UK property market: More still than sparkling

Highlights

- The reignition of the UK housing market has been a key factor behind the UK's recovery. But it has also produced plenty of angst that it's just an unsustainable boom.
- But even a cursory look at the data demonstrates that, particularly outside London, there is little or no evidence of a bubble. And there are good structural reasons why higher property prices are in any case sustainable.
- For the MPC, developments in the housing market are, rightly, way down the list of indicators it is watching. It will be developments in the labour market, not the housing market, which will determine when, and by how much, Bank Rate moves higher.

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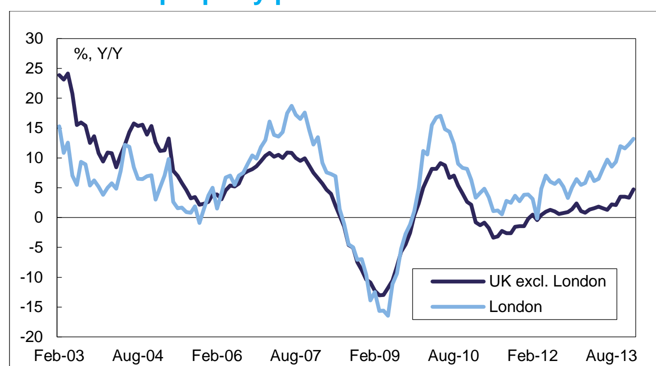
Housing recovery triggers plenty of angst

The reignition of the UK housing market, led by London, has been a key factor behind the rapid recovery seen in the UK over the past year. Not only has it fuelled a renaissance in the UK's recession-ravaged construction sector, boosting GDP growth directly, but it has also helped sustain, via confidence and wealth effects, what has been a surprisingly robust recovery in private consumption. But, rather than thank their lucky stars that a reviving housing market has helped lift the UK out of its deepest and longest recession in more than a century, the response of many, and in particular London-based commentators, has been to fret that it's all an unsustainable boom and that a crash waits just around the corner.

Residential property prices

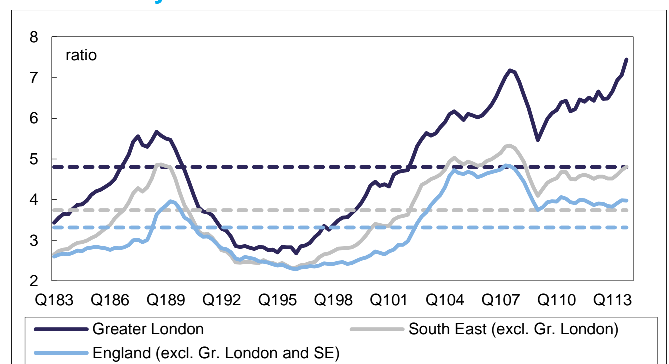


Source: Datastream and Daiwa Capital Markets Europe Ltd.

House prices are certainly recovering pretty strongly. According to the ONS, prices in the UK were up 6.8%Y/Y in January, the fastest pace of growth since August 2010. And prices are rising particularly strongly in London. So, having fallen in the immediate aftermath of the global financial crisis, UK house prices in January were 3.1% above their pre-crisis peak. London prices, meanwhile, were a massive 22.8% above their peak, leaving the average London house price nearly 8 times average earnings, also above the pre-crisis peak and more than two points above its long-run average.

Outside of London and the South East, however, it is a very different story. When London is excluded from the UK figures, prices remained 2% below their pre-crisis peak in January. And, the ratio of property prices to earnings, which rose to around five in the pre-crisis years, remains around a point lower.

Affordability: Prices to income*

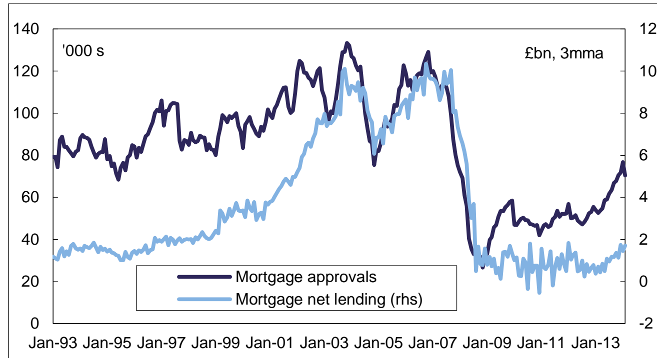


**Calculated as the ratio of Nationwide all property house price index to mean gross earning in each region. Measure for England is calculated as a simple mean of its regions. The dotted lines represent Q183-Q114 average.*
Source: Nationwide and Daiwa Capital Markets Europe Ltd.

