QUARTERLY ECONOMIC BULLETIN

VOLUME 25 July 2012

Association of AMI Mortgage Intermediaries

HIGHLIGHTS

UK ECONOMY

- The economy shrinks for three consecutive quarters.
- Despite the negative growth there is good news: Falling inflation is likely to boost consumer spending, falling unemployment figures are a sign of recovery and trade data show rising exports
- Investment has been one of the most disappointing features of the economy. Despite very strong cash positions, businesses are not investing, and most government cuts are not in current spending but investment
- The government should do more to boost the economy – longer term measures on the supply side e.g. reducing the red tape, improving skills and reforming overly restrictive planning policies will help the UK's long term productive potential.

HOUSING MARKET

- Prices are flat. The regions are much weaker than the capital, reflecting relative economic strength and also foreign money flowing into London
- The housing market was boosted early in the year by the impending end of the stamp duty holiday
- Supply of homes for sale is rising, keeping a lid on prices

MORTGAGE MARKET

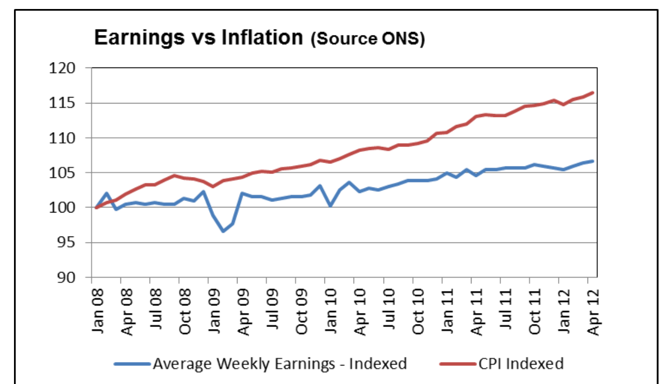
- Purchase volumes were strong in first half, up 7%, but the second half is likely to be more subdued
- Remortgage lending fell 7% year on year as last year's volumes were boosted by fears of rate rises
- Lenders such as HSBC and Santander introduced cheap five year fixes which will keep competitive pressures high
- No change to forecasts for the full year

Chart 1

UK key economic indicators	2008	2009	2010	2011	2012 e*	2013 e*
GDP	0.8%	-4.8%	1.7%	0.6%	0.3%	1.7%
CPI	3.80%	2.9%	3.2%	4.2%	2.0%	2.0%
RPI	3.1%	2.4%	4.6%	4.8%	2.7%	2.7%
Claimant unemployment (m)	1.05	1.63	1.48	1.61	1.7	1.71
PSNB next fiscal year (£bn)	£97	£156	£137	£126	£96	£105
Bank rate at end of period	2.39%	0.50%	0.50%	0.50%	0.53%	0.77%

* average of latest independent forecasts

Chart 2



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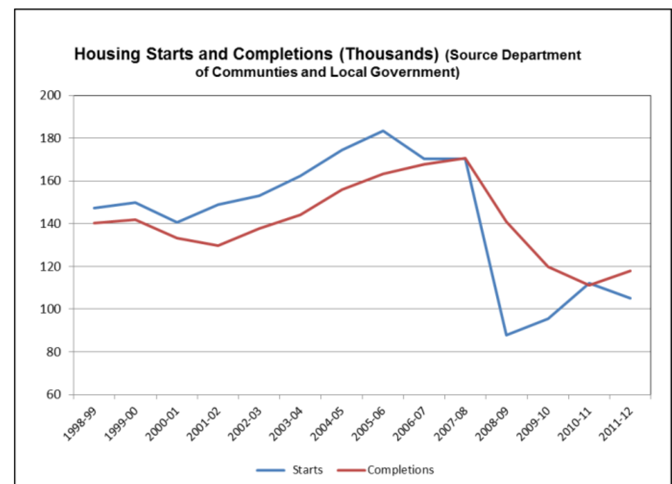


UK ECONOMY

Reducing the UK budget deficit is vital to the long term sustainability of government finances and the UK's prosperity. A coherent, credible, well communicated plan for fiscal consolidation is the only way to ensure the markets will tolerate large deficits in the short to medium term, without provoking a sovereign funding crisis in the UK. Such a crisis would bring sharply higher long term interest rates that would both push the deficit up further, and damage the growth potential of the economy, triggering a vicious circle of worsening deficit and debt dynamics. This is already happening to some of Britain's neighbours in the eurozone. But the squeeze on government spending is making it harder for the economy to grow, particularly in an international environment where our main trading partners in Europe are mired in the euro crisis and demand elsewhere in the world is slowing. It is only next year that the squeeze on government spending will become really tight. Without growth, reducing the debt burden and annual deficit relative to the size of the economy is a very difficult and painful process. Given the sluggish economy, it is important the government can continue to communicate a credible plan as it adjusts its deficit targets to handle the slower growth picture.

