*** STRICTLY EMBARGOED UNTIL 7.00AM Friday 16 November 2007 ***

House price growth to pause for breath in 2008

- **Economic tailwinds are turning into headwinds, and house price inflation is expected to drop from the current rate of 9.7% to 0% by this time next year**
- **A slower economy, stretched affordability, tighter credit conditions and lower buy-to-let demand will all take a bite out of house price inflation**
- **Interest rate cuts and tight supply will provide some support to price growth, but are unlikely to prevent a significant slowdown**
- **Scotland is forecast to have the strongest house price growth in 2008, while prices in Northern Ireland are forecast to fall somewhat from dizzying heights**

Commenting on the forecast Fionnuala Earley, Nationwide's chief economist, said:

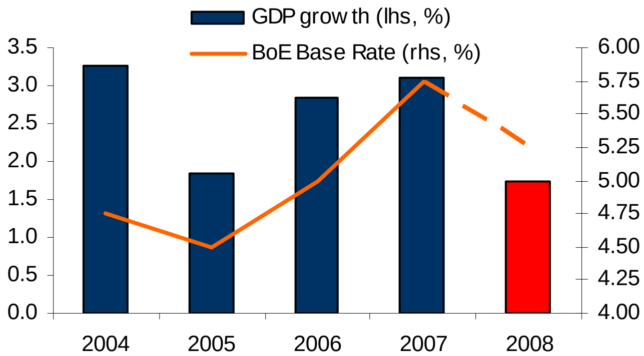
"House prices recorded another strong year in 2007, underpinned by significant economic momentum, ongoing housing shortages and strong buy-to-let demand. We forecast house price growth of 5-8% in December last year, and with two months left to go it looks like the middle to upper end of this range will be achieved. That being said, momentum is now fading, and a number of factors suggest that house price inflation will drop from its current rate of 9.7% to 0% by this time next year. The main reasons for this more subdued outlook lie on the demand side of the market, where a slowing economy, tighter credit conditions, stretched affordability for first-time buyers and lower house price expectations appear likely to reduce the level of activity. The supply-side of the market will still be characterised by widespread housing shortages, in spite of government targets to increase house building. These shortages will provide some offsetting support to prices amid the weaker demand environment, particularly in the south of the UK.

Economic tailwinds turn into headwinds

"The strength of the economy was a key support to the housing market for most of 2007. A global economic boom allowed London to benefit from its position as a leading international financial centre, while the manufacturing sector shrugged off the strong pound and high raw material costs to record a relatively strong year. The buoyant economy proved supportive of buyer confidence and helped keep housing demand at high levels, particularly during the first half of the year.

"Yet, as we move into 2008, economic tailwinds are increasingly being replaced by headwinds. To begin with, the economy's strength forced the Bank of England to increase base rates to a six-year high, which has been feeding into the pricing of mortgages and other types of credit. Further upward pressure on mortgage rates – particularly at the riskier end of the lending spectrum – has stemmed from the credit crunch that began in August, a result of large losses on investments in securities linked to US sub-prime mortgages. Petrol prices of £1 per litre are also squeezing disposable incomes and represent another dampening factor for the economy.

Slowing economy but lower interest rates

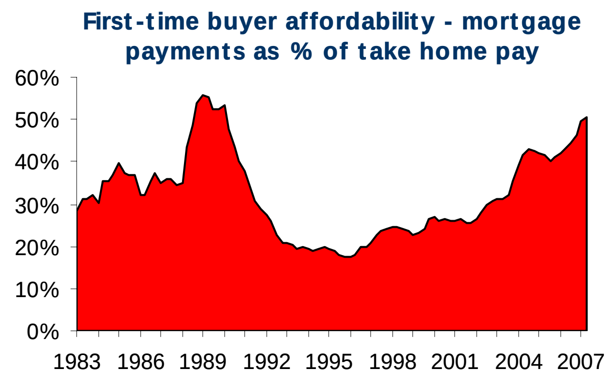


Source: ONS, Nationwide forecasts

"As a result of these developments, we expect economic growth to fall below 2% next year, from over 3% in 2007. Such a slowdown would be comparable to the UK experience of 2005, but would still be a far cry from conditions seen in the early 1990s. Nonetheless, a slower economy will produce some loosening in the labour market, with a slight rise in unemployment and fairly subdued wage growth. As signalled in the November *Inflation Report*, this leaves room for the MPC to reduce interest rates by 50 or possibly 75 basis points by the end of 2008. Such a cut would clearly be a relief to many homeowners, but rates would still be higher than when they started rising in 2006. On balance, the economic background will not be as supportive of buyer confidence and house price growth expectations.

