# Housing market activity set to weaken again next year

- Overall sales volumes to weaken by around 5% in 2019
- National house price growth likely to come to a standstill but supply shortage should negate outright falls
- Rental growth to accelerate slightly during 2019 due to declining availability of homes for let

The UK residential market has continued to struggle against several well-established obstacles over the past year. Affordability issues, a lack of stock, political uncertainty and the prospect of further interest rate rises have all been factors seemingly weighing on activity to varying degrees. Sentiment has remained relatively subdued as a result, with new buyer demand tailing-off gradually throughout much of 2018. Sales volumes have also weakened during the past twelve months, while house price inflation has continued to cool at the national level. In the near term at least, we remain unconvinced that activity trends will break away from the recent sluggish picture.

Nevertheless, tackling the challenge around supply and affordability remains a primary goal on the domestic political agenda, with the prime minister announcing a scrapping of the local authority lending cap for housebuilding in the latest attempt to boost delivery. Just how effective the policy measure will be in lifting housebuilding remains to be seen, but, either way, the government still faces a huge task in reaching their 300,000 new homes per year target 2022.

### Recent improvement in housebuilding has slowed

Although total net additions to the housing stock across England have now improved in five successive years, the rate of progress over the past year has slowed significantly. Indeed, 222,000 housing units were added in 2017/18, an increase of only 2% from the previous year's figure of 217,000. This represents the smallest yearly pick-up since the recovery started, following a low point of 125,000 net additions in 2012-13 (chart 1).

Perhaps of greater concern is the fact that growth has slowed noticeably even before surpassing the level hit prior to the onset of the global financial crisis. Furthermore, a closer look at the statistics reveals that this has occurred even though additional dwellings created through change of use (such as conversion from office to residential) were 68% higher last year than in 2007/8. From this point on, arriving at the government's target of delivering 300,000 new houses per annum will require a further 35% increase. In fairness, the most timely figures available suggest growth may have regained some momentum, with nearly 240,000 Energy Performance Certificates issued for new dwellings in the

**Chart 1: Net additional dwellings (England)**

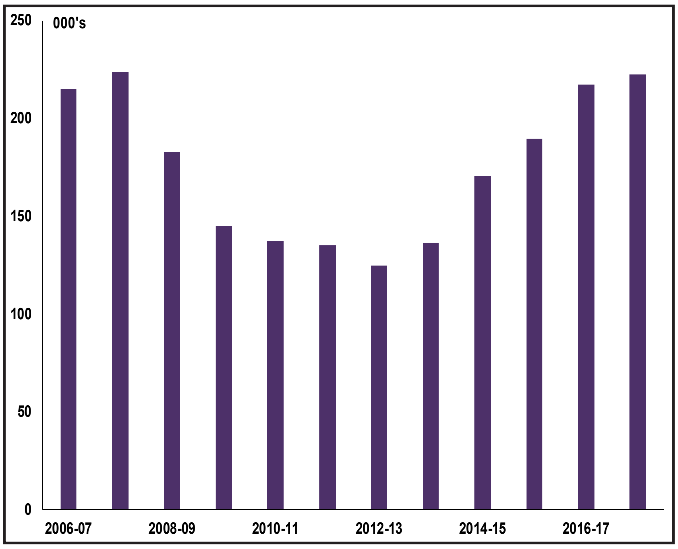
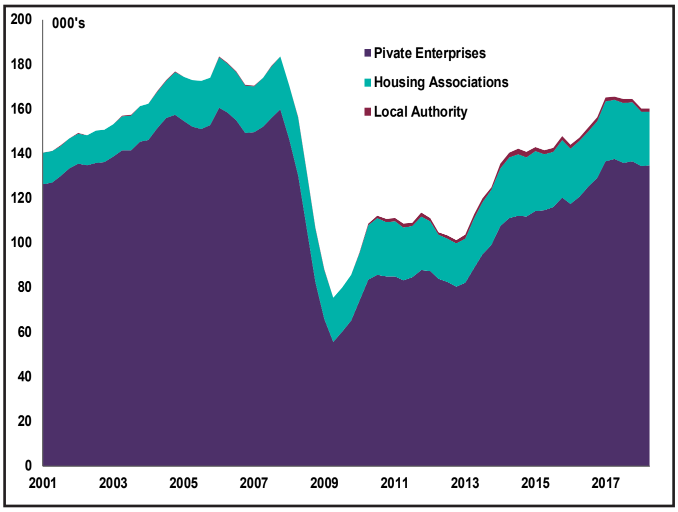



**Chart 2: Housing starts across England by tenure**



twelve months to Q3 2018 (up 9% on this time last year). However, the fact that construction started on 160,000 new homes in the year to Q2 2018, down 3% annually, does not bode particularly well for housing delivery prospect further out (chart 2).

