RICS Housing Update

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Supply shortfall to underpin house prices in 2014

Executive Summary

- The demand-supply imbalance is the key challenge facing the residential sales market in 2014 with new instructions to estate agents close to stagnating according to recent feedback received by RICS.
- This will drive a further pick-up in house prices over the course of the next twelve months; our central expectation is that prices at the headline level (ONS index) will rise by eight per cent.
- London will continue to lead the way on prices but the better macro newsflow and the ongoing improvement in the employment picture will help to support a more broad based recovery in the housing market across the country.
- Transactions will continue to rebound despite the withdrawal of support for household borrowing through the Funding for Lending Scheme. After breaching the one million mark for the first time since the onset of the credit crunch, total sales across the country could reach 1.2 million during the coming year.
- The cost of mortgage finance is likely to edge upwards during the latter part of the year which will contribute towards a gradual slowing in the rate of house price inflation and a more stable trend in transactions in 2015.
- Rents will rise in 2014, albeit at a more modest pace than house prices, with RICS indicators pointing to the strongest gains in the East and West Midlands.
- Development activity should continue to rebound as housebuilders respond to the increased availability of mortgage finance; new housing starts are likely to reach around 155k over the next twelve months.
- While welcome, this will still leave the additions to the stock of homes falling some way short of household formation and thus insufficient to address the ongoing crisis over the provision of sufficient shelter for all tenures.
- Our forecasts for this year and next are provided in the table below:

	2013p	2014f
GDP %[1]	1.5	2.7
Base rate %[2]	0.5	0.5
House Prices % [3]	5	8
Transactions mn [4]	1.05	1.2
Housing Starts 000s [5]	125	155

Notes: [1]annual average, [2]Q4, [3]ONS Q4 y/y
[4]HMRC annual total, [5]CLG England only annual total
p = provisional, f = forecast

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It may be beginning to fade from memory but barely a year ago, the mood across much of the UK housing market was still pretty downbeat. Roll the calendar twelve months forward and the picture looks very different even if the excessive focus on the particularly strong London property market does at times overshadow the more tentative pick up in both activity and pricing in most other parts of the country.

Critical to this turnaround has been the improvement in the macro economy which has materially surprised on the upside. However, perhaps inevitably, there have been significant feedback loops with both the Funding for Lending Scheme (FLS) and the Help to Buy (HtB) initiative supporting higher housing transactions levels as well as the related benefits this provides for the wider economy.

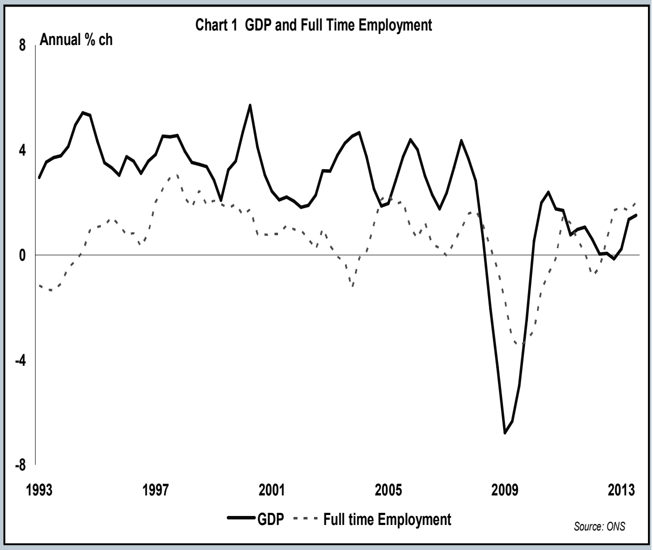
Significantly, despite the more positive tone to the market there remains a meaningful shortfall in supply whether of existing or new stock. This is a theme we will return to later in this note but it is clear from the latest RICS Residential Market Survey that the lack of property coming to the market is not only driving prices upwards but is also holding down sales at a level lower than would otherwise be the case.

