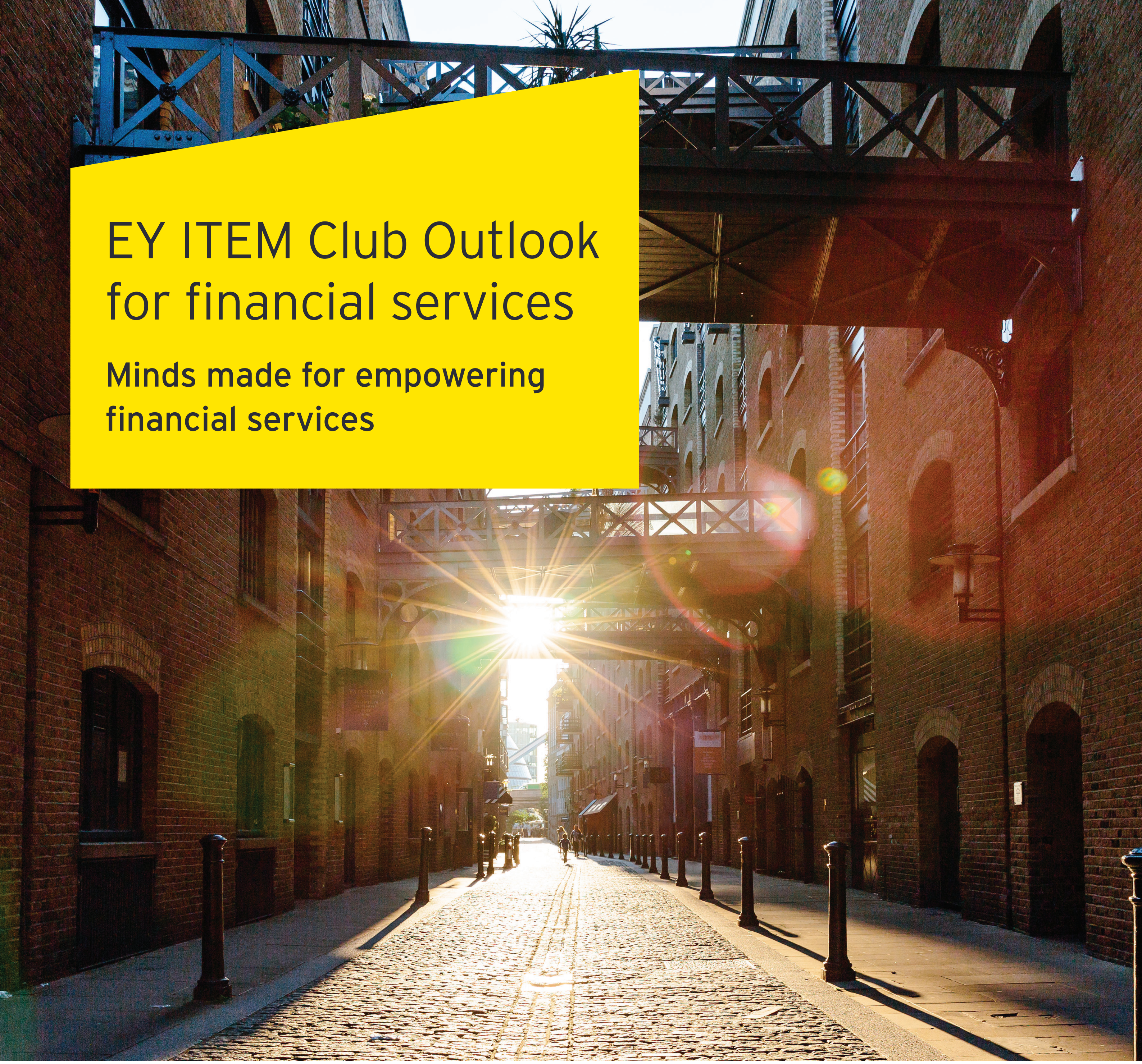
EY ITEM Club Outlook for financial services

Minds made for empowering financial services



February 2021

Building a better working world

About this report

The *EY ITEM Club Outlook for financial services* examines the implications of the EY ITEM Club's economic projections on the financial services sector. EY is the sole sponsor of the EY ITEM Club, which is the only non-governmental economic forecasting group to use the HM Treasury model of the UK economy. Its forecasts are independent of any political, economic or business bias.

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In conjunction with ITEM's Chief Economist Howard Archer, Oxford Economics is responsible for producing the forecasts and analysis provided in ITEM's forecast reports. Oxford Economics is one of the world's foremost independent providers of global economic research and consulting using unique global economic models.

EY
Building a better working world

What makes EY distinctive in financial services
Over 84,000 EY professionals are dedicated to financial services, serving the banking and capital markets, insurance, and wealth and asset management sectors. We share a single focus — to build a better financial services industry, one that is stronger, fairer and more sustainable.

