# QUARTERLY ECONOMIC BULLETIN

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Association of AMI Mortgage Intermediaries

## Introduction

AMI is continuing to provide members with a quarterly economic analysis from our two highly respected guest contributors.  In this latest Economic Bulletin Barry Naisbett from Santander and Robert Gardiner from Nationwide set out their views on the current state of the economy, the housing and mortgage market.  We hope you enjoy the contributions.

The UK economy continues to move forwards although there are recent signs that consumer sentiment remains fragile.  Both overseas investment and UK consumer expenditure have recently reacted to interference from the UK Financial Policy Committee.  The addition of Loan to Income caps and more focussed stress testing has already impacted the London property markets.  With the problems still latent within the Eurozone economies, the strength of the UK economic recovery is brought into question.  When combined with the horizon risks, the principal of which is the 2015 UK General election, the pressure to increase UK interest rates has receded.

It is uncertainty that will slow growth.  UK companies continue to sit on huge cash piles and remain unconvinced that now is the time to invest in their businesses.  Merger and acquisition activity also remains subdued with share floatations also being withdrawn.  It will only be when UK plc begins to believe in the future that we will see the real transformation of our economy.

Government revenues remain subdued with the tax take not matching the growth in jobs and departmental spending still running at high levels.  Some commentators wonder if this is due to the growth in low paid jobs close to tax limits taking people off the unemployment register but not active enough to raise significant tax revenues.  Also the social bill continues to escalate as the elderly continue to cost more than expected.  It will take more than the changes to the pension regimes planned to change this in the next decade.

Robert Sinclair

Chief Executive, AMI

## The view from Santander – Global slowdown potentially impacts UK recovery

The latest pronouncements from the International Monetary Fund (IMF) make interesting reading from at least three different angles. First, the IMF is warning about any complacency about the state of the global economy. Here we are, some five years after the recession and the IMF notes that the global economic recovery is 'one that is brittle, uneven and beset by risks'. Of course, the latest news on the eurozone is well covered in the UK press and it remains decidedly downbeat. The European Central Bank (ECB) cut policy rates again in September and has started to move forward on an asset purchase programme in order to boost economic activity, in an environment where inflation has fallen to just 0.3%. The latest news from Germany showed a fall in industrial production of 4% in August and there has been a sharp drop in exports too. GDP in France stagnated in the first half of the year and Italy has fallen back into recession. Since Europe remains our largest trading partner, it is perhaps not surprising that recent surveys of UK manufacturers have shown activity losing some momentum. The IMF also points out that other areas of the global economy are experiencing difficulties, too. As examples, Russia is being affected by various trade embargos and the ebola outbreak is adversely affecting trade in parts of West Africa.

