Fathom Research
26 May 2016

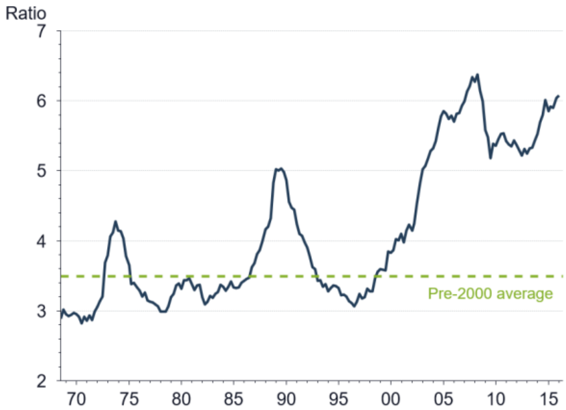
The UK's housing bubble: ready to pop?

- **The UK's house price to income ratio has been inflated to within a whisker of its pre-recession peak and is well above its long-term average.**
- **Property prices would need to fall by up to 40%, or household income grow at ten times its current pace for the next five years, in order to bring the ratio back to balance.**
- **We maintain our view that this increase is demand driven, brought about by both exceptionally low real rates of interest and Chancellor Osborne's Help to Buy scheme.**
- **The housing market is likely to remain overvalued at anything other than near-zero interest rates. Fearful of destabilising the fragile arithmetic that underpins the housing market, we believe that Bank Rate normalisation is a distant prospect – regardless of the EU referendum result.**

Following the financial crisis, the UK house price-to-income ratio fell by almost 20%, from an all-time high of 6.4 to 5.2 where it hovered until early 2013. In the 2013 Budget, Chancellor Osborne introduced a game changer in the form of his Help to Buy (HTB) scheme. Providing loans and guaranteeing mortgages, this triggered a surge in residential property prices. House price inflation reached double-digits and the price to income ratio rebounded. Consequently, the UK's housing market remains highly overvalued at anything other than near-zero interest rates.

Ironically, it reached boiling point in the first quarter of this year as a result of the imminent imposition of a higher rate of stamp duty on second homes and buy-to-let properties — introduced in a bid to cool the sector. Now in place, housing market activity looks to have slowed. But with real mortgage rates as low as they are today, we suspect that macro-prudential measures will do little more than turn the heat down to a gentle simmer — postponing the return to a more normal interest rate environment and prolonging the housing bubble.

UK house price to income ratio



Source: Thomson Reuters Datastream / Fathom Consulting

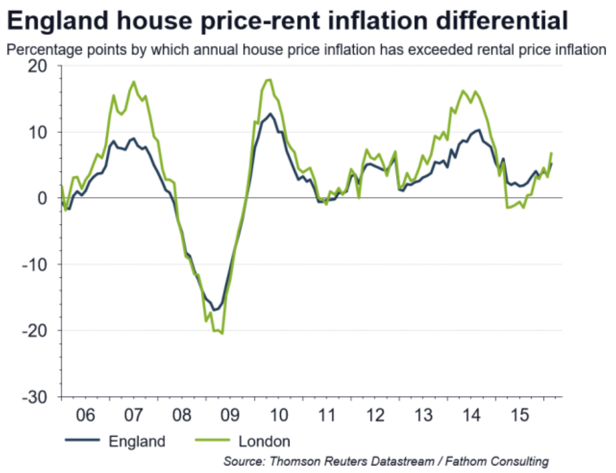
In May 2014, we argued that, contrary to popular opinion, the increase in property prices relative to income had little to do with a shortage of housing supply.[1] We did not dispute that growth of the housing stock had slowed, but our analysis suggested that the increase in

[1] UK housing shortage evident everywhere but the data, May 2014.

the house price to income ratio was driven by a demand boost — brought about by exceptionally low real rates of interest. Two years on, we have taken the opportunity to reassess that view.

The house price to rent differential

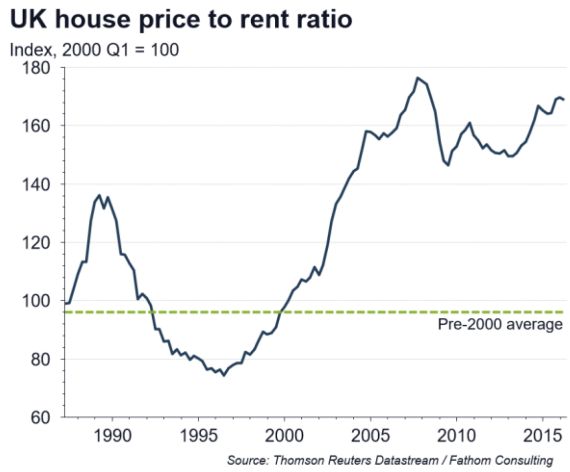
House price indices are not measures of the price of housing. Rather, they tell us about the cost of owning a physical asset that is able to provide a flow of housing services over time. A more accurate gauge of the price of shelter is provided by housing rents. Interestingly, house prices are booming, but rental costs are growing at a significantly slower pace. We find that, on average, the annual pace of house price inflation has exceeded rental price inflation by 2.3 percentage points per annum since 2006. In London, that figure rises to an average price to rent differential of 4.1 percentage points.



