Wednesday 12 October 2005

Analysis

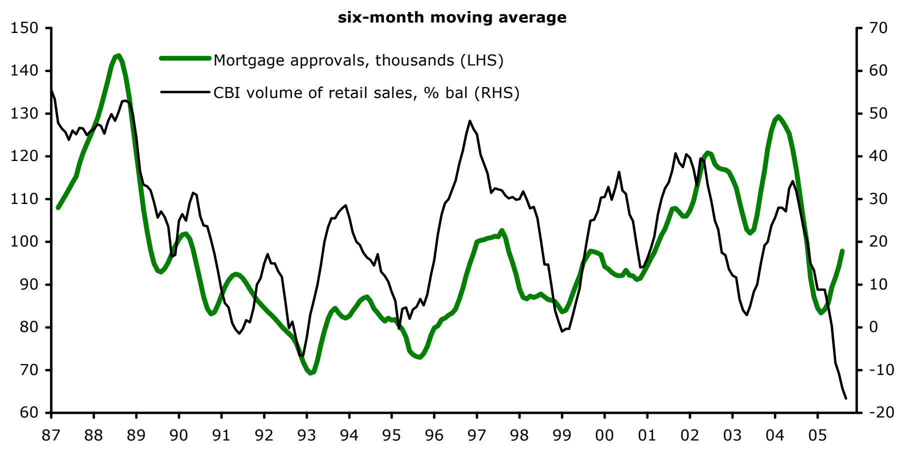
# Euro Vision

# False alarm

**The UK's housing market improved in the summer as interest-rate expectations reversed. But we remain cautious about the outlook for domestic demand. The MPC will be slow to cut rates again as it is worried about inflation and wants to rebalance the economy.**

Europe

**Chart 1 : Mortgage approvals and retail confidence**




*Source: EcoWin*

### Housing market recovery?

Recent UK consumer data have been mixed. Retail confidence fell to its lowest ever level in September but mortgage approvals jumped in August. A reversal of interest-rate expectations appears to have brought buy-to-let investors back to the market. In July, money markets were pricing in two 25bp rate cuts by the end of the year.

### Stronger domestic demand?

If investors are buying houses again, domestic demand could be stronger than we expect in 2006. Banking and real-estate services should benefit. House prices could stabilize, limiting the negative 'wealth effects' on consumption. It might also support housing investment and boost retail sales of household goods.

### SIPP off?

The prospect of tax reforms might also be encouraging investors to return to the property market. But it is unclear the government will allow the tax breaks on residential property to go ahead next April. The government's finances are weak. It wants to boost homeownership rates rather than subsidize rich investors.

### Monetary policy

But even if the government introduces the reforms, the MPC could disappoint investors by being slow to cut rates. The MPC is worried about rising import prices and a lack of spare capacity. If domestic demand recovers, the MPC expects inflation to remain above target. It would prefer to rebalance growth towards exports.

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# False alarm

**The UK's housing market improved in the summer as interest-rate expectations reversed. But we remain cautious about the outlook for domestic demand. The MPC will be slow to cut rates again as it is worried about inflation and wants to rebalance the economy.**

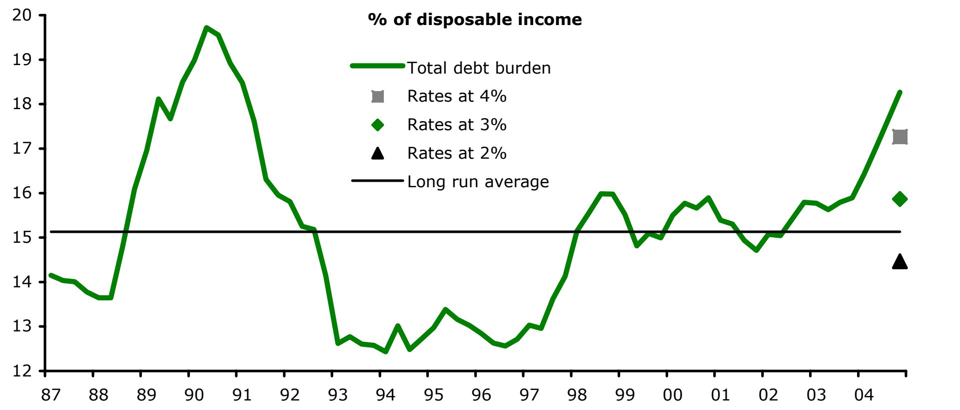
**We remain cautious about UK domestic demand**

