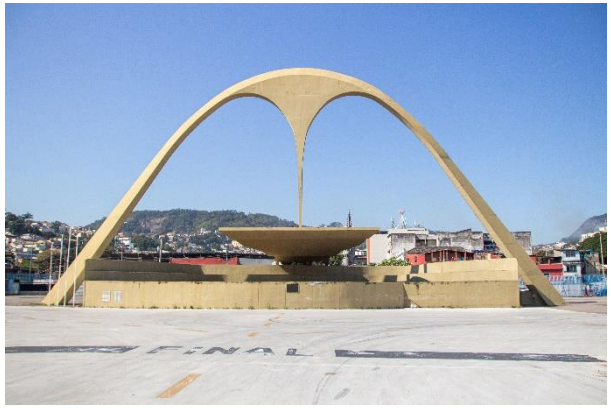
Economic Perspectives

London's apotheosis

and the rebalancing of the UK economy



Peter Warburton

12 November 2020

With the invaluable assistance of Tom Traill and Yvan Berthoux

Apotheosis – the highest point of development

- London's fabulous decade has ended

'Big Smoke' is home to more than 270 nationalities and 300 languages.

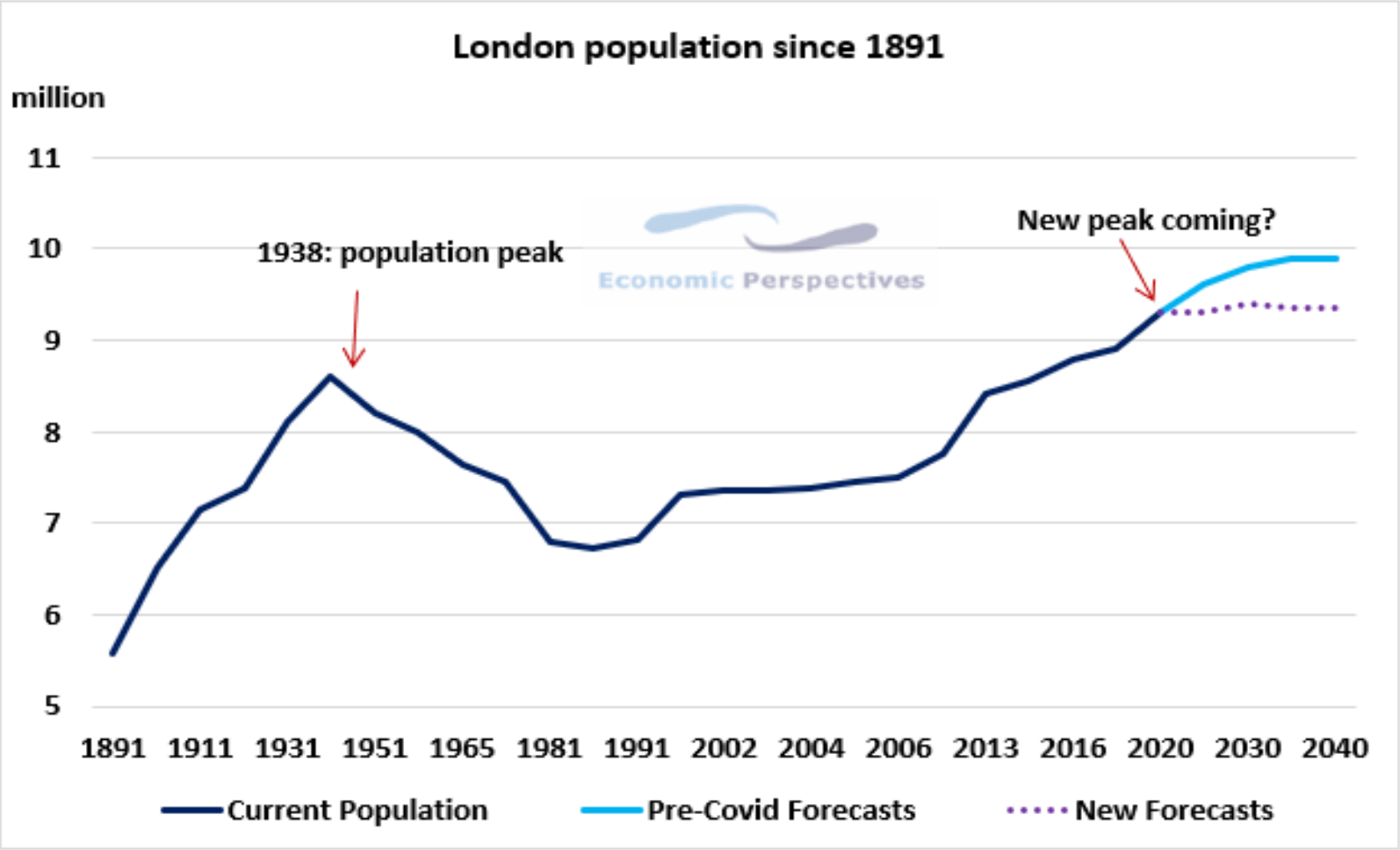
Nicky Morgan highlighted tourism's £68 billion contribution to the UK economy. The industry, she said, accounted for 1.6 million jobs and last year, the UK attracted 38 million visitors who spent £22.7 billion.

PM Boris Johnson: "Our capital city London has become the number one tourist destination in the world. The British Museum attracts more visitors than one European country I am too diplomatic to identify."

Schroders Global Cities Index

City	Country	Region	Score	Rank
Los Angeles	United States	North America	8.23	1
London	United Kingdom	Europe	8.19	2
Hong Kong	Hong Kong	Asia	8.15	3
Boston	United States	North America	8.06	4
Seattle	United States	North America	7.98	5
San Francisco	United States	North America	7.97	6
Sydney	Australia	Oceania	7.96	7
Chicago	United States	North America	7.96	8
New York	United States	North America	7.95	9
San Jose	United States	North America	7.94	10
Houston	United States	North America	7.77	11
Melbourne	Australia	Oceania	7.73	12

London's burgeoning population



London's growing problem of lack and deprivation

- High rental costs hit workless households hard

Q1 2020	Five years ago
28% of Londoners **(2.5 million people)** are in poverty	**27%** of Londoners **(2.3 million people)** are in poverty
81% of London population growth has been down to more births than deaths over the last five years	
56,000 London households are in temporary accommodation, **an increase of 30%** compared with five years ago	**43,000** London households are in temporary accommodation (2014)
75.6% employment rate in London	**71.6%** employment rate in London
19,961 families in London were affected by the benefits cap in November 2019 – **a 76% increase** over the last five years	**11,354** families in London were affected by the benefits cap
76% of children in poverty in London **(550,000)** are in working families	**68%** of children in poverty in London **(470,000)** are in working families (2013/14)

6.1 million jobs in the capital in 2019

67% of London adults in workless families are in poverty

Poorest 10% of Londoners earn 1.8% of total net income

Poorest 50% of Londoners earn 23.9% of total net income

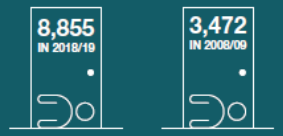
Richest 10% of Londoners earn 31.7% of total net income

One in five (21%) Londoners report high levels of anxiety

Poverty rates in Inner London are 10 percentage points higher than in many parts of the North of England

8,855 people were seen sleeping rough in London by outreach workers in 2018/19

3,472 people were seen sleeping rough in London by outreach workers in 2008/09



Households in poverty in London face housing costs that, on average, amount to 56% of their net income

Violence and sexual offences are 2.1 times as prevalent in the most income-deprived 10% of London neighbourhoods compared with the least income-deprived 10%

15.5% of 19-year-olds in Inner London do not have level 2 qualifications (GCSEs or equivalent), compared with 14% in Outer London and 18.4% in the rest of England

