UK recession coming as economy begins to contract

Not all of the latest weakness in UK GDP is explained away by September's extra bank holiday, and we're expecting further declines in output over the coming quarters. As the cost of living squeeze continues, we expect a 2% hit to GDP by next summer, though much depends on how the government's energy support evolves between now and then

These third-quarter GDP figures are somewhat skewed by the extra bank holiday in September, which marked the Queen's funeral

Queen's funeral added to September's GDP hit

The UK economy shrank by 0.2% in the third quarter of the year, marking the start of what's likely to morph into a recession spanning several quarters.

Admittedly that's less bad than expected, partly because August's data was revised more favourably. Unsurprisingly these latest figures are also somewhat skewed by the extra bank holiday in September, which marked the Queen's funeral. Workplaces – including many that would typically be open on a bank holiday – were reported to be temporarily closed. GDP fell by 0.6%

during September as a result. That muddies the water when it comes to assessing the underlying strength of the economy, and probably also means the fourth quarter figures will be a little higher than they otherwise would be, assuming the lost activity returns in October.

Further weakness is coming

Nevertheless, there are unmistakable signs that the economy is slowing. The ONS hints that at least some of September's GDP hit was unrelated to the funeral, while retail sales have now fallen for two consecutive months. We expect a further decrease in data released next week.

We also expect to see a similar trend in hospitality over the coming months, which has been operating well above pre-pandemic levels for some time on the back of renewed consumer interest. Lower consumer spending appetite is likely to help push GDP into a second-straight contraction during the fourth quarter. We're pencilling in a 0.3% hit to economic activity, the same as the Bank of England.

As the winter wears on, we also expect to see more strain emerge in manufacturing and construction – both of these sectors suffered noticeably during the 1990s and 2008 recession. The fall in manufacturing new orders, linked to falling global consumer demand for goods and rising inventory levels, as well as higher energy costs, point to lower production by early 2023. Likewise, the sharp rise in mortgage rates, and the very early signs of house price declines, point to weaker building activity through next year.

A winter recession looks highly likely

Wrapping that all together, we currently expect a cumulative hit to GDP of roughly 2% by the middle of 2023. That would be a comparable hit to the 1990s recession, and is somewhere between the Bank of England's two forecasts released last week – one that was premised on no further rate hikes (rates constant at 3%), and one which assumed a terminal Bank Rate of 5%. We expect Bank Rate to peak at around 4%.

Ultimately a lot will depend on next week's budget announcements. A lot of the focus understandably will be on how the Chancellor closes the forecasted fiscal deficit in 2026/27. But above all, we'll be looking for details on how the government will make its energy support less generous from April, something which has the greatest scope to reshape the 2023 outlook.

The Chancellor has signalled support for households will become more targeted in a bid to make the policy less costly. The challenge here is that there's no easy way of targeting support efficiently, and it may be that the Chancellor simply differentiates households by whether they receive means-tested income support. The upshot is that we could see the majority of households shift back to paying the Ofgem-regulated price, which is updated quarterly.

The sharp fall in wholesale gas prices could see most households paying £3,300 on average during FY2023, compared to £2,500 annually under the government guarantee. That would equate to roughly 9% of household disposable income and would add a further drag to overall economic activity next summer.

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