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Fixed Income Research

UK Economic Outlook: Divergences and convergences

Society of Professional Economists

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See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

Monday 15 January 2018

Possible Brexit timeline

KEY

- Completed
- Expected

2016

- **23 Jun 2016** — Referendum to leave EU

2017

- **29 Mar 2017** — PM triggers Article 50
- **19 Jun 2017** — Negotiations begin
- **8 Dec 2017** — “Sufficient progress” on divorce deal

2018

- **22/23 Mar 2018** — Agreement on ~2Y transition deal (EEA-style)
- **Ongoing** — Passage of EU Withdrawal Bill
- **Oct 2018** — FTA principles agreed
- **Q4 18/Q1 19** — Parliamentary ratification (inc. UK) on final deal

2019

- **29 Mar 2019** — UK formally leaves the EU
- **Ongoing** — Detailed FTA negotiations

2020

- **Ongoing** — Detailed FTA negotiations
- **31 Dec 2020** — Transition ends, prelim FTA begins

2021

- **Ongoing** — Detailed FTA negotiations
- **31 Dec 2021** — Final FTA begins

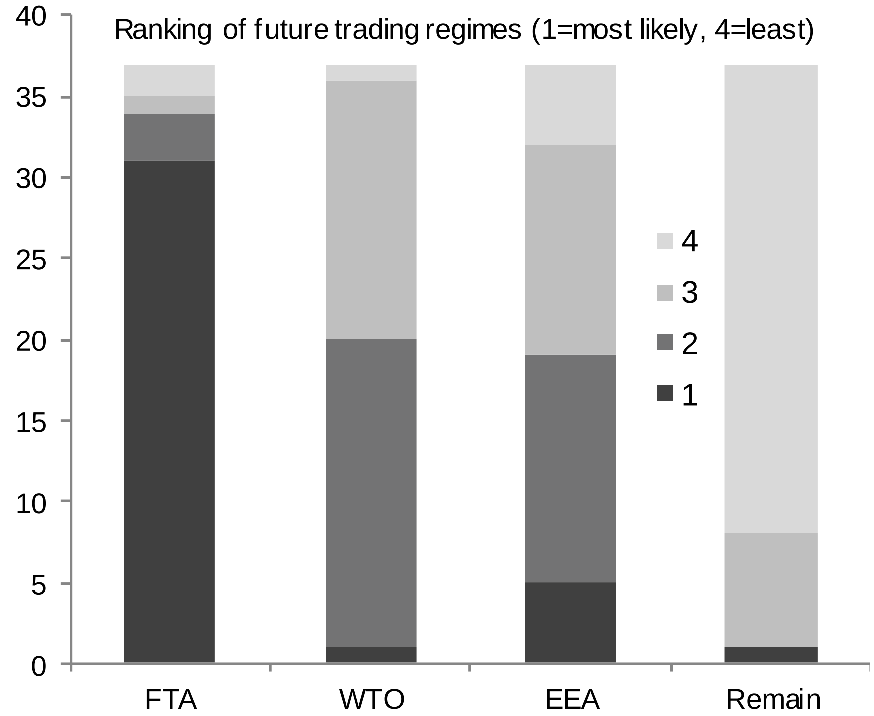
Source: European Commission, Nomura

Where the Brexit process might finally lead

Despite falling support for Brexit, a “Canada+” style FTA is generally thought to be the most likely outcome

