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Housing Market Monitor

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Housing market: forecasts up, yet outlook less positive

- Persistently falling mortgage rates drive housing market higher
- More relaxed lending criteria and lower transaction tax to boost housing market in 2021
- But economic backlash will take its toll in due course
- Price and purchase forecasts revised slightly up

The latest housing market data are as positive as ever. Transaction volumes continue to rise and in August prices even recorded their biggest increase (8.2%) in the past one and a half years. The main reason for this buoyancy is the sustained fall in mortgage rates. Risk premiums in the financial markets ran up in April, but then fell back thanks to government support and major central bank interventions. As lenders can raise funding cheaply, mortgage rates continue to decline.

The lower mortgage rates are making homes more affordable. And the current increase in incomes is adding to this effect. The collective labour arrangements made in the pre-corona era and the government's furlough schemes are currently propping up incomes. But the most recent collective labour deals are already less positive and the government will gradually phase out the support measures, so the beneficial impact from these sources will fade. If unemployment starts to rise, many households will suffer loss of income. In this case housing will become less, rather than more, affordable, particularly when interest rates bottom out and no longer contribute to greater affordability.

However, it may be a while before this deterioration in affordability actually materialises. If financial markets remain on an even keel, mortgage rates could still fall a little further. In addition, lending criteria will be relaxed next year: the cost threshold for the National Mortgage Guarantee (NHG) will be raised, double-income households will be allowed to borrow more, and study debt will be less burdensome when taking out a mortgage. In addition, the transfer tax for buyers up to 35 will be lowered. All these factors will support the housing market, as will the persistent supply constraints and the greater importance of a pleasant house for home workers. There is no hard evidence for the latter assertion, but search analysis suggests that prospective buyers are showing more interest in properties with an extra room and outdoor area.

Against this backdrop, we have raised our forecasts. Though the housing market is cooling more slowly than expected, a turndown remains plausible in the longer term. The first indication of this would be a fall in the transaction volume, followed by growing price pressure. Whereas we initially assumed a 5% decline in purchase volume this year, we now foresee a stabilisation. For next year we are sticking to our forecast of -10%. The price level will rise 7¼% (was 6%) this year and stabilise (was -2%) next year.

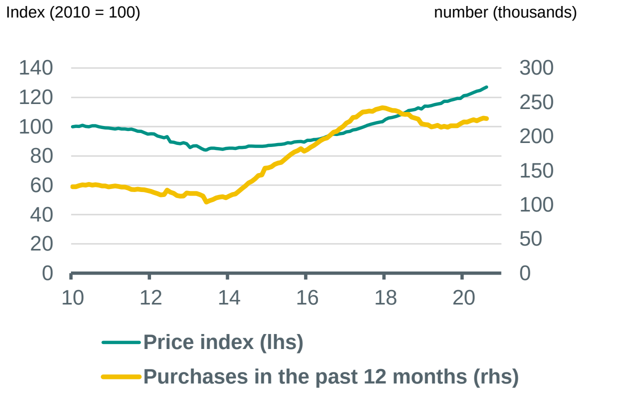
Housing market intact despite historic economic decline

The Dutch economy has taken a hard blow. GDP contracted 9.4% in the second quarter relative to the same quarter last year. The coming quarters will also see activity weakening due to a fall-off in demand and corona-related production disruptions. We think that the economy will not return to its former level until 2023. And with the second wave of infections now threatening the economy, it may be even later.

In recent months, government support measures have kept businesses afloat and employees in work. But this aid is impeding the necessary adjustment to the new situation. The government will therefore gradually withdraw its support from 1 October. This will cause unemployment to rise at an accelerated rate. Various large companies have already announced reorganisations.

