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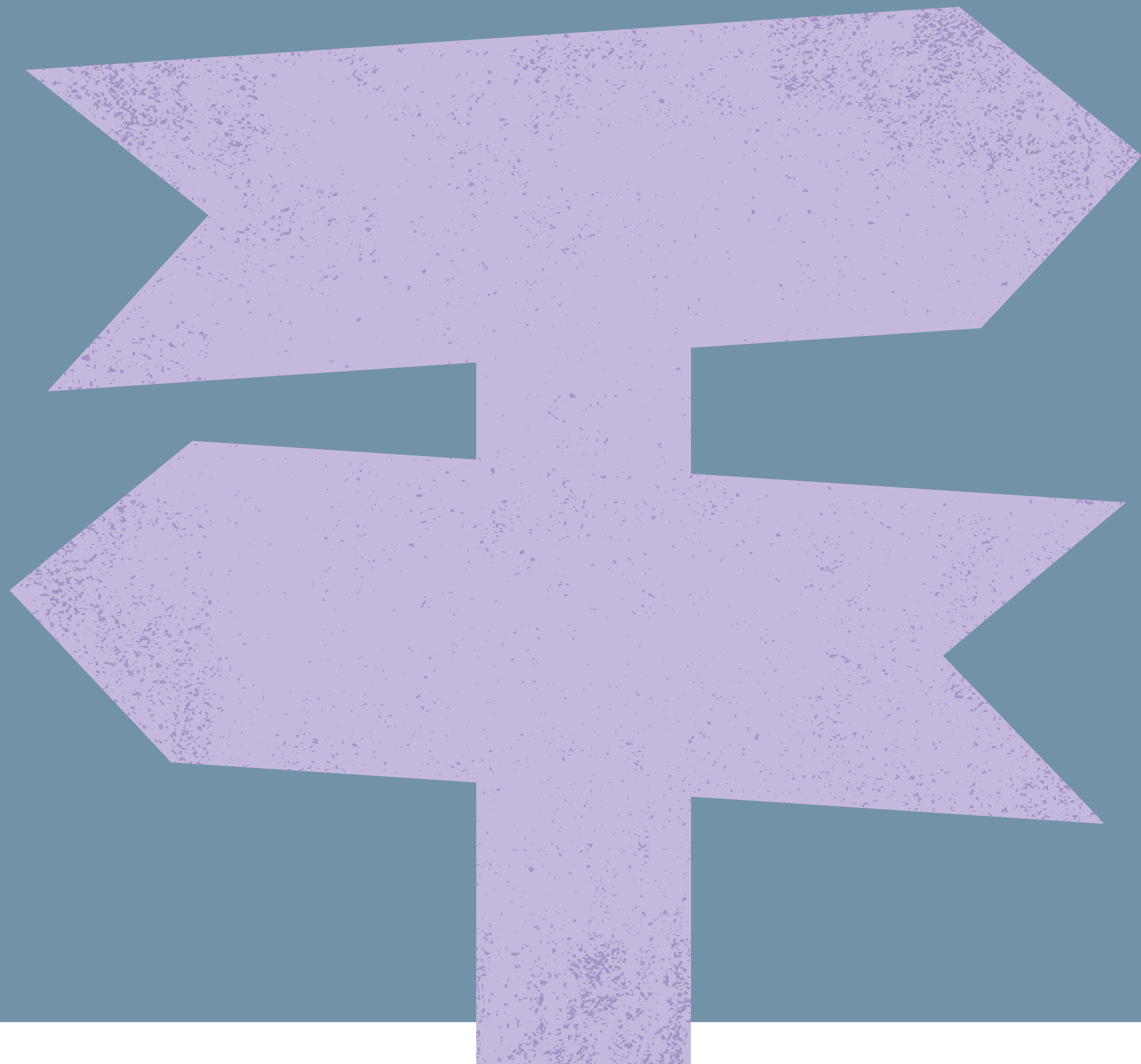
THE YEAR AHEAD: ECONOMIC OUTLOOK BRIEFING 2019/20



INTRODUCTION

The overall picture for charity finances during the next financial year is mixed. There are real concerns about the UK economy, not least from the uncertainty that our decision to exit the EU has created, and the lack of clarity on what our future relationship with Europe will look like. This has also spawned a political malaise which has led to important pieces of legislation being delayed, most notably regarding trade and immigration.

