The outlook for the UK housing market

To understand how the UK housing market is likely to perform in the future, we need to examine the factors which have driven price growth over recent decades, argues Liam Bailey.

"Low interest rates have placed the housing market in suspended animation."

Liam Bailey, Head of Residential Research

While the housing market is influenced by a huge number of issues, our research points to five key indicators which in large part dictate the health of the market: (1) the balance of new supply and demand, (2) mortgage market accessibility, (3) the cost of debt, (4) household income growth and (5) the performance of the UK economy.

As demonstrated on the table below, the gauges on all five of our indicators pointed up during the extended boom through to 2007. A combination of high demand for housing, a shortfall in new housing supply, easily accessible and relatively cheap mortgage debt, and rising household incomes all served to push prices and transactions to very high levels.

Where are we now?

We lost support from indicators 2, 4 and 5 in early 2008 when mortgage lenders began to reduce their exposure to the market and household incomes were battered by the weakening economy and rising inflation.

Prices began their sharp nose-dive in 2008. But later that year our third indicator was super-charged as the Bank of England slashed interest rates. Aided by even lower new-build supply, prices bounced back in 2009 through to 2010.

By 2011, however, the support from ultra-low interest rates had become insufficient to offset the increasing pressure on household finances as unemployment rose and wages lagged inflation. Prices and transactions have once again begun to slide.

The impact of very low interest rates has been to place the housing market in suspended animation. Though there are few forced sales and repossessions, the support for prices against a backdrop of weaker access to mortgage finance means first-time buyers and upsizers are being kept out of the market and transaction volumes are static.

Figure 1

Knight Frank's Housing Market Indicators

Support for price growth and transaction volumes

Stongly positive · Positive · Neutral · Negative · Strongly negative

	ACTUAL		FORECAST				
	Pre-2007	2008-2011	2012	2013	2014	2015	2016-2021
1 Demand/supply balance	Positive	Stongly positive	Stongly positive	Stongly positive	Stongly positive	Positive	Positive
2 Mortgage market accessibility	Stongly positive	Strongly negative	Negative	Negative	Neutral	Neutral	Positive
3 Cost of debt	Neutral	Stongly positive	Stongly positive	Stongly positive	Positive	Positive	Neutral
4 Growth in household income	Stongly positive	Strongly negative	Neutral	Neutral	Positive	Positive	Positive
5 UK economy	Positive	Strongly negative	Strongly negative	Neutral	Positive	Positive	Positive

Source: Knight Frank Residential Research

Where next?

Our conclusions on the UK market in the short to medium term point to three scenarios – one seemingly impossible and two real possibilities:

Scenario	Events	Likelihood
The upside	A rapid global economic recovery feeds through to improved UK employment conditions and household finances. Prices stabilise with a return to nominal and real growth, and a related upswing in transactions.	5%
The slow correction	Very low interest rates are maintained in the medium term, but transaction volumes remain muted. Prices fall in nominal and real terms in 2012, followed by low nominal growth but real falls in 2013 and 2014, before a slow recovery in prices and volumes post-2015. This is our central scenario.	75%
The sharp correction	A trigger event creates conditions similar to those in 2008, with rapid price falls and an equally rapid return to more stable pricing. Under this scenario transaction volumes would fall from even today's depressed levels.	20%

Our view is that conditions in the UK mainstream market over the next few years will resemble our 'slow correction' scenario, under which the market will experience an extended period of low transaction numbers and price falls in real terms.

The most plausible trigger event for our 'sharp correction' is a second banking crisis.

A collapse of the euro or a serious sovereign debt crisis in the US or UK could easily create these conditions, with a seizure of inter-bank lending and credit availability. An alternative trigger event would be a prolonged spike in inflation, feeding through to a rapid rise in UK interest rates which would cause significant distress in the market.

Long term

If our short and medium-term outlook leaves you feeling underwhelmed, fear not, things look better when we turn our attention to 2015 and beyond.

Returning to our five indicators, we can be relatively confident in our assumption that housing demand will remain strong, and it seems unlikely that the coalition government will be able to destroy the British love affair with all things NIMBY. So while new-build volumes will rise, they are unlikely to have a structural impact on pricing.

Our assumption is that interest rates will rise from 2013, but will remain low in a historic context for the foreseeable future. It also seems reasonable to assume that, despite a government desire to regulate the sector, there will be more relaxed access to mortgage market funding in the future.

