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IN DEPTH

UK

Odds of a UK recession are now greater than even

20 July 2017

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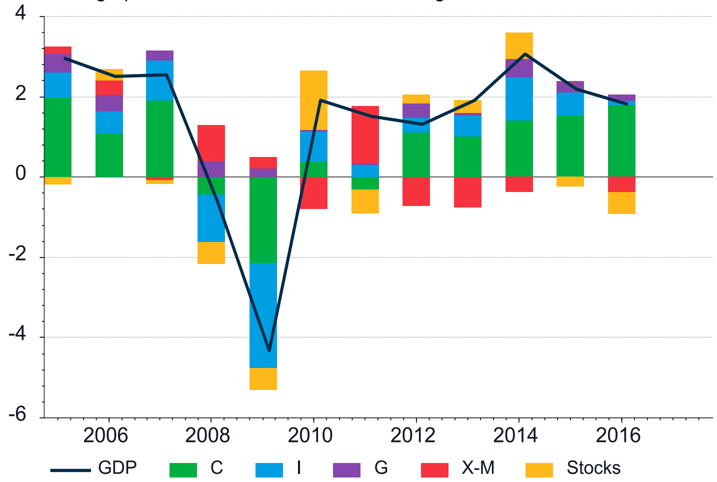
Defying widespread expectation of a recession, the UK economy weathered the Brexit storm better than the majority of forecasters, ourselves included, anticipated. That was thanks, in large part, to the strength of consumer spending. But that tide has since turned: the brief period of real wage growth is over; household finances are stretched; and June's inconclusive general election has reignited concerns about the nation's economic prospects. With the key driver of UK GDP growth, the consumer, under assault, we believe that there is now a greater-than-evens chance of a technical recession in the UK over the next year.

There is a greater-than-evens chance of a technical recession in the UK

In our view, the most plausible explanation for consumption surprising on the upside since last year's vote is that households were surprisingly rational, bringing forward expenditure in anticipation of sterling weakness ahead. But as we highlighted last quarter, that explanation carries ominous connotations for an economy dependent on the consumer for growth. Indeed, buying in advance of sterling-induced price increases merely shifts consumption from one quarter to another. Thereafter, unless wages keep pace, consumers' real purchasing power is reduced. That is bad news for an economy that relies on consumer spending to drive growth.

Contributions to UK GDP growth

Percentage point contributions to annual GDP growth



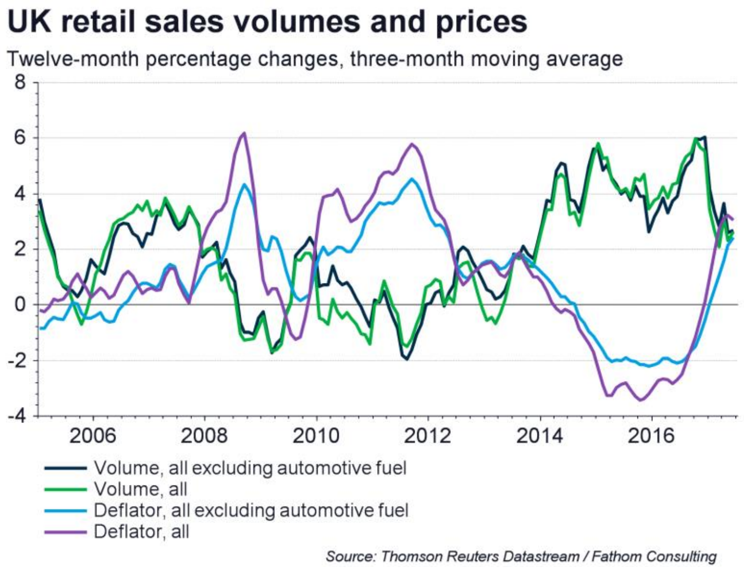
Source: Thomson Reuters Datastream / Fathom Consulting

The linchpin of UK economic growth, the consumer, is under assault

Continued

Since then, our concerns have crystallised. Above-target inflation and weak wage growth mean that the brief period of real earnings growth is over. Data confirm that households are feeling the pinch. As the chart below highlights, less than a year ago retail goods were falling in price, down 3% or more. Now they are rising by more than 3% per annum. In response, the pace of annual retail sales growth (adjusted for inflation) has slowed sharply.

