

2004 – a game of two halves?

- Price of average UK property forecast to rise 9% in 2004
- London prices to grow by 6%, while the North will see 12%
- First-time buyers to remain an endangered species

Forecast	2002	2003	2004
House Price Index (Dec on Dec % changes)	25%	15%	9%
London (Q4 on Q4 % Changes) #	21%	7%	6%
West Midlands (Q4 on Q4 % Changes) #	30%	17%	9%
North (Q4 on Q4 % Changes) #	27%	29%	12%
Sales, m	1.59	1.39	1.40

Our full regional forecast for the year ahead is in table 2 on page 5

Commenting on the forecast Alex Bannister, Nationwide's Group Economist, said:

“Given benign economic conditions, with real post-tax mortgage rates at a 20-year low and unemployment at a 28 year low it is no surprise that house prices will have risen by around 15% in 2003. However, real disposable income¹ growth was the lowest since 1994, suggesting that homebuyers’ expectations played an important role in boosting house price growth during the year. In contrast, house sales fell back to 1.39m – with the fewest first-time buyers for two decades. 2004 is unlikely to see a significant rise in first-time buyers as affordability deteriorates further in the face of higher house prices and mortgage rates.

“However, we expect £137bn of remortgaging in 2004, compared with £123bn this year, and almost the same again will switch to a better deal with their existing lender. Many borrowers will take this opportunity to withdraw equity, particularly as house prices will continue to rise, although increased caution may reduce growth for this type of lending.

“The housing market will carry considerable momentum into early 2004 and we expect house price growth to be biased towards the first part of the year. Later in the year, rising mortgage rates and slow income growth will dampen confidence. House price expectations are also likely to become more realistic, especially in the North where prices are currently rising at an unsustainable pace. We expect UK house price growth of 9% in 2004.

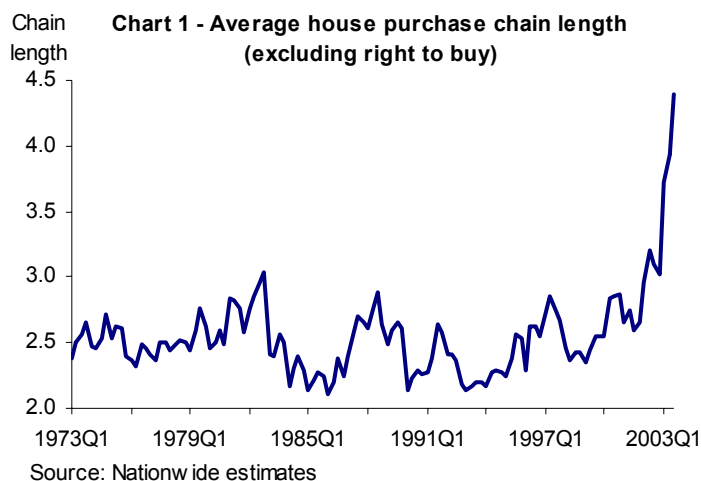
“There will be less regional variation than in 2003. The Northern regions are expected to see the highest price growth, at around 12%, as a result of strong labour markets and positive house price expectations. London is forecast to be the slowest growing region for the second year running given stretched affordability. However, improved prospects for City jobs and supply shortages will keep house prices rising at around 6% in 2004.

“Recent years have seen expectations push house price growth above what economic conditions would suggest. A reversal or continuation in this trend are both plausible scenarios in 2004 and provide the most significant risk to our forecast. In addition, economic imbalances remain in the UK, and US, with high private sector debt levels suggesting corporate and personal sectors alike may at some stage pull their horns in. It is unlikely that a small rise in interest rates would cause such a retrenchment since, even though households are highly indebted, most can cope with a modest rise in interest rates. A deteriorating labour market, therefore, remains the most plausible forecast risk.”

House price growth exceeded expectations in 2003...

Following rapid increases in house prices over the last few years, which culminated with prices rising 25% in 2002, a slowdown during 2003 was almost inevitable. However, although price growth slowed, the housing market remains surprisingly robust and the likelihood is that prices will have risen by around 15% in the year to December. This compares with our forecast, originally published in December 2002, of a 10% rise in house prices.

In last year's forecast we suggested that given stretched affordability, fewer first-time buyers would make it onto the property ladder. 2003 has been notable for the significant decline in first-time buyers (c360,000 compared with 521,000 in 2002). During the year fewer people bought their first home than in any year since the early eighties. The absence of first-time buyers has boosted the average chain length significantly (see chart 1). It now stands at 4.4 compared with around 2.5 in the eighties.



Purchases by existing homeowners during 2003 are likely to exceed 2002 (870,000 up from 847,000), but this still represents low levels of turnover (4.8% of owner occupier stock compared with 5.6% in the late eighties). This has largely been due to more cautious behaviour of Southern buyers many of whom chose to stay out of the market at the time of the major conflict in Iraq.

...as the tale of two sectors continued...

2003 will be the third consecutive year of below average economic growth with GDP rising by around 2%. This was slightly lower than we had forecast, however, the mix of growth – strong consumer activity but weak export performance and investment – proved favourable for the housing market.

