ACHMEA MORTGAGES

Investment Update H2 2024

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Mortgages

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1. Investing in Mortgages

Dutch mortgages are an interesting investment category for investors. They offer an attractive combination of return and risk and also provide diversification benefits within a portfolio. The low level of unemployment, the strong payment behaviour of homeowners and the tightness of the housing market provide a solid base for mortgages as an investment category. As always, though, the outlook is uncertain.

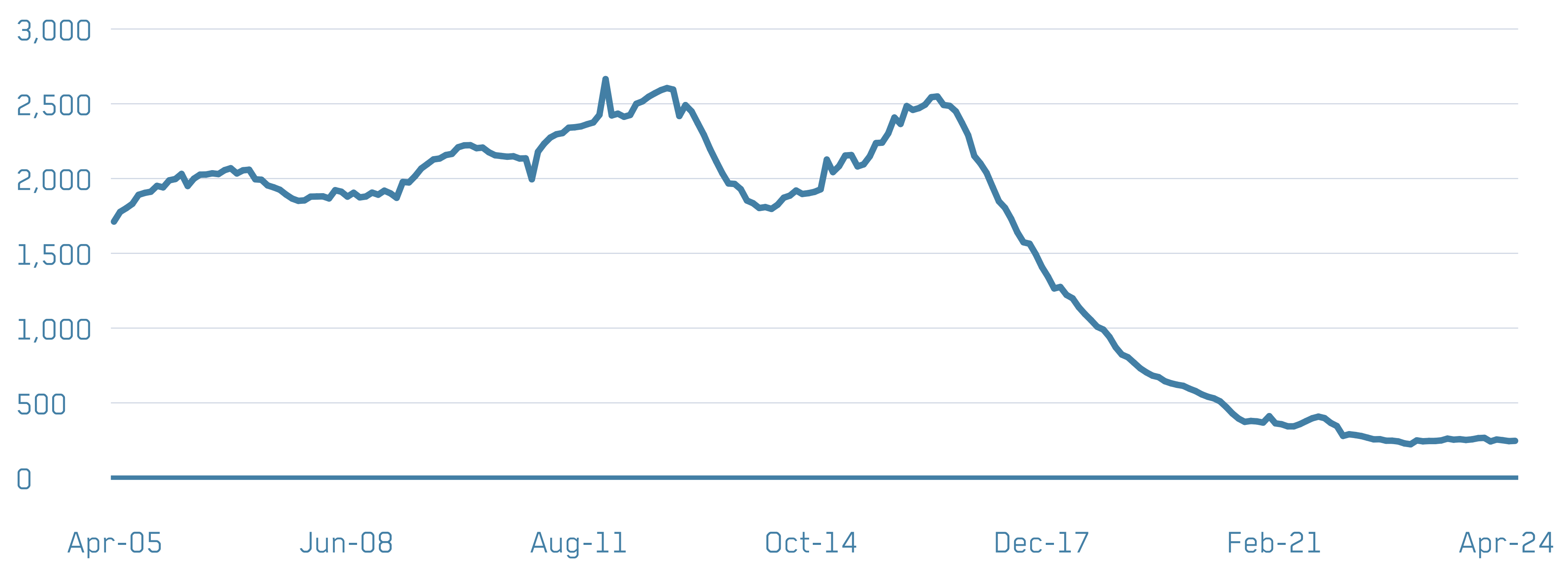
The credit risk for an investor in residential mortgages consists of the risks of households defaulting on their mortgage and a drop in the value of properties. Both depend largely on the general macro-economic environment and the situation on the housing market in particular. More specifically, rising unemployment and rising mortgage rates are the most important warning signals, while deep recessions, preceded by strong increases in house prices, can lead to falling property prices.

The current economic situation is favourable for this asset class. Unemployment is low and is not expected to rise materially in the foreseeable future, providing a high degree of income security. The Dutch economy stagnated last year, but is expected to gain some momentum in the remainder of 2024 and in 2025.

While mortgage rates rose sharply in 2022 as the ECB embarked upon an aggressive tightening cycle, they have traded in a range since early 2023. 10-year yields on government bonds have mostly moved within a range of 2.0% to 3.0% since then, and mortgage rates have reflected this pattern. The ECB has started cutting official rates in June 2024 and, as a result, bond yields and mortgage rates are not expected to rise materially in the foreseeable future.

GRAPH 1. FORECLOSURES (FORCED AUCTIONS - 12-MNTH TOTAL)

Source: Land Registry



In any event, the payment behaviour of Dutch homeowners is strong. Even during the depth of the crises in 2008/09 and 2011/13 the rise of the default rate on mortgages was modest. Dutch households give a high priority to servicing their mortgage debt, even when they are under financial pressure. As a result, foreclosures are low. In recent years they have even been lower than prior to the financial crisis of 2008/09.

Last, the housing market is characterised by shortages. And despite good intentions, building activity has been low. While some improvement may be coming, the housing market remains tight, which underpins house prices.

2. Macro-Economic Developments

International: diverging patterns

The global economy has been characterised by divergence in recent quarters. The US economy has exceeded growth expectations, while China and Europe have struggled. The economy of the eurozone more or less stagnated last year. Dutch economic growth had outperformed in the previous two years, but was below the eurozone average in 2023.

The strong economic performance in the US was a surprise. With hindsight, this was due to expansionary fiscal policy, the rise in immigration and households using the financial reserves they had built during the pandemic to prop up their spending. By contrast, poor growth in the eurozone did not come as a surprise. High inflation eroded real incomes, and the sharp rise in interest rates in 2022 was another burden for the economy that also impacted growth in 2023. In addition, the war in Ukraine affected the eurozone economy more directly than the US.

But things are looking up for the economies in Europe. Inflation, while still above the ECB's target, has come down significantly which is supporting real incomes as wage increases now exceed inflation. As a result, consumer spending should improve. World trade is expected to strengthen, which will also be helpful.

The outlook is not without risks. The factors that have led to robust growth in the US are disappearing and growth there is expected to soften. Economists who were wrong last year in forecasting a recession in the US have become more cautious and most are now calling for a 'soft landing', but an even less favourable development cannot be ruled out.