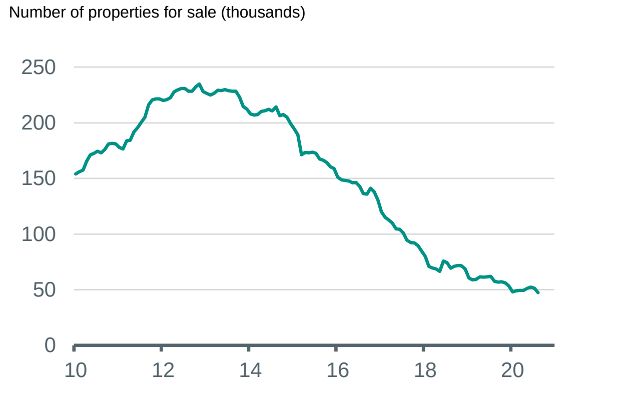
The housing market has so far remained largely unaffected by this sombre outlook. The transaction volume is still high. According to Statistics Netherlands (CBS), 148,000 pre-owned homes were purchased in the first eight months of this year, 5% more than last year. New-build purchases are also on the rise. Based on data from the Dutch Construction Association (NVB), the number increased 12.5% in the first eight months of 2020 to 22,500.

House prices and purchases continue to rise



Source: CBS/Land Registry

Housing supply remains very tight



Source: huizenzoeker.nl

According to property website huizenzoeker.nl, the number of properties up for sale has sunk to less than 47,000. Given the large number of transactions, the turnover rate must be high. The Dutch Association of Real Estate Brokers (NVM) says that houses sold in the second quarter were only on the market for 28 days on average. Properties never changed hands so swiftly. Overbidding is still the rule rather than the exception in the current tight market. The NVM calculates that bids were on average 1.5% above the asking price in the second quarter. And that is despite the continuous rise in the average asking price for properties. The average asking price in September was EUR 444,000 according to *huizenzoeker.nl* – 4.4% higher than in the same month a year ago.

Different valuation yardsticks underline the relentless rise in prices. Statistics Netherlands puts the average purchase sum for pre-owned housing in August at EUR 336,000, 6.4% higher than in August 2019. Based on the price index, the valuation was 8.2% higher. Property values are at their highest level since 1975. Adjusted for inflation, the current valuation is just under that peak. According to Calcasa, cheaper dwellings are displaying an even faster price appreciation than the higher-end properties, where the market is less tight. The increase in the price segment above EUR 500,000 is 4.8%, less than half the rate of appreciation in the segment up to EUR 150,000. One consequence of the strong price rise in the lower end of the market is that the housing stock in the segment up to EUR 150,000 has shrunk dramatically.

A regional shift can be seen within the Netherlands. Until recently, the Randstad conurbation was the epicentre of rampant price growth. No longer. Today, it is the provinces of Groningen, Flevoland, Overijssel and Drenthe that are leading the way. The number of purchases also confirms that the Randstad is losing momentum and that its share in the national transaction volume is shrinking. This is mainly due to the large cities where the transaction volume is under pressure. Amsterdam, The Hague and Utrecht even saw the number of transactions decline in the second quarter compared to the same quarter last year. The downward trend in the large cities already started before corona. The decline may be a harbinger for the rest of the country, as the major cities traditionally set the tone for the national housing market.

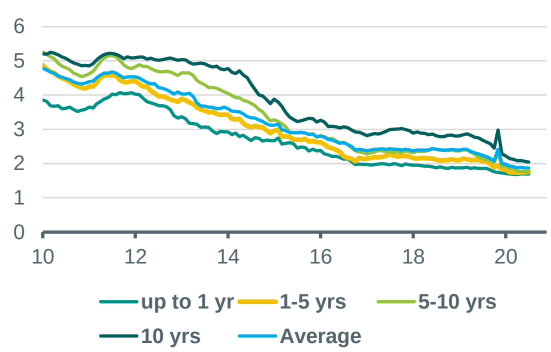
Low interest rates provide support

The Netherlands is not an isolated case. In other countries too, house prices are advancing strongly, albeit not as rapidly as here. After a brief period of weakening, international prices have resumed the upward trend. According to the DallasFed index, global prices climbed 6.6% in the first quarter, after rising 6.2% in the previous quarter.

One important reason for the renewed surge in prices is the low mortgage rates. In the Netherlands too, mortgage rates have dropped dramatically in recent years and continue to slide. Since December, the 10-year fixed rate on loans has fallen 60 basis points to 2%. The decline is contributing to better affordability. Calcasa estimates that the net housing costs with an interest-only mortgage ran to 13.6% of the net household income in the second quarter. The percentage for an annuity loan was 32.7%. Two quarters ago both percentages were still around two percentage points higher.

