EY ITEM Club
Outlook for financial services

Minds made for empowering financial services

Spring 2019

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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 for 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.

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.

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We are a global leader in assurance, tax, transaction and advisory services. Over 30,000 of our people are dedicated to financial services, serving the banking and capital markets, insurance, and wealth and asset management sectors. At EY Financial Services, we share a single focus – to build a better financial services industry, not just for now, but for the future. Together let's build a better working world.

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The latest *EY ITEM Club Outlook for financial services* regrettably tells a familiar story - low growth, weakened demand for credit and falling business investment. Since the financial crisis, we have been hearing that we face short-term sluggish growth and the economy would return to higher growth in the longer-term. Whilst the first part of this has never failed to deliver, the second part has unfortunately not yet materialised. Since we started the financial services Outlook in 2014, annual growth in Gross Domestic Product (GDP) has never been above 2.9%. Last year the UK economy grew by 1.4%, the slowest rate since 2009, and this year GDP growth is forecast to run at just 1.3%.

There are always good reasons for the economic recovery being pushed further out. The impact of geopolitical uncertainty on the outlook this Spring is undeniable, with political uncertainty surrounding Brexit and increasing international trade protectionism impacting both consumer and business appetite to borrow and spend.

The *EY ITEM Club Outlook for financial services* is based on the scenario that an agreement over the UK's withdrawal from the EU will be reached by the new 31 October deadline. But even in this event, the UK economy is forecast to deliver growth of only 1.3% this year, with a marginal increase to 1.5% in 2020. Should the UK leave without an agreement, the economy is forecast to suffer stagnation in late-2019 and even a mild recession in the first half of 2020.

Whilst the Brexit outcome remains uncertain, business investment continues to fall. Companies have been holding off on some of the longer-term commitments that require investment. This means, despite banks being keen to lend, little new demand for corporate lending is expected in 2019.

Even if the UK leaves the EU with an agreement in October and firms implement the investment projects they have currently put on hold, we're unlikely to see the impacts of these investments until well into 2020.

Consumers are also putting off big purchases. Despite inflation slowing, average earnings increasing and historically low levels of unemployment, consumers are avoiding big ticket purchases and choosing to build up household savings instead. The household saving ratio is forecast to rise from 4.5% in 2018 to 5.2% this year. As a result, growth in consumer credit and general insurance is likely to weaken.

For assets under management (AUMs), market troubles and a stronger pound acted as a strong drag on growth in 2018. It dropped 6.8% to £1.19t in the biggest fall seen since 2008, and our forecast for AUM at the end of 2019 sits at a modest £1.24t, which is still below 2017 levels.

However, Brexit and global geopolitical uncertainty are not the only issues to contend with. Even if the economic landscape improves, there are longer-term trends outside of these high-profile short-term factors that the industry is having to respond to. These include a steady decline in car ownership rates among young people, reflecting a fundamental shift in attitudes and the 'uber-effect'; maturity and saturation in the use of car contracts, which are therefore not driving growth in consumer credit; and continued high (and to many potential buyers, unaffordable) house prices, holding back mortgage demand. In addition, net interest margins have been squeezed for over a decade thanks to an unprecedented period of very low official interest rates, and we're not expecting big rate increases when rates do go up. This is having a real impact on profitability across the sector and is forcing firms to think about their business model.

We are also seeing new trends emerging, which the industry will want to watch closely; for example, data shows that life expectancy has started to decline for the first time since records began.

Brexit continues to make the headlines, and rightly so – it poses a significant challenge to many firms in the short and long-term - but there are also more profound trends we shouldn't lose sight of. Profitability has been squeezed for more than a decade and economic conditions are not likely to dramatically improve - regardless of how Brexit plays out. Against this backdrop, financial services firms face increasing shareholder pressure to find other ways to drive growth and improve performance. We expect to see diversification into new products and services as well as investment in technology as they seek to drive growth, improve client experience and achieve greater operational efficiencies. The preparations and investments that firms make now based on longer-term trends will determine their success in the next three to five years, and contribute to the UK's leading position in financial services well beyond Brexit.

