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The E.U. will force through a year-long "flextension"; don't bet on an earlier exit, given stalling Con-Lab talks.

A long extension would rule out the capex-led period of above-trend GDP growth that we expected in H2...

...but rising unit wage cost growth and underlying services inflation might still trigger a rate hike.

Don't Rule Out a 2019 Rate Hike, if the Brexit Extension is Long

The point when businesses and households can breathe a sigh of relief about Brexit looks set to be delayed again this week. The Prime Minister wrote to E.U. Council President Tusk on Friday, asking for a further short extension of article 50 until June 30, and promising to hold European Parliament elections on May 23, if the Withdrawal Agreement still has not been ratified. Mr. Tusk, however, appears to have other ideas. He reportedly is proposing to leaders of the EU27 that the U.K. should be granted a "flextension", which would push back the deadline for the U.K.'s departure by one year, but would enable the U.K. to leave earlier if it ratified the WA before then.

Mr. Tusk will get his way. *The PM has no negotiating leverage and other members of her Cabinet have conceded that a long extension was likely.* Her request for a June 30 deadline was motivated both by a desire to ensure that no time remains for another referendum and to try to shift some responsibility for a delay onto Mr. Corbyn, if cross-party talks don't bear fruit before the emergency European Council meeting on April 10. But just like last time, the E.U. will decide the parameters of the extension.

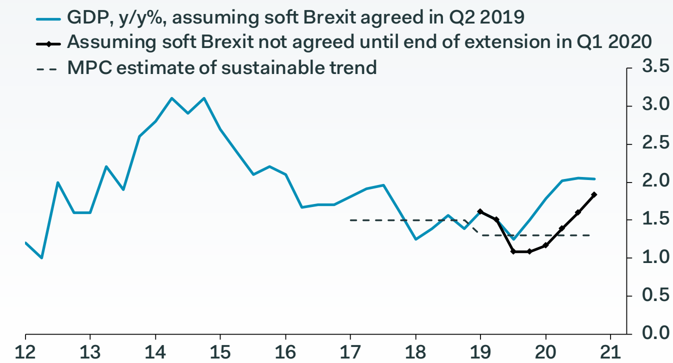
Admittedly, the leaders of *all* 27 member states must agree to the terms of the extension. France, in particular, has tried to drive an uncompromising line and is concerned that the U.K.'s continued presence in the European Parliament could be a roadblock to further budget increases and reforms. But Mr. Tusk consistently has held out hope that the U.K. eventually will reverse its decision to leave via a second referendum; we suspect this explains why he is keen to offer a long extension. E.U. leaders also want to avoid meeting every few months to agree yet another extension. So we expect the French government to fail again to persuade others to accept a very short extension and to refrain from using their veto, given that a no-deal Brexit would hurt both sides.

If the extension is long, the pressure on both the Tory and Labour leaderships to wrap up cross-party talks quickly will ease, reducing the chances that Brexit goes ahead in Q2 probably to below 50%. The PM hoped that Mr. Corbyn would give some ground, because he would bear some responsibility for a no-deal departure if talks were inconclusive. But with no-deal risk fading into the middle distance, Mr. Corbyn likely will maintain his ambiguous stance on Brexit, fearing that putting his name to a compromise deal would enrage either Remain or Leave supporters in his party and in the country at large.

Instead of reaching a compromise, both parties likely will propose a series of options for MPs to vote on in the coming weeks. But the indicative votes process showed that no majority exists yet for any Brexit option, and the pressure on MPs to compromise also will fade with a long extension. The indicative votes process also revealed that just over half of all Tory MPs would prefer a no-deal Brexit over any other Brexit option that is softer than Mrs. May's deal. They likely will bide their time, knowing that they stand a good chance of being able to replace Mrs. May with a Brexiteer one year after the last confidence vote on December 13.

