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Zero Gravity

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Even Isaac Newton would have had trouble figuring out the housing market. Understanding apples is a piece of cake by comparison.

As autumn approaches, where are we on the outlook for house prices? The honest thing to say is that nobody is sure.

One of my students is writing a summer dissertation on this and was in my office last week. She showed me an updated graph of real house prices in the United Kingdom. The price comparison, or 'deflator', for her graph was the retail price index.

What emerges is a picture that since 1970 looks like a jagged repeatedly-rising-and-then-falling tidal wave of real house prices. It has a trend that is strongly up. My student's calculated index of real house prices has increased markedly over three decades – from a value of about 40 to one of about 130. Nevertheless, over this period there have been pronounced cycles. There were sharp spikes in 1974 and 1989, and a small one in 1981. Price declines followed. The fall in real house prices was especially big through the period of the early 1990s. Then real house prices peaked at about a value of 85, and fell over the next few years to approximately 60.

What will happen in 2004/5? For quite a while I have been gloomy about the future of house prices, and I still am. So far, my fears have been proved wrong. In various newspaper columns and media interviews, I advised people to buy shares not houses. That bit of advice has turned out moderately well, because the stock market is up a lot since the Spring of 2003, but my forecasting abilities on the housing market itself have been out.

For the present levels of real house prices to be sustainable, the historical patterns in the data would have to change fundamentally, and permanently. In terms of my student's graph of prices, the upward sloping cycle would suddenly have to level off at its highest-ever plateau, and then run flat. This would be like climbing the Himalayas and getting to Mount Everest and then discovering that just over the peak there was an enormous plain that ran and ran and ran. I have never known the historical patterns in any market's data to change in such a way.

Let's try to be two-handed.

If you want to be optimistic about house prices, and are reasonably balanced, what kind of argument should you make? You should argue that the market will gently cool; it will start to run flat in nominal terms; selling prices might drop fractionally but not much; house sellers will stay calm over the next five years; real house prices will fall quite a lot, courtesy of inflation, but in cash terms nobody will lose huge sums on their homes.

If you want to be pessimistic about house prices, and are reasonably balanced, your options are darker but not crazy. A BBC survey recently found that almost a fifth of people think that house prices will fall by more than 10%. You should argue that what will happen is that the fizz will run out of the housing market and worry will set in; fairly big house-price drops will be necessary to shift homes in certain areas; Wales and Yorkshire may be OK but things will be less cheery in London and the south; some people will run into negative equity and there will be a contagious fall in confidence.

There are no certainties. I tend to a version of the latter view. But, at the time of writing, that damn apple just will not drop.