More positive signs on the economy

Growth expectations in the UK are turning increasingly upbeat for 2014 even as the newsflow across much of the rest of Europe remains weak. Our central scenario envisages the economy expanding by something in the region of 2.7% which represents a material upwards revision from our previous estimate. However, we still have some on-going concerns about the balance of this growth with the contribution of trade to the overall outcome likely to continue to be depressed by the poor performance of many of the UK's main export markets.

A critical issue from a policy perspective is how the stronger domestic economic climate filters through into the jobs market. The relative firmness of employment in recent years, albeit some of it part-time and on temporary contracts, has been well documented and an element of payback is probable as the recovery in activity takes hold and productivity picks up from recent lows. Chart 1 demonstrates the point showing that the increase in full-time employment has been significantly better than might have been expected on the basis of past experience. That said, even with a much needed improvement in the productivity picture the unemployment rate is likely to head downwards from its current level of 7.6%. Indeed, the Bank of England has acknowledged this by bringing forward (in November) its estimate of the point at which the key ILO measure reaches its 7 per cent policy threshold from the end of 2016 to the latter part of 2015.

Notwithstanding this, we are still comfortable with the view that there will be no formal change in monetary policy over the next twelve months. Indeed, the recent decision to exclude household lending from the FLS as of the beginning of 2014 coupled with the increasing attention being given to macroprudential tools, both in the Financial Stability Report and in recent speeches from Bank of England governor Mark Carney, clearly indicate that the authorities are keen to hold off raising interest rates prematurely.



Even so, the cost of mortgage finance could still begin to edge upwards towards the end of the year for a number of reasons. First, there will still be a (natural) temptation from the gilt market (with swap rates following) to begin to discount the first interest rate hike at some point. Alongside this, there is the potential for spillover into bond yields from the US as the Federal Reserve begins to taper its quantitative easing programme. In addition, the decision to remove mortgage lending from the FLS will, even if not a game changer, still eliminate one source of cheap finance for lenders. And finally, new rules on lending will formally come into place in April next year with the implementation of the mortgage market review; while this may not directly impact on cost, it could do so indirectly and may have some influence on credit availability.

Demand outstrips supply

Considerable attention has been directed towards the government's Help to Buy scheme in driving the pick-up in buyer activity that has been visible over the course of this year. We would acknowledge both the direct and indirect consequences of the policy but would also highlight the success of the FLS, at least

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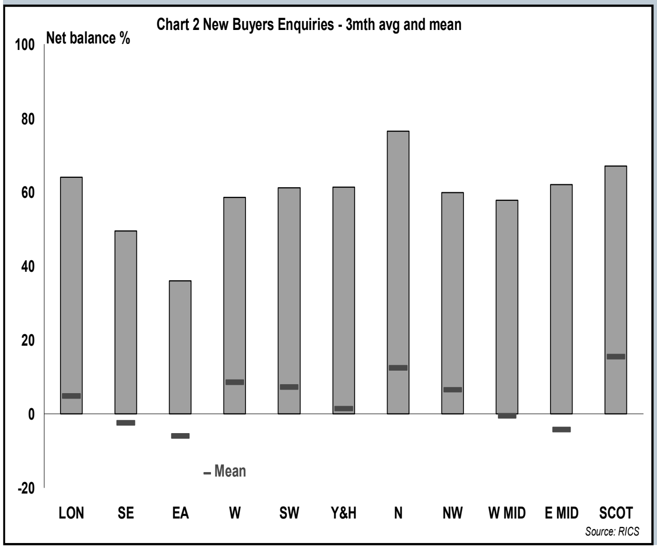
in this specific area of credit provision, as well as the more general improvement in the macro climate in changing the mood music.

