

The British property market

Mathieu Bouville

Historical price evolution

According to Halifax, “over the last five decades [1959–2009] UK house prices have risen by 2.7% a year, allowing for inflation.”¹ According to Nationwide data, Fig. 1(a), property prices have increased annually since 1952 by 9% nominally, and by 2.85% in real terms since 1975.

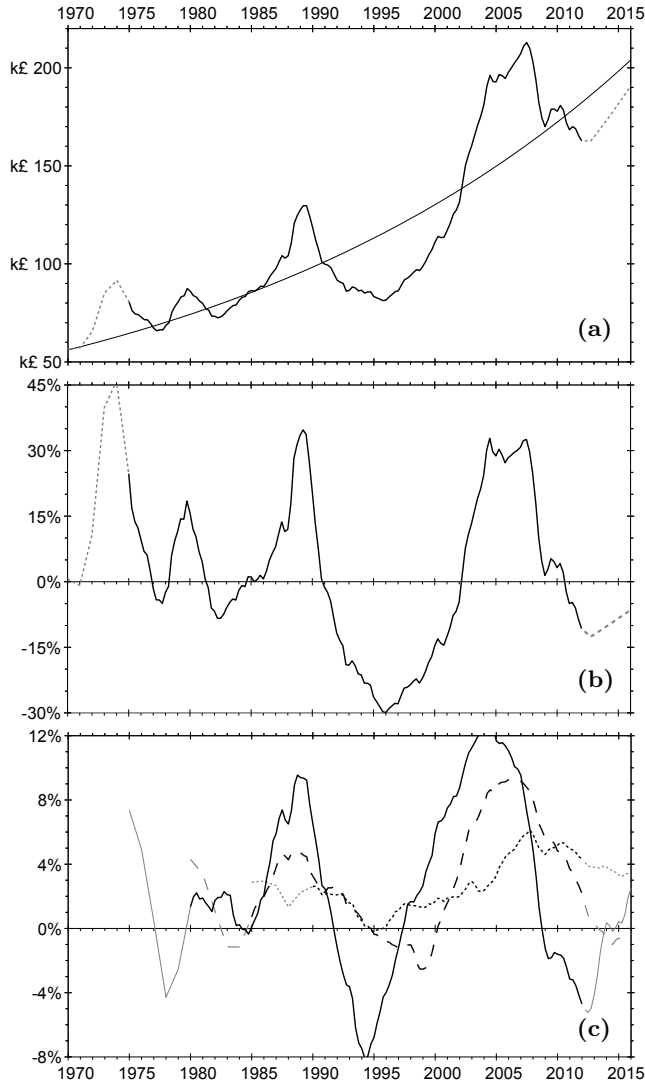


FIG. 1: (a): Average property price in the UK in today’s pounds and exponential fit. Data: Nationwide. (b): Discrepancy between the prices and their exponential fit. (c): Annualized real increases over rolling 5-, 10- and 15-year periods (respectively solid, dashed and dotted lines). Extrapolations are based on no real change in 2012 and +5% thereafter.

	discrep. w/ trend	annual. 5-year	annual. 10-year	afford- ability	price- to-pay	price- to-rent
1973	$\approx 45\%$	$\approx 10\%$	—	—	—	$> 10\%$
1977	-4.0%	$\approx -4\%$	—	—	—	-7%
1979	20%	2%	$\approx 4\%$	—	—	30%
1982	-7.5%	0%	$\approx -1\%$	—	—	-25%
88–89	36%	10%	4.8%	148	3.9	25%
94–96	-29.5%	-8%	-2.5%	46	2.1	-40%
04–07	33%	13%	9.3%	136	5.4	55%
09–12	-11%	-5%	$+2.2\%$	88	4.1	$+25\%$
expect.	$< -4\%$	$< -5\%$	$< -4\%$	< 60	< 2.5	$< -25\%$

TABLE I: Peak value and subsequent trough of the discrepancy with the historical trend, the annualized price variations over 5 and 10 years, the affordability, the price-to-pay ratio and the price-to-rent ratio.

