DON'T UNDERESTIMATE THE UK CONSUMER

Elevated economic and political uncertainty is increasingly weighing on the outlook, causing the UK economy to experience some loss of momentum. One bright spot, however, has been the consumer, which has accounted for a greater share of economic growth since the EU referendum and provided a significant offset to weakness in other areas of the economy. In this note, we consider the current state of household spending, concluding that the conditions for it to remain a key contributor to economic growth remain strong.

UK ECONOMY FACING A NUMBER OF HEADWINDS

Domestic and international concerns are weighing on the outlook, resulting in a loss of economic momentum

The outlook for the UK economy has become more uncertain in recent months, driven by a combination of domestic and international factors. Domestically, rising political uncertainty associated with the UK's planned departure from the EU and the lack of progress in the negotiations are increasingly weighing on sentiment. The government's position on Brexit has hardened, both in terms of its negotiating stance with the EU and its stated commitment to leave – with or without a deal – at the end of October. The fluid nature of the situation is further complicated by the range of possible paths to a series of potentially very different outcomes to break the deadlock. Meanwhile, developments outside of the UK, including the persistence of trade tensions and the associated spillover effects onto business sentiment, have also combined to deliver a weaker outlook, particularly in the manufacturing sector.

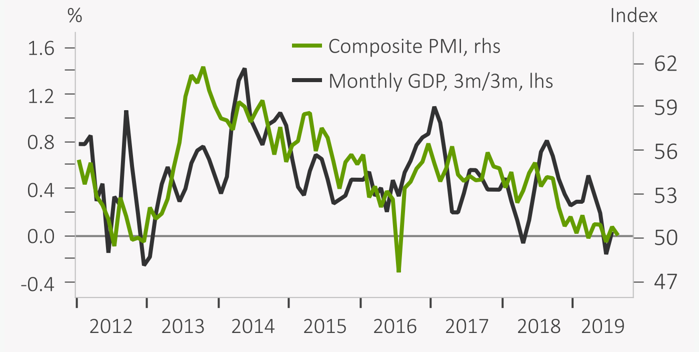
These factors have created significant volatility in recent economic data, reflecting firms stockpiling and shifts in seasonal shutdowns (particularly in car manufacturing) ahead of previous Brexit deadlines, with GDP growth of 0.5%q/q in Q1 followed by a contraction of 0.2%q/q in Q2. However, looking through this volatility, it is clear that the rise in uncertainty has caused the UK to experience a loss of economic momentum. Moreover, the further softening in surveys of business activity, including the IHS Markit Purchasing Managers Indices (PMIs) and the Lloyds Bank Business Barometer, suggest that underlying growth in the UK economy is likely to remain subdued, especially in the near term (chart 1).

THE CONSUMER HAS BEEN A BRIGHT SPOT

Consumer spending has proved resilient, providing an offset to weakness elsewhere in the economy in recent years

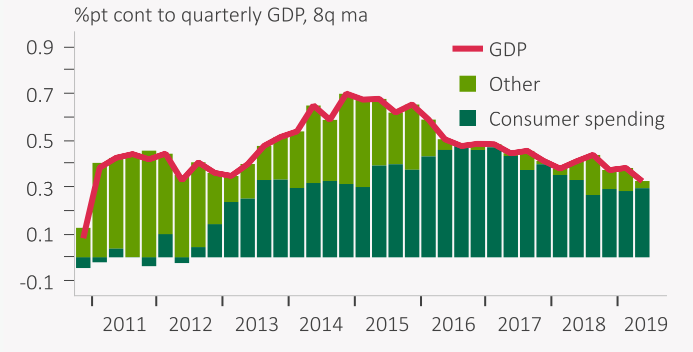
Elevated uncertainty has had a dampening effect on economic decision-making, particularly in the corporate sector, with business investment contracting in five out of the last six quarters. A notable bright spot for the economy, however, throughout the last few years has been the resilience of the UK consumer (chart 2). Since the Brexit vote in 2016, consumer spending has increasingly shouldered the burden of growth, accounting for around 70% of all UK GDP growth in the last three years and providing a significant offset to weakness elsewhere in the economy.

