UK consumer outlook

Solid recovery ahead as Brexit-vote shock fades

July 2018

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Summary: rebound ahead for household consumption

Brexit hurts: Leaving the EU will lower the UK’s long-term potential growth rate and future growth rates in household wealth, real wages and consumption.

Initial shock over: Concerns about a collapse in short-term demand after the UK voted to leave the EU have not materialised in a serious way. Labour demand has continued to tighten relative to supply.

Rebound in real wages ahead: The mismatch between unemployed workers and the skills demanded by firms is widening. Real wage growth is likely to accelerate over the medium term as nominal wage growth rises to 3% and headline inflation trends towards 2%.

Consumption growth likely to pick-up nicely next year: A recovery in real wages may not immediately translate into a big pick-up in spending. Before going back to the shops in a major way, households may choose to slow their demand for credit and rebuild savings for a while to compensate for extending their balances sheets last year. As a result, expect the headline growth rate in real private consumption to remain subdued in 2018 (c1.2%) before rising to 1.9% in 2019 and 2020.

Key risks
- A disorderly no-deal hard Brexit
- A spreading of the London housing market correction

Key statistics
- c66% → consumption as a percentage of UK GDP
- 2.2% yoy → consumption growth five-year average to Q1 2018
- 1.7% yoy → Berenberg projection of consumption growth Q2 2018 to Q2 2020
- 0.83 → consumption growth and GDP growth (yoy %) correlation coefficient
Softer household consumption since the Brexit vote

• The Brexit vote ushered in the end of the consumer boom: Partly boosted by cheap oil, real consumer spending growth averaged 2.8% yoy in the 12 months leading up the Brexit vote. But higher import prices from the Brexit-vote related drop in sterling weakened the rate of growth in real consumption to an average of 1.5% yoy in Q4 2017 and Q1 2018. Real spending growth on durable goods and services – which makes up the bulk of consumer purchases – has more than halved.

• But nominal demand has remained firm: Data on retail spending show that nominal spending growth has increased to a post-Lehman high since the Brexit vote. As prices rose, households simply opened up their wallets more to target the level of real consumption they desired. Latest data show a sharp uptick in real spending as headline inflation has fallen.

• Stronger real spending growth ahead - if the UK avoids a hard Brexit and inflation continues to fall back towards the BoE’s 2% target.
Real income growth rebounds after dip

• **An early warning sign:** When the UK voted in June 2016 to leave the EU, sterling dropped sharply (by 16% in June-October 2016) as markets priced in higher long-term uncertainty and weaker long-term potential growth for the UK. The lower exchange rate pushed up producer prices and headline inflation. Real wages declined by c1% between June 2016 and February 2018.

• **The initial shock is fading:** Real wages have started to recover. Nominal wage growth is edging towards 3% – close to a post-Lehman high, but well below the pre-Lehman normal rate. As long as sterling remains stable or rises modestly, headline inflation should gradually trend towards the BoE’s 2% inflation target. Real wage growth is still modest. However, as nominal wage growth continues to pick up, real wages should gradually edge up over time.

• **Watch out for another near-term hit from oil prices:** Headline inflation (currently 2.4% yoy) will temporarily drift up towards c2.7% in coming months as the recent rise in the price of oil to the $70-75 range per barrel of Brent crude pushes up energy prices.
Consumer confidence robust despite hit to incomes

- **Confidence recovering**: Helped by the low oil price and strong employment gains, in June 2015 UK consumer confidence reached its highest level (+7) since January 2000. The long-term average (since 1975) for the GfK consumer confidence index is -9. In the run up to the June 2016 Brexit vote until December 2016, consumer confidence declined sharply to -13. During 2017, as real wages have started to recover, consumer confidence has edged back up to the long-term average (-9 in June).

- **The Brexit effect on expectations**: Households’ expectations for the general economic situation in 12 months declined by more than confidence following the Brexit vote – reflecting both the short-term effect on confidence from the fall in real wages, and the drop in long-term growth expectations. While expectations have recently rebounded along with the pick-up in confidence, a sizeable gap remains between the two indicators.

- **Still solid demand**: Despite the correction in confidence and expectations, household plans to buy a home or a car, or to spend on home improvement, have remained elevated at a close to post-Lehman high since the Brexit vote.
Solid finances amid elevated inflation expectations

- **The legacy of the financial crisis**: Households’ reported financial situation declined sharply in 2008 during the financial crisis. It fell further during the euro crisis.

- **The recovery until Brexit**: Improving labour market fundamentals and rising household net worth pushed households’ current financial situation to a record high and their expected financial situation to a post-Lehman high. Although the uncertainty from the Brexit vote has hit households’ financial confidence, the overall impact has been modest – both remain at high levels. Households’ expected situation has improved nicely in the past six months.

