RESIDENTIAL
RESEARCH

LONDON RESIDENTIAL REVIEW

Summer 2013

THE CURRENCY EDITION:

Assessing the impact of the weak pound on the prime London property market, now and in the future

A HEADY COCKTAIL

Against an all too familiar backdrop of economic turmoil in Europe and ongoing weak economic performance in the UK, the prime London property market has continued to prosper.

"An appetite for tangible investments, ultra-low interest rates and a weak pound help make up the perfect ingredients for that heady cocktail – the safe haven investment."

Liam Bailey, Global Head of Residential Research

While prime London rents have struggled, and are 3.2% lower over the past year, demand from investors as well as occupiers has ensured that capital values for the city's best stock have been pushed higher.

Average prices for prime property in London have risen by 57% since March 2009, with a 7.7% increase in the 12 months to April this year (figure 1). London's price growth compares favourably with other leading global cities such as New York and Singapore, which have seen -26% and 45% price growth respectively over the four years since March 2009.

"London's 57% price growth over the past four years, compares favourably with price performance in other leading global cities, such as New York and Singapore."

The key issue which has propelled London prices over recent years has been an appetite from global purchasers for tangible investments. Add in ultra-low interest rates, together with the fact that not only is London outside the Eurozone but that the pound is weak, and you have the perfect ingredients for that heady cocktail – "the safe haven investment."

Ok, so having the world's best schools, a unique cluster of leading universities, a trusted legal system, the English language, clear property title, and enjoying the status of being the world's most important city to global HWNIs (see The Wealth Report 2013) all help. But currency performance, the cost of money and the fear of financial investments have been instrumental in pushing prices higher.

With the pound entering a renewed phase of weakness we have taken the opportunity to examine the impact of currency arbitrage in this report. Over the following two pages we provide a detailed assessment of recent and future implications on relative pricing for international purchasers.

Tax change

Having passed the first anniversary of the introduction of the new £2m+ tax regime, including the 7% rate of Stamp Duty, we can assess its impact on transaction volumes.

In figure 2 we set out our experience of the change in transaction volumes in the 12 months to the end of March 2013, postdating the introduction of the new regime, compared to the same period to March 2012, before its introduction.

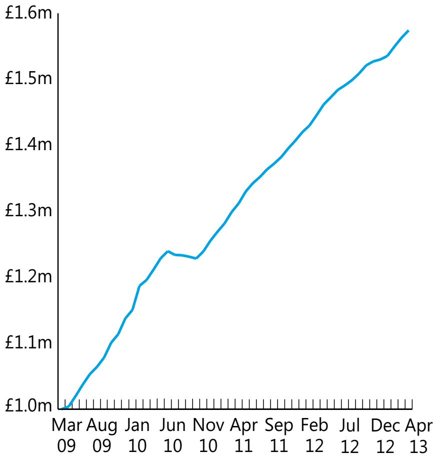
As we have reported previously, the £2m+ market was hit hard by the uncertainty over associated changes to annual charges and CGT. But following clarification on the detail in December – the market emerged much more strongly in Q1 this year.

It is probably unsurprising that the sub-£2m bracket benefitted at the expense of the bracket just above £2m. Our view is that over the long term the impact of the new 7% rate will be to reduce transactions in the £2m-£3m bracket by around 5% below the level they would otherwise have been.

The interesting finding is that, all things being equal, the impact of the tax change appears to fall off to almost zero above £3m. This does not mean there aren't real risks from additional political and tax activism targeted at the prime market. But, for the moment at least, there has been sufficient momentum in the market to keep transactions, largely, on track.

Continued on page 5...

Figure 1
Price performance
Prime central London price growth, based on £1m invested in March 2009



Source: Knight Frank Residential Research

CURRENCY MATTERS

For international buyers, London property is seen as an effective method of diversifying investment portfolios. The lack of entry and exit barriers, compared to other markets, supports inward investment from overseas, especially from buyers looking for a "safe haven" in an uncertain economic climate.

