5th January 2024

# Market Commentary

*Residential Analysts*

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## United Kingdom – 2023 Review

- **A Hangover, Second Wind, & Comatose Market**
- **Failure to Complete & Sticky Prices**
- **Escape At Any Price & Anything But The Price**

The housing market in 2023 started with a hangover thanks to the Truss turmoil but it quickly turned into a second wind as mortgage rates fell and activity recovered during the spring and early summer. However, inflation remained sticky and interest rate expectations rose, leading to a sharp rise in mortgage rates. The market stagnated as activity levels fell again and prices eased while the crisis in the private rented sector continued. The prospects for 2024 look more positive but there are short-term risks created by this period of higher rates.

### The Truss Hangover

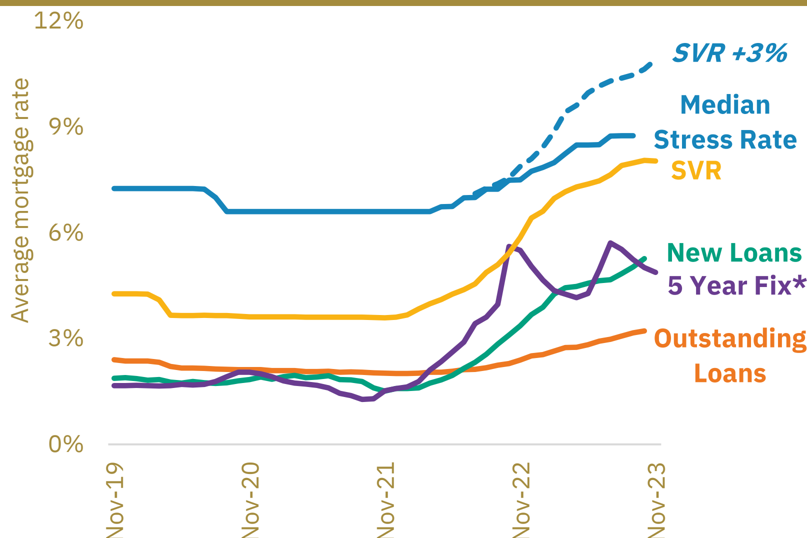
2023 started with the last dregs of the Truss turmoil still working their way through the housing market. Activity levels were well below normal levels and house prices were falling, reflecting the rapid rise in mortgage rates the previous autumn. It was clear that a market downtown was in progress, but there was still uncertainty about the likely scale of its impact. Were we about to see the double-digit price falls suggested by the rise in rates or would the market stagnate with house prices mostly falling in real (inflation-adjusted) terms thanks to a lack of forced sellers. Despite the uncertainty and ongoing cost of living crisis, there were already some signs of improvement as interest rate expectations had already fallen (Fig 1) and quoted mortgage rates began to ease (Fig 2).

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

### A Second Wind

As mortgage rates fell back towards 4% in early 2023 (e.g. the 5 Year Fix in Fig 2), there were signs that buyer demand was still holding up despite the turmoil. Along with a relative lack of homes for sale, this demand helped maintain a competitive market in many locations despite lower activity. And thanks to this sustained buyer demand, listing portals began reporting an increase in demand and sales agreed returning to pre-pandemic levels.

