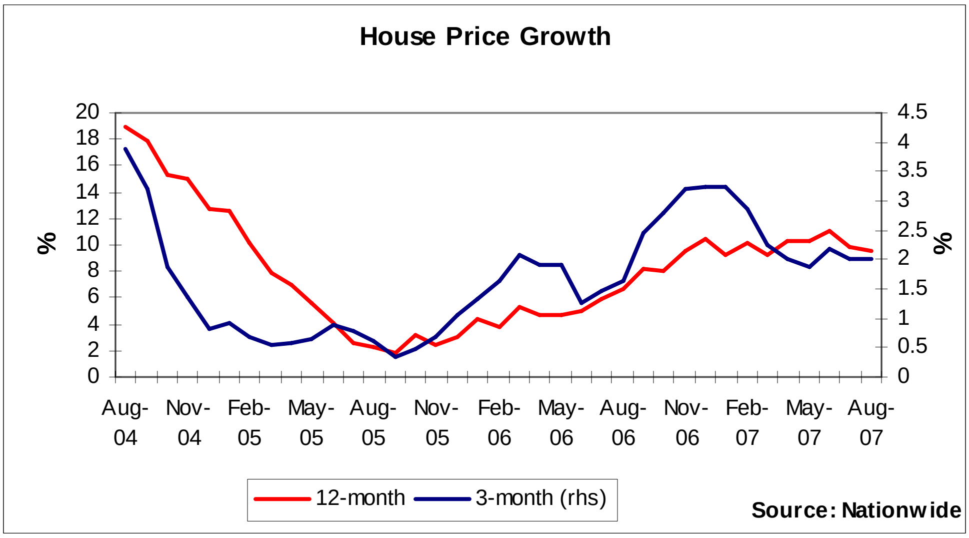
Economic Background

Whilst the base rate remained unchanged in August, there is strong upward pressure on mortgage rates as a result of recent uncertainty in financial markets. The 3-month LIBOR rate exceeded the base rate by a greater margin in August than any time since 2000 and the differential was increasing in the first week in September.

UK residential pricing

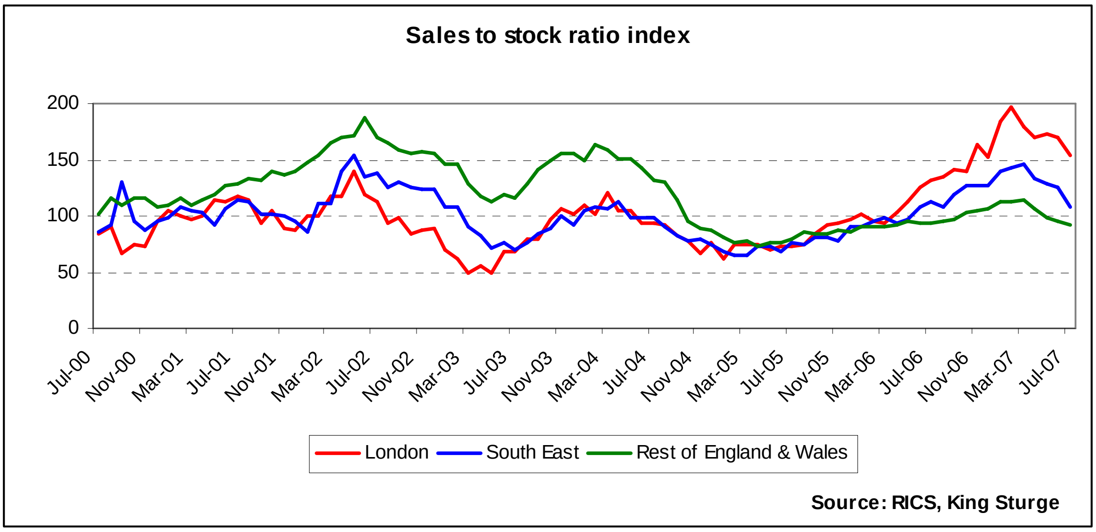
UK residential prices rose by 9.6% in the year to August, according to Nationwide (Chart 1). The 12-month growth rate has been hovering around 10% throughout 2007. There has, however, been a weakening in the short-term growth trend, over three months, in the summer.

