RESIDENTIAL MARKET UPDATE

Knight Frank

APRIL 2010
PRE-ELECTION SLOWDOWN

"The UK housing market slowed noticeably in March and April has seen a continuation of the reduction of sales volumes and slower price growth. With so much at stake from May's election – in terms of taxation and spending – we do not expect a resumption of stronger market activity until after the election."

Liam Bailey, Head of Residential Research, Knight Frank

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Housing market update

The strong period the UK housing market has experienced since last March has begun to be replaced by a more uncertain phase. The supply of property for sale has increased, albeit marginally, and purchasers are feeling a little less pressured to agree terms. Negotiations, which until recently would have completed rapidly, are taking longer to conclude. The upcoming election is beginning to impact on the market.

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Buyers and sellers offer different reasons for delay, but the election is a common and convenient excuse for many. With so much potential change to both taxation and spending, and with such little clear guidance on the future policy landscape from all parties, who can blame anyone for dragging their feet at the current time?

The more leisured approach taken by both sides of the market appears to have fed through to market performance. Latest results from the Nationwide confirm that price growth stalled in February, recording a fall of 1% which ended a nine month run of consecutive price rises, although in March the rate began to rise again – with growth of 0.7% over the month.

London and the South East continue to outperform the rest of the UK. Prices in the more expensive parts of London, according to our Prime Central London Index, rose 0.7% in March, a substantial slow down on recent monthly totals, which averaged 1.8% in the six months up to February.

The Bank of England confirmed that the number of loan approvals for house purchase (47,094) was lower than the January figure (48,099) and below the previous six-month average (55,130). Approvals for remortgaging (27,297) were higher than in January and also higher than the previous six-month average, while approvals for other purposes (25,017) were higher than in January but still below the previous six-month average.

There are indications that the supply and demand imbalance in the housing market, which contributed to strong price growth over the last year, is beginning to close. The RICS housing market survey confirms that while the volume of new buyer registrations continues to rise, its is now being outpaced by the supply of properties for sale.

Turning to new supply from the house building industry, the market here has improved noticeably from 12 months ago. Applications to build new homes across the UK during the period November 2009 to January 2010 rose by 65% from the historical lows of the same period a year ago (from 14,738 to 24,315). Despite this positive indicator, an undersupply of property is

APRIL 2010

RESIDENTIAL MARKET UPDATE

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expected to be a key feature of the UK housing landscape over the next two years at least.

When we consider the market outlook, the main issues remain the macro-economic fundamentals as well as the priorities of the new government following the election. There is no escaping the importance of the outlook for inflation alongside the cost and availability of mortgages.

Budget review

The increase in the nil stamp duty band for first time buyers from £125,000 to £250,000 was very welcome. First time buyers are a critical link in the housing market and any encouragement for these buyers to enter the market will have a positive impact on the market.

We noted in our February review that affordability constraints are being felt by the inability of borrowers to pull together acceptable deposits – rather than the actual cost of servicing debt. Therefore the removal of the need to find £1,250 to £2,500 for first time buyers at the lower end of the market is to be welcomed.

The new 5% stamp duty rate for £1m+ properties will be likely to have several unintended consequences. Previous experience points to a likely bunching of sales above this level in the three months running up to the implementation. The longer term impact is likely to be a reduction of sales volumes as people in this bracket try to avoid trading and incurring a new hefty tax liability.

With greater use of offshore company structures to avoid the liability, combined with potentially lower transaction volumes, there will be limited additional revenue generated from this new band.

The really critical issues for the economy and the housing market were unsurprisingly left unaddressed in the budget. The impending £310bn mortgage funding gap was not thought worthy of mention (see below for more comment on this).

The budget also saw an announcement to maintain a five year supply of "deliverable, viable housing land" and some proposals to reduce the regulatory burden on housing development. These were all very welcome aspirations, but in reality slightly woolly and ill defined, the house-building industry ought not to expect significant changes in these areas overnight.

Economic update

With the UK economy back in growth, and with new improved (although still awful) government deficit forecasts presented at the budget, the economic backdrop to the housing market is on the mend.

