Market Briefing: September 2023

Key developments in the housing and mortgage markets

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Executive summary

- Output rose 0.2% in Q2 following a 0.1% increase in Q1. Although estimates suggest GDP fell 0.5% in July it was impacted by strikes on the rail network and in the NHS and followed a strong performance in June.

- CPI inflation fell unexpectedly to 6.7% in August, as a softening of some food prices offset a rise in forecourt petrol prices. Core consumer price inflation fell sharply from 6.9% to 6.2%.

- In early September, Andrew Bailey, governor of the Bank of England, told the Commons Treasury Committee that he did not expect Bank Rate to rise much further. Following this the MPC left rates unchanged for the first time in almost two years at their September meeting.

- In May to July, unemployment rose from 4.2% to 4.3% and other labour market indicators also softened slightly. Despite this, wages grew by 8.5% in the year May to July, but these figures were affected by one-off bonuses in the public sector. Regular pay, which excludes bonuses, was up 7.8%, unchanged from the previous month.

- Both housing transactions and mortgage approvals fell in July, but on a three-month on previous three-month comparison, they were up by 7% and 18% respectively. Gross lending for house purchase and remortgaging were also both up on this comparison, suggesting the housing and mortgage markets are stabilising.

- House prices are also showing a more robust picture. Both the Land Registry and Nationwide indices have been up on a three-month on previous three-month comparison in recent months.

- Fixed-rate mortgage pricing eased slightly in August after the spike that followed disappointing inflation figures in April and May. Average 10-year fixed-rate pricing was below that of either 2 or 5 years in August but the share of customers fixing for this longer period remains low.

- There was a 9% rise in mortgage arrears of more than 2.5% of the loan balance in Q2 to 0.84% of all loans. Within the total, buy-to-let arrears rose much faster, up 29% to 0.44%, although they remain at less than half the rate in the owner-occupied market.

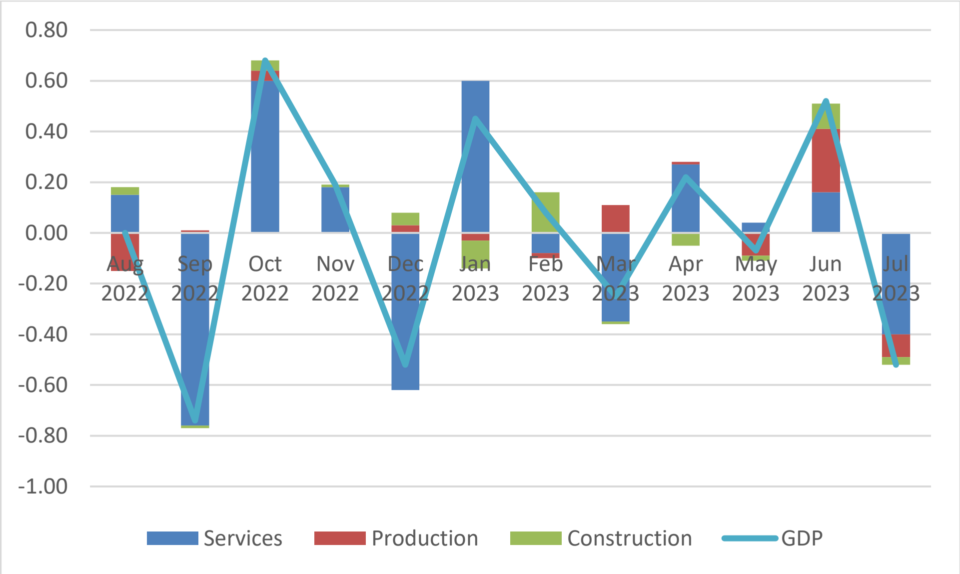
The economy

Output

Output fell 0.5% in July, but this only reversed a similar increase in June and on a three-month comparison, GDP was up 0.2%, the same rate of increase seen in the second quarter. Since the middle of last year output has settled into a pattern of very slow growth but has so far avoided slipping into recession (defined as two consecutive quarters of GDP contraction).

On a sectoral level, services, production and construction all fell in July (see Chart 1), but this followed a strong performance for production in June, which left this sector as the main contributor to growth in the three months to July. The weak performance of services in July was partly the result of strikes in the NHS, which reduced human health activity by 3.4%.

