

Housing and mortgage market forecasts: 2006-2008

- Economic growth looks set to be stronger this year and interest rates more likely to rise than at the time of our December forecast.
- Housing activity has been stronger than expected over the past six months. The number of transactions has picked up from the low levels of early last year and price growth has regained momentum. Both home-owner and buy-to-let demand have been strong.
- We expect the level of transactions to be lower in the second half of 2006 and in 2007.
- The introduction of HIPs next June is expected to result in fewer listings and transactions, although by how much is uncertain.
- The momentum behind house price growth is likely to ease as demand moderates and house price growth is likely to be in line with average earnings next year.
- We expect gross mortgage lending to be a record £310 billion this year, helped by the recovery in property sales and the strength of remortgaging. Net lending is expected to be £100 billion.
- Arrears and possessions are set to rise modestly, but remain at historically low levels.

Table 1: Forecast summary

	2003	2004	2005	2006	2007	2008
House price growth, Q4, year on year % change	16	15	5	7 (2)	3 (2)	4
Property sales, England and Wales (Land Registry), millions	1.28	1.26	1.03	1.20 (0.97)	1.06 (0.97)	1.14
First-time-buyers, % of loans for home-owner purchase ^(a)	29	29	36	36 (38)	36 (39)	36
Remortgages by home owners, % of gross advances to home owners ^(a)	48	45	44	42 (43)	45 (44)	40
Gross advances, £bn	277	291	288	310 (285)	285 (285)	300
Net advances, £bn	101	101	91	100 (80)	85 (75)	95
Arrears, over 3 months, number at end period	93,790	92,090	111,930	120,000 (120,000)	130,000 (120,000)	120,000
Possessions, in period	7,830	6,030	10,310	15,000 (12,000)	15,000 (12,000)	15,000
GDP, %	2.5	3.1	1.8	2.5 (2.2)	2.8 (2.7)	2.5
Base rates, Q4, %	3.75	4.75	4.5	4.75 (4.5)	4.75 (4.5)	4.5

Source: Bank of England, National Statistics, HM Land Registry, Survey of Mortgage Lenders (SML), Regulated Mortgage Survey (RMS), CML

Notes: February 2006 forecast update shown in brackets.

(a) 2005 figures for these measures are a composite of first quarter SML data and RMS data for the remaining three quarters.

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Economic background

Compared with our forecasts published in December, economic growth looks likely to be a little stronger this year and interest rates seem more likely to rise a little than to remain unchanged or fall.

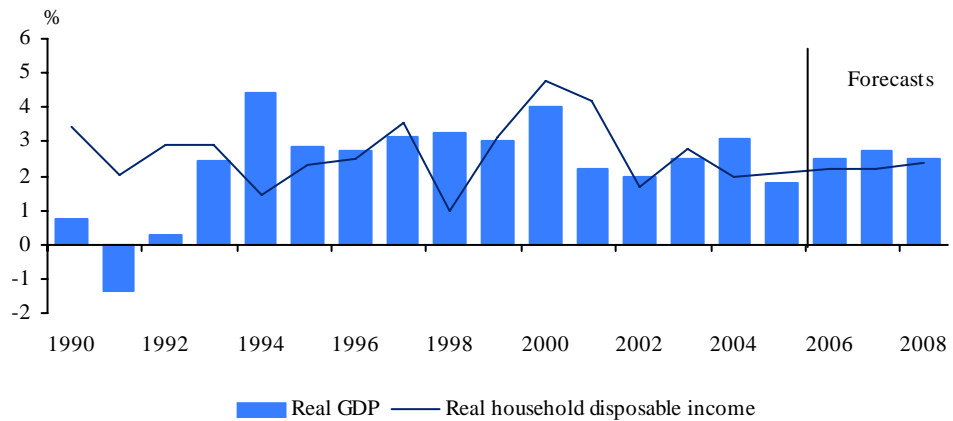
Economic growth fell below the long-term trend rate between the middle of 2004 and the fourth quarter of 2005, but it has since picked up to around the trend rate.