## Housing market recovery?

**Recent consumer data have been mixed**

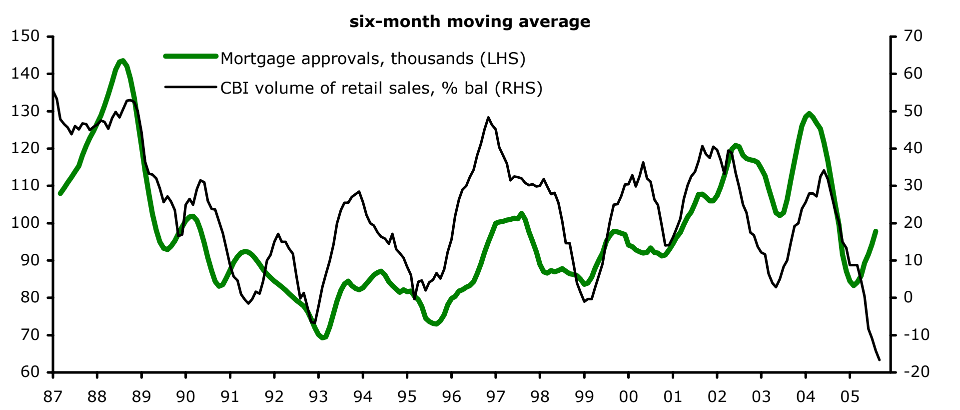
Recent UK consumer data have been mixed. Retail confidence fell to its lowest level ever in September as consumers struggled to repay the debt taken out in recent years (Chart 2 – taken from 'Payback time', *Euro Vision*, 16 June 2005). But mortgage approvals jumped in August as the Bank of England cut interest rates. This divergence between housing and retail activity is unprecedented (Chart 3). Perhaps investors, not ordinary consumers, are returning to the housing market.

**Chart 2 : Household debt servicing burden**




*Source: ABN AMRO estimates*

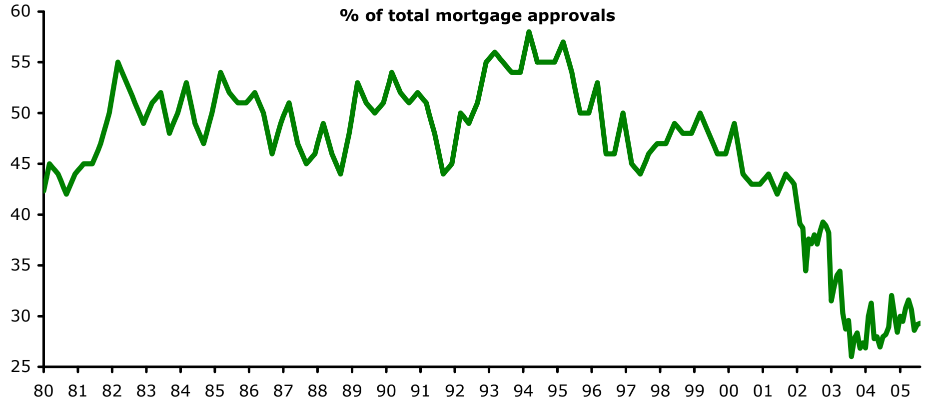
**Chart 3 : Mortgage approvals and retail confidence**




*Source: EcoWin*

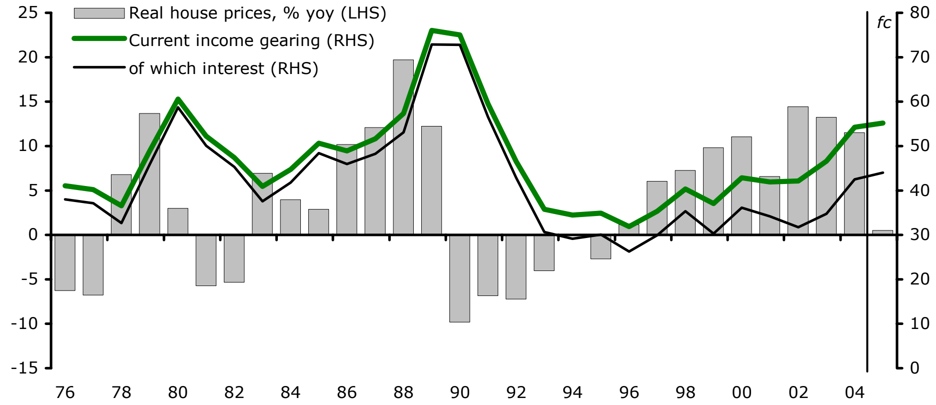
The latest data from the Council of Mortgage lenders supports this view. First time buyers are still struggling to buy property (Chart 4). This is because homes remain unaffordable for the average homebuyer (Chart 5). But the latest RICS survey hinted that the property market could be benefiting from a recovery in investor demand.

