Property – a ticking time bomb?

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Property engenders much emotion, we look at whether or not it is potentially over-valued and how endemic this is globally.

The 2020 United States Census Bureau revealed that US households had 64% of their aggregate wealth (after debt) in home equity and retirement accounts. 44% being exposed to pure property both primary and rental.

Between 1940 and 2000, home ownership went through a revolution, which researchers refer to as ''the great mortgaging''. American home ownership rates rose from 45% to 70% and in Britain, from 30% to 70%. This theme became pervasive across the world.

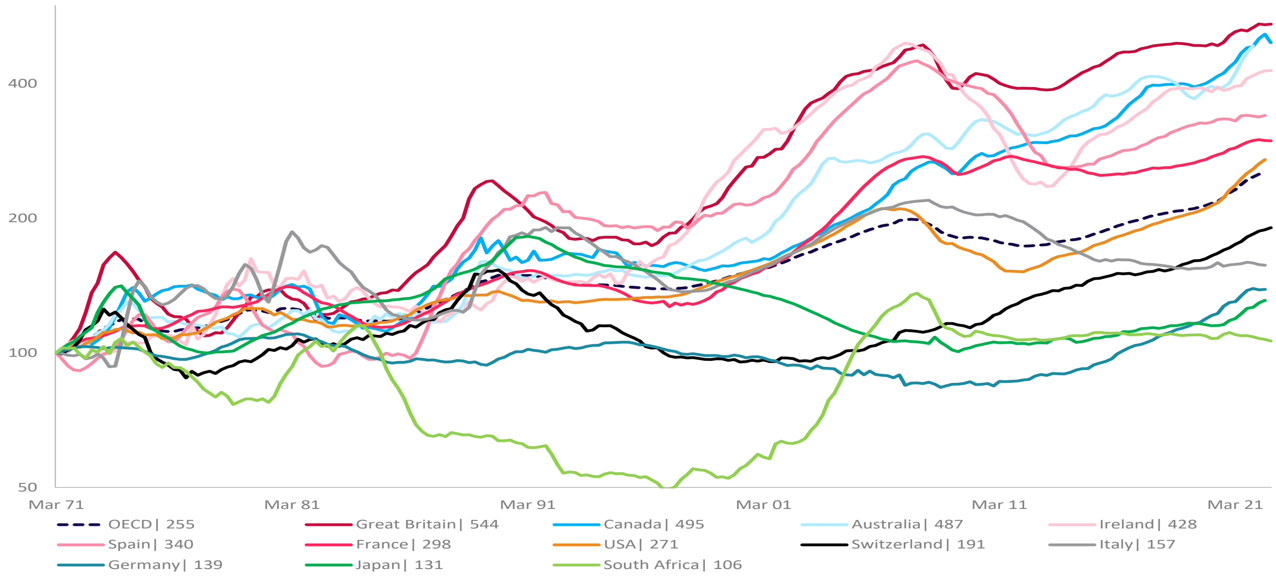
Considering its significance, residential property is key to consumer confidence and thus consumption (OECD - 60% of GDP), which in turn is key to economic growth. Bear in mind that the globe has entered a new era of elevated inflation and subdued growth.

We briefly highlight the pending risks to the global residential property market, and compare these versus the 2008 bust. What should we be worried about?

Excessive price gains

Not all residential markets have grown equally due to idiosyncratic factors including property stock levels post 2008, unique central bank interest rate policies, and emigration trends. With that said, most markets have experienced rapid home prices growth since the GFC, and price gains further accelerated through Covid. The attached graph shows how real house prices have moved across various markets over the decades.

Chart 1: OECD Real House Price Indices



Source: OECD Website (https://data.oecd.org) (as at 30 September 2022)

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Rising interest rates – two concerns here

The first is the extent to which mortgage rates have risen in the past 6 months. A US 30-year fixed term mortgage in early 2021 would have cost a mortgage holder under 3%, and this is now closer to 7%. Rates were last at these levels in the early 2000's.