Chart 1 – Sources of GDP growth %

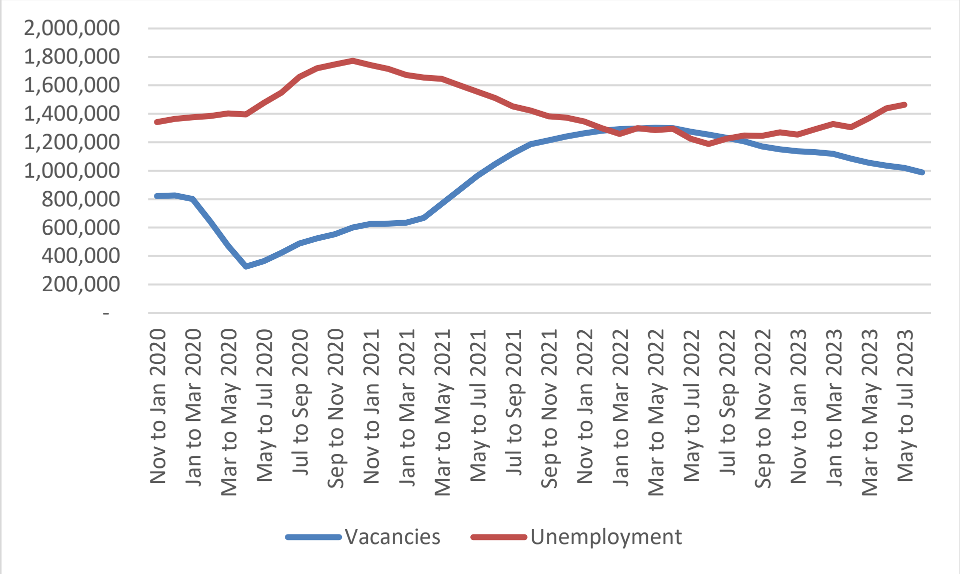


Source: Office for National Statistics

Labour market

The labour market continues to exhibit a pattern of gradual easing of demand. Job vacancies have fallen by 313,000 since their peak in March to May 2022 or 24%, falling below a million for the first time since May to July 2021 in the three months to August, while the number of unemployed has risen by 179,000 since the same date (see Chart 2), a 14% increase. This has taken the unemployment rate up from a low of 3.5% in July 2022 to 4.3% in June 2023, the highest rate since August 2021.

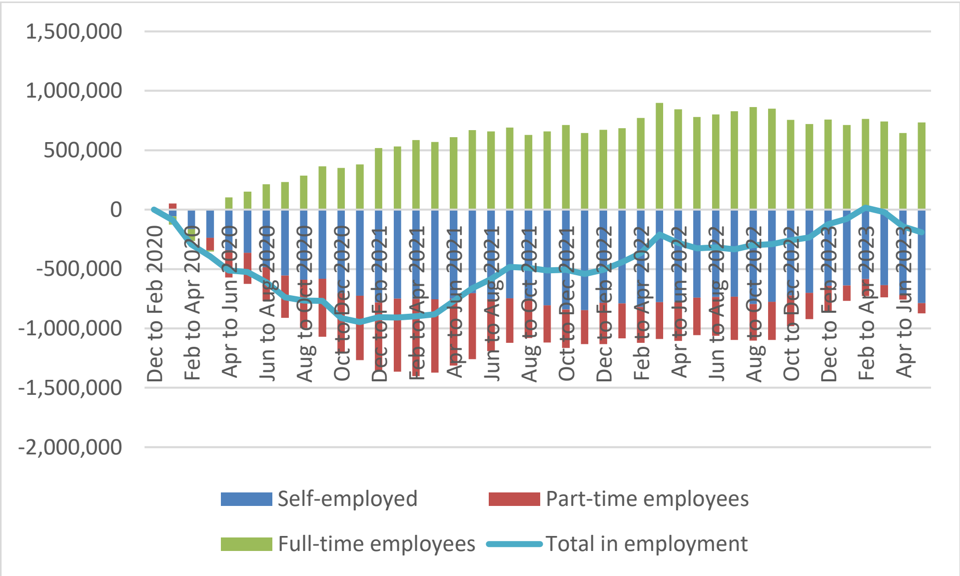
Chart 2 – Job vacancies and unemployment



Source: Office for National Statistics

Over the same period, total employment has been broadly flat with the inactivity rate falling, although it has risen again over the latest two months. Looking at the trend since the start of the Covid pandemic (see Chart 3), overall employment levels have recovered to nearly the pre-pandemic level but with a sizeable rise in full-time employees and a somewhat larger fall in self-employment.

