OPPORTUNITY IN A TURBULENT WORLD

The 2009 Knight Frank Residential Market Forecast

Key headlines

- UK residential prices will fall 30% from their peak, taking values back to September 2003 levels
- Sales volumes will hit a low point in late 2008, at only around 30% of their long term average
- Sales volumes will recover to reach 60% of their long run average by the second half of 2009
- Development land values outside London are already down 33% from their peak, with a further 15% to go in 2009
- Equity rich investors and speculators are already in the market, targeting distressed land and property sales
- The top of the agricultural land market has been reached, we expect price falls of up to 10% from the 2008 peak

The joy of forecasting in chaotic times

Forecasting is complicated enough when the world is behaving largely as you would expect. In the current financial maelstrom, where all economic rules seem to have been rewritten or cast aside, predicting where property values might be next week, let alone next year, appears rather foolhardy. It seems somewhat akin to picking the winner of the 4:20 at Chepstow when you don't even know who is running. However, even during these unprecedented times our experience and insight still means we are well placed to provide informed judgements and forecasts.

Where do you begin when the world is falling apart?

We cannot begin to forecast the performance of the housing market without understanding where it sits in the wider economy.

The key themes behind every aspect of the credit crunch are a fear of the unknown and a feeling of helplessness. When nobody knows what will happen tomorrow, the natural instinct is to put up the shutters and go into defensive mode, hoping somebody will sort out the problem so normality can resume.

Banks won't lend to each other because they don't know if they will be repaid, and consumers find it hard to get mortgages because lenders with access to funds have little confidence in the value of the asset they are lending against. Even potential buyers with finance are holding back, waiting for the market to fall further.

Ultimately, it is governments who are expected to sort out a mess of this scale. Markets clamour for decisive action and then dismiss the results, even when it involves hundreds of billions of pounds, as being too little too late.

Our feeling now, though, is that the decision by Alastair Darling to support UK banks to the tune of up to £500bn, and the Bank of England's emergency 50 basis point cut in interest rates, will restore some stability to the market – if for no other reason than there is no plan B. This is probably the best that Mr Darling can offer without the very real chance of bankrupting the nation.

Even in the light of this assumption, there is more pain to come. Despite the extra taxpayers' cash available, banks will take time to rebuild their capital bases. With the UK entering recession, unemployment is likely to increase, and with it disposable income and household budgets will fall.

Housing price falls, bad news for some – but not everyone

The fact that prices of houses are falling is not a catastrophe for everyone. There are just under 26m households in the UK, 18m are in owner-occupation and 3m live in privately rented property – so approximately 21m are in the private sector. Our forecast suggests that house prices will slip back to September 2003 levels. A total of 5m properties were bought after this date, meaning the remaining 16m should at least escape a loss of value to below their original purchase price.

In nominal terms, by the time that the process of price falls concludes, only 24% of property owners are likely to see an erosion of their property value to below the level they paid for it.

Ignoring their economic impact, price falls are pretty much irrelevant to those in social housing or tenants in the private rented sector. It might sound harsh to those experiencing the pain of negative equity - but price falls will be generally welcomed by those without a foot on the ladder, particularly those who had given up all hope of ever affording their own home.

When will house prices stop falling?

The central question for anyone who owns their own home is – when will prices stop falling? Our forecast (Figure 1) suggests that we will be closing in on the bottom of the market during 2009.

Prices in the UK peaked in late 2007 and have fallen sharply since that point. Our forecast suggests that we are now at least half way through the process of price falls, with around 15% of an estimated 30% peak-to-trough decline already factored into prices.

Some markets are experiencing very different conditions from the national or regional average. As we will explore later, the regional new-build sector has already seen substantial price falls, with examples of 50% or more in several locations. It looks as if price declines are already coming to a close here – with investors sensing that "fair pricing" is almost at hand.

So when do values start to rise again?

Table 2 provides our price forecast in cumulative terms. The shaded cells point to the period when prices return to their 2007 peak, a process which, on average, will be complete by 2015, led by central London (2012) and concluded by Northern Ireland (2019).

Our recovery picture is based on the assumption that mortgage providers will adopt a far more conservative lending approach once the credit crunch unravels. However, it is also worth noting that we do not have the oversupply problems of Spain and the US, and, indeed, a shortage of housing will become more apparent with time.

