Market Commentary

Residential Analysts

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United Kingdom – April 2022

- **The Next Crash & Rational Exuberance**
- **Interest Rates, Energy Costs, & Policy Mistakes**
- **House Prices & Turnover**

The housing market may still be booming but risks are rising. There are increasing warnings about a recession while some forecasters are downgrading their predictions for house price growth next year. A crash is still far from guaranteed but it is worth considering what the next market downturn could look like. At the very least to explore what could be done to alleviate the challenges and issues it creates for the housing market and wider economy.

The Next Crash

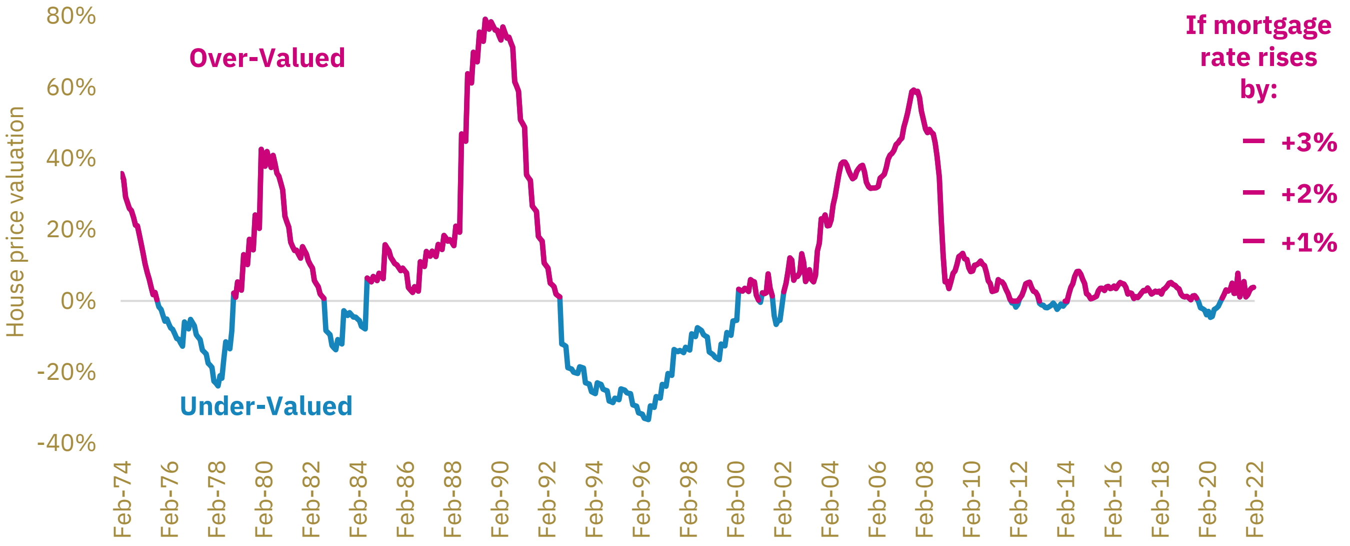
The cost of living crisis has barely registered on the housing market - so far. House prices are still rising rapidly and transactions are continuing at higher than pre-pandemic levels. Most house price indices are reporting annual growth of around 10%. Most measures of market activity - including website activity, sales agreed, mortgage approvals, and actual transactions – are all pointing to levels 10-15% higher than those prior to the pandemic in coming months. The housing market is still working, at least for those able to afford it, while the threat of rising mortgage rates provides further incentive to rush rather than delay any purchase.

But the risks to the housing market are rising. The cost of living crisis is squeezing household finances, especially for those towards the lower end of the income distribution (typically renters). Meanwhile interest rates are rising, which will eventually feed through to higher mortgage rates and higher housing costs for mortgaged home owners. The UK's economy may have recovered from the worst of the pandemic lockdown but it was already struggling to deliver meaningful growth in the preceding years. The war in Ukraine continues to disrupt the global economy and the news of massive lockdowns in China is concerning. There are substantial risks to the housing market and forecasters are already downgrading their predictions for next year with some expecting a correction.

Rational Exuberance

It is worth considering the state of the market when assessing the potential for a correction - as we did at the start of the pandemic. Like then, and despite current high rates of house price inflation, the national market looks reasonably priced given the underlying fundamentals of wages, mortgage rates, and lending conditions. While it may partly reflect the pricing out of large numbers of people, there are limited signs of the stresses usually seen prior to a house price crash. Repossessions are near record lows, buyers have higher incomes than average, and mortgage lending conditions are benign - with low loan-to-value ratios, repayments well within affordable levels, limits on high loan-to-income lending, stress-tested buyers, and longer fixed-rate periods on repayment mortgages. However, while the underlying fundamentals suggest house prices are reasonably priced at current levels, the fundamentals may be about to change – potentially quite quickly.

