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CIO Viewpoint

Assessing the UK's economic prospects

Investment Solutions

6 February 2023

Will the UK's recession prove short and sharp? By many measures - productivity, infrastructure and business investment, health and trade, the UK economy lags its peers. As the government tries to restore confidence in the country's fiscal prudence, rising living costs and infrastructure pressures have led to the broadest labour disruptions since the 1980s. We examine the UK's challenges.

Among G7 economies, the UK's is the only one still smaller than before the pandemic. It is also the only major economy that the International Monetary Fund (IMF) expects to contract in 2023, and will probably continue to underperform in 2024 (see table). That forecast was echoed by the Bank of England (BoE), which said on 2 February that it expects a -0.5% contraction in the UK economy in 2023. That is an improvement compared with three months ago. We also see the economy contracting slightly in 2023, by -0.2%, before a modest recovery in 2024.

Latest IMF World Economic Outlook Growth Projections

(real GDP, annual % change)

	Estimate	Projections	
	2022	**2023**	**2024**
World Output	3.40	2.90	3.10
Advanced Economies	2.00	1.20	1.40
Eurozone	3.50	0.70	1.60
United Kingdom	4.10	-0.60	0.90
Germany	1.90	0.10	1.40
France	2.60	0.70	1.60
Italy	3.90	0.60	0.90
Spain	5.20	1.10	2.40
US	2.00	1.40	1.00
Japan	1.40	1.80	0.90
Canada	3.50	1.50	1.50
Other Advanced Economies	2.80	2.00	2.40
China	3.00	5.20	4.50
India	6.80	6.10	6.80
Russia	-2.20	0.30	2.10
Brazil	3.10	1.20	1.50

Source: IMF, January 2023

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Key takeaways

- The UK economy's growth lags peers. It is expected to contract in 2023 as inflation, strikes, high energy and mortgage costs take a toll
- The government plans to raise total taxes to their highest levels in eight decades, cut debt and halve inflation. The next budget is scheduled for 15 March
- We expect the Bank of England's base rate to peak at 4.25%, with inflation averaging 5% over 2023
- We recently increased positions in financial stocks globally, which are heavily represented in the FTSE 100. Sterling should stay weak: we see EURGBP around 0.92 over 12 months, and GBPUSD in a 1.22–1.25 range.

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Weekly publication of Lombard Odier – Contacts: Investment Solutions, investment-solutions@lombardodier.com
Data as of 6 February 2023 unless otherwise stated.

Other advanced economies are also – variously – experiencing inflation, labour shortages, and an energy shock. But the UK has been hit by all of these, compounded by domestic inflation pressures, including the choice to leave the European Union and cut-off access to its single market for trade, services and labour. Such structural difficulties are not easy to manage, either within the BoE's timeframe for tackling inflation through higher interest rates, nor the current lifetime of the present Parliament, which ends no later than January 2025.

The UK is suffering from a cost of living crisis on the back of higher mortgage costs, food and energy bills. Three months into office, Prime Minister Rishi Sunak has promised to slash inflation in two, expand the economy and reduce the country's debt. He has his work cut out. Chancellor Jeremy Hunt has reversed his predecessor's tax cuts and now plans to take the total tax burden to 37.1% of GDP, the highest level in almost eight decades, according to the Office for Budget Responsibility. More detail should be included in the new budget scheduled for 15 March 2023.

Last week, the BoE increased its benchmark interest rate by 0.5% to 4%, taking UK borrowing costs to their highest level in 15 years. Language from Governor Andrew Bailey suggested that the hiking cycle is nearly over, suggesting that the next rise may be 25 basis points (bps) as the risk of a deep recession diminishes. We expect rates to rise to 4.25% and stay there for most of 2023, with inflation averaging 5% over the year. Falling energy prices have been the biggest positive contributor to falling inflation. While lower energy prices reduce the cost of the government's financial support to households, consumers will continue to pay historically high heating bills.

