Market Briefing: March 2022

Key developments in the housing and mortgage markets

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Executive summary

- The Russian invasion of Ukraine has heightened uncertainty, pushing up global energy and commodity prices. Unless the crisis is quickly resolved, this will feed into higher UK producer input and output prices and consumer prices. The CPI is already rising at the fastest rate since 1992, up 6.2% in the year to February and was already forecast to go higher before the conflict in Ukraine, in particular due to the forthcoming rise in the energy price cap.

- The rise in consumer price inflation prompted the Bank of England to raise Bank Rate to 0.5% in February and 0.75% in March. Markets were anticipating a rise in Bank Rate: average low LTV mortgage rates have been rising since late summer. However, growing competition in the 95% LTV market, as lenders unwind their Covid induced restrictions, has more than offset the impact of increased Bank Rate for these loans so far.

- The Bank of England faces a difficult balancing act as higher energy and commodity prices are both inflationary and detrimental to domestic activity as they squeeze corporate profit margins and reduce households' real incomes. It may be impossible to avoid a period with both high inflation and low or negative growth.

- The labour market remains buoyant with record numbers of job vacancies and falling unemployment. This has underpinned wage growth which was 4.8% in the three months to January. The Bank of England will pay particular attention to trends in pay growth, watching for signs that wages are following prices up, and may feel compelled to raise Bank Rate faster and further if earnings accelerate.

- The housing market continues to be characterised by limited supply and strong demand, putting upward pressure on prices. As a result, house price inflation in the latest 3 months rose at a double digit rate despite the removal of the impetus of the stamp duty holiday.

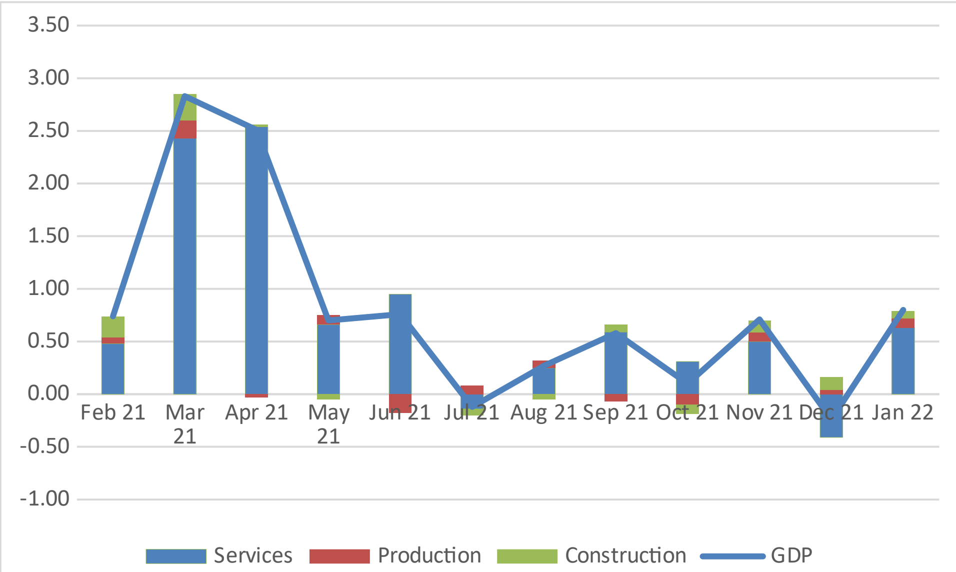
- Lending data confirms that remortgage activity is rebounding after a year when lenders prioritised house purchase lending. The prospect of higher interest rates has also encouraged some borrowers to look to fix their rate for longer.

The economy

The UK economy grew by 1.0% in the final quarter of 2021 taking output to within a whisker (0.4%) of its pre-pandemic level. Services remained the driving force behind the recovery, rising 1.2% despite the negative impact of the Omicron variant on accommodation and food services during December.

Construction output increased by 1.0%, reversing the decline of the previous quarter although survey responses reported that the industry still faced a shortage of inputs and workers. Production was 0.4% lower in the quarter and 3.6% below its pre-pandemic level. Within this, manufacturing was flat but with offsetting trends of strong growth in pharmaceuticals while machinery and equipment saw large falls, partly as a result of shortages in the supply of some inputs.

