How rising interest rates could decimate the housing market

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With the announcement of a further hike in interest rates to 3.5% KIS Finance (https://www.kisbridgingloans.co.uk/) has been looking at how this 9th consecutive rise since last December could decimate the housing market.

The UK economy is currently reeling from a barrage of problems. With inflation running at 10.7%, significantly above the 2% target, and the cost-of-living soaring, households are under extreme pressure.

Furthermore, the decision by the Bank of England to increase interest rates from 0.1% last December to their current rate of 3.5% has added a further layer of pressure onto a struggling population. With no end to the current crisis in sight, this latest rise is likely to bring added misery to those who are already struggling.

Why is the Bank of England raising interest rates during a recession?

In the normal scheme of things, the Bank of England would usually reduce interest rates in a recession to try to stimulate growth. Similarly, in times of high inflation they would use the same form of monetary policy to raise interest rates, to control inflation by reducing spending.

However, the economy is currently in the challenging situation of facing both high inflation and a recession at the same time. In response the Bank of England has been increasing interest rates to try to reduce consumer spending and bring inflation under control.

The question is, what will be the impact of this approach when the current key inflationary drivers are unprecedented. Usually increasing inflation is linked to the economy overheating due to excessive consumer spending on non-essential items such as sports cars, holidays, entertainment and luxury items.

Currently it is essential items that are rising in price, so raising interest rates will decrease the money we have available to spend on these items, meaning we buy less of them, decreasing the demand and lowering their prices. All understandable if this was for new cars, holidays and other luxury items, but this is not for luxury items, we are talking about essential items, and reducing people's ability to buy food and pay their energy bills!

What factors are driving current inflation rates?

Current inflation rates are being driven by external global factors; the impact of the war in Ukraine, energy costs, supply chain issues, labour shortages and the lasting impact of the pandemic. Therefore, placing further downward pressure on consumer spending by raising interest rates will have little effect

on these factors and is impacting consumers' ability to purchase essential items such as food and heating.

Why traditional answers could make things a lot worse

Following the traditional route of raising interest rates to curb expenditure is only serving to further the misery for both individuals and businesses, who are in the grip of a cost-of-living crisis. In fact, this approach may make the prospect of a long recession more likely, as the potential for economic growth is severely hit, meaning that we can't grow our way out of this recession.

Whilst inflation fell slightly last month from 11.9% to 10.7%, it is still significantly above the target level of 2%. It's therefore not surprising that the Bank of England is focused on bringing this down, but in the current complex environment, is raising interest rates so significantly, the answer? Squeezing consumers and commercial borrowers too hard will stagnate any growth in the economy and push us further into recession.

Bad news for households?

The Office for Budgetary Responsibility (OBR) are forecasting a record breaking 4.3% drop in disposable incomes per person during the current tax year, which will be the largest fall since the Office of National Statistics' records began in 1956. They are anticipating that this will reduce to a drop of 2.8% during the next tax year, but this is still highly concerning and is only the third time there has been a drop over 2 consecutive tax years.

Many economists believe that the current interest rate hikes will lead to a recession as growth and investment slows, but that in time interest rates will fall again. However, in the meantime the damage is being done and companies and individuals are feeling the hit of soaring interest rates alongside high rates of inflation.

The Bank of England has stated that "if necessary we will raise interest rates further to make sure inflation comes down" and are predicting a "very challenging" 2 year recession. But what will that mean for homeowners, first time buyers and the overall housing market?

What will this mean for the housing market?

Interest rates have been at a record low since 2009, so we've all got use to low mortgage rates and our borrowing habits have been shaped by this. However, the current soaring interest rates are already having a huge impact on the housing market, for both existing homeowners and those trying to get onto the property ladder for the first time.

Recent data has shown that 1 in 4 mortgage customers have seen their repayments increase every 6 weeks since December 2021, with those on variable rate or tracker mortgages (where the rate is linked to the

base rate of interest) being the first to feel the impact.

Renters are also feeling the pressure as many landlords are having to increase rents to cover their own increased buy to let mortgage interest costs.

Will people lose their homes?

Interest rate increases of the level seen over recent months will have an enormous impact on people's cost of living and could see many fall into mortgage or rent arrears, and ultimately even lose their homes.

With the latest increase in interest rates from 3% to 3.5%, the impact on someone on an average tracker mortgage will be around £43 per month. Those on variable rate mortgages will see an average increase of £31 per month. This comes on top of the impact of rate rises over the previous months, which means that the average tracker mortgage customer is now paying around £327 more a month than they were in December last year. Increases of this quantum are likely to have a significant impact on household budgets and for some will be impossible to absorb.

