Market Briefing: December 2022

Key developments in the housing and mortgage markets

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December 2022

Executive summary

- Since the last Market Briefing, Kwasi Kwarteng's mini-budget of 23 September and the Bank of England's announcement the previous day that it would start to sell government bonds to unwind QE sent the bond market into turmoil. The situation was exacerbated by pension funds' need to sell bonds to raise cash to meet margin calls on derivatives, having pursued a strategy known as liability driven investment which created leveraged exposure to bond prices.

- Such was the volatility in the interest rate swaps market in the wake of the min-budget that many lenders felt compelled to withdraw their fixed rate mortgage deals until it became clear where pricing would settle. At one point swap rates were indicating that Bank Rate would exceed 6% by mid-2023. Lenders that did continue to offer fixed rates raised their pricing sharply.

- The turmoil in financial markets and consequent spike in fixed rate mortgage pricing had an immediate impact on sentiment in the housing market. Housebuilders reported a drop in sales and rise in cancellations while the Nationwide and Halifax both reported falling house prices in October and November. The RICS residential market survey reported a sharp fall in both buyer enquiries and agreed sales.

- Inflation exceeded expectations in October, with the 12-month change in the CPI rising to 11.1% before falling slightly to 10.7% in November. RPI inflation reached 14.2% in October, the highest rate since 1980, but inflation would have been higher still if the government had not intervened to cap domestic energy bills.

- The UK economy appears to be entering a recession with GDP falling by 0.2% in the third quarter. The main driver was falling private consumption although business investment has also been weak. The latest monthly estimate was more positive with GDP rising 0.5% in October although this largely reflected a bounce back in output following the impact on output of the Queen's funeral.

- There are early signs of a slowdown in the labour market with unemployment rising from 3.5% in July to 3.6% in August and 3.7% in September. The number of job vacancies has fallen from a peak of 1.3 million in March-May to 1.19 million in September to November. Regular pay, which excludes bonuses, has been picking up since late 2021 and reached 6.1% in August to October but is failing to keep pace with inflation.

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The economy

It is estimated that GDP fell by 0.2% in the third quarter. On a sectoral basis, production fell 1.5% with output down in all 13 manufacturing sub-sectors defined by the ONS. Production has now fallen for five consecutive quarters. Services output was flat while construction output rose by 0.6%. Within the components of demand, private consumption was 0.5% lower, government consumption was 1.3% higher and fixed capital formation rose 2.5%, but this was due to higher investment by government as business investment fell 0.5%.

The monthly profile shows a slightly brighter picture in October with GDP rising 0.5%, largely reversing a 0.6% decline in September (see Chart 1). But the additional bank holiday marking Queen Elizabeth's funeral was a major factor determining this profile. Services output rose 0.6% and construction by 0.8% while production was flat on the previous month.

