1st September 2022
Market Commentary
Residential Analysts
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United Kingdom – August 2022

- **This Is Getting Scary**
- **Regional Repayments**
- **Rental Squeeze**

The housing market is still booming but time is running out. The cost of living crisis is squeezing finances, interest rates are increasing, rents are rising, consumer confidence is collapsing, and climate change is causing havoc across the globe. This is getting very scary. While the housing market may be supported by a last rush to lock in low rates, these multiple headwinds will begin to hit market activity and probably house prices in coming months.

This Is Getting Scary

Back in April we warned that rising energy costs, changes in interest rates, and policy mistakes have all been key factors leading up to previous housing market downturns in the UK. This autumn the UK looks set to tick off all three and more. Our primary expectation for the future of the housing market is still stagnation – prices stuck at high levels thanks to sellers' sticky expectations but fewer buyers, leading to much lower turnover. However, the combination of factors is increasingly suggesting that we might see a significant fall in house prices.

The cost of living crisis is already hitting household and business finances and it is only going to get worse. While lower income households and smaller businesses will be worst affected, the scale of the increases in energy bills and other costs will be felt across the economy. Unfortunately the government's proposed solutions (e.g. cutting VAT) are underwhelming. More poverty, hunger, homelessness, crime, and deaths are all likely outcomes this winter unless government provides serious financial support for households and businesses as soon as possible.

The cost of living crisis is squeezing finances and rising interest rates will only add to the pain of mortgage borrowers. Interest rates are rising rapidly though current housing market activity is still being driven by buyers who have managed to lock in low rate deals. The average quoted rate for a two-year fix at 75% loan-to-value was 3.5% in July but the average rate on all new mortgage advances was 2.3%. That's higher than the 1.8% recorded in July 2021 but still affordable. However, with Bank of England data on financial market expectations for Base Rate in one year's time now well over 4% (Fig 1), it appears likely that the mortgage rates actually obtained by new borrowers will rise much higher in coming months.

Fig 1: Financial Market Expectations for Base Rate
Source: Bank of England

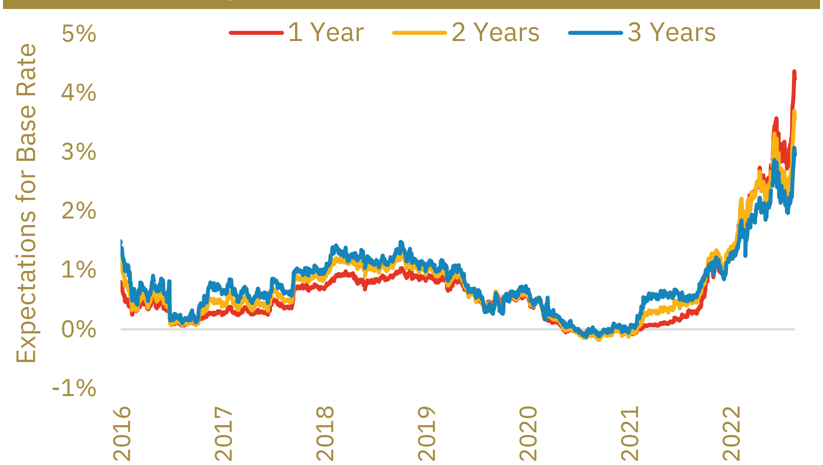
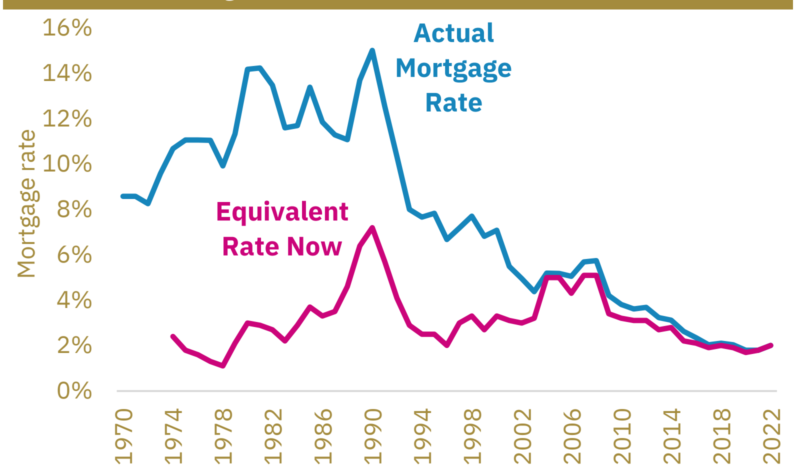


