HENRY COOK
Senior Europe Economist

Economic Research Office

T: +44 (0)20 7577 1591
E: henry.cook@uk.mufg.jp

MUFG BANK, LTD.
A member of MUFG, a global financial group

Still in the slow lane

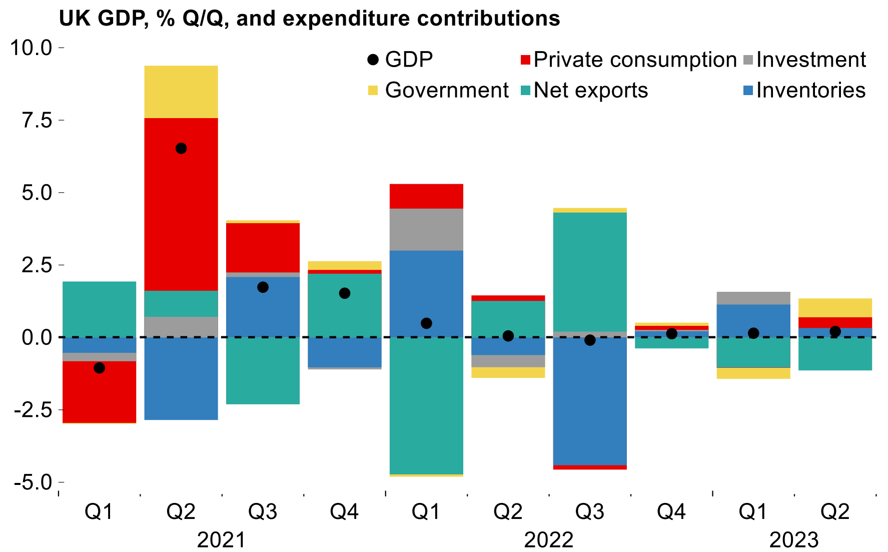
16 August 2023

- Not only has the UK economy avoided recession but the latest growth figures surprised on the upside, supported by resilient domestic spending.
- The longer-term trend is less encouraging: growth is essentially flatlining. Supply-side challenges and the ongoing pass-through of higher interest rates are set to remain headwinds for the UK economy.
- We look for UK GDP growth to average 0.4% this year and 0.6% in 2024, with pass-through from higher interest rates providing the main headwind.

The economy continues to avoid recession

The UK economy continues to show its resilience, eking out 0.2% Q/Q growth in Q2 despite persistent inflation pressures, rapid monetary policy tightening and a working day lost for the King's coronation. This was above the consensus expectation (0.0%) and is plainly good news.

Chart 1: Resilient domestic demand sees the UK economy evade recession



Source: ONS, MUFG Bank Economic Research Office

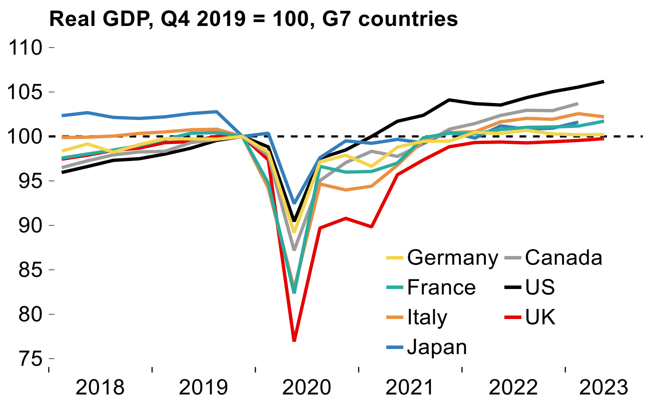
By expenditure component, household consumption (0.45% Q/Q) contributed strongly despite CPI averaging 8.4% across the quarter (never underestimate the UK consumer). There was also solid growth in government expenditure (0.65% Q/Q) after increased public sector pay awards. Total investment was flat but there was more encouragement from the business investment component (3.3% Q/Q) which is now, finally, above its 2016 level. It remains well short of the pre-referendum trend however, and was boosted by aircraft deliveries. Nonetheless, the overall picture for domestic demand was encouraging (Chart 1). Net trade developments were less rosy: a 1.1pp drag on quarterly growth. Services exports slumped by 4.0% Q/Q – the series is volatile but this would be a concern if the strong services trade performance in 2022 (10.1%) were to continue to reverse.

