**Blog 06/04/17 – UK Economy: Shop Till You Drop**

Eight years after the last UK recession, a key driver of growth – consumer spending – may be sowing the seeds of the next downturn … or at best prolonged sub-par growth. Here are three reasons to worry.

**Wrong Kind Of Borrowing.** The problem is strong growth in consumer credit, especially on credit cards. In February total household debt was £1.5trn of which mortgage lending accounted for £1.3trn and nearly £200bn consumer credit. But mortgage lending grew by a modest 3% over the previous 12 months whereas consumer credit expanded by 10.5%, close to a 12-year high.

The Bank of England (BoE) points out two problems with this wrong type of credit growth. First, it is the result of intense competition and an easing of credit supply conditions. Lenders have lengthened interest-free periods on credit card balance transfers; they have increased maximum loan limits; and they have lowered borrowing rates. Hence, the potential for rash lending decisions is rising.

Second, banks can lose more money, more quickly. In the 2016 stress tests, UK banks lost £18.5bn on consumer credit versus £11.8bn on mortgages, even though the consumer credit stock is much smaller. One reason for this is the short maturity of consumer credit, which means that credit quality can worsen quickly. Another is the higher rates of interest, with the result that consumer credit has a disproportionate impact of household debt service costs. And, finally, consumer credit borrowers are more likely to default than mortgage debtors.

**Too Little Saving.** The latest national accounts showed the household savings ratio fell sharply to 3.3%, the lowest since 1960. The data may be revised and ultra-low interest rates may be part of the reason but it is hardly healthy.

**Wrong Kind Of Growth.** And, finally, a study last month by the Bank for International Settlements shows that debt-fuelled consumer booms damage growth prospects. Looking at 54 economies over 1990-2015, there were three key and worrying findings. One, a one percentage point increase in the household debt to GDP ratio tended to lower long-run growth by 0.1%. Two, the negative long-run effects on consumption intensify as the debt/GDP ratio exceeds 60%. And, three, for GDP growth that intensification seems to occur when the ratio exceeds 80%. The household debt to GDP ratio in the UK was 87.6% in 2016.

The chart shows that there has been a major deleveraging since early 2010. The ratio ran up by a staggering 39 percentage points in just 13 years, before retracing eleven points by early 2015. Even so, it remains worryingly high.

**Market Implications.** Leaving Brexit aside, Britain’s growth prospects look sluggish and this makes us wary of the UK equity market. Valuations are high and Absolute Strategy Research ranks the UK market poorly on quality and balance sheet characteristics. UK equities need strong economic growth ahead to boost earnings and dividends. Unfortunately, that looks unlikely.