Standard Life Investments

Weekly Economic Briefing
Global Overview

Safe as houses?

02 June 2015

2014 was a good year for housing in most of the developed world. Across its sample of 23 countries, the Dallas Fed's weighted-average nominal house price index increased by 3.9%, marking the best performance since 2006. The stand-out markets were Ireland, the UK, Sweden and Australia, though gains were recorded in 17 countries. Of the six markets where prices fell, five were in the Eurozone, including France, Italy and Spain. The reasons for the widespread housing recovery are simple; historically low interest rates, thawing credit availability and more entrenched recoveries are all stimulating demand against a backdrop of sluggish supply growth.

With aggregate nominal prices in the developed world having now recouped almost all of their losses since the crisis, it is natural to ask whether housing is once again overvalued. The short-answer is no, or at least not yet. When nominal prices are adjusted for inflation they are still some 9% lower than their peak, and when adjusted for changes in disposable income, they are 12% lower (see Chart 1). Of course, aggregates mask significant variation at the country level. Australia, Canada, Germany, Switzerland, New Zealand and Norway all have price-to-income ratios that are above their mid-2008 levels, with all except Germany well into over-valued territory. This is a key reason why their central banks and financial supervisors have been tightening macro-prudential rules, even while monetary policy settings have been kept highly accommodative. These are also the developed countries that are most in danger of a significant housing correction whenever the next global downturn hits. Housing markets are generally in a different place in the emerging world; the big post-crisis declines seen in most developed countries were avoided as growth accelerated strongly. Although EM housing is not generally overvalued, some countries, including China, Malaysia, Hong Kong, Singapore, Brazil, Colombia and Peru, have seen imbalances build as policymakers encouraged or allowed credit to either households or developers to grow rapidly to support growth. With growth now slowing, authorities have a different problem; namely, preventing crumbling housing markets from bringing the rest of the economy down.

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A long way to go

The housing market has shown significant improvement since it was devastated by the financial crisis. Housing starts have more than doubled since April 2009, existing home sales are up nearly 50% since the middle of 2010, national real house prices are around 10% higher than their post-crisis trough, mortgage delinquencies and foreclosures have dropped significantly, mortgage debt has stopped declining and credit standards are no longer tightening. Yet, on all these measures, **there is still a long way to go before the housing market can be considered healthy.** Residential investment will not and should not return to its pre-crisis peaks, but at just over 3% of GDP, it remains lower than the troughs recorded after the recessions of the early 1980s, early 1990s and early 2000s (see Chart 2). It would also be dangerous for the ratio of house prices to disposable income to return to its pre-crisis levels, but at 22 percentage points (ppts) below its peak, it too could increase further without becoming a systemic risk. Meanwhile, it would be better for the economy if mortgage credit was at least increasing in real terms and a larger proportion of credit-worthy households could get access to mortgage financing.

Zeroing in on more recent trends, **housing activity appears set to make a larger contribution to GDP growth in Q2, after a soft second half of 2014 and start to 2015.** Housing starts surged by a little over 20% in April as building conditions thawed after a harsh winter. New home sales, which feed directly into growth through brokers' commissions, and indirectly through the purchase of furnishings and other household items, also rebounded strongly in April for the same reason (see Chart 3). Existing home sales have been more disappointing, but the solid upward trend in pending home sales, which lead actual sales by a month or two, implies that they too are likely to pick up over the coming months. Meanwhile, each of the major indexes of house prices - including Case-Shiller and Core Logic - are on track to increase by 5% or more this year.

A stronger housing market is unambiguously good for the economy. Housing is the most cyclical of industries and generates large, positive spillovers for other sectors as well. With that in mind, housing activity is one of the key components of growth that we will be watching when the Fed begins tightening policy, most likely later this year. With the federal funds rate stuck at zero for more than six years now, **economists can only make educated guesses about the ability of the economy to absorb higher interest rates.** Indeed, housing indicators slowed substantially in the wake of the 2013 taper tantrum, when long-term interest rates rose sharply even while short-term rates were unchanged. If rising policy rates cause housing activity to slow substantially, Federal Open Market Committee members may signal that an even more gradual tightening cycle lies ahead. Conversely, if higher rates are absorbed with little effect, officials are likely to infer that the neutral policy rate is also rising, which would also suggest that the terminal rate is higher than the bond market is currently pricing in. This uncertainty is a key reason why some Fed officials want to begin raising rates this year; tighten early and you have time to observe the impact and adjust the pace of tightening accordingly.