Even with the Bank of England reducing its forecast for GDP growth for 2010 from 2.25% to 1.5%, there is increased confidence that the UK ought to escape a double dip recession.

CPI annual inflation – the Government's target measure – was 3.4% in March, up from 3.0% in February.

The upward pressures to the change in CPI annual inflation are widespread, the largest coming from housing and household services where prices rose slightly between February and March this year but fell a year ago. The 1% fall between February and March 2009 was the largest monthly fall on record for this series.

The latest ONS data shows that wage growth in the private sector (excluding bonus payments) is very weak, rising by only 0.4% in the year to January. Although the public sector has yet to experience a similar moderation, wages here grew by 4% over the same period.

Unemployment appears to have peaked, at least for the moment. The total number of the unemployed fell by 33,000 over the three months to January 2010 reaching 2.45m, the largest quarterly fall since July 2007.

Risks

The fact that the economy has turned a corner into growth is in itself a great relief. However there is still a real concern that the level of private and public debt was not substantively addressed during the recession, and there is the nagging feeling that the UK has seen a 'correction postponed'.

For good reason, a large part of the government's efforts to avoid economic meltdown in 2008 and early 2009, was provided

APRIL 2010

RESIDENTIAL MARKET UPDATE

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as support for the banks. In return the banks were able to slash mortgage costs (following the lead from the Bank of England base rate) and even increase lending volumes from the dire level they had reached.

The problem is that this support can not last forever, and the banks will have to begin to pay this money back. The unwinding of schemes, such as the Special Liquidity Scheme, which lent over £300bn to UK banks means that there will now be a need to raise substantial debt in the market, which is likely to increase the cost of bank borrowing.

At the same time, the end of the QE programme means that the most significant buyer of gilts has left the market. The implications are that bond yields will rise, with a similar impact on swap rates and the cost of fixed rate mortgages.

The impact of both of these factors is likely to be a tightening of mortgage lending even during this year, as banks position themselves for a more difficult climate as government support is withdrawn. In addition, mortgage costs are likely to rise even if inflation and the UK base rate remain at current levels.

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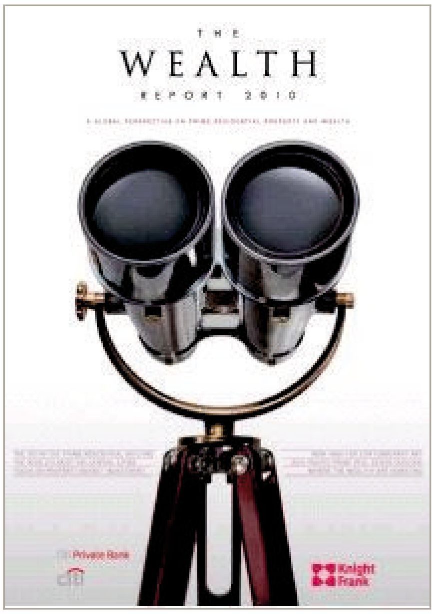
APRIL 2010

RESIDENTIAL MARKET UPDATE

Recent market leading research publications



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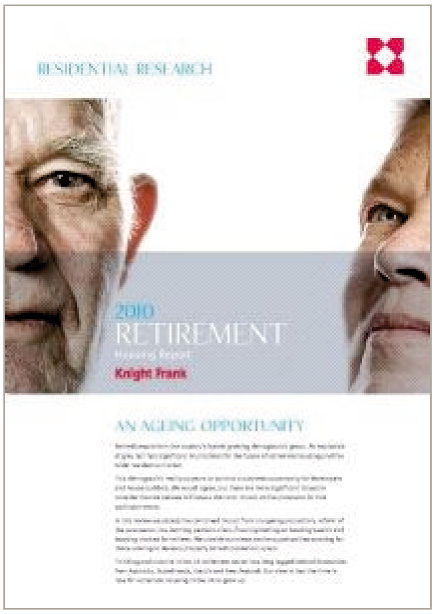

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