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Housing market monitor

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Recession and interest rate risk affect housing market outlook

- Rising energy prices erode purchasing power and increase recession threat
- Maximum mortgage credit amount decreases due to higher mortgage interest rates
- House prices are rising extremely fast, but for how long?
- Number of house purchases decreases, further decline expected

The economic outlook is deteriorating rapidly. Inflation is rising due to higher energy prices. The increase is also threatening to become embedded in inflation expectations, so that the inflation rise, which is temporary on paper, may become permanent. This is all the more true as inflation expectations are rising. The latter is something that worries central bankers. They are preparing to tighten monetary policy by purchasing fewer financial debt securities and raising official interest rates. This translates into a rise in interest rates on government loans, which is accompanied by higher mortgage rates. Thus, the years of sustained decline in mortgage rates are behind us. This has repercussions on the housing market, as mortgage interest rates are a determining factor in determining the amount that can be borrowed for house purchases.

Higher mortgage rates will translate into a decrease in the number of transactions. These will be more difficult to achieve if sellers have a high selling price in mind and buyers are unable to pay this price due to a lack of access to finance. This friction will initially lead to a drop in the number of transactions and an increase in the stock of houses for sale, something that has already been visible in recent months. In our previous publication, we assumed that the number of transactions would fall by 15 per cent this year and stabilise next year. In view of the decline so far, the growing economic problems in the second half of the year and the struggles in the construction sector, this is probably too positive an assumption. We are therefore revising our estimate to -17.5 percent this year and -2.5 percent next year.

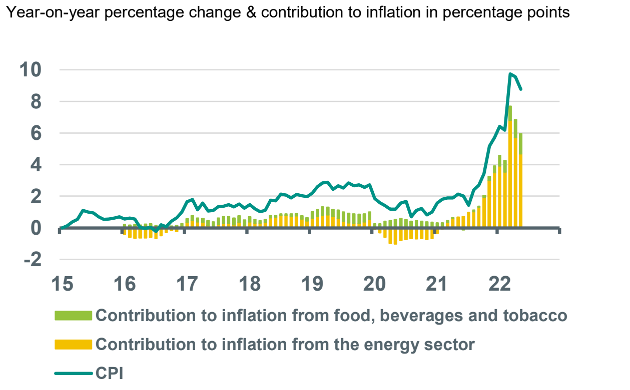
In the second instance, with some delay, the price development will follow. For now, the price index of the Land Registry is still rising extremely fast, by 18.8 per cent year-on-year in May. But there are signs of change. There is still a lot of outbidding, but not by as much as before. We assume that the rise in prices will slow down. The average increase will be 15 percent this year and 2.5 percent next year. Previously, we assumed 12.5 and 5 percent respectively. The reason for the increase this year is that the realisations so far are pulling up the annual average. Next year, there will be no such 'luxury'. Due to higher interest rates and the threat of recession, the annual average will be much lower. Also in the following years, the price development will be moderate, because the loss of purchasing power leaves less room for mortgage expenditure. The Nibud will further tighten the income lending standards. In combination with higher mortgage interest rates, this means that homebuyers will be able to borrow less.

Another economic setback

The economy has barely recovered from the corona crisis, and is already suffering another blow. The energy supply is no longer guaranteed. Since the invasion of Ukraine, the European Union has wanted to be less dependent on Russian gas. It is trying to achieve this by accelerating the transition to sustainable energy. This enormous task cannot be achieved quickly. In the meantime, alternatives, such as LNG from other parts of the world, must fill the gap in the energy supply.

