RETTIE & CO. RESEARCH REPORT
Scottish property market insight

RETTIE

2022/23 WINTER MARKET BRIEFING

A Challenging Winter

AN EVENTFUL YEAR

2022 has been an eventful year. Russia's invasion of Ukraine triggered a number of significant effects, as rising energy costs fuelled inflation and contributed to a cost-of-living crisis that has rekindled memories of the early 1970s, with industrial action rife and governments struggling to handle the impacts of change.

Amazingly, the UK had 3 Prime Ministers and 4 Chancellors of the Exchequer over the course of the year. And even since our last Market Briefing in September a lot has changed. Significant political upheaval followed the end of Boris Johnson's premiership, leading to economic turmoil in the weeks following Liz Truss's ascendancy, followed by a gradual settling down in the markets as Rishi Sunak took charge.

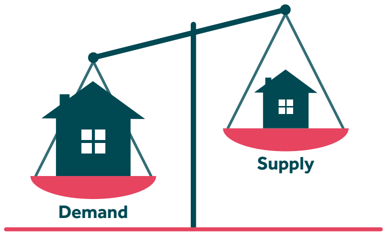
As the economic indicators have changed, so has our outlook, and this is reflected in this Winter Briefing.

> *Since our last market briefing in September a lot has changed.*

KEY FINDINGS

1. Sales slowing but no collapse

Rises in **interest rates** and **inflation** are dampening the sales market, although this is only mild for now. Sales in 2022 have **fallen back** compared to the high levels of activity in 2021. This is not unexpected, as 2021 represented an unusual market, driven by pent-up pandemic related demand.

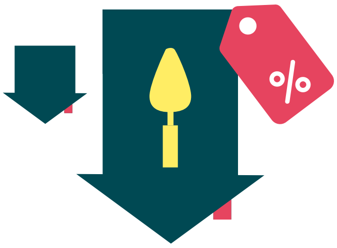


2. Demand continues to run ahead of new supply

Despite challenges facing the market, Rettie & Co. continues to see **demand outstrip supply** and remain above 2019 levels, with premiums over Home Report still being achieved in many markets.

3. Mortgage lending is impacting affordability and activity

Rising mortgage rates have seen the payment on the average property in Scotland **rise rapidly** (up around £600pcm compared to a year earlier, based on an average 2-year fixed rate mortgage). Currently the theoretical buying power supported by average earnings has **fallen by around a quarter**.



4. New build market reacts to slowing demand

The new build market is reflecting the signs of **slowing demand**, with **incentivisation** and **discounting** becoming more prevalent.

5. Looking ahead

Rettie & Co. are predicting a **cooling in market values** and **a contraction in activity** to below pre-pandemic levels for a time. Demand in **prime markets** is forecast to remain **robust**, although **lending challenges** for first-time buyers and second movers **will impact transaction chains**.

KEY FINDINGS EXPLORED

1. Slowdown in sales but no collapse

PRICES DAMPENED

After the turmoil caused by the Kwarteng Mini Budget and the somewhat soothing effect of the Hunt Autumn Statement, the housing market is now settled in for the seasonal slowdown.

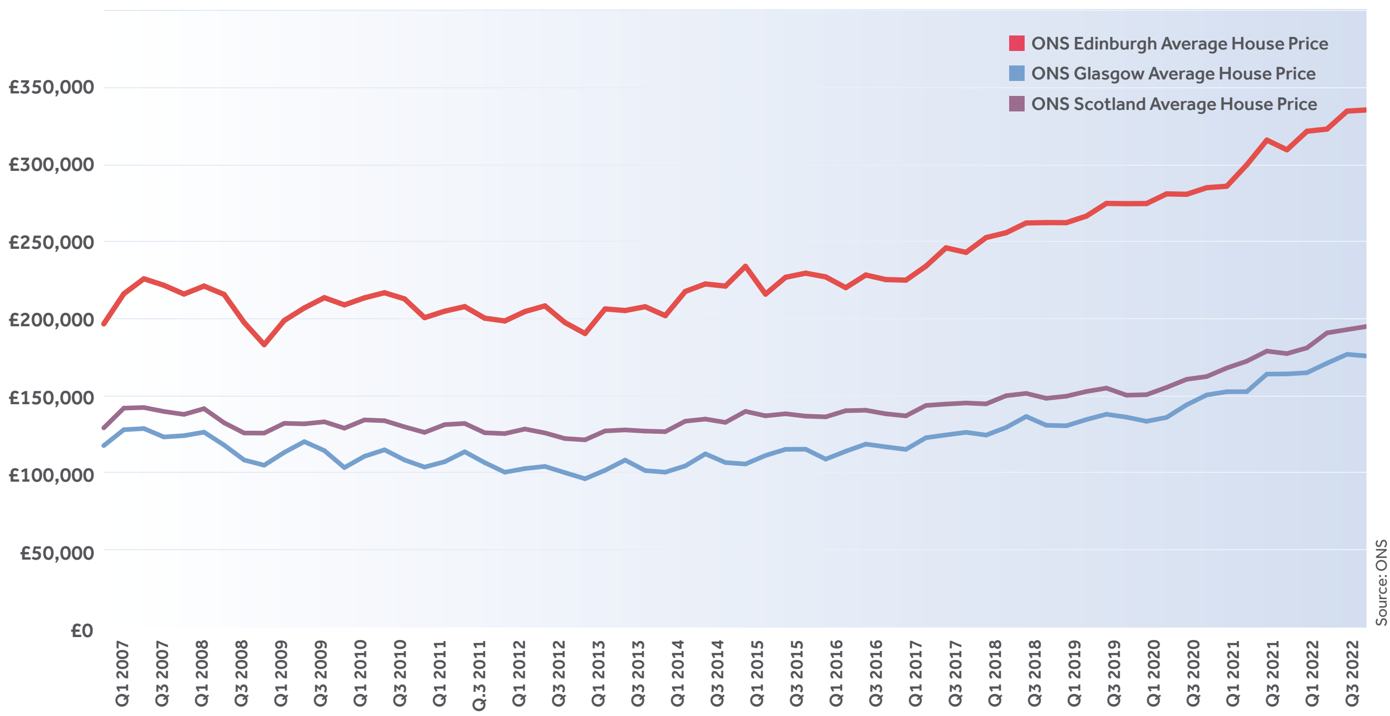
There are a lot of house price indices and most of them should be treated cautiously as they only tend to capture very small percentages of overall sales. The exceptions are the official house price figures released by the Office for National Statistics (ONS), Land Registry and Registers of Scotland, which do capture all market sales, although they can run a little behind other indices.

