

Residential Property Focus

The Forecasts Issue
Identifying new tiers
in the housing market

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This publication

This document was published in November 2010. It contains a review of all the key housing market indicators and news to the end of October 2010. The data used in the charts and tables is the latest available at the time of going to press. Sources are included for all the charts. We have used a standard set of notes and abbreviations throughout the document.

Glossary of terms

■ **Mainstream:** mainstream property refers to the bulk of the UK housing market with, for example, price movements monitored by reference to national and regional average values.

■ **Prime:** the prime market consists of the most desirable and aspirational property by reference to location, standards of accommodation, aesthetics and value. Typically it comprises properties in the top five per cent of the market by house price.

The most commonly used abbreviations are:

- Q310: refers to the third quarter of 2010
- Peak: refers to the first half of 2007
- LTV: Loan to value
- CML: Council of Mortgage Lenders
- RICS: Royal Institution of Chartered Surveyors
- ONS: Office for National Statistics
- F&BS: Financial and business services sector
- HMRC: HM Revenue & Customs

Foreword

The importance of good grades

An important shift in the nature of owner occupation has created the need for a change in the way we describe the market. **Yolande Barnes** introduces a new model

In the autumn of every year since 1989, we have given clients and friends our prognosis of what the coming year might hold for the UK residential property market.

In most years, these forecasts are a continuation of recent trends but once in a while, we call a turnaround in the market. Never before though have we so fundamentally reconsidered the way we actually describe the market as we have in this issue.

Twenty-one years ago, we started using a commercial property term to describe the markets that we have since specialised in monitoring. The term 'prime' is now widely used to denote the best and most desirable properties in the country. We have found that these markets, although small in numbers of transactions, have an important part to play in the wider markets, often leading the rest.

We now think that there has been another important shift in the nature of owner occupation so it is time to coin a further, new distinction within the markets. We are seeing an ongoing separation of the market into grades of different types of property. This is more than a cyclical phenomenon and it reflects an important and fundamental structural change in the way the market works and will work in future. These grades are likely to behave differently from each other because they will be occupied by different tenure groups and consequently be driven by different economic drivers in each case.

A change phenomenon

In order to help describe this change phenomenon, we believe it is appropriate to divide UK residential buildings into grades, relating to a building's desirability and use, so we are introducing another classification from the commercial property world. We are still using prime, secondary and tertiary to describe location but will be using grade A, B and C to describe individual properties. There is a link between prime and grade A. Prime counties, districts and neighbourhoods are likely to contain a higher proportion of this stock than tertiary neighbourhoods, but it is possible to find grade C buildings in prime and secondary neighbourhoods and grade A and B

buildings in tertiary locations. Our diagram on page 5 aims to explain our thinking.

There will be significant differences in the extent and timing of performance between different grades of stock. Large, well-built, light and airy family houses appealing to equity rich owner-occupiers (Grade A) will perform differently to small, rented studio flats valued solely by investors and their lenders for their income yield (Grade C).

Have and have-nots

With the division between the equity haves and the equity have-nots continuing to drive the shape of the market, and with government austerity measures impacting some locations more than others, we continue to expect a divide between regions too. This regional dimension is reflected in our forecasts for the next five years, which still anticipate a second slip in values before growth resumes.

Overlaying this, we expect grade A properties to recover first and fastest while grade C stock may languish for a while until a combination of relatively lower prices and rising rents boosts yields to a level that investors find irresistible.

Our forecasts have been revised since last year to reflect the polarisation in grades and category of property. This means that our prognosis for the prime markets, with their high proportion of grade A stock is little changed, while the mainstream markets, which are more heavily influenced by secondary locations and lower grade stock, have been revised downwards.

We have always said that the UK housing market is not a single market but a series of inter-related sub-markets. This theme is discussed overleaf and we look forward to exploring the factions further in future editions of this publication. It is in these differences that the biggest opportunities lie. ■

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'Never before have we so fundamentally reconsidered the way we describe the market as we have in this issue.'



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Market structure

The tiers of the housing market

Emerging trends in the UK housing market mean that the best is again separating from the rest. **Yolande Barnes** asks if the shift to distinct tiers will be permanent this time

There has been a structural change in the housing market which started long before the credit crunch took hold. It has become increasingly accepted that there is now a generation of households who will not be able to become owner occupiers for a number of years. In the past, these households would have been first time buyers, fuelling the expansion of mortgaged property ownership at the lower end of the market.

Like many aspects of the UK real estate market today, this situation has less to do with the availability of credit and everything to do with the availability of equity.

The deposit hurdle that buyers have to leap started to be insurmountable as long ago as 2000: mortgaged owner-occupation started to fall at this time. The withdrawal of high loan to value mortgage lending since the credit crunch has exacerbated the situation and further polarised the market. Transactions have been at an all-time low, but those that have occurred have been predominantly among former owner-occupiers with little or no mortgage borrowing and the average age of unassisted first time buyers has now risen to 37. This has concentrated trading activity at the upper end of the market.

Government house price data suggests that the gap between the equity haves and the have-nots has again widened

since 2007, with the lower tiers of the mainstream underperforming significantly. It has become well-known that the reduced availability of mortgage finance, particularly at higher loan-to-value ratios, has driven a substantial wedge between existing homeowners and those seeking to get their foot on the housing ladder.

This is strikingly illustrated by the change in the amount of equity – relative to earnings – that first time buyers have to find in order to access the mortgage market. It is now close to 100% of annual income. Even if loan-to-value ratios for first time buyers returned to their 25 year average of 91% (an unlikely event), then average deposits would still be equivalent to around 40% of a year's earnings.

Performance shift

While it is true that various tiers of the market perform at different stages of the housing market cycle, we think the current performance shift is more permanent and signals a fundamental change in the structure of the UK housing market.

We observe that both trading and price rises are taking place in markets where purchasers have significant levels of equity or access to equity (either through 'Bank of Mum & Dad' or other sources of lump sums such as bonuses) usually later in life.

