SPOTLIGHT
Savills Research

Mainstream Residential Property Forecasts

Lack of supply to underpin short term price growth before macroeconomic realities bite

The average UK house price has risen strongly in early 2022, increasing by 5.0% in the first four months of the year, according to the Nationwide index. This has been driven by a continued imbalance between demand and supply, which will maintain growth in the short term, despite strengthening economic headwinds. As a result, we expect prices to rise in the order of 7.5% in 2022.

But the strong price growth of the past two years (20% to the end of April), rising interest rates and a marked cost of living squeeze, have eroded affordability, especially in those markets where borrowers require a high mortgage relative to their income. This leaves limited capacity for further price growth, so we expect growth in the following four years of just 5.1%, across the country as a whole. As part of this we expect modest price falls next year as the heat comes out of the housing market.

This assumes that the Bank of England base rate is 1.75% in 2026. Should the bank relax mortgage affordability stress tests, as it has indicated it might, this would provide modest additional capacity for price growth. However, if interest rates rise higher than is currently being projected, capacity for price growth will be quickly eroded, and the prospect of price falls becomes more likely.

Regionally, we continue to expect the strongest price growth to be seen in the North of England and the weakest in the mainstream markets of London, despite a potential short-term boost as demand refocuses on urban locations.

Over this period we expect the prime market to outperform the mainstream market, as wealthier buyers are less impacted by the cost of living crisis and interest rate rises.

Figure 1 House price forecasts and economic assumptions – May 2022

	2022	2023	2024	2025	2026	Total
Average UK house price growth	**7.5%**	**-1.0%**	**1.5%**	**2.0%**	**2.5%**	**12.9%**
Residential transactions	**1,310,000**	**1,140,000**	**1,090,000**	**1,090,000**	**1,090,000**	**5,720,000**
Loan-to-income ratio	3.91	3.73	3.70	3.68	3.66	-
GDP growth (nominal)*	5.2%	3.3%	4.2%	3.8%	3.7%	21.9%
Bank base rate*	1.50%	1.50%	1.75%	1.75%	1.75%	-
Inflation (CPI)*	6.8%	1.1%	1.2%	1.5%	1.7%	12.8%

NB: These forecasts assume no change to existing mortgage regulation. Removal or relaxation of the mortgage affordability stress test would provide more capacity for house price growth, unless interest rates rise faster than we have assumed

Source: Savills Research and *Oxford Economics (figures year to Q4)