Chart 2: Residential investment remains low

Source: BEA, Datastream, Standard Life Investments (as of Q1 2015)

Chart 3: But a gradual recovery in train

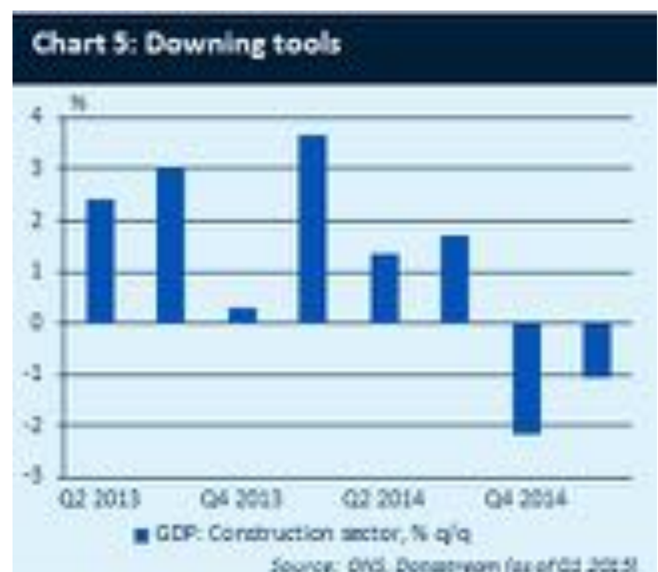
Source: Census Bureau (as of April 2015)

Planning is the problem

Much of the legislation announced in the Queen's Speech at the start of the new parliament was of a constitutional nature, such as the proposed EU referendum. There are, however, some bills that will have an effect on the economy, including measures to reduce small-business red tape and further increases in the tax-free income threshold. **A vital area for the government to come to grips with is the housing market.** The Conservatives plan to give tenants the right to buy housing association property and also aim to develop 200,000 new homes a year by 2020. A decade ago, the Barker Review of Housing Supply concluded that about 250,000 new homes are needed to be built every year to prevent spiralling house prices and a shortage of affordable homes. However, output has not reached anywhere close to those levels, and last year only about 140,000 were built (see Chart 4). Organisations such as the Home Builder's Federation emphasise problems related to the complicated planning system. Simplification measures agreed in 2012 have helped to some extent, so planning permissions have risen from 160,000 in 2011 to 240,000 last year, but restrictions remain too strict. The government is also taking steps to release surplus public sector land, although difficult decisions have to be made about building on the green belt. One suggestion being discussed is whether regulation of housing associations should be relaxed to help them build more social housing. A shortage of construction workers has also appeared, and is beginning to force up wages in this sector. In Q4 2014, wages rose about 6% from a year earlier.

A key driver behind expanding housing demand is the rapid expansion of the UK's population, which has surpassed 64 million. Over 5 million people have been added since the turn of the century, with immigration accounting for about 60% of the increase. This puts the recovery in mortgage approvals data into context. Despite a small rally in 2013-14, the series has, in effect, trended sideways at about 100,000 approvals a month, compared with over 300,000 just before the financial crisis. As such, the expansion of mortgage lending largely reflects rising house prices.

