COMMENTARY

Looking under the Hood: UK Economic Outlook and Implications

Economic Briefing Q1 2021

Marakon

Management Consulting at Charles River Associates

BRIEFING CONTEXT

What is in this Briefing

- The UK's latest macro-economic outlook in light of recent scientific, economic and geo-political developments
- A perspective on likely recovery scenarios and what we need to believe to get there
- Putting in context the impact of Brexit on the UK's economy
- The broader impact of the pandemic on public finances and implications for bond markets

Why it is Important

What may this mean for you and your company – a lost quarter, or a hidden opportunity? Forward looking executives are closely monitoring the macro-economic environment to:

- Re-base their internal financial forecasts to get more accurate estimates
- Re-imagine their consumer offering i.e. their category and channel strategy with a view on where they want to dial up or down
- Re-evaluate their decision on the work-from-home model and implied cost structures
- Re-think their Financial Framework re-balancing the trade-offs between growth, returns and risk
- Re-evaluate their cost of capital and implications for Economic Profit and Valuation

SUMMARY AND CONCLUSIONS

2021 was expected to be a year of recovery both globally and in the UK

- But that recovery may have to wait a little as high (and in many areas rising) infection rates require further lockdowns

We are now in a race between a more infectious virus and vaccine rollout

- In the UK, it seems plausible to expect that during the first quarter of 2021, enough vaccinations will have been delivered to protect all health and care workers, plus those over 65, from the virus. This would not only drive down infection rates but also disproportionately reduce death rates (perhaps by as much as 80-90%)

The economy can start to make a sustainable recovery from Q2 onwards

- <u>If, and only if,</u> the government succeeds in achieving its vaccination targets
- And the pace of the recovery will likely be insufficient to restore pre-Covid levels of GDP until 2023

With the huge economic and social impact of Covid dominating, Brexit is a side-show

- In the short run, Brexit may cause some trade disruption in early 2021
- But in the longer run, Brexit will act as a drag on UK economic performance, and may make it more difficult to get over the scars left behind by the pandemic

One important consequence of the pandemic is a weakened state of public finances

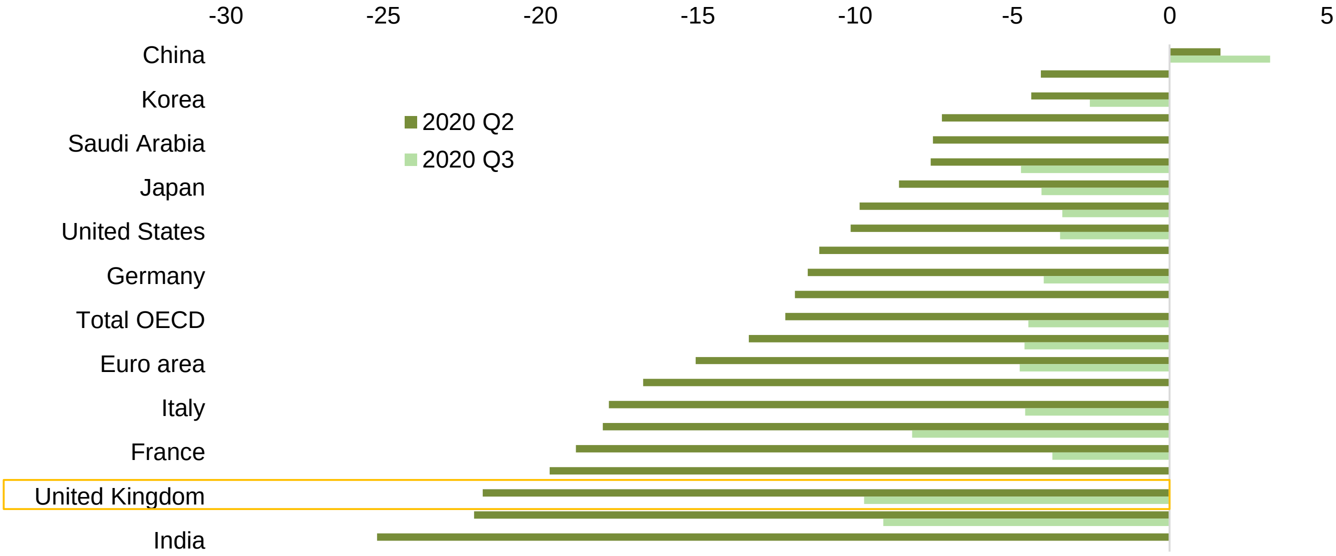
- The UK (and many other countries) will have a large long term structural budget deficit and levels of government debt in excess of 100% of GDP. Cutting public spending aggressively or raising taxes too soon would only make matters worse.
- So far bond markets have not reacted adversely to this prospect; low interest rates have implications for corporate cost of capital

THE UK HAS SUFFERED ONE OF THE WORST DOWNTURNS IN 2020

Amongst OECD countries, only Spain and India have suffered a more severe economic downturn during the Covid 19 crisis.

