Quarterly UK economic outlook

Q2 2023

mazars

Contents

Executive summary
Peak uncertainty

The global economy remains unbalanced as the pandemic disrupts global trade, supply chains and international relations. As a result, individual economies diverge and data is unpredictable and volatile. Decision-makers, be they in business or public policy, will struggle in 2023, not least because no clear trends seem to emerge.

Global economy

After narrowly escaping a financial accident, the global economy is poised to slow significantly in the first months of the year as interest rates continue to rise and inflation remains far from beaten. At the same time, regional economic divergence is increasing. The world remains a very unbalanced place and supply chain uncertainty is at its highest in many years.

UK Economy

Growth is set to slow down in the UK in 2023, more than in its developed market peers. Consumption and services look better than manufacturing, but the latter is usually a leading indicator, which means we could yet see a slowdown. The Windsor framework, if implemented, can significantly improve the longer-term outlook.

Consumption

After several months of dismal performance, consumption in the UK has unexpectedly picked up. However, we remain sceptical about the sustainability of this trend.

Labour

Unemployment is low but job vacancies remain very high. This means that there aren’t enough skilled workers to fill in jobs. Market forces alone are proving insufficient to solve this issue, especially in a climate of economic uncertainty, which may require a more systemic approach to resolve.

Rates

As global economies diverge, the Bank of England has signalled that its close to, or even possibly at, the end of its rate hike cycle. However, the course is far from linear, and the decisions of other central banks, as well as global inflation, will continue to influence UK rates.

Inflation

Inflation is falling, albeit at a slow pace. Consensus expects less than 7% inflation by the end of 2023 and less than 3% by the end of 2024. The road to getting there, however, will probably not be a smooth one.

Real Estate

The real estate is set to slow down, as consumers are pressured and the number of office workers is reduced. However, as long as interest rates level off and supply remains constrained, we expect the damage to be contained.

Corporates

Last year, windfall energy profits lifted British businesses. However, this year is projected to be difficult in terms of bottom-line earnings, as rising wages and lower demand put pressure on profits.

George Lagarias
Chief Economist, UK

The global economy
Stagflation, for now

After narrowly escaping a financial accident, the global economy is poised to slow significantly in the first months of the year as interest rates continue to rise and inflation remains far from beaten. At the same time, regional economic divergence is increasing. The world remains a very unbalanced place and supply chain uncertainty is at its highest in many years.

As we enter the fourth year of economic volatility, price pressures and rising interest rates continue to erode consumers' disposable income. Entering 2023, consensus saw a significant slowdown in the global economy, with many areas expected to be in recession. China's reopening, which thus far hasn't meaningfully contributed to global inflation, has improved the prospects for global growth, but overall the trend is negative.

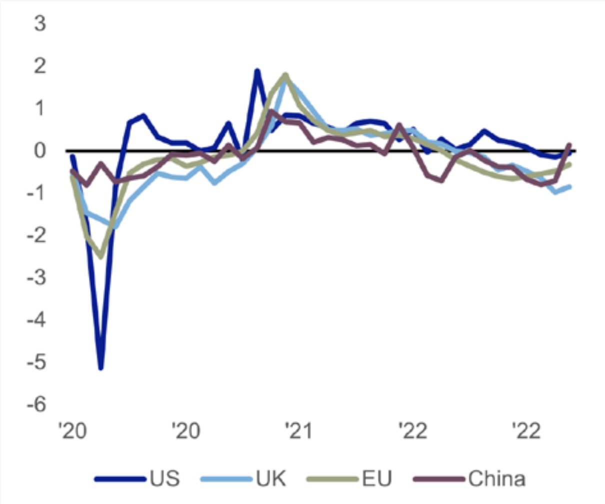
In the first months of 2023 we saw a balance of positive and negative news.On the positive side, the global services sector is holding up, and is set to improve as China abandons its zero-Covid policies and re-enters the global trade fold. Employment levels remain high and developed market consumers are by and large resilient. Better than feared weather in Europe has averted an economic accident due to energy shortages while the resilience of the financial system in the face of sharp rate hikes has been a welcome surprise.

Overall inflation has slowed down but remains too high for central bank comfort. However, not every consumer is resilient. Income disparities between earnings cohorts suggest that a large part of lower income consumers is already experiencing a significant fall in disposable income. While this has not fully translated into much weaker retail sales in developed markets, we have seen consumers increase their borrowing and drawing down savings to spend. And while overall employment levels are high, many global companies stepped up the number of job cuts in January and February. Meanwhile, global manufacturing continues to slow down, due to dwindling new orders and weak export demand. In the US, a Real Estate slowdown is unfolding and we are already seeing similar trends in Europe.

