UK Macro Outlook

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Executive Summary

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- The Invasion of Ukraine is creating a twin crisis of rapidly accelerating inflation and rising interest rates. Collectively these represent a major shock to the UK's economic outlook, which is already underperforming in light of the Covid-19 pandemic as well as Brexit trade and investment weakness. The UK economy is likely to contract by c.2% over 2022-2023.
- Consumer weakness is expected to be the main driver of contraction, with disposable incomes facing the largest single-year reduction since WWII, falling by c.4-5% in real terms for the average household in 2022.
- Our sector earning forecasts show significant contraction in earnings for consumer-facing sectors but greater resilience in counter-cycle sectors such as Financials.
- Asset markets face a prolonged period of uncertainty as the period of ultra-loose monetary policy which has support valuations since 2008 is unwound. We see continued weakness in global equities, particularly in growth and consumer stocks and falls in UK property valuations of c.5-8% over the next two years.

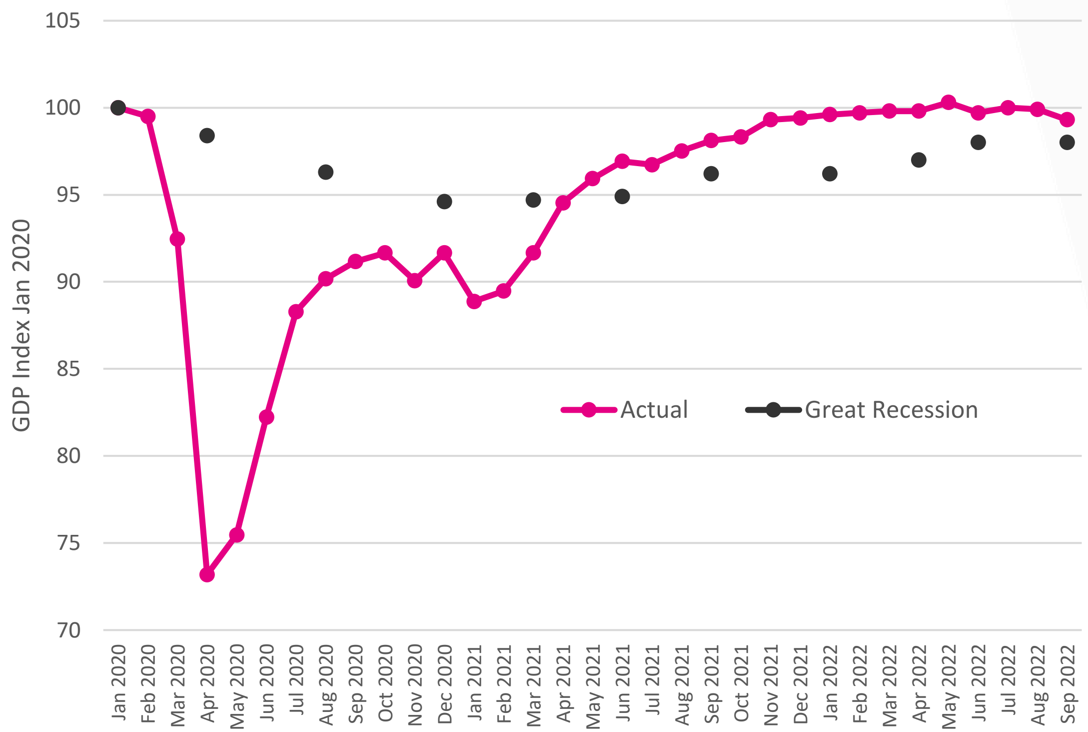
Contents

Macro Outlook

Covid-19 | The UK's recovery

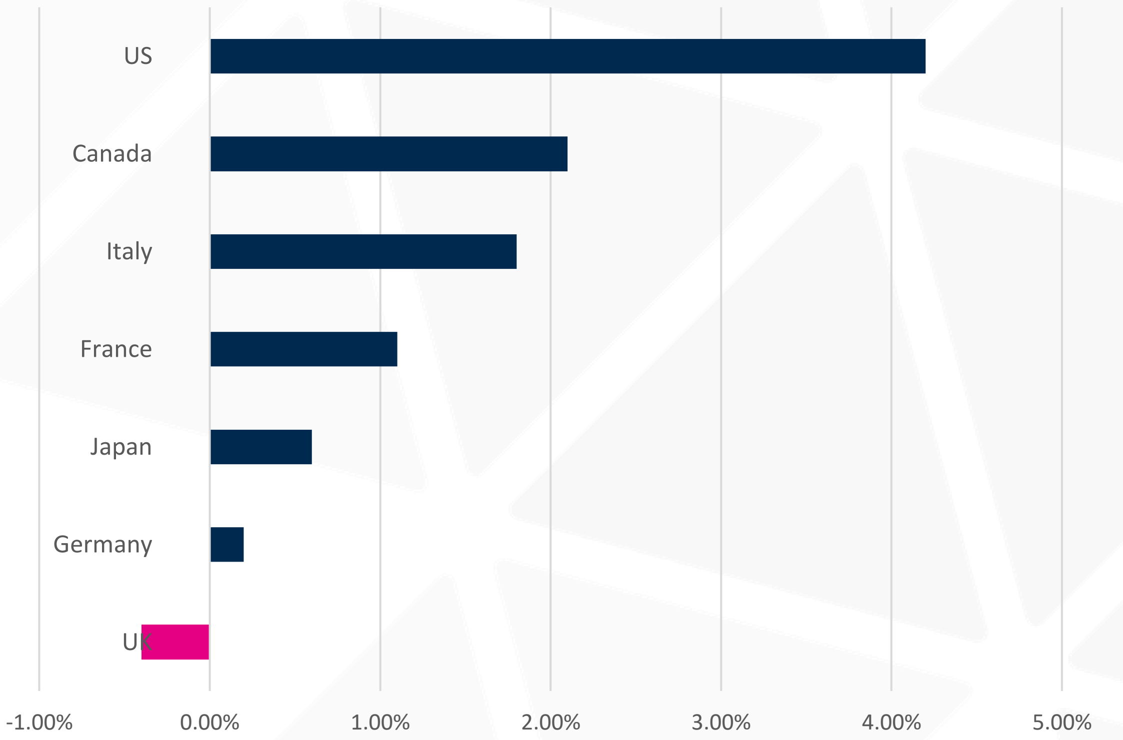
The UK's Covid-19 recovery has been poor relative to its peers, with the economy remaining c.0.5% below its pre-pandemic peak. Structural damage appears to have been far deeper, with trade and investment growth lagging pre-Brexit trends.

Post-Covid Recovery



Source: S&P Global

G7 Post-Pandemic Performance



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2022 Macro Trends

The invasion of Ukraine and the legacy of Covid-19 has caused a twin crisis of rising inflation and rising interest rates. These twin developments represent a major adverse shock to the UK economy.

Rising Inflation

Energy Price Shock Causing Inflation to Spike

Slides 7-8

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Rising Rates

Rising Inflation Causing Central Banks to Raise Rates

Slides 9

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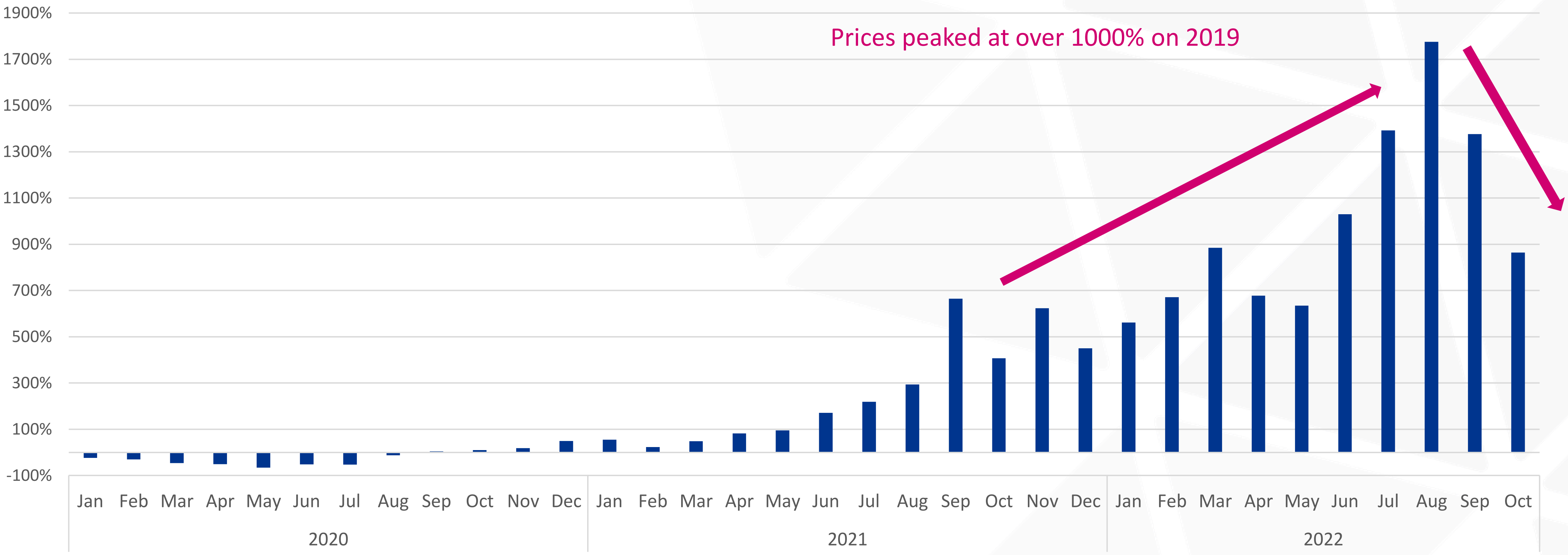
Energy Price Shock

European gas benchmarks remain above pre-Covid levels, however, they have softened from their peak in recent months in light of high storage levels and a mild autumn.

