EY ITEM Club Summer Forecast

As supply shocks fade,
higher interest rates bite

July 2023

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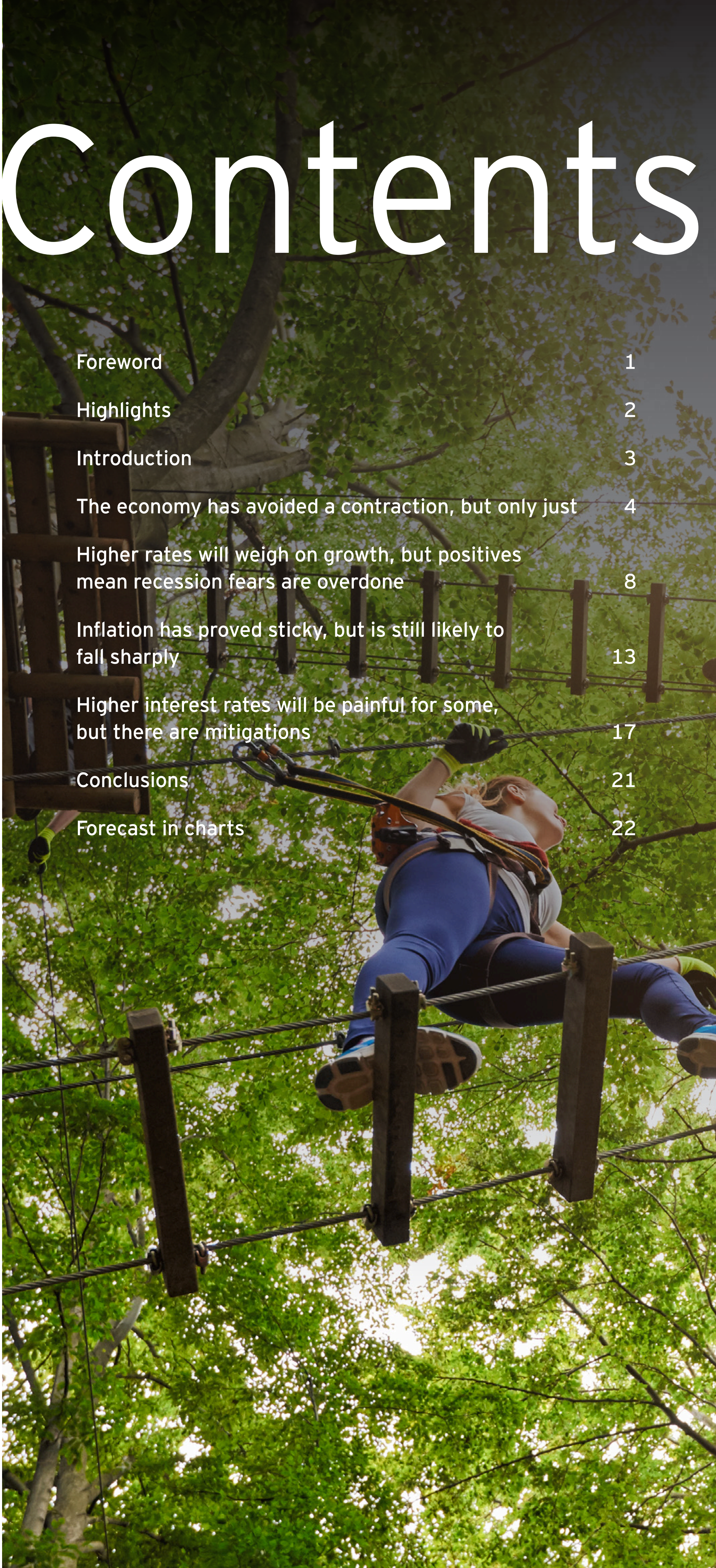

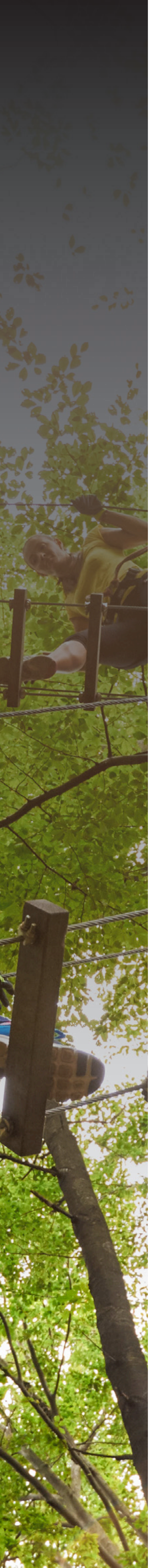

Foreword

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Sentiment on the outlook for the UK increasingly reflects a pendulum – the gloom of last Autumn where a recession seemed inevitable, gave way to better mood music in the Spring as the economy, and ultimately consumers and businesses, remained resilient in the face of a cost-of-living squeeze and rising interest rates. However, perhaps as a consequence of this better-than-expected outturn, inflation has proved sticker than many predicted, leading in turn to higher expectations around the path of interest rates.

The UK also appears somewhat of an outlier amongst western economies when it comes to inflation with the latest CPI measure running at 7.9%, compared to 5.5% in the eurozone and 3% in the US. Inflation in the US was largely a story of monetary and fiscal stimulus during COVID-19 stoking demand in the face of supply chain constraints, while in Europe it was the energy price shock that had most of an impact. The UK had the worst of both worlds – a high level of government support and an unusually elevated exposure to gas prices, plus COVID-19 lockdowns took a much heavier toll on the UK labour market, as a rise in inactivity and long-term sickness has meant that it has taken longer for the workforce to recover.

In this context, while EY ITEM Club has slightly revised up its GDP growth outlook for 2023 – up from 0.2% to 0.4%, the prospect of stickier inflation and higher interest rates and their impact on consumer spending and business investment means that it is now far more pessimistic on growth in 2024 – cutting the forecast from 1.7% to 0.8%, and with the drag from higher borrowing costs on growth also feeding into 2025. The recessionary sirens are probably also sounding, as there is a real risk that rates rise overshoot and tip the economy into a technical recession at some point in the next 6–12 months.

As inflation recedes – the nature of the squeeze on consumer spending may subtly shift. High inflation, particularly in the price of essentials, tends to impact the lowest paid, as they have less income for discretionary spending, while, to date, the middle classes have been able to draw down on pandemic-era savings. In contrast higher rates will impact mortgage holders hardest – and they tend to be those with higher incomes – albeit so far, the data does suggest that the benefits to savers from higher interest rates may actually be outweighing the impact on borrowers.

So far, so downbeat, so are there reasons to be cheerful? Well starting with inflation – the forces that drove it up initially – supply chain disruptions, the energy price shock (and arguably excessive stimulus from policy makers) – are all now receding – and indeed forward-looking measures such as producer price inflation, and the money supply – all suggest inflation should start to fall quite rapidly – perhaps calming some of the market sentiment around interest rate expectations.

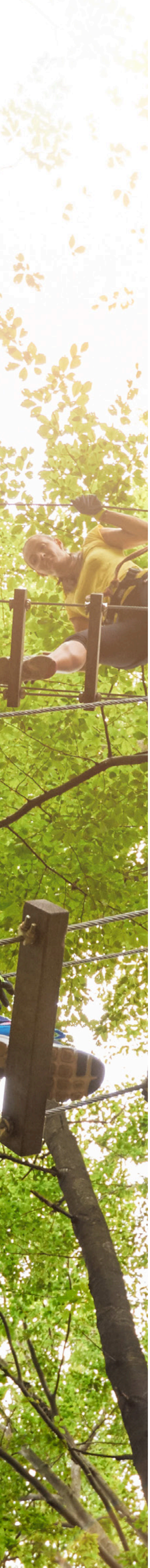
There has also been some better news in the labour market – the number of vacancies continues to fall, and both the size of the workforce and the number of people in work are finally back to pre-pandemic levels – this should start taking some of the heat out of the labour market, alleviating wage pressures, and give the Bank of England confidence to pause on rate rises.

Finally, while higher interest rates will impact on growth – and we have already seen a slow down in household and corporate borrowing – both households and corporate balance sheets remain healthy so we may avoid both a significant downturn in the housing market – so often associated with a deep recession in the UK – and extensive corporate stress leading to mass redundancies.

Over the longer term, there could well be benefits to productivity from higher rates. The ultra-low rates of the last 15 years have been correlated with low productivity growth across Western economies, and significant asset price inflation (particularly in housing), plus have arguably allowed poorly performing indebted companies to survive. A normalised rate environment (by historical terms) may be one element required to unlock the productivity puzzle that has be-deviled the UK economy for so many years.

Highlights

- The latest EY ITEM Club forecast for the UK economy comes against a mixed backdrop. The repercussions of the supply shocks that hit the economy in recent years and the Bank of England's (BoE's) actions in sharply raising interest rates are likely to condemn GDP to a period of sluggish growth in the near term. Inflation remains uncomfortably high; energy bills remain well above the level of a few years ago, and the workforce is significantly smaller than a continuation of pre-pandemic trends would have implied. The BoE's policy rate now stands at a 15-year high, and the rate rise cycle probably has further to run.
- On the other hand, the supply side of the economy is gradually healing from the last few years' turmoil. Disruption to global supply chains triggered by pandemic restrictions and changes in consumer spending patterns has been resolved. Inflation is coming down, helped by falling energy prices, and the shrinkage in the UK workforce during 2020 and 2021 has been made up in absolute terms.
- It follows that the outlook for the UK economy will be determined by two sets of competing forces. On the one side is the drag from a steep rise in interest rates; on the other, the boost to activity from less expensive energy and an improving supply-side picture. On balance, we think the latter should win out, meaning the economy avoids a recession. But a period of only mediocre growth is in prospect. That the economy looks to have been more resilient than hoped in the first half of this year means we've nudged forecast GDP growth in 2023 up to 0.4% from 0.2% expected three months ago. But the lagged impact of higher interest rates is predicted to hold back growth in 2024 to 0.8% from 1.9% previously.
- Based on wholesale spot gas prices, 2022's energy price shock has entirely reversed. The fall in gas futures prices, which influence the Ofgem energy price cap, has not been so dramatic, but enough to deliver a near-20% fall in the typical household bill in July, with another drop in bills likely in October. There's also been better news on labour supply, which shrank during the pandemic, threatening the economy's capacity to grow. Falling inactivity and high migration have contributed to the workforce recovering increasingly strongly over the last 12 months.
- But monetary policy has continued to be tightened, with the rise in interest rates over the current hiking cycle the biggest since 1989. Given the BoE's focus on backwards-looking data and its sensitivity towards criticisms that past policy was too loose, further hikes are likely to come. As things stand, mortgage holders, in the aggregate, could face paying an extra £60bn or so in interest payments each year, cutting disposable income and spending power. Higher rates will also weigh on business investment. While the damage will be mitigated by a significant increase in savers' interest income, the net effect on spending in the economy is still likely to be negative.
- But the extent of the monetary squeeze already working its way through the economy and the growing weight of disinflationary forces mean that we think current market expectations for Bank Rate to rise to around 6% are too aggressive. Lower energy bills and leading indicators, from producer prices to money supply growth, still point to a sharp slowdown in inflation over the second half of 2023 and into next year, cutting the UK's inflation differential with other countries. Falling inflation expectations, strong growth in labour supply and an easing demand for workers should weigh on pay growth and core price pressures.
- We think this should give the BoE leeway to pause rate hikes after one or two further increases and start cutting rates from the second half of 2024, easing the pain for borrowers. And while past (and prospective) rises in borrowing costs will cause undoubted hardship to some, the share of households directly affected is modest. Moreover, private sector balance sheets are unusually healthy. Debt burdens are much lower than the last time interest rates rose on a sustained basis, and liquid assets of households and firms relative to bank debt are both close to record highs. And it appears that the blow to household finances from mortgages being refinanced at higher rates is already being cushioned by a lengthening of mortgage terms and moves to interest-only home loans.
- The big risk is that structural peculiarities mean the UK turns out to be the exception to the rule of fast-falling inflation across advanced economies. Or, if it isn't, the BoE fails to appreciate that quickly enough. In either world, interest rates could continue to ratchet up to a level where even with the protection offered by robust household and corporate balance sheets, the economy falls into recession. On that count, the next few months, and what they tell us about how sticky inflation and strong pay growth are, will be key.



