

Executive summary

- The rise in house prices seen in recent months is a false dawn and prices are likely to fall again in the first half of 2010. It is likely to be more than five years before prices rise back to the peak levels of 2007.
- The recent stabilisation in prices largely reflects an acute shortage of available properties, with many homeowners either trapped in negative equity or reluctant to sell for fear of locking in the losses of the past two years. A small number of cash-rich buyers have supported prices, but the supply of these funds is limited so prices are likely to dip again in the first half of next year. A lasting recovery in house prices would only be possible if there is a sustained pickup in demand.
- With the majority of owner occupiers having a mortgage, the state of the mortgage market is a key factor. Mortgage lending remains very depressed, with banks more concerned with strengthening, rather than expanding, their balance sheets. Banks are displaying greater risk aversion by significantly tightening lending criteria, particularly in terms of loan-to-value ratios.
- First-time buyers are being hit particularly hard by this and, given that they typically purchase the cheaper properties, this also has significant implications for those looking to trade up. The number of transactions taking place is low and, with prices and transactions closely correlated, this is inhibiting the usual chain of events where rising prices provide homeowners with the equity to trade up, which itself pushes up prices.
- Banks have also sought to increase spreads across all products, thus offsetting some of the benefits to consumers of low interest rates. Fixed and variable rate products are both considerably more expensive than normal pricing rules suggest they should be, which is also restricting demand.
- Mortgage credit is likely to remain scarce and expensive until banks succeed in rebuilding balance sheets or raising shareholder capital such that they feel sufficiently confident to lend once more. Even then we will not see a return to the high income multiples, high loan-to-value ratios and cheap mortgage finance that householders became accustomed to in the first half of this decade.
- After dipping in the first half of 2010, we expect prices to stagnate over the following two years, before picking up gradually from 2011 as the wider economy strengthens and credit conditions ease. Thereafter we expect the legacy of several years of low levels of house building to be felt, with prices likely to be driven up by supply shortages.
- The southern regions have endured more significant price corrections and will continue to struggle in the short term due to weak affordability and sharp rises in unemployment. However, their prospects for prices are better over the medium term, given the likelihood of stronger population growth and the greater impact of fiscal retrenchment on the northern regions.

Introduction

In recent months there have been signs that the housing market is beginning to stabilise, but we believe that this is a false dawn and that prices are likely to start fall again in the first half of 2010. The latest ONS *General Household Survey* reported that 71% of UK houses are owner occupied, which is one of the highest rates of home ownership in the world and means that the housing market is central to the prospects of the UK economy. Prices fell by in excess of 20% from the onset of the global credit crisis in autumn 2007 and this special report assesses whether the market can recover from its recent woes.

A decade of unprecedented price growth was halted by the banking crisis

The UK housing market stagnated for a lengthy period after the recession of the early-1990s, but the decade from 1996 saw a sustained boom, with prices rising by 227% from trough to peak according to the Halifax. Various factors explain this unprecedented period of price growth, though perhaps the most important were the liberalisation of credit markets and a sustained period of low inflation, which made mortgage credit both easier and cheaper to access. This allowed a bubble to develop, with house price inflation running far ahead of household income growth.

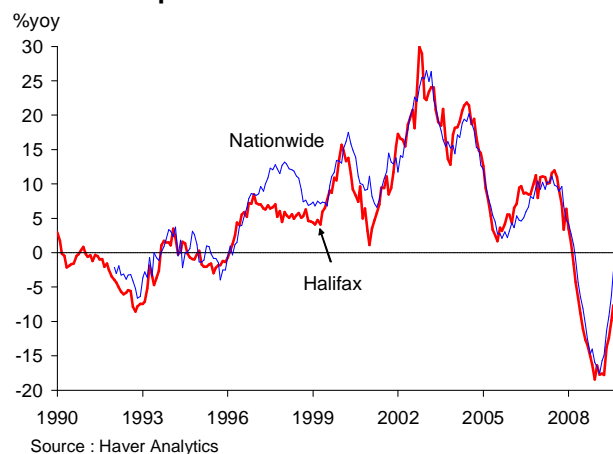
This also created large imbalances, with low affordability preventing first-time buyers from getting onto the property ladder and the rapid expansion of mortgage lending generating a reliance on wholesale markets for funding. UK banks were able to lend more because large excesses of saving in China and others in the Asia-Pacific region, together with a few developed countries including Japan and Germany, were being channelled back through the banking system in the US and Europe. But the banks became reliant on this funding, at the expense of retail deposits, and when interbank lending froze, this source of funding was withdrawn almost overnight. At the same time, the likelihood of large losses in the US sub-prime market was becoming apparent, and the banks responded to these events by significantly reducing lending. Many products were withdrawn, particularly the riskier high loan-to-value mortgages, and the cost of mortgage products was also increased, both through higher interest rates and increased fees.