**Fig 2: Average Mortgage Rates**
*Source: BoE *quoted rate at 75% loan-to-value - UK*

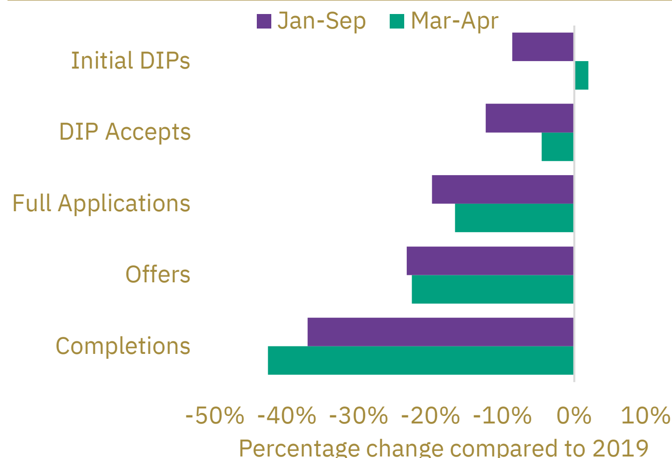



For example, Zoopla (PDF) reported "demand" and sales agreed were both higher in January than the 2017-2019 average while in February Rightmove (PDF) reported "the number of people contacting agents is up by 11% in the last two weeks compared with the same period in 2019". With rates falling and demand holding up, house prices bottomed out in March and began rising again - the Nationwide index shows prices had fallen 6.1% from their peak in August 2022 to trough in March 2023. With house prices now rising on a monthly basis, some commentators suggested the worst was behind us (PDF). However, there are some unanswered questions about just how strong this buyer demand was given the bounce in sales agreed has not fed through to transactions.

## Failure to Complete

Last spring saw some agents and listings portals reporting higher levels of sales agreed than recorded prior to the pandemic but it appears many of these sales were never completed as overall sales volumes remain lower. As we investigated back in November, a survey from the Intermediary Mortgage Lenders Association (IMLA) offers clues to what happened. The IMLA survey (PDF) of business volumes and conversion rates from Decision in Principle (DIP) through to completion suggests there are significant challenges in actually getting accepted for a mortgage and receiving an offer. It also shows managing to complete is even more difficult given the issues with chains many will have experienced last year (including many cash buyers dependent on mortgaged buyers for their sale).

**Fig 3: Intermediary Mortgage Activity**
*Source: IMLA Mortgage Market Tracker, BVA Bdrc*




As Fig 3 shows, the number of initial DIPs and DIP accepts have been relatively robust compared to 2019, especially in March and April. This is likely the point in the house buying process when offers have been made and sales agreed. Unfortunately, tracking the IMLA activity levels through the mortgage process shows an increasing fall-through in activity. It appears prospective buyers have been passing the first hurdle with a DIP and making offers, but then struggling to pass the more difficult parts of the borrowing process and actually buy the home they offered on. The continued rise of the SVR and stress test rate over the course of 2023 will be a factor despite the removal of the +3% stress test in August 2022 (see Fig 2). The failure to complete was highlighted in October when Zoopla launched a "Back to Market" tag for listings and reported "approximately 40% of sales falling through at the moment".

## Sticky Prices

It appears a significant proportion of the sales agreed during the first half of 2023 may not reach completion but at the time it looked like the housing market was improving. House prices increased slightly during the spring and early summer as low turnover and the constrained supply of homes available for sale ensured a competitive market for those people who could still afford to buy. There was clearly an expectation that high rates were a temporary challenge and, if households and corporates could just hold on till the autumn, then everything would be ok as rates eased.

Evidence of this behaviour can be seen in the rise in proportion of new loans on variable rate mortgages in Q1 and Q2 (Fig 4). Borrowers were clearly hoping that by suffering some short-term pain, they could benefit from lower rates later in the year. However, it wasn't just house prices that were proving sticky. Inflation was showing no sign of easing (Fig 5) and the cost-of-living crisis was still firmly underway.

The April inflation data published by the ONS in May marked a turning point. The data showed a smaller than expected fall in inflation while core inflation increased. Financial markets reacted and expectations for the Bank of England base rate rose again (Fig 1) and mortgage rates followed (Fig 2).

