RESIDENTIAL RESEARCH

UK RESIDENTIAL MARKET FORECAST

SUBDUED OUTLOOK FOR PRICE GROWTH

While the UK economy and housing market have held up far better than expected following the Brexit vote, the outlook for both remains uncertain.

Both the London and wider UK housing markets outperformed expectations following the referendum. After a sharp dip in confidence just after the vote, conditions have improved into the autumn. On most measures the mainstream UK market continues to perform strongly – with annual price growth likely to end this year at 5%.

Most regional markets have seen positive growth, the exception being Wales. The ripple of price growth from London continued in 2016 and we expect the end of year position to be that the East of England and the South East will both see stronger growth than that in Greater London.

Looking into next year we believe that the slowdown in prices which has been evident in central London over the past 12-months will spread to the wider region, with Greater London prices down marginally in 2017. This slowdown in the capital will likely be experienced across the rest of the country with price growth down notably on 2016 levels.

The main drivers for weaker market performance relate to economic uncertainty surrounding the Brexit process, which we believe will impact negatively on consumer confidence in the run up to and just after the serving of the formal "notice to quit" the EU. In addition the impact of reforms to the taxation of landlords will reduce demand from investors which will limit upwards pressure on prices.

Looking at the prime London market, we believe that a 7% fall in prices across the western part of central London in 2016 means that we are close to the bottom in terms of price adjustment in this market. Although there could be some further adjustment downwards in prime outer London markets through 2017.

For rental markets – it has been a mixed year for landlords in central London, demand from tenants has been strong, but this has been offset by a strong supply of rental properties. In our view there is a risk of further rental falls next year but not on the scale of the adjustments seen this year. The wider UK rental market looks relatively positive with modest rental growth expected. Rents could rise further if landlords begin to sell properties in an effort to offset to the impact of tax rises.

"The UK housing market has so far outperformed expectations following the referendum, however, price growth is expected to moderate next year as economic uncertainty and tax reforms impact on consumer confidence."

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Headlines November 2016

Both the London and wider UK housing markets have outperformed expectations following the EU Referendum

Price growth in 2017 is expected to be notably slower than this year, in all regions

However, the fundamentals of the UK housing market remain largely unchanged

Between 2017 and 2021 UK house prices are forecast to rise by 14.2% cumulatively

Knight Frank Residential Market Forecasts

	2016	2017	2018	2019	2020	2021	2017-2021
Mainstream residential sales markets							
UK	5.0%	1.0%	2.5%	3.0%	3.0%	4.0%	14.2%
London	7.0%	-1.0%	2.0%	2.5%	3.0%	5.5%	12.5%
North East	0.0%	0.5%	2.5%	2.5%	2.0%	1.5%	9.3%
North West	4.0%	0.5%	2.0%	2.5%	3.0%	2.0%	10.4%
Yorks & Humber	3.5%	1.0%	3.0%	3.5%	3.0%	2.0%	13.1%
East Midlands	5.5%	1.5%	3.0%	3.5%	4.0%	4.5%	17.6%
West Midlands	4.5%	1.5%	3.0%	4.0%	4.0%	4.0%	17.6%
East	7.5%	1.5%	2.5%	4.0%	3.5%	5.5%	18.1%
South East	8.0%	1.0%	2.0%	4.0%	4.0%	5.0%	17.0%
South West	4.5%	2.0%	2.0%	3.5%	3.5%	4.5%	16.5%
Wales	-0.5%	0.0%	2.0%	2.5%	2.0%	2.0%	8.8%
Scotland	2.0%	0.1%	2.3%	2.7%	2.8%	2.8%	11.0%
Prime residential sales markets							
Prime Central London East*	1.0%	1.0%	3.5%	3.0%	3.5%	4.0%	15.9%
Prime Central London West**	-7.0%	0.0%	1.0%	1.5%	3.0%	3.0%	8.8%
Prime Outer London	-1.5%	-1.5%	2.5%	3.0%	3.0%	4.0%	11.4%
Residential rental markets							
UK	1.2%	1.4%	2.0%	2.0%	2.0%	2.0%	9.8%
Prime Central London East*	-2.5%	0.0%	2.0%	3.5%	3.0%	3.0%	12.0%
Prime Central London West**	-6.5%	-2.0%	1.0%	2.0%	2.0%	2.0%	5.0%
Prime Outer London	1.5%	2.0%	3.0%	3.5%	3.0%	3.0%	15.4%

Source: Knight Frank Research

*City & Fringe, Islington, Tower Bridge, King's Cross and Riverside

**Notting Hill, Kensington, South Kensington, Chelsea, Knightsbridge, Belgravia, Hyde Park, Marylebone, Mayfair, St John's Wood

Mainstream UK residential market

The fundamentals of the UK housing market in the wake of the vote to leave the EU remain largely unchanged. An undersupply of housing in areas where it is needed most is the overriding issue across the country. Ultra-low mortgage rates continue to underpin pricing, although access to such deals are reserved for those who have reasonably large deposits.