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Macroeconomic overview

There will be little respite from the weakness the UK economy experienced last year

The economy expanded by 1.4% in 2018, the slowest rate since 2009. It looked like growth was picking up over the first three quarters of 2018, but this pattern was driven largely by erratic factors related to the weather, dragging on activity early in the year, then boosting it over the summer, and the last quarter of 2018 saw growth slip back. 2019 offers some upsides – lower inflation is boosting spending power, as should a relaxation of fiscal austerity. If a Brexit deal passes before the October-end deadline, some pent-up investment may come back on stream. However, more caution by consumers at home, and weakness abroad, particularly in the eurozone, present downsides. If a "no-deal" Brexit is avoided, we forecast GDP to rise by 1.3% this year, with growth in 2020 running at 1.5%. The UK leaving the EU without an agreement, however, would see the economy likely suffer stagnation or even a mild recession in the first half of 2020. In that eventuality, we forecast growth of only 0.1% next year.

Falling inflation and a pick-up in pay rises offers some upsides for consumer spending...

Consumer price inflation slowed in the second half of 2018 and into early 2019, reflecting the fading effect of past sterling weakness on import prices. Price pressures should ease further this year, aided by a recovery in the value of the pound if an "orderly" Brexit is achieved. Combined with growth in average earnings picking up - matching a 10-year high in early 2019 - the outlook for household spending power is brightening. This is aided by high and low levels of employment and unemployment respectively.

However, with the household saving ratio well below the long-run average, consumers may choose to use the gains from faster real income growth to bolster their finances rather than spending the proceeds. And the scope for further gains in employment is more limited. That factor is the main reason why we expect growth in real disposable income to slow to 1.6% this year from 2.1% in 2018, with the forecast rise in consumer spending also weaker (1.4% in 2019 versus 1.7% last year).

...but a continued lack of clarity on Brexit clouds the investment and trade outlook

Business investment proved a particularly weak part of the economy in 2018. A fall of 0.4% over the year was only the second annual decline since 2009. There seems little doubt that Brexit-related uncertainty played some role in this. If, as we expect, a deal between the UK and EU is reached before the October-end deadline for the UK's departure, firms may implement investment projects currently on hold. However, any post-Brexit bounce is unlikely to become apparent until 2020. On the trade front, a positive contribution to GDP from net trade in 2017 turned into a drag last year as growth in most major economies slowed. So far, 2019 has delivered mixed signs around global activity but, outside the US, prospects look subdued.

The Bank of England will struggle to raise interest rates more than once this year

With inflation forecast to run below the Bank of England's 2% target this year and economic growth - even under our assumption that a Brexit deal is struck - running at a modest pace, the need for tighter monetary policy is questionable. At most, the Bank may pursue one hike in Bank Rate in 2019, with August the most likely date for a rise in the official interest rate from 0.75% to 1%. But a "no-deal" outcome to the Brexit negotiations would probably lead the Bank to cut rates, as well as engage in unconventional policies such as quantitative easing.

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Banking

Prospects for lending growth are caught between opposing forces...

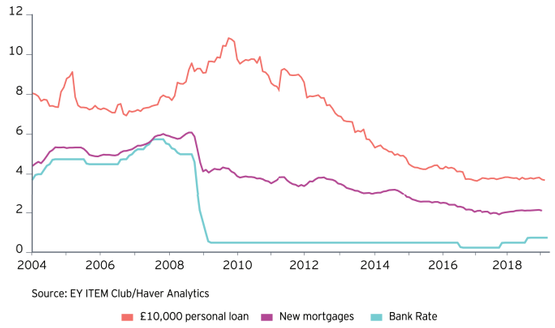
Following two years of stagnant or negligible growth in real household incomes, 2018 saw a decent 2.1% gain. Another rise is expected this year as inflation drops further and pay growth holds onto recent advances. However, the likelihood that households will err against further running down savings is set to dampen demand for credit.

