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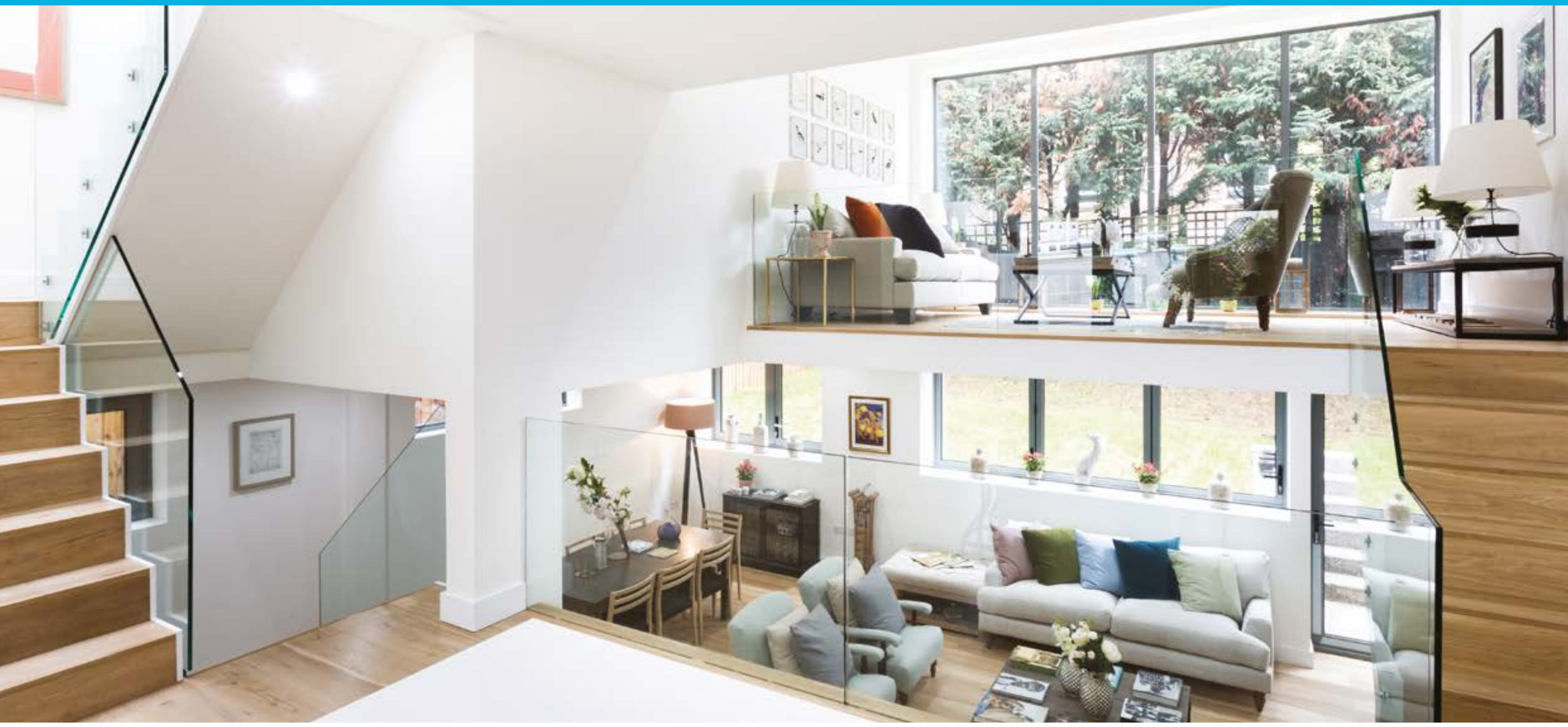


Q4 2014

RESIDENTIAL MARKET OUTLOOK

Following house price growth well ahead of the long run trend during the first half of 2014, recent months have seen an inevitable stabilisation. Monthly UK house prices are currently alternating between positive and negative territory, with annualised price growth slipping to 9.0% in October, down from its peak of 11.8% in June (Nationwide).

5%

Forecast of average annual increase in Prime Central London house prices, 2014-2018

