Economic Research

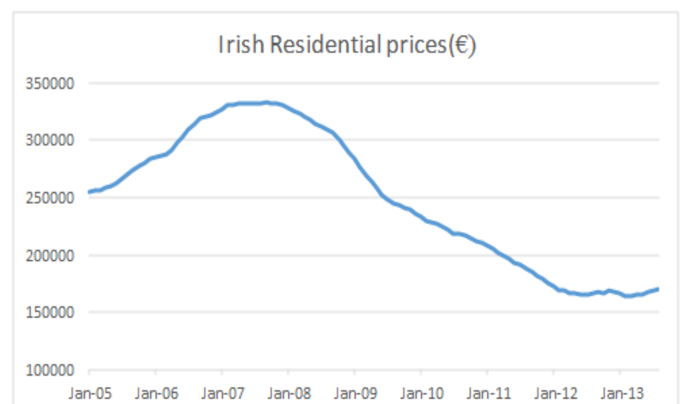
Irish Housing Market –Turning point but limp recovery likely 2 Oct 2013

Having experienced one of the largest and prolonged collapses in any developed economy the Irish housing market appears to be stabilizing; prices have stopped falling nationally and are rising in the capital, rents have risen sharply over the past year, transactions are picking up , planning permissions are increasing and house building may have bottomed. Yet there is one crucial element missing-credit growth- and in its absence any recovery is likely to be limp.

National residential prices appear to have bottomed in March and by August were showing 2.8% annual growth, although to put that in context the average price is around €170k against a peak of over €330k in mid 2007. The price rises are heavily skewed towards the capital, where values have risen by over 7% in the last three months, against largely flat prices elsewhere in the country. Indeed the pace of Dublin price increases have prompted some to worry about a bubble, although as our 'Bubble checklist' shows that is unlikely. Prices also appear undervalued on our 'Fundamental value' checklist, relative to rents and income, a view shared by others, ranging from the Central Bank of Ireland to the OECD.. Our affordability model also shows levels last seen in 1997 so some increase in demand for house purchase might well be expected, especially as price expectations may respond to the recent change in trend.

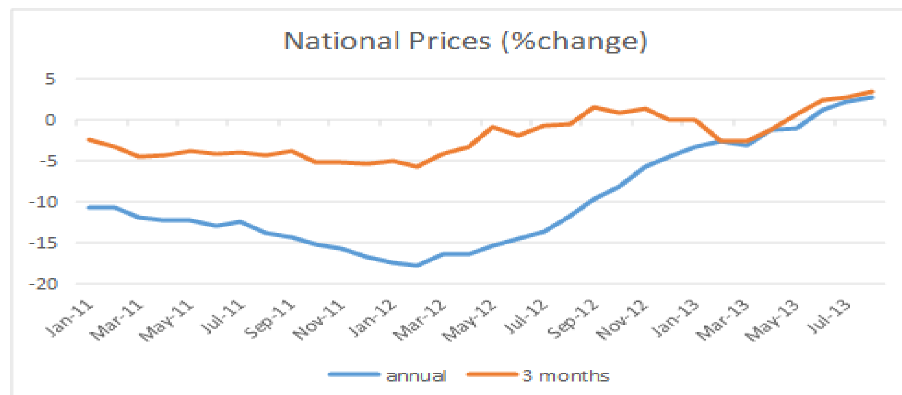
There is a significant amount of vacant property nationally but whether that is an effective supply is another matter as is evident in the upturn in planning permissions of late and the recent stabilization of house completions. The latter still implies an annual figure below last year's 8400 (perhaps around 8,000) however. That is also likely to be the pattern in terms of new mortgage loans, which we expect at 11,600 against over 14,000 last year. The value of new mortgage lending may also fall, to some €2.1bn from €2.6bn in 2012.

The lending data was influenced by the deadline on mortgage tax relief last year which resulted in a very weak first quarter of 2013 although the number of new loans has picked up since then, albeit still not strong enough to offset the impact of deleveraging elsewhere as net mortgage lending is still contracting by over 2% at an annual rate. Indeed, the number of new mortgages for house purchase over the first half of the year is running at less than half the transactions recorded on the Property Price register and we therefore do not expect prices nationally or indeed in Dublin to pick up materially, as a sustained price appreciation requires a stronger credit backdrop that currently seen in Ireland.



