EY ITEM Club Outlook for financial services

December 2021

EY

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.

OXFORD ECONOMICS

In conjunction with ITEM's Chief Economist Martin Beck, 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.

ey.com/ukfs

Contents

Macroeconomic overview

The relaxation of COVID-19 restrictions in 2021 has allowed the UK economy to steadily recover its pandemic-related losses. As of September 2021, Gross Domestic Product (GDP) was only 0.6% below its pre-pandemic level, compared to a shortfall of 8% at the start of the year and 25% in April 2020. However, the UK is now entering a harder phase of its economic recovery, with the 'boost' from reopening now largely past, and new headwinds emerging. Government support is being phased out, and employers' and employees' National Insurance Contributions (NICs) are due to rise. Furthermore, increasing energy costs and shortages from supply-side disruption have contributed to a sharp rise in inflation, which is likely to persist into 2022, translating into pressure on consumers' spending power. Nevertheless, households' balance sheets and the jobs market are both currently in a very strong position, which will materially help sustain the recovery.

An initially strong economic recovery has slowed

The UK's emergence from lockdown triggered an initially strong rebound in GDP earlier this year, but the rate of growth has since slowed. GDP grew 5.5% quarter on quarter (q/q) in Q2, up from a contraction of -1.4% q/q in Q1 2021. This expansion then slowed over the summer due to disruption from rising COVID-19 infections and an increase in the number of people that were 'pinged' by the NHS Track and Trace app. But activity has also increasingly been held back by supply-side problems, including shortages of staff, raw materials and transport. All of these factors contributed in varying degrees to GDP growth in Q3 slowing to 1.3% q/q. Looking ahead, whilst supply frictions and higher energy and fuel costs are expected to hamper growth in Q4, the strength of the recovery seen earlier this year means the EY ITEM Club forecasts the economy to have expanded 6.9% over 2021, the fastest rise since 1941. But, as the effect of economic headwinds become more apparent, growth is forecast to slow to 5.6% in 2022.

Consumer spending faces tension between the increased cost of living and strong household finances

The EY ITEM Club forecast expects consumer spending to rise 3.9% this year and 6.8% in 2022.

Consumer spending rose to 7.2% q/q in Q2 as COVID-19 restrictions were relaxed but, as pent-up demand faded, growth slowed to 2% q/q in Q3. Adding to this, the growing cost of living pressures mean prospects for real household income growth and consumption have weakened. Consumer Price Index (CPI) inflation is forecast to peak at a decade-high of almost 5% in early 2021 and is expected to remain above 3% until the second half of 2022. Two other headwinds come from recent benefit cuts and the forthcoming rise in personal taxes, with the introduction of the Health and Social Care Levy, in April 2022.

However, strong household finances should help to compensate for the weaker outlook for income growth. 'Excess' savings built up by households during the pandemic were around £170b in Q2 2021, equivalent to almost 11% of annual household incomes and 10% of consumer spending. Additionally, higher savings, alongside rapidly rising house prices, have resulted in an increase in household wealth. Furthermore, the demand for workers has been very strong, as seen in record hiring rates after the end of the furlough scheme in September.

Business investment has been slow to recover

The recovery in business investment over the summer and early autumn was slow-moving. Following a 9.3% q/q drop in Q1 2021, business investment then rose by 4.5% q/q in Q2 and again marginally by 0.4% q/q in Q3. This still left the level of investment in Q3 12% below that seen in Q4 2019, the last quarter before the pandemic struck.

However, recent business surveys have reported more robust investment intentions, and the strong financial position of firms, in aggregate, should support a solid recovery in business investment. Non-financial companies' holdings of bank deposits rose by over £130b between February 2020 and September 2021. This was £110b (around 5% of GDP, or half a year's worth of business investment) higher than if the average increase during 2018 and 2019 had continued.

The two-year super-deduction tax incentive, which took effect in April 2021, should encourage firms to make use of cash built up during the pandemic and bring forward capital spending.

However, a rise in the corporation tax (CT) rate from the current 19% to 25% from April 2023 presents a longer-term disincentive for firms. Overall, the EY ITEM Club thinks that the elements are still in place for a strong rebound in investment. Although low investment levels so far this year point to a fall of just over 1% in 2021, growth is expected to run at almost 14% in 2022.

Interest rates are likely to increase in early 2022

During autumn 2021, the market expectation was that UK interest rates would rise faster than previously anticipated. Although the Monetary Policy Committee (MPC) chose not to raise rates in November, a rise in Bank Rate following the December 2021 meeting is a live possibility, given some hawkish rhetoric from the Governor of the Bank of England (BoE) — and others on the MPC — and concerns about the recent pace at which inflation has been rising.