The forecast in the Bank of England's May Inflation Report shows growth strengthening a little further, raising the year-on-year rate to around 3% by the end of this year. Growth is expected to moderate a little during 2007 and to settle around the long-term trend rate of 2.5% in 2008.

World demand is expected to remain strong over much of the forecast period and this should assist the long-awaited rebalancing of UK demand growth away from household consumption towards exports and business investment.

Employment is expected to grow modestly. Real household disposable income is expected to grow a little below the long-term average.

Chart 1: GDP and household disposable income, annual % change

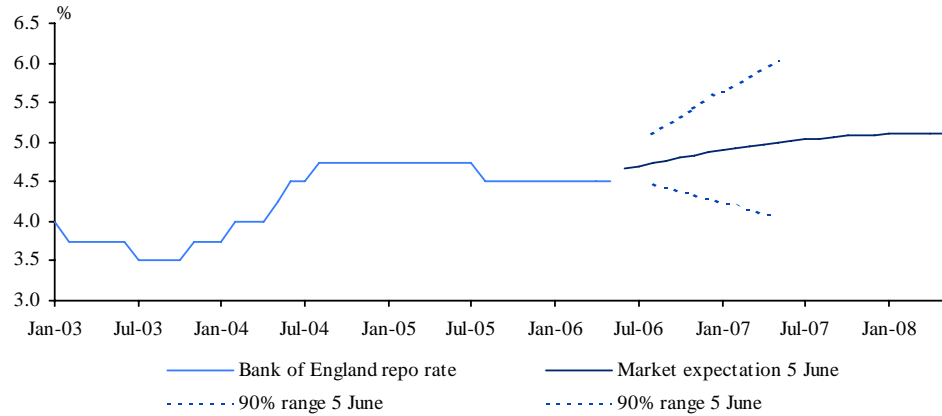


Source: National Statistics, CML

The strength of world demand growth has been the major factor behind the rise in energy and commodity prices to record levels. Although inflation has remained close to the 2% target to date and average earnings growth remains close to 4%, there appears to have been a step rise in inflation expectations. This, the limited amount of spare capacity in the economy and the possibility that higher energy prices have lowered the growth rate compatible with stable inflation have increased the risk that inflation will rise above the target.

Against this background, financial markets now expect the Bank of England's repo rate to rise to 4.75% by the end of this year. This profile is built into the Bank of England's growth and inflation forecast. The repo rate has been at 4.5% since August last year.

Chart 2: Bank of England repo rate and market expectations

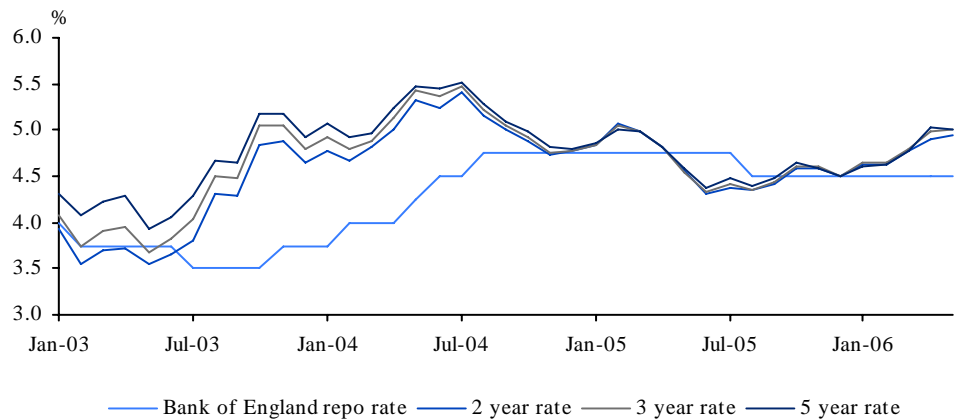


Source: Bank of England

Notes: The market expectation curves relate to commercial bank liabilities which will typically be 10-15 basis points higher than the Bank of England repo rate. The market expectation ranges are derived from short sterling option and futures contracts traded on LIFFE.

