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THE IMPLICATIONS OF FALLING U.K. HOUSE PRICES

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The Implications of Falling U.K. House Prices

"There are lots of good reasons why, over time, house prices tend to rise. One of the most important is the appropriate assessment of risk, in particular about the degree to which people should borrow. During housing bubbles, though, people too easily forget about risk and borrow too much. As a result, prices move a long way from their long-term 'fair value' trajectory, paving the way for a painful adjustment."—Stephen King, Global Head of Economics, HSBC, *Weekly Economic Review*, May 12, 2008.

"People often use the appreciation in their homes as a source of money by borrowing against them. The housing bubbles in the US, UK, and Australia, created a lot of this type of financing, and those countries are the most vulnerable to … knock-on effects. We have already seen some of the effects in the US with slower growth, and the UK probably is at the highest risk of following suit with the weakest housing market outside the US and the highest past levels of mortgage equity withdrawals."—Greg Jensen and Fred Post, *Bridgewater Daily Observations*, June 23, 2008.

Few things in financial markets are ever completely clear. However, the notion that U.K. house prices have further to fall is hard to dispute. Indeed, while unanimity within the financial community often sends us running for our contrarian hats, in this case we agree with the consensus. Namely, over the past several years U.K. house prices experienced a bubble similar to those in several other countries, including the United States and Spain—with gains driven by feverish transaction activity that was itself the result of extremely lax lending standards—and the unwinding of that bubble will cause prices to continue falling until they *at least* reach some semblance of fair value. For investors, of course, the more pertinent question is to what extent this seemingly inevitable fall in prices will impact U.K. economic activity and financial markets. We believe U.K. economic growth is likely to slow, and that financial markets are not priced to reflect this eventuality.[1]

With regard to falling house prices, the sectors likely to be hit the hardest are financials and those related to consumer spending, which is likely to suffer as mortgage equity withdrawal slows. However, it is important to note that we do not view the relationship between falling house prices and slowing growth as causal; rather, as both were artificially inflated by the rapid expansion of debt over the past several years, it is reasonable to expect both to suffer as the "debt bubble" unwinds. Said another way, falling house prices and slowing economic activity are two sides of the same coin; thus, falling house prices will not *cause* the economy to slow any more than they acted as an accelerant on the way up.

Whither House Prices?

While we do not make forecasts for house prices, for the U.K. or any other market, the current agreement among those who do is striking. Consider the following:

[1] For more details, please see our April 2008 Market Commentary *European Equities Are Not Cheap.*

- Capital Economics expects U.K. house prices to fall 35% from their late 2007 peak.
- HSBC, while not offering a specific forecast, said it is concerned “over both the length and depth of a housing adjustment.”
- Merrill Lynch expects prices to fall 5% in 2008 and 10% in 2009.
- Citigroup and UBS both expect prices to fall 6% in 2008.
- The Bank of England (BOE) noted in its most recent Financial Stability Report that “a range of leading indicators point to downside risks to the UK housing market.”

Most of these forecasts reflect recent downward revisions, as analysts have been getting progressively more bearish. Property price futures, meanwhile, are pricing in a fall of nearly 25% from current levels, with the market expected to bottom in 2011. Indeed, we were unable to find anyone who has forecast a rise in house prices for this year or next (although some expect a rebound in 2010). As mentioned, while such agreement can be a contrary indicator, in this case it seems to be well founded. (Still, it is worth noting that transaction activity has not ground to a halt, so clearly there are buyers who believe current prices are reasonable.) We have included a few charts (Tables A–D) that show various measures of house prices, mortgage debt, and housing activity, with the takeaway being that house prices and mortgage debt are very high relative to GDP and income, while activity has declined sharply of late. In short, while we have no forecast for U.K. house prices *per se*, it seems very reasonable to conclude prices have further to fall.

Investment Implications

More salient to investors, of course, is to what extent falling house prices should be expected to impact the U.K. economy and financial markets. In our opinion this is a very difficult question to answer with any specificity. Still, most analysts expect financial markets to be hit both directly and indirectly. With respect to the former, the dramatic rise in spreads for residential mortgage-backed securities (Table E) will continue to hit bank profits, while Merrill Lynch (for example) recently downgraded a slew of homebuilders. Meanwhile, falling consumer spending will indirectly affect the health of financial markets.

Nevertheless, it is difficult if not impossible to *quantify* the effects of falling house prices on financial markets, as you are talking about second and third derivatives with lots of moving parts. The BOE, for example, found it difficult even to link changes in house prices to changes in consumer spending in a 2006 report:

> “House prices and consumer spending have often moved together in the past. But that relationship is unlikely to be driven by the impact of house prices on aggregate wealth. Instead, it is more subtle. The relationship depends on causal links, such as the impact of house prices on the equity that people can withdraw from their homes to finance spending. *And, crucially, it depends on common factors — influences that affect both house prices and consumer spending.…In general, the implications of any rise in house prices rest on why house prices have risen*.”[2] (Emphasis added.)

