



Residential property forecasts

October 2011

In summary In the face of nail biting fluctuations on the world stock markets and negotiations in the political halls of Europe, the residential market in prime Central London has ploughed on seemingly regardless. Capital values are expected to end the year 8% up, only slightly shy of their 2008 peak, while rental values have already surpassed the market high, with growth of 11% expected by year end. The capital is not however immune to the economic instability with increasing evidence of cost pressures, on tenants in particular, impacting on behaviour and housing choices. Looking ahead, we forecast a subdued 2012 with rents and capital values achieving 2% and 3% respectively. A strong picture will emerge from the latter half of next year and from 2013 onwards as the economic recovery gains traction, led by the financial and business services sector in London.

Uncertain times for UK plc

In the face of daily headlines on the challenging economic environment, politicians and the Bank of England (BoE) have their attention focused firmly on stimulating domestic activity. However it is events unfolding outside the UK that are calling the shots. The International Monetary Fund's (IMF) downgrade of global growth projections highlights the depth of the problems. The US continues to report mixed economic data, while China has also seen a slowing in growth, although it is the issues in the Eurozone that are focusing the minds of the markets and policymakers alike.

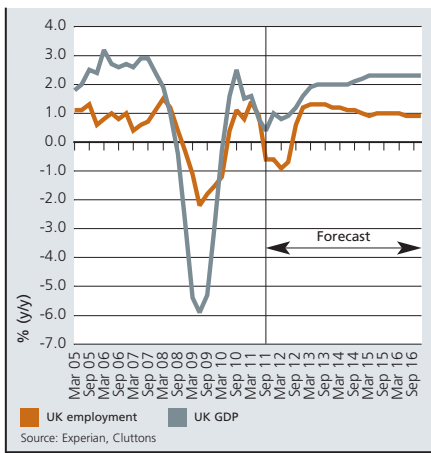
The ramifications of depleted global demand and trade are being felt at home across the economy. The once booming manufacturing sector has slowed over the last two quarters and while recent surveys suggest an upturn in orders, it remains vulnerable to a global dip in demand. The service sector, which makes up 75% of the UK economy, has not shown strong growth but has demonstrated a degree of robustness. This has enabled it to absorb some of the public sector job losses during 2011. Despite this, headline unemployment has seen a sharp increase over recent months reaching a 17 year high of over 2.57 million at the end of August. We expect this trend to continue with the private sector unable to keep pace with the significant number of public sector job losses to come. We anticipate unemployment to peak at just below 9%.

Given this backdrop, we are adopting a baseline scenario of 1.0% this year, increasing to 1.6% in 2012 for UK economic growth and thereafter slowly accelerating; but unlikely to return to trend level growth of 2.5% by the end of the forecast period. Undoubtedly, the risks are on the downside given the financial uncertainty in the Euro region in particular, but also globally. The relative impact however does vary significantly within the UK, with London expected to perform better in our baseline scenario with GVA growth in the capital expected to average 2.8% between 2012 and 2016, compared to a long term trend of 2.35%.

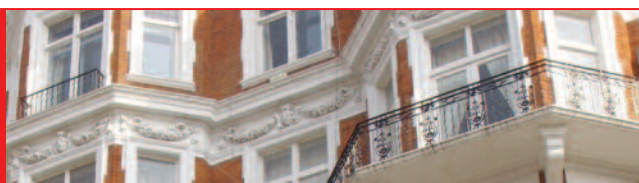
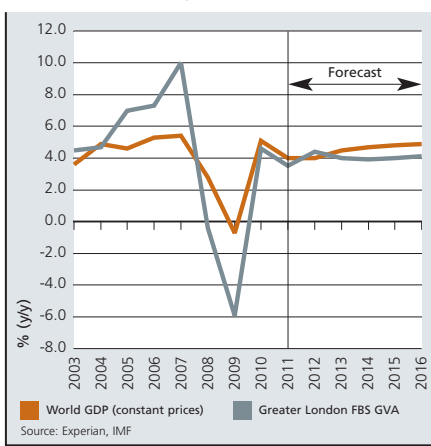
London's economy growing but not invincible

At present the capital is certainly proving relatively robust against the barrage of economic challenges, but it is not immune to global and domestic financial pressures. While the latest Markit Lloyds TSB London PMI survey signalled a solid increase in business activity, with a marked increase in new orders received, the pace of economic

UK economy



London's economic growth



growth in the capital also eased to a four month low. The financial and business services sector is influenced heavily by the outturn in global trade and economic growth which have both slowed during 2011. However, the IMF forecast global output will reach a positive, albeit below trend, 4% by year end which will provide London with a strong buffer against the current economic turmoil.