Data confirm that households are feeling the pinch



With headline inflation destined for letter-writing territory and wage growth unlikely to keep pace despite the unemployment rate reaching its lowest level since 1975, the squeeze on households' real incomes is likely to intensify in coming months. Our forecast points to peak annual consumer price growth of just over 3% later this year, while some survey-based measures, such as that shown overleaf, point to 4% or more.

The era of real wage growth is over

Interestingly, in seven of the last twelve months since the UK's vote to leave the EU undermined the value of sterling, headline inflation has surprised on the upside, resulting in a cumulative 0.3 percentage point overshoot from the median Bloomberg forecast. June's inflation print, however, was considerably weaker than expected, with the headline measure softening to 2.6%.

The biggest discrepancy between our forecast and June's outturn was due to food price inflation, which accounted for nearly a third of our 0.3 percentage point error. We suspect that the vast majority of forecasters underestimated this component as food prices are notoriously hard to predict. Indeed, producer price food inflation rose by 5.8% in the twelve months to June, its fastest pace in over five years. More muted consumer price food inflation of 2.6% points to a renewed supermarket price war.

Summer discounting by clothing retailers and suppliers of recreational goods was also larger between May and June this year than over the same two months a year ago. While this may well reflect the challenging consumer environment, with retailers enticing shoppers through competitive prices and loyalty schemes, sales are — by definition — temporary in nature. As a consequence, we believe that inflation has merely paused for breath, before rising again later this year.

Consumer price inflation has merely paused for breath, before heading higher

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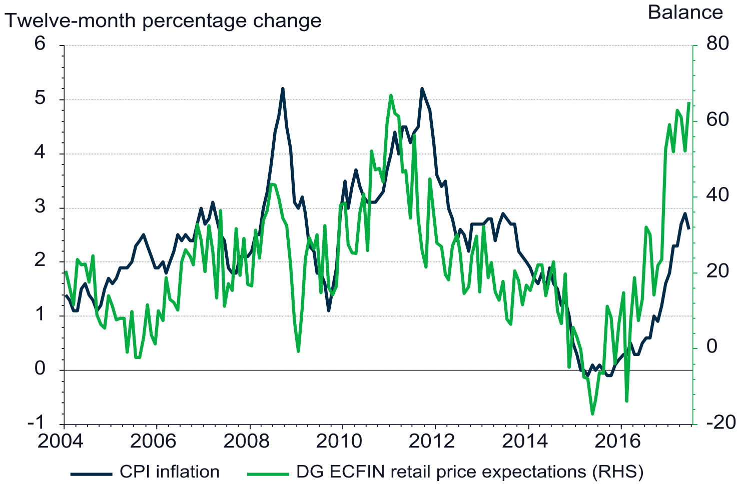
UK price expectations

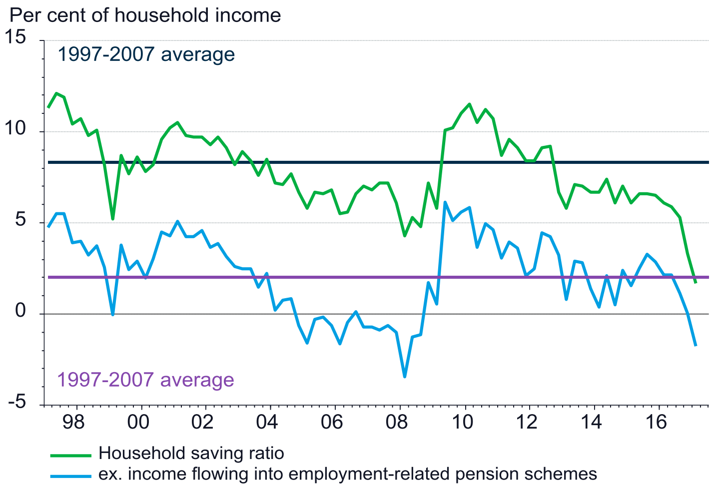


Source: Thomson Reuters Datastream / Fathom Consulting

Worryingly, efforts by increasingly cash-strapped consumers to preserve consumption have seen them eat into their savings. Data from the Office for National Statistics (ONS) reveal that households are, on average, spending more than ever as a share of their post-tax income. Strip out net pension contributions, and households spent more than they took home in the first quarter of this year. That implies that the British consumer has taken on even more debt.

