Market Update

November 2023

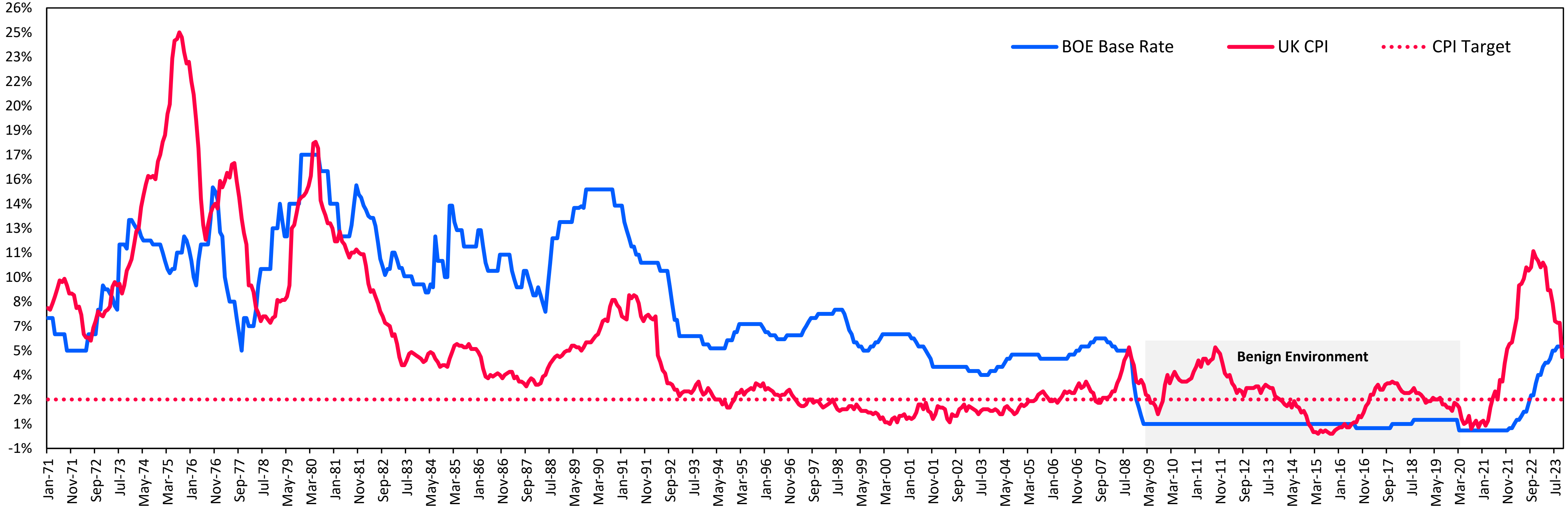
Kensington

UK CPI & Interest Rates **Where have we been?**

Kensington

- Last year inflation in the UK spiked to levels not seen since the late ‘80s, however the most recent **October print** has shown **inflation has fallen** at the steepest pace in over 30 years **to 4.6%**
- This spike in CPI prompted the Bank of England to **raise the base rate 14 times** since December 2021, to 5.25%, not seen since the GFC in 2008; however, the last MPC meeting saw a pause in the rate hiking cycle
- Although in recent times this rate seems high, in the years since 2009 there has been a relatively benign economic environment, until now; and if we look back at history, **the current Base Rate is in line with prints before 2008 and still much lower than in the early 90s and in the 80s** – rates may never be as low as they have been in the last 15 years, especially in current lifetimes

