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Economic Research:

Advance Signals From Europe's Housing Markets Point To Steadying Prices--For Now

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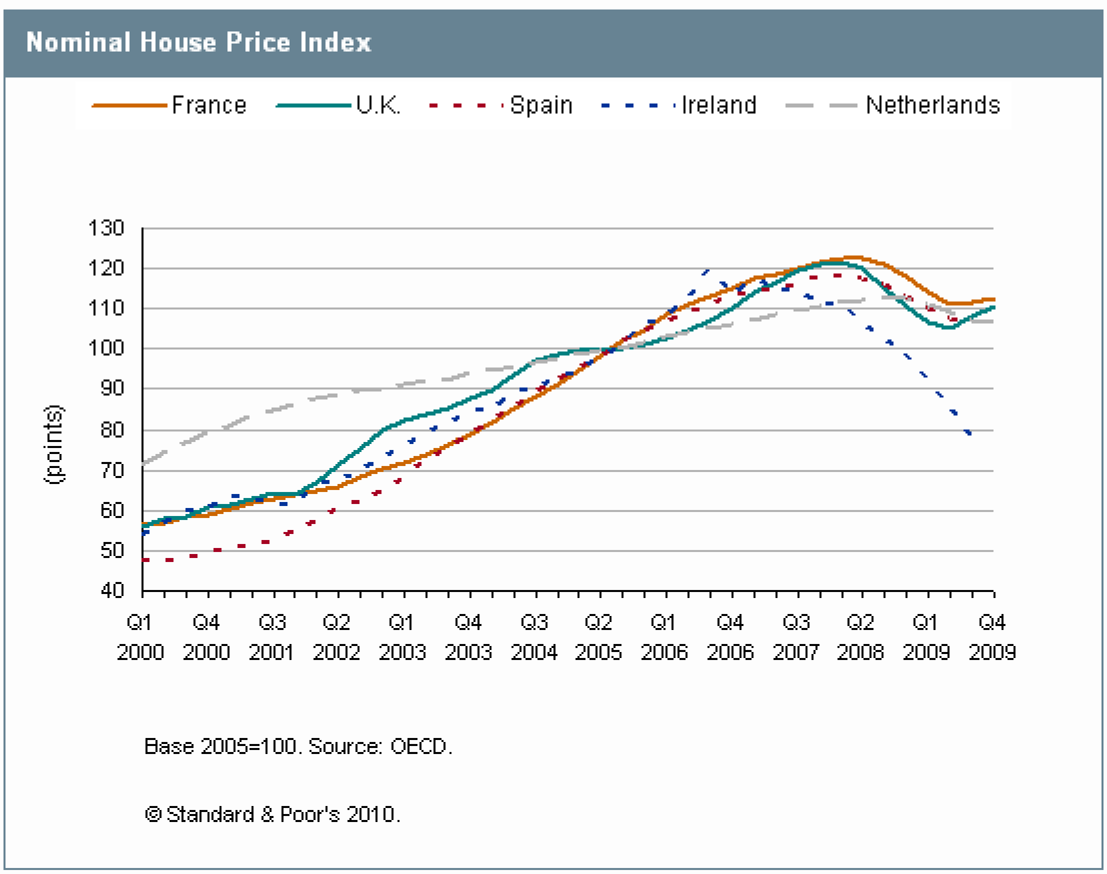
The good news is that European housing markets are generally showing signs of pulling out of the recent price correction. With the exception of Ireland, the price slump has slowed in many countries, including France, Italy, Spain, and The Netherlands. And in the U.K., house prices began heading up last year in November. However, following upwards of a decade of fast house price growth in Europe, Standard & Poor's questions whether the correction that started in the final months of 2007 is really over.

Are European Housing Markets Still Overvalued?

Nominal house prices continue to exceed 2005 levels, Ireland excepted (see chart 1). To us, this suggests that we may not yet have witnessed a full correction of some of the imbalances that the 1999-2007 housing bubble created, such as decreasing affordability or surging price-to-rent ratios. If so, we think prices could take a second dip later this year or in early 2011.

