

Market Overview - Contents

| | Page |
|------------------------|------------|
| Housing Market | 1-2 |
| Mortgage Market | 3 |
| Savings Market | 4 |
| Spreads | 5 |
| Interest Rates | 6 |

Housing Market

Key Figures

| | |
|---|----------|
| Monthly Index (seasonally adjusted) Q1 1993=100 | 290.1 |
| Monthly change (seasonally adjusted) | 2.1% |
| Annual change | 18.9% |
| Average price in April | £145,918 |

Headlines

- House prices up 2.1% during April taking the annual increase back up to 18.9%
- Prices increase by more than £100 per day
- Debt to slow the market over the medium-term

Analysis

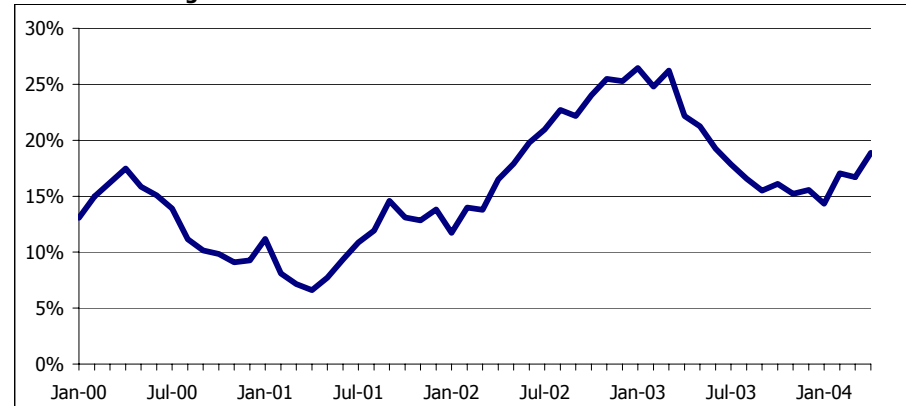
The price of the typical house rose 2.1% during April. The rise took the price of the average house to £145,918, an increase of nearly £3,500 in the month or more than £100 per day. The 7% increase in prices since the start of the year means the price of the average house has risen 18.9% compared with a year ago - the highest annual inflation rate since June last year. Prices have risen by an average of 1¾% per month this year so far. Our forecast of 15% implies average price rises of just under 1% per month for the remainder of the year – a clear reduction in the pace of price growth.

Having peaked at 26.5% in early 2003, UK annual house price inflation slowed to 14.3% in January 2004 before pushing back up to 18.9% this month. Underlying the average price rise, the UK housing market remains regionally polarised with prices continuing to rise rapidly in the cheaper North (prices were up 33.3% in the year to Q1) and more slowly in the South East (prices in London were up 6.3% in the year to Q1, but growth is likely to have picked up since then).

The number of market house purchase approvals (seasonally adjusted) remained high at 127,000 in March, suggesting activity in the housing market will remain strong over the summer. However, as was the case throughout 2003, when just 359,000 first time buyers managed to get on to the property ladder (down from 521,000 in 2002), the number of new entrants remains low. Just 34,000 bought in March and we expect only 350,000 to enter the market in 2004 as a whole. Between 2002 and 2003 buy-to-let purchases increased by 58,000 (from 130,000 to 188,000), but this increase has clearly not been significant enough to offset the decline in first-time buyers.

Our expectation remains that prices will rise a further 8% over the remainder of the year, taking the increase in prices to 15% in 2004. The economy is set to stay supportive to the housing market with unemployment remaining low and confidence relatively high. However, muted underlying income growth (income excluding bonuses), gradually rising interest rates and buyers downgrading expectations of future house price growth will cause the market to naturally cool over the second half of the year.

Annual % Change in House Prices



Commentary

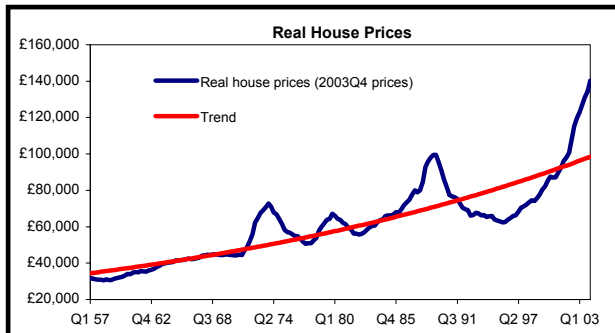
The forecast for house price inflation in the year to December 2004 is 15%. Over the medium term price growth is likely to remain nearer 4-5% (more in line with income growth) as the lack of first time buyers and high real debt burdens act as a brake on the market.