Why, if housing is truly in short supply, is the price of renting a property (the purest measure of the cost of housing services) not rising as rapidly? Our analysis leads us to conclude, as we did two years ago, that house price growth has been driven by demand, as opposed to supply.

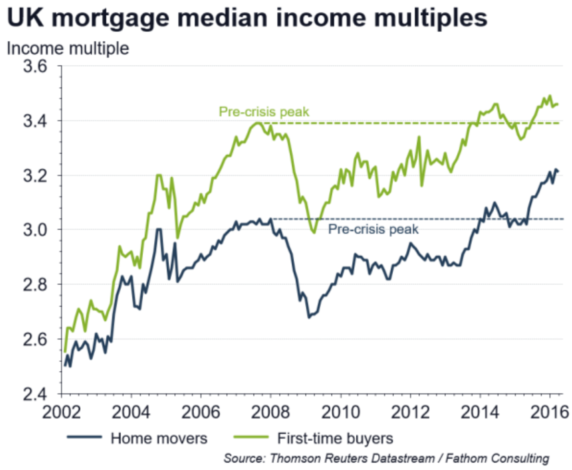
Indeed, our assessment of the factors that have pushed the house price to income ratio above its pre-2000 average of 3.5 suggests that the reduced rate of growth in the housing stock per capita, when compared to the rate of growth achieved pre-2000, explains less than a 10% increase in the house price to income ratio. Instead, we find that the fall in the cost of owning and maintaining a property, brought about by exceptionally low real rates of interest, accounts for most, if not all of the remainder. Since 2013, the demand for housing has been turbocharged by Chancellor Osborne's HTB policy and the search for yield — which has resulted in the accumulation of housing wealth as an investment alternative for low-yielding financial assets.

As a consequence, house prices are now close to an all-time high of more than six times disposable income. Based on this metric alone, prices may need to fall by as much as 30-40% to return to their long-run level — three and half times disposable income. Similarly, the house price to rents ratio is well above its pre-2000 average.



In the long-run, the house price to income ratio should be approximately mean-reverting, as it had been until the early 2000s. This is because the price to income ratio is a function of the real user cost of housing, which itself is a function of mean-reverting variables including real mortgage rates and transaction costs. Real mortgage rates will not remain as low as they are today, and when they do rise, the fragile arithmatic supporting the elevated house price to income ratio will unravel.

In the meantime, median income multiples on mortgages for both home movers and first-time buyers are high and climbing, with ratios now exceeding their pre-recession peaks. Worryingly, the proportion of mortgages offered at a high income multiple[2] is rising. Specifically, more than one third of joint mortgages granted, which account for just over half of all new mortgages, exceed this level, compared to under 30% at the pre-crisis peak.



More reassuringly, the proportion of lending at high loan-to-value ratios[3] remains considerably lower than in 2007. Consequently, the share of new mortages with both a high income multiple and high loan-to-value ratio remains well below pre-crisis levels.

More macro-prudential measures on the horizon

Between April 2017 and 2020, a gradual reduction of mortgage interest rate relief from the higher to the basic rate of tax will be phased in. We estimate that this will be equivalent to 15 basis points in additional mortgage-servicing costs per annum, totaling an additional 60 basis points by April 2020. In other words, the aggregate impact is likely to be relatively small. But by serving as a substitute for an increase in interest rates, these macro-prudential policies enable the Bank to postpone a return to a more normal policy environment. All the while, 'lower for longer' rates of interest are inflating the housing bubble and worsening the inevitable correction.

Fearful of destabilising the fragile arithmetic that underpins the housing market, we believe that Bank Rate will remain on hold until at least early 2018 — regardless of the EU referendum result. If the UK were to vote to leave the European Union, it would entail a toxic combination of both weaker economic growth and higher inflation. But we believe that concerns about triggering an even deeper economic contraction will mean that the MPC will look through any deviation in inflation from its 2% target — just as it did through 2008 to 2009, and again through 2011 and 2012. If it were to tighten Bank Rate, it could trigger a rapid correction in the UK housing market and compound the slowdown in economic growth.

Under our central scenario, in which the UK votes to remain within the European Union, the government refrains from further housing market intervention, and the MPC remains reluctant to raise rates, we expect house price inflation of 6.9% in 2016, softening to 4.3% in 2017.

[2] Defined as 3.5 times or more for a single applicant or 2.75 times or more for a joint mortgage application.
[3] Defined as a LTV ratio in excess of 90%.

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