RESIDENTIAL RESEARCH

Knight Frank

UK HOUSING MARKET FORECAST

Q4 2013 EDITION

UK AND REGIONAL PRICING FORECASTS

RENTAL MARKET ANALYSIS

COMPREHENSIVE DATA AND COMMENTARY

A NEW START FOR THE UK HOUSING MARKET

The transformation of the housing market in 2013 has been notable. Strong price growth might not be justified by market fundamentals, but government support and rising confidence have boosted short-term price movements argues Liam Bailey.

KEY FORECASTS

- Average UK house prices will rise by 7% in 2014
- Cumulative growth in UK prices of 24% to end of 2018
- Prices of property in prime central London will rise by 4% in 2014, with cumulative growth of 20% by end of 2018
- Prime central London rents to reverse 2013 declines and rise by 2% in 2014

LIAM BAILEY
Global Head of Residential Research

"Property price growth in 2014 and 2015 will be substantially higher than inflation."

In late 2012, as we finalised our forecast, prices in the UK were flat or slowly falling, with the notable exception of central London.

Everything made sense. London had been buoyed by a stronger economic revival compared to the UK, and flows of wealth from domestic and international investors contributed to the outperformance. At the same time the new 7% £2m+ stamp duty rate had knocked sales volumes, and signals from the market pointed to price growth in prime central London slowing down, and we pencilled in 0% price growth for 2013.

In the UK, we felt the market's weakness was justified by real affordability constraints. How could prices rise when real incomes were falling and mortgage market access was still limited to the equity rich? We forecast -2% for 2013.

And then everything changed. The 2013 budget saw the launch of Help to Buy, which, as we examine later in this report, has had a dramatic effect on market sentiment, far beyond the thousands of transactions it is directly supporting. At the same time the UK economy surprised to the upside, growing more strongly than most economists had expected.

By the second and third quarters of 2013 both the economy and the housing market were improving. Although, in the case of the housing market, outside London and South-East England the improvement was still only just noticeable.

Our latest forecast, as set out in this document, takes account of the changes in the economy and government support. We have been persuaded that growth in 2014 and 2015 will be substantially higher than inflation. However we have maintained our view that over the long term, while nominal and real price growth may remain positive, house prices are likely to rise more slowly than earnings for at least a few years after 2016. As Gráinne Gilmore explains on page 4, as base rates increase, price growth will be constrained.

