

Lending Strategy – 1 February 2010

The medium term outlook for the economy and mortgage market

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2009 will be remembered as the year when the UK economy finally bottomed at a level 6% lower in GDP output terms than at the peak in 2007. Last year represented the worst year for GDP output growth since 1921 and considerably weaker than in the early 1980's and 1990's.

So where does this leave us for 2010 and beyond. It looks increasingly likely that this year will be seen as representing the stable base for a more sustained recovery in 2011 and 2012.

The table below shows our main central macro-economic forecasts for the next 4 years.

Base forecast (1)

Base Forecast	2008	2009	2010	2011	2012	2013
GDP Growth (%)	0.6	-4.6	0.8	1.5	2.2	2.8
Real Consumer Spending (%)	0.9	-3.1	0.2	1.3	2.0	2.7
Real Investment Spending (%)	-3.3	-14.5	-1.5	1.4	3.5	4.2
Real Household Income (%)	1.6	3.8	1.0	1.5	1.7	2.5
CPI Inflation (Q4 %)	3.9	1.5	1.2	1.3	1.6	1.8
Bank Rate (Q4 %)	2.00	0.50	0.50	1.00	1.50	2.00
Libor (end Q4 %)	2.85	0.60	0.60	1.30	1.90	2.40
Libor Spread (Q4 %)	0.85	0.10	0.10	0.30	0.40	0.40
Basic Mortgage Rate (Q4 %)	5.40	3.60	3.60	4.30	4.90	5.40

Source : Hometrack. Includes Q3 GDP Revisions. Substantial revisions to real household income in 2008 and 2009

Interest rates are expected to remain steady throughout 2010 as the economy struggles to return to a robust economic growth path. Bank rate is forecast to start to rise in 2011 with mortgage spreads remaining similar to current levels as lenders continue to rebuild balance sheets and avoid overt growth strategies. The diminishing level of competition in the mortgage market as highlighted by the level of consolidation and absence of new players will enable lenders to maintain historically wide mortgage spreads and will only offer competitive deals to the lowest risks in the market.

The fiscal deficit is casting a large shadow over the medium term numbers as the government will need to grapple with making large cuts in public spending and increasing taxation by the end of 2010. Economists are split on the timing of any substantial tightening. However, I would argue the economic recovery would need to be underway for a couple of quarters before actually implementing substantial tightening otherwise you risk a deep double dip in economic output. The size of the challenge should not be underestimated and in practice the magnitude of the cuts in public spending required have not been experienced since the 1930's. This is a time for a radical and open review of all public spending and this should not include any arbitrary ring fencing of supposed core areas such as education and health. This process will require open engagement with the public to get the implicit support for the radical decisions needed. Star Chamber cuts will be difficult to sell to the public unless there is transparency, fairness and openness about priorities.

As a result of the above main fiscal and monetary assumptions, economic growth is likely to take 2-3 years before returning to a trend of around 2.5% or so. The outlook for real household income growth is being held down by low wage growth and higher unemployment and in the later years by a pick up in consumer price inflation. The UK economy will take some time to adjust to lower consumer spending and borrowing growth and the increased emphasis on investment and exports. The savings ratio is expected to rise over most of the forecast period and averaging over 6.5% compared to 3.4% at the end of 2008 and 2.4% in 2007.

Where does all this leave the mortgage and housing market?

The housing market has shown surprising strength in house price terms in 2009 but this largely reflects the mix of higher value transactions we have seen during the year. Many key sectors of the housing market remain extremely depressed and although reported rises in house prices have helped provide more confidence in the market the economic fundamentals remain weak. We expect activity to pick up around 20% over the next two years as consumers become more confident that house prices are close to the bottom.

Mortgage margins are expected to remain at around current levels so increasing interest rates from 2011 will act as a drag on the market. However, the fiscal challenges will ensure only modest growth in real household incomes and for this reason strong house price inflation looks unlikely.

Base forecast (2)

Base Forecast	2008	2009	2010	2011	2012	2013
House Prices (Q4%)(DCLG Measure)	-9	0	-1	1	3	5
Housing Transactions (E&W, m)	0.70	0.6	0.7	0.8	0.8	0.8
Housing Transaction Growth (%)	-44	-11	12	11	5	2
Mortgage Lending Stock Growth (Q4 %)	3.4	0.9	0.9	1.3	1.4	1.4
Net Mortgage Lending (£bn)	40	11	11	16	18	18
Gross Mortgage Lending (£bn)	255	142	148	166	186	198
Gross Mortgage Lending Growth (%)	-29	-45	5	12	12	6
Repayments as % of stock (%)	18	11	11	12	13	14

Source : Hometrack



Net mortgage lending is forecast to rise to around £18bn a year in the medium term which is less than 20% of the record level seen in 2007. Lenders will continue to rebuild balance sheets by maintaining wide mortgage spreads and avoiding higher risk segments and sectors. The realisation that any lending is likely to remain on the balance sheet for many years has engendered a far more conservative approach to lending from several of the 'growth players' of the past. Remortgages are likely to remain subdued until current mortgage rates move significantly below basic mortgage rate (SVR) and this could take some time.

House prices are forecast to move in a very tight range until 2012 and 2013 as any price increases are likely to be matched with additional supply coming on to the market. Whilst lending growth remains subdued the outlook for house prices (across the whole market) is likely to be limited to low growth or stability. Next month I will talk in more detail about the scenarios and some of the interesting work I have been doing on mortgage and housing models.