Property Prices

Prices are picking up... Residential property prices nationally, as captured by the CSO index, appeared to be bottoming in mid-2012 (rising by 1.5% in the three months to September) but subsequently fell again over the winter before hitting a fresh low in March, at an average value of under €164k from a peak value of some €333k in the summer of 2007 (our estimate as the CSO index does not give actual valuations). Prices have picked up since, rising for five consecutive months, leaving the annual change at 2.8%. Apartments fell by over 60% in the crash but are outpacing houses of late, with the former up by 6.2% over the past three months, giving an annual increase of 6.6%, against a 3.3% rise in house prices over three months and an annual 2.6%.



...**led by Dublin...T**he price trend is by no means uniform across the country, however; Dublin lead the downturn and is now leading a recovery, with prices up by over 7% in the three months to August and by an annual 10.6%. Anecdotally, the demand for three and four-bedroomed houses is seen as driving values but the CSO index does not support that view, as the annual rise in apartment prices in the capital , at 10.1%, is similar to that of houses (10.5%). In contrast, residential prices elsewhere in the country are still down on an annual basis (by 2.6%) but again appear to have bottomed in March, although the pace of increase since then has been modest, rising by just 0..7% over the past three months.

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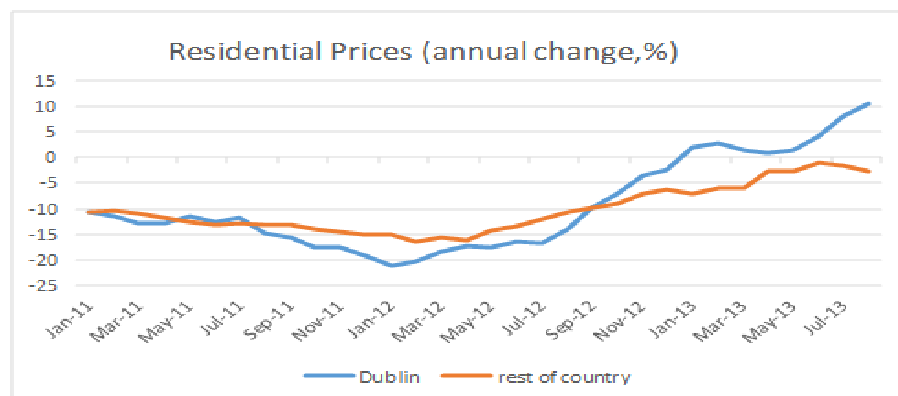


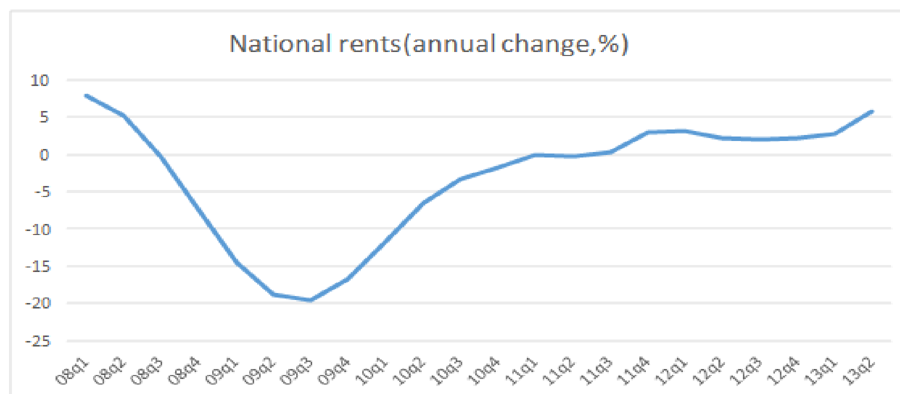
..**where vacancy rate is lower**...... It is a widely held view that the construction boom left too many houses and apartments 'in the wrong place' and not enough in the parts of Dublin sought after by families looking for bigger houses, close to amenities and work. The 2011 census supports that, with a vacancy rate of 5.4% in South Dublin against a national average of 11.5% (excluding holiday homes). The pace of price increases in the capital of late has prompted some to fear a localized

bubble forming , although as our checklist below illustrates, the conditions for that are far from being satisfied; the price gains are not of sufficient duration, at least as yet, or driven by excessive credit growth, which are some of the classic warning signs. Indeed, credit standards, as recorded by the Central Bank , have only recently returned to normal for mortgage loans after a prolonged period of tight standards. The transactions in the Dublin market are also running at around one-third of the national figure, judging by the Property Price register, which is similar to the pattern over recent years