House Price Indices

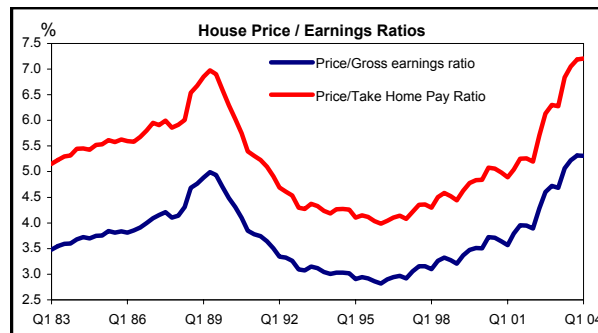
| Month | Index s.a. 1993 = 100 | Monthly Change % | Index n.s.a. 1993 = 100 | Annual Change % | Average Price £ | Property Transact'ns s.a., 000s |
|----------|--------------------------|------------------------|----------------------------|-----------------------|-----------------------|---------------------------------------|
| 2001 | 187.4 | avg. 1.1 | 186.6 | 13.8 | 93,544 | 1,457 |
| 2002 | 234.4 | avg. 1.9 | 233.8 | | 106,192 | 1,586 |
| 2003 Apr | 244.8 | 0.3 | 244.9 | 22.2 | 122,748 | 113 |
| May | 248.3 | 1.4 | 248.9 | 21.3 | 124,752 | 106 |
| Jun | 250.8 | 1.0 | 253.8 | 19.2 | 127,214 | 105 |
| Jul | 253.4 | 1.0 | 255.8 | 17.9 | 128,251 | 115 |
| Aug | 256.3 | 1.1 | 257.9 | 16.6 | 129,258 | 106 |
| Sep | 259.0 | 1.1 | 260.3 | 15.5 | 130,473 | 106 |
| Oct | 263.5 | 1.7 | 263.2 | 16.1 | 131,947 | 108 |
| Nov | 266.6 | 1.2 | 266.1 | 15.2 | 133,388 | 109 |
| Dec | 270.6 | 1.5 | 270.2 | 15.6 | 135,444 | 105 |
| Jan | 272.4 | 0.7 | 268.9 | 14.3 | 134,806 | 110 |
| Feb | 280.9 | 3.1 | 276.8 | 17.1 | 138,730 | 144 |
| Mar | 284.9 | 1.4 | 284.4 | 16.7 | 142,584 | 200* |
| 2004 Apr | 291.0 | 2.1 | 291.1 | 18.9 | 145,918 | - |

* Inland Revenue reported figures in Mar-04 boosted by clearance of a large data capture backlog.

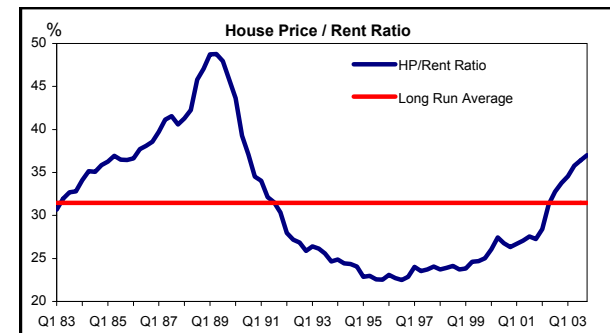
Housing Market



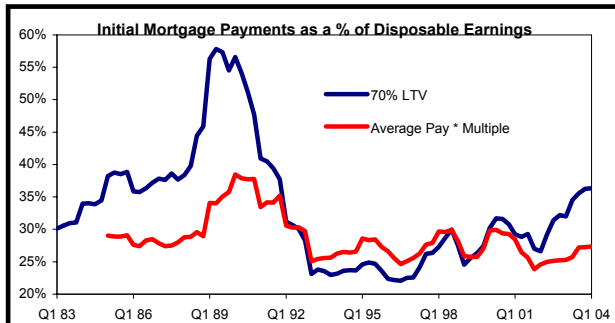
Over the long term the trend growth rate in house prices (after allowing for inflation) has been 2.3% per annum.