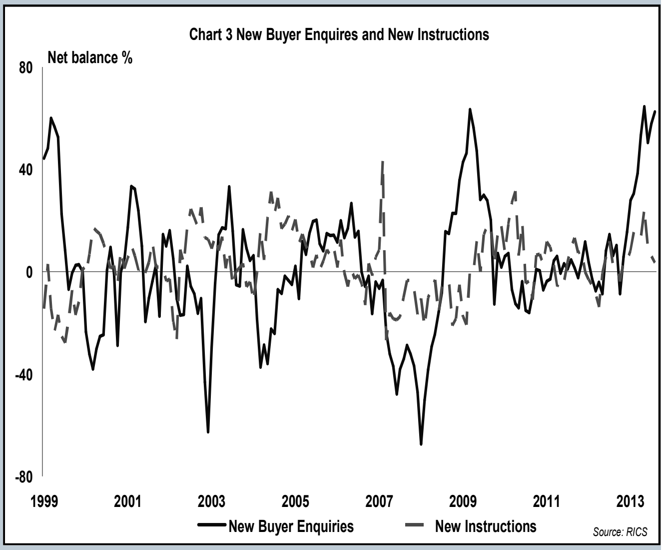
The RICS new buyers enquiries series has probably been the best indicator of this shift in sentiment with the headline measure having now recorded ten consecutive positive monthly readings. However what has been particularly striking has been the improving momentum in this series over this period; the average net balance reading over the last three months stands at 57 which is the highest figure recorded on a comparable basis since we began gathering data on this indicator in 1999. Moreover, it is not just the headline numbers which are showing a stark recovery; most of the regional data is telling a very similar picture.

Chart 2 tracks the average level of new buyer enquiries by region over the past three months (measured in a net balance format) and the long run average dating back in most cases to 1999 (the Scottish series began in 2004). In each area, the three month average is substantially above the long run mean. In London for example, the respective readings are 64 and 5. Meanwhile, the three month average is actually lowest in East Anglia but that needs to be set against a negative historical mean; moreover at 36, it is still consistent with a material pick up in buyer interest in the market.

Significantly, while demand has been rebounding strongly, the same cannot be said of supply. Chart 3 tracks the headline RICS new buyer enquiries series against new instructions on a net balance basis. Essentially these two series capture the momentum in both indicators, that is fresh demand and supply. Critically, the gap between the two series is pretty much as wide as it as been in the history of the data (April 1999), highlighting the failure in the supply of existing stock to respond to the stronger trend in demand.



Moreover, the story is once again pretty much the same at a local level. The gap between buyer enquiries and new instructions, albeit on a net balance basis, is greatest in the capital but is also particularly pronounced in East Anglia. Indeed, in every region this demand-supply proxy currently stands towards the upper end of its historical range.
Typically, one would anticipate the supply of stock



gradually increasing in response to an upswing in demand, but even in those parts of the country where this appears to be happening, it is doing so at a relatively modest pace. Part of the explanation for this trend may be the attraction for some homeowners of holding on to (their current) properties as an investment when they move. Another element could be blockages in the market (at the second hand 'entry level') resulting from Government support for the new build sector over a number of years at the expense of existing stock. Members are also telling us that in some cases vendors are keeping properties off the market for the time being in the belief they can secure a higher price in the not too distant future. However, arguably the more important part of the supply story is quite simply the shortfall in new build in the aftermath of the credit crunch as the focus of developers shifted towards restoring balance sheets.

Housebuilding gains traction

The precipitous drop in housebuilding in recent years has been pretty well documented. From a high watermark of just over 183k in 2007 (we focus on data relating to England only because it is released in a more timely way and dominates the aggregate UK number), the number of starts more than halved in 2009 and even last year they fell short of 100k. Developers were given a considerable amount of stick for this collapse in activity although they were quick to argue that a lack of demand backed-up by finance was a key issue driving their behaviour. And while the