In figure 2, however, you will note that our long-term nominal house-price growth rate is noticeably lower than the trend level seen historically. The key reason for this is seen when we turn to our fifth indicator – household income growth – which we expect to remain subdued in the long term.

Figure 2
Annual price growth forecast

		ACTUAL					FORECAST				
	20-year average to 2011	2007	2008	2009	2010	2011 (est)	2012	2013	2014	2015	2016-21 (annual change)
East Anglia	5.8%	5.7%	-16.6%	4.5%	3.4%	0.3%	-3.8%	1.3%	2.3%	3.3%	5.2%
East Midlands	5.5%	2.8%	-14.2%	2.5%	1.7%	0.8%	-4.1%	1.0%	2.0%	2.7%	5.0%
London	7.4%	12.8%	-15.1%	7.0%	2.5%	3.6%	-3.7%	1.4%	2.4%	3.4%	5.8%
North East	4.9%	3.7%	-11.0%	-2.0%	0.6%	-0.8%	-5.9%	-0.3%	0.9%	1.9%	4.4%
North West	4.9%	3.5%	-14.4%	2.7%	-1.9%	-0.8%	-4.8%	-0.6%	0.4%	1.6%	4.6%
Scotland	5.3%	10.1%	-8.1%	1.0%	-2.1%	-0.3%	-5.9%	-1.2%	-0.2%	0.8%	4.2%
South East	6.4%	7.9%	-15.7%	6.0%	2.4%	2.7%	-4.1%	0.9%	1.9%	2.9%	5.4%
South West	6.3%	6.4%	-14.9%	3.8%	2.1%	2.0%	-5.7%	-0.2%	0.8%	2.4%	4.8%
Wales	5.6%	4.2%	-12.1%	-0.3%	-1.9%	3.5%	-6.7%	-1.8%	-0.8%	0.1%	4.4%
West Midlands	5.2%	4.4%	-14.0%	2.1%	0.6%	0.7%	-5.7%	-0.1%	0.9%	1.6%	4.6%
Yorkshire	5.4%	2.6%	-13.6%	2.7%	-3.6%	3.1%	-4.2%	0.2%	1.0%	1.7%	4.2%
UK	6.0%	6.9%	-14.7%	3.4%	0.5%	1.3%	-5.0%	0.0%	1.0%	2.0%	4.8%

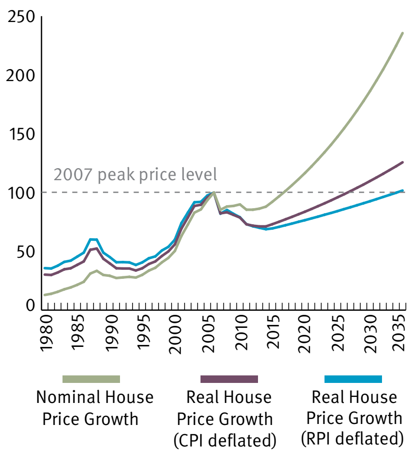
Source: Knight Frank Residential Research

Gráinne Gilmore
Head of UK Residential Research

Figure 3

Nominal and real house price growth

Actual and historic house price growth, deflated by CPI, RPI and earnings growth, indexed to 100.0 in 2007

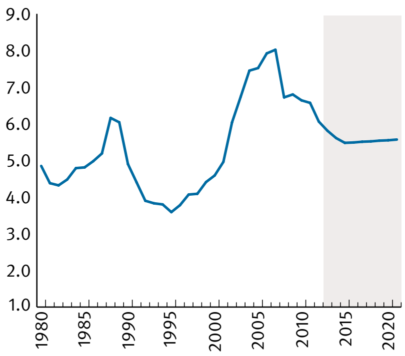


Source: Knight Frank Residential Research, Nationwide

Figure 4

House price to earnings ratio

Average house price divided by pre-tax average annual earnings



Source: Oxford Economics, Nationwide, Knight Frank Residential Research

The forecast examined

Following the sharp falls seen in 2008, UK house prices have remained remarkably stable, with a slow correction feeding through during 2011. Despite this relatively positive picture our forecast shows a 5% decline next year and little convincing growth until 2015. Gráinne Gilmore explains our reasoning.

From 2016, we expect the market to return to trend growth of around 4.8%, lower than the long-term growth of 6%, reflecting the irreversible impact that the credit crunch has had on the housing and mortgage markets.