**Chart 4 : First time buyers**




*Source: CML*

**Chart 5 : Debt servicing burden of a new mortgage**



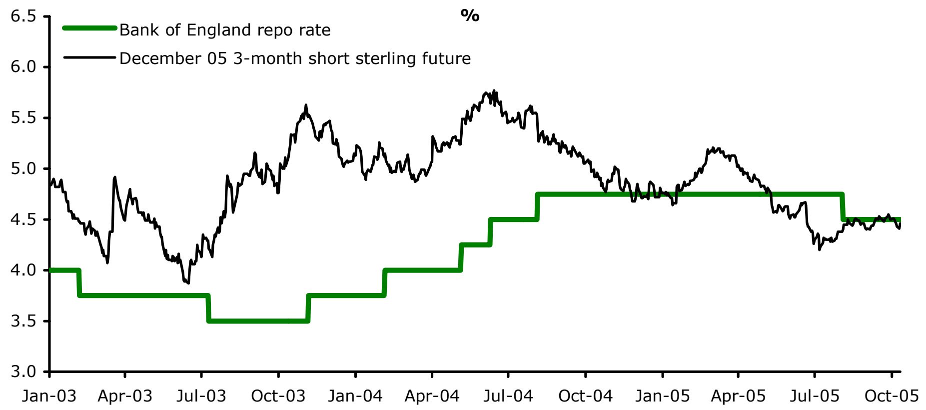

*Source: ABN AMRO estimates*

## Investor demand

**Investors might be returning to the property market**

Investors might be trying to play the interest-rate cycle. Interest-rate expectations reversed over the summer. In March, money markets were pricing in at least one more 25bp hike from the MPC by the end of the year. By July, markets were expecting two 25bp rate cuts instead (Chart 6). But the RICS survey also noted that "A number of investors are coming back into the buy-to-let market in view of the change in SIPP (self-invested personal pension) provisions next April". At present, individuals can invest in equities, bonds and commercial property in their SIPP and claim tax relief on their contributions. From next April, people will be able to invest more money per year and in a broader range of assets, including residential property.

**Chart 6 : Interest rate futures**




*Source: EcoWin*

## Stronger domestic demand?

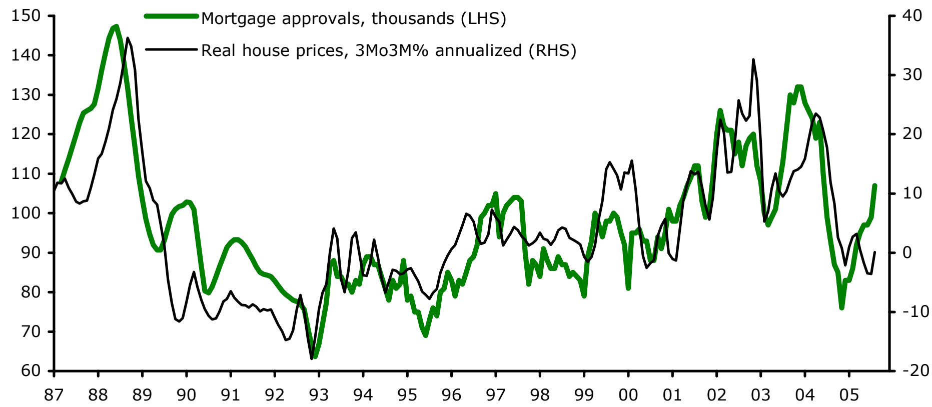
**This might support domestic demand in 2006**

We expect domestic demand to remain subdued next year. But if investors are buying property again, this could help the domestic economy in several ways. It might support house prices at their current levels, limiting 'wealth effects' for consumers. It could prevent a sharp decline in housing investment. It might also boost retail sales as landlords furnish properties.

It is impossible to know exactly why mortgage approvals have rebounded. It could be due to the turn in the interest-rate cycle or pension reform. Research carried out for the Property Investors' Show estimates that £6½bn will be invested in property through SIPPs next year. This would be equivalent to around 43,333 buy-to-let properties a year, or around 3,600 per month.

Given the historical link between mortgage approvals and real house prices, an extra 3,600 sales per month could boost house price inflation by just under 2% per year. The impact could be bigger than this depending if investors buy newly-built property or second-hand homes. If they buy second-hand homes, this could allow property transactions further up the chain to take place, further boosting mortgage approvals.

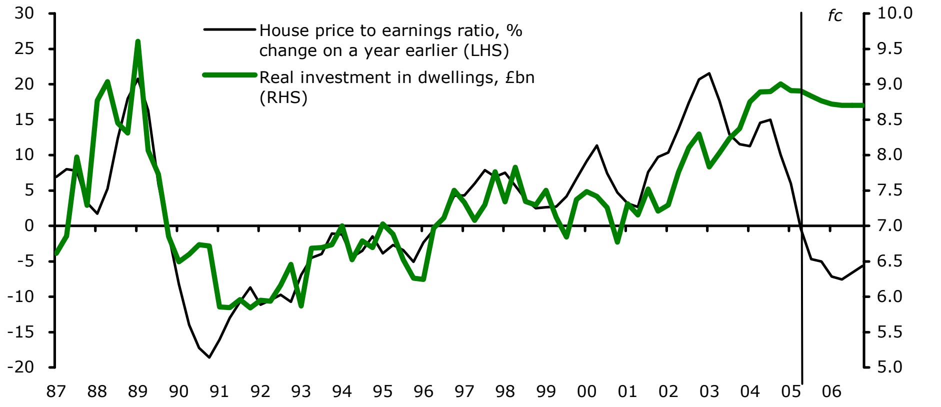
**Chart 7 : Mortgage approvals and real house prices**




*Source: EcoWin, HBOS, ABN AMRO estimates*

No matter what types of property investors buy, demand for banking and real estate services will increase. But if investors buy new property, this could limit the expected decline in housing investment. We currently expect investment in dwellings (purchase of new homes plus home improvements) to make a negative contribution to GDP growth in 2006.