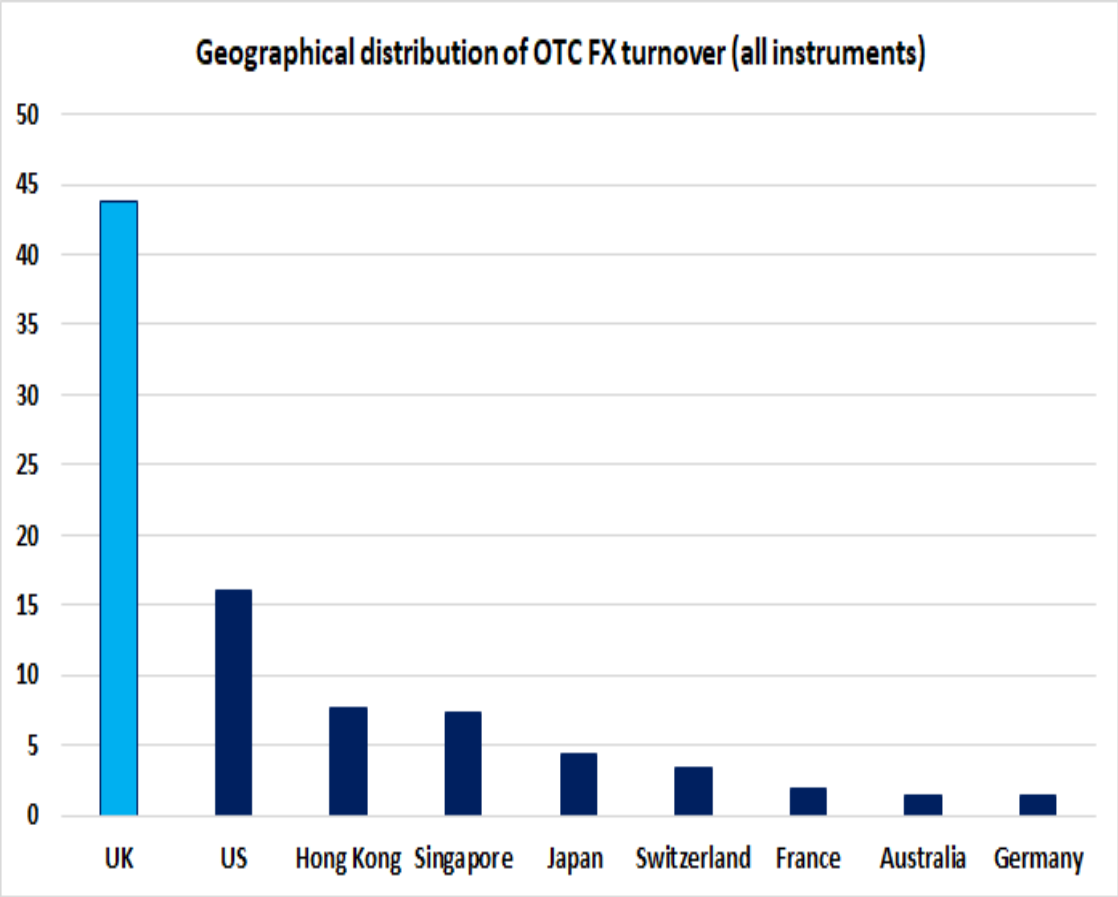
Source: London's Poverty Profile 2020, Trust for London

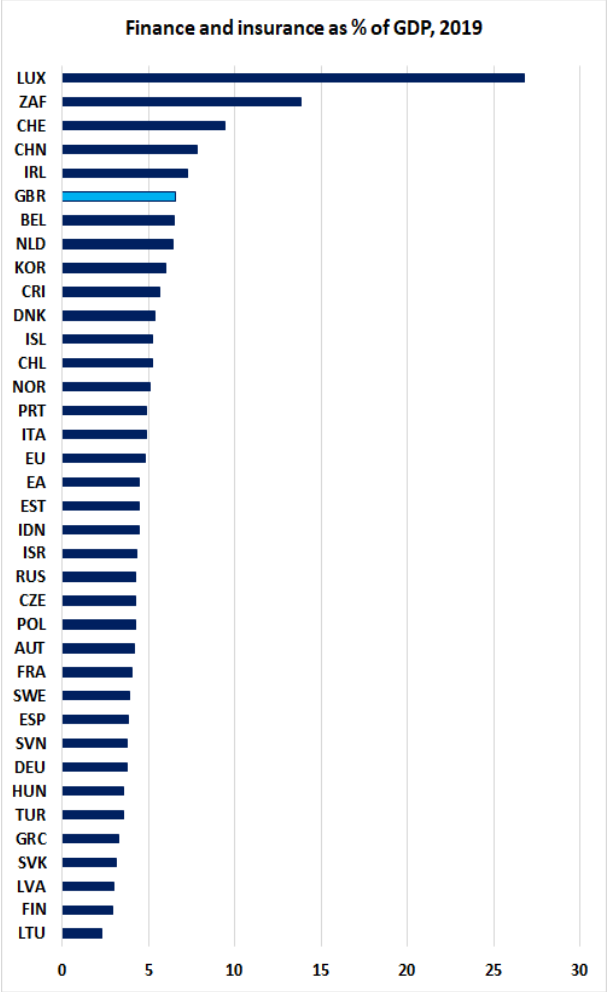
London's global allure: unique clusters

- The City of London: banking, insurance and finance, supported by legal and professional services, from consultancy to communications
- Creative and cultural: history, architecture, museums, galleries, the performing and visual arts, and associated technical skills etc.
- Life sciences and technology
- World-renowned universities
- Tourism

