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Heading towards a bleak winter

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The UK economy is hurtling into a severe cost-of-living crisis. Inflation is now into double-digits and there is worse to come with household energy bills set to soar in October. The depth of the downturn will largely depend on government policy. It seems that support will be increased beyond what has already been announced – but it is unlikely to be enough to offset the energy shock. A recession is likely, and the subsequent recovery could be slow.

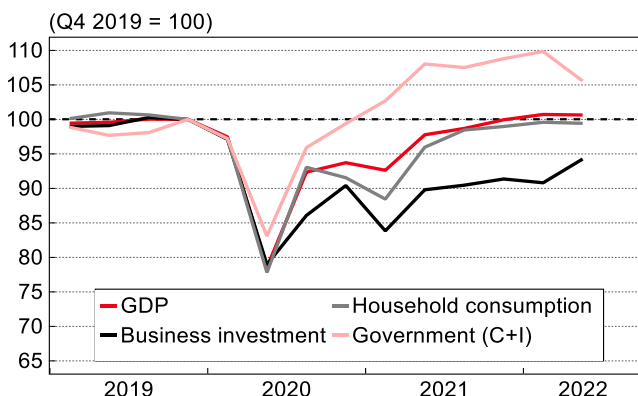
Pandemic distortions continue to cause GDP fluctuations

The UK economy contracted in Q2 (-0.1% Q/Q) with private consumption and general government expenditure providing a drag on overall activity. This was the first fall in quarterly GDP since the period of lockdown measures at the start of 2021. Despite this fall, UK GDP remains above its pre-pandemic level.

There are plenty of reasons to be concerned about the outlook for the UK economy down the line, but this Q2 growth figure was not as bad as feared. A contraction had been expected given the extra public holiday in June for the Queen’s 70th Jubilee and the wind-down of government COVID related activities such as testing (see [here](#)).

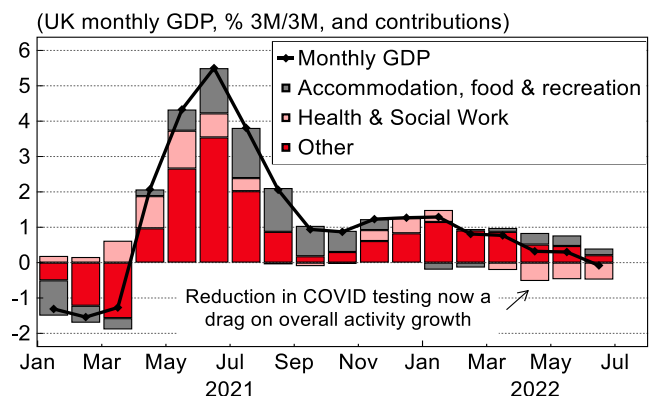
Customer-facing activities were notably resilient in the face of mounting inflationary headwinds for households. Accommodation and food services activities increased by 4.7% Q/Q, and arts, entertainment and recreation by 3.3% Q/Q. This suggests that post-pandemic pent-up demand remained relevant in Q2 and that the overall impact of the extra Bank Holiday was cushioned by the spending opportunity on food and drink etc., which is the flip side of losing an extra working day. This all served to reduce the clear drag from human health and social work activities, which fell by 5.4% across the quarter. We also suspect that there’s a boost from domestic tourism with a rise in ‘staycations’, which could be increasingly relevant to activity data in July and August. This means there could be a little more momentum into the second half of the year than the headline Q2 growth figure suggests.

GDP HOVERING AROUND THE PRE-PANDEMIC MARK



Source: ONS, MUFG Bank Economic Research Office

HEALTHCARE IS NOW A DRAG ON ACTIVITY



Source: ONS, MUFG Bank Economic Research Office

In terms of Q3 growth, distortions that weighed on activity last quarter will start to work in the other direction. After the extra bank holiday in June, Q3 will have the full complement of working days. The drag from health-related activities will have largely eased in Q/Q terms – 3.5m fewer vaccine doses were administered in Q2 versus Q1 after free COVID testing ended on 1 April. An autumn campaign to vaccinate the over-50s and vulnerable groups is expected to start in September, which should provide some support to Q3 GDP figures.

