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European Economic Forecast: Major Corrections On The Cards As Housing Markets Turn Down

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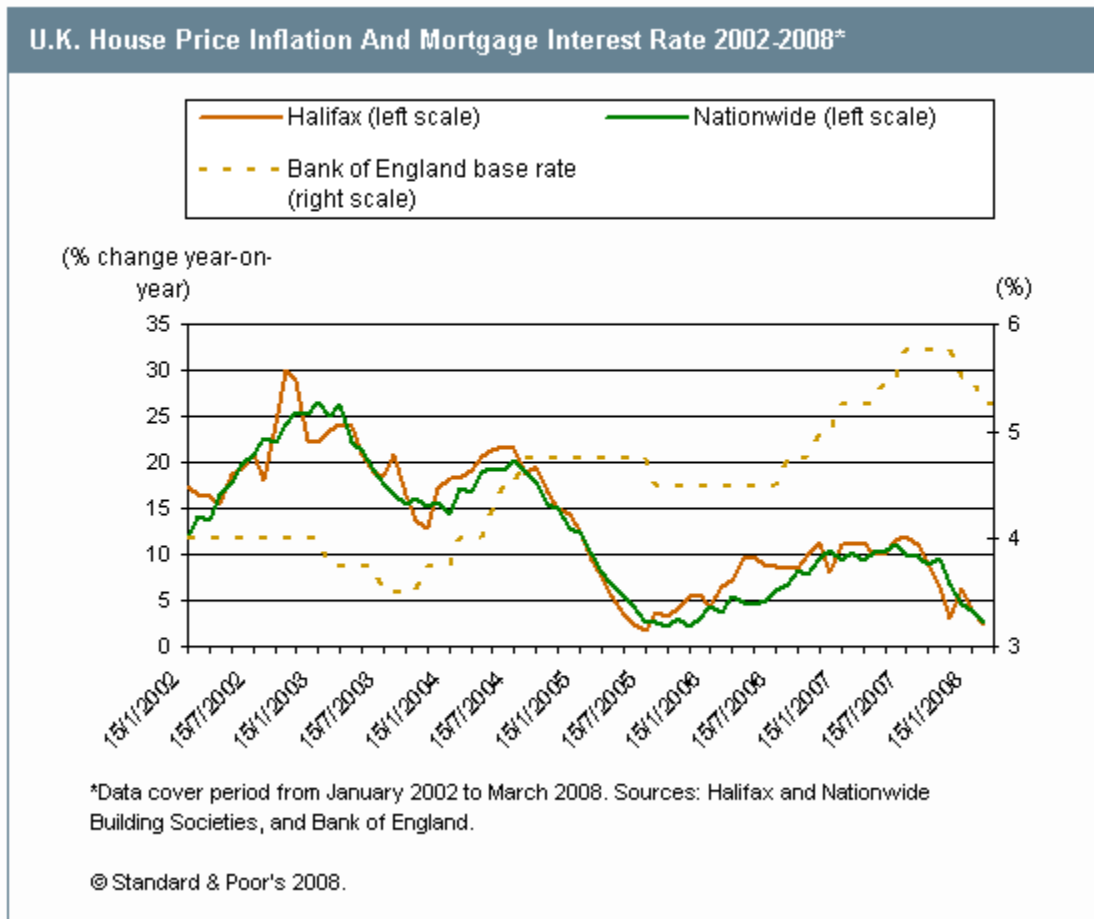
It's been a long time coming, but Europe's housing markets are finally, and overwhelmingly, turning down. And in those countries where the housing bubbles have been expanding for longer, Standard & Poor's believes the corrections could be severe and painful. Particularly at risk are the U.K. housing market, where the financial crisis is exacerbating issues of affordability and general economic gloom, and the Spanish housing market, which is coming to terms with a largess of new homes. At the same time, there are signs that housing in Ireland is becoming more affordable, while a combination of low indebtedness and fiscal stimulus should help support the market in France.

U.K. Residential Real Estate Wrestles A "Triple Whammy"

Most indicators suggest that the U.K. residential real estate market has entered a phase of substantially lower growth since the end of 2007. In November of last year, the Royal Institute of Chartered Surveyors' monthly survey pointed to an abrupt deterioration in market sentiment, with surveyors at their most negative on prices and agreed sales since May 2005 and April 1999, respectively. Since then, that deterioration has become even more evident. Gross lending declined to an estimated £24 billion in February, down 6% from a year earlier. And in the 12 months to February, house prices grew a meager 2.3% according to Nationwide and Halifax, two of the largest building societies in the U.K.