London's global allure: a global financial centre

- The FX capital of the world

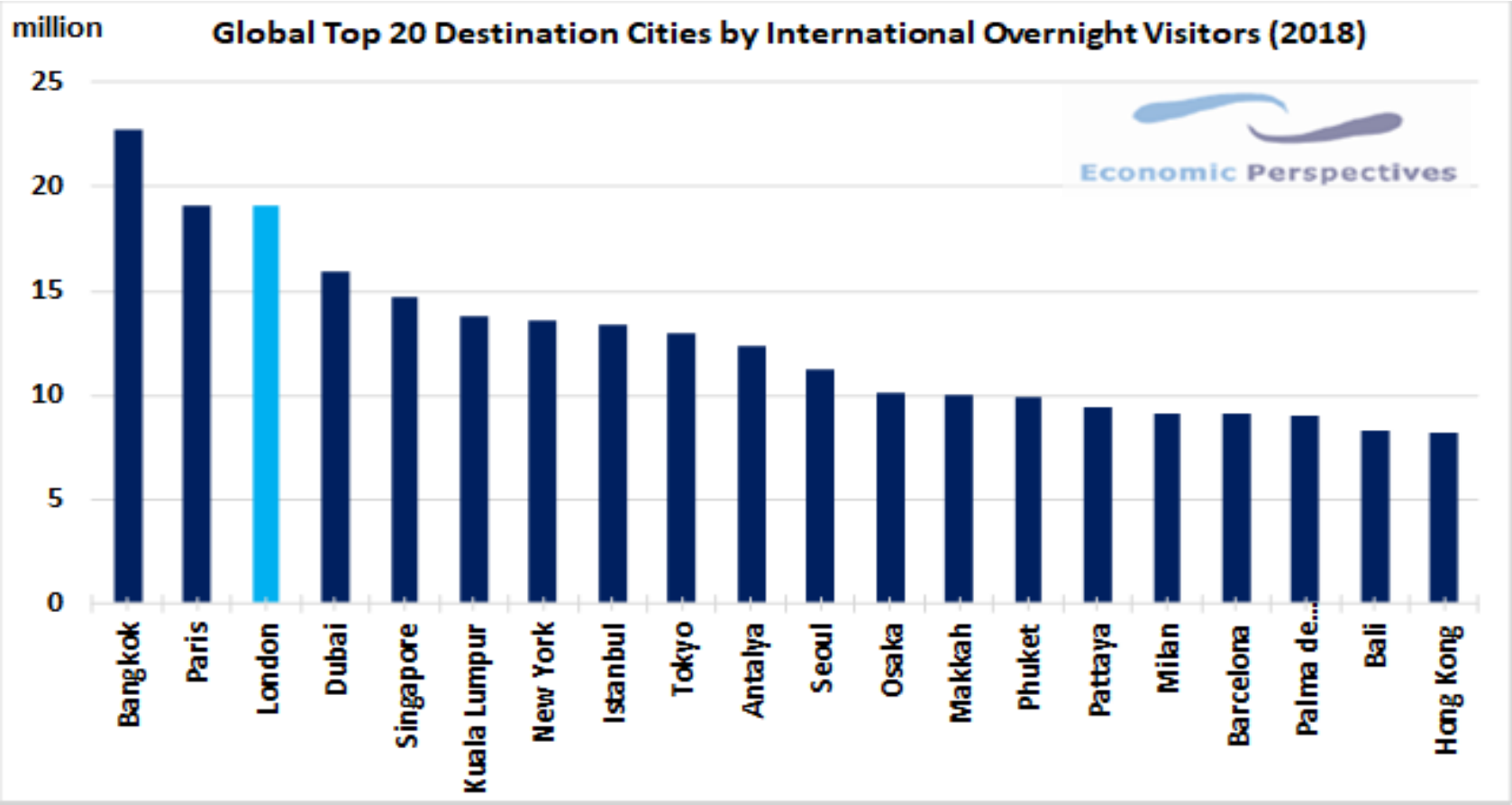




Source: BIS

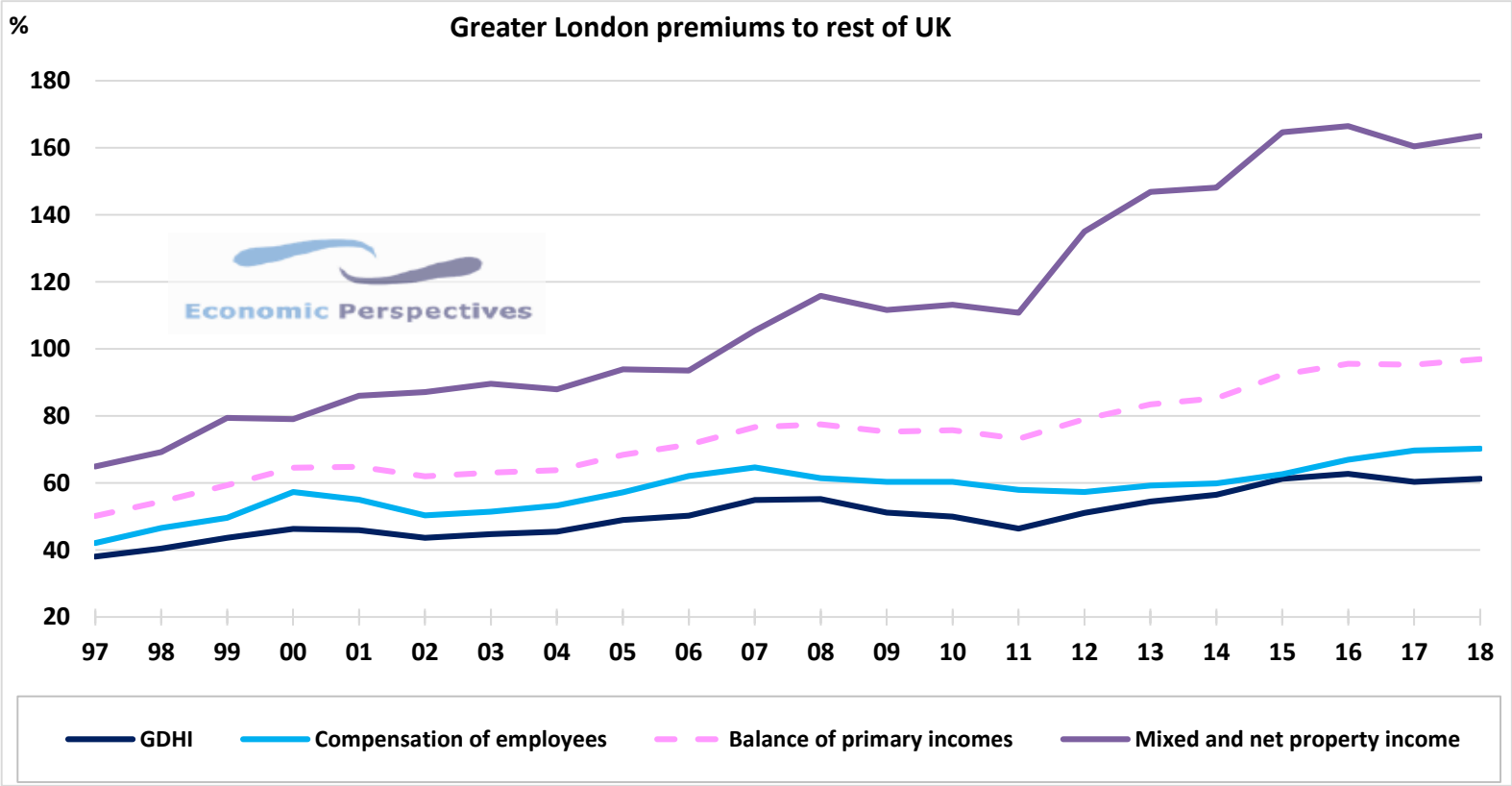
London's global allure: a global tourist destination

- Vying with Paris for #2 spot



London: flying high above the UK regions

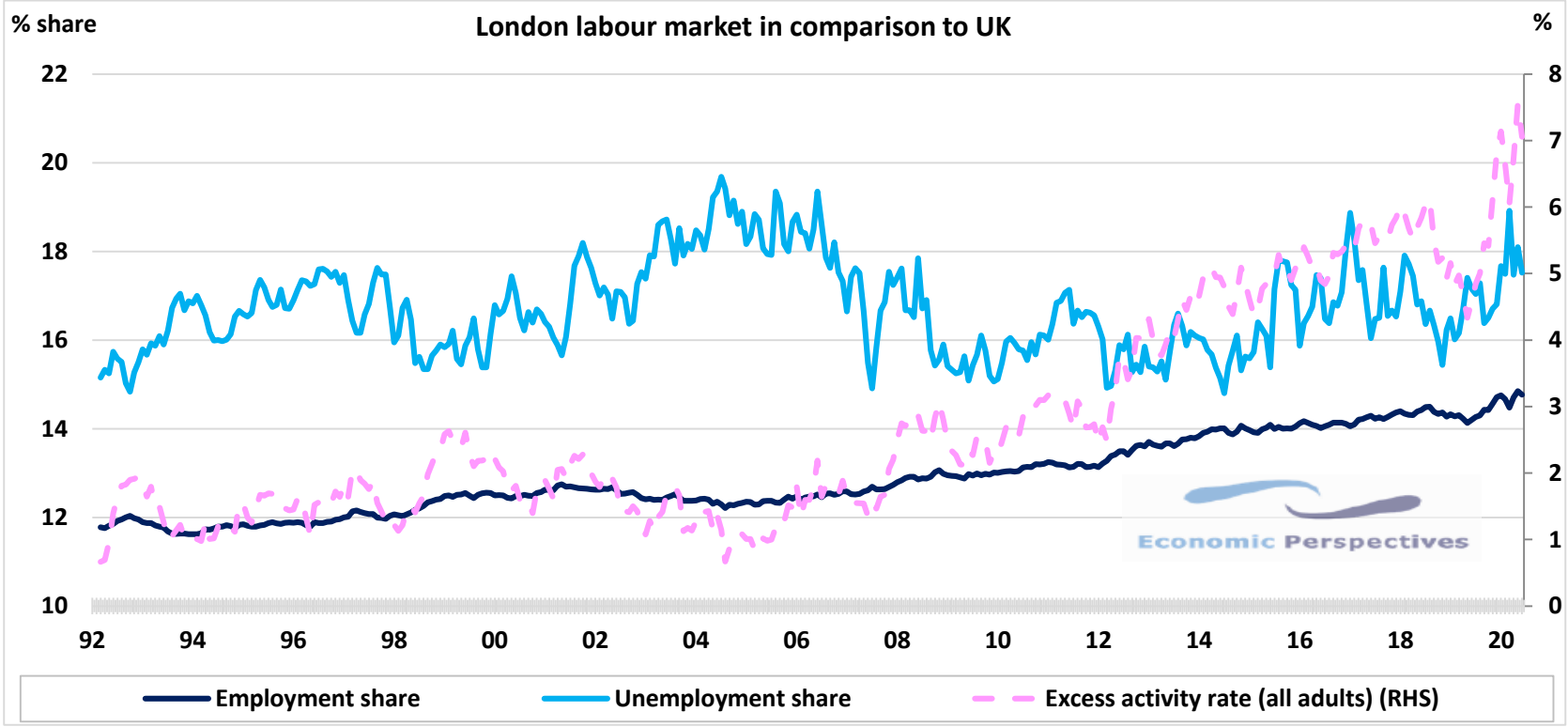
- Post-GFC monetary policy has fuelled divergence



