Global House Prices: A New Threat for Policy Makers

Jonathan Laberge, Strategist, Vice President
Robert Robis, Chief Strategist
BCA Research

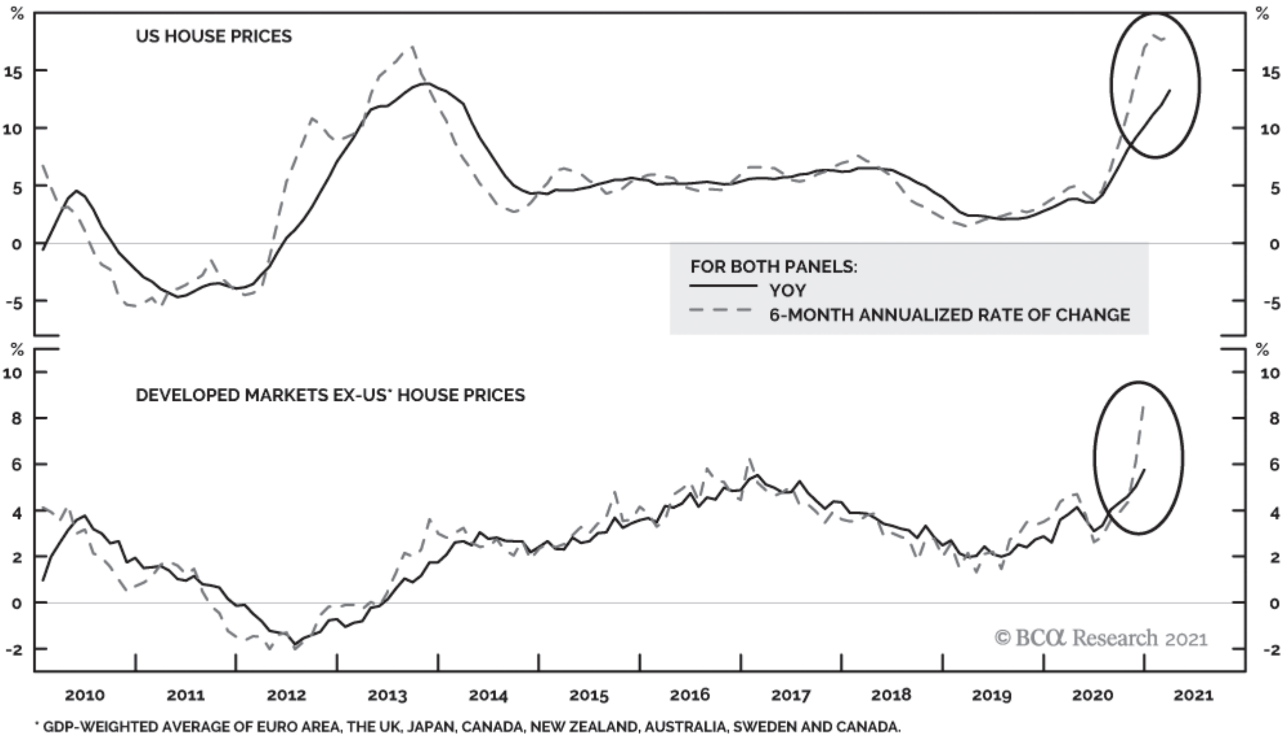
Global House Prices: A New Threat For Policymakers

The COVID-19 pandemic led to the sharpest economic recession since World War II, alongside an enormous rise in unemployment. Despite this sizeable and swift economic shock, however, house price appreciation accelerated last year in the developed world (Chart 1). To discuss the investment implications of the global housing boom, however, we must first accurately determine the reasons why it is happening.

When analyzing the surprising behavior of the housing market last year, the work-from-home effect brought upon by the pandemic emerges as an obvious factor potentially explaining house price gains. Last year, most office-based businesses rapidly shifted to work-from-home arrangements as an emergency response. However, with many workers preferring the flexibility of work-from-home arrangements, and employers finding no decline in productivity, work-from-home options have in many cases become permanent.

