Housing market activity unlikely to shift up materially in 2020

- Outlook for sales volumes broadly flat for the year ahead despite decisive election result
- National house price growth projected to come in around 2% over 2020
- Rental growth to accelerate further next year as supply/demand imbalance intensifies

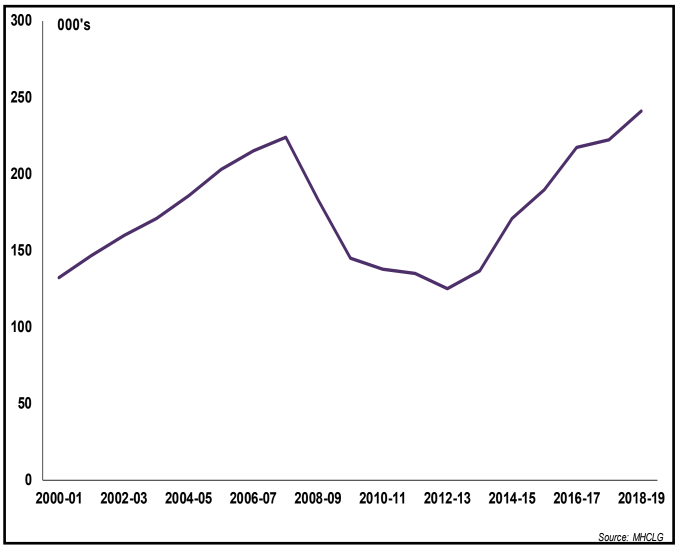
Activity across the UK housing market has remained relatively subdued over the past twelve months. Relentless political uncertainty, sluggish economic growth, stretched affordability and a shortage of stock have all contributed in some part to the rather stagnant backdrop. Given the list of headwinds, it is perhaps unsurprising that new buyer demand has reportedly weakened throughout much of the year, notwithstanding a brief improvement over the summer. This has translated into lower sales volumes across most regions in the year to date, while sentiment on the near term outlook suggests momentum is unlikely to turn in a more favourable direction in the short run.

Developments in the Brexit process before the January 31st deadline will inevitably play a role in shaping the outlook further ahead. As it stands, with the Conservative party securing a significant majority in the December general election, the withdrawal agreement should be passed with little challenge. This would ensure the UK enters an implementation period largely maintaining the status quo until the end of 2020. That could be enough to lift confidence across the market and spur on activity for a period of time. However, Brexit will remain in the headlines as negotiations begin on the future trading relationship with the EU. With only twelve months to come to an agreement, this leaves open the possibility of another intense bout of uncertainty as the next deadline draws closer.

Further improvement in housing delivery this year but signs are ominous for next

As far as policy relating to housing supply is concerned, the Conservative manifesto did not signal any substantive changes in approach. The target of delivering 300,000 new homes per year remains in place. Pledges have been made to simplify the planning system in support of this, but no real details have been given. In 2018/19, net additions to the housing stock across England totalled just over 241,000, an increase of 8.5% on the year before (chart 1). Furthermore, housing delivery numbers have now risen in six successive years, with the latest annual figure the highest since 1987. A sharp rise in change of use conversions (from office to residential primarily) was responsible for a sizeable chunk of the acceleration in housing supply growth between

Chart 1: Net additional dwellings (England)

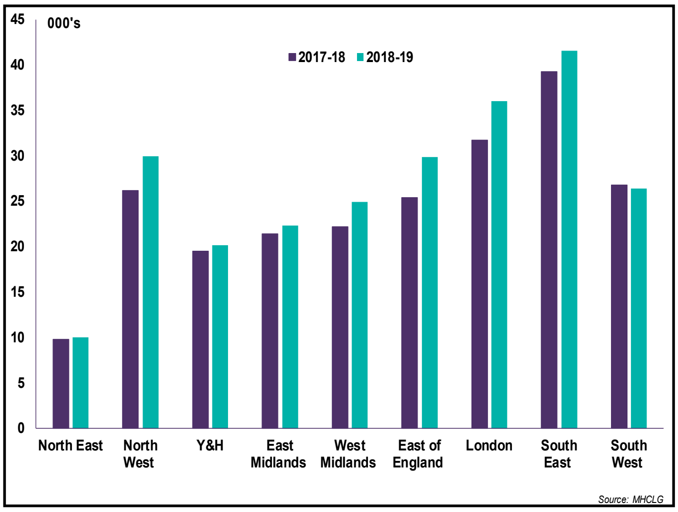


2014 and 2017 but this was not the case in the latest year. Indeed, 2018/19 saw the lowest number of change of use conversions in four years, albeit 29,000 is still considerably more than pre-global financial crisis trends. Instead, new build completions picked up smartly to 214,000 last year from 195,000 in the twelve months prior. As it seemed implausible that conversions could continue to rise indefinitely, the uptick in housebuilding arguably represents more sustainable progress towards hitting the government's 300,000 target.

