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Economic Research:

Low Lending Rates Keep Europe's Housing Markets' Recovery On Track

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Economic Research:

Low Lending Rates Keep Europe's Housing Markets' Recovery On Track

Housing market activity should continue to expand in nearly all major European countries this year, fueled by economic recovery and very favorable mortgage financing conditions. While uncertainties caused by the U.K.'s June 23 referendum decision to leave the EU could dent eurozone growth and, by extension, the housing market recovery over the next few years, we don't expect that it will derail it. We forecast eurozone real GDP will expand by 1.7% this year and we expect the European Central Bank's (ECB's) accommodative monetary stance, leading to historically low sovereign bond yields and mortgage interest rates, will spur improvements in Europe's housing markets.

The U.K. is the only housing market for which we forecast house price declines as a result of the Brexit vote, although strong market gains in the first half of this year should keep full-year house price rises at 5%, with the market only likely declining in 2017, by 2%. Although Ireland's economy has tight economic ties with the U.K., we expect its housing market will continue its robust recovery, with prices growing by 6% this year, aided by the ongoing improvement in the labor market and a housing supply shortage. The Netherlands, also exposed to the U.K. economy, should also continue to see nominal prices rise by 5% this year on the back of economic improvements and favorable policy measures. Even the French housing market, which has been falling in recent years, is showing some resilience and looks set to grow by 2% in 2016 and in 2017 against a backdrop of low lending rates and modest economic growth.

Overview

- We forecast house prices will rise in nearly all European markets this year on the back of historically low lending rates.
- We expect economic uncertainties caused by the Brexit vote will lead to house price declines in the U.K over the coming 18 months, but they are unlikely to strongly affect other European housing markets.
- The German housing market will see the strongest growth this year (7%), fueled by strong demand and tight supply.
- The Italian housing market, on the other hand, will likely see zero growth, as banking sector turmoil is affecting the nascent economic recovery.

We expect the strongest residential housing market gains this year will be in Germany, where robust economic fundamentals, a shortage of housing that is being further squeezed by the surge of migrants, and historically low lending rates should lead to prices inflating by 7% on last year. We forecast Spain and Belgium will each see house price rises of 4% this year. In Spain, economic growth, declining unemployment, and interest from foreign buyers should underpin a continued recovery of house prices. In Belgium, forthcoming changes to fiscal rules and very favorable loan rates are still underpinning demand this year.

While economic recovery and price incentives are also continuing to lift house prices in Portugal, a large stock of nonperforming domestic loans is still slowing the housing market recovery, capping house price rises at 3% this year. However, we forecast Italy's housing market will be the poorest performer in our survey, with zero growth, amid only a slow economic recovery and the possibility that financial conditions could tighten amid declining confidence in the country's banking sector.

Swiss house prices, meanwhile, are still undergoing a slow recovery, rising by a nominal 1% this year. House prices look set to rise only very slowly over the coming two years, held back by regulatory measures aimed at taming the market's rise, as well as the dampening impact of Brexit and weaker global growth on the economy.

Table 1

European Housing Market Forecasts

	2013	2014	2015e	2016f	2017f	2018f
Nominal house prices, % change year on year						
Belgium	1.1	0.9	1.5	4.0	2.0	1.0
France	-1.9	-2.5	-0.5	2.0	2.0	0.0
Germany	4.8	2.8	5.0	7.0	6.0	4.0
Ireland	6.3	16.2	6.5	6.0	2.5	3.0
Italy	-5.3	-3.6	-1.7	0.0	1.0	1.0
Netherlands	-4.3	2.0	4.8	5.0	3.0	4.0
Portugal	0.6	2.2	5.0	3.0	4.0	3.0
Spain	-6.3	1.8	4.3	4.0	2.5	3.0
Switzerland	4.6	0.4	2.3	1.0	0.0	1.0
U.K.	3.6	11.7	5.6	5.0	-2.0	2.5

e--Estimat. F--Forecast. Sources: S&P, OECD, Hypoport.

Belgium: House Prices Are Accelerating Modestly This Year

We expect nominal house prices in Belgium will grow by 4% before slowing in 2017 and 2018 (see table 2), as uncertainties surrounding the Brexit vote may hit economic growth and as market affordability declines.

Recent trends

After four years of quasi-stagnation, the housing market regained dynamism in the first quarter of this year. Property prices grew by 3.5% year on year, the fastest pace since March 2012. Moreover and according to the Belgian notaries, the number of transactions surged by 20% in May compared to the same month on previous year, and by 16.5% in Q2 2016 compared to Q2 2015. Reflecting the upward trend, new loans for housing purchases grew by 23% in the six month to June. The very positive loan production in 2016 comes after weaker 2015 volumes as households in Flanders rushed to purchase houses ahead of less attractive fiscal rules that took effect on Jan. 1, 2015.

More changes in the housing taxation regime in Wallonia in 2016, and due in the Brussels region in 2017, are keeping property activity artificially dynamic, as households in these regions are rushing to purchase houses ahead the introduction of less attractive fiscal rules. The Walloon region has decided to reform its housing program by scrapping mortgage tax relief on home loans signed after Jan. 1, 2016, and replacing it with "housing cheques". Similarly, the housing bonus in Brussels will be replaced by a reduction in registration fees from 2017. These fiscal reforms are, however, resulting in a loss for households as they reduce the deductibility of mortgage debt service. In the medium term and after 2017, as market affordability declines, households' borrowing capacity will be more sensitive to changes in interest rates.

For now, the property market seems to be particularly resilient to these fiscal changes. We think that the continuous fall in mortgage interest rates is enabling Belgian households to somewhat offset the negative impact of these measures (see chart 3). Lower interest rates are increasing households' borrowing capacity for monthly repayments, in our view. An increase in the average loan amount was used to offset much of the loss of revenue generated by the Flanders and Wallonia housing taxation. Interest rates for new housing loans dropped another 35 basis points (bps) to 2.07% in May, after decreasing 30 bps last year, while the average mortgage loan amount rose by 0.4% to €145,000 in June 2016 from 2015.

Future trends

Following the Brexit vote, we lowered our forecast for GDP growth in Belgium to 1.1% in 2017 and 1.3% in 2018 (from 1.5% and 1.6% previously), as the country, along with others in the EU, copes with and adjusts to the uncertainty surrounding the U.K.'s vote to leave the EU. Belgium is a small open country with high exposure to the eurozone and, as such, could suffer the most from Brexit. The U.K. departure from the EU and other global economic uncertainties, are expected to hit trade and investment activity. Belgium has one of the highest exposures to the U.K. via the trade channel. Belgian exports to the U.K. constitute 7.6% of its GDP, while the country's trade surplus with Britain equals 3.5% of GDP. Belgium also has large claims on the U.K., equivalent to 7% of GDP, which are vulnerable to the depreciation of the pound. Domestic demand and consumer spending in particular should remain resilient, however, as we expect a continued recovery in employment. The deceleration in labor costs and the introduction of labor market reforms to tackle rigidities should ease firms' ability to adapt to the economic cycle and benefit the country's economic performance.

After the Brexit vote, the ECB offered no additional monetary stimulus at its meeting on July 21. The central bank kept its main refinancing rate at 0%, its marginal lending facility at 0.25%, and its deposit rate at -0.4%. The ECB also kept its asset purchases program at €80 billion per month, and confirmed that monthly asset purchases are intended to run until the end of March 2017, or beyond, if necessary.

However, ECB President Mario Draghi stressed that the central bank was waiting for more information, including new ECB staff projections due in September. He also noted that "if warranted to achieve its objective, the Governing Council will act by using all the instruments available within its mandate." We believe that at its September meeting, the ECB is likely to refine some rules governing its asset purchase program, especially the issues/issuance limit and perhaps the lower bound in terms of yields (currently at the level of the deposit rate at -0.4%) for eligible securities. As a result, we expect sovereign bond yields will remain at historically low levels, hence weighing on mortgage interest rates and attracting international investors looking for yields and investing in Belgian real estate. Indeed, the average Belgian house price remains less costly by international comparison. An apartment in the city center of Brussels cost €3,300 per square meter on average in July 2016, compared with €9,400 in Paris or £17,000 in London, according to figures from Numbeo.com (based on online surveys of users who list their prices).

More fundamentally, the National Bank of Belgium's measure of affordability tells us that the Belgian housing market, after being broadly affordable in 2014, became overvalued by about 8% last year, notably owing to the absence of price corrections after the above-mentioned fiscal reforms came into effect. The extent of the overvaluation is uncertain, however, as several factors could drive property prices in either direction, such as changes in mortgage interest rates or an improvement in economic conditions. As a net result, we expect house price growth will accelerate modestly this year before slowing in 2017 and 2018. The persisting low interest rate environment should support household investment in real estate and therefore limit any price adjustments.

Table 2

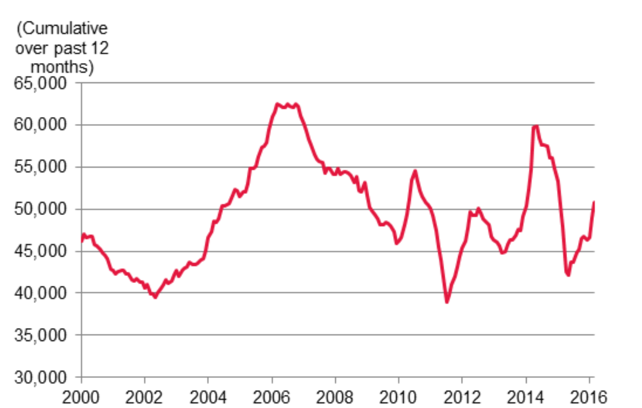
Belgium Housing Market Statistics

	2013	2014	2015	2016f	2017f	2018f
Nominal house prices (% change year on year)	1.1	0.9	1.5	4.0	2.0	1.0
Real GDP (% change)	0.0	1.3	1.4	1.4	1.1	1.3
CPI inflation (%)	1.2	0.5	0.6	1.5	1.8	1.5
Unemployment rate (%)	8.4	8.6	8.5	8.4	8.1	8.1

f--Forecast. Sources: S&P, Eurostat, Banque Nationale de Belgique, OECD.

Chart 1

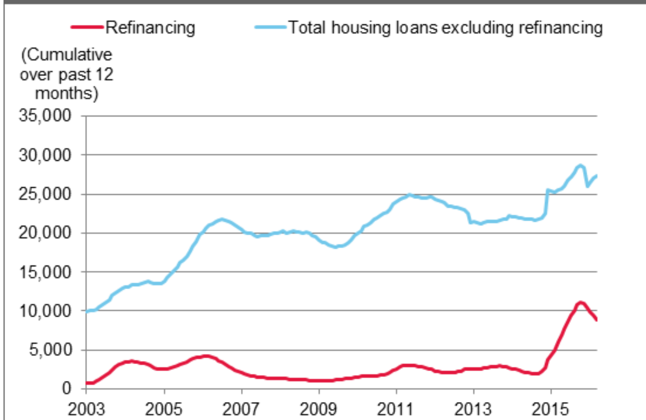
Belgium: Number Of Construction Permits



Source: National Bank of Belgium.

Chart 2

Belgium: New Housing Loans



Source: Statistics Belgium.

Chart 3

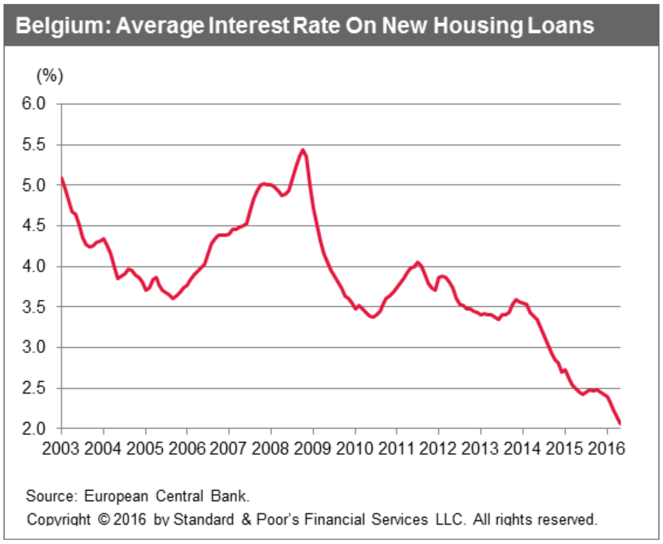
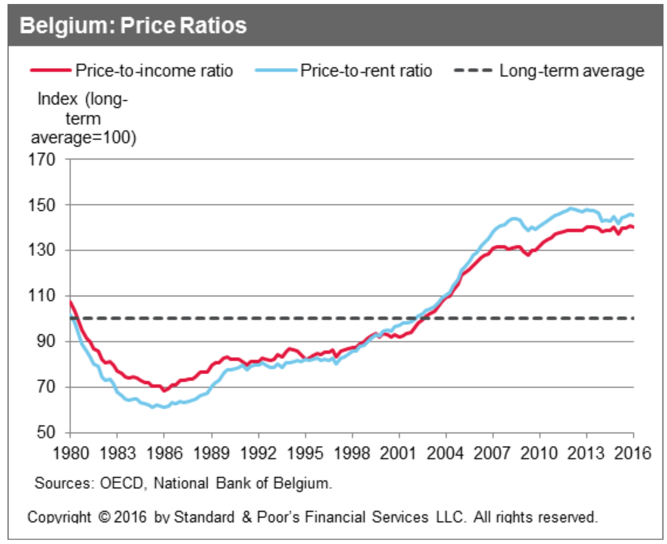


Chart 4



France: First time-Buyers Are Back

We forecast house prices in France will grow by 2% in 2016 and another 2% in 2017 (see table 3) against a backdrop of low lending rates and modest economic growth .

