

Spotlight on...

Housing market recovery



In 2008, the UK housing market saw a sharp downward adjustment in values with prices falling by -16% in the year according to Nationwide, and -18% down from 2007 peak values. This was precipitated by a significant contraction in mortgage lending, which caused transaction levels to fall by -60%. Against this background, and worsening global economic conditions, it is unrealistic to talk of an immediate bounceback, but looking further ahead, what can we expect in the housing market?

In this document, we look at the prospects for, and timing of, a housing market recovery.

Our forecasts

In November, we forecast that mainstream house prices would fall by about -25% from their 2007 peak over the course of 2008 and 2009, with minimal growth in 2010. We also forecast that average UK house prices would return to their previous high by the end of 2013, assuming that a deep and prolonged recession could be avoided and that mortgage markets would progressively ease over the next 2 – 3 years.

Within the prime markets, we saw the potential for slightly larger peak to trough falls. This was reflected in our forecast for a -30% total fall in prices in prime central London. Equally, we forecast that this more-volatile

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- ▶ market would lead the recovery especially given the prospect of early investment activity in the sector.

Since we made those forecasts, there has been little evidence of improved financial liquidity. The economy has gone into recession (as we predicted) but the further rapid deterioration in the outlook for the global economy, together with the prospect of widespread job losses, has effectively changed the short to medium term economic backdrop for both the mainstream and prime housing markets. This does not, in our view, change the quantum of house price falls but it does affect the length of time that we think prices will remain suppressed.

End of worst house price falls in sight

The worst of the falls in the residential property market could be over soon. Further price falls are expected but changing market conditions mean that the rate of fall may not be as great as it has been. There are emerging signs that the housing market is reaching the end of its free-fall period, so we could now be about to enter the latter stages of house price falls and be on the brink of the first stage in the recovery process.

“There are emerging signs that the housing market is reaching the end of its free-fall period...”

There will be many stages and regional variations in the future trajectory of house prices that will test the nerves of both home owners and investors but the opportunities for those wanting income returns and the prospect of long-term growth are clearly in place now. Anecdotal market evidence suggests that the interest from cash buyers is already much higher and that good-quality stock is being taken up, leaving a shortage of supply in some cases.

It is prime stock that is likely to first see an upturn and this will characterise the second stage of recovery. The third stage of more widespread recovery in the mainstream markets will be most dependent upon the depth and length of the recession. It is becoming increasingly likely that the worsening economic climate will have the effect of pushing out the timing of recovery from our earlier projections, perhaps by 12 months.

THE FOUR STAGES OF RECOVERY:

Stage 1: Low demand/Low supply. Mortgage market constrained, investor activity in core markets

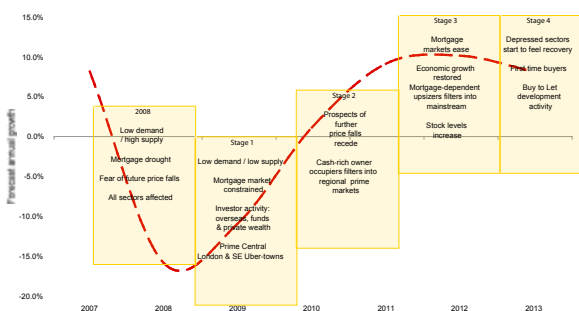
This stage is characterised by low supply as well as low demand levels which cause prices to bottom out. We have already seen a pronounced recovery in affordability, thanks to both price falls and reduced interest rates, which set the platform for a recovery when macro-economic conditions are right. However, the return to house price growth will be a faltering process and further bad news on the economy, particularly that which increases fear of unemployment, is likely to delay the point at which static prices turn to price growth.

Investor activity will be key to a recovery, first in prime central London and some favoured locations beyond the capital, meaning that London and prominent South East towns and University cities will lead the recovery again, as in 1992. Falls in sterling will bring international investors – both individuals and funds – into the market and cash rich buyers will also become more active, attracted by yields which have now moved out from 4.6% to 6%. Outside of the prime markets and at a local level, significant negatives at this stage include the rising number of repossessions and the stock of unsold property in some new homes markets. The Council of Mortgage Lenders expect repossessions to increase from 40,000 in 2008 to 75,000 in 2009. Much depends on whether this stock can be sold, for example to investors, in an orderly fashion or whether it will be allowed to ‘flood’ local markets. Local markets with either high repossession levels or large numbers of unsold newly built stock will see the largest falls in prices, regardless of various Government interventions.

