Welcome to Bulletin 45 | August 2014

In this issue we focus on:

- Residential Property Prices – Where are they Going?

In my last bulletin I drew comparisons between our UK residential property market and that of our European neighbours. I finished by posing the tricky question as to whether our residential market can hold on to current values, drive on to new highs – or whether a price drop is on the cards.

In most free markets, prices are the product of availability, cost and demand. But our property market isn't 'free' and therefore isn't subject to normal market forces. In the UK, the private housing market is of such importance, that its progress and stability carries major implications for the wider economy. We therefore have a market that's leveraged by a Government policy that protects the indebted, supports the imprudent and encourages the impulsive!

The stimulants of rock-bottom interest costs and taxpayer funded top-up loans has enabled the property market to tip-toe over an abyss and run on to new heights – to the delight of the housebuilders and the Government. But stimulants don't work forever – and the longer they're administered, the more severe the hangover once they're removed. Next month the Bank of England is to review the Help to Buy Scheme. The OECD have already called for restraint – so what's to happen next in the life-cycle of the residential property market? Let's step back, look beyond the headlines and study recent market history.

First we need to accept that London is a very different place from the rest of the UK. The property market in London has grown by a staggering 22% over the last 12 months, compared to a 'mere' 8% for the rest of England. Accepting that London is unique and cannot be taken as a guide for what's to happen elsewhere, I've concentrated on home territory and focused on domestic property in the West Midlands.

There are many property indices to study but perhaps the most informative is the Nationwide's 'House Price Index' – and it's from this that I've drawn the data.

I've studied 20 years of house price movement and from that have selected 'Terraced Property' as the choice of the first-time buyer and 'Detached Property' as an indicator of the mature market. The figures in the undernoted chart include a column of 'revalued' prices, to illustrate prices in today's terms. By starting in 1994 I've charted the price movements from the economic doldrums of 93/94 onwards.

The precipitous drop in house prices, from a peak in Q3 1989 into a trough that lasted until Q4 1995, was a period many of us remember.

The years leading up to 1989 had recorded strong economic growth, progressive reductions to basic rate tax, a slashing of higher rate tax from 60% to 40% and the impetus of mortgage interest relief at source (MIRAS).

The peak of Q3 1989 followed rapid rises in interest rates (from 8% in 1988 to 15% in 1990) and the inexorable slide into economic recession. House prices fell away steadily, recording a total fall of 30% by Q4 1994, excluding inflation. The phrase 'negative equity' came into being as home owners defaulted and properties were repossessed.

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Then in the 5 years from '94 to '99 lower interest rates and an improving economy brought stability and steadily rising values until, in the early 2000s, unrestricted lending caused values to take off – soaring by 20% a year …. until the economic collapse of 2008.

Since then, ultra-low debt servicing costs, active discouragement of repossession and continuing acceptance of high income to mortgage multiples have conspired to avoid a repossession feeding frenzy. Prices have therefore remained elevated at a level that may well become unaffordable if (when) interest rates break out of their current straitjacket.

West Midlands Terraced Property						West Midlands Detached Property	
Year	Bank Base Rate	Average Price	Revalued @ RPI To June 2014	Mortgage P/E Multiple	Repayment Affordability (% of Take Home Pay)	Average Price	Revalued @ RPI To June 2014
1994	5.5%	£ 43,408	£ 78,461	2.5x	21%	£ 83,465	£150,865
2000	5.75%	£ 53,530	£ 82,436	2.7x	25%	£124,242	£191,333
2004	4.75%	£108,290	£151,052	4.6x	37%	£193,396	£269,765
2007	5.5%	£129,444	£158,942	5.0x	46%	£227,598	£279,464
2009	0.5%	£102,760	£124,914	3.9x	33%	£197,891	£240,554
2010	0.5%	£113,902	£135,502	4.0x	32%	£215,892	£253,042
2011	0.5%	£115,730	£129,070	4.0x	32%	£217,883	£242,999
2012	0.5%	£113,740	£119,498	4.0x	30%	£215,689	£226,608
2013	0.5%	£117,600	£120,540	4.0x	30%	£216,682	£222,099
2014	0.5%	£130,024	£130,024	4.3x	33%	£238,589	£238,589

The current 'repayment affordability' of a 90% mortgage – of 33% of take home pay, adopts a median 4% interest rate. Should mortgage interest rates return to their long term average of 7%, then 33% 'affordability' becomes a 50% desperate struggle. And this is Mark Carney's principal reason for his suppression of rates. He reasons that with take-home income flatlining, any increase upon borrowers' interest charges will threaten to choke off the recovery. Well yes, no surprise here but the continuation of sub real-world borrowing costs and taxpayer subsidised support, exacerbates the problem and edges ever greater numbers of borrowers into the danger zone of mortgage inaffordability.

None of this is new; we've been heading in this direction for the last 5 years. But this latest wilful acceleration of 'credit', heightens the dangers and questions the motives. With monthly deficits now widening again – and the national debt double what it was 5 years ago, it seems to me that action on interest rates is imminent. Increases will be slow but gradual and progressive. House prices will falter – and then begin a steady retreat.

Next May looks to be too far away for the Election. By then, our worsening and over-budget Public Sector Net Borrowing position will have become difficult to swallow for our creditors. Debt costs will be on the rise and 'austerity' will transmute from political plaything to stark necessity. And that's assuming that the Scot's still want us!

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