CLUTTONS

Residential property forecasts

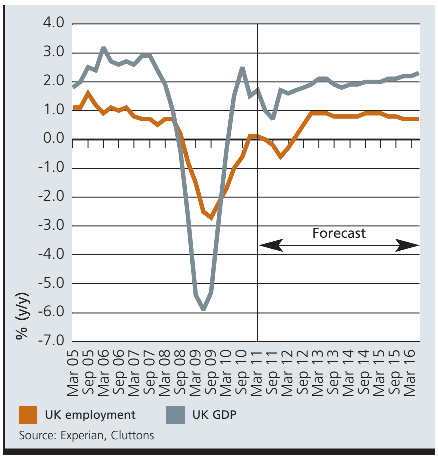
June 2011

In summary

Growing uncertainty over household circumstances, combined with a breach in the delicate balance between supply and demand, is placing downward pressure on mainstream UK house prices. However, the market has seen relatively few forced sales with homeowners appearing determined to hunker down and weather the economic storm. This has contained the increase in supply over the last 12 months, protecting the market from more significant price falls. As a result we expect mainstream UK house price growth to remain virtually unchanged in 2011, but with significant regional and city variations likely. Looking further ahead, we expect strength to return, with price growth set to average 5% from 2012 to 2015.

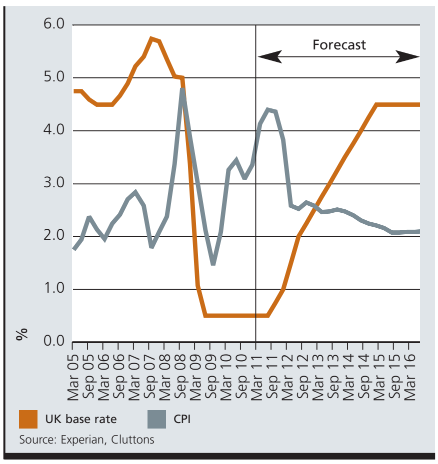
In contrast to the national picture, Central London continues to enjoy robust house price growth. Demand for lower budget homes has gathered pace and is amplifying the drought in the supply of homes on the market. We expect these supply and demand dynamics to be maintained during 2011 and forecast prices to grow by 6%, accelerating to around 8% from 2012 to 2015. Similarly, the capital's lettings market continues to experience positive rental value growth; albeit at a reduced pace than of late. Again, activity continues to be centred on lower budget homes, but rising demand is being offset by a slight expansion of supply in some markets which is helping to rein in further significant rental uplifts. During 2011, we anticipate rental value growth to reach 8% to 10%, easing to between 2% and 4% from 2012 to 2015.

UK economy



Source: Experian, Cluttons

Inflation and base rates

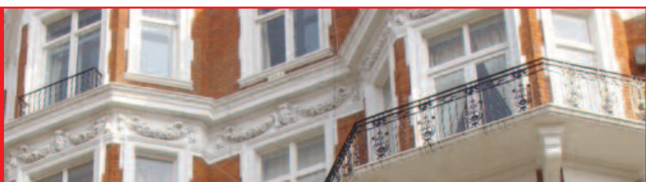


Source: Experian, Cluttons

Economy limps back to life

Following the 0.5% contraction in GDP growth during Q4 2010, the economy has made a positive, albeit weak, return to growth, with GDP expanding by 0.5% during Q1. Although this delivers a virtually static economic picture for the past six months, early Q2 figures point toward a return to more positive territory, though any expansion in the economy is likely to remain relatively mute. The British Retail Consortium has reported a 5.2% surge in retail sales during April, with the early onset of summer, coupled with the long bank holiday weekends and the royal wedding boosting activity. However, this should be set against March figures, which showed sales slipping by 3.5%, resulting in low net growth during spring. Household earnings continue to slip at near record rates, with Deloitte forecasting a fourth consecutive year of declining household incomes, the first time this has happened since 1870.

Positively, the service sector continues to show signs of growth. The Markit/CIPS UK Services PMI for April showed continued strength in the sector, albeit down slightly on March. Significantly however, new business in the service sector increased at its fastest pace for over a year. Similarly, despite slipping by 2.3% in Q4 2010 and a further 4.3% in Q1, initial data for April suggests that the construction industry is showing signs of moving towards more positive growth. The manufacturing sector on the other hand, which has so far acted as a lynchpin for the UK economy, appears to be faltering, with

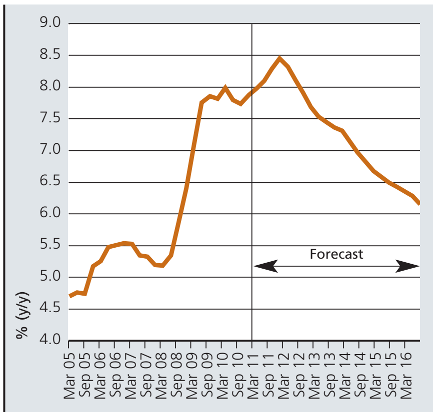


the Markit/CIPS UK Manufacturing PMI retreating during April as a result of the weakest growth in the sector in seven months. This follows a downward revision in March.

