DAILY RECKONING UK

Long-term rising property prices could now be in reverse, long-term!

By Jonathan Davis
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Editor's note: *Jonathan Davis is one of the most high-profile wealth advisors in the UK, and today, he has kindly agreed to share some of his insight with readers of The Daily Reckoning.*

Below, Jonathan hones in on the current property situation in the UK, and how he sees things playing out moving forward…

"You can't lose with property" scream the vested interests…

The estate agents, the bankers and other mortgage lenders, brokers, MPs (of whom 1/3rd are Buy-to-Letters), the developers, Buy-to-Letters and their PR organisations, Chartered Surveyors, parents even.

Readers of The Daily Reckoning know full well there is no such thing, in investing, as "You can't lose with…"

Indeed, when a market gets to the point when that is the consensus view, there is usually one thing you should do – run away fast, before the flood of those trying to get out and not be the last man standing. By this time, the last men are on their knees praying.

Indeed, many reading this will have an unshakeable belief in the investing miracle of property. After all, it has never gone down, sustainably. It always comes back etc etc.

Let us review the market, and then consider the outlook.

What are the primary movers of house prices?

If you said mortgage availability and rates you would be correct.

For ever and by everyone we have heard its supply and demand – well, kind of.

Supply and Demand are determined by mortgage availability. If a home was a billion pounds and you could borrow £999,950,000 many would.

It all depends on how much someone will lend. And remember, around a hundred years ago a mortgage was £200. Now it's £200,000.

So, how ridiculous is it to borrow nearly a billion pounds?

It's not population and square miles of land. Hong Kong has to be the most densely populated developed economy in the world, yet it has experienced its fair share of house price crashes.

It’s not numbers of properties and those to be built. That, again, is ruled by mortgage availability. You could build 100 homes or 1,000,000, and if there was sufficient lending, high prices would sustain.

Just like in Spain, Ireland, and the US – until the crash of lending in 2008. Lending did not crash, sustainably, in Australia, Canada, China and the UK etc.

So house prices only fell temporarily – in the economic recession of 2008 – and then quickly recovered.

Hence, when prices flattened in the UK in 2012 and looked as if they would crash – with the lowest borrowing rates in human history – the then Chancellor, George Osborne, launched the horrendous Help-to-Buy scheme (or as I call it Help to Sell…).

Thus, lending flowed and house prices rose again.

Prices also rose and stayed high due to the rise and rise of Buy-to-Let since 1998 – when we saw the first BTL mortgage.

So, as mortgage interest rates fell and fell, and lending rose and rose, naturally, prices rose. Liquidity alone fuels all asset prices and property is no different.

So, what if one of the two tailwinds to long-term rising house prices were to reverse?

What if interest rates stopped falling long-term, and actually rose long-term?

“Is the decades-long downtrend in interest rates finally over?”

You don’t need to be a technical analyst (of financial markets) to get nervous when you see the following chart – especially when you consider that the only trend in longer-term interest rates, that an entire generation of people has ever known, may have finally ended.

Mortgage rates are based on market borrowing rates. The chart below is of the US Government 10 year borrowing rate, over the last 100 years.

As everyone knows, interest rates peaked in the late 1970s, and have drifted down since.

This is, arguably, the most important chart in finance. It’s almost identical to the UK’s experience.

You can see, from the mid-20s to the early 60s, the 10 year borrowing rate stayed low, as inflation was low.

From then on, inflation and borrowing rates soared. They peaked in the late 70s, as many of you will remember.

Gradually, US and global inflation and interest rates fell. Indeed, look at the blue line. Nothing goes in a straight line. As the rate fell, from the 1980s, when it rallied, it never once rose above that blue line.

Until now.

Does this mean entering an era of rising rates, following an era of falling rates?

THAT is the question everyone in finance is (should be!) asking. And although nobody knows, the signs are that it is more probable that at any time in decades.

What we can say is inflation and interest rates are rising now. And, likely, they will continue to do so this year. Indeed, they will likely continue to do so until we have the next recession, whenever that will be. 2019? 2020? Who knows?

Did you hear the announcement from the Bank of England, last week?

The total change in tone, from previous statements was clear. This is what the Monetary Policy Committee meeting said:

"The Committee judges that… monetary policy would need to be tightened somewhat earlier and by a somewhat greater extent over the forecast period than anticipated at the time of the November report."

