The UK residential trend is dead but the cycle survives

Alan Patterson MSc FRICS
VARE Consulting Ltd

First presented in September 2020

Presenter

Alan Patterson MSc FRICS IMC

Alan is the Director of Business Development & Strategy, and Head of Fund Management in Funding Partners. He is a Fellow of the Royal Institution of Chartered Surveyors and holds a masters degree in Property Development (Project Management).

Alan has worked in the property industry for the whole of his working life. His experience in CBRE (formerly Hillier parker) was as a fund manager, then financial services and latterly as the Head of Investment Research. He gained experience of the equities markets as a director at Panmure Gordon and HSBC Investment Bank, before joining UBS Asset Management where he combined being Head of Fund of Funds, head of UK real estate research with equities management. He joined AXA Investment Managers, where he became Global Head of Research and Strategy in what is now the Real Assets group. He was also the managing director and Head of Research and Strategy at Gingko Tree, the European real estate subsidiary of the People's Bank of China.

Alan's skill base is as a property market economist and analytical researcher, believing that understanding macro trends and secular change is as important as stock selection and asset management.

A word about falls and recoveries

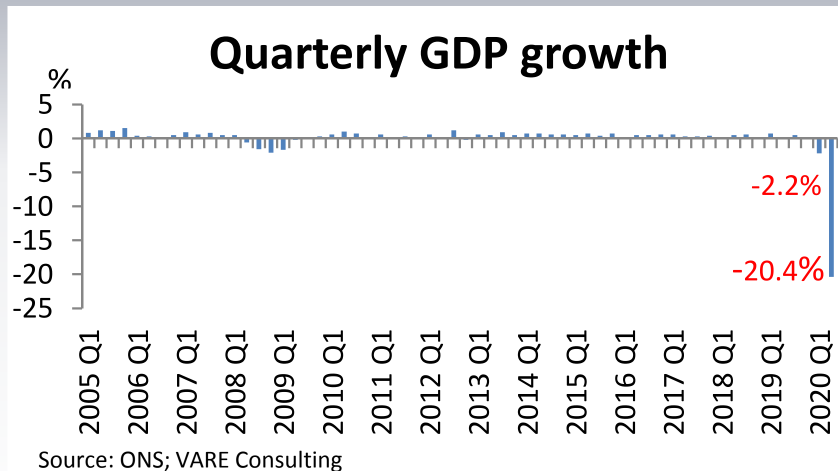
- There is a case often made by institutional fund managers that it is **impossible to time markets**. To a large extent, that suits their agendas and academics might well respond with that it is **impossible to consistently outperform the markets** by strategy or stock-picking
- I would argue that timing relatively efficient markets, like the equity or bond markets is very difficult over the very short-term, but it is easier over the long-term, and it is **easier for relatively inefficient markets**, like the property markets, where the transaction costs are high and there are frictional factors like **owner-occupiers**
- Going forward, into a world where trend growth and **trend returns are generally expected to be lower than in the previous cycle, the cycle will become more important**
- Indeed, I would argue that the advantages of playing the cycle can be confused by the our maths

Year	Value	Geometric return	Arithmetic return
0	100		
1	50	-50%	-50%
2	100	+100%	+100%
Average		0%	25%

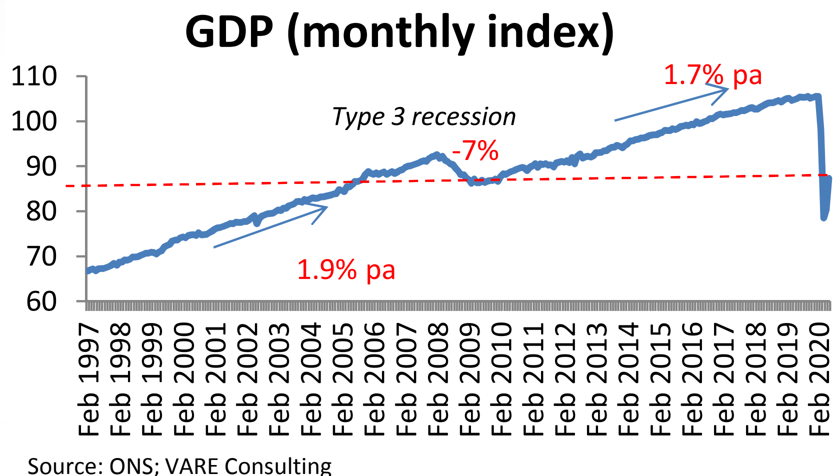
Holding over the whole cycle gives you zero capital growth but, such a scenario can be misleading: property depreciates in recessions and is subject to secular shifts – what comes out may not be what goes in

Some people may think in arithmetic terms, either because the cycle is masked by trend growth or 'noise' superimposed on it, or because there is a logical argument for it (!)

