HSBC Global Research

1 November 2022

UK State of Play

Dovish demand

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Economics - United Kingdom

- Against the backdrop of a somewhat more dovish mood in UK markets, we take a look at the demand side of the economy
- Household spending has been resilient, but ongoing headwinds include rising mortgage and rental prices
- Meanwhile, businesses look wary and the government seems set on fiscal discipline – not stimulus

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Three pillars of demand

The BoE has long expected that (a) we would see a slowdown in the demand side of the UK economy and (b) that this slowdown would help to moderate inflation pressures over the medium term. Although the second assumption is less clear, the first is more and more in evidence, and the winds are blowing in a more dovish direction: for the first time in this cycle, clients are starting to ask whether we are forecasting too much monetary tightening, as opposed to too little. In this note, we take a closer look at the domestic demand side, via its three key pillars: households, businesses and government.

Households: more headwinds ahead

Our central case is for a 2.5% fall in real incomes for households in 2023. One part of this painful puzzle is the cost of living – literally, in our homes. The impact of higher mortgages will feed through slowly but significantly. But higher rental prices worry us too. Still, the risks are in both directions: higher wage growth and lower gas prices, if they persist, could be game changers for consumer demand.

Businesses: wary

Businesses have been supporting the economy via what has remained an impressive pace of job creation. But the data suggest this is starting to turn. Meanwhile, surveys suggest confidence and investment intentions are waning, and insolvencies are picking up. With higher rates, energy bill uncertainty and a weak consumer picture, business demand looks decidedly dicey as well.

Government: scaling back, not splashing out

We will know more about the degree to which government demand might support the economy on 17 November, with the Autumn Statement. But it looks like the new prime minister is going to take a much more frugal approach than his predecessor. There may be some expectations management at the moment – so that some good news is left over to deliver on the day. But we think the likelihood is that the government will be joining households and business in a bit of belt-tightening. No wonder the mood has turned in a more dovish direction.

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Dovish demand

- After last month's hawkish turbulence, more dovish winds are blowing in the UK: in this note, we look at the demand side of the economy
- Household spending has been resilient, but ongoing headwinds include rising mortgage and rental prices
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Demand: the three pillars

Households divided, businesses wary, government scaling back

Three pillars: households, businesses, government

Dovish winds have been blowing globally of late – not least in the UK. The market has scaled right back on its expectations for monetary tightening from the Bank of England, as concerns about demand headwinds ramp up.

That dovishness rests on a weakening demand side of the economy. We have laid out the hawkish supply case elsewhere, but if the demand side was a driver of imbalances through the immediate post-pandemic recovery, it feels decidedly less so as we move towards the end of 2022.

In this note, we look at the three pillars of demand: households (whose salaries and wages accounted for 50% of national income in the year to Q2 2022), businesses (whose profits accounted for 17%) and the government (whose taxes accounted for 11%). With the latter, we also include an updated look ahead to the 17 November Autumn Statement.

Let us begin with the first and largest source of demand in the UK economy: its households.

