Detailed economic commentary on developments during quarter ended 30th June 2015

Capita Asset Services have provided us with the following comments:

- During the quarter ended 30th June 2015:
  - The economic recovery slowed in the first quarter;
  - Survey measures pointed to renewed vigour in Q2;
  - Wage growth picked up as the labour market tightens;
  - Deflation lasted only one month, but the outlook remains subdued;
  - Another split vote on the MPC drew nearer, but a rate hike this year remained unlikely;
  - The general election confirmed that the fiscal squeeze will re-intensify next year;
  - The possibility of a “Grexit” became greater.
- The latest economic data showed that the recovery slowed in the first quarter. However, the latest National Accounts painted the recovery in a better light than previously thought. Indeed, Q1’s quarterly GDP growth estimate was nudged up from 0.3% to 0.4% on the back of some stronger construction data. What’s more, given the strength of the business surveys, we wouldn’t be surprised if Q1’s growth figure was revised even higher in time.
- In any case, the surveys suggest that the recovery got swiftly back on track in Q2. On the basis of past form, the average level of the Markit/CIPS composite PMI is consistent with quarterly GDP growth of around 0.8%. And the Bank of England’s Agents’ scores point to a similarly-strong pick-up. Granted, only limited official data has been published so far for Q2, but April’s industrial production and trade figures paint an encouraging picture for the economic recovery at the start of the quarter.
- Early indicators suggest that the recovery in household spending has maintained plenty of momentum in Q2. Although retail sales volumes rose by just 0.2% on the previous month in May, this followed a 0.9% rise in April. Accordingly, even if sales volumes were unchanged in June, they would still have risen by 0.9% over Q2 as a whole, matching Q1’s rise. What’s more, spending off the high street looks to have remained robust as well. The Bank of England’s Agents’ Score of turnover in the services sector points to a further acceleration in nominal spending on services in the near term. In addition, the latest consumer confidence figures suggest that households still think now is a good time to undertake major purchases.
- Household spending should continue to be supported by developments in the labour market. The ILO unemployment rate has now fallen to 5.5%, not far above pre-crisis levels. And the employment rate is the highest since records began. The significant tightening in the labour market over the past eighteen months or so has begun to feed through into pay, with annual growth in headline average weekly earnings (excluding bonuses) picking up to 2.7% in April, its strongest since February 2009. We expect

nominal wage growth to strengthen a bit further over the coming months as the unemployment rate continues to nudge down. The subdued outlook for inflation should underpin real wage growth.

- The latest consumer prices figures showed that deflation lasted just one month. CPI inflation rose from -0.1% in April to +0.1% in May, reflecting the slower pace of falls in food prices and a rebound in petrol prices. We had stressed for a long while that deflation was likely to be fleeting, as it primarily reflected temporary external factors such as the fall in energy prices and food prices, as well as an appreciation in sterling, rather than weakness in domestic demand. Meanwhile, there have not been any signs that very low inflation has had any adverse second round effects on inflation expectations or spending decisions. Nonetheless, inflation looks set to hover just above zero for the next six months, and it wouldn't take much during that period, perhaps a renewed 10% fall in the oil price, for the UK to be tipped back into deflation.

- Unsurprisingly, then, the Monetary Policy Committee do not appear to be in any rush to raise interest rates. Granted, the minutes of June's MPC meeting showed that for two members, the decision to leave rates on hold was "finely balanced". And a recent interview with the Financial Times, resident MPC hawk Martin Weale suggested that he is not too far off restoring his vote to raise rates again. But with inflation close to zero, the first budget of the next parliament due to be published in July, and the situation in Greece becoming increasingly troubling, it looks that they will wait at least another few months before turning against the grain again. And with the rest of the committee likely to stand pat for even longer, it looks unlikely that there will be an increase in interest rates this year. Indeed, we still think that the first hike in Bank Rate will occur in Q2 next year, broadly in line with market expectations.

- Meanwhile, with the Conservatives winning an outright majority in May's general election, the fiscal squeeze is set to re-intensify next year. We will know more detail about the Chancellor's plans at the Budget on the 8th July, but we already know that in order to meet their manifesto pledge, the Conservatives will have to implement a fiscal consolidation worth around 5% of GDP over the next four years. And given that they have pledged to not increase VAT, income tax or national insurance in the next parliament, more of the planned squeeze will have to come through cuts to spending than in the last parliament. Admittedly, these plans may be watered down, but it is clear that fiscal policy will be a hindrance, not a help, to the economic recovery over the next few years, and underlines that monetary policy will have to remain extremely accommodative. Meanwhile, the general election brought with it another cloud to the economic recovery – namely a referendum on the UK's membership of the European Union which could happen during 2016, though a May date now appears unlikely.

- Internationally, the major development over the past quarter has been the deterioration of the situation in Greece. At the time of writing, the country is still a member of the euro-zone, but its future as part of the single currency has become increasingly uncertain. Greece urgently needs financial assistance in order to meet its debt repayments, but is unwilling to accept the reforms which creditors demand in exchange for funds. The situation is so severe that emergency capital controls have been imposed in order to stop the Greek banking system from collapsing. It is still possible that Greece and its creditors are able to strike a last-minute deal, but it is clear that this is likely to only offer a shortterm solution, and Greece will need to undertake substantial debt restructuring or outright default if it is to return its public finances to a sustainable position in the long run. Whilst the UK's direct economic and financial exposures to Greece are small, there could be an adverse impact on the UK's economy from a wider fallout and period of general financial market instability that would be likely to prevail if a "Grexit" were to occur.

- Finally, UK equity prices have significantly underperformed their US counterparts since the beginning of Q2, with the FTSE 100 falling by 2.3%, whilst the S&P 500 has fallen by only 0.5%. That said, UK equity prices have performed better than those in Europe, which have been hit by renewed fears of a Grexit. Meanwhile, sterling has remained strong against the euro, due to these fears as well as the ECB's ongoing programme of Quantitative Easing. UK 10-year government bond yields have also increased by about 50 basis points since the beginning of Q2. This probably reflects a confluence of factors, such as easing fears of a prolonged bout of deflation, and growing concerns about the impact of a deterioration in the situation in the euro-zone. In any case, gilt yields had looked too low early this year given the fundamental strength of the economic recovery.