The U.K. real estate market has arguably experienced two mini-cycles since 2001: First, accelerating house price inflation between January and November 2002, followed by a period of easing of about 11 months. Second, a short rebound until June 2004, then a deceleration through to July 2005 when house price inflation reached a low of 1.7% year-on-year. Running alongside those mini-cycles, with a lag of about six months, were upward or downward trending interest rates (see chart 1). In that sense, the current deceleration, which began in August of last year, could be attributed to the rise in interest rates from August 2006 to September 2007. If that logic holds true, interest rate cuts since last December could see house price inflation bounce back in the second half of 2008.

Chart 1



In our opinion, such a favorable outcome is extremely unlikely in the current circumstances. This is because the U.K. housing market is now experiencing three shocks at the same time--deteriorating levels of affordability, scarcer funding, and a cautious reaction from buyers to the domestic economic slowdown.

Affordability dips to a historic tipping point...

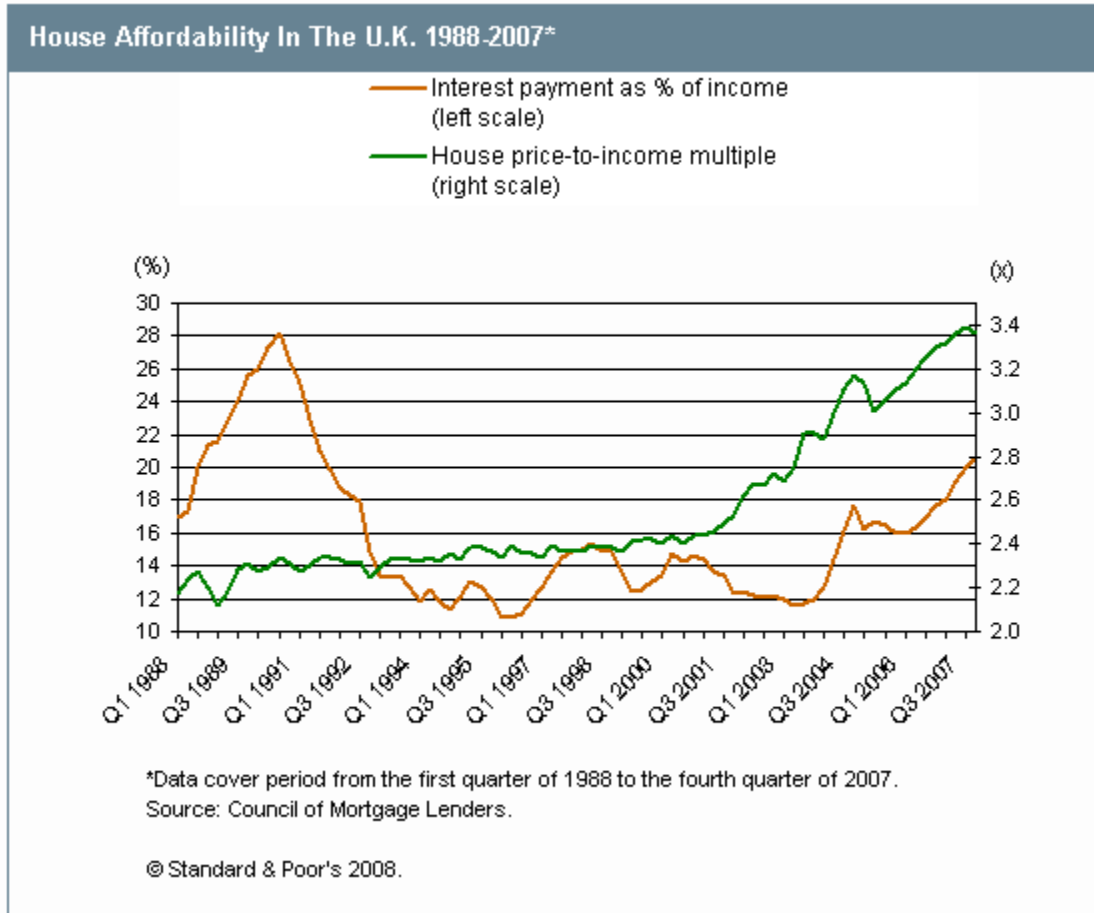
House affordability has been showing signs of stress for some time. As chart 1 indicates, the upswings since 2001 were of an ever-decreasing magnitude, suggesting that the markets were starting to running out of breath. But now, the price-to-income ratio is at an all-time high. This, combined with unprecedented levels of household debt (97% of GDP in 2007, compared with 59% in the Eurozone), calls for a significant correction.