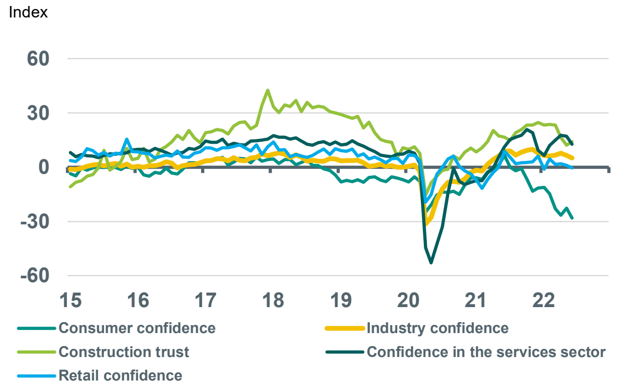
According to the International Energy Agency, the European plan to reduce gas imports from Russia by two thirds is very ambitious. A one-third reduction is considered more realistic by the agency. But even if that is achieved, the energy supply is not guaranteed. Russia is threatening to restrict the supply of gas to Europe even further or even to stop it altogether. In that case, energy prices would rise, purchasing power will fall and some energy-intensive sectors would be rationed. Entire production chains could then be squeezed.

Inflation higher, mainly due to energy and food



Source: Refinitiv CBS

Confidence in the economy declines



Source: Refinitiv

So a recession cannot be ruled out. And the unpleasant thing is that there are few means available to support the economy. The regular instrument for doing so, an easing of monetary policy, is in fact less applicable. In recent years, the European Central Bank (ECB) has conducted an accommodating monetary policy with very low official interest rates and purchases of financial debt securities. This pushed interest rates down. Because this policy entails financial risks in the longer term, a growing number of ECB policymakers want to abandon it.

ECB gears up for tighter monetary policy

The call for a less stimulative monetary policy is also supported by the sharp rise in inflation. Inflation is being driven up mainly by higher energy prices and the disruption to production chains caused by problems in international transport. On paper, these are temporary factors that central bankers would not normally worry about. But as the prices of an increasingly wide range of goods and services begin to rise, this time they do.

The ECB wants to step back in order to prevent the in theory temporary high inflation from turning into a structural problem. Although a repetition of the wage-price spiral of the 1970s and 1980s is unlikely following the flexibilisation of the labour market and the decoupling of inflation from wages, the ECB is not reassured that inflation will automatically return to lower levels. This is because expectations about future inflation are rising among households and businesses. This could become a self-fulfilling prophecy.

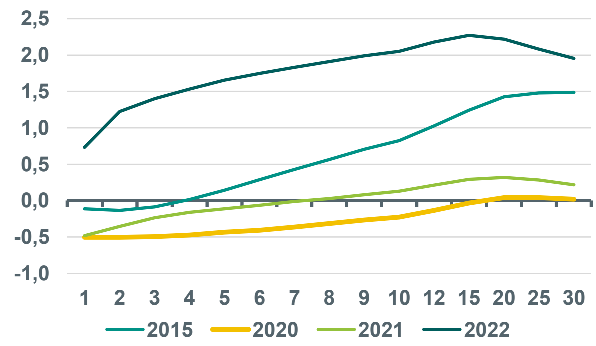
The ECB is already buying fewer financial debt securities than before and also wants to raise official interest rates. We think the ECB may raise the deposit rate by 1.5 percentage points to 1% early next year and keep it stable thereafter. This will lead to higher long-term interest rates. The 10-year rate on Dutch government bonds, which has increased by two percentage points to 2 percent since the beginning of the year, may rise further to 2.5 percent in the second half of this year. After that, if the economy slows down, rates will fall back to 1.75 percent by the end of next year.

Mortgage rates rise sharply

In the wake of this, mortgage interest rates are also rising. This is reflected in the 10-year mortgage rates offered on the Internet, which at an average of about 4 percent are more than 2 percentage points higher than at the beginning of this year. The increase is less visible in the series published by DNB for interest rates on concluded mortgage contracts. According to this series, the 10-year mortgage interest rate stood at 2 percent in April, compared to 1.75 percent in January, a much smaller increase. But this is because the DNB series follows the market rates with some delay.