Fig 2: Equivalent Mortgage Rate Measure
Source: Bank of England , ONS (2022 is Q2 2022 data)



A 4% base rate might suggest a return to "normal", with mortgage rates still comfortably lower than previous high rate periods. However, this would be a misunderstanding of how the mortgage market has changed in recent decades. Mortgages are now at much higher multiples of income, MIRAS is no longer available, and most are on a repayment basis. This leaves current borrowers very exposed to even slightly higher rates let alone those at 4% plus. To demonstrate this, we've calculated what the equivalent mortgage rate would be now to match the actual mortgage repayment ratios recorded in previous years. For example, repayments under the actual 14% rate in 1980 are equivalent to repayments at just 3% now.

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We expect the impact of higher mortgage rates and the rising cost of living to be seen first in lower activity levels. However, the scale of the crisis and the absence of any significant government support makes a large fall in house prices increasingly likely. As prospective buyers start to struggle to borrow enough to meet the high price expectations of sellers, activity levels will fall (we are intrigued to know how lenders are adjusting their affordability tests to account for the cost of living crisis?). This situation will lead to a stagnating housing market. While not immediately disastrous for the housing market, it would contribute to a weaker economy through all the various business directly and indirectly associated with housing transactions. For it to turn into a crash would require a large number of forced sellers. Unfortunately, the cost of living crisis increasingly looks like it may lead to that. And house prices are already looking over-valued (by 14% in July). But ever higher mortgage rates will continue to stretch the gap between what sellers want and what mortgage-based buyers can afford. For example, based on our simple model (Fig 2 last month) a mortgage rate of 4% suggests prices would be nearly 40% over-valued. This would require a 28% price fall to get average UK house prices back to an affordable level.

Regional Repayments

Assessing the spatial impact of rising mortgage rates on repayment affordability suggests the south of England is most exposed. As Fig 3 shows, first time buyer (FTB) repayments under higher mortgage rates are most stretched in the South East and least stretched in the North East / Northern Ireland. This result is not surprising given average loan-to-income multiples tend to be much higher in the south of England.

However, the relative variation in repayment affordability may be overstated, particularly under 2% mortgage rates. The analysis applies the same mortgage rate across all regions but the average loan-to-value (LTV) ratio also varies by region. LTV ratios have been lower in more expensive markets as the soft-cap on loan-to-income lending above 4.5 times income and stress tests were more binding. Therefore, the average FTB has probably had a higher mortgage rate in the North East than London. Also, if house prices do start falling then lenders are most likely to withdraw riskier high LTVs first.

