Note: The following is a redacted version of the original report published November 10, 2023 [13 pgs].

European Economics Analyst

UK Outlook 2024: Not So Different After All

- While the UK economic outlook looked substantially worse than for other advanced economies a few months ago, the UK's prospects have converged to other DMs in important respects. First, the economy has shown surprising growth resilience and (so far) avoided a recession. We expect growth to improve modestly in 2024 as real disposable income rises and the growth drag from the BoE's tightening diminishes. We look for growth of 0.6% next year, slightly above consensus.
- Second, the labour market has shown significant rebalancing. Our estimate of the jobs-workers gap—the total number of jobs relative to workers—has shrunk sharply from its peak and has now unwound more of the post-covid overheating than the US or the Euro area.
- Third, wage growth is finally starting to slow. The UK stood out notably for much of this year with much higher pay pressures, but we now see that sequential wage growth is easing and our analysis points to further cooling to around 4½% by the end of next year.
- Fourth, underlying inflation metrics have now clearly weakened. Sequential core inflation has slowed from around 9% in the Spring to 4% in September. While mostly driven by slower core goods inflation so far, services price pressures have also diminished and we see continued (albeit gradual) cooling ahead, with core inflation at 2.8%yoy by the end of 2024.
- Given these improvements in underlying inflation, we see the BoE on hold from here, just like the Fed and ECB. Faced with continued above-target inflation, however, we do not expect the MPC to consider rate cuts soon, despite sluggish growth. We expect the MPC to lower Bank Rate in 2024Q3 (in line with the ECB but one quarter before the Fed), followed by quarterly 25bp steps until reaching a terminal rate of 3%.
- While 2024 should be a better year for the UK, the economy still stands out unfavourably relative to other DMs across some dimensions. On the demand side, we look for weaker growth in the UK than elsewhere next year given a more modest rise in real household incomes and a more pronounced mortgage refinancing channel. On the supply side, we see significant constraints from a large post-covid increase in long-term sickness and changing immigration patterns since the EU referendum. As a result, we again expect the UK to face a

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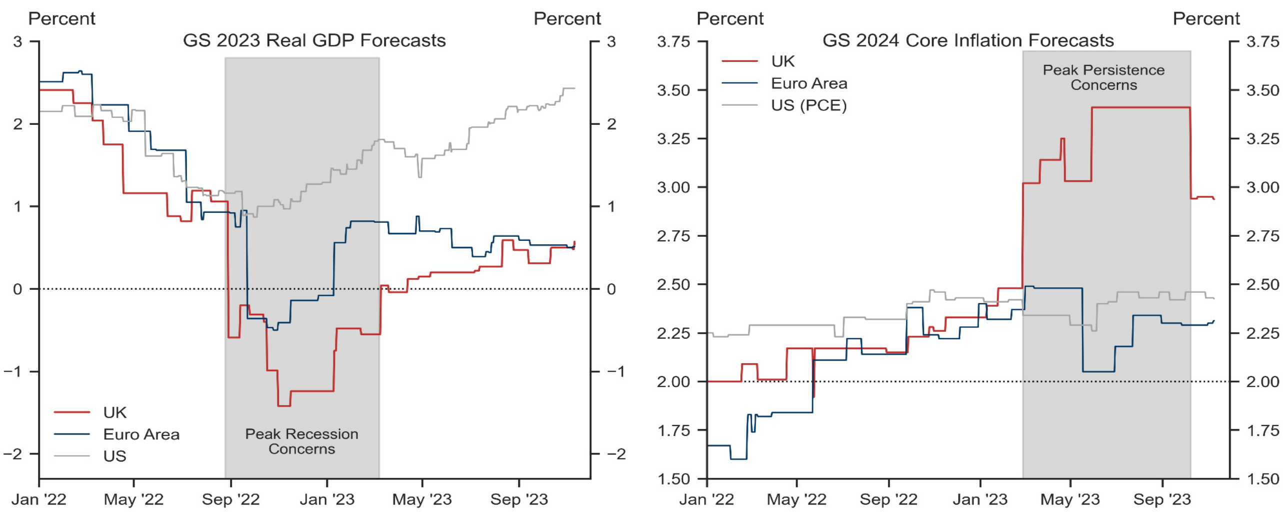
more adverse growth/inflation trade-off than other advanced economies in 2024.

- Following last year's tumultuous mini-budget, the government is consolidating the public finances. While temporary tax relief in the run-up to next year's general election is possible, we expect fiscal vulnerabilities — including a larger share of inflation-indexed bonds and prospects of significant losses from the BoE's Asset Purchase Facility —to constrain the scope for fiscal support next year.

UK Outlook 2024: Not So Different After All

A few months ago, the UK economic outlook looked substantially worse than for other advanced economies, with much weaker growth prospects and much higher underlying inflation (Exhibit 1). Recent developments, however, suggest that the UK economic outlook has converged to other DMs in important respects.