Bank of England Base Rate & Annual CPI



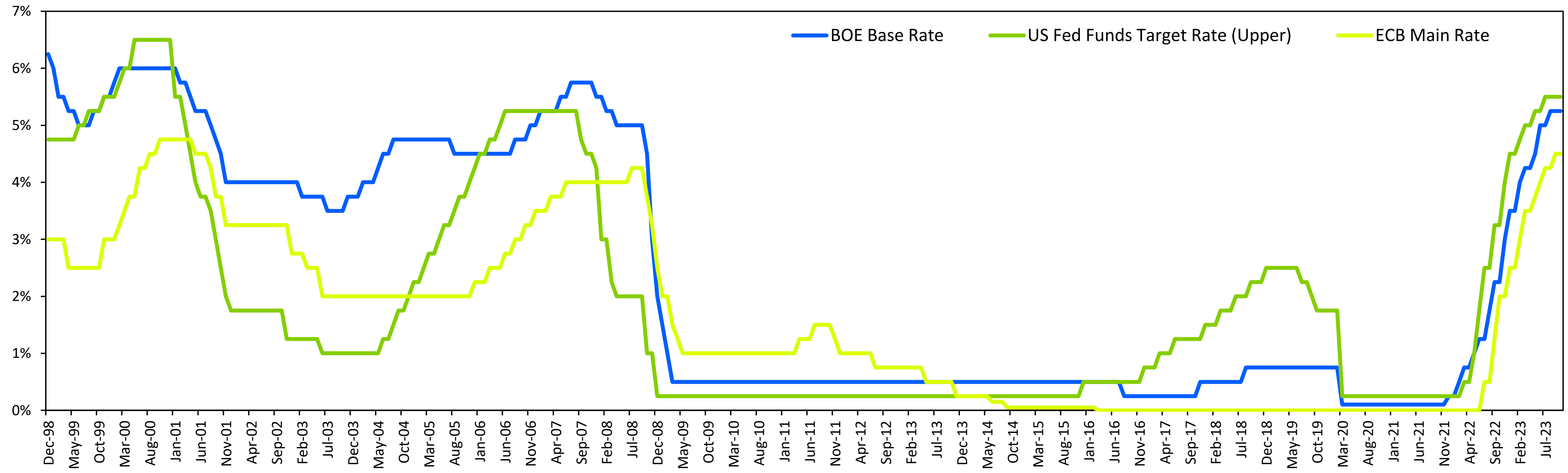
Source: Bloomberg - BoE and ONS

World Key Interest Rates How do we compare?

Kensington

- **Interest rates are high across the world**, with the key upper rates from the **Fed and the ECB at 5.5% and 4.5%** respectively
- In the UK, new borrowers have been hit by higher mortgage rates but, so have those that already own a home that have had to remortgage; meaning **the pain has been spread more evenly** between **buyers and existing owners** and the **housing market, even though subdued, keeps on moving**
- Due to the US having only 30-year fixed rate mortgages, **new borrowers are hit with high rates**, however those that own their own homes are **insulated from rate rises** and are therefore **less likely to sell in this environment**; this is also causing a shortage of houses in the US and driving up prices, which are **up 40% over the past 3 years. There has also been a massive decline in mortgage refinancing as customers have no incentive to lose their low rate mortgages**
- In the EU the story is not much better, with many EU countries dealing with the **common challenge of providing affordable and accessible housing** for their citizens

Key World Central Bank Rates

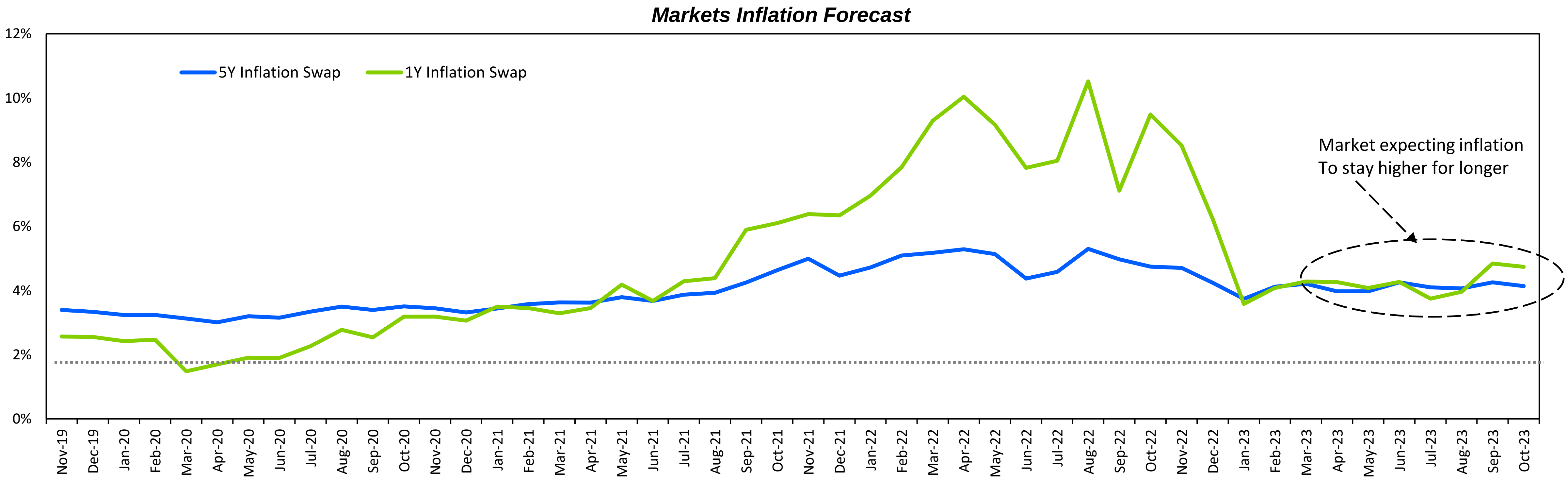


Source: Bloomberg

Inflation & Rates Where do we go from here?

