ABN·AMRO

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Housing Market Monitor

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Housing market turnaround: quick price correction

- Housing market falters due to drop in purchasing power, higher mortgage rates and ailing economy
- We adjust our estimates and instead of a 2.5% price rise we now foresee a 2.5% price fall in 2023.
- The relatively quick price correction gives support to house purchases.
- We therefore adjust our transaction estimates from -17.5% to -15% in 2022 and from -2.5% to -1% in 2023

In an increasing number of countries, the housing market is under pressure. The Dutch market is also in a downward spiral of fewer purchases, more homes for sale and falling house prices. The mood in the housing market has turned. After the Russian invasion of Ukraine, energy and food prices rose sharply. As a result, economic and financial uncertainty is growing, purchasing power is falling and mortgage rates are rising. As a result, the affordability of owner-occupied houses is deteriorating and transactions are more difficult to conclude.

The number of transactions has been declining in the Netherlands for some time. Until recently, this was mainly due to a lack of houses for sale, but now supply is actually increasing. Rather, it is the price level that is causing friction. Unlike during previous downturns, however, transaction prices are quickly adjusting. Recent NVM figures point to a sharp price correction in the third quarter. We expect the decline to continue in the coming quarters. For this year, we adjust our price estimate from +15% to +14% and for next year from +2.5% to -2.5%. However, if the upcoming recession is more severe than we currently foresee, a larger correction cannot be ruled out.

Compared to the financial crisis, the price correction and its impact on the economy remain relatively limited. This is because mortgage rates are historically low and we do not expect them to rise much further. Also, increased housing preference due to working from home and the ongoing housing shortage provide some support to house prices. What also provides counterweight is the tight labour market and low unemployment. Combined with government support to keep energy costs manageable, this makes households resilient. Furthermore, most homeowners are little affected by the increase in mortgage rates because they have locked in their mortgage rates for a longer period. Sharp price rises in the past contribute to positive equity. Finally, there are no structural reforms on the cards, as in 2012.

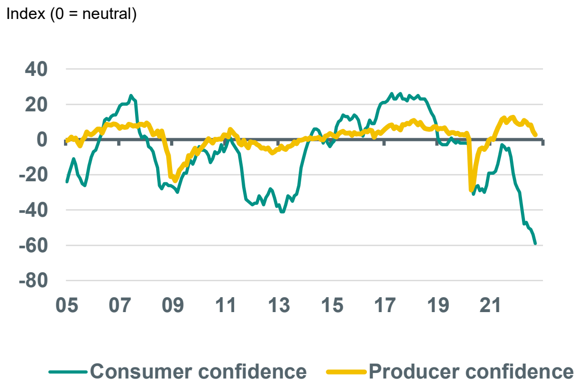
The advantage of a quick price correction is that transactions can continue. Without correction, houses would be for sale for longer and the flow in the housing market would stall. We now assume that the number of transactions will fall by 15% this year. Earlier, our forecast was a 17.5% decline. Next year, the number will not fall by 2.5%, as we indicated earlier, but by 1%. Important question marks do remain the Nibud lending standards, the cost limit of the National Mortgage Guarantee and the gift exemption. Changes here could be a reason to push the transaction over the turn of the year or bring it forward. In addition, the decline in the number of new homes completed and sold may hold back existing home transactions.

Pessimism over housing market outlook

Confidence in the housing market is declining. The housing sentiment indicator has fallen considerably in recent months and now scores negative. The number of respondents who are gloomy about the housing market is higher than the number of respondents who are positive about it. The reason for the drop is that a growing number of respondents find the housing market poorly affordable after the price hikes in recent years. Affordability is also depressed by recently increased mortgage interest rates. Furthermore, respondents indicate that the overall economic outlook has worsened. They are less confident about the development of their income and financial situation. Major financial decisions, such as buying their own home, are then compromised. Surveys show that interest in buying a home is declining and interest in selling is actually increasing.

