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The recovery will lose pace as the stronger pound and renewed fiscal tightening weigh on demand...

...But the MPC will still have to hike rates in 2016 to keep domestically-generated inflation in check.

GDP on track to grow by just 1.5% next year, no more than in the Eurozone.

Slowdown in Store as Fiscal Policy Tightens and Strong Pound Bites

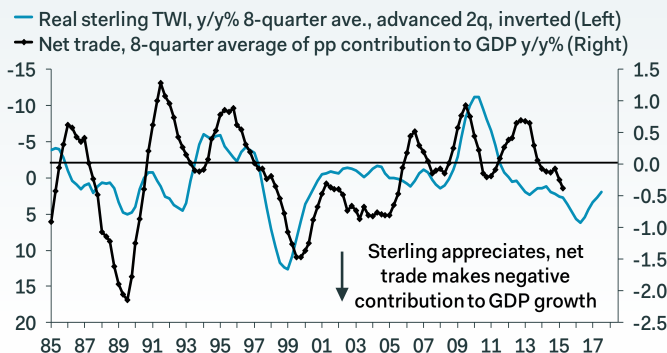
A powerful cocktail of cheap money, labour and commodities, allowed to infuse by a hiatus in the government's austerity programme, has reinvigorated the U.K. economy over the last three years. ***But these supports are now weakening while new headwinds are emerging. The U.K. economy is heading for a pronounced slowdown, one that is under-appreciated by most forecasters and under-priced by markets.***

A key impediment to further growth is sterling, which is still around 15% stronger on a trade-weighted basis than two years ago, despite falling by 3% since its summer peak. It takes time for trade contracts to be renegotiated and exporters to adjust their foreign market prices, so this appreciation is only now beginning to depress net trade. ***The peak impact of sterling's rise is likely to be felt in early 2016, as our first chart shows. By then, net trade will probably subtract a full percentage point from annual GDP growth.*** Slowing growth in EMs, to which UK exporters are more exposed than in previous cycles, suggests that a bigger drag from net trade cannot be ruled out.

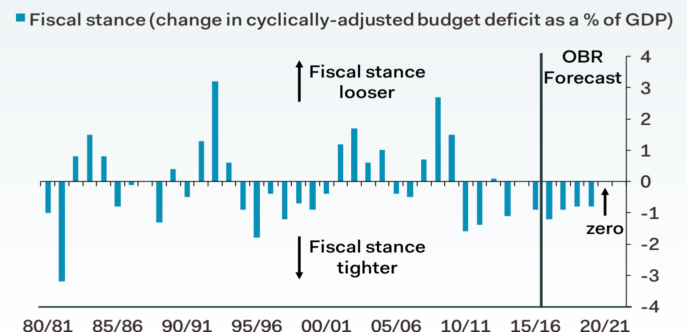
With the fiscal consolidation getting underway again after its pre-election pause, the domestic economy is likely to slow too. ***As our second chart shows, the fiscal stance—the annual change in the cyclically-adjusted budget balance, arguably the best measure of the impact of fiscal policy on the economy—will be very restrictive in 2016.***

Granted, recent revisions to the national accounts, showing that GDP growth strengthened from 1.5% in 2010 to 2% in 2011—the peak year of fiscal squeeze in the previous Parliament—have led some analysts to conclude that the economy isn't very sensitive to changes in the fiscal stance. But the relative comparator is not growth in 2010—which in any case would have been dampened as firms and households *prepared* for the looming fiscal tightening—but what growth would *otherwise* have been for an economy

NET TRADE IS SET TO KNOCK UP TO 1PP OFF GDP GROWTH IN 2016



THE FISCAL SQUEEZE IS RE-INTENSIFYING



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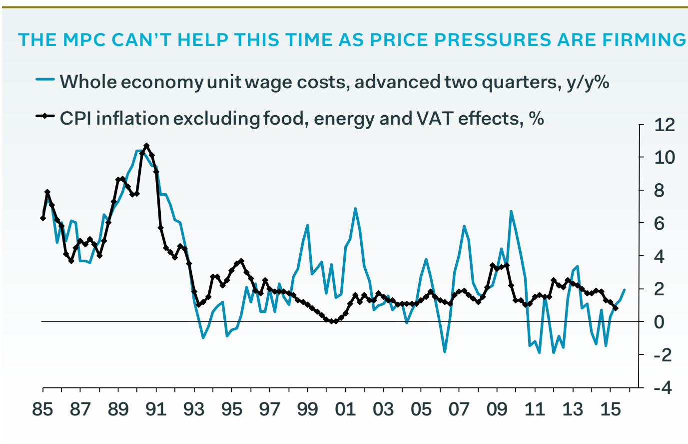
coming out of a recession in which GDP plunged by 6%. The recoveries after the milder recessions in the 1980s and 1990s both saw years of 4% GDP growth.

