

## PRIME CENTRAL LONDON PROPERTY REPORT - JUNE 2009

### THE SWORD OF DAMOCLES

I have woken up on many a morning since 2006 and asked myself: "Have I got this horribly wrong?" You see I sold all my interests in property in 2006 convinced that the market was incredibly overpriced.

Selling the investment properties was a simple decision. The yields had come down from 12% to roughly 6% so I could not see much further capital growth with interest rates at 5.5%. The managing agents were proving to be a pain too, so I sold and took my profits.

Selling my home was slightly trickier, but I was bored of it. I had also worked out that it was cheaper to rent than to buy, so I could live somewhere nicer for less. I had also met a young lady who I thought I might want to marry and I felt we would want to live elsewhere (providing I could fool her into thinking I was worth marrying). So the downside of selling was minimal.

It was a flawless plan except for one thing. It was apparently rubbish. The market went ballistic. By August 2007 the flat was worth 30% more than what I had sold it for (fortunately I did get married so at least I got something right even if Serena didn't).

#### **Why am I boring you with this?**

I worry that my bearish stance is based on my total failure to predict the size of the boom and that I am just trying to back my conviction of 2006. With the continuous talk of green shoots and many agents (but notably not all) calling the bottom of the market, I am continuously reviewing my opinion and the arguments on which it is founded to see if I have missed something.

## **So what is happening in the prime central London market today?**

You have to pity estate agents. Life is never easy. Either they have hundreds of properties on their books and not a buyer in sight – see 2008. Alternatively, there are plenty of buyers and this prize opportunity to earn lots of commission cannot be fully exploited because suddenly there is a lack of property – the story of March to May 2009. Anything remotely sellable has been snapped up and few owners want to put their property on the market

## **What are the reasons for this apparent shift in the balance of supply and demand?**

The obvious reason that has led to talk of green shoots is confidence. Buyers are back in the market, apparently sensing a deal or worried that we are near the bottom and that they might miss out before the next boom. It is important to note, however, that the vast majority of sales in prime central London have taken place in the sub £2m price bracket and especially in the sub £1m price range. These have been by cash buyers or those with substantial deposits.

This has led to comments such as this in the John D Wood newsletter:

*“In the last recession, between 1989 and 1994, the bottom lasted well over 6 months either side of November 1992. We did not know it was the bottom until the following summer – some six months later. The fundamental question now is has the market bottomed out?”*

*“When the economy starts to pick up and we see the FTSE rising through the 5,000 level, the property market will begin to follow – by which time it will be too late to snap up a bargain.”*

The message clearly is that we should all jump on the property bandwagon again before we miss the chance to pick up a “deal”. Obviously they and I have a very different idea of what constitutes a bargain. Apparently their view is that because something is cheaper than it was makes it cheap. Historically this has never been a very good indicator of value.

The gentleman in question also seems to think that the property cycle has contracted: If November 1992 was the bottom of the last crash then surely November 2010 would be the bottom of this crash rather than now? How likely is it that the fall in prices will be over more quickly when we are suffering a much deeper financial crisis now? If anything this downturn will be more drawn out than previous housing market collapses and therefore we have not seen the worst of it yet.

## **Meanwhile Kay and Co report in their May newsletter:**

*“Prices do seem to be recovering. Those clients of ours who stood firm and declined some of the more derisory offers received in the early part of the year are now getting offers very close to the levels they had wanted. So called “vulture buyers” are now appearing to be giving in and finally realising that*

*if they want to buy a property they are going to have to pay a fair price.” – But what makes a fair price? In this case it would appear to be a price that suits the vendor. Later in the lettings section of the same newsletter:*

*“It has been an interesting year for the local lettings market so far. We have seen an increase in the number of properties on the market to let and this, **coupled with most tenants having lower budgets** than in previous years, has resulted in rents dropping across the all sectors of the lettings market.”*

The highlighting is my doing – this is the real story. Why would buyers have or want to spend more money than renters? The simple fact of the matter is that there is much less money in the world than there was 18 months ago, which is why it will be impossible in the near term for prices to recover.

**Although these and other comments in the national press do not bear much scrutiny, as we will show later, they do have an effect on potential buyers & sellers.**

If everything is beginning to look rosy, as a buyer you may feel pressure to buy now otherwise the market may steam ahead without you. In the meantime as a seller why would you sell? You may start to believe that perhaps the high prices of 2007 are only a year away. Therefore it seems to make sense to hang on for a year and “make” 15-20% by doing nothing. It worked up to 2007, therefore it should work now is the prevailing logic. So people are not selling in the hope of future gains, not understanding what fuelled the boom of 2006/7, i.e. cheap & easy credit backed by high employment based on the “end of Boom & Bust” - ALL HAIL PRUDENCE!

