



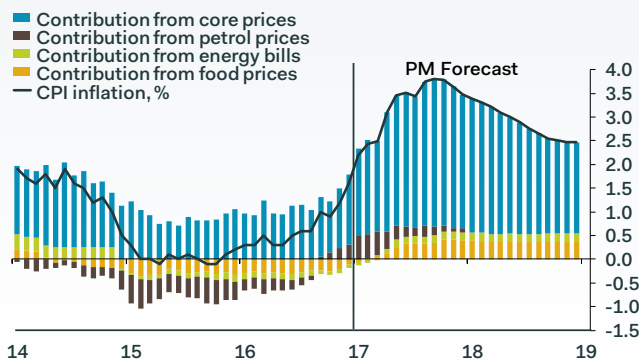
THE UNITED KINGDOM IN H1 2017

SAMUEL TOMBS, CHIEF U.K. ECONOMIST

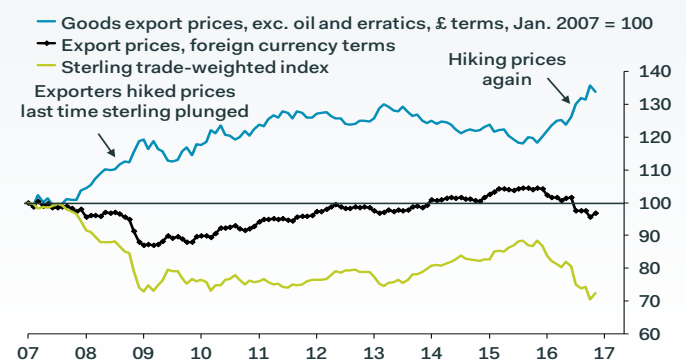
High Inflation Will Cripple Consumers and Tie Policymakers' Hands

- * **The adverse consequences of the Brexit vote will become painfully clear in 2017.** Sterling's depreciation will fuel inflation but boost net trade only modestly. Uncertainty about the terms of the U.K.'s access to the single market will ensure firms stick to plans to hire and invest more cautiously than in 2016. Meanwhile, policy likely will not stimulate growth. **High inflation will constrain the MPC** and the Chancellor will press on with the fiscal consolidation while the next election is distant.
- * Strong growth in household spending prevented the economic recovery from slowing immediately after the June referendum. But households benefited from sharp falls in commodity and import prices, which will be reversed this year. The 15% drop in trade-weighted sterling and the near-doubling of oil prices over the last year will push up **CPI inflation to an average of about 3% in 2017.**
- * Households' nominal incomes will not accelerate alongside inflation. Surveys of employment intentions have deteriorated and job vacancies have started to edge down. The decline in pay settlements towards the end of 2016 also suggests that **wage growth will not exceed the 2%-to-2.5% range** that has become the norm. Firms also will restrain wage growth in order to meet the cost of the apprenticeship levy—a tax of 0.5% on payrolls—that will be introduced in April, and imminent increases in minimum employer pension contributions.
- * As a result, spending will rise only if households save a smaller fraction of their incomes. But **the saving ratio is close to its all-time low** and people usually only borrow more when they are confident about the outlook for their incomes and wealth. The real wage squeeze and slowdown in house price growth will both weigh on sentiment. Growth in consumer spending therefore likely will average just 0.2% per quarter in 2017.
- * Business investment was down 2.3% year-over-year in the first three quarters of 2016. Admittedly, this partly reflected the impact of low oil prices on mining investment. But other investment also fell over the same period, by 0.7%, suggesting that Brexit risk already was dampening GDP growth last year. **Capex likely will decline further in 2017**, given that investment usually lags a few quarters behind investment intentions, which deteriorated after the referendum and have barely recovered since.
- * Meanwhile, **hopes for a meaningful boost to growth from net trade will remain unfulfilled**, because exporters have hiked sterling prices. The economy will enjoy a trade boost only when new entrants undercut existing exporters, improving the competitiveness of U.K. goods in global markets. But uncertainty about the U.K.'s future trading relationship with the rest of the world likely will mean that the economy rebalances towards exports more tentatively than in the past.