In particular, our original house price forecast was predicated on a modest increase in unemployment. But despite ongoing weakness in many parts of the corporate sector, unemployment will actually fall by around 30,000 in 2003. It is likely that many companies have decided to cut working hours rather than jobs in the expectation that the economy would strengthen. In addition, where jobs were lost – mainly in manufacturing – these were offset by the rapid expansion of public sector employment. At the same time as unemployment was falling employment was rising, reaching record levels during the year. However, this was probably not as significant for the housing market as many of the jobs created were part-time. Indeed, full-time employment (excluding self employment) fell slightly during the year.

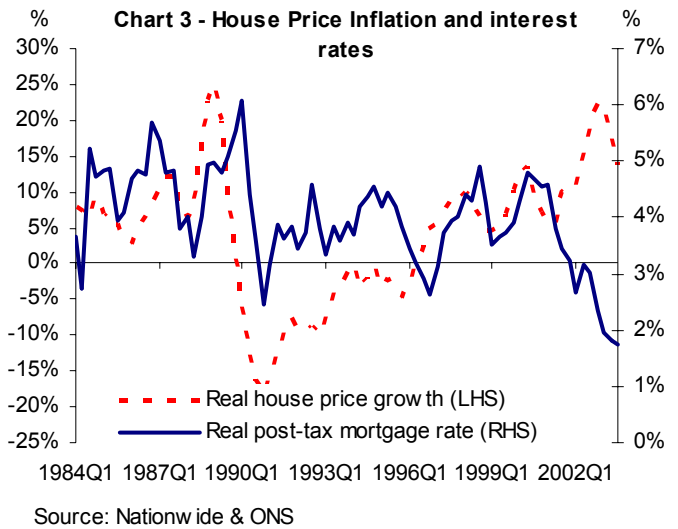
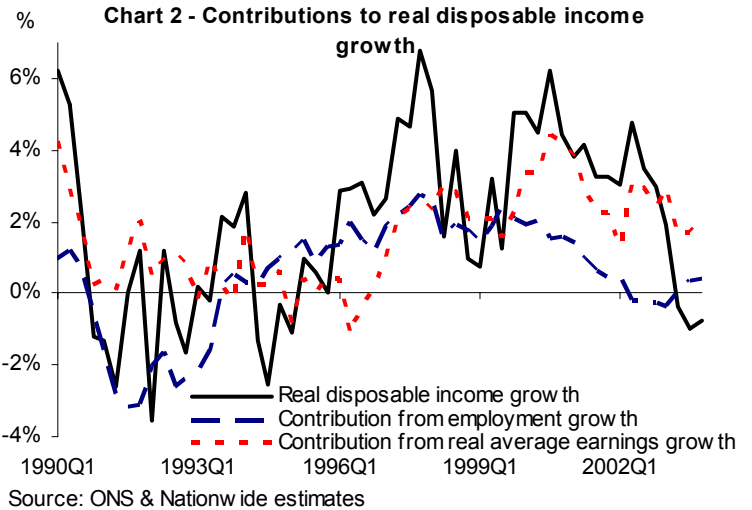
...with favourable backdrop to the personal sector

The relatively modest increase in employment will have supported, but not dramatically boosted, the housing market. Confidence is likely to have been underpinned by the fact that more people were in work (irrespective of whether full or part time), fewer people found themselves unemployed and fewer people knew of someone being made redundant. However, as chart 2 shows, average earnings growth was more important in driving overall household income in 2003. Overall household disposable income was unchanged in 2003 compared with a rise of 3.6% in 2002. With the prospect of higher taxes in the budget next April we believe real disposable income will be subdued again in 2004 and this will contribute to slowing house price growth.

The Monetary Policy Committee cut base rates twice in 2003 in response to weak global economic growth. Since then conditions have improved and November saw the first rise in base rates in over 3½ years. Short-term movements in interest rates tend to have relatively little impact on the housing market. However, a sustained large shift is more likely to have an impact on house price growth. As chart 3 shows, real post-tax mortgage rates fell from around 4.5% in 2000 to just 1.75% in late 2003 - their lowest since 1983. Even if base rates moved to a peak of 5%, as many predict, real rates would (at 3.4%) remain at 3 year lows.

North-South divide remains

Our expectation was that South Eastern regions would see price increases of 0-5%, the Midlands around 10% and Northern regions around 15%. In the event, price growth in all regions will be higher than originally forecast. London and the Outer Metropolitan are set to see increases of around 5-7%, price growth in the Midlands will be nearer 20% and increases in the Northern regions of England will be 25-30%. The large variance between the North and South is partly attributable to differences in affordability. But, labour market developments have also been important with relatively stronger employment growth in some Northern regions and bigger falls in unemployment. Expectations will also have played their part with Southern regions likely to have seen a return to more sustainable expectations while the Northern regions have become used to double digit price growth following two years of 25%+ growth.



House prices set to rise 9% in 2004...

Our forecast for house price inflation in the 12 months to December 2004 is 9%. However, underlying this forecast is the expectation this growth will be weighted more in favour of the first half of the year as the momentum already built into the housing market carries over into early 2004.