That said, the recent elimination of the Housing Revenue Account lending cap on local authorities for housebuilding is a significant change in policy. On the face of it, enabling local authorities to borrow more in order to finance residential developments could induce a real change in council housebuilding relative to recent years. Considering local authorities were responsible for just 1,550 housing starts last year (accounting for 1% of the total), it would appear there is plenty of scope for improvement. By removing the borrowing constraint, this could potentially unlock a meaningful shift in housing delivery, with the nation becoming less dependent on the major private developers (who currently produce 77% of all new starts).

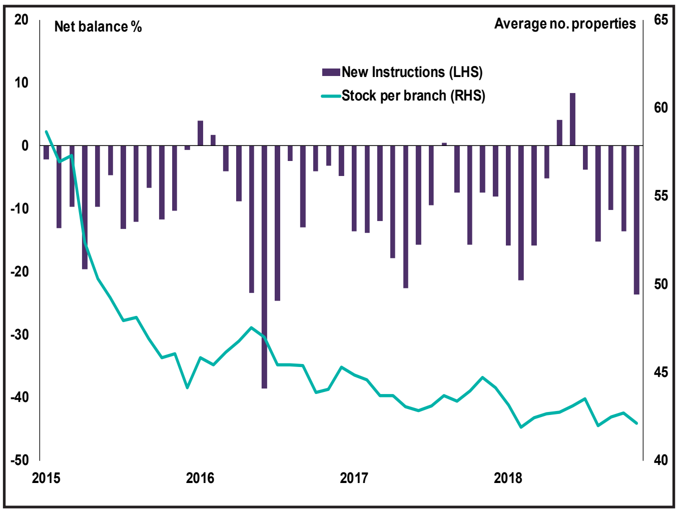
In reality, though, the likelihood of the policy being able to drive a material uplift in the development pipeline remains uncertain. What local authorities decide to do with the greater flexibility depends on how they view the financial consequences, the developable land available to them and, perhaps most crucially, their capacity to manage the process and go about building additional housing given skills shortages already evident across the construction sector. As such, although the outcomes remain highly unclear at this stage, forecasts from the Office for Budget Responsibility point to the policy adding just 9,000 extra houses over the five-year forecast horizon (an average of only 1,800 per year).

The government will therefore also be hoping that smaller housebuilders in the private sector can increase output. In support of this, extra money has been allocated to the Home Building Fund, now worth around £4.5bn. This is designed to assist developers obtaining finance to help with development costs as well as infrastructure work and will prioritise SMEs. Nevertheless, questions remain as to how many extra housing units this level of funding can deliver, with figures showing building costs so far running above the initial estimates.

Regarding the change of use of existing dwellings, a consultation has recently been launched around the possible relaxation of planning rules for retail conversions. Although this may help to further boost the headline numbers, research has shown that office to residential conversions under current Permitted Development rights have produced a higher amount of poor quality housing than schemes governed through full planning permission. Also, many of the homes produced have not been affordable. Policy therefore needs to be shaped in a way that ensures housing is delivered to a suitable standard and not just narrowly focussed on hitting numerical targets.

In another indication of the supply problems across the housing market, RICS survey data shows that average stock levels on estate agents books remain at near record low levels. In fact, since the beginning of the year, new instructions coming onto the market have reportedly fallen in nine months (chart 3). Moreover, in November, a net balance of 44% of RICS survey participants reported the number of market appraisals undertaken over the month was down on a year before. It therefore seems highly unlikely that the coming months will herald a noticeable uptick in supply available across the second-hand market.

**Chart 3: RICS New sales instructions and average stock levels**




## Sales to soften a little further

The aggregate number of sales across the UK housing market this year looks set to come in a fraction softer than 2017's total of 1.22million. Indeed, in the year to date, transactions are running 3% below the comparable stretch of last year. If the sales figures for the remainder of 2018 were to continue along the trajectory seen during the year so far, the annual total would equate to approximately 1.19million. That means sales activity will have gone backwards over the past two years, even though overall sales levels remain significantly below the 1.7million high-water mark set in 2006. Given the forces currently at work in the market, it appears more likely that activity will weaken slightly further in the near term, rather than turning in a more favourable direction.

First of all, momentum behind buyer demand remains weak, evidenced by the new buyer enquiries indicator from the RICS survey (a gauge of month to month changes) slipping progressively deeper into negative territory over recent months. Given the lead relationship between this metric and mortgage activity in the ensuing three months (displayed on chart 4) it also appears likely that mortgage approvals will start the New Year slightly down in annual terms.

