Corporate check-up

TREVOR WILLIAMS LOOKS AT WHAT LIES IN STORE FOR THE UK ECONOMY.

Overall corporate and equity market performance is linked to economic growth. In 2007, UK growth remained strong despite a number of challenging events including: the Bank of England's series of base rate increases, summer floods and food scares, the US sub-prime mortgage crisis in August and the first run on a UK bank for over 140 years.

THE BEST TRADING CONDITIONS FOR YEARS Solid, sustained growth in the UK and fast expansion in the global economy gave UK corporates the best trading conditions they'd seen for years. The benign economic environment encouraged corporates to expand both sides of the balance sheet – particularly in the past three years – with increases in both capital and income gearing evident across the corporate spectrum but there was also a strong rise in corporate wealth. As a result of the sustained period of robust 2.8% annual increases in UK growth seen in the last decade, corporate profits have reached record highs. This is particularly true for service firms, which have benefited from a global surge in liquidity and M&A activity. UK corporate default rate is also at a 15-year low, as a proportion of the number of registered firms, coinciding with 15 years of uninterrupted economic growth. Additionally, the most recent bankruptcy figures, for the third quarter of 2007, show a 4.4% decrease in the annual rate of bankruptcy compared with the same quarter of 2006.

The strong performance of the UK and global economy in the last 10 years has resulted in low default and bankruptcy rates, perhaps lulling some corporates into a false sense of security. In reality, the picture is not likely to remain so positive, though it will still be good. Take interest paid by companies as a share of income: this has risen and is now well above the average of the last 20 years. And with the economy expected to slow, corporates will be more exposed to the risk of rising defaults than at any time in the past five years.

Even with some growth slowdown likely in the last three months of 2007, the likelihood is that the economy expanded in 2007 by 3.2%. This is well ahead of the consensus expectation of 2.4% made in December 2006 (the LTSB forecast was for 2.8% growth) as well as higher than the 40-year average of 2.4% and the 10-year average of 2.9%. Consumer spending, company investments and government spending all contributed to this growth.

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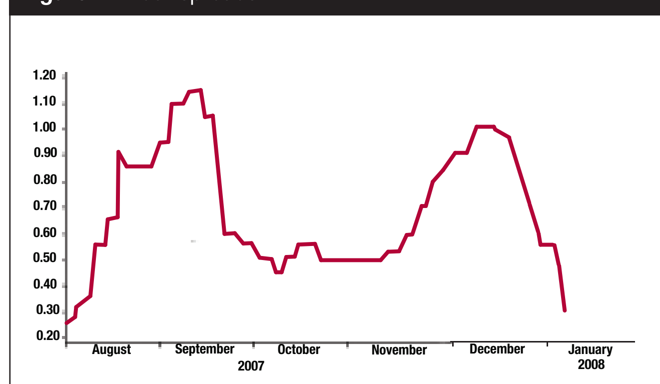
WHAT LIES IN STORE? Although our central view is one of slowing growth so a lessening of cost pressures, along with continued low wage inflation and consumer price index inflation remaining just above the 2% target in 2008, inflation will still pose a threat. Higher inflation than we project mainly driven by high input costs – soft commodities like food, and oil in particular – is still a real prospect in 2008. Indeed, continued relatively high oil prices in the context of the five year average of $52 a barrel are almost inescapable, which will lead to a curtailing of expansion plans and so lower borrowing for many corporates in 2008.

Big picture indicators point to the fact that UK economic growth will slow sharply this year compared with 2007, as the five interest rate hikes we've seen since August 2006 start to bite and consumer and company investment growth slows in response. Tightening credit standards, as a result of the recent turmoil in financial markets, and a slowdown in the UK's key exports markets in Europe, combined with a weak US dollar that will make UK exports more expensive in world markets, will also hinder growth. Our prediction is for a slowdown to 2.3% but some predictions are for growth to slow to as low as -0.1%. However, let's not forget that the shift from 3.2% to 2.3% still represents almost a 30% reduction, which will be interpreted in certain quarters as a dramatic slowdown worthy of the term recession, though that term is actually reserved for two consecutive quarters of negative growth.

Consequently, treasurers and financial directors are likely to see slower profit growth. And with the cost of servicing debt higher than in recent years – even if likely to decline as growth slows – at a time

Figure 1: Libor spreads



> IN TERMS OF THE IMPACT OF THE CREDIT MARKETS ON FINANCIAL MARKETS GENERALLY, IT IS CLEAR THAT SPREADS IN THE CREDIT MARKET ARE STILL WIDE, EVEN THOUGH THEY HAVE IMPROVED MARKEDLY SINCE THE WORST OF THE CRISIS IN AUGUST.

when consumer spending is likely to be lower, it may become more challenging for corporates to remain profitable.

