Market Briefing: September 2022

Key developments in the housing and mortgage markets

Rob Thomas, Principal Researcher,
Intermediary Mortgage Lenders Association (IMLA)

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Executive summary

- Inflation measured by the 12-month change in the CPI fell slightly to 9.9% in August after hitting the highest rate since February 1982 in July. Over the same period the RPI rose 12.2%. A further sharp increase in consumer prices was expected in October but the government's decision to cap energy bills can be expected to dampen the rise.

- GDP contracted by 0.1% in Q2, including a 0.6% fall in June but the July figure was better at plus 0.2%. The Bank of England is projecting falling output from Q4 2022 to Q4 2023, driven mainly by an unprecedented contraction in real household incomes as wages struggle to keep pace with inflation.

- The labour market remains strong despite weak output growth. Unemployment fell to 3.6% in the May-July period, the lowest rate since 1974. However, there are tentative signs of a slight softening, with job vacancies down 14,000 on the latest data compared with the previous period. Wage rises including bonuses were 5.5% in the 3 months to July, well down on the 7.0% figure recorded in March, and failing to keep pace with inflation.

- Unsurprisingly, mortgage rates have moved sharply higher this year in response to higher Bank Rate. 60% LTV 2-year fixed rate loans averaged 3.51% in August, against 1.39% in December. But higher LTV products have seen a more modest increase, compressing the differential between 95% and 60% LTV mortgages from 138bp in December to 64bp in August.

- There are tentative signs of a rebalancing in the housing market. The RICS Residential Market Survey for July showed a negative balance of new buyer enquiries for the third month but the stock of properties remains low, underpinning house prices. The lettings market remains strong, with rising tenant demand and lower landlord instructions putting upward pressure on rents. According to the Homelet rental index, rents were 8.5% up over the year to August.

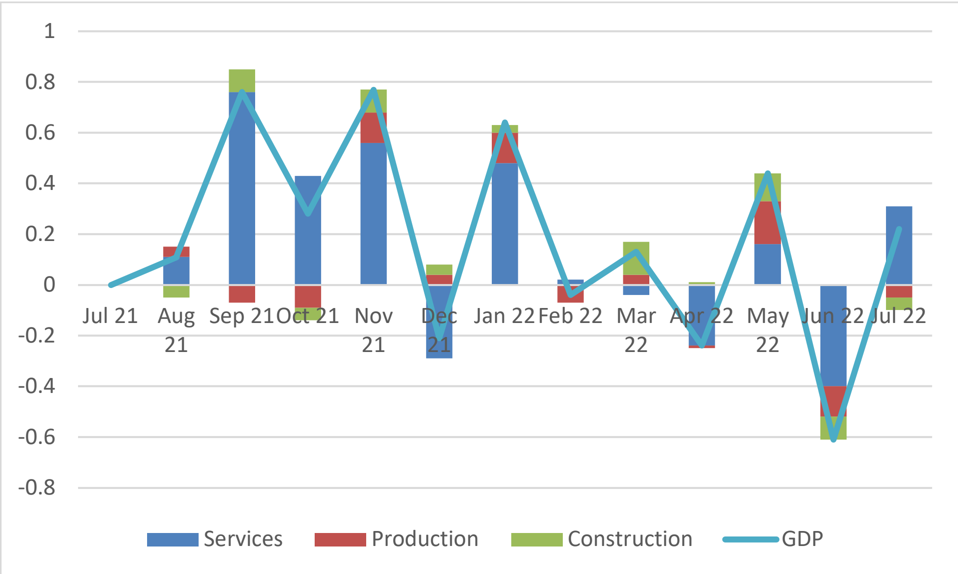
- On 1 August, the Bank of England removed the affordability test requirement, as it had indicated in June that it planned to do. This is not expected to have much impact on the amount consumers can borrow, given that the FPC LTI flow limit and the MCOB requirement that lenders take account of expected rate increases still apply, but at least lenders are not having to increase their stress rates in line with their reversionary rates.

The economy

First estimates suggest that the UK economy shrank by 0.1% in the second quarter with the services sector contracting by 0.4% and household consumption falling 0.2%, reflecting the pressures on family budgets from rising prices.

The monthly profile shows a slightly brighter picture in July with GDP rising 0.2% (see Chart 1). The Platinum Jubilee may however explain the rise as it reduced the number of working days in June. Services output grew 0.4%, but production and construction output fell by 0.3% and 0,8% respectively. Businesses continue to report that output is constrained by supply shortages for a range of inputs and labour shortages are also impacting some firms.

