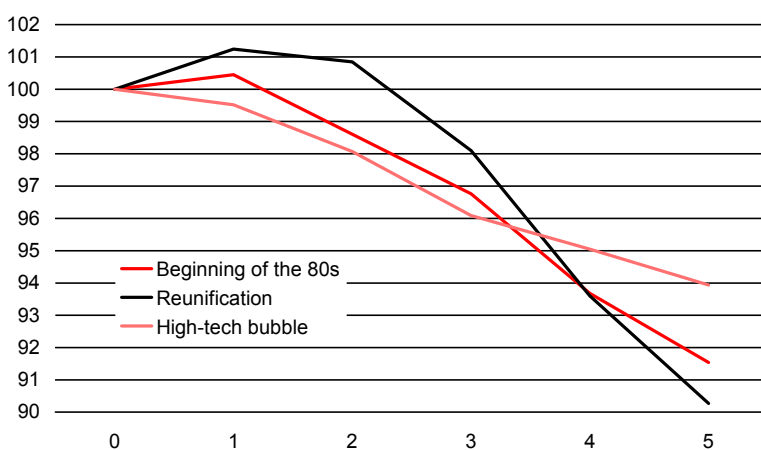


The German housing market probably won't escape unscathed

- The German housing market did not participate in the recent global price boom. Even though it does not have to contend with the bursting of a bubble, near-term home price data has also been pointing south recently for Germany. Is there now the threat of a similarly strong correction as in other countries?
- German home prices have increased much less strongly than household incomes in the past decade. Nevertheless, home affordability has remained relatively subdued to date. In an international comparison, absolute home prices in Germany were rather high for a long period in the past.
- Our model estimates point - based on household incomes and construction prices - to a perceptible but not drastic undervaluation of residential properties of close to 5%. In fact, home prices therefore even have upside potential overall.
- Despite persistently low new construction activity, there is, however, unlikely to be a general increase in price pressure, not least because of the negative demographic development. The competitive rental market and the relatively elastic supply of homes are also of help here.
- Furthermore, in the short term there is a prevailing negative cyclical factor: the labor market. In the last pronounced recessions, home prices regularly fell substantially in the wake of the labor market downswing, by at least 5% in real terms in a period of 5 years (cf. chart).

LABOR MARKET INFLUENCES DEMAND FOR HOMES

Real home prices after trend reversal on the labor market



Source: Federal Statistical Office, Bulwien, UniCredit Research

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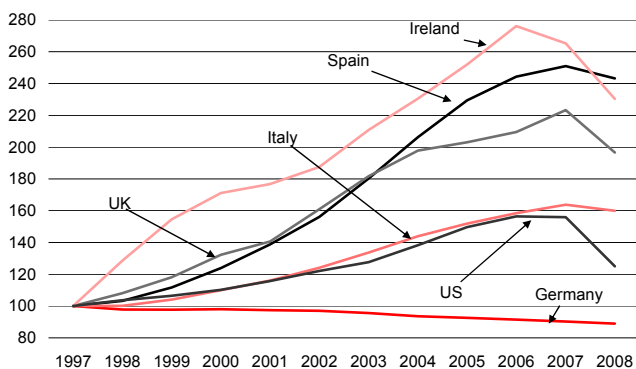
Price decline, even without price bubble

The global housing boom has run out of steam since the outbreak of the subprime crisis in the US. The countries that participated particularly strongly in the exceptional upswing in home prices in the past decade have recently seen home prices plummet across the board. A correction similar to that in the US can also be observed currently in, for example, Ireland and the United Kingdom. Also Spain has seen the downward momentum in home prices accelerate further recently. Germany was, in contrast, one of the few exceptions. Here real home prices have been trending down during the last ten years (cf. chart). Accordingly, Germany is currently not being confronted directly with the bursting of a price bubble and its negative ramifications.