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Foreword

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As we enter the second month of the UK's third national lockdown, it was with some apprehension that I started to read our most recent – and my first - *EY ITEM Club Outlook for financial services*. The forecast is predicated on a successful initial vaccine rollout followed by a subsequent relaxation of lockdown restrictions and, despite promising progress, whether the vaccination targets are met, how long current lockdown restrictions will last, and in what form they will be eased, are all unknowns that have downside risks. In addition, new virus variants add further layers of uncertainty and challenge to the mix.

However, if these unknowns unfold positively, the EY ITEM Club believes that the UK economy will narrowly miss a second recession and will rebound in the second half of the year, with Gross Domestic Product (GDP) rising 5% in 2021. This is good news, and a stark contrast to the 10.1% fall in 2020, but it should not be misinterpreted; it's a welcome improvement on a still very challenged economy.

For financial services firms the outlook is also improved, but, as noted, the risks remain predominantly to the downside. The sector is heavily supporting UK businesses through this challenging time, and business lending growth in particular is expected to remain historically high through 2021, although slowing from 2020's rate of expansion. Total business lending – including Government-backed loans - rose by 8% in 2020 and is forecast to grow by a further 5.4% this year, equating to £26b net being lent to firms on top of the £35.5b last year. To view this in a broader context, the average growth rate between 2015-2019 was 2.8%, evidencing that current borrowing for many is about survival, not growth or innovation. But as the economy recovers, and firms bounce back, banks must be poised to fuel growth.

Looking at household borrowing, although consumer credit is expected to increase 2.1% this year, this is a modest rise, reflecting continued consumer caution and the prospect of heightened unemployment as the Job Retention Scheme ends in April.

Meanwhile, a tightening of lending conditions for high loan-to-value mortgages and the stamp duty holiday ending in April means the mortgage market is showing signs of cooling off, despite ending 2020 on a strong note. Slower growth in overall lending and pressure on net interest margins from low interest rates will both impact banks' profitability. Profits will be even further challenged when Government-backed business lending schemes draw to a close and credit losses rise, although with household savings at an all-time high, spending is expected to surge once lockdown restrictions appreciably ease. Whilst this is a difficult environment to operate in, banks entered the pandemic well capitalised, and are positioned to weather the storm.

The insurance sector also continues to feel the severe financial impacts of the pandemic. COVID-19 related insurance pay-outs present ongoing challenges for growth and continued low interest rates are impacting profitability. Although for motor insurers, claims have fallen significantly with reduced traffic and fewer accidents. Outside of the pandemic, the sector is also contending with the devastating effects of flooding across the UK. How insurers manage these challenges will be crucial for thousands of people and, managed well, could meaningfully boost customer trust. On the asset management side, the outlook is relatively positive, following the global market recovery in H2 2020. UK assets under management (AUM) are projected to grow 7.1% in 2021, up on 2020's 3.6% growth (despite the economic turmoil), although down on 2019's 11.6% gain.

The longer-term forecast – based on the economy opening up from this spring – heralds a strong recovery in GDP, with 5% and 6.5% growth forecast in 2021 and 2022 respectively. Consumer spending is expected to rebound by 5.1% in 2021 and 7.4% in 2022 as social distancing restrictions are relaxed, representing a significant recovery on 2020's dramatic fall.

And, following a strong performance last year, UK equity prices look well-primed for further growth and may even outperform their international peers. All of this is welcome news for financial services firms as it reduces the risk of further write-offs on loans and provides a boost via higher consumer spending.

However, amid future growth predictions, there is a big, structural question yet to be answered. How will consumer and business behaviour change as a result of the pandemic? This is the second major global economic shock in recent times, and it could also have a fundamental ripple effect on spending behaviours and risk appetites.

Outside of the pandemic, there remain a multitude of other challenges for financial services firms to contend with. Brexit uncertainty still prevails as firms await further clarity on equivalence and the framework for regulatory cooperation. And further ahead, as the economy looks to a recovery, firms will be keen to engage with Government on how the UK proposes to achieve the ambitious green and digital targets set out in 2020.

Right now, the industry is focused on supporting the UK economy through these challenging times. But as we look ahead and forge a new path outside the EU, the current health and climate challenges only make a more sustainable financial future, underpinned by digital innovation and strong governance, ever more important, and UK financial services are uniquely positioned to take a leading role, at home and abroad.

Macroeconomic overview

The new COVID-19 pandemic lockdowns across the UK announced in January present a challenging start to the 2021 economic outlook. However, subject to an effective vaccination programme rollout, the EY ITEM Club forecasts that 2021 as a whole will deliver a rise in GDP, going some way to recovering the fall in output during 2020. The forecast rise in consumer spending should lead the economic rebound as social distancing restrictions relax, which is expected to start from Q2. However, some parts of the economy, in particular business investment, may see a slower recovery than others, and the pandemic is expected to leave some long-lasting impacts on certain sectors such as retail and commercial property.