TTF Wholesale Price Change on 2019

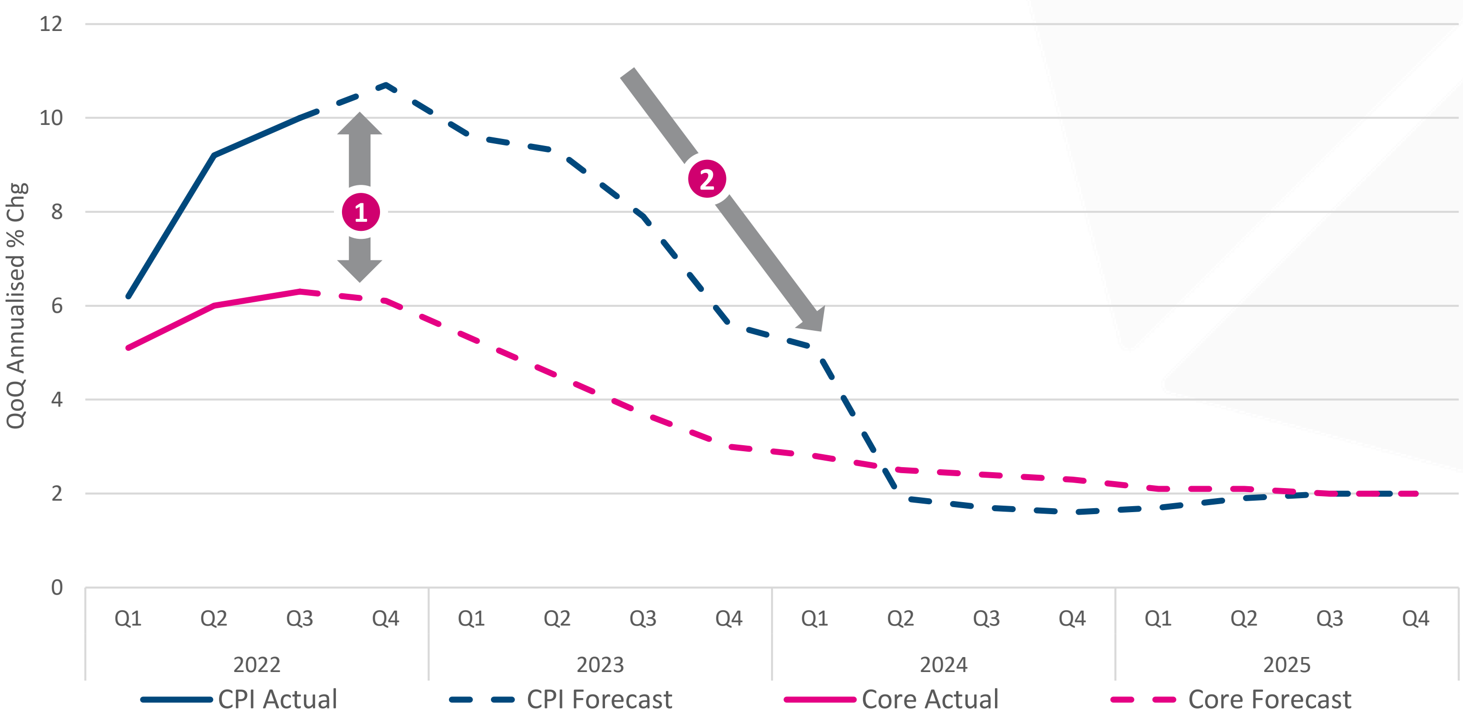


Source: S&P Global

Inflation

The shock to energy markets has sent inflation above 10% on an annual basis. Core inflation remains subdued, however, indicating that inflationary pressure whilst high will ultimately remain transitory. The market consensus for inflation is it will fall gradually through 2023, returning to target by 2024.

UK Inflation Outlook



Source: Goldman Sachs

1. Core inflation remains subdued relative to headline rates
2. Markets currently expect a sharp reduction in inflation after peaking in 2022

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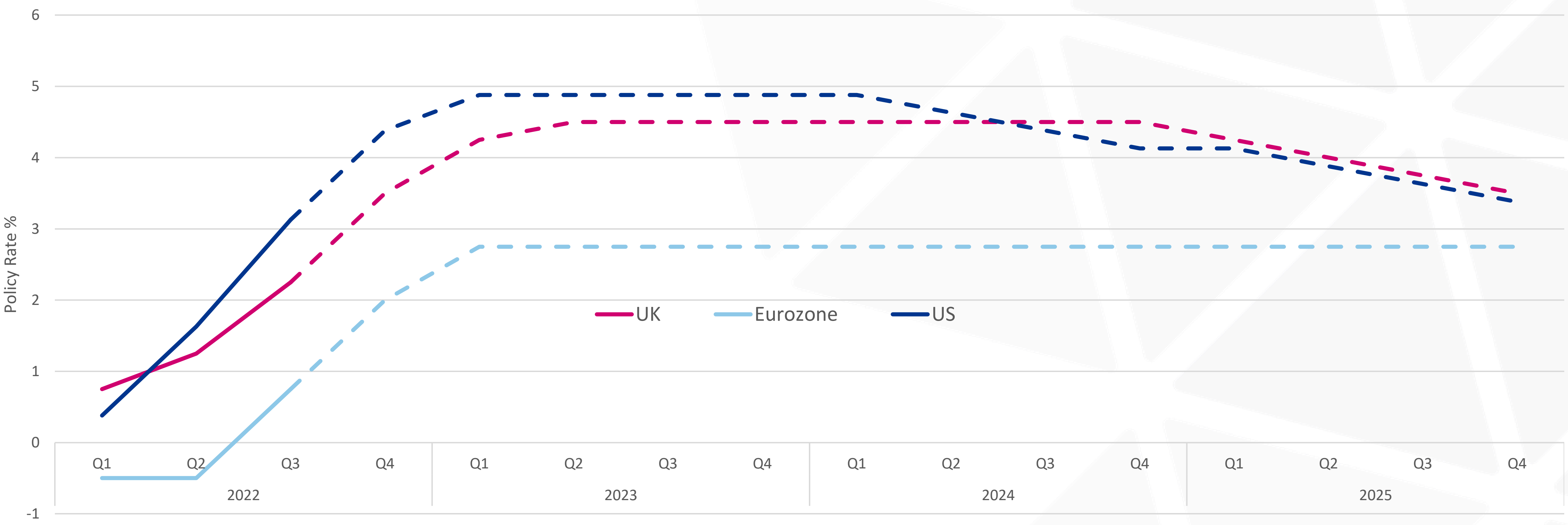
Rates

Central banks have reversed a decade of ultra-loose monetary policy in response to accelerating inflation. Central bank independence gives credibility to their 2% inflation targets. As a consequence, base rates are set to continue to rise in light of accelerating inflation. Market implied rates peak at 4.5% for the UK and c.5% for the US.

Base Rate Comparison

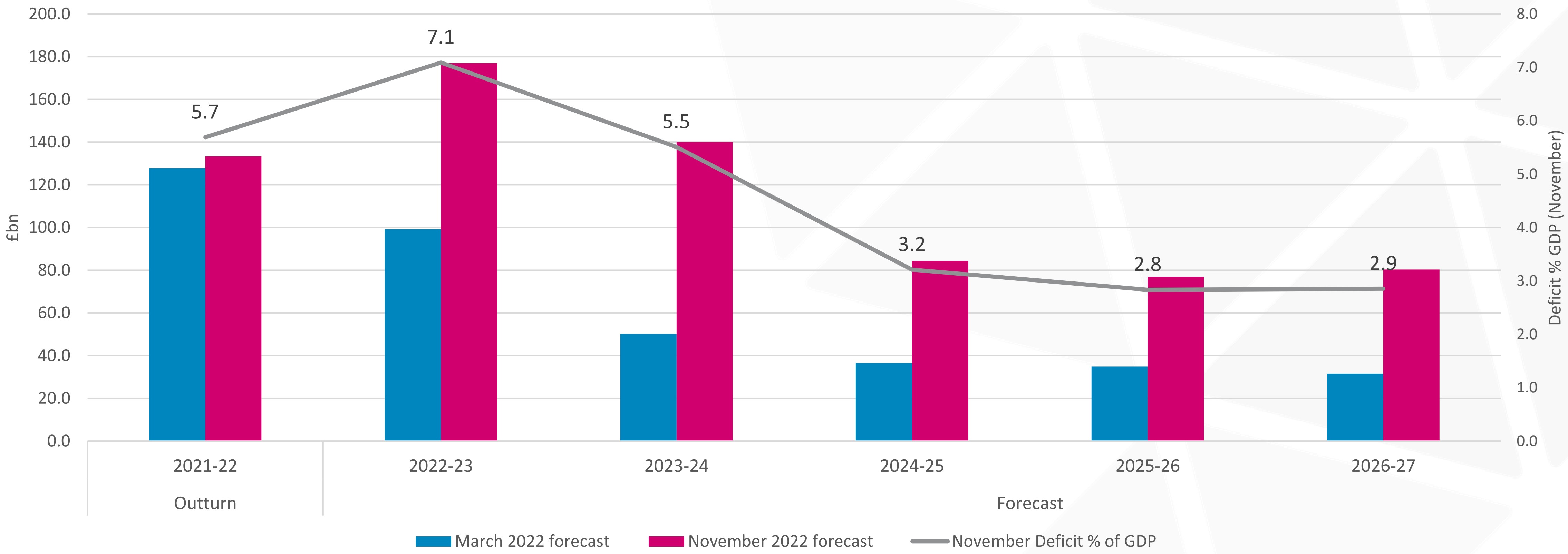


Source: Market Implied (Consensus)

UK Fiscal Position

Rising debt servicing costs and government support for retail energy customers has worsened the UK's debt position. Borrowing forecasts have increased materially relative to March, with the deficit peaking at 7% of GDP in 2022-23. As a consequence, the Government has unveiled a series of tax rises and spending cuts to stabilise public expenditure.