The effect of this was to trigger a collapse in activity and a rapid decline in house prices. From their peak in autumn 2007 until this summer, prices fell by 20% or more on all of the main indices, though the growth in house prices had been so rapid in the preceding period that this only moved prices back to 2004 levels. The number of new mortgage approvals in 2008 was just two-fifths of the previous year, while residential property transactions fell by 43%.

Recent months have seen increasing signs of stabilisation...

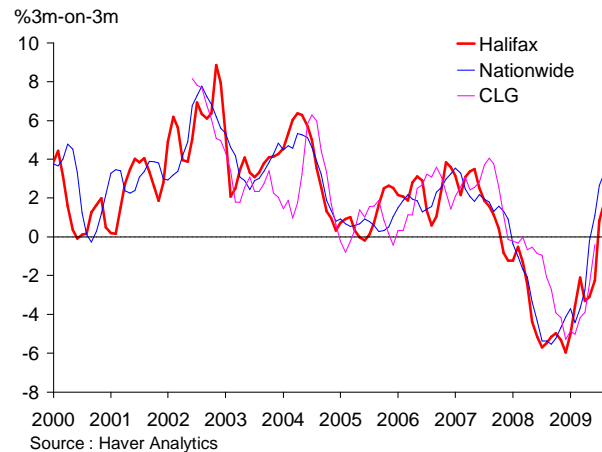
However, the last few months have seen growing evidence of stabilisation in the housing market, particularly in terms of prices. Both the Halifax and Nationwide indices were falling at a rate of more than 5% a quarter through the second half of 2008, but this year has seen a steady improvement culminating in both surveys reporting prices rising on a 3-month-on-3-month basis from July. As always these indices should be interpreted in the knowledge that they

UK: House prices



only cover mortgage lending to their own customers which, given the low level of transactions across the market, represents a very small sample, but history suggests that they tend to behave consistently with other housing market indicators. Indeed, the CLG index – which has a much broader sample – is also reporting improved results, albeit the latest month (June) is still showing modest price falls on a 3-month-on-3-month basis. However, given the time lag implicit in the different measures – CLG analyse prices at the completion stage, in contrast to the Nationwide and Halifax measures which record prices at the point at which the mortgage is approved – we would expect to see recent buoyancy in the lenders' indices replicated in the CLG data in the next couple of months.

