Market Commentary

It is now clear that housing and mortgage market activity is softening in response to rising interest rates.

The level of property transactions has been very strong in the early months of this year, but this reflects the strength of demand late last year. Buyer interest has since softened. The number of mortgage approvals for house purchase is now running 15% below the high levels of last autumn and at the lowest level since April last year.

The fall in buyer interest has been greatest amongst first-time buyers, where numbers are down 4% on a year ago. Making the first step onto the housing ladder has become increasing difficult. A typical first-time buyer is now borrowing more than 3.3 times their income and faces levels of mortgage interest payments relative to income last seen in the early 1990s.

But it not just first-time buyers who have been affected. March was the first month in which the number of loans to home movers fell below that of a year earlier. And the number of approvals for further advances has fallen to the lowest level since 2001 which suggests that higher interest rates are reducing the attractiveness of extracting equity to finance home improvements and general spending.

The impact of interest rates on activity has not been evenly distributed across the UK. Activity remains strong in London and the South East, Scotland and Northern Ireland where a number of special factors are supporting demand. And the supply of property is heavily constrained in London and the South East.

Annual house price growth remains close to 10%. It is 50% in Northern Ireland and close to 14% in Scotland and London, but around 7% to 8% in the Midlands and northern regions. The upward momentum has eased a little since the end of last year. The annual rate of house price growth typically moderates 6-9 months after a peak in mortgage approvals for house purchase, so we should expect it to start slowing during the second half of this year.

The underlying level of mortgage lending probably peaked in March. Gross lending then was £31.8 billion, but it fell to £30.1 billion in April. This was 9% up on a year earlier, although the lowest monthly figure since last October. Similarly, the underlying level of net lending has moderated to the levels of last autumn, although the value of mortgages outstanding continues to grow at an annual rate of close to 11.5%. The lower value of mortgage approvals seen in the

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last couple of months almost certainly means that the underlying levels of gross mortgage lending will soften a little in the months ahead.

The underlying level of mortgage approvals for house purchase is likely to continue to moderate until it becomes clear that the level of interest rates has peaked. We are not yet at that point. Indeed, interest rates of all maturities have risen further over the past month as the Bank of England raised Bank rate by 0.25% to 5.5% in early May and longer maturity rates built in the prospect of rates rising to 5.75% within the next month or two and to 6% by the end of the year.

The health of the housing and mortgage markets are not solely related to interest rates. Employment and household income prospects are also important, and these are expected to remain positive.

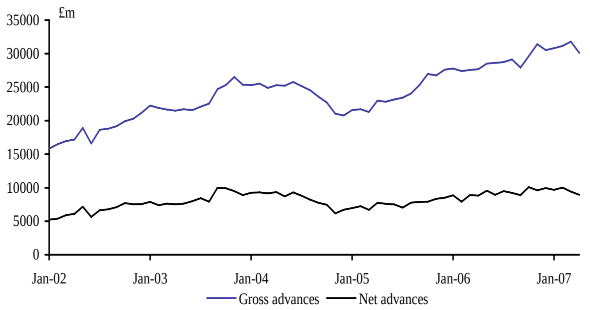
The Bank of England's latest central projections for the economy, published in the May Inflation Report, show the economy continuing to grow in a range of 2.75% to 3% over the next couple of years despite Bank rate rising to 5.75%. There is considerable uncertainty over the outlook, but this central projection is virtually unchanged from February when interest rates were expected to peak at a lower level and to turn down somewhat earlier than is expected now. And it is compatible with continuing growth in employment and close-to-trend growth in household incomes.

Parts of the economy have been, and are now expected to remain, stronger than the Bank previously thought, particularly business investment. The Bank is not obviously looking to squeeze the economy as a whole to increase the level of spare capacity in the labour and products markets to bear down on inflation. But it does appear that higher interest rates are being used to bear down on activity in the more interest rate sensitive parts of the domestic economy, of which the housing market is perhaps the most important, to offset this unexpectedly strong activity elsewhere.

The bigger picture is that the economy remains fundamentally healthy and that activity in the housing and mortgage markets will pick up again once it is clear that interest rates have peaked.