Stage 2: Modest equity demand/Low supply. Prospects of further falls recede and cash rich buyer activity spreads

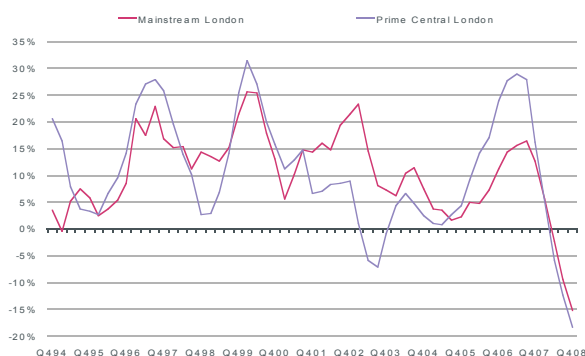
This is likely to be the most prolonged stage and characterised by relatively static prices and low levels of turnover. Against a backdrop of low stock, and as evidence builds of an end to substantial price falls in high profile prime markets, stability will spread. Fears of job loss and constraints on mortgage lending point to a ‘top down’ rather than a ‘bottom up’ recovery. Buyers heavily reliant on credit will be excluded and the equity rich will be the only players in the early stages of recovery. This

Stages in market recovery



Source: Savills

Historic growth and bounce back in the London market



Source: Savills/Nationwide



► means that, as the prospects of further price falls recede, equity rich purchasers will continue to be the main players. As a result of this, we expect the second stage of the recovery to be concentrated in the prime regional markets.

Stage 3: Medium mortgage demand/Modest supply. Markets ease, economy restored to growth and sellers return to market

A more widespread recovery needs liquidity to ease and growth to return to the economy. We think that this will not occur until 2012 at earliest and will be the recovery stage most sensitive to the depth and length of the recession. The third stage of the recovery will begin when mortgage dependent buyers are willing and able to take on a bigger role in the market. This is only likely to commence when credit liquidity eases, banks increase their loan to value ratios and buyers have sufficient confidence in their job security and earnings to consider increasing their mortgage commitments.

This would imply an easing of loan to value ratios but does not necessarily imply that finance has to be available at the income multiples and loan to value ratios common in 2007.

Because the commencement of this stage relies heavily on restored sentiment and job security, it is perhaps the stage most sensitive to the depth and length of the current recession. It will go hand in hand with the restoration of the banks and building societies appetite to lend and is dependent on the restructuring of the finance sector. Current indications are that this could push out the timing of any recovery in the housing market for at least 12 months beyond our original estimates.

Stage 4: Higher demand/higher supply. The most depressed sectors show signs of recovery and first time buyers and buy to let investors reappear

We continue to expect the recovery in the mainstream markets to start in London and the South East where the fundamental shortage of housing is most pronounced, and to filter progressively northwards through the UK over a 5 to 6 year period. Scotland, where affordability was less constrained prior to the downturn and where attitudes to borrowing have been more conservative, should also see an earlier recovery than most other parts of the UK.

Markets with a high concentration of repossessed or large numbers of unsold, newly-built stock will see the largest price falls and remain suppressed for longer, regardless of proposed Government interventions. These areas will require the highest levels of price correction before any recovery can begin.

Are we poised to embark on Stage 1?

Key market indices are currently showing between -15% to -20% falls from peak, but these mainstream indicators traditionally lag the 'forced sale' market, and discounts for distressed or forced sales are already running at -25% to -30% from their 2007 peak. 'Vulture' funds are likely to want to buy at a lower price than -25% from peak, so the bottom in some local markets could be significantly more than the average -25% we anticipate will register on the average house price indices. Equally,

there will be exceptions for high quality, high demand properties and localities which are likely to see falls significantly lower than the -25% average. Whilst we cannot rule out the possibility of further price falls, we believe the market will settle at around -25% from peak in the mainstream regional markets, and -30% in prime central London.