Falling support for Brexit raises second referendum chances

Most economists think an FTA is the most likely final outcome



Source: Reuters, YouGov, GfK, WhatUKthinks, Nomura

UK growth expectations damaged by Brexit

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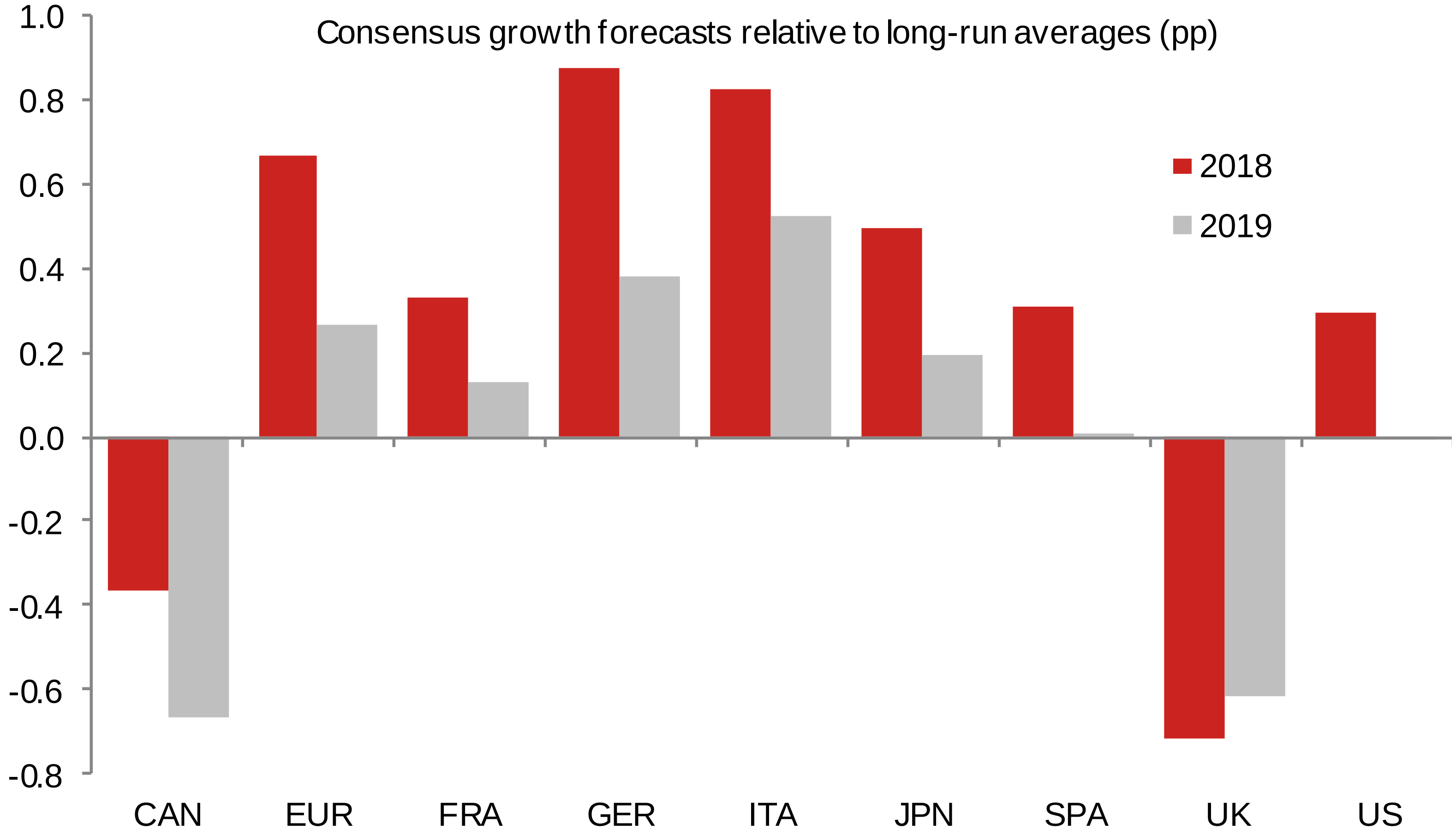
UK growth is expected to perform relatively poorly in light of the strength of the ongoing global economic recovery

Among developed markets UK growth this year and next is expected to be the weakest relative to its long-run (20yr) average

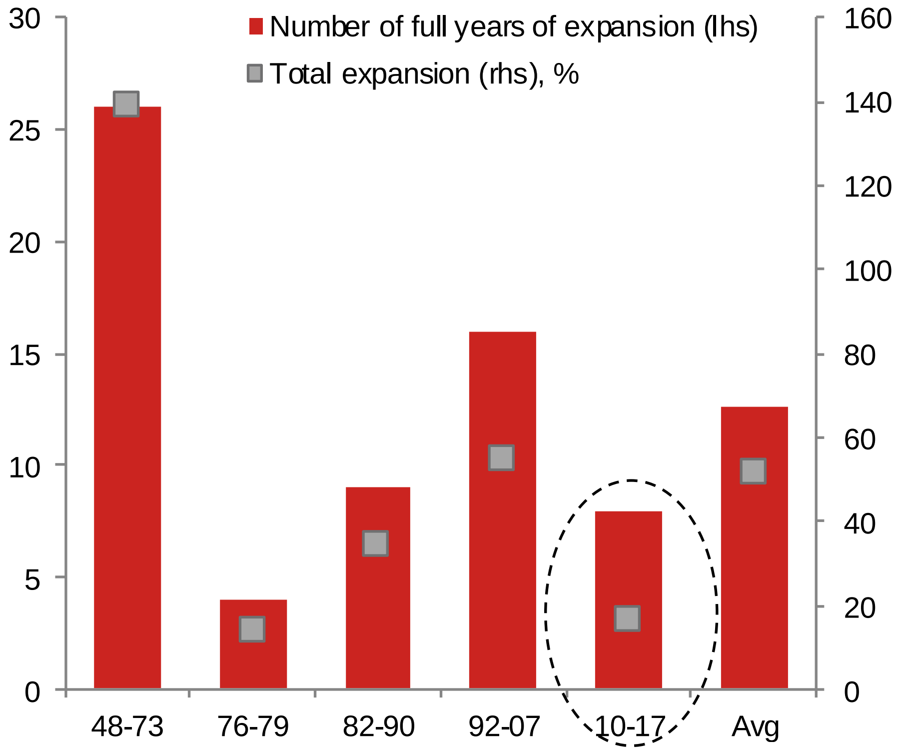


Source: Consensus Forecasts, national statistics offices, Haver Analytucs, Nomura

