RESIDENTIAL RESEARCH

Knight Frank

UK RESIDENTIAL FORECAST & RISK MONITOR

Q4 2014

UK AND REGIONAL PRICE FORECASTS | PRIME MARKET ANALYSIS | COMPREHENSIVE DATA AND COMMENTARY

PRE-ELECTION SLOWDOWN

In this edition of our Residential Market Forecast we set out our latest views on the outlook for the UK, prime London and prime regional markets; while in a new Risk Monitor feature we provide a high-level summary of the key issues set to influence market performance.

KEY FINDINGS

Average UK house prices will rise 3.5% in 2015

Cumulative growth in UK prices will total 18.2% in the five years to the end of 2019

While prices in prime central London will remain unchanged in 2015, cumulative growth will total 22.1% by end of 2019

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

Interest rate rises and the risk of a renewed economic slowdown represent the biggest risks to the UK housing market

LIAM BAILEY
Global Head of Research

"The General Election has the potential to influence the housing market significantly."

Last October we took the view that 2014 would see a widening of the residential upturn, which up to that point had been limited to London. While we expected London to continue to lead the market, we also expected annual price growth in the UK, which had lagged since 2009, to spike higher.

Our forecast that the UK would see 7% growth in 2014 appears so far to be prescient. Our view that Greater London price growth would peak in 2014, again appears likely to be vindicated.

One area we perhaps underestimated was the continuing momentum of the prime central London market, in particular the growing influence of the UK buyer on the back of improving domestic economic conditions. While we were right to anticipate a slowdown from the levels of growth seen in 2013, end of year growth in 2014 is likely to be closer to 6% rather than the 4% we pencilled in.

Assessing market risk

Looking ahead to 2015, the UK's General Election obviously has the potential to influence the direction of the housing market significantly, especially in central London. With the polls too close to call, we have not assumed a particular outcome for next year's election. Our forecast does not allow, for example, for the impact of a mansion tax, new rent caps or other similar political "innovations".

Instead, we have considered the potential risk from these and other issues in our new Risk Monitor (see pages 6 and 7). The development of our monitor follows regular requests from clients keen to understand the key issues we are tracking, and to understand how our thinking is evolving over time.

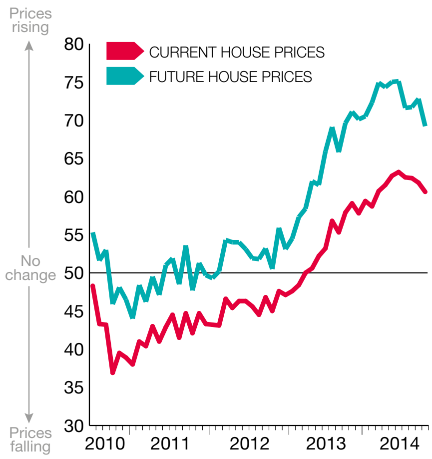
We have provided our assessment of the key risks to the UK's residential markets – and have ranked them in terms of, firstly, the likelihood of the event and, secondly, the severity of the risk to the market should the event occur.

Admittedly, while the definition of risk rather depends on your viewpoint, for a first-time buyer falling prices can be viewed as an opportunity, our reference point is deliberately narrow – the risk that house prices could underperform our central forecast scenario.

We stated last year that positive price growth was set to become a national story, with the ripple from London a well-established trend. We noted at the time that there was a flip-side to this development. Strengthening price growth in the short term would act to limit longer term growth.

We remain of the view that pricing in the UK is high in historic terms and affordability constraints will limit future price growth, especially as we move into a more normal period for price growth. However, with the UK economic recovery continuing to gain traction and with positive real wage growth increasingly likely over the next five years we believe there is scope for sustained price and rental growth beyond 2015.

FIGURE1
Sentiment moderating
Expectations for current and future house prices



Source: Knight Frank/Markit

FORECAST – MAINSTREAM MARKETS

The momentum in price growth and transactions seen in the last 12-18 months across England and Wales has started to slow. Gráinne Gilmore examines the outlook for the market.

