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NEWSLETTER

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Market Insight from CSA

UK Economic Outlook – 2016: no free lunch on cheap debt, but grounds for cautious optimism

There has been some relatively good economic news coming out of the UK in recent months, but referencing a leading supermarket group recently the interviewee, a senior manager, advised, "*The outlook for retail at the moment is on the up, but things are going to be short lived. The recovery of the sector after 2011/12 was a false improvement because it's been juiced up by low interest rates and money printing. It's backed by nothing really and I don't see it having legs*."

My interviewee went on to say, "*This is the real high point before the low. Too many business managers see this sales growth and they don't realise it's a lot of debt money, it's cheap money. When interest rates do go up, and they have to, they're going to be stuck*."

So what is really happening out there? Which sectors will be the winners and losers in 2016? What is the medium term view at this stage of the UK's economic cycle? David McClelland, Director of Carlton Strategy Advisors, presents some thoughts for corporate finance investors and lenders to consider before their next possible transaction…

UK macroeconomics increasingly reflect the global harmonic

Global growth was recorded at 2.4% in 2015, and is expected to increase to just over 3% this year. By comparison, the UK's economy is expected to maintain its 2.2% annual growth rate for 2015 through 2016 and 2017 - slightly above the average for other advanced economies.

Possibly because of a happy alignment of the stars, the UK's present day economy, similarly to that of other advanced nations, is benefiting from markedly lower global commodity prices. The reasons are twofold:

- Firstly, we have the impact of the slowdown in China's demand-side economy, as the nation reduces its debt burden and rebalances away from industrial production and infrastructure/fixed asset investment towards greater supply side domestic consumerism;
- Secondly, against a backdrop of generally softer global demand, Saudi Arabia has maintained levels of hydrocarbon production bringing prices down, as OPEC's leading swing producer maintains its market share land-grab in competition with higher cost North American frackers and re-emergent Iraq and Iran.

The direct impact of a slowing Chinese economy on the UK is limited given that China is not by any means the UK's most important export destination; North America and the rest of Western Europe carry significantly greater importance. Of greater significance is the fact that the economy of the UK is shaped more markedly by the level of its internal consumption.

Cheaper commodities and low inflation hand consumers a one-off 'freebie'

Shoppers in the UK have benefited from the effect of cheaper commodities lowering the cost of everything they buy and no more so than for heating and fuel. In effect, consumers have been handed a pay rise, without employers having to 'fork out'.

Since 2014, retail volume has risen by about 5% a year. Non-food retailers have done particularly well from the consumer's extra discretionary spending power on everything from cars to holiday travel. Annual spending on recreation rose by c.7% in 2014 and restaurants and hotels saw spending rise by c.5% in 2015. So have the services supporting those sectors. For example, Q3'15 year-on-year advertising industry expenditure increased by almost 7%.

Such growth, combined with an unemployment rate a little above 5%, should mean living standards for UK citizens are solidly improving. However, gains in household disposable incomes have come about because of the decline in inflation and this direct effect is not going to persist; it's a one-off impact - oil cannot fall another $70/barrel. Real incomes have been stagnant for most of the post-crisis phase, meaning that households have not been building up long-term savings.

Nor is the rise in household spending underpinned by rising UK productivity. Sustained increases in national living standards require higher productivity, allowing employers to pay more. However, whole-economy productivity lagged growth in labour costs in 2015. From this point on, wages rises will be at the expense of employers, starting with the recent increase in the minimum wage. This will have particular ramifications for those industries staffed and resourced by low skilled workers such as in retail, a sector where c.40% of employees receive close to the minimum wage with likely consequences on sector margins and employment levels in turn.

The UK economy can be further characterised by the nature and phasing of its property market – and one can be reminded of the frothy nature of the sector in the run up to 2008 and quick collapse not long afterwards. Jumping forwards six or seven years, land conditions are once again positive for builders with sales price inflation outstripping build cost inflation as demand outstrips supply.