Risks and opportunities for the UK economy

Despite Brexit the positive economic growth cycle could have plenty of room left to run

Typical cycles have been longer/more expansionary



Near-term risks and opportunities for the UK economy

Opportunities

1. Global recovery – highly open economy
2. Low sterling – export revisions
3. Less public sector austerity – globally
4. Rising wage growth, falling inflation

Risks

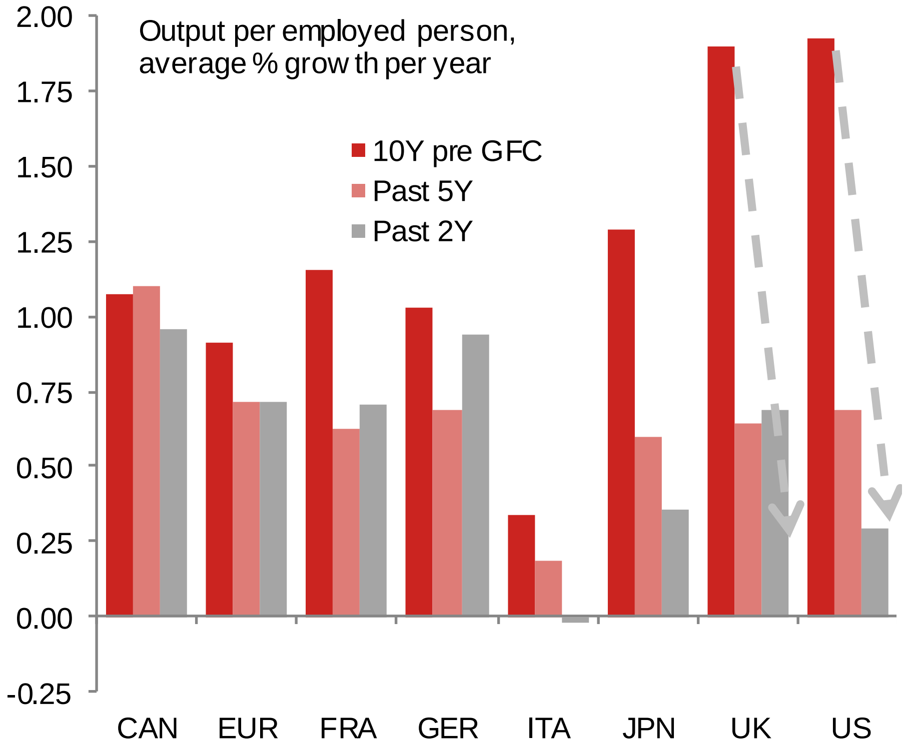
1. Brexit uncertainty and i) FX, ii) investment
2. Inflation and central bank/bond market response
3. Productivity growth has been weak (globally)
4. Potential financial instability

Source: ONS, Haver Analytics, Nomura

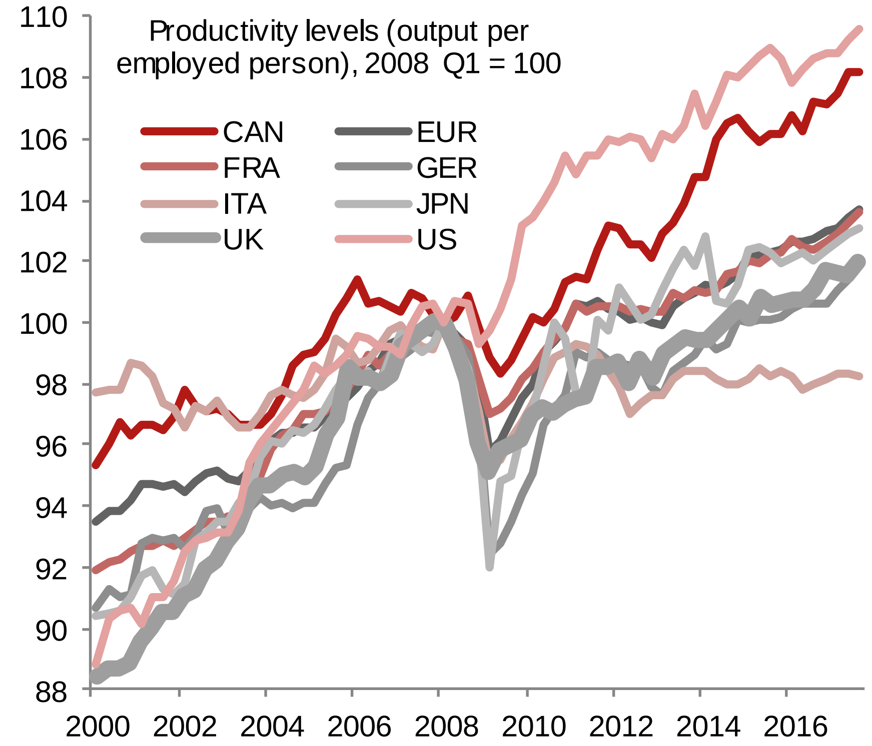
The UK has not been alone in its productivity experience