In addition, China has been the main growth engine for the world economy for two decades or so, but the country is now facing some significant challenges. Its demographics are unfavourable. Debt levels among local authorities are high and the real estate sector is in trouble, with many developers in financial difficulties. Moreover, a global wave of protectionism is making it more difficult for China to generate export-led growth.

Geopolitical tension is on the rise and is contributing to a fragmentation of the global economy, which constitutes another risk. Last, inflation could prove more persistent than assumed, which could also darken the overall economic outlook both in Europe and elsewhere.

The Dutch economy: from contraction back to growth

The Dutch economy disappointed last year. In March 2023 the government's Bureau for Economic Policy Analysis (CPB) was expecting economic growth to amount to 1.6%, but in reality, GDP barely grew: +0.1%. Real GDP actually fell in the first three quarters of the year.

Falling exports and companies running down inventories were two unexpected negatives for growth. Government consumption, on the other hand, was stronger than expected.

Private consumption was the main drag on growth last year and disappointed, as households, having suffered a significant loss of purchasing power in 2022, continued to be under pressure. Inflation was again higher than expected, leading to further real income losses for households. Only in the last quarter of 2023 did the consumer bounce back as the government paid out compensation for high energy bills. Households quickly spent at least part of this money and strong consumption growth in the final quarter of the year contributed to some recovery of GDP growth.

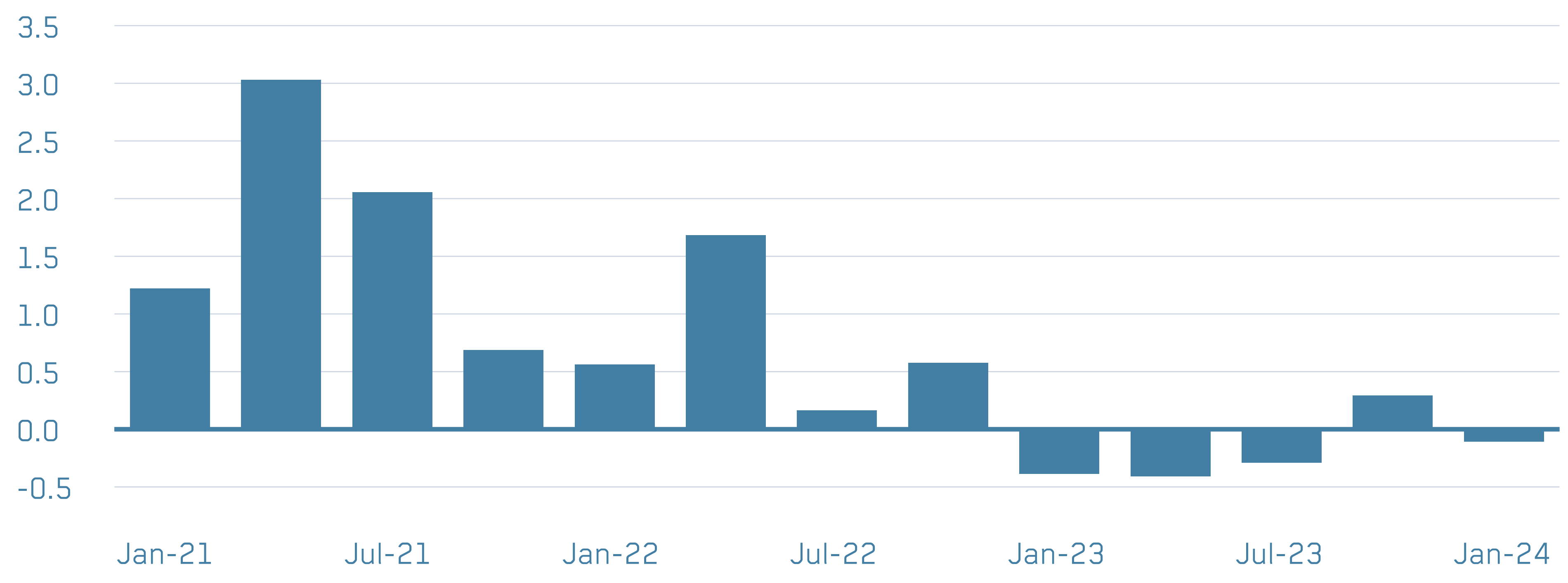
Consumer spending continued to grow in the first quarter of 2024. But as export performance remained weak, with companies continuing to run down inventories at a significant pace, GDP contracted again in the first quarter of this year, albeit only marginally: -0.1% (q-o-q).

The outlook for the Dutch economy is more positive. As inflation has fallen and wage increases have lagged, this year sees a meaningful improvement in purchasing power. In addition, leading indicators for global trade are suggesting that international trade should pick up. Dutch companies will be able to benefit. Surveys among industrial companies show that businesses are optimistic about the outlook for exports. This may also encourage them to increase capital spending, which is reflected in surveys. Last, companies cannot continue to run down inventories. Experience suggests that this process eventually has to be reversed. This will add to growth.

The ECB has cut official interest rates in June and is expected to ease monetary policy further. This may lead to some decline in bond yields and provide some further momentum to economic growth.

