Association of Mortgage Intermediaries

# Quarterly Economic Bulletin

## Volume 16 | November 2010

# ECONOMIC QUARTERLY BULLETIN

## VOLUME 16 October 2010

Association of AMI Mortgage Intermediaries

## HIGHLIGHTS

### ECONOMY

- National debt will reach 70% of GDP in 2013-14, even after proposed cuts and tax increases
- Annual deficit forecast to hit £149bn this year, 10% of GDP
- Economic growth difficult to forecast, more quantitative easing may be introduced

### OUTLOOK FOR THE BANKING SECTOR

- Liquidity remains tight
- Regulatory uncertainty as separation of retail and investment banking is still a possibility
- Questions over how sector will finance itself with £200bn of Special Liquidity Scheme to repay

### HOUSING MARKET

- Housing market continues to slow as mortgage finance constraints remain key obstacle for buyers
- Stock of homes for sale has risen, while buyer demand has weakened
- South east outperforming north, which will be hit by public job losses

### MORTGAGE MARKET

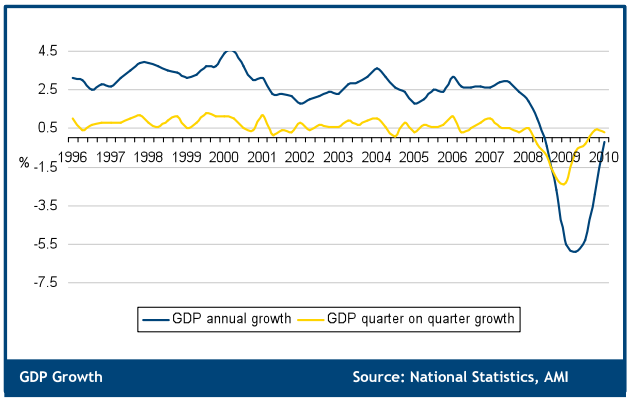
- No increase in lending volumes expected
- Progress in availability of higher LTV products has been curtailed
- Mortgage approvals expected to rise fractionally, but little energy in remortgage market

Chart 1.

| UK key economic indicators | 2008 | 2009 | 2010 e* | 2011 e* |
|---|---|---|---|---|
| GDP | 0.8% | -4.8% | 1.6% | 1.8% |
| CPI | 3.80% | 2.9% | 2.7% | 2.5% |
| RPI | 3.1% | 2.4% | 4.1% | 2.6% |
| Claimant unemployment (m) | 1.05 | 1.63 | 1.51 | 1.58 |
| Bank rate at end of period | 2.39% | 0.50% | 0.60% | 1.3% |

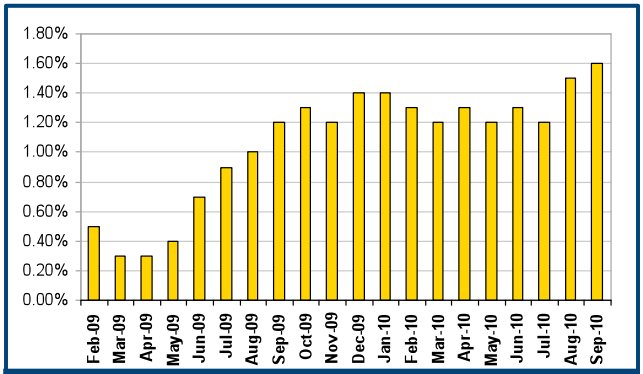
* average of latest independent forecasts

Chart 2.



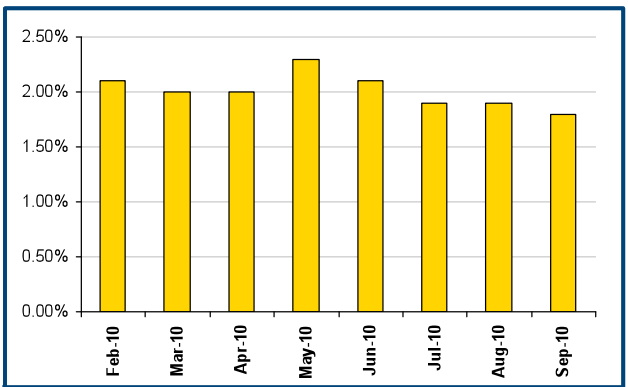

GDP Growth Source: National Statistics, AMI

Chart 3.




