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Challenging times for homebuilders and real estate companies

EXECUTIVE SUMMARY

It is no secret that the construction and real estate sectors are among the most cyclical sectors, sensitive to changes in the labour market, prices in commodities and, first and foremost, the interest rate environment and accessibility of credit. It is therefore no surprise that these sectors are currently under strain as interest rates have risen quickly, resulting in dwindling demand from both households and real estate companies. However, the latter are also frequently very leveraged, making turning a profit difficult in this landscape. The abrupt rise in interest rates also comes at an unfortunate time, as house prices and valuations rose quickly in late 2020 and 2021 while people were upscaling and interest rates were low. This means that several homebuyers and real estate companies took on much debt in the past few years that is now often – at least – twice as expensive as a year earlier.

2024 will therefore be a mixed year, with most actors in the construction and real estate sectors expecting it to bring some relief in the form of falling interest rates and less volatile commodity and energy prices. However, for many it will be a year of survival as the global economy is slowing down (Coface is forecasting global GDP growth to fall from +2.6% in 2023 to 2.2% in 2024, the lowest in a non-crisis year – 2009 and 2020 – since 2008), especially in the United States, labour markets are cooling, and financial conditions are tight. The latter point is very important as global debt stood around USD 307 trillion (333% of GDP) in the third quarter of 2023 with USD 149 trillion owed by households and non-financial companies, and those who need to refinance will be facing far higher interest costs, even with easing policy rates.

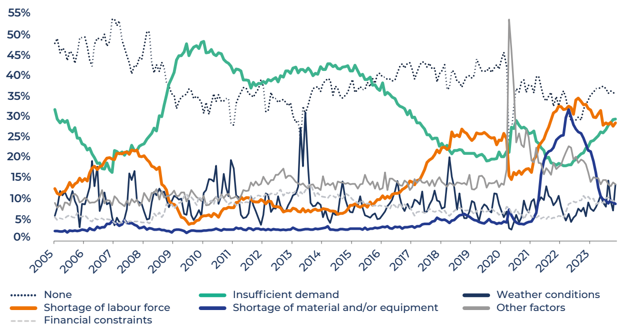
Signs of cracks are already evident. Corporate insolvencies within the construction sector have already risen by at least 20% year-to-date in 2023 compared with 2022 in Australia, Canada, France, Germany and Japan. Furthermore, commercial property prices are down almost 25% from their peak in the United States and Europe, and net profit margins of home construction and real estate companies have tentatively fallen in every quarter in 2023. In this context, the question is if the expected policy rate cuts will be sufficient and in due time to stabilise a weakening market.

The real estate market is still navigating a delicate balance between rising interest rates and a limited housing supply. Although house prices have adjusted somewhat to higher rates, the persistent supply constraints – caused by prospective sellers' unwillingness to move from their low mortgage rates or sell at a lower price – have kept them buoyant. However, from a demand perspective, it is expected that prices should decline in most advanced economies, particularly Germany, Japan and Italy. This conclusion is derived from a pricing model where housing is viewed as an investment. However, simple approximations of ratios between house prices and average rent or income levels having to return to their pre-pandemic levels also suggests a probable downwards correction in housing prices.

Homebuilders are seeing some fractures

Homebuilders have found themselves facing successive headwinds over the past few years with lockdowns challenging their usual way of working, a pandemic-induced surge in demand, as well as waves of labour and input shortages linked to post-lockdown hurdles. In Europe, this resulted in 'shortage of labour force' and 'shortage of materials and/or equipment' being the biggest impediments to construction cited by companies from 2021 to late 2023 **(Chart 1)**. This is echoed in the United States where job openings in construction are almost 30% higher than before the pandemic, and in Japan where 60% of construction companies mentioned shortage of labour according to a 2022 survey[1].

Chart 1 - Factors limiting construction in European Union [%, Share of respondents]

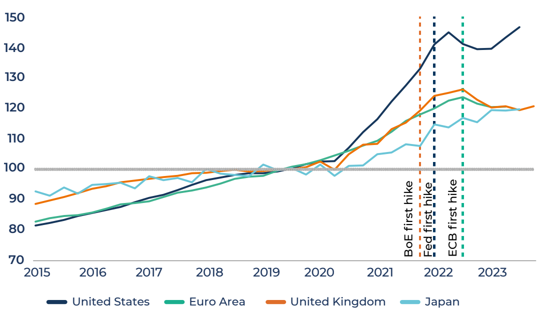


Source: ECOFIN, Coface

All these initial supply-side issues, along with the rapid increase in interest rates over the past two years, have resulted in construction costs rising from all avenues: materials prices went up, wage pressures intensified, and financing costs skyrocketed. Focusing on input costs for homebuilders, the producer price index for input in residential construction in the United States was 35% higher in November 2023 compared to four years prior, while the construction cost index in the European Union was up by 25% in Q3 2023 compared to Q3 2019.

