David Smith

THE SUNDAY TIMES

@dsmitheconomics

The Economic and Business Outlook

What's in prospect for the drivers of the housing market?

Four questions

- Can the economic recovery continue amid the turmoil, or is a recession is baked in?
- How bad will inflation be, and how long will last?
- How much will interest rates rise?
- What does this mean for the housing market.

It has been one thing after another

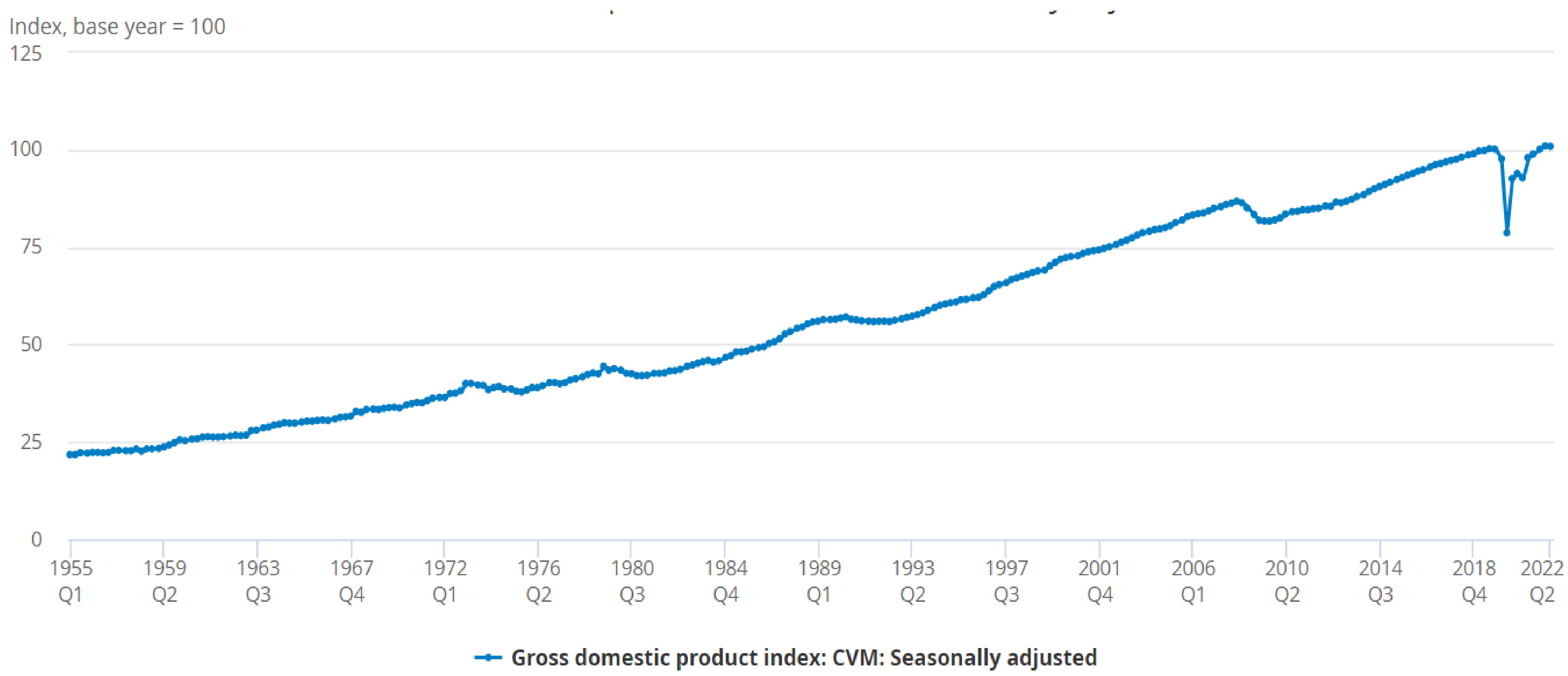
- The global financial crisis.
- Brexit & the Trump trade wars
- The pandemic.
- The Russian invasion of Ukraine

Like the Four Horsemen of the Apocalypse

What’s caused all the trouble?

- A huge energy price shock.
- Labour shortages.
- Supply-chain difficulties.
- Central banks are tightening policy, so the cost of borrowing is rising.

The UK economy is nearly back to pre-pandemic levels



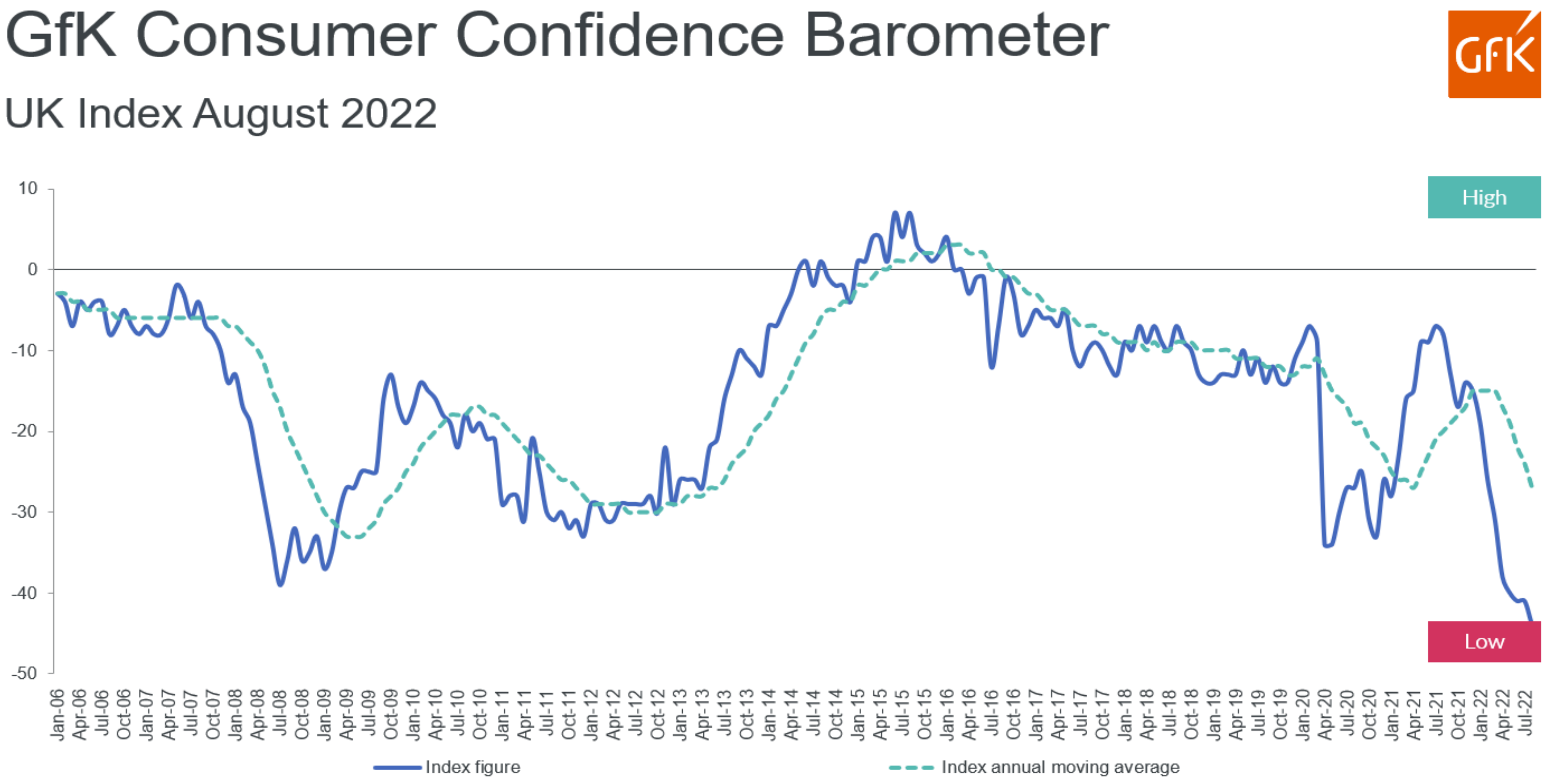
But now for the hard part

The issue

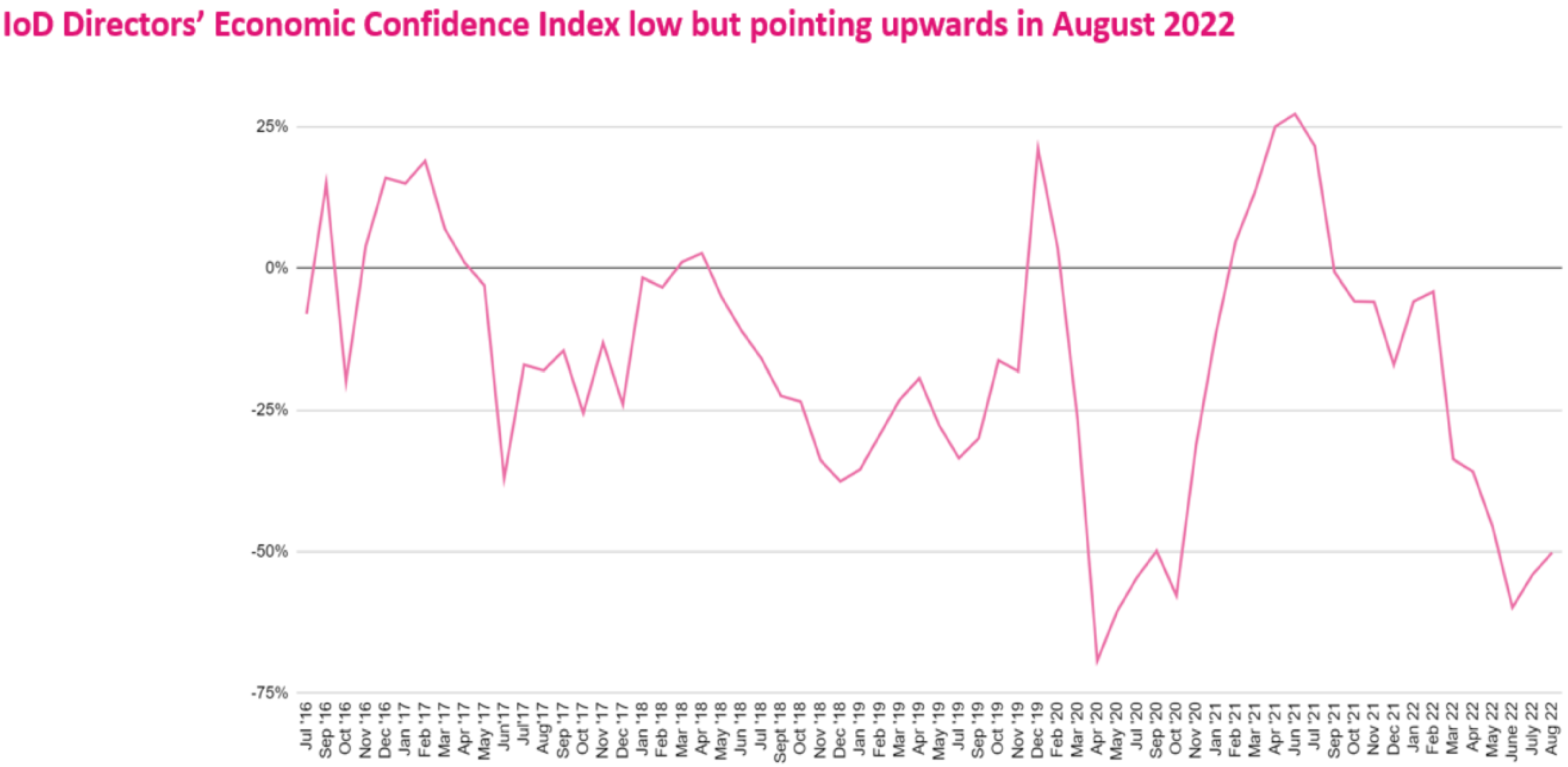
‘With inflation outpacing growth in nominal earnings and net taxes due to rise in April, real livings standards are set to fall by 2.2 per cent in 2022-23 – their largest financial year fall on record – and not recover their pre-pandemic level until 2024-25.’