However, while there is early evidence that the end of the furlough scheme did not negatively impact the jobs market, the EY ITEM Club does not expect a rate rise be announced. This is because the MPC has reported that it wants to fully assess the impact of the end of the furlough scheme in September before contemplating any change in policy (and comprehensive data on this won't be available until early next year). And as rising inflation is being driven largely by factors beyond the control of monetary policy, the EY ITEM Club expects the MPC to wait until February 2022 to raise Bank Rate to 0.25%, when the BoE's next set of forecasts are released (and if there is evidence that the jobs market hasn't been negatively impacted by the end of the furlough scheme). The current uncertainty surrounding the Omicron COVID-19 variant is another reason why the EY ITEM Club expects the BoE to delay announcing a rise in interest rates.

Another rise is then expected in August 2022, leaving Bank Rate at 0.5% at the end of next year. This would still leave the policy rate below the 0.75% level it sat at in early 2020, immediately before the COVID-19 pandemic struck.

Banking

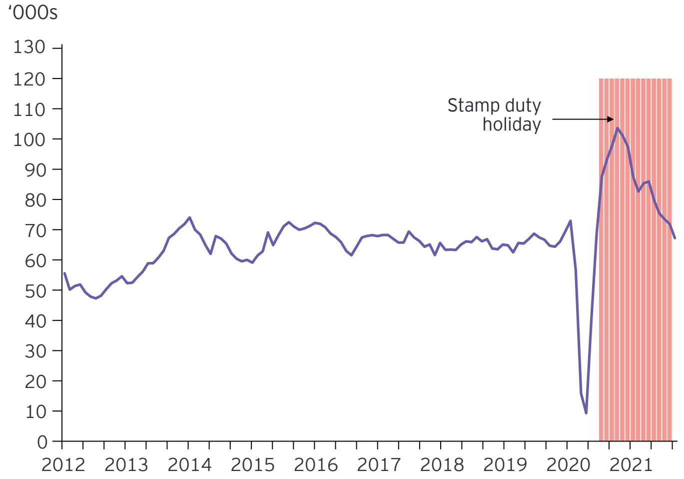
There have been contrasts this year between strong growth in net mortgage lending, subdued increases in consumer credit and falls in net lending to firms. And interpreting trends in mortgage lending have been further complicated by the stamp duty holiday. The withdrawal of the tax concession in October and the prospect of higher interest rates will impact mortgage growth, but other factors should continue to support home loans. The outlook for consumer credit is that of continued headwinds from plentiful household savings substituting for unsecured lending in funding some purchases. After firms took on considerable levels of debt in the early stages of the pandemic, the outlook for corporate lending is also subdued. Meanwhile, the improving macroeconomic outlook, particularly for employment levels, should keep loan-losses down across all categories of lending.

Demand for mortgage lending is likely to reduce in the short-term

The EY ITEM Club forecasts the stock of mortgage lending to rise 4% this year, the fastest rise since 2007, before easing to 3% in 2022.

The stamp duty holiday resulted in an increase in housing transactions and likely influenced the recent rise in house prices. Net mortgage lending averaged £6.9b per month over the first nine months of 2021, compared to a pre-pandemic average of £3.9b (during 2018 and 2019). In September alone, net lending increased to £9.3b, up from £4.4b in August, as buyers raced to complete their purchases before the stamp duty threshold returned to its normal level at the start of October.

Mortgage approvals increased during the stamp duty holiday, but have started to fall back



Source: EY ITEM Club/Haver Analytics

The tax concession's end saw net mortgage lending fall to £1.6b in October, the lowest since July. And mortgage demand is likely to stay relatively muted over the coming months as a consequence of increased borrowing earlier this year. This may be exacerbated by pressure on household incomes from higher inflation and tax rises – as well as rising mortgage rates – as lenders respond to expectations that the BoE will soon raise its policy rate. Overall, mortgage approvals fell to a 16-month low of 67,200 in October 2021, down from a peak of over 100,000 in late 2020, which suggests this process is already underway.

However, although some lenders have begun to raise rates on mortgage products, borrowing costs are increasing from a very low level. As of October 2021, the average interest rate on a new mortgage was 1.5%, the lowest since records began. Furthermore, competition amongst lenders may mean that rises in the official interest rate are not fully passed through into mortgage rates. And, although the momentum in housing market activity and mortgage demand is likely to soften, there is unlikely to be a sudden change.