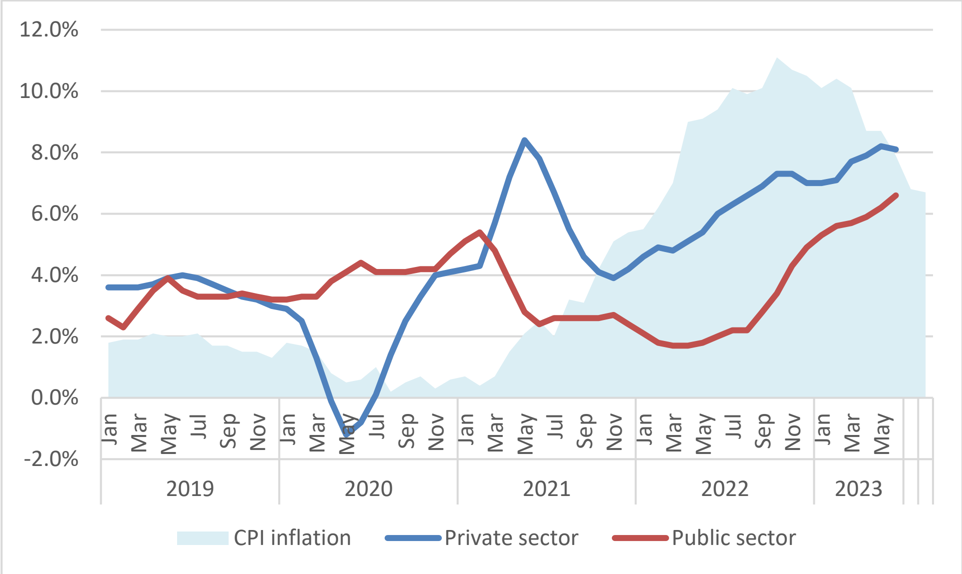
Chart 3 – Trends in employment since Covid pandemic



Source: Office for National Statistics

High inflation has encouraged workers to push for compensating wage increases since late 2021 but despite wage inflation having increased sharply since then, the jump in inflation has been such that real wages have continued to decline (see Chart 4). However, this period of falling real wages is now coming to an end. In May to July, average regular wage growth (excluding bonuses) was 7.8%, roughly in line with CPI inflation at that time. Inflation has subsequently fallen, dropping to 6.7% in August with further falls expected. Falling inflation and a weakening labour market should reduce upward pressure on wages in the coming months, but given the scale of cuts in real wages workers have experienced since late 2021, a rapid decline in nominal wage growth is unlikely as workers push to restore lost real income.

Chart 4 – Regular pay growth in the public and private sectors



Source: Office for National Statistics

Inflation and interest rates

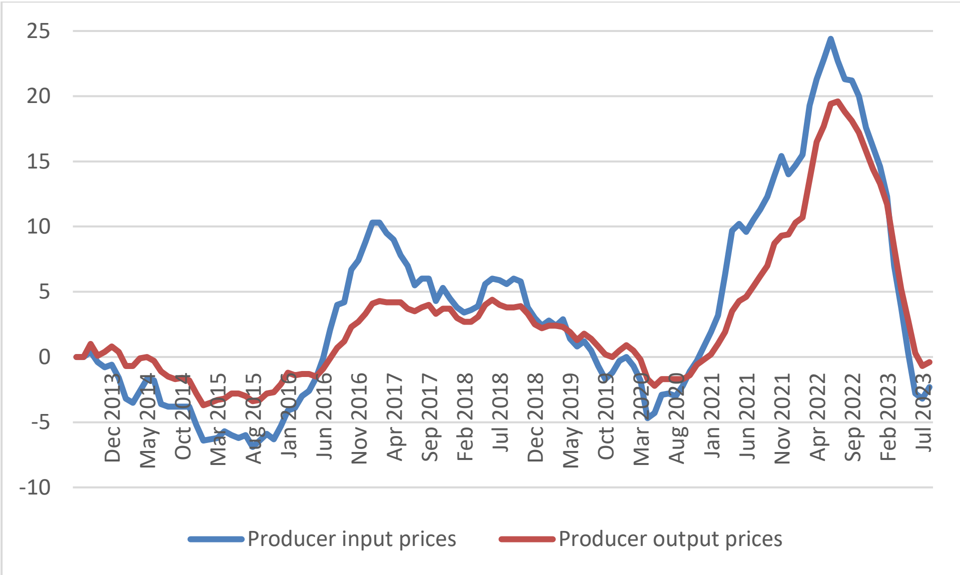
Global commodity prices, which had been a major factor driving higher inflation around the world in 2022 as the world economy recovered from the Covid pandemic, had eased significantly from late 2022. However, as the S&P GSCI Sterling Index shows (see Chart 5), the downward trend has reversed over the past month and a half with commodity prices rising nearly 11% since mid-August, led by a surge in oil prices.

Chart 5 – S&P GSCI Global Commodities Price Index in Sterling

Source: S&P

The decline in global commodity prices since 2022 can be seen in the sharp fall in inflation rates in UK input and output prices (see Chart 6). Producer input price inflation turned negative in June and in the year to August input prices were 2.3% below the level of a year earlier. Output prices include manufacturers' labour costs and margins and so, unsurprisingly, have not fallen as much, but did decline by 0.4% in the year to August.

