Appendix A

Economic Overview (August 2019)

Overview

The risk of a UK recession was evidenced by the 0.2% q/q contraction of GDP growth in Q2 and the weak August PMIs, but economists are confident that Q3 should prove better, and recession averted. The early holiday closure of car production in April means that the usual negative impact seen in August will not be felt this year, which should provide a sufficient boost to ensure that growth does not decline. However, looking ahead, performance will be defined by Brexit. While a “no deal” may not happen at the end of October, this might still only be kicking the can down the road to January if an extension to the process is requested/granted. If a deal can be achieved then the economy will just be at the mercy of the state of the global economy, but if a “no deal” proves the only way to exit the EU then there could prove to be more serious concerns.

The Eurozone economy is coming under some stress but to date, with manufacturing facing a downturn, the services sector is holding up well and providing a crutch on which the bloc can lean … for the time being. The services PMI business activity index points to solid, but unspectacular annual growth of 1.5%. The internally focussed element of the sector is being underpinned by the steady and gradual improvement in the labour market, where levels of unemployment are at a near 11 year low. Hiring intentions, though, point to slower employment growth to come and that labour shortages are not so great, which has been reflected in a slowing of wage growth in some areas. If household incomes weaken, and expectations of such increase, then the outlook for the services sector is not so upbeat, which in turn has implications for growth in the economy.

The inversion of the yield curve heightened fears of a US recession, but that is not reflected by data coming out of the real economy. Three of the coincident indicators of a turn in the economic cycle are still trending higher; the one exception is industrial production, which has been dragged into negative territory by the recession in the manufacturing sector. The change in the yield curve, though the best indicator

of a coming recession, is not being supported by any weakening in building permits or the stock market or an increase in jobless claims.

Japanese Q1 GDP growth was more robust than analysts had been expecting despite a marked slowing of employment growth. That slowing is more a function of structural problems than a cyclical issue, thus further declines can be expected. Q2, meanwhile, saw output per worker improve for the first time in two years. Given that business investment is expected to remain high relative to output, falls in employment growth will be less significant and productivity growth should improve. That improved output per worker could be a result of increased demand ahead of the October sales tax hike, which may, subsequently, see a dip as demand drops in Q4, but the underlying trend is higher.

Domestic problems in Hong Kong could cause problems for financial flows into China as the separation from the mainland has enabled the City to operate on a different system, which remains attractive to external investors etc. However, the ongoing disturbances have highlighted the increasing distrust among Hong Kong citizens of their mainland rulers in maintaining this differential, with the risk that the state may move in to quell the protests. With the City such an important offshore, global financial operation the thoughts are that the Chinese government will refrain from overly aggressive action. However, the economics of the position may be of less importance than the putting down of unrest, to prevent spread of unruly behaviour to the mainland. The world will keep a watching brief …

UK

A small bounce in GDP growth is expected in Q3 to avert a (technical – i.e. two consecutive quarters of negative growth) recession, particularly as businesses halted stock building and car manufacturers took early holidays in Q2. With car plants, unusually, staying open in August, this should be positive for Q3 GDP growth, but, notwithstanding this, economists put underlying growth at 0.2% q/q. The manufacturing/construction PMIs have slumped in recent months, but the services equivalent has held up well. This is likely to maintain the Q2 rate of growth at 0.1% through August, though the CBI growth indicator reflects Q3 stagnation. Some

analysts are expecting quarterly growth to be at 0.4% in Q3, but there are downside risks.

Household spending growth remained solid despite a slight slowing to 0.6% q/q in Q2. Provided there is not a “no deal” Brexit, there is no reason to think that this pace could not be maintained. The August Gfk consumer confidence index is consistent with 2-3% y/y retail sales growth. Meanwhile, stronger car sales in August suggest that, away from the high street, spending levels are holding up. Growth of household spending may have peaked for the time being but is not expected to go into a sharp reversal, given that steady income growth is forecast.

Brexit preparations have weighed on trade data for some time, but there is no doubt that external demand remains softer. The Q1 surge in imports ahead of the March Brexit date was reversed in Q2, with the swing reflected in net trade’s contribution to GDP, but the influence on overall growth was more than masked by increased stock building. Weaker global trade has dented exports, with those to the EU declining by comparison to elsewhere, reflecting some impact from Brexit. There has been some benefit to the UK from the Sino-US trade conflict, as exports to each have increased, as new suppliers are sought to avoid tariffs. However, forward looking indicators of exports remain consistent with weak external demand continuing.

Employment growth of 1.3% y/y in June remained above the long-term average, so Q2’s slowing rate of economic activity has not affected the labour market. The participation rate regained its 28-year peak of earlier in the year, which pushed the rate of unemployment a tick higher, to 3.9%. Average earnings growth, meanwhile, picked up to 3.7%. The strong rate of hiring looks unsustainable given that the labour market lags activity levels. The PMI employment balances are consistent with growth slowing to 0.7% by next year, while declines in job vacancy levels suggest a sharper ease. Wage growth may also have peaked according to surveys, but it should be sustained by the tight market conditions.

Consumer price inflation picked up to 2.1% and will remain around the 2% target before picking up in 2020. The decline in later 2019 will be the result of lower utility prices. A bounce in 2020, though, is likely as stronger wage growth should push up

core services inflation, while Sterling weakness will maintain the higher levels of core goods inflation.

Monetary Policy

With the debate over exactly how the UK is to achieve Brexit still as fractious as ever, the possibility, or indeed the likely direction of a near term change in monetary policy remains unclear. The markets are looking for a rate cut sometime in the next nine months, but some of this is premised by a “no deal” Brexit and the potential requirement to stimulate the economy in the wake of leaving. As this report was written, the problems facing the Government have pushed it to the brink, with no majority, the Prime Minister losing all of the key votes, including that passing a law to prevent a “no deal” Brexit in October, and a complete impasse over how to leave, he has called for a General Election. Will an election resolve the problem … or just return another hung Parliament? Either way, whoever accepts the keys to Number Ten will not find a resolution to the problem any easier to achieve. In the near term, the Bank of England’s Monetary Policy Committee will continue to sit on its hands and wait for an outcome of any variety to present itself before it takes any action.

The ECB’s policy stance has been redefined. With the economy struggling to generate sustained growth, the central bank has made it clear that a rate cut and further QE will be forthcoming. The timing is likely to be the end of Q3/beginning of Q4, just as Mario Draghi vacates his office and Christine Lagarde slips into his barely chilled seat. Analysts suggest that stimulus will provide little support for bank lending, but lower interest rates will feed through to lower borrowing costs, with the recent Bank Lending Survey indicating that demand for mortgages increased in Q2, but there was a sharp dip in demand for consumer credit.

The Federal Reserve cut interest rates by just 0.25% and then dampened expectations about future cuts. This will not sit well with the President who remains critical of the central bank for keeping rates too high, for too long. Markets still believe that the Fed will cut further but whether the Bank does so with the aggression being projected is open to question, with the Chairman indicating that the Fed will act as seen appropriate.

Appendix A

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, but is stalling in order not to undermine any potential trade deal discussions. An easing of policy would weaken the Renminbi and make Chinese goods cheaper to import, and this will be helped by the Fed's change of tack which suggested that a series of rate cuts is unlikely.

Source: City Watch June 2019 - Link Asset Services

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