HOUSING MARKET FOCUS

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Editor: Roger Bootle

Recent house price rises lack a firm foundation

- **The recent rises in the major house price indices have fanned hopes that the worst of the housing market correction is now behind us. Yet price rises driven only by a temporary imbalance between the number of willing buyers and sellers will not be sustained when the economic outlook remains so fragile, lending criteria have shown few signs of easing and housing is still overvalued**.
- **Survey data support the received wisdom that the upturn in buyer interest since the turn of the year has coincided with an acute shortage of property for sale. As a result, prices have risen.** Yet, given that, in a normal market, around two-thirds of buyers are also sellers, as existing home-owners trade up or down the ladder, the current imbalance is likely to be short-lived.
- **We expect market conditions to ease over the next few months.** With the extreme uncertainty of late 2008 and early 2009 now in the past, we expect sales instructions to rise. And if some of last year's accidental landlords now decide to sell up, new instructions could very plausibly outstrip demand. **In fact, RICS data show that new instructions rose faster than sales in July, suggesting that the market may already have taken its first steps towards correcting the supply shortages.**
- **History also suggests that recent developments are unlikely to signal an end to the correction.** A similar tightening in market conditions in early 1993 abruptly petered out. It was followed by a three year period in which house prices initially edged higher but then fell back. During that time, both affordability and valuation metrics looked attractive (suggesting no fundamental need for further house price falls) while the economy grew at above-trend rates and unemployment fell by a quarter.
- Today's situation is far less encouraging. A return to trend GDP growth seems a distant prospect, unemployment is more likely to rise further than to fall and valuation measures remain stretched. Thus the case for further house price falls, perhaps of 15% to 20%, seems pretty clear to us.
- **That said, further house price falls are likely to be far more gradual than those we saw last year. Although prices are unlikely to end this year more than 4% to 5% lower than in December 2008, with less of the required adjustment having taken place this year, if anything, the balance of risks to our forecasts of a 5% fall in house prices in both 2010 and 2011 probably lie to the downside.**

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Recent house price rises lack a firm foundation

All of the major house price indices have shown clear signs of stabilising over the past three or four months and more recently they have begun to rise.

The received wisdom is that the key driver of this change is that the recent rise in buyer interest has coincided with an acute shortage of property on the market. This has meant that sellers, seeing an increasing number of potential buyers passing through their door, no longer feel compelled to accept offers based on as deep a discount to asking prices as they did in the final stages of last year. Some anecdotal evidence also suggests that competitive bidding among buyers is also on the increase.

Such a situation is in marked contrast to the tail-end of last year when buyer interest was almost non-existent. This transformation raises some obvious questions. **What has triggered the change and how large has the mis-match between buyers and sellers become? How long might it last? And what does all this mean for the outlook for house prices?**

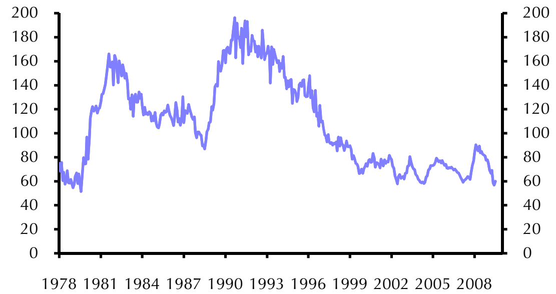
Tracking the changing supply/demand balance

Probably the best indicator of the supply of property for sale at any given time is the average number of unsold properties per surveyor. From a high of 90 properties per surveyor in February 2008, this has since fallen steadily to stand at just 60 in July 2009 – close to the lowest levels on record. (See Chart 1.)

However, as we saw only too clearly last year, a low supply of property for sale need not be a problem if no-one wants to buy. Rather, what matters for house prices is the balance between the number of willing buyers and sellers in the market.

We can derive a measure of these short term price pressures by combining data on the amount of stock currently for sale with the rate of sales activity in the market. For a given level of stock, higher sales are a sign that each property is selling more quickly. Thus sellers have more bargaining power than when sales are lower.

