UK Cities DNA

Don't stop thinking about tomorrow: charting a course for the UK's recovery

September 2024

The first of twelve insight papers in our UK Cities DNA initiative – putting real estate supply and demand in the context of the economic direction of travel.

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Charting a course for recovery

- The UK is currently experiencing a significant economic revival, with both recent and future growth projections being upgraded.
- The UK's position relative to other countries has improved: growth upgrades come at a time when other major economies are faltering, while the stable political transition contrasts with ongoing uncertainty and flux in large democracies around the world.
- In common with other developed economies, the UK faces several significant structural and social challenges.
- Far from being a separate consideration, real estate is at the heart of the solutions to many of the UK's current challenges, creating a generational opportunity for the sector.

A NEW DAWN?

If one takes the global financial crisis as a logical turning point, the UK is approaching almost two decades of major structural change. The size, composition, society, politics, and global positioning of the UK has evolved dramatically during this time, and yet there is nothing to suggest that the next 20 years will be any less transformational. While some change will be instigated at home, and unique to the UK, many of the triggers will be global in scale – from geopolitics to technology, from demographics to climate change.

These issues, and many more, are critical to the economic fortunes of future generations. Happily, the UK's starting position is enviable. The UK remains firmly among the world's leading economies, bolstered by its deep, globally influential financial markets. It is consistently at the forefront of technology and innovation, fuelling a virtuous cycle of funding, world-class education, and almost unrivalled talent attraction.

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The UK's influence on the global stage extends beyond its economy and into its rich cultural and diplomatic legacy. As a permanent member of the UN Security Council, a founding member of NATO, and a key player in the Commonwealth, the UK wields substantial political power. Additionally, it continues to exert considerable "soft power" through its media, arts, education, and diplomacy. British universities are among the most prestigious in the world, attracting global talent and fostering innovation across sectors. The UK's cultural exports – from music to fashion, literature to film – have left an indelible mark on global society, helping to maintain its international relevance. These factors enhance the UK's attractiveness as a destination for business and investment, contributing to its broader economic resilience.

Yet there can be no illusion that the UK is escaping the challenges common to many developed economies. Housing is expensive and scarce, while populations are growing. Established trading relationships are evolving, and an over-reliance on the service sector economy is risky when global relationships become strained.

On a more practical level, many day-to-day challenges simply become easier to manage in times of healthy economic growth. However, of the two big levers available, central banks remain reluctant to offer cheaper finance for fear of reigniting inflation, and while most governments recognise investment as a vital catalyst for growth, many lack the fiscal capacity to offer it after years of expensive pandemic support. Bond markets stand ready to punish any authority seeking to borrow beyond its means, and for those even tempted to test the theory, the UK's experience following the October 2022 'mini-budget' remains an all too fresh and sobering lesson.

What's more, some challenges seem more specific to the UK. These include significant regional disparities, weak productivity growth, and the difficulties of harnessing the long-term financial upside of successful startups, in a world in which overseas capital sees the UK's innovation landscape as a prime hunting ground.

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REAL ESTATE'S CRITICAL ROLE IN THE REVIVAL

This outline of the UK's myriad problems may seem abstract or even irrelevant for a research series about real estate. After all, most of the real estate implications are, at best, second order – one must scratch beneath the surface to uncover them. It may also seem a pessimistic start. In fact, we believe both assumptions are false for three reasons.

Firstly, we believe there is a chance for a once-in-a-generation reset of the UK's economic trajectory. Secondly, the benefits of this new phase will accrue more evenly across the UK. Thirdly, real estate is at the heart of many of the required solutions.

This research series will focus on exploring the latter two points in much more detail, but to round off the macroeconomic backdrop, there are at least five important elements to highlight.

1. A little bit of luck

Although we are more concerned with longer term trends in UK growth, it would be remiss not to highlight what has become a significantly more positive near-term picture. Since pausing for breath at the turn of the year, UK growth has consistently surprised on the upside, and the H1 24 performance was the strongest in the G7. Expansion is running well ahead of previous economic forecasts, despite initially stickier inflation, and just one base rate cut.

