Market briefing: September 2021

Key developments in the housing and mortgage markets

Bob Pannell

Economic Adviser, IMLA

Executive Summary

- The easing of social distancing restrictions has allowed a re-opening of the economy and a period of strong economic growth. This will fade somewhat in the second half as Covid support measures are withdrawn and the country tackles raw material and labour shortages.

- While it is difficult to gauge the true extent of inflationary pressures, the odds are shortening on the Bank of England nudging interest rates higher next year.

- The housing market has experienced huge spikes in activity associated with the stamp duty holiday. While the second half of the year will be quieter without stamp duty concessions, housing demand and house prices will continue to be supported by lifestyle preferences and attractive mortgage pricing.

- The availability and pricing of high LTV loans has improved materially over recent months. These trends look set to continue over the short-term and will provide much-needed support for first-time buyers who are having to cope with higher house prices and elevated deposit requirements.

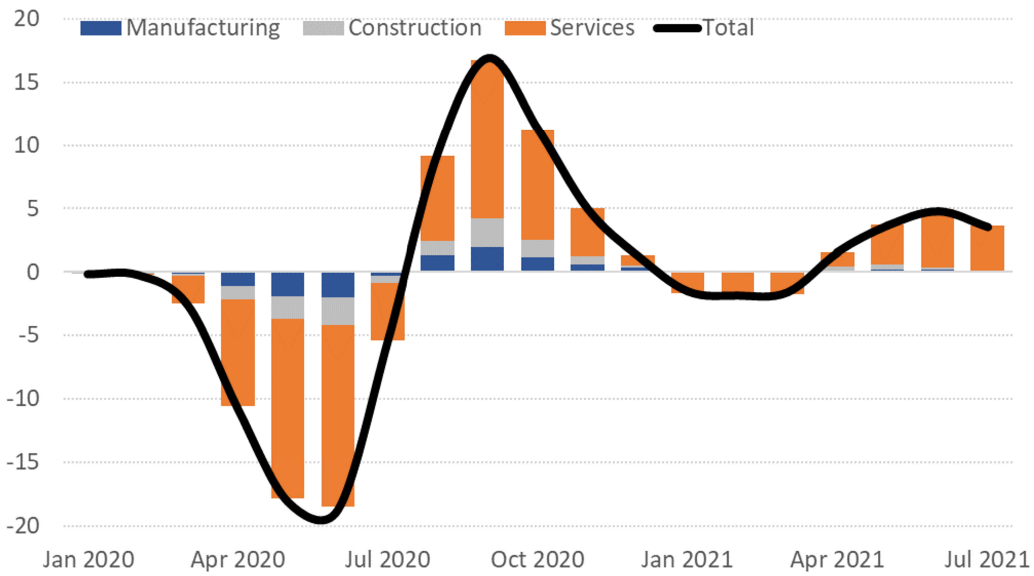
The Economy

The UK's recovery story was undermined a little by July's "pingdemic", on the back of strongly rising Covid infection rates associated with the Delta variant. This disrupted supply chains and dampened consumer demand, dragging down overall economic growth.

The latest monthly GDP figures indicate that the UK economy stalled in July.

While the UK continues to benefit from the easing of social distancing restrictions, GDP growth in the three months to July slowed to 3.6% from 4.8% in June.

Chart 1: Sources of GDP growth, %



Source: Office for National Statistics
Note: Figures show contribution to growth, latest 3 months on previous 3 months.

Real-time data suggest that economic activity regained momentum in August, helped by the first full month without lockdown restrictions and changes to the self-isolation rules to ease the "pingdemic" effect.

The economy looks to be on course for a decent second half. The latest [economic forecasts] compiled by HM Treasury point to 2.3% growth in Q3 and 1.6% in Q4, which would bring overall GDP growth for the year to nearly 7% - more than sufficient for the economy to regain its pre-pandemic level.

