

## Why the UK economic outlook is looking brighter

The UK stagnated through much of 2023 and might have even entered a technical recession, albeit a small one. But things are looking brighter. Rate cuts will dampen the mortgage squeeze and gift the government with extra room for tax cuts. While we don't expect a dramatic acceleration in UK growth this year, the chances of a recession have fallen



British Prime Minister, Rishi Sunak, is expected to call a general election later this year

### Markets are expecting a lot of rate cuts this year

This Friday, we'll get another dose of UK monthly GDP data. And while we're expecting a November bounce after a disappointing October, much of the reporting will likely focus on the possibility of a technical recession through the second half of last year. A second-consecutive 0.1% fall in GDP is still possible in the fourth quarter, but that's hardly much to write home about.

The broader point is that the economy stagnated through much of last year. And more importantly, there are some reasons to be a little more optimistic about 2024.

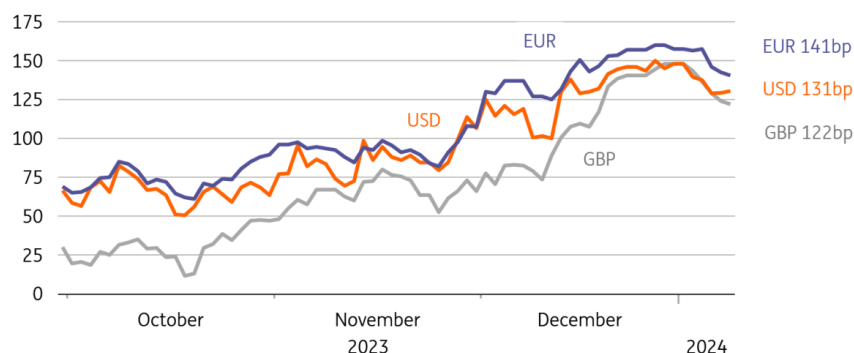
The UK is not alone in receiving a welcome boost from sharply lower market interest rates. Investors are now pricing five rate cuts from the Bank of England this year, and that's only slightly

less than what's priced for the ECB or Federal Reserve. But there are two ways the fall in market rates could have a more tangible impact on UK growth than elsewhere.

## Markets have ramped up rate cut bets

### 2024 rate cuts priced into financial markets (basis points)

December 2024 OIS relative to policy rate



Source: Macrobond, ING calculations

## The mortgage squeeze looks less worrisome with rate cuts on the horizon

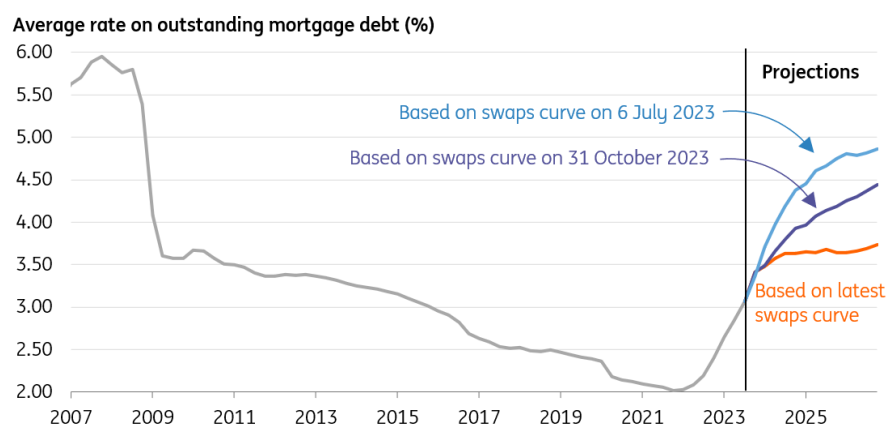
The first relates to mortgage rates. This has - rightly - been highlighted as an area where the transmission of rate hikes differs in the UK to elsewhere. The vast majority of UK mortgage holders are on fixed rates, and that has helped Britain avoid the more immediate consequences of higher rates compared to places like Canada or Sweden. Both have a high proportion of floating-rate debt and both have seen a larger hit to house prices and related economic activity.

But unlike France, Germany or the US, where homeowners are more likely to fix their rates for decades, the vast majority of UK lending is fixed for five years or less. The result is that roughly 20% of British homeowners are set to refinance this year.

With many households having refinanced already, the average interest rate paid on outstanding mortgages has climbed from around 2% to 3.3% as of November. Back in July, when markets expected the UK Bank rate to stay above 5% for at least two years, that average rate on existing lending looked set to climb to 4.5% by the end of 2024 as more and more homeowners refinanced away from low interest rates locked in pre-pandemic. Last summer, quoted rates on new mortgage lending surpassed 6%, and remain above 5%.