New restrictions have countered the strong economic rebound seen over the summer of 2020

The relaxation of last spring's lockdown prompted an initially strong revival in activity, with GDP rising 16% quarter on quarter (q/q) in Q3 2020. However, the record quarterly outturn masked a loss of momentum through last summer. Additionally, output is likely to have fallen in Q4 2020, reflecting England's four-week lockdown in November and further parts of the UK moving into higher, more restrictive, tiers of lockdown. The EY ITEM Club forecasts GDP to have dropped by 10.1% over 2020; the biggest fall in over 300 years.

The whole of the UK was placed into a national lockdown at the start of this year, which unfortunately points to the economy shrinking further in Q1. In addition, adjustments to new UK-EU trading arrangements are likely to temporarily weigh on UK firms' trading activity with the EU, impacting growth. However, the UK Government's programme to vaccinate all higher risk groups by mid-February could be completed in time to allow a meaningful reduction in social distancing restrictions from Q2 2021 onwards, which offers an upside factor.

Overall, the lifting of restrictions on some face-to-face activities, and the associated boost to consumer confidence should trigger economic recovery, with GDP forecast to rise by 5% this year.

Consumer recovery should be propelled by the surge in savings…

The Government's vaccination programme should allow restrictions on 'social consumption,' such as restaurant meals and leisure activities, to be lifted later in 2021. In that scenario, savings accumulated by households during 2020 could fuel a sustained recovery in consumer spending. The household saving ratio rose to a record high of 27.4% in Q2 2020, as consumer spending fell sharply, whilst household incomes – supported by Government schemes – fell much less than expenditure. As restrictions were eased during the summer last year, the saving ratio dropped to 16.9% in Q3 2020. However, this was still almost double the long-run average of 9.4% and offers scope to fund higher spending.

Nevertheless, there are some qualifications. The rise in household savings seems to be concentrated amongst high earners, whose propensity to spend accumulated wealth tends to be relatively low. Additionally, the prospect of higher unemployment rates when the Furlough Scheme ends in April 2021 could both depress incomes and dent confidence, encouraging some households to keep savings rather than spend them. The EY ITEM Club forecast sees consumer spending rebounding by 5.1% this year, following 2020's predicted 12.6% fall.

…but investment faces a slower return to normality

Business investment fell by a quarter in Q2 2020 as the lockdown and heightened uncertainty led some firms to put spending on fixed assets on hold. The recovery in Q3 2020 was only modest, leaving investment still almost 20% down on the level seen at the end of 2019, and, excluding Q2's more dramatic fall, at the lowest level since 2013.

Investment is likely to have fallen back at the end of 2020, as new lockdowns and the extension of restrictions across the country discouraged spending. Additionally, Brexit uncertainty peaked in the run-up to the end of the transition period on 31 December, which is likely to have paused investment plans – at least in the short term. Lockdown restrictions will continue weighing on investment in early-2021 but spending by firms should recover later this year as the vaccination programme is rolled out, Brexit uncertainty fades, and the economy slowly returns to normal. All the same, given the flux, investment at the end of 2021 is forecast to be 15% below the level in Q4 2019. Whilst uncertainty will recede, it will not disappear altogether, particularly in relation to the pandemic's more longer lasting effects on consumer spending preferences and working patterns.

Monetary policy will likely adopt a holding pattern

The adverse economic effect of tighter COVID-19 pandemic restrictions prompted the Monetary Policy Committee (MPC) to expand asset purchases by an additional £150b last November, adding to the £300b announced earlier in 2020. Subject to the distribution of a successful vaccination programme allowing a lifting of social distancing measures, 2021 is likely to be a quiet year for monetary policy, with Bank Rate remaining at 0.1%. However, if looser policy is judged necessary, increasing the pace of quantitative easing will probably be the MPC's first port of call. This would be before any consideration is given to cutting rates into negative territory, despite the recent announcements from the Bank of England asking banks to ensure they're ready to implement a potential negative interest rate from the second half of 2021.

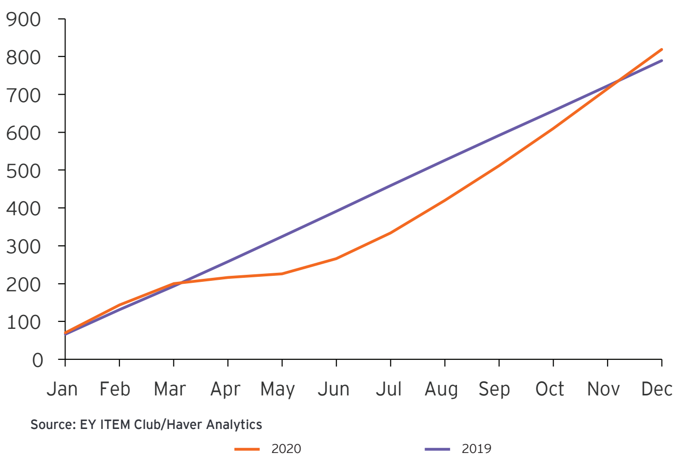
Banking

Despite the economic impacts of the COVID-19 pandemic last year, demand for mortgages ended 2020 on a strong note. However, the resilience in the market appears to have been driven by pent-up demand, and the temporary cut in stamp duty (which ends on 31 March), suggesting momentum may fall back in 2021. Whilst consumer credit is likely to return to growth this year, higher unemployment rates and the pandemic's likely impact on people's willingness to spend may prove to be a drag on individuals' appetite for taking on debt. Meanwhile, the extension of Government-backed loan schemes should support business lending in the short-term. Longer-term, a shift in focus to balance sheet repair points to overall slower growth.