UK Annual Borrowing Outlook



Source: OBR

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Real Economy

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Growth Shock Conduits

Consumption is being undermined by the twin challenges of rising inflation (predominantly from energy prices) coupled with rising rates pushing up debt servicing costs. Collectively these act to reduce real disposable income for UK households.

Rising Inflation

Energy Price Shock Causing Inflation to Spike

Slides 13-14

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Rising Rates

Increasing Debt Servicing Costs

Slides 15

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Disposable Income Shock

Slides 16

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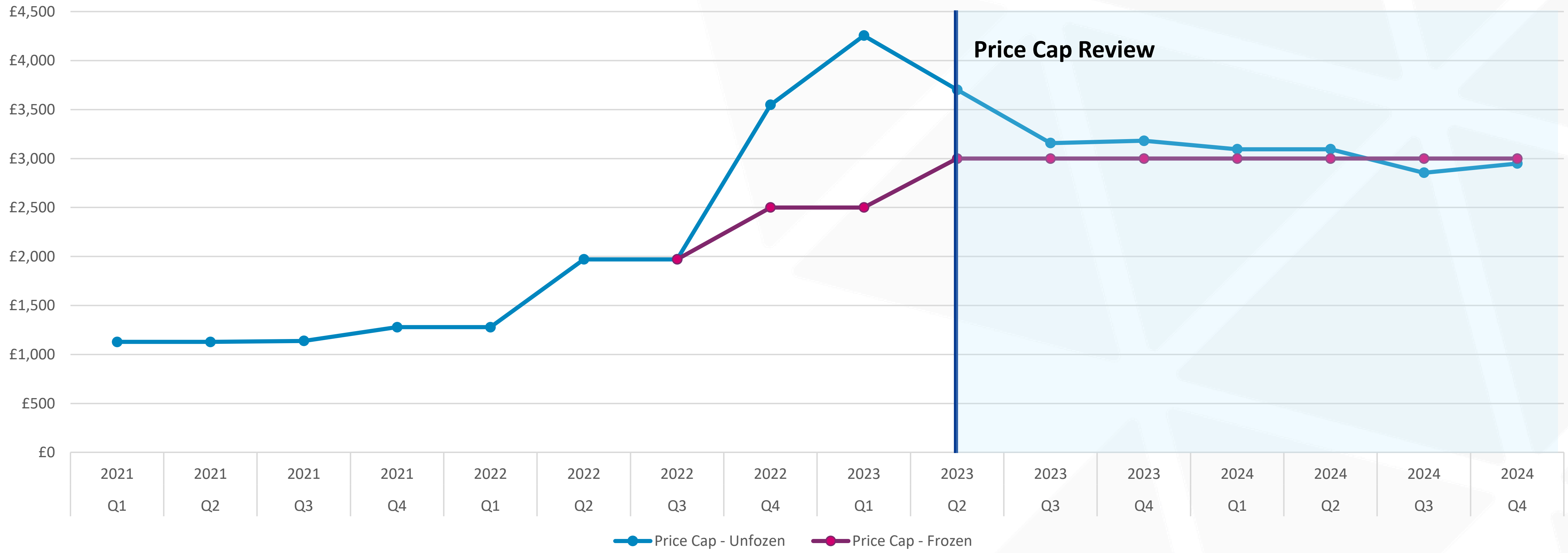
Retail Price Cap

Independent analysis suggests wholesale power prices would have led the retail price cap to rise to over £4,000 for the average household. Freezing the price cap at £2,500 has therefore led to considerable savings and dampened inflation by c.3%. The Government has committed to increase the frozen retail price cap in April to £3,000.

Energy Retail



Source: Cornwall Insights

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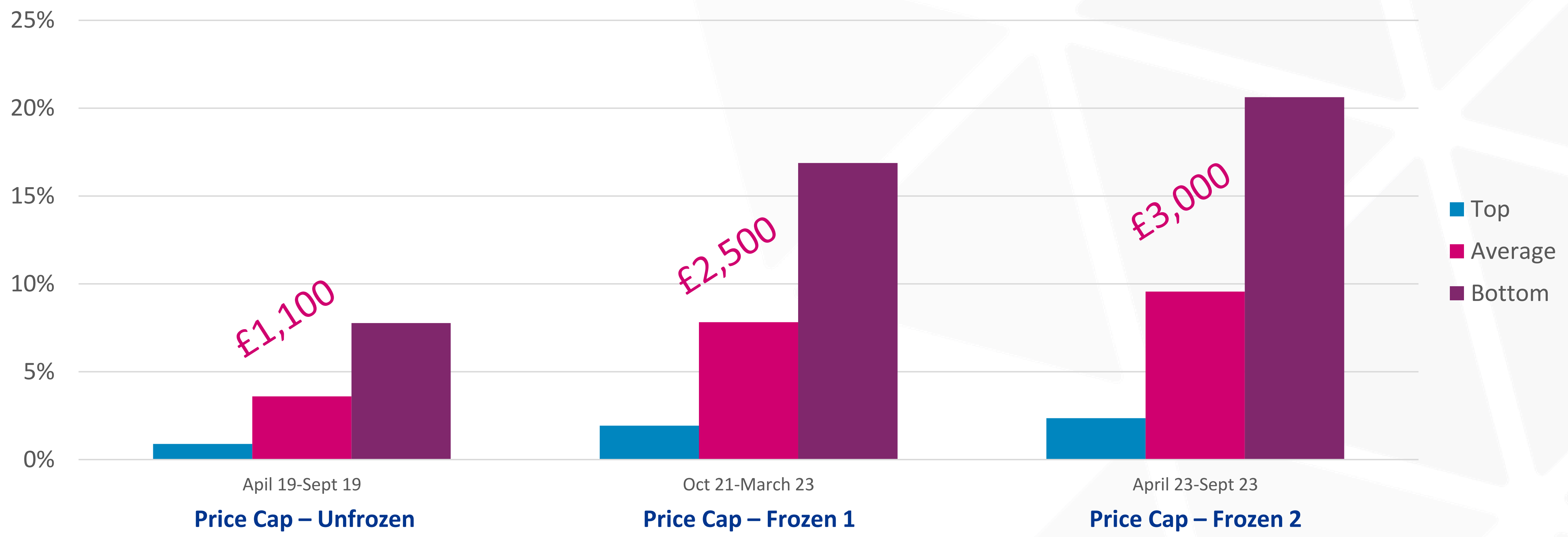
Energy Retail Prices

If the current retail price cap was to increase in April, average household bills could rise to £3,000, up from an average £1,100 in 2019.

For the poorest 10% this would represent energy costs rising to c.20% of their post-tax income.

Average Home Energy Cost by Income Decile

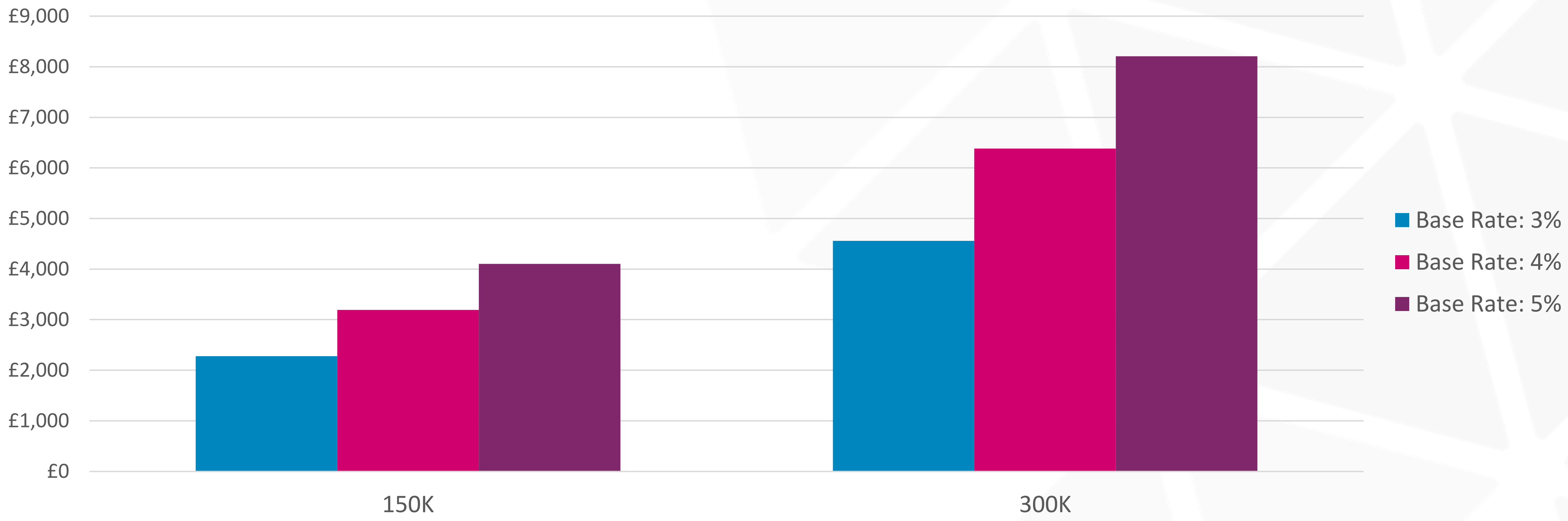


Source: Baringa Analysis

Rate Rise Impact

Rising interest rates are increasing debt servicing costs for UK households. If the market implied rate of a 5% base rate was to materialise, it is estimated annual mortgage costs would rise by c.£4,000 relative to January 2022 on a typical £150k mortgage.