Chart 1



The sales to unsold ratios in London and South East have been on a downward trend recently (Chart 2). The regions, however, still have noticeably tighter housing markets than in other areas of the country. This measure quantifies the difference between housing demand and supply and has proved an accurate lead indicator of pricing in the past.

Chart 2



There has been a degree of speculation concerning the contagion effect spreading to the UK from the US sub-prime mortgage lending crisis. We believe that the UK market is fundamentally more stable than in the US. US mortgage rates have risen more sharply than in the UK since 2004. Furthermore, completions per capita have been far higher in the US, resulting in a more substantial rise in housing supply than demand in recent years, which is the exact opposite to conditions in the UK.

UK mortgage lending has been resilient, with the July 3-month average higher than at any point since last October. The number of loan approvals in July was unchanged on the June figure, at 115,000. Large sub-prime lenders, however, did re-price loans in August. The Council of Mortgage Lenders, though, forecast that 2007 will be a record year for lending. This is reassuring but it should be borne in mind that the UK house price–disposable earnings ratio remains higher in the UK than in the US, so double-digit, annualised capital growth in the short term will not be a common feature of the market.

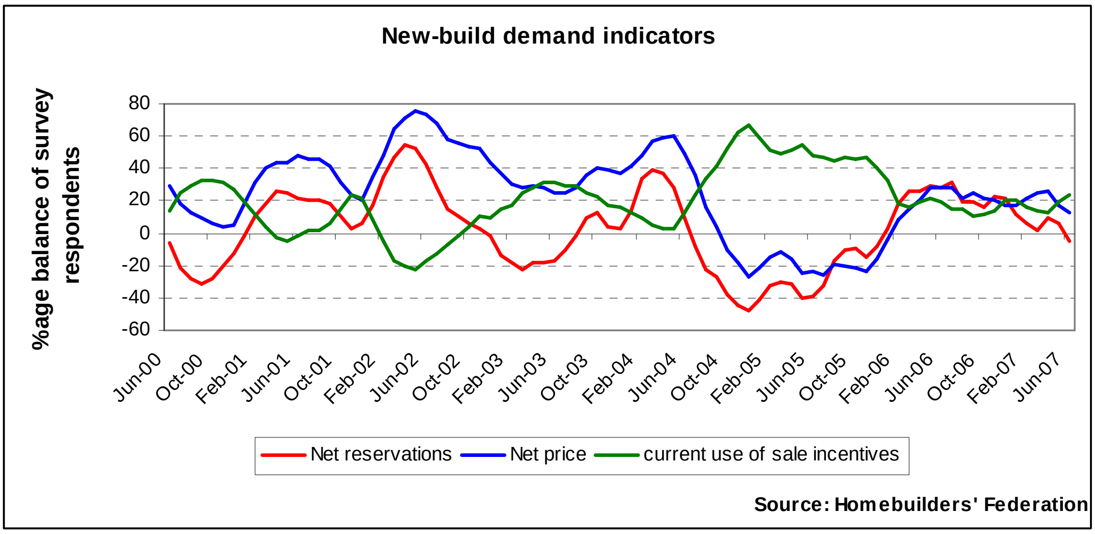
Investor activity remains buoyant, despite tightening landlord margins. In the first half of 2007, the number of buy-to-let mortgage advances fell 3% on the H2 06 figure, but it was 13% higher than the equivalent period in 2006, according to the Council of Mortgage Lenders. Foreign investors, who are not included in the CML analysis, also remain active. With global economic growth forecast to increase by 5% in 2007 and 2008, according to the IMF, foreign buyer activity is expected to remain solid.

The strength of the lettings market has supported recent investor confidence. Tenant demand relative to rental stock supply was higher than any point in nearly 5 years in Q2 2007, according to ARLA. Void periods dropped to their lowest level over the same period.

Rental growth in the Docklands was 12% in the year to Q3 2007. The strength of tenant demand in this market has resulted in the increasing occurrence of sealed bids.