Chart 2: Freddie Mac – US 30 Year Fixed Rate

Source: Bloomberg (as at 30 November 2022)

To appreciate the impact on a US household's cash flows, we modelled this change and monthly payments would have increased significantly by 44%. More concerning is that mortgage originators allow mortgage payments to be as much as 45% of total income. At 3%, this homeowner's original monthly mortgage payment accounted for 45% of her income, assuming static income, at 6.7%, the mortgage is 65% of her income.

Table 1: A typical American household's mortgage repayment

		3% (2021) 30-year fixed mortgage rate	6.7% current 30-year fixed mortgage rate
House price	$400 000	$1632 monthly	$2342 monthly
Down payment	$80 000		
Period	30 years		
Monthly payment		$1632	$2342

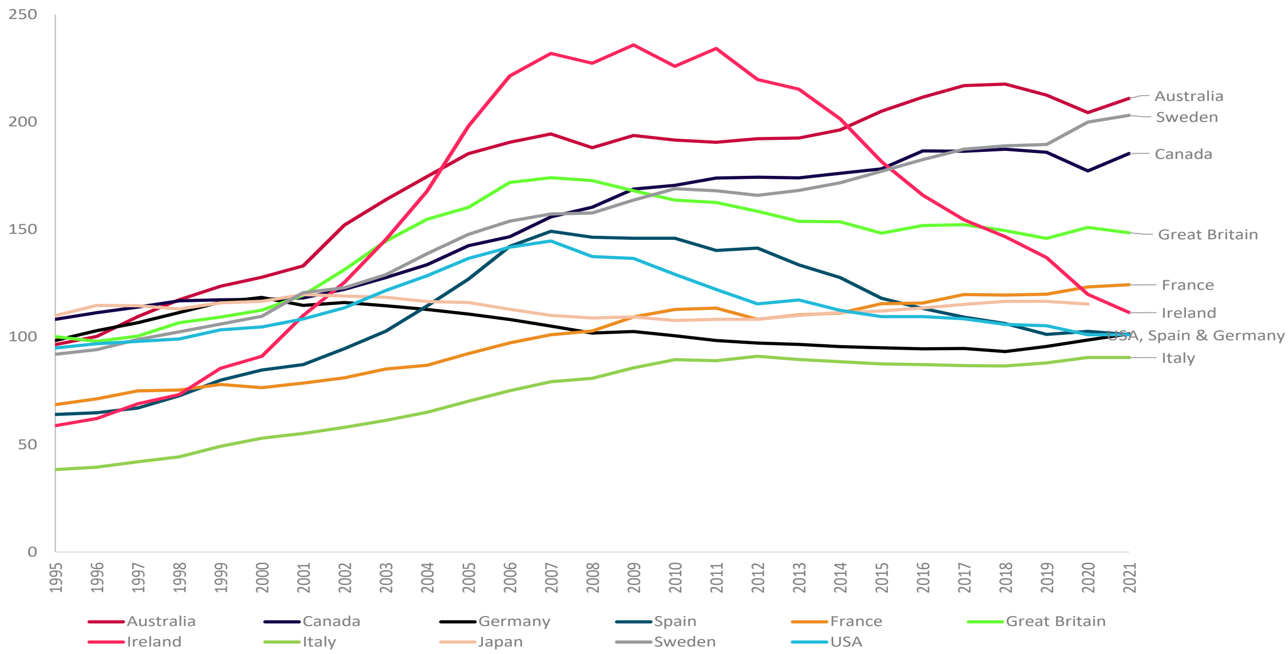
Source: US online mortgage calculator

Secondly, in many markets, a decade of very low and declining interest rates lured home buyers into variable interest rate schemes. In those markets more inclined for fixed rates, a significant percentage of these are due to reset within the next few years. In the UK for example, according to The Economist, 50% of fixed mortgages taken-out in 2021, will reset in 2023/2024. This makes mortgage holders highly susceptible to higher interest rates.