Fig 3: FTB Mortgage Repayments by Region
Source: Calculated using ONS/RMS data

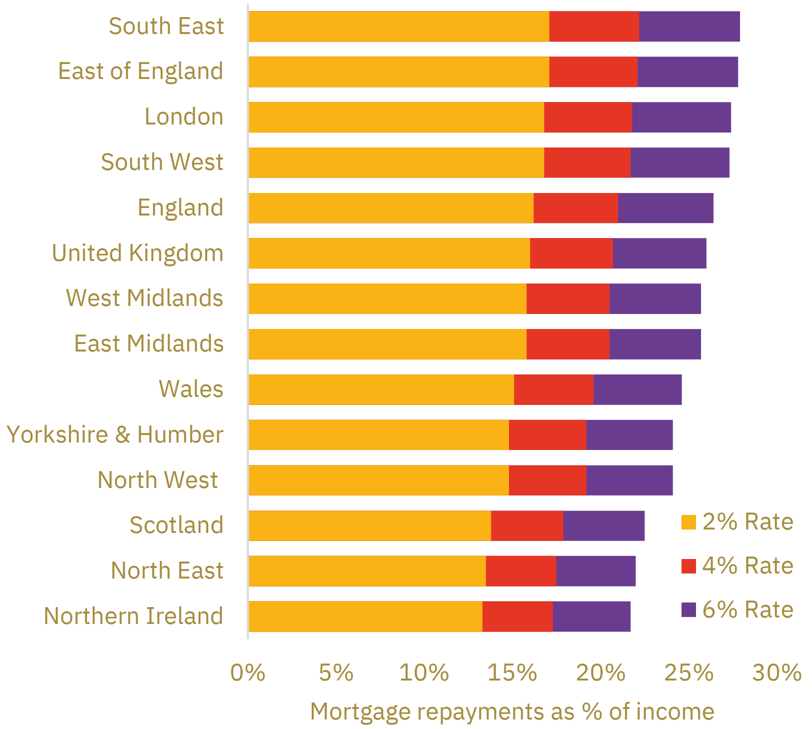
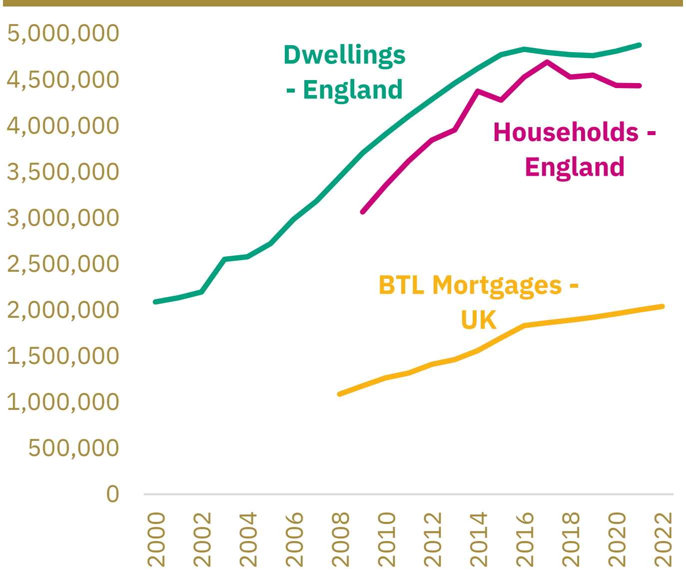


Fig 4: Size of the Private Rented Sector
Source: DLUHC, UK Finance



Rental Squeeze

Rents are rising rapidly across the country amidst a shortage of homes available to rent. The strength of demand for rental homes is not surprising given the rebound in city living but an explanation for the lack of supply is less clear. One of the go-to explanations is landlords selling up. While it's true that government policy has intentionally made it more difficult for landlords in recent years, there are not yet any conclusive signs of a mass sell-off. Data are poor but, as Fig 4 shows, the number of private rented dwellings and households has been relatively flat in recent years while the number of outstanding BTL mortgages continues to hit new record highs. Instead, it appears more likely that a shift to short-term lets (e.g. Airbnb), most existing tenants renewing, and an increase in tenancy lengths has temporarily led to fewer homes listed to rent. Irrespective of the cause, there is a clear need to help private renters with the cost of living crisis – especially as they were already badly hit by the pandemic.

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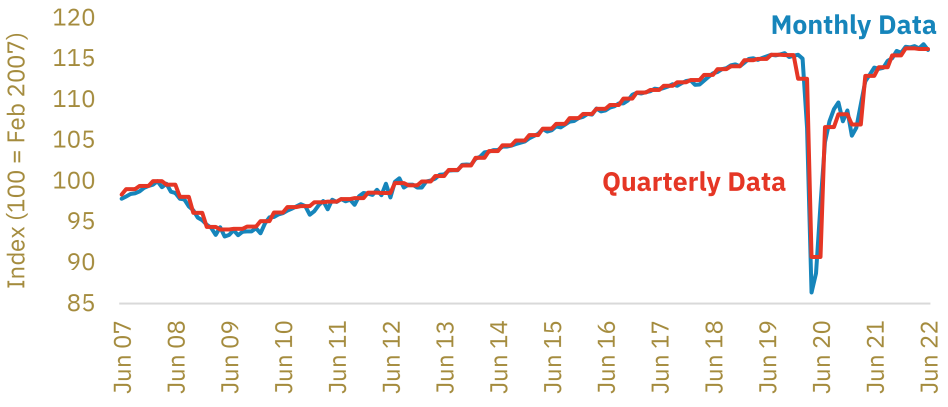
Market At A Glance

