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When will house prices finally crash?

By: [Fred Harrison](#)

“A sharp fall in real house prices is likely at some point in the relatively near future.” So said David Miles, Morgan Stanley’s UK chief economist, earlier this week. The former adviser to Gordon Brown believes that more than half of the increase in house prices in recent years has been driven by the mistaken belief that prices will just keep rising at double-digit rates. Once these expectations are disappointed, the market will be subject to a “sharp reversal”.

As to when the crash will come, he is more vague, suggesting it could be two years away, and describing attempts at calling the top of the market as pretty “hopeless”. I disagree. Look at the right data and a clear cyclical property pattern emerges. It suggests that by this time next year, the housing market could already have peaked. Let me explain.

UK property is very close to peaking

Last year, I claimed in *Boom Bust: House Prices, Banking and the Depression of 2010* that Britain was entering the final two years of the property cycle, and I still believe that’s the case.

As both David Miles and Bank of England governor Mervyn King have pointed out, by almost any measure available, house prices are hugely overvalued. In fact, a recent report from Dresdner Kleinwort argues that Britain’s housing market is more overpriced than at any time since 1948. The investment bank reports that the ratio of prices to disposable incomes typically peaks at more than six times. Such peaks were seen in 1948, 1973, 1988 and 2006.

David Owen at Dresdner Kleinwort says: “There was an earlier period when inflation and interest rates were both low and the UK housing market was as expensive as it is today: the late 1940s. As in other housing corrections, house prices then fell in real terms by more than 30%. They also fell in nominal terms.”

Commercial property is another key indicator of a looming crash. Property cycles terminate when the supply of highly priced premises exceeds the demand. According to Jones Lang LaSalle, the property adviser, rents in the City of London are now expected to rise to more than £70 a square foot. The last time rents achieved these levels was in 1988, just before the property market reached its previous peak.

Understandably, the UK's financial regulator is becoming concerned that banks are adopting a rather too cavalier approach to lending and disaster planning. Clive Briault, managing director of retail markets at the Financial Services Authority, warned the British Bankers' Association earlier this month that banks should now be factoring in the possibility of a 40% fall in property prices, and held out the prospect of a 35% increase in the rate of home repossessions. He pointed out that this was not a prediction – just a “severe but plausible” scenario.

And yet despite this rising tide of worry, the housing market has rarely been busier. In its latest house-prices report, Nationwide stated that in October annual house-price inflation stood at 8%. Gazumping has returned to tabloid headlines, as bonus-flush buyers outbid each other for top-end houses in London. Lenders such as Abbey National are now advancing home loans at five times people's salaries, helping to push prices towards their speculative peak. Some mortgages now offer income multiples of up to seven times salary.

But the fact is that house prices can't rise forever – at some point, people just can't afford them. The current frenzy of activity suggests a rapidly overheating market, and in fact the rise in repossessions has already begun, as overstretched first-time buyers and low income buy-to-let investors feel the strain from rising interest rates. But when will the real downturn begin?

UK house prices will peak in 2008

In line with my original prediction, I still expect house prices to stall early in 2008. There will be no single “trigger” event – the end will come as people realise their financial resources have been exhausted.

What makes me so sure that prices will peak in 2008? After all, even the Bank of England cannot decode the housing market – Mervyn King says he and his colleagues are unable to understand “why house prices relative to conventional earnings are as high as they are”. But in fact, one leading indicator is a very reliable guide to house prices and the state of the economy: land prices.

By looking at data spanning 300 years, my research suggests that the business cycle tends to work on the basis of 18-year periods, determined by the dynamics of the land market. The major event that preceded the recessions of modern history was the rise in the share of national income paid to the owners of land. Because land is in fixed supply – and people need it for both living and working – the share of national income going to its owners must increase relative to wages and profits as demand for land grows in line with the economy.

In other words, as land, and therefore property, becomes more expensive (because an expanding economy needs more of it, while the supply is fixed), spending on property squeezes both corporate profits and the money available to pay wages. So property-price growth starts to outstrip both wage and profit growth.

This can be seen clearly by comparing growth in various asset classes over the past ten years. House prices have risen 187%, according to the Halifax, against the rise in the FTSE All-Share index of just 57%. As for wages, over the past decade they have barely kept pace with inflation. But land prices have taken off on an exponential trajectory, rising 371% since 1996.

This is far from the first time this has happened. The main graph above shows a similar jump in land prices leading up to 1989 – and then a collapse in the value of that land after house prices peaked in early 1990. This resulted in the recession of the early 1990s, which hit its bottom in 1992. Historically, the cycle involves 14 years of stable or rising property prices followed by four years of recession – and so far, this is precisely what has happened this time around. After the last crash, house prices began to stabilise around 1993, which suggests 2007 will be the final growth year for this cycle, with a crash beginning in 2008, leading to a recession that reaches its bottom in 2010 – 18 years after the last slump.

And nothing has changed to suggest we are about to depart from the trend of history. In fact, the only major difference is one that spells even worse news for the global economy – business cycles across the world have now synchronised, and so have the property cycles.

Just look at what is happening in the US. The recent drop in the construction of new houses was the biggest fall in nearly 16 years. Prices are weakening, and consumers are borrowing themselves deeper into debt. But commercial property remains resilient, so it seems likely that real estate will help to bolster the economy for at least another 12 months.

Marry the trends in the UK and USA with similar trends in other property hot spots, stretching from Ireland and Spain all the way to Australia, and we begin to glimpse why I expect to see a property-led global depression by 2010.

Can we break the cycle?

Why do we repeatedly see this cycle of boom and bust? The trouble is that Government economic models focus too much on wages and profits, and they deliberately ignore the fact that rising land prices periodically squeeze wages and profits to the point where the labour and capital markets have to contract (see the illustration below). So forecasters end up being shocked when output drops below the Treasury's rosy growth path. That's why experts were shocked when the sharp increase in land values during the Barber boom of the early 1970s was followed by the recession of 1973/1974. Similarly, the squeeze of the late 1980s (the Lawson boom) was followed by the bust of 1992. And the Brown boom will be followed by the decline into 2010.

It's too late to prevent the downturn in the latest cycle. And the only way to break the ongoing cycle of boom and bust is through a fundamental reform of the tax system, moving towards taxation on rents paid to landowners, rather than wages and savings income. This would encourage people to invest more and work harder, rather than

focusing on ways to avoid paying tax on their income and savings. It would also mean that as the economy grows, and the value of land rises, so would the money collected by the Treasury to spend on public services.

Meanwhile, in terms of what investors should do, it's easy to say glibly that people shouldn't buy property, and it certainly isn't a good time to be thinking about becoming an amateur landlord. But if you do intend to buy a home to live in, it's more important now than ever before that you are aware of the potential risks involved and that you have a cushion in the form of a deposit and affordable monthly repayments.

The people who suffer the most will be those who overstretch themselves now, such as naïve first-time buyers taking out interest-only mortgages with no deposit. I believe prices could fall by as much as 20% in real terms – but it's important to remember that the property market varies from one location and property segment to the next. The buy-to-let sector – especially in the regional cities such as Leeds and Liverpool – will be severely hit, with prices dropping by as much as 40% from their current selling prices.