As recent data has made clear, the UK has struggled to emerge from recession and there are fears that the economy may start to shrink once more. This ongoing economic weakness, lacklustre earnings growth and the ramping-up of public sector spending cuts will take a toll on the housing market over the next 12 months.

The 5% drop in prices in 2012 will leave property values nearly 15% below their 2007 peak. In fact, even with the modest gains seen in later years, we forecast that average house prices will not hit 2007 levels again until 2018.

In real price terms, the picture is even more subdued, especially in light of the recent spate of high inflation which has eroded the modest price growth seen in the market.

As figure 3 shows, house prices, adjusted for CPI inflation, have fallen by 21% since the peak of the market and, according to our forecasts, will continue to decline until 2015, when they will have lost more than 29% of their value. On this measure, prices will not reach their previous highs until 2028.

This price re-adjustment is necessary, and continues the process of bringing house price/earnings ratios back to sustainable levels. As figure 4 shows, the house price/earnings ratio hit a peak of 8 in 2007, far above the long-term trend of 4.5. Our view is that while future affordability ratios will fall back from current levels, they will remain elevated above historical levels given the widening disconnect between supply and demand in the housing market.

The struggle facing first-time buyers (FTBs) trying to enter the housing market, contributes to our forecast. Whereas in 2007 FTBs could clinch a mortgage deal for more than their prospective house was worth, now they must save up for an average deposit of 15%.

A generation of buyers is suddenly expected to be able to access tens of thousands of pounds to do the same thing their predecessors did 'for free' just five years ago. The Bank of Mum and Dad, which has helped many FTBs, is under pressure from rising retirement and care costs.

FTBs will certainly find it much harder to buy a home, especially those leaving university with large debts from tuition fees. While we believe those who predict the development of a 'generation of renters' are slightly overcooking the pudding, the rental sector will continue to grow in importance.

There are encouraging signs of increased competitiveness among lenders vying for business from FTBs, and we believe that their number will rise in the medium term as the economy starts to recover.

We expect a gradual rise in overall housing transactions from next year, but do not foresee a return to pre-2007 levels in the next five years (see figure 8).

There is no doubt that prices over the last few years have been propped up by low interest rates. Our view is that interest rates will remain pegged at record low levels until well into 2013. This factor will not be enough to prevent price falls next year, although it will limit the extent of the decline.

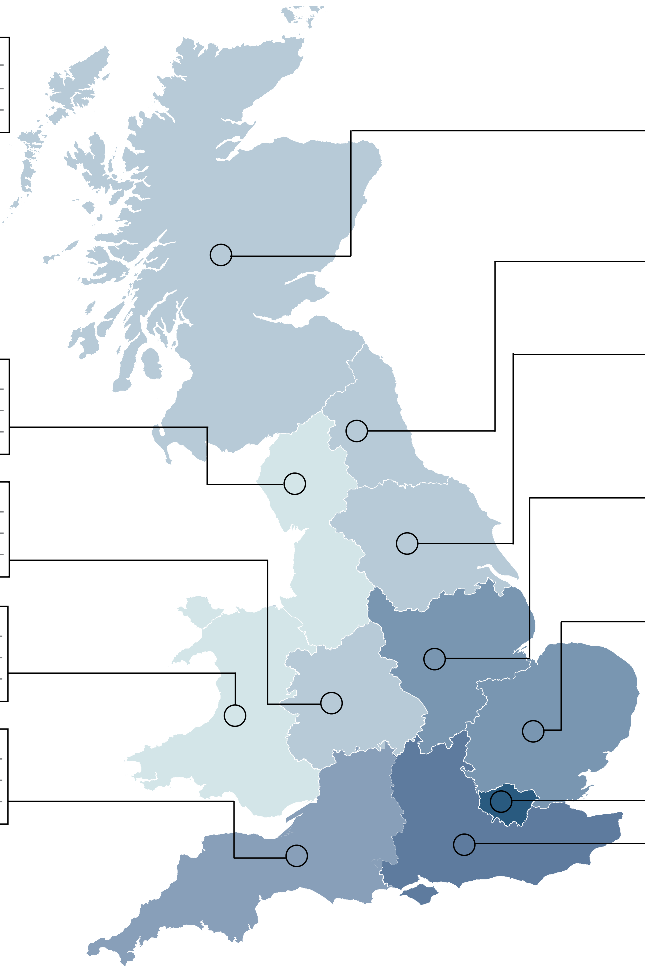
When interest rates do start to rise, there will be an impact on some homeowners, who will struggle with rising mortgage payments. While there is likely to be localised distress in some markets, our forecast assumes that borrowers will increasingly choose to fix their mortgage over the next one to two years.

