S P O T L I G H T   O N   V A L U E

economic and market ideas and how they may benefit our investors

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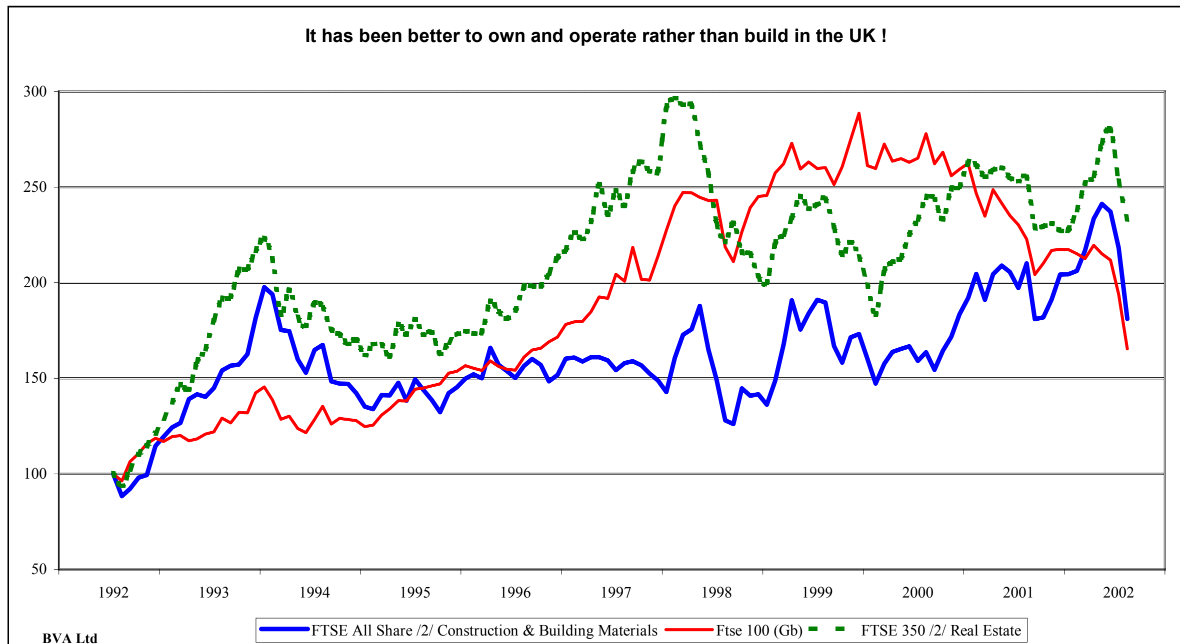
The housing sector in the British economy is pivotal to the strength of the economy, yet there are fears that another bubble has formed. We think the issues are more structural to the industry and require more detailed solutions. Getting it wrong though could cause immense damage to the UK economy as a whole

The housing and construction sectors in the UK are peculiar. There are strong imbalances in supply and demand, particularly in the South East of the country, yet profitability amongst house construction companies remains modest, and their shares under-perform the stock market. Owning and renting property on the other hand has been a more lucrative occupation, and shares in the property sector have performed well, particularly in the recent market downturn. Shortages of property and restrictive policies on the release of new land for residential housing purposes help push up prices. Higher prices bring about a potentially uneven distribution of benefits to society.



Windfalls to the elderly.

Despite the difficulties with stock markets and pension schemes, UK property prices favour those who have lived in the same place for a long time, and are sitting on a lot of "equity" in their property. The possibility of this equity "withdrawal" is what exercises the Bank of England, since it could lead to higher consumption, and under some circumstances to higher inflation. Hence there are arguments for somehow reining in the rise in property prices by increasing the cost of borrowing. Higher interest rates will choke off the rise in property asset prices and allow savings to flow into other areas of the economy – areas with arguably higher productivity.

The difficulty with this is that it only partly true. Higher interest rates are of primary concern

to those who have to borrow heavily to finance their purchases, and this applies in the main to younger members of society with young families. The more elderly are sitting on huge windfall gains, some of which can be monetized and consumed, or which might be used to buy other properties to be rent out as part of the proverbial nest egg.

Taxes on the young ?

At the other end of the age spectrum, high property prices pose real problems and make it difficult to get established on the "property ladder", the system whereby making judicious moves people can gradually move themselves into larger and larger dwellings. The difficulties become acute with lower paid so called "essential workers", who can no longer afford to live in London, but are increasingly obliged to travel quite long distances each day on antiquated railways or on over crowded roads. Building Societies are offering to lend on unheard of multiples of salary, up to 5 times in some cases, and a far cry from the more "normal" ratio of 2.5 times that was experienced back in the 1960's and 70's. All indicative of a bubble you might think.

