7th June 2023

Market Commentary

Residential Analysts

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United Kingdom – May 2023

- **Sticky Inflation**
- **Sticky House Prices**

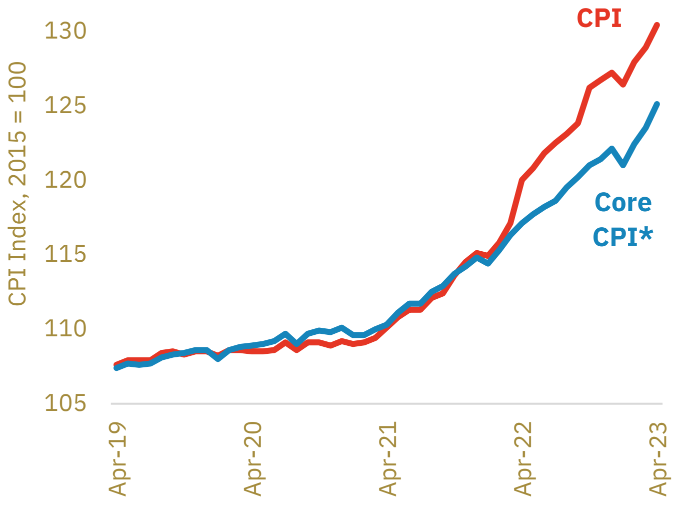
Inflation is proving to be stickier than many anticipated. This has led to a surge in interest rates as expectations for how high Bank Rate will go and for how long have increased. We're already seeing the fallout in the mortgage market and this will hit housing market activity and household finances in coming months. It also puts further pressure on real estate businesses and investors to adjust their business models and investment decisions to reflect the higher interest rate environment rather than hoping it all goes back to a low rate "normal".

Sticky Inflation

Inflation is proving to be much stickier than many anticipated. While the annual percentage increase in CPI may no longer be double-digits as the effects of last year's energy spike fall out of the comparison period, the 8.7% figure for April was apparently still higher than many expected. However, as Fig 1 shows, the underlying trend in both CPI and core CPI has been relatively consistent over the last two years so perhaps the data should not have been quite so surprising.

Fig 1: Consumer Price Inflation Index

Source: ONS (excludes food, energy, alcohol and tobacco)*



Surprise or not, the sticky inflation figures have led to a surge in interest rates as expectations for how high Bank Rate will go and for how long have increased (Fig 2). The impact is already being seen in the mortgage market with higher rates and fewer products available compared to just a couple of weeks ago (MoneyFacts). While not as severe as the Truss turmoil last autumn, this situation is a reminder that this is far from over.

Sticky House Prices

With mortgage rates heading higher, the spring surge in the housing market is likely to fade in coming months. It appears the surge was fuelled by competition amongst some lenders driving mortgage rates down to around 4% for better quality borrowers with big deposits and, with low lending volumes, cash buyers who are unaffected by mortgage market conditions. This led some to suggest the worst of the downturn was over. However, if mortgage rates stay above 5% then we will see the surge disappear as potential buyers with lower rates locked in make their purchases or withdraw from the market. This is just part of the inevitable adjustment process to an inflationary environment and a reminder that it can take a long time for the housing market to adjust. It's quite likely we'll see more volatility in the future as inflation and other data releases provide surprises both positive and negative – leading to some months where a correction appears unlikely and others where one looks imminent.

Fig 2: Market Expectations for Base Rate

Source: Bank of England

With interest rates staying higher for longer, there is a growing realisation amongst real estate businesses and investors that they will need to account for these changing conditions rather than hoping rates fall quickly and things go back to normal (whatever that is!). We're already seeing the fallout of higher rates in commercial real estate sectors across the globe but those involved in the UK residential sector have been slow to adjust. For yield-driven residential assets (e.g. build-to-rent, student housing, some but not all buy-to-let), we are yet to see yields (and hence valuations) fully reflect current interest rates. Meanwhile other businesses involved in real estate will have to reassess their business model assumptions given higher yields and borrowing costs alongside lower turnover. We're starting to see signs of financial stress and this is likely to increase in coming months. As we've said repeatedly here and over the last few months, this is far from over.