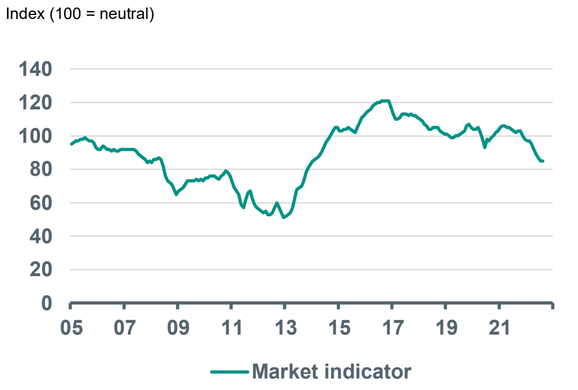
The cooling of the housing market is now also visible in the 'hard' figures. Estate agents report that the number of viewings is falling and that buyers are less willing to dig deep into their pockets. They are bidding above the average asking price less often than before. The rate of overbidding is also falling. The waning interest of buyers is reflected in the number of transactions. In the first eight months of this year, 124,000 existing homes changed hands, according to the Land Registry. In the same period last year, there were 156,000. The decline can be observed in all provinces. There is no great distinction by type of house either, although purchases of flats (always a current house segment) are declining less rapidly than for detached houses and a favourable energy label is a plus.

Economic sentiment deteriorated sharply



Source: CBS

Confidence in housing market also declines



Source: Home Ownership Association

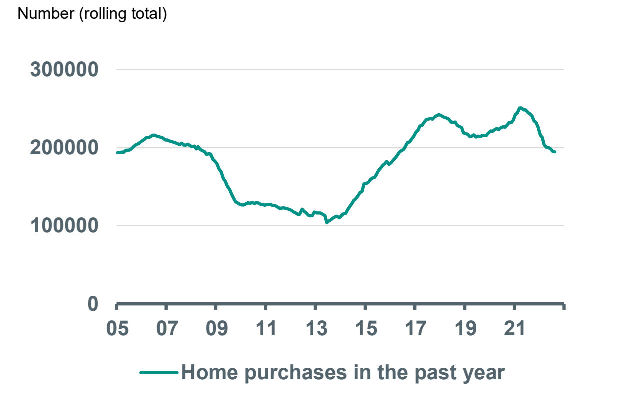
House price trends usually follow housing transactions with some lag. So too this time. But the reaction time is now much shorter than before. Sellers have a price in their mind when selling, often based on recent transactions of similar houses in their area. If the bid is below that price, sellers have trouble accepting such a disappointing offer. This is especially true if the bid leads to a residual debt upon sale. Only after their house has been for sale for a long time they are willing to compromise. Currently, such restrictions play a lesser role. Due to the sharp rise in house prices, sellers are in positive equity. This explains why sellers are more lenient and the price adjustment this time follows the transaction decline more quickly. Growing uncertainty due to the prospect of an economic downturn also plays a role.

After home purchases, house prices are now falling too

Until recently, house prices were still rising extremely fast. In January, prices of existing houses were as much as 21% higher than in January 2021, according to Land Registry figures. After that, house prices continued to rise monthly compared to the previous month, albeit at an increasingly modest pace. In August, prices were actually narrowly lower than in July and the price increase compared to August last year was only 12%. This trend is likely to continue, as the latest NVM price figures, which are slightly ahead of the Kadaster series, showed a solid decline in the third quarter. Prices were 5.8% lower than in the previous quarter, according to the brokers' association.

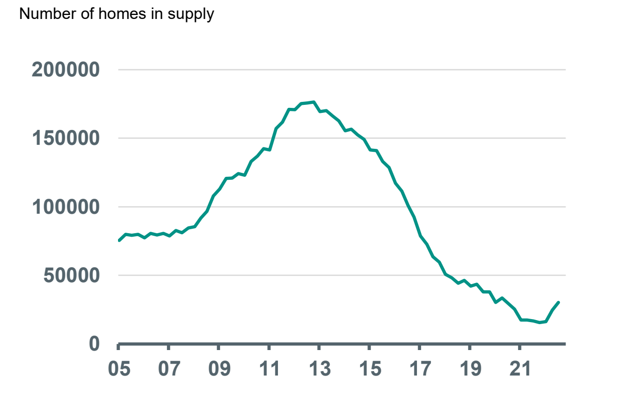
As with the number of transactions, house price growth is on a downward trend across the country. It is noticeable that there is more price differentiation by energy label and that price growth is levelling off even faster in the four major cities. This is in line with past experience, as the housing market in the larger cities reacts relatively strongly to cyclical fluctuations. And the outlook for the economy has worsened markedly in recent months. In response to the Russian invasion of Ukraine, food and energy prices have risen sharply. This erodes the purchasing power of households, causing them to consume less. It also puts pressure on companies' profit margins, causing them to suspend investments. As this is an international phenomenon, global trade is also under pressure. Globally, economic growth forecasts are being revised downwards.

