PANTHEON MACROECONOMICS

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Q4 GDP growth was all statistical shenanigans; the risk of future downward revisions is high.

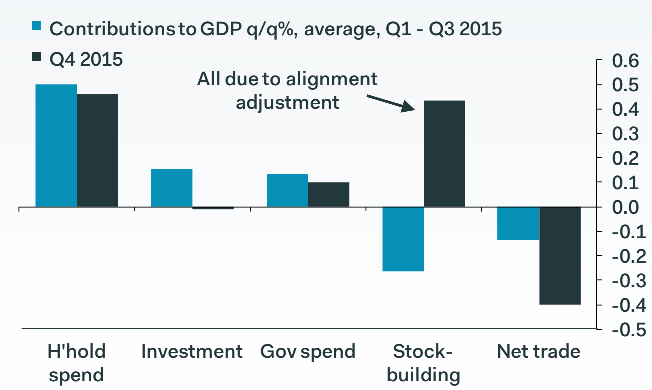
The recovery has become extremely reliant on growth in consumer spending, which is set to fade.

Investment is struggling as the oil sector retrenches, and the outlook for net trade remains bleak.

The Foundations of the U.K. Recovery are Remarkably Fragile

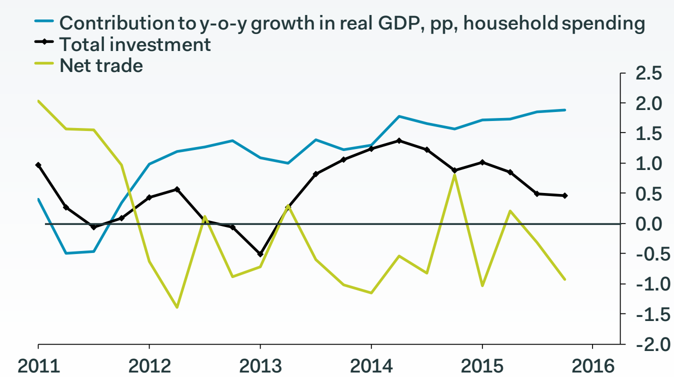
The preliminary estimate of a 0.5% quarter-on-quarter rise in GDP in the fourth quarter of 2015 was left unrevised, but that was the only nugget of good news from yesterday's second GDP release. ***The expenditure breakdown hardly could have looked more troubling.*** All the growth, and more, came from inventories, which added 0.6 percentage points to the quarter-on-quarter increase in GDP. Even worse, that contribution was entirely attributable to the "alignment adjustment", which is a statistical residual used to match the expenditure breakdown with the output details of GDP. ***Measured expenditure didn't increase at all in Q4, so the statisticians inserted an error term to bring the expenditure components in line with the output numbers.*** It is therefore highly likely that GDP growth will be revised down in time.

THE RECOVERY HAS BECOME LESS WELL-BALANCED...



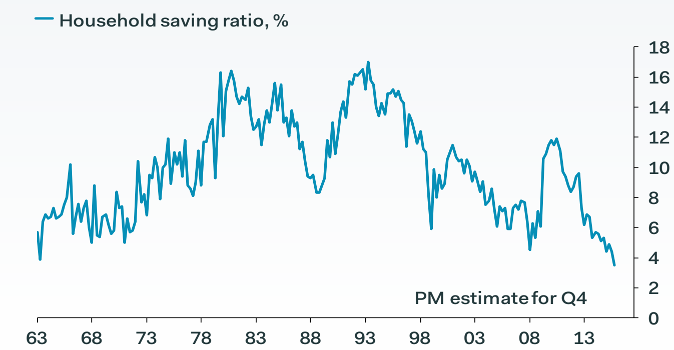
Meanwhile, real consumer spending punched above its weight, rising by 0.7%, but total investment fell by 0.1% and net trade subtracted 0.4pp from GDP growth. Growth contributions are volatile on a quarter-by-quarter basis, but investment and net exports have been slowing for a while, as our second chart shows. Consumers are the only driving force left behind the recovery, and this is troubling, because it's hard to see how household spending can maintain its recent momentum for much longer.

