July 2024

ECONOMIC UPDATE

In partnership with 4most – July 2024

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 new government inherits an improving economy; but the Bank needs to see more progress on inflation before it acts

- Given the huge structural challenges ahead in health and housing, it will be a relief for the new Labour government that its economic inheritance is improving. GDP growth in Q1 was revised up to 0.7% and with inflation back to target, interest rate cuts feel closer. Once households feel confident enough to spend again, a solid recovery is in sight.
- Positive real wage growth is gradually repairing the damage done during the cost-of-living crisis and the high savings ratio seen in Q1 gives strength to the argument that pent-up demand could lead to GDP growth above our current forecast of 1.1% in 2024 and 1.6% in 2025.
- Although inflation is back to 2%, the deflation in goods prices that brought it there may not have much further to run. History suggests that annual price rises in services close to 6% is not consistent with inflation remaining at target. The MPC was not quite ready to act in June. A first cut in August is likely if progress is made.
- Markets expectations of where rates will be in the coming years has already nudged down leading to significant repricing of mortgage rates. We still believe house prices are 10%-15% overvalued. But a combination of strong income growth, further modest cuts in product rates and small house price falls would see the market back in balance by the middle of next year.

Risk outlook

- Dangers from keeping interest rates too high for too long remains a key economic risk, albeit one that is starting to fade. Despite a rise in unemployment, the labour market still looks tight. And the measures the new government recognises its needs to take, helping get those detached from the labour market back in and to better match people with jobs, will not happen overnight. The same is true of housing market reform. But this area is likely to be a big break from the recent past.
- Geo-politics is one area where risks are now probably more heightened than normal. The US Democrats are in disarray and most polling shows Donald Trump on course to win November's election. In that event, the US would probably halt support for Ukraine and seek to alter NATO's strategy.
- Europe will have to devote more resources to defence, something the next French government may look positively on. For now, markets are in risk-on mode. As the Bank of England's recent Financial Stability Report highlighted, this can quickly change.

Inflation and interest rates

Inflation fell back to 2% in May, a couple of months early than we expected. Services inflation remains too high for comfort. Despite the good news, markets immediately saw slightly less chance of an August interest rate cut.

The MPC is mandated to target the headline rate, and not to worry about relative price movements. But goods prices inflation may not remain negative. Producer prices are edging up.

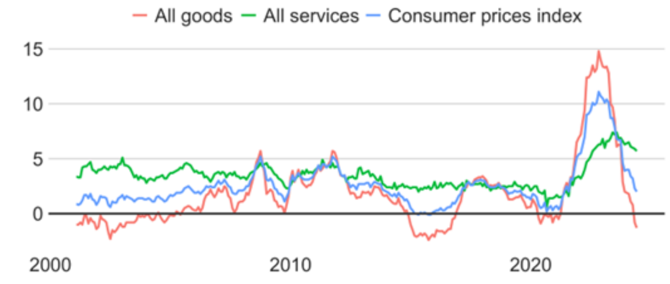
Energy bills will fall significantly in July. There was finally some good news on food prices in May. Inflation is expected to bob around target in the coming months and end the year slightly higher.

The Bank of England still needs further reassurance that the underlying pressures have been subdued. This may come in August when it is in possession of a new set of forecasts.

When the dust settled after the decision, markets priced in slightly lower interest rates right along the curve. With competition fierce in a thin market, this has already had a significant impact on mortgage rates.

Back to 2%. But services prices are rising much faster than when inflation was last at target