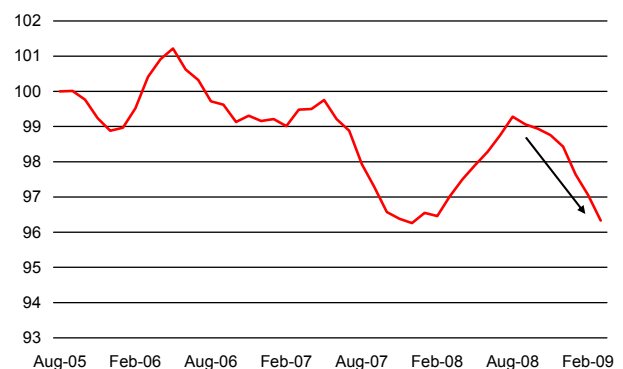
Nevertheless, home prices in Germany have also fallen recently. The Hypoport Home Price Index (HPX-hedonic), which is based on intermediated mortgages, has fallen 3% since last summer – driven by falling prices for existing homes (cf. chart). Unfortunately, there is as yet no generally recognized price index for the German housing market. And the data available from the OECD, the Bundesbank, Bulwien and Hypoport show, in some cases, diverging price developments in the short term. To be in a position to better assess the plausibility of the recent weakness of the near-time HPX, we therefore analyze in the following some important factors for the German housing market.

END OF THE GLOBAL HOUSING BOOM

Real home prices, index (1997 = 100)



HPX-hedonic, total, index (August 2005 = 100)



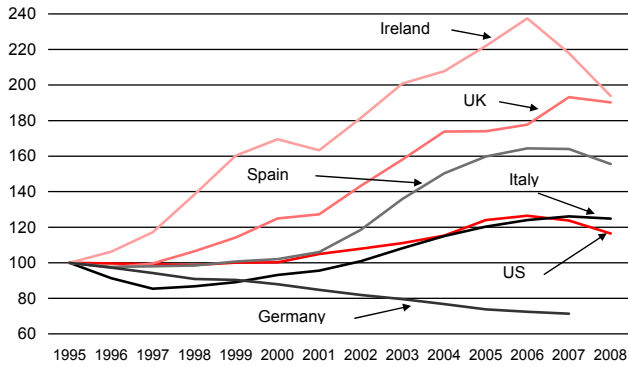
Source: OECD, Hypoport, Bulwien, UniCredit Research

Affordability has improved, but not above average

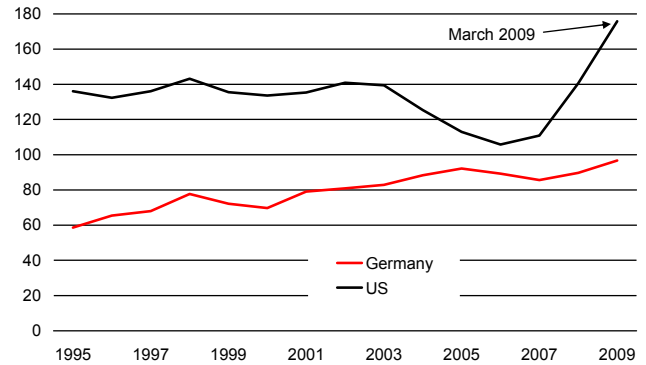
The protracted dry patch for German home prices begs the question whether and to what extent home ownership is undervalued based on economic factors. The closely-monitored OECD Price-Income Index shows for Germany - in contrast to most other countries – a pronounced negative deviation from the long-term average (cf. chart on the next page). That means that home prices have strongly underperformed disposable incomes. The price-income ratio is, however, merely a rough indicator that does not reveal a reliable, long-term equilibrium. Furthermore, the equilibrium is subject to enormous fluctuations over time and is in the process impacted significantly by additional factors. Factoring in additional key fundamental data can produce an entirely different picture in terms of over- or under-valuation.

UNDERVALUED OR OVERVALUED?

Home price-income ratio, index (1995=100)



UniCredit Affordability index



Source: Eurostat, OECD, Feri, LBS Research, UniCredit Research

METHODOLOGY OF THE HOME AFFORDABILITY INDEX

Our index is based in principle on the methodology of the US National Association of Realtors. It measures whether a typical household could qualify for a mortgage on a typical home. For our index, we define a typical home as an existing single-family home at an average national price. Income is defined as the harmonized disposable per-capita income published by Eurostat. The applicable mortgage rates are the effective mortgage rate on new mortgages published by the ECB for the member countries. Based on these variables, we calculate whether the average income is sufficient for a mortgage on a typical home.

