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Elston Insights

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UK Growth: that shrinking feeling

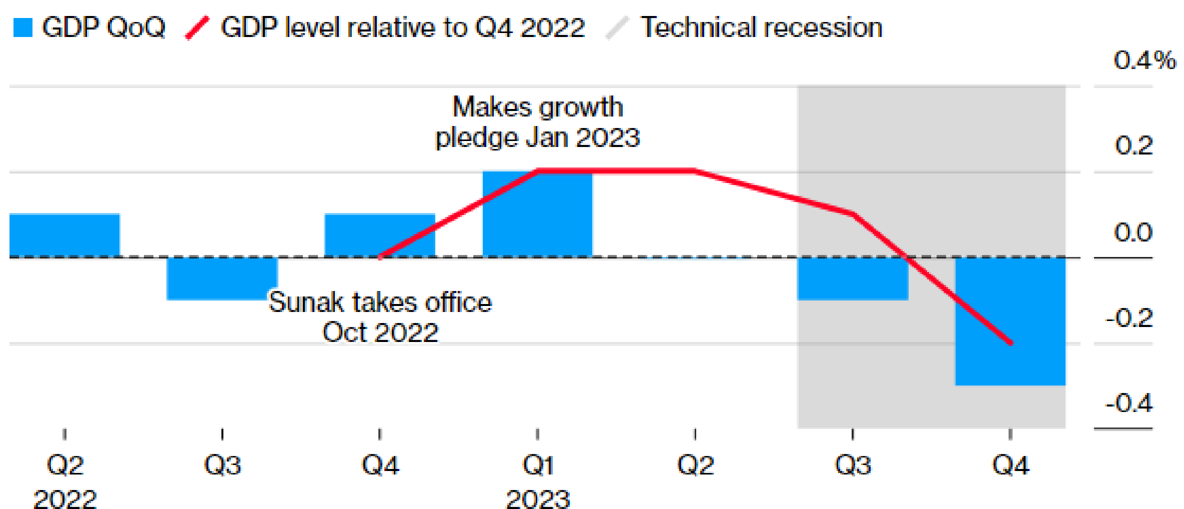
- The UK slid into recession in 2023
- A tricky balancing act for the Bank of England
- For well diversified portfolios, the impact should be limited

Recent data shows the UK slid into technical recession in the second half of 2023. This is bad news for the Government in this election year. It also creates a tricky balancing act for the Bank of England between holding firm on interest rates (and deepening the recession), or cutting too early before inflation is fully contained. For well diversified portfolios, the impact should be limited.

What happened?

Latest data from the Office of National Statistics shows that UK GDP fell 0.3% in 4q23, more than the 0.1% that was expected, and the BoE forecast of 0.0%[1]. 3q23 decline of 0.1% was left unrevised. As well as being a negative surprise, the two successive quarters of GDP decline mean that in the second half of 2023 the UK technically was in recession (defined as two successive quarters of GDP declines).

Fig.1. UK GDP quarter-on-quarter growth



[1] https://www.bloomberg.com/news/articles/2024-02-15/uk-fell-into-technical-recession-in-second-half-of-last-year

What it does it mean for the UK?

For politics: growing the economy was one of PM Rishi Sunak's five pledges for 2023, and won't be the only pledge to have failed. This provides little support for his election prospects in the context of already dire polls.