Supply-demand imbalance to determine prices short term

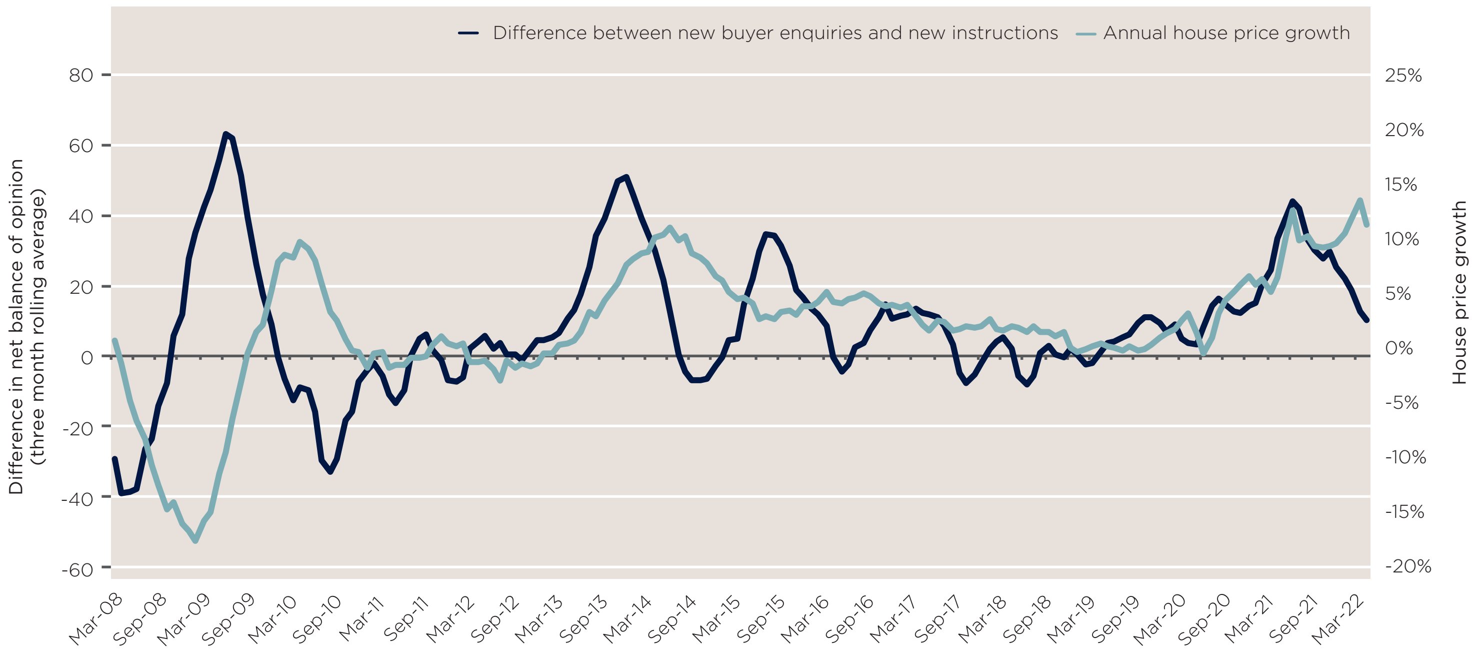
So far, the twin pressures of rising interest rates and a bout of high inflation have done little to contain house price growth. Instead, strong demand for a shortage of stock has caused a continuation of the robust price growth seen in 2020 and 2021.

Surveyors have reported that new buyer enquiries have exceeded new instructions every month since April 2019 on a three-month rolling basis, according to the RICS. Historically, the difference between enquiries and instructions has been a reasonable forward indicator of price movements. While this gap has narrowed recently, the number of homes available for sale per surveyor has reached its second lowest point on record in early 2022. That means it will take some time for supply and demand to rebalance and for macroeconomic factors to become the primary driver of house price movements.

Data from TwentyCI gives a further useful measure of the low levels of stock on the market. In February and March, the number of homes available to buy increased slightly, but remained more than a third below the 2019 level.

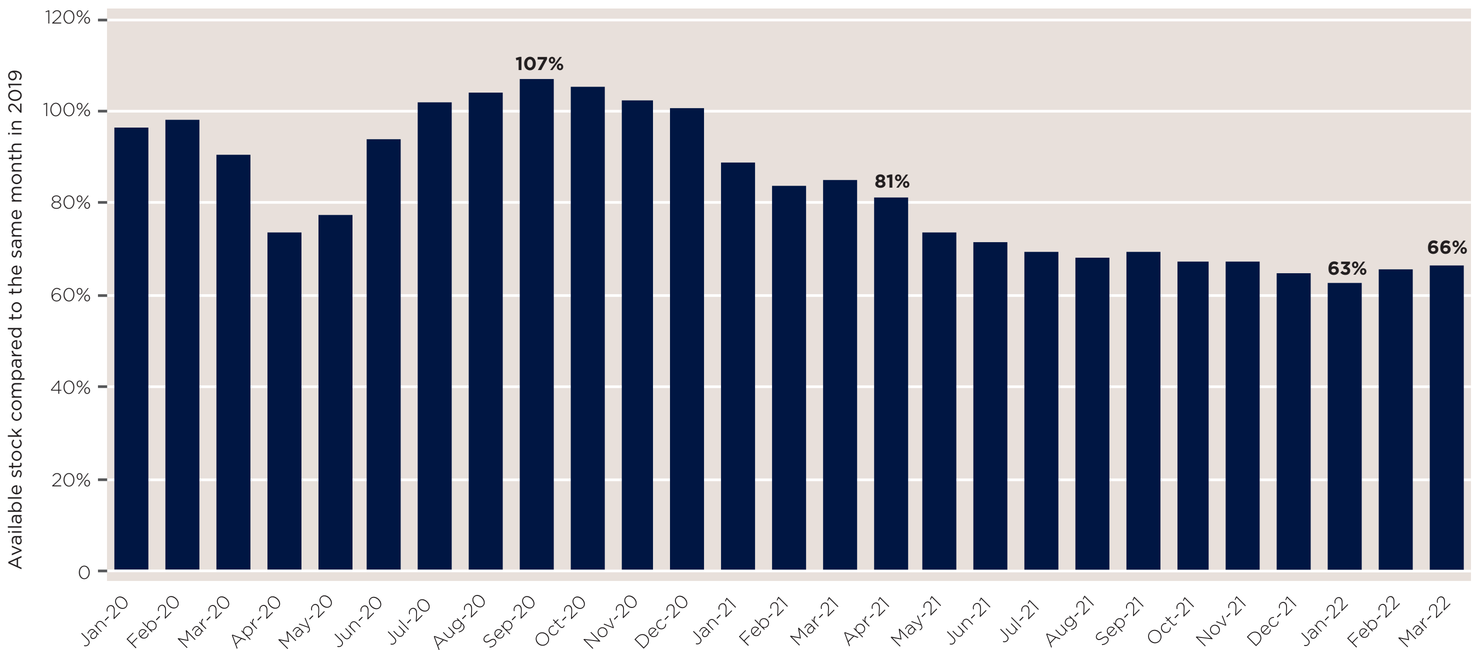
“So far, the twin pressures of rising interest rates and a bout of high inflation have done little to contain house price growth. Instead, strong demand for a shortage of stock has caused a continuation of the robust price growth seen in 2020 and 2021”

