Market Update October 2016

COMMENTARY:

Inflation set to rise.

But moderate inflation is good for the economy.

Provided it is expected and can therefore be managed.

If the US raise rates, BOE hand may be forced.

If this happens, watch out for increased mortgage rates and take action now.

However, property usually performs well in an inflationary environment.

We still have large need for additional housing

"*Slow growth and Inflation have a tendency to accompany large deficits and increasing debt as a percentage of GDP*". Bill Gross (ex-Co-Founder of PIMCO where he managed the firm's $270bn Total Return Fund)

With the slide in value in sterling, and yesterday's increased inflation forecast, this commentary will look at inflation and the effect on mortgage rates, and the property market. **Property tends to benefit from an inflationary environment provided mortgage balances are kept in check**.

Inflation is the rate of increase in prices for goods and services. The effect of inflation is to erode the value of your purchasing power. In a 12 month period where we might see 2% inflation, the purchasing power of your £1 today will be 98p in 12 months' time if you do not invest it. Whilst this may sound terrible, it's actually good for the economy. **Moderate inflation means that people and businesses need to make their money and assets work in order to generate an income to counter the reduction in value of money over time**. This drives investment, liquidity (as people are more inclined to transact to make money) and economic growth.

We do however need to differentiate between expected and unexpected inflation. The Bank of England has an annual 2% inflation target which it would hope to achieve through careful monetary policy. Our current situation may not be unexpected in so far that whilst we know the economy is in poor shape – the twin deficits (balance of payment having increased by £1.2bn last month) and high public sector net debt adding pressure – **Brexit was the catalyst that drove the fall in sterling**. This has resulted in an unexpected uptick in prices of raw materials which will be introduced to consumers over the next few months. Dependent on the increase in inflation, **there is an increasing chance that the Bank of England could raise rates**. Mr Carney may not do this for a while as a weak pound helps exports, and our economy is not yet ready for a rate increase, **but his hand may be forced if the USA increase their rates** (expectations of a December hike increasing, moving bond yields higher) pushing up the cost of much of the raw materials that we use (Oil for example), **quickly adding to inflationary pressure in the UK**.

What does this mean for property? **We are in a very low rate environment and as we have maintained for over a year, there is only really one way for mortgage rates to go: up**. There is already a 66% difference between the Halifax Home Owners initial 2 year rate and the standard variable rate and with so much pressure on mortgage rates (regulatory, governmental and now inflationary), we believe that home owners should take financial advice and consider beginning to either pay down their debt or re-mortgage into a longer term fixed rate product. Whilst the value of long term debt is usually eroded through inflation the cost of servicing the debt will increase, particularly in a low-wage inflation environment. This means less disposable income.

Property is an interesting investment class as it could be considered as a deflationary asset – a home produces no revenue and acts as a block for a large amount of money which is not being invested or used to grow the economy. In most countries, annual taxes generate revenue from property and as a consequence the asset is revalued upwards for tax purposes, at least in line with inflation. However, in the UK we have had property price increases above the very low rate of inflation due to both domestic and international demand and whilst we might expect a reduction in international buyers as a result of the reduced immigration from the EU, we are still building 100,000 fewer homes per year than we need. CNTD/…

Nevertheless, a substantial equity buffer has been built up in postcodes that we have analysed suggesting UK housing market is well placed to continue to outperform inflation, provided Mortgage payments can be maintained.

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Whilst demand may outstrip supply in most of the UK's markets, we may see some price volatility in the event of an increase in mortgage rates but in postcodes where we have seen a greater pace of price appreciation than increase in mortgage debt, **homeowners have built a comfortable equity buffer against any market moves** as our table for South West London (as an example) demonstrates.

Table 1: Percentage Debt and Price Increase in selected SW London Postcodes Q2 2013 to Q1 2016.

Postcode	Mortgage Debt Increase	House Price Increase	Growth
SW2	16.53%	58.61%	42.08%
SW3	1.53%	9.54%	8.01%
SW4	21.25%	37.48%	16.23%
SW5	9.65%	26.85%	17.20%
SW6	19.42%	15.83%	-3.59%
SW7	-4.23%	18.20%	22.43%
SW8	14.72%	44.22%	29.50%
SW9	33.99%	52.65%	18.66%
SW10	8.99%	5.31%	-3.68%
SW11	16.03%	54.79%	38.76%
SW12	20.99%	43.44%	22.45%
SW13	5.43%	35.71%	30.28%
SW14	13.60%	33.96%	20.36%
SW15	14.58%	30.85%	16.27%
SW16	16.37%	46.09%	29.72%
SW17	14.98%	54.55%	39.57%
SW18	21.08%	38.59%	17.51%
SW19	11.86%	23.32%	11.46%
SW20	17.02%	21.37%	4.35%

NB – This is the latest data from the CML, Q2 2016 available 7/Jan/2016. SW8 has one sub-sector where mortgage debt has increased 229% in this period but this is not representative of the whole postcode so we have excluded it from our calculations. The CML data accounts for approx. 75% of all mortgages. Source: Land Registry and Council of Mortgage Lenders. Calculations Maskells.

We believe that the UK property market is well placed to outperform inflation, **provided homeowners start paying down their mortgage balance and or re-mortgage into a fixed rate product.**

We have written extensively about the pressures BTL Landlords are facing, particularly as a result of the staged removal of mortgage interest relief. This is an ill-conceived idea, **as the last thing we need to do is to risk reducing our private rental stock** (by making it un-economical for landlords to own rental stock) when we are not building enough homes, where Help to Buy is being re-thought and in what will become an increasingly hawkish rate environment. However the good news for our Landlords is that under a standard Assured Shorthold Tenancy Agreements there is usually a clause allowing for rent increases in the second year of a tenancy of RPI plus a minimum of 3% and maximum of 8%. **This ensures that the rental income earned will not be eroded by inflation. There are very few investments that can afford this type of protection.**

The property market should welcome a measured injection of inflation into the economy yet we find it ironic that on the one hand our government, clearly understanding the importance of trade, is rightly seeking to negotiate post Brexit international tariff agreements but on the other hand is **prepared to maintain a very high tariff on the import of foreign income into one UK asset class, in the form of Stamp Duty**. Time to rethink this tax.