The ultra-low base rate in recent years has acted as an accelerant on demand, especially among home-movers and buyers who have amassed a deposit and can lock into low-rate fixed mortgages, ensuring their monthly payments will not rise for two or five years or even longer.

This rising appetite for property comes against the continuing shortage of new housing stock in the UK, putting strong upward pressure on prices in some areas. This has been especially evident in London, where both the fundamental lack of supply of new homes and a lack of existing stock on the market have combined to deliver large double-digit annual growth in prices in some local authorities just outside the central areas.

Construction activity has picked up markedly over the last year, but we still see a large shortfall in the delivery of new homes in the coming years, and this will continue to be a support to pricing in the UK.

The pick-up in sales activity has been notable over the last year, with the number of transactions across the UK rising by nearly a third to 1,211,560 in the year to August 2014, compared to the previous 12 months, indicating progress back to a fully functioning market.

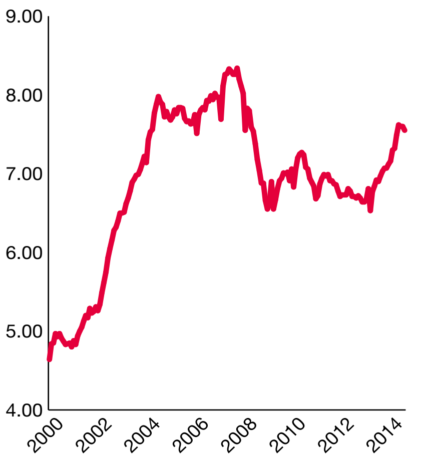
Price growth has not only gained momentum over the last 12 months, but is more widespread across the country than this time last year, when London and the South East accounted for a large proportion of growth. The market still remains highly regionalised however, with a notable range of price growth.

The extension of the Help to Buy Equity Loan to 2020 has removed a possible drag on activity in 2016, when it was initially slated to end. The Help to Buy scheme is not only helping new buyers climb onto the ladder but also stimulating supply, although this new source of housing is unlikely to make a significant impact on the large shortfall of new housing, and so will do little to effect UK house prices over this timeframe.

Although the economy has outperformed expectations this year, and unemployment has fallen dramatically faster than expected, there are still some hurdles for the market over the next year, not least rising interest rates, which have already started to have an impact on pricing.

While we expect the Bank of England will increase the base rate at a slow and steady pace (see risk monitor pages 6&7), the reality of higher repayments for borrowers with variable rate deals, or for new borrowers, after more than five and half years of ultra-accommodative monetary policy could take some time to settle in the market.

FIGURE 2
House price to earnings ratio
(England and Wales)



Source: Knight Frank Residential Research

In addition, some brakes have been applied to the market in recent months, including the new, stricter mortgage lending rules introduced under the Mortgage Market Review (MMR) in April. These have made securing a home loan more onerous, and have curbed lending to some potential buyers.

Additional policy tools, including limits on high loan to income mortgage lending could have a disproportionate effect in the London market, while the Bank of England's request for more powers to further intervene on loan to value ratios and debt to income ratios for banks and building societies could further impinge on mortgage lending. While such central bank guidance is not necessarily negative for the long-term health of the housing market, it could weigh on prices to some extent in the short term.

A final factor to consider is the growing gap between average incomes and house prices in some areas which is starting to act as a natural curb on prices (figure 2).

The pace of price growth has eased in the last few months, and we expect a continued slowdown in headline growth over the coming year.

Our monthly House Price Sentiment Index, produced with Markit Economics, which is a bellwether for property price movements across the UK, has indicated a slowdown in price growth from June this year, as shown on page 2.

We forecast that house prices will rise by an average of 3.5% in 2015 across England and Wales , with outperformance in some regions. In the five years to the end of 2019, we forecast cumulative nominal growth of 18.2%. This indicates growth of 12% in real terms.

