October 2023

ECONOMIC UPDATE.

THE MORTGAGE LENDER
real life lending

4most
ANALYTICS CONSULTING

Let’s introduce something awesome

We’ve teamed up with 4most Analytics Consulting to provide you with a monthly economist update.

The information in this pack is for educational and information purposes and does not constitute advice.

Overview

The Bank may finally be done. But higher oil prices show the path back to 2% could be long and bumpy

- Although quickly overshadowed, the government's row back on environmental measures is perhaps the most significant economic news in the last month. The short-run implications are limited – a shallow recession is still expected - but it highlights how shifting the goalposts makes long-term planning fraught with risk.
- Compared to the chaos of two months ago there is more confidence that the Bank of England is done, or nearly done. Keeping the Bank Rate at 5.25% was a slight surprise. Inflation did fall more than expected in August as volatile hotel prices dropped. But climbs in oil prices means the Bank remains ready to act again if coming readings disappoint. Rates are expected to remain at 5.25% until next summer.
- Market expectations of where rates are heading have largely fallen into line with the Bank's guidance. Mortgage rates are already coming down. The balance of risks is shifting, and it is much easy to make the case that house prices have bottomed out.

Risk outlook

- The sharp divergence in consumer confidence measures between the better and worst off is a reminder that there are plenty of winners from a move to a high interest rate environment. Upside risks remain centred on the resilience of the household sector.
- Oil prices at $90pb+ are a little at odds with rather downbeat assessments of global growth and of course unhelpful in terms of getting a grip on inflation. Geopolitical risks centre on the strained relationship between the US and China.
- As the US gears up for the next presidential election, the weak fiscal position is likely to get more attention. Running government deficits of this size when the economy is strong is a worry. If markets turn against US assets and yields are forced up even further, this could ripple around the world.

The economy has been resilient. But now shows signs of cooling

Over the last quarter, the size of the economy has been revised up, consumer confidence has improved, and inflation is in a better place.

Households and business are muddling through the cost-of-living shock.

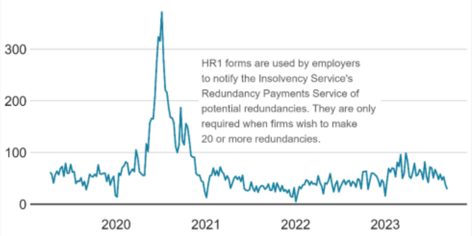
But the full impact of interest rate rises is uncertain and has yet to be felt. Surveys suggest manufacturers are now cutting jobs in response to sagging order books.

Just how tight is the labour market? The unemployment rate was 4.3% in May-July, 0.5% points higher than a quarter earlier. Meanwhile, vacancies have fallen sharply.

Much of the rise in unemployment reflects a move from inactivity that may not put much downward pressure on wages. And Wilko aside, there is little in the redundancy announcements to suggest a marked increase in job losses.

The number of employers proposing redundancies has declined recently

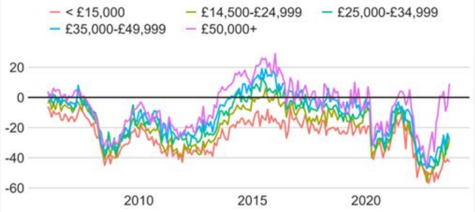
Number of employers



Source: Insolvency Service HR1 forms, via ONS. Week ending 10 September.

Consumer confidence for those on higher incomes has recovered; but those at the bottom are struggling

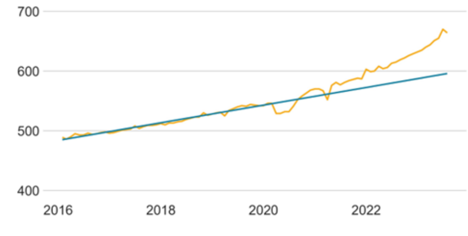
% balance



Source: Haver Analytics, GfK NOP. Data to September 2023

After the spike from NHS bonus payments, earnings dropped back slightly in July

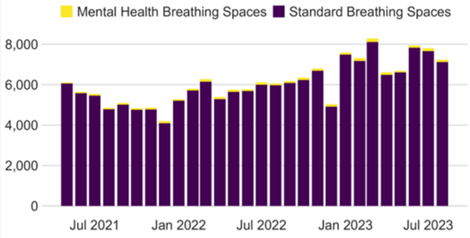
Total Average Weekly Earnings, including bonuses, £ per week