The rise in interest rates also resulted in rapidly deteriorating demand, as households could not afford to buy houses, especially as home prices had increased from Q4 2019 to Q2 2022 – and still remain high – as seen in **Chart 2**. Since Q2 2022, house prices have fallen in either nominal terms or real terms in all selected markets. Japan is an outlier as the Bank of Japan has not raised their policy rate. France and the US have only seen declines in real terms, while the UK and especially Germany have seen house prices fall in nominal terms – the latter falling by 14.9% between Q2 2022 and Q3 2023.

Chart 2 - Nominal house prices in selected markets [Index, 2019 = 100]

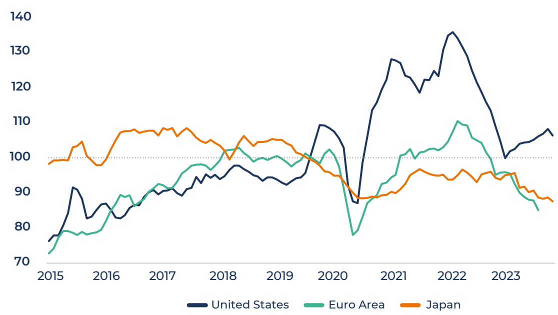


Source: S&P Global, Japanese Ministry of Land, Infrastructure, Transport & Tourism, BIS, Nationwide, Macrobond, Coface

At the same time as demand cooled, potential house sellers suddenly found themselves unwilling to sell as they either were dissatisfied with the fall in prices or were sitting with low fixed interest rates, disincentivising them to sell. The number of transactions has been dwindling over the past two years[2] in the US (falling 33% in the 12-month period to November 2023 compared to same period two years prior), UK (-31%) and France (-24%). This trend, despite lower house prices, highlights the current mismatch between buyers and sellers after the rapid rate increases.

The combination of labour and materials shortages, rising construction costs and an uncertain housing market is being reflected in housing starts and permits, which started declining from March 2022 in the US and Euro Area and from March 2023 in Japan. However, whereas permits have continued to decline in the Euro Area throughout 2023, they have recovered in the US, although they remain far below the 2021-22 levels **(Chart 3)**.

Chart 3 - Building permits in US and Euro Area and housing starts in Japan [Index, 2019 = 100, 3-month rolling average]



Source: Japanese Ministry of Land, Infrastructure, Transport & Tourism, US Census Bureau, Eurostat, Macrobond, Coface

High interest rates challenging commercial real estate companies

Like homebuilders, real estate companies' health is intertwined with financial conditions and the interest rate level as their core businesses are buying, selling and renting (often also operating), meaning they usually are highly leveraged. Commercial real estate companies – who are mainly active in non-residential segments such as industrial, office and retail – have been particularly sensitive to the plights of previous years with retail space challenged by lockdowns, both directly (when people were housebound) and indirectly (the acceleration of e-commerce), whereas the office segment is adapting to hybrid work that has resulted in lower and changing demand for working spaces. Office vacancy rates were the highest in more than 15 years at 20.2% in Q1 2023 in the US and back to 2016 levels in Europe at 7.5% according to JLL, a global real estate company. Japan is in a similar situation to Europe, as its vacancy rate is at 5.6%, the highest since 2015. In addition, commercial mortgages are also usually interest only loans, meaning that monthly instalments are lower but the repayment at the end of the loan, the principal, is usually larger.

All these changes in occupancy rates and interest costs have been reflected in commercial property prices **(Chart 6-next page)**, which initially fell during the turmoil of 2020 but rather quickly recovered due to the low interest rate environment in 2020-2021.

1 - https://www.statista.com/statistics/1113127/japan-full-time-employee-labor-shortages-among-companies-by-industry/
2- Even in Japan, transactions fell by 9%.

US homebuilders using all their incentive tools

The American housing market is facing similar difficulties to Europe with high construction costs and high mortgage rates – going from an average of 3.0% in 2021 to 5.1% in 2022, and up to 7.8% in November 2023, the highest level since 2000 – affecting both transactions and, by reverberation, housing starts. However, building permits have been somewhat recovering in 2023 (the annual change in number of permits went from -29% in January 2023 to +5% in November 2023) and housing starts began to recover too. So, what is causing this American exceptionalism?