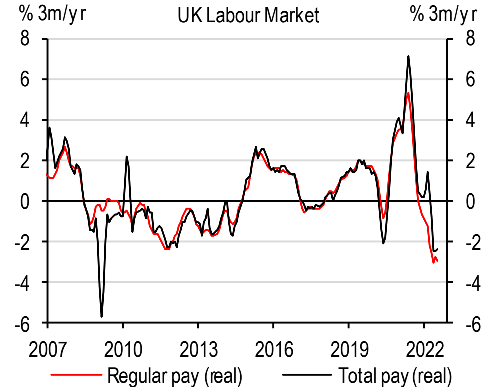
Households: a widening income squeeze

Hard times

The cost of living is biting for households

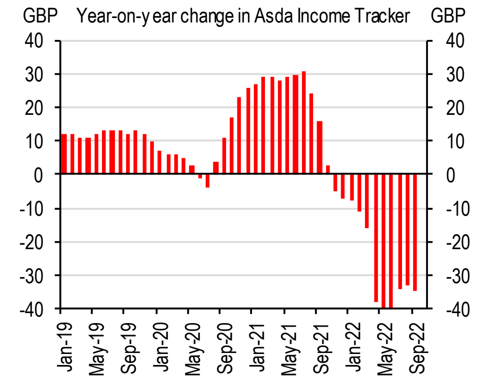
The cost of living crisis for households is well documented by now. With real wages falling (chart 1), the latest Asda Income Tracker shows that average weekly disposable income (spending money left over after essentials have been bought) stood at GBP208 per household in September 2022, down from a high of GBP247 in March 2021, and the lowest level since December 2018 (chart 2). This means the inflation we have seen in the last year or so wipes out three and a half years' worth of income gains. The GfK consumer confidence survey (chart 3) for October looks even worse, coming in only just above its all-time low.

1. Real wages are falling at the fastest rate since the global financial crisis



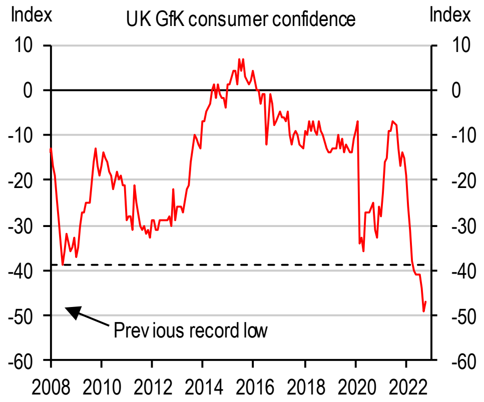
Source: ONS.

2. Disposable income is falling



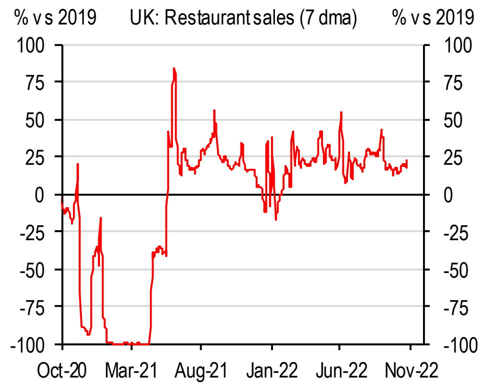
Source: CEBR ASDA Income Tracker.

3. The GfK consumer confidence index is close to its all-time low



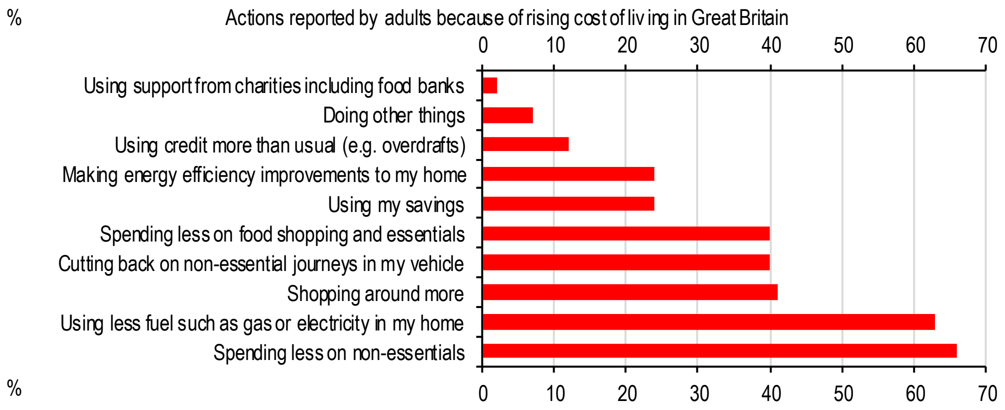
Source: GfK.

4. But that's not stopping demand for UK restaurant meals



Source: Open Table.

5. Differing answers to the ONS survey hint at stark economic divisions



Source: ONS (survey as at 12-23 October 2022).

This is undoubtedly starting to feed through to the consumer data. In August, the output of consumer facing services fell 1.8%, and stood 8.9% below its pre-pandemic level. Looking at the retail sector, UK customers spent 12% more in September 2022 than pre-pandemic – but they got 1.3% less.

