QUARTERLY ECONOMIC BULLETIN

VOLUME 26 May 2013

Association of AMI Mortgage Intermediaries

HIGHLIGHTS

UK ECONOMY

- UK economy forecast to grow 0.7% in 2013
- Declining worker productivity and underemployment reflect changing mix of activity in economy and labour force
- As inflation outstrips pay rises, wages are declining by 2% in real terms
- Business investment growth expectations revised down to 1.9%, but this may be offset by increased government investment
- Contradictory policy making is seeing credit easing and improved money supply, yet further pressure on banks to increase capital ratios

HOUSING MARKET

- Steady improvement in housing market as higher LTV lending and increasing confidence bolster house prices
- Housing market geographical divide widens as renewed Eurozone fears bolster investment in central London
- Positive outlook for homeowners as repossessions fall as a result of low rates
- Help to Buy may help boost falling housebuilding figures, but restrictive planning permission remains key obstacle to widening housing supply

MORTGAGE MARKET

- First time buyer market sees strongest start to a year since 2008
- Gross lending up 2% year on year and we forecast it will hit £155bn this year
- Escalating fees may discriminate against lower end borrowers, who already face an uphill battle to save for both a deposit and stamp duty.
- Progress will be steady as lenders focus on one area of risk at a time. More high LTV products, but affordability criteria remains tough

Chart 1 – UK key economic indicators

UK key economic indicators	2008	2009	2010	2011	2012	2013 e*
GDP	0.8%	-4.8%	1.7%	0.6%	0.0%	0.7%
CPI	3.80%	2.9%	3.2%	4.2%	2.7%	2.8%
RPI	3.1%	2.4%	4.6%	4.8%	3.1%	3.3%
Claimant unemployment (m)	1.05	1.63	1.48	1.61	1.57	1.6
PSNB latest fiscal year (£bn)	£97	£156	£137	£119	£89	£110
Bank rate at end of period	2.39%	0.50%	0.50%	0.50%	0.50%	0.55%

Chart 2 – Inflation vs. wages

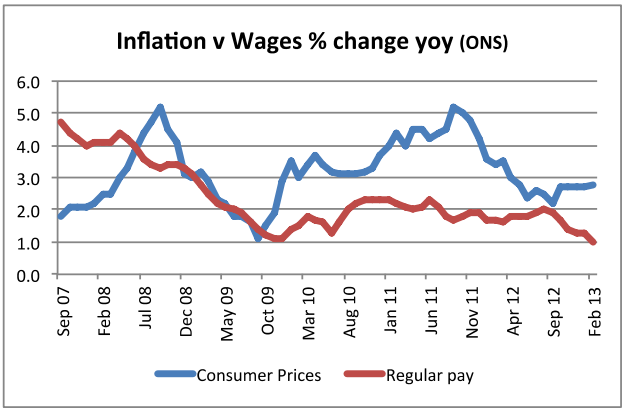
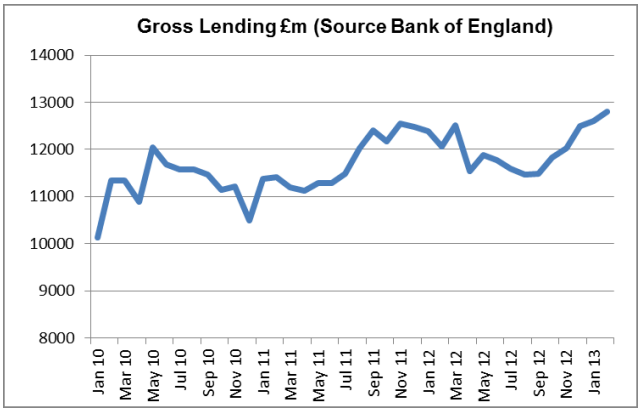