The real increase from the peak of 1989 to Q1 2012 was 25% — buying at the top of a bubble and selling in a depressed market 20 years later did not result in a loss. In fact, the dotted line in Fig. 1(c) shows that no 15-year period resulted in a real loss, which is also true for 12.5, 17.5 and 20 years. Today’s prices are back to those of nine years ago (checking for inflation).

“There were regular building cycles in the UK throughout the eighteenth century, which were measured by historians as having an average of sixteen years from peak to peak [...] a contemporary analyst, Fred Harrison, looking at the twentieth century has come up with a figure of nineteen years.”² This is consistent with 1973–1989–2007 [based on Figs. 1(b) and 1(c), the 1977–1980 increase was on a smaller scale (bear-market rally?)], and would place the next peak around 2023–2026.

Figure 1(b) shows that when prices are 25% above their long-term trend, prices soon fall. Based on this criterion, you would have sold at the end of the third quarter of 1988 for k£120 (in today’s money). Prices would have reached this value again only 13 years later; in-between they were as low as k£80, a third off. There was another sell signal mid-2004.

Search for fundamental valuation

Figure 2(a) shows “a fair-value measure for property based on the ratio of house prices to rents. The gauge is much like the price/earnings ratio used by stockmarket

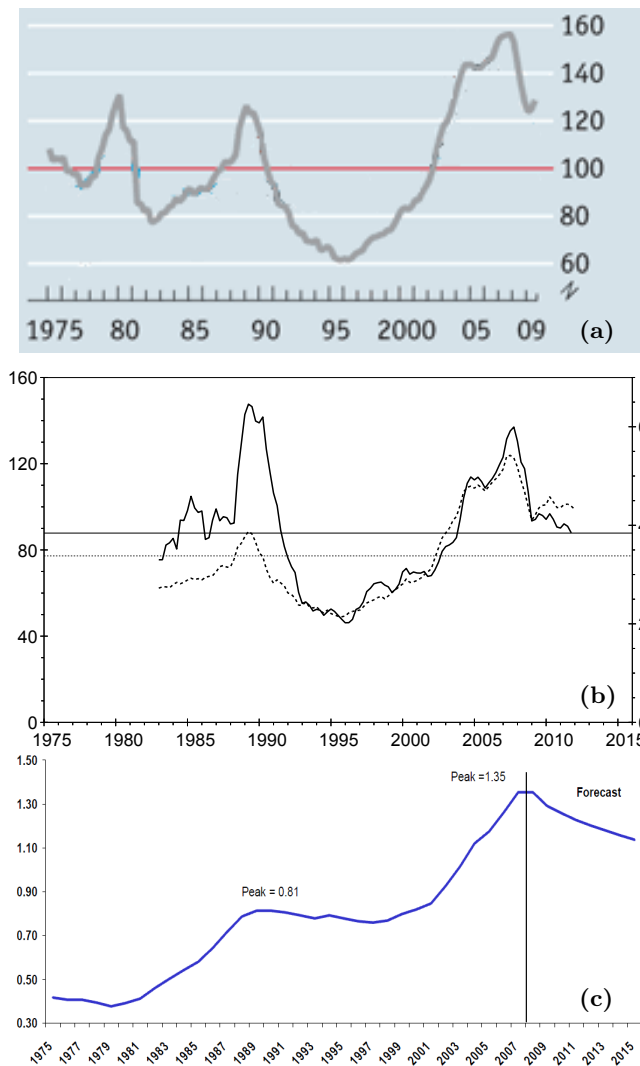


FIG. 2: (a): The ratio of house prices to rents (long-term average = 100). Source: The Economist. (b): Affordability index (solid line, left axis) and price-to-income ratio (dotted line, right) for first-time buyers. Data: Nationwide. (c): The ratio of mortgage debt to income. Source: Hometrack.

analysts. Just as the worth of a share is determined by the present value of future earnings, house prices should reflect the expected value of benefits that come from home ownership. [...] In Britain, where prices are increasing again, housing still looks expensive [overvalued by 29% based on data available in December 2009.]³ This makes the market after the fall as overpriced as it was at the top of the bubbles in 1980 and 1989.