Demand has been remarkably resilient, given the circumstances

Still, we might expect things to be even worse in the current conditions: generally speaking, the companies we talk to speak of relatively resilient demand (even if they worry about what is coming down the tracks). Meanwhile, not all data point to a consumer recession: the latest Open Table data showed restaurant customers up by 21% on average compared with 2019 (chart 4).

Some more equal than others

This likely reflects a two-speed story among UK households, which chart 5 hints at. The chart shows an ONS survey of households, of which 40% said they were spending less on food essentials. This chimes with the retail sales figures, which, grimly, show volumes of supermarket sales down 3.2% on pre-pandemic levels. It also chimes with the aforementioned Asda Income Tracker, which suggests that some 40% of UK households now have little or no discretionary income. Of those, the bottom 20% faced a shortfall of an average GBP63 a week, while the second bottom 20% had disposable income of just GBP2.66 a week.

But the same survey (chart 5) shows that "only" 66% of people are cutting back on non-essentials. That is a lot, of course, but it also suggests that a full third of the population are not cutting back *at all*. This implies 40% are buying less food, and a third are carrying on as normal, which is quite a striking divergence. That third carrying on as normal may be the reason for the remarkable resilience we continue to hear about from companies we talk to and which is also evident in the strength of the labour market. Perhaps some in this group have changed jobs and received a good pay rise, or perhaps they simply don't mind absorbing the extra cost, and reducing savings, in order to continue enjoying the post-pandemic freedoms.

Another energy bill rise to make things even harder in April?

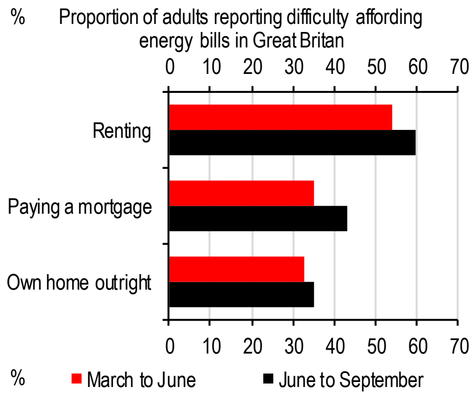
However, the pain looks set to continue, which could drag more people into the group reporting reduced spending. Much of the comfort blanket pledged by the Truss government has been withdrawn. Under her plans, families could have expected a 1p tax cut next year and a gradual decline in inflation – a key reason we forecast growth starting to pick up by Q2 2022. Instead, families now face (potentially) another 73% rise in household energy bills in April. For the 40% of the population who have zero spare capacity to absorb this shock, it is expected fresh government measures could be set out in the Autumn Statement to prevent further pain. But for the remaining 60% of households, it will be another slice out of their incomes.

Home truths

Another headwind that may have yet to fully play out is that many people are paying more for their homes as well. We have written elsewhere about the impact of higher interest rates on mortgages. Swap rates and mortgage rates are down a little since we wrote that, but the latter not by nearly as much as the former. The 5.5% mortgage rate we modelled for – which would raise spending on a GBP200k mortgage by GBP5,000 a year – is still below the 6.5% average that prevailed in late October (source: Moneyfacts).

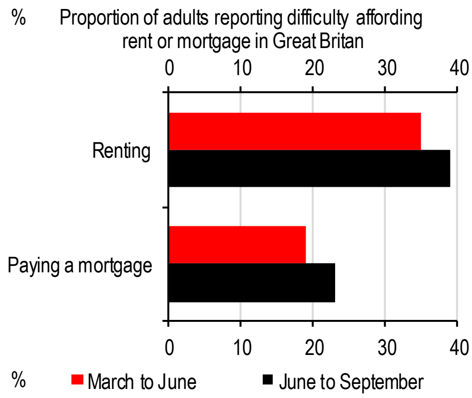
That will have an isolated but painful impact, on those households refixing their mortgages in the near term – and over time, the size of this group will increase as more fixed rate periods elapse. It may also mean that those who might otherwise have bought a home may either be unable, or choose not to in anticipation of a correction. This broader weakness in the housing market – we expect a 3% fall in prices over 2023 and a drop in activity – may have an additional impact on confidence and the spending associated with new homes.