Recent trends

Economic growth picked up to 0.6% in Q1 from 0.3% a quarter earlier and in line with the performance of the eurozone as a whole. Strong domestic demand and a smaller drag from net foreign trade were the main drivers behind this acceleration. In May, consumer confidence climbed to its highest level since the beginning of the crisis. Real disposable incomes are receiving some lift from the slightly better conditions in the labor market and very low inflation. Real disposable incomes rose 1.8% year on year in Q1 (2% a quarter earlier). The unemployment rate (International Labor Organization definition) hit its lowest level since 2012 in Q1 at 10.1%. It touched a new low at 9.9% in May. Initial estimates for growth in the second quarter were, however, disappointing. French growth was zero in the quarter. Even though a slowdown in French economic activity was expected after a strong first quarter, the breakdown was a downer. One-off factors, such as strikes in May and June, skewed Q2 GDP data to the downside, but the latest indicators, such as Purchasing Managers' Index (PMI) data, suggest the French economy is proving relatively resilient and may experience a modest rebound in the second half of the year.

The housing market has continued to feel the positive effects of the ECB's accommodative monetary policy. At 1.6% in June, interest rates on housing loans were 3.5 times lower than they were at the beginning of the previous decade. Housing loan rates are typically pegged on the 10-year sovereign bond yield, which averaged 0.17% in July from 0.78% in December 2015. Within the eurozone, French rates applied to housing loans are the lowest after Germany. For potential buyers, this decline has an effect on their buying power similar to what would have been the case if prices had dropped 22.5% since 2011, or 6% since October 2015. Such conditions have allowed first-time buyers to make a comeback in the market by contracting long-term loans (over 20 years) at fixed rates. About 40% of transactions so far in 2016 have been made by first-time buyers, up from 35% in 2015. According to FNAIM, the realtors' federation, transactions in the previously-owned segment of the housing market should reach 840,000 in the 12 months to June, up 17.3% from a year earlier. The recovery in transactions has so far had a limited effect on prices. In the 12 months to March, nominal prices were up 0.6%, marking the end of a continuous decline since June 2012. Yet, the market correction that seems to have now reached an end was relatively modest: from the previous peak reached in September 2011, prices were down 7.2% on a cumulative basis. Compared to their pre-crisis levels of December 2007, prices were down 4.3% in March 2016. Those comparisons show how critical the sharp decline in interest rates has been in restoring market activity. From a fundamental standpoint, average prices for previously owned dwellings averaged 4.66 years of income in June from 4.56 years a year earlier, according to the Observatoire du Credit Logement.

Future trends

The Markit composite PMI increased from 49.6 in June to 50 in July, showing the French economy in resilient mood following the Brexit vote in the U.K. and the terrorist attack in Nice on 14 July. The PMI figures came a day after the French statistical office released its business confidence figures for July, which showed confidence unexpectedly rising to a two-month high. Although it is early days, the evidence suggests that the U.K. vote to leave the EU has not had the expected immediate negative impact on confidence. We expect that GDP growth will be somewhat slower in the second half of the year from the strong rebound in Q1 (0.7% sequential rise) as 4% (annualized) growth in domestic demand seems hard to sustain. But the fiscal policy penciled in for 2017, the year of the presidential elections, could provide some support in the form of additional tax cuts for households. Business investment should also continue to benefit from fiscal incentives and very low interest rates. Overall, our forecast has GDP growth slowing somewhat in 2017 from 2016 (see table 3) but remaining above 1%. The unemployment rate is likely to decline steadily to 9.3% in 2017, a still elevated level by historical standards.

Against that backdrop, activity in the housing market will remain heavily dependent on trends in interest rates. Household indebtedness has been steadily increasing to 71% of incomes at the end of 2015, a level that appears still moderate by European standards. But as noted earlier, the market correction since 2007 has been quite moderate and the improvement in market affordability has been mainly caused by much lower interest rates. Our central forecast has long-term bond rates experiencing a very soft gradual increase in the next two years. If this is indeed the case, housing activity should continue to rise this year and stabilize next year. Prices could increase by as much as 2% in 2016 and 2017.

Table 3

France Housing Market Statistics

	2013	2014	2015	2016f	2017f	2018f
Nominal house prices (% change year on year)	-1.9	-2.5	-0.5	2.0	2.0	0.0
Real GDP (% change)	0.6	0.7	1.2	1.5	1.2	1.4
CPI inflation (%)	1.0	0.6	0.1	0.2	1.4	1.2
Unemployment rate (%)	10.3	10.3	10.4	9.9	9.4	9.3

f--Forecast. Sources: S&P, Eurostat, OECD, INSEE.

Chart 5

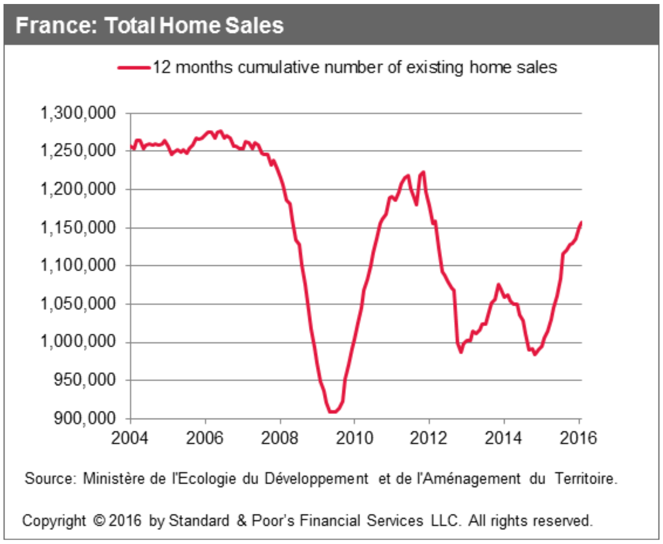


Chart 6

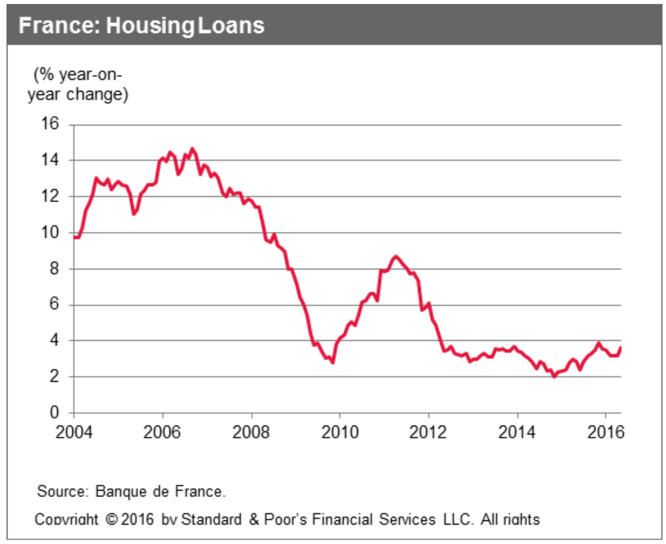


Chart 7

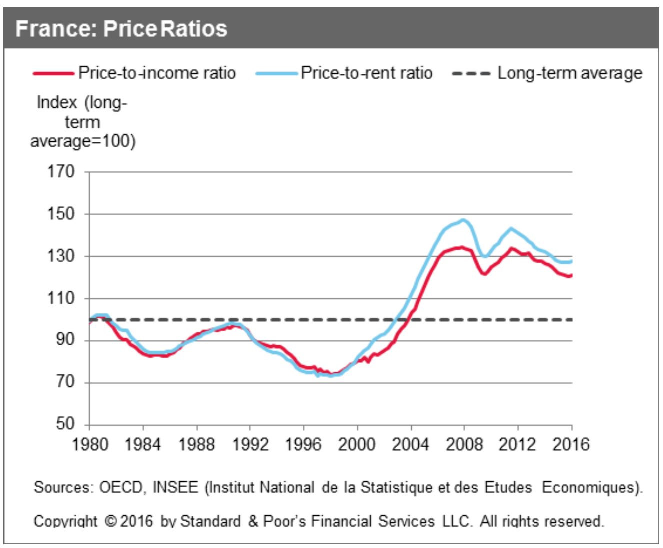
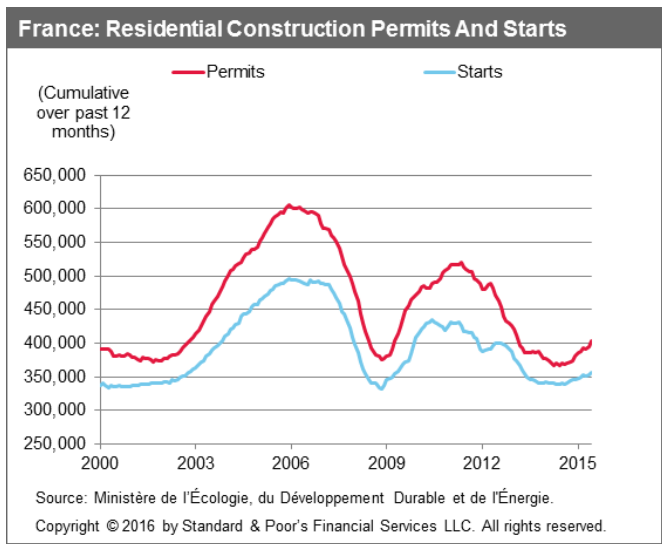


Chart 8



Germany: Strong Demand And Tight Supply Are Fueling Prices

We expect house prices in Germany will rise strongly this year by 7%, fueled by robust economic fundamentals, a shortage of housing that is being further squeezed by the surge of migrants, historically low lending rates, and a still affordable market (see table 4).

Recent trends

The upward trend in house prices is continuing unabated. Annual growth in prices for apartments and houses reached 6.4% in May after 4.8% in 2015. Between 2009 and 2015, prices rose by 30%. Larger price rises were recorded in major cities such as Munich or Hamburg (up over 50%). The German housing market was undervalued for years, as prices have been stagnant for more than a decade despite an improvement in household incomes. Measured by affordability ratios such as price-to-income and price-to-rent indices, German residential property prices were still below their historical average by 5% to 7% as of March 2016 (see chart 11). If the expansion cycle continues at the same pace as we expect, prices will stop being undervalued by the end of our forecasting horizon (2018).

Strong demand and a shortage of housing in many large German cities are underpinning the property upswing. Robust economic fundamentals, including the positive performance of employment and rising wages, are providing positive stimuli. The country added 560,000 jobs on an annual basis in May and the unemployment rate dropped to a record low level of 4.2% in the same month. While the positive trend in immigration to Germany has only marginally increased the number of persons in employment, they are driving the demand for housing, particularly in the lower price segment. Net immigration reached 1.1 million people in 2015 due to the large inflow of civil war refugees and asylum seekers from Syria and Afghanistan. The very positive lending conditions are also continuing to support demand for housing. Low mortgage interest rates are incentivizing Germans to become property owners. Interest rates fell to the historically low level of 1.79% in May from 2.0% at the end of last year (see chart 12). This was accompanied by a surge in lending to first-time buyers in particular. New business was up by more than 20% in 2015 compared to 2014.

At the same time, residential property construction output was disappointing. The number of dwelling completions picked up by a meager 1% in 2015 after a 14% surge in 2014. Looking forward, the number of permits rose considerably in the 12 months to April (+17.5%), pointing to stronger number of completions in 2016. The expansion of supply, however, is still unlikely to have filled the gap that has accumulated in recent years, especially in the largest cities. Indeed, demand for housing has been increasing strongly since 2009 and construction activity has been slow to respond, creating a supply shortage. According to the Federal Institute for Research on Building, Urban Affairs and Spatial Development (BBSR), the dwellings gap at end-2014 was an estimated 100,000, and the annual needs of new construction during 2015–2020 was 272,000 units, against completions of 247,700 units in 2015. Due to the large flows of immigrants in late 2015, estimates have been revised upward significantly. The Federal Ministry for the Environment estimates annual needs to be at least 350,000 units. Other private sector experts evaluate these needs at 400,000 units at least. The gap between recent new supply and needs appears to be more acute in the so-called affordable segment for low and middle-income households.

Future trends

A resilient domestic economy should somewhat insulate Germany from weak external conditions and the impact from Brexit. Nevertheless, trade and investment are likely to be negatively affected as a result of the uncertainty surrounding the post-Brexit negotiations between the U.K. and the EU. The U.K. is Germany's third-largest export destination and accounted for 25% of the total German trade surplus last year. The U.K. was also the second-largest destination of German direct investment. We cut our real GDP forecasts by 0.3 percentage points for both 2017 and 2018 to 1.5% and 1.4%, respectively (see table 4).