Chart 1 – Sources of GDP growth %



Source: Office for National Statistics

Labour market

The exceptionally strong conditions seen in the jobs market continued during the final quarter of 2021 and into the start of 2022. The number of employees on payrolls rose by 275,000 in February to a record 29.7 million. Although self-employment is still down on its pre-pandemic level this has been more than compensated by the rise in employees so the overall employment rate rose to 75.6% in the three months to January. Unemployment fell again to 3.9% in the three months to January while job vacancies hit another all-time high in December 2021 to February 2022 of 1,318,000, an increase of 507,000 from the pre-coronavirus level. Job moves are also at record levels.

Such tight labour conditions, with many employers struggling to fill roles, would normally be expected to fuel real wage growth but in January average total pay growth was 4.8%, below the rate of inflation.

Chancellor's Spring Statement

Rishi Sunak unveiled his Spring Statement on 24 March. The Chancellor warned of a worsening economic outlook following Russia's invasion of Ukraine, which has exacerbated the increase in energy and some other commodity prices.

Key highlights:

National Insurance threshold raised
Although the previously announced national insurance increases, to pay for health and social care costs, will not be reversed, there was a substantial increase in the threshold at which national insurance is paid from £9,880 to £12,570 at a cost of over £6 billion to the exchequer in 2022-23.

Income Tax
The basic rate of income tax is to be cut from 20% to 19% before the end of the current parliament. This will carry an annual cost to the exchequer of over £5 billion.

Employment Allowance
In a move designed to help small businesses, the Employment Allowance will increase from £4,000 to £5,000 meaning that each business will be able to reduce their overall employer's National Insurance liability by up to £5,000 a year.

Green energy VAT cut for homeowners
The Chancellor announced a cut in VAT from 5% to 0% for homeowners buying energy saving materials such as solar panels, heat pumps, and insulation for the next 5 years, although this is only expected to cost a modest £45 million in 2022-23.

Fuel duty was reduced by 5 pence a litre until March 2023.

Office for Budget Responsibility (OBR) March forecast
The OBR March forecast includes a large downward revision to growth this year from 6.0% to 3.8% and upward revision to peak CPI inflation from 4.4% to 8.7% (now expected in the final quarter of 2022).

The OBR has revised up its projection for mortgage rates from 2.1% in 2022 and 2.3% in 2023 to 2.5% and 3.1% respectively. It has also revised down its net mortgage lending forecast for 2022 from £65 billion to £52 billion. Despite this and weaker expected growth surprisingly the OBR's house price forecast has been revised up by 5% in 2022 and 6% in 2023.

Reported wage inflation had previously been distorted upwards by compositional and base effects (from the weakness of wages in the early stage of the pandemic) but these effects have largely fallen away. It remains to be seen whether a tight labour market will force wage levels up further in response to the sharp rise in inflation expected over the next few months. The Chartered Institute of Personnel and Development (CIPD) reports that employers expect median pay settlements of 3% in 2022 but the Bank of England's own survey of settlements suggests some employers are offering 5-7% rises, with much higher increases being offered to staff to switch firms.