1 Introduction

The backdrop to the latest EY ITEM Club forecast for the UK economy is a mix of the good and the bad. On the positive side, fears that last year's energy price shock would trigger a recession have faded. Indeed, after the economy expanded modestly in Q1 2023, it looks like GDP rose again in Q2, despite drags from industrial action and the extra public holiday for the Coronation. A dramatic fall in wholesale energy prices has helped, but other supply-side problems have also lessened. Global supply chains have returned to normal following COVID-19-related disruption, and declining inactivity and high migration mean the workforce has virtually regained its pre-pandemic size. But as the threat from one set of problems recedes, the danger posed by another – a major rise in interest rates in response to high inflation – is growing.

Although headline inflation has fallen back since the recent peak last autumn, the decline has generally been less rapid than we, and forecasters, in general, had expected. And core inflation, which strips out the direct impact of movements in volatile energy and food prices, has been heading in the wrong direction for much of this year, reaching a record high in May, although falling the following month.

The Bank of England (BoE) has responded by raising interest rates aggressively. Bank Rate now stands at 5%, a 15-year high, up from only 0.1% in late 2021. This represents the sharpest tightening in monetary policy since 1989. The scale of interest rate hikes means financial pain for households with mortgages, as well as increasing debt servicing costs for unsecured and corporate borrowers and holding back investment. While higher rates are boosting savers' disposable incomes, the net effect on spending is still likely to be negative. And concerns around the persistence of inflation mean the rate rise cycle has probably not reached a peak.

But there's nothing inevitable about sticky inflation, as unexpectedly rapid declines in price pressures in some of the UK's peers and June's downside UK inflation surprise demonstrate. And we're not capitulating in our view that inflation will become less and less of a problem over the second half of this year. Falling wholesale energy prices have started to feed into lower household gas and electricity bills. With energy an input, directly or indirectly, into every form of economic activity, less expensive energy should bear down on both headline and, with a lag, core inflation. Pipeline price pressures have started to fall in absolute terms and growth in the money supply has decelerated sharply. And inflation expectations are falling, which, combined with higher labour supply and weaker demand from a sluggish economy, should bring pay growth down.

As a result, we don't think it will be necessary for the BoE to engineer a recession to resolve the UK's inflation problem. That said, the likelihood of higher-for-longer interest rates means the outlook for the economy has, on balance, deteriorated compared with our last forecast in the spring. That deterioration isn't so noticeable this year. In fact, that activity in Q2 looks to have been less weak than we'd expected, plus a healthier-looking supply side means we've nudged up our 2023 growth forecast to 0.4% from 0.2% in the spring ITEM outlook.

But as the lagged effect of higher borrowing costs builds, and the timing of rate cuts is pushed back, we've cut forecast growth in 2024 to 0.8% from 1.9%. With spending by households and firms gaining from less expensive energy, falling interest rates and investment incentives, but borrowing costs still higher than we'd previously expected, growth is forecast at 1.7% in 2025, down from around 2% previously.

Our latest forecast report begins with a discussion of recent economic developments. Section 3 sets out the key elements of our new forecast. Section 4 looks at what's been keeping UK inflation high and why we still expect it to fall back. Section 5 considers the economic impact of higher interest rates. Section 6 concludes.

2

The economy has avoided a contraction, but only just

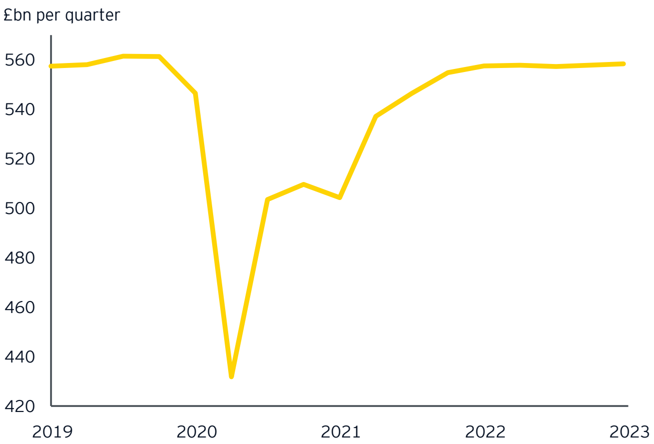
The economy grew slightly in Q1, with a mixed performance from the spending components

GDP eked out a 0.1% quarter-on-quarter (q/q) rise in Q1 2023. This left the economy only 0.3% larger than the same period a year earlier and still 0.5% smaller than its pre-COVID-19 size in Q4 2019.

Consumer spending stagnated in Q1 after a small rise in Q4 2022. But given the extent to which spending power was squeezed by high inflation, a flat performance was still suggestive of resilience on the part of consumers. Continued government support for energy bills will have helped. Although the income breakdown for Q1 showed real household incomes falling 0.7% q/q, that gave back only some of the strong 1.3% gain in the previous quarter. As a result, the household saving ratio edged down to 8.7% in Q1 from 9.3% three months earlier. This was still above the pre-COVID-19 norm (the saving ratio averaged 6% from 2015-19), implying that, on some measures, households retain the excess savings accumulated during the pandemic.

Elsewhere, there was once more significant volatility in the trade data due to flows of non-monetary gold, whilst a solid pickup in investment offset a large fall in government consumption. Within the investment heading, business investment rose 3.3%, a five-quarter high, probably aided by companies taking advantage of the super-deduction tax incentive before it expired at the start of April.

UK: GDP



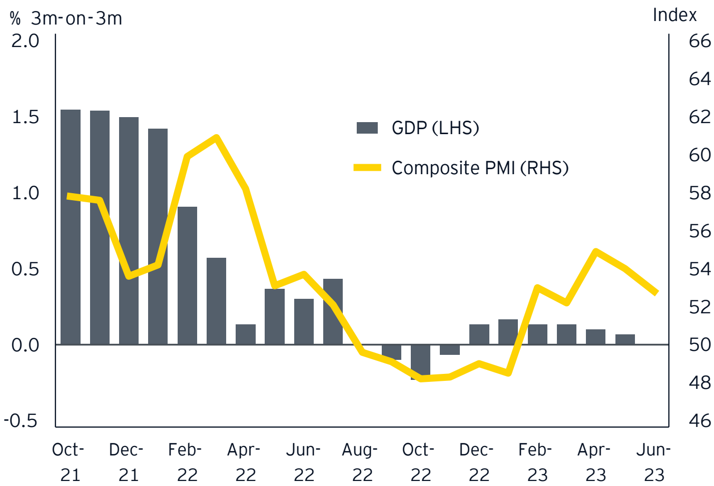
Source: EY ITEM Club/Haver Analytics

Growth looks to have continued in Q2, despite strikes and an additional public holiday

The economy's performance in Q2 was depressed by continued industrial action in some sectors and the extra bank holiday for the Coronation in May. But it looks like GDP still expanded. Output rose 0.2% month-on-month in April, and while GDP fell in May, reflecting the impact of one fewer working day than normal, a 0.1% drop was smaller than the consensus had expected. And other data has tended to surprise to the upside. Retail sales volumes rose in May and June, leaving quarterly growth in Q2 at 0.4%, the highest in two years. A further recovery in consumer confidence likely helped here – the GfK measure rose to a 17-month high in June (albeit slipping back the following month).

Elsewhere, the monthly CIPS/S&P Global activity surveys signalled growth in private sector activity over Q2. The composite PMI averaged 53.9, comfortably above the 50 'no-change' mark and a four-quarter high. And according to the ONS' Business Insights and Conditions Survey, while 67% of firms surveyed in June reported some form of concern for their business, this was the lowest share since March 2022.

UK: GDP versus composite PMI



Source: EY ITEM Club & S&P Global/CIPS

Evidence of continued momentum was despite the economy receiving less support than hoped from falling inflation. For sure, CPI inflation of 7.9% in June was down from a peak of 11.1% last October. But the fall has been smaller than in many other advanced economies. Moreover, both core and services inflation (the latter often cited by the BoE as a proxy for domestically generated inflation) have proved unexpectedly 'sticky', if moving in the right direction in the latest data.

One area of activity that has not shared in signs of growth observed in the wider economy is the housing market. What had appeared to be a tentative recovery earlier this year has petered out, with the latest numbers for mortgage lending and housing transactions suggesting that higher interest rates are taking a growing toll on activity.

Net mortgage advances were negative in both April and May (i.e., mortgagors paid back more money than they borrowed), a very rare occurrence, and mortgage approvals (a driver of future lending) in recent months have been around a quarter down on 2022 levels. That said, house prices appear to be holding up unexpectedly well. True, an average of the Nationwide and Halifax measures fell in June for the fourth month in a row. But the decline from the peak last summer has been restricted to only 2.5%–4%, depending on the measure used, eroding only a small part of the near-25% rise in values between the start of 2020 and mid-2022.

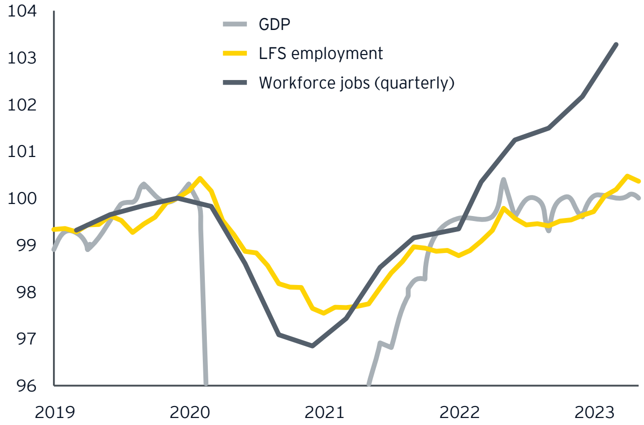
Concerns about a weakening labour market have eased

An economy expanding, but at a snail's pace, according to the official data, has been hard to square with a very strong jobs market. Employment on the Labour Force Survey (LFS) measure rose 250,000 in the three months to April on the previous three-month period, the biggest rise in almost a year. This finally took the number in work (33.1mn) above the pre-COVID-19 level in early 2020 and to a new record high. Employment gained 105,000 in the three months to May. The ONS' workforce jobs survey, which measures the number of jobs in the economy, rather than the LFS's number of people in work, has pointed to the economy enjoying a veritable jobs boom – workforce jobs rose by an unprecedented 395,000 in Q1 to a new record high of 36.8m. This suggests one (or a combination) of two things – either the survey data is misleading, perhaps because of a fall in response rates, or the GDP data is understating the economy's true strength.

Higher employment has been accompanied by a further drop in inactivity. The single-month 16-64 inactivity rate fell to 20.3% in May, close to a record low. This added to previous falls – the net flow of people out of economic inactivity between Q4 2022 and Q1 2023 was the highest on record. Falling inactivity contributed to the workforce in the three months to May growing at close to the fastest pace year on year (y/y) since mid-2016. More people in work, but a bigger workforce pushed the LFS unemployment rate up to 4%, 0.2ppts higher than the previous quarter but still low by past standards.