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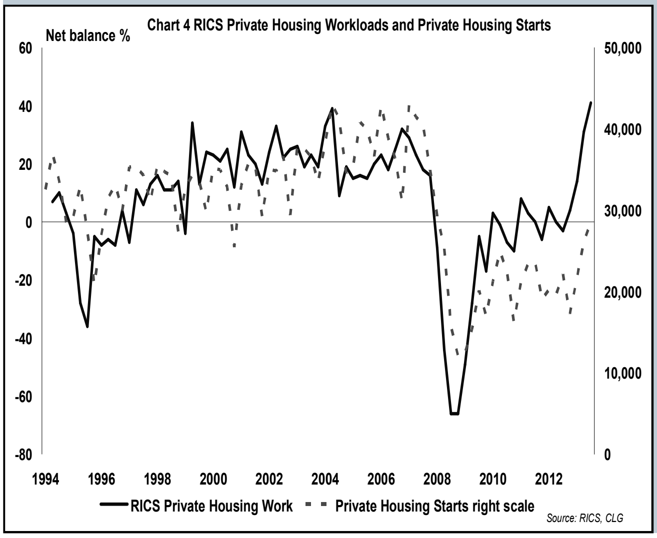
issue of how they choose to manage their landbanks is not about to disappear, the pick-up in activity in recent quarters undoubtedly provides some support for their argument. On the back of the greater range of mortgage products available as a result of the Funding for Lending initiative and more specifically the higher loan to values ratios on offer through Help to Buy, the 'effective' demand for property has gained traction.

This has been reflected in a rise in housing starts through the course of this year with new activity in the third quarter coming in more than 9% higher than in the previous three months and almost one-third up on the comparable period of 2012. Predictably, the lion's share of the increase over the last quarter has come from private developers with a modest rise from housing associations and local authorities adding little to supply. Nevertheless, this should still be sufficient to boost the total number of starts this year to around 130k although completions will inevitably be somewhat lower given the lags in the build process and the depressed level of activity over recent years.

RICS development indicators, which form part of the quarterly construction survey, suggest that this more positive trend will persist into the new year. The workloads net balance for private housing (which captures the change compared with the preceding three month period) has climbed to its highest level since the series began in the early 1990s, highlighting the momentum driving the turnaround in sentiment. The public sector housing picture understandably remains rather flatter although even here there are slightly less negative messages coming through; the net balance for workloads in this area in the third quarter returned to positive territory with the best reading since early 2008. Chart 4 tracks the RICS series for private sector housing workloads against actual starts; the former has historically been a good lead indicator of the trend in the latter. On this basis, it would not be unreasonable to assume that that private residential starts in 2014 will climb to around 125k and total starts to 155k.

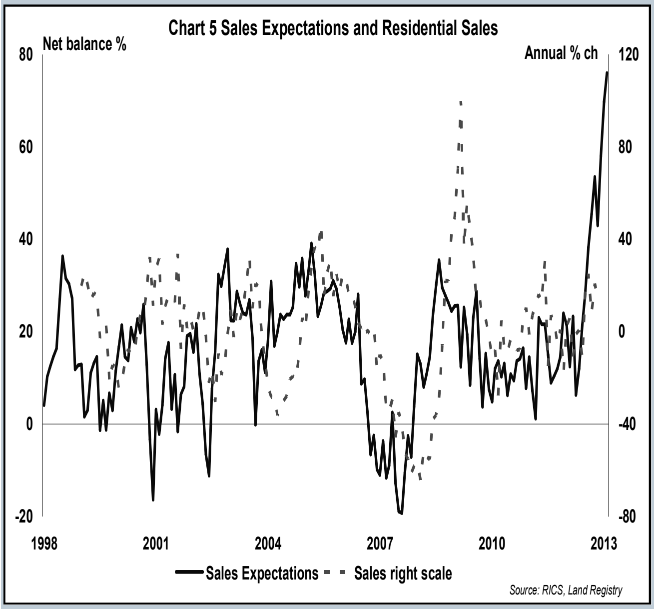


Although encouraging, the recovery in development activity is likely to make little impression on the more fundamental imbalance that that exists between household formation and the supply of shelter unless it is sustained for a number of years. We would acknowledge that forecasts of the former need to treated with some caution for a number of reasons including basic assumptions surrounding migration and cohabitation. Nevertheless, it is hard to see increases in housing stock getting anywhere near the 200k mark in the face of continuing constraints on local authority development (even after allowing for the slight relaxation announced in the Autumn Statement) and the relatively tight grant settlement for Registered Providers of social housing for the post-2015 period.

