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UK HOUSING MARKET – THE RISK TO WATCH

Berenberg Macro Flash

The housing market is the Achilles' heel of the UK economy

Because of badly designed rules for land and house building - which inhibit adequate supply growth – and misguided demand-side support from policy makers, the UK housing market is prone to large cyclical swings. These swings exacerbate the normal ups and downs in the economic cycle. Rising house prices in the 2000s, and risky lending practices, encouraged homeowners to withdraw equity to finance consumption. This extra demand fuelled the debt driven pre-Lehman upswing. When the housing market corrected in 2008, falling property values caused a balance sheet crisis for homeowners, worsening the shock to demand and deepening the recession. While the post-Lehman upswing in the housing market has been far less vigorous than before, the underlying problems have not been fixed. And although it is just a tail risk, yet again, we need to pay close attention to the threat posed by a potential slump in the housing market.

A downturn in London will probably be contained

Latest data indicate that the London housing market could be correcting. After a sustained surge in house prices during the post-Lehman expansion, prices declined in Q2 - 1% qoq - for the first time in five years. RICS data for July indicate that the weakness has continued into Q3 – Chart 1. Because of the large influence of foreign demand, which does not necessarily correlate well with domestic demand, the main driver of the national market, London exhibits its own unique dynamics. Since the Lehman-recession, the London property market has served as a safe haven for foreign capital. Strong foreign demand and a booming London economy have driven house prices to 48% above their pre-Lehman peak.

A combination of factors have weighed on London demand over the past year. First, the UK government raised stamp duty on second properties in April 2016. Second, Brexit created risks that were not appropriately reflected in the exceptionally low property yields at the time of the Brexit vote, triggering a re-pricing. Third, as the global economy improved over the past year, London has faced stronger competition from other global cities. While some London homeowners with high levels of debt may reign in their spending if the market corrects, as long as the national economy holds up, London house prices can fall without creating major systemic risks.

Outside of London – The market softer, but stable

UK house prices ex. London grew by 0.4% qoq in Q2, about half the average rate of the past five years. Unlike in previous upswings, the rest of the UK has not matched the upswing in London – Chart 2. Without the upswing, the national market is thus less vulnerable to a downturn. House prices ex. London are only just returning to their pre-Lehman peak. In real terms, they are c14% below the pre-Lehman peak. Meanwhile, London prices are c29% higher in real terms. RICS data for July show continued price growth for most places outside of the capital while other measures of the national market activity such as transactions and starts remain healthy, though well below their pre-financial crisis levels – Chart 3.

Why house prices matter for consumption

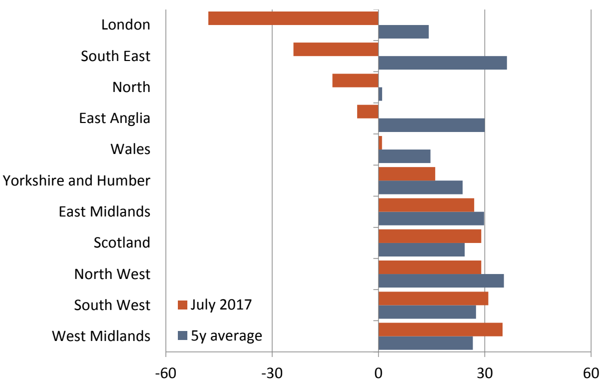
Household spending exhibits strong wealth effects as house prices fluctuate. Historically, national house prices and aggregate household consumption have tracked closely at a ratio of around 4 to 1 - a 10% yoy rise in house prices would normally imply around 2.5% yoy growth in consumption. Around one third of household net wealth is in property while over three quarters of household debt is from mortgages – Chart 4. Even modest declines in house prices could affect the regular spending habits of homeowners who are highly leveraged. A nationwide decline in house prices is not our base case. However, given the strong links between household balance sheets and the housing market, it is hard to imagine a scenario where a nationwide fall in house prices did not trigger a sharp contraction in aggregate household spending. While the government will have to face the music and fix the underlying problems in the housing market eventually, if the nationwide housing market came under significant pressure in the near-term, expect Chancellor Hammond to step in with a fresh round of demand side policy support to prop up the market, even if it would mean further kicking the can down the road.