The deterioration in affordability is a significant difference compared with the last major crisis in U.K. residential real estate markets, which occurred between 1988 and 1991. At that time, the fall in house prices was triggered by a dramatic surge in interest rates that saw interest payments peak at 28% of incomes (see chart 2). The abrupt surge led many borrowers to put their houses on the market, leading to an upswing in supply and a rapid decline in buyer enquiries. Affordability did not improve at the time because the overall economy fell into recession, causing incomes to plummet. But neither did it deteriorate prior to the downturn.

By contrast, affordability has been declining constantly since 2001, with house prices averaging 3.4x incomes in the

fourth quarter of 2007 against 2.4x at the same point in 2000. In turn, the rapid rise in prices has led borrowers to borrow more and over a longer period of time, pushing interest payments to 20.6% of incomes--the level they reached in late 1988 when the previous crisis began. Unlike interest rate shocks (such as in 1988-1991), affordability shocks cannot be reversed easily unless prices experience a severe correction. A simple calculation suggests that for the affordability ratio to return to its long-term average (early 1980s-late 1990s) of 2.5x, assuming incomes remain constant, prices would have to drop 27%. Ironically, a correction of this magnitude is close to the peak-to-trough fall in house prices expected in the U.S.

Chart 2



... Mortgage financing falls prey to the liquidity squeeze...

The funding shock is a direct result of the turmoil in the financial markets that began last August. Since then, and especially after the events surrounding Northern Rock PLC, lenders have found it increasingly hard to refinance new mortgages on the wholesale market. In fact, there have been very few placements of new mortgage-backed securities or covered bonds in the U.K. since August of last year. And despite repeated interventions by the Bank of England in money markets over the past six months, banks have been extremely reluctant to lend to each other: The spread between the LIBOR and the Bank of England's base rate has remained elevated, illustrating the high level of stress prevailing in the capital markets. Scarce funding compounds the effects of deteriorating affordability (that is, high house prices relative to incomes), making things even more difficult for potential buyers. First-time buyers are hit

particularly hard: By definition, they have to apply for a higher loan-to-value ratio in order to enter the housing market.

... And the specter of unemployment stalks the economy

The third shock is of a more general nature, as the U.K. economy is currently in the grip of a slowdown that started in early 2007 and gained momentum at the end of last year. We expect GDP growth to decelerate to 1.5% in 2008, from 3.1% in 2007, as consumer demand eases on the back of lower income growth. Meanwhile, corporate investment growth will slow as a result of deteriorating margins and demand prospects. Although the unemployment rate--an important leading indicator of real estate activity--remains low at 5.2%, unemployment is likely to move up in the coming months on the back of a significant slowdown in the financial services industry. We expect unemployment to rise to around 1.8 million at end-2008 and 1.9 million at end-2009, from 1.6 million at the end of 2007. In the past 30 years, every period of economic slowdown is associated with a slower phase in housing markets. In the late 1980s, these two developments (an economic slowdown and a downturn in housing) fed each other, eventually leading to a recession and a two-and-a-half year period of declining house prices.

Yet, other drivers should in the longer term help the U.K. housing market counter the strong headwinds described above. The buy-to-let market, for example, remains robust despite the recent fall in yields. In fact, the difficulty faced by first-time buyers wishing to enter the property market will in the short term support the buy-to-let segment. More fundamentally, the U.K. housing market is still suffering from a significant imbalance between supply and demand, especially in South-East England. Overall, demand has considerably outpaced supply in the past two decades. What's more, this picture looks unlikely to change soon: The number of new dwellings completed in 2007 matches that of the early 1950s (160,000), despite the obvious growth in the population and number of households since then.

