Housing market soft patch to persist through next year

- Overall sales volumes to soften slightly over 2018
- National house price growth set to come to a halt but a lack of supply likely to prevent outright declines
- Stamp Duty changes to have minimal impact on activity

Overall levels of activity across the residential sector have been a little underwhelming throughout 2017, with the latter part of the year in particular proving something of a disappointment. As the market ran up against intensifying headwinds, buyer enquires stalled, sales volumes stagnated and sentiment has turned altogether more cautious as a result. But housing remains at the very top of the domestic political agenda, and a lack of supply is perceived as the greatest challenge in need of addressing. To this end, the recent Autumn Budget was used to assert the government's ambition of delivering 300,000 homes a year (by the mid 2020's), coming alongside a tranche of policies aimed at getting us to that point. However, many of the announced measures are not due to come into effect until 2019/20, having little bearing on next year, while scepticism remains on the degree to which these will actually add to output further ahead. It seems the overriding issue of supply will again be the prominent theme when looking at the likely behaviour of the housing market over the course of 2018.

How far off the housing delivery target are we?

Amongst all the cynicism, it must be highlighted that net additions to the housing stock across England totalled just over 217,000 in the twelve months ending Q1 2017. This represents an increase of nearly 20,000 (12%) on the previous year and is in fact the second highest figure since this measure was introduced in 2001 (chart 1). If the current rate of growth were to be maintained, it would take just three more years to hit the 300,000 mark. The reality, of course, is not so straightforward. For one, nearly 18,000 of these additional dwellings came from office conversions under permitted development rights. It seems improbable that such conversions can continue to make such a hefty contribution (8%) indefinitely.

Furthermore, housing delivery across the country is hugely dominated by the large private sector housebuilders. As the government itself has acknowledged, it is unrealistic to expect this group alone to make up the deficit in supply, with their current pipeline pointing toward an increase of around 10% in the number of units developed over the next two or three years. If the government is serious about increasing supply to a degree that would hit the 300,000 per year target, we suspect that a comprehensive housebuilding programme

Chart 1: Net additional dwellings (England)

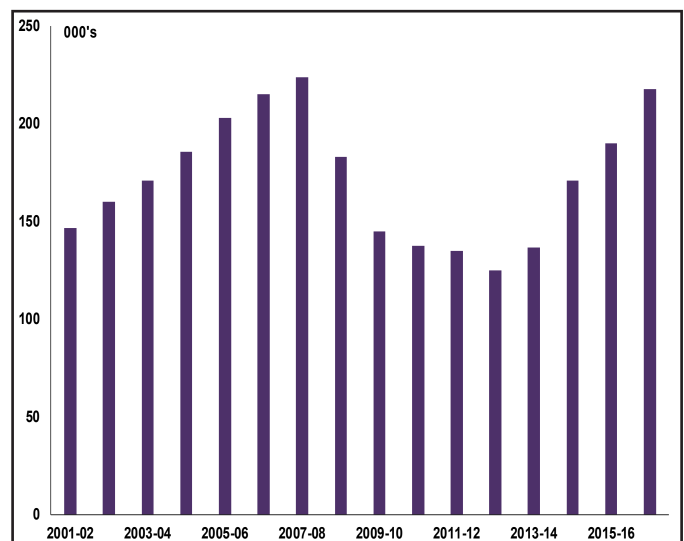
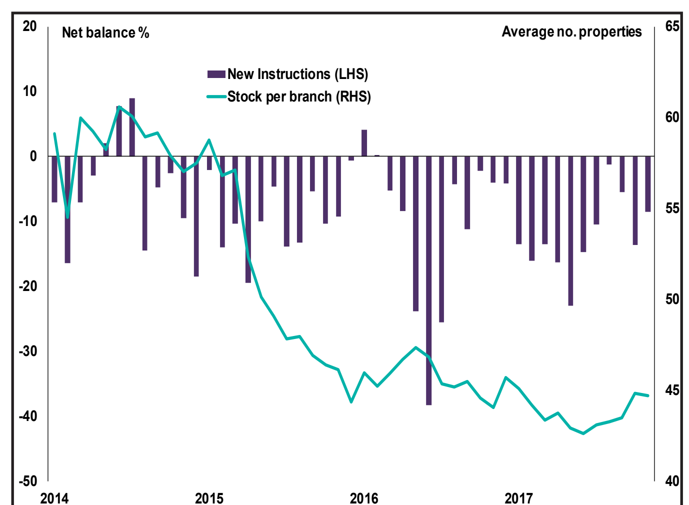


Chart 2: RICS new sales instructions and stock levels (per branch)



incorporating direct commissioning by central and local government would be needed (an approach being advocated by RICS).