Mortgage rates decline further

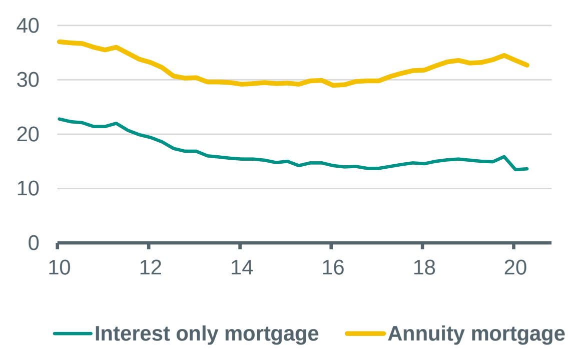
Interest rates for different fixed terms (%)



Source: DNB

Low interest rates contribute to affordability

Net housing costs as a percentage of net income (%)



Source: Calcasa

Lower mortgage rates and the resulting improved affordability is good for housing market sentiment. After falling sharply during the lockdown period, the indicator of the Homeowners Association (VEH) rebounded to a value of 99 in July and August. That is just a fraction below the equilibrium value of 100, which signals that prospective buyers anticipate some deterioration in the housing market. But confidence levels vary between younger and older buyers, low- and high-income households, and tenants and homeowners. This reflects the social divide. A divide that is emerging in various domains, including housing, and could be exacerbated by the impact of the corona crisis.

The low interest rates are, first of all, a structural phenomenon. Since the 1980s, interest rates have been falling due to the weakening rate of potential GDP growth and lower inflation. On top of this, demographic shifts (ageing) are fuelling the savings ratio, while technological advances (digitisation) are leading to lower investment costs and, hence, less demand for capital. As these trends will not be reversed soon, interest rates seem set to stay low for the time being.

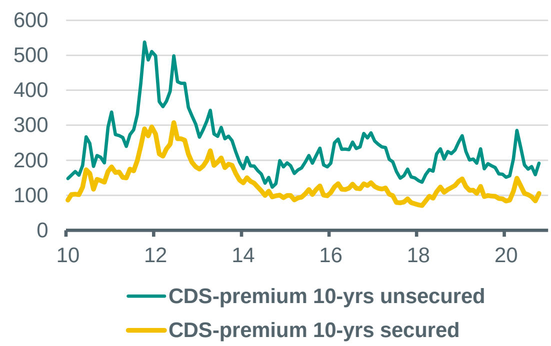
Another crucial factor is monetary policy. Central banks are buying up debt on a massive scale. They are pumping money into the economy in order to stimulate spending and prevent a further slowing of inflation. Eurozone inflation in August was -0.2%, significantly lower than the European Central Bank's long-term target of 2%. The corona crisis has dampened spending, potentially causing inflation to sink even further. So there is every reason for central banks to step up their efforts. In recent months, central banks around the world have announced additional monetary easing.

Government intervention and central bank aid calms financial markets

The prospect of an extended period of extreme monetary accommodation has brought calm to the financial markets. At the onset of the corona crisis, stress gripped the markets. Share prices nose-dived. Banks, in particular, took a battering because of the expected loan losses. The CDS risk premiums also shot up, pointing to higher funding costs for banks. This strengthened our expectation that mortgage rates might rise. Unjustifiably, as we now know.

CDS risk premiums down after spike in April

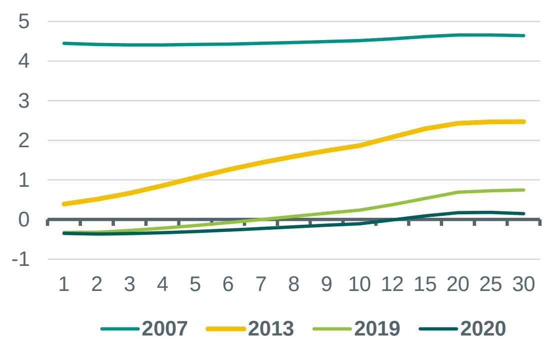
Basis points



Source: Reuters Datastream

Swap rates fall across broad spectrum of terms

Swap rates for different terms and different years (%)



Source: Reuters Datastream

Meanwhile, equity markets have climbed much higher. The financial stress has also largely disappeared. CDS risk premiums, for instance, have dropped towards pre-corona levels. This is largely thanks to the central banks. According to the BIS, monetary easing is responsible for half of the US and a fifth of the European share price recovery. Government policy is also underpinning the stock markets. Support packages are helping companies and households to absorb the worst blows. In addition, the agreement between European government leaders to set up a pandemic recovery fund constitutes an important signal of solidarity - which will fortify trust in the financial stability of the European Union.