Economic crisis



Source: ONS; VARE Consulting



Source: ONS; VARE Consulting

- Globally, economies are in **unprecedented recessions**, with governments providing unprecedented stimulus to prevent complete economic collapses
  - The Bank of England, in its May quarterly report, believes that **GDP will shrink by 14% in 2020** (the worst in 300 years), although in its **August report, it revised it to -9.5%,** with its forecasts close to those of the **independent forecasters which have a mean of -10% and a range of -7% to -14% (double-hit scenario)**
    - The difference is greater for **2021, with the BoE having a 9% growth forecast and 6.6% by the independent forecasts**
      - **These are all likely to prove optimistic**
  - **We are currently in a phoney recession**
- **Unemployment** was at **3.9% in January** (source: ONS), and the BoE is forecasting **7.5% (2.5m unemployed) by the end of 2020**, with the **independent forecasters having 6.6%**
  - This is a **key number** for the housing market as it determines the number of buyers who able and willing to take new mortgages
  - It also determines the rate of **wage growth**
- Annual **CPI Inflation** is forecast to be 0.3% for 2020 by the BoE and to be 0.5% and 1.9% by the independent forecasters

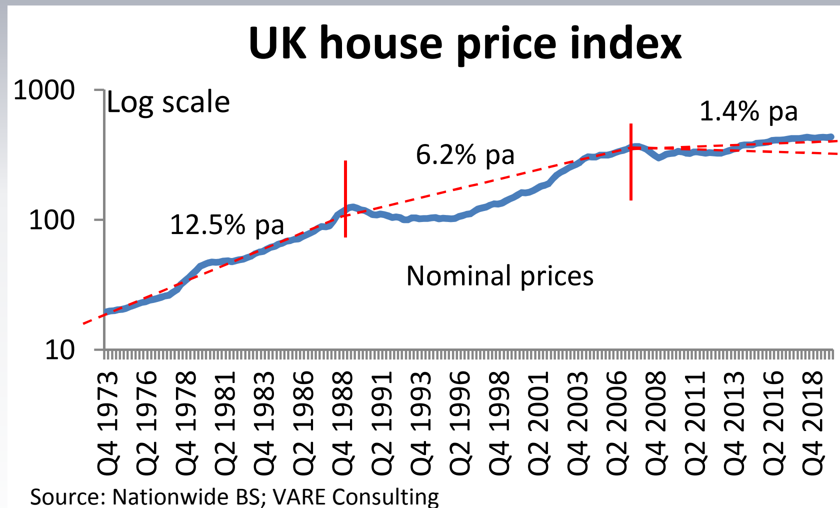
Inflation and property

- For decades, there has been a dispute about the **relationship between property values (and rents) and inflation**
  - The academics’ analysis indicates that they are **unable to find a significant correlation**
  - The market players argue that this is contrary to their experience: **values and rents rise during periods of inflation**

- **The difference is one of timing**
  - In the **short-term**, the **supply of properly is fixed and values are determined by supply v demand**. Thus, in a recession, values can fall by 20% and inflation might be close to zero. There is clearly no connection
  - But, in the long-term, **supply can be increased by building more**. The **cost of new housing is determined by construction cost inflation (and ancillary costs) and land prices**
    - The **cost of construction is close to CPI inflation** – it would be lower because increased automation/power tools reduces costs but this is countered by improving specifications (partly by regulatory demands)
    - **Land prices is a complicating factor**, as it is a **residual in a development appraisal** and, therefore, is responsive to demand, although there is high inertia/poor liquidity in a depressed market
      - This means that, to some extent, the **prices of new build can fall in a recession**, **but more typically, the supply is choked off.** This exacerbates the supply problem in the economic recovery phase, and **accelerates the recovery in house prices**