That's not to say the Budget did not contain some positive housing proposals, however. The Government has lifted the local authority borrowing cap for housebuilding which should benefit the provision of affordable council homes at some scale. There was new money for the Home Builders Fund which is aimed at supporting smaller housebuilders. The Housing Infrastructure Fund received a further £2.7billion, while £630 million was made available to help the delivery of 40,000 homes across small sites. In order to deliver these houses there needs to be a sufficient sized workforce, prompting the Chancellor to allocate £34million to developing construction skills. Nevertheless, more details are required on how these policies will work in practice.

In any case, even the recent uptick in housing delivery will not immediately be reflected in the second hand market, where RICS data continues to signal an acute shortage of supply. The average number of properties on estate agents' books remains very close to all-time lows, albeit this metric has been pretty stable over the past twelve months. The dearth of inventory has come as a consequence of the sustained deterioration in the flow of fresh listings coming to market. Indeed, since the beginning of 2014, the proportion of survey respondents reporting a rise in new instructions has exceeded those reporting a fall in only four months (chart 2). The prospective pipeline for instructions does not appear to be improving either, with 49% of contributors to the November survey reporting the number of appraisals/ valuations undertaken over the month were down on the equivalent period of 2016 (only 15% felt they were higher). As such, there are no signs as yet that 2018 will see a turnaround in supply across the second hand market.

Sales volumes to edge lower

Sales volumes across the national housing market look likely to total just over 1.2million in 2017, which is almost identical to 2016's outturn. In fact, in annual terms, the market has plateaued at levels very close to this since 2014. The period of recovery, following the recent low of just 850k transactions in 2009, has therefore stopped someway short of the near 1.7million pre-crisis high. Of course, activity in the run-up to the 2008 crash may be considered overexuberant in any event, but, going forward, there are several reasons to believe that sales could struggle to breach even the 1.2million mark during the course of next year.

For a start, survey evidence suggests the near term outlook for activity is muted, with the RICS New Buyer Enquiries indicator (our measure of month to month changes in demand displayed on chart 3) having fallen back quite noticeably going into the final quarter of 2017. That said, the negative trend diminished to some extent in the November survey results, but this still suggests momentum across the housing market will be lacking as 2018 gets underway. Looking beyond the national average, Chart 4 illustrates demand trends in London and the South East have been noticeably weaker compared to the rest of the UK. The net balance for enquires in both of these areas has been in negative territory for a number of months although, again, the latest results do show this turning less downbeat. The national figures, once London and the South East are excluded, still point to a flat picture for demand, having remained that way through virtually all of 2017.

Furthermore, the headline RICS metric on sales has deteriorated in recent months, as the proportion of agents

