

2008/9 could see dramatic turning point in housing market

Fred Harrison

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NO-ONE has perfect foresight, so risk is unavoidable when investing in property. But do we shoulder greater risks than are necessary? For two years, I have maintained that house prices would peak at the end of 2007 or at the start of 2008. With prices now rising at around 10%, I expect that double digit returns will prevail for the rest of this year.

My forecast exceeds those that have been published by some financial institutions. Halifax Bank of Scotland expects prices to drop to 4% in 2007. The RICS and the Council of Mortgage Lenders suggest 7%. Nationwide pitches its forecast at between 5% to 8%, with Lombard Street Research the renegade (10-15%). The consensus view is a cooling market with the numbers clustering around 6%.

I suggest that investors should recall the embarrassing revisions to last year's forecasts. HBOS, for example started the year at 3%, revised the number to 5% and concluded the year with 9%! This smacks of a guessing game rather than rigorous analysis.

Analysts rationalise forecasts by referring to "fundamentals" (employment and interest rates, and the like). But while these are relevant in the early stages of a business cycle, I claim that they currently count for little. The housing market is locked into a phase in which the quest is for capital gains, which tend to be insensitive to the rate of interest.

The return of Gazumping

IN *Boom Bust*, I describe the two-year "winners' curse" phase which terminates growth. This phase is characterised by gazumping, a word that returned to the headlines last summer.

History will be overturned if the cautious forecasts now being offered by others for 2007 turn out to reflect a "soft landing" in the housing market. Unfortunately, mainstream forecasters lack a coherent theory of the property cycle. That is why their predictions are usually wide of the mark.

When the going is good – as in the long upswing - it does not take deep insight to forecast short-term trends. The uncertainties are clustered around turning points in the cycle, which economists usually fail to anticipate. That is why they tend to underestimate the returns to be made from the upswing in the cycle, and to over-estimate the returns during the downswing.

Publicity surrounding forecasting errors can damage reputations. This helps to explain the cautious approach, of offering forecasts close to those of others. The herding instinct is identified in a recent study by McAllister *et al.* They reviewed the disagreements over the UK's housing market, and concluded:

Probably the most robust finding of the analysis so far is that real estate forecasters display the characteristics associated with a consensus. This seems to indicate herding among forecasters. Disagreement among forecasters is limited.

But when forecasters seek safety in numbers, the risks for investors are magnified. Why do I claim that risks in the property sector are unnecessarily high? After all, even the Bank of England admits that it cannot decipher trends in house prices. Is this really because they lack a robust theory of the property market? If so, where do we look for the blind spots?

Lessons from history

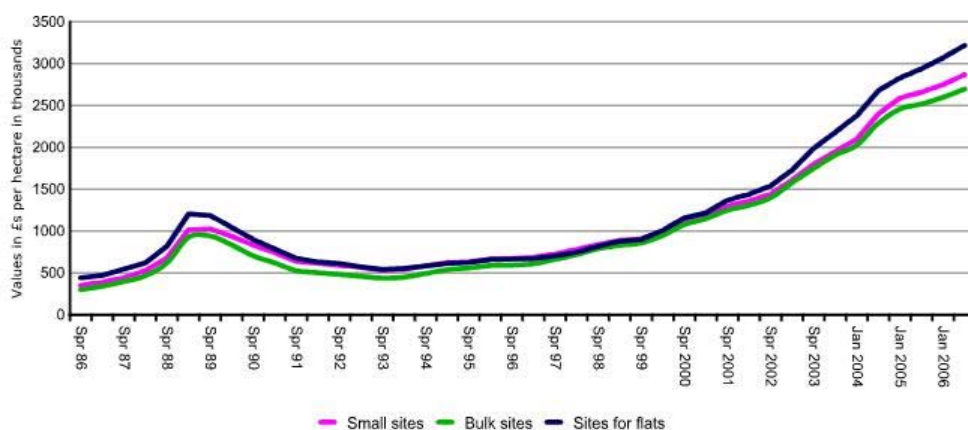
MACRO-economically speaking, economists have not yet developed the capacity accurately to predict growth beyond the very short term. This creates problems for the sub-sectors. Last month, for example, the House of Lords economic affairs committee blamed the Treasury’s forecasting mistakes for complicating the Bank of England’s job of controlling inflation.

I maintain that some forecasting errors are the result of poor theory. In the property sector, for example, we have voluminous evidence from history to guide theory-making. The data leaves us with little doubt that major turning points can be anticipated with a high degree of confidence.

The Treasury analysed two centuries of economic history to confirm the thesis that instability in the housing market was bad for the economy at large. In *Boom Bust*, I went back 300 years. Correctly interpreted, the property cycles would have enabled the Treasury to anticipate the recessions of 1973/4, 1992 and 2010.

Fig. 1

Residential Building Land Value Trends (England and Wales, Excluding London and Scotland) 1986 - 2006