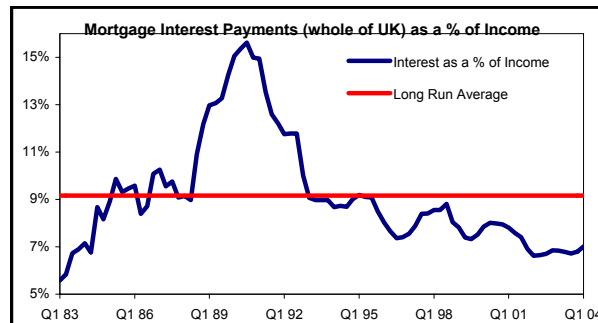
House price to earnings ratios are currently at record high levels...



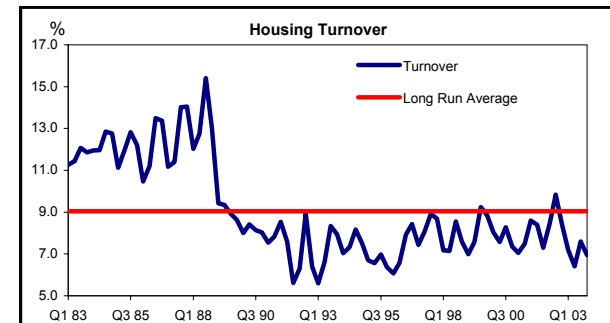
... but affordability is only just above the long run average and well below the level seen in the late 80's.



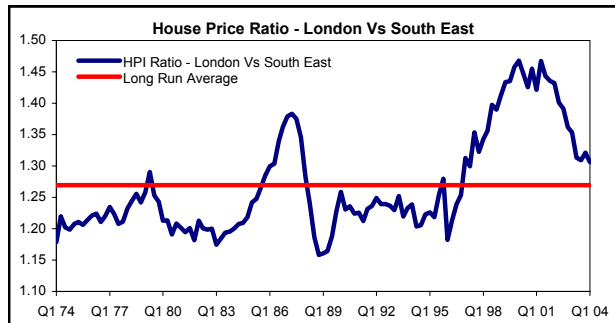
Affordability for those entering the market looks good.



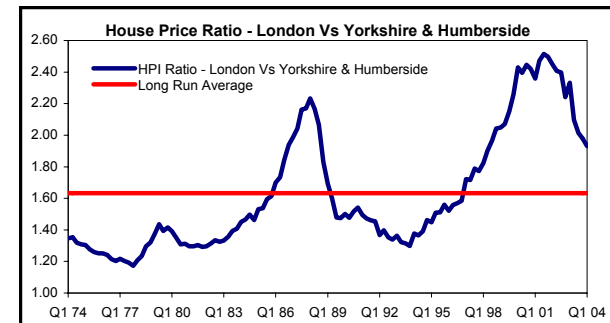
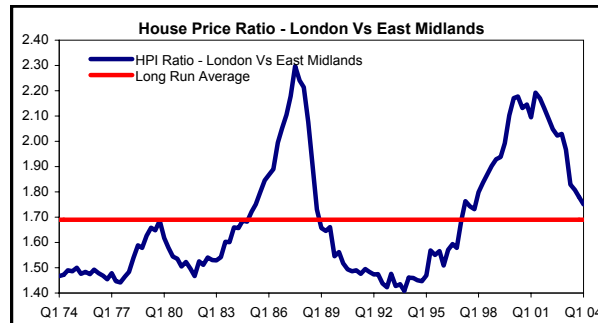
Mortgage interest payments for the economy as a whole remain low relative to income.



Housing Turnover is calculated as the ratio of transaction to housing stock.



The ratio of prices in London to prices in other regions is heading back towards its long run average. However, in contrast to the early 90's this is happening due to regions away from London "catching up" as opposed to prices falling in London.



Mortgage Market

Overview

Market gross advances in March were £24.4bn, 24% higher than Mar-03. The seasonally adjusted trend remains fairly level at around £25bn. Remortgage lending showed some recovery in March (at £10bn), although as a proportion of total lending remortgage accounted 41% compared to 47% a year earlier. In contrast, house purchase accounted for 46% of lending in Mar-04 compared to 41% a year earlier.