Source: ONS

Breathing Space Registrations were 19.4% higher than a year ago in August

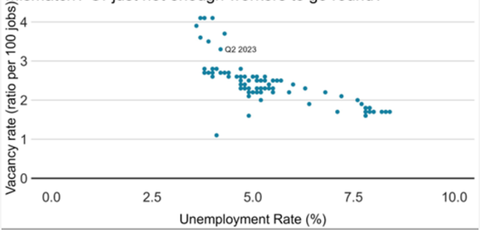
number in month, England and Wales



Source: Insolvency Service

The ratio of vacancies to unemployment has fallen, but is still high by historic standards

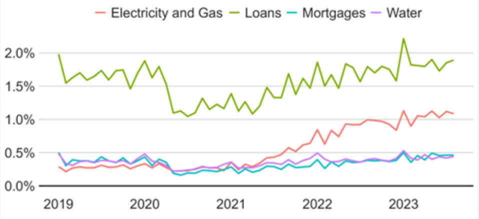
Mismatch? Or just not enough workers to go round?



Source: ONS. Data from Q2 2001

Despite the cost-of-living crisis, the direct debit failure rate for loans is not much higher than it was in 2019

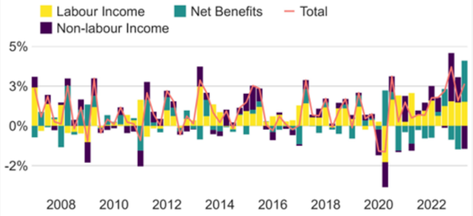
Direct Debit failure rate, non-seasonally adjusted, UK (%)



Source: Pay.uk and Vocalink, via ONS.Data to August.

The big uplift in benefits contributed to income growth of 2.7% in Q2 2023

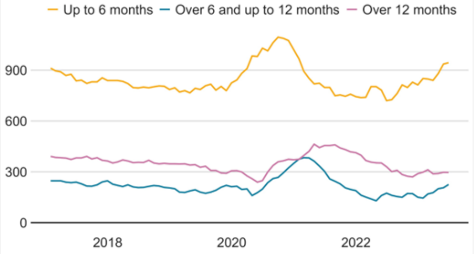
% points contribution to quarterly growth in nominal household income



Source: ONS

Short-term unemployment has risen

Level in 000s



Source: ONS

Inflation and interest rates

There is better news on inflation: the 0.3% increase in prices between July and August is slightly lower than average over the MPC era.

Some comfort will be taken from this and the visible falls in core and services measures. A 12% drop in the energy price cap could see the headline rate fall below 5% in October.

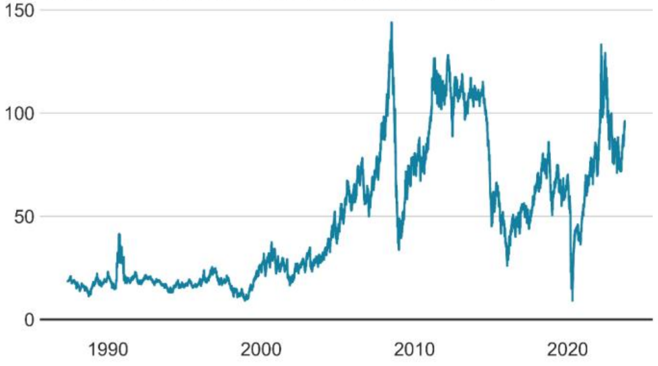
The decision to keep the Bank Rate at 5.25% in September was a close call. Better inflation news helped. But forward-looking business surveys suggesting weaker activity and easing cost pressures ahead probably tipped the balance.

With the effects of so much tightening still to digest, the peak is probably here. But what follows largely depends on the economic news. With energy prices rising and wage growth still strong it is by no means certain.

It may seem premature to talk about when rates will fall. The Bank would like to maintain the current stance for a prolonged period. And there is much debate – given revisions to the market curve – about where the neutral rate is.