The combination of a sharp deterioration in affordability, scarce funding, and the economic slowdown are about to cause a major slowdown in the U.K. real estate market. Our central forecast assumes house prices to be flat on average in 2008, with a modest increase of 4% in 2009. Repossessions will likely rise as a result of the worsening market conditions, to reach 45,000 in 2008 from 30,000 in 2007. Compared with previous downturns, these predictions appear relatively moderate. However, the downside risks should not be underestimated.

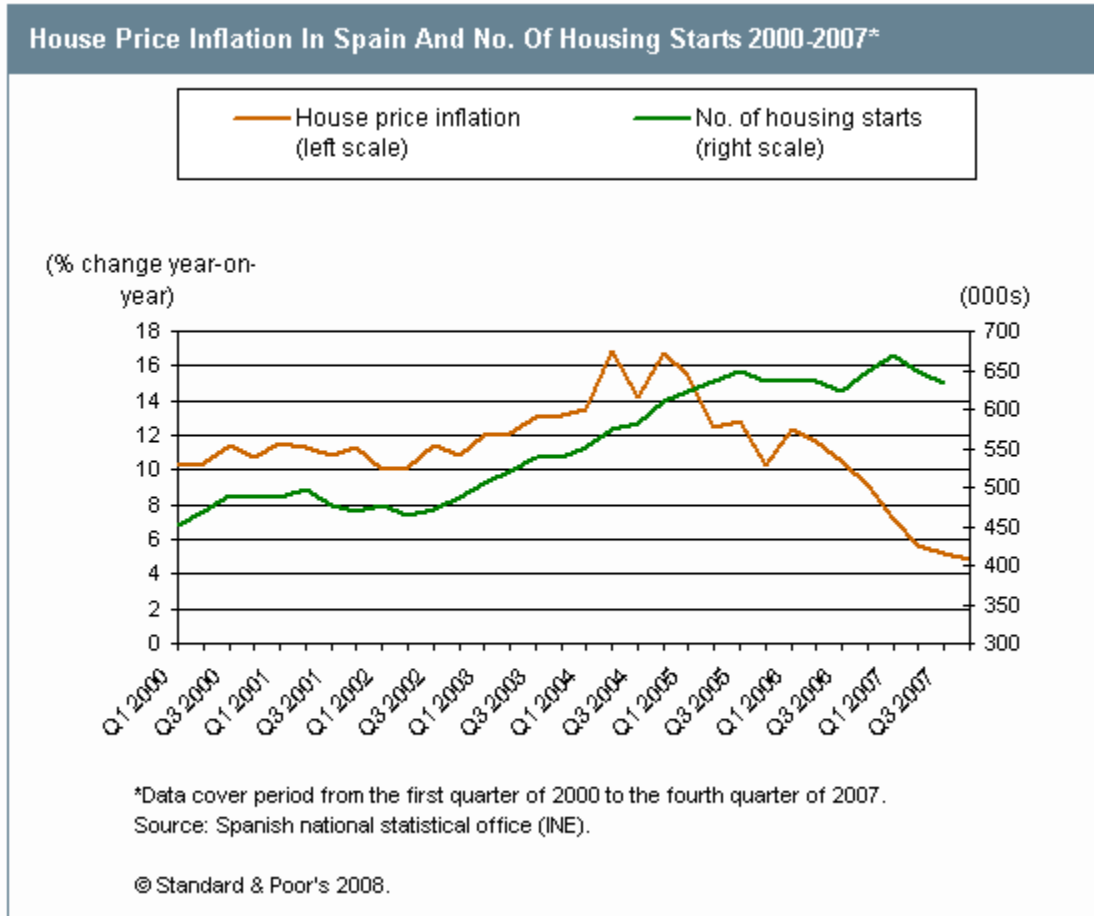
The Pain In Spain Is Anything But Plain

In August 2005, we warned that a red-hot Spanish housing market was growing at an unsustainable pace (see article titled "Can Europe's Housing Markets Break Out Of The Boom-Bust Cycle?," published Sept. 13, 2005, on RatingsDirect). We also cautioned that a slowdown was desirable in order to avoid a major collapse later on.

That slowdown did not materialize in the following 18 months. But data released by INE, the Spanish statistical office, on March 26, 2008, strongly suggest that the market has now taken a dramatic turn. In the 12 months to January, completed house sales were down a staggering 27% on the previous 12 months. Sales of second-hand dwellings, representing 52% of total sales, fell 36% over the same period, while sales of new houses were down 15%. Not surprisingly, total lending to home buyers fell 28% over the period. We note that the average interest rate charged by savings banks was 5.09% in January 2008, up from 4.12% a year earlier, while the average term was 26 years (unchanged). Moreover, borrowers continued to show a very strong preference for variable-rate loans (98.3% of total loans, up from 97.6% a year earlier).