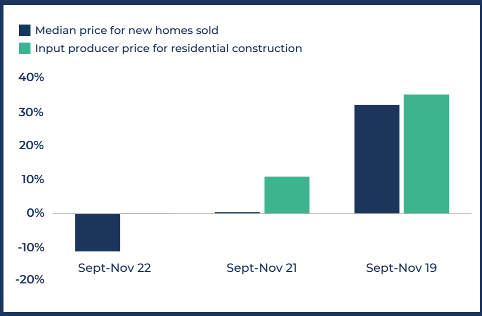
The answer is not straightforward as the economic situation differs between countries, but one of the key reasons is caused by some differences in the housing market structure. Firstly, the US housing market is dominated by long, fixed rate mortgages (usually 30 years) which mean that an immediate uptick in interest rates disincentivise more potential American sellers than in many other markets – where more will be sitting with variable or much shorter fixed rates. This becomes evident when looking at the difference between sales of existing and new homes: sales of existing homes have fallen by 21% year-on-year (YoY) when comparing the 12 months to November 2023 with the preceding 12 months, while sales of new homes rose by 1.4% YoY over the same period. People sitting in their current homes with a low fixed-mortgage rate simply are more reluctant to move as they are unwilling to accept a lower price for their current accommodation and to relocate to a new place with a higher mortgage rate. Meanwhile, home builders want and need to sell their existing inventory of built houses and are supported by a low housing inventory, especially in metropolitan areas.

To overcome this issue of unaffordability, homebuilders in the US have become more proactive in providing incentives to support demand. A survey from December 2022[3] found that 75% of homebuilders were using buydowns* to lower buyers' mortgage rates, allowing to lower buyers' interest costs for the first few years (temporary buydown) or the full loan period (full-term buydown). 60% were still reporting to offer such incentives in October 2023.

As an example, a 3-2-1 buydown essentially means that a buyer gets a 3 percentage points (pp) discount on the first year, 2pp discount the second and 1pp in the third. Therefore, despite the 4.7pp mortgage rate increase from November 2021 to November 2023, they would essentially experience only a 1.7pp net increase. However, importantly, the buyer still needs to be able to qualify for the higher loan.

While these incentives prop up demand, they have a direct cost for homebuilders who have to accept losing around 2-4% of the home sales price for a temporary buyback and around 6% for a full-term buyback. These additional costs for homebuilders are coinciding with an overall squeeze on margins as house prices for new residential construction have fallen by 10% over the past year, while input producer prices for residential construction are roughly unchanged.

Chart 4 - Median house prices and construction producer prices in the US [Change in % compared to September-November 2023]



Source: US Census Bureau, US Bureau of Labor Statistics, Macrobond, Coface

** Buydowns are the builders paying a percentage of the house price to a financier to lower future mortgage payments, essentially fronting future interest costs for buyers.*

China's real estate issues are not new and will not go away in the immediate future

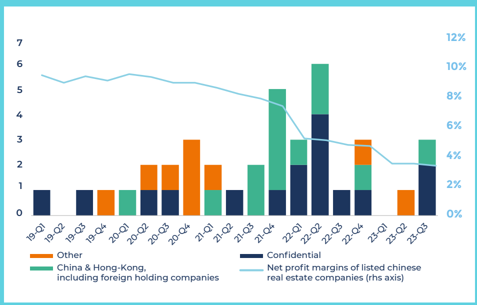
Headlines around the Chinese real estate sector have become more frequent since 2021 as worries around Evergrande, the second biggest developer in China, became public knowledge. While the "three red lines" – three metrics of fiscal prudency* that real estate developers should follow – introduced by the Chinese government in 2020 put a magnifying glass on the problems, the underlying issues surrounding the sector, however, go back further and have been building for over a decade.

China's housing market notably saw a large fall in prices back in 2015. It coincided with a default on debt by Kaisa, a large developer, but an oversupply of homes and a highly leveraged real estate sector were already highlighted back then. The Chinese central bank cut their loan prime rate from 5.76% to 4.3% from October 2014 to October 2015 to support the market. Additionally, large developers, including Evergrande, received generous credit lines from state-owned banks, which generally stabilised the sector.

With this in mind, the current crisis is merely a continuation of the longstanding problems of the sector that, broadly speaking, comes down to a highly leveraged growth model that works as long as activity continues to grow at a strong rate. Growth is, to put it mildly, lacking with housing starts down 22% YoY in the first 11 months in 2023 after falling by 39% in 2022, bringing them to their lowest level in 15 years. For real estate companies, revenue and CAPEX growth have been slowing down – and even falling in recent years – and net debt ratios are similar or higher than in 2015, while their interest charge coverage has worsened. Evergrande has made the headlines, but the problems are far more widespread as two-thirds of Chinese developers have defaulted on their foreign debt since 2021. As can be seen in **Chart 5**, 80% of global (non-confidential) corporate bond defaults since 2021 are by Chinese and Hong Kong based companies or their subsidiaries.