[2] *House Prices and Consumer Spending*, Quarterly Bulletin, Summer 2006.

Consider the very reasonable expectation that mortgage equity withdrawal (MEW) will fall sharply in coming years. U.K. GDP is roughly £1.3 trillion, of which 65% (£845 billion) is consumer spending. MEW, meanwhile, totaled £41 billion last year—3.2% of total GDP—the highest level relative to GDP in the world. If, as Capital Economics estimates, MEW falls to £25 billion this year and to £10 billion by 2010, then over the next three years U.K. homeowners will "lose" between £15 billion and £30 billion worth of purchasing power each year (about 1% to 2% of total GDP, and 2% to 3.5% of consumer spending) due to declining house prices. (All figures in nominal terms.)

However, the effects do not stop there. As Capital Economics notes, "the wider 'wealth effects' of house price falls should not be underplayed either … at the very least, falling confidence may make households more reluctant to borrow to fund their spending." We agree, particularly given our central point that the debt bubble has been the main driver of house prices and economic activity.

Still, it is difficult to discern how this would impact U.K. financial markets, although we can make some observations. To begin with, a continued decline in house prices would weigh on financials, which represent about one-quarter of the FTSE All-Share (by market cap). A decline in consumer spending, meanwhile, would likely hit consumer goods and services firms, which make up just under 20% of the FTSE All-Share, and to a lesser extent basic materials and industrials, which compose another 20%. However, falling spending would be unlikely to have an appreciable impact on sectors such as health care, oil and gas, technology, telecommunications, and utilities, which together make up slightly more than one-third of the index. While none of the sectors at highest risk can be said to be extremely overvalued, neither can any be described as downright cheap (Table F), particularly when one takes into account the high level of earnings relative to trend (for the market as a whole) and the uncertainty of future profit levels (particularly in the case of financials). In short, while a large segment of the market is exposed to direct or knock-on effects of house price declines, this is not, in our opinion, reflected in current prices.

Policy Matters

As noted above, we believe falling house prices, a weakening economy, and declining equity markets are all *symptoms* of the global debt bubble that is now beginning to unwind; thus, falling house prices should not be considered the *cause* of economic or equity market weakness. While this may seem like splitting hairs, in our opinion the distinction is critical, particularly for investors hoping policymakers' recent actions will "solve" the problem. To wit, if the fall in house prices were truly the cause of economic weakness, then it would indeed be simple for policymakers to ward off any ill effects by weakening the currency, intervening in markets to prop up prices, or even directly purchasing property and/or mortgages.

This, unfortunately, is not the case. Instead, the troubles in the U.K. housing market are but one piece of a far larger puzzle—a global debt bubble that has distorted a great variety of asset markets over the past several years, and that has severely weakened the underlying fundamentals of not just the U.K. economy, but the global economy as a whole. In short, the provision of cheap money (most notably by the U.S. Federal Reserve, which kept short-term rates at 1% for an entire year) spawned a house price bubble of epic

proportions, which itself spurred economic growth. Note, however, that the increase in house prices was itself *caused* by easy money. Thus, it cannot be said that rising house prices caused the uptick in economic growth; rather, cheap money created the *illusion* of increasing wealth (which led consumers to boost spending), with rising house prices serving as the conduit.

The bottom line is that, much as we feel equity market valuations do not adequately reflect the likelihood that profits will fall, perhaps sharply (due to having been driven higher by an unsustainable increase in debt-fueled spending), we view a fall in U.K. house prices as a *necessary* process that will help restore markets to more solid footing, as the rise in prices was largely due to an increase in consumer mortgage debt. Indeed, while some argue the house price boom was somehow due to fundamental factors, we find it instructive that the sharp rise in prices also coincided with a skyrocketing customer funding gap for large banks (Table G). In other words, since 2001 banks have increasingly lent more money than could be supported through deposits, with the balance funded through either securitization or wholesale funding markets. We view this gap as yet another symptom of the underlying disease.

It is also worth noting that the IMF, in a comprehensive study of asset price "busts," found that sharp declines in housing prices "were associated with more severe macroeconomic developments than equity price busts," in large part due to the sizable role played by the banking system in financing the preceding housing booms.[3] It could further be argued that house price busts have tended to be more damaging due to the more widespread nature of homeownership (the homeownership rate in the United Kingdom is roughly 70% at present), as opposed to equity markets where a small percentage of individuals and institutions control most of the shares.