GDP decline in the Covid crisis

Per cent change from 2019Q4



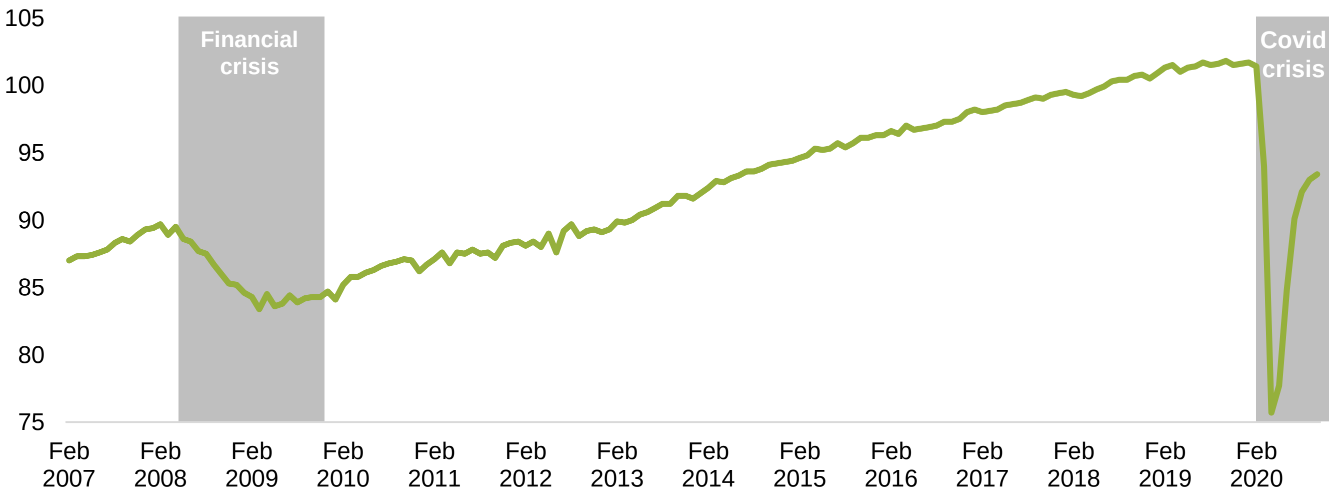
Source: OECD Economic Outlook, December 2020

BY OCTOBER, RECOVERY WAS SLOWING BUT SEEMED ASSURED

After a 25% collapse between January and April, by October GDP had recovered to 8% down. Manufacturing was down only 4% by then, but the much larger services sector was down 9%.

UK GDP index

Monthly estimate, 2018 = 100



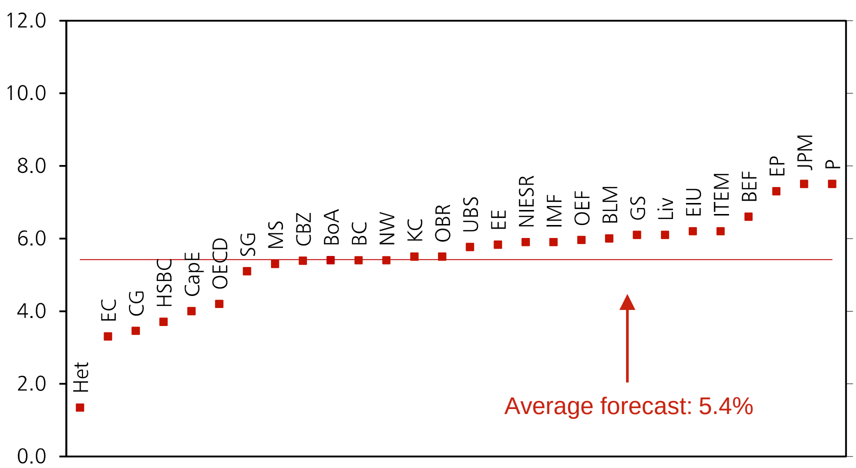
Source: ONS statistical release, Dec 2020
Latest data point is October 2020

ALL FORECASTERS EXPECT CONTINUED RECOVERY IN 2021…

All forecasters expect some kind of recovery in 2021, although none predict growth strong enough to fully reverse an estimated 11% GDP decline from 2019 to 2020.

GDP growth forecasts for 2021

Year on year percent change



BoA	Bank of America - Merrill Lynch
BC	Barclays Capital
BCC	British Chambers of Commerce
BEF	Beacon Economic Forecasting
BLM	Bloomberg Economics
CapE	Capital Economics
CG	Citigroup
CBI	Confederation of British Industry
CEBR	Centre for Economics and Business Research
CBZ	Commerzbank
CS	Credit Suisse
DCM	Daiwa Capital Markets
DB	Deutsche Bank
EE	Experian Economics
EC	European Commission
EIU	Economist Intelligence Unit
EP	Economic Perspectives
FC	Fathom Consulting
IHS	IHS Markit Economics
GS	Goldman Sachs
Het	Heteronomics
HSBC	HSBC Global Research
ING	ING Financial Markets
IMF	International Monetary Fund
ITEM	EY ITEM Club
JPM	JP Morgan Chase
KC	Kern Consulting
Liv	Liverpool Macro Research
MS	Morgan Stanley
N	Nomura
NIESR	National Institute of Economic and Social Research
OECD	Organisation for Economic Cooperation and Development
OEF	Oxford Economic Forecasting
P	Pantheon
NW	NatWest Markets
Sa	Santander GBM
S	Schroders Investment Management
SC	Scotiabank
SG	Societe Generale