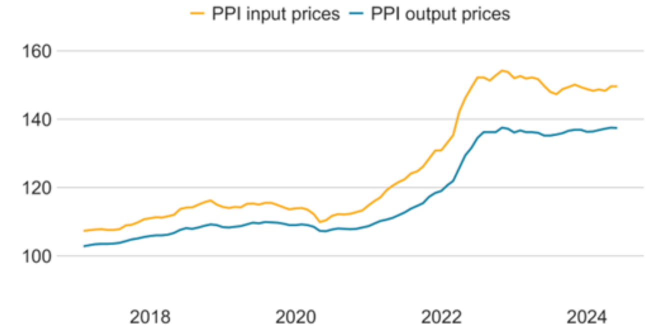
% change on year



Source: ONS

Producer prices have edged up a little

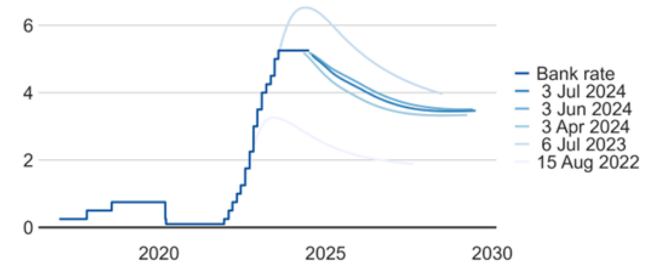
2015=100, non-seasonally adjusted



Source: ONS

Markets' expections of future Bank Rate have eased right along the curve over the last month

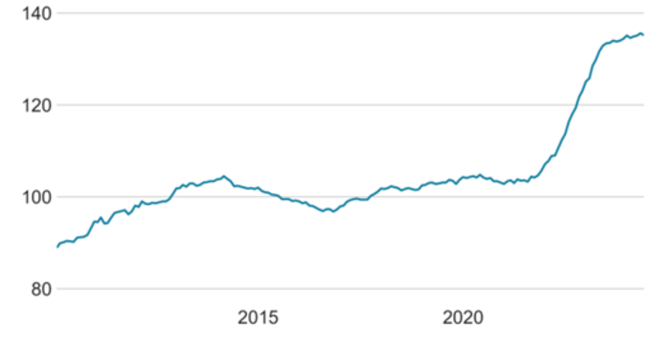
Expectation of Bank Rate implied by the OIS curve, %



Source: Bank of England

Food prices fell by 0.3% in May

Price level, 2015=100



Source: ONS

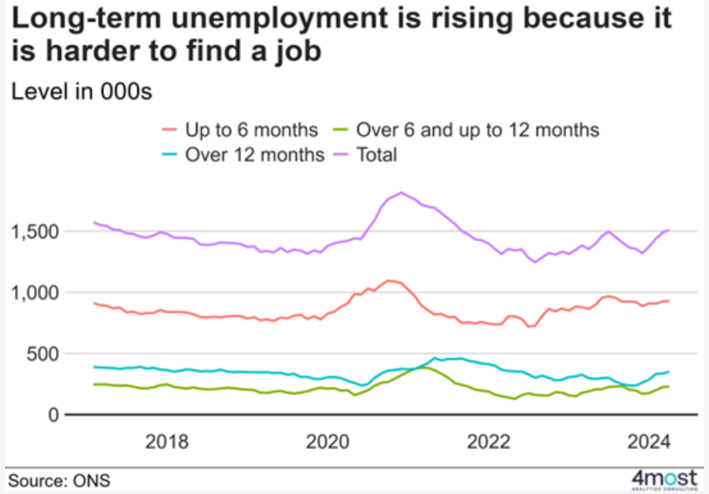
Labour market

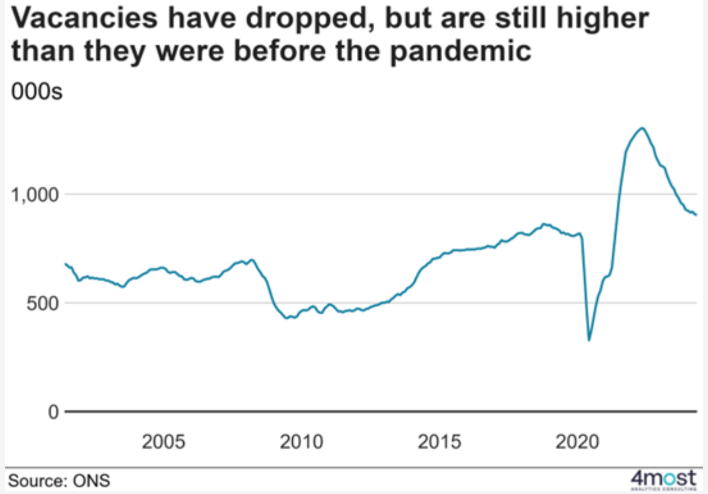
Although the unemployment rate has risen to 4.4%, it is difficult to make the case that the labour market is cooling down. Current wage growth is not consistent with a 2% inflation target.