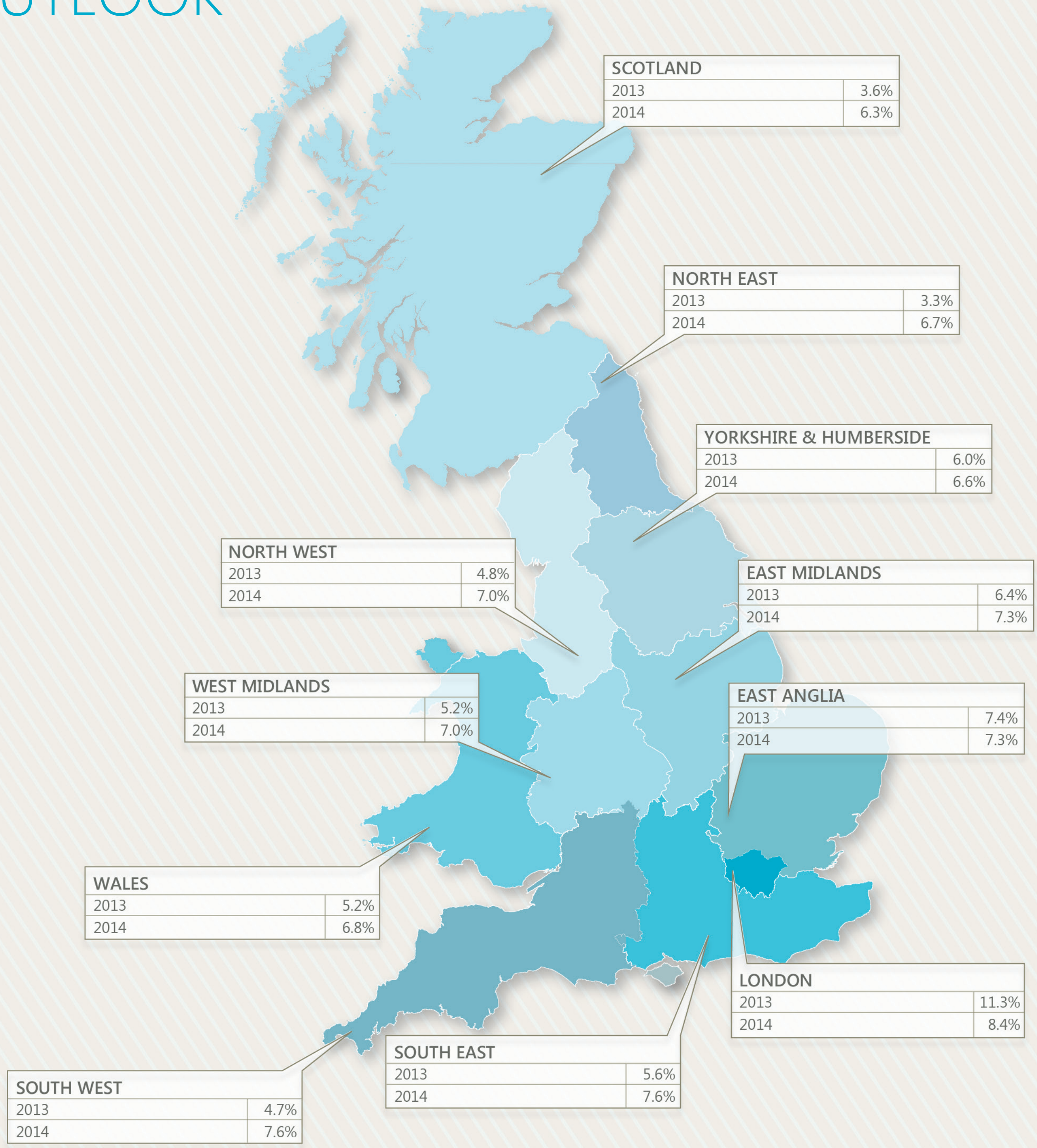
It also seems clear that the long awaited "ripple effect" has come into play. We see prime London delivering weaker growth than the wider market over the next two years, before reasserting its outperformance from 2016.

For first time in five years we can be broadly positive about the UK housing market. Price growth is encouraging transactions, contributing to labour mobility, and first time buyers are able to access the market in a way they couldn't even 12 months ago. Importantly these improvements are not limited to London, they are spreading.

There is however a flip-side to these improvements. Rising prices in the short term will limit longer term growth. The fact remains that pricing in the UK is high in historic terms, and while the government can encourage activity over the next two to three years, it can not change the fundamentals surrounding market affordability, especially as the 'special factors' of low interest rates and government interventions start to unwind.

REGIONAL MARKET OUTLOOK

FIGURE 1 **Knight Frank house price forecast, Q4 2013**



Source: Knight Frank Residential Research

UK HOUSING MARKET

UK house prices are set to rise by 24% by the end of 2018, our forecasts show, although once inflation is stripped out, the real expected growth in prices is 14%. Gráinne Gilmore considers the implications of renewed growth in prices.

"The stronger economy in 2016 should help a transition to a largely stimulus-free market."

GRÁINNE GILMORE
Head of UK Residential Research

The housing market in the UK has experienced a notable rise in transactions and prices in the second half of 2013, amid returning confidence in the economy and government interventions in the mortgage market. We expect this trend to continue.

This performance marks a turnaround from recent years during which the housing market in many regions outside London and the South East were largely moribund. Average UK house prices fell by 26% in real terms between late 2007 and the end of 2012, and, despite strong nominal price growth in 2013, prices are still nearly a fifth below their pre-crash peak in real terms.

The growth in house prices across the UK has led to fears of a housing bubble. Yet price growth has only started to outpace inflation very recently. In addition, average monthly transaction levels are still more than a third below the long-term average in England and Wales, according to the Land Registry.

