SAVILLS RESEARCH

Forecasting in an ever changing market

savills

- Values and activity have been more robust in the first half of this year than we previously anticipated, but the recent rise in mortgage rates means we expect further price falls over the next 12 months.
- The recovery is anticipated to come in 2024, once there are consistent signals that inflation is under control, and lenders have the confidence to reduce mortgage margins.
- The prime market is expected to continue to outperform the mainstream as it is less dependent on debt, with Prime central London leading the way.
- The mismatch between rental supply and tenant demand, coupled with strong wage growth means there is continued capacity for rental growth across the UK

Forecasting the housing market is undoubtedly the toughest and most uncertain element of a residential researcher's job. Back in November 2022, we were forecasting that mainstream prices would fall by 10% over the course of 2023, but return to positive growth from 2024.

The performance of the housing market in the first quarter of 2023 made that forecast look overly pessimistic, but more recent spikes in mortgage rates suggest there is still disruption to come. While we are not fully reforecasting at this point, given the scale of uncertainty in the market, this note sets out the key influences on the direction of the market over the next year.

-1.4%

House price growth in the first six months of 2023

3.2%

Rental growth in the first five months of 2023

What's happened since our November forecasts?

When we released our previous forecasts in November last year, the prospects for the housing market were looking bleak. This was in the wake of Liz Truss's mini-budget, the market was uncertain, the value of the pound was falling and interest rates rising rapidly. Prices fell in Q4 2022 for the first quarter since Q2 2020 and most commentators expected falls to continue into 2023.

Yet, the housing market defied expectations in the first half of this year. In November, we forecast price falls of -10% in 2023. But prices have actually fallen by just -1.4% in the first six months, and by -4.1% since their August 2022 peak. Market activity has also remained more resilient than expected, with completed transactions in the first five months of 2023 just -13% below the 2017-19 average.

Why did market activity and house prices show such unexpected resilience? We think there are three key reasons:

- **First, strong wage growth** has improved housing affordability. House prices have fallen by more than -12%, when accounting for inflation. Earnings growth has exceeded house price growth by 10% in the year to April 2023, meaning buyers earn more relative to the price of their house now than a year ago.
- **Secondly, buyers have adapted their behaviour** to the higher interest rate environment, taking out 30 or even 35 year mortgages in many cases to decrease their monthly bill and help them overcome affordability hurdles. This decision is driven by the strong incentive to leave the private rented sector, given that average UK rents have increased by 10.4% in the year to May 2023. This is helping to support demand in the short term, but further increases in mortgage terms will be limited, because banks are reticent to lend to buyers who may be approaching retirement while still repaying their mortgage.
- **Finally, cash buyers have been very active**, increasing their share of transactions to 46% in April, up from 34% in late 2022. With other buyers finding their budgets are squeezed by the cost of debt, cash buyers are taking advantage of a market with weaker competition to secure better deals. Many cash buyers are likely to be investors, for whom rental growth looks particularly attractive, given their returns won't be diluted by the cost of a mortgage.

While these factors have supported activity so far, the recent rise in rates has acted as a very strong headwind. We therefore still expect the housing market to weaken in terms of both prices and activity over the next two years.

> "Cash buyers have been very active, increasing their share of transactions to 46% in April 2023"

What influences what happens next?

Inflation and base rates

The key change since November has been the expected path of base rates. As a consequence of stubborn inflation, the peak is now expected to be 175 basis points higher than expected in November last year, and stay at that level for longer. The knock-on effect is that mortgage rates will remain higher across our forecast period, with the greatest squeeze on affordability extended throughout most of 2024.

The base rate is now expected to reach 5.75% this year and stay there until Q3 2024. Consequently, affordability pressures will weigh on growth for longer than we previously anticipated. We now expect price falls to extend through into 2024, albeit with the majority of the price adjustment to be in 2023, and expect the overall price adjustment to still be in line with our November 2022 figure of -10%.

However, if inflation falls more rapidly than expected, or if the UK slips into recession, we could see base rates come down earlier in our forecast period, which would ease some affordability pressures.

Figure 1: Bank of England Base Rate

Base Rate Forecast (Year end)	2023	2024	2025	2026	2027
November 2022 Forecast	4.00%	3.50%	2.50%	1.75%	1.75%
June 2023 Forecast	5.75%	5.25%	4.25%	3.25%	2.25%

Source: Oxford Economics

Mortgage margins

Lenders must price their fixed-rate mortgages with regard to the cost of debt over the next two or five years, so mortgage rates are influenced by both the current base rate and by future expectations for interest rates. Uncertainty in the last year as to the future path of interest rates has prompted lenders to increase mortgage rates well above the current base rate, taking a larger margin early in the fixed-rate period. Changes to this margin looking forward will continue to have a significant impact on buyer affordability.