What next?

For now, risks in the housing market do not pose a significant threat to our outlook for continued real household consumption growth and continued modest economic growth. Households fundamentals have strengthened during the post-Lehman expansion. Expect households to continue to temporarily use their balance sheets to smooth consumption during the real wage squeeze this year as higher import prices push inflation up. Continued solid labour demand will further underpin household confidence which should improve next year as real wage growth returns. This will lead to an acceleration in real consumption growth and support stronger housing demand across the country.

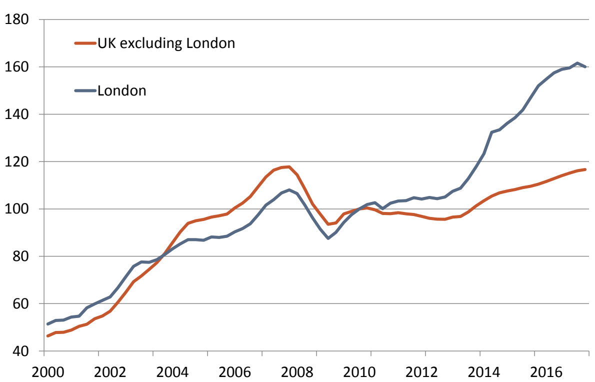
We look for real GDP growth of 1.7% in 2017, 1.6% in 2018, and 1.7% in 2019 – broadly in line with the BoE and a little above the market consensus (2017 = 1.6%, 2018 = 1.3%, 2009 = 1.6% (Bloomberg consensus 10 August)). While the BoE will pay attention to risks in the housing market, unless the entire market comes under threat, which remains a low probability risk, a correction in London will not distract the central bank too much its ultimate focus on inflation and broader economic conditions. As we wrote last week – see, 'Is the market misreading the BoE?' – a first hike in November of 25bps remains our base case.

Chart 1: RICS housing survey: change in prices (net balance %, July)



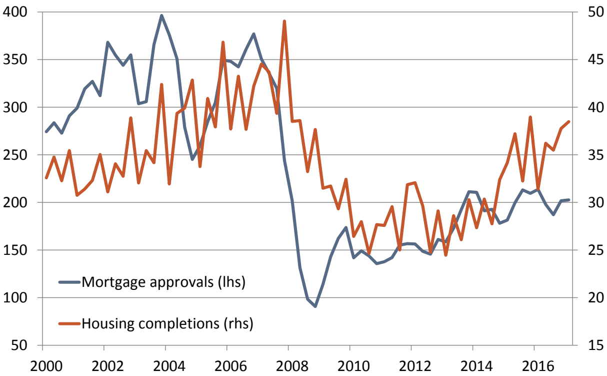
Notes: Percentage of chartered surveyors reporting a rise in prices minus those reporting a decline. Source: RICS, Haver Analytics

Chart 2: House price developments (Q1-2010 = 100)



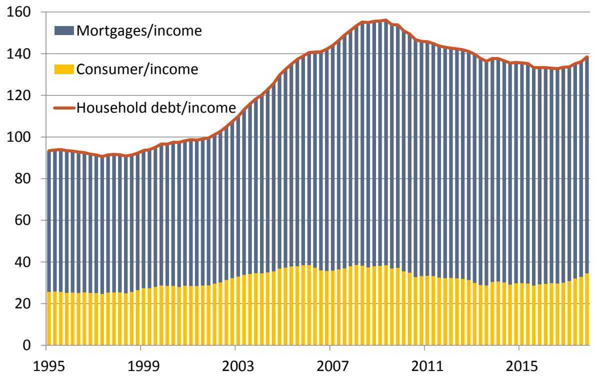
Notes: Quarterly data. Source: Berenberg Calculations, Nationwide Building Society

Chart 3: Number of mortgage approvals and housing completions (000s)



Source: Bank of England, Department for Communities and Local Government, Haver Analytics. Completions data for England only

Chart 4: Household debt as a percentage of income



Notes: Quarterly data. Source: Bank of England, ONS

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