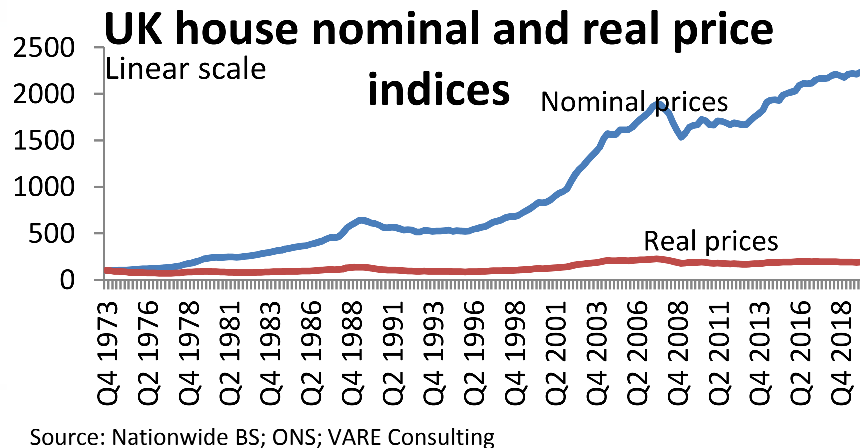
- **An aside about how house builders perform**
  - Historically, house builders have been described as **land-bankers** who also build houses
  - The 2008/9 recession exposed them to the **weakness of that strategy** – their land bank had a zero (in some cases, a theoretical negative) value and using the land for construction actually destroyed value by crystallising the loss
  - **Now most (if not virtually all) have moved to acquisition through options**
    - They never actually own the land until they are ready (or almost ready) to build. This reduces their capital requirements (higher return on capital) and lowers their risks (no land holding), while retaining a large part of the planning upside and all of the construction profit

Residential cycles

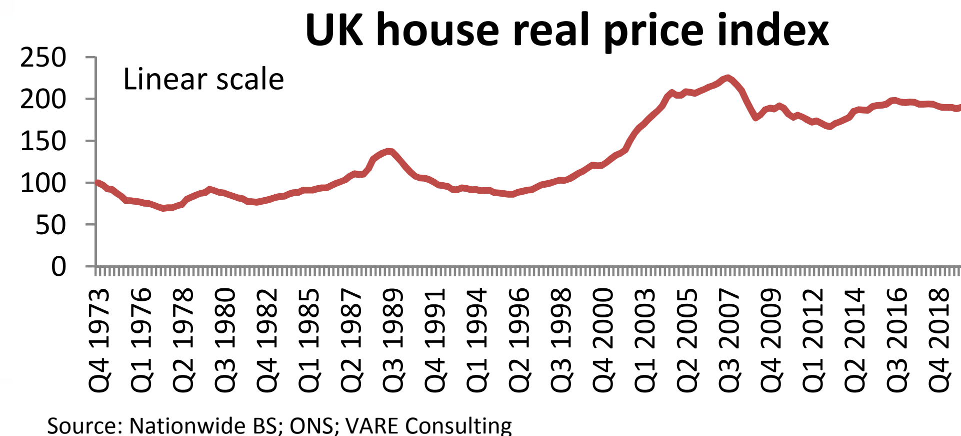


Source: Nationwide BS; VARE Consulting

- The **first chart may not be, visually, how most people see the evolution of house prices.** That is because it is on a logarithmic scale, which is appropriate for a long time series
  - The dashed lines represent the gradients, peak to peak, and these suggest that the **three periods** (a greater number of cycles) display a slowing of the rate of growth
  - The fundamental reason for that is that **inflation has been slowing** from the peak of the 1970s, when it reached over 25%
- The **second chart shows real growth** – ie stripping out inflation - in house prices, **compared to nominal growth**, on a linear scale
- The **third chart shows real growth alone – just for clarity**

