

What if Swedish Housing Prices Drop 15-20%?

- The housing market poses a risk to Swedish growth and the inflation outlook*
- The krona is feeling the pain but rates market yet to adjust*

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What if Swedish housing prices drop 15-20%?

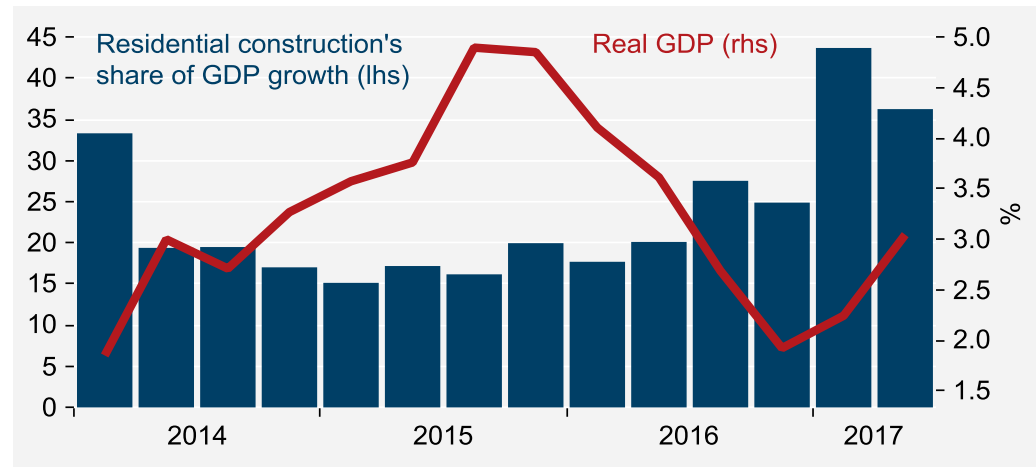
- After several years of surging house prices, together with recent macro prudence measures, affordability has been hit. On top of this, the supply of new (expensive) apartments, after a couple of years of booming residential investments, is now coming to the market. So far prices (of flats) in Stockholm have declined by some 10%, we assess.
- Previous downturns in the housing market suggest a fairly big impact on GDP via the residential investments. Our scenario implies sub-par growth but no recession.
- As private consumption has benefitted from the higher house prices in recent years the housing market poses a risk to both Swedish growth and the inflation outlook. Hence, the Riksbank will have difficulties in making an interest rate hike as currently planned.
- The krona is feeling the pain but the rates market is yet to adjust. This offers an opportunity to take positions for a re-pricing of the rates market (krona, stock market and the covered bond-SGB spread have already moved).
- Receive short end FRAs or swaps (1Y1Y) vs EUR. Go for a relative SEK steepener 1Y1Y-5Y5Y vs EUR and buy 5y SGB1054 vs Bobl.
- In a stressed scenario SEK can weaken further and EURSEK stay above 10 in the medium term.

Residential investment has been an important GDP driver in recent years

Residential construction

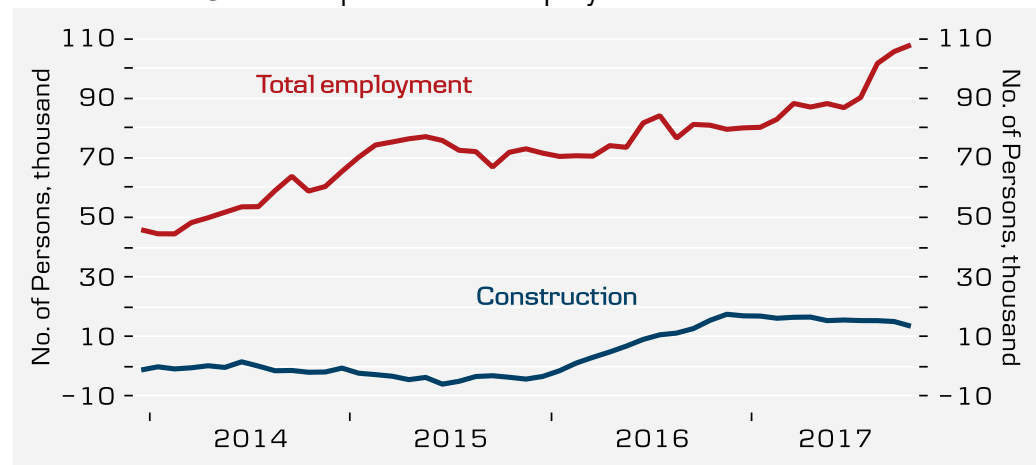
- Contribution to GDP growth around 40% (= 1 p.p. contribution)
- But only very minor contribution to employment growth
- Right now residential investment is the only factor explaining growth above trend

Residential investments a main growth driver



Source: SCB

But less important for employment



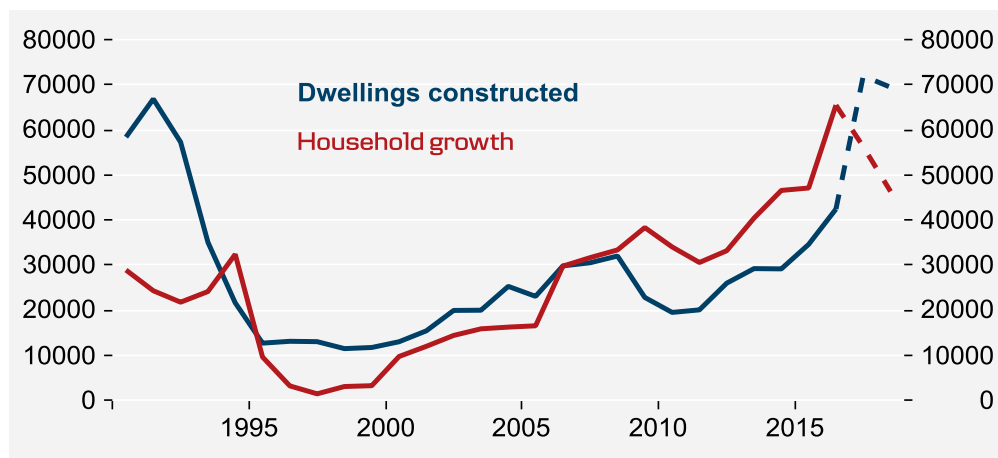
Source: SCB

The long-standing 'housing-gap' appears to be closing

Housing-gap

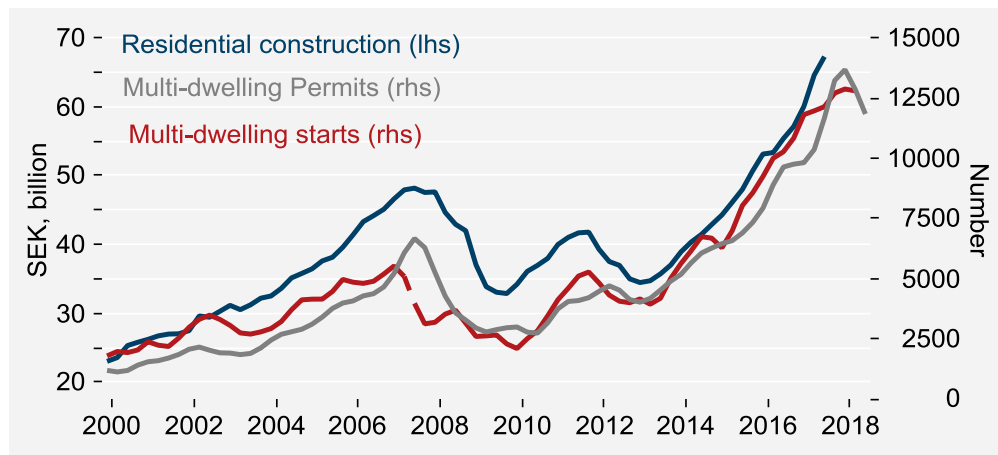
- Residential construction has been lagging household growth for many years
- However, the strong rise in residential construction since 2013 and the soaring multi-dwelling starts suggest the gap will close shortly
- That said, permits are now heading down