Well, the answer to this is yes and no. In the third quarter of 1990, the proportion of gross household income given to paying off mortgage interest stood at 15.1% and from that peak it has fallen to 7.9% today. According to the Nationwide Building Society mortgage payments in the first year of a loan are currently around 25% of take-home pay, half the average burden in the 1980s. Obviously this is not the case for those key workers who cannot find a way into the housing market in the high-price, south-east of the country. So on the grounds of "affordability", property remains relatively cheap ? What these figures do not say is what you are getting for your 25% of take-home pay. Whereas a few years ago this might have been a reasonable dwelling, today, it might now be a cupboard with attitude.

Nevertheless, it should be remembered that when borrowers were paying those higher interest rates of the 1970s and 1980s they also benefitted from the government's mortgage interest tax relief (Miras). True, nominal mortgage rates have stayed unchanged at 5.8% since last November and nominal mortgage rates are at their lowest level since 1959, but as inflation has fallen so the real mortgage rate has risen and there has been an increase in real monthly interest repayments since the beginning of the year of just over one-third.

In the past house-buyers were willing enough to devote a much higher percentage of their earnings to financing a mortgage because high inflation quickly eroded the value of the debt while the real value of the house continued to rise thanks to the pressure of demand for houses. Part of today's problems lies in the fact that a high proportion of British people have not yet realised that this game no longer works in quite the same way. It is still true that houses are an asset of strongly rising value, at least in those regions where there are jobs, so that the old process of intermittent selling and then buying at a higher level will ratchet the house-owner's wealth upwards. What is no longer true is that the value of the debt is steadily being eroded by inflation. The mortgagee now has to repay in full the value of his debt as well as interest on top of it. This makes those who have over-leveraged their

house purchase at least as vulnerable as those in the past to rising interest rates, so that a small rise in interest rates could have a disproportionately negative effect. However, as with asset price bubbles in other markets, it makes sense to stay in for as long as possible. So long as property prices increase faster than the rate of inflation, then these "real" gains means that it is possible to slowly climb the property "ladder". Although real borrowing costs have become higher as inflation has dropped, the proportionate increase in borrowing needed to fund the new house, may well be manageable given the increase in property values and so the rise in the owners "equity". But the "tax" element now entering the picture is that your earnings have to rise in real terms too if you are to afford ever larger mortgages – and this suggests that there is cap on property prices out there somewhere.

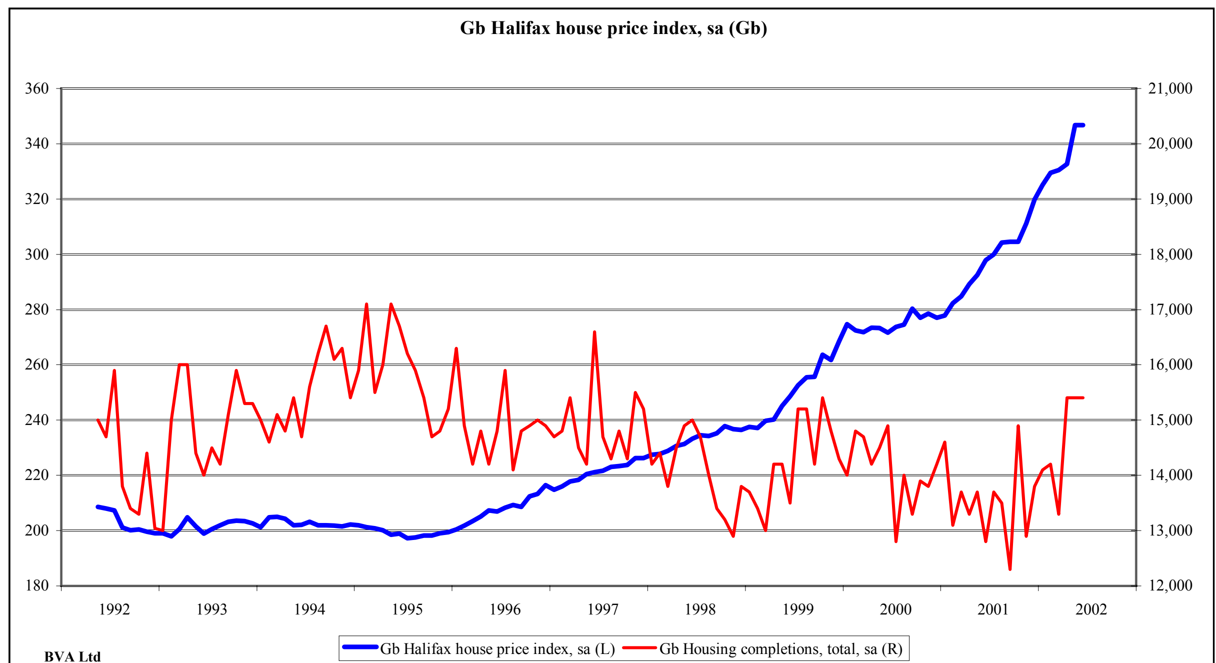
Pricking the bubble – are higher interest rates the answer ?