What's more, the impact of the fiscal squeeze in the early 2010s was mitigated by looser monetary policy; another round of QE began in October 2011, pushing market interest rates down sharply. ***This time, the Monetary Policy Committee—MPC—is less able to inject more stimulus to offset the fiscal squeeze.*** Markets already expect interest rates to remain on hold until early 2017 and, as the MPC discovered during its initial forward guidance, its ability to massage interest rate expectations further out is limited. More QE could be authorised, but unless the MPC bought gilts without end, yields can not be forced much below present rock-bottom levels. Further stimulus would also inflate the housing market, which is already heating up again and worrying the Bank.

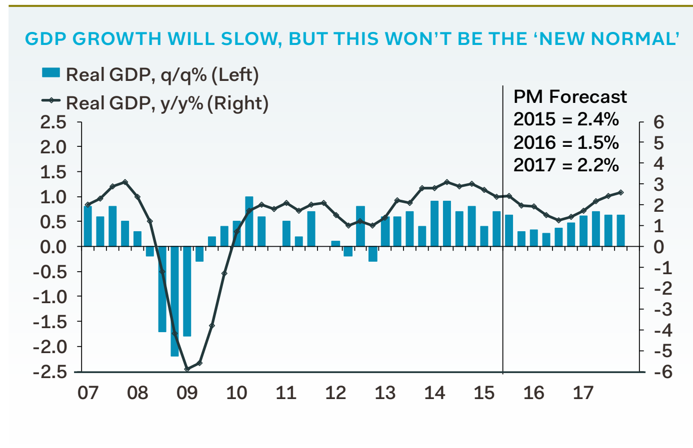
Moreover, slowing growth next year is likely to be accompanied by firming domestic price pressures. As our next chart shows, indicators of domestically-generated inflation such as unit labour costs have begun to pick up and are now near rates consistent with the MPC's 2% target for CPI inflation. *Unless unemployment rockets, weak growth in demand won't subdue these pressures; quite the opposite*. By weighing on productivity growth, a slowdown would *add* to the upward pressure on unit wage costs emanating from the labour market, which is now quite tight. Although the recent fall in import prices is likely to keep CPI inflation below its target until late 2016, the MPC probably will look through this influence. ***Accordingly, the MPC will still have to raise interest rates next year even as the economic recovery slows.*** We expect one hike in Q2, followed by another in Q4, leaving rates at 1% by the end of 2016.

With exporters struggling and the government retrenching, the onus will be on businesses and households to keep the recovery going. We expect steady, but slower, growth in both investment and consumption. Firms' profit margins are wide and their balance sheets are healthy. But with investment now comprising 9.7% of GDP—just below its pre-crash level of 9.8%—and caution likely to creep into boardrooms before the EU referendum, due by the end of 2017 at the latest, we expect growth in capex to slow. Meanwhile, growth in households' real incomes will fade as inflation rebounds, state benefits are cut and job gains slow.

In our view, then, the consensus forecast for GDP growth to moderate slightly from 2.5% to 2.4% next year does not come close to acknowledging the likely extent of the slowdown ahead. We expect GDP to increase by just 1.5% in 2016, no more than in the Eurozone and less than half the likely pace in the U.S. Weak growth won't last forever, since the factors weighing on the recovery will be transitory, not structural. ***But the best days of the U.K. economy's recovery are now surely behind it, even if monetary policy is not tightened.***



THE MPC CAN'T HELP THIS TIME AS PRICE PRESSURES ARE FIRMING



GDP GROWTH WILL SLOW, BUT THIS WON'T BE THE 'NEW NORMAL'

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THIS WEEK IN BRIEF

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

Monday, October 19

• Rightmove house prices (10)/00:01 BST

Asking prices are likely to have risen robustly, perhaps **0.5%** month-to-month, as recovering demand meets limited supply.

Tuesday, October 20

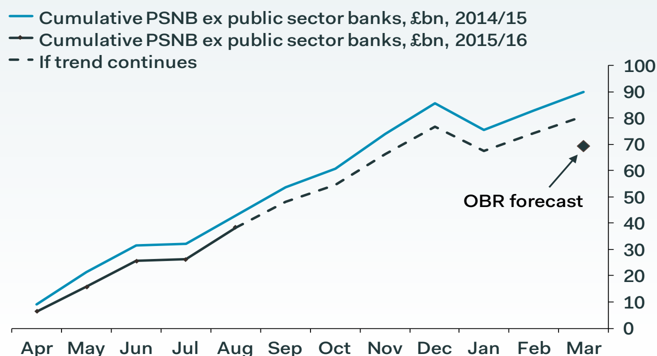
No significant data released.