Source: ONS Regional Statistics

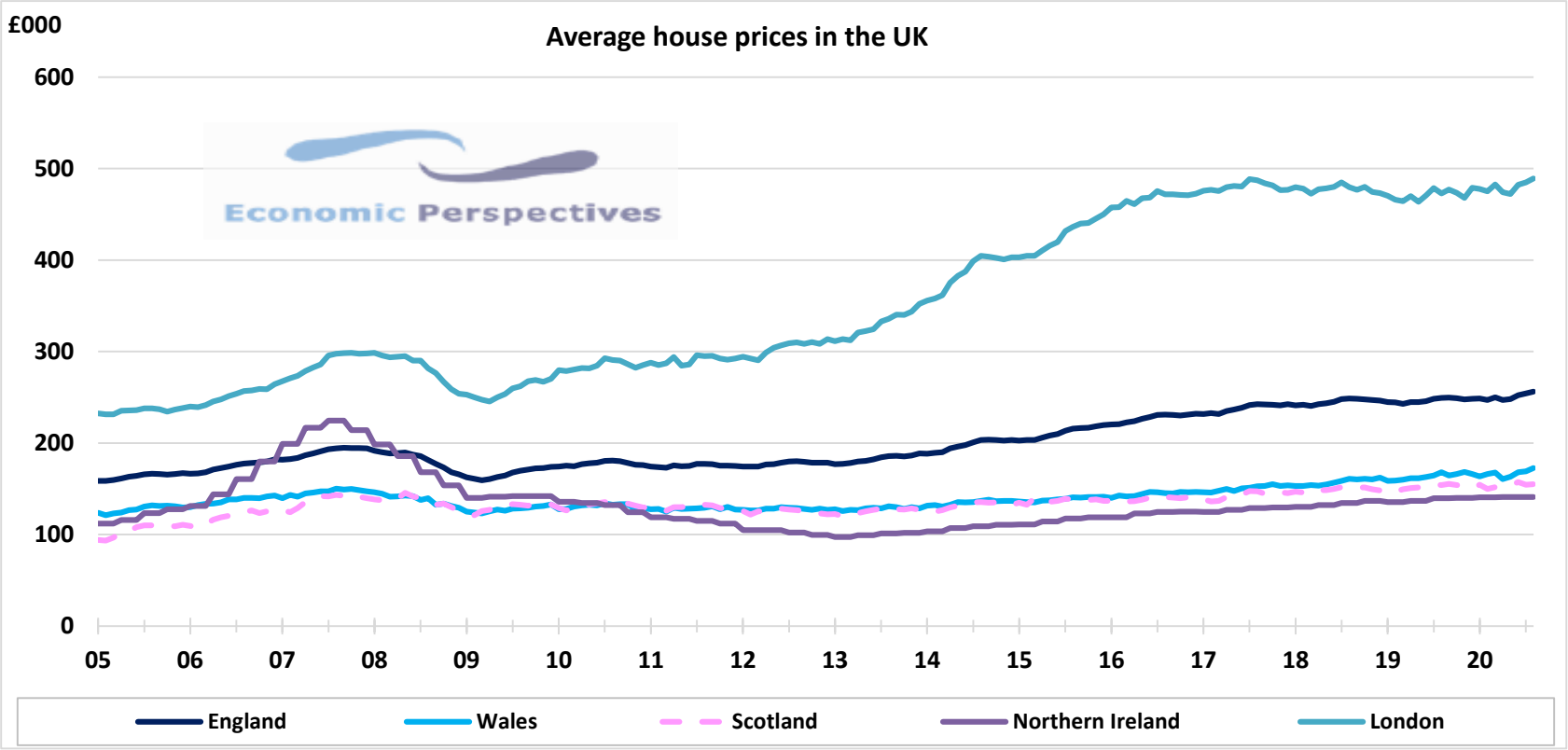
London: flying high above the UK regions

- 80.2% of Londoners (16-64) are economically active, bettered only by South East and East
- London added 212,000 jobs since last summer



London: flying high above the UK regions

- London's house price premium to England jumped from 53% in 2009 to 109% in 2016, easing back to 91% today



London's stormclouds

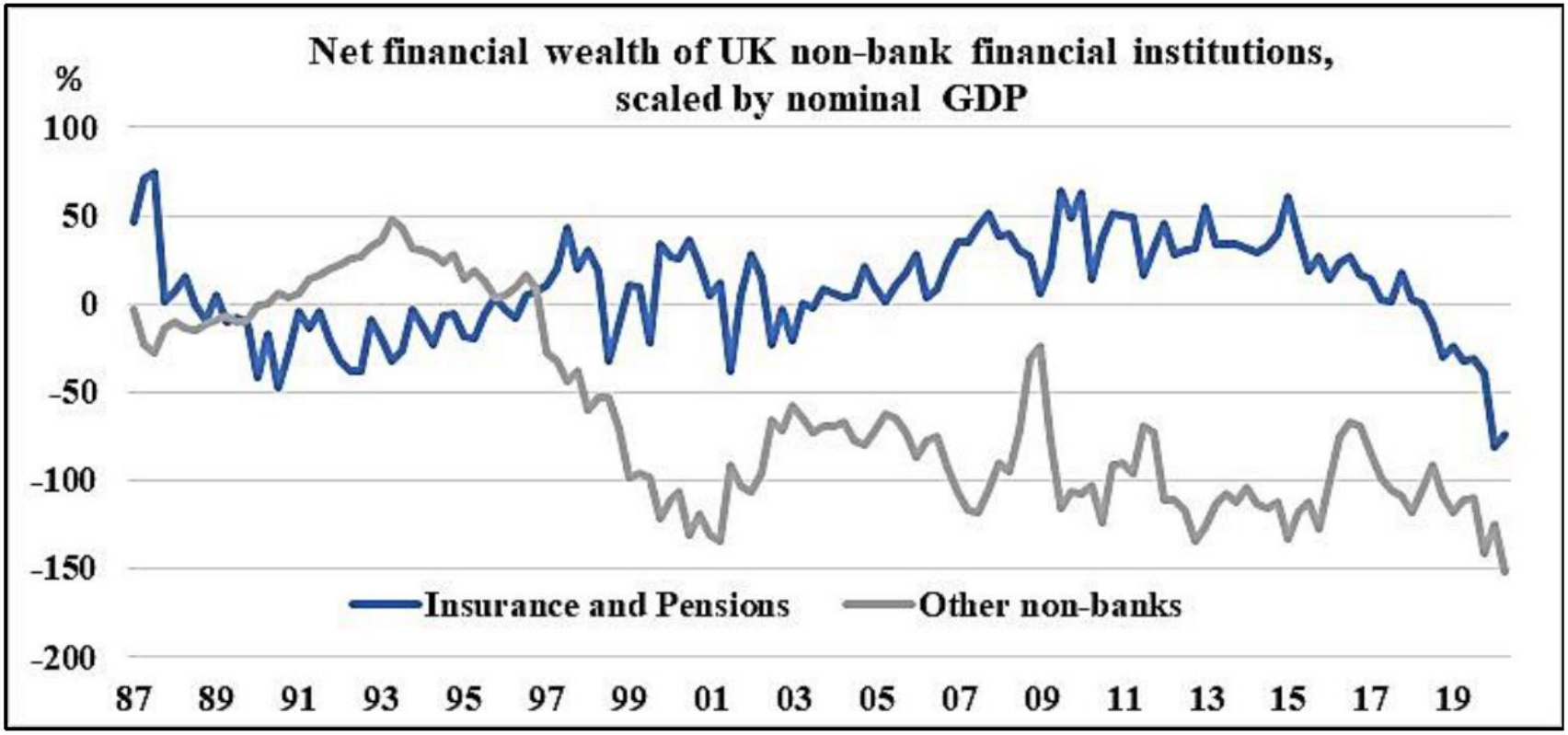
- Six ingredients of London's impending demise
- Monetary policy failings that have propelled the UK towards financial instability, with disproportionate impacts on the financial sector
- Over-confident expansion of real estate
- Terms of EU exit that are punitive for the City
- Imminent replacement of LIBOR by SOFR/SOFIA
- Souring of UK-China relations
- Differential impact on London of policy responses to Covid-19, turning opportunities into risks

1. Monetary policy failings undermining financial stability

- Failure to raise policy interest rates after 2015, fostering a new leverage cycle in financials
- Using Brexit as a smokescreen for financial repression in the form of additional QE and subsidised lending
- Very low interest rates have inflated the value of long-term liabilities and pushed pension and insurance funds towards deficiency and insolvency
- Very low interest rates have encouraged over-borrowing by other financial intermediaries and auxiliaries, raising financial instability risk

