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Interest rates low for longer: forecasts revised up

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- **Valuations hit new record after sharp price surge**
- **Prices driven up by low interest rates and supply shortage**
- **Government moves to accelerate new-build construction**

The housing market is hot. Prices are rising fast and are back above their pre-crisis level, at least in nominal terms. Adjusted for inflation, the national average price is still 13% below that level. One reason for the relentless increases is the housing shortage of housing. The number of properties for sale is shrinking, while new-builds also remain in short supply. Due to the lack of new-build activity, the housing stock is lagging behind the number of households. Housebuilding in the Netherlands is slow to respond to demand. This is a long-standing problem. To accelerate the house construction plans, the government has signed a National Housing Agenda together with construction-related parties, marking a first step towards addressing this issue. The falling trans-action volume in pre-owned housing is another signal of the imperative need for action. Would-be buyers are struggling to find a suitable home to match their budget. This is taking a toll on sentiment in the housing market. Which is still positive, but less buoyant than before - also because of the prospect of rising interest rates. Taking its cue from the Federal Reserve, the ECB is looking to normalise its monetary policy. And that is putting people on their guard. But we think the ECB will take its time over this. In fact, in view of the series of disappointing international economic data, the renewed doubts about Italy and the growing trade war threat, we have actually lowered our interest rate projections. This adjustment, combined with the increase in disposable incomes and the constrained housing supply, has prompted us to raise our price forecasts from 8% to 8.5% for this year and from 5% to 7% for next year. However, a word of caution is in order. If the international threats materialise, the housing market could be adversely affected.

Price and transaction forecasts

	Transactions (% y-o-y)	Prices (% y-o-y)
2017	12.6	7.6
2018	-5	8.5 (8)
2019	-5	7 (5)

Source: Group Economics

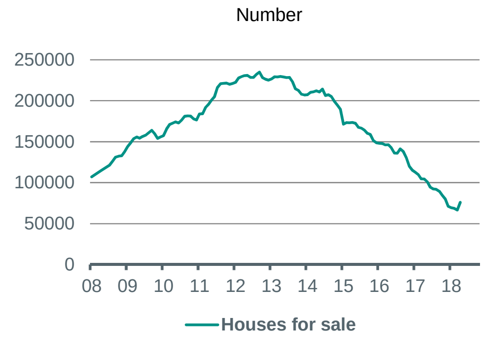
Falling transaction volume

The number of housing transactions is falling. According to the Land Registry, 87,000 pre-owned homes were sold in the first five months of this year - 6,000 less than in the same period of 2017. History teaches us that transactions often run ahead of prices.

The falling transaction volume is visible throughout the Netherlands. In virtually all provinces, house purchases were lower in the first quarter than in the same quarter last year. The sharpest decline was noticeable in the Randstad conurbation in the west. Only Limburg and Drenthe still saw purchases advance, albeit at a less powerful pace than in the previous quarters.

Purchases are decreasing, both because the post-crisis catch-up demand is flagging and because the housing supply is shrinking. According to home search website *huizenzoeker.nl*, a mere 76,000 properties were up for sale in June versus 104,000 in the same month last year. Due to the contracting supply, buyers have less choice and need to make an extra effort to find a suitable home.

Strong fall in number of properties for sale



Source: Huizenzoeker.nl

One reason for the contracting supply is that buyers are waiting longer before putting their house up for sale. They want to secure a new home before selling their existing property. Added to that, in today's rising market, the longer you wait, the higher the price you will probably get.

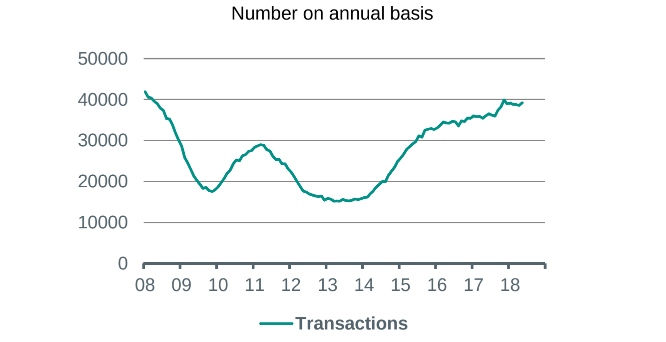
Houses coming onto the market rapidly find a new owner. In the first quarter, homes sold by members of the Dutch Association of Real Estate Agents (NVM) were only on the market for 56 days. Buyers must make an offer fast and have little time to decide. This applies in particular to apartments in popular cities. Such properties are also attracting a lot of interest from investors who are less dependent on external financing and can therefore decide more quickly.

