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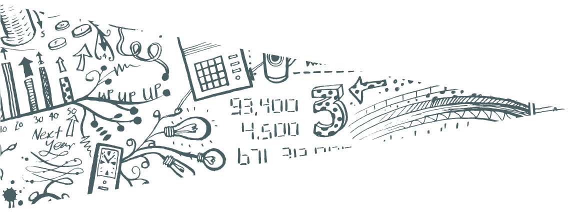
ITEM Club

Spring 2012 Forecast



Economic outlook for business

'Economic outlook for business' summarises the latest UK quarterly forecast by the ITEM Club, and gives ITEM's assessment of the implications for business.

Ernst & Young is the sole sponsor of the ITEM Club, which is the only non-governmental economic forecasting group to use the HM Treasury model of the UK economy. Its forecasts are independent of any political, economic or business bias.

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Forecast highlights

- A UK recession may have been averted, but this year's growth is likely to be lower than last year's depressing 0.7%. The ITEM Club's forecast sees growth at just 0.4% in 2012 and not returning to trend until 2014.
- Central bankers have again saved the day with their unconventional monetary policies. The ECB's LTROs have bought more time for the euro, while in the US and the UK, QE2 has turned investor sentiment from 'risk off' to 'risk on'. Central banks have now poured trillions of dollars and euros and a quarter of a trillion pounds into the markets to help their economies get out of recession. They cannot do much more to stimulate growth for fear of reigniting inflation, but they are there in the background if a new crisis emerges.
- Business spending has picked up nicely in the US, but UK plcs remain extremely reluctant to invest despite this proven ability of central banks to eliminate tail risk. The growth in UK business investment this year is likely to be similar to last year's paltry 1.2%, leaving it 12% below its 2008 level. Consequently, the economy is bleeding cash into company coffers at an alarming rate.
- This haemorrhage is sapping the strength of the economy, keeping it on the critical list. Although the forecast sees business investment growing by 6% next year and a further 10% in 2014, this will not be sufficient to get the economy moving rapidly. The company sector financial surplus moves up from 5.2% of GDP in 2011 to 5.7% in 2014.

Central bankers save the day – again

Once again, monetary policy has saved the day. In the Eurozone, the ECB's Long-Term Repo Operations have staved off a banking crisis and given the beleaguered sovereign debt markets a powerful shot in the arm. In the US, QE2 has helped turn investor sentiment around and rekindled business and consumer confidence, allowing the US economy to move ahead after the slowdown last autumn. The UK seems to have avoided a double-dip recession, but its economy continues to bump along the bottom and ITEM forecasts growth of just 0.4% this year.

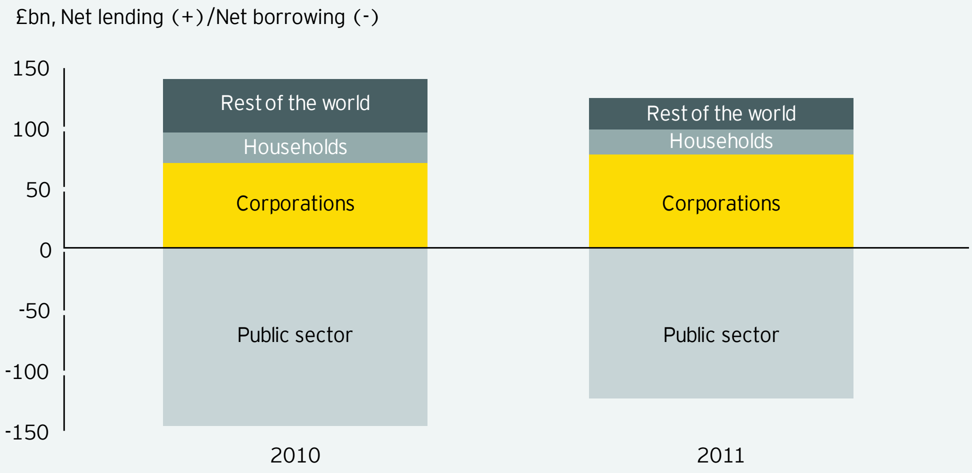
The reasons for this dismal picture are obvious and inescapable. As a nation we have been living beyond our means and need to adjust. Austerity is the word of the day, not only in the UK but also our major European export markets. Banks are not re-capitalising sufficiently quickly but are responding to higher capital requirements by reducing their balance sheets.

Large industrial corporations are accumulating cash ...

However, there is one part of the economy that has not been living beyond its means. The corporate sector is accumulating cash at an astonishing and accelerating pace and acting as a major drag on the rest of the economy, keeping it close to stall speed. It is hard to see any strong revival in the economy until companies start to release this cash by spending more on acquisitions, investment or dividends.