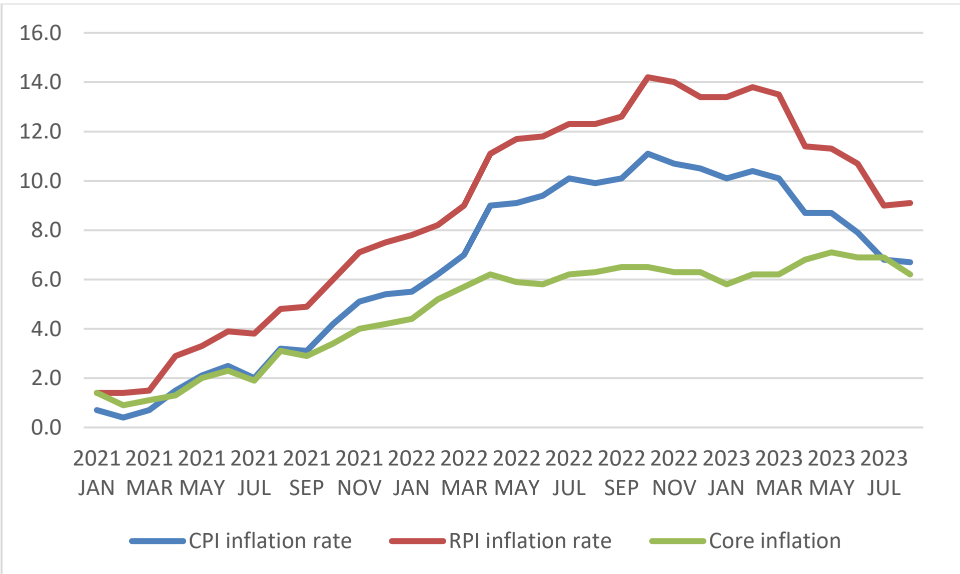
Chart 6 – Producer input and output prices (annual inflation)



Source: Office for National Statistics

After unexpectedly strong inflation figures in April and May, which caused market interest rates to spike, the news on inflation has improved and the August figures were better than predicted, with CPI inflation falling to 6.7%, as rising petrol prices were more than offset by lower supermarket prices for a range of foods (see Chart 7).

Chart 7 – CPI, RPI and core annual inflation



Source: Office for National Statistics

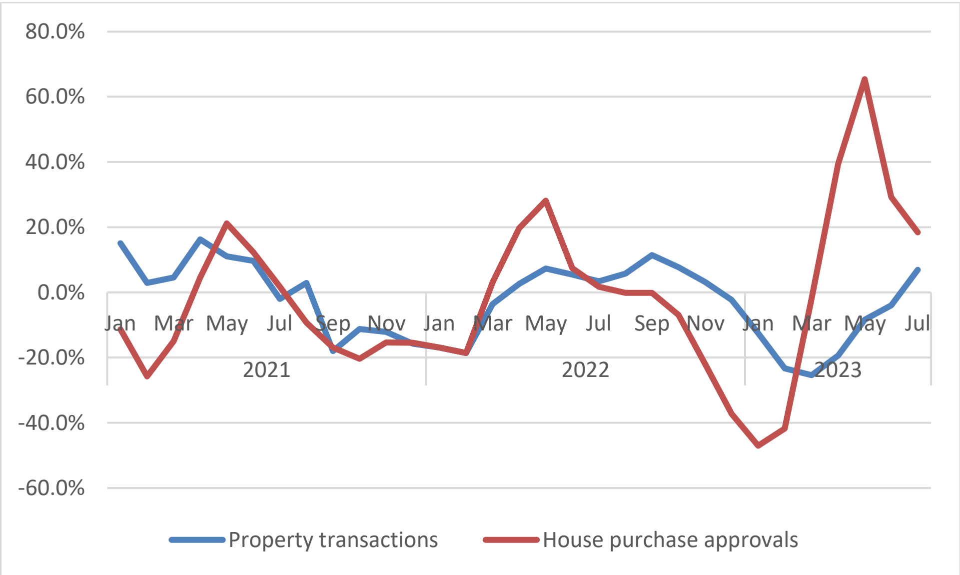
The fall in core consumer inflation, which excludes volatile food and energy prices, from 6.9% to 6.2% was particularly welcome. As Chart 7 shows, core prices have remained stubbornly high in recent months and the fall will ease pressure for more interest rate rises. But even before these figures were announced, Andrew Bailey, governor of the Bank of England, had told the Commons Treasury Committee that he believed we are near to the peak in interest rates and that we should see a quite marked fall in inflation this winter. Interest rates may remain around current levels for quite some time though, as wage pressures look set to ease only slowly, making a rapid return to 2% inflation challenging.