Exhibit 1: The UK Has Stood Out for the Past Year



Source: Goldman Sachs Global Investment Research

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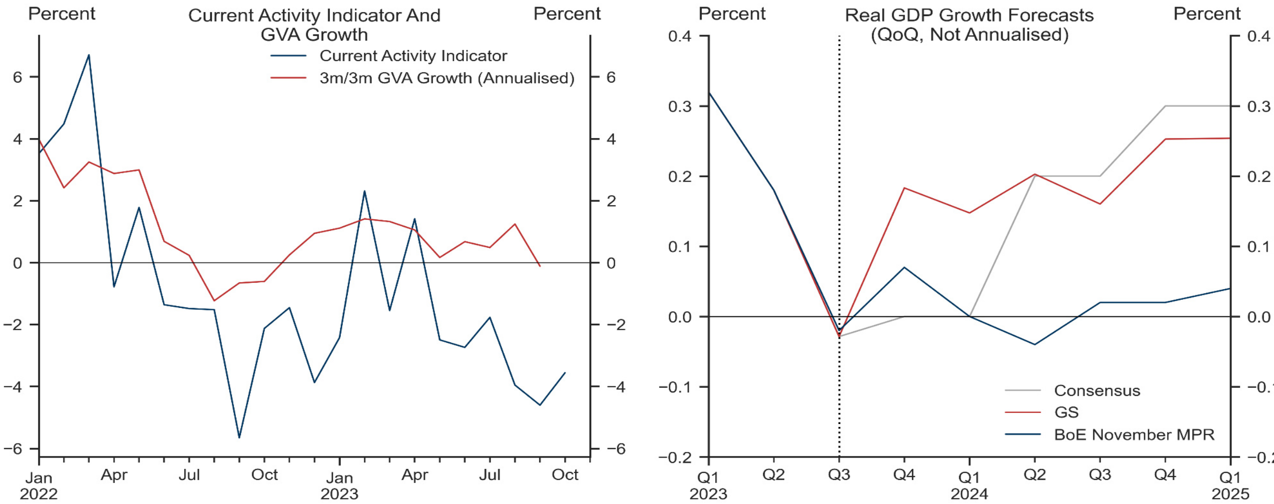
First, the economy has shown surprising growth resilience and (so far) avoided expectations for a recession. While the incoming data remain weak—with our Current Activity Indicator running at -3.6% in October—the GDP data have been more resilient and we look for slightly improved growth of 0.2% in Q4 (Exhibit 2).

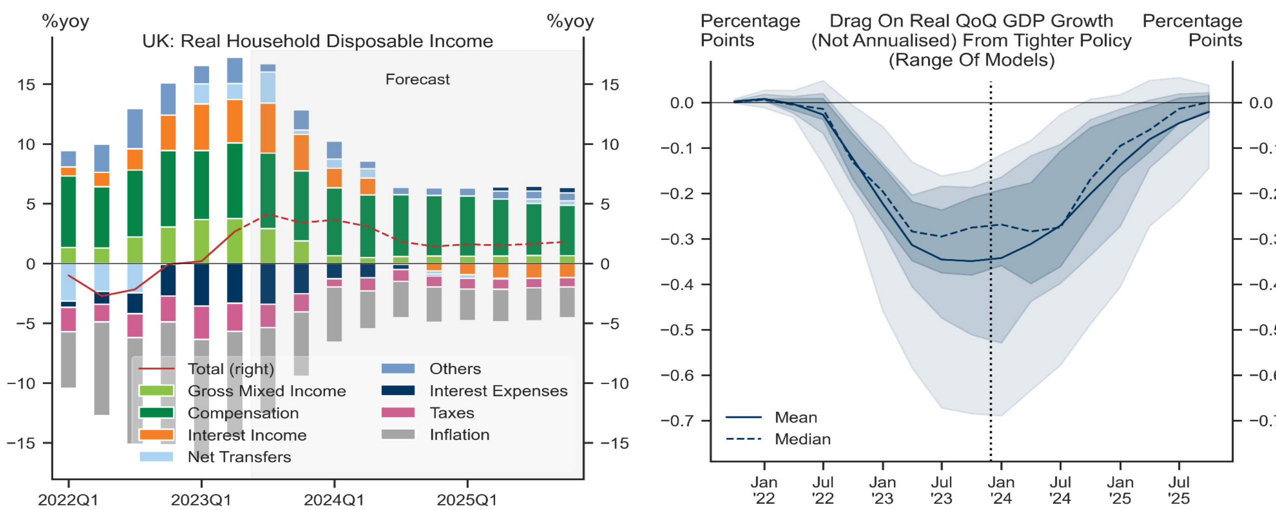
Exhibit 2: Weak But Positive Growth



Source: Goldman Sachs Global Investment Research, Haver Analytics, Bloomberg, Bank of England

Looking ahead, we expect growth to improve modestly in 2024 as two key growth drags diminish (Exhibit 3). Real disposable income is set to receive a significant boost of around 2.5% in 2024 as headline inflation falls and nominal wage growth remains elevated. And we estimate that the growth drag from the BoE's rapid tightening is now peaking (at 0.3-0.4pp) and set to fade steadily through 2024.