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IMF forecasts project UK economic growth of +0.6% in 2024, accelerating to +1.5% in 2025. The UK is expected to outperform the Euro area's largest economy in both 2024 and 2025, with Germany's GDP expected to grow by +0.2% and 1.3%, respectively.

Absolute economic growth is clearly linked to population size, and part of the reason for the UK's economic growth is therefore related to recent population growth. The UK is one of the few developed economies not expected to see a fall in population over the coming decades. Indeed, recent figures from the ONS show that in 2023,

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Don't believe the hype?

	Metric	Comment	Source
Economic growth	17.8%	Growth in inflation-adjusted UK output since 2007	ONS
Economic scale	6th	Ranking in list of economies by size, current $, 2023	IMF
Population growth	610,000	Net increase in population, year to mid-2023. England and Wales. The largest increase for 75 years	ONS
Politics	63%	Share of seats won by current labour government	Economics Observatory
Labour market	4.2%	UK unemployment rate, mid- 2024	ONS
Financial markets	2nd	London's ranking in regular survey of global financial centres	Long Finance
Venture capital funding	3rd	The UK's position in ranking of countries receiving VC funding since 2019	Pitchbook
Soft power	2nd	The UK's soft power – its national brand – is second only to that of the US	Brand Finance, Global Soft Power Index 2023

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England and Wales saw population growth running at its highest level for 75 years.

However, population growth alone is not the only factor at play. GDP per capita is set to grow by +1.5% per annum over the long term, outpacing many of the world's largest economies. Wage growth is slowing, but at around 5%, remains comfortably ahead of inflation. It is no surprise that consumer sentiment is finally into recovery mode.

As we'll explore in future sections of this research series, one of the keys to understanding the UK's economic potential lies in connecting the dots between its various strengths and challenges. The recent population growth, for example, plays a dual role in the economic landscape. On one hand, it helps fuel consumer demand, expand the labour market, and bolster GDP growth. On the other, it adds pressure to housing, healthcare and infrastructure systems that are already stretched.

As the UK's population increases, so too does the urgency to address these structural challenges, but it also provides an opportunity for targeted investment and innovation in sectors like real estate and sustainable infrastructure. These developments are not isolated trends but are interlinked aspects of the UK's broader economic narrative, demonstrating how population dynamics, housing, and investment all converge to shape the country's future prospects.

2. Ideas: the consolation of stagnation?

Perhaps it is the unprecedented chain of events that has shaped the UK's recent history, or perhaps it is a quality inherent in the UK itself: whatever the causes, one part of the economy that has remained in robust shape is that of idea generation. Only the US, China and India have more think-tanks than the UK, and along with industry bodies, universities, regulators and government departments, these organisations have turned their attention to a vast array of policy challenges in recent years. There has certainly been plenty to address.

The significance in this context is multifaceted. Firstly, these organisations often produce valuable research that can aid the efficient functioning of markets and economies. Secondly, their prominence serves to highlight areas of UK expertise on the global stage, as a valuable lever of soft power. Thirdly, recommendations can and do find their way into government policy. Indeed, both the Conservative and Labour Party manifestos contained nods to several of these recommendations, as did the recent King's speech, which set out the priorities of the new government.

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3. Investment nationalism: co-opting the private sector

When it comes to productivity, the UK has been a relative laggard amongst developed economies for many years. To combat this, the Labour Party's manifesto identified the need to reverse a weakness in both business and infrastructure investment, but also recognised a lack of fiscal capacity to offer much in the way of support. Broadly speaking, three solutions have been set out.

The first is to create a more stable environment for business decision-making. This entails committing to fewer policy changes – for example, annual, rather than bi-annual budget commentary, but extends to initiatives to smooth relationships with near-neighbours in Europe.