Housing and mortgage markets

Activity

Confidence in the housing market has been improving over the course of 2023, buoyed by lower mortgage rates as the financial markets stabilised after the turmoil of the previous Autumn. However, disappointing inflation figures for April and May (announced in late May and late June respectively) led the market to re-evaluate the outlook for interest rates, pushing rates up across the yield curve, raising swap and mortgage rates. By July, mortgage rates even surpassed those reached last Autumn, although better inflation figures have since allowed them to ease back.

Chart 8 - Transactions and approvals for house purchase (latest 3 months on previous 3 months)



Source: HMRC, Bank of England

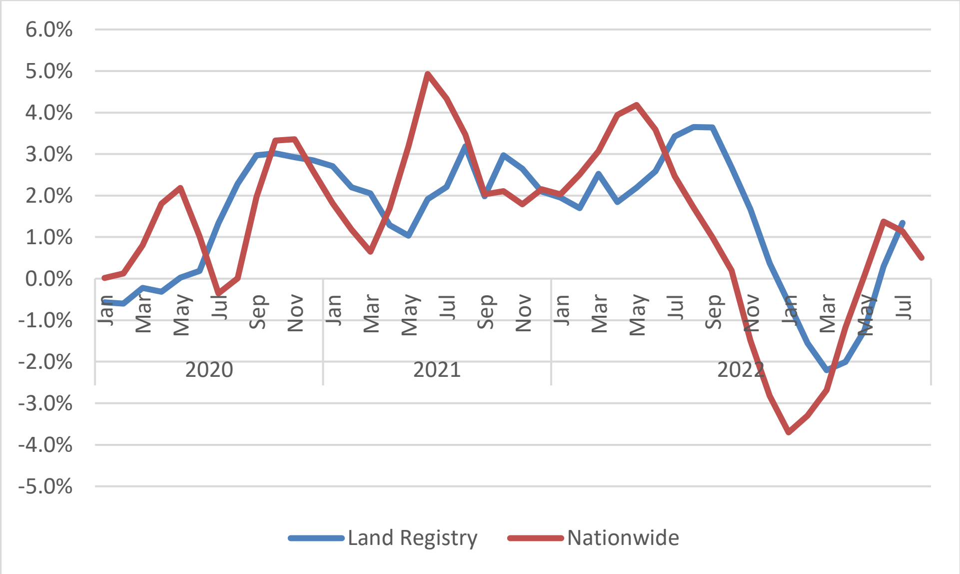
On a three-month on previous three-month comparison, property transaction levels, which were down 25% in March, have steadily recovered to stand 7% up in July. Similarly, mortgage approvals for house purchase have been up substantially on a three-month on previous three-month basis (see Chart 8). Although there is usually a seasonal pattern to approvals, as Chart 8 illustrates, the scale of the rebound was much sharper this year. It is too early to see the impact of the spike in rates in June and July on housebuying activity because of the substantial lags in buying process, so some weakness might be expected in the coming months, but as mortgage rates are falling again the market should be underpinned going into 2024.

House prices and rents

The resilience of the housing market is, perhaps, best illustrated by the trend in house prices. Although different series tell a somewhat different story, with the Nationwide and Halifax indices showing more weakness than the Land Registry figures, the trend in recent months has been back up again after the earlier softening. As Chart 9 shows, both the Nationwide and Land Registry index have been showing prices rising again on a three-month comparison recently. The Land Registry figures are yet to show an annualised fall. The RICS Residential Survey for August tells a more downbeat story of falling prices and price expectations and it is unclear why house price indices are more positive than RICS respondents.

The continued underlying shortage of supply and the limited signs of forced sellers means that, while houses are taking longer to sell, this is not the unambiguous buyers' market that might have been expected given the rise in mortgage rates and corresponding decline in buyer affordability.

