RICS Economics

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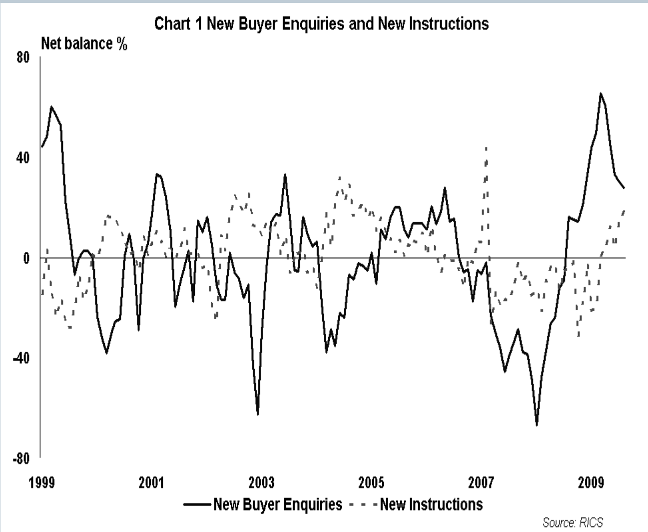
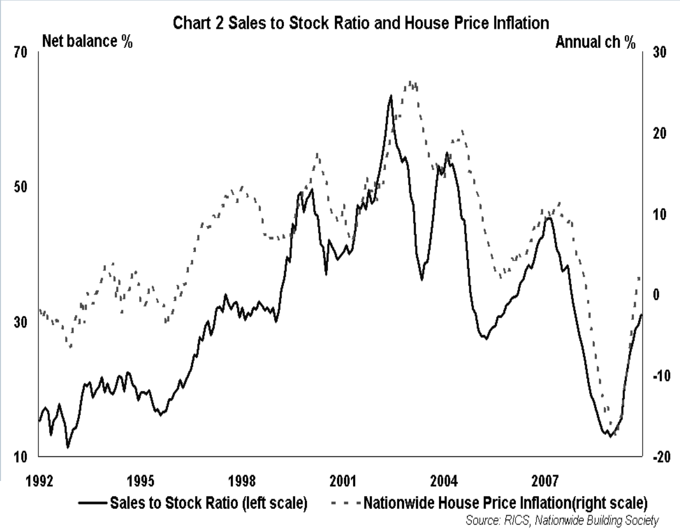
UK Housing Market: Battling The Headwinds

- The housing market has come through the past year in rather better shape than might have been expected in the wake of both the turmoil in financial markets and the subsequent sharp contraction in the economy. Nevertheless, significant challenges relating both to the macro environment and property market dynamics remain.
- The supply of property may now be beginning to increase but it continues to fall short of demand. This gap points towards further price gains over the coming month. Transaction levels are also likely to edge up a little further in 2010.
- But the prospect of higher interest rates and fiscal retrenchment will present material obstacles for the market to contend with later in 2010.

Despite the generally grim run of news on the economy over the past twelve months, the housing market has gradually regained some composure. Transactions levels, while still well down on historical norms, have doubled from the low point seen at the tail end of 2008. Meanwhile, prices have also begun to pick-up although there has been a strong regional dimension to this. Some parts of London are, according to recent RICS Housing Market surveys, seeing a return to 2007 peaks with reports of competitive bidding for the most desirable properties. However, other parts of the country have experienced a rather more laboured turnaround in prices. For what it is worth, most indices indicate that the recovery in the market has taken the average price (across the country) to within somewhere between and 10 and 15% of the high water mark.



Notwithstanding this improvement, much commentary on the residential market remains cautious at best. Fitch ratings, for example, has recently suggested that a 'double-dip' is quite likely and concludes a recent report on the house building sector by highlighting the possibility that house prices could yet drop by another 20%. RICS recognises that the residential market is likely to face some very real challenges over the next couple of years and would acknowledge that some renewed pressure on prices can't be ruled out. Even so, we doubt that any pullback will be of a significant enough magnitude to bring the average level of house prices across the whole of the country back to the lows touched in the early part of this year.



Supply shortage is still the key

Even with credit conditions remaining very tight and finance for loans with LTV's in excess of 75% both hard to come by and expensive, the increase in the demand for property has comfortably outstripped fresh supply over the course of 2009. This is most clearly visible in the comparison of the behaviour of the RICS 'new buyer enquiries' and 'new instructions' series from the monthly Housing Market Survey shown in chart 1. Interestingly, until June the latter was still falling despite the higher level of demand; this imbalance has helped to create the climate for the subsequent rebound in prices.