Fig 1: Actual House Prices Compared To Modelled House Prices – UK
Source: ONS, Bank of England



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Interest Rates, Energy Costs, & Policy Mistakes

It is rare for the UK's housing market to maintain an equilibrium. The market tends to alternate between boom and bust. But this is what it appears to have done since the financial crisis. As Fig 1 shows, prices may have risen rapidly in recent years but in line with wages and falling mortgage rates. Prices are at record highs but there is no national bubble to burst. Instead, the danger is that changes in interest rates, the cost of living, or policy mistakes, quickly alter the underlying fundamentals of current house price levels. And the problem with record high prices and record low mortgage rates is that the situation is more finely balanced than in previous periods.

Changes in interest rates, rising energy costs, and policy mistakes have all been key factors in previous housing market downturns. During the 1970s, changes in mortgage rates helped drive credit bubbles and busts in housing while rising energy costs squeezed household incomes and led to recessions – the Bank of England had to bail out lenders with a "lifeboat operation" in 1973. Similar interest rate mistakes were made during the late 1980s that were compounded by the rush to beat the MIRAS tax holiday deadline. However, while we can make comparisons and draw conclusions from previous downturns, each one is unique. For example, we don't know how the now highly financialised housing market will respond to rising interest rates while the cost of living crisis will significantly alter the monthly bank statements of buyers that only recently had them picked through by lenders.

House Prices & Turnover

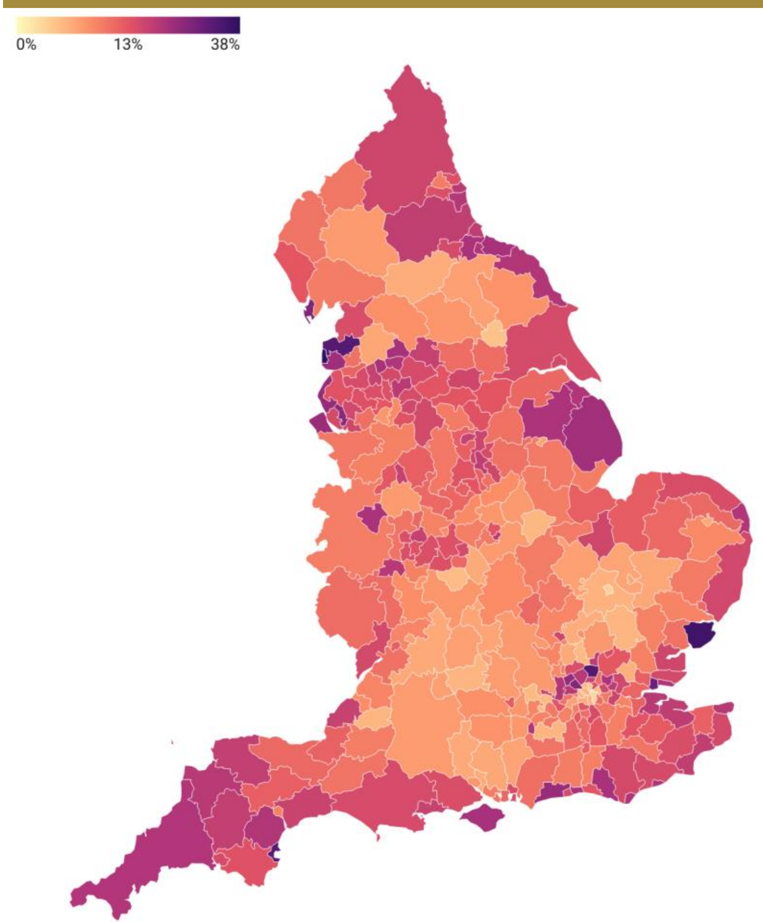
One of the lessons learnt since the early 1990s crash is the importance of considering both house prices and transactions together. Especially given the political and economic importance of avoiding a large house price correction. House prices reflect the price of homes actually transacting – usually a small proportion of the total stock. Therefore, at any given time, it is the balance between the number of homes available for sale and the number of willing and financially able sellers that dictates the price paid (in many cases the same people are selling and buying). The risk during a crash is that the number of motivated sellers outnumbers the willing buyers. The price then collapses. Both during the financial crisis and the pandemic, one of the priorities was to ensure that there was no excess of forced sellers. Forbearance by lenders, funding for developers to convert market sale homes to rental, and support for those made unemployed/furloughed were important policies in either minimising the fall in house prices during the financial crisis or avoiding a house price crash during the pandemic.

Therefore, while the size of any mortgage rate rises will be important, the question of what happens to house prices also depends on activity levels and government support. It's quite possible that a sudden rise in mortgage rates could lead to a house price correction – for example, Fig 1 suggests a rise to 3.6% (from 1.6% currently) would lead to prices being 30% over-valued. However, with a large number of homeowners owning their home outright and mortgaged owners not immediately affected thanks to longer fixed-rate periods (for the UK at least), most people may be able to sit tight and not sell. Rather than a correction, we might end up with stagnation and activity levels driven by death, debt, and divorce.

Perhaps the most immediate risk comes from the private rented sector. Tenants are facing large increases in rents on top of the cost of living crisis. For those at the lower end of the income distribution, the lack of uplift in Local Housing Allowance rates will put further pressure on their already precarious finances. Fig 2 opposite highlights the parts of England where housing benefit tenants make up a large proportion of private rented tenants. It is these areas that we might expect to see the first signs of stress in coming months.