Better funding conditions to underpin activity

Prior to the announcement of the changes to the FLS, the prospects for mortgage lending in 2014 looked reasonably encouraging notwithstanding the formal introduction of changes associated with the Mortgage Market Review in April. Even if the initial take-up by lenders of the second part of Help to Buy has been a little sluggish, the decision of the Yorkshire Building Society to offer a range of mortgage products with deposits as low as 5% outside the Government scheme was a clear demonstration of how the market has changed. It is particularly noteworthy that the initial interest rate on these mortgages is actually below those available through Help to Buy products. Meanwhile, our own numbers on perceived loan to value ratios (based on responses from surveyors in the monthly RICS Residential Market Survey) demonstrate that required deposits from lenders have decreased particularly in recent months not just for first-time buyers but also for existing owner occupiers and buy to let purchasers.

This raises the key question as to whether the withdrawal of FLS will have a material impact on the supply of mortgage finance. Although it is hard at this stage to be too definitive about the consequences, it is conceivable that it may result in fewer newer mortgage products that replicate the recently announced Yorkshire Building Society range. That said, there has been a very visible improvement in the underlying funding situation this year which is, for example, reflected in the higher volume of retail inflows into building societies. This is a view that that has also been highlighted in the commentary from mortgage lenders and leads us to the conclusion that there will not be a meaningful dislocation in the provision of finance as a result of the FLS change.



For the current year, total sales across the UK are likely to breach the one million mark for the first time since 2007 (1,050,000). And despite the headwinds discussed earlier, the likelihood is that transactions will be even higher next year. Sales expectations data from the RICS survey (which attempts to capture sentiment regarding prospective changes) remains strongly positive at both the three and twelve month time horizons. In the case of the former, the positive net balance of 76 represents the highest reading since this series began in 1998. Meanwhile, the more recently initiated medium term assessment tells a broadly similar picture with just over two-thirds of respondents anticipating an increase in activity over the year and the remainder expecting the picture to be broadly steady.

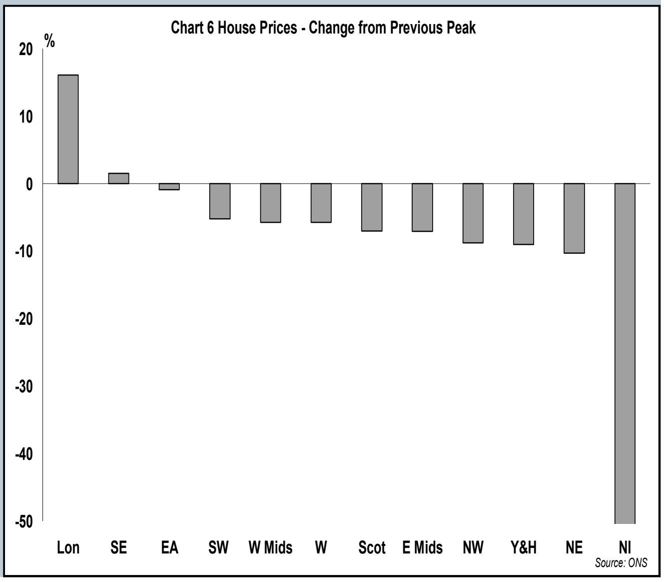
Chart 5 tracks the RICS three month sales expectations net balance against the change in Land Registry sales (measured on an annual comparison); we have used the Land Registry data because of its longer history than the HMRC series. It demonstrates the closeness of the relationship over an extended period if December 2009 (when activity was temporarily boosted by the phasing out of the stamp duty holiday) is excluded. Our analysis suggests that total transactions could climb to around 1.2 million in 2014, however we are assuming that mortgage lending rates remain broadly steady through the course of much of the year and that there is no recourse on the part of the Bank of England to macroprudential measures.