Wednesday, October 21

• D: Public finances (9)/09:30 BST

The fiscal consolidation is not going to plan. In the first five months of this fiscal year, borrowing on the main PSNB ex. public sector banks measure was only 10.3% lower than last year. If that trend persists, it will total £81B this year, £11B more than the OBR forecast in the summer Budget, as our chart shows. The annual comparison should look better after September's figures, since borrowing was an excessive £11B in September 2014, boosted by volatility in central government spending. We expect a deficit of about **£9B**, a near-20% annual reduction. But we think the Chancellor will need to announce additional austerity measures in time if he is to obtain a budget surplus in this Parliament. **Consensus: £9.8B**

BORROWING IS FALLING, BUT NOT AS QUICKLY AS PLANNED



Thursday, October 22

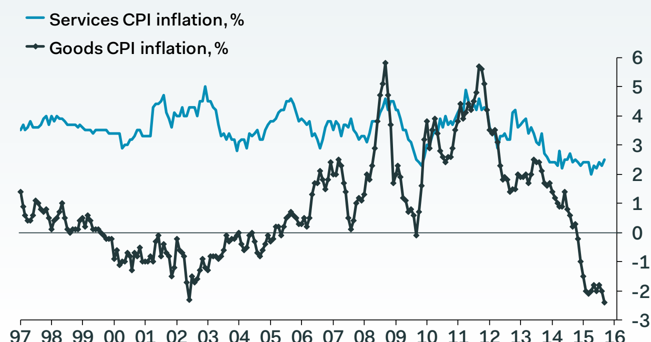
• D: Retail sales (9)/09:30 BST

September's retail sales figures will be flattered by the inclusion of August's later-than-usual bank holiday in the figures. The annual growth rate will also be boosted by the 0.8% month-to-month fall in sales volumes in September 2014, when warmer-than-usual weather hit clothing sales. The BRC's Retail Sales Monitor was affected by both distortions, and its measure of retail sales values, deflated by the BRC Shop Price Index, rose 5.8% year-over-year in September. As a result, we think the official measure of sales volumes rose **1.0%** month-to-month, pushing the year-over-year rate up to 5.5%. Nonetheless, we expect growth to slow to 2.5% in 2016, from 4.2% in 2015, as inflation rebounds and jobs growth fades. **Consensus: 0.4%.**

Friday, October 23

No significant data released.

CHART OF THE WEEK: DEFLATION IS CONCENTRATED, NOT PERVASIVE



PANTHEON'S FINANCIAL FORECASTS

	4pm Fri.	Dec	Mar	Jun	Sep	Dec 16	Dec 17
		End-month:					
Bank Rate	0.50	0.50	0.50	0.75	0.75	1.00	1.50
3m Libor	0.58	0.60	0.70	0.90	1.00	1.20	1.80
12m Libor	1.03	1.20	1.30	1.50	1.60	1.80	2.60
2-year Gilt	0.54	0.80	1.00	1.20	1.40	1.60	2.50
10-year Gilt	1.79	2.00	2.20	2.40	2.60	2.80	3.50
30-year Gilt	2.56	2.60	2.80	3.00	3.20	3.30	4.00
FTSE-100	6375	6400	6450	6500	6550	6600	7000
USD/GBP	1.55	1.50	1.48	1.46	1.44	1.42	1.40
EUR/GBP	1.36	1.39	1.40	1.40	1.41	1.42	1.40
Sterling TWI	91.0	92.3	92.4	92.4	92.5	92.6	91.2

PANTHEON'S ECONOMIC FORECASTS

	Q3 15	*Q4 15*	*Q1 16*	*Q2 16*	*2015*	*2016*	*2017*
	Period average:						
GDP, q/q%	0.6	0.3	0.3	0.3	-	-	-
GDP, y/y%	2.4	2.0	1.9	1.5	2.4	1.5	2.2
Employment, y/y%	1.2	1.2	0.7	1.0	1.4	0.8	0.7
Unemp. rate, %	5.4	5.3	5.3	5.3	5.5	5.3	5.2
Wkly earnings, y/y%	3.2	3.3	3.1	3.7	2.8	3.5	3.5
CPI, y/y%	0.0	0.0	0.9	1.3	0.0	1.5	2.2
RPI, y/y%	1.0	1.0	1.9	2.3	1.0	2.4	3.2
PSNB FY, £B	-	-	-	-	72	55	40
Cur. acc't., % GDP	-4.8	-4.3	-4.3	-4.4	-4.5	-4.5	-4.0
House prices, y/y%	3.5	4.3	6.6	7.7	4.5	8.0	4.0

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