

“The worst is over,” said Irish Auctioneers and Valuers Institute President Robert Ganly last Monday. His timing couldn’t have been worse. In the two seconds it took to say those words, a billion euros had been wiped off European stock markets. And the factors underlying last week’s rout in equities suggest that property markets are nowhere near the trough.

According to the think-tank Bruegel, European banks and other financial institutions own about €4 trillion of US financial assets. These assets consist of US equities, government bonds, corporate paper, and other securities such as bonds backed by sub-prime mortgages and credit card debt. Europeans have accumulated these assets over the past decade as the US desperately needed inflows of money to finance its enormous trade deficit.

With the US economy in recession, these assets are losing value. Worse still, European investors used mostly borrowed funds to buy these assets. This use of leveraging is magnifying the losses. Hence the sell-off of financial stocks.

Moreover, the huge writedowns by European banks may impair their ability to extend credit to businesses, which in turn will hurt the broader economy. That’s why investors also dumped non-financial stocks.

Which sectors will be hardest hit? Banks are unlikely to slam the brakes on mortgage lending, though they may not be able to find many customers anyway. Residential mortgage lending is a relatively low-risk activity, because homeowners rarely default on their mortgages.

But banks may sharply curtail lending to property developers, where the risks are greater. Commercial property looks particularly vulnerable.

A slowdown in commercial building would depress economic activity and employment, with adverse knock-on effects on the housing market. In this way, the US housing meltdown looks set to put additional pressure on house values here. The worst has yet to come.