Both HMRC and Land Registry figures suggest the recent pick-up in transaction levels has been broadly based with year-on-year increases in sales of between ten and twenty per cent in most parts of the country. Significantly, the more upbeat tone to sentiment in the RICS expectations series' broadly mirrors this trend with twelve month net balance readings strongly positive at a regional level; this is consistent with further material improvements in transactions in all parts of the UK.

Prices to be squeezed higher

The pick-up in turnover in the housing market has been encouraging but it has also been accompanied by a little more pricing power in the sector fuelling some fairly wild discussion about the re-emergence of a 'bubble'. Headline price indices provide some perspective on this concern although the various methodologies employed demonstrate the challenge of interpreting the relevant data. In nominal terms, the Halifax house price index is currently more than 12 per cent down on its previous peak, the Land Registry series 9 per cent (for England and Wales) lower, Nationwide just over 6% down with the ONS index pretty much at its January 2008 high. However, adjusting the latter series for the increase in consumer price inflation experienced over the past six years leaves even this measure almost one fifth down from its high in 'real' terms.

Critically, as has been widely documented elsewhere, the strong price trend is at this stage largely concentrated in London and the South East with many other parts of the country only just beginning to see some upturn in prices. Chart 6 demonstrates, using the ONS database, that in most parts of the UK house prices although now moving upwards are still well down on previous highs; the other house price indices predictably show the same picture but with bigger gaps. Northern Ireland alongside London is an outlier with prices in the former still only roughly half the level recorded at the high watermark.



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Looking forward, a key issue in terms of pricing is likely to be whether new instructions of property for sale begin to pick-up and get closer to the readings we are seeing for buyer enquiries. Typically in the past, most recently in the latter part of 2009, that has indeed been the case but whether it follows the same pattern is more open to debate as we have already discussed. Chart 7 shows how the interrelationship between new buyer enquiries and new instructions has over the past fifteen years been a reliable guide to turning points in house prices. It also suggests that the current imbalance would be consistent with a further sharp acceleration in monthly price gains during the first half of 2014.

Alongside the strong message being given by demand and supply indicators, the RICS prices expectations series' at both the three and twelve month time horizons tells a fairly similar story. The net balance reading for the former is at its best level since May 2002 while the latter, which was only started three years ago, is at an all-time high. Reflecting this, our central expectation is that house prices at the headline level will rise by a further eight per cent over the next twelve months.

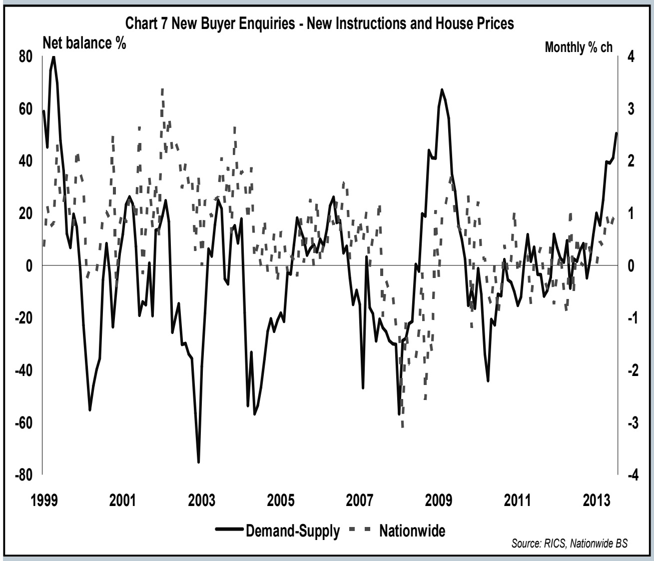

Chart 7 New Buyer Enquiries - New Instructions and House Prices

Significantly, this is likely to be reflected in positive price growth in all parts of the UK (see chart 8). Indeed, our judgement is that regional variations will be rather less marked than they have been hitherto. London is likely to remain the firmest market with international demand continuing to support activity in the centre despite the various tax changes the government is implementing. However, the outperformance of prime locations over housing stock in the rest of the capital has likely run its course as the economic recovery proves a stronger driver of housing dynamics. Moreover, better macro data helping to underpin confidence alongside the more favourable financial environment and the Help to Buy extension will drive pricing elsewhere. The East Midlands and East Anglia look on the basis of RICS data to record relatively strong gains in prices. And although the North (of the country) and Northern Ireland may see smaller increases, in both cases this will represent a material break from the extended period of weakness.