Chart 2 – UK job vacancies and unemployment

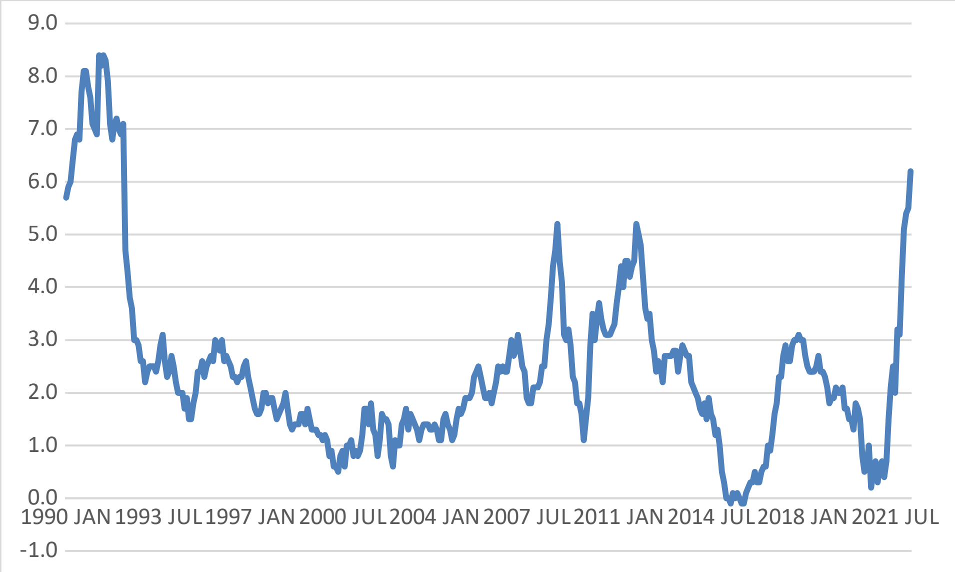
Source: Office for National Statistics

Inflation and interest rates

Inflation, as measured by the all-items CPI, hit 6.2% in February, the highest rate since 1992, while the all-items RPI rose by 8.2%. With some 22 million customers facing a 54% rise in the energy price cap from April, inflation is set to climb significantly higher this Spring, and this alongside national insurance rises has already been dubbed the 'cost of living crisis'. Russia's invasion of Ukraine can only add to these inflationary pressures.

Although central banks have been slow to react to higher inflation because of the difficulty in disentangling Covid supply disruption effects from more sustained demand effects, the Bank of England raised Bank Rate for the third time in recent months in March to 0.75%. Mortgage rates have already been raised in response with further increases in both Bank and mortgage rates likely. However, far more families are on fixed rate mortgages than in previous downturns, meaning that the impact of higher Bank Rate on the household sector will be much more drawn out than in the past, complicating the interest rate decision for the Bank of England.

Chart 3 – CPI annual inflation rate, %



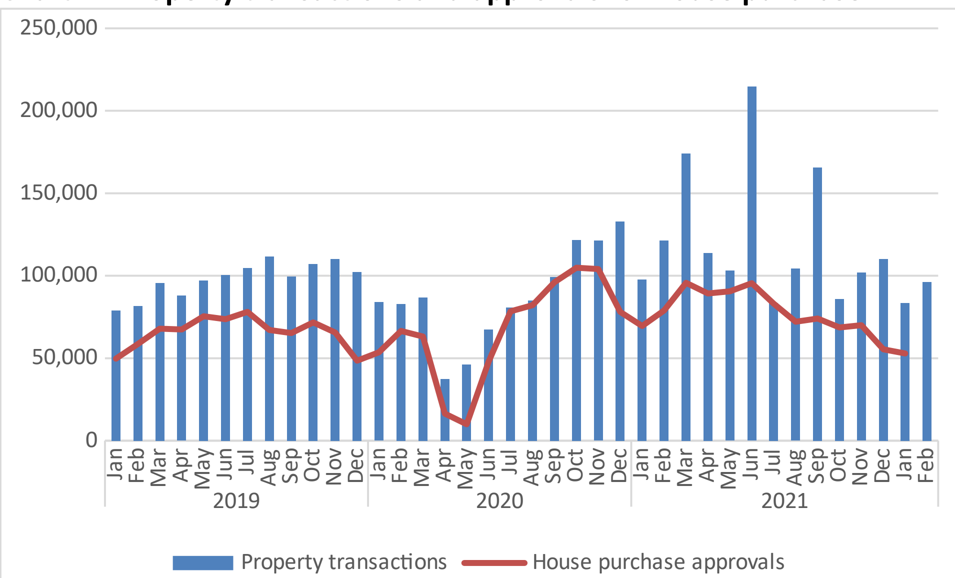
Source: Office for National Statistics

So far external factors have driven higher inflation. Average pay settlements do not suggest that wages will keep pace with these impeding cost increases. But the Bank of England will be watching pay growth closely to see any signs of a classic wage price spiral taking hold. With the tightness of the labour market it is entirely possible that earnings growth will pick up and under these circumstances the Bank of England is likely to feel it has no choice but to raise Bank Rate further and faster. Markets are currently expecting Bank Rate to reach close to 2% in 2023, but the risks to this expectation must be considered to be firmly on the upward side.