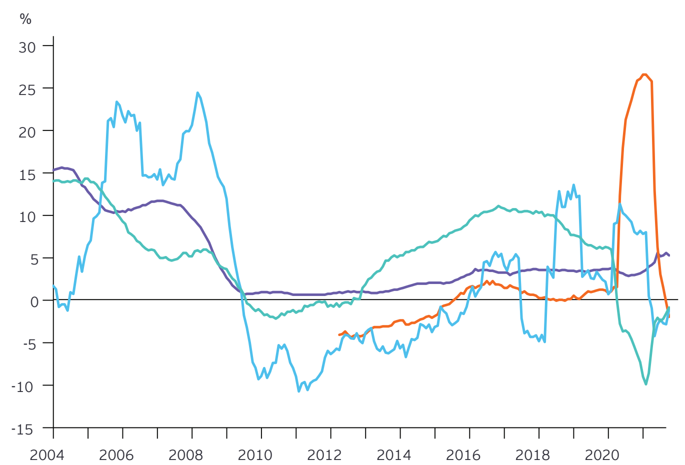
The pandemic appears to have triggered a structural increase in demand for houses as a result of people seeking more outdoor space and more room to work from home. This demand is being facilitated by the substantial excess savings accumulated by households during lockdowns (which rose to an estimated £170b in the middle of 2021).

The influence of these factors may diminish as the world, and with it, interest rates, move back to the pre-COVID-19 position. But it is unlikely to fade completely. And some changes – particularly the increase in house purchases to accommodate hybrid working – may signal the start of new long-term trends. Additionally, the jobs market is coming out of the pandemic far less impacted than was first anticipated.

A rebound in consumer spending has not been seen in consumer credit

The reopening of the economy earlier in 2021 resulted in a strong rebound in consumer spending. But the same was not seen in lending via credit cards and personal loans. Net consumer credit averaged £0.5b per month in the six months to October 2021, less than half of the monthly average of £1.2b during 2018 and 2019. In addition, a 1% year-on-year (y/y) fall in unsecured lending in October 2021 was the 19th month in a row to see a decline in net lending (compared to a year earlier). This was the longest continuous decline seen since the 2008-09 financial crisis.

Net lending to consumers and firms has contracted



Source: EY ITEM Club/Haver Analytics

Consumer credit
Mortgage lending
Lending to all non-financial businesses
Lending to SMEs

The very strong financial position of households is one factor which may have impacted credit demand. Households, on aggregate, accumulated substantial savings during 2020's lockdowns, far above what pre-COVID-19 trends would have implied. In cash terms, excess savings were around £170b in Q2 2021, equivalent to almost 11% of annual household incomes and 10% of spending. And more recent data on cash held in bank deposits suggests these savings grew further over the summer and early-autumn.

Another explanation for the weakness of consumer credit lies with a fall in new car sales, many of which are financed with credit. Limitations on the supply of new vehicles stemming from a global semi-conductor shortage has held down the number of new car registrations. The number of private vehicles registered in Q2 and Q3 2021 was almost 70,000 – or 14% – below the level in the same period in 2019, despite car showrooms reopening during the spring.

Some households may be using unplanned savings to finance big-ticket purchases instead of buying on credit. Given the scale of excess savings, this headwind to unsecured lending growth could persist for some time. Furthermore, the experience of two historically significant global crises in little more than a decade may result in a more cautious attitude among consumers and a weaker appetite for personal debt. Although the EY ITEM Club expects consumer spending to continue its recovery back to the pre-COVID-19 trajectory, a rebound in consumer credit is likely to remain muted in the short term. The EY ITEM Club expects unsecured lending to drop 0.7% this year, adding to 2020's 9.8% decline. 2022 is forecast to see a return to growth, helped by a recovery in car sales, but the forecasted 6.6% rise would still leave the stock of unsecured debt almost 5% below the 2019 level.