...AND NOW IS ALMOST ENTIRELY DEPENDENT ON CONSUMERS



Nominal household spending rose by a hefty 1.8% quarter-on-quarter in Q4, the biggest increase in three years. The complete picture of households' incomes in the fourth quarter has not been published yet, but we do know that the compensation of employees—comprising wages and salaries and employers' pension contributions—increased by just 0.7%. Households therefore seem to have reduced their saving further, as a proportion of their incomes. ***With the saving rate likely at a record low in Q4, little scope remains for households to continue to support consumption growth by saving even less.***

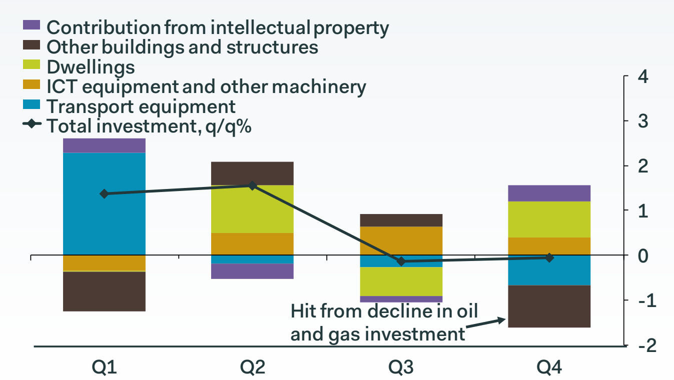
SPENDING GROWTH CAN'T BE BOOSTED BY DISSAVING MUCH LONGER



Spending growth, therefore, will fall back in line with income growth soon. Nominal incomes have grown briskly; they were up 3.8% year-over-year in Q3. But they will slow as the fiscal squeeze intensifies in April and job growth fails to maintain its recent stellar rates. Wage growth likely will pick up, but inflation will rise during 2016 too, ensuring that *real* income growth moderates. *We expect real incomes to rise by 2.2% this year, down from 3.5% in 2015.*

Meanwhile, the 0.1% quarter-on-quarter fall in total investment disguised a 2.1% plunge in business capital expenditure. Many analysts have attributed this to concerns about Brexit creeping into boardrooms, but corporate confidence has only just started to dip, implying that this headwind lies ahead. Instead, we think turmoil in the investment-intensive oil sector is now taking its toll. The industry breakdown of investment will not be published until the national accounts are released on March 31. But it was telling that investment in "other buildings and structures", which includes oil rigs, fell by 3.0% and subtracted 0.9pp from total investment in Q4.

INVESTMENT DROP PROBABLY WAS CONCENTRATED IN THE OIL SECTOR



Oil and gas investment has a lot further to fall, and it will continue visibly to depress the headline investment numbers. Oil & Gas U.K., the industry's trade body, expects total capital expenditure to fall to £9B in 2016, from £11.6B in 2015 and £14.8B in the previous year. The anticipated £2.6B drop this year is equivalent to a 0.8% fall in total investment and a 0.14% drop in overall GDP.

Meanwhile, we expect net trade to continue to depress growth in 2016, even though sterling has weakened sharply this year. Trade volumes usually take at least a year to respond to exchange rate movements. In addition, most manufacturers purchase imported materials invoiced in dollars, but price their wares to European customers in euros. The continued weakness of the euro against the dollar will ensure that exports struggle this year. What's more, the pound's weakness largely reflects uncertainty about the outcome of the E.U. referendum, rather than a shift in the outlook for monetary policy. Sterling therefore looks primed to snap back when the electorate shuns Brexit at the ballot box in June.

The best days of the U.K.'s economic recovery therefore lie behind it. We still expect GDP growth to slow to just 1.5% this year, from 2.2% in 2015. ***This slowdown, however, won't prevent a modest tightening of monetary policy this year as inflation pressures re-emerge.*** The Monetary Policy Committee has raised interest rates in the past when GDP growth has been below trend, due to concerns about wage pressures, and we think these worries will re-emerge again. With the labour market now tight, wage growth will exceed productivity gains by a hefty margin. The Committee will face extra pressure to tighten from the overheating housing market and interest rate hikes in the U.S., which will put intolerable downward pressure on sterling unless the U.K. begins to reciprocate. Accordingly, we still think Bank Rate will rise to 1% by the end of this year.

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THIS WEEK IN BRIEF

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

Monday, February 22

• CBI Industrial Trends Survey (2)/11:00 GMT
The total orders balance fell to **-17** from -1, consistent with manufacturing output falling by 2.5% year-over-year in Q1.

Tuesday, February 23

• MPC members' Treas. Committee Hearing/10:00 GMT
Mark Carney refrained from saying whether sterling is correctly priced, given Brexit risks. Gertjan Vlieghe implied further downside data surprises would push him to raise rates. But Martin Weale said he thinks that inflation will rise at a faster rate than most other MPC members anticipate.

Wednesday, February 24

• D: BBA Mortgage Approvals (1)/09:30 GMT
The British Bankers' Association's measure of mortgage approvals by the main high street banks for house purchase picked up to **47.5K** in January, from 43.7K in December. This surge unwound several months of declines, which had not shown up in the comprehensive official measure of approvals. We expect approvals to remain on an upward trend. Consumer confidence is high, real income gains remain strong, and mortgage rates are set to fall again in response to the decline in wholesale funding costs.

