QUARTERLY ECONOMIC BULLETIN

VOLUME 25 - February 2013

HIGHLIGHTS

UK ECONOMY

- The UK economy ended 2012 exactly the same size as it started.
- It was a volatile year, with the Olympics providing a sharp, but temporary boost.
- GDP is now shrinking again marginally; the trend is essentially flat.
- Forecasters expect a slightly better 2013, but still barely above 1%.
- Policymakers in the UK are under pressure to provide further monetary stimulus.
- In spite of negative GDP news, employment continues to surprise on the upside.
- Wages are growing very slowly and help explain why consumer spending is weak.

HOUSING MARKET

- Despite difficult economy, the housing marketing has held up well with prices falling only 1.5%.
- London continues to defy the national trend.
- First time buyers reached a five year high, though this is still around half the levels seen for 2006.
- Property prices could take another eight years to recover to levels seen in 2007.
- The squeezed middle is holding the market back as insufficient equity means they cannot trade up.

MORTGAGE MARKET

- Gross lending was £2bn higher in 2012 than 2011.
- The Funding for Lending scheme will help boost the market in 2013.
- The buy to let market remains strong, with robust tenant demand and high rents.

Chart 1 – UK key economic indicators

UK key economic indicators	2008	2009	2010	2011	2012 e*	2013 e*
GDP	0.8%	-4.8%	1.7%	0.6%	0.0%	0.9%
CPI	3.80%	2.9%	3.2%	4.2%	2.7%	2.5%
RPI	3.1%	2.4%	4.6%	4.8%	3.1%	2.8%
Claimant unemployment (m)	1.05	1.63	1.48	1.61	1.57	1.61
PSNB next fiscal year (£bn)	£97	£156	£137	£119	£89	£105
Bank rate at end of period	2.39%	0.50%	0.50%	0.50%	0.50%	0.50%

*average of latest independent forecasts

Chart 2 – Inflation vs wages

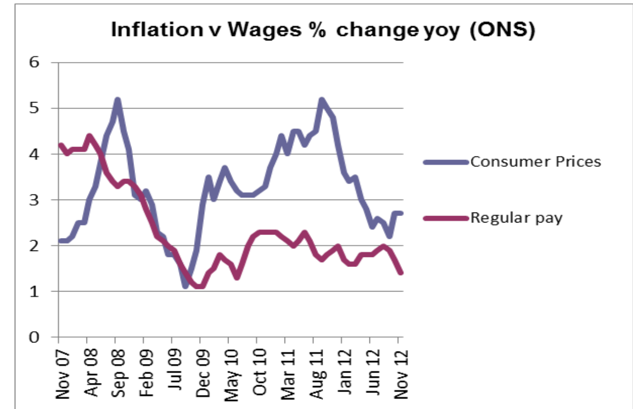
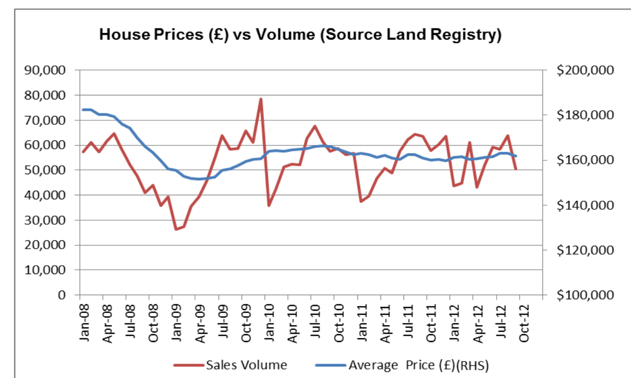


Chart 3 – House prices vs volume



UK ECONOMY

So it is official. The economy ended 2012 exactly the same size as it started. It was a fairly volatile year, as the Olympic Games ended nine months of contraction and caused a sharp bounce of 0.9% in the third quarter. This was followed by a renewed shrinking in the fourth quarter, when a worse than expected decline of 0.3% was reported owing in particular to a sharp drop in oil production in the North Sea after supply disruptions. Weakness in manufacturing, and continued difficulties in the construction sector completed the negative picture, while services were broadly flat. The news followed a series of relatively downbeat economic releases, which included negative business surveys, poor retail sales, and uninspiring trade data. It is quite possible that disruption related to the bad weather will also make the economy contract further in the first quarter, on the high street, on construction sites, as supply chains get interrupted, and as people are unable to get to work. (Chart 4)