In the all-important mortgage market, the story has continued to be a sluggish-but-stable one. The start of 2019 saw net mortgage lending rise by just over 3% on a year earlier. This is in line with the pace seen since 2016 and only one-third of the near 10% rate averaged in the decade up to the financial crisis.

The outlook offers some upsides for mortgage demand, including a continuation of low borrowing costs. Even in the event of an "orderly" Brexit, the Bank of England will have little reason to raise interest rates anything more than very gradually. The starting point for mortgage rates is a modest one – the average interest rate on new home loans averaged 2.1% at the start of 2019. Thanks to intense competition in the mortgage market, this was only four basis points higher than a year earlier and well under half the 5.23% averaged from 2004-07. However, the ratio of house prices to incomes began 2019 at an elevated 5.7, above the post-2000 average of 4.81. This illustrates how the relative unaffordability of housing will hold back mortgage demand. Overall, the stock of mortgage lending is forecast to rise by just under 1% this year, followed by 1.3% in 2020.

Borrowing costs have stayed down despite hikes in the offical interest rate

%



Source: EY ITEM Club/Haver Analytics

...with growth in real incomes picking up and interest rates still very low...

Although growth in net consumer credit in the second half of 2018 and into early 2019 continued to outpace that in mortgage lending, the margin of difference narrowed. February 2019 delivered a 6.3% year-over-year (YOY) increase, the lowest since September 2014 and well below the recent peak of 10.9% in November 2016.

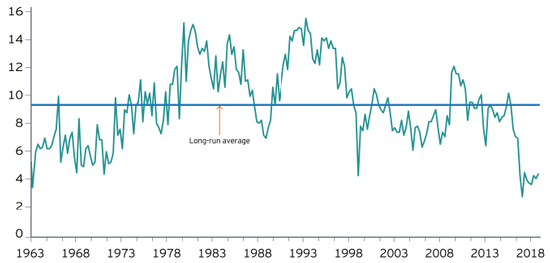
The bulk of the slowdown has reflected weaker demand for financing for new cars, a development that looks set to continue this year. Demand for diesel vehicles has fallen sharply, with buyers deterred by tax changes and reputational problems. Uncertainty around Brexit may, for the time being, discourage some people from making major purchases. And demographic developments, in the form of a steady decline in car ownership rates among young people, presents a likely longer-lasting headwind. In 1993, 55% of men and 42% of women aged 17 to 20 held a driving license. These proportions sat at 33% and 29% in 2017.

...but credit demand weakening and households expected to take a more prudent approach

Survey evidence on prospective demand and supply for unsecured credit suggests a relatively subdued outlook. According to the Bank of England's latest Credit Conditions Survey, lenders reported that - having decreased in the first quarter of 2019 - the availability of unsecured credit to households was expected to decline further in the second quarter. The length of interest-free periods on balance transfers and new purchases on credit cards also decreased significantly in Q1, with another drop expected in Q2. Moreover, that savings amounted to just 4.8% of the average households' resources at the end of 2018 - well below the long-run, post-1963 average of 9.4% - suggests that a more prudent attitude may take hold. We forecast that growth in the stock of consumer credit will slow from 4% in 2018 to 1.6% this year, with a recovery to around 2% in 2020.

Saving ratio is well below the long-run norm

Savings as a % of household resources



Source: EY ITEM Club/Haver Analytics

Meanwhile, weak business investment appears to be driving the slowdown in growth in the stock of corporate lending to both large companies and small and medium-sized enterprises. Spending by firms on buildings, machinery and other capital equipment dropped 0.4% in 2018, only the second annual fall since 2009.

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In the same year, growth in the stock of business loans ran at a three-year low of 2.7% in 2018 compared with 4% the previous year. With business investment forecast to see another decline this year, and the Bank of England's latest lending survey showing a drop in corporate demand for credit in Q1, we expect business loans to rise only 1.3% this year, before a recovery to 2.2% in 2020.