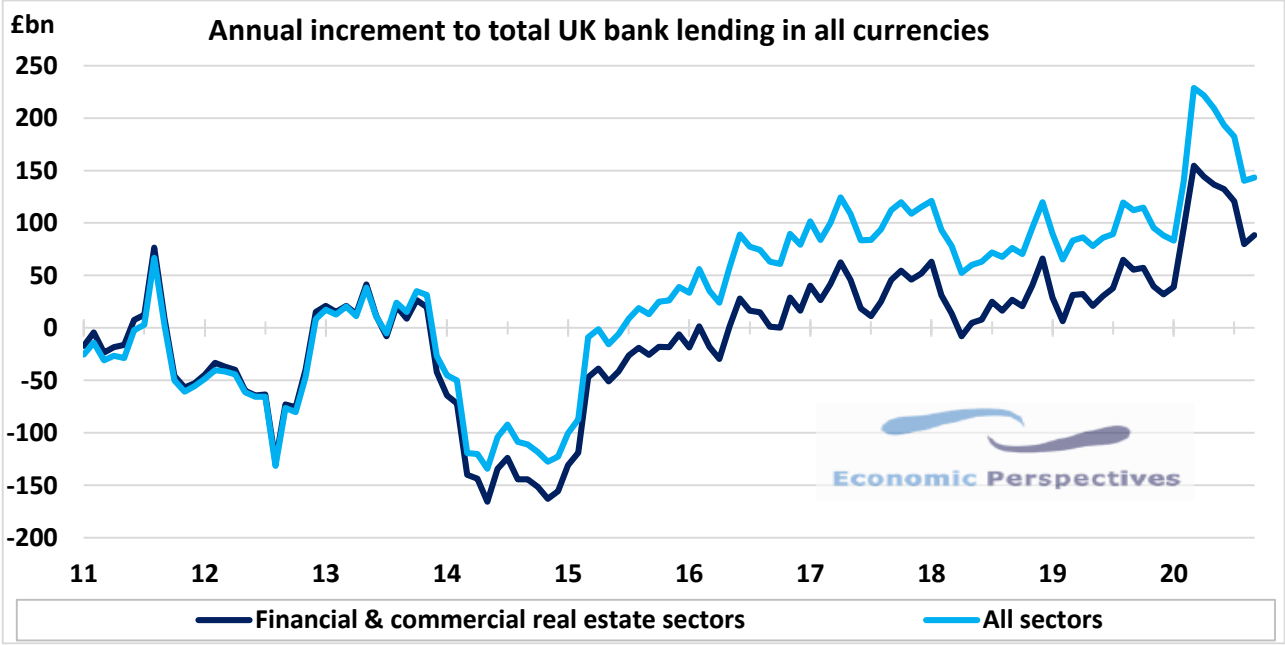
1. Monetary policy failings undermining financial stability

- Financial repression has weakened the solvency of long-term savings institutions – pension and life insurance funds



1. Monetary policy failings undermining financial stability

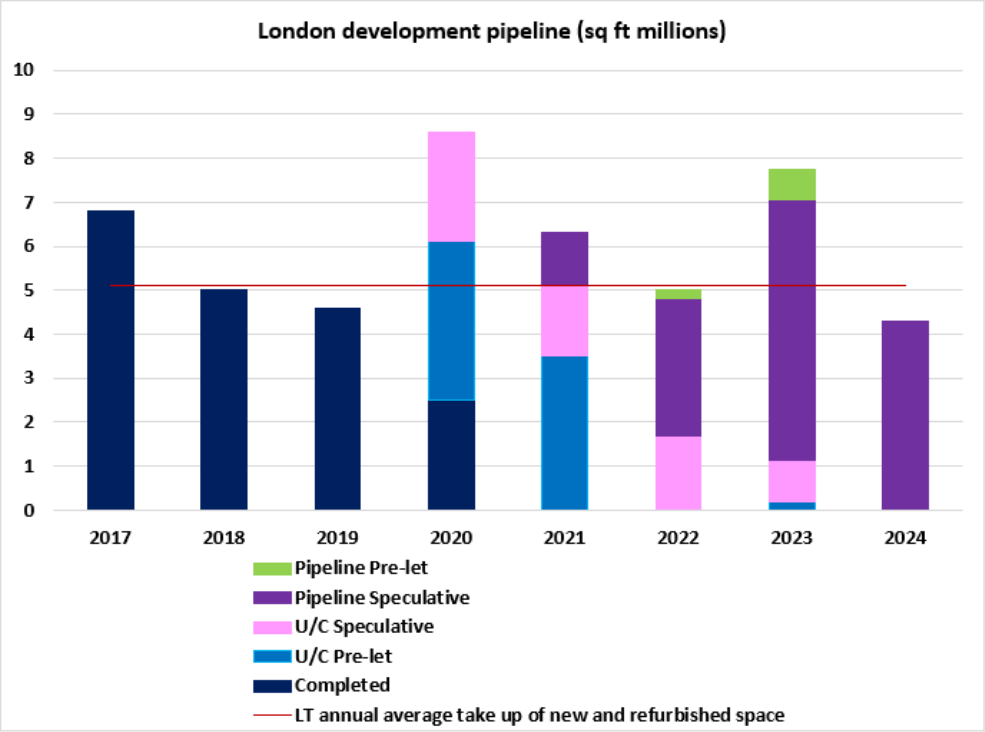
- Revival of bank lending from 2015 was skewed towards financial intermediaries: 43% of total over past 5 years and 62% in the past year
- Financial leverage underpins UK asset prices



2.Over-confident expansion of commercial real estate

- Prime property yields have arbitraged towards the repressed gilt yields, fostering over-confident real estate expansion

Covid-19 is likely to bring severe curtailment in demand for office and retail space over the next few years



Source: Knight Frank

2.Over-confident expansion of real estate

WEST END OVERVIEW

LEASING MARKET

SQ FT	Q3 19	Q4 19	Q1 20	Q2 20	Q3 20	% CHANGE 3M	% CHANGE 12M	LONG-TERM AVERAGE
Take-up	1.03 m	1.53 m	0.66 m	0.43 m	0.34 m	-21%	-0.67%	1.16 m
Availability	4.56 m	4.29 m	3.68 m	4.28 m	5.33 m	25%	17%	5.05 m
Vacancy Rate	5.3%	5.0%	4.2%	4.9%	6.1%	24%	15%	6.0%
Active Requirements	2.22 m	2.10 m	2.15 m	1.49 m	1.36 m	-9%	-39%	2.06 m

CITY & SOUTHBANK OVERVIEW

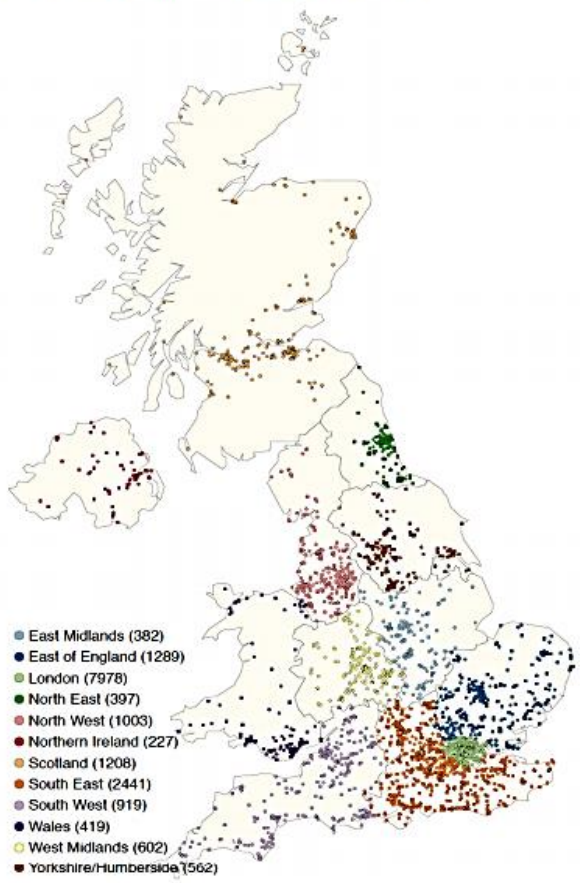
LEASING MARKET

SQ FT	Q3 19	Q4 19	Q1 20	Q2 20	Q3 20	% CHANGE 3M	% CHANGE 12M	LONG-TERM AVERAGE
Take-up	1.97 m	1.62 m	1.28 m	0.54 m	0.63 m	17%	-68%	1.74 m
Availability	6.14 m	6.43 m	7.16 m	7.47 m	7.99 m	7%	30%	8.32 m
Vacancy Rate	5.0%	5.2%	5.7%	6.0%	6.3%	5%	26%	7.0%
Active Requirements	5.58 m	5.17 m	4.44 m	3.51 m	2.82 m	-20%	-49%	4.18 m

3. Brexit was a regional issue

- London was outvoted by the regions

Figure 2: Equity Finance Deals by Company Location



Yellow=Remain; Blue = Leave

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/821902/sme-equity-finance-regions-research-2019-012.pdf

