SPOTLIGHT
Savills Research

Revisions to our mainstream residential market forecasts

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The significant impact of Covid-19

We published our first note on coronavirus and the housing market in March assuming a short-lived but significant economic downturn, where unemployment spiked but fell back relatively rapidly with a limited long term impact on the economy.

Given low levels of price growth in the run up to the crisis, very low costs of debt, significant short-term government support for jobs and lender forbearance we expected that falls in the average value of the UK home to be contained to 5-10%. However, we did not have enough information to be confident in being more specific than that. At the time it was unclear how long and to what extent social distancing would restrict activity in the housing market. But it was clear that there would be a significant impact on transaction levels in the short term.

A lot has happened since then.

Table 1 Revised transaction forecasts

	2019	2020	2021	2022	2023	2024
GDP	1.4%	-8.3%	7.8%	3.4%	1.5%	1.7%
Unemployment	3.8%	6.4%	4.3%	3.9%	3.7%	3.6%
Transactions	1,177,000	775,000	1,083,000	1,330,000	1,187,000	1,186,000
Change vs Nov-19 forecast	0%	-36%	-10%	+12%	0%	0%

Source: Savills Research, Oxford Economics

Table 2 Revised five-year forecast values

Mainstream residential price forecasts

	2020	2021	2022	2023	2024	5-year
North West	-7.5%	8.5%	9.0%	7.0%	6.0%	24.1%
Yorkshire & The Humber	-7.5%	3.0%	10.0%	8.0%	7.0%	21.1%
Scotland	-7.5%	7.0%	8.5%	6.0%	5.5%	20.1%
North East	-7.5%	2.0%	10.0%	8.0%	7.0%	19.9%
East Midlands	-7.5%	7.0%	7.5%	5.5%	5.5%	18.4%
West Midlands	-7.5%	2.0%	10.0%	7.0%	6.5%	18.3%
Wales	-7.5%	2.0%	10.0%	7.0%	6.0%	17.7%
South West	-7.5%	3.0%	8.0%	5.5%	4.0%	12.9%
South East and East	-7.5%	8.0%	5.5%	2.5%	2.5%	10.7%
London	-7.5%	6.0%	3.0%	1.5%	1.5%	4.0%
UK	-7.5%	5.0%	8.0%	5.0%	4.5%	15.1%

Source: Savills Research

N.B. These forecasts apply to average prices in the second hand market. New Build values may not move at the same rate.

KEY STATISTICS

Economic backdrop
GDP set to fall -8.3% this year, but with a rebound in 2021

Transaction activity
has fallen sharply, but will be back to normal levels by end-2021

