AMI Quarterly economic bulletin

Volume 21 | January 2012

Association of AMI Mortgage Intermediaries

Highlights

Europe

- European leaders exacerbate failure to fix eurozone crisis
- Latest long term fiscal pact does nothing to address current problems
- Departure of weaker states is a logical outcome, but never underestimate political will to keep eurozone intact

UK economy

- SUK recovery damaged by eurozone crisis
- Downgrades abound for 2012 - no growth expected for full year
- UK economy may well dip into recession during the period
- Inflation finally falling - better news for real household incomes

Housing market

- Housing market to drift downwards in 2012
- Transactions will be broadly flat
- Mortgage supply crucial to pick up in housing market activity

Mortgage market

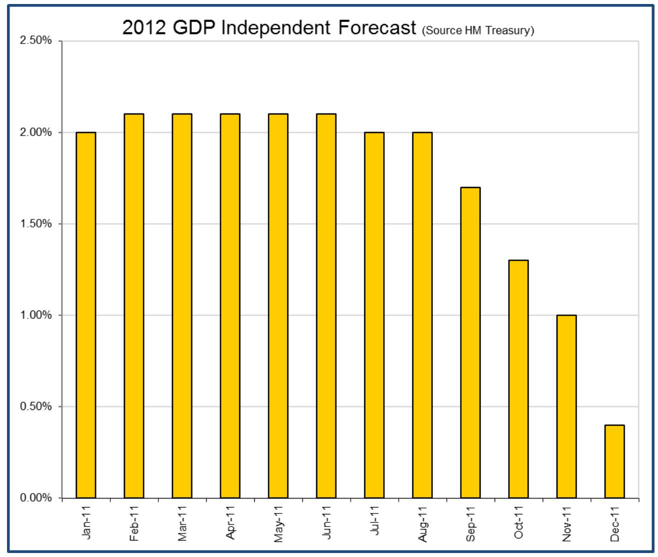
- Gross and net lending to be unchanged in 2012
- Arrears and possessions likely to remain relatively low while interest rates are so low
- Buy-to-let and private rented sector are the brightest spot in the housing and mortgage market for the long and short term
- Better to buy than to rent in the longer term

Chart 1

UK key economic indicators	2008	2009	2010	2011e*	2012 e*
GDP	0.8%	-4.8%	1.7%	0.9%	0.4%
CPI	3.80%	2.9%	3.2%	4.6%	2.0%
RPI	3.1%	2.4%	4.6%	5.1%	2.5%
Claimant unemployment (m)	1.05	1.63	1.48	1.62	1.81
PSNB next fiscal year (£bn)	£97	£156	£137	£128	£120
Bank rate at end of period	2.39%	0.50%	0.50%	0.50%	0.53%

* average of latest independent forecasts

Chart 2



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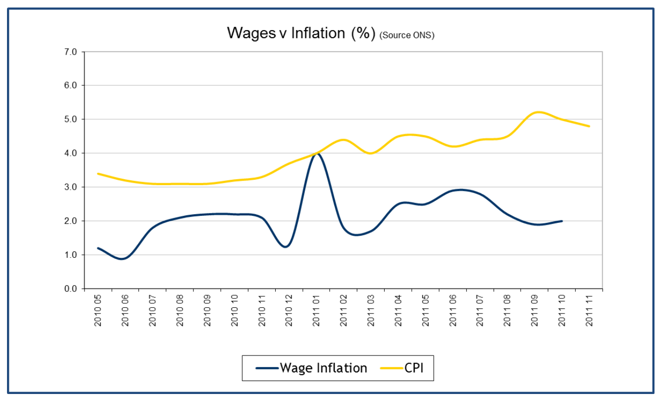

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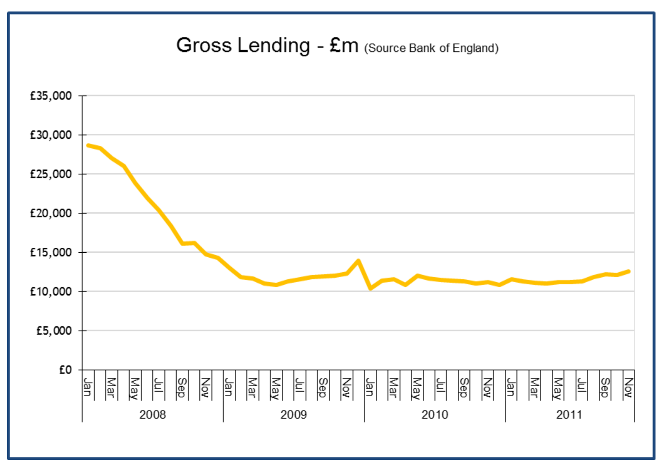


