenants registering, the expectation is that rental volumes will continue to rise over the summer and into the autumn.

The uncertainty ahead of the Brexit vote could be an explanatory factor for weaker registrations, although early signs are positive with no significant announcements that companies are pulling back from relocating staff to London following the referendum.

Indeed, the number of tenancies started across London via Knight Frank's corporate relocation service increased 72% in the three months to the end of June compared to the same period in 2015.

Furthermore, relocation budgets in many cases have risen due to the effects of a weaker Sterling, which means tenants are looking in higher-value areas and at higher-value properties compared to last year. The number of new prospective tenants registering with a budget of £1,500-plus per week increased 11% in the three months to 24 July compared to 2015.

Farmland

A sustained period of low agricultural commodity prices – feed wheat values have virtually halved since the end of 2012 – had already started to take some of the heat out of the farmland market prior to the EU referendum.

According to the Knight Frank Farmland Index, prices slipped by almost 2% in the final three months of 2015, the first fall in three years. This was followed by a 3% drop in the first three months of 2016, the biggest quarterly decrease since the Lehmans bank collapse in 2008.

Although uncertainty about the outcome of the referendum may have affected the number of transactions taking place during this period, Brexit fears did not have a significant impact on prices – according to polls a majority of farmers were in favour of leaving the EU.

In the second quarter of the year, which included the referendum poll, the rate of price moderation actually slowed with values falling by 1.7%.

It is too early to say what impact Brexit will have on land values over the longer term. Much depends on how the UK government will replace the financial support that farmers currently receive via the EU's Common Agricultural Policy.

Over the shorter term UK agriculture is actually benefitting from the drop in the value of sterling as it makes exports more competitive.

Residential development land

The overriding theme of the housebuilding and development market is the need for new housing in key locations across the country, and Brexit has not changed this dynamic. The country needs around 300,000 new homes a year, according to a recent report from the House of Lords.

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Yet the number of homes being built is still some way from meeting the Government's more modest target of 200,000 homes a year.

It is likely to take some more time for the market to fully reflect the vote to leave the EU. But one immediate impact has been rising hurdle rates among some developers, as a result of increased uncertainty about Brexit. This could weigh on land prices, especially greenfield sites and prime sites in central London. This highlights another emerging trend – the outperformance of price growth for residential development land in outer London and key regional cities compared to prime central London and more rural locations.

Aside from Brexit, the increase in construction costs seen over the last two years is also having an impact across the development market. As the pound remains weak, there is unlikely to be a reversal in this trend. There is still some uncertainty surrounding affordable housing requirements – especially the detail around Starter Homes. These factors may contribute to a slowing in development activity in the short-to-medium term, something which will only further exacerbate the imbalance in the supply of housing where it is most needed across the country.

RISK MONITOR

HIGHEST RISK 10 9 8 7 6 5 4 3 2 1 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 changes direction on rates, raising them more rapidly than expected to target inflation	Our expectation is that the UK base rate will not rise before 2019. Economic fundamentals and uncertainty surrounding Brexit suggest rates are likely to remain historically low for several years. Any reversal of policy by the Bank of England, due to rising inflation for example, could put pressure on mortgage borrowers. Rising rates would make alternative investments look more attractive, and could prompt investors to look less favourably on lower-yielding property investments.	1	4	5	1	4	5
GLOBAL ECONOMY	The UK economy is hit by weaker global activity	While the wider global economy is strengthening, there are still areas of weakness, stemming from slower than expected growth in emerging economies, combined with concerns over the ability of central banks to stimulate their economies. Fragile oil prices are compounding the issue. Any slowdown in the global economy could weigh on UK growth.	2	3	5	2	3	5
MACRO PRUDENTIAL POLICY TOOLS	The Bank of England imposes restrictive mortgage policies	The Bank of England's Financial Policy Committee has been granted powers to intervene in the mainstream mortgage market and has introduced criteria that will make it more difficult to secure a mortgage on a buy-to-let property. Lenders, already dealing with the EU Credit Directive which came into force in March, may react to signals from the Bank by becoming more cautious about lending, potentially weighing on mortgage availability, however this may be offset by the Bank's TFS funding scheme.	2	3	5	2	3	5
BREXIT	A deal emerges that is economically unfavourable for the UK	The UK will enter a protracted period of detailed negotiations over the shape of its future relationship with the EU. Balancing concerns surrounding immigration and single market access will be central to the talks. There is a risk that the UK loses some or all of its access to the single market, including passporting services for London-based banks. A second independence referendum in Scotland risks adding to market uncertainty which could impact on housing transactions.	2	3	5	2	4	6
GEO-POLITICAL CRISIS	Worsening geopolitical crises result in a wider economic fall-out	Political tensions are still high on a global scale, including the stalemate in the Middle East, and subsequent strains over large-scale migration and the threat of terrorism in Europe. The World Economic Forum has identified such issues as being among the biggest risks to the world in the coming year, and these could affect world trade and, as a result, global growth.	3	2	5	3	2	5
DOMESTIC ECONOMY	Uncertainty leads to sharply lower economic growth	The Bank of England has downgraded its forecast for UK economic growth in 2017 to 0.8%, from 2.3%, with a forecast of 1.8% growth by 2018, citing concerns over Brexit. A marked slowdown could have a knock-on impact on jobs and wages which would in turn affect demand in the housing market.	2	3	5	2	3	5
NEW BUILD SUPPLY	Housing supply exceeds demand	An oversupply of housing is unlikely to be an issue for most of the UK, where local housing markets are largely characterised by a lack of new homes. However, in some areas on the edges of central London, the issue of oversupply may be worth monitoring, particularly in higher price brackets.	1	2	3	2	3	5
POLITICAL RISK	New property taxes and restrictions on non-resident buyers	Property taxes remain a favoured tool of politicians in tackling wider affordability issues, irrespective of their effectiveness. However, in an effort to stimulate the housing market and wider UK economy post-Brexit, the chances of further large-scale property taxation are likely to have receded. Policy moves announced for 2017 around the tax treatment of those who are not domiciled in the UK may have an impact, although this is unlikely to reach beyond the prime central London market.	2	1	3	2	3	5
CURRENCY RISK	The current weak pound starts to strengthen against other currencies	Sterling has been the weakest performing currency in the developed world in 2016. As a result, UK assets, including property, look more affordable for overseas investors. While there has been some recent weakening in emerging market currencies, Sterling-denominated investments remain attractive. Sterling may rise against the dollar if and when a framework of an economically favourable Brexit deal emerges.	1	1	2	1	2	3

Methodology Statement: House price forecasts are based upon time series regression analysis of relevant statistically significant macro-economic variables adjusted in-house to encompass externalities such as likely risk factors.

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