Equity purchasers are highly discretionary and those markets that have

always been dominated by the equity rich (most notably the markets in London and the country that we have referred to for the past 20 years as 'prime') have different characteristics to those dominated by mortgage borrowers.

Right now, we are seeing significant differences in growth patterns between northern regions and southern regions. While this is undoubtedly coloured by the nature of, and prospects for, the regional economies (not least how public sector cuts will impact), the underlying differences between locations is the level of mortgage reliance in local housing markets. Southern housing markets generally have significantly higher levels of equity in them than most of those further north. It is this divide that marks the future of the UK's housing market.

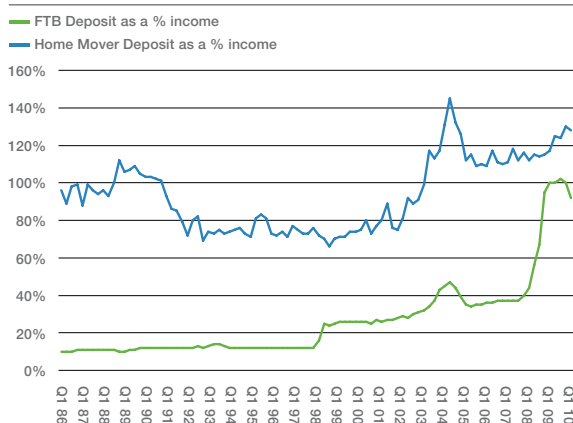
Equity-dominated markets

Markets dominated by mortgage borrowers are susceptible to changes to interest rates, changes to the cost and availability of debt and to changing employment prospects, notably fear of redundancy.

Markets dominated by equity are much less susceptible to these factors but more exposed to economic factors affecting wealth creation and bonuses.

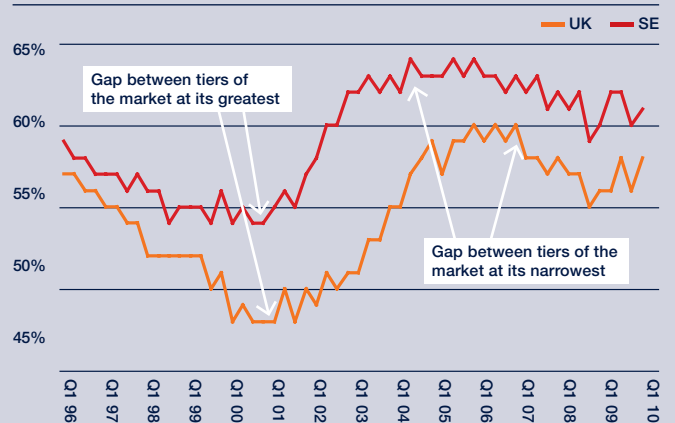
A significant rise in the opportunity cost of money return on funds on deposit would also appear to have an effect, encouraging

Graph 1.1
Deposit Affordability



Source: CML

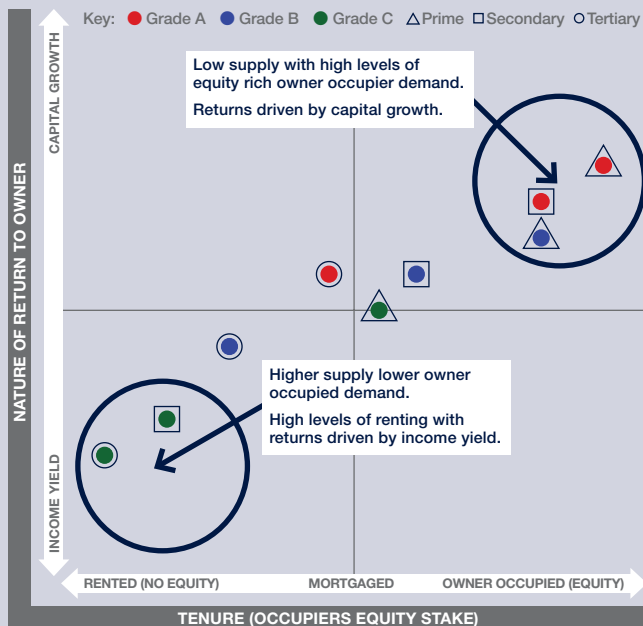
Graph 1.2 Lower Quartile (Bottom 25%) House Price as a percentage of Mean (Average)



Source: CLG/Savills

A new model for evaluating UK residential property

The market is expected to divide into grades by reference to the quality of the location and the dwelling (see right for examples). This will dictate the way it is occupied, the equity stake of the occupier and the financial returns to its owner (see below).



	TERTIARY	SECONDARY	PRIME
GRADE A	Tudor house near industrial estate	Superb warehouse conversion in Bow	Large Georgian Rectory in Oxford
GRADE B	1930's Semi under flight path	1960s estate house in Northampton	1960s family house in Harrogate
GRADE C	Near derelict terrace in Hull	1980s studio flat in Bracknell	Ex council flat in Westminster
	PLACE/LOCATION		

Source: Savills Research, November 2010

a switch to bricks and mortar when cash returns are poor.

The more discretionary nature of the equity-driven market and the maturity of most of the households in it means that stock and demand levels can switch quickly, particularly in low turnover markets. This also means that the equity-driven

markets are more volatile than mortgage-reliant ones (see right)

It now seems more likely that the younger and equity poor households will remain confined to the private rented sector, or reliant on shared equity schemes, not fully owning their home but having to pay some kind of rent on the whole or part of it. The prospect is that if they do buy, they will do so only much later in life and therefore skip what would historically have been referred to as a 'starter home'.

We anticipate that owner-occupier demand for lower quality, small properties will subsequently diminish as a result. Meanwhile these properties are more likely to be rented by those saving for their ultimate home. There will be pressure

on existing rental stock and, over time, increased income yields.

Under these circumstances, it is the income stream that will drive the value of these properties to investors, and not owner occupiers. This value will be determined by income yields relative to other asset classes and this will mean in the short to medium terms that the lower tiers of the market will have much less capacity for capital value growth.

