UK, Spring 2015

RESIDENTIAL MARKET OUTLOOK

The UK economy grew by 2.6% in 2014 as a whole, with growth in the final quarter at 0.5%. The view of the Monetary Policy Committee members is for the robust growth of 2014 to continue in 2015, helped by low inflation, a delay to domestic base rate rises and monetary stimulus measures taken in the Eurozone in particular. The easing in the austerity programme facilitated largely by the low inflation backdrop will also support growth.

3-4%

Central London annualised house price growth 2015 – 2016

4-5%

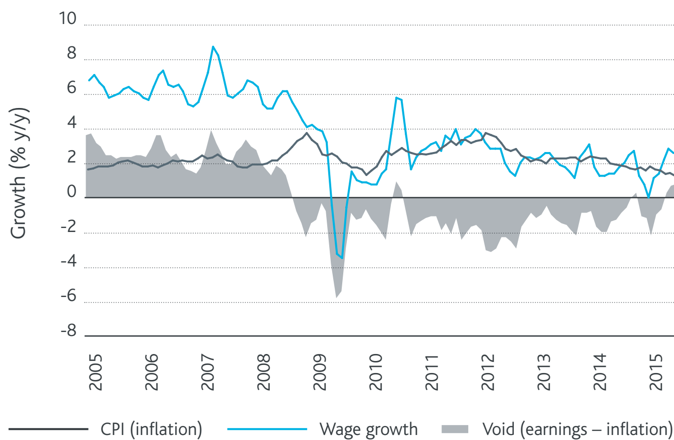
Central London annualised rental price growth 2015 – 2016

Hopes for greater balance in economic growth

The turnaround in UK economic growth over the last couple of years has been predominately driven by the consumer sector. There have been healthy gains in full-time employment, with the unemployment rate standing at 5.7%. Consumer confidence improved markedly in 2014, reflected in general spending, but also in bigger ticket purchases of cars, and notably housing. Looking ahead to 2015, the outlook for consumer spending remains positive, with a virtuous combination of a strengthening jobs market, positive earnings growth and very low inflation, or more likely deflation for a period. This economic package delivered a long awaited return to real growth in average earnings in late 2014, although in London this transition occurred many quarters earlier.

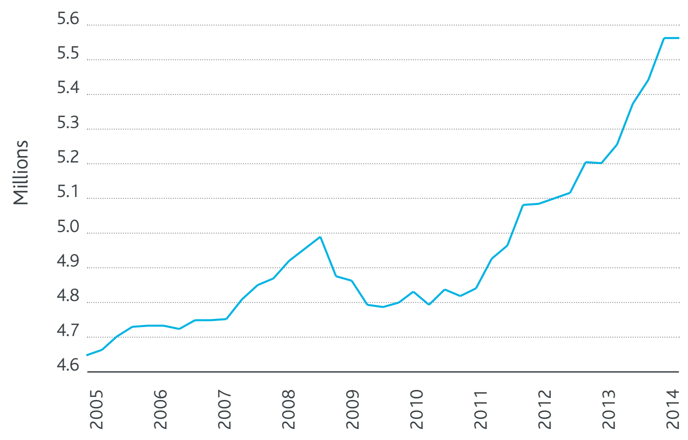
In contrast to the buoyant consumer activity, investment driven economic growth has proved slow to emerge. There were signs of an upturn in 2014, however in the fourth quarter the level slipped for the second quarter in a row, recording the biggest fall since 2009. It is likely that this is in part a result of the decline in the price of oil, although concerns over the election outcome may also be weighing on investment decision making. That said, London's economic recovery has outperformed the rest of the country, although this is far from even. The upturn in the services sector at a national level has faltered in recent months, but in London Business Services has shown strong growth, which has been reflected in letting activity in both the office and residential property markets. It is also notable that the telecoms, media and

Figure 1 – Real earnings growth



Source: ONS

Figure 2 – The growth in London's workforce



Source: ONS

technology sector, which maintained its expansion throughout the post financial crisis recession, continues to expand, while the financial sector is only just showing signs of recovery.

