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THE **UNITED KINGDOM** IN H2 2017

SAMUEL TOMBS, CHIEF U.K. ECONOMIST

Weak GDP and Wage Growth Will Keep Higher Interest Rates at Bay

* The jump in CPI inflation to nearly 3% and the emergence of three MPC members voting to raise interest rates has rattled markets, which now are pricing-in a 50% chance of a hike in the second half of 2017. ***Growth in activity and wages, however, likely will be too weak for the MPC to start normalising policy this year.***

* ***CPI inflation has only a little further to rise before it peaks, probably at about 3.2% near the end of this year, up from 2.9% in May.*** Sterling's depreciation suggests that inflation in the food and core goods sectors will rise to about 5.0% and 2.8%, respectively, in Q4, from 2.1% and 2.3% in May. These increases will collectively boost CPI inflation by 0.5 percentage points. But the renewed fall in the oil price implies that motor fuel's contribution to inflation will decline by 0.2pp over the next six months.

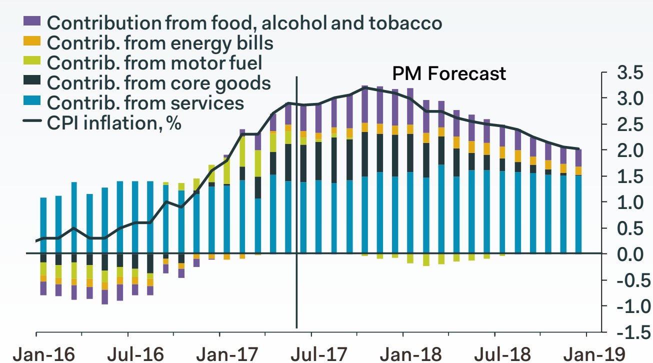
* Sterling's depreciation is *entirely* responsible for driving inflation above the MPC's 2% target. We think inflation will return to target by late 2018 as the import price shock fades. ***Measures of domestically-generated inflation have remained weak.*** Inflation in the services sector, for instance, was just 2.8% in May, well below its average of 3.5% of the previous two decades. Households' long-term inflation expectations also have remained below long-run averages. Meanwhile, year-over-year growth in average weekly wages was below 2% in April and May, and surveys point to only a modest recovery ahead.

* Admittedly, firms' hiring intentions are consistent with employment rising at a solid 1% year-over-year rate in the second half of 2017. This likely would push the unemployment rate down a little further from May's 42-year low of 4.5%. But "hidden" slack remains; many employees and self-employed workers want more hours. Surplus workers in the EU—where unemployment is double the U.K.'s rate—also are dampening wage gains.

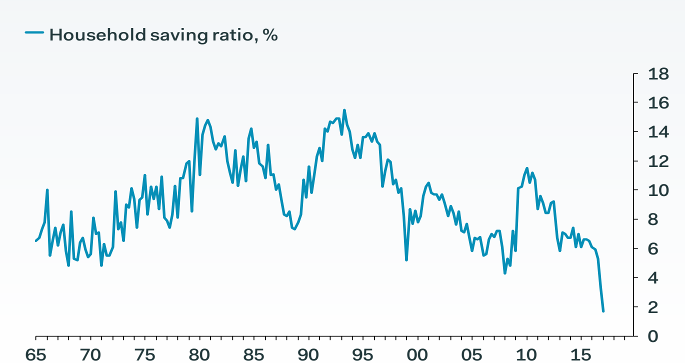
* Meanwhile, the slowdown in GDP growth to just 0.2% quarter-on-quarter in Q1 looks more than just a blip. ***Households' real incomes are set to flatline this year***, as further falls in real wages offset employment gains. People will be able to spend more only by saving less and borrowing more, but the saving ratio can't fall much further from Q1's record-low 1.7%, and consumer confidence has returned to the lows seen just after the referendum. And while many households will benefit when they refinance fixed-rate mortgages taken out earlier this decade, the average windfall will decline, now that mortgage rates have hit a floor.

