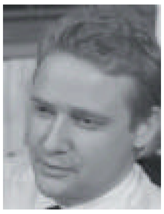
RESIDENTIAL MARKET UPDATE.

Knight Frank

APRIL 2011
SPRING MARKET UPDATE.



"The ongoing scarcity in mortgage funding continues to be responsible for weak sales volumes and largely static price growth. Homeowners face a nervous wait for interest rate rises in the coming months. If the Bank of England is able to spare the economy and the housing market by leaving the base rate at 0.5 per cent we envisage our forecast of an average price fall of 6 per cent in 2011 could prove pessimistic."

Liam Bailey, Head of Residential Research, Knight Frank

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Housing market

The UK housing market remains weak with prices edging up only 0.1 per cent year-on-year in March. While this reversed February's 0.1 per cent annual decline, it is not enough to suggest that prices are set for a continued recovery.

The mortgage market continues to be a significant barrier to a return to normality in the housing market, with lenders still applying strict lending criteria, thereby excluding many prospective purchasers from obtaining a loan.

While gross mortgage lending surged by 21 per cent last month, this largely reflected a resurgence in the re-mortgage market as homeowners, nervous that interest rates may rise, moved from their existing deals to new, fixed-rate, home loans.

The proportion of borrowers on variable rate deals, allowing them to take advantage of the record low base rate, has risen dramatically in the last two years, but data signals that this trend is beginning to reverse as rate rises loom. The base rate has been a record low of 0.5 per cent for more than two years.

Low financing costs have not mitigated the fact for many buyers, a lack of liquidity in the mortgage market is their primary concern.

The number of new mortgages approved for first-time buyers was just 12,400 in February, 11 per cent lower than in February 2010. The total number of loans for house purchase also fell by 12 per cent year on year to 32,300– just above the record low of 27,000 hit in November 2008.

To put the current level of mortgage lending in context, over the past two decades, house prices have been stable when mortgage approvals have averaged between 70,000 and 80,000 a month. Fewer approvals than this usually suggests weakening prices.

There are concerns that mortgage lending may be further hit as the Bank of England's Special Liquidity Scheme (SLS), which propped up mortgage banks during the crisis, comes to an end early next year, creating a mortgage 'cliff' as lenders concentrate on repaying the central bank.

Recent data from the Bank of England showed that banks have yet to repay nearly half of the £195 billion lent under the scheme.

But this could be partly offset by the recovery in the Residential Mortgage-Backed Securities and covered bonds market which has been seen over the first three months of the year, giving lenders more scope to raise funding via the markets.

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Lenders are unlikely to loosen their lending criteria immediately as a result of this, but continued improvement in the wholesale market will be a key feature of any recovery in the housing market.

Economic conditions

Wider economic conditions are also hampering the market at present. Although inflation fell to 4 per cent in March, down from 4.4 per cent in February, this is still well above the Bank of England's 2 per cent target.

Households are feeling the strain as their expenses rise while wage growth remains subdued. Spiralling fuel prices have not only pushed up the cost on the forecourts but have fed into widespread increases in prices. January's rise in VAT has also fed into rising prices while the tax changes which came into force in early April, such as the 1 per cent rise in national insurance, have hit household incomes.

While the 1 per cent rise in stamp duty on properties worth more than £1 million is not expected to overly dampen the relatively buoyant prime market it nevertheless prompted a surge in activity in March and early April as buyers rushed to beat the additional tax payment.

Knight Frank agents reported that transactions in the 3 weeks to the 5th April 2011 jumped to £333 million, compared to £74 million in the same period in 2010.

Most homeowners are feeling nervous about the prospect of a rise in interest rates in the coming months. The minutes from the Bank of England's April rate meeting showed that three of the nine-strong committee repeated their calls for a rate rise. If the initial estimates for GDP growth in the first quarter of 2011, due to be published on April 27th, show that economic growth is back on track after the surprise fall in GDP in the final quarter of last year, then calls for a rate rise could intensify.

But it is worth remembering that Andrew Sentence, one of the arch-hawks on the Bank of England's Monetary Policy Committee (MPC) who has led the calls for a rate rise, will step down from the end of June. He will be replaced by Goldman Sachs economist Ben Broadbent.

A rise in rates would likely act as a further dampener for buyers as mortgage costs rise, but it could also prompt an increase in distressed sales as homeowners struggle to cope with an increase in their monthly mortgage payments.

Our forecast for a 6% average price fall in the wider UK market, seems realistic if we assume that there will be fiscal tightening during the course of this year. However if the Bank of England is able to spare the economy and the housing market rate rises during the course of 2011 – our current forecast could well be too pessimistic.

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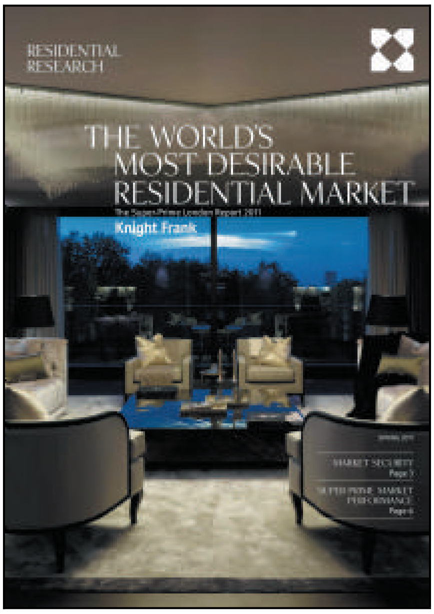

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Contacts

Liam Bailey
Head of residential research
liam.bailey@knightfrank.com
T +44 (0)20 7861 5133
M +44 (0)7919 303148

Andrew Shirley
Head of rural property research
andrew.shirley@knightfrank.com
T +44 (0)20 7861 5040
M +44 (0)7500 816217

James Kennard
Research consultancy
james.kennard@knightfrank.com
T +44 (0)20 7861 5134
M +44 (0)7500 065142

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