UK Economic Outlook

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12 October 2023

NatWest
Markets

UK economy – Flatlining GDP, mild recession in H1 2024

NatWest forecasts a flat-lining UK economy for much of 2023 & into 2024:

2023	**0.6%**
2024	**-0.3%**
2025	**0.7%**

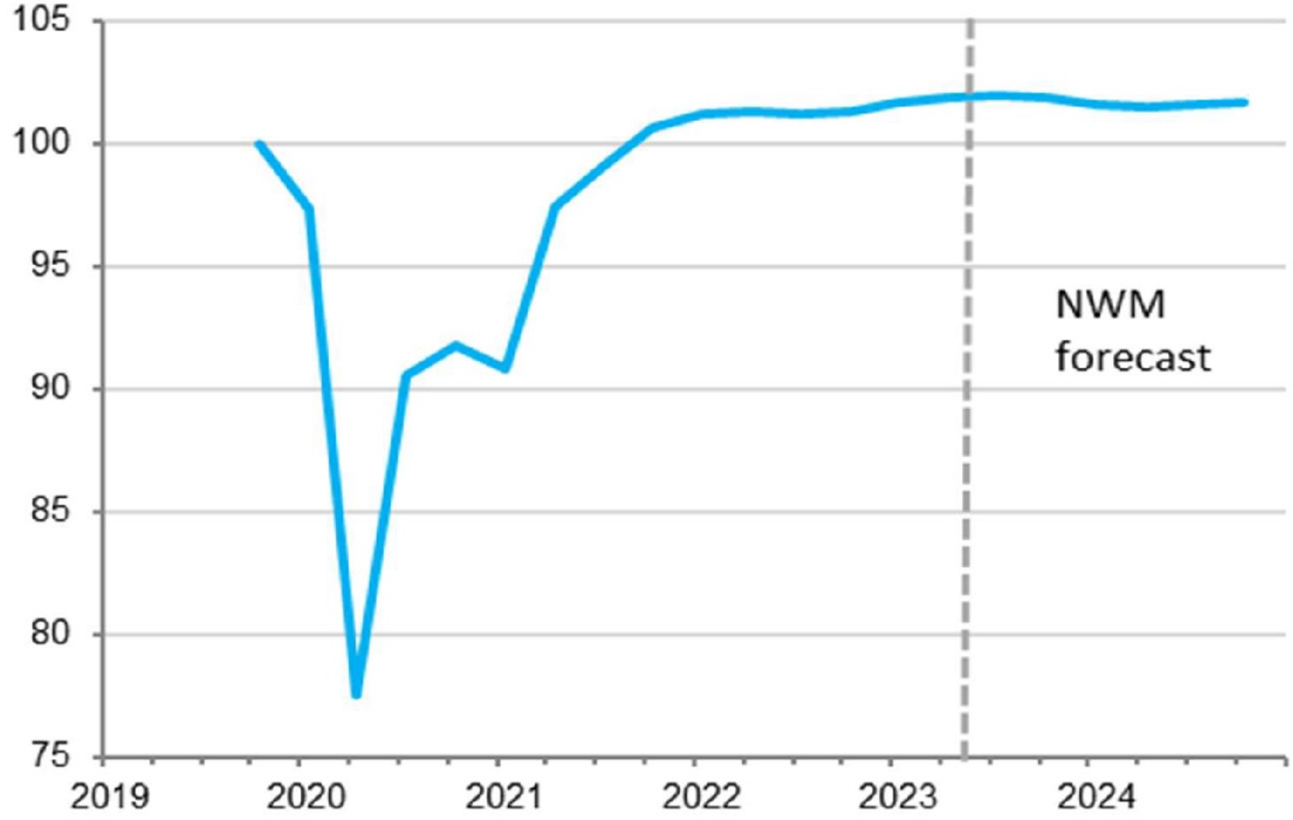
Consumer spending to moderate as debt-servicing costs increase, energy subsidies are withdrawn and unemployment rises.

UK *business investment* remains weak, weighing on near-term demand and medium-term productivity. Unclear if Budget tax incentives spur a sustained recovery.

Fiscal policy stimulus is being reduced but will remain supportive ahead of the expected autumn 2024 election.

UK GDP, level, rebased to Q4 2019 = 100

** These data include the National Accounts revisions published on 29 September 2023*



Source: ONS, NatWest

Recession risks . . . Rising (but not definitive)

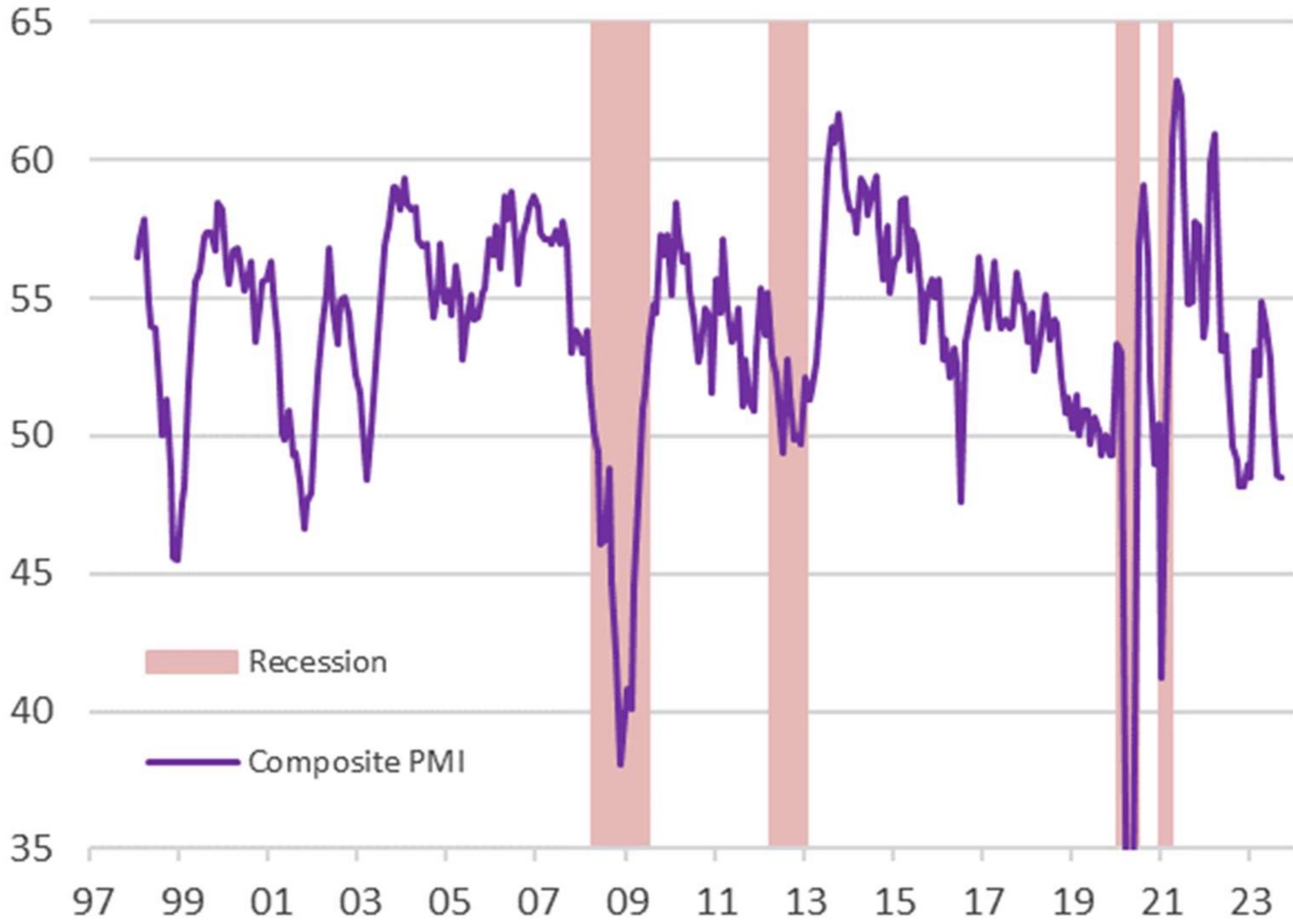
The Composite PMI (Purchasing Managers Index) survey has gone from signalling above-trend UK economic growth in the spring to recession by late summer.

