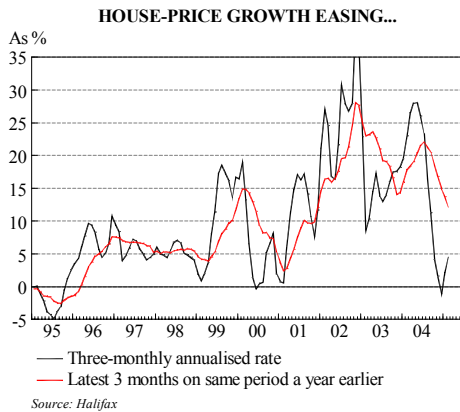


## PROGRESS REPORT ON THE UK HOUSING MARKET

- After a sudden jolt in the second half of 2004, the UK housing market stabilised at the turn of this year. A resilient labour market and relatively high level of consumer confidence have continued to support house prices.
- However, we do not expect any new pick-up in property inflation. The current mortgage approval level suggests a further slowdown in house price rises over the months ahead. Several other factors will also hinder price increases: some homes are now unaffordable to many people (first-time buyers in particular); lending conditions have tightened; supply is gradually adjusting to previous high demand.
- The most likely scenario remains that of a consolidation lasting several years, which would allow prices to fall into line with the fundamentals and risk premiums to gradually build up again.
- This optimistic scenario has one obvious drawback: in the past, a surge in house prices had always been followed by a sharp fall. Several risk scenarios – recessionary or, inversely, inflationary – that would lead to a crash are plausible, but the likelihood of them materialising is still fairly low.

### Much slower house-price inflation

The Bank of England's five rate increases between November 2003 and August 2004 bucked the trend in house prices. These were up 25% annualised in the spring of 2004 but had stopped rising by the end of the year. And the number of sales was well down: -25% yoy in the fourth quarter in England according to Land Registry data.



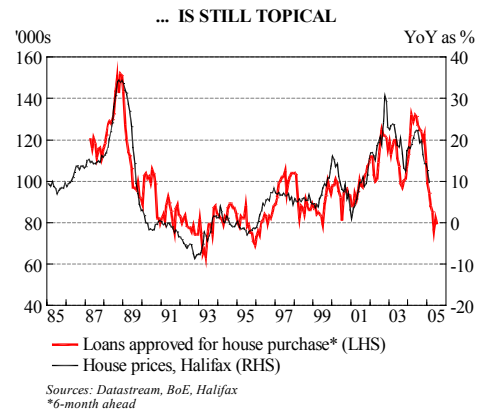
Nevertheless, the biggest mortgage lending institutions (Halifax, Nationwide) reported a stabilisation in housing activity at the turn of the year. According to the Halifax, prices fell 0.5% mom in February after increases of 1.4% in December and 0.7% in January. So monthly fluctuations did occur, but on the whole it would appear that price growth steadied at an annualised rate between 3% and 5% at the start of 2005. At the same time, the number of sales stopped falling: the Halifax reported that its estate agents noted the first increase in monthly sales for six months in January, and that this trend continued in February.

The stabilisation of the property market raises two types of question. The first is whether we are heading for a resurgence of house-price inflation and the second, linked to the first, relates to the increased probability that the Bank of England will raise interest rates again.

### Renewed property inflation is unlikely in the short term...

We doubt whether there will be a fresh surge in prices with all the risks that this would entail: if valuations were to drift further out of line with the fundamentals, the future adjustment would be even more painful.

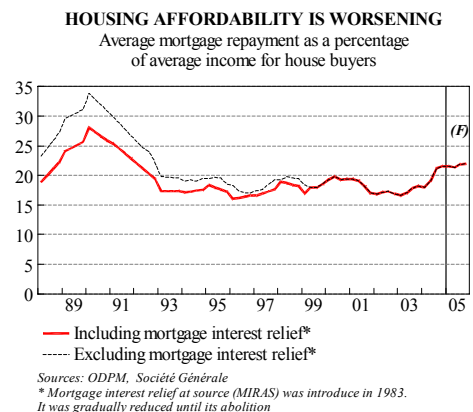
In the short term, the slowdown in credit growth resulting from the series of rate increases will probably continue to make itself felt. If the correlation between mortgage approvals and house-price inflation holds true, the average price of a home at the end of the first half of 2005 is unlikely to be much higher than it was a year earlier.



### ...or the medium term

By the beginning of the summer, the effect of past interest rate hikes – the last of which came in August 2004 – should have exerted most of their influence, hence the fear of seeing credit growth stabilise at a persistently high level and house prices take off again. However, we think other factors will combine with higher interest rates to weigh on house prices.

### 1/ No improvement in housing affordability



The rise in interest rates and leap in house prices seriously dented borrowers' ability to repay the loan in 2004. Calculated using ODPM data, this stands above its long-term trend but is well below the peak of 1990. The Halifax and Nationwide have made a similar calculation and drawn the same conclusion.

The worsening housing affordability has closed the market to some potential buyers, especially first-time buyers. These now account for just one third of borrowers, compared with a long-term average of nearly one half.

Mortgage lending rates should remain fairly stable in 2005 and are therefore unlikely to damage solvency further. Nonetheless with a slight increase in house prices household solvency will stay at the poor level of late 2004, despite the steady rise in income. Prices themselves are now an important factor in helping the market find its equilibrium.