But alongside these concerns, there are reasons for positivity. The UK labour market is going from strength to strength with unemployment at a record low, and employment and labour force participation all at near record highs. Due to better than expected self-assessment tax receipts, the deficit (public sector net borrowing) has fallen faster than previously forecast, and is now well below pre-crisis levels. Furthermore, earnings have started to rise above inflation, meaning more disposable income for individuals, which should translate into opportunities for charity income generation.

With a promise to 'end the era of austerity' from both the Prime Minister and Chancellor of the Exchequer all eyes are the on the upcoming Spending Review (set to be in the autumn alongside the Budget) which will set government departmental spending limits for the next three years. Another poor settlement for government departments central to the charity sector, particularly local government, would mean a likely increase in the number of beneficiaries and a greater demand for charity services, placing further strain on the sector's finances.

While the Autumn Budget 2018 contained some slight reductions to the administrative burden charities face and some additional sector specific pots of money, the concerns around charity expenditure have not gone away. For many charities, particularly those in the social care sector, the planned increase to the National Minimum Wage and National Living Wage has meant staffing costs are continuing to rise, and with a tight labour market and reduced migration this trend is set to continue.

It is understandable that many charities are primarily focused on the immediate challenges that they face, and delivering services to their beneficiaries, but it can be equally important to consider what the near future may bring and how they can plan to mitigate this. We hope this briefing will help charities gain a quick overview of some of the biggest economic issues affecting their finances, and aid in strategic decision making among executive teams and trustees.

NICOLA BARBER
Partner and Head of Charities, James Hambro & Partners

RICHARD SAGAR
Policy Manager, Charity Finance Group

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KEY ECONOMIC STATISTICS

UK GROWTH Q1 2019

0.5%

UNEMPLOYMENT

UK unemployment rate has fallen to historic lows of

4%

EARNINGS

3.1%

Median full time weekly earnings are expected to increase to 3.1% in 2019

UK GDP GROWTH

1.2%

Growth forecasts have been downgraded for this year and are also set to remain below 2% for the foreseeable future.

THE EMPLOYMENT RATE WAS OVER

75%

higher than a year earlier and the joint-highest since comparable estimates began.

INFLATION

2%

The OBR has forecast that inflation is set to remain within or below the Bank of England's 2% target for the next several years.

INTEREST RATES

0.75%

ECONOMIC OUTLOOK BRIEFING

THE BIG PICTURE

It's hard to find a time in recent history where there has been more uncertainty in the global economy. There is continuing uncertainty in the UK, largely resulting from Brexit and the political turmoil which has accompanied this (which will likely to continue for the foreseeable future), a volatile US stock market, Chinese growth flagging (due to a sharp decline in total factor productivity), and Eurozone growth at its slowest pace for four years.

While it is unwise to predict precisely when recessions will occur, many economic commentators have observed that we are closer to one than not. The International Monetary Fund has warned that the storm clouds of the next financial crisis are gathering, with predictions that global growth is set to plateau as a result of a US-China trade dispute.

In the UK, the most recent forecasts from the Office for Budget Responsibility (OBR) have downgraded expectations for UK growth to 1.2% in 2019/20 with it expected to rise slightly to 1.4% in 2020/21. Alongside some causes for pessimism, there are some reasons to be optimistic. Inflation is forecast to fall to the Bank of England's 2% target by 2020, and there is continuing good news from the labour market.