However . . . The UK PMI has predicted '7 of the past 2' UK recessions.

Having a higher conviction about recession would require the Composite PMI to be closer to ~45 for 3-6 months (latest reading: 48.5 in September 2023).

UK PMI as a predictor of recession

Source: ONS, Markit, NatWest



UK economy by main sub-sectors

Overall UK economic output (GDP) has barely grown over the past year: +0.2% 3m y/y.

Broad-based sluggish activity.

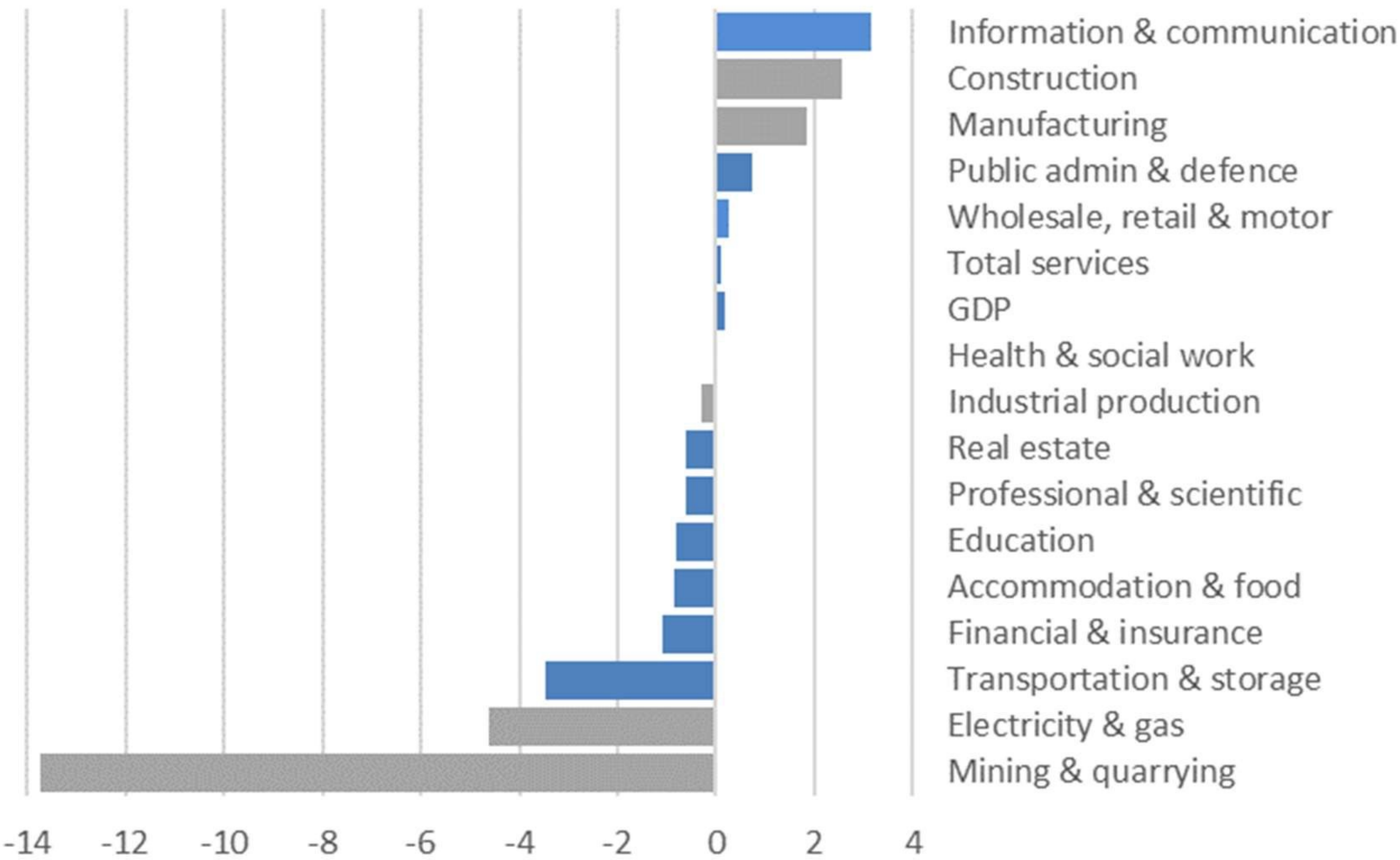
Some sectors have been affected by strikes (health, education & transport), others by higher interest rates (real estate). Mining & quarrying includes the highly volatile North Sea oil & gas output.

Slowing world trade growth does not bode well for manufacturing.

