Market Briefing: June 2023

Key developments in the housing and mortgage markets

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Executive summary

- Output has continued to hold up in recent months despite rising interest rates. First estimates of GDP growth in Q1 showed output up 0.1%, with the monthly estimate for April showing a further rise of 0.2%.

- Core consumer price inflation hit 7.1% in May, the highest rate since 1992 while CPI inflation remained at 8.7%, above market expectations. Rising domestic inflationary pressures are now offsetting the impact of lower global commodity prices.

- Concerns about the persistence of inflation have pushed up interest rates across the yield curve. The Bank of England raised Bank Rate to 5.0% on 22 June and the market now predicts that Bank Rate could go as high as 6% by the end of this year as the Bank faces the need to reassert its ability to bring inflation back to its 2% target.

- The labour market is now a significant source of inflationary pressure. Regular earnings across the economy rose 7.2% in the three months to April compared to a year earlier and in the private sector growth was 7.6%. Although unemployment has been rising and job vacancies falling modestly in recent months, the labour market remains tight with the unemployment rate at 3.8%.

- Housing transactions and mortgage approvals were both weaker in April. However, the latest RICS Residential Survey points to the market stabilising with a lower negative figure for buyer enquiries and a slight rise in the stock of properties for sale.

- The main house price indices are showing a somewhat mixed picture with the Nationwide index showing a fall of 3.4% in the year to May and Halifax/Markit a fall of 1.0% but the Land Registry still showing an annual gain on their latest figures. But the latest data from Nationwide suggest prices have stabilised for the time being.

- As a result of higher market interest rates, fixed rate mortgage pricing has risen since May with some lenders withdrawing products. Moneyfacts reported that average 2-year fixed rate mortgage rates reached 6% by mid-June.

- There was a small uptick in mortgage arrears in Q1. Arrears of more than 2.5% of the loan balance rose from 0.74% in Q4 to 0.77%. Possessions were also higher in Q1, but at 1,250 remain far below their historic average. Short term buy-to-let arrears (1.5%<2.5% of loan balance) rose fastest in Q1, up 32% to 0.18%.

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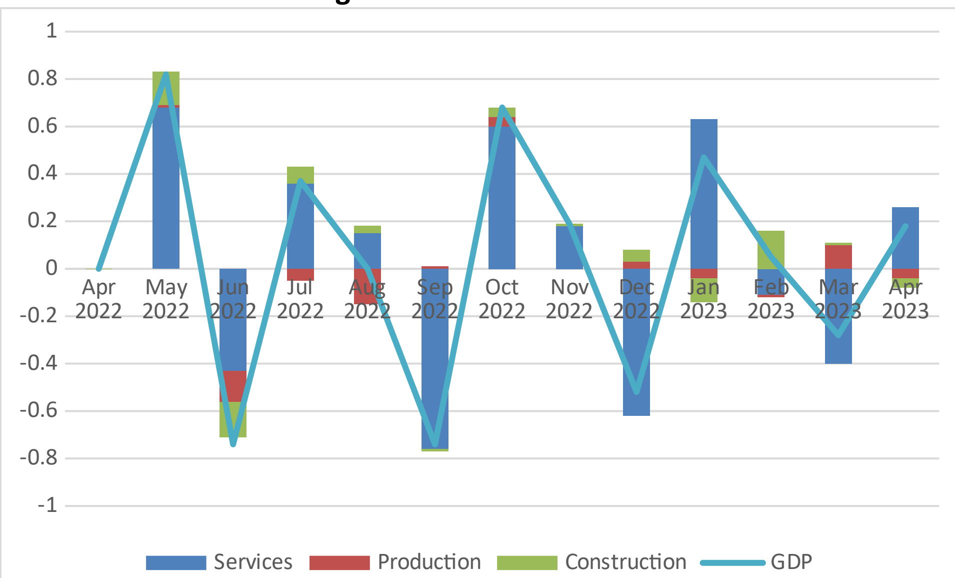
The economy

Output

Output continues to defy predictions of a softening. First estimates for GDP in the first quarter showed a rise of 0.1%, which was followed by an estimated rise of 0.2% in April. On a sectoral level, production performed better in Q1, rising 0.1%, buoyed by a rebound of 0.5% in manufacturing output while construction output was up 0.7% and services rose by 0.1%. Government investment was a strong driver in Q1, rising 9.7% but business investment also rose, by 0.7%. In contrast, private consumption was flat and government consumption fell.