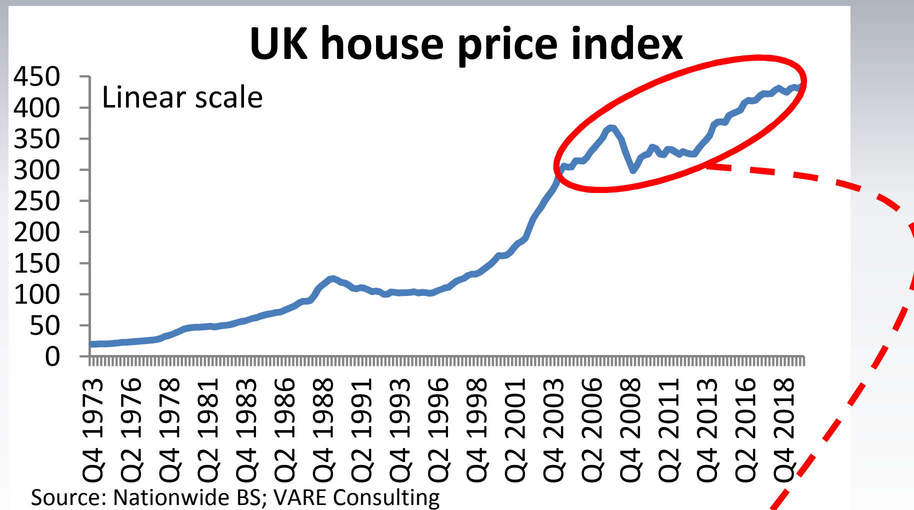


Source: Nationwide BS; ONS; VARE Consulting

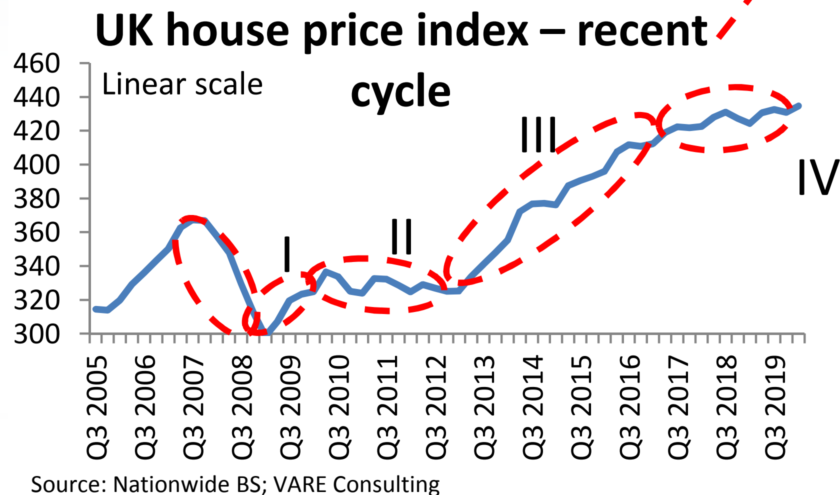


Source: Nationwide BS; ONS; VARE Consulting

The most recent residential cycle



Source: Nationwide BS; VARE Consulting



Source: Nationwide BS; VARE Consulting

- The end of the 2000s cycle came during the **recession of 2008/9,** leading and large causing the recession
- There was a '**bounce-back', to recover about half the fall**, in **phase I** of the recovery, reflecting the dramatic falls in interest rates
- After that, **phase II** was a period of **stagnation**, arguably reflecting the slow growth in the economy and the risk of a further drop in GDP, together with rises in long-term interest rates
- **Phase III** was the period of **substantial growth**, as confidence returned and buying was, for many people – particularly with the benefit of 'Right to Buy' a cheaper and more secure alternative to renting (the costs of which rose over virtually all of the cycle)
  - It was also supported, at the a macro level, by the sustained quantitative easing by the Bank of England
- **Phase IV** was a **slowing of growth** as prices started to plateau and, in some parts of the country, started to fall
  - Owner-occupiers had simply run out if ways of growing their financial strength

The end of the residential cycle

- The **residential market is unlike virtually any other asset classes** as, because it is dominated by owner-occupiers and not investors, prices are dictated in the long-term **not by supply and demand** but by the availability of finance (Source: Bank of England researchers John Lewis and Fergus Cumming)
  - This, I believe, is evidenced through land prices over the long term
  - But the Office for Budget Responsibility also uses mortgage availability from the Bank of England to predict **short-term house price movements. Mortgages are increasingly becoming restricted.**
- In the medium term, **real household income growth exerts** the greatest influence
  - This is **already falling**, but the greatest falls are still to come