But little evidence of widespread bubble

So, outside of London and (possibly) the South East, there isn't much evidence in the price data of a housing market bubble. And that's true when looking at other indicators. Mortgage approvals, while recently on the rise, remain very low. And that is even truer when looking at the amount of net new mortgage lending – again, while it has recovered somewhat, it remains exceptionally low. Indeed, both the number and amount of new mortgage lending are at levels last seen in the mid-90s, a time when the UK housing market was on its knees. Stripping out London, therefore, recent price developments look more like the early stages of recovery than a bubble.

Mortgage approvals and net lending

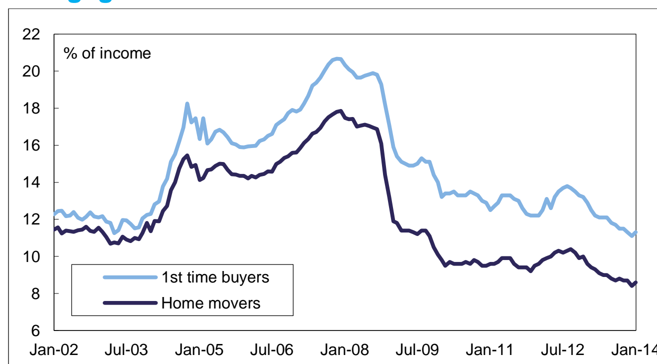


Source: Datastream and Daiwa Capital Markets Europe Ltd.

Structural factors point to higher house prices

Prices relative to earnings do, however, remain above their long-run average – doesn't this suggest that prices eventually need to adjust? Well, even ignoring the shortage of new housing supply that the UK's overly-strict planning rules perpetually delivers, there are good reasons why the sustainable price-to-earnings ratio could now be above its historical average. In particular, changes to both the financial and demographic backdrop mean that the traditional 25-year, 3 to 3½-times earnings mortgage may no longer be the most appropriate model. First, the period since the early-80s has seen a secular decline in interest rates (both in nominal and real terms). For the period 1992-2007, that reflected a much-improved inflation performance on the back of more credible macroeconomic policymaking (from an inflation perspective at least). And from 2007 onwards, in the wake of the financial crisis, interest rates have fallen to unprecedentedly low levels. This has all meant that mortgage interest payments as a share of disposable income have fallen to very low levels indeed.

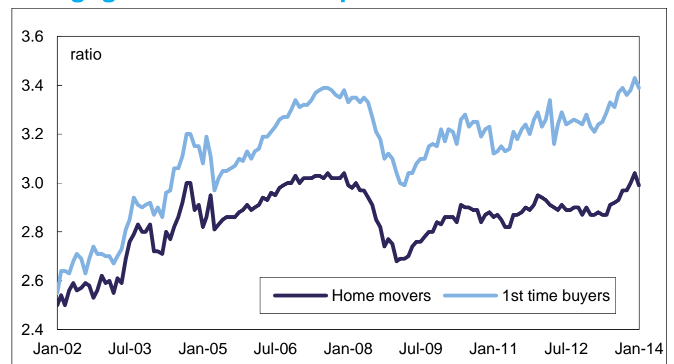
Mortgage interest costs



Source: Datastream and Daiwa Capital Markets Europe Ltd.

And looking ahead, there are good reasons to believe households will continue to enjoy relatively low interest rates for a long time yet. Clearly, the Bank of England remains some way off raising rates. And even once rates do begin to rise, they will only rise slowly. MPC members, meanwhile, have suggested that the long-run equilibrium level of Bank Rate can be expected to be materially lower than in the pre-crisis period, i.e. below 5%. Households can therefore, on average, expect to be able to afford to service larger mortgages relative to their incomes than in the past, justifying higher mortgage-to-salary multiples than have historically been the norm.