If property prices are rising in real terms and imposing substantial inter-generational gains and losses across the population, does this represent a threat to macro economic stability, and if so should the Bank of England raise interest rates ? It is certainly one way of achieving greater property price stability, but like the use of the atom bomb, its side effects may be at least as damaging as the good it is supposed to do. We favour an approach of "structural" intervention that would improve the legal and financial framework within which households are making their decisions.

- **greater stability in financing decisions needs to be available, and we suggest breaking the link between short term UK interest rates and the property market. We would favour the introduction of fixed term, fixed rate mortgages, like the Pfandbriefe in Germany. We could consider allowing mortgages to be transferable with the property, so that they stay with the "security" rather than with the person.**
- **Breaking these links would make it easier to countenance membership of the ERM/Euro, since higher short term rates would not automatically spill over into the housing market**
- **Discourage house speculation by increasing stamp duty on housing transactions, and on insisting on higher levels of own finance(equity) for more expensive houses. e.g 20, or 25% of a houses "value", with upper limits on mortgages of 80% of the house value – possibly adjusted still further in the light of market conditions.**
- **Steps need to be taken to increase the supply of housing. As the diagram below shows, there has been no secular increase in housing starts for many years.**
- **This means tackling the issue of the release of more Greenfield sites, and of encouraging the further use of Brownfield sites using reclaimed land. We need to move away from the current situation which can be described as building the wrong**

houses for the wrong part of the housing market, at the wrong price and in the wrong location.

- This may mean looking afresh at housing associations and more government owned housing. It might also mean better financial incentives to build more houses for rent.



This last point takes us onto the slippery area of politics and what is called "Nimby-ism". Local residents are often reluctant to approve the construction of new housing estates in "their back yard", and this can reflect in political movements that can unseat sitting MP's, and cause the government embarrassment.

And what about the Construction industry, how is it placed at the moment ?

The Council of Mortgage Lenders which represents the big banks and building societies fears that the market is heading for a crash and called for a rise in interest rates sooner rather than later, which helpfully would probably bring about the very crash it is seeking to avoid ! But the large construction companies do not agree; Frank Eaton, chairman of Baratt, Britain's third-largest volume builder, believes that the market has already normalised and that house prices have slowed enough to be sustainable. Further there has

been a strong fall in the share prices of the quoted house-builders over recent months and the financial community appears to judge that the housing boom is over. The sector's shares peaked in May and have since fallen by up to 20%. But the government's announcement that it would look into the housing problem gave the shares of the construction industry a sharp boost.

The City still fundamentally believes that the housing market is stuck in a boom-and-bust cycle and prices the sector's shares accordingly. Peter Johnson, the chief executive of Wimpey, feels that the financial markets have been discounting a much more difficult scenario than those in the business see as likely. Part of the reason for this wariness lies in the crash of the late 1980s when housebuilders overpaid for land and overbuilt and companies had to make huge asset writedowns. Thus, the immediate future is likely to reflect fears that the housing bubble is about to burst and that companies will suddenly find that they have properties on their hands that they cannot sell.

It may be that here we once again have a difference between the "finance capitalist" located in the City, and the more manufacturing orientated construction industry. Fear of a property bust could provoke a pre-emptive interest rate rise, that would then throttle back business activity everywhere, but would be particularly harsh on the construction firm. The construction industry itself remains determinedly optimistic.

As a short-term measure many housebuilders have been acquiring other companies. The sector has seen a string of mergers and takeovers : Westbury bought Prowting, Taylor Woodrow bought Bryant, Wimpey has bought McAlpine. This interest in mergers largely lay in the difficulties companies have been facing in getting land with planning permission to build. Sooner or later the companies will have to buy more land which is likely to push up house prices again. The industry is clearly hoping that the government's recent promises to provide more housing land will alleviate these difficulties. Contractors such as Morgan Sindall and Mansell, which have traditionally been among the biggest players at the lower end of the housing market, stand to be among the strongest beneficiaries as the government targets young couples trying to get on to the housing ladder and, of course, those key workers. The government will be using some of the extra spending allowed by Gordon Brown to be used for housing and of the £1.4 billion allocated to housing at least some will be used for cleaning up the brownfield sites that construction firms have been so reluctant to build on.