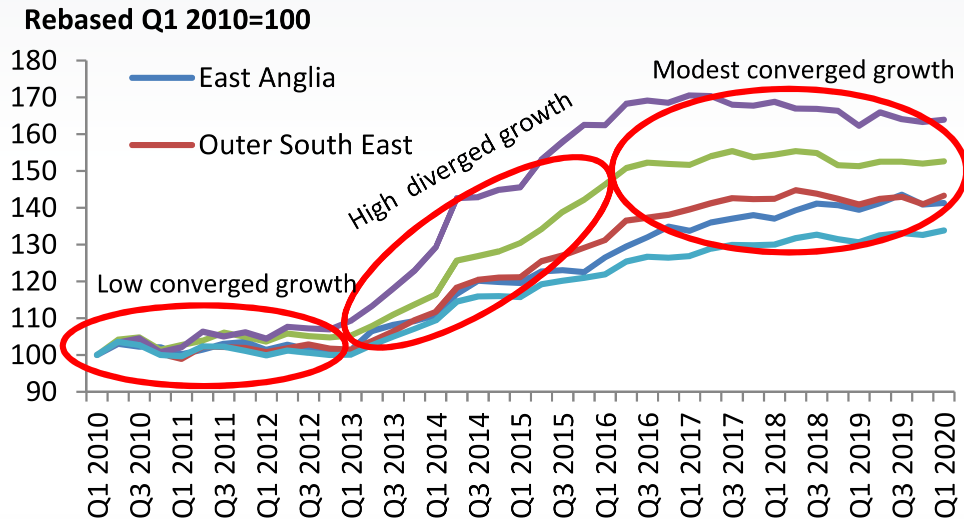
- **End of cycle**
  - Initially, we are seeing **a follow through of the stalled transactions** at around the agreed and expected prices. These have been facilitated by the **temporary stamp duty holiday**
  - The **next phase will be the downturn**, with falls in house prices mainly in 2021 and possibly (although unlikely) in 2022
    - This will be partially caused by the reduction of mortgage availability, but also by the short-term withdrawal by purchasers because of financial pressures
  - **Estimates of house price falls over the next one to two years vary between 5% and 30%**

- **The next cycle will arise from the ashes of the old cycle**
  - But the recovery **will inevitably be slow** and there will be **virtually no trend growth to help it**

Southern UK outperforms

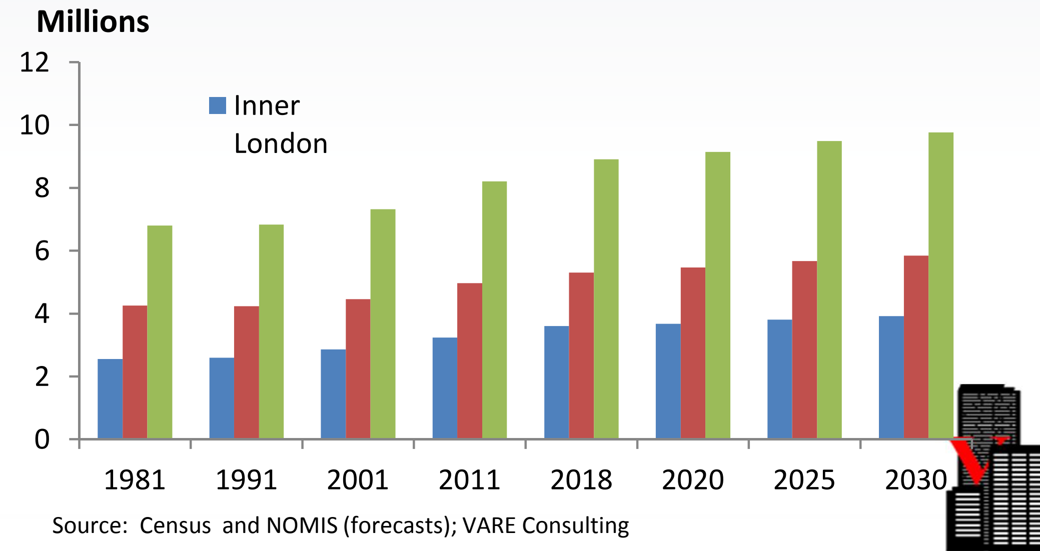
- Central Place Theory says that the land at the centre of the city is the most valuable land, as it is the most accessible
  - Values spread out
- **Over the past 10 years (ie the post-2008/9 recessionary period), London, followed by the surrounding areas, have outperformed the rest of the UK,** driven by the rising economic value of access to higher-earning jobs
- **London is the largest city in Europe and its population is also growing**