The end game of recent events is still far from clear. A so called 'disorderly default' followed by contagion in the sovereign, and ultimately private, debt markets will have severe implications for the UK economy and the lending markets on which most of the housing market relies. The 'disorderly downside' scenario could inevitably have more significant consequences in the short term for the capital, which is influenced more by the financial markets and exhibits greater property market volatility.

Take up low despite cheap housing finance

In the current scenario of a faltering global economy, combined with uncertainty in the Eurozone and debt markets, the Bank of England undertook a second round of quantitative easing (QE2) at a scale significantly ahead of that generally expected. Base rates have also been left on hold and it is assumed that the current rate will persist well into next year and possibly into early 2013. This monetary easing is set against a mixed picture on inflation, with CPI climbing to 5.2% in August. While this pace of price growth is expected to ease in early 2012 as the VAT uplift works its way out of the figures, there remain significant price pressures in the medium term.

Homeowners are benefiting from both mortgage costs at a historic low and an expanding number of mortgage options, with the number of products in the market reaching its highest level since November 2008 (Moneyfacts). Headline figures suggest this is supporting an upturn in market activity with July seeing the strongest level of house purchase mortgage approval for more than a year (BoE). The level of activity does however remain subdued; with the Council of Mortgage Lenders (CML) expecting minimal change in lending between 2010 and 2011.

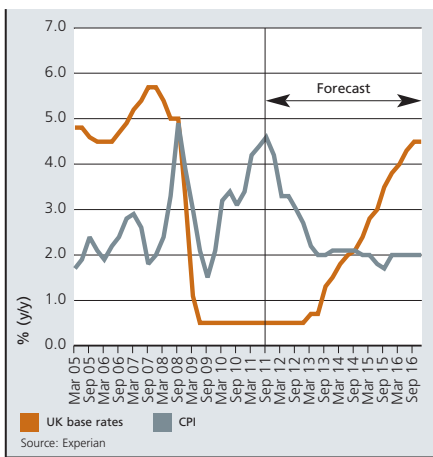
More significantly, the number of products geared to first time buyers (FTB) has expanded resulting in a 5% and 9% increase in the respective number and value of FTB loans issued in August 2011 compared with the previous year. However with an average deposit of 20% (CML) potential homeowners face considerable barriers, particularly in the south east. In Greater London this equates to a £60,000 deposit to purchase the average home and based on an average 3.2% income multiple requires a household income of £74,000 (Nationwide). With an average gross annual income in the capital of just over £37,000 (ONS), first home purchase presents a financial challenge even for couples.

UK market to remain weak

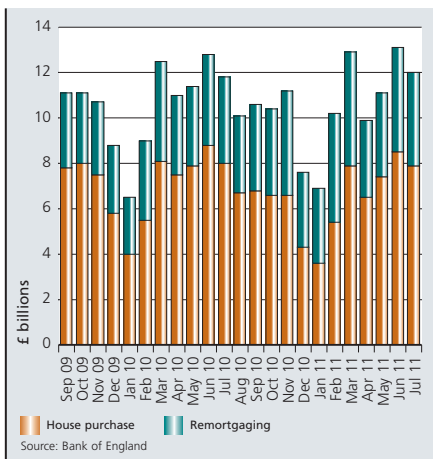
The uncertain economic outlook and associated weakness in consumer sentiment can be seen to an extent in recent house price movements. Nationwide reports prices remained relatively stable in Q3, falling by 0.1% giving an annual rate of change of -0.5%. This is broadly consistent with activity reported in the RICS Housing Market Survey (September) which suggests a softening in prices is occurring, although this has been contained by the subdued activity in the market and an extremely low level of newly developed housing added to the national stock.

The mixed picture reflects the variable economic fortunes of the country, with London the only region showing price gains according to the RICS (September). Nationwide reported a more mixed picture but low sales volumes are driving a seemingly erratic pattern of price movements; a trend which is expected to persist into 2012. While unemployment is likely to drive an upturn in forced sales, CML expectations for possessions remain mute by historical standards, in part due to the more supportive policies operated by lenders towards borrowers in difficulty. Despite this, 2012 is expected to prove a challenging year for many parts of the country with our average

Inflation and base rates



UK mortgage approvals for house purchases



house price forecast of 3% growth in 2012 masking a very mixed regional picture. We expect average annualised price increases to revert to a level marginally ahead of earnings growth of 5% per annum from 2013.