Chart 3

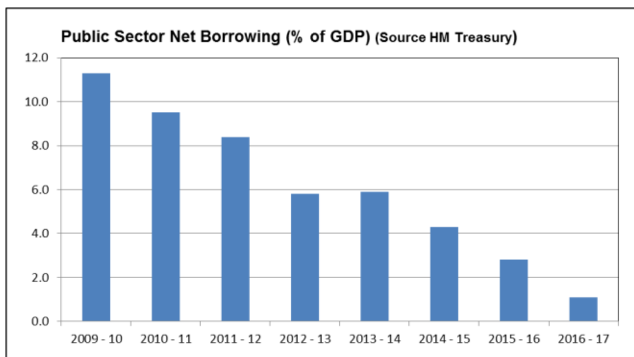
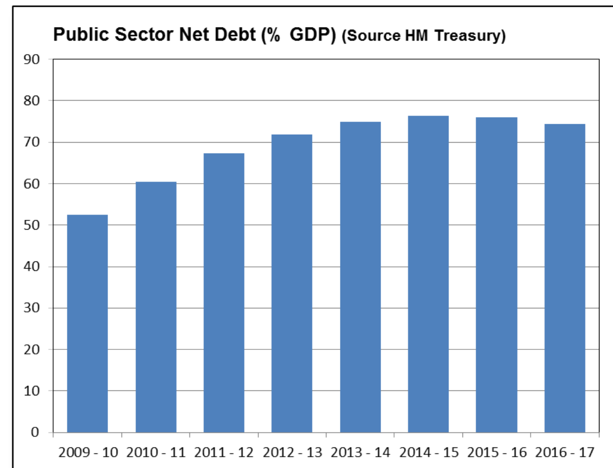
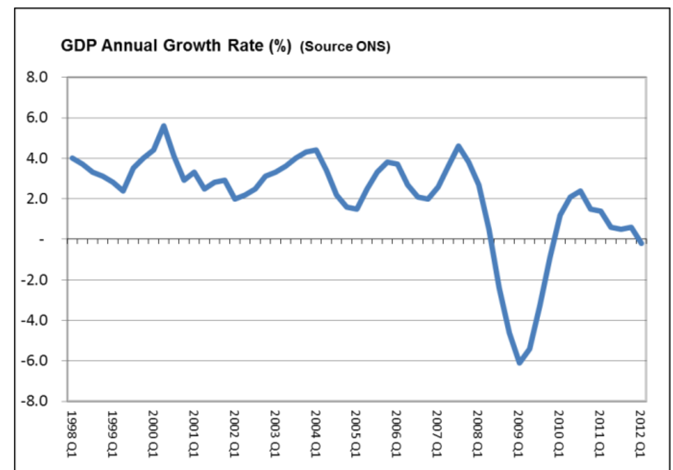


Chart 4



GDP fell 0.3% in the first quarter, and GDP from the previous quarter was revised down to -0.4%. Another projected fall of 0.7% in Q2adds to the challenges facing the Chancellor. What had initially looked like a blip which was contrasting with more positive survey information has turned out to be a renewed recession. Consensus estimates for UK GDP for 2012 are now for just 0.3% growth, implying a pick up in the second half of the year. The IMF in July downgraded the UK economy to 0.2% for this year, and we expect the consensus estimates to fall again by the time of our next report. It is conceivable there will be no growth at all in 2012. A year ago, economists expected the economy to expand over 2% this year but have steadily downgraded their expectations since. The Office of Budget Responsibility's (OBR) fan chart of GDP growth produced in March would now have the economy on one of the lower trajectories.