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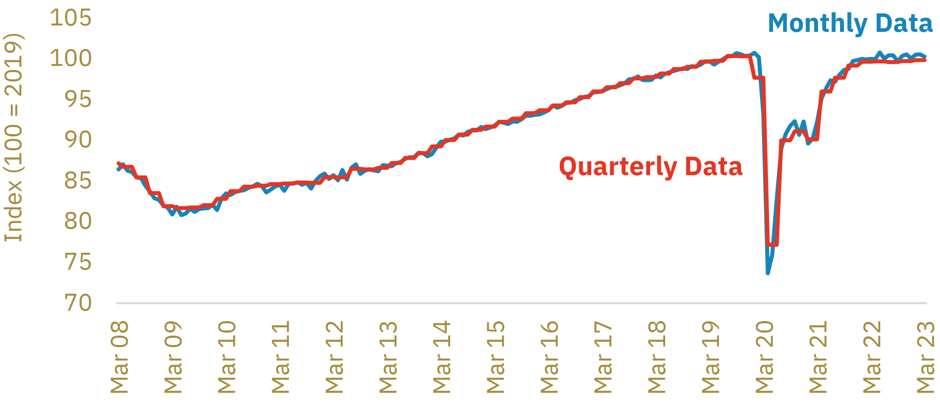
Market At A Glance

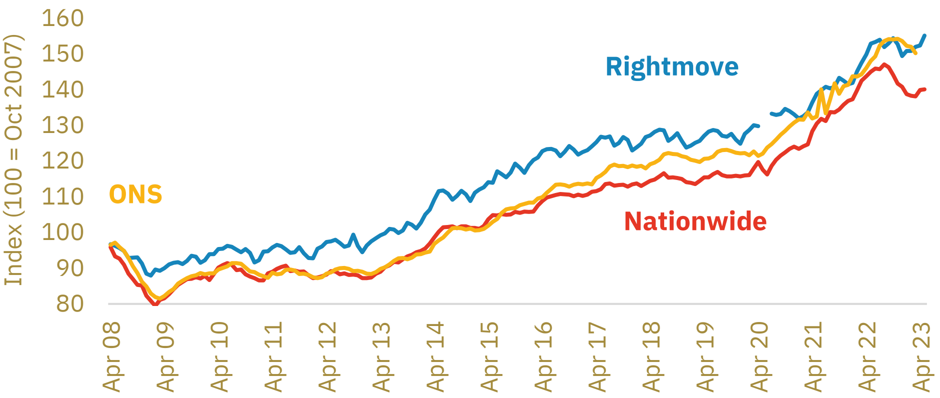
Economy – UK

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



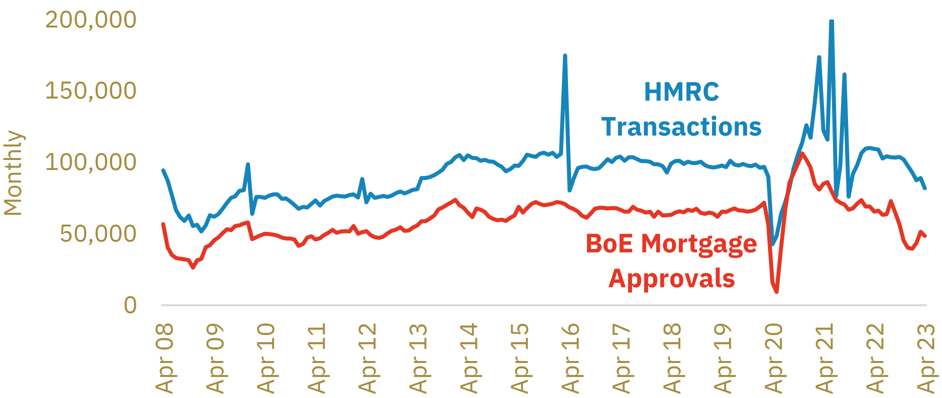
House Prices – UK

Rightmove reported a 1.5% annual rise in asking house prices in May 2023 while Nationwide reported a 3.4% annual fall in their mortgage approval based index in the same month. Meanwhile, the ONS reported 4.1% annual growth in its sales agreed index for the year to March 2023.



Transactions – UK

HMRC provisionally reported 82,120 residential transactions in April. This was 16.2% lower than the same month in 2019. Meanwhile, the Bank of England reported mortgage approvals for house purchase were 25.9% lower in April 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.