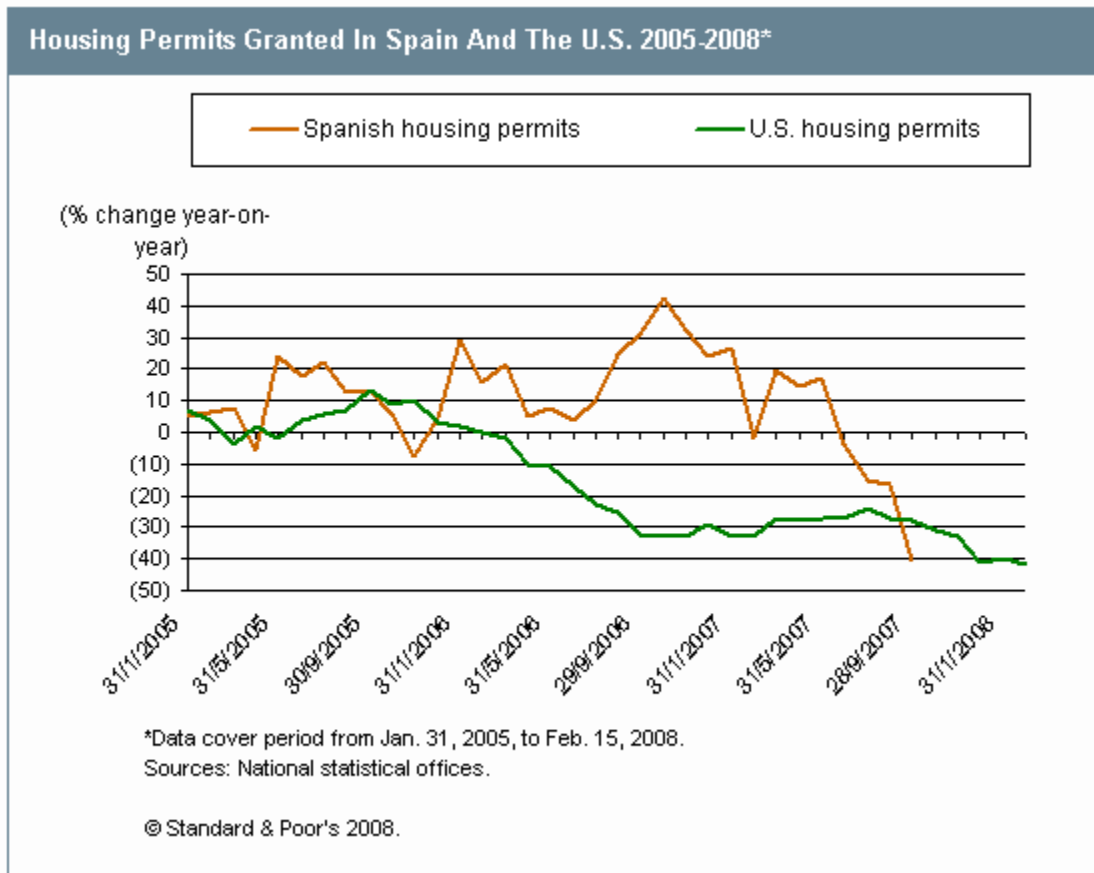
The biggest concern at this point is the lag between housing starts and the most recent trends in the market, as reflected by house price inflation and the number of actual sales. Housing starts stabilized in the second half of last year (see chart 3), but at still very high levels (650,000 annualized). At the same time, house price inflation decelerated steadily to 4.8% year-on-year in the fourth quarter of 2007 (9.1% a year earlier).

Chart 3



Permits for residential housing (see chart 4) seem to suddenly be acknowledging the shift in market trends, falling 40.6% in the 12 months to September 2007 (latest data available). There is always a lag, and some discrepancy, between permits and actual housing starts; permits typically outnumber starts because not all permits lead to actual completions. In the U.S., permits peaked in the third quarter of 2005, and housing starts in the first quarter of 2006. But the number of permits in the U.S. started to drop compared with previous year levels only in the second quarter of 2006. Furthermore, the deceleration was fairly gradual, as chart 4 shows. In other words, the sudden and brisk drop in permits in Spain, if confirmed in the next few months, would indicate an upcoming major collapse in housing starts.