Annualised Change in Mortgage Costs Relative to Jan 2022

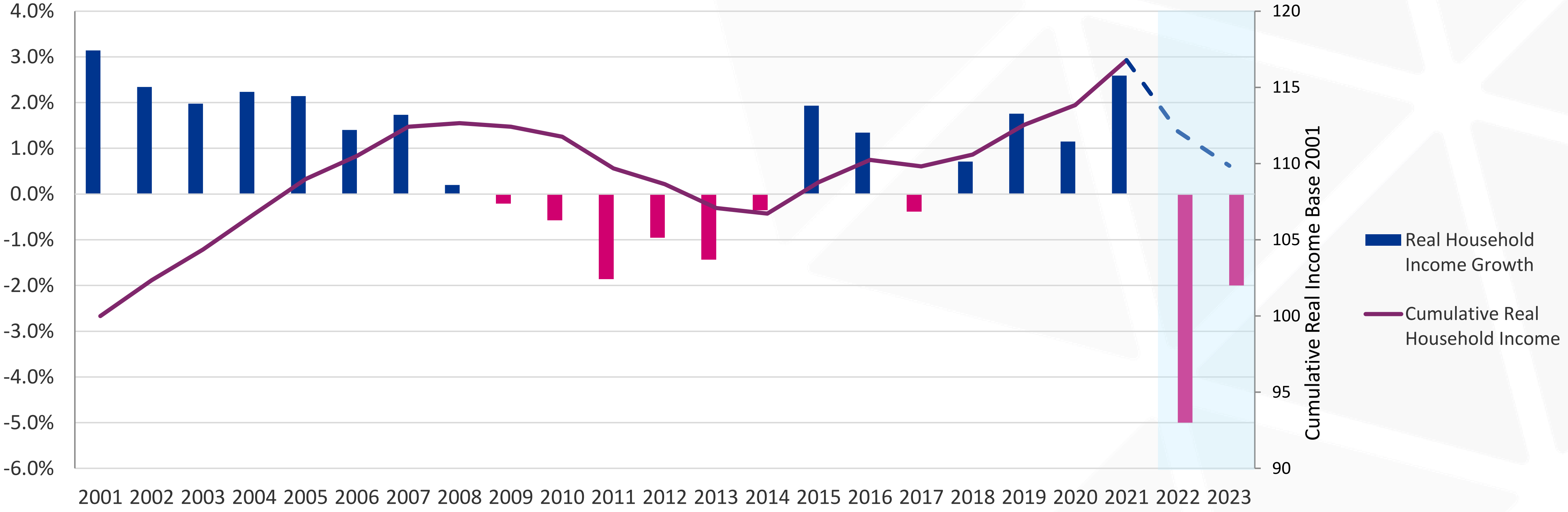


Source: Baringa Analysis

Disposable Income Shock

The twin shocks of rising inflation and rising interest rates represent a major disposable income shock to households. OBR estimates suggest this could represent a 4-5% reduction in real disposable income for the average households. This would represent the largest single-year reduction in living standards since WWII.

Annual Change in Household Income

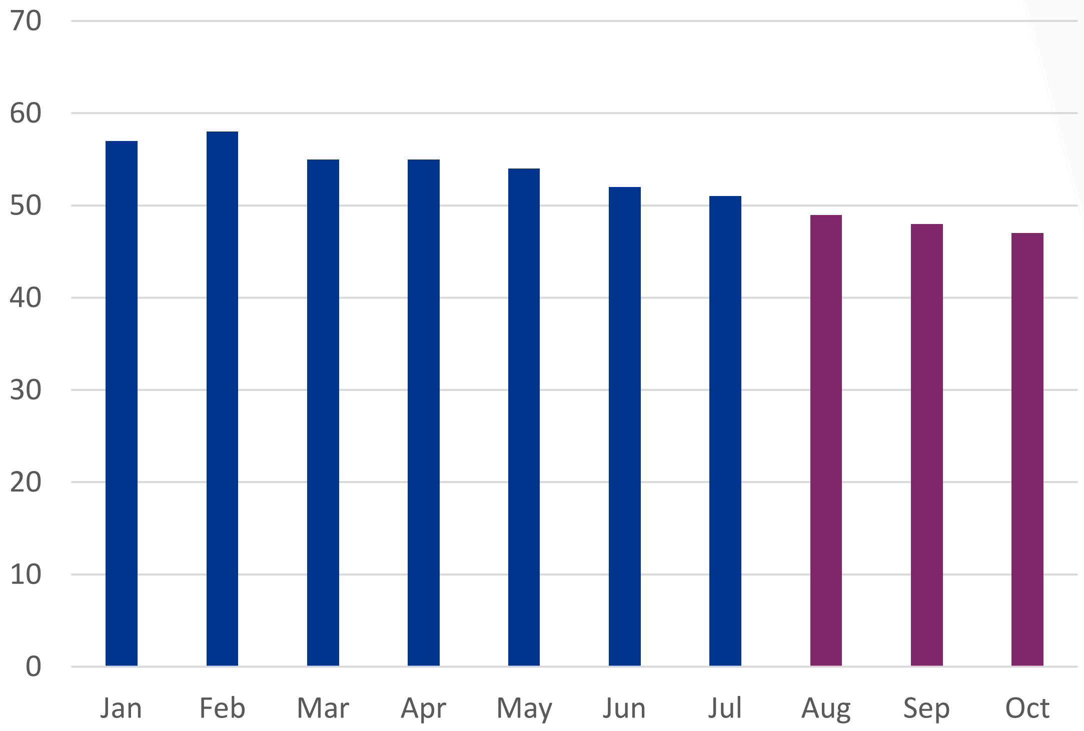


Source: OBR & Baringa Analysis

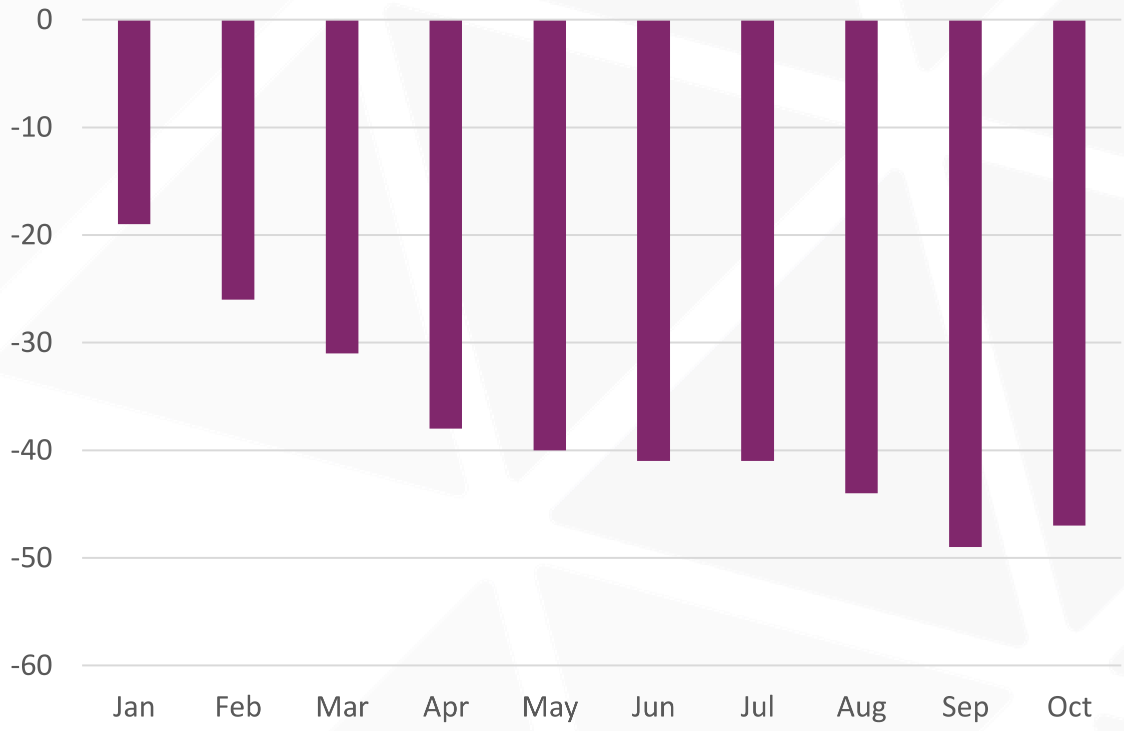
Leading Indicators Turn Negative

Rising inflation and rates are driving a collapse in confidence. Both leading producer and consumer confidence indicators are now negative as the outlook worsens.