Whilst a market peak is hard to spot, so too is the bottom of the market. There are lots of buyers watching the residential market very closely,

Table 1
Knight Frank house price forecast, annual change

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
UK	-14.0%	-11.0%	1.1%	7.0%	5.1%	3.6%	6.1%	6.2%	6.2%	6.2%
Greater London	-14.7%	-12.2%	1.9%	8.7%	6.7%	4.8%	7.0%	6.6%	6.6%	6.6%
Prime central London	-16.9%	-4.5%	6.2%	9.4%	8.6%	5.7%	6.8%	6.6%	6.6%	6.6%
South East	-12.9%	-9.6%	1.8%	7.1%	5.3%	4.1%	6.7%	6.1%	6.1%	6.1%
South West	-12.4%	-8.4%	1.2%	6.1%	4.4%	3.5%	6.2%	6.4%	6.4%	6.4%
Yorkshire	-13.2%	-10.5%	0.5%	5.2%	3.3%	2.3%	4.9%	5.4%	5.4%	5.4%
East	-14.7%	-11.6%	0.3%	5.8%	3.8%	2.4%	4.9%	5.6%	5.6%	5.6%
West Midlands	-13.1%	-9.6%	1.1%	5.9%	3.9%	2.8%	5.5%	6.5%	6.5%	6.5%
East Midlands	-12.2%	-9.4%	1.4%	5.8%	3.8%	2.8%	5.5%	6.2%	6.2%	6.2%
North West	-13.2%	-10.1%	1.0%	6.0%	4.1%	2.9%	5.5%	6.7%	6.7%	6.7%
North	-10.5%	-5.9%	0.9%	4.9%	3.5%	2.9%	5.6%	5.9%	5.9%	5.9%
Scotland	-11.2%	-4.6%	-0.8%	4.0%	3.6%	3.2%	5.7%	5.2%	5.2%	5.2%
Wales	-14.7%	-13.8%	1.8%	7.7%	5.1%	3.4%	5.9%	6.0%	6.0%	6.0%
Northern Ireland	-27.3%	-31.6%	2.1%	15.9%	11.2%	5.7%	7.1%	7.7%	7.7%	7.7%

Source: Knight Frank Residential Research

Table 2
Knight Frank house price forecast, cumulative house price growth (from Q4 2007)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
UK	-14.0%	-23.3%	-22.5%	-17.2%	-13.1%	-10.0%	-4.5%	1.4%	7.6%	14.3%
Greater London	-14.7%	-25.2%	-23.8%	-17.1%	-11.6%	-7.4%	-0.9%	5.6%	12.5%	19.9%
Prime central London	-16.9%	-20.7%	-15.7%	-7.8%	0.1%	5.8%	13.0%	20.5%	28.4%	36.9%
South East	-12.9%	-21.3%	-19.8%	-14.1%	-9.6%	-5.9%	0.4%	6.5%	13.0%	19.9%
South West	-12.4%	-19.8%	-18.8%	-13.9%	-10.1%	-6.9%	-1.2%	5.1%	11.8%	18.9%
Yorkshire	-13.2%	-22.3%	-21.9%	-17.8%	-15.1%	-13.2%	-8.9%	-4.0%	1.1%	6.5%
East	-14.7%	-24.6%	-24.3%	-20.0%	-17.0%	-15.0%	-10.8%	-5.8%	-0.5%	5.0%
West Midlands	-13.1%	-21.4%	-20.6%	-15.9%	-12.6%	-10.1%	-5.2%	1.0%	7.6%	14.6%
East Midlands	-12.2%	-20.4%	-19.3%	-14.5%	-11.3%	-8.8%	-3.7%	2.2%	8.5%	15.3%
North West	-13.2%	-22.0%	-21.2%	-16.5%	-13.2%	-10.7%	-5.7%	0.6%	7.3%	14.5%
North	-10.5%	-15.8%	-15.1%	-10.9%	-7.8%	-5.1%	0.1%	6.1%	12.3%	19.0%
Scotland	-11.2%	-15.2%	-15.9%	-12.5%	-9.4%	-6.5%	-1.2%	4.0%	9.4%	15.1%
Wales	-14.7%	-26.5%	-25.1%	-19.4%	-15.3%	-12.4%	-7.2%	-1.7%	4.1%	10.4%
Northern Ireland*	-27.3%	-50.2%	-49.2%	-41.1%	-34.6%	-30.8%	-25.9%	-20.2%	-14.0%	-7.3%

Source: Knight Frank Residential Research
* Northern Ireland sees values returning to their 2007 peak values by 2019

and they are desperate not to miss the floor when it comes. Equity-backed investors are already active, and more are waiting for prices to correct in the forthcoming months.