Chart 3: RICS New Buyer Enquiries - change against previous month

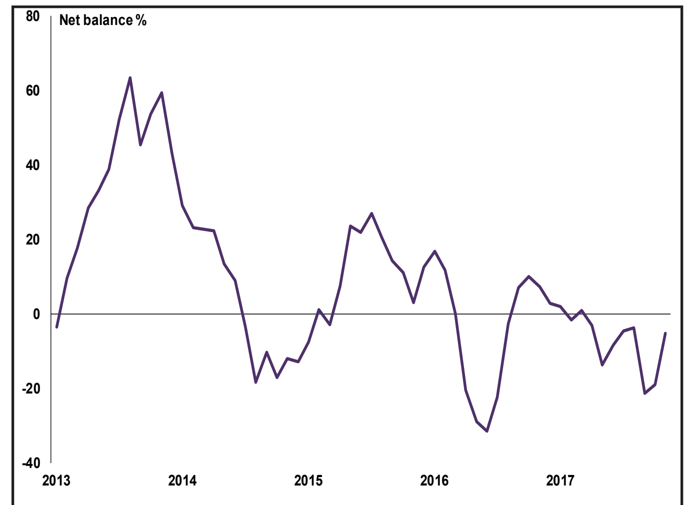


Chart 4: RICS New Buyer Enquiries - regional breakdown

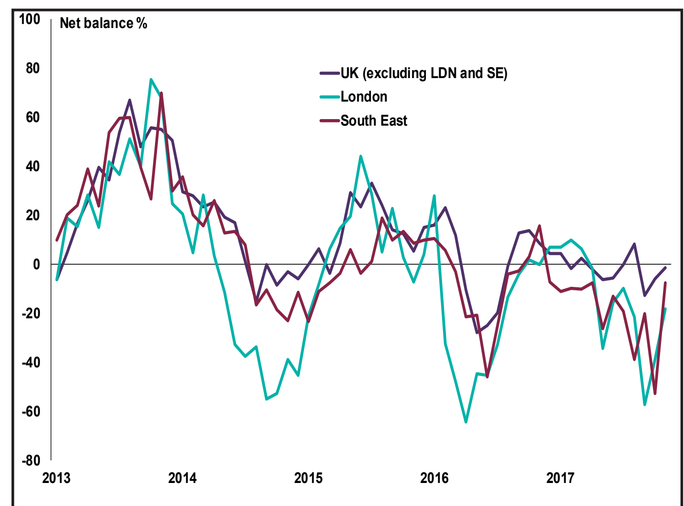
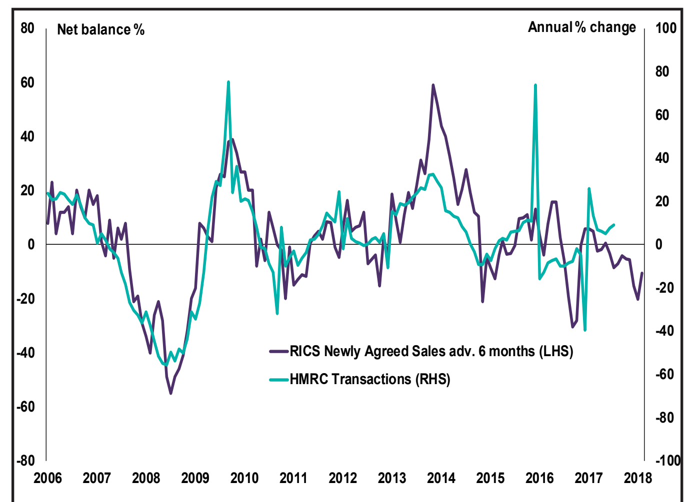


Chart 5: RICS Newly Agreed Sales and HMRC Residential Transactions



seeing a decline in transactions has increasingly outstripped those reporting growth. Chart 5 tracks the survey data against the annual growth rate in the number of residential sales reported by HMRC. The RICS figures, based on sentiment and also capturing activity earlier on in the process, have provided a very accurate lead indication of upcoming trends across the market. For the purpose of demonstrating this, the RICS Agreed Sales indicator has been pushed forward by six months. It seems the recent sales readings from the RICS survey are consistent with monthly transaction volumes, through the opening stretch of 2018, slipping to a level which would be comfortably down on the equivalent months of 2017. This points to sales being off-track to reach the 2017 figure of just above 1.2million around the midway point of 2018.

To get a handle on the outlook for the second half of 2018, it's important to examine the forces behind the recent softening in momentum and how likely these are to persist. One key element is clearly the aforementioned lack of stock, presenting potential buyers with very limited choice. If this then prevents would-be home movers putting their own property on the market, it further exacerbates the issue. As already discussed, it looks unlikely that this constraint will be alleviated anytime soon. Another obstacle being reported, at higher price points at least, is Stamp Duty. The increase in the top rate of tax levied in 2014 is still said to be having a lasting impact, impeding activity at these most expensive tiers of the market. Also, the additional 3% surcharge on second homes and investment purchases (coupled with the phasing out of mortgage interest relief) has curtailed demand and reduced the number of buy-to-let purchasers.