UK: House prices

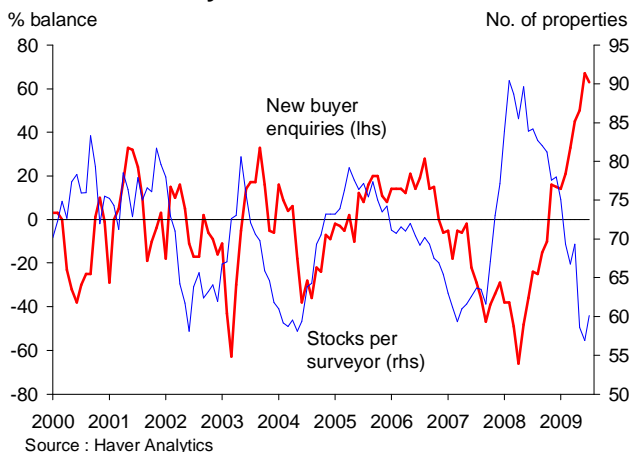


...reflecting an acute shortage of housing supply

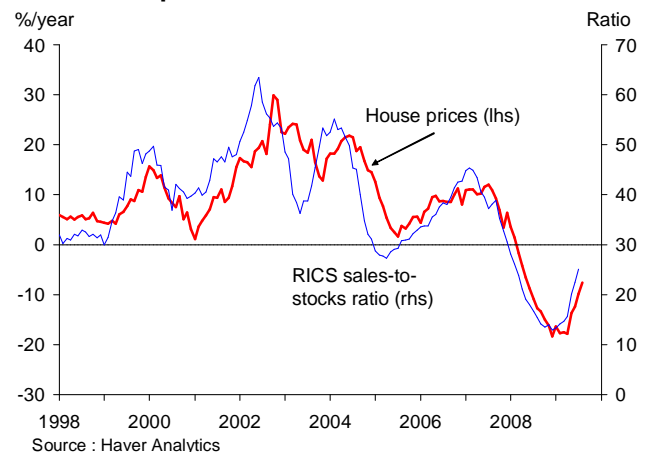
The stabilisation in prices is partly a function of a pickup in buyer interest, with RICS reporting that new buyer enquiries have been rising at the fastest rate on record in recent months. These are typically cash-rich buyers, to whom housing looks attractive given the sharp declines in prices over the past eighteen months and the low interest rates that their money would attract in the bank.

However, the most important factor is the very low level of housing supply. RICS has reported a progressive decline in new instructions, pushing the number of available properties per surveyor in June down to its lowest level since the survey began in 1978. There are a number of reasons for the severe supply shortage. Some homeowners are either trapped in negative equity or reluctant to sell for fear of locking in the losses of the past two years. Others prefer to stay on existing variable rate mortgage deals, rather than move to new, less attractive, deals. The low level of interest rates and the reluctance of lenders to foreclose has also limited the number of repossessed properties coming available.

UK: RICS survey



UK: House prices & sales-to-stocks ratio



This interplay of very low supply and strengthening demand is gradually increasing the ratio of sales-to-stocks and history suggests that this ratio is closely correlated with annual house price inflation. However, it is highly debatable as to whether these trends will be sustained. The capacity of these cash buyers is limited by their reserves of cash, while rising prices could itself attract a greater number of properties onto the market. A lasting recovery in house prices would only be possible if it is accompanied by a sustained pickup in demand, driving up the number of housing transactions taking place.

Mortgage availability remains severely restricted...

Given that 56% of owner occupiers have a mortgage, it would be difficult to make a case for a sustained pickup in prices without a recovery in mortgage lending, but this would still appear to be some way off. Though one of the aims of the Bank of England's programme of quantitative easing is to stimulate bank lending, thus far banks appear more concerned with strengthening, rather than expanding, their balance sheets.

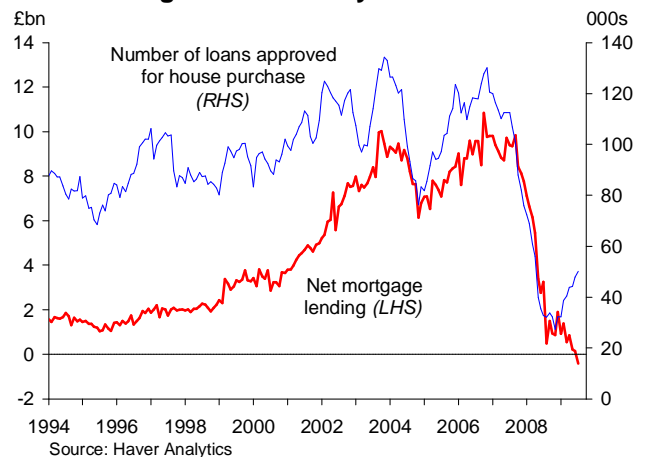
As a result mortgage lending remains very depressed.

Though the number of new mortgage approvals for home purchase has edged up steadily over the past six months, the total remains barely half the average of the past decade. And the flow of lending is very weak, with households repaying a net £400million of mortgage debt in July, the first net repayment since records began in 1993.

Though demand for credit is more subdued than it would be in less challenging times, the scarcity of mortgage supply is the main factor. Banks have severely restricted the amount of money that they are willing to lend, as

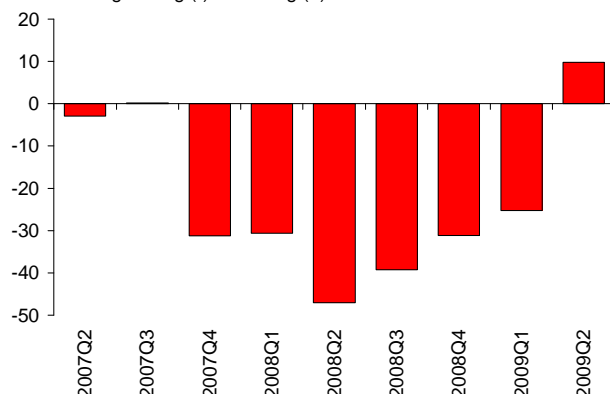
highlighted by the Bank of England's *Credit Conditions Survey*, which reported six successive quarters of significant tightening in mortgage availability, before a very modest increase in Q2. Banks have lost securitisation as a source of mortgage funding and this has been compounded by balance sheet pressures, caused by the massive write downs of the past year and the prospect of further rises in default rates as the full impact of the recession feeds through.