Chart 3 – Gross lending

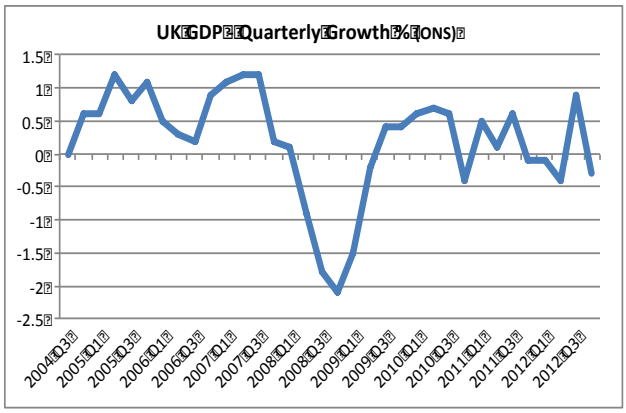


UK ECONOMY

Forecasts for the UK economy this year are down again. The IMF was the latest big organisation to trim its expectations for UK output growth in 2013 from 1% in January to 0.7% in April noting that the UK recovery is progressing, but is only doing so slowly in the context of weak foreign economies and domestic austerity. In this respect, it was merely playing catch up with everybody else, and its greater caution was part of a more negative reassessment of world GDP, which it now expects to grow 3.3% in 2013 compared to its previous forecast of 3.5%. Consensus for the UK is already at 0.7% for this year (cut from 0.9% earlier this year), with the OBR even more pessimistic, predicting expansion of just 0.6%.

The IMF also reduced expectations for 2014 from 1.8% to 1.5%, making the UK's the largest combined downgrade among the advanced economies. As sluggish as the UK economy is, it is not massively out of line with some of its main competitors, with Germany, for example, expected by the IMF to expand just 0.6% this year, while it predicts a mild recession in France.

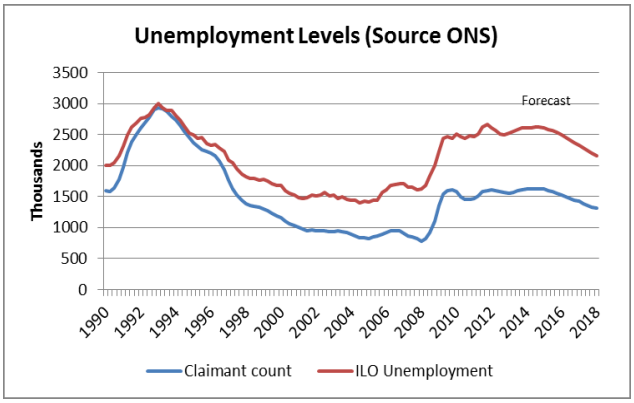
Chart 4 – UK GDP Growth



Most notably on policy, the IMF reversed its previous position, and suggested the UK government slow the path of its austerity program, accommodating higher borrowing in the short term to encourage economic activity, a notion rejected by the government.

Since January, along with slower growth, consensus estimates put inflation higher at 2.8% from 2.5%, the deficit is expected to be slightly worse, but unemployment should be a little better. Notwithstanding this, unemployment broke a trend of strong performance, rising 70,000 in the three months to the end of February according to the latest data from the ONS, pushing the total number out of work to 2.56m, or 7.9%, the highest in a year. The number of people in employment also fell, and wage growth slowed considerably. However the claimant count also fell, down to 1.53m, and there are still 71,000 more people working than a year ago.

Chart 5 – Unemployment levels



The unemployment data are somewhat backward looking, and most likely reflect the slowdown that took place in the economy towards the end of 2012. Overall, unemployment has performed very well throughout the difficult economic times of recent years, as wage growth has been kept so constrained.

Chart 6 – UK key economic indicators

UK key economic indicators	2008	2009	2010	2011	2012	2013 e*
GDP	0.8%	-4.8%	1.7%	0.6%	0.0%	0.7%
CPI	3.80%	2.9%	3.2%	4.2%	2.7%	2.8%
RPI	3.1%	2.4%	4.6%	4.8%	3.1%	3.3%
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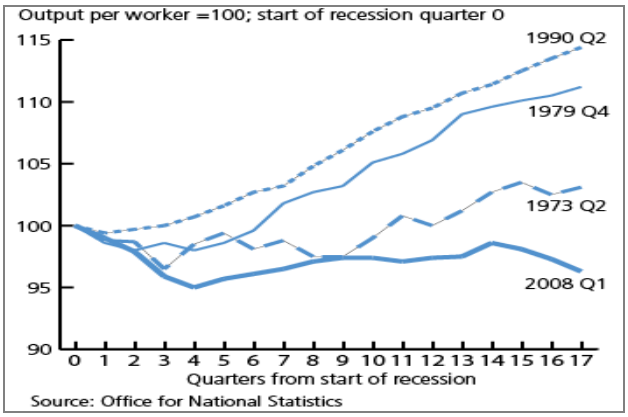
PSNB latest fiscal year (£bn)	£97	£156	£137	£119	£89	£110
Bank rate at end of period	2.39%	0.50%	0.50%	0.50%	0.50%	0.55%

*average of latest independent forecasts

The flip side of this has been very poor performance on productivity, with the UK lagging well behind its performance in previous cycles (see chart below).