Exhibit 3: Fading Headwinds

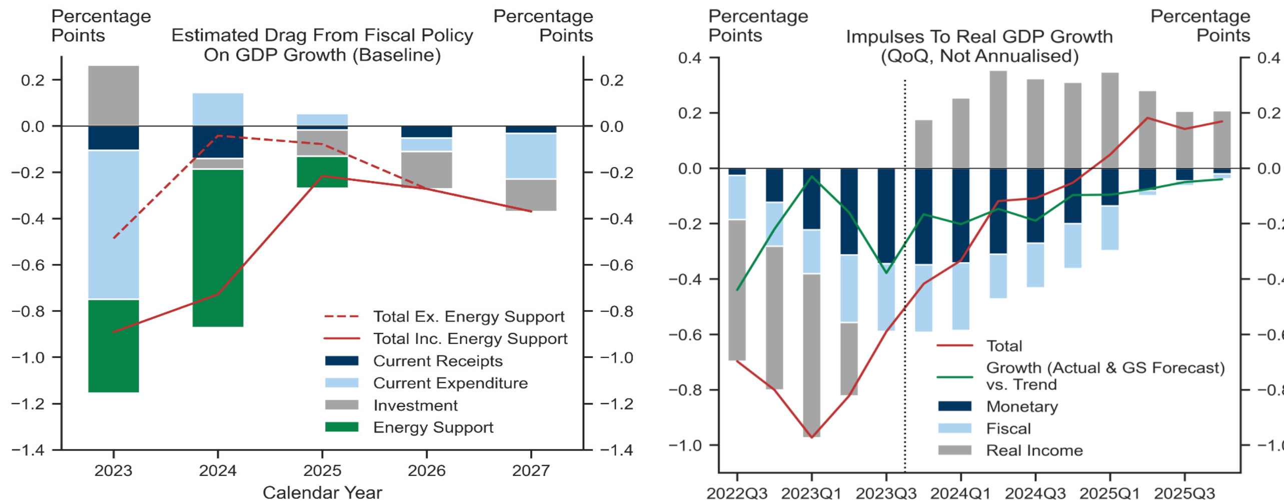


Source: Goldman Sachs Global Investment Research, Haver Analytics

Fiscal policy is likely to weigh on growth in 2024 as the government's covid and energy support measures continue to unwind. However, we estimate that the fiscal drag on growth will also decline slightly, deducting 0.7pp in 2024 after a 0.9pp drag in 2023
(Exhibit 4, left).

Taken together, our analysis of the main growth drivers points to a modest pickup in growth next year (Exhibit 4, right).[1] We therefore look for (not annualised) growth of 0.1% in Q1, 0.2% in Q2 and Q3 and 0.3% in Q4. At 0.6% for the year as a whole, our forecast is notably above the BoE's, slightly above consensus, but still significantly below our estimate of potential.

Exhibit 4: Slightly Better Growth in 2024

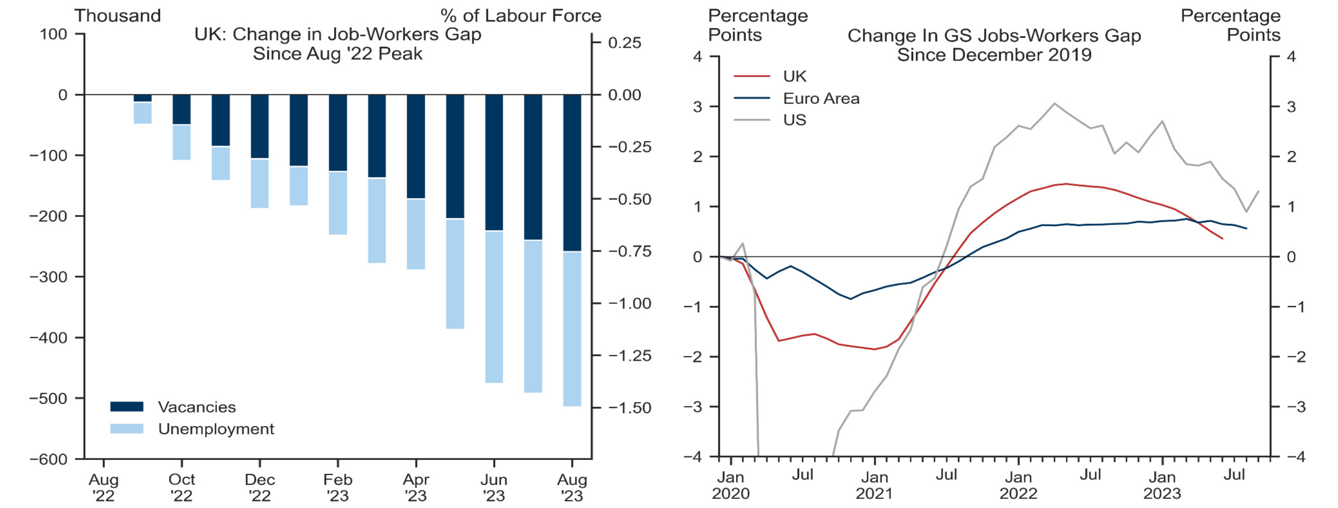


Source: Goldman Sachs Global Investment Research

Second, the labour market has shown significant rebalancing this year despite the resilience in growth. In particular, our estimate of the jobs-workers gap—the total number of jobs relative to workers—has shrunk sharply from the peak last August (Exhibit 5, left). While the initial rebalancing was driven largely by a decline in vacancies, more recently, a notable pickup in the unemployment rate to 4.2% currently (vs 3.5% at its low) has started to contribute to the rebalancing as well. Measured with the jobs-workers gap, the UK has now unwound more of the post-covid labour market overheating than either the US or the Euro area (Exhibit 5). Given our expectations for continued below-trend growth, we expect further labour market rebalancing over the next few quarters.