Rental markets

The growth of the rental market as a form of tenure will continue. The advent of large-scale investment in build-to-rent could start to lift the quality of rental accommodation, especially in city centre markets which could result in outperformance over our mainstream rental forecasts.

We expect rents to continue their upward trajectory as demand for rental accommodation grows. The prospective new powers for the Bank of England's Financial Policy Committee (FPC) to limit mortgage lending to those with a high debt to income ratio could extend the typical period of time spent by tenants in the private rented sector, especially younger prospective renters who will be starting to leave University next summer owing a full £27,000 in tuition fees.

GOING STEADY IN PRIME LONDON

Price growth in the next five years will be less headline-grabbing than the last five, says Tom Bill

Next May's general election has dominated the fortunes of the prime central London sales market in 2014.

The prospect of a mansion tax has contributed towards slowing demand, though annual price growth has not deviated far from an average of 7.9% over the last two years.

Our view is that will change next year, when we forecast zero growth.

If the threat of a mansion tax recedes, some degree of recovery is likely in the second half of 2015, as pent-up demand is released. To what extent the tax would be absorbed by the market if introduced is currently difficult to assess given the lack of detail.

Whatever the outcome of the election, our view is that growth will be less marked over the next five years than the last five, when prime central London's safe-haven appeal during the financial crisis contributed to a cumulative rise of 61%.

We forecast 4.5% growth in 2016 with a steady rise towards 6% in 2019, underpinned by the fact demand will continue to exceed supply.

However, there will be areas of outperformance, which could be particularly marked away from traditional prime markets as demand becomes increasingly focussed on the quality of the property and amenities and not simply the postcode.

Such overlooked residential markets include Bayswater, Fitzrovia and Midtown. Meanwhile, a series of developments around the City and fringe areas like Shoreditch is likely to keep above-average upwards pressure on prices in this evolving prime market.

The effect of this focus on property and amenities is demonstrated in Mayfair, where a high-quality new-build development pipeline means record prices are likely to be set over the next several years in what is an established super-prime market.

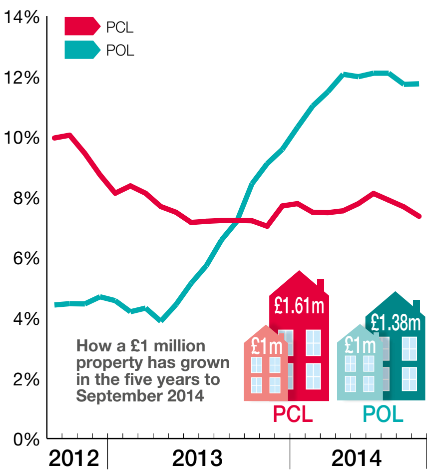
Elsewhere in 2014, there was double-digit annual growth in the area north of Hyde Park that extends from Notting Hill in the west to Islington in the east as buyers sought more value away from traditional markets. It suggests growth here is likely to outperform the average and a recent rise in demand for property near Regent's Park should continue.

Infrastructure will continue to play a key role and our view is that property located close to Crossrail stations will continue to outperform local markets.

The effect will be felt in east London, underpinned by a number of new schemes that will cement the area's reputation as a prime residential market.

FIGURE 3

The crossover: Annual price growth in prime London



Source: Knight Frank Residential Research

Our view is that cumulative price growth in prime outer London between 2015 and 2019 will exceed prime central London, largely because the UK economic recovery will drive price growth outwards from central London and benefit residential markets such as south-west London, where prices will also be underpinned by UK and European buyers seeking better value beyond prime central London.

Next year we forecast growth of 3% in prime outer London due to the dampening impact of the general election and an interest rate rise, growing to 5.5% in 2016 with steady growth of 5% in the three subsequent years.

Rental values in prime central London returned to growth at the start of 2014 as the UK economic recovery took hold. The number of tenancies agreed rose 48% in the first nine months of the year compared to 2013 and annual growth is nearing 2%.