Chart 1 – Sources of GDP growth %

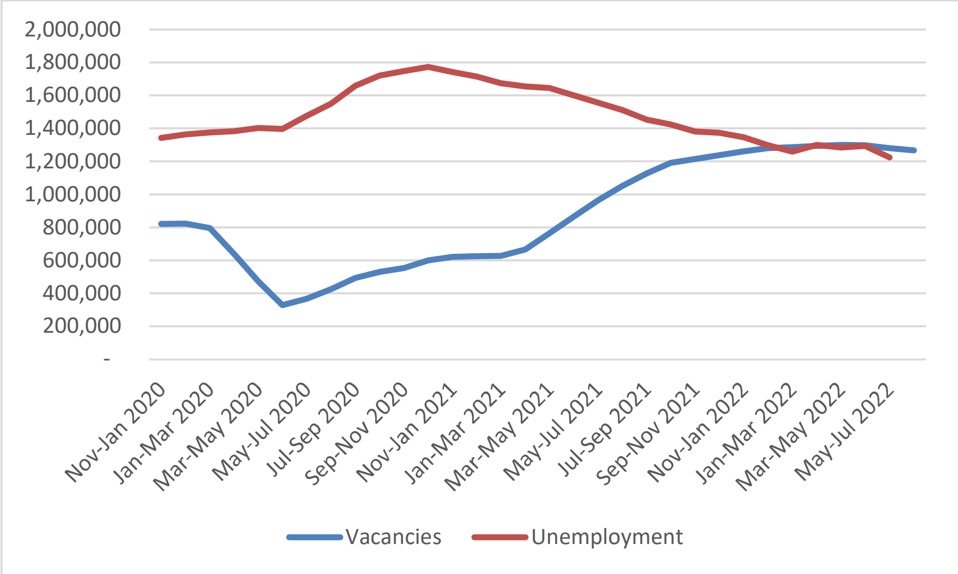


Source: Office for National Statistics

Labour market

The labour market remains strong despite the slow rate of growth. Unemployment fell to 3.6% in the May-July period, the lowest rate since 1974. However, there are tentative signs of a slight softening, with job vacancies down 14,000 on the latest data compared with the previous month after a 17,000 the month before (see Chart 2). The proportion of the working age population in employment also slipped in May-July by 0.2% to 75.4%, driven by a fall in the number of part-time employees.

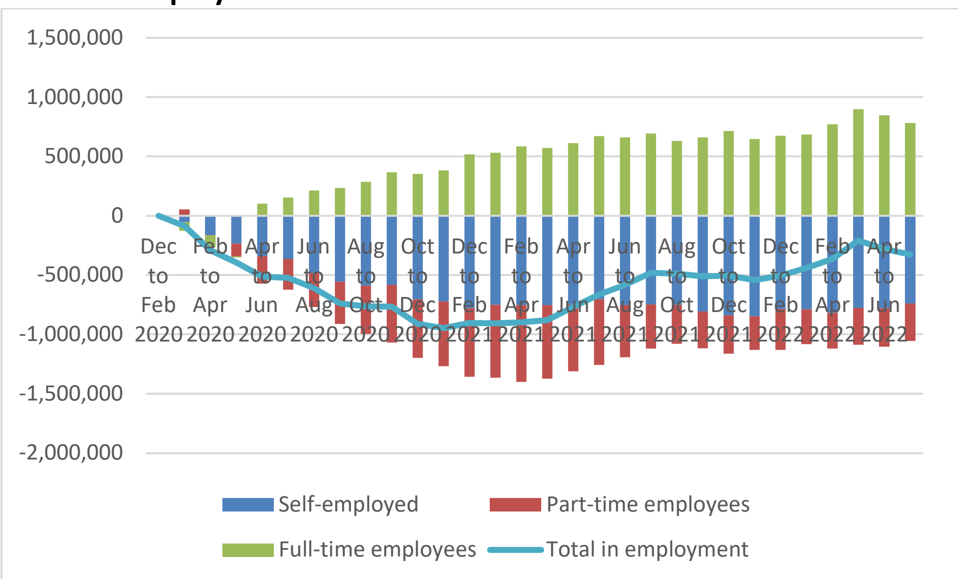
Chart 2 – UK job vacancies and unemployment



Source: Office for National Statistics

The May to July period saw a small decrease in the numbers employed and hours worked as well as the employment rate. Again, this may be a tentative sign of a weakening in the labour market and gloomy forecasts for output over the next 12-18 months from the Bank of England and others suggest that employment levels are likely to continue to fall. A key factor that has driven labour shortages has been the increase in inactivity (those not in work or looking for work) since the pandemic, but inactivity levels have stabilised in recent months and it is possible that rising living costs might force some people back into the labour market, contributing to a rebalancing of the market to the benefit of employers.