Source: Office for Budget Responsibility, March 2022.

With consumer confidence at rock bottom



And businesses worried too



As was the Bank of England

‘Abstracting from temporary factors, underlying UK GDP growth has slowed and the UK economy is forecast to enter recession later this year. Output is projected to fall in each quarter from 2022 Q4 to 2023 Q4. Growth thereafter is very weak by historical standards.’

Source: Bank of England Monetary Policy Report, August 2022

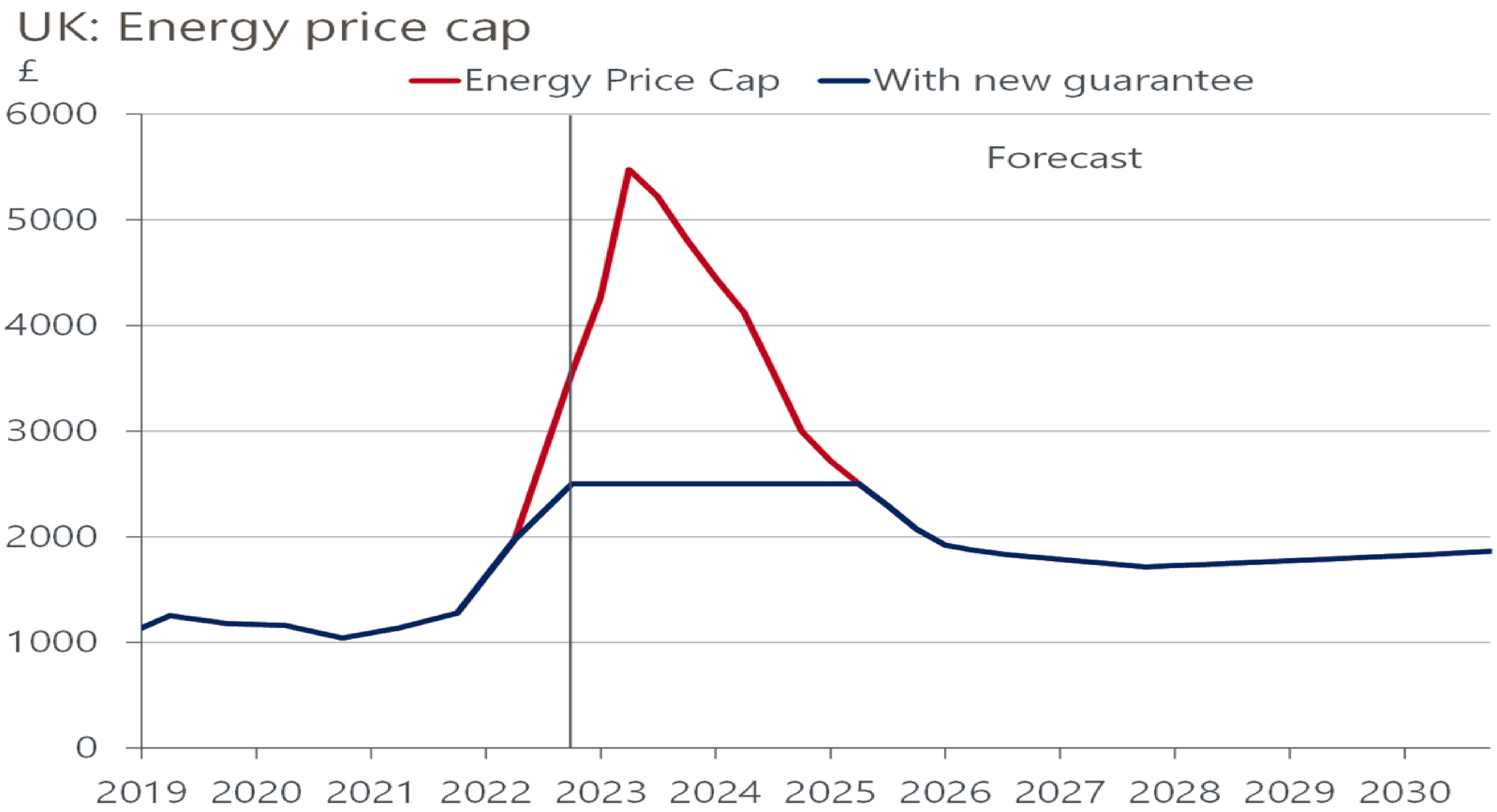
The response: PM wheels out the big guns

- A two-year energy price freeze, perhaps eventually costing a huge £150 billion, bigger than the furlough support offered during the pandemic.
- £34 billion of tax cuts; reversing previously announced increases in National Insurance and corporation tax.

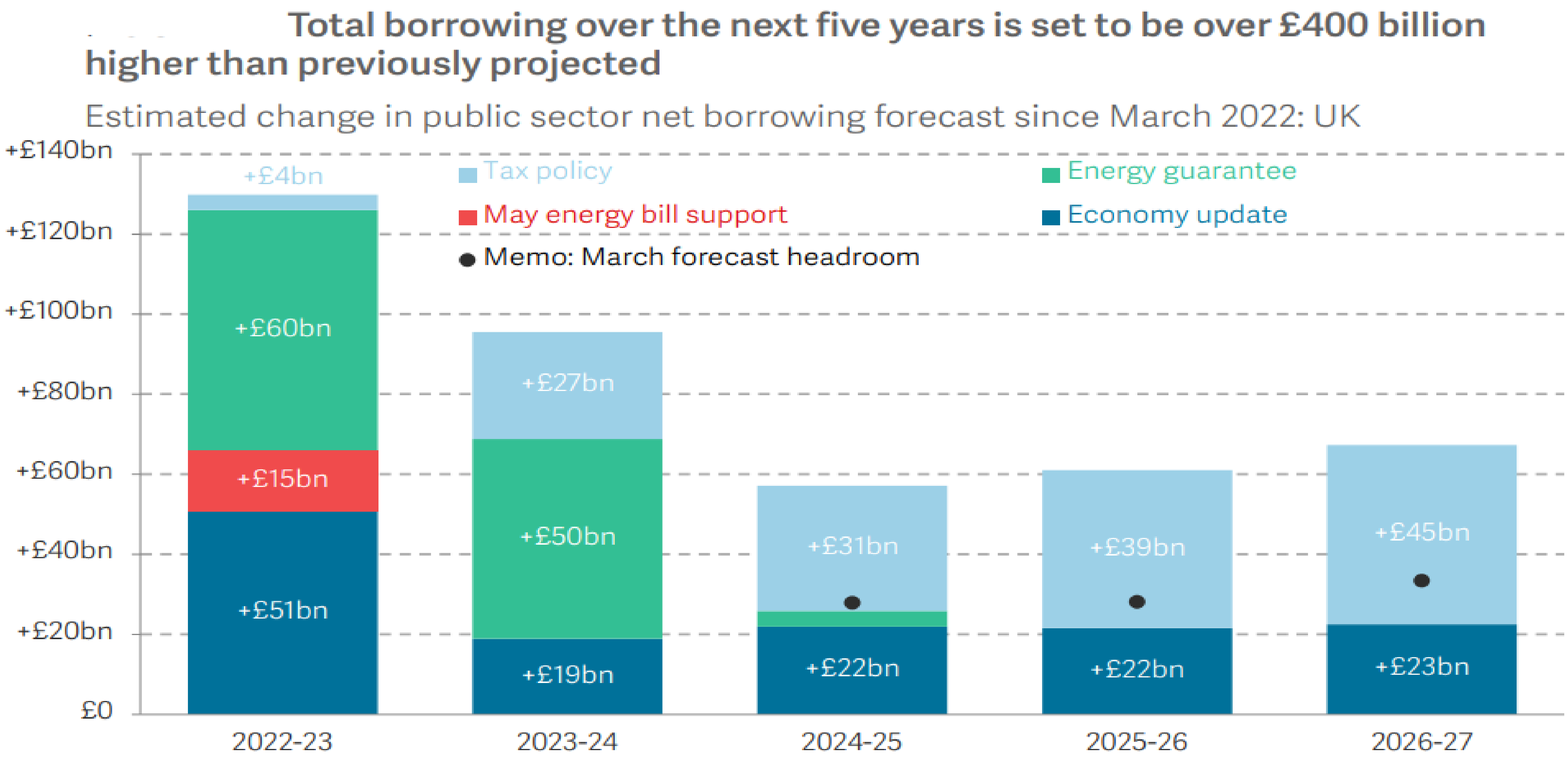
And much, much more

- Abolition of the 45% additional rate of income tax.
- Cutting the basic rate from 20% to 19% next April.
- Cutting stamp duty: lifting the threshold to £250k.
- Scrapping the cap on bankers' bonuses.
- A network of up to 40 investment zones.