Banks' profitability remains under pressure

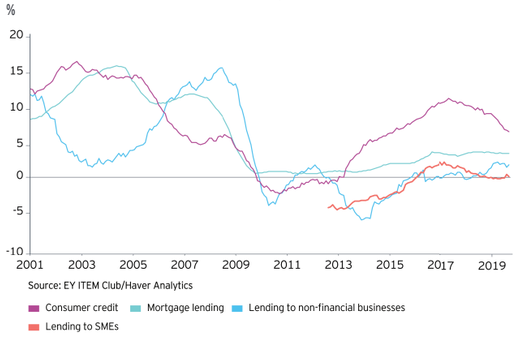
With growth in relatively high net-interest margin consumer credit lending likely to slow further, and expansion in low-margin mortgage lending continuing at a subdued pace, the scope for an improvement in banks' overall net interest margins looks modest. What's more, increased interest in helping customers out of standard variable-rate mortgages - together with proposed actions such as cutting fees for unauthorised overdrafts – could put further pressure on banks' profitability. Although the impact of replacing the London Inter-bank Offered Rate (Libor) has yet to work through, it also has the potential to adversely impact firms' profit and loss, and capital position. Additional costs include changes to contracts, systems, process models and potential customer redress and compliance costs.

Meanwhile, as of January 2019, total compensation paid by UK banks for mis-sold payment protection insurance (PPI) had reached £34.2b. The latest data, however, saw a modest drop-off in payments as the August 2019 deadline for claims comes closer. Compensation averaged £309m in the six months to February 2019, down from £378m over the previous six months. However, this was still above average compensation levels in both 2016 and 2017. Following the Financial Conduct Authority's (FCA) policy statement in February, the regulator's requirement that lenders inform certain customers with previously rejected PPI complaints that they may be able to bring up new complaints, could push up costs in the run-up to August.

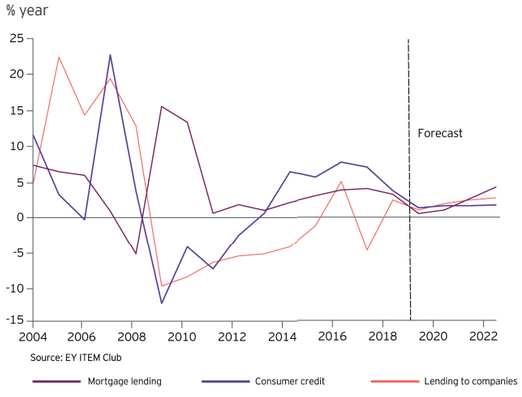
On a positive note for banks' profitability, the FCA's review of retail banking, some parts of which are still ongoing, avoided far-reaching measures to boost competition such as ending free current accounts. That said, and as the FCA's review pointed out, the entry into the market of big technology companies such as Amazon presents a potentially long-term source of competition and pressure on profits. Retail banks continue to plan for greater competition from a range of new entrants (such as neobanks and technology players) by investing heavily in different forms of digital transformation.

Taken together, these factors increase pressure to look for alternative sources of revenue, and we may see firms expanding the provision of financial advice, planning for demographic changes and focusing on growing markets.

Growth in household & business lending has been subdued



A sluggish but stable outlook for lending



Banking sector summary

	2017	2018	2019	2020	2021	2022
Total assets (£b)	7,311	7,454	7,545	7,647	7,806	7,980
Total loans (£b)	6,346	6,587	6,654	6,758	6,945	7,213
Business/corporate loans (£b)	424	435	441	450	462	476
Write-offs (% of loans)	0.3	0.3	0.6	1.0	1.1	0.9
Consumer credit (£b)	207	216	219	223	228	232
Write-offs (% of loans)	1.3	1.6	1.7	1.7	2.1	1.9
Residential mortgage loans (£b)	1,205	1,246	1,257	1,273	1,310	1,369
Write-offs (% of loans)	0.01	0.01	0.02	0.03	0.04	0.03
Deposits (% year)	-0.8	2.2	0.6	1.1	2.7	3.3
Loans/deposits (%)	141	143	144	144	145	145
Total operating income (£b)	136	124	125	127	131	135