Kensington

- The below graph shows 1-year and 5-year inflation swaps; a derivative used to transfer inflation risk from one party to another
- This provides a good indication of where the market believes inflation will be in 1- and 5-years' time; i.e. currently just over 4%
- Although **inflation fell sharply in October**, this was largely due to **lower energy prices**; however, **core prices were up 0.1% MoM** and **services inflation fell only by 0.3% MoM** (softer than expected)
- With energy prices set to rise again, although more modestly than we have seen previously, inflation remains sticky and therefore **rates are likely to hold until inflation returns to the 2% target rate**



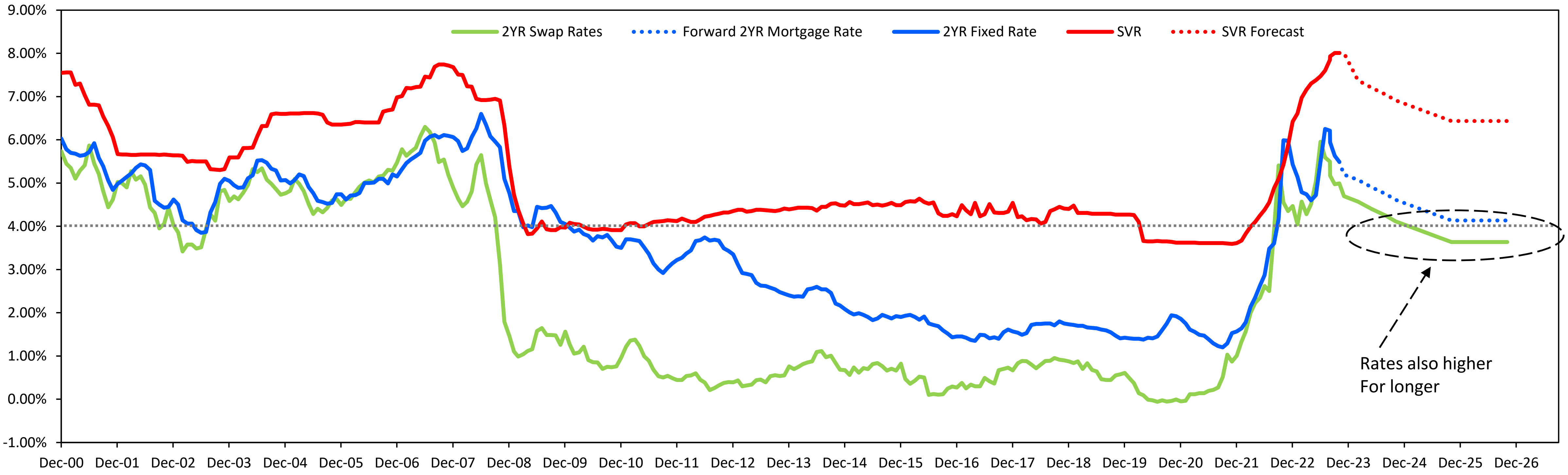
Source: Bloomberg

Mortgage Rates **Where Next?**

Kensington

- With **inflation** and the **BoE Base Rate** expected to **remain higher for longer**, what does this suggest for mortgage rates?
- Mortgage rates have been **exceptionally low for the last 15 years**; however, **these are not the norm -** mortgage rates before the financial crisis were between 4-6%
- Using forward swap rates, we can come up with a forecast for future mortgage rates if we assume:
  - 2yr fixed rates continue to track 2 year swaps
  - SVRs track BBR+3%
- Using this logic, the **2-year mortgage rate** is anticipated to **fall slowly over the next 2 years but stabilize around 4.%** by 2026