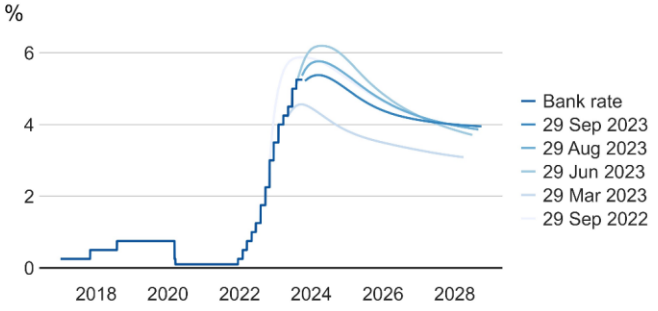
Oil prices are back above $90pb

Europe Brent Spot Price FOB (Dollars per Barrel)



Source: US Energy Information Administration. Data to 25 September 2023.

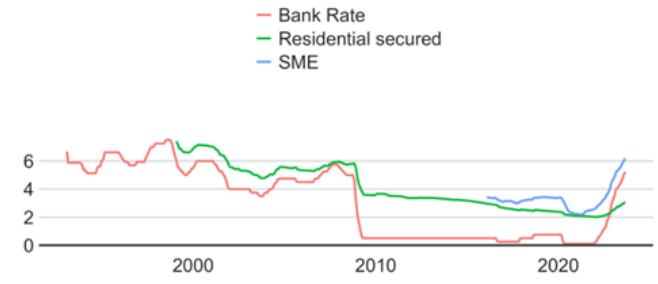
After September's MPC meeting, market expectations are more in line with the Bank of England's messaging



Source: Bank of England

Most SMEs have already felt the impact of a higher Bank Rate

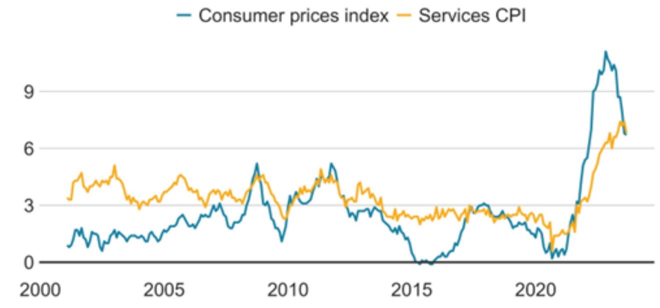
Comparison of Bank Rate to effective rate on outstanding balances



Source: Bank of England. Data to August 2023

Headline inflation eased to 6.7% in July; services inflation dropped from 7.4% to 6.8%

% change on year



Source: ONS

Mortgage market - rates

The big revision in market expectations of where the Bank Rate is headed in the short term has obviously seen product rates fall since the Bank of England published August's figures.

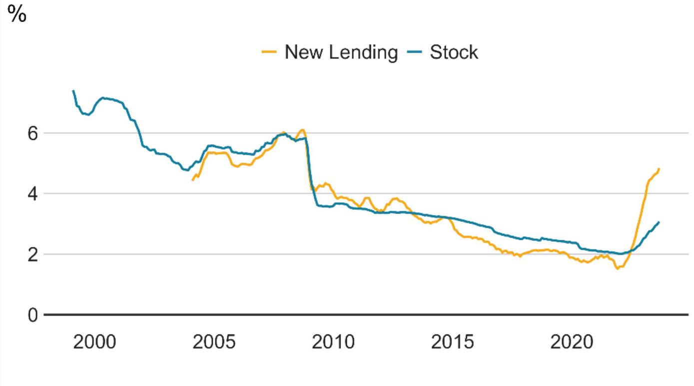
For those with big deposits, sub 5% deals are available, a long way from where were a couple of months ago.

How much further could rates fall? The scope looks limited given that banks appear to have compressed their margins as rates rose to do at least some business.

Today's pricing reflects markets buying into the 'higher for longer' message from central banks. That line will not hold if inflation falls back to target and growth stagnates.

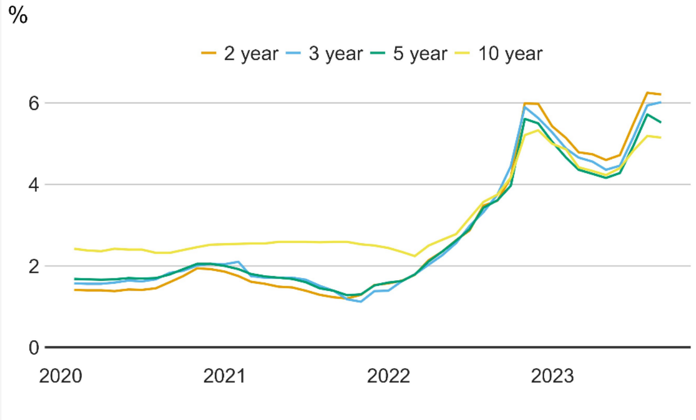
It is not obvious that the factors that took us into the low interest environment – demand for risk-free assets, ageing populations and weak productivity – have changed.

