

Economic and financial newsletter

Quo Vadis?

Thinking the unthinkable

Five potential surprises for 2023

#2 The price of Belgian residential real estate drops

Consensus view: "Belgian residential property prices cannot fall."

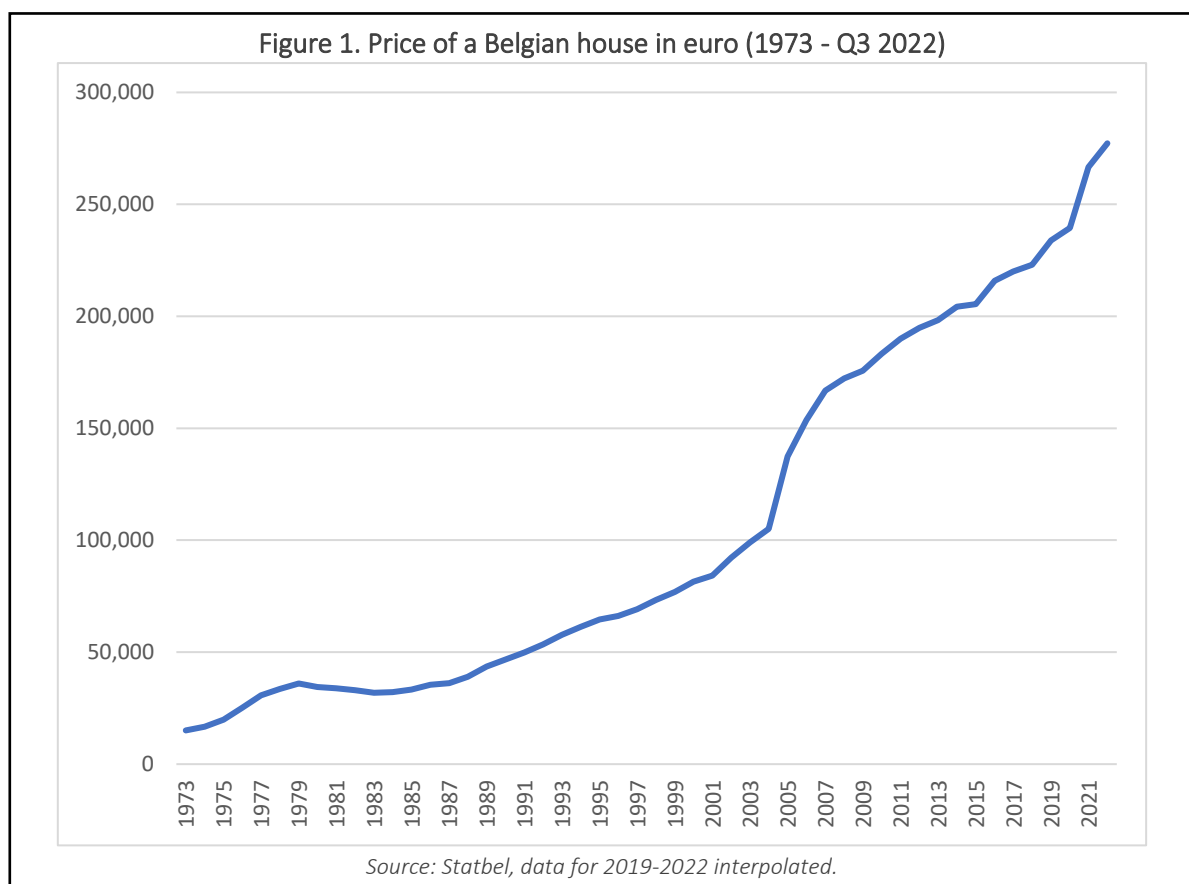
Quo Vadis: "The Belgian residential property market is facing a price correction [of old properties]."