Political and economic uncertainty is also proving a hindrance, leading to consumer confidence indicators measuring sentiment towards 'making a major purchase' to decline noticeably over the past twelve months (chart 6). In addition, the Bank of England's November rate hike, the first in over a decade, is only likely to add to buyer caution. Nevertheless, with interest rate expectations derived from financial markets not fully pricing in another move until January 2019, the upside for mortgage rates appears minimal. Finally, and perhaps now the biggest factor stifling activity (in parts of the country at least), is stretched affordability. According to the ONS, median house prices across England are now a greater multiple of average earnings (eight times) than at any point in history. Chart 7 shows just how comfortably this exceeds the 2007 ratio before the downturn. Taking all of this into consideration, our central case is for transactions to total roughly 1.15million in 2018 (chart 8). This would represent an approximate decline of 5% relative to 2017.

That being said, there is potentially some upside for activity stemming from changes in Stamp Duty. Following the November Autumn Statement, first time buyers purchasing a property worth up to £300k will no longer be required to pay any Stamp Duty. FTBs purchasing more expensive homes, up to £500k, will pay nothing on the first £300k but the normal 5% marginal rate will apply on the remainder. As such, this policy offers a maximum tax saving of £5000. Across the UK as a whole, the average price paid by first time buyers (according to Halifax data) is around £208k, translating into a reduction of approximately £1660. Although not an insignificant sum, it equates to just 5% of the average FTB deposit (£33k). Clearly, tax cuts are more substantial in the UK's most expensive regions, while for others, such as the North East of England, first time buyers (on average) already pay very little in Stamp Duty. In London however,

Chart 6: UK consumer confidence measures

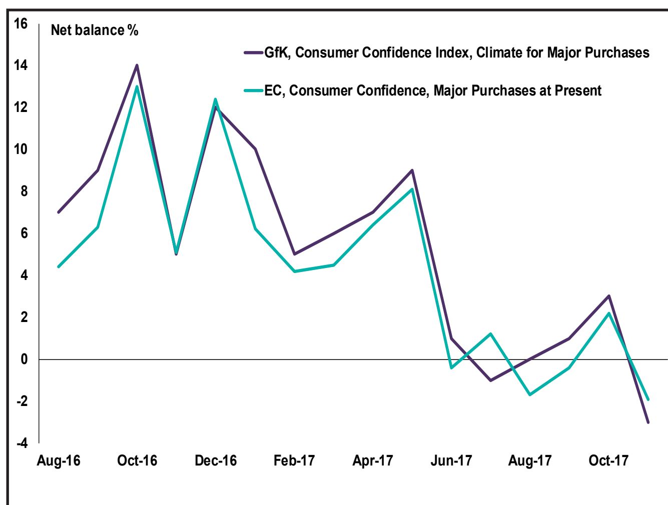


Chart 7: ONS median house price to earning ratio (England)