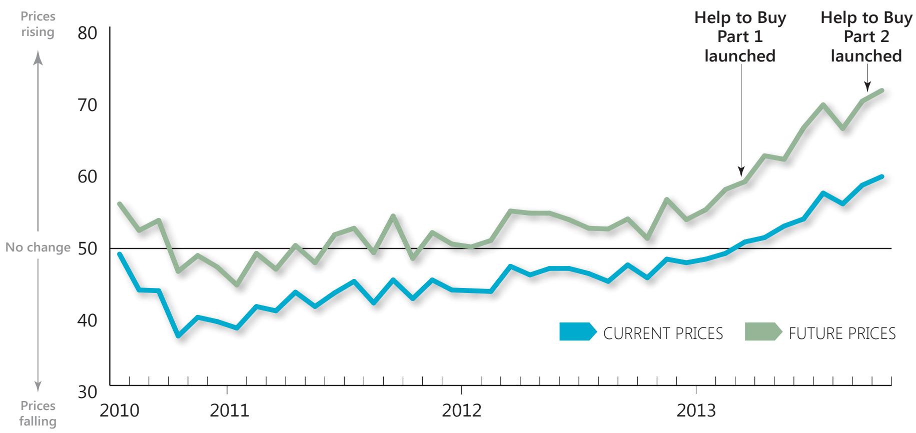
Help to Buy has certainly provided a boost to the market, but it is worth noting that the general economic outlook has also brightened considerably this year, contributing to rising confidence levels in the market. Household sentiment, as shown in the House Price Sentiment Index (figure 2) has picked up sharply, and there is increasingly positive news on employment and activity across the services and manufacturing sectors.

In addition, Mark Carney, the Governor of the Bank of England, gave reassurance that the short-term outlook for interest rates was benign, with his "forward guidance" – the first time the central bank has been so explicit about the future movement of interest rates.

It was noticeable that demand for mortgages picked up strongly in the late summer, even before the second, and major, part of the Help to Buy scheme was launched, indicating that the brighter outlook on the economy, as well as the anticipation of Government support was boosting the market.

The second phase of Help to Buy will ease access to the market for a wider group of

FIGURE 2
House price sentiment index



Source: Knight Frank/Markit

would-be purchasers, as well as making it easier for homeowners with low levels of equity to move home. This will loosen chains in the market, and help transactions which will propel the country towards a more fully functioning market.

Price outlook

We expect positive price growth across the UK next year – although with regional variations. While average house price values will continue to rise over the next five years, we see the pace decelerating as the end date for both Help to Buy schemes approaches during 2015 as shown on pages 6-7. In addition, we note that Funding for Lending will also be drawing to a close in 2015, and concerns about rising interest rates will likely gather pace.

We expect strong domestic and international demand to continue to support price growth in central London. Yet the dynamics of the London market have started to change. Rather than price growth being led by prime central London, as has been the case for several years, there will instead be a "doughnut" effect, as prices in the 29 boroughs surrounding the prime London core begin to accelerate at a faster pace.

This new trend will largely be driven by domestic demand, responding to the relatively brighter economic outlook for London compared to the UK, and the knock-on effect on job creation. The UK's capital is, to a large extent, the engine powering the country's drive out of recession. The sheer demand to live in or around London, coupled with the lack of supply in the Greater London area, will underpin this price growth.

The wider UK market remains highly localised, with those regions closer to London performing more strongly thanks to their economic connections to the capital. This is not to say that homes in the north of England will not experience some growth in prices in the coming years. We forecast that prices in the North East and North West will bounce back by 6.7% and 7% respectively in 2014, while the East Midlands will see price rises of 7.3%.

Without a dramatic increase in construction, we see the structural undersupply of housing in the UK as a factor underpinning prices. A "splurge" on supply would certainly help to bring market fundamentals back in line with long-term trends. But while housebuilders and developers have increased their development activity over the past year, it is very unlikely that this modest level of improvement will have any significant impact on pricing in the next few years.