That said, the UK faces several potential headwinds. Most immediately, and as recent debacles concerning CO_2 availability for food processing and distribution and the financial soundness of domestic gas suppliers starkly illustrate, energy, raw material and labour shortages are adversely affecting many parts of the economy,

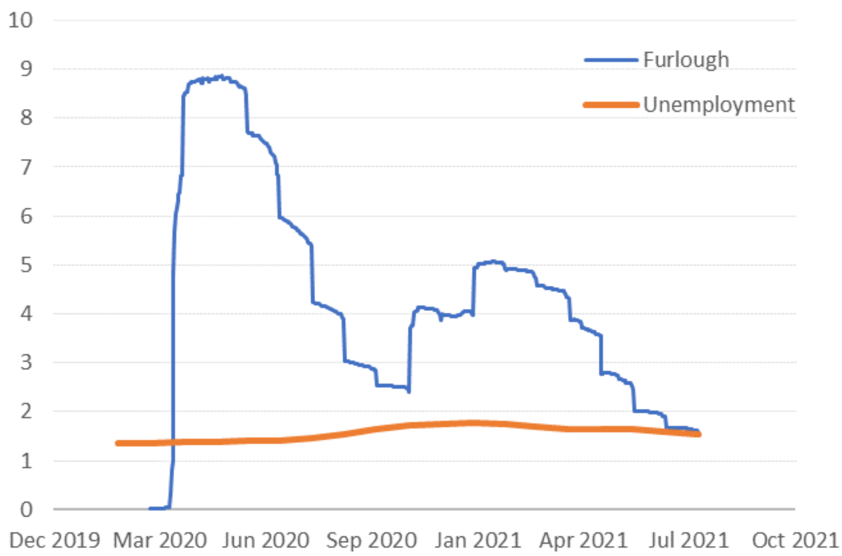
The Government has also recently announced higher National Insurance contributions and dividend taxes from 2022-23 to help fund dealing with the backlog of NHS treatments and social care reform. Further fiscal actions may result from this year's Autumn Budget scheduled for 27 October, alongside a spending review.

Meanwhile, publication of the Government's *Autumn and Winter Plan: 2021* provides a timely reminder that Covid-19 is still very much with us and that the economy remains vulnerable to a big rise in infections and hospital admissions.

Jobs market

While the Coronavirus Job Retention Scheme (CJRS) closes at the end of September, and 1.6 million staff were still on furlough as at the end of July, there is confidence that this will not trigger a sharp rise in unemployment given the large number of workers who have already come off furlough as the economy has reopened and the backdrop of a very strong jobs market.

Chart 2: Numbers on furlough or unemployed, millions



There has been positive news on the jobs front for most of the year.

In the three months to July, the headline unemployment rate fell by 0.3% over three months earlier to 4.6%. Figures for August showed other strong improvements. The number of payroll employees returned to pre-pandemic levels and job vacancies were not only a quarter of a million above pre-pandemic levels but also the highest since records began in 2001.

The earnings data have been distorted by significant Covid-related changes (this recently prompted the Chancellor to suspend the triple lock on pensions).

Annual growth in pay (including bonuses) was reported as 8.3% for the three months to July, but this is distorted in two ways. Firstly, the comparison is with a year earlier when measured pay fell sharply as large numbers put on furlough did not have their pay topped up by firms. There have also been significant compositional effects, with pandemic-related job losses skewed towards lower-paid roles.

The Bank of England has estimated that the underlying annual pay growth is currently about 4% - close to pre-Covid rates.

Such distortions should unwind over the coming months.

Although there is upward pressure on pay settlements especially in sectors where there are labour shortages, the jury is out as to whether higher pay rises will become more deeply entrenched.

Inflation and interest rates

Inflationary pressures are building, for the time being at least.

August saw a sharp upwards spike in the annual rate of inflation, with the Consumer Price Index including owner occupiers' housing costs (CPIH), increasing by 0.9% to 3.0% and the CPI rate of inflation targeted by the Bank of England rising by 1.2% to 3.2%.