Housing and mortgage markets

Activity

Chart 4 - Property transactions and approvals for house purchase



Source: HMRC, Bank of England

Over the past 12 months, housing transactions have been heavily distorted by the stamp duty holiday cliff edges in March, June and September. But monthly transactions since the end of the holiday (October 2021 to February 2022) have been 95,000, below the average during 2019. This points to transaction levels settling back to pre-Covid levels or possibly somewhat lower, given that some transactions will have been brought forward by the stamp duty holiday. The market continues to suffer from a severe shortage of stock for sale with the RICS Residential Market Survey showing near record low stock per surveyor branch, which is bound to hold back transaction levels in the coming months.

Mortgage lending for house purchase data reflects this lower activity, falling 14% between the third and fourth quarters while the number of loans for house purchase fell by 18%. At £41.2 billion, lending for house purchase was still above the 2019 average, reflecting the sharp rise in prices since the start of the Covid pandemic, with prices 17% higher in Q4 2021 than Q1 2020, but the number of loans for house purchase was 4% below the 2019 average in Q4.

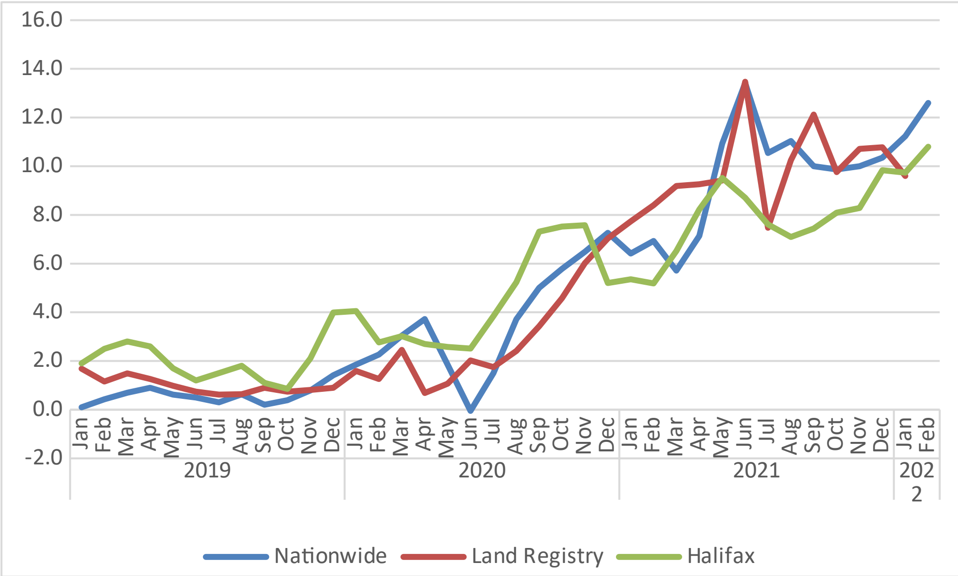
The more forward looking mortgage approvals data have also been weaker. The value of approvals fell 11% between the third and fourth quarters and the number by 15%, also taking this to below the 2019 average. January approvals were weaker still, falling 7% on December's already lower total.

In contrast, remortgage approvals have been picking up, rising 12% between Q3 and Q4 by number and 16% by value. The stamp duty holiday had required lenders to focus more resources on the purchase market to ensure that buyers could meet the necessary deadlines, which no doubt accounted for some of the weakness in remortgage activity in the first three quarters of 2021. With Bank Rate now rising some borrowers are looking to fix their rate for longer, suggesting that remortgage activity is likely to remain buoyant.

Prices and rents

The end of the stamp duty holiday did not see a rebalancing of supply and demand in the housing market with stock levels remaining close to their all-time lows. As a result, prices have continued to climb with house price inflation on the three main indices averaging just over 10% at the end of the year. If anything house price growth has accelerated with the annualised rate of increase in the Land Registry index reaching 13% between the third and fourth quarters.

Chart 5 – House price inflation



Source: Nationwide Building Society, Land Registry, Halifax

There has also been considerable upward pressure on private sector rents since 2020. In the year to February rents rose by 8.6% according to the Homelet Rental Index and 11.8% in London. The RICS Residential Market Survey has been showing the sharpest rise in tenant demand and rental price expectations for the next three months seen this century as people return to more normal working patterns. Homelet now estimates that the average renter spends 30.5% of their income on rent and 34.8% in London.