[1] Note that we use real compensation rather than broader real disposable income to calculate the real income impulse, to minimise overlap with the fiscal and monetary impulses. Our fiscal impulse will not precisely capture the quarterly profile of changes in fiscal support, which may partly explain the disparity between the impulse and actual growth in late 2022 and early 2023.

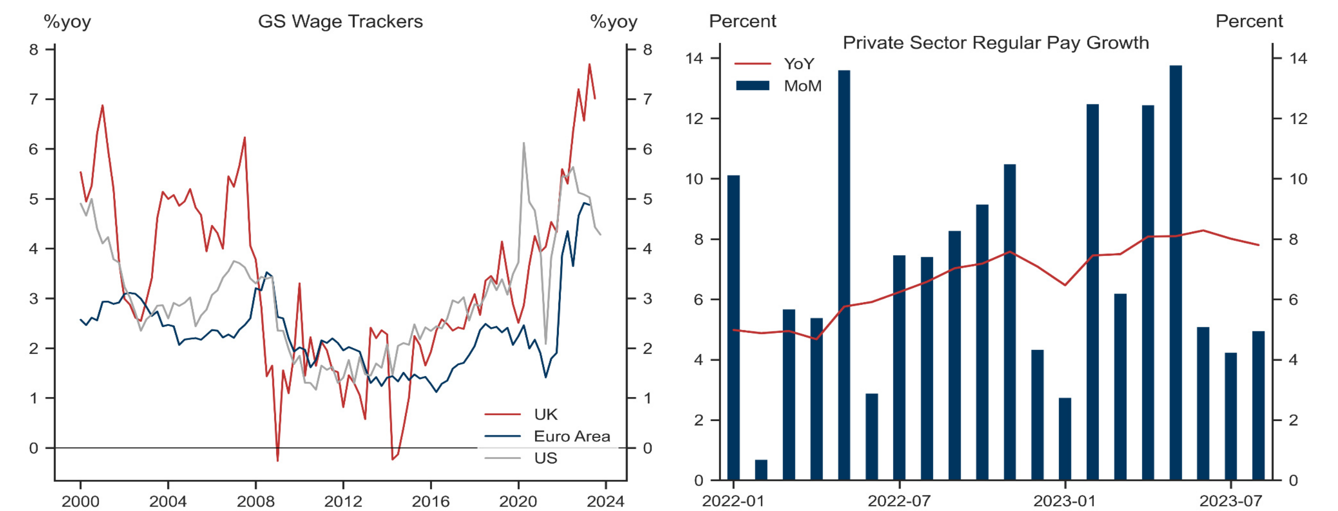
Exhibit 5: Significant Labour Market Rebalancing



Source: Goldman Sachs Global Investment Research, Haver Analytics

Third, wage growth is finally starting to show signs of slowing. The UK stood out notably relative to other advanced economies for much of this year, with our wage tracker (which averages across wage metrics) peaking at over 7.5%yoy in Q2 (Exhibit 6, left). While the annual run-rate remains very high, we now see pay pressures starting to ease sequentially. Although monthly prints tend to be volatile, gains in average weekly earnings have now slowed from a peak annualised pace of 13%mom in May to 5% mom in August (Exhibit 6, right).

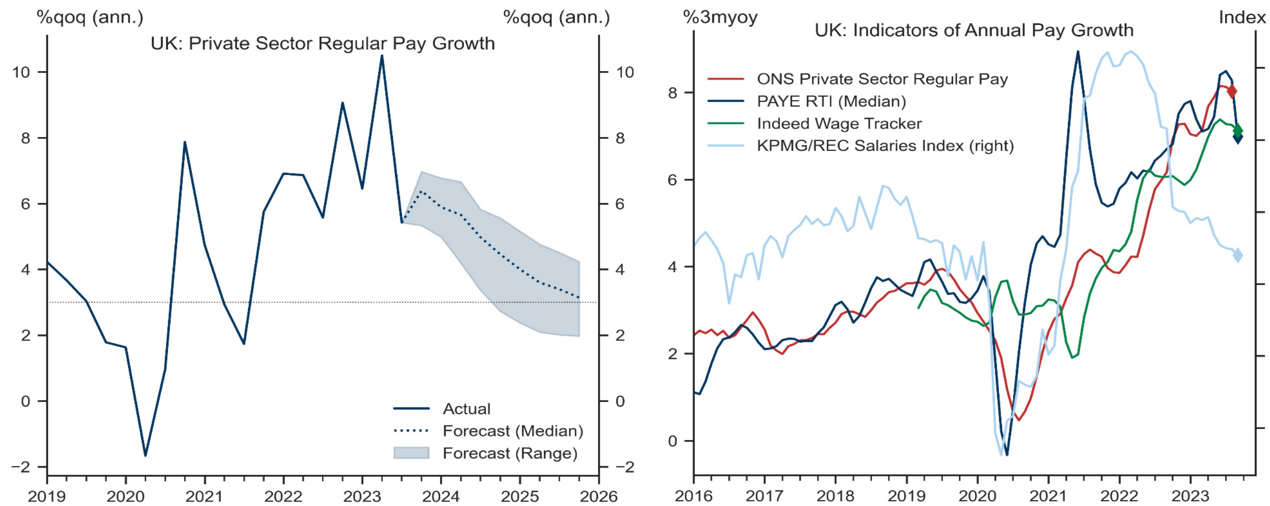
Exhibit 6: Wage Growth is Finally Starting to Slow