Sectors expected to remain relatively buoyant include information technology, professional & scientific and defence.

UK sectoral growth, % 3m y/y

Source: ONS, NatWest



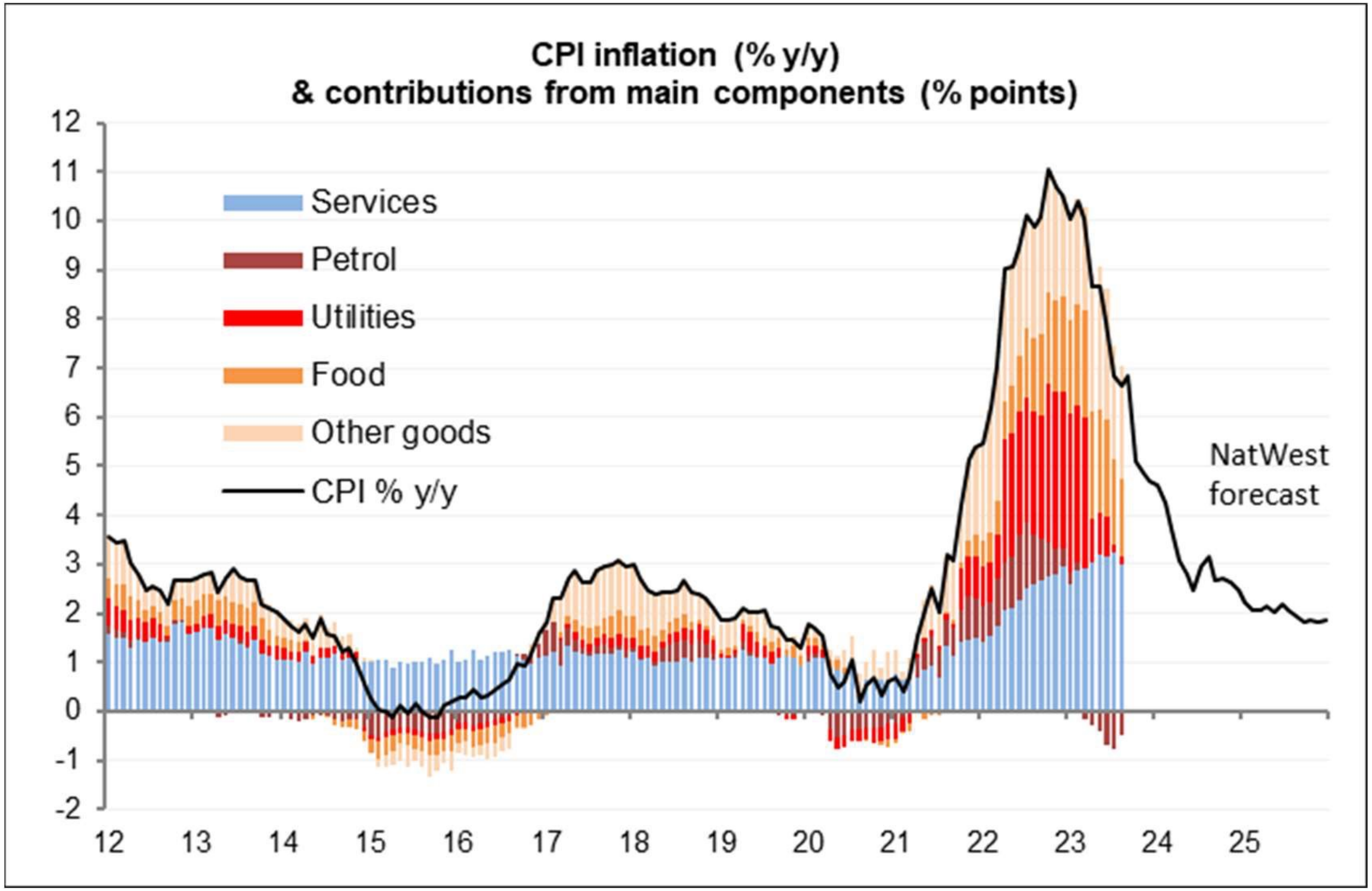
Inflation: Energy shock is unwinding rapidly, but . . .

The **energy inflation** shock has unwound: -3.2% y/y in August 2023, having peaked at 59.0% in October 2022. **Food inflation** has also begun to decline.

However . . . **Services inflation** remains elevated, at 6.8% running at >twice its long-run average.

Consumer goods inflation has been surprisingly high (5.2% y/y in August) given falling commodity inflation & shipping costs. Difficult to rationalise why *demand* for consumer goods would have increased.

CPI inflation is forecast to return to its 2% target by Q2 2025.