The calculation presupposes that the monthly mortgage payment (redemption and interest) does not exceed 50 percent of average disposable income. The assumed equity in the mortgage financing is 30% of the home price.

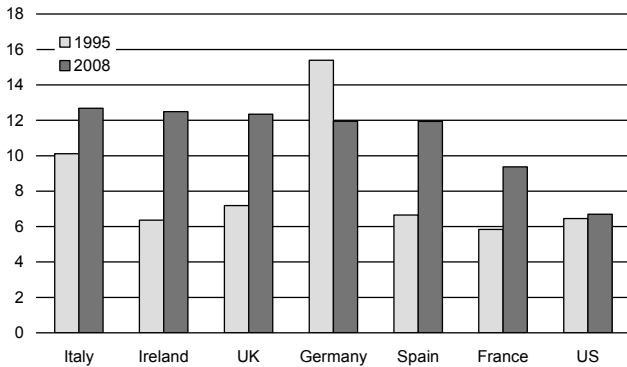
Interpretation of the indices: A reading of 100 means that a potential home buyer with an average income earns just enough to qualify for a mortgage on a typical home for an average price. An index reading above 100 means that a potential home buyer with an average income earns more than enough to qualify for a mortgage. An affordability index reading of 110 means, for example, that a potential home buyer with an average income has at his disposal 110 percent of the income that would be required to obtain a mortgage for 70% of the price of an existing single-family home. The higher the affordability index, the easier it is for the average home buyer to afford an average-priced single-family home.

In this context, we have calculated an affordability index for the purchase of a home. The index is based on annual data since 1995 and attempts to determine whether a typical home buyer can qualify for a mortgage on a typical home (see also box). Alongside the relative dynamic of home prices and incomes, the affordability index is, therefore, based on the absolute level of home prices and financing conditions for home buyers and builders. Even though the indicator for Germany has improved strongly since the middle of the past decade, it nevertheless remains just below the threshold of 100. For the US, for example, the index currently shows a much higher reading of almost 180 (cf. chart above). The perhaps surprisingly low level of the German affordability index at first glance reflects the fact that the absolute home price level in Germany¹ was well above average before the latest global home price boom. In 2008, prices of an average home in Germany ranked mid-field in relation to per-capita income compared to other important real estate markets (cf. chart on the next page). Similar to Ireland, Spain or the United Kingdom, an average of roughly 12 times annual per-capita income is required to purchase a home. It cannot, therefore, be simply assumed that German residential real estate is strongly undervalued.

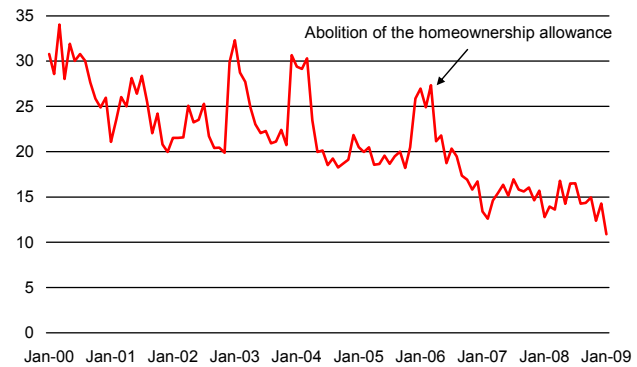
¹ Determining a representative average for the absolute value of an average home is rather complicated. The calculations of market players vary in some cases considerably, and can, therefore, have a very strong impact on the affordability index. The UniCredit affordability index factors in a selection of market valuations.