Figure 2 Gap between new demand and new supply narrows...



Source: Savills Research, Nationwide, RICS

Figure 3 ...but overall stock levels remain constrained



Source: Savills Research, TwentyCI

This means macro-economics will continue to take a back seat in the immediate future. But we do expect affordability pressures to moderate further price growth substantially over the remainder of this year, as buyers become more budget-conscious and demand progressively eases. The source of a slowdown is far more likely to be weaker demand (as banks increase mortgage rates and tighten lending terms) than a substantial increase in supply.

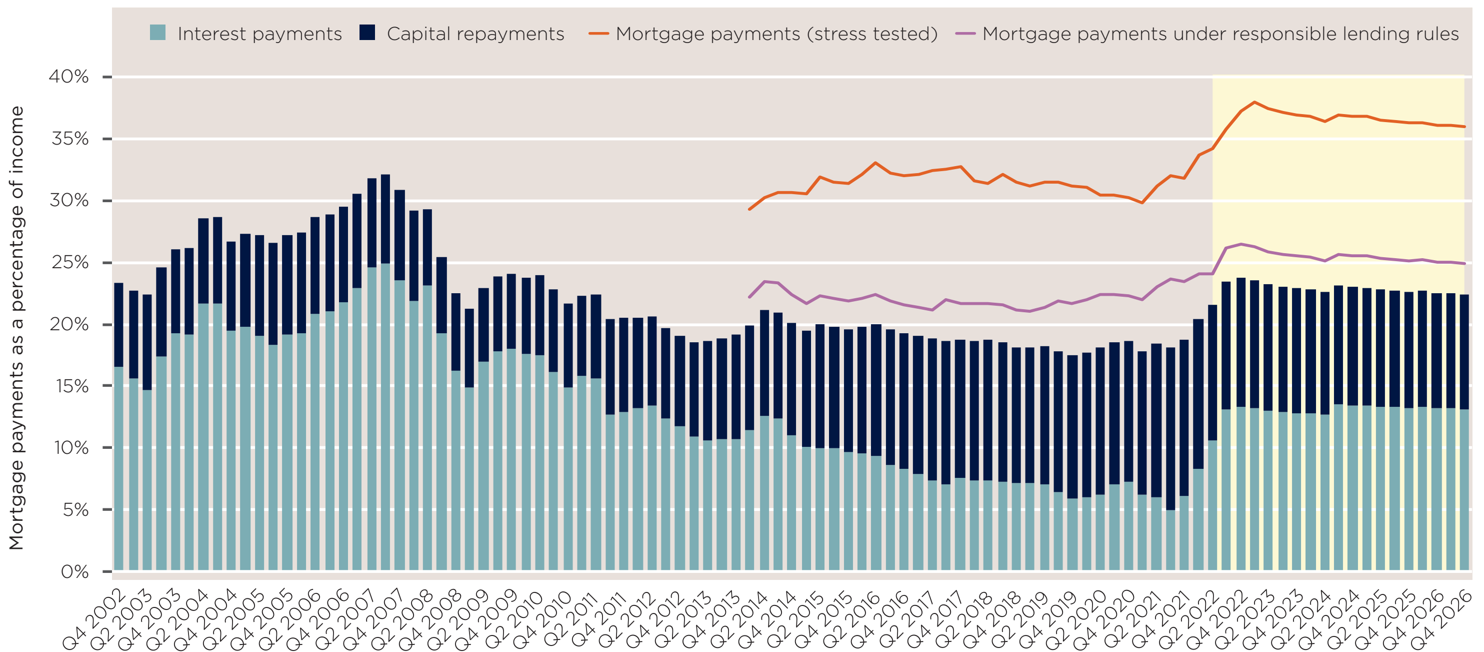
We have assumed no recession in our central forecast. While a brief dip in GDP growth is possible, we expect any effect on the housing market to be limited. The risk of a substantial rise in mortgage defaults and repossessions is also small. 79% of mortgage debt is owed by homeowners who are insulated from increasing interest rates because they have locked into low fixed-rate mortgages for up to five years. Those who have fixed for a period shorter than five years have to pass a relatively stringent mortgage affordability stress test. The labour market also remains very tight, and a significant rise in unemployment, which has previously led to large increases in stock coming onto the market, is unlikely.

