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CIO Viewpoint

Spring hope sees UK evading recession

Investment Solutions

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Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

Despite the recent strength of inflation, UK interest rates look close to peaking and the economy should avoid recession this year. Politicians face tough challenges on raising living standards, boosting productivity and getting people back to work, but the outlook has brightened in recent months.

The UK's economic prospects are looking up. On 22 March, Bank of England (BoE) Governor Andrew Bailey said he felt 'more optimistic' on the outlook, even after the Bank raised interest rates to a 14-year high of 4.25%. In mid-March, updated forecasts from the independent Office for Budget Responsibility (OBR) showed UK growth contracting just -0.2% this year (we estimate 0%), up from the -1.4% it expected in November. That would mean no 'technical' recession, defined as growth falling over two consecutive quarters. The OBR now sees inflation falling to 2.9% by year-end. It also expects Chancellor Jeremy Hunt to meet his own fiscal 'rule' of reducing net debt as a percentage of GDP over five years, although only just.

The September 2022 'mini-Budget' proved disastrous both politically and for market confidence in the UK, with a rout in sterling and sovereign bond prices. In contrast, the Chancellor's 15 March 2023 budget, the annual outline of economic strategy, was received calmly. Much of the good news on growth and inflation was due to factors beyond the UK's control, chief among them a sharp fall in energy prices. Lower gas and oil prices reduce the cost of the government's extended support for household energy bills, while falling bond yields in recent months have cut the Treasury's bill from interest payments. Meanwhile, the rise in the OBR's long-term growth forecasts (1.8% in 2024, 2.5% in 2025) are a result of improving labour supply, mostly from higher net immigration.

Growth-friendly measures

An improving growth and inflation picture gave the Chancellor room to announce tax cuts and spending increases, which are largely being targeted in a growth-friendly way. Plans to boost labour market participation include extending a scheme of 30 hours a week's government-funded childcare for three-year olds to younger children. The OBR believes this could bring 75,000 more people into paid work. More emphasis was also placed on encouraging retirees and those on universal credit back into employment.

Key takeaways

- The UK is narrowly expected to avoid recession in 2023, and inflation is expected to fall sharply by year end
- The Spring Budget contained some growth-friendly measures, but more work is needed to fix labour market issues, low productivity and investment, and falling living standards
- For now, we see the Bank of England's rate-hiking cycle peaking at 4.5% in May
- We see downside risks for sterling this year. We are keeping a balanced exposure to equities – including UK stocks – in client portfolios.

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Meanwhile, plans to raise investment include new allowances for large companies to offset capital spending against their tax bill. Tax-free annual allowances for payments into pensions were raised, and a lifetime cap on the amount that can be contributed before having to pay extra tax abolished. The government hopes this will help keep older workers, mostly in healthcare, practicing for longer. More defence spending and support for artificial intelligence technologies should also help growth.

Stability or stagnation?

However, many of the Budget measures are only temporary or partial solutions to some very pressing problems. A lack of childcare alone does not account for the UK's large numbers of 'economically inactive' people. Around 600,000 workers have been 'lost' since the pandemic, and 2.5 million people are out of work due to long-term sickness. But the Budget had few new measures to help the healthcare system, where long waiting times for treatment and cuts to mental health services could be thwarting efforts to get people back to health and employment.

While tackling chronic public and private sector underinvestment is also much needed, new investment allowances are only planned to last three years. Companies are thus likely to simply shift investment plans forward, rather than increase them permanently. Plans to boost economic productivity require long-term commitments, such as those laid out in the US Inflation Reduction Act or the EU Green Deal. A February report by an influential group of academics, policy advisors and former politicians had suggested bolder investments in science and technology, and reforms to pension schemes that would raise their very low investments in UK listed and private companies.

A limited recovery forecast post-2023 shows the UK economy continues to lack dynamism, while the cost of living crisis – also the source of many of the UK's ongoing pay disputes– continues to bite. Household incomes, adjusted for inflation, are forecast to fall 6% this year and next, and living standards will not recover to pre-pandemic levels until 2027, the OBR forecasts. Meanwhile, the tax burden as a share of GDP is set to rise to a post-World War II high.

Rates could peak in May

That said, the situation now looks to be slightly improving in 2023, helping consumer and market sentiment. Retail sales rose again in February, while a key survey of consumer confidence rose in March, although it remains in negative territory. Price rises are certainly on consumers' minds. Yet while the consumer price index (CPI) rose unexpectedly to 10.4% year-on-year in February, it is expected to fall fast in the coming months, aided by government help on energy bills. This would be good news for the Bank of England, which also has an eye on financial stability in the wake of recent bank failures. Depending on how price pressures evolve, we believe an additional 25 basis points hike to 4.5% in May could represent the peak of its hiking cycle.