According to the ONS, the **average house price in Scotland** in October 2022 was **£194,874**, which is the highest value on record. In **Glasgow**, there has been a **plateauing** of market values, with the average house price in October sitting at £175,675 compared to the peak of £177,173 a couple of months earlier. Edinburgh has also seen the **average price flatten** with values remaining around £335,000 over the past three months.

It seems clear that as well as a seasonal dampening effect, there is a wider market dampening effect caused by rises in interest rates and inflation, although this is only mild for now.

Average house prices have levelled off in late 2022 as the market has responded to changes in the mortgage market accelerated by the Mini Budget

Average House Price in Scotland, Edinburgh, Glasgow and Scotland, 2018-22



KEY FINDINGS EXPLORED

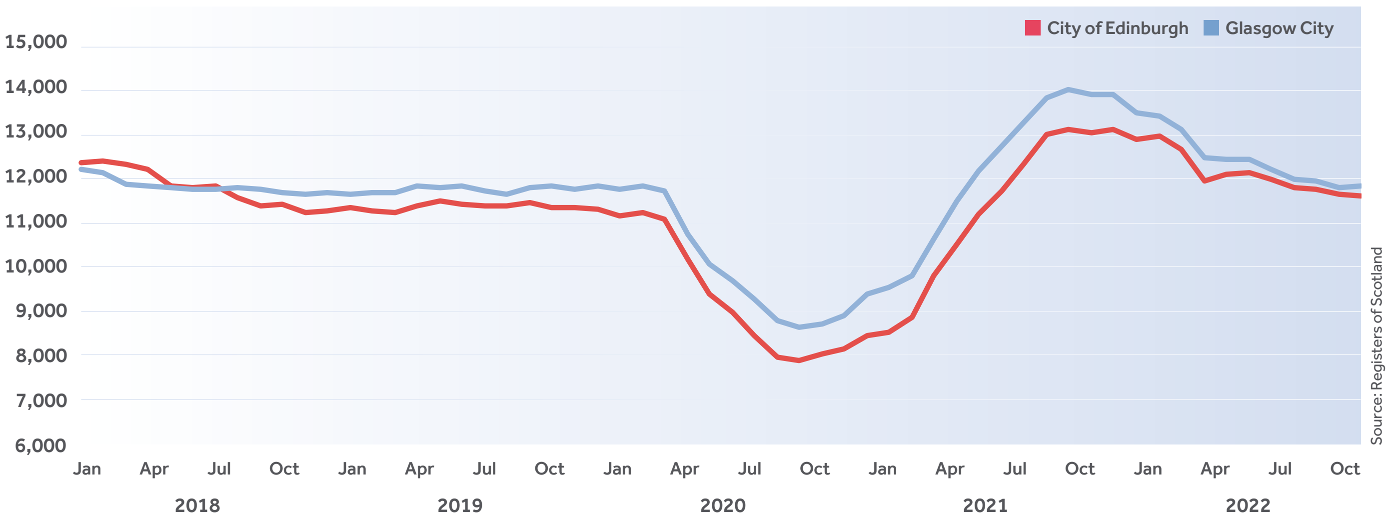
MARKET ACTIVITY FALLS

In terms of market activity, **sales in 2022 have fallen back** compared to the high levels of activity experienced in 2021. This is not unexpected, as 2021 represented an unusual market, driven by pent-up pandemic related demand.

In the year to October 2022, **sales in Edinburgh were 11% lower** than the same period the previous year, while **Glasgow reported a 15% fall**. It's worth noting that while activity in the past year is down on 2021 levels, sales activity across Scotland remains **3.2% up on pre-pandemic 2019 levels**.

Sales volumes in Scotland's two main cities have fallen back to pre-pandemic levels over the past year.

12-Month Rolling Total of House Sales by City.



KEY FINDINGS EXPLORED

THE MARKET IN CONTEXT

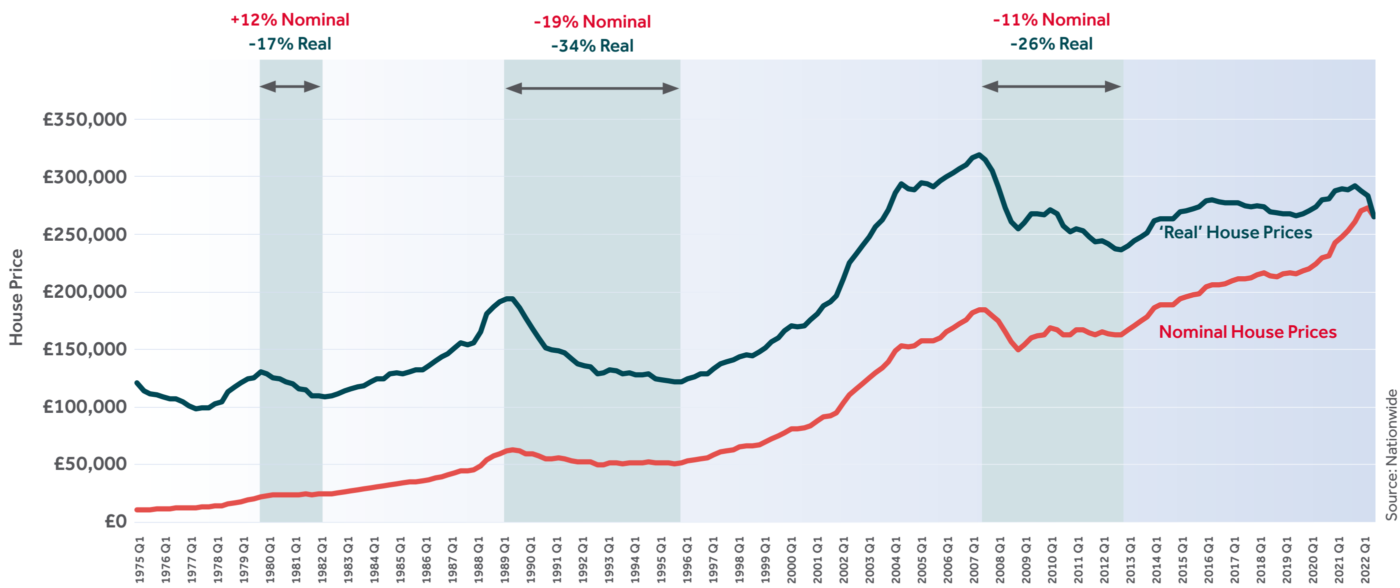
At times of uncertainty, especially following a period of buoyant housing market activity, it seems to be a national pastime to predict 'a house price crash' or 'market collapse'. Although such forecasts tend to be highly inaccurate, they still garner screeds of coverage, probably because they act as very effective clickbait. The most scaremongering prediction we could find has an average house price fall of 30% this year. While it would be negligent not to highlight the many challenges facing the market, **the current market situation should be read within context**.