UK Manufacturing PMI



UK Consumer Confidence

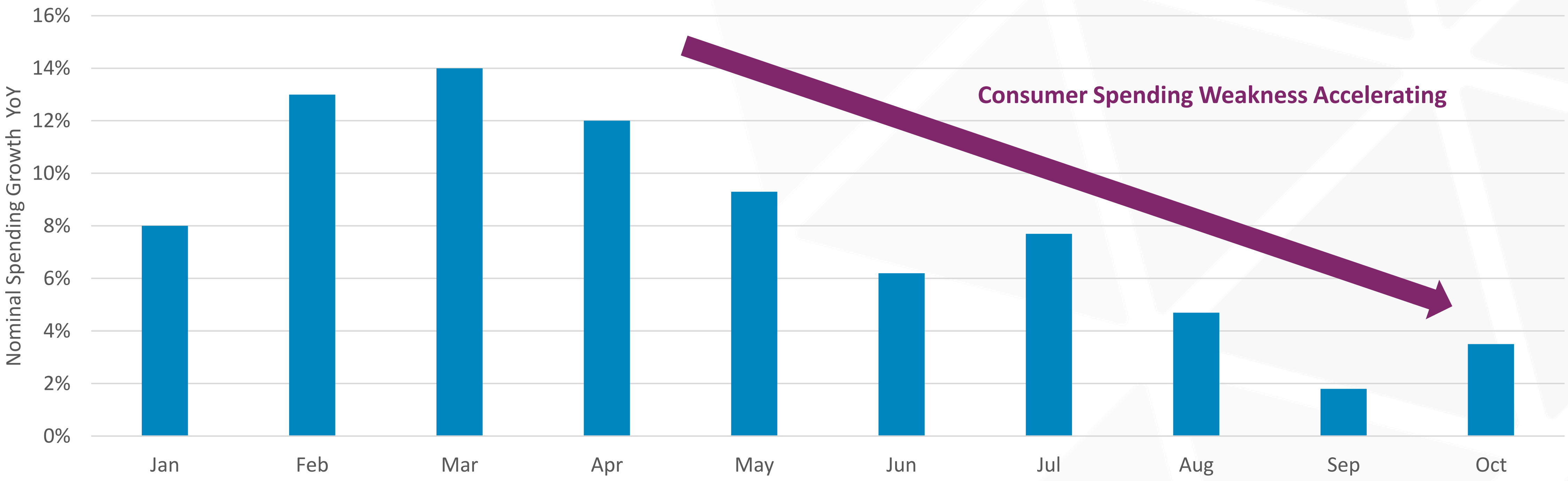


Source: Trading Economics

Consumption Outlook

Household spending is softening quickly as consumer caution reduces post-Covid spending exuberance, ending a period of pent-up consumer demand after the pandemic.

UK Consumer Activity 2022 YoY

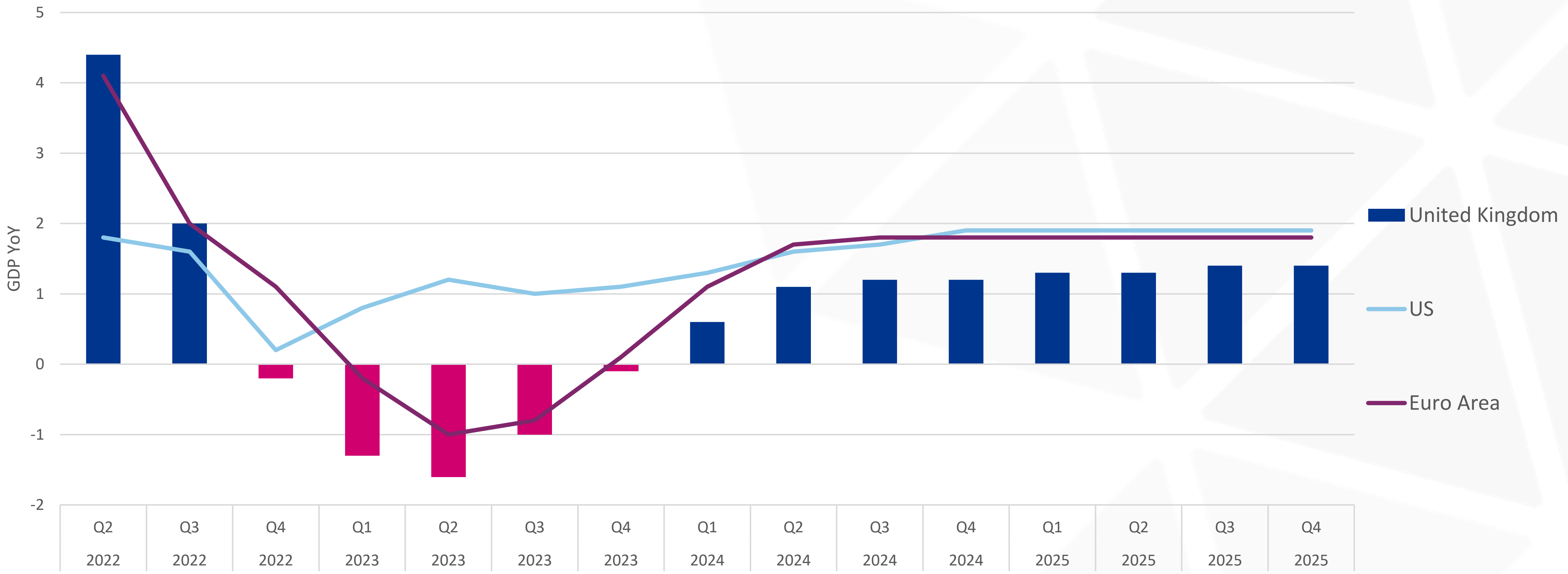


Source: Barclays Credit & Debit Card Spending

Growth Outlook

GDP forecasts predict a major economic downturn in 2023, both longer and deeper than peers. The UK economy is expected to contract by c.2% in 2023.

GDP Outlook

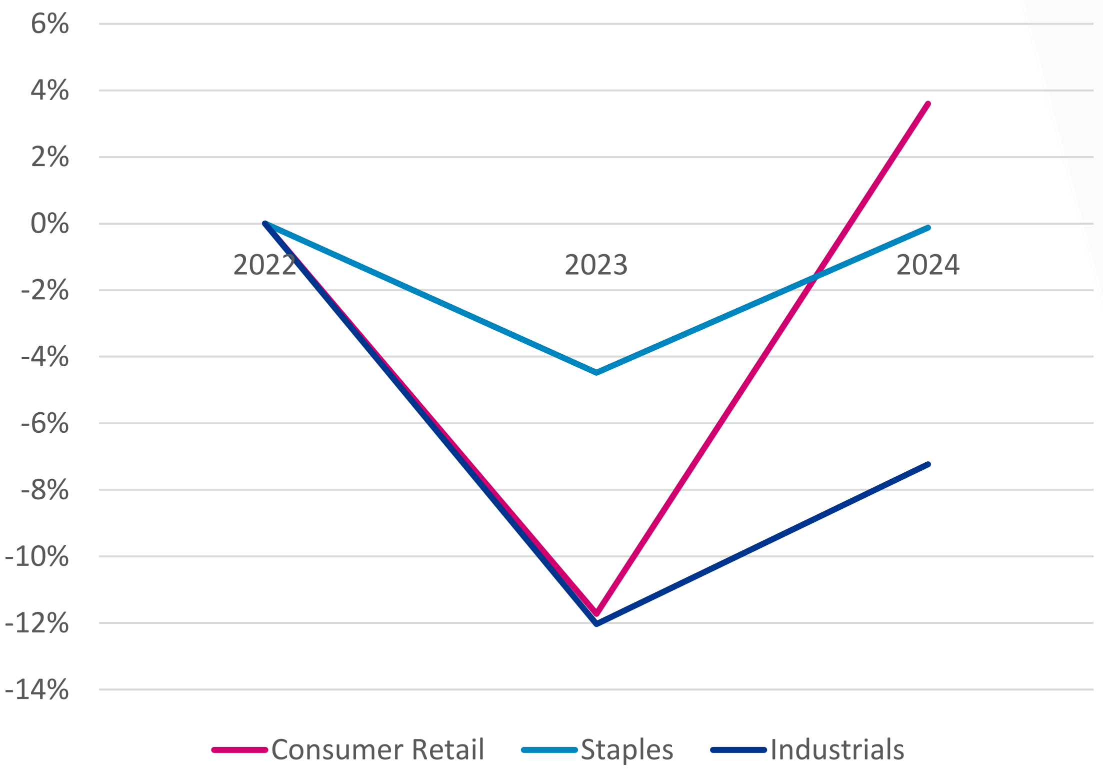


Source: Sell Side Consensus

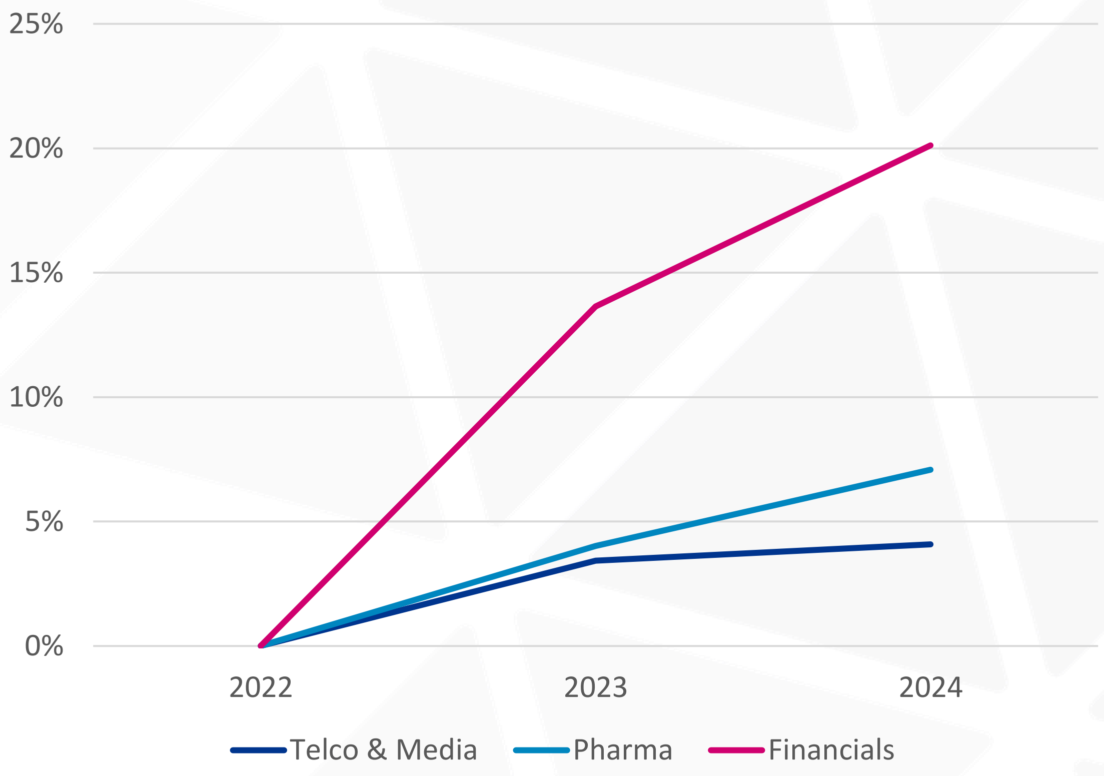
Earnings Outlook

Sector earning performance is split between those that are consumer facing and those more insulated from consumer activity. Consumer retail (discretionary) is expected to suffer most, whilst sectors which benefit from a higher rate environment, such as financials, are expected to show resilience.

