Could the British lion roar again?

Upside scenarios for the UK

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Multi-Asset - UK

- Talking the UK down is easy…
- …but what could go right?
- We set out the upside risks and cross-asset implications

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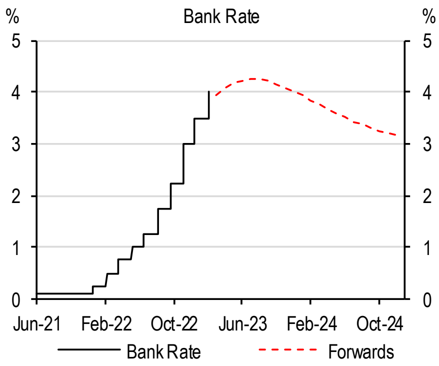
Not the best of times for the UK economy…

'UK-bashing' is all the rage among economic commentators, and it's easy to see why. Growth is slowing while inflation remains uncomfortably high. The Bank of England has hiked rates from 0.1% to 4% in a little over a year, with the true impact of that tightening yet to make itself felt. As households and businesses face a surge in energy bills, food, mortgages and other costs, consumer confidence is in the doldrums.

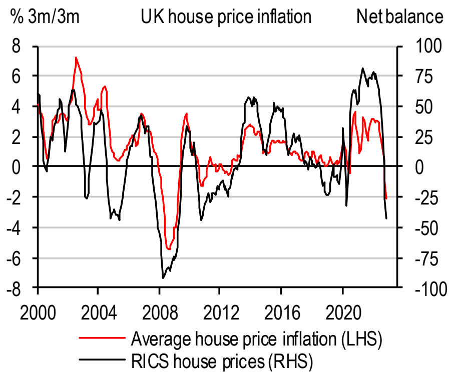
These recent woes come on top of a well-documented history of relative underperformance that began with the Global Financial Crisis – from low productivity gains and weak investment, to subdued export growth. Our forecast for UK GDP growth in 2023 is -0.6%.

1. A rapid tightening cycle…



Source: BoE

2. … has hit the housing market



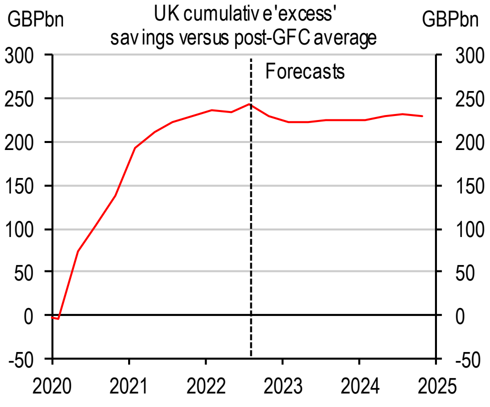
Source: Halifax, Nationwide, RICS

…but we still see reasons for hope

Many consumer-facing companies report remarkably robust demand. The economy grew in October and November of 2022, meaning the UK may perhaps have avoided a technical recession in the second half of last year. The labour market, too, remains resilient, having defied many economists' expectations – including our own – that the end of the furlough scheme post-pandemic would lead to a spike in unemployment.

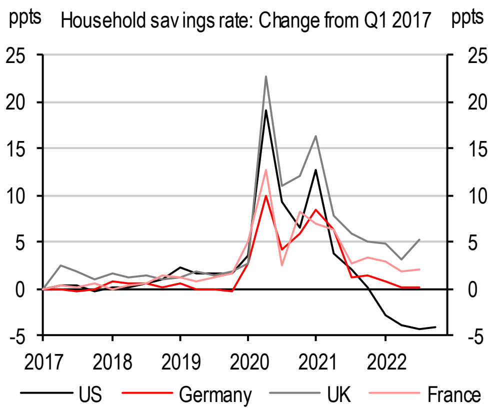
This is a Free to View version of a report with the same title published on 07-Feb-23. The full version of the note is available for clients of HSBC and contains further discussion of our upside scenarios for the UK economy. Please contact your HSBC representative or email AskResearch@hsbc.com for more information.

3. The UK hasn't run down the huge pile of savings built up through the pandemic



Source: ONS

4. While US households have reduced savings rates below pre-pandemic levels



Source: Refinitiv Datastream

What if... things turn out better than we anticipate again?

In this report we look at what could go right for the UK economy over the coming year, focusing on two potential scenarios:

- **Demand defies the income squeeze:** UK households increased their savings by around GBP250bn during the pandemic. What if, instead of hanging on to most of this wealth, they follow the US example – and start spending significantly more of it? This would boost growth, and could keep businesses hiring and investing as their confidence rises. In this scenario, we would also expect higher inflation and further Bank of England tightening.
- **Aggregate supply surprises:** We see four factors which have the potential to improve the UK supply side in the coming months: 1) regulatory reform allowing businesses to make meaningful efficiency gains; 2) a pick-up in business investment; 3) increased labour supply; and 4) an improving relationship with trading partners. Should any or all of these deliver a significant boost to supply, the resulting improved outlook could give the Bank of England scope to cut rates, at the same time as reducing pressure on public finances.

Best-laid plans

Stronger-than-expected growth would likely be supportive for sterling and for the market in general. The full note discusses various scenarios for sectors such as housing and real estate, to financial firms and the effect on gilts of the Bank of England's reaction to any surprises. We also explore the potential implications for credit, labour markets, travel, leisure, and discretionary retail.

Our base case remains that the UK faces a challenging outlook, and either of our upside scenarios coming true would be a pleasant surprise. But given the UK Chancellor's recent suggestion that market analysis should focus more on the positive, we are clearly not alone in asking: "What could get the British lion roaring again?"

Summary of scenarios and Implications

Asset class/ sector	Implications
Economics	We see two main upside scenarios. (1) If the labour market stays resilient and inflation falls rapidly, confidence could improve and spending grow – particularly if UK households ran down accumulated savings. This scenario could mean more inflation pressures and further BoE rate hikes, however. (2) The UK supply side improves, perhaps due to a rise in labour supply and/or a rise in productivity (reflecting regulatory reform or a pick-up in business investment). Any significant boost to supply could give the Bank of England scope to cut interest rates, at the same time as reducing pressure on public finances.
FX	The main driver of the currency has been external dynamics, while the improving environment for global risk appetite should remain supportive. Signs of activity data improving versus inflation and inflation expectations data surprising to the downside are also positive for sentiment, while the UK's wide external imbalances have shown signs of narrowing in recent months.
Gilts	For gilts, a demand-driven scenario that resulted in more monetary tightening would likely cause bond yields to push higher, flattening the curve, whereas a scenario where a recovery in supply pulls down on core inflation and enables the BoE to cut rates earlier would likely cause a steepening of the yield curve.
Equity Strategy	We are constructive on the outlook for equities in 2023. Risks are connected to the duration of any economic slowdown, the speed with which inflation moderates and the pace at which interest rates fall.

Source: HSBC Research

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