SVR & 2-Year Fixed Rate Forecast



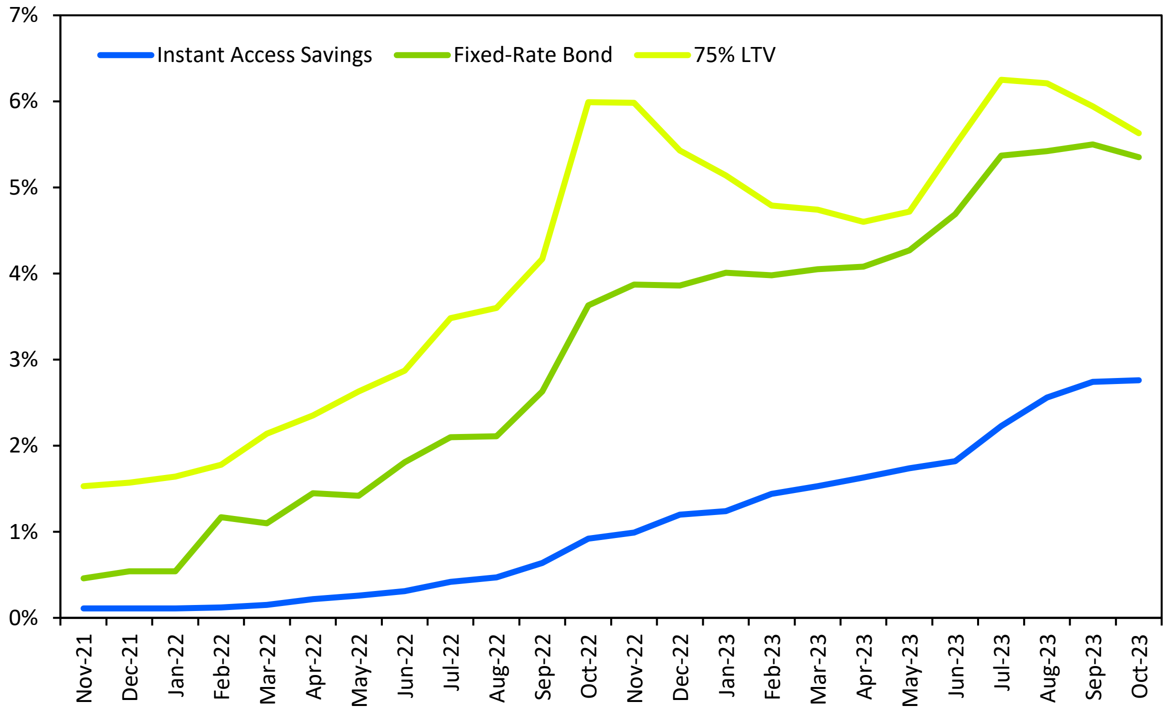
Source: Bloomberg

Bank Margins What is the difference between lending and funding?

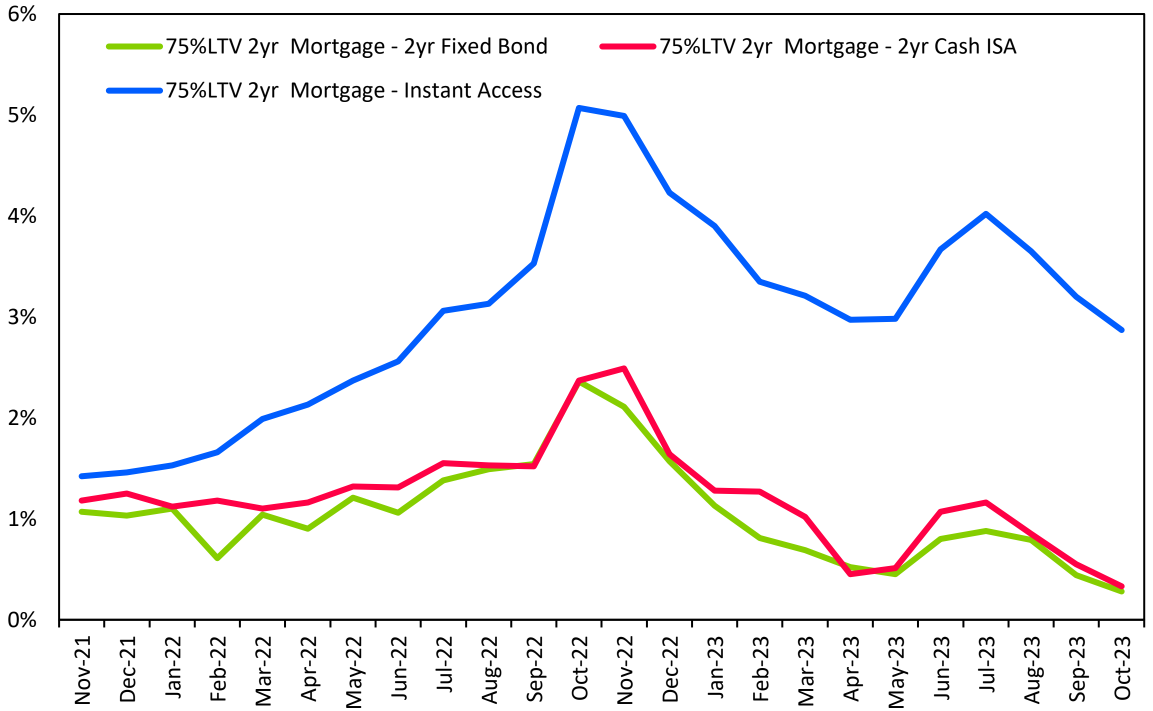
Kensington

- There have been a lot of headlines and news articles recently about how lenders have been **quick to increase mortgage rates** and **slow to increase deposit rates**
- **Bank profitability** is driven by the **difference in lending rates and cost of funds**, which for most is a function of retail deposit rates
- It is important for Banks to balance the interests of savers with mortgage borrowers
- Since last years Autumn Budget, where the country experienced huge volatility, **margins have been compressing** and for a 2-year fixed bond or 2-year Cash ISA vs a 2-year fixed 75% LTV mortgage profitability is next to nothing

