



PRIME CENTRAL LONDON PROPERTY REPORT - MAY 2009

THE BERNIE MADOFF SYNDROME

Please Remain Calm. Everything Is Under Control.

Well it has been quite a lively month since our last report. On Wednesday, 8th April the FTSE closed at 3925.5. As we write it is at 4441 – a 13% rise in one month. Meanwhile estate agents are rushed off their feet and complaining about a lack of stock. The green shoots have led to cautious optimism, if not outright certainty, that a new bull market has started.

It appears then that the politicians at the multiple G Summits were on to something: The way to solve excessive credit and the consequent over-indebtedness in the system is to lend and borrow more money! Damn clever these politicians.

So interest rates are at 0.5%. If you have cash in the bank you are earning less than peanuts. The government is incentivising you to try to find a better return elsewhere.

Where will you invest your money? Perhaps you will buy a blue chip stock yielding 5%. However, you might still be worried about share price volatility and want a “safe haven”.

What about property? After all everyone knows that if you hold property for the long term you are on to a “sure-fire” winner. Unlike shares in companies which can disappear

overnight, a house will always be there... Therefore you can always rent it out or live in it and it is a safe store of your wealth.

This logic/argument has always been put forth by those suggesting that property is an easy, flawless way to make money.

The purpose of this report is to review whether property is a foolproof system to riches.

THE GREAT ROULETTE TABLE

On the face of it property looks like a safe bet: you buy a home, live in it and become rich by doing nothing, but pay off your mortgage. Even better, buy multiple homes and have other people pay you for the privilege of living there. Again you accumulate vast wealth by doing nothing. What could go wrong?

Unfortunately this line of thought is not dissimilar to that of the gambler who visits a casino sure that he has a foolproof system to beat the house (excuse this and further dreadful puns to follow).

The gambler who is convinced he can break the bank by doubling up on red spin after spin will lose money because he has not taken into account two vital facts:

1. **It is not an evens bet**, red against black. There is one number, 0, which is green (in America they have two zeros on the wheel). This puts the odds slightly in the house's favour (before you ask – yes I do occasionally enjoy a flutter and no this is not a system I have used. I play Blackjack... badly.)
2. **There is a house limit**. Therefore you can only double up to a certain amount, e.g. If the house limit is £2000 and the minimum initial stake is £50 it only takes 6 consecutive blacks until you can no longer double up and you have lost a significant sum - £3150 - compared to your initial small stake on a sure-fire winner.

Likewise property is not as simple as it seems. Those who speculatively bought property as a buy-to-let investment, who overstretched themselves to buy a home or who bought a home with no substantial savings for a “rainy day” forgot to consider the following:

Yes, you can always rent out a property, but at some stage you will reach the house limit, i.e. there will be a limit to the amount that potential tenants will be prepared or indeed able to pay.

- i. What happens when you discover that the rent does not cover the costs of holding a property, e.g. mortgage payments, ongoing maintenance & fees (letting agents, service charges etc)?
- ii. What happens if you are not even able to rent out your property because of excessive supply? (Of course this could never happen in London or indeed

anywhere in the U.K. As politicians and house builders will tell you there is not enough land and too few properties to house us all...)

- iii. Most homeowners finance their purchase through a mortgage. What happens if you lose your job?
- iv. What happens if your mortgage rate changes?

These are just some of the simple issues that people should have considered seriously but did not.

What Does This Have To Do With The Prime Central London Property Market?

The problem is that the house limit has been reached and exceeded. A large number of landlords have been subsidising their tenants to live in their rental investments. Many still bought in the knowledge that the rent would not cover the costs, but what did that matter with prices inflating at 15%+ per annum? They were speculating on property for capital gains rather than real returns.

Unfortunately there were only two ways prices could increase:

1. Tenants paying more to increase yields – exceedingly unlikely unless there was a huge hike in earnings.
2. Other “Investors” would have to borrow more money to buy property in the hope of further capital gains. *Now extremely unlikely as mortgage lenders have realised that the housing boom was fuelled by cheap and easy credit rather than underlying fundamentals. Prices rose because they were allowing larger loan to value mortgages on higher earnings’ multiples, looser credit checks, inadequate rental cover, etc. This effectively meant that buying property became a huge game of pass the parcel. The parcel being an ever expanding debt* - this is not dissimilar to the business model which has been tried and tested by Bernie Madoff with limited success. It is the very basic reason why mortgage companies are, and will continue to be, reluctant to lend.