The Government's efforts to try and help buyers bridge this 'deposit gap' in a low interest-rate environment are evident in schemes such as Help to Buy. However, the challenges faced by first-time buyers throw the issue of affordability into sharp relief, especially in an era of low wage inflation.

The use of fiscal policy to try to shape the housing market, including stamp duty reform, has become an increasingly prevalent trend, which in turn is affecting the availability of second-hand stock for sale as buyers choose to stay put and build down, up, or out rather than move to a bigger house which comes with an added tax bill. An era of stability around housing taxation policy would help the market navigate potential economic uncertainty as the UK approaches Brexit.

The reform of mortgage interest relief for buy-to-let investors could see more properties returning to the sales market as landlords review their portfolios. However, since these properties are pepper-potted throughout the market, there is unlikely to be a large-scale UK pricing reaction, although the impact may be felt in some more local areas. This could lead to a decline in the supply of rental property, resulting in more demand for the burgeoning build-to-rent sector.

The Government's focus on improving transport has the potential to act as an fillip to the market in some areas, with improved connectivity helping to boost local economic performance, and aid the delivery of homes.

However, as the UK progresses down the road to Brexit, increased economic uncertainty could have knock-on effects on the housing market, especially if UK's economic growth and employment levels are affected.

Prime London residential market

Wider economic sentiment has been overshadowed by the UK's decision to leave the European Union and the election of Donald Trump. However, the more mundane reality of fiscal policy remains the single biggest curb on demand in the prime London property market.

In particular, higher rates of stamp duty are only now being more fully reflected in asking prices across the market, which will increasingly support transaction volumes. This trend is likely to accelerate alongside a growing acceptance that the prime London property market is operating in a changed regulatory landscape.

That said, the impact of higher rates of stamp duty on the London property market and the UK's tax revenues is an issue unlikely to completely disappear from the radar in 2017. Indeed, as a fuller assessment of the fiscal merits becomes possible, the issue could come into sharper relief, particularly if the trajectory of Brexit negotiations increases wider economic uncertainty.

In addition, buyers denominated in overseas currencies are likely to continue to benefit from a broadly favourable exchange rate and transaction volumes may also be supported as unrealistic expectations of an abrupt Brexit-induced price correction recede.

In the lettings market, stock levels continue to climb and rental value growth continues to fall. However, these movements are likely to temper in 2017 as some landlords, facing higher holding costs and lower rental values, may decide to sell, reducing stock levels and underpinning rental levels.

Prime Country residential market

Similar to the London market, higher rates of stamp duty continue to act as the biggest brake on price growth and activity on prime markets.

The reforms announced in December 2014, and the subsequent introduction of a 3% surcharge for individuals purchasing additional properties, have succeeded in making buyers more price sensitive, and is increasingly being factored in to asking prices and offers.

A similar trend has been observed in the prime markets across Scotland following the introduction of Land and Buildings Transaction Tax (LBTT) in April 2015.

As a result, we have seen the creation of a two-tier market where price growth is increasingly influenced by value, something which is expected to continue as we head into 2017.

The strongest markets continue to be affluent towns and cities that have outperformed their more rural counterparts in terms of price growth, although this differential is expected to narrow over the coming 12 months as buyers look to take advantage of the relative value offered by rural markets.

While there remain uncertainties, not least surrounding the terms and timing of the UK's exit from the EU, so far demand across the market has remained resilient. However, sensible pricing will remain key, especially for properties valued above £1.5 million where the highest rate of stamp duty applies.

UK rental market

Mainstream private market rents grew in 2016 in most regions although at a slower pace than the previous year. Scotland is the only region that has seen a reduction in monthly rents, while London saw rental growth decline to 2.7% in September (from 3.9% in January).

Knight Frank analysis shows that the annual change in private market rents across the country is currently at 2.2% (first three quarters of 2016), compared to 3.5% for the same period in 2015.

Significant constraints on the buy to let market in 2016 and 2017 are expected to change the balance of the rental market. The growth of the buy to let market is being constrained by stricter mortgage conditions, while existing buy-to-let landlords are facing reductions in tax relief.

This could point to an increase in rents, but this will depend on demand which will be driven either by internal migration due to job creation, overseas migration, or mortgage affordability for first time buyers as Help to Buy comes to an end in 2021.

