UK ECONOMY – DELAYED RE-OPENING UNLIKELY TO DERAIL RECOVERY

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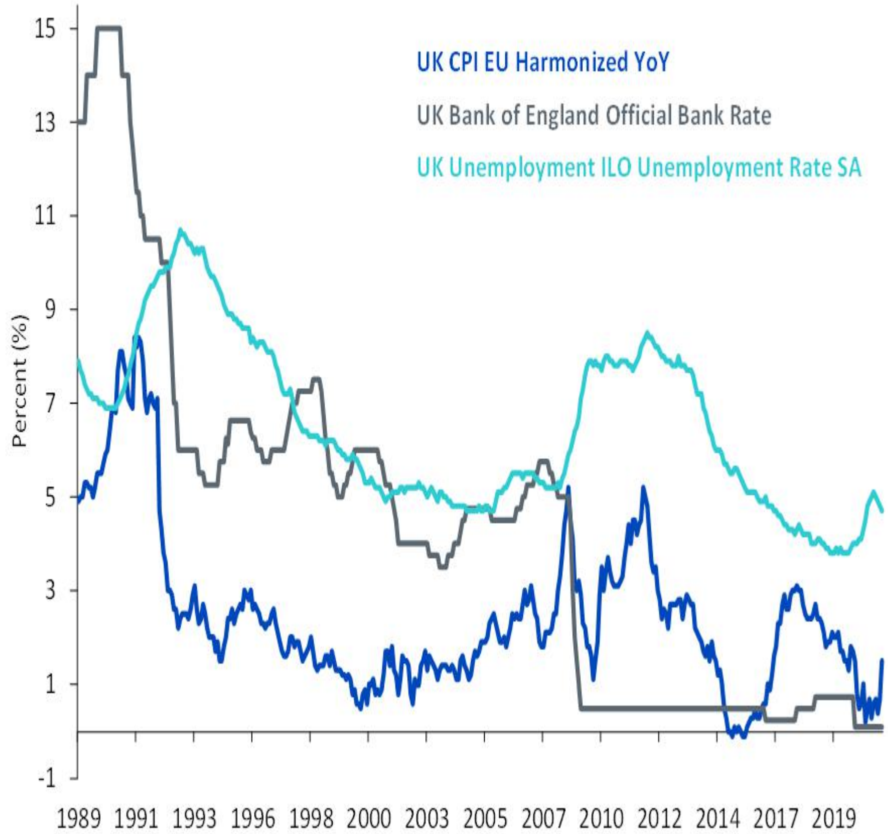
A slew of positive macroeconomic data releases this week – on inflation, growth and the labour market from the UK confirm our outlook that the UK's economic rebound is garnering momentum. This week the government was forced to delay lifting its final lockdown rules by another four weeks, owing to a resurgence in the new COVID-19 cases due to the highly transmissible Delta variant. We believe this is unlikely to derail UK's economic recovery, which appears to be improving quickly from the pandemic. High vaccination rates (77% of the adult population vaccinated once) in the UK have so far helped reduce hospitalisation rates.

Inflation overshoots but unlikely to alter monetary policy

The headline Consumer Price Index (CPI) in May rose by 0.6% over the prior month, pushing up annual inflation from 1.5% to 2.1%, above the Bank of England's (BOE) 2% inflation target. Excluding food and energy, core CPI inflation also increased sharply from 1.3% to 2.0% last month. The upward move in May's headline and core inflation was driven by typically volatile items such as clothing, recreational goods and hospitality, as hospitality sectors were allowed to reopen fully from 17th May, after having only been able to operate outside previously. The BOE had previously cautioned that inflation would rise above target this year after the reopening of the economy and peak around 2.5% in the latter half of 2021.

Figure 1 – Historical comparison of unemployment and inflation



Source: Bloomberg, WisdomTree, data available as of close 18 June 2021.

Historical performance is not an indication of future performance and any investments may go down in value.

Services sector drives the pace of UK economic growth

The UK economy grew by 2.3% in April compared to March as easing of restrictions helped drive a resurgence of activity, especially in the services sector. This also confirms on a rolling three-month basis that economic growth is back in positive territory (1.5%) for the first time since the end of 2020. While manufacturing and overall production sectors saw a fall in output, services were the main driver of the rebound as restrictions were lifted for many consumer-facing roles. The biggest beneficiary was the accommodation and food services sector, where activity rose by 44% in April but still remains 40.5% lower than levels in February 2020.

Momentum building in the labour market

The April employment report released this week also showed that headline labour market data improved in April in lockstep with the reopening of the economy. Unemployment fell for the fourth successive month to 4.7%, while labour demand continued to accelerate with vaccines in May well above their pre-pandemic level. The key challenge for the labour market will be when the furlough schemes are wound down over the summer. Since the beginning of June, 7.1% of the UK workforce remained on furlough[1]. The rebound is also feeding through into labour demand as vacancies recovered to 758k in the three months to May 20211. As firms start to rebuild capacity creating job vacancies, we expect the reabsorption of furloughed workers to resume over the medium term. However, we expect some slack in unemployment to remain among the low skilled and lower income workers.

Attractive valuations remain a catalyst for UK equities

Brexit has been a major headwind for UK equity markets long before the COVID pandemic struck. Owing to which UK equities have been under-owned by global investors. With greater clarity surrounding the Brexit deal (in December 2020) and a faster pace of recovery in 2021, helped by higher vaccination rates, global investors are turning their attention to UK equities once again. UK equity markets are known to have a higher exposure to consumer and leisure facing industries owing to which the UK economy suffered a sharp downturn during the COVID pandemic due to strict lockdown measures. The reopening of the UK economy has helped it to recover at a faster pace. Not only are UK equities trading at a 45% discount to international developed equities, but they are also yielding attractive dividends (around 4%). The WisdomTree UK Equity Income UCITS Index’s three highest sector allocations are among Financials (23.55%); Materials (15.67%); Consumer Staples (13.88%) with a very low allocation towards Energy (0.57%).

[1] Office for National Statistics

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