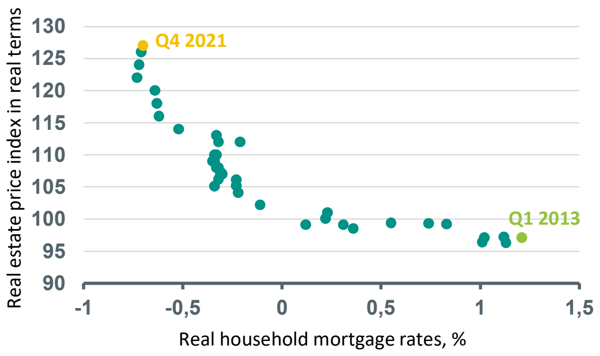
Higher financing costs for mortgage lenders

Interest rate on 3-month swap rates by maturity (in years)



Source: Refinitiv

Price response larger at low mortgage rates



Source: ECB

Mortgage rates are rising even faster than government rates. This is because the war has increased uncertainty among investors. This uncertainty is reflected in higher risk premiums on financial markets. The financing costs for mortgage lenders are therefore rising. Their costs are also rising because lenders have to maintain larger capital buffers for reasons of financial stability. If the economic situation allows, the countercyclical capital buffer imposed on banks by DNB will also be raised to 1 per cent in May next year.

We think that the rise in mortgage rates is not yet complete. Interest rates on both short and long term loans may rise further. Nevertheless, our forecasts are surrounded by uncertainty. If the economy slows down sharply, the ECB will refrain from taking overly drastic measures and interest rates will probably rise less sharply than we currently foresee. But even then, mortgage rates will be at significantly higher levels than in recent years.

The rise in mortgage interest rates has an impact on house prices, which are very sensitive to changes in interest rates. This is especially true when the interest rate is at a low level, as it has been in recent years. A fall in interest rates from 2 to 1 percent has greater consequences for house prices than a fall in interest rates from 6 to 5 percent. The reverse (when interest rates rise) is also true. Calculations by the ECB show that the inflation-adjusted price level can fall by some 0.8 to 1.2 percent for every 10 basis points increase in the inflation-adjusted interest rate.

Homebuyers can borrow less

The strong influence of mortgage rates on house prices is due to the fact that mortgage rates are a determining factor for the amount of mortgage that home buyers are allowed to borrow. When mortgage rates fall, as they have in recent years, mortgage costs fall and homebuyers can borrow more. When mortgage rates rise, as they are doing now, the allowed borrowing amount actually decreases. As a result, house hunters have less money to spend when buying a house.

Another determining factor for the amount buyers can borrow is the financial leeway households have to bear the mortgage costs. The higher energy costs take a substantial bite out of disposable income. DNB has calculated that the average disposable income drops by 0.7 per cent if energy prices rise by 35 per cent. The decline is three times greater with an energy price increase of 60 per cent, and even six times greater with an energy price increase of 85 per cent. As a result of the increased energy prices, buyers have less money to spend on their mortgage.

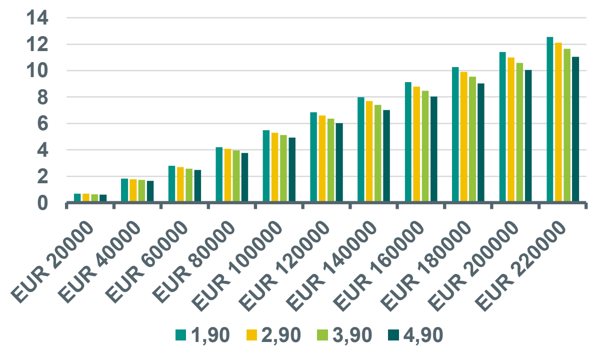
Hourly wages rise, but less than inflation

Percentage change year on year

Source: Refinitiv

Maximum credit amount decreases with higher

Amount (in hundred thousands of euros) by joint income at various interest rates



Source: Nibud

Nibud takes this into account when determining the maximum allowed loan amount. In determining the income lending standards, Nibud does calculate with four-year averages, so the recent loss of purchasing power will not be directly reflected in next year's lending standards. Nevertheless, the 2023 standards, which Nibud will soon announce, will probably be stricter than those of 2022. And if energy prices remain high, the borrowing standards will gradually be tightened further in the coming years.