Source: ONS, NatWest

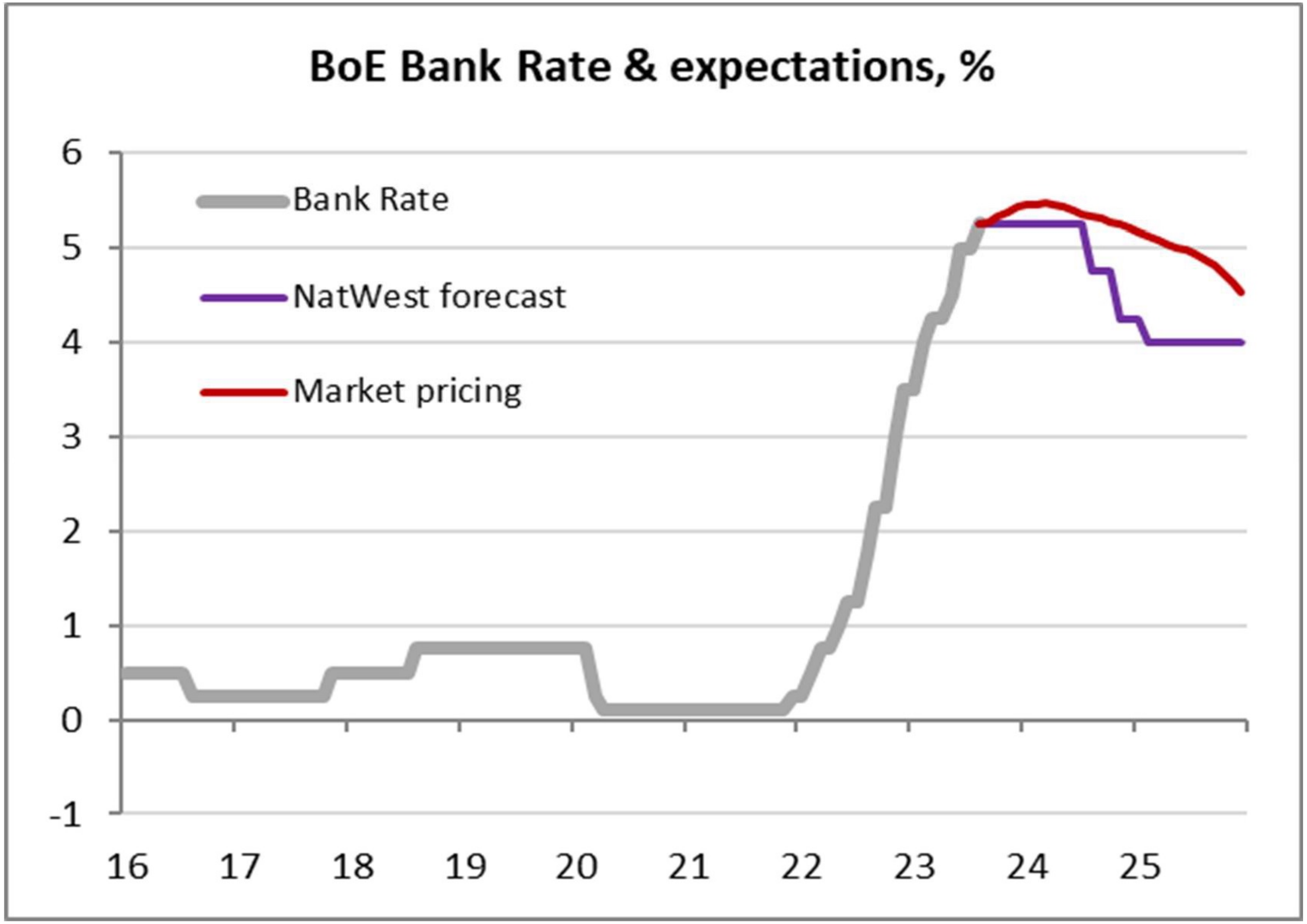
BoE Bank Rate: *(Over)*reaction function?

Our central case is that BoE Bank Rate has peaked at 5.25%.

But . . . modest upside risks to 5.50% in November 2023 and risks of further increases in Q1 2024 if wage inflation does not moderate sufficiently.

We do not expect the inflation path to allow ‘early’ (H1 2024) Bank Rate cuts, but we expect the initial cuts, when they come, to be larger (50bp+ clips) to address protracted lags in the transmission mechanism:

-50bp to 4.75% in Q3 2024
-50bp to 4.25% in Q4 2024
-25bp to 4.00% in Q1 2025



Source: Bank of England, Bloomberg, NatWest

Slower – but still powerful – pass-through from policy rates

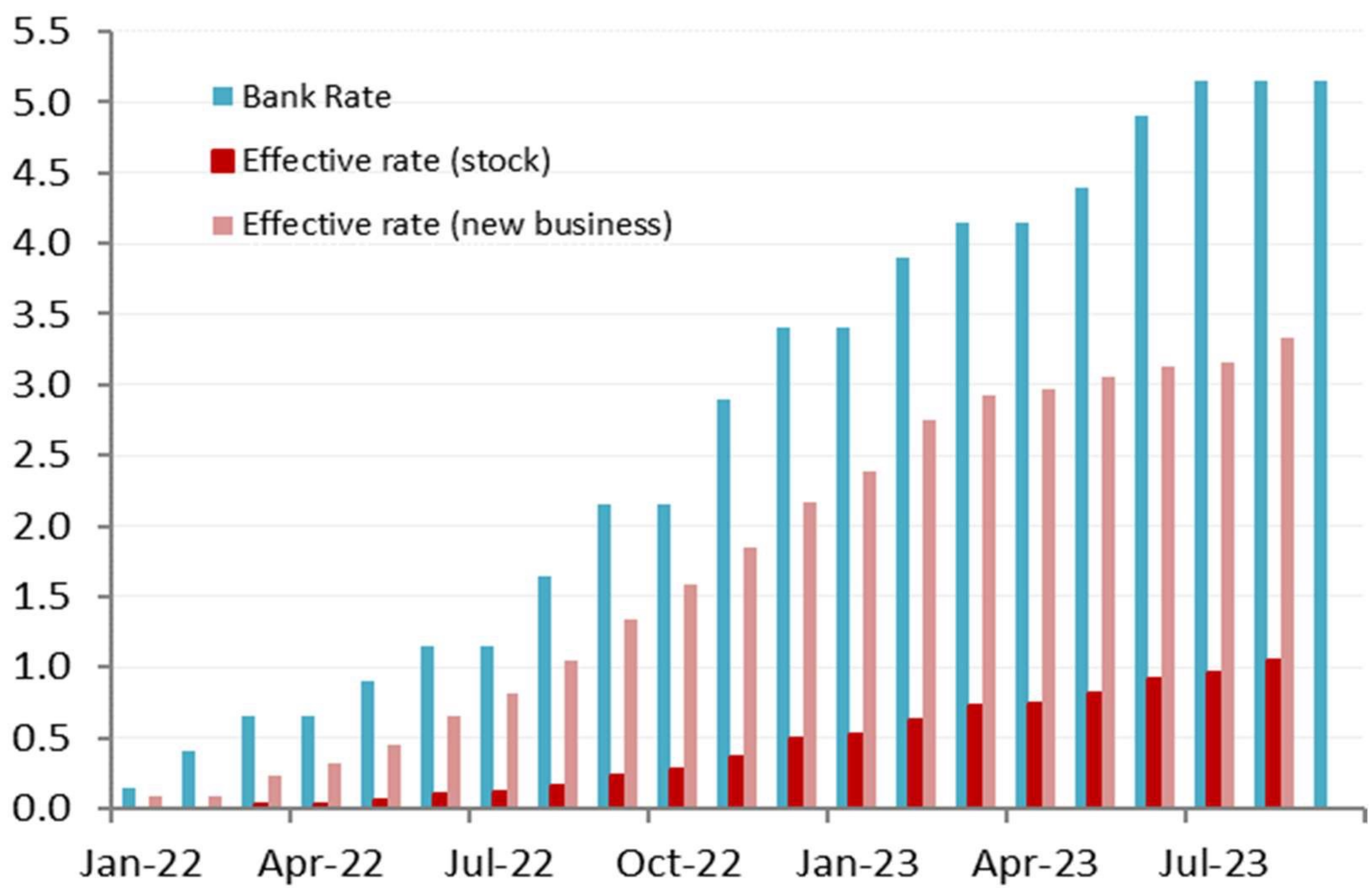
BoE 'effective rate' estimates suggest that only a modest proportion (~20%) of the Bank Rate rises since December 2021 reached mortgage borrowing costs by August 2023 (~20%).