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The structure of the housing market was already changing

Change in the structure of the housing market is already apparent, not in the fundamentals of supply and demand but in the way that homes are owned and financed. A gradual shift away from mortgaged owner-occupation and towards private renting was already being experienced even before the credit crunch. But the re-structuring of financial markets may well accelerate the move toward increased private renting and other forms of co-ownership. It will do this, on the occupier demand side, by preventing some households from entering the mortgage market and, on the investor supply side, by making residential investment returns look more attractive than other forms of investment. We expect to see continued growth of private renting regardless of whether property values bounce back quickly or remain depressed for another year or two.

Our rationale for eventual recovery

Our confidence that nominal property values will ultimately be restored to previous levels is based on our analysis of household purchasing power and the fundamental structural components of the housing market. Our model of affordability indicates that, because of the combination of price falls which have occurred to date and the limited cuts in mortgage rates that have occurred on the back of reduced base rates, the housing market is already in a period of theoretical price overcorrection.

This period of low property values and very low interest rates will result in higher household surpluses which will almost certainly be used to rebuild savings and reserves for as long as employment uncertainty persists. This will result in further 'overcorrection' of our affordability measure and will ensure that theoretical purchasing power will remain high (despite recession and increased fiscal burdens). House prices will then have the capacity to eventually return to quite substantial growth as soon as both sentiment and the economic outlook has improved and when mortgage finance is more readily available. This does not necessarily imply that it has to be available at the income multiples and loan to value ratios common in 2007, but it would imply more lenient loan criteria than currently pertain.

We must also remember that the basic structural component of the housing market is shelter, which every household needs and which we have not been building ►

► at a rate to keep pace with demand. Competition for housing is an upward pressure on values, whether it comes from renters or owner-occupiers. Other demand-side factors include investor and saver disillusionment with banks, bonds and equities. Despite price falls, bricks and mortar could look like a safer asset to hold. The Savills Research approach is more sophisticated than looking simply at house price to income ratios and the methodology also acknowledges the importance of the supply side of the market.

In the medium to long term, the inability of first time buyers to raise deposits rather than the inability to afford mortgage repayments mean that they will remain excluded from entry to the market, boosting demand for private rental property and co-ownership or equity loan schemes. This presents a huge opportunity for investors in private rental stock. If acted upon this should, in turn, underpin the recovery.

So where does this leave us now?

Whilst we cannot rule out the possibility that the market will overcorrect further than previously forecast because of the perilous state of the economy, it is arguable that most of the anticipated falls in the prime London and southern markets have already occurred. Where properties are 'forced sales' they are generally already discounted by -25 to -30%.

Auction sales, which are a rarefied and extreme barometer in the current market (because they reflect only a small proportion of potential buyers and not the whole market) have already shown discounts of this level. Because mainstream house price indices lag the 'forced sale' market (the extent being dependent on whether they are based on historical transactional activity or mortgage valuations) it is likely that such indices will continue to show price falls for several months after the forced sale market has bottomed out. The mainstream house price indices are therefore unlikely to pick up the earliest of the recovery activity.

In the early part of 2009, our agents are beginning to report an increase in applicant activity from the cash

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and equity rich. (It must be said that this increased interest has yet to be translated into significantly higher transaction numbers). The increased interest is fuelled partly by the poor income returns on cash and other investments that these investors are obtaining currently. By contrast, average gross yields from residential property have now shifted from 4.6% to 6%. Potential investment buyers will, we think, continue to be motivated by what they see as 'bargain' prices that look even cheaper to those overseas investors benefiting from sterling's depreciation. Savills most recent auction (February 2009) achieved a success rate of 87% properties sold which is the first transparent market evidence that the market is beginning to pick up, led by investor demand.

With discretionary sellers already notable absentees from the market, there is a very real prospect of stock shortages become more pronounced over the coming months. We are perhaps beginning to see a shift from the low demand / high supply market of 2008 to one where transaction levels remain low but the supply and demand for property is more evenly balanced.

Our view is that this puts us somewhere between the latter stages of house price falls and nearer the first of the stages in the recovery process. ■

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