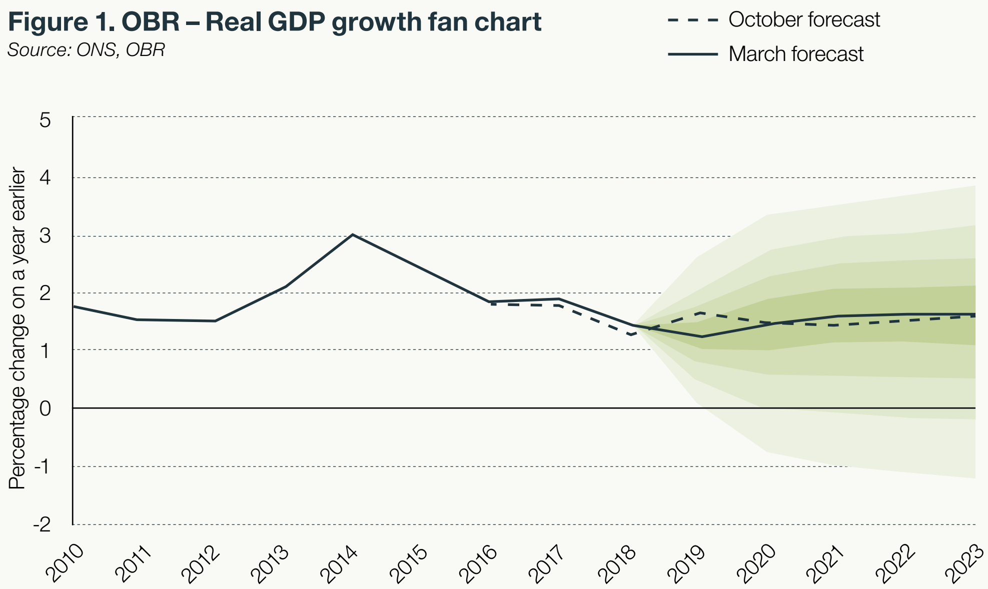
Unemployment is expected to remain at roughly 4% for the next few years, and the economic inactivity rate is expected to be just above 20%. These figures are at the joint lowest rate since estimates began in 1971.

Britain's economic growth has slowed sharply in the fourth quarter of 2018, with growth of only 0.2%, as both consumer spending and industrial production have contracted. There is little sign that things will get better this year. In spite of this anaemic growth, public sector net-borrowing (the deficit) is predicted to fall much faster than expected to £22.8bn in 2018/19, reducing even further to £13.5bn by 2023/24. In certain respects, the UK's public finances are faring better than many predicted.

The pound has continued to fall in value in 2018 and 2019, with any predictions of its future prospects highly conditional on how orderly the UK's departure from the European Union turns out to be, with many options still on the table. When forecasts from major financial institutions are considered, there is little consensus on how it will fare in 2019.

Figure 1. OBR – Real GDP growth fan chart

Source: ONS, OBR



INCOME

INCOME FROM INDIVIDUALS

The most recent NCVO almanac indicates that money from individuals continues to be the single largest source of income for charities, making up just over £22bn in total. Looking at the data in detail shows donations make up £7.8bn, legacies £3.1bn, fees for services £6.7bn, with fundraising accounting for £4.7bn.

As mentioned in the previous chapter, there is set to be increased volatility in the wider UK economy, but as evidence from the CAF UK Giving 2019 report shows, the part of this figure covered by individual donations (just over £10bn), has not previously been affected by the wider political and economic environment. For instance when comparing donations directly before and after the recession of 2008, there is very little if any difference. Giving also appears to be unaffected by negative news coverage of the sector or by fluctuations of trust in charities as measured by tracking polls. The data demonstrates that income from donations and legacies has remained fairly stable since 2005/2006. This is not to say that this trend might not change in the future, but should give some comfort to charities.

While the picture so far will be heartening for charities wishing to mitigate shocks which may occur to the UK economy, the impact on fees for services and fundraising is more contingent on earnings and disposable household income. This should not be particularly surprising, as people will only be able to spend money they have.

In considering the latest data and forecasts on real disposable household income from the OBR, it expects there to be a slight increase, but it will essentially remain fairly stable for the next few years, as the national accounts measure of earnings growth remained below the CPI.[1]

The OBR report outlines that real household income growth strengthened in 2018, as average earnings increased and inflation reduced slightly. They have also forecast this trend will continue with a similar modest increase in income growth in 2019, as inflation is expected to reduce further. Overall relatively weak growth in per capita real earning and real disposable income is to be expected for the foreseeable future.