The restoration of confidence in the financial markets is depressing interest rates on government loans. In line with this, the swap rates, an important measure for bank funding costs, have also dropped across the board. The strongest decline can be seen on the long side of the interest rate spectrum, i.e. for long-term loans.

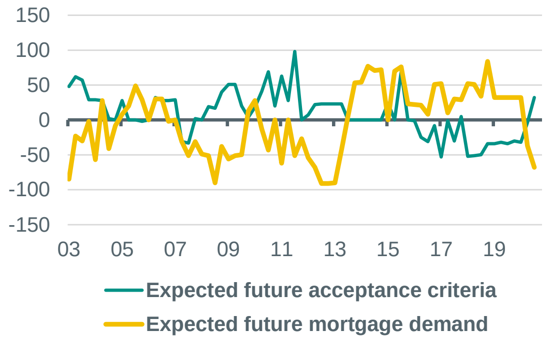
The decrease in long-term rates explains the sharp rise in demand for loans with a long fixed-rate term. The preference for long-term finance is also related to the desire for certainty. The security of a fixed rate comes at a price, however. The difference may be small, but the interest paid on long-term loans is higher than on short-term loans. People with a mortgage who move before their fixed term expires will miss out on this difference. An additional consideration is that repayments on shorter-term loans are higher. Assuming that the property does not fall in value, then the loan-to-value ratio will improve more quickly. This reduces the mortgage lender's risk and allows the mortgage borrower to negotiate a lower rate when remortgaging the loan; that is another advantage that eludes borrowers with long fixed-rate terms.

Mortgage origination volume growing strongly

The lower swap rates and CDS premiums have pushed down the funding costs for banks. Moreover, banks are benefiting from the temporary relaxation of regulatory capital requirements. As banks are required to maintain less capital as a percentage of risk-weighted assets, their funding costs are lower and more money is freed up for lending. Nevertheless, banks are becoming more cautious about extending mortgages because the risk of future losses increases as the economy deteriorates. That banks are tightening their criteria is evident from the *Bank Lending Survey*. In this survey they also express the expectation that demand for mortgages will decline in the coming quarter.

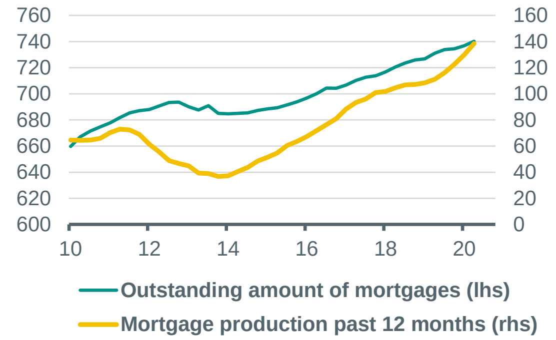
Banks anticipate tightening of criteria

0 = neutral value (>0 tightening of mortgage criteria / increase in credit demand)



Source: Bank Lending Survey DNB

Mortgage origination and outstanding amount



Source: Land Registry & CBS

Demand for mortgages is still strong. In the first eight months of 2020, 23% more mortgages were taken out than in the same period last year. Mortgage origination is 27% higher at EUR 98bn. The reason is clear: falling interest rates not only stimulate house purchases, but also lead to higher remortgage demand. According to IG&H, this accounted for no less than 40% of mortgage origination in the second quarter. Interest in remortgaging was fuelled further in the second quarter by the belief that interest rates might rise soon. Now that this expectation has receded, the enthusiasm for remortgaging is also beginning to wane. HDN mortgage application data for the third quarter point to a moderation in the pace of remortgaging demand.