Mortgage & Deposit Rates Have All Increased



The Margin Between Mortgages & Deposits Has Shrunk



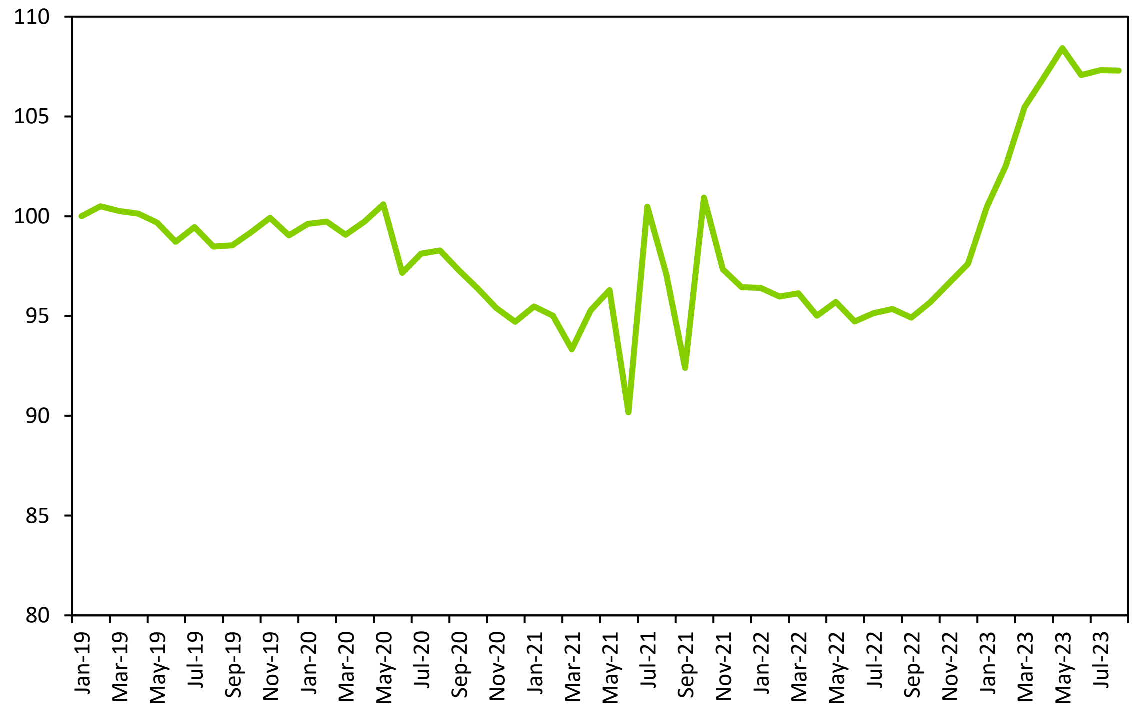
Source: BoE

Buy to Let Still a good investment?