Conclusion

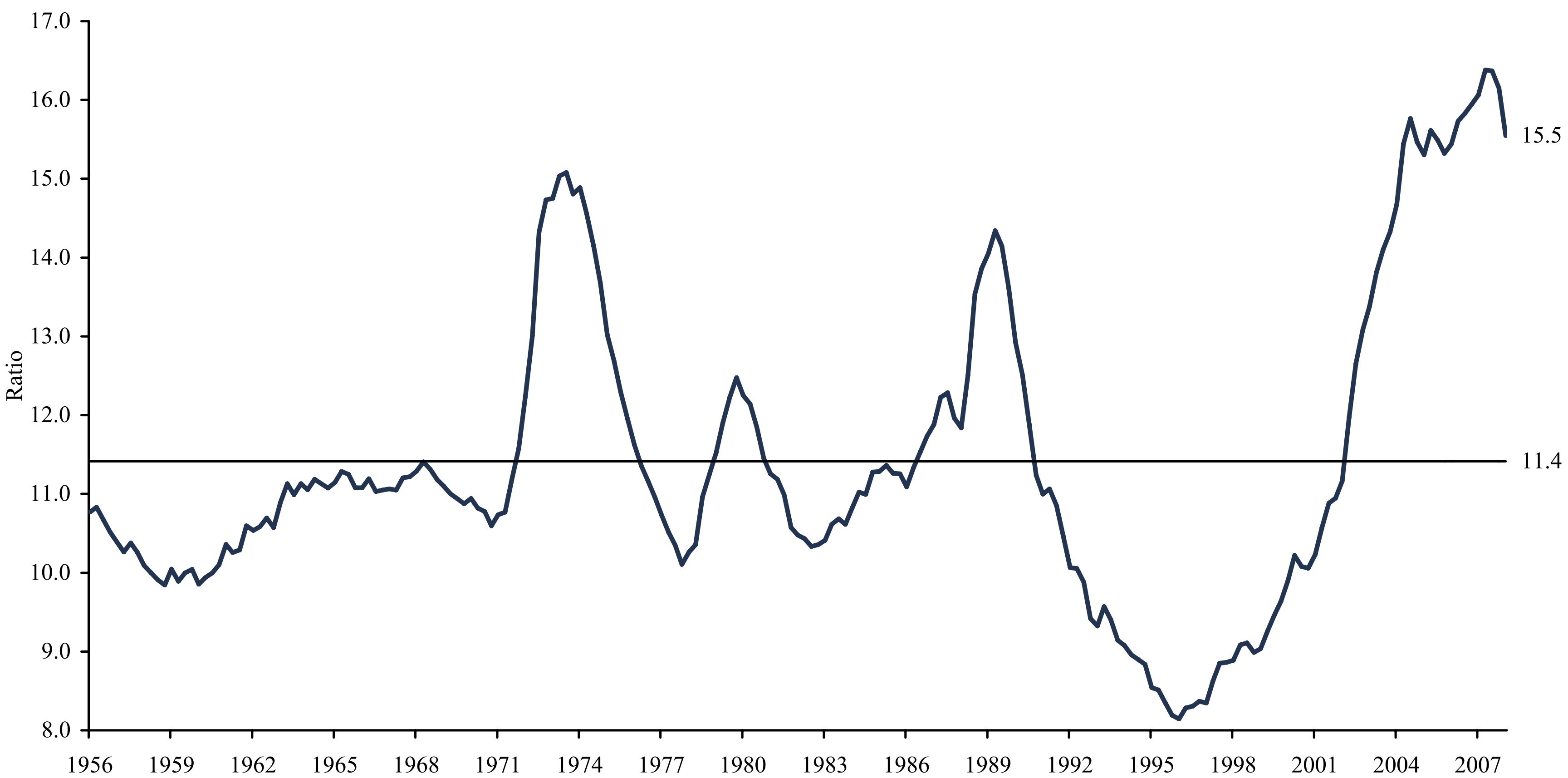
U.K. house prices seem almost certain to continue declining, perhaps more sharply than most expect. The U.K. economy is also likely to continue to struggle, while equity prices will probably decline if, as we expect, much of the recent surge in corporate profits turns out to have been a byproduct of the recent increase in consumer debt. We view all these eventualities as "payback" for several years of economic and asset price growth that was driven not by improved fundamentals, but rather by increased debt loads. With regard to declining house prices, the sectors most likely to suffer are financials and those tied to the health (or lack thereof) of consumer spending, although it is impossible to quantify the risks to these sectors with any sort of accuracy.

[3] IMF, *When Bubbles Burst*, 2003.