Chart 1 shows the sectoral composition of monthly GDP growth. As the largest sector, services has driven most of the variation in output over the past year. In April, services' strong performance more than offset falls in production and construction, but these latter sectors had been especially strong in March. The decline in construction in April was led by private housing repair and maintenance (down 5.7%) and new private housing work (down 3%).

Chart 1 – Sources of GDP growth %

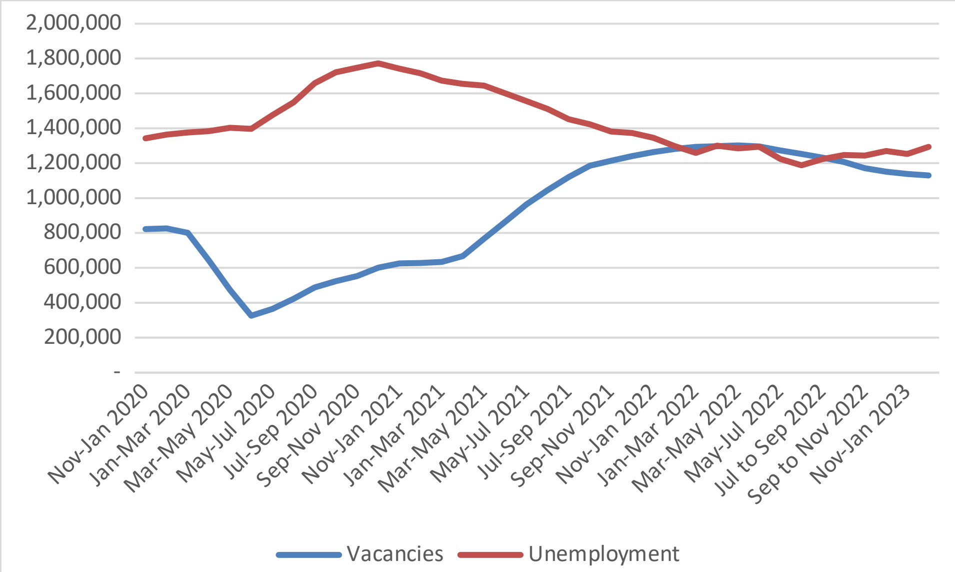


Source: Office for National Statistics

Labour market

As Chart 2 shows, despite a modest softening, the labour market remains relatively tight. Job vacancies have been falling gradually over the past 9 months from a peak of 1.3 million and unemployment has risen by 105,000 over the latest 6 months. But the ratio of job vacancies to unemployed persons remains near its all-time peak while the unemployment rate was 3.8% in March, only slightly above its 47-year low of 3.5% of July 2022.

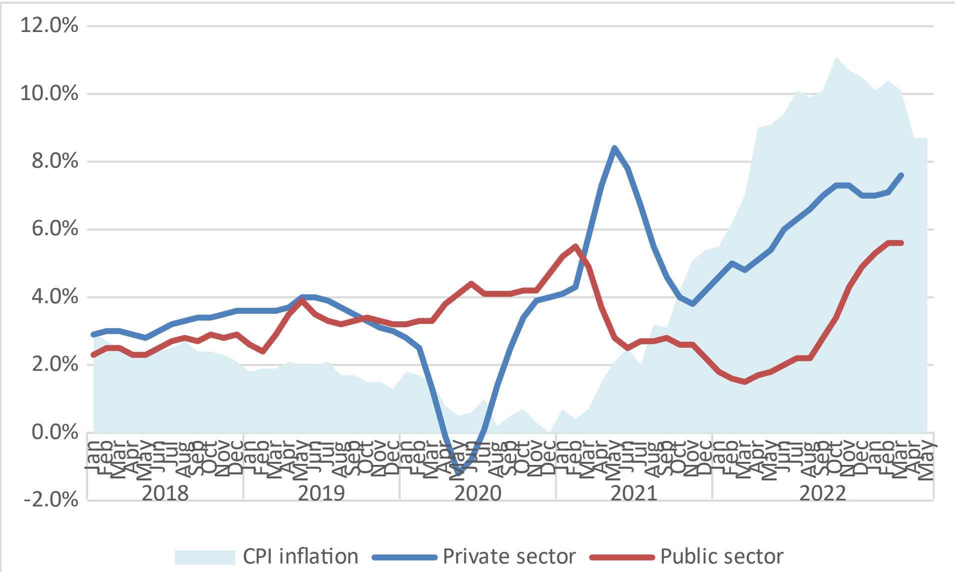
Chart 2 – Job vacancies and unemployment



Source: Office for National Statistics

The persistence of inflation and tight labour market have contributed to higher wage increases, though wage rises still lag CPI inflation (See Chart 3). In the February-April period, regular wages in the public sector rose by 5.6%, unchanged from the previous month but far above the figure of 2.8% recorded 6 months earlier. But in the private sector, regular wage rises increased again to 7.6%.