New definitions needed

Consequently, we expect a continued widening of the gap between the different grades of stock. This has led us to further refine our definition of the housing market tiers. While, in the past, we have used the term 'prime' to denote the best properties in the best places, we think it is now appropriate to distinguish between the most desirable and least desirable places with the terms Prime, Secondary and Tertiary, meanwhile adopting the commercial terms Grade A, Grade B and Grade C to denote the quality of, and market for, different types of buildings. ■

Lower quartile

The divergence between the bottom quartile of the market and the average is revealing. 1996 – 2006 was a period of sustained house price growth, but the lower tiers of the UK market lagged substantially. By 2001, the average value in the bottom quartile of the market fell to 48% of the average.

By contrast, in the second half of this period, much greater accessibility to mortgage finance, at relatively low interest rates boosted buying power and the average house price within the lower quartile rose to 60% of the national average. ■

Volatility higher in prime markets

Standard Deviation (Volatility of annual growth)	1992–2010
Average Mainstream UK	8.6%
Prime Central London	11.8%

Prime London

London's promise of prime performance

Wealth generated outside of the UK and the performance of the capital's financial sector will secure the future growth of London's prime markets, as **Lucian Cook** explains

In the past two housing cycles the prime London markets have significantly outperformed their mainstream counterparts in the five years following a housing correction.

In the period from mid 1982 to mid 1987 real price growth in the prime markets of central London was 90% compared to 39% in the UK mainstream, while in the period from the end of 1992 to the end of 1997 exceptional growth of 73% in prime central London dwarfed the meagre 8% seen in the mainstream. What then are the prospects for this to be repeated?

The UK's residential property markets bottomed out by the end of the first quarter of 2009. Since then, prime London growth has again outpaced that of the mainstream. In both cases, however, there is evidence that this growth may, in part at least, have been premature, driven more by stock shortages than any fundamental change in the economic drivers of growth.

Between April and September of this year price growth in London's prime markets was just 1.4%, in contrast to 7.8% in the preceding six months, and is forecast to close the year just 2% up. This reflects softening buyer sentiment and a more even balance between supply and demand.

Despite this, we continue to expect the prime residential markets of London to

outperform the mainstream over the next five years.

We have identified two key factors (see page 8) – the amount of equity at play and the pattern of economic growth – that will dictate levels and pace of price growth in different tiers and locations within the mainstream. These factors will also apply, though in different ways, to the prime markets of London.

The role of international cash

Whereas the mainstream markets are almost exclusively dependent on the distribution of existing equity across the UK, the prime London markets are more affected by the influx of equity from overseas buyers who typically account for 50% to 60% of the central London markets.

London's unique mix of business and culture means it appeals to a wide group of international buyers, both by nationality and origin of wealth. As such, the equity they introduce into the market is a function of wealth generated by a broad range of commercial activities operating across a number of countries and economies.

The strength of the UK economy is important not only to the domestic buyers who dominate the market in prime South West London, but also to overseas buyers. A strong economy contributes to the

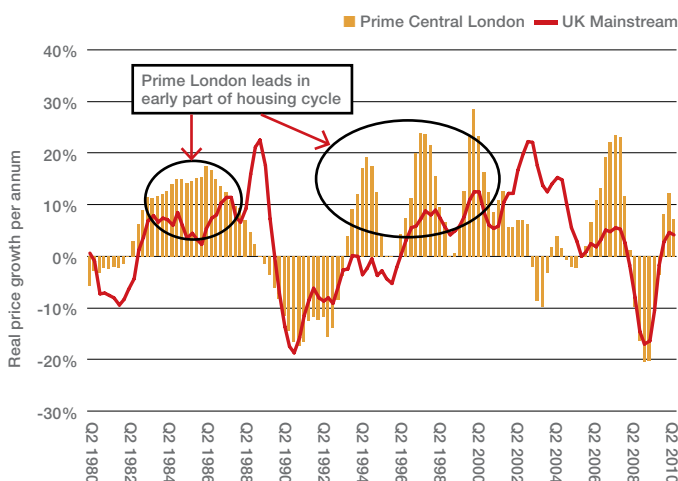
desirability of London as a safe deposit for international wealth, and assuming its place as a leading world city is retained, it will continue to benefit from wealth generated outside the UK. Accordingly, what happens elsewhere in the globe is of great, sometimes greater importance

Latest analysis from leading economic forecasting consultants, Oxford Economics, suggests the UK economy will grow by 8.2% from 2011 to 2013 and return to 2007 peak economic output levels by late 2012. By contrast, over the same period, the world economy is expected to grow by 12.1% and by 2012 its total output is expected to exceed its 2007 level by 18%.

Particularly strong economic growth is expected in India and China, with the very real prospect that wealth generated in these countries will play an increasing role in the prime London residential market.

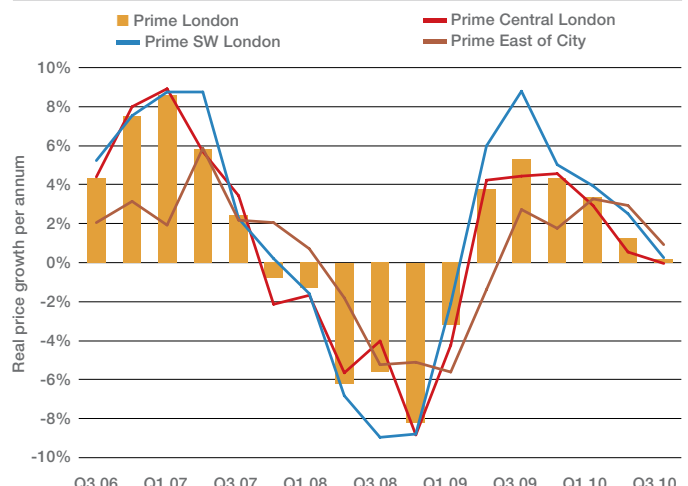
For now, however, Indian and Chinese buyers do not have anything like the market presence of the long-established Middle Eastern buyers, nor of the Eastern European buyers who emerged strongly in the latter half of the Noughties. Importantly, GDP growth and wealth generation in these regions (already very apparent in the prime London markets) is projected to outpace UK growth, even if not to the same degree as the emerging nations.