As with all forecasts of this kind, this will be highly dependent on the Brexit negotiations and the knock-on effect this has on the economy.

The OBR's forecast relied on assumptions regarding Brexit which turned out to false (that we would leave the EU on 29 March 2019), and as such, many of the presumptions they make in their models do not take into account the most up to date information we have on the UK's departure from the EU.

WHILE THE CONDITIONS FOR FUNDRAISING ARE CHALLENGING, IT IS NOT TO SAY THAT THERE ISN'T STILL VALUE IN INVESTING IN FUNDRAISING AND TRADING.

Nearly all forecasts and analyses indicate that leaving the EU will have a negative impact on public finances, and it has already meant the economy is 2% smaller than otherwise forecast, but it is difficult to determine the precise impact this will have on disposal household income. Suffice to say it is highly likely that overall it will not be positive.

Bearing all of this in mind we would expect to see a very slight increase in income from fees for services and fundraising this year and next, but as with many of these predictions there is a lot of uncertainty. It is important to note that this is an average projection, with significant variation for individual charities. If your charity relies primarily on individual donations you might not be affected by fluctuations in the economy.

The most up to date figures from the Institute of Fundraising's fundraising ratio survey from 2015 indicated that the rate of return on fundraising investment has continued to decline, and from conversations, it has most likely tightened further in the last year. The additional costs of generating voluntary income, largely resulting from the costs of regulation and GDPR, will have led to a greater squeeze on the fundraising rate of return.

While we do not have figures from the last year or so, people in the fundraising profession do not dispute that it is costing more money to raise funds than it used to, and there is little reason to believe that this trend will change, and the rate of return may even fall further, given the regulatory environment and the macro-economic challenges already outlined.

While the conditions for fundraising are challenging, it is not to say that there isn't still value in investing in fundraising and trading. In fact diversifying the kinds of fundraising you undertake may be the best opportunity to overcome a challenging environment.

Nonetheless, it is likely that there will be additional financial constraints placed on charities.

1. bit.ly/OBRMar19

INCOME FROM GOVERNMENT

PRESSURES ON LOCAL GOVERNMENT FINANCES

While government funding as a whole has been subject to austerity since 2010, cuts in spending have not affected government departments equally. While spending on health and international development have largely been protected, other government departments have borne the brunt of substantial cuts in public spending.

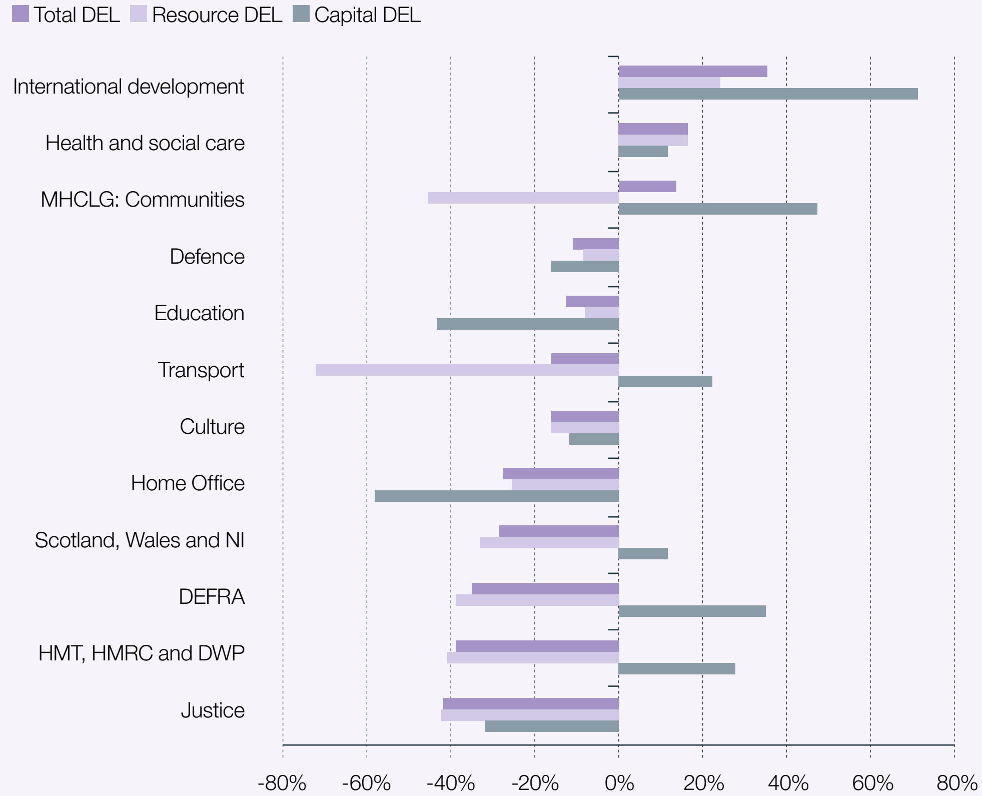
The longstanding commitment to spend 0.7% of Gross National Income (GNI) on international development has been a welcome pledge for INGOs and has meant that spending on international development has increased every year in real terms. With wider economic challenges, there have been signals from the International Development Secretary that this target might not exist in its present form post-Brexit, which, amongst other things, would include private investment contributing towards the target.