We forecast domestic demand will remain the key growth driver as real incomes are boosted, not least because of a healthy labor market. Before the U.K. vote, domestic demand had been robust in face of external shocks. Economic growth was very solid in Q1, with real GDP increasing sharply by 0.7%, supported by public and private consumption and strong construction activity.

We expect the labor market to remain favorable, marked by rising employment, a low unemployment rate, and improved wage prospects as a result of a tightness of the labor market. Unemployment should drop to 4.1% this year and next before rising slightly to 4.4% in 2018 on account of lower economic activity growth and an increased active population due to strong immigration flows. The integration of refugees to the German labor market will be key to boosting output in the longer term.

Heightened uncertainty following the U.K. vote is likely to intensify the demand for safe-haven assets such as German government bonds and German real estate. The results are twofold. First, mortgage interest rates are likely to fall even further, hence increasing household borrowing capacity and demand for housing loans. Second, yield spreads over sovereign bonds offered by rental returns are likely to remain attractive. We expect the ECB's monetary policy to remain very accommodative over the next three years. In the face of Brexit and downside risks posed to the eurozone economic growth, the bank is likely to refine some rules governing its asset purchase program, especially the issues/issuance limit and even perhaps the lower bound in terms of yields (currently at the level of the deposit rate at -0.4%) for eligible securities. The extremely loose financing conditions will remain a predominant factor supporting the rise in house prices. This suggests that demand will remain high and that, with supply being low, house prices will continue to rise.

However, risks of a housing bubble are not likely to materialize over our projection horizon. Over the past few years, the strong decline in interest rates did not lead to a pronounced jump in lending volumes. Banks' mortgage lending growth remains modest, although it picked up recently, rising by 3.3% year on year in May 2016 from around 2% in 2014. As a result, and relative to economic growth, mortgage loans have fallen from 39% of GDP in 2009 to around 35% in Q1 2016. This is because the housing market in Germany is structurally conservative: lenders typically demand a 30% down payment, while mortgage lending rates are usually fixed at about 10 years. Added to this, home ownership is low, at 53% compared to 65% in France and the U.K., and 73% in Italy, according to Eurostat. The rental market, meanwhile, is large and highly regulated. German households have typically favored rentals, but home ownership should increase in the coming years due to the incentives for tenants to purchase real estate in the currently low-interest-rate environment.

Table 4

Germany Housing Market Statistics

	2013	2014	2015e	2016f	2017f	2018f
Nominal house prices (% change year on year)	4.8	2.8	5.0	7.0	6.0	4.0
Real GDP (% change)	0.4	1.6	1.5	1.7	1.5	1.4
CPI inflation (%)	1.6	0.8	0.1	0.5	1.6	1.6
Unemployment rate (%)	5.2	5.0	4.6	4.1	4.1	4.4

e--Estimate. F--Forecast. Sources: S&P, Eurostat, Hypoport, Federal Statistics Office.

Chart 9

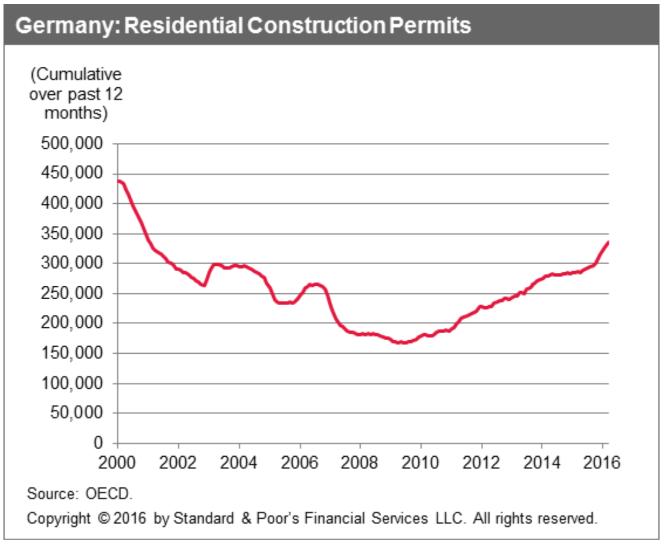


Chart 10

Chart 11

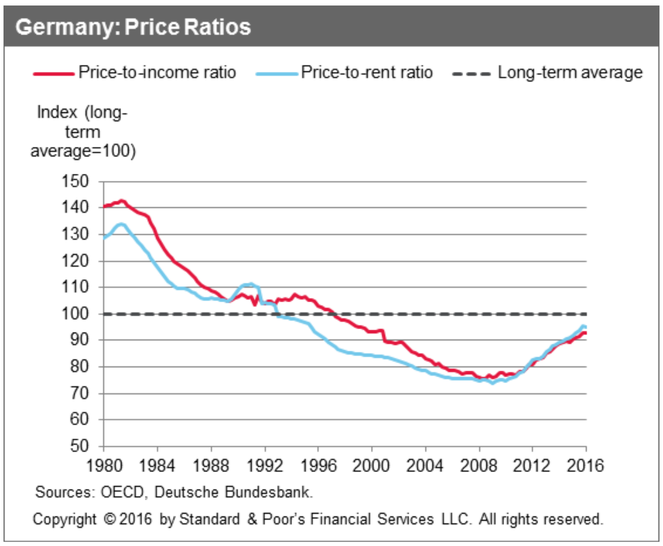
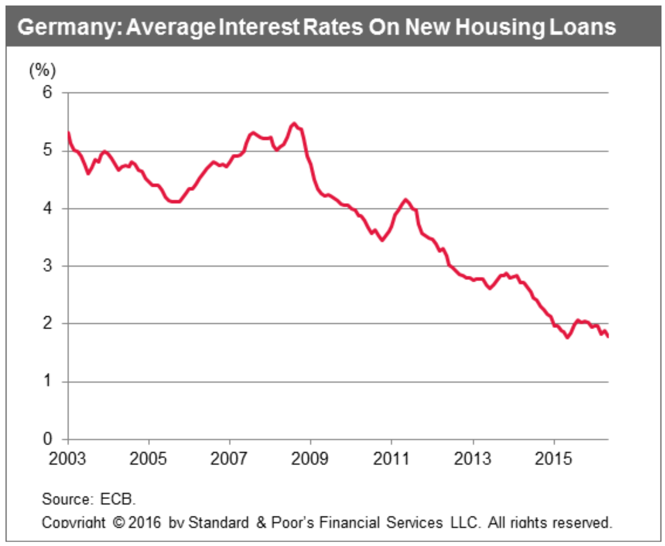


Chart 12



Ireland: The Recovery Continues, Underpinned By Supply Shortages

Ireland's economy is set to continue growing at robust rates in the next few years, with the recent vote in the U.K to leave the EU only dampening, but not derailing, the economic recovery under way in Ireland, in our view. The prospect of Brexit will also contribute to a slowing of house price inflation (see table 5), but the ongoing improvement on the labor market, along with a housing supply shortage that the decimated housebuilding industry finds difficult to address, will underpin relatively solid house price growth in the medium term.

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Recent trends

After already robust GDP growth of 5.2% in 2014, Ireland's economy outpaced all other eurozone countries (and, indeed, even China and India) when it grew an extraordinary 7.8% in the past year. Even if accounting for the fact that GDP in Ireland also includes undistributed profits of foreign-owned multinationals, which tends to inflate output, the underlying activity was very strong. (Our GDP numbers do not yet incorporate revised national accounts released on July 12, which show GDP in 2015 grew 26.3% in real terms, due to a reclassification of multinational companies' activity in Ireland.)

Moreover, while in the aftermath of the crisis the external sector played an important role in keeping the economy afloat, the momentum has now shifted almost entirely to domestic demand, making the recovery less dependent on, and less vulnerable to, external influences. Household consumption rose strongly in 2014- 2015, after flat-lining since the beginning of 2009. Investment has also started to recover and, encouragingly, in particular investment in residential dwellings, growth of which picked up to double-digit rates in 2014-2015, albeit from still extremely low levels.

Several years of very low levels of residential investment following the housing crash have translated into a significant housing shortage, with only about half of the demand, estimated at 25,000 homes, supplied to the market each year. This shortage is, in our view, the main driver of recently strong house price inflation. Indeed, after five years of consecutive and substantial house price declines, the trend reversed in 2013, and since then prices have seen a blistering recovery, rising by a cumulative 36%. The momentum extended into this year, with a 6.9% year-on-year increase in May. This continued improvement is largely driven by higher house price inflation outside of Dublin, with prices up 8.5% compared to 4.8% in Dublin over the same period. Prices outside of Dublin show the greatest catch-up potential, and are benefitting from the economic recovery now broadening to the rest of the country.

In addition to the shortage, the strong recovery of mortgage approvals 2012-2015, both in volume and value, is likely to have underpinned house price inflation. Finally, house prices have also benefitted from robust gains in economy-wide incomes over the past two years, after several years of decline. It is noteworthy, however, that the recovery in household incomes has so far not been driven by rising wages, but rather by a substantial pick-up in employment, up 8.7% in Q1 this year from its trough in Q3 2012 (the unemployment rate fell from just under 15% to 8.3% over the same period).

Future trends

As the labor market improves further in the next year, wage increases should start contributing more to rising incomes, which in turn should boost demand for housing to the extent that high household debt is not a constraint. Indeed, Irish households still bear a high debt burden compared to the rest of Europe. Average household debt in 2015 was still equivalent to 170% of disposable income, compared to 105% in the eurozone, but down from the extraordinarily high 230% at its peak in 2010.

Irish GDP growth should slow somewhat after the Brexit vote, owing to tight economic ties with the U.K. and a now weaker U.K. economy. We estimate the impact on Ireland to be between 0.3% and 0.7% a year 2017-2018, only dampening, but not derailing the strong domestic momentum. GDP should continue to grow at, under the circumstances, robust rates of 4.6% this year, 3.2% next year, and 3.0% in 2018. This relative slowdown in growth, due to the Brexit vote, explains to a large extent the deceleration in house price inflation in our forecast. In addition, tighter mortgage underwriting standards recently introduced by the Bank of Ireland, are likely to continue to have a dampening effect on house prices.

However, the persistent housing shortage will remain a key driver of house price inflation, as supply catches up only gradually with demand. The significant rise in house completions from 2014 is deceiving, as the recovery is starting from extremely low levels (this is the case in almost every other aspect of the Irish housing market). Indeed, while it is encouraging that completions are up 62% in the first five months of this year compared to 2013 (or 1,120 units on average each a month now compared to 690 units then), it will still take until 2020 for supply to catch up with demand, provided supply keeps growing at current rates of 15%-18% each year.

There are also first signs that the anticipation of a continued robust house price recovery, along with strong rent inflation recently at around 10% and an increasing number of households renting rather than buying, has started to attract institutional residential property investors, further underpinning the recovery in prices.

The main structural reason for the housing shortage is that the housebuilding industry is still suffering from the housing crash eight years ago and, although now on a firm path to recovery, it has not yet grown sufficiently large and resilient to provide enough homes to the market. Many businesses have failed and supply chains are still impaired in places. Output of the sector in terms of gross value added (GVA) fell by 60% from the peak in 2007 to the trough in 2012 and, as of today, activity has yet to regain levels last seen in 1998. The sector is very investment-intensive, and it will take time to rebuild.

Accentuating this situation, house prices are still 33% below their pre-crisis peak, while the cost of supplying a home to the market remains high, according to the Society of Chartered Surveyors Ireland (SCSI). It will take some time before margins improve sufficiently to allow the homebuilding sector to recover fully, supported by a gradually improving access to development finance, as banks work off the remaining crisis legacies on their balance sheets. Moreover, in order to avoid affordability from deteriorating, the government may need to take additional policy steps to reduce costs not directly related to construction activity.