Graph 2.1
Real (inflation adjusted) house price growth



Source: Savills/Nationwide

Graph 2.2
Quarterly prime London house price growth



Source: Savills/Nationwide

The role of UK generated wealth

UK buyer demand in London's prime markets has been driven by the growth in personal wealth fuelled largely by earnings from within the financial and business services sectors. The continued health of these sectors will therefore have a particular bearing on predominantly domestic prime London markets, such as those of Fulham, Clapham, Islington and the Docklands.

In the period from 1993, financial and business sector growth outpaced that of the London economy generally, triggering the spread of what is regarded as prime London into areas such as Bayswater, Marylebone, Wandsworth and Balham.

As has been well-documented, the financial sector contracted further than the rest of the London economy in the wake of the credit crunch. It is now expected to outperform the broader London economy in the period to 2015, though its effect on the capital's prime housing market is likely to be somewhat tempered by reform of the banking sector.

City pay structures have already been affected. The Centre for Economic and Business Research estimates that City bonuses for 2010 year will be £7 billion. In gross terms, this equates to a fall of just 5% from the previous year, but a full 40% below the peak.

A greater use of deferred bonuses, often paid in shares, has reduced the immediate spending power of those employed in this sector, although the total bonus pot is expected to increase to £10 billion pre-tax by 2014. The higher tax burden now associated with these bonuses will, however, leave them worth 13% less after



tax than in 2009, 45% down on the 2007 peak and back to 2003 levels.

This may mean there is a lag between bonus payouts and their appearance in the budgets of buyers as the bonuses of several years are aggregated before being invested in prime residential real estate.

Bouncing back

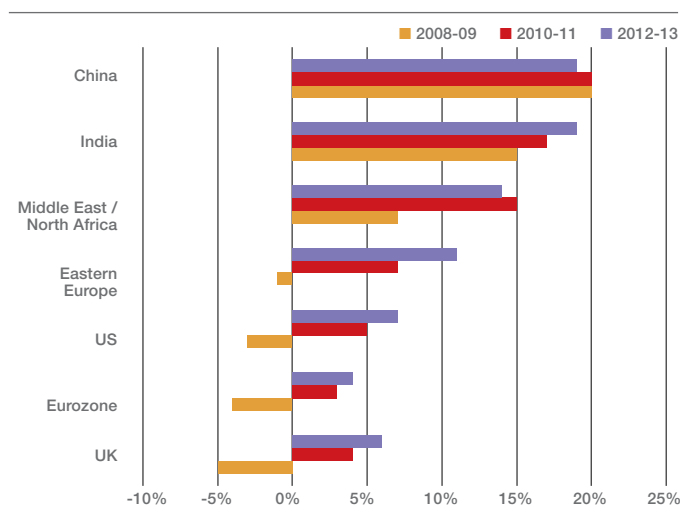
Nonetheless, these earnings, combined with sustained international demand, are expected to underpin growth in prime London values over the next five years. But just as the wealth and corresponding equity that is introduced into the market

fluctuates, so there will be periods when prices flatline or fall slightly, much as they did in the lumpy recovery of the mid to late 1990s.

As 2011 approaches, the market is beginning to respond to an uncertain economic outlook. Prime market sentiment is being affected by reports of price falls in the mainstream, and all evidence suggests that we may be entering such a lull typical of a market in recovery.

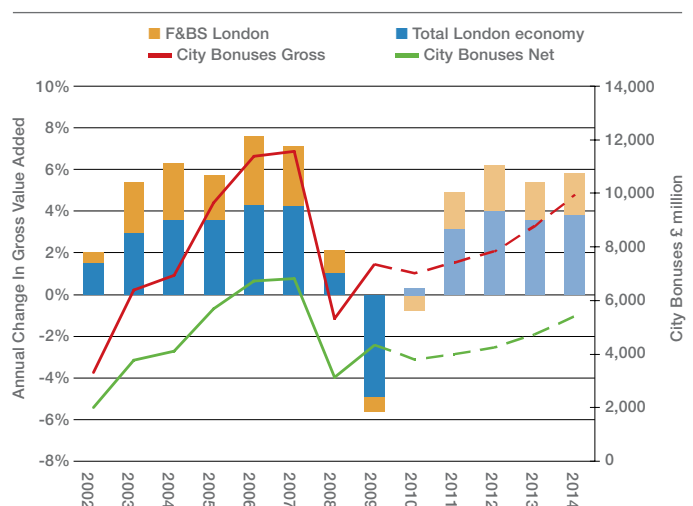
History tells us, however, that the prime market can bounce back from such a lull, even if the mainstream markets continue to show much slower growth. ■

Graph 2.3
Global Economic Forecasts



Source: Oxford Economics

Graph 2.4
Performance of financial and business services sector



Source: Oxford Economics, CEBR

Prime Regional

Equity remains the dominant factor

Where each prime regional market sits on the recovery timeline over the next five years will depend on its levels of equity. **Marcus Dixon** examines the wealth effect

The ability of the upper tiers of the residential market to outperform the mainstream depends to a great degree on the distribution of equity.

The corresponding depth of the different regional prime markets will be a key factor in determining where they will sit on the recovery timeline relative to prime London at one end and the UK mainstream markets at the other.

One measure of this depth is the percentage of sales that fall into higher price bands. Across the UK as a whole, sales over £750,000 accounted for just 1.7% of all residential transactions in 2008 and 2009, while sales over £500,000 accounted for 4.5% of total sales.

Across the South East a significantly greater share of sales transact at these higher levels. In the same two-year period, 2.6% of sales were over £750,000 and 7.1% over £500,000, signifying a prime market underpinned by a relatively deep pool of equity, often based on wealth generated in the capital.

