March 2012

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RESIDENTIAL MARKET UPDATE

Knight Frank

Budget time

It is a key month for housing policy with the end of stamp duty relief for first-time buyers, the start of the Mortgage Guarantee scheme and finally, the Chancellor's verdict on property tax

Key figures

UK house prices rose by 0.6% in February and are up 0.9% year on year

Prime central London prices rose by 0.7% in February and annual growth is 11.6%

Sales activity in prime central London has risen by 85% in the year to February

The 'mansion tax' debate rages ahead of the budget on March 21st

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UK housing market and economic overview

House prices rose by 0.6% in February, but this positive movement was hardly enough to offset the 0.2% fall in January and the 0.3% decline in December. The Nationwide data also showed that prices are up 0.9% year on year, but this masks a 3.5% decline since July last year.

The trend over the last three years in the wider UK market has been one of stagnating or mildly falling prices, but the situation in prime central London (PCL) has been the opposite, with prices on an upward trajectory. This continued in February, with prices for luxury London property hitting new highs.

As the Government and the country gear up for the Budget on March 21st, the subject on everyone's lips is tax. A debate has been raging for the last month on whether the Chancellor will introduce an additional **tax on property.** There is increasing pressure from the Liberal Democrats to introduce some form of wealth tax and reports suggest that such a scheme may be used as a bargaining chip in negotiations with the Conservatives in return for repealing the 50% rate of income tax. But there are serious concerns that families living in more expensive properties, who simply do not have an income to match, would be penalised by such a move.

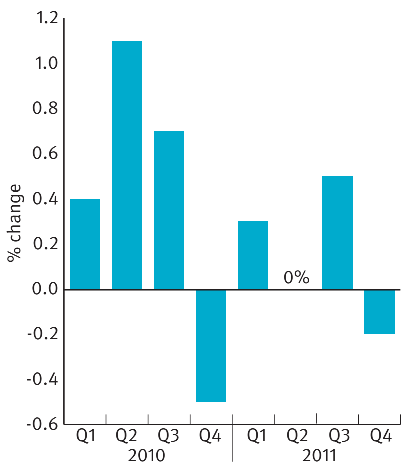
There are also other significant developments in the housing market on the cards this month, especially for home buyers. The **first-time buyer exemption for stamp duty** on purchases of homes worth up to £250,000 will come to an end on March 24th. But this comes after the introduction of the **NewBuy mortgage indemnity guarantee scheme,** under which housebuilders and the Government will underwrite some of the risk of purchasing a new home worth up to £500,000, allowing buyers to access mortgage loans worth up to 95% of the property's value.

The wider economic climate remains chilly. The eurozone crisis rumbles on, as Greece lurches from one political and economic summit to another. But here in the UK there have been some small signs of hope. While initial reports from the UK's dominant services sector showed a fall in the rate of growth, the UK Markit/CIPS services purchasing managers' index (PMI) also showed that UK business confidence rose to the

Figure 1

UK Economy: double dip on the cards?

UK GDP quarterly growth

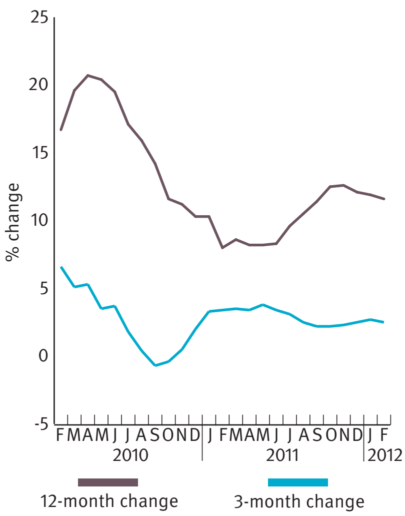


Source: ONS

Figure 2

Prime central London prices continue to rise

Prime central London average residential price change



Source: Knight Frank Residential Research

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> "AVERAGE PRICES IN PRIME CENTRAL LONDON ROSE BY 0.7% DURING THE MONTH, AND ARE NOW 11.6% HIGHER YEAR ON YEAR. PRICES ARE NEARLY 9% HIGHER THAN THEIR PREVIOUS PEAK IN MARCH 2008."

highest level in 12 months in February, no mean feat in such testing times.

The British Chambers of Commerce (BCC) also said that the country would avoid a double-dip recession this year, although it tempered this upbeat message by revising down its forecasts for the economy. It now expects GDP will rise by just 0.6% this year, down from a previous forecast of 0.8% growth.

But there are still stiff headwinds facing the **UK economy.** Unemployment continues to rise, and last month a leading ratings agency placed the UK's top-notch AAA sovereign credit rating on 'negative outlook', meaning there is a chance the credit rating could be cut, which would push up the country's cost of borrowing.

There are also rising fears over increased borrowing costs at a household level as some mortgage lenders have lifted their **standard variable mortgage rates** (SVRs) for existing borrowers, resulting in higher monthly mortgage bills. The SVR is the reversion rate that most fixed-term mortgages move on to after the deal comes to an end, and are usually linked to the base rate. Despite the Bank of England making no change to the 0.5% base rate, lenders are starting to raise the SVR anyway, setting a worrying precedent.

Prime market performance

Central London's prime property market continues to go from strength to strength. Activity levels have picked up markedly on the year, with sales subject to contract rising by more than 80% in the year to February. Average prices in prime central London rose by 0.7% during the month, and are now 11.6% higher year on year. Prices are nearly 9% higher than their previous peak in March 2008.

Yet examining the currency fluctuations since 2008 it is easy to see at least one of the factors making London such an attractive investment opportunity for overseas buyers. Those buying in US dollars can take advantage of a 15% discount compared to prices back in 2008 because of the weakness of the pound.

Overseas buyers now account for more than 50% of purchases in prime central London, with a notable rise in Italian buyers since the start of the year. We forecast that prices will rise by a further 5% this year.

Prime country house prices fell 3.1% in 2011, according to our latest quarterly data, while prices in Scotland prime market slipped by 3.2%.

Rental market

The increasingly fragile employment market, especially in the financial sector, has had an impact on rents in prime central London. Rents have fallen for several consecutive months, resulting in a quarterly decline of 0.4% in the three months to February. However demand in the market, especially in the lower price bands, has picked up, and declines in rents in this sector have been the most modest.

In the wider market, rents rose modestly in January, keeping the annual increase at just over 4%.

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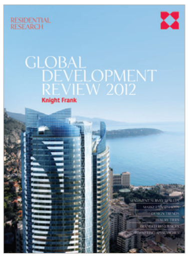

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