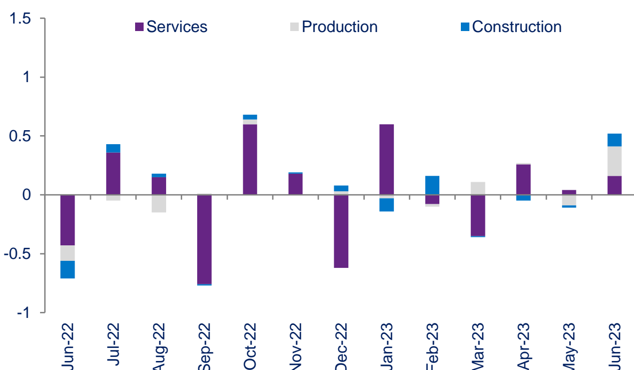
Pulse

Global Market Strategy - NIM | Solutions August 2023

The UK economic cycle put into context

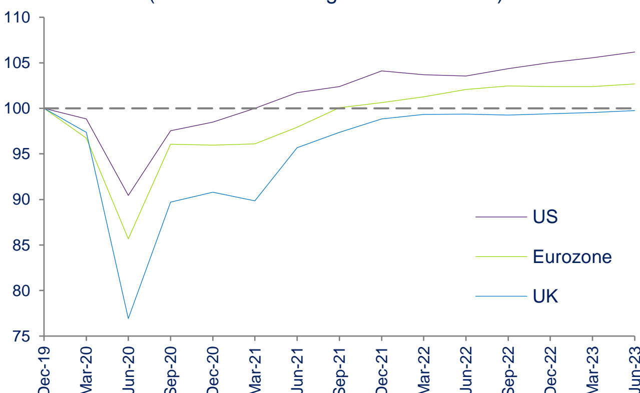
UK economy's advance in June gave a welcome lift to Q2.23 preliminary growth estimates, which came in at 0.2% QoQ, up from 0.1% in Q1, showing the UK economy keeps avoiding a recession. Among the main drivers, we note a significant increase in manufacturing output which came in at 2.4% in June, up from -0.1% in May, and led production output to be the largest contributor to June's growth (see Figure 1). This gain is especially remarkable as it coincided with very weak global manufacturing data. Final demand was also very strong, with business investment advancing 3.4% QoQ, up from 3.3% in Q1. Household's consumption surged at its strongest pace in almost two years: 0.6% QoQ vs. 0.0% in Q1; and in line with the recovery seen in the GfK consumers' confidence index since winter.

Fig. 1: Contributions to UK Monthly GDP Growth
(Source: Office of National Statistics & NIM Solutions)



However, despite this short-term outperformance the economy keeps facing lingering structural weaknesses. Reflecting in large part this has been UK's post-pandemic recovery which remains impaired compared to that of its peers. The level of GDP in Q2.23 stands 0.25pp below the level in Q4.19, compared with 6.2pp above it for the US and 2.7pp for the Eurozone (see Figure 2).

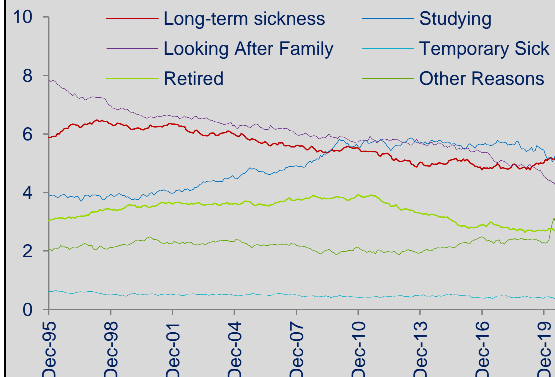
Fig. 2: Real GDP (100 = Q4 2019)
(Source: Bloomberg & NIM Solutions)



The case of UK's tight labour market

One way to look at UK's GDP shortfall is through the lens of its labour market. First, the total hours worked in Q2 2023 remains 0.5pp below their relative to their pre-pandemic level in Q4.19, similarly the employment rate remains 0.6pp lower and job vacancies stand 25% higher the level back then. Moreover, while the employment inactivity rate has been falling in recent months, it remains 0.4pp higher than its 2019 average level. Such a tight labour market has had negative consequences in the healthcare sector. The National Health Service (NHS) is facing numerous obstacles that are likely behind the 500,000 additional people (vs. pre-pandemic levels) that now report inactivity due to long-term sickness. The number of people waiting treatment on the NHS has increased from 4.2 million the pandemic to over 7.6 million in 2023. Conversely, the other reasons for inactivity have been falling quickly driven by households' need to tackle the loss of purchasing power (see Figure 3).

Fig. 3: UK Labour Inactivity Reasons as % of Workforce
(Source: Bloomberg & NIM Solutions)



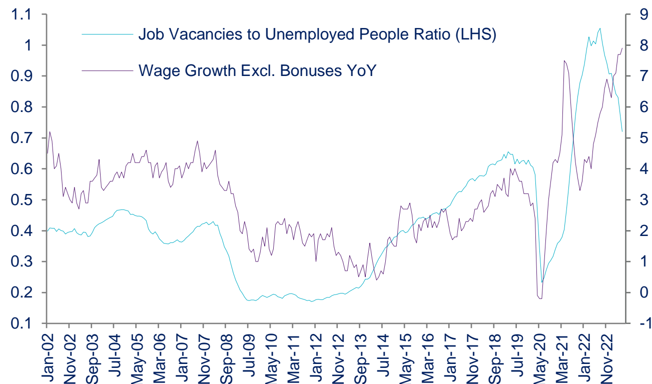
In addition, it is likely that Brexit did not refrain many European workers from leaving the UK during the pandemic. As result, the UK economy lost a proportion of its employed population, at least for the short-term. To sum up, the UK is suffering a challenging shortage of labour, with fewer available people to work and fewer employed people. Until the UK does not fix this problem, its UK's potential output will stay undermined, and the growth outlook will remain challenged relative to that of its peers.

