

Overnight Report

U can't touch this

Dario keeps handing us sticks to beat him with. After telling us about his pink mountain bike last week, he recently revealed his most recent music purchase: MC Hammer. This makes his criticism of Rob's musical tastes (the Pet Shop Boys and Abba) look pitiable. Obviously, this has very little to do with the subject of today's *Overnight Report*, which focuses on the US and UK housing markets. Except that markets clearly believe it's 'Hammer time' for US housing, while UK housing is 'Too Legit to Quit'. But if you ask me, it's UK homeowners who need to 'Pray' (Perkins tells me these are MC Hammer song titles – we've hit a new low).

Tim has outlined our view on the US housing market in previous *Overnight Reports*, so there's little point in repeating the analysis. In short, we remain optimistic that the economy will prove resilient to problems in housing and the worst could already be behind us. Yet despite our upbeat view, we recognize why investors are concerned. If problems in sub-prime cause a broader credit crunch across the economy, we could end up looking pretty silly (a feeling familiar to some of us – Ed). Still, there seems to be an inconsistency here. Markets appear relatively relaxed about the UK housing market, which looks more vulnerable to a correction.

At this stage, I should probably clarify something. We don't deny that US housing is overvalued. House prices will need to fall in real terms over the medium term. Yet given solid employment growth, rising incomes and – most importantly – unusually low long-term interest rates, it seems possible to rationalize where we are now. In contrast, developments in the UK look harder to explain. Still, it hasn't stopped some from trying. We are told the lack of spare land, rising immigration and demographic factors justify the premium on UK housing. But I'm yet to be convinced. These factors should boost prices and rents by a similar amount, as marginal buyers are forced into the rental market. Yet prices have risen far more quickly than rents over the last decade. The ratio of house prices to rents is now almost 50% higher than its long-run trend, compared with around 25% in the US. In fact, prices have risen so much faster than rents that rental yields are now below mortgage rates. In other words, property 'investment' is generating a negative cashflow. It's only the expectation of further capital gains that is sustaining demand.

With house prices appearing more detached from fundamentals, the UK housing market could be more vulnerable to a correction than the US. There are also reasons to believe this could be more problematic for the wider economy. Owing to the lack of supply flexibility (economists call it an 'inelastic' supply curve), the burden of adjustment would fall on prices rather than quantities, the opposite to what we have seen in the US (see the illustration on page 2). This is how 'spillover' effects could occur. Falling house prices would depress household wealth and spending, especially as UK consumers hold a larger share of their wealth in housing than in the US. And given the concentration of default risk and sharper increases in household debt, the banking sector could also be exposed. While the latest RICS survey shows UK housing is still 'Gaining Momentum', we all know 'This is the Way We Roll': a housing market collapse will undermine confidence in sterling, preventing the Bank of England from cutting rates and prolonging the downturn. (Next week, Vanilla Ice).
For more see last week's *Euro Vision 'Home Truths'*, 4 April 2007.

US jobless claims, import prices

- **Initial jobless claims, w/e 12 Apr: 342k (320k exp) after 323k (was 321k) w/e 7 Apr.**
- **Import prices, Mar: +1.7% mom (+0.8% exp) after +0.1% mom (was +0.2%) in Feb.**

■ The timing of Easter could help explain the spike in jobless claims. A more persistent rise would question the strength of the labour market. Energy explains the pick-up in import prices. But consumer goods import prices also rose 0.2% mom.

UK trade, RICS and BCC survey

- **Trade balance, Feb: -£4.3bn (-£4.0bn exp) after -£4.0bn (was -£3.8bn) in Jan.**
- **RICS house price balance, Mar: +25.5% (+21.0% exp) after +24.8% in Feb.**
- **BCC survey, 1Q07: manufacturers' home sales +26%; exports +21%. Services' home sales +27%; exports +25%.**
- The UK housing market appears to be stabilizing at strong levels, while domestic and export demand remains strong.