While some of the reported rise reflects last year's Eat Out to Help Out scheme, it is clear that cost pressures (Covid- and Brexit-related) are feeding through to many parts of the economy.

A key question facing the Bank of England's Monetary Policy Committee (MPC) is the extent to which such pressures will prove temporary and so can be looked through when setting monetary policy. For the time being, the Committee's central expectation is that global and domestic cost pressures will prove transitory, and that CPI, after hitting 4% in the fourth quarter, will subsequently fall back to close to its 2% target.

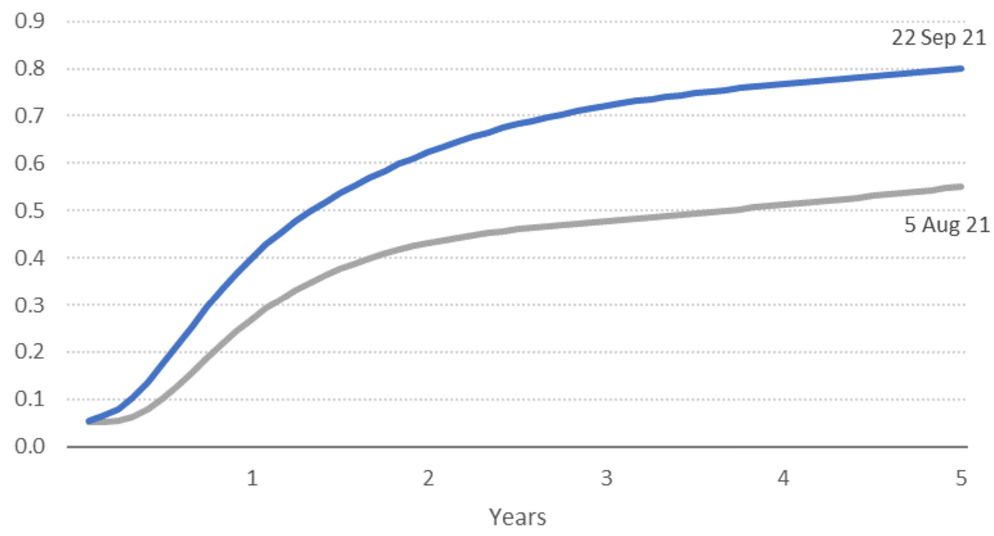
MPC members may have been a little slow to recognise the strength of inflationary pressures but the debate between policy-makers has shifted to when, rather than if, policy should be tightened.

Monetary policy was kept on hold at September's MPC meeting, although two members voted to stop the current asset purchase programme early.

Market implied measures of UK policy rates, on which MPC forecasts are based, have hardened over recent weeks (see Chart 3), bringing forwards when rates are expected to rise by a few months. They now imply that Bank Rate will increase to 0.25% next May and to 0.5% by the end of 2022.

The Bank updated its strategy for how it would tighten policy in its August Monetary Policy Report. The key take-away is that the Bank's initial moves would be to raise Bank Rate to 0.5%, after which point it would also start to unwind its stock of assets purchased under QE.

Chart 3: Market-implied policy rates



Source: Bank of England
Note: UK instantaneous OIS forward curve at the time of the most recent MPC meetings