Chart 1: Business activity surveys consistent with only modest economic growth



Sources: Macrobond, LBCB Analytics

Chart 2: Consumer spending has accounted for a greater share of economic growth since the EU referendum



Sources: Macrobond, LBCB Analytics

Chart 3: Labour market remains strong with employment rate at a record high and unemployment near multi-decade lows

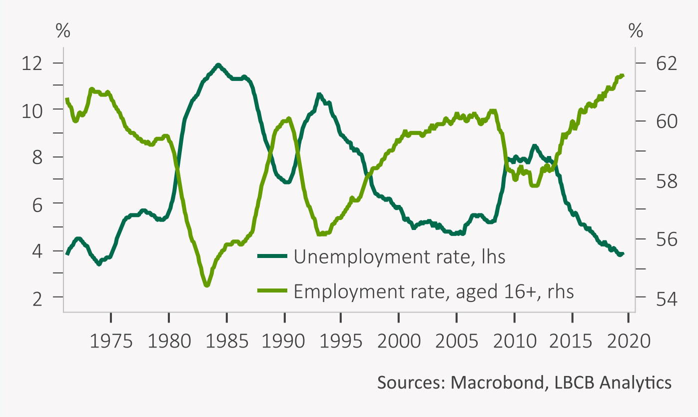
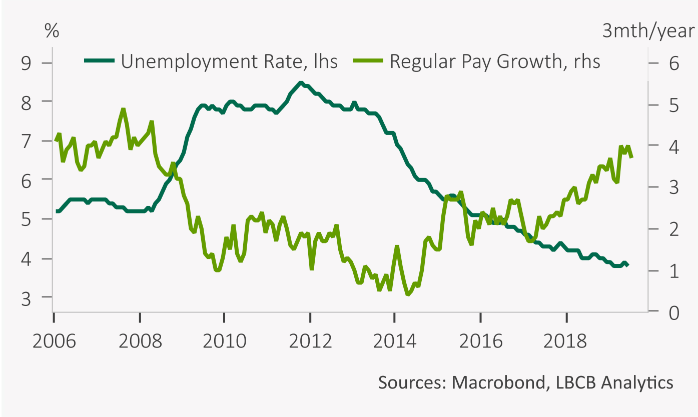


Chart 4: Low unemployment rate feeding into stronger pay growth



DEVELOPMENTS IN THE LABOUR MARKET HAVE BEEN KEY…

Record high employment and a multi-decade low unemployment rate have put upward pressure on wages

The fact that spending by households has proved so resilient, particularly against an uncertain economic outlook, largely reflects developments within the labour market. Lower levels of business investment, associated with the rise in uncertainty since the EU referendum, have meant that firms have increasingly relied upon labour as a way of boosting capacity in order to deal with increases in demand for their goods and services. This has pushed the rate of employment in the UK to new highs, while at the same time pushing the unemployment rate down to a level not seen in the UK since the mid-1970s (chart 3).

Accordingly, rates of pay growth have also increased and are now rising at their fastest pace since the financial crisis (chart 4). While it is true that hiring intentions have softened of late, the number of unfilled vacancies remains close to a record high (~820k) and suggests there is still a lot of pent-up demand for labour. Benchmarked against the number of people currently unemployed (1.32mn), on average there are currently less than two unemployed people per each unfilled vacancies. Typically, such a ratio is consistent with further gains in wage growth (chart 5), which along with reports of rising recruitment difficulties point to further upside in pay (chart 6). Taken together, strong gains in employment combined with rising pay growth have provided a supportive backdrop to consumer spending (chart 7).

…AS HAVE THE IMPROVEMENTS IN HOUSEHOLD BALANCE SHEETS

The low interest rate environment has supported an improvement in household financial positions

Households' financial positions have also benefited from the low interest rate environment. The share of disposable income that households are having to use to service their mortgage debt has fallen from a peak of around 11% of disposable income during the crisis to around 7% currently (chart 8). Low interest rates have encouraged a greater proportion of those with mortgages to take out fixed rate mortgage products. At present, over 90% of new mortgages are granted on a fixed rate with the share of the outstanding stock of mortgages that are on a fixed rate now above 70% (chart 9).

This suggests that even if policy rates were to rise, it would take some time to impact fully upon households. More broadly, because of lower market interest rates, it is likely that those mortgage holders that are rolling off a three- or five-year product soon, will likely benefit from lower product rates (chart 10), further easing the burden of servicing secured household debt. While it is true that the outstanding stock of unsecured 'consumer credit' has picked up to a record high, total household debt relative to income remains well