Economic realities bite

A combination of high house price growth, a squeeze on household finances, and increased interest rates have substantially eaten into the mortgage affordability cushion that existed before the pandemic. That affordability will be further depleted over the course of 2022.

Assuming two further base rate rises, our analysis suggests that mortgage payments as a percentage of income on a 25-year repayment mortgage will have risen to 24% at the end of 2022, compared to 17.5% three years earlier. To put that into context, that is back to levels last seen in 2010. But it still remains some way below levels seen in the run up to the credit crunch of 2007/08 and a long way short of the late 1980s / early 1990s.

Figure 4 Mortgage affordability (the average household buying the average home)



Source: Savills Research

The complexities of mortgage regulation...

Currently, unless a borrower locks into a fixed rate mortgage for five years or more, lenders are required to consider whether that borrower could afford their mortgage once their initial term ends and they revert to a standard variable rate. They then stress test that affordability to see whether the borrower can still afford mortgage debt in the event of a 3% interest rate rise.

Over the past four years particularly, borrowers have been able to lock into relatively inexpensive fixed rate mortgages for five years or more. Indeed, in 2021 some 49% of new lending was on this basis according to UK Finance. That has allowed these borrowers to avoid stringent stress testing off higher standard variable rates.

But for those who took on discounted variable rates or shorter fixed rate mortgages, the assessment of affordability on a stress-tested basis has underpinned their mortgage application. In the recent low interest rate environment, this has not proved a significant barrier to the amount they have been able to borrow relative to their income.

But by the end of this year, mortgage interest payments based on the standard variable rate plus an additional 3% are likely to reach 37% of a borrower's income. That figure is far more likely to act as a cap on the amount people can borrow going forward.

And if the cost of five-year money were to rise relative to short term fixed rates, it is likely that more people would be affected by the stress test.

...and its potential relaxation

So, the prospects for future house price growth will be partly determined by whether the Bank of England follows through on recent proposals to remove this particular form of mortgage regulation following a period of consultation that has now closed.

We say 'partly' because this stress test sits alongside two other forms of mortgage regulation:

- Lenders can have no more than 15% of their loanbook at or above a loan-to-income (LTI) ratio of 4.5.
- They are also bound by responsible lending rules, which require affordability to be tested, having regard to market expectations of future interest rates over a five-year period or current market rates plus 1% (unless they have fixed for five years or more).