Chart 4 – UK key economic indicators

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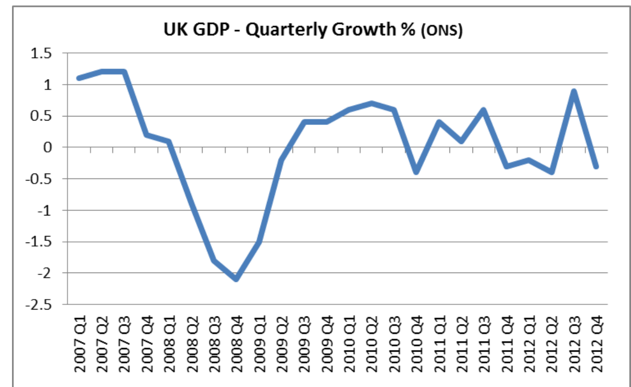
Nevertheless, headlines of a triple dip recession are rather meaningless when we are talking about very small percentage changes in any given period, and because of rather volatile factors. It is fair to dismiss one-off factors in terms of considering the overall direction of the economy, but they do affect the ability of the economy to generate both tax revenues for the government, and to put money in people's pockets to enable them to spend. However, the most important thing is to look at the overall trend. The figures will of course be revised, in one direction or another, but the main observation to make, is that regardless of volatility from quarter to quarter, the economy is essentially going nowhere. (Chart 5)

Chart 5 – GDP preliminary results



The IMF signalled a cautious note for the world economy at the Davos meeting, but forecast a slightly faster expansion than 2012, at 3.5%. The key risks to growth, according to the IMF, are in the developed world, the euro area, Japan and the US, where public debt levels are very high, and economies sluggish. For the UK, the fund cut its forecast for 2013 to just 1%, down from 1.1%, with its expectation for 2014 reduced as well from 2.2% to 1.9%. The IMF is now more pessimistic on UK growth than the Office for Budget Responsibility (OBR), which revised its own forecasts down to 1.2% this year and 2% in 2014, and blamed a weakness in net exports for the slower 2012, and likely to cause weaker growth than forecast in 2013. Independent forecasters are already more negative, and now only expect 0.9% growth this year, having cut their forecasts towards the end of 2012. (Chart 6 and 7)

Chart 6 – 2012 GDP independent forecasts

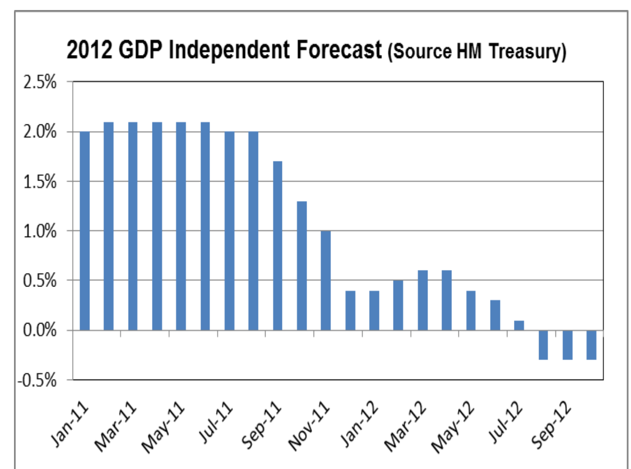
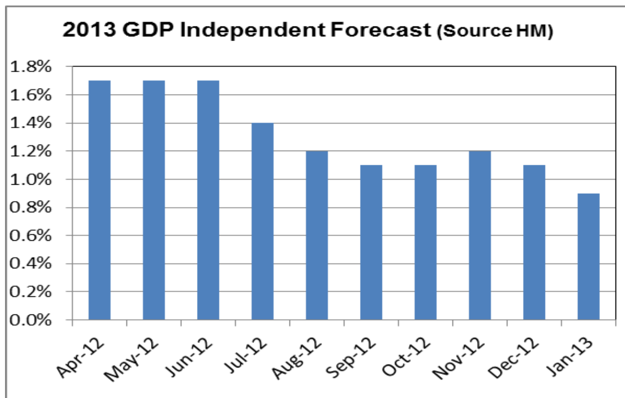
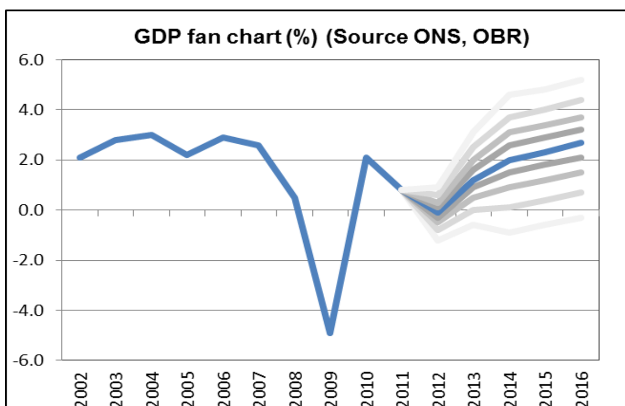