It is interesting to take a look at the current conjuncture from a cash-flow perspective. The chart below shows the net amounts earned or spent by each of the main sectors

UK: Net lending by sector, 2010–2011



of the economy in the last two years. Ideally each would be close to zero. What stands out is the government financial deficit or net borrowing, which pumped £147bn into the economy in 2010 and a further £122bn last year. But these massive figures were largely the consequence of cash being drained out of the economy and indeed the Exchequer by the private sector. The biggest drain was the company sector, which sucked a hefty £72bn out of the system in 2010, and a further £80bn last year. And most of this cash is being hoarded, not spent or invested. Non-financial companies increased their holdings of currency and bank deposits by £48bn in 2010 and a further £82bn last year, taking the total to £754bn, a staggering 50% of GDP.

It is not difficult to see how companies find themselves in this cash-rich position. Globalisation has dramatically increased the power of capital over labour, with workers at the bottom of the pile and even the 'squeezed middle' coming under huge pressure. This has been most apparent in the US where companies continued to post record profits right through the downturn. In the UK, companies have been swimming in cash while consumers have been drowning in debt.

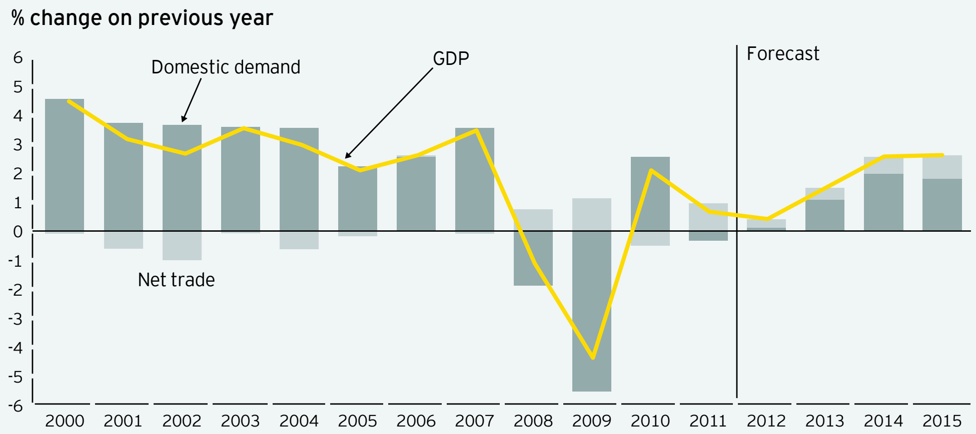
... but not investing

Economic forecasters at the Office for Budget Responsibility (OBR), the ITEM Club and elsewhere assumed that larger companies would soon spend much of this accumulating cash on investment. After all, it was very hard to justify putting funds into risky bank deposits with a return of less than 1% when investment spending had in many cases been pared back to a care-and-maintenance level during the recession. However, forecasters' expectations were not realised. While business spending has been very buoyant in the US, there has been no resurgence in the UK and judging by the investment intentions surveys there will be very little revival this year. Corporates cite lack of demand, volatility and unrealistic vendor expectations as reasons not to invest. The question is when this view will change – it may well be that corporate decision criteria are now out-of-date and don't reflect the new market environment.

Hence the forecast sees growth restrained by lack of investment ...

Whatever, the reason, the ITEM Club sees this situation becoming even more polarised over the next few years. The national accountants estimate that wages

UK: Contributions to GDP growth, 2000–2015



and salaries fell from 46.6% of GDP in 2009 to 45.3% in 2010 and just 45% last year. ITEM sees this share falling further to just 42.4% by 2015. At the same time, the share of non-financial company profits which reached 15.7% of GDP last year pushes up towards a staggering 20%. A modest revival in business spending is not sufficient to neutralise the corporate drag on the economy which keeps growth close to stall speed this year. The non-financial company financial surplus increases from 3.5% of GDP in the last financial year 2011-12 to 5% in 2015-16.

... whilst households remain under pressure

Households remain under intense pressure in labour and commodity markets. Private sector recruitment is barely able to offset the redundancies seen in the public sector. Average earnings growth remains well below inflation, which is being held up by rising petrol prices. The latest industrial surveys show that the rise in energy and raw materials costs has been absorbed by margins. But this is now likely to feed through to consumer prices, reinforcing the pressure on household finances and further delaying prospects of a consumer recovery.

Coupled with this, activity in the housing market is falling back now that the stamp duty holiday for first-time buyers has ended. Moreover, the Bank of England's latest Credit Conditions Survey is signalling a major tightening of credit standards, particularly for mortgage borrowers. Profit margins on mortgage lending have already widened and are projected to increase further over the next three months. This reflects the tightening of credit in the Eurozone as banks reduce their loan books in order to meet the more stringent regulatory capital requirements imposed last December.

In the face of these pressures, the forecast sees real household disposable income marking time this year after falling back in 2010 and 2011. Consumer spending increases by 0.8% this year as the saving ratio eases back. This accelerates to 2.2% by 2015, helped by a modest revival in real earnings growth. Turnover in the housing market dips after the strong start to this year, but begins to recover next year as the first-time buyer and credit shortages begin to ease. House price inflation is also likely to resume on this timescale.

Business investment starts to recover next year ...