Overall therefore, the balance of economic drivers looks set to support continued GDP expansion over the next two years. Our forecasts, provided by Experian, indicate the UK economy will expand by a further 2.4% in 2015, with growth slowing to 2.2% in 2016 as interest rate rises, expected as late as Q1 2016, and renewed fiscal restraint take effect. There are of course uncertainties given the prospect of a further coalition government and potential policy regimes that come into play, not least Mansion Tax. Furthermore external uncertainties, in the Eurozone in particular, will add to the potential economic obstacles over the next few years. Overall, however, the UK currently appears in a relatively robust position.

The UK housing market

The economic backdrop of a strengthening labour market combined with real wage growth, historically low interest rates and generally supportive housing policy propped up a robust housing market for much of 2014. The UK has seen two consecutive years of rapid average house price growth, amounting to 7.1% in 2013 and 8.3% in 2014 respectively. First time buyer activity was particularly strong in 2014, accounting for the highest proportion of home-buyer loans since 1999.

However, the second half of 2014 saw this swell of price growth give way to a cowed market. The average house price fell 0.1% in February following a 0.3% increase in January. Annualised growth now stands at 5.8%, the pace having fallen consecutively for the last six months (Nationwide). The Council of Mortgage Lenders (CML) reports mortgage lending dipped to £14.8 billion in January; an 11% decrease on December and 8% lower than lending in January 2014.

The gradual dismantling of supportive housing schemes introduced in the aftermath of the financial crisis is the prime driver of this tempering of the market. However, this has also combined with the introduction of tough mortgage lending criteria which has moved affordability thresholds for those looking to enter or trade up in the market without the benefit of substantive capital. These factors have collided with concerns over the outcome of the election and geopolitical uncertainty to stymie the housing market. While economic fundamentals are improving, this may unwittingly deepen the malaise in the housing market as sellers are in little hurry to move. More positively, slow house price growth, in combination with improved support for first-time buyers, including the new Help to Buy ISA, combined with revised new Stamp Duty Land Tax (SDLT) rates should help movement at the lower end of the market, and has the potential to allow more people to take their first step on to the housing ladder.

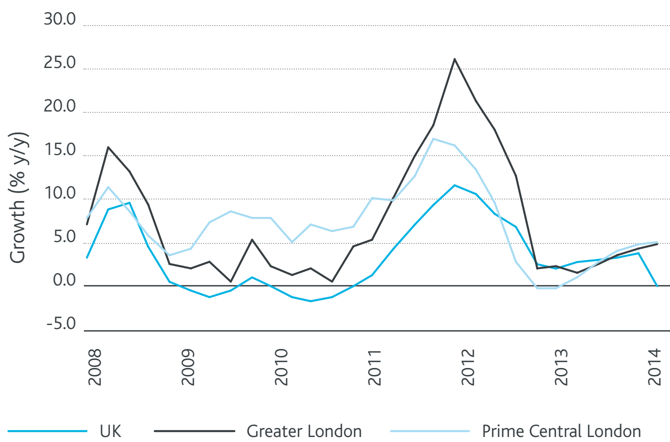
With all this in mind, we forecast subdued UK house price growth of 3-4% in 2015 and 2016. We expect average growth of 2.8% per annum over the next five years. This of course assumes no substantive change in policy in relation to housing or its taxation. This is a big assumption given the current position of political uncertainty.

Central London residential market

Capital values in Prime Central London (PCL) grew by 9.6% in 2014, down from 12.6% in 2013. As noted earlier, the capital as a whole benefited from an earlier, and sharper, upturn in both employment and real incomes. This drove both confidence and spending power, although against the backdrop of rapidly rising house prices most people found their spending power in the housing market reduced over the last two years.