Accordingly, we will have to revise down our forecasts for GDP growth in the second half of this

A LONG BREXIT EXTENSION WOULD DELAY CATCH-UP CAPEX GROWTH

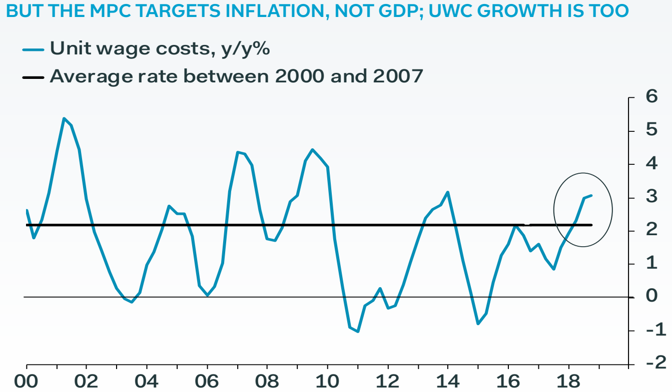


year, if the extension is a long one and cross-party talks remain deadlocked. So far, we have assumed that the WA would be ratified in Q2, unlocking some catch-up growth in business investment which would drive quarter-on-quarter GDP growth up to 0.4% in Q3 and 0.5% in Q4, from 0.3% in Q1 and Q2. But prolonged Brexit uncertainty likely would ensure that businesses continue to hoard cash and defer capex. *Accordingly, we would expect business investment to flatline in the second half of this year, ensuring that GDP growth stuck at a sluggish 0.3% rate.*

With these alterations, the chart above shows that year-over-year GDP growth would drop slightly below the MPC's estimate of its sustainable trend rate of "a bit below 1.5%" later this year. *As a result, our forecast that the MPC will raise Bank Rate once this year likely would become a marginal call.*

Nonetheless, the MPC is first and foremost concerned about inflation, not GDP growth. And the labour market now has emerged as a source of sustained inflation pressure. *Year-over-year growth in unit wage costs picked up to a nine-year high of 3.1% in 2018, from 1.5% in 2017.* It is now well above its pre-crisis average rate, as our next chart shows.

BUT THE MPC TARGETS INFLATION, NOT GDP; UWC GROWTH IS TOO

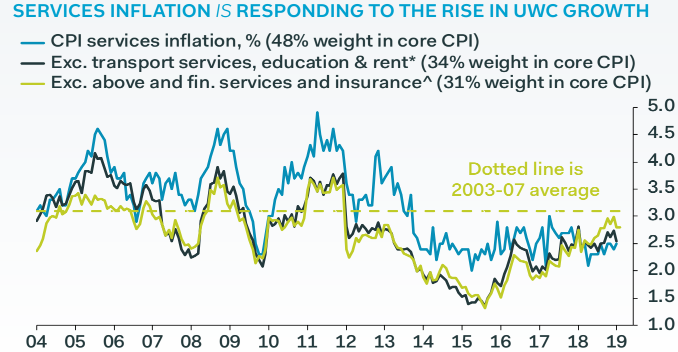


UWC growth is volatile, but we doubt that it will slow to the 2¼% rate anticipated by the MPC in February's *Inflation Report*. Both the unemployment rate and secondary measures of slack indicate that the labour market is very tight, while productivity likely will continue to stagnate, if business investment remains depressed.

Granted, the link between UWC growth and core inflation is not mechanical; firms usually absorb a portion of the extra costs. Nonetheless, our measure of underlying services inflation—which excludes the education, rent and insurance components that have been influenced by government policies, as well as volatile transport prices—is only just below its long-run average rate. *The MPC, therefore, has little scope to absorb a further increase in underlying services inflation, as government policies won't continue to depress the overall rate of services indefinitely.*

Note too that by keeping Bank Rate on hold, the MPC effectively would be allowing monetary stimulus to build, as the process of refinancing mortgages at ever lower interest rates would continue. Accordingly, we still think the 10% chance of the MPC raising Bank Rate before the end of this year priced-in by markets is far too low. We would see a 50/50 chance of a hike in the second half of this year, if the Brexit extension is a long one.

SERVICES INFLATION *IS* RESPONDING TO THE RISE IN UWC GROWTH



* Rents excluded due to enforced cuts to social rents; ^ Insurance excluded because a gov't ruling is depressing car insurance premiums

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THIS WEEK IN BRIEF

Note: "**D**" prefix denotes Datanotes for these releases.