Housing market 'boom' may start to lose steam…

Demand for mortgages remained very strong towards the end of 2020. Bank of England data showed 103,400 mortgages were approved in December 2020, only slightly down on November's 105,300 (which had been the highest since August 2007). Households took on an additional £5.6b in net mortgage debt in December, close to a five-year high.

Mortgage approvals in H2 2020 rapidly caught up with 2019's levels
000s, cumulative year-to-date



Pent-up demand appears to have played a role in driving up mortgage approvals and lending, with the recent strength partly reflecting postponed activity from earlier in the year. The temporary cut in stamp duty announced last July also appears to have made its presence felt, with the strength in approvals from the summer of 2020 more than offsetting the significant weakness seen earlier last year. Having reached a record low of 9,348 last May, mortgage approvals totalled 818,500 by the end of 2020, the largest number seen in one year since 2007.

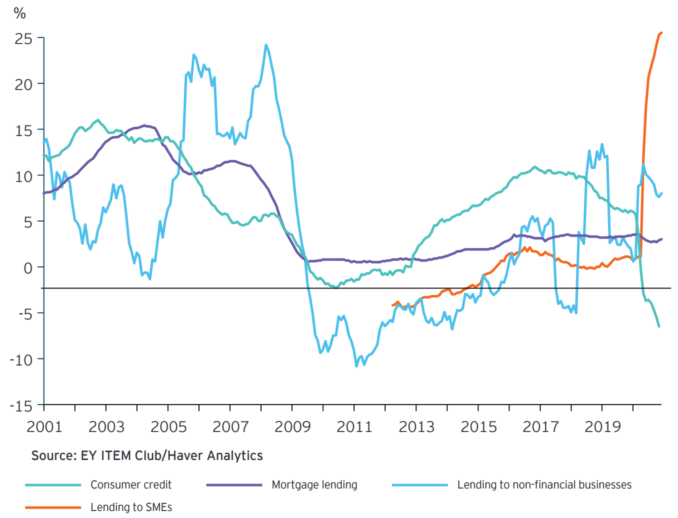
Buyers and sellers rushing to beat the stamp duty deadline in March could propel a further surge in mortgage lending in Q1 2021, particularly as the housing market remains open even under the most recent lockdown restrictions announced in early January. However, a tightening of lending conditions for high loan-to-value (LTV) mortgages, partly reflecting a reduced appetite for risk from lenders, could cool demand. As of December 2020, interest rates on new five-year mortgages with a 75% LTV ratio were 32 basis points (bps) higher than in April, and 119 bps higher for those with a 90% LTV ratio. Activity could reduce when stamp duty returns to its previous rate on 1 April 2021, which coincides with the date the Government's Help to Buy equity loan scheme is barred to all but first-time buyers. Additionally, the end of the Furlough Scheme on 30 April 2021 could trigger a rise in unemployment.

Job losses are likely to be concentrated amongst younger, lower-paid workers - a demographic which most homeowners, or property purchasers, do not traditionally fall into – which will make it even harder than usual for this demographic to get onto the property ladder. If the successful rollout of the vaccination programme allows the economy to reopen, lending may pick up again later in 2021, aided by continued low interest rates. Recent announcements from the Bank of England mean that banks now have to ensure they're ready to implement a potential negative interest rate in six months' time. However, the EY ITEM Club does not expect the Bank of England to have to take that step, given the anticipated economic recovery in the second half of 2021. Finally, the agreement of a new EU-UK partnership at the end of 2020 removes some uncertainty which was previously weighing on the housing market. The stock of mortgage lending grew by 3% in 2020, only slightly down on 2019's 3.1%. The EY ITEM Club forecasts growth in 2021 at 2.3%, followed by 2.6% in 2022.

…whilst a rebound in consumer credit may fall short of that in spending

The reintroduction of COVID-19 lockdown restrictions towards the end of 2020 hit consumer spending and contributed to net lending via credit cards and personal loans turning negative. Individuals repaid a total of £3.9b of consumer credit over September-December 2020, and annual growth in credit of -7.5% in December was the weakest since records began in 1994. With the new lockdown restrictions in January further restricting opportunities to spend, consumers are likely to continue making net repayments of consumer credit in Q1 2021.