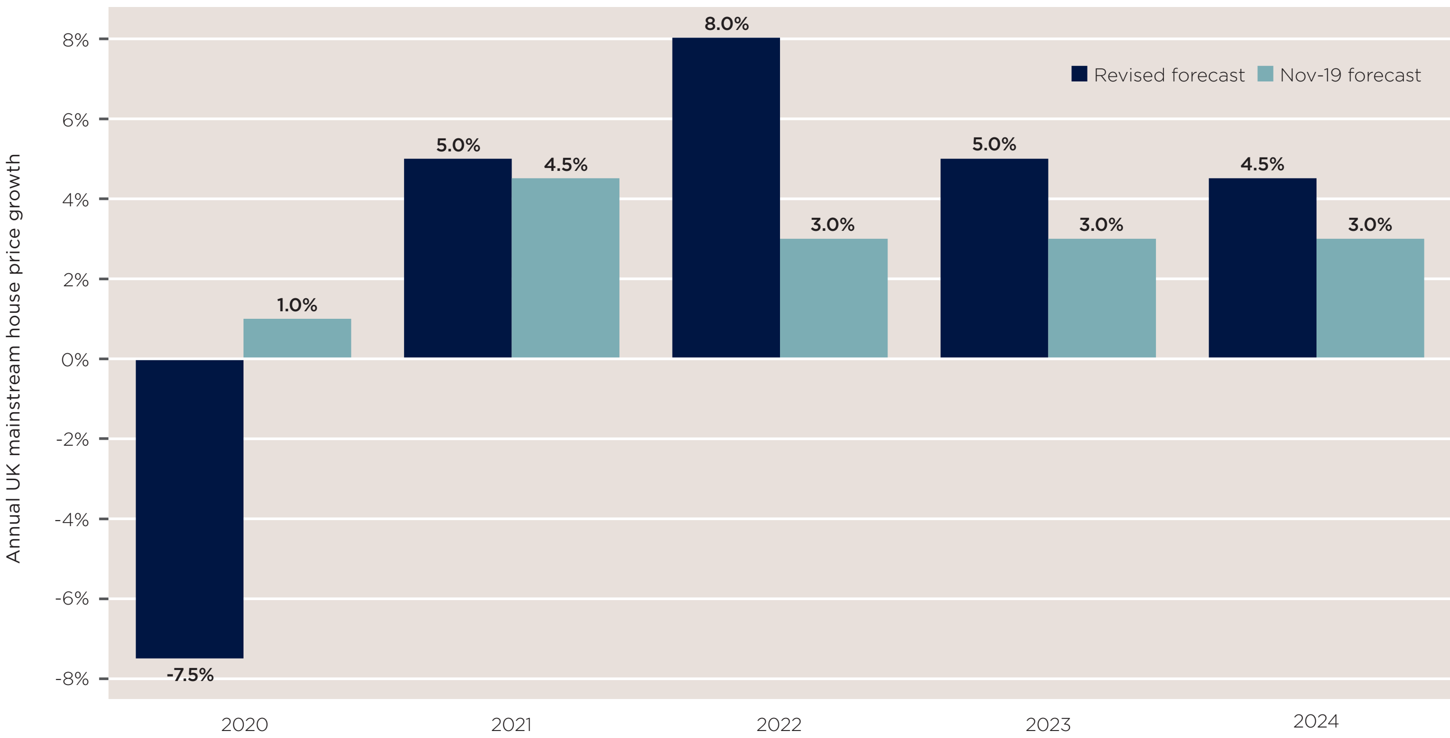
Mainstream
Our 5-year forecasts remain unchanged, but with changes to how growth unfolds year by year

Rents
tend to be more robust than prices; the link with income growth will continue

Development
will slow as construction sites adjust to social distancing

The Bank of England base rate is expected to remain at just 0.1% until 2022 Q2 and rise gradually thereafter

Figure 1 Previous and revised mainstream house price growth forecasts



Source: Savills Research

N.B. These forecasts apply to average prices in the second hand market. New Build values may not move at the same rate.

Two months of lockdown

It has become evident that the short term economic impact will be much greater than originally anticipated. The ONS has estimated that the economy contracted by 5.8% in March alone. Most forecasters have therefore downgraded their forecasts for the second quarter; substantially so in some cases.

Forecasters have also become more cautious over the ability of the economy to bounce back quickly. Expectations of a later, more gradual recovery are more widespread. Downside scenarios show much higher levels of unemployment that take longer to return to pre-Covid levels.

Subject to adopting a series of safe-working practices, the government has allowed the housing market in England to be reopened. This has eased the practical constraints on moving, meaning transactions will reflect people's appetite to move, rather than their ability to do so. In Scotland, restrictions on housing moves are expected to be relaxed on 18th June; Wales will announce whether home sales can resume on the same date.

Taken together that means we have revisited our house price and transaction forecasts, looking at how this might play out regionally. We will publish revised prime market forecasts following the release of our Q2 indices later this month.

The economic backdrop

Our housing market forecasts are based on the economic forecasts provided by Oxford Economics.

In the baseline scenario they published on 21st May, GDP falls of -2.0% in Q1 are followed by a further -14.0% fall in the second quarter of the year. Growth rebounds by 6.5% in Q3 , followed by 4.7% growth in Q4, bringing GDP falls to -8.3% over the course of the year.