Source: Bank of England/Oxford Economics

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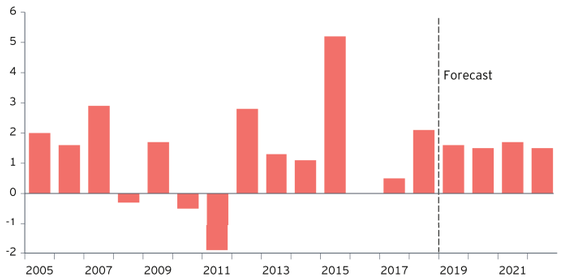
Insurance

A continuation of growth in real household incomes will bolster insurance demand...

Our forecast for another year of real growth in household incomes represents a positive for big-ticket purchases and, correspondingly, business for the non-life insurance sector. Having recorded stagnant or negligible rises in 2016 and 2017, last year saw household incomes grow 2.1% in real terms, the second fastest rise since 2013. Looking to this year, consumer price inflation is set to drift down and pay growth is holding on to its recent revival. However, employment growth is slowing, and 2019 is forecast to deliver a 1.6% rise in incomes, with a similar pace expected in 2020. This, nevertheless, will remain a long way short of the 3.1% increase averaged in the (pre-financial crisis) decade to 2007.

Household incomes are in for a period of sustained, if unspectacular, growth
% year



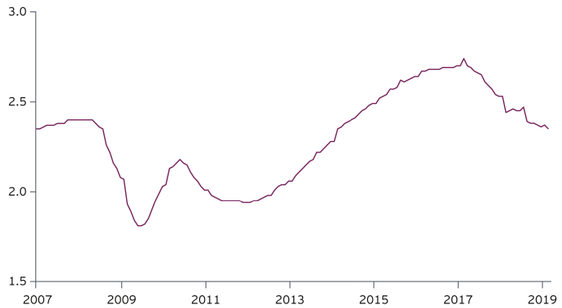
Source: EY ITEM Club/Haver Analytics

Our expectation that a Brexit deal will ultimately pass before the latest October Article 50 deadline is reached may encourage some big-ticket purchases, including property and vehicles, which had previously been held back by uncertainty.

...but general insurers face challenges from weak car sales and premium deflation

The industry, however, also faces challenges. In the general insurance market, growth in motor insurance premiums will be hindered by continued weakness in the market for new cars and evidence that the UK has passed "peak car." This may in part reflect a tailing off in the long-running windfall to consumers from PPI payments. Private new car registrations dropped 0.9% YOY in Q1 2019, the third consecutive quarterly decline. And registrations fell 6.8% in the calendar year 2018, the third year in a row of falling sales. The adverse effect on the supply of new cars arising from some manufacturers' unpreparedness for new EU emissions regulations (which came into effect in late 2018) suggests that part of the sector's recent weakness may be temporary. However, a rebound has yet to materialise. The latest data for March showed registrations down 2.8% YOY, while 2019 as a whole is forecast to see only a very modest growth of 1.9%.

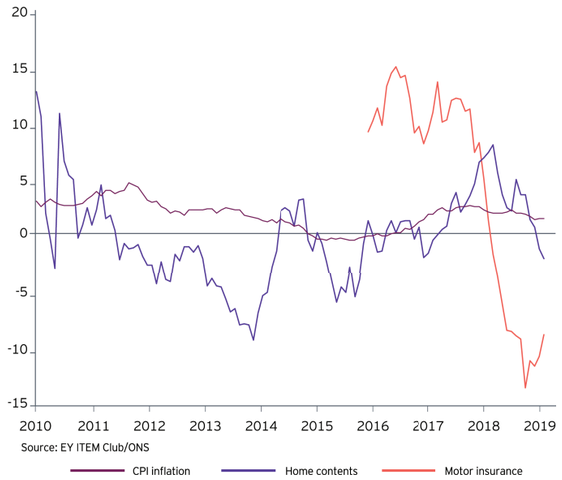
Car registrations continued to fall in 2018 and early-2019
Millions, rolling 12-month total