The UK's ultra-low base rate has certainly put a floor under prices since the financial crisis, making mortgage payments more affordable and creating an environment where repossessions have been very low. Credit has now become cheaper, thanks to Funding for Lending, and easier to access, thanks to the Government's Help to Buy scheme. We expect these government interventions to have a positive impact on sales volumes in the coming years, although we anticipate a temporary deterioration in transactions after the Help to Buy scheme ends in 2016.

In terms of prices, we see price growth slowing towards the scheduled end of these government schemes, as the market anticipates the gradual withdrawal of this mortgage stimulus.

By 2016 the economy ought to be on a stronger footing, with rising employment and rising real incomes. This will help the transition to a largely stimulus-free market, but we remain of the view that the UK will see a period of more modest nominal price rises after 2016.

HELP TO BUY: IN DETAIL

The first part of the Help to Buy scheme, the Equity Loan, has been popular since it was launched in April. Some 15,410 buyers have already used the loan to augment their deposits for a new-build home.

If take-up for the scheme continues to proceed at this pace, funding will run out in mid- 2015, before the scheme is due to end in early 2016. Our forecast assumes the government will provide additional funding to maintain the scheme through to the scheduled end date.

The effect on the new-build market has been noticeable. Our research points to the number of planning applications submitted for private homes, in schemes with 50 or more units, rising by 30% year-on-year over the summer. Of course the National Policy Planning Framework (NPPF) is also playing a part in this uplift.

The second part of Help to Buy, the Mortgage Guarantee, was launched three months earlier than planned by George Osborne. A month in, around 2,800 buyers have submitted offers for homes, around three-quarters of these being first-time buyers. The average purchase price has been £163,000. If this trend were to continue, the number of mortgages which could be approved under the scheme could be as high as 1.5 million, boosting current transaction levels by 75% a year, and taking sales volumes back to levels seen back in 2005.

However, the full range of mortgage products for the second part of Help to Buy are not yet available. This is important, as part of the Treasury's thinking behind the scheme is that as more lenders offer mortgage deals for buyers with 5% deposits, natural competition will drive down rates, making such loans more affordable on a repayment basis, and cutting the large margin between these loans and those for borrowers with larger deposit.

Yet there are many eyes focused on this scheme, not least those of the Treasury Select Committee and the Bank of England. Indeed the central Bank's Financial Policy Committee will be able to tweak Help to Buy if house prices are judged to be rising faster than fundamentals should allow, which would certainly affect take-up rates for the scheme.

Knight Frank 2014 forecast assumptions

Our forecast is made with a number of key economic and policy assumptions in place:

- Help to Buy Equity Loan scheme ends in April 2016 as scheduled
- Help to Buy Mortgage Guarantee ends in 2016/early 2017 as scheduled
- UK base rate does not rise unexpectedly or sharply, with the first rise coming late 2015/2016
- UK economic growth continues to recover (in line with Oxford Economics forecasts)
- No adjustments to Help to Buy by Bank of England Financial Policy Committee

Prime market

Prime central London property has outperformed since 2009, but will begin to lose ground compared to the mainstream market over the next few years, while the country house market will begin to strengthen.

Prices in prime central London have risen by more than 60% since their post crash low in March 2009, and now stand well above their pre-crash peak in early 2008. Despite increases in stamp duty on high-value property, and the talk of more tax reform in the future, the market has continued to deliver strong returns through 2013.

Our view is that price growth will continue in prime central London in 2014, however we believe growth is likely to stall in 2015 due to market uncertainty in the run up to the UK general election. Following the election, our longer term view is that price growth in prime central London will run ahead of inflation, leading to nominal as well as real price growth. Within the market however, we are not ruling out the possibilities for local outperformance, especially in areas where there is structural change to the market. One good example of this is Crossrail. As the opening of the high-speed service approaches, we forsee prices in and around central London stations gaining extra momentum.

Our forecast for prime outer London, covering prime south-west London, prime north London and prime east London, is that pricing here will outperform the central London market in 2014 and 2015, and again will see nominal as well as real price growth from 2016.

