Hearthstone
Investments

**Housing market outlook, September 2022**

**Key points**

- Supply shortages in housing persist
- Less excess in market than pre-Global Financial Crisis:
    - Mortgage interest payments as a percentage of take home-home pay significantly lower than before GFC (32% vs 45%)
    - Over 95% of mortgages with fixed rates
- Residential property less affected by economic cycles than commercial property– everyone needs a home
- Energy support package takes some of sting out of cost-of-living crisis for many renters
- Consensus forecast is for soft landing with reduced house price growth for 2023 combined with resilient rental levels

Geopolitical tensions and shock waves from the pandemic-induced global recession have combined to make this a time of unusual uncertainty for all investment markets. In the UK, the picture is clouded further by policy uncertainty linked to the government's internal problems, a general election less than 2 years away, and the continuing fall-out from Brexit.

What happens to house prices will be determined through the interaction of supply, demand and affordability.

**Supply**

- Supply has consistently fallen short of the government's target of 300,000 new homes a year, set to match demand from new household formation and to replace substandard stock This shortfall has been one factor behind house price inflation.
- Deliveries have bounced back to pre-Covid levels, at 243,000 new homes over the 12 months to June. However, the volume of new planning permissions granted has started to decline. The volume of planning permissions is a good leading indicator of future supply.
- The government has now abandoned its 300,000 pa target but, whilst there is a recognition supply needs to be sustained, the absence of a "stretch" target (and hence any criticism it hasn't been met!), means it's unlikely the existing shortfall will be fixed any time soon. This will help to support house prices through the coming downturn.

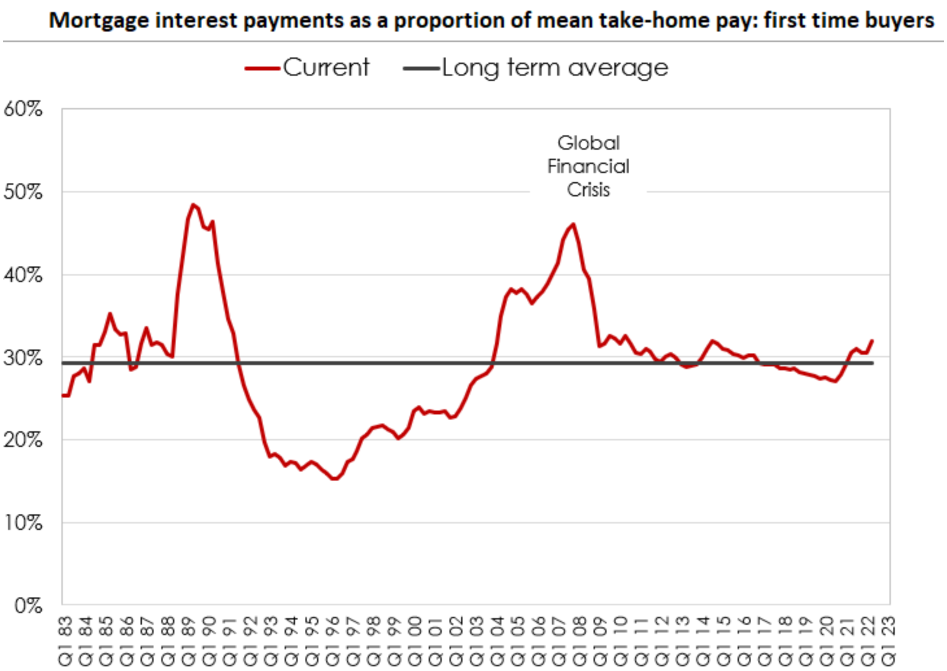
**Demand**

- While it can affect market activity, the state of the economy has little bearing on underlying demand – everyone needs a home - which makes the housing market more resilient than other property sectors in a downturn.
- After distortions caused by Covid lockdowns and government incentives to buy, demand is now more balanced and stable across the country.
- The ending of Help to Buy, inflationary pressures and rising mortgage rates will reduce demand from first time buyers.
- "Home movers" (existing homeowners), who have led price growth over the last two years, will be less affected by current cost pressures, and have accumulated savings through the pandemic
- This should help to support market liquidity, although overall market activity will dip through the slowdown.
- History shows that in times of economic uncertainty, rental demand for housing picks up – a pattern that is repeating itself now, and the opposite of what typically happens with commercial property, which helps to sustain occupancy, income, and rental value growth for investment portfolios.
- Small private residential landlords remain net sellers, adding to supply shortages in some areas, which is further fuelling rental growth

**Affordability**

- The path of general inflation (and in particular, energy costs), wage increases, mortgage interest rates and employment are key to affordability, and there are signs that input price pressures are now easing, which suggests that inflation (which may be yet to peak) could fall quite steeply by this time next year:


- On energy prices, much will depend on the outcome of government support aimed at reducing the impact of increasing energy price caps.
- Another policy area to watch will be tax cuts, ultimately designed to revive the government's popularity ahead of the election. Promises of early, unfunded cuts will make the MPC more nervous about inflation, and potentially push interest rates higher than would otherwise be the case. Diluting some of the pledges made during the hustings would reduce that risk and suggest more capacity for spending on public services.
- Because interest rates have been so low, mortgage costs are not particularly high in relation to household incomes (Source: Nationwide; Hearthstone):




