Tricks with RICS

February 2019

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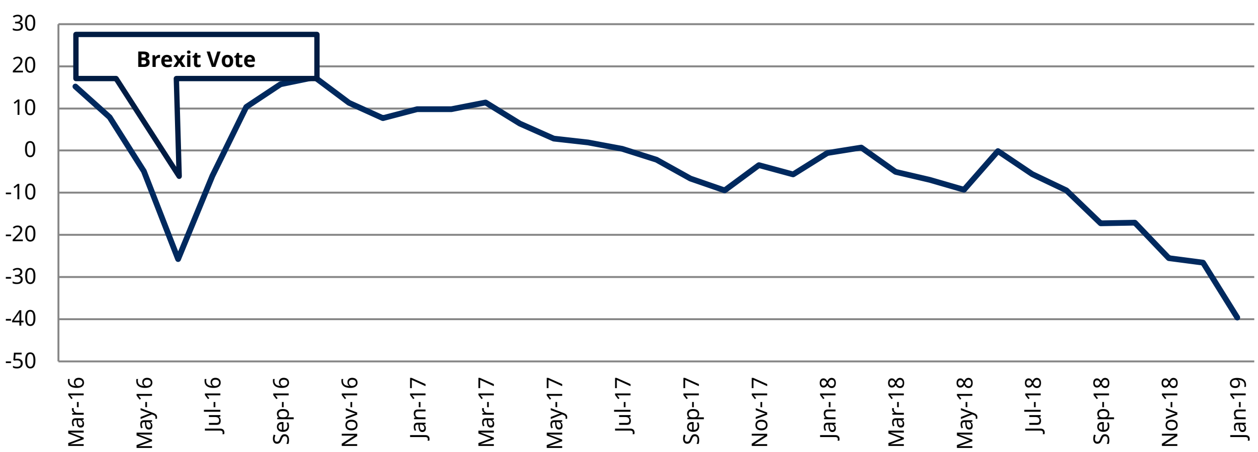
Property prices are a national obsession in the UK. Recent headlines and their interpretation, however, need some vetting. In this piece, we share our observations on UK house price statistics. Some of these statistics don't quite "jibe" since the Brexit referendum.

Figure 1 below shows the Royal Institute of Chartered Surveyors (RICS) Index of house price expectations. This Index is derived from a monthly sentiment survey which asks members (property appraisers) if they expect prices to go up, stay the same, or go down over the next 3 months. The RICS Index subtracts the percentage that predicted "down" from the percentage that predicted "up". The Index does not tell us the magnitude of expected price movement, just how broadly the group believes in the direction. We can see from the line graph that, as a group, property appraisers have been predicting near term price declines since August 2017.

