CB RICHARD ELLIS | MONTHLY VIEW

UK Residential Property Market: How low will it go?

20th November 2008

MARKET COMMENT

The housing market continues its downward trajectory. Our latest forecasts suggest that house prices will fall by around 30% from peak to trough and prices may not return to their 2007 levels until 2016.

"At the trough, average house prices will be in the region of £130,000; equivalent to levels last seen in 2003."

"Investors may help the market recover more quickly. As house prices fall the cost of mortgages will re-align with rents. With rental yields improving, investors will be persuaded into the market."

Jennet Siebrits, Head of Residential Research

The housing market continues to make headlines with prices falling at record rates. According to the Nationwide average house prices currently stand at around £159,000, which compares with the peak of £186,000 a year ago. The fall has been more rapid than in the 1990s crash. With increasing affordability constraints, the correction in the housing market is long overdue. However, the ongoing problems in the financial system are undoubtedly affecting the severity of the downturn. In this paper we examine the potential depth and length of the downturn.

House prices up to a third overvalued

We have considered three measures to determine the extent of overvaluation in the housing market. These are:

- Long term trends in real house prices;
- House price to earnings ratio;
- Interest payments as a percentage of income;

Perhaps surprisingly, these measures all provide relatively similar results. For example, based on affordability (the house price to earnings ratio and interest payments as a percentage of income measures) house prices were between 26% and 32% overvalued at the peak in October 2007. Historic trends suggest a similar level of over-valuation with the peak in house prices around 31% above trend value. Although house prices have already fallen by 14.6% from the peak, this suggests significant further falls to see a return to "fair value".

HOW OVERVALUED WERE REAL HOUSE PRICES AT PEAK?

Basis of Calculation	Influence	Overvalued at peak
Interest as % Income	House prices, Interest and Mortgage rates, Income.	32%
HP:E Ratio	Earnings, GDP	26%
Trends	Historic performance	31%

HISTORIC HOUSE PRICE TRENDS

Source: Nationwide

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However, value is only one driver of house prices…

The future path of housing market also depends on a number of economic factors. These include credit market developments, the economic downturn, consumer sentiment, and interest rates.

As the Bank of England's inflation report states we are yet to see the full economic fallout from the credit crunch. In the short-term credit constraints are inhibiting potential buyers. In the longer term lending criteria are likely to remain tighter, which will hamper demand.

Just as importantly we are now entering a recession. Various forecasts suggest the UK economy could shrink by between 1% and 2% in 2009 with inflation as low as 1% by 2010. Unemployment is expected to rise to two million by Christmas and will continue to rise thereafter. With this poor economic backdrop we will see further downward pressure on house prices.

In addition, underlying sentiment is very important; in a downward market consumers are reluctant to buy for fear of prices falling further. This can lead to prices over-correcting and falling below trend. In the 90s crash house prices significantly overcorrected with house prices falling by a fifth below trend.

So how low could it go?

This prognosis suggests house prices could significantly undershoot fair-value and fall by as much as 40% from peak to trough. However, we do not expect such a large correction.

Lower interest rates…

The MPC have already cut interest rates by 2% since October. With the prospect of lower inflation we expect further cuts. This will be beneficial for the housing market if they are translated through to lower mortgage rates.

Underlying housing shortage…

Historically housing completions have largely kept up with the household formation. However, over the last decade or so this has not been the case – as population growth has outstripped construction. The resulting demand and supply imbalance is partly responsible for the latest boom in prices. In the current slump housebuilding has slumped; as demand slowly returns, these supply pressures will mount and drive up prices.

And investors will return

Buy-to-let is often cited as the cause of all ills in the housing market. In contrast, investors may help the market recover faster than it otherwise would have. In recent years, high house prices have meant mortgage costs are in excess of rents so investors have been dependent on capital growth. However, as house prices fall the cost of mortgage payments will re-align with rents. As rental yields improve investors will be persuaded into the market – even without the prospect of immediate capital growth.

Our view?