ABSOLUTE PRICE FOR GERMAN RESIDENTIAL REAL ESTATE IN LINE WITH THE INTERNATIONAL AVERAGE

Absolute home price-income ratio



Building permits in thousands



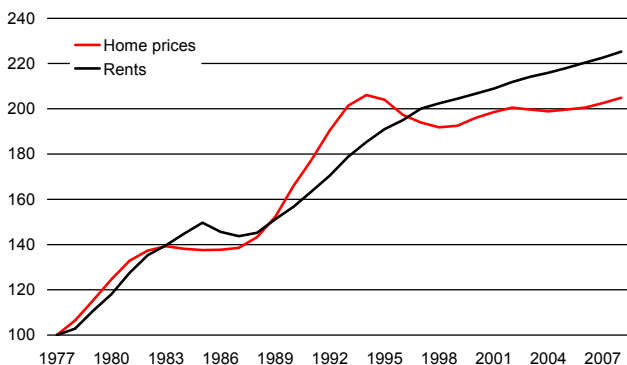
Source: Federal Statistical Office, Eurostat, OECD, LBS Research, national banks, UniCredit Research

Low new construction activity

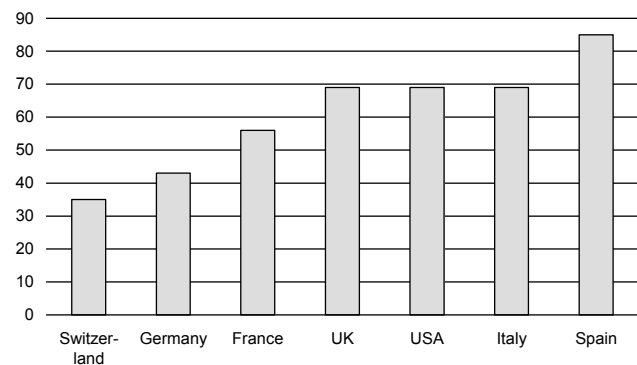
Residential construction activity has remained at a low level recently, after the abolition of the homestead exemption at the turn of 2005/06 had temporarily boosted building permits (cf. chart above). Even though the German government has now also expanded the Riester pension plan to include the purchase of a home, perceptible positive effects for the housing market have not emerged from this side. Many experts think the current level of home completions is clearly too low to satisfy demand over the medium term. Could we, therefore, see price pressure in the short term from the supply side? While certain bottlenecks cannot be ruled out – primarily in and around some big cities – analyses conducted by the Deutsche Bundesbank show that the supply side in Germany has been relatively elastic in the past. As a rule, the supply adjusts to demand in a timely manner and therefore helps to cushion price fluctuations. The broad rental market also functions in the same way. In an international comparison, Germany has a relatively low home ownership ratio of just over 40% - compared to the United Kingdom and the USA with almost 70%, or Spain with over 80% (cf. chart).

COMPETITIVE RENTAL HOUSING MARKET IN GERMANY

Index (1977=100)



Home ownership ratio in %



Source: Bulwien, Federal Statistical Office, Eurostat, US Census Bureau, UniCredit Research

The well functioning "competition" between the rental and home ownership markets tends to help prevent strong imbalances. In contrast to the boom countries, home prices and rents in Germany have developed relatively synchronously (cf. chart on the previous page). The rent yield has, in contrast to almost all other markets, improved considerably in the past decade. This development does, however, also reflect the strongly diverging regional risks of the German housing market. Persistently higher vacancy rates in East Germany and the negative demographic development there have, accordingly, triggered an increase in the risk premium and rent yield in East Germany.

Muted potential demand

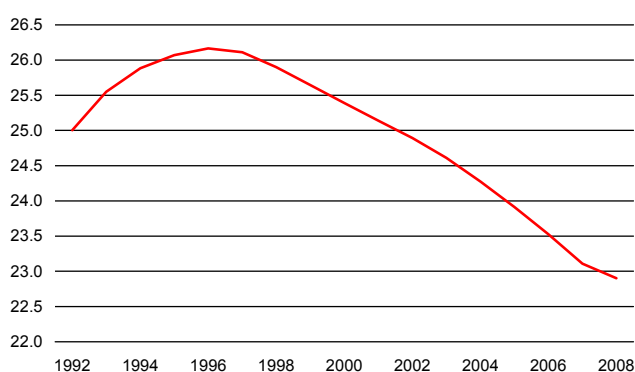
Furthermore, the development of potential housing demand also argues against strong price movements. The population in the 25-44 year age bracket – typically the range for potential home builders or buyers – has already been declining for over a decade (cf. chart). While the trend to smaller households has recently still helped to stabilize the demand for homes, a rapid dismantling of a high demand overhang is not probable overall – compared to other countries, such as Spain, where growth rates of the population at the age when they typically set up a household remain high.

