



PRIME CENTRAL LONDON PROPERTY REPORT - JULY 2009

EXTRAORDINARY POPULAR DELUSIONS...

In the preface to his book Extraordinary Popular Delusions & the Madness of Crowds, Charles Mackay writes:

“We find that whole communities suddenly fix their minds upon one object, and go mad in its pursuit; that millions of people become simultaneously impressed with one delusion and run after it ... Money, again, has often been a cause of the delusion of multitudes... Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, and one by one.”

These words were written in 1852. The author would no doubt have been unsurprised by the numerous booms and busts since then – the two most recent being the tech and housing bubbles. The fact is that these booms and busts are simply a reflection of two of the most powerful human emotions:

FEAR AND GREED - Powerful emotions that lead to irrational thought.

And trust me when I say I am becoming more and more concerned about my mental health.

Have I become irrationally fearful? Is my contention that the property market has further to fall, a reflection of the need to prove that selling my three properties in 2006 was the right decision? Am I motivated by greed,

i.e. the hope that the market will crash so that I can buy a bigger house in two or three years' time?

Questions, questions and the irritating thing is that *no-one* can know the answers. We can only look at probabilities... or we can believe the hype:

The following is from a newsletter sent last week by an estate agent in South Kensington:

*“During the month of May we had our best month this year with a new found confidence in the property market. This is a direct result of the correction in prices over the last 18 months, low interest rates levels being maintained and the weak Pound. **The housing market in Central London has now seen the worst of the falls** (my highlighting) and it is perceived to be a popular and good place to invest overseas money.*

We have registered more applicants than usual and with the continuing low supply of properties which is now running at approximately 50% of normal levels, this is resulting in multiple offers on many properties. We are achieving asking prices for vendors and in some cases higher than anticipated, due to the number of cash and overseas buyers who feel that now is the time to buy.”

All seems rosy then until you ask a simple question: Why has the housing market seen the worst of the falls? There is no reasoning just a rather confident statement. This seems to be based on the fact that they had a good May.

Admittedly there is a shortage of property for sale as Hamptons state in their report: They have 4.5 times as many buyers as at the start of the year. Meanwhile stock levels are 31% down on last year.

In the same Hamptons report, the lettings section reveals a different situation.

“New applicants registering fell slightly in May from the previous month but are still up considerably on the previous year, a 50% increase. Stock levels remain high and are still 9% higher than this time last year.

In areas where the market is dependent on corporate demand, rents continue to fall. It remains a tenants' market due to an excess of supply over demand and applicants are still making multiple offers and pulling out of deals at the eleventh hour. The fall

through rate continues to rise month on month and is treble the rate of this time last year. With so much choice in the market it is a priority for landlords to minimize void periods. This has led to many accepting low offers and being more flexible on terms agreed.

We have seen gradual improvements in the sales market and early signs suggest that this has encouraged some 'reluctant landlords' to return their properties to the sales market. This may cause a stock shortage in the future, however we are reliant on an improving economic outlook before we see demand increase substantially, and this is still some way off."

So supply/demand in the sales market has changed but this has not altered the fundamental problems. Now some may argue that if there is a lack of supply then the market has to go up and that the market is therefore stable. This unfortunately is unsound logic. The scenario was similar in 2007 – little stock, frenetic buying. Look what happened then.

Ahh, but prices are much cheaper, I hear you say.

Indeed prices are probably c. 15-20% cheaper, but that does not make them value.

Demand can often be driven by emotion rather than logic. In the medium to long term there is always mean reversion. Unfortunately this normally involves undershooting on the downside by a similar amount that we overshot on the upside.

And this is where we need to look to history. As McKay points out, these situations tend to unwind over time and never in a straight line. Invariably after the first downturn people believe that the market has become oversold and that a new buying opportunity has arisen. But is it realistic to assume that the housing market boom of the last c. 12 years has been corrected in just 18 months?

It took roughly three years of falls to work out the boom of the late eighties and the rise in prices was on a smaller scale to this one (as recent figures have shown this recession is also much bigger than the nineties). We are still way above the long term average of the house price to earnings ratio which is 3.9.

In the last crash this bottomed at roughly 2.9 times earnings. James Ferguson of Pali International has calculated in his Model Investor newsletter that house prices are still at 5.16 times earnings. As he points out this is still higher than the peak ratio in 1989 of 5.02 times and is probably the reason why HBOS stopped publishing their house price to earnings' figures in 2006 - it showed how overbought property had become.

However, prices are going up at the moment.

Savills reports that prime central London property prices are up 4.3% in the second quarter, but they do admit that the increase has been exacerbated by the low number of transactions. However, most observers assume that this means the worst is over for the market. Apparently it is impossible for the housing market to fall further if we have had 3 months of growth, because the housing market either collapses or zooms up without any deviation from the trend!!!