Chart 3 – Regular pay growth in the public and private sectors

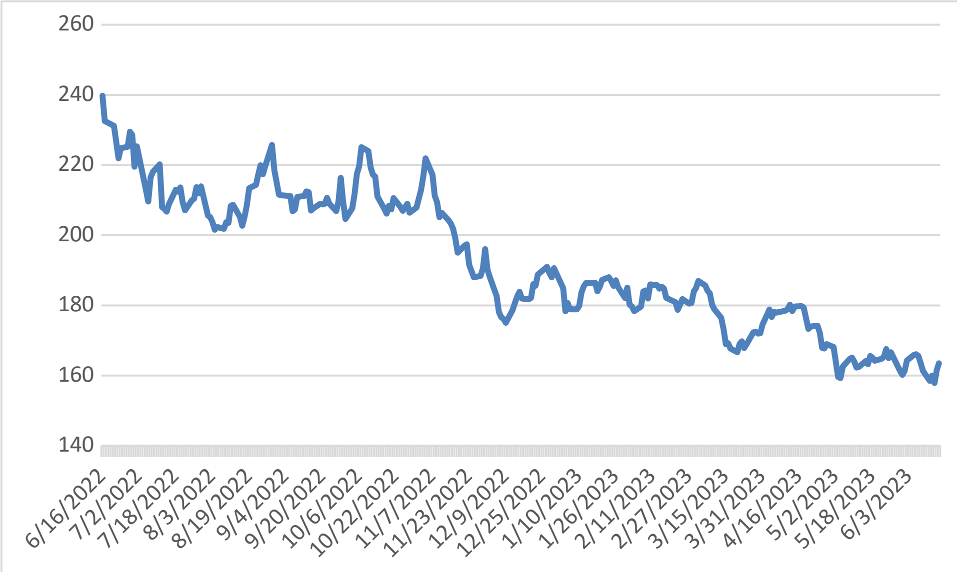


Source: Office for National Statistics

Inflation and interest rates

The positive news on inflation is the continuing downward trend in commodity prices. Chart 4 shows that the S&P GSCI Index in Sterling has fallen 32% since mid-June 2022 and 12% since the start of 2023. UK spot natural gas prices, which strongly influence electricity prices, have roughly halved since the start of the year though remain more than double their pre-pandemic level.

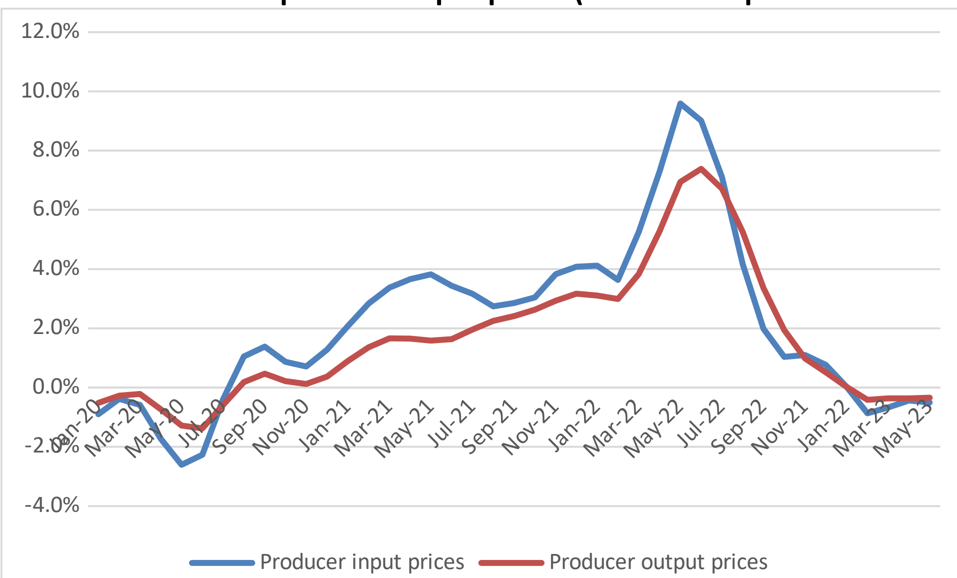
Chart 4 – S&P GSCI Global Commodities Price Index in Sterling



Source: S&P

Falling global commodity prices have helped to contain UK producer input prices, which have remained broadly flat since June 2022. On a 3 month on previous 3 month comparison, input prices are falling but the rate of decline is modest, 0.5% in May, actually slightly less than the decline in the 3 months to March (see chart 5). Producer output prices are also negative on a 3 month comparison and have been broadly flat since July 2020. This is positive news given that output prices reflect domestic cost pressures as well as commodity prices but producer prices only cover the manufacturing sector, which represents only around 10% of the UK economy.

