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Housing market: Why the downturn's not over yet

With prices rising, you might expect Money's panel of experts to be positive, yet the rapid recovery has left them downbeat, writes **Elizabeth Colman**

HOUSE prices look likely to end the year higher than they were in January, in defiance of dire predictions from industry experts. Prices have risen for five consecutive months, according to the Nationwide building society index, and are back where they stood in September 2008.

There has been a 4% rise over the year so far and on current trends, the gain could reach 6% by year-end. This is in sharp contrast to gloomy forecasts from the likes of the research consultancy Capital Economics, which predicted falls of 25% this year alone and 35% from peak to trough.

The strength of the rebound should come as no surprise to Sunday Times readers: in February, a panel of experts convened by Money said that the recovery, when it came, would be sharper and swifter than the leading forecasters were expecting.

With the average house price now at £161,816 — only 13% off the October 2007 peak — we convened another panel to discuss whether the upturn could last.

While our experts agreed that the rally would continue short term, they were surprisingly downbeat about the longer outlook. Simon Rubinsohn, chief economist at the Royal Institution of Chartered Surveyors (RICS), said that while prices could be back to their 2007 peak within eight months, the recovery was "unhealthy" because it had come so far, so fast. George Buckley, chief economist at Deutsche Bank, declared the market was "still in a bubble".

The panel raised concerns that the strength of the house price recovery could provoke the Bank into raising interest rates to contain inflation — precipitating a "double dip". Last week, Halifax said property values increased 1.6% during September.

Rising unemployment was the other factor that would halt the recovery, potentially sending house prices into decline again in 2011, or 2012, the experts said.

Fitch, the credit ratings agency, forecast last week that prices could fall steeply next year. It believes they will fall 30% from peak to trough, suggesting another 17% decline next year.

Here are the experts' views:

IN THE SHORT TERM

Kathryn Cooper, editor of Money: Why has the housing market enjoyed such a strong rebound?

George Buckley, Deutsche Bank: If we consider any measure of [housing] affordability — mortgage repayments as a proportion of income — it's looking fairly good right now. Repayments are just 28% of average incomes. It's no surprise that house prices are rising given that mortgage lending is starting to stabilise.

Simon Rubinsohn, RICS: There's also a global dimension. Central banks are pouring liquidity into the economy and pushing up asset prices, property in particular. It's not confined to Britain; other economies are fretting about the effect on prices. It wouldn't surprise me if we saw prices up on, say, Nationwide's index at peak levels.

Seema Shah, property economist at Capital Economics: In the short term, you could feasibly have another year of continuing price rises.

Ray Boulger, senior technical director at John Charcol: The sort of people who might have been repossessed in the late 1980s and early 1990s, when their interest rates doubled in 15 months, have this time seen their mortgage rates come way down because many are on trackers.

Government support is stopping lenders from repossessing, which will mean repossessions are not as bad as they were in previous downturns. Low interest rates are another key factor. For those reasons, we're going to see the market continue to improve in the short term.

Trevor Abrahmsohn, founder of Glentree International: The bottom of the market probably was in about April. Next year there will be a slow and progressive rise in prices. There's been a sea change in thinking among developers in the past six to eight weeks. I know a number that are taking quite a bullish view.

Lucian Cook, director of Savills Research: We have seen the bottom of the market, but that's not to say we won't get close to it again. I suspect there won't be the same demand in six or nine months that there is at the moment.

SIMON RUBINSOHN
Royal Institution of Chartered Surveyors
"It wouldn't surprise me if you see prices back up at peak levels by the middle of next year. But I don't think what's going on is terribly healthy."
House-price forecast 2009: +2% (previously -10 to -15%)
House-price forecast 2010: -5%
Interest-rate forecast: 1% by November 2010