Most regions saw an acceleration in the rate of new housing additions during 2018/19, with the East of England and the North West seeing the strongest improvements of 17% and 15% respectively (chart 2). Meanwhile, Yorkshire and the Humber, along with the South West, are now the only regions where net housing delivery (in terms of units added in single year) has not surpassed the pre-crisis peak.

Based on these statistics alone, it would appear that real headway is still being made in closing in on the targeted level of housebuilding. However, many other indicators are somewhat less encouraging regarding the outlook. For one,

Chart 2: Net additional dwellings by region



the MHCLG housing starts series (which admittedly provide a slightly narrower measure of new build) has now fallen in each of the last three quarters, leaving construction activity on new housing down 8% year on year. Starts have declined on an annual basis in almost every region, with the North East and London seeing particularly sharp declines. This slowing in the housing pipeline will likely be reflected in falling housing completions in due course.

More timely data from IHS Markit's survey of purchasing managers suggests that housebuilding activity has weakened further of late. Chart 3 illustrates the correlation between the IHS index and the housing starts figures, and points to a continued deterioration in the latter through the closing stages of 2019. Looking further ahead, it is important to note that the Help to Buy scheme will become limited to only first time buyers in 2021. Given the lead times involved, this scaling back of the policy may start to have an influence on house builders' construction plans next year. Moreover, with the scheme slated to be removed altogether in 2023, this adds another question mark to the outlook for housing supply over the medium term.

Outside of the private sector, the current trend in new build starts is pretty flat. Indeed, the latest figures from both housing associations and local authorities show construction has started on slightly fewer houses during the past twelve months than back in 2014 (private developers were responsible for 81% of all housing starts over the past year).

A challenge for housing associations has been the slowing in the sales market, which has undermined the cross-subsidy model. At the same time, they have been forced to devote significant amount of resource to addressing key issues around their existing stock, most notably fire safety. As far as local authorities are concerned, they have been responding to the new found freedom provided by the removal of the cap on HRA borrowing and in part this has been visible through the establishment of a significant number of housing companies to manage their development pipeline. This process will inevitably take some time to deliver an uplift in council building, but that could begin to come through in the coming years. That said, the more recent decision by the Treasury to increase the interest rate charged by the Public Works Loan Board (council's main source of finance) by 1% may actually discourage some investment into housebuilding given the higher costs involved.

In the second hand market, the shortage of stock available for sale remains a critical issue. RICS survey data shows average stock levels on estate agents' books hit a fresh all-time low back in June and inventory has remained depleted since then. This has been driven by a continued decline in the volume of fresh sales listings coming to market throughout much of the past year (chart 4). Furthermore, appraisals are reported to be down sharply on an annual comparison across all parts of the country. Based on this evidence, a material pick-up in new instructions seems unlikely to be on the way anytime soon. In the absence of an improvement in stock levels, prospective home buyers will continue to be presented with limited choice when searching for an appropriate house to buy, further weighing on activity going forward.