Trends in lending to consumers and to firms have continued to diverge



2021 should see social distancing measures relaxed, subject to a successful vaccination programme rollout. However, whilst this should prompt a strong recovery in consumer spending, the same may not be true for consumer credit. Households, in aggregate, accumulated substantial savings during 2020's lockdowns: households' bank deposits rose by £141b between March and December 2020, more than three times as much as the £42.5b during the same period in 2019. Additionally, some households may choose to finance big-ticket purchases using savings rather than credit. An overall more cautious, post-pandemic attitude amongst consumers could weigh on demand for personal debt. Another headwind to taking on debt is presented by the end of the Job Retention Scheme in April, which may trigger a rise in the unemployment rate as structural changes in the jobs market accelerated by the pandemic are exposed. Whilst the EY ITEM Club expects consumer credit will grow in 2021, the forecast 2.1% rise is small compared to 2020's 9.9% drop.

Extension of Government schemes should support business lending in the short-term

Government-backed loan schemes have continued to support lending to businesses. As of 24 January 2021, £71b had been approved in total under the Bounce Back Loan Scheme (BBLS), the Coronavirus Business Interruption Loan Scheme (CBILS) and the Coronavirus Large Business Interruption Loan Scheme (CLBILS). In net terms, lending to firms surged during the first lockdown in spring 2020, and a rise (albeit more modest) also occurred during the tightening of lockdown restrictions towards the end of last year. The stock of business loans in December 2020 was 8% higher than a year earlier and took total net lending in 2020 to £35.5b, compared to net rise of £8.8b in 2019. A rise in lending has been particularly marked for small and medium-sized enterprises (SMEs). According to the Bank of England, net lending to SMEs in 2020 was more than 30 times the level seen in 2019.

Pressure for corporates to rein back borrowing has been eased by a succession of extensions to the life of Government schemes. Applications are currently permitted until the end of March 2021 (compared to an original end date of November 2020 when the schemes were introduced last May), and the maximum length of the loans through the BBLS and CBILS was extended last September from six to 10 years. In November 2020, the Government also announced that BBLS borrowers could 'top up' their existing loan under the scheme if they had originally borrowed less than the maximum amount available.

The lockdown restrictions introduced in January 2021 are likely to prompt a rise in business lending as firms seek to compensate for lost revenue. However, as restrictions on activity are lifted, companies' need to borrow to support cashflow should be lessened, with their focus shifting to balance sheet repair and repaying the Government-backed loans. After growth in business lending of 8% in 2020, the EY ITEM Club forecasts a further 5.4% gain in 2021. However, as some firms shift to repaying loans, growth is forecast to slow to 1.8% in 2022.

Uncertainty remains in the timing and level of non-performing loans

Banks have had to adjust their models and gather additional data to measure and manage non-performing loans and calculate loan provisions. The major factors that will impact loan losses in 2021 are macroeconomic, specifically GDP and unemployment, alongside the impact of Government support. The economic uncertainty from the pandemic remains challenging and, in addition to this, the expected timing of defaults for consumer, SME and corporate loans remains difficult to predict given that default levels have yet to increase significantly due to the various Government support programmes.

Banking sector summary

	2019	2020	2021	2022	2023	2024
Total assets (£b)	7,441	7,464	7,792	7,980	8,224	8,527
Total loans (£b)	5,943	6,103	6,280	6,459	6,683	6,958
Business/corporate loans (£b)	444	480	506	514	523	531
Write-offs (% of loans)	0.3	0.3	0.5	0.3	0.2	0.2
Consumer credit (£b)	224	202	206	222	240	256
Write-offs (% of loans)	1.5	1.2	1.8	1.7	1.2	1.1
Residential mortgage loans (£b)	1,451	1,494	1,528	1,567	1,621	1,694
Write-offs (% of loans)	0.01	0.01	0.04	0.04	0.02	0.02
Deposits (% year)	1.0	7.3	5.2	4.9	5.0	5.1
Loans/deposits (%)	127.9	122.4	119.7	117.4	115.6	114.5
Total operating income (£b)	124	118	125	134	139	144

Source: Bank of England/Oxford Economics

Insurance

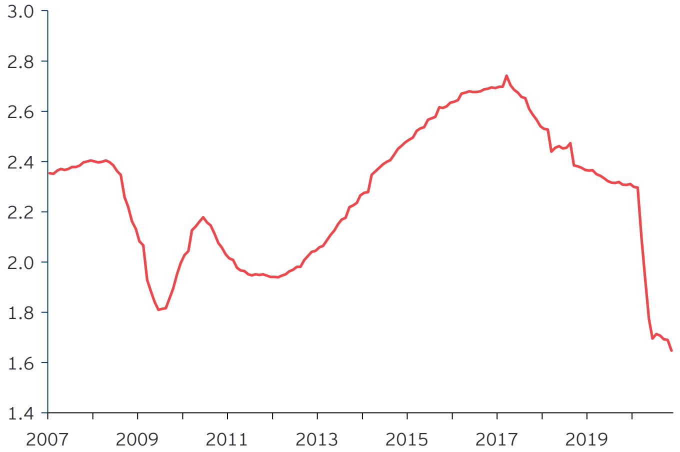
An economic rebound later this year should lift insurers in its wake

Subject to the successful rollout of the vaccination programme and the reopening of the economy, household income growth and demand for insurance products should increase this year. After real household incomes fell by a projected 0.8% in 2020, a 1.5% rise is forecast in 2021. However, the recovery in incomes will be held back by a forecast rise in the unemployment rate to a peak of almost 7% in the second half of 2021, along with the withdrawal of Government support measures. Structural changes to the way we work and travel triggered or accelerated by the COVID-19 pandemic could have mixed implications for the insurance sector.