Chart 7– 2013 GDP independent forecasts



In the OBR's updated forecast in December 2012, the new GDP fan chart shows a greater likelihood that the economy will remain in negative territory even as late as 2016. (Chart 8)

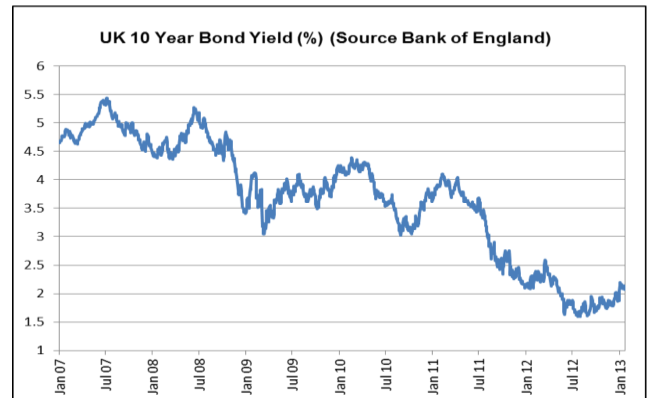
Chart 8 – GDP IEG forecasts



The OBR's central forecast is that growth is not expected to return to firmly above-trend rates until 2015 as credit conditions begin to normalise and financial markets return to a more stable position.

All three big rating agencies have the UK on negative watch, and it seems very likely that the UK's credit rating will be downgraded. As the UK's safe haven status slowly evaporates in the face of a more stable eurozone, there could be more pressure on the gilt market, with foreigners selling UK government bonds, pushing yields up and sterling down. This would be a reasonable response by foreign investors, since the UK does not warrant major investor confidence. The yield on government securities has already risen from its historic low in the autumn of 1.7% to over 2% by the beginning of the year. (Chart 9)

Chart 9 – Zero coupon bonds



The clamour is increasing for policymakers in the UK to ease conditions. Not only is there pressure for further monetary policy stimulus, but also for the government to row back on its policy of austerity. Nick Clegg even admitted that the cuts in government spending had been a mistake, and more spending on infrastructure is now under way to try to rebalance the economy and stimulate activity, including the announcement of an expanded high speed rail network. Indeed, as we have commented before, the government had erroneously relied heavily on cuts in investment spending to reduce the deficit, rather than tackling much more politically sensitive current spending. On the monetary side, it seems less likely there will be any further Quantitative Easing. In the recent Monetary Policy Committee meeting in January, only one member of the committee voted for more action. Policy has been on hold since July and the minutes show that the MPC is hoping the Bank of England Funding for Lending scheme will do more now to revive the economy then additional asset purchases. The MPC feels the Funding For Lending scheme is having the desired effect, pointing to the higher availability of credit over the course of January as the scheme had gained traction and confidence in markets had improved.

Employment remains an unexpectedly bright spot on the UK economic horizon. Full-time employment rose by 82,000 in the three months to November, reversing a switch to self-employment and part-time work, which we have seen in recent times. The ILO unemployment count fell by 37,000 at that period, taking unemployment to 7.7%, equivalent to 2.49m people. (Chart 10) A further reduction in youth unemployment is particularly welcome. Public sector employment fell 124,000 over the year to September, while private sector employment rose 627,000, both after adjusting for a reclassification of some jobs as private sector from public sector. (Chart 11)