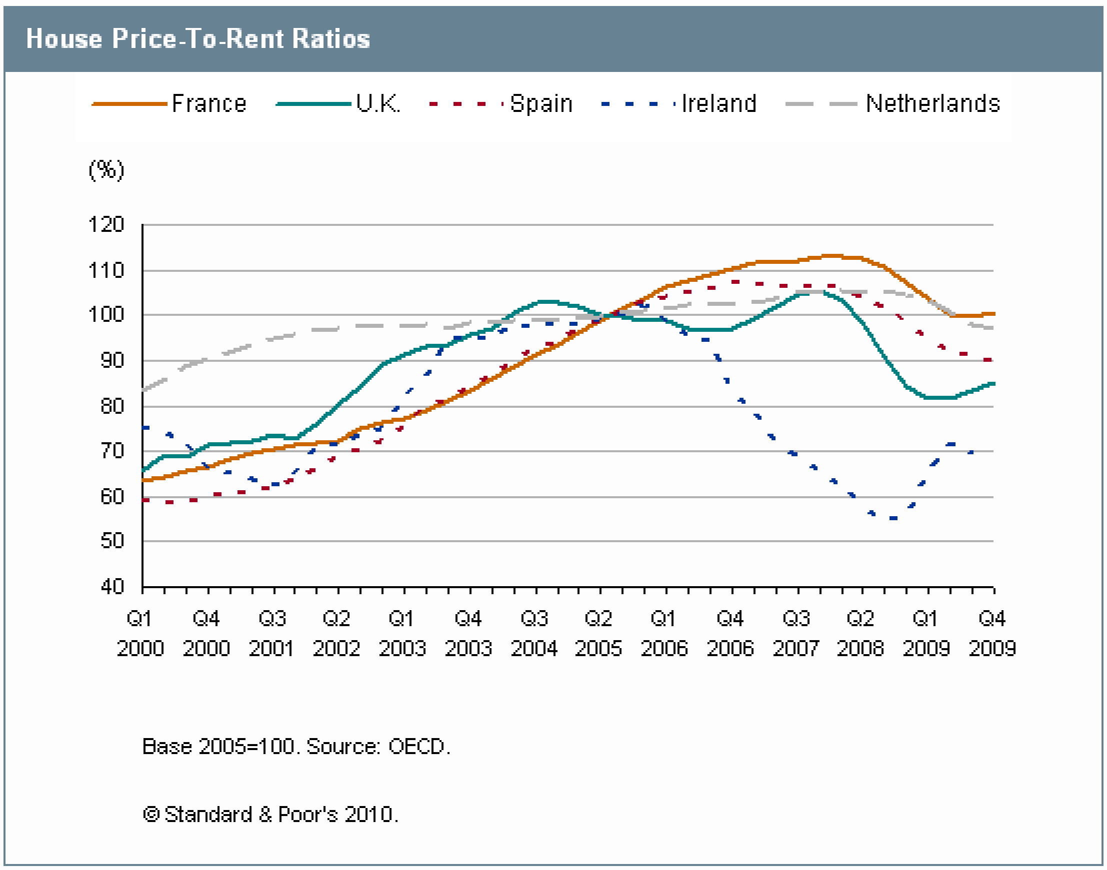
Chart 1



To evaluate what state housing markets are in, we typically look at structural factors and various market indicators. As we examine individual markets, we first study structural factors, meaning essentially the balance between demand for and supply of dwellings. We then review market indicators, including price-to-income ratios, which measure affordability for typical buyers, and price-to-rent ratios, which aim to assess expected yields for buy-to-rent investors.

Marked drops in price-to-rent ratios have occurred since the beginning of the market downturn in 2007 (see chart 2). Ireland's plunge stands out, falling to below early 2000 levels. France's so far softer downtrend, on the other hand, suggests that this market is still overpriced for buy-to-rent investors.

Chart 2



In order to assess in greater depth whether the price correction has now fully erased the excesses of the last bubble, we have compared current price-to-rent and price-to-income ratios with their long-term averages from 1997 to 2009. The result provides an overview of the markets we perceive as currently over- or undervalued (see table 1).

Table 1

Over(+)/Under(-) Valuation In Europe's Main Housing Markets

Difference between long-term averages and latest values in %

(%)	Price-to-rent ratio	Price-to-income ratio	Average of the two
France	20.0	17.0	18.5
U.K.	5.0	21.0	13.0

Table 1

Over(+)/Under(-) Valuation In Europe's Main Housing Markets (cont.)			
Spain	13.0	12.0	12.5
Italy	12.0	12.0	12.0
Switzerland	7.0	16.0	11.5
Netherlands	6.0	8.0	7.0
Ireland	(4.0)	(20.0)	(12.0)
Germany	(11.0)	(14.0)	(12.5)

Sources: OECD and Standard & Poor's calculations.

By both measures, the German market appears undervalued, which is not entirely surprising given that it did not take part in the housing boom that lifted--possibly too far--the other European markets shown. A look at those markets that seem to still display signs of froth shows that France firmly leads the pack on the overvaluation side, based on both indicators. We note that the French housing market decline has been relatively modest since the beginning of the correction, slipping only 8% between the peak in the first quarter of 2008 and the fourth quarter of 2009, after a 118% gain during the previous eight years.

The U.K. picture is more puzzling: The price-to-rent ratio suggests that the market is close to its long-term average, but the affordability ratio points to a large overvaluation at 21%. In our opinion, this could mean another correction in the offing. We note though that the long-standing excess demand for dwellings in the U.K. helps explain why rents are moving up while prices fall, which could either postpone or soften any future correction.

Spain, meanwhile, still has a ways to go: On both of our measures, the correction could erase another 12% of prices before the market regains long-term equilibrium. In contrast, Ireland's ongoing correction seems overdone: The market appears undervalued by about 12% by our calculations. Consequently, the steady fall in Irish house prices could look surprising, but the oversupply of dwellings may explain this. Lastly, the Dutch market appears close to being balanced. Its price rises were not as strong as the jumps of its neighbors after 2000.