Overall, the Q2 data painted a picture of resilience in the face of clear headwinds as the UK economy continues to dodge recession. In fact, after a gloomy spring we may now be past 'peak despair' when it comes to the UK's economic situation, at least when it comes to short-term data flow. Following a series of upside surprises on inflation and ever-higher interest rate expectations there was very little to cheer about earlier this year. There was finally some better news in the June CPI figures (down to 7.9% from 8.7% in May) and another substantial decline in July (to 6.9%), largely due to the 17% fall in the household energy price limit last month. Services inflation still looks a little too sticky for comfort, rising 0.3pp, but evidence from surveys and the producer price index bodes well for further normalisation of headline price growth. Despite stronger-than-expected wage growth figures this week, forward pricing for the peak BoE rate is still around 60bp lower than in early July after a dovish hike at the August meeting. Taken together, some cautious optimism has returned when it comes to the UK's situation.

Growth has flatlined since 2022

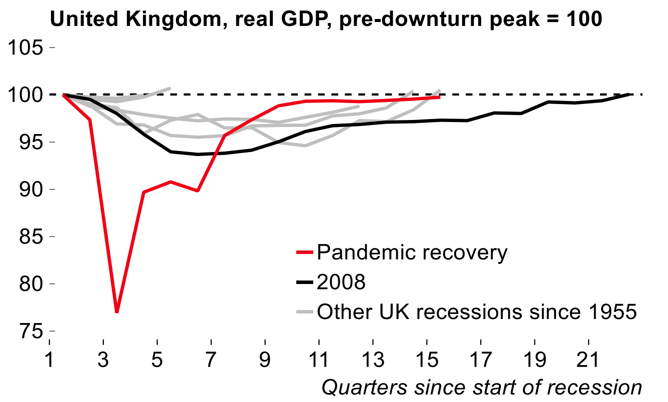
However, zoom out and the trend is less encouraging: growth remains anaemic. UK GDP is still below the Q4 2019 (pre-pandemic) level, unlike all other G7 economies (Chart 2). By our reckoning, this is now the second-slowest post-recession recovery in the UK since the 1950s. Only after the GFC did it take longer for GDP to recover to the pre-downturn level (Chart 3).

Chart 2: UK GDP still lags behind G7 counterparts



Source: Macrobond, MUFG Bank Economic Research Office

Chart 3: Now the second slowest recovery on record



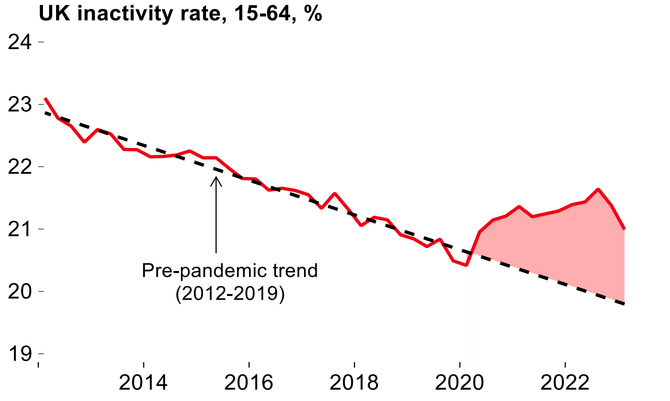
Source: ONS, MUFG Bank Economic Research Office

It's hard to make a case for any solid acceleration in growth from here. As well as the pandemic-induced supply-chain shock and the European energy crisis, the UK economy has also suffered from two additional supply-side problems: 1) Brexit and 2) higher economic inactivity, the latter of which is at least partly related to health service outcomes. As discussed previously (see here), both are longer-term issues.

On Brexit, it has been reported recently that the introduction of some import checks on certain food goods from the EU, due to come into force in October, will be delayed again – for the fifth time. Kicking the can down the road again will help the process of disinflation, but a lack of clarity about future policy will continue to hamper businesses (over 20% of firms still cite Brexit as a top-3 source of uncertainty). Our broad view remains that Brexit trade friction (through extra paperwork, etc.) is set to weigh on UK potential GDP growth for years to come.