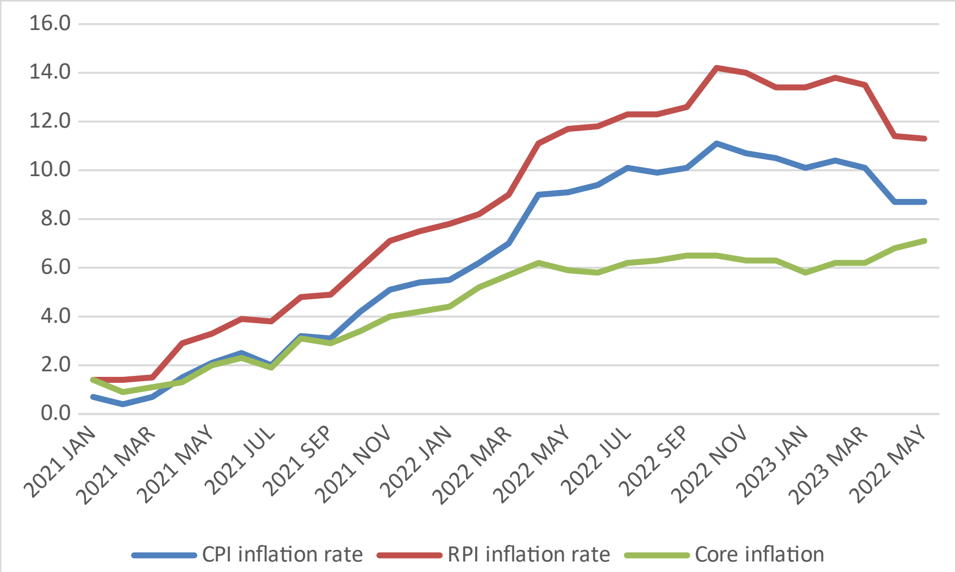
Chart 5 – Producer input and output prices (3 month on previous 3 month)



Source: Office for National Statistics

Despite the positive trend in producer output prices, consumer price inflation disappointed in April and May. CPI inflation fell less sharply than expected in April and was flat at 8.7% in May. Of particular concern was a sharp rise in core inflation, which excludes volatile food and energy prices, which went from 6.2% in March to 6.8% in April and 7.1% in May (see Chart 6).

Chart 6 – CPI, RPI and core annual inflation



Source: Office for National Statistics

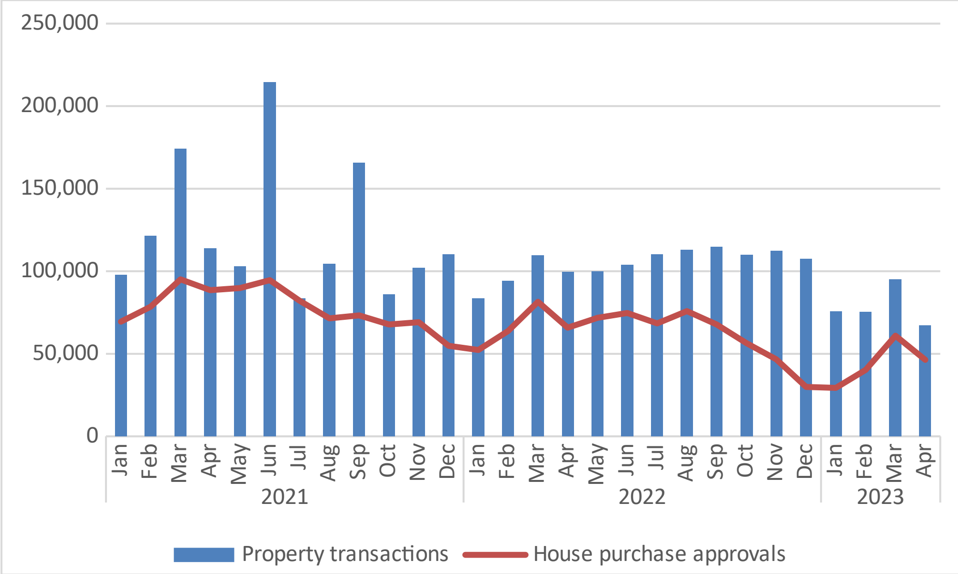
The rise in both core inflation and wages emphasises the degree to which the UK is experiencing a wage price spiral, where workers' attempts to maintain living standards increases firms' nominal costs, creating inflation persistence. As we found in the 1970s, such a spiral can prove difficult to break because expectations of higher inflation become embedded, influencing firms' and workers' decisions. As a result, financial markets are increasingly sceptical about the optimistic view that inflation can fall back to target in early 2024 and by mid-June the market was expecting Bank Rate to reach 6% by the end of 2023 and remain higher for longer than previously expected.