The effective rate on new secured lending was 4.84% in August



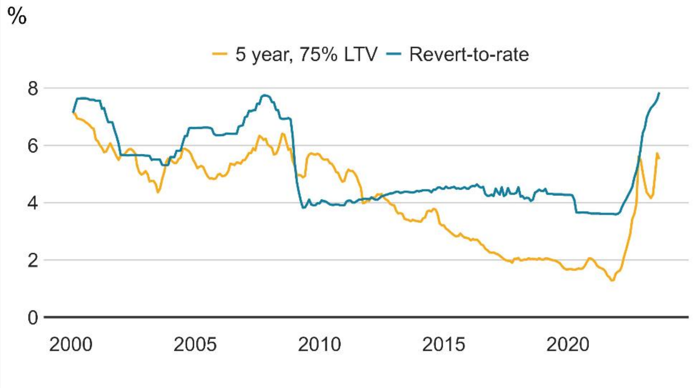
Source: Bank of England. Data to August

Quoted rates on 75% LTV residential lending



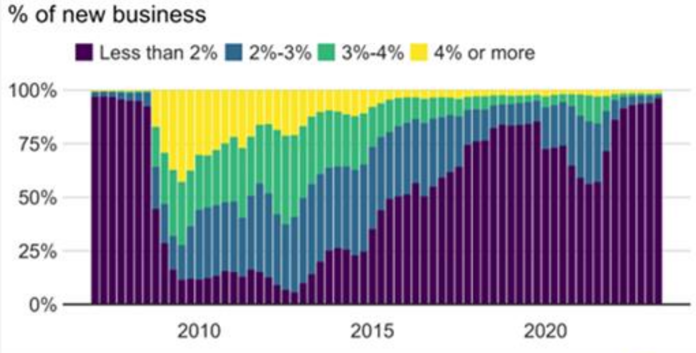
Source: Bank of England. Data to August 2023

The typical 'revert-to' rate was 7.85% in August



Source: Bank of England. Data to August 2023

The last time the share of gross mortgage advances with interest rates less than 2% above Bank Rate was this high was Q3 2007



Source: Haver Analytics, Bank of England MLAR statistics. Data to Q2 2023

Rental market

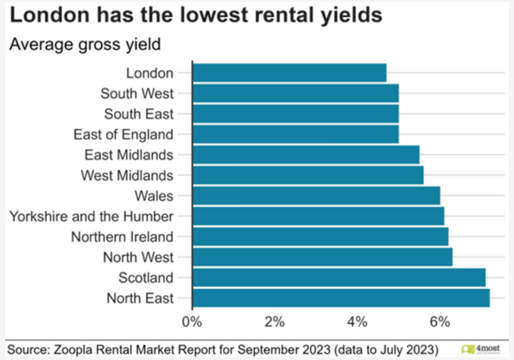
Government proposals to remove requirements to invest in energy efficiency will of course reduce landlords' costs.

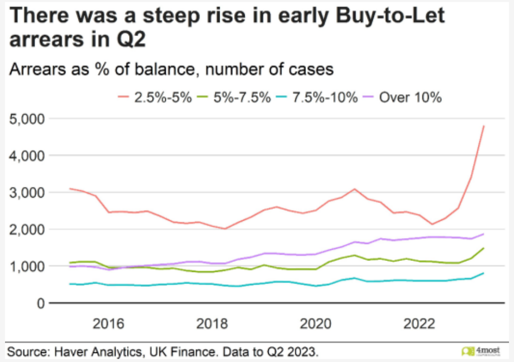
And with market expectations of peak rates being slashed, product rates are dropping. But even with mortgage rates at c 5%, in most regions, the economics remain challenging.

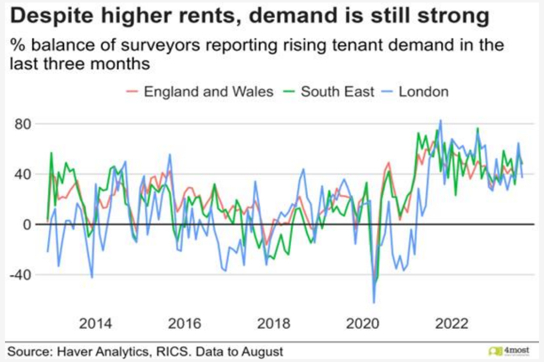
After the climate announcement, it would not be a huge surprise if the government ditched the Renters Reform Bill.