4%

Forecast of average annual increase in Prime Central London rents 2014-2018

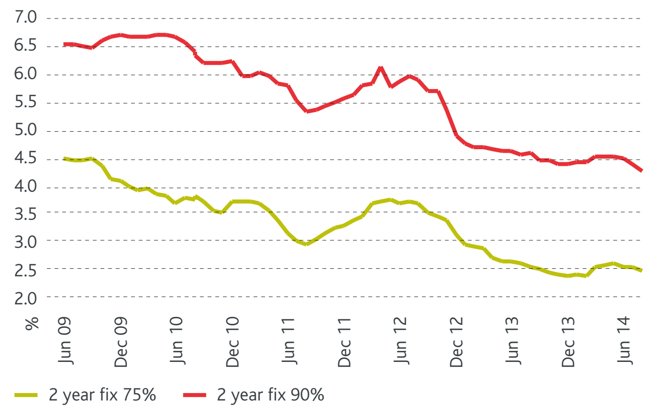
Positive but slowing economic growth

The market performance appears to beguile the current economic backdrop. The UK economy is enjoying a protracted period of growth, with expectations that GDP will have grown 3% by the end of 2014. This has been characterised by both low inflation and a strengthening labour market. The unemployment rate fell to 6.0% in the three months to September, down from 7.6% 12 months previously. This is the lowest level since late 2008. Consumer confidence remains close to the highs reached earlier in the year, despite the fact that households have faced a protracted recovery in their personal financial circumstances.

Finally however, earnings growth is showing signs of a long awaited upturn. September saw growth in real terms for the first time since 2008 when the economic downturn took hold. Whilst positive, this turnaround is driven more by subdued inflation than strong earnings growth. The latter depends on sustained economic growth and improved productivity. We expect GDP to grow by 2.6% in 2015 (Experian) which remains robust given the track record of recent years, but is subject to greater risk than was the case just a few months ago. The failure of the stronger European economies such as Germany and France to sustain their expansion casts caution over the sustainability of the UK recovery.

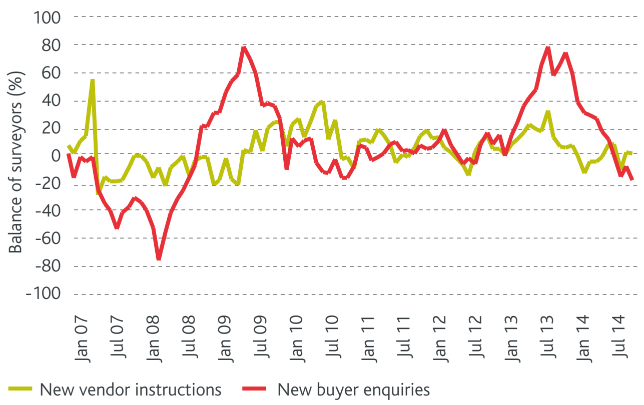
Concern for these economic and geo-political risks was seen clearly in the financial markets over recent months. However, it has also been reflected in mortgage rates, following a general

Mortgage rates slip back



Source: Bank of England

Market rebalancing in the UK



Source: RICS

acceptance that base rate rises will arrive later rather than sooner (probably at the end of Q1) and are likely to prove slight and steady. As a result we have seen mortgage rates dip back towards the all-time lows seen at the start of this year (see figure 1). This has been associated with further growth in the proportion of new mortgages taken out on a fixed rate; a positive outcome providing a degree of stability when rate rises do eventually take effect, albeit for a relatively small proportion of borrowers overall.

Buyer caution

Average UK house prices are now slightly ahead of their 2007 peak (Nationwide). However, price growth at a pace close to three times the long term trend, and falling real earnings, was clearly an unsustainable combination. The Mortgage Market Review added to these affordability challenges, pushing homes out of reach for many buyers. A slowing in the market was therefore inevitable. The number of mortgages approved for house purchases in September was 20% lower when compared to early 2014. This is evident in the RICS New Buyer Enquiries survey, which continues to report negative buyer sentiment (see figure 2). The slowdown in buyer demand is mirrored in the supply of homes offered for sale, with the RICS survey showing a relatively flat picture across the UK on average, albeit with a small uptick last month.

The unsustainable pace of price growth seen during the first half of 2014, supported in large part by historically low mortgage rates, and policy interventions such as Help to Buy and Funding for Lending, has now drawn to a close. Despite the positive turn in real incomes, we are facing a more subdued period in the wider UK market as we wait for affordability to realign with prices.

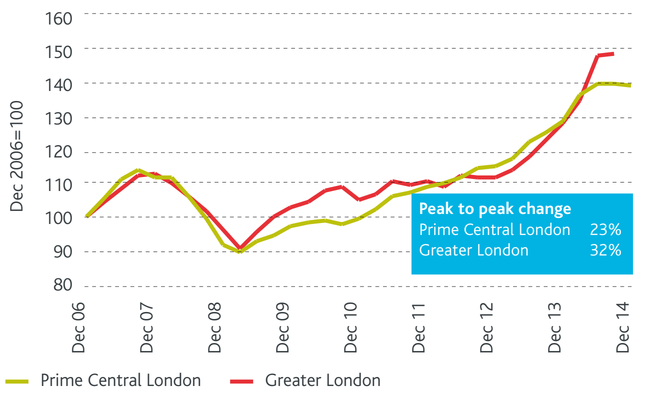
Our forecasts, produced on our behalf by Experian, are for annualised growth of close to 9% by the end of 2014 and 5-6% in 2015. This is marginally down on our projections earlier in the year, reflecting the weakening economic picture. There is a downside risk of a sharper than expected slowdown, presented by the dismantling of the monetary policy interventions. There have been pressures to remove these measures to avoid a house price 'bubble', but the recent trajectory of the market is likely to drive a gradual unwinding of the policies in tune with the economy.

