Appendix

Economic Overview (August 2019)

Overview

Financial markets in the UK priced in a Conservative majority at the General Election. This expectation raised the prospect of Brexit being delivered, pushing Sterling higher against both US Dollar and Euro. That expectation may, in turn, give the economy a boost, while Q4 looks set to post slower growth, with the possibility of flat growth, or possibly a slight contraction. If that fillip is not seen then the Bank of England may feel obliged to cut interest rates, but the promised post-election fiscal stimulus should generate some improvement in the economy.

The disappointing activity surveys, falling October retail sales and individual state data, indicating that industrial output has probably contracted again, provide further signs that the Euro Zone economy is still some way from recovering. Business surveys offer another gloomy view of November. Analysts suggest that this points to just 0.1% q/q growth in Q4, and the outlook for the start of 2020 is no better, with firms' expectations pointing to services activity slowing further. The ECB view that growth is set for a bounce next year looks a little premature.

Activity data points to US economic growth slowing from 1.9% in Q3 to below 1.0% annualised in Q4, but analysts suggest that could prove the base. The slowing is largely due to a reduction of inventories, which is close to running its course. Downside risks seem to be easing and appear limited, as a partial truce in the trade war is expected, while recent global data suggests some stabilisation. There are also positive signs that the Fed's rate cuts are beginning to deliver stronger demand in the housing sector, but firms remain cautious and some tightening has been seen in credit conditions and demand is only expected to pick up gradually.

As the month ended, the US was due to extend tariffs to nearly all Chinese imported goods. However, the President has shown a desire not to apply them since the day he announced them, particularly as US importers will have more difficulty in sourcing alternative suppliers than they had on earlier tariff impositions. Chances are that there will be a delay to the imposition, particularly as there appears to be stalemate in reaching a "Phase One" trade agreement. Given the lack of a Chinese reaction to

President Trump signing a bill relating to Hong Kong Human Rights and Democracy, the President may choose to defer the tariffs in order to prevent derailing trade negotiations.

UK

The economy expanded by 0.3% in Q3 (subsequently revised to 0.4%), after contracting in Q2, but seems to have slowed again in Q4. Brexit-related stock building and its impact on trade has complicated matters, but notwithstanding this, investment has stagnated and consumer spending growth slowed, which has dampened the impact of increased government spending. Coming into Q4, the monthly GDP updates in August and September had seen declines and the PMI surveys in the EZ and US reflected weaker levels of global demand. The CBI growth indicator and composite PMIs are consistent with GDP contraction in the final quarter, while the more upbeat projections only suggest growth by a whisker. The Q4 risks are to the negative but the election promises from all parties are of increased government activity, which should support growth over the coming years.

There is likely to be an easing of consumer spending growth in the final quarter but this could be short-lived if the new Government delivers a Brexit deal. The timing of Black Friday is likely to weigh on November’s annual retail sales figure but that should see a correction in December. Analysts, though, warn that a fall in October sales of around 0.3% could tip quarterly sales growth into negative territory. Indications are that a Conservative election victory and a Brexit deal could boost consumer confidence and spending. The further decline in the November services PMI suggests that consumer spending in the sector could be flat on the quarter. There is a sense that the PMIs may be a touch over-pessimistic, but consumers may be holding back on the Christmas spirit.

Weak export demand may prevent net trade adding to GDP growth for a third successive quarter, after strong export growth helped this area add 0.9% to Q3 GDP. Much of last quarter’s gain can be put down to firms’ on-going unwinding of stock-building ahead of the original March Brexit deadline. There has been a normalisation of trade in September, but the weakness of EU exports compared to

global sales could offer an early sign of some Brexit impact beginning to feed through. However, this could also be due to particularly weak growth in the bloc. Overall export demand is unlikely to pick up as global trade volumes are still falling and export order surveys point to worsening of the position for UK exporters.

Spare capacity in the labour market is limited, with the unemployment rate at a 45 year low, but the pick-up in GDP growth in Q3 may generate some job growth in Q4. Surveys, though, point to employment and wage growth easing, while the annual growth in job vacancies has been declining through the year, which suggests that employment growth could peter out. It is a similar picture in other indicators that also point to weaker labour demand undercutting wage growth further, following the decline in September. However, as noted, with a jobless rate of 3.8% there is little slack in the market and other labour market indicators, such as inactive workers who desire work, are near their pre-crisis lows.

The indications are that inflation will remain below the Bank of England target level for much of 2020, with the October CPI rate of 1.5% a near three year low. Much of the decline is energy inflation related and not easing of underlying inflationary pressures, but further falls in utility prices are on the cards. Underlying price pressures remain muted despite a pick-up in unit labour costs in Q2. This has been offset by firms absorbing the rise in costs into margins, in preference to passing them on to customers. Input price inflation remains negative and is currently at a three and a half year low so the fall in output price inflation could push core goods inflation to, or near to, zero - which is likely to restrict upside moves to below target.

UK early December Developments have seen the Conservative party secure a comprehensive election victory, which offers to stabilise the political situation and provide some certainty over Brexit on the 31st January. The Prime Minister is also trying to set a definitive date for the end of the transition period and conclusion of trade deals as 31st December 2020. That lack of flexibility could unsettle the markets as trade deals are complex transactions which are, generally, the result of protracted negotiations … just think US/China …. what happens if a trade deal is not concluded by the end of 2020 is a worry that could weigh on sentiment.

Monetary Policy

Monetary policy remains a little clouded by the post-election indication that the Government intends to adopt a more “hard” Brexit approach. With the economy struggling to generate meaningful growth in the current global climate, the uncertainty of a potential “no deal” withdrawal from the EU has resurrected interest rate cut expectations, with a move in the second half of 2020 back on the radar. Potentially adding to the uncertainty is the change of leadership at the Bank of England, with Mark Carney set to vacate office at the end of January.

New ECB President, Christine Lagarde has already indicated that the central bank should evaluate its current strategy and policy instruments to effect the best results for the economy going forward. However, with the economy generating only moderate growth, at best, policy will need to remain soft and accommodating and the likelihood is that there will be further cuts in the interest rate in 2020.

Fed members seem to be coming around to thinking that there may be no further rate cuts in 2020. Much may depend on the resilience of the economy, which could be dictated by the President’s policy toward tariffs and a successful outcome to the trade talks with China.

It is hard to see Japan raising rates while the economy continues to struggle to generate desired levels of inflation.

The Chinese authorities could ease policy further if the economy continues to slow and will be more likely to if the trade dispute with the US is not resolved. Even if “Phase One” is signed off, the differences between the two sides seem too great to be able to avoid prolonged problems over further deal progress.

Source: City Watch December 2019 - Link Asset Services