Figure 1: RICS House Price Expectations Index continues to see price declines

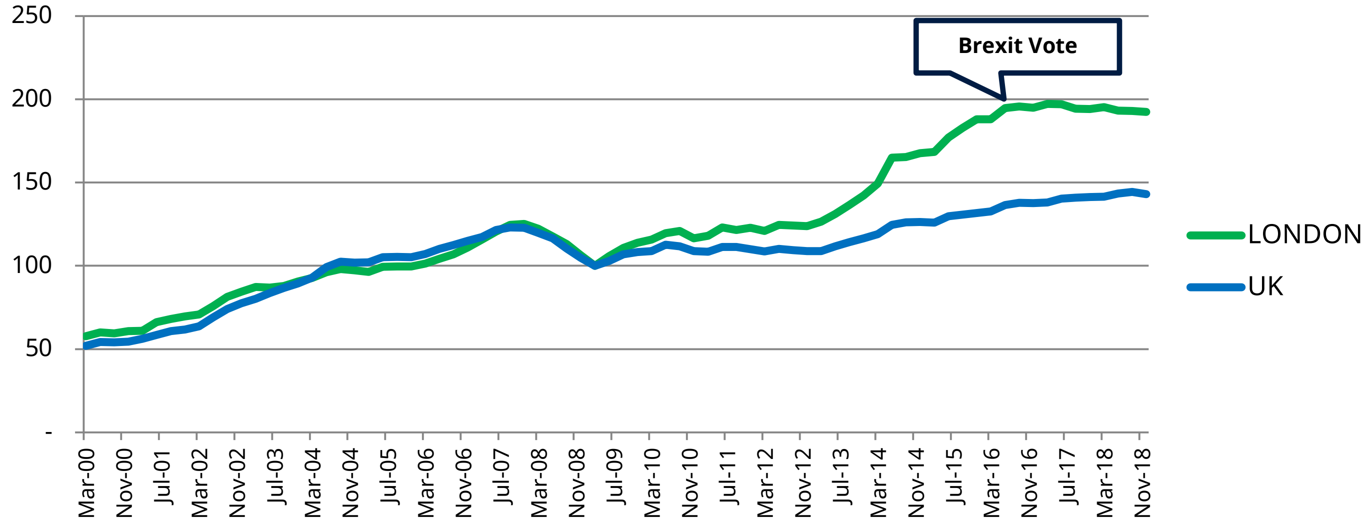


Source: RICS, January 2019.

Figure 2 (on the next page) shows the Nationwide Building Society's house price Indices for the UK, and London. The Nationwide series tracks actual house prices, over time, adjusting for housing quality, mix, and seasonality. These Indexes provide a good picture of actual home price changes nationally and regionally.

According to the Nationwide UK Index, house prices are up about 45% since the lows of 2009, while prices for homes in London are nearly double that of their 2009 level. Since the Brexit vote, at the national level, house prices have risen by about 5%, whereas house prices in London have fallen by about 1%. These actual price changes clearly contrast with the powerful negative sentiment of the RICS Index shown in Figure 1.

Figure 2: Nationwide House Price Index for the UK (all regions) and London



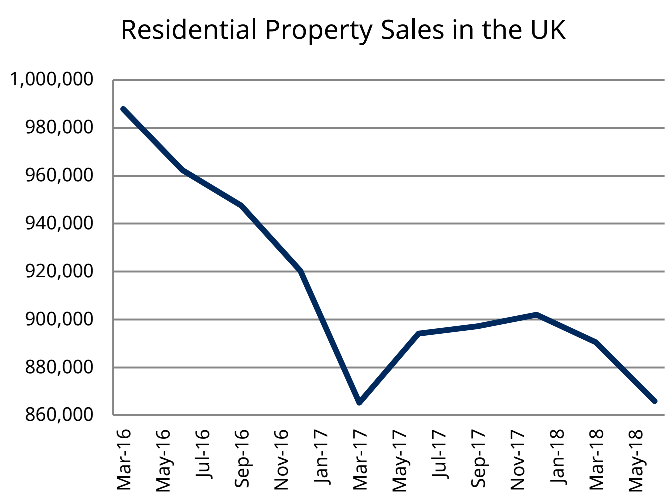
Source: Nationwide Building Society, December 2018.

It is worth trying to reconcile the different pictures represented by the RICS Index when compared to the Nationwide Indices, especially given that the RICS index is a survey of surveyors (who should know prices better than anyone else). Surveyors expected near-term price declines for nearly 18 months, where actual prices have either grown or showed a very minimal decline. We believe the answer to this question lies in transaction volume.

Housing as an "asset" has a bit of a twist to it. Houses are different from most other assets. They have day-to-day utility value, and they represent a "good" that owners both consume (use) and regard as an investment. Typically, transaction costs are high and there is not a perfect substitute. So, when asset prices decline, or when selling conditions deteriorate, the first thing that happens is that homeowners become less likely to put their home on the market. This is true unless, at the same time, a major life event occurs for the asset owner (e.g. unemployment, divorce or death) and the asset is financed. Note: UK mortgages are full recourse to the borrower, there's no "walk away" option to the extent the value of the home is lower than the amount that has been borrowed. The "recourse" aspect is a distinct difference between UK and US housing finance.

The two line graphs in Figure 3 show the decline in the volume of residential property transactions (quarterly, annualized) in the UK and in London since the Brexit referendum.