Uncertainty and volatility are the keywords for the months ahead. An unbalanced world produces unbalanced and unpredictable figures. The economy is decelerating. What remains to be determined is the velocity of the slowdown.

The global economy is slowing, but less than expected

Z-score of leading indicators



Global inflation is subsiding, slowly

Bloomberg global inflation

Source: Mazars

The UK economy

UK growth set to underperform

Growth is set to slow down in the UK in 2023, more than its developed market peers. Consumption and services look better than manufacturing, but the latter is a leading indicator. The Windsor framework, if implemented, can significantly improve the longer-term outlook.

As global growth is slowing down, the UK headline growth is widely expected to underperform most of its developed market peers in 2023. According to the IMF, Britain it is the only major G7 economy bound to contract this year (-0.1% to -1%) where Europe and the US are poised to marginally grow. In the short term this is the result of higher inflation, as well as tighter fiscal and monetary policies and financial conditions. Over a longer horizon, persistently low investment post Brexit and labour shortages are both pushing prices higher (further constricting financial conditions) and limiting output. Very high retail energy prices are weighing on household budgets. Following the 2022 mini-budget debacle and the consequent change in government, Chancellor Hunt is obliged to walk a very narrow fiscal path, which leaves no room towards the alleviation of consumers.

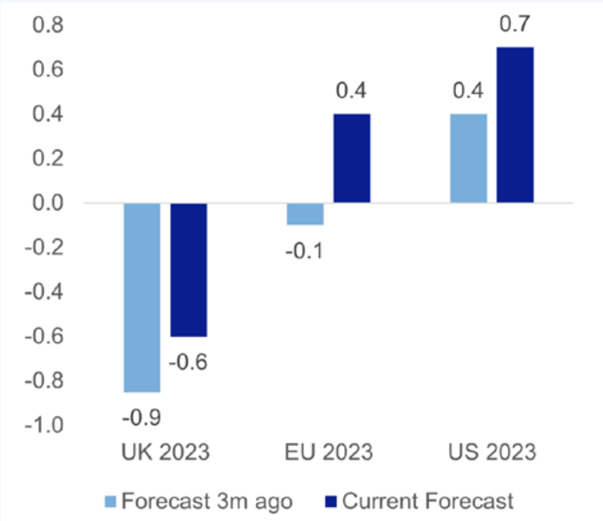
UK manufacturing activity has been contracting for at least seven months, as new orders and exports slowed down. Despite much lower input inflation many firms reported that production had been stymied by weak intakes of new work and disruptions caused by raw material and staff shortages.

Conversely, the UK service sector seems to be rebounding, after four straight months of contraction. Evidence suggests that there's a pickup for business services, as a result of the slightly improved global economic outlook and reduced domestic policy uncertainty. Having said that, consumer demand for final goods remains weak.

In terms of regions, London (due to its heavier focus in services) is outperforming the rest of the regions, which have experienced financial contraction. Having said that, most areas are seeing lower inflation and better employment. Except for London, conditions are relatively better in the East, South East and North East of England. The West Midlands has shown the biggest increase in optimism, while Northern Ireland remains the most pessimistic region.

The UK is the only major economy projected to contract

Bloomberg Economic Survey -2023 GDP estimates



Outlook: It is clear that much of the drag on the economic growth is due to Brexit complications. The UK is experiencing reduced availability of manpower, lower investment and difficulties in exports. The output gap, the difference between potential and actual output, stands at 2.7% and it is projected to fall by another 2% by the end of 2024. This means that productivity is bound to worsen.

The good news is that much of the problem is fixable. The government seems poised to improve relations with the EU. The bad news is that even if the Northern Ireland deal is implemented, the PM's intention to radically change regulations could lead to frictions, with the position of banks post-Brexit still unresolved. Additionally, British chip designer ARM's refusal to list on the London Stock Exchange, opting instead for a US listing, is a blow to London's credibility as a post-Brexit financial centre.

Consumption

Sustainable improvement or irrational exuberance?

After several months of dismal performance, consumption in the UK has unexpectedly picked up. However, we remain sceptical about the sustainability of this trend.

Consumption improved somewhat in January, but we remain sceptical about whether this is a sustainable trajectory.