**Chart 8 : Real investment in dwellings**

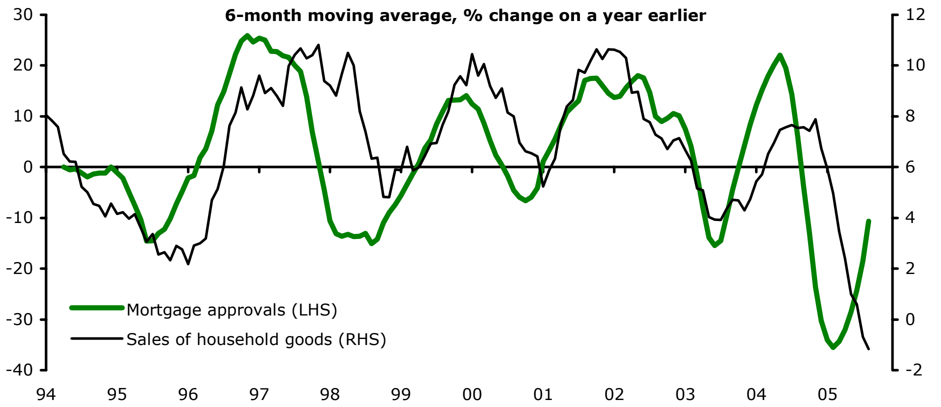



*Source: ABN AMRO estimates, National Statistics, Nationwide*

**Retail sales could recover**

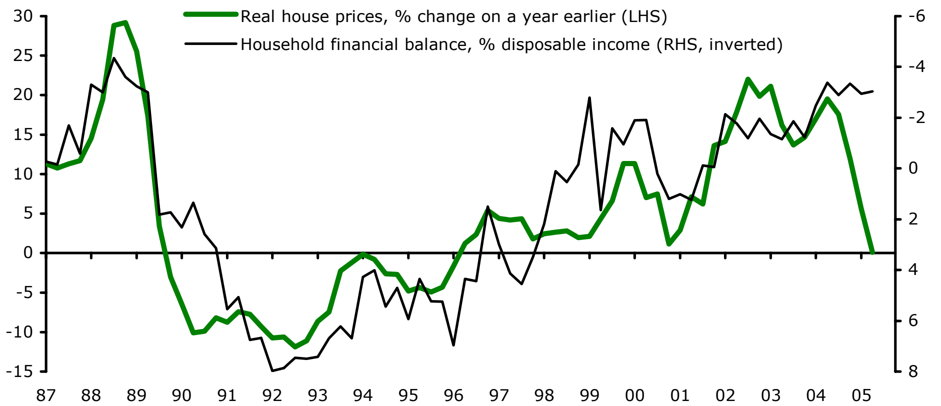
An investor-led recovery in housing activity could also support retail sales. First, landlords will need to furnish property, supporting household goods sales (which account for 3% of GDP – Chart 9). Second, if investor demand prevents house prices from falling, this will limit the 'wealth effect' on consumer spending. There is a good relationship between wealth growth and the household sector's overall financial balance (saving less investment – Chart 10).

**Chart 9 : Mortgage approvals and household goods sales**




*Source: EcoWin*

**Chart 10 : Real house prices and overall household sector financial balance**




*Source: EcoWin*

## SIPP off?

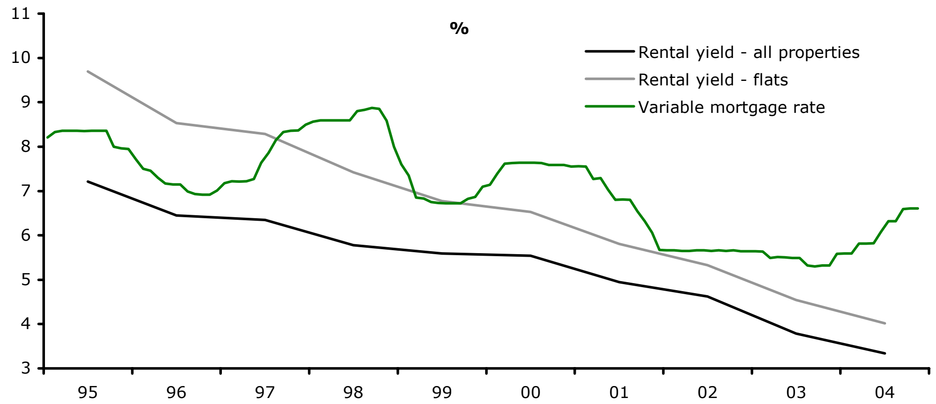
The analysis above suggests a stronger property market could boost domestic demand next year. But we remain cautious. The government might not introduce the tax reforms next year. And the Bank of England is likely to cut interest rates at a slower pace than people expect.