Capital to see historic high values in 2012

The financial turmoil appears to have heightened the appeal of real assets and prime Central London residential has emerged as a safe haven during 2011. The perceived security of the capital is evident particularly amongst international investors estimated at 20% of buyers, rising to 40% for homes priced over £5 million; although this is a small segment of the market. Overall demand reached a historic high in Q1 2011 and continues to hover close to this mark. Year-on-year enquiries in Q3 were almost 50% up on the same period in 2010, although we believe registered demand underestimates the underlying level, with new instructions continuing to attract a rush of applicants.

The sustained domestic and overseas demand, coupled with dwindling levels of stock over the summer, has driven a sharp increase in prime Central London capital values during 2011. Following moderate growth of 3.6% during 2010, quarterly value rises across the capital's prime market accelerated during the first half of 2011, peaking at 3.5% in Q2, before cooling to 1% in Q3, leaving prices 8.6% up at the end of the quarter. The slowing in the rate of growth in the third quarter does however mask the fact that some submarkets across Central London outperformed the average significantly. Islington and Holland Park for instance saw values rise by 2.4% and 2.2% respectively in Q3. At the end of the third quarter, residential prices in prime Central London were just 3.6% shy of the Q3 2007 peak, with expectations that this gap will be closed in 2012. Certainly house hunters, frustrated by a lack of options, are paying up to 10% over asking prices, already pushing values in certain transactions above the pre-recession peak. We expect latent demand and the severe shortage of stock to maintain price growth during Q4 with values ending the year 8.2% up on 2010.

Looking ahead to 2012 we expect to see a little more buyer nervousness creep into the market in the face of the domestic and global economic uncertainty, although this will be less from expectations of price falls than from the fear of changing personal circumstances. Job security and depleted investments tied up in the markets are weighing on potential buyers' minds and are likely to drive the deferment of purchasing decisions. However, this sentiment will also impact upon the supply in the market as homeowners hunker down until the economic outlook becomes a little clearer.

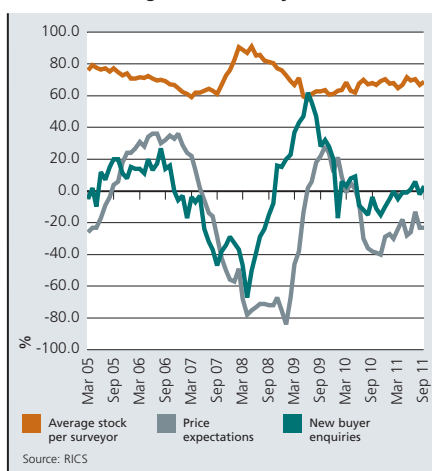
Even in the subdued economic climate expected for 2012, our econometric model suggests that values in the prime Central London market would increase by 6%. However, we believe that the uncertainty will place the market in a holding pattern for a couple of quarters as potential buyers and movers take a wait-and-see approach. Buyer appetite is expected to bounce back later in the year and therefore we forecast residential values in the prime Central London market to increase 3% next year with the growth focused on the latter half of 2012. Between 2013 and 2016, we forecast house price growth to average approximately 8% as global economic growth gradually gains traction.

Greater London, which will be impacted more significantly by job losses and a slowing economy, will see a more tempered return to growth with values expected to increase by an average of 5% over the next five years. However this upturn will be seen from 2013 onwards, in line with improved economic circumstances.

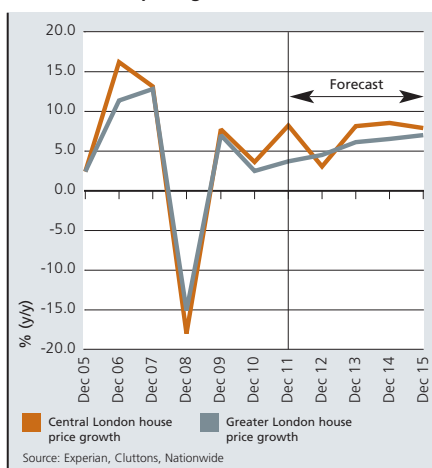
Rental market set to stabilise from 2012

Following the record 7.3% increase in lettings values across the capital in Q4 2010, rental rates have risen by an average of 3% per quarter during the first nine months of 2011, with Q2 enjoying the most significant increase (4.4%) giving a record annual growth of 20.4% at the end of the second quarter. The rate of expansion slowed to 1.4% in Q3, while annualised rental growth dipped to 17%, an anticipated trend

RICS UK housing market survey



London house price growth



following the period of strong growth. At the end of the third quarter, rental values were 10.7% higher than the pre-recession peak (Q1 2008) and are on course to end the year 30% higher than the trough of the market (Q1 2009).