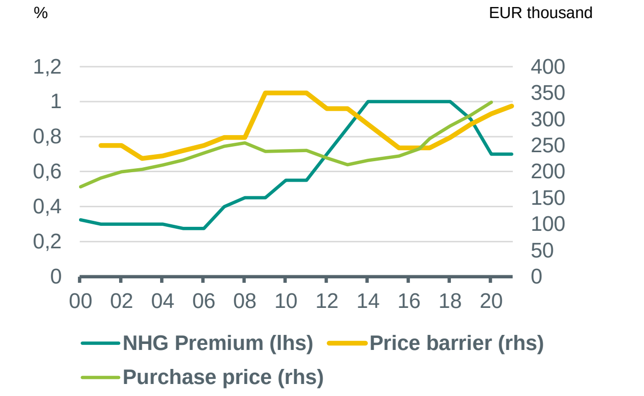
Remortgaging will become less attractive next year. Starting from 1 July 2021, banks will need a traditional property valuation report for all mortgages. Until that date, they can dispense with such a report for low-risk mortgages. This limits the costs of top-up mortgages for e.g. home conversions or home energy efficiency measures. If the loan-to-value ratio is under 90%, they only need a model-based valuation which is not just faster but also cheaper than a traditional on-site valuation.

A computer valuation costs EUR 25, as opposed to up to EUR 500 for an on-site valuation. So this measure which has been imposed by the European Banking Authority (EBA) burdens home buyers and remortgagers with additional expenses. Noteworthy is the fact that DNB has opted not to apply for an exception for the Netherlands. One reason is that EBA leaves room for a possible compromise: a hybrid valuation consisting of a model-based calculation that can be checked at a distance by a property valuer.

Lending criteria relaxed further

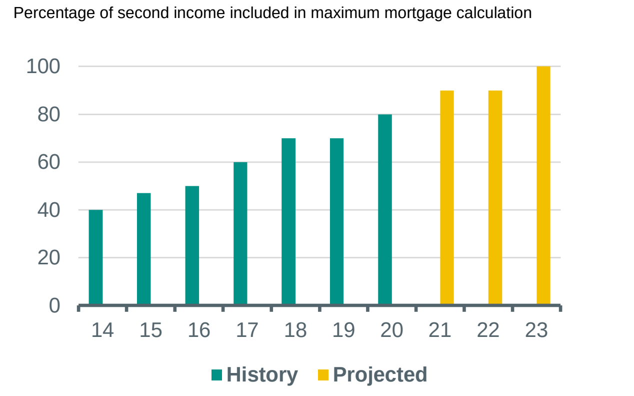
The lending criteria for home buyers are to be relaxed. Among other things, the NHG cost threshold will be raised next year by EUR 15,000 to EUR 325,000. The cost threshold for energy-saving measures remains 6% higher. The premium is also unchanged at 0.7%. In order to limit the degree of fluctuation, the cost threshold will in future be calculated on the basis of the average purchase sum over the past 39 months. Formerly, the average over the past three months was used. In addition, due to the lower interest rate on student loans, study debt will weigh less heavily on the mortgage amount that home buyers are permitted to borrow. Finally, a larger share of the second income will be included when setting the maximum mortgage amount, allowing double-income households to borrow more. This is in conformity with the Nibud recommendation which takes account of the upcoming tax changes in favour of double-income households.

NHG cost threshold in step with purchase sum



Source: NHG (National Mortgage Guarantee)

More mortgage based on second income



Source: Nibud

DNB will be less happy with this relaxation of the criteria. The central bank recently warned about the strong correlation between house prices and lending capacity. Thanks to the lower interest rates, buyers can take out a higher mortgage and bid more for the home they have in their sights. DNB contends that the maximum lending capacity is a much stronger driver of house prices than the shortage of supply. Instead of more relaxed lending criteria, DNB would rather see an increased effort to build more houses in order to boost supply. The shortage is currently estimated at 330,000 dwellings, 4.1% of the total stock. According to the forecasts, however, that shortage will not be resolved any time soon. In fact, the expectation is that it will first rise to 420,000 in 2025, or 5.1% of the stock, before starting to fall.