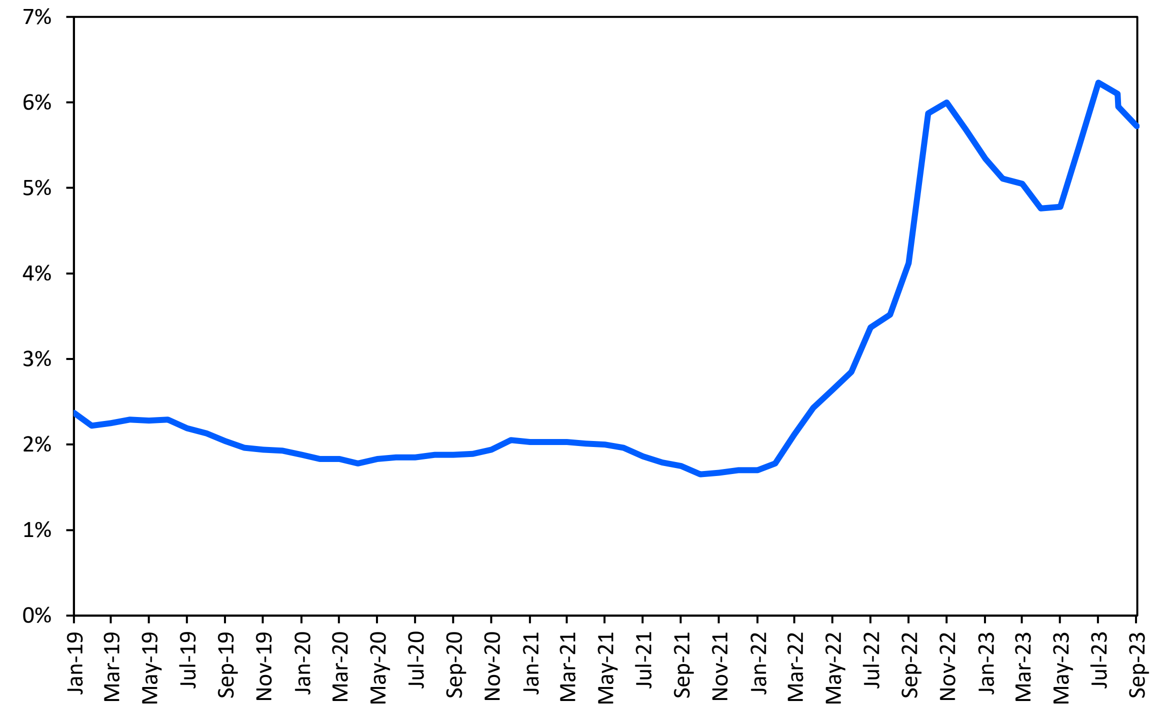
Kensington

- Changes over the years in BTL regulation (**3% stamp duty surcharge, reduction in mortgage interest relief, capital gains tax reductions** etc.) have meant changes in the type of landlords and how they operate
- Due to the changes mentioned above, there has been a steady **increase in Portfolio landlords** and **Limited Co. landlords;** these landlords also better placed as they are able to manage and rebalance increased rates across their portfolio
- **Higher mortgage rates** have meant landlords have had to **increase rental charges**, with average rents for new rental properties **10.5% higher in the 12 months to September** (according to Zoopla's latest Rental Market Report)
- However strong pay growth has supported this, with **some landlords able to pass on the higher costs**; those that have been unable to have likely had to leave the market, with the BTL market overall shrinking since the start of 2022

Gross Rental Yields – Rebased to 100



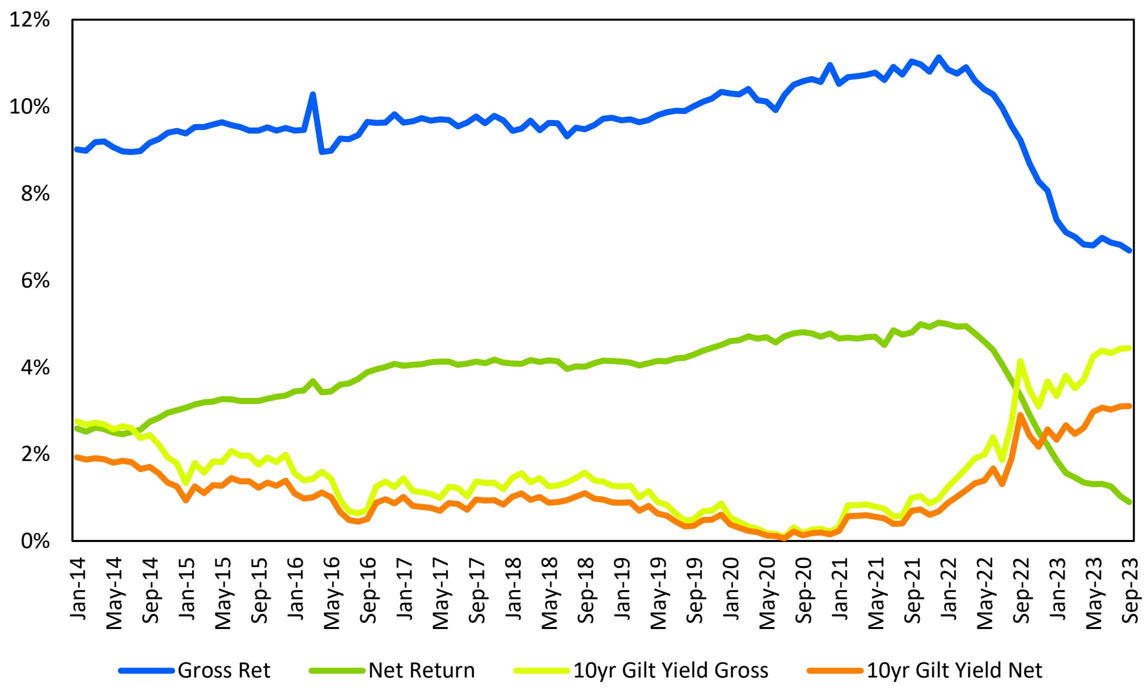
BTL 2yr 75% LTV



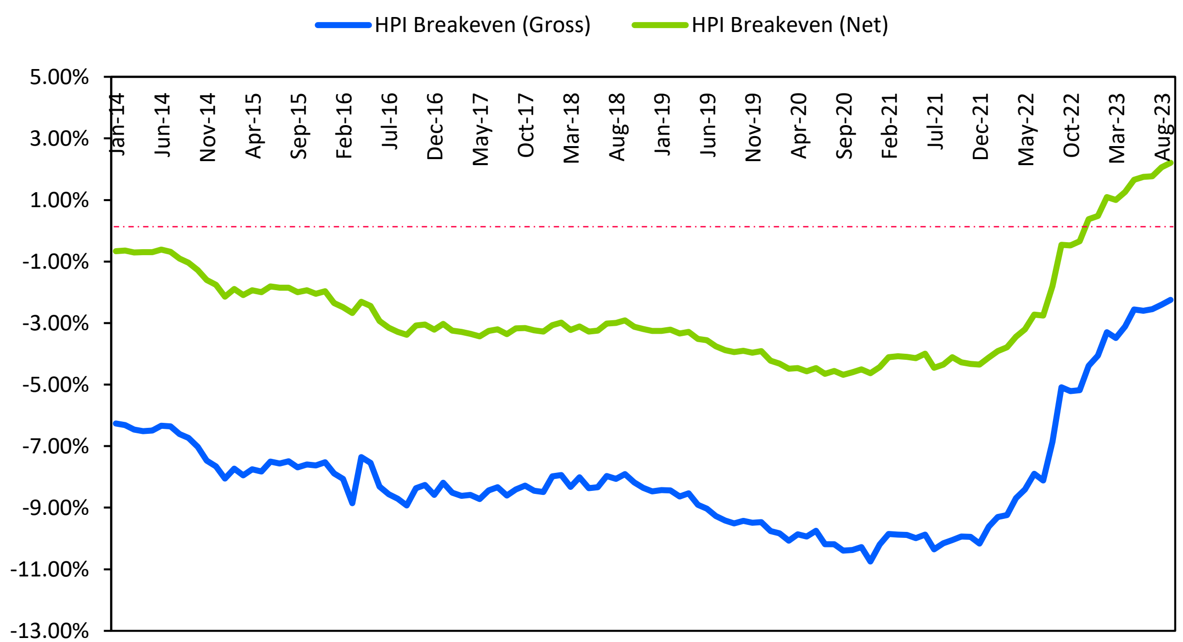
Buy to Let Still a good investment?