Housing gap closing



Source: SCB

Housing starts look toppish



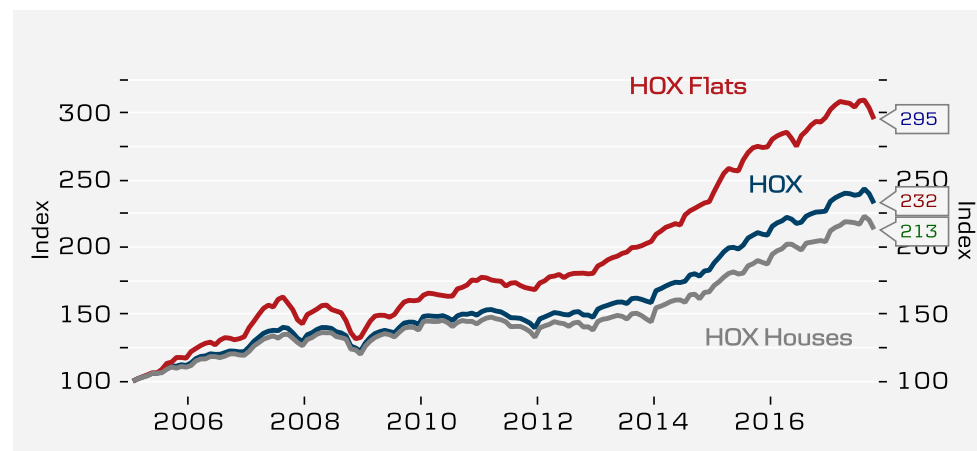
Source: SCB

Housing prices have started to decline as supply surges

Housing prices

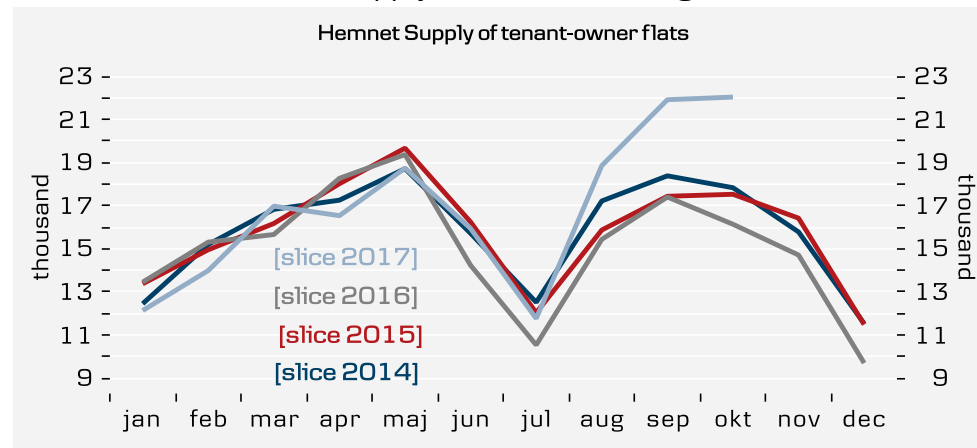
- House prices have doubled and flats prices tripled since 2005
- In the past three months Aug-Oct prices have declined about 5.5% (flats Stockholm)
- This comes on the back of a sharp increase in flats for sale
- We reckon the market for tenant-owned flats is the focal point

Housing prices 5% off peak and counting



Source: Valueguard

While supply of flats is booming

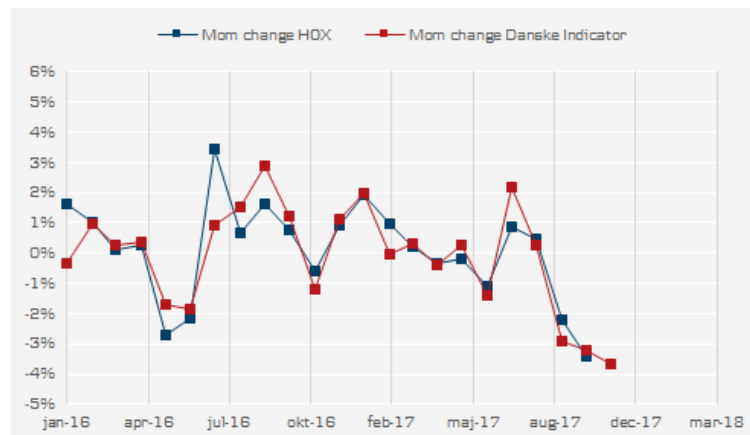


Source: Hemnet

Most recent indications suggest price decline in Stockholm flats is accelerating

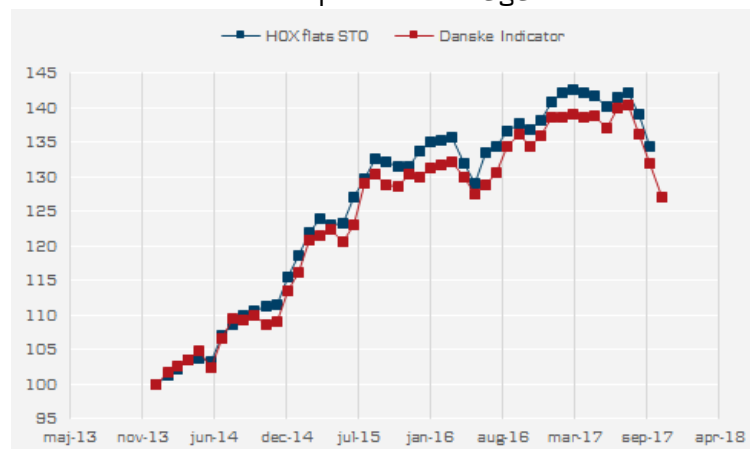
- Size-adjusted price indicator extracted from transactions reported to Hemnet
- Top chart m/m change -4% in November bringing price drop to some 9% since August
- Bottom chart indexed price level total decline now approaching 10% since peak this summer