Concern over the outlook for inflation is not restricted to the UK. Interest rates have been rising for some time in the United States and have recently started to rise in the Euro zone. This concern is reflected in longer-term interest rates. In the UK, two, three and five year rates are around 0.5% higher than at the beginning of the year and 0.6-0.7% higher than in the middle of 2005.

Chart 3: Market interest rates



Source: Bank of England

Notes: 2, 3 and 5 year rates are end-month or latest for commercial bank liabilities.

We take the Bank of England's central projections for growth and inflation and market expectations for interest rates as the basis for our forecast of housing and mortgage market prospects to the end of 2008.

Housing market prospects

Over recent months the housing market has been stronger than expected at the time of our last forecast in December 2005. In particular, the number of transactions has picked up from the low levels seen in the first half of last year, and price growth has regained momentum.

The weakness in transactions between the middle of 2004 and middle of 2005 almost certainly reflected the earlier increases in interest rates. Higher interest rates reduced affordability and the weaker demand that followed resulted in a softening in prices. A number of commentators expected prices to fall. Demand stabilised during the spring of 2005, once it became clear that interest rates had peaked. It strengthened in the second half of the year as potential buyers became more confident that prices would not fall and returned to the market. This resulted in upward pressure on prices as the market tightened.

In part, the higher level of demand reflects stronger buy-to-let investment. But first-time buyers also appear to be finding ways of entering the market at current house price levels. More parents and relatives are giving help with deposits and lenders continue to be innovative in developing flexible products to help first-time buyers.

The starting point for the forecast is that the underlying level of transactions appears to have stabilised at a relatively high level in recent months. There is also upward pressure on prices. Annual growth on the Halifax measure is close to 8% and on the Nationwide measure it is close to 5%. These compare with low points last year of close to 2%.

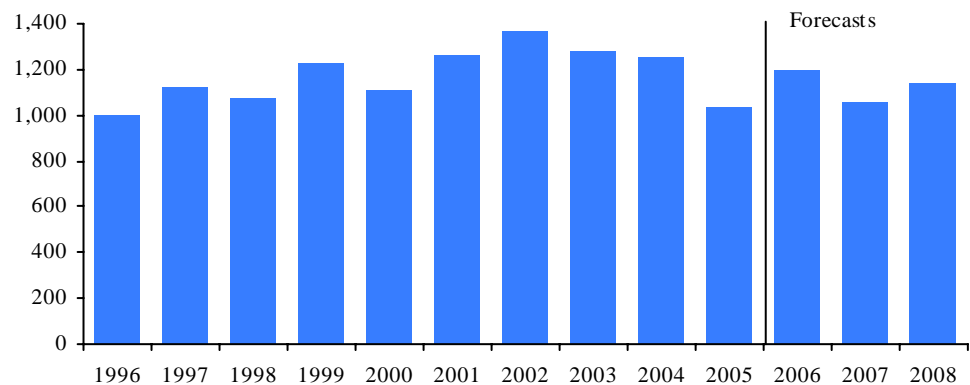
The immediate signs are that demand will remain robust over the next few months. But we take the view that confidence and activity are closely associated with interest rate movements and expectations.

The small rise in short-term interest rates expected in the second half of this year and the rise in fixed-term rates that we have already seen is likely to result in a modest fall in the level of transactions in the second half of this year, and we expect this to continue into 2007. Our forecast for a 16% rise in property sales in England and Wales this year reflects strength to date. It is compatible with a lower volume of sales in the second half.