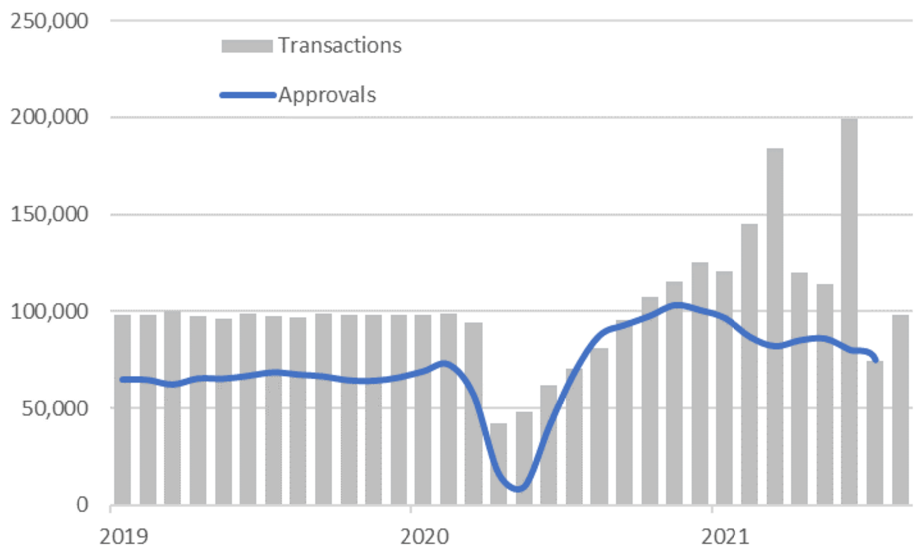
Housing and mortgage markets

Activity

Market activity this year has been heavily influenced by stamp duty changes, with significant spikes in property sales in March and June, coinciding with the dates when concessions in the different nations of the UK ended or began to be tapered (see Chart 4).

Stamp duty arrangements have already reverted to their previous settings in Scotland (since April) and Wales (since July), while in England and Northern Ireland the maximum saving shrank from £15,000 to £2,500 from July and disappears from the end of September.

Chart 4: Property transactions and approvals for house purchase, monthly



Source: HMRC, Bank of England

June - the last month of the full stamp duty holiday across most of the UK - saw a record high of nearly 200,000 transactions, according to HMRC. The peak in sales was especially pronounced in England, although this was unsurprising given that this is where the largest gains from stamp duty holidays were to be found.

A key question for mortgage lenders is what happens next.

It is normal for stamp duty holidays to be associated with distortions in purchase activity, with the usual picture being one of significant sales brought forward to take advantage of the holiday and then a dearth of activity in the months immediately following the end of the holiday – the so-called forestalling effect.

While evidence of forestalling can be seen in July's sharp fall in sales, the picture is more complex this time round.

The stamp duty holiday has undoubtedly been a significant catalyst for house moves and brought forward sales, but this has to be overlaid onto a fundamental shift in demand prompted by lockdown experiences and preferences for remote working. These appear to have motivated many existing home-owners to think about moving home or buying second/holiday homes.

Such underlying demand has not evaporated and continues to be supported by high levels of consumer confidence and low mortgage borrowing costs. This may help to explain why August saw a noticeable pick-up in sales and why activity across all the UK nations is on a par with corresponding pre-pandemic levels.

It is too early to say what longer-term trends may be and while the second half of the year will undoubtedly be quieter than the first, there are grounds for optimism.

Prices and rents

The main house price indices have shown signs of divergence and a greater degree of volatility recently, as happens from time to time.

