UK HOUSING MARKET FORECAST

Q4 2012 edition

Knight Frank

The outlook for the UK housing market

UK house prices will not reach their 2007 peak until 2019: the longest housing market recovery on record. UK housing transactions are expected to rise 2% in 2013, but will remain well below peak levels for the rest of the decade. Gráinne Gilmore explains:

"The fundamentals suggest that a further correction in prices is needed as the relationship between average earnings and average house prices is above the long-term average."

Gráinne Gilmore, Head of UK Residential Research

Some five years after the start of the financial crisis, the housing sector in the UK still does not bear the hallmarks of a fully functioning market.

Transaction levels have roughly halved since the last market peak in 2007, and are 35% below the 20 year average, as first-time buyers and those further up the housing ladder struggle with tighter mortgage lending rules.

House prices have been flat or modestly declining across the UK since 2010. This stasis is underpinned by unusual economic conditions, rather than a genuine equilibrium in the market.

The fundamentals suggest that a further correction in prices is needed as the relationship between average earnings and average house prices is well above the long-term average. This is illustrated in Figure 1, which shows how the house price earnings ratio for first-time buyers has moved. We believe that the new 'average' at which this ratio settles in the future may be above the historical average, but there is still a further readjustment required to reach that level.

Prices have been supported so far by ultra-low interest rates. This has resulted in monthly mortgage payments falling for some borrowers.

But it has not all been good news for borrowers. Those with only a small slice of equity in their property have struggled to re-mortgage, given that many lenders have scrapped the high loan-to-value (LTV) deals seen before the financial crisis. Instead, lenders in general now lend a maximum of 75% LTV. Only a handful of deals are available above this threshold and the most competitive deals are for those who have 30% or 40% equity. Indeed, most homeowners who do not have a 25% chunk of equity in their property must stay with their current lender, and are unable to reduce their monthly mortgage payments by shopping around the mortgage market for a more competitive deal.

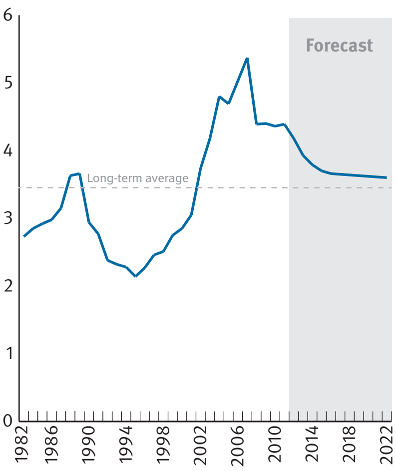
First-time buyers without a 25% deposit find it hard to climb onto the housing ladder at all, although some government initiatives, such as Firstbuy and NewBuy, have tried to open up the market to those with more modest deposits.

The Bank of England and Treasury Funding for Lending scheme, designed to boost mortgage lending as well as the availability of loans to small businesses, has yet to prove that it is really having a significant effect on the market, although there are initial signs that mortgage rates may have fallen slightly.

The recent Mortgage Market Review (MMR), which is likely to be implemented in 2014, underlines the fact that the current conditions in the mortgage market are not a post-crisis blip. Rather, this should be considered the 'new normal', and the housing market will certainly reflect that, taking years to reach the transaction levels seen at the peak of the market. We forecast only a 2% rise in transactions next year.

As the UK economy struggles to deliver convincing growth, there seems little chance of interest rates rising any time soon. In fact recent polls of economists show that the first interest rate rise is not expected until 2014 at the earliest, with some analysts expecting rates to stay at current levels until

Figure 1
House price to earnings ratio (FTB)



Source: Knight Frank Residential Research, Nationwide

2017. The low-interest rate environment will probably continue to put a floor under prices to a certain extent. This signals that rather than another sudden large price shock, homeowners face a slow real-term erosion of value in their property until the price-to-earnings ratio once again hits levels closer to the long-term average.

However, at some point, interest rates will rise. If they rise slowly, in tandem with a growing economy where new jobs are being created and average earnings are rising faster than inflation (this is the assumption we have used in our forecasts) the housing market can weather the change. But it must be noted that a sudden and unexpected sharp rise in interest rates could have an immediate effect – causing a price shock, as already over-extended homeowners are pushed past the limit. Such a move might also force banks, which are showing hitherto unseen levels of forbearance on bad mortgage loans, to take action, which could spur a sharp rise in repossessions, further exacerbating house price declines.