But with several rate cuts now priced, lenders are slashing rates rapidly. We therefore think the average mortgage rate on outstanding lending hasn't got much further to climb and we expect it to reach 3.6% at the end of this year, only a slight increase on where it is currently. Remember that only a quarter (28%) of households actually have a mortgage, and if only a fifth of them are refinancing this year, the impact on the wider economy shouldn't be overstated.

## Average mortgage rates are set to rise less aggressively in 2024



Source: Macrobond, ING calculations

Projections are based on the split of mortgage lending by initial fixation period, and assume an even proportion of borrowers refinance each quarter (for example, one eighth of those with two-years fixes). We have also assumed that a recent bias towards shorter fixation periods for those refinancing persists such that the share of those with two-year fixes gradually climbs.

## The Chancellor can expect £12bn extra "headroom"

In fact, so far households have actually seen a net increase in interest income as the Bank of England has raised rates. Partly, that's because savings rates have risen more readily than average mortgage rates. But it's also because households now have a similar quantity of interest-bearing deposits as they do liabilities, in contrast to the past 30 years or so where the latter has dominated the former.

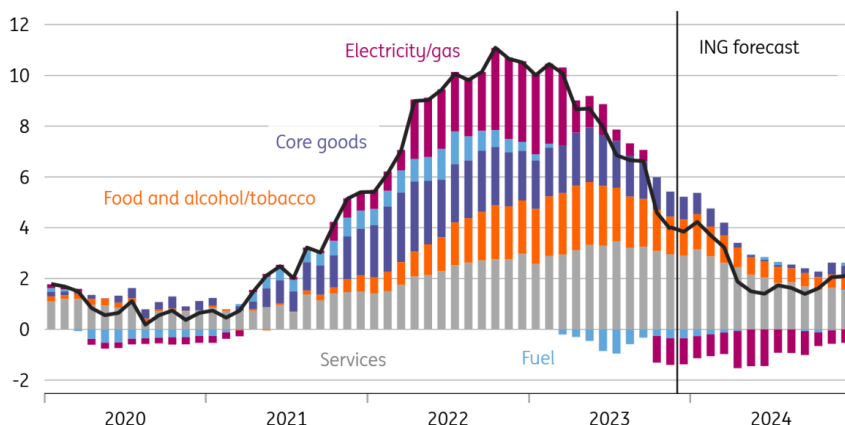
You'd expect the net interest income story to become more negative as savings rates fall and the passthrough of higher mortgage rates continues. And the distribution of those income-generating savings is largely concentrated among higher earners. Nevertheless, it does still act as a bit of a counterweight to the ongoing mortgage squeeze.

Lower market rates are also good news for the government. Ahead of an expected November general election, Chancellor Jeremy Hunt will be hoping to use his Spring Budget on 6 March to unveil tax cuts. Fortunately for him, the fall in both short-dated and, to a lesser extent, long-dated market rates/bond yields since November's Autumn Statement should unlock £12bn extra "headroom" by our estimates. That is extra money that he could, if he chooses, spend while still meeting his fiscal rules, and comes on top of the £13bn already available from November.

In other words, there's likely to be just shy of 1% of GDP worth of tax cuts that could be available, much of which would likely go on income tax if press reports are accurate. That could boost growth this year by, say, 0.2 to 0.4ppts, depending on what was announced. It is worth caveating that by saying that in order to meet its fiscal rules, the government is baking in a lot of tightening in subsequent years, including real-terms cuts in several spending areas.

But a more modest mortgage squeeze and prospect of potential tax cuts come alongside a backdrop of positive real wage growth. Headline inflation is set to fall to 1.6% in May on our current forecasts and stay below target until November. Some of that is linked to an expected 15% fall in household energy bills in April, more than offsetting the 5% increase last week.