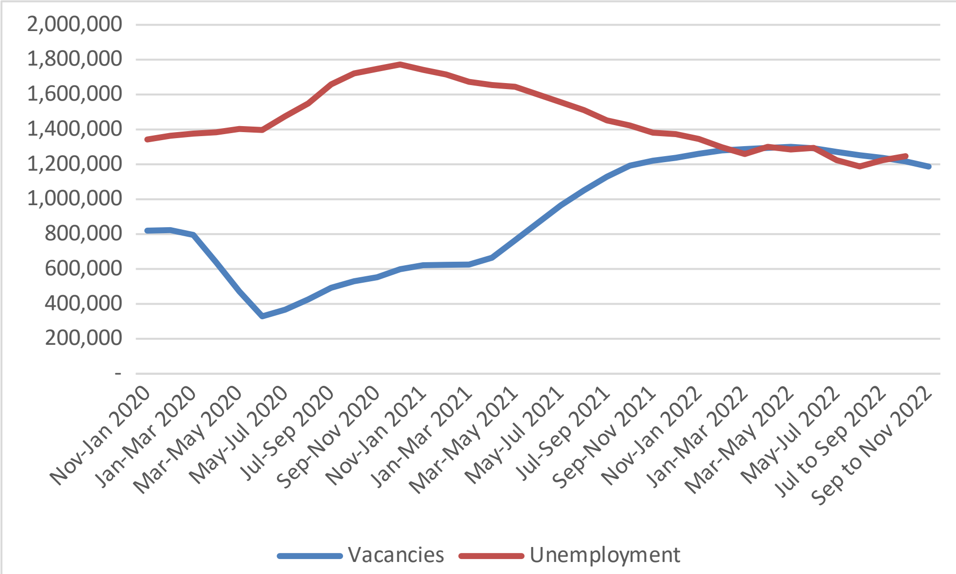
Chart 1 – Sources of GDP growth %

Source: Office for National Statistics

Labour market

There are signs that the labour market is softening in response to weakening economic conditions. The unemployment rate in September was 3.7%, up from 3.6% the previous month and a low of 3.5% in July while job vacancies fell from a peak of 1.3 million in March-May to 1.19 million in September-November (see Chart 2). However, the overall employment rate is still rising: in August to October it increased by 0.2 percentage points to 75.6% although it is still below pre-Covid levels. Higher prices may be encouraging some of the economically inactive to return to the labour force.

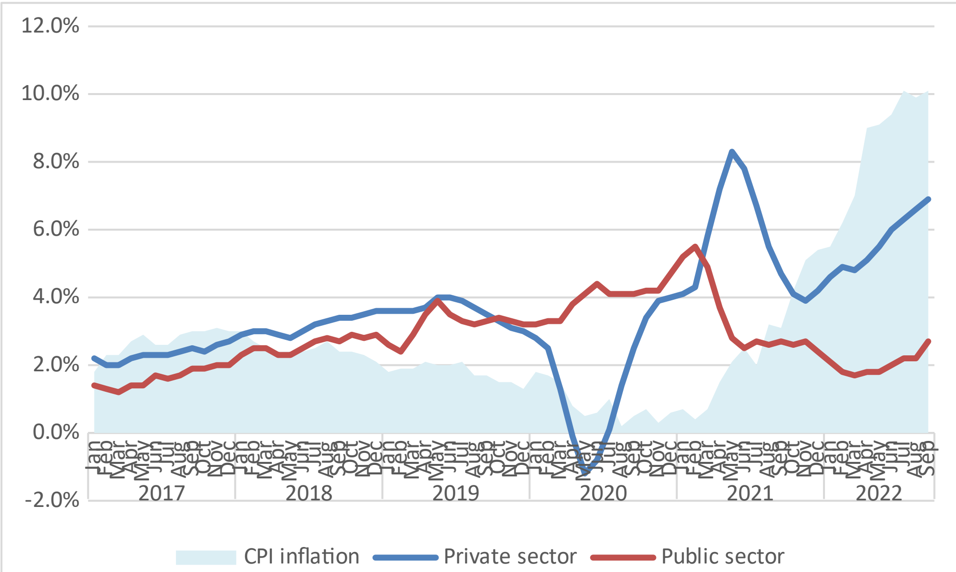
Chart 2 – Job vacancies and unemployment



Source: Office for National Statistics

Despite its recent softening, the labour market remains tight by historical standards and demographic trends, with the baby boomer generation moving into retirement, create the risk of a structural shortage of labour. Despite this, wages have failed to keep up with inflation since late 2021. As Chart 3 shows, this is true of workers in both the public and private sectors but is particularly acute in the public sector.

Chart 3 – Regular pay growth in the public and private Employment trends



Source: Office for National Statistics

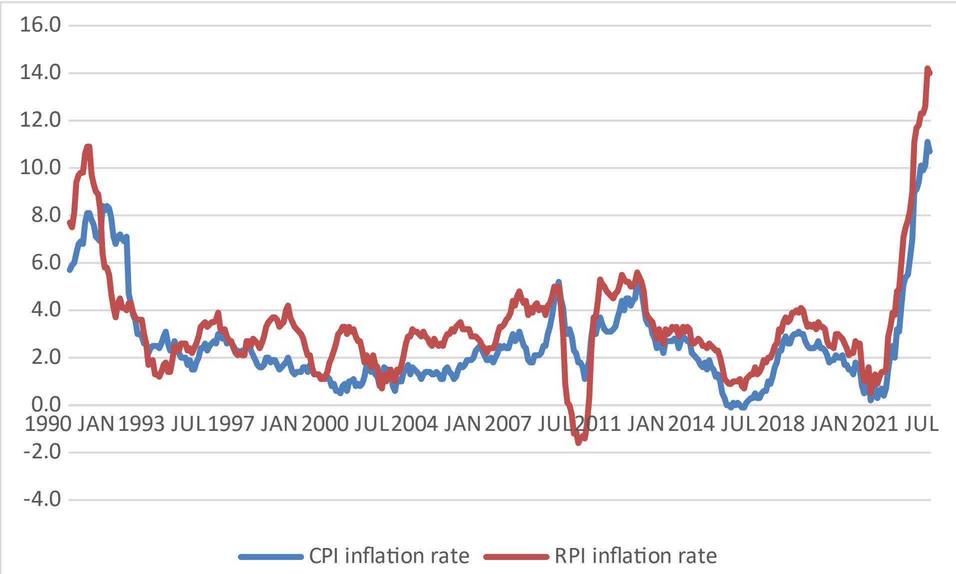
The Bank of England will be watching private sector wage inflation particularly closely as it is the largest single determinant of firms' costs. It must be a concern that regular private sector wages were rising at 6.9% over August to October compared to a year earlier while output per worker is barely above its level of three years ago.