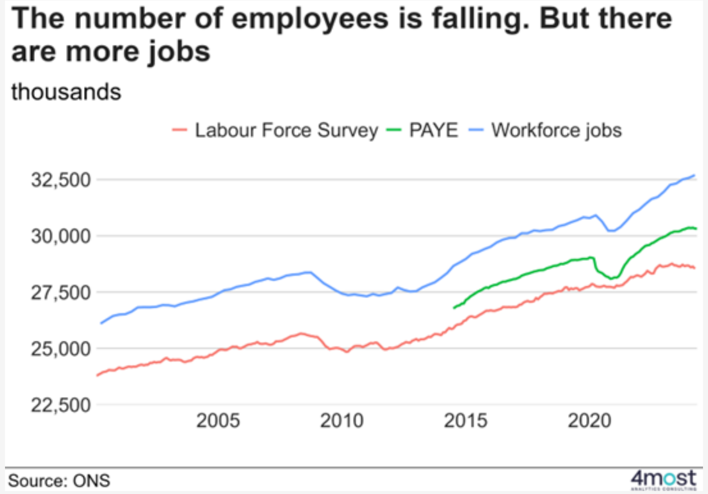
Concerns over the quality of the headline Labour Force Survey statistics are amplified by less pessimistic trends seen in surveys of employers which estimate job numbers, and by PAYE records. Unpicking this is a difficult task for the MPC.

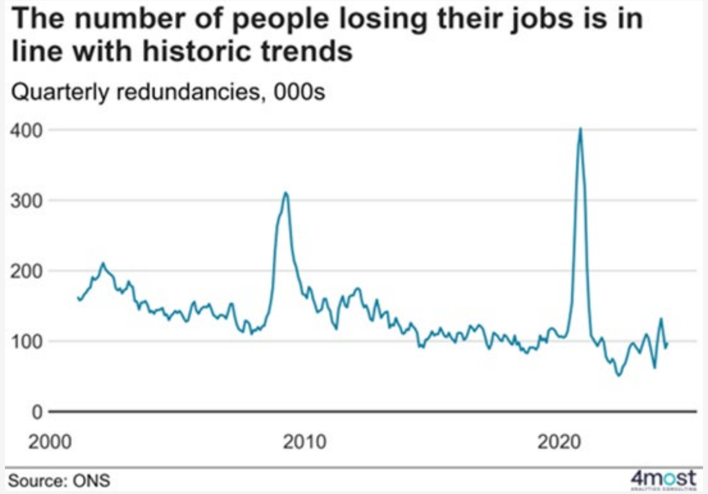
The numbers we can trust most show redundancies at normal levels and vacancies down, but not quite at 2019 levels. Not many people are losing their jobs. Those looking for employment are finding it harder.

The rise in unemployment is slightly at odds with the improvement in economic growth. We do not expect the rate to rise any further. But there are clear risks its will if interest rates remain higher for longer.









Housing market

Despite more sellers entering the market according to surveyors, there is no sign yet that headline prices are softening. It is hard to pick a pattern out of the regional numbers.