## Headline inflation set to hit 1.6% in May



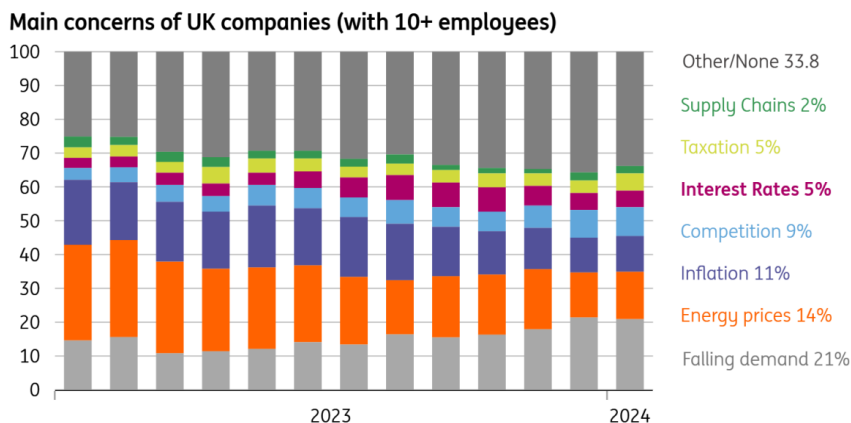
Source: Macrobond, ING calculations/forecasts

## Real wage growth is improving

By contrast, average earnings growth is falling much more slowly. The BoE's survey of Chief Financial Officers (CFO) shows that wage growth expectations haven't really changed for the past year. Even so, given the jobs market is cooling, we suspect private-sector pay growth can fall to the 4% area in late spring/early summer, down from 7.3% now. But that means it's still higher than inflation, and remember too that those on the National Living Wage will see a near-10% rise in wages in April.

None of this means we should expect a dramatic or imminent acceleration in UK growth. There's still an open question as to how higher rates will feed through to businesses this year. We know that small businesses have already felt the full force of rate hikes, given that most lending is on floating interest rates. But larger corporates appear to be more shielded, and the Bank of England reckons that refinancing risks this year are relatively limited, something that will have been helped by the sharp fall in market rates. Only 5% of businesses say higher interest rates are their biggest concern, according to ONS survey data. Nevertheless, it's an area with more limited data, and if businesses do come under greater strain, we'd expect greater pressure on the jobs market.

## How businesses rank their top concerns



Source: ONS Business Insight Survey

## The jobs market is cooling gradually, while savings have fallen in real terms

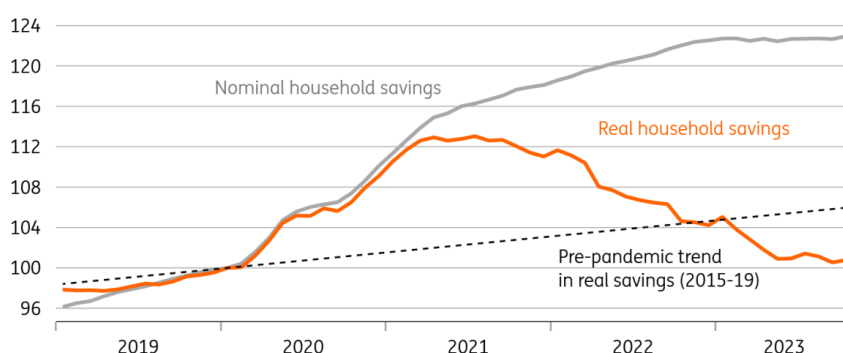
Admittedly, the jobs market is also an area with limited visibility, given recent reliability issues with the unemployment data. Improved figures are expected by Easter, but we know that unfilled vacancy numbers are falling quickly and will probably be back to pre-Covid levels by the summer. We expect the unemployment rate to drift higher this year, but not enough to drag the UK into a recession. This is, however, the major risk for this year's outlook.

Finally, there are questions about the availability of savings to boost spending this year. At face value, UK consumers still have a large war chest of "excess savings" where their US counterparts have spent them. And the headline savings ratio from the GDP figures rose through last year and stands above pre-Covid levels at 10%. But looking at data on household liquid deposits in bank accounts and adjusting for inflation, we see that the level of real savings sits below the pre-Covid trend. It's a similar story for corporates. So while balance sheets of both households and companies looks reasonably solid, the savings story isn't a reason to get carried away on this year's growth outlook.

## Real household liquid savings have fallen below the pre-pandemic trend

Household savings vs pre-pandemic trend - Real and nominal

M4 holdings (Jan 2020 =100)



Source: Macrobond, ING calculations

Data from Bank of England M4 holdings. Real savings deflated by CPI

## Bank of England implications

All in, we expect growth of 0.5% for 2024. That implies modest but positive quarterly growth through this year. For the Bank of England, stickiness in wage growth and services inflation, as well as the likelihood of a fiscal boost in March, potentially means rate cuts will come a little later than markets expect. We're sticking with our current call of an August cut, with 100 basis points of easing through the remainder of this year.

## Author

### James Smith

Developed Markets Economist, UK

[james.smith@ing.com](mailto:james.smith@ing.com)

## Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. (“ING”) solely for information purposes without regard to any particular user’s investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.