Italy: The housing market recovery

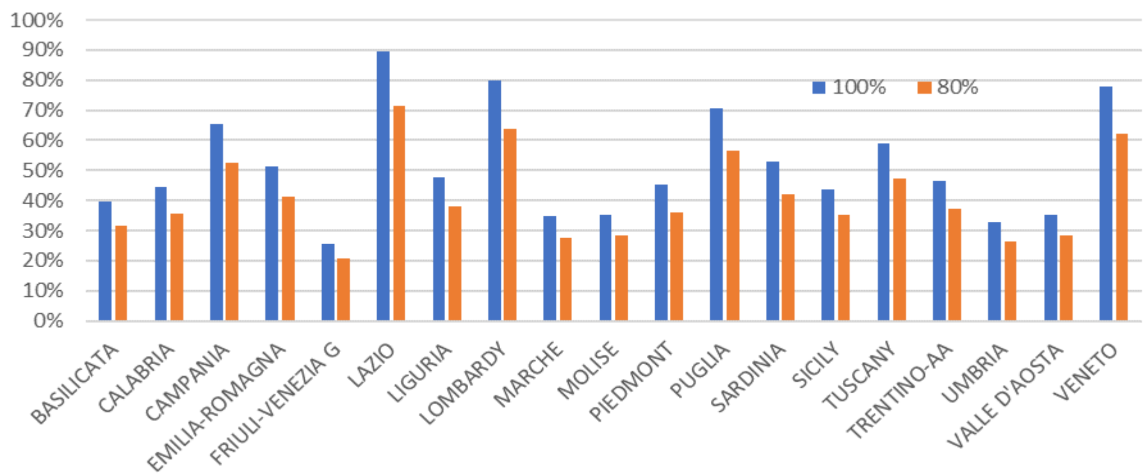
A first look at affordability

The housing market is reviving: transactions are up, price discounts are narrowing and the construction sector's expectations have risen. Historically low borrowing costs have improved the affordability of mortgages, and we expect demand to strengthen further. However, weak consumer confidence is an important barometer for illustrating that Italy's potential growth is stuck at zero and, without improvements, no housing recovery can be genuinely sustainable.

The housing market began a timid recovery in 2014, which is now evident across indicators. Transactions for residential and commercial have picked up, close to the 2010 levels. Construction sentiment has recovered across the board: both hiring intentions and price expectations are creeping up slowly. The Bank of Italy real estate survey suggests that liquidity in the residential market has improved, with an average time of sale of "only" seven months versus the peak of over 10 months seven years ago. The majority of flats are still being sold at a discount of around 12% over the asking price, but this cut has become narrower and the share of those that manage to sell has improved.

The Italian economy is on a cyclical upswing – our recent visit to the country highlighted expectations for real GDP growth north of 1.5% this year and 1% in 2018. The ECB is turning mildly hawkish, but retail borrowing costs are likely to stay exceptionally low for a while longer, so it is a good time to get a first look at the affordability of houses.

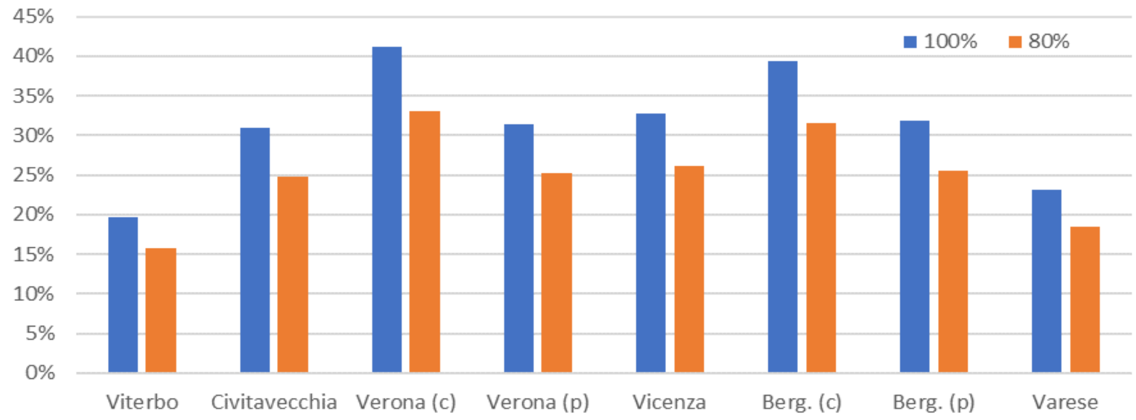
Debt servicing costs for a 60sqm flat in the regional capitals



Source: Agenzia delle Entrate, Istat, ADA Economics Ltd. Debt servicing costs measured by repayment of principal and interest for a 20 year mortgage at 2.1% divided by the estimate of regional disposable incomes, estimates for 2016. Estimates showing for a 100% loan to value mortgage and for an 80% one.