On the face of it, the data suggests that consumption is improving. Retail sales rose 0.5% in January ,wages continue to grow at an annual rate of 6.7% and the CBI (Confederation of British Industry) suggests that retail sales volumes are increasing. Consumer confidence has improved somewhat, but remains near cycle lows. Online business has lost some momentum, but overall its share of sales is 25%, 5 percentage points above pre-pandemic levels. Data from the US was similar in January, registering one of the best retail sales figures in recent history.

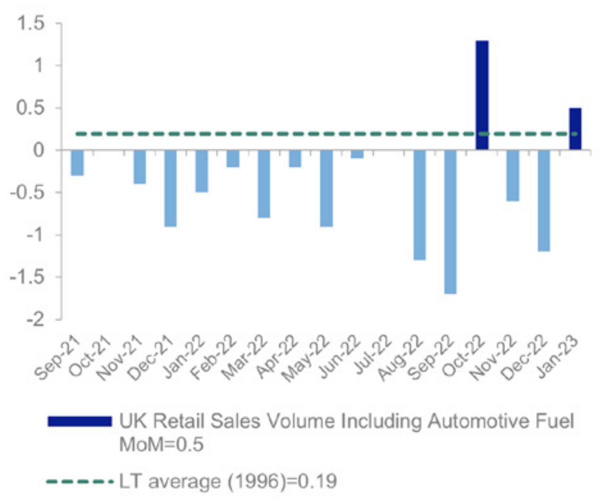
A recent survey by GfK suggested that consumers were suddenly more optimistic about their personal finances and the general economic situation, despite the hit to real incomes. The improvement was across all measures.

Outlook: despite the recent uptick in the data, we feel that overall the British consumer is facing an uphill battle. Consumer confidence, albeit having improved somewhat, is still near all-time lows. Consumers are turning to savings and higher debt to facilitate consumption, even for essentials. There is evidence that suggests that the recent uptick may be associated with post-holiday deals. Meanwhile, the impact of higher interest rates is just beginning to bite, as more mortgages require refinancing, at five to six times higher rates. Headline inflation remains above 10% and much higher for some consumer goods. House prices, a key source of wealth, have started to recede. The services sector may be buoyant, but poor manufacturing figures are a leading indicator.

Just looking at the underlying data, we should be more optimistic. Consumption is psychology and an uptick, however unexpected, should be welcomed. However, we would need to see a sustained trend before declaring that the consumer is resilient in the face of increasing hardship.

Consumption rebounded in January

Retail Sales, MoM



UK wages climb higher

Average wage YoY, 3m average

Source: Mazars

Labour market

Tight labour market, upskilling is key

Unemployment is low but job vacancies remain very high. This means that there aren't enough skilled workers to fill in jobs. Market forces by themselves are proving inadequate to address the issue, especially in a climate of economic uncertainty, which may require a more systemic approach to resolve.

Unemployment in the UK remains stubbornly low, at 3.7%, just 0.2% above an all-time low. Meanwhile, the labour participation rate is near an all-time high of 68.5% and projected by the OECD to rise further in the next year. Wage growth is running at 6.4% per annum, one of the largest increases in recent history. This is mostly due to elevating starting pay inflation, although the momentum of the trend appears to be slowing.

Job vacancies have dropped off, somewhat, from a record 1.3m last summer to 1.1m, but they are still far from the average of 673 thousand. This was mostly due a rise in temporary billings, however, as employers are hesitant to commit to new hires.

Hiring conditions were slightly better in Scotland the North of England and London, but worse in the Midlands. Nursing and Medical jobs are the most difficult to fill, whereas Hotel and Catering are the easiest.

The main reasons for the labour supply shortage are a) ageing population, b) restrictions on migration and c) the impact of the pandemic.