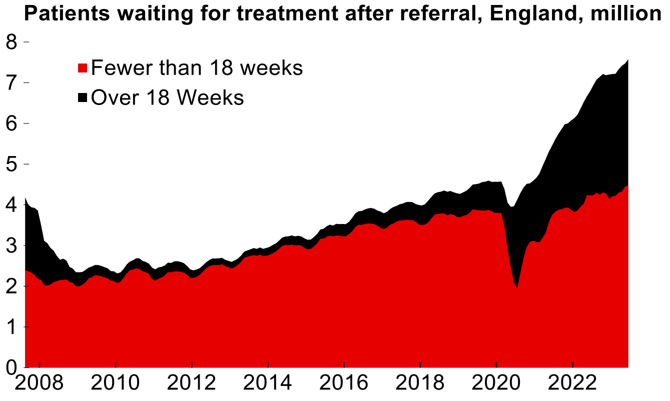
On economic activity, over 2.5m people cite long-term sickness as a reason for not participating in the labour force, with the number increasing again in the latest available data for May. There are no signs of improvement in health service bottlenecks: the latest data show that the number of patients waiting for treatment increased to a new record of 7.6m in England. The median wait time from referral to treatment was 14.3 weeks in June, roughly double the pre-pandemic figure.

Chart 4: Economic inactivity remains a challenge



Source: OECD, MUFG Bank Economic Research Office

Chart 5: The public health service remains stretched



Source: NHS, MUFG Bank Economic Research Office

Signs of resilience to the mortgage shock, but it's not over yet

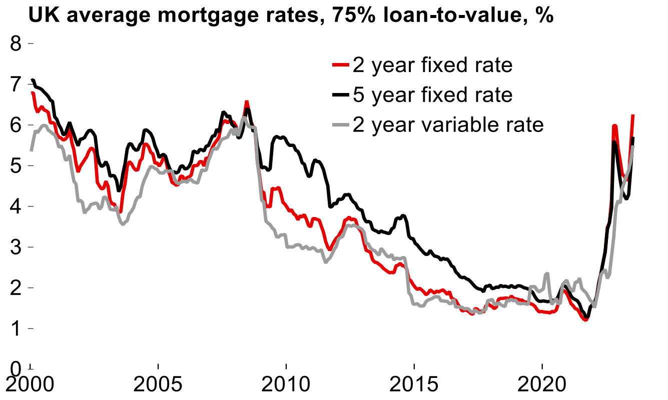
Household spending (60% of GDP) remains key to the outlook for growth. We mentioned above that consumers have been relatively resilient to the real income/mortgage payment shock. The ongoing strength of the labour market, where a few cracks are now appearing but the unemployment rate remains relatively close to historic lows, will have helped to support confidence. The number of online job adverts is holding steady at 2019 levels – there are still plenty of jobs out there, even though pandemic-related distortions to the labour market have largely faded. Meanwhile, the flipside of BoE rate rises hurting borrowers has been higher interest payments for savers, with UK banks relatively good at passing these on to deposit holders.

However, housing costs will likely dominate as the mortgage shock continues to pass through to the real economy. The majority (75%) of UK mortgage holders fix rates for two or five years. To illustrate the shock from BoE tightening, consider that the average quoted rate (on a 75% loan-to-value mortgage) for both terms has increased from 1.3% in October 2021 to around 6% currently (Chart 6). This shift would see monthly repayment costs on a typical 25-year mortgage for an average priced house in England increase by around 580GBP – or over 20% of median household disposable income (FY 2022).

Recent data are somewhat encouraging that households, in aggregate, are managing to navigate the extra mortgage burden. The ONS social trends survey shows that the proportion of adults finding paying rent or mortgage payments 'difficult or somewhat difficult' has fallen from 46% in early July to 38% currently. This is still high, but the fall could reflect some easing in real pay conditions – CPI-adjusted average weekly earnings growth is now back in positive territory, recovering from a low of -5.7% Y/Y at the end of 2022 to +0.7% Y/Y in the latest figures for June.

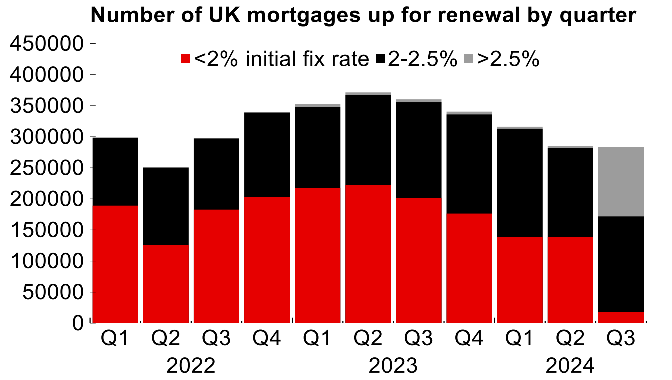
There has also been a clear trend for homeowners to extend the term of their mortgage when renewing the deal in order to decrease monthly payments (the government has tweaked regulation and promoted this as a possible approach for struggling households). However, the latest data from UK Finance suggest that we could be approaching the limit of term-extension – the proportion of new house purchase mortgages with terms of 30 years or more has plateaued in the last few months. Meanwhile, the rate shock will continue to pass through to the economy. Over 1.4m homeowners will re-mortgage from previous deals fixed which were fixed below 2.5% over the next five quarters (Chart 7).