Predictions for 2010 GDP Source: HM Treasury

Chart 4.



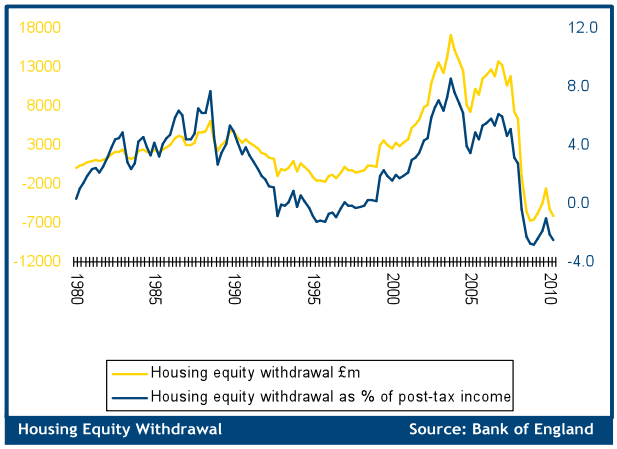

Predictions for 2011 GDP Source: HM Treasury

## ECONOMY

The spending review has dominated the UK economic and political scene since the election in May. The financial crisis did not cause the fiscal one, but it did hugely exacerbate the problems of what were already badly managed public finances. Much controversy centres on whether taking the axe to public services is an ideological act of a centre-right government intent on rolling back the frontiers of a state bloated by the spendthrift instincts of a previous centre-left government, or a necessary and immediate action to rescue the economy from a huge fiscal crisis. It could be both. The extent to which it is borne out of right-wing ideology matters because the desire to usher in a smaller state as soon as possible, regardless of the economic consequences, could easily see the UK slip back into recession. If it is based purely on an economic judgement that growth is strong enough now to allow us to tackle the gaping holes in the public finances and stop the national debt spiralling out of control, then it should help create a sound foundation for the future.

Martin Wolf, the respected FT economist, has consistently argued against excessive austerity. Cutting public debt when the private sector is also retrenching can only lead to a downward spiral. The UK has significant indebtedness in the private sector and consumers and companies are indeed focused on paying down debt. Since the second quarter of 2008, for example, housing equity withdrawal has been a negative £44bn as consumers seek to repay mortgage debt, rather than borrow against the value of their homes for consumption or investment elsewhere. The third quarter is likely to add roughly another £4-5bn to that total, making it the longest sustained period of rebuilding housing equity on record, and by far the largest amount in cash terms. By the end of September this year, more than half of all the equity withdrawn from housing for consumption during the boom years of 2006 and 2007 will have been paid back.

Chart 5.

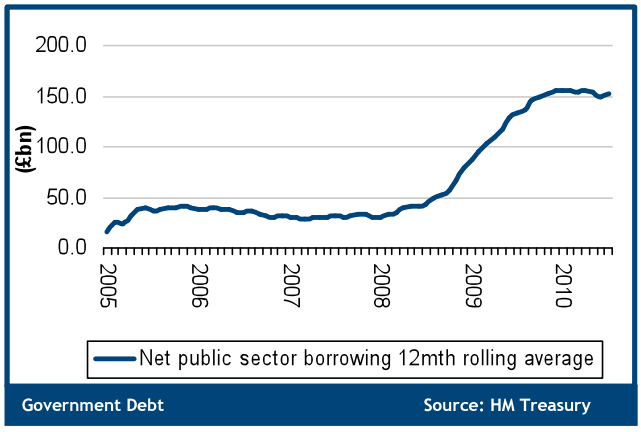



We expect this trend to continue for some time to come. New mortgage lending is also very low as the appetite for further leverage remains muted. Companies have also been restructuring their balance sheets, deleveraging and bolstering their capital bases – it's not only the banks who have been issuing new equity and cutting dividends. Wolf points out how countries should not run their budgets as if they were households. Borrowing in bad times is the solution countries should take to keep their economies going. This deficit spending is the method the UK and other advanced countries have used in the last two years to avoid a damaging slump. Government debt of course rises sharply, but when the private sector is ready to expand again, the deficit can be brought under control, while renewed economic growth will shrink the size of that debt relative to GDP, bringing it in turn, back under control.

When consumers and companies are busy paying down debt, it is arguable the government should not be following suit and cutting aggressively, given the dampening effect it can have on the economy. This is the heart of the double-dip recession argument.