That said, there is at last some evidence that the number of new instructions being registered with estate agents is beginning to increase. The most recent (November) Housing Market Survey actually showed 18% more respondents seeing an increase in supply than a decrease which was the highest positive reading since May 2007. But even with this boost, the inventory on the books of the typical estate agent remains close to historical lows. Indeed, the average level of stock turned down again in the most

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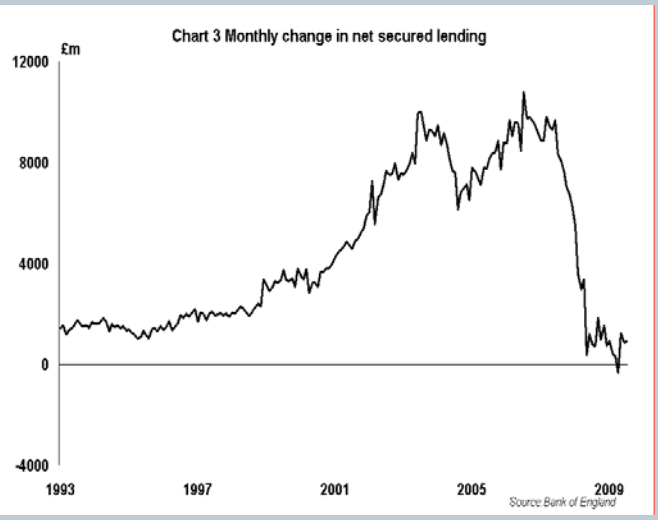
recent report indicating that the higher level of supply is still failing to keep pace with buyer interest. The result of this has been a further rise in the closely-watched RICS sales to stock ratio. As chart 2 demonstrates, this indicator has proved historically to be a fairly reliable guide to the trend in house price inflation.



So a major issue for 2010 is whether the gap between 'new buyer enquiries' and 'new instruction' is going to continue to close. One indication that this may indeed to be the case is provided by the most recent RICS Residential Lettings Survey (RSL). This has detected a drop in the amount of property coming to the rental market. Consistent with this pattern, the report also suggests the proportion of landlords planning to sell their property at the expiry of the existing tenancy has jumped to 3.2%, its highest level since the early part of 2008. These developments tie in neatly with the suspicion that a more active sales market is encouraging some so-called 'reluctant landlords' to capitalise on the improvement in sentiment. However, one word of caution is warranted here. Property, for good or ill, is likely to continue to be viewed as a relatively attractive home for savings certainly in comparison with the stock market or bank deposits given performances over the past decade. It could just be that the latest RSL is picking up a grouping of frustrated sellers from the past year rather than signalling the start of a meaningful new trend.

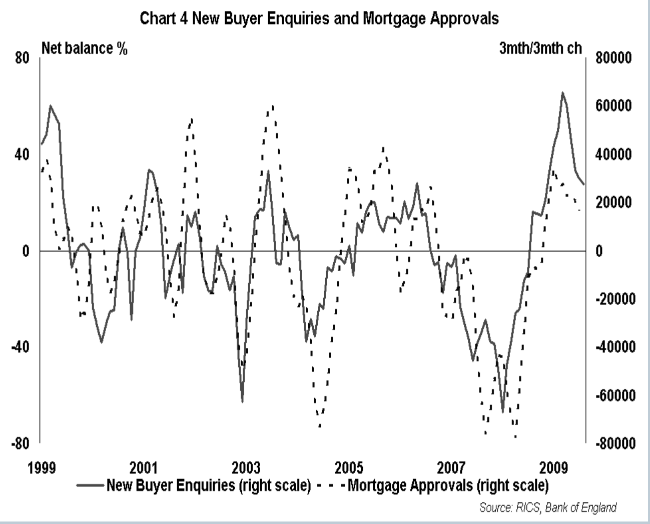
Meanwhile anecdotal evidence from estate agents, as noted in the comments included in recent Housing Market Surveys, suggests there is a widespread expectation that potential vendors are likely to be more willing to put property onto the market in the new year. With the lack of supply beginning to rival the squeeze on mortgage finance as a headwind holding back turnover in the residential market, it is perhaps not surprising that this is near the top of the wish list for the industry.