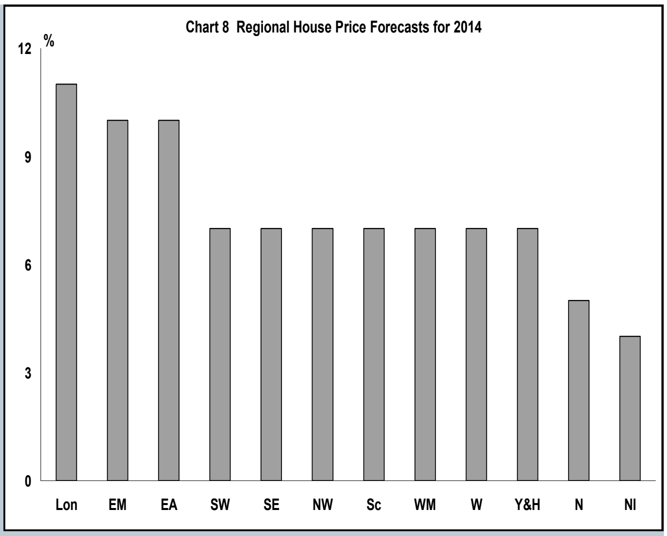

Chart 8 Regional House Price Forecasts for 2014

There has been some discussion about the possibility of affordability proving a constraint on house prices. A somewhat crude examination of house price to earnings ratio shows markets across the country already above long run averages. However, when the focus shifts to mortgage payments the picture is materially different with only London standing out as above the historic norm (and only modestly). As a result, we are not convinced that current prices will act as a constraint on the market in the absence of an increase in the cost of mortgage finance. That said, our suspicion that mortgage products will get a little more costly as 2014 wears on does lead us to the conclusion that house price growth will slacken again in 2015 and that transaction level will flatline.

One issue in particular that will continue to attract a significant amount of interest in the coming months is whether the property market in the capital is overheating. Unfortunately the starting point for this conversation is rarely a rational one with little consistency over what are the necessary conditions for a 'bubble'. A reasonable definition might include a period of significant outsize increases in real house prices, a big rise in leverage to finance these increases and a material upward shift in valuation as demonstrated by the price-to-rent ratio. On the basis, the capital is part of the way to meeting this criteria. However, given the importance of equity as a driver of house prices at the current time rather than debt and the substantial imbalance between demand and supply on RICS indicators, we find it difficult to conclude that this is indeed an appropriate description of the current environment.

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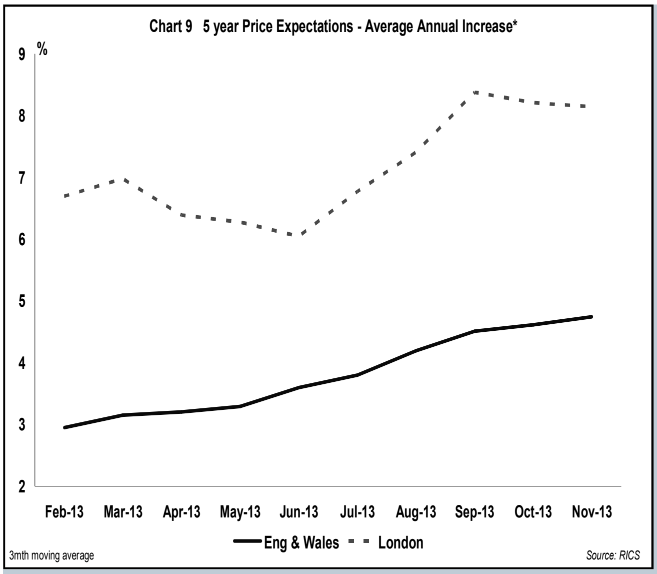