Imported inflationary pressures, largely a result of spiralling commodity prices, may be starting to ebb with the recent easing of oil and gold prices. The full impact of this on the headline UK inflationary rate will however only be felt if lower commodity prices are sustained. Unrest in the Middle East and North Africa, and the growing threat of a further restructuring of European bailout debt, combined with growing concerns over countries such as Italy and potential disruption from the Icelandic volcano, suggest global growth will weaken slightly, particularly in advanced economies. Domestically, the Office for Budget Responsibility (OBR) has reaffirmed its expectation of patchy quarterly GDP growth, ending the year with a 1.7% expansion in GDP. This combined with falling commodity prices, however temporary, will dampen calls for rate rises before the summer. The current scenario is in line with our expectation of an early autumn base rate rise. By the end of the year, we expect base rates to be between 0.75% and 1%.

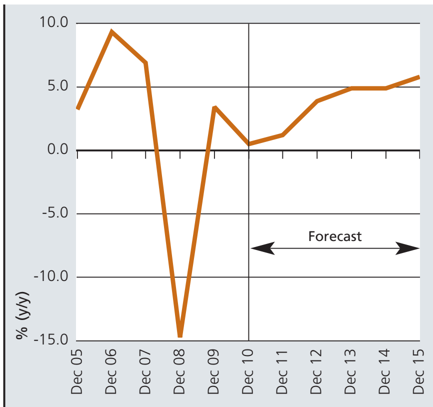
This positive, but tepid UK economic picture continues to contrast sharply with the London economy where growth has shown a significantly more positive picture. The Markit Lloyds TSB London PMI survey reports continued private sector activity in London for the eighth consecutive month in April. In fact, output has now risen for two years except for a pause in August 2010. This said, the pace of growth slowed in April, with the rate of increase in new businesses also slipping slightly. However this has not impacted on the rate of employment growth in the capital which continued to rise at a solid pace, ahead of the long run average. This is evidenced by the Reed Job Index which reported that job vacancy levels in London were up by over 25% on the 2010 average. This inevitably impacts on the dynamics of the residential market, providing a boost to household confidence which is generally lacking in regions outside the prime south east.

UK unemployment



Source: Experian, Cluttons

UK house price growth



Source: Experian, Cluttons

Wider UK market remains static

The economic uncertainty at a national level has deep repercussions for the UK housing market, which is showing signs of further price weakening in nearly all regions. According to the Council of Mortgage lenders (CML), the total number of homes repossessed in Q1 was 9,100, 10% lower than a year ago, although this represents an increase of 15% over Q4. Q1 saw a sharp decline in both the number of loans advanced (-26%) and the value of mortgages extended (-27%). First time buyers have also continued to experience difficulty in getting on to the property ladder with March figures from the CML showing a drop in both the value (-16%) and number of loans advanced (-17%) when compared to March 2010. Unsurprisingly, remortgaging activity has picked up, as home owners seek to buffer themselves from the prospect of higher base rates later on this year. The volume of remortgages grew by 14% in Q1, although the value was down 11% on Q4 2010. The prevalent lack of liquidity, coupled with marked buyer caution has left vendors with little choice other than to adjust their expectations in order to secure a sale. As a result, home values across the broader UK market continue to slip, with most major indices reporting varying degrees of monthly price deterioration. Following a 0.2% dip in April, Nationwide recorded a 0.3% rise in prices in May, an erratic pattern that is likely to be perpetuated during 2011.

Earlier in the year, evidence from RICS suggested a gradual improvement in both the number of new instructions and the volume of new buyer enquiries. The latest figures from April however show that the delicate supply-demand equation has been breached, with the volume of homes coming to market accelerating ahead of number of enquiries from potential home owners. This picture reflects the economic picture given the ongoing squeeze on real household incomes. The Lloyds April Housing Transactions Report echoes this pattern with a steep 47% decline in UK home sales since 2007, which translates into a near 50% reduction in the volume of transactions in England and Wales over the past three years.

Demand for UK property will inevitably depend on the health of the labour market and ensuing household confidence. It is evident that this return to confidence remains some way off. The fact that the full impact of public sector job losses is yet to be felt, coupled with the collective consequences of further cuts in real household incomes in 2011, rising inflation, fiscal measures and higher interest rates will mean an already cautious buyer market will be subdued still further. However, the recent flat picture for UK home values does signal a greater degree of price stability, reflecting low transaction levels and relatively few forced sales relative to historic trends at the same point in the economic cycle. To reflect this, we have revised our UK house price growth forecast for 2011 up very slightly to range between 0% and 1%, recognising that regional fluctuations will be significant.