There is a division between large firms and small and medium size enterprises (SMEs) paying down debt

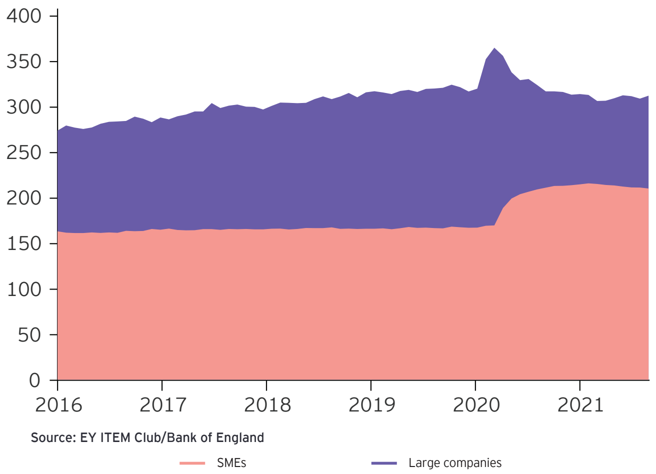
The pandemic prompted a sharp increase in UK corporate borrowing, as firms sought to replenish lost revenues, guard against a highly uncertain economic environment and take advantage of generous terms offered by government-backed loan schemes.

However, after an initial increase in bank debt in the early stages of the pandemic, companies have spent most of the past 14 months paying down liabilities. In net terms, the stock of bank loans to firms grew by £45b between February and June 2020, a 10% rise in the space of only four months. But the stock of debt has subsequently fallen back, with repayments exceeding gross lending in almost every month since summer 2020. As of October 2021, corporate debt was around £30b above its immediate pre-pandemic level in early 2020, 6.8% higher.

It's important to make the clear division here between large companies and SMEs paying down debt. Larger firms owed a total of £312.4b in October 2021, 2.4% less than the £320b owed in February 2020, just before the COVID-19 pandemic began. But SMEs' bank debt rose from £167.2b to £210.2b over the same period, which was a 25.7% increase. However, SMEs have been paying down debt in recent months, albeit to a more modest extent than large companies.

Large firms now have less debt than before the pandemic, while SMEs have much more

Stock of bank debt, £b



Source: EY ITEM Club/Bank of England

There has been a recent run of net debt repayments, which may be a consequence of some firms taking out loans for precautionary reasons, but not eventually needing to draw on them and now paying those loans back. This may be particularly relevant for government-guaranteed Bounce Back Loans for SMEs, which were interest-free for the first 12 months. The strength of corporate balance sheets is another potential explanation. Outlays on wages, investment and other expenses fell during the pandemic, while government schemes supported incomes and revenues. As a result, the profitability of companies overall was largely unscathed by the pandemic, while firms' holdings of bank deposits rose almost £140b between February 2020 and October 2021. In comparison, corporate cash holdings grew £27b over the equivalent period in 2018-19 (whereas they have typically fallen in past economic recessions).

Firms that can draw on cash piles to finance investment and other outgoings will likely hold back growth in business lending. The latest survey by the BoE's regional agents found that the majority of companies questioned said they would finance investment from existing cash buffers. There will likely be a rise in borrowing costs in the near future (if, as expected, the BoE raises the official interest rate), and this will weigh on the demand for loans. The EY ITEM Club forecasts business lending to fall by 0.3% in 2021, a marked contrast with growth of 8% in 2020. Growth is forecast to return in 2022, with the stock of loans to firms rising 2.4%, and this rebound should offer some offset to the anticipated rise in borrowing costs.

Banking sector summary

	2019	2020	2021	2022	2023	2024
Total assets (£b)	7,435	8,154	8,531	8,832	9,141	9,507
Total loans (£b)	5,934	6,296	6,462	6,668	6,941	7,257
Business/corporate loans (£b)	444	479	478	489	499	511
Write-offs (% of loans)	0.3	0.2	0.2	0.3	0.3	0.2
Consumer credit (£b)	224	202	201	214	234	248
Write-offs (% of loans)	1.5	1.2	1.3	1.2	1.2	1.2
Residential mortgage loans (£b)	1,452	1,497	1,557	1,604	1,669	1,752
Write-offs (% of loans)	0.01	0.01	0.01	0.02	0.02	0.01
Deposits (% year)	1.0	11.7	7.4	5.0	4.9	5.0
Loans/deposits (%)	127.7	121.3	115.9	113.9	113.0	112.5
Total operating income (£b)	124	120	131	142	148	153

Source: Bank of England/Oxford Economics

Insurance

Insurers expected to benefit from an improving economy, although will be impacted by increased cost of living

Insurers showed a considerable degree of resilience during the COVID-19 pandemic and should now see certain gains from the economic recovery. However, the increased cost of living as a result of rising inflation, higher energy costs and tax rises will impact demand for insurance. The EY ITEM Club forecasts a strong recovery in real household incomes coming to a temporary halt towards the end of 2021. But if, as the forecast expects, higher inflation is temporary, real incomes should recover as 2022 progresses.