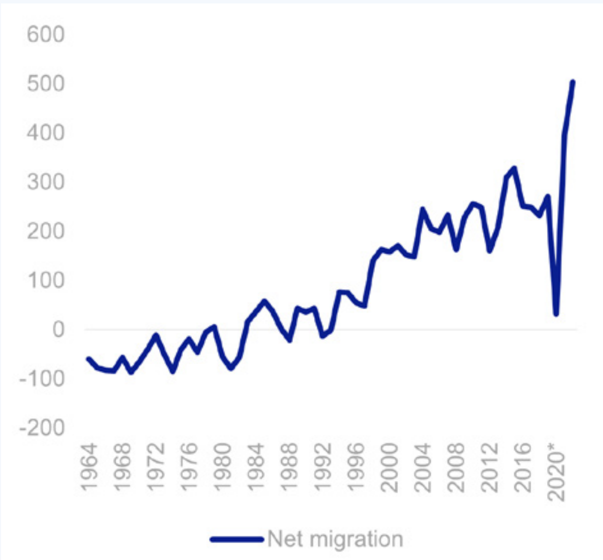
Outlook: We expect tough staffing conditions to persist for at least the next year. The high labour participation rate suggests that the pool of available individuals is being exhausted. The high net migration rate, however, indicates that staffing is mostly a skills problem. Partly this is due to Brexit. When Britain was part of Europe, training protocols in certain sectors, like healthcare, converged with those of European nations. As the UK is seeking employees from other countries, training takes more time than before. The government has already set course to improve relationships with Europe, which should allow for a better flow of skilled migrants. However, the major issue is upskilling of the existing workforce. We feel that market forces alone are proving insufficient, especially in a climate of economic uncertainty. Until the issue is addressed systemically, we should get used to a tight labour market, competitive starting or moving salaries and higher costs for businesses.

UK unemployment persistently low

YoY

Net migration is increasing

Annual net migration, UK



Source: Mazars

Interest rates & financial conditions

Tight rates, but are they tight enough?

As global economies diverge, the Bank of England has signalled that its close to, or even possibly at, the end of its rate hike cycle. However, the course is far from linear, and the decisions of other central banks, as well as global inflation, will continue to influence UK rates.

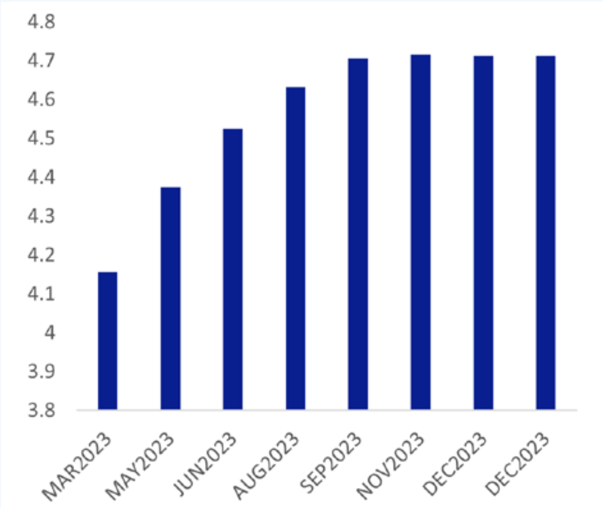
The global economy is becoming more disjointed. This creates divergence between central bank policies. The US central bank is close to pausing rate hikes, whereas its European counterpart has adopted a more combative stance against inflation. Meanwhile, in the UK, the calculus between the needs of the economy and the need to bring down inflation seems to be balancing.

The Bank of England has raised its base rate sharply over the past year, from 0.1% to 4%, as it combats consumer inflation. Rate hikes have been done in 0.5% and 0.75% increments since last summer. However, in the past few weeks, key Bank of England officials, have suggested that their rate outlook has become more dovish. Whereas markets now expect a final rate at 4.7%, in tandem with other developed markets like Europe and the US, Mr. Bailey indicated that there's no pressing need to raise rates beyond 4%, however he also didn't categorically confirm that the Bank was done with rate hikes for now. Mr Pill added that: *"I do have a high degree of confidence (about getting inflation to target) because we know what we're going to do. We've done a lot to achieve it, we're prepared to do more as necessary to ensure that we achieve it sustainably".* M4, a broad money supply index is at 2.7% for the year to January, suggesting that credit conditions are near their 10-year average and not too constricting.

Outlook: We are edging close to the end of the rate hike cycle. However, the interest rate environment is extremely uncertain. We believe that the central bank doesn't want to continue hiking rates sharply in the midst of a recession. Nevertheless, even though the Monetary Policy Committee wants to differentiate itself from other central banks, the reality is that it can't let its currency depreciate significantly. Currently markets think we should see 2 to 3 more 0.25%x hikes before a pause. Although governor Bailey has left room for a more immediate pause, we think that at least one more rate hike is on the cards. After that, we expect rates to remain elevated for some time.

