RESIDENTIAL RESEARCH

# RESIDENTIAL MARKET UPDATE.

Knight Frank

## DECEMBER 2010
## LOOKING FORWARD TO 2011.

"The UK residential market recovery, which had appeared relatively robust in 2009, stalled in 2010. While hampered by weak growth in real incomes and declining consumer confidence, the largest single issue to affect the market has been the difficulty large numbers of prospective buyers have had in accessing the mortgage market. With the risk of a double-dip recession receding, this issue of access to debt is likely to be the critical factor determining market performance in 2011."

**Liam Bailey,** Head of Residential Research, Knight Frank

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### Where we are now...

The relatively strong run that the UK housing market had enjoyed from March 2009 ended this year. Prices in the mainstream market began to decline from the early summer, and by July, prices in central London began to fall back.

In reality while the market appeared in relative good health up to the middle of this year, fundamental problems were affecting the market under the surface. For example the volume of sales continued to stagnate. Mortgage approvals for house purchases had been rising steadily from their low point of 27,000 in November 2008 to hit 59,000 in November 2009. Since this point mortgage lending has actually fallen backwards, hitting 47,000 approvals in September 2010 (50% below the level seen in September 2007).

The market in the UK has divided, between a equity rich top tier and an equity poor lower tier - in which prospective buyers have struggled to access the mortgage market. This wealth divide is likely to remain a dominant trend influencing the market in 2011.

### ...and where we are going

House prices in the UK will probably end 2010 unchanged on the start of the year, with rises in the first half offset by falls in the second half. Fears over the influence of spending cuts on the economy and the housing market look like they are being overplayed. It is the issue of declining real incomes which is where the problems for the housing market are likely to come from, and which will compound mortgage market restrictions. The negative impact of rising taxes and stubbornly high inflation on the one hand are not being offset by strong wage rises. Instead, an increasing number of employees are facing pay freezes or below inflation rises.

With the mortgage market seemingly unable to expand in terms of the volume of lending available we expect mortgage lenders will continue to target the affluent by maintaining the very wide differential in lending rates. Low rates will continue to be made available to those with equity stakes of 25% or more and much higher costs passed on to those with limited equity stakes.

### Main risks

The real risk to current housing values will arise if strong inflation continues into 2011 and forces the Bank of England to raise interest rates before mortgage lenders are able to narrow margins significantly. This will not only hamper the sales market - but also cause problems for existing owners, many of whom have been benefitting from very low variable rate mortgages.

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Additional risks to watch include mortgage market funding limitations. As we note above this is still a tight market in terms of available funds for lending - it could well get tighter as the Special Liquidity Scheme (emergency government lending to the mortgage sector) begins to be wound down from early 2011.

While the risk of an economic double-dip here in the UK seems to have retreated, the reality is that there is no way of foretelling how the current Eurozone chaos will play out and this continues to pose concerns for the UK economy.

## Central London outlook

In terms of market performance, there is no doubt that the strongest performing market is likely to be London and central London in particular. Anecdotal feedback from the market confirms that the “safe haven” role played by central London property is once again being recognised by international purchasers.

The view taken by many new entrants to the market – and the volume of new applicants from Europe looking to buy in central London has risen 23% year-on-year – is that London property is a strong defensive option as the difficulties in the Eurozone continue to play out and while the pound is still trading at a discount to the Euro. Spanish and Italian interest is very strong – with a year-on-year growth in applicant interest up by 40% from these markets.

Outside of Europe there is ongoing demand from Asia-Pacific buyers – who have benefitted from 30% to 50% price growth in Hong Kong, Singapore and other key Asian centres over the past year. These buyers are keen to take advantage of the weak pound and take money out of what have become arguably very hot markets in Asia.

Despite recent price growth in central London, Eurozone and Dollar-based buyers are still able to achieve an effective discount of 14% and 26% respectively due to currency movements on March 2008 prices in London.

One sector which has underperformed relative to the wider PCL market in terms of pricing - is the £10m+ sector. Prices in this bracket rose on average by only 0.3% in November, and are still down by 0.2% over the past six months. Despite this weaker price performance, sales volumes have performed very well.

After a dearth of £10m+ sales during the summer – volumes were down 80% in July and August compared with the levels seen in 2009 and 2008. However, there was a sharp rise in activity in October and November with over 20 £10m+ sales achieved each month, mirroring trends observed in the final quarter of 2009.

How to explain the recovery in high-end sales? In a word - confidence. An example is the Knight Frank Kensington and Notting Hill offices, which have jointly completed five sales over £10m in the last six weeks. While the sales were in the main to international buyers, all of these buyers were already living in the UK and they were looking to upsize their accommodation. These were all buyers who have been considering buying for over a year but only by October and November did they have the confidence to enter the market.

The central London market is operating to a different set of rules from the wider UK market.

## Prime regional and country house outlook

Similar trends to the London market are being observed in the UK's country house market. There was a significant problem in mid-2010 with property being over-priced by vendors, which helped to slow the market over the summer. Asking price reductions which took place during August and September certainly improved activity and we expect to see a similar level of sales in November and December as we saw in 2009 - which was a relatively strong period for this sector.

While regional prime markets have seen price growth since the recovery in early 2009, it has been nowhere near as strong as in London, and prices are still more than 10% below the peak level reached in Q4 2007. There are risks to this market, but the ongoing shortage of stock does not appear to be ending and we believe that 2011 will see price growth in this sector - albeit marginal.

## Summary

We are unlikely to see strong capital growth in any residential sector in 2011. The opportunity for speculative gains was presented in early 2009 and by mid-2010 this opportunity had all but disappeared, at least for the short-term.

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Despite this conclusion, interest in residential property from investors is growing. The key reasons are related to improving yields, rents have been rising steadily over the past two years, especially in southern England and London, and also supply and demand dynamics.

2011 will be the third consecutive year when new-build development volumes will struggle to reach even 50% of their 2007 peak level. Demand for accommodation in most parts of the UK, outpaces supply and for this reason affluent investors are continuing to add properties to their portfolios.

For those with access to equity next year, there will be considerable opportunities in the market. For the investor these opportunities will be centred on strong yielding properties and refurbishment projects and for developers it will be developing small to medium-sized sites with a product targeting owner-occupiers and longer-term investors.

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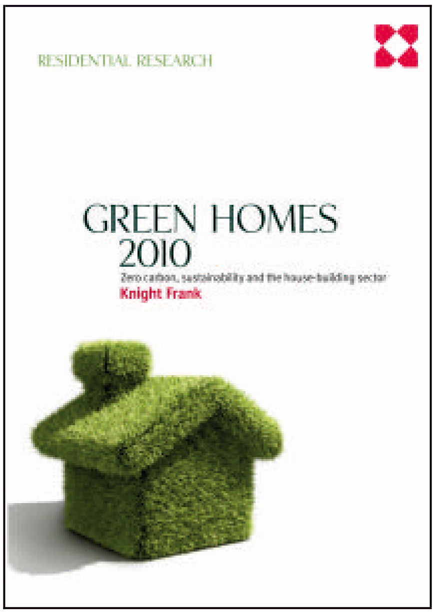


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