Chart 3: Housing PMI and housing starts

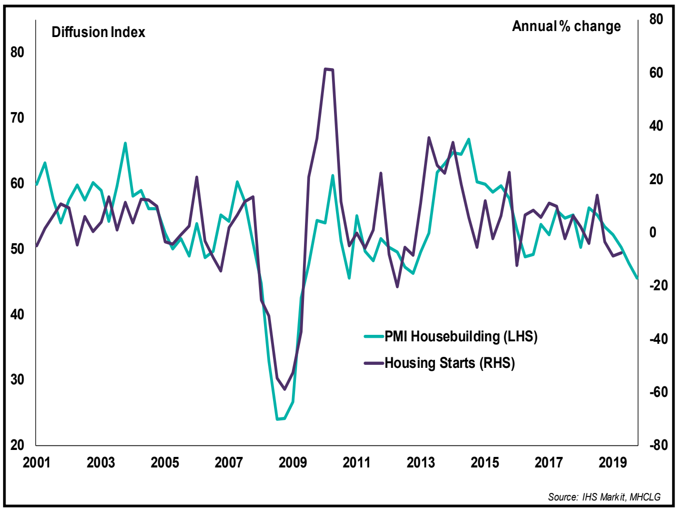
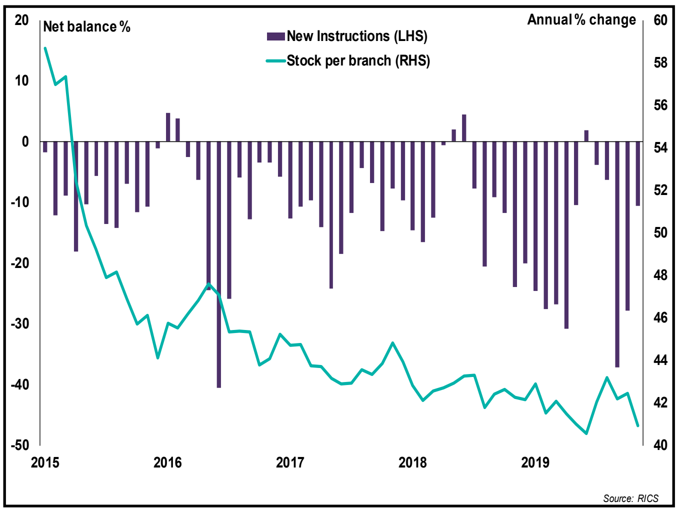


Chart 4: RICS New Instructions and average stock levels

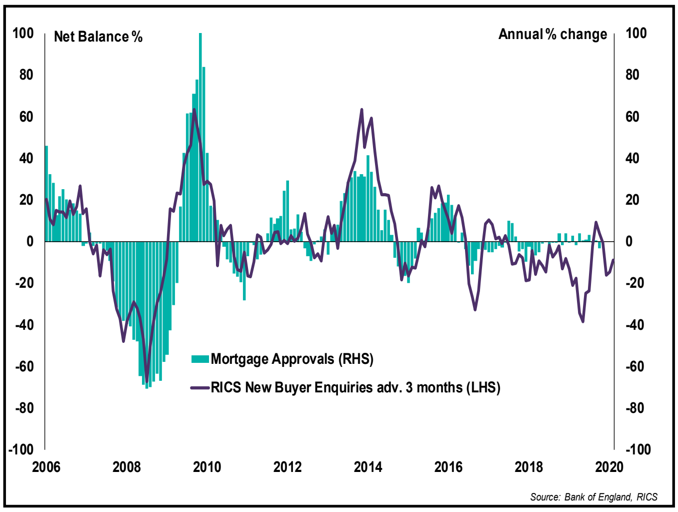


Sales volumes to hold steady over the coming year

In the year to date, the number of sales across the UK housing market in aggregate sits around 1% below the equivalent stretch of 2018. Judging by the rather flat signals coming from near-term expectations for activity, it seems a reasonable assumption that transaction volumes will end the year around the 1.18 million mark (HMRC measure). Although very marginal, this would be a third successive year of falling residential sales activity.

Meanwhile, with new buyer enquiries reported to have fallen in each of the past three months, it seems demand has little impetus notwithstanding the prospect of a more stable political environment. Chart 5 tracks the new buyer enquiries series alongside the mortgage approval statistics produced by the Bank of England, with the RICS numbers having a three-month lead. Admittedly, the survey results over the past year have been more downbeat than the mortgage lending figures. It appears that particularly pronounced spells of political uncertainty (concerns that the UK could fall out of the EU without a deal spiked before both the original and revised Brexit deadlines) hit sentiment to a greater extent than what was borne out in the hard data. Nevertheless, at the very least, the recent weakness in the survey results signals that mortgage approvals will struggle to see any uplift going into the New Year (currently down 3% year on year).

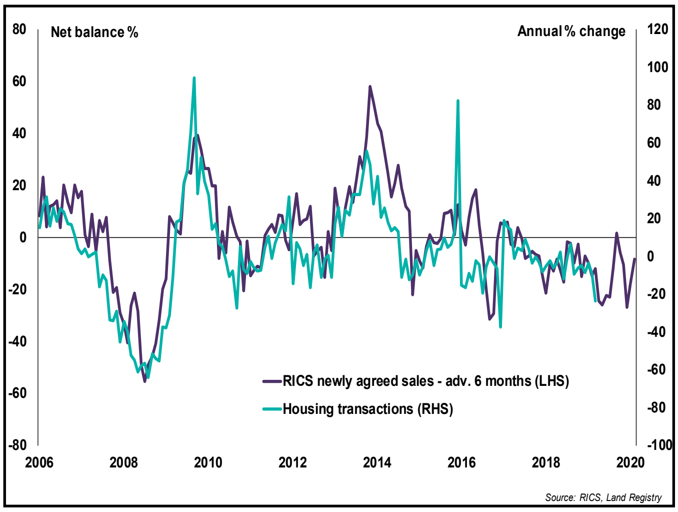
Chart 5: RICS New Buyer Enquiries and Bank of England mortgage approvals