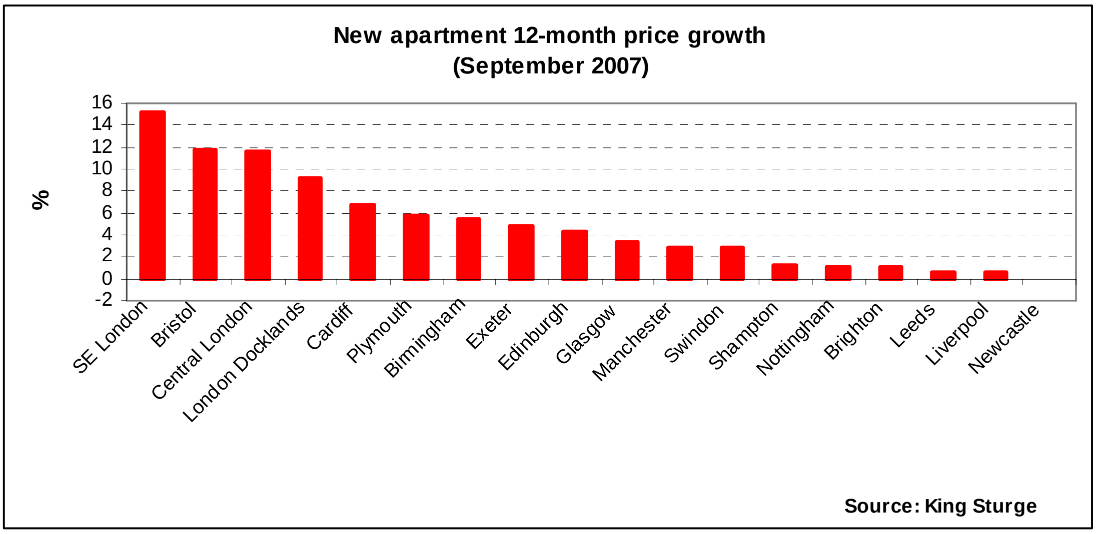
The new-build sector has experienced some adverse reaction to recent monetary policy tightening, but there does not yet appear to have been any dramatic effect (Chart 3). Indeed, the market has been relatively steady in recent months, given the financing environment. Reservation levels are most directly sensitive to base rate change of the indicators shown in Chart 3 and we may well see further lagged effects in pricing.

Chart 3



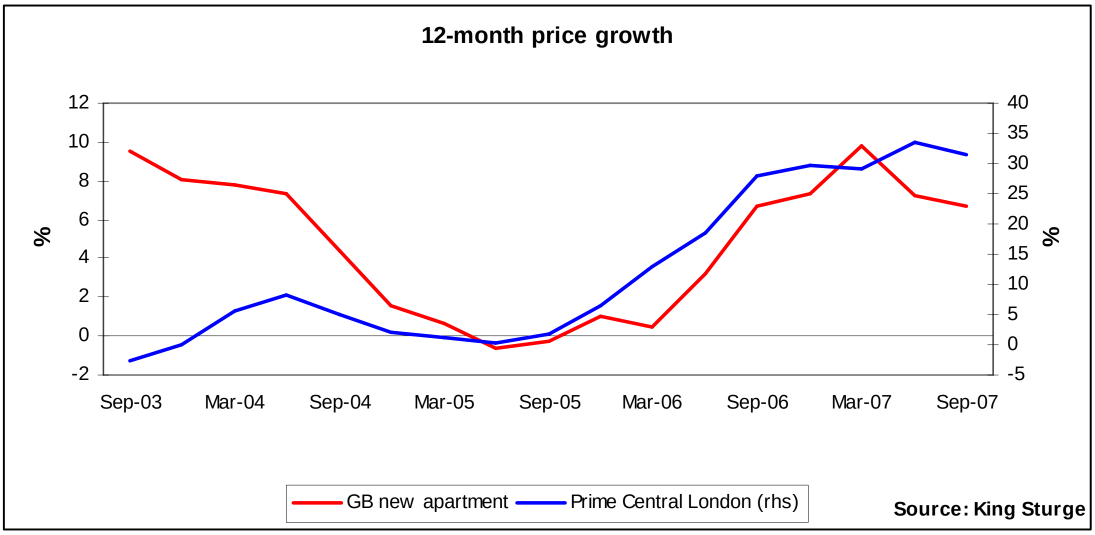
The King Sturge new apartment price index rose by 6.7% in the year to September, down from 9.8% in March. South East London (Greenwich & Blackheath) was the strongest market monitored, with 12-month price growth of 15.3%, followed by Bristol at 11.7% (Chart 4). The weakest market was Newcastle, where prices were unchanged over the past year.