Slowdown in London house price growth

The market slowdown has been more dramatically witnessed in Greater London (see figure 3), following the period of unsustainable price growth that occurred during the first half of 2014. Growth decelerated from 10.4% quarter on quarter in Q2, to just 0.2% in Q3. Despite this prices at the end of the quarter were up a fifth on the same point 12 months earlier (Nationwide). In the prime market, which has seen a sustained market recovery since 2010, prices were 16% ahead over the 12 months.

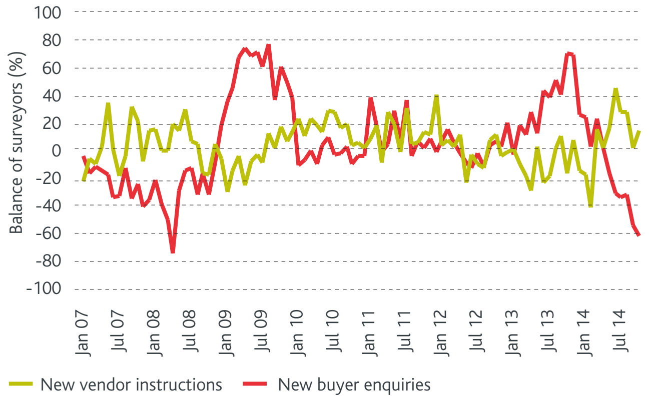
The slowdown in the market across London has been reflected in both demand and sales forging a market impasse as homebuyers and owners take a wait and see approach (see figure 4). This is occurring despite London's unique position of seeing average real income growth over the last two years. However, with home values across London close to 30% ahead of their pre-recession peak, affordability constraints are clashing with diminishing confidence. Political posturing at the upper end of the housing market, which will have the greatest impact in London, has not helped confidence and may extend market prevarication until after the election.

The London house price story since the financial crisis



Source: Nationwide, Cluttons

Falling demand in London



Source: RICS

The RICS survey indicates an upturn in vendors coming to the market over the last month. We see this as a reflection of households seeking to move on with their lives despite the uncertainties, combined with a degree of 'market testing'. Given a backdrop of an improving jobs market in the capital, few vendors will feel a financial imperative to sell if price expectations are unmet.

Despite the slowing in demand, we continue to see requirements particularly from first time buyers and growing families. There is particularly strong demand (and competition) for 'projects' that offer greater value for money. However, households looking to secure a particular property or location are finding their negotiating position limited and we expect this situation to persist. This will protect prices, which we expect to rise by around 10% in Prime Central London in 2014, slowing to just over 5% in 2015.

Across Greater London, we forecast average price growth to slow to 13-15% by the end of 2014, dipping to 5% in 2015, although there will be considerable variation in the performance of neighbourhoods across the capital. First time buyers looking for a new home will benefit from multiple schemes coming to the market over the next 12 months, which may raise the prospect of greater value to be secured in those markets poised for a significant increase in stock.

London's rental market benefits

The capital's rental market had shown signs of improvement early in 2014 and has been helped further by the slowdown in the sales market. We have seen an upturn in demand from new job starters and those choosing, or being forced, to sit out of the sales market. Employment growth in the financial and professional services sector has combined with a sharp increase in prospective tenants in the rapidly growing TMT sector in London, with new starters at Facebook and Google actively seeking homes in the capital.

This is driving a depth of demand that has not occurred since 2010 and as a result real rental growth is occurring in many locations. We have seen Prime Central London rents rise by 1% in Q3 (Cluttons) and current activity levels suggest further improvement in Q4. However, affordability remains an issue with corporate budgets now a little higher than they were, but still relatively low when compared to more affluent times prior to the recession. Given this backdrop, we expect annual rental growth of around 6% in Prime Central London by the end of 2014, moderating to close to 4% in 2015.

Growth forecast

	UK house prices	Greater London house prices	Prime Central London house prices	Prime Central London rents
2014	8.8%	17.1%	10.2%	6.1%
2015	5.7%	5.9%	5.2%	3.8%
Average 2014-18	3.4%	5.1%	4.2%	4.0%

Source: Experian, Cluttons

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For further details contact

Residential agency
James Hyman
020 7407 3669
james.hyman@cluttons.com

Residential lettings
Zoe Innes
020 3641 0517
zoe.innes@cluttons.com

Research
Sue Foxley
020 7647 7023
sue.foxley@cluttons.com

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