**Fig 4: New Loans by Rate Type & Fix Period**
*Source: Bank of England – purchase and remortgage*

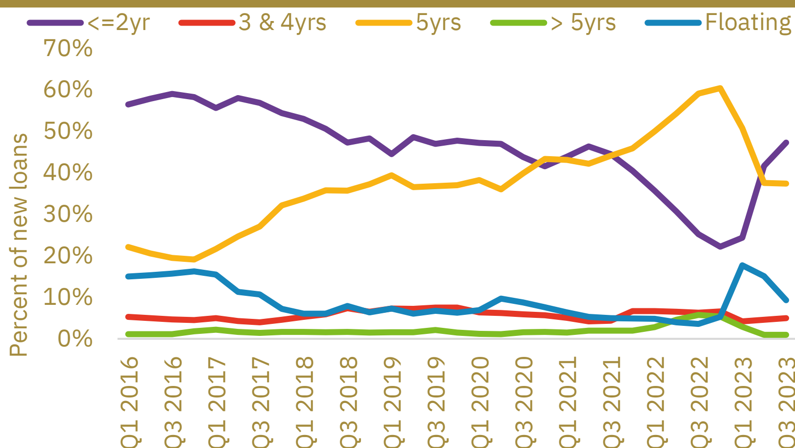
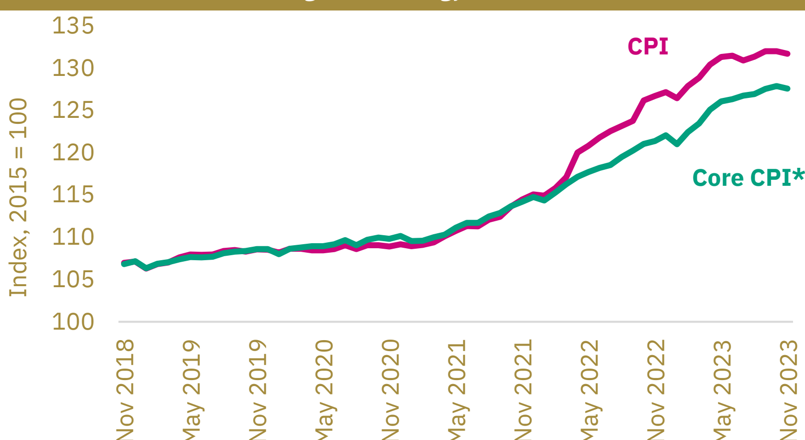



**Fig 5: CPI & Core CPI Index**
*Source: ONS *CPI excluding Food, Energy, Alcohol & Tabacco*



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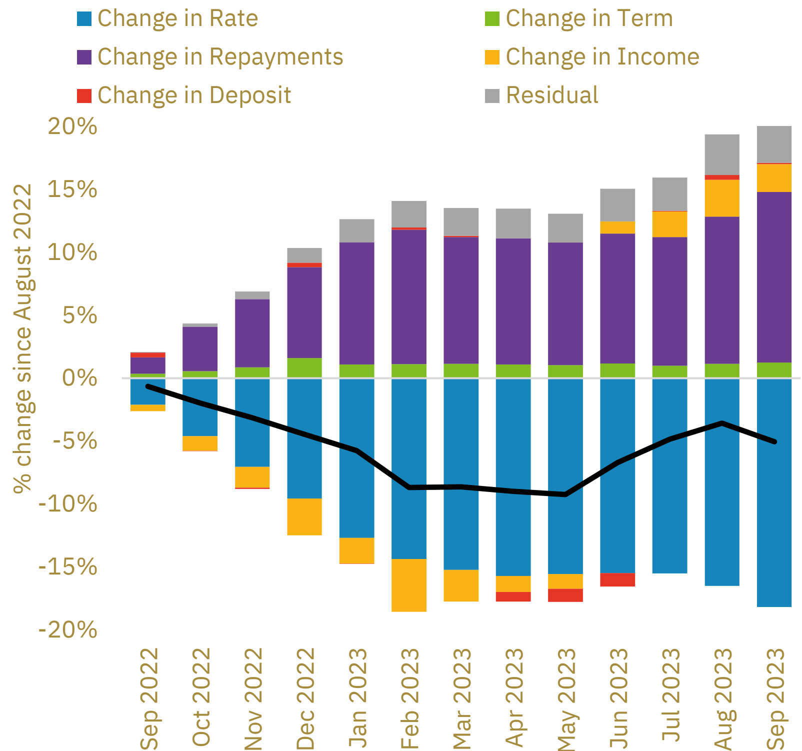
## Where's The Crash?

As inflation and earnings data disappointed financial markets over the summer, interest rates rose again, hitting new peaks in July (Figs 1 & 2). Higher mortgage rates further dampened activity over the summer as prospective buyers were increasingly priced out of the market but, while there are some signs that prices have fallen slightly in recent months, the impact of mortgage rates in excess of 5% has been less than might be expected.