Introduction

The previous edition of Quo Vadis covered the first potential surprise for 2023, notably an inflation that is much more persistent than generally thought. In this edition, we present a second potential surprise: a - Oh No! - price drop in Belgian residential real estate.

A market built as a brick house

For many, the idea of a price correction of Belgian residential real estate is a big taboo. The saying goes that Belgians have a brick in their stomach. Most Belgians are home-owners. A price drop would bring pain on a large scale. There is an unwavering belief that Belgian property prices cannot go down. Looking at the past, this is grossly borne out:

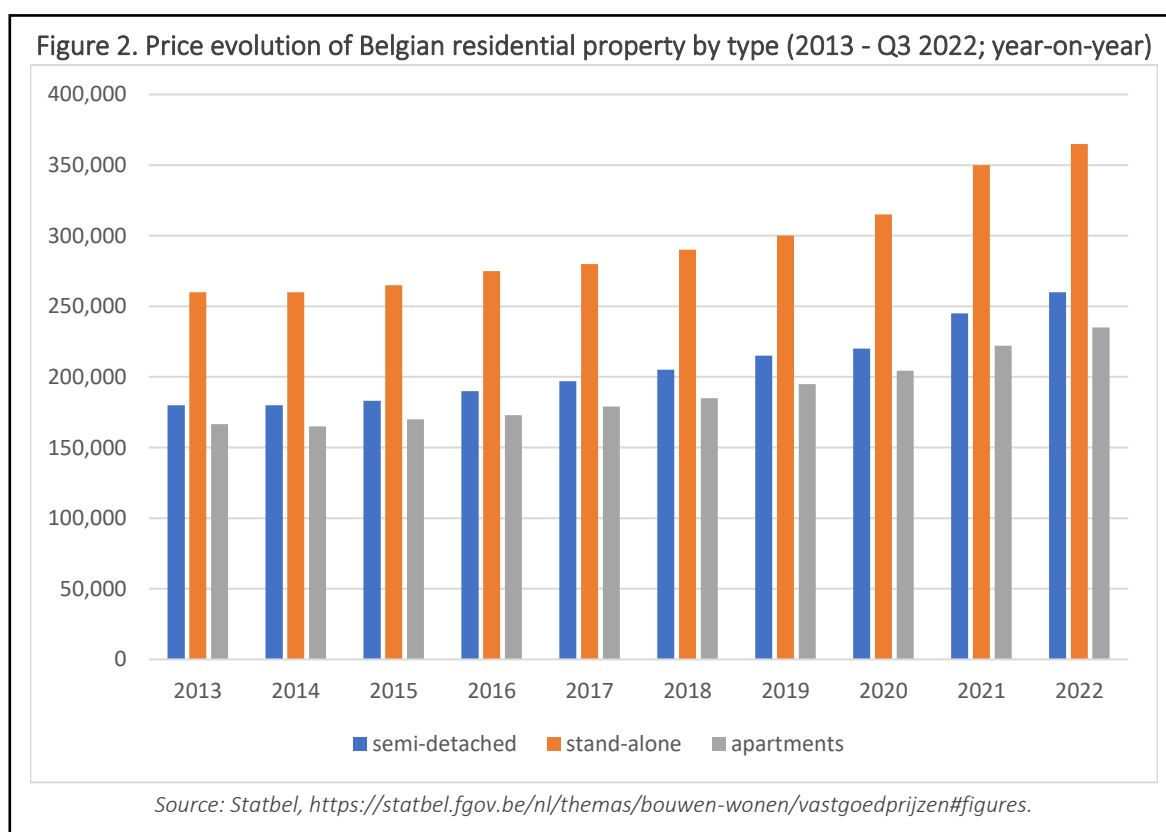


Indeed, nominal prices have never fallen since 1984. Not even the Great Financial Crisis in 2008 got the Belgian property market down. This can be explained by the non-speculative nature of the Belgian residential property market. This is partly due to Belgian real estate taxation, which discourages speculation by imposing high registration duties and capital gains tax on sales within a certain period of time. The legislation and customs surrounding mortgage credit impose certain limits on the percentage of the total purchase price that can be borrowed. Over the period 1973-2022, Belgian residential real estate increased on average (geometric mean) by a nominal 6.3% per year, while volatility (i.e. the standard deviation of those returns) was limited to just 6.7%. And the 6.3% return does not even take into account - when leased - rental income. With an average gross rental yield of 4% per year, investors thus end up with total gross returns of around 10% per year. Indeed, Belgian residential property has proven to be an excellent investment. In contrast, the Anglo-Saxon world tends to have fewer fiscal and regulatory constraints, making the property market there more speculative and therefore subject to occasional major shocks. The US subprime meltdown is a good example

Looking ugly

It can hardly be seen in Figure 1 due to scale effects, but between the end of 1978 and the end of 1983, prices nevertheless declined every year. The total nominal decline over that period was 11.5%. Taking into account the high inflation in those years, one could even speak of a real property crash. Cumulative inflation over that period was 32%. So in real terms, Belgian real estate lost more than 40% of its value. The culprit was the massive tightening of monetary policy - read a sharp increase in interest rates - that was needed to trigger the economic recession to curb the galloping inflation of the 1970s. To the extent that the past is a guide to the future, a nominal fall in the price of Belgian residential real estate and/or a real estate crisis defined as a sharp fall in real prices, while exceptional, is not inconceivable.