Source: Goldman Sachs Global Investment Research, Haver Analytics

Our analysis suggests that falling headline inflation and ongoing labour market rebalancing should cool wage pressures further in coming months, with sequential wage growth falling to around 4½% (not annualised) by end-2024 (Exhibit 7, left). Our projection for cooling wage pressures is consistent with the recent softening in other wage indicators, including PAYE RTI pay and the Indeed wage tracker (Exhibit 7, right).

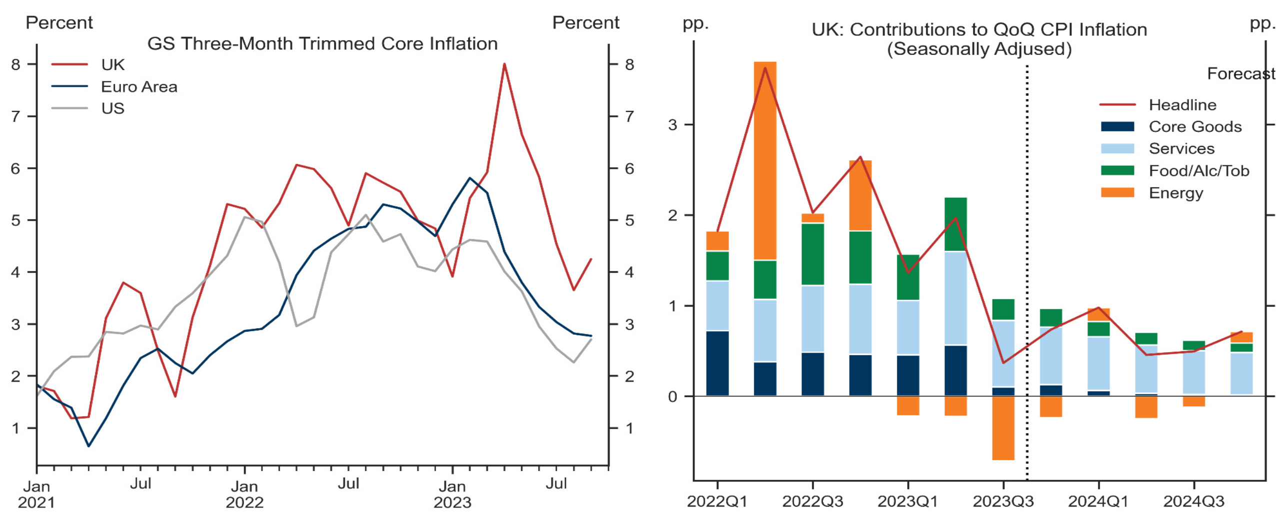
Exhibit 7: More Wage Growth Deceleration Ahead



Source: Goldman Sachs Global Investment Research, Haver Analytics

Fourth, underlying inflation metrics have now cooled significantly. Sequential core inflation stood out sharply relative to other countries in the spring, but the three-month annualised pace has slowed from over 9½% in April to around 4% in September. While most of this improvement has been driven by cooling core goods inflation, services price pressures have also diminished (Exhibit 8). We expect the disinflation trend to continue—albeit at a more measured pace—and see headline and core inflation at 2.6%yoy and 2.8%yoy at the end of 2024, respectively.

Exhibit 8: Easing Core Inflation

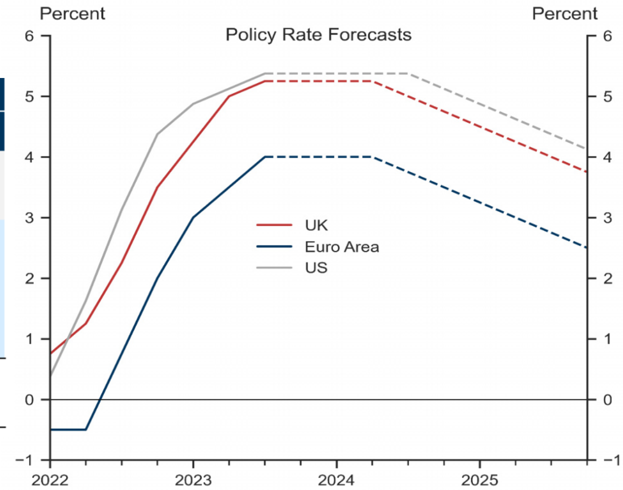


Source: Goldman Sachs Global Investment Research, Haver Analytics

Given these improvements in underlying inflation, we see the BoE on hold from here, just like the Fed and ECB. The MPC's three assessment criteria for inflation persistence—labour market tightness, wage growth, and services inflation—have been a good guide to the BoE's decisions recently, and we expect all three to show further progress in coming months (Exhibit 9).