Upcoming data releases

	Due	Market	Previous	ABN AMRO view
US trade balance, Feb	Fri	-\$60.0bn	-\$59.1bn	Following yesterday's sharper-than-expected rise
US PPI, Mar	Fri	+0.7% mom	+1.3% mom	in import prices, producer prices could also
Uni. of Mich. consumer confidence, Apr	Fri	87.5	88.4	surprise markets on the upside.

Important disclosures and analyst certifications regarding companies can be found in the Disclosures Appendix.

Equities

Dow Jones IA	12552.6	0.5%
S&P 500	1447.8	0.6%
NASDAQ	2480.3	0.9%
FTSE 100	6416.4	0.0%
DJ Stoxx 50	4280.0	-0.3%

Interest rates

3m ED future	5.25	0.01
2yr Treasury	4.73	0.01
10yr Treasury	4.74	0.00
30yr Treasury	4.91	0.00

Currencies

EUR/US\$	1.35	0.4%
US\$/JPY	119.08	-0.3%
A\$/US\$	82.93	0.6%

Commodities

CRB index	317.37	0.2%
WTI oil	63.85	3.0%
Gold (comex)	675.10	-0.3%

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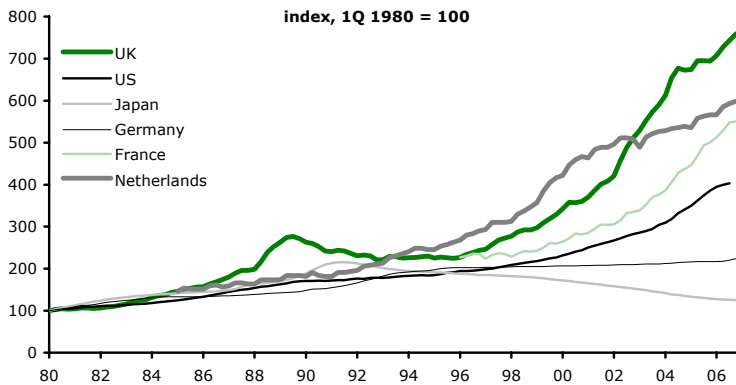
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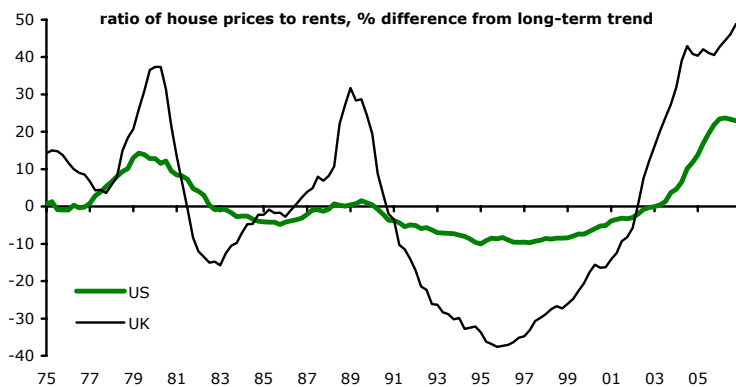
Home truths

Chart 1: International house prices



It seems puzzling that markets worry about excesses in the US, but remain relatively unconcerned about the situation in the UK. The UK has experienced much sharper increases in house prices than nearly all other developed economies in recent years (Chart 1). Is this justified? We think not.

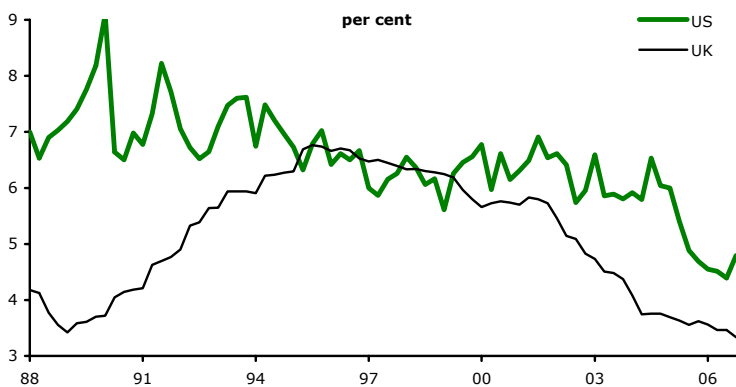
Chart 2: Relative housing valuations in the US and UK



Numerous attempts have been made to rationalize the premium on UK housing. These arguments generally highlight the shortage of supply or a sustained increase in demand (due to immigration or demographics). Yet these trends are not exclusive to the UK. The Netherlands and Japan have more acute land shortages, but have experienced less rapid increases in house prices.