In addition to this positive momentum, the rental market is likely to see a short-term gain from the sense of uncertainty that will moderate demand in the sales market in the run-up to the general election.

In the longer-term, rental value growth should accompany the recovery taking place in the economy as companies hire more staff and, in particular, the financial services sector recovers.

The prime London lettings market will also benefit from the city's young and growing tech workforce and an increased openness to renting after strong growth in the sales market.

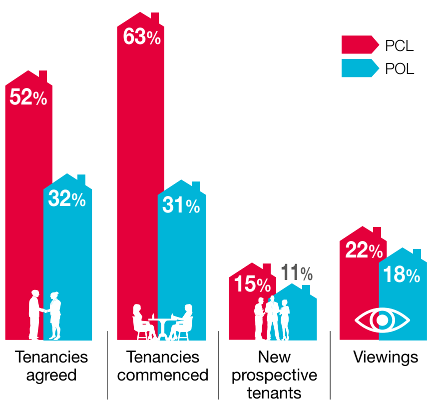
As with the sales market, rental values will be supported by a series of high-quality schemes in prime central London. A similar effect is likely in areas of prime outer London where institutional investors are becoming more active in the private rented sector.

We forecast cumulative rental value growth of 17% in both prime central and prime outer London between 2015 and 2019.

FIGURE 4

The rental recovery: growth in prime London over last two years

(Jan to Sept 2014 vs Jan to Sept 2013)

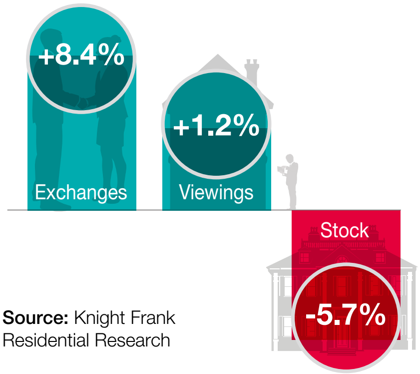


Source: Knight Frank Residential Research

MIND THE PRICE GAP

Prime country house prices have risen by 4.7% since last summer, but modest growth next year will ensure the value hunters another good year. Oliver Knight explains

FIGURE 5 **Ups and downs in the prime country market** (July-Sept 2014)



Source: Knight Frank Residential Research

While all prime markets are now seeing positive annual price growth, there are still noteworthy regional variations. In the South West, for example, prime prices have risen by 7.7% over the past year, while in the East Midlands growth was 3.3%.

Prime markets in the south have been boosted by the rise in property values in London and the surrounding commuter towns as well as an increase in the number of Londoners taking advantage of record prices in the capital and moving to the country, which many see as offering good value for money.

To illustrate this point, if you were planning to sell a £2m property in London in early 2009 and buy a property for a similar price in the country, a delay of five years until now would mean the London property is worth £3.4m and the equivalent country property £2.1m, leaving a £1.3m margin for reinvestment. This price differential is likely to result in more money moving from London to the prime markets in the country in 2015.

However, uncertainty about the outcome of the election, concerns over the introduction of a mansion tax and impending interest rate rises will weigh on activity in 2015 (see risk monitor), especially in the first six months of the year. Ultimately, these factors could determine whether there is a subsequent jump in country house values in the second half of 2015 or a slight fall followed by a slower return to growth.

It is difficult to assess what impact a tax on high value residential property would have on the market given the lack of detail about how it would be applied and collected.

Assuming there are no further changes to the taxation of high value property, our outlook for the prime sector next year is positive, although given the factors we have outlined price growth is likely to be slower than in 2014.

We forecast price growth of 2% in 2015 across the prime country market, with outperformance in some regions.

Homes located in town and city markets will see above average price growth driven by demand from those relocating from London and downsizers. Markets within commutable distance of the capital will also outperform. We are forecasting that price growth for prime properties in the South East, South West and East of England will outpace local mainstream markets as values are boosted further by the "ripple effect" from London.