High-Level Rental Index Summary for January 2022

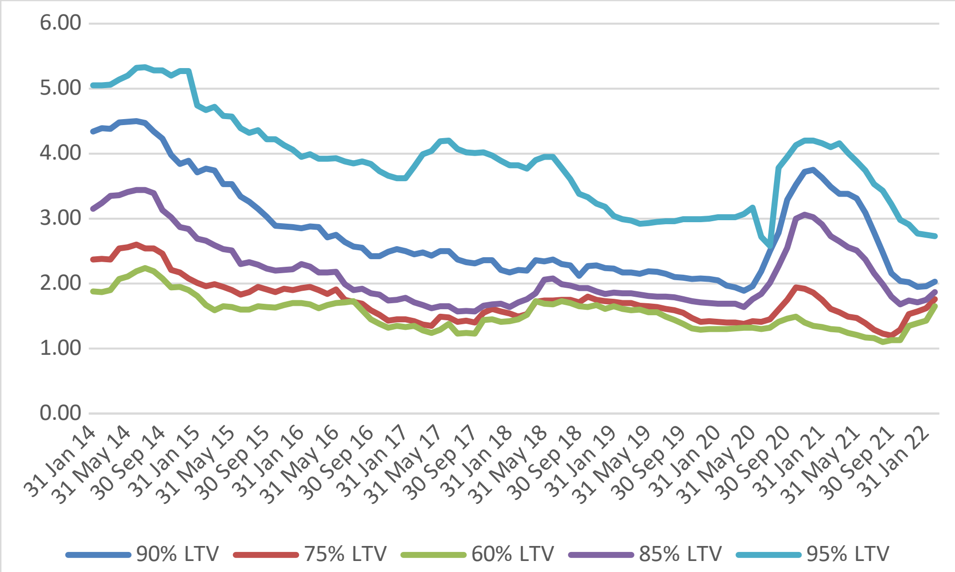
Region	Feb-22	Jan-22	Feb-21	Feb-20	Monthly Variance	Annual Variance	2020 Variance
Scotland	£760	£747	£678	£672	1.7%	12.1%	13.1%
Greater London	£1,757	£1,760	£1,572	£1,650	-0.2%	11.8%	6.5%
North West	£860	£855	£782	£755	0.6%	10.0%	13.9%
South West	£999	£989	£914	£849	1.0%	9.3%	17.7%
Northern Ireland	£718	£705	£662	£669	1.8%	8.5%	7.3%
Wales	£727	£727	£673	£650	0.0%	8.0%	11.8%
North East	£583	£578	£542	£517	0.9%	7.6%	12.8%
Yorkshire & Humberside	£730	£726	£680	£645	0.6%	7.4%	13.2%
West Midlands	£800	£792	£749	£708	1.0%	6.8%	13.0%
East Of England	£1,037	£1,035	£978	£916	0.2%	6.0%	13.2%
East Midlands	£745	£746	£704	£651	-0.1%	5.8%	14.4%
South East	£1,139	£1,128	£1,087	£1,018	1.0%	4.8%	11.9%
UK	**£1,069**	**£1,064**	**£984**	**£955**	**0.5%**	**8.6%**	**11.9%**
UK excluding Greater London	**£902**	**£897**	**£840**	**£791**	**0.6%**	**7.4%**	**14.0%**

Source: Homelet

Mortgage pricing and products

Even before the Bank of England raised Bank Rate in December, lower LTV mortgage rates were tracking higher, reflecting market expectations of higher interest rates. For 60% LTV mortgages, average quoted rates increased from 1.10% in August to 1.35% in November and 1.65% in February, before the latest Bank Rate rise.