Chart 5: Lack of available labour putting upward pressure on wages

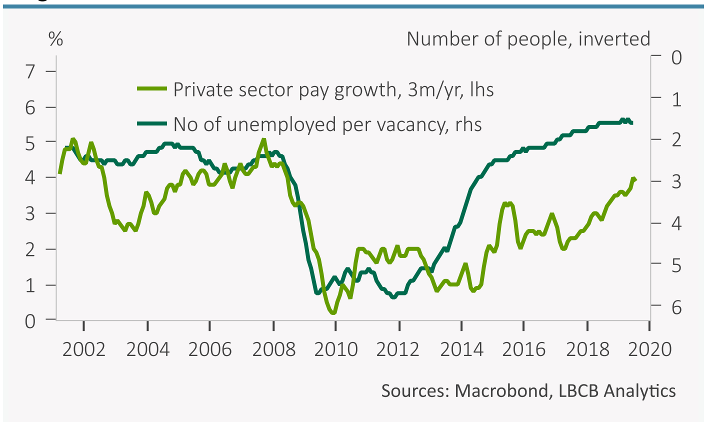


Chart 6: Firms are continuing to report recruitment difficulties

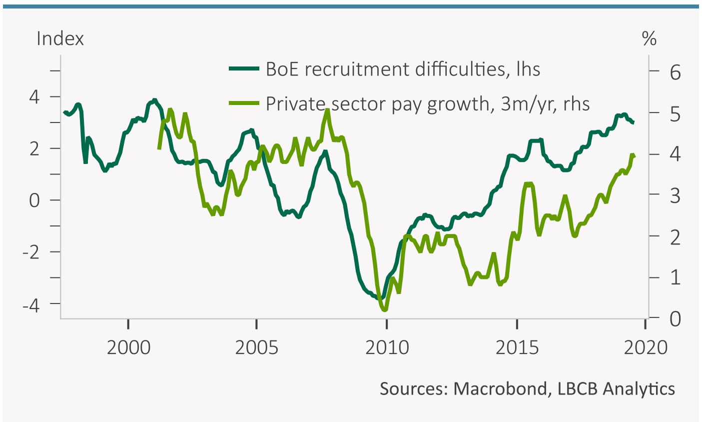


Chart 7: Rising pay growth has provided a supportive backdrop for consumer spending

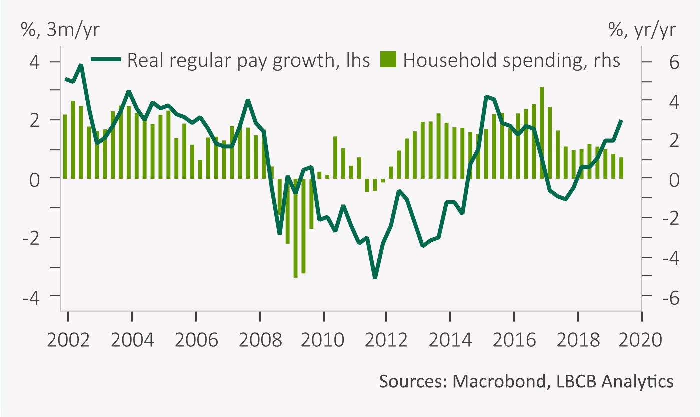
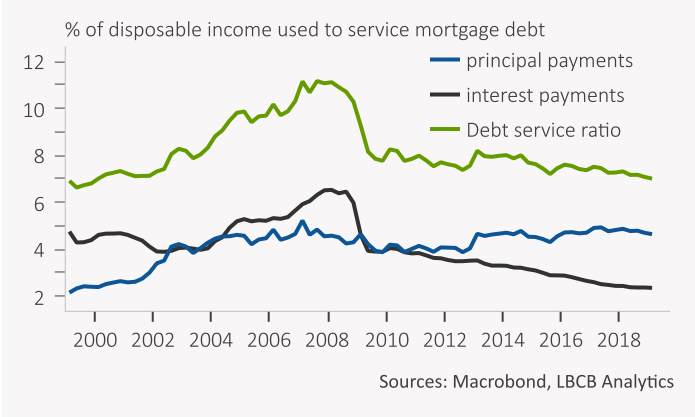


Chart 8: Proportion of income spent servicing mortgage debt has fallen, easing the pressure on households' budgets



below the highs reached during the financial crisis. Moreover, the net asset position (total assets minus total debt) of households has continued to improve.

SIGNS OF UK CONSUMER WEAKNESS EXAGGERATED

Surveys of retail activity and declines in headline measures of consumer confidence have provided a poor guide to official data on retail spending

The recent deterioration in surveys/reports of retail activity, both from the British Retail Consortium (BRC) and the Confederation of British Industry (CBI) – along with the GfK's headline measure of UK consumer confidence recently dropping to a six-year low – have raised some concern that the malaise in other areas of the economy may now be spreading to the consumer sector. In the UK, consumer spending figures are only published quarterly. However, given that around 40% of all spending by consumers is on retail goods, the monthly retail sales reports from the Office for National Statistics (ONS) are closely watched for a more frequent update.