Urgent need for more new-builds

As in the pre-owned segment, the number of new-build transactions is under pressure. In the first five months of this year, 14,000 new-builds were purchased, 3% less than in the same period last year.

The prices of new-builds are rising. By 16% in the first quarter according to the NVM. That is even more than in the pre-owned segment, where prices advanced about 10% (based on NVM figures). One important reason for the difference is the changed composition of purchased new-builds. Previously, these were mainly aimed at first-time buyers, now at home movers.

Stagnating construction dampens new-build purchases



Source: Dutch Association of Real Estate Agents (NVM)

This decline in the number of transactions points to problems in the construction industry. Closer inspection confirms that the number of new residential completions is far too low. Every year, about 80,000 new homes have to be built to meet the demand for housing. That is significantly more than the 62,000 completions in 2017. As is evident from the most recent figures, this gap will not be closed any time soon. Until 2020, the gap between the number of households and the housing stock is actually expected to grow.

The government acknowledges the problem and is seeking to address the housing shortage together with construction-related parties. To this end, they recently signed the National Housing Agenda, which sets out their joint ambitions for the housing market, both in terms of reducing the shortages as well as assuring the quality of housing and the residential environment. The Agenda alone will not resolve the problem, but it is a step in the right direction.

Sustained strong price increases

As the shortages will not be solved in the foreseeable future, sellers will retain the upper hand for the time being. They can ask the top price and need not make many concessions. Based on data of *huizenzoeker.nl*, the average asking price for a pre-owned home was EUR 377,000 in June, 12% higher than a year ago. But these higher asking prices are not deterring buyers. On the contrary, in about half of the transactions, buyers are offering the asking price or more. As a result, according to the NVM, the difference between the asking price and actual transaction price has shrunk to 0.7%.

All in all, house prices are rising fast. In May, prices were 8.9% higher than in the same month last year. Remarkably, all price segments are sharing more or less equally in the euphoria, with higher-end housing also enjoying strong price appreciation. Interestingly, prices of different construction years are also gravitating towards each other. Formerly, historical houses dating from before the second world war showed the strongest price increases. No longer.

In our view, this shift in the price development by construction year is not down to a change in buyer preferences. Rather, it is a sign that the prices of historical, usually centrally situated, homes have risen so far that buyers are being pushed to more affordable housing from later construction years in the suburbs. A similar shift can be seen in the rented sector. Rental website Pararius reports that rent increases are weakening in the expensive segment because few tenants can afford the high rents.

Large regional differences in price movement

Price movement in first quarter

	% y-o-y	% versus low point
Drenthe	6	-9
Friesland	8	-8
Noord-Brabant	8	-7
Gelderland	9	-7
Zeeland	4	-6
Limburg	7	-5
Groningen	7	-5
Overijssel	7	-5
Netherlands	9	-1
Flevoland	11	1
Zuid-Holland	10	3
Utrecht	9	3
Noord-Holland	11	10

Source: Land Registry

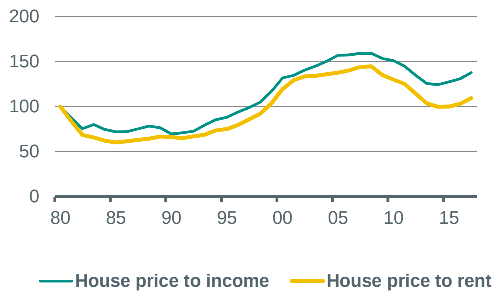
In the meantime, national average prices are back above their pre-crisis record level, at least in nominal terms. In real terms, adjusted for inflation, they are still 13% below that peak. And there are also large regional differences. The appreciation in value is fanning out from the large cities to adjacent municipalities and beyond. The Randstad conurbation is leading the recovery, with Noord-Holland as the front-runner. Prices there are now 10% above the 2008 level. In Flevoland, which is benefiting from the spillover from Amsterdam, prices have returned to their old level. The other provinces, however, are still off their former highs.

The sharp surge raises the question whether house prices haven't risen too far. Rule-of-thumb metrics, such as the house price-to-income or house price-to-rent ratio, suggest that prices are relatively elevated. And a recent IMF study confirms that prices are now slightly above the long-run equilibrium level [1]. The IMF does emphasise, however, that this is a theoretical estimate and therefore subject to uncertainties. In addition, the IMF warns that differences between the current price level and the calculated equilibrium can be sustained for a prolonged period, so that a price correction need not be imminent.