Credit finance still tight

Demand for property may have picked up from the lows touched at the back end of last year but with mortgage finance still hard to come by, transaction activity remain at the very low end of the historic range. The last Bank of England Credit Conditions Survey which relates to the third quarter suggested that lenders at the time were expecting mortgage finance to become a little more freely available in the final part of this year. That said, a similar expectation at the end of the second quarter proved to be unduly optimistic. Comments from respondents to the RICS Housing Market Survey cast doubt on whether there has been much of an improvement in the lending climate.

Meanwhile, to the extent that any change in mortgage rates could be viewed as indicative of a shift in lending behaviour it is hard to discern any material loosening in the picture. The latest data from the Bank of England up to and including November shows a broadly stable pattern in the cost of secured borrowing since the middle of the year. Moreover, although some slightly more attractive packages have been introduced in the run up to the year end they are unlikely to be significant enough to materially impact on the flow on finance.

The monthly net lending data highlighted in chart 3 demonstrates in the clearest possible terms the scale of the funding shortfall in the market. In 2007, admittedly at the peak of the cycle, net lending was typically running at around £10bn a month. Currently, it is struggling to reach one-tenth of this amount. The collapse in the securitisation market, notwithstanding some recent issuance, coupled with the retreat of foreign lenders suggests that the picture is unlikely to change very much over the next twelve months.



Buyer appetite yet to dissipate

Whether one looks at mortgage data from the Bank of England or Land Registry numbers on competed sales (in England and Wales), the story of 2009 is not dissimilar. Activity levels have pretty much doubled from the worst point but still remain some way down on what might be considered historical norms. As we suggested earlier, it has not just been lack of finance

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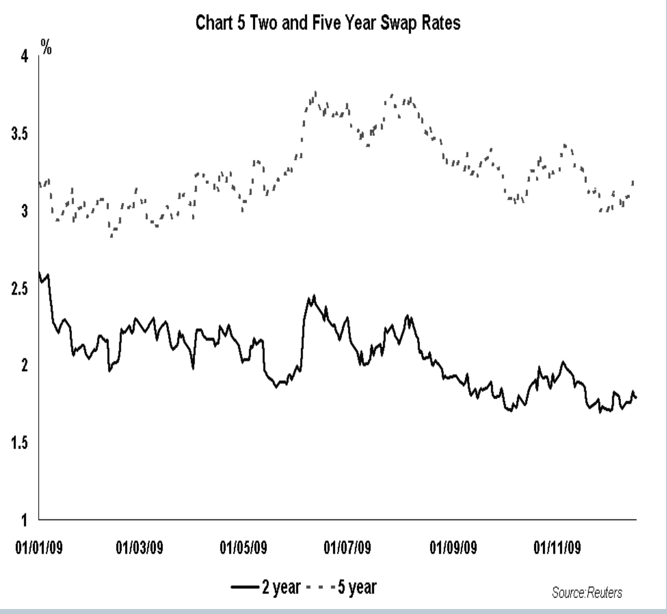
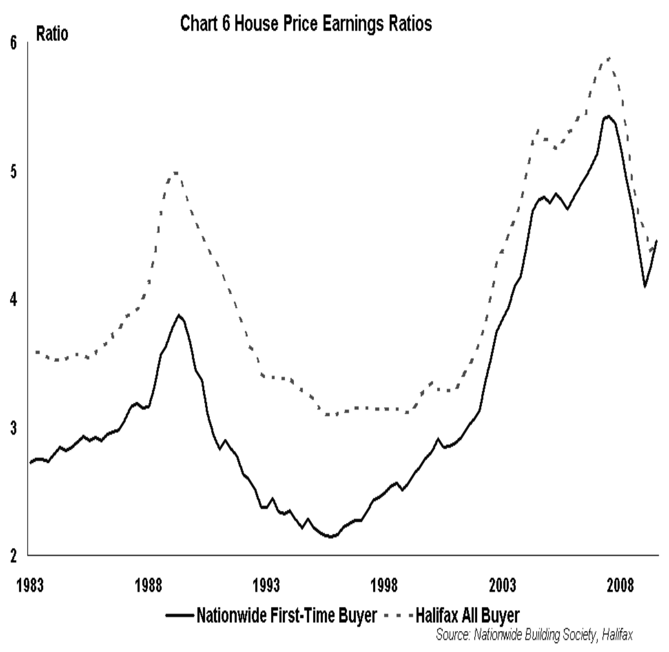
that has been responsible for preventing a more meaningful pick-up in activity; the absence of sufficient good quality supply has also played a role in impeding a stronger rebound in turnover.