In the wider economy, there is more austerity to come. George Osborne, the Chancellor, is being pushed hard for a fiscal plan B, but so far shows little sign of deviating from the schedule of public sector cuts which will continue well into next year and 2014.

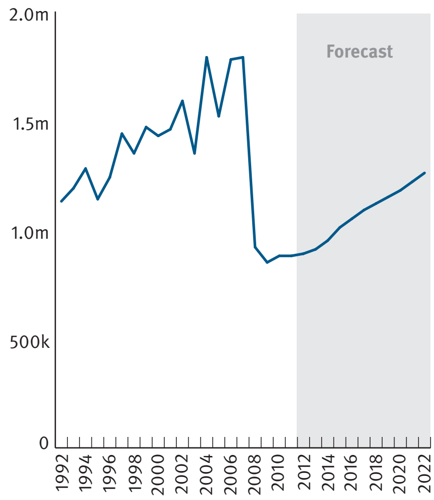
In fact, we do not see average prices reaching their 2007 peak again until 2019 – which would mark the longest period between price peaks in more than sixty years. Once inflation is stripped out, average UK house prices are unlikely to hit 2007 levels again in real terms until 2031.

We are also forecasting another small dip in **prime country** house prices next year. We expect prices to end this year down 4%, with some exceptions in 'hotspots' such as Oxford and Guildford, where we expect prices to rise modestly next year.

Overall, we expect a further average 1% decline across the market in 2013, before some growth returns as the economy starts to make more solid progress.

Turning to Europe, we based our forecasts last year on the assumption that the Eurozone would remain intact. That continues to underpin our outlook, although this does not rule out further turbulence in the single currency area, with troubling signs from the German economy raising the spectre of the powerhouse economy in Europe falling back into recession.

Figure 2
UK residential property transactions



Source: Knight Frank Residential Research
HMRC, ONS

Figure 3
Annual price growth forecast (UK mainstream market)

	ACTUAL						FORECAST	
	20-year average to 2011	2007	2008	2009	2010	2011	2012	2013
UK	6.0%	6.9%	-14.7%	3.4%	0.5%	1.2%	-2.0%	-2.0%
East Anglia	5.8%	5.7%	-16.6%	4.5%	3.4%	0.3%	-2.4%	-0.7%
East Midlands	5.5%	2.8%	-14.2%	2.5%	1.7%	0.8%	-1.6%	-1.0%
London	7.4%	12.8%	-15.1%	7.0%	2.5%	3.6%	-0.2%	-0.6%
North East	4.9%	3.7%	-11.0%	-2.0%	0.6%	-0.8%	0.5%	-2.3%
North West	4.9%	3.5%	-14.4%	2.7%	-1.9%	-0.8%	-1.8%	-2.6%
Scotland	5.3%	10.1%	-8.1%	1.0%	-2.1%	-0.3%	-3.6%	-3.2%
South East	6.4%	7.9%	-15.7%	6.0%	2.4%	2.7%	-0.9%	-1.1%
South West	6.3%	6.4%	-14.9%	3.8%	2.1%	2.0%	-1.0%	-2.2%
Wales	5.6%	4.2%	-12.1%	-0.3%	-1.9%	3.5%	-3.6%	-3.8%
West Midlands	5.2%	4.4%	-14.0%	2.1%	0.6%	0.7%	-1.3%	-2.1%
Yorkshire	5.4%	2.6%	-13.6%	2.7%	-3.6%	3.1%	-1.0%	-1.8%

Source: Knight Frank Residential Research

“We forecast that prices in prime central London will remain unchanged overall next year with more moderate growth from 2014 onwards.”

Liam Bailey, Global Head of Residential Research

Price growth in prime central London set to moderate

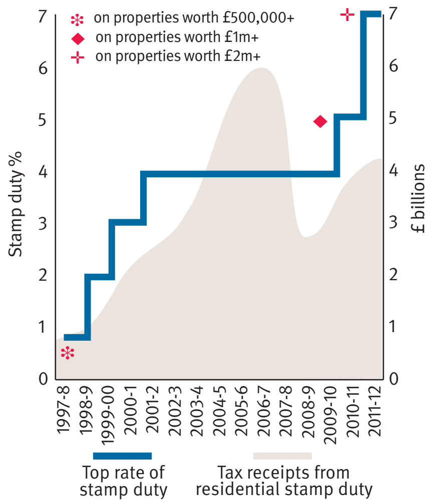
Tax changes are forecast to weigh on prime central London prices, with no price movement expected in 2013, argues Liam Bailey.