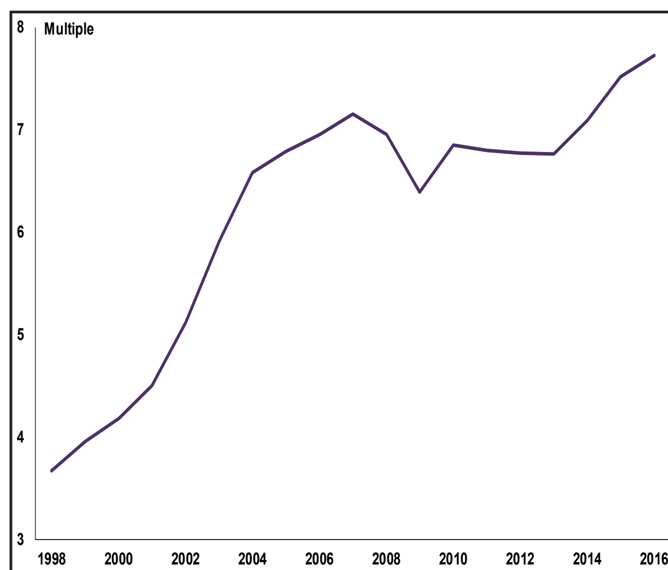
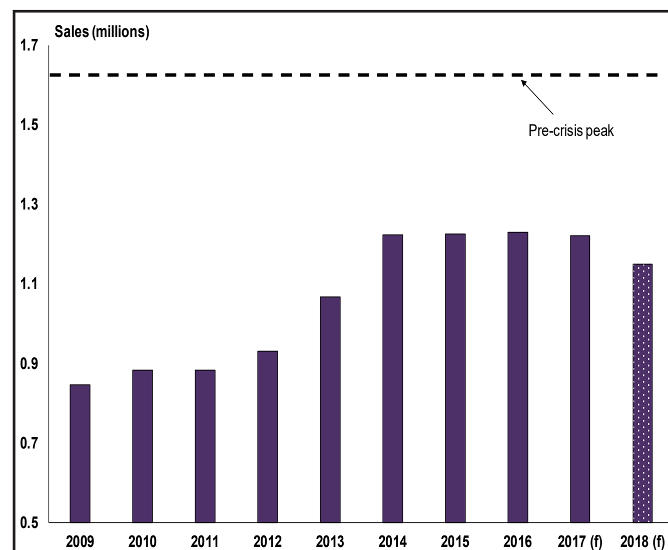


Chart 8: Annual residential transaction volumes



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average FTB prices are just shy of £410,000 and would therefore reap the maximum £5000 saving.

On the face of it, the reduced upfront costs for first time buyers will create some additional demand amongst this cohort. For those FTBs with less money to put down for a deposit, and subsequently more restricted by loan-to-value criteria, the saving on Stamp Duty could help them borrow more. In these instances, the removal of SDLT may enable properties to be purchased that otherwise could not have been afforded. However, in many cases, those benefiting from the relief will have purchased the property in any case and will not represent additional demand. Furthermore, previous experience suggests the reduction in tax will be capitalised in house prices. The OBR estimates average house prices will rise 0.3% due to the policy change. This is backed up by HMRC analysis estimating the Stamp Duty holiday for FTBs (for two years from March 2010) increased prices by 0.5-0.7%.

As a result, relative to other buyers, FTB affordability may improve slightly, but, with higher prices offsetting the tax saving, such a small change will have minimal impact in lifting home ownership rates (a stated goal for its introduction). In overall terms then, the policy change is unlikely to stimulate activity to any great extent.

Prices to see no change at the headline level

The headline price balance from the survey, which typically has a six month lead over the official house price index, is consistent with the annual pace of house price inflation fading further through the first half of 2018 (currently a little over 5%). Indeed, the feedback from members is now pointing to a flat outturn for national prices, on a year on year comparison, by the midway stage of the year (chart 9). For now, the RICS survey data is not signalling an outright decline at the national level, but rather, growth looks likely to come to a halt. It remains to be seen however, whether the moderation in the survey's price gauge (from a net balance of +28% a year ago to zero in November) has further to run, or if it will stabilise and begin to turn up from here.

With regards to the factors likely to provide some underpinning for prices going forward, as already highlighted, Stamp Duty exemptions for first time buyers should play a part. FTBs will now have more available to put down for a deposit, while a lower tax bill is also considered in a negotiation process. The upshot of this is that both parties are likely to share the saving to some degree, placing upward pressure on prices (pre-tax). The lack of stock on the market is also crucial, meaning even limited demand is being directed at a narrow range of properties. Furthermore, the labour market should remain solid over the year ahead, while any changes in mortgage rates should be minimal. In other words, conditions do not appear conducive to a rise in mortgage arrears (which would normally trigger a correction in prices). With very little forced selling, vendors have the choice of when to list their properties and can avoid doing so in a weakening market. Indeed, changes in fresh demand and supply have become virtually aligned, curbing downward pressure on prices from weakening demand.

Given this, even though we envisage activity falling slightly next year, our headline projection is that, come the end of 2018, prices across the UK as a whole will have seen almost no change with a year earlier.