The London wealth effect extends across swathes of the commuter-driven hinterland, with more than one in five sales exceeding £750,000 in 16 districts across the counties of Surrey, Hertfordshire, Buckinghamshire, Berkshire and Kent.

Arguably this London effect extends into parts of the South West and East of England, not just to second home locations such as the South Hams (with 3.1% above £750,000 and 9.3% above £500,000), but also to established prime London relation markets such as Bath (3.7% and 9.0%), and the Cotswolds (4.9% and 1.5%). However, the depth of prime markets in these regions is much more variable.

Affluent towns and suburbs

By contrast, in Wales, the Midlands and the North less than 0.5% of all transactions are above £750,000.

Prime markets in these locations tend to be more concentrated around a relatively small number of honeypot locations. Typically these locations are either affluent towns and suburbs (with good links to regional cities, quality housing stock and high performing schools), or the most attractive rural areas, often with high levels of second home ownership.

On the one hand they are the likes of Harrogate (2.8% over £750,000, 7.6% over £500,000) and the area around Wilmslow (4.2% and 10.2%), and on the other Derbyshire Dales (1.8% and 6.0%) and parts of Northumberland such as Castle Morpeth (3.2% and 8.2%).

Scotland is different again. Here 39%

of all sales over £750,000 took place in Edinburgh City in 2008 and 2009, this being the only Scottish location where such sales accounted for more than one in fifty transactions. Scottish prime markets, albeit lower value, are concentrated in the commuter belts around Edinburgh and Glasgow, save for the oil driven micro market of Aberdeen. Beyond these areas the prime Scottish country house market becomes more property than location specific.

Strong seam of demand

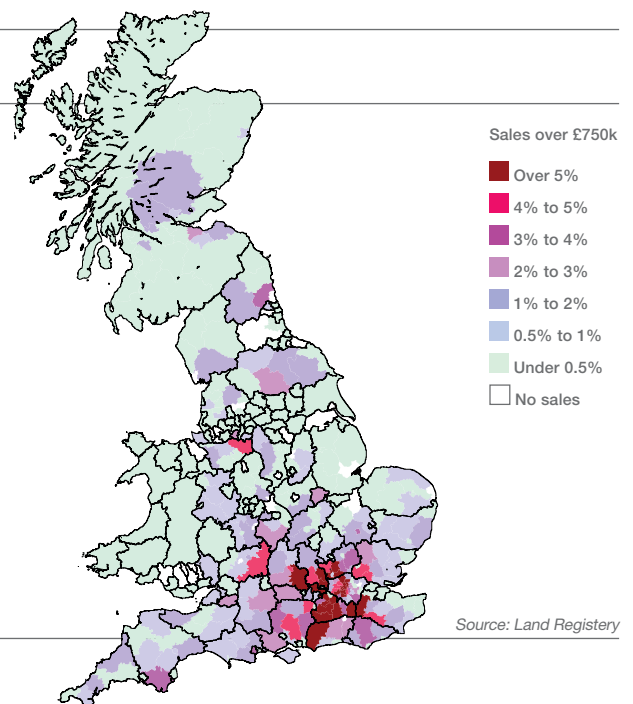
The relative depth of all of these markets is reflected in their different buyer profiles. For example, while international buyer demand remains primarily London focused, it is gaining a foothold in the upper tiers of prime in the South East and also some of established parts of the South West.

More importantly, the markets of the South are able to tap into a strong seam of demand from the financial and business services sector, while those of the Midlands and the North are more reliant on demand from the established professions and local entrepreneurs.

All prime markets are set to outperform their regional mainstream counterparts over the next five years but these differences will determine the extent to which this is achievable at a regional and local level. ■

Table 3.1
Percentage of regional property sales over £750,000 and £500,000

Region	% sales over £750k	% sales over £500k
London	6.5%	14.2%
South East	2.6%	7.1%
South West	1.3%	4.2%
Scotland	0.6%	1.7%
North West	0.4%	1.3%
West Midlands	0.4%	1.6%
Yorkshire and The Humber	0.3%	1.2%
East Midlands	0.3%	1.2%
North East	0.2%	0.9%
Wales	0.2%	0.7%



Source: Land Registry

Forecast values

Prime market forecasts

Growth in the prime markets will be fuelled by the continued introduction of overseas equity into London and the wealth generated by the financial and business sectors

Current market indications are that prices will soften in the short term due to weakened buyer sentiment, but our expectation is that the equity-rich prime markets will lead the recovery in house prices. Earliest growth will be fuelled both by the continued introduction of overseas equity into prime London and

also the wealth generated in the financial and business services sector that will first hit London and Edinburgh and then reverberate to their hinterlands. Wider economic recovery will bring price growth to other prime regional markets.

Prime market growth over the next five years is expected to be much higher than that in the mainstream repeating the

pattern witnessed in the mid to late 1990's. (For mainstream market forecast values see page 13.)

Our expectation is the equity-rich prime markets will lead the recovery in house prices.

Prime markets: Five-year forecast values

Forecasts	2010	2011	2012	2013	2014	2015	5 years to end of 2015
Prime central London	2.0%	-1.0%	10.0%	8.0%	6.5%	6.5%	33.4%
Prime Regional	1.0%	-1.5%	6.0%	5.5%	6.0%	6.0%	23.8%
Prime SE	2.0%	-1.0%	7.5%	7.5%	7.0%	6.0%	29.8%
Prime SW	1.5%	-1.0%	6.5%	6.5%	6.0%	6.0%	26.2%
Prime East	2.0%	-1.0%	7.0%	7.0%	6.5%	6.0%	28.0%
Prime Midlands/North	-0.5%	-2.2%	4.0%	4.0%	5.0%	5.5%	17.2%
Prime Scotland	0.0%	-1.5%	4.5%	4.5%	5.0%	5.5%	19.2%

UK prime: Current market snapshot

Location	Year on year	YTD	Last quarter	From peak
Central London	8.2%	3.4%	-0.1%	-10.4%
North London	7.7%	3.7%	0.0%	-9.7%
South West London	12.2%	6.8%	0.3%	-3.6%
East of City	9.2%	7.3%	0.9%	-7.8%
South East	5.7%	1.8%	-1.1%	-11.0%
South West	2.1%	0.9%	-1.1%	-22.1%
East	5.8%	4.0%	0.7%	-11.4%
Midlands/Northern	0.7%	-0.6%	-0.4%	-19.9%
Scotland	3.7%	0.8%	0.2%	-14.8%

Source: Savills Research

Key: Annual house price growth

6% & over
 4 to 6%
 2 to 4%
 0 to 2%
 -5 to 0%
 -5% & below

Prime analysis

■ The second half of 2009 and beginning of 2010 saw increased demand as improved confidence from cash and equity rich buyers translated into price growth. In Q2 and Q3 of this year recovery stalled, causing prices to remain static across the prime London, country house and prime regional markets.