Weak productivity growth has important implications for monetary and fiscal policy

Productivity growth has collapsed, esp. in the UK and US



Germany has fared no better than the UK since 2008

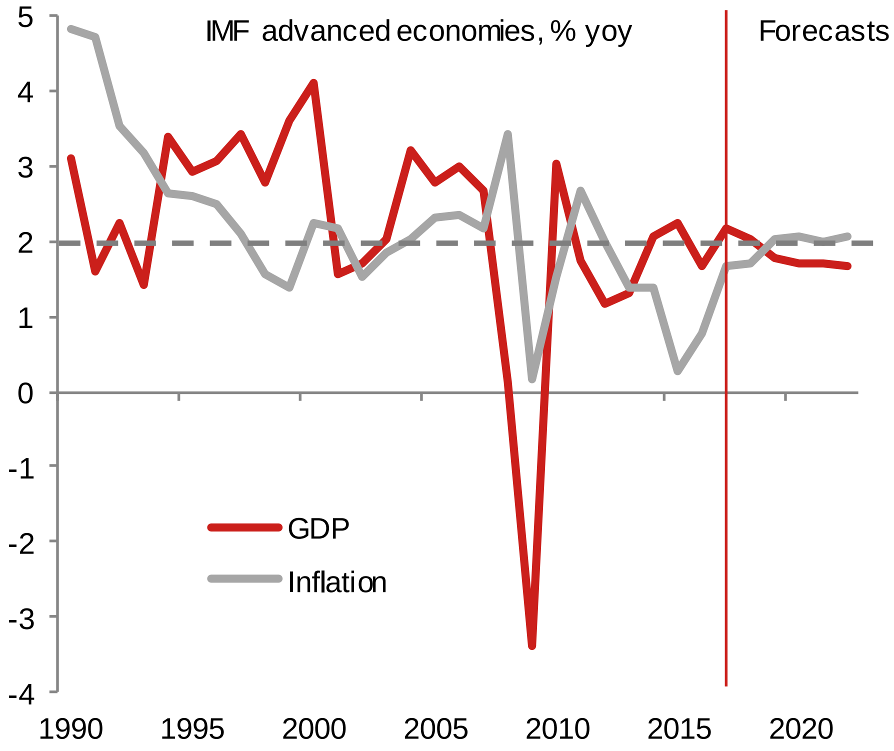


Source: ONS, Haver Analytics, Nomura

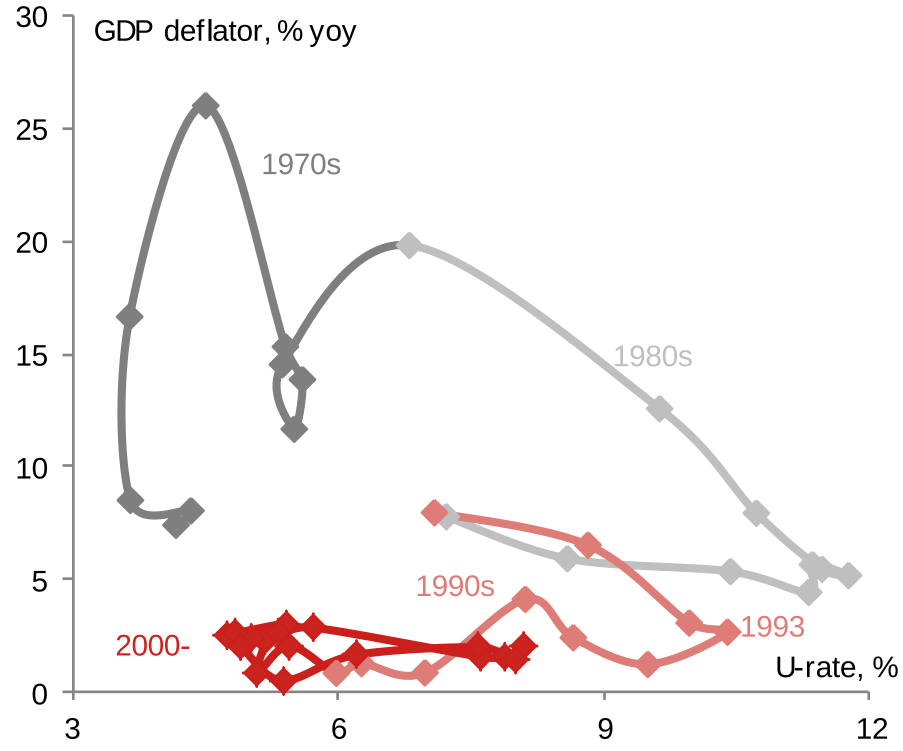
How will inflation respond to stronger global growth?