Figure 2(b) shows the ratio of property prices to average income and the affordability index. The affordability index corresponds to the mortgage payments as a percentage of take home pay (taking 1985 as 100 index), it thus accounts for both price compared to income and for interest rates. For example, the Bank rate reached

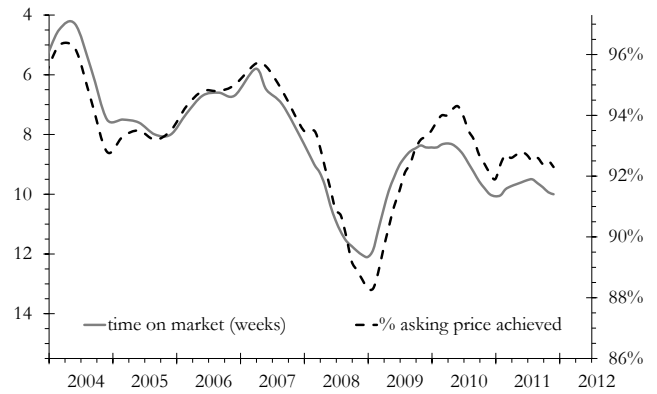


FIG. 3: Asking price being achieved and time on the market (inverted scale). Data: Hometrack.

15% in 1990, making mortgage borrowing very expensive regardless of prices. Conversely current rates are historically low, which explains why the affordability index was far above the price-to-income ratio then but is now at the same level in Fig. 2(b). One should bear in mind that affordability will deteriorate when interest rates increase.

One should note the great similarity between the price-to-income ratio and the price-to-rent ratio, dotted line in Fig. 2(a). Unlike the affordability index and Figs. 1(b) and 1(c), these consider that the market was far more overvalued in 2004–2007 than in 1980 and 1989 (other criteria make these three episodes about equally overvalued) and still is overvalued. Figure 1(a) shows a similar trend: this may hint that price-to-income and price-to-rent ratios need detrending. On the other hand this is also reminiscent of S&P 500 CAPE and q-ratio in 2000 that were worse than in 1929 and still nearly as bad as 1929 in the mid-2000s: they were right, the market really was still overpriced. A key question is why property prices increase so much faster than earnings: is this an artifact (a drop is yet to come) or is it a long-term evolution in spending (e.g. one spends less and less on food)? On the other hand, this cannot explain the price-to-rent ratio [Fig. 2(a)]: if housing is becoming a bigger and bigger part of our budgets, then rents should increase as well.

Figure 2(c) “shows the mortgage debt to income ratio over the last 30 or so years. There are two distinct peaks one in 1989 and the more recent peak in 2008. [...] Lower interest rates and much higher house prices have enabled the household sector to increase its overall debt levels [in 1999–2008] whilst only experiencing a modest overall increase in the mortgage debt to total wealth ratio.”⁴ Will the market need time to digest this binge borrowing?

Figure 3 shows that from mid-2007 to early 2009 sellers had to grant an increasing discount to buyers and it was taking longer and longer to sell. The trend then re-