- **Sustained-elevated inflation expectations**: Even as the initial sterling-related boost to headline inflation has started to fade, consumer inflation expectations remain anchored at a high level.

- **Unemployment expectations edging up too**: This is normal during the second half of the economic cycle (see the 2000s period).
Employment at a record high

- **An employment-rich upswing:** During the last five years, the UK labour market has added jobs at a rate of around c480k per year based on monthly jobs data. In the five years to 2008, average annual gains were just c290k per month.

- **Record high employment:** In sheer number terms, the UK labour market has added almost 3.4m jobs since 2010. Boosted by a steady inflow of qualified migrants, at 32.4m workers, UK employment is 10% higher than the 2008 peak of 29.7m.

- **No major Brexit hit:** Employment has continued to rise since the Brexit vote. Between June 2016 and June 2018 the UK has added c640k jobs.

- **Has the UK reached full employment?** At 61.1%, the employment rate (for workers 16+) is at its highest on record. At 4.2%, the unemployment rate is at its lowest since 1973 – below the BoE’s estimate of full employment (4.5%). If employment gains remain strong and unemployment continues to fall, expect the BoE to revise up its estimate of full employment as measured by the unemployment rate to 4.0% or lower.

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**Employment (total versus annual change)**

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<th>Year</th>
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<tr>
<td>2008</td>
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**Employment rate and unemployment rate**

<table>
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<th>Unemployment rate (%)</th>
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<tr>
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<td>2</td>
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<td>2016</td>
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<td>-3</td>
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Still solid demand for labour despite high employment

- **Solid labour demand**: Vacancies signal firms’ demand for labour. Rising vacancies show that firms want to increase their workforces – and implicitly, that firms are willing to raise their wage bills.

- **How long can jobs growth last?** If there is still more slack in the labour market, job growth should remain solid. But if slack is limited, firms will begin to offer higher pay to the candidates that are most suited to the firm’s preference of skills, pushing up total wage growth.

- **Broad-based employment growth**: It is a myth that employment growth during the post-Lehman upswing has mainly come from the rise in part-time work. Comparing total employment between 2007 and 2017, the UK has added c1.2m full-time workers and c0.5m full-time self-employed workers – a total of c1.7m. Meanwhile, the UK has added 1.1m part-time workers – of which nearly half (c0.5m) were self-employed.

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**Total number of job vacancies**

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<td>Vacancies (000s)</td>
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**Employment by type – 2007 versus 2017**

- **Full-time employees**: 2007 - 2200, 2017 - 2300
- **Part-time employees**: 2007 - 1500, 2017 - 1600
- **Full-time self-employed**: 2007 - 400, 2017 - 500
- **Part-time self-employed**: 2007 - 300, 2017 - 400

Monthly data. Source: ONS.

Annual data. Source: ONS
Fundamentals point to healthy rebound in real wages

**Labour market tightness versus real wage growth**

**Inflation expectations versus weekly earnings growth**

- **A split from the fundamentals**: In the long-run, real wage growth tends to track the degree of tightness in the labour market. The shock Brexit vote has temporarily forced a gap in this relationship.

- **Labour markets remain tight**: But as the initial concerns about a collapse in short-term demand after the UK voted to leave the EU have not materialised in a serious way, labour demand has continued to rise relative to supply – increasing vacancies relative to unemployment. Tight labour markets and elevated inflation expectations should support a continued rise in nominal and real wages over time.

- **Expect faster wage growth ahead**: Over time, the temporary effects will fade and nominal wage growth should accelerate to a little north of 3%, in line with the BoE’s medium-term forecast. While such a growth rate in wages is lower than in the past, it remains consistent with the slower post-Lehman trend rate of GDP growth and decline in expected trend growth since the Brexit vote.

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Monthly data. Real wages = average weekly earnings adjusted by headline CPI. Vacancies/unemployed is based on total number of posted job vacancies divided by the total number of people registered unemployed. Source: ONS.

Quarterly data. Source: ONS, Bank of England/TNS.
High debt, but higher net wealth

Household assets and liabilities as a ratio of income

Breakdown of aggregate household wealth, by components

- **UK household debt is high**: The bulk of debt (c75%) is made up of mortgages. The stock of mortgage debt rose significantly in the run up to the financial crisis. Rising house prices and easy-access to credit encourages households to withdraw equity to fuel the consumer boom. That stock of debt as a percentage of disposable income has not fallen in a major way during the post-Lehman upswing.

- **How can households carry so much debt?** Although the total value of household liabilities is high on a historical basis, the asset side of household balance sheets has improved significantly during the last 10 years. Household net wealth has risen from four times disposable income in 2009 to five times disposable income in 2018. Low costs of credit and a strong net wealth position enable households to carry a high debt burden.

