

UK Residential Price Forecasts

Awaiting the next house price surge

Despite multiple near term detrimental influences, UK house prices are set for a further surge



Chart 1. Medium term house price factors



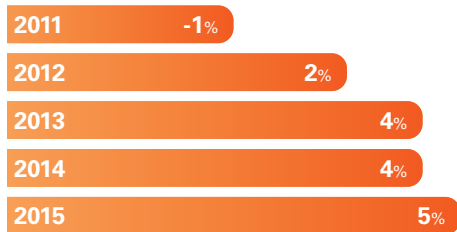
Negative

- 1 Poor housing affordability
- 2 Higher interest rates
- 3 Restricted mortgages

Positive

- 1 Population and household growth
- 2 Undersupply of housing
- 3 Aspiration to own home
- 4 Importance of housing asset
- 5 Level of housing equity

Chart 2. UK house price forecasts (%pa)



Sources

¹Lloyds/HBOS

²CML

³Hometrack

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King Sturge forecasts

We believe that the current housing market downturn will be shallow and short-lived. We are forecasting that UK house prices will fall marginally outside of London in the near-term, but will be rising again by 2012. Moreover, we believe that UK house prices will be increasing even more strongly during 2013-2015, led by the south and London in particular, with the balance of risk firmly on the upside.

Forecasting rationale

There are a multitude of reasons to argue that house prices will fall in the near term and there are also a number of factors which suggest that house prices are fundamentally too high in the UK. These include that the average house price is around 4.6 times average earnings¹, that first time buyers typically need a deposit of around £29,000¹, that around 80% of first time buyers receive parental support² and that the average age of a non-assisted first time buyer is now 36 years².

However, there are also a number of reasons why we believe that house price falls will be limited and why house prices will soon increase strongly again. The principal reasons are three-fold. Firstly, there is already an undersupply of housing in the UK and the gap between demand and supply is set to increase as new household growth is set to significantly outpace the rate of new housebuilding. Second is the desire for households to own their own home from both an aspirational and an investment asset viewpoint. The third point is that whilst there is such a high level of equity in the housing market, around 31% of UK housing is owned outright and a further 22% is owned with over 50% equity³, there will be sufficient capital to pass down to help first time buyers onto the housing ladder. Furthermore, a continued strong rise in house prices will reinforce the importance of these last two points.

The solutions are to increase supply or to reduce demand. Given the financial drivers of private housebuilders and the growing constraints of planning, public sector or heavily subsidised building are the only remedies. On the demand side, only tight restrictions on inward migration, controls on family size, a mass exodus of Britons abroad or a more deep-set shift to renting, could sufficiently constrain owner-occupier demand.

Both demand and supply solutions require heavy government intervention. But neither is likely to happen either at all or sufficiently over the next 5-10 years, implying that house prices will rise faster than earnings in the medium term and that households will be forced to accept higher mortgage service costs as a proportion of income. We fully acknowledge that this outcome is neither ideal nor desirable and will threaten to create an even greater divide between the 'haves' and the 'have-nots', but we are similarly of the view that the driving forces for higher house prices will not be derailed in the short to medium term.

Chart 3. 2011 UK house price factors

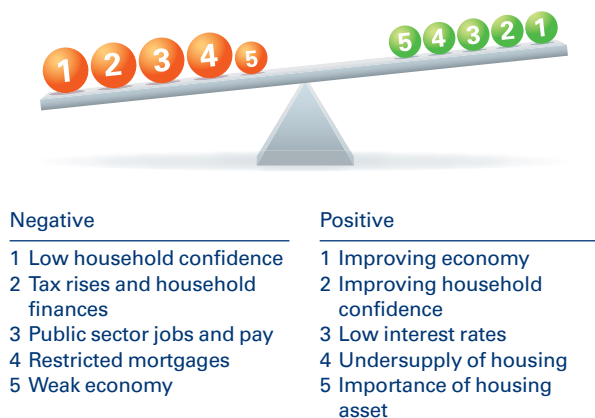


Chart 4. 2011 regional house price forecasts (%pa)

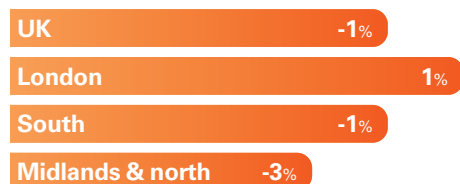
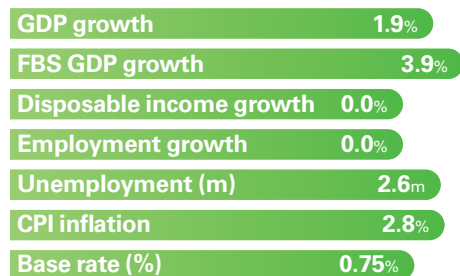


Chart 5. 2011 UK economic forecasts (Q4 %pa unless stated otherwise)



Source: Oxford Economics

2011

Weak housing market sentiment will lead to price falls early in the year but greater stability and some price rises will emerge later.