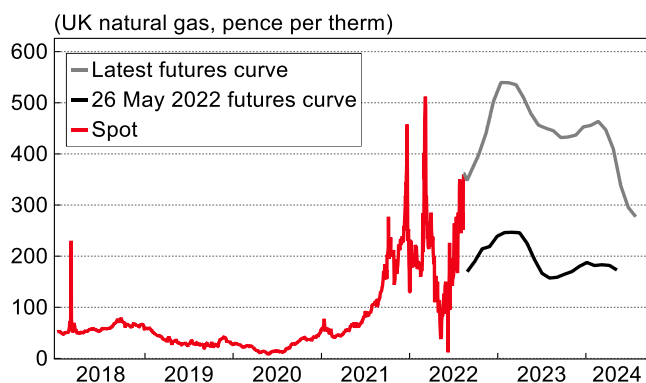
We are now looking for a small expansion overall of around 0.2% Q/Q in Q3. This would mean that the UK economy avoids a technical recession, at least for now. But, the period of respite is likely to be brief as cost-of-living pressures continue to mount.

A bleak winter ahead as energy costs continue to rise

Wholesale gas prices have risen significantly in recent months. The UK economy is exposed to this with around 80% of households using gas for heating, while a marginal pricing system means that the most expensive form of energy production needed to meet electricity demand (i.e. gas) sets the price for all forms of generation.

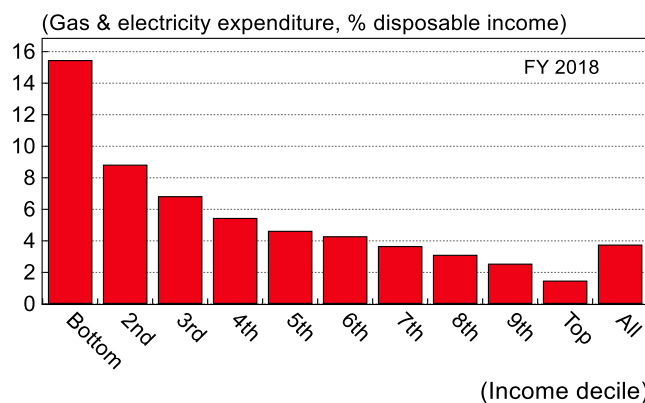
It now looks as though the UK's household energy price cap will increase by around 80% from October. This would come after a rise of 42% in April 2021, and take the average annual bill above 3500 GBP. Market pricing suggests further increases in the price cap at the start of next year. This points to a huge cost-of-living crisis. The UK's median household disposable income was around 31000 GBP in the financial year ending March 2021, and 16% of people live in households with income less than 60% of this figure.

GAS PRICING HAS CHANGED SIGNIFICANTLY SINCE THE LAST FISCAL PACKAGE WAS ANNOUNCED



Note: 26 May is when the previous fiscal support package for households was announced.
Source: Bloomberg, BoE, MUFG Bank Economic Research Office

LOWER-INCOME HOUSEHOLDS ARE HUGELY EXPOSED TO ENERGY COST INCREASES



Source: ONS, MUFG Bank Economic Research Office

It is a foreseeable crisis as the energy price cap is based partly on the gas futures market, and the government already announced fiscal support worth 37bn GBP (1.6% of 2021 GDP) in May to help households with energy bills this winter. This included a one-off payment of 400 GBP for all households, with extra support for pensioners and people on means-tested benefits. The package was well-targeted and the poorest households were set to be largely shielded from higher energy costs.

That is no longer the case with the increase in the energy price cap now likely to be roughly double what was expected in May. However, the UK government, mired in the Conservative leadership contest after the ousting of Boris Johnson, is yet to increase support. It will be up to Johnson's replacement, who will be announced on 5 September, to introduce fresh measures. Liz Truss is the clear favourite to win the contest (with betting markets implying a probability of around 90%).

Truss will be faced with a daunting in-tray. So far, she has suggested that her priority would be to cut taxes rather than increase transfer payments at an emergency Budget in September. Truss has said that she would reverse a National Insurance rise introduced by her rival in the leadership race, Rishi Sunak, when he was Chancellor.

