UK Outlook

February 2024

Economic Update

Bank of Ireland

Growth to pick up gradually after disappointing 2023

The UK economy has been characterised by three key trends recently. Firstly, GDP growth has been weak, with activity falling through the second half of 2023, matching the definition of a technical recession, albeit a mild one. Output has been weighed down by elevated inflation, the lagged effect of monetary tightening and the ongoing negative effect of Brexit on exports. Secondly, despite this the performance of the labour market has remained fairly solid, with employment continuing to expand. Unemployment has declined over recent months and is again below 4%. Vacancies have reduced somewhat however, and wage growth has moderated - though it remains fairly elevated. Thirdly, headline inflation has fallen quite sharply, to 4.0% in January, and is likely to fall to below 2% by April/May as the OFGEM energy price cap is reduced. However, the decline in core inflation has been more modest and it registered 5.1% in January, still well above the Bank of England 2% target.

Turning to the outlook, we expect growth to pick up gradually through the course of this year. This will be driven primarily by a recovery in consumer spending as household disposable income growth should comfortably exceed inflation. However, investment and exports are likely to remain sluggish in the near term. Overall, we expect GDP growth of 0.4% for 2024. Growth is likely to increase further in 2025 as the recovery in consumption continues, and investment and exports pick up. We expect GDP growth of 1.2% for the year as a whole. The forecasts for this year and next have been reduced slightly from our October Outlook (0.7% and 1.5%). Although growth is picking up, it will likely remain below potential, and as such the unemployment rate should rise slightly from here, towards 4.5%. Forward looking indicators of inflation, such as commodity prices and producer prices, continue to point to further declines. We expect inflation of 2.4% this year, dropping to 2.2% next year, though still elevated wage inflation presents upside risks. Given this outlook for improved though still moderate growth, and declining inflation, we expect the Bank of England to commence an easing cycle this summer, taking rates to 4.25% by the end of this year. An election is likely in the second half of the year – Chancellor Hunt will have one eye to this when he delivers his Spring Budget in a few weeks, with income tax cuts a possibility.

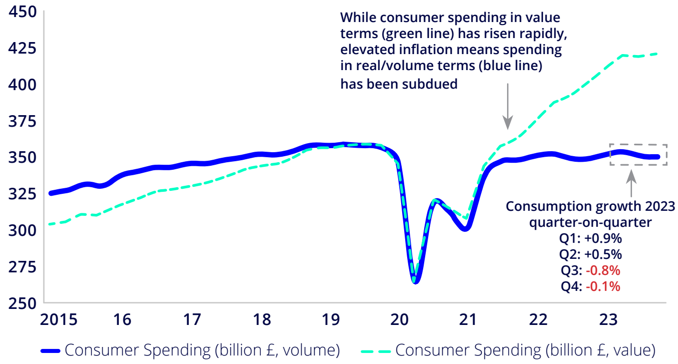
As always, the outlook remains subject to considerable risks, with geopolitical tensions to the fore. The war in Ukraine is ongoing, there has been an escalation of conflict in the Middle-East (which has negatively impacted key trade routes and maritime transport costs), and tensions between the US and China remain heightened. A deterioration in any of these conflicts could see rising energy and other commodity prices, supply chain disruptions, reduced trade, volatility in financial markets and ultimately a decline in global growth, with negative effects for the UK. Another risk – albeit one that is diminishing - is that inflation proves more persistent than expected, leaving the Bank of England unable to ease monetary policy materially.

	2023	2024(f)	2025(f)
Consumer Spending	0.4%	0.4%	1.2%
Government Consumption	0.6%	3.0%	1.5%
Investment	2.9%	-1.0%	1.2%
Exports	-1.4%	-2.0%	1.0%
Imports	-1.6%	0.5%	1.7%
GDP	0.1%	0.4%	1.2%
Employment Growth	0.7%	0.4%	0.5%
Unemployment Rate	4.0%	4.3%	4.5%
Inflation Rate	7.3%	2.4%	2.2%