Up to now, falling mortgage rates have helped provide some underpinning for demand in the face of political uncertainty. For example, Bank of England data shows the average rate of interest charged on a five-year fixed mortgage (75% LTV) has fallen from 1.79% to 1.63% over the past six months. Intense competition amongst mortgage lenders may have driven rates down recently, but, interest margins have already narrowed significantly and there may be limited scope for them to fall further from here (at least in the absence of any loosening in monetary policy).

When it comes to the outlook for transactions, RICS survey metrics paint a subdued near term picture, with the number of sales in the pipeline diminishing recently. Chart 6 maps the RICS Agreed Sales indicator against the Land Registry sales volume figures. The Land Registry records (which are not as all encompassing as the HMRC stats but do allow for more regional insights) have been a lot weaker than the mortgage lending numbers, posting year on year declines in each of the last seven months. Going forward, as the survey data offers a six month lead, the noticeable drop off in agreed sales towards the end of 2019 is consistent with monthly sales volumes remaining down in annual terms throughout the opening stretch of 2020.

Chart 6: RICS Newly Agreed Sales and Land Registry Transactions



Based on the weakness of the latest survey returns, a 5% cumulative decline would seem a reasonable estimate. According to the Land Registry, there were roughly 370,000 residential sales across England and Wales during the first half of 2019. If volumes were to drop by 5% over the comparable period of 2020, it would leave total H1 sales, on this measure, down to 350,000. That would represent the poorest total for the opening half of a calender year since 2013.

Nevertheless, it remains possible that political developments in the near future could lead to a reprieve from Brexit uncertainty (albeit potentially temporary). With the withdrawal agreement likely to be ratified early in the New Year, this would guarantee a transition period until the end of 2020. Significantly, since Brexit uncertainty has been viewed as a material impediment to housing market activity (77% of respondents were of this opinion when asked earlier this year), the transition period could provide some breathing space, lifting sentiment and releasing pent-up activity from both buyers and sellers. Under this scenario, sales trends could breakaway from the recent sluggish trajectory.

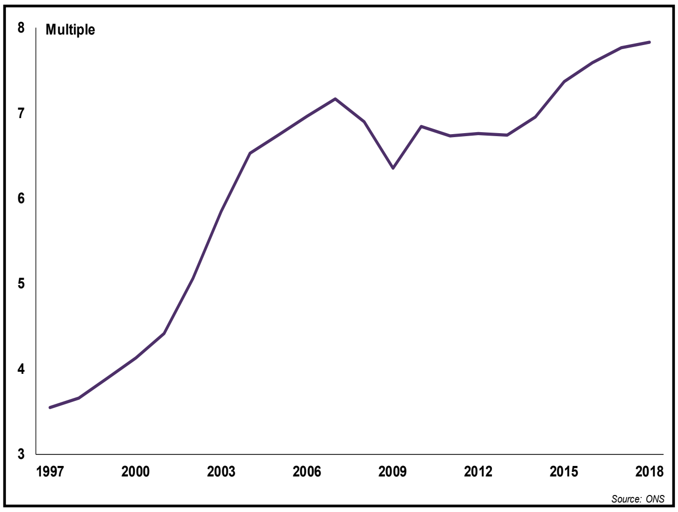
In keeping with this, twelve month RICS sales expectations have turned more optimistic recently, diverging with the relatively downbeat near term view. Indeed, a net balance of +35% of respondents in the November survey expect sales trends to improve over the coming year in its entirety. This is now slightly above the long run average of +29% and considerably more upbeat than this time last year, when the net balance was zero.

Of course, there is also the possibility that Brexit negotiations do not run smoothly, and less than twelve months is an ambitious time frame to attempt to form a trade agreement. Given the Conservative party's manifesto commitment that the implementation period will not be extended beyond 2020, there is still a risk that the UK could leave without a deal. In anticipation of this, concerns over the near term outlook for the economy would likely re-emerge in the final quarter of next year, again hitting the housing market as a result. In the end, while it is possible that political uncertainty subsides to help housing market activity through the early to middle stages of 2020, it will never be far from headlines. As such, many potential flashpoints could still arise that take a toll on confidence.