Chart 3 – Employment trends



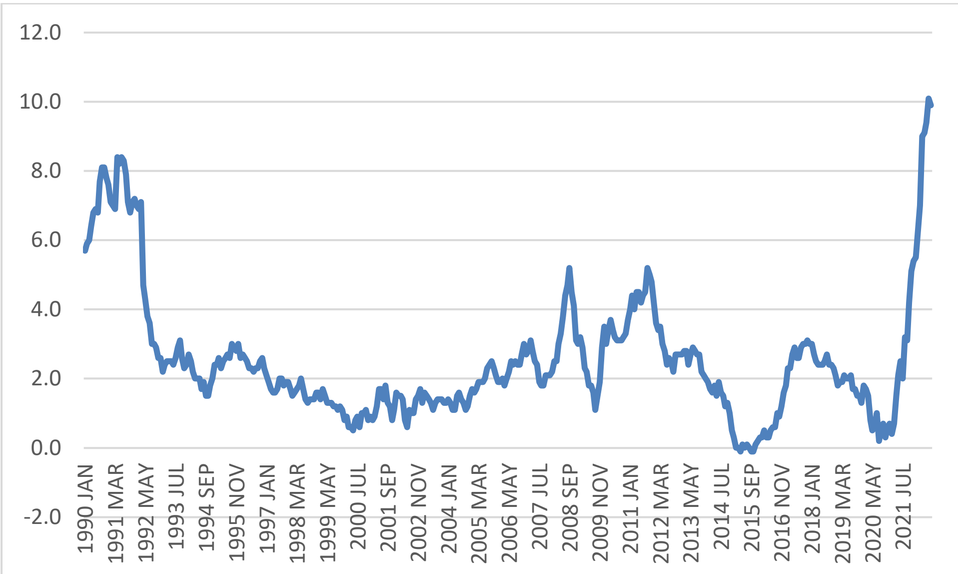
Source: Office for National Statistics

Despite the tight labour market, wage rises including bonuses slipped back from 7.0% in January-March to 5.5% in May-July. However, regular pay (excluding bonuses) has been accelerating in recent months with an annual increase of 5.2% in May-July, the highest since last summer. Adjusted for inflation, basic or regular earnings suffered their worst performance on record in April-June, falling 3.0% from a year earlier, with only a slight recovery to minus 2.8% in May-July.

Inflation and interest rates

The CPI inflation rate was down slightly at 9.9% in August (see Chart 4) after hitting the highest rate since February 1982 in July. RPI inflation continues to exceed that of the CPI, the August annual increase being 12.2%. A further sharp increase in consumer prices was expected in October but the government's decision to cap energy bills can be expected to dampen the rise. The Bank of England had been expecting CPI inflation to reach more than 13% in October but the majority of this was expected to be driven by gas and electricity prices, so inflation in October may be closer to 10%.

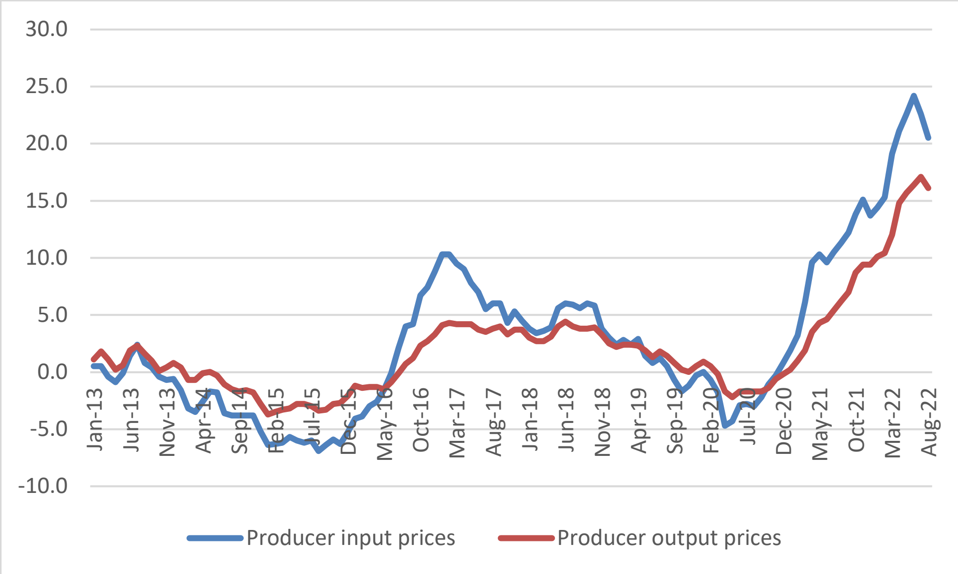
Chart 4 – CPI annual inflation rate, %



Source: Office for National Statistics

Producer input and output prices continue to show exceptional high growth on an annual basis (see Chart 5), but there are signs that input price inflation may have peaked, with the three-month on previous three-month rolling average falling to 3.9% in August from a peak of 9.7% in May. Three-month on previous three-month increases in output prices are also lower at 4.4% against 6.0% in June.