**Chart 4: RICS New buyer enquiries and Bank of England mortgage approvals**

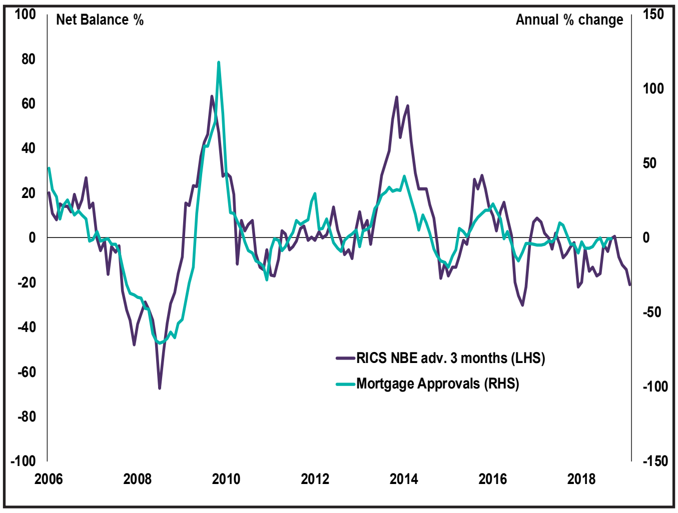
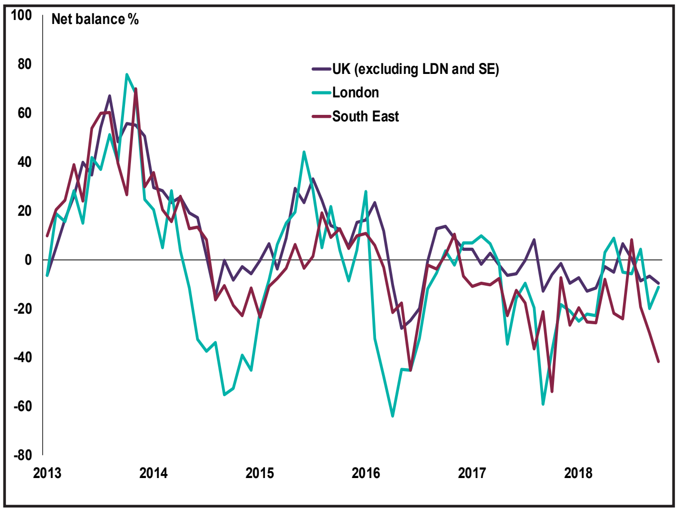


**Chart 5: RICS New buyer enquiries by region**

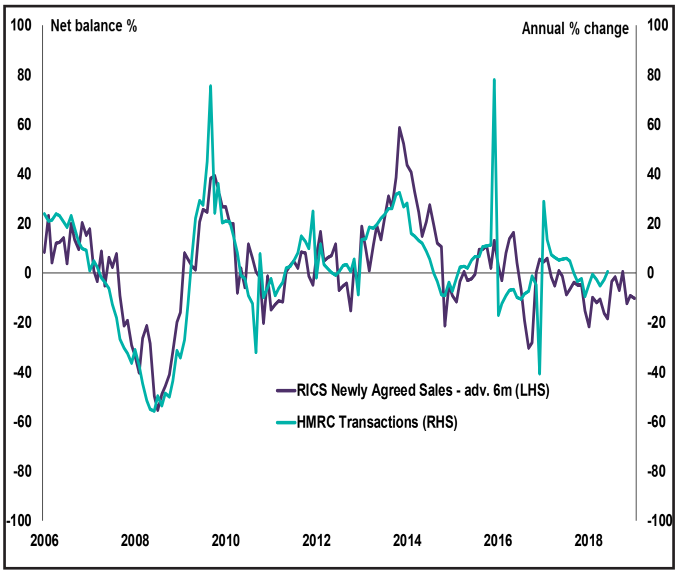



Drilling beneath the national figures, chart 5 shows that the recent weakening is not just confined to London and the South East. The national reading (excluding these regions) now also points to a renewed fall in enquiries, although admittedly demand in the South East has slipped to a far greater degree.

In terms of the outlook for completed transactions, the headline RICS survey indicator on agreed sales has also deteriorated through the final quarter of 2018. In fact, this series has failed to register a positive reading (where the proportion of survey participants reporting a rise in sales exceeds those reporting a fall) for twenty-two months. That said, the trend has been flat rather than particularly negative throughout parts of that spell, although the past few readings have become increasingly more downbeat.

