Market Commentary

Residential Analysts

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United Kingdom – October 2022

- **Sunak Saves The Day**
- **But It's Still Looking Scary**
- **High Loan-to-Income Lending**

The mini-budget shock may have eased with Truss' departure but a housing market downturn is still a very likely prospect. At the beginning of September, when mortgage rates were just hitting 4%, we warned the housing market was getting scary. In the aftermath of the mini-budget we said it was terrifying. Given recent events, we've downgraded it back to scary – but the fallout could still be severe for households, the market, and the economy.

Sunak Saves The Day

The immediate challenges facing the housing market have reduced thanks to the end of Liz Truss' record-breaking term as PM and Rishi Sunak's subsequent promotion. Financial market expectations for Bank of England Base Rate (Fig 1) have eased while mortgage rates have also fallen from their recent highs. The current Moneyfacts best rate guide suggests the lowest fixed rates are in the low to mid 5% range, having fallen from mid 6% a couple of weeks ago. Meanwhile, tracker rates will have offered some respite for those needing to urgently remortgage but Base Rate could rise sharply on Thursday though recent trends suggest most borrowers have chosen fixed rates (Fig 2). Unfortunately that's about the limit of the good news for the housing market.

But It's Still Looking Scary

Mortgage rates may have fallen but the prospects for the housing market are still very concerning. Rates may be lower than their recent highs but they're still well above the 4% levels when, at the beginning of September, we said the market was getting scary. For example, simple analysis of mortgage repayment affordability suggests house prices would need to fall by around 15% if mortgage rates stay at 5% though the exact figure depends on a number of other external factors. Absent these external factors, the market would probably slowly re-adjust to higher mortgage rates through a period of rising wages and lower turnover. Unfortunately, there are several other issues facing the housing market and economy.

Fig 1: Financial Market Expectations for Base Rate

Source: Bank of England

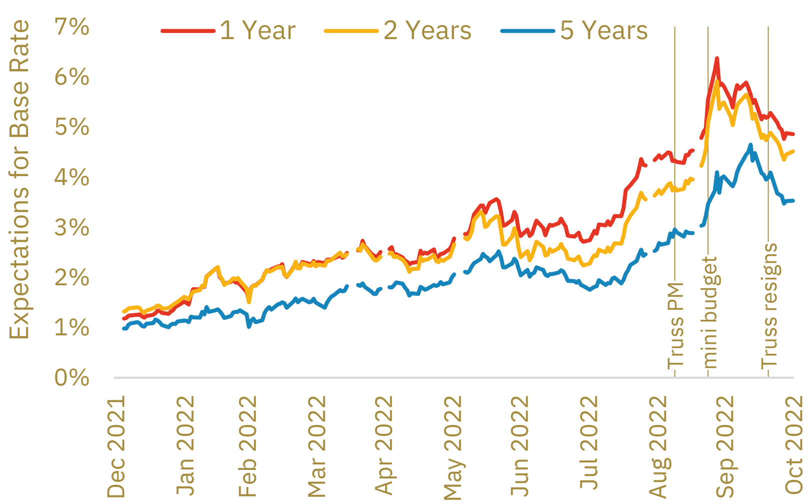
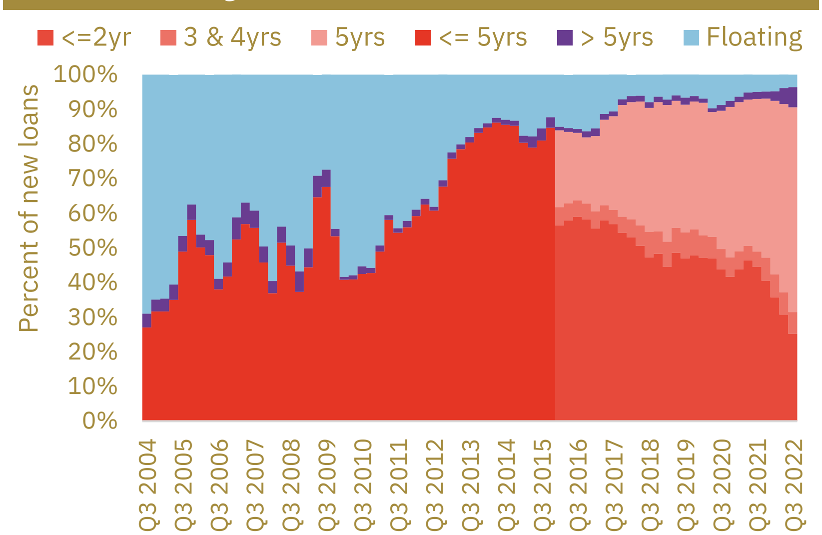