UK: Housing market activity



UK: Mortgage availability

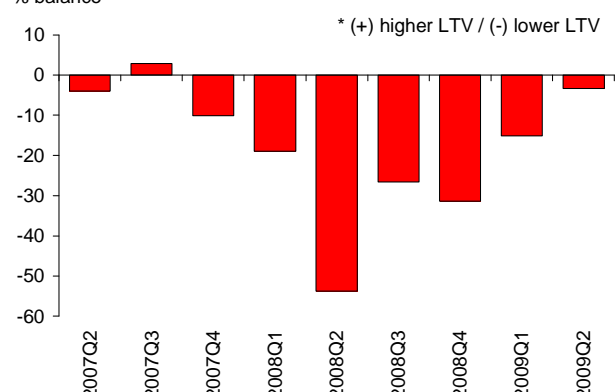
% balance tightening (-)/loosening (+) credit



Source : Bank of England Credit Conditions Survey

UK: Loan-to-value ratios

% balance*



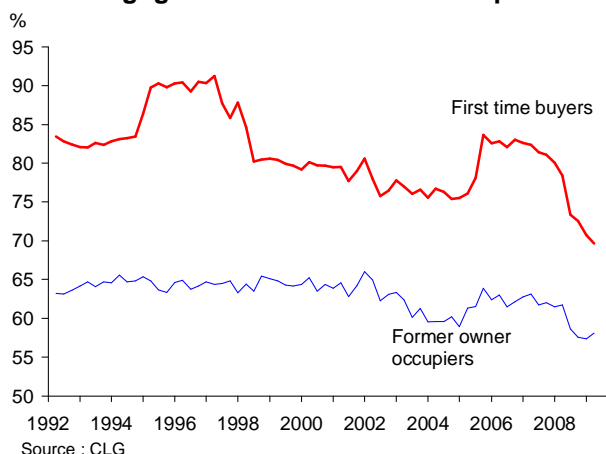
Source : Bank of England Credit Conditions Survey

In addition to restricting the supply of mortgages, the banks are also displaying greater risk aversion by tightening lending criteria. This is most clearly seen in terms of loan-to-value (LTV) ratios, which the *Credit Conditions Survey* suggests have been progressively tightened for the past seven quarters. Very few of the riskier 90% loan-to-value mortgages are still available – in contrast to some examples of loan-to-value ratios in excess of 100% prior to the banking crisis – and those which are available have significantly increased in cost compared with lower loan-to-value products. This is affecting not only those who are in negative equity, but also those who have significant equity in their homes who find the LTV now being asked is too demanding.

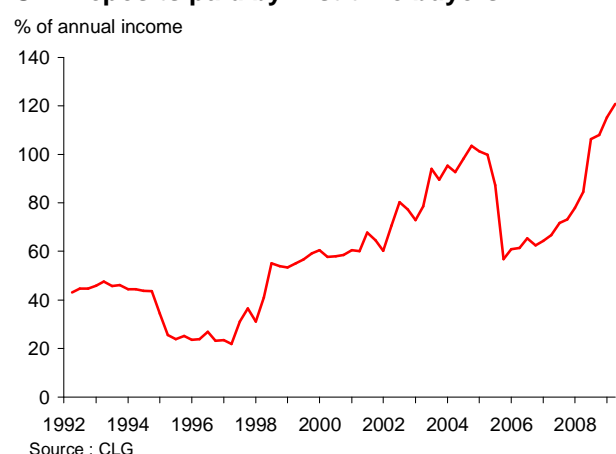
...with first-time buyers particularly badly hit

First-time buyers typically have higher LTV ratios so they are being hit particularly hard by the tightening of lending criteria. Prior to the onset of the banking crisis in 2007, first-time buyers were accessing mortgages worth on average 83% of the purchase price of their properties, but this has dropped rapidly to less than 70% in 2009Q2. At the same time they have been forced to find even larger deposits, with the average first-time buyer requiring a deposit equal to 121% of their annual income in 2009Q2.