In recent months, the surveys have painted a more sombre assessment of trends in the sector, particularly relative to the ONS' reports (chart 11). This has raised some concern that the downbeat message from these surveys may eventually be reflected in the official data. Much of the discrepancy between surveys and the official ONS retail sales report, however, is explained by differences in coverage. The ONS monthly retail sales report aggregates turnover from ~5,000 retailers and is estimated to account for around 93% of total retail spending, whereas the BRC's monthly retail sales monitor collects responses from a much smaller sample of retailers, around 95 companies, most of which are big retailers and only account for around 60% of total retail sales activity.

Moreover, of those retailers surveyed by the ONS, the majority (around 80%) are small- and medium-sized firms, and as a result, probably leaves the official report better placed to capture overall spending, especially at internet-only retailers. This suggests that the ONS report is most likely providing a more accurate assessment of trends in retail spending, particularly with an increasingly greater proportion of activity now taking place online (chart 12). Consequently, we would urge caution in interpreting the survey evidence and instead place more importance on the official data, which shows that the UK consumer has continued to prop up the economy.

Chart 9: Borrowers have taken advantage of the low interest rate environment to fix their mortgage

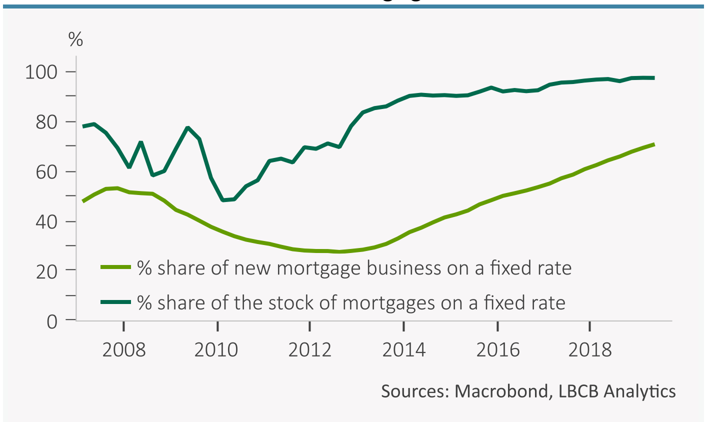


Chart 10: Average fixed rates for three- and five-year mortgages are lower relative to three and five years ago

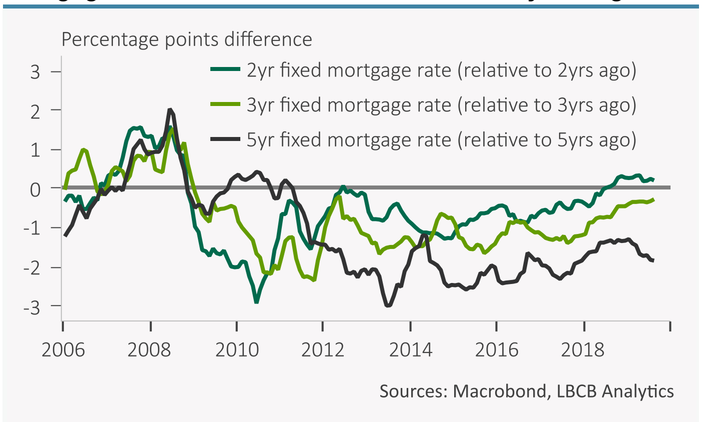
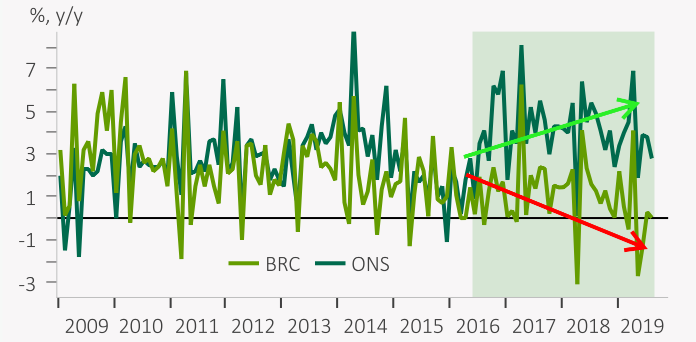
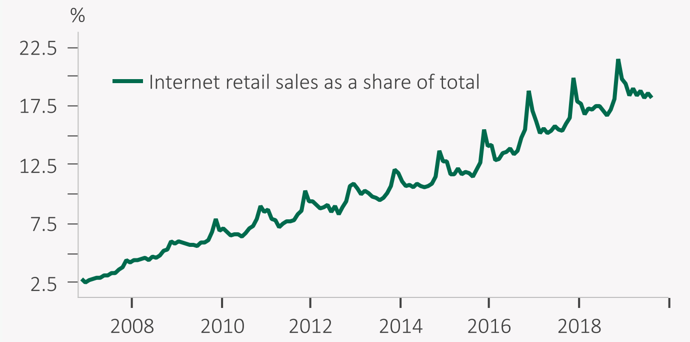