■ Average house prices across the prime markets of London remained flat over Q3, taking six monthly growth to just 1.4%. The uncertain economic outlook means new buyer inquiries have slipped. Stock levels have begun to rise but good rates of sale have prevented excess stock from building and price falls have remained modest.

■ Prime regional housing saw growth of 0.5% in Q2 2010, followed by a marginal softening in prices which fell 0.1% in Q3.

Mainstream

The mortgage affordability cushion

Does the UK mainstream housing market have the capacity for future growth? With mortgage affordability and sentiment both key issues, **Jim Ward** looks ahead

At the end of September 2010 the average UK house price stood just 6% above its 2005 level. This followed a period of extremely volatile price movements that saw annual house price growth peak at +10.5% in December 2006 and again in April 2010, and dip to -17.6% in April 2009.

Such significant fluctuations reflect extraordinary swings in the underlying key mainstream housing market drivers – mortgage affordability, mortgage availability, the cost of a deposit and underlying economic growth.

In this environment of flux the forecasting of house prices has become hugely problematic. In particular, dramatic shifts in buyer and seller sentiment have created short-term supply and demand dynamics which confound even the traditional fundamentals of forecasting.

In theory at least, mortgage affordability underpins the capacity for house price

Mortgage affordability underpins capacity for mainstream house price growth, though other drivers dictate if growth is achievable.

growth, though other drivers dictate whether or not that growth is achievable. This is particularly true in a credit constrained environment.

First, as the market readjusts to the broader economic environment, a short-term second slip in house prices is expected to correct some of the price growth of late 2009 and early 2010. Equally, the timing, scale and reach of future price growth will depend on a return to economic stability and accessibility to mortgage finance.

Capacity for growth

Without doubt mortgage affordability remains a prerequisite for house price growth in the majority of the market because most upsizers rely on a mortgage to make their next move up the ladder. While we favour more sophisticated models, an easy benchmark of mortgage affordability is the relationship between mortgage interest payments and borrowers' income.

Over the last 25 years mortgage interest payments have averaged less than 16% of the average borrower's income, peaking at 27% and 19% prior to the downturns of the early 1990s and late Noughties. By contrast, the current figure of 10.9% is the lowest, and theoretically most affordable, seen in the 35 years this data has been recorded by Council of Mortgage Lenders.

Improved affordability is, of course, mainly due to low prevailing interest rates, but it also reflects the reduced debt reliance of equity rich buyers who currently dominate the market.

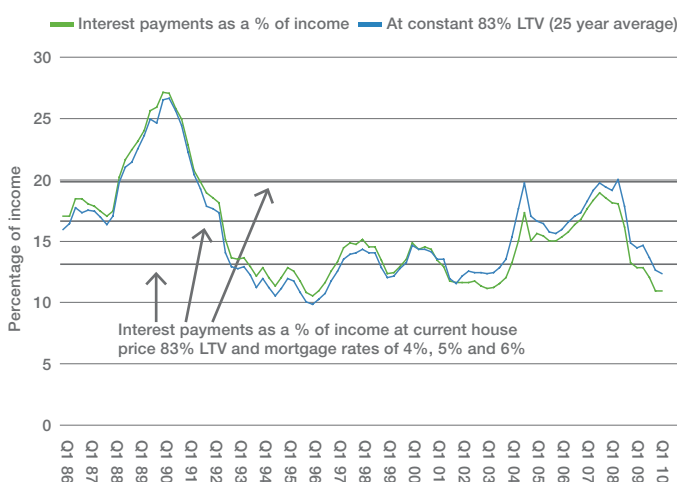
The result is that mortgaged buyers are now borrowing an average 73% of the value of their new property, compared to a 25-year average of 83%. Adjusting for this anomaly pushes affordability closer to the 25-year average, but does not narrow the gap significantly. Much of the affordability cushion remains.

In our opinion, this fact alone will mean the expected 'second slip' in values over the next 6-12 months should be contained to around 7%. Thereafter, the capacity of the market to grow will be dependent on what happens to mortgage interest rates, a function not only of bank base rate but also, importantly, of lenders' margins.

Base rates currently stand at just 0.5%, but lenders' margins have pushed the average mortgage rate to 3.75%, reflecting a lack of competition among mortgage providers.

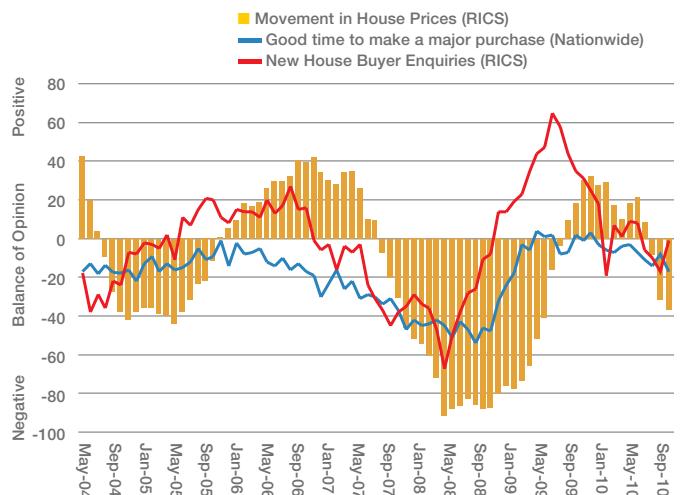
The consensus among economic forecasters is that base rates will rise slowly to 3.4% by the end of 2014, as competition gradually returns to the mortgage market. At the same time, lenders' margins are expected to fall from their current still

Graph 4.1
Affordability. Mortgage interest as a % of income



Source: CML/Savills

Graph 4.2
Sentiment indicators vs House price movements



Source: RICS, Nationwide



high levels, although overall we expect an overall rise in mortgage rates.