Housing and mortgage markets

Activity

The lags involved in the house buying process mean that significant changes in the market brought about by policy decisions such as stamp duty holidays or major economic shocks do not show up in the mortgage approvals and housing transactions data for around two and three months respectively. Thus the impact of the mini-budget in September, which caused fixed rate mortgage pricing to spike and damaged buyer confidence, became evident in December in the approvals data and January in the housing transactions data. As Chart 7 shows, both series subsequently improved but both transactions and approvals data for April were surprisingly weak, falling by 29% and 24% on the previous month respectively.

Chart 7 - Property transactions and mortgage approvals for house purchase



Source: HMRC, Bank of England

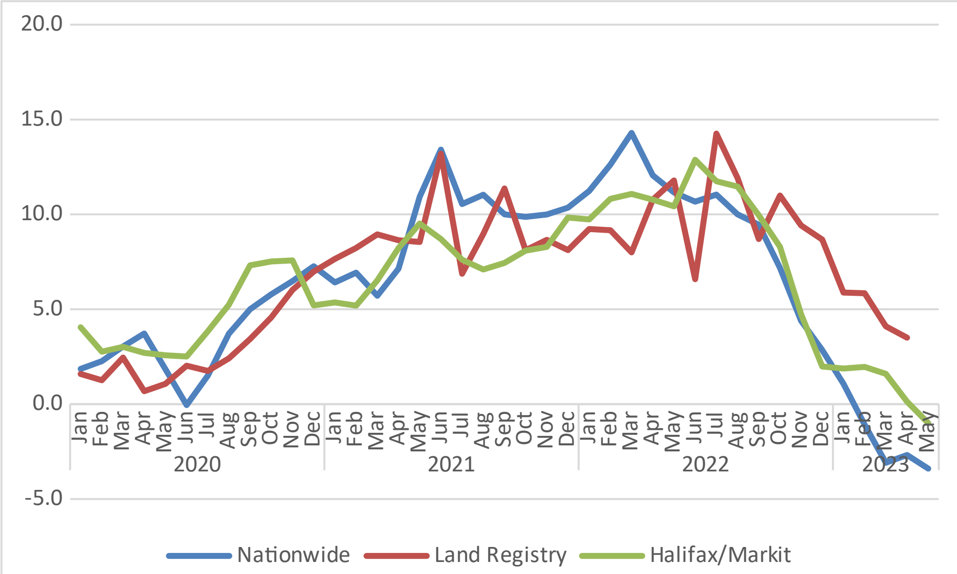
It is too early for the rise in fixed rate pricing since mid-May to have impacted mortgage approvals data, let alone housing transaction numbers. Even the May RICS Residential Market Survey, the most timely indicator, showed a less negative picture in terms of buyer enquiries, agreed sales and achieved and expected sale prices. But reduced buyer affordability from higher fixed and variable rate mortgages can be expected to impact housing demand in the coming months.

House prices and rents

House price growth also saw a lagged response to the mini-budget and subsequent market dislocation. While all slowing, the three main series, from the Land Registry, Nationwide Building Society and Lloyds Banking Group (the Halifax/Markit Index) have followed somewhat different paths (see Chart 8). The 12-month change in the Nationwide Index turned negative in February, reaching -3.4% by May but the Halifax/Markit Index showed its first fall in May and the latest figure from the Land Registry was a 3.5% rise in the year to April.

House prices appear to have confounded those who predicted a sharp correction this year and the latest monthly data from Nationwide suggest prices have stabilised for now. However, with mortgage rates rising again, a renewed softening is to be expected later in the year.