France: Has It Hit Bottom Already?

Recent trends in French house prices suggest that the housing market could have already turned the corner. According to FNAIM, the French Real Estate Federation, prices rose 1.8% year on year in the first quarter of this year following a 2.2% rise in the final quarter of 2009. Home sales picked up in the final months of 2009 to reach 575,000 for the year. This is about 30% below the peak in the middle of the past decade but still indicates that the market remains active.

Several factors may explain this rebound. First, the French housing market suffers from a lack of supply. According to market professionals, housing starts amounted to about 280,000 in 2009, compared with 370,000 in 2008, already 15.7% lower than the previous year. This worsening deficit in housing supply contrasts with demographic and sociological trends that would require an average 500,000 housing starts per year. Second, the residential real estate market continues to benefit from favorable fiscal policies. Of the 575,000 transactions in 2009, 150,000 benefited according to FNAIM from public aid in the form of zero interest rate loans (designed for lower-income households). Third, steadily declining interest rates have helped potential buyers. According to the French observatory for financing in residential housing markets (Observatoire du Financement des Marchés Residentiels), average rates for housing loans were 3.48% in April, down 167 basis points since November 2008.

While some of these features, especially short supply, are here to stay, we believe that it is premature to expect a sustainable upturn in the market. The French market remains overvalued, and the recent correction was not enough to offset the previous deterioration in affordability. According to the Observatoire du Financement des Marchés Residentiels, the price-to-income ratio averaged 3.76 years in the first quarter of 2010, marginally down from 3.82 years at the end of 2007. What's more, the ratio began rising again at the beginning of 2009.

Another reason to remain cautious on the housing market outlook is the French economy, which we see locked in slow growth until the end of 2011. This leaves little hope for a rapid decline in unemployment, which hit 9.6% in the fourth quarter of 2009, the highest rate since 1999. The French government announced in May that it will freeze public spending at its current level for the next three years. Household consumption, typically a key growth engine in France, will likely advance only modestly, in our view, during the next two years. This is because real disposable income--tantamount to consumer purchasing power--will likely stagnate this year (after last year's 2% rise), while inflation picks up gradually on the back of mounting energy prices. At the same time, we expect wage increases to remain contained. Depressed incomes spell bad news for the housing market, which relies on first-time buyers to maintain momentum. First-time buyers are typically younger households, precisely those that flat income growth particularly affects.

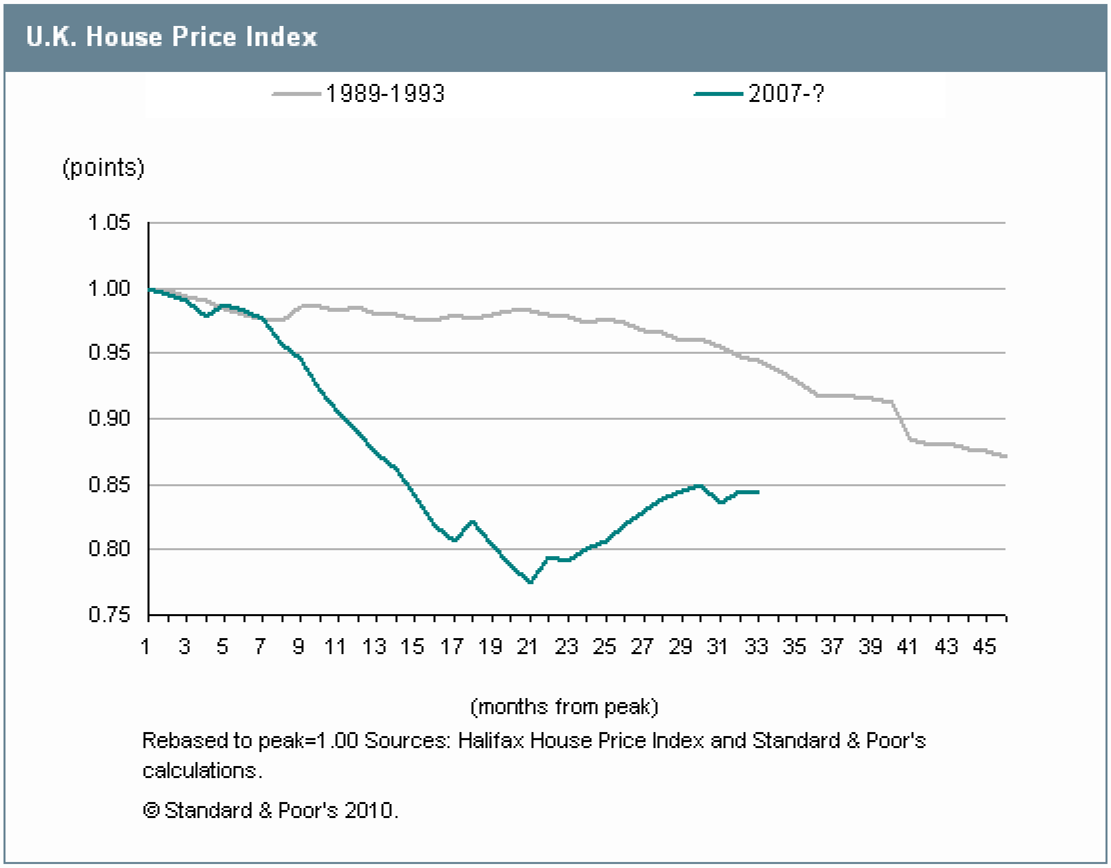
Unfavorable economic conditions and a "still-expensive" market lead us to expect house prices will hover around their current levels in the next 18 months. But interest rates could be a swing factor that takes the market down again. As noted earlier, interest rates on housing loans are currently very low, in line with government bond rates. Still, the abundant supply of bonds on international capital markets, buoyed by sovereign issues, is likely to push rates up in 2011. This potential rise would most probably be passed on to domestic borrowers. At this point, though, we do not anticipate that yields on French public debt will increase significantly in 2010. But if they were to rise, they could cause the housing market to contract again.