Table A

RATIO OF NATIONWIDE HOUSE PRICE INDEX TO PER CAPITA U.K. GDP

First Quarter 1956 – First Quarter 2008

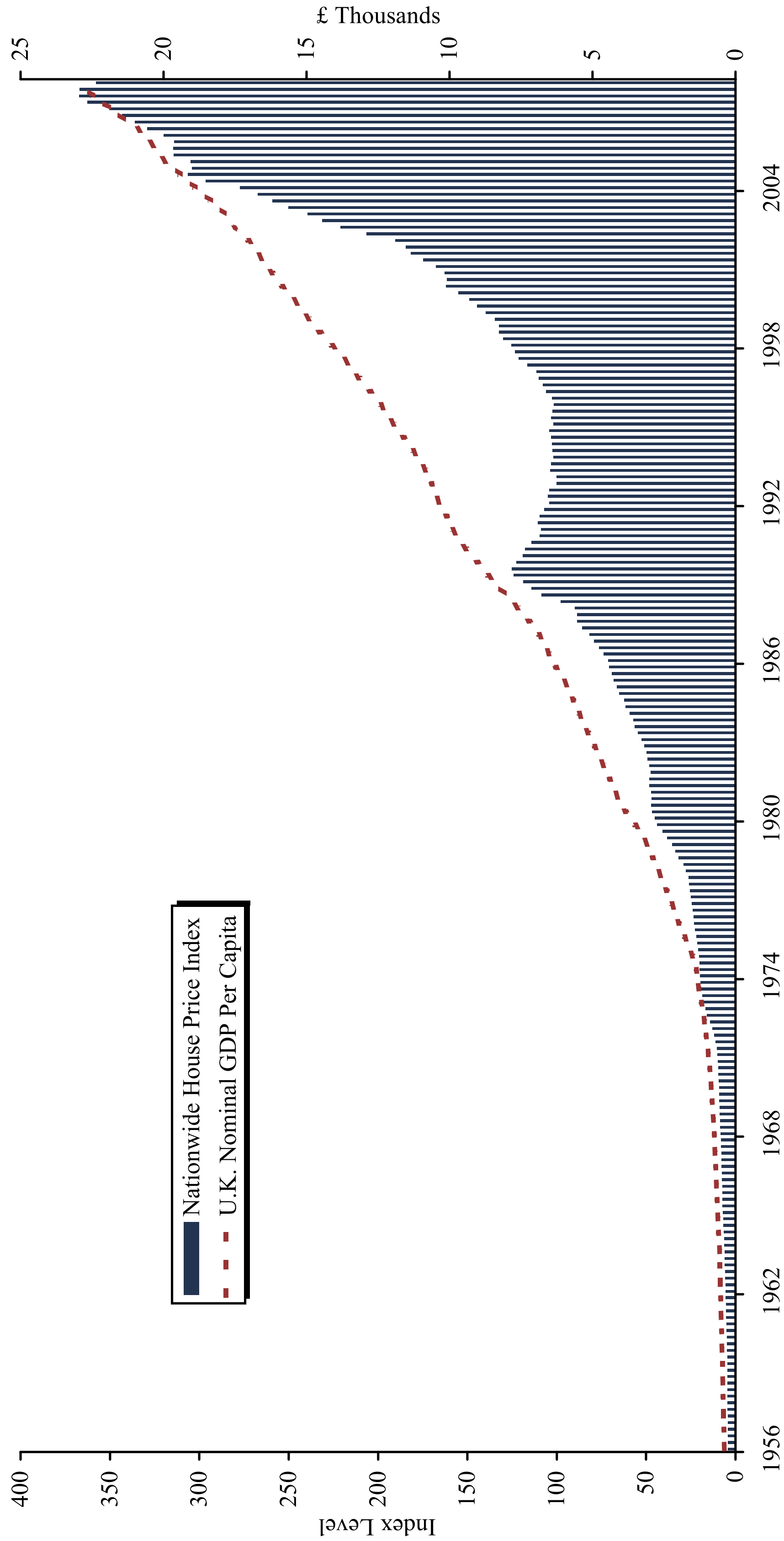


Sources: HSBC and Thomson Datastream.

Table B

HOUSE PRICES AND PER CAPITA U.K. GDP

First Quarter 1956 – First Quarter 2008



Sources: HSBC and Thomson Datastream.