The National Bank of Belgium [NBB] and the ECB have argued for years that the residential Belgian real estate market is overvalued. The NBB estimated the overvaluation at nearly 21% in the first three quarters of 2021. The ECB's model arrives at an overvaluation of 8.7% on average over the same period. Since mid-2021, we have been faced with an unprecedented rise in mortgage rates. In early 2021, you could still borrow a 20-year fixed mortgage at a rate of around 1% (in 2020 even at an even lower rate), today you pay around 3.3%. But the Belgian residential property market still seems little affected by the sharply higher interest rates:



The Statbel data in Figure 2 run until the end of the third quarter of 2022 and show an increase of around 6%. The Real Estate Barometer of the Belgian Federation of Notaries published figures for the full year 2022 on 12 January: house prices rose by an average of 8.2% (the median by 9%) and apartment prices by 3.6% (the median by 5%). The Belgian residential market seems able to sustain its strong price momentum.

So is the Belgian property market immune to the sharp rise in mortgage rates? No. Belgian inflation is 10% in 2022. In real terms, house prices have fallen by 2% and apartment prices by as much as 6%. The market is clearly cooling since mid-2022. Recent figures on new mortgage applications, recorded by Immotheke-Fintheke, Belgium's largest mortgage intermediary, show a very sharp drop. In the market, you can see that the period where buyers bid against each other to well above the asking price is behind us. There is oversupply in some regions. The real price drop has already started, but the sharply higher interest rates would, all other things being equal, justify a much higher markdown. Let's make a rough calculation. If you assume that real estate has a duration (interest rate sensitivity) of 10, somewhere between that of a bond and a stock, a 2% (3%) rise in interest rates justifies by itself a 20% (30%) price drop. But we also have to take into account sharply rising inflation. The ABEX index measures the evolution of construction costs. It increased cumulatively by 17% in 2021 and 2022, as much as general inflation. Assuming that residential property prices, all other things being equal, rise in line with the ABEX index (which is mainly the case for properties less than 10 years old), if we add all factors together, we arrive at a theoretical nominal price fall of between 3% and 13%, 8% on average.

Nobody seems to believe in it, not even the numerous Belgian banks that consider the market overvalued, but could it be that the Belgian residential property market is facing a nominal price drop? Quo Vadis feels obliged to at least ask the question. And for this we turn to none other than Warren Buffett.