In the near term, a good steer on the level of mortgage approvals can be gleaned from the RICS 'new buyer enquiries' series. The latter effectively tracks the change (compared with the previous month) in the number of estate agents seeing an increase rather a decrease in interest. It has been slipping in recent months but still stands at a high level by comparison with its long run trend. More importantly, it is also continuing to signal that the volume of transactions will continue to rise over the coming months albeit at a less marked pace that has been the case hitherto. This is clearly demonstrated in the in chart 4.

However, there are a number of other factors which suggest that interest in the market may slacken as the year progresses. A series of tax increases have already been signposted starting with a return to the previous regime for both VAT and Stamp Duty on January 1st. This will be followed by the hastily announced tax on bank 's bonus payments (in the Pre Budget Report) and the increase in the top rate of income tax to 50%. In addition while the Bank of England continues to emphasize the fragility of the forthcoming recovery in the economy, it is likely that at some point it will want to begin to lift the base rate from its current emergency level as well as exiting from the £200bn quantitative easing programme.



While the latter was not directly designed to support the residential market, it clearly has been beneficial by holding gilt yields down and by inference the swap rates that help to determine the cost of fixed rate secured lending (see chart 5). Unwinding this programme may not actually begin in 2010 but without further additional purchases and the supply of paper



running at elevated levels, the risk is that yields will drift higher. Alongside this, RICS envisages that base rates will be raised at least once if not a second time towards the tail end of the year running at elevated levels, the risk is that yields will drift higher.

Affordability is a potential obstacle

For the time being, accessibility to the property market is clearly the big issue with at least fourth-fifths of first-time buyers being forced to rely on parental support in one of form of other to get a foot on the ladder of home-ownership. It is hard not to view this as a worrying development with very real implications for the future of society. That said, for those who are able to access finance in the current climate, servicing costs are not at this stage a major obstacle. Indeed with interest rates likely to stay low through the course of the coming year, affordability (providing one can scrape together the requisite deposit) should remain a second tier issue. Yet the fact the house price earnings metrics are rising again is something that should not be ignored. The Nationwide Building Society measures first time buyer house prices against earnings which it publishes on a quarterly basis. The ratio slipped from a high of 5.4% in 2007 to 4.1% but has since rebounded to 4.5% as chart 6 shows. To put these figures in some context, the average ratio since 1983 is 3.3% and it is 3.7% since the beginning of 1996. The Halifax series on affordability also reproduced in the chart is a broader measure taking into account all buyers but it tells a not dissimilar story. Valuation metrics never fell as far as long run averages before picking up again. Significantly, however, mortgage repayments as a percentage of income remain close to their lowest level since 2002. This is a key reason, alongside the range of government initiatives, why level of household mortgage distress has fallen someway short of the experience of the early 1990s.

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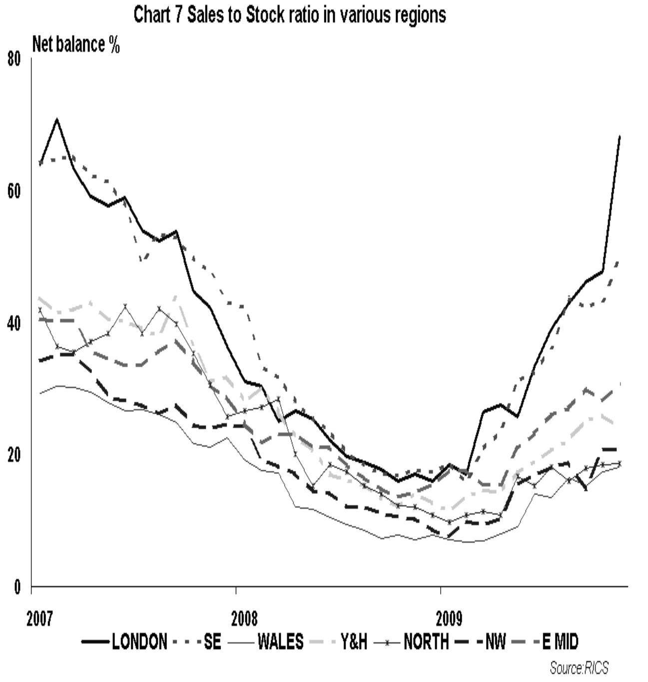
RICS Economics

