Asset Management

The UK economy

An extract from UK real estate insights - Issue 13, July 2009

PRICEWATERHOUSECOOPERS

The UK economy

As discussed in the previous edition of UK real estate insights and at our conference in May, the nature of the real estate crisis is changing, and we are seeing increasing signs of tenant distress. The prospects for the UK economy are therefore key. Simultaneously with the publication of this edition of UK real estate insights, we are also publishing our UK Economic Outlook. The executive summary of the report is set out below.

Highlights

- UK GDP is projected in our main scenario to fall by around 4.25% in 2009, but GDP should start to pick up later this year and into next year, with modest average growth of around 0.5% in 2010 projected in this scenario.
- Consumer spending growth is also expected to turn negative at -3.5% in 2009, due to the severe squeeze on consumer spending from high debt levels, tighter credit conditions, falling housing wealth and rising unemployment. We also expect a further 0.75% decline in consumer spending in 2010 and only a gradual recovery thereafter as households seek to reduce their debt burdens and return their savings ratios to more normal levels.
- Business investment growth is expected to fall sharply in 2009 as a result of the continuing credit crunch, while housing investment will also continue to decline. In our main scenario, house prices may not bottom out until 2010 with only a very gradual recovery thereafter.
- Destocking made a major contribution to the very sharp fall in GDP in Q4 2008 and Q1 2009. While the reversal of this stock adjustment could lead to quarterly GDP growth becoming positive again before the end of 2009, there is a risk of a relapse into recession in early 2010 (allowing also for the effect of VAT rising back to 17.5% from 1 January 2010).
- Public spending growth will remain positive in 2009 and 2010, but will need to be cut back sharply in the medium term to bring under control a budget deficit that is projected to rise to over 12% of GDP in 2009/10. Significant tax rises are also likely to be needed from 2011 onwards, over and above what the government has already announced.
- Slower global growth has dampened exports, but imports have fallen even more sharply, which should enable net exports to make a positive contribution to overall GDP growth in 2009. The relative weakness of the pound compared to levels typically seen in the previous decade will also tend to support a gradual export-led recovery in 2010.
- Risks around growth in our main scenario are more balanced than earlier this year, but are still somewhat weighted to the downside. We therefore recommend that businesses should stress test their plans and valuations against an alternative ‘prolonged recession’ scenario in which GDP falls by around 5% in 2009, with negative growth continuing into 2010. But an upside scenario where growth rebounds to above trend levels by the end of 2010 can also not be ruled out.
- Inflation is projected to fall back below target during the second half of 2009 as the economy slows and to remain below target during 2010, but there are still considerable uncertainties around this relating to the path of global commodity prices and sterling.
- The bank rate is assumed to be left at 0.5% for the rest of 2009 in our main scenario. There will be a continuing focus on quantitative easing by the Bank of England to ease liquidity and credit conditions in key financial markets.
- This issue includes a detailed assessment of the potential adverse impact of the downturn on different age groups. We find that the youngest age group is the most exposed to rising unemployment, but that older workers nearing retirement will also be severely hit as they are not only at relatively high risk of losing their jobs in downsizing exercises, but will also have seen their prospective pensions and their housing wealth fall very significantly over the past two years.

Continued

The UK economy

Recent developments

The UK economy moved into a severe recession during the course of 2008, with the rate of decline accelerating even further in the first quarter of 2009 according to the latest official GDP estimates (see Figure 1.1).

More recent business surveys and data releases point to a significant moderation in the rate of decline in Q2 2009, although official GDP estimates for that quarter were not available at the time of writing. Consumer and business confidence has become less negative, purchasing managers surveys now point to a modest upturn in activity in services and less steep declines in manufacturing and construction, and the housing market has also shown some tentative signs of stabilising, albeit at a low level. Several other major economies have also shown signs of bottoming out according to OECD leading indicators.