### **The Real Danger**

More worryingly, however, there is another reason why some homeowners and buy-to-let investors are not selling. They can't. In a desperate bid to get on the property ladder or to increase their property empires they took out huge mortgages. 110%, 100%, 90%, 80% - If you bought in the last two years at these loan-to-values you are in negative equity.

This also does not take into account all those people who withdrew equity from their homes in the belief that prices would keep heading ever higher towards the heavens. Therefore many who should have had a comfortable equity cushion have in fact spent this on holidays, cars and other shrewd investments. Of course, while interest rates are low most owners can cover the costs of holding a property and therefore do not have to crystallise their losses by selling... yet.

So for a substantial number of people their homes and “property pension” are no longer the source of comfort that they should be. Instead their mortgages hang over their heads waiting to fall and financially crush them. The thin thread that is keeping the mortgage payments suspended at a manageable level is an historically low interest rate. This is the only lifeline and it could break at any moment.

## **Unfortunately the thread is already beginning to fray:**

Peter Rollings, managing director of estate agent Marsh & Parsons says:

*“There’s a severe shortage of stock on the market and with prices down by up to 30% - the value in the London market is encouraging buyers with large deposits, cash buyers and foreign investors to invest in London property. The Bank of England must continue with their programme of quantitative easing on Thursday – recovery in the mortgage market is essential to sustain this improvement.”*

This hints at the problem. Prices can only go up if banks increase mortgage finance, i.e. pump more debt into the market. However, Mr Rollings and many other commentators seem to have forgotten that the lending practices of the last four to five years were an aberration. They were the cause of the boom and sudden implosion of the financial system.

Consequently mortgage lenders are proving to be reluctant to lend. Some have even raised their rates despite no change in the base rate.

Rates have crept up slightly for the following reasons:

- Swap rates (which influence fixed rates) rose slightly about 6 weeks ago but have fallen back. Lenders price their tranches of fixed rates on swap rates and therefore we are seeing the effect of that slight increase in pricing at present. There is a school of thought that swap rates have hit their floor and the only way is up! Over the last 3 weeks they have been up and down daily with no real trend indication.
- There are very few (really) active lenders in the market. Notably: Abbey, Alliance & Leicester, Northern Rock, RBS and Woolwich. As they have been offering competitive rates, their service levels have suffered and back-logs have occurred. Also, they have attracted significant market share. Consequently, a number of these have increased rates temporarily to clear their back-logs and to avoid being over-exposed to the market. It remains to be seen whether other lenders (particularly those of the new Lloyds group) look to take on some of this business in the coming weeks by offering more competitive rates.

(Thank you to Steve Straker of Cartlidge Morland for this information)

For those on Standard Variable Rates (SVR) this could be a worrying phenomenon. Who has an SVR? Predominantly those who cannot remortgage, due to their high loan-to-values, i.e. arguably the most vulnerable to higher interest rates. Admittedly it is cheaper for some people to be on a SVR. However, what happens if interest rates rise and lenders don't offer you another option?

For those of you not familiar with mortgages, the SVR is set by the whim of the banks, so there is no official tie to the base rate like a tracker mortgage for example. The BBC

recently suggested that 40% of mortgages were on SVR's! (we cannot confirm this figure).

There have been some other worrying signs: The Abu Dhabi sovereign wealth fund have sold out of Barclays – admittedly at an exceptional profit after what looked like a duff decision, but is it possible that they have seen something they don't like in the loan book? After all they were supposed to be long term investors.

In addition Money Week reported that: *“the Treasury recently refused to release information about the results of Britain's banking stress tests to Bloomberg, because apparently disclosure “at this time may lead to uncertainty in financial markets, either in relation to specific institutions or more generally... such instability could require further action by the authorities.”*

It would appear that the banking system is far from fine. We can expect mortgage lending to remain tight for some time. If you are on a variable rate then you can only hope that interest rates do not start to climb rapidly.

### **Another question to consider: who is going to continue buying property?**

Prices then have stabilised slightly over the last two months because of interest by cash buyers and those with large deposits.

For prices to increase somebody will have to pay more than the current crop of cash buyers. Other cash buyers will presumably not want to pay more as yields will be absurdly low for the risk being taken – Rental yields = 3.5% so if you have a 70% buy to let mortgage at 5.5% you are losing money (and this is assuming a 100% tenancy rate which is unrealistic on the whole). A 3.5% return may seem attractive to a cash buyer who is receiving 1.5% from the bank. But factor in costs, lack of flexibility and the risk and it barely seems worth it. For example your first year's rent is wiped out simply by 4% stamp duty over £500k. That is before you consider void periods, fees, insurance, service charges etc, etc.