Homes valued under £2m, less affected by talk of potential tax changes, will also grow at a faster pace than those valued above this level in 2015.

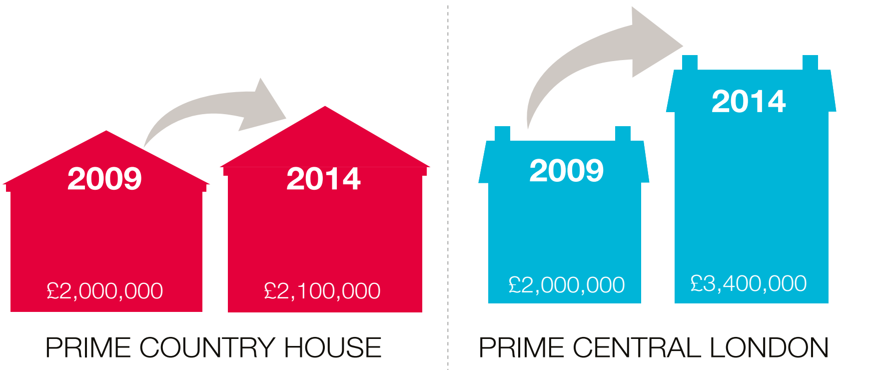
"NO" VOTE TO BOOST SCOTLAND'S PRIME MARKET

Following a brief period of uncertainty in the run up to the referendum on Scottish Independence the certainty provided by a **'No' vote, ensuring Scotland remains part of the United Kingdom,** has allowed the prime property market to return to more normal trading conditions.

We expect to see an increase in the number of transactions at all levels of the market as buyers and sellers, who may have put off making decisions until after the vote, return to the market. Activity will be greatest in key cities including Edinburgh, Aberdeen and Glasgow as well as in the rural counties which make up their commuter belts.

But there are hurdles on the horizon which have the potential to curtail growth in the prime market. A new Land and Buildings Transaction Tax, replacing the current Stamp Duty levy, comes into effect in April 2015 and will mean that buyers of more expensive homes will have to stump up more tax up-front when purchasing a property which could impact activity, especially in the short term following its introduction.

FIGURE 6 **Mind the 'price' gap**
How much would a £2m property purchased in 2009 be worth today?



Source: Knight Frank Residential Research

RISK MONITOR

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 10 (high).

Our measure of risk is deliberately narrow – namely the risk that house prices could under perform our central forecast scenario, published on page 8.