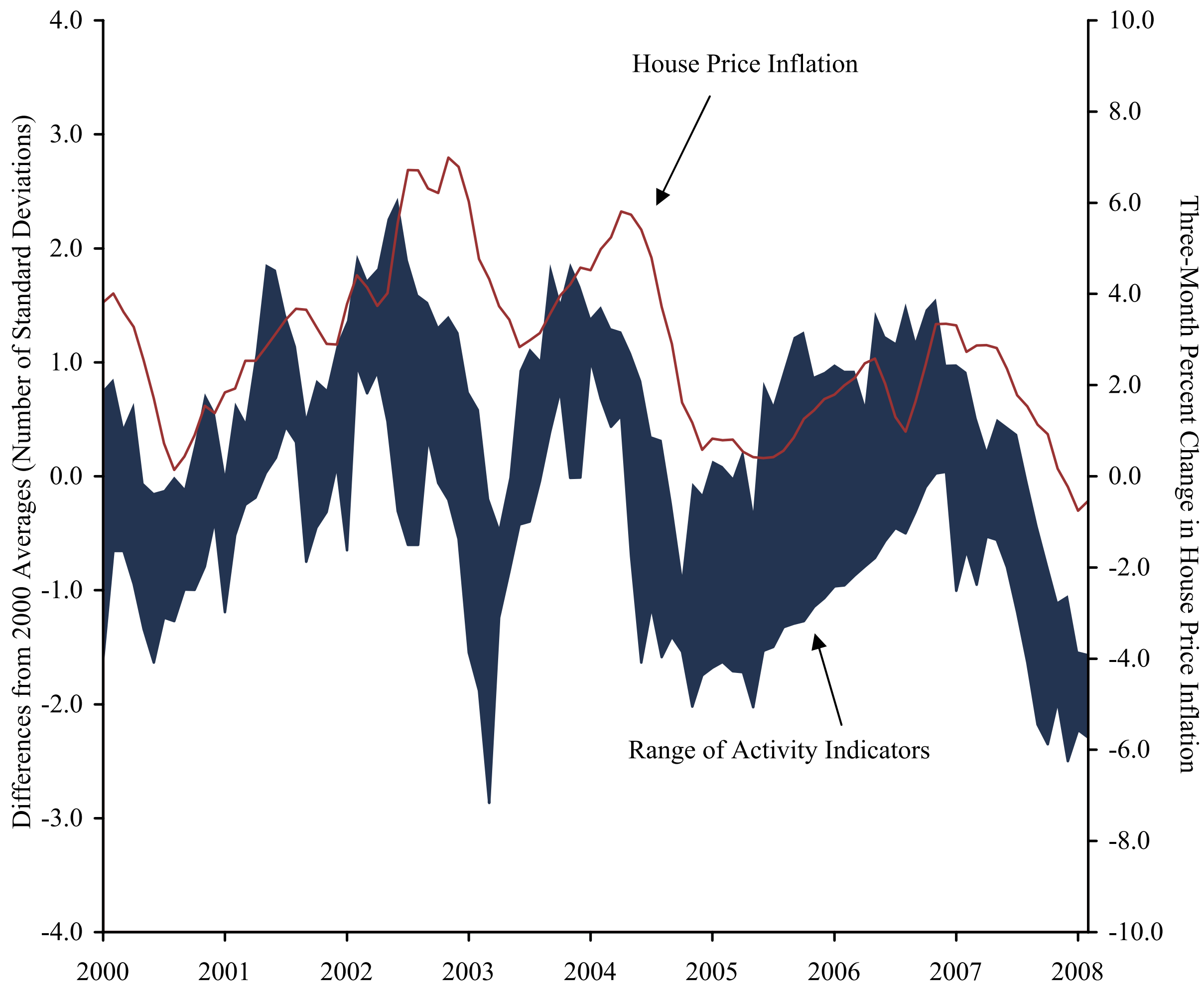
Note: GDP data are through fourth quarter 2007.

Table C

U.K. RESIDENTIAL PROPERTY MARKET

Inflation and Activity Indicators

31 January 2000 – 31 March 2008



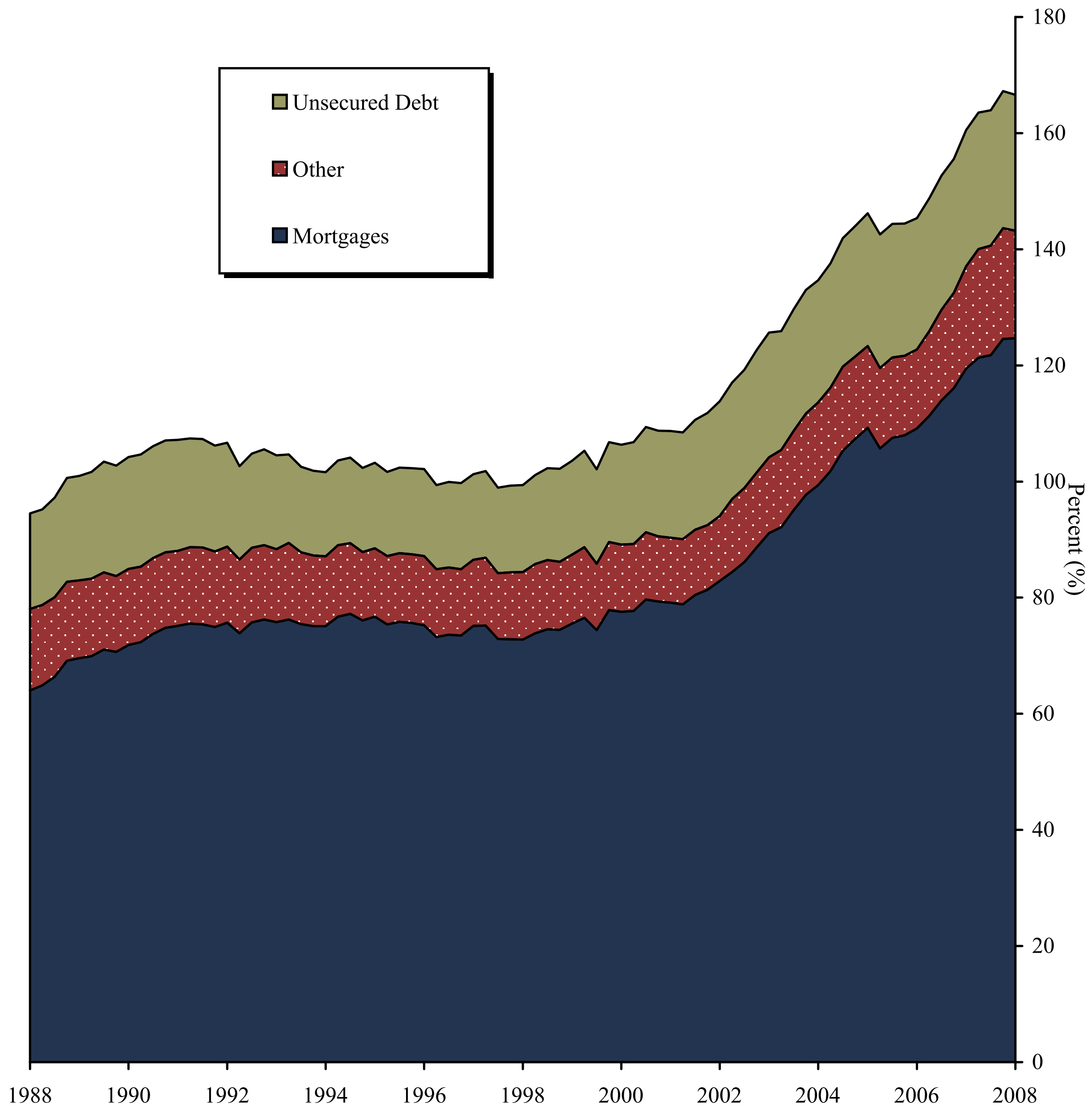
Sources: Bank of England, Halifax, Home Builders Federation (HBF), Nationwide, and the Royal Institute of Chartered Surveyors (RICS).