Exhibit 9: BoE On Hold Until 2024Q3

Metric	MPC Meeting				
	Jun	Aug	Sep	Nov	Dec (GS Exp)
Unemployment Rate	3.8%	4.0%	4.3%	4.2%	4.3%
Private Sector Regular Pay (3myoy)	7.6%	7.7%	8.1%	8.0%	7.4%
Services CPI Inflation (yoy)	7.4%	7.2%	6.8%	6.9%	6.7%
Change in Bank Rate	**+50bp**	**+25bp**	**+0bp**	**+0bp**	**+0bp**



Source: Goldman Sachs Global Investment Research, Haver Analytics

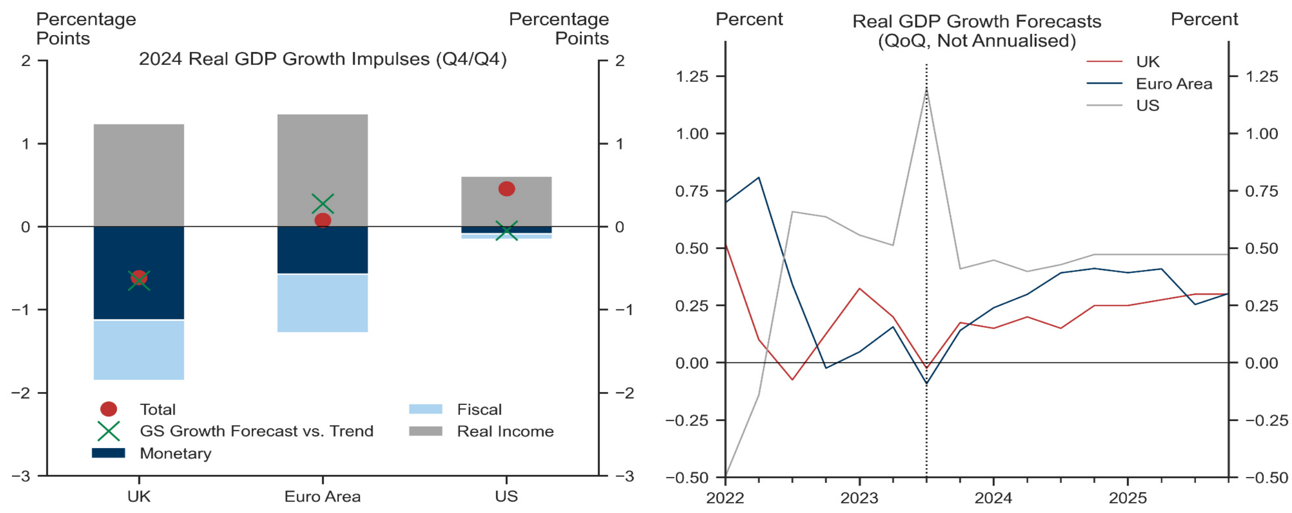
Faced with continued above-target inflation, however, we do not expect the MPC to tilt towards rate cuts soon, despite sluggish growth. In particular, we believe the BoE will want to see the outcome of the January and April pay-rounds to confirm that underlying wage growth is, in fact, slowing as anticipated before contemplating rate cuts. We expect the MPC to lower Bank Rate in 2024Q3 (in line with the ECB but one quarter before the Fed), followed by quarterly 25bp steps until reaching a terminal rate of 3%. We have raised our forecast of the terminal rate by 50bp, in line with our projections for the Fed and the ECB.

But Not Quite the Same

While these considerations will likely make 2024 a better year for the UK, the economy still stands out unfavourably relative to the US and the Euro area economies across a number of dimensions.

On the demand side, we look for weaker growth in the UK than elsewhere next year (Exhibit 10). One reason is that real disposable income is likely to improve by less, reflecting stickier inflation in the UK. The other reason is a more persistent drag from higher policy rates, given a more pronounced mortgage refinancing channel. We therefore expect the UK to face more persistent demand headwinds in 2024 than the US or Euro area.

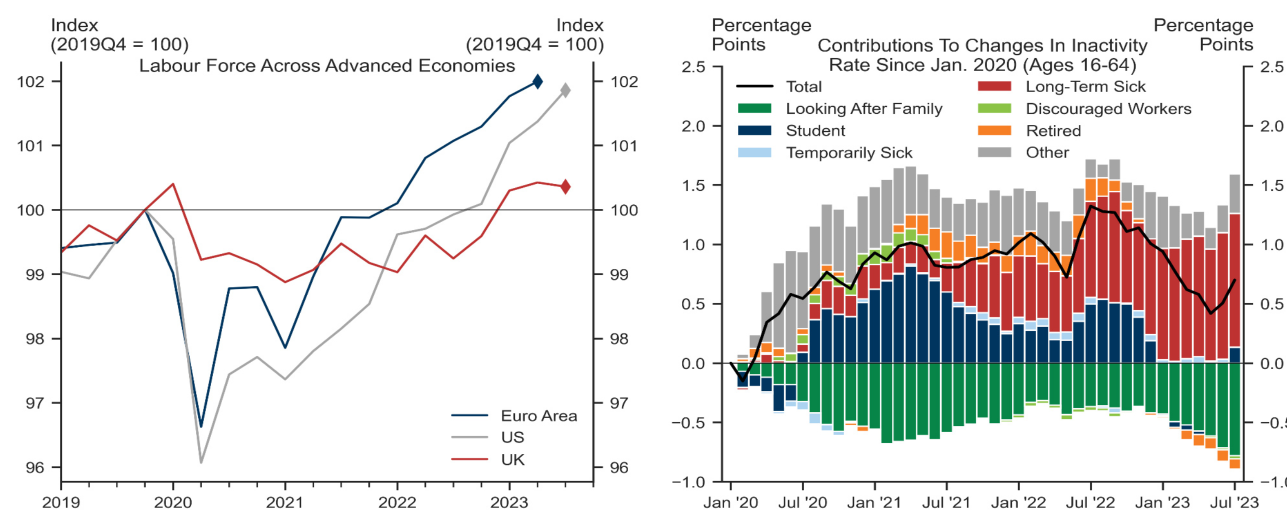
Exhibit 10: More Muted Growth Pickup than Elsewhere