Assuming a lenders' margin of 1.1% (higher than the pre credit crunch norm), this would represent an effective mortgage interest rate of 4.5%, bringing interest repayments as a percentage of income back in line with the 25-year average.

Mortgage interest rates would need to rise to 6% (indicating a lenders' margin of around 2.6%) for the average cost of a mortgage relative to a borrower's income to rise back up to its 2007 peak.

This suggests that mainstream UK house prices now have, at a minimum, the capacity to grow in line with earnings, while earnings growth will be reliant on the performance of the private sector given public sector wage freezes and job losses. But the potential for further growth exists even if net income growth is tempered by a higher tax burden and the squeeze on benefits available to the middle classes.

Achieving capacity

The extent to which mortgage markets are able to normalise will particularly affect the timing, geographical spread and, importantly, the ability of different tiers of the housing market to grow.

In terms of timing, sentiment will also be key. Weakening prevailing sentiment almost certainly means that mainstream UK house prices will fall back over the latter part of this year and some of the next.

Indeed, price falls of 0.8% and 0.9% were seen in the third quarter of 2010 according to the Nationwide and Halifax indices respectively. This chimed with the

experience of estate agents, a net balance of whom saw price falls from July through to September according to the RICS.

This reflects widespread uncertainty over the economy, in particular, the effect of public spending cuts, that financially will make up 80% of the proposed measures to eliminate the budget deficit over the next five years.

But, as discussed, underlying affordability should put a floor in the market. After a relatively short period of adjustment, house prices will be relatively static for the second half of next year, and as the country returns to peak economic output we expect real house price growth to return.

Certainly, the suppressed transactions levels of the past three years should mean there is no shortage of pent-up buyer demand. But the full extent to which this demand is able to proceed will lay in the hands of the banks.

We must therefore conclude the credit crunch and its legacy will continue to affect the housing market for at least the next five years with the ability to substantially reshape it over the longer term. ■

UK transaction and rental forecasts

Recovery continues, but it is gradual

Our forecasts have concentrated on house price movements. For house builders and those aspiring to get on to or progress up the housing ladder, the number of transactions will be of equal, if not greater, importance.

In 2008 and 2009 transaction levels were just 53% of pre-credit crunch levels. Evidence from the first eight months of this year suggests little improvement.

Improved transaction levels are highly dependent on improved sentiment, but also require better mortgage availability. Without this they will struggle to return to within 25% of their pre-credit crunch levels by 2015, thus excluding many aspiring buyers from the market. This will inevitably put pressure on the rental sector and act as a driver for rental growth. ■

	UK Housing Transactions	Versus 2006 peak
2006	1,665	100%
2007	1,620	97%
2008	922	55%
2009	848	51%
2010	860	52%
2011	900	54%
2012	1,000	60%
2013	1,100	66%
2014	1,200	72%

Source: HMRC

Mainstream Regional

Employment set to create a divide

The distribution of private and public sector employment points to a North-South divide in the UK mainstream market recovery. **Jacqui Daly** identifies the key issues

Two key factors will determine the relative speed of recovery of the country's regional housing markets. The first is the distribution of housing equity, which indicates that the less mortgage reliant housing markets of the South, particularly the affluent South East, will be able to respond more quickly to economic growth and an improvement in sentiment. The second is the pace of that economic growth itself.

Although the housing downturn affected most regional markets to a similar degree, the performance of house prices since the bottom of this market, in early 2009, has shown a much greater North-South divide.

Nationwide figures suggest that by the end of the third quarter of 2010, prices in the South East had recovered to within 5.5% of their peak, while those in the North East were on average still 12.9% below their peak. We expect these differences to become wider as we move into a more sustained housing market recovery.

With the current government pinning its hopes on a private sector led recovery and placing public spending cuts at the

heart of its policy to reduce the budget deficit, the relative contributions of private and public sector employment to regional economies will be critical.

Public sector cuts

The growth in public sector employment over the past decade has been well-documented, having risen by 16% in the UK as a whole.

The extent of this growth has been significant in Yorkshire and Humberside and also the South West. However, it is the relative size of public sector employment compared to private sector that leaves the North particularly exposed, as the housing market recovers.

In the South East, for example, only 17% of the workforce is employed in the public sector compared with 23% in the North East, leaving its economy far more exposed to the impact of the comprehensive spending review (table 5.1).

The comparative advantage of the South over the North, Scotland and Wales comes not only from its lower exposure to resulting unemployment but also, critically, reflects the much stronger earnings

generated in the private sector (table 5.2).

With the prospect that affordability assessments will be a central precept of mortgage regulation, this private sector earnings gap will undoubtedly significantly impact on the relative purchasing power of buyers across the different regions of the UK.

The local effect

At a more local level the nature of public sector employment will have a very real bearing on the extent to which local markets are affected by spending cuts.