U.K.: An Almost Sustainable Price Recovery

Price contractions associated with the current downturn in the U.K. market are probably over for the most part, we think, but the pace of house price growth is likely to slow markedly in the coming quarters. We might even see some small price dips again by the end of the year, depending on the extent of a pick up in interest rates.

The U.K. housing market has experienced a prompt price recovery, on the heels of a sharp but short lived correction. Year-on-year prices stopped falling in October of last year, according to the Halifax house price index. Since then, house price inflation has revisited positive territory. The latest Halifax reading shows prices up 8.7% in the 12 months through April. Compared with the 1989-1993 downturn, the currently shorter correction has been decidedly steeper (see chart 3). And unlike the several years of price stability that followed the previous downturn, this time prices have bounced back up rather strongly. At the end of April, prices had already climbed 9% from the trough one year earlier.

Chart 3



We see several factors explaining this quick rebound in the short term. Mirroring trends in the rest of Europe, U.K. interest rates have plummeted. The Bank of England's base rate stands at 0.50% currently, down 500 basis points since August 2007. Buyers also took advantage of the government's stamp duty holiday on properties valued below £175,000, which expired at the end of 2009.

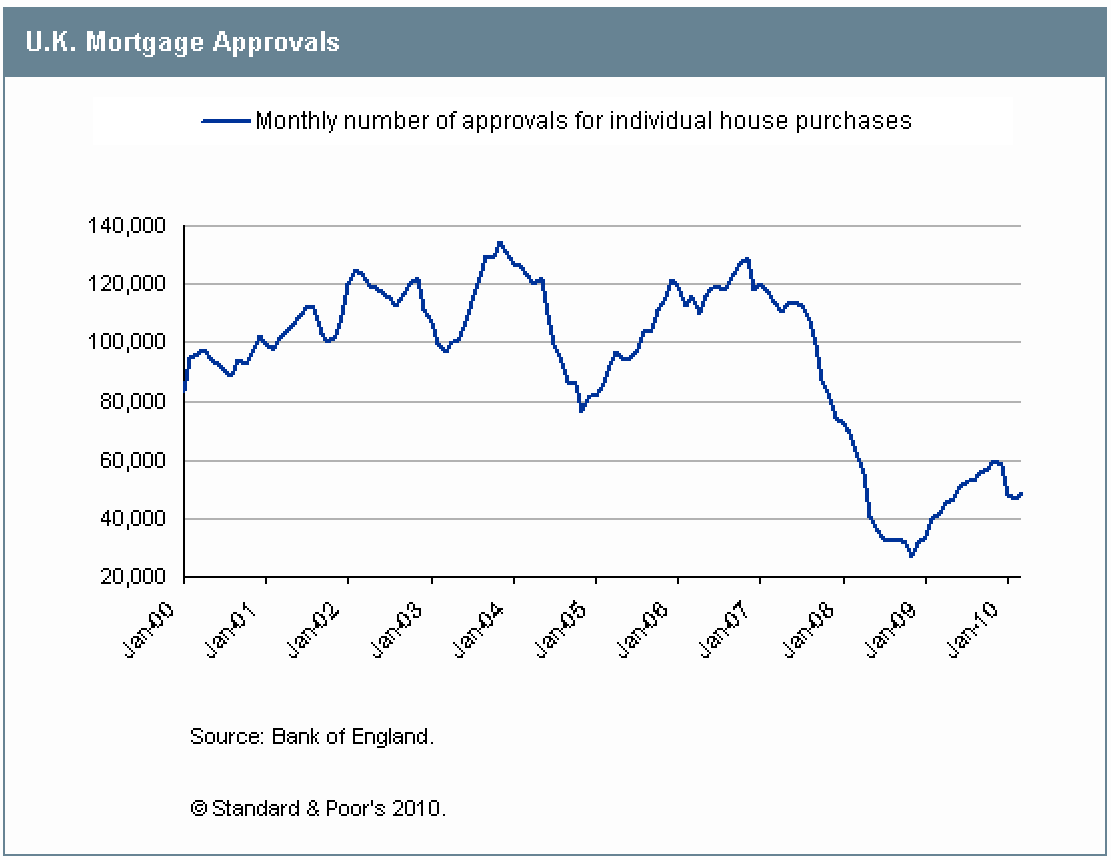
More fundamentally, the U.K. residential real estate market has suffered from a chronic shortage of dwellings, which explains the home price resilience. Market professionals estimate that housing completion should average about 250,000 a year to meet demand. This contrasts sharply with annual housing output running at about 150,000 dwellings for the past 20 years. And it has shrunk since 2008, widening the gap between supply and demand.