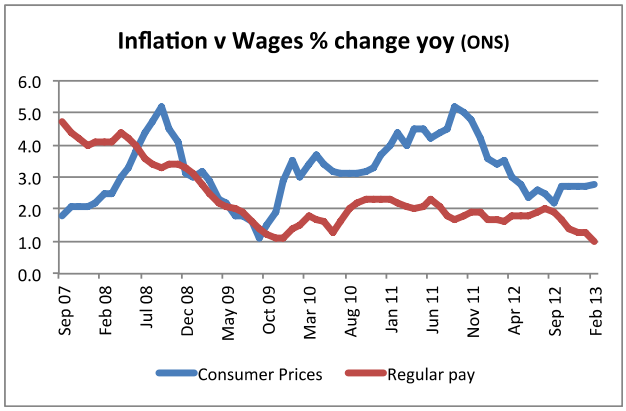
Chart 7 - UK productivity: post-recession performance



Work recently undertaken by TheCityUK and others shows how the declining productivity reflects the change in the mix of activity in the economy and changes in the complexion of the labour force. High productivity sectors have become much smaller (like financial services) while low productivity sectors like the public sector have taken up a larger share of national income and activity. That has brought the average down for the whole economy. Meanwhile, there is growing underemployment, owing to a rise in part time and self-employment (although this switch to part time employment has begun to reverse). So, although the number of workers in jobs may remain high, the number of hours they are doing is lower, and therefore the output per worker (i.e. productivity) is worse than before. Wages are also under pressure. Firms are holding onto their employees to protect the skills, but with a ready pool of flexible labour, there is no need to raise wages. At the same time firms may be substituting relatively cheap labour for capital, which is difficult to come by and expensive while bank lending remains so constrained, and that is also mitigating against a recovery in productivity. Usually more capital investment means more efficient working and greater output per worker.

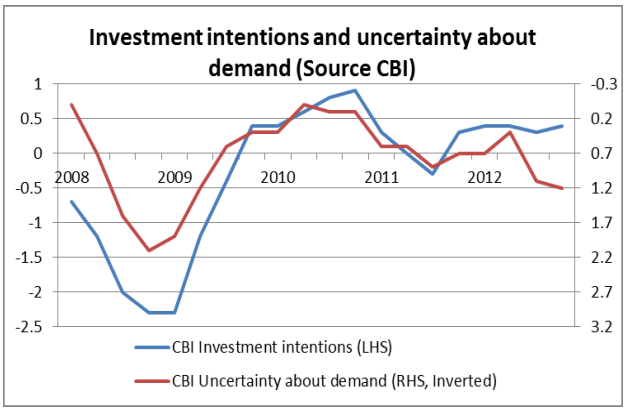
Excluding bonuses, earnings rose just 1% year on year in the three months to the end of February, one of the lowest ever increases. Including bonuses it rose 0.8%. Pay in the public sector rose significantly faster than the private sector, up 1.6% compared to 1% in the private sector (ex bonuses). Including bonuses, public sector also did better than the private sector. With CPI inflation at 2.8% in the year to March, wages are declining in real terms at a dramatic rate of almost 2%. The combination of these real wage declines with the weakness of sterling has the happy effect of significantly improving the U.K.'s competitiveness compared to other countries, at least in the short term, but its impact on economic activity is negative because it makes a big dent in consumer spending power, weakness that is showing up in the high street. This real cut in incomes explains why the OBR cut its expectations for consumer spending growth by almost half in its latest forecasts. Household consumption is a very large part of the overall economy, so a cut of 0.4 percentage points is quite significant for the overall GDP.