Notes: The house price inflation data are an average of Halifax and Nationwide data. The published Halifax index data since 2002 have been adjusted by the Bank of England to account for a change in the calculation method. The shaded area shows the range between the minimum and maximum readings of five indicators: HBF site visits, HBF net reservations, RICS new buyer inquiries net balances, the RICS sales to stocks ratios, and the number of loan approvals for house purchase. House price data are as of March 31, 2008. Activity data are as of February 29, 2008.

Table D

RATIO OF HOUSEHOLD SECTOR DEBT TO ANNUALIZED AFTER-TAX INCOME

1 January 1988 – 1 January 2008



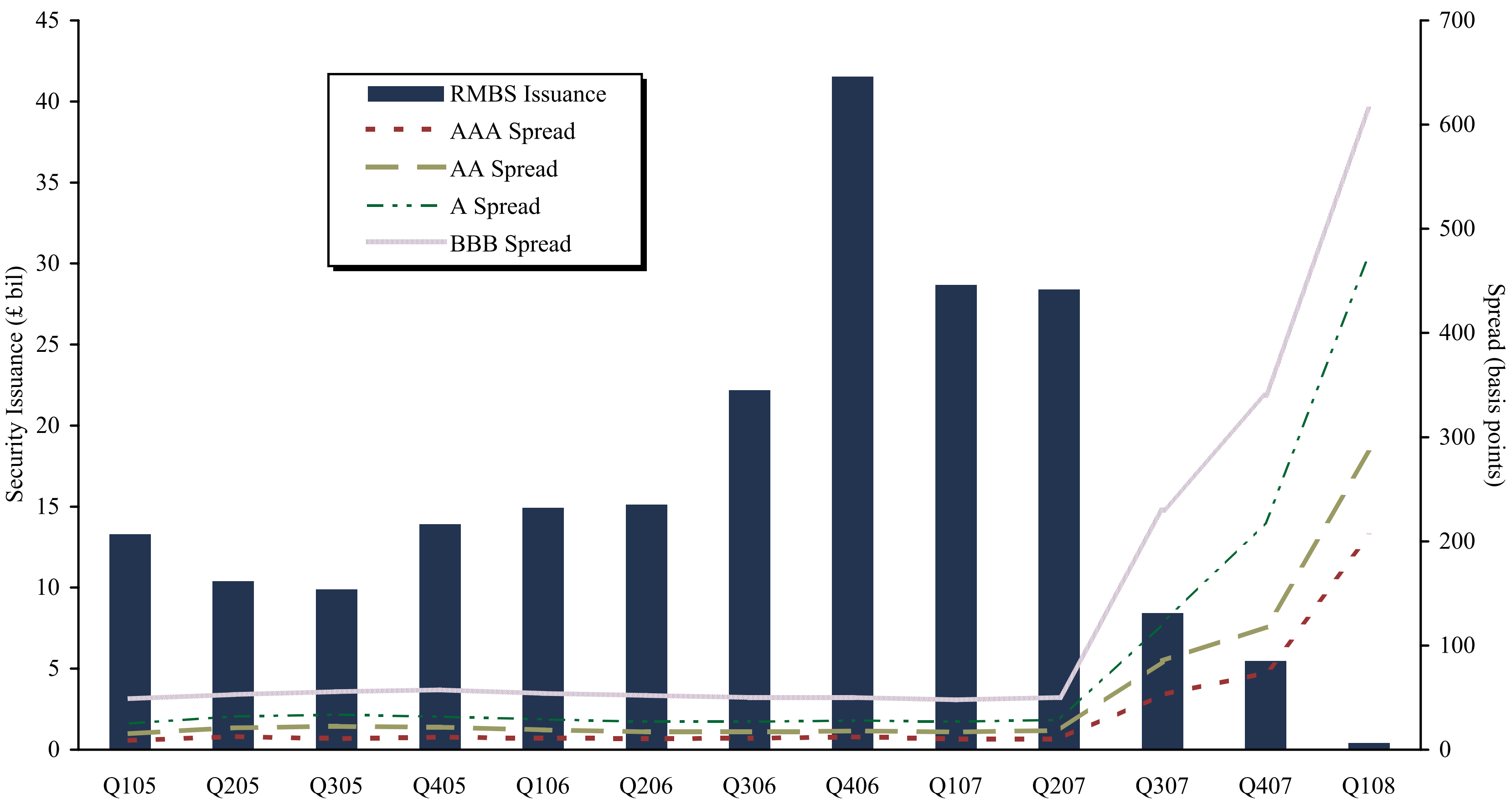
Sources: Bank of England and The Office for National Statistics (ONS).