UK: Mortgage advance as % of house price

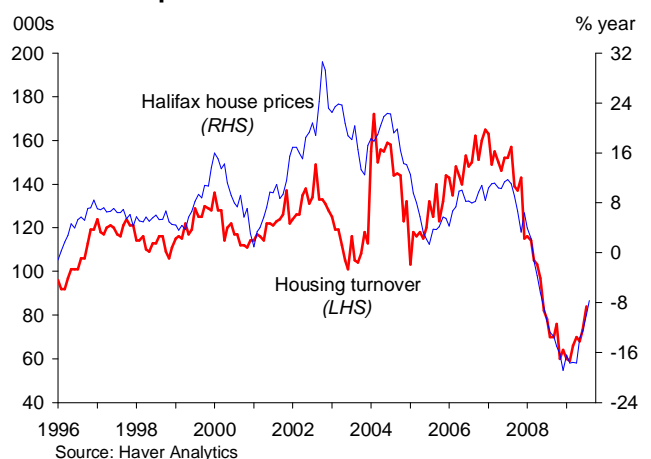


UK: Deposits paid by first-time buyers



This is significantly reducing the number of first-time buyers who are able to enter the market which, given that they typically purchase the cheaper properties, will have significant implications for those looking to trade up. This has the effect of clogging up the market and holding down the number of transactions taking place. With prices and transactions closely correlated, as shown on the chart to the right, this is inhibiting the usual chain of events where rising prices provide homeowners with the equity to trade up, which itself pushes up prices. Therefore, in order for the housing market to function properly it is essential that moves are made to bring first-time buyers back into the market, else the current status quo of a low number of transactions, dominated by speculative cash buyers, is likely to be maintained.

UK: House prices and turnover

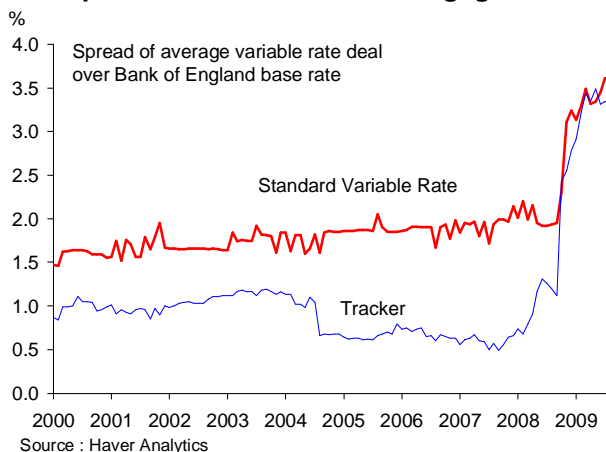


Those mortgages which are available are relatively costly

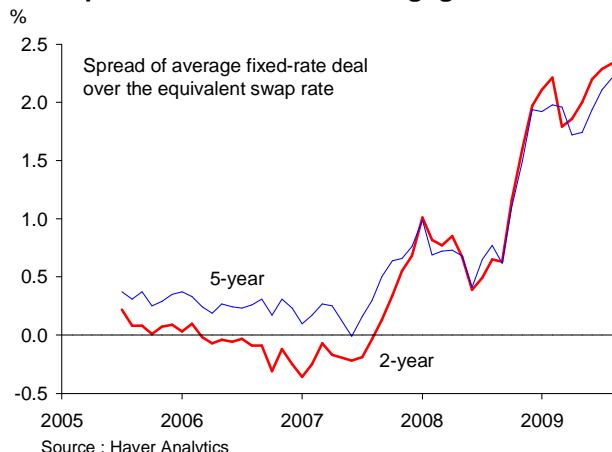
The cost of mortgages is also constraining demand, with banks increasing spreads across all products, thus offsetting some of the benefits of low interest rates to homeowners. As the Bank of England reduced base rates from 5% in early-October to 0.5% in March, the banks passed on progressively smaller proportions of the cuts into their Standard Variable Rate (SVR). As such, the spread between the average SVR of UK banks and building societies and the Bank of England base rate has risen from 195bp in October to 360bp in August. Though earlier in the year banks could justifiably point to the fact that Libor rates were considerably higher than the base rate, this is no longer the case and indeed 3-month Libor has fallen sharply over the past two months, while the average SVR has actually increased.