Chart 8 – Inflation v Wages



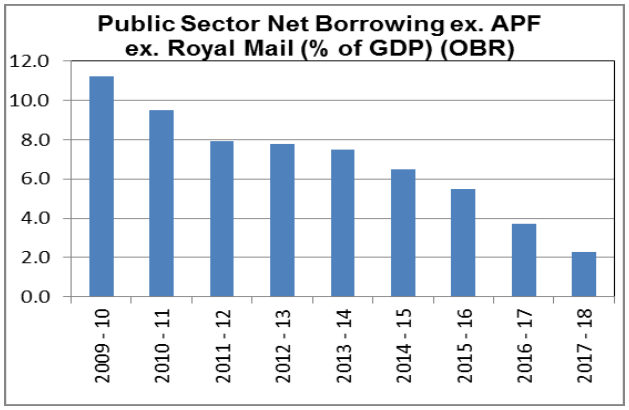
The OBR's other big downward revision was in business investment, whose expected growth rate it has now cut by three percentage points for 2013. It now thinks business investment will grow by just 1.9% this year. The constraints on lending to businesses are one of the key reasons behind the weakness, but also, while demand is weak and labour cheap, businesses have less incentive to invest as well.

Chart 9 - Investment intentions and uncertainty about demand



The OBR has however upgraded significantly its forecast for government investment. When the coalition came to power it slashed investment spending very hard. Investment spending is politically easy to cut in the short term, although for the long term it is a very bad idea not to keep investing in the country's infrastructure. Infrastructure investment increases the productive capacity of the economy and helps keep it competitive. More recently the government has announced increases in investment spending, and brought forward future plans in order to try and stimulate the economy. This is a very good idea. Current spending cuts can continue if investment remains healthy.

Chart 10 – Public Sector Net Borrowing



We have avoided a triple dip recession, but we should remember that with output essentially flat, a quarter here or there of slightly negative or slightly positive growth is just a continuation of the same sluggish position that we have been experiencing the last couple of years.

Chart 11 – OBR Forecasts

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast[1]					
	2011	2012	2013	2014	2015	2016	2017
Output at constant market prices							
Gross domestic product (GDP)	0.9	0.2	0.6	1.8	2.3	2.7	2.8
GDP Level (2011 =100)	100.0	100.2	100.8	102.6	105.0	107.8	110.8
Output gap (per cent of potential output)	-2.7	-2.7	-3.6	-3.7	-3.4	-2.9	-2.3
Expenditure components of GDP at constant market prices							
Household consumption[2]	-1.0	1.0	0.5	1.2	1.7	2.4	2.8
Business investment	3.1	4.9	1.9	6.1	8.6	8.6	8.6
General government consumption	-0.1	2.6	0.4	-0.7	-0.4	-1.0	-1.8
General government investment	-26.2	2.7	2.6	5.0	1.8	-1.5	-1.2
Net trade[3]	1.2	-0.8	0.1	0.1	0.1	0.1	0.1
Inflation							
CPI	4.5	2.8	2.8	2.4	2.1	2.0	2.0
Labour market							
Employment (millions)	29.2	29.5	29.8	29.9	30.1	30.3	30.5
Average earnings[4]	2.3	2.1	1.4	2.7	3.6	4.0	4.0
ILO unemployment (% rate)	8.1	7.9	7.9	8.0	7.9	7.4	6.9
Claimant count (millions)	1.53	1.59	1.58	1.63	1.59	1.48	1.38
	Changes since December forecast						
Output at constant market prices							
Gross domestic product (GDP)	0.0	0.3	-0.6	-0.3	0.0	0.0	0.0
GDP Level (2011=100)[5]	0.0	0.3	-0.3	-0.6	-0.6	-0.6	-0.6
Output gap (per cent of potential output)	0.0	0.3	-0.1	-0.3	-0.3	-0.3	-0.4
Expenditure components of GDP at constant market prices							
Household consumption[2]	-0.1	0.4	-0.4	-0.3	-0.1	-0.1	-0.1
Business investment	0.2	1.1	-3.0	-2.1	-1.6	-1.5	-0.9
General government consumption	-0.3	0.2	1.1	0.7	0.8	1.1	1.3
General government investment	-5.9	11.9	5.1	0.1	4.8	1.1	-1.9
Net trade[3]	0.0	-0.1	-0.1	0.0	0.0	0.0	0.0
Inflation							
CPI	0.0	0.0	0.3	0.2	0.1	0.0	0.0
Labour market							
Employment (millions)	0.0	0.0	0.2	0.1	0.1	0.1	0.1
Average earnings[4]	0.1	-0.7	-0.8	0.0	-0.1	0.0	0.0
ILO unemployment (% rate)	0.0	0.0	-0.3	-0.2	-0.1	-0.2	-0.2
Claimant count (thousands)	0	-4	-78	-63	-41	-49	-53

[1] The forecast is consistent with the second estimate of GDP data for the fourth quarter of 2012, released by the Office for National Statistics on 27th February 2013.
[2] Includes households and non-profit institutions serving households.
[3] Contribution to GDP growth, percentage points.
[4] Wages and salaries divided by employees.
[5] Per cent change since December.

