The drivers of house prices revisited

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The normal short-term factors that drive house-price inflation are economic growth (real growth in disposable household income) and interest rates, as both affect affordability. Economic growth also tends to create new jobs, which boosts the demand for housing, and if the supply side (new developments) cannot keep up, prices accelerate. In a booming economy, this lag time is a real problem as the gestation period of new residential estates is about four years.

A long-term driver is construction costs. The reason for this is the substitution principle. If the prices of existing houses rise to levels where it is cheaper to build new, the potential buyer might choose the new build. Thus, the cost to build new keeps the prices of existing stock in check.

Exceptional factors that could affect house prices are migration and the insistence by some municipalities on inclusionary (low-cost) housing in higher-priced developments. These factors are wildcards and are not contained in our forecasting models:

- Migration of well-qualified people to a country or a city when the supply of new houses cannot keep up with the influx. Cape Town experienced this phenomenon towards the end of the Zuma era as a result of ‘semi-migration’ from the rest of the country. On the western seaboard of North America and in some Australian cities (to mention a few successful conurbations), Chinese buying properties have had a similar effect. However, in this instance, it was mostly money that migrated, not people, and this has now come to an end.
- The City of Johannesburg has already, and the other major cities are planning to implement policies that would force developers to include low-cost housing in their middle-class developments. As always, the devil is in the detail, and unless such policies are carefully crafted, it has the potential to disrupt the supply of new houses, which would eventually create a scarcity of middle-class housing. This would of course make existing housing more expensive.

Interest rates

Above we mentioned interest rates as a ‘normal’ driver of prices. They can be modelled and can impact house inflation in two ways:

First, when interest rates are ultra low in absolute terms through financial engineering – as many countries have had since the Great Crash in 2008 – affordability is greatly boosted, resulting in an artificial boom in prices, even though the economy might be showing pedestrian growth. Should interest rates be normalised to more sustainable levels one day, imagine what that would do to house prices and other assets in those countries that now have policies of near-zero interest rates. Blood will flow in the streets, and we wouldn’t escape the fallout in SA, even though our interest rates are at sustainable levels.

Second, during periods of demand-pull inflation (as SA had during the second half of the 1970s and 1980s), interest rates are generally low *relative to* consumer and house-price inflation, which makes financial gearing very profitable. Thus, the home investor builds capital as the capital return (through fast-rising prices), together with the income return, outpaces the interest cost of a mortgage. This causes a self-reinforcing buying frenzy.

The interesting thing about an era of demand-pull inflation is that interest rates are at times *positively* correlated with house-price inflation (interest rates and prices rise together). The explanation for this weird phenomenon is that the monetary authorities do raise interest rates to combat inflation, but not fast enough. Thus, financial gearing stays positive (creating capital financed by the 'cheap' money of the mortgage lenders). This happened in South Africa when the Reserve Bank wasn't independent from the government and the government, in the precarious political situation of the time, wasn't prepared to face the political fallout of rising interest rates. This explains why the independence of the Reserve Bank was written into our Constitution.

Demand-pull inflation can be described as too much money (created by the central bank) chasing too few goods in a fast-growing economy. This allows retailers and other role players in the economy to get away with price increases that would otherwise not be feasible. People who were adults during such a period tend to have a firm belief in the infallibility of bricks and mortar for the rest of their lives. They would say things like: If only I had bought property x when it was on the market for R500 and look what is the value now! This type of argument ignores factors like the cost of financing and holding costs like property taxes, insurance and maintenance and how well a substitute (ungeared) investment (like shares) would have done.

In contrast, cost-push inflation is caused by increased costs of production (increased labour costs, increased costs of raw materials). Furthermore, a weakening rand hikes the prices of not only imported goods but also the prices of locally manufactured goods via import-parity pricing (the prices of locally produced goods tracking the prices of imported goods).

This is the type of situation in which South Africa finds itself in 2019: We are not in a fast-growing economy and the Reserve Bank is following a sensible monetary policy (no cheap money). Thus, the prices of new builds (the substitute mentioned above) are largely driven by the cost of building materials and labour. For investors, this is no recipe for getting rich quickly.

About location

Location does play a role in the value of a property. A brick put down in an upmarket suburb adds more value than the same brick put down in a downmarket area. Similarly, being close to an informal settlement is not value-enhancing. However, when buying an existing home, this negative should be priced in already. The same applies to a house next to a busy street or in a crime-ridden area.

There is no scientific evidence that closeness to a cellphone mast or high-voltage power line affects health. However, in the marketplace, it is the perception that counts.

About ageing and changing tastes

Fashions come and go, and this also apply to the layout, building materials and finishes of a property. When I bought a townhouse (erected in 1982) 15 years ago, my daughter, when seeing the bathrooms for the first time, exclaimed: Oh, it's so 1980s!

Thus, houses age like everything in the universe. For this reason, a valuer cannot compare the price achieved by a 30-year old house with a 1-year old home without making an adjustment for ageing.

I suspect that pools have become less popular in Cape Town after the drought that ended in 2018. In fact, rigorous research I did in 1989 in Bellville showed that a pool did not add any value, even then! A possible explanation at the time would have been the short swimming season in the Cape combined with the hassle and cost of maintaining the pool. But then again, teaching your children to swim is highly commendable.

As a matter of interest, architectural style does not add or subtract from value. The explanation is that what is horrid to one potential buyer is acceptable or even pleasing to another.

About adding a granny flat

When contemplating adding to your existing house, the first rule is to be compliant with the municipality's bylaws. Submit plans and don't take shortcuts. But beware of overcapitalizing (creating a house that cost too much given its location).

Adding a granny flat to a house on a large stand could be profitable as the stand is free and the renting of granny flats is growing in popularity. In addition, municipalities like them because they densify the urban space. ◇

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