While there has been strong house price growth following the end of the first lockdown restrictions from mid-2020, this has been accompanied by rising consumer price inflation. **When accounting for inflation**, the recent price increase is **less acute** than previous housing bubbles. For this reason, it's not anticipated that the market will see the same price correction as previous cycles. Indeed, in the housing market downturn in 2007/08, there were similar predictions of housing market carnage and price falls of +30%. In reality, the nominal average house price in Scotland fell around 11% from peak to trough.

It is not anticipated that the market will see the same price correction as previous cycles.

The housing market downturn that resulted from the Global Financial Crisis saw the nominal average house price in Scotland fall by 11% with a real terms fall of -26%.

Nominal UK House Prices vs 'Real' Inflation Adjusted House Prices, 1975-2022



2. Demand continues to run ahead of new supply

Against the backdrop of catastrophising, an interesting indicator of market sentiment is the **balance of supply and demand within the market**. For an insight into market change, we use the number of new applicants applying to Rettie & Co. and compare it against the number of all new properties coming to the market on a leading portal across all agents.

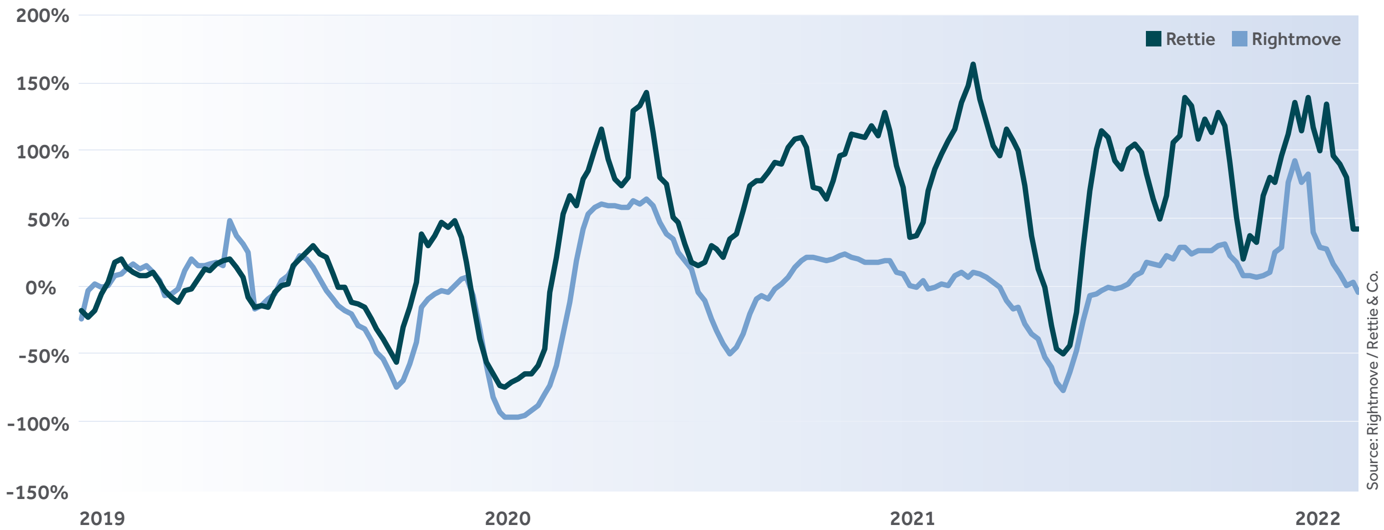
Indexing figures on the average number of new applicants and new listings in Edinburgh on a 4-week period in 2019, we can clearly see some of the main market patterns over the last three years, including the **fall in activity caused by the pandemic** and **the subsequent rebound to levels well above the pre-pandemic average**.

Over the last three years, Rettie & Co. have consistently registered a higher level of buyer demand than supply coming to the market. As the latest figures to November 2022 show, the gap between demand and new supply has narrowed. However, **there are still more new applicants than new stock**, which supports the modest level of price rises still being seen.

There are still more new applicants than new stock.

Demand being registered by Rettie & Co. remains above pre-pandemic levels and above new supply in the market although the gap has closed in recent weeks.

Supply Demand Index: 4-Week Rolling Total of New Rettie & Co. Applicants vs New Portal Listings in Edinburgh Indexed to Pre-pandemic (2019) Average.



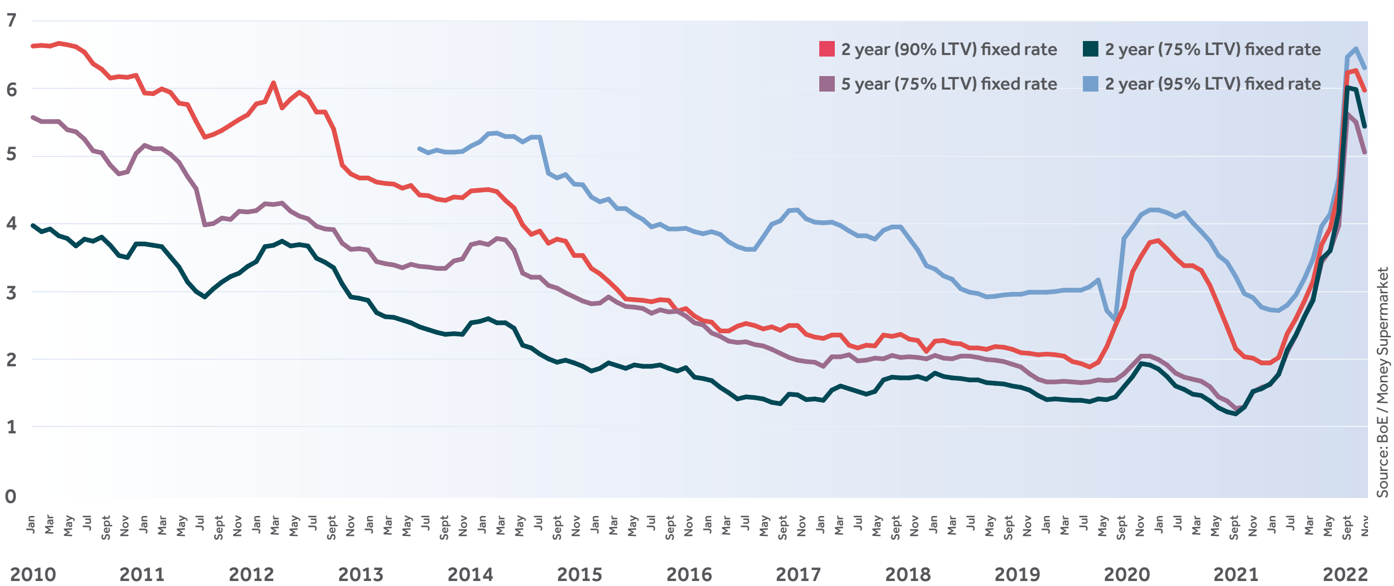
3. Mortgage lending is impacting affordability and activity