Chart 4



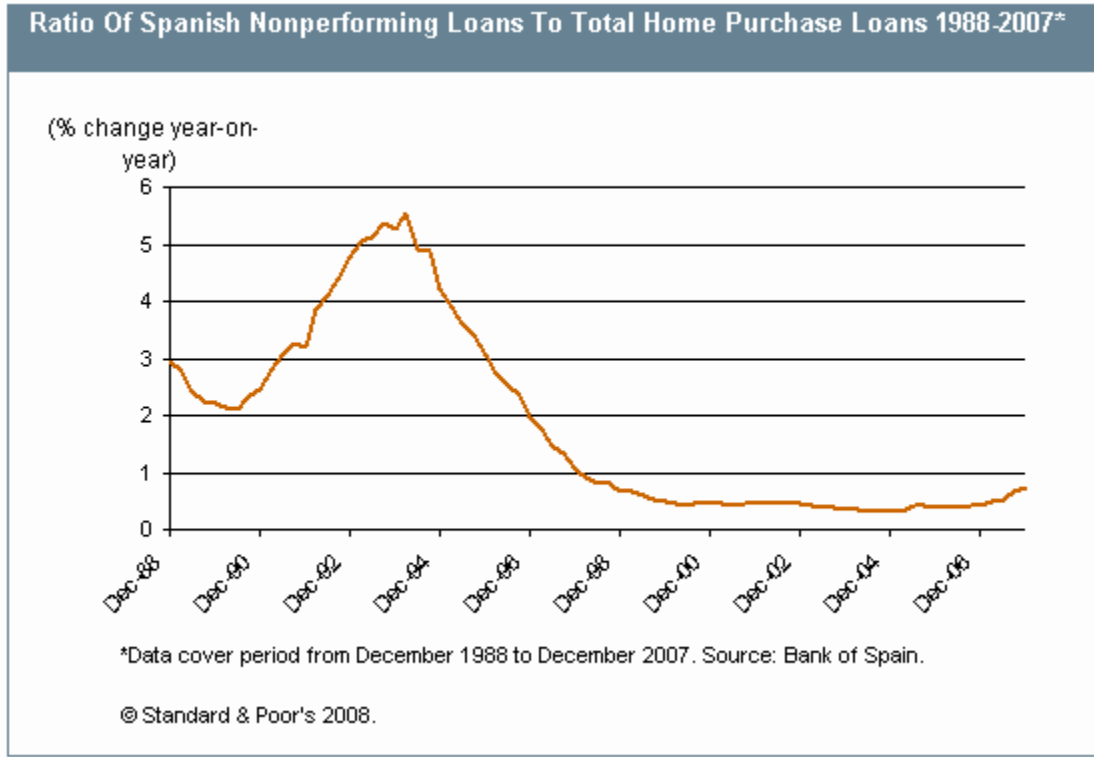
The average number of housing starts in Spain over recent years totals 700,000 per year. Yet the population has only been rising by about 600,000 per year. Even allowing for some catch-up earlier this decade, the supply of dwellings has clearly outpaced demand (and obviously not every new addition to the total population requires a new home). Furthermore, U.N. projections indicate a slowdown in population growth in coming years, to about 500,000 per year.

These developments in the residential real estate market are particularly worrisome given that the Spanish economy is heavily dependent on growth in its construction sector. Housing investment amounted to 10% of GDP last year. Before the current housing crash, the equivalent figure in the U.S. was 6.5%. One in five jobs created since 2000 in Spain is in construction. It therefore seems likely that housing investment will experience a major cutback in the next 12 to 18 months. A decline of 20% would simply bring it back in line with overall demographic trends. But experience suggests that after a prolonged boom, the pendulum can swing way over to the other side, presaging a larger fall. Equally, we expect house price inflation to turn negative this year and in 2009, in a 0% to negative 5% range each year.

In the previous real estate market slump of the early 1990s, defaults on housing loans increased markedly, to a peak of 5.5% in March 1994 from a low of 2.1% in June 1990 (see chart 5). Since then, default rates have stayed consistently below 1.0%. The average default rate increased somewhat in 2007, to 0.73% in December from 0.43% a year earlier. Further increases are likely this year, although the default rate should remain below the levels of the

early 1990s.

