The impact of negative inflation on prospective house prices in the UK

The latest inflation figures for the United Kingdom were released on 17 November 2015. According to the UK government's preferred measure, which is the Consumer Prices Index or CPI, there was negative inflation over the past year of -0.1%.

This has largely been brought about by a slowing of demand across the world for raw materials such that commodity prices are down across the board. These include copper, down 30% over the last year, steel, down by 40% - which has attracted headlines in the UK due to the impact that low prices have on UK production which depends on higher labour costs than competitors across the globe - and oil, down by 43%, which you will have noticed at the petrol pumps of course.

A quick search of movements in other commodity prices shows that prices are actually down across a range of sectors, including leather prices (down 37%), rice (16%), wheat (24%), beef (32%), shrimp (39%) and bizarrely, coffee down by 33% - I say bizarrely because Starbucks still managed to put their prices up. Bucking the general trend though, the price of cocoa is up by around 2½%! Pity, I hear you say.

Given that so many commodity prices are down by so much it's actually a bit of a wonder dis-inflation per the CPI isn't actually greater. More troubling still, the Retail Prices Index or RPI (which was the preferred inflation measure used by previous governments) is positive at 0.7% at 17 November 2015 – I can only suspect there are a number of middleman (Starbucks!) doing very nicely at this point in the cycle.

The Bank of England has a remit to try and keep inflation at around 2%, with dis-inflation/inflation so low, there appears little prospect of an interest rate rise in the near term.

With dis-inflation and a return recently to increasing pay rises (1% even this year for civil servants) this leads potentially to an increase for many in disposable income. According to research undertaken a few years ago by Robert Schiller in the US (he of the Case Schiller Index) an increase in disposable income inevitably leads to an increase in house prices – apparently if we have spare cash we are all predisposed to spend it on improving our housing position.

At the same time, with interest rates so low at 0.5% there are very few options for savers looking to make a decent return on any cash they hold, as well as a huge incentive for individuals to borrow if they think they can get a better return on that money in the medium to long term. The obvious target for both – housing.

Perhaps it is no wonder then that in the UK house prices in November were up 3.7% on a year earlier according to the Nationwide (up, but slowing apparently).

The signals are now here that despite the downward pressure from commodity prices in the last 12 months and US official inflation being at only 0.2% the US federal reserve is signalling an increase in interest rates, perhaps as soon as this month. This could herald a turn in the cycle in the UK too. As to what might happen in Europe though is still anybody's guess.

So what will happen to UK house prices if interest rates rise?

For many, with mortgage borrowing costs of around 2.5%, a 0.25% increase in the base rate will result in a 10% increase in the cost of borrowing. That is potentially significant if you have bought recently, particularly if you have borrowed to fund a buy to let mortgage and you rely on the rent to pay the mortgage. Apparently buy to let lending comprises 19% of all mortgage lending.

A rise in interest rates is not the only potential black cloud on the horizon for buy to let landlords. In the Budget Statement announced by George Osborne in July there is to be a restriction on tax relief allowed on mortgage interest relief against buy to let income and limitations on annual wear and tear allowance, both of which will increase the tax burden for many landlords. In the Autumn Statement on 25 October it was announced that from April 2016 there will be 3% stamp duty charge on all buy to let properties/holiday homes bought by individuals. New measures have also been introduced that require capital gains tax to be paid within 30 days rather than within 9 months of a tax year end.

It seems then that it is likely that during the course of 2016 if interest rates rise there will be some challenges for the housing market. It is possible though that the freeing up of pension rules will mean that some of the forces exerting downward pressure on house prices may be offset by a new wave of cash from pensioner "would-be landlords", many of whom may be immune from the effect of interest rates if they have a decent sized pot of cash to invest, albeit that will not help avoid the new 3% stamp duty charge.

With a peak in high end London prices apparently having been reached (due in part to a strong and strengthening pound and increases in stamp duty), it remains to be seen how this will play out next year, but for now it looks like a few catalysts are in place and pending that will undermine the housing market in 2016.

Note: For quoted commodity movements please see the website:
http://www.indexmundi.com/commodities