Stressed Sectors



Resilient Sectors



Source: Broker Consensus & Baringa Analysis

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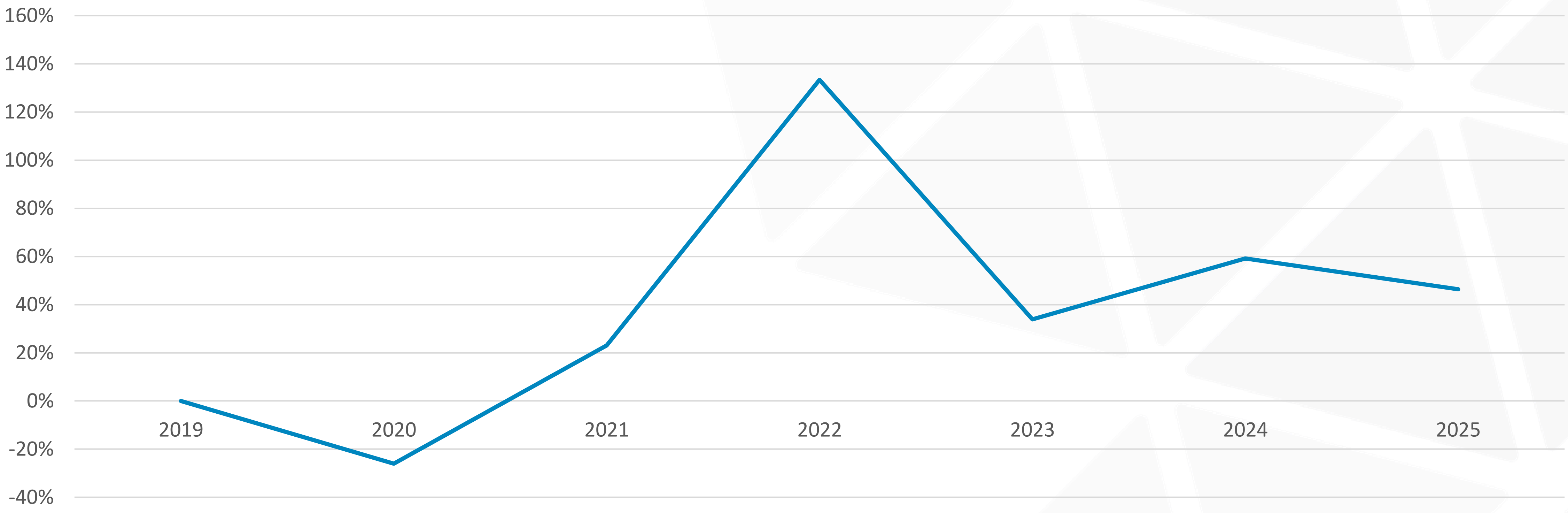
Earnings Outlook

Energy and commodity players stand in a category of their own owing to the shock to energy markets driving super-normal profits in the sector. Downside risks exist, however, in the form of windfall taxes to reduce profit surpluses. These taxes may be deductible from UK investment, complicating the blended tax implication.

Energy (Upstream, Generation & Retail)



Source: Broker Consensus & Baringa Analysis

Asset Markets

2022 Shock to Equity Valuations

2022 developments have led to adverse environment for asset markets. Rising inflation, rising rates and a negative growth outlook contribute to an adverse environment for global equities.

Rising Inflation

Reduced Savings Available for Investment

+

Rising Rates

Reduced Present Value of Future Cash Flows

+

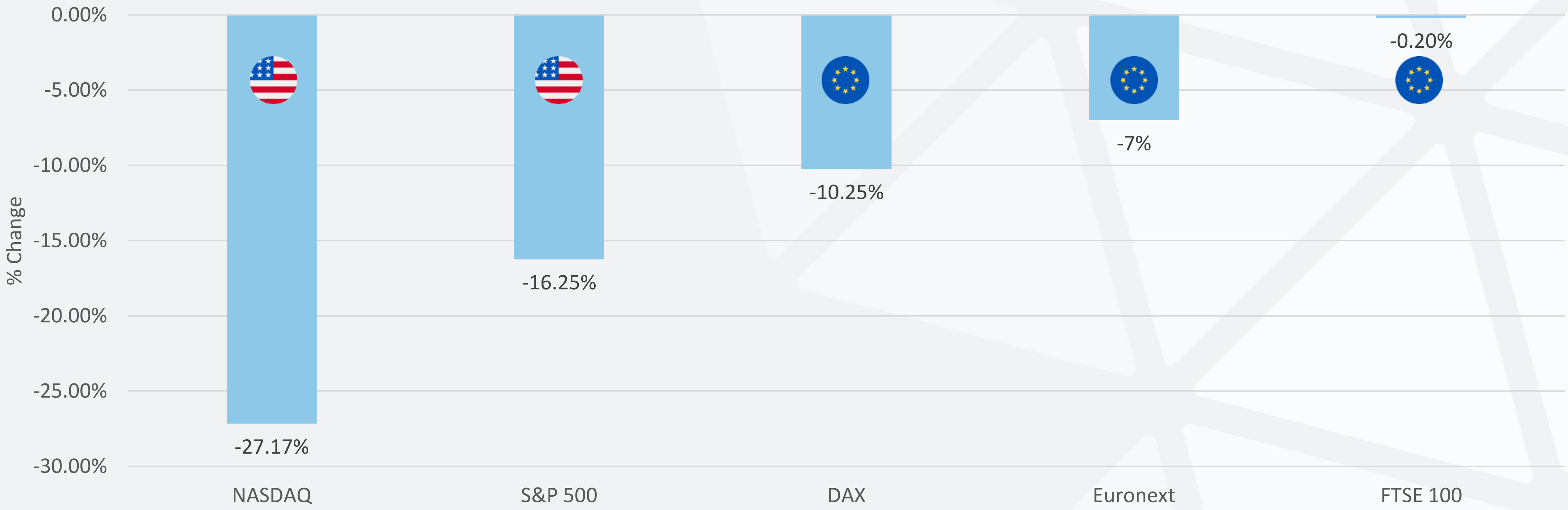
Negative Growth

Reduced Expected Earnings

Global Equity Market Performance

Equity markets globally have seen major falls YTD. These losses have been considerably worse in the US relative to European indexes.

Global Equity Performance (YTD)



Source: S&P Global – as of 17th November

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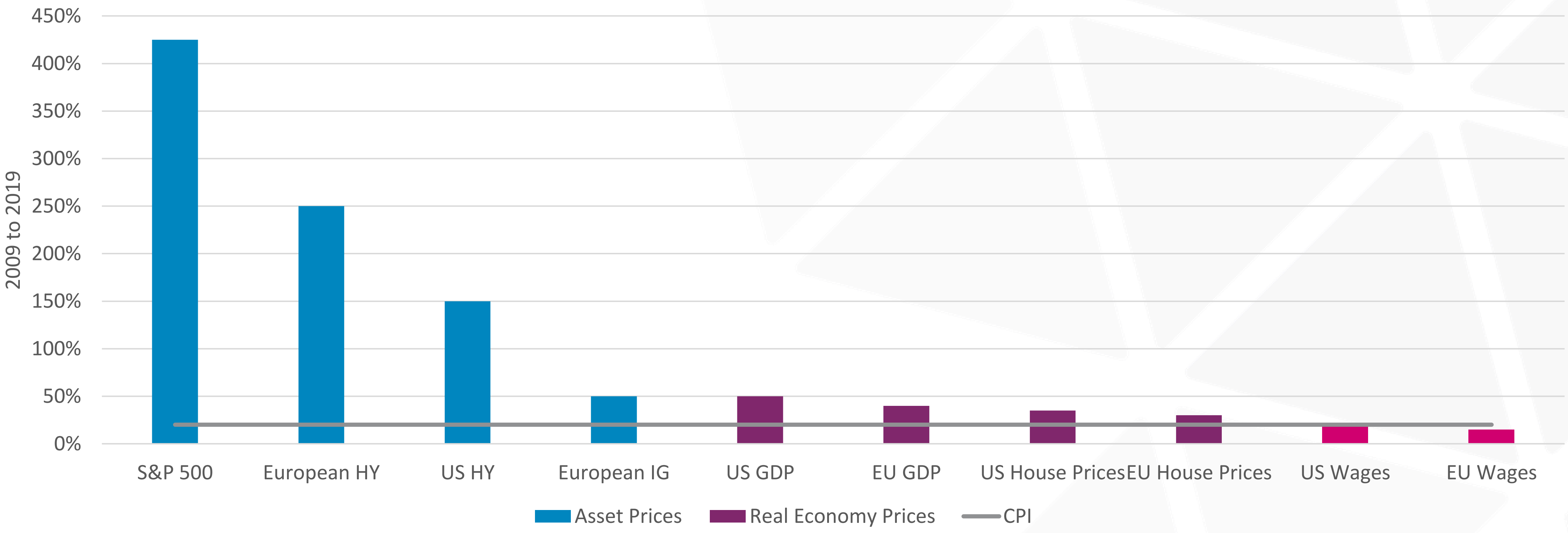
US Equities Overstimulated Since '08

There are signs that ultra-loose monetary policy has historically overstimulated US equities with very strong performance since 2008, creating the potential for a price correction.