Chart 5 – Producer input and output prices



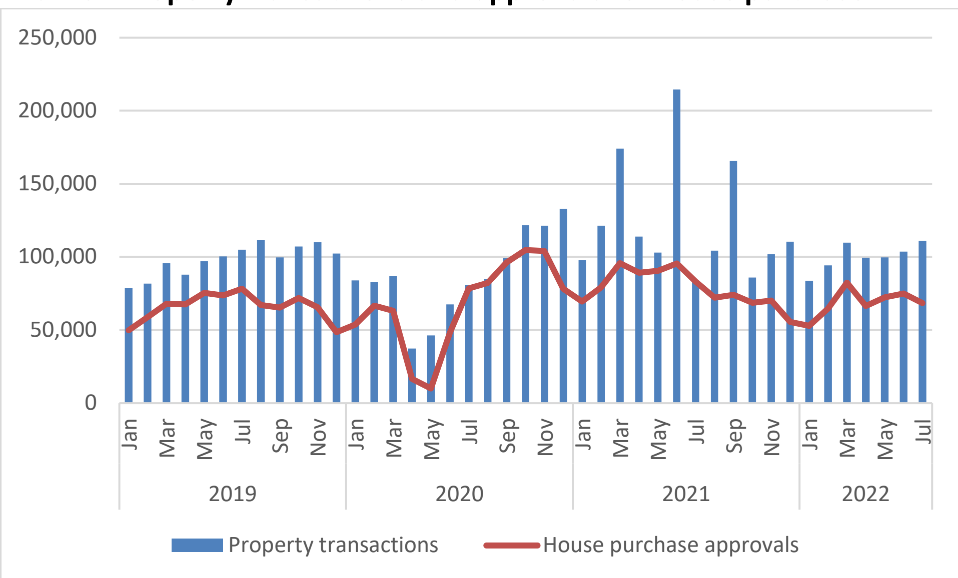
Source: Office for National Statistics

Housing and mortgage markets

Activity

Housing transaction levels have remained strong despite the limited stock of properties on the market, rising interest rates and the deteriorating economic outlook. In July, transactions reached 111,000, the highest total so far this year. But house purchase mortgage approvals, which are more forward looking, paint a more subdued picture, falling to 68,000 in July, 13% short of the 2021 monthly average (see Chart 6).

Chart 6 - Property transactions and approvals for house purchase



Source: HMRC, Bank of England

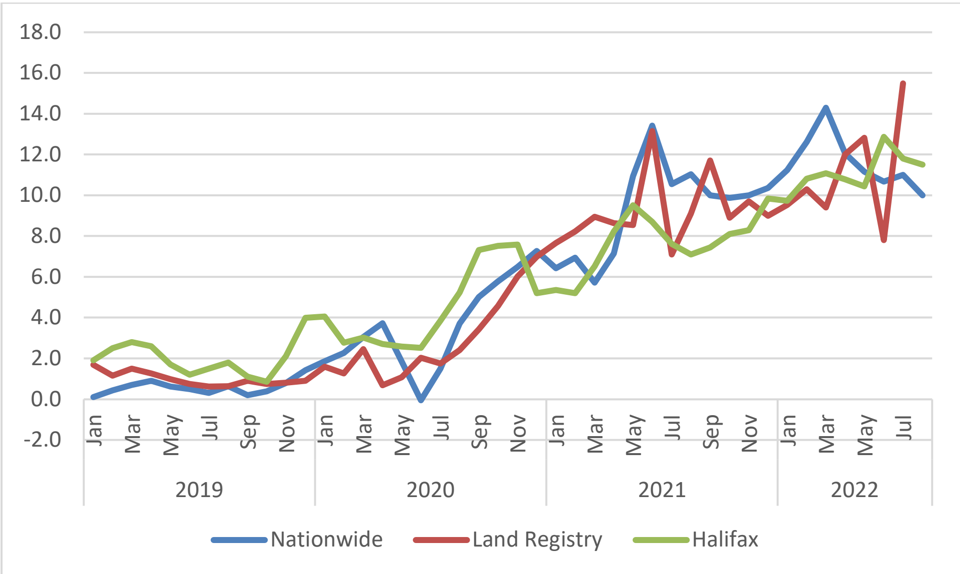
Although the market is still characterised by a severe shortage of stock for sale, with the July RICS Residential Market Survey showing a further fall in the inventory of properties per surveyor branch, there are tentative signs that the market is cooling. The survey showed a negative balance of new buyer enquiries for the third month in July with new vendor instructions only marginally negative.