The introduction of HIPs next June is expected to have a negative impact on transactions in 2007, although the magnitude is difficult to quantify. As the cost of HIPs is likely to fall most heavily

on sellers, there will be an incentive for them, and particularly speculative sellers, to list before June. But as first-time buyers stand to benefit from the improved information and lower transactions costs associated with HIPs, they are likely to delay purchases in the months immediately before June. So actual transactions could be depressed in the spring, while the disincentive for speculative sellers to list their properties after June may result in fewer successful chains being formed and a permanently lower volume of transactions. Purely for forecasting purposes, we have built in a small negative impact on transactions in 2007, but the impact could be much greater and more protracted. We strongly urge the government to undertake more work on this.

Chart 4: Property sales, England and Wales, thousands

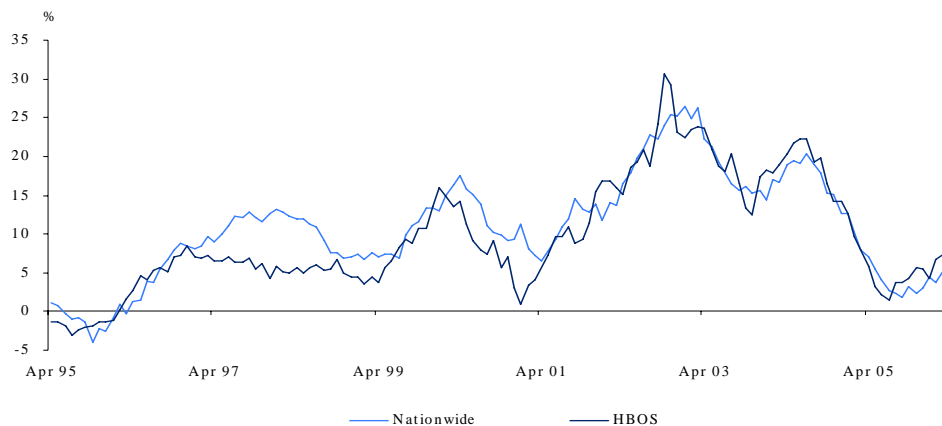


Source: HM Land Registry, CML

The momentum behind house price growth is expected to ease as demand moderates, but we do not expect this to be sufficient to lower the annual rate of growth this year to below 7%. During the course of next year the level of demand is expected to be associated with price growth broadly in line with average earnings. Our forecast is for growth of 3% between the end of this year and the end of 2007.

At this distance, prospects for 2008 look brighter. The more benign inflation outlook is expected to result in lower interest rates by early 2008. This in turn should support demand from home-buyers and buy-to-let investors and result in firmer house price growth.

Chart 5: House price growth, % year on year



Source: Halifax and Nationwide

Mortgage market prospects

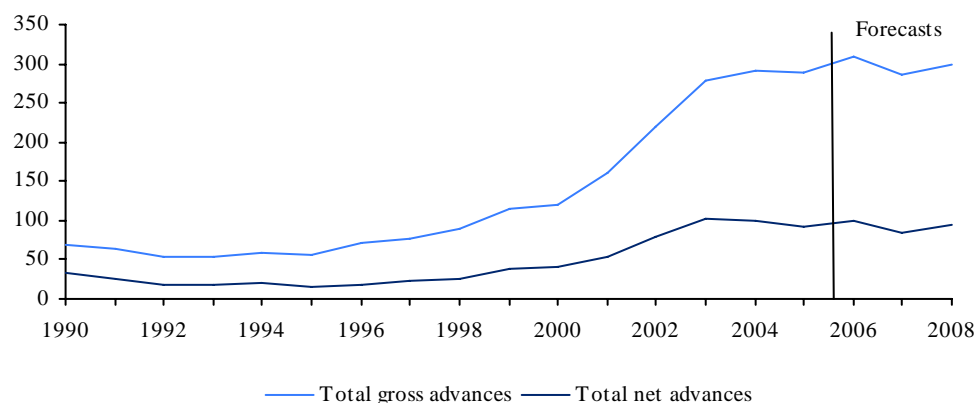
Underlying gross mortgage lending has been running at record levels of £28-29 billion a month since last autumn. The upturn in lending reflects the clear recovery in property sales during the second half of 2005 and strong levels of remortgaging. Rate-driven remortgaging was particularly strong last year as the number of maturing fixed-rate deals increased during the year.