Monday, April 8

• **No significant data released.**

Tuesday, April 9

• **D: BRC Retail Sales Monitor (3)/00:01 BST**

We expect year-over-year growth in like-for-like sale values to drop to **-2.0%** in March, from -0.2% in February, because the survey period in March 2018 included the week before Easter. **Consensus: -0.9%.**

Wednesday, April 10

• **D: GDP (2)/09:30 BST**

We expect a **0.0%** month-to-month print for February GDP, which would sustain the three-month on three-month growth rate at 0.2%. Industrial production probably fell by around 0.5%. Average temperatures were unusually high in February, so output in the energy supply sector likely fell by about 4.0%. We think that manufacturing output held steady; the Markit/CIPS survey suggests that production only stepped up a gear in March, when manufacturers rushed to produce goods while imports were readily available. Meanwhile, we expect construction output to flatline, despite the slight downward trend signalled by the PMI, because the unusually warm weather likely enabled more work to go ahead than usual. Services output, however, likely rose by 0.1%, offsetting the fall in IP. Further increases in retail sales and car sales suggest that output in the distribution sector rose by 0.5%, boosting growth in overall services output by 0.05pp. **Consensus: 0.0%.**

• **D: Trade (2)/09:30 BST**

A pick-up in precautionary stockpiling of goods produced overseas likely caused the trade deficit to increase further in February. We look for an increase to £4.2B, from £3.8B in January. **Consensus: £3.9B.**

• **Emergency E.U. Summit in Brussels/17:00 BST**

The length of the further Brexit extension will be determined. Theresa May has requested a short extension to June 30, but E.U. leaders likely will only agree to this if cross-party talks have borne fruit. It is more likely that the E.U. will offer a one year extension, but with the option for the U.K. to leave earlier if it ratifies the Withdrawal Agreement.

Thursday, April 11

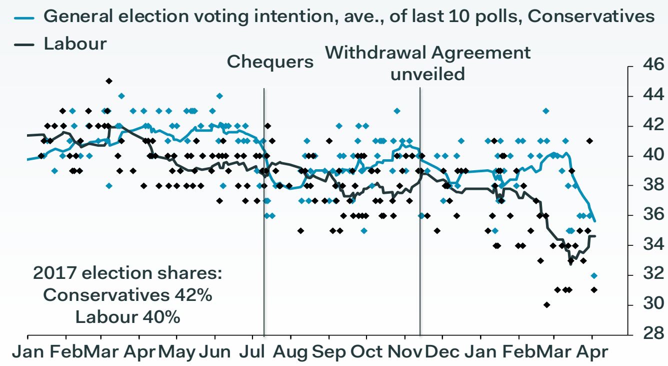
• **D: RICS Residential Market Survey (3)/00:01 BST**

We expect the house price balance to decline to **-30** in March, from -28 in February, amid no let up in Brexit uncertainty. **Consensus: -28.**

Friday, April 12

• **No significant data released.**

CHART OF THE WEEK: AN ELECTION WON'T FIX THE TORIES' PROBLEMS



PANTHEON'S FINANCIAL FORECASTS

		End-month:				
	5pm Fri.	Mar	Jun	Sep	Dec	Dec 20
Bank Rate	0.75	0.75	0.75	1.00	1.00	1.50
3m Libor	0.83	0.85	1.00	1.10	1.20	1.70
12m Libor	1.07	1.06	1.30	1.40	1.60	2.00
2-year Gilt	0.70	0.61	1.00	1.10	1.20	1.80
10-year Gilt	1.12	1.00	1.50	1.70	1.80	2.20
30-year Gilt	1.66	1.55	2.00	2.10	2.20	2.40
FTSE 100	7447	7000	7200	7400	7600	8000
USD/GBP	1.30	1.30	1.36	1.38	1.40	1.40
EUR/GBP	1.16	1.16	1.24	1.25	1.27	1.27
Sterling TWI	79.6	79.7	84.3	85.6	86.8	86.8

PANTHEON'S ECONOMIC FORECASTS

	Period average:						
	Q1 19	Q2 19	Q3 19	Q4 19	2018	2019	2020
GDP, q/q%	0.3	0.3	0.5	0.6	-	-	-
GDP, y/y%	1.5	1.3	1.2	1.6	1.4	1.4	2.0
Employment, y/y%	0.8	0.7	0.8	0.8	1.2	0.8	0.9
Unemp. rate, %	4.1	4.0	4.0	4.0	4.1	4.0	3.8
Wkly earnings, y/y%	3.4	3.2	2.9	2.6	2.9	3.0	3.2
CPI, y/y%	1.9	2.1	1.8	1.8	2.5	1.9	2.1
RPI, y/y%	2.6	2.9	2.6	2.7	3.4	2.7	3.1
PSNB FY, £B	-	-	-	-	23	30	40
Cur. acc't., % GDP	-4.5	-4.6	-4.8	-4.9	-4.1	-4.7	-5.0
House prices, y/y%	1.9	1.7	1.3	1.2	3.3	1.5	2.5