Many observers, however, argue that this is not the case. Their view is that high and increasing property prices were inevitable as there is a shortage of property and that this is what has always driven prices up. However, there are plenty of properties for people to inhabit, there has just been a lack of stock to buy.

Knight Frank reports that the demand for renting has increased 20%. However, the **NUMBER OF PROPERTIES AVAILABLE HAS INCREASED BY 67%**.

To put this into perspective let’s look at the following table which shows the letting statistics for March. This data has been collated by lonres.com and includes most but not all of the major estate agencies.

<u>Area</u>	<u>Properties To Let</u>	<u>Under Offer</u>	<u>Let</u>
South Ken/W.Chelsea	537	161	72
Bayswater	384	85	43
Chelsea	381	125	52
Hampstead	352	55	24
Marylebone	326	103	36
St John's Wood	304	37	13
Kensington	229	66	28
Knightsbridge	208	56	22
Pimlico, Victoria, Westminster	207	70	22
Notting Hill	186	44	13
Earls Court	172	30	14
Regents Park	141	19	12
Mayfair	125	34	12
Belgravia	109	29	12
<u>Holland Park/West Kensington</u>	<u>83</u>	<u>20</u>	<u>10</u>
Total	3,744	934	385

As you can see there are a vast number of properties available with only 35% being rented (this is exceedingly generous as we are assuming that all those “under offer” proceed). Because of this oversupply, landlords are under further pressure as tenants are negotiating lower rents thus further forcing down yields. This in turn will further reduce the price other investors will be willing to pay.

It is also much harder for current rental investors to find financing:

- The number of buy-to-let products has fallen from 4,384 in July 2007 to just 213 according to moneysupermarket.com and landlords now need a deposit of at least 25% to access the most competitive deals.
- Fees are also now an issue with some mortgages requiring a painful 3.5% arrangement fee.

- Interest rates on these products have not fallen by as much as plain residential mortgages as the banks clearly perceive this sector to be a greater risk.
- To add further problems for current landlords, rental cover must now be c. 125% compared to c.110% a year ago. This will create huge problems when mortgages need to be reset.

Indeed mortgages in general are much harder to acquire as reported in The FT Weekend 18-19th April:

“Mortgage declines have increased by nearly 400 per cent in the past two years, according to figures from moneysupermarket.com.

In 2007 roughly 2.3 per cent of vetted mortgage applications were rejected; however, this has risen to 8.8 per cent so far this year. All the applications were qualified against the lender's criteria prior to submission and on paper appeared to fit. However, lenders still found reasons to reject them.”

If buyers with good credit ratings are being rejected why are the banks not lending? What are they afraid of? Is it possible lending will contract further?

Ultimately, many more buy-to-let and accidental landlords will become forced sellers.

What Does This Mean For House Prices In Prime Central London?

Estate agents are flat out at the moment. There has been a marked increase in viewings. For example, one estate agency placed a house in Notting Hill on the market a week ago. They have had 44 viewings and four offers at the asking price. Properties under £2m are in particular demand and there is currently a shortage of quality stock.

Owners are not placing their property on the market, because they believe that a return to peak 2007 prices is just around the corner. In the meantime the costs of holding a home are still low.

However, **we do not believe that this is a turning point in the market**. It is simply typical market behaviour: potential buyers see that property in prime central London is cheaper than it was and therefore think that it is value. They feel that they must buy now otherwise the opportunity will be lost. The stockmarket is the same. It has not gone down in a straight line so do not expect the housing market to descend in a straight line either.

Consequently our opinion has not changed from our last report: prices on the whole are still a long way from being close to value. In fact by every historical indicator prices are still massively overvalued. The risks are still predominantly on the downside:

Rising Unemployment

Lower earnings (fewer bonuses/reduced working hours)

Restricted lending.

Lower rental returns.