London to outperform

All the major house price indices show London to have been the strongest regional market since sentiment began to improve in the early part of this year. This is also something that is borne out by the RICS Housing Market Survey. The price expectations net balance moved back into positive territory earlier in the year than any other part of the country. Meanwhile, new buyer enquiries rebounded much more strongly in the capital over the last twelve months than in other parts of the country while the net balance of net instructions has been particularly subdued. Chart 7 tracks the sales to stock ratio for a number of regions over the course of 2009 demonstrating how market tightness has been much more visible in London than elsewhere. The strength of buyer interest in London can in part be explained by the dramatic turnaround in the fortunes of the financial services industry as well as the weakness of sterling which has attracted foreign investors particularly in prime locations. Although it would be wrong to rule out some catch up over the course of 2010, the arguments seem at this stage to be fairly balanced. The ending of the extended zero rate band for stamp duty will in all probability have only a limited impact on the residential market in aggregate but will have a regional dimension with the Midlands, Wales and Scotland most at risk according a recent questionnaire sent out to RICS members. However, London could be more adversely affected by the increase in the top rate of tax to 50p in April as well as the planned charge on bank bonuses pools. Looking beyond this, the prospects of a significant scaling back in public expenditure points towards a more even regional economic performance over the next few years. This has the potential to have a significant impact on the behaviour of house prices across the country.

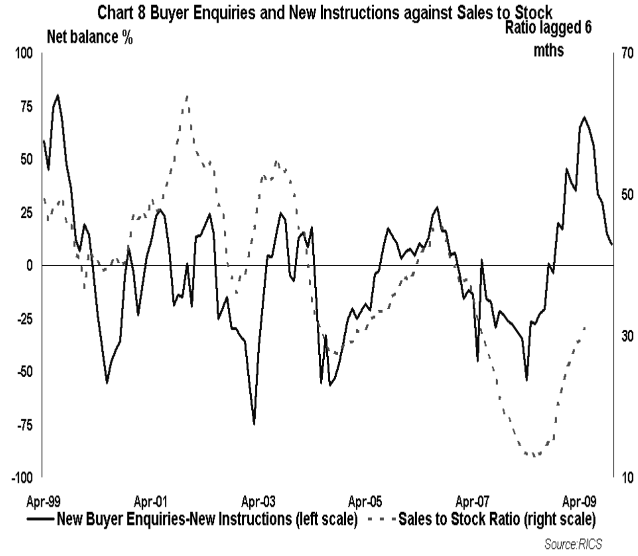
Chart 7 Sales to Stock ratio in various regions



The outlook

Transaction activity as measured by Land Registry data points to completed sales in the final quarter of 2009 coming in somewhere between 55 and 60,000 (monthly average). This compares with the February low point of 26,700. The combination of further increases in buyer enquiries and more supply is consistent with a further rise in the number of completed sales over the coming year; our suspicion is that by the final quarter of 2010, the average volume of transactions may climb to around 70,000 (mortgage approvals data covering the whole of the UK will be broadly similar).

Chart 8 Buyer Enquiries and New Instructions against Sales to Stock



Now to the price outlook. The central scenario in this forecast is for the typical price on a residential property (as measured on the index compiled by the Nationwide Building Society) to continue to rise during the early part of 2010 before slipping back modestly. Much has been made of the dampening impact of an increase in new instructions in the new year. Our analysis (chart 8)shows that even if the gap with new buyer enquiries continues to narrow, it will be pretty much the spring before the sales to stock ratio begins to turn down (signalling a deceleration in the annual rate of house price inflation). Reflecting this, we envisage house prices being just a little higher in the final quarter of 2010 than at the end of this year (1to 2%). Although it is not difficult to find reasons why there may be a positive surprise (continued weakness of instructions, lack of new build, more marked easing in lending criteria), we are still inclined to view the risks as being skewed slightly more towards the downside. A major reason for this is the uncertainty surrounding the economy. While some comfort can be drawn from the improvement in most sentiment indicators, the recovery in the economy is unlikely to materially exceed 1.5% in 2010. The labour market will in all probability remain fairly flat. And as discussed earlier, even if the timing of a policy tightening is hard to specify, the inevitability of such a development is not.

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