Lack of stock set to remain key driver of UK housing market for now

- Supply shortfall to continue pushing prices higher with a 6% increase likely over course of 2016
- Sales activity will also rise albeit a little more modestly
- Government initiatives hold out the prospect of a further material uplift in the development pipeline

The words housing and crisis have rarely appeared so inseparable. This has been most visibly reflected in the way the issue has steadily climbed up the policy agenda with a raft new of intiatives announced by the Conservative government since the general election. At one level, it might reasonably be argued that the impact of these measures will be to increase both affordability and accessibility to the market. However as we contend in this short note, the underlying dynamics still point towards higher house prices over the coming year. Indeed, our best guess is that the likely increase will outstrip any commensurate rise in household incomes.

Supply is the story

One theme has dominated the private housing market this year, the dramatic fall in inventory on the books of estate agents. The reason has been pretty straightforward; there simply has not been enough properties coming back to the market to replenish the stock sold. For the record, the headline net balance for New Instructions shows RICS members reporting a fall in the flow of second hand property registered with them in all but one month over the course of 2015. And in the most recent survey (for November), more than 50% of respondents unprompted cited the lack of supply as a key driver of market behaviour. The sheer extent of this trend is clearly visible in chart 1, which tracks the RICS measure of average Stock per Surveyor (per branch) over the past seventeen years. For much of the period, there has been a pronounced cyclical pattern but this has clearly broken down since the early part of 2014 with the headline reading slipping to a historic low of less than 46 properties.

Explaining the shift in the supply pattern of second hand stock is more of a challenge than identifying the broad trend. In an effort to build an understanding of what the industry believes is driving this development, we recently asked an additional question on the subject in the residential survey questionnaire. This produced a somewhat circular principal response with 40% of contributors suggesting that the lack of stock with agents was detering would-be buyers from putting their own property on the market because ‘there was nothing to purchase’ (chart 2). The next most cited factor was economic uncertainty with around 13% believing this to be restaining supply followed by 11% who pointed to affordability

Chart 1: Stock of Property per Surveyor (per branch)

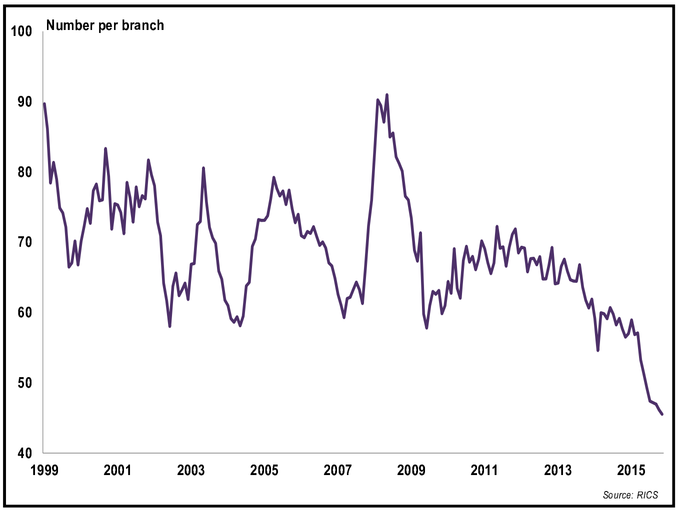
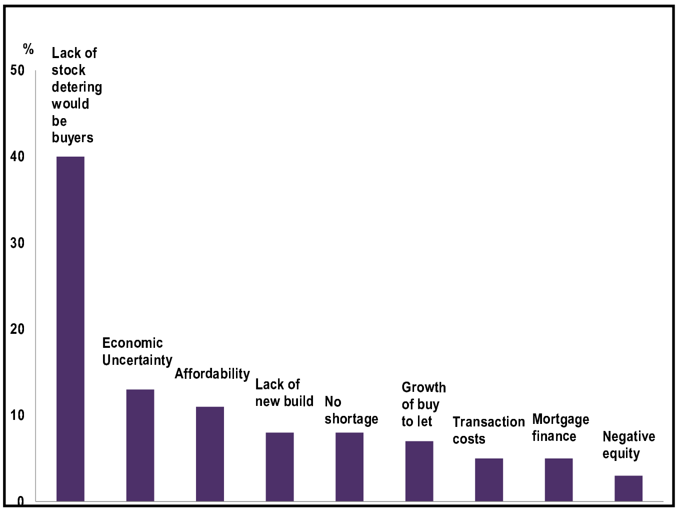


Chart 2: RICS Residential Market Survey - Reasons for Lack of New Instructions



related issues. Further down the chain were responses focusing on investment and the rise of BTL (Buy to Let) as well the lack of new build and transaction costs.