Source: EY ITEM Club/Haver Analytics

With insurers having to compete in a shrinking market, deflation in motor insurance prices has continued into 2019. In the year to March 2019, the cost of car insurance dropped 8.9%, the 12th consecutive month to see a fall. In the same month in 2018, prices had been rising at an annual rate of 1.7%. The price of home contents insurance has also moved in an unfavourable direction from the point of view of premium income growth. Prices dropped 1.8% in the year to March, compared with rises of 4% - 5% in the latter part of 2018.

Motor insurance prices have moved firmly into deflation
% year



Source: EY ITEM Club/ONS

Overall, our latest forecast shows non-life premium income growing 2.2% this year, up from 1.3% in 2018, and it is expected to rise to 2.2% in 2020.

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Falling premiums exaggerate likely hit to insurance profits

Following last year's investigation by the Competition and Markets Authority (CMA) and the FCA, the decision by some insurers to move away from a "loyalty penalty," where long-standing customers are charged more than new ones, is another potential drag on profits. Citizen's Advice estimate that the cost to consumers of this penalty is around £700m per year.

On the face of it, deflation in insurance premiums is another factor that should weigh on returns in the sector. However, the passing of the Government's Civil Liability Act in December 2018 and the likely reduction in whiplash claims which should follow - along with the review of the Ogden discount rate due to take place later this year - mean that lower premiums are likely to be accompanied by lower costs for insurers. Meanwhile, evidence that long-running improvements in longevity have stabilised or even started to reverse should cut the cost of annuities and boost insurers' profits as they adjust assumptions around mortality. Mortality data from England and Wales shows that life expectancy in 2018 at age 65 was more than a year lower than in 2015. We forecast profit growth of 7% this year and 7.3% in 2020, close to the rates seen in the last two years.

Life insurers face the hurdle of another year of depressed interest rates

Troubles in the global economy stemming from a slowdown in the eurozone, and ongoing and potentially new trade disputes between the US, China and the EU, point to interest rates globally rising more slowly than previously expected. That inflation across major economies has continued to remain unresponsive to falling unemployment will also hold back central banks from "normalising" monetary policy.

We expect the Bank of England to raise Bank Rate at most once this year, leaving the official interest rate at 1%. Meanwhile, the US Federal Reserve is forecast to keep rates on hold and the European Central Bank is expected to keep the eurozone's official interest rate in negative territory.

This will maintain pressure on life insurers' returns from depressed bond yields. We expect 20-year gilts to end this year at 2.1%, only marginally higher than the 1.8% seen at the end of 2018.

Meanwhile, a slower pace of global growth, and already-elevated equity price values in the US, specifically, represent headwinds to equity price growth this year. However, following a sharp fall in equity values at the end of 2018, a more recent recovery - along with the boost to sentiment from our expectations of a Brexit deal - mean the Financial Times Stock Exchange (FTSE) All-Share Index is forecast to end 2019 7% higher than a year earlier. This is a marked improvement on the 6.6% YOY drop seen in the last quarter of 2018.

As a wave of defined benefit (DB) pension schemes de-risk, the incentives for scheme members to convert DB rights to defined contribution (DC) assets and rapid growth in the bulk annuity market - sales of which hit a record high in 2018 - will continue to fuel investment and growth in the life and pensions sector. Overall, supported by our prediction of another year of rising real household incomes, following a 2.5% increase in 2018, we think gross life premiums will see a 2.1% increase this year, with growth accelerating to 3.1% in 2020.