Table 5

Ireland Housing Market Statistics

	2013	2014	2015	2016f	2017f	2018f
Nominal house prices (% change year on year)	6.3	16.2	6.5	6.0	2.5	3.0
Real GDP (% change)	1.4	5.2	7.8	4.6	3.2	3.0
CPI inflation (%)	0.5	0.3	0.0	0.5	1.0	1.8
Unemployment rate (%)	13.1	11.3	9.4	8.0	7.5	7.0

f--Forecast. Sources: S&P, Eurostat, OECD, Central Statistics Office

Chart 13

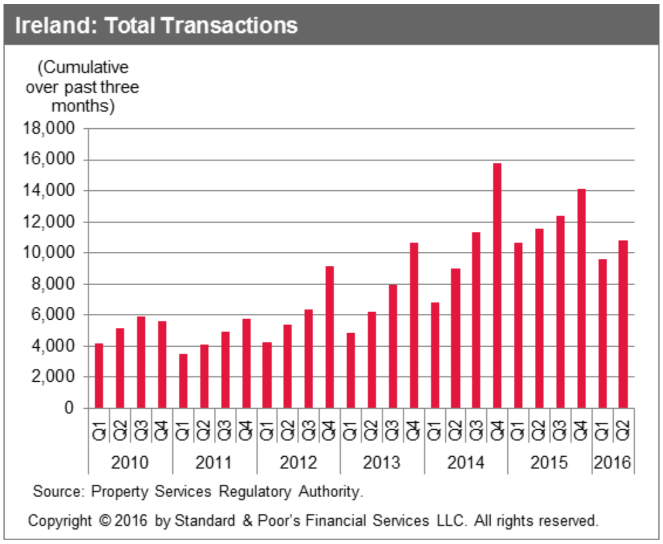


Chart 14

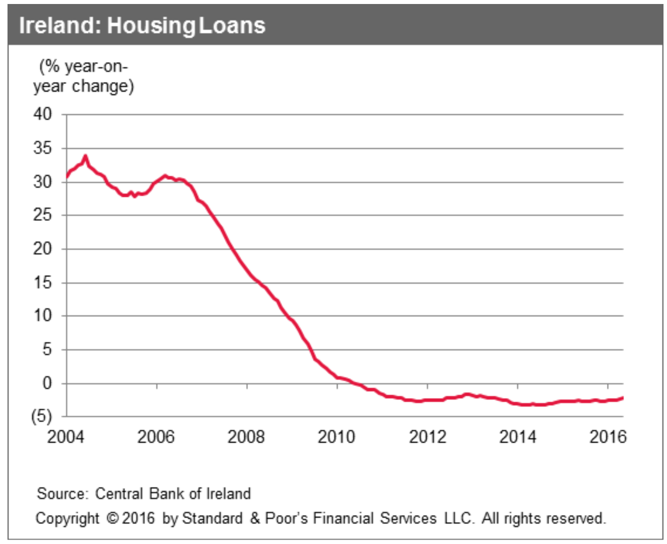


Chart 15

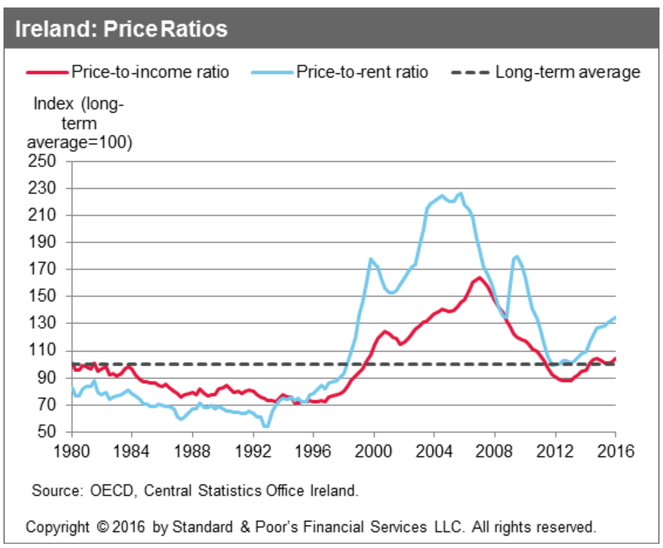
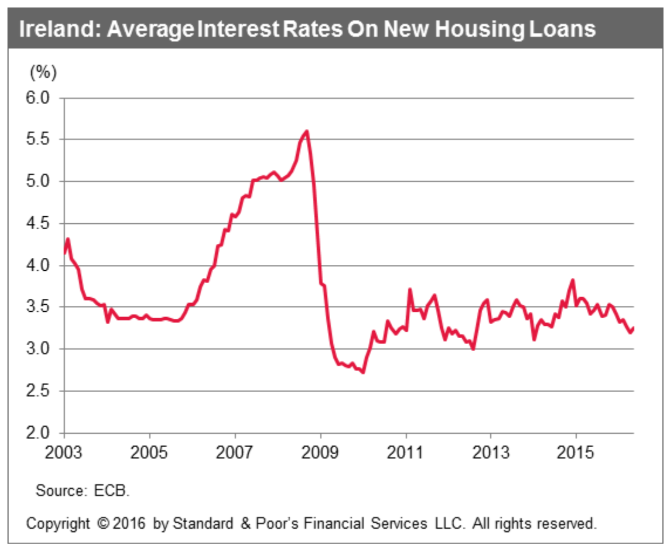


Chart 16



Italy: Banking Sector Turmoil Could Hinder The Nascent Recovery

We forecast only a slow recovery in house prices in Italy, with zero growth this year and market rises of 1% in 2017 and 2018 (see table 6), amid only a slow economic recovery .

Recent trends

Housing activity in Italy started its revival last year, but the recovery has not yet been reflected in prices. Indeed, prices adjusted by inflation have been in falling for eight years. Between March 2008 and March 2016, prices tumbled by 20% (and 26% in real terms). The Italian economy has been growing modestly since the beginning of last year, supported by domestic demand and consumer spending in particular. An improvement in the labor market, low inflation, and interest rates at a record low underpinned real household disposable income, while exports have gained from the much more competitive euro. Yet, despite the economic recovery, the housing market has only eased, falling at a slower pace of 1.2% in Q1 2016, after losing 1.7% in 2015 and 3.6% in 2014.

A large supply of unsold houses could explain the lack of a recovery in prices. The number of homes changing hands fell by more than 50% between 2006 and 2014, and has only gradually recovered by 10% since then. The housing market turmoil has been more reflected in the rapid collapse in transactions than in the fall in prices (see chart 17) as homeowners refused at first to sell in expectation of a future price rebound. The home ownership rate is relatively high in Italy compared with other European countries, as more than 73% of households own their property compared to 65% in France or 53% in Germany. The recent change in sellers' expectations and their acceptance of a reduction in prices are currently underpinning transaction activity, but this is resulting only in a delayed and gradual drop in house prices.

The recent slight increase in home sales has been accompanied by a rise in confidence in the construction sector, which in June rose to its highest since September 2008, suggesting that developers are more confident in a recovery in the housing market. The recovery in the construction sector nevertheless remains very limited. The number of permits for new residential buildings, which has been down by 85% from 280,000 in 2005 to 41,000 in 2015 only started to stabilize last year, but we can't say it has really picked up yet.

Besides the overall improvement in the domestic economy, the other key factor driving the residential property market was the easing in financial conditions and the improvement of the mortgage market. The demand for mortgage loans rocketed last year and continued to be very strong in the first five months of the year. New housing loan volumes doubled last year and reached 74,000 in the 12 months to May, surpassing the annual level recorded before the crisis in 2007. Households are indeed benefiting from a rapid decline in mortgage interest rates, which fell 35 bps in 2015 and another 25 bps since the start of the year (see chart 19). Italy has been the main beneficiary of ECB's very accommodative policy as it helped reduce financial fragmentation among eurozone countries and pushed down sovereign bond yields since last year to historically low levels.

Future trends

The Brexit vote has triggered both political and financial uncertainty in Italy. The biggest risks to the economic outlook in Italy from a Brexit are mostly indirect, as the country has one of the lowest direct exposures to Brexit among all large eurozone countries. Direct Italian exports to the U.K. are fairly modest and only account for 1.3% of its GDP. Italy is mostly exposed to potential political, economic, and financial contagion from Brexit: the economic recovery is still nascent, the banking system is fragile, and the upcoming Italian constitutional referendum in October could, if lost, trigger a political crisis with the resignation of the prime minister and new elections, which could bring to power the populist party Five Star Movement (M5S).

Until now, the slow and fragile recovery has been mostly supported by domestic factors and particularly by private consumption. Real GDP grew by a modest 0.3% quarter on quarter in Q1, following 0.2% growth in the previous quarter. We expect the Brexit vote to shave off 0.4% from Italian GDP growth in both 2017 and 2018, as consumers and businesses may put spending plans on hold. We expect Italian growth to decelerate, rising by just 0.8% next year and 0.9% in 2018, compared with 1.1% this year. Domestic demand is likely to be supported by consumer spending on the back of an improving labor market, low inflation, and various tax cuts. Although there are signs that Italian exports are starting to perform better, a sustainable recovery will still require a strong rebound in investments. Yet, a legacy of bad debts is likely to limit banks' lending policies and weigh on the prospective recovery in capital formation.

Besides, credit growth in Italy remains exposed to the fragile banking system. Following a rocky start to the year, Italian banks are facing increasing market turbulence amid investors' concerns about their creditworthiness. In July, Italian bank equity price indices collapsed to the lowest level since the sovereign debt crisis in 2012. Confidence in the Italian banking sector's profitability has been undermined by an expected renewed economic slowdown following the Brexit vote, the prospect of interest rates staying low for longer, and mounting concerns about high nonperforming loans.

Bad loans in the country have grown significantly in the past years as a result of the protracted recession, recently reaching about 20% of total outstanding loans in the system. Current regulatory constraints have prevented the Italian government from creating a wider support package, like those implemented in other European countries, such as Spain or Ireland. This includes the creation of a proper "bad bank", which has the capacity to acquire assets below market value. We note that European state aid rules, which explicitly require private sector involvement to reduce or avoid the use of public funds, significantly constrain the government's capacity to provide unconditional support to stressed banks. Nevertheless, we believe that rising euro-skepticism in several countries, and uncertainty regarding the economic and financial consequences of the "leave" result in the U.K.'s June referendum on EU membership, could provide the Italian government with some bargaining power in these ongoing discussions. We think that the current financial turmoil, including the decline in Italian banks' stock, could trigger a tightening in credit conditions and constrain lending supply activity, which as a result could again delay the recovery of the housing market.

As a result, we still expect a slow recovery in prices over the forecast horizon, as the economy is expected to recover more slowly and financial conditions could remain tight.

Table 6

Italy Housing Market Statistics

	2013	2014	2015	2016f	2017f	2018f
Nominal house prices (% change year on year)	-5.3	-3.6	-1.7	0.0	1.0	1.0
Real GDP (% change)	-1.8	-0.3	0.6	1.1	0.8	0.9
CPI inflation (%)	1.2	0.2	0.1	0.2	1.4	1.2
Unemployment rate (%)	12.1	12.6	11.9	11.4	11.1	11.1

f--Forecast. Sources: S&P, Eurostat, OECD, Nomisma.

Chart 17

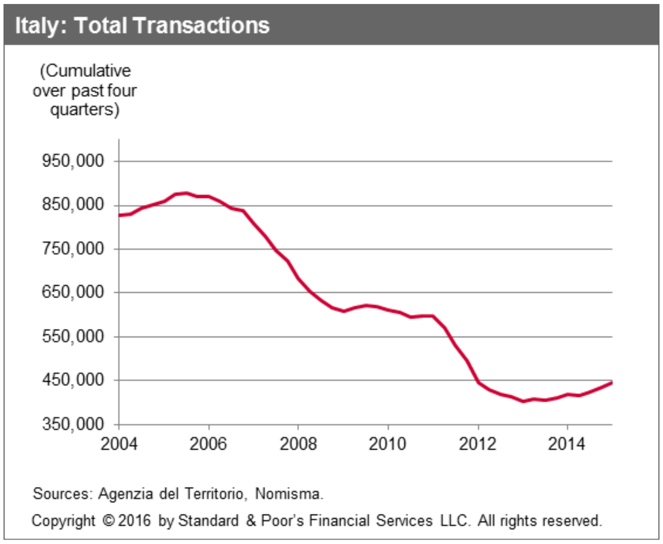


Chart 18

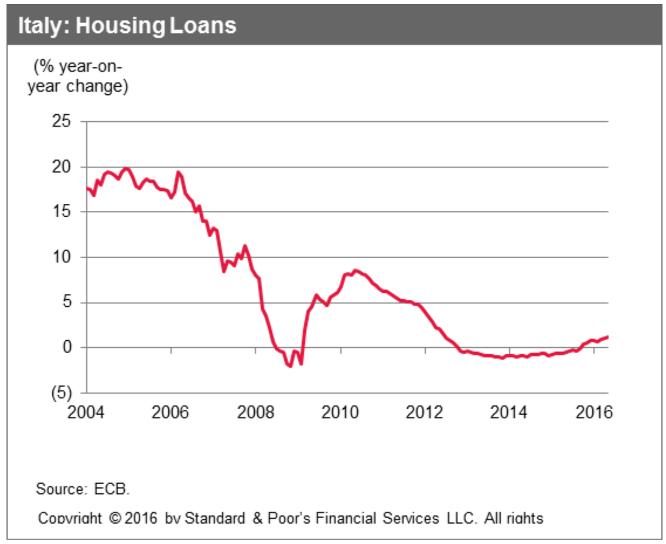


Chart 19

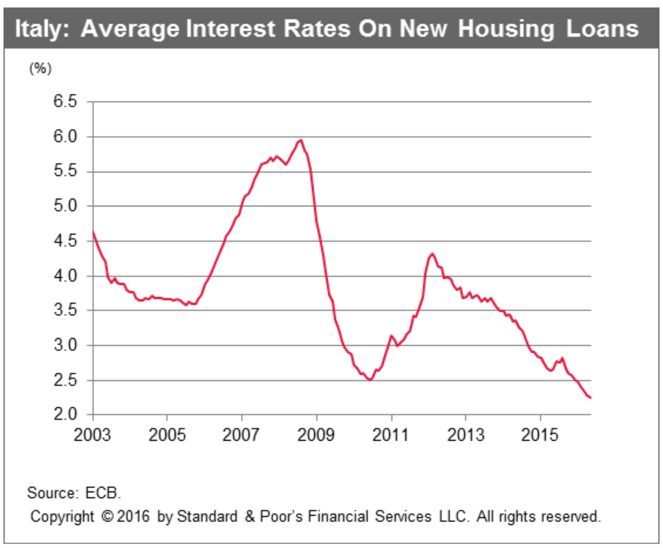
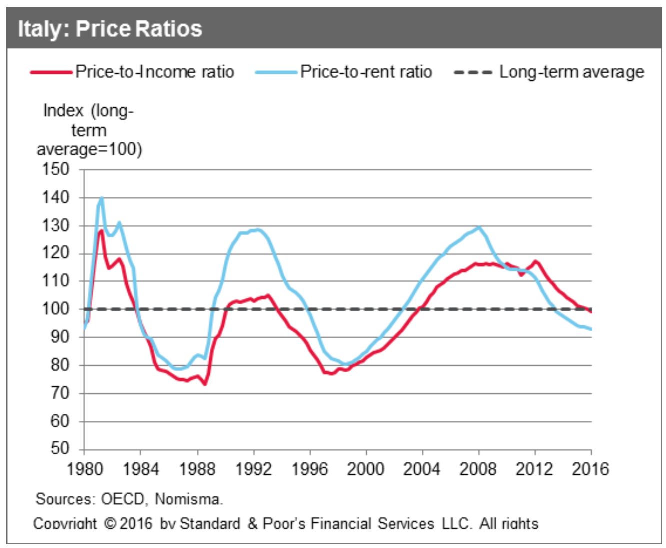


Chart 20



The Netherlands: The Strong Housing Market Recovery Continues

We expect the house price recovery will continue in The Netherlands this year, with nominal prices rising 5%, on the back of economic improvements and favorable new policy measures (see table 7). However, uncertainties surrounding the Brexit vote could contribute to slowing price growth to 3% in 2017 given the Dutch economy's exposure to the U.K.