Some counterweight to the loss of purchasing power comes from the labour market. Unemployment is low and a lot of vacancies. This translates into higher wage growth, as can be seen, among other things, from the recent collective bargaining results. Although wage growth is too low to fully compensate for the rise in inflation, employees will feel reasonably comfortable about the future of their jobs and their income despite the economic setback. For now, employers are happy to hold on to their hard-to-find staff.

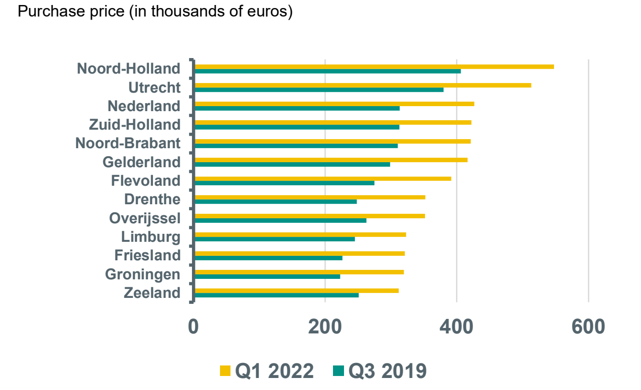
House prices continue to rise

On balance, we can say that although nominal incomes are rising, they are coming under considerable pressure in real terms. In combination with the rise in mortgage interest rates, this is leading to a deterioration in the affordability of the housing market. Affordability is also under pressure due to the sharp increase in house prices. According to the Land Registry, prices were 1.2 percent higher in May than in the previous month and 18.8 percent higher than in the same month a year earlier. The average purchase price now stands at EUR 429,000 compared to EUR 361,000 in May last year.

However, there are significant differences, with high purchase prices in the Randstad and lower prices in the border provinces. The average purchase price varies from EUR 311,000 in Zeeland to EUR 548,000 in the province of North Holland. From the second half of 2019, the increase in the value of homes in the four major cities lagged behind the rest of the Netherlands. But in the first quarter, the difference was again minimal. This is probably due to the loosening of the corona restrictions, as a result of which living in the city is once again gaining more allure and the benefits of living there outweigh the higher costs.

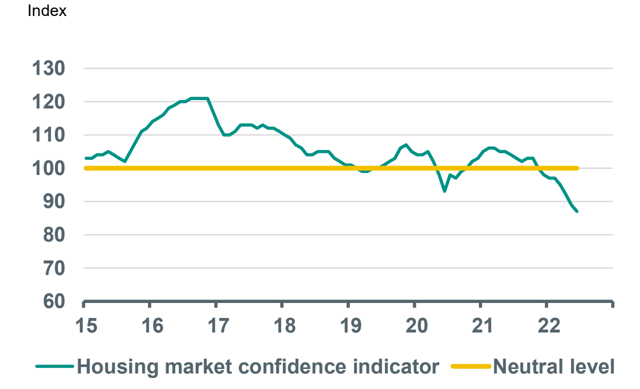
The strong increase in value during the corona period is largely due to the increase in demand for housing. This increased due to the fall in interest rates. Apart from extra credit, this also led to more interest in residential investments. In addition, there has been a shift in housing preferences. This is particularly true in areas where there is a lot of working from home. The demand for living and outdoor space increased the most there. According to research, as much as half of the price increase in the United States can be attributed to the shift to working from home.

Large house price differences between regions



Source: CBS/Land Registry

Growing pessimism about housing market



Source: Dutch Home Owners Association

Gloom prevails

The continuing increase in prices and purchase prices up to and including May according to Land Registry figures is difficult to reconcile with the statistics from the Dutch Association of Estate Agents (NVM), which indicate that the median transaction price in the first quarter, at EUR 328,000, was EUR 12,000 lower on balance than in the previous quarter. A possible explanation for the difference is that the NVM series is ahead of its time, because NVM registers the price at the moment the purchase agreement is signed by both parties, while the Land Registry only registers the price at the moment of transfer at the notary.