We took the estimates of the cost per square metre from the Revenue Agency of the regional capitals, and we calculated the average cost of 60 and 80 square metre (sqm) apartments across the country. Over 73% of Italians own their own homes, but currently 80% of housing transactions are funded with a mortgage, so we calculated both the price to income and debt servicing ratios for an average new mortgage of 20 years, underwritten at the prevailing interest rate of 2.1%.

Debt servicing costs down significantly in the smaller cities



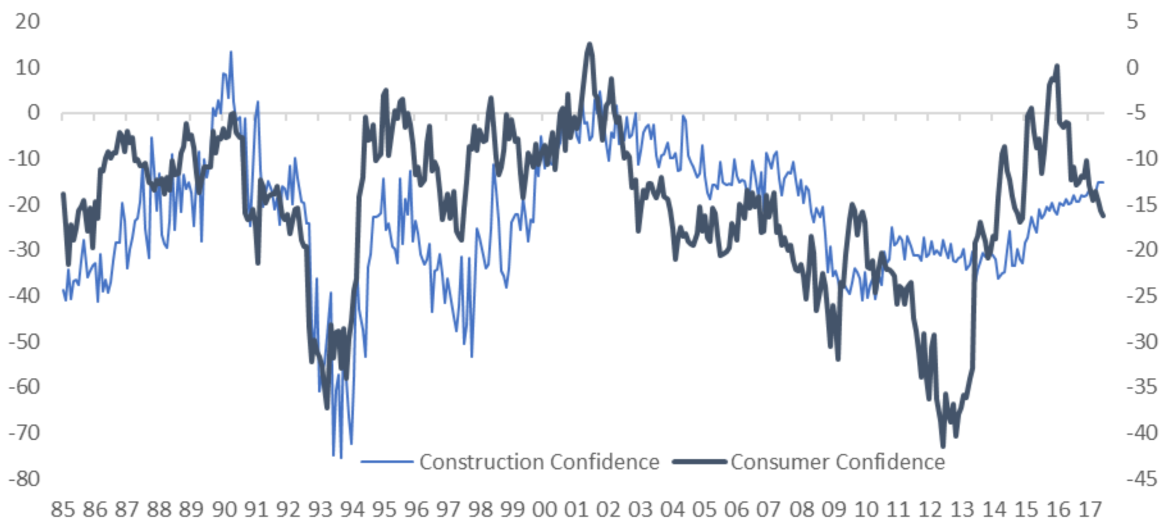
Source: Agenzia delle Entrate, Istat, ADA Economics Ltd.

The result of our calculations is that, whilst more affordable than in the past, the market is still rather expensive if we take a 100% mortgage, and especially for “large” apartments of 80sqm. Three important caveats should be highlighted: first, valuations in smaller towns can be half what we observe in the regional capitals and there is a significant price discount for areas slightly away from the centre even for the main cities. This point is illustrated in the chart above, where we show the same debt servicing ratios for a 60sqm flat for smaller cities in the most expensive regions: Lombardy (Varese, Bergamo), Lazio (Civitavecchia, Viterbo) and Veneto (Verona is showing above both for the centre (c) and semi-peripheral areas (p)). Secondly, affordability would improve for families with two wage earners, although we do not believe this factor is that common in Italy, given the still low labour participation of women.

Last, but not least, the Bank of Italy is guiding the banks to keep an 80% loan to value ratio and, indeed, the average mortgage is taken out with a ratio of 73% currently. Reworking our calculations assuming a 20% deposit shows an average loan to income ratio of just under 7x and an average debt servicing cost of 40% for the regional capitals: so, not cheap, but not dissimilar from what is observable in central Europe these days.

To us, the economic recovery and attractive borrowing costs suggest that the housing market is likely to maintain its current recovery trajectory in the coming year. That said, in our view, in the long run, no housing recovery can be genuinely sustainable if the potential growth of an economy is stuck at zero – as is the case for Italy – and, thus, the risk that average wages compress further significantly in the coming years. That consumer confidence has been falling for over a year is symptomatic of the improvement in GDP not yet being enough to genuinely improve citizens' well-being. In addition, there are pockets of particularly expensive areas – such as Lombardy, Veneto and Lazio – which are likely to benefit from the recovery (and the Brexit fallout in the case of Milan) but, given the already fairly high valuations for the regional cities, these areas raise questions about the risk of overvaluation in the coming years.

Construction confidence up, but consumer sentiment down



Source: Macrobond, ADA Economics Ltd. Note: consumer confidence showing on the RHS

Raffaella Tenconi, 11th July 2017

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