Interesting as this feedback is, it is hard not to feel that the responses to this question underestimate the impact of the collapse in the development pipeline following the onset of the Global Financial Crisis. It is true, as chart 3 highlights, that the volume of homes being completed has now picked up from the lows seen in the immediate aftermath of the recession but even allowing for this, the number still remains some way adrift from current household formation (let alone making good the shortfall of recent years).

Higher prices the result

It always seems slightly trite to suggest that the reason for rising prices is that demand is greater than supply. However, key RICS indicators do at least provide a helpful narrative around which this imbalance can be analysed. Significantly, the RICS New Buyers Enquiries series (a reliable proxy for fresh demand) has identified a rebound in interest from potential purchasers since the spring which has compounded the pressures resulting from the supply shortfall (and the drop in New Instructions). Indeed the gap between these two RICS indicators suggests that price pressures are unlikely to dissipate anytime soon.

What this means in terms of headline inflation rather depends on your choice of starting point. With the Halifax index still showing prices posting an annual gain of 9% but numbers compiled by the Nationwide Building Society running at less than half this amount, that decision is clearly quite material. Our preference is to continue to focus on the ONS price index where the latest reading (for September) shows the cost of housing 6% up on a year earlier.

Chart 4 tracks the RICS New Buyer Enquiries minus New Instructions net balance against the official measure of house price inflation. To demonstrate just how effective the former is in signalling turning points in the latter, we have advanced the RICS indicator by 12 months. From this it is evident that even if the RICS balance doesn't always capture the magnitudes of change fully, it is excellent in signalling the direction of travel and highlighting turning points. Indeed, on this basis alone it would not be unreasonable to expect house price inflation to begin to accelerate once again over the coming months (possibly reaching double digit gains briefly) before slowing in the second half of 2016. This is reflected in our forecast which looks for inflation to decelerate to the 6% area by the final quarter of the year.

For the record, the field work for the November RICS survey was conducted either side of the Chancellor's Autumn Statement which contained a raft of new measures of significance for the market. Roughly two-thirds of responses actually came after the announcement but we suspect the ramifications are likely to be more visible in the data over the coming months once contributors have had a little more time to digest the measures.

The most immediate influence is likely to be felt through the 3% surcharge on BTL purchases which, if nothing else, is likely to bring forward some property transactions. How this plays out beyond next April remains to be seen although since the additional charge can be offset against future capital gains tax, the ramifications for the market may be less than was initially assumed.

Chart 3: UK Housing Completions

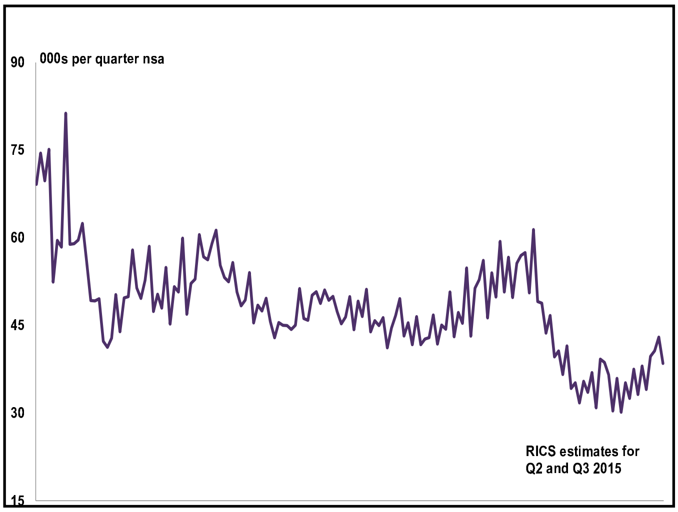
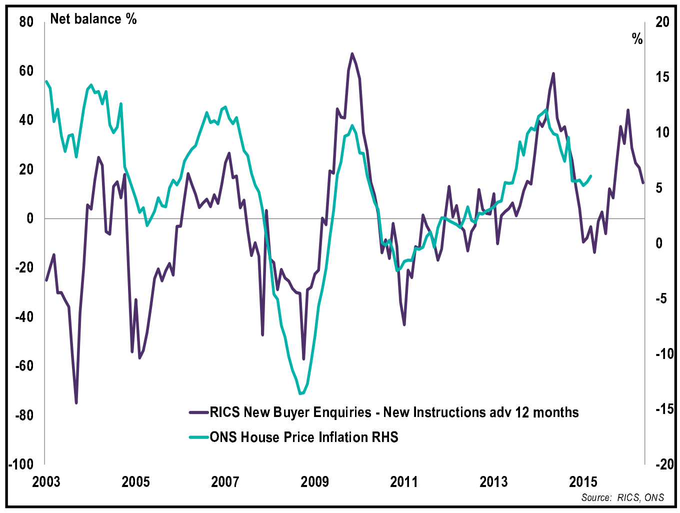