Source: Goldman Sachs Global Investment Research, Haver Analytics

On the supply side, we see more pronounced constraints in the UK than elsewhere (Exhibit 11, left). Labour force participation has been weaker, reflecting a sharp increase in long-term sickness since the pandemic (Exhibit 11, right). Moreover, we have shown that changing immigration patterns since the EU referendum have constrained labour supply and contributed to labour shortages in certain sectors. Consistent with this, we estimate that the structural unemployment rate in the UK stands at around 5%, above the BoE's latest estimate of 4½%.

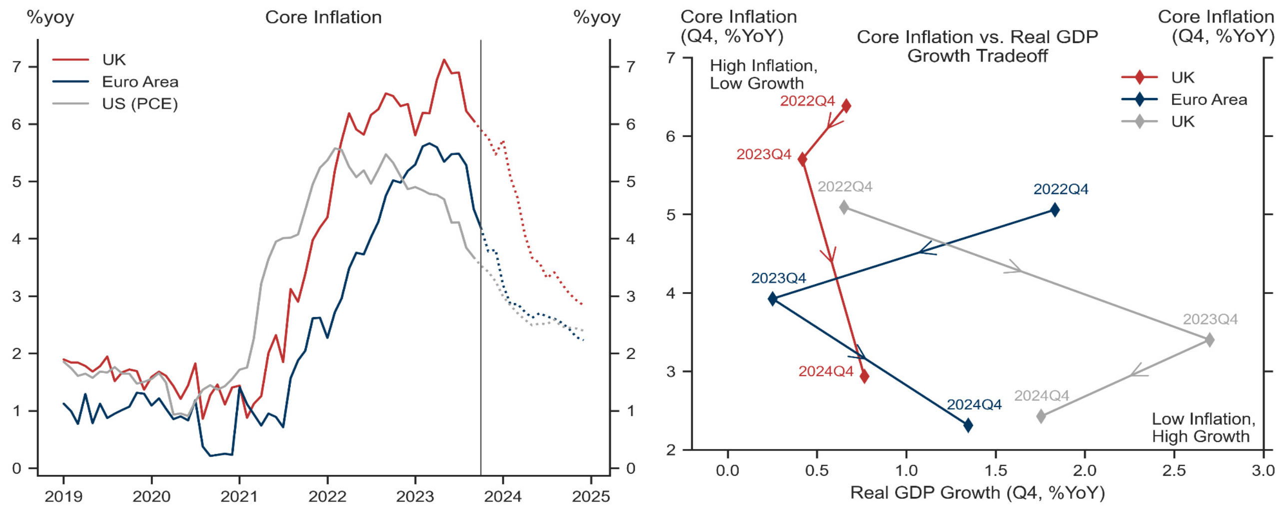
Exhibit 11: A Weaker Supply Side



Source: Goldman Sachs Global Investment Research, Haver Analytics

We therefore expect the UK economy to face a more adverse growth/inflation trade-off than other advanced economies in 2024 (Exhibit 12). We look for 0.6% growth next year, below 0.9% in the Euro area and sharply below the expected 2.1% in the US. But we expect core inflation of 3.8% in the UK, still notably above that in the US (3.2%) and Euro area (2.6%).