RISING MORTGAGE RATES

The role that lending plays in driving the housing market has not been so clearly illustrated at any time since the Global Financial Crisis. **The rapid recent increase in average mortgage rates have seen a rise to levels not experienced in the previous decade**. However, there has been some pullback in recent weeks after the settling effect of the Autumn Statement.

The cost of borrowing has increased dramatically but has stabilised in recent weeks.

Average Lending Rate by Product and Term, 2010-22.



KEY FINDINGS EXPLORED

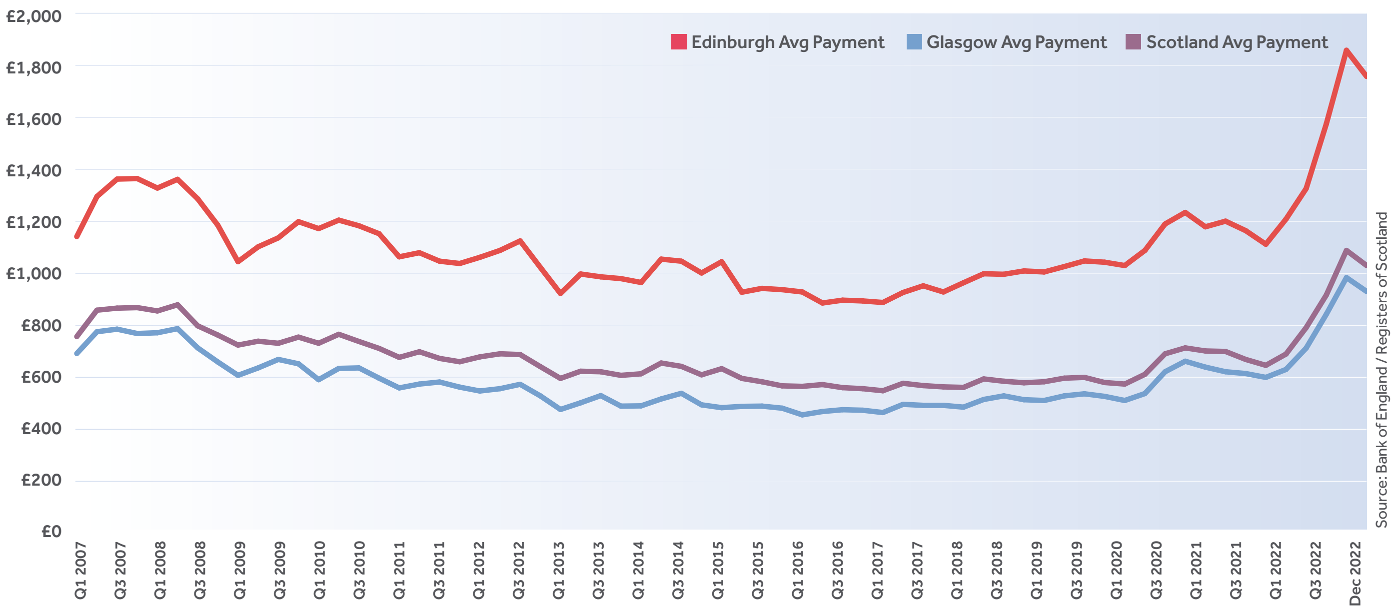
ADJUSTING FOR INFLATION

The impact that changes in lending have on affordability, and potentially on house prices, can be illustrated in a couple of ways.

Firstly, looking at the change in the mortgage payment on the average property, we can see the combination of **rising house prices** and the **recent spike in the cost of borrowing**, which has driven the payment on the average house price in Edinburgh from around £1,100pcm in late 2021, to over £1,850pcm at the peak of the mortgage crisis, and which, by the end of 2022, had receded to under c.£1,750pcm.

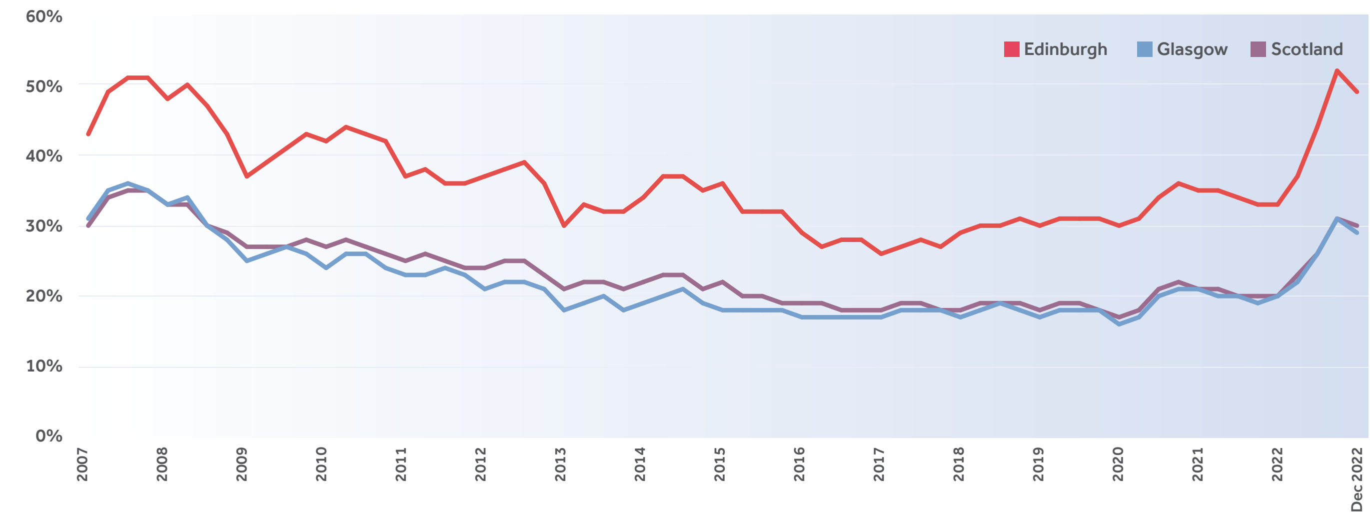
The payment on the average house price has increased sharply in late 2022.