In addition, rising interest rates will have the positive impact of boosting the incomes of savers and pensioners, easing the squeeze on at least some consumers.

The map below provides an overview of our regional outlook, and illustrates how the markets in the North and South will continue to diverge.

Given the large falls which have already happened in the North of England, affordability levels are lower than in the South. But despite this, we expect bigger price falls than in the South as the northern regions are more heavily dependent on the public sector. As such, we could see a localised rise in repossessions because of public sector job cuts, placing further downward pressure on prices in these areas.

Map 1
Mainstream and prime regional forecast



UK	
Mainstream market growth (2012)	-5.0%
Prime market growth (2012)	-2.8%
Mainstream recovery to 2007 peak	2018

Scotland	
Mainstream market growth (2012)	-5.9%
Prime market growth (2012)	-3.6%
Mainstream recovery to 2007 peak	2019

North East	
Mainstream market growth (2012)	-5.9%
Prime market growth (2012)	-4.7%
Mainstream recovery to 2007 peak	2019

North West	
Mainstream market growth (2012)	-4.8%
Prime market growth (2012)	-4.4%
Mainstream recovery to 2007 peak	2020

Yorkshire & Humberside	
Mainstream market growth (2012)	-4.2%
Prime market growth (2012)	-4.2%
Mainstream recovery to 2007 peak	2019

West Midlands	
Mainstream market growth (2012)	-5.7%
Prime market growth (2012)	-3.9%
Mainstream recovery to 2007 peak	2019

East Midlands	
Mainstream market growth (2012)	-4.1%
Prime market growth (2012)	-3.8%
Mainstream recovery to 2007 peak	2017

Wales	
Mainstream market growth (2012)	-6.7%
Prime market growth (2012)	-4.0%
Mainstream recovery to 2007 peak	2020

East Anglia	
Mainstream market growth (2012)	-3.8%
Prime market growth (2012)	-3.4%
Mainstream recovery to 2007 peak	2017

South West	
Mainstream market growth (2012)	-5.7%
Prime market growth (2012)	-3.6%
Mainstream recovery to 2007 peak	2018

London	
Mainstream market growth (2012)	-3.7%
Prime market growth (2012)	5.0%
Mainstream recovery to 2007 peak	2015

South East	
Mainstream market growth (2012)	-4.1%
Prime market growth (2012)	-0.7%
Mainstream recovery to 2007 peak	2016

Note: darker areas indicate regions with most rapid recovery

Source: Knight Frank Residential Research

Prime regional markets

Will prime property in the regions be protected from the tribulations we expect to see in the mainstream market? The answer: only to a point.

The prime regional markets across the UK have struggled to lift their performance above that of the wider mainstream market, as noted in our recent commentary on the country house market.

With prime London prices racing ahead over recent years, we would normally expect to see this growth ripple out across the UK, but this has not happened.

Some of the activity in the Capital has rubbed off on the most desirable parts of the South East. Prime property prices across this region have risen by 0.4% over the past year, following a heroic climb of 11.4% from the mid-2009 trough. There does however remain a significant difference between the London and country markets, and this difference comes down to international buyers.

Excluding the highly sought-after Surrey estates such as Wentworth and St George's Hill, international buyers are relatively rare outside of London. Where almost 50% of prime London properties in the £1m+ market go to international buyers, the comparative figure in the country market is just 12%.

Domestic concerns are key influences in the prime country market, despite the fact that buyers and sellers tend to be wealthier and far more equity-rich than the average UK buyer. With the UK economy struggling and wealth creation under pressure, vendors are having to compete keenly on price.

In our regional map on page 4, we contrast our forecast for prime regional price growth in 2012 with the mainstream market. While we believe the prime market will outperform in the short term, this outperformance will be minimal and will not translate into positive price movements.

The widening gap between prime country and London property will begin to underpin the country house market in the medium term, especially when we see a return to stronger domestic economic growth. To illustrate this point, if you were planning on selling a £5m property in London in early 2009 and buying a property for a similar price in the country, delaying for two years until now would have seen your London property rise in value to around £6.75m and the country property rise to around £5.5m at best, leaving a £1.25m margin for reinvestment. This opportunity is likely to result in more money moving from London to the prime markets in the south from 2013 onwards.