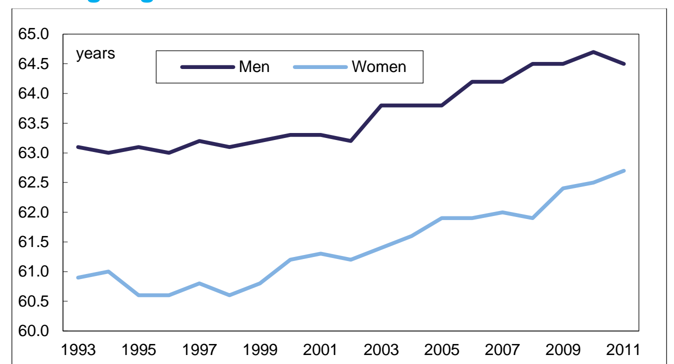
Mortgage-to-income multiple



Source: Datastream and Daiwa Capital Markets Europe Ltd.

Meanwhile, with longer life expectancy (up from 71 to 79 for men between 1981 and 2011), has come longer working lives. And working lives can be expected to rise further in coming years as both life expectancy and the retirement age rise further. These developments are making the traditional 25-year mortgage term look increasingly anachronistic.

Average age of withdrawal from the labour market



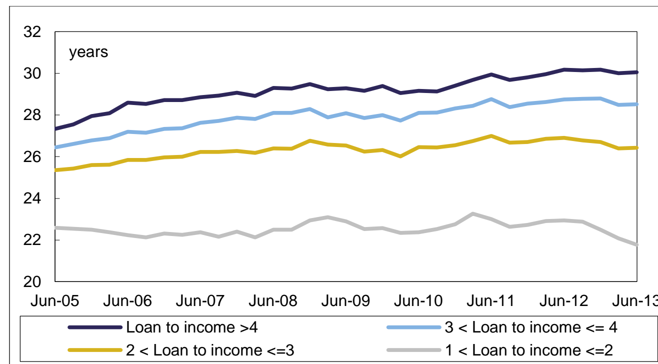
Source: ONS

Mortgage market adjusting to structural changes

Indeed, the mortgage market is slowly changing to reflect these changing demographic and economic factors. The average mortgage term for first time buyers has been slowly drifting higher over recent years, particularly (and unsurprisingly) for the higher loan-to-income ratio mortgages. Equally, the share of new mortgages with a loan-to-income ratio in excess of four and a half times has been rising steadily over the same period. Longer

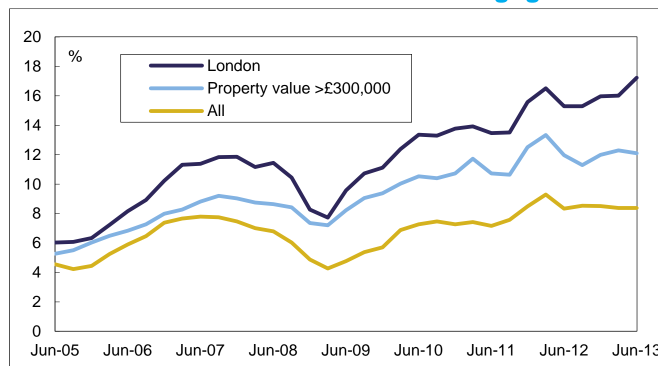
mortgage terms and higher gearing both serve to support a higher equilibrium price-to-earnings ratio.

Mean mortgage term for first-time buyers



Source: the Bank of England

Share of new loan-to-income>4.5 mortgages



Source: the Bank of England

Search for yield an important factor

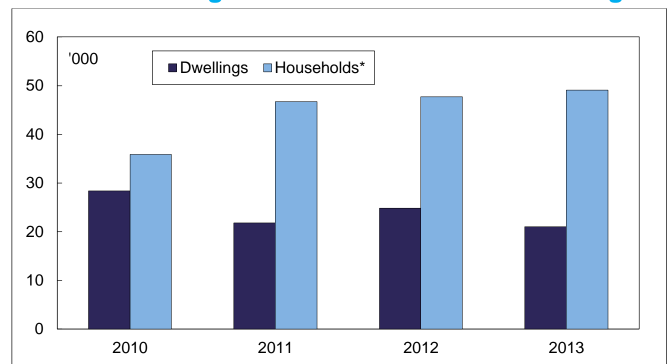
And there is another reason why the secular fall in real interest rates should support higher house prices – it has had the effect of making property more attractive relative to other possible investments, notably fixed income instruments. In a world in which ten-year Gilts are yielding below 3%, and interest rates right across the maturity spectrum are expected to remain below historical norms for many years to come, it is entirely rational that money should flow out of fixed income products and into property, where yields have been higher. And it is also entirely rational that, in a world where alternative "safe" investments are yielding lower levels, that property prices should rise, and hence yield levels fall closer to levels available elsewhere. And that is precisely what has been happening in London, where the rent to price ratio has fallen markedly over the past couple of years. The fall has been, unsurprisingly, much less pronounced outside London, providing further support to our view that, outside London at least, current (and indeed higher property prices) look far from unsustainable even if, as we would expect, Gilt yields rise further as the recovery progresses.