In line with quite buoyant transaction numbers, mortgage lending for house purchase figures have remained relatively strong this year: the July figure was £17.1 billion and the average so far this year is £15.5 billion. Although this is down on 2021, it was above the pre-pandemic level of 2019. But remortgage activity has been much stronger this year, driven in large part by customers taking longer-term fixes to avoid expected rate increases. Total remortgage lending in the year to July was £62.9 billion, 39% ahead of the corresponding period of 2021. By contrast, product transfers have been subdued this year with the first quarter total of £46.1 billion down 4% on the quarterly average for 2021.

House prices and rents

House price inflation continues to be driven by the shortage of property on the market. Both the Nationwide and Halifax indices showed double digit increases in August (see Chart 7), albeit with a slowdown from the previous month. The latest Land Registry figures, however, showed a sharp rebound to 15.5% growth from the previous 7.8%. This partly reflected base effects as June 2021 was a particularly strong month because of the stamp duty holiday, pushing down the annual comparison in June. On a three-month rolling average, Land Registry data showed prices were still up 3.9% in the May-July period.

Chart 7 – House price inflation



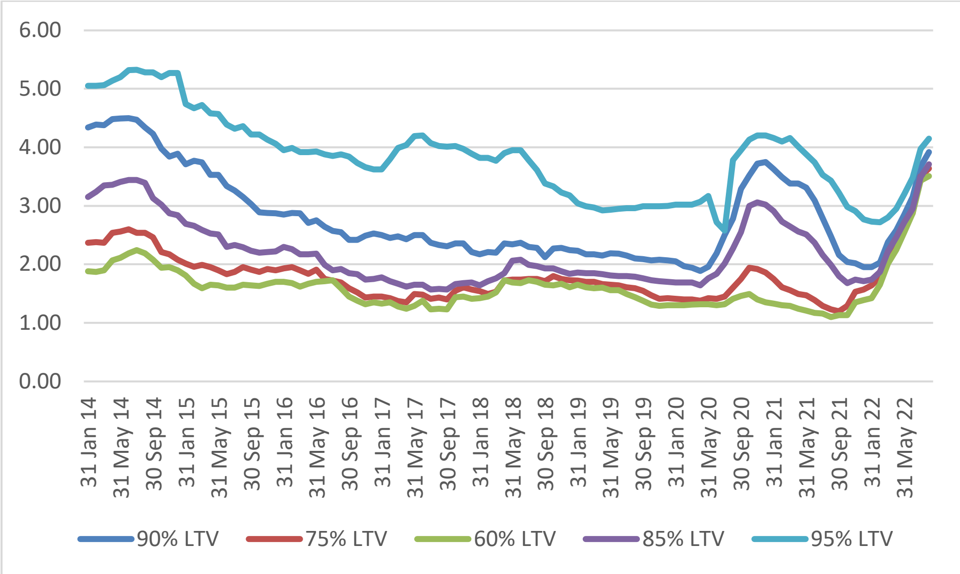
Source: Nationwide Building Society, Land Registry, Halifax

The July RICS Residential Market survey of the letting market continued the pattern of recent months, with sharply rising tenant demand and falling landlord instructions. This is creating scarcity of supply and putting upward pressure on rents. According to the Homelet rental index, rents were 8.5% up over the year to July and 10.8% higher in London, although these numbers were slightly down on previous months.

Mortgage pricing and products

As Chart 8 illustrates, lower LTV 2-year fixed rate mortgage rates have surpassed their early post-Covid peaks. By the end of August, 60% LTV products averaged over 3.5%, more than two percentage points above January's level. But lenders have not raised higher LTV mortgage rates by as much, leading to a compression of spreads between low and high LTV mortgages. For example, 2-year fixed rate 95% LTV mortgages averaged 4.15% in August, only 1.5 percentage points above the January number.