Mortgage Payment on Average House Price in Edinburgh Based on Average Loan to Value, Loan to Income and Rate for a 2-Year Fixed Rate Mortgage, 2007-22.



However, when both incomes and mortgage payments are **adjusted for inflation**, this situation is **less stark**. When mortgage payments are shown as a percentage of gross income, then we can see that whilst costs have risen sharply, **they remain within historical precedence**.

Inflation Adjusted: Average Mortgage Payment vs Average Earnings



KEY FINDINGS EXPLORED

AFFORDABILITY AND BUYING POWER

Considering how affordability has changed relative to earnings, the impact on buying power is quite stark. The buying power supported by 35% of gross household income peaked in early 2020 and 2022, due to the low cost of borrowing and rising incomes. The increase in the cost of borrowing means **that the buying power of the average household income has fallen by around a quarter**.

For Edinburgh, an average household spending 35% of gross income would be spending £1,261pcm on their mortgage. If they secured an average 2-year fixed rate mortgage at c.85% loan to value (LTV) **at the start of 2022**, they would be paying **2.4%**, which would support a price of **£284,000**.

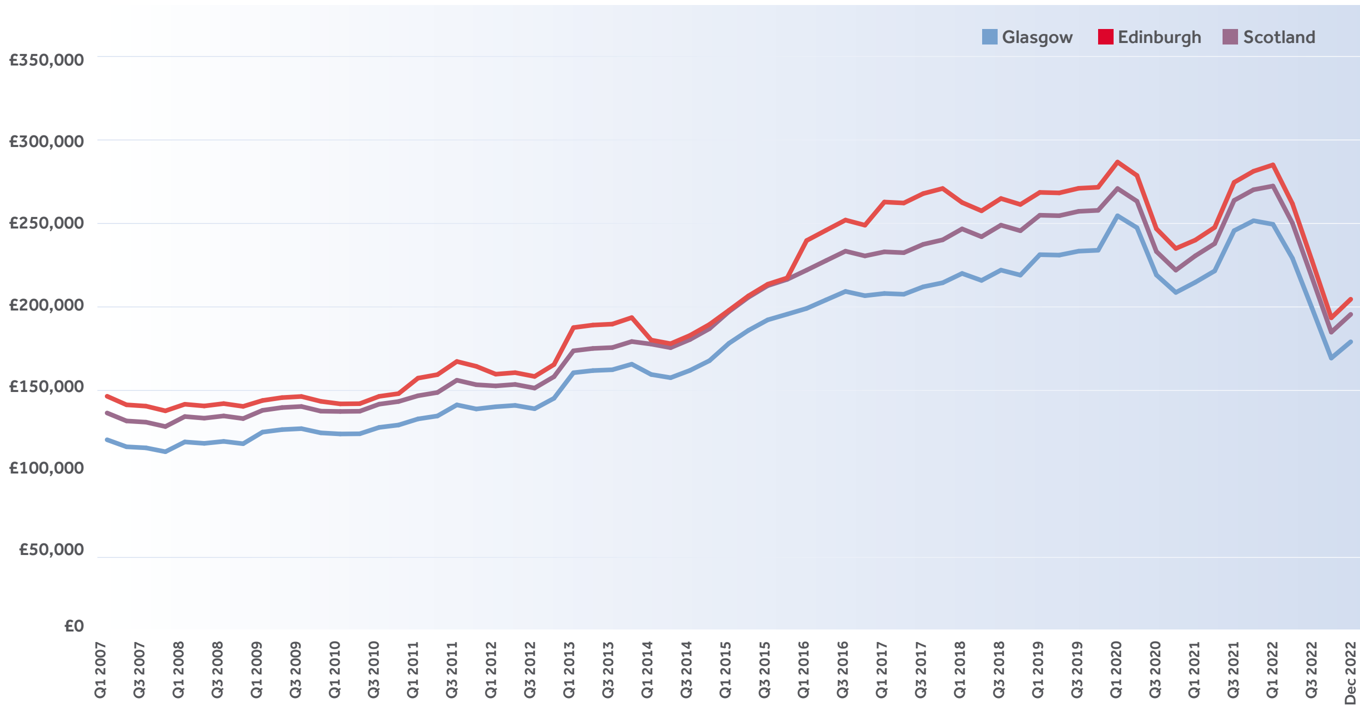
However, with the average rate for this product rising to **5.2% in the current market**, the same £1,261pcm payment would support a value of **£211,000**.

While there will not be a direct correlation between this fall and prices in the market, this does illustrate how the reach of many buyers, **especially first-time buyers and younger households with less equity**, will be impacted.

The increase in the cost of borrowing means that the buying power of the average household income has fallen by around a quarter.

The monthly number of mortgage approvals fell 35% year-on-year in November.

Estimated Buying Power Based on 35% of Estimated Gross Household Income and Average Lending Rate for a 2-Year Fixed Rate Mortgage, 2007-22.



