UK Outside the European Union - How Will London Residential Markets Fare?

October 2016

The decision by the United Kingdom population to leave the European Union caused much volatility in financial markets in the immediate aftermath and has thrown considerable doubt around the future trajectory of the UK and particularly London property markets. While the extreme volatility has now moderated, the medium term outlook remains uncertain as both sides prepare for mammoth negotiations. There are many factors to consider, both positive and negative. In this note we look in more detail at some of the major influences on the London residential market in the short to medium term.

- London is underprovided in housing especially below the £2 million mark. Government figures indicate that there will be an annual shortfall of 20-25,000 housing units each year for the next four years.
- The population of London is set to rise by almost a million people by 2020, increasing demand for housing - especially affordable units - even further.
- London tops the rankings in terms of the overall business environment, financial sector development, infrastructure, human capital and overall reputation as one of the top cities in the world.
- The UK economy, which has grown strongly in recent years, is forecast to outperform the rest of Europe and the Eurozone, despite Brexit. Noises from government indicate that the autumn statement in November will provide an additional economic boost.
- The devaluation of the pound could offer a once-in-a-generation entry point for new and experienced investors. Historic lows against many Asian currencies are unlikely to last for a sustained period of time.
- The situation will evolve – trust your instincts and watch the fundamentals. There are more reasons to buy and hold than sell.

The London residential market has performed well for investors over the last decade: rents have risen, values are up and the economy has grown at a reasonable rate. Then Farage, Johnson and Gove decided to, as the International Monetary Fund said, 'throw a spanner in the works,' and now you're thinking what is the best thing to do – **get out, just hold on or is now the time to get in?**

Despite the reams of newspaper headlines and internet blogs about article 50 of the Lisbon Treaty, the main short-term effects that June 23rd brought about are the political landscape and changes in investor sentiment globally towards the UK. The UK remains in the EU and even when it leaves it will still be one of the largest economies in the world, which now has the potential to take full control of its economic and demographic destiny for good or ill. The London housing market has for many years been one of the most attractive investment locations globally for individual investors. While recent tax and legislative changes have altered the investment landscape slightly, it remains one of the most liquid cities offering opportunities across the price spectrum.

But what should you do now? Follow the old property adage of **"Don't Forget the Fundamentals."**

1. London is underprovided in housing

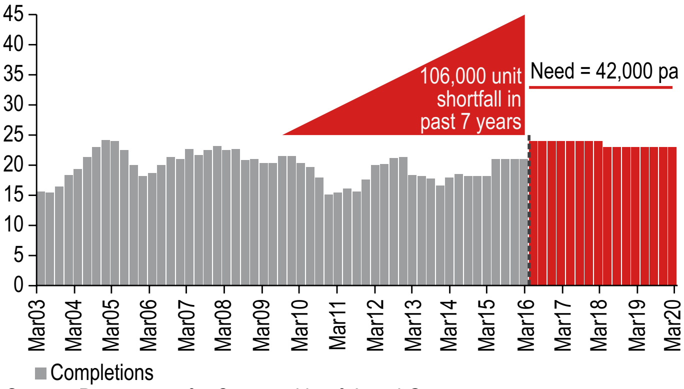
One of the major issues blighting major cities globally, and London is no exception, is the undersupply of residential accommodation, particularly affordable housing. Despite numerous local and central government initiatives the geographical constraints and elongated planning process means that, for several years, supply has failed to live up to demand for London housing (Figure 1). There is no short term solution to this predicament meaning that there is a natural floor under any significant downturn in pricing.

However, a slight correction in the short to medium term is possible; but on the plus side it will make London look more attractive internationally as the rental yield should increase given the lack of good quality stock and the continued demand for rental accommodation.

London remains an incredibly elastic residential market in terms of the relationship between prices and demand. While much of the construction over the last 10 years has been at the luxury end of the market in central London, the majority of the undersupply in housing is below the £2 million mark within the outer suburbs. This gap in the market has been identified by developers and more stock will be forthcoming in the medium term but still not at the levels needed to fill the structural undersupply.