The winners in this market will be anyone with equity who can buy over the next six months. Those requiring significant finance will be unlikely to be quick enough on their feet. Vulture funds and cash-rich individuals will be the first to benefit.

It may be hard to stomach but opportunistic buyers are looking for distressed property sellers. They are interested in individual properties – repossessions in particular – and also development land, or even newly completed developments. In fact, anything where values are felt to have fallen as far as they are likely to.

Prime markets – London

Prices in prime central London are already 12% lower than their peak level. Our view is that they are likely to end 2008 almost 17% down as a whole, with a further decline due in 2009. With the exception of the new build sector, the central London market is set to be the earliest to hit the bottom in 2009. However, we do not expect price growth until 2010.

This market is dominated by workers from the city – and with bonus, wage and employment prospects low over the next year or so, it is easy to understand why prime central London has suffered so sharply. The fact that transaction volumes have halved over the past year demonstrates how confidence has changed in this sector.

After 2010, the general shortage of housing in central London – unlikely to change given the constraints of planning and conservation policy – will ensure a return to steady, if not rapid, price growth.

Until very recently the super-prime sector – comprising properties worth over £10m – had seemed to be defying the downturn, with prices rising each month, indeed, properties in this sector are still worth 10% more than a year ago.

This sector peaked in August, and prices fell by 1.7% in September. Despite obvious volatility in the wealth portfolios of super-prime buyers, we do not expect average price falls to reach more than 10% in total.

Value decline in this sector will be limited by the fact that vendors would rather take properties out of the market, than sell at a discount to the price they paid. In addition, these owners are much better placed in wealth terms to weather the storm than they were in the early 1990s.

Table 3
Knight Frank – property market sector forecasts

Sector	Forecast type	2007 actual	2008 end of year forecast	2009 full year forecast
UK all residential	House price	4.7%	-14.0%	-11.0%
Prime central London	House price	28.6%	-16.9%	-4.5%
Super-prime London	House price	42.4%	3.0%	-5.0%
Prime country houses	House price	7.9%	-15.0%	-8.0%
UK all residential rents	Rental prices	7.5%	2.0%	4.0%
Prime central London rents	Rental prices	16.9%	-2.3%	3.0%
Development land	Land price	3.2%	-38.0%	-10.0%
UK all agricultural land	Land price	25.0%	16.0%	-4.0%

Source: Knight Frank Residential Research

Prime markets – country

Values in the prime country house sector initially seemed to be holding up as the wider market fell, but it is clear now that this was due more to reluctance on the account of vendors to cut prices than any inherent ability to ride out the storm.

We believe that prices will fall 15% in 2008 as a whole, with a further 8% fall in 2009.

Purchasers, even those without funding issues, are playing a wait-and-see game in the assumption that the market is unlikely to bounce back soon. They are still looking – viewings for some of our offices are actually up – but nobody is in a rush unless they think a real bargain is up for grabs.

Where prices are sufficiently realistic the effect in some cases has been startling. Over the past month we have seen three attempted gazumps on multi-million pound properties. This shows that there are buyers in the market looking and waiting to pounce when the right opportunity arises – but only where they see values at a level reflecting a significant discount on last year's peak.

As ever, it is the rarer properties at the top of the market that attract most interest. Even now there is a dearth of the very best houses for sale. The prime country market has the advantage of a finite level of stock and this means prices should rebound more quickly. There are not vast swathes of empty country houses sitting on the market.

Investment

There is clear evidence that less committed and over-geared buy-to-let investors are leaving the market. The number of new buy-to-let mortgages dropped in the second quarter and we expect further falls when the third quarter figures are unveiled. The number of these buy-to-let mortgages in arrears is rising rapidly, albeit from a low base.