The sharp fall in the value of the pound against rival currencies in 2008, compounded by the fall in central London prices during the initial stages of the financial crisis, spurred inward investment from 2009, especially from buyers with currencies pegged or linked to the US dollar. The Eurozone crisis served to push European buyers into the market.

Our research, which takes into account currency forecasts from the Economist Intelligence Unit and our own forecasts for prime central London property prices, through to 2018, confirms the impact of currency fluctuations on London's attractiveness for overseas investors, by referencing current and projected future prices to their level in March 2008.

Prime central London residential prices, average discount from March 2008 prices, allowing for currency fluctuations.

September 2008 Lehman Brothers files for bankruptcy

March 2009 Bank of England votes to create £75bn through quantitative easing

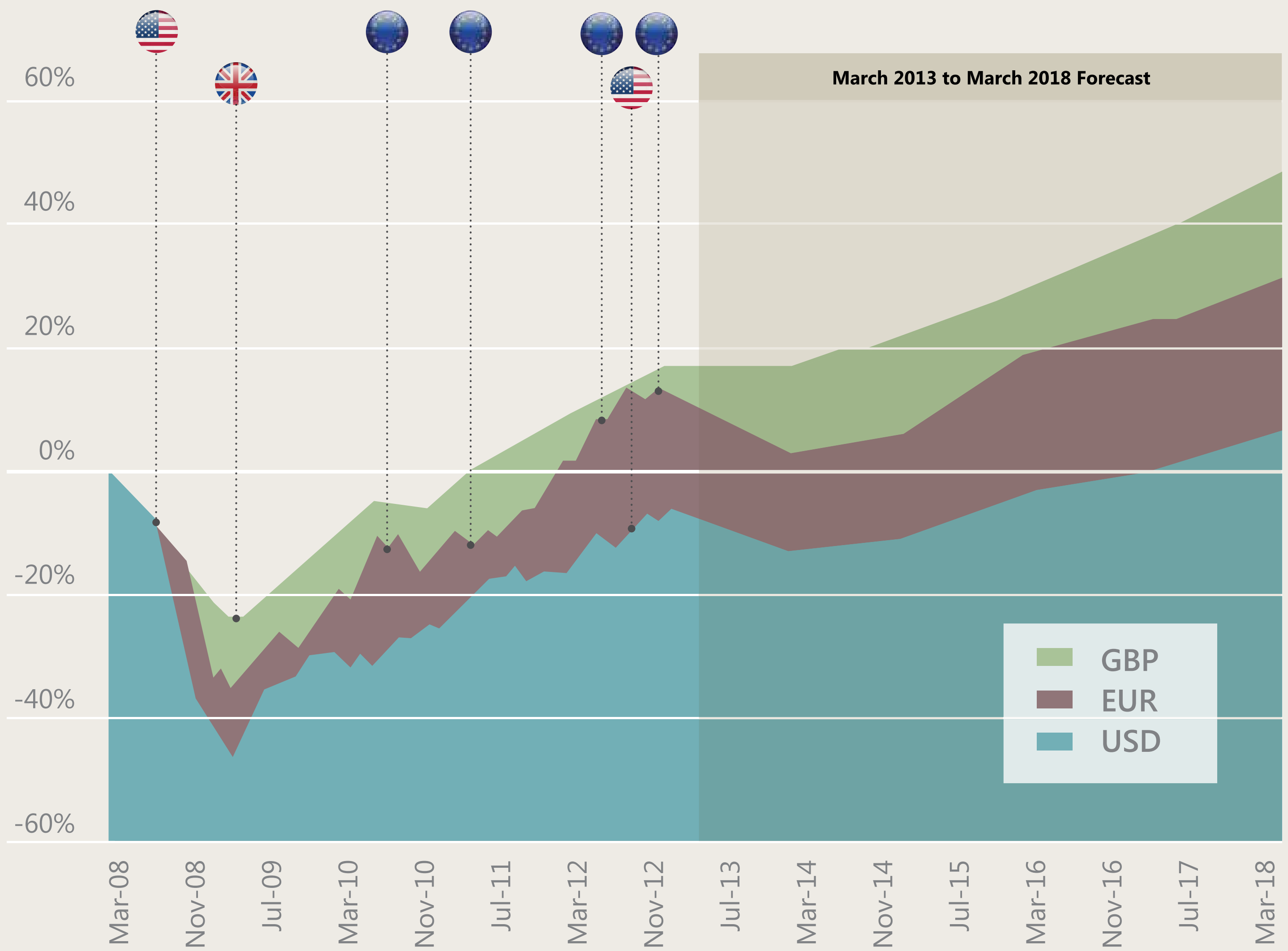
May 2010 EU/IMF agree €110bn bailout for Greece