Europe

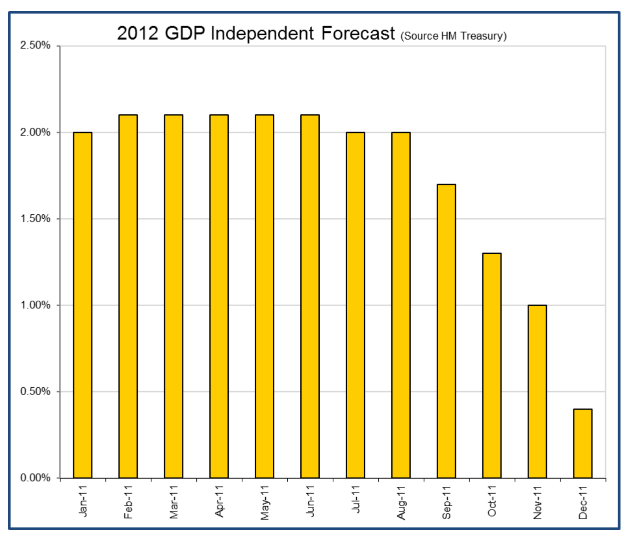
The biggest single obstacle to a UK recovery remains completely beyond the UK's control - the crisis in the eurozone. Since our last report, there have been no new steps that will solve it. Financial measures agreed in September quickly unravelled, and the new fiscal compact agreed in December did nothing to address the serious current situation, and is unlikely to change the long term governance of the single currency area much either. Essentially it reinforced for the long term the existing growth and stability pact agreed at Maastricht, which has patently failed to discipline governments in their economic policies. Moreover, the downgrade of the French sovereign credit rating from AAA will make it harder to structure rescue funds, not to mention remove the political figleaf that financial decisions are not being controlled solely by the fiscal hawks in Germany, whose economy continues to outperform. Unfortunately, the eurozone continues to treat this as a fiscal crisis when it is primarily a current account one with huge surpluses built up in the core matching huge deficits on the periphery; this misapprehension, which economist Martin Wolf of the FT has expertly explained, lies at the root of the failure by politicians to stop the rot. Until competitiveness can be equalized, there is no escape from the debt crisis.

Normally a currency devaluation can adjust an underperforming country's competitive position. In the absence of that option, you either need a good bout of inflation in the core European countries to allow the periphery to see its relative position improve, or a long and painful deflation in the periphery, slashing wages and prices and shrinking the economy to achieve the same aim. The former is political anathema to the Germans and other hawkish nations, the latter economically unsustainable for Greece, Italy, Spain, Portugal and probably Ireland, and politically therefore highly unlikely to succeed. Furthermore, the deflation option does nothing to solve the damaging debt dynamic as the debt mountain rises as a percentage of shrinking GDP. You can of course start writing tax cheques in surplus countries to send to deficit ones, just as wealthy areas of the UK subsidise the poorer ones, but then you have an even bigger political headache - how to create full fiscal union in the face of likely public opposition, and how to inject democratic accountability.

The final option is for the eurozone simply to break up - indeed it seems very difficult to imagine how at the very least Greece can avoid leaving the currency bloc. Nevertheless, betting against the political steel of the eurozone leaders to protect the single currency in its entirety is a dangerous game, even in the face of logic and reason. Defaults may not be avoided, but protecting the integrity of the whole currency area will be of paramount importance to leaders there.

The one step that has provided some breathing space is the decision by the ECB to provide massive liquidity to the banking system to ease a credit crunch that is underway in Europe. This measure evades the German objection to quantitative easing, a policy which would provide temporary shelter while the politicians fix the roof. The current scheme is instead intended to encourage the banks in turn to use all the essentially free loans, not just to protect banks in search of lenders, but also to buy the sovereign debt of struggling nations and bring the yields down to more sustainable levels, thereby breaking the vicious circle of funding. The banking system is already creaking with the weight of suspect sovereign debt, however, and is in turn imperilling the credit rating of the nations that stand behind those banks, so there is no certainty that this policy will work.