Chart 8 – Annual house price inflation



Source: Nationwide Building Society, Lloyds Banking Group, Land Registry

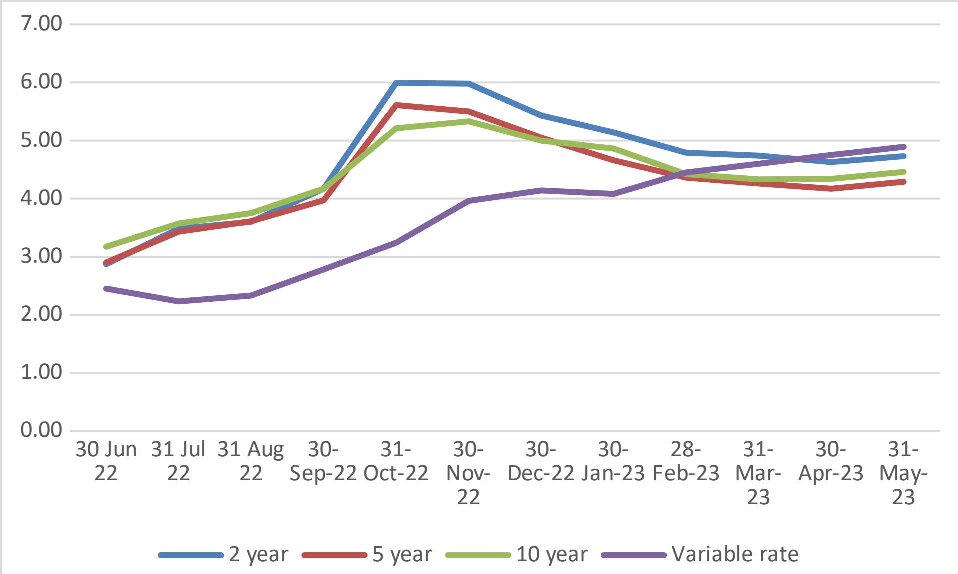
The rental market remains strong. Homelet reports that rents on new contracts were 10.0% higher than a year earlier in May while the ONS series, which tracks existing rental contracts was up 5.0%, the highest figure since this series began in 2016. London continues to show above average rental growth at 11.3% on the Homelet Index. The long standing pattern of rising tenant demand and falling landlord instructions continued in May according to the RICS Residential Market Survey.

Scotland showed the highest rate of growth in new rental contracts in May according to Homelet at 13.4%. This may reflect the impact of Scottish government measures to cap the price of existing rental agreements, which letting agents report has increased the number of landlords seeking to exit the market.

Mortgage pricing and products

The disappointing inflation figures for April had an immediate impact on market interest rates, pushing up the cost of funding fixed rate loans. By mid-June Moneyfacts was reporting that the average 2-year fixed rate mortgage exceeded 6%, the level it reached after the September mini-budget. Some lenders have also withdrawn products in response. In April, average variable rate prices moved above those of 2-year fixed rate products, reflecting recent increases in Bank Rate (See Chart 9, which uses Bank of England data which is up to the end of May).

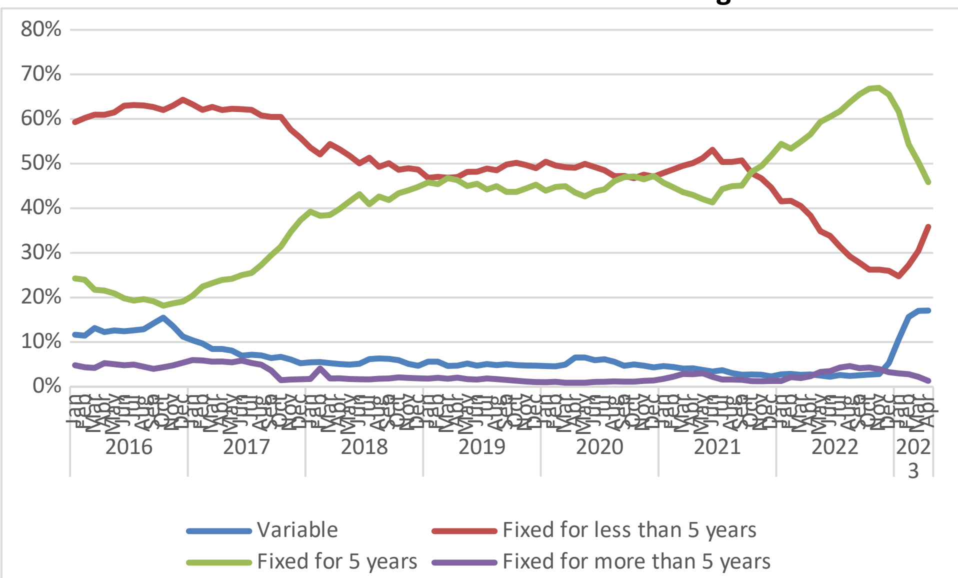
Chart 9 – Fixed and variable rate mortgage pricing (75% LTV)



Source: Bank of England

Data on the mortgage product type borrowers are taking out only extends to April, so it does not reflect the recent rise in mortgage rates. However, it does show a significant shift from 5-year and above fixed rates to shorter term fixed and variable rate products (see chart 10). This shift may reflect homeowners' desire not to be locked into higher rates for an extended period. However, as markets forecast that interest rates will remain higher for longer, fixing for a longer period does at least insure against the risk of still higher rates in the future.