At the same time the deals available for new mortgages and remortgaging are much less attractive than before, both in terms of tracker and fixed rate mortgages. In August, the average rate available on a tracker deal was more than 330bp above the Bank of England base rate, compared with an average spread of 90bp between 2000 and 2007. Similarly, the spread between the average fixed rate deal and equivalent swap rate – the rate which banks pay to borrow fixed rate funds in wholesale markets – has widened significantly across all LTV ratios. For a two-year fixed rate deal on a LTV ratio of up to 75% the spread over two-year swap rates averaged zero in 2006-7, yet the spread in August 2009 was in excess of 230bp.

UK: Spreads on variable rate mortgages



UK: Spreads on fixed rate mortgages



This has obvious dampening effects on demand from new customers, but it will also have implications for existing customers. While customers, whose existing fixed rate and tracker deals have expired and reverted to the SVR, are happy at present, they will be less so once base rates have begun to increase again, particularly if – as we expect – lenders seek to maintain current spreads and fully pass on any future base rate rises. And unless homeowners have a portable mortgage deal, the less attractive deals now available act as a disincentive to move.

While mortgage funding is so scarce and expensive it is difficult to make a case for any sustainable recovery in house prices. And the situation is unlikely to change materially until banks succeed in rebuilding balance sheets or raising shareholder capital such that they feel sufficiently confident to lend once more. But even then, with banks having to place a greater reliance on retail deposits as a source of funding, we will not see a return to the high income multiples, high LTV ratios and cheap mortgage finance that householders became accustomed to in the first half of this decade, which is likely to result in a more stable market and a much lower level of transactions over the medium term.

Rising unemployment will have a dampening effect...

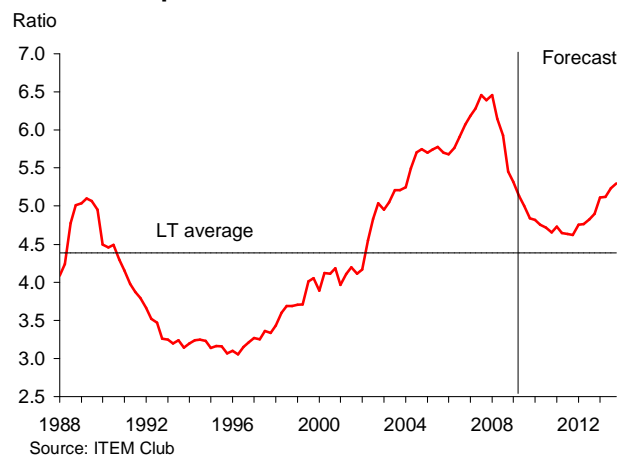
The state of the wider economy, in particular the labour market, will also be unsupportive to house prices over the next couple of years. Unemployment has already increased from 4.7% to 7.8% on the ILO definition and our forecast shows it peaking at 8.8% or 2.76 million next spring. Though this is somewhat lower than the massive drop in output over the past year had suggested might be the case, this is largely because the flexibility of the labour market has ensured that some of the pain has been shared in earnings rather than just employment levels. And earnings growth is likely to remain subdued, given the likelihood of a prolonged period of below target inflation.

The combination of rising joblessness and weak earnings growth is bad news for the housing market. The threat of unemployment encourages consumers to save more and to pay down debt, rather than add to their existing burden. The uncertainty also discourages consumers from committing to big decisions such as buying a house.

The weakness of earnings growth has also meant that, despite the sharp drop in house prices, affordability has not improved to any great extent. The house price to income ratio now stands at 5.0, below the peak of 2007 but still substantially higher than the average of the past twenty years which stands at 4.4. Indeed, our

assessment of the 'fair value' for house prices – which takes into account variables such as unemployment and household incomes, as well as interest rates, demographics and housing supply – suggests that prices are now just 5% undervalued. Though this compares with an overvaluation of 12% at the beginning of last year, it does suggest that there is less scope for a bargain than there had been at the bottom of the previous house price cycle. At a time when lenders are tightening lending criteria, including income multiples, the combination of low affordability and a subdued labour market will prevent any significant take off in house prices.