UK: GDP, employment and jobs

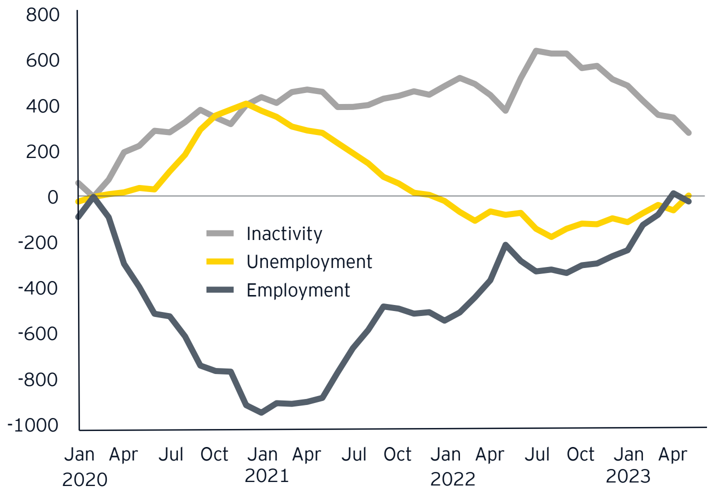
Dec 2019/Q4 2019 = 100



Source: EY ITEM Club/Haver Analytics

UK: Labour market indicators

Change in level since February 2020, '000s



Source: EY ITEM Club/Haver Analytics

Granted, the number of people who reported being unable to work because of long-term sickness has continued to rise, hovering around a record high of 2.5mn in the three months to May. This was almost a quarter above the Q4 2019 level. But other categories of inactivity have declined, particularly among older age groups. Overall, as of the three months to May, inactivity among those aged 16–64 was 360,000 lower than the recent peak in summer 2022, although still 280,000 higher than at the start of 2020.

Lower inactivity and a rise in the jobless rate weren't the only indicator suggesting that the labour market may be loosening around the edges. Job vacancies continued to decline over the late spring, falling to the lowest level since summer 2021. This pushed up the ratio of unemployed to vacancies to the highest in 21 months. However, vacancies were still above 1mn (a level that had never been reached before 2021) in the latest data, and the ratio of unemployed to vacancies has stayed low by historical standards.

Signs of loosening in the jobs market haven't been accompanied by less-heated pay growth. Regular pay (excluding bonuses) rose 7.3% y/y in the March to May period, a joint record high. Growth in private sector regular pay also accelerated, reaching 7.7%, another record (excluding the pandemic period). The pickup partly reflected the impact of the near-10% rise in the National Living Wage in April (which will continue to bolster y/y pay growth until April 2024) and the conclusion of several public-sector pay deals, although a breakdown of pay by industry showed growth strongest in relatively high-earning sectors, such as professional services and information and communications.

However, there have been some countervailing signs of softening pay growth. The KPMG/REC survey measure of pay for new permanent hires, which has historically led growth in the official measure by around a year, showed pay rises in June at the slowest since April 2021. And some of the BoE's regional agents have reported that pay settlements in the second half of this year could be lower than in the first half, largely due to lower near-term inflation expectations, with a looser labour market also expected to play a role.

The BoE has reacted aggressively to stubborn inflation

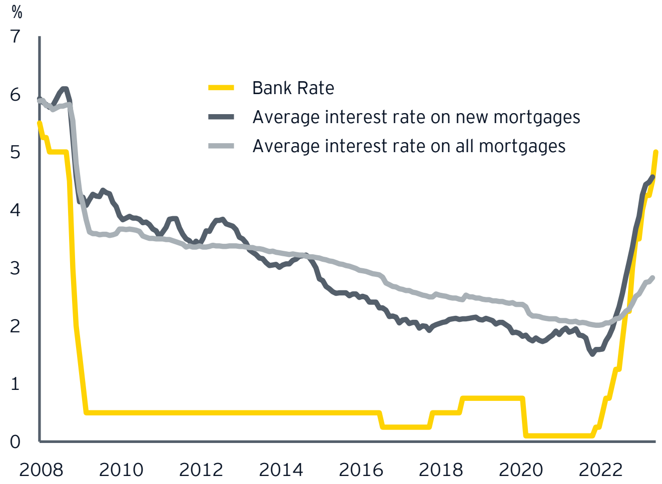
The last three months have seen no let-up in the cycle of interest rate rises that began in December 2021. The MPC voted to increase Bank Rate by 25bps in its May meeting. The committee then took the scale of rate hikes a step further in June, raising rates by 50bps to 5%, the highest since September 2008.

May's surprise inflation release, which showed no change in headline inflation and rises in core and services inflation, plus stronger-than-expected pay growth and robust demand for workers, meant June's jumbo increase did not come as too much of a surprise. And June's policy statement repeated the message from recent meetings that additional evidence of inflation persistence would require further monetary tightening.

There were hints that the MPC thinks there's still more to do. June's policy statement argued that 'second-round' effects from high inflation to domestic price and wage setting were likely to be more persistent. And while the MPC paid lip service to concerns about the impact of high-interest rates on borrowers and the rental market, it implied that these were a secondary consideration to the objective of getting inflation down.

Rises in Bank Rate and market expectations of more hikes to come mean the previous fall in quoted mortgage rates that followed a calming of mini-budget-related market turmoil has reversed. The average effective interest rate on all new mortgages reached 4.57% in May, the highest in over 13 years.

UK: Mortgage interest rates



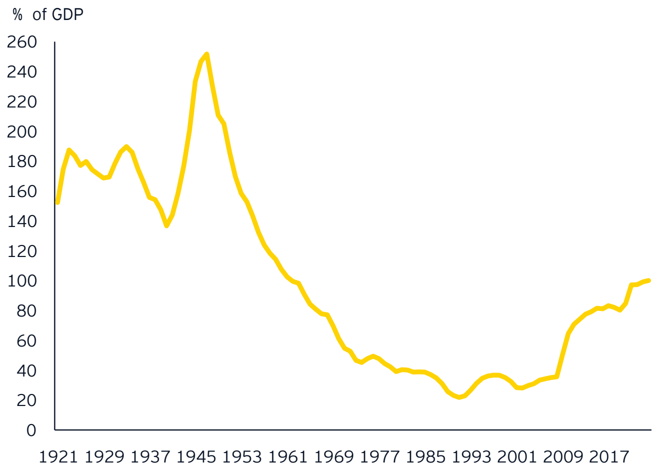
Source: EY ITEM Club/Haver Analytics

Quoted mortgage rates rose in May for the first time since last December and increased further the following month. The average rate on a two-year fixed 75% loan-to-value (LTV) mortgage jumped to 5.5%, 290bps higher than 12 months earlier. The average rate on a five-year fix with the same LTV reached 4.95%, up 233bps on June 2022.

Government borrowing has remained high, pushed up by the cost of energy support and high inflation

The latest public sector borrowing numbers have shown the deficit higher year-on-year, but lower than the OBR was expecting. Borrowing in the first three months of 2023-24 was £54.4bn, £12.2bn more than the same period in 2022, but £7.5bn less than the OBR's projection.

UK: Public sector net debt



Source: EY ITEM Club/Haver Analytics

The year-on-year overshoot has largely been a function of stronger-than-expected growth in spending, reflecting the cost of energy support schemes, the impact of high inflation on debt interest payments, and increasing staff costs following the recent NHS pay settlement.

June's public finances data also showed public sector net debt stood at 100.8% of GDP, remaining above 100% of GDP for only the second month since the early 1960s.

3

Higher rates will weigh on growth, but positives mean recession fears are overdone

2023 growth upgraded, but rate rises mean we've cut our 2024 forecast

Q2's activity surveys, alongside the hard economic data available, lead us to think GDP grew 0.1% in the second quarter, repeating Q1's performance. But that activity in the first half of the year was held back by industrial action implies that the GDP data likely understates the underlying strength of the economy.

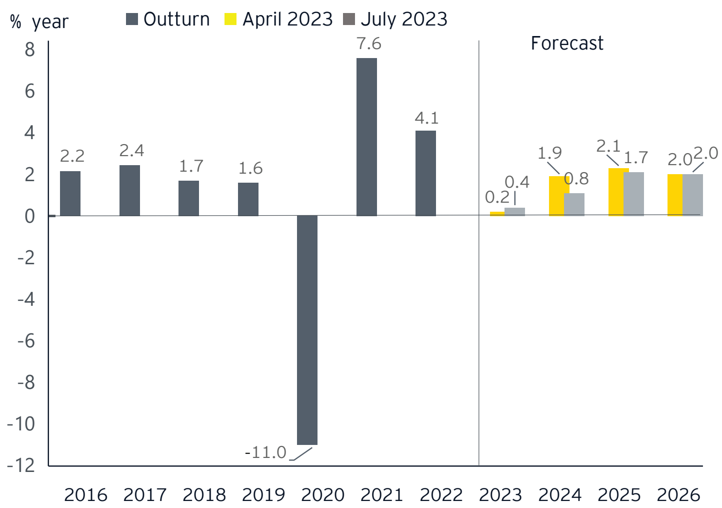
With Q2's extra bank holiday effect reversing in Q3, some industrial disputes hopefully being resolved and households benefiting from a cut in energy bills, the economy should continue to expand over the summer. However, stickier-than-expected inflation means that pressure on spending power from price rises is likely to ease less quickly than we'd hoped three months ago. As section 3 explores, we still think inflation will fall meaningfully over the second half of 2023, as the effect of last year's energy price shock on headline and core inflation fades and falling inflation expectations, weaker labour demand and stronger supply cause wage growth to slow.

But the CPI measure of inflation is now forecast to end 2023 at close to 5%, compared with the 3% anticipated in the spring. As a result, real household income growth this year will be weaker than hoped. And stubborn price pressures mean monetary policy has been tightened by more than we'd anticipated. With the BoE getting ahead of market expectations with May's 50bps hike in Bank Rate and the effect of previous policy tightening still to come through fully, it's not implausible that rates have peaked. But the BoE may need more time before it is comfortable switching its focus away from backwards-looking data and chasing 'credibility' to an improving inflation outlook. We've therefore assumed two further 25bps rises in Bank Rate, one in August and a second in September.

It follows that the outlook will be predominately shaped by a face-off between falling energy bills and inflation versus the lagged effect of the major rise in interest rates since late 2021 (with perhaps more to come on that front). Given the better-than-expected first half of 2023 and a healthier-looking supply side, we've modestly raised forecast growth this year to 0.4% from 0.2%. But with the run of recent and prospective rate hikes set to have most of their impact in 2024, we've cut forecast growth next year to 0.8% from 1.9%.

That said, we do not see a recession (two consecutive quarters of falling GDP) either this year or next. Falling inflation should give the BoE leeway to start cutting rates next year, reducing the pain from high borrowing costs, as well as restricting the full blow of the peak in mortgage rates to a relatively small share of households. And as Section 4 explains, several factors mean the scale of monetary policy tightening over the last 18 months shouldn't be as economically damaging as in the past.

UK: GDP



Source: EY ITEM Club/Haver Analytics

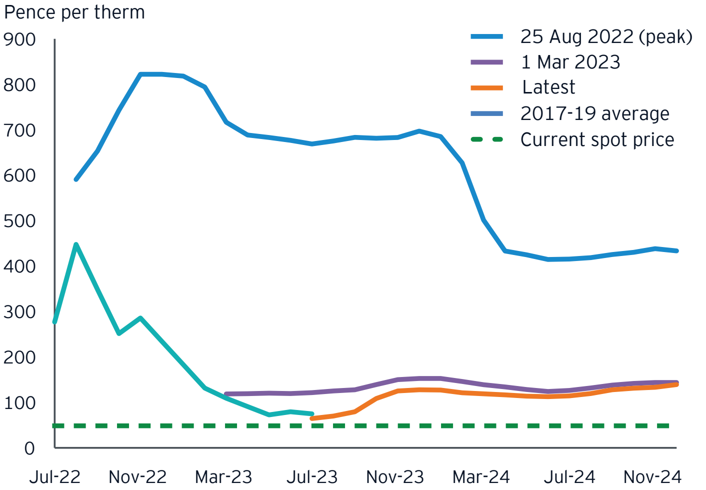
Moreover, the reversal of last year's energy price shock presents a powerful counter to the headwind of higher interest rates. Lower energy bills will boost disposable incomes and consumer demand. On the supply side, a return to more 'normal' energy prices should support productivity by increasing the volume of goods and services it's profitable for firms to supply when the price of an important input falls. The economy's capacity to grow will also gain from the revival in workforce growth and support to business investment from the 100% expensing introduced earlier this year. While higher-than-expected interest rates will hold back activity, we think GDP growth should build to 1.7% in 2025.