Skinny dipping

One of Warren Buffett's most famous statements is that *"... only when the tide goes out do you discover who's been swimming naked"*. Perhaps less well known is that that statement begins with *"... A rising tide floats all boats..."*. What Buffett means by this is that when the economy is doing well, all companies, strong and weak, benefit. But when the economy is bad, the weak companies stand naked in the surf. You can extend this rule to the relationship between the evolution of interest rates and the prices of financial assets. When interest rates fall, as they did until not so long ago, the price of all assets, quality and less quality, went up. Now that interest rates are rising, the opposite is happening: the prices of stocks and bonds, the weak and overvalued up front, have fallen sharply. Applied to the Belgian residential property market, we need to distinguish between the old, low or non-energy-efficient properties and the generally young energy-efficient ones. Due to the sharp rise in energy prices, the real estate market is now split into two segments: that of energy-efficient and that of non-energy-efficient homes. For the former, you already pay a premium in the price, and all indications are that in the future, with the continued and increasing focus on energy efficiency, the price evolution will diverge between the two segments. Highly energy-efficient properties will remain in demand and have a relatively favorable price evolution, but properties with a major energy handicap will be naked in the surf. Price divergence is already a reality at the extremes of the market. In Flanders, for example, the average price of a house with the best energy performance (A or A+ label, i.e. with energy consumption below 100 kilowatt hours per square meter per year) rose by 33.2 per cent in the last five years, that of a flat by 28.6 per cent. However, properties with the lowest energy performance (F label, i.e. with energy consumption above 500 kilowatt hours per square meter per year) are looking at a nominal price drop. On top of that, since this year buyers are legally obliged to renovate an energy-wasting house. A house labelled E or F must be refurbished to level D or better within five years. Owners get a reprieve until 2030.

The risk that the least - energy-efficient properties will face another price drop is high. And they make up a significant part of the overall market. In Flanders, for example, existing properties (not counting new construction) consume an average of 382 kilowatt hours per square meter per year, while the upper limit for new construction is 20. 50% of Flemish houses have an F or E label. Apartments score a little better because they are more encapsulated than houses: only 17% have an F or E label. The risk that A-label houses will fall in price is smaller, even with sharply rising interest

rates, but too much enthusiasm on their price appreciation potential should be tempered by the affordability problem that is starting to become acute for a middle-class family. The Affordability Index of business newspaper de Tijd (see edition of 20 January) is on stormy alert. The index calculates that a Belgian family with a median income needs 37% of its income to be able to pay the mortgage costs of an average home, in Flanders even almost 40%. This puts us at a dismal record and well above the 33% considered the upper limit of prudent budget management. For Belgium as a whole, the figure is 37%. Apartments still remain affordable: the mortgage costs of an average apartment take a 30% bite out of the median family budget, below the 33% limit, but a new-build flat naturally costs more. The Federation of Notaries calculated that the price of a new-build apartment is almost 23% above that of an existing one. This implies that, all other things being equal, a new-build apartment would gobble up 37% of median income and a new-build home (under the assumption that a new-build also costs 23% more than an existing home) 46-49%! Many young buyers therefore need financial support from parents and grandparents, but there are limits there too. The average financial wealth of a Belgian may be 130,000 euros, but this average is heavily skewed by the super-rich. The median financial wealth is only a good 20,000 euros. Energy-efficient new properties are thus increasingly becoming a luxury for the happy few. And single people with modal incomes are completely out of the picture. They already make up more than 40 per cent of households today and more than half in the future.

What does this mean for the price evolution of the overall market? The weight of the most energy-efficient properties in the total number of transactions (by which price evolution is measured) pales in comparison to that of the less energy-efficient ones. In 2021, only one in every flat sold was a newly built flat. So even if the prices of the most energy-efficient properties hold firm in 2023, their weight in the overall market is too small to offset the negative price trend of the non-energy-efficient properties. So it is by no means inconceivable that the overall price evolution of the Belgian residential property market will turn red in 2023.

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