Chart 5



The Celtic Tiger Stops Dead In Its Tracks

The latest data on the Irish housing market for January 2008 shows a yearly price decline of 8%, while the growth in housing loans has also eased substantially (see chart 6). House price inflation has been negative in Ireland since the middle of last year, the residential real estate market easing in early 2007 after years of rapid growth.

Chart 6



Current real estate market conditions largely reflect the potent combination of elevated house prices and higher mortgage rates. The latter--5.34% on average in December 2007, up from 4.81% a year earlier--are particularly significant in a country where most mortgages (76% of the total in 2007) are at variable rates. Ireland joins Spain, Portugal, and The Netherlands as an economy with one of the highest levels of household debt in the Eurozone: 175% of disposable incomes in 2007, compared with 164% a year earlier.

The Irish construction sector is reflecting these conditions. After a record 88,000 homes built in 2006, the corresponding number for last year was about 75,000. Looking forward, housing completions should continue to decline in 2008-2009 to about 50,000 a year.

At the same time, affordability for first-time buyers is slowly improving, which will support market activity in the longer term. Evidence of this improvement can be found in the housing affordability index computed by DKM, a consultancy firm, and published by the Irish Property Buyer magazine. The index ticked up in 2007 due to the decline in house prices, the doubling of mortgage interest relief from January 2007, and the increase in household disposable incomes (5% in 2007). Mortgage repayments amounted to 22.6% of net incomes on average in December 2007, compared with 26.4% a year earlier. Further increases in mortgage interest relief this year and increases in tax credits and tax bands should improve the index even more this year.

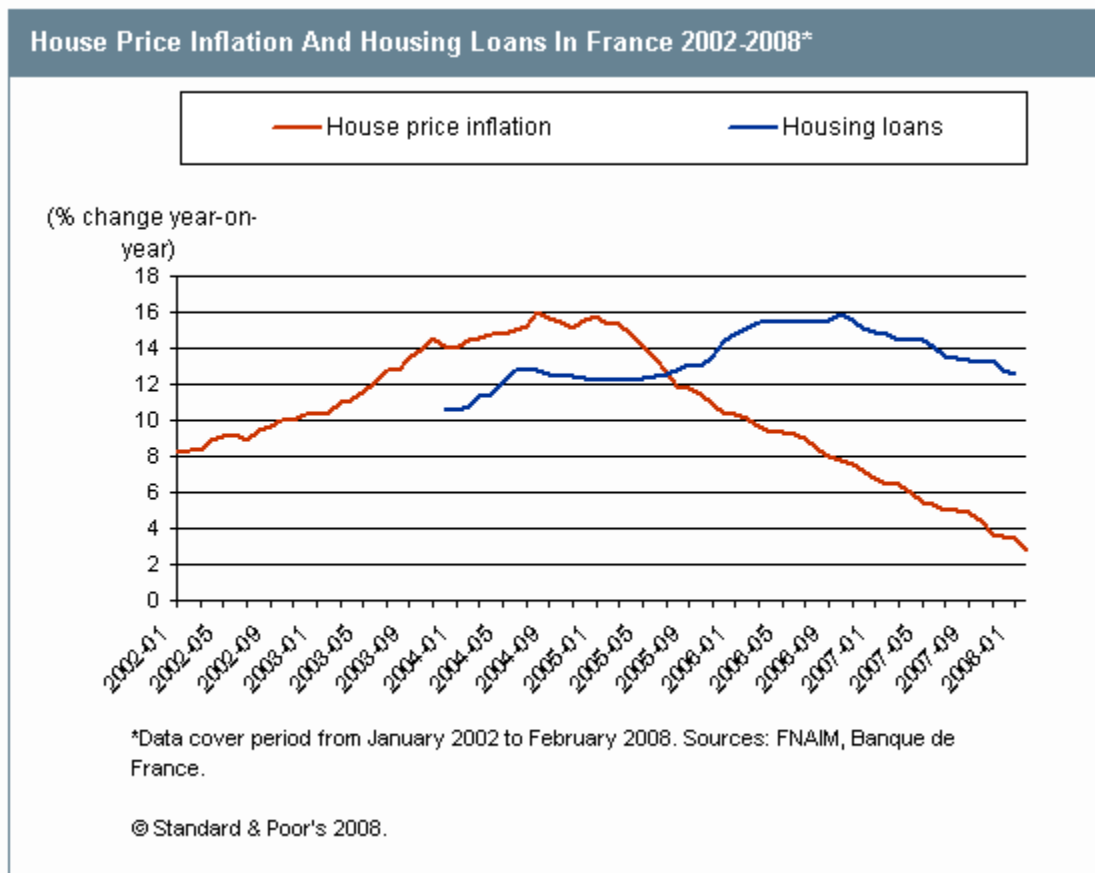
Even so, the current downturn will extend well into 2009. We expect house prices to decline by about 6% this year,