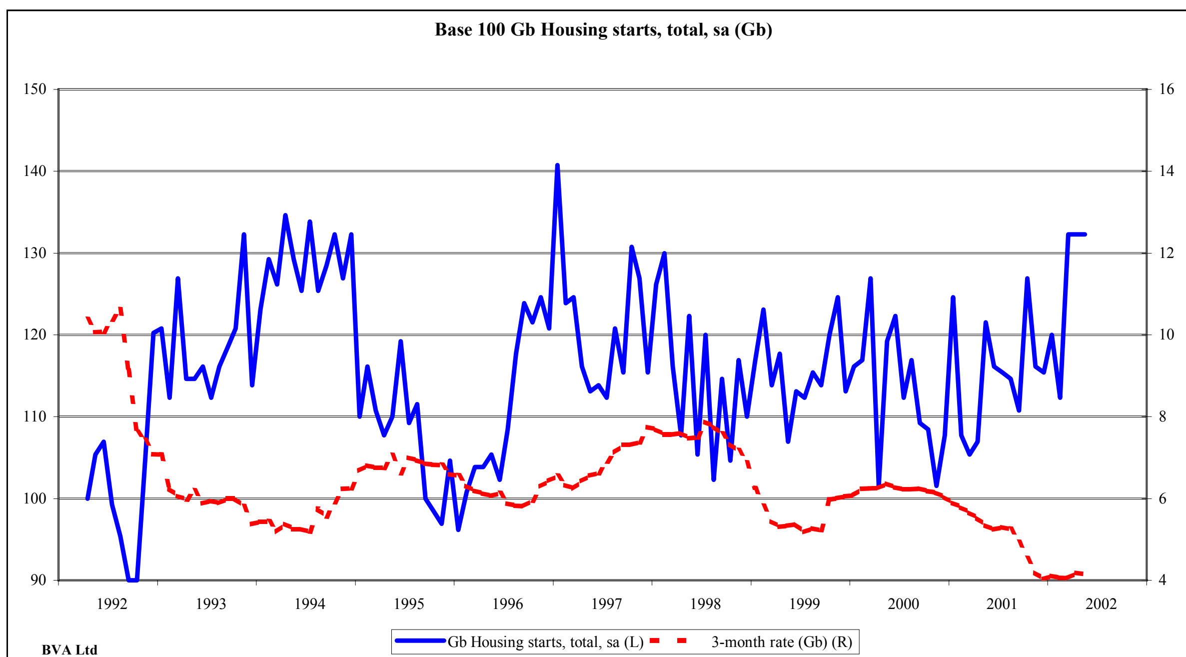
While the construction industry has been delighted by the government's announcement last week, slowly some of the difficulties in achieving the government's aims are emerging. The need to tackle the infrastructure, services and facilities are foremost among these. Anthony Dunnett, chief executive of the South East England Development Agency, said, "The government is going to have to challenge statutory bodies to fast-track the provision of infra structure which can often take several years to bring forward, but it is vital health clinics

and schools are built if we want these new homes." The government will have to make sure that there are the transport links and the local services to support the new communities. And there is a shortage of town planners and structural engineers. Prescott has announced a £350 million package to employ more specialists. But the truth is that much of what is going on is generalities and grandiose plans while the i's still need to be dotted and the t's still need to be crossed. All these plans may well take rather longer to realise than the government is making out.

So, is doing nothing the best option ?

It seems to us that left to its own devices market forces will eventually ensure that the bubble comes to an end. But this might be a long time coming, and will create huge regional imbalances. Congestion and costs will rise further in the South East, raising fears of that old chestnut the Selective Employment Tax, designed it will be recalled by an earlier Labour government to push services out of the south east and into the regions. Left untended, the costs of doing business in the South East will become prohibitive, and yes there will be stronger pressures to re-locate elsewhere in the UK, or possibly abroad. Public demands for "action" could then trigger belated investment in roads and rail and other social infrastructure, and buildings will probably get taller as population densities rise still further.

In order to avoid this fate, some intelligent intervention, particularly to increase the supply of housing and housing land at affordable prices seems sensible, as to plans to greatly enhance communications links between areas of high activity and density, to less prosperous more distant regions.



The idea that higher interest rates will brake the housing market is clearly documented by experience. The graph above shows that when short term rates rise, the number of housing starts falls. The perversity of this though is that while it helps sort out issues in the short run, it actually makes the longer term problem of a lack of housing stock worse in the longer run, and so helps maintain higher property prices – something the policy was designed to avoid !!!