Non-life insurers have benefited from a strong housing market, but are impacted by supply disruption

One important support to non-life insurance demand over the last year has been the strength of housing market activity. Housing transactions averaged 135,000 per month over January to October 2021, more than a third higher than the monthly average of 99,000 during 2018 and 2019. The stamp duty holiday prompted a sharp increase in activity as buyers brought forward purchases to benefit from a lower stamp duty bill.

The end of the tax holiday on 30 September 2021 will likely see this momentum decline. But the appetite to buy houses, and demand for associated insurance products, is also supported by other factors. As previously outlined, the pandemic appears to have triggered a structural increase in demand for houses outside of main cities as a result of people seeking more outdoor space and more room to work from home. This demand is being facilitated by substantial excess savings accumulated by households during lockdowns, along with very low borrowing costs.

The recovery in new car sales has been challenged by supply issues

Registrations in millions, rolling 12-month total

Source: EY ITEM Club/Haver Analytics

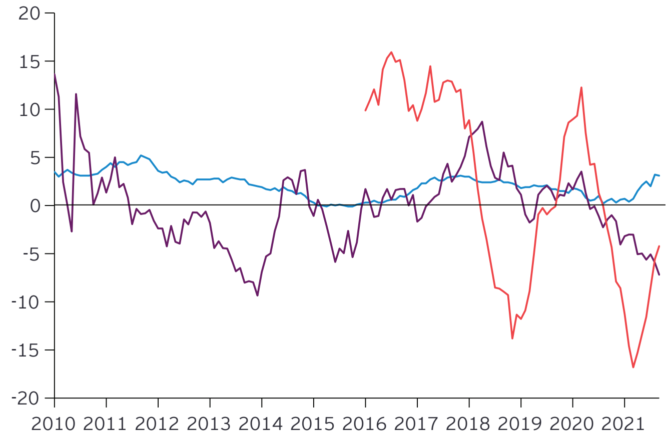
However, the picture for new vehicle purchases — another big-ticket item which supports demand for non-life insurance products — has been less resilient in the last few years. This is due to a lack of availability of new cars, as manufacturers have struggled with a shortage of semi-conductors. New car registrations initially responded very strongly to the reopening of car showrooms in April. But supply bottlenecks have curtailed this momentum; new car registrations in Q3 were more than 30% down on the same level a year earlier. The EY ITEM Club forecasts a total of 1.77m new car registrations in 2021, around a quarter below the 2.3m registrations in 2019.

As these supply issues are addressed, the level of new car registrations should increase in 2022. And, although the short-term outlook for household incomes has been impacted due to rising inflation, low unemployment levels will offset some of this pressure.

Meanwhile, deflation in insurance prices has remained a feature across non-life categories. This is partly a consequence of fewer claims during lockdowns which has allowed insurers to keep prices down. In the year to September 2021, the average price of motor insurance fell 4.2%, the 13th successive month of falling prices. Deflation was more marked in home-contents insurance, where prices fell 7.2% y/y in September 2021, continuing an unbroken run of price falls which began in May 2020.

The price of insurance has continued to fall

Annual % change in price



Source: EY ITEM Club/ONS

However, the rising price of second-hand cars is likely to see motor insurance prices start to increase again. Used car prices rose 22% between April and September 2021, the biggest increase over an equivalent period since records began. And the reviving economy should help to mitigate headwinds facing the sector. The EY ITEM Club forecasts non-life premium income to grow 8.6% this year, a marked increase on 2020's 1.7% rise. As the momentum of the recovery fades, growth is forecast to slow to 3.5% in 2022.

An end to ultra-low interest rates will bring change

Life insurers continue to be impacted by record low interest rates, but the direction of travel is becoming more favourable. Although the MPC did not raise rates in November 2021, two members did vote to tighten policy, and the EY ITEM Club expects a majority to take that position early next year, with the Bank Rate forecast to increase from 0.1% to 0.25% in February 2022. The EY ITEM Club then expects a further increase to 0.5% in August 2022. Investors have taken the prospect of tighter policy on board, pushing up long-term market interest rates; the 20-year gilt yield reached almost 1.5% in October 2021, 50 basis points higher than its level in the summer. Although yields subsequently dropped back, the EY ITEM Club expects the 20-year yield to reach 2% by the end of 2022, the highest since 2016.

A continued revival in global equity prices from the lows seen during the pandemic has reduced pressure on insurers' balance sheets. The EY ITEM Club expects equities will continue to move higher, albeit at a slower pace, following strong year-to-date gains. Equity prices are likely to come under increasing pressure as central banks begin to tighten monetary policy, but this should be offset by the strength of the ongoing earnings recovery.