If international development has coped reasonably well, local government spending has fared particularly badly, with central government cuts to local authority resource spending down more than 40% in real terms. What makes matters worse is that much of the remaining funding is designated for services where local government has a statutory duty, with adult and children's social care services accounting for the largest share. With an aging population, the spend on these services is set to increase for many years to come, placing further pressures on local government finances. The impact has been felt in many authorities, as demonstrated by Northamptonshire County Council going bankrupt, and subsequently having to make £41.4m of savings in 2019-20. Northamptonshire is not alone, with many authorities struggling to balance their books, facing overspending and having to make further cuts to services. The subsequent effect this contraction has on charities has not only meant that grants to charities have reduced, but also that the number of potential beneficiaries is expected to increase.

In the autumn of 2019 the Chancellor will undertake a Spending Review, which will allocate funding to government departments for 2020-21 and for the next three years. Alongside setting what each department will receive (departmental expenditure limits), the Chancellor will also determine the overall spending envelope (total managed expenditure), which will give clear evidence if the Prime Minister's pledge to 'end the era of austerity' will become a reality.

Figure 2. Real-terms department budget changes, 2010-11 to 2019-20

Source: Institute for Fiscal Studies, The Outlook for the 2019 Spending Review



INVESTMENT OUTLOOK: PICKING A ROUTE PAST MOUNTING MARKET ANXIETIES

NICOLA BARBER, PARTNER AND HEAD OF CHARITIES, JAMES HAMBRO & PARTNERS

As we entered 2018 the economic backdrop appeared overwhelmingly positive. Economies across the globe were expanding, the US unemployment rate was approaching record lows and inflation remained contained. In addition, President Trump had delivered a significant stimulus to the US economy in the form of a corporate tax cut, passed in late 2017. James Hambro & Partners, however, saw a more precarious situation – high bond and equity valuations, the potential for economic momentum to slow from elevated levels, and the lack of another one-off stimulus creating a tough comparative for 2019.