The government argues that not to act to bring the deficit swiftly under control risks Britain's credit rating, and brings the prospects of sharply higher interest rates and in turn, another recession. Remember at this point the government is still only talking about cutting the deficit (the shortfall of tax income against public spending), not cutting the net national debt (excluding the cost of bank recapitalisations) which will continue to rise sharply, from 35% of GDP a few years ago, to over 70% in 2013/14 (excluding the cost of bank recapitalisations, even after taking into account the spending cuts and tax increases to come.

Chart 6.




The experience of peripheral eurozone countries such as Greece, Ireland, Spain and Portugal shows how sharply interest rates can rise when the markets doubt a country's ability to finance itself. In the UK, yields on government debt have remained very low, and have fallen slightly since the election, indicating the markets are giving the thumbs up to an austerity drive.

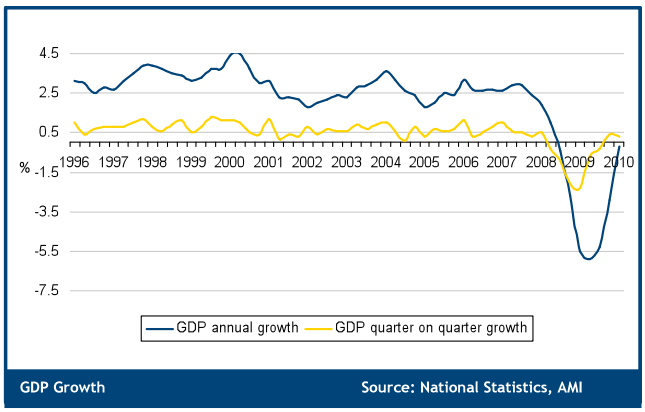
This year the deficit is forecast to be £149bn, down a mere £6bn from 2009/10, equivalent to 10% of GDP, and boosting our total indebtedness as a nation to 62% of the size of our economy. Mervyn King, governor of the Bank of England, has been urging the government to have a clear and credible plan for reducing the deficit, providing important support for George Osborne's plans. The IMF is also backing the government. The Treasury has pencilled in £23bn of cuts in 2011/12 (plus £10bn of tax increases), rising to £83bn by 2014/15 (the equivalent of dispensing with all the armed forces, all schools and Wales).

It is true that austerity should not be taken too far. Ireland seems to be demonstrating how very sharp public spending cuts can then push an economy back into recession, making the debt burden higher. Our judgement is that the government is right to be pushing ahead with its programme fiscal consolidation. It is not as draconian as Ireland's and does not start to bite until next year. £81bn of annual reductions by 2014/15 is enough to eliminate the structural deficit, assuming the economy does not deteriorate significantly. The strong Q3 GDP figures have given the government breathing space and confidence the recovery can withstand the cuts.

It doesn't feel like it to most consumers and most businesses, especially those operating in the mortgage industry, but if the economy expanded over the summer, which survey data suggest it did, then it has been growing for a year, with the recession ending in Q3 09. The economy grew a rapid 0.8% in Q3 (see chart 7), boosted by construction, which had until recently seemed lacklustre, and stronger than expected consumer demand. The revised Q2 data also offered some relief as the preliminary numbers

suggested only public spending was sustaining the recovery.

Chart 7.




Consumption has recently picked up as consumers save a bit less - the household savings ratio was until recently been well above the average for the decade as consumers put money by, but it dropped to a two year low of 3.2% in the second quarter (reflecting the rebound in economic growth and confidence).

Chart 8.

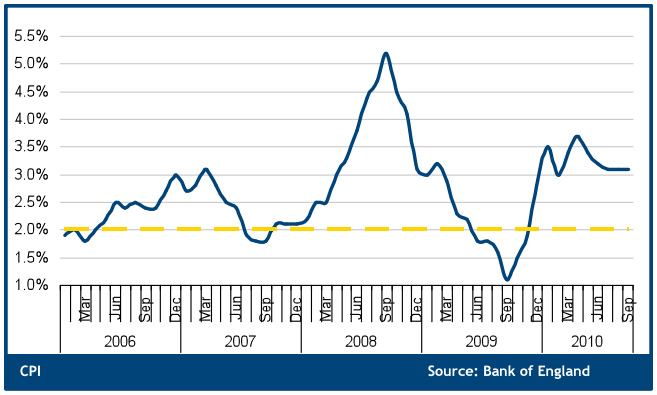
Strong retail surveys suggest this continued in the third quarter too, even though earnings growth (now accelerating, but still only up 2% yoy in August) is below inflation). Unemployment is falling, having just reached 7.7%, a pretty strong performance, although public sector job cuts may now push it higher, while a cutback in demand for services by the government will also cause some job losses in the private sector too.