Source: HM Treasury, *Forecasts for the UK economy: a comparison of independent forecasts*, No. 401, December 2020

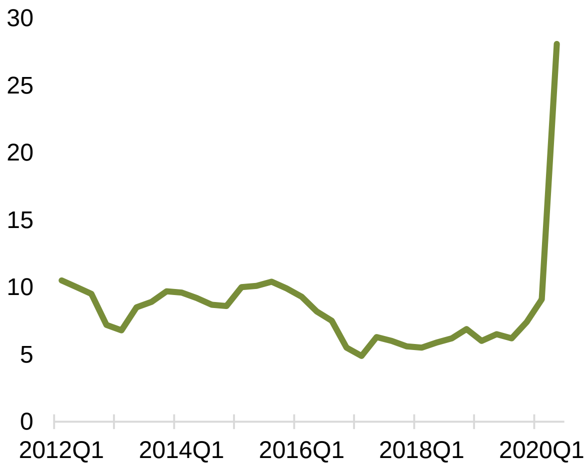
…WITH PENT-UP DEMAND SEEN AS A BIG RECOVERY DRIVER…

Household saving has risen to levels not seen for decades and better-off households have substantial excess spending power, much of which will likely be spent in sectors which have suffered most.

Household saving has increased sharply

UK Household Saving Ratio

Household saving as percentage of household income

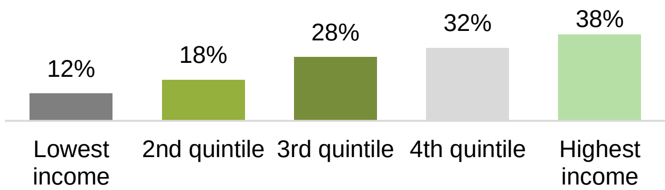


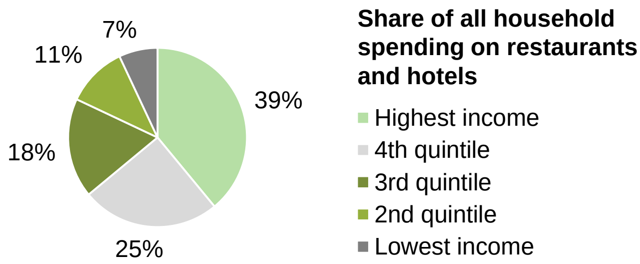
Source: Office for National Statistics

Better-off households have saved most

Proportion of adults who increased their rate of saving

From February to September 2020





Source: Resolution Foundation analysis of Office for National Statistics, Family Spending and YouGov data

…IMPROVING BUSINESS CONFIDENCE IS ALSO A DRIVER…

Business confidence fell sharply in early 2020. Combined with squeezed profits this drove a 25% fall in business investment. But signs of recovery should trigger a virtuous spending-confidence circle.

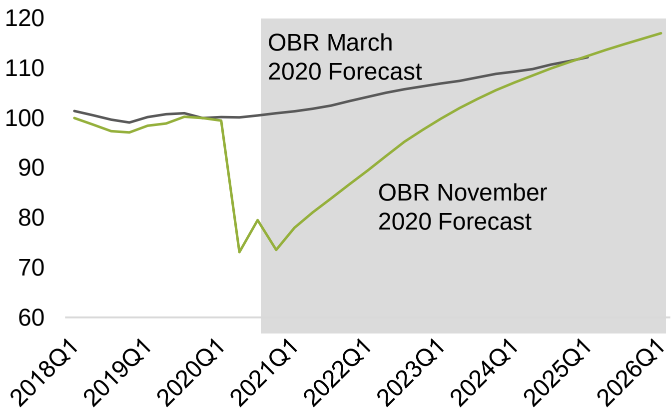
Business confidence fell sharply in 2020…

CBI quarterly survey of manufacturing optimism

Source: CBI

…recovery in 2021 is expected to boost investment

Business investment, including OBR forecasts
Index, Q4 2019 = 100



Source: Office for Budget Responsibility, Economic and Fiscal Outlook, November 2020

…AND MOST SECTORS EXPECTED TO SEE SOME IMPROVEMENT…

All sectors expected to see some recovery, even those most affected in the crisis. Wholesale and retail expected to be close to pre-crisis levels as demand recovers.

