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Residential Property for Children

Published on: 16 December, 2022 | Author: Investment Team

Many of our clients have children and grandchildren who, with the ineluctable passage of time, are now adults with young families of their own. We are often asked what we think the outlook for property prices looks like and whether now is a good time to buy a new house.

It is a notoriously difficult question to answer, not least because the default view of housing in the UK is that it always goes up in price. The sector can make a wise man look foolish; our Chief Economist in a previous life was famously “short” housing, preferring to rent rather than buy, more than a decade ago. That didn’t turn out so well.

Since our crystal ball is no shinier than anybody else’s, we can only turn to the historical record and look at the data behind housing markets.

The first thing to note is that house prices do not always go up. In fact, from 1989 to 1996, UK residential property prices, according to data compiled by the OECD from national sources, were entirely flat having fallen in the period immediately after 1989 by some 10%-15%.

Following the GFC of 2008/9, house prices fell in aggregate, with large regional variations, by up to 15% before resuming their upward march as interest rates were cut and the policy of “quantitative easing” was introduced to induce positive “wealth effects” by supporting asset prices.

“Ay, and there’s the rub,” as Hamlet would put it.

In a recent paper authored by David Miles, formerly of the MPC at the Bank of England, and Victoria Monro, the two economists demonstrate that the principal determinant of house prices is “lower real interest rates” and not, slightly counter-intuitively, changes to the supply side i.e. building more or fewer houses. In fact, the R^2 or “Coefficient of determination” between the change in housing prices and change in interest rates is minus 0.75 (on a scale between 0 and 1).

Baldly, if interest rates go up, house prices go down.

Since 1980, UK residential house prices have risen, in aggregate, by a factor of 13 times. At the start of that period UK interest rates were a rather startling 16%. In our late twenties and early thirties, some of us were paying 17.5% on mortgages; 2/3 of annual incomes.

In the intervening period, UK base rates have fallen almost, but not quite, in a straight-line bottoming at 0.1% in 2021. In that gigantic decline in interest costs (allied to tight supply) you have the driver of the immense growth in property prices over that period.

Some serious considerations follow from that tight financial relationship.

1. Quite obviously interest rates have been rising recently, commencing early this year. The historical record suggests that rate rises impact house prices with a time lag of about 1 year. Interestingly this month the ONS (Office for National Statistics) along with the Halifax pointed to early signs of declines in house prices.

2. The key to the interest rate outlook is the outlook for inflation and therefore how high interest rates will peak. There are some indications the CPI is beginning to fall and one theme for 2023 is that CPI may fall more rapidly than markets expect. However, the average base rate in the UK over 300 years is 4.85%. This contrasts with the current base rate of 3%. Rates are still easy compared to modern British economic history.
3. The third leg to the puzzle is incomes. The high inflation of the 1970s and early 1980s was validated by and offset by high rates of nominal incomes growth. Since the turn of the century incomes growth in the UK has simply failed to accelerate growing at barely 1% per annum since 2000.

So, the ingredients for housing appreciation: falling interest rates, stable and low inflation, along with rising wages are all absent. That would argue for a period of a flat but, more likely, falling property prices, at least for a time, until wages and prices adjust to a new stable equilibrium.

Is it for nesting or investing?

The financial implications for young homeowners are potentially severe. When rates were 17% average house prices were £24,000. Today average house prices are £293,835 with average outstanding mortgages at £137,934. The point being that a change in rate from 17% to 18% was insignificant (the damage having already been done) and mortgage values were low. However, a change from 1% to 6% on a higher starting value is potentially life changing.

The historical record would suggest that where possible, potential homeowners should perhaps, wait a while before plunging in.

On the other hand, mortgage debt is distributed very unevenly.

We suspect that the traditional Banks of Mum and Dad, Grandma and Grandad should brace themselves for requests for help to secure the dream home that just popped-up on Zoopla.

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