Leaving Brexit to one side, the housing market is still up against some fundamental challenges even without the ongoing political saga. In particular, affordability remains stretched, although this is more of an issue in some parts of the UK than others (more detail on this later). The ONS estimates that, on average, house prices are now eight times higher than annual earnings across England and Wales (chart 7). Relative to incomes, national house prices are comfortably higher than at any other point since these records began in 1997. Furthermore, calculations from Halifax show the average first time buyer deposit now stands at £41k. The average house price first time buyers are faced with has increased by 62% over the past ten years, from just below £140k in 2009 to around £225k in H1 2019. Even though low mortgage interest rates are favourable for borrowers, high house prices present a considerable obstacle. For the time being, there is little reason to anticipate headline affordability improving to any significant degree next year and will likely continue to constrain activity.

Taking into account the enduring difficulties around stock levels and affordability, it is hard to see 2020 bringing a noteworthy uplift in transactions. Our central estimate is that sales volumes remain very close to the 1.2 million mark, with some of the weakness in the early part of the year offset by a brief bounce on the back reduced nerves around Brexit (even if this proves temporary).

Chart 7: ONS ratio of median house prices to earnings

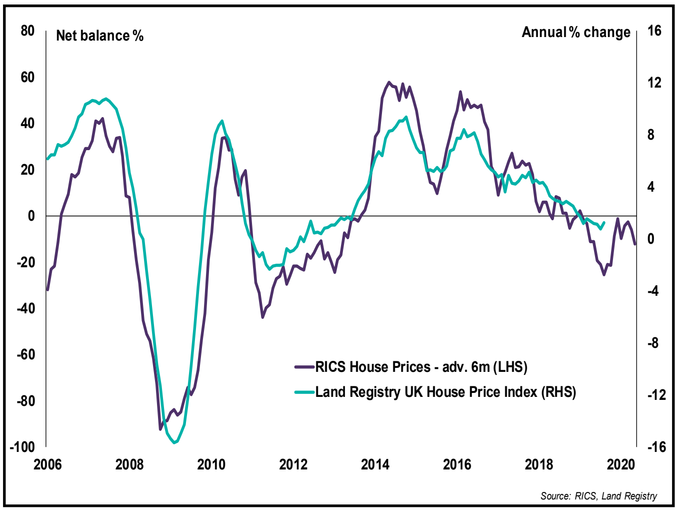


Prices to edge up by around 2% next year

Over the past twelve months, house prices at the national level have seen very little growth if any. Statistics produced by Nationwide (0.8%), Acadata (-0.5%) and Rightmove (0.3%) all point to a broadly flat year on year comparison, while the Land Registry figures signal a marginal pick-up of 1.2% on the same basis. As to the future, the RICS Survey data provides an accurate guide to likely house price movements at the six and twelve month time horizons.

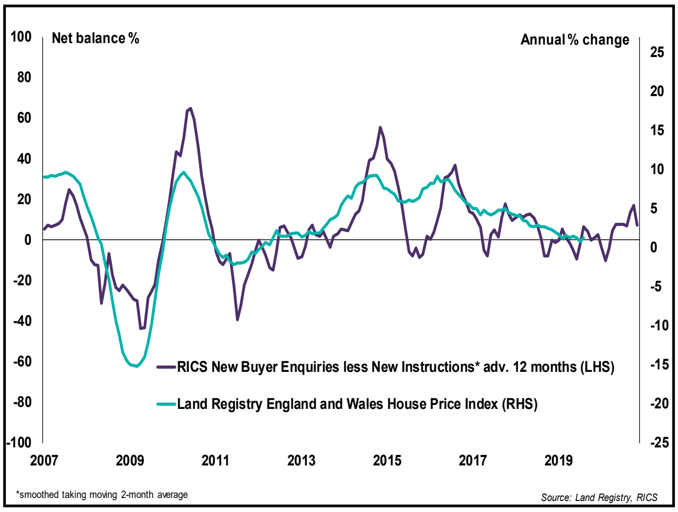
Chart 8 below plots the headline RICS price indicator against the official house price index, with the former pushed forward by six months. With this six month lead, the survey's sentiment data exhibits an impressive correlation of 0.93 alongside the Land Registry price data. As such, the flat to marginally negative net balance readings returned in the survey recently are indicative of a continued near stagnation in house prices through the first half of 2019.