Chart 6 maps the survey data alongside the annual growth rate in the number of residential sales reported by HMRC. The RICS data is based on sentiment and also captures activity at an earlier stage in the sales process. For these reasons, it provides an accurate steer on the likely direction of market trends up to six months before the hard numbers, based on the transactions themselves, become available.

**Chart 6: RICS Newly agreed sales and HMRC residential transactions**

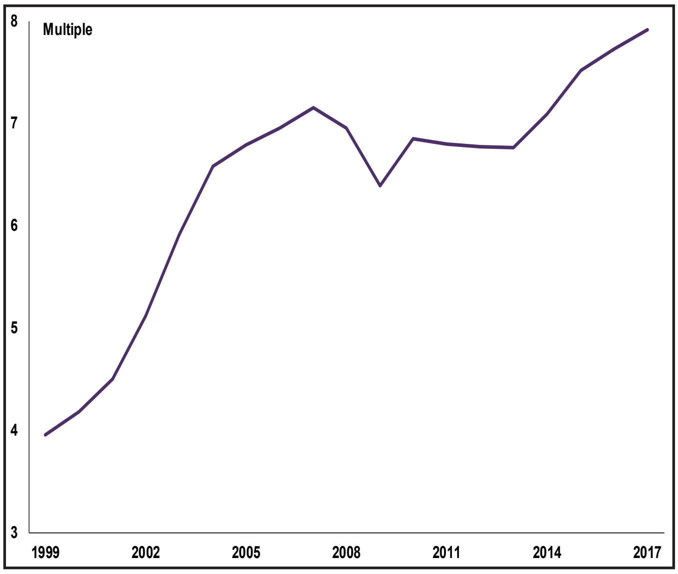



On the basis of the recent decline in the RICS Agreed Sales indicator, it looks as if monthly sales volumes are going to come in comfortably down year-on-year through the opening period of 2019. Pencilling in moderate declines over the first six months of 2019 produces a total of roughly 570,000 transactions during H1 2019 (down 4% on the equivalent period in 2018).

In order to determine what could be in store over the second half of the year, an assessment of the factors weighing on the market, and how likely they are to persist, is required. One crucial aspect behind the softening in buyer activity over the past couple of years has been the shortage of stock available.

As signalled by the RICS statistics on average inventory levels and the flow of new instructions, not enough properties have been coming back on the market to replenish the stock sold. The shortage of housing available for sale presents potential buyers with a narrow range of choice and is likely deterring demand. Unfortunately, as previously discussed, the prospect of supply being significantly boosted any time soon appears minimal, meaning a lack of supply will remain a restraint in H2 2019.

**Chart 7: ONS ratio of median house prices to earnings**




Another part of the equation, and perhaps the most dominant now, is that affordability has become increasingly stretched. Looking at the national figures, the ONS estimates that house prices are now a greater multiple of earnings than at any other point since records began (chart 7). What's more, data from the Halifax shows the average first time buyer deposit is over £33k, 71% higher than in 2008. Such high house prices are shutting out more and more people out from accessing the market, and forcing others to save longer for a deposit. Even for those who could in theory afford to buy, current prices may still be off-putting. Unfortunately, there is little reason to anticipate a material improvement in affordability next year either.

Aside from this, political and economic uncertainty appears to be causing hesitancy amongst buyers, with the impact seemingly intensifying as the Brexit deadline draws near. Anecdotal evidence certainly suggests that worries over the potential disruption that may arise have knocked confidence across the market. For instance, the process of Britain's departure from the EU was cited as a negative influence no less than 73 times by contributors to the November RICS Residential Market Survey. Going forward, it remains very unclear at this stage just how everything will unfold, but different scenarios can be drawn-up which could conceivably move sentiment in either direction.

