United Kingdom – April 2023

- **Is This It**
- **Barely Normal**
- **Take It Or Leave It**

The housing market has clearly weakened over the last six months but house prices have not yet fully corrected given the increase in mortgage rates and activity levels are better than expected. This note asks if this is it for the house price correction and looks at what the possible consequences for the housing market could be if so.

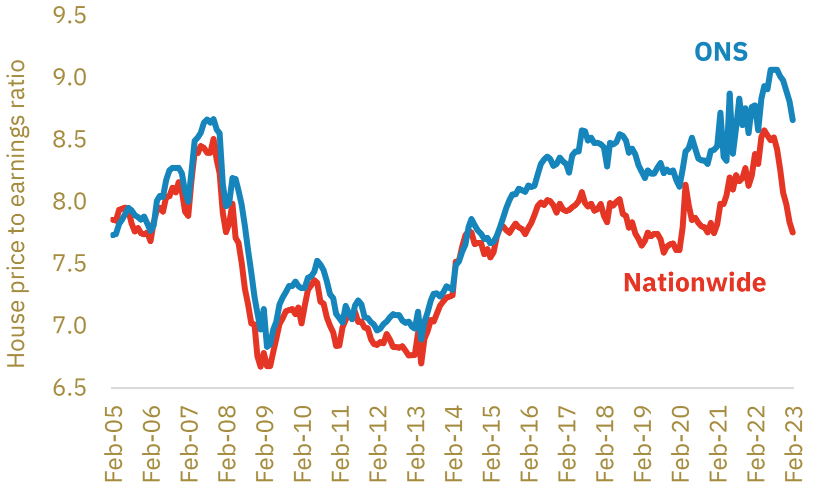
Is This It

The housing market is undoubtedly now weaker than it has been in recent years. House prices have eased, activity levels have fallen, housebuilders are struggling, and stock levels are rising. However, there are signs(PDF) that sales agreed have recovered back to pre-pandemic levels and nominal price falls are still firmly in the single-digits. So why haven't we seen the scale of price correction implied by higher mortgage rates (15-20% falls)?

There are several reasons why the correction has not been as severe as expected. The first is the underlying economic environment with high inflation and rising wages. As Figure 1 shows, house prices relative to earnings have already fallen significantly based on some measures. For example, the house price to earnings ratio based on the Nationwide index and ONS total weekly pay has already fallen 10% since its peak in May last year. The fall recorded by the ONS house price index is much smaller (-3%) though this will reflect it being completion rather than mortgage approval based. As we've previously highlighted, rising wages could contribute a significant part of the required adjustment during this period – much like the 1970s market downturns.

Fig 1: House Price to Earnings Ratio

Source: ONS, Nationwide



Meanwhile, the robust levels of activity appear to be partly thanks to the strength of demand from first time buyers. Normally during a period of housing market turmoil, it is first time buyers that are most excluded from the market as mortgage lenders restrict the availability of higher loan-to-value mortgages. This time it appears they are benefitting from lenders continued desire to be active in the market - possibly helped by the larger deposit funded lenders looking to squeeze smaller ones that are more dependent on wholesale funding. However, while higher loan-to-value product availability has improved, it is well below normal levels and the mortgage rates on available high loan-to-value products are still very high.

An additional driver of first time buyer demand is the terrible state of the rental market. While new buyers may be paying a higher proportion of their income on repayments - even with much longer mortgage terms (FT) – the cost of repaying a mortgage is still cheaper than renting for most. However, the depth of first time buyer demand is uncertain given the impact of higher rates and very large deposit requirements. There were already signs that many of the buyers categorised as first timers may not be quite as new to the market as they first appear (see Chart of the Week). We will have to wait and see if that is the case now but any further signs of weakness in the market or wider economy could quickly lead to the supply of mortgages for first time buyers shrinking.