Nevertheless, this flat national forecast is brought about by growth in some regions being counterbalanced by price declines in others. Indeed, it does appear that there is scope for some pullback in prices across a few regions, most

Chart 9: RICS National Price Balance and Land Registry National House Price Index

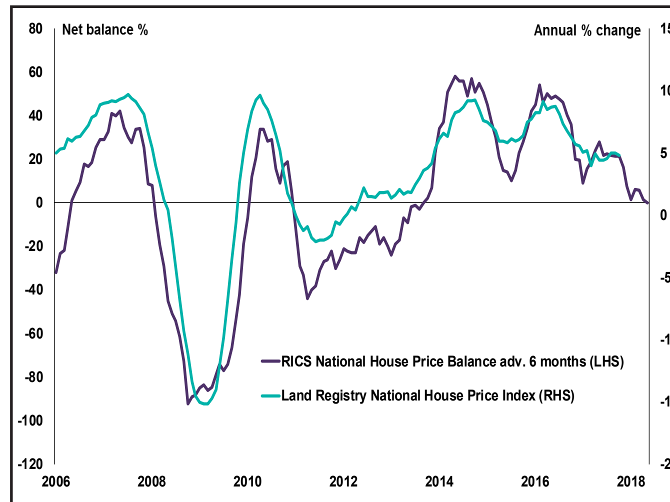


Chart 10: RICS London Price Balance and Land Registry Inner London House Price Index

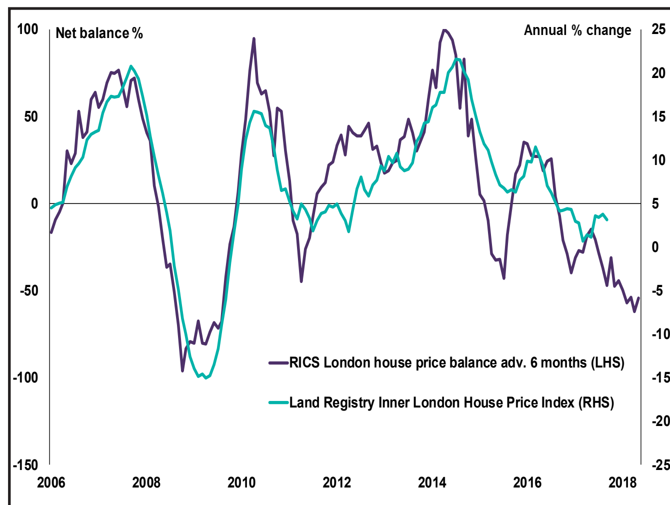
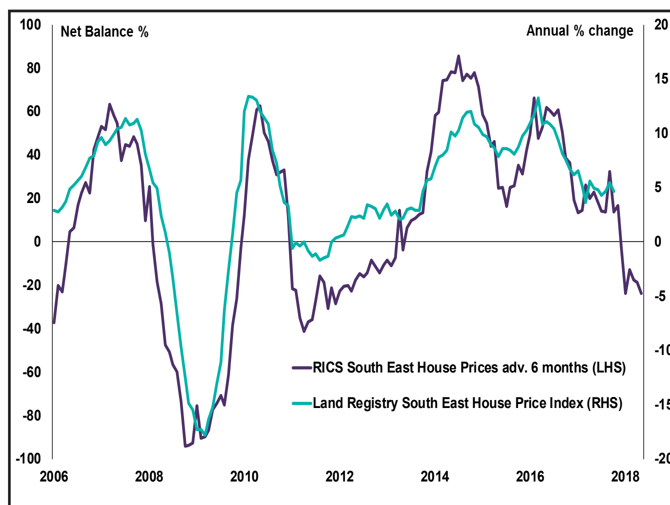


Chart 11: RICS South East Price Balance and Land Registry South East House Price Index



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notably in London and the South East (particularly over the first half of 2018). In terms of London, chart 10 maps the relevant price series from the RICS survey (again advanced by six months) against the house price index produced for inner London by the Land Registry. The downbeat survey returns in this area are signalling prices across the inner London boroughs are likely to edge lower in the coming months.