Despite recent government intervention and the loan prime rate cut by 40 basis points (bps) since the start of 2021 (and almost 90bps since 2019), the outlook for the sector is still depressed by both short-term and more structural problems. In the short-term, the main issue is one of confidence, with Chinese households far less inclined to buy new builds as they consider the sector too risky. This problem is particularly serious in China where *deposits and advanced payments* make up around a third of funding for real estate developers, and it has fallen by 41% in the first 11 months of 2023 compared to the same period in 2021. The more fundamental problem is the need to change the business model of developers from a leveraged growth model, like a start-up, to a more balanced model – essentially what the Chinese government intended with the "three red lines" – that can endure in a country with a slowing population growth. However, with the construction and real estate sector driving around 25% of GDP growth, a slowdown and a more sustainable business model will, in turn, lower future GDP growth.

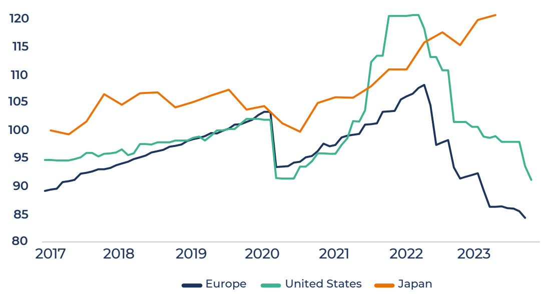
Chart 5 - Global corporate bond defaults of homebuilders/real estate companies and net profit margins of Chinese real estate companies [Number of defaults, Ratio in %]



Source: S&P Global, Refinitiv Datastream, Coface

** Three rules are (1) liabilities should not exceed 70% of assets, (2) net debt should not exceed 100% equity, and (3) money reserves should be at least 100% of short term debt.*

Chart 6 - Commercial property prices in key markets [Index, 2019 = 100]



Source: Greenstreet, BIS, Coface

Since April 2022, commercial property values have, however, been declining fast – particularly in the US and Europe as policy and market rates started to increase.

High interest rates pose challenges for real estate companies from different avenues, with the most obvious and immediate impact being a slowdown in both the number of property transactions and their overall value. In the current environment, this is already visible with the volume of commercial property transactions in Europe more than halving over the past year (down 58% YoY in Q3 2023) and at its lowest level since 2010. Similarly, it was down by 53% YoY in Q3 2023 in the US and down 37% YoY in Asia-Pacific. The second avenue in which interest rates affect real estate companies is financial costs, as these companies are highly leveraged, meaning that rising interest rates are feeding into their interest expenses.

3 - https://jbrec.com/insights/rate-buydowns-help-buyers-purchase-new-homes/

Looking at three of the largest players within commercial real estate (CBRE, Colliers, and JLL), it is clear where their business is currently struggling. Revenues from their core business, advisory & workplace management continued growing at a slow rate of 2.4% in the first nine months of 2023 compared to the first nine months of 2022, while their real estate investment and capital markets segments – buying and selling of properties – saw revenues fall by around 30%. It is also noticeable that their interest expenses (net of interest income) have gone up by nearly 220% in the first nine months of 2023 compared to the same period in 2021, going from a combined total of around USD 90 million to USD 285 million. This rise in interest cost is coinciding with the companies seeing their operating income falling, highlighting how higher interest rates are affecting both revenue and costs of real estate companies.

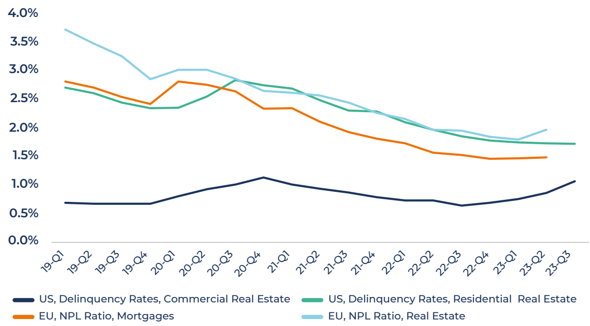
Rising non-payment risks: Delinquencies, Defaults and Insolvencies

The past few years have not only been defined by successive crises, but also continuous government support and intervention to overcome these crises. This includes a myriad of instruments including furlough schemes, government-backed loans, as well as changed rules or moratoriums on insolvency, rent and repossessions. These measures have resulted in non-performing loans (NPLs) and delinquency rates often falling during these past years along with insolvencies. They dropped to all-time lows in the construction and real estate sectors.

The low NPLs, delinquency rates and insolvency levels were partly driven by financial support measures – like (1) furlough schemes or direct payments allowing households to make their interest payments, (2) business loans ensuring companies could do too, and (3) government-backed loans meant that governments took over the bad debt, which helped banks' asset quality – and the regulatory measures, which meant that creditors could not file winding up petitions or repossess dwellings. Even so, another important reason was also the strong economic recovery in 2021 and early 2022 and a very low interest rate environment.