The IMF expects inflation to return back to central banks' targets despite relatively modest global growth

Subdued supply growth may drive global inflation higher



Flatter Phillips curve aided by inflation targeting

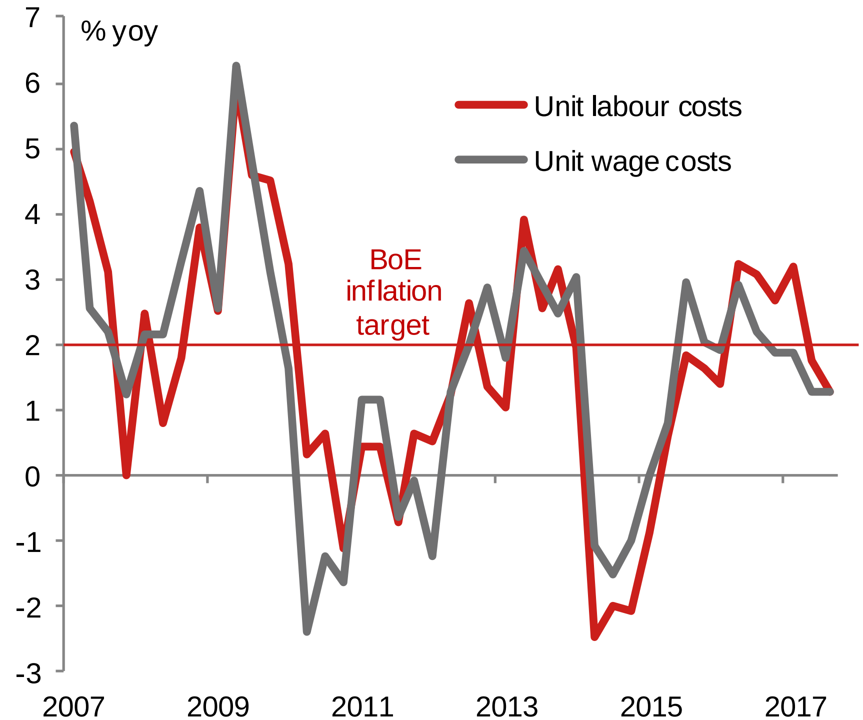


Source: ONS, IMF, Haver Analytics, Nomura

Above-target inflation only because of sterling's influence

There is little evidence as yet that UK domestically generated inflation is picking up