Over recent years the country house market has underperformed the London market by some margin, and until 2013 saw price falls. The ripple effect we have referred to elsewhere in this document is likely to contribute to stronger price growth for the country house market in 2014 and beyond, in line with our regional forecasts.

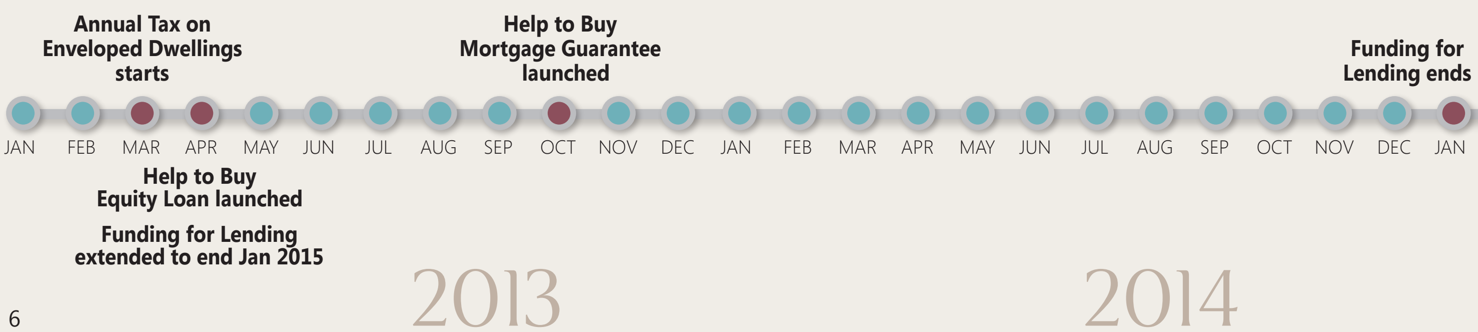
Within all prime markets, we expect that the divergence in price performance depending on price bands will continue. As well as disparity between price movements across the regions, we have observed in recent months that the disparity between the markets in the sub-£2 million price bands and the £5m+ bands has been widening, both in London and the country. The 7% charge for stamp duty on homes worth more than £2m has boosted the popularity of homes below this price threshold, and it is these sales which will continue to drive the prime market in the coming year or two.

FIGURE 3
Annual price growth forecast, Q4 2013 (based on Nationwide house price index)

	ACTUAL					FORECAST						
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2014 – end of 2018 (cumulative growth)
UK	-14.7%	3.4%	0.5%	1.2%	-2.0%	7.0%	7.0%	5.0%	4.0%	3.0%	3.0%	24.0%
Prime central London	-16.9%	6.1%	10.3%	12.1%	8.0%	6.5%	4.0%	0.0%	5.0%	5.0%	5.0%	20.0%
Prime outer London	-12.7%	11.2%	6.1%	1.2%	3.5%	9.3%	7.0%	2.0%	4.0%	4.0%	4.0%	23.0%

Source: Knight Frank Residential Research

TIMELINE OF FACTORS AFFECTING HOUSING MARKET:



Rental market

Rents across the UK have been rising since 2010, albeit at a more modest pace since early 2012. But we see room for rental inflation as earnings growth starts to gain momentum across the UK in the coming years.

There has been speculation that the support offered under Help to Buy could have a significant negative effect on the rental market. While taxpayer subsidies for mortgages may weigh on rental demand and rental growth in some areas over the next two years, high demand for rental property, especially in and around the main urban centres, will mean continued growth in the sector.

Rising interest rates will put some further upward pressure on rents from 2015-16, as affordability levels for homeownership are eroded. Our view is that rental growth from 2016 may start to outpace house price growth, driving yields, and attracting additional buy-to-let investment.

The private rented sector has doubled in size across the UK since 2001, and now accounts for close to 5 million dwellings, or 17% of total housing stock. If this trend continues, the size of the sector will swell to 6 million in 2017.