Chart 5



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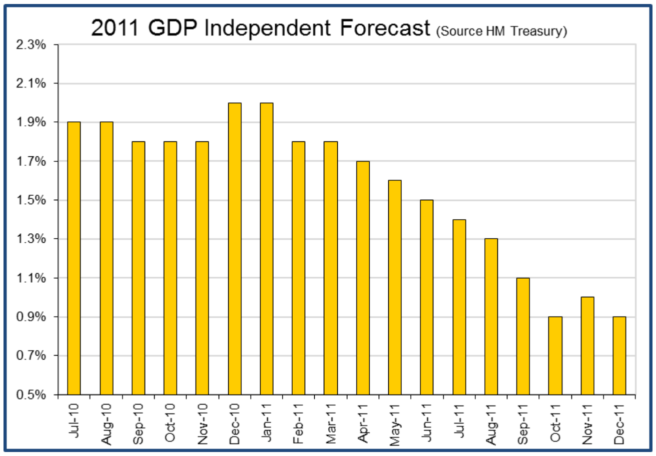
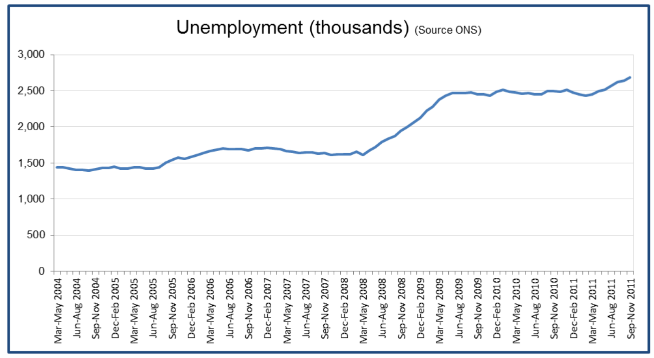


The European crisis has most likely already tipped the eurozone into recession. The effect on confidence here in the UK is severe. The OECD, Ernst & Young Item Club, and the CEBR, think the UK economy is already shrinking and will do so in Q1 2012 too. The average of independent forecasts expects the economy to have scraped ahead by just 0.9% in 2011, a sharp downgrade from the 1.3% expected at the end of Q3, and less than half the 2% expected at the beginning of last year. Growth will elude the UK almost completely in 2012. Independent economists expect 0.4% (compared to their 1.7% at the end of Q3), but the risks are exceptionally high, and even this meagre increase can allow for a recession between the final quarter of 2011 and second quarter of 2012. The downgrades come across the board for 2012 - inflation, growth, interest rates are all expected to be lower, borrowing and unemployment higher. The latest OBR forecast is still more optimistic than independent economists, expecting 0.7% growth next year. Unemployment has now reached 2.68m, or 8.4%, rising for six consecutive months. It actually could be much worse, and although it is likely to continue to rise in the coming months as public sector cuts bite deeper, we are still optimistic it will stay below the 3m level.

Chart 7

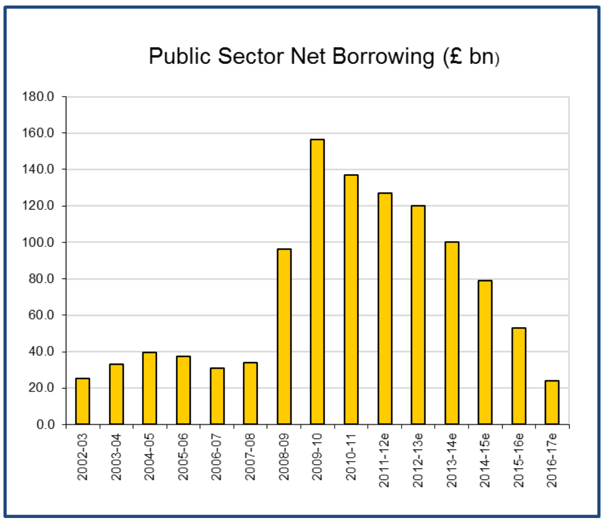


The weak jobs market means there is little upward pressure on wages. Inflation expectations meanwhile rose in August to their highest level in three years. On average consumers expect prices to rise 4.2% over the coming year-more than double the BOE's 2% annual target and the highest rate of expectations recorded since August 2008. In May, respondents expected prices to rise 3.9%.

UK economy

The much weaker forecasts for the UK economy mean the OBR had to revise upwards its calculation of the structural deficit, the permanent part of the annual shortfall that will not disappear as the economy recovers. Total public sector net debt will top £1trn this year, just over two thirds of GDP and will continue to spiral up before stabilising at £1.5trn (78% of GDP) in 2016/17. Given this more pessimistic forecast, the chancellor was therefore forced to announce in November that eliminating the budget deficit would take a further two years, well into the next parliament, meaning a grim election campaign promising further austerity - a grim seven year run of cuts and high taxes.