Chart 6: Mortgage rates have soared to around 6%



Source: BoE, MUFG Bank Economic Research Office

Chart 7: The lagged pass-through to mortgage holders



Note: Fixed rate deals only, some transactions not included.
Source: Macrobond, MUFG Bank Economic Research Office

Weak expansion remains our base case

The resilience shown in the Q2 data is encouraging. Our base scenario remains that the UK economy will avoid a recession, but growth will remain muted over the next 18 months or so. That is, quarterly growth will be flat or slightly positive. We look for UK GDP growth to average 0.4% this year and 0.6% in 2024, with pass-through from BoE tightening, and higher mortgage rates in particular, as the main headwind. We also expect that deterioration in the labour market will increasingly weigh on confidence over the next year.

So, short of a synchronised global upswing scenario to drag the UK along – perhaps prompted by relief of a Fed soft landing in the US – it's hard to make much of a case for an upside surprise for the UK economy from here. There could be *some* pre-election fiscal giveaways from the UK government (the next election is likely to be held in autumn next year). However, stretched public finances after the pandemic, energy crisis and interest rate shock will not allow for a great deal of fiscal support. The bottom line is that it's likely to be a slow grind ahead for the UK economy – a recession may be avoided, but growth figures are unlikely to provide much to cheer about.

CERTIFICATION

The author(s) mentioned on the cover of this report hereby certify(ies) (or, where multiple authors are responsible, individually certify with respect to each security that the author covers in this report) that the views expressed in this report accurately reflect their personal views about the subject company(ies) and its (their) securities, and also certify(ies) that they have not been, are not, and will not be receiving direct or indirect compensation in exchange for expressing any specific recommendation(s) or view(s) in this report.

DISCLAIMERS

This report has been prepared by the Global Markets Research, US Rates and Credit Strategy desks within MUFG Bank , Ltd. ("MUBK") and MUFG Securities EMEA plc ("MUS(EMEA)") and may be distributed to you either by MUBK, MUS(EMEA) or by another subsidiary of the Mitsubishi UFJ Financial Group ("MUFG").

Legal entities and branches

The securities related businesses within MUFG (together referred to in this presentation as "MUFG Securities") are: (1) MUFG SECURITIES EMEA PLC ("MUS(EMEA)") which is authorised in the United Kingdom by the Prudential Regulation Authority ("PRA") and regulated by the Financial Conduct Authority ("FCA") and the PRA (FS Registration Number 124512). MUS(EMEA) has a branch office that is registered at Level 3, East Wing, The Gate, Dubai International Financial Centre, PO Box 506894, Dubai, UAE ("Dubai Branch"). The Dubai Branch is authorised to operate in the Dubai International Financial Centre ("DIFC") as a Non-DIFC Entity (Commercial License Number CL1656) and is regulated by the Dubai Financial Services Authority (Reference Number F002623); (2) (MUFG Securities (Europe) N.V. ("MUS (EU)") which is authorized and regulated in the Netherlands by the Dutch Authority for the Financial Markets (AFM) and also regulated by De Nederlandsche Bank (DNB). MUS (EU) Paris Branch is regulated in France by the Autorité de contrôle prudentiel et de résolution (ACPR) and the Autorité des marchés financiers (AMF); (3) MUFG SECURITIES AMERICAS INC. ("MUSA") which is registered in the United States with the Securities and Exchange Commission ("SEC") and regulated by the Financial Industry Regulatory Authority ("FINRA") (SEC# 8-43026; CRD# 19685); (4) MUFG SECURITIES (CANADA), LTD. ("MUS(CAN)") is an investment dealers registered in Canada with the Ontario Securities Commission ("OSC") and in each province and territory of Canada, a member of the Investment Industry Regulatory Organization of Canada ("IIROC"), and a member of the Canadian Investor Protection Fund ("CIPF"). Customers' accounts are protected by CIPF within the specified limits; (5) MUFG SECURITIES ASIA LIMITED ("MUS(ASIA)") which is incorporated in Hong Kong, licensed under the Hong Kong Securities and Futures Ordinance and regulated by the Hong Kong Securities and Futures Commission (Central Entity Number AAA889). MUS(ASIA) is registered as a foreign company under the Corporations Act 2001 of Australia ARBN No. 169 329 453; and (6) MUFG Securities Asia (Singapore) Limited ("MUS(SPR)") which is licensed as an approved merchant bank by the Monetary Authority of Singapore. In respect of the financial services provided to wholesale clients in Australia, MUS(ASIA), MUS(EMEA), MUS(USA) and MUS(SPR) are each exempt from the requirement to hold an Australian financial services licence under the Corporations Act 2001 of Australia under the Australian Securities and Investments Commission Class Order Exemption CO 03/1099, CO 03/1103, CO 03/1100, and CO 03/1102, respectively. Each of MUS(ASIA), MUS(EMEA), MUSA, MUS(CAN), and MUS(SPR) are regulated under the laws of Hong Kong, the United Kingdom, the United States, Canada and Singapore respectively, which differ from Australian laws.