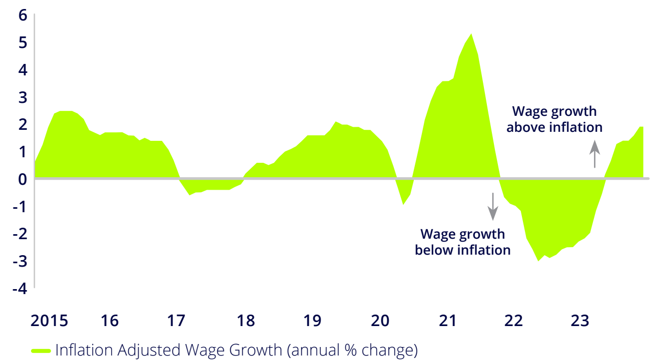
Consumer spending to strengthen

Consumer spending held up fairly well in the first half of last year, despite elevated inflation, rising mortgage rates and depressed consumer sentiment (it was up 0.9% in Q1 and 0.5% in Q2 on a quarter-on-quarter basis). However, perhaps reflecting a lagged response to these pressures, consumer demand weakened in the second part of the year with consumption down 0.8% in Q3 and 0.1% in Q4 in quarterly terms. The household savings rate rose from 7.9% in Q1 to 10.3% by Q3, and possibly higher in Q4, despite consumer credit growth remaining fairly robust (up 8.5% year-over-year in December). For the year as a whole consumption was up only 0.4% on an annual basis, with weakness in spending on food/drink, household goods/services and recreation in particular – no doubt linked to sharp price rises in these categories.

The outlook for consumers has brightened a bit of late though, reflected in a rebound in consumer sentiment over recent months. Furthermore, income growth has remained robust (with wages and other income - such as from social benefits, self-employment and interest/dividends - all growing strongly) and with inflation declining fairly sharply this means real (i.e. inflation adjusted) incomes are likely to expand solidly this year and next. We expect real household gross disposable income to increase by about 1.5% this year and perhaps 1.0% next year. This will likely support consumption growth of 0.4% this year and 1.2% next year. The relatively weak projection for this year partly reflects negative carry over effects as spending was subdued in H2 last year – in Q4/Q4 terms we expect growth of roughly 1.0% this year. The outlook for the housing market has also improved, with prices rebounding a little at the end of 2023, and forward looking indicators such as the RICS survey looking more positive.



Source: ONS

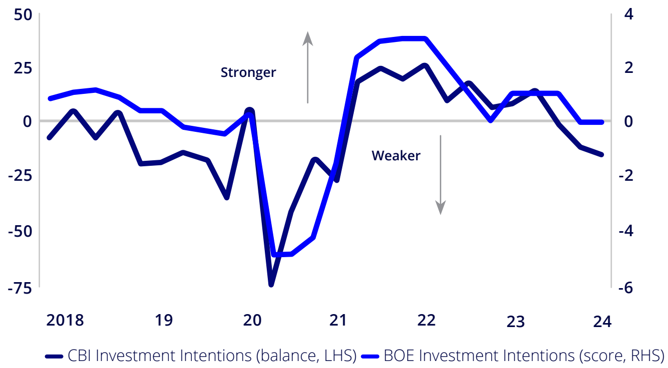


Source: ONS

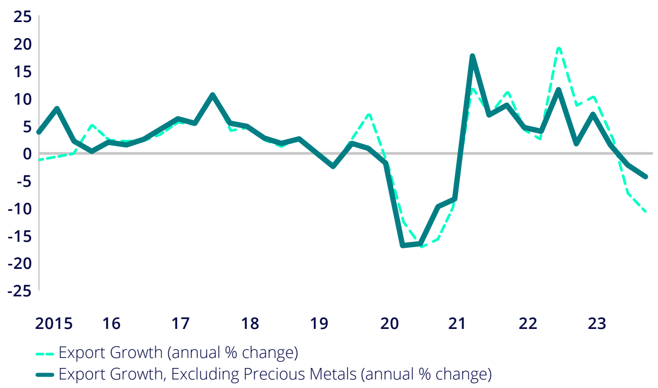
Fairly subdued outlook for investment and exports