Sectoral change in output

% change over period

Sector	Jan to Apr 2020	Jan to Nov 2020	Jan 2020 to Mar 2021	Weight in whole economy
Accomodation and food services	-91	-68	-26	29
Other services	-50	-40	-29	37
Construction	-45	-14	-10	64
Transportation	-40	-22	-17	40
Education	-39	-19	-14	57
Wholesale and retail	-36	-19	-2	104
Administrative and support	-36	-32	-25	53
Human health	-31	-24	-21	75
Manufacturing	-29	-11	-8	101
Professional, scientific and technical	-19	-14	-10	77
Information and communication	-11	-8	-7	66
Agriculture	-8	-4	-2	6
Energy and water	-7	-4	0	38
Finance and insurance	-5	-3	-2	68
Real estate	-2	-2	-2	135
Public admin and defence	0	1	1	49
Total	-26	-15	-10	1000

Source: Office for Budget Responsibility, Economic and Fiscal Outlook, November 2020

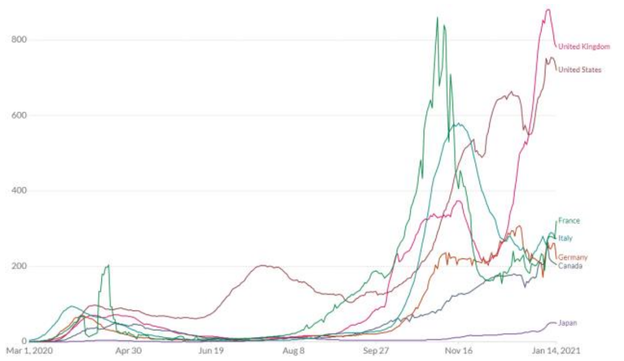
…BUT THE NEW COVID STRAIN HAS WORSENED THE OUTLOOK…

The new virus strain seems to have fundamentally changed the situation. At the end of the second lockdown on December 4th, UK daily cases were running at 214 per million; now that number is 634.

Accelerating infection rates in the UK…

Daily number of confirmed Covid-19 cases per million people[1,2]

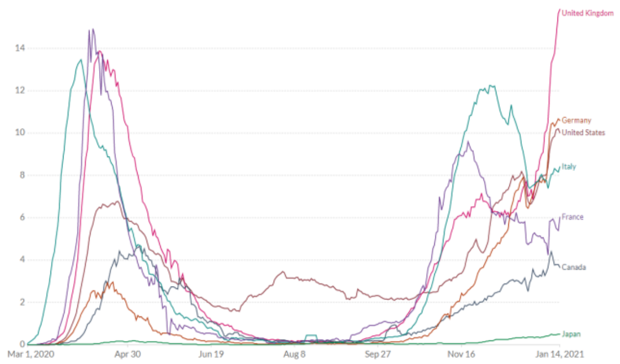
Household saving as percentage of household income



…and higher death rates and NHS capacity issues

Daily number of confirmed Covid-19 deaths per million people[1,3]

Rolling 7 day average



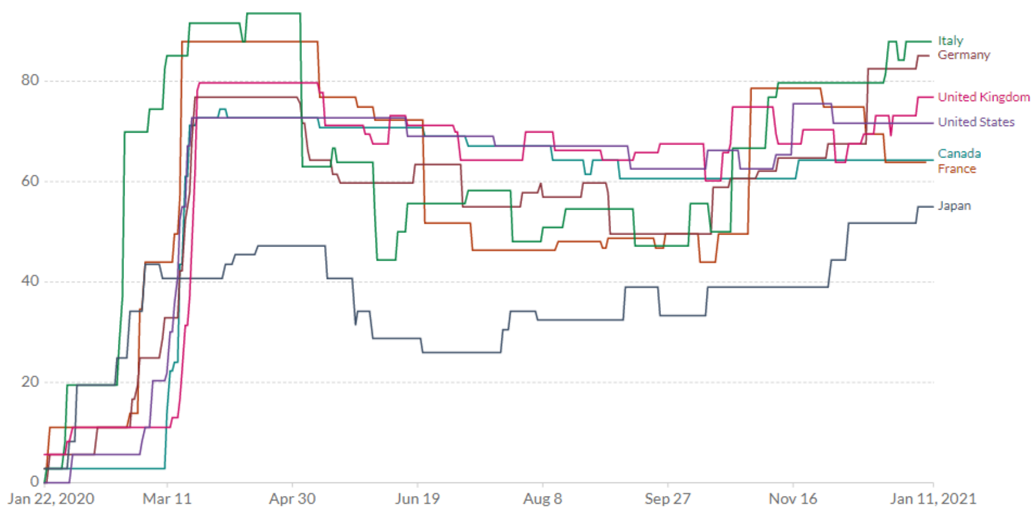
1. Source: Johns Hopkins University CSSE Covid-19 Data, last updated 14 January 2021, from Our World in Data.
2. The number of confirmed cases is lower than the number of actual cases; the main reason for is limited testing.
3. Limited testing and challenges in the attribution of the cause of death means that the number of confirmed deaths may not be an accurate count of the true number of deaths from COVID-19.

…AS GOVERNMENT RESTRICTIONS INCREASE

The overall level of restrictions in the UK is now close to where it was at the time of the first lockdown. Further restrictions in early 2021 may take push stringency levels to new highs.