Fig 2: Private Rented Housing Benefit Claimants

Source: DWP , ONS – as % of households in private rented sector



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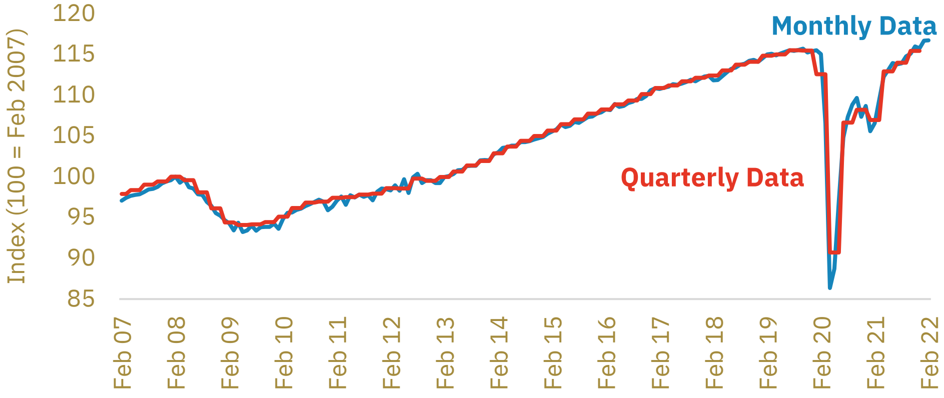
Market At A Glance

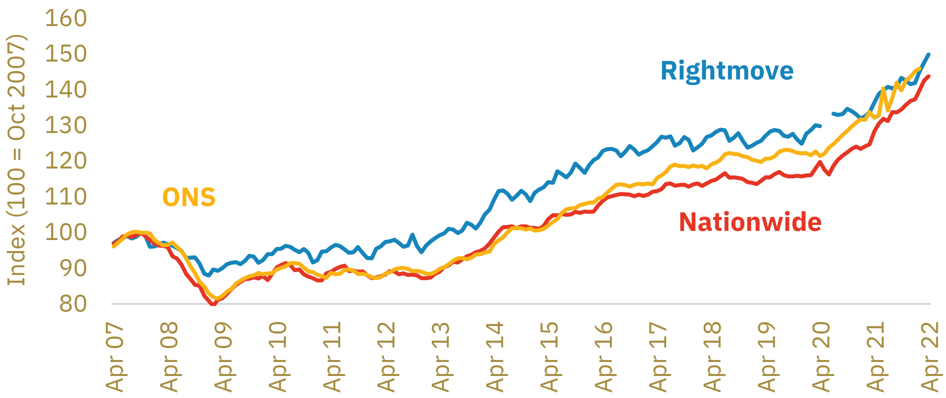
Economy - UK

The ONS monthly estimates reported GDP was 9.5% higher in February 2022 than the same month in 2021. This left monthly GDP 1.1% higher than the pre-pandemic peak recorded in January 2020. However, this data will inevitably be revised in coming months and years.



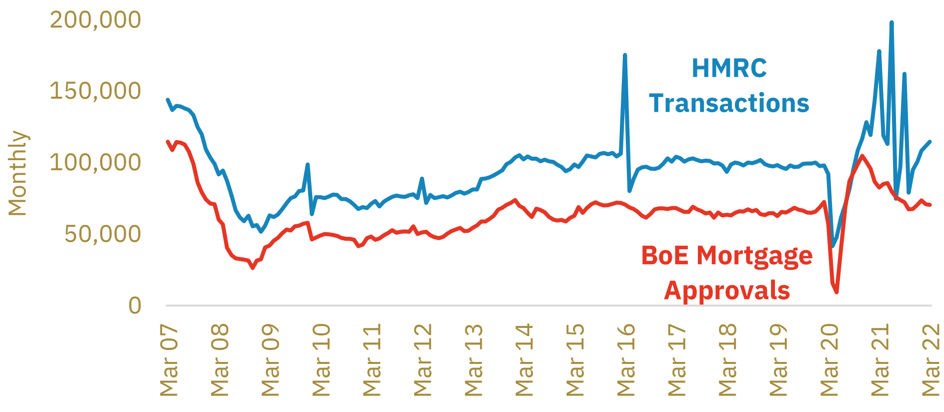
House Prices - UK

Rightmove reported a 9.9% annual rise in asking house prices in April 2022 while Nationwide reported a 12.1% annual rise in their mortgage approval based index in the same month. Meanwhile, the ONS reported 10.9% annual growth in its sales agreed index in the year to February 2022.



Transactions – UK

HMRC provisionally reported 115,000 residential transactions in March. This was 16.4% higher than the same month in 2019. Meanwhile, the Bank of England reported mortgage approvals for house purchase were 12.5% higher in March 2022 than the same month in 2019.



New Supply - England

The latest net additions data for 2020/21 reported a 216,490 net new homes in England with 194,000 new build completions. The latest quarterly house-building data suggests there were 220,000 new build completions in 2021 while there were 238,500 new build Energy Performance Certificates in the year to Q1 2022 – a leading indicator for net housing supply.