Figure 1 – London Development Completions Needed

No. of housing units per year (000s)

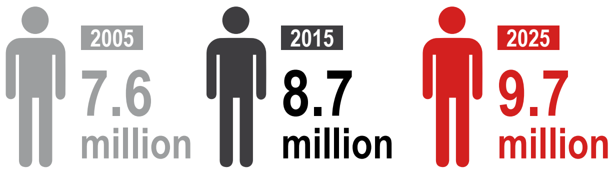


Source: Department for Communities & Local Government

2. Population set to rise, increasing demand further

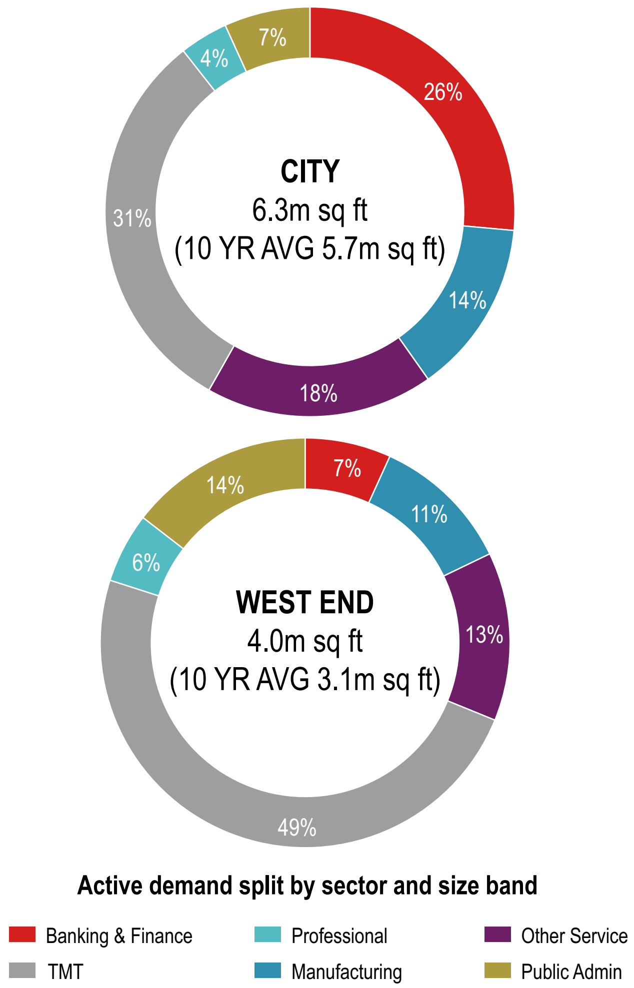
The supply shortfall is only set to get worse as London's population continues to rise over the short, medium and long term (Figure 2). Over the next 10 years almost a million more people are expected to move to London, a 10% increase, as more new jobs are created across a wide range of industries and services. While its status as a European financial hub may be under scrutiny, the transformation of the London office market has been underway since the financial crisis of 2009. London is now one of the world's most important tech hubs with the technology, media and telecom (TMT) sector being the biggest new occupier of space in the last seven years. This broadening of the occupier base means that London is less reliant on financial services than it was a decade ago (Figure 3).

Figure 2 - Greater London Population,2005-2025 (Forecast)



Source: GLA 2015 Round Demographic Projections

Figure 3 - Central London Office Take Up, YTD 2016



Source: JLL

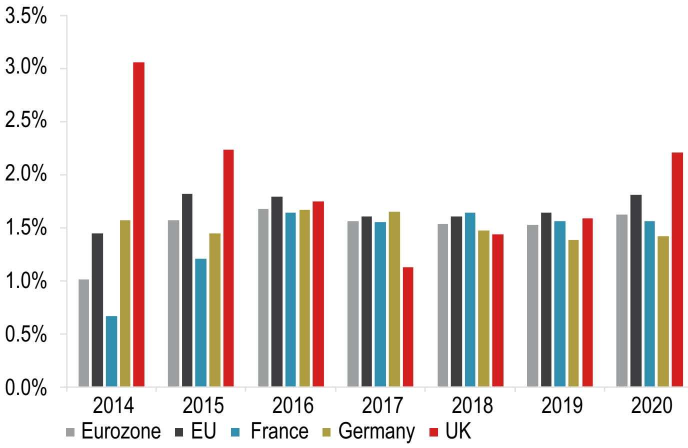
Much of the new population will come from countries outside of the EU and other parts of the UK. London remains the main source of career progression within the UK and such is London's global status that 80% of all new arrivals come from outside of the EU. The global status that London commands means it will continue to attract people consistently placing pressure on housing levels, particularly at the sub £2 million mark.