The Bank of England have concluded that the LTI caps have been more effective in preventing individual borrowers from taking on unsustainable levels of debt in a low interest rate environment. But in an era of higher interest rates we would expect the affordability stress test to become more of a constraint, as we have detailed above.

Accordingly, removing or relaxing the stress test will provide some upside to our house price forecasts. The extent of that additional capacity will depend on the precise terms of any reform, how lenders interpret and apply the underlying responsible lending rules and how far they are prepared to push LTI multiples to regulatory limits.

In this respect, we expect the Bank of England to take a relatively cautious approach. The two remaining planks of mortgage regulation mean that any reform is unlikely to result in an opening of the mortgage credit floodgates.

Where does that leave us?

Our affordability projections assume that the Bank base rate ends 2026 at 1.75%, based on forecasts provided by Oxford Economics. That would imply that, from the end of 2022 to the end of 2026, there is limited capacity for house price growth of c.5.1% across the country as a whole. Such price growth would keep loan-to-income (LTI) ratios some way below current regulatory limits but would mean affordability is stretched on a stress-tested basis.

Sensitivities to more prolonged inflation and higher interest rates

Oxford Economics expect the rate of inflation to fall significantly in 2023, as the recent spike in energy and food costs fall out of the annual data. In this central scenario, interest rates do not need to rise beyond 1.75% to bring inflation broadly in line with target.

However, given recent hawkish rhetoric by members of the MPC, we have also considered the possibility that interest rates rise more significantly than we have assumed in our central forecast. If this occurs, capacity for house price growth will be rapidly eroded and the risk of house price falls will increase.

The tables below show how sensitive our affordability model is to different interest rate scenarios. In the event the current stress test is retained, a 1% increase in the bank base rate at the end of our forecast period (to 2.75%) could severely limit the capacity for price growth from the end of this year. Alternatively, it could mean the market becomes increasingly confined to more affluent households, which would likely result in a lower transaction market. The latter effect would particularly impact first-time buyers, who generally have lower incomes. The most likely result lies somewhere between the two scenarios.

The tables also illustrate that, were the stress test to be removed, there would remain a reasonable affordability cushion that would provide much greater capacity for price growth over the longer term, though the ability to unlock this will be constrained by other forms of mortgage regulation.

Figure 5 Mortgage payments as a percentage of income under various scenarios:

House price growth to Q4 2026	Base rate at Q4 2026: 1.25%	1.75%	2.25%	2.75%	3.25%	3.75%
1%	19.0%	20.0%	21.1%	22.2%	23.4%	24.6%
7%	20.1%	21.2%	22.4%	23.6%	24.8%	26.0%
13%	21.2%	22.4%	23.6%	24.9%	26.2%	27.5%
19%	22.3%	23.6%	24.9%	26.2%	27.6%	29.0%
25%	23.5%	24.8%	26.1%	27.5%	29.0%	30.4%

Source: Savills Research

Figure 6 Stress-tested mortgage payments as a percentage of income under various scenarios:

House price growth to Q4 2026	Base rate at Q4 2026: 1.25%	1.75%	2.25%	2.75%	3.25%	3.75%
1%	30.7%	32.1%	33.4%	34.8%	36.1%	37.5%
7%	32.6%	34.0%	35.4%	36.8%	38.3%	39.8%
13%	34.4%	35.9%	37.4%	38.9%	40.4%	42.0%
19%	36.2%	37.8%	39.4%	41.0%	42.6%	44.2%
25%	38.0%	39.7%	41.3%	43.0%	44.7%	46.5%

Source: Savills Research

Regional accents: Midway through the second half of the cycle

We continue to expect the Midlands and North of the UK to show the strongest house price growth, with slower growth in London and the South. In the market's current 'mid-to-late cycle stage', prices will grow most rapidly in those areas that have seen the least value growth since the peak of the market in 2007/8.