Stabilization of construction prices

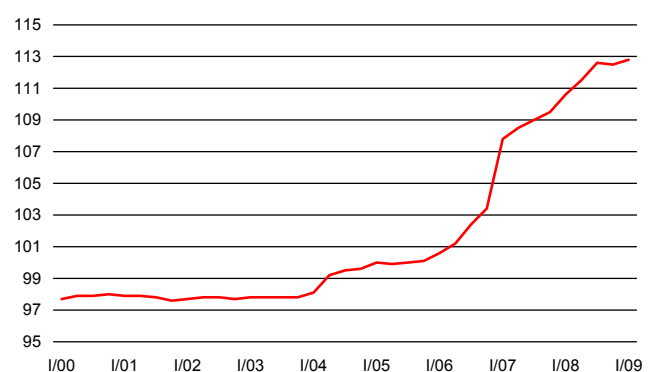
Above and beyond that, construction prices have stabilized recently. The rapid rise in raw material prices during the past boom phase of the global economy has also seen the costs of building a home spike temporarily since 2006 (cf. chart). This was also a key reason for a temporary substantial increase in nominal home prices for new construction in Germany. Prices of existing homes, in contrast, continued to decline. An additional negative factor here should have been the growing appeal of energy-efficient buildings, which depresses the value of older existing homes. Since the middle of last year, construction prices have stabilized and moved broadly sideways recently.

DAMPENING EFFECT OF DEMOGRAPHICS AND CONSTRUCTION PRICES

Population at the age when a household is created in mn



Construction prices, index



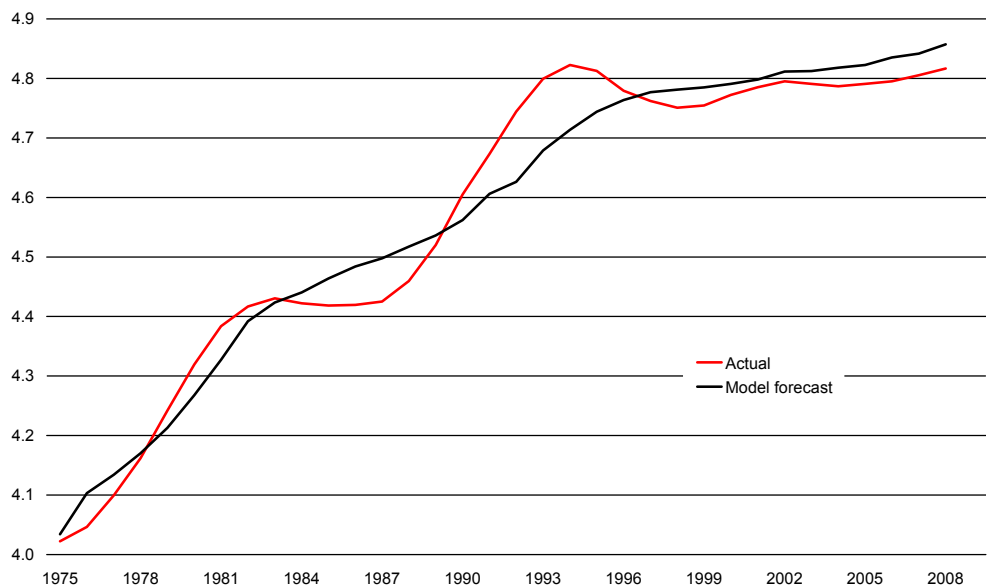
Source: Federal Statistical Office, UniCredit Research