The sector itself is also likely to develop in the next five years, with a step-up in the delivery of specifically designed rental blocks, in contrast to much of the existing stock which is primarily aimed at owner-occupiers. These new blocks, backed by institutional investment, will be more akin to the new modern purpose-build student property accommodation being built in university towns than many rental flats currently on the market; the apartments are designed specifically for rental accommodation and will come with a range of amenities attractive to tenants. The delivery of large-scale private rented units will help boost housing supply, and cement the rental sector as a major part of the UK's housing stock.

In central London, prime rents have underperformed the national average, with an overall decline of 1.7% in the 12 months to October 2013. The weakness of the financial sector in 2011 and 2012 has been the main cause of this downward movement of rents. Our view is that rents will begin to rise modestly in prime central London in 2014, as renewed job creation an optimism, especially in the City, creates increased demand from tenants.

FIGURE 5
UK dwellings

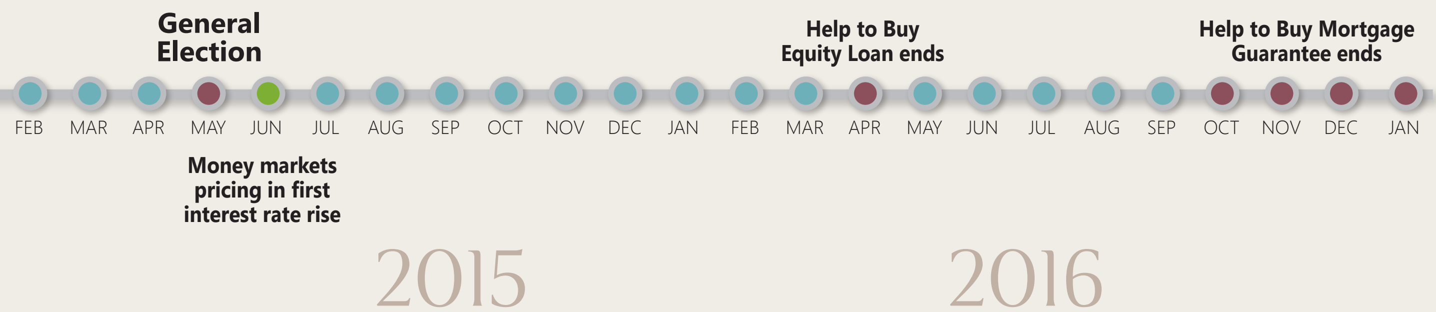
Owner occupied	65%
Privately rented	17%
Rented from Registered Provider (eg Housing Association)	10%
Rented from Local Authority	8%

Source: DCLG

FIGURE 4
Prime London annual rental forecast, Q4 2013

	2013	2014	2015	2016	2017	2018	2014 – end of 2018 (cumulative growth)
UK	2.5%	2.0%	2.5%	3.5%	3.5%	3.5%	16.0%
Prime central London	-2.5%	2.0%	3.0%	3.5%	4.0%	4.0%	18.0%
Prime outer London	-0.3%	2.0%	3.0%	3.5%	3.8%	3.8%	17.0%

Source: Knight Frank Residential Research



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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 five key macro risks and their impact on different sectors of the UK housing market.

		Ranking of risks by sub-market, where 1 represents the largest risk		
RISK	DOWNSIDE SCENARIO AND IMPACT	MAINSTREAM UK	PRIME UK*	PRIME LONDON**
Interest rates	The Bank of England raises the bank rate earlier than expected, and continues to increase the rate faster than anticipated	1	1	3
Sterling	The pound strengthens sharply against international currencies	4	4	2
Eurozone crisis	Another tremor in the Eurozone prompts a break-up of the Eurozone, and shakes global markets	3	2	2
Mortgage lending	Banks rein back mortgage lending as they come under more pressure over capital requirements	2	2	3
Economy	The UK economic recovery fails to gain momentum	1	1	2

*£1m+ in South East, £750,000+ elsewhere
**£1m+ in Greater London, £2m+ in prime central London
Source: Knight Frank Residential Research

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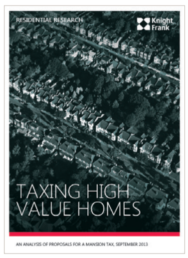

Taxation of Prime Property Report 2013

London Review Autumn 2013

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