Fig 2: Fixed Rate Period on New Lending

Source: Bank of England



In isolation, these higher mortgage rates would cause hardship for some households but the impact on the wider housing market and economy could be managed. However, alongside higher mortgage rates, there is the cost of living crisis with high inflation and increasing energy costs alongside rapidly rising rents. And it now looks like we can add public spending cuts and pay caps to the list – a further drag (directly and indirectly) on the economy. The prospects for the housing market and economy are looking scary – and any deterioration in one will feed through to the other. The housing market has become so dependent on low mortgage rates that any adjustment is going to be painful for those directly involved. Unfortunately, the current economic and political situation suggests it could be painful for everyone.

High Loan-to-Income Lending

High loan-to-income ratios (LTIs) are perhaps one of the most important indicators of risk in a period of rising mortgage rates - along with existing mortgage payments and debt servicing ratios. However, the lack of public data makes it difficult to understand what is happening to high LTI lending and who the borrowers are.

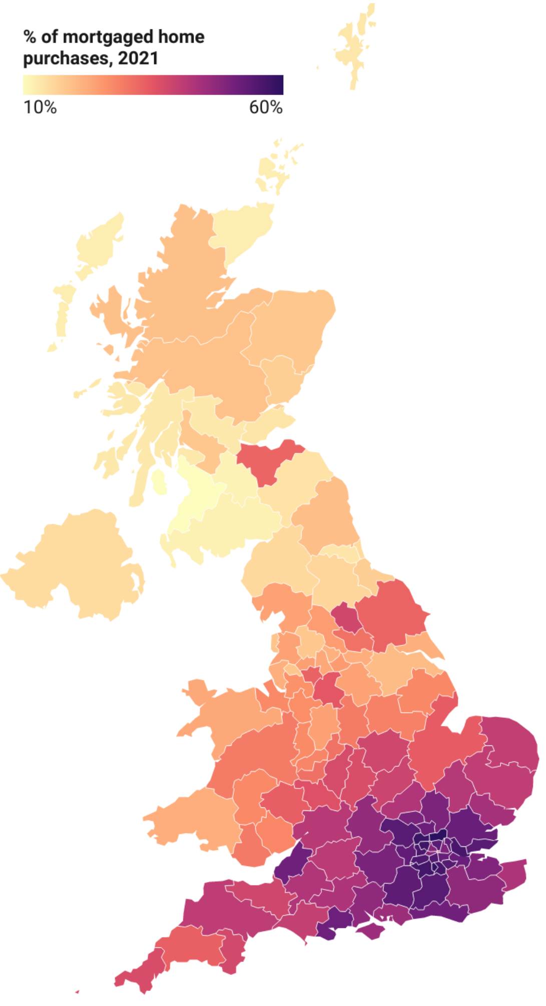
There are occasional releases within Bank of England reports though the data is not always available. For example, a technical annex to the December 2021 Financial Stability Report (PDF) shows around 10% of new mortgages are above the 4.5 times income soft cap (BoE chart 3) and highlights the concentration of mortgages just below the cap (BoE charts 9 & 10). It also suggests UK households with higher LTIs cut spending by more between 2007 and 2009 than those with lower LTIs (BoE chart 7).

Meanwhile, a 2020 paper from the FCA (PDF) investigating how the 4.5 soft cap affected the market contains some interesting details on borrower characteristics. Data in FCA table 1 for the post-cap period (Apr 2015 to Sep 2015) is dated but insightful. It shows higher LTI borrowers (4.5+) were more likely to be home movers than first time buyers, with an average age of 34. Their average income was lower than that of lower LTI borrowers (£48,953 for LTIs 4.5-4.7) with a slightly smaller proportion of joint income applicants (46% for the same group). Their average mortgage term was longer, close to 30 years, but their average initial mortgage payments as a percentage of income were still slightly higher – rising as the LTI increases. Further data in FCA table A presents the regional picture, with high LTI lending concentrated in the south.