The work-from-home effect has undoubtedly created new demand for housing. However, we find that the work-from-home effect better explains differences in price gains across housing types and within large metropolitan areas, rather than national-level changes in

Chart 1. House Prices Are Surging Around the World



house prices. Looking at the US, for example, the four cities that saw the most negative net migration in 2020 relative to 2019 - San Francisco, New York, Seattle, and Los Angeles - still saw double-digit house price inflation, only modestly below the national average. Similarly, in both Paris and London, core urban house prices have continued rising, even though they have been outstripped by gains in the suburbs and outer boroughs.

Despite the broader location flexibility that work-from-home policies now provide to potential homeowners, it seems inconceivable that the housing market would have responded this way given the pandemic shock without significant support from policy. Above-the-line fiscal responses to the pandemic have totaled in the double-digits in advanced economies, and monetary policy has contributed to easier financial conditions via rate cuts, asset purchases, and sizeable programs to support financial market liquidity.

In advanced economies, the size of the fiscal response and the gain in house prices are clearly positively correlated. In fact, fiscal measures correlate even better with the acceleration in house prices. However, the strongest relationship is between the pre-pandemic monetary policy stance (measured as the difference between the 2-year government bond yield and the Taylor-rule implied policy rate) and house price gains over 2020, sporting an R2 of 49%.

To sum up, we strongly doubt that the net effect of work-from-home policies in the midst of an extreme shock to economic activity would have caused the rise in house prices that we have observed, certainly not to this level, without major support from policy. This underscores that policy, and not the work-from-home effect, has and will likely remain the core driver of the global housing market.