This slow pass-through reflects the large proportion of the mortgage stock tied to fixed rate products (~85%, with roughly half of this share on 5-year fixed rates).

Still, the pass-through is occurring and can be seen in the latest mortgage rate deals and in the 'effective rate' on new mortgages (pass-through is closer to 66%).

BoE Bank Rate & UK mortgage rates, cumulative change % points

Source: BoE, NatWest



Surveys suggest a moderation in hiring

Key survey data (KPMG / REC survey on permanent staff demand and permanent staff placements) show a sizeable fall since early 2022, with survey balances at decade lows (aside form the pandemic lockdown period).

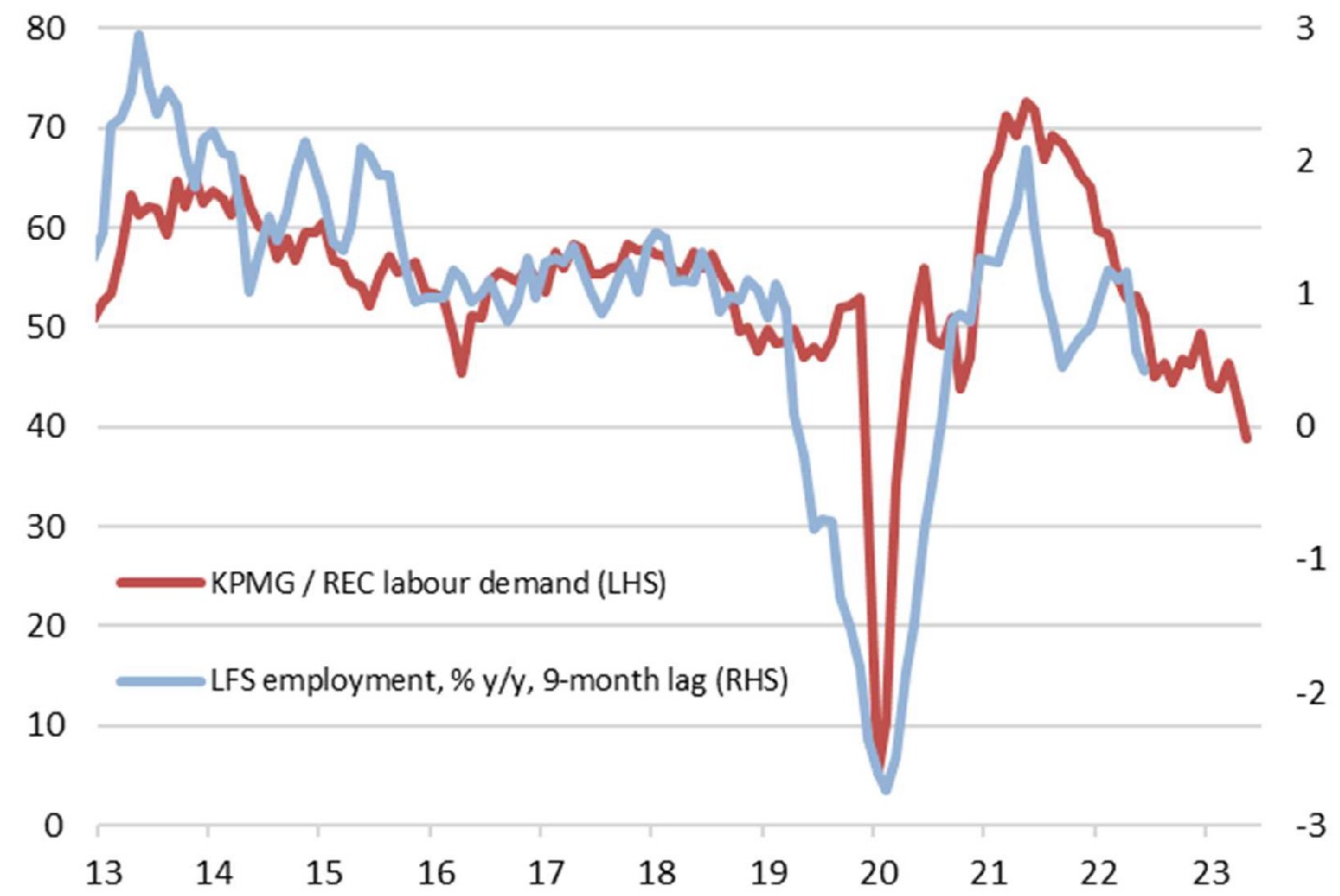
The surveys are consistent with ongoing moderation in employment throughout 2023 and into 2024.

We forecast employment growth to slow from 1.0% y/y in 2022 to 0.6% in 2023 and -0.4% in 2024.

The unemployment rate is forecast to rise from 4.3% to 4.6% at end-2023 & 5.2% at end-2024.