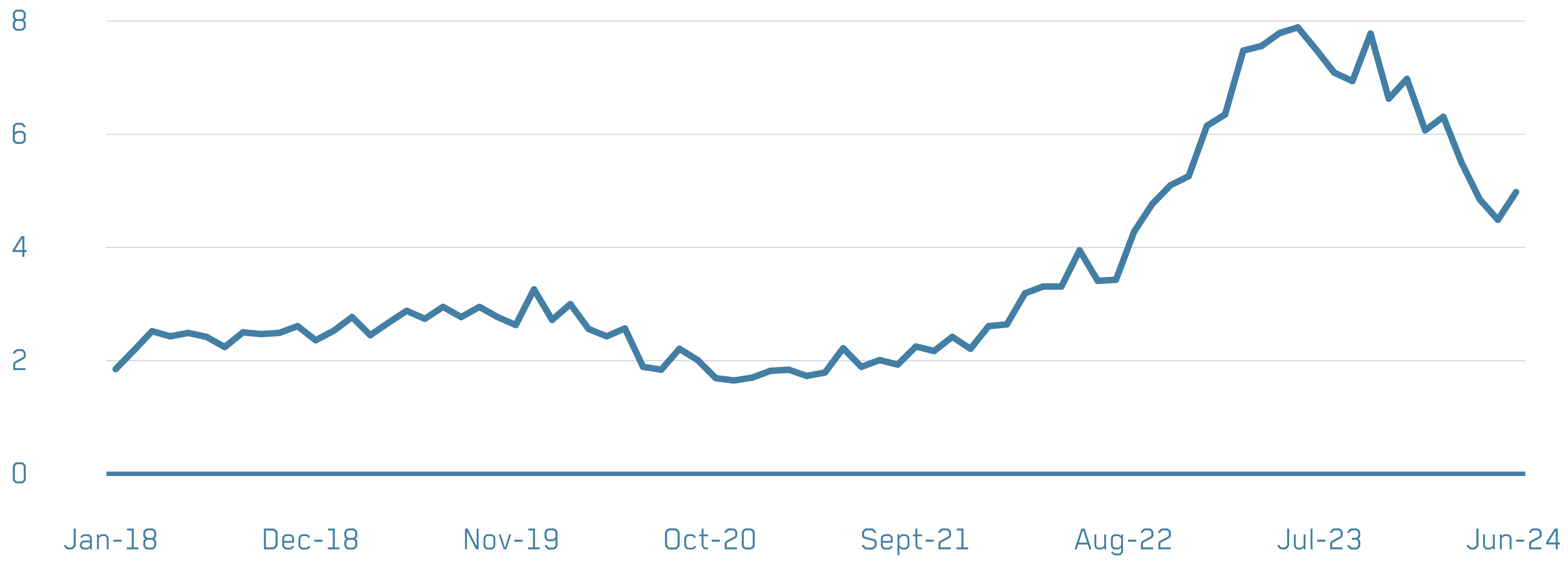
GRAPH 2. GDP GROWTH (% Q-O-Q)

Source: Macrobond



GRAPH 3. WAGE INCREASES: NEW COLLECTIVE LABOUR AGREEMENTS (% 12-MNTH BASIS)

Source: AWVN



Inflation can still be a problem

On the official CBS-measure Dutch inflation amounted to 10.0% in 2022 and then fell to an average of 3.8% in 2023. How quickly inflation can return to the 2.0% level the ECB targets for the eurozone as a whole remains to been seen. While the year-on-year inflation rate has fallen further (and stood at 2.7% in May) progress towards the 2.0% level has been slow recently. In fact, in the first five months of the 2024 the consumer price level rose more than in the first five months of 2023.

The inflation picture is currently quite complex and confusing. Disappearing supply chain problems and lower energy prices are pushing inflation down, but this will be temporary. Wage increases have become the main driver of inflation. They are set to moderate. In fact, that has already been happening. However, the labour market in the Netherlands is unusually tight, as it is in many countries. High wage increases may therefore be more persistent than would be consistent with 2% inflation. In addition, fragmentation of the global economy may boost inflation in the medium term as may the 'energy transition'.

As inflation started to come down in late 2022, participants on financial markets began to price in an aggressive easing cycle by the main central banks. At some stage, markets were expecting the US Federal Reserve to cut their official rates seven times in 2024. The ECB was expected to follow suit.