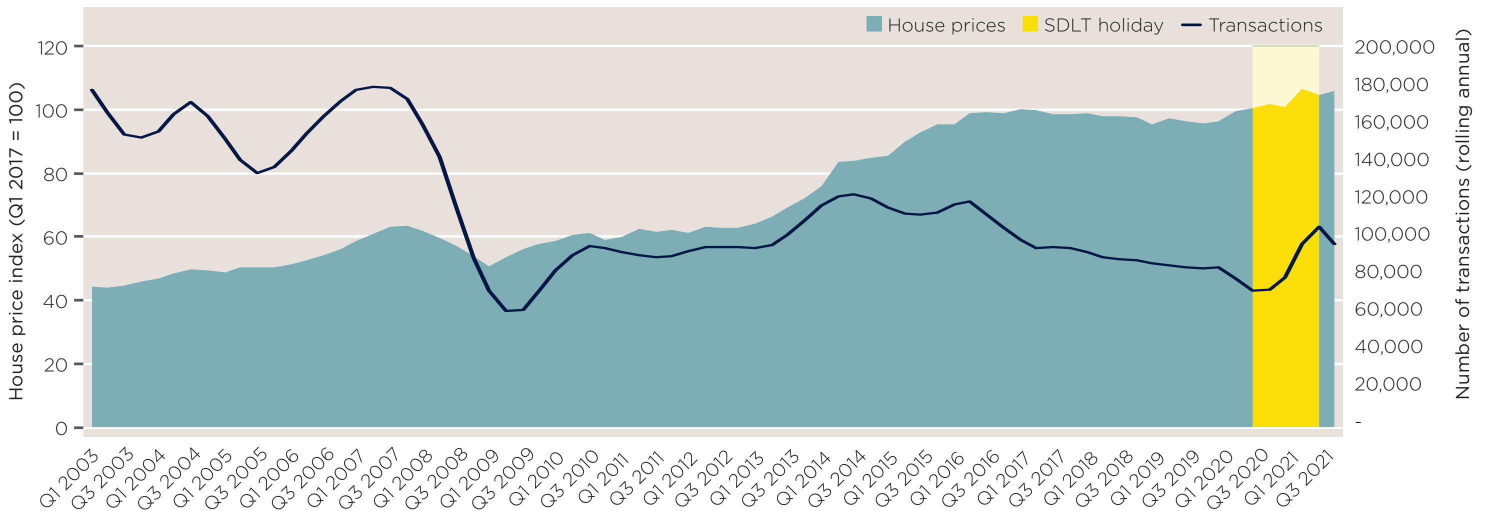
This has its root in the unequal affordability squeezes seen across the country.

Buyers are more wealthy than the average household in all regions. The gap is largest in areas such as London where price growth has been highest in the last 15 years and affordability pressure is therefore greatest.

In these areas the gap between the average buyer and the average household has widened over recent years. As prices have risen, the market has become increasingly confined to more affluent households, as those on lower incomes have been priced out of the market. This sets a precedent for what might happen elsewhere.

In the North, however, prices have not risen as significantly and affordability is not as stretched. LTI ratios are lower, meaning there is greater capacity for borrowers to take on more debt before reaching an affordability ceiling. Price growth is likely to be stronger as a result.

Figure 7 Transaction activity in London in a longer term context



Source: Savills Research, Nationwide, HMRC

Figure 8 Regional capital value forecasts

	2022	2023	2024	2025	2026	Total
North West	10.0%	-0.5%	2.0%	2.5%	3.5%	18.4%
Yorkshire and The Humber	10.0%	-0.5%	2.0%	2.5%	3.5%	18.4%
Wales	10.0%	-1.5%	2.0%	2.5%	3.5%	17.2%
North East	9.0%	-0.5%	2.0%	2.5%	3.5%	17.4%
East Midlands	8.5%	-1.0%	2.0%	2.5%	3.0%	15.7%
West Midlands	8.5%	-1.0%	2.0%	2.5%	3.0%	15.7%
Scotland	8.5%	-1.0%	2.0%	2.5%	3.0%	15.7%
South West	7.5%	-1.5%	1.5%	2.0%	2.5%	12.4%
South East	6.0%	-1.5%	1.0%	1.5%	1.5%	8.6%
East of England	6.0%	-1.5%	1.0%	1.5%	1.5%	8.6%
London	3.5%	-1.0%	0.5%	1.0%	1.0%	5.0%
UK	7.5%	-1.0%	1.5%	2.0%	2.5%	12.9%

Source: Savills Research

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