

## Appendix A

### Economic Overview (May 2019)

#### Overview

The view is that after stronger than expected Q1 growth the remainder of the year could prove more of a struggle. Certainly, Q2 data so far has been weak and a further Brexit delay or a “no deal” Brexit, either of which is likely, will do little to offer a boost. Economists suggest that this means GDP growth, interest rates, gilt yields and Sterling will remain lower for a prolonged period. That will not, though, set it apart from the rest of the world, which is also stuttering on trade worries and the broader impact of the trade war on global economic prospects. Consequently, the UK economy is in much the same place as the EZ in Q2.

Market inflation expectations in the EZ have eased to levels where the ECB has previously relaxed policy. Indeed, the central bank’s indicator, the five year/five year inflation swap level is at a near three year low. The ECB suggested, in April, that this was down to a lower expectation of inflation overshooting the target level, but the level has, subsequently, fallen further. Economists are now looking for the ECB to strengthen

forward guidance and put generous terms to the TLTROs being introduced in the Autumn. However, that may not markedly raise expectations, which could result in the need to revert to additional Quantitative Easing.

Falling US core inflation appears to be of little concern to the Fed. However, with stock market gains at a near record high, those downside influences are being reversed. Nevertheless, even removing these factors, core inflation has softened, which must be

down to a slowing in unit labour costs growth, which is likely to push core inflation lower still. While the imposition of tariffs on Chinese goods may put upside pressure on consumer prices in the latter part of the year, the Fed will likely focus more on the effect on real activity. Analysts see Q2 GDP growth of less than 2% annualised, which raises the possibility that interest rates could be cut before year end.

Japanese Q1 GDP growth of 0.5% q/q was unexpected and coupled with total hours worked falling by 3% q/q has put productivity at its strongest level in nearly four years. This is in line with evidence that firms have been increasing investment spending when faced with capacity shortages and the tight labour market. Software investment hit record levels, with business investment likely to remain high relative to output. As such, productivity growth should remain solid, but though this is good for growth it is not what the Bank of Japan needs in its quest for 2% inflation.

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Chinese retail sales growth slowed to the weakest rate since 2003 in April. In part this was down to falling fuel prices, but there was also a reduction of spending on household appliances, furniture and food, suggesting a broad-based weakness, which indicates signs of household caution about the future. That is reflected by the dip in Q1 consumer confidence, with the worsening trade relations between the US and China only going to add to the problem.

**UK**

Q1 proved better than expected with a pick-up of quarterly growth to 0.5%. However, that may have been inflated by activity being brought forward ahead of the original 29th March Brexit date, with the likely consequence being a subsequent easing in Q2. Stock building was a key driver, but as some of this was imported, the increase of imports saw a negative contribution from net trade. That said, there will also have been some activity driven by a no-deal withdrawal. Government consumption and investment increased, with business surveys indicating that firms' investment will remain subdued. Surveys have been fairly downbeat about Q2, with the composite PMI consistent with little or no growth, while the manufacturing sector activity appears to have contracted. The CBI growth indicator is similarly pessimistic, and forecasters suggest that Q2 GDP growth will recede close to zero.

After a strong opening quarter, household spending will be pared back, but a sharp downturn is not expected. April retail sales were flat but that followed healthy growth through Q1. The BRC and CBI sales activity measures fell in May, but this was down to unwinding the boost generated by the impact of the early Easter. That said, annual sales growth is still expected to slow in the near future. There was a slight improvement in the services PMI, which suggests that spending in the sector has improved. Meanwhile, the healthy labour market is underpinning consumer confidence, which in turn could see spending supported by a pickup in household borrowing.

Weakening overseas activity is likely to result in slowing export growth, which will impact on the short-term outlook for the external sector, which is confirmed in the PMI survey. Real import volumes increased by over 2% in Q1, as firms looked to stock up ahead of the original Brexit date. The import surge saw net trade make a negative contribution to Q1 GDP, and pushed the trade deficit to a record high. Goods import volumes should recede in Q2 as stockpiles are unwound, which should see net trade add to Q2 GDP growth. US-China trade problems should not impact on the UK too greatly.

While the labour market may have seen employment and earnings growth slow, this does not point to any sharp reversal. The rate of unemployment hit a 44 year low of 3.8% in March, with full time

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employment still on the increase. Nonetheless, the rate of annual employment growth slowed to 1.1%, with survey evidence pointing to greater slowing ahead.

Consumer price inflation should remain around the 2% target but has the potential to rise early next year. The bump to 2.1% in April was, largely, due to rising utility prices and a later Easter. Some retracement is possible in May, while the decline in sterling oil prices will have a drag effect on inflation a little later. Core goods inflation fell to 0.1% in March, the weakest since January 2017, but this is merely a lagged impact of the earlier decline in import price inflation and, therefore, should not be sustained. Underlying price pressures were evident, with input price inflation edging higher to 3.8%, while core services inflation was also a touch higher at 3.1%. This raises the prospect that higher wage costs will add to inflationary pressures, which will lead to CPI heading higher, above 2.5% in the early part of 2020.

The political situation in the UK took its inevitable turn when Prime Minister, Theresa May, announced that she will stand down on June 7th, having failed to make any headway in gaining approval of her Brexit deal from the House of Commons despite numerous attempts. The obvious suspects were immediately put into the frame, some making their intentions clear early on, while one or two lesser lights also put their hands up. Front runner from the off is Boris Johnson but will he be able to pull the party together and garner the support that he needs through what promises to be an exhausting period at the hustings. The circus surrounding the selection will be in town for some time and in the meantime Parliamentary business will be side-lined...but then that has been the case for some time, with Brexit. If the process runs its full course, the PM's successor is not expected to be announced before late July, possibly just after the Parliamentary summer recess commences. The incoming leader will then have just over three months to Brexit, which is not much time for negotiations, unless you are a hard Brexit PM, in which case that may be more than enough. Markets will monitor developments and the promises of the candidates closely, with the emergence of a hard Brexit favouring leader a potential cause for market concern. The uncertainty continues.

### Monetary Policy

Monetary policy in the UK remains on hold as the Brexit debate continues, with the clock winding down to the October 31st withdrawal date. The discussion has been given a fresh edge with the Conservative Party leadership election, the result of which could totally reshape policy in this regard. The increased prospect of a "no deal" withdrawal, if a hard line Brexiteer is installed as the new leader/Prime Minister, has raised all sorts of questions and added to the uncertainty that already existed. The Bank of England MPC probably wants to raise rates given the signs of increased upside inflationary pressures, but the combination of Brexit and growing concerns about the global

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economy has kept members straightjacketed where monetary policy is concerned. There will be a national sigh of relief once Brexit has been concluded, as this one topic has reduced the government of the country and effective central bank policy to secondary importance. Market expectations are that policy will remain unchanged for the remainder of the year and into 2020.

The ECB's policy stance has been clearly stated ... it does not see any policy change until mid-2020 at the earliest, given their concerns about economic slowdown.

The Federal Reserve has indicated that it is most unlikely to raise US interest rates this year, offering a dovish view of both domestic and global economic prospects. Analysts believe that even this softer view is still likely to prove over-optimistic and the central bank may be forced into cutting rates if the US economy slows as some fear.

It is hard to see Japan raising rates while the economy continues to struggle to generate desired levels of inflation. China, though, could move in order to undermine some of the impact of the US tariff policy. An easing of policy would weaken the Renminbi and make its goods cheaper to import, and this will be helped by the Fed's change of tack regarding its interest rates.

*Source: City Watch June 2019 - Link Asset Services*