CREDIT CRUNCH PHASE 2 AND THE IMPACT ON HOUSE PRICES

Many economic forecasters have stated that the financial crisis engulfing the global economy is under control and a recovery is soon to take place. The 'green shoots' of recovery are they say, now firmly in evidence as industrial production declines have slowed, house prices shown signs of stabilising and interbank lending rates fallen back toward more normal levels. Consequently, this will probably lead to a sharp recovery in economic output in the second half of 2009 and early 2010. Indeed many of the more optimistic forecasters would have us believe that this recovery will be 'V' shaped in which growth quickly returns to its normal long term trend say, 2.5 – 3.5% in the UK, Europe and North America. Disaster and financial meltdown have been averted and the world can look forward with confidence to the dawn of a new era of prosperity.

At the time of writing equity markets have given a strong 'thumbs up' to the above 'hypothesis' which rests on a number of important assumptions. A vital assumption is that the global banking system is being sufficiently recapitalised to provide resources that will enable banks to withstand the remaining impact of the recession that will undoubtedly create further losses and write down in loan portfolios. More importantly; Government's worldwide have made clear that they are not prepared to let institutions fail. Confidence is therefore improving setting the stage for a return to a more normal trading environment in which lending restrictions will ease and growth will resume.

So what then are the possible hurdles that may scupper the optimists hope for an early and powerful economic recovery? Whilst it is undoubtedly true that banks have successfully raised new private equity capital in addition to vast sums of public money, the recently completed 'stress tests' of the 19 largest US financial institutions gives some guide as to the problems that remain. Critics of the tests point out that the parameters of the 'stresses' were wholly inadequate. For example; the tests used a 10.3% average rate of unemployment in the US for 2009 yet that rate stood at 8.9% in April 2009 and is almost certain to rise significantly in the remainder of this year and quite possibly in 2010. The rate of unemployment has often been called a 'lagging indicator'. In other words, unemployment often continues to rise even after the 'bottom' of the economic cycle has been reached when output declines cease.

Rising unemployment will cause further damage to financial institutions as defaults soar and loan losses mount. Further losses will be faced on residential property loans but also on the commercial property, credit card and personal loan books sitting on the banks balance sheets. It is by no means certain that the capital buffer held by banks will be sufficient to withstand this second 'wave' of financial damage.

In terms of the commitment by Government's to ensure that banks do not 'go bust' the provision of substantial capital and financial support for the banking system has been accompanied by most industrialised nations and larger emerging market economies such as China, embarking on an unprecedented 'economic 'stimulus' package. In addition, 'printing money' or 'Quantative Easing' (QE) as Central Bankers like to call it is in theory providing substantial liquidity to the UK, European and US economies.

Much of the policy response in terms of QE has been directed at reducing mortgage interest rates and its impact on those rates is little understood by housing market commentators. Rather than physically manning the printing presses and producing piles of crisp new Sterling, Euro or Dollar notes, QE is the more sophisticated, modern way of producing vast quantities of money without anybody really noticing!

QE is simply the purchase by Governments of their own outstanding National debt otherwise known as Gilts, Treasury Stock or Government Bonds. For example; here in the UK HM Treasury recently began a £150 billion program in which Gilts are being repurchased from financial institutions who then receive 'money' which the Government hopes they will go out and spend thus increasing the money supply and stimulating economic growth. The institutions receive the money from the sale of their Gilt holdings electronically i.e. they can view their bulging account at the Bank of England online. Far better than having to take delivery of wheelbarrows full of freshly printed notes a la Zimbabwe!

But how you may ask is this related to mortgage interest rates? Well the QE program can be targeted directly at repurchasing longer term Government debt say, 25 year Gilts. It is these longer dated maturities that actually determine the cost of borrowing. The wholesale costs of money that banks obtain from the 'money markets' in order to lend to mortgage borrowers, relates directly to 25 and 30 year Gilt 'yields'.

A vital aspect of the early stage of the credit crisis was the reliance by institutions such as Northern Rock on short term rather than long term funding for lending to mortgage borrowers. Such institutions secured short term say, 2 – 3 year loans from the money markets to lend to borrowers often on a 25 year mortgage term. For many years they were able to 'roll over' these short terms loans as and when they fell due. However, when the credit crisis began in 2007 Northern Rock were unable to roll over their short term 2 – 3 year loans as the interest cost of that money was greater than the interest rate being paid by borrowers. It is now accepted that the risk of bank mortgage lending can only be controlled by 'matched funding' i.e. the bank raises money from the money market on a 25 year basis if that is the term of the mortgage.

And how precisely does a QE program aimed at repurchasing 25 year Gilts assist in reducing mortgage interest rates? Well this is due to the inverse relationship between the price of the Gilt and the yield or 'interest rate' on that Gilt. This relationship dictates that as the price of the Gilt rises, the yield falls and vice versa. For example; a Government issues a 25 year Gilt of £100 with an annual interest rate or yield of £5 i.e. 5%. If two years later interest rates were to rise to say, 10% and the owner of the Gilt wished to sell to re-invest in assets with a return closer to 10% he will not be able to receive back what he had paid on purchasing the Gilt. In other words, the price of the Gilt has fallen whilst the yield has risen as a buyer would only be prepared to pay say, around £50 for a Gilt yielding a £5 or 10% annual return.

If a Government QE campaign targets 25 year maturities this will drive up the price of those Gilts, reducing the yield and therefore mortgage interest rates. Given that it is these longer term Gilt yields that are the determinant of mortgage rates the fact that base rates remain at historically low levels of close to zero per cent is largely irrelevant. Only the relatively small proportion of borrowers who were lucky enough to have opted for a 'tracker' rate linked to the Bank of England base rate should worry about the direction of base rates rather than longer dated Gilt yields.

However, it is the new issuance of Gilts by UK, European and US authorities in order to fund a huge economic stimulus programme that is likely to have the most interesting impact on mortgage interest rates in the next few years. The simultaneous raising of debt by large numbers of countries may well translate into phase 2 of the crisis. Early attempts to raise new debt have given some indication of the problem that may soon arise as the funding ‘blitz’ moves into top gear as the year progresses. Currently, buyers of the new gilts are accepting historically low interest rate returns given the ‘risk free’ nature of the asset. In the near future it is distinctly possible that asset managers will seek higher returns particularly if they believe that economic growth will soon return. They will then seek to invest in riskier asset classes for example; stocks and shares to improve their returns. Ultimately they will demand higher interest rates on any Gilt purchases especially as supply reaches its peak over the next twelve to eighteen months as Governments around the world seek to take on vast amounts of medium and longer term debt to fund their stimulus packages.

There is no doubt that a ‘buyers strike’ i.e. a refusal of institutions to buy up new debt unless compensated by attractive rates of return, will result in substantially higher interest charges for mortgage borrowers. This would have a major implication for house prices and be likely to create further downward pressure. Those with a vested interest in the housing market returning to ‘boom’ times will deny that residential property prices remain grossly overvalued despite recent price falls. A glance at all the key historically reliable metrics, especially the crucial average price to average income ratio tells a different story. A thirteen year housing boom between 1995 and 2007 based on lax lending and cheap money have left their mark.

Will house prices and therefore affordability return to 3-3.5 time’s average price to average earnings? Yes, it is simply a question of time. If mortgage interest rates stay where they are it seems likely that the correction will take place over a long period of time. For example; if prices were to fall say 8% in 2009 and not grow at all for ten years then the ratios will be back in line with historical norms. However, if mortgage interest rates rise significantly in the near future as debt issuance peaks, house prices will drop back sharply just in time for the next election!