Shortages and strikes

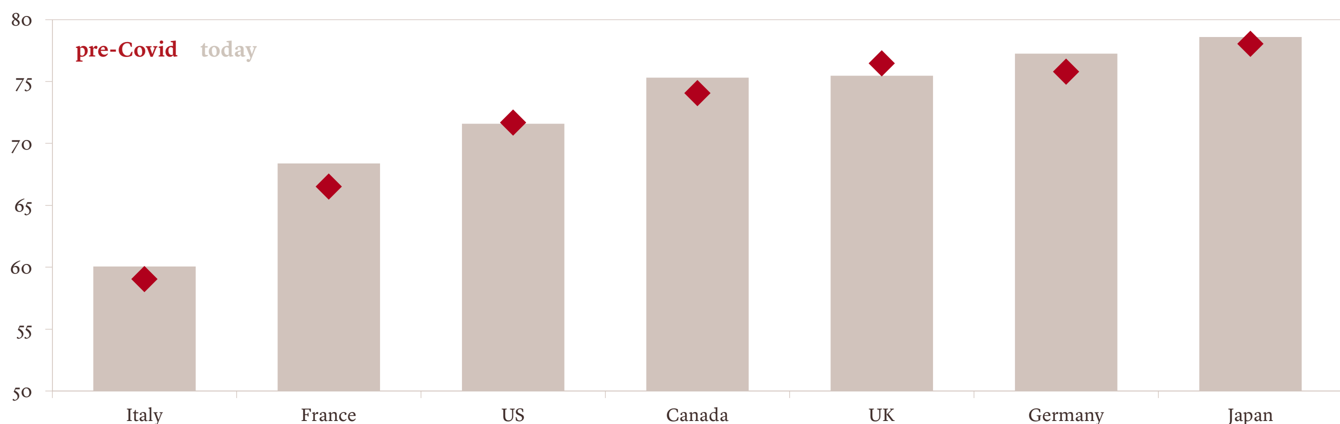
Higher living costs have fed unrest and a season of strikes. Industrial action is now so common that the BBC publishes a calendar of which sectors are hit by strikes and where. Postal workers, firefighters, teachers, civil servants and, for the first time, doctors and nurses, are all taking action. Private sector wages in the UK are rising, but not keeping pace with inflation and the public sector is asking for increases above inflation. Striking workers also highlight a lack of government investment in infrastructure that has increased demands on services already suffering from too few workers and inadequate resources. The problem is compounded by the UK's slowing productivity growth since 2008.

The UK undoubtedly has labour market issues, compounded by Brexit. A study last month estimated that between 2019 and September 2022, the UK saw a net loss of 460,000 workers from the EU, with an increase of 130,000 non-EU workers. In total, that indicates a net shortage of 330,000 workers.

The participation rate in the labour market, said BoE Governor Andrew Bailey last week, has not recovered and "that is what really makes the UK stand out," (see chart 1). One contributor to the UK's shortage of workers remains long-term sickness. More than 2.5 million people in the UK were not in work in November 2022 because they are "long-term sick," according to the Office for National Statistics (ONS) (see chart 2). That compares with 2 million people in early 2019.

1. Labour market participation remains below pre-pandemic levels

Employment rate, ages 16 to 64 (in percent)



Source: Bloomberg, Lombard Odier

Accident & Emergency

This may be a reflection of the current state of the National Health Service (NHS). The UK's healthcare system continues to lag its nearest neighbours in a ranking of 'treatable deaths.' The ONS highlights the effects of Covid, an ageing population and longer waiting lists: time to treatment in England increased from seven weeks in April 2019 to almost 14 weeks in August 2022, the report found.

The NHS's budget has stagnated since 2010, meaning that it has failed to keep pace with inflation and the need for long-term investments. In January, Mr Sunak, unveiled a plan designed to rejuvenate the NHS. It includes improving response times for ambulances, cuts to waiting times for treatments and the introduction of same-day emergency care. The plan also includes 'virtual' hospital beds in the form of at-home online monitoring, designed to reduce the number of admissions. The government has committed to an annual 2% rise in spending per capita, but the plan does not directly address the NHS' more than 133,000 job vacancies in the three months to September 2022.