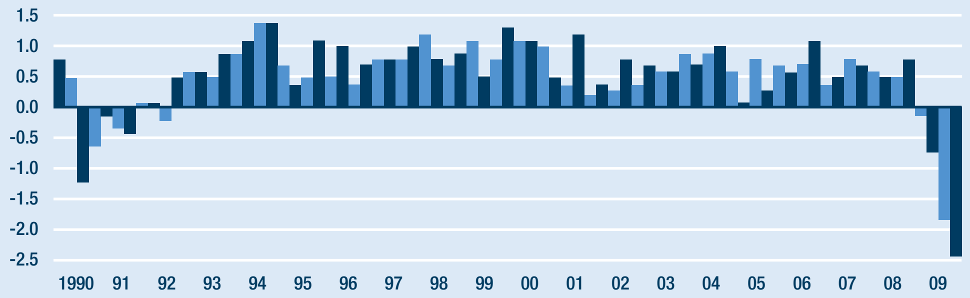
However, the extent of the good news should not be exaggerated and to a significant extent just reflects the normal operation of the stock cycle: the period of very sharp destocking has run its course, which will lead to an automatic recovery in orders and output levels in the short term, but the question is whether this upturn can be sustained in the face of rising unemployment and still fragile confidence levels. Credit conditions have improved to some degree, but are likely to remain relatively constrained for some time to come. Oil prices have started to rise again and the pound has not been as weak in recent months as it was earlier in late 2008 and early 2009.

Governments around the world have introduced fiscal stimulus packages to support monetary policy easing, although these are pushing budget deficits up to worryingly high levels from a longer term perspective, not least in the UK. The global financial system remains fragile, with further major shocks possible, despite government intervention to support the banking system across the world.

Future prospects

Our main scenario sees UK GDP falling by around 4.25% in 2009, but with quarter-on-quarter growth edging back into positive territory by the fourth quarter, due in large part to the stock cycle effects mentioned above. But there could be a relapse into negative growth in Q1 2010 after VAT rises back to 17.5% on 1 January next year. Thereafter, we would expect a gradual recovery to resume as the effects of past fiscal and monetary loosening feed through, but growth in 2010 is still likely

Figure 1.1: Quarterly GDP growth % change on the previous quarter



Source: ONS (note that Q2 2008 growth is zero)

Table 1.1: Summary of UK economic prospects

Indicator (% change on previous year)	HM Treasury forecasts (April 2009)		Independent forecasts (June 2009)		PwC Main scenario (July 2009)	
	2009	2010	2009	2010	2009	2010
GDP	-3.75 to -3.25	1 to 1.5	-3.7	0.6	-4.25	0.5
Consumer spending	-3.25 to -2.75	0 to 0.5	-2.9	-0.4	-3.5	-0.75
Investment	-11.25 to -10.75	-3.25 to -2.75	-10.5	-3.0	-13	-3
Manufacturing output	-12.75 to -12.25	-0.25 to 0.75	-10.8	0.7	-11	-0.25
CPI (Q4)	1	1	1.0	1.6	-1.25	-1.75

Source: HM Treasury Budget 2009 and Survey of Independent Forecasts (average values), PwC scenarios rounded to the nearest quarter of a percent. Investment refers to total fixed investment.

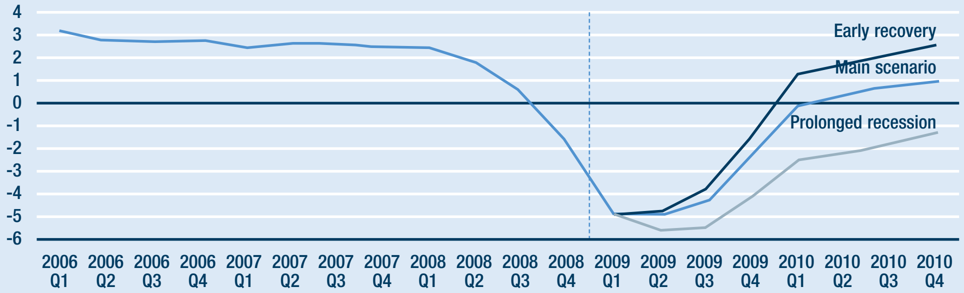
to remain modest at an average of only around 0.5% for the year as a whole.

As shown in Table 1.1, our main scenario is broadly similar to the latest average independent forecast for 2010, but less optimistic than the Treasury's Budget forecast regarding the pace of recovery in 2010.