Danske's price indicator points to 4% drop through mid-November



Source: Valueguard, Danske Bank

Prices peaked in August



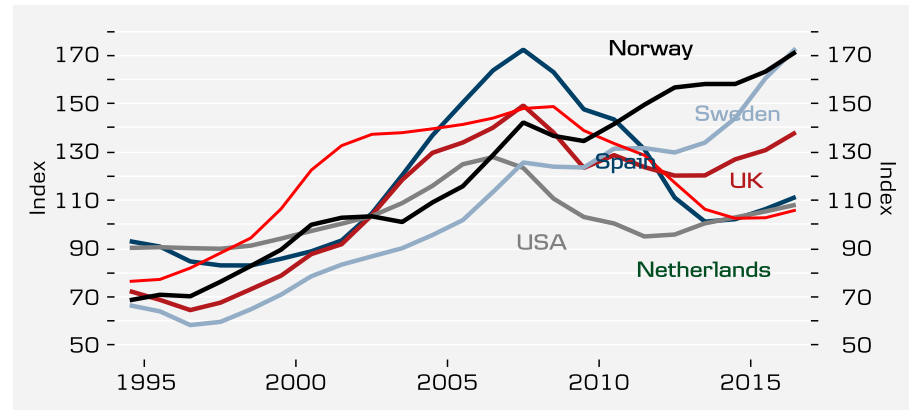
Source: Valueguard, Danske Bank

Prices and debt are high in international comparison

Signs of strain

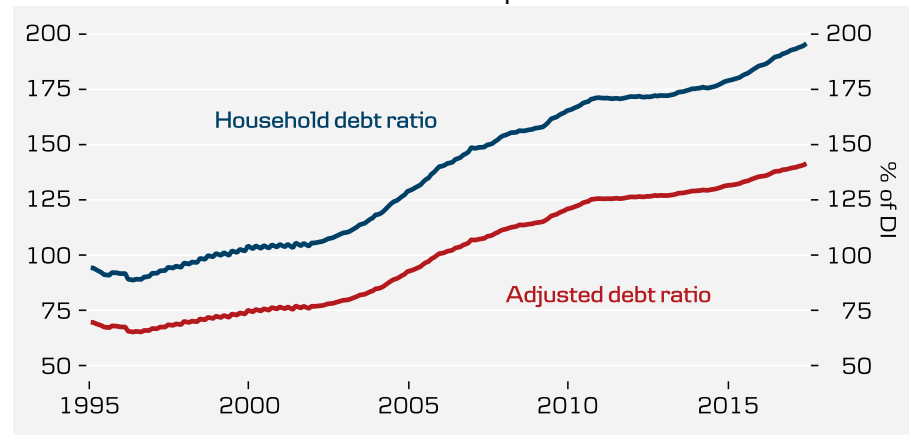
- Swedish price-to-rent is at extreme highs together with Norway (rent control causes distortion)
- Swedish households' debt-to-disposable income ratio is very high too
- The latter, however, declines dramatically if disposable income is adjusted for tax-funded expenses

Price-to-rent extreme in Sweden and Norway



Source: OECD

Swedish debt ratio at extreme - but less so when adjusted for tax-funded expenses



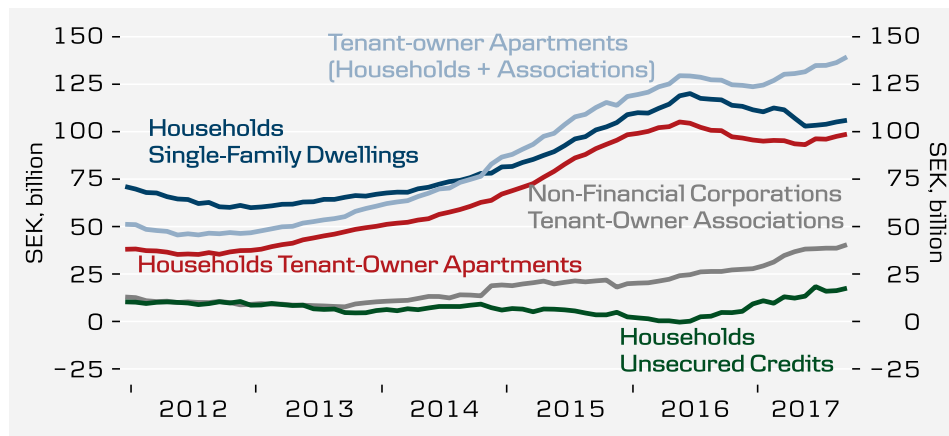
Source: SCB, OECD

Credit growth to tenant-owner flats is at record high

Credit growth still high

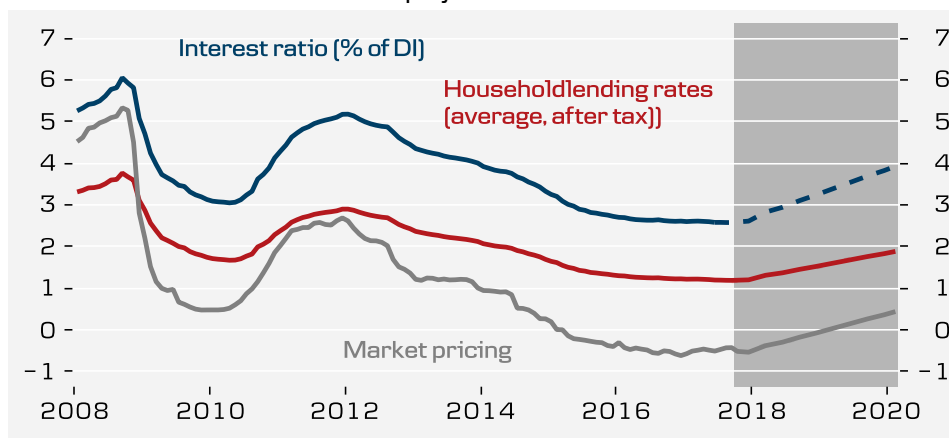
- Worrying sign that combined credit growth of tenant-owner flats (households + associations) and unsecured credit are at record high
- However, the interest ratio (% of DI) is currently at a corresponding record low
- Last year's mandatory amortisation requirement has probably raised the monthly cash-expenses but only applies to new loans
- Impact on marginal buyer important for prices though