Some recovery in 'big-ticket' demand will support non-life insurers

In 2020 there was decreased demand for big-ticket items which support demand for non-life insurance products. The 1.6m new cars registered in 2020 was 30% down on registrations in 2019, and the lowest for any year since 1992. And, despite a mini-boom in the housing market after last spring's lockdown restrictions were relaxed, housing transactions of 1.04m in 2020 were still 11.5% below the 1.18m recorded in 2019.

The new car market has continued to decline
Millions, rolling 12-month total

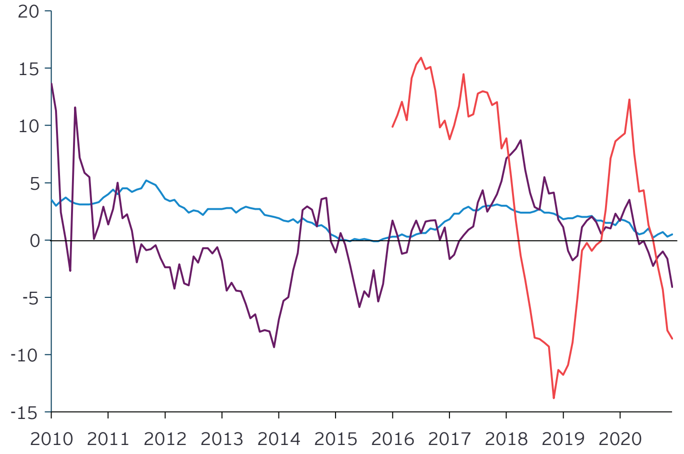


Source: EY ITEM Club/Haver Analytics

However, the prospect of a strong consumer recovery in 2021, subject to social distancing restrictions being lifted, suggests a more positive outlook for insurers this year. The sustained reopening of showrooms contributes to the EY ITEM Club's forecast of 2m new car registrations this year, making up some of 2020's drop. However, headwinds to the housing market from April's end to the temporary stamp duty holiday, along with new restrictions on the Help-to-Buy scheme, mean the EY ITEM Club forecasts transactions (an important driver of big-ticket - and insurable - household purchases) falling further this year, with a strong rebound delayed until 2022.

Meanwhile, for some the fear or reality of higher unemployment rates when the Furlough Scheme ends in April may lead to deferred purchasing or renewing of insurance policies. And a continuation of recent price developments does not bode well for premium income. In the year to December 2020, the average price of motor insurance was 8.6% lower than a year earlier, it was the third successive month to witness falling prices and was the steepest decline since March 2019. Deflation was also present in the price of home contents insurance. Prices fell 4.1% y/y in December 2020, continuing a run of y/y falls which began last April.

Insurance prices have sunk into deflation
Annual % change in price



Source : EY ITEM Club/ONS

Overall, the EY ITEM Club forecast sees non-life premium income growing by 2.7% this year, following a projected 0.8% fall in 2020.

Ultra-low interest rates will remain, despite prospective recovery

Although most economies across the world should enjoy strong recoveries this year, the extent of economic contraction during the pandemic points to central banks keeping interest rates at current ultra-low levels for a few years to come. The EY ITEM Club doesn't expect the Bank of England to raise the official UK interest rate from 0.1% until early-2023. This will continue to depress investment yields for life insurers, particularly those with guaranteed products, and further increase interest in alternative, higher-risk investments such as infrastructure and real estate. The EY ITEM Club forecasts the 20-year gilt yield at only 0.7% this year and 0.9% in 2022, compared to a higher average of around 1.8% in the five years prior to 2019.

The revival in global equity prices from the lows of March 2020 has reduced pressure on insurers' balance sheets. Although valuations now appear very stretched, a robust earnings recovery should help drive additional returns this year, especially for those markets and sectors which have lagged in the recovery so far. UK equities appear well placed in this environment. The market is amongst the most efficient globally and UK corporates are likely to see a meaningful improvement in profitability as global industrial activity expands. UK equities should also benefit from the UK-EU trade deal agreed at the end of 2020 which alleviates some uncertainty and should help to lower the UK equity risk premium.

The pandemic has led to individuals becoming more aware of risk and this may increase demand for risk protection, including life insurance. Indeed, interest in life protection spiked during the first lockdown in spring 2020. Furthermore, demographic developments continue to favour the sector, supporting flows of money leaving defined benefit (DB) schemes and moving into individual pensions and pensions drawdown products. The rise in the state pension age to 66 in October 2020 has boosted pension contributions, whilst the UK population aged 60 or older is projected by the Office for National Statistics (ONS) to grow from 16.4m in 2020 to 18.1m by 2025.

