Detailed economic commentary on developments during quarter ended 30 June 2018

- **During the quarter ended 30 June 2018:**
  - The economy showed signs of regaining momentum after the slowdown in Q1;
  - Employment growth rose strongly but wage growth softened;
  - Consumer price inflation eased further;
  - The MPC struck a more hawkish tone at its June meeting;
  - Public sector borrowing undershot the Office for Budget Responsibility's (OBR) forecasts;
  - Progress on Brexit negotiations stalled;
  - Equity markets were buffeted by increased global trade tensions.
- **GDP quarter 1 2018.** The Quarterly National Accounts revealed that the economy expanded by an upwardly-revised 0.2% in the first quarter. The adverse weather appears to have played its part, with the construction sector knocking 0.1% off growth. However, the ongoing squeeze on households' real incomes also probably contributed to the softness. Note that household spending grew by just 0.2%. What's more, business investment contracted by 0.4%, after rising by 0.2% in Q4.

- The 0.2% quarterly rise in real **household spending** was the weakest in nearly six years and almost entirely funded by a drop in the savings ratio to its second-lowest on record. Indeed, at 4.2%, it is well below its average of about 8%. This raises concerns about the sustainability of spending growth ahead, particularly if households rebuild savings in response to rising real incomes. However, there are signs that spending growth has picked up in Q2. Retail sales volumes expanded by more than 1% on the month in both April and May, and consumer confidence has trended upwards this year.

- The Markit/CIPS **all-sector PMI** points to quarterly GDP growth of around 0.4% in Q2 so far, suggesting that the economy has regained some momentum in the second quarter. Meanwhile, the PMI survey doesn't include retail activity which appears to have rebounded in Q2 suggesting that if anything the survey is understating the pickup in GDP growth. Admittedly, the official output data for April is mixed. Construction output grew by only 0.5% in April from the 2.3% drop in March and the run of manufacturing growth appears to have come to an end, with a sharp 1.4% monthly drop in April. But note that the dominant services sector output expanded by 0.3% in April, suggesting that the sector got off to a good start in Q2.

- Meanwhile, the **labour market** has continued to show signs of strength. The unemployment rate stood at a multi-decade low, reaching 4.2% in April. Employment growth has also been impressive this year, rising by a quarterly 146,000 in the three months to April and by 1.4% on a year earlier. Such strong gains in employment have been possible thanks to a surge in the number of people joining the workforce. The various measures of hiring intentions and

surveys of employment that we follow suggest that this growth could be maintained, at least in the short term.

- Headline total **pay growth** has softened over the past few months, dropping from 2.8% in January to 2.5% in April. But this is largely due to base effects and weakness in bonus payments. Indeed, headline regular pay growth has picked up to 2.8% in April, up from 2.4% in Q4 and surveys of pay settlement point to growth of around 3.0% by the end of the year. As a result, nominal earnings growth has now overtaken inflation for the first time in twelve months.

- Indeed, **CPI inflation** has fallen back from 3.0% in Q4 to 2.4% in May, as the inflationary impact of sterling's past depreciation has eased. However, rising oil prices over the past few months, from around $67pb at the start of April to a 3-year high of $80 in May in response to concerns about supply disruptions, has put upward pressure on firms' costs. Indeed, producer input price inflation has risen from a low of 3.9% in February to 9.2% in May and producers have managed to pass on some of the rise in costs to consumers, with annual output price inflation edging up from 2.5% in April to 2.9%. What's more, the utility price hikes announced by the 'Big 6' energy firms will probably cause inflation to tick up temporarily in the coming months. But we still think that inflation will fall back this year given the offsetting downward pressure from easing food price and imported goods inflation.

- A run of weak economic data, alongside comments from Governor Carney signalling that the Monetary Policy Committee (MPC) is in no rush to raise rates, saw investors push back their expectations for the next interest rate hike from May to November. Indeed, the **MPC's May meeting** revealed the Committee's desire to wait for confirmation that the slowdown in Q1 was temporary. The May *Inflation Report* also showed that the Bank expects inflation to return to the 2% target at the two-year horizon on the basis of just a 50bp increase in Bank Rate over the next two years.