Affordability pressures likely to act as a constraint on price growth

"House prices have now risen in excess of earnings for 11 of the past 12 years. For a considerable period of time, this had only a limited impact on the affordability of monthly housing costs, as interest rates fell to record lows. But now that interest rates have risen by 125bp since August 2006, mortgage payments are taking an increasingly large share of take-home pay, particularly for first-time buyers. The ratio of first-time buyer mortgage payments to take-home pay is now close to an all-time high, and there appears little room for it to climb further in a slowing economic environment. For affordability to come back to long-term norms, either earnings growth needs to outpace house price inflation or interest rates need to come down. Although we believe interest rates have peaked, they are only expected to come down slowly, as inflation expectations are lifted by high oil and food prices, and the beneficial impacts of cheap imports from China begin to fade. For this reason, house price inflation will need to lag earnings growth next year, and this is a key driver of the overall forecast.

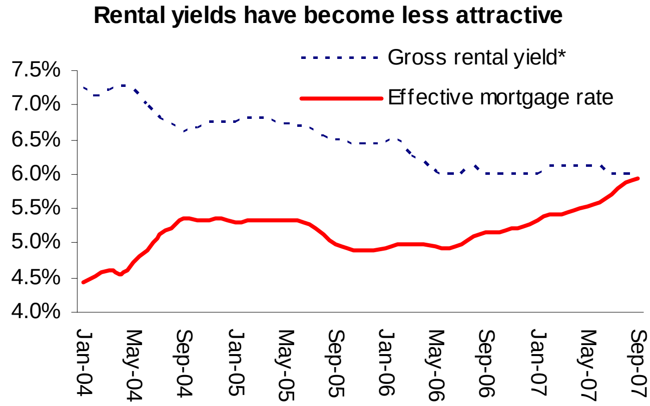


Source: Nationwide, ASHE

Will buy-to-let keep booming?

"Buy-to-let investors have been a key support to house price growth in 2007, and have replaced some demand from first-time buyers dropping out of the market. But as interest rates and house prices have risen, rental yields have become much less attractive and investors have had to rely on house price growth to deliver good returns. As the slowing economy causes house price expectations to be revised down, there is likely to be less interest in new buy-to-let investments, particularly from those with shorter investment horizons. On top of this, the credit crunch is likely to lead buy-to-let lenders to tighten their rental cover and LTV criteria, making it more difficult for new investors to enter the sector.

"Yet, while poor yields, lower house price expectations and tighter credit conditions are all likely to take some froth out of buy-to-let and limit its contribution to price growth, recently reported fears of a mass exodus from the sector appear overdone. The growth in buy-to-let appears to have been driven by a shift in preferences toward property as a retirement provision, following the equity bear market earlier in the decade and the emergence of large deficits in company pension schemes. This is consistent with survey evidence suggesting most landlords are long-term investors rather than speculators, and that they would not exit the market abruptly.[1] Even with only modest house price growth, those in it for the long-haul can expect satisfactory returns. Our overall view of buy-to-let is therefore that the rapid growth of recent years will moderate, but that pessimistic sentiment about the sector's prospects should not be exaggerated.



Source: Bank of England, Paragon.
*Gross rental yield excludes agency fees, operating expenses and void periods

[1] Source: *ARLA Review and Index*

Supply to remain an important support to prices

"A slowing economy, poor first-time buyer affordability and a slowing buy-to-let market are all factors that point to weaker demand. On the supply side, however, prices will still find an important support. Compared to countries such as the United States, Ireland or Spain, the UK has not seen nearly as strong a response of residential building to the high house price inflation of recent years. The government's Housing Green Paper has stated that the current level of house building is falling short of projected household formation by 38,000 units per year. Although the Green Paper has committed to raise growth in the housing stock from 185,000 units per year to 240,000 units by 2016, this is a long-term project that will not alleviate shortages in 2008.