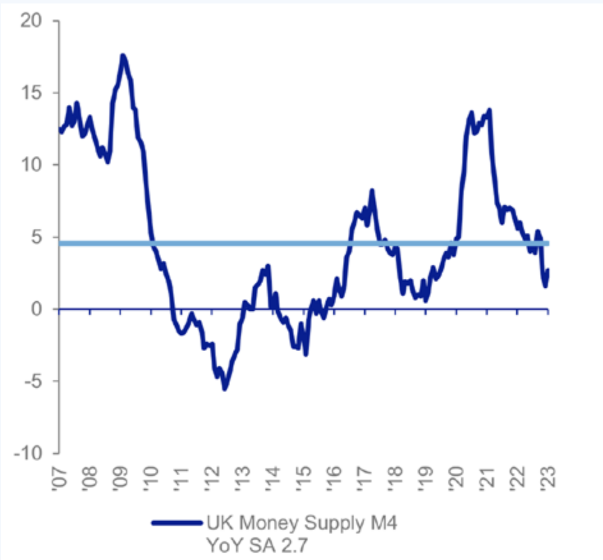
Markets expect 0.75% higher rates

Implied market expectations for UK rates



Monetary conditions are somewhat tighter

M4, YoY



Source: Mazars

Prices

Inflation has started falling. Is it enough?

Inflation is falling, however at a slow pace. Consensus expects less than 7% inflation by the end of 2023 and less than 3% at the end of 2024. The road to getting there, however, will probably not be a smooth one.

UK households continue to struggle with a once-in-a-generation cost-of-living crisis. However, the situation seems to be improving.

UK CPI inflation fell 0.6% in January, more than expected, as the cost-of-living crisis rages on. It is the first negative number in twelve months and consistent with the weakness we have seen in retail in the past six months. It means that companies don't have much more room to pass on cost increases to consumers. Input cost pressures are also easing, but the numbers remain erratic, with some items such as electronics and metals pushing higher.

On a year-on-year basis, however, the number remains uncomfortably high at 10.1%. Due to the base effect, we expect the number to materially come down after April.

The largest contributions to inflation come from non-discretionary items, such as housing and household services (electricity, gas, fuels), and food and related products. Some key products like low-fat milk, sugar and olive oil have risen more than 40%.

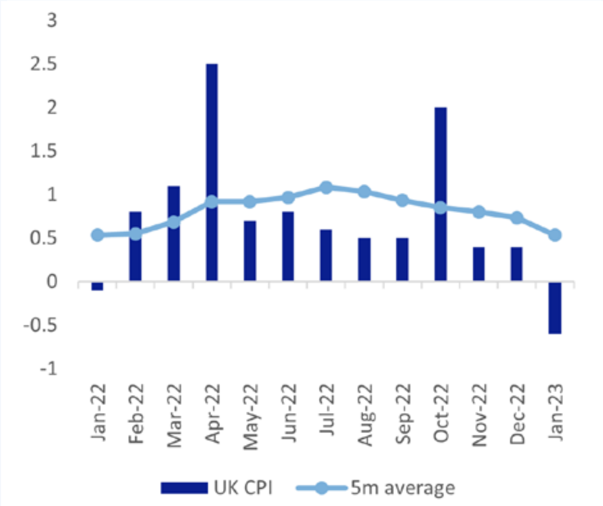
Conversely, passenger transport costs are falling (due to falling oil prices) as are restaurant and hotel costs.

Wage inflation stands at 6.7% for the year to January, the highest level in two decades – barring the post-lockdown rebound.

Outlook: Analysts expect inflation to fall to 6.7% by the end of 2023 and 2.4% by the end of 2024. Our own view is similar to these forecasts. Consumers are stretched and demand is waning (despite the recent strong retail figures), so end prices should eventually be contained. However, we don't expect the course to be linear. Our main theme for the year is "macroeconomic volatility". As global supply chains are being reconfigured and the war in Ukraine rages on, we expect rebounds in inflation and surprises. Overall, we also expect prices to remain elevated for some time.

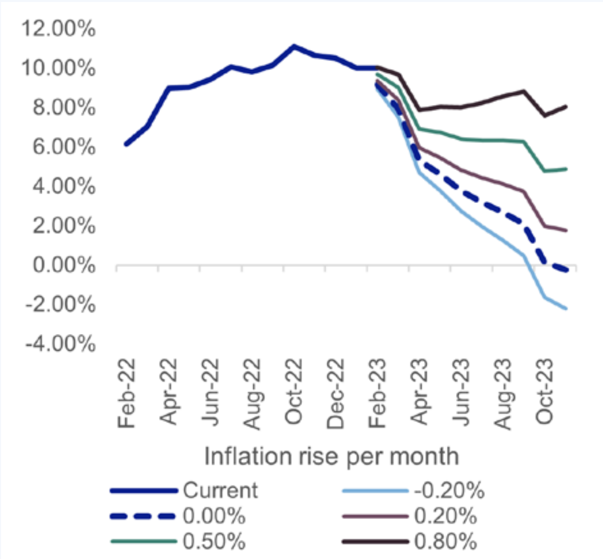
UK CPI fell for the first time in a year

UK CPI MoM



Most scenarios have inflation around 6% by summer

Scenarios, UK CPI



Source: Mazars

Real estate

Drop, but not a reckoning (yet)

The real estate sector is set to slow down, as consumers are pressured and the number of office workers is reduced. However, as long as interest rates level off and supply remains constrained, we expect the damage to be contained.