With government support phased out, moratoriums ended, and interest rates quickly increased, the vulnerability of the sector is starting to slowly show, especially in the commercial segment. As can be seen in **Chart 7**, the delinquency rate for commercial real estate has risen for four consecutive quarters in the US and is back to the highest level since 2015,

Chart 7 - Delinquency rate and NPL Ratio in the US and the European Union [Rate in %]

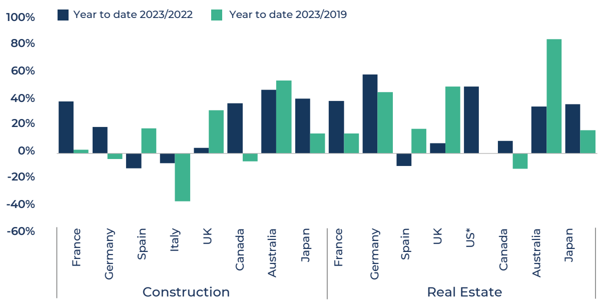


Source: Federal Reserve, EBA, Macrobond, Coface

albeit far below the post Great Financial Crisis rates. In the Euro Area, the NPL ratio saw the first uptick in three years in Q2 2023, and Germany, like some other member countries, has seen it double from its 2019 ratio (2.2% in Q2 2023, twice as high as the 1.1% average of 2019).

Both the construction and real estate sectors are usually canaries in the coalmine for the wider economy when it comes to an economic downturn or a rise in insolvencies. Homebuilders and real estate companies quickly feel the brunt of a slowing economy as building work slows down and transactions wither in number and value. As can be seen in **Chart 8**, insolvencies in the construction sector grew over the past year in most of the selected countries – especially France, Canada, Australia, and Japan – and are above pre-pandemic level in half of the countries (Spain, UK, Australia and Japan – noticeably roughly 50% higher in Australia). Insolvencies within real estate similarly picked up speed in 2023 with Germany, Australia and Japan seeing a large upsurge in insolvencies from the previous year and are now above the 2019 levels, especially in Germany – highlighting the poor state of its real estate sector – and Australia.

Chart 8 - Corporate insolvencies in construction and real estate in selected countries [Change in %]



Note: Year to date (YTD) is January to September for Germany, Spain, Italy; YTD is January to October for UK and Australia; and YTD is January to November for France, Australia, Japan, US. US is for public companies or private companies with public debt where either assets or liabilities exceeded USD 2 million, or private companies where either assets or liabilities exceeded USD 10 million. Source: National sources, S&P Global, Coface

This year has had numerous notable bankruptcies of construction and real estate companies and several articles about the rising number of companies forced to file for insolvency. Two prominent bankruptcies in 2023 were the pan-European Signa Group, the (part-) owner of the Chrysler Building, Selfridges, and the KaDeWe building, whose holding company filed for insolvency in November 2023, and the American office space provider WeWork, which has more than 700 locations in over 35 countries and filed for chapter 11 bankruptcy, also in November 2023. These bankruptcies were partly due to idiosyncratic reasons that made both companies vulnerable to current trends – Signa operated with high property valuations, high debt and had a large pipeline, and WeWork was already an unprofitable growth company that is succumbing to lower occupancy rates and tight credit conditions. However, what exacerbated both their downfalls were trends that affect all actors in the sectors: more expensive and less attainable debt, lower asset valuations, and lower occupancy rates.

2024 Outlook: Lower rates will help the market but many risks persist

When looking at the outlook for 2024, the first important factor to consider is the interest rate environment. 2024 is expected to be the year where major central banks, including the Federal Reserve (Fed) and European Central Bank (ECB), will start to cut rates, which would bring some relief to the construction and real estate sectors. The Fed has hinted at three rate cuts of 25 bps in 2024, totalling 75 bps over this year, while the ECB is expected to cut somewhere around the same magnitude throughout the year **(Chart 9)**.

Chart 9 - Key risks and their expected development in 2024

Source: Coface

The anticipated fall in interest rates will help housing demand. However, one needs to be realistic regarding the level of these cuts and the impact that they will have for homebuilders and real estate companies. At the end of 2023 (October 2023), in the Euro Area, an average new household loan for house purchase stood at 3.9% and at 5.3% for a general loan to a non-financial corporation (NFC). Cumulative rate cuts of 75 bps from the ECB, along with unchanged risk premiums from banks, would result in rates around 3.15% and 4.5%, respectively. This would still be far above the 1.6% and 1.9% faced by households and NFCs, respectively, in 2019. It would actually be necessary to go back to 2012-13 to find a period when they faced comparable rates. Given that several households are still benefitting from lower fixed rates, where some will need to be renegotiated, and given that banks' lending margins on loans for house purchases are low (at the lowest since 2008 in the Euro Area), the average rate of outstanding loans is expected to fall by less than 75 bps.