Chart 4: RICS Demand - Supply and House Price Inflation



Meanwhile the other measures that will be introduced in 2016 are in most cases, although not all, linked to new build rather than existing stock. That should provide some reassurance that they will not simply feed through into higher prices. Nevertheless, the manner in which they are applied might mean that there could initially be a bigger boost for demand (rather than supply) given the inevitable lags in the development pipeline. In particular, the Help to Buy equity loan scheme has not until now been widely used in the London area but the enhanced size of the benefit for purchasers in the capital is likely to see that change.

Higher mortgage rates on the horizon

Money markets continue to take a fairly sanguine view on the timing of the first increase in base rates and perhaps for good reason (see chart 5 on page 3). On a number of occasions over the past few years, there has been a sense that a tightening in UK monetary policy was nearing only for the mood music to change as a result of some shift in the external environment. And if one was looking for a justification for delay this time around, it could lie with the latest slide in the oil price which has taken the cost of crude to its lowest level since 2009.

An immediate consequence of this is that forecasters are questioning whether their earlier presumptions for a gradual pick-up in inflation are likely to be met. It is worth recalling that the high water mark for CPI inflation in 2015 was just 0.3% and that the latest fall in oil prices could, if sustained, take a further 0.2 percentage points off the inflation rate over time.

The Monetary Policy Committee (MPC) of the Bank of England was already showing some concern over the possibility that zero(ish) inflation could become entrenched in the pyschology of wage bargainers (as highlighted in the latest average earnings data), households and businesses and the slide in oil prices through the $40 per barrel mark will do nothing to assuage this fear. For the time being, we are sticking with our view that the MPC will want to look through the current low level of inflation and focus instead on its medium term projections. Even if these need to be revised a little lower, the general upward trajectory against a backdrop of solid if unspectacular growth could arguably pave the way for a modest first move in rates around the middle of the year particularly given the recent lead provided by the US Federal Reserve (Fed).

It is worth bearing in mind that even if the money markets are right in their current presumption, this may not prevent some rise in the cost of mortgage finance over the course of the year. Critically, a key factor will be how the US bond market reacts to the turn in Fed policy and how this feeds through into both gilts and the swaps market (which drives the price of mortgage loans).

As an aside, there is room to question whether the current cost of money is appropriate from a property perspective given the recent price action in the residential (and for that matter, the commercial) real estate markets. Rightly, Mark Carney has made it clear that targeting house prices is not part of his remit but given some of the concerns that have been raised, it does appear likely that, at the very least, the macroprudential toolkit will again be drawn on over the coming year to complement the stance of monetary policy.

Sales expectations turn more positive

2015 was a year of two halves when it came to residential transactions. Until June, completed sales as recorded by HMRC were running at less than 100k per month. However since then, they have exceeded that number in every month reflecting some improvement in mortgage availability and the continuing improvement in household confidence. As an indicator of the latter, the most recent European Commission survey of UK consumers shows the proportion of respondents looking to make a major purchase over the next twelve months at close to its best level since 2003. Moreover, the response to the question regarding a house purchase over the same period tells an even stronger story.

The best RICS indicator of the near term prospects for activity is the Newly Agreed Sales series. Chart 6 shows how this leads the year on year change in HMRC transactions by around six months. Our interpretation of this is that it is broadly consistent with sales climbing from around 1.22 million in 2015 to somewhere in the range of 1.25 to 1.3m in 2016. Significantly in the wake of the Autumn Statement, the near term RICS Sales Expectations net balance jumped from from 34 to 47, its best reading in two years while the medium term indicator also picked-up.

