Detailed economic commentary on developments during quarter ended 30 June 2019

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During the quarter ended 30 June 2019 *(quarter 2 of 2019):*

Brexit was delayed until 31st October 2019;

GDP rose by a solid 0.5% q/q in Q1, but contracted at the start of Q2;

The fundamentals that determine consumer spending remained healthy;

Inflation bobbed around the Bank of England's 2% target;

There was a widespread fall in investors' global interest rate expectations;

The MPC kept Bank Rate on hold at 0.75%, but struck a more dovish tone;

The economy posted a **stronger-than-expected expansion in Q1 of 0.5% q/q,** but that was probably a temporary high as activity was brought forward ahead of the original 29th March Brexit deadline. As a result, we doubt Q2 will be as good. Indeed, stock building added 0.9 ppts to the quarterly rate of GDP growth in Q1 as firms built up their stocks ahead of a possible no deal Brexit. Admittedly, a large chunk of these stocks were imported, so the net boost was smaller than this – perhaps around 0.3 ppts. Nonetheless, stock building will exert a similar *drag* on GDP growth in Q2.

In fact, the chances of the economy escaping a **quarterly contraction in Q2** seem to be receding in light of the latest survey and official data. GDP fell by 0.4% m/m in April, the largest monthly fall in three years. This partly reflected the decision by car manufacturers to bring forward their annual car plant shutdowns from August to April in case of a no deal. As a result, vehicle production dropped by 24% m/m knocking 0.2 ppts off overall GDP in April. Granted, the Society of Motor Manufacturers & Traders (SMMT) car production data suggest that these losses were recouped in May. After all, production rose by 60% m/m, which probably provided a 0.3 ppts boost to GDP in May.

Even so, GDP may still struggle to expand in Q2 as a whole – we have pencilled in a contraction of 0.1% q/q. Indeed, June's manufacturing PMI suggests the sector is still suffering from a Brexit-related hangover and a weak global economy and probably shrank in Q2.

What's more, household spending will probably fall short of the impressive 0.6% q/q rise in Q1. Retail sales volumes were flat in April and fell by 0.5% m/m in May. But a major slump in consumer spending in Q2 or further ahead seems unlikely.

Indeed, looking through the Brexit volatility, while consumer confidence has been relatively weak, the fundamentals that determine consumer spending have remained healthy. Admittedly, **employment** only rose by 32,000 in the three months to April, well below the

98,000 average monthly rise in 2018. But with the unemployment rate still at its 45-year low of 3.8%, the tightness in the labour market has pushed up wage growth. Indeed, the headline measure excluding bonuses nudged up from 3.3% in March to 3.4% in April – just below the decade high of 3.5%. And with inflation bobbing around the Bank of England's 2% target**, real wage growth has reached its highest rate since late 2016.**

CPI inflation dropped from 2.1% in April to 2.0% in May as the previous upward pressure on airfares due to the later timing of Easter unwound. Underlying price pressures look subdued too. Core services inflation fell from 3.1% to 2.9% in May and input price inflation dropped from 4.5% to just 1.3%, its lowest rate since June 2016. At the same time, output price inflation nudged down from 2.1% in May to 1.8%.

Nonetheless, there are still some reasons to think that CPI inflation will edge up at the end of the year as rising agricultural prices push up food inflation and core inflation starts to pick up now that the lagged effects of a fall in import price inflation have come to an end. What's more, the recent pick-up in wage costs is consistent with a **rise in core services inflation to just shy of 4% in early-2020.**

Bank Rate. Meanwhile, investors have reassessed the outlook for UK monetary policy and have gone from expecting rate hikes in early May to now expecting *cuts*. This is partly because of the weakening global outlook and rising expectations of rate cuts in the US and euro-zone. But growing concerns over a no deal Brexit have also weighed on expectations. Indeed, at the Treasury Committee in June, the Governor of the Bank of England, Mark Carney, gave the strongest hint yet that in a no deal Brexit, the Monetary Policy Committee (MPC) would cut rates. In that scenario, we think that rates would be cut fairly quickly from 0.75% to 0.25%.