Chart 9.

There is no certainty this is a renewed strong trend for the economy after the recent successes, and one quarter of strength could easily be followed by a softer one. Investment and exports are the most favoured sources of growth and where the government is pinning its hopes, but there is little evidence of an export driven growth surge, or a significant drop in Britain's current account deficit. Running a current account deficit essentially means that British consumers are supporting economic activity in other countries, rather than our own.

The economy has recovered better than we expected, but it remains on life support with interest rates very low and £200bn of additional money from the quantitative easing programme still circulating, while the effect of sharply tighter fiscal policy is yet to come. Price inflation is unfortunately still stubbornly high, thanks in large part to the depreciation of sterling and also to the rising costs of commodities from oil to wheat. Price rises have slowed, though. RPI fell to 4.6% in September from 5.3% earlier this year, while CPI has come down from 3.7% to 3.1% (see chart 10). But inflation still being above target, and inflation expectations continuing to rise, have made it tougher for the Bank of England to provide more stimulus.

Chart 10.




The MPC is also divided on what to do. David Miles and Adam Posen, both prominent members of the MPC, recently disagreed with colleague and interest rate hawk Andrew Sentance, pointing to how few signs there were that a normal recovery, with rising wages, rapid lending growth and growing consumer and industry confidence, was under way. Sentance frets about inflation and believes the recovery has firmer footings.

Chart 11.

There is no chance of a rise in interest rates in the short term, and the consensus view that rates will end next year at 1.3% is rather heroic given the fragile state of activity.

Chart 12.

| UK key economic indicators | 2008 | 2009 | 2010 e* | 2011 e* |
|---|---|---|---|---|
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In fact, rather than tightening, another round of quantitative easing (QE2) is a distinct possibility. Adam Posen wants it soon, and highlights the need for it to focus on private assets (as in the US) rather than government debt. If the Bank of England buys corporate bonds or other assets on bank balance sheets, that would certainly create more liquidity in the banking sector and in the lending markets. The apparent failure of the first round of QE to achieve this is one of its main criticisms, although no-one can tell you what would have happened if it had not been done. The hope is that bond markets would take QE2 positively, pushing yields down and making money cheaper for the whole economy. It is a risky strategy, however, as QE is, eventually, and by its nature, inflationary. Timing its reversal would be crucial and by no means an easy task. Bond yields would rise sharply if the moment was missed, and a painful interest rate squeeze would be needed to eliminate unwanted inflation.

To sum up, the UK economic road is particularly obscure at the moment, making it especially hard for policy makers to formulate the right response. What has to be done over the medium to long term is crystal clear – eliminate the budget deficit and ideally move to a surplus to speed the process of reducing the national debt burden. How quickly and aggressively to take the necessary measures is the where the dilemma rests.