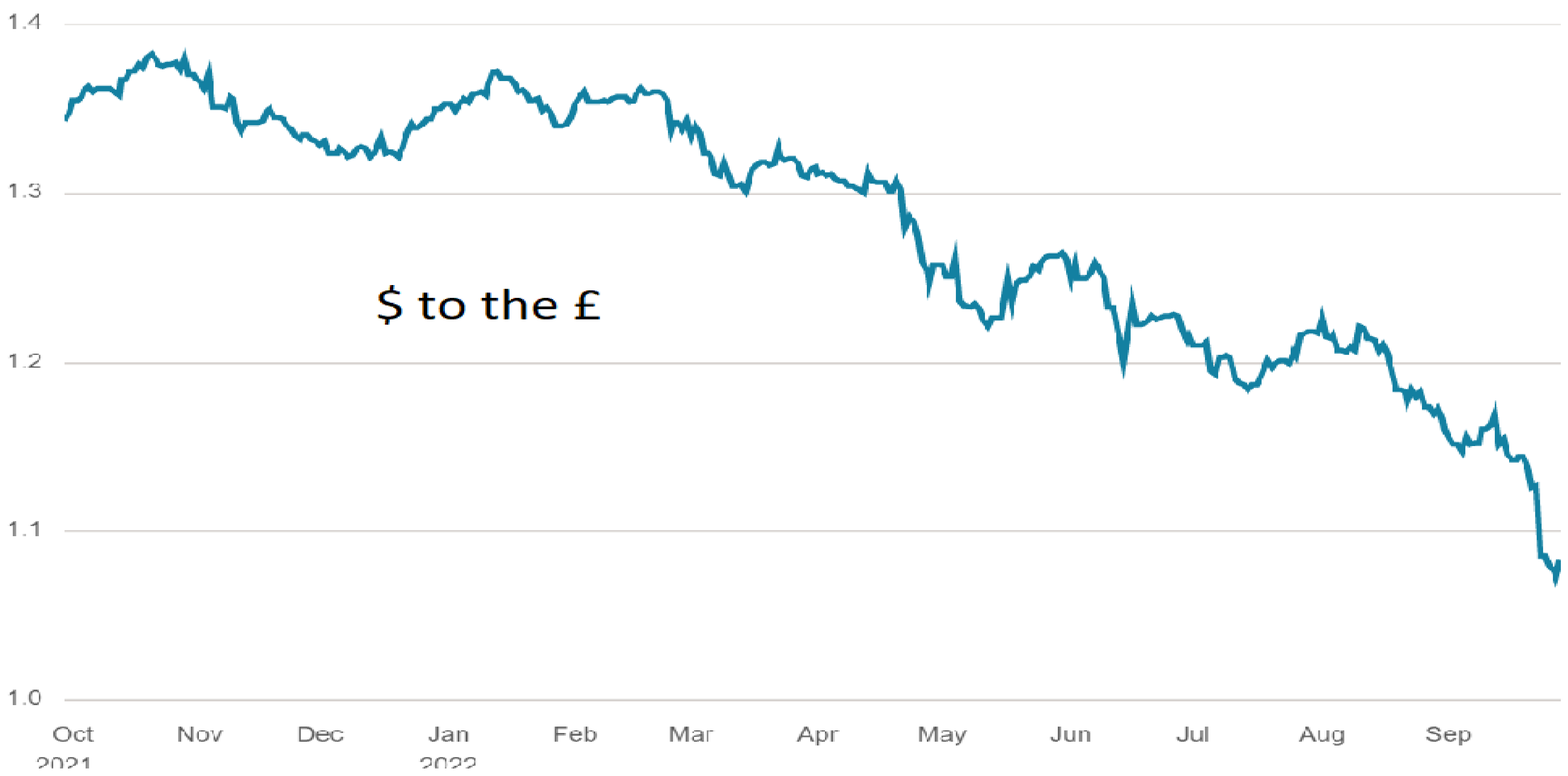
To head off a catastrophe



With consequences for debt



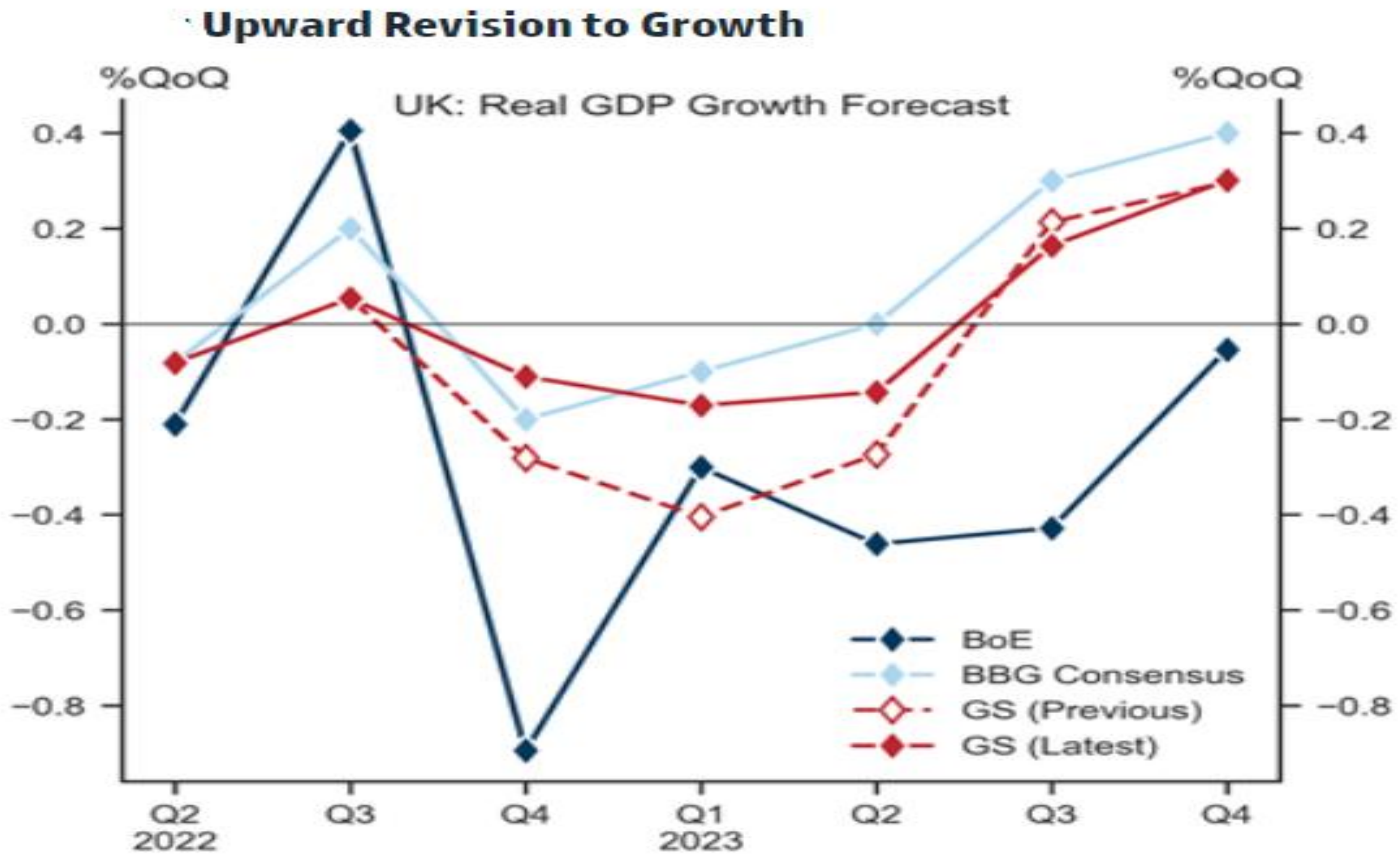
… the pound



1.4
1.3
1.2
1.1
1.0
$ to the £
Oct 2021
Nov
Dec
Jan 2022
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep

… and gilt yields

Perhaps not enough to prevent a recession



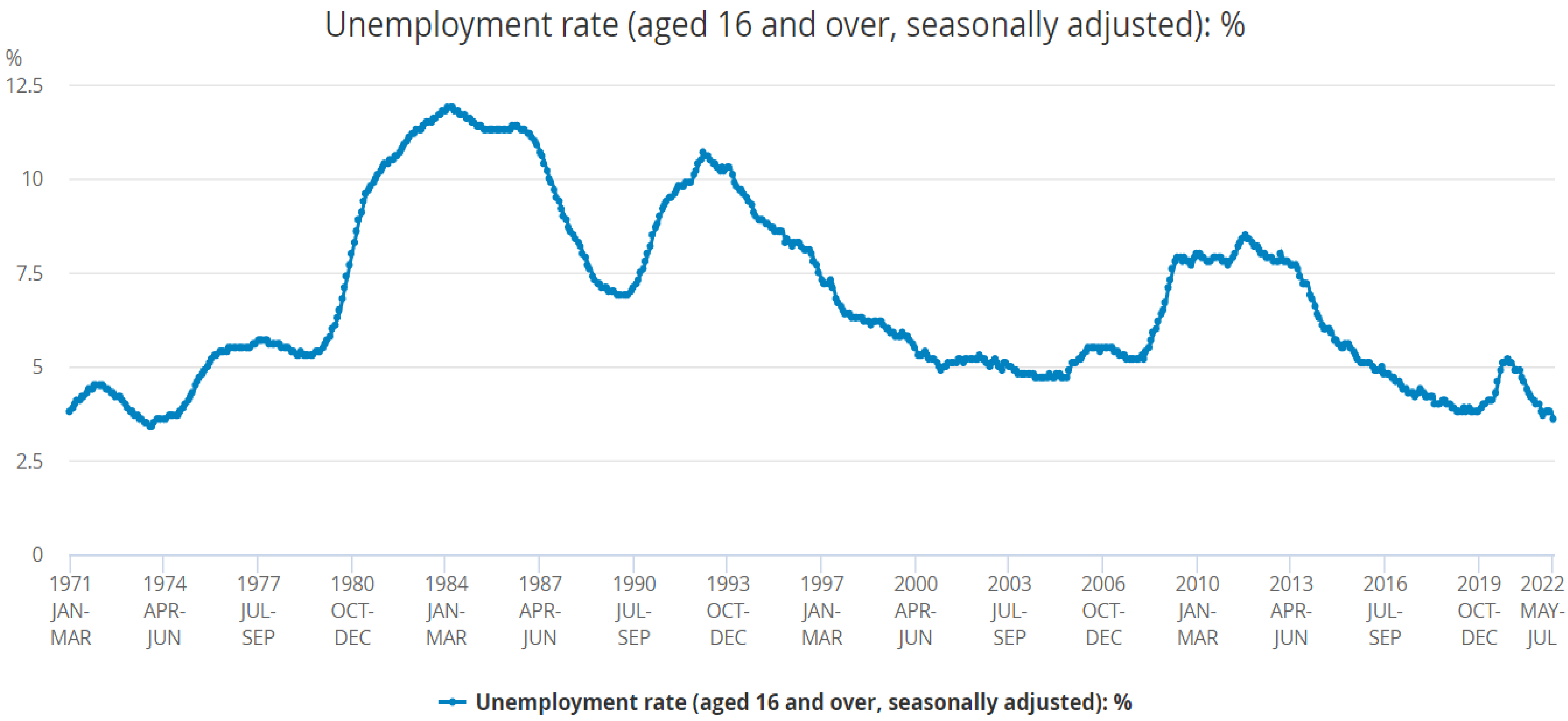
Source: Goldman Sachs

Though with luck only a very mild one

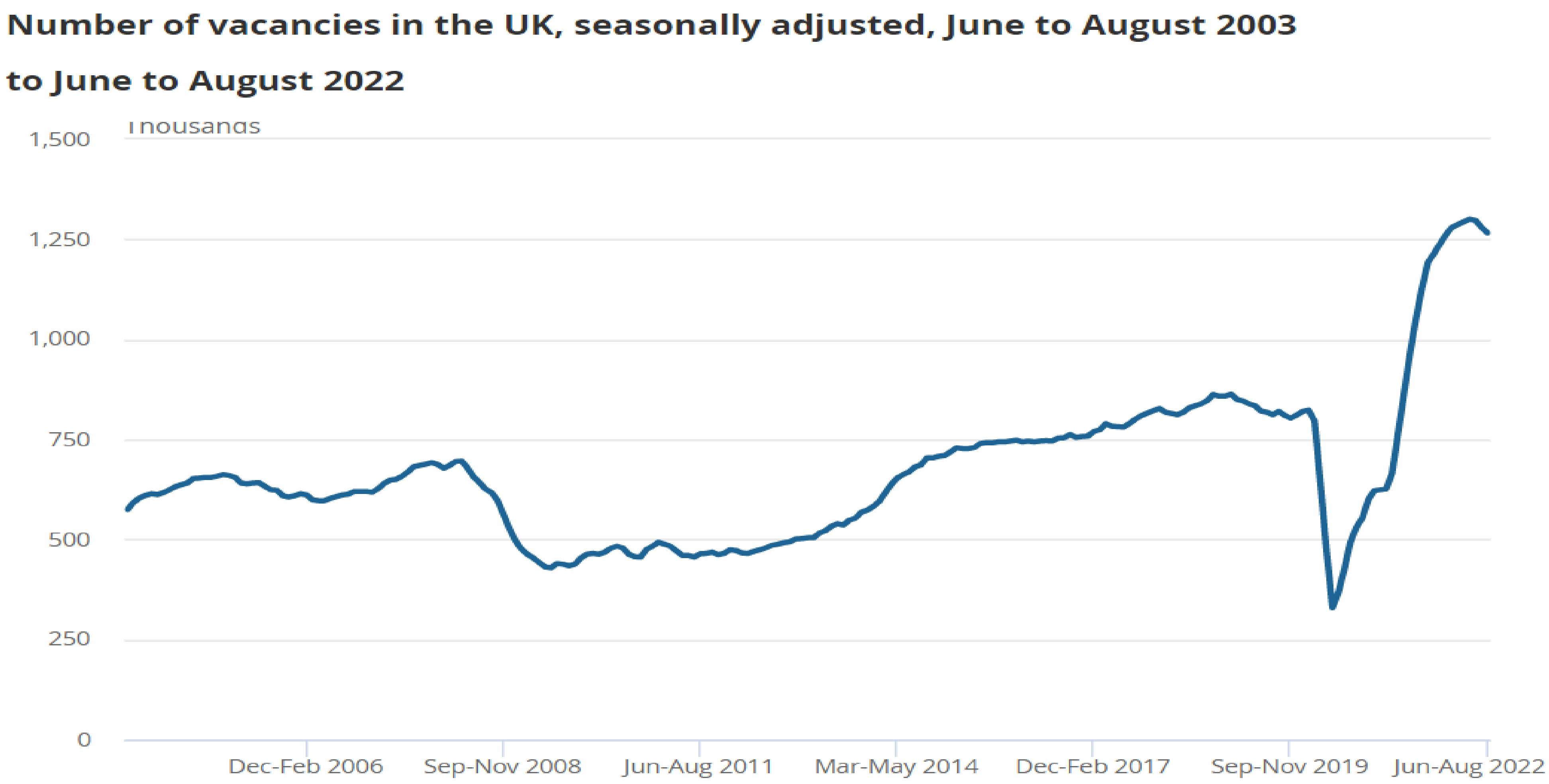
'While we continue to forecast a technical recession in the UK, we expect it to be a mild and shallow contraction. We expect the incoming recession to be much smaller than those experienced in the past due to a combination of fiscal support, excess savings, and strong labour market momentum.'