Bubble Checklist-Dublin		
	1 year	3 years
Price change	10.6%	-19.0%
Credit Growth	-2.20%	-10.0%
Credit standards	Normal	Tight

..cash buyers predominate ... Cash transactions account for over half the national housing sales year to date, and if Dublin is similar that argues that the pace of price appreciation may run out of steam in the absence of a credit upturn. The latter is absent, judging by figures on new mortgage lending from the Irish Banking Federation; the number of new mortgages for house purchase picked up in q2 after a weak first quarter but are still running below last year's levels. Employment has risen, and at a surprising pace, helping to boot household incomes, which is the key driver of housing and mortgage demand, while price expectations are also important and may now be turning positive given the change in actual prices of late. We expect some growth in lending in 2014 although the number of effective lenders is much smaller than it was at the peak of the boom

..**Prices may have overshot on downside**...The scale of the residential price fall seen in Ireland since 2007 (over 52% nationally and some 58% in Dublin) has meant that prices now look undervalued on a number of fundamental metrics, a fact noted by the OECD, the IMF and research from the Irish Central Bank, among others, and we have developed our own checklist to benchmark prices against fundamentals. One is affordability, as measured by the cost of servicing a new mortgage relative to income, and is certainly not an impediment to price appreciation. The price to rent ratio is another metric of interest and in Ireland's case rents (as measured by the CSO) bottomed far earlier than prices (in early 2011) and have risen strongly since, increasing by an annual 6% in the second quarter of 2013 and by over 7% in August. As a result the price to rent ratio is now well below its longer term average and the inverse , the rental yield, is now at 5.7% on our estimates, a figure last seen over 10 years ago.



..including relative to income.... A third check is to compare house prices to income and again that ratio is well below the average over the last twenty years and back to levels seen in the latter 1990's, so as the table below confirms, prices on all three measures imply that residential property values in Ireland now look to have overshot on the downside, which is perhaps understandable given the scale of the decline in employment and GDP and the collapse of the banking sector.

House price valuation-relative to long term average

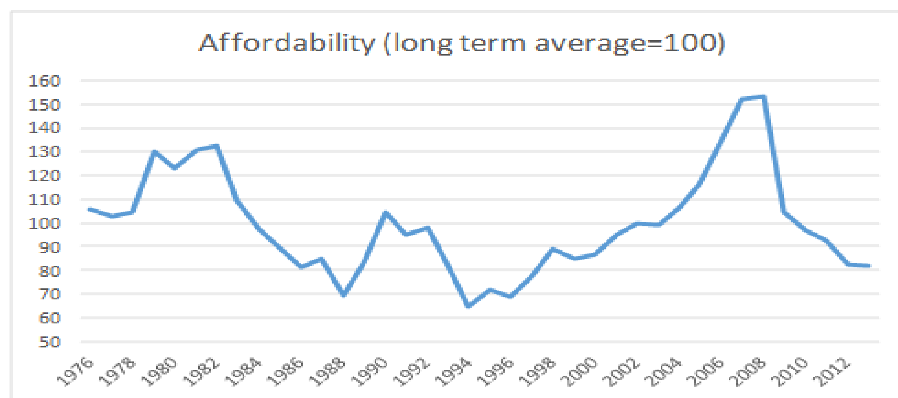
	Period	Current
Affordability	1975-2013	-18%
Price/rents	1996-2013	-25%
Price/income	1975-2013	-17%

...**but price appreciation may be modest**...We will monitor these trends over time and no doubt at some stage in the future they may start to flash warning signs. We are a long way from that point, we suspect, and we doubt that price increases will be anything other than modest in the shorter term given the credit backdrop– housing is ultimately credit driven and any recovery based on cash purchases will eventually run out of steam. In a less fragmented market cash transactions would account for less than 20% of the total while annual turnover in the market, at less than 1.5% of the outstanding housing stock , is also well below the 3% plus figure that one might consider as normal. In addition, many existing home owners are in negative equity, making it difficult to trade-up, while almost 100,000 are in arrears on their current mortgage loans. The number of repossessions is also vey low by international standards and is likely to rise although we doubt that the volume will be on a scale over a short period which would have a material impact on national prices. In addition, CPI inflation is extremely low and likely to remain so for a period which implies that any modest growth in real house prices will require only similarly modest growth in nominal prices.