With a slowing economy, an uptick in corporate insolvencies and rising unemployment, the problem of high vacancy rates, is not expected to improve much in the coming year. This will be particularly problematic in the US where the past years have seen high and rising office vacancy rates despite solid economic growth domestically. However, more companies are requiring employees to return to the office, which could somewhat mitigate this trend. Investments in better office amenities (communal areas, gyms, etc.) will be needed to entice workers to come back, which is an opportunity for commercial real estate companies that invest in this – as companies will look at "smaller but better" spaces. This will however require investments in the short-term and be a disadvantage for commercial real estate companies with more traditional office buildings in their portfolio.

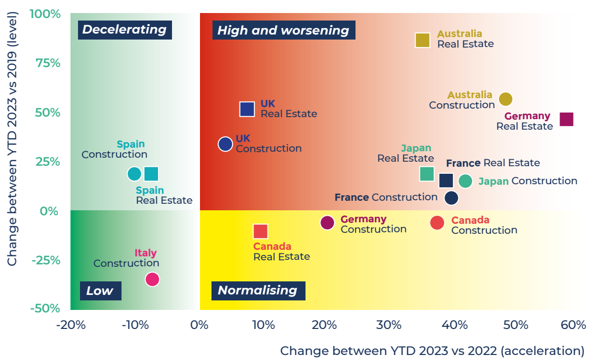
The outlook for costs is somewhat more benign with easing commodity and energy prices. However, shortage of materials is still higher than before the pandemic and shortage of specialised labour – and a generally higher nominal wage growth in 2024 – continues to be an issue contributing to increased labour costs for homebuilders in particular. Even if they are still elevated, a more stable outlook for costs will lower early risks for construction companies, especially the risk of an uptick in costs between agreed contracting prices at tender and the time of actual construction.

Banks, especially American and European, are still reporting further credit standards tightening for both residential and commercial real estate with a worsened risk perception remaining a main reason. This could be an even more serious issue in 2024, as more real estate companies and homebuilders will need to refinance their maturing debt than in 2023, adding to a higher rollover risk (i.e. the risk that a company cannot refinance maturing debt with new loans). For example, in Europe, capital market debt maturing will rise by 14% year-on-year[4].

Interest rates and valuations are inversely correlated, which is why falling rates would be expected to support house prices in 2024. However, in spite of anticipated interest rate cuts, we do expect a further fall in house prices and valuations in many markets as the issue of affordability and limited credit is expected to continue in the coming year. Additionally, despite the overall fall in prices, there continues to be a mismatch between buyers and sellers' anticipated prices, and it is thereby assumed that many transactions will be dominated by those that need to sell. Higher delinquency rates and NPL ratios could suggest more repossessions and forced home sales, and some real estate companies will be forced to sell properties at substantial discounts to improve their balance sheets. The other side of the coin is that when credit is tight and interest rates are high then *cash is king*, and liquid companies with strong balance sheets can thrive in this environment, especially in the real estate sector where certain buyers are able to buy properties at massive discounts (like the Central Group that bought half of the KaDeWe department store building in Berlin from the aforementioned Signa Group at a 60% discount).

Overall, payments delays are still frequent with 76% of companies experiencing them in Latin America and Europe[5], and 57% in Asia-Pacific according to the most recent Coface Payment surveys, and the average payment delay is higher for the construction sector than the overall average in almost all surveyed countries. As can be seen from **Chart 10**, insolvencies are rising in both construction and real estate, and is generally either only somewhat normalised in certain countries or on a continued upward trend in others. In all countries except for Spain and Italy, the number of insolvencies rose in both sectors which coincided with most of these countries returning to a normal level of insolvencies in 2023. Spain and Italy are unique cases as they have recently changed in their insolvency laws.

Chart 10 - Development in construction and real estate insolvencies [Change in %]



Note: Year to date (YTD) is January to September for Germany, Spain, Italy; YTD is January to October for UK and Australia; and YTD is January to November for Canada, France, Japan. Source: National sources, Coface

4 - https://www.scoperatings.com/ratings-and-research/research/EN/175388
5 - Weighted average of payment surveys from France, Germany and Poland.

These changes resulted in an uptick in Spain in 2022 and continuous low insolvencies in Italy, in addition to the latter country having had a «superbonus scheme» signs scheme that has supported its construction sector so far[6].