Investment increased by a healthy 2.9% year-on-year last year – this was driven by robust growth in business capital spending (up 6.1% on an annual basis) and in government investment (up 9.2%), though housing investment was weak (down 5.2%). While the underperformance of housing was no surprise given the significant rise in interest rates, business investment proved more resilient than expected. Turning to the outlook – we expect investment to decline modestly this year, down 1% for year as a whole. With surveys of business investment intentions softening somewhat towards the end of last year we expect business capital spending to pull back slightly. Government investment growth is likely to remain positive, while housing investment will continue to fall, albeit the pace of decline should begin to moderate through the course of the year. Investment growth should recover in 2025, up 1.2% as house building stabilises and as Chancellor Hunt's move to make the 100% tax deduction for business capital expenditure permanent starts to positively impact business investment plans.

Following a post-Covid rebound export growth has weakened over recent quarters, weighed down by sluggish growth in some key trading partners, particularly in Europe, and the ongoing adjustment to the new post-Brexit trading arrangements. Exports were down 10.3% year-over-year in Q4 last year and 1.4% for the year. However, when trade in highly volatile precious metals is excluded, which gives a better sense of the underlying trend, these figures are -4.0% and +0.5% respectively. For last year as a whole goods exports were notably weaker than services exports (down 8.0% versus up 5.3% for services). A strong pick up in export growth over our forecasting horizon is unlikely in our assessment, due to Brexit related headwinds and sluggish global growth – we expect exports to contract by 2% this year (albeit largely reflecting negative base effects) before recovering to growth of 1% in 2025.



Source: Confederation of British Industry, Bank of England

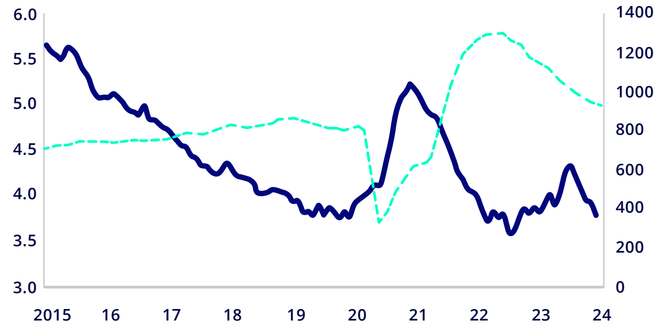


Source: ONS

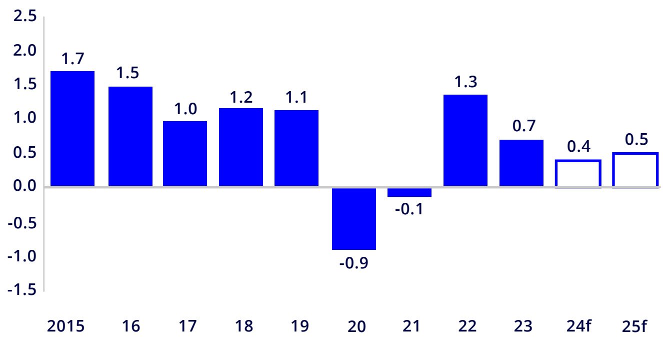
Unemployment to tick up slightly

The ONS issued labour market data on February 13, though with a health warning about greater uncertainty surrounding estimates than usual (due to low survey response rates). After a weak reading in Q3, employment rebounded in Q4, up 0.2% quarter-on-quarter. With a decline in the labour force over the second half of last year, as inactivity rose (with rising long term illness a key driver), this jobs growth was enough to push the unemployment rate back down to 3.8%, from 4.1% in Q3. While this is lower than anticipated by the Bank of England, they will take some comfort from the fact that pay growth continued to ease into the end of last year, with average total weekly earnings growth in the three months to December down to 5.8% from 6.7% in the prior period and a recent high of 8.5% last summer. Vacancies remain above their pre-Covid average, but they have declined over recent quarters, albeit relatively modestly in the past couple of months. One other notable implication of the labour market data is that, with employment growth of 0.7% in 2023 comfortably exceeding GDP growth of 0.1% it means that economywide productivity declined last year.