Continued

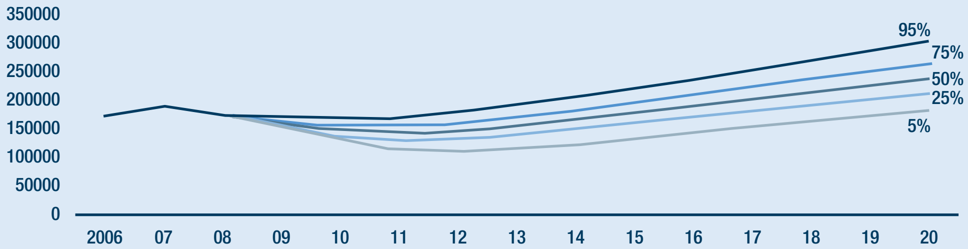
The UK economy

Figure 1.2: Alternative GDP growth scenarios Year-on-year % growth



Source: ONS, PricewaterhouseCoopers

Figure 1.3: Fan chart for UK house price projections (plausible range) Average UK house price (£)



Source: PwC analysis based on average of Halifax and Nationwide indices for nominal house prices; the model estimates 5% chance of house prices being below bottom line and 95% chance they are below top line in chart; 50% line shows the median projection

Both our main scenario and the projections of other forecasters are subject to significant margins of uncertainty, as indicated by the alternative GDP growth scenarios shown in Figure 1.2. Risks to our main scenario for growth are more balanced than earlier in the year, but are still weighted somewhat to the downside, particularly in the short-term. We would therefore recommend that businesses should stress test their plans against the 'prolonged recession' scenario shown in Figure 1.2, which envisages a 5% fall in GDP in 2009 with output continuing to decline throughout 2010. This is not the most likely scenario, but it certainly cannot be entirely ruled out. At the same time, the possibility of an earlier and stronger recovery can also not now be ignored, given recent relatively more positive data.

Consumer spending is projected to fall by around 3.5% in 2009 and a further 0.75% in 2010 in our main scenario. This reflects the squeeze on household spending power from credit constraints and rising unemployment.

This also takes into account the impact of an expected further fall in average UK house prices before bottoming out in 2010 in our main scenario, although there are considerable uncertainties around any such projections as illustrated in Figure 1.3. As in the 1990s, we would expect the period of relatively subdued house prices to extend well beyond the end of the technical recession as measured by GDP and this is reflected in our probabilistic house price model projections in Figure 1.3.

Business investment[1] is also likely to remain weak in 2009, reflecting both slower expected future demand growth and the influence of tighter credit conditions, even if the latter have started to ease somewhat in recent months. Housebuilding is also expected to remain subdued in 2009 and 2010, even if the worst of the decline in activity in this sector may now have passed.

Net exports are projected to make a positive contribution to GDP growth in 2009 and 2010 in our main scenario, although this is more due to weak imports than strong exports. The boost to exports from the fall in the pound since 2007 is offset by continued difficult economic conditions in the UK's key export markets in Euroland and the US.

Our main scenario for UK GDP growth would be consistent with inflation (CPI), falling back further during the rest of 2009 and probably remaining below target in 2010. In this case, it should be possible for official short-term interest rates to be held at levels close to zero during 2009 and early 2010, which should eventually help to revive the economy in conjunction with the ongoing quantitative easing programme. In the medium term, there is a risk that inflation could pick up again as and when the economy recovers, which could eventually cause interest rates to rise quite sharply to pre-empt this risk. But this is not likely to be an issue in the short term.

1 Business investment is the largest component of total fixed investment, which also includes housebuilding and government investment.

Continued

The UK economy

Table 1.2: Summary assessment of income and wealth effects of the downturn by age group

	Age groups			
	18-24	25-44	45-64	65+
Unemployment	XXXXX	XX	XXX	0
Average earnings	XXX	XX	X	0
Interest income/payments	+	++	+	XX
Pensions/equity wealth	0	X	XXX	X
Housing wealth	0	X	XX	XXX
Total net impact*	**-7**	**-4**	**-8**	**-6**

Key: X = negative, 0 = zero or non-material, and + = positive impact on income or wealth
*Net balance of positive and negative effects – illustrative only
Source: PwC assessment

Longer term outlook for the public finances and medium-term policy implications

Looking further ahead, we would expect the pace of recovery in the UK economy in 2011 and beyond to be held back by the need to get the public finances back under control in the medium term. Public spending will need to be tightly constrained in 2011 and beyond as part of a programme of fiscal austerity, probably also including significant tax rises that will be needed to bring down the budget deficit, which the Treasury projects to be around 12% of GDP in 2009/10 and 2010/11.

The Treasury has recognised the scale of the problem in the Budget and is planning a programme of fiscal tightening, building up to just over 6% of GDP by 2017/18, equivalent to around £90 billion per annum at today's GDP values. But, we believe that the full extent of the fiscal tightening required could be around 10% of GDP (or around £140–150 billion at today's values), given the need to allow for both the longer term fiscal costs of an ageing population and the possibility that medium-term trend growth may well be somewhat slower than the Treasury projects.