The demand for housing may have paused in the spring, but **last week's data suggested that the UK economy has begun to recover towards the early summer.** In May, the CBI Distributive Trades survey reported a surge in the volume of sales for the time of year from -1 in April to 30 in May. It stated that while "warmer weather may have helped, in our view the consumer upturn has much deeper foundations: confidence, real incomes and jobs are all buoyant, while household balance sheets and credit availability have improved significantly". A YouGov/CEBR survey also reported that consumer confidence surged this month, to its highest level in a year, as more households expected their finances to improve in the coming 12 months. The construction sector held back the economy in Q1, when GDP was only 0.3% higher than in Q4 (2.4% pa). On the output side, construction declined by 1.1%, while manufacturing showed a small 0.1% increase (see Chart 5). Meanwhile, service sector output growth slowed to 0.4%, the weakest performance for two years, largely driven by financial and professional services activities, while wholesale and retail grew 1.1%, and accommodation and food services 1.6%.

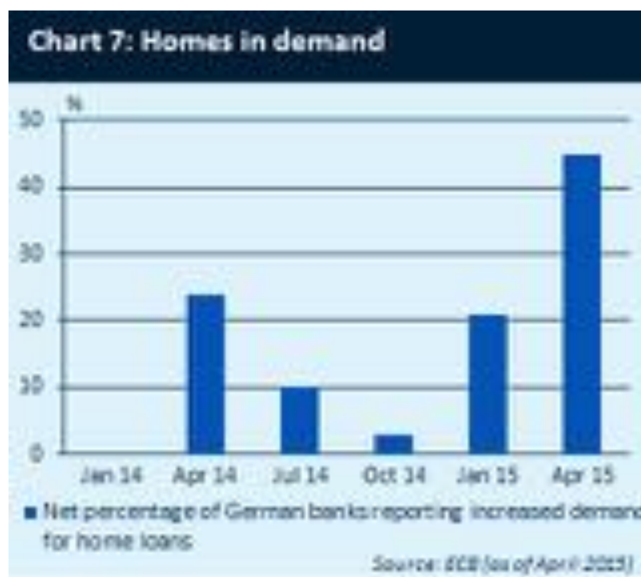


Building a recovery

Historically, it has made little sense to talk of a single European housing market. Although capital flows across borders, land itself is immobile, while each country regulates housing supply and mortgage financing very differently. It is no surprise then that price and construction trends can differ significantly across countries. As an example, in real terms, Spain and Ireland saw house prices more than double in the ten years before the crisis, while Germany actually saw some retrenchment (see Chart 6). The excessive increases in the former countries occurred despite booming construction, as rapid credit accumulation, low real interest rates and expectations of strong capital gains all stimulated demand. In contrast, lending conditions tend to be more restrictive in Germany and there is also a stronger renting culture.

However, as the recovery in Europe progresses, there are some encouraging signals emerging in the housing market from parts of both the core and periphery. House prices in Ireland rose 15% in 2014, while Spanish prices are finally stabilising. Meanwhile, German house prices are now on a firm upward trajectory because interest rates have fallen to historically low levels against a backdrop of a very tight labour market. This improvement has been supported by a loosening of credit standards for house purchases; although standards tightened slightly in April, there had been a net loosening every month prior since the beginning of 2014. Other results from the ECB bank lending survey are also encouraging: European banks recorded a 29 index point net-increase in demand for housing loans in April. This demand is being directly facilitated by loose monetary policy, reduced financial fragmentation as well as improving economic conditions. Meanwhile, the Targeted Long-Term Refinancing Operation is indirectly helping to improve liquidity in the market.

The embattled construction industry is recovering simultaneously with prices: in 2014, 20% of new employment in Spain was in the construction industry and industry sentiment is improving in Ireland, with construction PMI figures jumping to 57.2 in April. As is to be expected, metropolitan areas are the epicentre of housing strength. In Germany, urban housing supply shortages driven by migration from both rural areas and other countries to the main cities of Berlin, Munich and Frankfurt have been driving up prices, as well as real rents. Rent costs are pertinent in Germany, with half of Germans choosing to rent rather than owning property, compared to an EU average of 71% home ownership. The culture of avoiding leverage in Germany means that lower interest rates are of less value to German households compared to their counterparts in other European countries. Indeed, lower rates can reduce consumption as income from bonds and deposits falls. However, there have been significant increases in demand for loans for house purchase, increasing by 21% and 45% in January and April respectively, suggesting that households are seeking to take advantage of low interest rates (see Chart 7). For those who do continue to rent, the government has agreed to implement a controversial cap on rents to appease disgruntled tenants. While politically popular, this move threatens to dampen domestically-led growth potential in such an export-reliant economy.