May 2011 Portugal granted EU/IMF bail-out worth €78bn

June 2012 Spanish borrowing reaches record high

July 2012 IMF Head Christine Lagarde warns the threat of "going over the fiscal cliff" could weaken the US economy

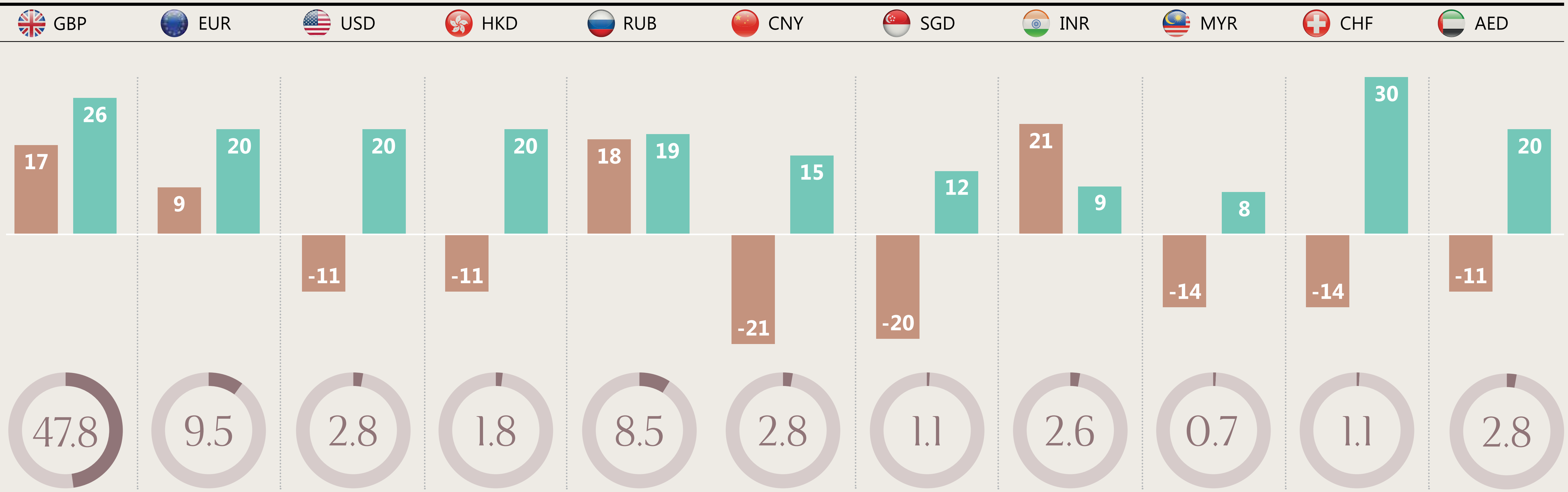
November 2012 European ministers reach agreement over a €85bn bailout for Ireland



Price change so far... Prime central London residential prices, average % change March 2013 compared to pre-crisis peak in March 2008, allowing for currency fluctuations.

...and in the future prime central London residential prices, average % forecast change March 2018 compared to March 2013, allowing for currency fluctuations.

Market share £2m+ prime central London % market share, March 2012 - March 2013, split by purchaser's national currency.



Investor interest

When we look at the rental market we see the clear impact of domestic economic weakness. I noted previously that rents in central London have fallen over the past year, a pattern at odds with the situation in the rest of the country.

In the UK as a whole, rents have been pushed higher by strong demand from prospective buyers unable to enter the sales market due to the lack of an adequate deposit.