Chart 10 – Unemployment figures

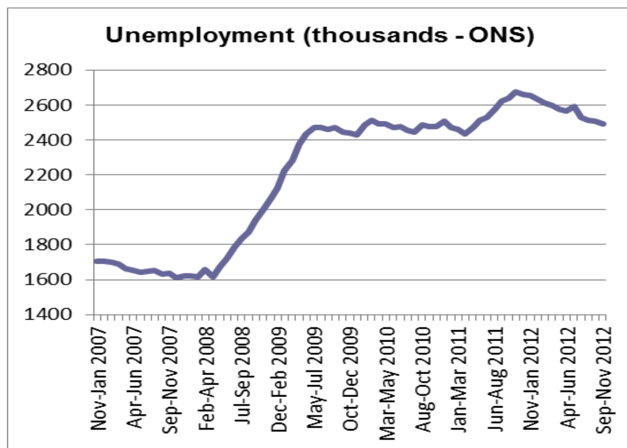
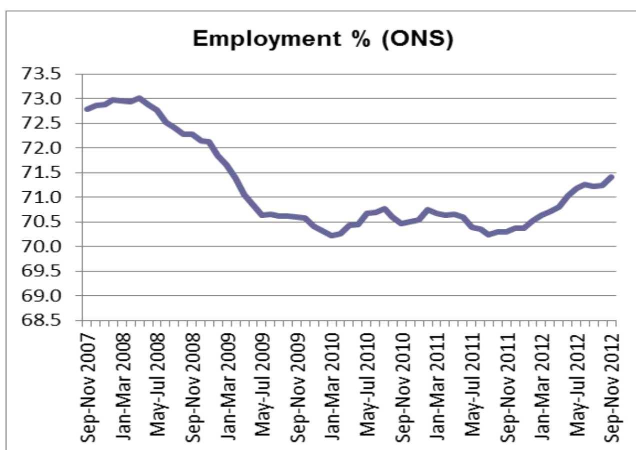
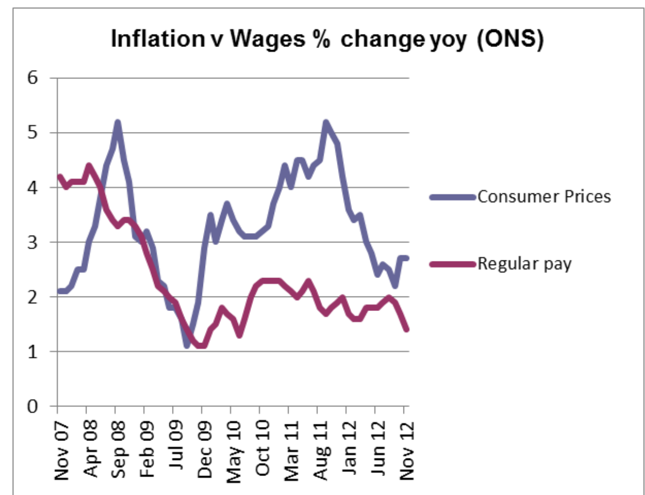


Chart 11 – Employment figures



There is a price. Wages are growing very slowly. (Chart 12) Total pay including bonuses only rose 1.5% in the year to November, well below the rate of inflation which is at 2.7% (CPI). Real earnings, after adjusting for inflation, have fallen almost 12% since their peak in February 2008. That is a very large decline, and helps explain why consumer spending is stubbornly weak. Since consumer spending makes up around three fifths of the economy, lack of growth here will make it very hard for the economy overall to make any progress. The lack of demand will also hold back corporate investment. Growth in employment without growth in GDP also means the UK economy is less productive, as does the growth of labour without additional capital. This also helps explain the relatively weak wage increases.

Chart 12 – Inflation v wages



Furthermore, it is quite hard to see unemployment continuing to perform so well as we move into 2013; many commentators expect progress will slow, and that unemployment may even begin to rise modestly by summer. There is after all, only so long an economy that is not growing can continue to create jobs. The large number of high-profile bankruptcies on the high-street is certain to have an effect, for example, even though they mainly reflect retailers whose business models are out of date, rather than being casualties of economic decline. Times of economic weakness often create shakeouts in industries, removing weaker players and ensuring those who are better adapted to a changing world will be around for the longer term.