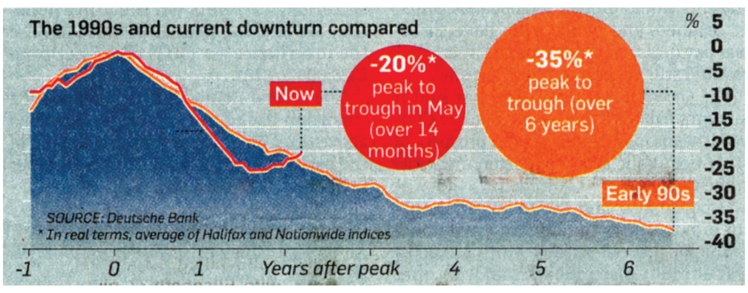
GEORGE BUCKLEY
Deutsche Bank
"House prices went up by 200% over 10 years; they've fallen by only 13%. If we were in a bubble before, we probably still are."
House-price forecast 2009: -9% (previously -15%)
House-price forecast 2010: +1.5%
Interest-rate forecast: 1.25% by September 2010

SEEMA SHAH
Capital Economics
"As a first time buyer myself, I wouldn't want to expose myself to the market right now."
House-price forecast 2009: +3% (previously -25%)
House-price forecast 2010: -10%
Interest-rate forecast: 1% by March 2012

LUCIAN COOK
Savills
"There is a real opportunity to buy now - if you're an up-sizer, and you have a big deposit."
House-price forecast 2009: +2% to +5% (previously -5%)
House-price forecast 2010: -7% to 0%
Interest-rate forecast:

TREVOR ABRAHMSOHN
Glentree International
"The London market almost defies gravity, particularly with weak sterling favouring anyone buying in euros."
House-price forecast 2009: -2% (previously -2%)
House-price forecast 2010: +5%
Interest-rate forecast: 1% by June 2010

RAYBOULGER
Charcol
"We are seeing a few signs of lenders getting more competitive. Mortgage margins will narrow, although not to the levels they were before."
House-price forecast 2009: +7.5% (previously -5%)
House-price forecast 2010: +6%
Interest-rate forecast: 1% by December 2010



IN THE LONGER TERM

Cooper: Do you see this rally continuing?

Buckley: As soon as interest rates go back to normality or somewhere near normality, house prices will not look at their right level. If interest rates were at their long-run average — that's actually 7.1%, as opposed to Bank rate currently at 0.5% — mortgage repayments as a percentage of disposable income would be 37.2% now. That's where it was at the start of 2007.

There is probably more downwards adjustment to go. The decline we have seen in real terms is very similar to what we saw in the 1990s, when prices continued to fall.

Cook: There's still a big constraint, which is access to mortgage finance — particularly for those with small deposits. The market is being driven by the people who are in the market. Next year you may find it reflects much more the people who are still out of the market.

Rubinsohn: Looking at our surveys, we have had only two months in a row where we've had new instructions [from sellers]. The level of supply is way below that needed, given the sudden rush in demand, to hold prices stable. That is a short-term problem, though.

The ratio of sales to stock is key here. It is still at low levels but if we start to see more supply coming on tap, that could begin to shift the equation, particularly as mortgage supply remains a constraint on sales. I'm looking at that indicator particularly carefully at the moment.

Shah: There's going to be a second leg to this downturn. Timing is incredibly uncertain. Because interest rates have been so low, there just haven't been any forced sellers. But we're almost in a sweet spot at the moment with the economy, so either that recovery continues as it is, at which point the Bank of England will have to stop the quantitative easing programme and rates will go up, which means affordability goes down the toilet, or the economic recovery falters, in which case unemployment starts rising again. Neither seems to be very supportive for the housing market in the long term.

Boulger: Of the 10m residential mortgages in this country, 3m to 3.5m are held by people who can afford their mortgage but would not be able to get another if they wanted to move house — because they don't have enough equity in their property for the deposit needed or because they're subprime or self-certified and those deals have pretty much disappeared.

That's going to constrain activity for quite some time because those people have either got to stay put or they've got to sell up and rent, which most probably won't be keen to do. I see activity increasing only relatively slowly.

Buckley: This cannot go on forever. Look at the past six months: house prices are up 7.2% on the average of the Nationwide and Halifax indexes since February, so that's close to a 15% annualised rate of growth. That is a little bit worrying when you have an inflation target of 2%.

Cooper: It almost sounds like you are worried about another bubble.

Rubinsohn: What's going on is not indicative of a particularly healthy economy. It's not a testimony to a successful market.

Buckley: House prices rose 200% over 10 years; they've fallen by only 13%. If we were in a bubble before, we're probably still in a bubble.

Cook: Unemployment is another reason why we could see a softening in the market, because demand is essentially driven by the cash rich. Also, we don't think unemployment is going to peak until next year.