3. Brexit: punitive exit terms for financial sector

- Jobs turnover in London has been plunging since Brexit, down nearly 80% in the past 3 years, with identified job losses of around 25,000.
- Worst hit sectors:
  automotive, transport, food & drink

Source: Morgan McKinley

Brexit Job Loss map

3. Brexit: punitive exit terms for financial sector

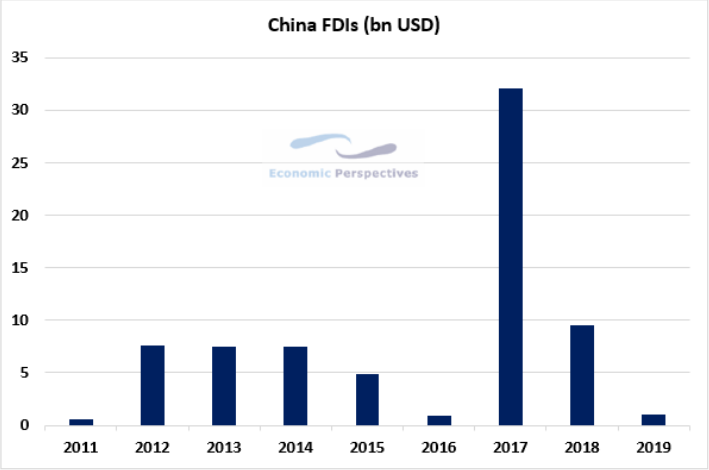
- UK investment banking failed to obtain the "equivalence" ruling needed to replace "passporting" regime of EU member states
- UK clearing houses have equivalence for 18mths from January, to facilitate derivatives contracts
- Banks have established subsidiaries in Dublin, Paris and Frankfurt to ensure business continuity
- Potential loss of up to a quarter of UK financial services revenues, including from overseas banks using London as an EU gateway

4. Vulnerability to replacement of LIBOR by SOFR/SOFIA

- Positioning of collateral for repo is critical
- LIBOR regime to close at end-2021
- US financial institutions are c. 70% of the activity of the City. Offshore hedge funds, another 20%
- Funding source switches from interbank liability (LIBOR) to secure collateral based offshore
- Where will USFI's house their collateral – in UK or US jurisdiction?
- City has the infrastructure, but the collateral is in US and is now dependent on US Fed and govt

5. Souring of UK-China relations

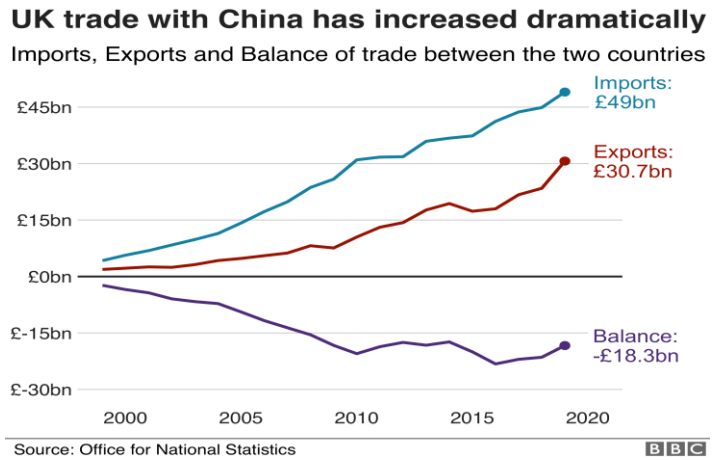
- China has become a more important economic partner in recent years

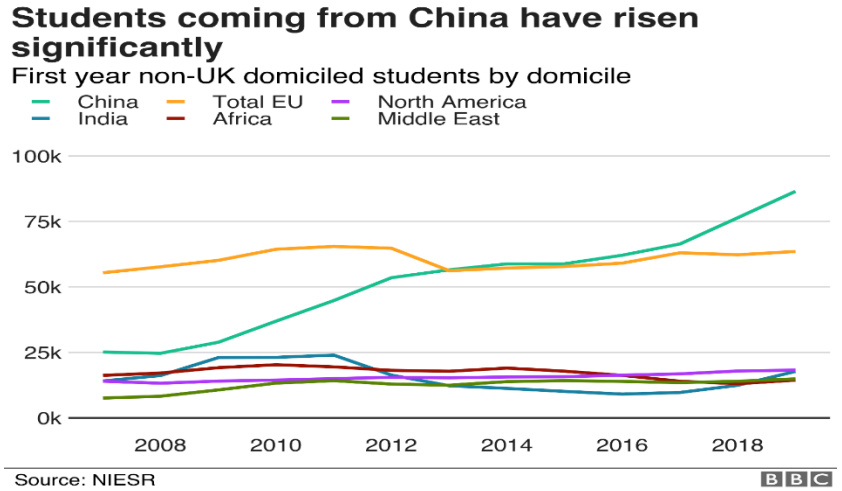


Source: Financial Times

China is a major investor in the Hinkley Point nuclear power plant in Somerset

Image removed





6. Covid-19 has overturned London's advantage

Data period: 13 February - 29 September 2020
Date updated: 9 October 2020

Mapping city centre recovery

Footfall

Top 10

Basildon	132
Chatham	129
Birkenhead	123
Blackpool	116
Burnley	112
Doncaster	108
Telford	107
Southend	105
Wigan	103
Bournemouth	102

Bottom 10

London	35
Manchester	51
Cardiff	51
Birmingham	55
Oxford	55
Liverpool	59
Edinburgh	60
Leeds	61
Glasgow	62
Newcastle	65

Spend

Top 10

Blackpool	116
Huddersfield	110
Burnley	109
Birkenhead	105
Barnsley	104
Northampton	103
Hull	102
Bournemouth	101
Basildon	102
Plymouth	101

Bottom 10

Aldershot	57
London	59
Coventry	65
Southampton	66
Newcastle	66
Oxford	67
Manchester	67
Cardiff	68
Sunderland	69
Edinburgh	70

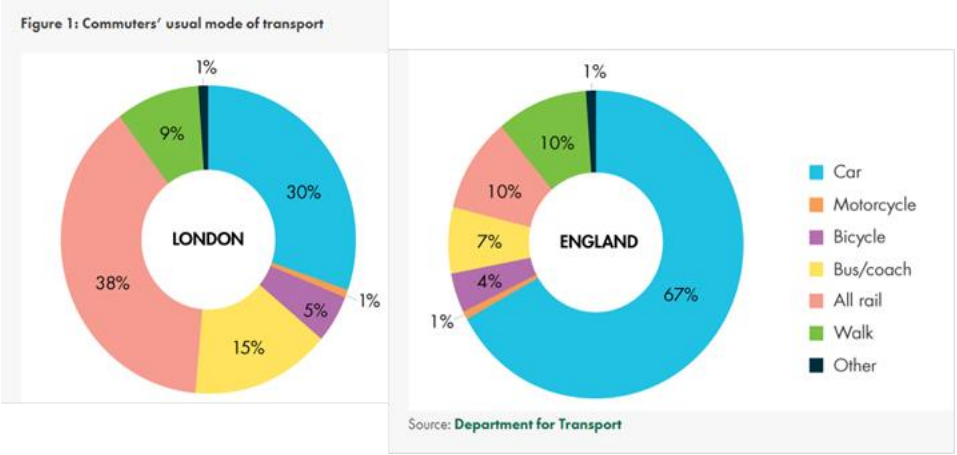
This map shows the average footfall in city centres for the last full week of September, compared to pre-lockdown levels. It shows that, although all cities experienced a sharp drop in activity as a result of the lockdown, some are seeing it return faster than others.