Household finances are already stretched

UK household saving ratios



Source: Thomson Reuters Datastream / Fathom Consulting

This reliance on credit to shore up consumption is not only worryingly reminiscent of the pre-crisis years, but is unlikely to last. Following a period of rapid consumer credit growth, supported by cheap rates and extensions of interest-free offers, financial regulators have voiced their concern, and it appears that their warnings are being heeded.

The Bank of England's latest Credit Conditions Survey, conducted between 22 May and 9 June, reports that lenders have already tightened their credit scoring criteria and reduced the availability of unsecured credit to households, with a further decrease expected in the third quarter. Rising default rates on unsecured lending, which were said to have increased significantly in the second quarter, are also likely to have motivated this decision.

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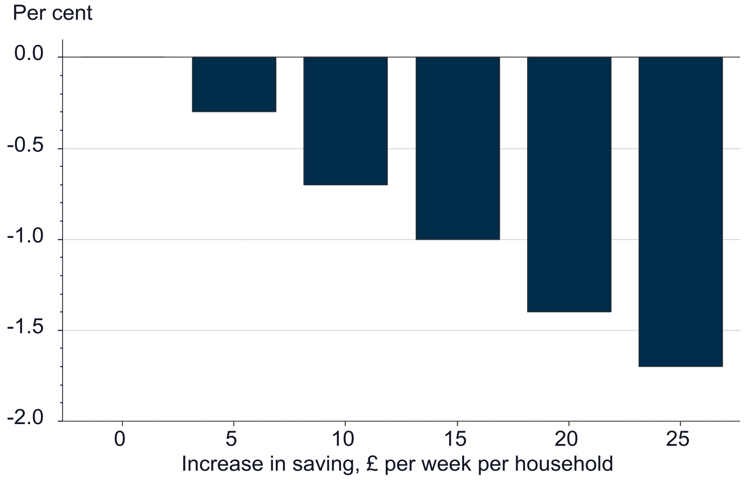
With household finances already stretched, and without borrowing to fall back on, the sustainability of consumption, and in turn economic growth, is in doubt. Another source of potential instability is an abrupt shift in consumer sentiment. As the 2008-09 global financial crisis demonstrated, waning consumer confidence is associated with a sharp increase in the average saving rate.

A little bit of saving is all that it would take

With June's unexpectedly inconclusive general election reigniting concerns over the UK's political and economic outlook, it is not inconceivable that precautionary savings may rise. With economic growth subdued, we find that just a small increase in savings (as little as £10 a week per household) could cause the UK economy to contract. What is more, it is not only consumers that are less upbeat following last month's general election, business confidence has taken a knock too.

Impact on GDP of small increases in saving



Source: Thomson Reuters Datastream / Fathom Consulting

Revisions to the savings ratio will not be a game changer

By not properly accounting for dividend income, the Bank of England estimates that the ONS has understated self-employment income by enough to raise the saving rate by 1.5 percentage points in 2012 alone. The revised series will be made available in the Blue Book in October, but data revisions for the past few years will be available in August. These revisions would need to be sizeable, changing the more recent profile significantly, in order for us to judge that households' financial situation is sufficient to sustain spending despite the real earnings squeeze.

It is not unusual for the consumer to lead a downturn

Accordingly, the only bright spot on the UK horizon is business investment intentions, which have rebounded since January. Nevertheless, we are unable to rule out a consumer-led downturn. Using Granger Causality tests between the expenditure components of UK GDP, we find that past values of consumption help predict investment but that the reverse is not true. In other words, it is not unusual for the consumer to lead a downturn.

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Granger Causality tests between UK expenditure components

Sample 1955 to 2017

Granger cause…

Does….	C	I	G	X	M
C		✓	✗	✗	✓
I	✗		✗	✗	✓
G	✗	✗		✗	✗
X	✓	✗	✗		✗
M	✓	✓	✗	✓	

Source: Fathom Consulting

With this in mind, we remain considerably more pessimistic than most. Not only are finances stretched, meaning that households have limited savings into which they can dip, real incomes are falling and the crackdown on unsecured lending is likely to make the usual buffer of consumer credit both less enticing and less readily accessible. For this reason, with the UK consumer under assault, we believe that there is now a greater-than-evens chance of a technical recession in the UK over the next year.

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