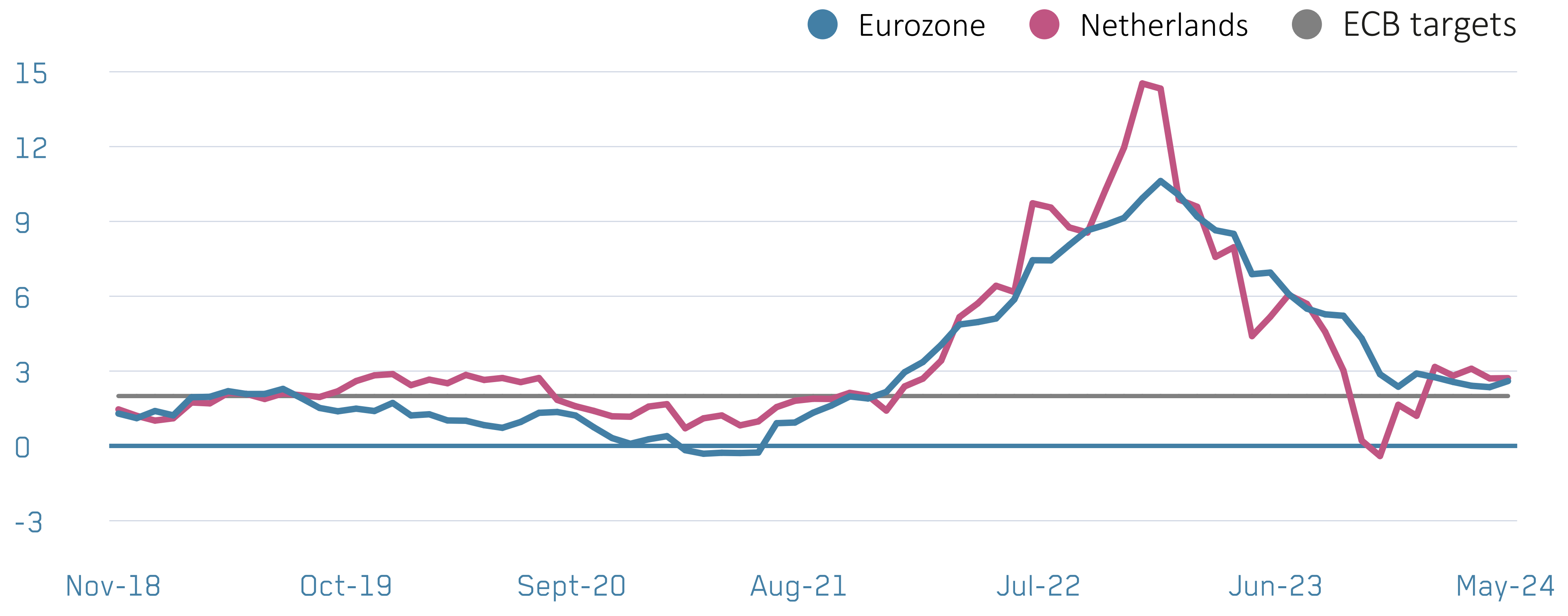
Monetary policy and interest rates

Much has changed since then. Disappointing US inflation data, robust economic growth and communication by Fed officials have changed market participants' minds. Fed rate cuts will come later and will be less aggressive than expected last year. The ECB, on the other hand, cut its official rates by 25bp, as expected, in June this year. Lower inflation and much weaker growth in Europe than in the US justify the divergence in policy. Experience suggests that a first rate cut is exactly that, a first, to be followed by more. As inflation has not yet been beaten, growth is picking up somewhat and the Fed will not embark on early and aggressive rate cuts, the ECB is bound to move cautiously.

Bond yields have been below central bank rates for some time, both in Europe and the US. This limits the scope for a significant drop in yields and therefore in mortgage rates with an interest rate fixed for a long period. While bond yields may grind higher, it will probably require a clear re-acceleration of inflation to push yields materially upwards. That does not seem very likely. This limits the risk from rising borrowing costs to the housing market.

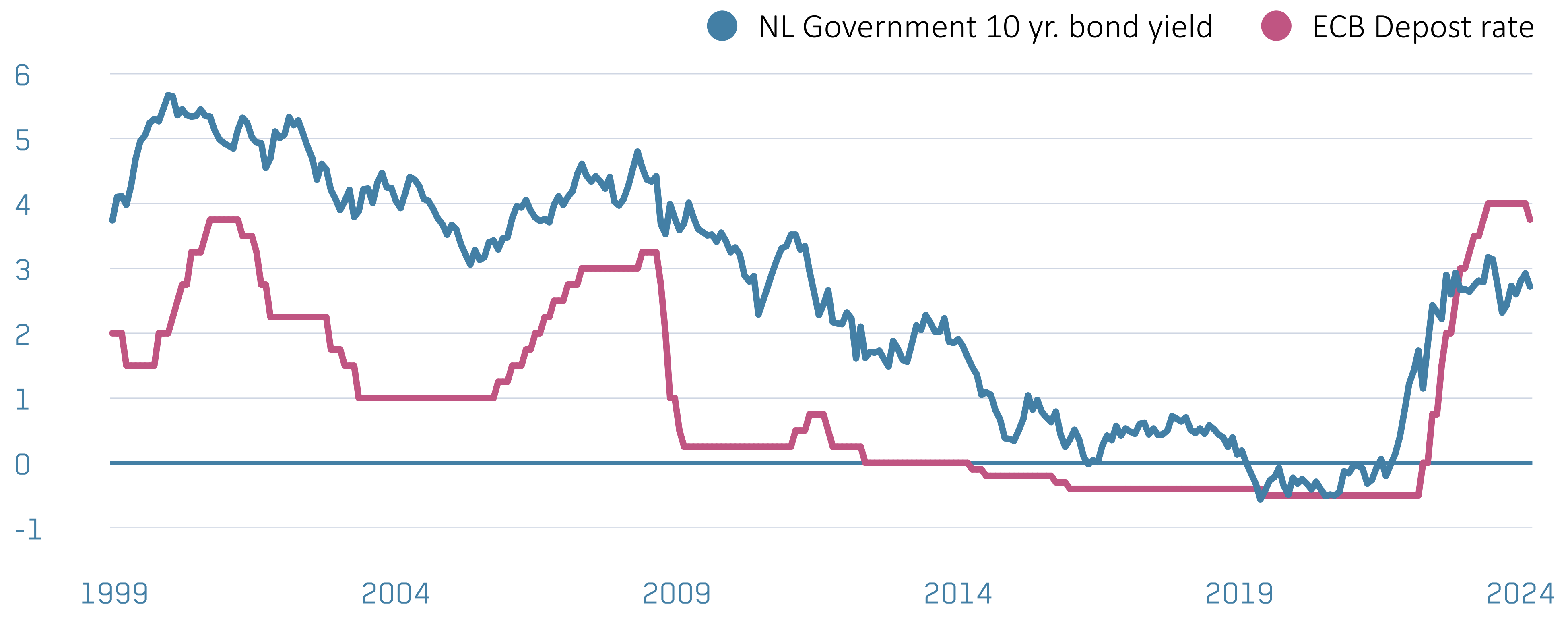
GRAPH 4. INFLATION (%)

Source: Macrobond



GRAPH 5. INTEREST RATES (%)