Chart 5



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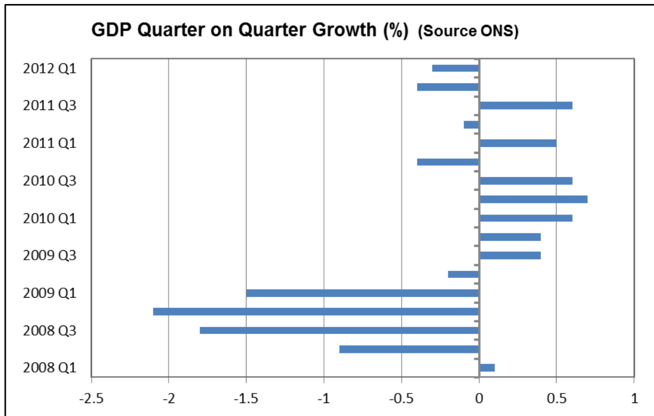

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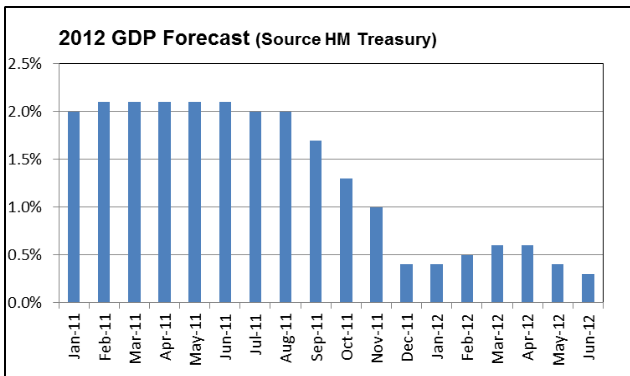

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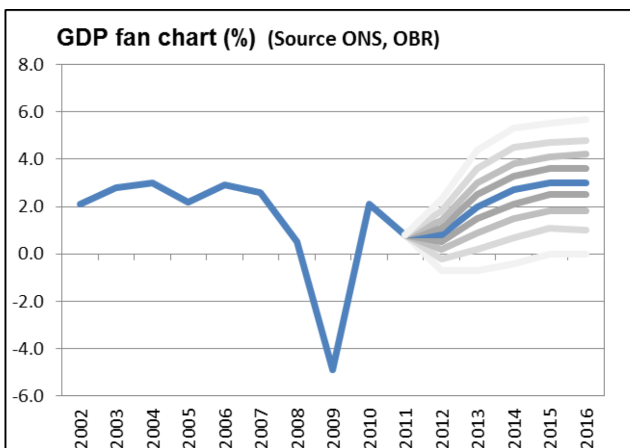
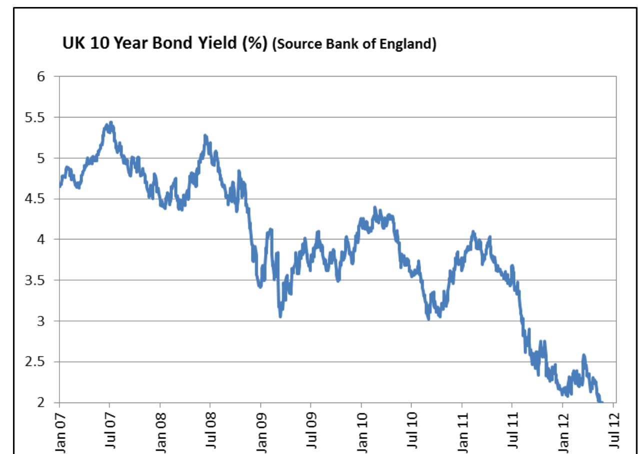


To a large extent the problems in the eurozone are to blame. Problems in the European banking system are making trade and project finance more difficult, a general lack of confidence is inhibiting business and consumer activity, and weakness in the economies of the UK's main trading partners in Europe are all acting as dampening factors in the UK. But the UK government can and should be doing more to boost the economy here. Supply side policies designed to reduce red tape, improve skills, and reform overly restrictive planning policies are all examples of important measures that can boost the UK's productive potential. Improvements on the supply side will also foster a better environment for investment.

Investment has in fact been one of the most disappointing features of the economy in recent years. Between 2000 and 2009, the average share of total investment (including government investment) in UK GDP was 16.9%, below that of France (20.3%), Germany (18.1%) and the US (18.6%). The sharp fall in investment at the end of 2011 was one of the key reasons UK GDP declined 0.4% in the final quarter.

