UK PMI suggests the technical recession is over

The UK's service sector moved further into growth in February, according to the PMIs, and interestingly is performing better than in the eurozone. That might be linked to the fall in market rates over the past six months and the more immediate consequences for both the mortgage squeeze and the direct feedthrough to the Chancellor's tax-cutting plans

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PMIs suggest the outlook is getting brighter

The latest UK purchasing managers indices are a further sign that the economy's fortunes have started to improve since the start of the year. The services PMI ticked up to 54.3 and what's interesting here is that it is still markedly higher than the equivalent eurozone number.

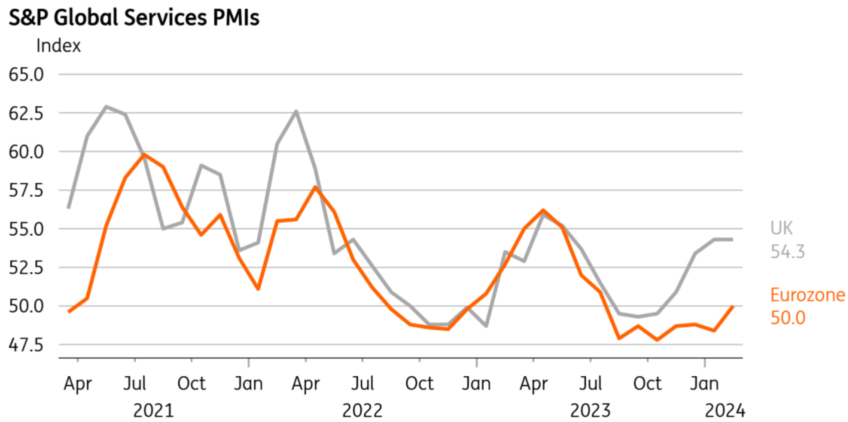
Exactly why that is isn't totally clear. Generally, the UK outlook appears similar to that of Europe more broadly. That said, some of the divergence may be down to the fall in market rates. While the US, eurozone and UK have all seen investors ramp up rate cut expectations over recent months – albeit a little less so now than at the start of the year – there are two reasons why the feedthrough to UK activity may be a little more noticeable in the short-term.

The first is the mortgage squeeze. Britain was more tangibly impacted by rising mortgage rates than the likes of the US or France/Germany, where it's more common to fix mortgage rates for over a decade. That means existing homeowners have been more insulated relative to the UK, where a greater share of households have moved onto higher rate products. By the same logic, the outlook for 2024 is more sensitive to where mortgage rates go from here than those other economies. And we now estimate that around two-thirds of the UK's mortgage squeeze has come and gone and the impact on households will be more modest this year than previously expected. Real wage growth is also positive and is also likely to stay that way throughout this year.

The anticipation of rate cuts will also boost the headroom available to the chancellor at the spring Budget on 6 March. While investors have pared back expectations for Bank of England easing this year, rate expectations for four to five years ahead, as well as 20-year yields, are still lower than they were when the Office for Budget Responsibility last produced forecasts. While it's hard to predict with too much accuracy, we think the chancellor's "headroom" – a gauge of what he could theoretically spend and still meet his fiscal rules – will have increased from £13bn in November to roughly £19bn this March. That's not a huge shift, but is likely to enable the chancellor to implement a set of tax cuts that will, at the margin, have an impact on 2024 GDP.

The bottom line is that we're likely to see a return to modest, positive growth rates from the first quarter of this year. That likely means an end to the small technical recession experienced through the second half of 2023.

UK vs eurozone service PMIs



Inflation is more important for the Bank of England

For the Bank of England, none of this is that consequential for the timing of rate cuts. In fact, the warning in the accompanying PMI press release from S&P Global that service-sector price pressures remain high will be of greater concern. We expect services inflation and wage growth to remain sticky in the near-term, though both should show further progress lower by the summer. We are forecasting the first rate cut in August.

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