Source: Macrobond



3. Housing market

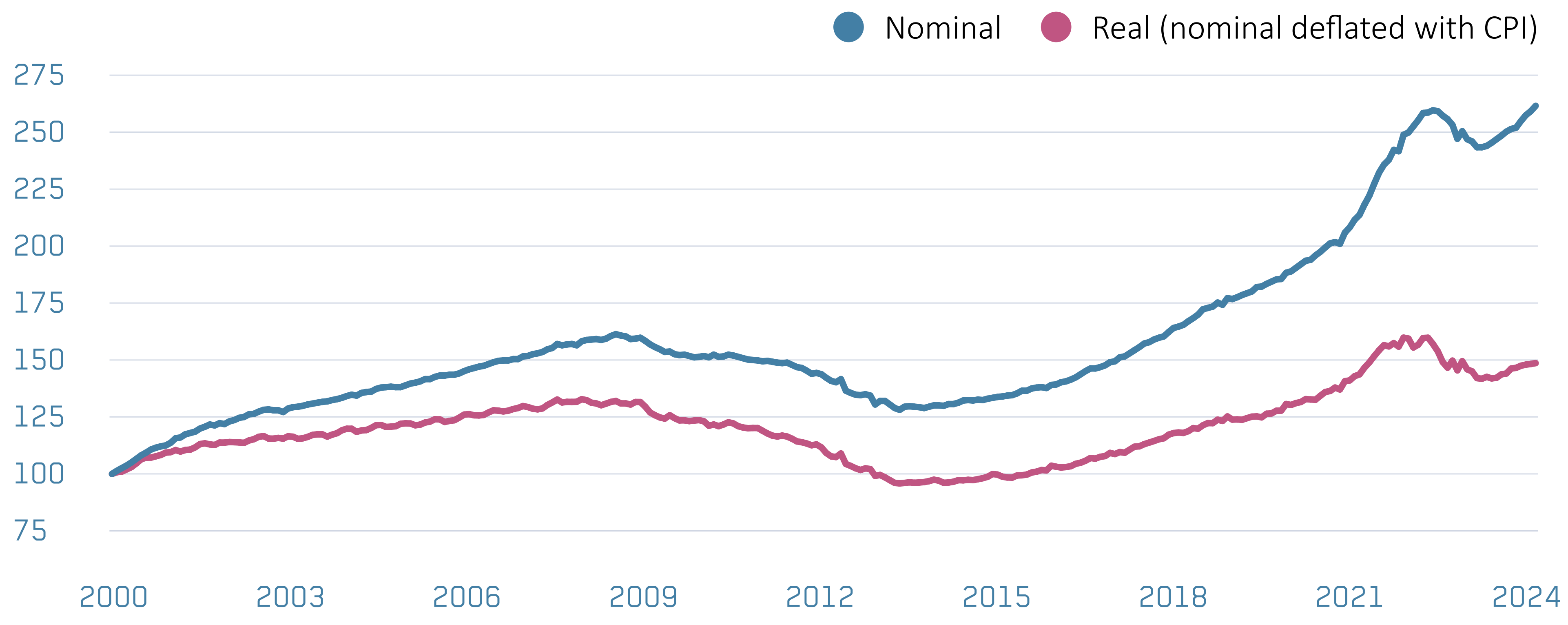
The Dutch housing market got a knock from rising mortgage rates in 2022. The very sharp increase that started right from the beginning of that year reduced the amounts home buyers could borrow, and this translated into falling prices on a month-to-month basis from August that same year. Year-on-year, house prices fell from early 2023 on.

The decline in prices was short lived, lasting less than a year, and was relatively modest. Prices fell by just over 6% from peak to trough. While mortgage rates fluctuated in 2023, they remained stabile on average last year. More importantly, nominal incomes rose significantly in 2023. Wage increases accelerated sharply in a delayed response to surging inflation. Higher incomes, in turn, increased the borrowing capacity of households, supporting house prices in the course of the year. Prices have now recovered more or less to the peak from before the decline, although they still fall short of the peak if one corrects for inflation.

Another factor underpinning house prices is the continued scarcity of homes that has been characteristic of the Dutch housing market for some time. Despite ambitions to build significantly more houses, the number of building permits granted started falling in the course of 2021. Rising costs of building materials, a shortage of labour and problems in the process of granting permits related to the 'nitrogen crisis' were responsible. First-time buyers, in particular, suffered from the scarcity as well as the price increases that pushed many properties beyond their financial reach. Following the trend in building permits, the number of transactions on the housing market has declined, both for new and for existing homes.

GRAPH 6. HOUSE PRICE INDEX (JAN 2000=100)

Source: Macrobond



GRAPH 7. BUILDING PERMITS (RESIDENTIAL) (*1,000; 12-MNTHS TOTAL)

Source: Macrobond

Fortunately, the market appears to have taken a turn for the better in the first quarter of this year. Confidence in the housing market is improving and building permits have risen a little. The number of mortgage applications has risen sharply in the first three months of the year: 26% year on year. That said, many mortgage applications are for loans to pay for renovations and extensions. These homeowners prefer to improve their current homes rather than try to find another, as the market remains tight.