**OUTLOOK FOR THE BANKING SECTOR**

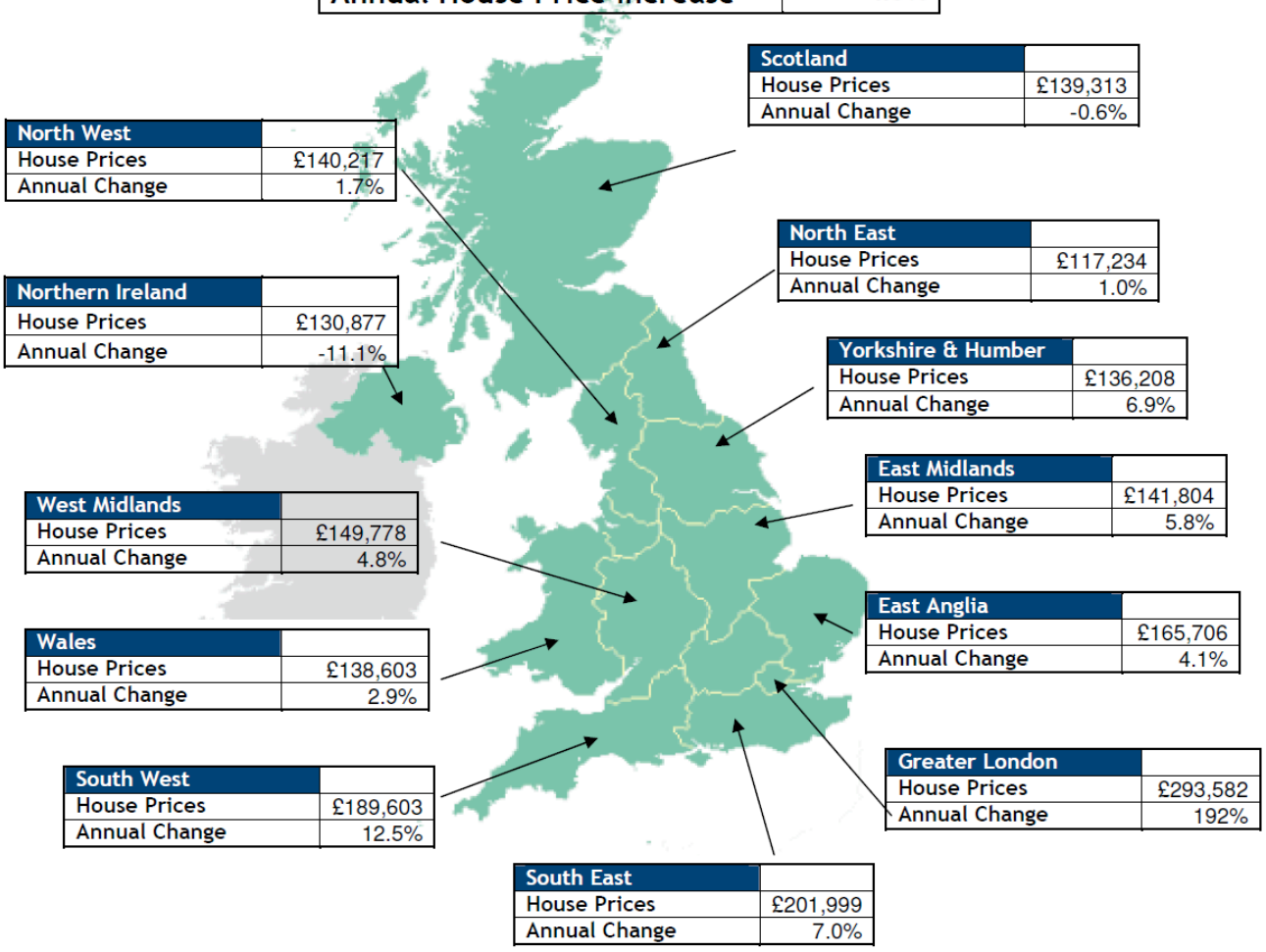
The banking sector is still not functioning normally. Liquidity is tight, lending is low, and wholesale markets are disfunctional. Meanwhile regulatory uncertainty is raising existential questions for the banking industry and raising the prospect of defections by UK banks to other, kinder, territories. The government has not yet addressed the shape of the banking sector, but the rhetoric suggests it does not seem disposed towards leniency. The separation of retail and investment banking is still on the table, and industrial policy will be tilted towards reducing our heavy dependence on finance as the largest industry in the UK, perhaps aiming to halve the size of the banking sector as a share of GDP over time.

There is also still the question of how the sector will finance itself as the special liquidity scheme (SLS) begins to withdraw its £200bn support from April next year, while also rolling over another £500-600bn in other short term financing over the next year to eighteen months. They are currently not raising enough to meet this need, and face higher capital requirements under Basle 3 too. Standard Chartered, one of the strongest UK banks (thanks to its largely Asian business) has just announced a large rights issue to bolster its own capital, even though it is already relatively well capitalised. Others may need to follow. The conditions for strong credit growth to flourish certainly are not present and we continue to believe the SLS will have to be wound down over a longer period than the Bank of England is at present prepared to concede.

**HOUSING MARKET**

Chart 13.