Consumer spending faces a battle between less expensive energy and higher interest rates

Household disposable incomes in late 2022 and early 2023 were more buoyant than we expected, boosted by strong growth in cash wages and the increase in benefits that occurred in April. And July's fall in energy bills, reflecting previous drops in wholesale prices, offers another prop to discretionary spending. The Ofgem price cap fell to £2,074 in July, reducing the typical household gas and electricity bill by £426, or 17%, compared with the level set under the previous Energy Price Guarantee (EPG). This was the first fall in bills in two years. A further decline in wholesale prices in recent months implies the Ofgem price cap will probably be reduced again in October when the cap is recalculated. This should leave bills at least £600 lower at the end of this year than 12 months earlier.[1]

Spot gas prices stood at 65–70 pence per therm in mid-July, down from a peak of over 600 pence per therm last August and close to the lowest in more than two years. Forward prices, which are more relevant for the Ofgem price cap, have also declined further. At the time of writing, prices for the delivery of gas over the rest of 2023 and 2024 averaged around 115 pence per therm, although this was still double the average price in the late 2010s. Oil prices have dropped slightly from three months ago, as have agricultural goods and metals.

UK: Gas spot price and futures curves



Source: EY ITEM Club/Haver Analytics

Meanwhile, consumer confidence has continued to revive, underpinned by falling petrol prices and better prospects for energy bills. The GfK sentiment measure rose to a 17-month high of -24 in June, with a particularly strong gain in households' confidence in their own personal financial prospects.

For sure, confidence remained low in absolute terms (the GfK index averaged -6 between 2015 and 2019). But signs of a revival in consumer spirits could make people more confident in drawing on the still-sizeable excess savings built up during the pandemic or making more use of unsecured borrowing. The job security provided by continued low unemployment should have a similar effect.

However, these positives face off against a much bigger squeeze on the finances of some households from higher interest rates (and the potential for further rate rises to come) than we anticipated in our last forecast. The second half of this year will see around 800,000 households come off fixed-term mortgages taken out when mortgage rates were much lower, and a further 1.2mn in 2024. That the proportion of mortgagors on fixed-rate deals has risen so much over the last decade or so means that the lag before higher rates start to bite has increased. But when that point comes, because the average mortgage is so much bigger now than in the past, the loss to disposable income of a 1% rise in interest rates is correspondingly greater. For example, the average mortgage advance in the three years to 2022 was equivalent to 7.3 times average wages, compared with a ratio of 6.5 in the three years to 2007.

Section 5 looks in more detail at the economic consequences of higher borrowing costs and factors that could mitigate the pain. In our view, the scale of recent rate rises will impose undoubted hardship on many households. But there are several qualifications to headlines about 'mortgage catastrophe'.

We expect unemployment to remain low, meaning the big driver of repossessions in past periods of rising rates should be avoided. Mortgage debt is concentrated among relatively high-income households, who also hold the bulk of pandemic-era savings, leaving this group relatively better placed to deal with higher mortgage costs. A smaller share of households has a mortgage than in the past. Households' balance sheets in the aggregate are relatively healthy, with debt burdens lower than in the mid-2000s and households' liquid assets much higher. And there is already evidence that a growing number of mortgagors are reducing the immediate pain of higher rates by extending the term of their home loans. As a result, we don't think that recent rate movements will push the consumer sector, or the wider economy, into recession when set against fading pressure from high energy prices.

That said, even after consumer spending is forecast to flatline this year, a slower recovery in real household incomes and the lagged impact of higher rates mean we've downgraded growth in consumer spending in 2024 to 0.6% from 1.8% previously. As pressure on real incomes from inflation diminishes and the BoE cuts rates back, consumer spending is forecast to rise by 1.7% in 2025.

1. Cornwall Insight estimates that latest wholesale prices mean the annual energy bill for a typical consumer should drop to £1,871 in October. See Dr Craig Lowrey, 'Average price cap forecasts fall as Ofgem revises definition of typical energy consumption', Cornwall Insight, 29 June 2023. https://www.cornwall-insight.com/press/average-price-cap-forecasts-fall-as-ofgem-revises-definition-of-typical-energy-consumption/

The BoE may not have finished rate hikes yet, but we think market predictions of Bank Rate at around 6% are too aggressive

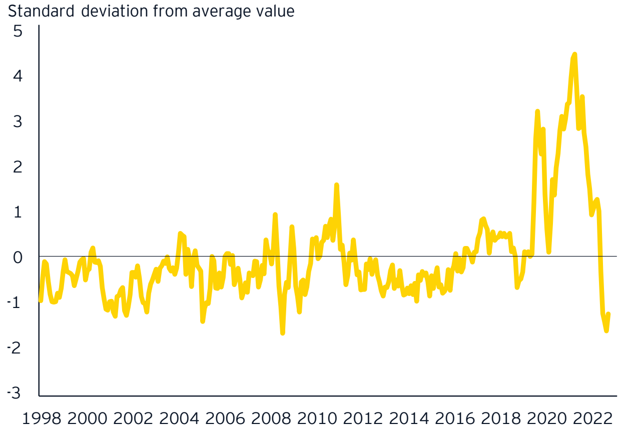
The cost of a fixed-rate mortgage depends on where the markets expect interest rates to be over the life of the fix. Investors are currently predicting a peak in Bank Rate of around 6% at the start of next year, implying an interest rate of close to 7% on a typical fixed-rate mortgage.

Growing disinflationary forces mean we think rates going to such a level would see the BoE flipping from one mistake in the recent past – keeping monetary policy excessively loose – to the opposite and tightening policy to an unnecessary degree. In practice, we're doubtful the BoE would make such a mistake.

That the 50bps rise in Bank Rate in June's MPC meeting got the committee ahead of market expectations (which had erred towards a 25bps rise) may give it leeway to skip what had been a widely expected further rate hike when the MPC meets next in August. The prospect of headline inflation coming down noticeably over the next few months would give further cover for a pause. Inflation in June was lower than the consensus had expected, and July's reading will be pushed down by a material fall in household energy bills, reflecting the cut in the Ofgem price cap.

However, it was noticeable that the MPC didn't use June's policy statement to push back against market expectations for where Bank Rate is headed. The implication is that criticism of the BoE's credibility has hit home. After all, as bad as the recent inflation numbers have been, they're now in the rear-view mirror.

Global: Supply Chain pressures



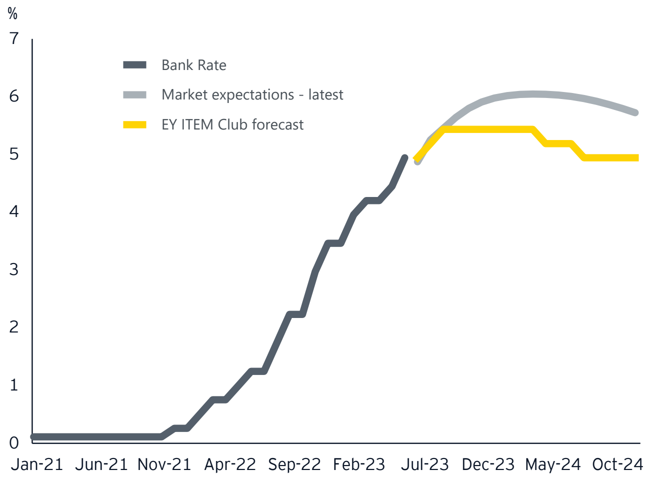
Source: EY ITEM Club/Federal Reserve Bank of New York

The supply shocks that struck the economy over the last few years and hampered the ability of GDP to grow without generating inflation are all receding. Aided by China's re-opening, measures of global supply chain pressures are now at their lowest in at least 25 years. As already noted, wholesale energy prices are below their levels immediately prior to Russia's invasion of Ukraine. And while the workforce is still meaningfully smaller than a continuation of the pre-COVID-19 trend would have implied, the direction of change over the last 12 months has been increasingly positive.

Relatedly, as Section 4 of this report explores, leading indicators for inflation are looking more benign – growth in pipeline price pressures in June turned negative for the first time since late 2020, inflation expectations among households and firms have continued to fall, energy bills declined by close to 20% in July, growth in the money supply has slowed to a crawl from double-digit rates in 2021, the balance between labour demand and supply has started to move in favour of the latter and the stronger pound will bear down on import prices. Moreover, the BoE's own estimate is that around two-thirds of the pain of past rises in interest rates is still to come.

These developments mean we think that inflation should fall fast in the second half of 2023 and into 2024, if not ending this year as low as we'd expected in our last forecast. And improving inflation prospects would ideally be the focus of a central bank setting a policy lever which doesn't have its full impact for 18 months to two years into the future.

UK: Forecasts for Bank Rate



Source: EY ITEM Club/Haver Analytics

But the extent of the BoE's recent forecast errors, communication missteps and, arguably, policy mistakes during the pandemic mean the committee appears to think that it doesn't yet have the luxury of focusing on what's to come, rather than what has passed. As a result, we expect a further 25bps rise when the MPC meets next in August and another hike in September. Beyond that, disinflationary forces (including from higher interest rates themselves) will be becoming ever more apparent, as will the economic damage of tight monetary policy. It will be increasingly hard for the MPC to argue that policy should be set to guard against upside risks. Consequently, we think Bank Rate at 5.5% should prove the peak, and the rates will start to be cut from the second half of 2024.

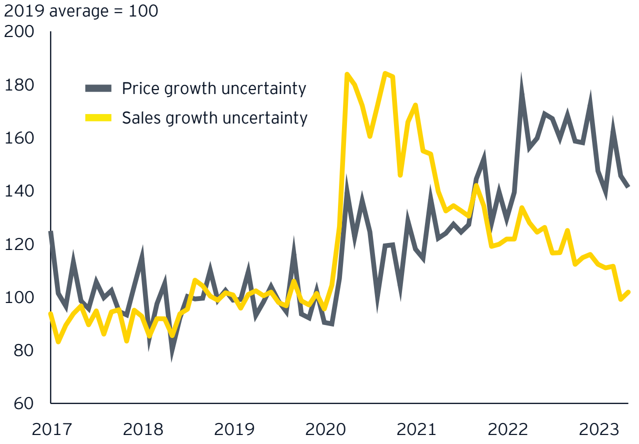
Business investment faces obstacles from higher rates but should gain from cheaper energy and 100% expensing

As Section 4 outlines, the UK corporate sector's aggregate financial position leaves it in a better position to cope with higher interest rates than in the mid-2000s, the last time rates rose on a sustained basis. As of the start of this year, corporate bank debt relative to GDP was close to the lowest in at least 25 years, and companies' liquidity (bank deposits relative to bank debt) was near a record high.

But increased borrowing costs mean firms with debt will have fewer resources to finance investment. As of May, the average interest rate on new floating rate corporate loans was 6.37%, almost 370bps higher than 12 months earlier. Rates on fixed-rate loans were up 249bps. Higher interest rates will increase the hurdle rate that investment projects need to pass to be economically viable. These developments are likely to hold back the recovery in business investment, which while sluggish, has started to run ahead of overall GDP. As of Q1 2023, business investment was 1.1% above the level in Q4 2019, while GDP was 0.5% lower.

But corporates' appetite to invest also enjoys some positives. Full-expensing capital allowances, which allow firms to reduce their taxable profits by 100% of the cost of their investments in plant and machinery, are now in play. Lower energy prices will directly reduce energy costs for businesses and may indirectly reduce other input costs along the supply chain, freeing up resources. Less expensive energy should also increase the productivity of capital equipment by allowing fixed assets to be used more efficiently.

UK: Firms' uncertainty about sales and price growth



Source: EY ITEM Club/Bank of England

Lower energy prices also appear to be reducing uncertainty, a move which should be a positive for investment. According to the BoE's Decision Maker Panel (DMP) survey of corporate CFOs, more than a quarter of firms reported that their overall level of uncertainty was very high in October 2022. That had fallen to around 10% as of May, driven in part by declining uncertainty over prices.[2] Overall, and supported by a strong start to 2023, business investment is forecast to rise 1.8% this year and 1.6% in 2024, before growth picks up to 4.3% in 2025.