UK: House price to income ratio



...as will higher default rates

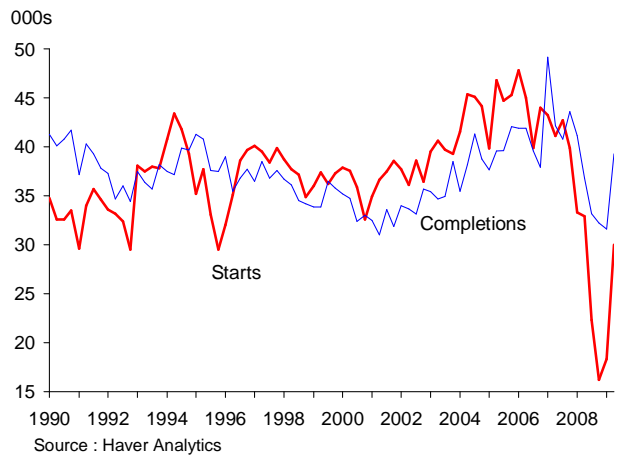
Thus far repossessions have been much lower than in the property slump of the early 1990s; in late-1991 repossessions peaked at almost 20,000 per quarter, yet this time around the high point has been 12,700 in the first quarter of this year, since when they have actually fallen. This partly reflects the influence of low interest rates, but it is also a function of lenders' reluctance to foreclose and crystallise a loss, for fear of damaging their regulatory capital positions.

Though these factors will remain in play for the foreseeable future, which should ensure that the peak in repossessions is considerably lower than in the early 1990s, the spectre of rising unemployment is likely to put upward pressure on default rates, which are likely to remain above-average for some time to come. This will maintain the pressure on banks' balance sheets, reinforcing the disincentives to lend. And given that repossession sales almost always occur at steep discounts, it should have a dampening effect on prices.

Low levels of house building should support prices in the medium term

Though a number of demand-related factors will continue to weigh on house prices, the collapse in house building over the past two years has the potential to provide some support over the medium term. UK housing starts were down 37% in 2008 and though the more timely figures for England show a recovery in the first half of this year, they remain well down on the long-term average. Furthermore, the period of robust house building over the first half of this decade generated an imbalance in supply, with density requirements and site availability driving a city centre apartment building boom which has seen many flats left unsold.

England: Housing starts & completions

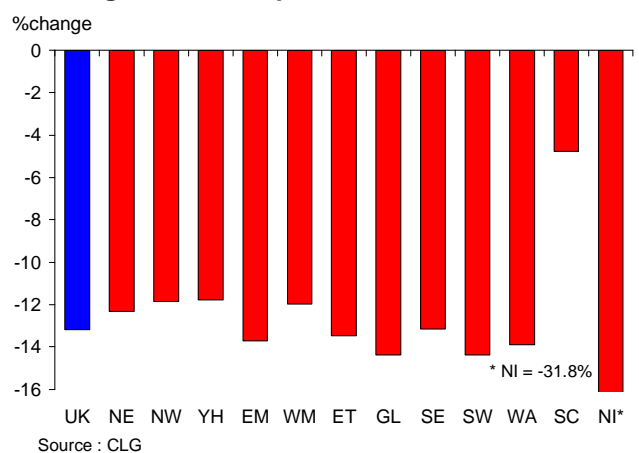


In 2007 the government announced that it planned to build 240,000 new homes every year to 2016 to cater for a growing population. Our own forecasts assume much weaker migration in the future, so our estimation of the number of new homes required is a little lower. However, with just 175,000 completed last year – and even fewer likely to be completed this year, given how weak housing starts have been – it is clear that house building has already fallen some way behind schedule. Furthermore, with the housing market only now beginning to turn there is still little incentive for private house builders to step up building, or for the banks to supply the finance for large scale projects, suggesting that the government's target is likely to be undershot for a number of years. The cumulative effect of successive shortfalls in new house building points to the prospect of tight supply conditions over the medium term, which should help to support prices.

Significant regional disparities likely to persist

Though no regions have been exempt from falling prices, the crash was not distributed evenly and the early signs suggest that the recovery will be similarly unbalanced. Aside from Northern Ireland – which experienced an extraordinary boom and slump, seemingly divorced from trends elsewhere in the UK – the largest declines over the two years to 2009Q2 were in the south of England, in particular Greater London and South West. In part this reflects the unwinding of the previous surge, with these areas having enjoyed the strongest gains in the mini-boom of 2006/7, but they are also characterised by very high price-to-income ratios and, in the case of London in particular, a reliance on City bonuses to underpin demand. By some distance, Scotland has been the least affected, reflecting its position as the most affordable region of the UK.