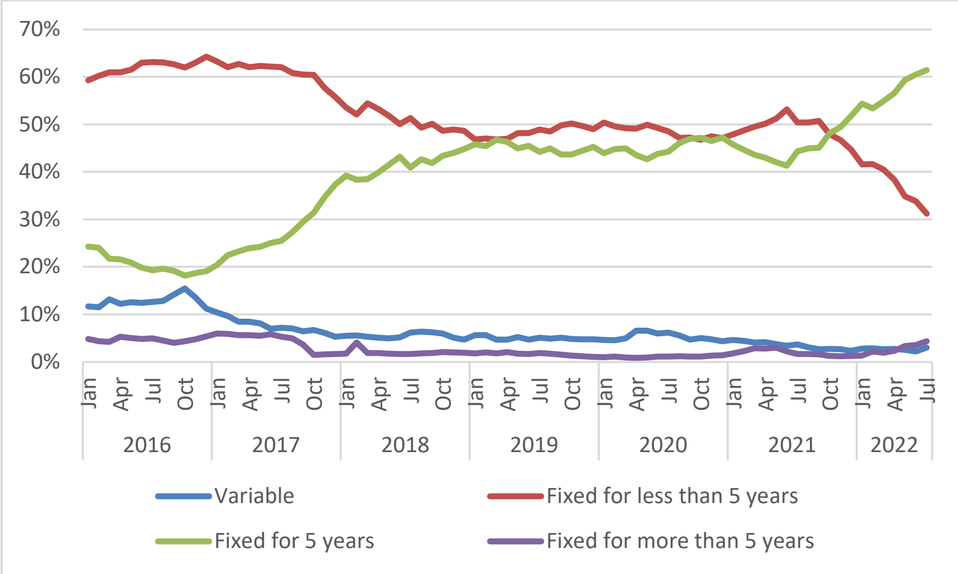
Chart 8 – Average 2-year fixed rate mortgage rates, % pa



Source: Bank of England

The shift towards longer term fixed-rate mortgages continues, driven in part by a flattening of the yield curve which has left little differential in funding costs between short and longer term fixes. In July, the share of lending fixed for 5 years reached 61% and that of loans fixed for more than 5 years reached 4%, close to its previous record. Only 31% of loans were fixed for 2 years (see Chart 9).

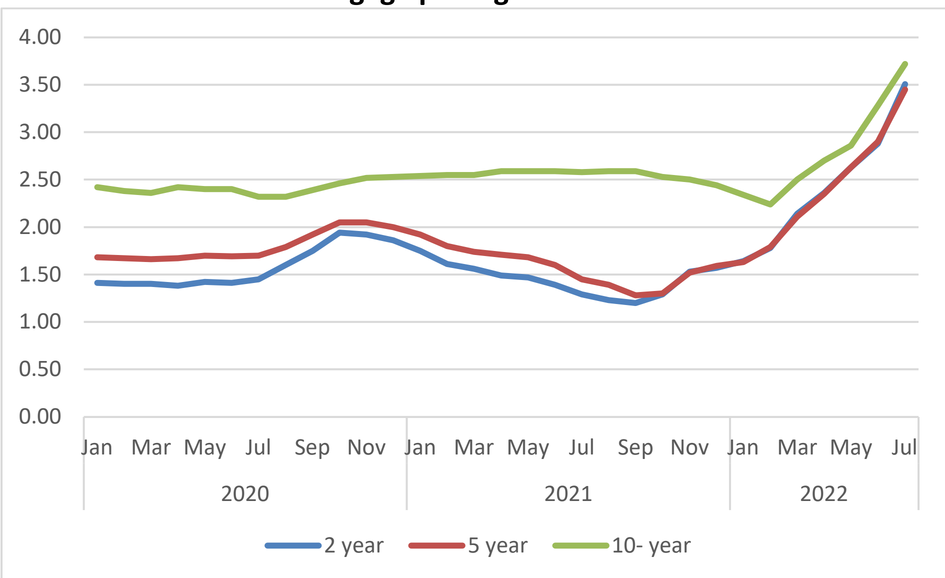
Chart 9 – Fixed and variable rate share of new lending



Source: UK Finance

As Chart 10 illustrates, the differential between 2- and 5-year fixed rate deals has all but disappeared since late 2021 and even 10-year fixes are averaging only a 20bp premium over 2-year deals. This is despite a degree of volatility in the 10-year gilt market, which drives the cost of longer term money. In late June, 10-year gilt yields rose to 2.7% before falling back to 1.8% by late August before rising again to 3.1% by mid-September, the highest level in over a decade. By late August, the market was expecting Bank Rate to hit 2.75% by November and 4% by May 2023.