**We remain cautious**

Our long-held negative views on the housing market have stemmed from two factors. First, house prices are unaffordable for first time buyers. They cannot afford the deposit or the monthly mortgage payment. Second, rental yields have fallen below the mortgage rate, resulting in negative 'carry' for buy-to-let investors (Chart 11). The tax advantages of purchasing a buy-to-let property through a SIPP (income tax rebate on the deposit, no capital gains tax, no income tax on rental income) justify lower rental yields than would otherwise be the case. But the government will come under increasing political pressure if the stereotypical rich investor from London buys up all the affordable homes in the country.

**House prices are overvalued**

**Chart 11 : Rental yields**




*Source: ODPM, HBOS, ABN AMRO estimates*

The government is committed to boosting homeownership. Its fiscal position is also weak. Of the £6½bn estimated to be invested in property in 2006, £4¾bn is estimated to be new money, whereas just £1¾bn is expected to displace other pension investments such as equities. So the government could lose around £2bn (or 0.2% of GDP) in tax receipts next year (40% of £4¾bn). Given these factors and the potential for mis-selling, we would not be surprised if the government restricts the tax advantages of investing in property in SIPPs before the reforms are introduced next April.

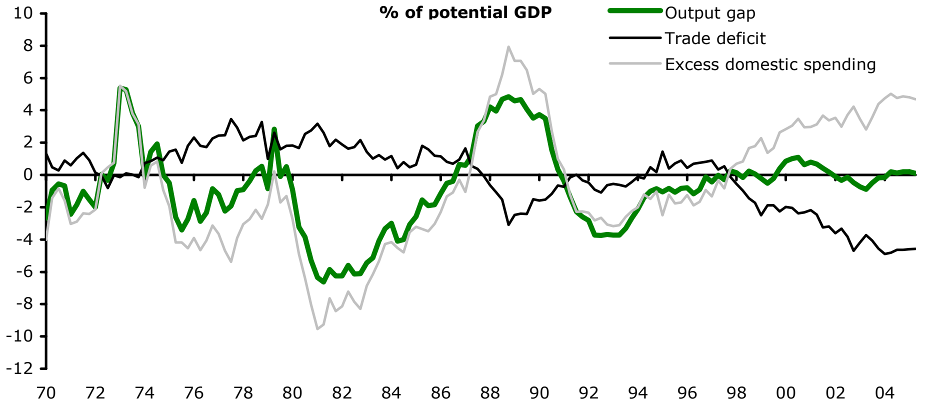
**The government wants to boost homeownership, not subsidize investors**

## Monetary policy response

Even if the government does not change the rules on SIPPs, property investors and consumers could be disappointed by the Bank of England's reluctance to cut interest rates further. The core of the MPC wants to rebalance the UK economy away from consumer spending and housing investment towards exports. The UK is spending more than it can produce. The output gap is close to zero and the real trade deficit is around 4½% of GDP. If we combine these variables, we can derive a measure of excess domestic spending. This measure is as extreme now as it was in 1989.