## UK House Prices

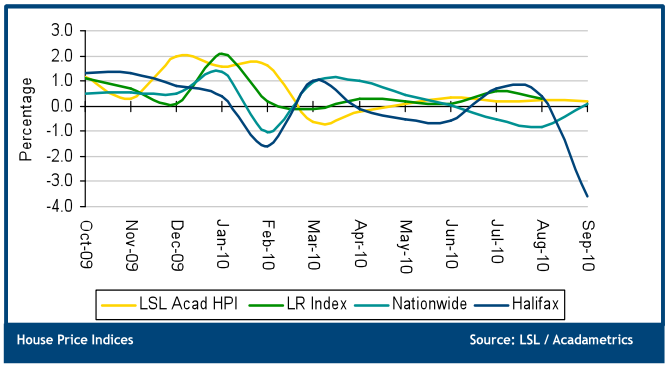



SOURCE: NATIONWIDE, Q3 2010 REGIONAL HOUSE PRICE QUARTER AVERAGES

## HOUSING MARKET CONTINUED

Average property values in England as a whole are 8.7% below their peak levels of 3 years ago according to Zoopla.co.uk's valuation model and now stand at £225,045, but are up by 11.2% over the past 18 months from the lows reached in March 2009, with southern regions faring best, and likely to continue to do so as public spending cuts hit the more heavily state-dependent northern regions. But the housing market continues to slow. There is a lot of conflicting information out there from different indices, with the September Halifax figures, which implausibly showed a record 3.6% decline, creating particular hysteria. The more reliable three month trend from Halifax shows a more modest 1% drop in values. Nationwide reported a 0.1% increase, and a similar 1% drop over three months. The LSL/Acadametrix index whose statisticians essentially try to bring the Land Registry index up to date showed a 0.3% increase in September. Their index is based on a much larger sample than Halifax, includes a broader range of home values, and includes cash purchases, which the lender's statistics naturally do not.

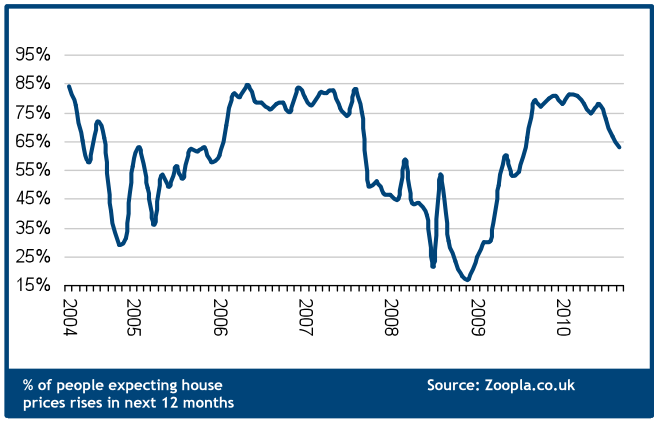
Chart 14.




Cash purchases make up a very significant share of some local markets – currently over two thirds in some prime central London areas, according to estate agents Marsh & Parsons. On a national basis, cash buyers accounted for a quarter of purchases in the first eight months of the year (based on the difference between the number of loans advanced and the number of housing transactions).

Crucially, the supply of homes for sale has risen this year (partly stimulated the abolition of HIPs) while at the same time, demand for property has weakened markedly. Buyers are increasingly biding their time and refusing to bid up property, safe in the knowledge there is less competition from rivals, and other homes to choose from. Confidence in the outlook for prices is also still slipping.

Chart 15.

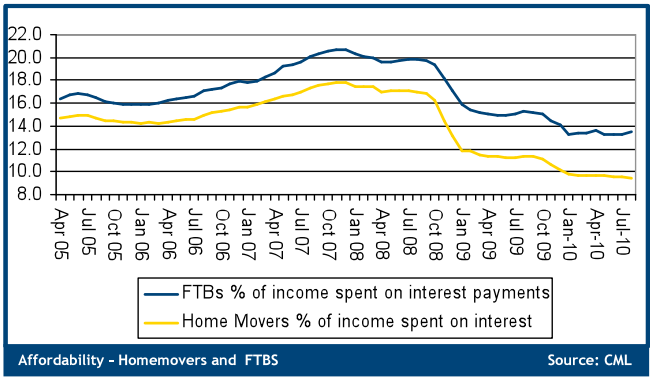



Zoopla.co.uk's quarterly confidence survey still shows two thirds are optimistic, perhaps because it questions people actually engaged in house-hunting, buying and selling, but the proportion of respondents expecting prices to fall has more than doubled since the spring to one in four.