Tighter monetary policy abroad points to sluggish growth in the UK's main export markets

The global economic outlook is looking a little better than we expected three months ago. In particular, the most serious risks of a substantial tightening in lending standards and contraction in credit from banking sector turmoil over the spring have failed to materialise.

Among the UK's major trading partners, the US economy looks to have enjoyed solid growth in Q2, with activity benefiting from strong income growth amid persistent labour shortages and households' willingness to spend their excess savings. However, the eurozone has fallen into a mild technical recession. GDP shrank 0.1% q/q in Q1, following the same-sized drop in the previous quarter. And the PMIs and other activity surveys point to activity having stalled in Q2.

Falling inflation in the US and eurozone and tight labour markets in both economies mean real disposable incomes should put in a better performance, supporting demand for imports, including from the UK. However, the impact of cumulative rate hikes by the Fed (a rise of 500bps since early 2022) and ECB (up 400bps in less than a year), tighter lending conditions and high inflation suggest that growth will slow in the US and remain sluggish in the eurozone this year.

2. Bank of England, 'Monthly Decision Maker Panel data – June 2023'. https://www.bankofengland.co.uk/decision-maker-panel/2023/june-2023

Persistent inflation and higher-for-longer interest rates are the biggest risks to the forecast

The key risk to our latest forecast revolves around the outlook for inflation and interest rates. Inflation could prove more stubborn than we expect. After a long period when the 'Phillips Curve' relationship between inflation and unemployment appeared to have broken down, workers' greater awareness of the effect of inflation on their real incomes and a revival of labour militancy could see that relationship re-established, keeping pay growth strong.

In this world, the BoE may have to engineer a significant rise in unemployment and, correspondingly, a much weaker economy if it were determined to get inflation back down to the 2% target. The ITEM model suggests that every 25bps on Bank Rate reduces GDP growth by 0.1%–0.2% after 18 months or so, a similar sensitivity to the BoE model.[3] So it's not stretching credibility to see how more aggressive-than-expected action on the part of the BoE could potentially push the economy into recession next year. This risk could crystalise even if the inflation outlook improves as we expect, were the BoE to set policy with an excessive focus on noisy incoming data, ratifying elevated market expectations and restoring credibility.

A second risk revolves around energy prices and their interplay with the war in Ukraine. The timing of any end to the conflict remains very uncertain, and tensions between Russia and the West, and sanctions, could persist long after any resolution. 2022-23's unseasonably mild winter in Europe and successful efforts to broaden energy supply sources have significantly reduced the risk of energy shortages or spikes in prices in the coming winter. But a colder-than-usual 2023–24 winter and the cut-off of remaining Russian pipeline flows would push prices up and keep inflation higher for longer.

A third risk, but one which would imply a better outlook for the economy, is that we're underestimating the extent to which activity and inflation will be affected favourably by the reversal of the three-fold supply shock of the last few years (disruption to global supply chains from COVID-19 lockdowns, rocketing energy prices last year and the decline in the size of the UK workforce in 2020 and 2021). Hindsight may suggest that forecasters should have been more circumspect in attaching permanent consequences to what may prove to have been temporary impediments.

The EY ITEM Club forecast for the UK economy, Summer 2023

% change on previous year except borrowing, current account and interest and exchange rates

	GDP	Domestic demand	Consumer spending	Fixed investment	Exports	Imports
2020	-11.0	-12.3	-13.2	-10.5	-12.1	-16.0
2021	7.6	8.8	6.2	6.1	2.2	6.2
2022	4.1	4.4	5.6	8.6	9.9	13.3
2023	0.4	-0.4	0.0	1.1	-1.4	-3.7
2024	0.8	1.2	0.6	0.6	2.1	3.1
2025	1.7	1.8	1.7	2.4	2.1	2.3
2026	2.0	2.1	2.0	2.6	2.0	2.2
	Net Govt Borrowing(*)	**Current account (% of GDP)**	**Average earnings**	**CPI**	**Bank Rate**	**Effective exchange rate**
2020	14.5	-3.1	1.7	0.9	0.2	78.0
2021	5.6	-1.5	5.8	2.6	0.1	81.4
2022	5.6	-3.8	6.3	9.1	1.5	79.6
2023	5.1	-1.9	5.8	7.6	4.8	79.2
2024	3.2	-1.9	3.1	3.4	5.0	80.2
2025	2.8	-2.1	2.6	1.7	3.7	80.5
2026	2.2	-2.2	2.9	2.0	3.5	81.4

Source: EY ITEM Club

* Fiscal years, as % of GDP

3. See James Cloyne & Patrick Hürtgen, 2014. "The macroeconomic effects of monetary policy: a new measure for the United Kingdom", Bank of England working papers 493, Bank of England. https://ideas.repec.org/p/boe/boeewp/0493.html

4

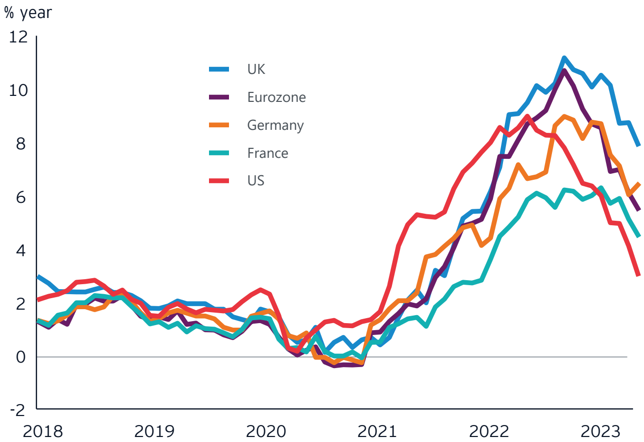
Inflation has proved sticky, but is still likely to fall sharply

A better-than-expected performance from the economy over recent quarters means the UK is now looking less of an outlier among its international peers when it comes to GDP growth. But one area where it's standing further out from the herd is inflation, and not in a good way. As of June, CPI inflation was 7.9% in the UK, higher than in every other G7 economy (where inflation ranged from 6.4% in Germany and Italy to 3.1% in the US). The fall from last autumn's peak has also been modest compared with many other major economies. But we still think inflation is likely to drop quickly and that the coming months will see the gap with other countries narrow.

Energy bills have risen far more in the UK than elsewhere, but this differential should now narrow

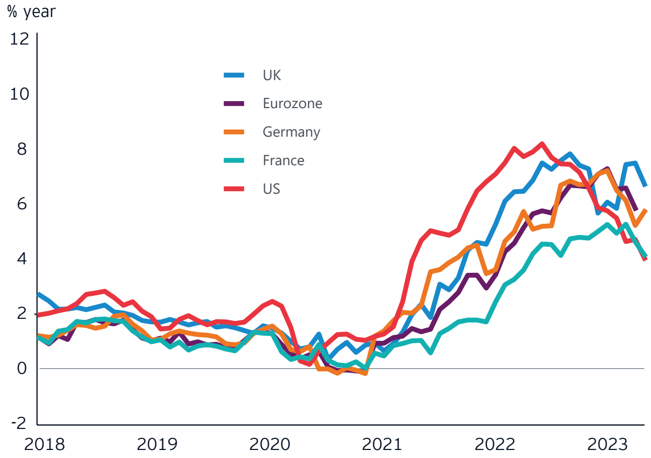
The biggest factor keeping UK inflation high, both in absolute terms and relative to other major economies, has been energy bills. As of June 2023, the retail price of gas and electricity was 110% higher in the UK compared with January 2020, versus rises of 50% in the eurozone and only 25% in the US. Expensive energy has pushed up headline inflation directly and has likely played an important indirect role in increasing core inflation, given every economic activity uses energy. Excluding energy bills, the UK's relative inflation performance looks better, with UK inflation below that in the eurozone in the early part of this year and lower or in line with US inflation during 2021 and 2022.

CPI inflation



Source: EY ITEM Club/Haver Analytics

CPI inflation excluding direct contribution of energy bills



Source: EY ITEM Club/Haver Analytics

The comparative scale of the rise in UK energy bills is striking. The difference from the US reflects the absence of a global market for gas. US energy production has increased significantly but without a consummate rise in the capacity to export. As a result, higher domestic supply has kept prices down. Differences in energy bill rises between the UK and the eurozone come down largely to different approaches to supporting households and firms, between capping bills versus providing cash support to households. The UK approach in the form of the EPG was relatively lumpy, and it's the timing of that lumpiness that offers hope that headline UK inflation should increasingly converge with its peers in the second half of this year.

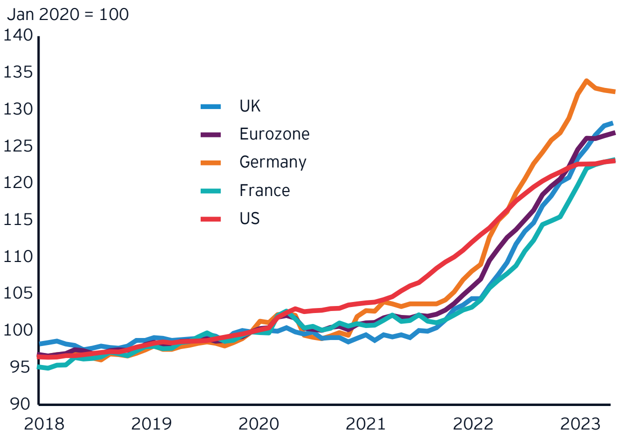
As Section 3 discussed, falls in wholesale energy prices mean household bills have now reverted to being set by the Ofgem price cap. This resulted in the typical household bill dropping to £2,074 in July from the EPG's £2,500. Bills are likely to fall further in October when the Ofgem cap is recalculated. Consequently, the UK's energy inflation differential with other countries should diminish.

Food prices have also played an important role in high inflation, but prospects here are improving

Still, UK inflation has remained relatively high in the last few months, even when the direct impact of energy bills is stripped out. Food prices have played a role in this. Expensive energy, disruptions to Ukraine's supply of agricultural products to the global market and poor harvests drove up annual CPI inflation for food from 4% in January 2022 to a peak of 19.6% in March.

Food price inflation has since fallen back a little but was still a very high 17.4% in June. In comparison, food prices in the eurozone that month were up 12.6% y/y and by 5.7% in the US. Comparisons over a longer timeframe puts the UK in a somewhat better light. Comparing June 2023 with the start of 2020, rises in UK food prices have been very similar to price rises in the eurozone and below those in Germany.

Food prices



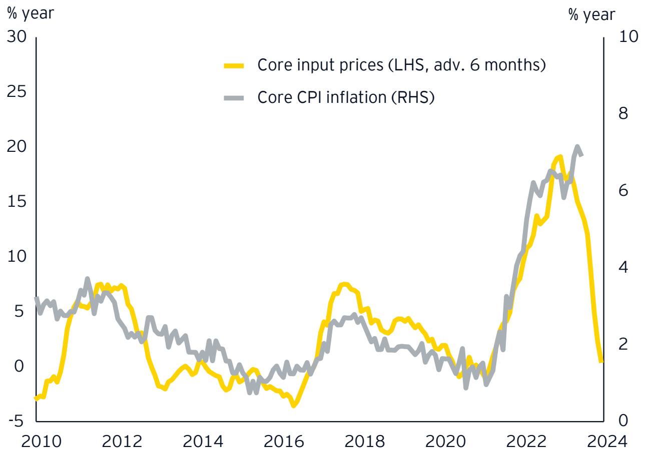
Source: EY ITEM Club/Haver Analytics

Just as with energy, the food inflation outlook is improving. Recent months have seen the rises in the price of inputs for food manufacturers slow significantly. As of June, food input prices were rising at an annual rate of close to 5%.