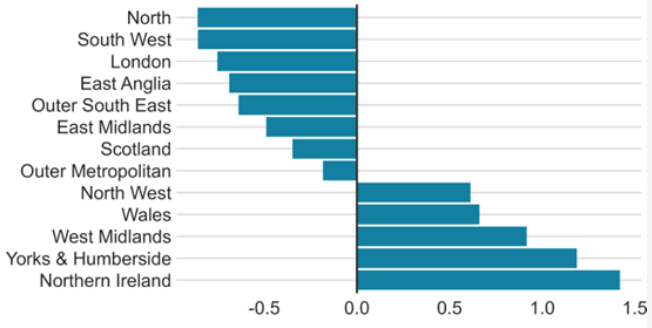
Our forecast does pencil in modest further falls given the disconnect in what affordability measures suggest about the current combination of prices and mortgage rates. Hometrack estimates that house prices were 8% overvalued in Q1

Housing policy and taxation has potential to disrupt the market post-election. But big moves like Capital Gains Tax on first homes and revaluation of council tax bands seemed to have been ruled out by Labour.

Prices have been underpinned through longer mortgage terms and high loan-to-income ratios. Bank of England returns show the proportion of high LTI approvals fell sharply in Q1, although some industry figures are surprised at this. But these sources of support do not look that sustainable in the long term.

Overall UK house prices were stable in Q2 but most regions saw small falls

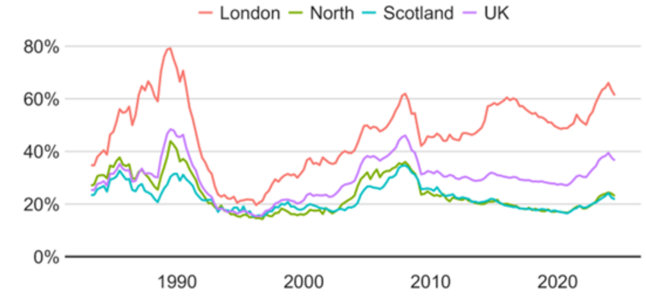
% quarter, seasonally adjusted index



Source: Haver, Nationwide

First Time Buyer affordability improved in Q2 but remains very stretched

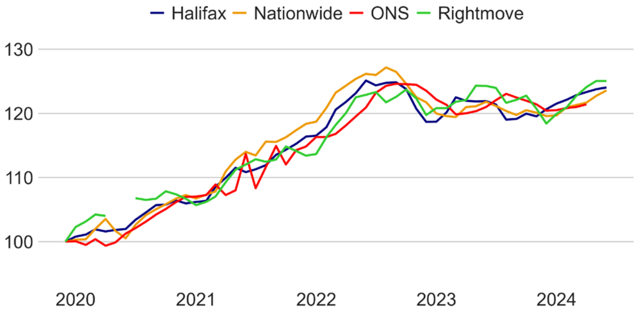
First Time Buyer mortgage payments as % of take home pay



Source: Nationwide. Data to Q2 2024

Despite stretched affordability, asking prices are at all-time highs

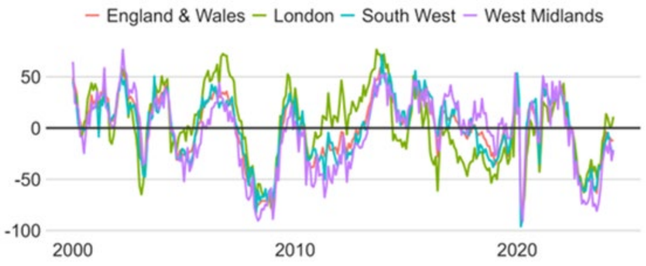
Non-seasonally adjusted, indexed to December 2019=100



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

Surveyors in the South West and West Midlands are more downbeat than those elsewhere

% balance of surveyors expecting house prices to rise in the next three months



Source: Haver Analytics, RICS. Data to May

Rental market

Rents on new lets across the UK are up around 6% on a year ago, but growth in London is just 1.3% after a fall in June (Homelet). Zoopla also reports drops in Nottingham, Brighton, York and Cambridge over the last quarter.