Recent trends

Economic growth experienced a significant pick-up in pace at the beginning of the year, with GDP expanding 0.5% over Q1 compared to 0.2% in the previous three months. The expansion was broad based: exports rose 3.4% over the quarter and the momentum seems to have kept pace in the second quarter, according to early estimates for April-May. Exports of services were the main driver behind this impressive performance. Housing investment was also a strong contributor, rising 6.7% in the quarter. Household consumption rose 0.5% after having stagnated in the second half of 2015, but remained weaker than could be expected in view of the strong fundamentals affecting the household sector. Growth in real disposable incomes has been robust, reaching 3.3% in Q1, thanks to hefty rises in wages (1.8% year on year in June), negative inflation (-0.2% in June), a steady improvement in the labor market with the jobless rate at 6.1% in June, and a tax cut amounting to €5 billion this year.

In line with the overall economic climate, the housing market got off to a strong start this year. The number of transactions amounted to 93,212 in the first half of the year, up 24% from the same period a year earlier. Total transactions are now back to their mid-2008 levels (see chart 21). Interest rates applied to housing loans reached new record lows for all fixed-term periods, underpinning strong growth in mortgage lending (see charts 22 and 23). New loans were up 23.6% in the 12 months to May. These favorable economic and financing conditions have pushed nominal house prices further up. In the 12 months to March, prices were up 5.2%. That's 8% above their lowest point in the second half of 2013, but still 14% below their peak in September 2008.

Future trends

While the U.K. decision to leave the EU will weigh on the economic performance of the entire eurozone over the next several years, the Dutch economy stands out as one of the region's most exposed, after Ireland. Exports of goods and services to the U.K. amount to 9% of GDP. The U.K. has also been a prime destination for direct investment from The Netherlands. In 2014, the stock of direct investment in the U.K. stood at £208 billion, much more than any other large eurozone country. French investment by contrast stood at £98 billion, and Germany's at £72 billion. As a very open economy, The Netherlands is also likely to be indirectly impacted via its trade relationship with the rest of the eurozone.

It is certainly too early to make a full estimate of the impact on the U.K. economy and on its key trading partners. Our very initial estimates suggest that it will produce a drag on U.K. GDP of 1.2% in 2017 and 1% in 2018. For the eurozone as a whole, we project a 0.8% hit to GDP in the next few years. For The Netherlands, our initial estimates suggest a hit of 0.7% of GDP next year and in 2018 (1.5% on a cumulated basis). It remains to be seen to what extent higher volatility and uncertainty related to Brexit will impact the Dutch housing market. Although weakened, household consumption in our new forecast will still grow by 1.2% in each of the next two years and unemployment will continue to fall, albeit less rapidly.

In addition, a number of new policy measures will affect housing market activity. From Jan. 1, 2017, the one-off gift tax exemption will rise from €53,016 per child to €100,000. The measure will only apply if used for the following purposes: buying, improving, or maintaining one's house, or repaying housing debt. The measure will not apply, however, to people who already made use of the exemption in 2013 or 2014. Another measure concerns a relaxation of lending criteria this year and next, as the second income in a household will be taken into account, giving additional purchasing power especially for first-time buyers. On the other hand, the maximum loan-to-value ratio will be reduced each year by 100 basis points from 102% this year. The maximum level of mortgage interest relief will also be reduced gradually by 50 bps a year from 50.5% at present.

Turning to market fundamentals, the recent rise in prices hasn't translated into a deterioration in market affordability, as measured by the price-to-income ratio. As noted earlier the recent price rebound came after a prolonged correction, as disposable incomes have enjoyed solid increases as well. Importantly, we expect interest rates to remain very low over the next two years as the ECB stance stays very accommodative. This will no doubt underpin demand growth in the housing market. On net, we expect house price increases to slow to about 3% next year from 5% in 2016. An upside that should be contemplated, however, is that Amsterdam stands out as one of the possible financial centers competing to somehow "replace" the City of London depending on the outcome of the Brexit negotiations between the U.K. and the EU. If this was to become more plausible, the Amsterdam housing market could become quite overheated.

Table 7

The Netherlands Housing Market Statistics

	2013	2014	2015	2016f	2017f	2018f
Nominal house prices (% change year on year)	-4.3	2.0	4.8	5.0	3.0	4.0
Real GDP (% change)	-0.4	1.0	1.9	1.8	1.4	1.2
CPI inflation (%)	2.6	0.3	0.2	0.3	1.6	1.3
Unemployment rate (%)	7.3	7.4	6.9	6.2	6.0	5.8

f--Forecast. Sources: S&P, Eurostat, Kadaster, OECD, CBS Statistics Netherlands.

Chart 21

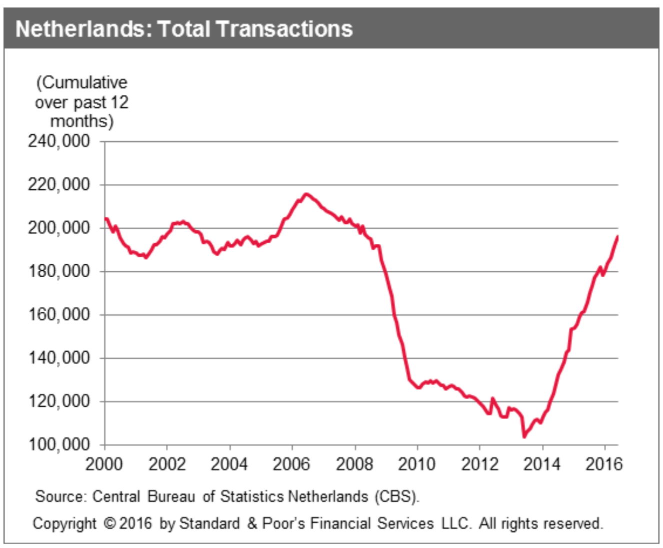


Chart 22

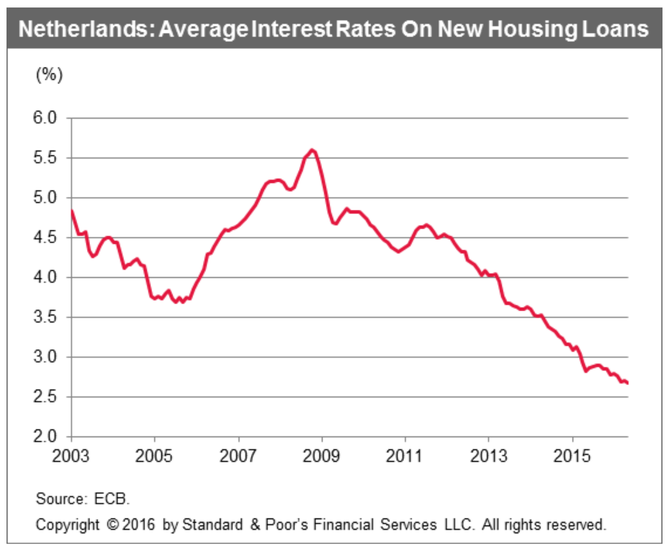


Chart 23

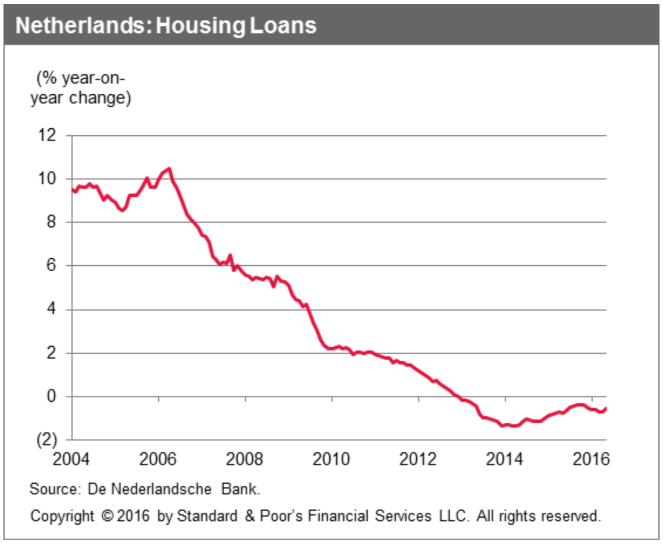
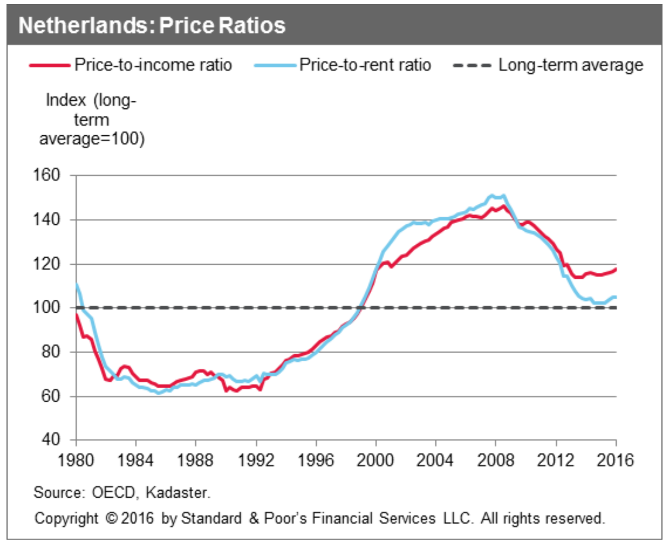


Chart 24



Portugal: The Fragile Housing Recovery Is Susceptible To Headwinds

Economic recovery and price incentives are continuing to lift house prices in Portugal. Nevertheless, the recovery is still susceptible to external headwinds, while still high unemployment and a large stock of nonperforming domestic loans are continuing to slow the housing market recovery. We expect house prices will rise by 3% this year and 4% in 2017, after 5% in 2015 (see table 8).

Recent trends

The housing market recovery is strengthening amid positive economic conditions, an improvement in the mortgage market, strong demand from international investors, and a shortage of houses for sale. Residential property prices surged 7% year on year in March 2016, following 5% growth last year. This was the fastest rate of expansion since 2001. Prices grew strongly in populous and tourist regions, such as Algarve and Lisboa, but the recovery has also expanded to less popular regions, such as Centro. In June, the RICS Housing market survey showed sales at their fastest pace in 10 months, while other forward-looking indicators also suggested a sustained recovery. Respondents are now projecting prices will rise by around 4% per year over the next five years.

The Portuguese housing market is highly affordable and attracting foreign investors in search for yields. The price-to-rent ratio is very low compared to the long-term average (see chart 28), suggesting that the market may be undervalued by 19% as of March 2016. The market is benefiting from the reforms implemented as part of the Economic Adjustment Programme agreed with the European Commission, ECB, and International Monetary Fund. These measures made the property market more dynamic, with rental contracts being gradually upgraded to near-market rates. These legal changes are attractive for investors, especially in large cities, such as Lisbon or Porto. Tax incentives such as "the golden visa" scheme or the non-habitual residents' tax regime, mainly attractive for retired foreign workers and high-net-worth individuals, are also supporting the rise in prices. The government scheme granting five-year residency permits to non-EU citizens who buy properties of at least €500,000 attracted around €2 billion in property purchases from foreign investors between October 2012 and June 2016, according to the Immigration and Borders Service. Three-quarters of the 3,609 permits have been issued to Chinese citizens. And this trend is accelerating: 821 resident permits were issued in the first six months of 2016, compared to only 766 in 2015.

The improving sentiment on the housing market has only marginally lifted the construction activity, adding to the supply shortage. Although the total number of construction permits issued in the 12 months to May 2016 was up 26%, it only reached the very modest level 9,111 (see chart 25). This is still well below the 65,000 recorded in the year 2007. Meanwhile, completions of new family housing units continued to fall. The number of dwellings completed declined by 27% year on year to 6,600 units in 2015 compared to 70,000 dwellings built per year before the financial crisis.