However, the benefit to the sector from pensions auto-enrolment suffered some interruption in 2020. According to the ONS, 77% of UK employees were members of a workplace pension scheme in 2019, up from 47% in 2012 when auto enrolment began, and the highest membership rate since comparable records began in 1997. Furthermore, data from the Pensions Regulator showed a total of £90.4b saved by eligible savers in 2018, an increase of £16.8b from 2012. However, data for the first half of 2020 showed that employee and employer contributions fell by 11% and 5% respectively between Q1 and Q2, likely reflecting a significant share of the workforce being furloughed. But if the Furlough Scheme is closed, as planned, in April 2021 and the economy reopens from the spring onwards, contributions should pick up again.

The EY ITEM Club forecasts life premiums to grow by 3.8% this year, after a projected fall of almost 10% in 2020.

The COVID-19 pandemic's impact on profits will become clearer

To date, insurance claims related to COVID-19 across the industry have been much lower than consensus predictions made early in the pandemic. And there have been some positives for profits. For example, with more customers staying at home, reduced traffic and fewer accidents are expected to have lowered claims and loss costs of motor insurers.

And the impetus the pandemic has given insurers to expand digital ways of working should deliver cost savings, albeit with investment costs to absorb and the effect unlikely to become apparent until the end of this year.

However, there are potential headwinds in the form of investment losses and the possibility of COVID-19 related increased payouts in some lines, such as business interruption. Support to insurers from temporary changes in behaviour will fade as the economy returns to normal whilst, for some insurers, gains in sectors like motor insurance are merely offsetting losses in other areas, such as travel. Meanwhile, given it will take some time for economies to fully make up COVID-19 pandemic-related losses, there is little prospect of higher interest rates, which will weigh on insurers' ability to generate profit growth. Additionally, the FCA's ban on loyalty penalties from the second half of 2021 will also impact profits.

Longer-term, demographic developments will continue to bear on the performance of the life sector. Although life expectancy for men and women in 2019 rose to 79.4 years and 83.1 years respectively, the rises continued to be small in comparison with that seen during the 2000s. And the impact of the COVID-19 pandemic may have seen some reversal in 2020. In summary, the market has seen such a disparate range of forces – some positive and some negative – in 2020 that predicting the total impact on profitability is challenging. Overall, the sector has weathered the storm fairly well, but it's expected there will be a wide spread of individual results reflecting business mix and effectiveness of response.

Insurance sector summary

	2019	2020	2021	2022	2023	2024
Life gross premium (£b)	177.4	160.4	166.5	177.5	186.8	195.8
% year	0.6	-9.6	3.8	6.6	5.2	4.8
Life gross claims payments (£b)	152.5	152.4	151.5	158.0	164.4	170.4
Life claims ratio (%)	86	95	91	89	88	87
Non-life gross premium (£b)	76.0	75.4	77.4	81.1	84.3	87.5
% year	0.5	-0.8	2.7	4.7	4.0	3.7
Non-life gross claims payments (£b)	35.0	40.3	41.9	43.2	44.2	44.6
Non-life claims ratio (%)	46	53	54	53	52	51
Net profit (£b)	9.5	5.1	6.3	7.5	7.1	5.7

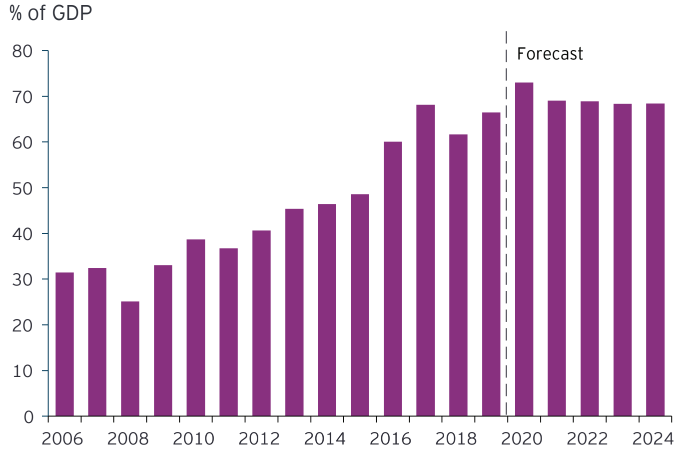
Source: OECD, Swiss Re, Oxford Economics

Wealth and asset management

Global bounce-back should mean a positive year for UK AUM

The UK shared in a global market recovery in the second half of 2020, but the FTSE All-Share Index still ended 2020 12% down on the level a year earlier, compared to a 16% gain for the US S&P 500 and a 3.6% rise in Germany's DAX index. However, bonds put in a strong performance, aided by ultra-loose monetary policies from the Bank of England and other central banks, and the weakness of the pound boosted the value of overseas assets held by UK asset managers. Overall, despite the economic turmoil, UK AUM grew by a projected 3.6% to £1.5t in 2020, although this was a slowdown on 2019's 11.6% gain.