James Hambro &Partners

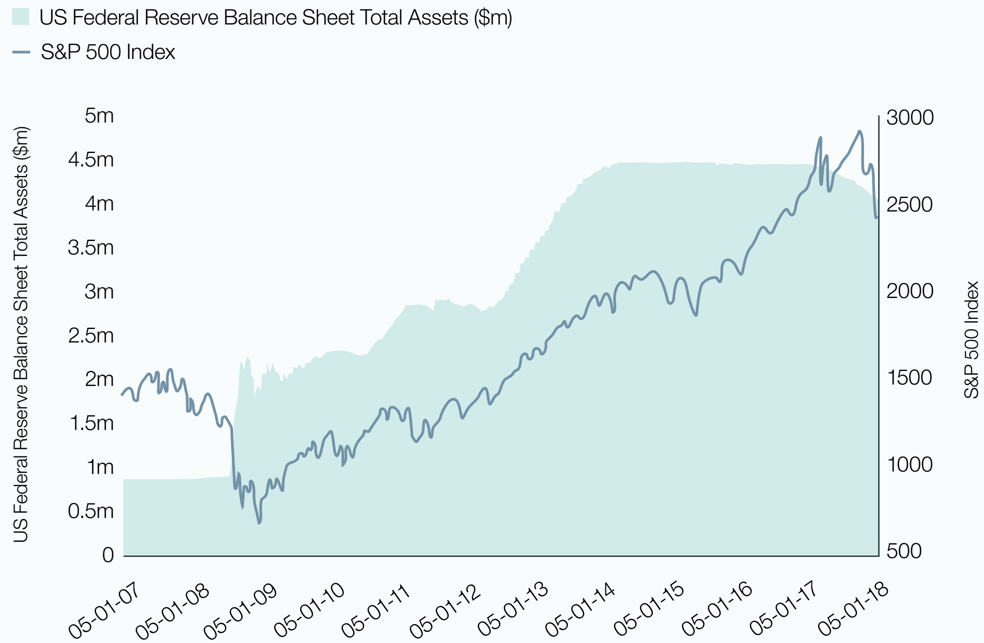
FUNDAMENTAL CHANGE IN FISCAL POLICY

At any point in the past ten years one could have compiled a list of anxieties that make for an uncertain investment landscape and today is no different – Trump's trade wars, slowing economic growth, the continued rise of populism in Europe, and of course Brexit, to name a few. However, while in previous years markets have managed to grind higher, there was a key difference in 2018. Firstly, the US Federal Reserve continued its path of interest rate normalisation, raising rates four times during the year on top of the three increases completed in 2017. But perhaps more importantly, February 2018 was the point at which the 10-year experiment in quantitative easing went into reverse – see Figure 3 – as the Fed started the process of shrinking the balance sheet.

Since 2008, central banks, led by the US, have injected liquidity into the financial system by buying assets in the open market, pushing prices up and forcing bond yields down.

Figure 3. US Federal Reserve Balance Sheet Total Assets ($m) vs S&P 500 Index

Source: Bloomberg Data and the Federal Reserve, January 2019



From April 2018, taking account of all central bank activity across the globe, the world entered, for the first time, a period of quantitative tightening.

The years of central bank stimulus and extremely low interest rates have gradually built up areas of excess as investors have searched for yield and return. In the 2000s, excess was found in the housing market and mortgage-backed securities; today public and private debt are cause for concern. Corporations have taken debt to levels not seen since 2007, while the amount of leveraged loans and high yield debt is now double the amount outstanding in 2007.[2] Slowing growth and high levels of debt, rising interest rates and falling liquidity are key to understanding why volatility has picked up so markedly in recent months.

After many years of asset price reflation and strong returns, we continue to view the global economic setting as precariously balanced. Whilst there is always a list of anxieties, 2019 feels like a year where markets will be more greatly influenced by a confluence of economic factors and political policies, many of which have binary outcomes and may rumble on for months.

2. A leveraged loan is a type of loan that is extended to companies or individuals that already have considerable amounts of debt and/or a poor credit history, S&P Global Market Intelligence

THE UNCERTAIN CONSEQUENCES OF BREXIT

Another significant unknown is the impact of Brexit. The deluge of news and opinion on Brexit in the UK media has perhaps inured UK-based investors to the possible risks, particularly if the UK's departure is prolonged or disorderly. Nevertheless, financial markets are a discounting mechanism – i.e. participants are trying to take a view on future threats and opportunities – so the anticipated consequences of Brexit should already be, in part, reflected in the price of UK equities, gilts and sterling.