Chart 8: RICS National price balance and Land Registry national house price index



Further out, combining the individual series from the survey on new buyer demand and fresh listings offers a useful steer on the outlook for prices twelve months ahead. As illustrated in chart 9, the balance produced by subtracting new buyer enquiries from new instructions has risen of late (mainly as a result of new instructions declining sharply). This is pointing to house price inflation edging higher towards the back end of next year. Admittedly, this series can be a little volatile, but, in each of the last three months, it has consistently hinted at a slightly stronger rate of house price growth down the line. In keeping with this, twelve month expectations taken directly from RICS members have risen over the past few months, with a net balance of +33% of respondents anticipating prices to increase over the year ahead.

Chart 9: RICS Demand minus supply and Land Registry house price index



However, given all the aforementioned factors likely to restrict sales activity over the coming year, any acceleration could be minimal, perhaps leaving UK average house prices up by around 2% annually by the end of 2020.

Chart 10: RICS London price balance and Nationwide London hosue price index

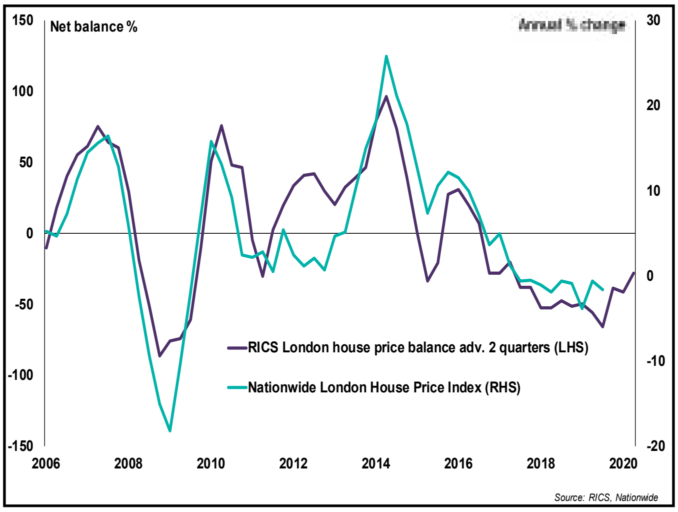
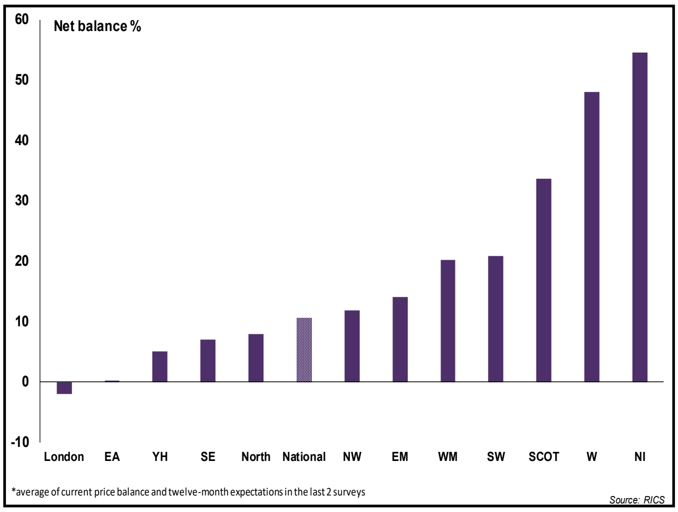


Chart 11: RICS Price sentiment by region



Looking beneath the national average, house price growth is still set to diverge across the UK. That said, in London, which has displayed the weakest trend in house price inflation over the past couple of years, there are tentative signs that conditions are stabilising. According to the Nationwide index, overall London house prices have fallen by 5% since their 2017 peak. Since the second quarter of 2019 though, RICS survey feedback in the capital has become progressively less downbeat on the whole, albeit respondents are still reporting price declines. As shown in chart 10, the way this correlates with the Nationwide Index suggests that, from being down by -1.7% year on year currently, London house price inflation could move out of negative territory over the coming six months.

Likewise, sentiment towards prices in the South East has turned a lot less negative of late. In both London and the South East, growth in incomes has exceeded that of house prices over the past twelve months, leading to an improvement (albeit modest) in affordability metrics. Calculations produced by Capital Economics show the house price to earnings ratio in London has fallen from a peak of 13.4 at the beginning of 2017 to 11.6 in Q3 2019. Alongside this, the house price to earnings ratio was still rising in the South East up until the start of 2018, but has since some down from 10.4 to 9.7.