Covid Stringency Index[1, 2]

Index of severity of government constraints



1. Source: Oxford COVID-19 Government Response Tracker, Blavatnik School of Government, and Our World in Data
2. The index on any given day is calculated as the mean score of nine policy measures, each taking a value between 0 and 100. The project calculates this index using nine specific measures, including: school and workplace closures; restrictions on public gatherings; travel restrictions; stay-at-home requirements and testing and tracing policy

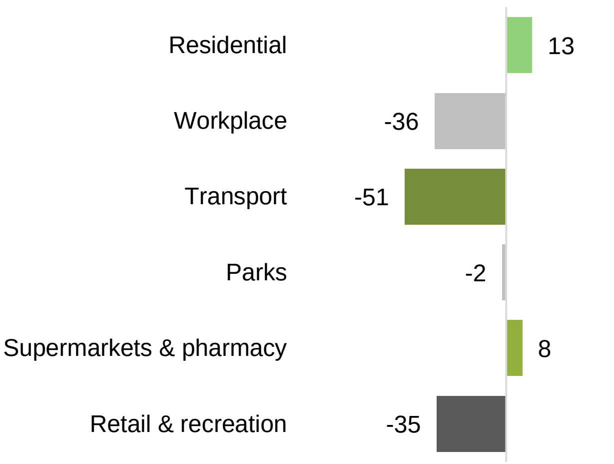
IN THE IMMEDIATE FUTURE THE VIRUS WILL STALL RECOVERY

Mobility is trending downwards again as Tier levels rise across the country. A further decline seems likely in January as we approach experience another nationwide lockdown.

Transport most impacted by restrictions

Mobility indices by activity

% deviations from early February baseline, 5 day average for the period immediately prior to Christmas

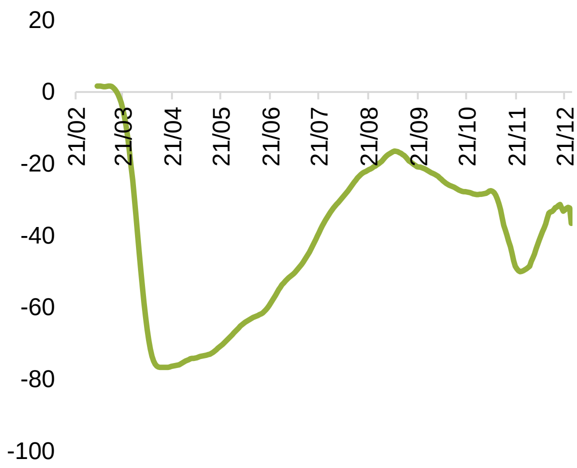


Source: Google Covid-19 Community Mobility Reports

Retail and recreation mobility trending down

Retail and recreational mobility

% deviations from early February baseline, 14 day moving average



Source: Google Covid-19 Community Mobility Reports

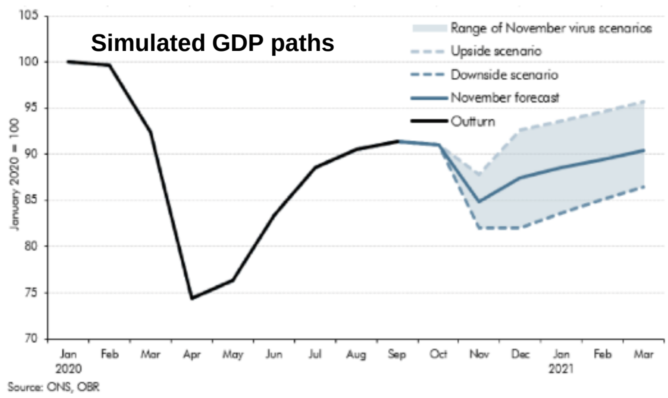
BACK IN NOVEMBER, THERE SEEMED THREE POSSIBLE SCENARIOS

Three OBR scenarios for Government efforts to manage Covid-19…

Office for Budget Responsibility: November scenarios for Covid-19

Key drivers	Upside scenario	Central	Downside scenario
Test, trace and isolate	Effective	Partly effective	Ineffective
Public health restrictions: lockdown to vaccine	Medium-low	High-medium	Very high
Vaccine widely available	From Spring 2021	From mid-2021	Vaccine ineffective

…and three economic scenarios that follow from that



MOST LIKELY SCENARIO TODAY

Since November, we've had good news on likely vaccine rollout and bad news on infection rates. At likely rollout pace ~15m people could be vaccinated in Q1 - enough to reduce deaths by 80-90%, allowing restrictions to be eased and household and business confidence to recover again.