Future trends

Following two consecutive years of positive economic growth, we expect the economic recovery in Portugal will moderate in 2016. We have slightly revised down our short-term economic outlook as a consequence of the U.K.'s decision to leave the EU. Portuguese exports to the U.K. are modest and account for only 7% of goods exports in 2015. However, the effects are likely to be indirect, as confidence, uncertainty, and second-round effects mean that GDP growth will not improve in H2 as much as we previously envisaged. Overall, we downgraded our GDP growth forecasts to 1.3% this year, 1.2% next year and 1.3% in 2018 (compared to 1.4% this year and 1.5% in 2017 and 2018 previously in our pre-Brexit vote projections). While we continue to be optimistic about the upward trend, considerable risks remain.

Rising consumer confidence and a steadily improving labor market are supporting growth in housing market activity, but a sustained improvement will also depend on the strength of the economy and whether the recovery can regather momentum. Despite the recent improvement, Portugal has a long way to go before it achieves a full recovery. GDP is still 6% lower than in early 2008. Moreover, we expect the economy will remain constrained over the medium term. Unemployment, although falling, is still high at 11.6% in May 2016. Although low inflation has some positive implications for competitiveness, it also increases the economy's considerable debt burden. We think households could be reluctant to take on more debt, particularly in an environment of still high unemployment. Housing policy in Portugal has allowed households for many decades to buy a home by conferring mortgage subsidies, helped push up home ownership from 52% in 1981 to 75% in 2015, according to Eurostat.

Besides, the housing market needs continued support from credit to maintain the momentum. The ECB's very accommodative monetary stance is creating relatively favorable financial conditions in Portugal and reviving the mortgage market. New housing loans increased by 70% in 2015 and reaching volumes in May, not seen since December 2011, while mortgage interest rates fell by another 45 bps in May 2016 from May 2015 (see charts 26 and 27). However, Portugal's still fragile banking system struggles to accommodate the correction of the economy's high dependency on external funding and investment. Banks remain dependent on the ECB to roll over debt maturities previously funded by external investors. Meanwhile, banks still hold a large stock of nonperforming legacy assets (11.6% of domestic loans in 2016 according to our estimates), which is hampering the supply of credit. Hence, annual growth of net housing loans is still negative, at -3.6% in May 2015 (see chart 26).

Portuguese bonds have been recovering after the major sell-off in mid-February. At one point, the spread over the German bund reached 400 bps before narrowing to around 300 bps, while the equivalent Spanish and Italian spreads are currently trading around 110 bps-130 bps. This is because political uncertainty over potential budget shortfalls, the partial reversal of certain reforms, and a weakening outlook have raised concerns in the marketplace about the soundness of the fiscal path. The markets' expectations of further monetary easing following the Brexit is, however, continuing to push credit spreads lower.

Table 8

Portugal Housing Market Statistics

	2013	2014	2015	2016f	2017f	2018f
Nominal house prices (% change year on year)	0.6	2.2	5.0	3.0	4.0	3.0
Real GDP (% change)	-1.1	0.9	1.5	1.3	1.2	1.3
CPI inflation (%)	0.4	-0.2	0.5	0.7	1.3	1.5
Unemployment rate (%)	16.4	14.1	12.6	11.8	11.4	11.0

f--Forecast. Source: S&P, Eurostat, OECD.

Chart 25

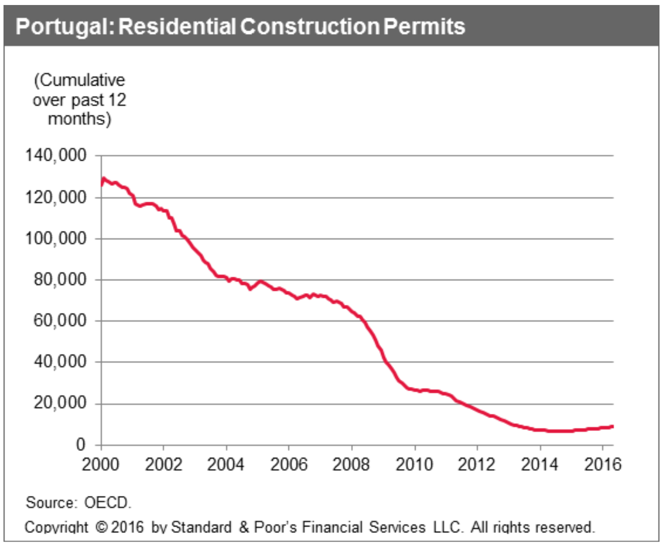


Chart 26

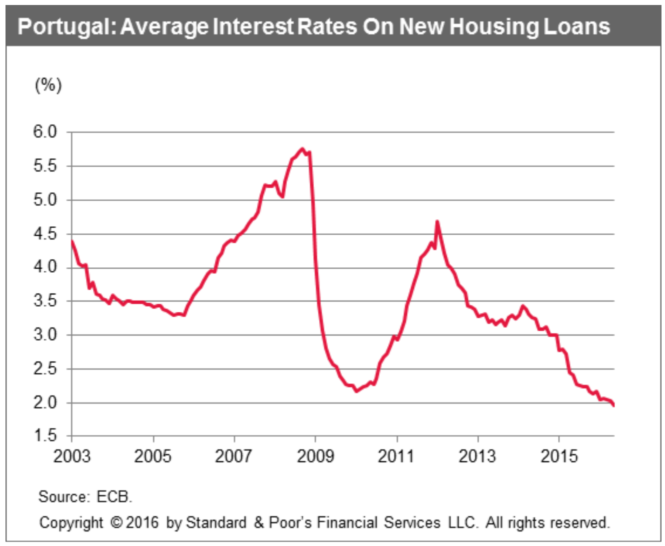


Chart 27

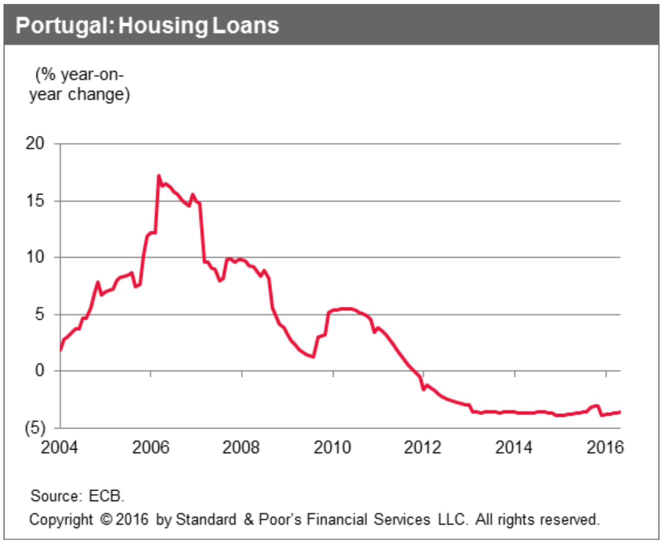
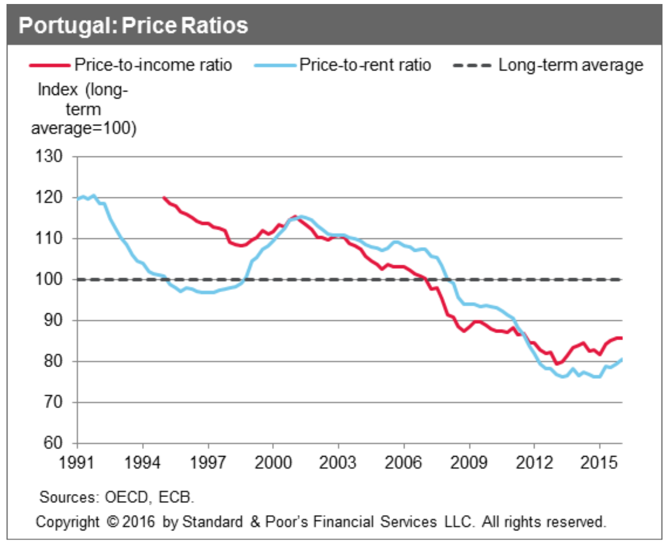


Chart 28



Spain: Robust Economic Growth is Fueling The Housing Recovery

Robust economic growth, declining unemployment, and interest from foreign buyers should underpin a continued recovery of house prices in Spain, with nominal prices rising by 4% this year and 2.5% in 2017, according to our forecast (see table 9). Although the Brexit vote is unlikely to have a big impact on the Spanish economy, the weaker pound could nevertheless dent purchases by U.K. buyers, currently the largest group of foreign buyers of Spanish properties.

Recent trends

Economic growth in Spain remains robust, with initial estimates showing that GDP rose 0.7% in the second quarter. Domestic demand continued to be the key driver of growth, especially consumer demand and capital expenditures. Residential investment has also started to recover after almost nine years of continued decline. By contrast, net foreign trade remained a drag on growth for the second year in a row. Buoyant economic activity translated into a marked improvement in the labor market. For 2015 as a whole, full-time employment has increased by 501,700, while the number of part-time employees rose 23,300, bringing the unemployment rate down to 20.75% by year-end. The improvement continued in the first half of this year, although at a slower rate. Total employment recorded a strong 3.3% increase year on year, representing 513,300 additional jobs in the private sector and 61,500 in the public sector in one year. Yet this wasn't enough to cause a further fall in the jobless rate, which rose to 21%, up 0.25% from the previous quarter. In absolute terms, unemployment was 4,791,400 in the first quarter.

The housing market has benefitted from the more favorable economic conditions. Building permits for new housing, while admittedly starting from rock-bottom, increased 43% compared to 2014. But housing starts were still at 5.7% of their 2006 levels. Meanwhile, for 2015 as a whole, housing sales rose 11.5% (2% a year earlier). The majority (71%) of residential properties were purchased by residents of the autonomous regions in which the property was located. But the second-biggest group of buyers was foreigners, who represented 17.3% of the transactions. Sales to foreigners were up 13.1% in one year. By country of origin, the share of U.K. buyers reached 21.3%; France was the second most frequent country of origin (8.7%), and Germany the third (7.3%). Strong foreign demand was particularly visible in the Balearic Islands, where sales to foreigners rose 26% year on year; it was also particularly strong in the Canary Islands and in Murcia.

The recovery in the housing market has continued in the first half of 2016. Transactions were up 23.6% in the 12 months to May (see chart 29). Mortgage lending has continued to be a key factor underpinning growth in demand. The ECB's very accommodative monetary policy has kept interbank interest rates on a downward path throughout 2015 and so far in 2016. The 12-month EURIBOR rate, the main mortgage loan benchmark in Spain, has been in negative territory for most of the year, reaching -0.059% on July 19, from 0.18% a year earlier. Average interest rates charged on new housing loans reached 2.05% in May, a record-low (see chart 30). Consequently, new lending has continued to rise heavily (see chart 31). The pick-up in housing activity has been associated with higher prices. In the 12 months to March 2016, nominal prices were up 6.3% (1.6% a year earlier), consolidating their growth trend. In sequential terms, prices have been steadily rising since the first quarter of 2014. For the first time since the beginning of the global crisis, house prices increased in all autonomous regions, with Madrid and Catalonia leading the chase.

Future trends

We expect the economic recovery to continue in the second half of 2016 before slowing somewhat in 2017. The prospects of slower growth in the U.K. economy in the next few years following the Brexit vote should not have too big an impact on Spain's foreign trade. Spanish exports to the U.K. represent 1.6% of its GDP, about the same as France (1.4%), and much less than The Netherlands (6.6%) or even Germany (2.7%). Domestically, the prospects for household consumption remain favorable, as job creation, lower tax pressure, and the lack of inflationary pressures continue to boost real disposable incomes.

A robust economy and still very favorable financing conditions, as the ECB maintains its very accommodative stance through at least 2017, will continue to provide support to the recovery in the housing market. In addition, the reduction in unemployment and the improvement in living standards are likely to make the country a more attractive destination for immigration, generating an additional source of demand for housing. Spain experienced a deep demographic transformation during the 2000s, which saw its population jump from 40 million in 2000 to nearly 46 million in 2008, with 90% of this increase through net migration. But since 2008, net migration has turned sharply negative as economic conditions deteriorated sharply in the country. The foreign population in Spain has fallen by nearly a million to 4.75 million in 2015. As of 2016, net migration could turn slightly positive again.

Under conservative assumptions regarding potential growth in the long term, the Spanish statistical office projects net positive immigration will average 13,000 people a year in the period 2015 to 2030. While this is likely to underpin slightly stronger demand for housing in the medium term, weaker demand from the U.K. should also be considered. As noted above, the U.K. forms the largest group of foreign buyers. Following the pro-Brexit referendum on June 23, the pound lost ground against the euro, curtailing that group's purchasing power in the eurozone. In addition, uncertainties regarding the future status of U.K. nationals in the EU once a new relationship has been negotiated are also going to curb the flow of potential U.K. buyers in the Spanish residential housing market.