Chart 11: Surveys have painted a more-sombre picture of health than the official retail sales figures



Sources: Macrobond, LBCB Analytics

Chart 12: An increasing share of retail sales is taking place online, an effect likely not fully captured by the surveys



Sources: Macrobond, LBCB Analytics

The fact that UK consumers have continued spending also contrasts with the recent downturn in 'headline' measures of UK consumer confidence. Since the 2015 general election, at which the promise of an EU referendum formed part of the Conservative Party's manifesto, consumer confidence has steadily deteriorated, recently dropping to a six-year low according to the GfK (chart 13).

However, a closer examination of the survey results shows that much of the decline in the overall measure has been led by a marked drop in households' expectations for the wider economy, resonating with the deterioration seen across a number of business activity surveys. However, this pessimism is in sharp contrast to households' perceptions about the current state (and 12 months ahead prospects) of their own finances, which have held remarkably resilient.

HOUSEHOLDS' DESIRE TO MAINTAIN SPENDING PATTERNS SHOULD NOT BE UNDERESTIMATED

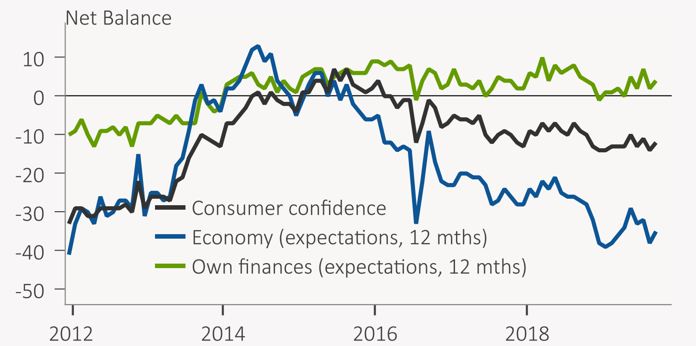
During previous episodes of squeeze, households have reduced the proportion of income saved

Meanwhile, another striking feature has been the appetite of households to maintain spending patterns. While it is true that the purchasing power of household earnings has been helped by stable and relatively contained consumer price inflation, at times of high inflation households have resorted to reducing the proportion of their income that is saved (the saving ratio) in order to maintain spending habits.

This was particularly evident after the EU referendum in 2016, when the sharp fall in the pound pushed import prices higher leading to a sharp acceleration in inflation in the quarters that followed, thus eroding some of the purchasing power of the pound in people's pockets. However, rather than reduce consumption, households responded by lowering their saving ratio (chart 14), highlighting a strong appetite to maintain consumption patterns.

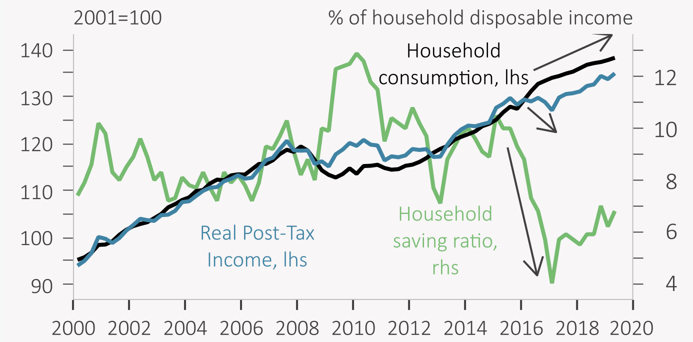
Overall, therefore, the UK consumers' ability and appetite to keep on spending should not be underestimated. While developments around Brexit are likely to remain a key influence over the UK economy for some time and could yet test the consumers' resolve, in our view, the conditions for the consumer to continue shouldering the burden of growth in the UK remain intact.

Chart 13: Drop in consumer confidence due to weaker economic prospects while personal finances holding firm



Sources: Macrobond, LBCB Analytics

Chart 14: Do not underestimate the UK consumers' desire to spend



Sources: Macrobond, LBCB Analytics

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