Decomposed credit growth



Source: SCB

While interest payments to income at low



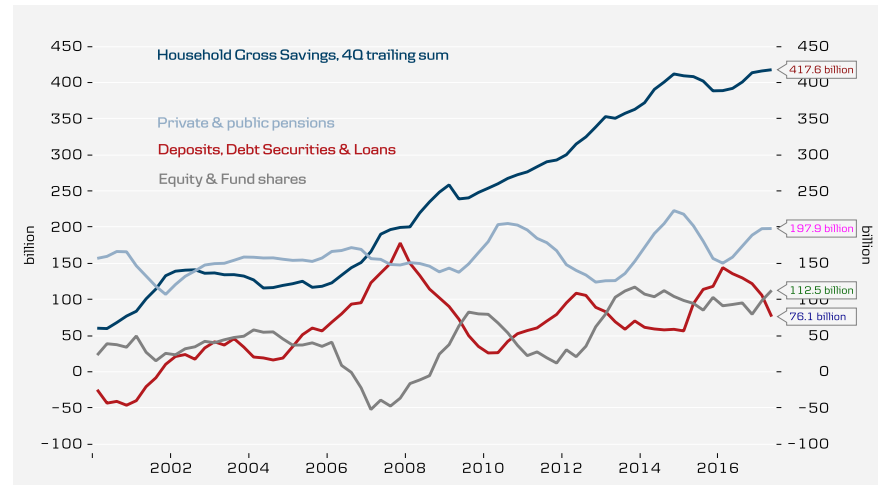
Source: SCB

Household finances are very strong

Households finances

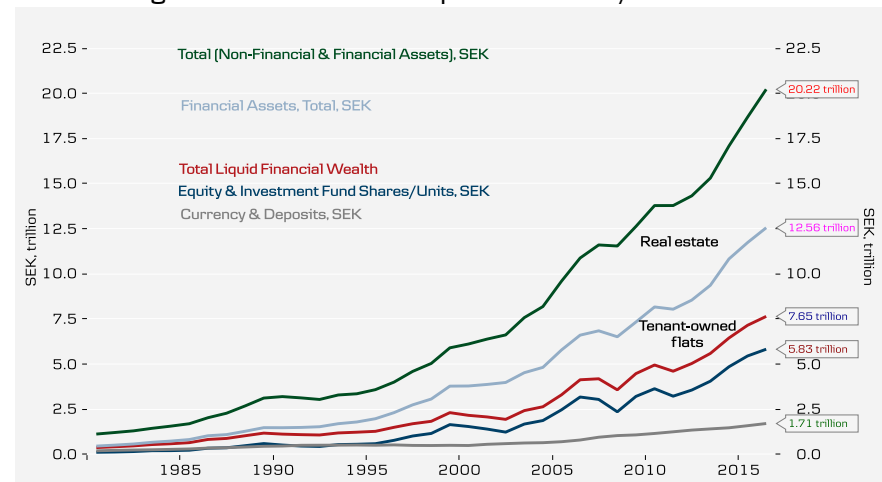
- Gross savings (and the savings ratio) is very high. Roughly half is fixed, mandatory public and private pension schemes
- Household net worth is at a record high. The value of dwellings (villas) and financial net worth (which includes tenant-owner apartments) makes up 2/3 of the total

Record high savings of which half is in liquid financial assets



Source: SCB

Strong balance sheets – liquid assets 1/3 of total



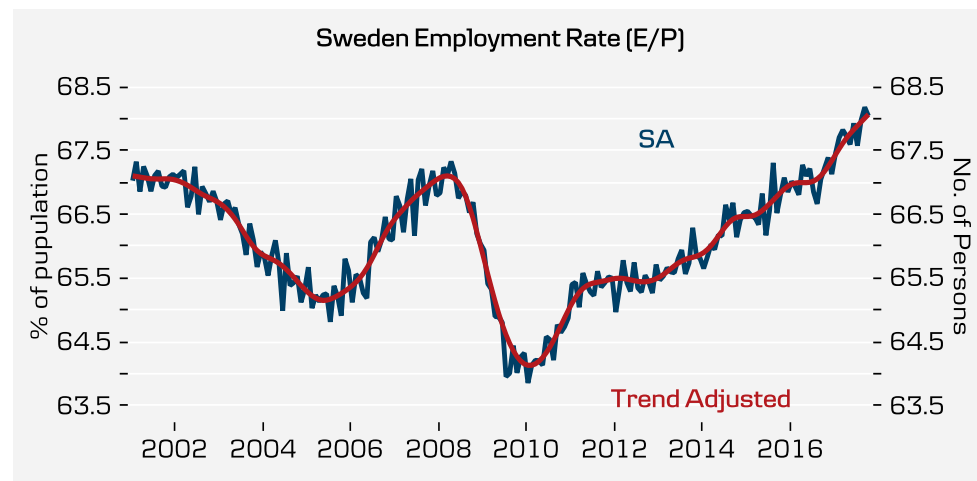
Source: SCB

Strong employment but weak wage and income growth

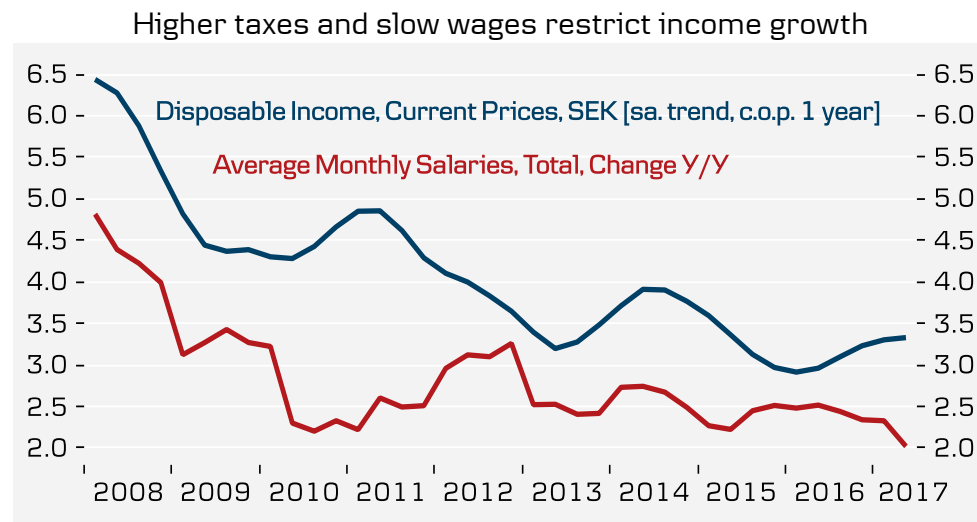
Overall super-strong labour market not likely to be toppled by housing

Household finances

- Employment continues to rise faster than population, pushing the employment rate to record highs
- The drawback is that disposable income growth has been slowing on the back of tax increases and slow wage growth



Source: SCB



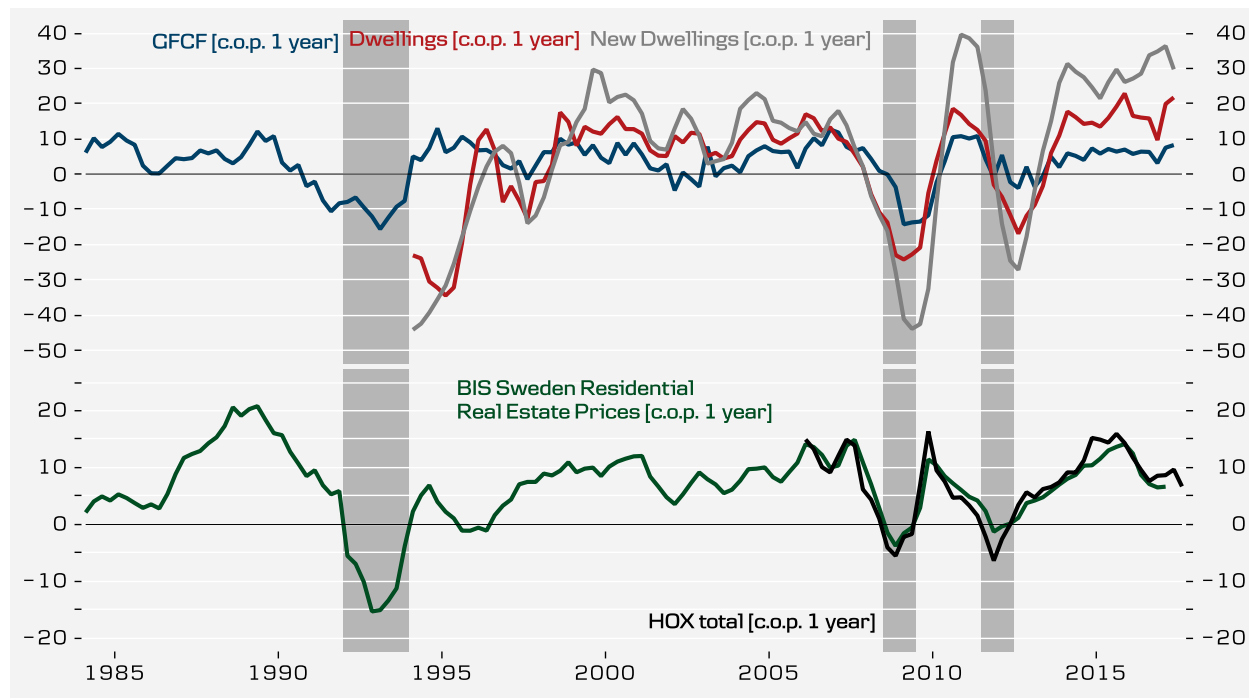
Source: SCB

How might falling housing prices impact residential construction?