The public finances depend on the economy growing, and ministers have been warned they will need to make more cuts in the year to come. According to the OBR’s December statement (which some already consider overly optimistic), public sector net borrowing (PSNB) is forecast at £108 billion or 6.9% of GDP this year, less than was thought earlier in the year after the profits on the Bank of England’s Asset Purchase Facility (APF) were transferred to the Exchequer in some convenient accounting. (Chart 13 and 14)

General tax receipts are better than hoped, though there will be a 4G auction windfall. PSNB is then forecast to decline to £31 billion or 1.6 per cent of GDP by 2017-18, a smaller and slower improvement than predicted in March – mainly because the weaker outlook for the economy will reduce expected tax.

Chart 13 – Public sector net borrowing

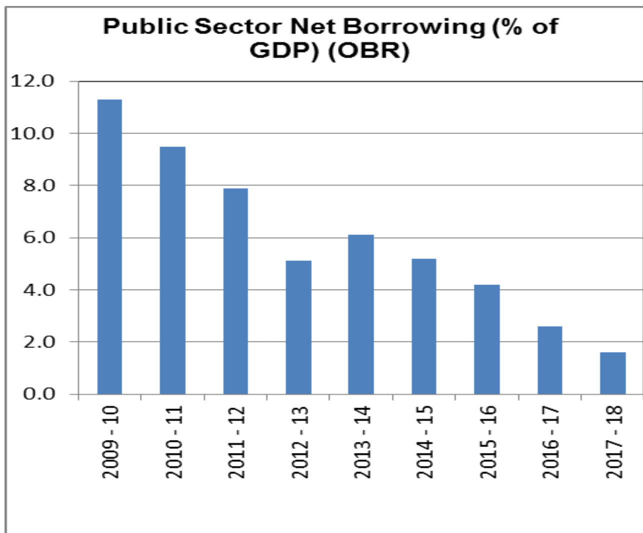
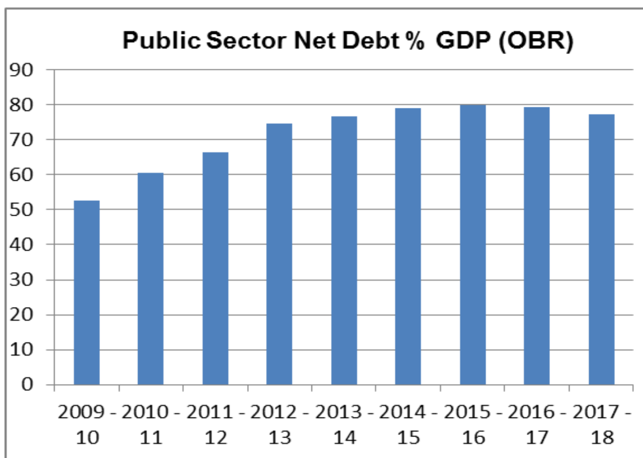


Chart 14 – Public sector net debt



HOUSING MARKET

The housing market is not doing too badly at the moment. Given the weakness in the economy it is a surprise that prices fell only 1% during the year according to Nationwide's figures, and 1.5% according to the Land Registry. The supply of new housing remains very limited, lenders continue to show leniency for borrowers in arrears, the relative strength in the employment market means few people are losing their jobs and therefore putting their house at risk, and interest rates are very low, so mortgages are relatively easy to finance. (Chart 15) There continue to be very large regional variations, with regions to the south doing well, while those in the North are tending to show much greater price weakness. London continues to operate its own micro housing market, which defies the wider national trend. (Chart 16) The number of first-time buyers according to Halifax has reached a five year high as 216,000 borrowers bought their first home in 2012, 12% more than 2011, though this is still around half the levels of 2006. Recent research by Barclays shows why getting on to housing market is so much harder these days. In 1995 it took only a year to save a typical deposit for a first time buyer. It now takes eight times as long, although conditions have improved a lot since 2009 when, at its worst, it took 10 years to save a deposit. Changing house prices and changing loan to value ratios are the main reason to explain the big increases. Lower house prices in 1995 combined with 95% loan to value mortgages made saving for a deposit easier. Today, even though higher LTV products are available, the average is just 80%, so deposits are typically around £31,000. Getting these new first-time buyers to buy property is crucial to the health of the wider market, to enable people to move to new property.