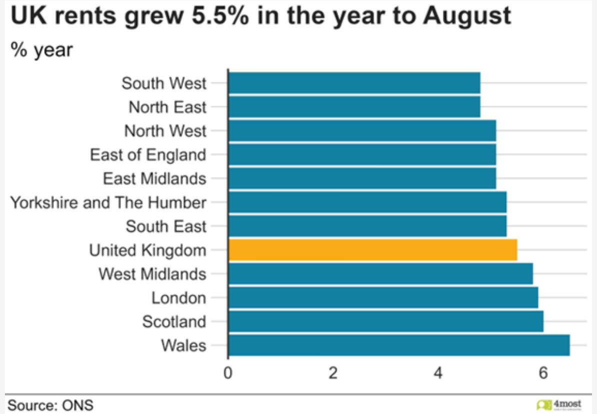
None of this will comfort tenants, who face higher energy bills given a lack of investment in insulation. Demand for property continues to outstrip supply.

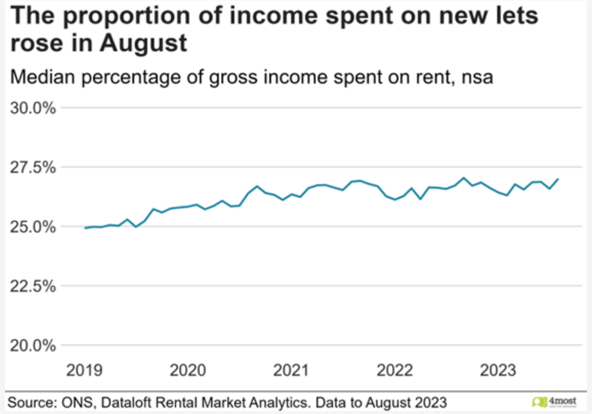
Affordability is increasingly becoming the binding constraint on rent increases according to Zoopla, especially in central London.











Housing market

With market expectations of the likely path of the Bank Rate shifting dramatically, it has become much easier to argue that house prices are not significantly overvalued.

While swap rates rather than Bank Rate directly determines mortgage rate, the squeeze on the gap to the policy rate is striking. Product rates may prove sticky.

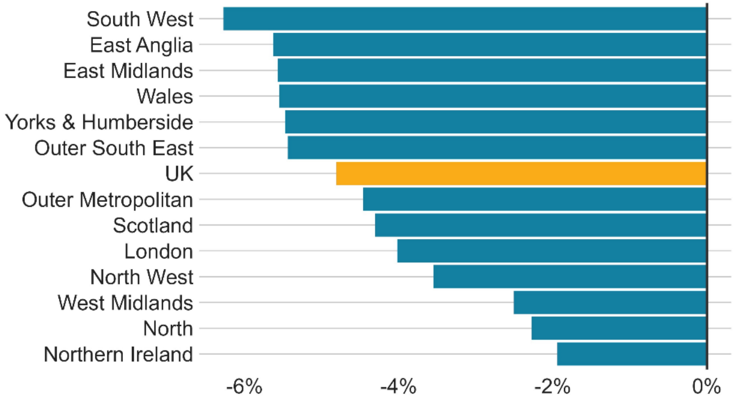
That, along with low rental yields in many areas, is a key reason why it feels too early to call the bottom of the market with any great confidence.

It is unlikely to be a coincidence that prices have (generally) fallen furthest in areas where rental yields are lowest. London, the South West and South East still look very overvalued under this lens.

Wages continue to grow faster than expected – another factor that makes it possible to argue that prices have reached the trough.