With output growth set to pick up over coming quarters, albeit gradually, it seems likely employment will continue to expand through this year and into 2025 – we are pencilling in growth of 0.4% for 2024 and 0.5% for 2025. We expect a slight pick up in labour force growth after the weak performance in H2 last year, supported by ongoing strong inward migration flows, which should mean unemployment ticks up marginally to about 4.3% this year and 4.5% next year. Wage growth is likely to continue to moderate towards rates consistent with 2% inflation (roughly 3%), though there is still some distance to go and there are upside risks which will be closely watched by the Bank of England.



Unemployment Rate (%, LHS) Vacancies ('000, RHS)
Source: ONS

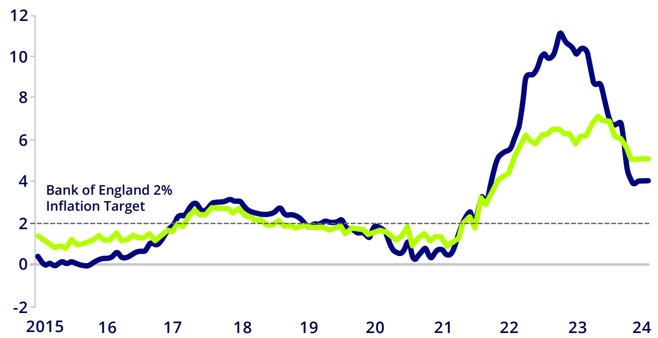


Employment Growth (annual % change)
Source: ONS, Bank of Ireland

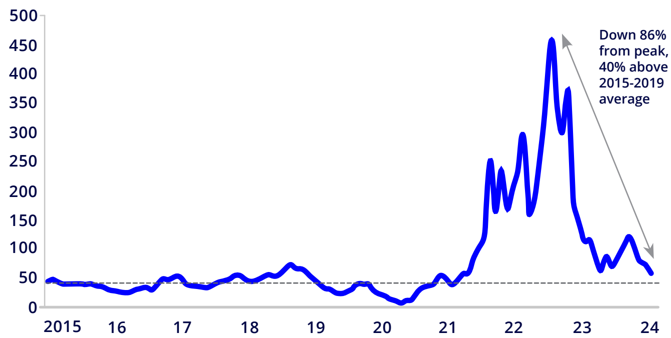
Inflation to ease further

Headline inflation fell significantly through the second half of last year (from 7.9% in June to 4.0% in December). There were a number of key drivers behind this trend, including declines in oil and gas prices, an easing of food price inflation on foot of declines in global food commodity prices, as well as declining durable goods (clothing, electronics, cars etc.) inflation as domestic and global supply chain conditions continued to improve from the Covid and Ukraine war shocks. Services inflation declined more modestly however, in part due to still strong – though gradually moderating - wage growth. Inflation was unchanged in January this year, in both headline and core terms (4.0% and 5.1% respectively), lower than consensus expectations and those of the Bank of England, as declines in a range of categories offset a rise in energy prices.

This pause in the disinflation process is almost certain to prove short lived however, as the OFGEM energy price cap is set to decline sharply in April – this will likely push headline inflation down to 2% or lower. While inflation may pick up again a bit through the summer, due to base effects, this is likely to be temporary and the big picture is that inflation pressures should continue to ease. Forward looking indicators such as low levels of producer price inflation, and energy price trends, support this conclusion. In particular, wholesale gas prices have fallen significantly and this will continue to place downward pressure on inflation for some time via direct (gas/electricity bills) and indirect (business costs) effects. We expect inflation to average 2.4% this year, declining to 2.2% next year. Risks to this outlook include the possibility that geopolitical tensions flare up further, which could raise energy prices and/or shipping and transport costs, as well as the possibility that domestic wages and services prices prove more sticky than anticipated – this latter risk will be watched very closely by the Bank of England.