In response to the economic threat and the worsening housing market outlook due to higher mortgage interest rates, more people are putting their homes up for sale. After all, postponing the sale offers less advantage when prices are rising more slowly. According to NVM figures, 17,000 houses were on offer in the first quarter, 1,500 more than in the previous quarter. Recent reports from estate agents suggest that this number increased further in the second quarter. The acute shortage of existing homes on offer continues, but is expected to become less of an obstacle to housing transactions.

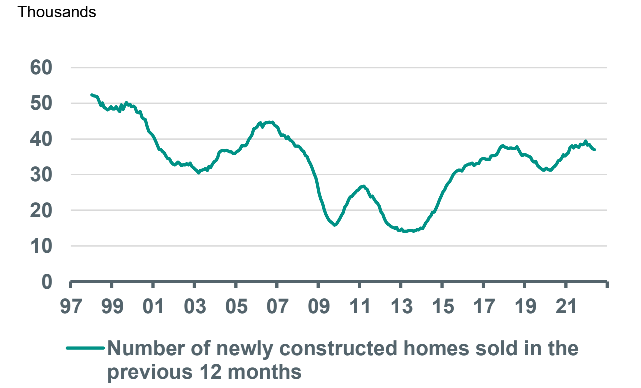
The lack of houses for sale is still a major reason for the decline in confidence in the housing market. The owner-occupier index dropped to 87 in June, well below the neutral level of 100. This is also due to the higher mortgage interest rate and the increase in mortgage charges that this entails. Besides the lack of houses for sale, the rise in interest rates is a major spoiler of sentiment on the housing market.

The lower confidence level is reflected in the decrease in house purchases. In the five months up to and including May, 76,000 existing homes were sold. Historically, the first five months of the year account for some forty percent of annual purchases. Extrapolating the transactions up to and including May to the rest of the year suggests that the total should reach 202,000 this year, a tenth less than last year when 226,000 transactions took place. However, with the economic slowdown in the offing, we estimate that this number will be even lower.

Substantial housing shortage remains a difficult problem to tackle

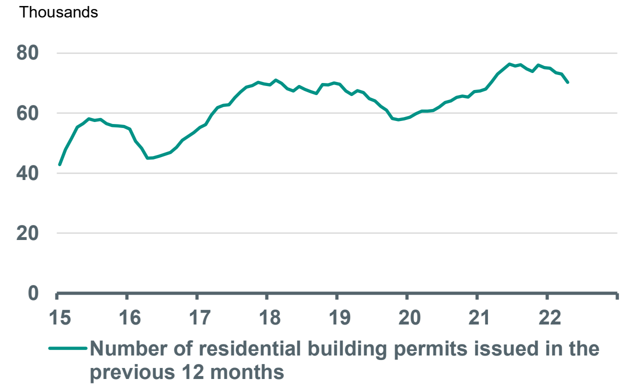
The number of transactions in new houses is also declining. In the first five months of the year, 13,500 new-build homes were purchased. In the same period last year, the figure was 16,000. However, no firm conclusions can be drawn from this, as this number also depends on how many homes are under construction and how many have been completed. This fluctuates due to all kinds of factors, such as the availability of building plots and skilled labour and the number of construction permits issued.

The number of new-build transactions declines



Source: WoningbouwersNL

Prospects for new building not very bright



Source: CBS

The government is keen on boosting housing construction. It is betting on the transformation of shops and offices. Office space is becoming available because large companies and the government have embraced working from home and because an estimated 40 per cent of offices do not meet the environmental requirements that will come into force from next year. The increase in online shopping is reducing the demand for retail premises and making it necessary to redevelop shopping areas. Nevertheless, the potential number of new homes that can be created through transformation is limited.

In addition, the government is focusing on the construction of temporary housing. Unfortunately, the realisation of the plans lags behind the stated ambitions. Investments in flex homes are lagging behind due to the high costs. Construction requires additional infrastructure and it is unclear what the residual value is. In addition, municipalities are afraid that temporary housing will become permanent housing, which could spoil their spatial planning in the long run. Only a limited number of municipalities are strongly in favour of flexi-dwellings.