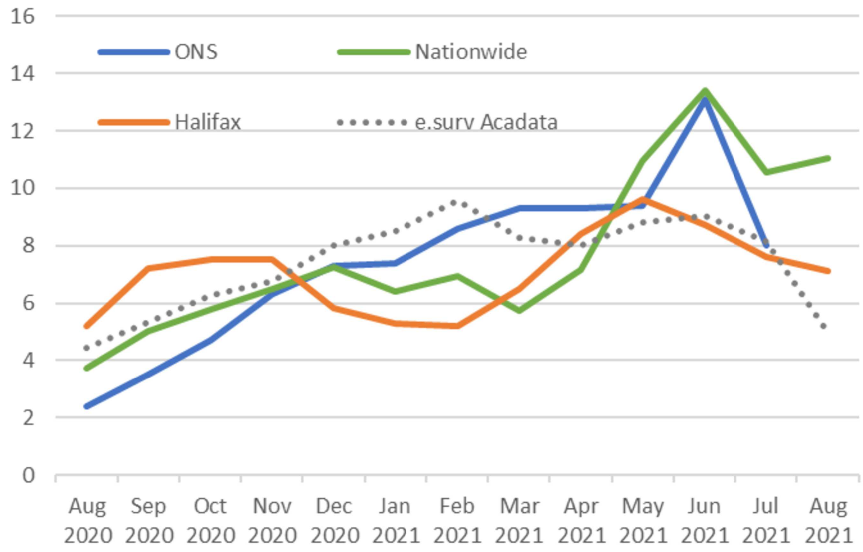
To some extent, all the main measures are struggling to reflect market developments, given the large swings in buyer activity over recent months and, in the case of ONS and Acadata reporting, delays in the processing of official data.

In such circumstances, it is best to step back a little from the detail and to focus on what the big picture is likely to be.

In the author's view, annual house price inflation peaked mid-year at about 10% and has eased back gently after the most generous stamp duty concessions ended in June. Growth rates look set to moderate further through the rest of this year and into 2022, as stamp duty effects fall away and the government withdraws its furlough and other pandemic stimulus packages.

That said, there is an ongoing lack of new supply coming onto the market and this points to continued support for house prices.

Chart 5: Measures of UK house price inflation, % year on year



Source: Office for National Statistics, Nationwide, Halifax, e.surv Acadata
Note: e.surv Acadata figures relate to England and Wales only

The drop in new buyer enquiries reported by the Royal Institution of Chartered Surveyors (RICS) for the last couple of months is outweighed by the fact that the number of properties being listed for sale has fallen for much of the year, resulting in estate agents having record low levels of housing stock available for sale.

Regionally, Scotland and Wales appear to have barely noticed the end of their stamp duty holidays, with prices increasing year-on-year in July by nearly 15% and 12% respectively, according to ONS.

Meanwhile, confidence in London prices has begun to recover as city life slowly resumes. The capital's stock overhang has shrunk considerably as sales instructions ease and rental yield and capital gains opportunities boost sales.

The experiences of the private rental sector closely echo those in the sales market, with strong rental demand and stock shortages pushing rental prices sharply higher over recent months.

The average UK rent in August was up 6.9% on the same time last year, according to HomeLet.

One factor behind the acceleration has been the sharp turnround in the London lettings market, which has now seen rental price increases for the third month in a row after a year of decline. Another has been the decision of landlords to take advantage of the renewed appeal of UK holiday destinations by switching their properties to short-term lets, reducing the supply of private rental homes and putting upward pressure on rents

Mortgage lending

Reflecting stamp duty distortions on house purchase activity, gross mortgage lending and net lending hit new highs of £43.8bn and £17.9bn in June, according to figures from the Bank of England (BoE). This comfortably exceeded the previous record levels set just a few months earlier in March.

Predictably, lending has fallen back sharply in July to levels below year-earlier and 2019 levels. In the case of net lending, we had the relatively rare instance of a small monthly net repayment being reported.

While it is impossible to extrapolate from such roller-coaster behaviour, monthly approval numbers give a more meaningful insight into the future (see Chart 4). They have been trending gently lower since their peak at the end of last year, but as of July were still running 10% higher than year-earlier levels. This suggests that activity over the coming months may be subdued but not dramatically so.

First-time buyers

The surge in house purchase lending activity has first and foremost been about movers. Q2's recovery in loans to movers comfortably outpaced that for first-time buyers across the whole of the UK except Scotland, according to UK Finance's latest *Household Finance Review*. In the year to June, there were about 460,000 movers buying with a mortgage, up 50% on a year earlier, whereas the comparable figures for first-time buyers were a little under 400,000 and 28%.