Chart 9



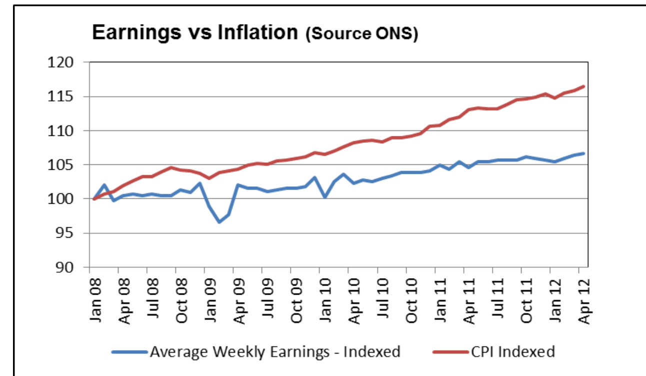
Most of the investing load has been carried by the state; government investment grew at twice the level of business investment between 1990 and 2010. Business investment as a share of GDP was the second lowest among advanced countries in the last decade, and it has continued to decline, falling to 7.8% in 2011. This is not due to a lack of capital in the private sector. Company cash piles are currently very high (estimated by ITEM at £754bn, half of GDP), so in theory firms have the capacity significantly to increase their investment activities, but with economic confidence weak, and spare capacity in the economy, there is little incentive to do so. Companies reacted to the 2008 financial crisis when borrowing was no longer available by focusing on cash flow and rebalancing their balance sheets to protect them from a possible second credit crunch. The OBR expects business investment to begin to pick up more strongly from 2013, and forecasts it will make up one third of GDP growth by 2016. The government has also offered new guarantees on investment projects, claiming it could unlock £40bn

of projects which are unable to get financing. Even if the ultimate value of such projects is smaller, schemes like this are all steps in the right direction.

Government cuts have targeted investment spending much more than current spending, given the political ease of cutting projects that affect private contractors rather than noisy and well organised public sector workers. Public sector gross investment will fall 29.6% between 2011 and 2016 in real terms, while current spending will fall only 2.8% according to the OBR. General government gross fixed capital formation (a measure of government investment) will fall from 2.4% of GDP in 2010/11 to just 1.6% by 2016/17. This is the wrong approach. The government has earned credibility from the markets on its deficit cutting plans and delivery, which means the market will tolerate higher borrowing if it is for the right sort of spending – productive investment is the right sort. The government can finance itself very cheaply at present and should make the most of that to invest in infrastructure projects that will boost the long term growth potential of the economy. The lack of new airport capacity is one such constraint on future growth. The recently announced electrification of the Midland main line is a good example of what should be done, although it won't begin until 2014.

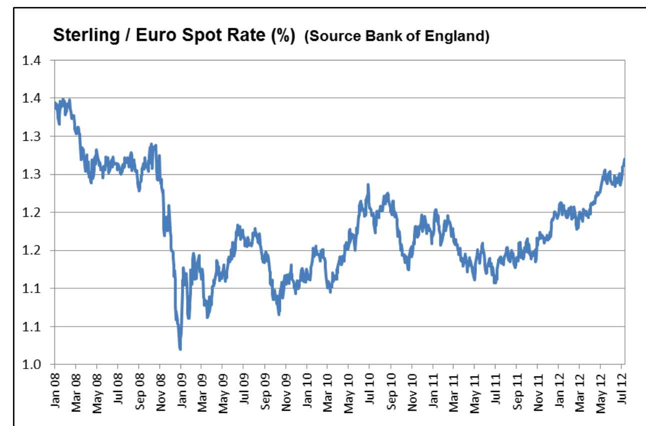
The news is however by no means all bad. CPI inflation fell for the ninth consecutive month in June and more than expected, reaching 2.4% (CHART CPI). Wet weather pushed summer clothing costs down over 4% alone in the month and food and petrol prices were lower too. Lower inflation will provide a boost to consumer spending power, or more accurately, reduce the speed of erosion of spending power relative to wages. Average weekly earnings were £467 in April, a mere £5, or 1% higher than a year ago, a real terms decline of almost 2%. Last September when CPI peaked at 5.2%, wages had risen only £8 on the previous year, a real terms decline of 4.5%. Consumption is the largest part of the economy, so some growth here brought about by an improvement in household spending power will make a big difference to overall GDP.

Chart 10



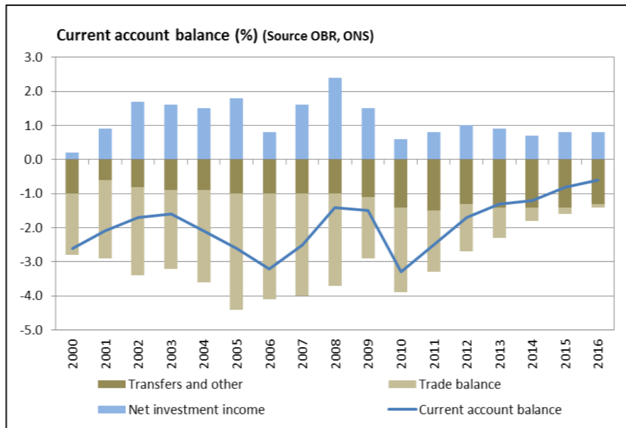
Even though the UK economy is too heavily dependent on consumption, it will make up the bulk of the growth in GDP as the economy begins to recover, contributing about two thirds of GDP growth by 2016, according to the OBR. Inflation should continue to trend downwards over the rest of the year even though commodity prices have begun to rise again recently which may slow further CPI declines. Wider inflationary pressures are weak, as the global economy slows and the UK economy remains so sluggish. Sterling has also appreciated sharply against the euro over the last year, up 15% (Chart 9), while only falling 4% against the dollar. On a trade weighted basis it is 7.4% stronger, which will also weigh down on the cost of imports, keeping inflation under control.