[1] Geng N., 'Fundamental Drivers of House Prices in the Netherlands? A cross-country analysis', *IMF Country Report* 18/131, IMF, May 2018

This conclusion corresponds more or less with that of the CPB Netherlands Bureau for Economic Policy Analysis. In a recent report, the CPB acknowledges that the market is hot but added that, in view of the constrained housing supply and low mortgage rates, there were no signals of a bubble.[2] In another report, the CPB states that any price correction in the future will have less consequences than in the past because of the lower loan-to-value ratios, the restriction of mortgage interest relief to annuity loans and the increased preference for long fixed-rate periods.[3] We subscribe to these analyses, also in view of the sustained robust GDP growth and on the assumption that the government will stick to its current housing market policy.

Prices are rising compared to rents and income



Source: OECD

ECB wants to change interest rate policy

But we do foresee a weakening of the upward momentum for house prices next year. One reason for this expectation is the sentiment in the housing market. This has become less positive. The Confidence Indicator of the Homeowners' Association has declined further in the past months. The optimistic respondents still outnumber the pessimists, but the gap is narrowing. In May the indicator showed a reading of 104, seventeen points below the record set in November 2016 and just above the neutral level of 100.

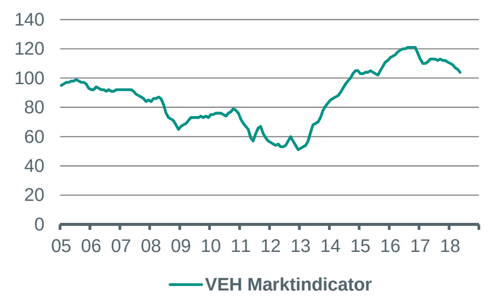
The fading optimism has to do with the constrained housing supply. Would-be buyers are limited in their options and are having to settle for less than their dream house.

Another factor is the growing prospect of rising interest rates. The ECB recently signalled its intention to end quantitative easing. After December, it will not buy any more debt to increase its securities holdings. From January 2019 the ECB can position itself for an increase in the official interest rates, though ECB president Draghi has hinted that any moves are unlikely until the end of the summer. That is later than we previously thought. For this reason, and also because of the recently disappointing international economic data, the growing uncertainty about Italy and the mounting threat of a trade war, we have revised down our interest rate forecasts. At the end of 2018, the yield on 10-year government bonds will not be 1.3% but 0.9%.

[2] Groot S. e.a., Oververhitting op de Nederlandse huizenmarkt? *CPB Background Document*, CBP, June 2018
[3] Van der Wiel K e.a., Risicorapportage Financiële Markten, *CPB Memorandum*, CPB, May 2018

Existing homeowners will not be greatly affected by this interest rate hike. Many have switched their mortgages to longer fixed-rate periods, so their monthly expenses will remain the same for the time being. Moreover, the application of income criteria set by the National Institute for Family Finance Information (Nibud) ensures that higher interest rates are already factored in during the mortgage lending process. This means that homeowners have an income buffer to absorb a future increase in their housing expenses. Finally, many will also have higher incomes by the time any such increase occurs.

Weakening optimism about housing market



Source: Calcasa

First-time buyers will probably suffer more from higher interest rates, as it means they can borrow less based on their income. This prospect prompted the House of Representatives to ask the CPB to look into the consequences of a relaxation of the repayment conditions. The CPB concluded that such a move would lead to significantly lower tax revenues and a further distortion of the housing market. So the repayment conditions are unlikely to be relaxed for the time being.

Higher interest rates will presumably also dampen the interest of investors in the housing market. They will turn to alternative investment opportunities, causing their share in house purchases to decrease. In the past decade, their share in the house transaction volume doubled to 10%. This increased investor interest also contributed to the sharp price increases in recent years.

Renewed interest for mortgages with short fixed-rate period?

One interesting question concerns the extent to which changing interest rates might influence the choice of fixed-rate mortgage periods in the future. Recent years have witnessed a strong preference for long fixed-rate periods. Twenty years or more is the rule rather than the exception. This may change if long-term rates rise and short-term rates remain low.

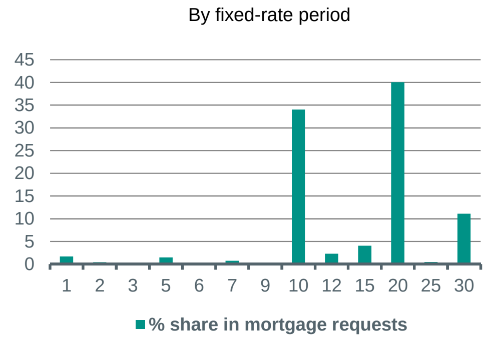
According to a study of the Italian central bank, the average mortgage term influences the speed at which monetary policy is transmitted to the real economy[4]. Pointing to the big differences in national preferences for fixed-rate periods, the study concludes that the impact of monetary policy decisions can also vary strongly from country to country. The differences are partly attributable to supply factors. Countries where banks rely

[4] Albertazzi, U., 'Fixed rate versus adjustable rate mortgages: evidence from euro area banks', *Working Paper no. 176*, Banca d'Italia, June 2018

heavily on *wholesale funding* (e.g. via issuance of securitisations and *covered bonds* with long terms) typically lean towards longer fixed-rate periods.