Insurance sector summary

	2017	2018	2019	2020	2021	2022
Life gross premium (£b)	166.3	170.5	174.0	179.4	186.0	193.3
% year	2.0	2.5	2.1	3.1	3.7	3.9
Life gross claims payments (£b)	150.0	150.4	150.3	151.8	163.4	172.2
Life claims ratio (%)	90	88	86	85	88	89
Non-life gross premium (£b)	59.1	59.8	61.2	62.6	65.1	67.9
% year	3.2	1.3	2.2	2.3	3.9	4.3
Non-life gross claims payments (£b)	32.0	31.4	31.3	32.3	33.9	35.6
Non-life claims ratio (%)	54	52	51	52	52	52
Profits (£b)	6.7	6.8	7.0	7.3	7.6	8.2

Source: OECD, Swiss Re, Oxford Economics

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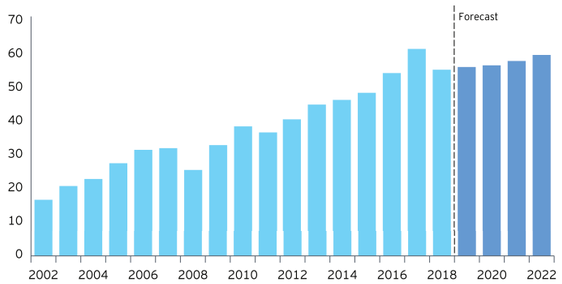
Wealth and asset management

Market troubles and a stronger pound weighed on AUMs in 2018

A weak performance from many asset classes in 2018 combined with a modest strengthening in sterling's value acted to drag on growth in UK AUMs last year. Notably, the FTSE All Share Index in the last quarter of 2018 was 6.6% down on its level in the same period in 2017, the worst end-year performance since 2008. Additionally, the pound's value was up 1.5% against a basket of currencies, compared with a 5.8% drop in 2017, pushing down on the sterling value of foreign assets held by UK asset managers. AUMs in 2018 dropped 6.8% to £1.19t, the biggest fall since 2008 and a sharp reversal from the £1.28t and growth of 17.4% seen in 2017. With AUMs forecast to rise 4.7% this year and 4.4% in 2020, we expect some rebound, albeit soft by the standards of the period since the financial crisis.

In GDP terms, AUMs should see a modest recovery from 2018's drop
% of GDP



Source: EY ITEM Club/Haver Analytics

An uncertain global outlook and the continued absence of inflation should favour bonds

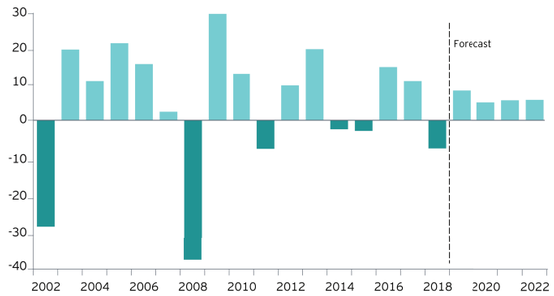
The outlook for asset allocation in 2019 is looking favourable for low-risk assets like bonds. A more subdued performance from the global economy and, correspondingly, a less hawkish attitude from central banks toward hikes in interest rates will support bond values. The eurozone economy slowed sharply in the last quarter of 2018. While the US has continued to put in a strong performance, some of the factors underpinning this – notably tax cuts and rises in federal government spending – will diminish this year. Moreover, there are plenty of geopolitical triggers which could unsettle markets for riskier assets, ranging from the still-present risk of a "no-deal" Brexit, to US-China trade strife and to instability in the Middle East.

If, as our forecast assumes, a Brexit deal is confirmed before the end of October, this should boost the attractiveness of UK equities, which have continued to underperform in other major global stock markets indices over the last year. However, a "no-deal" outcome would probably hit equities and favour gilts considering that, under that outcome, the Bank of England would be likely to keep interest rates lower for even longer.

Brexit-related developments in sterling will also influence asset allocation. While the positive effect on sentiment from a Brexit deal should be good for UK equities, we also think a deal would support a steady recovery in the pound, with sterling reaching $1.38 by mid 2020. This will mechanically drag on the value of foreign-currency denominated assets held by UK asset managers.