Chart 5: Money Market Interest Rate Expectations

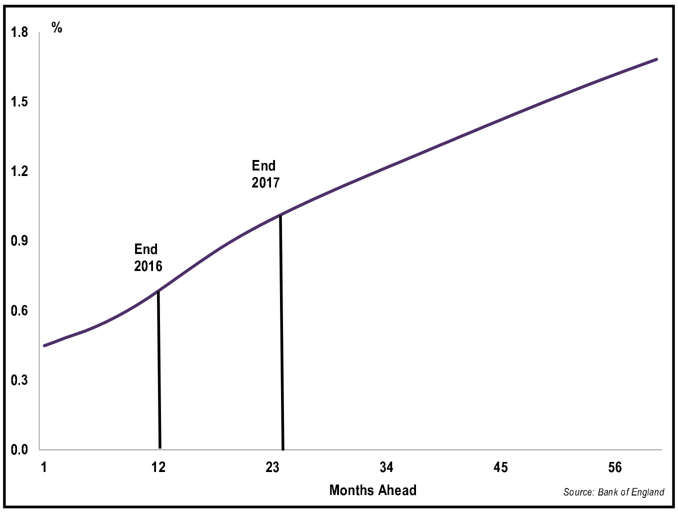
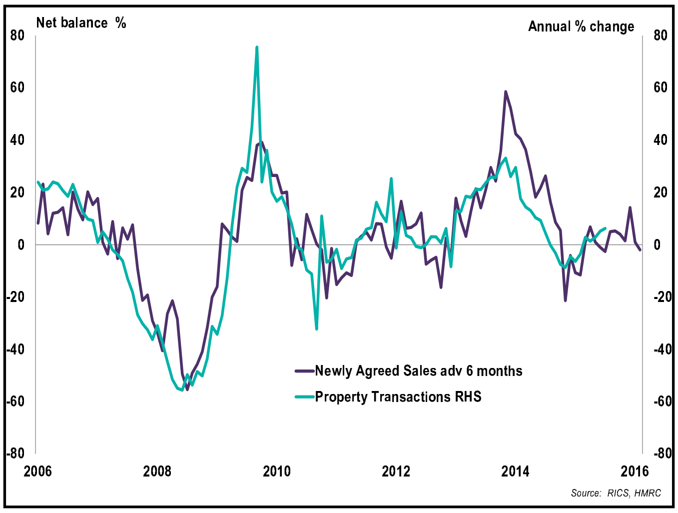


Chart 6: RICS Newly Agreed Sales and Property Transactions



This is consistent not just with the idea that the BTL changes will accelerate activity from potential investors but also that the broader drift of government policy towards home ownership (including Starter Homes and the enhanced shared ownership scheme) will lift ‘effective’ demand. Meanwhile, if the Bank of England does look to extend macroprudential policy, in the first instance it has been pretty well signalled that this will focus on restricting loans in the BTL sector rather than the wider market.

Rents to remain firmly underpinned

It is not just the measures announced pertaining to BTL which promise to have an impact on market rents. The decisions to put in place a framework that sees social/affordable rents falling by 1% per annum for the next four years as well as counting Starter Homes as a replacement for rented properties under S106 guidelines will result in the delivery of a more modest pipeline of accomodation in the social tenure. One consequence could be to continue to drive demand for market rent accomodation albeit from a slightly different demographic cohort. How this plays out with regard to the changes in housing benefit and any uplift in instititutional investment in the sector remains to be seen.

Some of the other changes in tax treatment of rental income announced over the past year by the Chancellor raise questions about the ongoing commitment of existing BTL investors to the sector over the medium term. That said, since the changes are not due to start taking effect until 2017, any direct consequences may not be visible for a while. In any event, the feedback to the lettings element of the RICS Residential Market Survey continues to paint a generally firm picture.

At the national level, the Tenant Demand net balance is continuing to outstrip the New Instructions series as has been the case in every quarter since the early part of 2009. This has been reflected in the RICS Rent Expectations numbers which, as chart 7 demonstrates, are consistent with average private rents increasing by a further 3% over the course of the next twelve months - note that the RICS series has been advanced by four quarters in the chart.