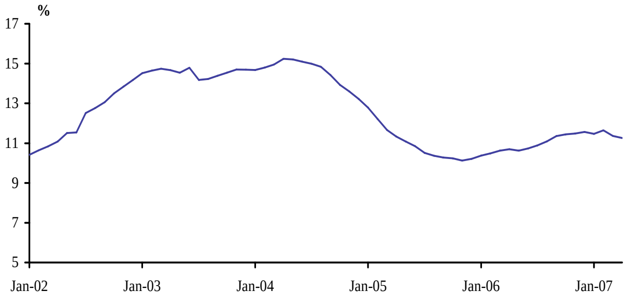
Our updated Housing and Mortgage Market Forecasts: 2007-2008 will be published later this month.

Chart 1: Gross and net lending



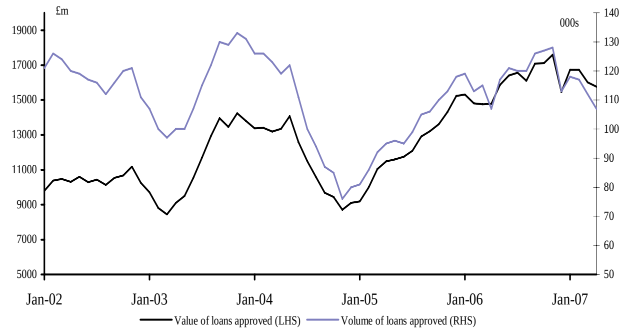
Source: Bank of England
Notes: Seasonally adjusted

Chart 2: Annual growth in value of outstanding mortgages



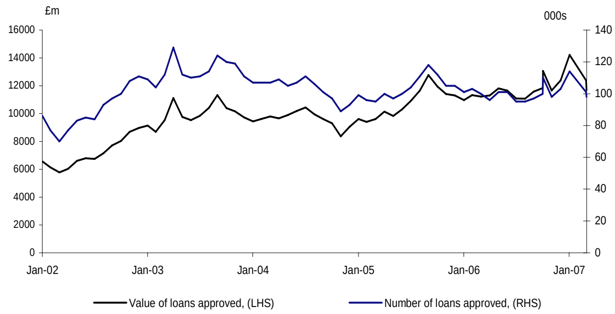
Source: Bank of England

Chart 3: Loans approved for house purchase



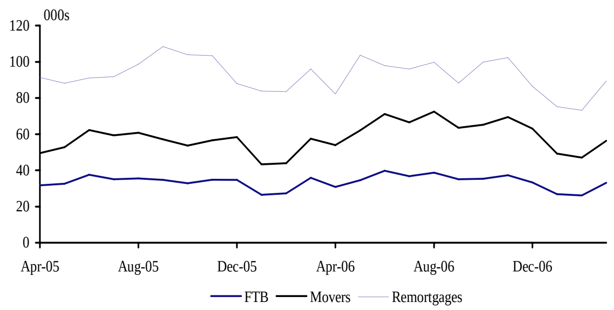
Source: Bank of England
Notes: Seasonally adjusted

Chart 4: Loans approved for remortgaging



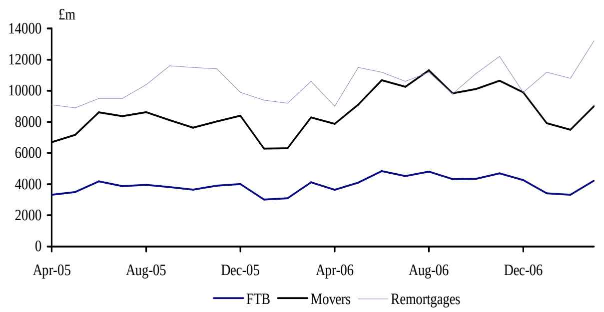
Source: Bank of England
Notes: Seasonally adjusted

Chart 5: Number of advances



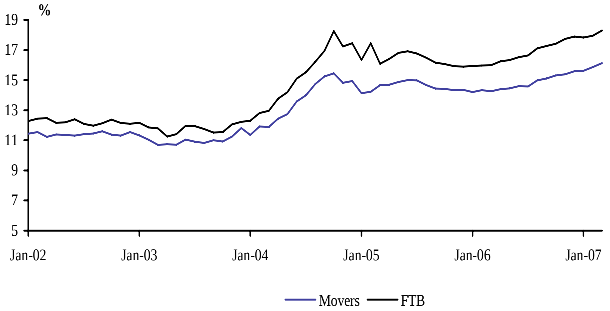
Source: CML/BankSearch Regulated Mortgage Survey
Notes: Not seasonally adjusted