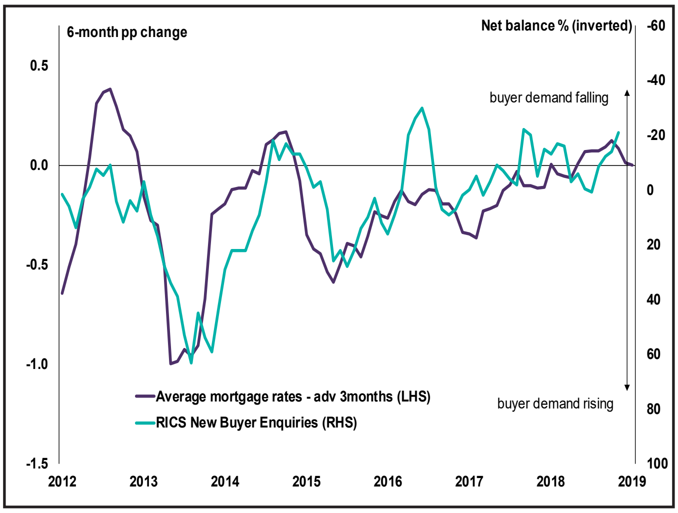
A potentially more favourable path could develop next year if a deal were to be agreed sooner rather than later. This would give buyers the assurance of a two-year transition period (at least) while avoiding a cliff-edge Brexit. Even so, it is still difficult to gauge the exact reaction, as whether the deal is judged to be 'good' or not is open to interpretation. Furthermore, the agreement would only cover the withdrawal, leaving open the possibility of troublesome flashpoints emerging while the details of the future trading relationship are negotiated. Nevertheless, an initial agreement would, at least in the near term, provide greater clarity and likely bring about some uplift in confidence.

Conversely, if the situation were to take a more acrimonious turn and the UK left without a deal, this would likely have serious negative consequences for housing market activity over the coming year. For a start, the Bank of England's projections suggesting house prices could fall 30% under a disorderly Brexit scenario have been well documented. This alone could induce a wait-and-see approach from many would-be buyers under those circumstances.

It is worth stressing that this modelling from the Bank was undertaken for financial stability purposes. Some of the assumptions behind the disorderly Brexit scenario seem implausible to us. Mainly, we would expect the Bank to cut interest rates and potentially restart quantitative easing in the wake of a no-deal. The analysis behind the 30% fall in house prices assumes the policy rate would be hiked to 5.5%. Nevertheless, a negative shock to the economy resulting from a no-deal outcome, expected by the majority of economic forecasters, would hit incomes and reduce demand for housing. Although a no-deal Brexit cannot be ruled out, we still believe the former narrative to be the more probable outcome.

Complicating matters further, however, is the likely path of interest rates in the context of an orderly Brexit. Given the Bank of England views domestically generated inflationary pressures to be on the rise, there will be an appetite to press on with a gradual tightening in policy where possible. Chart 8 demonstrates the strength of the negative correlation between changes in mortgage rates and the RICS New Buyer Enquiries series. Based on this evidence, even if mortgage rates only drifted a little higher over the course of 2019, that would appear sufficient to weigh on demand to a certain degree. Taking all of this into account, it appears more likely than not that transactions will again dwindle slightly in 2019 as a whole. Our central projection would be for sales to fall by 5%, leaving the annual total close to the 1.15million mark.

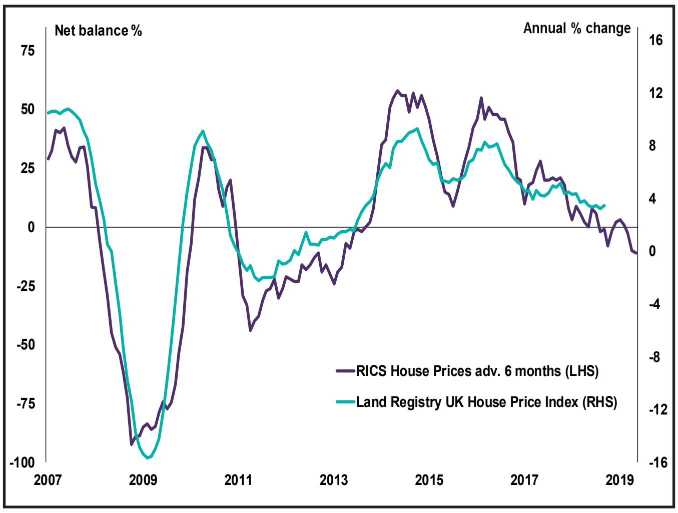
**Chart 8: Changes in mortgage rates and RICS new buyer enquiries**




## Prices to stagnate with risks lying to the downside

The RICS survey results can also be drawn upon to give an accurate steer on the outlook for house prices. Crucially, the survey's headline price net balance, which typically has a six month lead over the official house price index, moved lower for a fifth consecutive month in the November results. Mapping both alongside one another gives a firm indication that price growth will continue to ease through the opening stages of 2019 (chart 9). Having already cooled from around 4.5% at the start of 2018, the official measure now shows house price inflation running at 3.2% year on year. Other measures, such as the Nationwide House Price Index, report a slower rate, with their estimate placing annual growth at just below 2%. Nevertheless, comparing either of the indices with the RICS data portrays the same message. National house price growth looks set to fade further before coming to a standstill by the midpoint of 2019.