**The Bank of England might disappoint investors**

## Chart 12 : UK excessive domestic spending gap

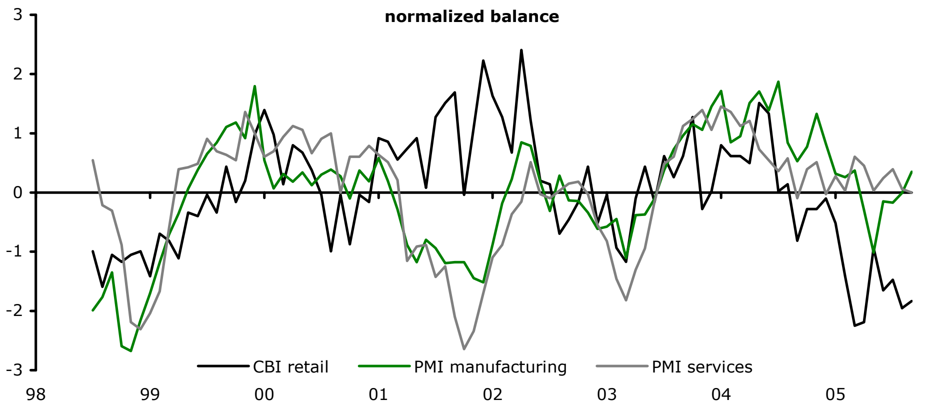



*Source: OECD*

**The Bank wants to rebalance the economy**

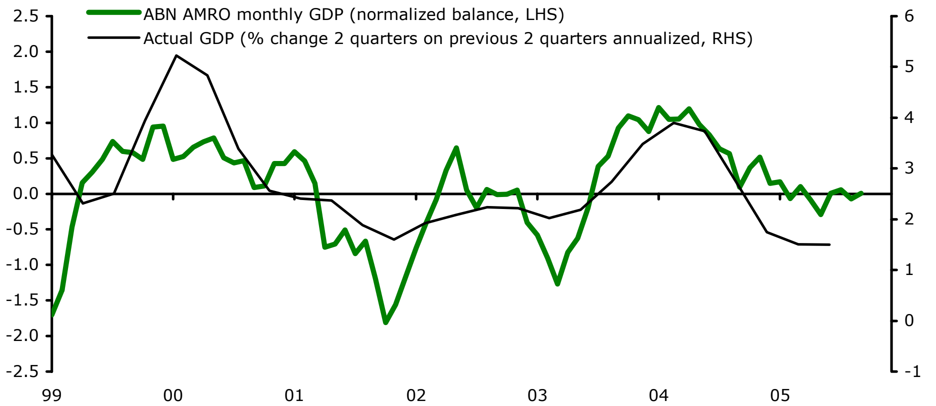
To resolve this imbalance, domestic demand needs to be weaker than in previous years and exports need to improve. With the global economy strong, financial markets buoyant and sterling no longer rising, this rebalancing is starting to happen. The manufacturing PMI has improved in recent months and the services PMI has held firm. This has offset continued weakness in the retail sector (Chart 13), so our estimate of monthly GDP suggests growth is only marginally below trend (Chart 14).

## Chart 13 : Business confidence




*Source: ABN AMRO estimates, Reuters, CBI*

## Chart 14 : Monthly GDP



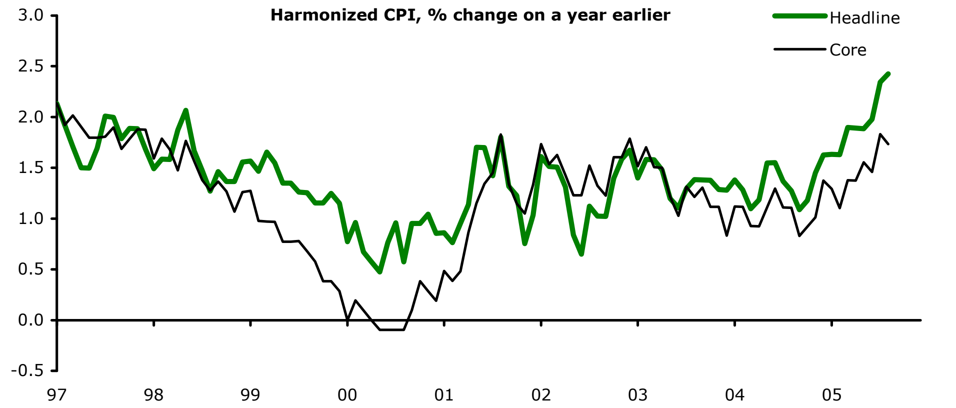

*Source: ABN AMRO estimates, Reuters, CBI, National Statistics*

## Inflation concerns

**It is worried about inflation**

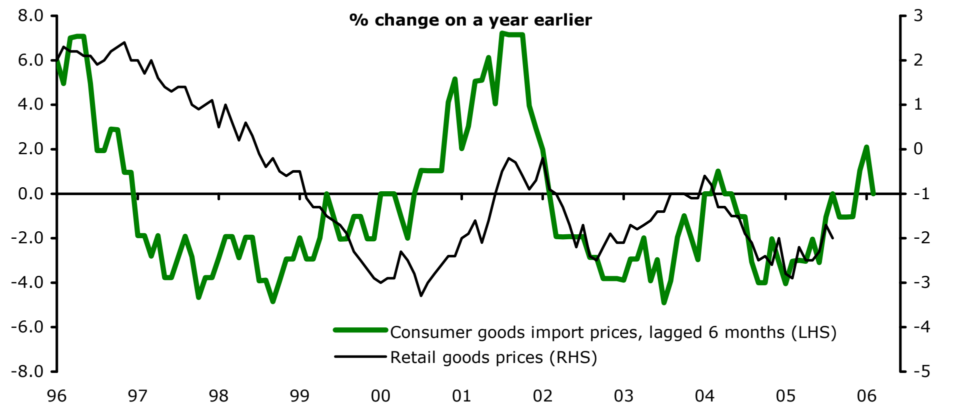
Not only is strong global growth supporting exports. It is also boosting import prices. High oil prices have pushed headline inflation above target (Chart 15). But core inflation is also rising as retailers pass on higher underlying import prices (Chart 16).