Mortgage rates resetting from low rates to higher Standard Variable Rates

Increasing taxes (for everybody eventually)

QUITE SIMPLY THIS MEANS LESS MONEY WILL BE AVAILABLE TO SPEND & THIS MUST LEAD TO LOWER PRICES.

Against this the only support for the housing market are **record low interest rates** and sterling weakness.

The favourable exchange rate for overseas buyers is offering some support, but this effect is exaggerated by the media as the vast majority of buyers are still British. The exception is the super prime market where overseas buyers do dominate. However, Knight Frank reports that in March: “Top end properties in the £10 million plus bracket fell by 2.2%.” Clearly then, the exchange rate only has a limited effect.

The other great concern is inflation, which would have an effect on interest rates. Whether this will come to pass is open for debate – Japan has had low interest rates for years but has not suffered inflation (house prices dropped over 75% from peak to trough! We are not suggesting that this is likely in London, but it is something to keep in mind).

However, the threat of inflation or even worse stagflation cannot be ruled out– unfortunately with inflation come high interest rates. As the unbelievably low interest rates are really the only thing propping up the property sector, inflation or stagflation will not be good. One only has to look at inflation and the interest rates of the early nineties to see how swiftly they can move and what affect this would have on the housing market (we are not suggesting that property is the worst investment in inflationary times. However, it is also not the simple answer to inflationary problems either).

IT IS NOT ALL DOOM AND GLOOM

As apocalyptic as much of this may sound, the world will still continue to rotate and we will all need somewhere to live. The purpose of this report is to highlight the dangers of being swept up by the herd and simply buying a property because it seems like a good idea or because you have been told there are not enough properties to buy.

Although the market in general is overpriced in our view, there are still individual opportunities. Not many at the moment, but there will be more in the future. You need to position yourself to take advantage. Be patient and cautious. As has been

demonstrated the risks are predominantly on the downside, so it is unlikely that the market is going to shoot up again.

Therefore take your time to do your research and due diligence. Ultimately you need to ensure that you are in the right place at the right time to take advantage of the best opportunities when they arise. This means that if you are serious about buying a home or investment you must scour the market by being in regular contact with every agent in your target area (this may sound obvious but most buyers fail in this task – there are over 100 estate agents in Kensington & Chelsea alone – if you only register with twelve the odds of success are stacked against you).

If you see a home that you fall in love with and are confident that you can finance it over the long term, then buy it.

If you are planning to buy an investment do your calculations to make sure the figures make sense. Do not rely on rental predictions from just one estate agent. Research the market. If you don't you only have yourself to blame.

Again there is no need to rush into anything. If you are renting, you are being subsidised by your landlord. Enjoy it.

Best regards,

Jeremy McGivern

p.s. If you know of anyone who would be interested in receiving this newsletter please ask them to email Jeremy@mercuryhomesearch.com and we will add them to our list.

p.p.s. If you would like to receive our free report “The Seven Biggest Mistakes London Property Buyers Make (and how to avoid them)” please email Jeremy@mercuryhomesearch.com

p.p.s. If you would like to contact Mercury Homesearch to discover how we can help you acquire the finest home or investment your money can buy please call +44 (0) 800 389 4280.

“We would highly recommend Mercury Homesearch; they made the whole process of buying a home incredibly easy and they negotiated a large price reduction, which comfortably covered their fees.” **Mr & Mrs Evans – Notting Hill**

“I have never had a service that I would recommend as wholeheartedly as Mercury Homesearch. From beginning to end, Mercury helped us through the tortuous process that is buying a house -- from dealing with estate agents, to employing solicitors, negotiating the price (and getting a much better deal than I would have attempted) and recommending an (excellent) removals firm, to

picking up the keys when we had finally completed. In doing so, Mercury struck exactly the right tone, never telling us something just because we wanted to hear it but delivering any news, exciting or disappointing, in such a way that the experience never became too stressful. Had it not been for Mercury, we would never have succeeded in buying the house we have bought: they helped us refine our thoughts about what really mattered to us, they found us a property that fitted those criteria exactly and they managed to negotiate it into our price range. We'll be using them again." **Mr & Mrs D. Loehnis (Lancaster Gate)**