This Is Not 2007/08 … Yet

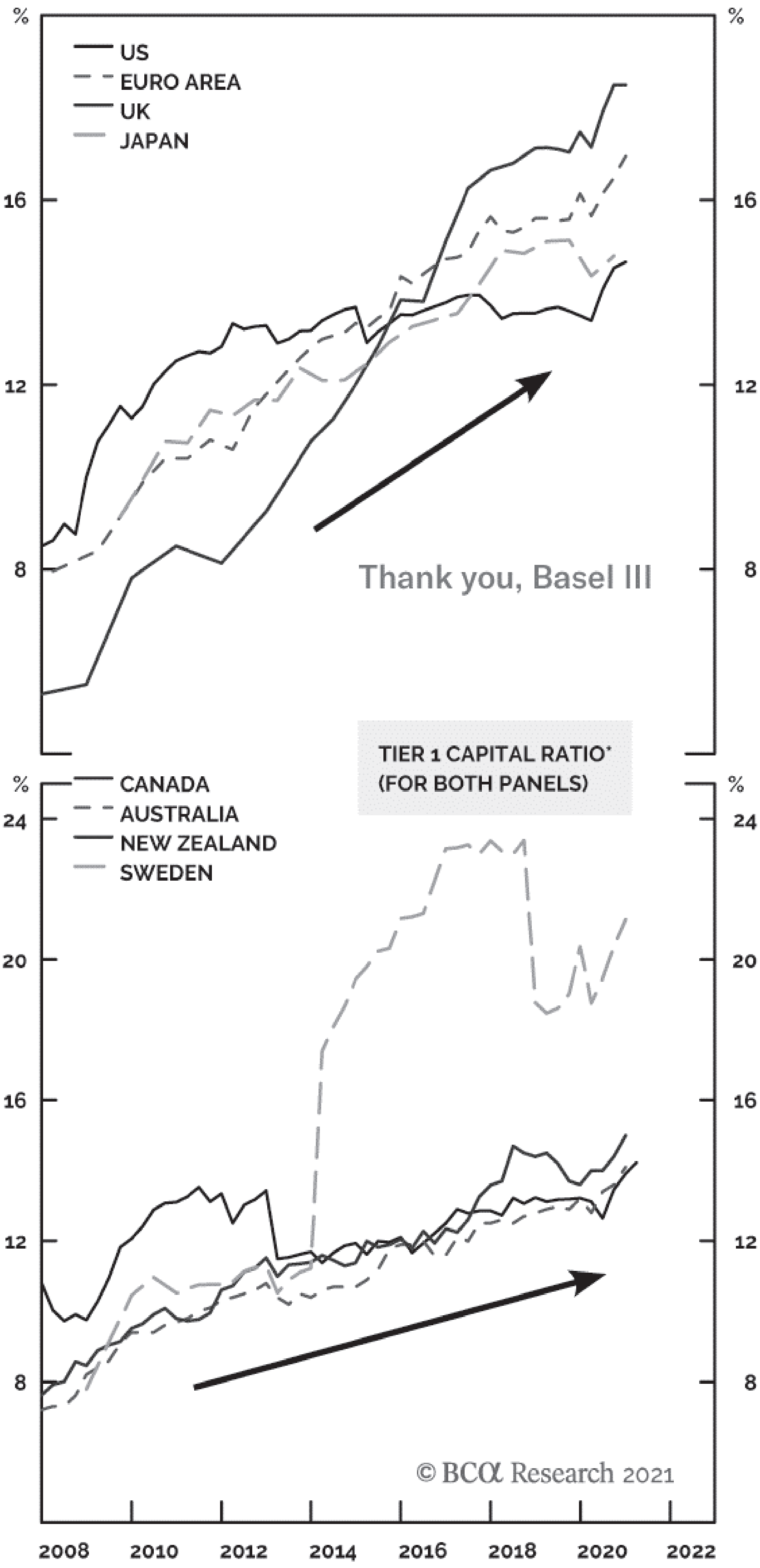
Despite the rise in household indebtedness over the past year, we are not yet in a 2007/08 scenario. While household sector debt-to-GDP increased sharply last year, the rise in this ratio largely reflects denominator effects—namely a sharp contraction in nominal GDP. The overall figure also masks diverging trends in mortgage and non-mortgage debt. In the US, euro area, Canada, and Sweden, household mortgage debt has accelerated to varying degrees, underscoring that households have likely paid down non-mortgage debt with some of the savings that they have accumulated from a significant reduction in spending on services. This changing mix within household debt - less higher-interest-rate consumer credit, more lower-interest-rate collateralized mortgage debt – could, on the margin, help mitigate financial stability risks from the housing boom by moderating overall debt service burdens.

In the US, the quality of new mortgage lending has also improved, with an increasing majority of lending being made to borrowers with very high FICO scores, in sharp contrast to the steady lending to “subprime” borrowers that preceded the 2008 financial crisis. US bank balance sheets are also now less directly exposed to a fall in housing values, with residential loans now representing only 10% of the assets on US bank balance sheets, compared to 20% at the peak of the last bubble.

This puts the US in the “lower-risk” group of countries in Europe, the UK and Japan where mortgages are less than 20% of bank balance sheets. This compares favorably to the “higher risk” group of countries—Canada, Australia, Sweden, and New Zealand where residential loans as a share of balance sheets range from 32-49%. However, global commercial banks area in general far better capitalized today, with double-digit Tier 1 capital ratios, thanks to regulatory changes made after the Global Financial Crisis (Chart 2).

Net-net, we conclude that the overall financial stability implications of the current surge in house prices in the developed economies are relatively modest on average. However, if house prices continue to accelerate and new homebuyers are forced to take on ever increasing amounts of mortgage debt, financial stability issues could intensify in some countries. Services spending will recover in a vaccinated post-COVID world, as economies reopen and consumer confidence improves, which will likely end the trend of falling non-residential consumer debt offsetting rising mortgage debt in countries like the US and Canada. Overall levels of household debt could begin to rise again

Chart 2. Global Banks Can Withstand A Housing Shock



* SOURCE: IMF AND NATIONAL CENTRAL BANKS.

relative to incomes, building up future financial stability risks when central banks begin to normalize pandemic-related monetary policies – a process that has already started in some countries because of the housing boom.