**Chart 15 : Inflation**




*Source: EcoWin*

**Chart 16 : Underlying import prices and retail goods prices**

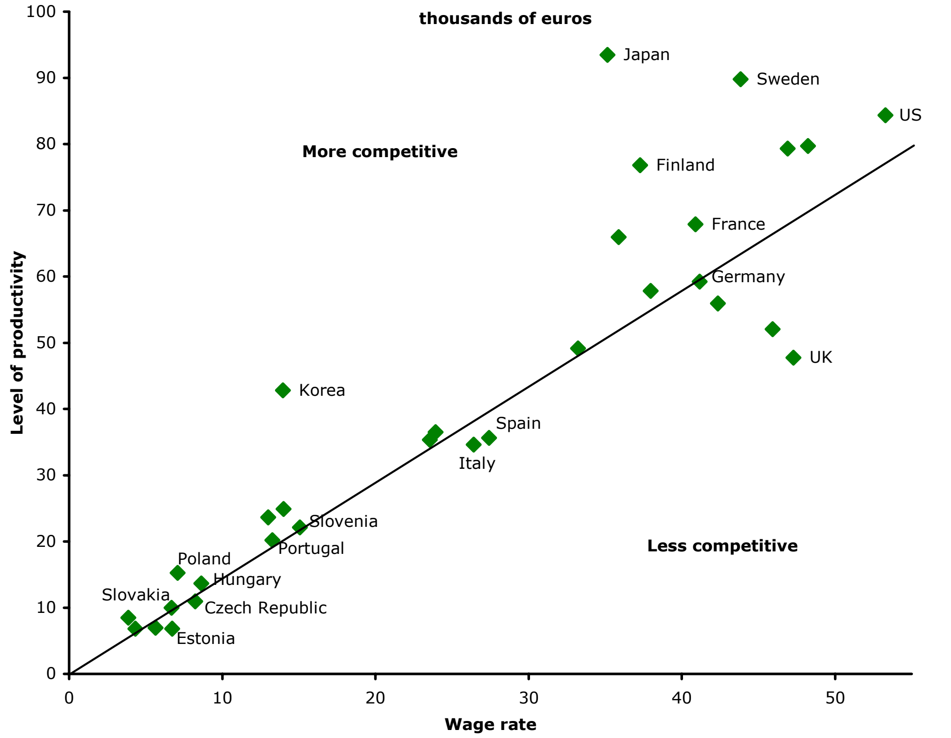



*Source: EcoWin*

**Sterling needs to fall**

Import prices could accelerate further if sterling were to decline. We believe sterling is significantly overvalued. In euro terms, UK manufacturing wages are around 15% higher than those in Germany, even though industrial productivity is 20% lower. A recent study commissioned by HM Treasury estimated that the pound was overvalued against the euro by around 7-25%. Model simulations suggest a 10% fall in the effective exchange rate is equivalent to a 100bp easing of monetary policy. We believe the ECB has moved to a tightening bias and if money markets begin to price in higher ECB interest rates, sterling could fall against the euro. Sterling is also overvalued against Asian currencies and we expect these to continue to appreciate as China moves towards greater exchange-rate flexibility.

**Chart 17 : Manufacturing labour costs and productivity**




*Source: ABN AMRO estimates, European Commission*

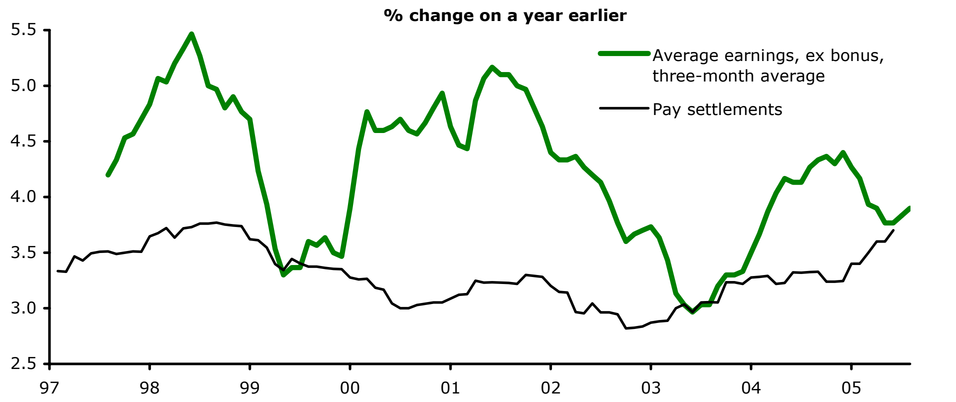
**It is worried about higher wages**

Rising import prices would concern the MPC. The latest minutes suggest some members are concerned that a temporary rise in inflation due to higher oil prices could feed through into inflation expectations and wages. If this were to occur, the MPC is worried that it would be painful to bring wages back under control. Interest rates might have to rise significantly to depress output and employment.