* Firms' profit margins have improved over the last year, but businesses have lacked the confidence to increase investment and have run up huge cash reserves instead. GDP growth would pickup if firms spent just a small fraction of their stockpiled cash. ***But firms have left vast sums of cash abroad, suggesting they are more likely to invest overseas and hedge Brexit risk than to expand operations at home over the next year.***

INFLATION IS NEAR ITS PEAK AND SHOULD BE BACK AT 2% IN LATE '18



GROWTH IN CONSUMPTION CAN NO LONGER OUTPACE INCOMES



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* Net trade has made a *negative* contribution to GDP growth over the last 18 months, despite sterling's huge depreciation. By contrast, net trade already had begun to boost GDP growth at the same stage after large depreciations in 1967, 1976, 1992 and 2008.

* ***We expect net trade to begin to support GDP growth over the next year, but the boost likely will be underwhelming by past standards.*** The attractiveness of locating production in countries with depreciated currencies has declined as supply chains have become global. Huge uncertainty over the U.K.'s trade links also will ensure that the economy's rebalancing toward exports is slower and more tentative than in the past.

* On a brighter note, we are less worried than most that the hung parliament will harm the economy over the medium term. GDP growth has not been linked strongly to political uncertainty in the past. The economy grew rapidly in the late-1970s and mid-1990s, even though minority governments verged on collapse.

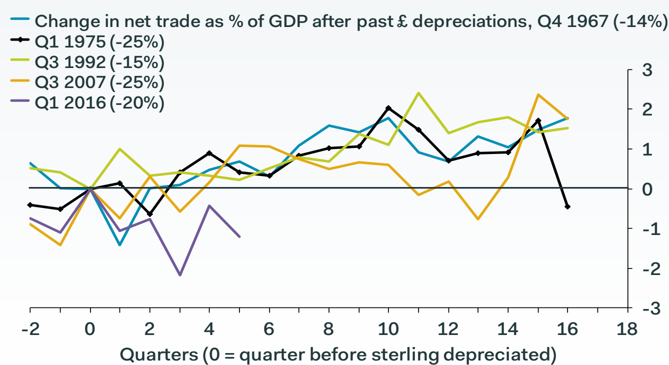
* ***Hopes that the election result means that the fiscal consolidation will be reduced substantially in the Autumn Budget, however, likely will be dashed.*** The pact between the Conservatives and the DUP might not last for a full five-year term, but another election does not look imminent, so it makes sense to push through austerity measures in the near-term. The Chancellor also will retain as much scope as possible to loosen policy to support the economy in the event of a damaging Brexit. The fiscal consolidation might, however, be rebalanced towards tax increases; note that taxes nearly always rise in post-election Budgets.

* ***Accordingly, we continue to think that the economy will struggle over the next 18 months, with GDP rising by just 1.5% in both 2017 and 2018.*** The MPC has based its decisions to a far greater extent on its expectations for the average rate of GDP growth over the next two years than its expectations for inflation, as our final chart shows. Weak growth will mean that spare capacity persists, keeping inflation subdued over the medium term. As a result, we doubt the MPC will commence a tightening cycle this year or next. We can't rule out the Committee reversing last year's rate cut and then stopping there—a "one and done" strategy suggested by some members—but the risk that this would lead to a damaging rise in interest rate expectations among households and firms likely will dissuade the MPC from considering even this modest move.