Given the likely difficulties many investors will have in remortgaging, these problems will multiply. Highly geared, recent investors will be among the biggest losers from the downturn. However, those with low borrowing should be able to ride out the storm, and will benefit from stronger rental market conditions over the next few years.

Rents rose across the UK by 7.5% in 2007, this year we expect growth to be no higher than 2%. In 2009 we expect a return to growth in line with average earnings inflation (c4%).

The outlook for those entering the market next year is much more positive. With capital values at least 30% below the 2007 peak, gross yields in many areas will reach 7% and even 8%, at a time when the costs of borrowing will be falling.

We expect to see the emergence of a new class of residential property investor, more focussed on rental returns than house price inflation.

New-build properties

The new build sector has been the market most affected by the housing downturn, with flats in the regional centres amongst the earliest and most high-profile victims. Prices have now fallen by between 20% and 50%, and a large proportion of the growth early investors saw has now disappeared. The problems are not confined to flats. In many locations new build houses have fallen by between 15% and 25% in value since last year's peak.

Most house builders are desperate for cash and, unlike owners, cannot opt to wait for a better market. There is evidence, though, that some cash-rich developers are choosing to rent out their property rather than sell at prices that could, in some cases, be lower than build cost. This could prove to be a model that becomes more widespread over future years – although VAT rules are proving a significant barrier.

Residential development land

The crisis in the sector has had a dramatic effect on the market for development land. Developers' acquisition activities have been put on

hold and in some cases they have begun to sell land banks to raise cash. Others have gone bust and their holdings have been put up for sale – providing an entry point to the speculator.

Outside the M25, land prices have fallen by 33% on average, although in some locations the decline has been more severe. Even in London, prices have fallen by 10-15%.

Investors are watching this market very carefully and there is evidence that there are substantial sums of money earmarked for land. Further falls in prices during the remainder of this year and early 2009 will provoke the first moves, bringing about a recovery in demand.

Construction activity

The lack of activity among house builders is having other, more profound effects. In the second quarter of this year, the number of new starts was over 40% lower than during the same period in 2007. The third and fourth quarters will see even more dramatic declines, and the total number of completions for this year could be below 100,000, a figure that is unlikely to be improved upon next year.

This is clearly well below the 240,000 homes the government needs to meet its target of 3m new homes by 2020. It is even further below the 270,000 that its advisor, the National Housing and Planning Advisory Unit, believes are needed each year to meet demand.

The undersupply of housing is clearly set to worsen over the next few years, setting the scene for new price growth once confidence returns to the market. Low land values and falling build costs will set the scene for a new phase of development activity.

However by the time the recovery comes, traditional house builders may not necessarily own the land with planning permission – we believe a large portion will be in the hands of sovereign wealth funds, other institutions, local councils or wealthy individuals. New approaches involving joint ventures or consortia developing new communities over the longer-term may emerge. We may even see 'build-to-let' become a reality.

There is one serious barrier to residential development over the next few years. The boom in land values and house prices has led to a huge increase in the planning obligations laid on developers. In many cases, the consents that are in place call for new transport infrastructure, flood defences, and, particularly, large amounts of affordable housing, much of which is no longer viable The government and local councils will have to adopt a more flexible approach if they want to see activity return to historic levels, let alone meeting their targets.

International prospects

The view from international residential markets is less straightforward than that of the UK – if that is at all possible. There are some common themes: a reduction in transaction activity, a slowdown in new construction and sharply lower, and increasingly negative, price growth.

The more mature markets, such as Spain, Ireland and the US, which are more debt-driven and whose banks had greater exposure to toxic assets, have been most affected by the global credit crunch. In contrast, many emerging markets - Bulgaria, Russia, and China - continue to exhibit robust growth.

There is a differential between prime and non-prime markets. This trend is to some extent born out in the prime locations of the Swiss Alps, Monaco and Cote d'Azur where buyer interest – if not price growth - remains solid, albeit lower than last year. The reality is that even the top of the market is becoming a more difficult place to secure sales.

IT SEEMS INCREASINGLY PERVERSE TO ASK PURCHASERS TO PAY A TAX ON AN ASSET WHICH IS DECLINING IN VALUE.

International development

In the development sector, there has been a noticeable growth in very large, second home projects across the globe. Many of the high profile schemes are huge, with several multi-thousand unit schemes under development in locations including the Middle East, Mexico and Europe.