Another side-effect of higher base rates over the period since August 2006 will be slowing house price inflation. Low interest rates and higher employment encouraged borrowing, and increased wealth held in homes and equities over the past few years has reduced savings levels to their lowest level in decades. If rising house prices encouraged consumption, then slowing house prices will discourage it.

All in all, average interest rates in the next five years by our projections are likely to be at least 1% above the average level of the preceding five years, so we would not expect income gearing to fall much below the 20-year average. Ultimately, we expect slower economic growth and higher than average interest rates (though likely to fall back toward 5% by mid-2008) to result in a rise in UK bankruptcies – a figure that may be exaggerated by a prolonged credit crunch that widens corporate borrowing spreads.

IMPACT OF CREDIT CRUNCH From 9 August, when the story first broke, the financial news has been dominated by credit crunch fears. In its latest Financial Stability Report the Bank of England cautioned that although there had been signs of recovery in credit markets some aspects of the market in more complex derivatives remained illiquid and the financial system was vulnerable to further shocks.

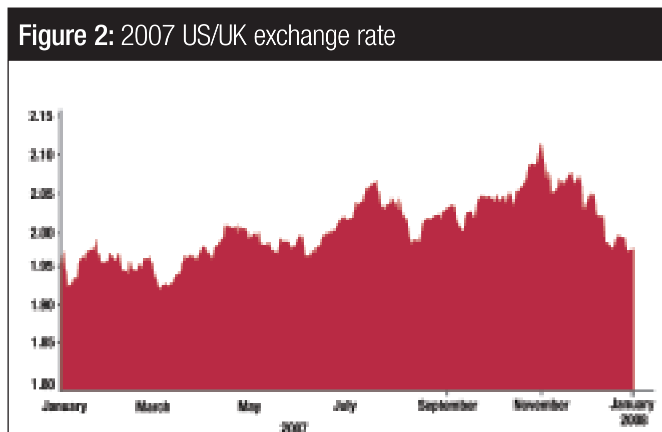
The fact is that the financial system has undoubtedly been affected by this recent turmoil and this has driven fears about the outlook for the overall economy in 2008.

In terms of the impact of the credit markets on financial markets generally, it is clear that spreads in the credit market are still wide, even though they have improved markedly since the worst of the crisis in August. Risk pricing is almost certain to remain at higher levels than in the pre-August world and corporates should prepare for higher borrowing costs in the medium term and for tougher conditions to be demanded by lenders.

CABLE RECORDS This increased cost of borrowing will not be helped by sterling's performance in 2007, which has underpinned our view that international trading conditions will become tougher. Trading with the US – as CABLE hits record levels – will be difficult (see *Figure 2*). But the real challenge lies in Europe, where we expect European growth to slow affecting UK exporters' performance in key European markets. However, the pound has fallen against the euro and so this may mitigate the impact on the UK of the slowdown in the growth rate of the EU economy, as the weaker currency will make UK exporters more competitive.

For the global economy as a whole, emerging markets will drive much of the increase in growth – this has become a persistent feature of recent years – and we will therefore become increasingly reliant on them to drive growth in UK exports.

Figure 2: 2007 US/UK exchange rate



Overall, however, an economic slowdown in 2008 will help to reduce some of the imbalances in the UK economy, like the widening in the trade deficit. This may facilitate a more sustainable pace of growth in the years ahead, though slower growth will pose challenges. In the near-term, we expect CABLE to remain just below the $2.00 mark but then to gradually fall back to around the $1.80 mark as the year progresses and the US economy gets over the worst of its economic slowdown. This will increase our competitiveness in dollar areas but also increase the risk of inflation.

In the months ahead we should see some ease in the credit crisis – bringing some depth back to the wholesale debt markets. Further UK interest rate cuts are expected in the months ahead, due to slower economic growth that we expect to become evident in official data. If this turns out to be right, we would expect to see UK base rates at 5% by the spring or summer of 2008.

However, corporates should remain focused on the real economy and their finances – particularly if the government borrowing requirement increases significantly. Ultimately, the risk is that the government will be forced to raise taxes to help ease financial constraints on the public sector if economic growth slows and tax revenues fall in consequence. From a corporate's perspective this will be particularly worrying as the brunt of tax increases in the last few years has fallen disproportionally on the business community. But the authorities will be aware that an increase in corporation tax will only hurt UK companies at a time when it is more important than ever to be globally competitive.

LOOKING VULNERABLE The UK corporate sector is perhaps more vulnerable to an economic downturn than can be inferred from just looking at its current strong profit position and good credit rating. If our UK growth projection of 2.3% for 2008 is undershot, expect a more marked rise in company defaults. If this transpires though the Bank of England may respond with even more aggressive cuts in interest rates. Regardless of the precise outcome, it is clear that things will not be as smooth for UK businesses in 2008 as they have been in recent years. Certainly, for treasurers and finance directors, there is likely to be renewed re-appraisal of capital and income gearing positions and investment plans for 2008 as they strive to keep their companies competitive.

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