Chart 12 – GDP fan chart

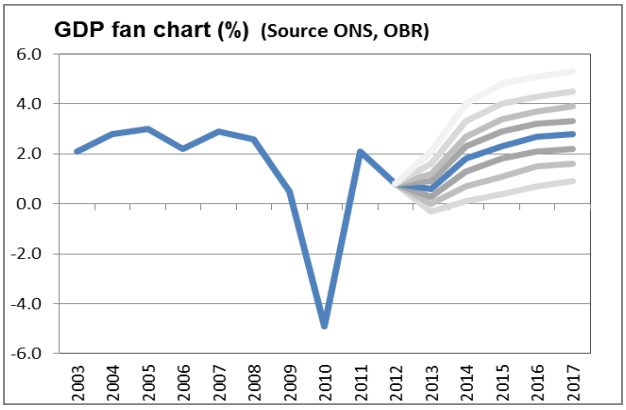
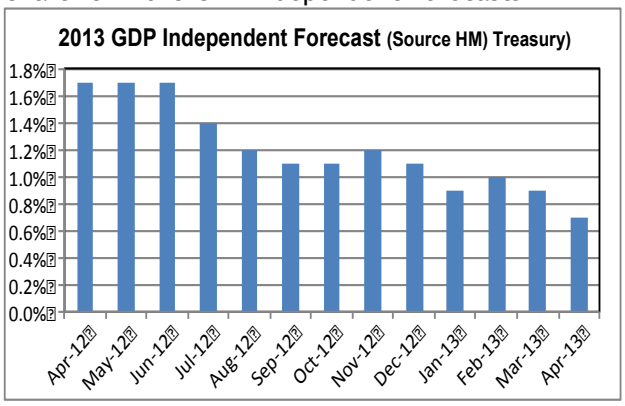


Chart 13 – 2013 GDP Independent Forecasts



How the Bank of England should respond to the economic picture is causing controversy, not least within the reinforced walls of Threadneedle St. Each month between February and April, the governor voted for £25bn more quantitative easing, but each time was outvoted by the other MPC members to keep the total at £375bn. May is a key month because the Bank publishes new economic forecasts at that time, but it is clear that although asset purchases may begin again, the Bank is unlikely to do so before the new governor takes up his post in July. The IMF has suggested that the Bank of England should widen the pool of assets that it buys to take more than just government securities, perhaps including corporate bonds, for example, as a way of lowering borrowing costs and easing access to finance for companies wanting to invest. Mervyn King has consistently opposed to this view, but the new governor may take a different line.

Inflation expectations have drifted up and with sterling weak, the committee is judging the lever of more money supply may create demand in an economy without the flexibility to supply it. With inflation in any case likely to move up above 3% later in the year, the committee instead wanted to see

more action to free up the credit market, and an extension of the £80bn Funding for Lending Scheme has been agreed as a direct means of getting loans to businesses and homebuyers. Funding for Lending does already seem to have had some impact on the mortgage market. Mortgage rates have come down and there are some extremely attractive mortgage deals on the market. But there is still not enough lending reaching businesses, according to HMT, the Bank and the IMF - the rationale behind incentivising increased lending to small businesses in the changes. Bank of England data in March showed that £13.8bn had been drawn down from the FLS by the thirteen participating banks by the end of December since the scheme began in August. However the stock of lending had actually fallen by £1.9bn owing to shrinking loan books at RBS, Lloyds and Santander, by £2.4bn, £5.6bn and £6.3bn respectively. Barclays has been the most enthusiastic user of the scheme so far, accounting for £6bn of the £13.8bn drawn down, and increased lending by a similar amount. Nationwide took £2bn and increased lending by £3.6bn.

These figures demonstrate the schizophrenia at the heart of policy making. While credit easing and money supply levers are pulled to encourage activity and lending, regulators are bearing down on the banks to increase their capital ratios. The new Financial Policy Committee, the part of the Bank of England responsible for managing the financial sector, declared in March that banks need an additional £25bn in capital to cover further losses in their books. All other things being equal, that means less lending and less profitable banks – not a good way to encourage a return to brisk activity, and at odds with the policies like the extension of the FLS.