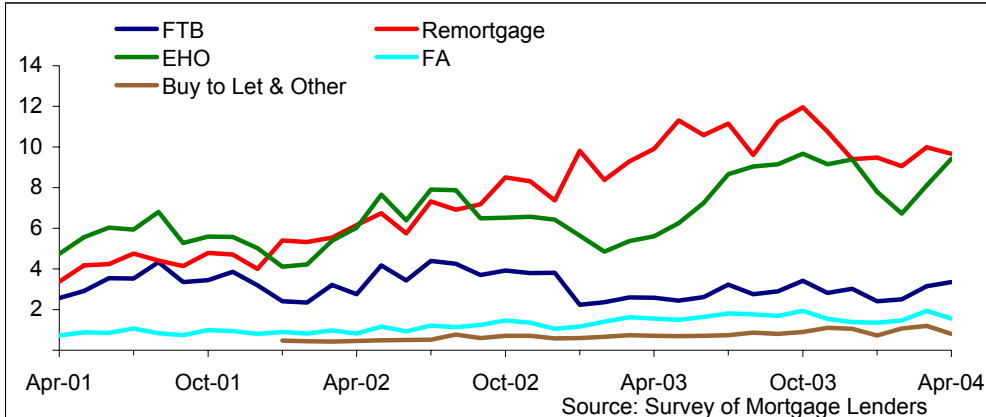
Outlook

There were record gross approvals in March (£33bn), 36.7% higher than a year ago. Both house purchase and remortgage approvals were record highs. Approvals for house purchase were up 72% on last year and accounting for 53% of all approvals (highest proportion since Jul-02). Remortgage approvals were up 9% on last year, accounting for 37% of all approvals. Preliminary figures suggest approvals for April may be c£28bn. This suggests that, at least in the short run, lending volumes will remain high over the next two-three months with the structure of lending being 50:40 in favour of house purchase over remortgage with further advances accounting for the remainder. Net lending volumes are likely to reduce from the highs of 2003/4 primarily due to a gradual decline in mortgage equity withdrawal as borrowers react to rising interest rates.

| | Gross Approvals | Total Gross Advances | G.Adv. for Housing | G.Adv. for Remortgage | Principal Repaid | Net Advances |
|---------|-----------------|----------------------|--------------------|-----------------------|------------------|--------------|
| £m | | | | | | |
| 2002/03 | 264,609 | 230,095 | 121,328 | 94,173 | 149,074 | 81,021 |
| 2003/04 | 322,495 | 285,185 | 130,633 | 124,431 | 181,517 | 103,668 |
| Mar-03 | 24,133 | 19,608 | 7,956 | 9,285 | | 6,619 |
| Apr-03 | 24,854 | 20,362 | 8,192 | 9,900 | 13,450 | 6,912 |
| May-03 | 24,871 | 22,202 | 8,699 | 11,314 | 14,363 | 7,839 |
| Jun-03 | 26,439 | 22,772 | 9,847 | 10,579 | 13,932 | 8,840 |
| Jul-03 | 28,809 | 25,592 | 11,890 | 11,156 | 15,882 | 9,710 |
| Aug-03 | 26,667 | 24,022 | 11,785 | 9,608 | 15,056 | 8,966 |
| Sep-03 | 29,156 | 25,783 | 12,048 | 11,243 | 16,090 | 9,693 |
| Oct-03 | 30,971 | 27,873 | 13,096 | 11,945 | 17,051 | 10,822 |
| Nov-03 | 27,979 | 25,358 | 11,959 | 10,763 | 15,965 | 9,393 |
| Dec-03 | 23,536 | 24,268 | 12,422 | 9,406 | 16,627 | 7,641 |
| Jan-04 | 20,893 | 21,748 | 10,206 | 9,478 | 13,033 | 8,715 |
| Feb-04 | 25,329 | 20,823 | 9,225 | 9,059 | 14,026 | 6,797 |
| Mar-04 | 32,993 | 24,382 | 11,264 | 9,980 | 16,042 | 8,340 |
| % YoY | 36.7% | 24.3% | 41.6% | 7.5% | #DIV/0! | 26.0% |