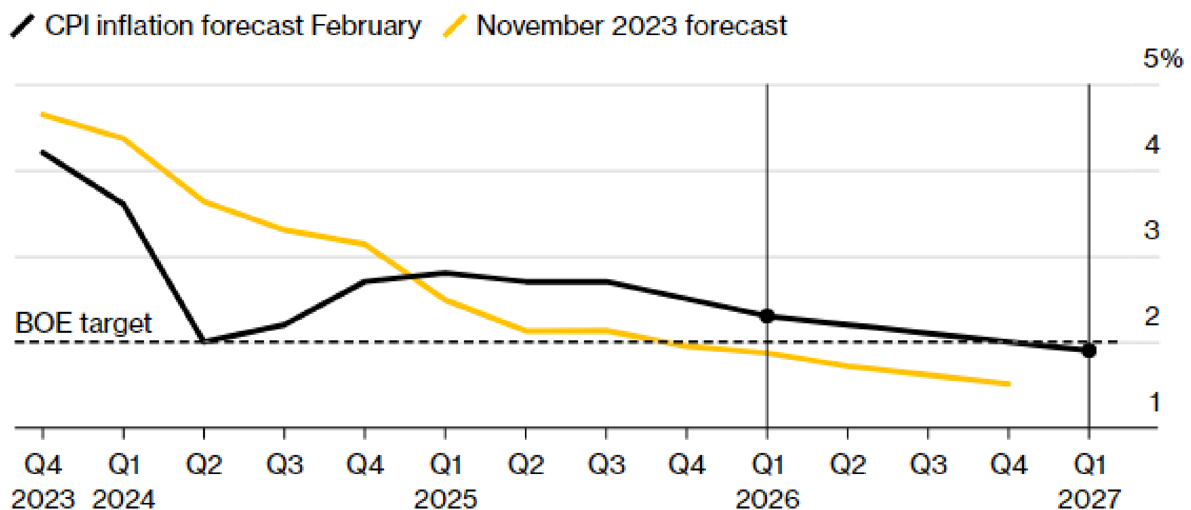
For the economy: the deceleration in growth means the initial bounce back after Covid has played out, and the economy is stagnating with above-target inflation.

For monetary policy: the Bank of England's mandate is to target inflation, not to support growth. But if the BoE were to leave rates unchanged, there is a risk they could crush growth and drive inflation below 2% target. The slowing of the economy should help cool inflation, and bring forward the possibility of rate cuts.

What is the market reaction?

The market is focused primarily on how this will impact the BoE's decision-making. They were late on to inflation. Could they be late onto starting to ease restrictive policy? The BoE has previously indicated its next move on rates will be downward. But it has also suggested it needs to see more evidence that inflation is indeed receding. It expects inflation to fall to the 2% target by May. The most recent inflation print (+4.0%yy in January, slightly below +4.1% estimate) did nothing to disturb that thesis. However, looking further ahead, estimates for inflation whilst now much lower for 2024 and 2025[2], but remain above target rate until 4q26: so it's a difficult balancing act.

Fig.2. UK inflation is falling faster than previously expected



[2] https://www.bloomberg.com/news/articles/2024-02-01/bank-of-england-signals-rate-cuts-possible-once-inflation-eases

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Based on market-implied rates, investors are fully expecting a first cut in August, with a 70% chance of a cut in June. The BoE's next rate decision is 21st March 2024.

What does it mean for key asset classes?

We consider the potential impact of this UK recession data on multi-asset portfolios by considering the impact on four key asset classes.

- Global Equities: a UK recession would have almost no impact on Global Equities, which can make up the bulk of an equity allocation within a multi-asset portfolio. The UK economy is not sufficiently large in a global context to impact other markets.
- UK Large-Cap Equities: for large cap equities, represented by the FTSE 100, the majority of their revenues is earned overseas and predominantly USD based. This can provide supportive under a weaker GBP scenario.
- UK Mid-/Small-Cap: Share prices are forward looking, economic statistics are backward looking, so for UK mid-caps and small-caps, arguably their share price performance has already priced in UK recession risk. Mid-caps and small-caps have been more pressured by higher interest rates, so could fare better as and when interest rates start coming down. The timing of the BoE "pivot" is key for this exposure.
- Bonds: The prospects of lower BoE interest rates could be positive for longer-duration UK bonds. Again, the timing of the BoE "pivot" is key. Within the Global bonds exposure, because of potentially weaker Sterling as rates fall, unhedged global bonds could fare better than their GBP-hedged counterparts.

Summary

News of a UK recession adds to the general sense of malaise in the UK political and news arena. But for investors in well-constructed, globally diversified portfolios, that have the flexibility to adapt to changes in the market and economy, this news not have a material impact on portfolios. By contrast, US earnings, valuations, and interest rates have far greater bearing on global risk appetite and global markets that could impact portfolios. And these – along with broader and geopolitical risk considerations – should also be navigated carefully.

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Further Reading

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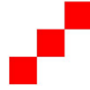

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