Our central view on Brexit is that a compromise will be reached enabling the UK to leave the EU. It is in the nature of these highly charged negotiations that there will be a substantial amount of brinksmanship. The European authorities do not want to make it easy, for fear of setting a precedent, and the UK government has internal discord and a weak grip on power. The risks however are rising.

Our longer-term view is that Brexit would be a mild but persistent negative for the UK economy if we become a high tax economy on the edge of Europe. Sustained economic expansion typically comes from productivity growth and/or population growth. Declining external investment and an end to the frictionless movement of goods, services and labour between the UK and Europe, its biggest trading partner, make it likely that the UK economy will grow more slowly than it would otherwise have done.

The implication for the UK equity market may be less negative, as a large number of London-listed companies are international, not domestic, deriving large proportions of their revenues from overseas, and so should reflect global business conditions and would benefit from weaker sterling.

PROCEEDING WITH CAUTION AND FAVOURING QUALITY EQUITIES

Throughout 2018 James Hambro proceeded with caution for client portfolios, taking risk out and building up cash levels. We have gradually weeded out the companies that carry higher risk for this point in the cycle – in particular, companies that have used debt and acquisitions to grow – and invested in larger, more liquid companies with low debt, high cash flow generation and sustainable dividends. We have rarely had a significant position in corporate debt but today we have no exposure at all.

While portfolios have not been immune to market movements, these actions have helped to mitigate drawdowns, and while equity valuations have come back to more attractive levels and are no longer 'priced for perfection' we do not yet see a significant opportunity to raise the tactical weight in our preferred long-term asset class.

The fourth quarter of 2018 represented the worst quarterly fall for world equities since 2011 and the collapse of 14% was the ninth worst in the S&P 500's history. This was followed by a strong recovery in the first quarter of 2019 despite investor participation seemingly being low and forensic analysis of the bond yield curve inversion (when the long-term bond yields fall below those of short-term US treasuries) highlighting the extent of negative sentiment.

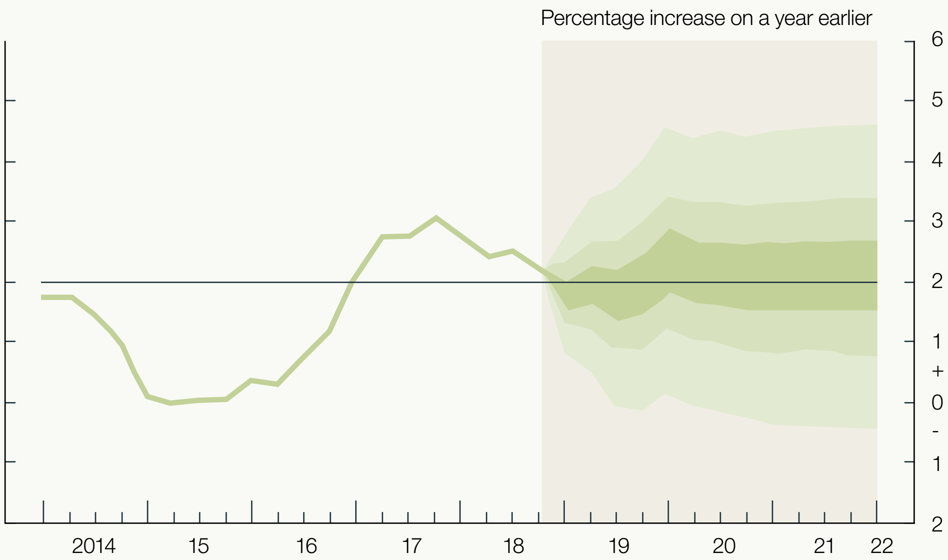
Going forward, we remain constructive on equities following a change of tone from central banks regarding their interest rate policies and remain underweight fixed interest holdings on valuation grounds.

EXPENDITURE
INFLATION

As with previous years inflation continues to be a risk for the charity sector. To merely maintain the current spending power charities will need to generate billions in additional income, and this would be no mean feat with such a challenging environment for generating additional income.