The spatial patterns are further emphasized by FOI data from the FCA (thank you). It shows the number of mortgage sales for home purchasers and a number of subgroups. One of these is the number with an LTI of 4 or more. The data, by postcode area, is shown in the map opposite and again highlights the higher proportions using high LTIs in the south of England and other high house price areas.

Fig 3: High LTI (4+) Lending, 2021

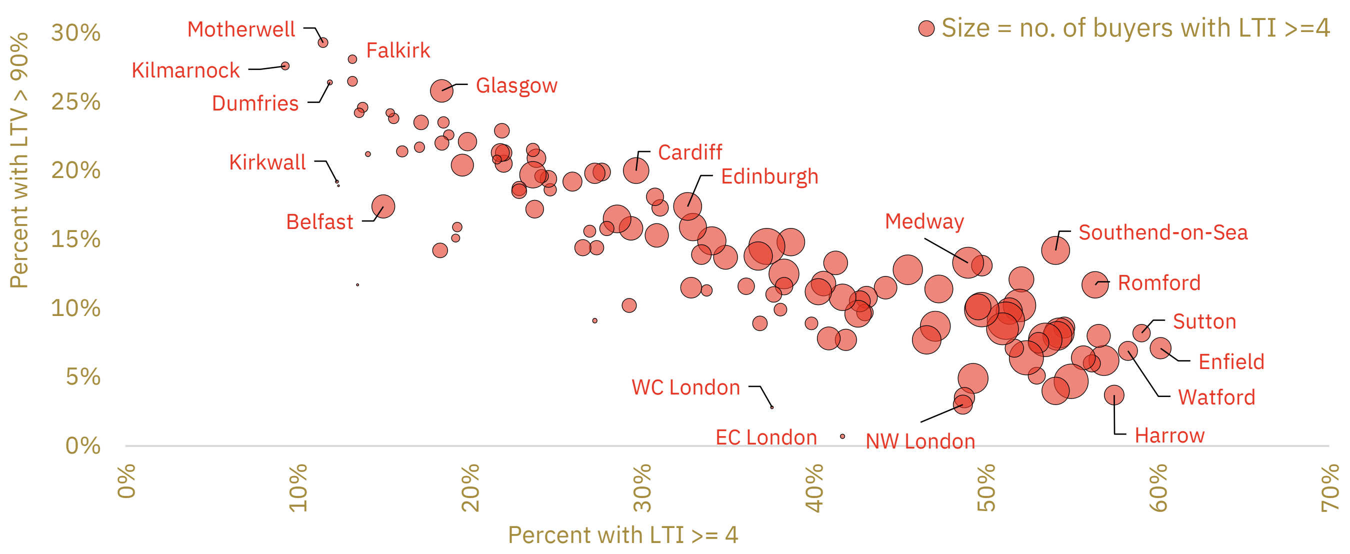
Source: FCA FOI data, Open Door Logistics



One key feature of higher LTI lending is they tend to have lower loan-to-value (LTV) ratios – as per the 2020 FCA paper and the FOI data in the chart below. This suggests the threat of negative equity may be lower in the event of price falls. However, it is likely that the areas with higher LTI lending will be the ones hit hardest by higher mortgage rates – leading to falls in activity along with bigger squeezes on household incomes and spending.