Chart 10 – Fixed rate mortgage pricing



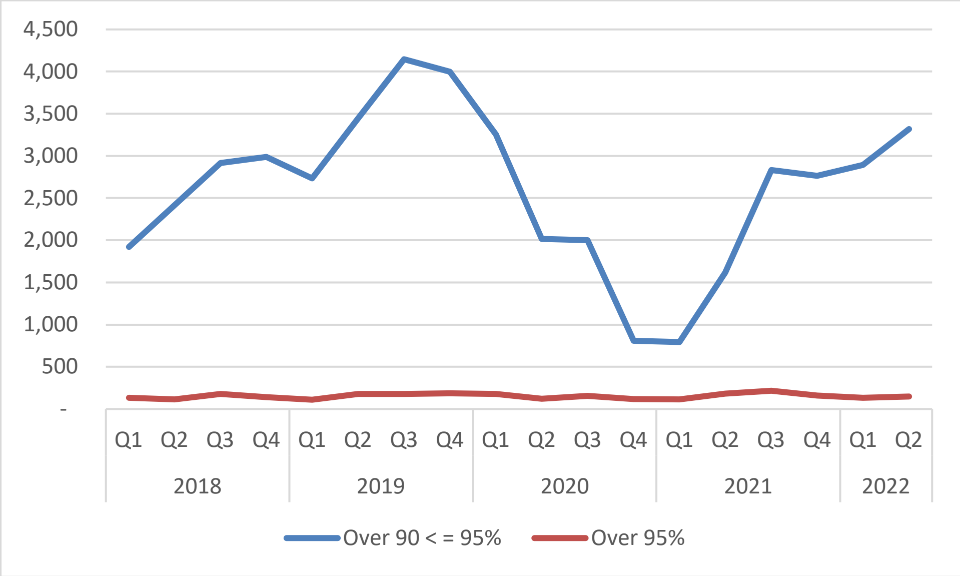
Source: Bank of England

High LTV lending

The recovery in high LTV lending since the pandemic has been aided by the government's Mortgage Guarantee Scheme, under which lenders are offered credit protection above 80% LTV on loans from 91-95% LTV. Up to the first quarter of 2022, this scheme supported 18,000 completions with an aggregate mortgage balance of £3.2 billion, with 5,600 of these completions in Q1 2022. Although the scheme terminates at the end of the year, this should not have a negative impact on the market as there is a healthy supply of high LTV mortgages outside it with, for example, building societies choosing not to use the scheme.

Another government scheme to support buyers with modest deposits, the Help to Buy equity loan scheme, is also set to close soon. The scheme, which is exclusively focused on new-build property, is only available on homes that will be completed by the end of this year. In Q1 2022, it supported 5,400 completions with an aggregate value of £1.7 billion, suggesting that the scheme is already winding down as completions totalled nearly 9,000 in the previous quarter.

Chart 11 – Value of lending by high LTV band (% of total)



Source: Financial Conduct Authority

Buy-to-let market

The buy-to-let market is showing surprising strength this year both in remortgage and house purchase transactions. Remortgage volumes were £21.2 billion in the first seven months of the year, 33% up on the same period of 2021. House purchase lending was £9.7 billion and although this was down 13% on the same period in 2021, that was an exceptional period because landlords benefitted from the stamp duty holiday, which incentivised purchases even though the stamp duty surcharge remained. Compared to the average of 2019, house purchase lending in the year to July was 52% higher.

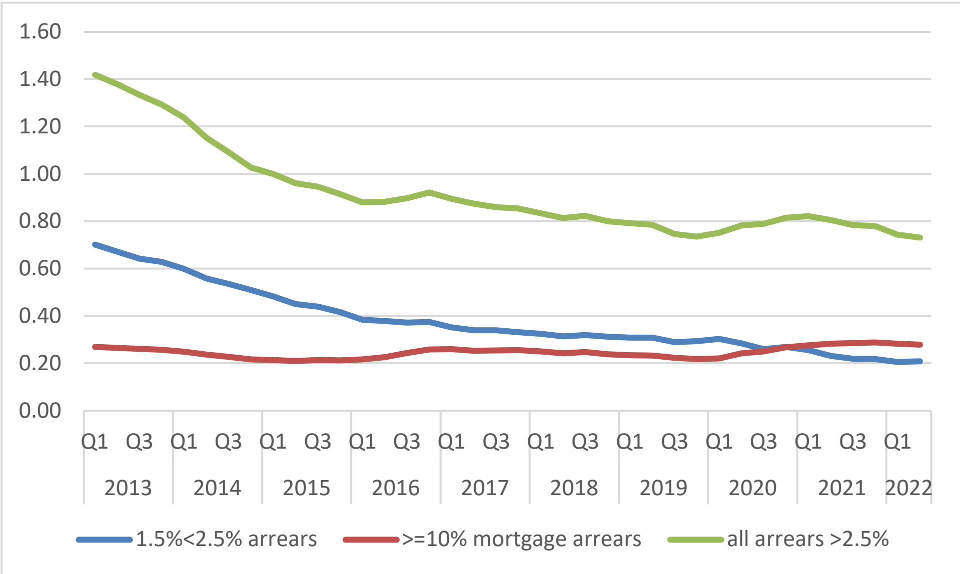
It is not entirely clear why buy-to-let house purchase lending is as strong as it is. Landlords have faced a raft of tax increases since 2015, regulation of the sector has increased significantly and there are further proposals from government that are unfavourable for landlords, including plans to abolish so-called no-fault evictions and, further in the future, possible onerous minimum EPC requirements. However, tenant demand is strong and rents are rising fast, which may have encouraged some landlords to increase supply.