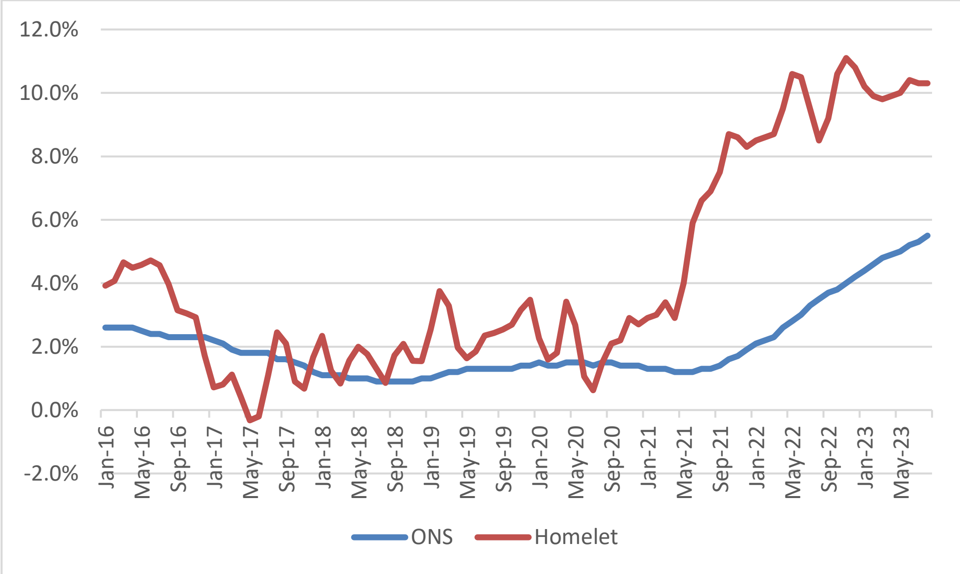
Chart 9 – House price inflation (latest 3 months on previous 3 months)



Source: Nationwide Building Society, Land Registry

There are few signs of the private rental market slowing. The Homelet Rental Index, which tracks new contracts, moved back into double digit growth in May and has remained there since, with rents up 10.3% in the year to August. The ONS Index of Private Rental Prices, which measures existing rental contracts and therefore tends to be less volatile, was up less at 5.5% in the year to August but is on a clear upward trend (see Chart 10). The RICS Residential Market Survey continued to show rising tenant demand coupled with falling landlord instructions in August, pointing to further rental price inflation.

Chart 10 – Private rental price growth

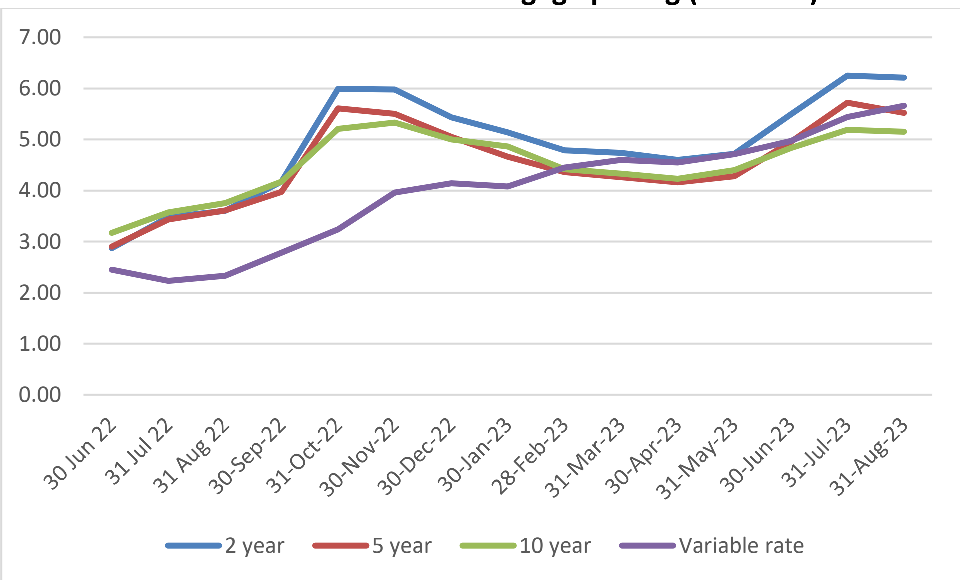


Source: ONS and Homelet

Mortgage pricing and products

There were small falls in average fixed-rate mortgage rates in August though, unsurprisingly, variable rate pricing increased to reflect recent hikes in Bank Rate (see Chart 11). Average 10-year fixed-rate products are cheaper than 2 or 5 year fixed or variable rate products, reflecting the market expectation that interest rates will fall over the coming years.

