Residential property derivatives – should we listen?

- The recent improvement in economic sentiment has been reflected in a shift in residential property derivative pricing. However, while we agree that house price declines in 2009 and 2010 will be smaller than previously expected, we suspect that the implied outlook for 2011 is too sanguine.

- The house price correction has given the residential property derivatives market a strong platform from which to grow as institutional investors and developers have looked to hedge their property exposure, while speculators have looked to profit from the falling market without being directly involved in physical real estate. However, despite this growth, the property derivatives market is still thin, so pricing signals need to be interpreted with care.

- Unlike commercial property derivatives which are concentrated on swaps, in the residential property market, the focus is on forwards on the Halifax house price index. The forward trade involves market participants going long (buy) or short (sell) the contract depending where they think the Halifax index will be at a given point in time. At maturity, the buyer (the seller) of the contract receives (pays) the difference, whether positive or negative, between the actual level of the index and that specified in the contract.

- How useful are derivatives as a predictive tool? In an ideal world, derivatives would offer an early warning of turning points in the wider market as derivative investors with direct exposure to the physical market react to developments on the ground before they are reflected in the published statistics. But, while there is little history on which to form a judgement on the residential property derivatives market, that does not seem to be the case.

- For example, according to Tullet Prebon, between December 2007 and July 2008, the forwards market moved from pricing in a 9% fall in house prices in 2008 to pricing in a decline of 17%. The eventual outturn was a 16% fall. However, the decline in forward prices over that time period coincided with, but did not anticipate, a steep deterioration in all housing market indicators. This suggests that the derivatives market was simply reacting to the published data.

- More recently, the market has again been subject to a steep shift in pricing. (See Chart 1.) Between March and May, the market moved from anticipating a decline in prices of 30% between 2009 and 2011, implying a peak to trough fall of around 40%, to pricing in a decline of 10% this year, 5% next year and 0% in 2011, or a peak to trough fall of 27%.

- Again, however, this shift in pricing appears to have followed, or at best coincided with, the rise in buyer enquiries, stabilisation in mortgage approvals, and the stronger Nationwide house price figures of the past few months.

- For 2009 and 2010, the latest residential property derivative “forecasts” are very similar to our own. However, we think that unemployment has much further to rise and the economic recovery will prove sluggish. (See Chart 2.) Accordingly, we would not rule out further house price falls in 2011 or, indeed, an improvement in residential derivative pricing for that period.

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