On 6 September, the Scottish government announced plans for emergency legislation to impose a rent freeze and moratorium on evictions for both the public and private rented sectors until at least March 2023. This follows changes that made certain mandatory grounds for eviction under the Scottish private residential tenancy discretionary, reducing the certainty with which landlords can exit their investment. Such measures have caused alarm amongst landlords who, faced with rising maintenance and mortgage costs, will not be able to increase rents.

Arrears and possessions

Mortgage arrears fell slightly again in Q2, although the fall was marginal. The strength of the job market has helped keep arrears down but lenders are concerned that the squeezed real incomes we have seen this year will soon start to impact on people's ability to meet their commitments including mortgage payments. Landlords are also likely to face higher rent arrears as tenants struggle with their bills, potentially pushing up buy-to-let mortgage arrears.

Chart 12 – Mortgage arrears (percentage of balance)



Source: UK Finance

Possessions have also remained at remarkably low levels. There were 350 repossessions carried out in Q2, little more than half the quarterly average of 2019, the last year before Covid-related measures impacted the repossession process. It is not clear why repossessions have remained quite so low but, with growing cost of living pressures, it is reasonable to expect the trend to be upwards from now on.

Withdrawal of affordability stress requirement

On 1 August, the Bank of England removed the mortgage affordability stress test which required lenders to assess borrower affordability on reversionary rates plus

3%. IMLA supported the removal of the stress test, as MCOB responsible lending rules require lenders to take into account expected interest rate increases when assessing affordability. The regulatory rule limiting lenders' issuance of loans at or above 4.5 times income to 15% continues to constrain lenders, so the rule change is unlikely to have much impact in the current environment. However, it does mean that lenders are not having to increase their stress rates in line with their reversionary rates.

Prospects

The government's decision to insulate households from most of the effects of recent energy price hikes is a bold move. The overwhelming majority of the cost of the measure is expected to be met by increased borrowing, the government viewing the energy emergency much as another rare one-off event akin to the Covid pandemic. 10-year government bond yields have risen in response and are above 3%, the highest rate in over a decade, suggesting that the markets are becoming more concerned about debt sustainability.

Another concern is how the Bank of England will view the government measure. To the extent that it maintains household incomes, it could be viewed as a concern because spending may be stronger as a result. On the other hand, inflation is likely to be significantly lower than previously feared this autumn, perhaps closer to 10% than the 13% the Bank was previously expecting. This in turn could take some pressure off wage settlements, reducing the risk of a more serious wage price spiral.

But even with households' utility costs capped, the impact of higher imported energy cannot be entirely alleviated: the price of every good and service contains an element of energy costs and these will work their way through the economy. So in contrast to the Covid pandemic, this crisis is unambiguously an inflationary shock which requires monetary policy to be tightened rather than loosened.

If previous episodes when energy prices have spiked are any guide (mid-1970s, early 1980s and early 1990s), interest rates will have to rise further with a negative effect on asset prices including residential property. Between February 2020, before the pandemic, and July 2022, UK house prices rose by 28%. Over the same period wages rose by only 12%. Much of the buoyancy in the property market can be attributed to the sharp monetary easing in response to Covid. A tightening now can be expected to have the reverse effect.

Fortunately, the subdued mortgage market we have witnessed since the financial crisis should ensure that the level of financial stress amongst borrowers does not rise to the levels seen in earlier downturns. The fact that more borrowers are on rates fixed for a number of years should also reduce the risk of a severe spike in arrears. Nonetheless, lenders are committed to working with customers who find that their financial situation becomes a challenge.