Prime property prices in central London have bucked the trend of the wider housing market in the UK over the past few years, bouncing back 50% after the post-crisis trough to reach a new high. Last year we forecast another year of growth, which we have seen, although the level of growth exceeded our expectations for a 5% rise in values in 2012.

The demand for luxury London homes from overseas buyers looking for a safe-haven for their money, as well as a slice of London life has helped drive price increases. The weakness of the pound makes the investment even more attractive, particularly for those buyers who have currencies pegged to the US dollar. This growth might have continued into next year, albeit on a more modest basis as prices bumped a ‘natural ceiling’, but government policy is set to have an impact on the market next year.

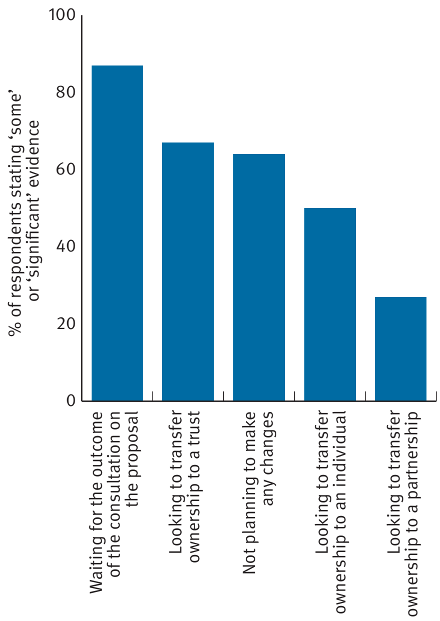
In March, George Osborne raised the stamp duty charge for purchases of homes worth more than £2m to 7%, up from 5%. For those buying through a company structure, the charge was raised to 15%. But, crucially, the Chancellor also announced a consultation on further charges for those buying through a company structure – an annual charge of up to £140,000 a year, as well an extension of capital gains tax. These measures will not be confirmed until next month, and have created an air of uncertainty among buyers who own property in a company structure, or who were considering buying a property in this fashion. As a result, there is an air of ‘wait and see’ in the market, and this has had an impact on transactions, with £2m+ sales volumes down by 25% year-on-year in the three months to the end of October 2012.

Figure 4
How the top rate of stamp duty has risen



Source: Knight Frank Residential Research

Figure 5
Property tax shake-up
How have clients reacted to the proposal for an annual change on properties owned by a ‘non-natural person’?



Source: Knight Frank Residential Research

Figure 6
Prime London annual price growth forecast

	ACTUAL						FORECAST					
	20-year average to 2011	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017-2021 (annual change)
UK	6.0%	6.9%	-14.7%	3.4%	0.5%	1.2%	-2.0%	-2.0%	1.0%	2.0%	3.5%	4.2%
Prime Central London	10.1%	28.6%	-16.9%	6.1%	10.3%	12.1%	8.0%	0.0%	4.0%	6.0%	6.0%	6.0%
Prime Outer London	8.9%	11.1%	-12.7%	11.2%	6.1%	1.2%	3.5%	1.0%	3.0%	4.0%	5.0%	5.0%

Source: Knight Frank Residential Research

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If the measures are introduced as laid out in the Government's consultation, we expect to see a significant proportion of property owned through companies switched into private ownership, either in a single name or a trust structure. Some property owners may put their home on the market, but some buyers will continue to buy and hold property through a company structure because it suits their needs. We will revisit our forecast in the wake of the announcement if the Government decides to bring different rules forward.