Meanwhile, it wasn't surprising that the **MPC** kept Bank Rate on hold at 0.75% at June's meeting given the drop in GDP in April and inflation falling back to target in May. What was perhaps more surprising after its hawkish comments in May, was the Committee's new-found dovish tone. The MPC noted that "the near term data have been broadly in line with the May Inflation Report, but that **downside risks to growth have increased."** It also sounded more concerned about the possibility of a no deal Brexit. Instead of chastising the market for underestimating how much interest rates might rise as it did in May, the MPC pointed out that "the ongoing tension between the MPC's forecast…of a smooth Brexit and the assumptions about alternative Brexit scenarios that were priced into financial market variables".

Turning to fiscal policy, regardless of the Brexit situation, all roads appear to lead to **looser fiscal policy.** There was good news for the Chancellor at the end of 2018/19. Public sector net borrowing (PSNB ex.) came in only just above the OBR's February forecast of £23.4bn in 2018/19 – a far cry from the £37.1bn the OBR predicted in March 2018. Admittedly, PSNB ex. will probably rise slightly this year due to a number of promises made by the current Chancellor Phillip Hammond in the 2018 Budget, including spending on the NHS. But the OBR's projections still suggest that there is around £27bn headroom against the current fiscal rule.

Indeed, both **Johnson and Hunt** are promising wider ranging and bigger tax cuts and spending rises with the policies announced so far adding up to £20bn and £40bn a year

respectively. Of course, using up the headroom is not free money. It simply means that there is room to increase borrowing without breaking the current fiscal rule that the cyclically-adjusted budget deficit has to be below 2% of GDP in 2020/21.

Of course, how much borrowing rises depends on **the outcome of Brexit.**

- If a deal is reached, faster GDP growth would reduce public spending, raise tax revenues and cut the deficit, perhaps allowing fiscal policy to be loosened without borrowing rising at all.
- However, in a no deal, the weaker economy would push up the deficit. As a result, the new Chancellor would have to choose between keeping the fiscal rules intact or loosening fiscal policy to give the economy a boost. We think that he/she would opt for the latter, arguing that exceptional circumstances allowed for his/her fiscal rules to be suspended.

The fact that both Johnson and Hunt seem willing to leave the EU without a deal means **the chances of a general election** and a Labour government have also risen, as Parliament may vote to bring down the government. Looser fiscal policy seems to be on the cards under a Labour Government too. Admittedly, Labour only plans to raise borrowing by a small amount, in part because it plans to pay for higher day-to-day spending with tax increases. But there is a big question mark over whether Labour would manage to raise as much money from its planned tax rises as it claims. Indeed, the Institute for Fiscal Studies thinks that, at best, Labour will raise £41bn rather than £49bn, leaving a “manifesto black hole” of nearly £10bn.

Turning to the **financial markets**, concerns over global growth and subsequent falls in interest rate expectations have caused **developed market bond yields to slump** – the 10-year gilt yield fell from 1.05% at the start of the quarter to 0.81%. However, lower interest rate expectations have supported increases in equities. The FTSE 100 finished the quarter around 2.5% higher although it underperformed compared to the S&P 500 perhaps since the FTSE 100 has a high concentration of energy firms, so the fall in oil prices over the quarter has probably weighed on its overall performance.

Meanwhile, despite the narrowing in the gap between 2-year government bond yields in the US and the UK to around 100bps, which would normally put upward pressure on sterling in relation to the dollar, **sterling** has fallen to $1.26 this quarter. This is mainly because investors have become more concerned about a no deal Brexit with betting markets now pricing in about a 30% chance of a no deal compared with just 15% at the start of May.

Elsewhere, in the **US**, the markets are convinced the **Fed will start to cut rates in July.** But we think that a temporary truce in the trade war means it is slightly more likely that a cut will be delayed until September. However, a sharp slowdown in GDP growth in the second half of 2019 should still prompt the Fed to cut interest rates by a cumulative 75bps.

Meanwhile GDP growth in the **euro-zone** will probably only manage 0.2% q/q in Q2. Our expectations for interest rates in the euro-zone are roughly in line with market expectations – we have pencilled in a 10bps cut in September from -0.4% currently to -0.5%. What’s more, we expect the ECB to re-launch QE in October.