Source: Bank of England / Money Supermarket / ASHE / Scottish Government

KEY FINDINGS EXPLORED

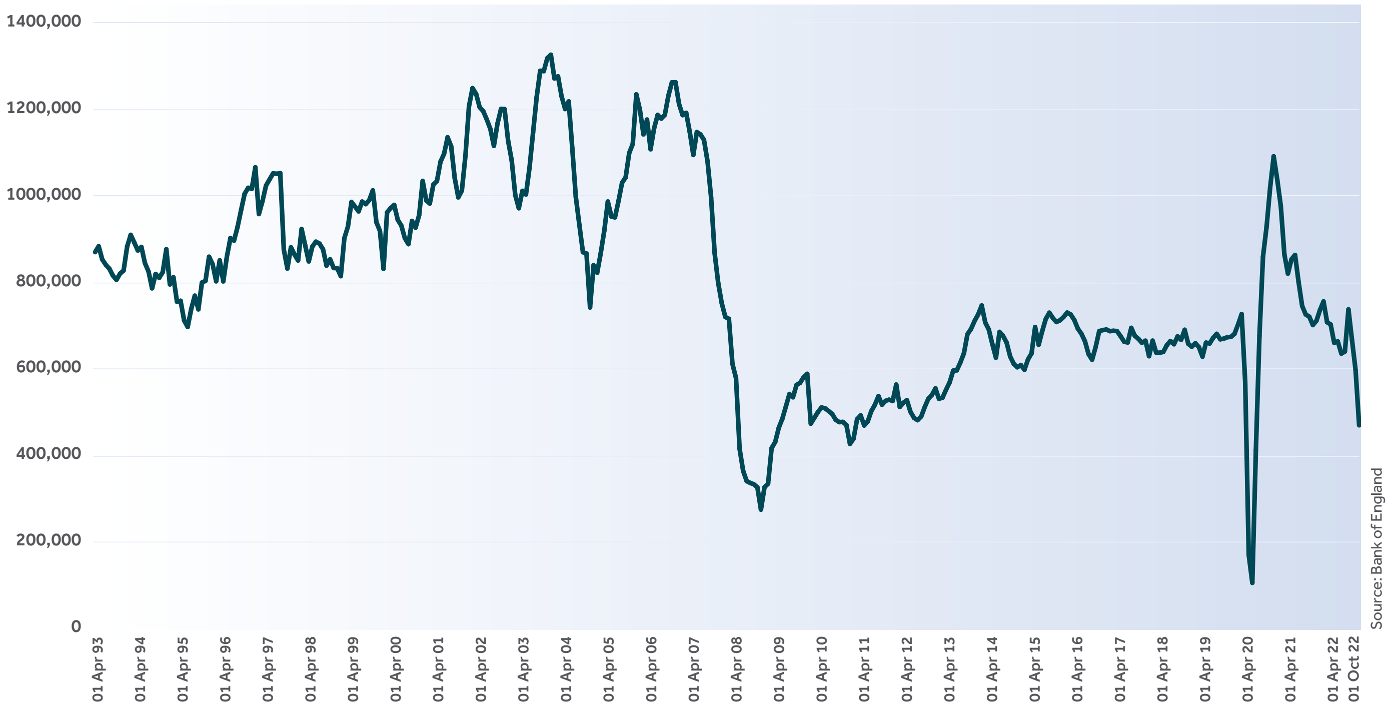
MORTGAGE APPROVALS ARE FALLING

This change in the lending landscape has worked through to mortgage approvals. The latest data from the Bank of England for mortgage approvals in November shows **a fall in lending** to c.46,000 approvals, **down 35% on the same time last year**.

However, it's worth noting that the rate of re-mortgaging in 2021 and 2022 has been high as households have locked in lending to avoid a potential payment shock in the next year or so.

The monthly number of mortgage approvals fell 15% year on year in October but re-mortgaging was up 22% YoY.

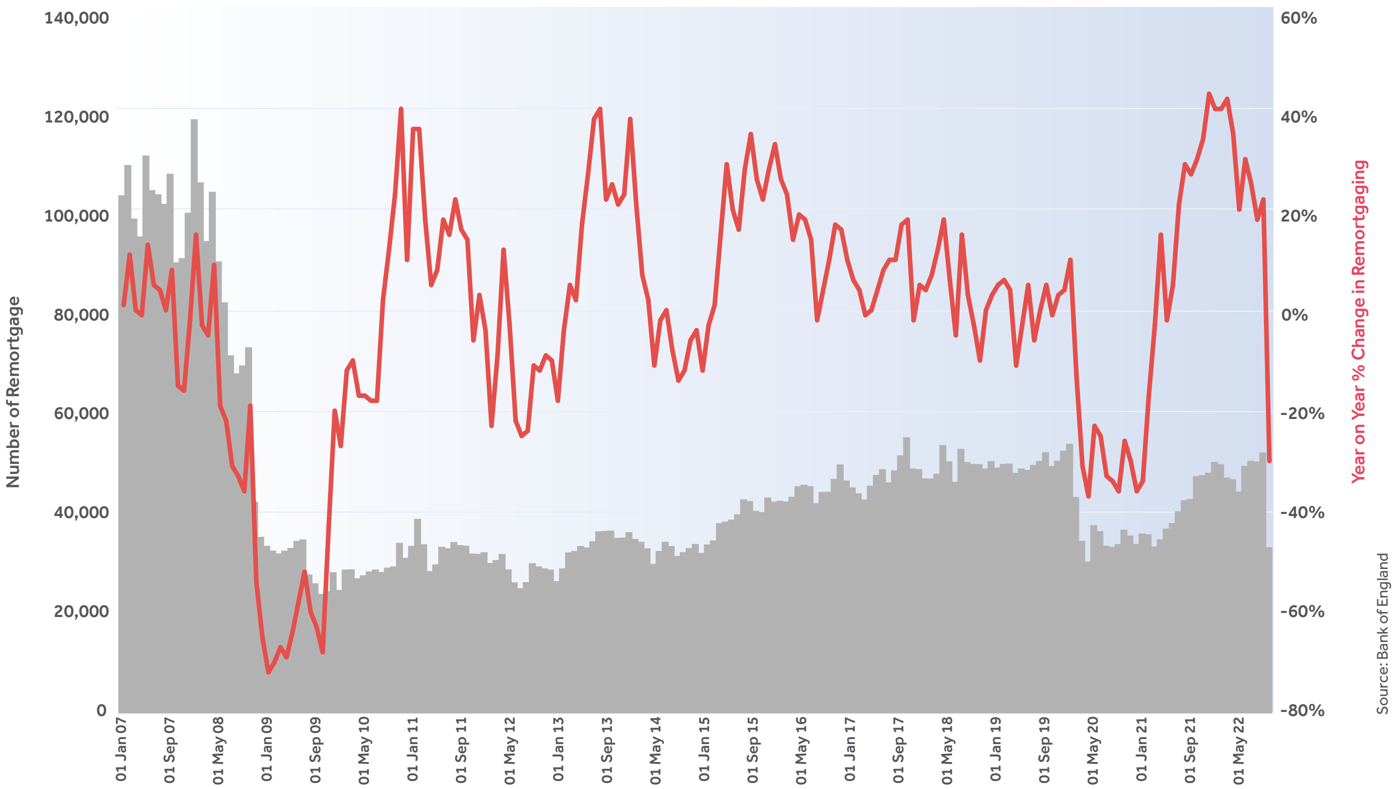
Number of Total Sterling Approvals for House Purchase to Individuals (Seasonally Adjusted), 1993-2022.