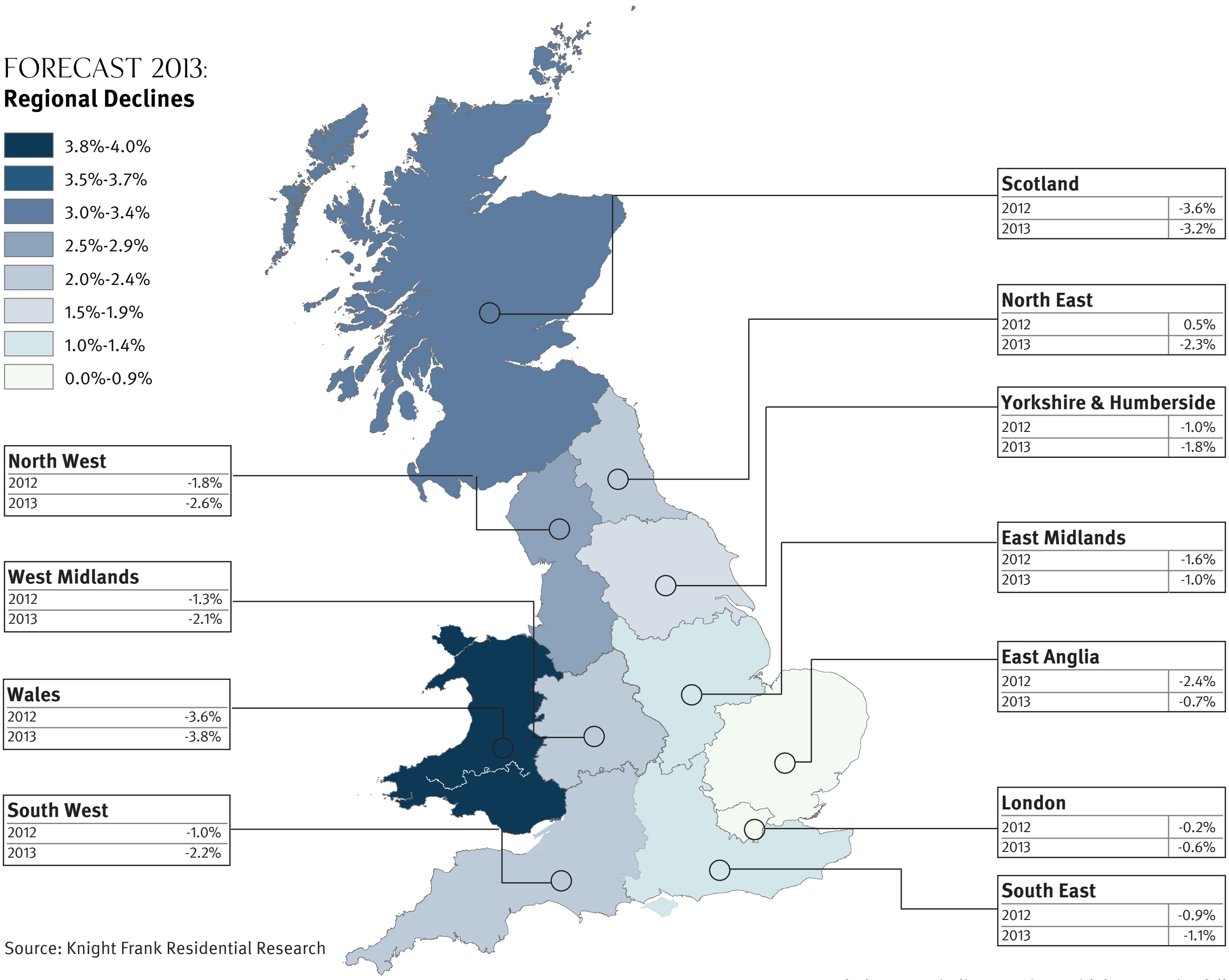
The continued discussion about a 'mansion tax', whether it is the Liberal Democrats' idea for an annual charge on owners of property worth £2m+, or an introduction of extra council tax bands for properties worth £1m or £2m, is also causing some disquiet in the market. As the Government has been shown time and again, the housing market can absorb change, but long-term discussions create uncertainty, which can be the most damaging factor of all.

We forecast that prices in prime central London will remain unchanged overall next year, before more moderate price growth is seen once again from 2014 onwards.

However, within next year's forecast, we expect that separate sectors of the market will perform at different speeds because of the new stamp duty rules. As might have been expected, price growth in the £2m-£5m band slowed in the wake of the introduction of the new rules in March, while price growth and market activity in the sub-£2m band flourished. We expect this to remain the case, and this trend will also have a knock-on effect in prime outer London, where many family homes fall into this sub-£2m category.

Map 1

Mainstream regional forecast



	2012	2013
Scotland	-3.6%	-3.2%
North East	0.5%	-2.3%
Yorkshire & Humberside	-1.0%	-1.8%
East Midlands	-1.6%	-1.0%
East Anglia	-2.4%	-0.7%
London	-0.2%	-0.6%
South East	-0.9%	-1.1%
North West	-1.8%	-2.6%
West Midlands	-1.3%	-2.1%
Wales	-3.6%	-3.8%
South West	-1.0%	-2.2%

Source: Knight Frank Residential Research

Note: darker areas indicate regions with largest price falls

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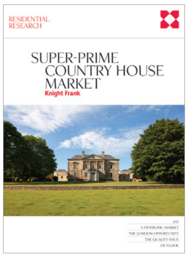
The Wealth Report 2012



Super Prime Country Report 2012

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