Household debt

Since the GFC, households in Northern Europe, Canada and Australia have grown their debt levels to the point that they are currently double their net disposable incomes. Fortunately, and this is the silver lining for the global property market, household debt levels are much lower in the US, Spain, Italy and Ireland. Consumers here clearly learnt past lessons, as these markets were at the epicentre of the previous housing market crash in 2008.

Chart 3: Debt to disposable income

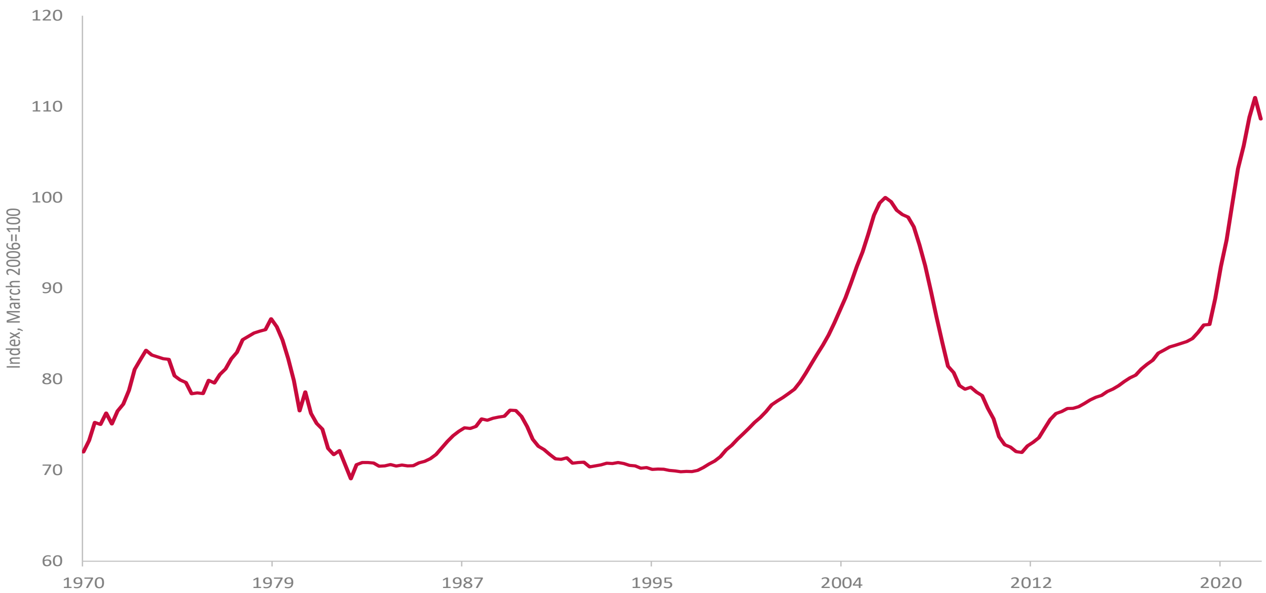


Source: OECD Website | https://data.oecd.org/hha/household-debt.htm (as at 31 December 2021)

Affordability – renting versus buying?

A natural tension exists between the cost of owning versus renting, these forces should, over time, keep property prices in check. But distortions are apparent and presently, the affordability index (see attached, the USA market as a global proxy), clearly indicates that prices relative to rentals are at all-time highs, in fact, at levels which last precipitated a housing collapse.

Chart 4: Index of the OECD U.S. House Price-to-Rent Ratio



Source: Bloomberg (as at 30 September 2022)

At the end of 2021, our Northstar Market Report was dedicated to explaining our concerns around developed market equity valuations – they were too high. Unfortunately, we end 2022 with another warning – bubble-like property markets in Northern Europe, Australia, and Canada.

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