According to the researchers, however, demand factors drive national preferences for specific fixed-rate periods. The main determinant is the difference between long- and short-term rates. The greater this difference, the stronger the demand for short fixed-rate periods. In addition, borrowers sometimes see a short fixed-rate period as an alternative form of unemployment insurance. This is because economic weakening and rising unemployment usually cause short-term rates to fall. Short-term rates are therefore more popular in countries with a weak social safety net. Finally, financial literacy plays a role in the choice between short or long periods. Financially literate borrowers, who are aware of the premium they pay for long fixed-rate periods, have a strong preference for short terms.

Preference for fixed-rate period based on mortgage



Source: HDN

Slower rise in new mortgage business

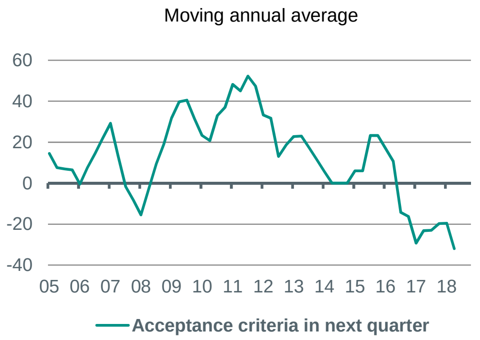
Though the lower transaction volume feeds through in the number of extended mortgages, new mortgage business is still growing. Apart from the sustained price increases, this also has to do with remortgaging. But growth in new mortgage business is weaker than before. According to the Land Registry, new mortgages amounted to EUR 104bn in the twelve months until end of May, EUR 13bn more than in May 2017. In the twelve months until May 2017, new mortgage business accelerated by a total of EUR 21bn.

Statistics Netherlands (CBS) has recalibrated its method for calculating the outstanding mortgage amount and now also includes mortgages extended within families. The result is a higher outstanding amount. According to Statistics Netherlands, the outstanding mortgage amount in the first quarter totalled EUR 698bn, EUR 9bn more than a year earlier, a modest increase compared to the growth in new mortgage business. Continuing high voluntary repayments and the obligation to make annuity repayments are pushing the amount lower.

Compared to the house prices, the increase in the mortgage amount is extremely moderate. This suggests that the current house price appreciation is not being driven by lending. The increase in the mortgage amount is also extremely modest as a percentage of GDP growth. In GDP terms, the mortgage amount fell from 96% of GDP in the first quarter of 2017 to 94% in the first quarter of 2018. That is still high by international standards, however.

Data from the Dutch Central Bank (DNB) indicate that house buyers are not taking more risk than before. The proportion of first-time buyers borrowing the maximum loan-to-income amount has remained steady at 43% for years. Moreover, first-time buyers are putting down larger deposits and are borrowing less in loan-to-value terms.

Banks are relaxing their mortgage criteria



Source: DNB NB: a negative score means a relaxation and vice versa.

Meanwhile, banks are relaxing their acceptance criteria. The improving economy is translating into increased employment, lower unemployment and higher disposable incomes. As a result, the number of homeowners with payment arrears is falling. According to the Dutch Credit Registration Office (BKR), their number has decreased to 86,000, 12,000 less than a year ago. Foreclosure sales are also historically low at less than one hundred per month, or 0.4% of the total purchases. Thanks to the sustained price increases, the number of people at risk of negative equity is steadily shrinking. In the first quarter the Dutch Homeownership Guarantee Fund (WEW), the fund behind the National Mortgage Guarantee (NHG), received claims to the value of EUR 5.3m, 69% less than last year.

The WEW is now seeking to serve new target groups with a personalised approach. From now on, customers who are retired or due to reach the state pension (AOW) retirement age within ten years will no longer be assessed on annuity criteria but according to their actual expenses. As a result, more older people will qualify for an NHG loan. Eligibility is subject to two conditions: the future monthly expenses may not exceed the current monthly expenses and the interest rate must be fixed for at least twenty years. The change is designed to make it easier for older people to move to a different (smaller) house and thus improve the mobility in the housing market.

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