Brexit impact

Brexit is contributing to this list of complications. Last week marked the third anniversary since the UK's first Brexit arrangements kicked in. The BoE estimates that UK trade fell 14% since January 2021, and that business investment is 8% lower than in 2019. Some Brexit effects still remain ahead, including full UK customs checks beginning in 2024.

Despite opinion polls showing that a majority of voters now agree that "Britain was wrong to leave the EU," neither of the UK's two largest political parties want to re-open a fractious national debate. In the short run, the UK is negotiating new trade arrangements with the EU over Northern Ireland's status, which enjoys preferential access to the single market through the Republic of Ireland, at the price of customs complications with the rest of the UK.

Global index

UK government gilt yields remain higher than their German and French equivalents. The benchmark 10-year gilt yielded 3.1% last week, 100 bps and 50 bps higher than the respective German and French government equivalents.

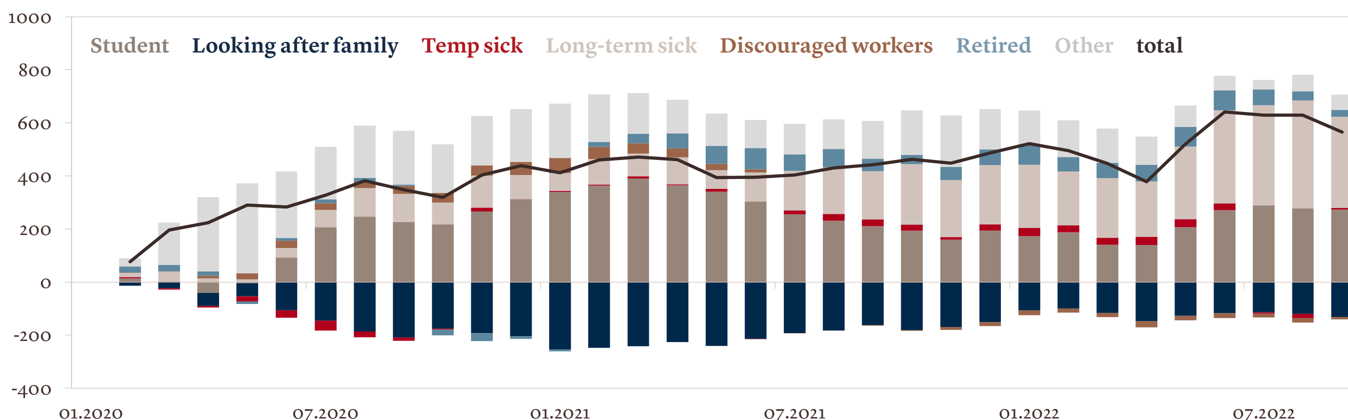
From an international investor's point of view, the UK's FTSE 100 index remains highly exposed to businesses that derive much of their revenues from global markets. Political disruptions undermined these UK-listed businesses' ratings, and the index's valuations remain among the world's most attractive, despite a strong relative performance in 2022. Helped that year by a weak pound sterling and large sectoral exposure to commodities and defensive names, the index outperformed global equities by 25% in local currency terms, and by 13% in constant currency.

Until September 2022, we had a preference for UK stocks, and anticipated their better relative performance. However, as the economic challenges grew, including mutual funds flowing from the country, we reduced our position. We recently increased our investments in financial stocks more widely, which are heavily represented in the FTSE.

In the current environment, and faced with so many long-term structural challenges, we expect sterling to remain weak. We see the euro-sterling rising towards 0.92 over the next 12 months while sterling-dollar should trade in a 1.22–1.25 range over this period. We think fair value for euro-sterling remains higher following the UK's declining share of global trade.

2. Long term sickness a key reason behind inactivity

UK economic inactivity by reason (cumulative change from December 2019)



Source: Bloomberg, Lombard Odier

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