The characteristics of U.K. housing stock also contribute to explaining the shortage. Planning and other state controls of greenfield development and building densities tightly regulate building. At the same time, most dwellings are single-family houses. According to the Royal Institution of Chartered Surveyors (RICS), in 2000 82% of households lived in houses. Furthermore, the housing stock is relatively old: 41% of dwellings were built before 1945 and only 13% since the mid-1980's, according to the RICS.

The longevity of the current bounce back in prices remains a legitimate question, in our opinion. The market remains overvalued, albeit to a lesser extent than the French market (see table 1). House price affordability remains stretched for first-time buyers relative to historical standards. RICS data suggest that the house price-to-earnings ratio for first-time buyers stood at about 4.3 years of earnings in the final quarter of 2009, versus the long-term average of 3.4 years.

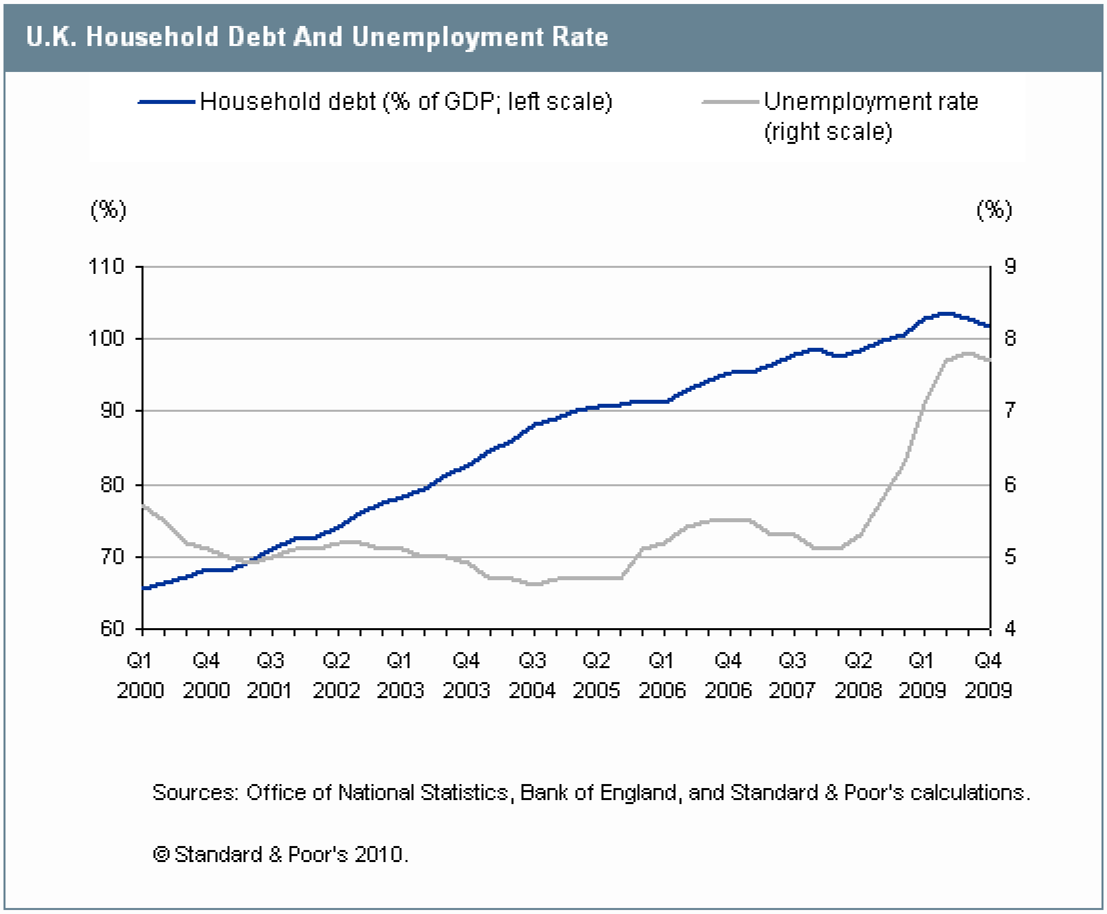
Housing transactions dropped in the early part of this year, which admittedly could be a counter effect of the end of the stamp duty holiday. The government's recent announcement to raise the stamp duty exemption threshold to £250,000 for first-time buyers may lift transactions again in the coming months. But prices have stabilized since the beginning of the year. Mortgage approvals have also pulled back--to remain at historical lows--after rising in 2009 (see chart 4). Mortgage approvals typically constitute a reliable leading indicator of price movements three to six months ahead.