In the wake of the pandemic governments sought to provide broad assistance to their economies. In the UK, some focus was given to the real estate market, which resulted in incentives that temporarily increased demand for home ownership, pulling prices upwards. Demand has softened as the economy is entering a recession. Rising costs in living and materials needed for construction and refurbishing further reduce the available income for would-be buyers, dampening demand.

For the year to February UK house prices contracted by -1.1%. Excluding the pandemic, it is the first decline since 2012. Conditions for those looking to buy a home are deteriorating. Mortgage costs for first-time buyers are reaching 40% of their take-home pay (up from an average of 25%). The overall cost of a 10% deposit now exceeds 55% of an average annual income.

More forward-looking indicators suggest that residential work has dropped at the steepest pace in 32 months. New orders and employment continue to decrease. Prices have come off somewhat as a result of lower demand for building materials but remain elevated. Having said that, forward-looking confidence is improving.

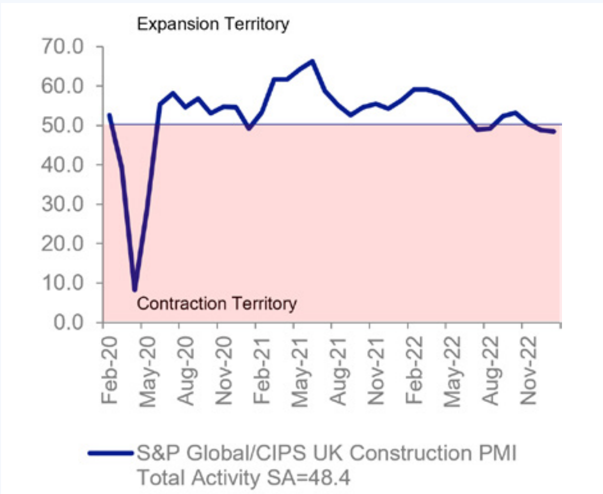
Outlook: Looking at the US market, where mortgages are very long term, we see evidence of a sharp drop, close to 2008 Global Financial Crisis levels. For commercial real estate, office based employment is projected to drop, putting further pressure on commercial real estate. Meanwhile, we expect pressure on consumption to persist, despite a recent “green shoot” of data. Therefore, affordability should drop off further. Having said that, limited housing availability, stabilising interest rates and better relations with Europe should somewhat mitigate the drop.

House prices and mortgage approvals drop

Nationwide House Price Index (LHS), Mortgage Approvals (RHS)

Construction is contracting

<50=contraction



Source: Mazars

2022 was better than 2023

Last year, windfall energy profits lifted British businesses. However, this year is projected to be difficult in terms of bottom-line earnings, as rising wages and lower demand put pressure on profits.

UK Corporates (MSCI UK) experienced one of their best years in recent times, with earnings more than doubling in 2022 (+144%) as a result of the index's exposure to energy and materials. Gross margins remained elevated, at 35%, As we enter 2023, however, the picture is changing. Manufacturing is weakening, as a result of slower external demand and fewer new orders. Services are holding up better, but profits in more labour-intensive companies are also suffering from the impact of higher wages. Inventories rose significantly last year as well, as a result of Brexit-related pressures.

However, business valuations remain low. Listed UK companies trade at about 10.5x their earnings, as opposed to their 20-year average of 14.5x.

Outlook: We expect 2023 to be a more difficult year for corporates. Last year was good, mostly due to profits in the energy and materials sectors. The war in Ukraine initially disrupted supply chains, but materials have found different (albeit more expensive) routes. As oil prices stabilised, we don't expect similar performance this year. Consensus suggests that earnings should drop around 7% in 2023 versus the previous year, even though analysts believe that top line revenue will grow.