Indicators of domestic inflation – like ULCs – are subdued



Source: ONS, Haver Analytics, Nomura

Domestically generated inflation (DGI) has fallen

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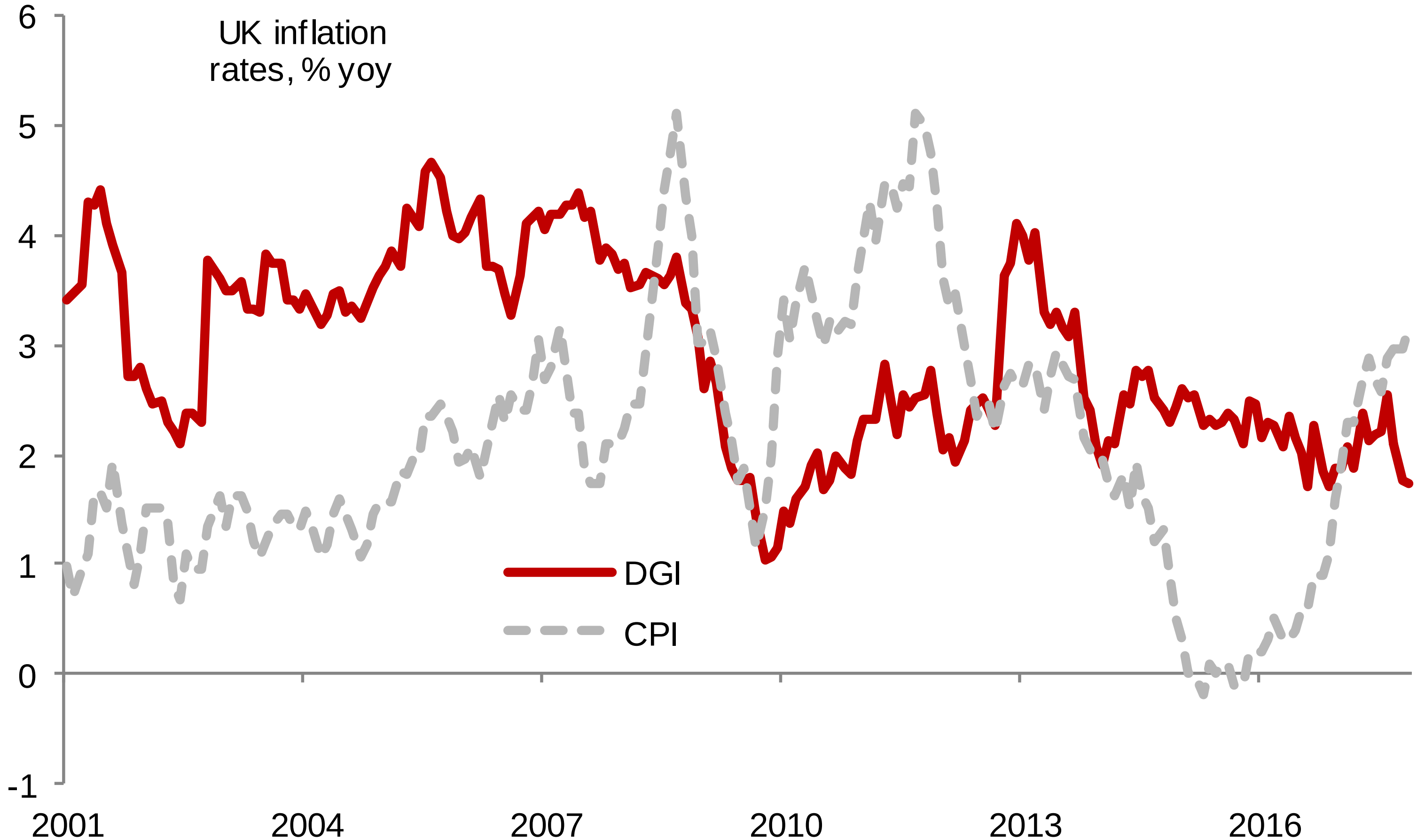
There are various measures of DGI – from unit labour cost growth to service price and wage inflation

Our own measure of DGI – which combines those components of CPI least exposed to sterling – has fallen of late