The second strand is to use a limited pool of public capital to backstop specific risks. For its part, the government has pledged £7.3bn in funding for a National Wealth Fund to attract private investment into UK infrastructure. By carefully aligning public and private sector interests, the UK can leverage its capital more effectively, stimulating growth without overextending its finances.

The third is to encourage a redirection of some pools of domestic capital back to the UK, to invest in everything from start-ups to listed companies, and infrastructure. This stems from a concern that domestic institutions like insurance companies and pensions funds have steadily reduced the share of their capital that they invest in the UK over the past 25 years to very low levels.

The suggestion that more of this capital should be invested in the UK is not without contention. Critics argue that the role of these organisations is to generate the best outcomes for their members or stakeholders, regardless of the countries in which opportunities lie. This task should not be subject to constraints on where they can or should invest. A pragmatic view recognises this principle, yet also acknowledges that redirecting even a small fraction of overseas capital back into the UK could significantly boost domestic investment.

It is clear that at the time of writing (September 2024), the dust is yet to fully settle on these ambitions. It will be an important space to watch. Chancellor Rachel Reeves is reportedly seeking to unlock further investment from government pension funds, along similar lines to successful initiatives in Canada.

Longer term, as the significance of defined benefit pension schemes gradually wanes, defined contribution schemes could eventually step in to take their place as investors in the UK. Defined contribution funds are still emerging in scale, and many believe that Britons contribute too little of their earnings at present.

4. Picking winners

Much has been made of the government's so-called industrial strategy. For some, the mention of these words will be enough to evoke thoughts of failed car manufacturers, strikes, and endless decisions by committee. The reality is that the industrial strategy of today is more a recognition of the country's strengths than any significant financial backing by the government.

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Of itself, reassuring the business sector that the government recognises the important of finance, services, technology, life sciences and climate – to name a few – is valuable. But unlike, for example, the Inflation Reduction Act in the US (which saw $370bn committed to 'green' initiatives), the sums involved in the UK are small.

The digital economy represents one of the UK's most promising growth sectors, contributing significantly to its global competitiveness. The UK has emerged as a hub for fintech, cybersecurity, AI, and digital health, attracting significant venture capital and global talent. For example, London continues to rank among the world's top financial centres, in part due to its thriving fintech ecosystem. Furthermore, the UK's role in the digital economy is not confined to domestic markets; it plays a pivotal role in global digital trade, offering expertise and innovation that shape industries worldwide. By nurturing its digital sectors, the UK can capitalise on its strengths in technology and innovation, driving future economic growth and maintaining its position as a global leader in the digital age.

5. Why the UK? A question that is becoming easier to answer.

Why should investors, businesses, or global talent commit to the UK? It has remained relatively easy to make a compelling case for the UK throughout the journey of the past two decades – the volume of cross-border investment transactions undertaken, the amount of global capital raised, and population growth provide the evidence of that. Yet even the optimist would recognise that the answer has been more nuanced in recent years. That has now begun to change – for the better, and at pace.

A more positive reappraisal of the UK is partly the result of a clearer vision set out by the current government, as well as the fortuitous upswing in current growth rates. But it is also a quirk of timing: just as the UK is looking more assured, uncertainty amongst comparable countries is on the rise.

While the influence of politics on markets can sometimes be overlooked, recent events in France underscore just how disruptive political uncertainty can be: the spread between French and German 10 year bond yield grew by 30bps at the point of peak French election fever, only to fall back as the challenge from the Marine Le Pen's Rassemblement National declined. The bigger picture is that there is little sign that either economic or political uncertainty is in retreat around the world, meaning that the premium attached to stable, pragmatic countries such as the UK will be strong.

Don't stop thinking about tomorrow, don't stop, it'll soon be here. It'll be here better than before, yesterday's gone, yesterday's gone.

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We like questions, if you've got one about our research, or would like some property advice, we would love to hear from you.

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