Figure 5

Knight Frank's Prime London Market Global Indicators

Support for price growth and transaction volumes, from strong (up arrow) to weak (down arrow)

	Pre-2007	2008-2011	2012	2013	2014	2015	2016-2021
1 Global GDP	↑	→	→	↗	↗	↗	↑
2 Exchange rate (GBP vs. USD)	↘	↑	↗	↗	↗	↗	→

Source: Knight Frank Residential Research

Prime London: top of the world?

Price growth in prime central London between March 2009 and September 2011 totalled 37%. This is the fastest rate of recovery seen in the market for 35 years. With prices now at an all-time high, many observers are questioning their stability.

The London market has benefited from a weak pound and growth in global wealth portfolios, demand for international educational opportunities, and demand for 'safe haven' assets on the back of recent geo-political concerns.

The diversity of demand for prime London property has been a significant strength for the market, and a key factor behind our relatively positive outlook for the market (as shown in figure 6).

It could be said that there has been an element of speculation in some of the purchases made during the past two years in London – with prices rising, new buyers have been drawn to the market to chase even

Figure 6

Prime London annual price growth forecast

	ACTUAL						FORECAST				
	20-year average to 2011	2007	2008	2009	2010	2011 (est)	2012	2013	2014	2015	2016-2021 (annual change)
UK	6.0%	6.9%	-14.7%	3.4%	0.5%	1.3%	-5.0%	0.0%	1.0%	2.0%	4.8%
Prime Central London	10.1%	28.6%	-16.9%	6.1%	10.3%	11.0%	5.0%	0.0%	4.0%	6.0%	7.0%
Prime Outer London	8.9%	11.1%	-12.7%	11.2%	6.1%	4.0%	-2.0%	2.0%	5.0%	6.0%	6.0%

Source: Knight Frank Residential Research

higher gains. But our research confirms that the majority of buyers in central London purchase for a long-term investment, not short-term price growth.

Looking ahead there is a strong likelihood that geo-political issues will continue to push overseas buyers into London, especially at the top end of the market. The forthcoming Russian election in 2012 has already spurred increased activity from Russian buyers, and the ramifications of the Arab Spring are still not fully played out – buyers from this region are still looking to invest in London.

In figure 5 we provide two additional indicators which reflect the international nature of the prime London market: global GDP and the performance of sterling against the US dollar. Global GDP represents the most accurate proxy for global wealth creation. At the moment we believe this measure will remain neutral in terms of its influence on the prime London market in 2012, before becoming a more positive influence from 2013. In our table of key risks below we consider the main alternative scenarios for the UK and global economy.

With regard to the second additional indicator – the performance of sterling – we expect to see a gradual increase in the value of the pound in the period up to 2015, which will slowly erode the benefits currently experienced by foreign purchasers. From 2016, economic recovery in the UK should push sterling's value to a level where it becomes a neutral influence on London pricing.

While international issues will be critical to the London market, domestic concerns will become increasingly important over the next 12 months. Taxation, for example, is likely to become more controversial. The desire by the Conservatives to abolish the 50% income tax rate, and the call from the Liberal Democrats to introduce a new 'mansion tax' (which we discuss on page 7), would both have a direct impact on the demand for luxury property and on price performance.

The ability of the City of London to create new jobs following the cuts made by investment banks earlier this year will again directly affect the prime and even super-prime markets in 2012.

These issues surrounding wealth taxes and financial sector performance will also affect buyer confidence. The quicker a political settlement on London's long-term role is established, the more confident wealthy buyers will be.

For the moment we are still very far from the position elaborated by Peter Mandelson in the 1990s, of being "intensely relaxed about people getting filthy rich". Even when we consider the caveat that accompanied his statement: "as long as they pay their taxes", the idea that politicians today are even remotely relaxed about the first part has become increasingly debatable.

Figure 7
Key risks
Our forecast is based on assumptions made on macro-economic outcomes both here in the UK and globally. These assumptions represent our opinion of the most likely course of events through 2012 and beyond. In this table we examine six key macro risks and their impact on different sectors of the UK housing market.