There is a real threat to the viability of these larger schemes – especially where local infrastructure and transport access have not been properly planned for. A number of developers are finding it much tougher to secure finance on new projects or are facing re-negotiations on existing credit lines. This has prompted developers to consider various incentives to entice prospective buyers and give comfort to their lenders that they are actively seeking ways to negotiate what has become a much harder market.

Listed developers have the additional stress of honouring shareholder dividends at a time when cash flows are under pressure and stock markets are taking a dim view of property stocks generally.

International forecast

There are markets where a combination of structural deficiencies and liquidity issues have pushed residential markets into serious and likely longer term decline. Spain, the Baltics and the US are the most obvious examples, where a combination of oversupply and the credit bubble have created a downturn which is likely to take many years to work out.

In the Baltics, the price distortion impact of foreign speculators has been an additional factor.

There is a group of countries where prices and buyer activity are declining, exacerbated by the credit crisis, but where structural characteristics also suggest that, when credit lines are re-opened, a reasonable recovery should be expected. Singapore, Australia and Portugal would fit in this category.

The final group of countries, which includes Brazil, France and Italy, for example, are those which, despite some local over pricing and supply issues, are still reasonably healthy, with excellent or rapidly improving infrastructure. These locations will avoid significant price falls.

The markets we are most positive about in the short to medium term include established locations such as Paris, Berlin, Cote d'Azur , Singapore, the Swiss Alps and the Caribbean. We would also include emerging markets such as coastal Montenegro, north east Brazil, Poland (secondary Polish cities) and Abu Dhabi.

Farmland

UK

Farmland values were, until recently, growing strongly on the back of booming global commodity markets and increased farmer optimism and demand. Last year, values rose over 25% and it looked as if this figure would be matched again in 2008. Prices, however, weakened very slightly during Q3 and annual growth will probably be about 16%, lower than last year but still somewhat better than the residential market.

The drop in prices is due to a fallback in cereal prices and a huge cost hike in agricultural inputs such as nitrogen fertiliser. Smaller farms with pretty houses, which were often bought by residential purchasers, are also proving much harder to sell.

However, a lack of supply and continued tax incentives to own land mean values are unlikely to fall as far as other markets. Our view is that the fall in prices from the Q2 2008 peak will be no more than 10%.

International

An increase in world population and changing consumption habits in developing countries, not to mention large scale degradation or the commercial development of farmland, suggest long-term support for values. This is reflected in the number of funds that have been set up to invest in international farmland and sharply rising values in the US, South America and Eastern Europe.

While the fundamentals behind such investments look sound, the same factors also point to increasing food shortages and subsequent unrest. It is difficult to predict how governments, particularly in developing countries, will react to food security issues caused by increasingly volatile commodity markets and weather patterns. There are already signs that foreign ownership of land or other agricultural assets will come under increased scrutiny.

RESISTING THE TEMPTATION TO TINKER IS PROBABLY THE BEST THING POLICY MAKERS CAN DO IN THE RESIDENTIAL MARKET.

Risks to our forecast

Forecasting is an imprecise science at the best of times; however in the current climate where events with major global impact are happening on a weekly or even daily basis, the importance of caveats is significantly heightened.

Our forecasts have assumed no further major shocks emerge to destabilise the world's financial and economic systems, however in the light of recent events we cannot rule out any further nasty surprises. Some of these could have ramifications far beyond the price of property.

A new sub prime

The most recent "bad news" story to emerge relates to credit default swaps which, according to some commentators, could potentially prove more harmful than the sub-prime debacle and have already contributed to problems faced by insurance giants such as AIG. We have to some extent allowed for this within our forecasts but the worst case scenario could be cataclysmic. Total exposure to these unregulated financial instruments is an estimated $50-$60 trillion.

The failure of government bail outs

Continued stock market falls across the globe suggest the multi-billion pound bank bailouts announced by the UK and US governments and recent interest cuts have failed to stabilise markets. If markets do not recover some momentum soon, there will be a realisation that there is no plan B. Even the US cannot afford to keep pumping billions into the markets. The worst-case scenario would be a major government defaulting on its bond repayments.