What's more, this negative outlook is no longer confined to central London. Over the second half of 2017, the weakness in the survey data also spread to the broader South East, with this series also providing a strong steer on price trends in the outer London boroughs. The price net balance for the South East (displayed on chart 11) fell beneath zero much more recently than that for London, but is also now at a level that would be consistent with modest price declines.

By way of contrast, we suspect prices will continue to drift higher in most other parts of the UK (East Anglia and the North East being two further exceptions), with the strongest gains coming in Northern Ireland, Scotland, Wales and the North West of England. In each case, house prices (relative to earnings) are comfortably below pre-crisis levels, meaning affordability constraints are not biting to anywhere near the same extent as in London and the South East.

Chart 12 displays the regional breakdown of RICS members' price and sales expectations (blended to reflect both the three and twelve month time horizons). In net balance terms, respondents to the residential survey appear most confident that both prices and sales will rise in Northern Ireland, Scotland and Wales, relative to all other areas, over the coming months. At the other end of the spectrum, expectations remain downbeat in London and are relatively flat in the South East.

Rents to increase modestly

Not helped by some policy changes over recent years, supply across the private lettings market seems likely to face significant headwinds going forward. The additional 3% Stamp Duty surcharge on BTL transactions has knocked investor demand substantially. During the year leading up to its introduction, the number of buy-to-let mortgages being advanced averaged 10,000 per month. Meanwhile, over the following eighteen months, the number of BTL mortgage approvals has averaged just 6000. The challenges do not stop there however. The withdrawal of mortgage interest tax relief (coming in stages up until 2021/22) will further reduce the appeal of BTL as an investment.

The housing market survey was used back in August to gauge perceptions on the net change in the number of landlords in light of the less favourable policy backdrop. Quite emphatically, 83% of respondents (once 'unsures' were removed), felt there would be more landlords exiting, rather than entering, the market over the coming twelve months. The picture is pretty similar at the three year horizon, with 76% of contributors feeling there would be greater numbers of landlords exiting the market (chart 13). Given BTL accounts for around 95% of the private lettings sector, it's difficult to see build to rent developers fully plugging this gap. Consequently, this does not bode well for rental affordability going forward.

Already, there are growing signs that affordability constraints are taking their toll on demand. Indeed, across the UK as a whole, tenant demand stagnated in the three months to October. In fact, the net balance of just +1% represents the softest quarterly reading since 1999. Nevertheless, alongside this, landlord instructions have declined in each

Chart 12 - Price and Sales Expectations by Region

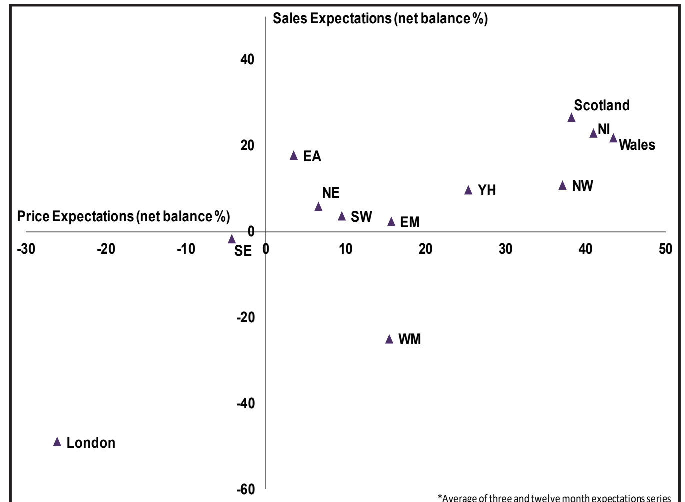


Chart 13: RICS members' perceptions - Will there be more landlords entering or exiting the market?