This was down from a peak of 22.9% in October 2022 and consistent, based on past form, with food price inflation slowing to around 5% by the end of this year. That shop prices are often based on contracts set three, six or even 12 months in advance means there could be a relatively long lag between movements in the price of raw foodstuffs and the price shoppers pay. But that the shop prices of some basic foods, such as bread, edible oils and milk, have now started to fall suggests those lags are working through.

The outlook for input costs, in general, is looking more favourable. Producers' input costs fell 2.8% in the year to June, down from a peak rise of almost 25% in mid-2022 and the first negative reading since November 2020. And growth in factory gate prices fell to a 30-month low of 0.1%. There have also been significant slowdowns in the core measures of these indicators, particularly core input price inflation, which fell in June to the lowest in almost three years.

UK: Core CPI inflation and core manufacturers input prices



Source: EY ITEM Club/Haver Analytics

Based on past form, core input price inflation leads core CPI inflation by around six months, implying that the latest slowdown in the former could see core inflation fall below 3% by early 2024.

Could pay growth frustrate a fall in inflation?

There are two main risks to the prospect of an improving inflation picture. One is a continuation of the recent strength of wage growth, with firms passing on higher wage costs to consumers via higher prices. That wages have played a key role in driving UK inflation higher isn't entirely convincing. Between the early 1990s and 2019 (later periods are distorted by the furlough scheme), the correlation between changes in average pay and inflation two quarters later was close to zero, suggesting that wages in that period were a coincident, not a causal, element of the inflationary process. To the extent that pay has played a role, the difficulty we face in predicting whether this source of persistence will continue is in explaining why earnings growth has been so strong, particularly in comparison with other major economies.

The reason frequently cited is that a rise in inactivity has cut the supply of workers. But while the workforce did shrink in 2020 and 2021, inactivity has been falling for most of the last year, and the latest inactivity rate for 16–64-year-olds was only 0.8ppts higher than the record low at the start of 2020 (21% versus 20.2%), relatively small beer. What's more, net migration into the UK has proved far higher than expected. The year to December 2022 saw a net inflow of 606,000 people, nearly double pre-COVID-19

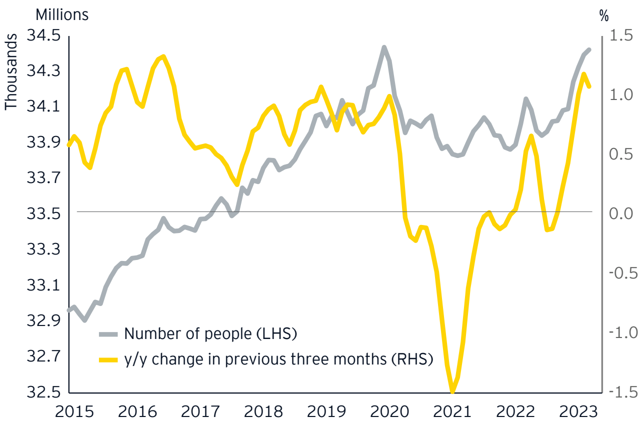
4. For example, services such as residential and care homes need electricity to provide lighting and warmth. And many of the consumption items that make up core inflation, such as clothing, durable household products and trips to the cinema, are highly reliant on energy.

levels, of which around a quarter was people coming to work, and their dependents. And the UK's inactivity rate is lower than in the US and many European economies.

A combination of falling inactivity and high inward migration meant the workforce in Q1 2023 was only 0.1% smaller than its peak pre-COVID-19 size in Q1 2020. What's more, y/y growth in the economically active population in the three months to April was the highest since mid-2016. This is feeding through into an easing in recruitment difficulties. The BoE's DMP survey for June showed the percentage of firms finding it 'much harder' to find staff down to 29% from 65% last summer.

A more convincing labour market explanation for strong pay growth is a counterfactual one. The workforce in Q1 was still around 2.5% smaller compared with a world where it had grown in line with the pre-pandemic trend (what the second chart below terms 'adjusted' labour supply). While the UK is not alone in seeing labour supply shrink relative to past norms, it does stand out in terms of the size of the shortfall. For example, as of Q1, adjusted labour supply was lower by 2.1% in Germany and 1.8% in the US but 0.1% higher in France.

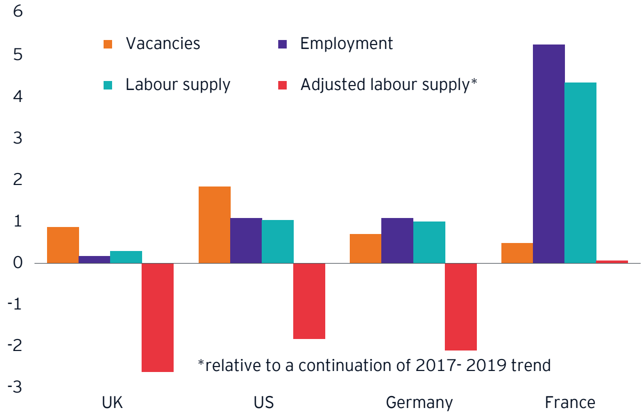
UK: Economically active population



Source: EY ITEM Club/Haver Analytics

Change in labour market indicators

Change between Q4 2019 and Q1 2023 as % of labour force



Source: EY ITEM Club/Haver Analytics

The recovery in workforce growth means the gap between actual and effective labour supply should shrink. At the same time as supply is growing, demand for workers is softening, as witnessed by falling vacancies, and job-to-job moves (which are typically accompanied by a pay rise) are now back to pre-pandemic levels, having spiked in 2021 and 2022. These moves offer one set of reasons for why we think pay growth should gradually moderate over the rest of this year and into 2024.

Another factor impacting this outlook is falling inflation expectations. The latest Bank of England/Ipsos quarterly Inflation Attitudes Survey showed inflation expectations for the year ahead at 3.5%, an 18-month low. Lower energy bills and falling petrol prices mean this trend should continue. As expectations and actual inflation come down, so should workers' pay demands and employers' willingness to pay more.

Evidence that 'greedflation' is holding inflation up is lacking

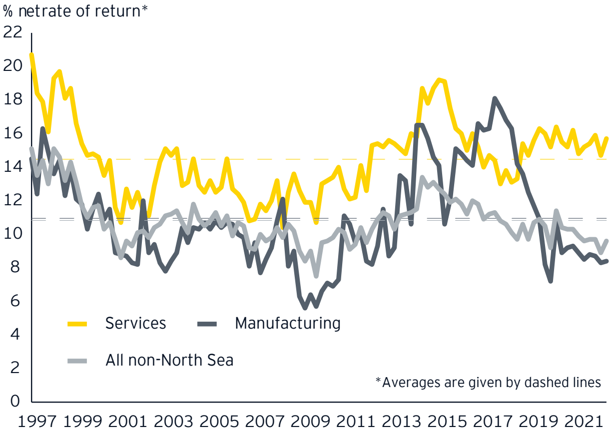
One thing that could stop falling input costs and reduced wage pressure translating into lower inflation would be margin increases at the retail stage of the supply chain. This relates to what some have termed greedflation – firms supposedly exploiting a narrative of 'unavoidable' increases in prices to expand margins.

Greedflation is a problematic concept. Greed is a constant, so isn't an obvious explanation why inflation should be so much higher now than in the past. And evidence that higher profit margins have pushed up prices is, so far, lacking. The net rate of return earned by all UK non-financial companies was 9.8% in Q4 2022, unchanged from the previous quarter and below the pre-COVID-19 norm (returns averaged 10.8% from 2015-19).

Excluding companies operating in the North Sea, whose profitability was hit by falling energy prices at the end of last year, net returns earned by UK companies did rise in Q4. But this still left returns below the long-run average. It's true that the share of profits in GDP jumped in Q4 2022 and again in Q1 2023 to the highest in almost three years. But this was due to government energy bill support being classified by the ONS as a subsidy to energy providers, adding to measured profits. It follows that the profit share likely fell in Q2.

A more nuanced version of the 'profit margins' argument is that the sensitivity of consumer demand to price rises has fallen because of the savings accumulated by households during the pandemic. This has left companies more willing to pass on the impact of higher input costs to consumers.

UK: Profitability of UK companies



Source: EY ITEM Club/Haver Analytics

Typically, if firms are compelled to put up prices significantly, consumer demand falls, the economy goes into recession and weaker demand causes inflationary pressures to drop back. But the strength of household balance sheets has put a spoke in the wheel of that process. But this theory also conflicts with evidence that profit margins are not unusual by past standards, even in sectors such as food, which have come under scrutiny for supposed price gouging.[5]

5

Higher interest rates will be painful for some, but there are mitigations

At the time of writing, markets were pricing in a further four 25bps hikes in Bank Rate, taking the policy rate to 6% by early 2024. We think this is too aggressive and that an improving outlook for inflation and the BoE factoring in the effect of past rate rises means Bank Rate will probably top out at a no more than 5.5% (implying rate hikes in August and September, followed by a pause).

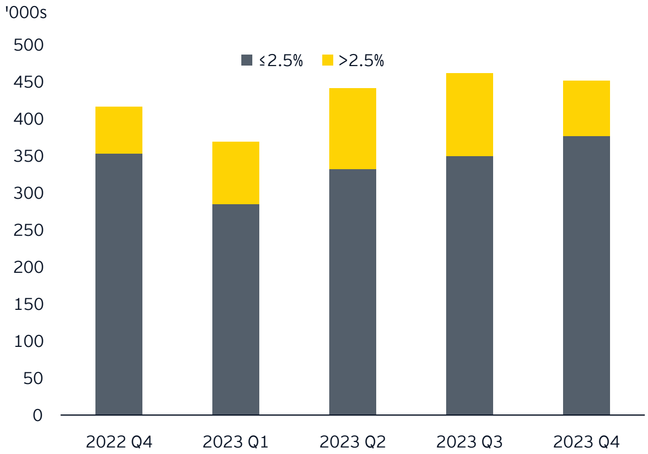
That said, with rates increasing from 0.1% in late 2021, a peak of 5.5% would still represent the biggest tightening in monetary policy over an equivalent period since 1989. Given this context, it's understandable that some are predicting a recurrence of the early 1990s recession as a result of the scale of rate increases. We're not so sure.

The average mortgagor rolling off a fixed-rate deal faces an extra £3,000+ in annual interest payments

According to the BoE, around a quarter of the outstanding stock of mortgages, equating to just over 2mn mortgages, have reached, or will reach the end of their fixed-rate term between 2022 Q4 and the end of 2023. Amongst this group, the median outstanding balance was around £130,000, with an average remaining term of around 20 years and an average interest rate of around 2.0%[6]. Annual interest payments would increase by just over £3,000 for the typical household if their fixed rate increased by 400bps (the rise implied by the latest data for fixed-rate mortgages).

This is a significant sum of money. In aggregate terms, households would ultimately be spending an additional £60bn per year or so in mortgage interest payments (taking the current £1.6tr stock of mortgage debt and assuming average mortgage rates ultimately increased by 400bps), equivalent to around 3.5% of gross disposable income.

UK: Outstanding mortgages expiring by the end of 2023



Source: EY ITEM Club/Bank of England

UK households have interest-bearing assets, and liabilities and balance sheets are in good shape

But there are several mitigations. First, UK households have interest-bearing assets, as well as liabilities. In 2022, households received £13bn in interest payments, when the average interest rate on interest-bearing sight deposits (around 60% of all household deposits) was 0.32% and on time deposits (40% of the total), 0.75% (implying a weighted average rate of 0.5%). As of April, the average sight deposit rate had increased to 1.4%, while time deposit rates averaged 2.45%, lifting the weighted average rate to 1.8%. Assuming the weighted deposit rate rises further to, say, 2.5%, higher interest payments would increase total disposable income by around £50bn. Allowing for this, the net impact of higher rates on overall household incomes (if not spending, given different propensities to consume among borrowers and savers) should be very small.