Taking all these factors into account we expect house prices to fall by 30% from peak to trough. This will mean that at the crater, average house prices will be in the region of £130,000; equivalent to levels last seen in 2003. But, we do not expect a quick turnaround. In the '90s it took nearly nine years for prices to return to their previous peak. If this downturn followed a similar timeline prices would not return to the 2007 peak level until 2016. Some commentators argue this downturn will be deeper and faster to recover than the last. We think the economic outlook precludes this. Although we expect to reach the crater fairly rapidly – by perhaps the beginning of 2010, we expect a significant period of stagnation.

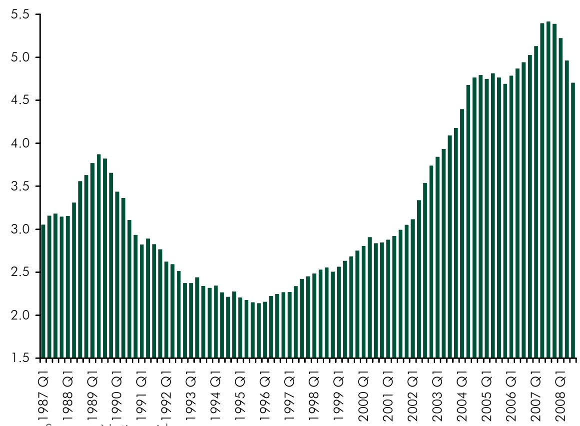
Strong negative sentiment in the derivatives market

Pricing in the derivatives market implies further falls in house prices of around 35% over the next three years. This is on top of 16.4% falls since August 2007 (according to Halifax HPI Index). This is higher than even our worst case scenario. The current high degree of negative sentiment in the market is certainly being translated into pricing. And, historically derivatives have tended to over and undershoot the peaks and troughs.

CHART 1: A COMPARISON OF NOMINAL HOUSE PRICE GROWTH IN LAST CRASH WITH THIS CRASH

Source: CB Richard Ellis; Nationwide

CHART 2: FIRST TIME BUYER HOUSE PRICE TO EARNINGS RATIO



Source: Nationwide

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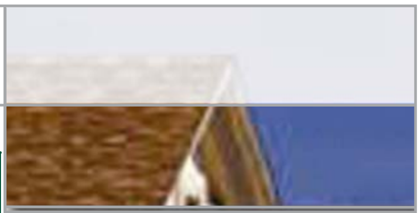

TABLE 1: HOUSING MARKET SUMMARY

	Period	Figure	% Change pcm	% Change pa	Comment	Expected Date of next release
Nationwide House Price Index	Oct	£158,872	-1.4%	-14.6%	House prices are £30k less than in Oct 07	28/11/2008
Halifax House Price Index	Oct	£168,176	-2.2%	-13.7%	House prices have returned to 2005 levels	05/12/2008
Mortgage Approvals	Sep	33,000	3.1%	-67.3%	The 2nd lowest level since records began	01/12/2008
Transactions	Sep	59,000	-2.7%	-53.4%		Nov-08
Repossession	H1 07	18,900	n/a	47.7%	This is 0.16% of all loans	2009
Gross Mortgage Lending	Sep	£17.7bn	-10.0%	-42.0%	Lowest monthly figure since Jan '05	20/11/2008
Interest Rates	6th Nov	3%			A 150 basis point cut. This is the lowest IR since 1955 and the largest cut since 1981	04/12/2008
CPI	Sep	5.2%			Rising from 4.2% in Aug	18/11/2008
GDP	Q3 08	-0.5%			Falling from 0% growth in Q2 2008	Jan-09
Un-employment	3m to Sep 08	5.8%			1.82m unemployed; the highest number in 11 years. Unemployment rose by 140k in the last quarter	Nov-08

Other important dates:

- **Pre-Budget Report** –24th November 2008
- **Crosby Review** – 24th November 2008
- **Release of the Bank of England's Latest Statistics** – 1st December 2008.
- **Bank of England Quarterly Bulletin** – 15th December 2008.

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