Goldman Sachs, September 12, 2022

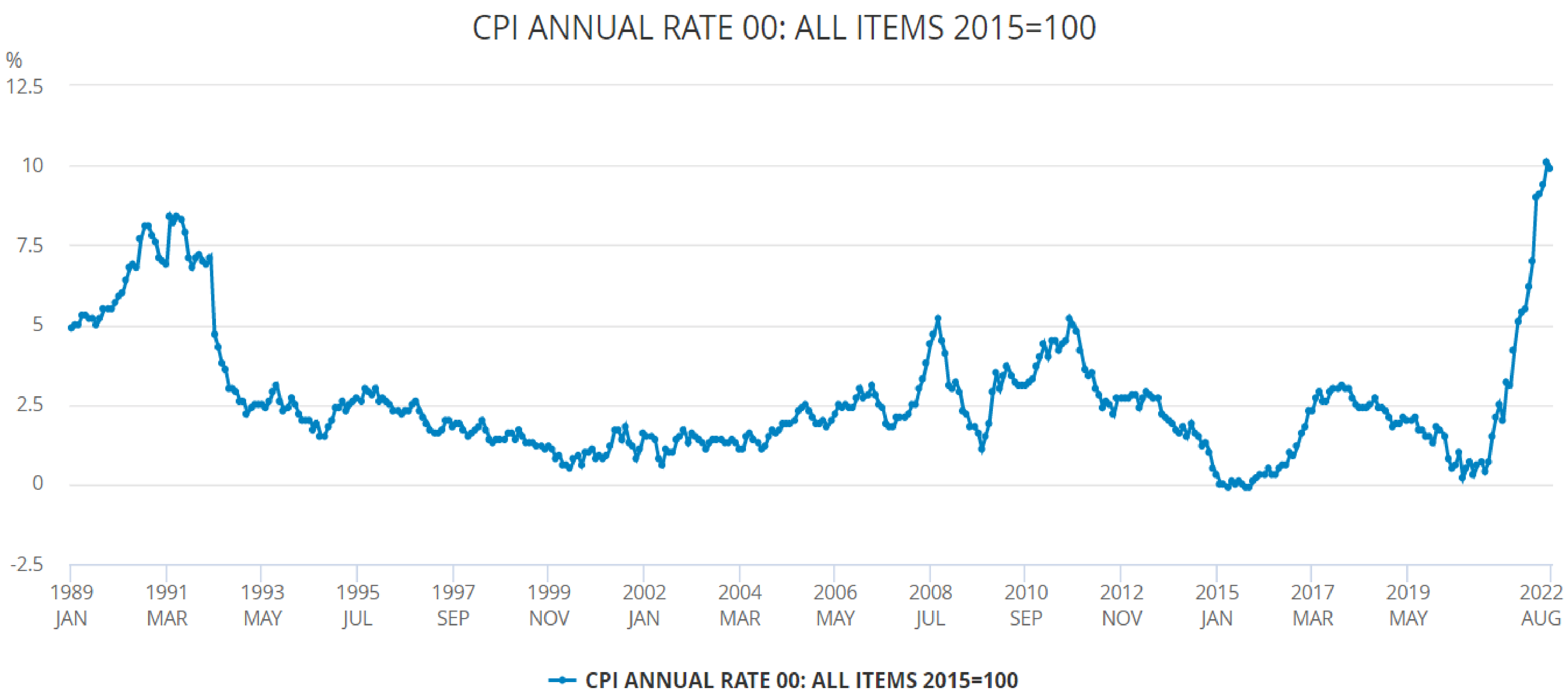
Because unemployment is very low



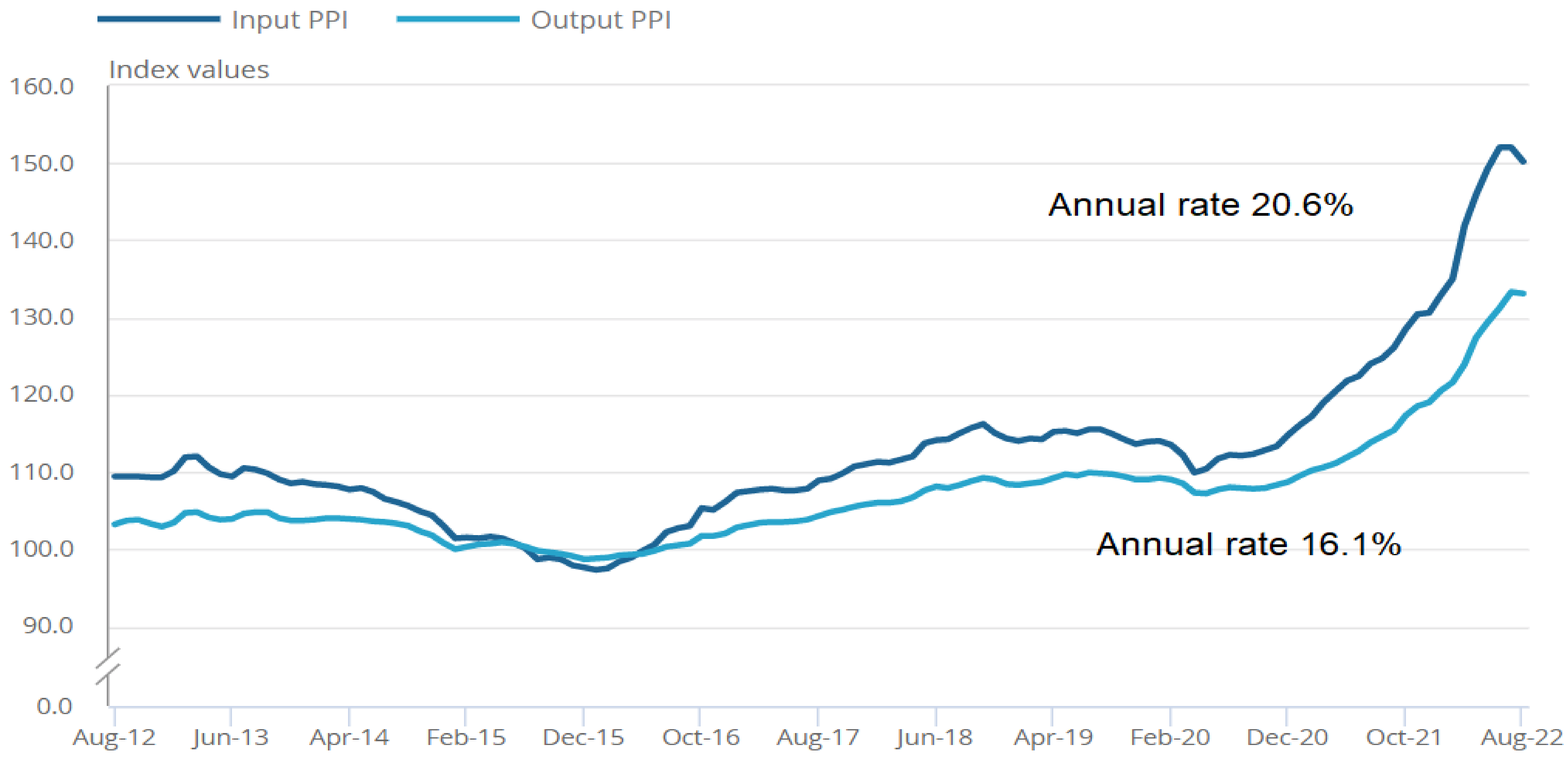
And there are near-record vacancies



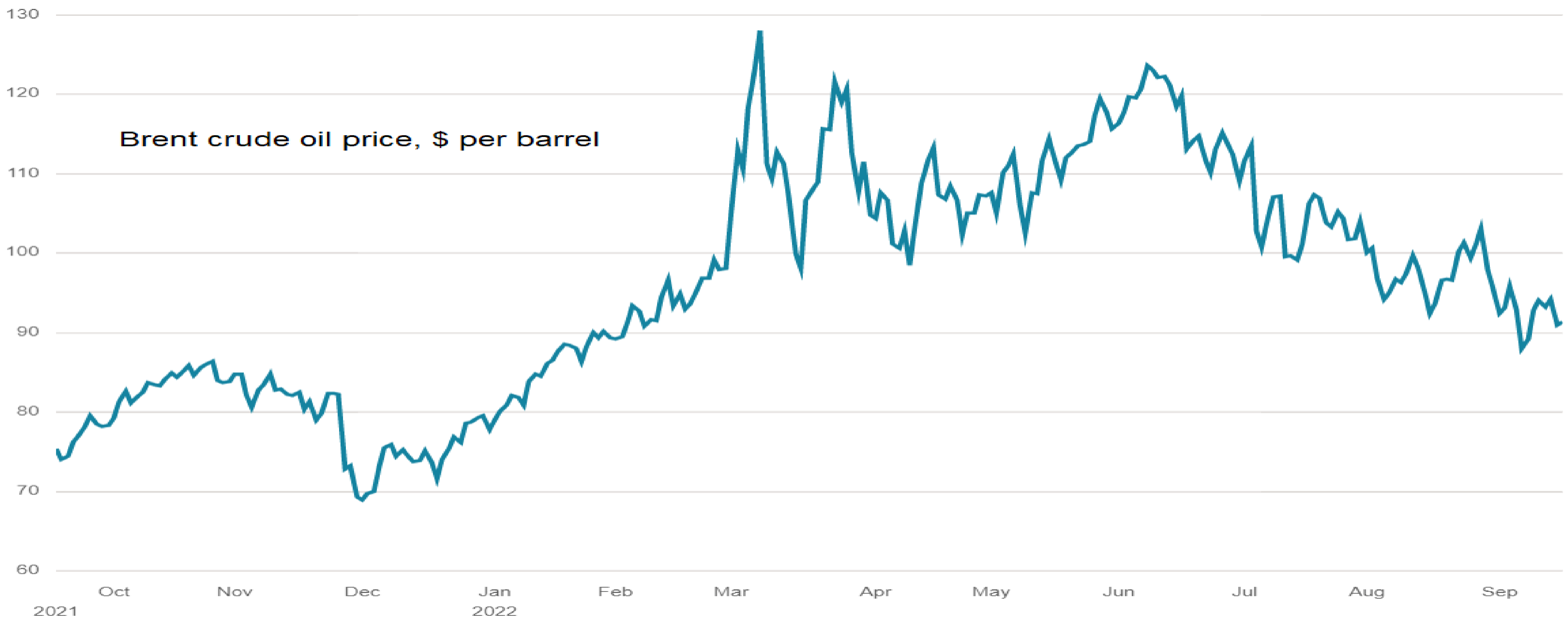
2. Inflation has been rising fast



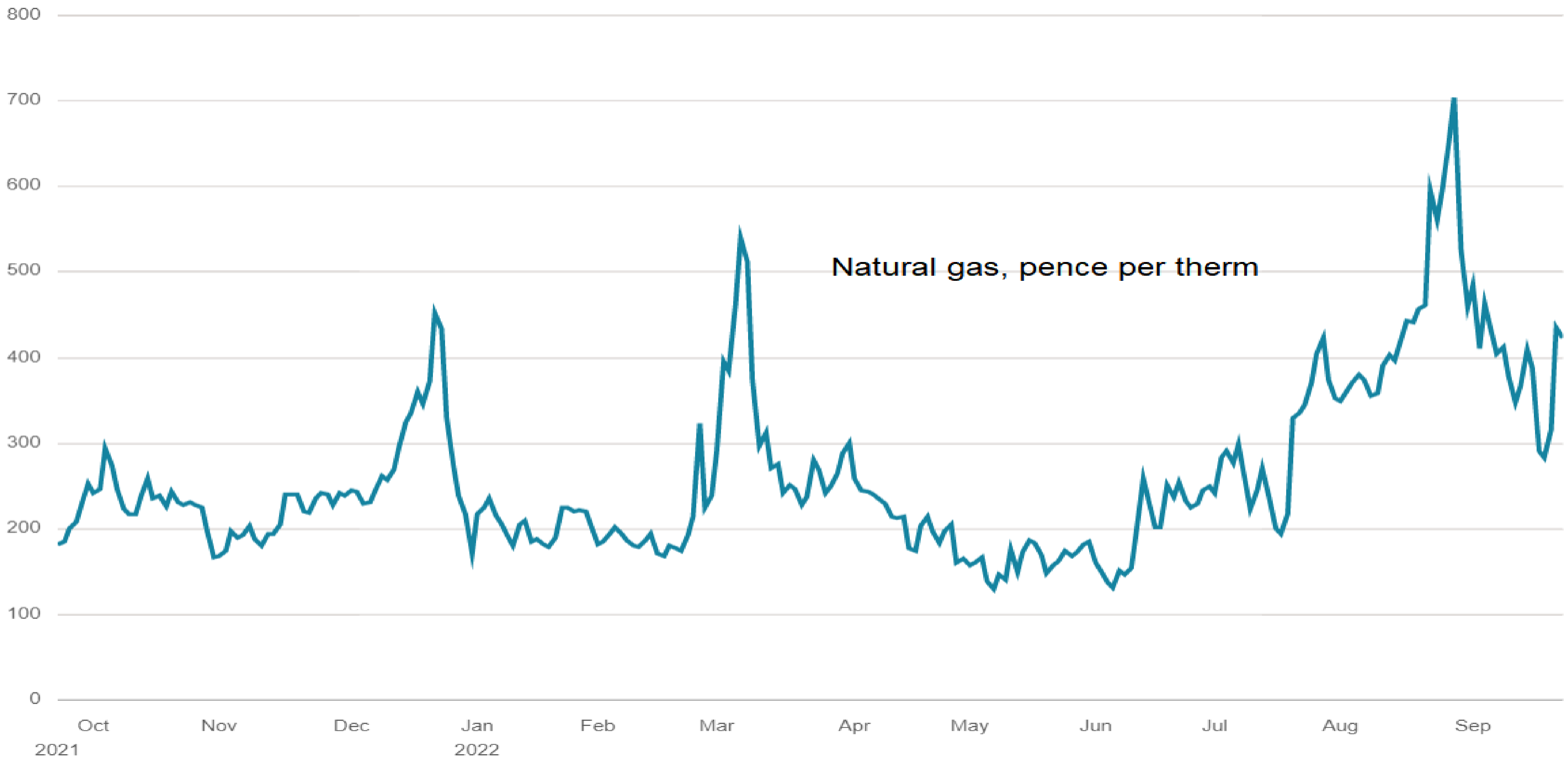
As have business costs and prices



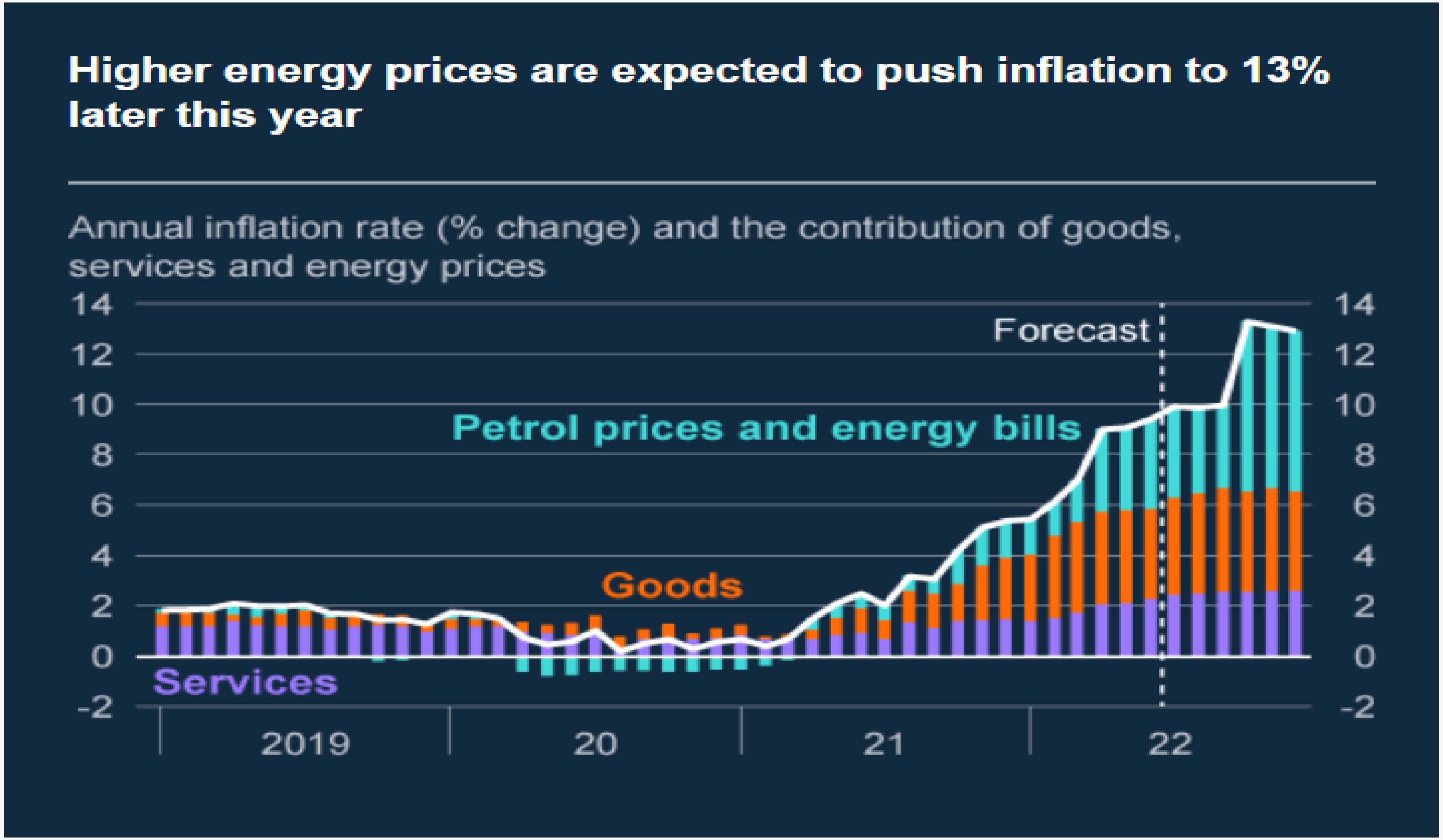
The oil price has dropped from its highs