6. Renters are more likely to struggle to pay energy bills…



Source: ONS.

7. …and the cost of their residence



Source: ONS.

Renters more likely to be struggling already

Moreover, if fewer people are able to buy, that will also exacerbate another issue that has been worrying us: rentals. In the CPI inflation measure, these are up "only" 4.2% y-o-y. But that is the aggregate of all renters: for private renters moving homes, prices are up by considerably more: the Rightmove rental index reported a national increase in asking prices of 11% y-o-y, rising to 19% in Inner London (with similarly large rises reported in other cities, including Birmingham, Manchester and Edinburgh, table 8). The Rightmove survey also said that demand "greatly outweighed" supply of rental properties in the UK, and that demand for studio flats had risen by 71% y-o-y, given "stretched budgets and the returning popularity of city centres". Separately, a survey by iPlace Global found that 16% of landlords were considering selling properties, in the face of higher costs (*Guardian*, 21 Oct 2022).

Charts 6 and 7 demonstrate why this could be a worry: renters are already more likely to struggle to pay household bills than people with a mortgage. As more rental contracts elapse – and more landlords see their mortgage costs rise – more people will be subject to these higher prices.

8. Rental price hotspots

Area	Region	Average asking rent per calendar month (Q3 2021, GBP)	Average asking rent per calendar month (Q3 2022, GBP)	Annual change
Newbury	South East	1,003	1,226	+22.2%
Manchester	North West	959	1,157	+20.5%
Cardiff	Wales	870	1,041	+19.6%
Sale	North West	873	1,037	+18.8%
Wilmslow	North West	965	1,142	+18.3%
Edinburgh	Scotland	1,002	1,182	+18.0%
Torquay	South West	764	899	+17.7%
Salford	North West	972	1,144	+17.6%
Birmingham	West Midlands	882	1,037	+17.6%
North Shields	North East	600	705	+17.4%

Source: Rightmove.

It could be better, it could be worse

Higher wages or higher unemployment could make all the difference

Numerous things play into the outlook for household demand in the UK: population, employment, participation, wage growth, savings, confidence and fiscal policy all affect spending decisions.

Chart 9 lays out three scenarios: our central case is for a 2.5% fall in real incomes in 2023, with no growth in 2024. That is already one of the worst performances for real incomes on record, and compares unfavourably with the 1970s, when wage growth broadly managed to keep pace with inflation.

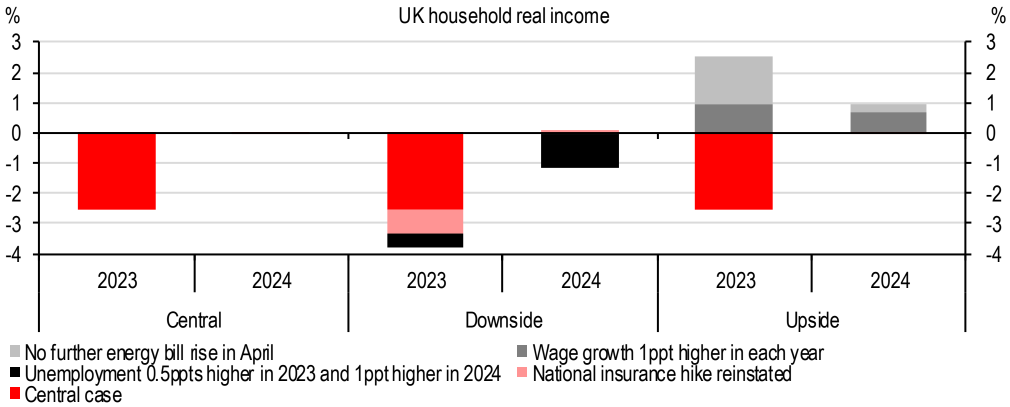
But we also set out downside and upside risk scenarios.