The Bank of England base rate is expected to remain at just 0.1% until 2022 Q2 and rise only gradually thereafter. This means repayment affordability is highly unlikely to be a catalyst for house price falls for those with a stable income.

Oxford Economics also predicts that unemployment will rise to a peak of 6.5% in the third quarter of 2020, returning below 4.0% by 2022. While this represents an additional 860,000 people out of work, it is important to note this unemployment rate is still lower than the five years following the Global Financial Crisis.

“The housing market in England reopened on 13th May, meaning transactions will reflect people's appetite to move, not their ability to do so”

Figure 2 Long-term trends in unemployment rate (International Labour Organization definition)

Source: Oxford Economics

Impact on transaction activity

For the seven and a half weeks from 23rd March to 13th May, the housing market was effectively in lockdown. Transaction activity over this period was severely suppressed. The latest data from HMRC suggests there were just 38,000 transactions in April, -55% below the five year average. Many of these sales would have exchanged before lockdown began.

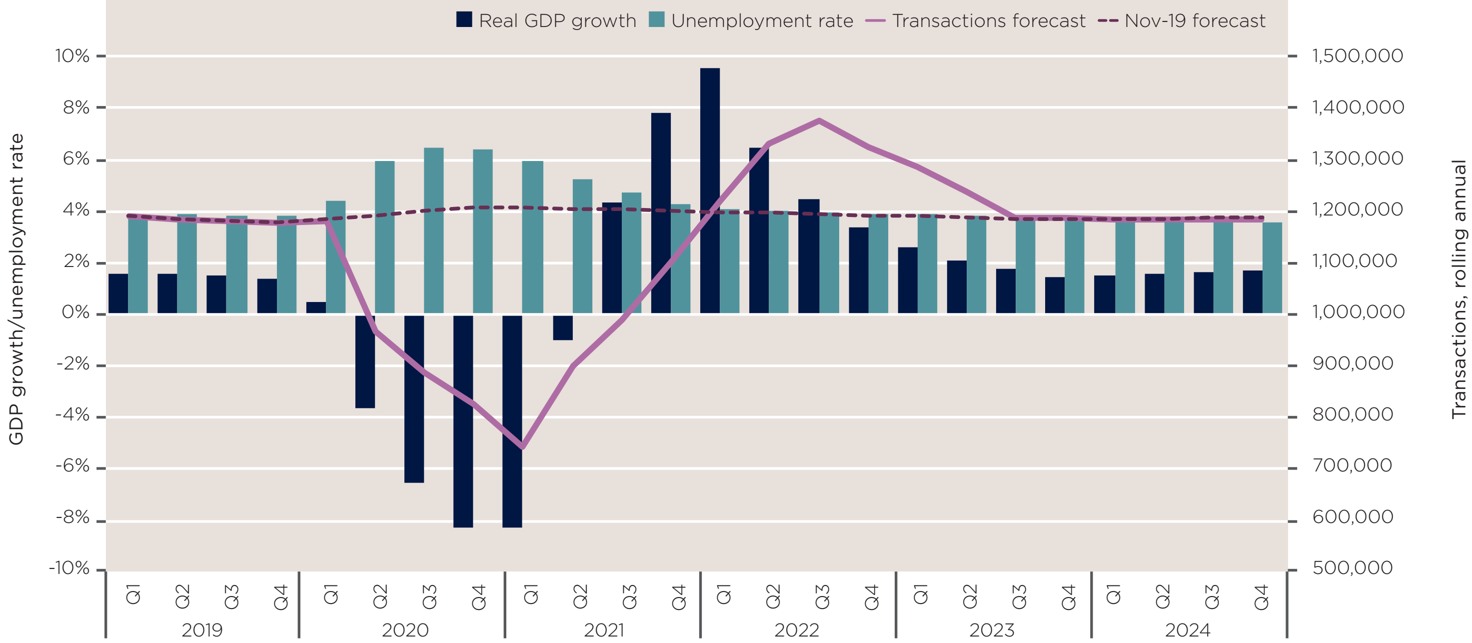
In the short term, weak consumer sentiment will limit any bounce in activity following the housing market reopening. Over the coming years a higher unemployment rate will impact perceptions of employment and financial security, which hold the key to both house prices and transactions.

