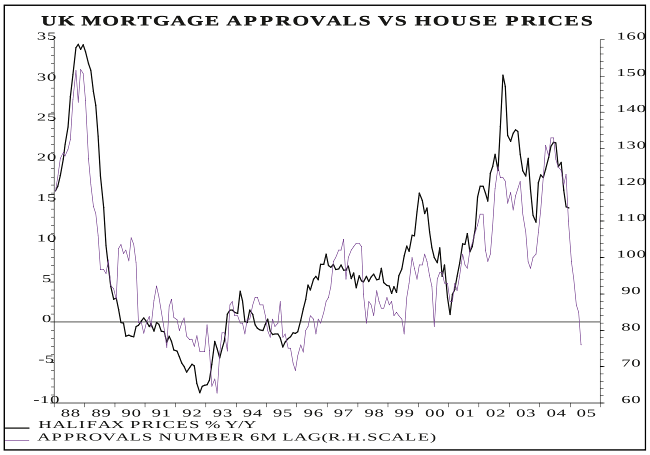
January 11th 2005

GFC ECONOMICS

DAILY COMMENTARY

WILL THE HOUSING BUBBLE BURST IN 2005?

The MPC will more than probably leave rates on hold at Thursday's meeting, but the next move is looking all the more certain to be down. The sharp decline in mortgage approvals, which is now on a par with that seen in the bursting of the 1980s housing bubble, highlights the continuing downside risks facing both house prices and retail sales. The approvals data on its own now points to both annual retail sales growth and house price inflation turning negative by mid-year. The Bank of England, however, remains relatively sanguine about the prospects for consumption and housing, and will not want to be rushed prematurely into cutting rates. Notwithstanding yesterday's report of a substantial decline in producer price inflation, the MPC may also continue to worry that the upward pressure on wages will fuel a rise in inflation. By the spring, however, the picture should be that much clearer, setting the scene for the Bank to start cutting rates.



Rates Cuts Draw Closer

As has been the case at their last four meetings, the MPC this week is very likely to vote 9-0 in favour of leaving rates unchanged. This unanimity, however, disguises the fact that the outlook for the economy remains clouded with uncertainty. Indeed, the outlook is contentious enough to cause two members of the rather more colourful 'shadow' MPC to call for a rate rise at this week's meeting, at the same time as one was voting for a rate cut. However, the view of the general public is more important than that of this somewhat eccentric collection of economists, and a recent survey by Lloyds TSB shows that 70% of consumers expect borrowing costs to rise further. The reality, by contrast, is that rates have very likely peaked and the MPC may already be a tad closer to easing policy. The minutes of the MPC's December 9th meeting disclosed that for some members 'the downside risks to inflation projection had increased, but not enough to make a persuasive case for a reduction in rates'. This is the first time cutting rates has been mentioned. Moreover, since then the economic data has highlighted the downside risks to the economy.

The most striking figures to emerge recently have been mortgage approvals. The number of "approvals for home purchase" fell in November to their lowest level since September 1995, and are down 42.5% from their high a year ago. This decline now exceeds the peak fall of 39.4% y/y seen at the height of the last property bubble in 1989. The change in regulatory regime governing mortgage lending at the end of October could potentially have inflated this decline, but the Council of Mortgage Lenders believes this effect is likely to have been limited. The collapse is worrisome because approvals have been one of the best lead indicators of house prices and currently point to annual house price inflation turning a small negative by the middle of the year. This implies small outright price m/m declines over coming months, though so far the main house price indices show only a stabilisation of prices.

Mortgage approvals are not the only housing indicator echoing the behaviour seen in the last housing bubble. The house price/average earnings ratio is now above the highs seen in the late-1980s, and the debt to housing wealth and net housing equity to income ratios are at similar levels to those seen in that period. Of course, this has to be set against the fact that in two critical ways the housing market does not look as stretched or pose as big a risk to consumption as it did back then. As the Bank of England has been at pains to emphasise, income gearing (including both interest and principal repayments) remains at comparatively low levels.