Rates will rise in the UK, folks. This has been inevitable since the Pound Sterling started really strengthening (October 2016) and UK Government borrowing rates had soared.

In the summer of 2016, the Government was borrowing, over 10 years, at a rate of merely 0.5%. Now, it is over 1.5%. A **trebling** in c 18 months. This was the market telling the Bank of England that inflation is here and you need to raise the Base Rate. The Bank has finally got the message.

As to the future, if, in the next recession, rates and inflation fall but to a higher level than the lows of 2016, then, yes, we will be in an **era** of rising inflation and interest rates.

Already in the US, 30 year mortgages (they fix long-term across the Pond) have risen from 3.3% to 4.3%. **A 30% rise in mortgage costs…!**

The question that springs to my mind is 'if mortgage rates rise, materially, **for years,** how can that be a long-term tailwind to house prices?'

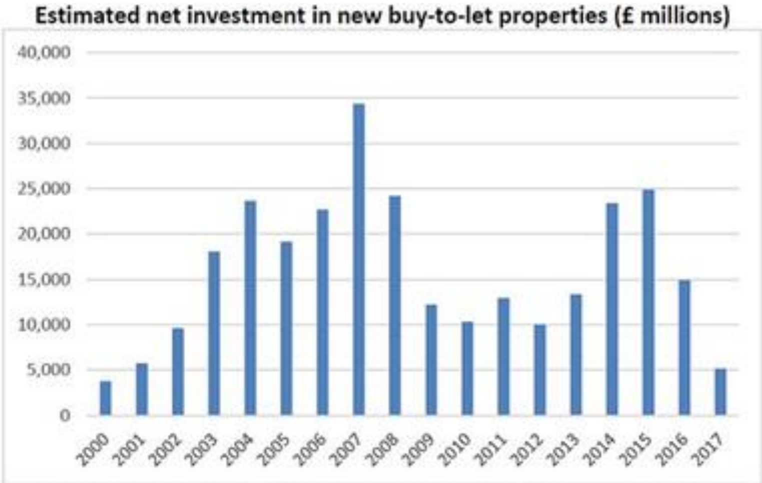
Answer: They can't.

So, one of the primary movers of house prices, over the long term, MAY be turning from a tailwind to a headwind.

Another long-term prop to house prices has been *Buy-to-Let*. However, it looks as if that horse too has bolted.

Buy-to-Let has plummeted 80% in the last two years.

Stark figures from the Intermediary Mortgage Lenders Association show net investment in *Buy-to-Let* property fell from £25Bns in 2015 to just £5Bns in 2017.



Source: IMLA estimate. 2017 is projection based on year to October data. UK Finance and Nationwide

They estimate that between 2000 and 2017, UK *Buy-to-Let* landlords bought some £289Bns (WOW!) of property, amounting to 1.8 million properties. That's a lot of demand which is now falling away.

Estate agents tell us landlords have found it harder to remortgage over the past year as a result of tougher lending standards imposed by the Bank of England.

It means that the vast majority of landlords have been selling off existing properties and not rebuying, i.e. not expanding portfolios, and/or simply they have been reducing their mortgages.

With the big increases in *Buy-to-Let* taxation, started in April 2016, and tighter lending, it seems to me the primary issue is likely to be materially reduced demand and, therefore, increased supply for properties. It is unlikely *Buy-to-Letters* have the resources to reduce debts, materially.

So, in summary, we could be seeing a reversal from an era of falling interest rates to an era of rising rates and, at the same time, demand for property is falling.

Both of these, materially, are detrimental to residential property prices.

I conclude that, from a financial asset perspective, this is not the time to be buying a house, investing or trading up. It could be a good time to sell, divest or trade down though.

About Jonathan Davis:

Jonathan Davis BA MBA FCII FPFS is a highly-respected economist and wealth adviser. He has worked in finance since the mid-1980s. In 2007 he launched Jonathan Davis Wealth Management, attracting private clients from all over the world.

He advises on preserving and growing family wealth. He is one of the most high-profile wealth advisers in the UK making regular appearances on television and radio. He holds Masters degrees from British and French Universities, as well as being qualified at the Chartered level, twice over, in Financial Planning disciplines.

He presents the entertaining and informative The Booms and Busts Show podcast, which is the fastest growing economics and markets show on itunes (with some politics added in), focussing on the many benefits of free markets and capitalism as well as personal investing. He lives in Hertfordshire.