In setting interest rates the Bank faces a dilemma: household real incomes are being squeezed by falling real wages but nominal wage inflation is far above the rate consistent with its 2% inflation target. If wage raises continue at this rate in 2023 and 2024, Bank Rate will have to keep rising.

Inflation and interest rates

Both CPI and RPI inflation eased back slightly in November from their recent highs of October (see Chart 4) but inflation would have been even higher were it not for the government intervention to cap energy prices for consumers. The government's Office for Budget Responsibility (OBR) forecasts that consumer inflation will fall rapidly during next year due to so-called base effects, as previous price increases drop out of the 12 month comparison.

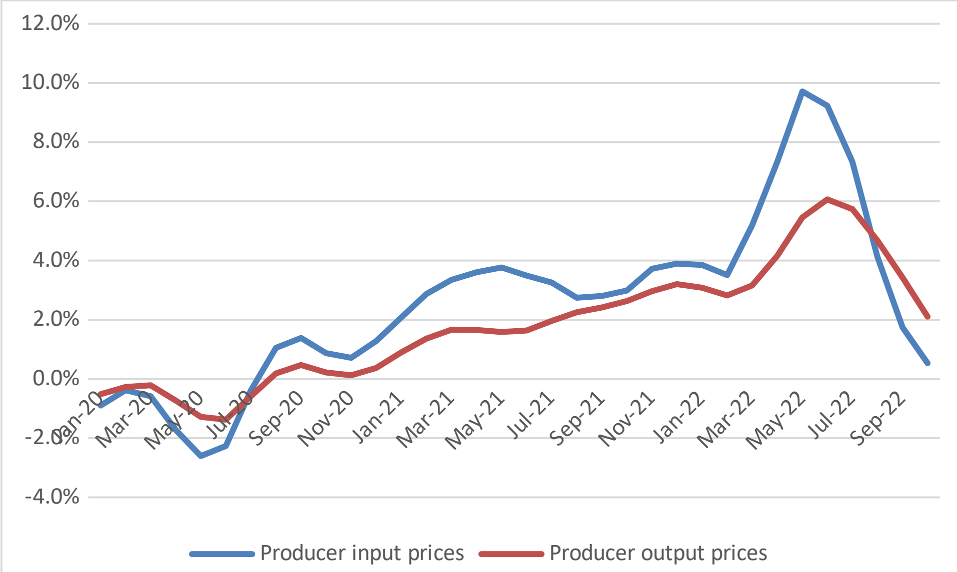
Chart 4 – CPI annual inflation rate, %



Source: Office for National Statistics

Indeed, producer input and output prices do provide cause for some optimism. While the annual rate remains high at around 19% and 15% respectively for input and output prices, looking at the more timely 3 month average compared to the previous 3 months producer input prices were up only 0.5% in October (2% on an annualised basis) and output prices up 2.1% (see Chart 5). This is far below the peaks of 9.7% and 6.1% recorded in May and June respectively. However, with the 3 month on 3 month annualised rate of producer output price inflation still at 8½% and wage settlements rising, it is not clear that output prices can support as rapid a fall in consumer inflation as the OBR predicts.