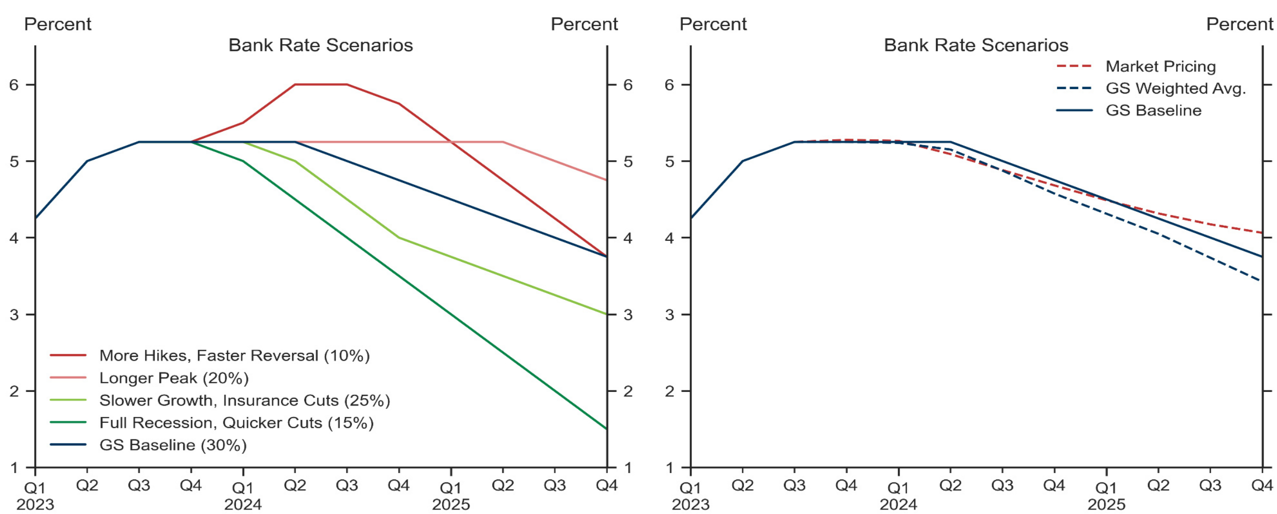
Exhibit 12: A Less Favourable Trade-Off



Source: Goldman Sachs Global Investment Research, Haver Analytics

Faced with a more difficult trade-off, the outlook for the BoE remains more uncertain, especially compared with the ECB (Exhibit 13, left). In particular, we have lower conviction in the BoE baseline path (30%) than in the Euro area (40%) or US (35%) and see a higher chance of renewed hikes in H1 (10%). But we also see a substantial probability of earlier cuts—with more room to lower rates in the UK than the Euro area—and from mid-2024 onwards our probability-weighted path is therefore below market pricing (Exhibit 13, right), in contrast to our views for the Fed and ECB.

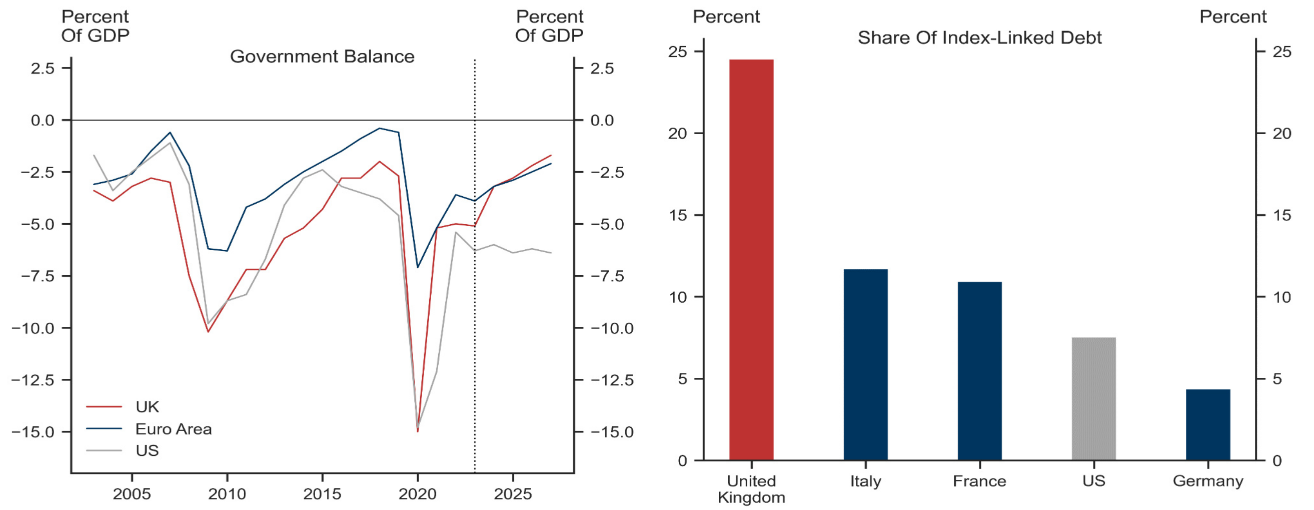
Exhibit 13: A Wider Range of Outcomes for the BoE



Source: Goldman Sachs Global Investment Research, Haver Analytics, Bank of England

Following last year's tumultuous mini-budget, the UK's public finances now look broadly similar to the US and Euro area. The debt/GDP ratio has risen by comparable magnitudes and, while deficits remain large, the government plans to improve the budget balance in coming years (Exhibit 14, left).

Exhibit 14: A Similar Fiscal Outlook



Source: Goldman Sachs Global Investment Research, Haver Analytics, OBR

That said, underlying fiscal vulnerabilities remain. In particular, the UK has a much larger share of inflation-indexed bonds, prospects of significant fiscal losses from the BoE's Asset Purchase Facility, and a sharp increase in the share of debt held by foreign investors (Exhibit 14, right). While temporary tax relief in the run-up to next year's general election is possible, we expect these vulnerabilities—combined with higher inflation levels—to constrain the scope for fiscal support in 2024.

European Economics Team

Disclosure Appendix

Reg AC

We, Sven Jari Stehn, Filippo Taddei, Christian Schnittker, James Moberly, Alexandre Stott, Ibrahim Quadri and Katya Vashkinskaya, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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