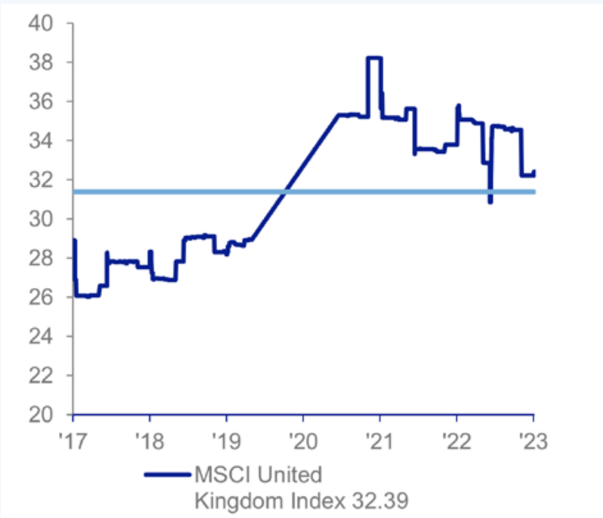
This indicates significant margin contraction. Rising wages put increasing pressures on prices, especially in the service sector. A 5% rise in wages is estimated to reduce FTSE 350 earnings by 10%. Additionally, lower disposable incomes, especially for marginal consumers, should pressure firms to keep prices at acceptable levels, further compressing profit margins.

UK companies are valued below average

Trailing 12m P/E ratio

UK companies have been enjoying high profit margins

MSCI UK, gross margin



Source: Mazars

UK homeworking

Those who can work from home, do so

In February 2023, the Office of National Statistics released its report on Homeworking for the UK.

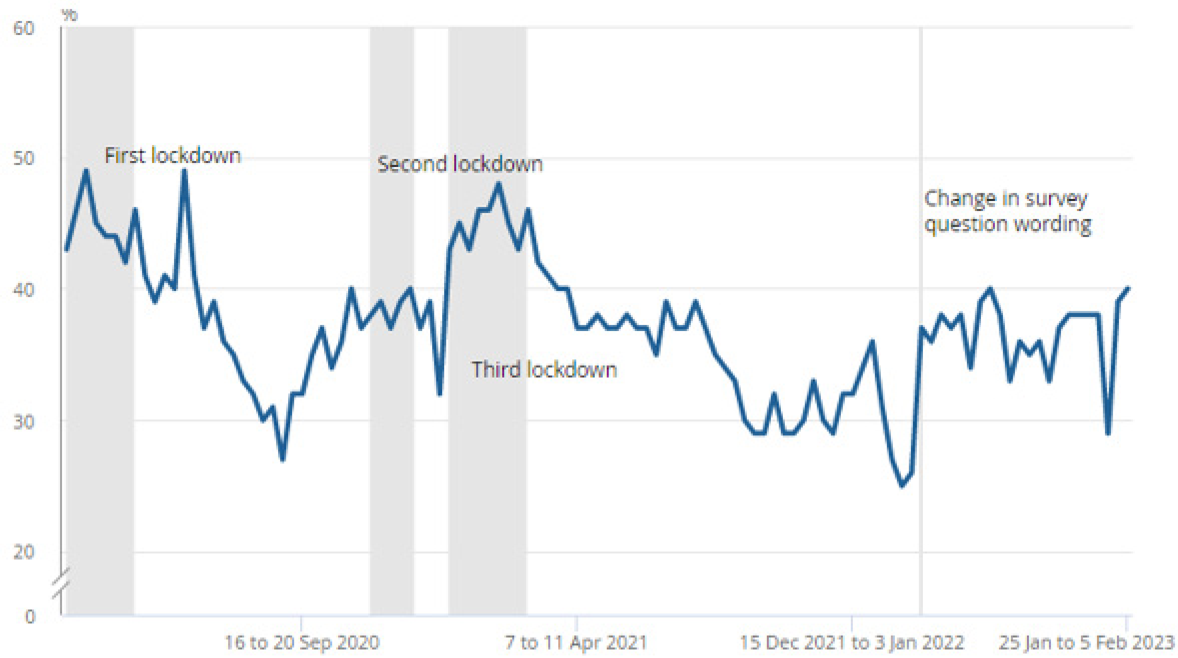
Its key findings were:

- Before Covid, only 16% of workers reported doing some work from home.
- Presently 40% of workers do some sort of hybrid working, or completely work from home.
- The trend is increasing
- Hybrid working is higher in
  - London
  - Workers in the highest income band
  - Those educated at least to a degree level
  - Parents
  - 33-44 age bracket
  - Those in professional services
- Hybrid working is less desirable and less available to younger workers
- 50% simply aren't able to do hybrid working
- Only 10% of the workforce are able to perform their work in a hybrid fashion and don't.
- The desire is strong.