Then there is the money that the state wants to invest to support the construction of new housing. More affordable homes must be built quickly. But the Court of Audit recently cracked down on the programme that the government is using for this purpose, the EUR 1bn Housing Impulse. The Court of Auditors is critical of whether the Housing Incentive Programme is helping to achieve the envisaged goals, whether it is being used in the right regions and whether it is not displacing other projects. Finally, the Court of Auditors warns against the high administrative burden.

This is no good news at all. And then there is the nitrogen crisis, which is escalating with the unusually fierce farmers' protests. The costs of construction projects are also rising: on the one hand because of the sharply higher prices of building materials, on the other because of rising interest rates. There is a danger that construction projects will grind to a halt as a result. Margins are disappointing and post-calculations are needed to share the pain of cost increases. Combined with the shortage of workers, all this does not bode well for housebuilding activity and the reduction of the extensive housing shortage.

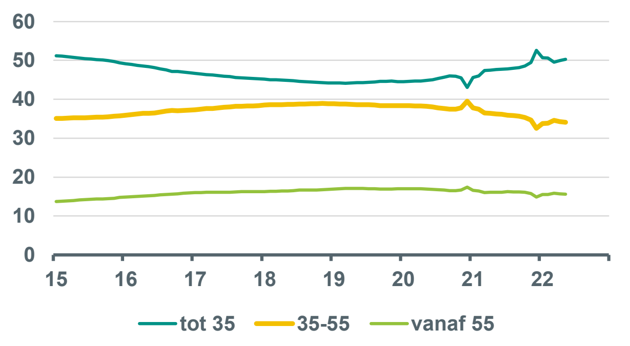
In addition to the more short-term measures that the government is now taking, structural reforms are needed to avert the housing market crisis in the long term. A group of economists recently published a proposal for this.

First-time buyers suffer most from higher interest rates

Among home purchases, the share of buyers over 55 years of age has fallen by one percentage point to 16 percent since the outbreak of Corona. The share of buyers under 35 rose by five percentage points to 50 percent and that of the group in between declined by four percentage points to 34 percent. This shift is due to the reduction of the transfer tax for first-time buyers under the age of 35 to 0 percent. The gift tax exemption also plays a role. First-time buyers are making more use of it (for 22 percent of first-time buyers in 2021 as opposed to 15 in 2018) and those selling on are making less use of it (for 9 percent of purchases by first-time buyers in 2021 as opposed to 10 in 2018).

Increased share of young people in home buying

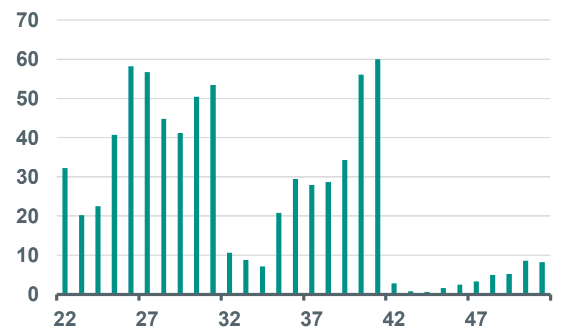
Percent



Source: Land Registry

Volume of mortgages by remaining term

Amount in billions of euros



Source: DNB

But the transaction share of young people will decrease again over time. The gift tax exemption for own homes for those between 18 and 40 will be reduced from EUR 106,671 to EUR 27,231 in 2023 and then abolished in 2024. Starters with wealthy parents will therefore find it harder to get a foothold. In addition, the maximum transfer tax exemption is increased from EUR 400,000 to EUR 440,000, but this increase does not outweigh the increase in value this year, which means that fewer first-time buyers will benefit from the exemption. Furthermore, investing in refurbishing an do it yourself home becomes less attractive due to the higher price of building materials.

However, the main reason why we think that the transaction share of young people will decrease is that mortgage interest rates are rising and the maximum allowed borrowing amount is falling. First-time buyers are relatively badly affected by this, as they have little savings and must finance a large part of the purchase with a mortgage. They also have no surplus value, nor can they take a previously agreed low mortgage rate with them when they move house. This is in contrast to those who move up the property ladder, who do have these advantages.