In figure 3 we have contrasted recent rental growth with the central London jobs market. It is not the smoothest pattern, these years include the end of the 2000s boom, followed by the 2008-09 global financial crash, the initial bounce in 2010 as the City expanded on the back of expectations of renewed economic activity, and finally the more recent shakeout in the City as hopes of economic recovery were stymied by the Eurozone crisis.

The jobs data tells the story of London's economy very clearly. The data here represents the total number of new City and professional services vacancies advertised through Morgan McKinley in the first quarter of each of the last few years – it is not an overly positive picture thus far in 2013.

Our long term rental forecast: 4% per annum

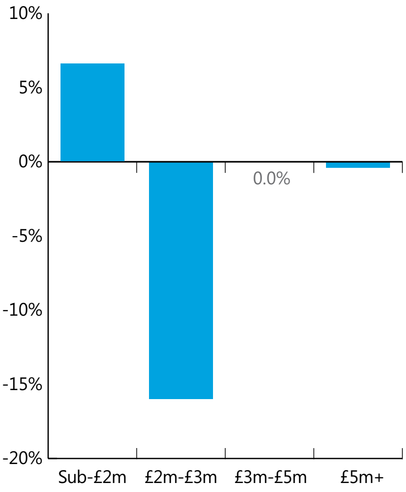
That said, our recent reporting on the prime London rental market has pointed to the resilience of demand. Tenants employed in the technology and media sectors, in particular, have taken up some of the slack from a weakened financial services sector.

Our view is that 2013 will deliver modest rental growth and in reality it will be 2014 before we see stronger, sustained, growth in rents. After 2014 our long term forecast is for rents to rise by around 4% per annum, which is equivalent to long term incomes growth.

While there are undoubtedly short term risks, the long term picture for investors in London is positive. Recent news that the Office for National Statistics has revised upwards its forecast for household numbers in London to 2021, by 4.7% percentage points, and the impact of infrastructure projects, exemplified by Crossrail, will improve the capacity of London's economy. We expect both factors to contribute to higher demand for accommodation.

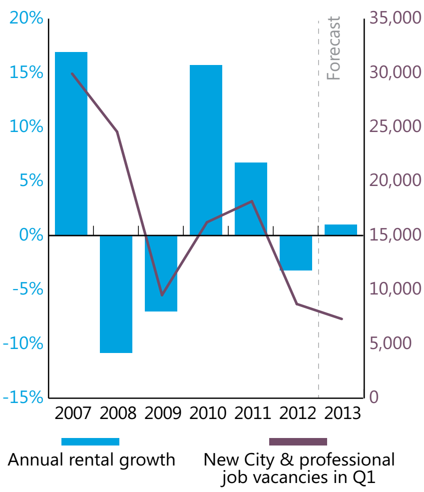
While investors might be disgruntled by a fall in rental income at the current time, the surge in capital values has ensured that total returns have remained at double digit levels for each of the past three year (figure 4).

Figure 2
Prime sale volumes in central London
12 months to end of March 2013 vs. same period to March 2012



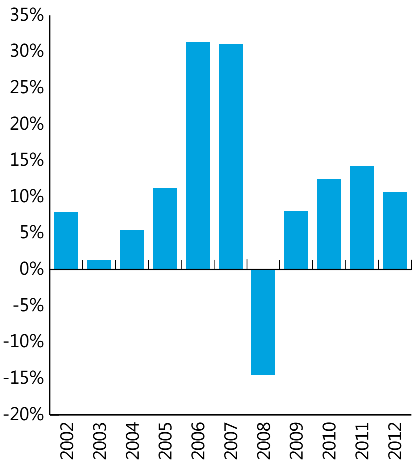
Source: Knight Frank Residential Research

Figure 3
Rental growth vs job vacancies
Annual rental growth in prime central London and new city & professional job vacancies in Q1 each year



Source: Knight Frank Residential Research, Morgan McKinley

Figure 4
Total investment returns
Annual total returns on prime central London property, capital growth and net income return



Source: Knight Frank Residential Research

Knight Frank

The weak pound and London property

As we explain in our main article, it's no secret that international demand has been one of the main factors contributing towards recent growth in prime central London property prices.