On the political front, UK Prime Minister Rishi Sunak has also made good strides improving relations with the EU. The UK and EU have now formally adopted a deal to resolve a post-Brexit trade dispute involving Northern Ireland, although it still faces opposition from Northern Ireland's Democratic Unionist Party. Relations are also brightening with France, where a recent meeting with President Emmanuel Macron was the first bilateral summit between the country's leaders in five years, and where the pair agreed a new framework to manage undocumented migrants crossing the Channel.

Reflecting the improving political and growth outlook, sterling has risen against both the US dollar and euro in the past month. However, over a 12-month horizon, we expect it to lose ground, given improving real yields available elsewhere and the currency's historical underperformance in periods of financial stress. We see EURGBP rising towards 0.92 over the next 12 months. UK 10-year government bonds are currently yielding around 3.36%, down from highs of 4.47% in the aftermath of the Autumn mini-Budget. Meanwhile, the UK's FTSE 100 index looks attractively valued, but concerns over the health of the financial sector may continue to weigh on stock markets in general – and the UK's bank-heavy index – for now. For this reason, we retain our overall neutral stance on equities, and a balanced approach to risk across client portfolios.

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SWITZERLAND

GENEVA
Bank Lombard Odier & Co Ltd[1]
Rue de la Corraterie 11 · 1204 Genève · Suisse
geneva@lombardodier.com
Lombard Odier Asset Management (Switzerland) SA
Avenue des Morgines 6 · 1213 Petit-Lancy · Suisse
Support-Client-LOIM@lombardodier.com
Management Company regulated by the FINMA.

FRIBOURG
Banque Lombard Odier & Cie SA · Bureau de Fribourg[1]
Rue de la Banque 3 · 1700 Fribourg · Suisse
fribourg@lombardodier.com

LAUSANNE
Bank Lombard Odier & Co Ltd[1]
Place St-François 11 · 1003 Lausanne · Suisse
lausanne@lombardodier.com

VEVEY
Banque Lombard Odier & Cie SA · Agence de Vevey[1]
Rue Jean-Jacques Rousseau 5 · 1800 Vevey · Suisse
vevey@lombardodier.com

ZURICH
Bank Lombard Odier & Co Ltd[1]
Utoschloss · Utoquai 29-31 · 8008 Zürich · Schweiz
zurich@lombardodier.com

EUROPE

BRUSSELS
Lombard Odier (Europe) S.A. Luxembourg · Belgium branch[2]
Avenue Louise 81 · Box 12 · 1050 Brussels · Belgium
brussels@lombardodier.com
Credit institution supervised in Belgium by the National Bank of Belgium (NBB) and the Financial Services and Markets Authority (FSMA).

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Lombard Odier (Europe) S.A.· UK Branch[2]
Queensberry House · 3 Old Burlington Street · London W1S 3AB · United Kingdom
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Lombard Odier (Europe) S.A.
291, route d'Arlon · 1150 · Luxembourg · Luxembourg
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Lombard Odier Funds (Europe) S.A.
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Lombard Odier (Europe) S.A. · Sucursal en España[2]
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sao.paulo.office@lombardodier.com
Supervised by the Comissão de Valores Mobiliários of Brazil.

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Bank Lombard Odier & Co Ltd · Representative Office Dubai
Conrad Business Tower · 12th Floor · Sheikh Zayed Road · P.O. Box 212240 · Dubai · UAE
dubai@lombardodier.com
Under the supervisory authority of the Central Bank of the UAE.

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Israel Representative Office · Bank Lombard Odier & Co Ltd
Alrov Tower 11th floor · 46 Rothschild Blvd. · Tel Aviv 6688312 · Israel · telaviv@lombardodier.com
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JOHANNESBURG
South Africa Representative Office · Bank Lombard Odier & Co Ltd
4 Sandown Valley Crescent · Sandton · Johannesburg 2196 · South Africa · johannesburg@lombardodier.com
Authorised financial services provider Registration number 48505.

NASSAU
Lombard Odier & Cie (Bahamas) Limited
Lyford Cay House · Western Road · P.O. Box N-4938 · Nassau · Bahamas · nassau@lombardodier.com
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Lombard Odier & Cie (Bahamas) Limited · Representative Office in Panama
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Lombard Odier (Hong Kong) Limited
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Lombard Odier (Singapore) Ltd.
9 Raffles Place · Republic Plaza #46-02 · Singapore 048619 · singapore@lombardodier.com
A merchant bank regulated and supervised by the Monetary Authority of Singapore.

TOKYO
Lombard Odier Trust (Japan) Limited
Izumi Garden Tower 41F · 1-6-1 Roppongi, Minato-ku · Tokyo 106-6041 · Japan · tokyo@lombardodier.com
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