Strong correlation

- Historically, the price elasticity of residential investment appears to be on average 3-4
- This means a 10% change in prices leads to a 30-40% change in residential investment

Residential investments are sensitive to housing prices

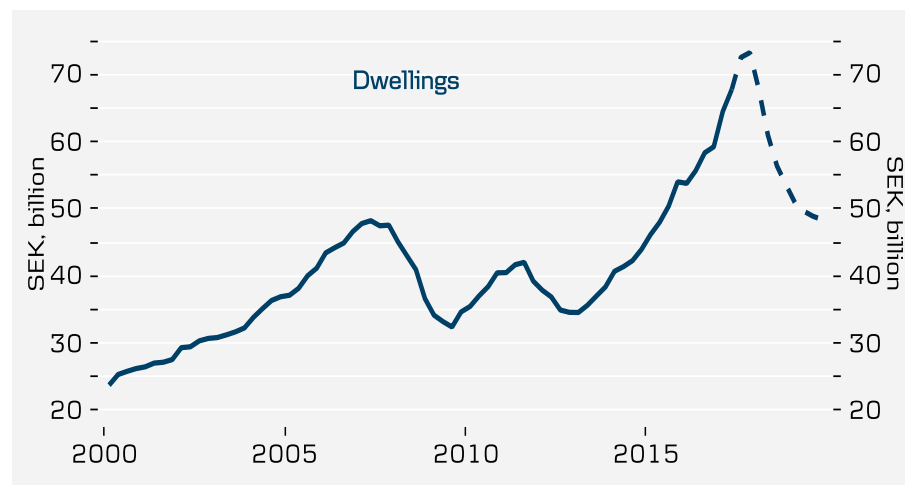


Source: SCB

A risk scenario based on a 15-20% price drop

- 30% y/y drop in residential investment 2018 (and another 10% in 2019)
- A slight negative impact on PC (wealth and feel-good effect)
- But positive impact on net exports (weaker SEK, strong export markets and less imports) and inventory build-up
- Sharp slowdown in domestic demand
- No recession but growth clearly below trend
- Still at an early stage but we assess 35-40% probability for the risk scenario

An increasing likely scenario for residential investments



Source: SCB, Danske Bank

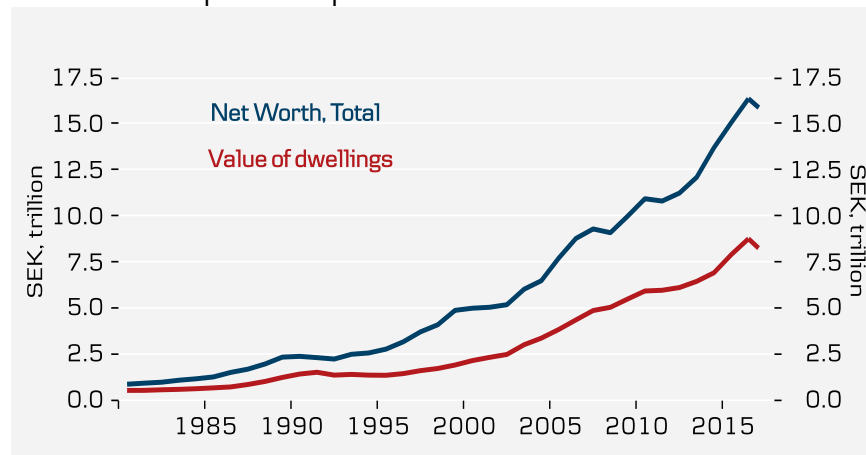
	Current forecast	Risk scenario
2018		
GDP	1.9	1.2
Private consumption	1.4	1.2
Public consumption	1.6	2.3
Gross fixed investments	3.1	-3.5
FDD	1.9	0.2
Inventory change	0	0.3
TDD	1.9	0.6
Exports	3.3	3.9
TD	3.1	2.9
Imports	3.3	2.7
Net exports	0.1	0.6

Source: Danske Bank

Will the 'feel-good' factor go away if prices drop 15-20%?

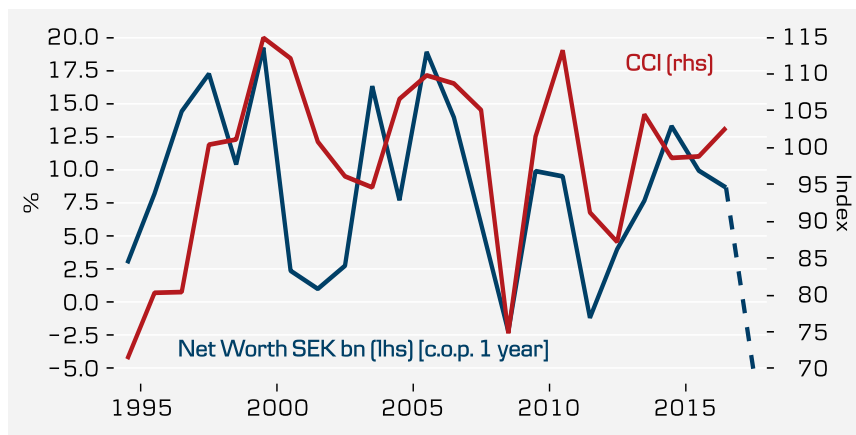
- Will cut some SEK1,300-1,750bn off household housing wealth
- That will reduce household net wealth by 7.5-10%...
- ...which is likely to hit confidence and slow private consumption