- For a long time **the yield for a new BTL investor** (with a mortgage) was **far in excess of the risk-free government bond yield** (LHS) even when taking into account 10% costs and 30% tax on both
- **Buy to let had a further advantage of a positive outlook** for **capital appreciation** and a **rental income** that was loosely linked to inflation
- However, that started to change in mid 2022 as mortgage rates and gilt yields started to increase; **on a net basis the BTL return is heading for zero** if we don't include capital appreciation
- The chart on the RHS shows the capital appreciation (per annum) that is required on the BTL property to give a better return than the risk-free government bond. That has finally turned positive, i.e. **for the typical investor buying a BTL property with a mortgage** (or refinancing) **the HPI must be 2% per annum** (or 22% cumulative) **over the next 10 years**

Levered BTL Returns vs UK 10yr Government Bonds



Annual House Price Change Needed to Give the Same Return on BTL as Government Bonds (10yr)

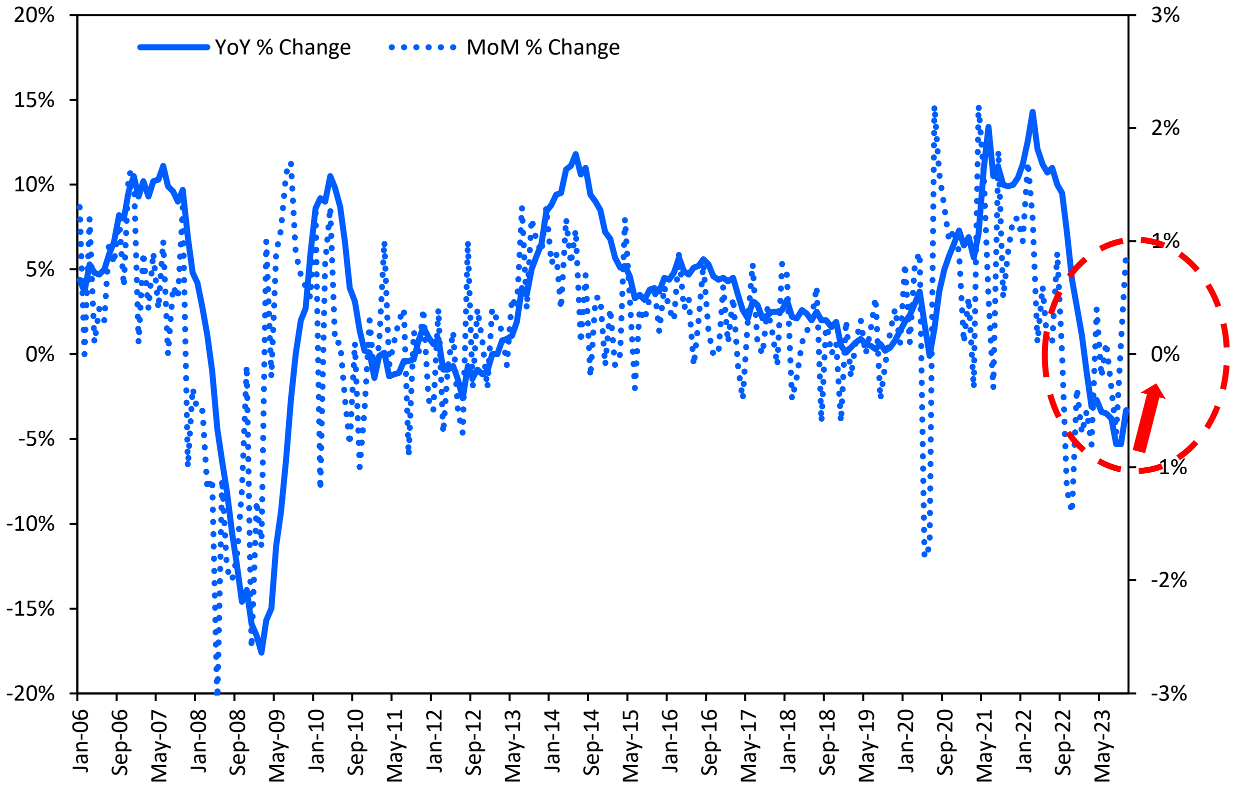


House Prices Which direction?