CHART 1: UNSOLD PROPERTIES PER SURVEYOR, 1978 – JULY 2009

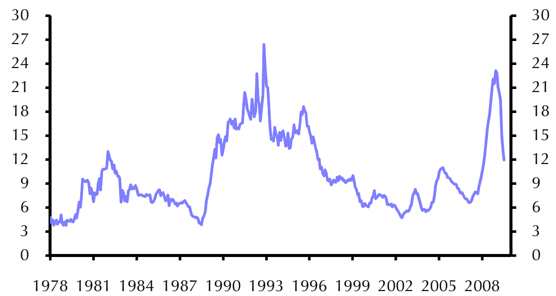


Source – RICS

This measure can be expressed either as the ratio of sales to unsold stock or, alternatively, as the number of months taken to clear the existing stock of property on the market at prevailing rates of sale.

As Chart 2 shows, the months of unsold stock rose sharply from a figure of around 7.5 months in mid-2007, to a peak of 23.5 months in December last year. Since then, however, it has dropped sharply to stand at 11.9 in July.

CHART 2: MONTHS OF SUPPLY ON THE MARKET 1978 – JULY 2009



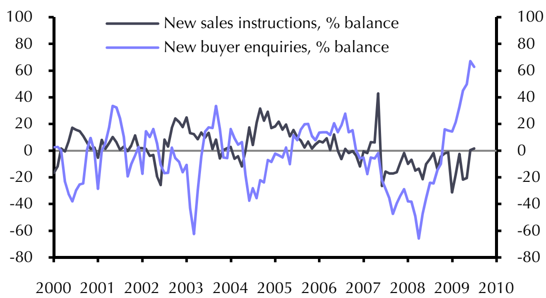
Source – RICS and Capital Economics

While still above a 30 year average of around 10 months, there has clearly been a marked tightening in overall market conditions during the first half of this year. So what has triggered this change and what does it mean for the outlook for house prices?

What has triggered the change?

Data from the RICS show that the tightening in the housing market seen since December, reflects a steady fall in the number of new properties coming on to the market, at the same time as the number of active buyers has risen. (See Chart 3.)

CHART 3: SURVEYORS REPORTING HIGHER BUYER ENQUIRIES AND SALES INSTRUCTIONS THAN THE PREVIOUS MONTH, 2000 – JULY 2009



Source – RICS

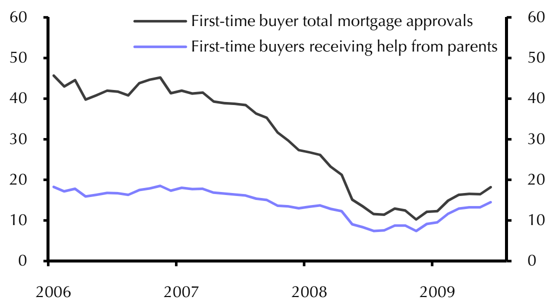
It does not seem hard to rationalise why new sales instructions have remained so weak. For a start, although in theory it can make sense for anyone looking to trade up to do so while prices are falling, few people like the idea of selling into a falling market.

In addition, during 2008, a rise in job insecurity, rising levels of negative equity and a sharp tightening in mortgage lending criteria all took their toll on the number of homeowners who were able or willing to move home. Surveys suggest that households have become a little less fearful of losing their jobs since the turn of the year, but neither the incidence of negative equity nor the tightening in lending criteria have eased to any great extent.

However, that raises the question of who is driving the rise in demand? After all, in a normal market, roughly two thirds of transactions involve existing home-owners who are trading up or down the ladder. In other words, if there has been a sharp fall in the number of sellers there should also have been an equivalent fall in the number of buyers.

There are probably three main groups driving the recovery in demand. First, data from the CML point to a small recovery in the number of first time buyers. (See Chart 4.) Not surprisingly, however, given still-tight lending criteria, the rise has been pretty modest and restricted to those lucky enough to be able to rely on relatives for financial support.