- Buyers are used to low interest rates, so any change will be painful for some, particularly as wage increases will fail to match the inflationary spike. However, the immediate effect of rate rises is blunted by the high proportion of fixed rate mortgages, and rate changes take time to filter through into mortgage rates (see UK Finance/BoE charts below):

Chart1: Relationship between the Bank Rate and mortgage rates

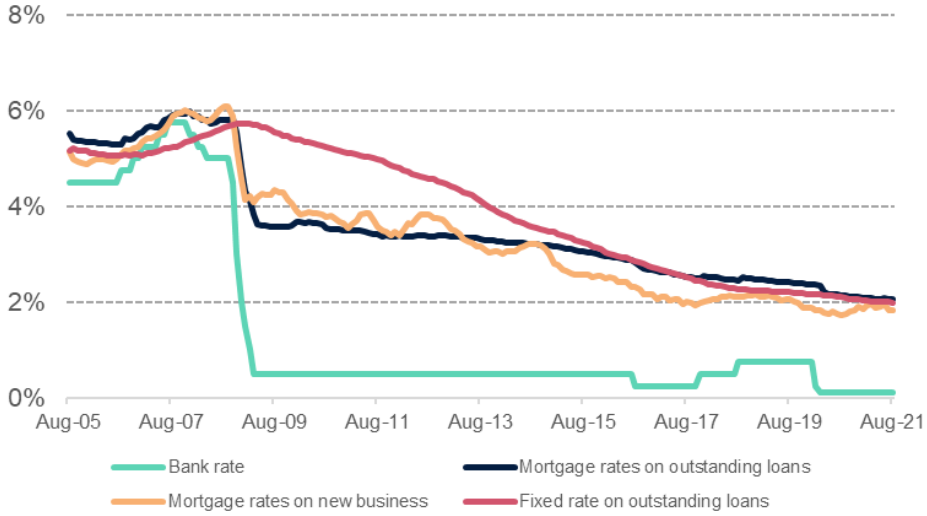
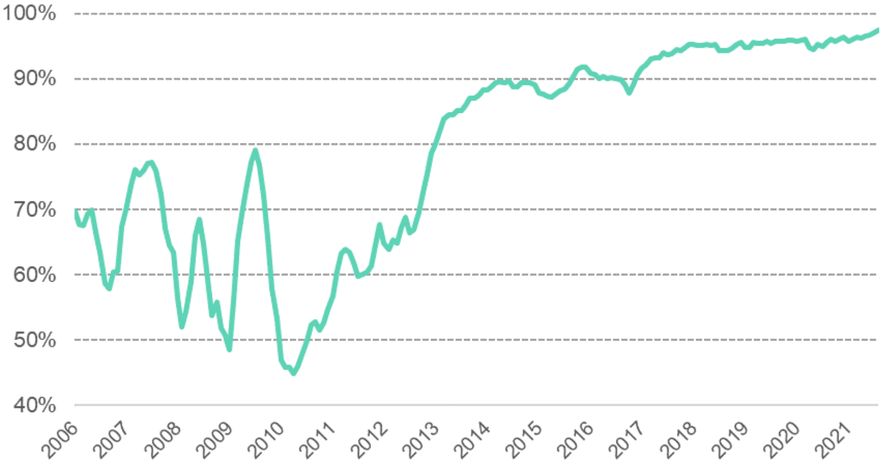



Chart 2: Proportion of new homeowner mortgages taken out on a fixed rate




- Unemployment is extremely low going into the cost-of-living crisis. While this seems set to rise, the labour market is unusually tight following the upheavals of recent years, which will help to soften the economic impact.

**Geopolitics**

- We are assuming a prolonged conflict in Ukraine, but with economic pressures being felt on both sides, an earlier than expected resolution could yet offer some upside.
- The new government's position on the Northern Ireland Protocol could affect trade frictions with the EU, positively or negatively, depending on the approach taken.

**House price forecasts**

- Despite increased pessimism around the outlook for the economy, most forecasters are predicting a "soft landing" for house prices over the next 2 years.
- In the Treasury's latest (August) forecast survey 10 of 13 forecasters expected prices to increase year-on-year in 2023, when affordability pressures are likely to be at their most intense, at a median rate of 1.2%, sharply down from the 6.7% shown for this year. The most pessimistic projection is a decline of 4%.

- The Office for Budget Responsibility shows calendar year projections to 2026 as follows:

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|---|---|
| 2022 | 7.4% |
| 2023 | 1.3% |
| 2024 | 1.5% |
| 2025 | 2.5% |
| 2026 | 3.1% |

**Rental values**

- The strength of rental demand and local supply shortages will help to support rental levels, despite wider cost of living pressures.
- Where rental values are more resilient than prices, income yields will improve, although the full benefit may be subdued until affordability pressures ease.

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