No need to panic

In March, the Bank of Japan published a paper outlining efforts to improve its ability to detect signs of overheating in the real estate market. Such a step may seem excessively precautionary given nationwide land prices fell -0.4% in 2015 and have been negative for more than two decades. However, **conditions in Japan's real estate market are changing,** even if the prospect of a property bubble remains a remote one.

Let us start by examining transaction data. The most common indicator of activity in the residential sector is housing starts and, judging by the most recent data, conditions are far from buoyant. Housing starts fell to 913,000 in April and remain someway below the levels prior to the consumption tax hike. Perhaps a better comparison though, is the trend in housing starts following the 1997 tax hike, and here the recent level of activity is noticeably higher (See Chart 8). Turning to sales, year-on-year sales data remains noticeably weak, due to the brought forward demand ahead of last April's consumption tax hike. However, the more immediate trend is more encouraging. Tokyo condominium sales were up 29% month-on-month in April based on a 3-month moving average basis – although the pace has slowed after a surge in transactions at the start of the year. Another important consideration is trends in real estate finance. According to the most recent Bank of Japan Tankan Survey, **banks' lending attitudes to the real estate sector are as favourable as they have been since the 1980s.** At an individual level, conditions are also favourable, with Japan Housing Finance Agency currently offering its 35-year fixed rate loan at 1.54%, slightly above the record low of 1.47% posted earlier this year. Other major banks have slashed mortgage rates as competition for lenders has heated up. Another factor that should be proving supportive is a string of government incentives, such as home buying subsidies, housing loan-related tax cuts and tax exemptions for cash gifts used to purchase homes. Despite the backdrop, actual loan demand remains lacklustre.

A final factor to consider in judging the health of Japan's housing market is residential property price trends. While the national average has continued to decline, the story within Japan metropolitan areas has been more upbeat. **In the central Tokyo wards of Chiyoda-ku and Chuo-ku, residential land prices were up a relatively robust 6.3% and 6.4% respectively over the past year.** However, widening this out to the whole of the nation's three largest metropolitan areas, the magnitude of appreciation remains relatively moderate. Residential land prices in Tokyo, Osaka and Nagoya were up 0.5%, 0% and 0.8% year-on-year respectively in 2015. This partly reflects the relatively weak wage trends in Japan, with real income growth weighing on condominium price growth (See Chart 9). With housing activity, credit and price growth still moderate, it seems premature to worry about a property bubble in Japan. What will be more interesting is whether the pockets of strength in certain urban areas begin to broaden out to the rest of the country or whether they will accelerate away, leaving the majority of Japan stuck with house price deflation. If it is the latter, we may expect the Bank of Japan to become increasingly nervous about housing market stability.

