RESIDENTIAL MARKET UPDATE.

Knight Frank

SEPTEMBER 2011
MAINSTREAM MARKET STUTTERS, PRIME LONDON SHINES.

"Prices and rents in prime central London hit new highs in August as the weak pound and low interest rates enhanced London's status as a safe haven. The wider UK housing market continues to feel the effects of the worsening economic outlook, although low interest rates are helping to support prices."

Gráinne Gilmore, Head of UK Residential Research, Knight Frank

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UK housing market and economic overview

The housing market ended the summer much as it started; mainstream values stuttered while prime London prices continued to climb strongly.

Average house prices in the mainstream UK market fell by 0.6% during August and were down 0.4% year on year. The less volatile three-monthly price growth measure also eased from 0.3% to 0.1%.

With average values still marginally higher than they were in April, according to Nationwide, there was a clear signal that stability in the market is continuing, despite little propensity for growth.

It is worth remembering that house price indices based on mortgage lending data, such as those from Nationwide and Halifax, can only give an indication of what is going on in the market given the recent drop in mortgage lending, and in particular their share of the mortgage market since the financial crisis.

If we look at the less timely data from the Land Registry, which records the prices achieved in house price sales, the trend is broadly similar. It shows that average prices in July were down 2.1% year on year, but have remained between £160,000 and £166,000 since November 2009, underlining that the market is broadly flat.

Economic context

There is no doubt that buyer confidence is being knocked by the deteriorating economic outlook. The Bank of England's Inflation Report, its three-monthly update on the state of the economy, made for uncomfortable reading last month. The Bank revised down its forecast for economic growth, to around 1.5% GDP growth this year and 2.2% next year.

These are at odds with the official forecasts from the Office for Budget Responsibility (OBR) which will cause disquiet amongst policymakers as the government's spending predictions are based on the OBR's forecasts. If the economy fails to grow as fast as expected, tax receipts will fall short, and the government may be forced to make even deeper spending cuts to balance the country's books. This would further hamper confidence in the housing market, especially in areas which are heavily reliant on public sector employment.

The global economic outlook has also darkened. Despite a last-minute agreement among US policymakers about the country's debt ceiling last month, Standard & Poor's, one of three major leading credit rating agencies, downgraded the country's credit rating. The downgrade could eventually push up borrowing costs for the government, and

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drive up interest rates on consumer loans too.

The crisis in the eurozone rumbles on, with policymakers still battling to come up with a solution to the ongoing debt problems.

But given the downbeat economic picture both at home and overseas, the Bank of England indicated in the Inflation Report that interest rates were set to stay pegged at 0.5% until late next year at the earliest, benefitting existing homeowners with tracker or variable rate mortgage deals.

The chances of a rate rise receded further as the minutes from the Bank's August rate-setting meeting showed that the nine members voted unanimously to keep rates on hold, with two members reversing their previous calls for rate rises. Many independent economists are forecasting that rates will not rise until 2013. The question now is whether the Bank will introduce more quantitative easing to add to the £200 billion already pumped directly into the economy through asset purchases.

But despite low interest rates, the division in the mortgage market between those with and without a large deposit or hefty equity in their home only seemed to widen during the month.

While some lenders, typically smaller lenders vying for market share, offered loans with rock-bottom rates, these deals were reserved for those who had a 30% or even 40% deposit and a top credit rating. Borrowers, typically first-time buyers, who do not have a large deposit must pay much higher mortgage rates, if they can secure a deal at all.

Total mortgage lending remained muted, with gross lending falling by 1% between June and July. Total lending was down 6% from July last year, and lenders expect little uplift over the coming months.

We forecast that house prices in the mainstream market will edge down further this year, but given the benign interest rate environment, the decline may be slightly less than the forecast 6%. But if prices fall more slowly this year, the bounce-back next year could also be more muted, especially if interest rates start to rise.

Housing market activity

Activity in the market remains depressed, with RICS reporting a further drop in sales in July. However the number of new buyer enquiries rose slightly, an encouraging sign that activity may edge up in the months to come. Housing supply is still constrained however, with the number of sellers instructions falling in July as new vendors are unwilling to accept reduced selling prices.

London remains the bright spot however, with new buyer enquiries and new instructions both rising strongly during July, signalling that transactions are set to rise further.

Rental market

Demand for rental property continued to rise across the UK in July. Rents grew in every region as the small rise in supply of rental properties failed to meet demand, although the continued rise in rental instructions is starting to weigh on expectations for the pace of growth in rents over the next three months.

Rents rose fastest in London and the South East, with agents highlighting the large numbers of would-be first-time buyers being forced into rented accommodation because they can not secure a mortgage.

Prime London rents hit a new high in August, driven up by demand from international tenants who now account for six out of every 10 lettings. Rents rose by an average of 0.2% during August in the prime central London areas, and have now climbed by 26.3% since June 2009. We expect that prime London rents will continue to rise faster than inflation over the next three years.

Prime market performance

Prime London property prices rose by 0.9% in August, taking them to a new record high as demand and overall activity continued to grow. Prices have been supported by the weak pound, offering overseas buyers a discount on London house prices despite the recent strong rise in values. Eurozone buyers can still benefit from a 10% discount on prices compared to the last market peak

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in 2008, while those buying in US dollars or a currency pegged to it can achieve an 18% discount.

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We forecast that there is more growth to come in prime London. Our central forecast is for 9% growth this year, but there is a possibility of strong double-digit growth. We forecast a further 6% uplift next year.

Prime country house prices have remained stable this year, and while they are around 1.6% down year on year, they are still 6.4% higher than in mid-2009. We forecast that prices will remain flat for homes prices between £1 and £5 million this year, and that values for homes priced over £5 million will rise by 2%.

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