Extra tax or benefits cuts would eat further into real incomes

The downside scenario includes the reinstatement of the rise in national insurance tax introduced by Rishi Sunak as Chancellor and then removed by Liz Truss (of which more below). This adds 0.8ppts to the real income squeeze. Equivalent tax rises or benefits cuts would have the same effect. We also consider a faster than forecast rise in unemployment. If the rate were 0.5ppts higher than our central case in 2023 and 1ppt higher in 2024, this would squeeze aggregate household incomes by an additional 0.5ppts this year and 1.1ppts in 2024. So adding both into our central case could mean real incomes fall by 3.8% in 2023 and 1.1% in 2024.

But economists are not always pessimistic. We also consider two upside risks: one possibility is that wage growth is stronger than we have allowed for. Adding a percentage point to our forecasts of wage growth (so increasing our 2023 forecast from 5.0% to 6.0% and our 2024 forecast from 3.8% to 4.8%) adds 0.9ppts to real wage growth, reducing the squeeze from 2.5% this year to 1.6%, and allowing real incomes to rise by 0.7% in 2024.

9. Central case, upside and downside scenarios: the outlook for real incomes depends on many factors



Source: HSBC estimates.

But there are upside risks too, with higher wages or lower inflation

If there were no further rise in household energy prices in April – whether due to lower wholesale prices or extended government support – that would take a further 1.6ppts off the squeeze in 2023, and allow real incomes to grow by 0.3% in 2024.

Putting the two upside risks together would mean no income squeeze in 2023, and a rise of 1.0% next year.

What this exercise demonstrates – apart from the near impossibility of accurate forecasting – is that relatively small changes can make a huge difference to the outlook. For now, though, our forecast of a 2.5% squeeze and no growth next year feels like a reasonable central case.

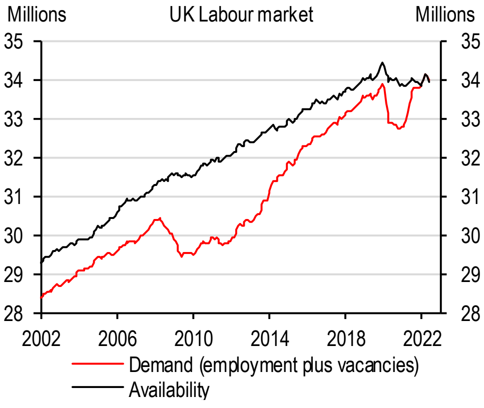
Business not usual

Surveys suggest wariness

Tough times for firms

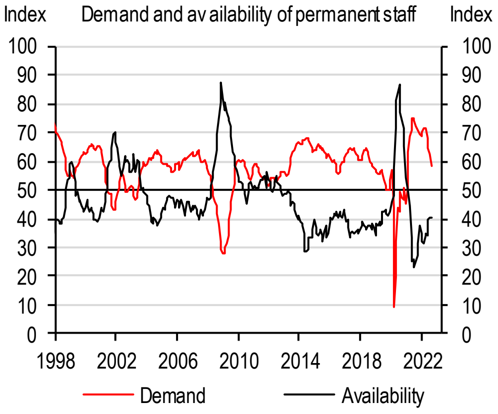
Can business demand sustain the UK economy in the face of the economic headwinds? To some degree, it has been, primarily through the demand for labour (chart 10). This has been a sweet spot in the UK economy despite all the bad news – and it is one that goes a long way.

10. Labour market demand has recovered more than supply… but may be stalling



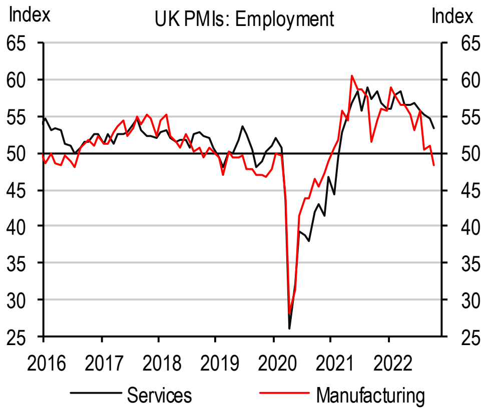
Source: ONS.