Chart 11



Trade has also improved sharply, and should continue to make a positive contribution to growth, although not as much as it would if the eurozone were in better shape. The current account is improving significantly, mainly as a result of the falling trade deficit, one reason why the currency has been stronger.

Chart 12



Government spending will detract from economic growth from next year (this year it will make a net zero contribution) according to the OBR's most recent forecasts.

Table 1 breaks down the contribution different components of the economy will make to growth; the OBR's forecasts are a little out of date, but still are useful for understanding the relative contributions that the main planks of activity will make.

Table 1

Source - OBR	Percentage points, unless otherwise stated						
	Outturn	Forecast					
	2010	2011	2012	2013	2014	2015	2016
GDP growth, per cent	2.1	0.8	0.8	2.0	2.7	3.0	3.0
Main contributions							
Private consumption	0.8	-0.5	0.3	0.8	1.5	1.9	1.9
Business investment	-0.2	0.0	0.1	0.5	0.8	0.9	1.0
Dwellings investment[2]	0.4	0.1	0.0	0.5	0.6	0.5	0.5
Government[3]	0.5	-0.3	0.0	-0.3	-0.5	-0.6	-0.6
Change in inventories	1.3	-0.1	-0.1	0.0	0.0	0.0	0.0
Net trade	-0.5	1.2	0.4	0.5	0.3	0.2	0.1

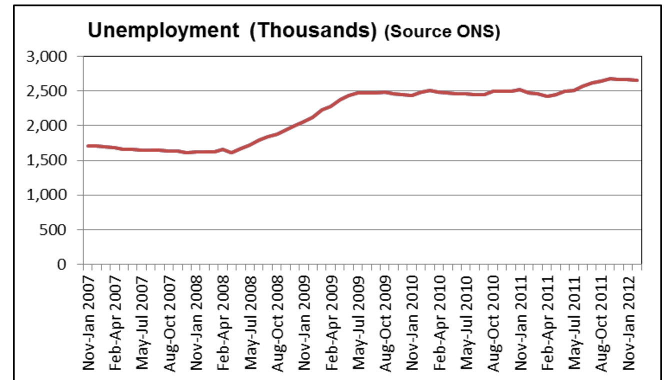
[1] Components may not sum to total due to rounding and the statistical discrepancy.

[2] The sum of public corporations and private sector investment in new dwellings and improvements to dwellings.

[3] The sum of government consumption and general government investment.

There is also good news on the labour market. Unemployment fell in June for the fourth consecutive month, dropping 65,000 to 2.58million the lowest level in a year, a rate of 8.1%. Youth unemployment also fell. Employment rose and vacancies increased by 10,000 to 471,000. London added the most jobs, although with the population growing to eight million the rate of unemployment is still high at 8.9%. Northern regions performed worst, especially Yorkshire and the Humber, because the sensitivity to public sector employment is much greater in these parts of the country. Those regions with greater private sector activity will continue to do better, particularly as public sector cuts bite deeper next year. With the economy so weak it is hard to explain why the labour market is improving so consistently, although there does seem to be an element of labour hoarding going on by firms – falling productivity is evidence that firms are using more labour for the same levels of output

Chart 13



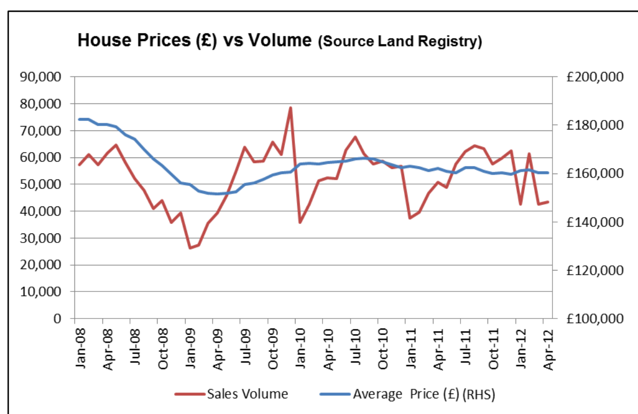
Taken together, the economy does look in better shape now than it has for some time, but it remains to be seen whether the positive signs actually translate into growth.