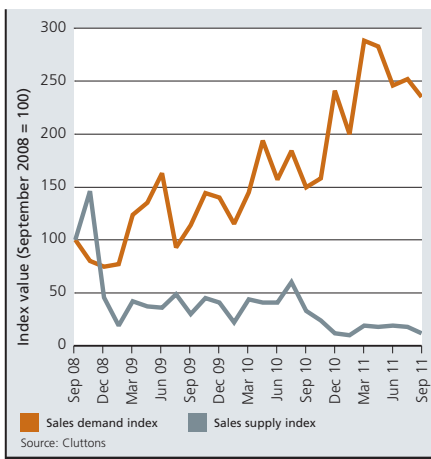
The apparent levelling out of rents is due primarily to caution amongst landlords who are striving to maintain existing tenancies without creating voids triggered by tenants facing significant rent rises at renewal. There have, of course, been exceptions to the RPI-linked uplifts recorded over the summer; long running tenancies with rents well below market levels have seen increases of between 15% (Clapham) and 20% (Hyde Park). The growing pressures in the market have driven an increasing number of landlords to investigate exiting the market, taking advantage of the sharp upturn in capital values, although at present a relatively small proportion are proceeding to sale.

While landlords undoubtedly are feeling greater resistance from tenants on rental uplifts, it remains the case that the demand for rental property continues to outpace the available rental stock. Tenant demand was especially strong during the late summer which pushed overall rental requirements to a record high. At the end of Q3, year-on-year lettings demand was almost 50% higher than the same time last year, while tenant enquiries were 25% up on Q2. Late summer is a period traditionally associated with a spike in demand and this year has been no different, with several locations across the capital reporting the busiest September on record, with strong demand from international students taking up courses starting in the autumn. On a submarket level, areas in the vicinity of Tower Bridge, an area known to cater to finance and legal professionals, saw demand increase by almost 40%, putting additional upward pressure on already limited stock.

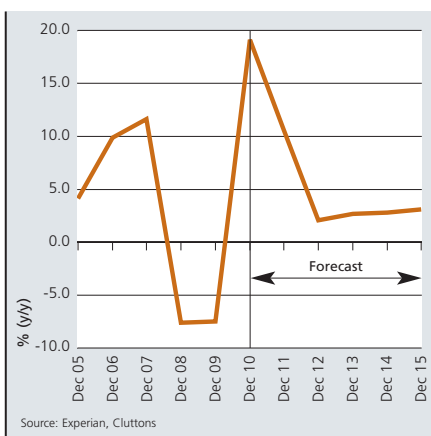
However, while stock shortages persist across Central London, the financial challenges facing younger households, in particular, are clearly evident in the lower budget segment of the market. Mortgage payments as a proportion of income for first time buyers are ahead of the long run average, reaching 52% of average take home pay. Furthermore, the substantial deposit requirements continue to delay potential home purchase and are extending the period in which singles and couples find themselves renting and seeking to contain housing costs. This is exemplified by the growing number of renters opting to jointly let larger properties in order to minimise outgoings, resulting in widening budget spreads in some submarkets in Central West, particularly in areas such as Hyde Park and Holland Park. We expect this pool of joint-renters to grow rapidly over the coming months.

Given inevitable financial pressures over the coming quarters, we are unlikely to see the pace of rental growth witnessed in the first half of 2011 sustained. Recent evidence of a slowing in the rate of rental increases is in line with our forecast for 2011 and we expect to see close to 11% growth this year. While continued economic uncertainty, restrictive bank lending and sliding real incomes will underpin a long term structural demand for rented housing in the capital, we expect the current stabilisation of rents to be maintained into 2012, with growth of 2% over the year. Looking further ahead we forecast rental growth to return to trend, averaging 3% between 2013 and 2016. However given the pressure on stock from tenants with limited housing options, the uncertainty associated with this forecast is on the upside.

Prime Central London sales supply and demand



Central London rental value growth



Prime Central London covers:

Central South West South Kensington, Chelsea, Knightsbridge, Belgravia, Pimlico and Westminster

Central West Hyde Park, Notting Hill Gate, Marylebone, Bayswater, Kensington, Mayfair and Holland Park

Central North West St John's Wood, Regent's Park, Hampstead, Primrose Hill, Belsize Park, Maida Vale and Islington

Central South East Shad Thames, Borough, South Bank, Surrey Quays, Wapping, Limehouse and Isle of Dogs

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