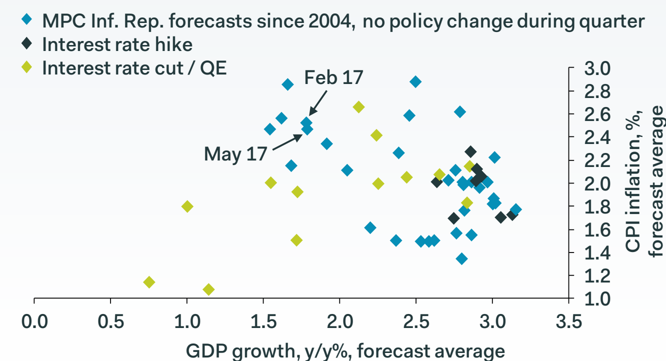
* ***Our working assumption remains that Britain will join the EEA in 2019, thereby preserving unfettered access to the single market.*** The government does not have time to negotiate a comprehensive free trade agreement with the E.U. before March 2019—the deadline imposed by Article 50—and its threat to walk away without a deal lacks credibility. Public concern about immigration also has plunged since the referendum. The Government's reliance on the DUP, which wants to maintain a "frictionless" border with the Republic of Ireland, has boosted the chance of a soft Brexit too. To appease Eurosceptics, EEA membership would be branded an 'interim' step, but it would stand a high chance of becoming semi-permanent, in our view.

* ***Investment likely will revive and the pressure on consumers' real incomes will lift in 2019 if Britain opts for soft Brexit, paving the way for higher rates.*** The resulting sharp rise in rate expectations and decline of the hard Brexit risk premium should enable sterling to recover to around $1.40 and €1.27. Gilt yields, however, likely would rise sharply, with 10-year yields ending 2019 at about 2.5%, up from 1.3% currently.

THE LEAST EFFECTIVE DROP IN STERLING EVER?



THE MPC HIKES ONLY WHEN IT EXPECTS HIGH GROWTH & INFLATION



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Economic Activity (y/y%, full-year average)	2015	2016	2017	2018	2019
Household spending	**2.5**	**2.8**	**1.7**	**1.0**	**2.2**
Fixed investment	**3.4**	**0.5**	**0.8**	**0.2**	**3.0**
Government spending	**1.3**	**0.8**	**1.3**	**0.9**	**0.8**
Inventories, cont. to GDP growth	**-0.2**	**-0.5**	**-0.3**	**0.2**	**0.3**
Domestic demand	**1.9**	**1.5**	**1.2**	**1.0**	**2.4**
Exports	**6.1**	**1.8**	**3.5**	**3.5**	**2.5**
Imports	**5.5**	**2.8**	**3.0**	**2.0**	**3.0**
GDP	**2.2**	**1.8**	**1.5**	**1.5**	**2.2**

Labour Market, Costs and Prices (y/y%, full-year average, unless stated)	2015	2016	2017	2018	2019
Output per worker	0.7	0.3	0.4	0.7	1.2
Employment	1.7	1.4	1.2	0.8	1.0
Unemployment rate (%)	5.4	4.9	4.4	4.2	4.0
Average weekly wages	2.6	2.4	2.0	2.5	3.0
Unit wage costs	1.4	1.8	1.7	1.9	1.8
CPI	0.0	0.7	2.8	2.4	1.8
Core CPI	1.1	1.3	2.5	2.4	1.7
RPI	1.0	1.7	3.5	3.5	3.0
House prices, Nationwide measure (end year)	6.9	5.2	1.5	2.0	3.0

Other	2015	2016	2017	2018	2019
Current account, % GDP	-4.3	-4.4	-3.0	-2.5	-3.0
Budget deficit, £B, FY	76.0	47.0	62.0	48.0	23.0
Budget deficit, % GDP, FY	3.8	2.3	3.0	2.3	1.0
Bank Rate, December	0.50	0.25	0.25	0.25	1.00
Asset Purchase Facility, £B, December	375	435	435	435	435
10-year gilt yields, end year	1.96	1.24	1.40	2.00	2.50
30-year gilt yields, end year	2.67	1.88	2.00	2.50	3.00
$ per £, end year	1.47	1.23	1.25	1.35	1.40
€ per £, end year	1.36	1.17	1.14	1.23	1.27
FTSE 100, end year	6242	7143	7200	7000	7000

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