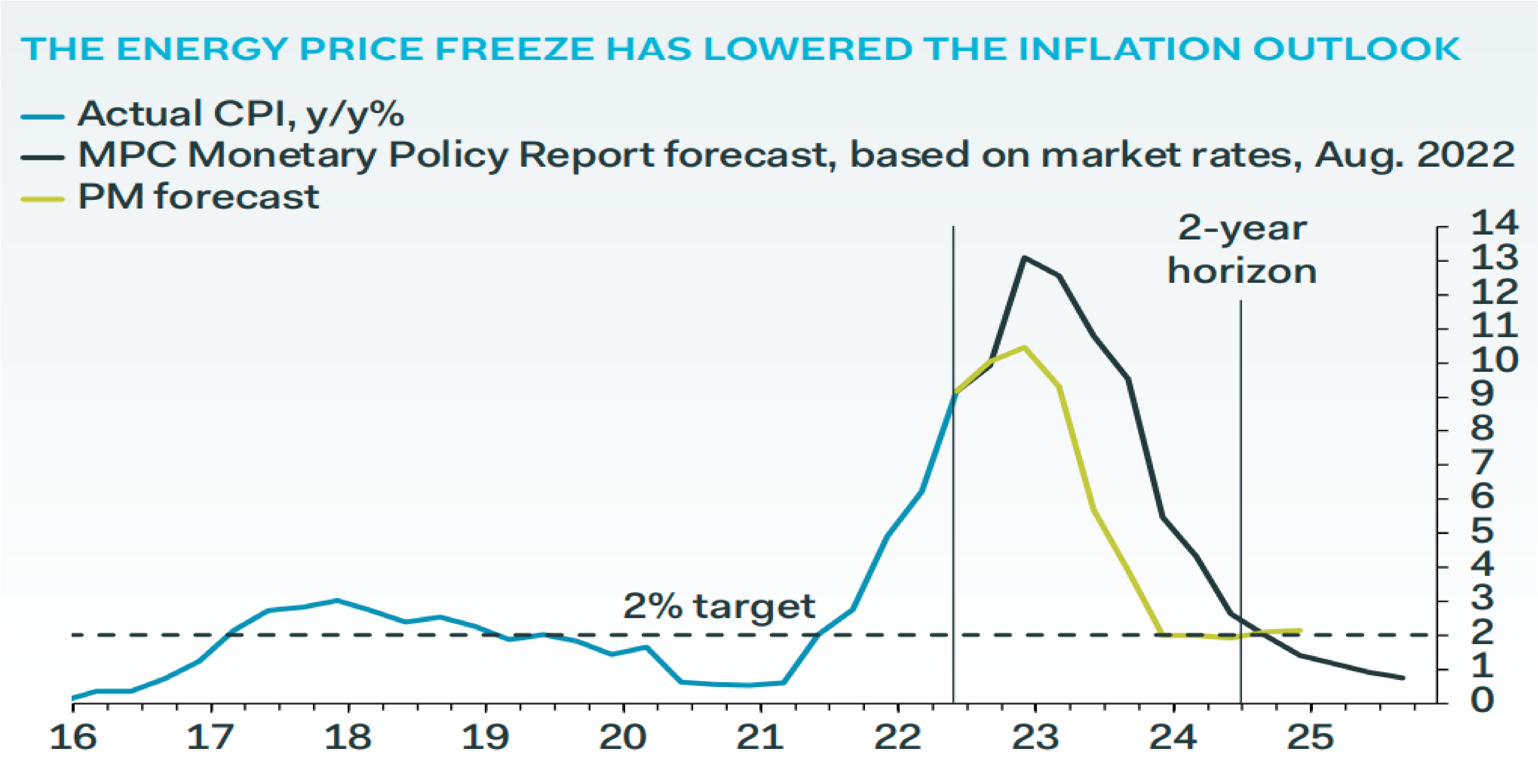
But it's mainly about gas prices



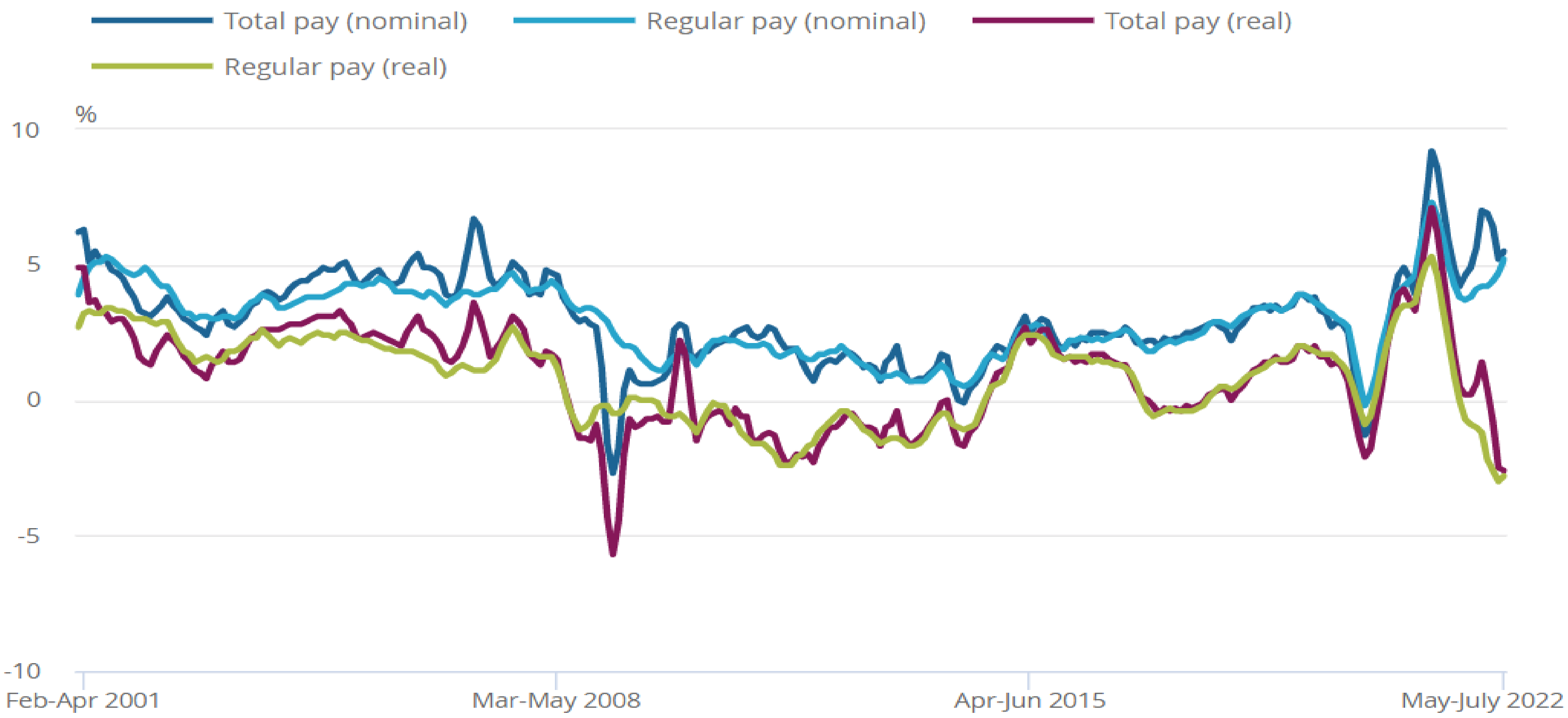
The Bank of England feared 13% inflation



But the energy freeze will keep it below that



Average pay rises are well below inflation



There are reasons why high inflation should not be permanent

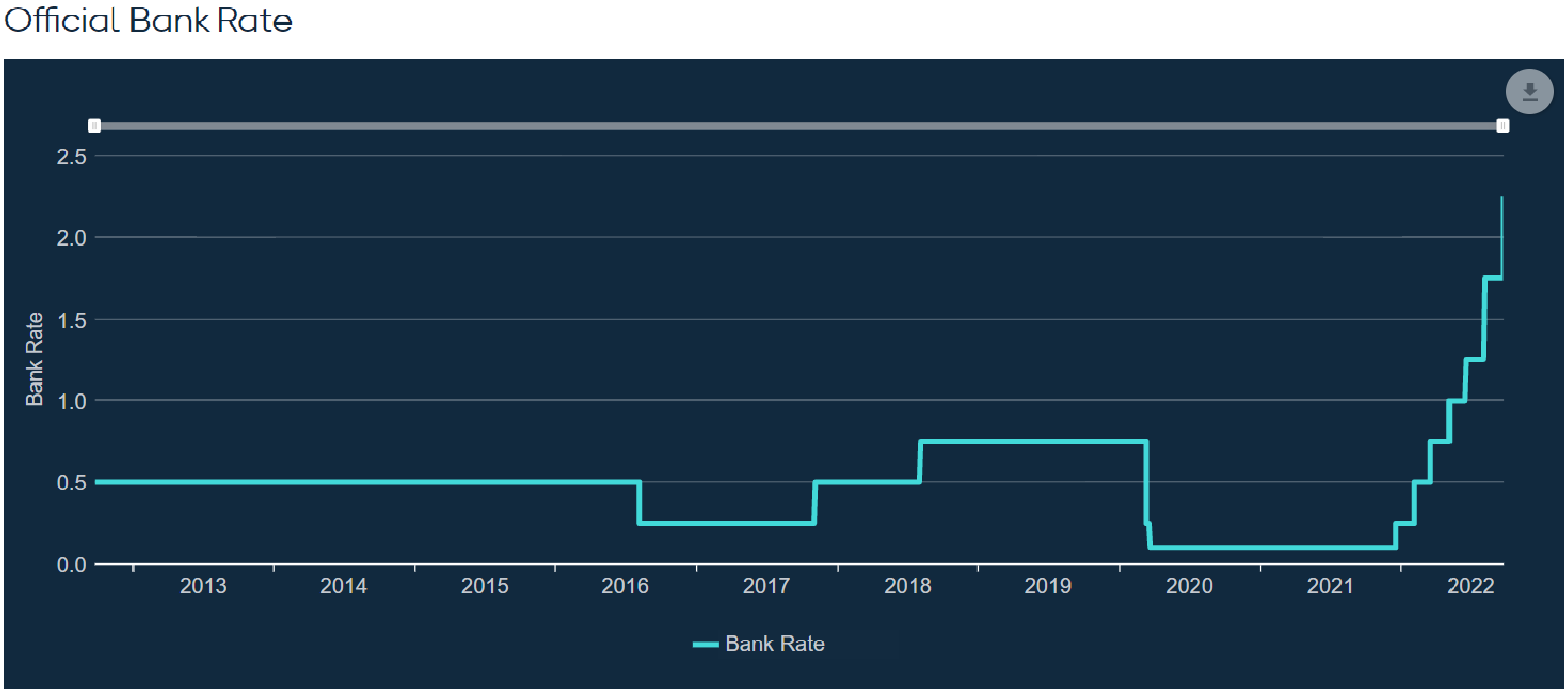
- Energy price spikes tend not to last, despite Russia-Ukraine.
- Despite labour shortages, there isn't yet evidence of a wage-price spiral.
- The big money supply expansion associated with QE is over.