UK: Regional house prices, 2007Q3-2009Q2



In the short-term the regional pattern is likely to continue along similar lines. Areas of southern England are likely to lag the national upturn because, with affordability so stretched, first-time buyers face a greater struggle to enter the market, while existing homeowners find it much harder to conform to the LTV standards currently demanded by

lenders. These regions are also likely to suffer the largest uplifts in unemployment, given their relatively larger exposure to the financial and business services sectors.

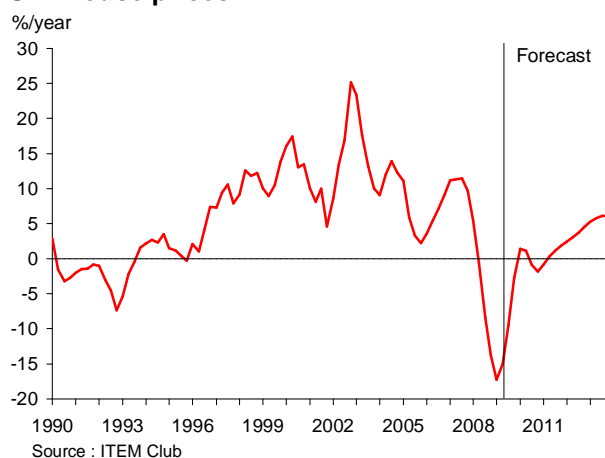
However, over the medium term we would expect the southern regions to prosper ahead of the rest of the UK. This is because these areas tend to attract the highest levels of inward migration, in contrast to many parts of the north of England where population levels are likely to stagnate or even decline. The government has acknowledged these trends in planning the majority of new house building in the south, but with land scarce and RDAs struggling to accommodate the volume of housing required, there is potential for supply pressures to build. Demand factors will also favour the south over the medium term, with northern regions typically having a greater reliance on the public sector, making them vulnerable to the more austere regime likely to be implemented after next year's election.

Conclusion

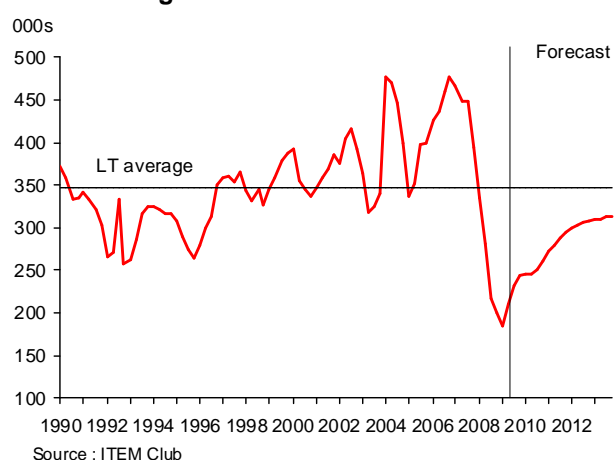
After two years of substantial price falls, the housing market appears to be stabilising. However, this is largely due to a short-term imbalance between supply and demand, caused by an acute shortage of available properties. With mortgage lending very depressed, the market is being supported by a small number of cash-rich buyers, for whom housing has become more attractive given improved affordability and the poor interest rates that their money would attract in a bank. However, the supply of these funds is limited and the fundamentals which underpin housing demand remain unsupportive. Therefore, after a brief recovery over the second half of this year, we expect prices to dip again in the first half of next year.

The state of the mortgage market is the key factor. Mortgage lending remains very depressed, with first-time buyers finding it harder than ever to break into the market and the cost of credit is not significantly lower than last year, despite official interest rates being slashed. This situation is unlikely to change materially until banks succeed in rebuilding balance sheets or raising shareholder capital such that they feel sufficiently confident to lend once more. Without a sustained increase in mortgage lending, transaction levels will remain low, which is likely to result in a much more stable market and more subdued price growth. Our forecast shows prices stagnating over the next two years, before picking up gradually from 2011 as the wider economy strengthens and credit conditions begin to ease.

UK: House prices



UK: Housing turnover



Thereafter we expect the legacy of several years of low levels of house building to be felt, with prices likely to be supported by supply shortages, particularly in parts of southern England where in-migration levels are at their highest. However, it is likely to be more than five years before prices rise back to the peak levels of 2007.