Regarding market fundamentals, the sharp correction that took place between 2008 and 2014, generating a cumulative decline of 36% in prices between March 2008 and March 2014, has made the market much more affordable. The price-to-disposable-income ratio fell to 6.4 years at the end of 2015 from a peak of nine years in 2007. Overall, we expect the housing market to remain positively oriented with prices increasing 4% this year, and 2.5% next year as more supply is released on the market.

Table 9

Spain Housing Market Statistics

	2013	2014	2015	2016f	2017f	2018f
Nominal house prices (% change year on year)	-6.3	1.8	4.3	4.0	2.5	3.0
Real GDP (% change)	-1.7	1.4	3.2	2.8	1.8	1.9
CPI inflation (%)	1.5	-0.2	-0.6	-0.2	1.4	1.2
Unemployment rate (%)	26.1	24.5	22.1	19.5	17.8	16.3

f--Forecast. Sources: S&P, Eurostat, Banco de Espana, OECD, Instituto Nacional de Estadistica (INE).

Chart 29

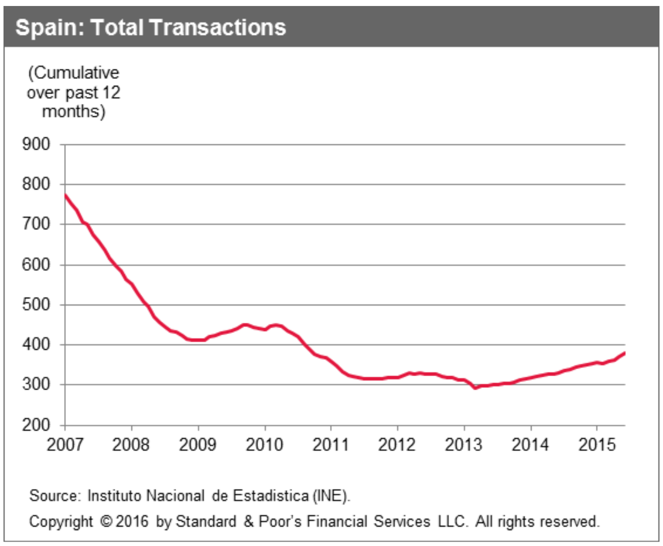


Chart 30

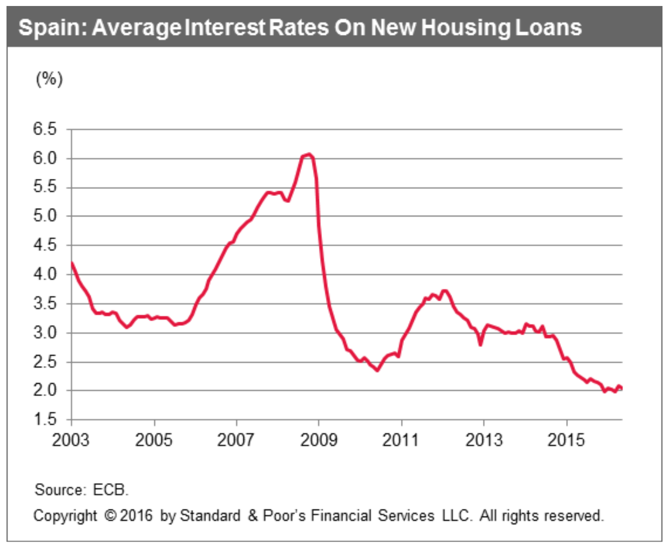


Chart 31

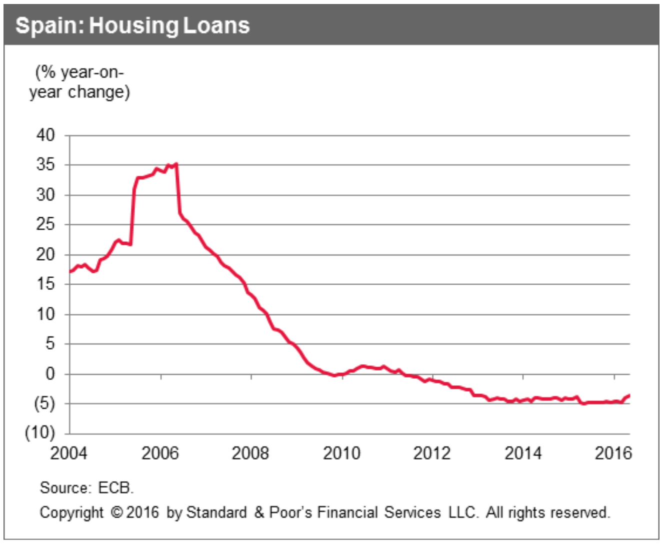
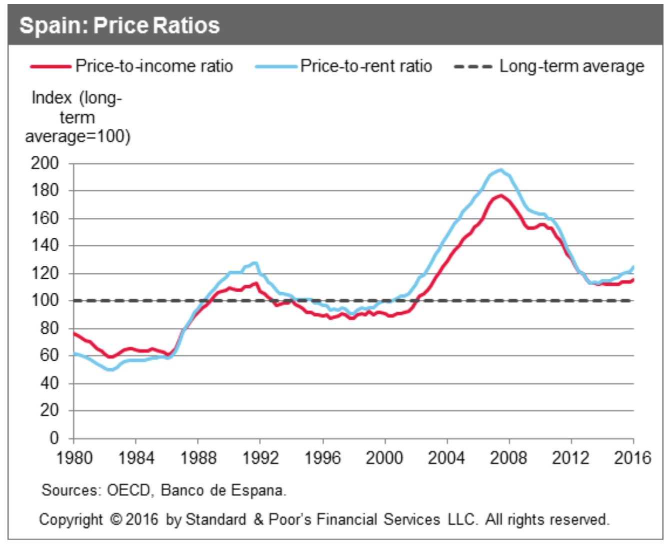


Chart 32



Switzerland: House Prices Are Seeing A Soft Landing

House prices in Switzerland look set to rise only very slowly over the coming two years, held back by regulatory measures aimed at taming the market's rise, as well as the dampening impact of Brexit and weaker global growth on the economy. We forecast nominal price rises of 1% this year, zero in 2017, and 1% in 2018 (see table 10).

Recent trends

Before the U.K. vote to leave the EU, the Swiss industrial sector and exports showed signs of recovery, after being hit by the sharp appreciation of the Swiss franc in January 2015. The Swiss currency stabilized at 1.10-1.11 Swiss francs to the euro in March-May, but is still much stronger than the 2014 level of 1.2. The currency strengthened to 1.08 Swiss francs to the euro during the run-up to the U.K. referendum on EU membership in June, 2016, and has since stayed close to this level, owing to its status as a safe-haven currency. The PMI in manufacturing dropped to 51.6 in June from 55.8 in May. While this is a marked decline, it follows unusually strong April-May readings, and the June figure is still well in expansion territory, signaling a continuing recovery in the sector.

Unemployment remains low, but was on the upward trend throughout 2015 as employment in tourism, consumer services, and manufacturing was hit by the strong Swiss franc. Unemployment edged up to 3.44% in Q1 2016 as employment gains did not match an increase in the labor supply. The PMI employment sub-index moved into the positive territory in May and rose meaningfully in June, signaling improved labor market conditions in manufacturing.

The Swiss National Bank (SNB) has maintained its expansionary policy of negative interest rates. The central bank continues to signal its willingness to intervene in the foreign exchange market if necessary to ease pressures on the Swiss franc. Meanwhile, Swiss bond yields turned negative for the first time across the whole yield curve in July as investors rushed to safe-haven assets in the aftermath of the shock vote to leave the EU in the U.K. referendum. With the exception of the 50-year maturity, where yields became marginally positive, most bond yields are now in negative territory at below the pre-referendum levels. Interest rates on five-year fixed-rate mortgages fell to 1.2% in May.

Despite the support from ultra-low interest rates and a slightly improved economic outlook, the housing market softened in H1 2016. Price increases for single-family homes decelerated to 1.2% year on year in Q2 2016, from 2.3% last year, while owner-occupied apartment prices posted only marginal gains. In the rental apartment segment, prices actually dropped by 1.7% over the year to Q2 2016. This is mainly due to regulatory measures, including self-regulation by banks, aimed at taking heat out of the housing market. Swiss residential property prices grew on average by 5% annually between 2008 and 2013, well above the pace of household income growth, resulting in declining affordability. Household debt, which primarily consists of mortgage debt, rose to 200% of household disposable income, one of the highest levels among the OECD economies. Bank exposure to the real estate market is high, making banks potentially vulnerable to a turning of the housing cycle.

The regulatory measures aimed at taming the housing cycle consist of self-regulation under guidelines from the Swiss Bankers Association, as well as legal directives. Self-regulation measures limit loan-to-value ratios (at around 80% for owner-occupied housing), and set thresholds on debt-service payments. Generally, banks require debt-service costs not to exceed one-third of gross household income. Debt service cost is calculated at a reference interest rate, typically at 5%, to which 1% of maintenance costs and 1% amortization costs are added. Legal directives include compulsory amortization, rules regarding the down payments, and countercyclical capital buffers. These measures have limited the number of people eligible for housing loans. This is evident in the slowdown in housing loan growth, to 2.7% in May 2016, from 3.4% in 2014 and an average of 5% over 2009-13.

As to the rental segment, which experienced price declines this year, it appears that high property prices coupled with rent controls resulted in lower rental yields, reducing demand for rental properties.

Future trends

We expect economic growth to gather pace in the next two years. We slightly revised our GDP growth forecast for Switzerland to 1.5% in 2017 and 1.7% in 2018 following the Brexit vote, from 1.7% and 1.9% previously. The direct impact of the expected slowdown in the U.K. on the Swiss economy is likely to be limited as exports to the U.K. account for only 2% of Swiss GDP. However, Switzerland's financial and foreign direct investment (FDI) exposure to the U.K. economy is significant. The increased uncertainty and weaker global growth outlook will weigh on investment and exports. The stabilization of the exchange rate means that the impact of the 2015 shock is gradually fading away. The safe-haven appeal of the Swiss franc may bring about additional pressures on the Swiss currency, especially if major central banks' monetary policies become even more accommodative. We assume that the SNB will intervene if necessary to keep the franc in the 1.7-1.11 range.

We expect house prices to rise very slowly in the coming two years. A gradual strengthening of economic activity, accompanied by an improvement in labor market conditions, bodes well for housing demand. The ultra-low interest rate environment is also supportive for the market, as mortgages become more affordable, while property investment looks more attractive, as alternative investment instruments offer very low and even negative returns. Against that, still high prices and regulatory measures are appearing to halt demand. We believe that Swiss regulators and banks will fine-tune the regulatory measures if the impact goes beyond the intended "soft landing".

Immigration is an unknown factor in housing demand for the next two years. So far, strong immigration to Switzerland has supported the residential property market, and net immigration should remain solid over the next two years for economic reasons. However, the 2014 referendum outcome against "mass immigration" could bring disruption in 2017, the year when new immigration rules should be implemented.

Table 10

Switzerland Housing Market Statistics

	2013	2014	2015	2016f	2017f	2018f
Nominal house prices (% change year on year)	4.6	0.4	2.3	1.0	0.0	1.0
Real GDP (% change)*	1.8	1.9	0.9	1.1	1.5	1.7
CPI inflation (%)*	-0.2	0.0	-1.1	-0.5	0.4	0.8
Unemployment rate (%)*	3.2	3.2	3.3	3.7	3.8	4.0

f--Forecast. *December forecasts, pre-SNB decision. Sources: S&P, Eurostat, OECD, Department for Communities and Local Government.