5. For an analysis of recent moves in corporate profitability, including among supermarkets, see 'Price and Monetary Policy Transmission in a Globalised Economy – speech by Swati Dhingra, external member of the Monetary Policy Committee, Manchester Metropolitan University, 13 June 2023. https://www.bankofengland.co.uk/-/media/boe/files/speech/2023/june/price-and-monetary-policy-transmission-globalised-economy-speech-by-swati-dhingra.pdf
6. See Bank of England, 'Monetary Policy Report', November 2022. https://www.bankofengland.co.uk/-/media/boe/files/monetary-policy-report/2022/november/monetary-policy-report-november-2022.pdf

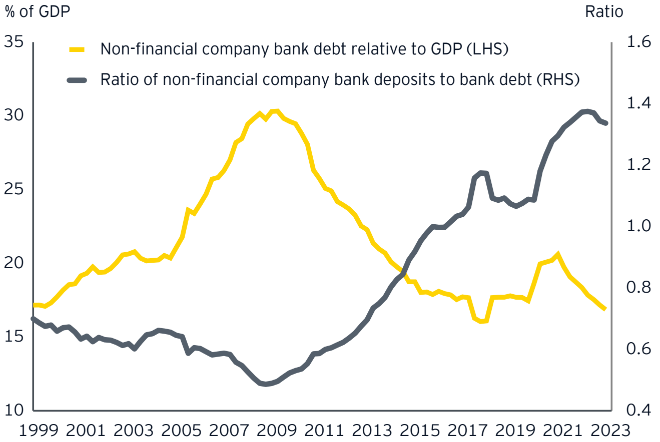
Second, the financial position of households and firms is unusually healthy, reflecting the deleveraging and high savings rates of recent years. The ratio of household debt to annualised income stood at 129% in Q1 2023, down from a peak of 155% in 2008. At the same time as debt burdens have fallen, households have accumulated significant assets in recent years, aided by the major unplanned savings built up during the pandemic.

In Q1 2023, households' liquid financial assets (currency, bank deposits, loans, and securities other than shares) were equivalent to 113% of annualised income, compared with a pre-pandemic (2015–19) average of 96%. Although house prices have slipped back since late 2022, the value of the UK housing stock has increased significantly in recent years. We estimate that net household wealth was the equivalent of around 7.5 times annual income in Q1 2023, up from just under 7.2 times in Q4 2019.

In aggregate, corporate balance sheets are also in good shape. Although firms borrowed heavily in the early stages of the pandemic, they've been deleveraging since late 2020, adding to the debt reduction which occurred during the 2010s. As of Q1 2023, sterling bank debt held by UK non-financial companies was equivalent to 18% of annualised GDP, the lowest in five years and down from around 30% of GDP in the mid-2000s.

And just like households, UK companies have accumulated substantial liquid assets over the last few years. As a result, corporate liquidity (measured by the ratio of non-financial companies' sterling bank deposits to their sterling bank debts) was close to a record high in April and more than double the ratio in the mid-2000s.

UK: Corporate debt and liquidity

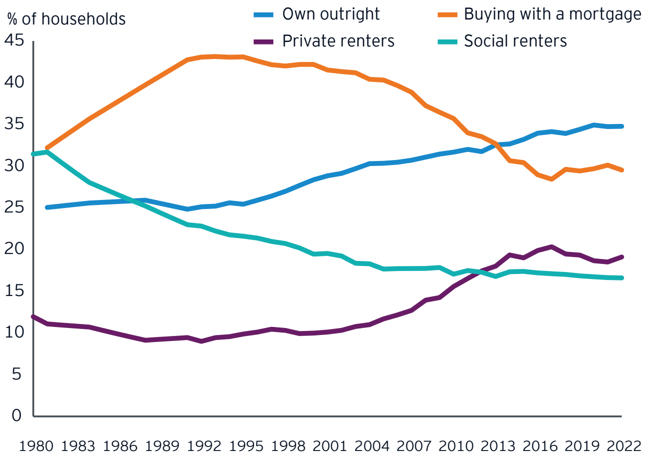


Source: EY ITEM Club/Haver Analytics

The distribution of mortgage debt also points to some resilience to higher rates

Granted, the distribution of debt and assets also matters. But here, there are further reasons to think the economy will prove more resilient to higher interest rates than some fear. As a result of the high deposits mortgage lenders have required in recent years, the number of first-time buyers has been low. This has contributed to the share of households with a mortgage (and so directly exposed to rising mortgage rates) falling from 40% in 2005 to 29.5% in 2021–22, close to the lowest since at least 1980. This is very different from the pre-financial crisis position of a historically high homeownership rate and many highly indebted first-time buyers. Moreover, households with mortgages generally have relatively high incomes.

UK: Housing by tenure



Source: EY ITEM Club/English Housing Survey

In 2021–22, only 14% of this group was in the bottom two income quintiles versus almost 70% in the top two quintiles. Households with mortgages are also likely to have savings compared with other forms of tenure, savings which should act as a buffer against the impact of higher mortgage payments. Then there's the case of 72.6% of mortgagors who had savings in 2021–22, compared with 51.9% of private renters and only 25.7% of social renters.[7]

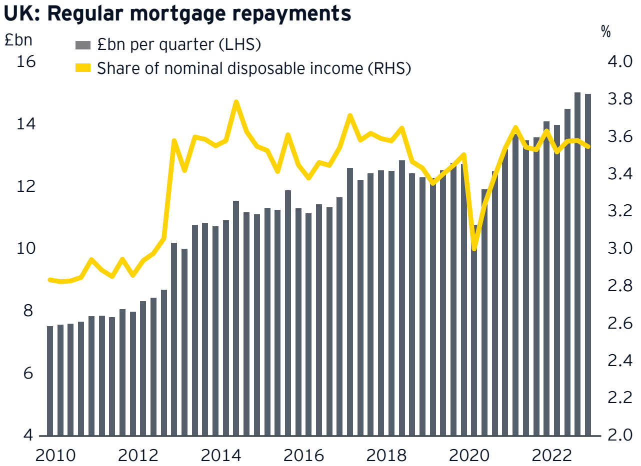
It's also the case that households' burden of servicing debt is rising from an unusually low level. Interest payments (including consumer credit) absorbed 4% of household income in Q1 2023. Although this was up from the record low of 3.4% in Q1 2022, it was still well below both the long-run (post-1987) average of 6.8% and almost 10% just before the financial crisis in early 2008. Relatedly, mortgage arrears (a sign of borrowers' financial stress) are still very low. Mortgages in arrears accounted for only 0.89% of total loan balances in Q1, up from 0.81% in Q4 2021. In comparison, the share of arrears stood at 2.1% at the start of 2007, the tail end of the pre-financial crisis expansion. Meanwhile, the ratio of corporate interest payments to profits was 8.7% in Q1, compared with the long-run average of 13.5% and a fraction of the 25% peak reached at the end of 2007.

That said, as fixed-rate debt rolls over and new loans are taken out, these debt servicing burdens will increase. For example, as of May 2023, the average interest rate on outstanding fixed mortgage debt was 2.83%, whereas the average rate on new fixed mortgage debt was 4.57%. It follows that even if the BoE were to bring rate hikes to an immediate halt, people refinancing a fixed-rate loan would pay significantly more than they do at present. This is being mitigated at the moment by strong growth in average cash wages, but as discussed, we expect pay growth to slow (admittedly, a development which would also err in favour of reversing rate rises).

However, lenders have options to reduce the immediate pain to borrowers from higher rates. Extending the term of mortgages is one, and a second option is allowing a switch to interest-only mortgages when the time comes to refinance.

The evidence suggests this forbearance is already happening. According to BoE data, of those borrowers who remortgaged in 2023 Q1, around 15% extended their existing terms.[8] Regular mortgage repayments in May were £5bn. Although this was 7.2% higher than a year earlier, that increase was proportionately much smaller than the rise in average mortgage rates (from 2.08% in May 2022 to 2.83% 12 months later) over the same period. And regular repayments as a share of nominal household incomes in Q1 (3.6%) were no higher than at the start of 2021.

UK: Regular mortgage repayments



Source: EY ITEM Club/Haver Analytics

The agreement reached between the government and mortgage lenders in June should encourage more forbearance from lenders. This will permit customers to switch to an interest-only mortgage for six months or extend their mortgage term to reduce their monthly payments and switch back to their original term within the first six months. Both options can be taken without a new affordability check or affecting borrowers' credit scores.[9]

Finally, the cost of fixed-rate mortgages depends on where the markets expect interest rates to be over the life of the fix. Much of the recent talk of mortgage crisis seems to assume that interest rates will (i) rise significantly higher and (ii) stay at that high level for a long time. We're doubtful on both counts, anticipating that the BoE will probably max out with further 25bps rise in rates and start to cut borrowing costs from the second half of next year. So, while mortgagors renegotiating fixed-rate deals next year will almost certainly face significantly higher rates than in the past, they're unlikely to be as high as current market pricing predicts.

7. See Tables 1.3 and 1.19 of English Housing Survey 2021-22, Household annex tables, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1139366/2021-22_EHS_Headline_Report_Section_1_Households_Annex_Tables.ods
8. Bank of England, 'Financial Stability Report', July 2023. https://www.bankofengland.co.uk/financial-stability-report/2023/july-2023
9. HM Treasury, 'Chancellor agrees new support measures for mortgage holders', 23 June 2023. https://www.gov.uk/government/news/chancellor-agrees-new-support-measures-for-mortgage-holders#:~:text=%E2%80%9CThe%20second%20is%20that%20if,impact%20on%20your%20credit%20score.

6

Conclusions

Our latest forecast is set against a backdrop which, in some respects, is brighter than of late. The supply shocks which struck the economy in the last few years have reversed or are in the process of doing so. Supply chain damage looks to have healed, inflation is coming down on the back of falling energy prices and the contraction in the UK workforce during 2020 and 2021 has been made up.

But the repercussions of those shocks still look likely to condemn the economy to a period of sluggish growth in the near term. Inflation remains uncomfortably high; energy bills are still a long way from the levels of a few years ago and the workforce is still smaller than a continuation of pre-pandemic trends would have implied. We're reasonably confident that these metrics should continue to move in favourable directions, causing a steady improvement in growth prospects. But what will be crucial is how the BoE perceives things and the choice it makes between setting interest rates on the basis of an improving inflation outlook or, instead, focusing on old data and reacting to criticism that monetary policy was too loose in the past by veering in the opposite direction.

If inflation declines steadily and the BoE takes the former approach, avoiding the further aggressive tightening markets currently expect, growth should benefit from stronger demand and supply. On the demand side, falling inflation will boost household spending and consumption — and less expensive energy, supply chains back to working order and 100% expensing should promote investment. On the supply side, a continued recovery in the workforce and the reversal of the energy price shock will aid the economy's capacity to grow and the efficiency with which it does so.

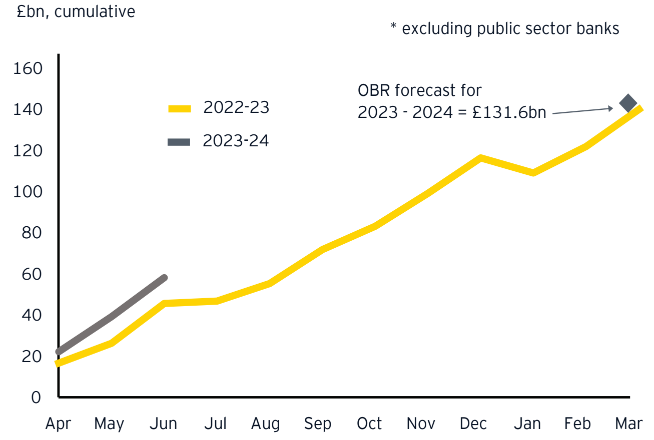
The big risk is that structural peculiarities mean the UK turns out to be the exception to the rule of fast-falling inflation across advanced economies. Or, if it isn't, the BoE fails to appreciate that quickly enough. In either world, interest rates could continue to ratchet up to a level where even with the protection offered by healthy household and corporate balance sheets, the economy falls into recession. On that count, the next few months, and what they tell us about just how sticky inflation and strong pay growth are, will be key.