However, this sort of income tax tweak would provide scant help to lower earners – those on the minimum wage would save just 60 GBP annually. Truss also plans to cut green levies on energy bills. These are set to constitute less than 5% of bills from October, so such a move would have a small effect. Further ahead, Truss wants to scrap the planned increase in corporation tax from 19% this year to 25% in April 2023. There were encouraging signs for business investment in the latest GDP release (+3.8% Q/Q) after anaemic growth since the EU referendum in 2016. But it can be a volatile series and we doubt UK firms will have a huge appetite for investment given the dismal macro outlook over the winter and into 2023, so the prospects of indirect support to households through a healthier economy seem dim.

Fiscal support will surely be bolstered – but to what extent?

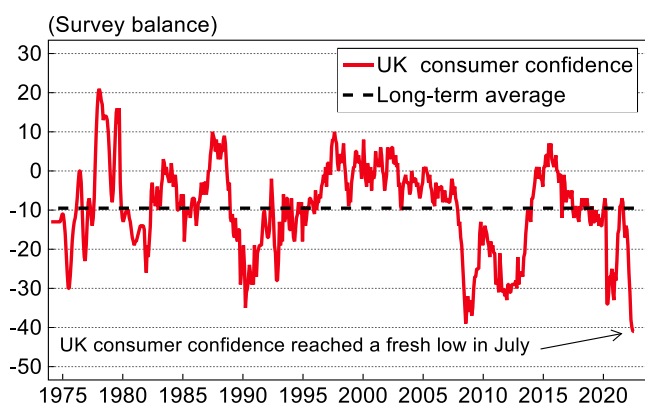
The Bank of England's latest projections, which do not assume any increase in support beyond what has already been announced, outline five consecutive quarters of negative GDP growth from Q4 2022 to Q4 2023, with growth thereafter to be “very weak by historical standards”, and the unemployment rate rising above 6% in 2025.

There are certainly plenty of warning lights flashing – consumer confidence has reached a fresh all-time low and the buffer of savings accumulated by households during the pandemic has been mostly eroded by inflation and rising costs of living.

That said, the outlook probably won't be quite as dire as the BoE describes – we know that there will be at least *some* increase in fiscal support from September. However, Truss' current policy pledges look plainly insufficient in terms of supporting economic activity given the scale of the energy crunch that is coming down the track.

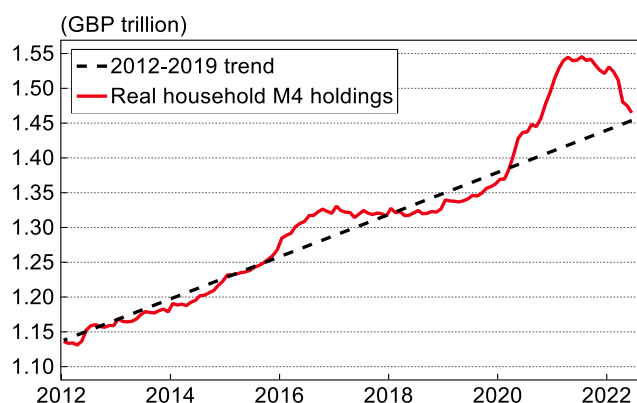
For now, there is probably an incentive for Truss and Sunak to talk up the possibility of tax cuts and downplay the likelihood of direct transfers to more vulnerable households (Conservative members, who vote on the outcome of the contest tend to be wealthier than the average UK citizen). So we expect the next PM to increase targeted support measures beyond what has been pledged during the ongoing leadership contest once elected. It's still a guessing game, however, as to what degree of extra help will be provided, or how targeted it will be.

CONSUMER CONFIDENCE IS AT AN ALL-TIME LOW



Source: GfK, MUFG Bank Economic Research Office

SAVINGS BUFFERS HAVE BEEN ERODED



Source: Bank of England, ONS, MUFG Bank Economic Research Office

Our base case is that extra measures will ease cost-of-living pressures to a degree, but fall short of fully shielding the poorest households from the October energy price cap increase as was the case with the May package. The government is likely to be wary of introducing fiscally expensive measures that would be politically hard to unwind if energy prices remain elevated. Meanwhile, the delay in announcing any extra support is not helpful – the energy story dominates the news and we expect an increase in precautionary saving to increasingly drag on spending through Q3.