Official (Labour Force Survey) employment data & KPMG / REC survey

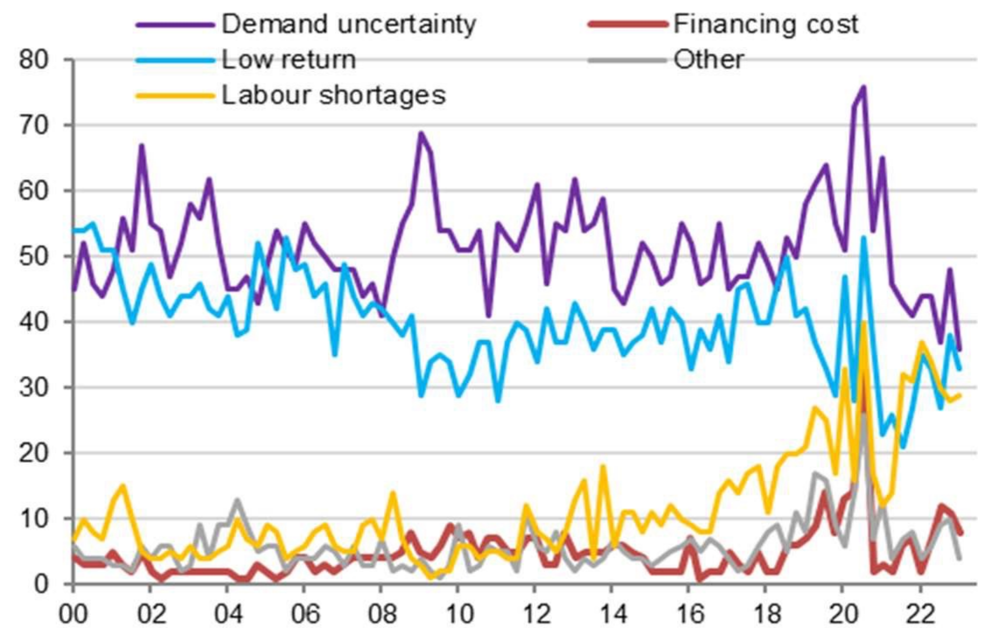
Source: ONS, KPMG / REC, NatWest



The UK's post-Brexit Achilles' Heel: Business investment

Business investment, level, real-terms
Rebased to January 2016 = 100 (**EU Referendum June 2016*)
Source: ONS, NatWest

Business investment & sub-components, levels, real-terms
Rebased to Q4 2029 = 100
Source: ONS, NatWest



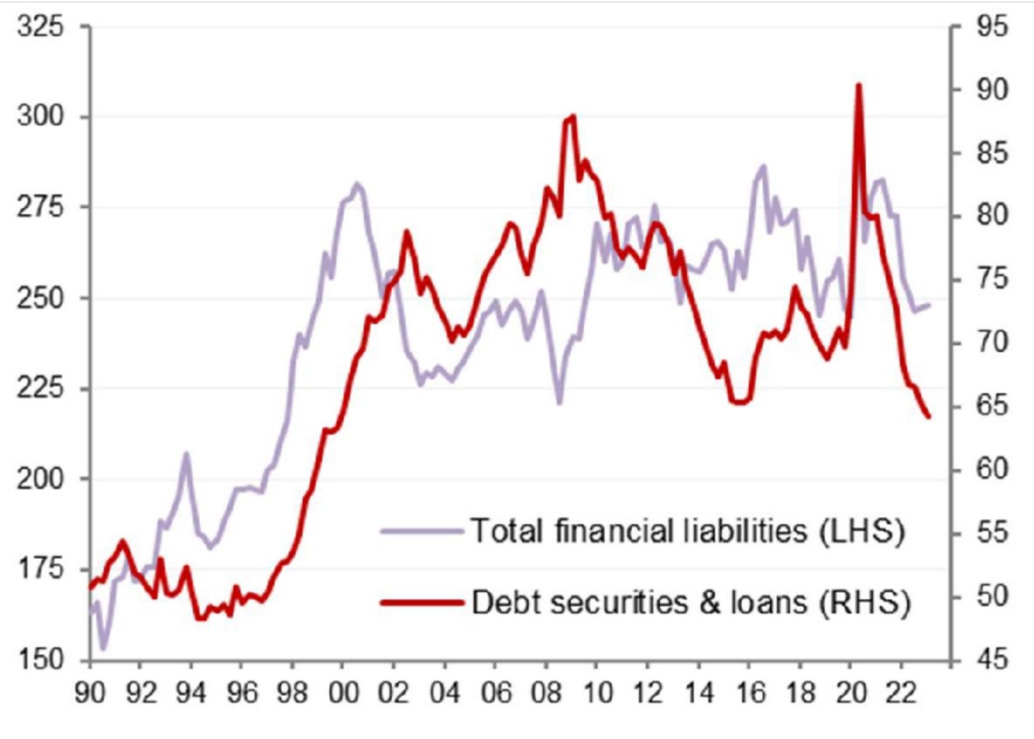
Perhaps the principal concern around the medium-term outlook for the UK economy is the persistent weakness of business investment – barely above 2016 pre-EU referendum levels and almost 20% below where it would have been had the long-run trend of 2½% y/y growth been maintained.

CBI survey on factors holding back investment. Concerns over 'demand' (a cyclical recession) remain the single biggest barrier, though uncertainty has diminished since the pandemic. 'Low return' might be thought of as a more fundamental structural issue (Brexit?). Financing concerns have risen but remain low.

UK corporate debt levels are relatively low

UK corporate sector financial liabilities, % of nominal GDP

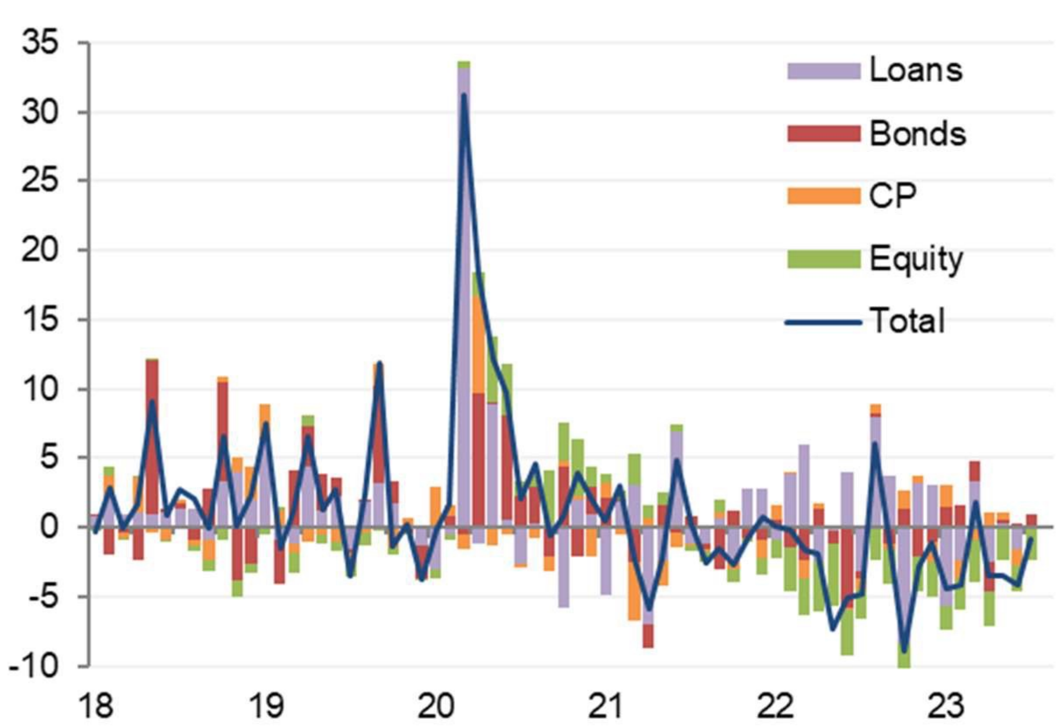
Source: BoE, NatWest



- **UK corporate debt levels appear manageable – in aggregate.** Debt securities & bank loans are at two-decade lows as a % of nominal GDP. Even once equity & pension liabilities are included, corporates' 'total financial liabilities' are at the lower-end of their range over the past decade and mid-range over the past two decades.