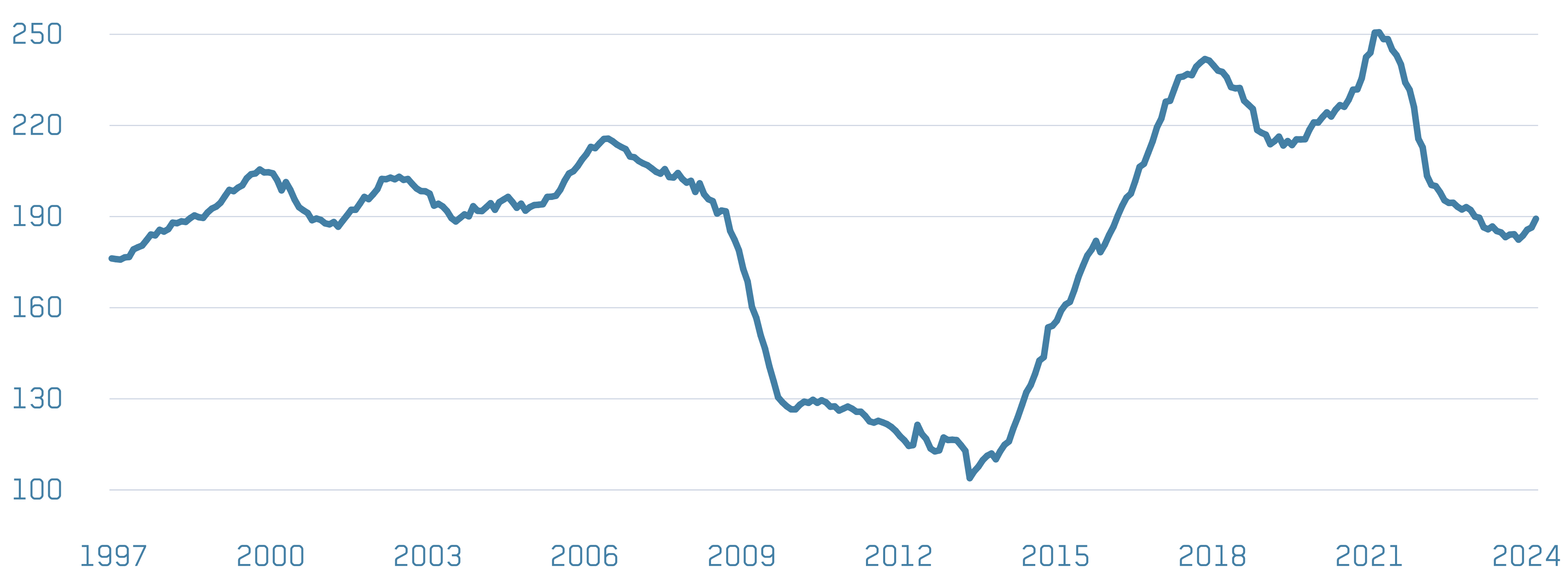
Policies to address housing shortage

Successive governments have tried to address the shortage of houses, though not with overwhelming success so far. The focus has been on supporting first-time buyers, increasing the availability of affordable homes and pushing buy-to-let investors out of the market. Stamp duty for buy-to-let properties, for example, has been raised in steps to 10.4%, while it is 2% for owner-occupant buyers and even 0% for first-time buyers between 18 and 35 years old. The price cap for the 0% stamp duty was raised from EUR 440,000 last year to EUR 510,000 this year. In addition, local authorities can take measures against buy-to-let transactions.

New legislation that is expected to be passed by parliament shortly, the Affordable Rent Act (Wet Betaalbare Huur), will move a lot of rental properties from the free rental market onto the regulated market. It is estimated that rents of some 300,000 properties will be reduced by some EUR 190 per month. This legislation is controversial. It is good for the relevant tenants, but will make renting out properties less profitable for the landlords. In fact, in combination with some changes made to the taxation of properties, renting out some of these homes becomes loss making. This is triggering a number of landlords to sell these properties. That is good for the number of homes for sale, but it reduces the number of rental properties, of which there already is a significant shortage.

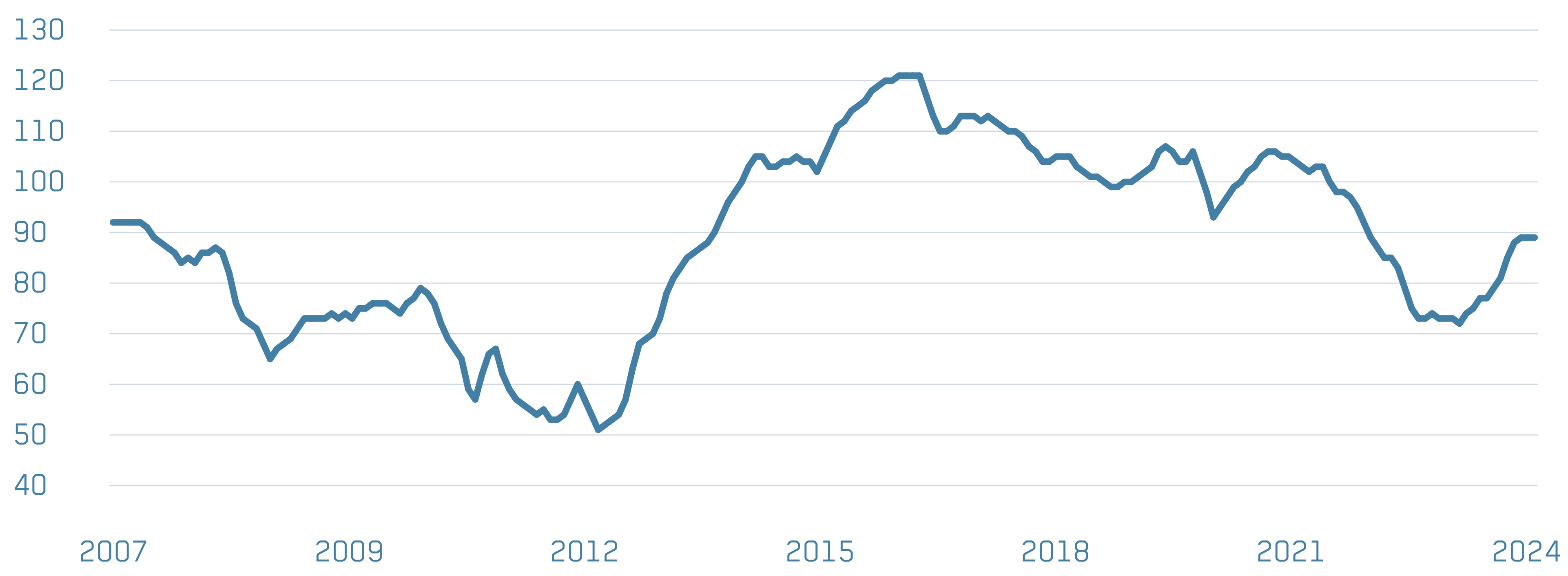
GRAPH 8. NUMBER OF HOUSING TRANSACTIONS (12-MNTHS TOTAL, *1,000)

Source: Macrobond



GRAPH 9. HOUSING MARKET CONFIDENCE (INDEX, VEH)

Source: Vereniging Eigen Huis



Housing market outlook

The outlook for house prices is positive. Economic growth is likely to pick up during the next year and a half, unemployment is expected to edge a little higher, but remain low by historical standards, incomes are rising relatively rapidly, mortgage rates are more likely to move lower than to rise and the housing market will remain tight.

The dynamics of the housing market may also improve somewhat, but the overall situation can still be described as 'very unsatisfactory' as the shortage of homes is now estimated at some 390,000 units, close to 5% of the housing stock.

The modest rise of the number of building permits granted in the first quarter is a positive sign, although it has to be borne in mind that it will still take well over a year or even longer before more permits translate into these houses becoming available to occupants. The recent rise in mortgage applications is also a positive sign. And the various government measures to facilitate an increase in construction may bear fruit. The government has decided to play a more active, centralised role in identifying where more homes should be built, which can make a difference, though not in the very short term.

There are, however, also doubts about the effectiveness and possible unintended side-effects of some of the measures. Estate agents' association NVM, for example, questions the very strong emphasis on building affordable homes as they argue that the measures fail to facilitate people moving up the housing ladder. The process of 'moving up' is what gives the market its dynamism, they argue.