Chart 15 – House prices (£) vs volume

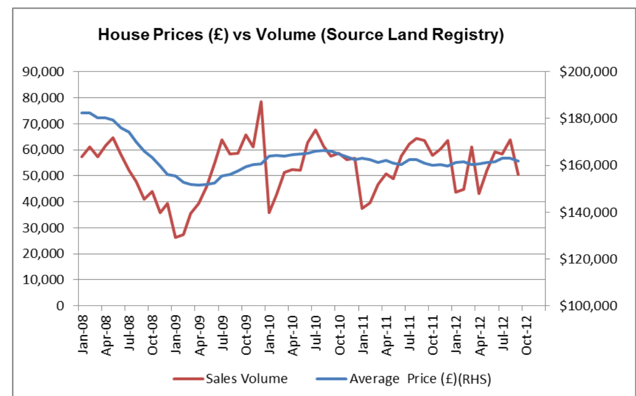


Chart 16 – Annual change in house prices by region. Source: Land Registry House Price Index

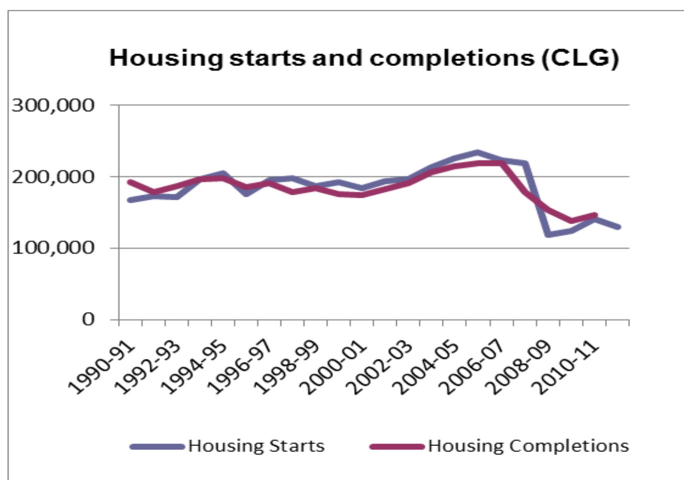
Region	Monthly change (%)	Annual change (%)	Average price (£)
London	3.1	8.4	£371,223
South East	0.6	3	£211,092
East	0.1	1.1	£173,315
South West	-0.6	0.3	£170,337
West Midlands	1.3	1.7	£130,251
East Midlands	-0.2	0.1	£122,646
Yorkshire and the Humber	0.7	-0.7	£116,798
Wales	1	0	£116,402
North West	-0.9	-3.5	£108,257
North East	1.9	0.3	£99,974

Prices are now much cheaper and relative to wages have fallen even faster. But they remain typically five times the average wage, compared to a long-term average of four. The picture has improved significantly from the peak of 6.5 times, but it shows house prices are still not cheap on a long-term comparison. There are no factors that look likely to spark another housing boom. Given the long wind down process of over-indebted households and over-indebted government, the conditions for a boom are some long way off, Knight Frank thinks property prices will take another eight years to recover to the levels last seen 2007.

Transaction numbers in the year to the end of October were 659,000 according to the Land Registry, 16,000 more than the previous twelve months. The year to come is likely show further improvement as conditions in the mortgage market ease. Indeed, the most recent survey from RICS predicts an increase in property sales over the next three months, with a positive balance of 24% of estate agents optimistic on the outlook for the market.

Housing supply remains a problem. Although completion of new homes rose in the period 2011/2012, the number of new homes started actually fell, boding badly for the continuing supply. Nationwide, the number of households being created continues to outstrip the number of new homes being built. The NewBuy scheme should help, however, in particular boosting the first time buyer numbers since they qualify for the mortgage guarantees. (Chart 17)

Chart 17 – Housing starts and completions

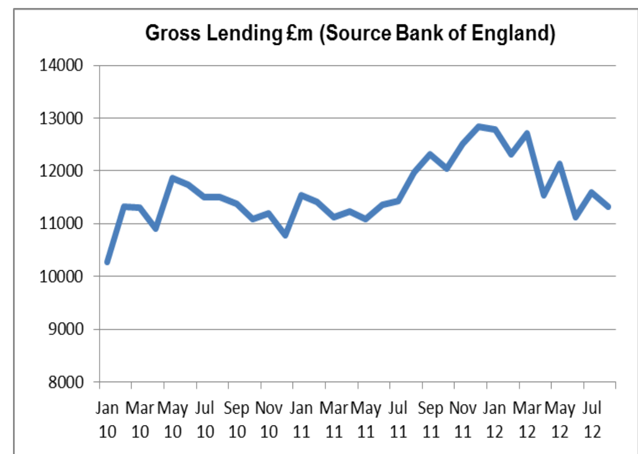


A lot is talked about first time buyers, but there is a squeezed middle in the housing market, who are unable to trade up because they have insufficient equity. With house prices lower and mortgage requirements tighter, and perhaps with the continuing household income squeeze, they simply do not qualify for the mortgage they would need to move up the housing ladder. Indeed they may not even qualify for a mortgage on their own house if they had to buy it again today given their financial circumstances. These people are also partly behind the relatively moribund state of the housing market. And of course, unless they trade up, the next rung on the housing ladder will remain rather congested for those first-time buyers who are ready to move off their starter home and on to the next step.

