WEALTH MANAGER

David Stevenson: House prices will keep rising until 2025

With policymakers set to keep rates low, the housing market will edge up for another two to three years, according to economist John Calverley.

by DAVID STEVENSON
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If you listen to the Cassandras, autumn is shaping up to be a grim few months. A shortage of lorry drivers and natural gas will intensify inflationary pressures.

The *Times* this week even went so far as to suggest that that old term of national ridicule – banana republic – is back from the 1970s as an explanation as to why international investors are underinvested in UK equities.

As a professional contrarian, I'm not convinced we should all start despairing of the UK as an asset class quite yet. As evidence of that, I'd point to the UK housing market. I maintain that a large part of the UK economy is either directly or indirectly impacted by its overpriced residential housing market. We should start worrying if collapsing house prices started to drag down new home builds, the banks with their mortgage books or vast swathes of what remains of the high street.

At the moment, I don't see any sign of that market breakdown even though it's obvious to all but cave dwellers that the UK housing market – at least in the Southeast – is stupendously overpriced. If anything, the UK residential market is defying all the gloomsters who worried about the end of the stamp duty holiday, which was a ruinous waste of public money, in my view.

UK investors need to have a handle on the housing market, as it influences so many of the businesses we invest in. I've already banged the drum in previous columns about what is wrong with the structure of that market and why I believe the UK housebuilders remain a safe haven, despite their obvious and egregious failings.

But I am no expert on the subject, so I sought the counsel of someone with a deep knowledge of the sector – John Calverley (pictured below), who is currently chief economist at UK investment advisory house, Tricio. Calverley has more than 40 years' experience in international economic research and was previously chief economist and strategist for American Express Bank and head of macroeconomic research at Standard Chartered.

Crucially, he's written extensively on the subject of housing in his book *Bubbles and How to Survive Them* (2004), which warned of the risks of a US housing crash. The second edition, *When Bubbles Burst: Surviving the Financial Fallout*, was published in 2009. Calverley keeps a close eye on the UK housing market, so I caught up with him last week to find out what he thinks might happen next.

Do you think the extraordinary run-up in house prices will continue for much longer?

UK house prices fell about 20% in 2008-09 during the great financial crisis and then started to rise steadily from 2013 before accelerating over the last year. The rapid rise in 2020-1 is likely due to the fall in interest rates, desire for more space and the cut in stamp duty. All three of these recent drivers are now reversing with the stamp duty holiday over, Covid restrictions eased and interest rates likely to rise next year.

But I don't expect that the uptrend in house prices is over. The economy is recovering, employment is increasing and interest rates will rise only slowly. It is unusual for house prices to fall significantly in the absence of a recession and/or a big rise in interest rates, neither of which looks likely near-term.

Do you think there is a longer cycle in property and what drives it? For instance, many property experts talk about the legendary 18-year cycle.

Yes, I think there is a longer cycle. There is evidence of an 18-year cycle in house prices. Such a cycle was first identified by Homer Hoyt writing about Chicago land prices in the 1930s and it seems to be born out in many countries.

For example, in both the US and UK, house prices peaked in 1989-90 and then again in 2006-07. It is not exactly 18 years – I tend to think of 16-19 years. I think it is caused partly by a development cycle. That is, during a house price boom, more houses are built. Then along comes the bust and it takes several years for the excess housing to be absorbed. Meanwhile, new housebuilding slows, setting up the lack of supply which leads to firming prices again.

This aspect of the cycle has been more evident in places like Spain and the US 'sand states' (Florida, California, Arizona etc), where planning rules allow development to be rapid during the boom times. In the UK, where planning rules are very tight, the building cycle plays less of a role. More important I think are memory and price expectations in creating the cycle.

The pain of a housing bust lasts for some time. For many years afterwards, people hesitate to buy a house for fear they will lose money. It takes a new generation to come along, to observe steadily rising prices, with little memory of the past bust. They are the ones who drive the price rise on and create the next cycle. That process takes more than one ordinary business cycle, typically seven to 10 years, and stretches out to about 18 years.

So, the current cycle might have further to run, but what might cause the housing market to turn?

The biggest risks are always large rises in interest rates and a recession. Historically, rises in interest rates to deal with inflation often bring a recession, so you get a double whammy.

My guess is that the next downturn, due around 2025, will come from higher rates and possibly an economic slowdown of some sort. That said, a small rise in rates in the context of an improving economy will probably slow or even stall the rise, but I doubt we will see a major fall.

Assuming the prognosis is still broadly positive, do you think the big listed housebuilders are still in a good spot?

In the UK, as I mentioned, we don't see a very pronounced building cycle compared with other countries. During the boom times supply is not massively larger than during ordinary times.

The supply of new houses relative to the total stock of houses is quite small as we mostly live in relatively old houses, compared with countries like the US or Spain. So, builders are less exposed, except to major recessions.

I don't see a major recession near-term and I expect house prices to continue to rise moderately, for the next two to three years or so. However, the peak of the current 18-year cycle is due by 2025, so beware of that.

How seriously do you take the talk of government policymakers taming the big builders and their landbanks?

The problem in the UK, and the reason house prices are so high and our houses are small compared with other countries, is the lack of supply of building permissions from local authorities. The idea that housebuilders are hoarding land is wrong, I think. If they get planning permission for a big development of say 500 houses, of course they won't build them all in one year. That would be hard to do given local labour constraints and would flood the local market with supply.

So, they build up to 50 a year and sell them over 10 years or so. It looks like there are hundreds of houses, with planning permission left unbuilt but that is just part of the natural supply process. Politicians will probably damage supply if they try to interfere with this. I doubt they will do anything major.

How likely do you think we are to see positive real rates in bonds and interest rates?

Compared with target inflation rates of 2%, current mortgage rates of around 1% are negative in real terms. Arguably they are even more negative compared with actual inflation, which is heading to 3-4% in the UK.

One way to get to positive real rates is 'Japanification', where inflation goes negative, ie deflation. I don't think that is likely in the UK. I worry more about inflation staying higher than 2% in the coming years. The Bank of England will doubtless respond by raising interest rates but I expect them to move fairly cautiously so real rates are likely to stay negative for some time, though probably gradually moving back up to zero.

Getting to positive real rates seems a long way away. With debt in the UK and globally at high levels, if central banks raise interest rates too fast or too much, they will cause a recession. I think they will move slowly and cautiously.