According to a different survey by Bloomberg, 75% of employees in London would rather quit rather than return to the office full-time.

More workers opt towards hybrid working

Proportion of working adults in Great Britain, until February 2023



Source: Mazars

Appendix

Forecasts for the British economy

UK	2022	2022	2023	2023	2024	2024	2025	2025	2026	2026	2027	2027			
	2022		2023		2024		2025		2026		2027		30y Avg	Tendecy	Mazars view
Economic Growth - GDP (Curr. 0.4%)	4.0%		-0.6% to -1.4%		0.9%		2.3%		2.2%		1.5%		1.9%	▼	In growth is slowing down fast. The economy is projected to slow down significantly in H1 2023 where a recession is the base case scenario
	4.10%	4.10%	-3.30%	0.90%	-1.20%	3.00%	2.35%	2.35%	2.20%	2.20%	1.50%	1.50%			
Consumer Inflation (Curr. 10.1%)	10.5%		6.7%		2.4%		2.0%		2.0%		2.0%		2.3%	=	Inflation has started to veer off after the end of the eyar, as input pricies and Year-on-year effects begin to take hold. However UK inflation may be prolonged due to idiosyncratic job market conditions
	10.50%	10.50%	8.68%	4.92%	4.33%	0.57%	3.88%	0.20%	3.88%	0.20%	3.88%	0.20%			
Unemployment (Curr. 3.7%)	3.7%		4.3%		4.7%		4.7%		4.3%		4.2%		6.1%	=	Although labour conditions are set to remain exceptionally tight because of Brexit, unemployment could begin to rise, even more than consensus, if growth falters significantly.
	3.70%	3.70%	5.46%	4.07%	6.53%	3.73%	6.41%	3.62%	6.34%	3.55%	6.51%	3.71%			
Budget Balance (Curr. -4.93%)	-6.4%		-5.4%		-3.6%		-2.8%		-2.9%		-2.4%		-4.1%	▼	Market reaction to the Kwarteng (Sep '22) budget has significantly curtailed potential spending. Still, a change in government or easier market conditions could yet expand the budget.
	-6.70%	-6.70%	-7.00%	-3.80%	-5.20%	-2.00%	-4.44%	-1.23%	-4.45%	-1.25%	-3.97%	-0.76%			
House Prices YoY (Curr. 9.8%)	10.7%		-1.2%		-5.7%		1.2%		3.0%		3.5%		5.8%	▼	We expect House prices to come off materially in 2023, as a result of pressures on real incomes and higher long term rates
	10.68%	10.68%	-4.39%	1.93%	-8.82%	-2.51%	-1.94%	4.38%	-0.11%	6.20%	0.36%	6.67%			
Year end interest rates (Curr. 4%)	3.4%		4.4%		4.5%		4.1%		3.8%		3.6%		3.1%	▲	The BoE is projected to hike rates possibly until 4.5%-4.75%. However, tight labour markets and protracted supply-side inflation could cause the central bank to hike more and keep rates up for longer.
	3.44%	3.44%	4.91%	1.96%	5.00%	1.10%	5.00%	0.85%	5.00%	0.49%	5.00%	0.09%			
GBP/US Dollar (Curr. 1.2)	1.00		1.11		1.14		1.32		1.34		1.37		1.56	▲	Currently, Pound Sterling rebounded from its lowest level against the Dollar since 1985. For the next few months we the relationship to move sideways. However, over the longer term (+6m), we think that the Pound will likely rebound.
		1.00	-	1.12	-	1.15	-	1.32	-	1.34	-	1.37			
Euro/GBP (Curr. 0.89)	0.88		0.90		0.89		0.88		0.88		0.88		0.77	▼	We are currently agnostic. On the one hand, Brexit pressures are severe. On the other, Europe finds itself potentially humstrung due to high energy prices and possible shortages
	-	-	-	-	-	-	-	-	-	-	-	-			

2022-2024 consensus view. After that, IMF WEO Oct 2022
Unemployment, Budget, House Prices, Rates and Currency OBR Nov 2022

In Red the Downside Scenarios, In Green the Upside Scenarios

Contacts

David Baker, Chief Investment Officer
T: +44 (0)7580 999 021
E: david.baker@mazars.co.uk

George Lagarias, Chief Economist
T: +44 (0)20 7063 4721
E: george.lagarias@mazars.co.uk