MORTGAGE MARKET

Bank of England figures for the full year are not yet available, but the CML estimates that gross mortgage lending in 2012 reached £143bn, £2bn higher than the previous year, and essentially bang on the target we discussed at the beginning of the year. Lenders have stuck very close to their mortgage budgets for the year, while they are busily restructuring their balance sheets. (Chart 18)

Chart 18 – Gross mortgage lending



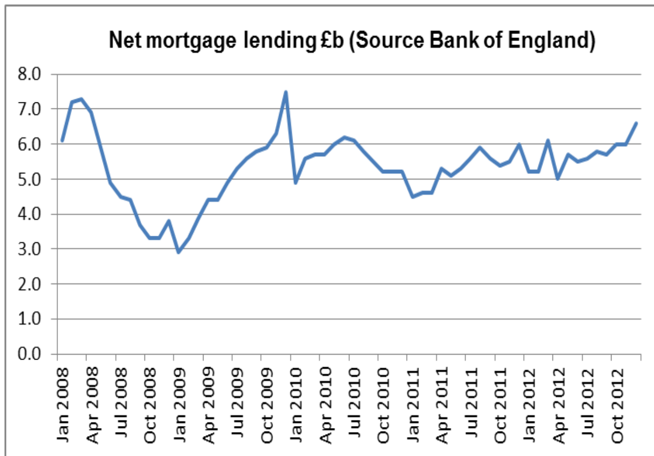
The Funding for Lending scheme will certainly help the housing market through 2013, thanks to additional funds made available to banks on the condition that they lend them to customers. So far the Funding for Lending scheme seems to be flowing more into the housing market than to businesses who may need to borrow to invest. Banks seemingly remain rather cautious about lending to small businesses at present. But it is not only this. The building societies have pretty much repaired their balance sheets, and have funds available to lend, and

are successfully gathering deposits as well. With up to £60bn in Funding For Lending available, mortgage pricing already seems to be responding. Some two year fixed rate deals have dropped to 1.99%, and there are some very innovative products coming out that are trying to help first-time buyers get on the ladder. Barclays Family Springboard product has received particularly good reviews, enabling the borrower to put down 5%, with the balance of the deposit being placed by the parents in a fixed term deposit account earning interest until their offspring has paid that portion of the mortgage down.

In accordance with a more positive tone in the Bank of England's credit conditions survey, the CML now forecasts a much punchier in £156bn gross lending for mortgages for 2013 as confidence improves and banks use the new funds to lend to households. At AMI, just to be different, we think it will be slightly lower at £155bn. Allowing the banks greater flexibility over their financing so far seems to be helping the marketplace.

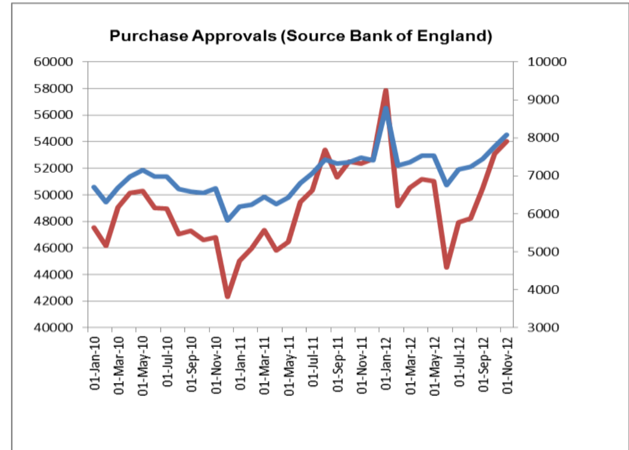
Net lending could end 2013 at about £10bn, as repayments and redemptions continue to track closely alongside the new lending. It is possible that net lending may pick up more significantly during the year, given the additional money expected at the gross level. (Chart 19)