11. The jobs PMI suggests that imbalances have been unwinding since Q3 2021



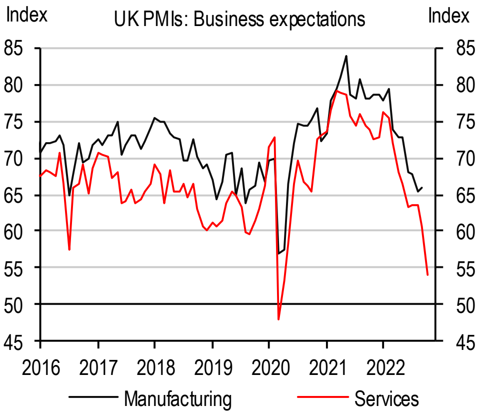
Source: KPMG/REC Jobs PMI.

12. Activity PMIs point to slower services hiring and outright cuts in manufacturing



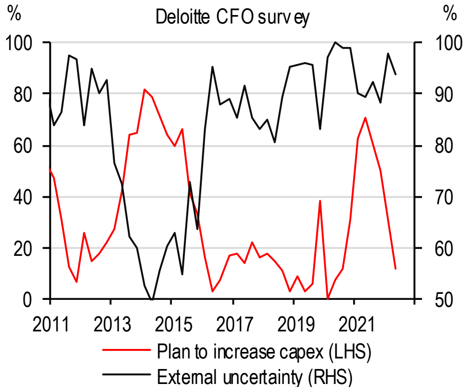
Source: S&P Global PMIs, Refinitiv Datastream.

13. Optimism seems to be fading



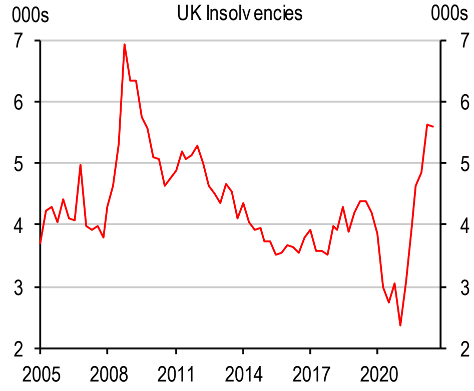
Source: S&P Global PMIs, Refinitiv Datastream.

14. Investment intentions have fallen back



Source: Deloitte CFO survey.

15. Insolvencies rising too… albeit from a low base



Source: UK Government.

Surveys suggest jobs bonanza is stalling

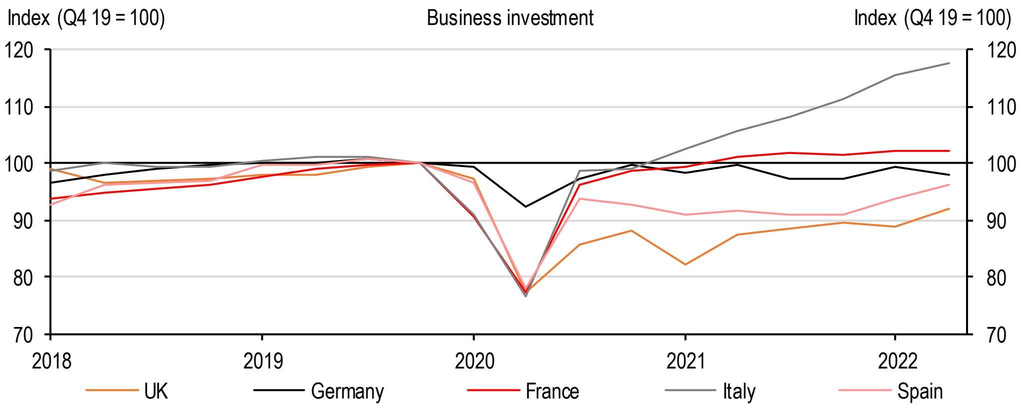
Still, the surveys suggest that this is turning. The outlook has improved slightly for businesses since we wrote our note *Business not usual* (25 Aug 2022) with the energy support package announced by the government and the reversal of the national insurance hike. But in another sense, businesses now face weaker consumer demand – and uncertainty as to what support will be available in April, when the energy price freeze ends. Certainly, surveys indicate weakening confidence, which may impact hiring and investment decisions (chart 13).