London – a unique housing market

But what about London – surely prices there have become totally out of line with fundamentals? And, at eight times average earnings (and still rising) that, on the face of it, has to be a distinct possibility. But there are reasons why prices in London should be rising significantly faster than in the rest of the country. First, London's population growth over recent years has significantly outstripped the increase in the supply of dwellings, something that is likely to remain the case, with the number of households anticipated by the Greater London Authority to increase by almost 300k between now and 2020, and the population set to rise by more than half a million, to top 9 million by 2019.

This rapid population growth, meanwhile, has been augmented by a huge surge in foreign buyers. This has partly been the result of specific events, including the euro crisis and Arab spring. But it has also been the result of more structural changes resulting from the march of globalisation, in particular the rise of emerging markets, and the global search for yield. While definitive figures on foreign purchases are not available, anecdotal evidence suggests that foreign buyers in recent years have outweighed domestic buyers in both prime London and for new-build apartments in the past couple of years. What that has done is not only to drive prime prices in particular higher, but also to push domestic buyers into areas that they previously would not have considered, forcing prices higher there (and helping to drive some increases in supply in those areas, where development opportunities are often more readily available). How this transformation of London property into a global reserve currency ultimately plays out is anybody's guess. But to the extent that many of these foreign buyers are cash buyers (and hence not vulnerable to rate increases) and want London property for reasons other than purely economic ones, they represent a set of owners unlikely to become forced sellers. And, without forced sellers, a significant crash in property prices seems unlikely.

London dwellings & households – annual change



**GLA projections. Source: GLA, DCLG and Daiwa Capital Markets Europe Ltd.*

No bubble, so no need for MPC to react

So, while so much commentary talks about a UK housing market bubble, a look at the data reveals that to be largely a function of London-based commentators reflecting their own experiences. It is definitely not the experience of the vast majority of the country. Look beyond Greater London and there are few if any signs of a housing market bubble – quite the opposite in fact. Certainly, there is nothing in the data to suggest that the MPC needs to be thinking about tightening monetary policy now in response to developments in the housing market.

Housing markets no longer a job for interest rates

In any case, raising interest rates is no longer the only tool available to the Bank of England if it deemed that developments in the housing market posed risks further down the line. Indeed, the MPC's latest utterances on the future of policy explicitly stated that higher interest rates would only be used as a last resort in trying to mitigate risks to financial stability. The tools in the Bank's new macroprudential armoury would be deployed first via the Financial Policy Committee (FPC), which has already indicated that it is already monitoring developments in the housing market closely. And some steps have already been taken, notably to remove household lending from the Funding for Lending scheme from the start of 2014. In addition, it has set out the numerous measures it could take, up to and including limits on the loan-to-value or loan-to-income characteristics of mortgages. Raising rates to cool the housing market is no longer the only tool available to the Bank of England.

Help to Buy is a boon, not a curse

One particular power the FPC has is to provide the Government with an annual assessment of the impact of its Help to Buy scheme, which provides government support to homebuyers. This scheme, many commentators assert, is merely fuelling a housing bubble and the FPC should tell the Government exactly that, putting pressure on it to scrap the scheme. But the data so far available on the usage of Help to Buy don't suggest that it is doing much to boost the London property market. By February, while the scheme had provided assistance to more than 17,000 buyers, only 6% of those were in London. If there is a bubble in London, it's not Help to Buy that's fuelling it. And, to the extent that the equity loan element of Help to Buy is specifically aimed at boosting new housing supply, the FPC is unlikely to be overly concerned by its recent extension to 2020.

Bank Rate will rise. But not because of house prices

So, for all of the hand-wringing about the UK housing market, the statistics just do not bear witness, outside of London at least, to anything approaching a bubble. Given that, the MPC rightly has shown no interest in reacting to developments in London's property market. And even if it did feel that action was required, that action will come from the FPC in the form of macroprudential measures, not rate increases. For the MPC, the focus is on what's happening in the broader economy. Bank Rate will likely rise in the next year or so. But it will be developments in the labour market, not the housing market, which will determine when, and by how much.

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