Chart 5 – Producer input and output prices (3 month on previous 3 month)



Source: Office for National Statistics

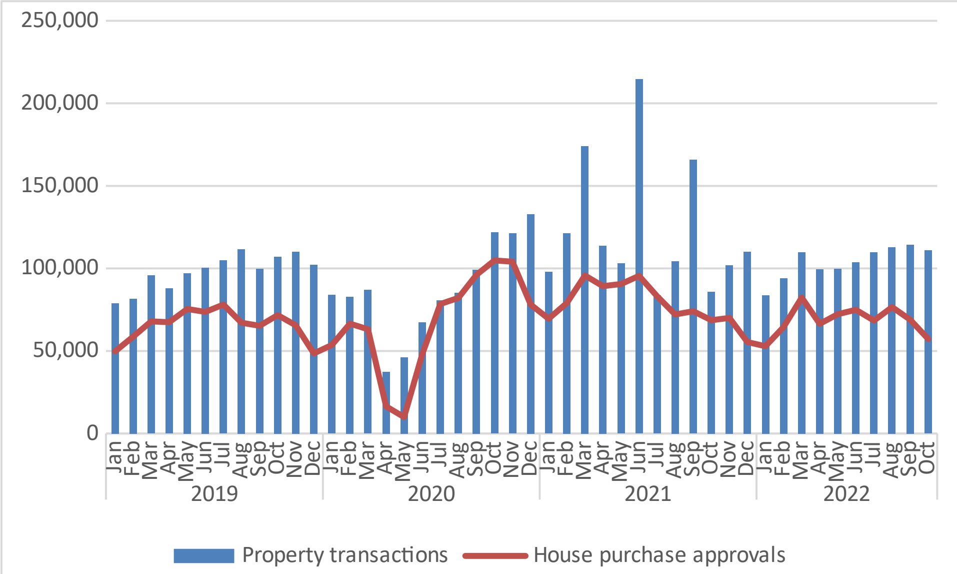
Housing and mortgage markets

Activity

The RICS residential survey has recorded sharp declines in a range of data over recent months including sale prices achieved, new buyer enquiries and price and sale expectations. More lagging indicators of housing market activity, such as housing transactions and mortgage approvals, do not yet show the full impact of the Autumn slow down in the market (see Chart 6) although approvals for house purchase were down 17% in October.

However, one source of cautious optimism comes from the November RICS survey, which showed a lower negative balance from respondents concerning new buyer enquiries and agreed sales. This suggests that the market has partially recovered from the shock that followed the market turmoil of late September and October. With fixed rate mortgage pricing trending down again, there is a good change that buyer confidence will stabilise further although variable rate mortgage pricing is still expected to rise in response to further Bank Rate increases.

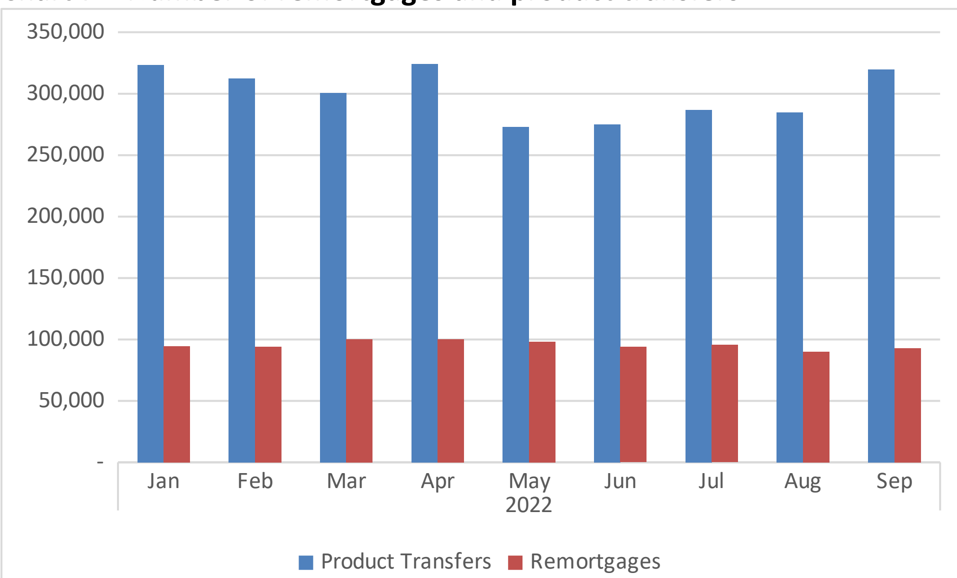
Chart 6 - Property transactions and approvals for house purchase



Source: HMRC, Bank of England

After performing strongly earlier in the year, as many borrowers switched to protect themselves against rising interest rates, the remortgage market cooled heading into the Autumn but in contrast product transfers were sharply higher (see Chart 7). Rising affordability pressures could favour product transfers going forward, as borrowers can move to a new rate without undergoing a new affordability assessment.