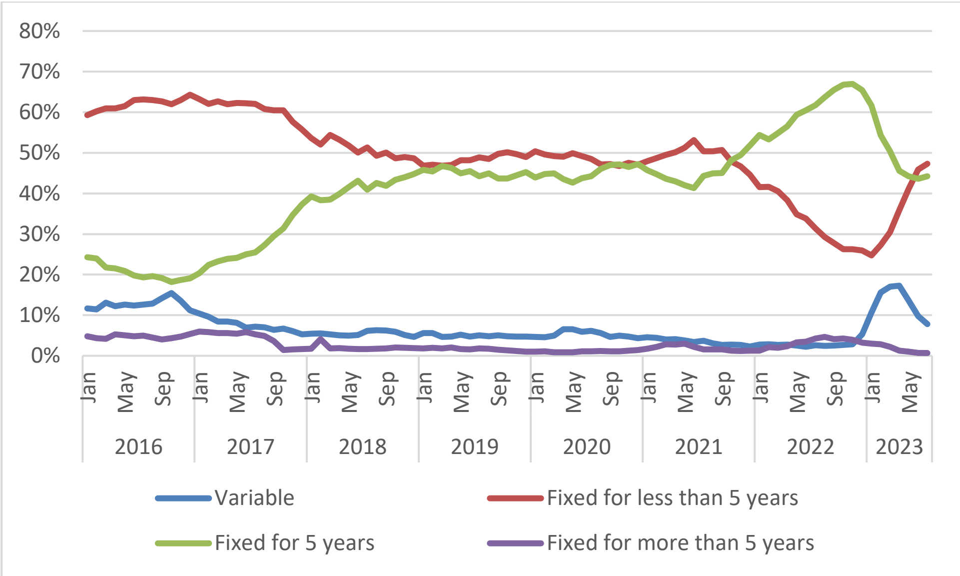
Chart 11 – Fixed and variable rate mortgage pricing (75% LTV)



Source: Bank of England

Data on the mortgage product type borrowers are taking out show a sharp reversal of the rise in variable rates. At the peak in April, 17% of new mortgages were on a variable rate, falling to 8% in July. When fixed rates jumped many borrowers opted for a variable rate to avoid being locked into what were considered temporarily high fixed rates, knowing they could always switch later. But the steady rise in variable rates, reflecting higher Bank Rate, has made this a relatively unattractive option today. The recent resurgence of 2-year fixed rates may also reflect expectations that rates will be falling again within a year or two. Despite the price competitiveness of rates fixed for more than 5 years, appetite for these products has not grown, perhaps reflecting the view that even if rates do not fall quickly they are likely to fall back over the next decade.

Chart 12 – Fixed and variable rate share of new lending

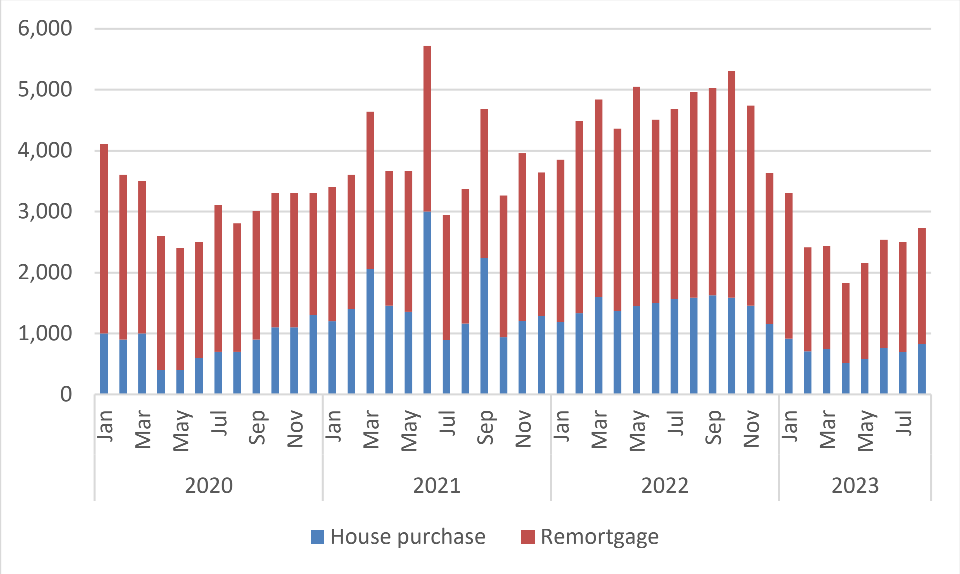


Source: UK Finance

Buy-to-let market

Buy-to-let lending was impacted more severely by the market turmoil of last Autumn than the mainstream market. This may reflect the greater impact of rising rates on interest-only borrowers, which includes the vast majority of buy-to-let borrowers. The scale of the slowdown in lending is evident from Chart 13. In the calendar year to August, average monthly buy-to-let lending for house purchase fell 50% against 2022's average and remortgage activity by 44%. However, there has been a clear upward trend since the low point in April and it is likely that the fall in remortgaging reflects more customers taking product transfers.

Chart 13 – Value of buy-to-let lending (monthly £ millions)



Source: UK Finance

Proposed minimum EPC ratings scrapped

As part of his announcement on green targets on 20 September, the prime minister announced that the government will not be proceeding with proposals for enhanced minimum EPC requirements for private landlords. Instead he suggested the government could encourage improvements in energy efficiency through selective subsidies, announcing that grants under the boiler upgrade scheme would be increased by 50%.