For example, the housing markets in locations such as Oxford, Cambridge and Edinburgh, each with numerically high levels of public sector employment, are unlikely to be as exposed as those of Newcastle, Liverpool and Plymouth. This is because a high proportion of the public sector roles are in sectors such as education and healthcare which seem for now to be relatively sheltered from the deepest public spending cuts. ■

Table 5.1
Public sector employment levels

Region	% of workforce (Q408)	Increase Q499 - Q409
Northern Ireland	29%	13%
Wales	24%	15%
North East	23%	12%
Scotland	23%	16%
North West	21%	15%
Yorkshire & Humber	21%	22%
West Midlands	20%	17%
South West	19%	24%
London	18%	11%
East	18%	13%
East Midlands	18%	17%
South East	17%	14%
United Kingdom	20%	16%

Source: ONS

Table 5.2
Average weekly wages across the public and private sector 2009

Region	Private Sector £	Public Sector £	Public v Private
Northern Ireland	380	488	128%
Wales	397	436	110%
North East	406	435	107%
Yorks and Humber	428	427	100%
North West	442	439	99%
West Midlands	441	437	99%
Scotland	461	450	98%
East Midlands	450	430	95%
South West	441	414	94%
East	473	428	91%
London	714	597	84%
South East	529	437	83%

Source: ONS / Oxford Economics

Forecast values

Mainstream market forecasts

Regional variations in the growth of values in the mainstream market is a consequence of increased pressure on household incomes and mortgage affordability

Our mainstream forecasts have been revised to account for a stronger than anticipated 2010. The prospect now is that the falls originally forecast for 2010 will span late 2010 and the first half of 2011. Increased pressure on household incomes from far-reaching austerity measures together with the prospect of more prolonged constraints on mortgage lending have caused us to delay and temper the recovery forecast.

We also now assume much wider regional variations. Nonetheless, we expect affordability to put a floor under house prices and allow the return of house price growth from late 2012 and 2013 depending on the region. (For prime market forecasts see page 9.)

Making the grade

The impact of grading on residential values

Deviation from forecast
(end of 2010 – end of 2015)

Grade A +5%

Grade B 0%

Grade C -5%

(See pages 4 & 5 for a detailed explanation)

The new Savills model for evaluating UK residential property anticipates grade A properties exceeding their local mainstream market five-year average house price growth by 5%, while grade C properties will underperform by 5%.

Grade A +5%

Grade B 0%

Grade C -5%

Mainstream markets: Five-year forecast values

Forecasts	2010	2011	2012	2013	2014	2015	5 years to end 2015
UK	-0.5%	-3.0%	1.5%	3.0%	5.0%	5.0%	11.8%
London	2.5%	-1.0%	6.0%	8.0%	7.5%	6.0%	29.1%
South East	2.0%	-1.5%	5.0%	7.0%	7.0%	6.0%	25.5%
South West	0.5%	-2.5%	3.0%	5.0%	6.0%	5.5%	17.9%
East of England	1.5%	-2.0%	4.0%	6.0%	6.5%	5.5%	21.4%
East Midlands	0.0%	-2.5%	2.5%	4.0%	5.5%	5.0%	15.1%
West Midlands	-2.0%	-4.0%	-0.5%	1.0%	4.0%	4.5%	4.8%
North East	-3.0%	-4.5%	-2.0%	0.0%	3.0%	4.5%	0.7%
North West	-2.0%	-4.0%	-1.0%	0.5%	3.5%	4.5%	3.3%
Yorks & Humber	-2.5%	-4.5%	-1.5%	0.0%	3.5%	4.5%	1.7%
Wales	-1.0%	-3.0%	0.0%	2.5%	4.0%	4.5%	8.1%
Scotland	-2.0%	-2.5%	0.0%	1.0%	3.5%	4.5%	6.5%

Key: Annual house price growth

-5% & below
 -5 to 0%
 0 to 2%
 2 to 4%
 4 to 6%
 6% & over

Summary

A fundamental regrading

An important shift in the nature of owner occupation means it is time to create a new way to describe the market. We are seeing an ongoing separation of the market into tiers that are likely to behave differently from each other because they will be occupied by different tenure groups and consequently be driven by different economic drivers in each case.

We will still be using prime, secondary and tertiary to describe place but will be using grades A, B and C to describe buildings.

■ See page 3

Tiers of the housing market

Government house price data suggests that the gap between the equity haves and the have-nots has widened since 2007, with the lower tiers of the mainstream underperforming significantly. While it is true that various tiers of the market perform at different stages of the housing market cycle, we think the current performance shift is more permanent and signals a fundamental change in the structure of the UK housing market.

We are also seeing a significant gap in the growth patterns between northern and southern regions. While this is coloured by the nature of, and prospects for, the regional economies, the underlying difference between locations is the level of mortgage reliance in local housing markets. Southern housing markets generally have significantly higher levels of equity in them than those further north. It is this divide that marks the future of the UK's housing market.

■ See pages 6-7

Prime London

There is a prospect of short term price falls, but thereafter earnings from the capital's financial sector combined with sustained international demand are expected to underpin growth in prime London values. We continue to expect the prime residential markets of London to outperform the mainstream over the next five years.

■ See page 8

Prime Regional

The depth of each regional prime market will be a key factor in determining where they will sit on the recovery timeline, relative to prime London at one end and the UK mainstream markets at the other. All prime markets are set to outperform their

regional counterparts over the next five years but individual market differences will determine the extent to which this is achievable on a regional and local level.

■ See page 8

Mainstream

After a short period of adjustment, house prices will be relatively static for a period. As the country returns to peak economic output we expect real house price growth to return.

The pattern of mainstream price growth over the next five years will depend on the extent to which the mortgage markets are able to normalise. This will affect the timing, geographical spread and the ability of different tiers of the mainstream housing market to grow.

■ See pages 10-11

Mainstream regional

The relative contributions of private and public sector employment to regional economies will be critical. The relative size of public sector employment compared to private sector leaves the North more exposed, pointing to a growing North-South divide as the housing market recovers.

■ See page 12

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The latest research findings relating to residential development in the UK.



Estate Benchmarking Survey 2010

Analysing the performance of property assets of 200 estates across the UK.



Spotlight on... Prime Rental Market

Investigating the current market conditions of the prime rental market.



Market in Minutes... Prime London Residential Markets

A performance analysis of prime residential markets in central London.



Market in Minutes... Prime Regional Residential Markets

A countrywide analysis of the UK's prime regional markets.



Market in Minutes... Q310 Farmland Market

An update of the agricultural land market in the third quarter of this year.

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