We are currently seeing a release of pent-up demand, which may trigger a brief spike in transactions in England over the summer. But uncertainty around values and rising unemployment will add to lender caution, particularly when lending at higher loan to value and loan to income ratios. The risk of a 'hard Brexit' at the end of the year may weaken business appetite to recruit more staff, slowing any rebound in employment.

We predict completed transactions will remain low at 25% of the five-year average over the second quarter of 2020. However, the reopening of the housing market in England for viewings and transactions on 13th May, together with a pick up in sales agreed since then, gives us confidence that activity should be able to recover gradually over the second half of the year.

We expect transactions to return to normal levels by 2021 Q3, followed by a year with more transactions than normal as we work through the pent up demand that accumulated during 2020.

Figure 3 Transaction forecasts in the context of GDP and unemployment



Source: Savills Research, Oxford Economics

Impact on mainstream residential values

In March we predicted UK average house prices would fall between -5% and -10% over the course of 2020. At this stage, we believe falls are likely to lie around the middle of that range, -7.5%. This would be less than half the level of falls seen in both the early 1990s recession and in the wake of the Global Financial Crisis.

What, then, of the capacity for price growth over the next five years? Here there is a trade-off between the lower earnings growth than we previously expected and the lower cost of debt. Despite lower medium term economic and earnings growth, lower interest rate expectations mean mortgage repayment affordability is actually expected to be better by 2024 than we predicted in November last year. While lenders bruised by mortgage payment holidays may be more cautious in the short term, appetite to lend will return once the economy enters recovery and unemployment starts to fall.

We must also consider what's happened to people's ability to save for a deposit. While lower interest rates mean mortgage repayments may shrink, so too will interest paid on savings. Many investments in stocks and shares will have lost value during the crisis. And households facing furlough or unemployment may have had to dip into savings to subsidise their fixed costs. On the other hand, households with stable incomes have been able to increase how much they save.

This means while there is capacity for a fairly significant bounce in house prices at some point in the next five years, it will only occur once consumer, business and lender confidence improves.

