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OUT OF THE ORDINARY

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Could the economy affect the housing market?

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This week, my colleague and fellow Welsh national, John Wyn-Evans, is still enjoying a well-deserved break and I am writing the Weekly Digest following the Chief Investment Officer's column last week. At the time of writing, I am sitting in my new apartment on one of two pieces of furniture we own, with a cloud of questions floating over my head. Have we bought at the market peak? What if house prices decline significantly? What have I done? This leads me to write about the housing market, interest rates and inflation.

The British population is obsessed with house prices, and that is no surprise because the overwhelming majority of people have much of their wealth tied up in property. House prices have increased 68% from June 2012 to June 2022, which equates to a compound annual growth rate of 4.85%. The UK's average selling price is £286k, compared to £170k, 10 years' ago, according to the UK House Price Index.

What has driven UK house prices up and will they stay there?

A core argument is that the UK's housing shortage will support the market because demand will outstrip supply. However, there is some academic evidence to the contrary. In periods of high demand, house prices have declined in the past.

The health of the housing market is intrinsically linked to base interest rates. Low rates traditionally reduce borrowing costs and push up asset prices. There are costs to home ownership, but these are potentially offset by a household's expectations of capital gains on the asset.

Therefore, a risk to house price growth is the current upward interest rate cycle, which is in full swing amid monetary policy tightening to combat inflationary pressures. Mortgage rates are increasing, with the five-year fixed mortgage rate now averaging 3.5% versus 1.3% last October, according to Bank of England data. If mortgage rates continue to increase, this could dampen demand and slow housing transactions.

There are many variables influencing the interest rate cycle including inflation. The latest UK Consumer Price Index print was an eye-watering 10.1%, the highest amongst the G7 countries, and this will increase pressure on the Monetary Policy Committee to consider even higher rates when it next meets on 15 September 2022.

Could unemployment affect the market?

Historically, a decline in house prices has coincided with an increase in the unemployment rate (currently at 3.8%). For example, the housing market declined significantly in the early 1980s during the period when unemployment rose from 8% to a peak of 11.9%. In the early 1990s, another decline in house prices accompanied unemployment climbing from 7% to 10.7%. During the Global Financial Crisis, unemployment increased rapidly and reached 7.9% in March 2009 (source: ONS data).

The good news is that the unemployment rate at the moment is not flashing any red lights, but this comes with the caveat that unemployment is a lagging economic indicator.

What is the effect of the cost-of-living crisis?

There are two ways to analyse housing affordability, although they reach conflicting conclusions. Firstly, one can look at house prices as a ratio of income. Affordability looks constrained according to this indicator.

Secondly, one can look at the mortgage repayments as a percent of take-home pay. On average, this figure is 31%, versus the historical average of 36%, based on data for 25% mortgage deposits from the Office of National Statistics from 2011 to 2018.

What can the performance of housebuilders tell us?

While the broad view is critical for assessing the health of the UK housing market, a company-level view is also very valuable. Many housebuilders have benefited from the Help-to-Buy scheme that has helped first-time buyers onto the property ladder. Despite this scheme ending in 2022, the listed UK housebuilders have been reporting strong demand and order books and demonstrated that consumer appetite is currently healthy.

Which brings us to the tightening regulatory requirements on the horizon.

According to the government, heating and powering buildings comprises 40% of the UK's total energy use. By 2025, all new builds will have to produce 75-80% less carbon emissions than new homes under current regulations. The path to net-zero carbon homes is a challenging one, with Part L (energy efficiency) and Part F (building ventilation) coming into effect in June 2023 for England. Some housebuilders have told us this will add an estimated £3k to the cost of a building plot, but they expect the additional cost to be passed on either to the land vendor or the customer. Whether a new home buyer will pay a premium for a green and more energy efficient home is open to question.

What is the role of property as an investment?

The performance of the UK residential housing market has been particularly strong for the last ten years. However, with the beginning of the monetary policy tightening cycle, inflationary pressures and new regulations coming into the picture, the foundations of the housing market will certainly be tested.

Within a broader portfolio context, property is a diversifying asset class but less liquid than stocks and bonds. We recognise that the greater part of most people's wealth is in residential property and at Investec Wealth & Investment we invest in commercial property to help diversify portfolio risk.

Economic Commentary

FTSE 100 weekly winners

Just Eat Takeaway.com N.V.	20.0%
AstraZeneca PLC	5.0%
London Stock Exchange Group plc	4.6%
Polymetal International Plc	4.5%
British American Tobacco p.l.c.	4.3%
BP p.l.c.	4.0%
Coca-Cola HBC AG	3.7%

FTSE 100 weekly losers

Abrdn plc	-9.7%
Persimmon Plc	-9.6%
ITV PLC	-8.9%
Mondi plc	-7.9%
AVEVA Group plc	-6.8%
Entain PLC	-6.7%
Aviva plc	-6.6%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

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