Chart 10 – Fixed and variable rate share of new lending



Source: UK Finance

Calls for government mortgage support as interest rates rise

In the wake of rising mortgage rates, on 16 June, Liberal Democrat leader Ed Davey renewed his previous call for a mortgage protection fund at an estimated cost to government of £3 billion. And some Conservative politicians have echoed these sentiments: Jake Berry MP has called for the return of mortgage interest tax relief at source (MIRAS).

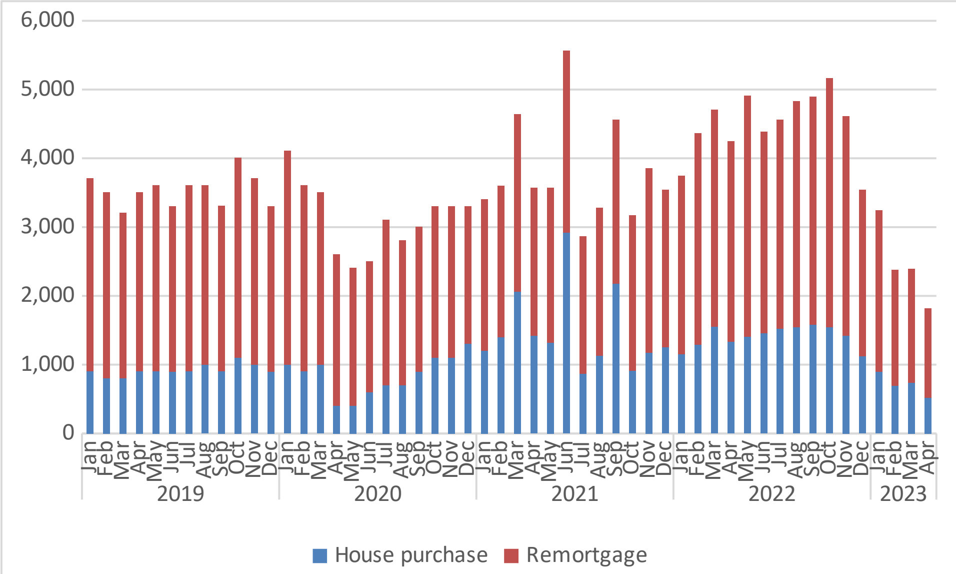
However, Chancellor Jeremy Hunt has ruled out a package of mortgage support but has invited lenders to a meeting to discuss what can be done for borrowers in distress. Other commentators have also cautioned against providing taxpayer support to mortgage borrowers. Charlie Bean, a former Deputy Governor of the Bank of England, said he thought government support would be inappropriate. In an interview with *The Independent* newspaper he said "I don't see why the taxpayer should be asked to bail out a subset of households who happen to have taken out what turned out to be excessively large mortgages."

Rachel Reeves, the Shadow Chancellor has outlined a 5-point plan to encourage lenders to provide more support for borrowers in distress. Although there are limited details, she appears to suggest that borrowers should be allowed to choose to switch to interest only or extend their mortgage term and reverse these changes at their discretion. *The Guardian* reports that the FCA has responded by saying that it has already given guidance to banks to encourage them to offer support along those lines if they felt it was in a borrower's best interests but forcing banks to offer such support could impede their ability to decide what is in the best interests of each individual borrower.

Buy-to-let market

Buy-to-let lending has slowed sharply this year, affecting both lending for house purchase and remortgaging activity. In the year to April, there was a 47% decline in the average monthly number of house purchase loans advanced compared to 2022 and a 41% decline in remortgages. The largest contributory factor was probably the pressure on affordability. Brokers report that some buy-to-let customers looking to remortgage are failing to meet affordability requirements at today's mortgage rates so are opting to take product transfers instead. Current buy-to-let mortgage rates also make it harder to find profitable new investments, as net rental yields, which take account of operating costs, are typically now below mortgage rates.