Source: Bank of England, Survey of Mortgage Lenders

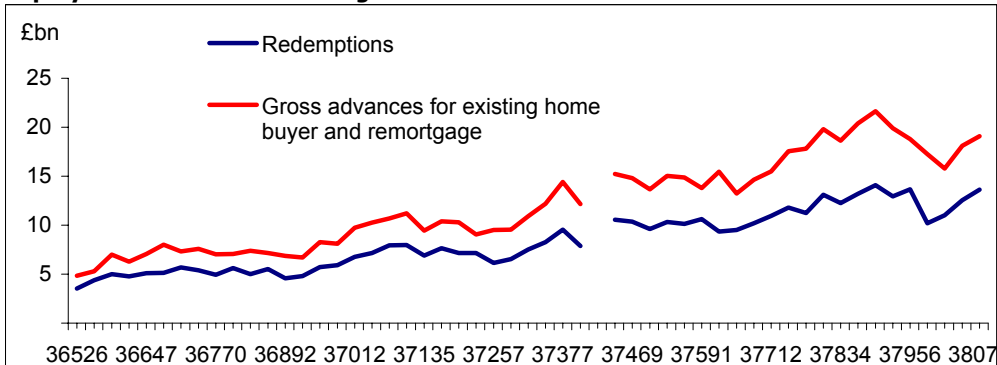
Market Gross Advances



Commentary

Recent months has seen a seasonal pick up in lending to existing home owners. Given record levels of house purchase approvals reported in March, it is expected that lending to existing home owners will increase further in the next few months. Lending to first time buyers has showed signs of a small increase, 12% higher then a year earlier, but remains low compared to recent years.

Equity withdrawal not declining



Commentary

The difference between the level of redemptions and the total advances for existing home buyers and remortgages is one element of mortgage equity withdrawal. For this group there has been an increase in equity withdrawal over time. However, as seen in the chart, mortgage equity withdrawal remains fairly strong but does not appear to be increasing further. Currently around 70% of advances to existing home buyers or those remortgaging is matched by redemptions.

Savings Market

Overview

Flows & Outlook

The savings market remains strong with retail deposit balances rising £72.5bn in the 12 months to March 2004 compared to a rise of £54.9bn in the 12 months to March 2003. It is likely that a significant part of this strength relates to the strength of the mortgage market. Whilst one group is gearing up another is trading down in the housing market with much of the withdrawn equity being deposited in savings accounts. We expect the mortgage market to remain relatively strong over the remainder of the year and as such the retail deposits market is unlikely to weaken in the near future.

Pricing

2003/4 saw one base rate cut and two increases. These changes have given deposit takers the opportunity to portfolio manage deposit books. As a result the spread of rates on E savings to rates on notice accounts has widened by 24bps over the year. Base rates have already risen once during 2004/5 and we expect another two rate before the end of the financial year and in response to this the E to notice spread is likely to widen further during 2004/5.