Although in both instances this remains well above the long run average (7.2 for London and 6.9 for the South East), there has been some downward adjustment. Given that the lending environment is still very accommodative, this small improvement may just be filtering through into a more stable outlook for prices and activity going forward. Indeed, our central projection is for London and South East house prices to hold steady in 2020.

While London and the South East may then become less of a drag on the national averages, areas such as the North West of England have seen a cooling in price growth compared to six months ago. Going forward, expectations for price movements in the region are not quite as elevated now as they were at this time last year, but remain comfortably positive nonetheless. Chart 11 displays RICS survey participants' sentiment on prices, using a combination of views on current trends and twelve-month expectations.

A handful of regions display a largely flat assessment on the outlook for house prices on this basis, including London, East Anglia, Yorkshire & the Humber and the South East. At the other end of the scale, Northern Ireland and Wales posted the firmest readings on this measure, while the remaining regions/countries all display solid expectations for price growth.

Bringing this altogether, the weighted national net balance stands at +11%, consistent with our projection of modest house price gains in the year to come. The risks to this forecast seem pretty evenly balanced. Any movement on interest rates could of course have an impact, although consensus forecasts are pointing to no change in policy rates next year. Indeed, despite the deteriorating global economic backdrop and benign inflationary environment, plans to ramp up fiscal spending next year could dissuade the MPC from cutting rates. On the flipside, uncertainty over what might happen at the end of the implementation period (provided the withdrawal agreement is passed shortly) may prevent the committee voting to hike rates if economic growth surprised to the upside.

Rental growth to accelerate to 2.5%

The lettings market has continued to run-up against its own supply challenges over the past year, with the flow of fresh rental listings weakening consistently. The RICS indicator capturing new landlord instructions has now been stuck in negative territory for fourteen straight quarters, the longest stretch of declining supply since the survey began back in 1999. What's more, in the three months to October, a net balance of -22% of survey participants noted a fall in landlord instructions, the weakest quarterly reading on record (chart 12). The additional Stamp Duty surcharge on buy-to-let investments and a further phasing out of mortgage interest relief both continue to weigh on investor decisions. Consequently, there is little reason to expect a turnaround in the balance of landlords entering/exiting the market going forward.

Alternatively, institutional development of purpose built rental properties has continued to increase sharply over the past year. The number of completed build to rent (BTR) units now stands at 35,000, having risen by 31% over the twelve months to Q3 2019. Although the number of units under construction picked-up by a more modest 5% over the same period, a further 77,000 are in planning (23% more than this point last year). That said, even once the 'in planning' and 'under construction' totals are included, that equates to just under 150,000 build to rent units across the UK.

Putting this into perspective, there are around 4.5 million households currently estimated to be living in privately rented accommodation, with a further 600,000 new households expected to be added across the sector by 2023 (Knight Frank projections). Given the relative scales, growth in BTR is unlikely to keep pace on its own with the rise in PRS households. Additionally, according to JLL research, tenants in a BTR development will typically pay an 11 per cent rental premium, meaning this option could be too expensive for a significant portion of renters.

Set against this, tenant demand has been gaining momentum over recent quarters. In fact, the RICS gauge of quarterly changes in tenant demand picked-up to a three-year high in the three months to October. This has driven an increase in rental growth expectations, which, as demonstrated in chart 13, are now consistent with a further acceleration over the coming year. As it stands, the ONS measure of rental growth is running at an annual pace of 1.3%. From here, rents look set to gather speed, with growth potentially reaching the 2.5% mark in twelve months' time. Interestingly, anecdotal evidence from the RICS survey adds some weight the idea that the ban on lettings agent fees imposed earlier this year is, in some cases, being passed on through rent hikes. Although there is inevitably some debate on the impact of the ban at this stage, it does raise the possibility that the change in policy could be contributing to rental increases.

In London, there has been a noticeable shift in expectations over the past twelve months. Chart 14 illustrates the extent to which rental growth projections have strengthened, with the net balance climbing to +22% in October, from just +1% at the end of 2018. On past form, this appears to be pointing to rental growth in London quickening from 0.9% year on year currently to close to 3% by the end of next year. Away from the capital, near term rental expectations are positive across all areas. In most cases, these expectations are more elevated now than at this time last year, suggesting the imbalance between supply and demand is exerting further upward pressure on rents right across the UK.