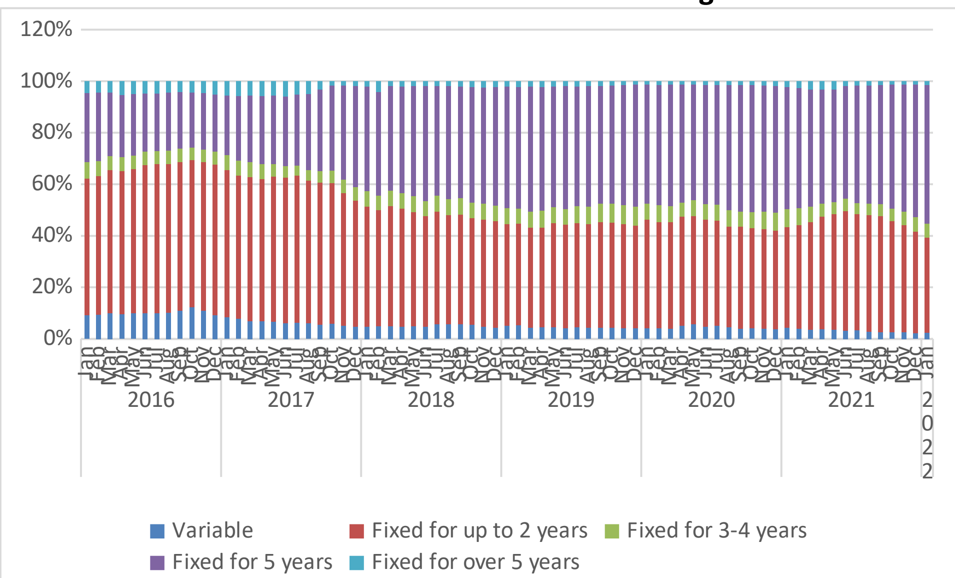
Chart 6 – Average 2-year fixed rate mortgage rates, % pa



Source: Bank of England

But the picture for higher LTV loans is different with increased availability of products as lenders unwind the tightening they put in place during the Covid pandemic. This partly reflects the availability of the government Mortgage Guarantee Scheme, which was introduced in April 2021, and catalysed lender confidence to return to the 95% LTV lending that most had suspended during the pandemic.

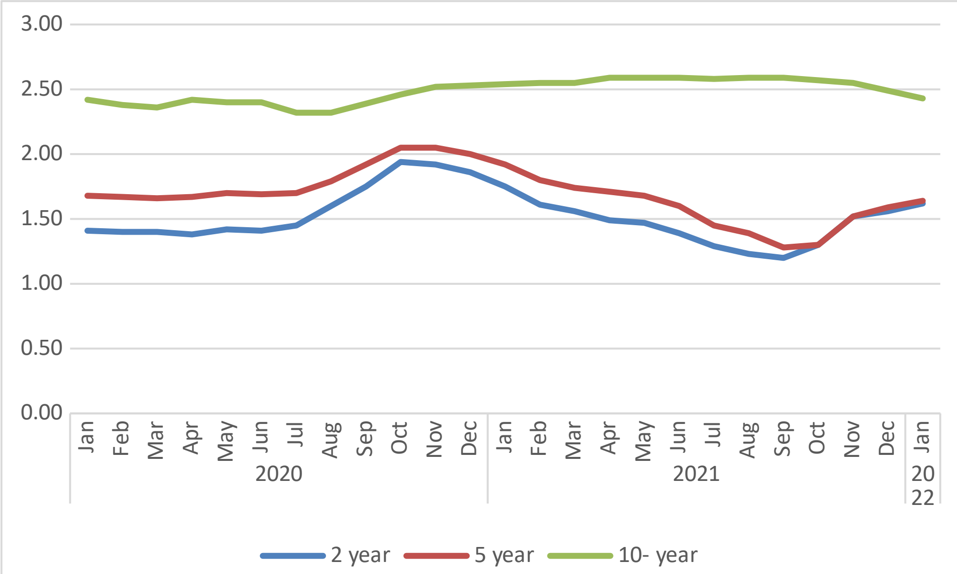
Chart 7 – Fixed and variable rate share of new lending



Source: UK Finance

The shift towards 5 year fixed rate products has continued in recent months. In January, 5 year fixes reached a record share of 54% of new lending, at the expense of variable rate loans, which comprised a new low of only 2%. 2 year fixes, which constituted the majority of lending as recently as 2017, comprised 37% of lending in January.

Chart 8 – Fixed rate mortgage pricing



Source: Bank of England

The growing popularity of 5 year fixes partly reflects the increasingly competitive pricing of these products relative to shorter term fixes and variable rates, in turn reflecting a flattening of the interest rate swaps curve. But it may also reflect mortgage regulations that require loans fixed for less than 5 years to be stressed for affordability purposes. Although many lenders apply the stress rate across all products, some lenders do differentiate their treatment, meaning that some borrowers may be able to borrow more with a 5 year fixed product.