KEY FINDINGS EXPLORED

Over 2021/22 there has been an increase in re-mortgaging as homeowners have secured low rates.

Count of Re-mortgaging and Year-on-Year Change (%), 2007-22.



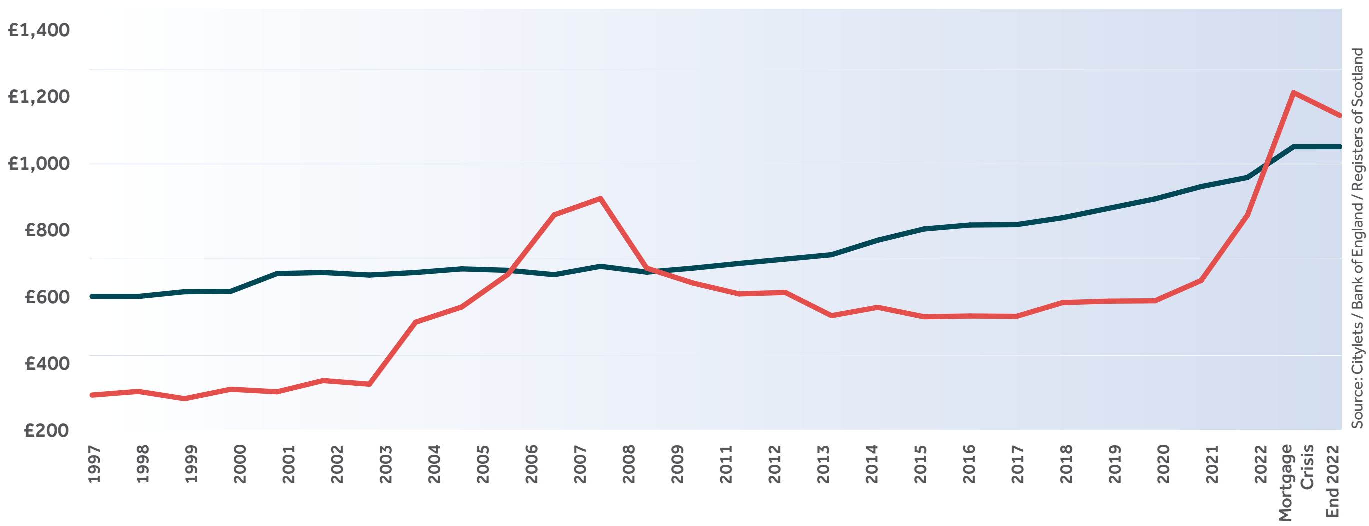
FIRST-TIME BUYERS DISINCENTIVISED

Another key dynamic in the market is the relationship between the **cost of buying** and the **cost of renting**, which affects **the incentivisation of house purchase**.

When house prices are rising and debt is freely available and/or cheap, the likes of first-time buyers are incentivised to make the step on the tenure ladder from renting to ownership. However, with the rising costs of buying, there has been an inversion in the comparative cost of renting versus buying, and this will likely **discourage many households from moving from renting to ownership** at this time.

The cost of ownership is now higher than the cost of renting and will likely disincentivise some buyers from entering the sales market.

Average Scottish Mortgage Payment Based on Average House Price and Rate on a 2-Year Fixed Mortgage vs Average Scottish Rent, 1997-2022.



KEY FINDINGS EXPLORED

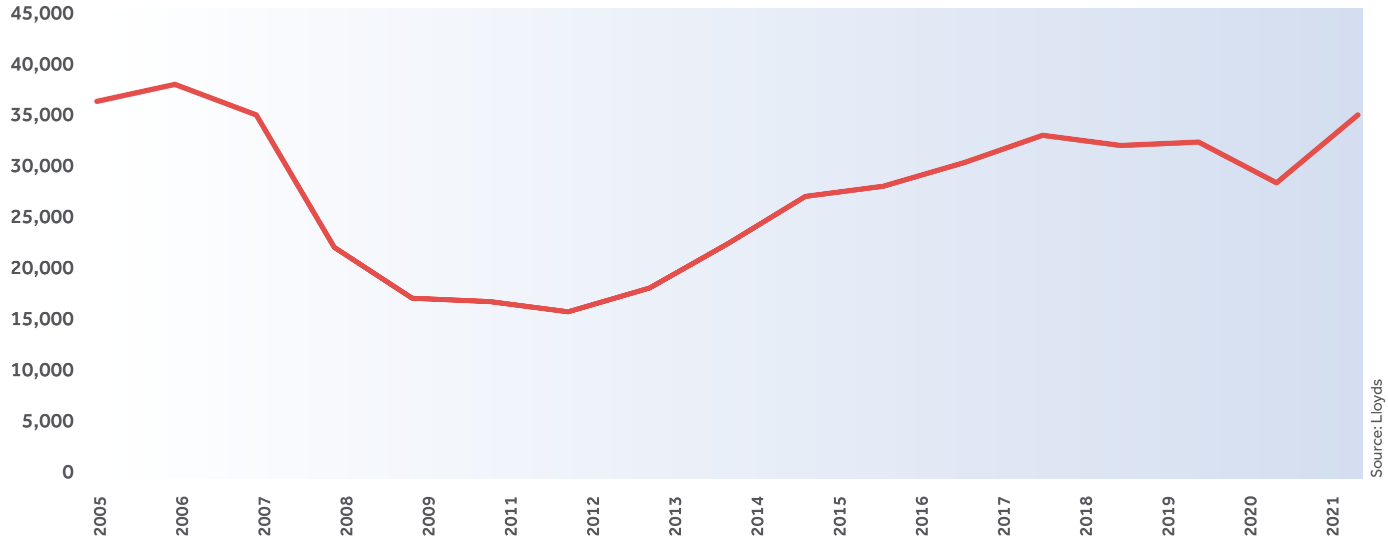
A key issue in the years following 2008 was the collapse in first-time buyers due to lending conditions and criteria tightening. From a peak of over 38,000 in 2006, there were only 16,220 first-time buyers entering the market by 2011.

As they're often the most reliant on available lending and tend to lack the equity reserves of those already on the property ladder, **this group is once again most likely to see a drop in market activity**, which will have **an impact on chains higher up the housing ladder**.

> *The rising costs of buying... will likely discourage many households from moving from renting to ownership.*

First time buyers were acutely impacted in the last market downturn and the recent increase in mortgage costs will once again see this group impacted.