We also highlight the temptation that future governments may face to relax the monetary policy regime (e.g. by raising the inflation target), so as to 'inflate away' part of the massive public debt that is building up. This would be likely to be self-defeating in the longer term and, to guard against any such temptation, we would recommend that all major political parties should commit clearly and unambiguously in their manifestos for the next general election not to make any such changes to the UK monetary policy regime.

Which age groups are being worst affected by the economic downturn?

In the report we look at a range of possible income and wealth effects of the downturn on different age groups. Our key conclusions from this analysis are summarised in Table 1.2, which shows that:

- The youngest age group (18–24) is suffering most from rising unemployment rates and this seems likely to continue. However, older workers (45–64) will tend to find it more difficult to find a new job if they are made unemployed.
- Young workers saw slower average earnings growth than older workers in 2008.
- Older generations tend to be net savers, while younger generations tend to be net borrowers. Therefore, benefitting more from current historically low interest rates (although some of them may also have suffered more from restrictions on the availability of credit).
- Workers approaching retirement who rely primarily on defined contribution pensions may have to work for longer because the value of their pension has been hit by both falling equity prices and relatively low annuity rates in recent years. State pensions, in contrast, have seen strong real increases recently, but interest income for retired savers will have been reduced to very low levels since late 2008.
- Older age groups have on average been impacted more by falling equity and house prices, due to their greater wealth holdings. Overall, therefore, all age groups will have suffered significantly from the current downturn. But the illustrative net balance calculation shown in the final row of Table 1.2 suggests that older workers approaching retirement with defined contribution pensions may have been worst hit overall, followed by the youngest workers (aged 18–24), who tend to be most likely to lose their jobs in a severe recession. There are no age groups that are fully immune from the adverse effects of the downturn, but the 25–44 age group may be relatively less affected,

Continued

The UK economy

due both to its somewhat lower exposure to unemployment increases than younger workers and to being the age group with the most to gain from recent falls in mortgage interest rates.

To access a video of the highlights of UK Economic Outlook **click here**. To access the full report **click here**.

Which industry sectors are most vulnerable to the economic downturn? Which will recover first?

Almost all industry sectors are being affected to some degree by the current economic downturn. This shows which sub-sectors are regarded as the most vulnerable to the effects of the current recession. The graphs below show the results for the sub-sectors considered in the two excercises.

As outlined in the March edition of UK real estate insights, we have developed a PricewaterhouseCoopers Sector Vulnerability Index that combines 10 key economic and financial indicators for 15 major industry sectors.

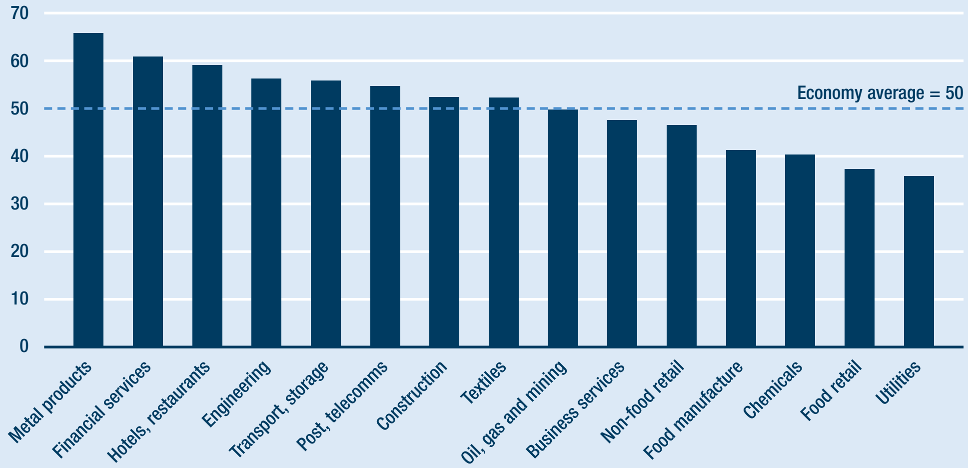
In April we produced an upturn index that indicates which sectors are likely to benefit faster from the eventual recovery in the UK economy than the average for the sectors covered by our analysis.