UK equities remain relatively well placed for growth. Values are inexpensive relative to historical norms and are well placed to benefit from the ongoing global economic recovery and higher commodity prices, given the composition of the FTSE. However, more domestic small cap companies may struggle against a backdrop of rising costs and a weaker pound.

Meanwhile, the long-term psychological repercussions of the pandemic could boost demand for insurance. Many have now lived through two economic shocks in the space of 12 years – the second of which was triggered by the current global pandemic – and this could increase demand for risk protection, including life insurance. Insurers also reported spikes of interest in protection products each time lockdown restrictions tightened. And demographic developments continue to favour the sector, supporting flows of money leaving defined benefit schemes and moving into individual pensions and pensions drawdown products, despite closer regulatory scrutiny. The rise in the state pension age to 66 in October 2020 boosted pension contributions, and the UK population aged 60 or older is projected by the Office for National Statistics (ONS) to grow from 16.7m in 2021 to 19.6m by the end of the decade.

Additionally, the sector continues to benefit from pensions auto-enrolment. ONS data showed that in April 2020 (the latest available data), nearly eight out of ten UK employees (78%) had a workplace pension.

This compared with less than half in 2012 when automatic enrolment was introduced. Although 2020 was the first year to see the share level off, the proportion of employees paying into a pension didn't fall, despite millions of workers being furloughed.

After life premiums fell 11% in 2020, the EY ITEM Club forecasts a return to growth of 5.3% this year, before increasing to 7.6% in 2022.

The profit outlook for insurers is brightening

A gradual return to normality should boost profitability for the insurance sector. The success of COVID-19 vaccinations in weakening the link between virus infections and mortality will reduce mortality-related losses experienced by life insurers during the pandemic, although there will also be impacts to annuity providers. And, whilst interest rates will take time to revert to pre-pandemic levels, life insurers will welcome a world where rates are rising not falling.

There have also been changes triggered by the pandemic that could support the profit outlook for non-life insurers. For example, the continuation of home working remains above pre-COVID-19 levels even as the initial impact of the pandemic fades. This should influence the current lower frequency of claims, reflecting, for example, fewer vehicle accidents during rush hour.

Nevertheless, regulatory developments may counter these positives. From January 2022, the Financial Conduct Authority (FCA) will require insurers to offer existing home and motor insurance customers the same terms as they would receive as a new customer. This will probably have the biggest impact on home insurance, where differences in pricing for new and renewal businesses are at their largest. However, there is some evidence to suggest that the impact of the pricing review has already been factored in, and so the impact on profits may be more muted than expected.

The improving macroeconomic environment this year will help the insurance sector recover some of 2020's losses. However, a likely rise in claims on the non-life side (as working and driving patterns continue to normalise), along with the FCA's pricing reforms, could negatively impact insurers' profits. Overall, the EY ITEM Club forecasts profits to rise by 24% this year, and to continue in 2022, with profit growth of 16% expected.

Insurance sector summary

	2019	2020	2021	2022	2023	2024
Life gross premium (£b)	177.4	157.9	166.3	178.9	188.6	197.6
% year	0.6	-11.0	5.3	7.6	5.4	4.8
Life gross claims payments (£b)	152.5	150.0	153.0	161.0	166.0	171.9
Life claims ratio (%)	86	95	92	90	88	87
Non-life gross premium (£b)	76.0	77.3	83.9	86.9	89.2	91.2
% year	0.5	1.7	8.6	3.5	2.6	2.3
Non-life gross claims payments (£b)	35.0	41.3	45.0	47.5	48.6	49.3
Non-life claims ratio (%)	46	53	54	55	55	54
Net profit (£b)	9.5	5.1	6.3	7.3	8.0	8.6

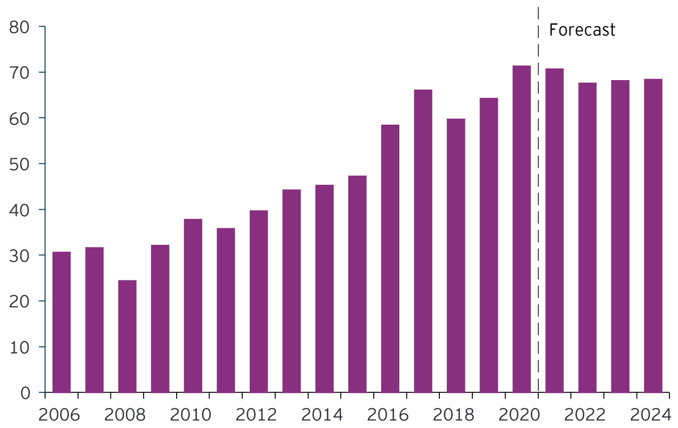
Source: OECD, Swiss Re, Oxford Economics

