ETF Securities Macro & Equities Research:
The UK to enter the economic doldrums

Summary

- A combination of weaker loan growth, sterling weakness, squeezed corporate margins and negative real wages are likely to push the UK into a period of very low growth in the coming year.
- UK corporates have seen a substantial deterioration in interest cover, and falling earnings caused by a weakening economy are likely to exacerbate the deteriorating economic growth outlook.
- More cyclical sectors such as mining tend to be much more vulnerable, as does the real estate sector, which tends to decline by 4% over a 6-month period.

Our UK business cycle indicator

The UK’s economic growth prospects have come in to question in recent months after tense Brexit negotiations. Looking at the economy since the UK exited recession in February 2010 it has certainly been the weakest recovery of the 5 post recession recoveries since the 1950’s, but by no means the longest one.

Our business cycle indicator is not entirely correlated with GDP growth, typically taking longer to recover than GDP growth, we believe this reflects the delay in looser monetary policy transmitting into the corporate lending environment. For example, it wasn’t until the introduction of the second and third rounds of quantitative easing in 2011 and 2012 that the UK lending environment began to markedly improve, and therefore the business cycle improve.

We can blame Brexit

Sadly, this economic improvement looks to be coming to an abrupt end - our cycle indicator immediately began deteriorating in March 2016, after the first set of data became available following the announcement of the EU referendum. BBA loan growth began to weaken and the LEI began to flatten. Furthermore, the weaker sterling, caused by the Brexit vote has pushed up producer prices, forcing import costs higher and consequently squeezing corporate margins. We have also seen further declines in loan growth leading to a steady decline in the UK’s growth prospects. Higher inflation has also put further pressure on wages, with real wage growth now being...
negative for the fourth month in a row, further constricting consumers’ spending power.

Alarmingly, our business cycle indicator now suggests the UK could slip into a period of very low growth in the coming year. We believe only a continued strong recovery in sterling, a recovery in loan growth and wage growth would turn around the UK’s fortunes. We are reluctant to state that a recession is likely at this point as it remains very unclear how the Brexit negotiations will play-out.

The market implications

In our report, *Vulnerabilities exposed by rising interest rates*, from a regional perspective we find, like households, that Europe and the US have the healthiest interest coverage ratios, while UK corporates have seen a substantial deterioration in interest cover, having falling from 9x in 2012 to just 3.4x today. The FTSE is therefore much more vulnerable to interest rate rises and falling earnings caused by a weakening economy, potentially exacerbating the economic growth outlook. Within the UK, we find the most vulnerable sectors are resource and property related sectors.

Interest expense coverage ratio

Historically FTSE 350 performance has varied at various stages through the economic cycle. Breaking down the cycle in to four components, we find distinct performance differences within sectors. The FTSE 350 tends to perform the best when the business cycle is negative but is beginning to rise and performs the poorest when the cycle begins to rollover after a period of strong economic performance.

The countercyclical nature of equity market performance is due to the bubble of optimism popping, when equities are usually over extended from a valuation standpoint. Valuations at the beginning of 2017 were at their highest since the credit crisis but the recent weak sterling has increased valuations due to inflating overseas source earnings.

We see the positive impact of currency on equity valuations as transitory. Our cycle indicator highlights the UK growth outlook is deteriorating and is likely to turn negative, and in such a scenario the FTSE350 has historically risen by 2.2% over a 6 month period. The best performing sectors at this stage tend to be defensive sectors such as utilities and defence contractors and those sectors that can deliver cost efficiencies for corporates such as software and computer services.

Sector performance in the business cycle

More cyclical sectors such as mining tend to be much more vulnerable, as does the real estate sector, which tends to decline by 4% over a 6-month period. These also happen to be the sectors which are the most over-leveraged from an interest coverage perspective.

We believe the UK’s economic growth prospects are very contingent on economically beneficial negotiations with the EU and a very cautious approach from the Bank of England, as a policy error or a bad deal could tip the UK into recession.

Investments may go up or down in value and you may lose some or all of the amount invested. Past performance does not guarantee future results.
Important Information

General

This communication has been issued and approved for the purpose of section 21 of the Financial Services and Markets Act 2000 by ETF Securities (UK) Limited ("ETFS UK") which is authorised and regulated by the United Kingdom Financial Conduct Authority (the "FCA").

The information contained in this communication is for your general information only and is neither an offer for sale nor a solicitation of an offer to buy securities. This communication should not be used as the basis for any investment decision. Historical performance is not an indication of future performance and any investments may go down in value.

This document is not, and under no circumstances is to be construed as, an advertisement or any other step in furtherance of a public offering of shares or securities in the United States or any province or territory thereof. Neither this document nor any copy hereof should be taken, transmitted or distributed (directly or indirectly) into the United States.

This communication may contain independent market commentary prepared by ETFS UK based on publicly available information. Although ETFS UK endeavours to ensure the accuracy of the content in this communication, ETFS UK does not warrant or guarantee its accuracy or correctness. Any third party data providers used to source the information in this communication make no warranties or representation of any kind relating to such data. Where ETFS UK has expressed its own opinions related to product or market activity, these views may change. Neither ETFS UK, nor any affiliate, nor any of their respective officers, directors, partners, or employees accepts any liability whatsoever for any direct or consequential loss arising from any use of this publication or its contents.

ETFS UK is required by the FCA to clarify that it is not acting for you in any way in relation to the investment or investment activity to which this communication relates. In particular, ETFS UK will not provide any investment services to you and or advise you on the merits of, or make any recommendation to you in relation to, the terms of any transaction. No representative of ETFS UK is authorised to behave in any way which would lead you to believe otherwise. ETFS UK is not, therefore, responsible for providing you with the protections afforded to its clients and you should seek your own independent legal, investment and tax or other advice as you see fit.