The Monetary Policy Implications Of Surging House Prices

Surging house price inflation is not likely to give a boost to realized inflation measures – an important issue given the current backdrop of rapidly rising realized inflation rates in many countries. Housing costs do represent a significant portion of consumer price indices in many developed countries, ranging from 19% in New Zealand to 33% in the US. The euro area is the outlier with housing having a mere 2% weighting in the headline inflation index.

"Housing" categories overwhelmingly measure only housing rental costs and not actual house prices. This is an important distinction because rents – which are often imputed measures like in the US and not even actual rental costs - are rising at a far slower pace than actual house prices in most countries, so the housing contribution to realized inflation is relatively modest.

So the good news is that booming house prices will not worsen the acceleration of realized global inflation that has concerned investors and policymakers in 2021. Yet that does not mean that central bankers will not be forced to tighten policy to cool off red-hot housing demand fueled by persistently negative real interest rates.

In advanced economies, real policy interest rates are at or very close to the most deeply negative levels seen since the 2008 financial crisis. And markets are discounting that real rates will be at or below 0% for most of the next decade. In our view, the current boom in housing demand and mortgage borrowing provides clear evidence that negative real rates are below equilibrium and, thus, are stimulating credit demand.

Thus, the only way for a central bank to cool off housing demand will be to raise both nominal and, more importantly, real interest rates. Central banks in countries with more stretched housing valuations will be forced to turn more hawkish sooner than expected, leading to tapering and, eventually, rate hikes to cool housing demand.

Investors should limit exposure to government bonds in markets where housing is more expensive and real yields remain too low, like Canada, New Zealand, and Sweden, over the next 6-12 months. Bond markets in countries where house prices are not rising rapidly enough to force policymakers to turn more hawkish more quickly – like core Europe, Australia and even Japan - are likely to be relative outperformers.

BCα Research

BCA is a world leading provider of independent investment research. Since 1949, the firm has supported its clients in making better investment decisions through the delivery of leading-edge economic analysis and comprehensive investment strategy research. BCA provides its services to financial professionals across six continents through a wide range of products, services, and meetings. The firm maintains a head office in Montreal, with local offices in London, New York, San Francisco, Hong Kong, Sydney, Cape Town and São Paulo.

Jonathan Laberge, Strategist, Vice President

Jonathan is currently BCA Research's Strategist, The Bank Credit Analyst. Since joining BCA in 2008, he has served as a Senior Analyst of the Global Asset Allocation service, a Strategist for the U.S. Investment Strategy service, as most recently as interim head of the China Investment Strategy service. Prior to BCA, he also held the position of Strategist with another independent macro research provider, focused on global asset allocation, global fixed income strategy, and a series of special reports particularly focused on the euro area. Jonathan has a Bachelor of Commerce in Finance/Economics and a Master of Science in Finance from Concordia University. He also holds the CFA designation.

Robert Robis, Chief Strategist

Robert is currently Chief Strategist for BCA Research's Global Fixed Income Strategy service. Since rejoining BCA Research is 2014, he has also headed up BCA Research's US Bond Strategy service. Prior to that, Robert was the Head of Fixed Income Macro Strategies and Senior Portfolio Manager at ING Investment Management in Atlanta. Earlier in his career, Robert was a Global Fixed Income & Currency Strategist and Senior Portfolio Manager at OppenheimerFunds Inc. in New York and a Proprietary Trader at J.P. Morgan Chase & Co. in New York. Robert holds an MA in Economics from New York University, a BA in Economics from the University of Western Ontario and is a CFA charterholder.