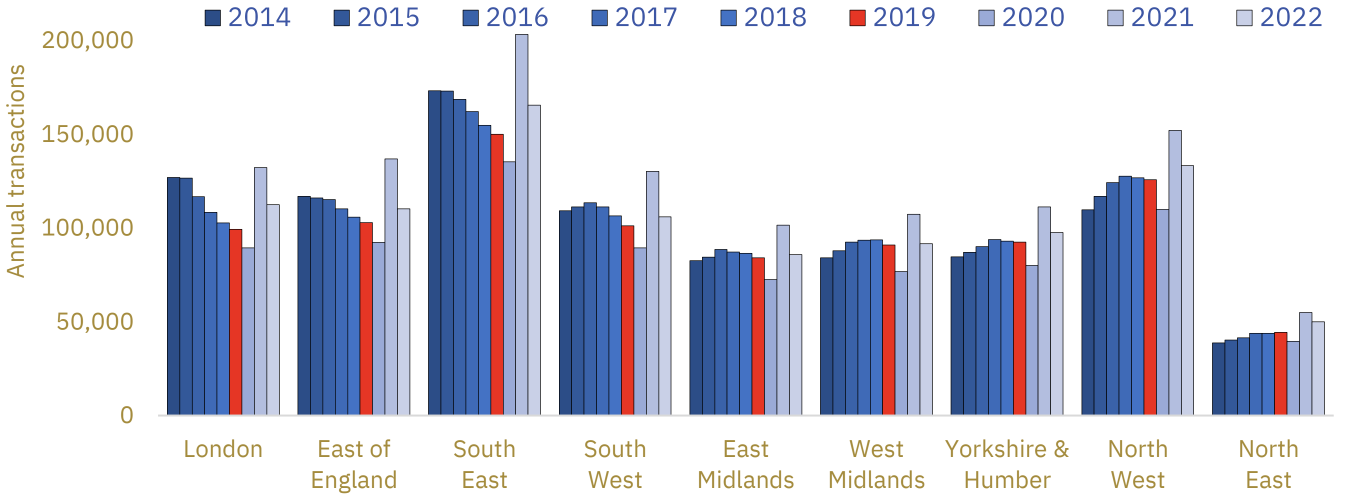
On the supply side, the stock of homes available for sale has been increasing(PDF). The increase in homes for sale has helped contribute to the weakening housing market, with vendors needing to be more realistic on pricing and accept bigger discounts to asking price than this time last year. However, despite all the reports of landlords selling up, there is still a relative shortage of homes for sale when compared to pre-pandemic levels. Meanwhile, despite the lack of homes available for sale, the volume housebuilders do not appear to be benefiting to the same extent as they were this time last year or as their peers in the U.S. are currently. The end of the Help-to-Buy equity loan scheme has clearly hit them hard while the political uncertainty around local plans and housebuilding targets is a further concern. There are signs of bulk sales but housebuilders still appear reluctant to fully engage with institutional build-to-rent investors given the impact on pricing and business models this would probably require.

Barely Normal

A further complication when assessing the current state of the market is the repeated comparisons to 2019 – the last full calendar year before the pandemic. While the housing market in 2019 might appear similar to previous years at a national level, there had been some significant underlying changes to the market. As Figure 2 shows, transactions in London and the south of England had fallen from 2014 to 2019 (-22% in London) while they had risen across the north of England over the same period (+15% in the North West). This was partly a reflection of the shifting housing market cycle - affordability was increasingly stretched in the south and loan-to-income limits were having an effect. It was also due to the impact of stamp duty land tax changes – hitting the south harder and shifting the balance of buyer demand from investors to first time buyers in all but the most expensive markets. The central London market was worst affected with falling prices and a massive collapse in turnover. There were also concerns from housebuilders about the slowing market while the general election added additional worries for many investors. The 2019 housing market was not normal and may be limited as a benchmark. Unfortunately, it will take some time for public sub-national data to be released and allow us to assess quite how the current market compares. So for the time being, it is best to be aware of the challenges when comparing to 2019.

Fig 2: Residential Transactions by Region

Source: HMRC, HM Land Registry



Take It Or Leave It

There is still widespread uncertainty about the future trajectory of the UK housing market. Buyer sentiment is currently better than expected but the impact of higher mortgage rates is still feeding through to existing borrowers while the cost of living crisis continues to hit households hard (Resolution Foundation). Meanwhile anecdotal evidence suggests a growing divergence between those dealing directly with buoyant home buyers and those dealing with the more corporate side of the residential market – and perhaps more aware of the growing risks in the commercial property market. There is still recognition amongst those in the latter group that the residential investment market has not yet fully recognised the shift in interest rates and quite how sticky those rates now appear to be. As we have frequently noted, there are still widespread risks - both known and unknown - at the fringes of the housing market and a larger house price correction is still very possible.

However, it is worth considering the implications for the housing market if this is it – i.e. what happens if prices do not fully adjust to reflect higher interest rates. It's likely that over the longer term rising wages would continue the adjustment but in the short term there could be some serious consequences if prices remain high.

The housing market was already heavily dependent on wealth. Your ability to become a homeowner and move is dependent on having wealth from friends and family or your own - typically built up through house price appreciation. Once you had bought, the cost of ownership had been relatively low compared to the historic average and much lower than the cost of renting. Having a higher income than average was important, but that has become much more so in recent months. Buying also now requires accepting that you will be paying a higher proportion of your income on your mortgage at a time when other costs have also risen - that will hit consumer spending. It now seems likely that, particularly in the absence of any government support, your ability to become a first time buyer will be even more dependent on having more wealth and a higher income than your peers. This is likely to further widen the widespread inequality in housing and homeownership. With the market increasingly dependent on these wealthier and higher income groups, it looks possible that activity will be more constrained in the future and demand for rental homes rises further. As we wrote last month, this might be the best it gets.

