When will house prices finally crash?

In 2008, says author Fred Harrison. Here's why – and what you can do to protect yourself against the fall

"A sharp fall in real house prices is likely at some point in the relatively near future." So said David Miles, Morgan Stanley's UK chief economist, earlier this week. The former adviser to Gordon Brown believes that more than half of the increase in house prices in recent years has been driven by the mistaken belief that prices will just keep rising at double-digit rates. Once these expectations are disappointed, the market will be subject to a "sharp reversal".

As to when the crash will come, he is more vague, suggesting it could be two years away, and describing attempts at calling the top of the market as pretty "hopeless". I disagree. Look at the right data and a clear cyclical property pattern emerges. It suggests that by this time next year, the housing market could already have peaked. Let me explain.

UK property is very close to peaking

Last year, I claimed in *Boom Bust: House Prices, Banking and the Depression of 2010* that Britain was entering the final two years of the property cycle, and I still believe that's the case.

As both David Miles and Bank of England governor Mervyn King have pointed out, by almost any measure available, house prices are hugely overvalued. In fact, a recent report from Dresdner Kleinwort argues that Britain's housing market is more overpriced than at any time since 1948. The investment bank reports that the ratio of prices to disposable incomes typically peaks at more than six times. Such peaks were seen in 1948, 1973, 1988 and 2006 (see chart on the facing page).

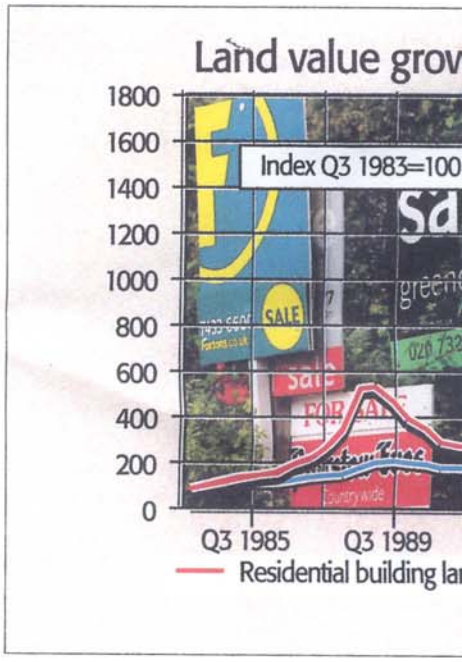
David Owen at Dresdner Kleinwort says: "There was an earlier period when inflation and interest rates were both low and the UK housing market was as expensive as it is today: the late 1940s. As in other housing corrections, house prices then fell in real terms by more than 30%. They also fell in nominal terms."

Commercial property is another key indicator of a looming crash. Property cycles terminate when the supply of highly priced premises exceeds the demand. According to Jones Lang LaSalle, the property adviser, rents in the City of London are now expected to rise to more than £70 a square foot. The last time rents achieved these levels was in 1988, just before the property market reached its previous peak.

Understandably, the UK's financial regulator is becoming concerned that banks are adopting a rather too cavalier approach to lending and disaster planning. Clive Briault, managing director of retail markets at the Financial Services Authority, warned the British Bankers' Association earlier this month that banks should now be factoring in the possibility of a 40% fall in property prices, and held out the prospect of a 35% increase in the rate of home repossessions. He pointed out that this was not a prediction – just a "severe but plausible" scenario.

And yet despite this rising tide of worry, the housing market has rarely been busier. In its latest house-prices report, Nationwide stated that in October annual house-price inflation stood at 8%. Gazumping has returned to tabloid headlines, as bonus-flush buyers outbid each other for top-end houses in London. Lenders such as Abbey National are now advancing home loans at five times people's salaries, helping to push prices towards their speculative peak. Some mortgages now offer income multiples of up to seven times salary.

But the fact is that house prices can't rise forever – at some point, people just can't afford them. The current frenzy of activity suggests a rapidly overheating market, and in fact the rise in repossessions has already begun, as overstretched first-time buyers and low income buy-to-let investors feel the strain from rising interest rates. But when will the real downturn begin?



Prices will peak in 2008

In line with my original prediction, I still expect house prices to stall early in 2008. There will be no single "trigger" event – the end will come as people realise their financial resources have been exhausted.

What makes me so sure that prices will peak in 2008? After all, even the Bank of England cannot decode the housing market – Mervyn King says he and his colleagues are unable to understand "why house prices relative to conventional earnings are as high as they are". But in fact, one leading indicator is a very reliable guide to house prices and the state of the economy: land prices.

By looking at data spanning 300 years, my research suggests that the business cycle tends to work on the basis of 18-year periods, determined by the dynamics of the land market. The major event that preceded the recessions of modern history was the rise in the share of national income paid to the owners of land. Because land is in fixed supply – and people need it for both living and working – the share of national income going to its owners must increase relative to wages and profits as demand for land grows in line with the economy.

In other words, as land, and therefore property, becomes more expensive (because an expanding economy needs more of it, while the supply is fixed), spending on property squeezes both corporate profits and the money available to pay wages. So property-price growth starts to outstrip both wage and profit growth.