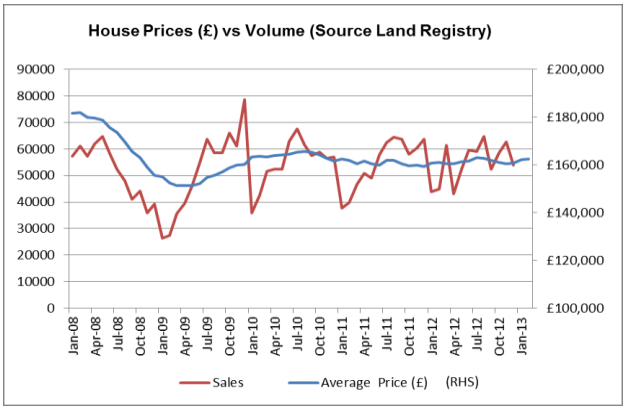
Overall, the picture for the economy looks pretty uninspiring, but there is a very slow and gradual improvement underway. We don't think the unemployment figures will deteriorate much, and even if inflation rises a little bit further from here, it is not going to go significantly higher. Most importantly for brokers, there have been signs of life in the housing market, with greater activity on transactions and mortgage lending, spurred by government initiatives such as the Help to Buy scheme and Funding for Lending. That is certainly very positive.

HOUSING MARKET

While the housing market hasn't hit anywhere like its pre-crunch heights in the first three months of the year, conditions do seem to be improving – albeit gradually.

The housing market is in the ideal position of being a lever that the government is trying to pull to help bolster the economy. While there is still more that can be done, the Help to Buy scheme is a welcome extension to the NewBuy scheme, and lenders and borrowers alike are already benefitting from the cheaper money on offer through the Funding for Lending scheme. As a result of interventionist policies, Ernst & Young Item club predicts transactions will climb by 7.5% across the UK, to hit 1m this year, calculating that that the £3.5bn Help to Buy scheme will eventually be able to fund 100,000 mortgages.

Chart 14 – House prices (£) vs. volume



Borrowers are already starting to see increased high LTV lending trickle through following the introduction of FLS and house prices have demonstrated steady annual growth as a result; the major lender indices are pointing in the same direction. Halifax recorded a 1.1% annual rise in March, while Nationwide's figure put the increase at 0.8%.

But the picture is far from uniform across the country. While prices have risen 6.3% annually in London, and 2% in the South East according to the latest Land Registry data, they've actually fallen in four regions (chart 15).

Chart 15 – Annual change in house prices by region. Source: Land Registry House Price Index

Region	Monthly change Monthly Change (%)	Annual change Annual Change (%)	Average price (£)
London	-0.1%	6.3%	£370,819
South East	0.6%	2.0%	£211,749
East	-0.4%	0.3%	£173,846
South West	-0.8%	-0.7%	£170,299
West Midlands	-0.5%	-0.1%	£129,406
East Midlands	0.4%	0.3%	£122,653
Yorkshire & The Humber	1.3%	-0.9%	£116,567
Wales	3.6%	1.7%	£120,410
North West	3.3%	-0.6%	£110,608
North East	3.4%	4.3%	£100,363

Much of the upwards thrust in house prices in the capital remains driven by overseas and cash buyers looking for an asset that has demonstrated its past resilience in the face of a struggling economic climate. As a result, homes in central London have seen the fastest rises. Properties in Kensington & Chelsea are worth 12% more than a year ago. By way of contrast, Barking & Dagenham has seen prices fall nearly 2% over the same period. With the Eurozone crisis rearing its head once more, we expect continued investment from overseas to perpetuate this regional disparity.

House price sentiment seems strong – a recent Halifax survey suggests 45% of respondents expect prices to rise this year, the strongest optimism in two years, while just one in eight expect prices to fall. However, signs of confidence are returning in the industry too. Estate agents and brokers alike have been generally reporting increase in underlying activity in 2013. Although there were only around 2,400 more sales in England and Wales in 2012 than the previous year, we anticipate a more significant increase in 2013.

That said, sales activity is still being impacted by the time it is taking for a whole chain to complete. Conservative valuations continue to slow the sales process, while we still need more bottom-up impetus from first-time buyers to free buyers further up the chain.