First signs of optimism returning to some parts of Financial Services

According to the latest CBI/PwC Financial Services Survey, many parts of the UK's financial services sector expect business volumes to rise in the next quarter after 21 months of falls, while

Impact of downturn on tenants PwC Sector Vulnerability Index

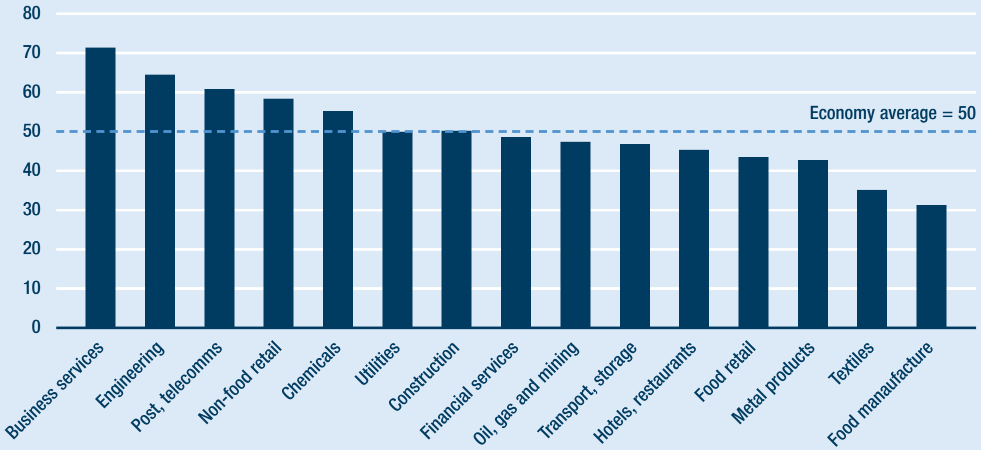
Higher index value = greater economic and financial vulnerability



Source: PricewaterhouseCoopers

Impact of downturn on tenants PwC up-turn Index

An overall score above 50 indicates a sector that is likely to benefit faster from the eventual recovery of the UK economy than the average for the sectors covered by our analysis



Source: PricewaterhouseCoopers

Continued

The UK economy

optimism about the overall business situation has risen for the first time in two years. But banking remains under pressure.

Although the three months to June saw levels of business, income and profitability continue to fall, this was at a much slower pace than earlier this year. This suggests the industry may now be on a gradual path towards recovery, though differences between the sectors remain.

Insurance companies are the most optimistic about growth in business over the coming quarter, while banks also expect volumes to rise. Building societies have experienced extremely tough business conditions since early 2008, but are now hopeful that volumes, income and profitability will stabilise in the next quarter. By contrast, securities traders and investment managers expect the recent improvement in their business to be short-lived, with volume declines expected to resume next quarter.

Although there are some more 'glimmers of encouragement' in the survey for the real estate industry, there is little to be cheerful about in this. There is nothing to suggest a rapid return of liquidity and the news regarding the financial services sector as tenants, particularly in London, is gloomy. The sector is expecting further reductions in profitability, employment and expenditure on property. It is also worrying for the longer term that overall, financial services firms were slightly less optimistic about the competitiveness of the UK as a financial centre than in March.

[Click here to access the full report]

Slight optimism also returns to retail

Following on from the Christmas trading update in January 2009, Andrew Garbutt, Retail Director and Stuart McKee, Corporate Finance Partner at PricewaterhouseCoopers have presented a webcast looking at the key trends and themes over the first quarter of 2009 and the outlook for the remainder of the year. The key messages are:

- Macroeconomic statistics are inconclusive as to where we are in cycle;
- However, other consumer data is starting to suggest a bottoming out and turnaround – sentiment appears to be improving – most evident in younger and higher demographics;
- This is likely driven by falling housing costs and utility prices, and also falling debt servicing costs – putting more pounds in the pocket. There is also evidence the recession media intensity has abated;
- In retail sales, there is some evidence of a 'declining decline' – evidence mirrored in the US. The US$:£ exchange rate will still have a serious impact on gross margin, but it is looking better than predicted and there are mitigating factors;
- Managing stakeholders – from pension trustees, credit insurers to the more routine players – is as critical as ever. It is vital to avoid complacency;
- There are opportunities for retailers – very good property deals, 'sales in play', opportunity for sales to foreign nationals and the growth of the Internet. Some retailers are still performing strongly – grocers, value players and young branded fashion in particular

[Click here to access the webcast]

For further information regarding macro-economic advice for the real estate industry, please contact Yael Selfin, who is Head of Macro Consulting, Economics in our Market & Value Advisory practice.

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