NOVEMBER 2022

MORTGAGE AND PROPERTY REPORT

Kensington

Welcome to the November 2022 edition of the Mortgage and Property Report.

Many countries including the UK, the US, Australia and across the EU, have all increased interest rates to tackle rising inflation. In this issue, we look at how borrowers are affected in different ways with the rates on their mortgages increasing.

Key Highlights

- Inflation in the UK is at a 41-year high, and the Bank of England has been increasing the base rate to try and combat it
- There will be 2 million mortgages refinanced over the next year that will have to move onto much higher rates than they have become accustomed to
- High inflation is widespread across the world however affects customers in different geographies differently due to different funding models

Introduction

Due to the high inflation levels in the UK (11.1% in the 12 months to October) the Bank of England ("BoE") has been sharply raising its benchmark interest rate; the Bank of England Base Rate ("BBR"). There have been eight consecutive rises to BBR taking it from 0.1% to currently 3.0%, with the most recent rise being the largest increase in 33 years and the highest rate in 14 years. As a result of this, swap rates and mortgage rates in the UK have sharply increased throughout 2022 (see figures 1 and 2), taking them from historic low rates to levels not seen since the Global Financial Crisis. Although current mortgage rates are not the at the highs previously seen in the mid 90's, the rate at which they have increased this year is going to impact millions of UK customers that have to refinance their fixed rate mortgage, with mortgage rates up to 6x higher within a span of just 10 months.

According to recent data, the BoE has advised that around 2 million mortgages will have reached the end of their fixed term between Q4 2022 and the end of 2023 and that around 80% of them have a current fixed rate below 2.5% (that is about 25% of the outstanding OO and BTL mortgages expected to be refinanced in the next 12 months). Of those due to the refinance in the coming year, the average balance is £130,000 with an average remaining term of 20 years and interest rate of 2.0%. Based on these figures, the average UK mortgage borrower is expected to pay £280 more in interest per month if they decide to refinance with another fixed rate mortgage i.e. a surplus of more than £3,000 a year in mortgage bills versus what they currently pay. A painful prospect given the cost-of-living crisis.

Mortgage rates have dramatically increased following the large jumps in swap rates which reflect the market's expectations of where the BBR will be in the future. For example, the 2-year swap rate is currently trading around 4.5% which is the level where the markets expect BBR to be in 24 months. Mortgage lenders use the swap rate levels to price their fixed rate mortgage products – the pricing of a 2-year fixed rate mortgage is calculated using the 2-year swap rate plus a product margin which varies subject to customer's circumstances, property charateristics and LTV.

As can be seen in figure 2, the sharp and sudden increase in swap rates was very detrimental to mortgage lenders as they were not

Fig 1: UK 2-Year & 5-Year Fixed Rates (75% LTV)

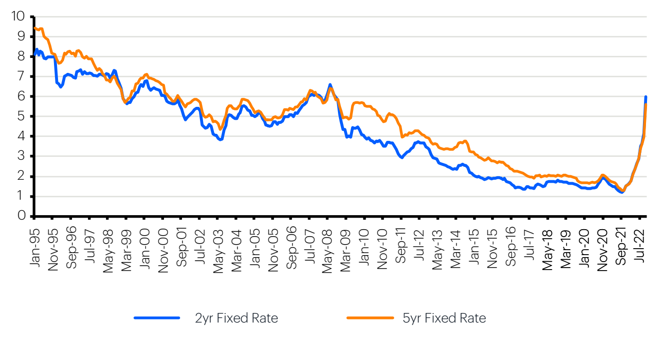
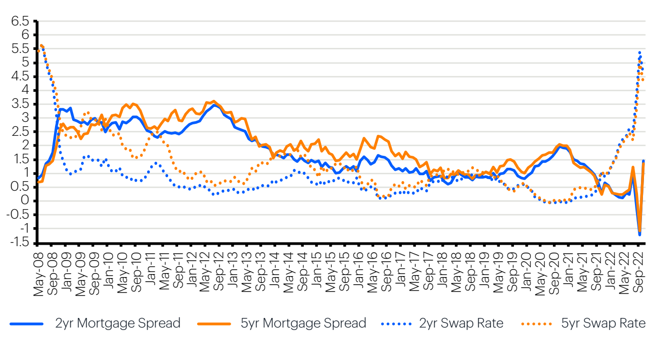


Fig 2: 2-Year & 5-Year Swap Rates vs Mortgage Spread



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able to immediately reprice their mortgage products and therefore while swap rates were at highs, they continued to offer their current range of mortgage products at a loss (the increase in swap rates ate into their profitability margins).

We have seen some stabilisation in the swap markets since Sunak was appointed as the Prime Minister, albeit still at very high levels; however, with inflation still unprecedently high, we do not expect swap rates to decrease anytime soon and therefore UK mortgage customers will continue to face higher mortgage rates for some time.

Mortgage lenders have finally been able to price products at margins of 1.0%-1.5%, which compares to the average over the last 5 years of 1% and 1.2% for 2 year and 5-year mortgages respectively.

However, sharp mortgage rate rises are not just UK-centric; we are seeing an increase in mortgage rates across the world.