RISK	SCENARIO	IMPACT	UK			PRIME LONDON		
			LIKELIHOOD	IMPACT	RISK SCORE	LIKELIHOOD	IMPACT	RISK SCORE
INTEREST RATES	The UK bank base rate rises more rapidly than expected	Our expectation is that the Bank of England base rate will rise to hit 1% by Q4 2015, and 1.75% by Q4 2016. A more rapid rise would quickly translate into higher mortgage rates, putting pressure on current borrowers, and potentially reducing the ability of new buyers to finance property purchases at current pricing levels. Higher mortgage rates could feed through to an increase in repossessions, (numbers of which remained unusually low throughout the recent housing market downturn) leading to an increase in supply of available property. Rising rates are likely to make alternative investments more attractive, and could prompt investors to look less favourably on low yielding property investments.	2	5	7	2	4	6
ECONOMIC GROWTH	The UK economy stumbles on the back of weaker global activity	The UK economy continues to outperform most developed markets. One of the key risks to ongoing growth is a renewed period weakness in the global economy. In the Eurozone deflation is becoming a more potent issue and has the potential to create renewed recession conditions there. Outside of Europe, emerging markets, including China, have seen a reversal to economic conditions since 2013, which together with the ongoing withdrawal of US QE could act to reinforce this situation. The growing Middle East crisis, centred on Syria, could easily damage global economic conditions by pushing oil prices higher, and disrupting world trade.	3	3	6	3	3	6
MACRO PRUDENTIAL POLICY TOOLS	The Bank of England imposes overly restrictive mortgage lending policies in the UK	The Bank of England is leading a push towards greater use of macro prudential measures to help manage risk in the UK housing market. Thus far these efforts have mainly been expressed as regulations limiting high loan to income lending. But the Financial Policy Committee is seeking direct powers to intervene in the market to control loan to value ratios and debt to income ratios. There is no sign yet that the Bank, upon receiving these powers, will use them, but the move could weigh on mortgage availability as lenders become more cautious. We believe the short term risk to the market, that regulations are drawn too tightly and applied to widely, is off-set by the benefits of longer term market stability.	1	4	5	1	3	4
NEW BUILD SUPPLY	Rising new-build completions move housing supply ahead of demand	Outside London and a few, very specific, regional markets this is a non-issue in our view at the current time. In most areas of the UK the real issue is under-supply, which has been helping underpin price growth. In London however, and especially the key development hubs around the edge of central London, this issue is worth watching. We remain of the view that at a macro level it is almost impossible to imagine new-build delivery ever outpacing demand for housing in London. The real question is over the ability of developers to maintain their target prices as competition rises in adjacent developments – this points to risks of localised over-supply in some price bands which could weigh on prices, and potentially spread to secondary markets. In our view the relationship between rental yields and rising interest rates will be critical in this scenario.	1	3	4	3	3	6
WEALTH TAXES	Introduction of new taxes on high-earners and high-value property following the 2015 election	There are clear signs that the Labour party, and potentially the Lib-Dems, will include pledges for the reintroduction of the 50% income tax rate, higher non-dom levies and some form of "mansion tax" in their upcoming election manifestos. The most immediate risk will be faced by the central London market as a result of a "mansion tax", however without firm details on rates and exemptions – we can only guess at the likely impact on pricing. Recent announcements from the Lib-Dems appear to point towards a softening of their stance on a mansion tax, in favour of a partial reform of the existing council tax.	2	2	4	2	4	6

Source: Knight Frank Residential Research

10 9 8 7 6 5 4 3 2 1

HIGHEST RISK … LOWEST RISK

RISK	SCENARIO	IMPACT	UK			PRIME LONDON		
			LIKELIHOOD	IMPACT	RISK SCORE	LIKELIHOOD	IMPACT	RISK SCORE
EXCHANGE RATE	The pound strengthens appreciably 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. A strengthening in the pound much above this level would begin to weaken the attraction of UK property for investors, and could begin to encourage profit taking from those overseas purchasers who locked in especially favourable rates in either 2009 or 2010. London would be most affected by this process, ironically the UK regions could begin to see stronger demand from overseas buyers who are committed to the UK but find the combination of high London prices and a strong pound too much to bear.	2	1	3	2	4	6
CRIMEA CRISIS	Worsening crisis in Crimea leads to severe EU sanctions and weaker rouble	Restrictions on Russian investment and overseas assets have so far focussed on a tightly drawn group of named individuals. Without a noticeable increase in the scale of the crisis it is difficult to see how this will expand to more general restrictions. The prime London market would face some risk from this scenario – if the EU were to impose draconian restrictions on a much wider group of Russian investors, which would be likely to compound the recent strengthening of the pound which has risen more than 15% against the rouble since the beginning of 2014. However with Russian purchasers well invested in the London market, and only accounting for 7% of £1m+ transaction in London (12 months to September 2014), the impact is likely to be limited.	2	1	3	2	2	4
QUANTITATIVE EASING (QE) TAPERING	Global QE withdrawn too quickly	Global QE programmes aided property prices by supporting the shift towards lower long-term interest rates. At the same time the process helped to drive alternative asset yields lower and boosted the popularity of property investments. The unwinding of programmes will reduce long term downward pressure on interest rates and will blunt longer term asset price growth. The real risk is that the programmes are ended, and even reversed too rapidly. With the global economic recovery far from assured this seems unlikely.	1	2	3	1	2	3
RENT CONTROLS	New rent controls and mandatory fixed-term tenancies are introduced following the 2015 election	The initial announcement from the Labour Party that they were in favour of a reintroduction of rent controls, and also mandatory fixed term tenancies, does not appear to have been followed up with detailed policy formulation. If these ideas are followed through after the election, while there could well be a sell off of rental stock, a widely expected side-effect would be an immediate hike in rents. In the longer-term, the restriction of rental growth could weigh on capital values – for example the growth in the embryonic institutional private rental sector could slow, impacting on construction and supply of new housing, helping to push prices higher.	1	2	3	1	2	3
RESTRICTIONS ON FOREIGN BUYERS	New rules impacting on non-residents attempting to buy property in the UK	Price growth in the central London market has been boosted by inward investment from overseas buyers. Policies aimed at limiting demand from overseas have in recent years focussed on levelling the playing field between resident and non-resident purchasers, (for example the removal of the CGT exemption for non-resident purchasers), and reducing the attraction of holding property in a corporate (or similar) envelope (as shown by the introduction of the ATED). There have been muted calls for more draconian restrictions, however due to the global and open nature of the UK and especially London market, more substantial changes appear low risk.	1	1	2	1	3	4