Regional variation

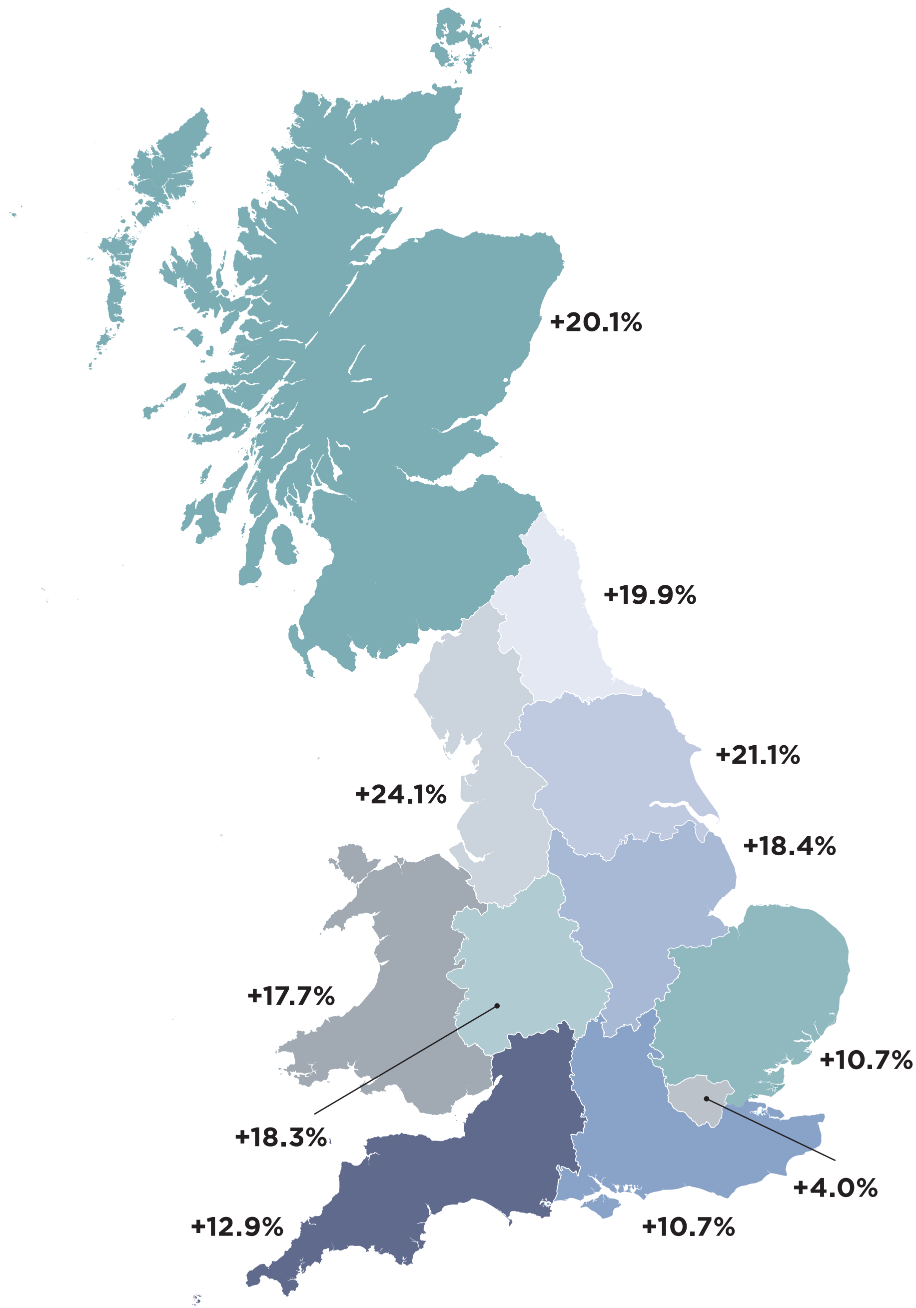
We expect short term house price movements to be relatively uniform across the UK, with similar downward pressures on prices and transactions in 2020. However, we do expect the pace of subsequent recovery to vary.

At this stage in the housing market cycle, we would normally expect the Midlands, North, Wales and Scotland to perform strongest, with slower growth in London and the South where values rose faster in the decade preceding the EU referendum. Covid has the potential to change that dynamic in the short term.

Different employment sectors have faced different challenges during lockdown. For some sectors, such as Professional, Scientific & Technology, the impact is relatively mild, with many employees able to work from home. For others, such as Accommodation & Food Service, remote work is not usually an option. Housing markets will recover fastest in regions with more jobs in more resilient employment sectors.

We therefore expect London and the South East to lead the housing market recovery. These regions also benefit more from lower interest rates, which in the short term will ease some of the affordability pressures that have constrained price growth there. Regions with a higher reliance on tourism, such as the South West, will recover more slowly, even though affordability is less of a challenge.

Figure 4 Five year compound house price growth by region



Source: Savills Research

Downside risks to our mainstream forecast

Oxford Economics also presents a downside economic scenario with a longer lockdown, more persistent economic contraction, and a longer, slower recovery, hampered by financial stress. In this case quarterly economic output only returns to pre-Covid levels by mid-2023. That leads to much higher unemployment projections, with unemployment peaking in the first quarter of 2021 at just short of 10%.

