WHAT GOES UP, MUST COME DOWN ... EVENTUALLY

What goes up, must come down – or so the saying goes, originally a reference to the pervasive effects of gravity. But it seems a phrase that has only very weak relevance to the UK’s residential property market. The onset of the liquidity crisis in the summer of 2007 seemed finally to have put an end to the inexorable rise in house prices, not just in the UK but elsewhere too. From the Dublin to Dubai, property prices declined sharply as the credit fuel for the global property market fire finally ran out.

Depending upon which index one looks at, the liquidity crisis that turned into a credit crunch caused UK property prices to fall on average by 20% (Nationwide index) to 22% (Halifax index) from their peaks. These sharp price falls caused the house price to earnings ratio to plummet from historic highs, as this week’s chart shows. On average, at the peak of the property market bubble, people were willing to pay between seven and eight times their annual salary for a house. This ratio fell sharply to six as prices tumbled, but still only to a level equivalent to its previous peak in the late 1980s … before prices fell dramatically.

The worrying aspect of this chart is that this ratio has been climbing steadily since the end of last summer.
It is fairly obvious why it should rise, isn’t it? After all, the global economy is booming, personal incomes are on the rise, personal tax rates are set to decline and the UK government’s finances are in such fantastic shape that there will be dramatic job creation in the public sector in the coming years. This is an obvious background for a rise in house prices and for a renewed enthusiasm for piling every last penny into the housing stock again.

Ok, that’s enough of the sarcasm. The truth is that the economic background for housing is very weak today, particularly when one considers the overvalued starting point. So why are people bidding up the price of homes relative to their incomes once again?

The Bank of England’s MPC have spent a great deal of time trying to find evidence that Quantitative Easing (QE) has worked. They began by telling us that a signal of its success would be the growth in particular measures of the money supply. But when this growth failed to materialise they argued that evidence of an expansion of bank lending would be sufficient to proclaim the policy a success. But bank lending has been weak too. So they then went on to argue that the reduction in corporate bond spreads and rise in equity prices could also be seen as confirmation that the experimental policy had worked. But to be honest the contraction in sterling corporate bond spreads and the rally in UK equity prices has been often more than matched in financial markets where QE has not been implemented.

In my view however, the recovery in the housing market is a direct consequence of QE. As brain surgeons say, it’s not rocket science. Slash policy rates to (near) zero in a country where a significant proportion of mortgages are of the variable rate kind, and where many are of the tracker kind, in a property market with a deficit of supply, then it should come as no surprise that house prices rise, even from an overvalued basis.

However, over the next couple of years, public sector employment levels will be cut; the next government, whatever their political colour will have no choice. As interest rates rise – and they will rise again – mortgages will become less and less affordable, and as time goes by more and more mortgagees that are currently benefiting from mouth watering tracker and fixed rate deals that were struck when banks were falling over themselves to give mortgage applicants money, will come to an end.

Against this background, there is only so long that the UK’s property market can defy gravity. It will come down with a bang should we experience a full blown sterling crisis. But it is more likely to fall to earth slowly over time as the MPC gradually normalise policy rates and as the new government gradually gets to grips with its gargantuan debts.

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