Backdrop & drivers

Weak household sentiment and economic conditions will be key features of 2011. The mood of the nation will be dominated and dampened by the weight of government austerity measures, public sector job losses, the January VAT rise and higher household costs, especially early in the year.

However, whilst this general mood will remain throughout the year, there will be an increasingly positive mindset developing as the year progresses. We are expecting the UK economy to continue its steady recovery during 2011 although GDP and employment growth will be rather unbalanced with the private sector expanding as the public sector contracts and with the south outpacing the north. Household finances will remain stretched, with real disposable incomes not rising, but the weak economy should mean that the base rate will be held at 0.5% for most if not all of 2011 (Chart 5).

Housing market forecasts

We believe that these weak economic and household conditions, especially during the first half of the year, combined with continued tight mortgage lending conditions, will lead to some house price falls during early 2011. However, we do not foresee large house price falls and believe that greater stability and even price rises, more likely in London and the south, will return during the second half of the year. A strong feature of the market will also be low turnover. We are forecasting that less than 1 million UK transactions will take place in 2011.

We are expecting regional price growth differences (Chart 4). London is likely to be relatively resilient as the economic recovery will be stronger, public sector cuts less influential and supply shortages more acute. Regional markets, especially where public sector employment is important, are likely to be harder hit even if the job axe does not fall until post-2011. More detailed regional forecasts are presented later in the report. Importantly, housebuilding volumes will remain low.

Forecast risks

Although we would not rule out another year where house price rises are higher than forecast, we believe that the balance of risks to our central forecast are marginally on the downside. We could see sharper house price falls if the austerity measures depress medium term household confidence as well as near term sentiment. Price falls would also be greater if interest rates were increased sharply in response to inflationary pressures. Even then we do not foresee house price falls in excess of 5% nationally. Global or domestic double dip scenarios are becoming increasingly remote possibilities. Our forecasts assume that new FSA rules, that would severely constrain mortgage lending even further, are not implemented.

Chart 6. 2012 UK house price factors



| Negative | Positive |
|--------------------------------|--------------------------------------|
| 1 Public sector jobs and pay | 1 Stronger economy and confidence |
| 2 Lowish household confidence | 2 FTB stamp duty initiative ends |
| 3 Weakish household finances | 3 Resurgent pent-up housing demand |
| 4 Unbalanced economic recovery | 4 Less restrictive mortgages |
| 5 Restricted mortgages | 5 Housing undersupply and importance |

Chart 7. 2012 regional house price forecasts (%pa)

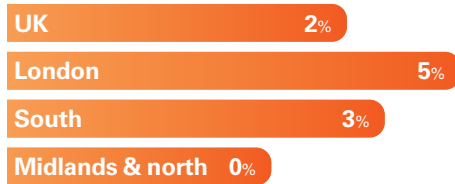
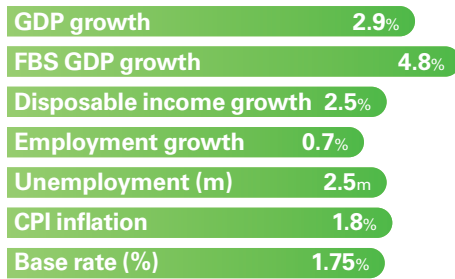


Chart 8. 2012 UK economic forecasts (Q4 %pa unless stated otherwise)



Source: Oxford Economics

2012

Positive UK house price growth will return as the economy strengthens and negative influences fade. London will outperform.

Backdrop & drivers

2012 will be the first year of above trend GDP growth in the UK since 2007, and although the economic backdrop will still be quite muted, consumer confidence will improve after several years in the doldrums as private sector job and pay prospects improve and a much needed feel good factor begins to infiltrate the nation's mood, boosted also by the Olympic effect.

GDP growth is forecast to be 2.9% and real disposable income growth 2.5% while employment growth will be positive for the first time since 2008. London will lead with GDP growth of 3.2%. The base rate should rise further during 2012 but even at 1.75% by the year-end it will still be supportive of house prices.

Housing market

The housing market in 2012 will be facing competing forces. On the one hand the continuing fiscal squeeze and restrictive mortgage conditions could combine with increasing interest rates to stifle higher house price growth, especially in midland and northern regions. On the other hand an improving private sector economy and better job and pay prospects could help feed more positive household sentiment and lead to greater housing demand.