Over 2021 and the first half of 2022, the average margin above base rate for a 2 year fixed term mortgage was 1.4%. Market uncertainty following the mini-budget resulted in average margins jumping to just over 4%, but increased certainty coupled with expectations that the base rate would soon be falling saw margins fall to 0.5% percent in the first four months of 2023. Average margins for a five year fix have been even lower, and at times five year terms were available at a discount to the base rate.

The surprisingly high inflation figures for May prompted a reversal of this trend, as lenders were returning to pricing in future rate rises. As a consequence, mortgage rates have risen much more quickly than the base rate over the last couple of months.

The June inflation figure was lower than expected, causing market expectations of interest rates to fall once again. If this forms part of a sustained drop in inflation, we anticipate lenders will once again reduce margins, particularly for longer term fixed lending. However, given the current high levels of uncertainty, any indicators around inflation, wage growth or economic activity that point to base rates staying higher for longer are likely to result in higher mortgage margins, putting a further squeeze on affordability.

The UK inflation rate fell to 7.9% in June, the lowest level since March 2022. If this trend continues, lenders will gain the confidence to reduce mortgage margins.

Lender forbearance and forced sales

While the path of base rates and lender attitudes to risk remains uncertain, there is greater certainty around existing borrowers and their exposure to refinancing risk. 1.9 million home owners will be coming to the end of the fixed rate portion of their mortgage over the next 18 months. Although many will have been stress tested on their ability to afford repayments at rates even higher than those currently available, there will still be significant increased pressure on households' budgets.

> "There is greater certainty around existing borrowers and their exposure to refinancing risk"

However, this is unlikely to result in significant volumes of forced sales from those no longer able to afford mortgage repayments. At the end of June, Government announced an agreement with major lenders offering borrowers the ability to switch to interest-only payments or extend mortgage terms without affecting their credit score. Lenders have also agreed that no homes will be repossessed within 12 months of the first missed mortgage repayment. We are likely to see a continued balance between muted demand and supply, resulting in a lower transaction market, rather than large volumes of stock coming to the market which could prompt more significant price corrections.

The exception to these muted levels of activity could be mortgaged Buy to Let landlords facing increasing costs coupled with a higher regulatory burden. This is likely to be particularly concentrated in more expensive locations where rental yields are lower, and the size of mortgage loans has made an increase in repayments harder to bear. However, the number of landlords exiting the sector is not expected to be at a scale that would move values in the wider market.

Prime Market

In our November 2022 forecasts, we expected the prime markets to be more resilient than the mainstream. Less dependent on mortgage finance, this part of the market has been somewhat insulated from the turmoil of the last year. Prime central London, where the vast majority of buyers use cash, has performed the strongest, with values falling just -0.9% during the past year. In more discretionary markets driven by lifestyle considerations, such as the Scottish country house market, values have also held up well.

But elsewhere, buyers have been price sensitive, particularly in more debt driven markets surrounding London. Even though the prime markets have not felt the same affordability squeeze as in the mainstream, savvy buyers are not paying the premiums seen over the last three years, given the wider market context. Realistic pricing will be crucial throughout the rest of 2023 and into 2024, but we don't anticipate that price adjustments will be any greater than our original forecast for 2023 of -2.0% in Prime central London and -6.5% in prime regional markets

Rental Market

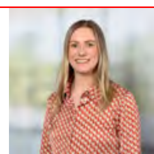
The fundamental drivers in the Private Rented Sector remain much the same as in November, when we released our current forecast. Crucially, there remains a supply-demand imbalance that is widest in London, which will continue to drive rental growth over the next 12-18 months. Rental increases over the first half of the year, coupled with strong income growth, suggests that 2023 UK rental growth may slightly outperform our November 2022 forecast of 6.5%.

On the supply side, rising interest rates have made it increasingly challenging for mortgaged Buy-to-Let landlords to make the numbers stack up, prompting some to sell up and exit the sector. This, combined with tenants staying in their properties for longer, has reduced the number of properties available for rent.

Over the next five years, we expect the relationship between earnings growth and rents to hold up. Rental growth ultimately remains subject to an affordability ceiling, so any rental growth in excess of our 2023 forecast will mean growth is slower in subsequent years.

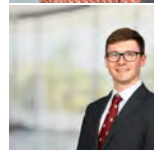
Contacts

Emily Williams
Director
emily.williams@savills.com
020 3618 3583



Frances McDonald
Director
frances.mcdonald@savills.com
020 7409 5904

Ed Hampson
Associate
ed.hampson@savills.com
020 3107 5460



Dan Hill
Analyst
dan.hill@savills.com
020 7299 3065

This report is for general informative purposes only. It may not be published, reproduced or quoted in part or in whole, nor may it be used as a basis for any contract, prospectus, agreement or other document without prior consent. Whilst every effort has been made to ensure its accuracy, Savills accepts no liability whatsoever for any direct or consequential loss arising from its use. The content is strictly copyright and reproduction of the whole or part of it in any form is prohibited without written permission from Savills Research.