Chart 4



Economic fundamentals are also unlikely to help keep house prices up. Household debt remains elevated, although it has started to drift down in the past three quarters, and the unemployment rate is at its highest since 2000 (see chart 5).

Chart 5



Furthermore, we think uncertainties about the future direction that fiscal policies could take are incentives for consumers and potential homebuyers to adopt more prudent stances. Standard & Poor's currently estimates that U.K. general government debt will rise to 77% of GDP in 2010. Finally, we believe an interest rate hike seems most probable by the end of this year or early in 2011, putting an end to the current period of exceptionally low interest rates.

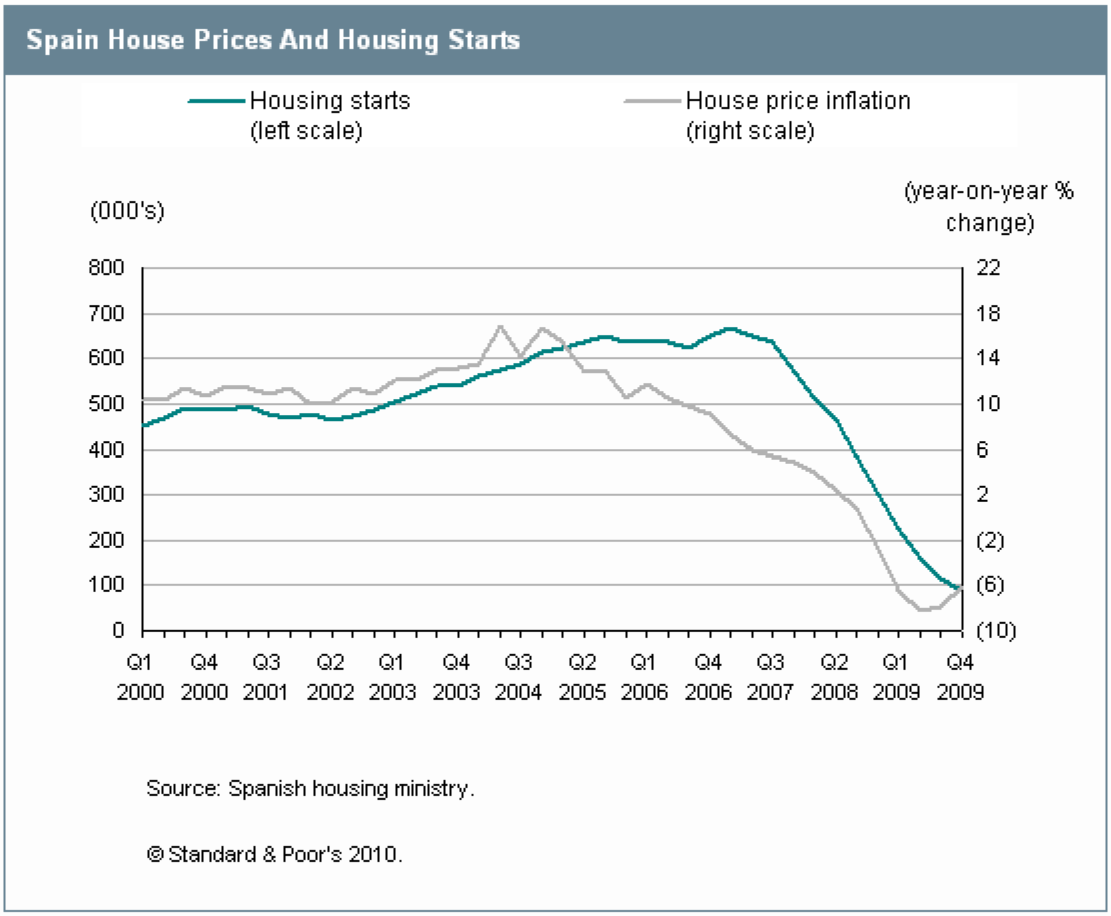
Spain: A Halt In The Free Fall

We see signals that the Spanish housing market free fall is nearing a close, although conditions are still fragile. The pace of price declines has ebbed; according to official figures, house prices were down 6.1% year on year in the final quarter of last year, after shedding 7.8% a quarter earlier. Tinsa, one of the largest property valuation firms in Spain, estimates that prices were down 5.3% in the 12 months to March 2010, compared with 6.6% in December 2009. According to Tinsa, house prices plunged no more than 16% from peak to trough, which is much less than in the U.K. or Ireland.