There are several reasons why it is turnover and not house prices that absorbed the increase in mortgage rates last year. The large number of outright owners and high proportion of borrowers on fixed rates has help insulate many from the immediate impact. Meanwhile, the support for those struggling with higher rates is significant (FCA/Mortgage Charter) and, in theory, most borrowers have been stress tested at higher rates (Fig 2). This has helped limit forced sales but does not explain how buyers have continued to be active despite higher rates.

**Fig 6: Contribution to Change in Purchase Price**

*Source: BuiltPlace calculations using UK Finance data*



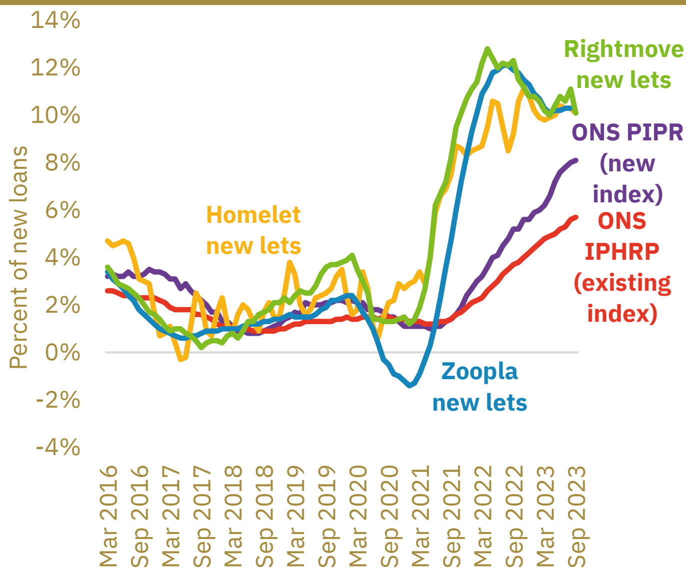

Our analysis of UK Finance data shows that, while there has been an increase in cash only purchases, mortgage dependent buyers have also adjusted to higher rates. As Fig 6 shows, the average price paid by a mortgaged buyer (black line) has fallen since the market peak in August 2022. However, it should have fallen much further given the rise in mortgage rates (blue bars) but has been mostly compensated for by a rise in the average repayments (purple). Basically, house prices haven't fallen further because new borrowers are paying more each month.

## Escape At Any Price

New mortgage dependent buyers might be paying more for the privilege of home ownership than in recent years but it's still a much more attractive proposition than staying in the private rented sector – if they can afford to escape. The cost of buying (especially the deposit) has been a barrier since the financial crisis but 2023 saw the cost of owning increase significantly. Monthly repayments for a first-time buyer are now around 22% of gross income compared to 17% back in mid 2022. But this is still lower than the cost of renting for many households.

**Fig 7: Annual Percentage Change in Rents**

*Source: ONS, Homelet, Zoopla, Rightmove*




The state of the private rental market has been shocking for many years, with affordability and security of tenure among the serious issues. 2023 saw rent affordability worsen as high tenant demand continued amidst a lack of homes available to rent. There was also actual evidence of a net sell-off by landlords as the number of outstanding buy-to-let mortgages fell and sales by landlords increased. The Scottish Government reacted by capping rental increases to 3% and the government finally introduced the Renters (Reform) Bill in May.

There are some signs that rental growth is easing and re-linking Local Housing Allowance to the 30th percentile of local rents will temporarily help some households while the supply of new build flats looks set to increase in some cities in 2024. But there's still a lack of properties available to rent relative to tenant demand and, with first time buyer numbers around 20% lower than last year, the upwards pressure on rents will probably continue through 2024.