Affordability is certainly not a problem, given the low level of interest rates and lower home values. Just 9.5% of the average home mover's income is spent on mortgage interest according to the CML, almost half the peak at the end of 2007 (see chart 16). First-time buyers are now spending one seventh of their

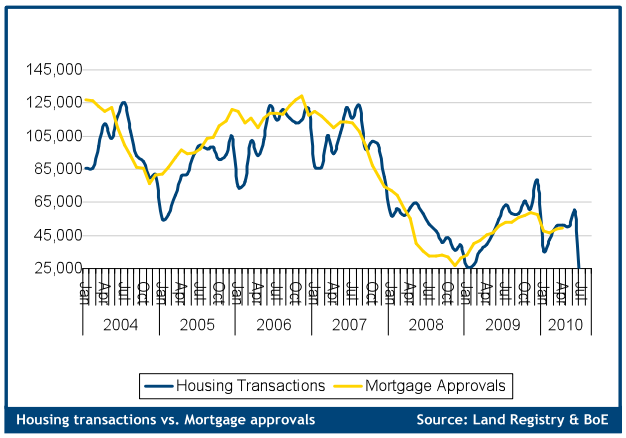
income on mortgage interest, compared to just over a fifth at the peak.

Chart 16.




Transactions are sharply up on a year ago, but the pace of improvement is slowing even though we are still well below the peak. They rose 8.6% in June (latest confirmed Land Registry figures), following 30-50% rises in preceding months (see chart 17). LSL/Acadametrix estimate the number of homes sold in September rose 11.4% over September of last year and was up on August. Since January LSL estimates just short of half a million (498,700) homes have been sold in England and Wales, 62% of the long term average number of housing transactions for the same period over the last fifteen years.

Chart 17.

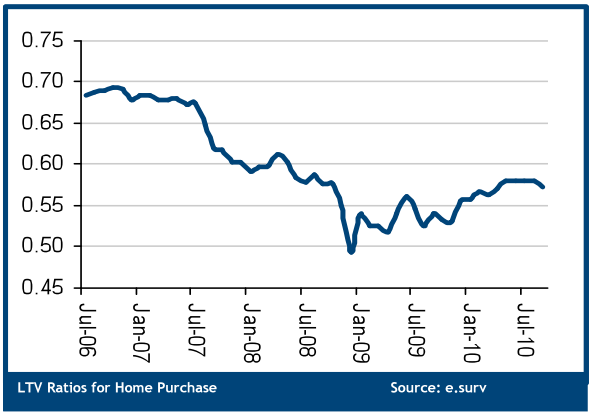



The housing market is still constrained by the lack of mortgage finance. With the mortgage market review recommending tougher credit scoring than in the past (potentially hitting first-time buyers hard), mortgage supply is unlikely to contribute to a new boom, although we are not among those predicting a renewed housing crash.

## MORTGAGE MARKET

The recent credit conditions survey from the Bank of England reported no expected increase in the credit being made avaiable for secured lending in the coming quarter, after a year of improvement. It also saw an end to improvement in product terms such as lower rates and improved loan-to-value ratios. This already looked to be borne out in September, when e.surv, the largest surveying group in the country, published its first mortgage index. It noted how LTVs had fallen in September by the largest amount in a year, after six months of steady improvement. The average LTV fell to 57.2% in September from a two year high of 58.1% in August.

Chart 18.




e.surv also noted how much tougher criteria are for lower value borrowers. In September 2006 borrowers wanting to buy a home priced less than £125,000 typically got a 75.9% mortgage. Now they are only

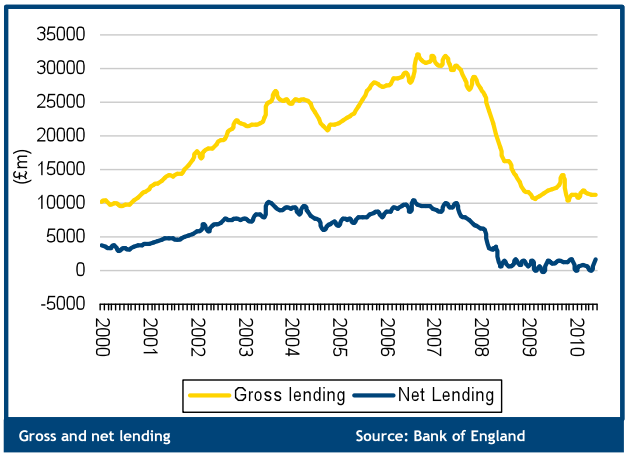
offered a 64.3% loan on average, a decline of 11.6 percentage points. Meanwhile someone buying a home worth £500,000 can borrow just 3.8% less than four years ago, almost as if the credit crunch never happened. Their average LTV has only declined from 55.6% in September 2006 to 51.8%.