Affordability

Cost of new mortgage is half 2007 level...The average new mortgage for house purchase over the first half of 2013 was just under €170k, a level last seen in 2004. The average mortgage rate on a new loan that year was 3.5%, which is only slightly above the rate operating this year, according to the Central Bank data on retail rates, making the monthly payment on a 25-year mortgage similar at €825 to €850 . This is also almost half the €1600 existing at the peak of the market in 2007 so that data alone tells us that the burden of paying for a new mortgage has eased substantially and is at least back to levels seen a decade ago.

.. **and has averaged 29% of income since 1975**...A more complete measure would take account of these payments relative to income , and such affordability indices are commonplace in any discussion of mortgage lending although that calculation is complicated in Ireland by the lack of consistent income data over a long time frame. One could use household disposable income per capita but that includes transfers and a wage income measure would be more appropriate if one is considering the mortgage market. Average earnings in the economy are published but the data only goes back over a few years so we have constructed our own income series, defined as the total amount paid out in wages and salaries divided by the number of employees in the economy . On that basis a new mortgage has averaged just over 29% of income since 1975 and we take that as our yardstick for affordability and it proves a useful indicator of overheating as well as highlighting periods where mortgage payments are low and hence by implication that house prices are also affordable. Affordability was unusually good in the mid- 1990s and only deteriorated slowly for a time despite rising property prices because income also rose , before signaling vey unaffordable mortgage levels by 2006 and 2007 as credit standards slipped. Mortgage lending was extraordinarily strong in those years, of course, but only because the average term of the loan was extended well beyond 25 years.

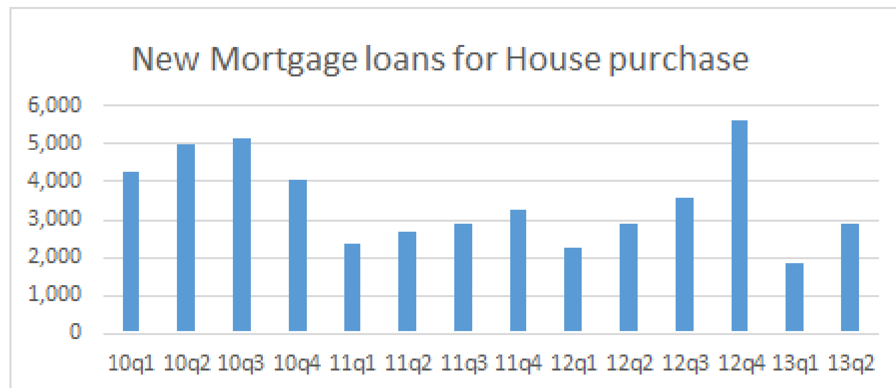


.. **and is now back to 197 levels**...Affordability has improved dramatically since then largely reflecting much lower prices (and hence new mortgages) and lower interest rates, despite some falls in income although the income variable has now started to rise modestly. For 2013, for example, we estimate a new 25-year mortgage will absorb just 24% of income so our affordability index stands at 82 or some 18% below the long term average of 29% and at a level last seen in 1997. Good affordability is not a sufficient condition for a strong housing market but it is probably a necessary one and is certainly not an impediment to a recovery in mortgage lending and house prices

Mortgage lending

Lending increased in 2012...New mortgage lending peaked in 2006 at an extraordinary €40bn (over 20% of GDP at that time) , with €28bn of the total for house purchase (and over 110,000 mortgages for that purpose)and the balance a mix of top-up loans (€6bn) and re-mortgaging (also €6bn). The latter has collapsed to just €22mn In the first half of 2013, indicating in part the degree to which competition in the supply of credit has contracted over the past seven years. The combination of falling house prices , fewer house completions and a prolonged slump in employment led to a plunge in demand for house purchase , to just €2.1bn in 2011 , but that appeared to be the cycle floor, as lending picked up in 2012 to €2.5bn reflecting a 28% increase in the number of loans for house purchase, to over 14,000, which offset a further (8%) fall in the average size of a new mortgage. Demand was brought forward by the ending of mortgage tax relief in that year, which resulted in a surge in loans drawn down in the final quarter (some 5.600, a 73% rise on the previous year). Lending figures for the first quarter of 2013 showed that impact with the number of loans falling back to around 1800 , a 19% annual decline.