Prices have fallen most in the South West

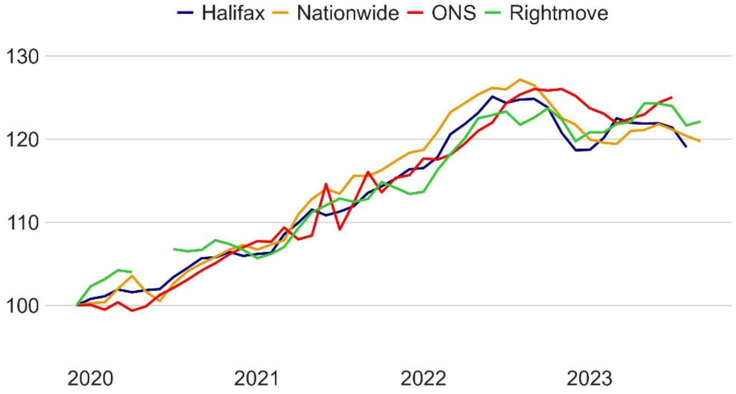
% fall from the peak



Source: Haver, Nationwide. Data to Q3 2023

Asking prices edged up again in September

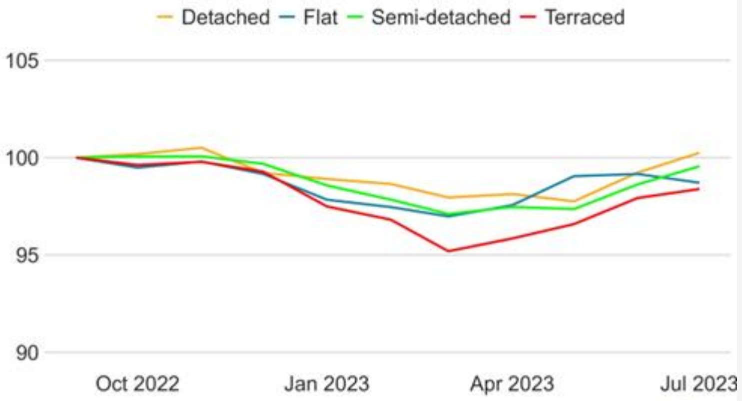
Non-seasonally adjusted, indexed to December 2019=100



Source: Haver Analytics, ONS, Nationwide, Halifax, Rightmove

The price of flats has fallen recently

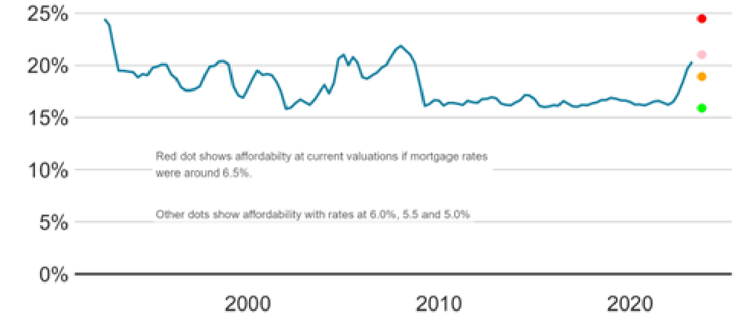
September 2022=100, non-seasonally adjusted