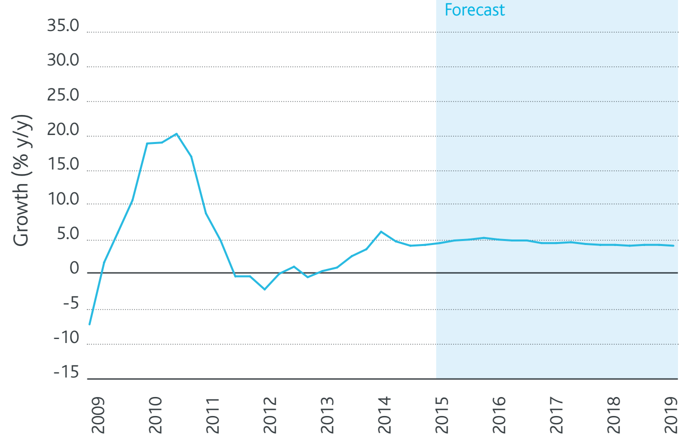
As was the case in the wider UK market, the second half of 2014 saw a 'change of speed' in the London housing market, with a slowing in activity and price growth, despite the undoubted strength of the London economy. In Greater London as a whole, this translated to 2.5% price growth in Q4, but resulted in a fall in annualised house price growth from 21.0% at the end of Q3 to 17.8% at the end of Q4. In Prime Central London the slowdown was more marked; we recorded a 0.4% fall in Prime Central London capital values in the last quarter of the year.

Figure 3 – Capital value growth forecasts



Source: Cluttons, Experian, Nationwide

Figure 4 – Prime Central London rental growth forecast



Source: Cluttons, Experian

In common with the wider UK market, affordability concerns, mortgage finance restrictions and political uncertainty conspired together to stall activity. The sudden change in the SDLT inevitably had a disproportionate impact on Prime Central London, not helped by the strengthening in sterling, which has somewhat reduced the appetite of non-Dollar denominated overseas buyers. The London RICS House Price Survey backs up this decline, with the year ending firmly in negative territory both for new instructions and new buyer enquiries.

The start of 2015 has been a little more positive and we expect to see capital values in Q1 show a marginal rise. However, there is a plethora of uncertainties that will overhang the market for the coming quarters. The housing market, tax and the political football of inequity present risk for the Prime Central London market in particular. Mansion Tax is an illustration, although there are many ways in which London could be impacted negatively or indeed positively by policy decision post-election.

Looking further ahead, we feel Prime Central London capital values will perform in line with the Greater London average, although this will mask a range of performance and drivers. Affordability will dominate much of the market as those living and working in London, even in highly skilled positions, struggle to find suitable homes they are able to afford. The opening up of locations through transport infrastructure improvements and the added stock associated with the development of these areas will improve the quantum of housing available in some markets which will temper price growth to an extent.

Over recent years we have seen a new openness amongst established Londoners and incomers towards location choice. We expect this trend to continue over the medium term. This openness has been driven by a financial imperative as affordability pressures change behaviour, but has been facilitated by the shifting geography of London. The City Fringe and East London have found their place in the Capital's housing market with the growth in the TMT sector and also grand projects such as the Olympics and its 'new village' legacy. It is expected that over time other infrastructure hotspots such as Battersea and Brent Cross will evolve in a similar manner.

Over the short to medium term however, our forecasts, provided by Experian, suggest Prime Central London capital value growth will be 3.0-4.0% for 2015. Due to the concerns over affordability, we expect growth to average 4% per annum over the next five years, well below the performance of the previous four years.

Central London lettings market

In contrast to capital values, rental values have been growing throughout 2014. Overall growth for the year was 6.0%, a marked rise from 2013 which saw figures rise by just 0.3%. Of course, there is a clear and inevitable link between the slowdown in capital value growth and the rise in rental value growth. However, it is not just tenants who have been priced out of the buyers' market who are fuelling this rise.

The improvement in the employment market through 2014 is a key driver of rental demand in the capital. New job starters accounted for a significant proportion of new tenants in the capital. The RICS recorded consistently positive figures for tenant demand in London throughout 2014, although 2015 has seen a more mixed picture. While many households are choosing to stay put where rents are not rising, others are increasingly willing to move to reduce costs, often in order to save for a deposit to buy. As a result, tenants are proving flexible in location in order to cut costs. Restricted corporate budgets where available have driven this trend to an extent.

Given the dynamics of the residential market in London and expectations for a continued strengthening in the economy, our forecasts suggest rental values will continue to rise ahead of inflation. With Experian we forecast rental value growth of 4-5% in 2015; with the five year average expected to be similar.

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