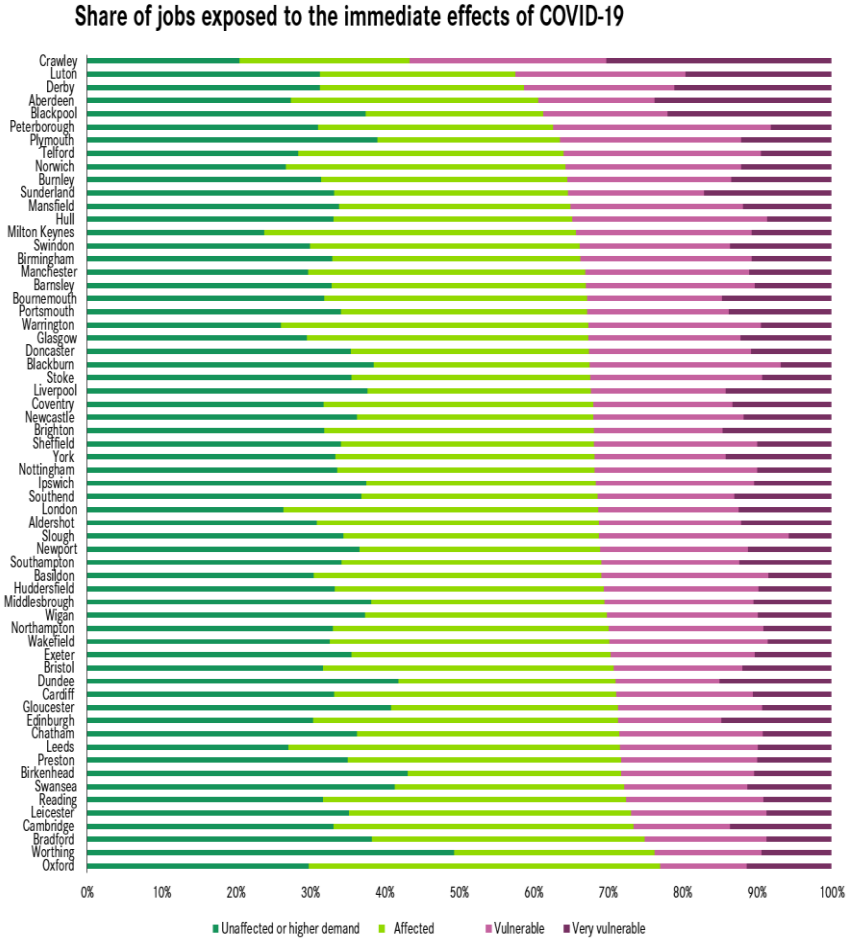
The darker the green, the closer the city centre is to its pre-lockdown levels.

6. Covid-19 has overturned London's advantage

- Devastation of the commuter economy

While London's sectoral composition does not suggest that it is especially vulnerable to the impact of Covid-19, its much more concentrated use of public transport implies a much larger impact from social distancing





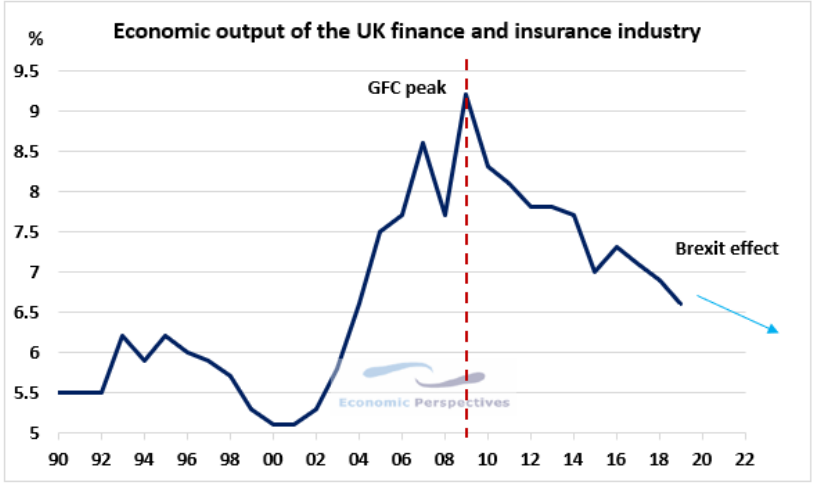
6. Covid-19 - the fiscal threat

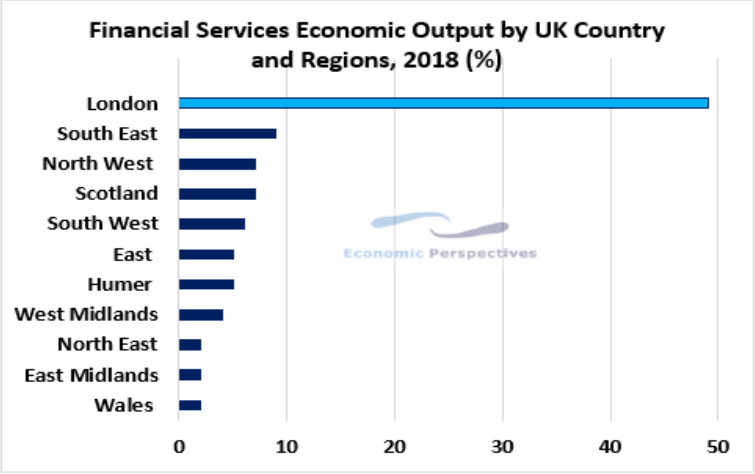
- Colossal increase in the budget deficit in 2020 implies that strenuous efforts will be made to bring the public finances under control in 2021-23
- London's financial wealth and premium incomes will be prime targets for additional taxation, including owners of second homes and buy-to-let landlords
- Proposals to raise corporation tax rate to 24%
- Already, there is a proposal to withdraw VAT refunds for non-EU visitors from January 2021

The rebalancing has begun

- Humbling of finance started with the GFC
- Fastest growing sectors in last 5 years:

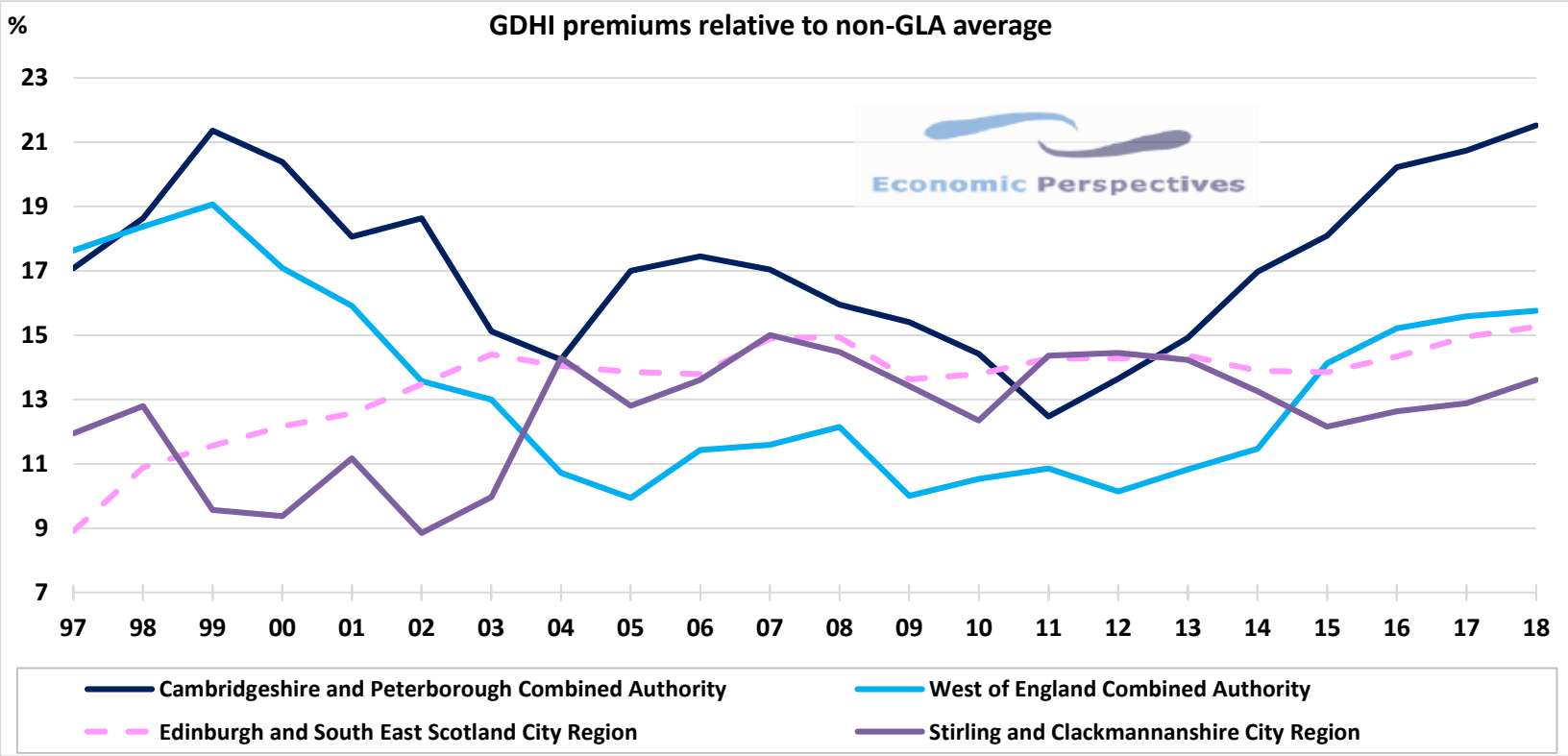
  Transport, storage and communications (3.6%)
  Scientific administration and support (3.5%)
  Construction (3.2%)
  Wholesale and retail trades (2.9%)