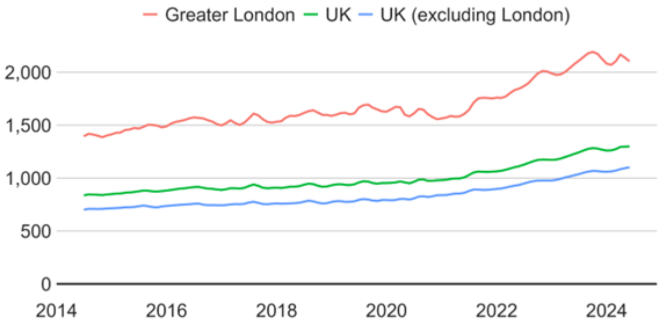
Affordability as ever is key. Demand is still outstripping supply across the UK. Rents (based on the ONS stock measure) are expected to end the year 8.2% higher than a year earlier as existing tenants roll onto new contracts.

A survey by Foxtons suggests landlords are indifferent about a Labour victory. But abolition of accelerated no-fault evictions feels on the cards, with possible improvements in EPC requirements also quite likely.

But the recent rocketing in rents reveals supply as the big challenge. Labour's plans to build 1.5 million homes over the course of the next parliament would ease much of this pressure and potentially boost the BTL sector. But this is much easier said than done.

Average rent on a new tenancy in London fell by 1.6% in June

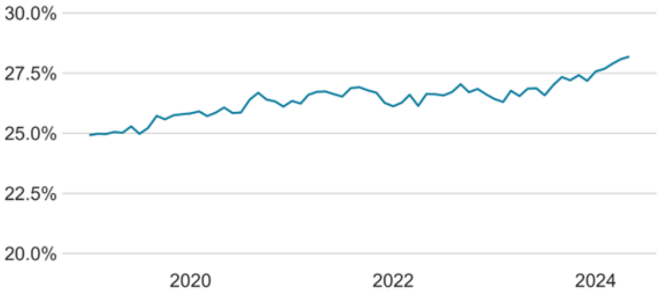
£, monthly rent on newly let property



Source: Homelet. Data to June.

The proportion of income spent on a typical new let is 1.5% points higher than it was three years ago

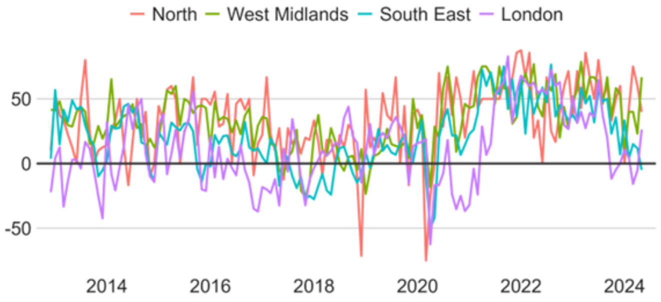
Median percentage of gross income spent on rent, nsa



Source: ONS, Dataloft Rental Market Analytics. Data to May 2024

Tenant demand is still rising in more affordable areas

% balance of surveyors reporting rising tenant demand in the last three months



Source: Haver Analytics, RICS. Data to May

The vast majority of surveyors still expect further rent rises

% balance of surveyors expecting a rise in next three months

Source: Haver Analytics, RICS. Data to May

Mortgage market - activity

Activity has improved over recent months, but affordability limits the extent of any upside. Lower rates are needed to unlock the market; the good inflation figures have brought some relief.

With firms competing aggressively for market share again as economic uncertainty lifts, the market could improve faster than expected.

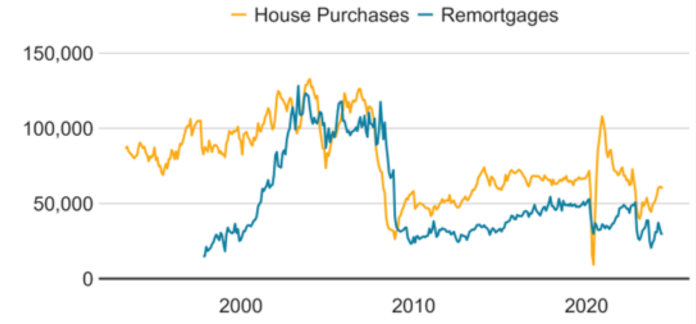
Borrowers are still betting that mortgage rates have further to fall judging by the higher proportion of variable rate products taken out in Q1. And while fixed rates are still the preference, most of these are now written on terms of two years or less.