There are further reasons why price growth could be stronger. The two year stamp duty holiday for first-time-buyers for properties under £250,000 will end on March 25 2012 and this should lead to a surge in purchases during Q1 2012. This could also prove the catalyst to release some broader-based pent-up housing demand from previous years, especially if the feel good factor spreads. This should force prices higher assuming no excessive overhang of properties on the market, with momentum continuing into the remainder of the year.

Our central forecast is for UK house prices to increase by 2% in 2012. London in particular, but also the south, is expected to lead with London seeing rises of 7% or more. Prices are likely to remain stable in midland and northern areas. The number of housebuilding starts will increase in 2012 but will still be quite muted and well below required levels. The housing undersupply problem will therefore grow further.

Forecast risks

We consider it far more likely that house price growth will outperform our central forecast than underperform in 2012. Even if household confidence and housing demand remain weak in 2012, the larger hit to the housing market will have been in 2011 rather than in 2012. We think it is more plausible that pent-up housing demand and improving household confidence will combine with a renewed 'need' to get on the housing ladder and that these factors will force house price growth higher than our central forecasts.

Chart 9. 2013-2015 UK house price factors



| Negative | Positive |
|------------------------------|-----------------------------------|
| 1 Poor housing affordability | 1 Population and household growth |
| 2 Higher interest rates | 2 Undersupply of housing |
| 3 Restricted mortgages | 3 Aspiration to own home |
| | 4 Importance of housing asset |
| | 5 Level of housing equity |

Chart 10. 2013-2015 regional house price forecasts (%pa)

| | 2013 | 2014 | 2015 |
|------------------|------|------|------|
| UK | 4% | 4% | 5% |
| London | 7% | 7% | 6% |
| South | 5% | 5% | 5% |
| Midlands & north | 2% | 3% | 4% |

Chart 11. 2013-2015 UK economic forecasts (average %pa unless stated otherwise)

| | |
|--------------------------|------|
| GDP growth | 2.9% |
| FBS GDP growth | 5.7% |
| Disposable income growth | 2.8% |
| Employment growth | 1.3% |
| Unemployment (2015Q4, m) | 2.2m |
| CPI inflation | 1.9% |
| Base rate (2015Q4, %) | 5.0% |

Source: Oxford Economics

2013-2015

Higher housing demand will conflict with low housing supply to deliver strong house price growth despite stretched affordability.

Backdrop & drivers

The UK economic recovery will be in full swing, with GDP growth of circa 3% pa, and will be more broadly based than earlier in the recovery. Employment growth will begin to accelerate with earnings growth, disposable incomes and consumer spending all back to trend rates or above. The base rate will rise back to 5% and could go higher to contain stronger house price growth.

Housing market

Although the impact from government austerity measures will be fading, household finances for some will still be tight and affordability, mainly in terms of deposits but also from higher interest rates, will all be constraints on house price growth. However, we expect the positive influences of a stronger economy, better job and pay prospects, heightened household confidence, a release of pent up housing demand and a relaxing mortgage lending environment, to increasingly outweigh the dampening house price influences.

Furthermore, the more fundamental supports for house price growth discussed on page 2, the undersupply of housing, the desire to own and the level of housing equity, will play an increasingly important role in driving house prices higher.

We expect London to continue to provide the highest price growth although a significant development during this period will be the more broadly based nature of house price growth which will increasingly spread across all UK regions (Chart 10). The volume of housebuilding will continue to increase although will still be significantly below required levels.

Forecast risks

Given the nature of asset prices and the experience of the UK housing market, the path and magnitude of house price growth may not be as smooth as portrayed here. Moreover, given the aforementioned fundamental price supports as well as the pent up demand factor, we believe that the balance of risk to our central forecasts is firmly on the upside. This is despite an acknowledgement that housing affordability will become increasingly stretched and that many first time buyers will continue to struggle to raise required deposits and gain a footing on the housing ladder. We can easily foresee at least one year of significantly higher house price growth during this 2013-2015 period as the shackles from previous years are cast aside.

Chart 12. 2011-2015 Central London house price factors



Chart 13. London house price changes (%pa)

| | 2011 | 2012 | 2013-2015 |
|----------------------------|------|------|-----------|
| Prime Central London | 3% | 8% | 7% |
| New Central London - prime | 5% | 7% | 7% |
| New Central London - other | 2% | 6% | 7% |
| Greater London | 1% | 5% | 7% |
| UK | -1% | 2% | 4% |

London

Backdrop & drivers

London is already leading the economic recovery and although there will be more public sector job losses in London these will be outweighed by greater private sector job creation, even in 2011. GDP growth of 2.5% in 2011 and 3.6% pa during 2012-2015 and FBS output growth of 3.9% in 2011 and 5.6% pa in 2012-2015 will be well ahead of UK growth rates.

