RESIDENTIAL RESEARCH

RESIDENTIAL MARKET UPDATE.

Knight Frank

MAY 2011

PRIME LONDON PROPERTY VALUES CLIMB AS MAINSTREAM MARKET STUTTERS.

"The positive performance of London house prices is filtering through into the surrounding areas, helping push up prices of prime country properties in the home counties. But the wider market continues to struggle, although the benign interest rate environment will provide some support."

Gráinne Gilmore, Head of UK Residential Research, Knight Frank

"Prices remain under pressure as mortgage lending is constrained, with disappointing mortgage lending figures from the Bank of England underlining the lack of credit available to would-be purchasers."

UK Housing market

House prices slipped by 0.2% in April, the biggest drop since November last year. This latest decline means that average property values have fallen by 1.3% year-on-year, the largest annual slide in nearly two years.

Prices remain under pressure as mortgage lending is constrained, with disappointing mortgage lending figures from the Bank of England underlining the lack of credit available to would-be purchasers.

Some 47,557 loans were approved by lenders for house purchase in March, according to the Bank's figures, and while this was up from 46,708 in February, it was below the 48,000 level expected by the markets.

Hopes that lenders may be starting to loosen their lending criteria, especially for first-time buyers, following the recent launch of an array of new deals for those with a five or ten per cent deposit, have been tempered by the onerous small-print on the loans.

Borrowers who have only a 5% deposit must have a guarantor for most deals, while those with a 10% deposit must pay hefty fees and interest rates up to 4 percentage points higher than some of the most competitive deals on the market.

Sluggish economic growth is also affecting confidence in the market. Recent official data showed that Gross Domestic Product (GDP) – the main measure of the country's economic health – rose by a smaller than expected 0.5% in the first quarter of the year, merely reversing the 0.5% decline seen in the final three months of last year.

The muted GDP figures, coupled with recent downbeat survey data from businesses across the UK, suggest that underlying economic growth stalled between January and March. This will give policymakers a headache as they embark on the planned public sector spending cuts.

Households are also feeling the strain as inflation continues to rise, standing at 4% in March, more than double the Bank's target rate of 2% inflation.

Despite the inflationary pressures, it is likely that fragile economic conditions will lead to a further period of benign interest rates, which will be positive for homeowners who have outstanding mortgages. The Bank of England's Monetary Policy Committee (MPC) voted this month to keep the base rate at a record low of 0.5% for the 26th consecutive month.

Our forecast for price falls of 6% across the UK this year incorporates the impact of the

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proposed public sector spending cuts and at least one base rate rise. If the Bank of England's MPC decides to keep rates on hold until into 2012, then price declines may be less pronounced.

Housing market activity

According to the latest RICS national housing market survey, stock volumes remained muted during March and buyer interest also stayed largely flat. The number of newly agreed sales also remained unchanged in March. Anecdotally there are indications that the long Easter and Royal Wedding weekends are being followed by a rise in buyer interest.

The rental market continues to perform strongly, with tenant demand outstripping supply across the country. This has helped push up rents in many regions, with London and the South East leading the way. Landlords are now receiving average yields of around 5%, which are expected to stay stable throughout the year.

With the owner-occupier market continuing to struggle, the rental market is becoming a more important sector over time, with evidence from the Council of Mortgage Lenders confirming that banks are becoming more willing to lend to established landlords, a positive development for the sector.

Prime market performance

Prime property in central London continues to buck the national trend, with sustained demand for the very best properties pushing up prices by 1.3% in March. This increase took the annual rise in prime property prices to 8.6%.

Average prices in this sector are now 30% higher than when the market troughed in March 2009, and are hovering just 1% below the market peak in 2008.

Demand from European and other overseas buyers is boosting the market. Nearly half of all sales of London £2m+ prime property were to foreign buyers in the first three months of the year. French and Italian buyers are at the forefront as they look to shelter their capital in a safe haven as the Eurozone crisis rumbles on.

This trend, coupled with a continued rise in demand from Asia, especially China, signals that the market will continue its relatively buoyant trend this year.

The robust prime central London market filtered through to country homes in the early part of this year, boosting prices as sellers of London property looked to invest in properties outside London, especially in the counties surrounding the capital.

Average selling prices of prime country homes rose by 0.5% between January and March, partly offsetting the falls seen in the second half of 2010.

But there were sharp regional divides. Houses in the South East and South West of England recorded the strongest growth while the average values of country homes in the North of England and Scotland slipped slightly.

Prices are expected to continue to trend upwards at a modest rate this year as a shortage of prime homes, especially in desirable areas such as Oxfordshire and the Cotswolds, shore up values.

Our view for the prime markets is that prices are likely to noticeably outperform the wider UK market, with price growth of 3% forecast for central London and the prime country market likely to remain unchanged across the year.

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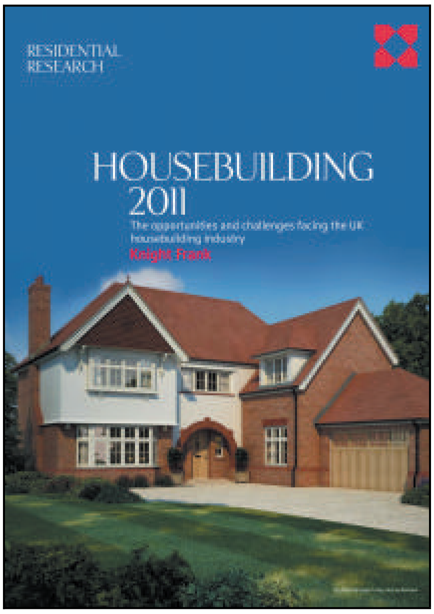

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