UK net monthly corporate financing, £bn

Source: BoE, NatWest

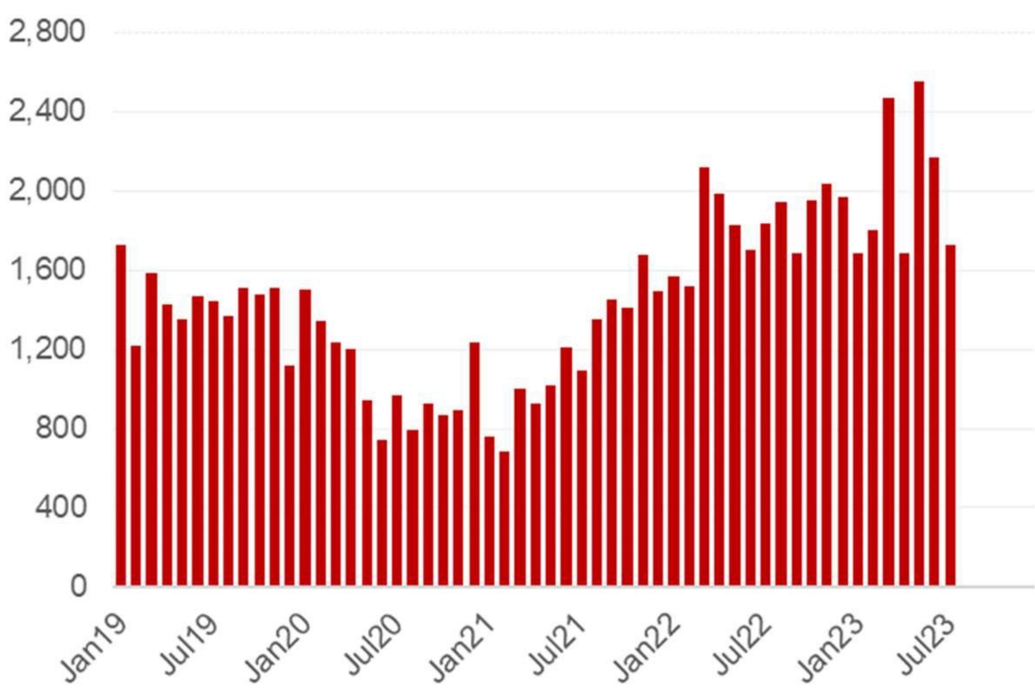


- **The UK corporate sector continues to repay debt: an average monthly repayment of £2.5bn since the beginning of 2022 vs average monthly borrowing of +£2.0bn in 2019 (ie, the year before the pandemic).** Provides reassurance from a near-term financial stability perspective, but also reflects damaged confidence and risk appetite.

Corporate bankruptcies trending higher

UK Corporate insolvencies (non-seasonally adjusted data)

Source: BoE, NatWest

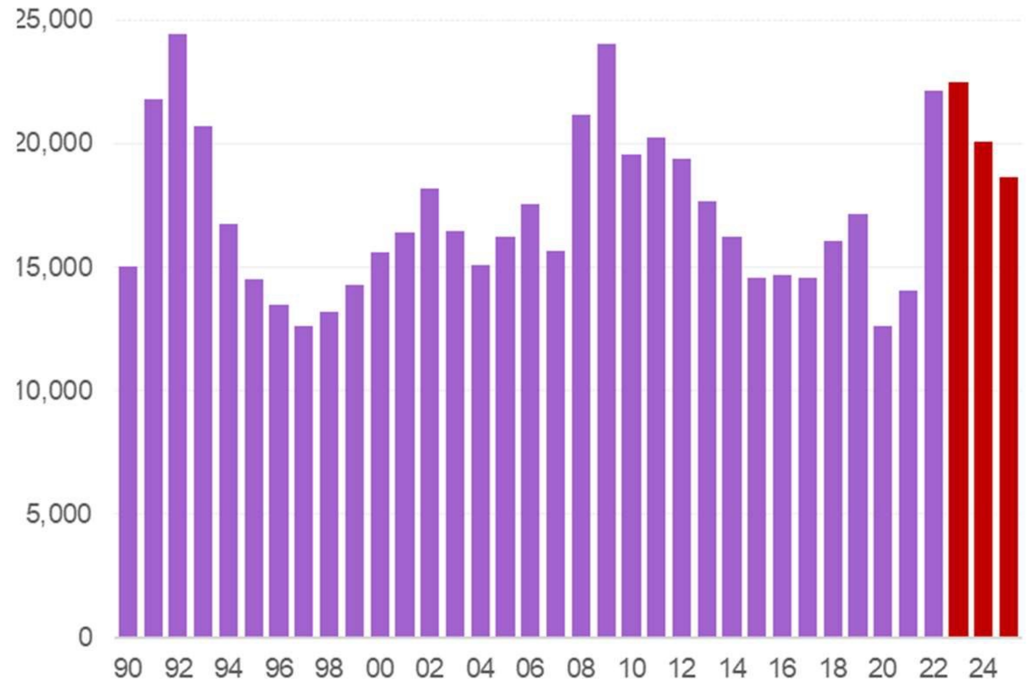


UK corporate insolvency numbers have been volatile over this year – spiking higher in May before returning to more typical levels in June and July.

There is probably still some post-lockdown normalisation occurring following a period of greater debt forbearance and financial support. The cumulative level of actual insolvencies is marginally above a counter-factual pre-pandemic trend.