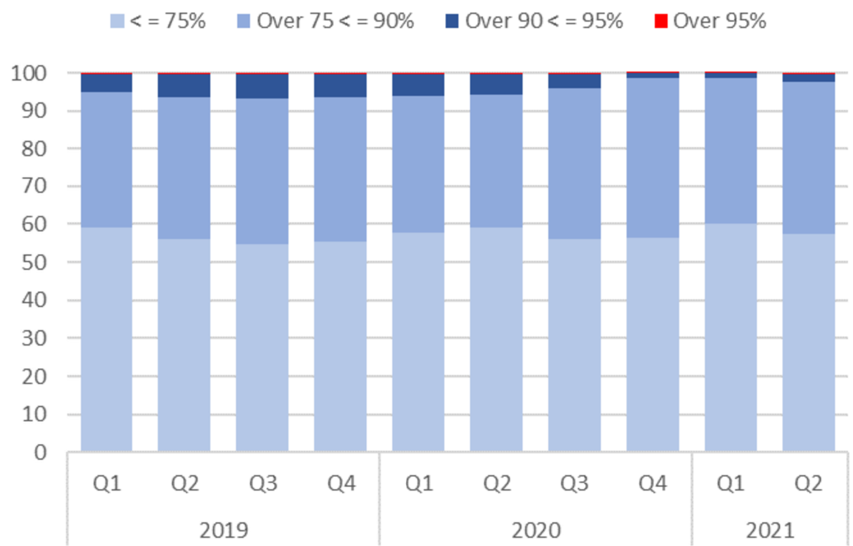
The indications are that since June the number of movers has fallen away more quickly than first-time buyers. This makes sense given that movers would have been more strongly motivated to take advantage of the stamp duty deadlines. Given the shift in demand preferences following lockdown, the favourable equity position of many home-owners and good availability of mortgage credit, we would expect to see mover activity settle down at a higher level than in the years preceding Covid.

The prospects for first-time buyers seem less certain.

First-time buyers were adversely affected through the post-lockdown period - we estimate they now face extra costs of about £15,000 in England and Wales and £10,000 in Scotland because of recent house price increases.

With no house price correction expected any time soon, this adds to the affordability pressures facing would-be first-time buyers, skews the market a little bit more in favour of higher income households and raises a question as to what extent ongoing affordability pressures may undermine first-time buyer numbers.

Chart 6: Higher LTVs as % of new mortgage lending



Source: Financial Conduct Authority, MLAR statistics

The gradual return of higher LTV loans has begun to unwind the situation, at least as far as deposit requirements are concerned, but as the regulator's MLAR figures for Q2 show the proportion of higher LTV loans taken up by borrowers remains well below pre-Covid levels. This reflects product availability and the stricter lending criteria, higher credit scores and other exclusions that sit around high LTV products.

Government schemes remain hugely important for first-time buyers. The latest Help to Buy Equity Loan Scheme statistics report 46,000 loans to first-time buyers in the year to March (the last year of the old scheme). The new scheme only runs for two years, limits support to first-time buyers only and applies regional price caps, and this may mean that take-up shrinks to fewer than 30,000 annually. With the Government ambition to gear up the First Homes Scheme to delivering 10,000 units a year, there is an obvious gap for private schemes or fresh Government initiatives to plug.

Buy to let

Investors were not slow to take advantage of the tax savings made possible by the stamp duty holiday. Buy-to-let landlords completed the largest monthly purchases since 2016, as UK Finance recently reported, with the rolling 12-month total of purchases exceeding 100,000.

While activity has slowed since mid-year, higher rents and a resurgence in demand, especially in London and other major cities, as the economy opens more fully, should underpin a reasonable second half.