Number of home purchases decreases



Source: land registry

Stock of homes for sale rises again



Source: NVM

Maximum mortgage amount down due to decline in purchasing power and increase in mortgage interest rates
Governments are stepping in to give relief. After much deliberation, the Dutch government has decided to help family households by absorbing a substantial part of higher energy costs through caps on energy prices. But government subsidies cannot fully restore purchasing power. The same holds for collective wage increases, which are higher than in previous years due to the tight labour market and generous financial buffers in the corporate sector. Government measures and wage increases are not enough to completely wipe out the loss in purchasing power. This leaves households with less money for housing. This is likely to lead to gradually tighter Nibud lending standards in the coming years. There will soon be a definitive answer to this when Nibud publishes the new financing burden tables. The result will be that families will be able to borrow less for house purchases based on their income. This will have a dampening effect on house price developments.

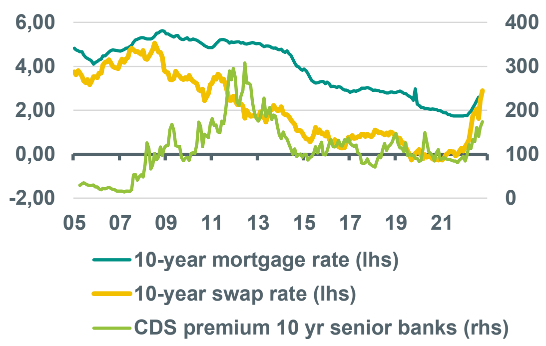
Apart from income, mortgage interest rate is also an important variable in determining the maximum mortgage amount. The higher the mortgage interest rate, the lower the credit limit. Mortgage interest rates have risen sharply since the beginning of this year. The mortgage interest rate offered on loans with a 10-year fixed-rate period has risen by 3 percentage points to above 4 per cent this year, according to Van Bruggen Adviesgroep. This also means buyers can borrow less. How much less, that depends on income level. At the current Nibud lending standards, the amount is about 10 per cent lower on average. HDN figures from mortgage applications show that the average home purchase amount in the third quarter has already fallen by 4 per cent compared to a year ago and that buyers are also borrowing less based on their income. The average mortgage amount is now 4.1 times income versus 4.4 times income in the third quarter last year, according to HDN.

The cause of the mortgage rate hike is again the war in Ukraine initiated by President Putin and the ensuing energy and food price hikes. The price hikes see central banks jeopardising their inflation target. To prevent inflation from settling into price expectations and making inflation persistent, they are tightening monetary policy. They are buying up less assets and raising their official policy interest rates. The central banks' policy shift leads to higher interest rates in financial markets.

The war in Ukraine is also creating uncertainty among investors. They see their assets shrinking in real terms, i.e. adjusted for inflation. The higher inflation, the higher the interest rate they request. In times of uncertainty, investors also distinguish more sharply between so-called risk-free and more risky assets. This translates into higher risk premiums for mortgage lenders compared to the government. Thus, the difference between swap and government interest rates has increased. Premiums on banks' Collateral Default Swaps are also currently significantly higher. The combination of rising interest rates and higher risk premiums leads to an increase in funding costs for mortgage lenders, who pass on these higher charges in their mortgage interest rates.

Financial risk drives up mortgage rates

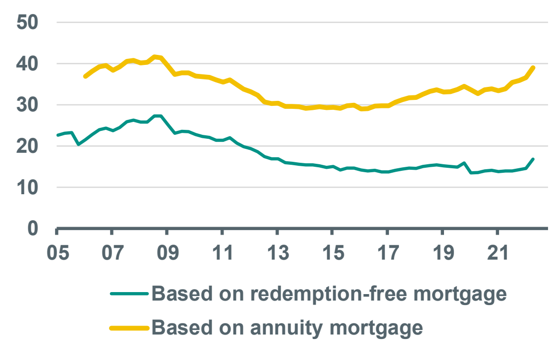
Percent Basis points



Source: DNB

Affordability of owner-occupied houses worsens

Net housing costs as a percentage of net income



Source: Calcasa

Recent interest rate hike causes major shifts in mortgage market

We assume that government long-term lending rates may still rise in the coming period, but that the peak is in sight and a slight decline may follow next year. Central banks will tighten monetary policy further. We reckon that the European Central Bank will raise the deposit rate to 2% in the coming months and then stick to that rate for a longer period. Just a few months back, the rate was at -0.5%. The higher rate will push down economic growth, causing inflation to weaken. Once this happens, the rise in long-term government interest rates will come to an end. However, a major downward revision is not in the cards, including mortgage rates. Indeed, because of the threat of recession and the credit risks involved, investors will hold on to higher risk premiums for mortgage lenders.