Market Data

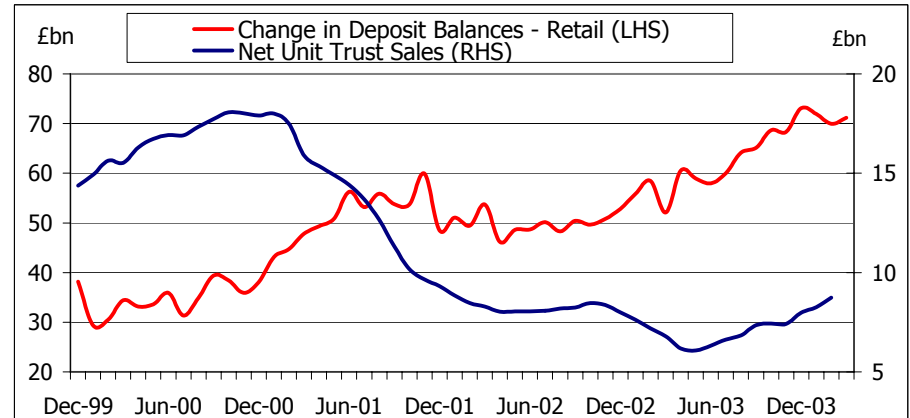
| | Stock (£bn) | | | Announced Market Rates (%) [#] | | | |
|---------|-------------|--------------|--------------|---|--------|------|------------|
| | Cash ISA* | Total Market | Total H'Hold | Notice | Postal | ISA | E accounts |
| 2002/03 | - | - | - | 1.90 | 2.97 | 3.94 | 3.63 |
| 2003/04 | - | - | - | 1.68 | 2.55 | 3.58 | 3.49 |
| Mar-03 | 71 | 750 | 677.40 | 1.71 | | 3.65 | 3.47 |
| Apr-03 | 77 | 756 | - | 1.71 | 2.69 | 3.65 | 3.47 |
| May-03 | 78 | 760 | - | 1.74 | 2.68 | 3.65 | 3.47 |
| Jun-03 | 79 | 771 | 693.40 | 1.73 | 2.61 | 3.64 | 3.49 |
| Jul-03 | 80 | 772 | - | 1.55 | 2.48 | 3.44 | 3.39 |
| Aug-03 | 80 | 779 | - | 1.52 | 2.43 | 3.38 | 3.39 |
| Sep-03 | 81 | 788 | 701.54 | 1.53 | 2.35 | 3.38 | 3.25 |
| Oct-03 | 81 | 793 | - | 1.53 | 2.39 | 3.38 | 3.25 |
| Nov-03 | 82 | 802 | - | 1.65 | 2.55 | 3.57 | 3.46 |
| Dec-03 | 82 | 809 | 721.26 | 1.71 | 2.54 | 3.63 | 3.51 |
| Jan-04 | 82 | 808 | - | 1.71 | 2.54 | 3.63 | 3.51 |
| Feb-04 | 83 | 811 | - | 1.81 | 2.63 | 3.73 | 3.74 |
| Mar-04 | 87 | 823 | - | 1.95 | 2.75 | 3.85 | 3.95 |
| Apr-04 | - | - | - | 1.95 | 2.75 | 3.85 | 3.95 |

Source: Bank of England, Planning Estimates

* Ex National Savings

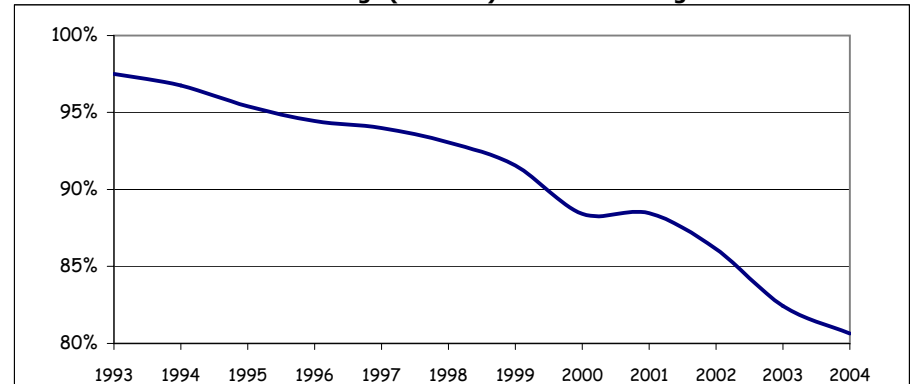
[#] Recorded rates at end of month, source Blays/Nationwide estimates

Market Flows



Retail deposit change in balances over the last 12 months have broken through the £70bn barrier. However unit trust flows have strengthened, as have investment ISA sales.

Ratio of Retail Savings (ex NS&I) to Retail Lending Balances



The strength of lending has meant that savings flows have been unable to keep pace. Wholesale funding volumes have therefore been strong. In addition securitisation has grown significantly. Going forward the imbalance between retail funding and lending will put downward pressure on spreads.

Spreads

Retail Spreads & Margins

Market trends & Outlook

Over the last year book rates have moved significantly following movements in LIBOR and base rates. Mortgage book rates are now at the same approximate level as one year ago although savings rates are higher, driven by increasing competition for retail funds. Overall this has created a drop in the retail spread of 17bp over the year.

Market expectations for the year end are now at 5% for interest rates, up from 4.75% at the start of the year. With house price inflation and consumer spending continuing apace, a 50bp base rate increase cannot be ruled out. Competitive pressures are expected to remain strong, possibly pushing the retail spread even lower.