Chart 33

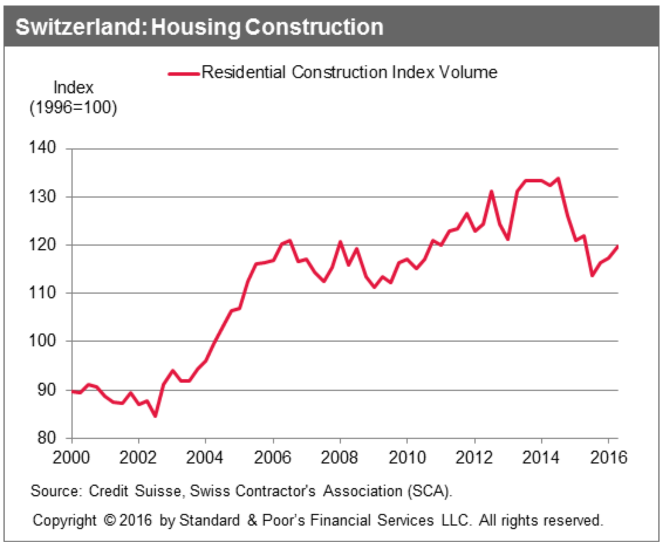


Chart 34

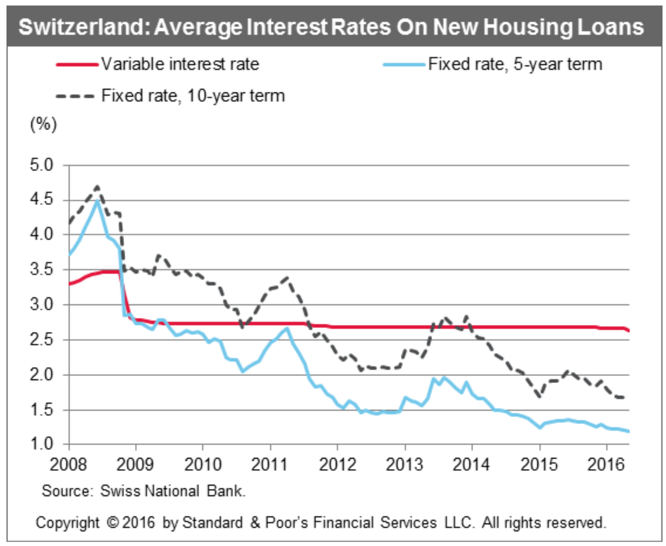
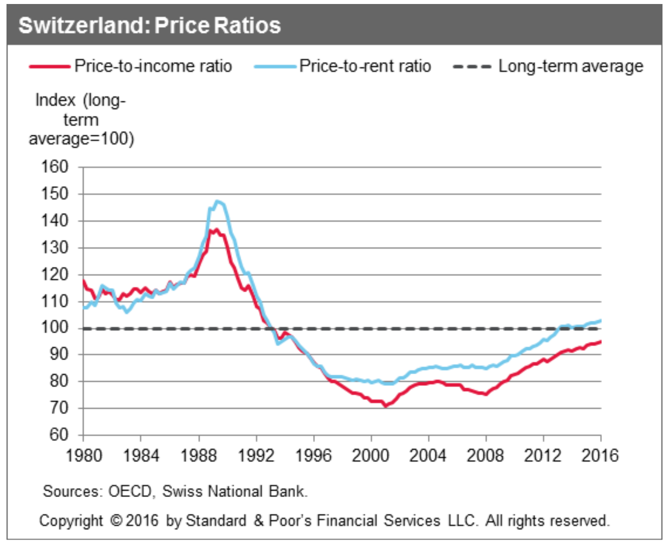


Chart 35

Chart 36



U.K.: Brexit Will Dent House Prices Amid Heightened Uncertainty

Following the June 23 referendum vote to leave the EU, the outlook for the U.K.s economic performance, both in the short and longer run, is dominated by pronounced uncertainties and downside risks. By extension, these uncertainties are also overshadowing the outlook for the U.K. housing market, where we expect prices to start falling in the second half of this year, continue declining moderately in 2017, before starting to recover in 2018 (see table 11).

Recent Trends

The reaction of global financial markets was violent but short-lived. Longer-lasting effects were mainly, and unsurprisingly, observed in the U.K. markets. Shares of some predominantly U.K.-focused companies, especially some banks and homebuilders, continue to trade well below pre-referendum levels, and the pound sterling has, for now, stabilized about 10% below its pre-referendum rate against major currencies. This reflects expectations that the damage to the U.K. economy may be substantial.

However, apart from the financial market reaction, no hard economic data on the impact of Brexit on the U.K. economy is available yet. Nevertheless, some of the soft data, which are already available, support expectations of a substantial negative impact. In particular, the widely watched composite PMI deteriorated markedly in its first post-Brexit reading in July, dropping to 47.7 from 52.4 points in June. But while the drop below the 50-point threshold that separates expansion from contraction signals a clear slowdown of economic activity in the immediate aftermath of the vote, it would be too early to call a recession based on this single reading alone. It is also worth noting that this latest PMI reading is much closer to levels seen during the 2012-2013 eurozone crisis, during which the U.K. economy continued to grow at rates above 1%, than to readings observed at the height of the recession in 2008-2009.

This would also be in line with our forecast, published shortly after the referendum (see "Europe's Economic Outlook After The Brexit Vote," dated July 4, 2016). This sees U.K. GDP growth slowing to 1.5% in 2016, but does not anticipate a full-fledged recession in the final two quarters of the year, nor in the following two years. The impact in the

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medium term, however, will still be pronounced, with growth averaging only around 1% in 2017-2018, less than half of what we would have expected otherwise.

One of the key factors that will slow GDP growth in this new post-referendum reality, characterized by heightened uncertainty about the outlook, is investment: Businesses as well as households are likely to shelve some major investment plans until uncertainty lifts, or even scrap those plans altogether. For households, this may apply in particular to home-buying decisions. Reduced investment spending will not only directly affect GDP. It will, via second-round effects, also translate into lower employment and more moderate wage growth at a time when inflation is set to accelerate due to a much weaker pound. As a result, households' spending power (and room for savings) will suffer, which will further weigh on growth.

Already in our previous forecast, in which we had assumed the U.K. would vote to remain in the EU, we expected U.K. house price inflation to decelerate somewhat this year, after strong gains in the previous two years. Following the Brexit vote, we now expect house prices to fall slightly in the second half of this year and throughout next, before starting a moderate recovery in 2018. Stronger than expected price gains in the first half of this year, however, will still see house prices up solidly (under the circumstances) for the year as a whole.

Transactions and gross mortgage lending had spiked in March as buyers rushed to complete purchases before the new stamp duty on secondary home buy-to-let (BTL) properties came into effect in April this year. The subsequent slowing in Q2 is largely a correction to that earlier surge in activity. But the June RICS survey of the residential market, which includes post-referendum responses, now points to a marked deterioration on almost all fronts. The index for new buyer inquiries fell to its lowest level since mid-2008, sales expectations turned negative for the first time in four years, and price expectations also entered negative territory. We attribute this to the currently high degree of uncertainty: similar to businesses, households are finding it difficult to commit to large investment projects when job security in particular has deteriorated.

The Bank of England (BoE) had long prepared plans for the Brexit contingency that has now become a reality to ensure the stability of the financial sector and to support the economy. On July 14, its Financial Policy Committee (FPC) implemented the first of these measures with the reduction from 0.5% to 0% of the countercyclical capital buffer for banks, a measure which could free up additional bank lending to the tune of £150 billion. The BoE left its key policy rate unchanged at 0.5% after the July meeting of the Monetary Policy Committee (MPC), but further easing measures now seem all but certain to be implemented following its meeting on Aug. 4.

The BoE faces a trade-off between supporting the economy via stimulation of bank lending (which would require monetary easing), and lowering high inflation as a result of the depreciated pound (which would require monetary tightening). We think the bank's decision will be straightforward. Indeed, inflation stood at a still very benign 0.5% in June, despite higher energy prices, and we don't expect the now weaker pound will stoke it above 3%, a level the BoE would likely tolerate without intervention, given the extraordinary circumstances. The minutes of the MPC meeting in July also gave exceptional guidance on what direction monetary policy will likely go, saying that "most members of the Committee expect monetary policy to be loosened in August." This of course means that interest rates should be even lower for even longer.

However, fixed mortgage rates will likely not move one for one with central bank rates. Given the already record low level of mortgage rates (fixed rates on new loans stood at 2.7% in May) and the fact that 80% of new business is in the form of fixed rates, lenders are approaching a lower limit of rates in terms of profitability. Indeed, some lenders have already increased premia on tracker rates in anticipation of looser monetary policy being implemented during the summer. Still, although we don't expect mortgage rates to fall much lower, they will remain low for long and should continue to support house prices.

Future trends

The precise medium-term ramifications of the U.K.'s decision to leave the EU remain surrounded by significant uncertainties. Much will depend, for example, on how good an exit deal the U.K. will get; but also how well the U.K. government will manage uncertainty after triggering the exit procedure. It will also depend on how decisively both the BoE and the ECB (which has no interest in too strong a euro) will continue to tackle threats to financial stability should such threats emerge.

One such threat, and a downside risk to our forecast, would be, as the FPC points out, strongly pro-cyclical behavior of BTL investors, where these investors sell when the economy is on a downturn and buy on an upturn, hence accentuating the cycle. Moreover, under current plans, the government is gradually phasing out the tax relief on interest payments for BTL mortgages during 2017-2020, contributing to declining attractiveness of BTL. It may well be that, in order to support the BTL market, this measure will be postponed in the autumn statement, when we also expect other measures to be deployed to tackle a slowing economy. Indeed, while the new Chancellor of the Exchequer, Philip Hammond, has rejected an emergency budget, he has already announced that the target of a budget surplus by the fiscal year 2020/2021 has been abandoned. This seems partly a realignment of targets with fiscal realities, especially in view of lower expected revenues on the back of weaker economic performance. But it may also give some hope for less austerity in the coming years, which should provide some relief to household incomes in an otherwise now more difficult economic environment.

Other factors should also mitigate more substantial house price deterioration. Construction activity should slow in anticipation of weaker prices, which in turn will contribute to maintaining the structural supply shortage of housing in key regions, such as London and the south-east. At the same time, there remains a significant amount of pent-up demand for housing, and some households, including would-be first-time buyers, currently still priced out of the market, may find it more affordable to buy in the next few years. Moreover, the prime market, especially in London, should retain some of its attractiveness as safe-haven investment despite potential price declines, not least because the majority of investors in that market do not originate from the EU and will remain largely unaffected by an eventual Brexit. The weaker pound also means they may get much better value for their money. Altogether, this should ensure there is a floor, not too far below current levels, to any price deterioration.

Table 11

U.K. Housing Market Statistics

	2013	2014	2015	2016f	2017f	2018f
Nominal house prices (% change year on year)	3.6	11.7	5.6	5.0	-2.0	2.5
Real GDP (% change)	2.2	2.9	2.3	1.5	0.9	1.0
CPI inflation (%)	2.6	1.5	0.0	0.9	2.2	1.7

Table 11

U.K. Housing Market Statistics (cont.)						
	2013	**2014**	**2015**	**2016f**	**2017f**	**2018f**
Unemployment rate (%)	7.6	6.2	5.4	5.1	5.7	6.4

f--Forecast. Sources: S&P, Eurostat, OECD, Department for Communities and Local Government, ONS.

Chart 37

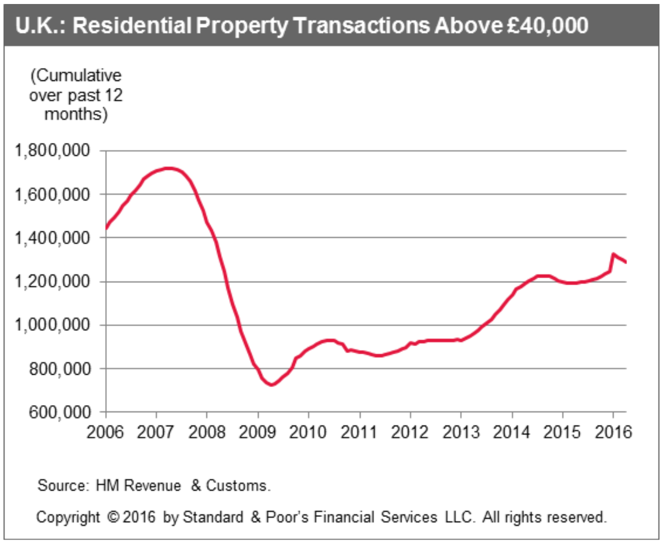
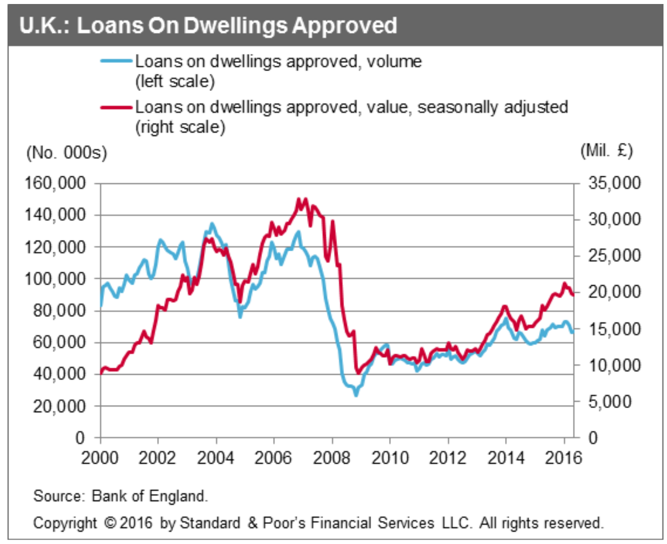


Chart 38



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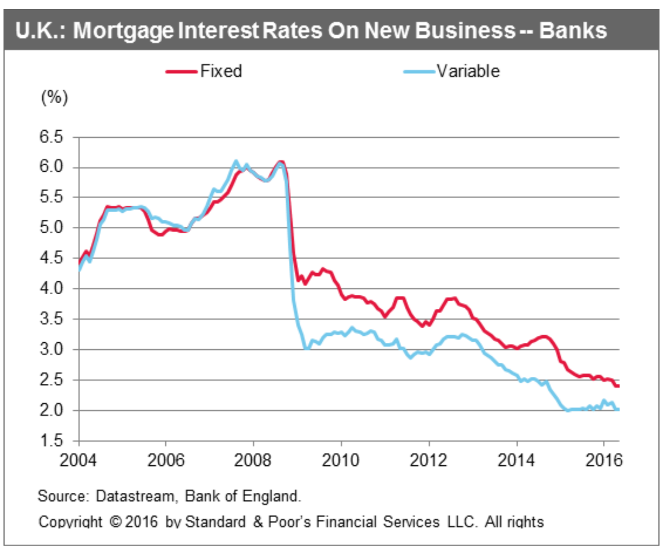

Chart 40