Chart 7 – Number of remortgages and product transfers



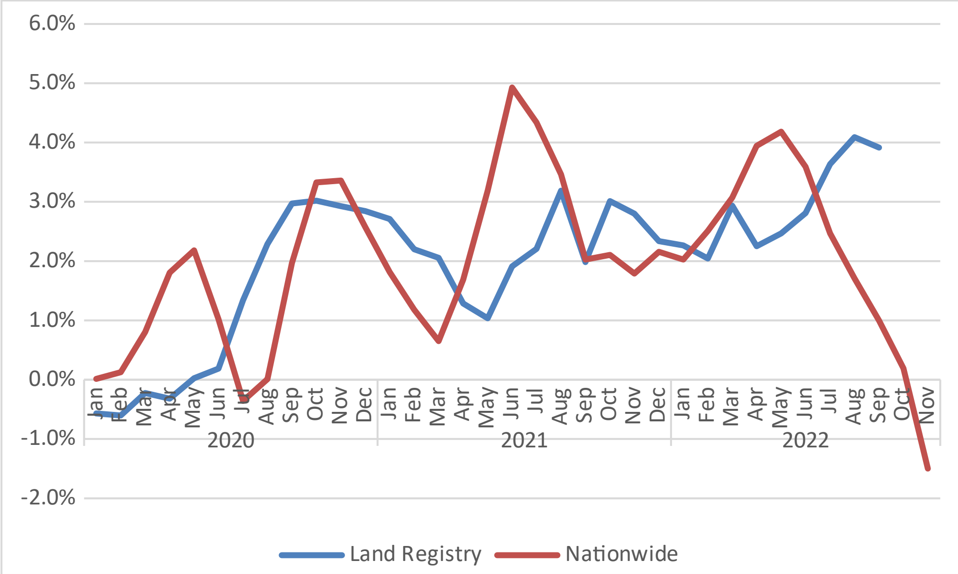
Source: UK Finance

House prices and rents

House price inflation was surprisingly strong up until September. Annual house price inflation was in double digits on all the main indices until August and comparing the latest 3 months on previous 3 month, the Land Registry recorded a gain of 3.9% in

September, an annualised rate of 17%. But the more timely Nationwide index shows the impact of altered market sentiment over the past three months with a rapid plunge into negative territory by November (see Chart 7).

Chart 7 – House price inflation (latest 3 months on previous 3 months)



Source: Nationwide Building Society, Land Registry

The November RICS residential market survey showed the letting market remained strong with a balance of 35% of agents reporting a rise in tenant demand and a net 27% reporting a fall in landlord instructions. Unsurprisingly this imbalance of supply and demand is putting upward pressure on rents. A net 43% of agents expect rents to rise over the next 3 months while the Homelet index showed a 11.1% rise in the year to November, the highest increase being in London at 14.5%.