CHART 4: MORTGAGE APPROVALS FOR FIRST TIME BUYERS, 000S PER MONTH, 2006 – JUNE 2009

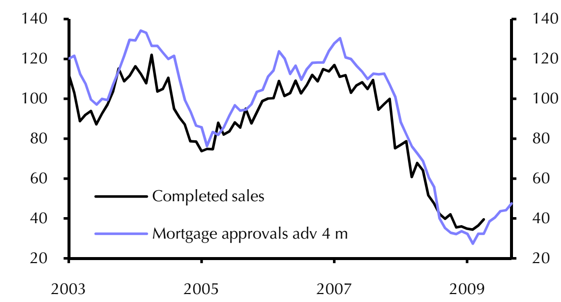


Source – Thomson Datastream, CML and Capital Economics

Second, there also appears to have been increased demand from cash buyers. This group is likely to include overseas buyers and cash-rich individuals seeking a better return than is available in the bank. They could also include returners – people who sold up at or around the peak, moved into rental accommodation and who are now looking to take advantage of the price falls already seen.

There is no accurate way of measuring the number of cash buyers but over the past few months, the number of completed sales has been rather stronger than the number of mortgage approvals suggests that it should have been. Part of this is likely to be explained by a rise in the time taken to move from mortgage approval to completion in the ultra-weak market conditions of the second half of last year. Even so, the data also seem to support the idea that cash buyers have become more important in recent months. (See Chart 5.)

CHART 5: MORTGAGE APPROVALS AND COMPLETED SALES, 000S, 2003 – JULY 2009



Source – RICS and Capital Economics

A third part of the explanation could also simply be a shift in sentiment brought on by the interest rates cuts in late 2008 and early 2009 and the subsequent signs of improvement in some of the economic data. After all, given how long it was taking to sell a property in the second half of last year, many of those people with their houses on the market at that time, may not have bothered looking for another property until they had received an offer on their own.

As buyer interest levels began to rise around the turn of the year, sellers who began to receive more viewings, and indeed offers, may themselves have begun to look for a property. If so, this simple switch in sentiment will have boosted active demand in the market, without boosting the supply of property for sale.

How big is the imbalance?

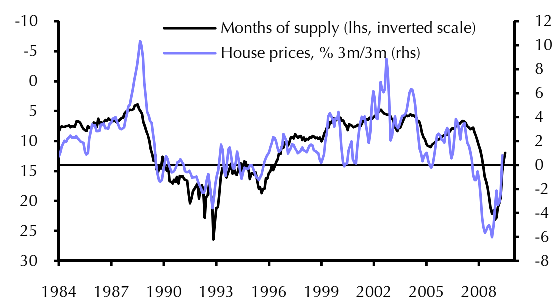
Common sense dictates that in a normally functioning market, where the majority of sellers are also buyers, a large and lasting imbalance between the two groups is unlikely to emerge – or at least to last for long.

And that also appears to be the message from the data on the months of unsold stock. After all, while this measure has recently fallen sharply, the bigger picture is that both stock and sales remain unusually depressed.

Of course, it is possible that measures such as the months of unsold stock underplay the extent of excess demand in the market. Given the time between when an offer is accepted and the property changes hands, completed sales are, at best, a rough guide to *current* levels of activity in the market. What's more, sales only record *satisfied* demand. They do not include all those who actively want to buy but cannot because they have been outbid by someone with deeper pockets or a better credit rating and thus a larger mortgage offer.

However, while we can't dismiss this possibility out of hand, if the months of unsold stock data are understating the extent of excess demand in the market, we would expect their relationship with house prices to have broken down. But this is not the case. (See Chart 6.)

CHART 6: HOUSE PRICES AND THE MONTHS OF UNSOLD STOCK, 1984 – JULY 2009



Source – RICS and Capital Economics

So where do we go from here?

Chart 6 also shows that the recent sharp tightening in market conditions is far from unprecedented. In early 1993, the months of unsold stock fell from a high of 26.4 to around 14 over a 7 month period. It then stayed broadly stable for around 18 months before rising again during 1995.