What will this mean for house prices?

House prices are already being affected, with the average annual increase in house prices falling in November to 4.7% from 8.2% the previous month. This equates to a 2.3% monthly fall in prices, which is the most significant since the recession in 2008.

At the same time Zoopla have reported a 44% decrease in demand for housing since the mini-budget which saw interest rates soar.

With the price of an average house falling from £268,282 to £263,788, current homeowners will be affected if they are looking to re-mortgage when an existing fixed rate comes to an end. This is because the loan to value of their mortgage may well have increased if the value of their property has fallen, which will add further costs to finding a new mortgage product.

People who are struggling to make ends meet may want to downsize to reduce their outgoings on mortgage payments and running costs. However, if house prices fall, they may not be able to do this due to losing equity in their current property or even finding themselves in negative equity. This could also be the case where couples are separating and need to sell their house but find themselves trapped, as they no longer have enough equity in their house to split and purchase a smaller property.

Those with fixed rates due to expire shortly may want to lock into a new fixed rate now to have some greater certainty over the coming months, but the reality is that their mortgage outgoings will be greatly increased from what they have been used to and there is a worrying possibility that the number of repossessions may increase as a direct result of unsustainable mortgage costs.

What does the future hold?

With the Bank of England stating that rates may not go as high as originally predicted, there is hope that fixed term mortgage rates may start to level out, as lenders will look at the likely interest rates over the next 2 to 5 years when setting fixed term rates. But in short term a huge number of mortgage products have been removed from the market and those who are currently looking for a fixed term product have a very limited choice.

At what level could interest rates wind up?

There is a lot of uncertainty in the market and the Office of Budgetary Responsibility (OBR), who are the official forecasters, have been criticised for predicting “implausibly high” mortgage rates. The OBR has forecast that the effective rate on existing mortgages will nearly double from 2.2% in September 2022 to 4.3% by summer 2023, peaking at 5% across the second half of 2024. This refers to the average cost of all existing mortgages.

Some analysists are now predicting that the effective interest rates on outstanding mortgages will peak at 3.7% by the end of 2024 rather than the 5% forecast by the OBR. If this were the case, in real terms this amounts to a substantial difference of £200 a month in repayments for a £200,000 mortgage.

This lack of certainty is having a dampening effect on the housing market, as buyer put off making a move until there is a clearer picture of how the coming months will pan out.

Why may the OBR have got their predictions wrong?

The reason that some are questioning the OBR forecast is that it was calculated in the 3 working days until 26 October, when the impact of the mini budget and the uncertainty that it created, was strongly affecting the markets.

However, those facing the prospect of having to re-mortgage when their current fixed rate ends or are buying for the first time will still be facing much higher repayments than they would have previously expected.

How will the widder economy be affected?

The policy of raising interest rates to control inflation will certainly worsen the economic outlook for the near future. Growth will be stalled due to the soaring cost of living from energy bills, food prices mortgage rates and other finance costs, all of which are squeezing the economy and driving down the consumer spending which is needed to support growth in the economy.

Higher interest rates will also discourage businesses from investing. The resulting reduction in business

expansion and the creation of new jobs will all reduce the capacity for new growth in the economy. This is of particular concern as the cure for recession is growth.

Alternative approaches, such as raising VAT to curb expenditure rather than using interest rates, would mean that the main burden was not just on borrowers, and could spread the pain more evenly across the population. However, raising interest rates remains the current approach to the issue, despite the devastating effect that this will have on the housing market and industry.

Bank of England stand by their decision to raise interest rates

The Bank of England still stand by their stance that inflation needs to be bought under control as the first priority and that they expect it to fall back by the middle of next year. They have announced that they expect interest rates to "peak lower than priced by the financial markets" and are clearly trying to reassure people, rather than kill off any prospects of growth.

However, with so many unknowns in the mix, such as the impact of the war in Ukraine, there can be little certainty in the market.

In the meantime, the push on interest rates is have a devastating impact on many businesses, households and the housing market, the damage from which will be felt for many years to come.

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About KIS Finance:
KIS Finance are an independent finance broker specialising in bridging finance, development finance, commercial mortgages, equity release, and secured loans. Their team of advisors have considerable experience across multiple different areas of the finance sector, as well as insurance and compliance.

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