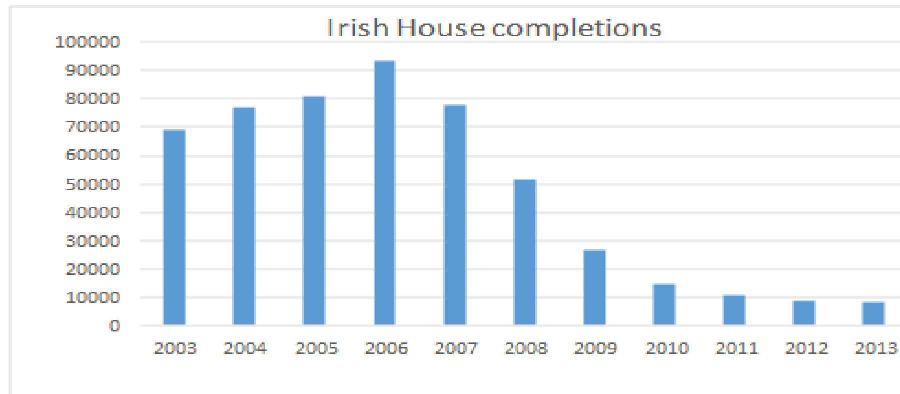
.**but may fall back again this year**....The second quarter saw a recovery, to over 2800 which was marginally higher than the same period in 2012 and the latest figure available for approvals imply that drawdowns will show annual growth in q3. Base effects will then kick in, however , and we expect the number of loans this year to emerge some 18% below last year's total for a total of 11,600. The size of the average new mortgage may also decline, albeit modestly, and we expect the value of new mortgage lending to be around €2.0bn with the total figure (including top-ups and re-mortgaging) to be €2.1bn.



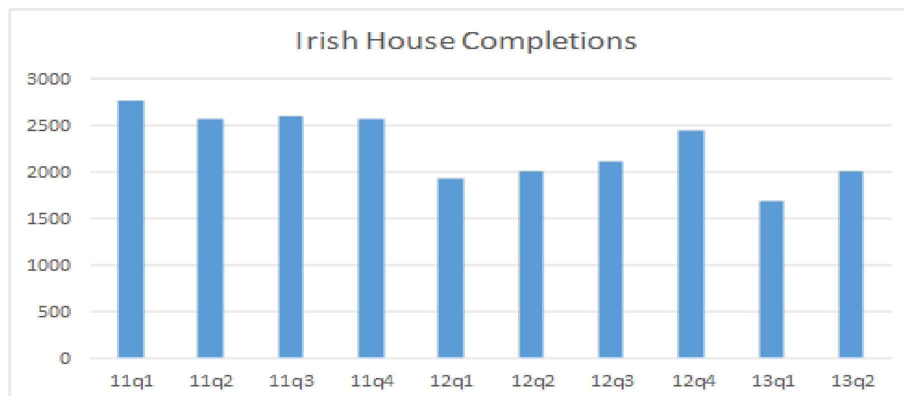
...**modest pick -up seen for 2014**...One significant positive for mortgage lending is the recent advance in employment (an annual 34,000 rise in q2), and wage income is also showing some marginal growth. The steady fall in the unemployment rate may also be going some way to reduce economic uncertainty and boosting consumer confidence. House building may also be at or close to bottom but these positive factors for mortgage demand must be offset against the broader economic backdrop, with the Irish economy likely to have recorded no growth over 2012 and 2013, and the prospect of another deflationary Budget . In addition almost 100,000 existing home owner mortgages are in arrears and many would –be buyers are in negative equity so the prospects of a sizeable acceleration in mortgage lending in 2914 look slim. Irish households are still deleveraging with debt declining by over €30bn over the past three years, with the result that net mortgage lending is still declining, falling by an annual 2.3% in August. Despite this debt repayment the household debt burden has only fallen marginally and is still extremely high at close to 200%, so it is impossible to say when this process will come to a halt