Relative strength expected in Scotland, but weakness in Northern Ireland and Northern England

"Although price growth is expected to average 0% for the UK as a whole, some regions are expected to perform more strongly than others. The region we believe will see the strongest performance next year is Scotland, where prices are expected to rise by 4%. The house price to earnings ratio in Scotland is lower than anywhere else in the UK, showing that affordability has not worsened to the same extent as in other regions. Scotland has not participated as strongly in past house price boom cycles, and this probably makes it somewhat less vulnerable to weaker conditions in the UK market as a whole. Moreover, the strength of oil prices is likely to benefit specific local markets with exposure to the sector, such as Aberdeen.

Source: Nationwide, ASHE

"At the other end of the affordability spectrum, Northern Ireland has quickly become the least affordable UK region for first-time buyers. This is due mostly to the phenomenal house price growth that the Province saw in 2007. At the end of the third quarter, prices were up by over 40% year-on-year, while earnings growth remained in the low single digits. At this stage, it appears that there has been some overshoot of house prices in Northern Ireland, and that there will be some falls next year. Our forecast is currently for a 5% decline, which would make the Province the worst-performing region for 2008, but still leave it the best-performing region over a two-year period.

"For the rest of the UK, those regions with more severe supply shortages are generally expected to see slightly stronger price growth. After a very strong 2007, London is expected to see price growth flatten out in 2008. Lower financial market activity is likely to have a negative impact on bonuses and confidence in the City, which were important contributors to the strength of the market in 2007. First-time buyer affordability is also under considerable pressure in London, though one should add that the deterioration in affordability has been much less abrupt than in Northern Ireland and may therefore not have as great an impact. The supportive factors for London prices are severe supply shortages, the positive economic impact of Olympic spending, and a likely continuation of demand for prime central London properties from buyers in oil-producing and emerging market economies.

Nationwide house price forecasts	2008 Price growth (%)
Scotland	4
Outer South East	1
Outer Metropolitan	1
London	1
East Anglia	0
West Midlands	0
East Midlands	0
UK	0
Yorkshire & Humberside	-1
Wales	-1
South West	-1
North West	-2
North	-2
Northern Ireland	-5

"Elsewhere in England and Wales, prices are likely to be weakest in the Northern regions, where some minor falls are expected to occur. Supply shortages are generally less severe in the Northern regions, and it follows that weaker demand conditions are likely to have more of an impact on prices there.

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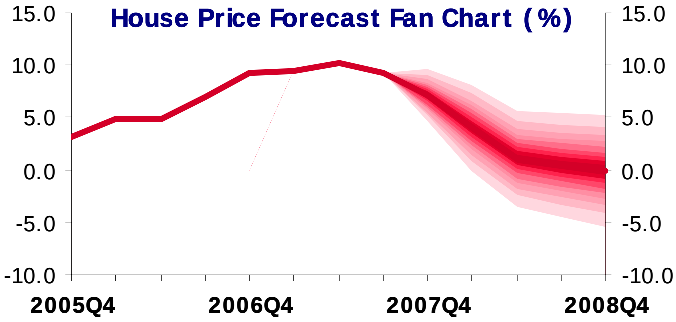
Risks to the forecast



"The future is inherently uncertain, and it is impossible to rule out other unanticipated events having either a negative or a positive impact on house prices. Based on the information currently available, 0% inflation is our best estimate of the most likely outcome, but there are plausible risks in both directions. The main downside risk is that continued financial unrest or a US recession cause the economy to slow even more sharply than expected, leading to a more significant rise in unemployment, higher levels of forced sales and lower house price expectations. On the upside, there is a chance that the pronounced economic slowdown we are predicting will not materialise. The economy's quick recovery from the Russian debt default crisis in 1998 showed that while global financial market shocks may lead to sudden losses of confidence, this can sometimes prove temporary and not impact strongly on future economic activity. It is also possible that the current forecast underestimates the upward pressure on prices from supply shortages, or the degree to which first-time buyers will be willing to increase spending on mortgages in order to fulfil aspirations to homeownership.

"If realised, no growth in house prices may come as a disappointment to many homeowners, but must be put in context. House prices have risen very strongly over the past decade and have delivered large gains in financial wealth. From a longer-term perspective, a year of flat house prices will contribute more to the future stability of the market than a year of 10% inflation and ever worse affordability. Now may well be a good time for price growth to pause for breath."

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