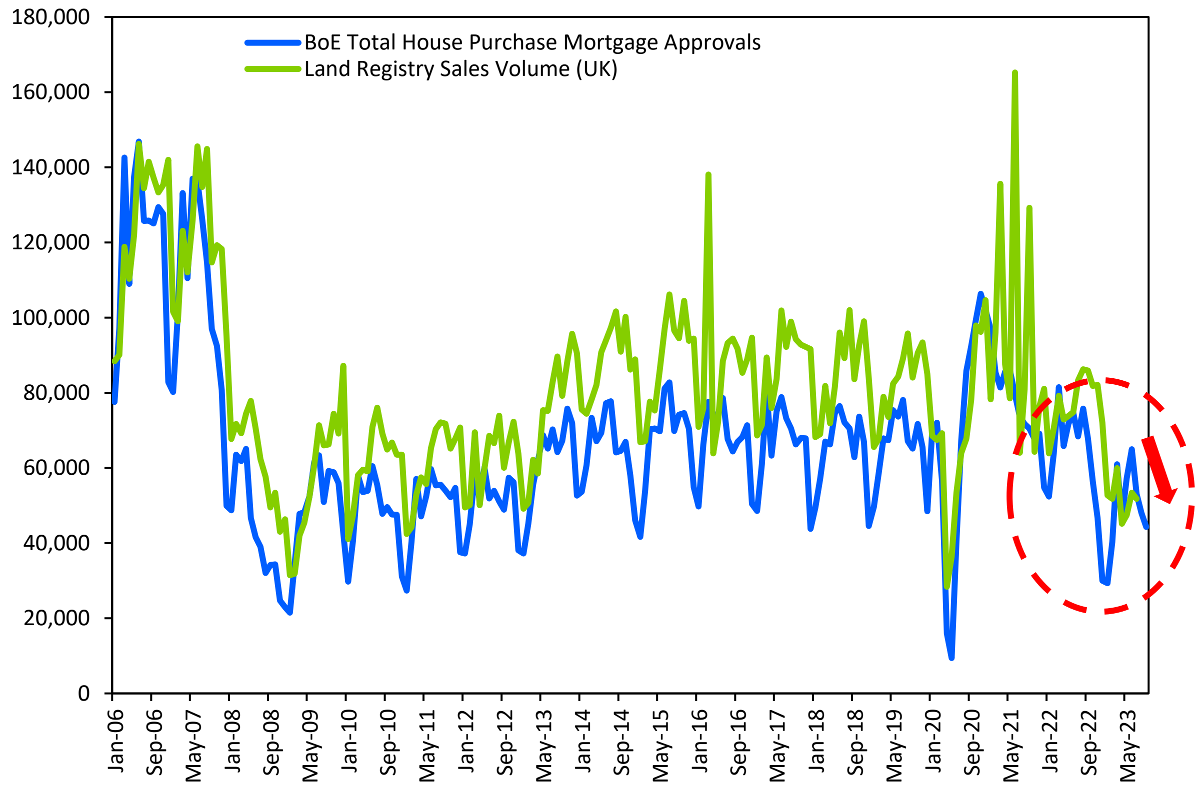
Kensington

- The Nationwide House Price Index saw the start of a recovery with a **0.9% rise in house prices in October**
- Although the **mortgage market remains weak**, with net house purchase **mortgage approvals falling to a 7-month low** of 44k in September, down from 48k in August and 53k in July
- Therefore, the question remains **whether this is a real recovery** or is a result of **lower available housing supply**, with sellers less inclined to sell in a high rate / lower house price market. BTL is less attractive compared to other asset classes so this could reduce demand / increase supply

Nationwide House Price Index



UK Mortgage Approval and Sales Volumes (by number)



Source: Nationwide Building Society

The Autumn Statement Key Housing Sector Takeaways

Kensington

- ✓ **Infrastructure projects and planning applications to meet guaranteed faster timelines**
- ✓ **£110m invested in the next 2 years to deliver high quality "nutrient mitigation schemes" - unlocking 40k homes**
- ✓ **£32m to "bust the planning backlog and develop fantastic new housing quarters in Cambridge, London and Leeds,** which will lead to many thousands of additional dwellings"
- ✓ **£450m to local authority housing fund to deliver 2,400 homes**
- ✓ Mr Hunt also promised a consultation into new permitted development rights, which would **allow any house to be converted into 2 flats as long as the exterior remains unaffected**
- ✓ **Increase the local housing allowance to the 30th percentile of local market rents –** providing 1.6 million households an average £800 additional support next year