Looking further ahead we expect strength to return to the market, although this is likely to prove a slow process, dependant on household confidence. Furthermore, a continued lack of mortgage funding, particularly at higher LTVs, will remain a barrier to activity and hamper the pace of value growth. We therefore expect values to increase by nearly 4% in 2012 and then by 5% in both 2013 and 2014, before climbing to 6% in 2015. The rises in the latter half of our forecasting time frame will be on the back of an improved economic environment and greater household confidence as spending cuts work their way through the economy and the private sector takes some benefit.

Central London prices to maintain growth

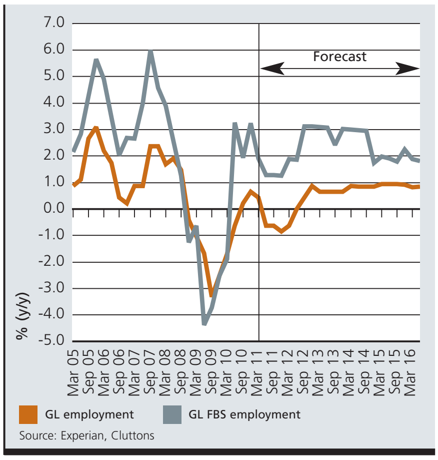
Following the slight growth of 0.8% in house prices during Q4 2010, home values in Central London accelerated by a further 2.5% during Q1, racing ahead of UK house prices, which shrank by 0.3% during the same period. The shortage of homes for sale across the capital, coupled with the sharp upturn in demand seen in February, is helping to support robust capital value growth rates, which, on an annualised basis, stood at 4% at the end of February. While London faces many of the same economic hurdles as the rest of the UK, the global economic influence on the capital has underpinned confidence and demand in the housing market. This has been reflected in both the demand and supply picture with requirements increasing, but the appetite for sales remains low given expectations of continued value growth.

Unlike the rest of the UK, overseas cash buyers continue to play a critical role in supporting the capital's housing market, particularly as they remain unaffected by ongoing lending restrictions and have been aided by the persistence of sterling's relative weakness. The early April Stamp Duty rise to 5% saw buyers rushing to close deals before the deadline, however overall demand for homes in the million pound bracket has not been dampened by the tax change. Demand is also being supported at the lower budget end of the property spectrum with a rapidly growing number of buyers on the market with budgets in the £500,000 to £1 million range. The intensification of activity at this end of the market is putting an additional strain on an already undersupplied market. Activity in other price brackets remains stable with registered super-prime budgets rising to £30 million in some areas.

Further compounding the supply shortage is an ongoing reluctance to move home in an undersupplied market; locating an ideal home is challenging and the cost associated with a move remains a major deterrent. In response, some home owners are choosing to upgrade, or expand existing properties, further choking the natural cycle of homes supply. Furthermore, a sizeable cohort of often reluctant landlords are listing their properties on both the sales and lettings markets in order to maximise their options. Few professional landlords are seeking to crystallise the value of their assets and are instead opting to enjoy the strong capital growth and rental values currently delivered by Central London properties.

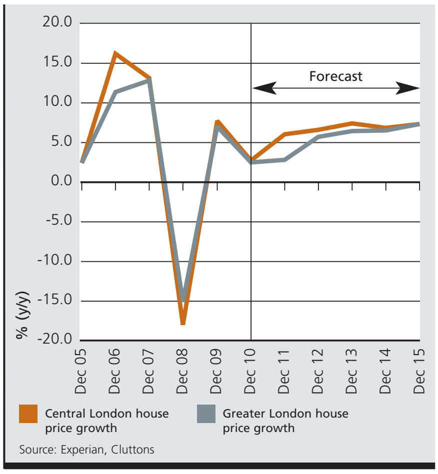
As a result of the tightness in the supply, more mainstream properties, which had to date been dismissed as unsuitable, are attracting the attention of frustrated buyers, who are willing to take a second look given the limited options available. The steady trickle

Greater London economy



Source: Experian, Cluttons

London house price growth



Source: Experian, Cluttons

of transactions of more mainstream homes is quickly eroding the dwindling supply available. As a result, by mid April, supply was down by 55% when compared to the same period in 2010, while demand rose by nearly 50% over the same period.