### 2/ Tighter lending conditions

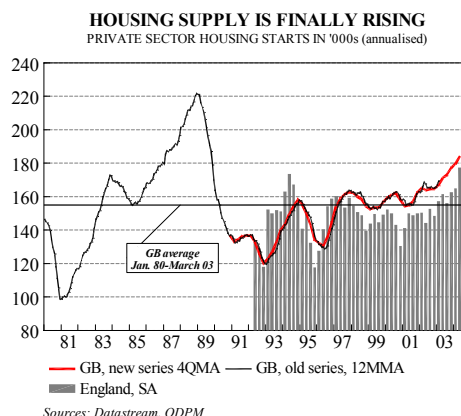
The quality of credit issued to UK households remains excellent. Mortgage arrears dropped to historical lows in 2004: 0.8% of the total outstanding, compared with a peak of 4% in 1994. However, the first signs of deterioration – albeit from these extremely low levels – were noted in the second half of 2004 with an increase in short-term arrears. Arrears of three to six months were up by more than 8%, from 49,700 in H1 to 53,960 at the end of the year<sup>1</sup>. The Council of Mortgage Lenders is expecting the increase in short-term arrears to continue at a modest pace; it also feels that this will involve a greater number of people falling into arrears of more than six months and that this will eventually lead to more repossessions<sup>1</sup>. Although the risk environment remains favourable, some credit establishments have already tightened their lending conditions. One such example is the Halifax Bank of Scotland (HBOS), which, in the publication of its results on March 2nd, announced that its share of the new mortgage market had fallen from 25% to 17%. This was presented as the direct consequence of measures taken to tighten lending conditions with, in particular, a reduced loan-to-value ratio<sup>2</sup>.

We think banks will be a little stricter with borrowers by being more selective: lower LTV ratio, using different rates of interest depending on the customer, etc. The scale of current mortgage debt – around 110% of disposable income at the end of 2004 – and the further increase in the number of bankruptcies and personal insolvencies<sup>3</sup> will also encourage lending institutions to be prudent and to stop using a higher volume of lending to offset the pressure stiffer competition is exerting on their margins.

### 3/ Supply is gradually adapting to past demand

One of the structural causes put forward to explain the leap in house prices was the low level of new homes in proportion to the increase in the number of households. The Barker report (Review of Housing Supply, HMSO, March 2004) diagnosed the lack of supply and its failure to respond to the rise in prices. The study included a list of recommendations.

However, it should be noted that the construction rate of new homes has accelerated swiftly over the past two years. This trend is likely to continue in 2005 and although it will not be enough to fill the structural gap between supply and demand, it will help limit house-price inflation.



All things considered, we are expecting supply and demand to rebalance to some degree, easing tension on prices. Demand will fade in response to the loss of buyer solvency caused by more restrictive lending conditions, while supply will improve with an acceleration in the rate of construction.

### ***Our central scenario remains that of a soft landing***

All in all, our conclusion is not so different from the one we drew in May 2004 (*A brutal adjustment to the property markets is unlikely in the next 12 months*, Monthly Report, May 2004), namely that the most likely scenario is one of a consolidation (stagnation or minimal change in prices) lasting several years – a bit like the situation in the Netherlands since 2001. This would enable prices to fall back into line with the fundamentals and risk premiums to slowly build up again.

At a macroeconomic level, individuals would lose the benefits of wealth effects that encouraged consumer spending in recent years, although this would not be too serious as we are expecting the purchasing power of gross disposable income to continue improving. In terms of monetary policy, the confirmation of a soft landing for the property market could, by helping to ease the downside risks to the economy, prompt the BoE to raise its repo rate again (see the section on pages 10-11. Another 25bp rate hike would not damage household solvency to the point of undermining our scenario.

This optimistic scenario has just one – albeit potentially major – drawback: a past surge in house prices has always been followed by a sharp correction. As such, it is worth going back over the two types of risk to our forecasts: 1/ a recessionary shock affecting households in particular (employment, income, confidence). A significant appreciation of the pound or further jump in oil prices may see this risk materialise by pushing up unemployment; 2/ a sharper-than-expected rise in inflation, which may happen if the UK economy overheats (extremely tight labour market with rapid wage growth) or oil prices continue soaring, with a 1994-style bond crash and a new monetary tightening cycle at stake. For the moment, we feel the probability of any such scenarios arising is relatively low.

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<sup>1</sup> See *Repossession Risk Review*, Council of Mortgage Lenders, January 2005.

[http://www.cml.org.uk/servlet/dycon/zt-cml/cml/live/en/cml/pdf\\_pub\\_mcomm\\_RRR.pdf](http://www.cml.org.uk/servlet/dycon/zt-cml/cml/live/en/cml/pdf_pub_mcomm_RRR.pdf)

<sup>2</sup> HBOS intends to uphold this restrictive policy in 2005, and is aiming for market share of between 15% and 20% for new mortgages. Of note: in terms of outstanding mortgage debt, HBOS is the runaway leader with a total market share of 22.5% in 2003.

<sup>3</sup> The rise in the number of insolvencies – and the fact that this has risen above the level of the early 1990s – certainly results from legal changes but, as the BoE highlighted in its last inflation report, it also reflects a real uptrend in personal insolvencies, especially as there is a similar situation in Scotland where there have been no legal changes.

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