UK Corporate insolvencies, actual & NatWest forecasts for 2023 & 2024

Source: BoE, NatWest



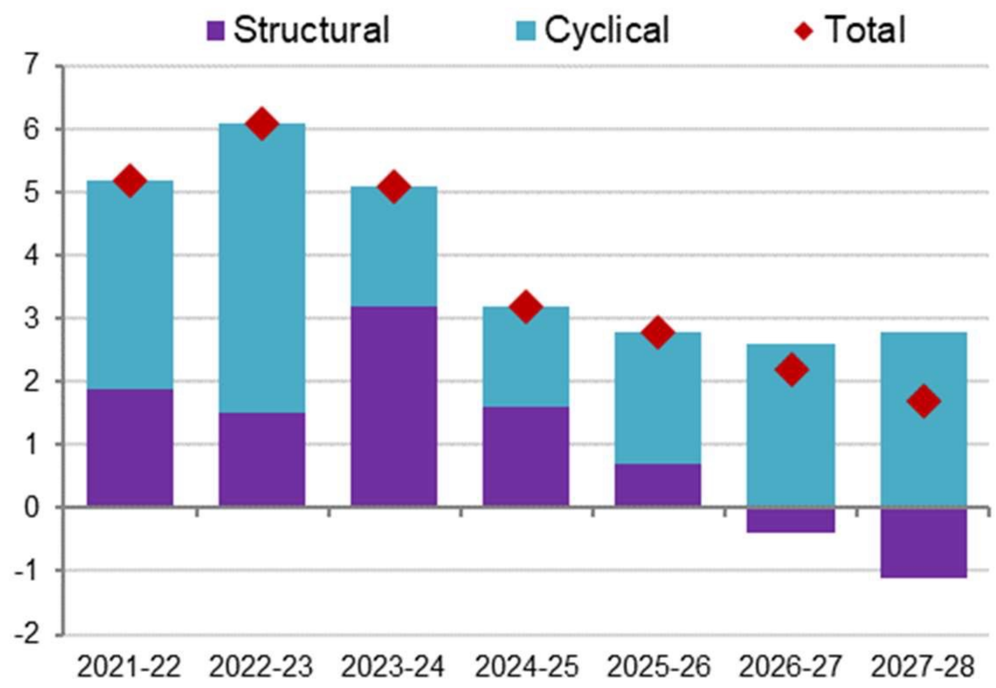
With only negligible GDP growth expected in 2023 & 2024, we expect the level of corporate insolvencies to remain some way above pre-pandemic levels – though not to the highs seen during the GFC.

The risks around our forecast are probably skewed to the upside as the transition to materially higher interest rates threatens the viability of marginal firms.

Fiscal policy: Still stimulative but limited headroom

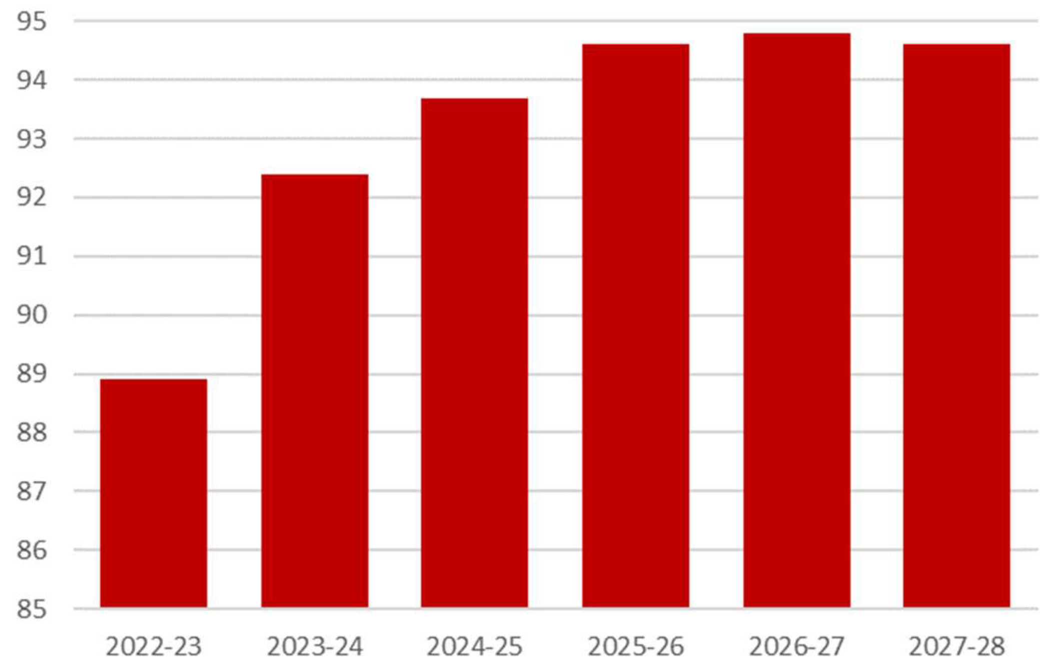
UK PSNB-ex: Total, structural & cyclical, % of GDP

Source: ONS, OBR, NatWest



UK public sector debt, % of GDP

Source: ONS, OBR, NatWest



- **Ongoing sizeable structural fiscal deficits**, notably in the coming 2023-24 FY and into 2024-25 FY, are likely to materialise (expected autumn 2024 election). Tax rises in 2025 and beyond?

- **Limited fiscal headroom** is also apparent in the UK public sector debt projections: which rise by ~5% of GDP before falling by 0.2% of GDP in 2027-28 FY to meet the Government's fiscal rules.

UK economy outlook – Key Views

- **A flatlining UK economy in 2023 & 2024 – with rising risks of recession.** Data show the economy losing momentum, even before the impact of interest rate rises has been fully felt. Medium-term: weaker trend GDP growth (~1% y/y) on a depleted capital stock, less favourable trends in labour participation and post-Brexit structural challenges.

- **We forecast BoE Bank Rate to have reached its peak at 5.25%.** Modest risks of +25bp to 5.5% in November. We do not expect ‘early’ rate cuts (i.e., in H1 2024) but a lowering rates to more neutral levels (to ~4%) from H2 2044 and 2025 is our central case.

- **Inflation has peaked but Core CPI components are expected to remain somewhat sticky** – at least until into 2024 once the lagged monetary policy tightening bites.

- **Wage inflation is not expected to moderate significantly until into 2024.** Falling headline CPI inflation will, ultimately, be a key factor in moderating nominal wage growth. Early survey data show a clearer moderation in wage settlements and expectations. Further rate rises will reduce demand, limiting firms’ ability to pass on price increases.

- **Limited fiscal headroom but some scope for further, relatively modest stimulus ahead of the expected autumn 2024 election (½% - 1% of GDP).** Tax rises beyond? The Truss fiscal ‘experiment’ is likely to ensure greater caution by policymakers and shore-up the authority of independent institutions.

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