Chart 8



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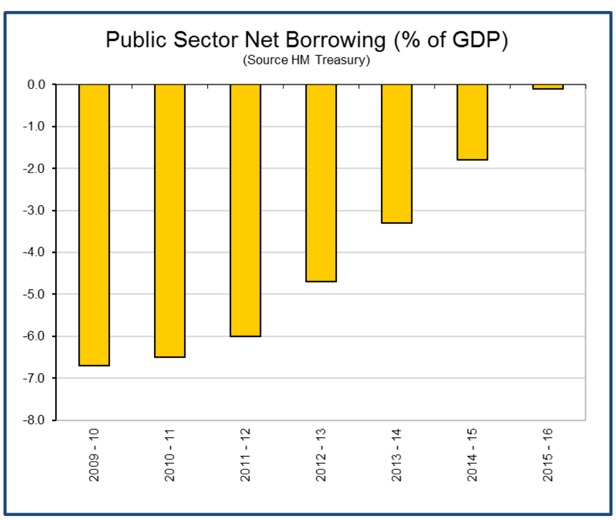
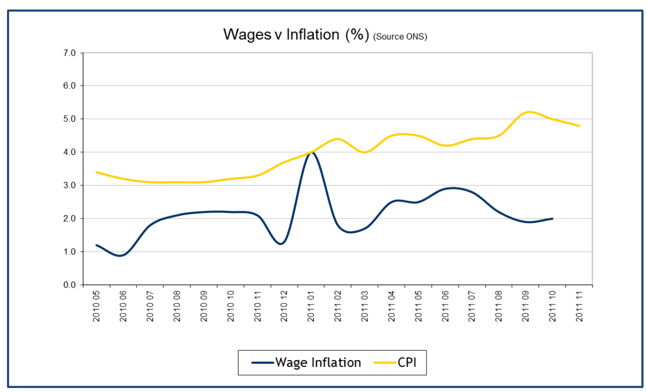


One of the silver linings this year should be on inflation. The Bank of England has a pretty poor record on meeting the inflation target – it's been above the target of 2% every month since December 2009 although to be fair to the MPC, food, fuel, and other commodity prices, are not sensitive to interest rate changes in one economy; they are all set on international markets and reflect global supply and demand. Fuel and energy prices added 1.5% to the 4.8% inflation of the last year. Similarly the increase in VAT to 20% last year has caused an inflation blip that won't be repeated, adding 1% to overall price increases. Without these two factors, inflation would have been half its level over the last year.

The squeeze on incomes rising at half the level of prices has had a major impact on depressing demand. Inflation will drop back towards target this year as some of the uncomfortable base effects (like VAT) drop out of the numbers, and even though income growth is likely to languish, in real terms, household income will do better this year than during a painful 2011. That will help consumers to spend and, in turn, the economy to grow.

Chart 10



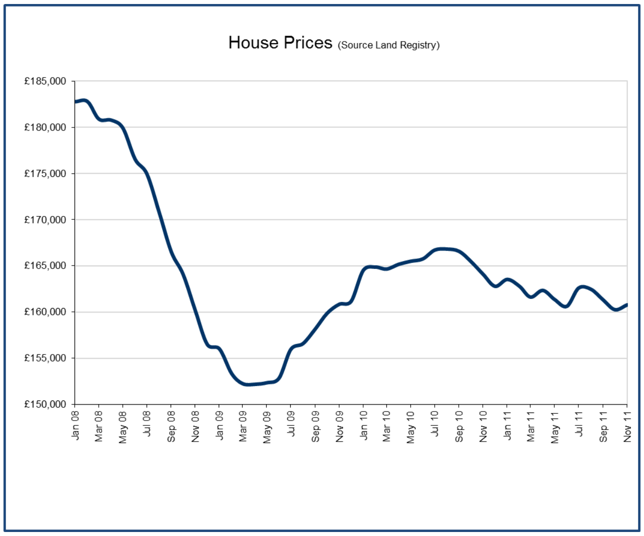
Expanding the money supply should in theory boost inflation, and it probably has a little bit (the Bank estimates it has added 1-1.5% to CPI), but the economy is too weak, and the credit supply mechanisms too restricted due to tight bank lending, to prevent the policy from continuing owing to undesirable effects on prices. Indeed, the weaknesses in the financial system have diminished the effectiveness of expanding the money supply - not enough of the cash is finding its way from banks into lending to businesses and consumers, and stimulating the multiplier effects that promote economic growth. The latest round of quantitative easing began in October and added an additional £75bn to the programme, taking the total since March 2009 to £275bn. It will be completed in February. It is hard to imagine that further rounds will not be undertaken as the year progresses.