and stay approximately flat in 2009. This extended and sharp correction in the housing market will weigh heavily on construction activity, causing a deep slowdown in overall economic growth in 2008. The construction sector currently accounts for almost one-quarter of gross national output and employs about 13% of the workforce. So a sharp and rapid slowdown in the sector will have major knock-on effects. We forecast that GDP growth will average 2.3% in 2008 and 2.9% next year. This is less than one-half the 7.4% average annual growth rate enjoyed by the "Celtic Tiger" in the 13 years spanning 1994-2006.

A Benign Outlook For Housing In France

According to calculations from the Organization for Economic Cooperation and Development, nominal house prices in France rose 208% between 2000 and the third quarter of 2007--far more than in the U.S. (166%), but less than in Spain (242%). Yet the French real estate market started to ease back at the end of 2006, house price inflation declining to 3.6% in the 12 months to December 2007 (7.2% a year earlier). The decline was even more pronounced in the fourth quarter of last year, with price inflation back to its 1995-1999 annual average of about 3.0% (see chart 7).

Chart 7



In 2007, interest rates on housing loans increased by an average of 90 basis points (bps), to 4.70% for 20-year loans and 4.80% for 25-year loans. Higher borrowing costs, along with a deterioration in consumer sentiment throughout

the year, contributed to the market easing. On the supply side, housing starts surged from 316,000 (annualized) in mid-2003 to a peak of 443,000 in September 2006. They have remained resiliently in the range of 410,000-430,000 since then, suggesting that the balance between supply and demand will continue to improve.

We hold a rather benign view on the outlook for the French housing market in the medium term, and for several reasons. First, there is a relatively low level of indebtedness in French households (47% of GDP in the third quarter of 2007, compared with 59% in the Eurozone, and 97% in the U.K.). This implies that households are relatively less exposed to the current financial crisis and have more breathing space in terms of house price increases and affordability. Second, we expect that the French economy as a whole will continue to enjoy mild and steady growth this year and next (1.5% to 1.8% GDP growth), largely because of resilient consumer demand and corporate investment. Crucially, unemployment will continue to decline, albeit at a slower pace, to 7.0% at the end of 2009 from 7.5% in the final quarter of 2007. Third, the new fiscal incentives adopted in 2008 will provide some help to the housing market. In essence, the new measures reduce the interest burden for borrowers by an average of 25% over five years (after five years, interest payments are no longer deductible), with a front-loaded effect of 40% in the first year. Calculations made by FNAIM, the French association of realtors, suggest that those fiscal incentives will reduce the average ratio of mortgage payments to incomes by 7.0 points in the first year, and 3.5 points in the next four years.

That said, the French real estate market is unlikely to return to the heady rates of growth seen earlier this decade. Rather, we expect house price inflation to return to its mid-1990s average of about 3% in the medium term, after a year of flat to slightly declining prices in 2008.

Main European Economic Indicators						
Real GDP (% change)	Germany	France	Italy	Spain	U.K.	Eurozone
2007	2.5	1.9	1.5	3.8	3.1	2.7
2008e	1.8	1.6	0.7	1.8	1.5	1.7
2009f	2.0	1.9	1.2	1.6	2.1	2.0
CPI inflation (%)						
2007	2.0	1.5	1.8	2.7	2.3	2.2
2008e	2.2	2.3	2.6	3.4	2.3	2.7
2009f	1.9	2.0	2.0	2.5	1.9	2.0
Unemployment rate (%)						
2007	8.8	8.3	6.0	7.8	5.0	7.4
2008e	8.4	7.8	6.2	8.3	5.3	7.1
2009f	7.0	7.6	6.0	8.0	5.0	7.1

f--Forecast. e--Estimate.

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