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4. Outlook for the asset class

#1 Mortgage debt as a percentage of GDP is declining

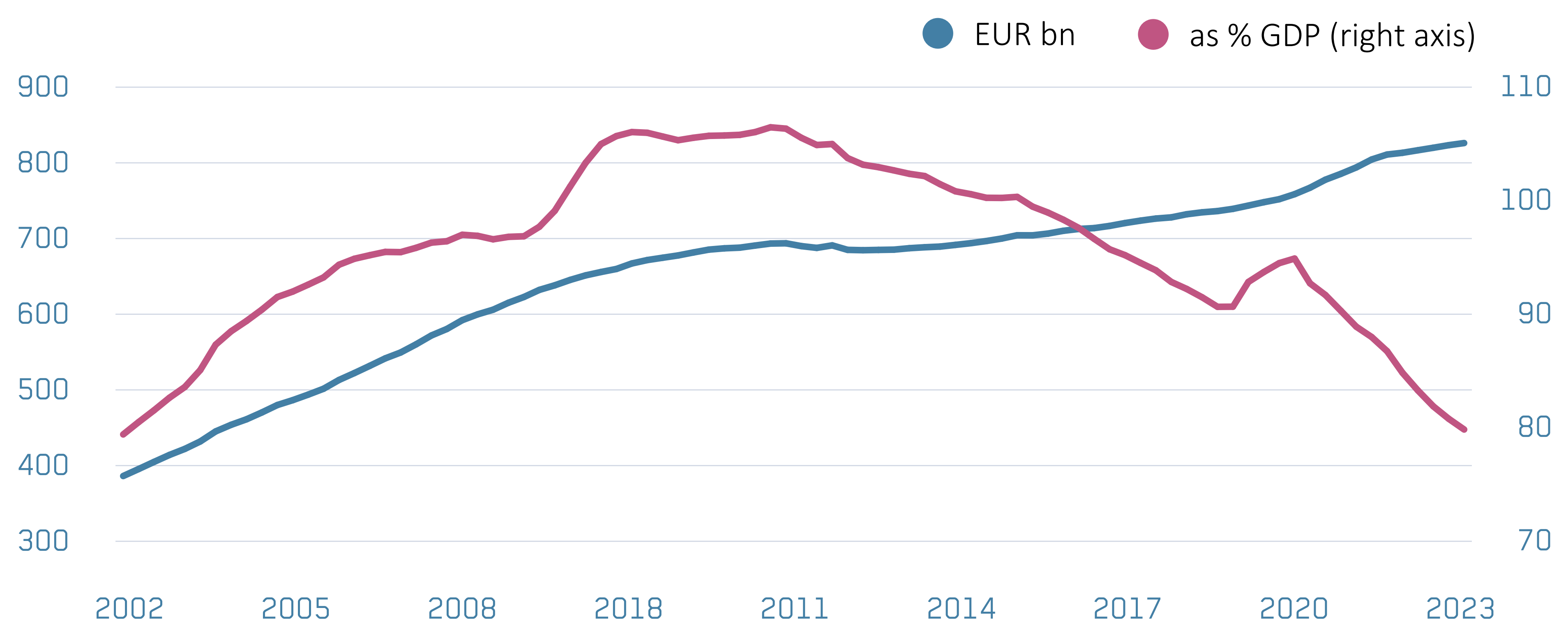
At the end of the 2023, the outstanding residential mortgage debt amounted to approximately EUR 826 billion, up some EUR 12.9 billion or 1.6% from year-end 2022. The banks account for about 69% of the total. Pension funds and insurers together account for approximately 10% and investment institutions for more than 10%. The remainder is on the books of other financial institutions.

As nominal GDP is growing faster than mortgage debt, the ratio of mortgage debt to GDP has been falling for a number of years. This has been a target of policymakers as they considered household finances too vulnerable to adverse developments on the housing market. Measures to get the ratio down, like discouraging interest-only mortgages, were implemented during the crisis of 2011-2013. The drop in the ratio suggests these measures have been very effective. This is positive for financial stability and provides comfort to mortgage lenders.

The sharp rise in mortgage rates caused activity on the mortgage market to decline significantly in 2022 as higher borrowing costs made refinancings unattractive. While the number of new mortgages has been cautiously trending up in recent quarters, refinancings have not recovered as mortgage rates have not fallen materially. As a result, turnover in the mortgage market is still significantly below pre-2022 levels.