Knight Frank Residential Market Forecast Q4 2014

	2014	2015	2016	2017	2018	2019	2015-2019
Mainstream residential sales markets							
UK	8.5%	3.5%	2.5%	3.0%	4.0%	4.0%	18.2%
London	15.4%	3.5%	4.0%	5.0%	5.5%	5.5%	25.8%
South east	12.5%	5.0%	3.0%	3.5%	5.0%	5.0%	23.4%
South west	9.5%	4.0%	2.5%	3.0%	4.5%	4.0%	19.3%
Eastern	13.5%	4.5%	3.0%	3.5%	4.5%	5.0%	22.2%
East Midlands	8.5%	3.5%	2.0%	2.5%	4.0%	4.0%	17.0%
West Midlands	8.5%	3.5%	2.0%	2.5%	4.0%	4.0%	17.0%
North east	6.0%	3.0%	2.0%	2.0%	3.0%	3.5%	14.2%
North west	7.0%	3.0%	1.5%	2.0%	3.5%	3.5%	14.2%
Yorkshire & Humber	4.0%	3.0%	2.0%	2.0%	3.5%	3.5%	14.8%
Wales	4.0%	3.0%	2.0%	2.5%	4.0%	4.0%	16.5%
Scotland	5.0%	3.5%	2.5%	3.0%	4.0%	4.0%	18.2%
Prime residential sales markets							
Prime Central London	6.7%	0.0%	4.5%	5.0%	5.0%	6.0%	22.1%
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%

Macro-economic drivers (full year / end of year forecasts)	2014	2015	2016	2017	2018	Source
GDP	2.9%	2.5%	2.4%	2.4%	2.4%	*
CPI	1.8%	1.9%	2.0%	2.1%	2.1%	*
Unemployment Rate	6.3%	5.9%	5.6%	5.6%	5.4%	*
UK Base Rate	0.5%	0.9%	1.6%	2.2%	2.7%	*
Average earnings	2.5%	3.2%	3.6%	3.7%	3.8%	**
£ / $	$1.67	$1.67				***

Source: Knight Frank Residential Research
*HM Treasury Independent Forecasts ** Office for Budget Responsibility ***OECD

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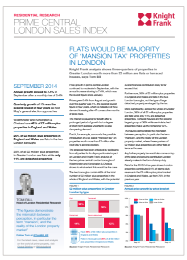
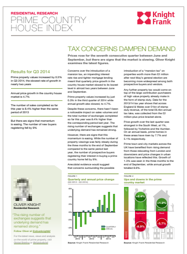


Prime Central London Sales Index Sept 2014

Prime Central London Rental Index Sept 2014

UK Residential Market Update Sept 2014



Prime Country House Index Q3 2014

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