Article

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UK Property Market

In April this year the International Monetary Fund announced that One Trillion US Dollars was going to be written off as a result of the United States sub prime mortgage market failure. The losses incurred by banks and other financial institutions as result of buying what turned out to be little more than well packaged junk bonds, have had a considerable knock on effect in the United Kingdom because of the change in market sentiment and the difficulties associated with operating a geared mortgage business, which brought about the demise of Northern Rock.

As a result of this market shift, it is now quite clear that the gravy train has ground to a halt for property investors, marking the end of a prosperous decade for homeowners and developers alike. The question for most however, is how much are their assets going to shrink in value by the widely predicted market correction that is expected to occur in 2008?

This is always a difficult outcome to predict and although housing recessions are quite cyclical to the UK market, the circumstances surrounding the current one are very different to those of previous property slumps.

If we reflect on the property crash of the early nineties, the catalyst for a correction in house prices was extraordinarily high interest rates (initiated by the Government to control the value of the pound within the ERM) and a poor economy that was damaged by a long bear run on the equity market (brought about by long term negative sentiment during the lead up to the Gulf War). This time round however, the macro economic position is really quite robust as the United Kingdom has flourished through an extended period of controlled inflation and comparatively low interest rates.

Over the past decade however, house prices have risen by 180% and the expected correction is quite an easy one to deduce because house prices are simply too high and they either need to remain level for a period of time or come back down. The likelihood of house values falling has been increased by the US credit crunch, which has caused a lack of liquidity in the market because banks are no longer able to borrow money (to lend to homebuyers), as easily or as cheaply as they have been able to do historically and it is now quite difficult for a home buyer to get a mortgage unless he or she has a lot of equity and a decent income to support the interest payments.

The announcement by the Bank of England on the 21st of January to review the way that banks can borrow money from the Treasury will certainly ease the position but it is to be expected that sub prime mortgage deals and 100% loans will be off the radar for quite some time to come, which will undoubtedly impede the ability of first time buyers and buy to let investors to acquire property. It will also mean that the types of property that this catchment of the market generally buys will be affected the most.

One could argue of course that whilst the departure of sub-prime borrowers from the market place will create a slow down, if someone has absolutely no money and has to borrow all of it from a bank; they are not ideally suited to becoming a home owner as they cannot afford the acquisition and have more limited emotional attachment to a property that they have not committed any of their own money to.

Unlike previous housing trends, which have generally started with a correction in the London housing market, we can expect to see the opposite to occur, with the provincial areas of the United Kingdom being affected more heavily, particularly those areas that have seen the highest house price increases over the past five years. These growth areas have not generally been stimulated by a vibrant local economy but by the demand of buy to let investors purchasing cheap property to build their property portfolios. Their demand has pushed house prices well beyond realistic values in these areas and prices are therefore likely to tumble a great deal more dramatically than in stronger economic areas such as the South East where less dramatic increases have occurred and where house prices have historically been higher because of the inherent local wealth and density of population, economic migration and the ongoing shortage of housing. Equally, there is unlikely to be any reason why people cannot afford to pay their mortgages as interest rates are on the way down and by the end of 2008 we should expect to see the base rate at circa 4%.

Although we have seen the Bank of England respond to the needs of the economy by bringing down interest rates, borrowers are yet to experience the benefit as the LIBOR rate (the rate at which banks typically borrow money), is quite high at present because of the liquidity squeeze in the banking sector and many mortgage packages are linked to LIBOR so that banks can manage the margin on their loan books. But LIBOR rates will gradually settle again as the financial sector gains more confidence and further rate cuts will be of benefit to all.

So the position is likely to be that less people move home in 2008 and that the market will slow down and house prices will fall. Certain areas of the United Kingdom that have seen exponential house price growth will be affected the most. New build apartment values are equally likely to be hit harder because many have been sold at inflated prices by developers to offer financial incentives such a cash-backs and rental guarantees to buyers.

It is interesting to note that many buy to let investors are not overly negative about the property climate. There are strong arguments for buy to let investors to be so pragmatic about a housing slump because their medium term objective is to service debt from rental incomes and a cut in interest rates will enable them to more easily pay loan interest and sit on their portfolios until the next housing boom. So unless they are intending to sell property in the short term they will not be directly affected.

All the same, house prices are going to drop and 2008 is likely to be chalked up as a buyers market and a year for bargains as there will be plenty of property owners that slip into negative equity or who have insufficient liquidity to sustain property ownership. We are also likely to see some failures within the property development sector as New Build property is going to be harder to shift and it is only that larger group that will be comparatively debt free that will be able to sit out the slow down.

The ideal way to identify where property price values should settle to should ideally be calculated in relation to a price earnings ratio. As property prices fall, the potential rental income will proportionately rise and by the time investors can achieve a yield of more than 6% then property becomes quite an attractive asset class for an investor to hold. In the long term therefore, property remains an ideal area for investment and for those that have the inclination and the financial resources, 2008 will offer up a lot of property bargains.