MUFG Bank Ltd ("MUBK"), is a limited liability stock company incorporated in Japan and registered in the Tokyo Legal Affairs Bureau (company no. 0100-01-008846). MUBK's head office is at 7-1 Marunouchi 2-Chome, Chiyoda-Ku, Tokyo 100-8388, Japan. MUBK's London branch is at Ropemaker Place, 25 Ropemaker Street, London EC2Y 9AN, and is registered as a UK establishment in the UK register of companies (registered no. BR002013). The principal office of MUBK's Canada branch (MUFG Bank, Ltd., Canada Branch) is located at 200 Bay Street, Suite 1800, Toronto, Ontario, M5J 2J1, Canada. MUFG Bank's Canada branch is an authorized foreign bank branch permitted to carry on business in Canada pursuant to the Bank Act (Canada); Deposits with MUFG Bank Canada are not insured by the Canada Deposit Insurance Corporation. MUBK is authorised and regulated by the Japanese Financial Services Agency. MUBK's London branch is authorised by the UK Prudential Regulation Authority ("PRA") and regulated by the UK Financial Conduct Authority ("FCA") with limited regulation by the PRA.

General disclosures

This report is for information purposes only and should not be construed as investment research as defined by MIFID 2 or a solicitation of any offer to buy or sell any security, commodity, futures contract or related derivative (hereafter "instrument") or to participate in any trading strategy. This report does not constitute a personal recommendation and does not take into account the individual financial circumstances, needs or objectives of the recipients. Recipients should therefore seek their own financial, legal, tax or other advice before deciding to invest in any of the instruments mentioned in this report.

Certain information contained in this report has been obtained or derived from third party sources and such information is believed to be correct and reliable but has not been independently verified. MUFG does not make any guarantee, representation, warranty or undertaking, express or implied, as to the fairness, accuracy, reliability, completeness, adequacy or appropriateness of any information or comments contained in this report. Furthermore the information may not be current due to, among other things, changes in the financial markets or economic environment. MUFG has no obligation to update any such information contained in this report.

The information contained in this report may contain forward-looking information ("FLI"). FLI is information regarding possible events, conditions, or results of operations that is based on assumptions about future economic conditions and courses of action and may be presented as either a forecast or a projection. This report is not intended to forecast or predict future events. Past performance is not a guarantee or indication of future results. Upon receipt of this report, each recipient acknowledges and agrees that any FLI included herein should not be considered material. Recipients should consult their own legal and financial advisers for additional information. Any prices provided herein (other than those identified as being historical) are indicative only and do not represent firm quotes as to either price or size.

This report is proprietary to MUFG and may not be quoted, circulated or otherwise referred to without our prior written consent. Notwithstanding this, MUFG shall not be liable in any manner whatsoever for any consequences or loss (including but not limited to any direct, indirect or consequential loss, loss of profits and damages) arising from any reliance on or usage of this report and accepts no legal responsibility to any investor who directly or indirectly receives this material.

Country and region specific disclosures

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or is located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to any law, regulation or rule. Each entity and branch within MUFG is subject to distinct regulatory requirements and certain products and services discussed in this document may not be available in all jurisdictions or to all client types.

In this regard, please note the following in relation to the jurisdictions in which MUFG has a local presence:

• United Kingdom / European Economic Area (EEA): This report is intended for distribution to a "professional client" or "eligible counterparty" as those terms are defined in the rules of the FCA and PRA. In other EEA countries, this report is intended only for persons regarded as professional investors (or equivalent) in their home jurisdiction.