3. UK set to outperform Europe economically

Since the financial crisis of 2008/2009, the UK economy has grown at a consistently faster rate than the Eurozone due to its diverse labour pool and favourable labour laws. The consistent investment in transport infrastructure and flexibility of monetary and fiscal policy has seen global capital target the UK, creating economic growth and employment across a number of sectors.

Despite the uncertainty brought about by the referendum, the UK economy is still forecast to perform better than the largest economies in Europe as well as the overall Eurozone and EU over the medium term. The lack of structural reform in the Eurozone will continue to hamper economic growth and ultimately this will be a much bigger issue than any short-term political volatility. If the UK can show that it can survive just as well outside the Union then global capital will continue to flock to it (Figure 4).

Figure 4 – GDP Forecasts, Selected Markets 2014-2020 (Forecast)



Source: Oxford Economics

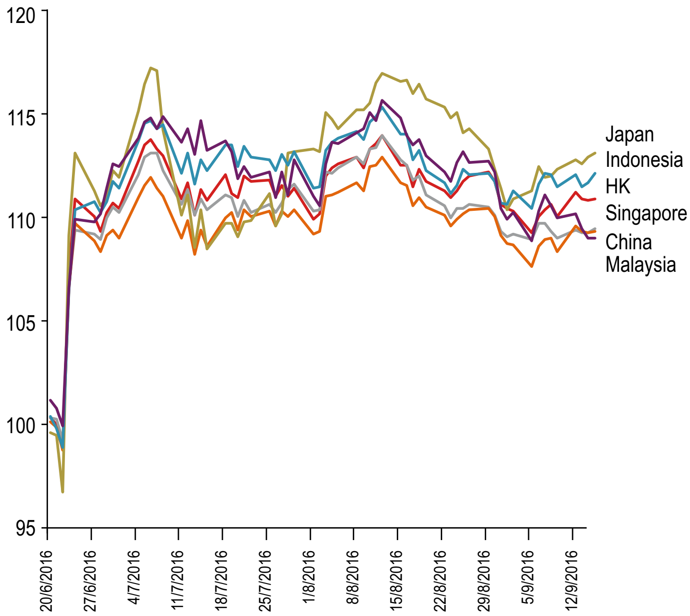
4. Competitive to buy, sell and hold

One of the first indicators to show the way the vote was going was the UK pound. After initially strengthening, as the vote outcome became clearer, the currency dropped precipitously against virtually every currency. In Asia it remains down by between 10-15% against the majority of the major currencies. Does this make the UK look like an appealing entry point and could it get even better over the next few months? The Bank of England has now acted with an interest rate cut and further quantitative easing, demonstrating how big an impact it believes Brexit will have on the UK economy. The next milestone for the currency alongside further economic data showing activity post the Brexit vote will be the government's autumn statement in November. It is widely believed that the new administration will loosen its strict fiscal framework and provide further stimulus to the economy, with possibly some residential-specific policies. Given the UK's large current account deficit, a larger than expected stimulus package will almost certainly see the pound fall against the Asian currencies once again.

However, over the medium to long term this is likely to be a temporary attraction for investors. While the pound is at historic lows against many Asian countries, it is likely that as the situation with the EU becomes clearer so the relationship between the pound and other countries will move back towards longer term averages (Figure 5).