• D: CBI Distributive Trades Survey (2)/11:00 GMT
The reported sales balance fell to **+10** in February from +16in January and is consistent on the basis of past form with year-over-year growth in official retail sales volumes easing to about 2%. Retailers have become more downbeat about the near-term outlook too. The expected sales balance fell to +2 from +10, its lowest level since May 2013.

• Speech by MPC member Sir Jon Cunliffe/18:10 GMT
Sir Jon Cunliffe remains in the middle of the dove-hawk spectrum. He stated that the MPC has a range of tools it could use if disinflationary pressures intensified. But he emphasised upside risks to the inflation outlook from the labour market and suggested more macroprudential tools could be deployed if credit growth continues to strengthen.

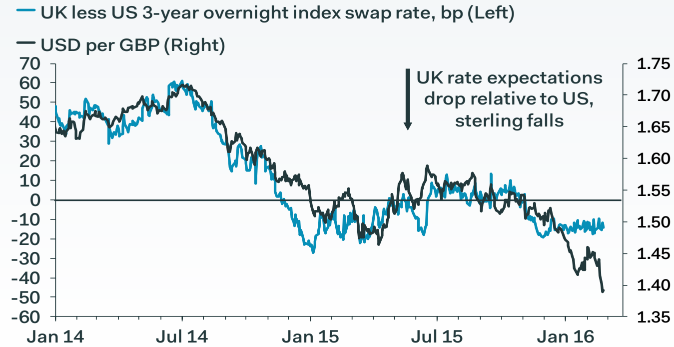
Thursday, February 25

• D: Second Estimate of GDP (Q4)/09:30 GMT
GDP increased **0.5%** quarter-on-quarter in Q4, in line with the preliminary estimate. But the recovery looks very unbalanced. Household spending rose by 0.7%, while total investment fell by 0.1%, reflecting a 2.1% plunge in business investment. Net trade subtracted 0.4 percentage points from the quarter-on-quarter growth rate of GDP, while inventories made a 0.6pp positive contribution to growth.

Friday, February 26

• D: GfK Consumer Confidence (2)/00:01 GMT
We anticipate a small fall in the GfK consumer confidence index to **+3** from +4 in January. The index would remain in the top 15% of all past readings since 1974, pointing to further near-term momentum in spending. **Consensus: +2.**

CHART OF THE WEEK: BREXIT RISKS NOW CLEARLY HITTING STERLING



PANTHEON'S FINANCIAL FORECASTS

		End-month:				
	3pm Thu.	Mar	Jun	Sep	Dec 16	Dec 17
Bank Rate	0.50	0.50	0.50	0.75	1.00	2.00
3m Libor	0.59	0.60	0.70	1.00	1.30	2.30
12m Libor	1.01	1.10	1.50	1.70	2.00	3.00
2-year Gilt	0.30	0.50	1.00	1.50	1.80	3.00
10-year Gilt	1.35	1.80	2.20	2.40	2.60	3.50
30-year Gilt	2.32	2.60	3.00	3.20	3.40	4.00
FTSE 100	5996	6000	6050	6100	6200	6500
USD/GBP	1.39	1.40	1.38	1.40	1.42	1.40
EUR/GBP	1.26	1.35	1.37	1.39	1.41	1.40
Sterling TWI	85.4	88.6	89.2	90.5	91.8	91.2

PANTHEON'S ECONOMIC FORECASTS

	Period average:						
	Q4 15	*Q1 16*	*Q2 16*	*Q3 16*	*2015*	*2016*	*2017*
GDP, q/q%	0.5	0.3	0.3	0.3	-	-	-
GDP, y/y%	1.9	1.8	1.4	1.4	2.2	1.5	2.2
Employment, y/y%	1.9	1.3	1.6	1.2	1.6	1.1	0.7
Unemp. rate, %	5.1	5.0	5.0	5.0	5.4	5.0	4.8
Wkly earnings, y/y%	1.9	2.3	2.5	3.0	2.4	3.0	3.5
CPI, y/y%	0.1	0.6	0.8	1.0	0.0	1.0	2.2
RPI, y/y%	1.0	1.7	2.2	2.5	1.0	2.3	3.5
PSNB FY, £B	-	-	-	-	78	55	40
Cur. acc't., % GDP	-3.8	-3.9	-4.0	-4.0	-4.1	-3.9	-3.3
House prices, y/y%	4.4	5.4	6.2	7.4	4.4	8.0	4.0