The employment index in the PMI surveys is still positive for the service sector, but turned negative in October for manufacturing, indicating job losses. The KPMG/REC Jobs PMI points to an easing in the imbalance which has been happening since around Q3 2021 (charts 11 and 12). And the recent rise in insolvencies (chart 15) will do little to improve job prospects. These surveys are reflected in the recent hard data, but only subtly: employment and vacancies have fallen a little, but weak supply of labour means that the unemployment rate fell to a new multi-decade low of 3.5% in the last update.

If business investment didn't recover in 2021, then why would it in 2023?

In terms of investment, we are not particularly optimistic. The conditions in 2021 were pretty good for investment: rates were low, the government had a very generous tax incentive – the super deduction – and the post-pandemic recovery and completion of the Brexit process had lifted confidence. Yet as chart 16 shows, business investment in the UK has failed to recover from the pandemic in the UK as it has elsewhere. We doubt the conditions of 2023 – higher rates, recession and the scheduled end of the super deduction – will spur a big rebound. Certainly, chart 14 does not suggest one is coming.

16. UK business investment has had a very slow and sluggish recovery since the pandemic



Source: ONS, Eurostat, Refinitiv Datastream.

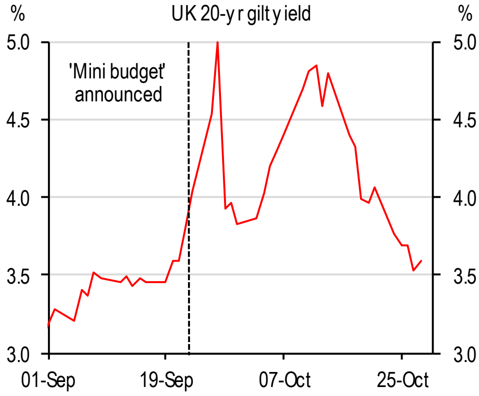
Government: Austerity ahead?

From 'Mini Budget' to Medium Term Fiscal Plan to Autumn Statement

Life comes at you fast in the world of UK economics at the moment. We published our budget preview on 18 October, but quite a few things have changed since then:

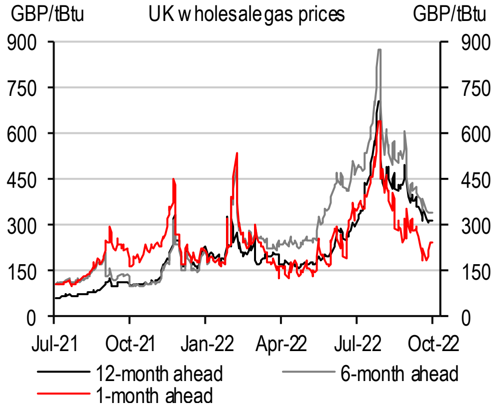
- Bond markets have rallied, with the 20-year yield down from 4.93% on 27 September to 3.76% now (chart 17) and market pricing for the peak of Bank Rate down from 6.5% at the height of the turmoil around 4.75% now. Overall rate moves bring down projected government interest spending for a saving of around GBP10-15bn compared with a Budget delivered on the originally planned 31 October date.

17. Lower bond yields will save the Chancellor some money



Source: Refinitiv Datastream, HSBC.

18. The impact of lower gas prices is less clear



Source: Refinitiv Datastream.