Regional outlook

In order to build up a picture of the regional story for the next twelve months, we have drawn heavily on the feedback provided as part of the RICS Residential Market Survey. The price forecasts highlighted in chart 8 show East Anglia set to record relatively strong gains continuing a trend that has been clearly visible through the course of 2015. The region has the strongest (smoothed) reading both for the current RICS Price Balance (typically a six month lead) and for the near term RICS Price Expectations series. Meanwhile the North (East) is likely to see rather more modest gains in prices with our 2016 projection close to the latest ONS number for the area (2.9%). In terms of transactions, the strongest growth this year (on the basis of the Land Registry data currently available) has been in the North (East) and Wales. RICS indicators suggest both areas will continue to show solid sales growth over the next twelve months with expectations also firm in Scotland and Northern Ireland.

Medium term prospects

The government has set itself the challenge of reversing the downward drift in home ownership which it, will in part, achieve by effectively replacing ‘affordable’ properties to rent with ‘affordable’ properties to buy. It has also pledged to drive a significant increase in new development through some of the initiatives already discussed and, quite possibly, a further relaxation in planning rules. Despite this, there remains some scepticism that the overall impact will be to make the housing market in aggregate more affordable. Significantly, as chart 9 shows, RICS feedback (in November) suggests that both prices and private rents are set to grow strongly over the next five years although it is interesting that projections for the latter are now exceeding the former.

While these expectations are certainly plausible, we would question whether they fully reflect the likely impact of the governments announcements on housing. We continue to have real concerns about the focus of policy on ownership at the expense of renting (both social and private) and would prefer to see a broader package of measures introduced that delivers across all tenures. Nevertheless, we find it hard not to conclude that the initiatives currently being put in place will result in a material increase in the supply of housing over the coming years. Aside from stabilising (and quite possibly reversing) the downward trend in the proportion of homeowners, it could (encouragingly) also result in rather more modest medium term price gains than are currently envisaged.

Chart 7: RICS Rent Expectations and Private Rents

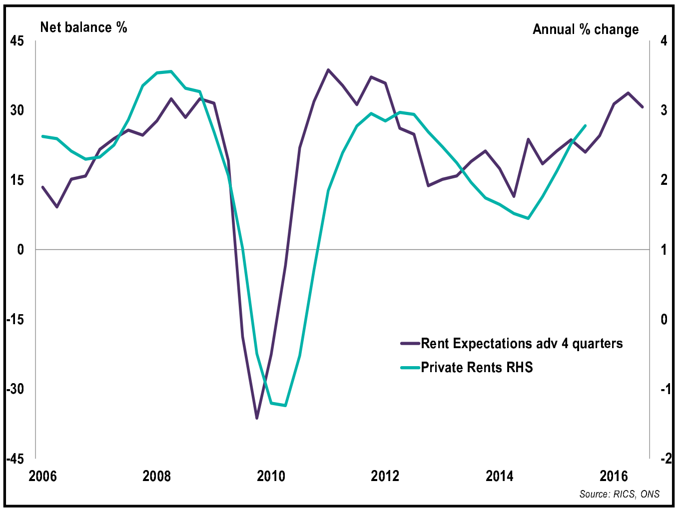
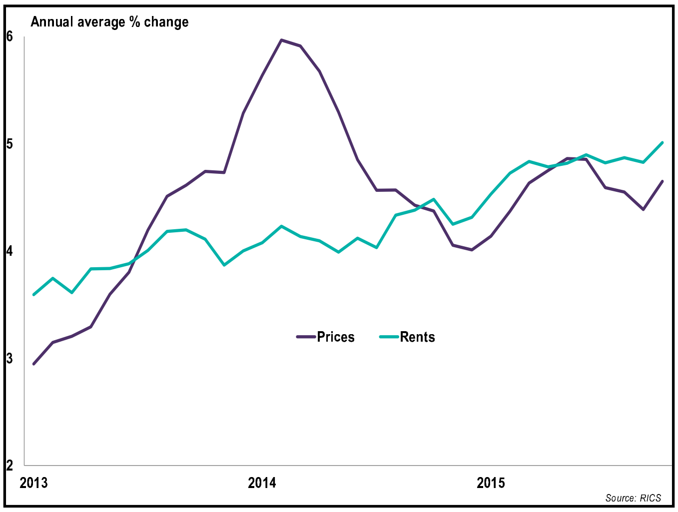


Chart 8: RICS House Price Outlook by Region

Chart 9: RICS Residential Survey - Five Year Projections (smoothed)



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