**Chart 9: RICS National price balance and Land Registry national house price index**

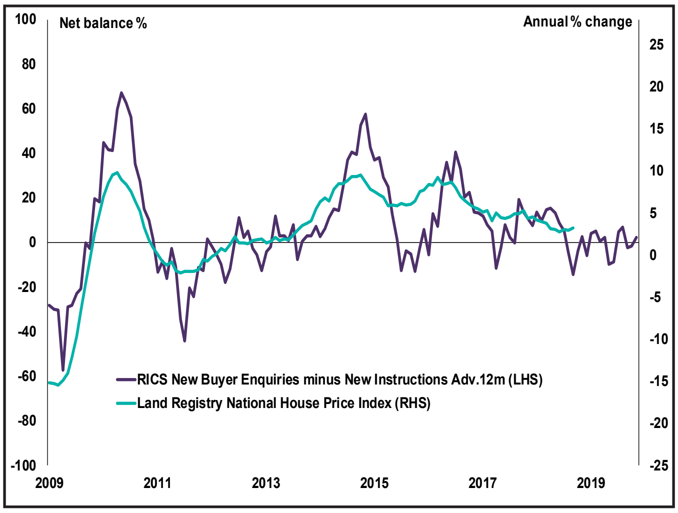



If the sequence of weakening readings for the headline RICS price gauge were to continue from here (extending a run that has already seen the net balance slip from +3% to -11%), that would then signal the potential for an outright decline in national house prices. As it is, with the net balance sitting so close to zero (readings can range from between +100% and -100%), we view the indicator to be pointing to a flat outturn for now. From this point forward, however, overall conditions across the market and the economy may act to negate downward momentum gathering, at least in terms of the national averages.

Indeed, the shortage of stock available could prove an overriding feature underpinning prices at a certain level. Although buyer demand has deteriorated noticeably of late, this has been accompanied by an equally sharp fall in new instructions coming to the market. The point being, recent changes in active demand and supply have been relatively balanced. Looking ahead, consensus forecasts expect the rate of unemployment to continue drifting down from an already near 40 year low. And, while a slight rise in mortgage rates next year may dent new buyer demand a touch, such a small increase is unlikely to cause a noteworthy rise in mortgage arrears. Many vendors will therefore be under no real pressure to sell, meaning they can choose to avoid listing their property at a time when the market is weakening or decide not to cut asking prices. As such, one of the key conditions which would normally preclude a correction in prices should be avoided.

With that in mind, chart 10 shows the RICS New buyer Enquires net balance, minus that for New Instructions, with the combined measure providing a good guide as to the upcoming direction of price movements a year in advance. The recent falls in both demand and supply metrics offset one another to produce a flat reading. The survey data is therefore pointing to a more or less stable outlook for prices, consistent with flat expectations from survey respondents at the twelve month horizon. Based on this, our full-year forecast is for prices across the UK as a whole to see little change, despite the softer sales outlook.

**Chart 10: RICS Demand minus Supply and Land Registry house price index**




However, beneath the unchanged national average, the picture is expected to vary significantly across different parts of the UK. For instance, respondents across London and the South East have consistently returned a downbeat assessment on pricing trends over recent months. Tracking the RICS price balances for London and the South East against the relevant regional data from the Nationwide index (chart 11 and 12) illustrates the scope for prices to pull-back slightly in both cases during the first half of next year.

Driving this negativity, these areas display a much weaker outlook for sales volumes than the UK average, with subdued activity prospects placing downward pressure on prices. The main issue appears to be the sheer scale of