But there are also reasons to be concerned

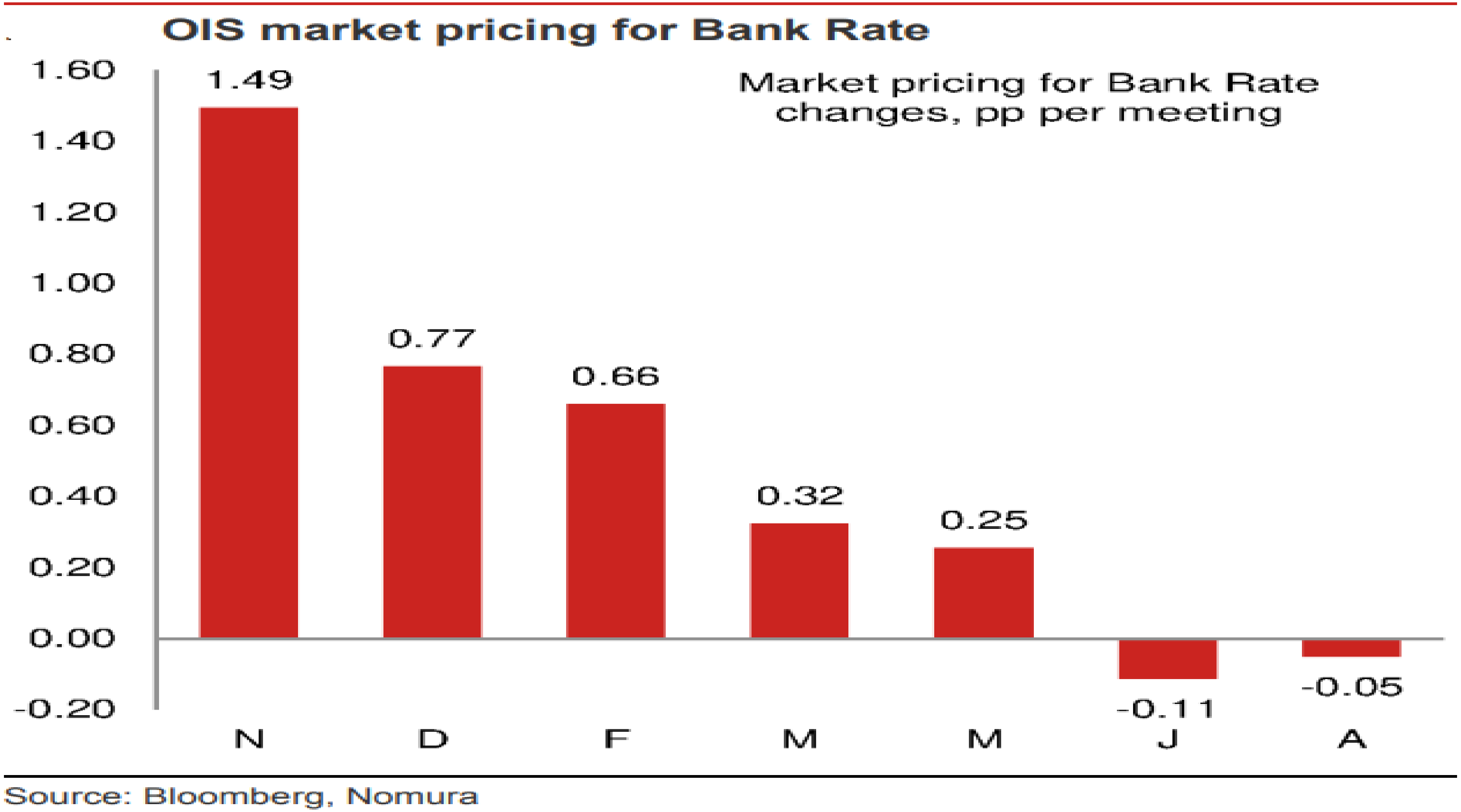
- China’s lockdowns, in pursuit of a zero-Covid target, mean supply-chain difficulties are as bad as they were two years ago, though may now start to ease.
- We may already have seen the inflation benefits of globalisation and the “China effect”. It kept inflation low for 25-30 years. It may be harder to do so in future.

3. The interest rate dog has been barking a lot recently

Taking rates up to their highest in 14 years



And markets think there's plenty more to come

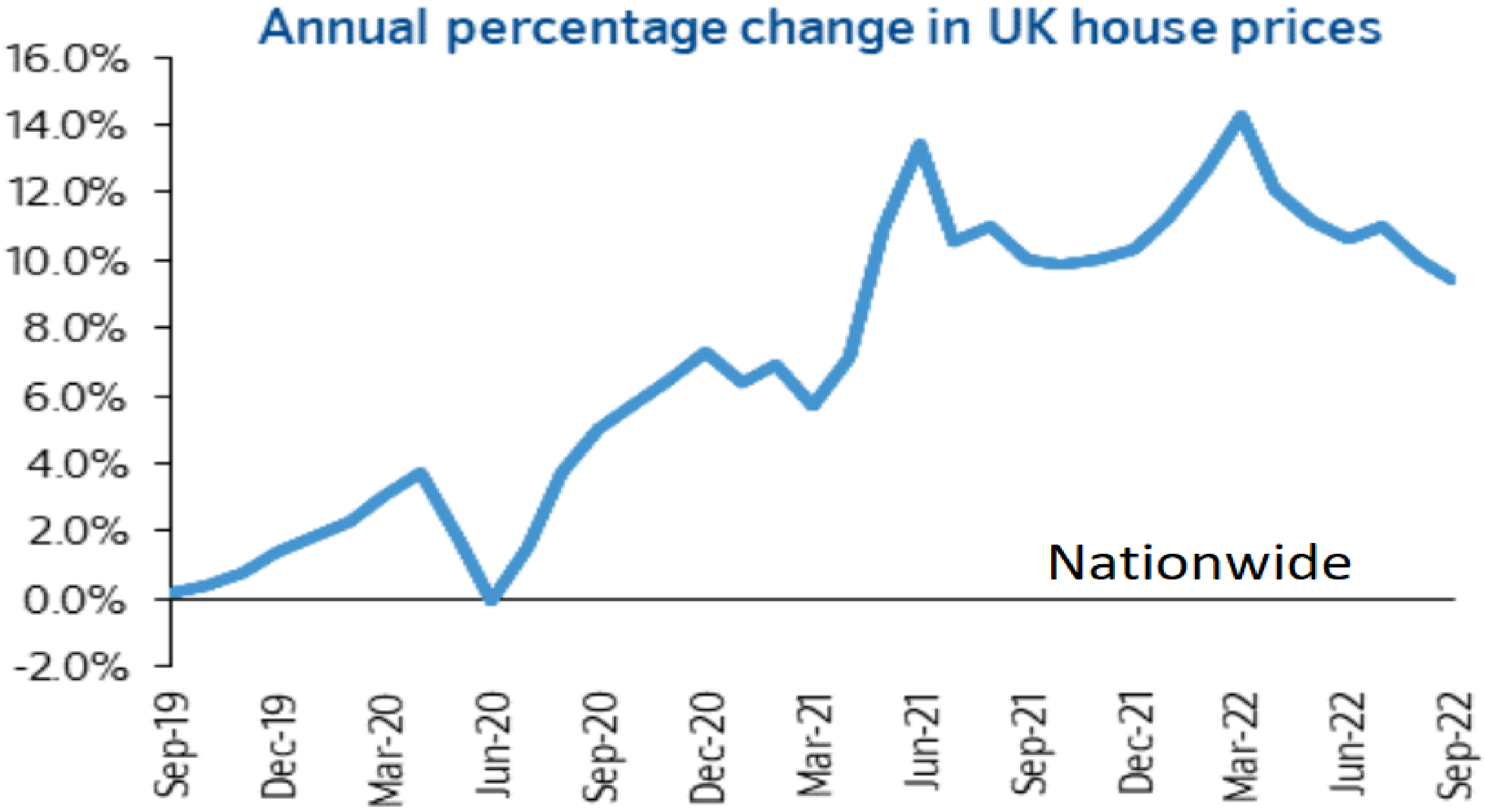


So expect some more rate rises

- Central banks, having thought that the rise in inflation was temporary or ‘transitory’, and outside their control, have been forced into action.
- As well as raising rates, they are trying to shift from QE, quantitative easing, to QT, quantitative tightening.
- Their main concern is that inflation expectations and pay settlements do not rise too much.
- Expect the Bank of England to raise official interest rates to about 4%, so still below levels prevailing before the financial crisis, though markets expect more. But 6% or 7% rates look highly unlikely