Model shows moderate undervaluation

The uncertain data situation for the German housing market makes quantitative analyses difficult. Nevertheless, using the annual data available since 1975, the long-term trend of German home prices can be shown relatively well in a co-integration relationship. In our estimate we use disposable incomes at the household level together with construction prices (by far the most important cost factor for the construction of a new home) to calculate the so-called "fair" value for homes. Both explaining variables have a similarly strong impact on the price trend on the housing market. In the short or even medium term, home prices can fluctuate around the stated trends, but these deviations are eliminated over time and prices return to the equilibrium path (error correction mechanism). Our model results support the preceding qualitative analysis. At the moment, they show no drastic but nevertheless a perceptible undervaluation of home prices of close to 5% (cf. chart).

HOME PRICES BELOW "FAIR" VALUE

Home prices, nominal, logarithmed



Source: Bulwien, Federal Statistical Office, UniCredit Research

Labor market as price brake

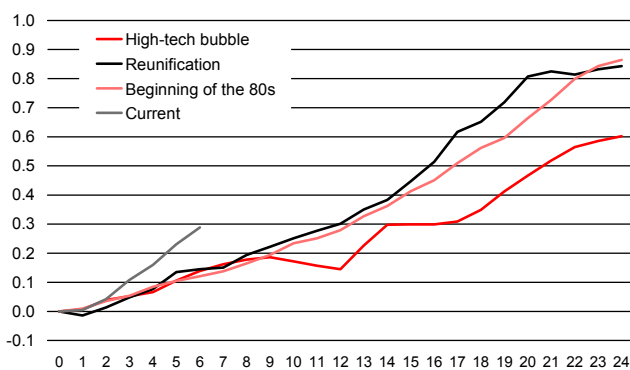
Even though our analysis so far suggests that home prices are undervalued, it would be unwise to hope for an increase this year or next. There is namely a further very important cyclical factor that can explain the recent weakness of the HPX and that will probably dictate the short-term trend: the labor market. Despite the intensive use of short-time work, adjusted unemployment has already jumped by close on 300k since October of last year, twice the rate in the comparable period of earlier pronounced recessions (cf. chart on the next page). And corporate hiring plans point to a still high adjustment requirement in headcounts until well into next year. The fall-off in demand for homes because of rising unemployment and high job insecurity has always triggered a perceptible negative trend in real home prices in the last three "large" recessions. In this environment, households become more cautious when deciding on whether to buy a home, and lending becomes tighter. Both depress demand in the housing market. Furthermore, rising unemployment increases the supply of properties on which mortgages can no longer be serviced, and they therefore have to be sold. Within five years after the trend reversal on the labor market, real home prices fell by a total of between

5-10% (cf. chart). The two phases with the strongest price declines (beginning of the 80s and reunification) were, however, preceded by an upward trend in home prices. This was, however, not the case when the high-tech bubble burst.

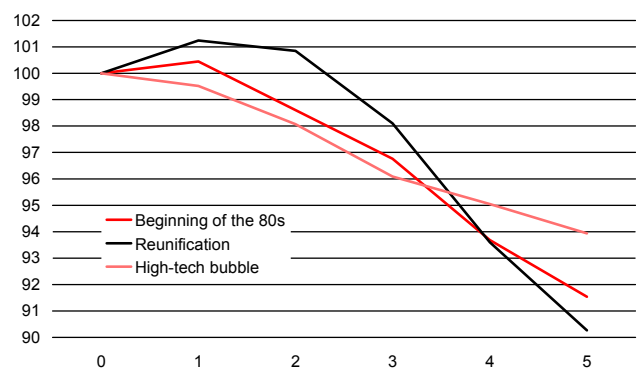
Even though the German housing market is not affected by a price bubble and, furthermore, shows signs of being undervalued, above all the labor market development argues in the short term for a continuation of the real loss of value in the German housing market – albeit by no means as pronounced as in other countries.

LABOR MARKET HAS A STRONG IMPACT ON DEMAND FOR HOMES

Cumulative increase in unemployment after the low in mn; x axis: months



Real home prices after trend reversal on the labor market; x axis: years



Source: Bulwien, Federal Statistical Office, UniCredit Research

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