**Chart 11: RICS London price balance and Nationwide London house price index**

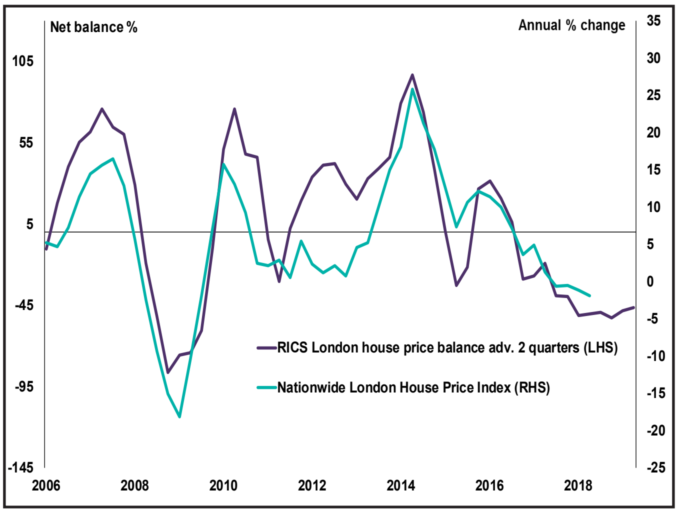
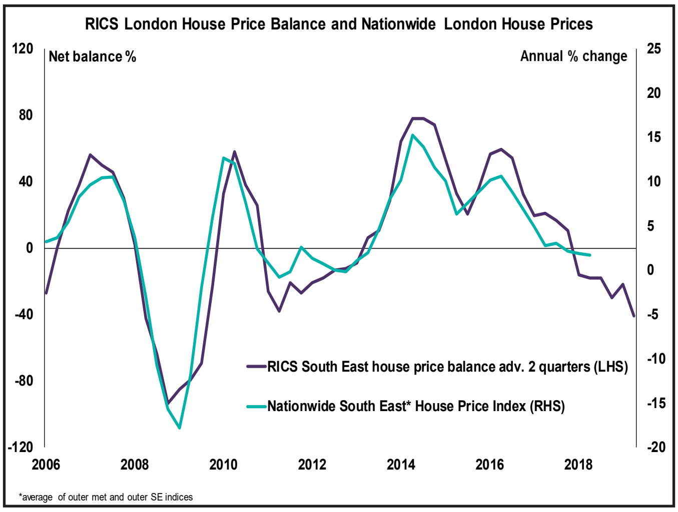



**Chart 12: RICS South East price balance and Nationwide South East house price index**



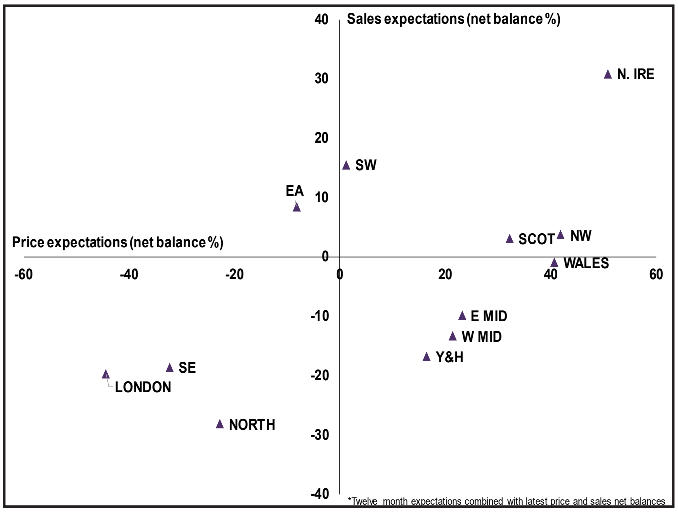

the affordability challenge. Going back to the ONS figures, median house prices in London and the South East are a respective 12.4 and 10.3 times higher than average regional earnings. What's more, the average first time buyer in London puts down a deposit of £115,000, while in the South East this stands at £53,000 (Halifax data). Regulations limiting the availability of high loan-to-income mortgages are now also biting to a greater extent. In further evidence that homes are finding it increasingly difficult to find a buyer at current prices, unsold stock levels have drifted higher in both areas since the start of the year. This is despite the still weakening flow of new sale instructions throughout much of 2018.

Elsewhere, prices may struggle to see much uplift across a few further regions over the year ahead. The North East of England would be another example where twelve month price expectations are negative. Meanwhile, sentiment in East Anglia and the South West sits in a broadly neutral zone at present, consistent with a continued flattening out in prices over the next twelve months.

By way of contrast, survey participants remain fairly confident that prices will continue to rise across all other areas. In particular, Northern Ireland, the North West of England, Wales and Scotland continue to return firmly positive projections, implying price growth will retain solid momentum over the year ahead.

Chart 13 displays RICS members' expectations for both prices and sales at a regional/country level. This goes to emphasise the degree of divergence in the outlook for different parts of the UK. In summary, though, further growth in some regions looks likely to offset a negative trend in others, while a broadly stable picture seems the most probable outcome for the remaining areas. Bringing this altogether is what leads us to expect the national averages for prices to look relatively flat come the end of 2019.