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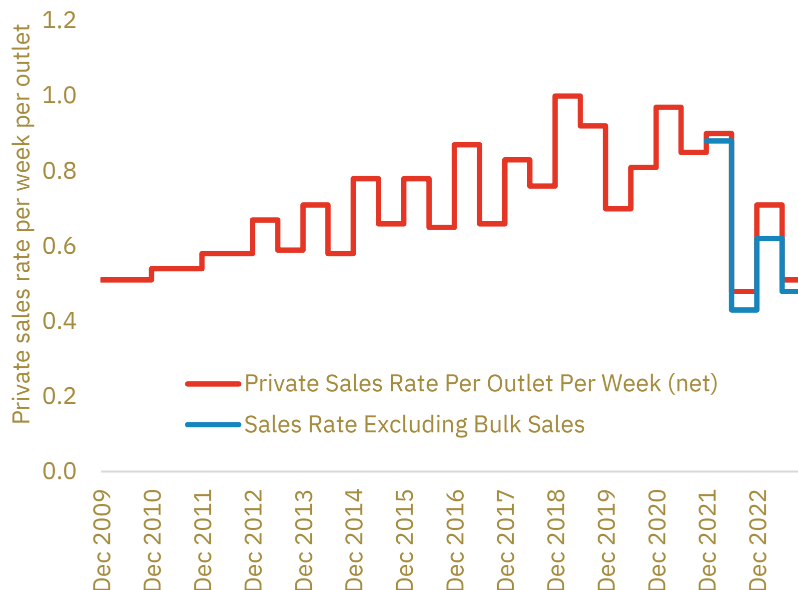
## Anything But The Price

Housebuilding has probably been the residential market sector most affected by the impact of rising mortgage rates given it also coincided with the end of Help-to-Buy equity loan (a pain for us analysts trying to unpick the relative impacts!). The impact on housebuilder sales rates has been substantial, with most reporting big falls and many relying on bulk sales to investors and registered providers to slightly improve sales rates (Fig 8).

**Fig 8: Taylor Wimpey Private Sales Rate**
*Source: Accounts and Trading Updates*



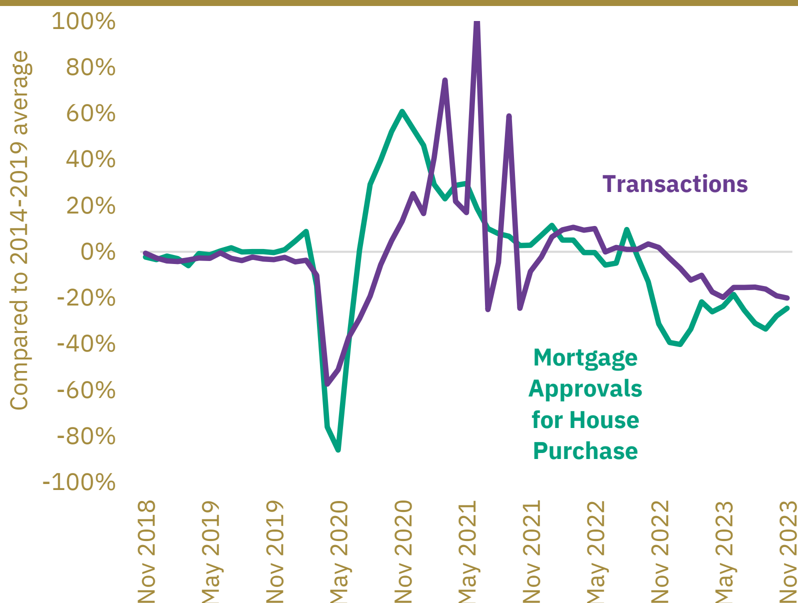

Despite the lower sales volumes, housebuilders have been unwilling to adjust their headline pricing, instead preferring to use incentives where possible and increase marketing. During the Help-to-Buy boom years, housebuilders abandoned listing portals as they built their own lists of ready and willing new build buyers. But with reduced demand, housebuilders are now increasing their advertising on portals with large numbers of new listings in some local markets. For example, Rightmove recently reported the majority of the growth in their key metric "average revenue per advertiser" was thanks to new homes developers. Assessing the use of incentives is difficult but it's regularly said that housebuilders will offer anything other than lowering the price. Last year I spotted a local housebuilder offering a BMW i4 and cash rebate though I'm not sure what a lender would make of it.