• United States of America: This report, when distributed by MUSA, is intended for Institutional Investors ("Institutional Accounts" as defined by FINRA Rule 4512(c)). When distributed by a non-US affiliate of MUSA, this report is intended for distribution solely to "major U.S. institutional investors" or "U.S. institutional investors" pursuant to Rule 15a-6 under the U.S. Securities Exchange Act of 1934, as amended. Securities referenced in this report may have been underwritten by MUSA and/or its affiliates. Nothing in this report should be considered an offer or solicitation of an offer to buy or sell securities or any other financial product or a commitment of any kind with respect to any transaction.

IRS Circular 230 Disclosure: MUFG Securities does not provide tax advice. Accordingly, any discussion of U.S. tax matters included herein (including any attachments) is not intended or written to be used, and cannot be used, in connection with the promotion, marketing or recommendation by anyone not affiliated with MUSA of any of the matters addressed herein or for the purpose of avoiding U.S. tax-related penalties.

• Hong Kong: This report is only intended for distribution to a "professional investor" as that term is defined in the Securities and Futures Ordinance and should not be passed onto any other person.

• Singapore: This report is only intended for distribution to an "institutional investor", "accredited investor" or "expert investor" as those terms are defined under regulation 2 of the Financial Advisers Regulation. It is solely for the use of such investors and shall not be distributed, forwarded, passed on or disseminated to any other person. Investors should note that, as a result of exemptions that apply when this report is distributed to "accredited investors" and "expert investors", MUSS is exempt from complying with certain requirements under the Financial Advisers Act, including section 25 of the Financial Advisers Act (which requires a financial adviser to disclose all material information on certain investment products), section 27 (which requires a financial adviser to have a reasonable basis for making recommendations on investments) and section 36 (which requires a financial adviser to disclose any interests that it holds in securities that it recommends).

• Canada: When distributed in Canada by MUS(EMEA) or MUSA. MUS(EMEA) operates under an International Dealer Exemption from registration with the securities regulators in Alberta, British Columbia, Manitoba, Ontario and Québec. MUSA operates under an International Dealer Exemption from registration with the securities regulators in all Canadian Provinces and Territories. When distributed by MUS(EMEA) or MUSA, this report is only intended for a "permitted client" as that term is defined under the National Instrument 31-103 in Canada and is not intended for re-distribution to any other person. When distributed by MUS(CAN), this report is only intended for an "institutional client" as that term in defined under the IIROC dealer member rules and is not intended for re-distribution to any other person. The information contained herein is not, and under no circumstances is to be construed as, a prospectus, an advertisement, a public offering, an offer to sell securities described herein, or solicitation of an offer to buy securities described herein, in Canada or any province or territory thereof. Under no circumstance is the information contained herein to be construed as investment advice in any province or territory of Canada and is not tailored to the needs of the recipient. • Japan: This Note, when distributed by MUFG Securities affiliates located outside of Japan, is intended for distribution in accordance with Article 58-2 of the Financial Instruments Exchange Act 1948 ("FIEA") i) to a "Financial Instruments Business Operator" engaged in "Securities-Related Business" as defined in the FIEA or ii) to the government, the Bank of Japan, a qualified financial institution defined in Article 209 of the Cabinet Office Ordinance Concerning Financial Instruments Business, Etc., or an Investment Manager.

When distributed by Mitsubishi UFJ Morgan Stanley Securities Co., Ltd. ("MUMSS"), this Note is intended for distribution to a "Professional Investor (tokutei-toushika)" as defined in the FIEA.

• United Arab Emirates: This report is only intended for distribution to a "Professional Client" or "Market Counterparty" as those terms are defined under the rules of the Dubai Financial Services Authority and only a person meeting the criteria for these terms should act upon this report.

• Australia: This Note is only intended for distribution to persons in Australia who are sophisticated or professional investors for the purposes of section 708 of the Corporations Act of Australia, and are wholesale clients for the purposes of section 761G of the Corporations Act of Australia. This Note is not intended to be distributed or passed on, directly or indirectly, to any other class of persons in Australia.

Other jurisdictions:

MUFG Securities also relies on local registrations or regulatory exemptions in order to undertake certain securities business in other countries. In Thailand, MUS(EMEA) has a derivatives dealer registration with the Securities and Exchange Commission, Thailand. In Canada, MUS(EMEA) and MUSA each operate under an international dealer exemption registered with the securities regulators. MUS(EMEA) operates under the exemption in Alberta, Quebec, Ontario, British Columbia and Manitoba. MUSA operates under the exemption in all Canadian Provinces and Territories..

.