- Gas prices have also continued to fall (chart 18), which should reduce the cost of energy support – though perhaps not by as much as one might expect. Current prices reflect the unusually mild weather we have seen of late, which may not last, and in any case, energy companies have already bought ahead for the winter. Meanwhile, support for businesses has been extended, such that it is now backdated to the start of December 2021. We would think the government would maintain its forecast of GBP60bn for support this year, although additional support next year might cost less if prices stay low.
- We have a new Prime Minister (PM), Rishi Sunak, who appears set on maintaining a high degree of fiscal discipline (*The Times*, 28 Oct 2022), without any changes to the existing mandate he introduced as Chancellor.

Lower yields buy the Chancellor a little space… but will he use it?

The lower yields and commodity prices in more recent times could arguably allow the PM and his Chancellor, Jeremy Hunt, to let their foot off the fiscal brake a little. After all, one could argue that austerity in the 2010s contributed to the weak recovery post-global financial crisis. And the circumstances at the moment are such that cuts to public services or benefits will be particularly impactful – with public services already under strain and the cost of living crisis already biting for benefits recipients. Politically, too, it may be tough for the PM. His party appears unified for now, but prior to his appointment as PM, many MPs had threatened to rebel against cuts to benefits (*The Guardian*, 4 Oct 2022).

We had suggested in our preview that the Chancellor might push out the timeframe for achieving the target – to close the budget deficit and reduce the debt-to-GDP ratio – from three years to five years.

It seems the new PM is not going to take the easy road. After all, he might argue, we don't know to what extent the falls in UK borrowing costs rest on the "eye wateringly difficult decisions" Chancellor Jeremy Hunt has pledged to take. Newspaper reports (*The Times, FT*, 28 Oct 2022) suggest that he wants to find GBP50bn of savings – closing a GBP40bn funding gap, with a GBP10bn margin of error.

One possibility highlighted in those reports is a further freeze of income tax thresholds and allowances, into the next Parliament, pushing more people into higher tax brackets. That would reportedly raise GBP5bn a year by 2026/27. Other options include cutting departmental budgets, capital spending plans, benefits or a combination of all three.

Nothing will be easy, and the dilemma is expressed neatly by the head of the Institute for Fiscal Studies (IFS), Paul Johnson:

> **Get it wrong in one direction and we risk another damaging rise in interest rates on gilts, and perhaps a fall in the value of sterling bringing yet more inflation. Get it wrong in the other direction and unnecessary pain is visited upon household incomes or public services**
>
> **Paul Johnson, IFS, writing in the *FT*, 18 October 2022**

Managing expectations so there is still some good news to deliver on the 17th?

Ultimately, the government may be engaging in some expectations management. The PM refused to rule out suspending the pensions 'triple lock' – whereby pensions rise by the higher of average wages, inflation or 2.5% – in Parliament in late October. But given its political contentiousness, it might be in his interests to keep some good news to announce on 17 November.

In terms of the numbers, we were expecting about GBP100bn of extra borrowing this year and next. The likelihood, in wake of the recent news, is that those numbers will be too high – particularly next year, given lower yields and gas prices, and given the appointment of Rishi Sunak, due to his apparent preference for more strident tightening (even if the benefits of the latter might be mitigated by lower growth forecasts from the Office for Budget Responsibility).

Conclusions

Overall, if we look at our three pillars of demand, we can see why the market has become more dovish. Under Liz Truss, household demand was supported to some degree – by tax cuts and the energy freeze – and that in turn supported the outlook for companies. Under Rishi Sunak, a lot of that has been withdrawn, and further cutbacks may be yet to come. Of course, the Truss support measures would have come at a high price: higher inflation and rates, potentially necessitating even more fiscal consolidation in the future – but that is another, now hypothetical, story.

Demand from each of our three pillars looks set to stay weak, if not weaken further, from here, and the risks to our growth forecasts are to the downside – we published them just after the so-called 'mini Budget'. The questions are: will this weaker demand reduce inflation pressures, and over what period? Against a backdrop of improved supply on the goods side, we might see some discounting over the winter, which should help. The part of the story that the BoE is most worried about – the labour market – may take longer to unwind. Thus far, it has put a relatively large weight on the impact of weaker demand and the income squeeze on core prices. We will see on 3 November at the next Monetary Policy Committee meeting whether it maintains that view.

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