## A Comatose Market

The second half of 2023 saw the growing realisation that rates were staying higher for longer than most had originally expected. As concerns about sticky inflation grew, the expectation that interest rates would have to rise further increased. Mortgage rates followed and the usual autumn selling season was a poor shadow of its usual self as mortgage dependent borrowers struggled to borrow enough to meet the still high price expectations of sellers. Even cash buyers struggled as issues further down the transaction chain delayed or stopped sales. As Fig 9 shows, mortgage approvals for house purchase had collapsed to 40% lower than the pre-pandemic average in January following the Truss turmoil. As rates eased in the spring and early summer, approvals recovered to around 23% below the pre-pandemic average but, as rates then rose, approvals fell away to a hit a low of -33% in September. Recent months have seen a recovery in mortgage approvals but transactions continue to trend lower.

The corporate side of the residential market was also not immune from the worsening outlook. Many businesses had clearly hoped to wait it out until the market improved but as the recovery in rates got pushed further out, there were growing signs that the they were starting to suffer. The listed housebuilders had already seen a collapse in sales rates, and many were looking for efficiencies and consolidation in their businesses while cutting back on future development activity. The build-to-rent market also saw a slowdown in investment activity despite the positive spin put on it by agents (a larger share of lower activity) and a shift to single-family rental (houses on new build estates). With a collapse in overall transactions, those businesses dependent on turnover will also have struggled. There will be lots of people and businesses hoping the recent fall in rates increases activity.

**Fig 9: Market Activity**
*Source: Bank of England, HMRC*



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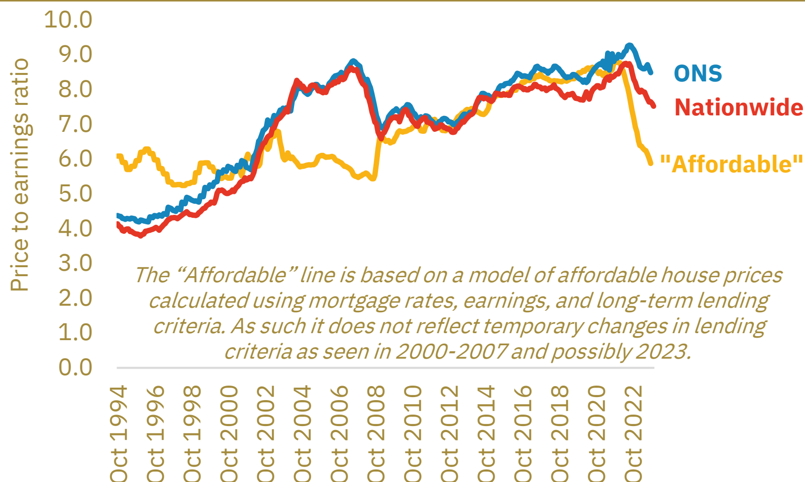
## 2024 Outlook

At first glance, the outlook for 2024 looks better when compared to this time last year. Inflation is easing, expectations for interest rates are receding, and mortgage rates are falling rapidly. We've avoided a housing market crash and some commentators are declaring the worst is over – and this time they might be right. However, despite the apparent strength of the employment market, it is still not clear how much damage this period of high inflation and high interest rates has done to the economy and where interest rates could settle in the medium term. If we (and policy makers) are lucky and rates fall rapidly, then the damage will hopefully be minimal, and the much threatened (including by me!) price crash should be avoided. But it's still not certain.

As Fig 10 shows, while the nominal price correction has been minimal, the correction when adjusted for average earnings has been larger, taking the price to earnings ratio back to pre-pandemic levels. However, the fall has not been as sharp as suggested by long-term trends in what might be considered "affordable" as borrowers have squeezed lending criteria and paid more each month to cope with higher rates. This outcome raises an interesting question of what might happen if rates rapidly improve but the recent relaxation in lending criteria does not tighten in response. Our simple modelling suggests house prices could end up around 20% higher than the 2022 peak if average mortgage rates fall to 3% and the stress test rate falls by a similar amount.