The spreading credit crunch

This is already happening; even markets without a high level of toxic debt are dragged down. This was exhibited recently when Japanese stock markets plunged, even though the country's banks are relatively well capitalised. To a certain extent our forecasts rely on the Asian economies remaining relatively buoyant. Even though the region's fundamentals still look sound, the credit crunch has proved capable of springing lots of surprises.

The long view – what does the future hold

Are we just witnessing a downturn in a housing cycle that will inevitably bounce back or will there be fundamental changes in how property ownership is viewed?

In this section we have permitted ourselves to cast our eye into the future and make some broader predictions.

Another bubble?

If past behaviour is anything to go by – and memories do seem to be short - Miss Prudence, so beloved of Mr Brown, may well be forgotten rather quicker than expected by mortgage providers once some sort of normality returns to the lending market.

The fundamentals of strong UK housing demand will remain, but the slump in house building will exacerbate the supply deficit and will help to drive prices higher. There is a good chance that we will soon be inflating the next bubble.

Outright ownership is no longer the default ambition

We believe that a wholesale shift towards a French or German model, where long-term or even lifetime renting is considered normal, is a step too far. But we do feel that occupation options will become more flexible in the future with people able to choose from a mix of shared-ownership and rental options.

This will be encouraged (subject to VAT reforms) as development partnerships take a longer-term view and opt to rent out a larger proportion of new housing stock. A more cautious approach among mortgage providers could mean this is the only option for those who cannot access social housing.

A larger rental sector will emerge from this credit crunch by default as lenders opt to rent out repossessed houses instead of selling them on for a potential loss. The yields and cash flows from such portfolios will prove attractive.

The government takes control

Government is likely to take this opportunity to become more directly involved in the development market. Major homebuilders will no longer be the sole mechanism for future growth. We could see government developing the land itself, perhaps through joint ventures with companies with a greater capacity for major projects, such as the large construction firms.

House building trends will change

Those developers left in business will no longer focus on high-volume inner-city flat developments. They will try where possible to target family houses in the outer suburbs where there is more tangible demand. Urban development will concentrate on ‘edge of centre’ brownfield sites where there is a possibility of developing high-value mixed accommodation as part of a wider gentrification.

Policy recommendations, Knight Frank’s five-point plan for government

Don’t try to stop a falling market

One for the short term. Resisting the temptation to tinker is probably the best thing policy makers can do in the residential market. Most interventions to date (interest-free equity loans for first-time buyers etc) have been designed to prop prices up. This is not a good idea and is counter productive; it also encourages low income groups into homeownership at the wrong time.

House prices have fallen and will fall further – unfortunate for some owners but fortunate for those without a stake in the market. It is an uncomfortable process, but is best left to run its course.

Reform the Basel II regulations

One for the long term. Reform the rules which dictate mark to market valuations and move towards judging bank solvency on long term returns on loans and assets, not volatile current market values.

Plan for the gradual but total abolition of stamp duty

Given the condition of public finances this is a long shot. Stamp duty is a tax on mobility and serves to gum up the housing market in unforeseen ways. The tax is particularly counter productive in terms of labour market and economic flexibility. The market coped with substantial rises in the rates of stamp duty during the boom years. Now that prices are falling it seems increasingly perverse to ask purchasers to pay a tax on an asset which is declining in value.

Act decisively to ensure more homes are built

Government ambitions to provide large volumes of low-cost and environmentally sustainable housing stock are laudable but remain in reality a pipedream. There is a need to reform planning laws and enable housing associations and other public-private partnerships to build more, especially in areas where property prices beyond the reach of average or low earners.

Invest in infrastructure and be more flexible about planning obligations

Many schemes have been given planning consent with the proviso that developers provide affordable housing, new transport links and even schools or flood defences. Plummeting land values and house prices mean that development is no longer viable – and in some cases the sites may be less than worthless. If it wants to see homes built, the government needs to adopt a more flexible approach to planning obligations – both existing ones and new agreements. However, new houses will still require infrastructure and, over the next few years, only the government will be in a position to fund it.

ALTOGETHER BETTER

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Technical notes on the Knight Frank residential market forecast

Our forecast of the Nationwide Seasonally Adjusted Index is based on an econometric panel estimation model, which takes regional differences into account by using fixed effects specification and regional input variables. Independent variables include the Bank of England base rate, inflation, disposable income, supply and demand projections.

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