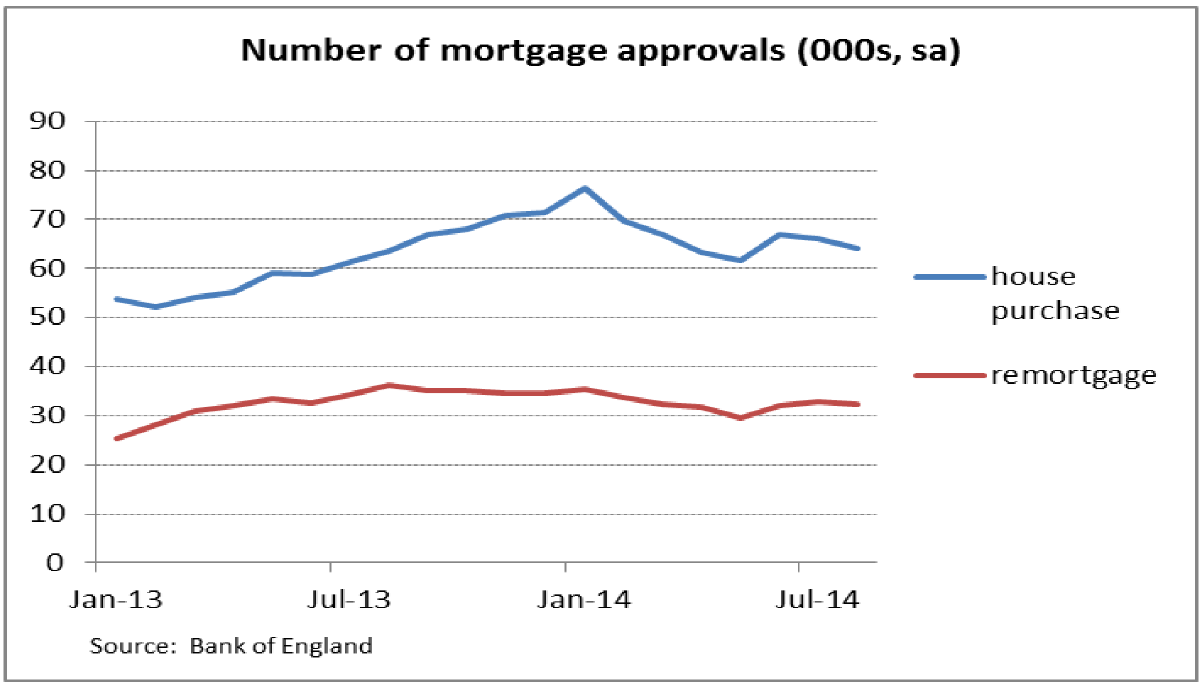
Secondly, the IMF is much more upbeat about the prospects for growth in the UK economy than in many other economies. It now forecasts that the economy will grow by 3.2% this year and 2.7% next, although it does note a downside risk to these forecasts because of the weakness in the eurozone. After being rather critical of the UK's austerity policies and economic performance (and prospects) for some while, the IMF seems to have changed its tune. Indeed, of the major industrial economies only the USA is expected to come close to the growth performance of the UK. The UK economy has grown robustly for six consecutive quarters and output at the end of the second quarter was 2.7% above the pre-recession peak level. Of course, output growth is not the only indicator of economic health – employment matters too. Employment growth in the UK has been strong - in July the number of people in work was 418,000 (1%) higher than six months previously and 1 million (4%) higher than two years earlier. A substantial increase in self-employment has played a major part in this – self-employment is up 318,000 (8%) over the past two years. But full-time employment has grown too - up 728,000 (4%).

The third interesting feature of the IMF's report was the revision to its forecast for global growth. The IMF has yet again had to reduce its forecast. The IMF is not really known for having an overly optimistic take on the economic outlook but over the past three years it has quite consistently been on the optimistic side of the fence. It is not clear why this should have been the case - perhaps the negative shocks to economies have just kept coming unexpectedly, or perhaps the recession and its aftermath have had a longer lasting negative effect on the global economy than the IMF had expected. After all, such deep and concerted recessions are unusual. As a consequence, analysing their longer-term impacts is not a well-developed science.

One feature of the recent UK economic news that might not have helped the IMF is that our major economic statistics tend to be subject to revision. The official statisticians have just been through a major exercise which has led to revisions both to GDP over time and to the components that comprise it. The revisions include both some methodological changes and some information updates. A couple of the outcomes are of particular interest. The first is that the level of GDP has been consistently revised upward over the past decade. As a result, it is now estimated that output moved above its pre-recession level in the third quarter of 2013 rather than only recently. In addition, the recession was not quite as deep as first thought – even so, a 6% fall in output remains the sharpest contraction in activity in the past-war period.

The second interesting feature concerns the expenditure contributions to economic growth. The figures for both investment and consumers' spending have been revised. As a result, it now appears that investment spending made a bigger contribution to the recovery than previously thought. It was not just a consumer-led recovery and so there is some evidence of re-balancing of the economy. There is still, however, little evidence of a more complete re-balancing because export growth (or, more strictly, net trade growth) has not made a significant contribution to the upswing. The change to the investment spending figures is somewhat complicated, however. The new figures now include research and development expenditure within investment, adopting to a new international definition standard.

Despite the more positive UK growth story, there are still risks to the outlook. In its latest World Economic Outlook, the IMF highlighted some concerns about the housing market, particularly the rate of house price growth and, echoing the Financial Policy Committee (FPC), the level of household indebtedness. Recent figures on a range of indicators seem to be showing that the housing market is now slowing down a little. The survey evidence from chartered surveyors shows a drop in new buyer enquiries and in house price expectations, particularly in London. These could be early signals of a wider slowdown. Nationally, the number of loans approved for house purchase has been gradually edging down from a high level since January. So while activity is still higher than last year or two years ago, the momentum seen in the past eighteen months appears to be waning. In addition, as house price growth has started to spread out across the country, so the recent indicators suggest that the pace of price increases in the London area has started to abate.