House Building

Leading indicators point to an upturn in completions...Planning permission for just 6150 housing units were granted last year from 11,800 in 2011 and a cycle peak in 2004 of over 100,000. Permissions have picked up this year, however, to over 4,200 in the first two quarters with the number of apartments already ahead of last year's total, albeit still extremely low by historical standards. Permissions may not all come to fruition but are one leading indicator of completions, as are Bond registrations which have also picked up this year, although the significance of the latter has been dampened by the high proportion of single houses now being built, presumably to demand.



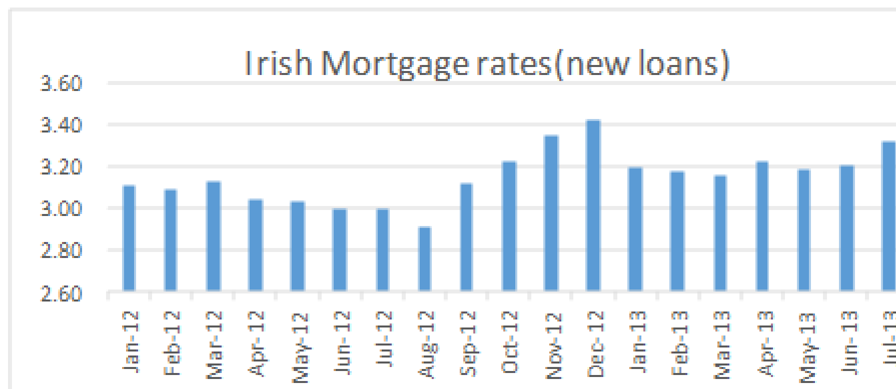
Although annual total may still be below 2012...The available data on completions does point to a modest annual increase over recent months although the total for the first half of the year , at 3,700, is still down on the corresponding figure of 3,900 in 2012. Consequently we doubt if last year's annual figure of over 8,400 will be bettered and expect some 8,000 for 2013, although the recent trend does imply that 2014 will see the first annual increase since 2006. The housing stock stands at around 2 million units so the current addition to supply amounts to just 0.4% and well below the depreciation rate.



Interest rates

Radical difference between new and existing rates...The majority of existing mortgage holders in Ireland are on a Tracker rate (a variable rate with a fixed spread to the ECB refinancing rate). The ECB rate is currently 0.5% so most borrowers are paying an annual rate of between 1.5% and 2%, an historic low, which is positive for them but a major negative for the main Irish lenders, who cannot fund at that rate. Consequently, new borrowers have two options - a fixed rate or a standard variable rate which is no longer linked directly to the ECB rate and will vary with the costs of funds to Irish banks. The latter will in turn depend on the cost and availability of customer deposits, money market rates , the willingness of banks to provide liquidity to each other and the risk premium payable by Irish banks.

..**although access to market funds for Irish banks has improved**...That premium has fallen over the past year and a number of banks have raised longer term funding secured on mortgages (covered bonds). The funding markets as a whole are also functioning a little better but are still far from the position existing prior to 2007, while the misguided targets on loan to deposit ratios imposed on Irish banks has effectively been dropped as it resulted in a price war for deposits, which helped savers but raised the cost of funds and hence the cost of Irish loans. The number of active mortgage lenders in Ireland has also fallen sharply , so reducing competition. The net result is that quoted variable rates currently stand around 4.5% and hence well above that paid by many existing borrowers. The Central Bank issues data on the actual average rates paid on a new loan (including up to 1 year fixed) and this is lower, at 3.3% for July, although up from under 3% a year earlier.



...**rates to stay low for some time**.. .We do not expect much movement in these rates in the near term in the absence of another blow-out in investor sentiment towards the euro area as market rates are likely to remain low given the economic backdrop in Europe and the ECB's commitment to keep official rates at current or lower levels for an extended period. For those on Tracker rates there is still the prospect of another cut in ECB rates but that is less certain than the prospect of rates staying low for some time, with the market not anticipating the first rise until late 2015.