Note: Other is made up of households' total financial liabilities excluding secured and unsecured debt (including bills that are due to be paid).

Table E

U.K. PRIME RESIDENTIAL MORTGAGE-BACKED SECURITY ISSUANCE AND SPREADS

First Quarter 2005 – First Quarter 2008



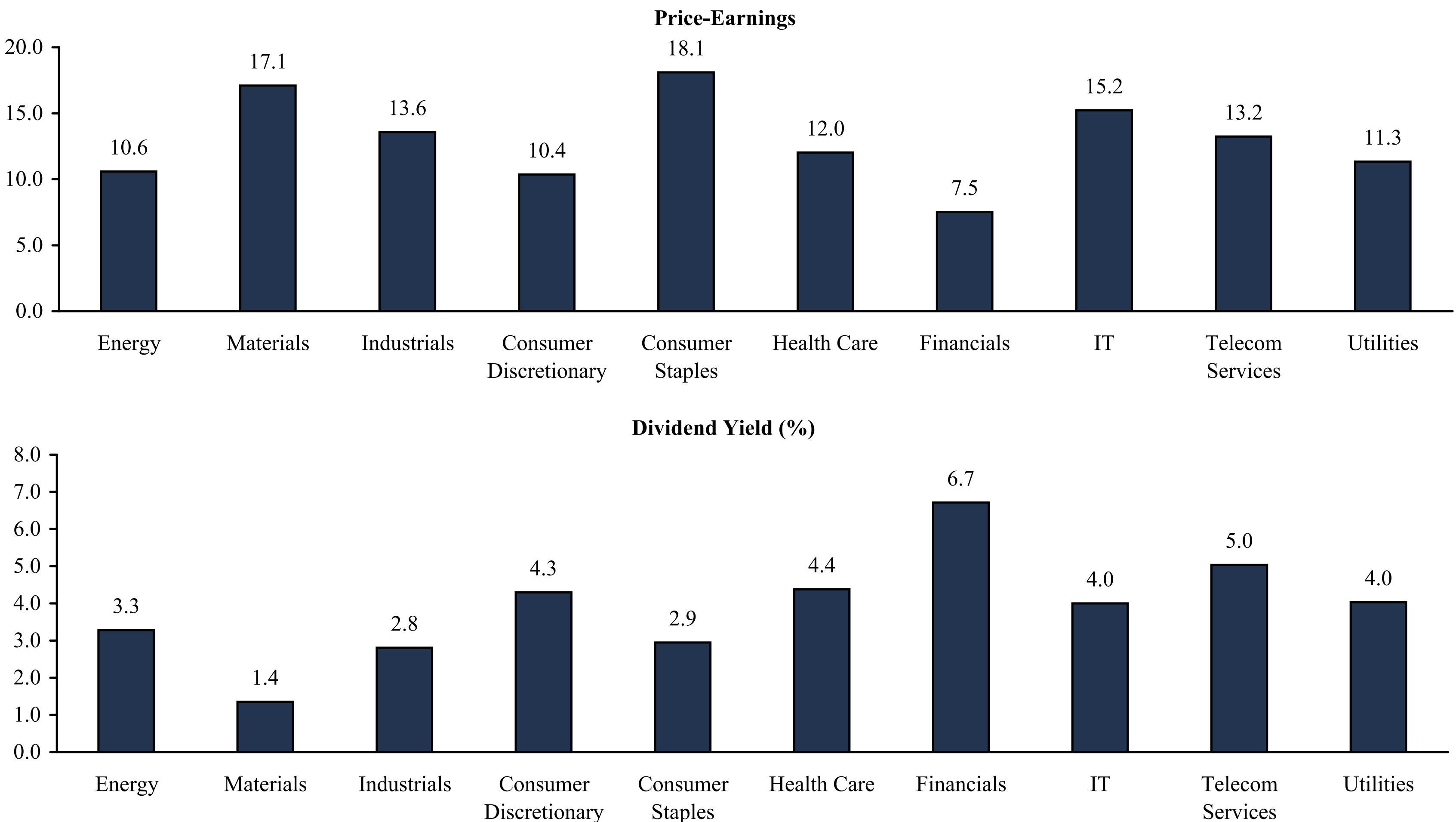
Sources: Bank of England, Dealogic, and Lehman Brothers, Inc.