Price Increases 2009-2019 (Assets vs Real Economy)

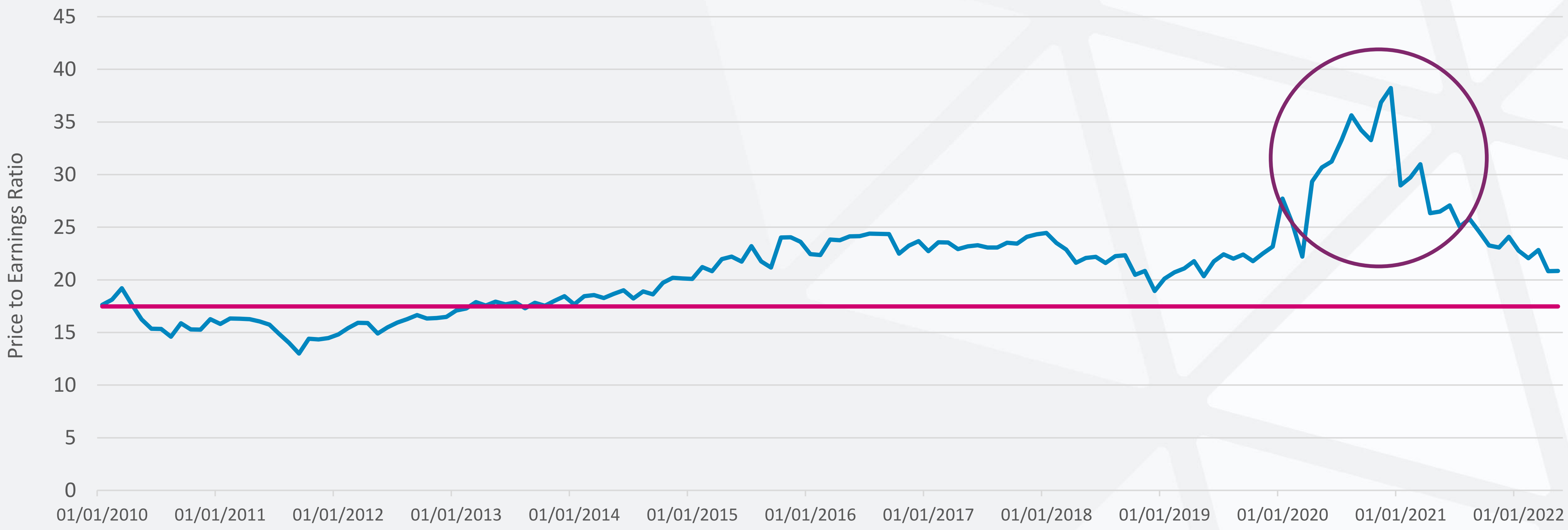


Source: S&P Global & Baringa Analysis

S&P Price to Earnings

In addition, price to earnings ratios were high on account of a pandemic rally in equity markets owing to significant monetary and fiscal stimulus in the US. S&P PE ratios ran well above long-run trends during the pandemic, signaling an overvaluation.

S&P 500 Price to Earnings Ratio

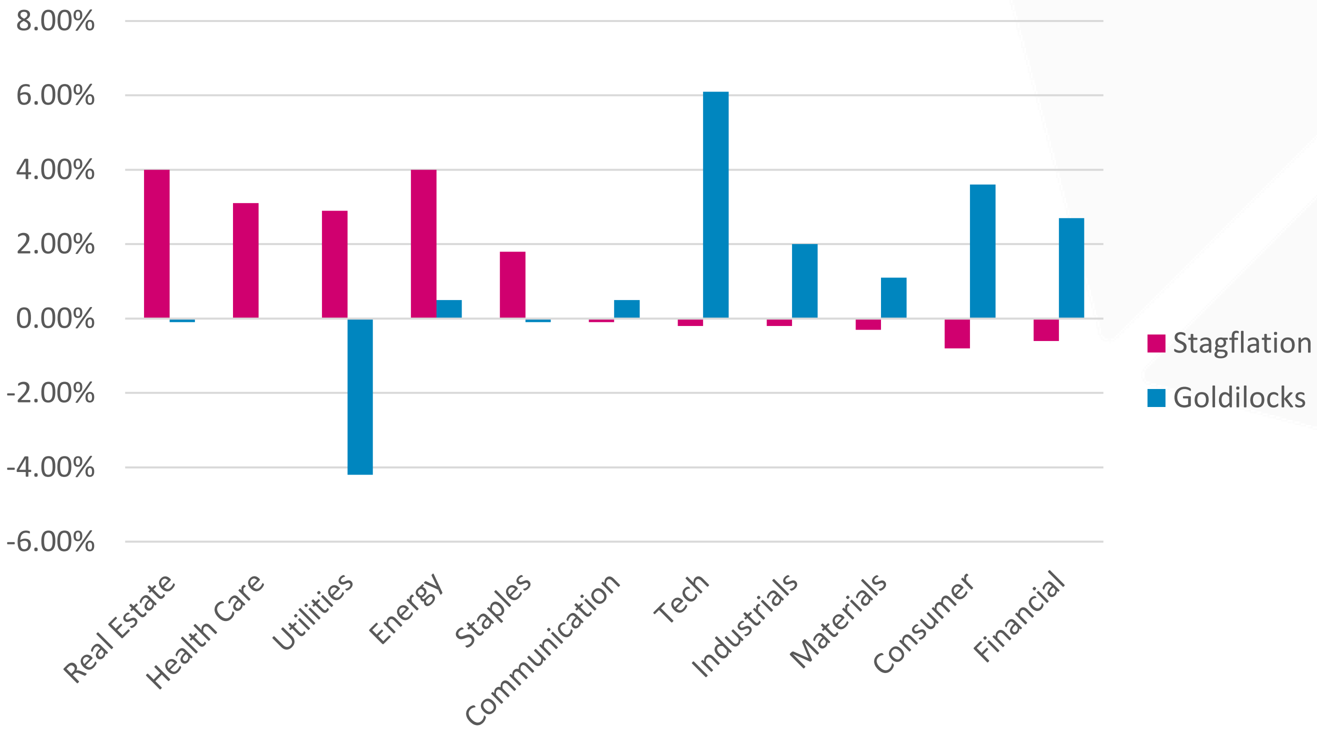


Source: S&P Global

Future Equity Outlook

Economic history shows that certain sectors such as commodities, utilities and staples tend to outperform in low-growth and high-inflation environments.

Relative S&P Historical Sector Performance 1950-2019



Source: S&P Global

	Demand	Inflation
Reflation	Rising	Rising
Goldilocks	Rising	Falling
Stagflation	Falling	Rising
Contraction	Falling	Falling

2022 Shock to Property Valuations

2022 developments have led to an adverse environment for UK property. Rising inflation, rising rates and a negative growth outlook contribute to an adverse environment for UK property.

Rising Inflation

Reduced Real Incomes, Reducing Affordability

+

Rising Rates

Increased Mortgage Costs, Reducing Debt Affordability

+

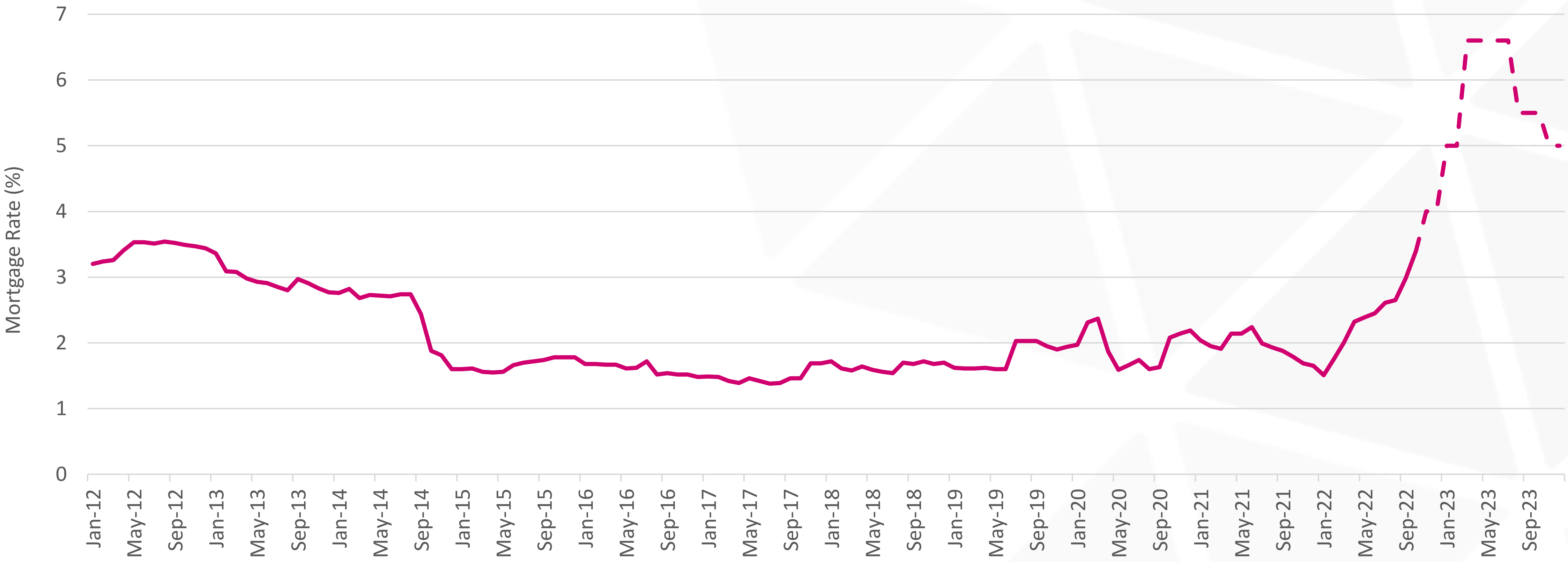
Negative Growth

Reduced Expected Earnings & Reduced Buyer Confidence

Mortgage Rates

Market implied base rates indicate rapidly rising mortgage rates for UK households. Currently implied rates could peak at 6.5% in 2023.