Rubinsohn: Arguably, you could say that 2011 is going to be a bigger story for unemployment, when the public spending cuts start to have a material impact. Our view was that prices would drop back next year, but I wonder whether if this run continues it will be the latter part of next year or even 2011 when we see the drop.

Shah: We can expect to see a tail-off [in house prices] in 2011 and 2012 because of unemployment.

OUTLOOK FOR INTEREST RATES

Boulger: Interest rates are going to be the key, and if they go up too far, too quickly, that will bring down house prices again.

Abrahmsohn: Interest rates will start to rise toward the middle to the end of next year but some of the banks and building societies may cut a bit of their margins because at the moment those margins are obscene. That means the amount consumers actually pay may not be that different even if interest rates do rise a little.

Boulger: I'm not sure it is at all clear that rates will start rising in the middle of next year. It is a big unknown. The longer it takes the economy to improve, the longer interest rates are going to have to stay low.

Buckley: Mervyn King [governor of the Bank of England] has called this the "nice decade" — a great moderation, if you will. I worry that over the next 10 years we won't see this "nice" decade. We may see a period where there is exactly the opposite — where we need higher interest rates, and lower growth, to keep inflation at the 2% target. People do not think about that when rates are low. They just think "affordability is very good; I need to buy a house".

Shah: We could see the Bank reacting a lot sooner than anyone expects, considering we've had this run-up in house prices.

Rubinsohn: We don't think interest rates will rise until November next year, so quite late given what's going on in the housing market. I can't help but feel that if we continue to see strength in the market, it will filter into the way the Bank thinks. At the moment, I'm still saying November, but the risk is it's going to be brought forward.

OUTLOOK FOR MORTGAGES

Boulger: Gross margins [the price of new mortgages over the cost of funding] are the highest they've been for a long time. We are seeing a few signs of lenders beginning to get a bit more competitive. As Bank rate rises, those spreads will narrow. They won't narrow back to the levels we had before, but they will narrow.

Cook: There is a huge difference between mortgage credit being affordable and being available. At the moment, there is still extremely constrained access to finance.

Boulger: There are still no really long-term fixed-rate mortgages available. I don't think protecting yourself for even five years is long enough. If interest rates don't start to go up for three or four years, which is possible, then having a five-year fix could mean you come out of it at just the wrong time.

FIRST-TIME BUYERS

Cook: First-time buyers have got the rough end of the stick. They're clobbered by the requirement to raise a big deposit.

Shah: As a first-time buyer myself, it is impossible to put a deposit at the level required to get a good mortgage rate. That immediately puts me out of the market. The other thing is, is it a good time to buy? First-time buyers are the ones most at risk of losing their jobs in the next two years. I wouldn't expose myself to the market right now. I would want to see what happens over the next year; if it means that I missed the bottom of the market, so be it.

THE LONDON MARKET

Cook: Prime London markets have come back much quicker than the rest of the country. Prime southwest London had second-quarter growth of 6.4% and third-quarter growth of 8.4%, although it is still something like 15% off its peak.

Abrahmsohn: I've seen London change since the early 1970s from a quaint historic city to somewhere diplomats and prime ministers want to have second homes. Then you've got the exchange rate, which is favouring anyone in euros — and if you earn money in petrodollars, there is an incentive to buy in this country.

With all this pressure on a finite market, plus people already in the London market considering buy-to-lets, there is a lot of positive pressure. I've always had this robust view of the London market; it almost defies gravity, somehow.

Cook: There is a big difference between the prime and equity-rich markets and the other end of the scale, where a lack of access to finance and unemployment could have a more prolonged impact. The difference between the equity "haves" and "have-nots" over the next five years is going to be quite significant.

SO WHAT SHOULD I DO?

Boulger: Potential buyers should go ahead provided they can get finance at a rate they are confident they can afford. If prices rise another 6% next year, a buyer today will be in a better position even if they have to pay, say, an extra two percentage points on their rate than if they buy in a year's time, even if they then qualify for a slightly cheaper mortgage.

Cook: The big difference now, compared with early 2009 or 2008, is the realistic prospect of sale in a reasonable period. If you are putting the property up for sale now ... you have a reasonable degree of certainty. There is a real opportunity now, if you're an upsizer and you have a big deposit.