Repossessions figures also point to a better outlook for homeowners. The latest figures in the Land Registry – a recent addition to their monthly data – show that repossessions in December actually fell by 26% compared to the same month in 2011. Rock bottom interest rates and Funding For Lending are making the cost of financing a mortgage historically low, while lenders continue to show forbearance on non-performing loans. With the relative stability in the employment market –the increase between December and February notwithstanding - fewer borrowers have lost jobs and so have been unable to keep up with historically low payments. However, one side-effect of the low level of repossessions nationwide is the reduced number of properties being released onto the market, a knock-on effect that is supporting house prices and dampening overall transaction numbers.

With repossessions levels low, a key stumbling block for transactional activity – and conversely a strut for house prices – remains the lack of new homes being built. In 2011-12, although 129,560 new homes were started, this represents a drop of 8% on the previous year, and points to a continuing undersupply of homes in the medium-term in the face of far more rapid household formation.

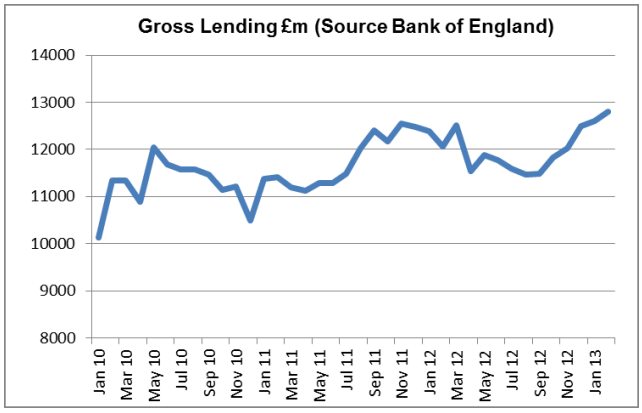
The Help to Buy scheme announced in the budget should help here, building on the limited progress of the NewBuy scheme which only resulted in 1,500 new home sales in its first nine months, according to the HBF. But while Help to Buy may help builders sell existing stock - and therefore finance new developments, it's not a game changer. The time it takes to secure planning permission and build new properties remains a significant hurdle to opening up the long-term supply.

MORTGAGE MARKET

Like the wider housing market, the mortgage market is seeing a step by step recovery, and the year has started positively given the lassitude in the wider economy.

According to the CML, the first-time buyer market saw the strongest start to the year since 2008, with first time buyer house purchase loans accounting for 43% of all new mortgages in February. Overall, gross lending in the first two months of the year was 2% higher than at the same point last year, totalling £25.4bn. There is some way to go, but given the last year's start to the year was boosted by those hurrying to beat the end of the stamp duty exemption, we believe lending will still hit our full year forecast of £155bn.

Chart 16 – Gross mortgage lending

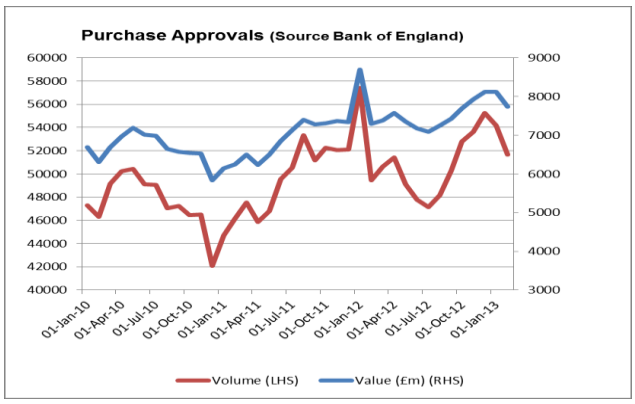


Net lending totalled £11.5bn in 2012. Although redemptions and repayments have not been drastically outstripped by new mortgage lending in the early part of the year, we will likely see 2012's net lending total overtaken as availability improves.

The Bank of England's latest Credit Conditions Survey has reported easing credit conditions for those seeking mortgages with an LTV higher than 75% for a third successive quarter. As previously discussed, not all lenders have grown their loan books despite the FLS. But those lenders making the most of the cheaper funding - circumventing costlier wholesale funding markets - are competing for market share, and headline rates continue to trend downwards. Indeed, on average lenders also expect spreads to tighten over the second quarter as a whole, which points to even lower rates.