Chart 4



The King Sturge Prime Central London price index rose by 31% in the year to September, slightly lower than the record level reached in June (Chart 5). The amount of stock on the market has risen recently, reflecting a wider national trend, but the imbalance between demand and supply still remains more evident in this market than any other in Britain. The higher end of the market continues to out-perform as stock priced at £4m or more experienced 12-month price growth of 38%, compared to 29% for stock priced below that level.

Chart 5



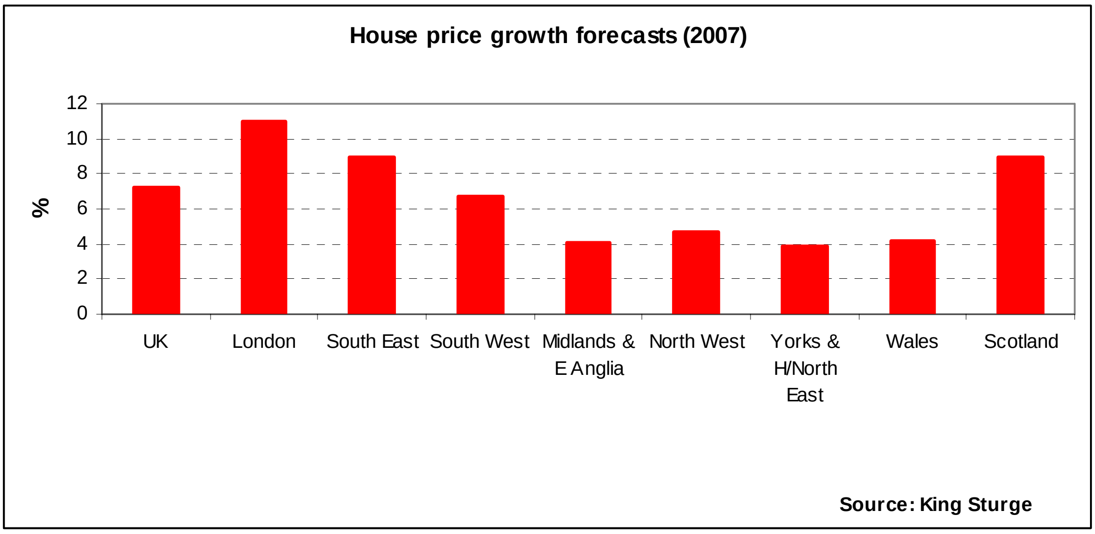
The recent uncertainty on the financial markets has naturally resulted in uncertainty over year-end City bonuses, with compensation commentators anticipating a 10-15% fall in levels seen last year, even though global merger and acquisition activity reached a record level in H1 07. The lower end of the prime Central London market has seen the most direct adverse effect from the recent jitters on the finance markets. Autumn should see lower levels of property lending backed by anticipated year-end bonus payments than was the case in 2006.

In the corporate sector, Persimmon announced that it had achieved 85% of its full-year sales target by August with forward sales for the rest of the year 3% higher than the equivalent period in 2006.

Forecasts

We continue to forecast price growth of 7% for the Nationwide UK house price index in 2007 (Chart 6). Into 2008, we anticipate ongoing pressure from stretched affordability with a year-end UK forecast of 3-4%.

Chart 6



In the Prime Central London, we continue to forecast 20% price growth in 2007. Into 2008, recent financial market uncertainty has inevitably adversely affected the outlook for 2008 but the acute supply/demand imbalance means that double-digit price growth next year is a realistic assumption.