We think the massive supply overhang for dwellings could have caused an even steeper fall in prices, however. According to the Spanish Ministry of Housing, after averaging 250,000 per year in the 1990s, housing starts shot up to 500,000 in 2003-2005 to peak at 760,000 in 2006 (see chart 6). This figure exceeds the housing starts of

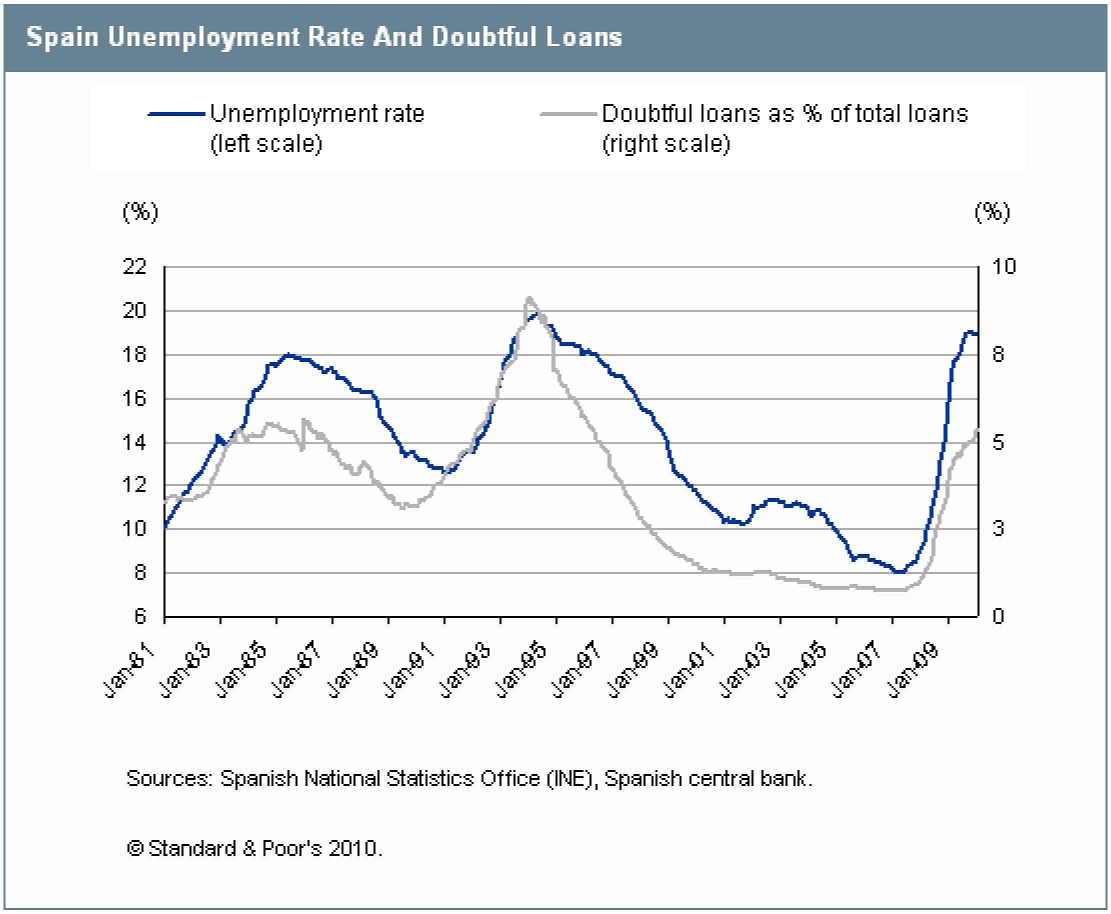
Germany, Italy, France, and the U.K. combined for the same year. Following the collapse in demand, unsold homes totaled about 600,000 by the end of 2008, according to the Spanish Association of Promoters and Developers. But other estimates point to an even bleaker picture. Spanish bank Banco Bilbao Vizcaya Argentaria, S.A. calculates that excess supply represented about 1 million dwellings at the beginning of 2009. Given the annual change in new households down to about 300,000 currently, it will likely take several years to absorb the glut.

Chart 6



Meanwhile, economic fundamentals continue to be unfavorable. This particularly affects the labor market, in our view. Since the onset of the recession, the Spanish economy has lost 1.8 million jobs, or 9% of the total workforce, based on data from the Spanish national statistics office. The contraction represents 55% of all jobs lost in the Eurozone, although Spanish employment represents only 13% of the single currency area total. National statistics show that jobs in the construction sector alone shrank by 870,000. Yet employment in this sector still amounted to 9% of total employment at year-end 2009 (down from 13% at the end of 2007), well above levels in other European countries, such as 7% in France for instance, suggesting that further adjustments may be on the way. Overall, the jobless rate for the whole economy stood at 19% in February. This severe deterioration has translated into a rise in the share of doubtful loans in total bank loans to 5.4% (see chart 7). But that is still short of the 9.1% observed in February 1995 during the previous economic downturn.