Looking at the insolvencies in the last available three months of 2023 (e.g., Sep-Nov for France and Jul-Sep for Germany), corporate insolvencies are still rising in 13 out of the 15 points from Chart 10 and accelerating in just over half (53%), and notably insolvencies in construction also rose in both Spain and Italy. With the sectors' current headwinds and the tight credit markets, non-payment risk is expected to remain elevated and even worsen in some markets in 2024.

This paper has mainly focused on some of the most vulnerable parts of the construction and real estate sectors. It is important to note that many of the aforementioned issues are also prevalent for the wider industry, however some pockets of the industry are still doing better with a more benign outlook for 2024. One of these is construction related to infrastructure and sustainability, both energy efficiency and energy production, as both have a strong pipeline and are benefitting from government policies and incentives. Another subsector that is anticipated to perform better is construction for manufacturing, which is currently supported by new activity stemming from reshoring – or nearshoring – and industrial policies, driven by the current geopolitical environment. This is affecting a myriad of sectors within manufacturing but is already particularly clear for semiconductors and other sensitive areas. Most advanced economies are looking at some form of industrial policies, and while policies in China, Europe and the United States have made the biggest headlines, construction activity is expected to be impacted by these trends in most regions.

Forecasts suggest home price falls in advanced economies

There is a substantial mismatch between buyers and sellers in current markets with sellers unwilling to sell and buyers unable and/or unwilling to buy given the current price and interest rate environment. Residential prices are multifaceted with many factors affecting them at the same time. A residence is both a consumption and an investment good, and several financial and liquidity limitations, including regulatory ones, play a role. Additionally, housing has a relatively inelastic supply as it takes time to construct.

This section will employ a simple asset-based pricing model to analyse and gain insights into the anticipated changes in residential prices in 2024 from a buyer's standpoint, particularly when considering housing as an investment. In the model, based on a 2004 Bank of England bulletin[7], the estimated price is based on the rental income from a residence, growing at a fixed rate and discounted by the real risk-free rate and a residential risk premium.

$$P_t = \frac{R_t(1+g)}{r_t^f + k_t^r - g}$$

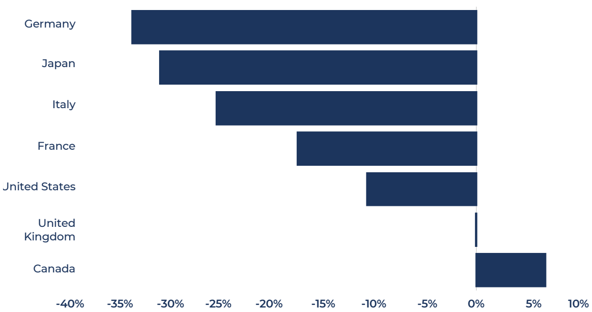
$$P_t = price;\ R_t = rent;\ g = rent\ growth\ ;$$
$$r_t^f = risk\ free\ rate;\ k_t^h = residential\ risk\ premium$$

It is assumed that the house price is only based on the discounted value of the rent of the house, and these rents grow at a steady constant rate. The price is discounted not only by the alternative risk-free rate but also a risk for purchasing a residence, whether this is underlying property risk, credit risk or a liquidity premium. In this model, house prices will thereby be positively impacted by **(1)** higher rent and higher overall rent growth, **(2)** a lower real risk-free rate, and **(3)** a lower risk premium associated with residential property. The reverse – lower rent, higher rates and premia – will have a negative effect on house prices.

The model does not factor in individual preferences for homeownership over renting, variations in housing types, housing supply dynamics (such as chronic undersupply), or other market shocks (such as excess savings during lockdowns facilitating higher down payments or a desire for upsizing as a consequence of lockdowns).

This analysis covers seven rather different large advanced economies – Canada, France, Germany, Italy, Japan, United Kingdom and United States – in both Asia, Europe and North America.

Chart 11 - Expected change in real residential prices between 2023 and 2024 [Change in % between 2023 and 2024]



Source: National sources, BIS, Macrobond, Coface

The findings of the model presented in **Chart 11** show that most countries should see an overall fall in house prices in 2024 compared with the previous year. The estimated declines range from 34% in Germany and 31% in Japan to a marginal fall in prices in the United Kingdom. The key drivers of the fall in residential prices are the rising long term government real rates, our proxy for the real risk-free rate, which have risen in almost all observed countries, whereas the residential risk premium rose and has stayed high in Italy and Germany. As already mentioned, the German real estate sector is currently struggling with nominal house prices having already dropped by 15% since their peak in mid-2022, and overall financial uncertainty frequently leading to scrutiny of more (perceived) riskier markets, and thereby rising spreads. This combination of a higher real risk-free rate and risk premia explains why Italy and Germany fare markedly worse than their peers. Meanwhile, Japan stands out as its residential prices have outperformed in the years up to and including 2023. Among the seven countries analysed, the model finds that prices should only increase in Canada (+7%) with real residential prices growing modestly between 2019 and 2023, and importantly the real interest rate having risen the least among Western countries.