Headline CPI Inflation (annual % change) Core CPI Inflation
Source: ONS

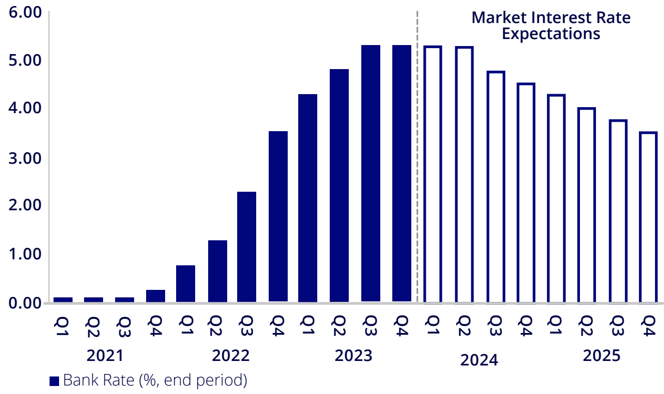


UK Natural Gas Prices (pence per therm) 2015 - 2019 Average
Source: Bloomberg

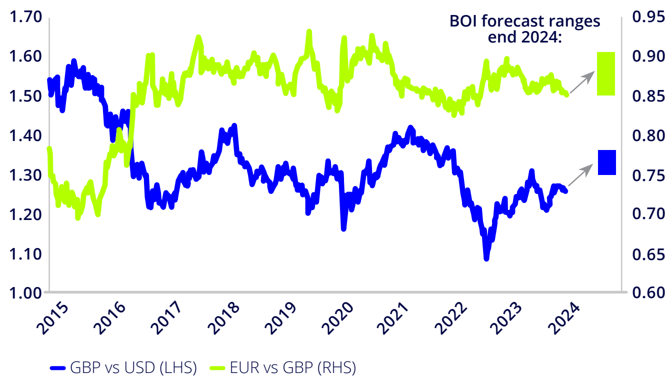
Bank of England rate cuts on the way

The Bank has held Bank Rate unchanged at 5.25% since September last year, most recently on February 1 when the MPC vote was 6-3 in favour of no change (two dissenters wanted to hike 25bp, one wanted to cut 25bp). The Bank noted that "GDP growth is expected to pick up gradually" and that "the labour market has continued to ease, but remains tight by historical standards", while in relation to policy they continued to strike a cautious tone stating that policy "will need to remain restrictive for sufficiently long to return inflation to the 2% target". Financial markets continue to expect the BoE to reduce rates in 2024, though they have recently pushed out the timing of the first cut - a full quarter-point reduction is now not priced until August. Market pricing then implies a 25bp rate cut roughly every quarter until end 2025, at which point Bank Rate would be 3.50%. Monetary policy easing should help to support an economic recovery through this year and into 2025, particularly via its impact on interest sensitive sectors such as housing and business investment.

This year is set to be a busy one on the political front, with a UK general election likely in the second half of this year. Chancellor Hunt will no doubt have this in mind when he delivers his Spring Budget in early March, with income tax cuts a distinct possibility, though his room for manoeuvre vis-à-vis the fiscal rules is limited. While 10 year Gilt yields are off the levels that prevailed at the time of the last outlook in October (c. 4.5%), they have risen off their recent lows (c. 3.5% in late Jan) and now stand at about 4.1%. In the FX market the pound is trading at just over $1.25 versus the dollar and close to £0.85 versus the euro. We expect sterling to strengthen somewhat versus the dollar over the balance of the year, but to lose some ground versus the euro.