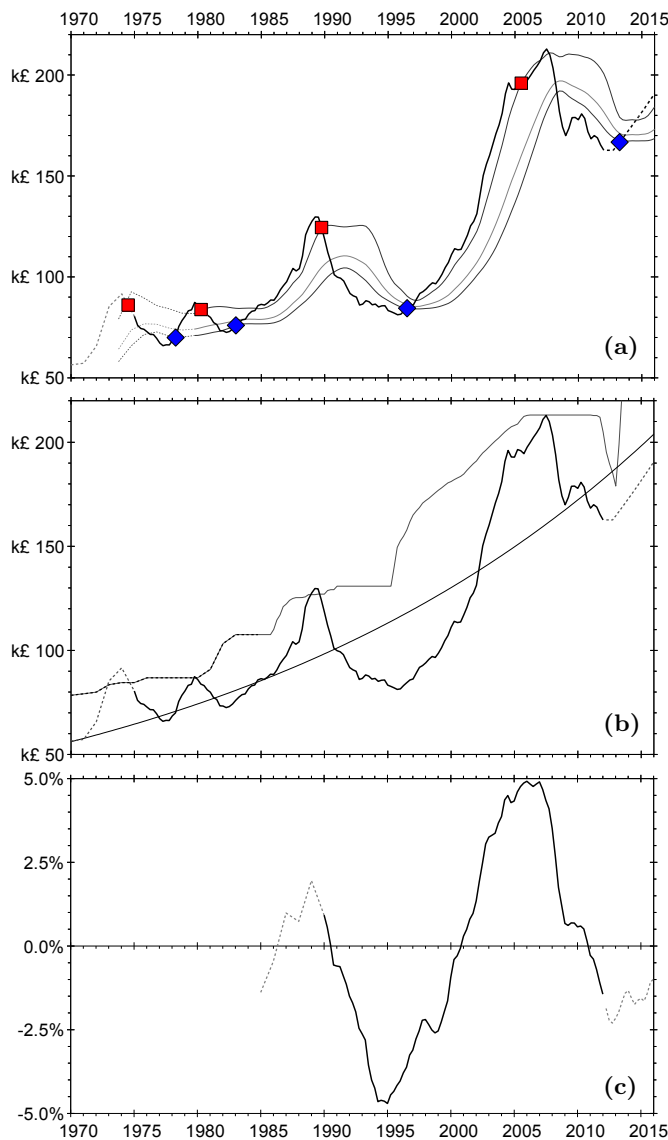


FIG. 4: (a): Bollinger bands for the real UK property prices (5 year simple moving average, $SMA + 1.2\sigma$ and $SMA - 0.5\sigma$). (b): Maximum of the maxima of the discrepancy with the long-term trend. (c): Weighted average of the 3 curves of Fig. 1(c) minus the long-term average, 2.8%. Extrapolations (dotted lines) assume no real change in 2012, then +5% p.a.

verted but for the past two years the situation has been degrading again.

Prospects

Figure 1(b) shows that whenever the real price was more than 15% over the historical trend (1975, 1980, 1989 and 2002–2007) it then fell to 5% below it (if not further). In 1989 when the discrepancy reached 30% it then fell to –30%. Today, the value is –11% (see Table I).

Figure 4(a) shows Bollinger bands.⁵ The data are above the top curve during rising markets (1985–1989 and 1996–2005); when they let go (red squares) a fall is to be expected (even though in 2005 it took a few years). And the data are below the bottom curve during falling markets (1990–1996 and nowadays). The blue diamonds indicate buying opportunities. Even though 2012 may be one of them, there is no buy signal yet, and if prices were to stay flat in real terms, then the bear market may not be considered over until 2013.

One would be interested in knowing ‘what is the highest property price 5 to 10 years after the discrepancy reached some value?’, thus allowing for a variation of durations of cycles. For instance in Q1 1990 we look at the maximum property value between Q1 1995 and Q4 1999 and in Q4 1994 at the maximum between Q4 1999 and Q3 2004. We then use as upper bound for Q4 1999 the maximum of the maxima obtained for Q1 1990 to Q4 1994 (so that extrapolation can be done only 5 years in advance). Figure 4(b) shows this maximum based on the discrepancy with the long-term trend. While it is definitely not a precise prediction (after all it is based on the maximum of the maxima), it has the advantage of near certainty: when the curve hits the upper bound (1973, 1980, 1989, 2007) it is due for a sharp drop.

Figure 4(c) shows that the price increase over 5, 10 and 15 years is above the historical average when markets overheat. Peaks are reached in 1988 and 2006, and a bottom is in 1994; this is slightly before price extremes.

¹ <http://newsvote.bbc.co.uk/1/hi/business/8468605.stm>.

² V. Cable, “The Storm” (Atlantic Books, 2009), p. 5.

³ http://www.economist.com/businessfinance/displayStory.cfm?story_id=15179388.

⁴ http://www.hometrack.co.uk/documents/Gary_Styles/GS.Lending-

Strategy_0709.pdf.

⁵ (i) The value of 5 years was not optimized, whereas the number of standard deviations was chosen for its retrospective predictive power.

(ii) Note the asymmetry of the coefficients.