7

Forecast in charts

Fiscal policy

UK: Public sector net borrowing*

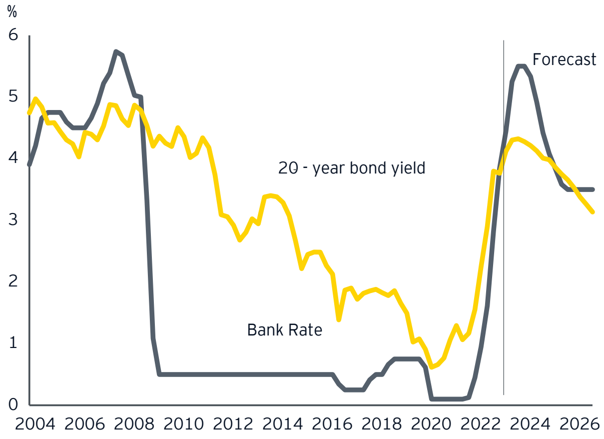


Source: EY ITEM Club/Haver Analytics and OBR

- Public sector borrowing (excluding public sector banks) in the first three months of 2023-24 was £7.5bn, or around 12%, below the OBR's forecast.
- GDP growth and inflation this year are likely to be higher than the OBR expected, a positive for tax revenues. But this will be offset by upward pressures on spending.
- In particular, higher inflation combined with higher short- and long-term interest rates will significantly increase the level of debt interest payments.

Monetary policy

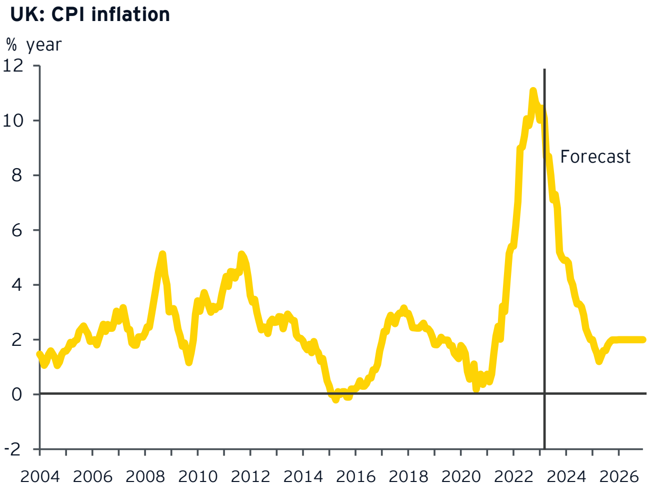
UK: Bank Rate and 20 - year bond yield



Source: EY ITEM Club

- May's disappointing inflation data was followed by the MPC raising Bank Rate to 5%, the highest since September 2008.
- Concerns about inflation stickiness and strong pay growth mean markets currently expect several more hikes before Bank Rate peaks at around 6%.
- We think an improving inflation outlook and that the full effect of past rate rises has still to come through means the MPC will not need to go so far. We've pencilled in two further hikes in Bank Rate.

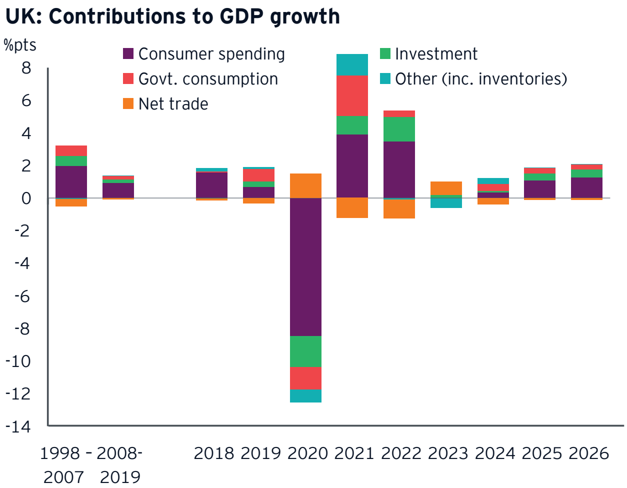
Prices



Source: EY ITEM Club/Haver Analytics

- CPI inflation has fallen back since last autumn's peak. But the drop has been slower than in other countries, and underlying measures have generally proved stubborn.
- Inflation should fall meaningfully over the next few months, as cheaper energy feeds into household bills and lower production costs for firms.
- We think inflation will end this year at just under 5% before declining to 2% in late 2024, as cheaper energy, slower pay growth and a sharp deceleration in money supply growth feed into lower core inflation.

Activity

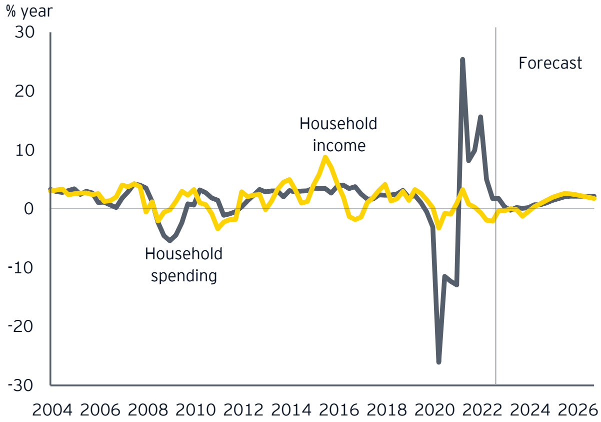


Source: EY ITEM Club

- The economy grew 0.1% q/q in Q1 2023 and looks to have expanded by a similar amount in Q2, despite drags from industrial action and an extra public holiday.
- Falling energy bills, strong growth in employment and rising consumer confidence should see the GDP continue to rise in the second half of 2023.
- However, the impact of past and prospective rises in interest rates is set to have a growing adverse effect. We expect the economy to expand 0.4% in 2023 before growth picks up a little to 0.8% in 2024.

Consumer demand

UK: Real household income and spending

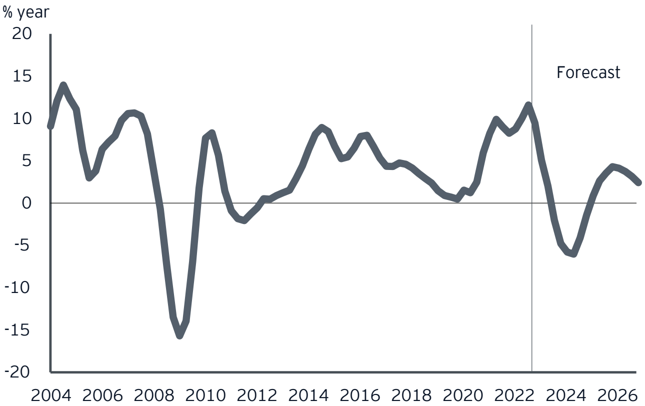


Source: EY ITEM Club

- Consumer spending stagnated in Q1 2023 after rising 0.2% in the previous quarter. Still-high inflation and a fall in real household incomes dragged on consumption.
- Rising consumer confidence, falling energy bills and higher returns on savings offer some upsides for consumer spending.
- But the scale of interest rate hikes will squeeze the spending power of many borrowers. Consumer spending is forecast to record zero growth this year before rising 0.6% in 2024.

Housing market

UK: House prices

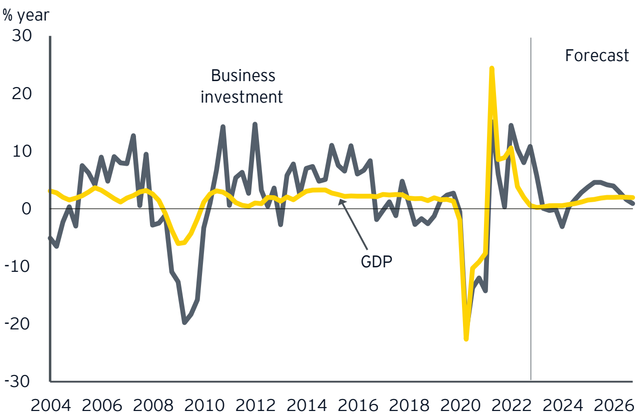


Source: EY ITEM Club

- House prices across different measures have seen little or no decline so far this year but are modestly down from last summer's peak.
- The recent jump in mortgage rates threatens to further weaken housing market activity and push down values. On the other hand, households' financial position is relatively healthy, and unemployment is low.
- We expect average house prices to stagnate this year before falling 4.5% in 2024.

Company sector

UK: Business investment and GDP

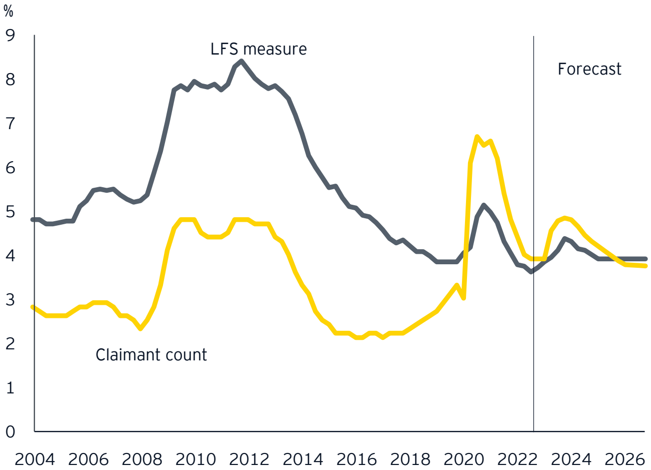


Source: EY ITEM Club

- Business investment saw a strong 3.3% q/q rise in Q1, which was a four-quarter high. This finally took investment above its pre-pandemic level in Q4 2019.
- However, Q1's strength was probably exaggerated by companies bringing forward spending to gain from the super-deduction tax incentive, which ended in April.
- Higher interest rates and a sluggish economy mean investment growth may slip back, although less expensive energy and new tax incentives offer counters. Business investment is forecast to rise 1.3% this year but only 0.4% in 2024.

Labour market and wages

UK: Unemployment rate

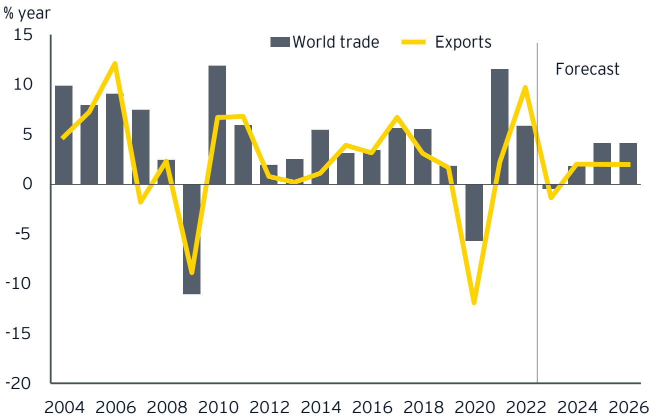


Source: EY ITEM Club

- Although job growth has been healthy, falling inactivity and an expanding workforce caused the LFS unemployment rate to tick up to 3.8% in the three months to April. And wage growth has remained strong.
- That vacancies have continued to fall back points to the demand for workers easing. With the supply of labour rising strongly, this should put downward pressure on pay.
- We expect the unemployment rate to rise only modestly, peaking at between 4% and 4.5%.

Trade and the balance of payments

UK: Exports and world trade



Source: EY ITEM Club

- Trade flows have continued to be volatile, driven by movements in non-monetary gold and changes in the method the ONS uses to measure imports from the EU.
- Excluding trade in precious metals, the current account deficit narrowed to 2.6% of GDP in Q1 2023 from 3.3% in Q4 2022, aided by a narrowing in the trade deficit.
- Rising interest rates abroad and the stronger pound will hold back UK export growth. Sluggish growth in the UK economy will weigh on import demand, but there will be some offset from the boost to (import-intensive) investment from the temporary 100% capital allowances.

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