Although the expected variations between the pre-pandemic level in 2019 and 2023 in the model appear more pessimistic than the observed trends – with real

6 - The Superbonus 110 initiative entitled houseowners to a tax credit up to 110% of the cost of upgrading their home. It will be replaced by a less generous scheme in 2024.
7 - https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2004/asset-pricing-and-the-housing-market.pdf

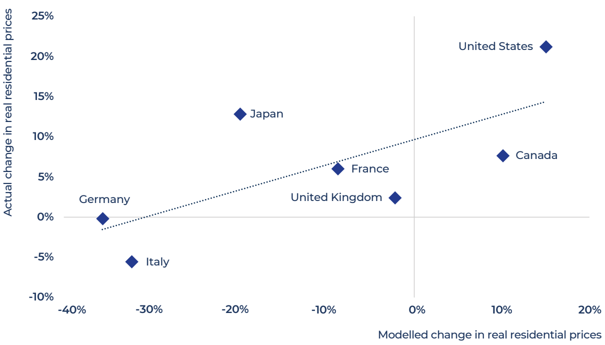
residential prices surpassing their 2019 levels in all seven countries, except Italy, in 2023 – the model does reflect certain aspects of the situation. Notably, the countries identified as the model's worst performers, such as Italy and Germany, correspondingly experienced the lowest growth in real residential prices (and a fall in Italy), while the United States emerged as the country with the most substantial price increase.

As evident from **Chart 12**, the United States is an outperformer which can be attributed to several different factors like **(1)** an increase in wages along with a strong labour market, which has helped with amounts possible to borrow, **(2)** big one-off payments that helped with down payments, **(3)** proactive homebuilder incentives to support demand, and **(4)** a fall in the already low housing supply as people are unwilling to give up their current low rate mortgages – as already discussed in a previous box – to mention a few. These factors are not incorporated in the model, which only looks at house prices from an investment perspective, but they will have contributed to the better performance of residential prices in the United States.

Focusing on different factors will often lead to alternative results, and the difference between the results from the investment pricing model and other metrics are noteworthy. Using Bank of International Settlements (BIS) data, **Chart 13** shows the required change in prices for the house price to rent paid (price-to-rent) ratio and the house price to income (price-to-income) ratio in 2024 to return to their 2019 levels. These approximations, not unlike the model, finds that the (nominal) prices in the United States should fall by around 14-16% whereas they find that prices in the United Kingdom should fall between 3-6%. Although they suggest a fall in Japan between 6-12%, this is far less pessimistic than the model. The price-to-income ratio surprisingly suggests that house prices should actually rise in Italy, Germany and France while the price-to-rent ratio suggests that prices should decrease, but less than the model suggests (and the most in France out of the three). Lastly, both approximations disagree with the finding that house prices should rise in Canada, and contrarily suggest a fall between 9-10% needed in 2024 to return to pre-pandemic ratios.

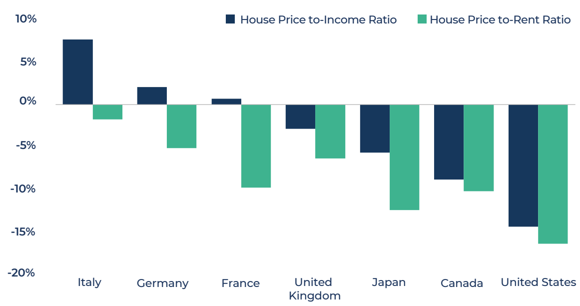
As emphasised and apparent, numerous factors have an influence on residential property prices. Yet, a comprehensive examination, whether approached from an investment perspective or by assuming a restoration of the balance between residential prices and average incomes or rents, indicates that residential prices continue to exceed their presumed levels. Some of this disparity can be attributed to external factors such as shifts in demand or constrained supply. However, the fact that banks' lending margins for house purchases remain below pre-pandemic levels cautions against hoping that policy rate reductions will result in one-to-one cuts in mortgage rates. Consequently, the anticipated relief from policy rate cuts may not offer the requisite assistance, heightening the likelihood that the underlying factors explored here could impact residential prices in 2024, suggesting potential falls in the majority of countries examined.

Chart 12 - Expected and actual change in real residential prices between 2019 and YTD 2023*
[Change in % between 2019 and YTD 2023]



Note: First nine months of 2023. Source: BIS, Macrobond, Coface

Chart 13 - Required annual change in residential prices to return to 2019 ratios
[Change in % between 2023 and 2024]



Source: BIS, Macrobond, Coface

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