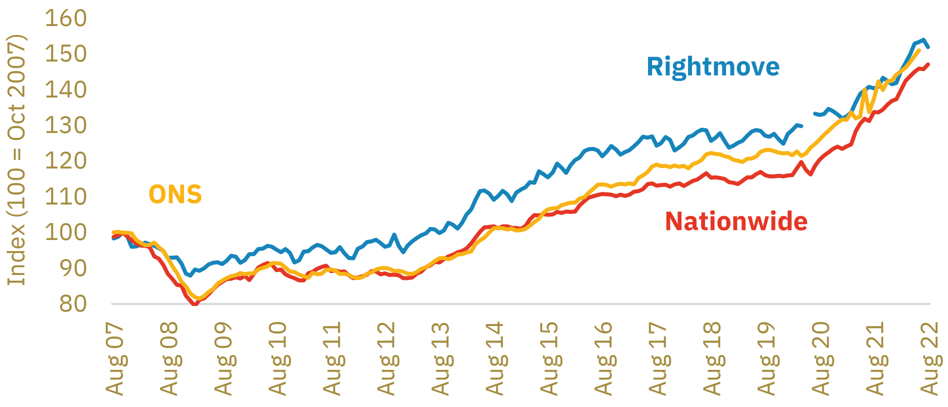
Economy - UK

The ONS monthly estimates reported GDP was 1.9% higher in June 2022 than the same month in 2021. This left monthly GDP just 0.5% higher than the pre-pandemic peak recorded in January 2020. However, this data will inevitably be revised in coming months and years.



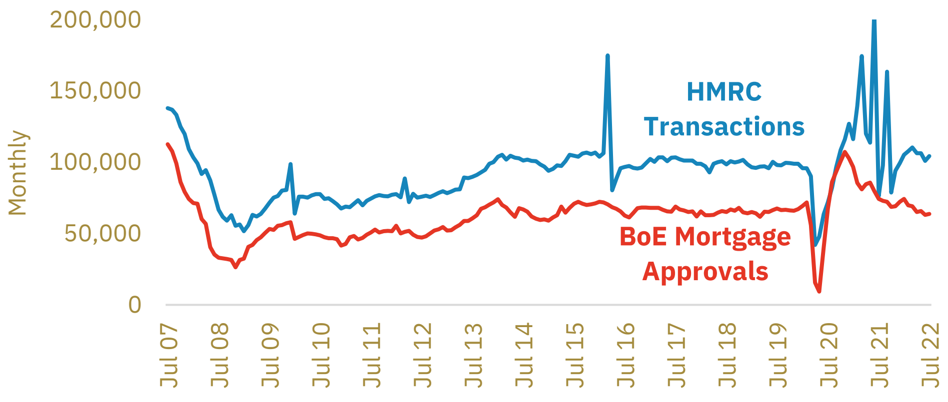
House Prices - UK

Rightmove reported a 8.2% annual rise in asking house prices in August 2022 while Nationwide reported a 10.0% annual rise in their mortgage approval based index over the same period. Meanwhile, the ONS reported 7.8% annual growth in its sales agreed index for the year to June 2022.



Transactions – UK

HMRC provisionally reported 104,500 residential transactions in July. This was 6.3% higher than the same month in 2019. Meanwhile, the Bank of England reported mortgage approvals for house purchase were 5.8% lower in July 2022 than the same month in 2019.



New Supply - England

The latest net additions data for 2020/21 reported a 216,490 net new homes in England with 194,000 new build completions. The latest quarterly house-building data suggests there were 214,000 completions in 2020/21 while there were 243,200 new build Energy Performance Certificates in the year to Q2 2022 – a leading indicator for net housing supply.