Together this is likely to have a much greater impact on the strength of buyer demand over the next 12 months, putting further downward pressure on mainstream prices and transactions. It also suggests a weaker recovery when prices bottom out.

Irrespective of low interest rates, we believe this scenario would reduce the prospects for house price growth over the five years from 2019 to 2024 from 15% to 5%, though the gains for those who buy at or close to the bottom of the market will be significant.

Transaction activity would also recover slower, only returning to normal levels in the second half of 2022, rather than mid-2021.

We have followed the Oxford Economics assumption that the Brexit transition period will either be extended beyond 2020 or that we will see a stopgap deal allowing trade to continue until the full detail is agreed. Should the UK revert to trading with the world on WTO terms, economic growth would slow, which would negatively impact housing market performance.

Rents

Rental values tend to be more resilient than capital values during a downturn. Rents fell just -2% following the Global Financial Crisis, whereas house prices fell -18%. We expect rents will also remain relatively resilient in the coming months and years, albeit there may be greater pressure in areas more reliant on international tenants and students.

We based our forecasts last November on rents continuing to rise in line with income growth. We expect this relationship to continue.

Taking into account the revised income growth forecasts from Oxford Economics, that suggests we are likely to see rents rise 13.6% by the end of 2024, slightly lower than the 15.4% growth we predicted previously. Taking this together with our price forecasts, it suggests rental yields will be slightly lower in 2024 relative to today, in line with lower interest rate expectations. However, yields will fluctuate over the short term. This could create attractive opportunities for investors willing to hold for the long term.

Table 3 Revised rental growth forecasts

Mainstream rental forecasts

	2020	2021	2022	2023	2024	5-year
UK	-1.5%	5.5%	3.0%	3.0%	3.0%	13.6%
London	-1.0%	6.5%	4.0%	3.0%	3.0%	16.3%
UK ex. London	-2.5%	5.0%	4.0%	2.5%	2.5%	11.9%
Income growth	-1.6%	5.4%	3.1%	2.8%	3.1%	13.4%

Source: Savills Research, Oxford Economics

Note: These forecasts apply to average rents in the second-hand market. New build values may not move at the same rate.

Prime

In our April sentiment survey, prospective buyers in the prime markets were, on balance, less committed to moving over the next six months, but more so over the period of the next 12-24. This suggests this part of the market will be relatively price-sensitive in the short term. But the fundamentals of demand remain sound over the medium term, albeit with some changes in buyer behaviour.

Over the past five years the top end of the market has been particularly exposed to political uncertainty and higher levels of direct taxation, meaning that pricing is not stretched as it has been when we have entered previous downturns.

In particular, prices in Prime Central London were 19.7% below their 2014 peak prior to the Covid-19 crisis. For those buying in other currencies, the value on offer in this market was even greater, given the relative weakness of sterling. Accordingly any further softening in prices in this market is likely to create a compelling buying opportunity which, subject to easing of international travel restrictions, we believe should underpin a recovery in that market.

Our survey also identified a significant increase in demand for prime country property, which has been backed up by the levels of buyer enquiries, viewings and offers which we have seen for homes in the country, since the housing market in England reopened. This reflects a renewed appetite for space and access to the outdoors.

We will publish revised prime residential value forecasts following the release of our Q2 index results at the end of June.

Development

As at 27th May, sites with capacity for 9,400 homes were still closed, while 156,000 were closed but have since reopened. Where sites have resumed construction, social distancing means that work progresses slower. Housebuilder reports vary, but most report they are operating between 50% and 80% of normal capacity. Assuming social distancing remains necessary for the rest of 2020, we predict construction capacity will remain restricted to no more than 80% of normal levels for the rest of the year. A greater proportion of housebuilders are also reporting availability of materials as an obstacle.

From 13th May, developers could apply to their local council to work on site for longer hours. This could help construction capacity return more quickly. However, we expect capacity will remain limited due to social distancing measures and pressures on supply chains.

We will publish further detail on the residential development market in our upcoming briefing note in early July.

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