While inflation (CPI) has fallen in Q1 of 2019 to below the Bank of England's 2% target, the Bank of England's central projection predicts CPI to increase slightly to 2.3% by 2020 and then reduce slightly to 2.1% by 2021, remaining at 2.1% in Q1 of 2022. It's important to note that these projections are probabilistic, and as Figure 4 demonstrates, there is still a reasonable chance that inflation could increase to levels not seen since 2011.

Figure 4. CPI inflation projection based on market interest rate expectations, other policy measures as announced
Source: Bank of England February 2019 – Prospects for Inflation



It's important to note that inflation does not occur equally for goods and services. For instance, the prices of health goods and services have decreased over the last year, while education has increased slightly, meaning charities which purchase educational services might have seen prices increase even though the overall rate of inflation has fallen.

Following a report from the House of Lords Economic Affairs Committee report outlining problems with the Retail Prices Index (RPI) the government is set to respond to the recommendations, and may make changes which will have consequences for the way inflation is measured in the future, which could have important implications for the sector.

IT'S IMPORTANT TO NOTE THAT INFLATION DOES NOT OCCUR EQUALLY FOR GOODS AND SERVICES.

OPERATING COSTS

STAFFING

As with previous years, staffing costs account for almost a third of most charities' expenditure, although of course this figure could differ greatly depending on the kind of charity, with some spending far less than this and others much more.

Staffing costs have remained fairly flat for charities during the last decade or so, with wages today at a similar rate as they were in 2011, as on average wages have increased at the same rate of inflation. In fact, the median income in 2018 was still 3.7% lower in real terms than it was before the financial crisis in 2008. This has meant that a charity's wage bill would not have increased sharply over this period.

But there are signs that earnings have begun to pick up and are forecast to increase above the rate of inflation for the 2019/20 period. At the lower end of the earnings the National Living Wage (NLW) and National Minimum Wage (NMW) have continued to increase above the rate of inflation, with the government setting a target for them to reach 60% of the median wage by 2020. There have also been hints that the Chancellor would like to increase this further, although this has yet to be confirmed.

This will mean further cost increases for those charities which employ workers on the NLW and NMW.

Rather than discuss the specifics of the UK government's proposals for migration, suffice to say that with the end of free movement to and from the EU, charities that currently rely on EU workers will likely find it more difficult to hire staff. This will also mean that wages will need to increase, given the increased competition for workers.

Unemployment remains at historically low levels and is forecast to remain well below 5% for the foreseeable future. While many claim that the new jobs that have been created in recent years have been part-time or in the 'gig economy', this is not borne out by the data, which indicates that the vast majority of new jobs have been full-time.

TAX

There were a few administrative tweaks to the tax system for charities in the most recent Budget. These include: increasing the upper limit for trading that charities can carry out without incurring a tax liability, and allowing charity shops using the retail Gift Aid scheme to send letters to donors every three years when their goods raise less than £20 a year, rather than every tax year.

These developments were alongside a change to the Gift Aid Small Donations Scheme (GASDS), allowing charities to increase the individual donation limit under the GASDS to £30. But overall the tax environment for charities has not changed fundamentally in the last few years. However, as has been identified previously by CFG, there have been a number of taxes which have increased, and are set to increase further. There were also changes to business rate relief, with the government cutting bills by a third for retail properties with a rateable value below £51,000 (until April 2021).

While CFG has been pushing hard for reductions to the charity tax burden, given the state of the public finances, and uncertain times ahead for the economy, it is unlikely that there will be sizeable tax cuts in the near future, and depending on what happens to the economy, it is entirely possible that taxes will in fact increase for the sector.

In the longer term, there has been a steady increase in the political pressure on charitable tax reliefs, with a number of commentators calling for reliefs to be decoupled from charitable status. CFG continues to oppose such a move and will continue to lobby on this issue.

As has already been outlined, local government finances have been under severe pressure for some time, so it would be prudent for charities that currently receive discretionary rate relief to plan for further cuts or a loss of the relief entirely, even if this never comes to pass. With the revaluation of business rates on the horizon, occurring during 2021, there could be further bad news for charities, depending on what occurs in the property market.

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