Source: Bloomberg

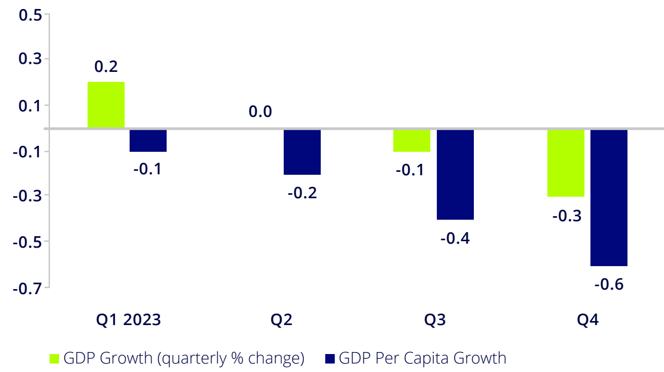


Source: Bloomberg, Bank of Ireland

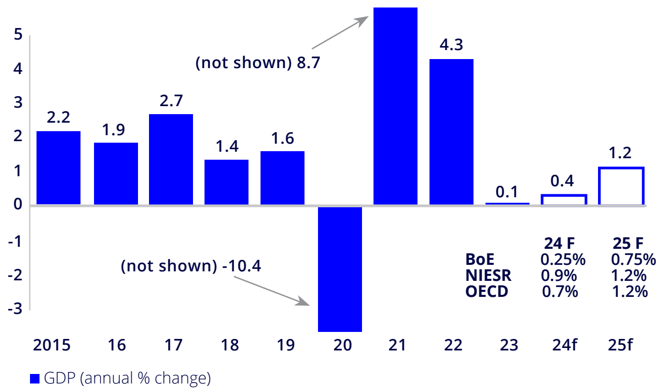
Growth to improve gradually after weakness in 2023

Growth disappointed last year, particularly in the second half of the year. After a decline of 0.1% quarter-in-quarter in Q3 GDP fell by a further 0.3% in Q4, worse than consensus expectations for a broadly flat reading (the weakness was fairly broad based across sectors and expenditure categories). The picture was even worse when looked at in per-capita terms, with output down every quarter last year (and as mentioned before, productivity was negative as well). For the year as a whole GDP grew by only 0.1%. Consumer spending was up 0.4%, government consumption rose 0.6%, investment increased 2.9%, though exports were down 1.4%. Stocks were also a drag. While these are preliminary numbers and could yet be revised somewhat it seems clear than the multiple headwinds faced by the economy last year - including the lagged effect of monetary policy tightening, high energy prices and inflation, and the negative impact of Brexit on trade – weighed on activity.

However, we believe the outlook for this year is a little better. Of the three major headwinds mentioned, two should ease this year, with interest rate cuts from the Bank of England likely, while lower energy prices will see inflation decline, boosting household spending power and easing business costs. Of course, the structural headwind of Brexit will remain in place, though its effects should ease a bit over time. For the year as a whole we expect GDP growth of 0.4% - this would be higher and close to 1% if not for negative carry over effects from H2 last year. Growth should strengthen to 1.2% in 2025, close to the most up to date estimates of the UK's potential growth rate of about 1.25%-1.50%. Raising that potential growth rate through investment in infrastructure and human capital and enhanced economic dynamism will be a key challenge for future governments.



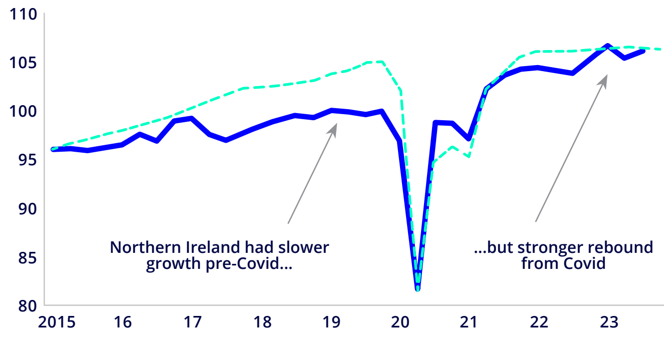
Source: ONS



Source: ONS, Bank of Ireland

Return of Stormont a positive for the NI economy

The Northern Ireland Composite Economic Index expanded by 0.7% quarter-on-quarter in Q3 last year, leaving it 6.2% above pre-Covid levels – a stronger rebound than for the UK as a whole. The unemployment rate remains low, at roughly 2.5% at end 2023, though in the context of high structural inactivity levels. Signs in relation to economic activity in early 2024 are reasonably positive, with the composite PMI above 50 in January (51.4 versus 51.6 in December). All sectors were above 50 bar construction. However, of more importance than the short term ups and downs of the economic data is the recent restoration of Stormont. After two years without a power sharing administration the parties agreed to return and a new government is now in place. This is a positive development for the NI economy and should provide somewhat of a boost to consumer and business confidence. It should also facilitate an increase in public sector current and capital spending, which has been stalled of late.



Source: NISRA, ONS

Forecasts	2023	2024(f)	2025(f)
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Employment Growth	0.7%	0.4%	0.5%
Unemployment Rate	4.0%	4.3%	4.5%
Inflation Rate	7.3%	2.4%	2.2%

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