Chart 19 – Net mortgage lending



Mortgage approvals reached 54,036 in November and for the year to the end of November, were 3% higher than the previous year, therefore broadly in line with the increase in housing transactions. In 2013, we expect mortgage approvals to rise, reflecting the greater amount of money flowing into the mortgage market. (Chart 20)

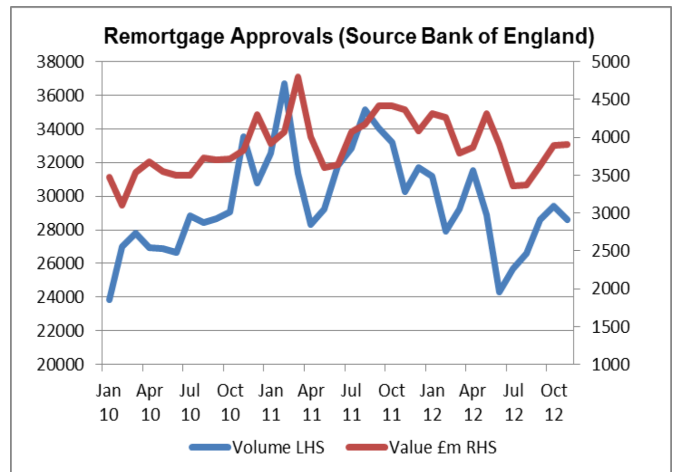
Chart 20 – Purchase approvals



It is worth remembering, that before the financial crisis, monthly mortgage approvals were roughly 90,000, and that the housing market was a significant driver of wider consumer spending. Any additional activity in the housing market will be very positive for retail sales, but also wider economic activity as for example, additional renovation gets stimulated, providing work to thousands of small building firms.

There were 43,000 fewer remortgages in the year to the end of November, as customers moved off the wave of five year fixes booked in 2006 and 2007, and three year fixes booked in 2009. Finding SVRs high, they moved on to new deals last year where they could. Those with insufficient equity are stuck on SVRs. As a result 2012 was more subdued for the remortgage market. (Chart 21)

Chart 21 – Remortgage approvals chart



Buy to Let

The buy to let market remains strong. Rents have dipped slightly in recent months, mainly reflecting seasonal factors, but overall the market is enjoying strong tenant demand. Rents are 3.2% higher than a year ago according to LSL, which is more or less in line with inflation, but above average earnings. Of course, home owners are still seeing a decline in the costs of servicing their mortgages as mortgage rates are low and falling, so the gap between the cost of renting and the cost of owning is actually rising. The total return to a landlord of owning property in 2012 was 6.2% comprised of £7835 in rental income and a small capital gain up just over £2000. Rental property is currently yielding 5.4%.

To capitalise on the strength of the market, UK lenders are introducing a wider range of buy to let products, after many withdrew from market after the crisis. There were well over 400 buy to let products on the market by the end of 2012. Arguably, buy to let is much lower risk than owner occupation, because the property comes really a rental income attached to it, and LTV ratios are low. On top of that, prices are higher, so banks can make good margins. There has also been an increase in re-mortgaging activity on homes in multiple occupation according to buy to let broker - 'Mortgages for Business'.

2013 should be a further step towards recovery for the housing and mortgage market, with buy to let being seen as a sound investment even in troubled times.

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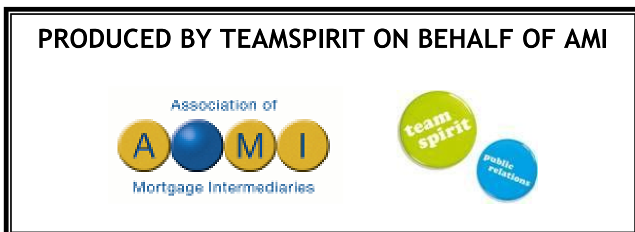

Download Nationwide's quarterly report on regional house prices

Last week Nationwide released their latest HPI report, in case you missed it you can download the full December 2012 HPI here.

You can also download the latest Q4 regional House Price Index report here.

A quick summary of regional house prices:

- 11 out of 13 UK regions saw annual price falls during 2012
- London best performing region in 2012
- Northern Ireland continued to see largest price falls
- Within England, the North/South divide in property prices continued to widen

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