**Pay settlements have increased**

For this reason, the MPC should be concerned by the recent rise in pay settlements. These have jumped in recent months (Chart 18). Overall wage inflation has remained contained, but this reflects weaker growth which has reduced bonus and overtime payments. The rise in pay settlements suggests unit labour costs are also increasing.

**Chart 18 : Pay settlements and ex-bonus average earnings**




*Source: EcoWin, Bank of England*

## Policy outlook

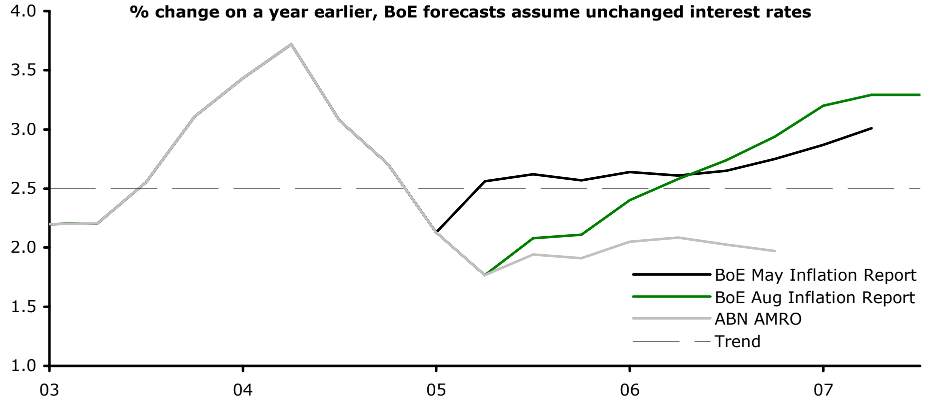
**Interest rates might be below neutral**

The MPC is also unsure what the neutral rate of interest is in the UK. The fact consumer demand slowed as the MPC hiked rates in 2004 suggests high debt levels have reduced the neutral rate of interest in the short-to-medium term. But if productivity growth holds up, the economy should continue to grow at a nominal rate of 5% in the long term (2½% real growth and 2½% GDP deflator) and this is the benchmark for the neutral rate of interest. The fact investor demand could be returning suggests interest rates remain below neutral for some people.

**The Bank expects inflation to remain high if domestic demand recovers**

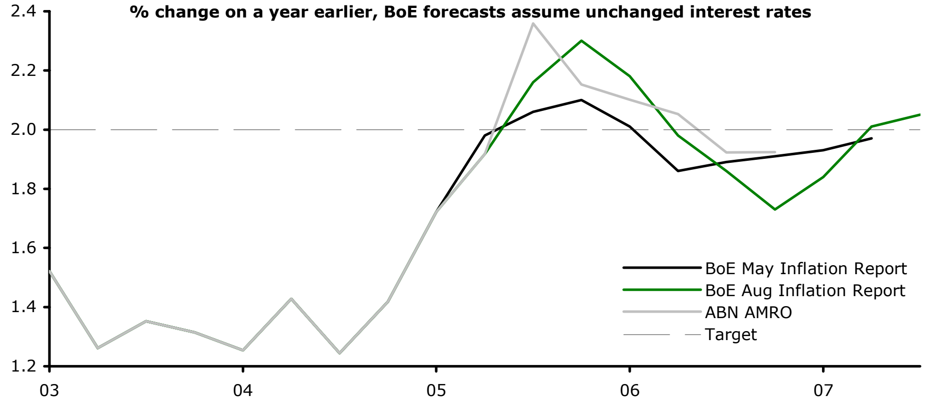
Although the MPC did cut interest rates in August, the move was not supported by the Bank of England's governor, Mervyn King. And even those 'outsiders' who voted to cut interest rates only did it as an insurance policy in case domestic demand remained weak. They admitted the rate cut could be reversed if necessary. If domestic demand were to recover because of a return of buy-to-let investors, the MPC will be concerned that monetary conditions are too loose and will want to raise interest rates again. The Bank of England currently sees the risks to economic growth on the downside. But in its central forecast, it sees domestic demand recovering, pushing overall GDP growth back above trend (Chart 19). If this were to happen, the Bank expects inflation to remain above target in future years (Chart 20).

**Chart 19 : GDP forecasts**




*Source: Bank of England*

**Chart 20 : Inflation forecasts**




*Source: ABN AMRO*

**We remain cautious on domestic demand**

So we remain cautious on the outlook for domestic demand. Buy-to-let investors could be disappointed if the government fails to implement tax reforms. And the Bank of England's inflation concerns should dampen expectations of further rate cuts in the near term. There is still some speculation in the press that the Bank of England will cut rates again in November. We expect the Bank will hold off until next May before cutting interest rates again (see 'Misery and Paralysis Committee', *Euro Vision*, 7 September 2005).

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