**Fig 10: House Price to Earnings Ratio**

*Source: Nationwide, ONS, Bank of England*

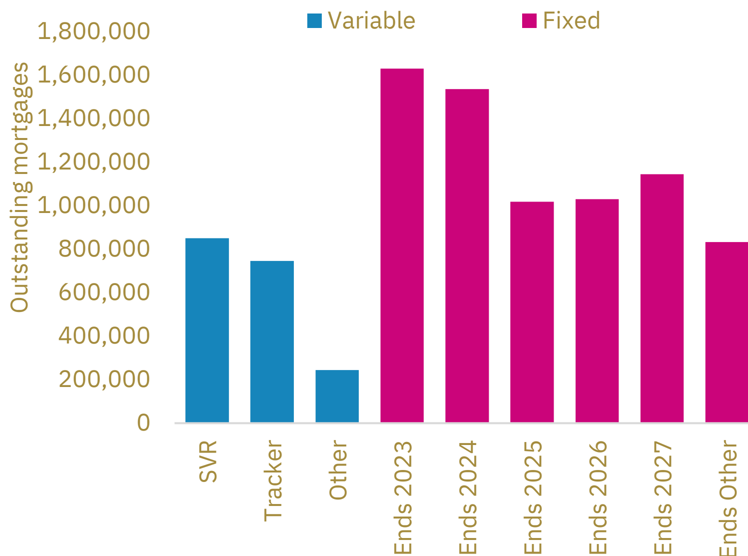



The outlook for the housing market is probably more positive than it's been in nearly two years but the poor state of official employment data means there is still some uncertainty about just how well the economy can cope with this period of high inflation and interest rates. It has been clear for a long time that the fallout is very unevenly distributed. Some households will continue to be relatively unaffected (or even benefit from higher rates) while others will suffer. FCA data shows over 370,000 fixed rate mortgages were expected to end in December/January – possibly the worst time of the year given all the other bills due - and over 1.5 million will end this year (Fig 9).

Mortgage arrears will increase this year (UK Finance forecast a 22% increase) but support from lenders is substantial and it is unlikely that we will see a significant increase in repossessions when compared to previous downturns. Mortgage lenders will do everything they can to avoid this outcome and the court system probably couldn't cope anyway. In absence of a big rise in unemployment, the prospect of large numbers of forced sales still looks unlikely outside of localised areas with lots of landlords selling or new build developments completing.

**Fig 11: Rate Type & Fix End – Dec 2022**

*Source: FCA via GLA*




Perhaps the biggest difference in the housing market compared to this time last year is the increase in available supply for sale. Although new listings have been in line with normal levels, the number of homes available for sale has been rising due to lower transaction volumes. This is especially the case for larger properties at the upper end of their respective local markets and could be a drag on prices if buyer demand does not bounce back as mortgage rates fall but could also trigger more activity if the market recovers.

In summary, the prospects for the housing market this year are more positive than last year, but we still have serious concerns about the short-term economic risks created by this period of higher rates and inflation. While it is possible for a rapid rebound in house prices if mortgage lending criteria remain relaxed, the long-term potential for price rises and higher activity will be constrained if rates stay closer to historic levels than their pre-pandemic lows.

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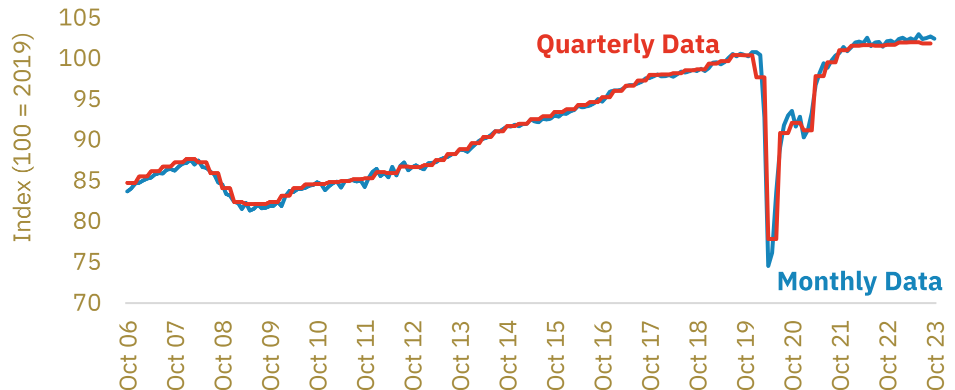
## Market At A Glance