One indicator that we watch particularly closely in this regard is the five year price expectations series from our monthly Residential Market Survey, as this provides a guide to how longer term sentiment amongst practioners in the industry is shifting. Significantly, as far as London is concerned the November survey shows prices are expected to rise by eight per cent in each of the next five years (see chart 9) making a total compound gain of around forty-five per cent over the period. While we don't have a hard and fast idea of what constitutes 'outsize increases', a further acceleration in the expectations for London prices would be a source of some concern. The chart also demonstrates that longer term (five year) price expectations have also begun to edge upwards in other parts of the country. In the rest of the South East they now stand at an average of six per cent per annum, with the West Midlands, Yorkshire and Humberside, East Anglia, Scotland and Northern Ireland all around the four per cent mark (representing a compound gain of more than twenty percent over the period).

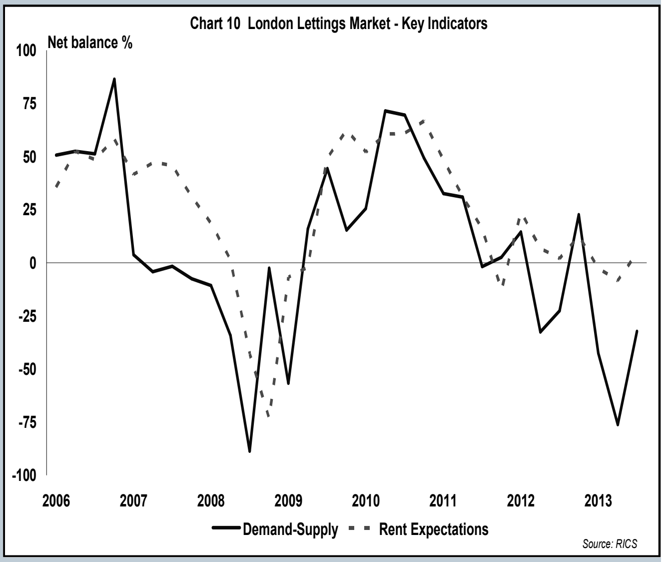
Lettings takes the strain

A year ago we talked about the emerging resistance to rent increases in some parts of the country. More recently, the lettings market is having to contend with the increased incentives supporting the sales market. Interesting, the feedback we are getting from members has a strong regional dimension with tenant demand a little flatter in London than it was. This, accompanied by a further rise in supply, is contributing to the more stable trend in rents across the capital, a point highlighted by chart 10. Elsewhere around the country, demand is also growing a little more modestly than was previously the case, however, the rental picture appears to be more solidly underpinned at this point.

At the headline level, our numbers point to rents rising by a further two per cent in 2014. The West Midlands could see the largest gain over the year with the demand- supply balance suggesting a further increase in the region of three per cent to be quite plausible. The picture for the East Midlands also appears relatively robust with the subdued supply trend driving up rents by a further 2.5 to 3 percent. By way of contrast, we project rather more modest gains in rents, around one per cent, in both London and East Anglia. Although Help to Buy coupled with the improved availability of mortgage finance more generally has seen a shift in appetite in some parts of the country back to home ownership, our judgement is that this is unlikely to be sufficient to reverse the longer term trend point to a growing private rental market.

The latest data from the English Survey of Housing shows the owner occupation tenure comprising around 65 per cent of households compared with 71 per cent in 2003. Over the next couple of years, this is in all probability likely to change little. However with house price earnings ratios, as we noted earlier, already quite extended and the cost of mortgages set to rise at some point, it would not be a surprise if the strength of the house sales in 2014 proves hard to replicate in subsequent years.

Meanwhile, the decision by the Chancellor in the Autumn Statement to provide local authorities with a little more flexibility to increase borrowing to boost their development programme, although welcome, is not of a magnitude to fuel a significant revival in housebuilding. Indeed, the enhanced 'Right to Buy' proposal could offset the potential increase in council housing stock which suggests that the proportion of households in social housing will at best hold steady over the coming years.



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