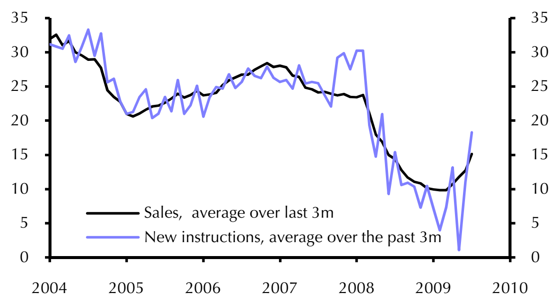
Over that three year period house prices were volatile, rising in some months and falling in others. Although the initial trend was upward, this was subsequently reversed, with average house prices reaching their absolute low in mid-1995.

We suspect that the housing market may now follow a broadly similar path. However, unlike the early 1990s, we suspect that house prices now are more likely to continue trending down than to simply track sideways.

Indeed, the latest survey from the RICS suggests that a rebalancing of the housing market may already be underway.

By comparing the average number of sales per surveyor with changes in the unsold stock on the market it is possible to back out an estimate of the average number of new instructions received by agents. The instructions figures are far more volatile than the sales data as they are also affected by people who withdraw their property from the market before it has sold. Yet the data show that, in July, in contrast to most of the past 18 months, new instructions not only matched but exceeded sales. (See Chart 7.)

CHART 7: COMPLETED SALES AND NEW INSTRUCTIONS, 2004 – JULY 2009



Source – RICS and Capital Economics

Admittedly, one month does not make a trend. And a similarly strong rise in net new instructions in April was not sustained. **But with much of the uncertainty that characterised late 2008 and early 2009 having receded, a further rise in new instructions seems more likely than not over the next few months.**

Does it matter where these new instructions come from? After all, if they come simply from a rise in the number of existing homeowners looking to move home, that would simply leave the relative numbers of buyers and sellers unchanged, thus doing little, if anything, to ease let alone reverse the current upward pressures on prices.

However, over the past 18 months developers, house-builders and some existing homeowners have resorted to renting out property that was proving difficult to sell. Meanwhile the normal steady drip feed of former BTL properties coming onto the market as a tenancy expired almost completely dried up during the second half of last year. Thus there is likely to be a large pool of property whose owners might now feel the time has come to test the sales market once again. If this was to begin to come onto the market it would increase the amount of property for sale, but not the number of active buyers.

In addition, we would not be surprised if demand began to rise more slowly from here. There must surely be a limit to the number of cash buyers in the market or to the number of returners. And, in absolute terms, the number of first time buyers receiving help from relatives has now returned to levels which are only a touch below their pre-correction levels.

What's more, many of these buyers will be discretionary with no urgent need to buy and little incentive to overpay. Meanwhile, increasing competition for retail deposits among lenders is slowly driving up savings rates and this is likely to persuade some potential investors that property, with its additional costs and risks is a less attractive option than it seemed a few months ago.

While these factors are almost impossible to quantify, on balance, it seems probable to us that measures such as the months of unsold stock will begin to rise again over the next few months, first dissipating and then reversing the current upward pressure on average house prices.

But while we do expect to see a rise in sales instructions we are not forecasting a huge rise in completed sales. Rather, we expect the market to be characterised by a low, if slowly improving, level of turnover for some time to come.

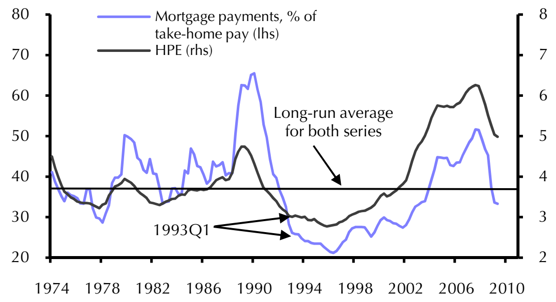
After all, we estimate as many as two million households may either be in negative equity, or have too little equity left to put down even a 10% deposit. In other words, up to 20% of mortgage holders may now find that their ability to move home has been severely, if not completely, curtailed. Meanwhile, the evidence that the mortgage market is freeing up remains very limited. Tight lending criteria are likely to act as a brake on demand for some time to come.