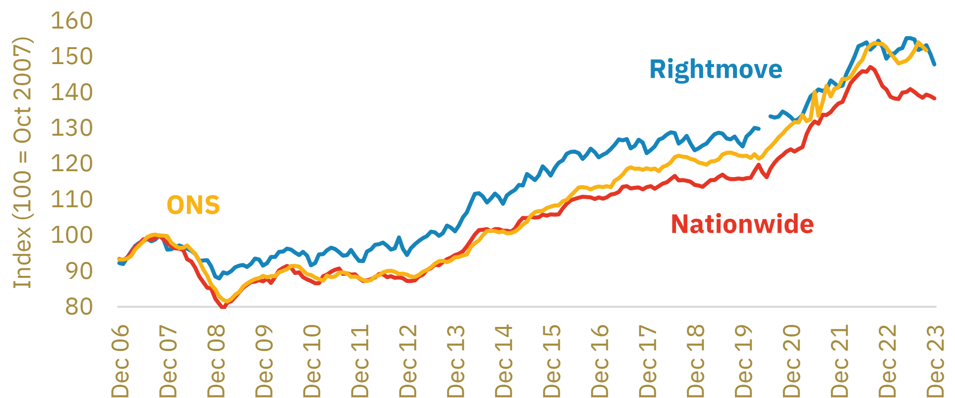
### Economy – UK

The ONS estimated monthly GDP increased 0.3% in the year to October 2023. Thanks to recent revisions, monthly GDP was 1.6% above the pre-pandemic peak recorded in January 2020. However, this monthly data will continue to be revised in the future.



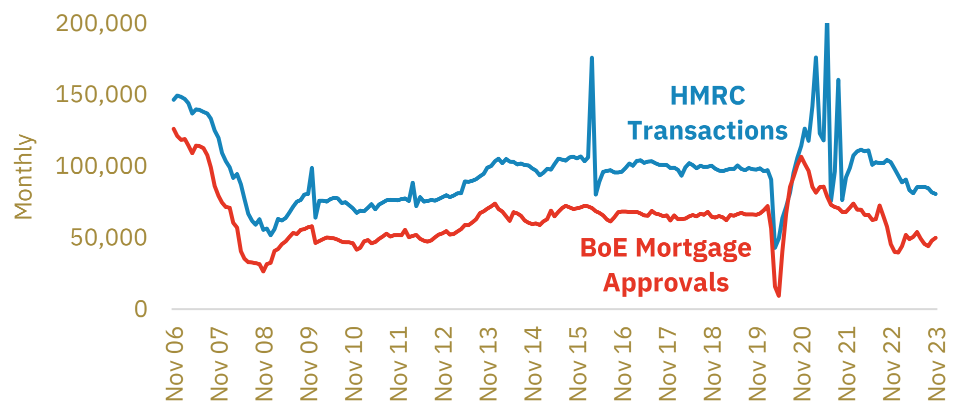

### House Prices – UK

Rightmove reported a 1.1% annual fall in asking house prices in December 2023 while Nationwide reported a 1.8% annual fall in their mortgage approval based index over the same period. Meanwhile, the ONS reported a 1.2% annual fall in its sales agreed index for the year to October 2023.




### Transactions – UK

HMRC provisionally reported 80,780 residential transactions in November. This was 17% lower than the same month in 2019. Meanwhile, the Bank of England reported mortgage approvals for house purchase were 24% lower in November 2023 than the same month in 2019.




### New Supply – England

The latest net additions data for 2022/23 reported 234,400 net new homes in England with 212,600 new build completions. The latest quarterly house-building data suggests there were 205,900 completions in the year to Q2 2023 while there were 237,000 new build Energy Performance Certificates in the year to Q3 2023 – a leading indicator for net housing supply.