It is against this background that the Monetary Policy Committee (MPC) will be making its decisions on Bank Rate in the coming months. Two members have already voted to raise policy interest rates and the key issue is whether the incoming economic data will persuade some others on the committee that the evidence supports the view of those looking to raise rates. Of course those voting to hold rates may well find themselves in a position to argue that the latest evidence strengthens their view on holding rates. We'll just have to watch and wait.

## The view from Nationwide - Outlook for the housing market remains unclear

There is considerable debate about the underlying strength of demand in the housing market. While the noise in the data caused by the introduction of Mortgage Market Review measures is starting to fade, the signals remain decidedly mixed.

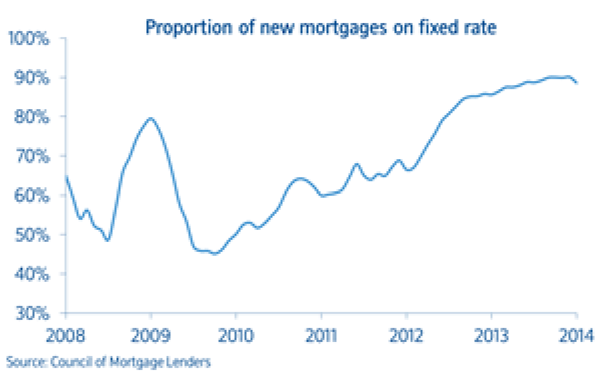
The number of mortgage approvals for house purchases rebounded slightly and then stabilised through the June to August period after falling by almost 20% between January and May. There are tentative signs that house price growth may be moderating because, after sixteen monthly price rises in a row, UK house prices declined by 0.2% in September taking the annual pace of house price growth down to 9.4% from 11% in August.

Some forward looking indicators, such as new buyer enquiries reported by surveyors, suggest activity may remain relatively soft, at least in the near term. However, this is difficult to reconcile with encouraging news in the wider economy, with rapid increases in employment and strong consumer confidence readings.

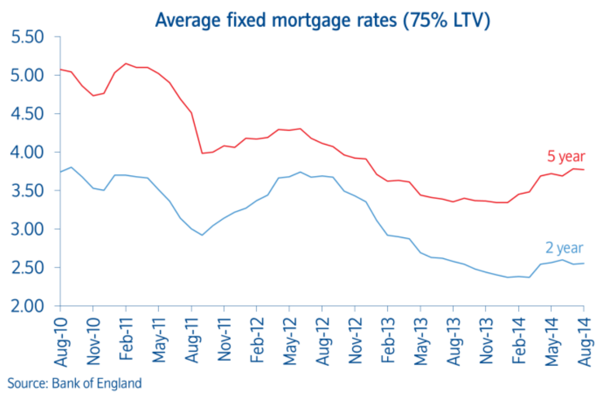
Time will tell, but with interest rates likely to remain low by historic standards and labour market conditions expected to continue to strengthen, it seems likely that activity will gradually pick up through 2015.

## Fixed rate mortgages increasingly popular, but variable still dominates the stock of mortgages

One trend that has shown few signs of abating in recent months is the increasing preference of borrowers for fixed rate mortgage deals (see chart). Data from the Council of Mortgage Lenders suggests that around 90% of new mortgages were contracted on fixed rates in recent months, up from 66% two years ago. As you might expect, fixed rate deals are most popular amongst first time buyers for whom certainty over monthly payments is likely to be particularly important (95% of new mortgage lending to first time buyers is currently on fixed rates).



Borrowers taking out fixed rate mortgages have benefited from historically low interest rates. For example, the average two year fix (for those with a 25% deposit) is currently 2.55%. While this is a little higher than earlier this year, it is still more than one percentage point below the level prevailing in 2012 (see chart). This has helped offset the negative impact of rising house prices on affordability. Indeed, even though house prices are at an all time high, the cost of servicing a typical mortgage is still close to the long term average as a share of take home pay.




Despite the high proportion of new mortgage lending on fixed rates, the majority of the stock of outstanding mortgages - around 60% - are on variable interest rates. This is a marked shift from the pre-crisis period where the proportion of mortgages on variable rates was 38%. Moreover, the majority of recent fixes are for relatively short time periods - 63% are for two years and around 30% for five years.

Nevertheless, the housing market should be able to cope with higher interest rates, provided the increase is gradual and that the economy and labour market remain in good shape. Guidance from the Bank of England suggests that the increase in interest rates is likely to be gradual, and that they are expected to settle at a level somewhat below the average prevailing before the financial crisis, which should help ensure borrowing costs remain manageable.

Santander

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