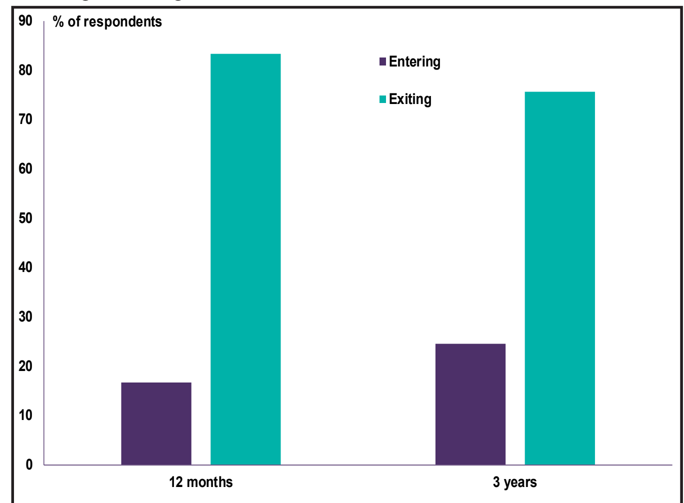
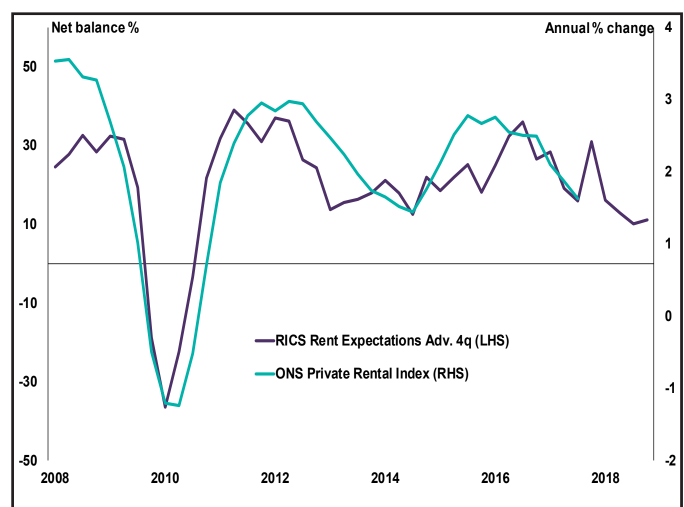


Chart 14: RICS Rent Expectations - National



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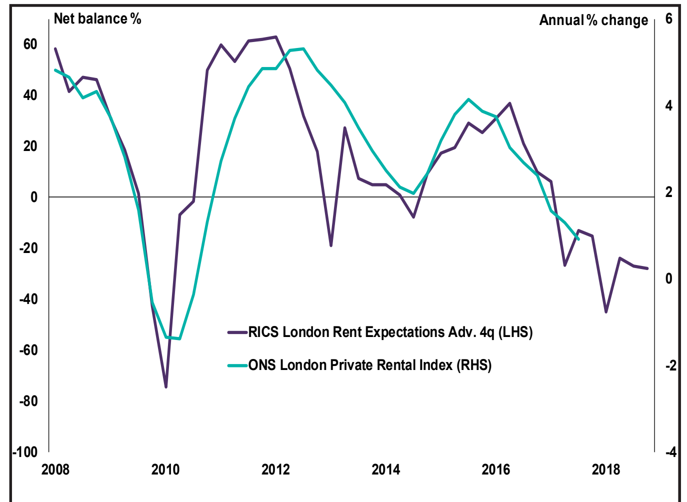
of the last three quarters, meaning that even with the flat demand backdrop, fresh supply (in net balance terms) is falling short. Consequently, shown in chart 14, rental growth expectations remain in positive territory, albeit this series is pointing to a further moderation in the pace of rental gains towards 1%, from 1.6% at the moment.

In London, the near term rental growth expectations series is signalling a flat to marginally negative outlook for 2018 (chart 15). This comes on the back of fairly sustained period over which demand has been weakening in the capital. Feedback tells us there is a mismatch between landlords' desired rental levels and tenants ability to pay, with the resulting reduction in activity meaning supply in the London lettings market is not being absorbed by demand for the time being.

The longer term view on rents, both at the national level and across London, is that growth will strengthen to average a respective 3% and 2% per annum over the next five years. Critically, these projections outstrip those for prices over the same period, adding further weight to the idea that supply pressures could be even more acute across the lettings market.

Chart 15: RICS Rent Expectations - London



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