HOUSING MARKET

The housing market from a national perspective is becalmed. Volumes are still in their post-crisis range of between 40,000 and 60,000 transactions per month, with a stronger blip before the end of the financial year as buyers rushed to complete transactions before first time buyer stamp duty concessions expired.

The Land Registry House Price Index saw May house prices rise 0.5% compared to April (latest data). This takes the average house price in England and Wales to £161,677, essentially flat compared to a year ago. Unsurprisingly, London experienced the highest increase in its average property value over the last 12 months, up 7.7%, reflecting the differing economic performance around the country but also the continuing flow of foreign money into London property.

Chart 14



The monthly Office for National Statistics (ONS) house price report for April also confirmed signs of a two-speed UK housing market, with London homes rising fastest in value at 4.9% in a year, compared with a national average of 1.4%. Conversely, there was a fall of 1.3% in the North West of England, and Yorkshire and the Humber. Geography has always been a key factor in house price, but relatively low levels of activity have highlighted significant differences in prices across the UK, which look to only be exacerbated in the short to medium term.

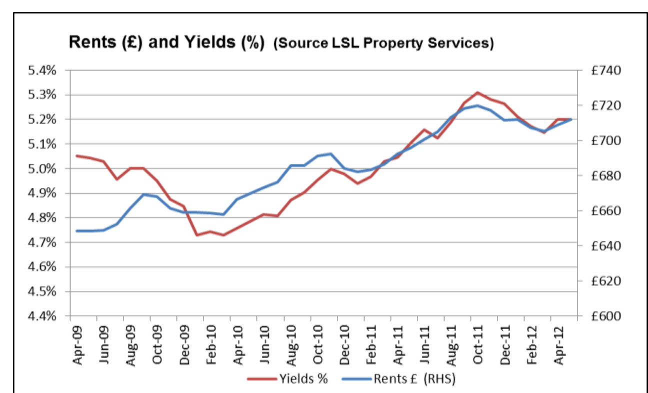
Meanwhile, the national housing survey from Hometrack, published in June, found that new buyer registrations fell for the first time in five months, with demand slipping 0.5%. Hometrack has warned that prices will fall in the second half of the year by 1.3%, due to ongoing eurozone worries. This pessimism was also confirmed by a doubling in the number of postcode districts with price decreases over the month from 12.1% to 23.4%.

Both Halifax's and Nationwide's house price indices remained volatile. Nationwide's Index reported a 1.5% year-on-year fall in June as the biggest since August 2009. It suggests a general housing market decline, with a 0.6% month-on-month decrease in June, which can be partly attributed due to the ending of a stamp duty concession for the first-time buyers in March. This had an effect of bunching up sales at the beginning of the year. Halifax also warned that stagnation lies ahead, although there is little to suggest a decline will gather pace, as its index bounced by an unexpected 1% in June.

Rightmove reported a large increase in new listings of homes for sale, with nearly 30,000 sellers a week came to the market in the three weeks prior to the Jubilee weekend, the highest new listed amount for two years, suggesting that further price increases will be unlikely in 2012 as fresh housing exceeds demand. Anecdotally, there does seem to be a lack of good quality housing coming on to the market, however.

The private rented sector is still very strong indeed. Rents rose again in May, according to the latest Buy-to-Let index from LSL Property Services plc. Average monthly rents are now reach £712 and a pricey £1,038 in London. Rents rose in all but three regions (East Midlands, Wales and North East), with London and South East seeing the fastest rental increases, at 4.2% and 3.1%, respectively.