Wealth and asset management

UK assets under management (AUM) have benefited from strong global growth in asset values

UK AUM have benefited from a sustained global recovery in asset values over the course of this year. As of October 2021, the FTSE All-Share Index was 13% up on its level in January 2021, while equity indices in the US and Europe experienced even larger gains. Additionally, inflows have benefited from a sharp increase in activity among retail investors during the pandemic. The EY ITEM Club forecasts UK AUM to grow by 7.3% in 2021 to £1.68t, building on a 6.1% rise in 2020.

Asset price growth means the AUM-to-GDP ratio should fall only slightly this year
% of GDP



Source: EY ITEM Club/Haver Analytics

Some major central banks, including the BoE, have recently indicated that they will respond to recovering economies and rising inflation by tightening monetary policy, or at least reining back further stimulus. Therefore, the future environment for continued asset price appreciation is unlikely to be as favourable as it has been in the last few years. Additionally, there is uncertainty over whether elevated retail investor interest may fall back now that life is returning to normality. But there is scope for further growth in UK AUM; global activity is benefiting from the easing of COVID-19 restrictions and there is plenty of fuel for continued expansion, including savings built up by households during lockdowns. The EY ITEM Club therefore forecasts AUM to rise a further 3.2% in 2022 to £1.73t.

Equities and bonds face the prospect of a less supportive monetary policy environment

Growth in AUM has been fuelled by very loose monetary policy globally. In the UK, the BoE's policy rate has been at a record low of 0.1% since March 2020 and the UK central bank is close to completing £150b of gilt purchases which began in November 2020. But rapidly rising inflation has seen the tone of monetary policy makers become increasingly hawkish in recent months and investors reappraise how quickly UK interest rates will increase.

As previously outlined, the EY ITEM Club expects the BoE to raise interest rates from 0.1% to 0.25% next February, with a further rise to 0.5% in August 2022.

The BoE has been at the forefront of major central banks in signalling tighter policy. And although the US Federal Reserve System (Fed) and the European Central Bank (ECB) have not been so explicit on the prospect of raising interest rates, both central banks have begun to rein back the extent of monetary loosening. The ECB slowed the pace of its Pandemic Emergency Purchase Programme (PEPP) in September, while November saw the Fed begin tapering the pace of its asset purchases.

The EY ITEM Club expects global equities will continue to move higher, albeit at a slower pace, following strong year-to-date gains. Valuation multiples are likely to come under increasing pressure as central banks begin to tighten monetary policy, but this should be offset by the strength of the ongoing earnings recovery. Indeed, the Q3 earnings season suggests that companies have been able to largely mitigate rising cost pressures.

UK equities remain relatively well placed for future growth. Large cap values appear inexpensive compared with historical norms and are in a good position to benefit from the ongoing global economic recovery and higher commodity prices (given the composition of the FTSE 100).

Additionally, the outsized presence of value stocks in the UK index means higher inflation won't be as much of a headwind compared to markets where growth stocks are more important. On the other hand, the focus on Environmental, Social, and Governance (ESG) investing – and the increased emphasis on a green recovery post COP26 – may negatively impact the fossil-fuel heavy FTSE 100. Additionally, more domestically-focused UK small cap companies may struggle against a backdrop of rising costs and a weaker pound. Meanwhile, action by the UK Government and regulators to promote investment in patient capital aimed at delivering longer-term returns, such as the launch of Long-Term Asset Funds (LTAFs) could deliver positive impacts for both customers and the wider economy.

The outlook for bonds has become less positive. Rising inflation globally and more hawkish rhetoric from central banks is making fixed-income assets less attractive and could prompt a shift into riskier assets which are considered a better hedge against inflation. Central bank bond purchases will come to an end in the UK at the close of this year, and are being scaled back in other major economies, which will also weigh on bond values and put upward pressure on yields.