Fig 4: High LTI (4+) & High LTV (>90%) Lending by Postcode Area, 2021

Source: FCA FOI data



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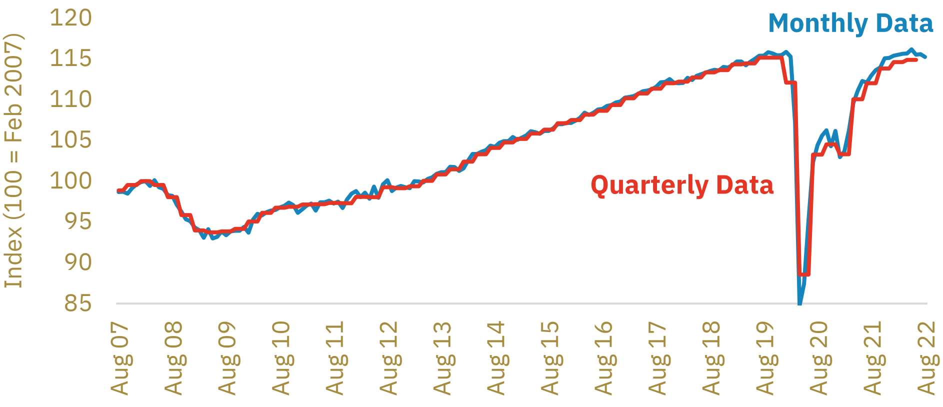
Market At A Glance

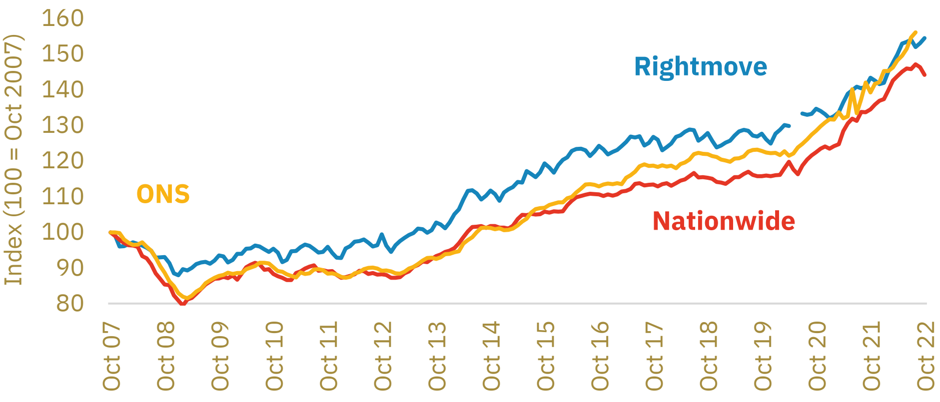
Economy - UK

The ONS monthly estimates reported GDP was 2.0% higher in August 2022 than the same month in 2021. This left monthly GDP 0.6% below the pre-pandemic peak recorded in January 2020. However, this data will inevitably be revised in coming months and years.



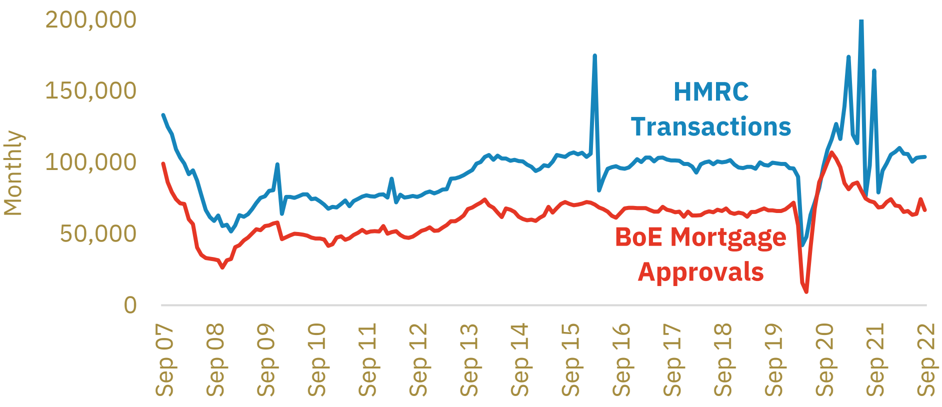
House Prices - UK

Rightmove reported a 7.8% annual rise in asking house prices in October 2022 while Nationwide reported a 7.2% annual rise in their mortgage approval based index in the same period. Meanwhile, the ONS reported 13.6% annual growth in its sales agreed index for the year to August 2022.



Transactions – UK

HMRC provisionally reported 104,000 residential transactions in September. This was 3.9% higher than the same month in 2019. Meanwhile, the Bank of England reported mortgage approvals for house purchase were 0.3% higher in September 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 216,800 completions in the year to Q2 2022 while there were 246,200 new build Energy Performance Certificates in the year to Q3 2022 – a leading indicator for net housing supply.