Macro-prudential

On 28 February, the Bank of England released its consultation *Withdrawal of the FPC's affordability test Recommendation*. This followed a review of the FPC's macro-prudential measures in the mortgage market which was outlined in section 3 of the Financial Stability Report of December 2021.

The Bank of England is proposing to remove the stress test requirement that it first imposed in 2014, which requires lenders to assess affordability at the reversionary rate plus three percentage points. The FPC explained its decision by stating that "the stress rate encapsulated in the test has remained broadly static, reflecting stickiness in reversion rates despite the fall in average quoted mortgage rates. This demonstrates that there is considerable uncertainty about how the stress rate encapsulated in the affordability test might move in future, and in turn about the effect the test could have."

The Bank further explains that it believes that the LTI limit of 4.5 times, under which lenders are restricted to no more than 15% of new loans, "is likely to play a stronger role than the affordability test in guarding against an increase in aggregate household indebtedness and the number of highly indebted households when house prices rise rapidly, and that the additional insurance provided by the affordability test would be small."

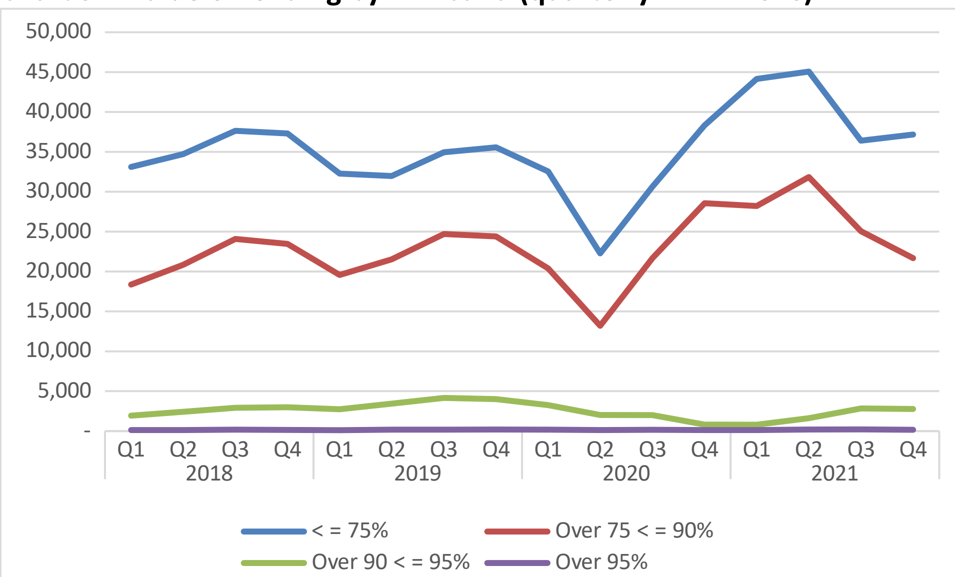
If the FPC's stress test requirement is removed, affordability will continue to be assessed according to the FCA's MCOB rules on responsible lending. These rules state that "a mortgage lender must have regard to market expectations… on appropriate interest rate stress tests. A lender must also assume that interest rates rise by a minimum of 100 basis points during the first five years of the mortgage." Thus the proposed change would effectively reduce the minimum stress from 3% to 1%.

We welcome the plan to remove the stress test, which we have argued assesses affordability based on an unduly high mortgage rate. However, we also have concerns about the arbitrary nature of the LTI limit. The responsible lending rules create a framework that assesses what size of loan a borrower can comfortably afford but borrowers who can afford an LTI above 4.5 can still be rejected because of this cap. This is likely to have a disproportionate impact on first time buyers and lower income borrowers seeking smaller mortgages. The consultation closes on 6 May.

High LTV schemes

The market for high LTV products continues to recover after lenders restricted availability in the wake of the Covid pandemic. In Q4 2021, regulated lending over 90% LTV constituted 4.7% of the total by value against a low of 1.2% in Q1. Before the pandemic this was running at over 6% but as recently as 2018 such high LTV lending was running at below 4%.