Source: UK Valuation Office

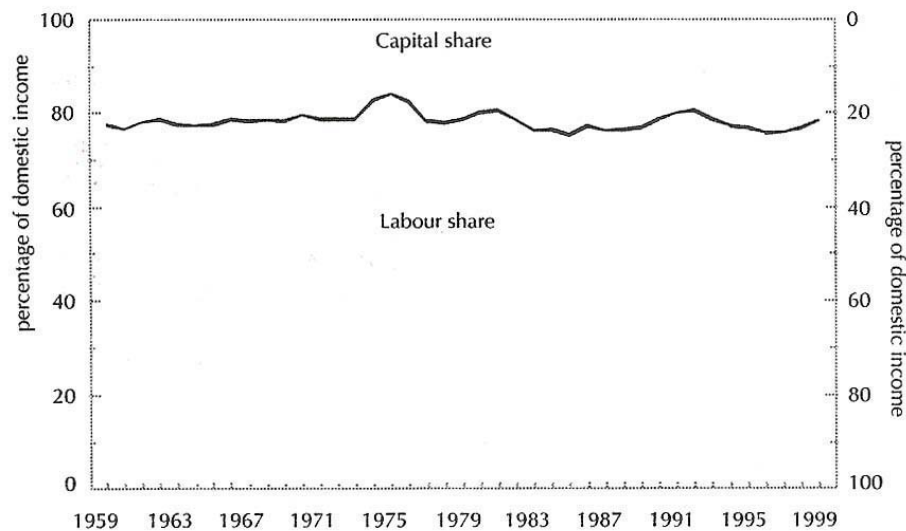
Within the general business cycle (which averaged 18 years), I identified a 14-year property cycle. The key was the land market. The price of land rose faster than for other assets, and turned down ahead of recessions. Would this have alerted us to

the current downturn in the US housing market? American house prices began their climb in 1992 and terminated 14 years later, in 2006.

Land prices for England and Wales, covering the tail end of the last property cycle (which peaked in 1988/89), and the looming end of the current cycle, are shown in Fig. 1. But the Treasury’s model is not swayed by this empirical evidence. In fact, the Treasury deliberately excludes the returns to investors in the land market. For forecasting purposes, the Treasury assumes that the shares of income going to labour and capital are more or less constant, and the share going to land as rent can be ignored (Fig. 2).

Fig.2

Factor shares in domestic income net of stock appreciation and rental income, 1959–1999



Source: HM Treasury

Shocks to the System

THE Treasury’s model means that the forces which generate turning points are camouflaged. As the National Audit Office - which tests the Treasury’s assumptions every year - accepts:

[I]t is not possible to forecast unforeseen shocks to the economy, which would tend to move the economy off its trend path in the medium term.

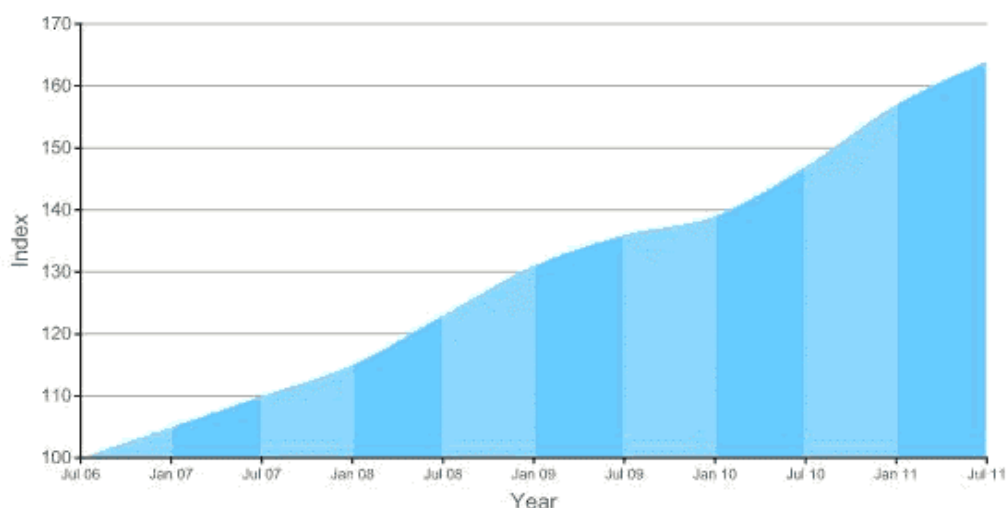
Obviously, events unforeseen come as a shock. But if a Nelsonian blind eye is turned on one of the key components of the economy, it is not surprising that we are caught unawares by the onset of booms and busts! I have shown that most of the “shocks” do originate within the economy, and the seismic traces lead us to the land market.

For 2007, I expect the robust house prices in the South to ripple out to the English regions. This forecast is based on a theory of the distribution of rent which I describe in *Ricardo’s Law*. But what of land prices over the next five years? Beginning in 2008, land prices will weaken and then crash in 2009. This will be the result of a house price to earnings ratio of seven – a prediction which I published two years ago. Today, the ratio stands at 6.4. If house prices rise by 13.5% this year, and

assuming rises of around 4% in the current round of pay negotiations, we should see a ratio of 7 in 12 months time. That's when the market will stall, the prelude to the Big Crash.

Fig. 3

UK Residential Building Land



Source: UK Valuation Office

My expectation is not shared by the Valuation Office, which encourages the view that land prices will rise at a healthy double-digit pace through to 2011 (see Fig. 3). Investors will want to juxtapose this forecast with the Financial Services Authority's recent warning of a possible 30% crash in house prices!

The early warning signs of a looming housing crisis are to be found in the land market. Look what has happened in the US: Wimpey, in reviewing its prospects, is making provision for a reduction in the value of its American land bank, and is reported to be writing down group net assets by around £40m.

To erase some of the risk in the housing market, surely it is time to rethink the theory of property and its cyclical behaviour?

Sources:

Fred Harrison, *Boom Bust: House Prices, Banking and the Depression of 2010* (2005), and *Ricardo's Law: House Prices and the Great Tax Clawback Scam* (2006), Shephard-Walwyn.

Patrick McAllister, "Analysing UK real estate market forecast disagreement" (2005), www.reading.ac.uk/REP/wp/wp1305.html

National Audit Office, *Audit of Assumptions for the March 2001 Budget*, Stationery Office, March 2001.