Chart 15



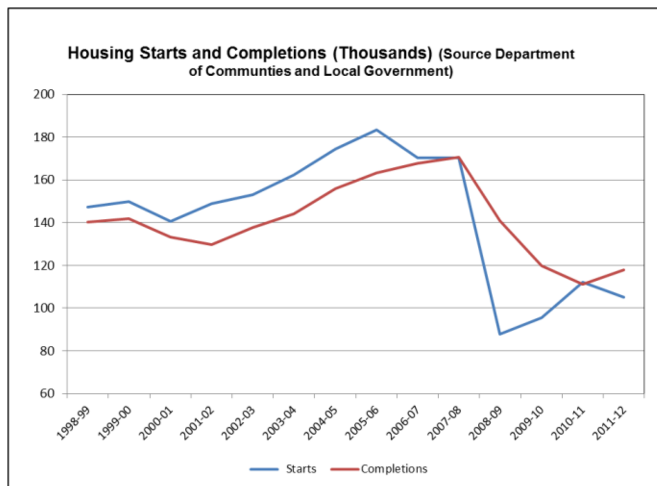
Average total returns for investors in property were 4.8% in May, up from 3.7% in April. This represents an average return of £7,912, with a rental income of £7,666 and a capital gain of £245. Flat property prices over the next twelve months mean an average investor in England and Wales will just take home the yield of 5.2% over the next 12 months. A fall in bond yields to 1.9% in the last quarter, while rental yields

were steady has also increased the attractiveness for property in yield terms. Rental arrears took a turn for the better in May, with the general tenant population coping well with high rents and the rising cost of living. Only time will tell if this trend will continue as households are predicted to struggle under ongoing financial pressures and fragile consumer confidence.

Household financial pressures were examined by the Joseph Rowntree Foundation who predicts that by 2020 the number of home owners under the age of 30 will fall to 1.3 million, a staggering drop of 46%. Even more worrying, government data indicate that the quantity of affordable homes under construction fell by 68% between 2011 and 2012, coining the term ‘generation rent’, with young people being unable to step onto the property ladder.

Housing starts remain very subdued as housebuilders worry about demand and about how to finance their projects. Annual housing starts totalled 104,970 in the 12 months to March 2012, down by 6% compared with the 12 months to March 2011. Annual housing completions in England actually rose, reaching 117,870 in the 12 months to March 2012, an increase of 6% compared with the 12 months to March 2011. This is still far below the rate of household formation.

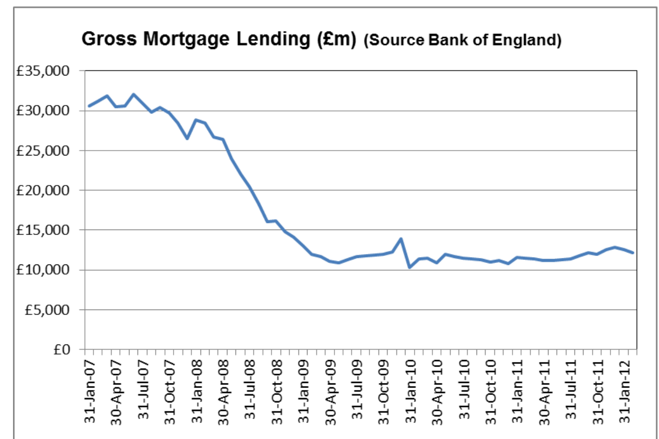
Chart 16



There is still very little to suggest a rapid revival in the property market this summer, with ongoing eurozone uncertainty and the Olympics, the housing market will take a backseat. Agents will be hoping for an extra lift in activity in September to give the property market some momentum for the remainder of the year.

MORTGAGE MARKET

Chart 17



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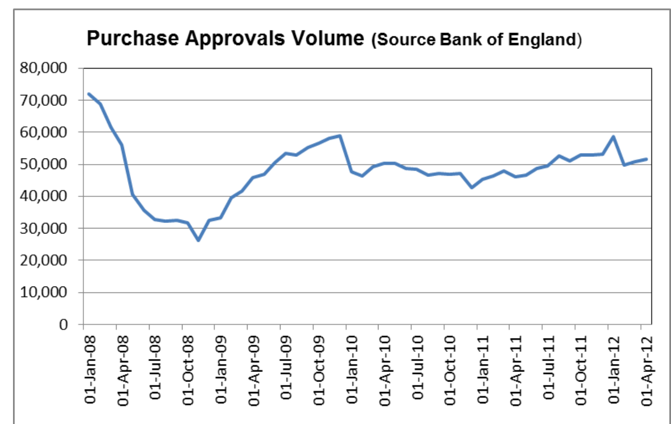

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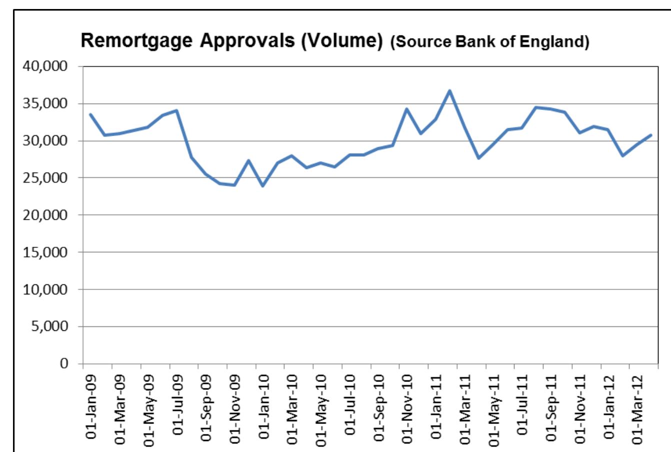