**Chart 13: RICS Price and sales expectations by region**



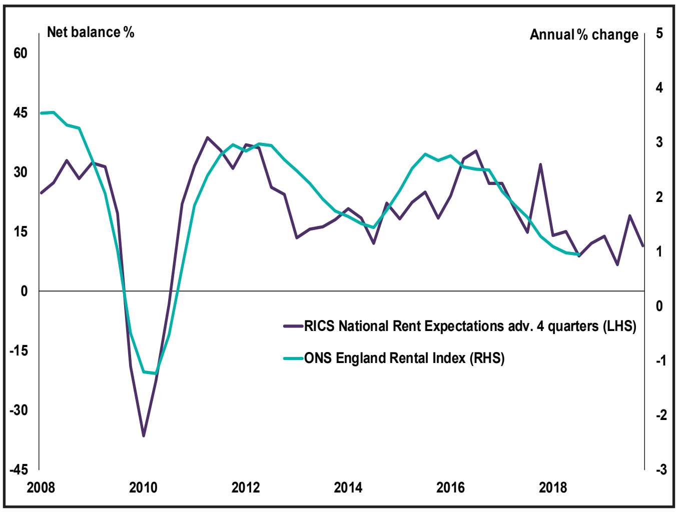

## Rental growth to accelerate slightly

The challenge around supply is no less of a problem on the lettings side of the residential market, with policy changes in recent years not helping in this regard. The additional Stamp Duty surcharge payable for buy-to-let investments has certainly had a lasting impact on slowing numbers of landlords entering the market. Furthermore, the phasing out of mortgage interest relief, with further reductions still to come over the next few years, is also being factored into investors' decisions. As it stands, the RICS indicator tracking landlord instructions coming to market has already been in negative territory for ten successive quarters. This is the longest stretch of declining supply in the rental market since the series began in 1999.

On a more positive note, according to the British Property Federation, institutional development of purpose built rental properties has picked-up. The number of completed build to rent units increased by 26% in the twelve month to Q3 2018, now standing at 26,000. The pipeline going forward also appears strong, with construction underway on a further 42,000 units while 64,000 are in planning. That said, considering there are an estimated 4.6million households in the private rented sector, these numbers remain on a pretty small scale. Consequently, despite recent strong growth, the build to rent sector will struggle in the near term to fill the gap left by smaller landlords deciding not to enter or exiting the market. Supply challenges will therefore likely continue to mount, and this will be a source of upward pressure on rents over the year ahead.

Although tenant demand has increased over the past couple of quarters, it has done so only marginally, perhaps being held back by a mixture of affordability constraints and a lack of choice. Nevertheless, even this marginal demand growth, when met with declining supply, has been enough to keep rental expectations comfortably positive. As demonstrated in chart 14, the current level of expectations is pointing to rental growth picking up slightly over the coming four quarters.

**Chart 14: RICS National rental expectations and ONS national private rental index**

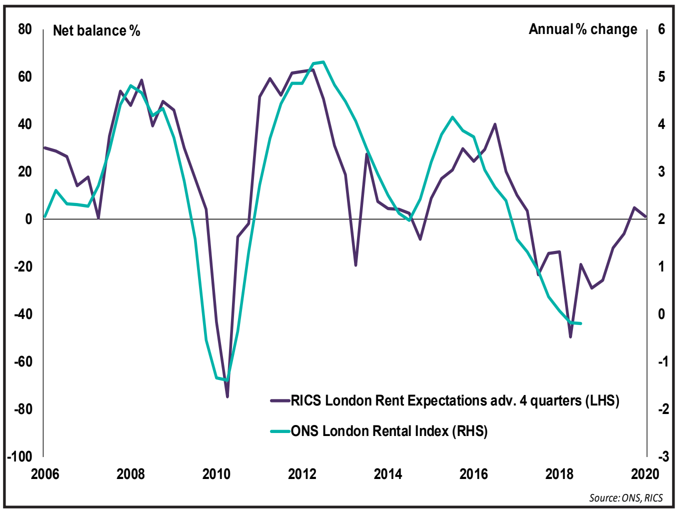



As of Q3 2018, the ONS measure of rents across England shows an increase annual of 0.9%. At the end of 2019, the rate may have quickened slightly to sit between 1.5 and 2%.

In London, where rental growth projections were quite clearly negative at this point last year, the past few quarters have seen a consistent recovery in the outlook. Supply is again the main story behind this trend. Back when the additional Stamp Duty charge on landlords was about to be brought in, there was a rush of transactions looking to beat the deadline. This led to a sharp rise in the number of properties being listed on the rental market in London over a short space of time. Coinciding with a period of weakening tenant demand across the capital, rental expectations were knocked as a result. However, a lot of this supply has since been absorbed, with demand turning in a more favourable direction, while landlord instructions have begun to tail-off along with the wider market.

On the back of this, having stood at -26% during the final quarter of 2017, the net balance for rental expectations across the capital has since improved to +1%. Given the way this correlates with the ONS London rental series, the data now appears to be signalling a potential 2% increase over the coming twelve months (chart 15).

**Chart 15: RICS London rental expectations and ONS London private rental index**



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