Chart 11 – Value of buy-to-let lending (monthly £ millions)



Source: UK Finance

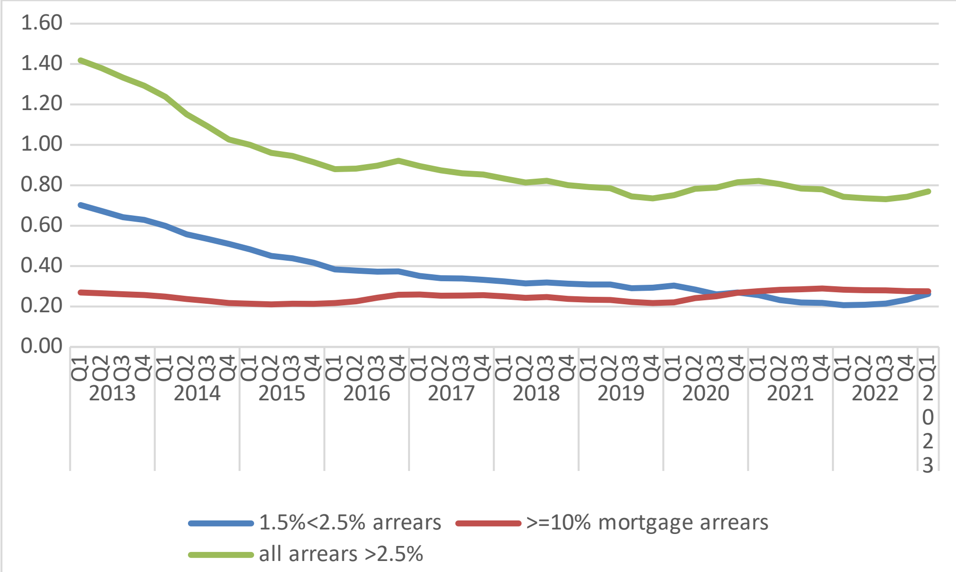
April was a particularly weak month for buy-to-let lending. Total gross lending of £1.9 billion was below any single month during the pandemic and the lowest monthly total since 2013. With mortgage rates increasing since then, the likelihood of a strong rebound in the coming months cannot be considered high.

Arrears and possessions

Short term mortgage arrears showed a 11% rise in the first quarter. Arrears of 1.5%<2.5% of the mortgage balance rose from 0.23% of all mortgage accounts in Q4 to 0.26%, although this remains a very low figure by historical standards (see Chart 12). Longer term arrears, those of 10% or more of the loan balance, were unchanged for the fourth consecutive quarter in Q1 at 0.28%. All arears over 2.5% of the loan balance were 0.77%, up from 0.74% in Q4. There was a more significant increase in short term arrears in the buy-to-let market in Q1, up 32% on Q4, than in owner-occupied lending, which was up by 9%.

1,250 properties were taken into possession in Q1. Although this is the highest quarterly total since Q1 2020, the figures had been impacted by the moratorium on possessions during the Covid pandemic and the latest number is far below the pre-2020 average. With mortgage rates rising there is concern that arrears and possessions will show larger gains in the coming months and years but lenders stress that anyone who is concerned about their ability to pay should contact them to discuss their situation.

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



Source: UK Finance

Prospects

The hope that a rapid decline in inflation would provide the economy with a glide path back to lower interest rates without going through a recessionary period has taken a blow over the past couple of months thanks to a sharp rise in core inflation, which excludes the traditionally volatile prices of food and energy. The Office for Budget Responsibility (OBR) March forecast that CPI inflation would fall to 1.5% by Q1 2024 and 0.5% by the end of 2024, looks to have failed to grasp the extent to which domestic prices have become a driver of inflation.

The surge in inflation that was initially provoked by a sharp spike in commodity prices had such a large impact on business and household costs, particularly through the energy market, that it triggered broader price rises and increased nominal wages as workers sought to maintain living standards as best they could. With CPI inflation now at 8.7% and regular wages up by 7.2%, against the background of very weak productivity growth, we appear to have entered a wage price spiral in which the expectation of further inflation has become somewhat embedded in the system.

The Bank of England is a long way from achieving the 2% inflation target with which it is tasked. Inflation is likely to fall back to around 5% by the end of this year but given the significant reduction in real wages seen over the past 18 months, it cannot be likely that workers will accept wage increases below this level and many will push to claw back lost real income. If wage inflation does prove to be sticky, failing to fall with inflation, with productivity growth expected to remain below 1%, wages could become the main driver of inflation next year. This scenario would leave the Bank of England with little choice but to keep Bank Rate higher for longer to slow the economy to weaken firms' and workers' pricing power. To borrow John Major's famous phrase, the Bank might conclude that "if it isn't hurting it isn't working".