Another £100bn is not out of the question; the big unknown of the fate of the eurozone will determine how much is needed. With the Treasury committed firmly to fiscal consolidation, there will be no room for deliberately expanding the budget deficit, particularly when weak growth or even another recession would make the deficit bigger in relative terms compared to a smaller economy and bigger in absolute terms than predicted as the automatic stabilisers of, for example, higher unemployment benefit payments kick in. So with the government unable to use tax cuts or spending increases to boost activity, the only levers left are monetary ones. And that means more QE. One day, the Bank of England will have to sell all the bonds it has bought back to the market to mop up all the liquidity it has created, but that seems a long way off for now.

Housing market

The housing market did not move at a national level in 2011. Nationwide and the Land Registry measured increases in house prices in 2011 (1% and 1.4% respectively, the latter is the 12 months to November), Halifax and Rightmove indices registered declines of 1.3% and 1.5% respectively. This masked significant regional variations, with London, the South East and East Anglia showing stronger growth, and Northern Ireland, Yorkshire and the North West declining most.

Chart 11



Prices since 2007 are lower in all regions on Nationwide's index, with similar relative strength in London and weakness to the north. There is nothing to support a new surge in housing values in the coming year. Mortgage availability will not improve, real incomes remain under pressure, the economy is stagnant and confidence is low. The average forecast for 2012 is for a fall of 1.3%, and there will no doubt be continued marked variation between the regions with those regions most exposed to job losses seeing greatest weakness.

Chart 12

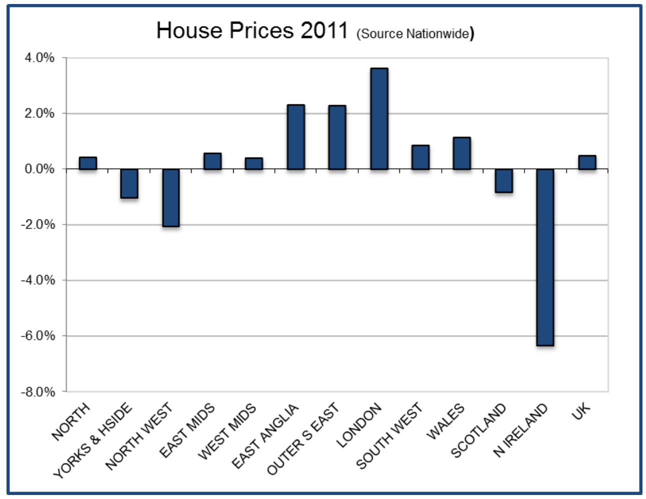
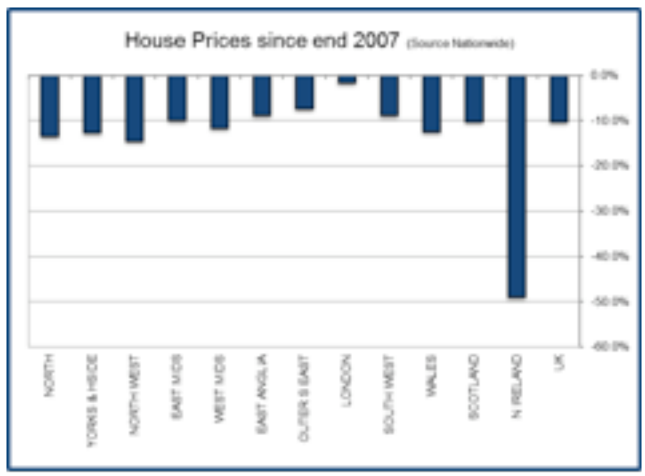