Number of First Time Buyers in Scotland by Year, 2005-22.



4. New build market reacts to slowing demand

The new build sector is often a particularly responsive element of the market, as it's driven more by company balance sheets than personal finances. This means that when a market tightens or activity slows, changes in prices can become visible more clearly.

Rettie & Co. has **a market leading database** tracking **over 2,600 historic new build developments across Scotland**. Using this resource, we've noted **an upturn in discounts and incentives** being offered to the market.

In the Autumn, discounting was starting to increase as the cost-of-living crisis emerged and mortgage rates rose. Incentives assisting with utility bills and offering specification upgrades became more common at many Central Scotland volume developments, with these incentives typically equating to a **c.2-4% discount** on values. As the cost of borrowing has rapidly increased, this level of discounting has increased, rising to **around 5-6%** in a number of developments through a range of packages.

This level of discounting for volume house builders is a useful indicator of market direction. However, it does not necessarily predict activity within specific markets or locations. Our own experience, in both the new build and wider markets, is that **demand in Glasgow and Edinburgh remains high**, especially in prime locations. This experience is borne out by the fact that premiums above Home Report are still being achieved by our sales teams despite the tougher market conditions and weaker sentiment. This emphasises that not all homes are the same and **knowledge of submarkets and geographies is crucial** in understanding the changing market conditions.

Demand in Glasgow and Edinburgh remains high, especially in prime locations.

RETTIE & CO. REVISED OUTLOOK

The market should pick-up again after 2024 … but the world is an uncertain place just now and, as ever in forecasting, we assume 'other things being equal.'

BASE RATES FORECAST TO RISE UNTIL END 2023

Looking ahead there can be no doubt that the housing market is set to have a challenging time over the next year and this will probably continue into 2024.

In its last Quarterly Monetary Policy Report (Nov 2022), the Bank of England highlights that market expectations suggest **base rates rising to 5.2% by Q4 2023, before falling back to 4.7% in Q4 2024 and 4.4% in Q4 2025**. Base rates were last around this level in 2008. However, market expectations have lowered since this time and, in early 2023, **other commentators are suggesting that base rates are expected to peak at around 4.25-4.5% this year**.

THE GLOBAL FINANCIAL CRISIS (GFC) – PARALLELS AND DIFFERENCES

Using the Global Financial Crisis of 2008/09 as the most recent reference point, some parallels and differences can be drawn. At the time of the financial crisis, mortgage rates were at a similar level to now, but lending conditions were looser and the market peaked at 153,000 transactions in 2007. The global recession and banking sector turmoil and bailout led to a 11% nominal fall in average prices in Scotland. However, the major impact was a fall in transactions of around 56% from over 150,000 sales a year to 67,000 in 2008/09.

The restructuring and regulation of the banking sector and lending practices has subsequently meant that **the market has never again reached this peak of activity**, recovering to around 100,000 sales on average in the past 5-7 years.

At the peak of the housing market in 2007, before the crash, the balance of total loans in arrears was 3.81% of all loans. The arrears rate peaked in Q4 2010 at 7.7%, around two to three years after the market peak, when, despite the base rate being 0.5%, average lending rates remained around 6%. This was a time when many households held off on making house moving decisions, weathered the downturn and opted out of the market. The sharp drop in transactions and lack of new build activity supported house prices, and Scotland (and the wider UK) avoided the kind of crashes experienced in countries such as Ireland and Spain.

In the middle of 2022, the arrears rate was similar to 2007 levels at 3.9% and, based on the BoE base rate forecast, we are likely to see lending rates remain around current levels for the next 12 months before starting to fall once again. **For these reasons, we would anticipate that,**

RETTIE & CO. REVISED OUTLOOK

while there is likely to be a cooling in prices, it will be transactional activity that will be most impacted as households weather the current uncertainty.

LOOKING AHEAD

In a worst-case scenario, if transactions retreated to a base level of c.70,000 sales per year, as experienced in 2008/09, this would represent a fall of 30% from the pre-pandemic average. **More likely is a return to the calmer market conditions experienced throughout the mid-2010s**, where transactions were typically around 85,000 to 95,000 per annum. While this would be a fall of around 25% from the pent-up post pandemic market peak of 2021, it would be a cooling of around -15% from more typical market conditions.

The market should pick-up again after 2024, when most of the fallout from events of this year should have washed through, but the world is an uncertain place just now and, as ever in forecasting, **we assume 'other things being equal.'**

The 2022 data shows relatively strong average price growth, especially given market performance in the earlier part of the year. The headwinds currently being experienced will strengthen in 2023, when the fuller impacts of the rise in mortgage rates and the cost-of living crisis will bite.

It's difficult to see how the housing market can avoid the effects of an economic recession that is set to last for the next two years, although it is expected to be relatively shallow compared to previous recessions. As highlighted above, **we believe that the main adjustment will be in transaction activity**, which will likely drop back, particularly as fewer first-time buyers enter the market and chains are affected, but also due to more negative market sentiment meaning that people will drop out of the market for a time.

However, house moves still happened in 2008/09 as people in many circumstances have to move. **We do not believe that the next downturn will be as severe as that during the GFC**, particularly as the banks are better capitalised and lending has not been as lax as it was in the run-up to 2008/09. However, neither is there the 'big bazooka' that the Government has used to stave off the impacts of other downturns. We cannot expect a new Quantitative Easing programme or a furlough scheme to appear this time.

OUR FORECASTS

Our forecasts suggest (on a central basis), **a fall of 15% in market activity** (transactions) in 2023 before gradual recovery back to trend over the following two years.

Average prices look like topping 6% in 2022 based on data to October, but reversals now seem very likely for 2023 and 2024 with continued rises in interest rates and an economic recession. Again, we are assuming a gradual return to trend as the economy recovers.

Scottish Transactions Forecasts

Year	Lower	Central	Upper
2022	95,000	100,000	105,000
2023	75,000	85,000	95,000
2024	85,000	95,000	105,000
2025	90,000	100,000	110,000
2026	95,000	105,000	115,000

Average Price Forecasts

Year	Lower	Central	Upper
2022	5%	6%	7%
2023	-3%	-5%	-7%
2024	-1%	-2.5%	-4%
2025	2%	4%	6%
2026	2%	4%	6%

As of 16th December 2022, the additional dwelling supplement (ADS) of LBTT has risen from 4% to 6%. This will affect any transaction where the purchaser already owns another dwelling. Circa 25% of residential returns have an ADS element.

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