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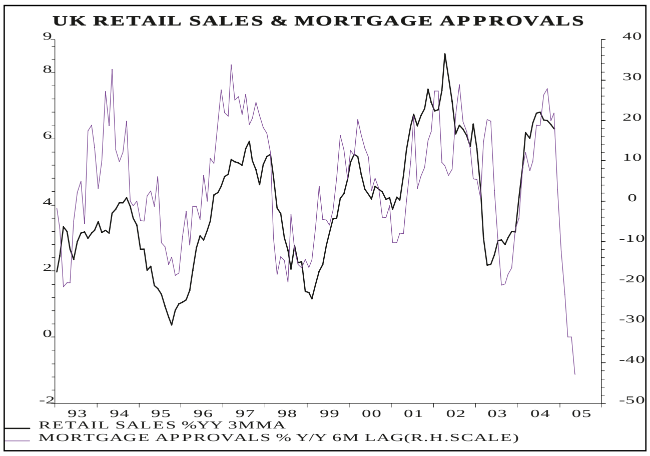
And importantly, new borrowers, who are the most vulnerable group to both a fall in house prices and a rise in rates, are significantly better positioned now, both in terms of housing collateral and income gearing.

All this, however, is only reassuring up to a point. After all, even if we do not see a re-run of the early 1990s, which saw a 30% decline in house prices in real terms, this still leaves us open to a significant fall in prices. Similarly, consumer spending growth could grind to a halt over the coming year and still perform significantly better than in 1990/91, when consumption fell a cumulative 3.0% in real terms over eighteen months. The fundamentals are also only half the story. They may be key in triggering the bursting of a bubble but often play a secondary role in determining the extent of the subsequent correction. It is worth remembering that, even though base rates had been cut to 6% by early 1993 from their high of 15% in 1990, house prices continued to decline in real terms for another three years. Psychology is critical and, with the potentially footloose buy-to-let investor a new phenomenon, the potential for the expectation of price declines to become self-fuelling as investors exit the market remains a real risk. This said, the fact that residential property can be put into personal pensions from April 2006 could put a floor under house prices if they were still falling in eighteen months time.



The Bank of England has taken comfort from the fact that the correlation between consumer spending and house prices has broken down since 2001. However, as we argued in our commentary on November 15th, there is an alternative and more worrying explanation for this dichotomy. The fall in the stock market and the pensions crisis may simply have offset the ongoing support from housing. With several high profile reports recently highlighting the extent of the pensions problem and housing also now becoming an additional negative, the downside risks to consumption are all too obvious. Indeed, the collapse in “mortgage approvals for home purchase” poses a threat to spending independent of any impact it might have on house prices. A fall in housing turnover is liable to hit expenditure in areas such as home furnishings, which are obvious beneficiaries when individuals move houses. Indeed, approvals have tracked retail sales growth well over the last decade and now point to retail sales growth turning negative by mid-year. The decline in approvals has also not been confined to loans for house purchases. Approvals for remortgages have also fallen sharply; the number of approvals is down 29.4% y/y while their value has dropped 21.7% y/y. This is not insignificant as approvals for remortgages in November were only 5% smaller in value than those for house purchases. Furthermore, a recent survey showed that a majority of remortgagors spent the money mostly on home improvements, which are in theory captured in the national accounts in housing investment than consumption.

All this suggests consumer spending is likely to slow significantly. Retail sales growth has already turned down from its highs in the summer and should weaken further over the next few months. Today's BRC data and trading statements from various retailers suggest that Christmas trading was relatively tough, with volume gains only achieved by heavy discounting. That said, the truth will only really be known in late February, after both the December and January official retail sales data have been released. This, along with a misplaced complacency regarding the housing market and its impact on spending and lingering labour market related worries over inflation, mean the Bank may hold off cutting rates for longer than it should.