Figure 3: Residential property sales have sharply declined since the Brexit vote

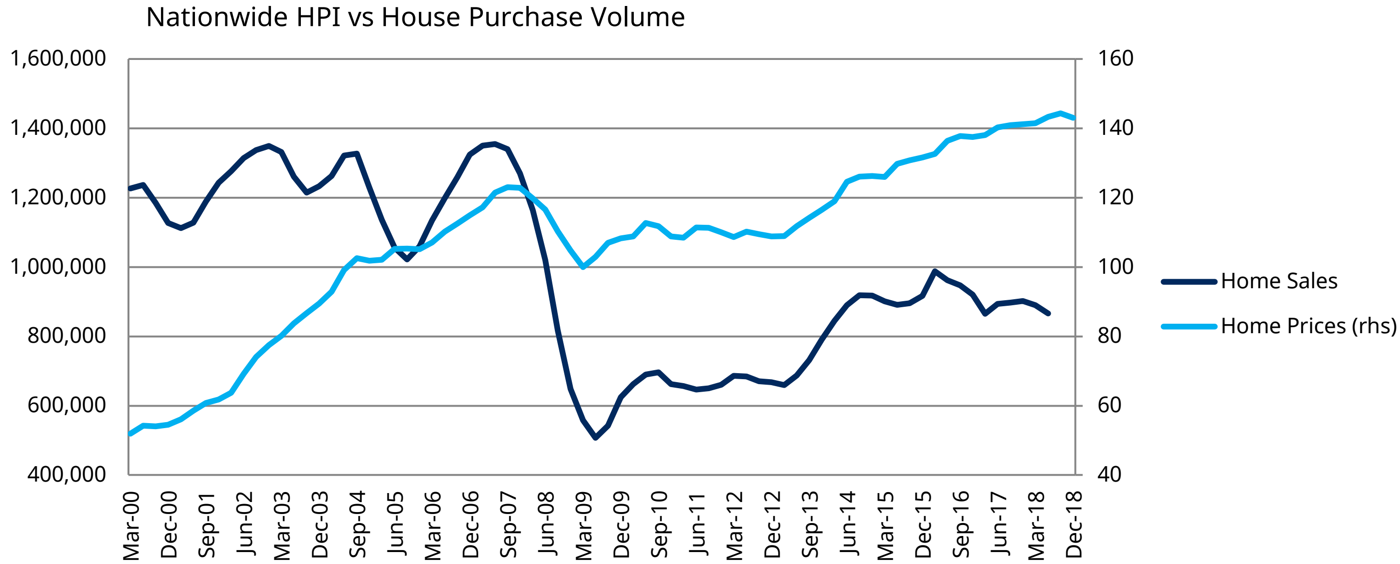


Source: UK Office for National Statistics, December 2018.

Since the Brexit vote, residential property sales volumes have declined 12% nationally, and they have declined 30% in London. This is good evidence that while the RICS negative expectations for house prices don't necessarily lead to house price declines, they can lead to transaction volume declines. This in turn reduces available supply which then provides a cushion to house price changes.

We've seen this mechanism at work before. Figure 4 shows house prices and transaction volume over a longer term. During the financial crisis, home prices declined by 20%. However, the volume of transactions declined by 63% during this time. With the reduction in home sales, inventory for sale declines and prices began improving again less than 18 months after they initially declined.

Figure 4: The decline in UK housing in the wake of the financial crisis has provided a floor to house prices



Source: UK Office for National Statistics, December 2018.

We think this voluntary supply limiting mechanism, which is driven by the asset characteristics of homes in the UK, will serve as a support, or floor, for house prices in the UK.

The reciprocal agreement already agreed between the UK and the EU will allow EU citizens who currently reside in the UK to remain even after Brexit, so there won't be any forced selling from that front, at least over the foreseeable future. And a hard Brexit, which carries the risk of rising unemployment, is a low probability event.

Conclusion

In summary, while headlines have focused on the RICS decline, we appreciate the fact that there are some tricks to considering the transmission of sentiment to asset prices. We also believe that owning seasoned UK mortgages – that is, mortgage loans that have had exposure to the 2007-2009 asset price decline – is an attractive way to gain some "Brexit" premium, in a market with borrowers that have been tested previously through a period of asset price stress.

Important information