The forecast shows business investment increasing by just 1.2% this year, but it starts to pick up next year, with growth of 6%, followed by nearly 10% in 2014. Capital spending in the public sector is falling back sharply now, and even with housing investment picking up, economy-wide investment falls back again this year. It grows by 4.1% next year before accelerating to 7.8% in 2014.

... and exports make an important contribution ...

Export markets are a big challenge for UK businesses at the moment. Shipments to Europe have inevitably been restrained by the problems in the Eurozone, yet shipments to non-European destinations have been performing well. Exports of goods increased by 5.1% last year in volume terms and exports of services were up by 3.9%. ITEM expects exports to grow by 4.5% this year and imports by 3.5%, but over the remaining years of the forecast export growth moves ahead of import growth more convincingly.

The ITEM Club Forecast for the UK Economy, April 2012

Figures are % changes on previous year (except government borrowing, current account, interest rates and exchange rates)

Year	GDP	Domestic demand	Consumer spending	Fixed investment	Exports	Imports	Net government borrowing [1]	Current account (% of GDP)	Average earnings	Inflation (CPI)	3-month interest rate [2]	Effective exchange rate [2]
2009	-4.4	-4.4	-3.5	-13.4	-9.5	-12.2	11.0	-1.5	1.7	2.2	1.2	80.6
2010	2.1	1.6	1.2	3.1	7.4	8.6	9.4	-3.3	3.6	3.3	0.7	80.5
2011	0.7	-0.9	-1.2	-1.2	4.6	1.2	8.3	-1.9	2.1	4.5	0.9	79.9
2012	0.4	0.3	0.8	-0.4	4.5	3.5	5.8	-1.9	2.0	2.8	1.0	81.3
2013	1.5	1.0	1.1	4.1	7.4	6.0	6.1	-0.4	2.8	2.1	1.3	80.4
2014	2.6	2.0	2.1	7.8	8.0	6.2	4.3	0.4	3.2	2.0	2.3	79.1
2015	2.6	1.8	2.2	6.5	7.3	5.1	2.7	1.3	3.9	2.0	3.3	77.5

[1] Fiscal years, % of GDP [2] Average over calendar year

… but the risks to world markets remain daunting

However, the euro time bomb has not been defused: it is still ticking away. Whilst the ITEM Club's worst fears have not materialised, thanks largely to the ECB's Long-Term Repo Operations, it seems unlikely that the Greeks will be able to support their shrunken debt burden. The situation in the Iberian Peninsula remains critical while the politicians are still bickering about the trillion euros needed for the firewall. It seems hard to see a positive growth outlook for these countries given the scale of the austerity programmes and tightening credit conditions that they face.

In the Middle East, Egypt, Libya and other countries remain in turmoil during their second Arab Spring. As ITEM feared, tension between Iran and the west has already boosted world oil prices. At the same time the economic and social problems facing China also remain a concern. The US economy remains the odd man out, supported by much stronger demand in both business and consumer spending than seen in the UK, although how long this can be sustained in the face of gasoline at four dollars a gallon remains to be seen. But this is a minor worry set against the wide range of risks to our major European markets.

Implications for business

- The business outlook has improved dramatically this year and the number of profit warnings has moved down to a low level. Business-to-business transactions are recovering nicely. However, the domestic economy remains vulnerable as government support is withdrawn and credit remains tight.
- The Bank of England's latest Credit Conditions Survey is signalling a major tightening of credit standards, reflecting the effect of the new capital requirements upon the euro banking system. Lending profit margins have already widened and are projected to increase further over the next three months, increasing the headwinds for the commercial and residential property markets and the businesses that depend on them.
- Shoring up the core business and ensuring it is resilient and able to weather any storms remains the number one priority. Stress-testing the business's resilience under realistic scenarios and developing appropriate risk mitigation plans is a sensible course of action. However, corporate treasurers have a key role in ensuring the appropriate balance between risk and reward. Holding too much cash will ultimately not pay off.
- Having taken steps to protect the core, companies should then look to optimise where they can. For example, the capital markets remain very receptive to respected corporate names. Indeed, with spreads on bank lending increasing, many companies can now fund their borrowing at long-term yields that are no higher. However, US and UK Treasury yields have been moving up in recent weeks, and are likely to push up long-term corporate yields.
- There are opportunities emerging in the new economic environment. Banks are looking to reshape their portfolios; private equity firms have assets to divest; value-focused corporates will sell off non-core assets; and governments have privatisation plans. Companies need to ensure they are well positioned to exploit these opportunities. In particular it is important to assess whether their decision criteria such as hurdle rates, and their planning assumptions, such as economic growth rates, accurately reflect likely future market conditions. Holding cash today in expectation of better future returns may turn out to be the wrong strategy.
- Consumer-orientated businesses face a difficult year with no significant likely upturn until the autumn. Consumers continue to deleverage and after several difficult years there are signs that behaviours are changing, shifting attractiveness across segments and products. Continuing to invest in tracking and understanding consumer behaviour remains critical for businesses exposed to consumer spending.
- After three business-friendly Budgets and with more tax cuts in the pipeline, the Coalition has handed responsibility for the recovery to the business community — which needs to grasp this opportunity quickly or face the consequences after the next general election.

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