High Inflation & Rising Rates: The Global Impact on Mortgages

Similar to the BoE, the European Central Bank ("ECB") has been increasing rates to combat inflation this year, which for the EU was at 10.7% in the 12 months to October. The ECBs key interest rate was raised by 50bps in July, the first increase in 11 years and the largest since 2000 and was raised again by another 75bps in October. It is currently set at 1.5% - the highest level since 2009; ECB rates had been negative for 8 years prior to the July increase. This in turn has caused mortgage rates across the EU to increase, albeit more moderately than the UK. Average mortgage rates across the Eurozone were at ~2.4% in September; this is the highest rate in 7 years and 1% higher than at the start of 2022. With continued rate rises expected by the ECB, further increases are sure to materialise.

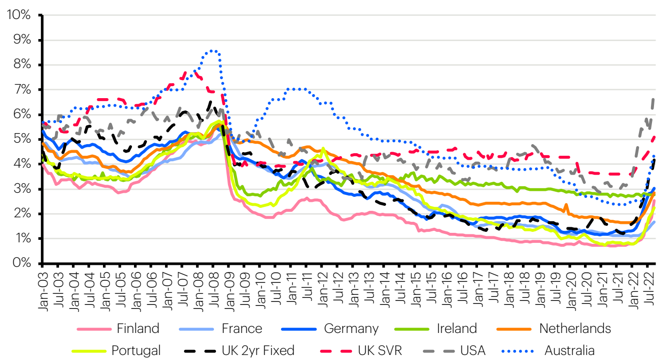
However, mortgage borrowers in certain geographies are not impacted as much as the UK by the recent global rise of rates due to different funding models. In a number of countries like the US or France, the dominant instrument in the market is long term fixed rate mortgages (over 30 years). This contrasts with borrowers in the UK and Ireland, where it has long been common to fix for shorter periods (2 to 5 years, although fixing your rate for longer (>10 years) has become a more popular trend) and regularly refinance. Australian borrowers generally choose variable rate products and will likely be most impacted by sharp rate rises in the near term.

High inflation is widespread across the world, hitting 7.7% in the US in the 12 months to October. The Fed is maintaining its pledge to continue fighting persisting inflation with aggressive rate hikes, increasing rates to a new target of 3.75% to 4% in its latest increase at the beginning of November. US mortgage rates recently topped 7% for the first time in 20 years and mortgage applications in the US have been declining, reaching their lowest level since 1997. While those with an existing mortgage are likely to be less impacted due to the longer fixed terms taken, this will impact those looking to enter the housing market and will see first time buyers pushed out as affordability is severely impacted. Similarly in France, although rates are much lower (currently around 1.68% for 30 years), many banks do not have an appetite to provide mortgages in the current economic backdrop (there are also no specialist lenders in France and only a limited number of banks that offer new mortgages) therefore first-time buyers are struggling to get onto the property market.

In Australia the CPI inflation rate reached 7.3% in the 12 months to September, a 32-year high, and is due to peak at around 8% by the end of the year. The Reserve Bank of Australia ("RBA") recently raised rates by 25bps to 2.85%; a 9-year peak and its 7th consecutive hike, with 275bps of rate hikes since May of this year. Similar to the UK, with persisting high inflation, RBA rate rises and a choppy economic backdrop, Australian mortgage rates have increased significantly throughout 2022. Although rates in Australia have been historically higher than the UK, they reached record lows post covid and have had a sharp increase in 2022 – an average 3-year fixed term rate is currently around 6% and a variable rate is 4.9%. In Australia, the majority of borrowers opt for a variable-rate mortgage, although a much higher proportion during covid opted for fixed rates due to the exceptionally low rates offered. 2022 has seen a reversion back to variable rate loans, with many Australians not wanting to lock in at the higher rates. This could put pressure on the budgets of many households, as rates are expected to continue rising to combat inflation and remain elevated for the foreseeable future.

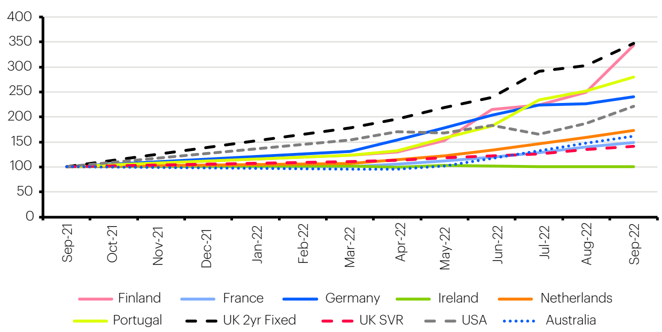
As you can see in figure 3, the US mortgage rate is the highest absolute rate of those compared (as at Sep-22), however looking at figure 4, the rate at which the UK 2-year fixed mortgage rate has

Fig 3: Global Mortgage Rates



Nb. The above show average rates on loans to households in each month for house purchases from monetary financial institutions in the respective countries

Fig 4: Mortgage Rate Increases - Rebased to 100



Nb.: Total calculated by weighting the volumes with a moving average defined for cost of borrowing purposes and rebased to 100

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increased far outstrips it; and is also the most increased rate across Europe. The UK standard variable rate is one of the least increased rates and is converging with the 2-year fixed.

Although mortgage rates in the UK have increased significantly this year, we do not expect to see them returning to the low levels that we have become accustomed to over the last six years and in fact the rates we are seeing now are likely to be the norm for years to come.

Sources

Fig 1: BoE Data (Latest data available to Oct-22)
Fig 2: BoE & Bloomberg Data
Fig 3 and 4: ECB, BOE, RBA & Bloomberg

NVG/CM/8001/020/NOV22