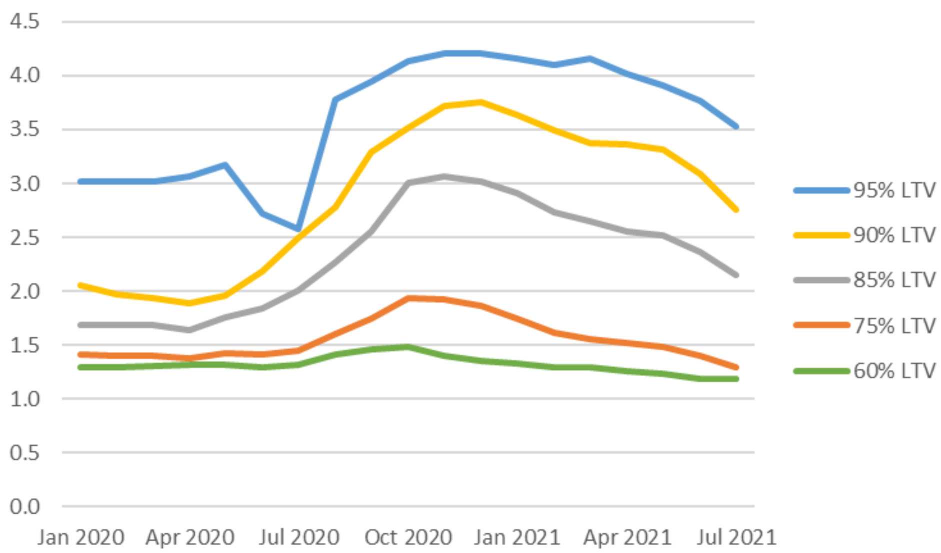
For the time being, arrears remain at low levels, although the end of the furlough scheme and the £20-a-week rise to universal credit from the end of September are likely to aggravate financial strain for some renter households.

Mortgage products

Borrowers have enjoyed progressively lower mortgage rates over the year, as lenders' capacity and appetite to lend has strengthened. Intensifying competition has seen greater product choice and keener pricing across the board.

This has underpinned high levels of refinancing, especially product transfers. Strong refinancing activity looks set to continue over the coming months, even as the purchase market slows, helped also by significant waves of maturing fixed-rate deals.

Chart 7: Quoted rates, 2-year fixed rate mortgages, % pa



Source: Bank of England

Lower LTV loans (75% and below) are not only cheaper than a year ago but also at or close to historic lows.

While the number of mortgage products at 90% and 95% LTV levels has improved considerably over recent months and gathered pace since the Government announced its Mortgage Guarantee Scheme, we have not yet regained corresponding 2019 levels. The premium over corresponding 75% LTV loans is narrowing, Bank of England figures show, but higher LTV loans continue to be more expensive than pre-Covid.

That said, 2-year fixed rate 95% LTV mortgages have dropped by nearly a percentage point to 3.57% from 4.47% in April, MoneyFacts recently reported.

Further competition and downward pricing seem likely until such time as the Bank of England tightens monetary policy, given that individuals and firms have boosted deposits over the past 18 months and ring-fencing limits other lending opportunities for the large banks.

Prospects

The Government unwinds the furlough scheme and other Covid support measures from the end of September, and this represents a substantial test for the resilience of our jobs market and the wider economy. Supply problems, raw material and labour shortages and associated inflationary pressures add an extra degree of uncertainty.

For now, these look like temporary challenges that can be overcome, with the jobs market strong and confidence levels running high.

As the final vestiges of the stamp duty holiday end shortly, a picture of the true extent of the shift in demand preferences prompted by the Covid pandemic will begin to emerge. While transaction volumes will undoubtedly be lower, the evidence from Scotland (where the usual stamp duty arrangements have applied since April) suggests that housing demand will hold up reasonably well.

Competitive mortgage deals should underpin the market over the coming months, albeit first-time buyer numbers may be under some pressure.

Looking beyond the short-term, the pick-up in inflationary pressures may not prove as transitory as the Bank of England hopes and there is a growing probability that next year will see the UK headed on a path of gentle increases in official interest rates.