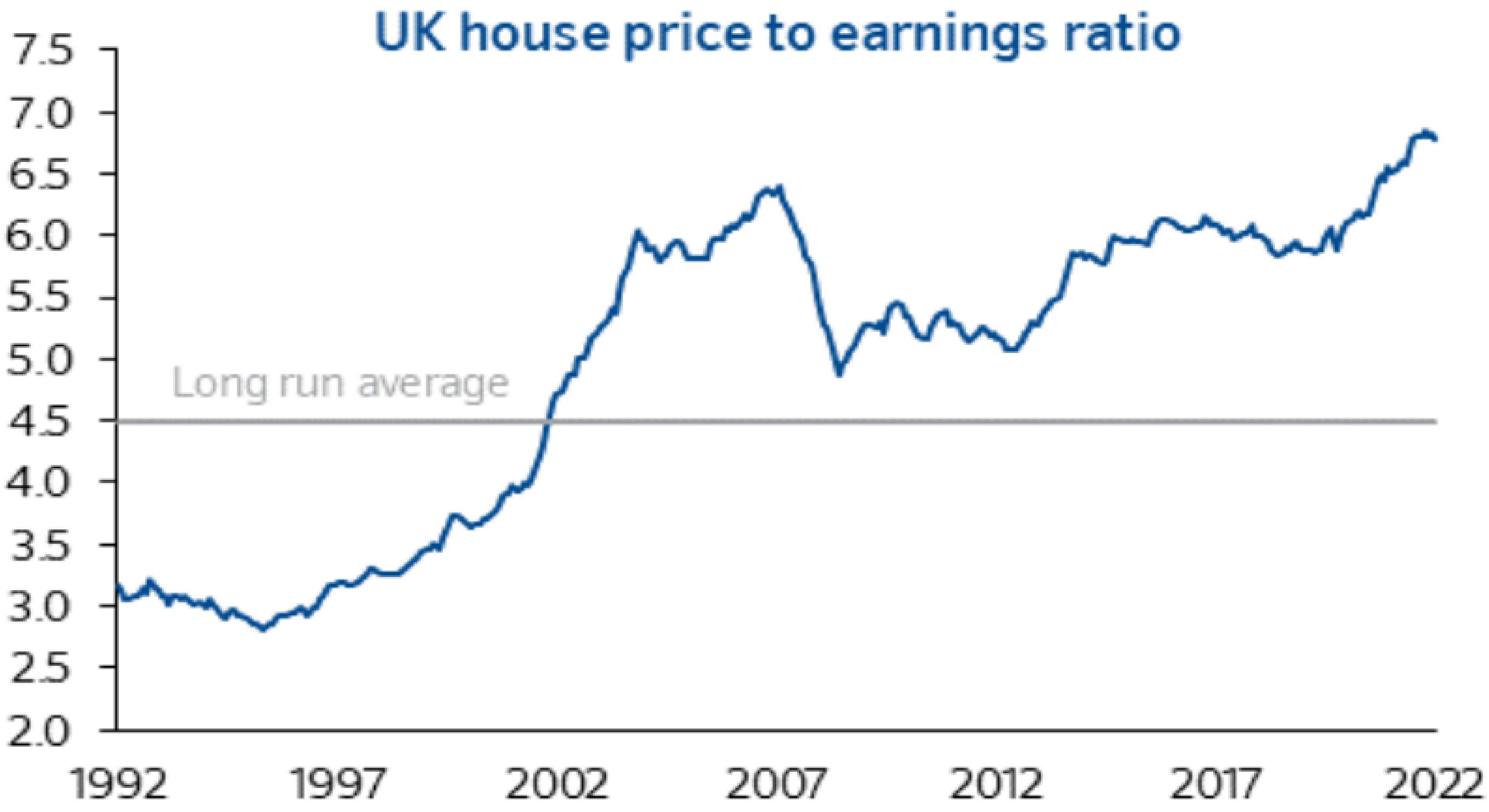
4. Storm clouds gather over housing

With prices coming off the boil

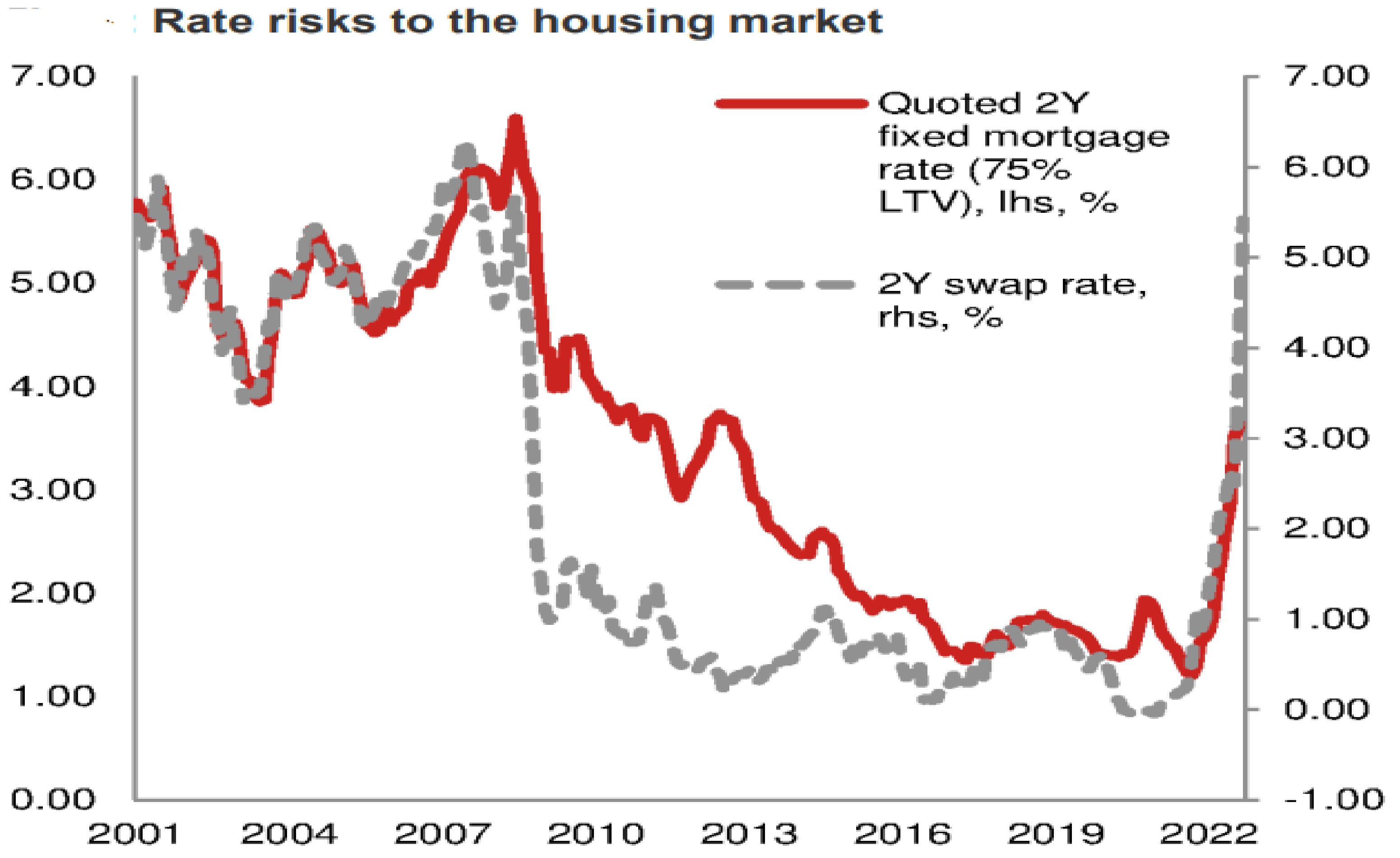


The pandemic boom is over

Because of a combination of this

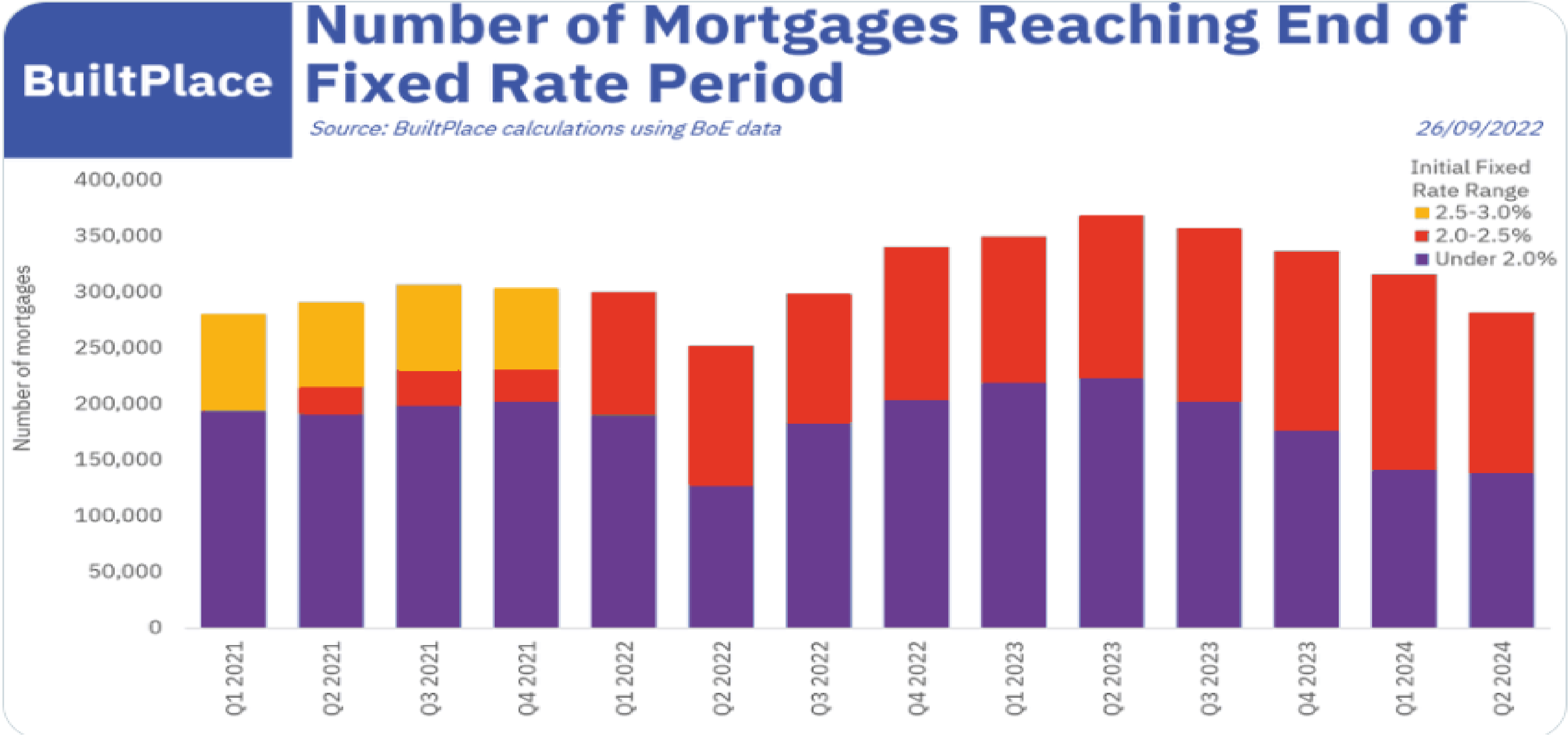


And this ….



Source: Bank of England, Bloomberg, Haver Analytics, Nomura

The effect is slower than in the past



So maybe a sharp slowdown rather than a crash

But don’t forget to count those skips

And let's hope for not many more black swans