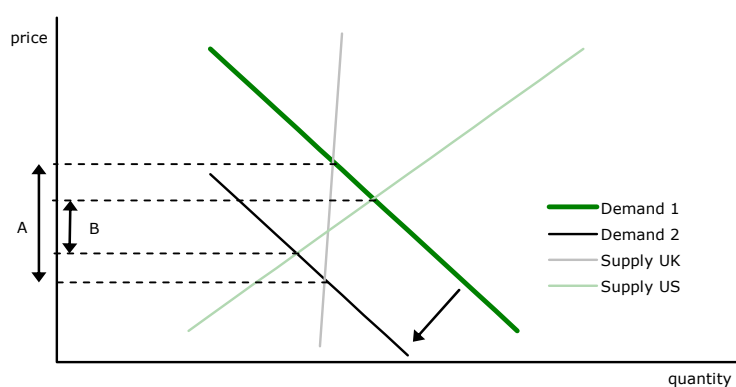
More significant, an increase in housing demand or shortage of supply should put upward pressure on rents, as well as on prices. Over the long-term, rents and house prices should grow in line with each other. Yet this has not been the case. Prices have risen much more rapidly than rents in recent years, suggesting UK housing is overvalued by nearly 50% compared with about 25% in the US (Chart 2).

Chart 3: US and UK rental yields



Rather than fundamentals supporting the housing market, expectations of future gains and speculative activity seem to be driving prices higher. The level of rental yields is perhaps the clearest evidence of this. In the UK, rental yields have fallen below mortgage rates (Chart 3). This implies that housing 'investment' is generating a negative cashflow. With buy-to-let demand now accounting for 25% of all new mortgages, this illustrates how fragile demand could be to a shock to expectations.

Chart 4: Illustration of supply and demand in the US and UK

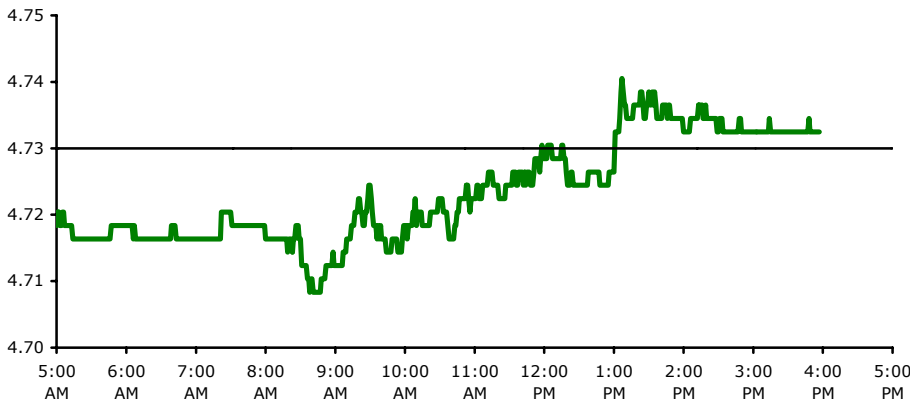


This greater degree of overvaluation makes UK housing more vulnerable to a correction than the US. It could also have more significant implications for the wider economy. Owing to the lack of land and inelastic supply, the burden of an adjustment would fall on prices rather than quantities. A given change in demand will generate a larger drop in prices (Chart 4). In regions where land is more abundant, such as the US, the adjustment primarily comes through quantities (i.e. construction output). A fall in UK house prices would depress household wealth, hurting consumer spending. It could also leave the banking sector exposed. If sterling then collapses, the Bank of England could find itself unable to respond.