In particular, with 75% of FTSE 100 and 50% of FTSE 250 companies' revenue earned outside the UK, a higher exchange rate will, all else equal, reduce the attractiveness of UK equities.

2019 should deliver some bounceback from a poor 2018 for equities
FTSE All Share, % year (Q4 to Q4)



Source: EY ITEM Club/Haver Analytics

A mixed outlook for equities may offer some boost to alternative asset categories like property - but with the rise in DC assets, this will have to be balanced against the suitability of a different risk profile. With several major economies seeing a steady deceleration in property price inflation during 2018, evidence suggests that we may be in the late stage of a real estate cycle. This will caution investors and limit growth in investment in this asset class.

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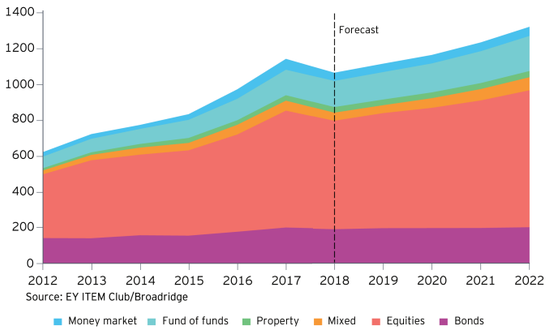
Composition of AUMs is expected to see little move
£b



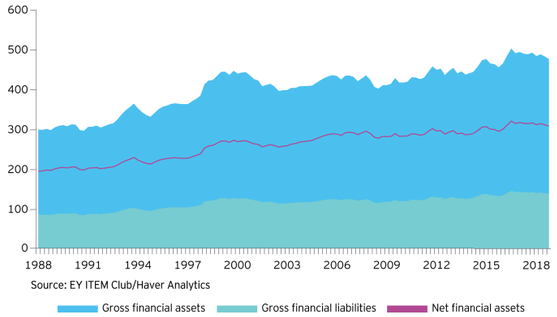
Rising auto-enrolment rates should support inflows, although weaker growth in wealth won't help

Domestically, the AUM sector is benefiting from growing government-compelled saving. April saw the total contributions rate under pensions auto-enrolment rise to a minimum of 8%. The Department for Work and Pensions (DWP) estimate that in the current 2019-20 fiscal year, an additional £19.7b will be contributed to pensions annually because of automatic enrolment, equivalent to almost 1% of forecast GDP. Some customers might opt out as contribution rates rise, but inertia means they are unlikely to do it without a triggering event such as changing jobs.

Meanwhile, growth in pay will feed automatically into rises in AUMs and life insurers' income as a result of auto-enrolment, especially if opt-out rates remain low. This effect will be magnified by the recent rise in contribution rates.

Current record high employment (both in level and rate terms) should also bolster inflows from UK workers. Additionally, our forecast for some recovery in the household saving ratio from the near-record low seen last year is also AUM-positive. However, the effect of recent weakness in asset markets on households' financial wealth may present a headwind to AUMs. Gross financial assets held by households rose 1% in the year to Q4 2018, well down on the 5.4% rise averaged in 2016 and 2017. That said, the level of UK household wealth remains high. Net of financial liabilities, this was equivalent to 337% of household incomes in Q4 2018, compared with an average of 283% since records began in 1988.

Household financial wealth has dipped slightly
% of household income



Wealth and asset management sector summary

	2017	2018	2019	2020	2021	2022
Total assets under management (£b)*	1,275	1,188	1,244	1,299	1,376	1,473
% year	17.4	-6.8	4.7	4.4	6.0	7.1
Bonds (£b)	187	181	187	187	188	191
Equity (£b)	647	598	634	662	702	753
Fund of funds (£b)	158	163	171	180	198	218
Hedge (£b)	1.3	1.1	1.1	1.1	1.1	1.2
Mixed (£b)	180	160	165	179	196	214
Money market (£b)	68	51	52	53	55	57
Property (£b)	34	35	35	36	37	39

*UCITS and non-UCITS assets
Source: Oxford Economics; Broadridge

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