- However, the **MPC struck a more hawkish tone at the meeting in June.** Three members voted for an immediate rate rise, citing that the benefits of waiting for additional information were limited and that there may be some upside risks to the MPC's May *Inflation Report* forecasts for earnings growth. The minutes also revealed that the Committee placed more weight on the recent rebound in consumer spending and the survey indicators, than the weak production figures for April. The probability of an interest rate hike in August now stands at close to 70% up from around 30% a month ago.

- Elsewhere, the **public finances** continued to undershoot the OBR's forecasts. Public sector net borrowing for 2017/18 came in £19bn below what the OBR predicted in March 2017 and the current budget, (based on day-to-day spending), recorded its first full-year surplus since 2001/02. Borrowing so far in 2018/19 is 25% lower than at this stage last year, largely due to weaker local authority spending growth, and VAT and income tax receipts have risen strongly. While it is still early days and the figures are subject to revisions, the promising start to the year eases the pressure on the Chancellor to find the money to deliver on the Government's promise of an additional £5bn health expenditure by 2020/21. Note that even before the latest improvements, the OBR's forecast predicted that the Chancellor would

have £15bn of headroom in meeting his target for a cyclically-adjusted deficit of 2% of GDP in 2020/21.

- The Government managed to avoid giving Parliament the option to take over the **Brexit negotiations** in the event of a "no-deal Brexit", but instead proposed an amendment to the EU Withdrawal Bill that gives the decision of how much influence Parliament has, to the Speaker of the House of Commons. Meanwhile, the European Council expressed concern about the lack of progress on the Withdrawal Agreement at the EU summit in June. The EU has dismissed the UK's proposal for the whole of the UK to remain within the EU's customs territory. As a result, for the UK government to keep its pledge to avoid any physical infrastructure on the border between the Republic of Ireland and Northern Ireland, and the need for checks on goods crossing the Irish Sea between Northern Ireland and the UK, it would need to "rub out" its red line of leaving the customs union entirely. Given the slow pace of progress on negotiations, the December European Council meeting is now being seen as the most likely date for the Withdrawal Agreement, and terms for the UK's future relationship with the EU, to be signed off.

- Turning to **financial markets,** increased global trade tensions have buffeted equity markets over the past few months. Indeed, the EU retaliated with reciprocal measures to the US tariffs on imports of steel and aluminium and the US singled out China with import tariffs worth a total of $250bn. Of the measures already announced, the UK would not be significantly affected, but clearly would be vulnerable in a scenario of a global trade war. The **FTSE** ended the quarter almost 8% higher, slightly outperforming the S&P 500 and other global equity indices, due to the boost from the rise in oil prices at the start of the quarter on equity valuations. The **trade-weighted sterling index** drifted 1% lower over the quarter, largely due to a depreciation against the dollar since mid-April, as relative interest rate expectations moved in favour of the US. **10-year gilt yields** also dropped by around 10bp, but this masks considerable movements during the quarter. Indeed, yields fell sharply due to a rise in safe haven demand as concerns about the new Italian government surfaced towards the end of May. This was accompanied with a downward revision to investors' interest rate expectations in the UK.

- Internationally, the **US Federal Reserve** hiked interest for the seventh time in the tightening cycle, taking the Fed funds range to 1.50%-1.75%. The consensus among economists and Fed officials is now for two more 25bp rate hikes in 2018 and a further three 25bp hikes in 2019. On the activity front, the US economy lost some pace in the first quarter, but this appears to be mirrored across most developed economies. Indeed, all major European economies slowed and the **Eurozone** expanded by just 0.4% on the quarter, down from 0.7% in Q4 due to a large drag from net trade. Meanwhile, the **ECB's decision** to end its asset purchases by December was accompanied with a dovish stance on interest rates, noting that they are unlikely to raise rates until late 2019.