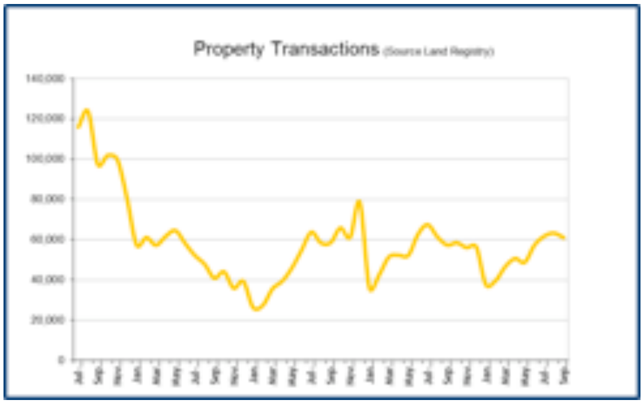
Chart 13



Transactions are also weaker on a full year basis. They dropped 7.4% in the twelve months to the end of September according to Land Registry statistics, reaching 637,000. The middle of the year showed the greatest weakness, but by the late summer and autumn, transaction levels were approaching those of the same period of 2010 again, mirroring a late-year pick-up in mortgage approvals. Transactions have performed worse than mortgage approvals this year, suggesting there may now be a slowdown in the number of cash buyers willing to buy property. Without a sustained pick-up in transactions there is little scope for prices to begin to rise either.

Activity remains less than half the levels of the peak of the market. In a repeat of the last three years, mortgage availability must improve for the market to see greater turnover in 2012.

Chart 14



Mortgage market

2011's mortgage market showed a little more life than the previous year, but that was from a very low base. Gross lending was £139bn from December 2010 to November 2011. This compares to £135bn in the calendar years2010 and £143bn in 2009. Purchase approvals initially flatlined, before beginning to pick up towards the end of 2011; in the three months to the end of November, they were 11% higher than the same period in the previous year. For the full year to the end of November they were 1% lower. Remortgages staged a recovery for the full year, with volumes rising 15% for the full year. Exceptionally low and stable rates in 2010 deterred remortgaging, but in the first half of 2011 there was a (misplaced) concern that interest rates would rise on economic recovery, and this spurred a mini-flurry of refinancing by borrowers enjoying low variable rates. Even though there is no likelihood of higher base rates for the foreseeable future, product rates are indeed now moving higher. This reflects the squeeze in the wholesale money markets making it expensive for banks to fund their lending, but lenders also point to higher regulatory costs and the expectation of poorer credit performance as reasons for pressure on product rates.

Chart 15

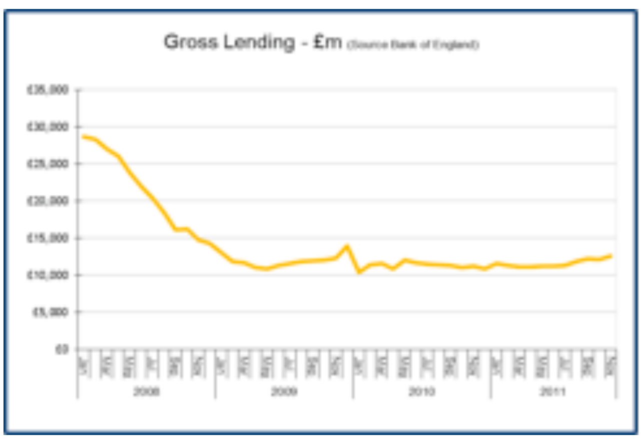
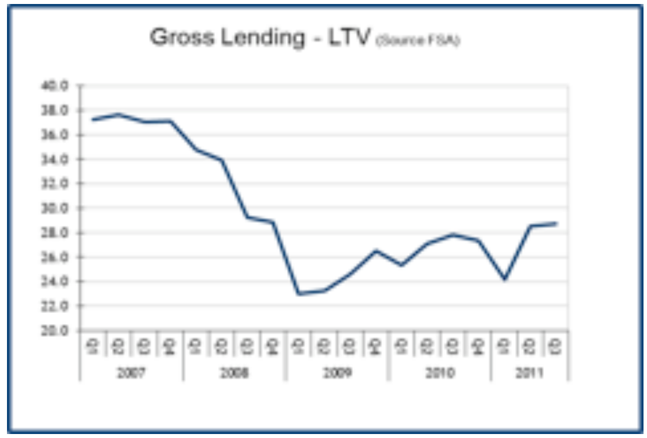


Chart 16



2012 is going to look very much like 2010 and 2011. Gross mortgage lending will be unchanged at between £130 and £140bn, with net lending at £0-£10bn. The sum of lenders' sales targets is higher than this, but market conditions mean growth is unlikely to be realised, especially while pressure remains on lender balance sheets. Remortgaging is likely to continue at the current low levels - about 33,000 per month. Purchase approvals seem set for around 49,000 to 51,000 per month this year.