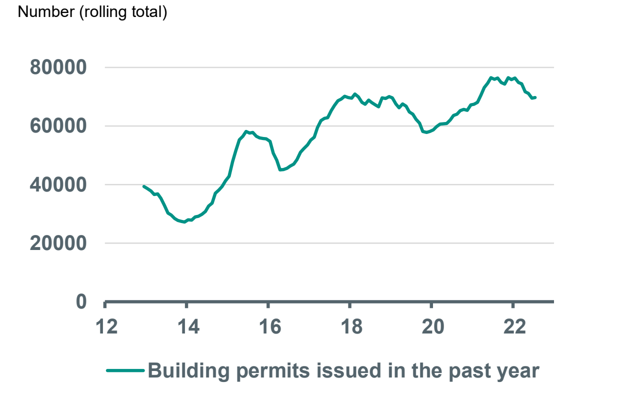
The recent rise in interest rates has reduced the preference for mortgages with long 20- or 30-year fixed-rate periods. Instead, loans with 10-year fixed-interest periods are again more frequently chosen. Another consequence of the interest rate rise is that mortgage refinancing is less popular. In recent years, this was still done on a large scale, causing mortgage production to reach record highs. Now the refinance market has dried up. Whenever possible, move-up buyers are actually happy to take their mortgage rates, if they are below current market rates, with them when they move house. Recent interest rate developments also create more room to make mortgage repayments without compensation for the bank. When the contract interest rate is below the market interest rate, the restriction that the repayable amount is limited to 10 per cent is removed.

Finally, there is more interest in remodelling mortgages, especially with the aim of making the home more sustainable. After all, with current energy prices, this is becoming increasingly financially attractive. On the contrary, other renovations are being put on hold because of the great difficulty in finding construction workers that work at an attractive rate. The sharply higher cost of materials is not helping either. The rise in material costs is largely linked to increased energy prices. But if the construction frenzy in Asia subsides due to the crisis in China's construction sector, the price spike of building materials is likely within sight.

Housing development is in the doldrums

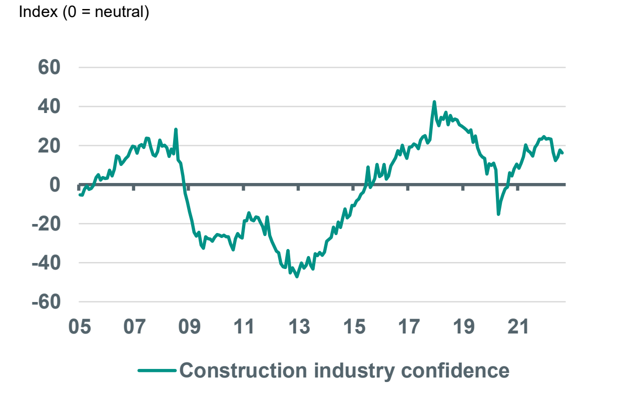
The Netherlands also has its share of problems in the construction sector, although these are of a totally different order than in China. While too many houses have been built there, not enough are being realised here. The underlying problems in the construction sector are well known. The lack of land, building materials, construction workers and municipal officials to grant permits is acute. Rising interest rates are making it harder for projects to get off the ground. In addition, environmental and climate issues are hindering housing construction. The problem of nitrogen has become more acute in recent years and more attention is being paid to the risk of flooding. Research shows that the growing information on flood risk in Japan is already increasingly being reflected in land prices there.