A fall in GDP but rise in AUM in 2020 pushed up the AUM/GDP ratio to a record high



Source: EY ITEM Club/Haver Analytics

Subject to a successful vaccine rollout, a relaxation of lockdown restrictions and the resulting rebound in economic activity, UK AUM should see further growth in 2021. With the added benefit of a deal on Brexit, UK equities, which at the close of 2020 were trading at a significant discount to global peers, look to have more room than most to rise in value. Although a strengthened pound will partly offset these positives, the EY ITEM Club expects the value of AUM to rise by 7.1% this year to £1.64t.

UK equity values look well-primed for growth

Globally, the strong performance of equity prices in 2020 suggests that this year's hoped-for economic recovery may already be largely priced in. Whilst a good year for economic growth may not be such a great year for stock market returns, the discount which UK shares are currently trading at relative to other markets - the price/earnings ratio for the FTSE sits at around 20, versus 40 for the US market - combined with the removal of the risk of a no-deal Brexit, suggests that UK equities may outperform their international peers.

A greater appetite for risk prompted by a brighter economic environment could support valuations for alternative, riskier asset categories. However, the structural effect on demand for property from the shift to home working will dampen demand in this sector. And the disappointing performance of many UK hedge funds during the pandemic relative to index-funds is likely to weigh on inflows into this category.

The outlook for bonds is mixed. An economic recovery will probably rule out central banks loosening monetary policy further - including the Bank of England cutting interest rates into negative territory - which will reduce the case for fixed-income assets. And an economic recovery combined with the policy stimulus provided by Governments and central banks may raise fears amongst investors of the return of inflation, prompting a shift into riskier assets. However, continued large-scale bond purchases by central banks - for example, the Bank of England has committed to purchasing an extra £150b of gilts this year - will support bond values and counter upward pressure on yields.

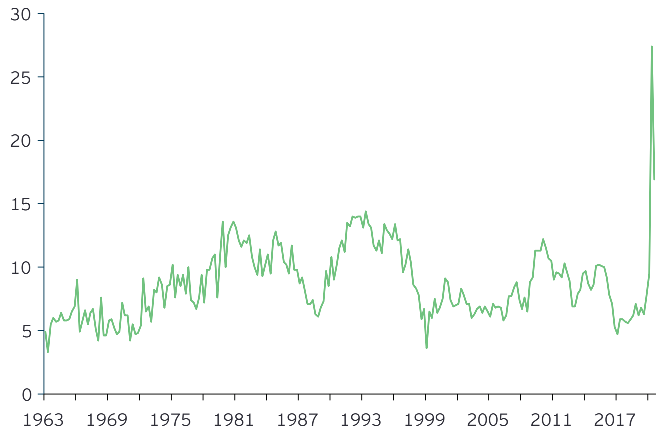
Meanwhile, the social impact of the COVID-19 pandemic and ambitions for a 'green recovery' may continue to promote the rise of environmental, social and governance (ESG) investing.

Household balance sheets will emerge from the crisis in a strong position

Despite fewer opportunities to spend, the Government support to household incomes through measures such as the Furlough Scheme, mean that household balance sheets look set to emerge from the COVID-19 pandemic in good shape. Whilst the household saving ratio has fallen back from the record peak of 27.4% recorded in Q2 2020, it's expected to have averaged 17.5% last year, exceeding the previous peak of 14.3% in 1993. Moreover, over January-December 2020, households added £150b to bank deposits, almost three times the extra £55b saved in 2019.

Additionally, in the year to Q3 2020, household gross financial assets reached the equivalent of 492% of incomes, the second highest on record.

2020 saw a record year in household savings
% of total household resources



Source: EY ITEM Club/Haver Analytics

Household savings should fall back as the economy reopens and consumer confidence revives. However, many people have now experienced two major economic shocks in 12 years, and the pandemic in particular may encourage a greater degree of cautiousness in spending. The EY ITEM Club forecast sees the household saving ratio averaging 11.5% over 2021-24, compared to 6.5% from 2016-19. Despite this, the possibility that taxes - including taxes on wealth - may ultimately rise to pay for the fiscal cost of the COVID-19 pandemic, could result in some of the fruits of higher savings flowing to the Government, rather than into AUM.

Wealth and asset management sector summary

	2019	2020	2021	2022	2023	2024
Total assets under management (£b)*	1,474	1,527	1,635	1,722	1,776	1,848
% year	11.6	3.6	7.1	5.3	3.1	4.0
Bonds (£b)	235	244	247	246	249	252
Equity (£b)	727	748	812	863	891	931
Fund of funds (£b)	197	211	230	248	259	272
Hedge (£b)	1.6	1.0	1.1	1.2	1.3	1.3
Mixed (£b)	170	169	184	196	204	215
Money market (£b)	109	121	126	129	132	135
Property (£b)	35	33	36	39	40	41

*Funds where at least 60% of assets are held by UK-domiciled investors
Source: Oxford Economics; Broadridge

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