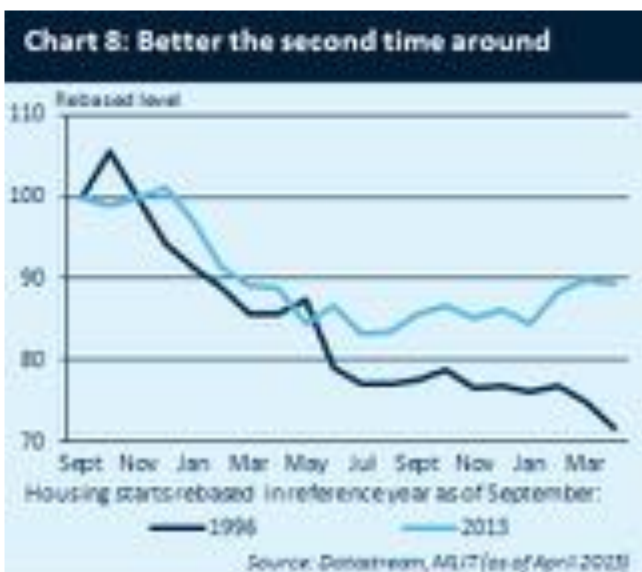


Chart 8: Better the second time around

Chart 9: Real incomes weigh on prices

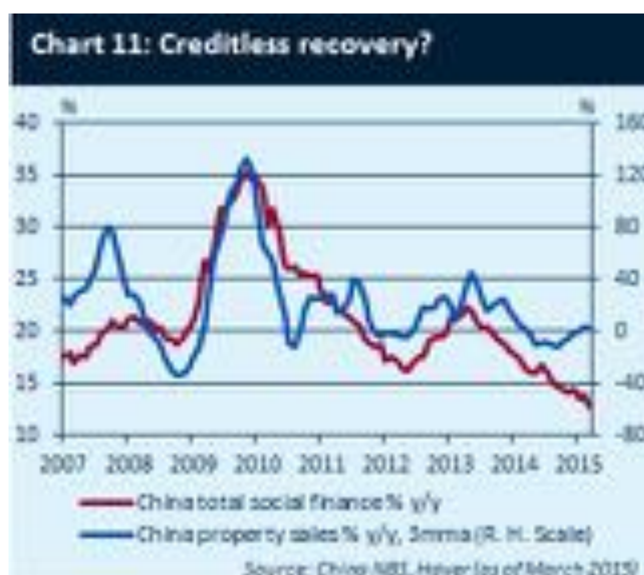
Emerging Markets

Property pressures

The property market has been one of the primary engines of China's rapid growth over the last decade and a half. Real estate investment increased from 4% of GDP in the late 1990s to 15% of GDP in 2014. Residential investment now accounts for 15% of fixed asset investments and 15% of total urban employment. Due to the strong linkages to several upstream and downstream industries, property influences an even larger share of China's overall economic activity. In addition to affecting growth, a slowdown in the property sector adds to the risk of a disorderly deleveraging. According to McKinsey, 40-45% of total outstanding debt is directly or indirectly real estate-related, and most of the rapid build up in leverage post-2009 was in the real estate and construction sectors. Accordingly, Chinese policymakers recognise the importance of the property sector and are attempting to manage the slowdown. **Recent measures have provided some short-term support but are unlikely to substantially improve construction activity over the long run.**

It is now widely accepted that China's housing market is past its peak and likely that construction will continue to fall as a proportion of fixed asset investment. **Last year marked a turning point in the market - price growth slowed across the country, transaction volume and new starts decreased, and real estate investment weakened.** Unlike the previous downturn in 2012, this was not sparked by tightening measures aimed at cooling the market but by weak demand. Policymakers reacted quickly with cuts to mortgage rates and required minimum down payments. It appears that these efforts have effectively stabilized the market. Average mortgage rates fell by 72 basis points (bps) and 23bps in Q4 and Q1 respectively, when benchmark lending rates were cut by 40bps and 25bps. Another 25bps benchmark rate reduction in May could push mortgage rates even lower. Collectively, these cuts have had an impact, with prices rebounding in recent months (see Chart 10).

Although sales have improved in the short term, there are reasons to believe that the bounce will be short lived. Credit growth and housing have always been closely correlated in China (see Chart 11) and although recent rate cuts have been positive for the market, credit conditions are still very tight. The rate cuts have not led to increased growth in credit volumes; both bank lending and aggregate financing were weaker in April than expected, with bank loan growth steady at 14% and total credit growth coming down further to 12%, the slowest since 2006. In part, this reflects weak investment demand, but it is also a result of cautious lending by banks. If credit growth continues to slow, it's reasonable to assume there will be no sustained bounce in the housing market. Additionally, there is a significant overhang of supply that developers need to work through before they begin launching new projects. **Due to the excess supply, growth in new housing starts remains in negative territory largely because of rising inventories of unsold properties.** As of mid-2014, the ratio of unsold floor space to floor space sold showed a rapid build up of inventory since 2013 and as high as 24 months' worth of sales at current rates. Until the overhang is absorbed, the real estate sector will continue to be a drag on growth.



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