The rebalancing has begun

- Some promising regional growth trends, but evidence of a Northern Powerhouse effect is absent thus far



The case for UK's regional hubs

- Profiles of best performing cities and large towns

Category	Characteristics	Examples
Super cities	(Very) strong on a range of indicators.	Cambridge, London, Oxford
All-rounders	Strong performance regarding business and university innovation but not as strong as the super cities when it comes to output.	Bristol, Derby, Edinburgh, Manchester
Business innovation-led innovators	(Very) strong innovation output (mainly patents). Strong business, weaker or very weak university innovation (or no university at all).	Slough, Reading, Crawley, Aldershot
University-led innovators	Strong innovation activities by universities.	Cardiff, Coventry
Applied innovators	(Very) weak innovation output despite doing well in the rest of the indicators.	Luton, Southampton
Commercialisers	Cities in the top 30 per cent with appropriate basic requirements. Most of them are strong in the commercialisation of ideas but have less complex innovation systems.	Leeds, Glasgow, Milton Keynes
Disjointed innovation system	Cities scoring highly for basic indicators but lacking crucial innovative capacity.	Aberdeen, Swindon, Birmingham

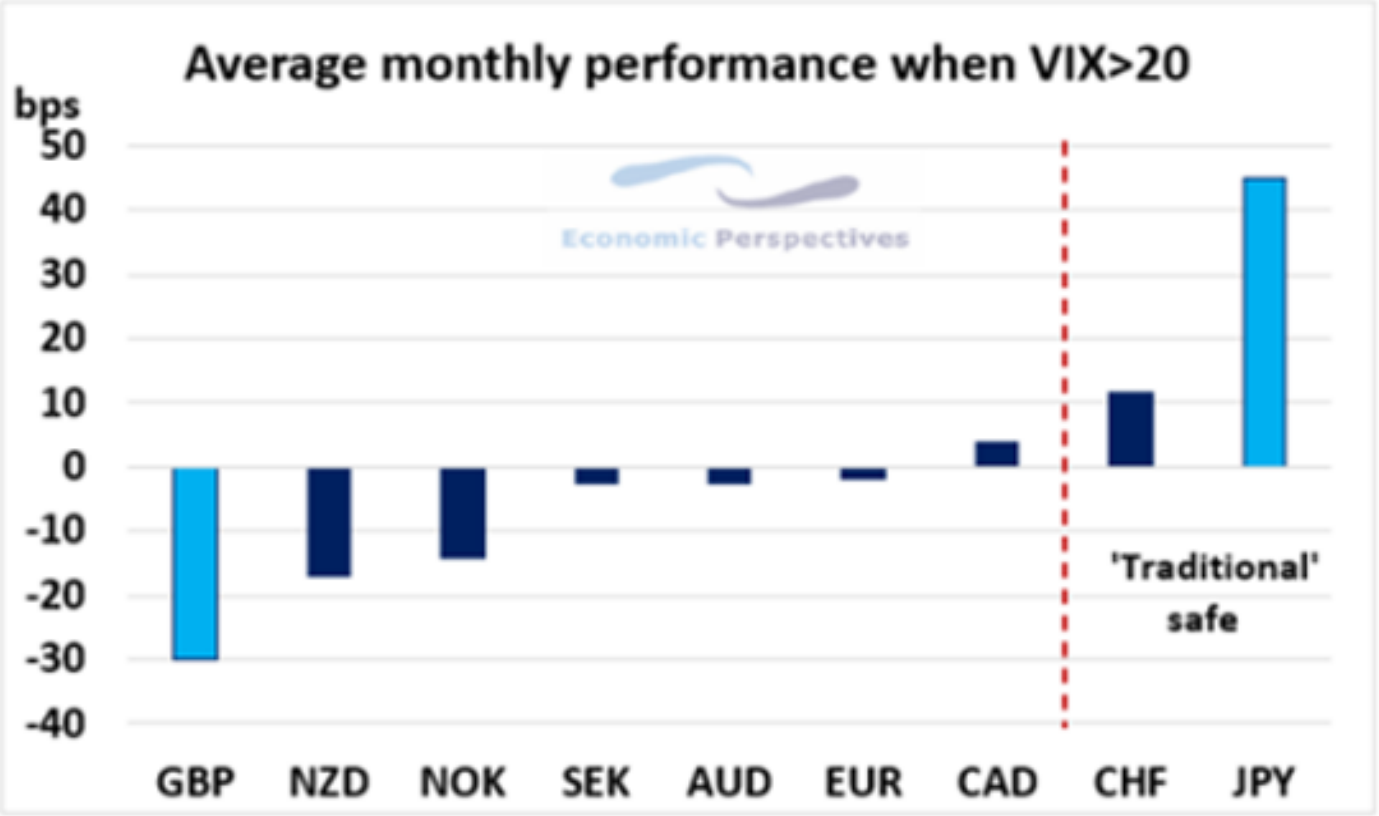
Source: https: //cp.catapult.org.uk

Key aspects of regional development

- Revitalisation of regional cities
- Enterprise zones with lower taxes and lighter regulation
- Expansion of local borrowing facilities and local government bond issuance
- Fast-track expansion of renewable energy capacity
- ? Postponement/cancellation of HS2 and diversion of resources into regional transport
- Roll-out of 5G and ultra-fast broadband to rural areas

Potential implications: Sterling to act as the safety valve

- Sterling generally depreciates strongly in periods of high-volatility regime



Source: Eikon Reuters, EP calculations

Potential implications: downgrading of UK sovereign debt

- A shift to the upper medium grade?

Description	S&P	Moody's	Fitch	DBRS	Grade
Prime	AAA	Aaa	AAA	AAA	Investment
High Medium Grade	AA+	Aa1	AA+	AA(high)	
	AA	Aa2	AA	AA	
	AA-	Aa3	AA-	AA(low)	
Upper Medium Grade	A+	A1	A+	A(high)	
	A	A2	A	A	
	A-	A3	A-	A(low)	
Lower Medium Grade	BBB+	Baa1	BBB+	BBB(high)	
	BBB	Baa2	BBB	BBB	
	BBB-	Baa3	BBB-	BBB(low)	
Speculative	BB+	Ba1	BB+	BB(high)	Speculative
	BB	Ba2	BB	BB	
	BB-	Ba3	BB-	BB(low)	
Highly Speculative	B+	B1	B+	B(high)	
	B	B2	B	B	
	B-	B3	B-	B(low)	
Substantial Risk	CCC+	Caa1	CCC+	CCC(high)	
	CCC	Caa2	CCC	CCC	
	CCC-	Caa3	CCC-	CCC(low)	
Extremely Speculative	CC	Ca	CC	CC	
	C	Ca	C	C	
In Default	RD	C	RD	RD	
	SD	/	SD	SD	
	D	/	D	D	

Source: World Government Bonds

Potential implications: house price differentials to narrow

	H1 2020 (actual)	H2 2020	2021	2022	2023	2024	5 years to 2024
London	3.7%	1.5%	0.0%	1.0%	4.0%	2.0%	12.7%
South East	2.3%	3.5%	0.0%	2.5%	5.0%	3.0%	17.3%
East of England	2.3%	3.5%	0.0%	2.5%	5.0%	3.0%	17.3%
South West	1.3%	3.0%	0.0%	3.0%	5.5%	3.5%	17.3%
East Midlands	1.5%	1.5%	0.0%	5.0%	7.5%	5.5%	22.6%
West Midlands	0.7%	1.5%	0.0%	5.0%	7.5%	5.5%	21.7%
North East	0.3%	0.5%	0.0%	5.5%	8.0%	6.0%	21.7%
North West	3.9%	0.5%	0.0%	6.0%	8.0%	6.5%	27.3%
Yorkshire and The Humber	1.8%	1.0%	0.0%	5.5%	8.0%	6.0%	24.1%
Wales	1.7%	1.0%	0.0%	5.0%	7.5%	5.5%	22.3%
Scotland	1.8%	2.0%	0.0%	5.5%	8.0%	6.0%	25.4%
UK	4.0%		0.0%	4.0%	6.5%	4.5%	20.4%

Source: Savills Research

Economic Perspectives

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