Notes

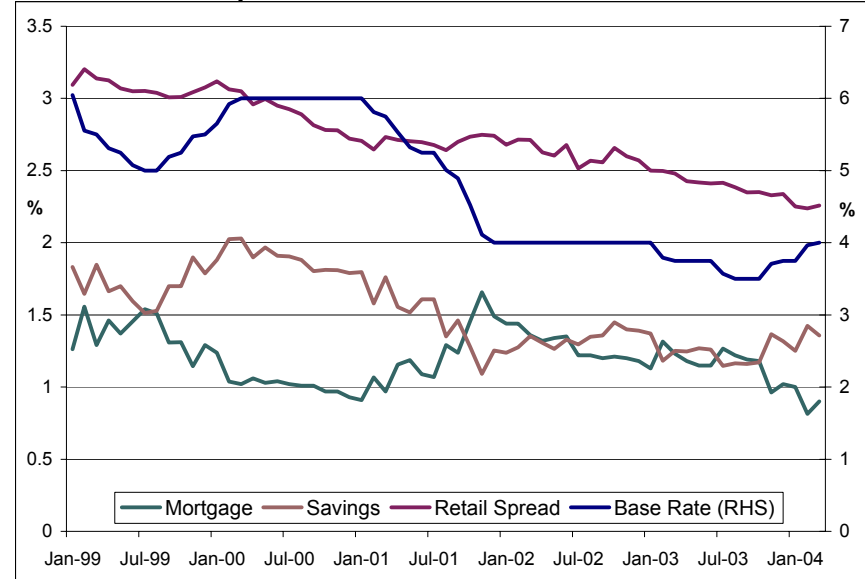
Due to a reworking of the calculation of book rates at the start of the year, the Bank of England book rates changed significantly, creating a structural break in the time series. Structural break adjustments have now been applied to the historic rates in the table below. The **approximate** effect of the change between the two series was; decrease the mortgage book rate by 10bp, increase the savings book rate by 2bp, hence reducing the retail spread by approximately 12bp. Consumer credit rates were also affected; personal loans decreased by 10bp, overdrafts did not change and credit card rates increased by 30bp. The calculation was altered to cover a greater proportion of the market and is considered more accurate.

Market Book Rates

| | LIBOR | Mortgage | Savings | Mort-Sav Spread | Personal Loans | Overdrafts | Credit Cards |
|---------|-------|----------|---------|-----------------|----------------|------------|--------------|
| 2000/01 | 6.01 | 6.96 | 4.14 | 2.82 | | 10.84 | 16.29 |
| 2001/02 | 4.57 | 5.98 | 3.28 | 2.71 | 10.37 | 10.20 | 15.13 |
| 2002/03 | 3.99 | 5.21 | 2.63 | 2.57 | 9.39 | 9.54 | 14.22 |
| Apr-03 | 3.65 | 4.93 | 2.50 | 2.43 | 8.98 | 9.24 | 14.12 |
| May-03 | 3.63 | 4.90 | 2.48 | 2.42 | 8.98 | 9.23 | 14.03 |
| Jun-03 | 3.64 | 4.90 | 2.49 | 2.41 | 8.95 | 9.23 | 14.02 |
| Jul-03 | 3.49 | 4.84 | 2.43 | 2.41 | 8.85 | 9.14 | 13.79 |
| Aug-03 | 3.52 | 4.72 | 2.34 | 2.38 | 8.75 | 9.09 | 13.93 |
| Sep-03 | 3.70 | 4.69 | 2.34 | 2.35 | 8.81 | 9.15 | 13.98 |
| Oct-03 | 3.80 | 4.68 | 2.33 | 2.35 | 8.79 | 9.16 | 13.98 |
| Nov-03 | 3.98 | 4.67 | 2.34 | 2.33 | 8.75 | 9.28 | 14.08 |
| Dec-03 | 4.02 | 4.77 | 2.43 | 2.34 | 8.82 | 9.37 | 13.92 |
| Jan-04 | 4.06 | 4.75 | 2.50 | 2.25 | 8.70 | 9.38 | 13.96 |
| Feb-04 | 4.17 | 4.78 | 2.54 | 2.24 | 8.80 | 9.45 | 14.22 |
| Mar-04 | 4.29 | 4.90 | 2.64 | 2.26 | 8.86 | 9.64 | 14.01 |

Source: Bank of England

Interest Rates & Spreads



The above graph shows the progress of the mortgage and savings straddles over time. The straddle being the absolute difference between the book rate and the base rate, i.e. the components of the retail spread.