Of course, we could be wrong, although, for the reasons set out above we doubt that the months of unsold stock data will continue to fall to the lows seen during the boom years. But it could plausibly track sideways at current levels, as it did in the 1990s. But, even if that was to happen, **there are good reasons why house prices will continue to trend lower rather than rise or even remain stable at current levels.**

First, by early 1993 both affordability measures and measures of valuation such as the house price to earnings ratio were well below their long run averages. In other words, not only was housing affordable at this point, but it also looked cheap in relation to earnings. This meant that there was no fundamental need for house prices to drop further from that point.

Today, by contrast, **while ultra-low interest rates have left affordability measures looking favourable, valuation measures such as the house price to earnings ratio remain stretched.** (See Chart 8).

CHART 8: MORTGAGE AFFORDABILITY AND THE HOUSE PRICE TO EARNINGS RATIO, 1974 – 2009Q2



Source – Thomson Datastream and Capital Economics

Furthermore, mortgage credit is likely to remain in short supply for the foreseeable future. And with interest rates only headed in one direction from here, we believe that both lenders and borrowers will be far less willing to use high income multiples to bridge the gap between house prices and earnings than they were during the boom. If that is right then downwards pressure on house prices is likely to remain in place for some time to come.

In addition, by the first quarter of 1993, the early 1990s recession was well and truly over. Output had risen for three consecutive quarters and unemployment was within a whisker of its peak. Indeed, by mid-1993 the economy was growing in line with its trend of around 2.5%. It continued to grow in line with or above trend rates throughout 1994 and 1995. As a result, over that period, unemployment fell by almost a quarter.

Today the situation is very different. Although the economy may have stopped contracting in the third quarter, we cannot yet be sure. **And the bigger picture is that growth looks set to remain weak for some time, with GDP rising by perhaps 0.5% next year and just 1.5% in 2011.** As a result, we think that unemployment will continue to rise until late 2010, and is unlikely to begin to fall until late 2011 or early 2012.

Against that backdrop, and given the fact that the market remains overvalued, we find it hard to imagine that house prices can stabilise at current levels, let alone rise on a sustainable basis.

However, while the case for significant further house price falls, of perhaps 15% to 20%, seems pretty clear to us, judging how long it might take for those falls to materialise is far more difficult.

Not only is the current low level of stock complicating the picture, but the low level of interest rates, as well as Government intervention to limit the number of possessions made by the banks, are both resulting in a lower number of forced sellers in the market than past experience would have suggested. As a result, house prices may now be far slower to adjust than they were last year, before interest rates had been cut and before the Government had intervened to limit possessions.

Indeed, in the short-term, it would not be too surprising if house prices continue to post modest further gains. And it is certainly plausible that prices finish the year 2% to 3% higher than December 2008. **We suspect it is more likely, however, that prices will stabilise or begin to ease back during the Autumn months. Even so they are unlikely to be more than 4% to 5% below December 2008 levels.**

Next year we see no reason to change our view that price falls will continue. But if we are right in expecting the economy to expand by just 0.5% and unemployment to rise further then, with less of the required adjustment having been delivered in 2009 than we had expected, **if anything, we suspect that the risks to our current forecasts of a 5% fall in both 2010 and 2011 lie to the downside. In other words, the further prices rise in the short term, the larger the second leg of the house price correction is liable to be.**

Conclusions

Much has been written about the lack of residential property for sale at the moment and whether the resulting stabilisation and subsequent rises on house prices could be a sign that the correction is all but over.

Yet the very fact that this issue is attracting such interest is surely a sign that, deep down, few people believe that the resulting rise in house prices over the past few months can be sustained.

To us, therefore, the recent better than expected news from the housing market is simply a useful reminder that economies rarely contract or expand in a smooth or entirely predictable fashion. It does not change the big picture that house prices still need to fall by a further 15% to 20%.