Chart 9 – Value of lending by LTV band (quarterly - £ millions)



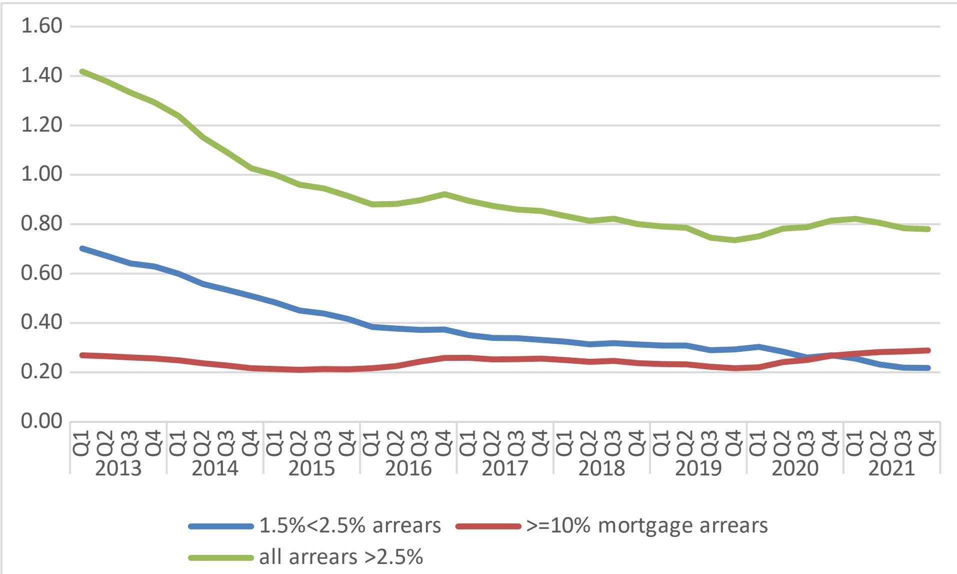
Source: Financial Conduct Authority

The government's Mortgage Guarantee Scheme, which was announced in the March 2021 Budget and covers loans with an LTV of between 91% and 95%, saw completions of 6,535 loans up to the third quarter valued at £1.2 billion and was successful at catalysing a wider adoption of 95% loans by lenders not using the government scheme which included building societies, none of which have used it.

Arrears and possessions

The feared rise in mortgage arrears stemming from the end of the furlough scheme and other support measures has not materialised. Indeed, short term arrears (between 1.5% and 2.5% of mortgage balances) hit a record low in Q4 2021 of 0.22%, 19% below the same quarter a year earlier and 28% below Q1 2020. In contrast, longer term arrears (at or above 10% of mortgage balances) increased by 8% in the year to Q4 and by 31% since Q1 2020 but this was to be expected as the moratorium on possessions during much of the pandemic prevented these loans from being foreclosed on.

Chart 10 – Mortgage arrears (percentage of balance)



Source: UK Finance

Possessions data has also been surprisingly positive in recent months. After the end of the moratorium on possession proceedings it was expected that the backlog of cases that could not previously be actioned would start to flow through, albeit with a lag. Yet possession numbers were a modest 710 in the final quarter of 2021. While still up on the trough recorded at the end of 2020, this number was down on the previous quarter and well below the 2019 average of 2,000 a quarter, although this partly reflects the difficulties courts are facing dealing with a backlog of work.

Prospects

With the global economic disruption of the Covid pandemic still apparent, a new source of uncertainty has arisen from the Russian invasion of Ukraine. For the UK domestic economy this is likely to mean higher energy prices and increases in the price of some other commodities, all of which can only add to inflationary pressures already evident from the supply-chain disruption and an imbalance of supply and demand brought about by the pandemic.

Although higher import prices are inflationary they also have a depressing effect on activity as they reduce real household incomes and squeeze corporate profit margins. This poses a challenge for the Bank of England in determining the appropriate monetary policy response: higher inflation points to the need for higher interest rates while lower real output suggests a more accommodative policy stance.

The sheer scale of inflationary pressures and the fact that real interest rates are heavily negative as a consequence, suggests that the Bank of England will feel compelled to continue raising rates. How high Bank Rate goes and for how long it remains at these higher levels will be determined to a considerable extent by domestic wage pressures and the extent to which producers can absorb higher costs in their margins. With a tight labour market, it must be a concern that pay increases will move higher, provoking the Bank of England into more aggressive Bank Rate rises than currently expected.