Fast vaccine rollout can avert a downside…

Office for Budget Responsibility: November scenarios for Covid-19

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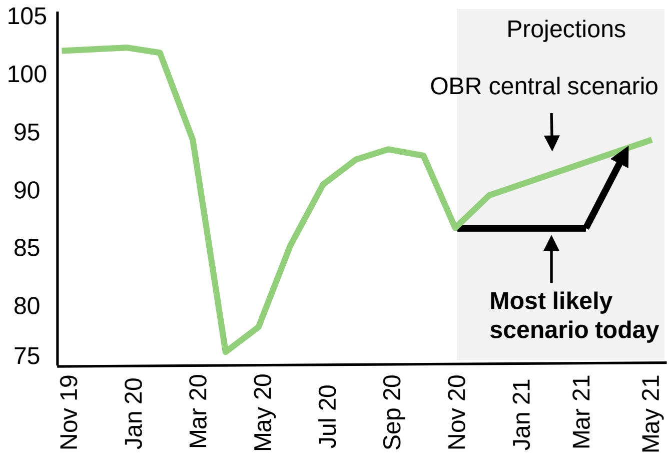
Most likely scenario today

Source: Marakon update based on OBR scenarios from Economic and Fiscal Outlook, November 2020

…and pull the economy back up

Monthly GDP index

Index of gross value added, March 2020 = 100



Source: Marakon estimates based on Resolution Foundation analysis

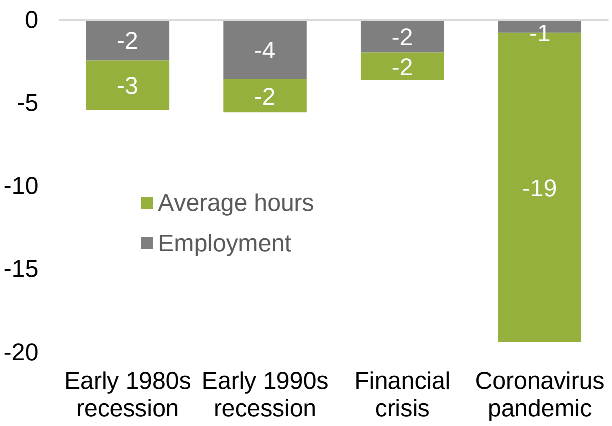
EVEN WITH A VIRUS ROLLOUT, 2021 WILL BE CHALLENGING

The Government's Coronavirus Job Retention Scheme (CJRS) plus support for self-employed and businesses has prevented many job losses in 2020, but may just have delayed some to 2021.

Hours worked have fallen rather than jobs…

Change in employment and hours in recessions

Percent

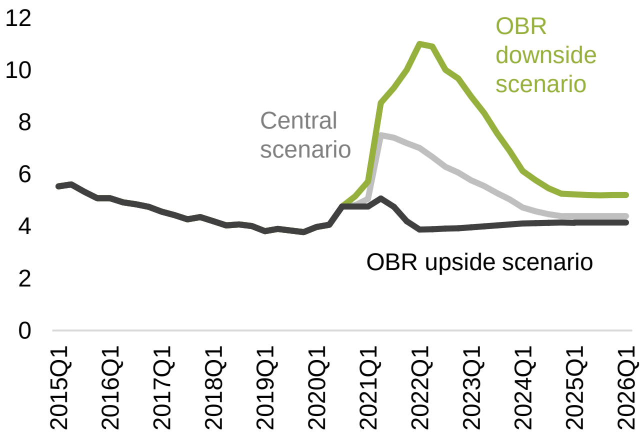


Source: ONS, OBR

…but unemployment is set to jump as CJRS ends

Unemployment rate across scenarios

Percent



Source: ONS, OBR

IN THE SHORT RUN, BREXIT IS A SIDE-SHOW…

Since the 2016 referendum, business investment has been weaker than pre-referendum forecasts. The OBR estimate that UK GDP is already 1.4% lower than it would have been if the referendum vote had gone the other way.

- Even before the Covid pandemic, the UK had slipped from being one of the fastest growing G7 countries to the slowest

The Bank of England assumes that Brexit-related disruption to trade could reduce GDP by 1% in 2021 Q1

- For context, the new Tier restrictions that have resulted from rising Covid-19 infections could reduce GDP by ~6% in Q1

…BUT WITH BIG LONG-TERM IMPLICATIONS FOR THE ECONOMY

Whilst clearly better than leaving without a deal, all recent studies suggest that the sort of deal agreed implies a weaker UK economy than would have been the case if we had remained inside the EU.

The free trade deal agreed is better than the only alternative on the table in December

- Leaving without a deal would have meant trading on WTO terms, implying tariffs on UK exports to the EU and imports from the EU

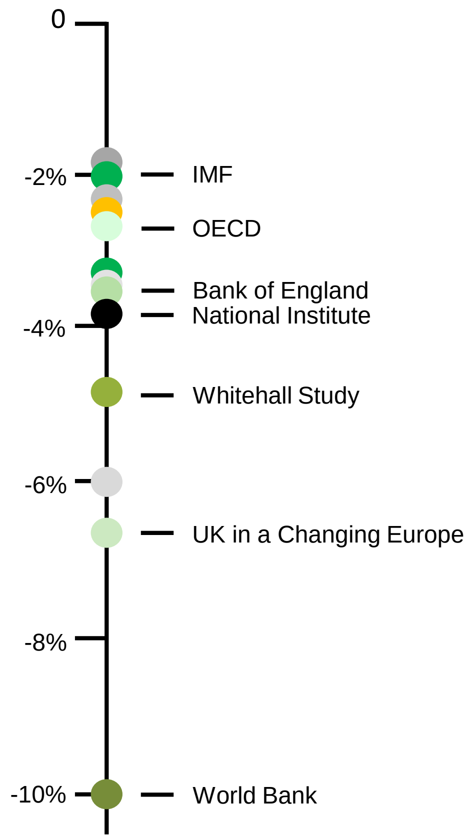
The Office for Budget Responsibility estimate that a free trade deal of the sort agreed in late December could be expected to reduce long run productivity (and hence GDP) by around 4% compared with what might have happened if we had stayed in the EU

- This estimate is the average of the studies shown in the chart on the right

Such estimates ignore the UK's growing trade in services with the rest of the EU and therefore underestimate the likely impact of leaving.