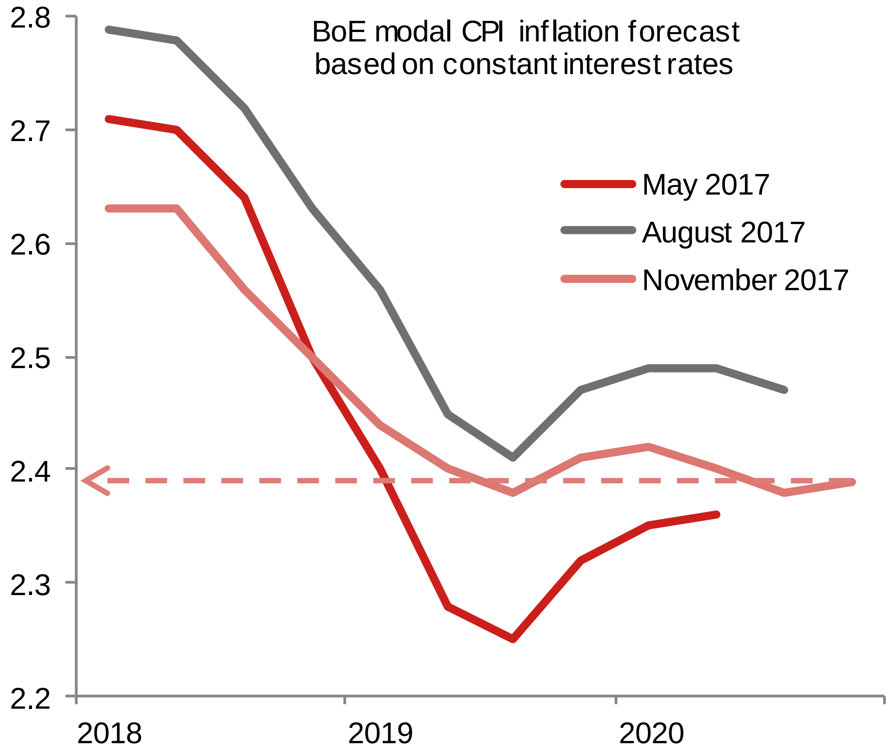


Source: ONS, Haver Analytics, Nomura

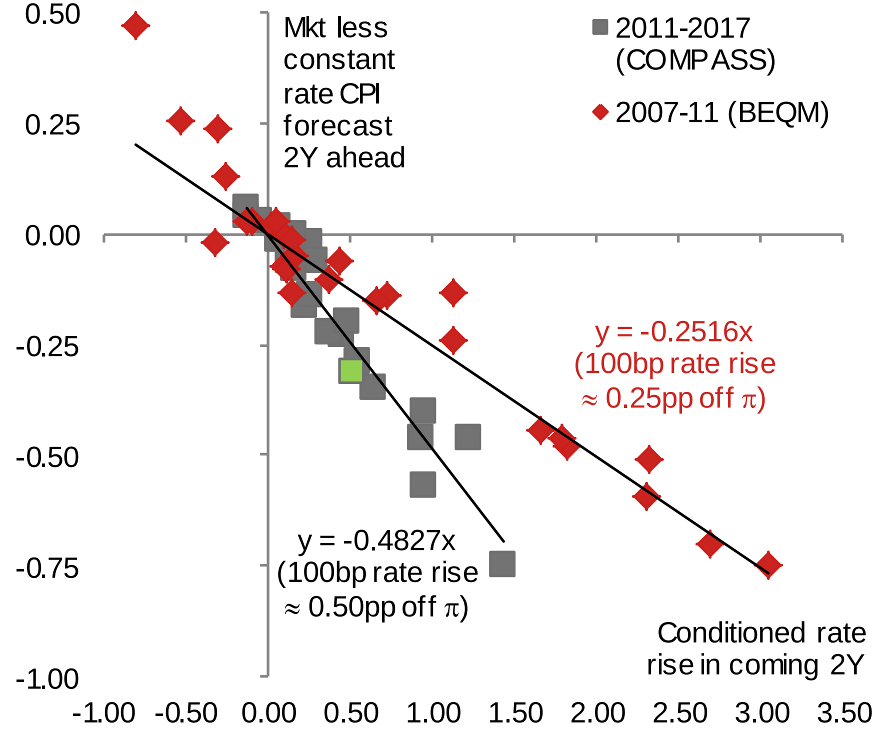
BoE sees inflation four tenths above target by end-2020

An overshoot of 40bp in the Bank's constant-rate inflation forecast suggests four 25bp rate hikes are needed