...as backdrop to the housing market remains broadly favourable

The global economic outlook has undeniably improved compared to this time last year and in this more positive environment for exports and investment we expect the UK economy to grow by around 2.7% in 2004. Inflationary pressures are likely to remain relatively muted and given this we expect the MPC will only need to raise interest rates to 4.75% by the end of 2004. The direct effect of such an increase is unlikely to be overly significant on the housing market. In cash terms, for someone entering the housing market on a typical income multiple, it would take payments as a proportion of take home pay from 27% now to 31% in 12 months time. More important is likely to be its impact on homebuyers' interest rate expectations. Rates had been falling or on hold for 3½ years but now rates are likely to be rising, we may see expectations alter.

We expect an improving corporate sector outlook to mean the labour market remains supportive with a recovery in hours worked and only a modest increase in unemployment (to 0.95m). Average earnings growth is likely to pick up slightly to 4% but will remain low compared to the 1980s and 1990s. This means that the real burden of debt will only be eroded slowly, constraining existing homeowners ability to trade up. In conjunction with this, the fact that borrowing costs will edge higher, a continued absence of first-time buyers and buyers developing more realistic expectations of future house price increases will combine to slow house price growth during the second half of 2004.

Our view is that most borrowers can cope with a small rise in interest rates. If base rates do end next year at 4.75% then a typical buyer will see their payments rise from 27% to 31% of take-home pay. However, some borrowers may have significant unsecured debts and may be more vulnerable. Our concern remains that lenders should not pursue market share aspirations at the expense of pushing borrowers into increased and unsustainable indebtedness.

Table 1: Forecasts

	2002	2003*	2004*
House Price Index (Dec on Dec % changes)	25	15	9
Mortgage payments (% of take-home pay)	25	27	31
House price to earnings ratio	4.7	5.2	5.5
Total Gross Mortgage Lending, £bn	216	270	298
External Remortgage, £bn	80	123	137
First-time Buyer Lending, £bn	42	33	34
First-time Buyers, % of house sales	38	30	28
GDP % year	1.6	2.3	2.7
Average earnings, % year	3.6	3.4	4.0
Real disposable income, % year	3.6	0.0	2.2
Unemployment, m, Q4	0.94	0.93	0.95
Base rates, %, Q4	4.0	3.7	4.6
* forecast			

More uniform regional growth expected

We believe that Northern Ireland and the Northern regions will see prices growing fastest at around 12%. Both are expected to enjoy continued strong employment and income growth into 2004. London is forecast to see the lowest growth given that affordability is already stretched. Price growth is likely to be similar to this year as prospects for City jobs and bonuses are offset by weakening affordability, rising interest rates and some job losses in other sectors. Supply shortages, as outlined in the recent Barker Review, will also underpin growth in house prices in the South East over the coming years.

Table 2: Regional Forecasts

% year Region	Q3 03	Forecast Q4 04
NORTH	32%	12%
YORKS & HUMBERSIDE	29%	12%
NORTHERN IRELAND	12%	11%
NORTH WEST	24%	11%
SOUTH WEST	14%	10%
WALES	26%	9%
SCOTLAND	14%	9%
EAST MIDLANDS	21%	9%
WEST MIDLANDS	21%	9%
UK	17%	9%
OUTER SOUTH EAST	15%	8%
EAST ANGLIA	15%	7%
OUTER METROPOLITAN	13%	6%
LONDON	8%	6%

Source: Nationwide

Upside risks...

Higher house price growth could occur if employment and earnings prospects improved (perhaps on the back of a burgeoning world economy). Lower interest rates would also provide a fillip for the market. However, the most likely reasons for higher house price inflation in 2004 are either that household's price growth expectations remain higher than expected, or if lenders look to inflate the market by allowing further strong upward movements in typical advance to income ratios.

...but localised price falls cannot be completely ruled out

On the downside, expectations also provide a major risk. While it is not clear what could bring about a sizeable downgrade to expectations, it cannot be ruled out at some stage over the next few years. It is quite conceivable that this could lead to prices stagnating in 2004 (and to fall in some areas). A deteriorating labour market, such as a large rise in unemployment or a drop in earnings growth, remains the most plausible downside risk to our forecast. Job shedding in the face of higher rates and a downturn in the global economy could easily occur given high levels of corporate indebtedness.

Significant policy uncertainties persist

The Miles review of the mortgage market and the Barker review of housing supply are expected to announce policy recommendations by next Spring's budget. Although both reviews recently published interim reports, the likelihood is that these reviews will have a medium, rather than short-term impact on prices. Clearly, changes that increase the prospect of more house building or more expensive mortgages would tend to dampen house price growth. However, increases at the budget to existing taxes (e.g. stamp duty or income related taxes) or the possibility of new housing taxes (e.g. VAT or Capital Gains Tax on housing) would have a greater negative influence on prices in 2004.

Press enquiries to:

Alex Bannister (Group Economist)

Tel: 01793 657672

alex.bannister@nationwide.co.uk

Sarah King (Press Officer)

Tel: 01793 657225

sarah.king@nationwide.co.uk

¹ Calculated as wages and salaries less taxes on income and council tax