15-20% price drop shaves 7.5-10% from net wealth



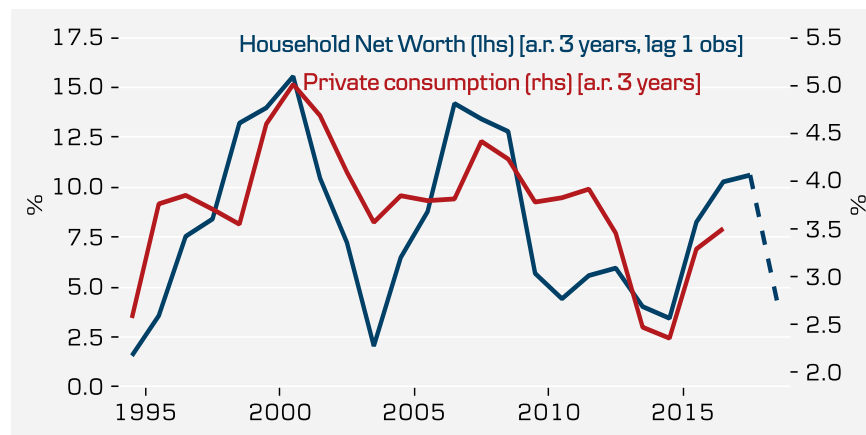
Source: SCB

Negative wealth effect means weaker CCI



Source: NIER, Danske Bank

And in turn moderate consumer spending

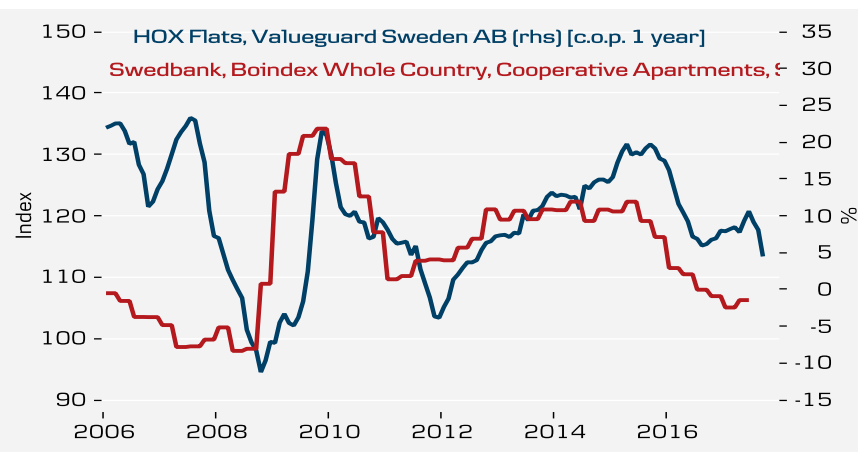


Source: SCB, Danske Bank

Stretched housing affordability despite ultra-low rates

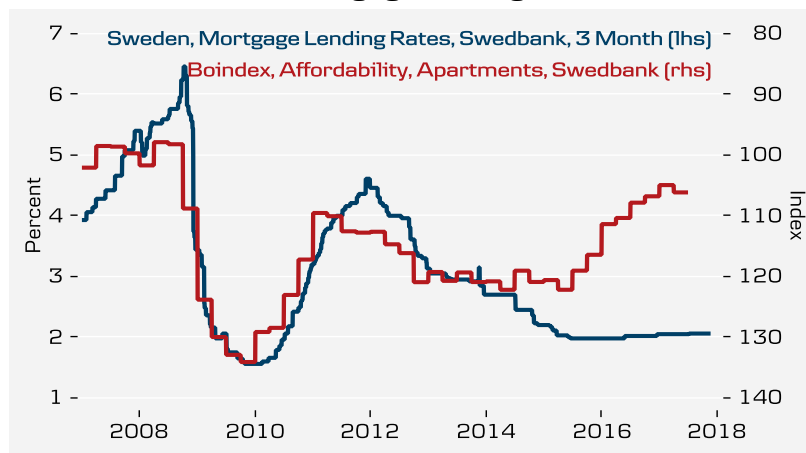
- The affordability index, 'Boindex', has declined (higher prices, taxes etc) and suggests more downside risk to prices
- The affordability index is at its lowest since 2008. This is despite the mortgage lending rates also being close to record lows
- Private consumption could of course be affected by more cautious households

Prices on flats have started to fall with affordability having declined a lot



Source: Valueguard, Swedbank

Affordability index at lows (rev. RHS) despite close to record low mortgage lending rates



Source: Valueguard, Swedbank

How do the Riksbank, FSA (FI), government and markets react?

Riksbank latest forecast:

- Residential investments grows roughly 20%-2017, 3.5%-2018 and -1%-2020*
- Residential prices seen rising but at slower pace than hitherto

Riksbank keeping monetary policy loose

- No rate hike during descending housing market
- QE (other asset classes) could be considered at some point
- Lower repo rate not very efficient
- Wider credit spreads?
- Weakening SEK

Financial Supervisory Authority (FSA)

- Adjustment of amortisation requirement?

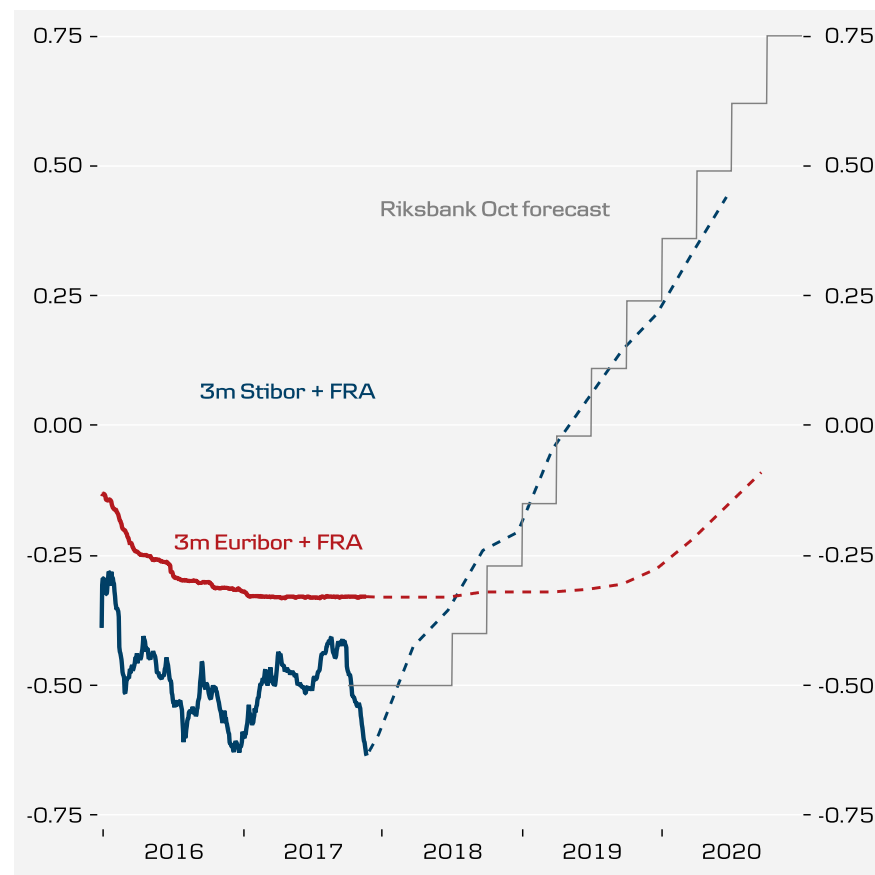
Politics/fiscal policy

- Interest tax deductions maintained
- Automatic stabilizers will come into play

Banks pulling back

- Credit restraint for properties
- But not other businesses?
- Strong banks (very robust cover pools)