Historically cash buyers also make up only 25% of the market. Therefore the only way prices can increase is through an increase in lending. However, as we have pointed out this is highly unlikely. It is universally recognized that reckless lending caused the bubble. Banks are no longer willing or able to lend as they did from 2005-7. Not even the geniuses we have as politicians can change this despite their apparent wizardry with expense claims.

In fact the Independent reports that Professor Chris Hamnett, of King's College, London, has published a policy paper for the Institute for Public Policy Research think-tank.

*“In the paper he proposes the introduction of strict limits on residential lending. He says potential borrowers should have a deposit of at least 5 per cent and loans should be limited to 3.5 times joint salaries. He has also called for an end to self-certified lending and wants to force buy-to-let borrowers to put down deposits of at least 25 per cent.”*

This would force house prices to stay near the long term house price to earnings ratio of roughly 4:1. Unfortunately we are still above this long term average and historically we have always undershot this average on the way down – in the crash of the 1990's the ratio reached a low of 2.9 times earnings.

### **What About Inflation?**

This is the other way prices could increase. Of course this masks the situation and house prices would still drop in real terms. Some argue that property is a great asset to have in inflationary times and depending on your situation this may be true. However, if you are on a variable rate mortgage, or were coming to the end of a fixed mortgage, and interest rates started to shoot up to counter inflation, the result would be ugly. This is exactly what happened in the early 1990's. So you need to be very careful about using property as a hedge against inflation.

Most of the risk therefore would appear to be on the downside. However, I must admit that we have numerous clients who are keen to buy despite knowing our views. Some are based overseas and are taking advantage of the weak pound. Others are based in London and just want to buy a home. What is interesting though is that buyers who may have spent £12m in 2007 (and who are still more than capable of doing so) are now much more circumspect and are not committing to anything. In some cases they are looking to acquire properties for £2m instead of buying larger apartments to add to their portfolios.

So perhaps I was wrong in 2006 and continue to be wrong now. Perhaps the market is near the bottom.

### **Reports like this certainly don't help my nerves:**

'House prices in Britain rose last month, confirming that the slump in the south of England has levelled out, according to the Halifax Building Society,' ran the story in The Times. 'The Halifax's latest quarterly survey shows that prices in general rose by 0.5%, and the indications are of a definite bottoming-out'.

Except the above statements were not made this week or last week. In fact, they were made in October 1990. House prices didn't bottom for another two to three years after this (I am indebted to Dominic Frisby at Money Week for producing this gem of a quote).

As I have said in previous reports no market declines in a straight line. Many will see value purely because the market is cheaper than it was. However, this does not take into account how overinflated prices had become. Obviously I cannot guarantee that we have not reached or are not near the bottom of the market. However, I look at all the potential

hazards and compare them with the very few glimmers of hope and the odds seem stacked towards much bigger drops to come.

**Positives:**

Historically Low Base Rate

Overseas Money

**Negatives:**

Rising Unemployment

Lower Wages (fewer and smaller bonuses)

Falling Rents

It is cheaper to rent than to buy

Restricted Financing

Increasing Taxes

The Long Term House Price To Earnings Ratio Is Above The Long Term Average (historically we have always undershot on the way down too).

In my view we are on a knife edge: If inflation or worse, stagflation, get out of hand then higher interest rates will cripple buy-to-let investors, accidental landlords and the thousands who are currently overstretched by massive debt.

Alternatively deflation will also have a crippling effect as this will also force prices lower while making the debt burden harder to carry. Unlike the Japanese of the '90's we do not have huge amounts of savings to act as a buffer.

**What does this mean for you?**

As I have mentioned we have numerous clients who still want to buy for their own valid reasons. The information in these reports is general because it has to be by nature. You have to look at your own situation and decide what is the best course of action for your circumstances. There are opportunities to buy well even in this market, but they are relatively rare. Therefore if you are committed to buying a property you need to ensure that you are doing your due diligence, i.e. having total market coverage to ensure you are seeing the best opportunities available.

Despite what the papers say do not feel pressurised into having to buy just because,

temporarily, there is little on the market. Negotiate hard. Set yourself a target price based on accurate research and information. If the sellers won't accept this price or less, simply find another property.

Patience and caution are still essential.

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](mailto: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](mailto: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)**