Market Commentary

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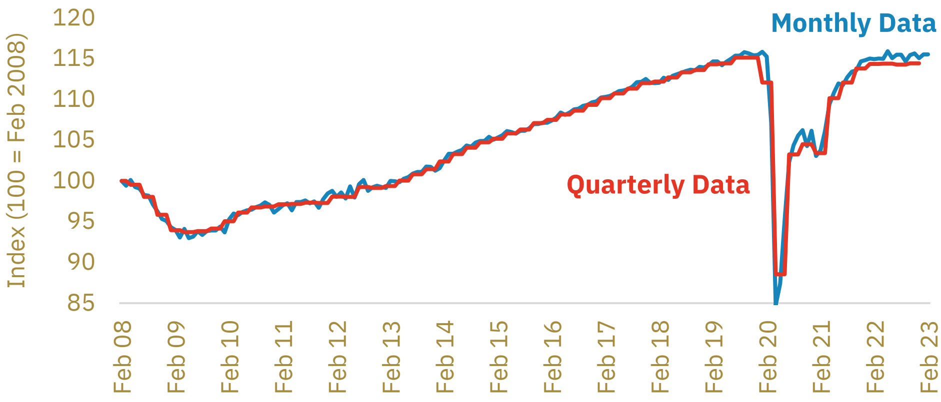
Market At A Glance

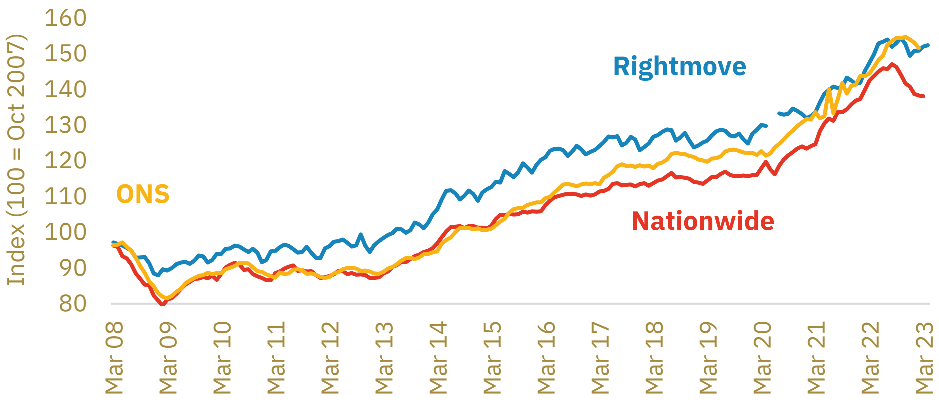
Economy – UK

The ONS monthly estimates reported GDP was 0.5% higher in February 2023 compared to the same month in 2022. This left monthly GDP 0.3% below the pre-pandemic peak recorded in January 2020. However, this data will inevitably be revised in coming months and years.



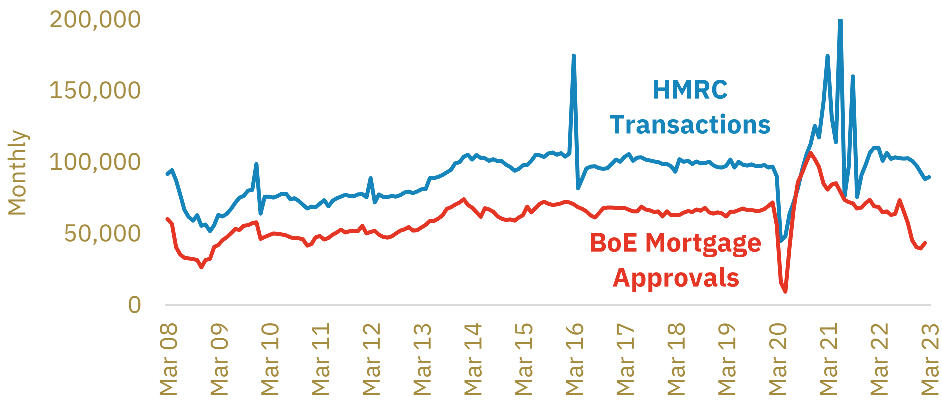
House Prices – UK

Rightmove reported a 1.7% annual rise in asking house prices in April 2023 while Nationwide reported a 31.1% annual fall in their mortgage approval based index in March. Meanwhile, the ONS reported 5.5% annual growth in its sales agreed index for the year to February 2023.



Transactions – UK

HMRC provisionally reported 89,560 residential transactions in March. This was 8.2% lower than the same month in 2019. Meanwhile, the Bank of England reported mortgage approvals for house purchase were 32% lower in February 2023 than the same month in 2019.



New Supply – England

The latest net additions data for 2021/22 reported 233,000 net new homes in England with 210,000 new build completions. The latest quarterly house-building data suggests there were 222,200 completions in the year to Q4 2022 while there were 246,800 new build Energy Performance Certificates in the year to Q1 2023 – a leading indicator for net housing supply.