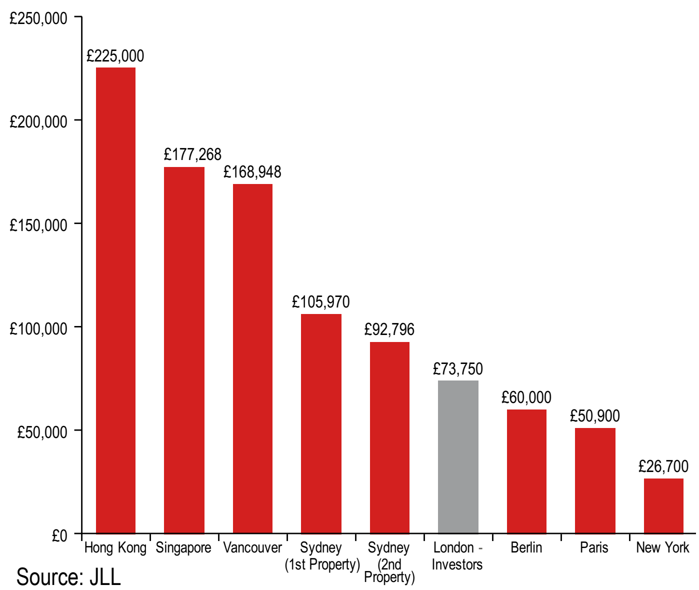
Alongside further currency weakness the UK remains one of the most competitive locations globally to buy, hold and sell residential property. Compared to Asia Pacific cities, London offers a more competitive argument in terms of how much leakage you could suffer from transactional and holding taxes. Transaction costs in London are much lower when compared to Hong Kong, Sydney and Singapore (Figure 6).

Figure 5 – Movements against the GBP since 20 June 2016



Source: DataStream

Figure 6 – Residential Transaction Tax Comparison (based on £1 million property purchase - foreign buyers)



Source: JLL

5. The situation will evolve – trust your instincts and watch the fundamentals

Irrespective of the outcome of the Brexit negotiations the UK will continue to be one of the most important economies in Europe and globally. However, given the level of uncertainty and a lack of clear direction at present there are pros and cons to investing in the residential market:

- **Mismatch between supply and demand** - The discrepancy between supply and demand is structural and almost impossible to solve given the restrictions on planning and zoning.
- **London will always be an international cit**y – For centuries London has been a global city, trading with all corners of the world. It leads global rankings in terms of the business environment, financial sector development, infrastructure, human capital and overall reputation as one of the top cities in the world.
- **Fundamentals of the UK property market are unique and will remain so** – The UK has one of the most sophisticated and developed residential property markets in the world. The access to information and data alongside the rule of law and clarity on landlord and tenant practices should not be underestimated.
- **High levels of liquidity means you can sell at any time** – One problem you won't experience if you do want to sell is finding buyers, both domestic and international.
- **London's population is set to increase and the volatility will be replaced by sustainable growth** – As with most major cities worldwide London's population is set to increase as global urbanization continues. And where people go, price growth and economic growth follows.
- **If you missed out first time around, now is the time** – London may not be this investible again for a long time with the combination of lower pricing and currency devaluations.
- **Opportunities in the open and secondary market** – With uncertainty comes a multitude of responses. Opportunities will emerge in the open and secondary residential markets as developers and investors weigh their options.
- **Pound at historic lows and may go lower** – Interest rates are lower, more quantitative easing and higher government spending. Further government stimulus in the autumn statement may put further pressure on the currency.

Investment scenarios:

Watching the fundamentals will be even more important in the coming years as negotiations will undoubtedly seesaw, we see three possible outcomes:

Red light - The Brexit negotiations once they begin in April 2017 become drawn out, acrimonious and take much longer than the proposed two year timetable. This has the result of further weakening the UK economy and the pound drops, pushing up inflation and interest rates. Foreign investment reduces dramatically as discussions continue to drag on and residential prices drift down on lower first time and foreign buyer interest. A 'hard' Brexit recession is the outcome, which is a negative in the short to medium term on all sectors of the economy.

Yellow light - Brexit negotiations swing back and forth once they start, with no clear winner. The UK economy plateaus, growing below trend at around 1% for a number of years and the currency underperforms its global peers even with higher interest rates and higher inflation. 'Uncertain' Brexit is the outcome and UK property prices slowly decline as a lack of domestic demand weighs on the rental sector and the lack of income growth subdues buyer demand.

Green light - The Brexit negotiations, once initiated, get off to a good start with both sides willing to compromise. French and German elections produce stabilising results and the UK's exit from the EU produces a win win outcome. While investment and economic activity remain subdued in the short term, indicators pick up quickly and capital flows quickly back into an independent UK with good links to the rest of Europe. 'Soft' Brexit is the outcome and residential markets improve on strong demand and a faster growing economy.

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