The majority of Dutch mortgages have a long fixed-interest period, only 4 percent are flexible. Periods of twenty years and more have been very popular in recent years. Most homeowners will therefore not be affected by the recent increase in mortgage interest rates. Nevertheless, a quarter of mortgages will expire in the next five years. However, a large number of these were taken out a long time ago, often at higher rates than are currently customary. Despite the recent rise in interest rates, these mortgage holders could therefore still benefit in terms of housing costs.

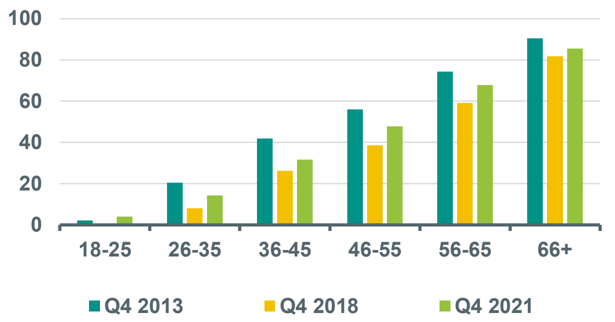
Buyers take more risks when buying a house

A growing group of homeowners took more financial risk last year. For example, the share of instalment-free mortgages in all age groups increased again after years of decline, even though interest cannot be deducted as it is for annuity-based loans. When interest rates are low, the tax benefit apparently does not outweigh the burden of the repayment obligation. Now that interest rates are rising again, this trend is likely to reverse and interest only loans will become less popular.

Another way in which homeowners have started to take more risk is by making optimum use of the available finance when buying a house. First-time buyers in particular do this in order to get by in a heated market. More than half of first-time buyers borrow more than 90 percent of the maximum loan to income amount. Those selling on have also started to borrow more in relation to their income. This means that those who have recently bought a house are the most vulnerable to a drop in income due to a divorce, for example, or to an unexpected house price correction.

Interest only loans become more popular

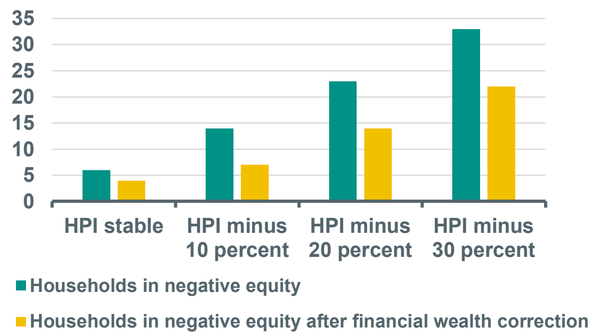
Percentage of total mortgage loans by age group



Source: DNB

Share of underwater mortgages in price

Percentage share (calculations based on end 2019 figures)



Source: CPB

Risk of price correction present, but smaller than during the credit crisis

The risk of a price correction will grow if the economy enters a recession and people lose their jobs. Another risk is that investors will look elsewhere and start to undervalue rental properties on a large scale. After all, when interest rates are higher, their preference is for investments with a shorter duration. Another reason why investors might decide to give up rental properties is that recent government measures, such as buy-out protection, rent regulation and increased transfer taxes, make renting less attractive.

In the event of a house price correction, the risks are fortunately not as great as during the financial crisis. The outstanding mortgage debt of EUR 783 billion is now much lower in relation to total housing wealth and has fallen below 50 percent. The decrease is due to the fact that more repayments have been made since then, both voluntary (in view of the low savings rate) and mandatory (because of the larger proportion of annuities in outstanding mortgages). This has reduced the risk of a large number of homeowners' mortgages going underwater.

CPB figures also show that the number of homeowners with a mortgage under water after a price correction will be lower than during the credit crisis. These are based on the situation in 2020. Because prices have risen since then and families have saved more, the situation is now more favourable. On the other hand, few buyers are making use of the NHG, because the cost limit has risen more slowly than the average purchase price and fewer buyers are eligible. The NHG share is below 20 per cent for purchases and below 30 per cent for outstanding mortgages.