GRAPH 10. RESIDENTIAL MORTGAGE DEBT

Source: Macrobond



#2 Fundamentals of the owner-occupied housing market remain very solid

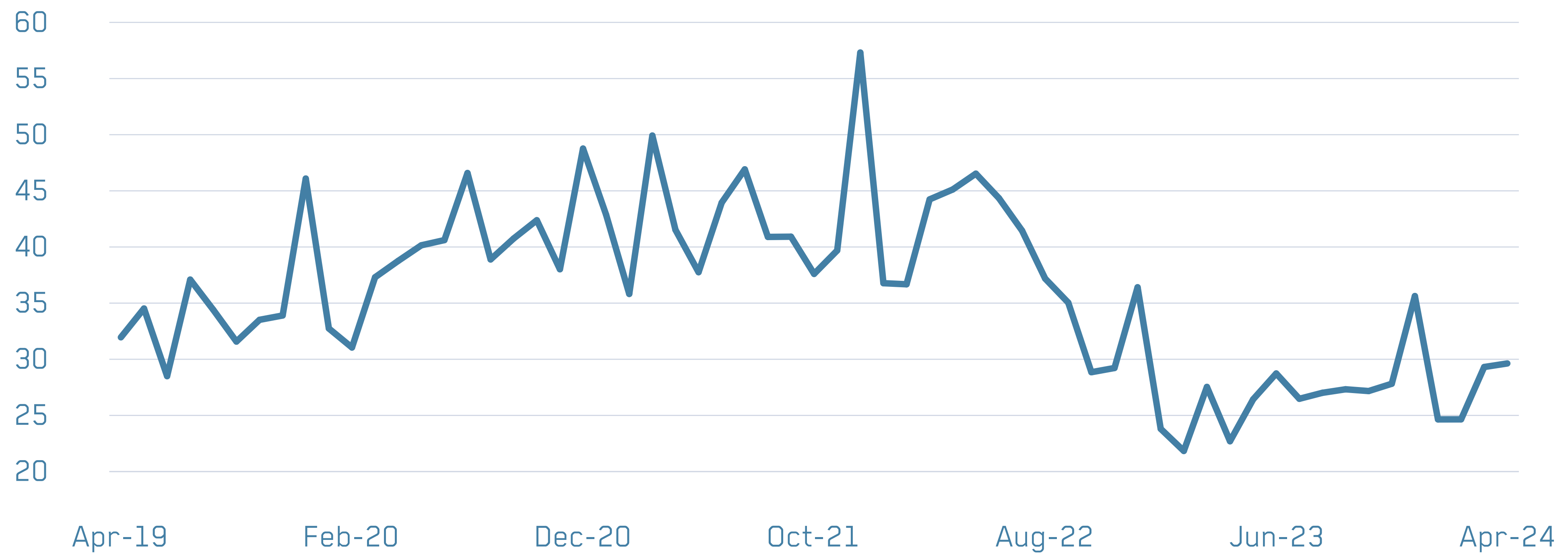
The economic outlook is moderately positive. Economic growth is bound to pick up. While unemployment may edge up somewhat as a delayed response to last year's economic stagnation, any rise should be small, and the absolute level of unemployment will still be historically low. As a result, a rise in defaults on mortgage loans is not anticipated. In fact, as mortgage rates are more likely to fall than to rise, the financial burden on a given mortgage is likely to ease somewhat.

Incomes will continue to grow more rapidly than inflation this year and next. The consequence is that households will be able to take out larger mortgages which will contribute to a sustained rise in home prices. There may be a shift in the housing market as borrowers are now allowed to secure somewhat higher mortgages for the purchase of homes with a better energy rating.

Finally, although it looks like building activity will pick up somewhat, the delays between permits being granted and homes being completed are considerable. The housing market is therefore expected to remain tight.

GRAPH 11. NUMBER OF NEW MORTGAGES (*1,000)

Source: Land Registry



#3 Interest rates more likely to fall than to rise

Forecasting interest rates is a mug's game. Getting inflation down to the central banks' target may take longer than expected, but central banks are determined to make that happen. If inflation disappoints, it does not necessarily follow that they will raise rates. Instead, it means that interest rate cuts will be postponed and implemented more slowly than expected.

A rise in bond yields and mortgage rates cannot be ruled out if inflation disappoints, but any such rise will be limited. Now that the ECB has started cutting rates, bond yields and mortgage rates are more likely to fall, although the fall will be limited as bond yields are lower than official rates. In any event, the interest rate outlook would not appear to represent meaningful risks to the housing market. Instead, the interest rate outlook is mildly supportive of the market.

#4 Climate Risk for Dutch Mortgages

While the fundamentals of the Dutch housing market remain strong and economic conditions appear favorable, climate risk presents a growing challenge for market stability. The Netherlands, of which a large part is at or below sea level, is particularly vulnerable to climate change, facing increased risks from rising sea levels, severe flooding, and extreme weather events. These environmental changes can significantly damage properties, affecting their value and insurability. Consequently, homeowners in high-risk areas may struggle to secure or renew insurance, potentially leading to mortgage defaults if properties become uninhabitable or too costly to repair.

Fortunately, the Dutch government has implemented measures to mitigate these risks. For example, the Delta Plan aims to reinforce the dykes along the Dutch coastline, enhancing flood protection. Despite the positive economic outlook for the Dutch mortgage market, it remains crucial to integrate climate risk assessments into long-term housing market strategies.

5. Update Investment Focus

Investing in Dutch residential mortgages

The Dutch residential mortgage market has a lot of variation in types of mortgages based on Loan to Value (LTV), fixed interest periods and guarantee with or without NHG. Based on these variables, the mortgage rate, credit spreads and ultimately the risk-return ratio for an investor are determined. The LTV and NHG guarantee in particular determine the risk profile.

The outlook for mortgages remains solid with limited credit risk. Unemployment is low and is not expected to rise materially in the foreseeable future, providing a high degree of income security. Mortgages with a high LTV (greater than 80 percent when originating new mortgages) have higher spreads than mortgages with a NHG guarantee.

Since the bottom of the Dutch economy in 2013, it has been a favorable segment of the mortgage market. A more defensive attitude would include a strategy that focuses on mortgages with a low LTV (less than 80 percent), possibly supplemented with NHG mortgages. If a strategy with more credit risk is chosen, the mortgage segment with an LTV greater than 80 percent still has value. The major macroeconomic changes in recent years have resulted in a constant recalibration of the strategy in relation to credit risk. Examples are lockdowns due to the pandemic, the war in the Ukraine, sharply increased energy prices and, as a result, sharply increased inflation. In addition, the unprecedented tightening of monetary policy by central banks in response after more than a decade of monetary expansion. Central banks have raised interest rates at a record pace to slow the demand side of the economy in order to cope with soaring inflation. All this has led to so much uncertainty that it requires a constant recalibration of the strategy depending on economic expectations and the desired credit risk. As of late, credit spreads between LTV segments have tightened which could lead to a recalibration of the investment strategy.

Sustainability is also an essential component for mortgage investments. Investors ask for defined ambitions, objectives and a concrete approach for, among other things, the sustainability of the homes on which the mortgage rests. The SFDR legislation has a stimulating effect on this. This is made concrete with energy labels and options to reduce CO_2 emissions. Mortgage lenders can stimulate energy efficiency and climate resilience of homes with interest discounts on a mortgage with a sustainable home or extra borrowing capacity and actions regarding sustainability of existing mortgages. We see the mortgage industry moving towards implementing more sustainability measures to improve the energy efficiency of the mortgage portfolio and move towards a net zero portfolio, in line with the ambition to be net zero organization by 2050.

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