The Conservative manifesto outlines their aim to 'rebalance the housing market towards more home ownership'. In support of this, shared ownership products, they say, will be made simpler to end the confusion and disparity between different schemes. Shared ownership has certainty seen considerable growth as a tenure over recent years, with over 200,000 UK households now living in shared ownership homes. Even though it can provide an attractive, affordable route into home ownership for some, choice is still somewhat limited given the number of schemes in any given area, while mortgage availability is restricted due to some lenders being unwilling to offer loans in the sector. Furthermore, there are also constraints on who the property can eventually be sold on to.

This all means that the option of shared ownership may not be available for many, while, for others, it might not be desirable. It is therefore still critical to ensure that supply across the private rented sector is supported in a way that prevents rental costs escalating. It is also vital to guarantee that adequate standards are met, which could be done by introducing appropriate regulations. Read the RICS policy statement which outlines our recommendations for government and local authorities.

Chart 12: RICS New Landlord Instructions

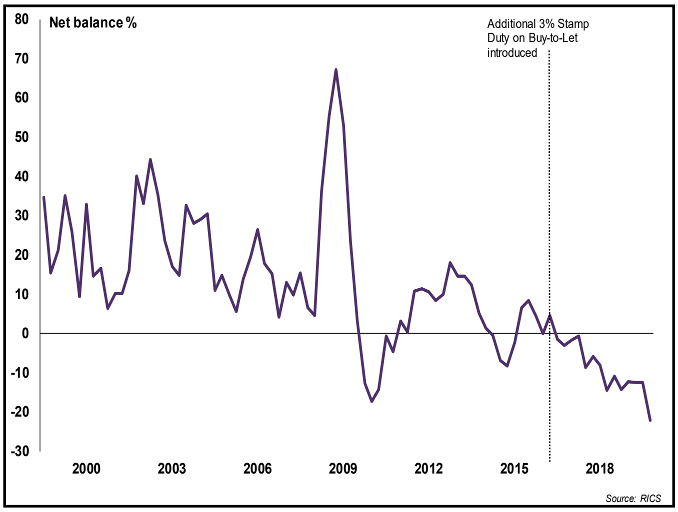


Chart 13: RICS National rental expectations and ONS national private rental index

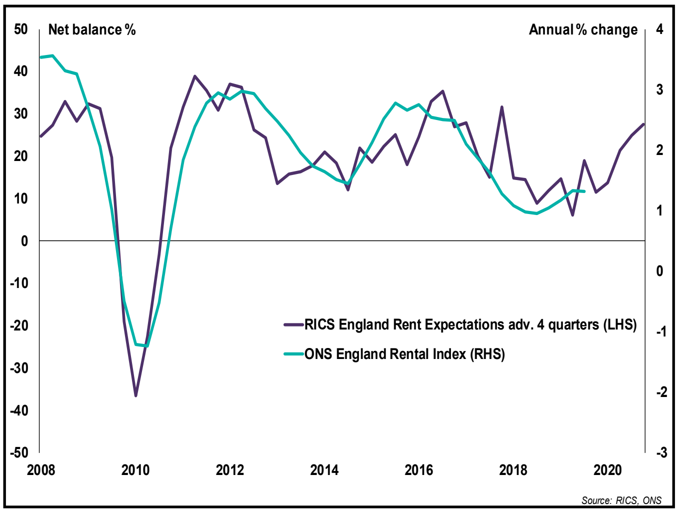
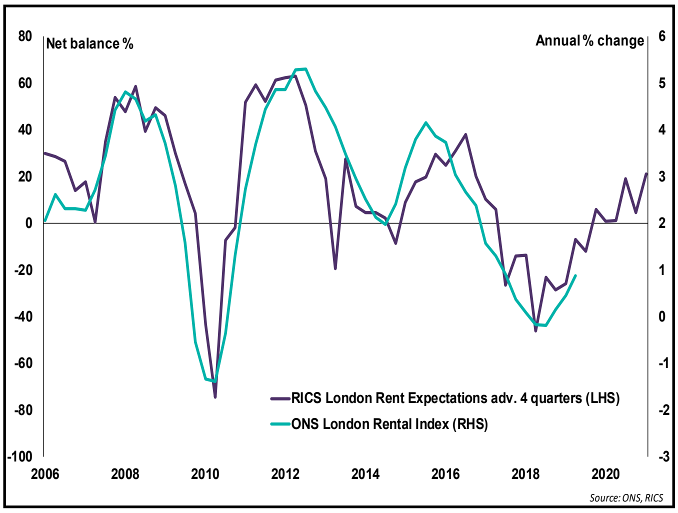


Chart 14: RICS London rental expectations and ONS London private rental index



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