Since the start of 1999 the retail spread has been on a downward trend, with some small periods of relief for financial institutions due to the increasingly competitive environment. Throughout the majority of this period the savings spread has remained above the mortgage spread, making it the greater contributor to the retail spread. What is more noticeable however is the opposite movements for the mortgage and savings straddles as base rates rise and fall.

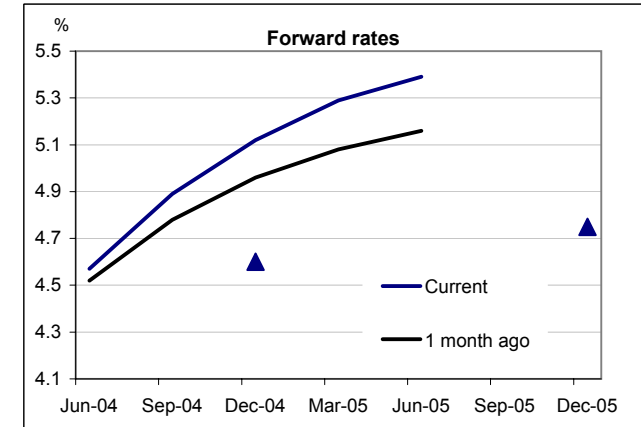
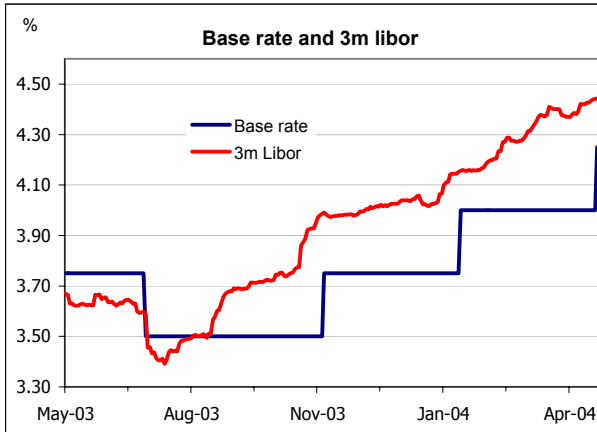
The 18-month period from the start of 2002 to late 2003 saw base rates remain relatively constant, although savings and mortgage margins fell slightly. Recent base rate rises have seen financial institutions taking more from the savings books in comparison to the mortgage books, with the mortgage margin remaining around a historic low point of 80-90bp. However, this masks the true effect on group margins, which may gain via swaps as LIBOR continues to race ahead. These movements will have a direct effect upon group margins. Those with a large retail savings book may be set to benefit as the savings margin increases, whilst those providers who have a significant dependence upon wholesale funding may be harmed as LIBOR continues to race ahead. On the mortgage side, providers' book structure will be important as to whether rising interest rates will have a positive or negative effect. In addition, interest free liabilities will contribute more to the group margin as interest rates rise.

Interest Rates

Interest rate outlook

Recent data suggests a further strengthening in the UK and global economies. However, domestically growth remains unbalanced with consumer borrowing and spending growing strongly contrasted to a manufacturing sector struggling to pull out of recession. Following May's 25bp rise in the base rate we expect the next upward move to come in August and for rates to peak at 4.75% by year-end. However, the continued strength of consumer activity does mean that the risks to the forecast are on the upside. However, by pricing in rates of around 5.50% for the medium term we believe that the market is overdoing it on the high side. The opposite happened last summer.

Although the latest inflation report strikes a slightly more hawkish note we expect the gradualist approach to rate tightening to continue. Reasons why rates need not rise as quickly or as high as markets expect include the strength of sterling and the fact that strong earnings growth is largely due to bonuses and not underlying pay pressure. Commodity prices have risen but this may dampen demand rather than push up inflation. Comment in the inflation report does hint at the MPC being less worried about the impact of rate rises on the housing market, but on balance the committee is likely to remain cautious about raising rates too quickly.



▲ Survey of Forecasts published by HM Treasury.