The proportion of borrowers taking fixed rate loans is on the increase again, reaching 52% in August. This is clearly a sign that borrowers feel rates cannot stay this low forever, and are starting to lock in in greater numbers - a sensible move on the part of home-buyers.

Mortgage approvals for house purchase in September will be fractionally up on August on a seasonally adjusted basis accorting to e.surv's analysis, having fallen slowly for five months in a row. Remortgage approvals were slightly better in August, but are still tracking at very low levels. With many people paying down debt, happy on their lender's SVR, or unable due to poor credit scoring to get a new loan, there is little energy in the remortgage market. We are not seeing lending falling off a cliff, just no new money coming in terms of credit supply and no dramatic increase in demand.

The lack of lender competition is no doubt partly to blame, along with their financing constraints. Net lending to the end of August is a mere £7bn, while gross lending was £90bn. For the full year, net of £10bn is likely, while it now looks improbable that our expectation of £140bn gross will be reached. There are no real catalysts to suggest things will improve significantly in 2011. We expect gross lending to stay at close to this year's level, making three years in a row where gross lending will have hovered close to £140bn. Net lending is also unlikely to increase as people continue to focus on paying back their mortgages.

Chart 19.

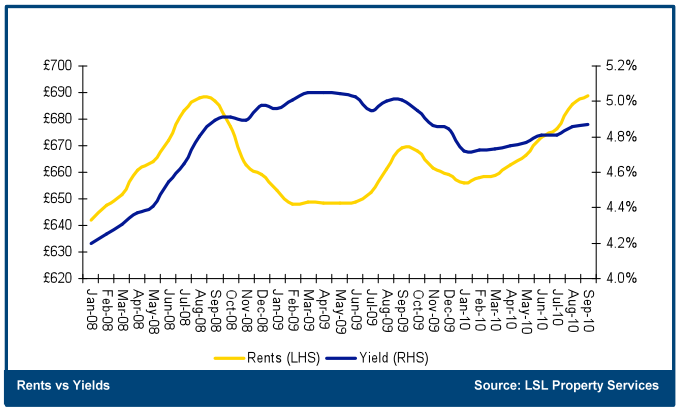



Gross and net lending Source: Bank of England

**BUY-TO-LET**

The buy-to-let market seems to be undergoing a bit of a revival, despite the slow down in house prices. The latest buy-to-let index from LSL showed rents exceeded their pre-crisis peak in September, boosting total returns for landlords over the last year to 10.4%, bringing an average return per property to £16,567. Property is now yielding 4.9%.

Chart 20.




Rents vs Yields Source: LSL Property Services

Annualising the modest house price growth of the last three months, buy-to-let would produce an expected return over the next twelve months of 9.2%, according to LSL. Tenant demand is at an eight-year high according to ARLA, while supply is constrained. Buyers sitting on the sidelines or unable to get finance are competing for scarce rental property, pushing up rents.

In Q2 this year, 13% more mortgages were advanced than in the previous quarter. Although the 24,900 loans advanced in Q2 were less than a third of the levels three years ago, there is a recovery underway.

Chart 21.

New lenders are entering the sector too. Following the launch of Precise Mortgages earlier in the year, Aldermore and Paragon returned to the buy-to-let market recently too. Products also seem to be improving perhaps as the much dulled competition in the sector is starting to sharpen; The Mortgage Works has recently launched some products with an 80% LTV. Recent research by broker, Mortgages For Business shows that the number of buy-to-let mortgages available has risen by 396% in the past year – albeit from a low base. Moneyfacts research also showed that rates charged are falling too.

Landlord confidence is down a bit as the short-term gains of the last eighteen months are unlikely to be repeated. Longer term however, greater mortgage regulation of owner-occupier loans will sustain demand for the private rented sector. Furthermore, the review of student financing, which will usher in a new age of self-funding students with much larger post-graduation debts, will push the age of home-ownership back further while education debts are repaid. People will stay in rented homes for longer in future.

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Association of
AMI
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# Quarterly Economic Bulletin

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