- The UK has a comparative advantage in service, which account for ~80% of GDP
- The UK could have expected to be a major beneficiary of moves to make the Single Market more effective in services

Estimates of the long run effect of a UK-EU free trade agreement on UK potential productivity[1]
Percentage points difference from a scenario in which the UK remains in the EU single market



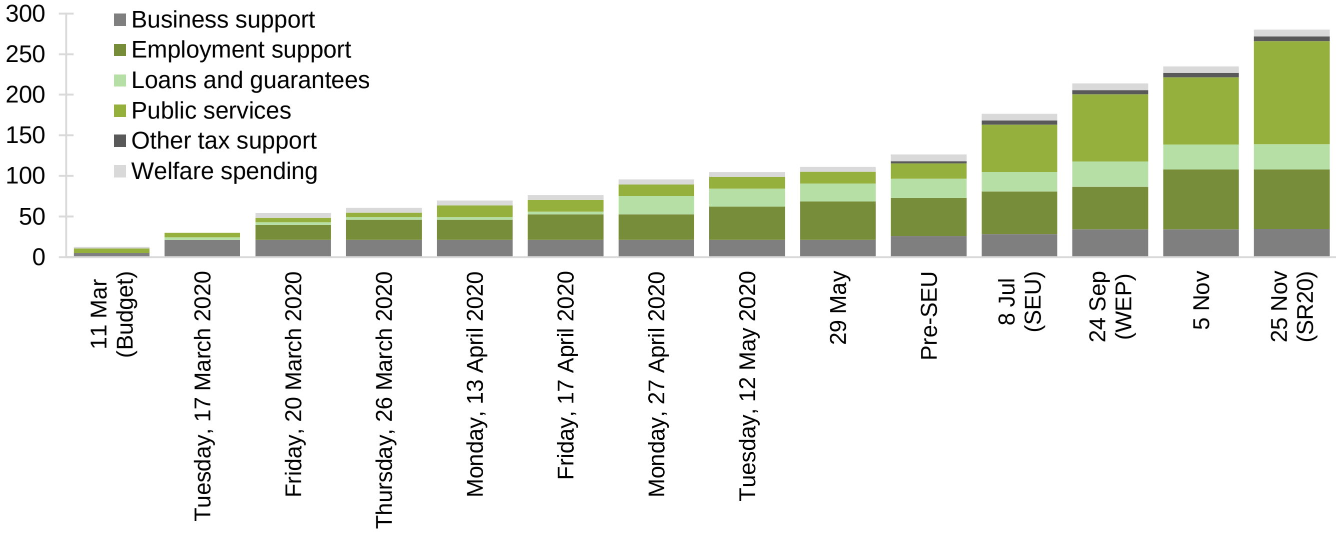
1. Source: 13 Research studies published since the 2016 Referendum, looking at the likely impact of a free trade agreement with the EU

PUBLIC FINANCES: THE ELEPHANT IN THE ROOM

The cumulative cost of covid-19 related policy measures adds up to £280bn, the equivalent of ~40% of the government's likely total tax revenues this year, with the job retention scheme and spending on fighting the virus the largest categories of extra spending

Cumulative cost of virus-related policy measures

£bn

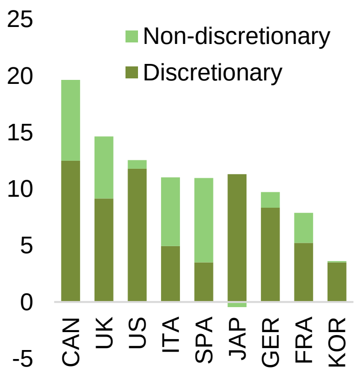


1. Source: Office for Budget Responsibility, November 2020
2. SEU: Summer Economic Update. WEP: Winter Economic Plan. SR20: Spending Review