Vendors are back, but only a small majority of surveyors questioned in May expected that to be translated into improving sales.

Hometrack reports sales up 8% higher than a year ago but still well below what might be thought of as normal.

There were 60,000 mortgage approvals for house purchase in May

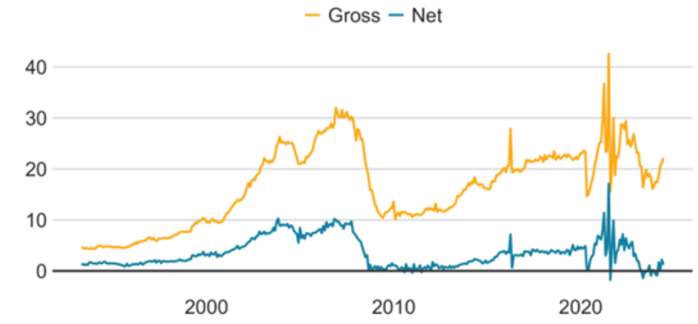
000s per month, seasonally adjusted



Source: Bank of England

Individuals borrowed, on net, £1.2bn of mortgage debt in May

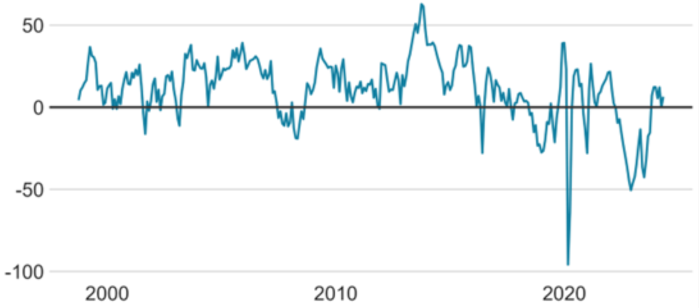
£bn a month



Source: Bank of England

Surveyors expect the sales market to remain lacklustre in the coming months

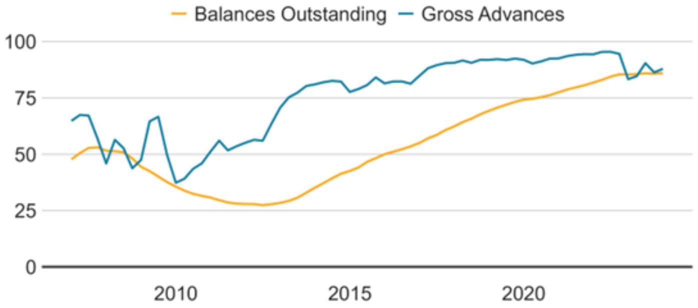
% balance of surveyors expecting sales to rise in the next three months



Source: Haver Analytics, RICS. Data to May

The proportion of new mortgages written at fixed rates remains much lower than before the Bank Rate rises