Fewer building permits are being issued



Source: CBS

Challenges for construction sector pile up



Source: Refinitiv

Recently, three more sustainability issues have been added for Dutch housing construction. Is there enough drinking water, can the new homes be connected to the already overburdened energy grid and how about noise pollution? And as if it is not already complicated enough, there are again doubts about the introduction of the Omgevingswet next year due to IT and staff support challenges. This new law will make it easier to object to construction projects. All this poses additional risks for housing construction. All these issues add up to a Gordian knot. Against this backdrop, it comes as no surprise that the number of houses realised keeps falling short of the stated ambition.

In the coming years, the number of houses completed will be disappointing again. This is because fewer building permits are again being applied for and issued. The decline is due to uncertainty caused by increased material, wage, and interest rate costs. In addition, housing investors are more cautious due to tax changes on rentals, stricter rent regulation and other restrictions, such as the obligation of self occupancy and the plans to give municipalities more leeway in allocating homes, both in the rental and owner-occupied segment. This will make it even more difficult to create a solid business case for construction projects. When no one wants to take on the investment risk, construction projects will stall. This raises questions about the feasibility of ABF Research's calculated construction target of adding 1.2 million homes by 2036. That many new homes is needed to accommodate population growth and close the statistical national housing shortfall of 315,000.

Cabinet hardly takes any new measures on Budget Day

A major part of the construction task has to come from flex housing. For now, realisation of these is hardly succeeding. Municipalities are reluctant because of the required investments in infrastructure around flex housing. Moreover, they fear losing control over spatial planning if temporary housing becomes permanent housing. In addition, the problem is that investors are reluctant since they are uncertain whether there is still room for their flex house after project dismantling. The government came up with three solutions on Budget Day. The central government will sit down with municipalities to see where these flex homes can be located. It is possible that additional expertise from the State could help. Furthermore, the State Real Estate Company is going to purchase flex housing centrally for municipalities and corporations. The idea behind this is probably that this can keep costs down. Finally, the central government is setting up a guarantee fund that will provide compensation if an investor cannot dispose of his flex-housing elsewhere.

Furthermore, in terms of housing market policy, the cabinet offered little new on Budget Day. The cabinet limited itself to implementing measures already announced earlier, such as the termination of the increased gift exemption, which will be permanently scrapped in 2024. Next year, it will go down from roughly EUR 107,000 to around EUR 29,000. Furthermore, from 2023, mortgage interest will become deductible at the basic rate in Box 1 of around 37%. The owner-occupied house lump sum will fall from 0.45% to 0.35% of the WOZ value next year. Above a WOZ of EUR 1.2 million, it will be 2.35%. The so-called Hillenaftrek decreases to 83.83% and the transfer tax exemption for first-time buyers up to 35 years of age goes up from EUR 400,000 to EUR 440,000.

For real estate investors, things will become less advantageous after Budget Day. For instance, the transfer tax rate for non-residential properties (rental and holiday homes) will go up to 10.4% from 2023. The so-called vacant value ratio will also be adjusted. As a result, home investors will receive less discount on the WOZ value when taxing in Box 3. Furthermore, borrowing from one's own private limited company, for example to invest in real estate, will become less attractive, as debts above EUR 700,000 will be subject to box 2 tax sooner. The cabinet also announced to expand the regulated rental sector by increasing the upper limit of initial rents in the regulated rental sector from 141 to 187 points, or from EUR 763 to EUR 1,000. The announcement also revealed that the government wants to overhaul the rental housing valuation system. Currently, amenities such as a communal courtyard and the energy label currently are hardly taken into account. This should be changed in the future, so that the rent and the quality of the property correspond more closely. For the short term, the cabinet came up with the decision to adjust the system of rent indexation. Normally, the annual rent increase is linked to inflation, but due to sharp price increases, it will be linked to wage growth in 2023. By doing so, the government will ensure that the rent increase will be lower. This may be a setback for some landlords, but this measure supports tenants' purchasing power and tempers inflation.

Need for further policy

The cabinet's policy deviates on several fronts from the structural reforms recently advocated by a group of economists, including on taxation and rent regulation. The cabinet did write a response to the group's proposals. In it, it states that it will work with some of the proposals. For instance, the government welcomes the proposal to include energy costs in income lending standards. The current standards are based on the average energy costs of a house with energy label C and do not take into account the differences in energy consumption of houses. More differentiation will stimulate making houses more sustainable, limit the financial risks of energy price increases for mortgage lenders and lead to greater house price differences based on energy efficiency. The government is also sympathetic to the suggestion to include the long-term development of house prices when testing housing plans against regional housing needs.