Furthermore, after having lagged the disinflationary process in other DM countries, headline inflation in the UK is finally coming off. The harmonized headline CPI came in at 6.8% YoY in July, down from 7.9% in the prior month and well off its peak at 11.1% last October. Like other DM countries, falling domestic energy bills and annual base effects in goods prices, such as food and energy prices, are behind this decline in headline inflation. For its part, however, the core

CPI stayed unchanged at 6.9% YoY in July as airline fares and accommodation services rose more than expected. A continued elevated pace of service inflation is particularly worrisome as it risks keeping core inflation underpinned even once the drag from goods inflation has faded; making it hard for the BOE to opt for a pause.

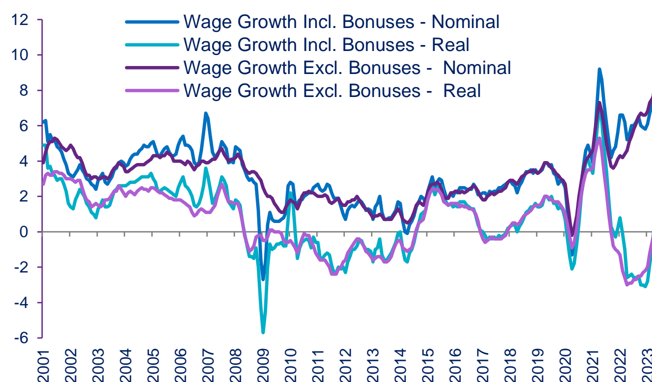
Moreover, the last job report showed that while growing signs of loosening in the labour market are emerging, so far there has been no response in wage growth. In fact, wage growth accelerated to 7.8% YoY in June from 7.5% in May. On this front, the BOE will welcome the increase in the unemployment rate from 4.0% to 4.2% in June, especially as rising unemployment normally leads to a slowdown in wage growth. But there are limits on how long unemployment can keep rising without a reduction in long-term sickness or material job losses. Sharply falling job vacancies may prevent the BOE from tightening much further, but vacancies need to continue falling in a context where the labour market remains very tight, especially in the service sector (see Figure 4).

Fig. 4: UK V/U Ratio & Regular Wage Growth
(Source: Bloomberg & NIM Solutions)



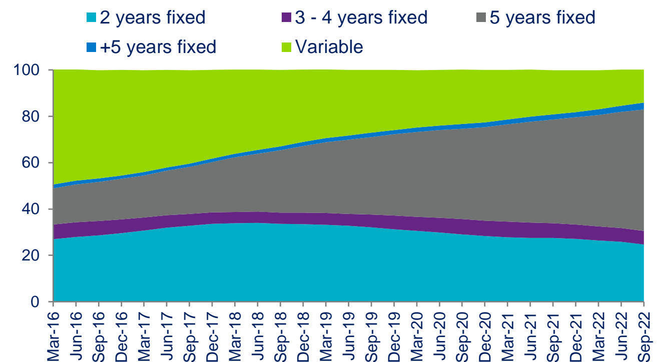
But should job losses stay relatively contained, vacancies may find it difficult to continue falling, at least at the necessary pace. This is because real wage growth has now turned positive for the first time in 19 months and, thus, as long as employment remains stable, households' real disposable income should support demand in the coming months. While this is positive news for UK families, the BOE cannot neglect how elevated nominal wage growth is (see figure 5).

Fig. 5: UK Average Weekly Earnings Annual Growth
(Source: Office of National Statistics & NIM Solutions)



Another variable the BOE needs to account for is the impact that higher interest rates is having and is expected to have on households' expiring fixed-rate mortgages. The UK is known to be more exposed to expiring fixed rate mortgages than Europe and the US. However, according to the last Financial Stability Report (FSB) published by the BOE in July, it will take time for the full impact of higher interest rates to come through. Data shows that the proportion of outstanding UK fixed-rate mortgages at in Q3.22, stood at 86%, up from 51% in Q1.16 (see Figure 5). Therefore, most fixed-rate borrowers have so far been insulated from higher rates, as the majority are still within their fixed-rate period.

Fig. 4: Distr. of UK Outstanding Mortgages by Type of Interest Rate
(Source: Office of National Statistics & NIM Solutions)



In addition, the mortgage debt-servicing ratio, which measures the share of households' net income spent on mortgage payments, is expected to rise from 6.2% to around 8% by mid-2026, which would remain below the peak above 10% seen during the GFC. However, what needs close monitoring are SMEs, particularly as the subdued economic outlook continues to feed through. This is because their heavy reliance on floating rate loans to get funding will make them bear the burden of higher rates earlier.

All in all, it goes without saying that the BOE is in a very tricky position, having to choose between two potentially negative outcomes: continue to hike rates and risk an unnecessarily painful economic downturn or wait for the lagged effects of prior hikes to feed into key indicators while risking having wage growth triggering another round of inflationary pressures. In our view, waiting to see how long the loosening in the labour market continues for –and the extent to which nominal wage growth reacts to such loosening– is likely to be perceived by the BOE as non-worth risk at this stage. Therefore, we maintain our conviction in expecting a further two 25 bp hikes –in September and November– taking rates to 5.75% by yearend, with risks to see additional hikes clearly tilted to the upside.

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