House price indices



Source: Nationwide Building Society

London population



Source: Census and NOMIS (forecasts); VARE Consulting

Secular shifts

- **Acceleration of trend to online shopping**
  - The UK has, with strong price competition , low cost of internet services and high density of population, been a global leader in online retail sales
    - These represented **21% (source: ONS) of total retail sales by the end of 2019** and rose to a peak of **33% in May**, before falling back to **28% in July**. Further falls are to be expected but an acceleration of the trend to online shopping has likely occurred
    - The biggest losers during the pandemic have been the local shops, hastening the destruction of the high streets and making town living less attractive
- **Acceleration of trend to working from home or, at least, out of the office**
  - Many large businesses were already moving to **'hot desking'** or allowing the staff to work from home, typically for one day a week
    - Again, **this has accelerated** and although there will be reversal of the 100% working from home that some office workers are apparently 'enjoying', this is likely to be only partial
    - This will **release large amounts** of (particularly lower-value) offices in city centres, which will be obsolete
      - **Some of this may be re-utilised for alternative uses**, such as residential, although such conversions are not easy, typically end up with sub-standard housing, and may lack proper amenities. **Expect greater obsolescence**
- **All of this points to an acceleration of the trend towards rural or semi-rural living for some people**
  - This move was not untypical for young families anyway, but workers are now increasing freed from commuting requirements and the virus has facilitated many of them from reconsidering their work-life balance
    - In addition, the ned to accommodate a home office means that **larger properties are required** and moving out makes that possible for similar housing costs
    - The **effect amongst younger workers is likely to be more muted**, not least because of the reducing number of car ownership amongst them. For them, city centre flats will retain an attraction

Residential investment strategy

- **The previous cycle was supported by exceptional factors**
  - Primarily stimulated by the fall in interest rates and supported by quantitative easing

- **The new cycle**
  - **Interest rates cannot fall any further** (from 0.1%) and the BoE does not intend to expand QE (August 2020 statement)
  - It is **extremely unlikely that productivity growth will be any better** in the new cycle than in the previous cycle
  - **Therefore, the trend rate of house price growth will be lower**

- **Other asset classes and sectors are likely to fare worse**
  - Bond prices are around historic highs, while commercial property is declining in value

- **A buy and hold strategy may not** – as in other asset classes – be as effective as it has been in the past

- **Investors should switch from a beta strategy, to an alpha strategy or an enhanced beta strategy**
  - Buying at the **low point in the cycle** (still to come) and selling at close to the high point (in perhaps five years' time)
  - Adding value by **investing in value-add** (improvements by planning consent, refurbishment, etc) or **opportunistic assets** (redevelopment, gaining planning consent, etc)
  - Concentrating on particular **specialist activities**
  - Taking advantage of **secular shifts** causing differential price movements in terms of size, location, etc

- **Manage risk**
  - **Keeping debt low** to avoid enhanced downside risk
  - **Diversify**

Back page

Copyright

This document has been prepared by VARE Consulting Ltd, who retains copyright ownership of it. Extracts may be utilised for bona fide purposes provided that the source is acknowledged; otherwise the consent of VARE Consulting should be obtained prior to its dissemination.

Risk warnings

This document is intended for discussion purposes and does not constitute investment advice. It is not intended to be a fully comprehensive analysis of the subject matter and VARE Consulting does not warrant that all factors determining performance and/or risk have been addressed. It should not be relied on as the basis for a decision to enter into a transaction or as the basis for an investment decision. The views of VARE Consulting may be subject to change without notice.

Regulatory requirements

VARE Consulting Ltd, 7 Werna House, 31 Monument Street, London EC3R 8BT (contact alan.patterson@varecon.co.uk, 07551 162436) claims exemption of investment advice regulatory requirements under Article 53 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 as amended.

Sources

Where third party data have been utilised, its source is acknowledged. VARE Consulting has taken reasonable care to confirm that the data is accurate and appropriate as presented, but does not warrant that it is correct or that it may not be subsequently modified.

© 2020 VARE Consulting Ltd. All rights reserved.