Chart 17

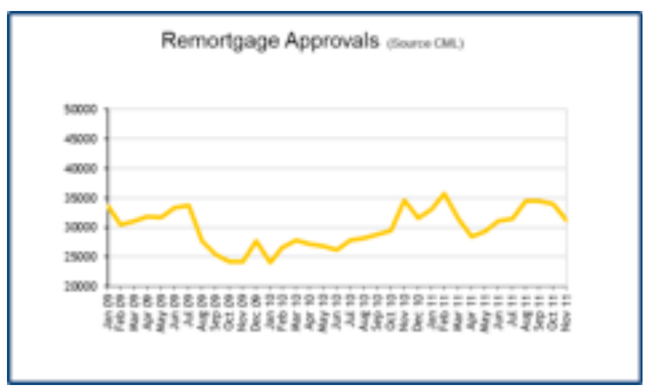


Chart 18

There was a very fractional increase in higher LTV lending in 2011. For the period Q4 2010 to Q3 2011, FSA data showed that >75% LTV increased to 27.2% of the total, from 26.7% in the previous twelve months. The trend is more strongly upwards, with the proportion of higher LTV lending in Q3 2011 reaching 28.7%. There is no reason to expect a sharp tightening in criteria this year.

Despite the ongoing weakness in the economy and the strains on household incomes, mortgages are performing well. Exceptionally low interest rates are largely to thank for the drop in mortgages more than three months in arrears; the latest data shows just over 2% are in this category, down from 2.5% in 2009. Possessions are following this trend, and remain low compared to previous downturns thanks to continued forbearance by lenders.

Chart 19

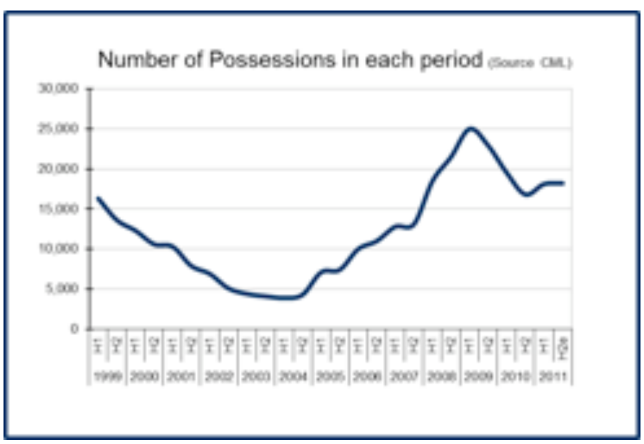
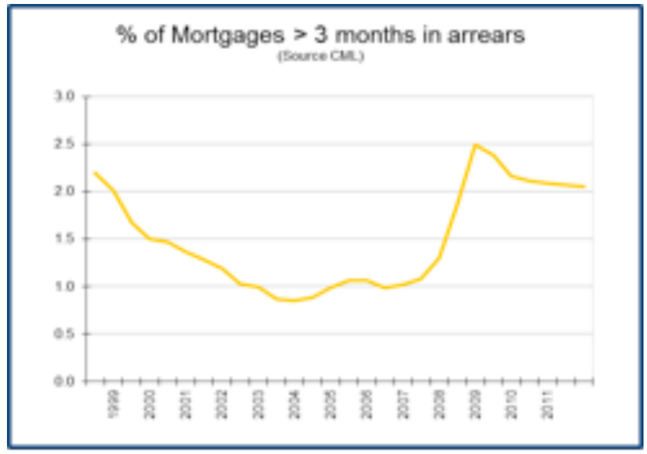


Chart 20



Buy-to-let and the private rented sector

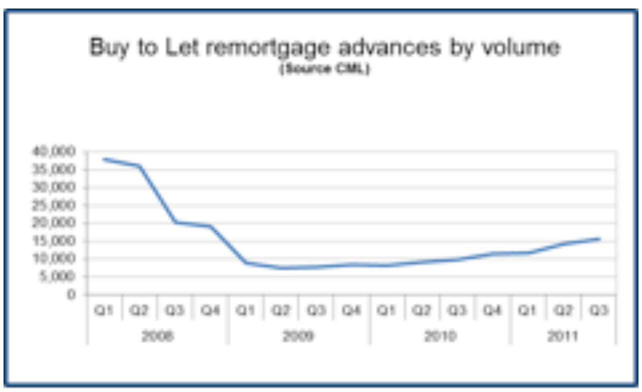
The private rented sector is rapidly expanding and now accounts for 4m homes, almost one in six of the UK total. ARLA expects this to reach 6.6m in ten years from now, equivalent to 22% of tenure, as demographics and economics continue to create a growing legion of renters. Savills estimates the value of these rented homes is 839bn, 19% of the total value of UK housing. The larger share of value compared to stock reflects the heavy skew of the rented sector towards higher value metropolitan regions, and especially London.