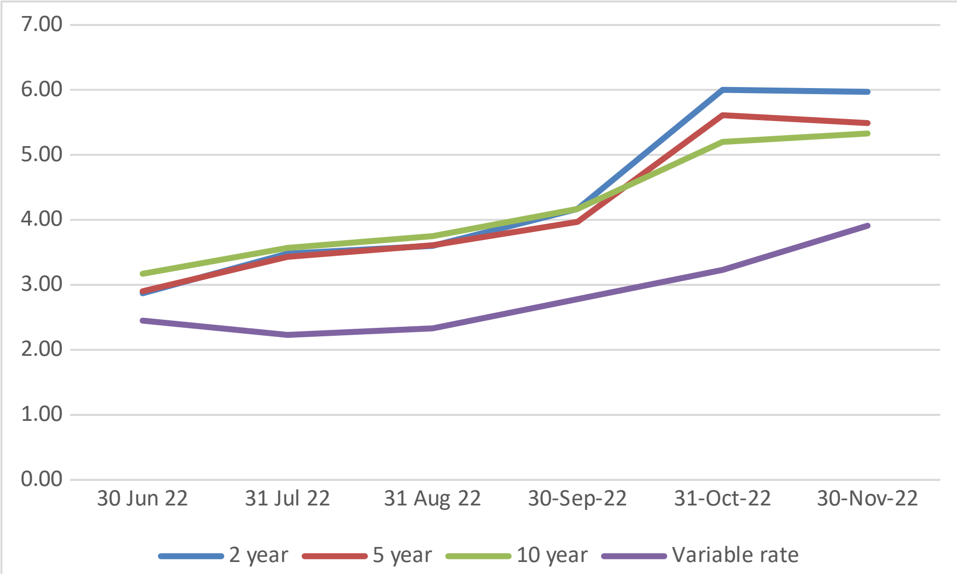
Mortgage pricing and products

Since the last Market Commentary, fixed rate mortgage pricing was subject to extreme volatility in the wake of the mini-budget on 23 September and the previous day's announcement from the Bank of England that it would start selling government bonds back to the market to unwind its QE programme. Investors were concerned about the implications for bond prices, leading to a rapid sell off in the gilt market. 10 year government bond yields, which had been below 2% at the end of July hit 4.5% by the end of September.

As pricing in the interest rate swaps market is determined by the differential between short and longer term interest rates, the collapse in bond prices drove swap rates up, leaving lenders scrambling to reprice their fixed rate products. So rapid was the change in pricing that many lenders pulled all their fixed rate mortgages while others had to hike their interest rates dramatically.

As Chart 8 shows, Bank of England average mortgage rate data do not fully reflect the scale of market turmoil but do show the very sharp rise, particularly in 2 year fixed rates, which hit 6% in October, having average 4.17% in September and as little as 2.87% in June. By contrast, variable rate pricing has been more stable as this is driven by short term money market rates which are in turn determined mainly by Bank Rate.

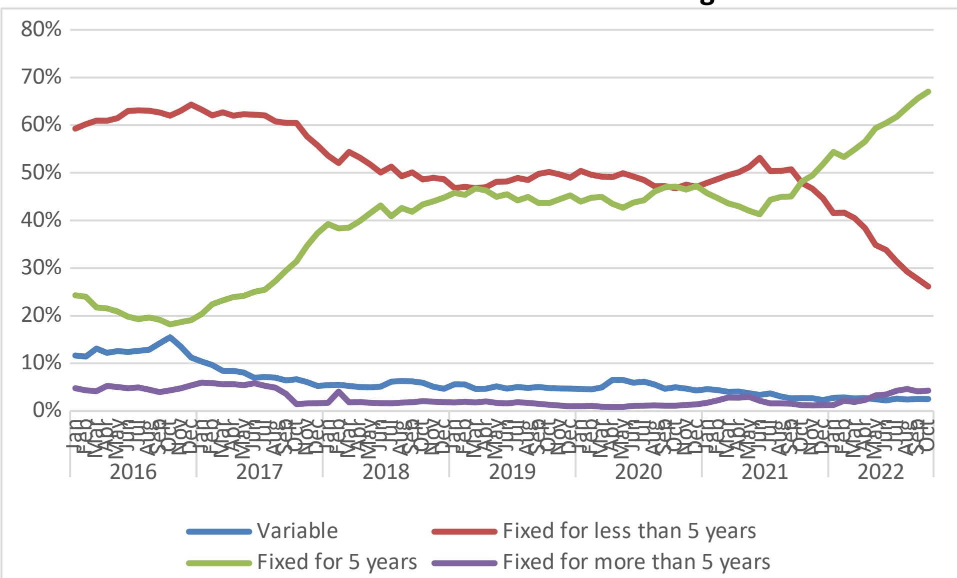
Chart 8 – Fixed rate mortgage pricing



Source: Bank of England

UK Finance data on the breakdown of new lending by type of interest rates does not reflect the increased competitiveness of variable rate loans (see Chart 9). Indeed, given the lags between a mortgage being approved and the loan being drawn down, customers with fixed rate mortgage offers made before the market turmoil would have had every incentive to proceed with what then became a far better deal than anything on the market. In October, a record 67% of loans were 5 year fixes.

Chart 9 – Fixed and variable rate share of new lending



Source: UK Finance

Future shares of fixed and variable rate loans will be determined to a large extend by the relative movement of short and longer term rates. Fixed rate mortgage pricing has already fallen back as the government has successfully calmed the bond market and short term interest rates have risen with Bank Rate now at 3.5%. So it is entirely possible that fixed rates will continue to maintain their current popularity.

High LTV lending

As Chart 11 shows, high LTV lending continued to make a strong recovery up to Q3 2022. But these data are not timely enough to show the impact of the recent market turmoil, which only started towards the end of September. Many lenders pulled their fixed rate products and there has been increased anxiety about declining house prices. However, the mortgage market has stabilised well since then, with a good range of high LTV products still available.