Riksbank will not be able to do much stimulus this time



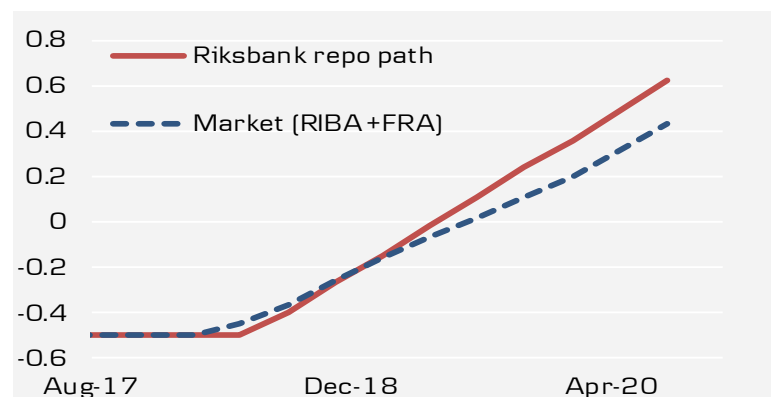
Source: Macrobond Financial, Danske Bank

* Our estimate based on RB's forecast of GDP growth and residential investments' share of GDP

Housing market risks not reflected in current pricing

- The rates market is not paying enough attention to the cooler housing market.
- Market pricing is very close to the Riksbank's repo rate path. Remember, the Riksbank still expects residential prices to rise, albeit at a slower pace, but if this outlook were to change it would most likely also alter its outlook on monetary policy.
- Market pricing $\leq 5y$ suggests the Riksbank will be one of the most aggressive central banks. Pricing implies a relatively rosy scenario in Sweden, compared to other markets, both in terms of growth, inflation and the housing market.

Market pricing close to Riksbank's view on repo rate path, which assumes higher residential prices



Source: Riksbank and Danske Bank

Market expects the Riksbank to 'out-hike' peers over the next five years

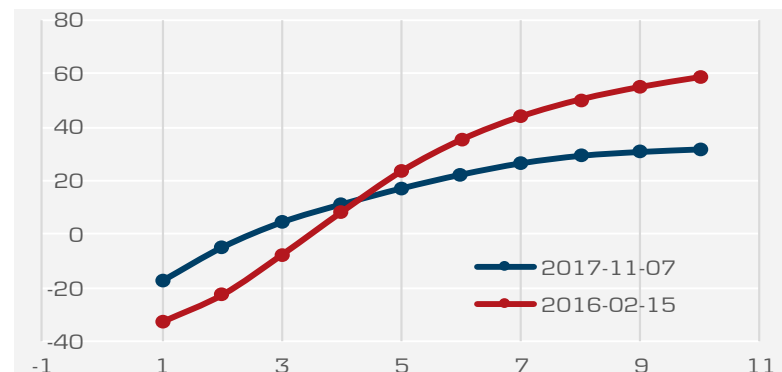
Yearly rate hikes priced (OIS pricing)					
	2018	2019	2020	2021	2022
Riksbank	30.5	24.6	40.4	36.4	35.1
ECB	2.6	22.5	25.9	25.5	26.4
FED	40.1	13.4	4.1	3.1	6.7
BOE	25.6	14.4	9.6	9.9	7.3
Norges Bank	11.7	22.9	25.0	21.7	20.5

Source: Danske Bank

Housing market risks not reflected in current pricing

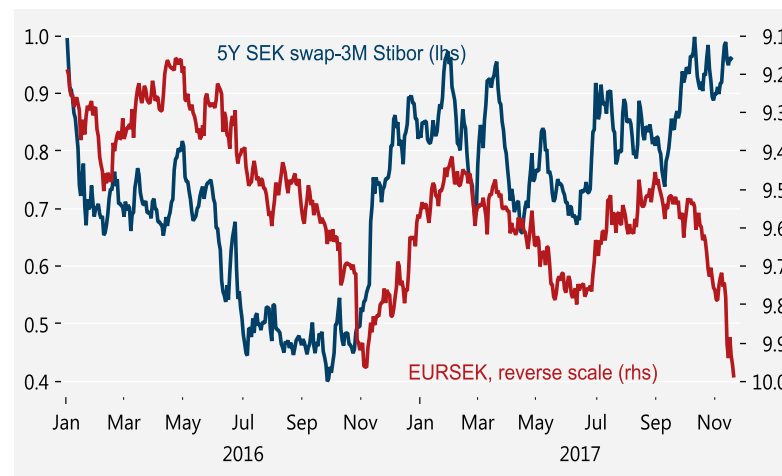
- There has been a significant repricing of the Swedish yield curve over the past 18 months, with a relative flattening of the SGB/SEK swap curve.
- With the peak in both inflation and growth behind us and with a housing market that risks slowing growth and inflation, but with less room to do QE in SGBs, despite a dovish Riksbank, we see some reversal of the flattening move as very likely.
- We recommend receiving SEK 1Y1Y vs. EUR and doing the opposite in the 5Y5Y spread where we have seen 68bp of flattening over the past 18 months. The roll down in such a trade is 11bp over 6m.
- **Pay SEK 1Y1Y and Pay 5Y5Y and do opposite in EUR in a curve box @ 32bp. P/L: 60bp/18bp.**

SEK swap curve has reshaped over the past 18 months relative to EUR swap curve - time to reverse



Source: Riksbank and Danske Bank

EURSEK sharply higher while rate unaffected

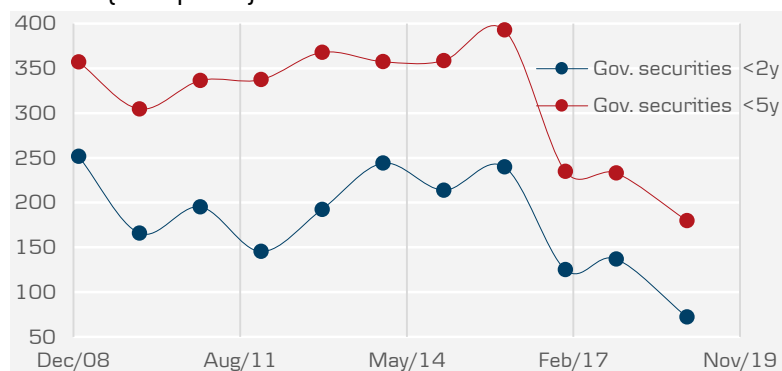


Source: Macrobond Financial, Danske Bank

Housing market risks not reflected in current pricing

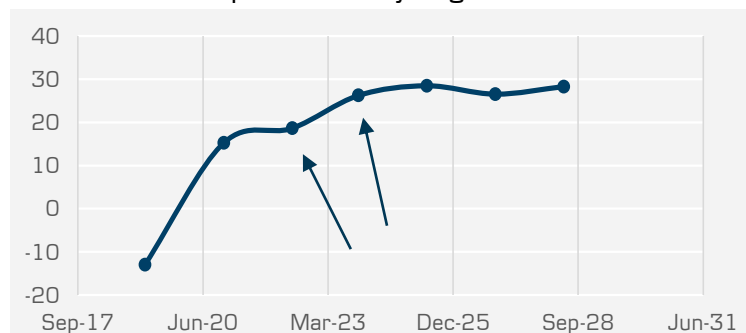
- The scarcity of short-end government securities will be a major market theme in 2018. The stock of T-bills will be cut to lowest on record since 1985.
- On top of this the Riksbank holds 50% of bonds <5y and the Debt office will concentrate issuance in the 10y segment.
- In March the T-bond index duration extension will, we estimate, be the largest at least since 2005. This will be supportive to SGBs in general.
- Hence, we like to buy SGBs in the 5y segment vs. Bobls. We see some 20bp in potential over 1-3m in this trade given a shortage of bonds but also as a repricing of the Riksbank is likely.
- **Buy SGB1054 vs Bobl @ 10bp. P/L: -10bp/25bp.**