A recession looks hard to avoid

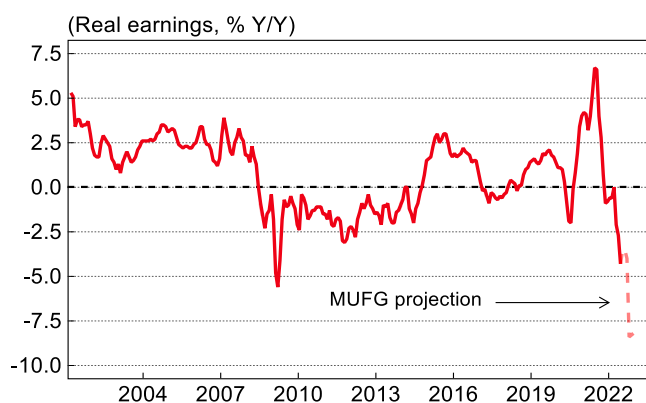
While our current forecast is not as bleak as the BoE's, we do expect a UK recession around the turn of the year. After some mild and brief respite in Q3, GDP is set to contract considerably in Q4 as energy costs (and price rises more broadly) rock the UK economy. The energy price cap is to be adjusted more frequently from next year (from every six to every three months) and current market pricing points to another increase in January, so we have pencilled in a consecutive, albeit more moderate, GDP contraction in Q1 next year.

Any subsequent recovery is likely to be sluggish. Recent BoE rate hikes will increasingly filter through to the real economy. 80% of UK mortgage holders are on fixed rates, but at the end of these fixed rate deals, which are typically between two and five years in length, home-owners will be forced to re-mortgage onto considerably more expensive terms. We think that the BoE will struggle to raise rates quite as high as has been priced in by markets, but another 50bp hike in September still seems more likely than not at this stage, meaning over 200bp of tightening since this time last year. We also expect unemployment rates will start to edge up by year-end as the sense of gloom around the economy intensifies and firms start to put off hiring decisions.

Meanwhile, the ONS has suggested that 7% of businesses were affected by industrial action in June. That figure is likely to rise, providing a further drag. The (so far) resilient labour market may embolden more workers to strike against a background of sharp falls in real pay, which is likely to continue for some time. Our current inflation forecasts are in line with the BoE's: CPI is likely to rise above 13% in October (10.1% currently) when the price cap increases.

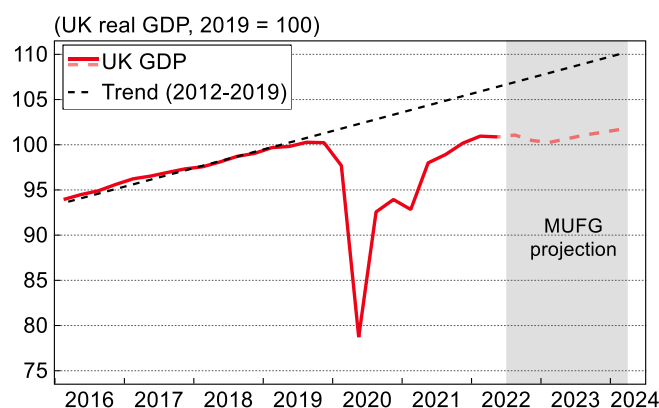
So it is set to be an extremely challenging period for the UK. Overall, we expect UK GDP growth of 3.4% in 2022 (which is hugely flattered by a carryover effect of 2.8pp from last year). We then expect annual average growth of just 0.2% in 2023, with the UK economy left staggering after what looks set to be an extremely tough winter.

THE SQUEEZE ON HOUSEHOLDS WILL INTENSIFY



Source: ONS, MUFG Bank Economic Research Office

OUTLOOK – RECESSION THEN A SLOW RECOVERY



Source: ONS, MUFG Bank Economic Research Office

UK MACRO FORECASTS

<i>% Y/Y unless otherwise stated</i>	2019	2020	2021	2022F	2023F
GDP	1.7	-9.3	7.4	3.4	0.2
Household spending	1.2	-10.5	5.9	3.9	0.0
Government spending	4.2	-5.9	14.3	-0.3	1.3
Fixed investment	0.5	-9.5	5.9	6.3	2.6
Net exports (<i>contribution, pp</i>)	0.1	1.0	-1.4	-3.6	-0.7
Unemployment rate (%)	3.8	4.6	4.5	3.9	4.5
CPI	1.8	0.9	2.6	9.4	6.0
Average weekly wages	3.5	1.7	5.9	4.9	3.2

Source: ONS, MUFG Bank Economic Research Office

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