Chart 11 – Value of lending by high LTV band (£ billions)

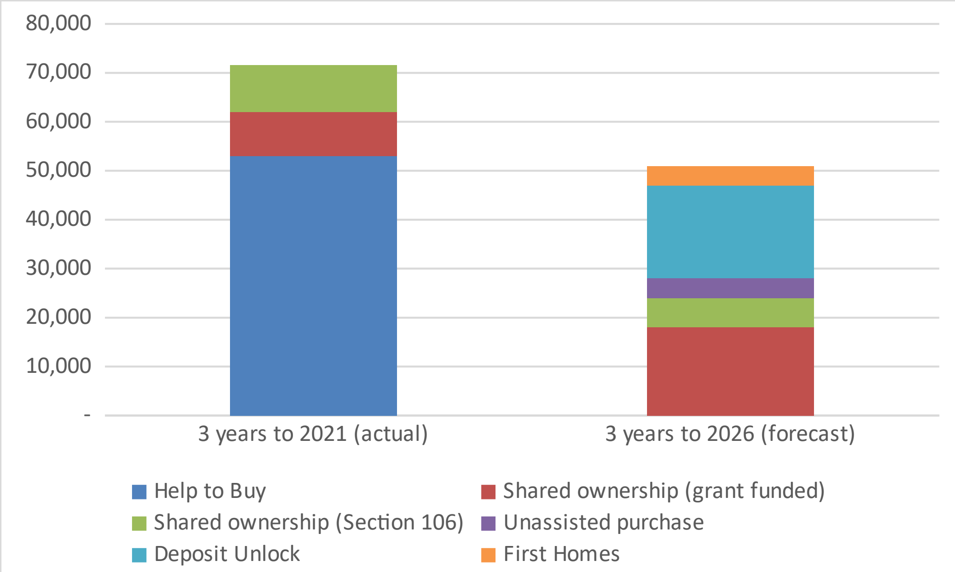
Source: Financial Conduct Authority

The government has announced a 12 month extension to its Mortgage Guarantee Scheme, which was set to expire on 31 December 2022. Some lenders had been calling for an extension in the wake of the market disruption following the mini-budget as the number of high LTV products had fallen.

Another government scheme, Help to Buy equity loans, closed to new applicants on 31 October. The scheme, which was restricted to new build properties, supported nearly 370,000 sales between its commencement in 2013 and June 2022. The scheme was restricted to first time buyers with regional price caps in 2021 and volumes have been lower recently, with only 13,000 sales in the first half of 2022 compared to 50,000 over 2020 as a whole.

The focus is now turning to how builders will fill the gap left by the end of Help to Buy. Chart 10 shows a projection produced by Savills in their paper *Support for new homes sales: life after Help to Buy* (January 2022). Savills expects an increase in shared ownership sales driven by higher grant funded shared ownership. It also expects the new government initiative, First Homes, to deliver some 4,000 sales a year by 2024-26. But it expects the largest contribution to come from a private sector initiative, Deposit Unlock[1], which it expects to deliver 19,000 sales a year.

Chart 10 – Savills comparison of annual new build sales before/after Help to Buy



Source: Savills

Deposit Unlock is a mortgage insurance scheme that allows lenders to lend on new build property above 90% LTV and up to 95% LTV with protection down to 60% LTV, paid by the selling builder on a pay as you go basis. This means that all builders can access the scheme on the same basis regardless of size. Deposit Unlock launched in summer 2021 and now has three participating lenders, Nationwide and Newcastle Building Societies and Accord as well as almost all the large builders and many smaller ones. Several more lenders are in the process of joining the scheme.

There are also a number of private sector share ownership and shared equity schemes now available, mostly on both new and existing properties. These schemes are only possible because private capital wants exposure to residential property and has found direct the purchase of properties in the private rented sector to be a less advantageous channel to deliver this exposure. However, if we are to face a quite prolonged period of falling house prices there must be a question mark over how willing investors will be to continue to back schemes that expose them to falling property prices.

Buy-to-let market

The buy-to-let market was hit hard by the turmoil in financial markets from late September with many lenders withdrawing their fixed rate products and those that remained being repriced to as much as 7%. At this level some landlords would

[1] The author is a consultant to Gallagher Re, the firm that manages Deposit Unlock

struggle to meet affordability requirements but rates have fallen back and the best 5 year fixes are now below 5%.