THE PANDEMIC HAS WORSENED FISCAL POSITIONS EVERYWHERE…

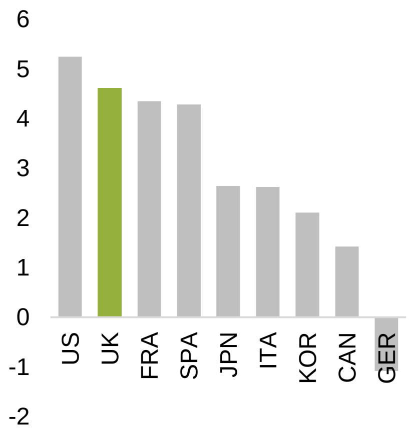
Big increases in deficits this year…

Change in 2020 budget deficit[1,2]
% of GDP



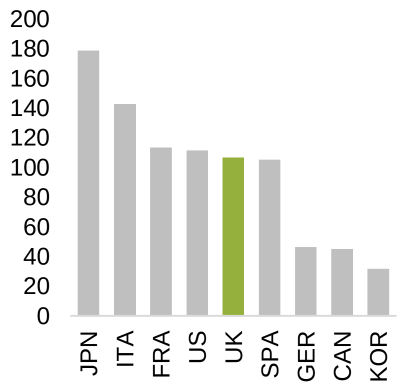
…bigger underlying deficits in the medium term…

2024 structural deficit[1,3]
% of GDP



…and higher levels of government debt

2024 net government debt[1,4]
% of GDP

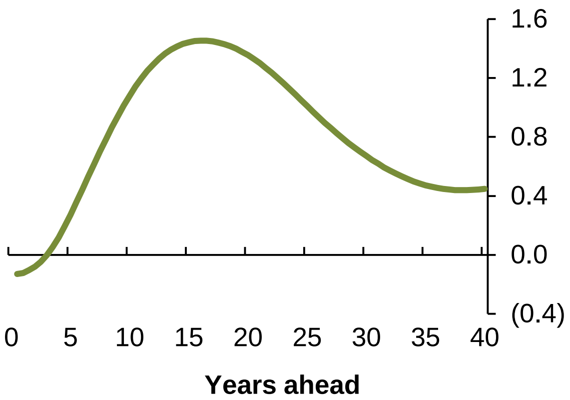


1. Source: IMF
2. Discretionary changes are those that result from policy decisions. Non-discretionary changes result from a weaker economy's impact on welfare spending and taxes
3. The structural deficit is the deficit that would still be there even if the economy were operating at full capacity. This distinguishes it from the cyclical deficit that might result from a weak economy.
4. Net debt is estimated by deducting the value of publicly-owned assets from gross government debt

…BUT BOND MARKETS SEEM UNPERTURBED

The yield curve implies an expectation that rates will stay low for the next 40 years …

UK instantaneous forward curve (gilts)[1]
11 Jan 2021 %



…which has implications for corporates' cost of equity and capital decisions

- Barring a marked shift in market expectations, sustained low risk-free rates imply a lower cost of equity
- Unless there have been a sustained offsetting rise in the equity risk premium (UK equity risk premium has been on a downward trend over the last 5-10 years), the cost of equity for most companies going forward will be ~2-3 percentage points below historic levels
- Individual companies need to have a perspective on what the relevant beta for them and for their industry in the long term is
- Given the evolving dynamics above, it is important to have an up-to date view on corporate cost of equity and WACC as it has major implications for decisions about resource allocation and dividend policy

1. These curves are based on the yield on UK government bonds (i.e., gilts). A forward rate is the interest rate applicable for a period in the future, implied by the current yields for gilts of different maturity. An instantaneous forward rate is a concept used in financial markets to represent the estimated forward rate as the period of the loan tends to zero.
Source: Bank of England calculations based on Bloomberg and TradeWeb data.

QUESTIONS YOU MAY BE ASKING

- How sensitive is my company's demand algorithm to the latest macro-economic scenarios? What does this mean for our financial plan? E.g., will we still have enough funding capacity to meet our financial commitments?
- What are the implications of this revised forecast on my short term consumer offering? E.g., how do I adjust my offering to take advantage of the current dynamics and expected unlocking of pent-up demand?
- How does delayed economic recovery impact my category or my channel strategy? E.g., should I adjust my distribution footprint as demand shifts from transport hubs and cities to residential areas?
- How does this impact our firm's work-from home model, and implied cost structure? E.g., how should I adjust my office footprint to balance cost and employee productivity, whilst prioritising employee health?
- How should I alter my Financial Framework in light of the revised outlook to suitably trade-off growth, risk and returns? E.g., how should I prioritise re-investing in the business vs. returning cash to shareholders?
- Do I have a clear point of view on my company's cost of equity and WACC in light this revised macro-economic context? E.g., do I have a view on what my company's beta is?

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ABOUT MARAKON

Marakon is a strategy and organizational advisory firm with the experience and track record of helping CEOs and their leadership teams deliver sustainable profitable growth. We get hired when our client's ambitions are high, the path to get there is not clear (or taking too long) and lasting capabilities are as important as immediate impact.

We help clients achieve their ambitions for sustainable profitable growth through:

- Stronger strategies and advantaged execution based on:
  a. A better understanding of what drives client economics and value
  b. Insight into changing industry dynamics and the context in which clients need to succeed
- A stronger management framework to generate better ideas and link decisions and actions to value
- A stronger organization with a more focused top management agenda and well-aligned resources
- A more confident and effective leadership team that's focused, decisive, and strategic

We have a joint team delivery approach where client ownership and engagement is paramount. Partners are highly engaged in the work product and supported by strong analytical and industry relevant capability. We work as advisers and catalysts in close, trust-based relationships with top management teams.