As a result of better options for buyers with lower deposits or equity in recent months, and following a strong surge towards the end of 2012, mortgage approvals stood at 51,653 in February, up 4% on a year ago, and 2% above the average of the previous twelve months.

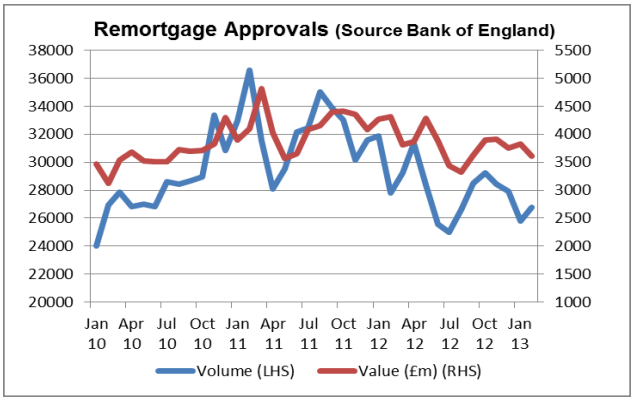
Chart 17



However, lenders are taking one step at a time approach to lending criteria. While the availability of high LTV products may be increasing, banks and building societies have by no means slackened their affordability criteria. The CML reports that in February the average income multiple for a first time buyer actually fell to 3.19, down from 3.26, while there was a similar story for home movers. We are seeing lenders address one particular area of risk at a time, rather than simply loosening criteria across the board.

In the year to February, there were 332,766 remortgages, 12% fewer compared to the previous 12 months. Many borrowers are still waiting for value to rise further to build enough equity to remortgage onto more favourable products, but those that are favouring longer-term fixed rate products.

Chart 18 – Remortgage Approvals



Mortgage fees have hit the headlines lately, and as rates have dropped, the initial fee payable to secure a mortgage product has increased. Moneyfacts calculate that the average fee is now £1,522, the highest in 25 years. Initial arrangement fees are good news for lenders' balance sheets, allowing profit to be booked on day one. However, the concern is that escalating fees may discriminate against lower end borrowers, who already face an uphill battle to save for both a deposit and the cost of the stamp duty tax. In this environment, advice will be more crucial than ever, and prospective borrowers will need the insight of intermediaries to navigate beyond headline rates to find the most affordable and appropriate mortgage products.

BUY TO LET

2012 saw buy to let lending reach its highest in four years, with new 136,900 loans compared to 121,500 in 2011, according to the CML's latest figures. In

fact, buy-to-let is growing as a proportion of the mortgage market. In 2012, it accounted for 11.5% of gross lending, up from 9.8% in 2011. Tenant demand is strong, and according to LSL Property Services, rents are rising at 4.2% annually, protecting an investment against the effects of inflation, without factoring long-term capital gains. Returns look healthy, with the average landlord making a total annual return of £10,329 in the year to April.

That said, new buy to let borrowers are finding it more difficult than experienced investors. Lenders are still concerned over repossessions, and affordability criteria remain a difficult obstacle for many prospective new landlords. Equity too, is king, and the rates enjoyed by investors who can supply a 40% deposit are still far cheaper to those with just 25%, as lenders price sensitively to mitigate risk.

Tenant arrears remain an issue that landlords and their advisers must be vigilant of, especially in a context of rising rents. Templeton LPA report that in the first quarter, the number of tenants in more than two weeks of arrears climbed to 94,000. Despite this, the proportion of buy to let borrowers in mortgage arrears is much lower than that of owner occupied. 1.14% of buy to let loans were in three months of arrears or more at the end of 2012, compared to 2.03% of owner occupied loans.

While there are certainly more reasons to be optimistic about the wider mortgage market in 2013, the sheer weight of tenant demand and the relatively cheap rates for those who can secure finance means buy to let will be at the centre of any sustained growth in the mortgage market.

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Download NFI's quarterly report on regional house prices

Nationwide recently released their latest HPI report, in case you missed it you can download the full March 2013 HPI here.

You can also download the Q1 regional House Price Index report.

A quick summary of regional house prices:

- 7 out of 13 UK regions saw annual price rises in the first quarter of 2013
- London remains best performing region on an annual basis, with prices at a new record high
- Scotland is the worst performing region in Q1

Download the full Q1 regional report here.

For further information about Nationwide For Intermediaries visit their website or contact your local BDM.