Source: Land Registry

At mortgage rates of 5.0%-5.5%, house prices begin to look fairly valued

Payments as % of income for a typical new mortgage for house purchase



Source: UK Finance, DCLG, Bank of England, 4most estimates

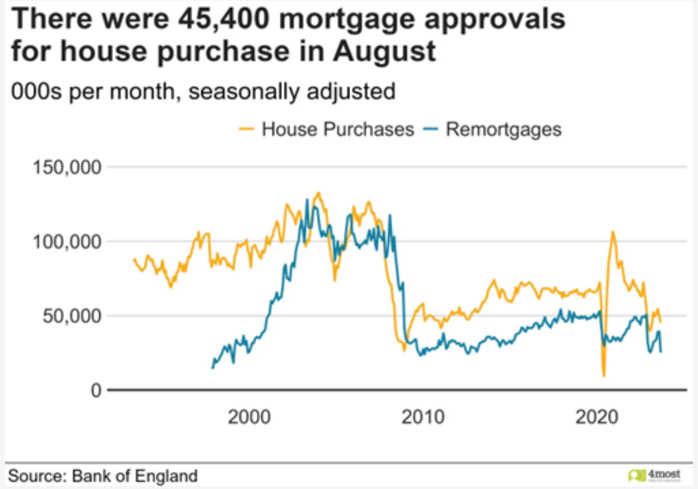
Mortgage market - activity

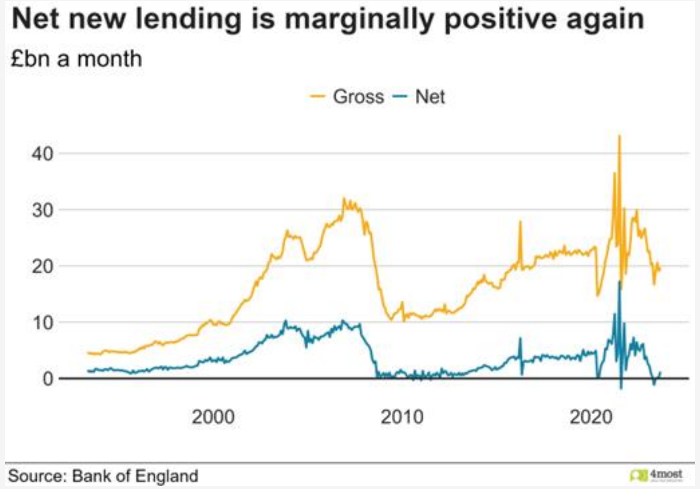
The jump in mortgage rates in July was mirrored by a slump in approvals in August. With market expectations now not pricing in any more tightening, the market should rebound strongly.

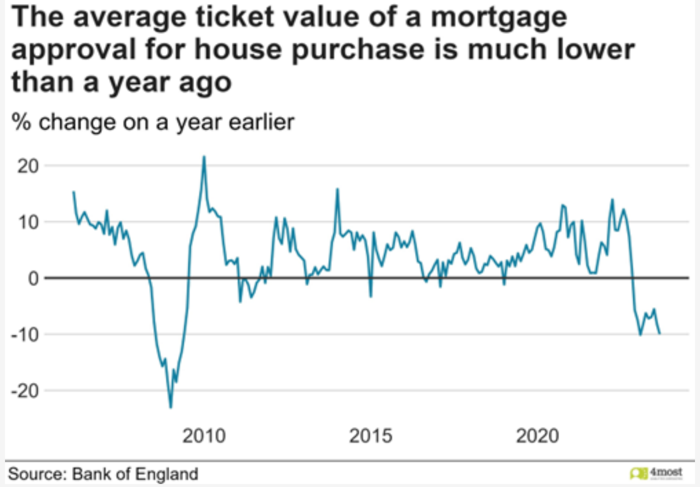
But affordability limits the size of any improvement. Halifax reports the number of First Time Buyers in January-August was 22% down in the same months in 2022 but still comprised half the market.

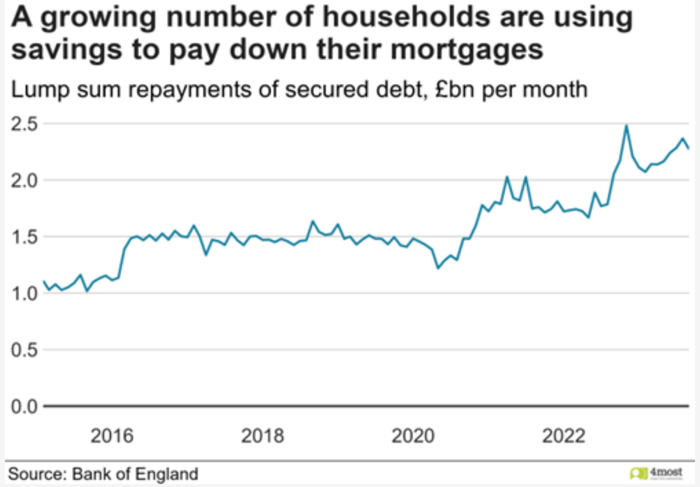
In some respects, it is surprising the share is not higher, given the challenge to Buy-to-Let. The average loan size has fallen much more than house prices, which is consistent with stories of FTBs choosing smaller cheaper properties in less attractive locations.

There is a big incentive for customers to overpay their mortgages, although the sums involved are small relative to outstanding mortgage balances (0.14%).









Concluding thoughts

Given the huge shocks to the economy in recent years, the resilience shown is remarkable.

- It is looking more likely that those that argued that inflation would prove transitory are going to be proved right. And the cost of getting inflation down has not been as high as many feared.
- Central banks would like to keep interest rates higher for longer. This would give them scope to deal with the next downturn when it arrives. It is not clear the economy will cope with higher rates. As well as the impact on consumers and businesses, higher borrowing costs add pressure to the public finances.
- Few of the structural factors that have driven the equilibrium interest rate down over decades have gone. If higher rates are to stay, then there are still questions about asset price, especially equities and commercial property. But much of the news may already be priced into the housing market

THANK YOU.