Inflation would be 40bp above target without rate rises



BoE model shows inflation more sensitive to rate moves now

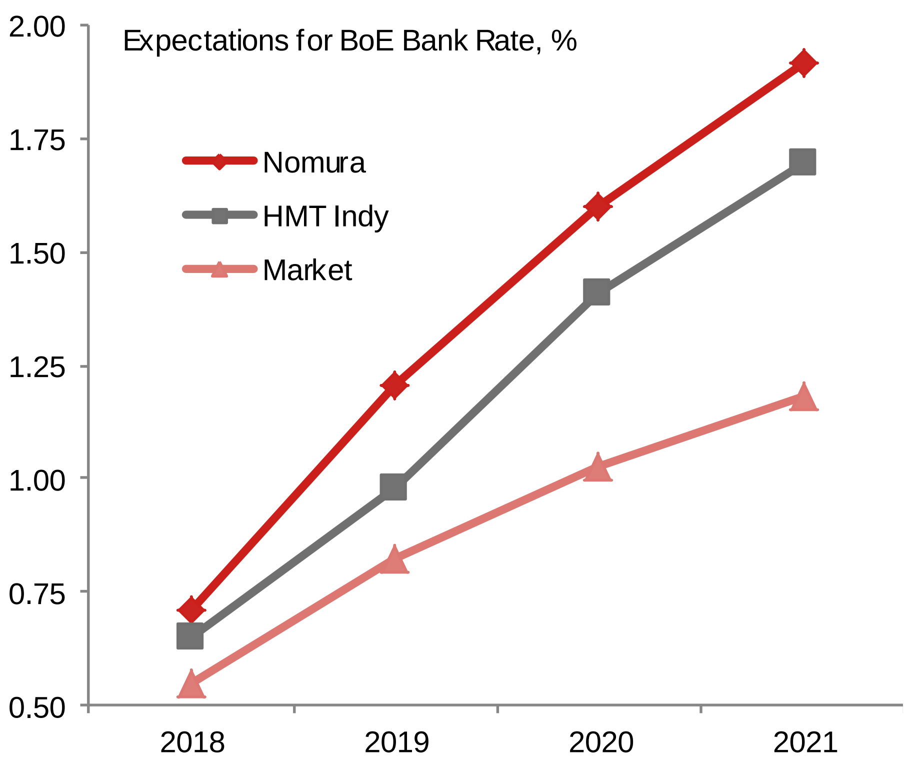


Source: ONS, Bank of England, Bloomberg, Haver Analytics, Nomura

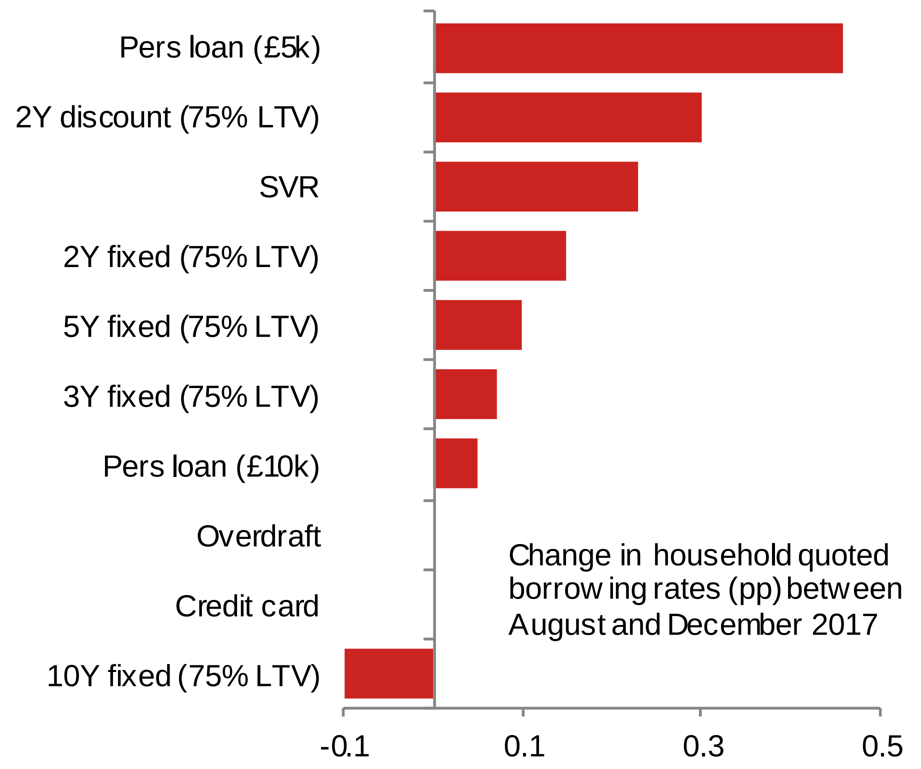
How our rate forecast compares with markets/consensus

We expect the BoE to raise rates in May and November of both this year and next

We are above market pricing; QE run-off to slow pace of hikes



Since August's repricing mortgage rates have risen modestly



Source: HM Treasury, Bank of England, Bloomberg, Haver Analytucs, Nomura

The UK economy: 60-second view

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Brexit assumptions

- "EEA-style" transition is agreed by spring 2018, expires end-2020
- Phase 2 negotiations (agreement of broad principles for the eventual "Canada+" style FTA) to be completed by October 2018
- That FTA takes longer to fully agree than the transition period – key measures adopted before end-2020, possible extension

Labour Market

- Growth forecasts consistent with a small rise in unemployment
- U-rate below BoE's NAIRU, suggests wage growth to rise
- Wage growth of 3.5% (6mma) consistent with 2% inflation target and 1.5% productivity growth – latter could be far weaker
- Slack being eroded – demand less availability at near record high

Economic growth

- Growth of 1.8% 2017, falling to 1.5% for 2018 & 2019 (modestly above and below consensus respectively for 2018 & 2019)
- Risks to business investment, consumption to recover in 2018
- Net exports contribute positively as imports slow and exports supported by a) GBP fall, b) external growth

Public finances

- The OBR forecasts revised down growth sharply (0.4pp per year to 1.4% average in 2018-21) thanks to weaker productivity
- Near-term deficits cut (better outturns), but from 2019-20 slower growth & loosening raised the deficit by 0.6% of GDP per year
- Autumn Budget measures loosened policy by up to 0.5% of GDP

Inflation

- CPI looks to have peaked at 3.1%, set to fall sub-2.5% by mid-18
- £ fall supported the rise: UK CPI more FX-sensitive than EUR CPI
- Domestic inflation still weak but some measures rising
- RPI peaked at 4%; RPI-CPI wedge to rise back above 100bp
- Inflation expectations mixed: long-run benign but 5Y5Y B/E up

Monetary Policy

- Following the first BoE hike in a decade we now expect the Bank to raise rates twice per year – May & Nov in 2018 and 2019
- Monetary policy more potent because of rising household debt – housing affordability has never been as sensitive to rate changes
- Half-life of Gilt APF (% GDP) is just 6 years if reinvestment stops

Appendix A-1

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