Source: EcoWin, OFHEO, BLS, Nationwide, ONS, Bureau of the Census, DCLG, Halifax, ABN AMRO

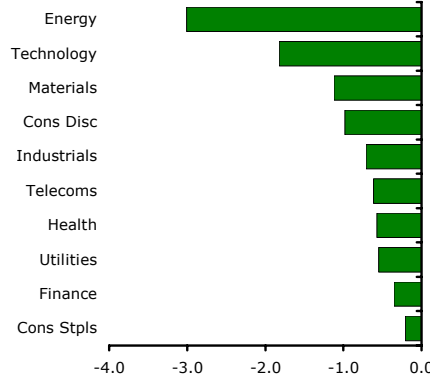
Market summary

Chart 5: US 10-year cash bond yield



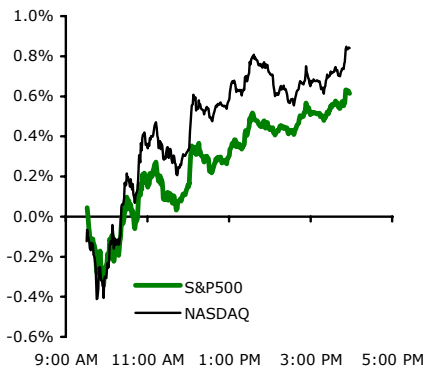
Source: Bloomberg

Chart 6 : S&P GIC sectors



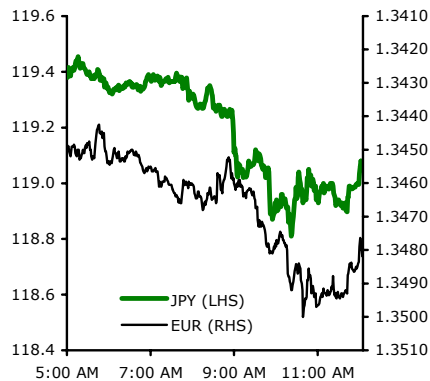
Source: Bloomberg

Chart 7 : S&P500 and NASDAQ



Source: Bloomberg

Chart 8 : EUR/US\$ AND US\$/JPY



Source: Bloomberg

Equities

Dow Jones IA	12552.6	0.5%
S&P 500	1447.8	0.6%
NASDAQ	2480.3	0.9%
S&P Small 600	418.9	0.7%
Phila Semicndtor	475.3	0.9%
Phila Gold & Silver	143.3	0.0%
FTSE 100	6416.4	0.0%
DJ Stoxx 50	4280.0	-0.3%
DAX	7143.0	-0.1%
CAC	5748.9	-0.1%
SMI	9110.1	-0.3%
TOPIX	1726.2	-0.7%
Nikkei	17540.4	-0.7%
Hang Seng	20380.2	-0.3%
ASX 200	6158.2	0.1%

Interest rates

Fed fund future	5.25	0.00
3m ED future	5.24	0.00
2yr Treasury	4.73	0.01
5yr Treasury	4.65	0.01
10yr Treasury	4.74	0.00
30yr Treasury	4.91	0.00
2yr/10yr spread	0.00	-0.01
US 10yr swap	5.27	0.00
10yr Mortgage	5.69	0.00
Aus 90D bill future	6.60	-0.01
Aus 10yr future	5.94	-0.02
IBOXX spread	94.65	0.14
VIX index	12.66	-0.83

Currencies

EUR/US\$	1.35	0.4%
US\$/JPY	119.08	-0.3%
STG/US\$	1.98	0.2%
US\$/CHF	1.22	-0.4%
A\$/US\$	82.92	0.6%
US\$ index	82.37	-0.4%

Commodities

CRB index	317.37	0.2%
WTI oil	63.85	3.0%
Gold (comex)	675.10	-0.3%
Silver (comex)	13.90	0.0%
Copper (comex)	349.3	-2.3%
Nickel (LME)	47700.0	-2.3%
Zinc (LME)	3520.0	-0.8%
Alumin (comex)	126.4	-0.8%
Lumber (CME)	248.8	-0.3%

Source: Bloomberg

All chart times are 9.30 GMT.

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