UK headed for stagnation as rate hikes start to bite

Higher savings rates have so far helped offset only modest increases in average mortgage rates. But that's set to change through 2024, and this means higher interest rates will act as a growing drag on UK activity. Rate cuts are likely to start from next summer

Governor of the Bank of England Andrew Bailey.

Higher savings rates have helped offset higher mortgage rates so far

The Bank of England's rate hike cycle has almost certainly concluded, and the focus is now switching to rate cuts. Policymakers are adamant that these are a long way off, a view that markets have largely bought into. While we've seen a big repricing lower in UK rate expectations this summer, investors still expect Bank Rate to stay north of 4% for the next three years.

We're less convinced. Bank rate closer to 3% seems like a more sensible medium-term level, and cuts are likely from next summer. Part of that is a recognition that much of the impact of past rate hikes is yet to hit the economy.

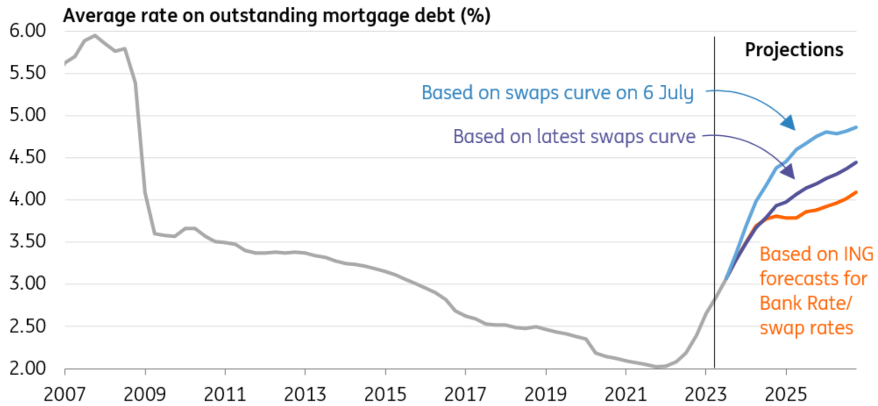
So far, the average mortgage rate has risen from 2% to just above 3%, despite quoted rates on new lending surpassing 6% over recent months. By contrast, the rate paid on instant access savings has increased by almost 200 basis points in the same period – and fixed-rate saving rates by considerably more still. In other words, the impact of higher rates on household cashflows has thus far been relatively neutral.

But that's set to change.

The fact that the vast majority of mortgage lending is fixed for less than five years means a sizeable chunk of UK homeowners will refinance over the next year, much more so than in places like the US or parts of Europe where longer-term fixes are more prevalent.

Our estimates show that the average rate on UK mortgages will rise to close to 4% by the end of next year, even under our base case, which includes Fed rate cuts from the spring, BoE cuts from the summer and an accompanying slide in bond yields. And it's important to remember that the negative impact of higher lending rates is likely to be much larger than the positive impulse we've had from higher deposit rates so far in this tightening cycle.

Average rate on outstanding mortgages set to approach 4% in 2024



Source: Macrobond, ING calculations

Projections are based on the split of mortgage lending by initial fixation period, and assume an even proportion of borrowers refinance each quarter (for example, one eighth of those with two-years fixes). We have also assumed that a recent bias towards shorter fixation periods for those refinancing persists such that the share of those with two-year fixes gradually climbs.

The impact rate hikes will be felt more heavily next year

Those benefitting from higher savings rates are typically higher earners who are less likely to spend the windfall. The same is unlikely to be true of higher mortgage rates, and we'd expect an ever-increasing drag on consumer spending as a result.

For businesses, the hit from higher rates has been more rapid. The higher prevalence of floating rate debt – especially for smaller businesses – appears to be taking its toll on cash holdings and margins. Unemployment does appear to be rising as a result, though issues with the data are making it difficult to be sure about how rapidly this is happening. Business surveys, including the PMIs, are weak too – but again, these also appear to be suffering from reliability issues.

Any hope that some of these pressures will be offset by the Treasury would be misguided. The

Chancellor will unveil his latest budget later this month, but there's very little space for stimulus. Borrowing this year may have been roughly £20 billion lower than expected, but that windfall will be quickly eaten up by upward revisions to future debt repayments.

Put of all of this together, and it seems likely that the economy is headed for near-stagnation and possibly even recession, though the latter isn't our base case.

While it's true that higher mortgage rates are a challenge, remember that only around a quarter of households have a home loan these days, and a considerably higher proportion own their home outright. The backdrop for real wages is also improving, with inflation set to fall noticeably over coming months and private-sector nominal pay growth proving much stickier. Whether or not we do end up in recession will largely depend on whether the recent uptrend in unemployment persists through the winter months.

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