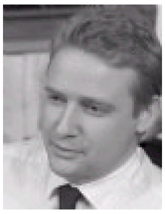
RESIDENTIAL RESEARCH

RESIDENTIAL MARKET UPDATE

Knight Frank

AUGUST 2010
SUMMER SLOWDOWN



"The UK housing market has experienced a noticeable slowdown in the last two months. There is growing evidence of rising supply levels. In London stocks were 25% higher in July compared to a year earlier, and applicant volumes have slipped, by around 20% over the same period. The strong price growth that characterised the market up to May has gone and prices are flat, at best, or in most cases edging downwards."

Liam Bailey, Head of Residential Research, Knight Frank

"While the economy is expanding, bank lending to business has been shrinking, by an annual rate of 6%."

Economic update

There have been some very positive indicators for the economy in recent weeks which ironically have been a cause for both relief and concern, as we shall consider below. The key announcement relates to the recent second quarter GDP estimate for the UK which was surprisingly robust at 1.1%, up from 0.3% in the first quarter.

Economic growth is being led by services, manufacturing and, surprisingly, by construction. This latest estimate for GDP growth suggests the economy grew in the three months to the end of June at the fastest quarterly rate since early 2006. The annual rate of growth is now 1.6%. Added to the good news was the fact that retail sales rose in June by more than expected, at 0.7%.

While the economy is expanding, bank lending to business has been shrinking, by an annual rate of 6%, which is partially explained by corporate deleveraging. This can not be the full explanation, and if the banks are unable to reverse this decline in credit supply then the economic recovery could be threatened.

The recent stress tests of UK and European banks were widely welcomed – especially as the rather low benchmarks set were easily passed by the UK banks. However, the lesson from the US, where banks went through the same process a year ago, is that the official recognition of bank stability does not automatically feed into increased lending.

Of all the economic issues weighing on the UK housing market, the key ones are the threat to household wealth from tax rises, which will impact on household income in 2011 and 2012, and also the threat of rising interest rate costs.

The apparent strength of the UK economy in the second quarter will add weight to the arguments being put forward by Andrew Sentance, a member of the Bank of England's Monetary Policy Committee, that action needs to be taken sooner rather than later to control emerging inflation. Although CPI fell in June to 3.2% it remains above the Bank of England's 2% target.

Added to the above debate is the fact that the pound has strengthened against the euro and also the dollar in recent months, partially on the back of better economic news from the UK.

Other economists point to the recent compression of gilt yields (and continuing downward trend of Swap rates) as well as the need to counter the impact of tax rises and spending cuts. For these analysts rates will need to remain low for some time – well into 2014 according to some recent estimates.

The outlook for the economy seems to be dividing into three distinct scenarios. The first is one that governments, both here in the UK

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and elsewhere, are basing their hopes on, slow but steady growth, which will over time take the economy out of the dangerous position we are now in. The second view seems to be that western government stimulus packages are inevitably going to lead to hyperinflation. The third view is that a mix of government austerity and private sector deleveraging will lead to deflation.

At the moment it seems that the central banks, including the Bank of England, have decided that to achieve the first outcome they need to adopt a mix of the second and third alternatives, by shrinking the state at the same time as keeping interest rates as low as possible to incubate private sector growth.

Residential market update and outlook

The latest surveys from the RICS, as well as our own data, confirm that the stock of available properties for sale has been rising for the last three to four months. At the same time the volume of new buyers has been falling back.

The reality is that both measures were at very extreme levels in early 2010. There has been a significant imbalance since the beginning of 2009. In central London, for example, there have been 10 new buyers registering for every new property that has come to the market, this compares to a long run average of six to one.

The rebalancing of the market certainly puts pressure on prices – because it is very low supply that has been a big contributory factor to price growth – but it is not as significant as might be expected. One of the factors which has been apparent, at least anecdotally, is the impact of the abolition of the Home Information Pack, which has brought more speculative vendors to the market.

For those looking for bad news, the mortgage market has provided some more evidence that the housing market is under pressure from tight lending conditions. We have noted in previous Market Updates that the outlook for mortgage market lending is not strong, and evidence from a survey conducted by the British Bankers' Association in June confirmed that the market is beginning to tighten up. Some 34,813 new loans were approved in June, the first fall in four months. The recovery in lending volumes which began at the turn of the year has begun to reverse, it seems unlikely that the lack of wholesale funding will turn around in the short-term suggesting a serious revival in mortgage lending is unlikely to occur this year.

We also need to consider the regulations being looked into by Adair Turner, chairman of the FSA, who has stated that regulators should be determined to put an end to boom and bust in the credit markets. Since property is a key part of the credit cycle, it is clear, at least from a regulatory point of view, which way lending to property is heading. Tighter rules governing lending will inevitably mean lower price growth in the long run and will slow the recovery of the market in terms of sales volumes.

Looking at the new-build market, the volume of starts is beginning to slow. The number of house-building registrations dipped from 10,870 to 9,263 between May and June. While the long term outlook for the housing market points to a strong requirement for new accommodation, in the short-term supply will be dictated by economic and political considerations.

It seems increasingly likely that prices will begin to dip in the second half of 2010. It is unlikely that the prime markets will escape this process, indeed the prime London market saw the first price fall in 15 months in July, according to the Knight Frank Prime Central London Index.

The main complaint of agents at the current time is that houses are set to enter the autumn market between 5% and 10% overpriced. With asking to achieved prices currently standing at 95%, the inference of this is that prices are likely to fall back by around 5% before the year end.

Assuming interest rates can remain low for the long-term – more significant price falls ought to be avoided. But with a combination of a higher volume of homes for sale, weak demand on the back of government spending cuts, rising taxes and weak income growth, the short-term outlook for the housing market is more challenging than it has been for 18 months.

UPDATE

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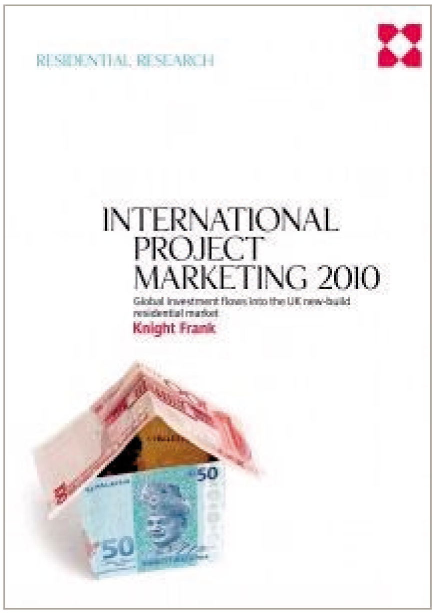

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