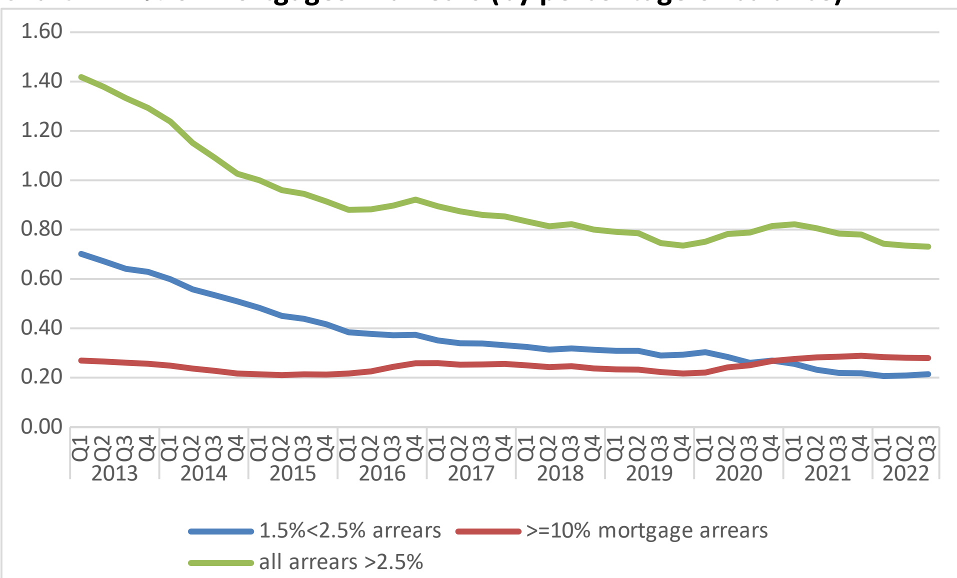
However, there is no indication that the market dislocation reduced lending volumes. On the contrary, October saw exceptional strong lending driven by a surge in remortgage activity to £3.6 billion. It is possible that some borrowers were concerned that interest rates might go even higher while others switched to tracker rates to avoid locking in higher fixed rates.

Buy-to-let lending for house purchase has also held up well in recent months. The annualised total for the year to October is only 3% below 2021's strong total, which was boosted by the stamp duty holiday. Compared to 2019, the last year before the Covid pandemic, house purchase lending was up 57% on an annualised basis in the year to October. Rising tenant demand and higher rents, which rose by 11.1% in the year to November according to Homelet, appear to be encouraging some landlords to expand their portfolios.

Arrears and possessions

Mortgage arrears of 2.5% of the loan balance or more fell slightly again in Q3 despite the worsening cost of living crisis, although the fall was small. Rising interest rates have not yet had much impact as the majority of borrowers are on fixed rates and therefore still benefitting from the exceptional low mortgage rates of recent years. However, the number of borrowers in longer term arrears (10% or more) has not fallen in line with total arrears but has been rising since 2015, which suggests there is a cohort of borrowers numbering some 30,000 who are particularly vulnerable to further financial shocks.

Chart 12 – % of mortgages in arrears (by percentage of balance)



Source: UK Finance

As expected, the number of possessions is starting to rise after a period when they were artificially suppressed due to the Covid moratorium, reaching 1,120 in Q3. Still, they remain substantially below the pre-Covid average in part because of enhanced forbearance by lenders. However, with economic conditions worsening and mortgage rates substantially higher than they were, a rise in arrears and possessions seems difficult to avoid.

Prospects

Inflation may have now peaked and is forecast by the OBR and Bank of England to fall sharply in 2023 as the commodity price shocks of 2022 start to fall out of the 12 month comparison. But domestic inflationary pressures are increasing as firms and workers seek to maintain real income levels in the face of double-digit inflation.

As a result, even though the economy is expected to be in recession next year, there is a strong possibility that the Bank of England will have to continue to raise Bank Rate to dampen demand to suppress domestic inflationary pressures. This would put further pressure on homeowners whose mortgage deals come up for renewal and affect the amount that home buyers are able to borrow, which is likely to put downward pressure on house prices.

It therefore seems likely that the very strong conditions seen in the mortgage market over the past two years will not persist in 2023. Nonetheless, lenders can take comfort from the sound footings on which the mortgage market stands: borrowers have been assessed for affordability on rates that are still well above current mortgage rates; borrowers have not used housing equity to finance a spending boom of the kind that preceded earlier downturns; and owner-occupiers as a group have never had such a strong cushion of housing equity to fall back on.