% of business at fixed rate



Source: Haver Analytics, Bank of England MLAR statistics. Data to Q1 2024

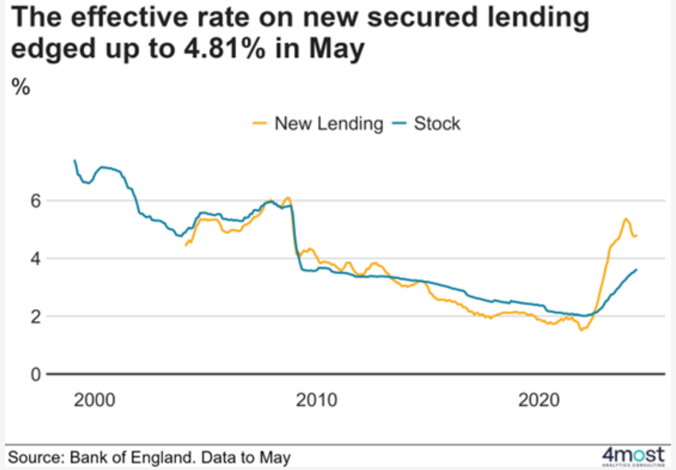
Mortgage market - rates

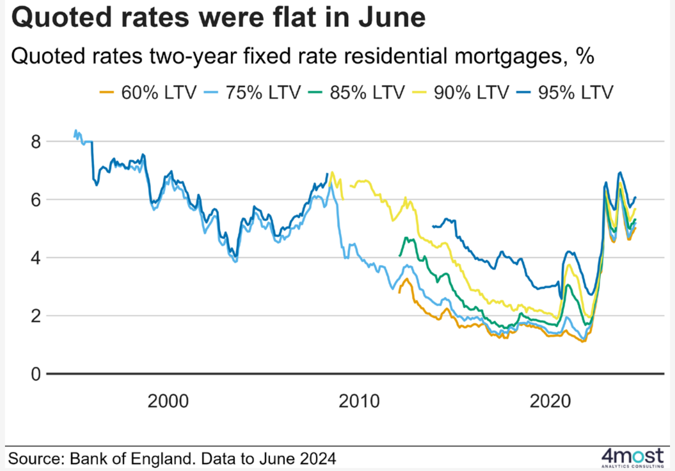
The effective rate on new lending in May was 4.8% with quoted rates in June on 75% LTV lending in a range from of 5.16% (2-year fix) to 4.65% (5-year fix).

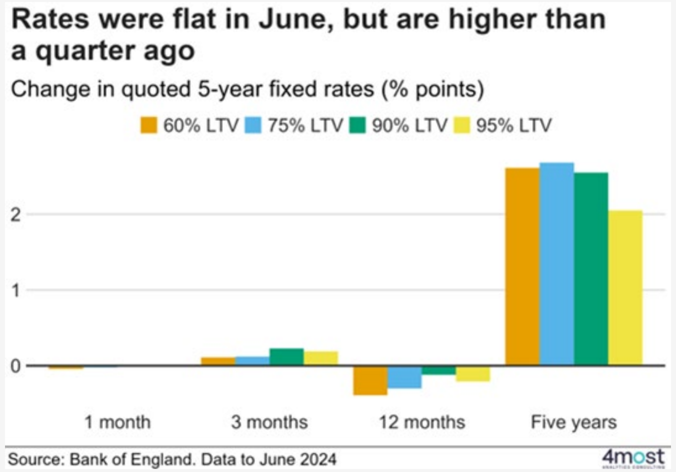
No-one can say with any confidence what the neutral interest rate is. Markets are pricing in a rate around 3.5% for Bank Rate.

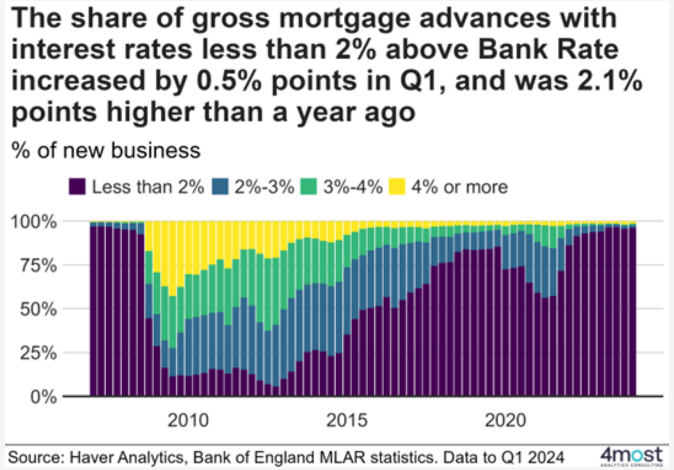
Our view is that is at the top end of expectations. A fall in inflation below target – not an outlandish view – could see product rates fall further.

With firms looking for market share, the proportion of deals with rates less than 2% points above base is high by historic standards (although Bank Rate is expected to fall of course). But the overall story is one of a continued squeeze on margins.









THANK YOU.