New initiatives to stimulate new-build construction

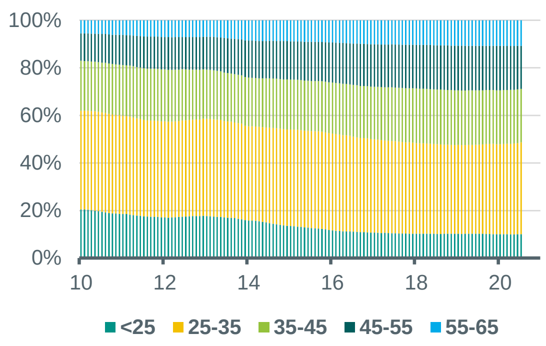
The cabinet is pulling out all the stops to stimulate house building. On Budget Day it announced the intention to bring forward investments. Another plan is to explore the possibility of a guarantee scheme to prevent house construction grinding to a halt as happened during the financial crisis. It is also studying solutions for the nitrogen problem, such as lower threshold values for new-builds. We doubt that these efforts will be sufficient to rapidly lift construction activity to the targeted 95,000 dwellings per year. One problem is that the assumptions about the effectiveness of the totality of nitrogen measures are rather optimistic.

The most surprising Budget Day announcement was that the State intends to play a more executive role in large-scale house building by making clearer arrangements with municipalities and provinces. This marks a break with the past, when the State steadily devolved responsibility for spatial planning to lower government. There is also a proposal to set up a National Land Development Authority. However, a return to the old situation of centralised control is unlikely according to the PBL Netherlands Environmental Assessment Agency.

Cabinet scraps transfer tax for young house buyers

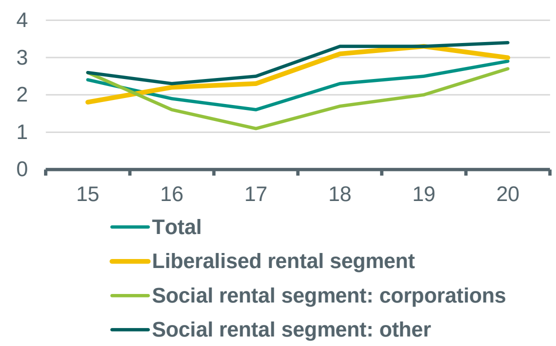
On the tax front, the debate about mortgage interest relief remains as topical as ever. The European corona recovery fund has put this debate in a new light. To be eligible for gifts from this fund, the Netherlands must implement structural reforms. Finance Minister Wopke Hoekstra sees the accelerated winding down of the mortgage relief scheme as a suitable bargaining counter in this context.

Share of young people in house transactions



Source: CBS/Land Registry

Further rental increases in private and social



Source: Statistics Netherlands (CBS)

The coming year will bring few changes in the tax sphere. The only change announced by the cabinet on Budget Day concerns transfer tax. The rate for buyers aged 18 to 35 will drop to 0% in the coming five years, while investors will see the rate rise to 8%. As there is also a rate of 2% for older buyers and 7% for buyers of commercial property, there will soon be four rates: an administrative nightmare.

Transfer tax is a disruptive tax. Scrapping such a tax is a good idea in itself. But we doubt whether this particular move will achieve the cabinet's aim of giving first-time buyers a helping hand. According to the CPB, the current tightness of supply entails that the financial windfall will mainly drive up prices in the first-time buyer segment and only lead to a limited increase in first-time buyer purchases. However, first-time buyers may experience less competition from investors who are required to pay 8% transfer tax. Given the stable rental income and lack of investment alternatives, it is by no means certain that the higher tax rate will scare off investors. Moreover, investors may also pass on their increased costs in the rental price. In that case, tenants will be left worse off.

Another disadvantage of the increased transfer tax rate is that professional landlords and housing associations who manage their portfolio by buying and selling dwellings amongst each other will be saddled with higher costs. That will leave them with less money to build rented housing and make their existing stock more sustainable. This is remarkable in view of the recent arrangements where housing associations agreed to raise the annual production of social rented housing to 25,000 and build 10,000 flexible dwellings in the coming two years. In addition, housing associations have been given room to build for the mid-market segment. The market test, which obliges municipalities to give commercial parties priority in tenders for the construction of private rented housing, has been suspended for three years.