RISK MONITOR

HIGHEST RISK 10 9 8 7 6 5 4 3 2 1 LOWEST RISK

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 five (high), collectively contributing to our combined Risk Score. Our measure of risk is deliberately narrow – namely the risk that house prices could under perform our central forecast scenario.

RISK	SCENARIO	IMPACT	UK			PRIME LONDON		
			LIKELIHOOD	IMPACT	RISK SCORE	LIKELIHOOD	IMPACT	RISK SCORE
DOMESTIC ECONOMY	Slower than expected economic growth	The outlook for the UK economy has brightened since the immediate aftermath of the UK's vote to leave the EU. Even so, the majority of forecasters expect there to be a notable slowdown in GDP growth next year and 2018 as uncertainty about the roadmap for an EU exit persists. Slower growth could impact employment and wages, which could exacerbate affordability concerns and impact buyer demand across the country.	2	4	6	2	3	5
BREXIT	Brexit negotiations with the EU result in an unfavourable deal for the UK	The UK economy has so far maintained broad equilibrium since the vote to leave the EU, but the weakness of sterling reflects longer-term uncertainties surrounding the UK economy. There is much focus on passporting rights for financial institutions in the City of London. Failing to achieve these rights or a suitable alternative in a Brexit deal could have implications for the central London market. More broadly, a less favourable deal or the absence of a stable transition period could result in second-round economic effects which could affect the whole housing market in the medium term.	2	3	5	2	4	6
INTEREST RATES	The Bank of England raises rates more rapidly than markets expect	The Bank of England moved to cut rates to a new record low in August. Our expectation is that interest rates will not increase before late 2018. Even with rising inflation due to weaker sterling, the central bank is expected to stay its hand in order to balance the economic uncertainty caused by the UK negotiations to leave the EU. If rates start to rise before this time, or at a faster rate than expected, this could put pressure on mortgage borrowers. There is greater upwards pressure on swap rates following the US election due to higher inflation expectations, as well as the relatively strong performance of the UK economy, which increases the likelihood of higher mortgage rates. Rising interest rates would push yields higher on a range of investments, which could affect investor appetite for lower-yielding property investments, although the search for stability could help counter this.	1	4	5	1	3	4
GLOBAL ECONOMY	The UK economy is affected by weaker global growth	A ripple effect from a weakening in global economic growth, stemming from underperformance in emerging economies, the uncertain course of Brexit negotiations and uncertainty over the US approach to global trade could be felt in the UK. This could affect economic fundamentals, which would, in turn, affect the domestic housing market. However, in a period of global economic volatility, the allure of 'safe-haven' investments, such as bricks and mortar, will play a role.	2	3	5	2	2	4
GEO-POLITICAL FACTORS	Geo-political events cause an economic slowdown	Global political tensions have been exacerbated by the uncertainty following the election of Donald Trump as US President, although this may be ameliorated as further policy clarity emerges from the US. Closer to home, there are still strains in the EU over migration, the approach to Russia and uncertainty around the upcoming elections in France and Germany in 2017 as the Brexit negotiations gather pace. Factors such as these could affect world trade and business sentiment and, as a result, global economic growth.	2	3	5	2	2	4
MORTGAGE LENDING	Sudden adjustments to LTV or LTI ratios	The Bank of England's Financial Policy Committee (FPC) has gained powers to control new mortgage lending in order to protect the market from future shocks. Its new powers are being extended to the buy-to-let market in January 2017. The FPC can now step in and direct lenders to adjust loan-to-income and loan-to-value ratios on loans for homebuyers. Any sudden change in policy here could impact activity in the market, especially when house price to earnings ratios are rising, making affordability a key issue in some parts of the country.	2	3	5	2	2	4
POLITICAL RISKS	New property taxes	Property taxes are a favoured method among politicians of trying to address affordability concerns while raising revenue. Given the multiple changes to stamp duty introduced in the last five years and question marks over their effectiveness, the likelihood of another ramp up in charges is limited. Policy changes that come into force next year relating to non-doms will be most felt in London. Overseas property ownership is likely to remain a live issue as the UK exits the EU, though balanced by an increased need to attract inwards investment.	1	2	3	1	4	5
NEW BUILD SUPPLY	Oversupply of housing	An oversupply of housing is unlikely to be an issue for most of the UK, where local housing markets are largely characterised by a lack of new homes. However in some areas on the edges of central London, the issue of oversupply may be worth monitoring. A failure of local policies to also reflect the array of demand, across affordability and age spectrums, could lessen the ability of homeowners to move up and down the housing ladder, weighing on activity.	1	2	3	2	2	4

Methodology Statement: House price forecasts are based upon time series regression analysis of relevant statistically significant macro-economic variables adjusted in-house to encompass externalities such as likely risk factors. The forecast uses the Nationwide House Price Index as a base.

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