Remortgaging activity involving equity withdrawal appears to have held up well, in part due to switching between secured and unsecured lending. This has helped support underlying net lending at close to £8.7 billion a month so far this year compared with £7.6 billion in 2005. The underlying level of mortgage debt outstanding is increasing at 11% year-on-year.

The impetus from fixed-rate remortgaging is likely to be less pronounced over the next couple of years, with the number of maturing deals rising by less than 10% in 2006 and 2007, to 1.2-1.3 million, compared with around 50% last year. New fixed-rate deals are also less attractive relative to variable rate products than they were six months ago. Unmortgaged equity positions will remain strong for the vast majority of households. This may encourage high levels of equity withdrawal this year, although slower house price growth is likely to be acting as a constraint by the end of the year and throughout much of 2007.

Our forecast is for gross mortgage lending of a record £310 billion in 2006. This is up from £288 billion in 2005 and a substantial upward revision to our previous forecast. Gross lending is expected to fall to £285 billion in 2007 before recovering to £300 billion in 2008.

Chart 6: Gross and net lending, £ billion



Source: Bank of England, CML

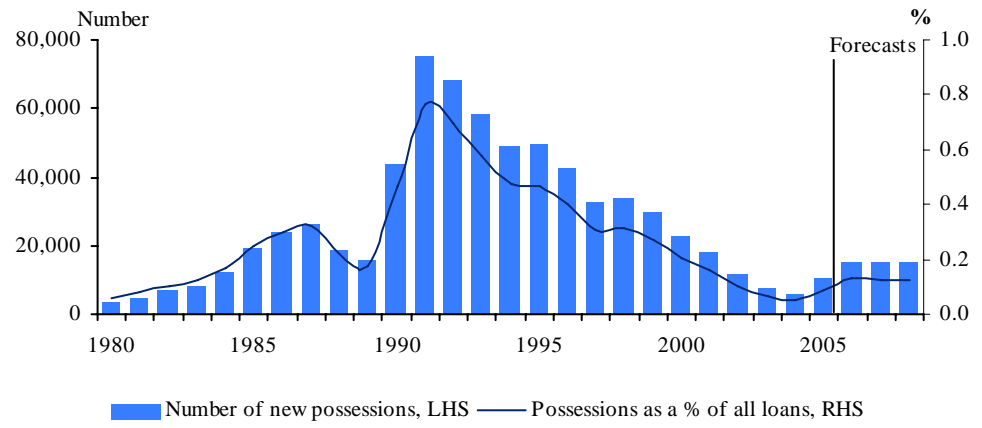
With the number of housing transactions expected to be substantially stronger than in 2005, and continuing appetite for equity withdrawal, we expect net lending to rise to £100 billion in 2006. A lower level of transactions, slower house price growth and reduced appetite for equity withdrawal is expected to result in lower net lending, of £85 billion, in 2007, but it is expected to rise again, towards £100 billion, in 2008. If realised, mortgage debt would grow by more than 10% this year and by 8% in 2007, substantially outpacing growth in household income.

The number of mortgages three or more months in arrears has risen from the low point in 2004. The number of mortgages in early arrears appears to have levelled off, but the number in longer-term arrears continues to rise, albeit at a slower rate. Together, these developments suggest that the number of possessions will rise this year.

The modestly less favourable interest rate background now expected will raise mortgage interest payments relative to income. Such rises tend to be associated with rising arrears a few quarters later which in turn may be associated with a higher level of possessions. We forecast a modest rise in arrears in 2007 and possessions of close to 15,000 a year between 2006 and 2008.

The key perspective is that arrears and possessions are at historically low levels and are set to remain so.

Chart 7: Possessions



Source: CML