Risk	Downside scenario and impact	Ranking of risks by sub-market, where 1 represents the largest risk		
		Mainstream UK	Prime Regional	Prime London
UK recession	The potential for a UK recession, with the ensuing negative impact on employment and earnings growth, would have a direct and substantial impact on the UK mainstream market, accentuating price falls predicted for 2012 and undermining the limited growth in transactional activity seen this year.	1	1	3
Rapid rise in UK base rate	Our forecast assumes rates remain held at 0.5% through 2012 and into 2013, returning to 4.5% in 2016. Any contraction of this timeframe, potentially caused by higher-than-expected inflation, will feed into more forced sales and weaker price growth than we are currently forecasting.	2	4	4
Eurozone crisis	A collapse in the euro would see a return of 2008 lending conditions, with an effective closure of credit markets. The potential for 'safe haven' investments could soften the blow in London, but this risk remains significant for all markets.	3	2	2
High inflation and low household income growth	The UK is currently enduring a period of real declines in household income, with earnings rising more slowly than inflation. Our forecast assumes that this process reverses during 2012 with earnings growth hitting 2.9% and CPI inflation falling back to 2.4%. A less benign outcome will weigh on price growth.	4	5	5
Restricted mortgage availability	There has been some improvement to mortgage availability, and the number of higher LTV products in particular has risen over the past 12 months, although accessibility for first-time buyers is still limited. Without renewed stress in the credit markets it seems unlikely that this situation will weaken further in 2012.	5	6	6
Global recession	While a fully fledged world recession remains an unlikely prospect, one covering Europe and North America remains a real possibility. Weaker confidence and wealth creation would reduce demand in the London market. The impact on the wider UK market would be mainly felt through the knock-on impact on the UK economy.	6	3	1

Source: Knight Frank Residential Research

Hostage to fortune

Four predictions for the future

1 Governments will stop trying to support house prices

We have said before that resisting the temptation to tinker is probably the best thing policy makers can do in the residential market. Most interventions since 2007 (such as interest-free equity loans for first-time buyers, and support for shared equity) have been designed to prop prices up. This is not a good idea, it helps a small and fortunate group of first-time buyers while actively hindering everyone else.

We think there is a growing realisation in government that its role is to support supply-side initiatives, for example the accelerated release of development land with easier purchase terms (the new 'Buy Now: Pay Later' policy) and reforms to the planning system. These at least have the aim of helping to widen housing market accessibility through increased supply.

2 Coalition planning reforms will lead to more private housing completions

The caveat here is that it will take a while for completion volumes to rise in a meaningful way. Our belief is that once the National Planning Policy Framework comes into force, the incentives to build will increase.

In the short term we could see a spike in applications, as developers look to capitalise on an embryonic new system, and local authorities work to supply the mandatory additional 20% of development land in the first five years of the scheme's operation.

While appeals from disgruntled local residents and community groups could slow the approvals process, we think the new planning laws could help to appreciably boost the number of private dwellings through the next market cycle. A reduced role for public sector developers will nonetheless mean that the government will struggle to achieve its ambitious housing targets in full.

3 The 'mansion tax' will not see the light of day

Speak to one half of the Coalition and the mansion tax has become a totemic issue (just look at its name). Speak to the other half and they recoil in horror. Trying to gauge where the final decision will lie is pretty much guesswork.

Our view is that Mr Osborne will give the Lib Dems something in return for the abolition of the 50% income tax rate, possibly involving a combination of a delayed date for abolition of the tax together with new enhanced high-value council tax bands.

4 Crossrail will boost prices in London and the South East, further accentuating the North/South divide

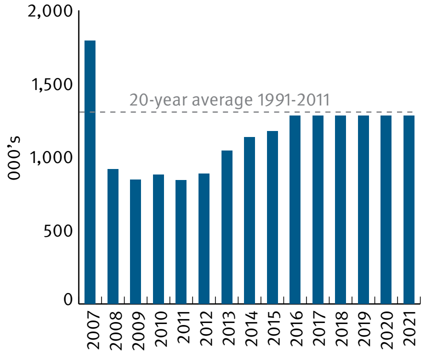
The new transport link provided by Crossrail in 2019, from Maidenhead in the west to Abbey Wood and Shenfield in the east, via Paddington, Bond Street, the City and Canary Wharf, will boost the number of workers who can commute into the capital, helping support house prices in the surrounding areas.

Within the capital, the train link will change the dynamics of the housing markets in the localities around the stations, with prices in Paddington, Bayswater, Farringdon, the City and the City Fringe in Whitechapel set to particularly benefit.

London and its growing hinterland needs new infrastructure, but the dynamism this type of project lends to accessibility and economic flexibility in the South will enhance and entrench the economic and housing market divide with the North.

Figure 8

UK housing transactions forecast



Source: Knight Frank Residential Research

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