We expect a positive impact on the economy and household sentiment from the Olympics as well as from an increasing gap between housing demand and supply in the capital, despite strong competition between housebuilders, especially in central areas, as new development will continue to fall short of requirements and targets. London, and central London in particular, will also be influenced by exchange rates, the FTSE and the global economy, all of which are expected to be supportive of house prices.

Housing market forecasts

We are expecting two key themes for London. Firstly that house price growth will outperform the UK throughout our forecast period, but especially in the early years, and secondly that prime and central areas will outperform the rest.

The broad Greater London housing market is driven predominantly by the domestic market and above average earning Londoners, and with GDP, FBS and employment growth all expected to be positive in 2011, housing demand should remain reasonably steady despite weaker sentiment elsewhere in the UK. In the medium term, the better London economy is also expected to lead to stronger house price growth than in the UK.

In more central and prime locations, where demand derives from higher income brackets and is driven predominantly by international buyers, we are forecasting positive and stronger price growth even in 2011. We expect that because the sterling and US dollar exchange rate will remain at around \$1.55 during 2011-2015, and despite a slight strengthening of the pound versus the euro, international demand will remain strong. This will be further supported as prices are already 25% below peak levels in US\$ terms. Other supports will include a marked increase in global wealth powered by a recovering world economy, a lack of new development in central areas and a decreasing supply of property to buy due to overseas and domestic investment.

We are forecasting that prices in prime new central London schemes will rise by 5% in 2011 and grow by an average 7% pa during 2012-2015 and will be only marginally lower for less prime schemes. For the wider Greater London market we are predicting a price increase of 1% in 2011 will accelerate to 5-7% during 2012-2015 (Chart 13).

Chart 14. 2011-2015 South, midland and north house price factors



| Negative | Positive |
|------------------------------------|------------------------------------|
| 1 Public sector jobs and pay | 1 Improving economy and confidence |
| 2 Low household confidence | 2 Pent-up housing demand |
| 3 Mortgages & interest rates | 3 Population and household growth |
| 4 Tax rises and household finances | 4 Undersupply of housing |
| 5 Poor housing affordability | 5 FTB stamp duty initiative |

Chart 15. South, midland and north house price changes (%pa)

| | 2011 | 2012 | 2013-2015 |
|-----------------------------|------|------|-----------|
| South | -1% | 3% | 5% |
| Midlands & north | -3% | 0% | 3% |
| UK | -1% | 2% | 4% |

Note
 South is defined as the South East, Eastern and South West government office regions.
 Midlands and north is defined as East Midlands, West Midlands, North West, North, Yorkshire & Humberside, Scotland and Wales.

South, midlands and north

South

We do not expect southern regions to match the economic and employment growth fortunes of London but conditions will be superior compared to midland and northern regions. South eastern regions will reap some benefit from the faster improving London economy and will not suffer to the same extent as some other locations in terms of public sector job cuts. Over the period 2011-2015 GDP growth in the south is forecast to average 3.2% pa compared to 3.0% pa nationally while employment growth of 1.1% pa is predicted to outpace the 0.9% pa national average.

We are forecasting that house prices in the south will fall during 2011 but only by around 1%. Prices may fall further than this during the first half of the year before rising marginally later. From 2012 economic and employment growth will be accelerating and the resultant stronger housing demand will combine with a lack of recent development activity to force house prices around 3% higher before growth pushes to 5% pa during 2013-2015.

We judge the balance of risk to be on the upside of these central forecasts, especially during the 2013-2015 period when the release of pent-up housing demand following several years of subdued activity could cause a house price surge.

Midlands and north

Throughout our forecast period we expect house price growth in midland and northern regions to underperform compared to London and the south. The principal reasons are the greater initial and ongoing impacts from the public sector cuts and the resultant slower economic and employment growth. Over the period 2011-2015 GDP growth is forecast to be 2.7% pa compared to 3.0% pa nationally while employment growth of 0.6% pa is forecast to be below the 0.9% pa national average.

In 2011 we are forecasting that house prices will fall in the region of 3% but the balance of risk is that prices could fall further than this. However, for all of the reasons previously stated, we think it unlikely that prices will fall by more than 6-7% on average.

We think that the recovery in house prices in midland and northern regions will be quite muted, and deferred, compared to London and the south. The ripple effect may take longer to impact in this business cycle. We are forecasting 0% house price growth in 2012 will rise steadily towards 4% by 2015 (Chart 15). The balance of risk to our forecasts is on the downside in 2011 and 2012 but on the upside thereafter.

The team



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