Chart 6: Value of advances



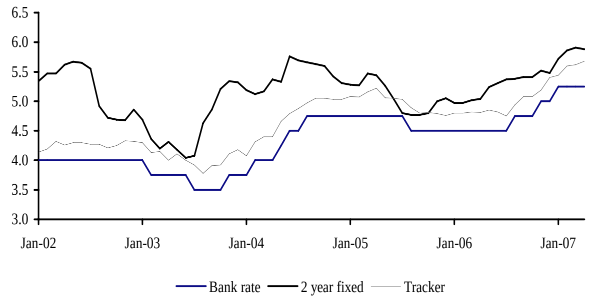
Source: CML/BankSearch Regulated Mortgage Survey
Notes: Not seasonally adjusted

Chart 7: Interest payments as a % of income, FTB and movers



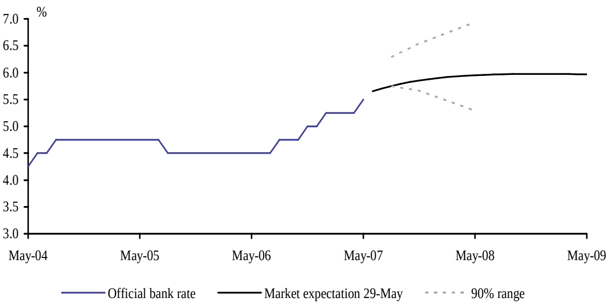
Source: CML/BankSearch Regulated Mortgage Survey

Chart 8: Mortgage interest rates



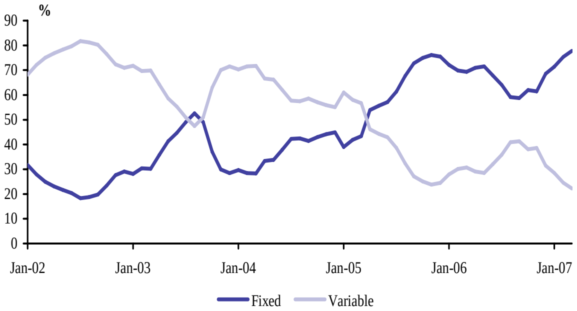
Source: Bank of England
Notes: Mortgage market rates are based on a loan to value ratio of 95%

Chart 9: Interest rate expectations



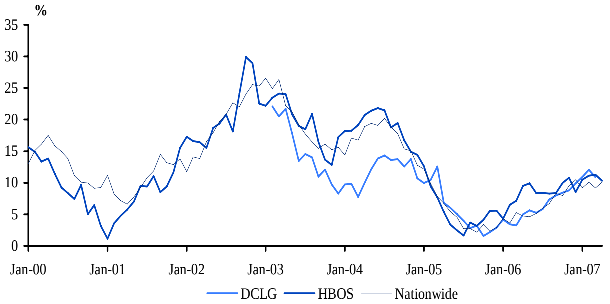
Source: Bank of England
Notes: The market expectation curves relate to commercial bank liabilities which will typically be 10-15 basis points higher than the Bank of England's official bank rate. The market expectation ranges are derived from short sterling option and futures contracts traded on LIFFE.

Chart 10: Fixed and variable rate mortgages – share of new loans



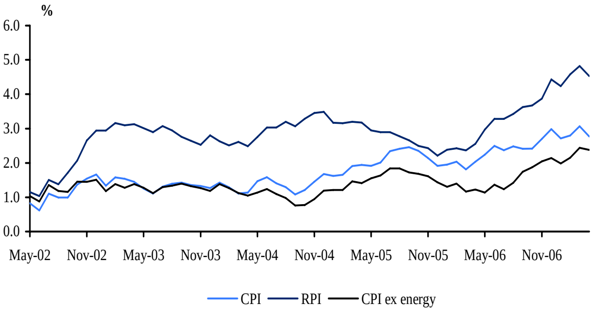
Source: CML/BankSearch Regulated Mortgage Survey

Chart 11: House price growth, annual % change



Source: DCLG, HBOS, Nationwide

Chart 12: Inflation



Source: Office for National Statistics