In another agent's newsletter out today they open with the classic:

"June has seen the revival of the property market with the bounce reverberating around the Capital offering hope that the residential property market is stabilising. The rise in property prices has been driven by opportunistic overseas investors and cash buyers from the UK who sold up in 2006/7. We feel the time has come to pick up quality stock at prices which may never be seen again."

Now I find this sort of comment irritating not because it is in complete contrast to what I think, but because there is no reasoning. Now to be fair to estate agents they are paid by their clients to sell their homes for the highest price possible. They are legally obliged to do so, which is why buyers need to take their advice with a pinch of salt. However, they could at least offer some reasoned analysis or argument. But they don't. Perhaps there isn't a valid argument?

But this is the question with which I have been torturing myself: what does it mean if the market goes up? Would this signal a new paradigm?

As those who have been unfortunate to receive these ramblings for some time will know, I run for cover whenever I hear the words New Paradigm. It is the clever way of saying "It's different this time". The consequences of perceived new paradigms are invariably horrific. Nevertheless a new

paradigm must not be discounted. So, what would it mean if prices were to continue rising in the current economic situation?

1. **Yields would continue to decrease** – rental yields will not climb because, as we have seen, there is still an excess of rental property on the market.
2. **The long term house price to earnings ratio would reach new highs** – house prices are now still above their long term average. If prices rose while earnings continued to fall or at best stayed flat (remember a huge number of people have lost their jobs and bonuses for the majority have been severely reduced or a thing of the past) apparently this would be sustainable.
3. **More debt would be needed to fuel the increases** – if the banks were to lend more the rules of mathematics would have been proven to be wrong. i.e. the way to solve massive debt is to take on ever more debt – quite how this will ever be repaid is anyone's guess.
4. **Effectively it would be impossible for most people to buy these properties in the future** - unless they had huge cash reserves as no bank could lend against the yields or earnings multiples required for the size of mortgage. This is assuming there is not a huge rise in earnings which seems unlikely.
5. **There would be a class of landowners who had vast sums tied up in property but receiving paltry returns.** Landlords would be subsidising their tenants (this is already happening). Property would really become a burden.

Is this scenario realistic or sustainable?

Having quizzed a number of private bankers and mortgage brokers about the lending part of the equation, it seems not. Unless of course there is a dramatic upturn in the fortunes of the world economy. As a leading indicator the world of shipping gives us an insight into how many goods are being transported, i.e. what is the current demand for goods. This quote from Bloomberg says it all:

“The shipping index could "crash down as far as it has advanced", says carrier operator Precious Shipping. "The fundamentals still overwhelmingly point to a world economic recession with tremendous job losses, and we

suspect that will put a real dampener on the current burning hot BDI (Baltic Dry Index)".

I don't believe it will take much to reverse this current rally in prices.

If interest rates go up, then those servicing mortgages will find it harder to maintain their homes. The same is true if unemployment rises. This will lead to more forced sellers.

And if interest rates remain at these levels one has to assume that the numerous bailouts have failed and that deflation has taken hold. This again will lead to higher unemployment, lower earnings, less lending & lower rents - Again leading to more forced sellers, lower prices and rent.

It should be noted that all this is likely to take place on a continuing low number of transactions.

But for now, greed seems to have taken hold again. For example, I was speaking to an agent earlier in the week, who was pulling her hair out – she had just put forward an increased offer of £3m on a £3.25m flat, which had been rejected. The owner is now considering increasing the asking price. This is becoming a common problem.

Low interest rates mean that there are very few forced sellers. This in turn means that there is a shortage of supply on the market. However, the key fact is there is not a shortage of properties in which to live. If there were, rents would have held up and yields would have increased.

I believe that the dangers of **rising unemployment, restricted lending, lower earnings, low rental yields and excess rental supply, sky high house price to earnings ratios** combined with the uncertain economic background makes it more probable that we will see further falls in house prices.

Now I have to admit that we are acting for clients who know our views and still want to buy property for their own specific reasons. The purpose of these reports and other information we supply is to allow you to make an

informed decision, based on the likelihood of what will happen combined with your own requirements. Therefore I am not suggesting that you should sell your home and live in a bunker. Nor am I suggesting that buying a home is wrong for everybody. However, buying because a number of other people are is a dangerous game.

For the record these are my statistics for June:

Potential Client Enquiries: 7

New Clients Proceeding: 2

Clients Delaying Purchase: 5

My bank manager thinks I am mad. Now that I have put this in writing I am inclined to agree. I need a holiday.

Best regards,

Jeremy McGivern

p.s. If you have any questions you would like answered in these reports, please email Jeremy@mercuryhomesearch.com. All comments on these reports are also welcome.

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)