Article 50 & Property – March 2017

COMMENTARY:

Brexit – We filed for Divorce. Acrimony and a Bill will ensue but like all parents, they will have to find a way to get on.

50 years from now, will history remember the day the UK triggered Article 50? or will it be the convoluted negotiation process? or the fact that at the end of it all, Brexit was a fudge and our relationship with Europe hardly changed. As at today, 1st April 2017, battle lines are being drawn- last week it was Intelligence and the latest is that Gibraltar now seems to be "in play" - and soon we will arguing about the divorce bill. As Damian Lewis, in his role as a hedge fund manager in *Billions* maintained, that, if done properly, "no-one walks away from a negotiation happy". I am sure that this will be the case here as well.

Excellent article Merryn Sommerset-Webb.

In a very well written article in Saturday's FTMoney, Merryn Somerset Webb argues that we have bigger problems to worry about than Brexit, notably household debt, our Debt to GDP level (and where to invest). She concludes, that in some form or another, that we will still have "*a deep and special relationship with the EU, just one which is not as deep and special as it is today*", that London will remain the world centre of finance (think Equivalence – Art.38 of MIFIR) and the Great Repeal Bill is exactly the opposite of what it proposes to be – it is an adoption of EU Law. Our view on the underlying message from the article is that we should expect a "Norway Deal" – or access to the EU on a "pay with no say" basis. As Estate Agents, we can live with that – it keep the UK property market open to foreign investment.

..But what does this mean for us?

So where does that leave us with respect to property? Below is a 3 part view, looking at the economy, housing and Brexit where we conclude that affordability is biggest issue and likely to be remain so in the medium term.

Economy is growing but household spending is down. Lack of investment in business due to Brexit but expect higher rates.

The ONS reported that the UK Economy grew by 0.7% in the final quarter of 2016 but warned of "a slowdown within business investment which fell by 0.9%". The Economy ended the year with some momentum : YOY GDP growth was lower at 1.9% vs consensus at 2% but still within expectations. Whilst the Economy grew, consumer spending however fell by 0.7% (0.4% inflation adjusted). The tensions faced by our economy were highlighted by the UK's biggest mortgage lender:

Lloyds Banking Group (LBG) maintained in their 2016 annual review (Feb 2017), "*How the economy evolves in 2017 is highly dependent on the type of EU-exit deal that companies expect to be achieved in 2019"* (this goes to investment) and "*how much squeezed consumer spending power is offset by improved competitiveness of exports fallowing the fall in Sterling".* They expect unemployment to remain low during 2017 but rise at the start of 2018 by 0.3% (sic) *and "they expect house prices to continue to rise by around 3% supported by the ongoing shortage of property, low levels of housebuilding and exceptionally low interest rates*". (UK Land Registry Index increase Jan 16-Jan17 6.22%)

House prices down according to Nationwide for the first time since 2015.

Interestingly LBG note that market rates imply an increase of the base rate to 0.5% during 2018 and to 0.75% in 2019. The USD / GBP forward exchange rate market has taken account of this with sterling -0.08% against USD in December 17 and +1% by June 2018. but LBG don't address the effect of these base rate increases on mortgage rates. One can be sure that if Lenders are able (see West Bromwich BS Court Case) to pass these on, they will, which may be why LBG's predicted increase may lower than last year's 6.22% (above).

Since the above was written , Nationwide announced that house prices fell for the first time since 2015 (-0.3% in March vs +0.6% in February). The fall was due, according to economists, as a result of a lack of confidence generally and in particular due to Brexit (inflationary pressure on family spending), a slowdown in acquisitions by Buy to Let Landlords due to increased SDLT and mortgage lending constraints.

CNTD/…..

But this mess is our making – we have borrowed too much and this has nothing to do with Brexit.

Choose your next property location carefully…

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Even without the additional pressures of Brexit, our economy and housing markets were already suffering. We have written ad-nauseam about the twin deficits and public sector net debt, but we must also look at household debt: The bank of England estimates 2016 household debt to income to be 136% (2009 140%) with a debt service ratio of 8% (8% 2009). Compare this however to 2000 where the debt service ratio was also 8% but the Debt to Income ratio was 100%, we can understand the cheap leverage in our economy. If our asset prices (and by this we mean housing) are to continue to rise, we must either earn more money (increase GDP) or borrow more. For some, this is not possible, either due to MMR or they simply do not have enough money. As such, home ownership is now down to 62.5%, the lowest since 1985 and why 1 in 5 families live in the private rental sector, up 12% from 10 years ago (source DCLG)

The counter to this is (as noted by LBG) that population growth and lack of home building is keeping house prices up. The Bank of England is also keen to keep house prices stable (and remove as far as possible high LTV BTL mortgages which is sees as risk to the economy) as a falling market will require mortgage lenders to further shore up their balance sheets: Increasing mortgage LTV's on balance sheet, under Basel III, may require further capital injection into the banks, creating headline instability which we can ill-afford over the next few years (even though Tier 1 capital ratios are at an all-time high for now.)

So what should one do? Financial commentators such as Merryn advocate *holding a diversified multi-asset portfolio, swapping expensive markets for value markets*, and hold cash and gold. Whilst we see property (as a home or investment) as part of a long-term diversified multi-asset portfolio, we do believe that clients should look at the <u>suitability of the property for their individual or family needs first</u> and only then look at mortgage debt levels in any area they are considering buying, particularly "value markets" (The two are not mutually exclusive) There is plenty of equity in the UK housing market but growth in markets where the natural buyers require mortgages to transact will be limited by affordability and availability of debt going forward. Other areas, which may well be more expensive and less levered, may provide better capital protection. This may explain why we have seen a surge in activity in Prime Central London even with our ill-conceived SDLT levels. Regardless of Brexit, our current housing problems were inevitable – we have borrowed too much and have not built enough.

However, if we believe that the status quo between the UK and EU will be maintained, then these next 2 years could be an opportunity to buy in areas with little debt and where prices are off by 10-15%. From the Sage of Omaha:

"Be Fearful When Others Are Greedy and Greedy When Others Are Fearful"

The views expressed in this paper are personal.

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