In the mortgage market, one eighth of outstanding mortgages are now buy-to-let, up from one in seventeen six years ago. This reflects structural changes in household structure and housing tenure that are part of a long-term shift in Britain. As the private rented sector takes a bigger share of tenure, mortgage brokers can look forward to healthy volumes.

The market was misunderstood in the boom. There was a big expansion in the number of investors in the private rented sector, many of them poorly informed speculators with only one or two properties, but the vast bulk of the market in terms of stock remained in the hands of professional landlords, so the overall market was not unstable or out of control. The professionals were always investing for the longer term, naturally hoping for capital growth, but ensuring they earned a solid income in the process. ARLA's Q3 figures in 2011 showed the annual return from rental property was 9% over the last five years for cash buyers, and 22% for those using gearing. The yield on rental property is now 5.3% according to LSL Property Services, which owns the UK's largest lettings agent. Property is the only asset with an inflation beating yield. This compares to bond yields of just 2% and cash rates of 3.1% (source Moneyfacts). Rents stabilised for the first time in almost a year in November according to LSL, and were up 3.5% yoy, with London and the south east seeing 4.2% increases, the highest rent inflation in the country.

Chart 21

Chart 22



On a more cyclical, shorter-term basis, the buy-to-let market is also a real beneficiary of the squeeze on regular mortgages. With rents getting so expensive and interest rates stable and low, there is a very clear financial advantage to buying compared to renting, if you can get finance. Most can't and frustrated first-time buyers alone continue to accumulate in the private rented sector at the rate of about 100,000 per year on a normalised basis. Compared to the peak of the first-time buyer boom in 2007, the shortfall is even greater. Cash buyers of rental property are a very important constituent of the market, but buy-to-let mortgage volumes are rising too. Mortgage volumes for purchase rose 14% in the year to the end of Q311 (CML) and rose 26% in Q3 itself yoy. Remortgage volumes rose even faster, up 48% for the twelve month period and 59% for the quarter yoy. New entrants are adding competition to the market too. Most recently Santander has begun offering buy-to-let products, and LTVs are beginning to expand from the recent standard 75%. Aldemore and Leeds Building Society now offer 80%.

LSL warns that total returns on current trend are likely to be negative in the short term. They point out that if property prices maintain the same trend as the last three months, a cash investor could expect to make a total annual loss of 0.7% over the next 12 months - equivalent to £1,144 per property. Investors need to take at least a five year view, however, and most will look through shorter term weakness and respond to the tenant demand signals.

From a lender perspective, buy-to-let loans perform well too, given the much higher margins they provide to lenders. In the first half of 2011, the possession rate of buy-to-let homes was 0.21%, a little higher than the 0.16% for owner occupiers (CML), while three month arrears performance is much more similar between the two groups at 2.4% for buy-to-let (including receiver of rent) and 2.1% for owner occupiers. Lower possession rates relative to arrears for owner occupiers most likely reflect greater forbearance by lenders to people in their own homes.

Whether home ownership is a good or a bad thing is another matter altogether. Certainly a rented home is the right thing for some people for some of the time, to fit a lifestyle or time of life, but over the long term, buying will make sense under most reasonable economic scenarios. Intuitively this must be so. The buy-to-let market only exists because there is margin in it for the investor. The accumulated value of this margin is the saving for a homeowner. For example, the total cost of buying, maintaining and insuring your own home over 50 years, assuming mortgage rates of 5% and inflation of 2% would be a little under half a million pounds. A renter seeing his rent rise with inflation for 50 years, would pay £610,000 for the same home, even after allowing for interest income on the money he would save by not paying a mortgage or initial deposit. At the end of the 50 years, the renter would have saved some capital of course, but the homeowner would own an asset that it is reasonable to assume would have risen with inflation too. Accounting for this would massively skew the calculation even more in favour of home ownership. The biggest sensitivity in the calculations is inflation, but higher inflation would tend to affect rental payments more than mortgage payments, and would push the value of the owned home up to boot. The model is simplified, but nevertheless demonstrates the magnitude of the advantage in owning.

For the long term, people are right to aspire to buy.

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Association of AMI Mortgage Intermediaries

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