Note: The yield spreads were calculated by using the quarterly average five-year spread over LIBOR.

Table F

MSCI U.K. INDEX SECTOR VALUATIONS

As of 31 May 2008

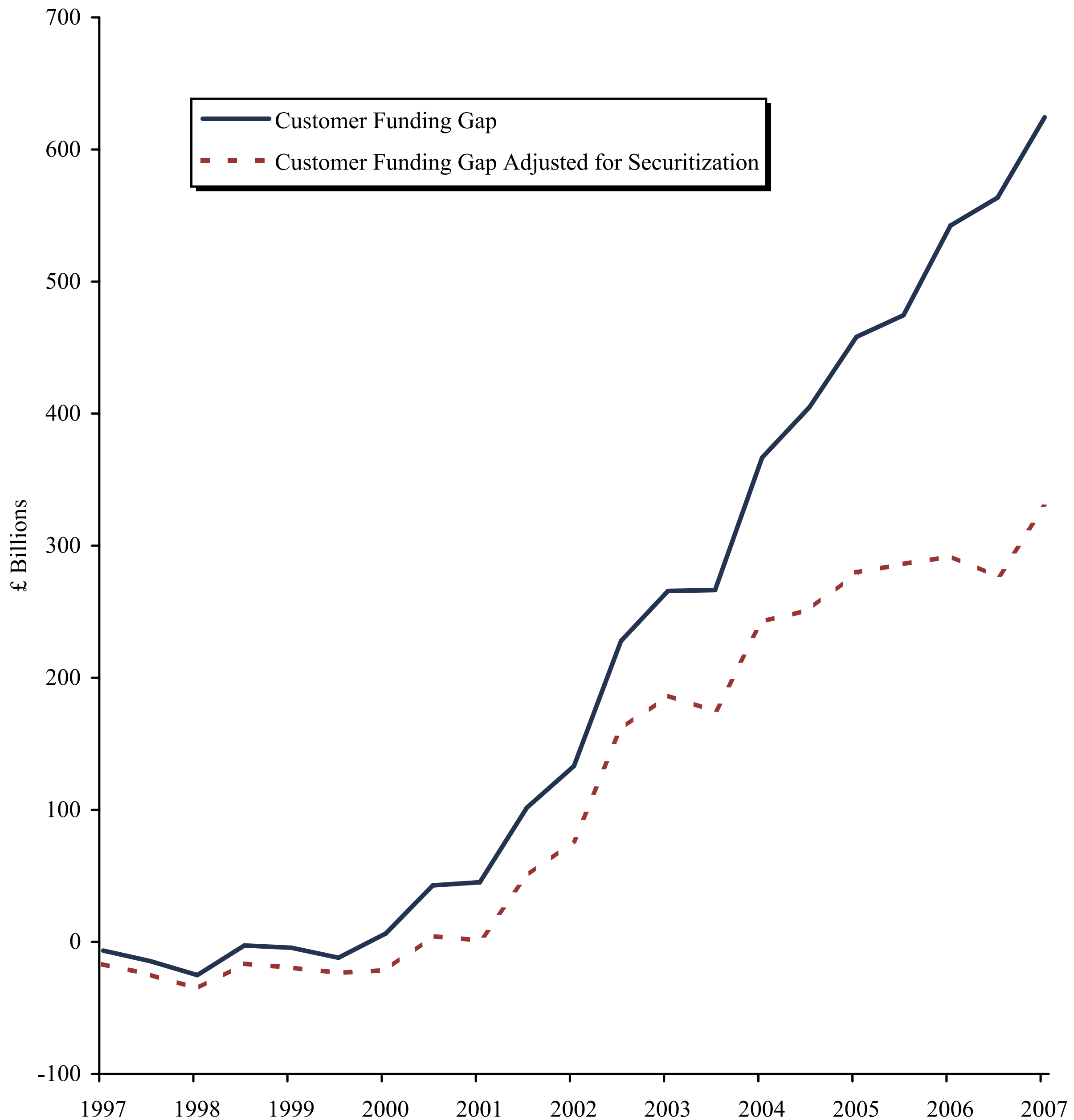


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Table G

MAJOR U.K. BANKS' FUNDING GAP

31 December 1997 – 31 December 2007



Sources: Bank of England and Dealogic.

Notes: The data exclude Nationwide. Where not available, stocks of securitizations are estimated from issuance data. Customer funding gap is customer lending less customer funding, where customer refers to all non-bank borrowers and depositors.