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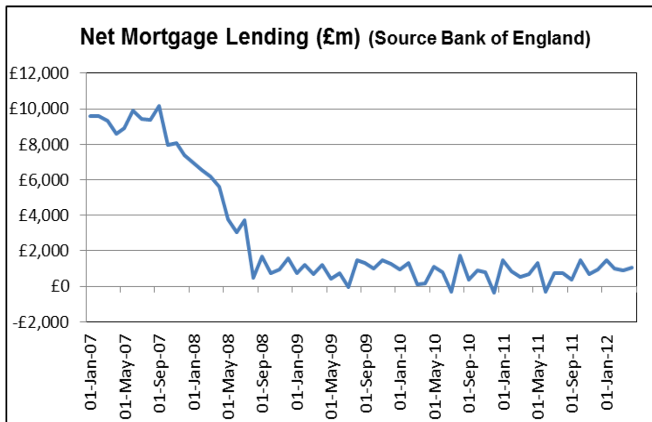

House prices remain high in relation to incomes, at more than five times average earnings. Affordability appears less stretched when comparing the cost of mortgages to incomes, with repayments on a typical mortgage equal to around 31% of take home pay, which is the lowest level for a decade. A new study from Barclays also found that owning a home rather than renting it will save £194,000 over a fifty year period, showing that buying rather than renting may make more sense economically, and offer long term financial stability, with rents rising considerably over time. The key for buyers is to overcome the initial hurdles of getting on the housing ladder.

The end of the stamp duty holiday for first time buyers caused a marked dip in mortgage lending after a strong end to 2011 and beginning to 2012 as buyers rushed to bring forward their purchases. Nevertheless, mortgage approvals for house purchase looked healthier than the same period in 2011, up 13.6% in the first four months. Demand is certainly there, particularly among first time buyers which the CML report to be around in greater numbers. To a large extent the increased approvals also reflects a somewhat improved supply of loans and greater competition in the market.

By the end of June, gross lending had reached £67.8bn year to date, up 6.8% compared to £63.5bn in the same period last year. We expect the second half to show less growth as there were some big months in the late summer of 2011 which will be hard to beat. Nevertheless, the second half should be better for intermediaries as lenders will turn increasingly to them to ensure they meet their targets. For the full year, we are not changing our forecast of £130-140bn gross lending (2011 was £140bn). Net lending we expect to again be in the £0-£10bn range, entailing almost no increase in the net mortgage books of the UK's lenders.

Remortgage lending fell 7% year on year in the four months to the end April, as borrowers last year feared increases in interest rates and volumes rose to beat them.

Rates have been higher this year, but now, with swap rates declining in recent weeks, the additional £50bn QE and talk of an interest rate cut from 0.5%, mortgage rates are coming down. Lower volumes year on year may reflect the hope of more cuts to come. If more lenders launch headline rates as cheap as HSBC's 2.99% five year fix, volumes are likely to rise, and indeed we expect more such products to appear. Indeed Santander has followed HSBC in announcing a five-year fixed rate mortgage at a rate of just 2.99% with a loan-to-value ratio of 60%. Both products benefit wealthier borrowers much more as the booking fee is very high - adding 0.5% per year to the effective interest rate on a £100k mortgage, but only 0.25% to one twice that size. No fee mortgages benefit borrowers needing small sums.

ARREARS AND POSSESSIONS

The CML reported that the number of repossessions in the first quarter of 2012 was 9,600, the same as in the first quarter of 2011, breaking the recent trend of year-on-year increases in repossessions. Overall, the repossessions landscape appears stable for the time being.

Through the first quarter of the year, there was a modest improvement in the total number of mortgages in arrears. The number of mortgages with arrears of 2.5% or more of the outstanding balance fell to 157,800 (1.4% of all loans), down from 160,300 at the end of December 2011 and 170,500 at the end of the first quarter of 2011.

The CML has indicated it may revise down its 45,000 central forecast for repossessions in 2012. However, continuing pressures on household finances, changes to welfare benefits, and an upward drift in mortgage rates all have the potential to make the situation worse.

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