The average price of a home in England & Wales rose over 6% in Dec'15, compared to a year earlier, with house price inflation now at its highest level since Jan'14. Builders report continuing growth in the gross development values of both short and long-term land pipelines. However, in another characteristic of the UK, building planning consent remains a perennial problem serving to constrain supply.

No free lunch on debt

Low saving rates, changes in pension regulations and city population influx drive property market demand. These stimulants can reasonably be expected to be with us for a while. The 3% increase in the rate of stamp duty applied to Buy-to-let properties from April might curb demand from landlords and investors, but Help-to-buy and other 'ease-of-entry' schemes will act to bolster market activity, particularly demand from first time buyers serving to 'prop up' property from grass-roots levels. This, no doubt, will be good for the makers of kitchen and bathroom furniture!

The net effect of the UK's consumer-led 'mini-boom' has been to see the annual growth rate for (unsecured) consumer credit over the year to December rise to c.9%, a near 10-year high. Additionally, with mortgage approvals hitting heady heights not seen since 2008, this creates an overall debt burden that leaves borrowers exposed to rising interest rates. When rates do rise, more spending on mortgage interest will leave less for the high street. Folks have done well out of deflation, but the future may become tougher!

Seeking a middle ground on interest rates

The UK's position on interest rates is caught between the US 0.25% rate rise in Q4'15 and the Eurozone's round of further monetary stimulus following that. The slump in the price of oil to under $30 a barrel, at the time of writing, from $114 in June 2014 will continue for as long as Saudi Arabia, Russia and others fail to curb production – and world trade fails to soak up supply. With subdued inflationary and wage pressures, interest rates in the UK might not follow the US for another several months before continuing to drift further upwards in 2017.

Present domestic demand eases concern that the UK maybe facing an abrupt economic slowdown, but it suggests robust growth may not return until the world economy regains composure. Meanwhile, political 'do-nothing-for-the-moment' sentiment on interest rates has pushed the value of Sterling down against the Dollar and up against the Euro, adding another layer of complexity for exporters.

Manufacturing dependent on world trade and strategic alignment to markets

Manufacturing in the UK is particularly dependent on world trade, as home-built GDP skews increasingly towards services. Output amongst UK manufacturers contracted 0.1% over 2015 and remains approximately 6% lower than its pre-crisis high of 2007.

The automotive and civil aircraft manufacturing sectors, for example, remain in positive phases of their respective economic cycles driven by continuing strong demand from customers, particularly in Asia. However, the immediate outlook remains bleak for all those businesses involved in the oil and gas sector supply chain until such times as oil reverts to something north of $80 per barrel. Until then the focus of global O&G exploration and production will be on cost reduction and containment as new investment projects are cancelled and others mothballed. The winners, of course, will be those industries that stand to benefit from cheaper fuel and raw materials input prices, such as domestic airlines and elements of the downstream chemicals and plastics industries serving consumer driven OEM type markets.

Grounds for cautious optimism

All told, CSA is cautiously optimistic about the UK economic outlook and therefore prospects for business managers and their financial backers.

Key positives are the present buoyancy of consumer markets. Public sector expenditure will be tamed and brought to heel, if slowly, releasing budgets for more productive re-investment. On top of this export opportunities will re-present themselves as mainland Europe recovers and an already resurgent North America consolidates traction. Lastly, there will be further prospects for the UK's products and services suitably targeted towards China and India's growing consumer markets.

Headwinds include the muted prospects for global oil and gas. There will be further uncertainty surrounding the UK's commitment to the EU, placing a possible moratorium on both local and inward investment decision making. Lastly, rising nation state protectionism and QE-initiated currency wars will do nothing positive for global trade.

So is the UK out of the woods… or heading into further economic quick sands? For equity investors and debt lenders the answer boils down to… an ability to partner best-in-class business owners and management teams, understanding the industry sector and carrying out sufficient due diligence to mitigate levels of transaction risk.

CSA is a commercial due diligence and business strategy consultancy with clients across the private equity and corporate banking sectors. For information about how CSA can help you to assess business and market attractiveness please contact: carlton-advisors.co.uk