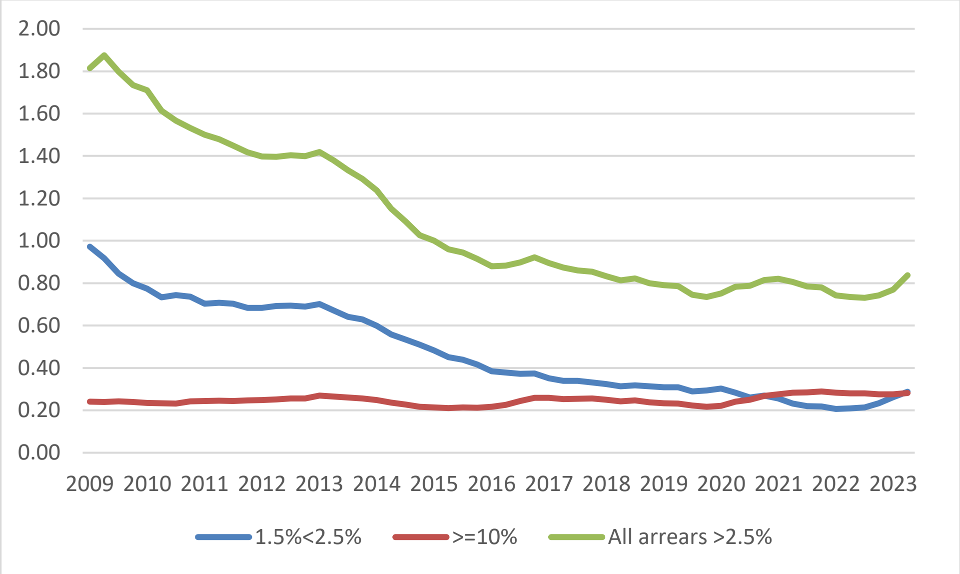
The National Residential Landlords Association (NRLA) welcomed the announcement. Chief executive Ben Beadle said: "It is welcome that landlords will not be required to invest substantial sums of money during a cost of living crisis when many are themselves struggling financially". However, Generation Rent responded by describing the change in policy as a "colossal error" by the government, adding: "Leaving the impact on the climate to one side, it makes the cost of living crisis worse and damages renters' health".

Arrears and possessions

It is only to be expected that the higher mortgage rates seen since the middle of last year would start to lead to higher arrears, but the rise across the whole mortgage market has been moderate to date (see Chart 14). Arrears of more than 2.5% of the loan balance rose 9% in Q2, but in the buy-to-let market the increase was significantly higher at 29%. It is, however, worth bearing in mind that, at 0.44%, the level of buy-to-let arrears of over 2.5% is still less than half that of owner-occupiers.

Possessions data have been equally benign this year. The total number of possessions actually fell back 10% in Q2 to 1,120. While buy-to-let possessions rose to 440, the increase was a modest 7%. Arrears and possessions are likely to continue to trend up as more borrowers come to the end of cheap fixed-rate deals struck in previous years, but the industry can take encouragement from the picture we have seen to date. Rising real incomes should also take some pressure off in the owner-occupied sector while rising rents will help landlords to meet higher mortgage payments.

Chart 14 – % of mortgages in arrears (by percentage of loan balance)



Source: UK Finance

Prospects

Considering the scale of the shock from higher global energy and food prices since the post-Covid reopening and Russian invasion of Ukraine, the economy has performed reasonably well, with output flat rather than falling. Although the labour market has softened, unemployment, at 4.3%, remains low by historical standards and consumer confidence is rising, perhaps reflecting the fact that wage growth is now exceeding inflation after 18 months of falling real wages.

With inflation expected to continue to fall quite sharply over the course of this year, real wage growth is likely to accelerate, while the governor of the Bank of England has stated that interest rates may now be near their peak. This positive combination could underpin sentiment going forward, ensuring that demand in the housing market will be sustained. Indeed, although mortgage lending for house purchase has fallen sharply so far this year, the housing market is holding up quite well with prices having risen on a three-month on previous three-month basis in recent months. The underlying lack of supply continues to influence the market, making a serious price correction look like an increasingly remote possibility.

While rising real incomes and a plateauing of Bank Rate are positive factors for the housing and mortgage markets going forward, the corollary is that interest rates may have to stay at these levels for longer. In particular, if wage increases fail to fall rapidly from their current rate of 7.8% for regular pay and 8.5% including bonuses, the Bank of England will feel under pressure to demonstrate its commitment to the inflation target through tougher action. Thus, we should not rule out further Bank Rate increases next year and attention will turn increasingly to the wage rather than inflation figures to determine whether the Bank will need to tighten policy further.