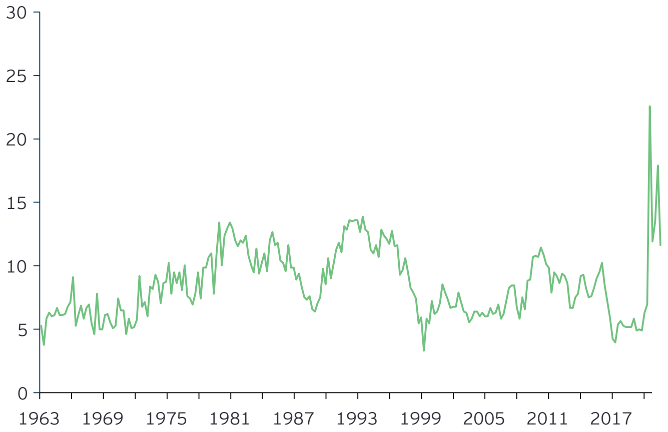
However, rising interest rates should make money-market funds more appealing for investors. And the perception that property is an asset that tends to hold its value in an inflationary climate could encourage inflows into property funds. However, mass home working during the pandemic means that the outlook for the property sector is uncertain. 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.

Households' appetite to save has remained above pre-COVID-19 levels

Despite the lifting of social distancing restrictions earlier this year, savings by UK households have remained above pre-pandemic levels. The household saving ratio did fall from 18.4% in Q1 2021 to 11.7% in Q2 – which implied some return to more 'normal' savings behaviour over the spring and early summer – but this left the ratio still high by historical standards.

The saving ratio was still well above the long-run average in Q2

Savings as a % of total household resources



Source: EY ITEM Club/Haver Analytics

Savings averaged 7.1% of household resources between 2000 and 2019. As outlined previously, 'excess' household savings were around £170b in Q2, equivalent to almost 11% of annual household incomes, and more recent data on cash held by households in bank deposits suggests excess savings grew over the summer and early-autumn. And households' balance sheets are also very strong in other respects. Household gross financial assets reached £7.4t in Q2 2021, the equivalent of 484% of incomes, an increase from £6.9t, or 462% of incomes, in the last quarter of 2019.

The FCA's efforts to encourage savers to move some of their cash into investments, via more tailored guidance and simpler advice services, should help the AUM sector benefit from higher household saving. Many have anticipated that the appetite to save should fall as the country moves out of the pandemic. However, savings have continued to grow by more than normal in recent months – despite the lifting of COVID-19 restrictions – which could indicate a new, more cautious attitude. The EY ITEM Club forecast expects the household saving ratio will average around 7.5% over 2022-25, compared to 6.5% from 2016-19.

Wealth and asset management sector summary

	2019	2020	2021	2022	2023	2024
Total AUM (£b)*	1,474	1,563	1,677	1,731	1,818	1,893
% year	11.6	6.1	7.3	3.2	5.0	4.1
Bonds (£b)	235	249	254	250	248	251
Equity (£b)	727	774	859	891	940	981
Fund of funds (£b)	197	209	233	243	263	277
Hedge (£b)	1.6	1.0	0.7	0.8	0.9	0.9
Mixed (£b)	170	174	183	192	206	217
Money market (£b)	109	125	117	122	126	129
Property (£b)	35	32	30	32	35	38

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

EY | Building a better working world

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find newanswers for the complex issues facing our world today.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. EY member firms do not practice law where prohibited by local laws. For more information about our organization, please visit ey.com.

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.

EYG no. 010613-21Gbl
ED None

In line with EY's commitment to minimize its impact on the environment, this document has been printed on paper with a high recycled content.

ey.com/ukfs

About Oxford Economics
Oxford Economics was founded in 1981 to provide independent forecasting and analysis tailored to the needs of economists and planners in Government and business. It is now one of the world's leading providers of economic analysis, advice and models, with over 700 clients including international organisations, Government departments and central banks around the world, and a large number of multinational blue-chip companies across the whole industrial spectrum.

Oxford Economics commands a high degree of professional and technical expertise, both in its own staff of over 80 professional economists based in Oxford, London, Belfast, Paris, the UAE, Singapore, New York and Philadelphia, and through its close links with Oxford University and a range of partner institutions in Europe and the US. Oxford Economics' services include forecasting for 200 countries, 100 sectors and 3,000 cities and sub-regions in Europe and Asia; economic impact assessments; policy analysis; and work on the economics of energy and sustainability.

The forecasts presented in this report are based on information obtained from public sources that we consider to be reliable but we assume no liability for their completeness or accuracy. The analysis presented in this report is for information purposes only and Oxford Economics does not warrant that its forecasts, projections, advice and/or recommendations will be accurate or achievable. Oxford Economics will not be liable for the contents of any of the foregoing or for the reliance by readers on any of the foregoing.