Chart 7



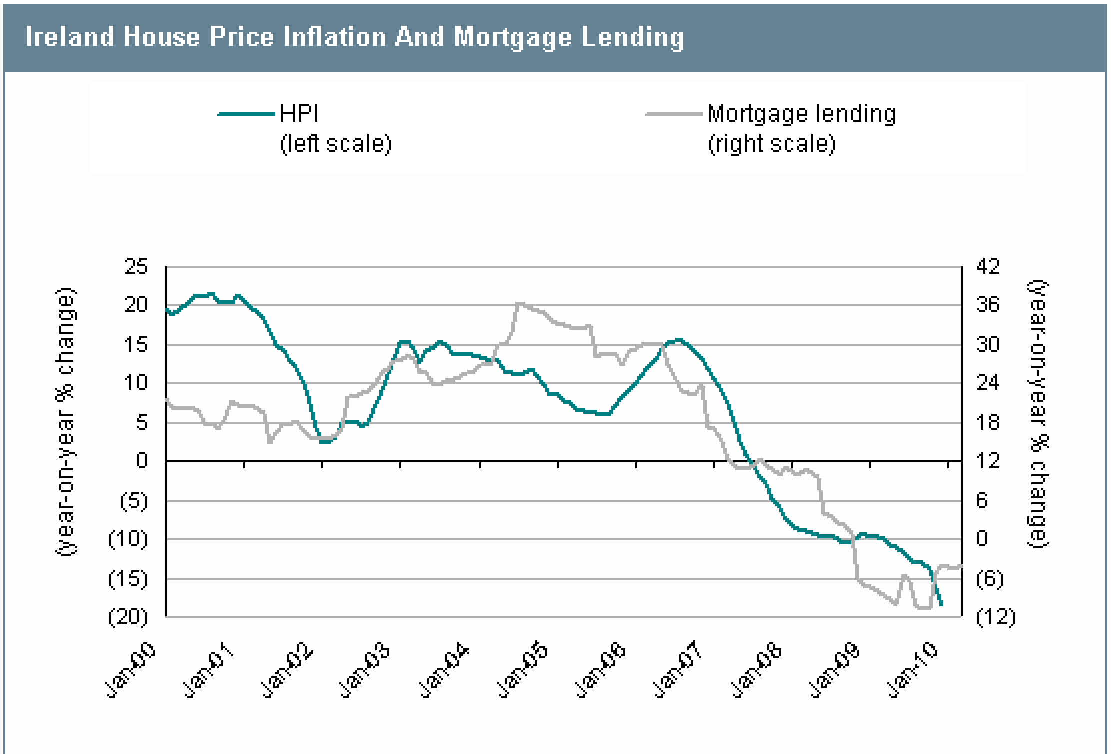
We think the adjustment in the housing market will likely continue for at least another year. And we expect the Spanish economy to remain in recession this year, with real GDP declining 0.6%, before picking up gradually to 0.8% growth next year. The pace of declining house prices will likely continue to ease, we believe, but it will take at least another year before the market achieves sustainable stabilization.

Ireland: The End Is Not In Sight

In contrast with other European markets, Irish house prices are continuing their pronounced fall. The latest reading of published prices shows an 18.5% decline in the 12 months ended December 2009. And even worse, month-to-month declines have gathered momentum. Prices narrowed 3.3% in December, the biggest monthly contraction since the beginning of the downturn in March 2007.

Fundamentals driving the Irish market have nevertheless improved dramatically (see table 1). The market appears undervalued today compared with long-term historical averages. The sharp drop in mortgage rates, to 2.65% at the end of last year from 5.5% a year earlier, according to the Bank of Ireland, has boosted affordability. This means that new mortgages cost on average €1,000 a month to service, more than €600 less than a year earlier. Yet mortgage lending has continued to shrink, although at a slower pace in the first few months of 2010 (see chart 8). This suggests that demand for housing is likely to remain very weak.

Chart 8



Sources: ESRI and Permanent TSB, Central Bank and Financial Authority of Ireland.

On the supply side, house completions continue to fall. They amounted to 26,420 last year, according to the Irish Department of the Environment, compared with 51,724 a year earlier and 93,419 at the peak in 2006. Figures for the first quarter of 2010 point to a continued slowdown; completions totaled 3,759 or almost half the year-earlier number. But signs of excess supply persist. Rents--those factored into CPI--were still down 13% in the 12 months to March, after a 30% decrease in 2009.

We think the economy will likely remain unsupportive for another year at least. After contracting 7.1% last year, we anticipate GDP will narrow 0.5% this year before bottoming out next year. With unemployment hitting 13.6% in April, consumers will likely remain cautious on the back of fiscal tightening by the government. The savings rate climbed to 11% last year, according to Bank of Ireland estimates, from less than 3% in 2007. All these factors lead us to expect another year of falling housing prices, shedding perhaps as much as 10% before the market troughs in 2011.

A Second Dip In Prices Isn't Out Of The Question

To be sure, the housing bubble and its aftermath have had a significant impact on economies across Europe. And, not surprisingly, the most overheated housing markets--those in Spain and Ireland among them--seem to be lagging in the recovery. For now, however, prices seem to be steadying in most economies. But even those countries that are seeing a rebound in housing prices are by no means out of the woods yet. And a second dip in prices remains a possibility in several markets, either later this year or in early 2011.