For a large number of international buyers, investing their money in London property is seen as a method of diversifying their portfolio, and for some with economic or political turmoil at home bricks and mortar in London offers a real method of safeguarding at least part of their wealth.

The fall in the value of the pound against rival currencies over the past five years has only served to make the prospect of owning luxury homes in the capital more appealing. After an initial fall during the financial crisis, in sterling terms property prices in prime central London now stand 17% above their March 2008 peak.

As our calculations confirm, currency fluctuations mean that for a number of overseas buyers prices calculated in their domestic currency still sit below this level.

Our chart on pages 3 and 4 illustrates how the weak pound has resulted in exchange rate advantages for foreign buyers.

The graphic takes into account currency forecasts to 2018 from the Economist Intelligence Unit and our own forecasts for prime central London property.

Prime central London property prices are expected to increase by a further 26% in sterling terms between March 2013 and March 2018. However, property values will increase at a much slower rate over that same time for the majority of international buyers.

For US dollar-denominated buyers for example, prices are expected to increase by 15% over this period. By 2018, our calculations show that prices in US dollars will be just 6% higher than the previous market peak in 2008.

As the US emerges from the recession in better shape than most developed economies, the dollar is expected to benefit. A string of upbeat economic data and an anticipated end to quantitative easing should ensure the dollar continues to strengthen against the pound and euro over the next five years.

As a result, entry to the prime central London property market will become more affordable for dollar-denominated buyers and for those whose currencies are pegged to the US dollar.

Ben Jones, an analyst at the Economist Intelligence Unit, explains that the US dollar has regained strength against other currencies, including the pound, as a result of improving economic figures and fiscal consolidation in the US, combined with a rise in Eurozone economic risk. He notes that "the US dollar is rising against other major currencies because the US economy is outperforming its peers to a noticeable degree. The Eurozone is in a recession and the UK economy is stagnant."

"Encouraging economic data from the US – and weak figures from the Eurozone and many emerging markets – have raised positive sentiment in the US dollar, both because of the better news in the US and owing to the safe haven effect, which attracts investment to US-dollar assets when global sentiment softens."

This outlook suggests that London's appeal to international buyers is likely to remain supported over future years. Between March 2012 and March 2013, some 52% of all £2m+ homes in prime central London were purchased by non-UK buyers, with buyers with domestic currencies pegged or shadowing the dollar predominating.

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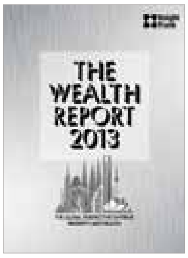

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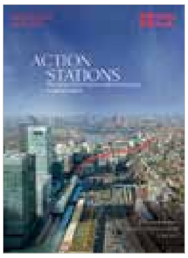

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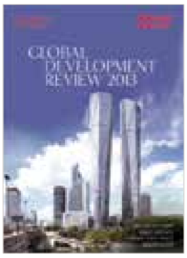

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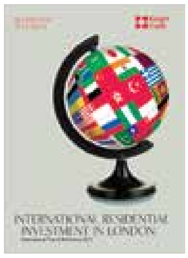

International Residential Investment in London 2013

Knight Frank Research Reports are available at **www.KnightFrank.com/research**

Knight Frank area definitions: 'Prime central London' is defined in our Prime Central London Sales Index as covering: Belgravia, Chelsea, Hyde Park, Kensington, Knightsbridge, Marylebone, Mayfair, Notting Hill, Regent's Park, St John's Wood, Riverside* the City and the City Fringe. 'Prime London' comprises all areas in prime central London, as well as Canary Wharf, Fulham, Hampstead, Richmond, Wandsworth, Wapping and Wimbledon.

* Riverside covers the Thames riverfront from Battersea Bridge in the west running east to include London's South Bank. The City Fringe encompasses the half-mile fringe surrounding most of the City including Clerkenwell and Farringdon in the west and Shoreditch and Whitechapel in the east.