2-Year Standard Variable Rate Average

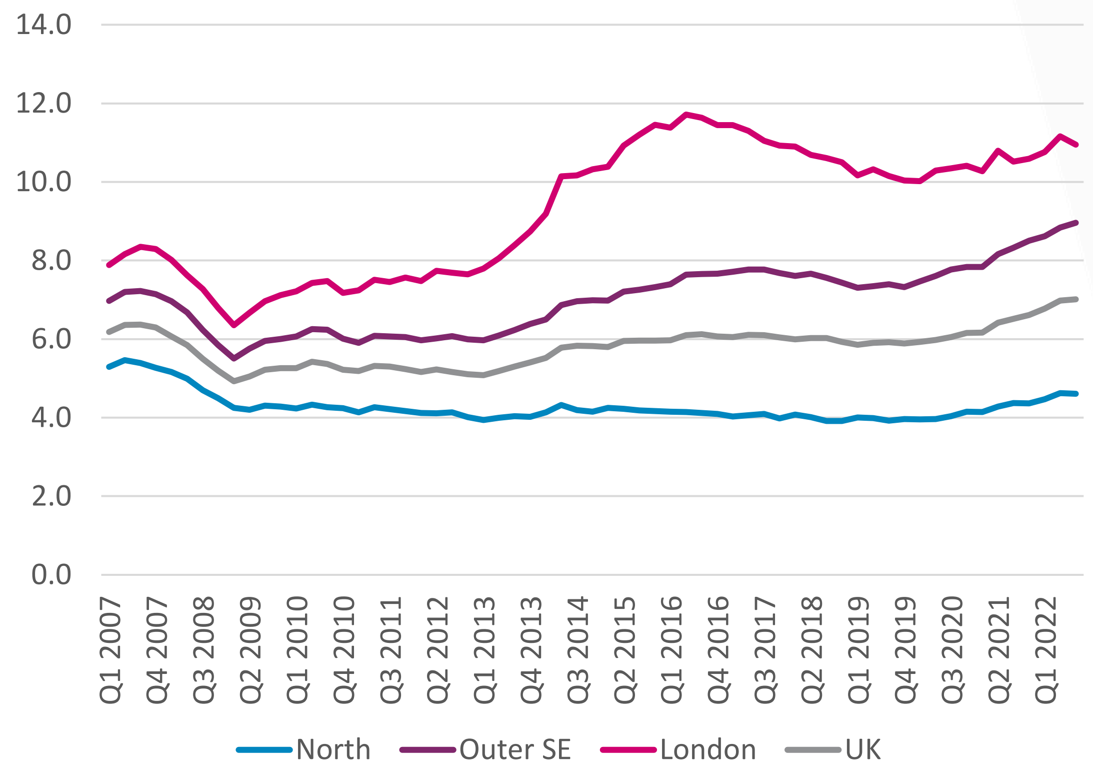


Source: Baringa Analysis

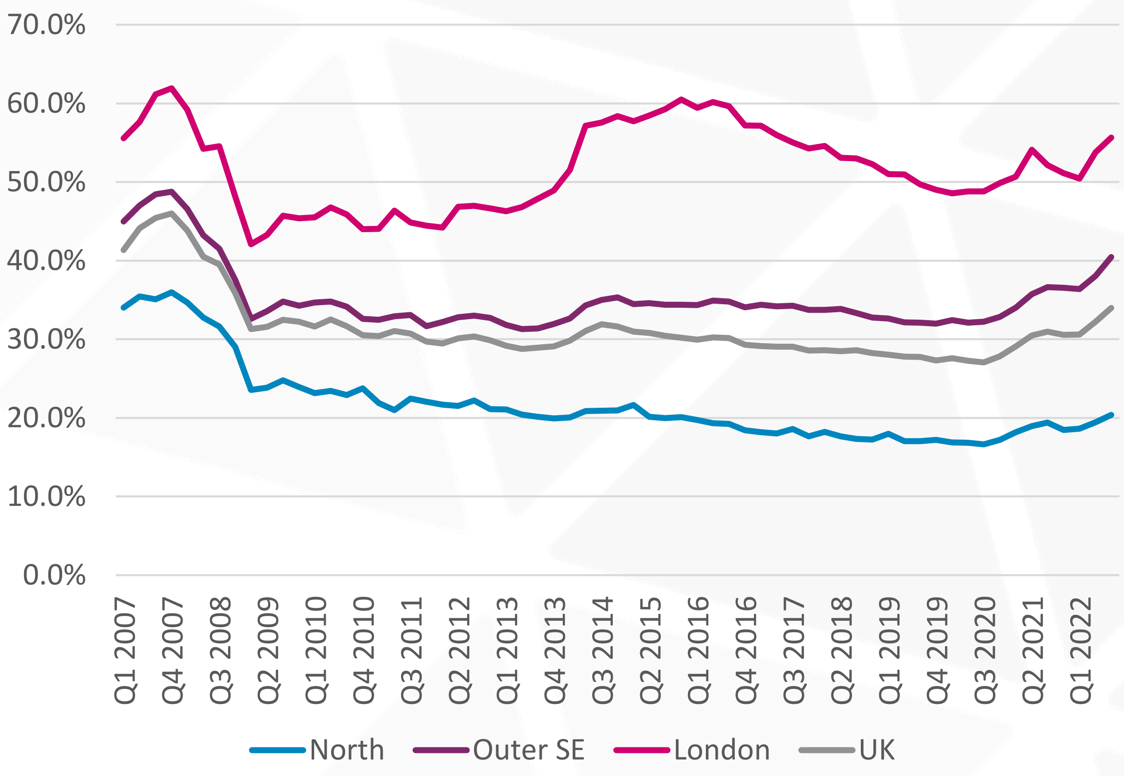
London Valuation Risks

Price to earnings ratios are high in London, running at c.11 times earnings in 2022. More concerning, mortgage affordability for first-time buyers is running at highs of over 50% of take-home pay even before the increase in mortgage rates. London property therefore faces major affordability risks as incomes fall and mortgage costs rise.

Price to Earning Ratio



FTB Mortgage % of Income

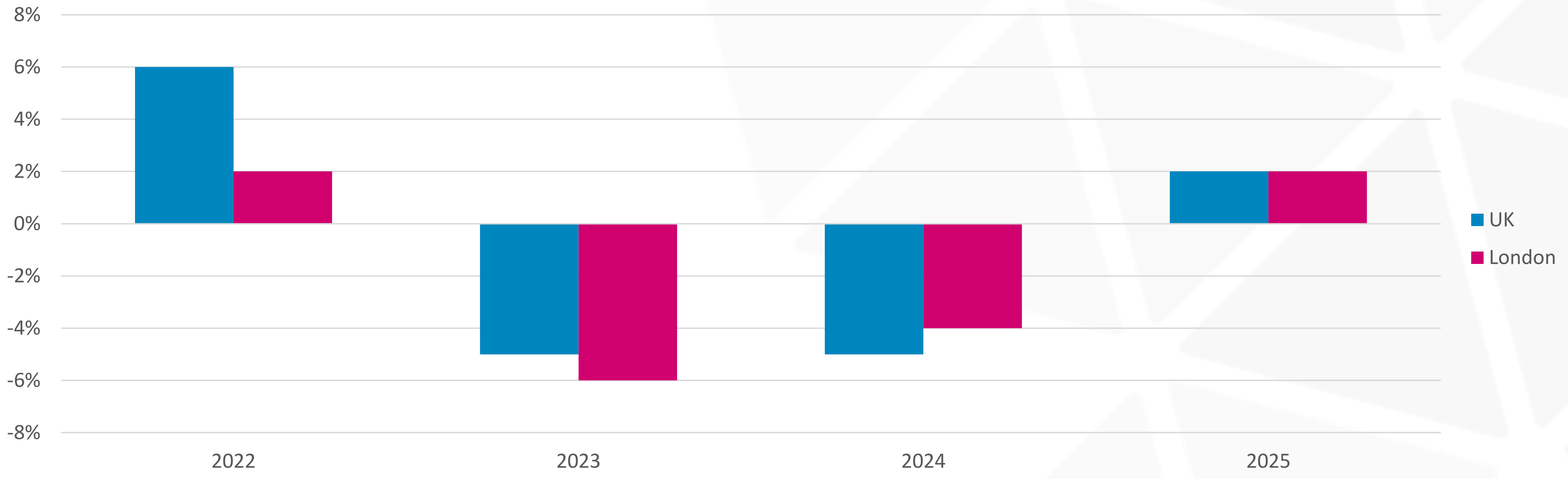


Source: Nationwide Data Hub

UK Property Price Outlook

As a consequence of high property values, market consensus is for falling property prices in both 2023 and 2024. London property, as outlined previously, faces the most acute affordability challenges and therefore is expected to see the most significant property price correction.

UK Property Price Forecast (Annual YoY Change)



Source: Knight Frank

Get in touch to find out more

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