- **The wealth factor**: The major chunk of household wealth is pensions (41%). However, as pension wealth is not accessible during a person’s working life, wealth coming from property de facto counts for more than 50% of workers’ accessible wealth — even though it makes up around a third of total net wealth.
Falling inequality, but debt troubles lower incomes

• **The income gap is getting smaller**: One prevailing myth is that income inequality in the UK has risen since the financial crisis. This is simply false. The opposite is true instead. Boosted by solid labour demand and a rise in the income tax threshold, the bottom 20% of workers have enjoyed the strongest rise in real incomes (15%) since 2007, followed by the second quintile. Meanwhile, real incomes for the top 20% have stagnated.

• **But low income households still have the largest debt burden**: While the proportion of households reporting a high debt burden has fallen across all income bands, a significantly higher proportion of households in the bottom 10% report a high burden of debt. As poorer households typically have a higher propensity of consumption (as a percentage of total income), rising interest rates could squeeze their consumption growth by more than other income bands.

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**Annual data. 1. Households are ranked by their equivalised disposable incomes, using the modified OECD scale. 2. Source: ONS. Growth is reported in real terms, that is estimates for earlier years have been adjusted to take account of inflation. Source: ONS.**
How does the UK compare to other major economies?

- **The consumer is top dog**: Household consumption matters more for the UK than for other major European economies. Consumption makes up around 66% of UK GDP, just below the 69% for the US and well above the 54% of GDP in the Eurozone. When UK households are willing to spend, the UK economy typically does well. If consumption picks up, UK growth can rebound in 2019 and 2020 even if growth in the US and Eurozone moderates.

- **More debt, more assets**: While UK household debt as a percentage of disposable income is high on a European basis, and even relative to the US, UK households’ net wealth position is relatively strong. UK households are wealthier than their German, French and Italian counterparts on the continent, but not, unsurprisingly, wealthier than American households.
Strong consumer credit growth, mortgages subdued

- **Rebound in consumer credit**: Net consumer credit has almost recovered to its pre-recession level. Interest rates on credit cards and overdrafts have actually risen slightly during the last 10 years despite the BoE’s accommodative policy of rate cuts and quantitative easing, while personal loan rates are only slightly lower versus a decade ago.

- **Recovering fundamentals, not cheap money, drive credit demand**: The recovery in consumer credit appears to be the product of the broader economic and employment recovery, rather than the product of stimulative monetary policies by the BoE.

- **Still subdued mortgage lending**: Increased regulation on mortgage lending and already high levels of mortgage debt weigh on demand for mortgages. Net mortgage volumes remain more than 50% lower than the pre-crisis peak despite a drop in interest rates on both floating and fixed rate mortgages.

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**Consumer credit net volumes and lending rates**

- Personal loan £5,000 (%), lbs
- Credit cards (%), lbs
- Overdrafts (%), lbs
- Consumer credit (rhs)

**Mortgage net volumes and lending rates**

- Fixed rate 2 year 75% loan-to-value (%), lbs
- Standard variable rate (%), lbs
- Fixed rate 3 year 75% loan-to-value (%), lbs
- Mortgages (rhs)


Household saving rate likely to remain low

How much of a risk is the low household savings rate? Not much, at least when times are generally good. Strong employment gains, easy access to credit, and a strong net wealth position – households felt confident enough last year to lower their rate of saving to smooth consumption as real incomes declined following the Brexit vote. During the next downturn, the low rate of saving now may matter. Falling asset prices and a lack of cash for a rainy day could exacerbate any likely weakness in consumption that comes from job losses.

For now, there is little incentive to save: Households are not reckless when they save less at negative real deposit rates – money sitting in the bank would lose value at negative real interest rates. Only cautious households would save more when real returns are negative. Households’ improved net wealth position further discourages saving at negative interest rates. Although survey data suggests household intentions to save are rising, the savings rate is likely to remain low until real rates of return improve.
Risks from the housing market – the London story

• **A systemic risk:** Historically, national house prices and household consumption have tracked closely at a ratio of around four to one: a 10% yoy rise in house prices normally implies c2.5% yoy growth in consumption. It is hard to imagine a scenario where a nationwide fall in house prices did not trigger a sharp contraction in aggregate household spending.

• **No need to worry yet:** Unlike in previous upswings, major parts of the UK have not matched the upswing in London and its neighbouring markets. Without the boom, the national market is thus less vulnerable to a downturn. The mainly London-based risks in the housing market thus do not yet pose a significant threat to the economic outlook for the UK as a whole.

• **Why is the London and south-east market softening?** 1) the UK government raised stamp duty on second properties in April 2016; 2) Brexit has created risks that were not appropriately reflected in the exceptionally low property yields at the time of the Brexit vote, triggering a re-pricing; and 3) as the global economy improved over the past two years, London has faced stronger competition from other global cities.
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