Available stock of government securities (T-bill and SGBs) up to 2y and up to 5y including forecast for 2018 (last point)



Source: Danske Bank

SGB curve steep out to 5-6y segment

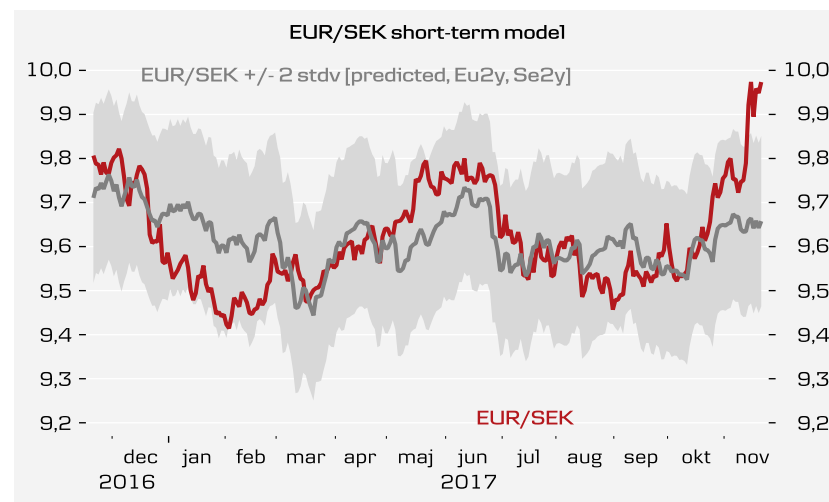


Source: Danske Bank

The SEK has weakened, likely going even weaker

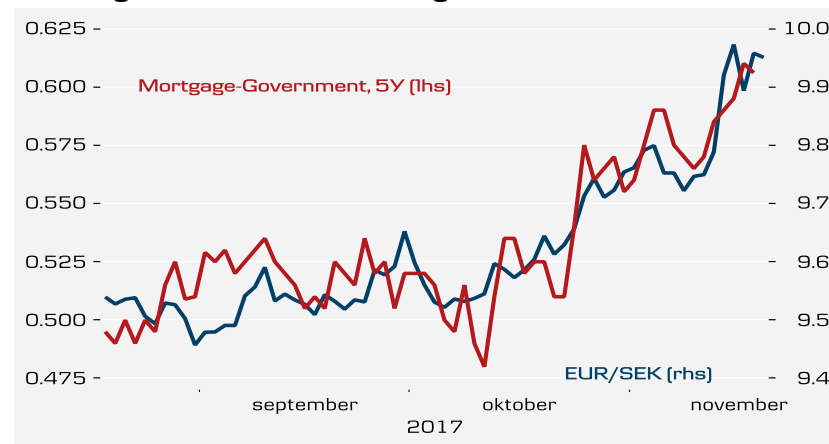
- The sudden and drastic deterioration in housing market sentiment has weighed heavily on the SEK over the past few weeks.
- The lower chart shows a strong correlation with the mortgage spread. The SEK is an easy way to express a negative view on the Swedish housing market. We expect EUR/SEK to continue trading with a housing market premium.
- EUR/SEK trades more than 3 standard deviations above a rates-implied fair value. In our view there is substantial room for repricing of the Riksbank, which will put upward pressure on EUR/SEK fair value.
- We see scope for 2-5y swap spreads to adjust by 10-25bp, which could push EUR/SEK's fair value toward 9.90 with SEK swap rates beta around unity (c.p.).

EUR/SEK c.3 standard deviations from rates-implied fair value



Source: Danske Bank

Housing market concerns weigh on SEK

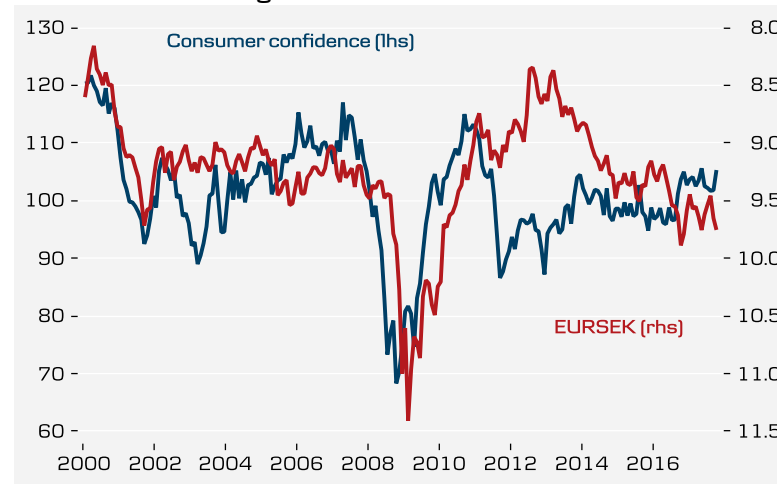


Source: Macrobond Financial

The SEK will remain under pressure going forward

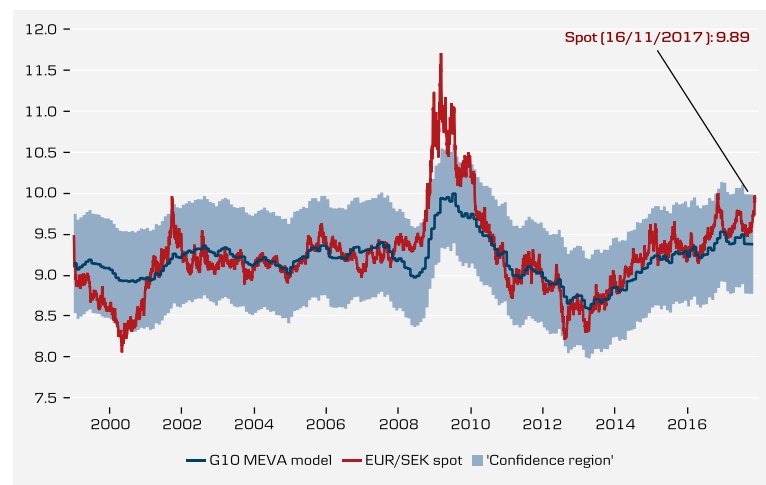
- We see EUR/SEK above 10.00 in the next few months, with risk to our 1-3M target at 10.10 being on the upside.
- In the base case we have penciled in a slight rebound in the SEK over 12M (e.g., valuation, lower chart).
- However, an increasing downside risk to our GDP forecast suggests that the Riksbank will need to stay low for longer. Maybe even lag ECB exit.
- Weak SEK will be a cushion for lack of domestic inflation dynamics, as domestic demand set to weaken.
- If our 'risk scenario' materialises we could see EUR/SEK above 10.00 even in 12M.

Downside risk to growth - a headwind for the SEK



Source: Danske Bank

Housing market worries to keep SEK fundamentally cheap



Source: Macrobond Financial, Danske Bank

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Michael Boström, Michael Grahn, Stefan Mellin, Carl Milton and Marcus Söderberg.

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Date of first publication

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