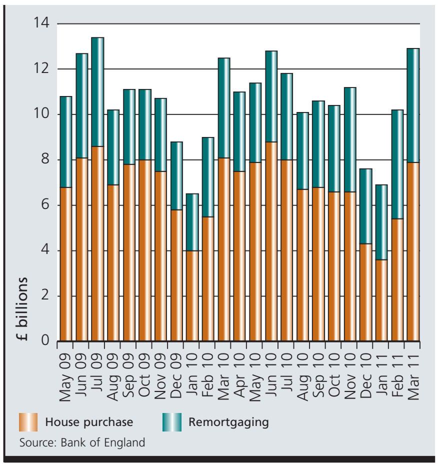
The combined effect of rapidly mounting demand and diminishing supply supports our long term outlook for prices. The market imbalance will maintain upward pressure on property values during 2011 with prices in Central London forecast to rise by 6%, however certain submarkets across the capital, which are influenced heavily by global demand drivers, are likely to outperform the Central London average. During 2012, we expect house price growth to remain steady at around 7%, while price expansion between 2013 and 2015 is likely to average between 7% and 8%. 2016 will see further buoyancy in the market, with home values expected to grow by nearly 8%. Our forecasts factor in greater confidence that will return to the market following the anticipated normalisation of economic growth both in the UK and globally, in the wake of the global economic downturn. In the latter half of our forecasting time frame economic growth is not only expected to gather pace, but quarter-on-quarter growth is expected to be sustained at 0.5% to 0.6%.

Lettings market set for another good year

After growing by an average of 4.5% throughout each quarter of 2010, rental growth in Q1 2011 slowed to 3.1%. This comes after rental values surged by 7.3% in Q4 2010, the highest quarterly increase on record. Following a faltering in demand at the start of the year, a modest recovery was observed in March, which continued throughout April, with overall demand increasing by 13% over the same period in 2010. This however masks the fact that year-to-date demand is just 0.2% above the January to April period in 2010. Landlords have grown more conscious of the unstable market and economic conditions and are opting to retain existing tenants by limiting the pace of rental uplifts. This is reflected in the average rate of uplifts at renewal which currently stands at approximately 4%. While severe supply constraints remain in most markets, some areas in Central West, such as Chelsea and Kensington, have seen stocks replenished as households downsize to manage rising living costs. At the same time, a number of properties in the area have returned to the market following renovation and refurbishment work, allowing the supply-demand equilibrium to stabilise to a degree. However, like all other markets across the capital, lower budget accommodation (£250 to £650 per week) remains both highly sought and in short supply. As a result, it is this segment of the market which is experiencing the highest level of rental growth in many areas.

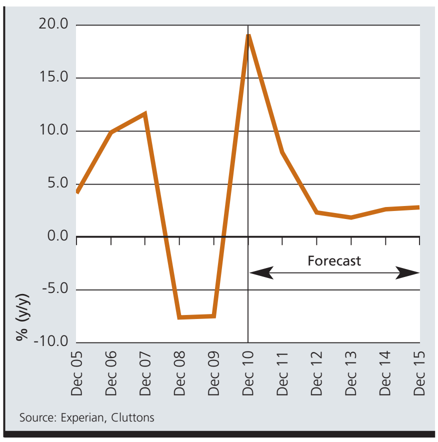
Current trends support our forecasts for rental value growth in 2011, which we anticipate will range between 8% and 10%. This upward revision reflects the dearth of lower budget homes which is sustaining positive quarter on quarter growth, albeit at a diminishing rate. The significant pressure on households facing depleting real net incomes means that it is unlikely that demand for rental property will be dampened. However, in order to retain and attract tenants, lettings values are unlikely to see a repeat of last year's record 19.1% increase. Certainly, the upturn in demand in those markets which are perceived to offer greater value is expected to persist, as both businesses and households keep a keen eye on costs. In 2012 and 2013, we expect growth rates to range between 2% and 4%. 2014 and 2015 are, however, likely to see a return to the historical average growth rate in the region of 3%.

UK mortgage approvals for house purchases



Source: Bank of England

Central London rental value growth



Source: Experian, Cluttons

Contacts

Andrew Forrester	Consultancy	andrew.forrester@cluttons.com	020 7647 7094
James Hyman	Sales	james.hyman@cluttons.com	020 7407 3669
Lynn Hilton	Lettings	lynn.hilton@cluttons.com	020 7647 7280
Sue Foxley	Research	sue.foxley@cluttons.com	020 7647 7023

Whilst every effort has been made to ensure the accuracy of the data and other material contained in this report, Cluttons LLP does not accept any liability (whether in contract, tort or otherwise) to any person for any loss or damage suffered as a result of any errors or omissions. The information, opinions and forecasts set out herein should not be relied upon to replace professional advice on specific matters and no responsibility for loss occasioned to any person acting, or refraining from acting, as a result of any material in this publication can be accepted by Cluttons LLP. © Cluttons LLP 2011

research