STERLING'S DEPRECIATION WILL PUSH INFLATION ABOVE 3% IN 2017



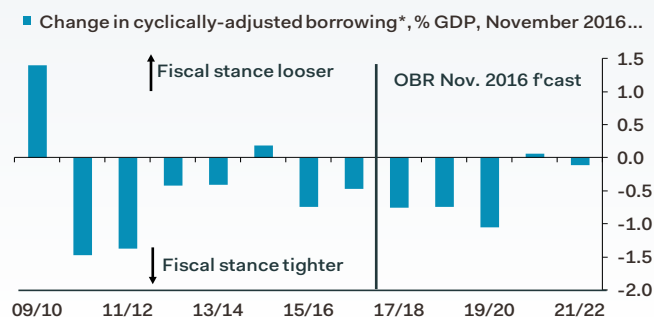
EXPORTERS HAVE HIKED PRICES; U.K. GOODS ARE NOT COMPETITIVE



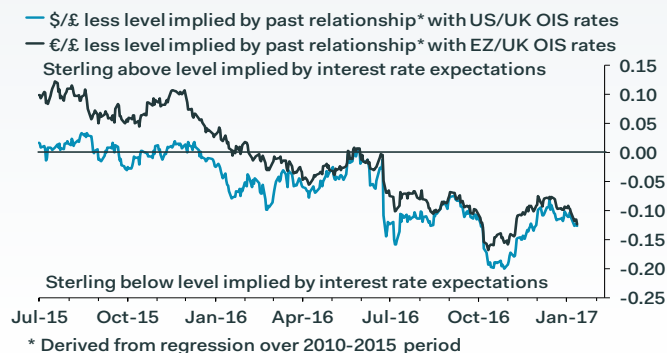
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- * Meanwhile, the Chancellor passed up the chance in the Autumn Statement to pause the fiscal consolidation; he plans to reduce cyclically-adjusted borrowing by 0.8% of GDP in 2017/18. **As a result, the fiscal tightening is set to be nearly twice as large this year as in 2016/17.**
- * Admittedly, Mr. Hammond has retained scope to spend more than currently planned and still meet his new rules, which are less onerous than his predecessor's. But this **"fiscal headroom" will vanish if gilt yields rise significantly**—a real risk, given the close correlation between gilts and U.S. Treasuries—or if the OBR revises down its GDP forecasts to the consensus. The Chancellor also will want to retain scope to loosen policy when Brexit actually happens and for the period before the 2020 election.
- * Meanwhile, **the MPC will have to be alert to the risk that the imminent burst of inflation will become ingrained** via an upward shift of either inflation expectations or wage growth. The Committee also cannot act entirely independently of other central banks; cutting interest rates at the same time that the U.S. Fed is raising them would put intolerable downward pressure on sterling and upward pressure on inflation.
- * **Monetary policy, therefore, will be less stimulative than in previous years.** Each year, households have benefited from a decline in debt servicing costs, freeing up money for discretionary spending. The recent rise in market interest rates suggests that the fall in mortgage rates following the MPC's actions in August will be reversed over coming months. Many households will still benefit from refinancing fixed-rate mortgages obtained earlier this decade, but the gains will become smaller now that mortgage rates have hit a floor.
- * Beyond 2017, the outlook for the economy depends on the outcome of the Brexit negotiations. The Government currently is prepared to leave the single market in order to control immigration, and it may exit the EU's customs union too in order to gain the opportunity to cut trade deals with non-EU countries. **We continue to think, however, that markets are under-pricing the chances of a soft Brexit.** The economy soon will replace immigration as the public's main concern as inflation rises and job prospects worsen. The spike in gilt yields in October shows that the Government must maintain international investors' confidence if it is to meet its fiscal targets and its commitments to lower taxes. In addition, the Government's majority of just 14 MPs means pro-Remain Conservatives have leverage. Finally, elections in Europe this year could alter the political landscape, leaving more countries in favour of controlling immigration and reforming the EU.
- * Concerns about a hard Brexit have pushed sterling \$0.14 and €0.13 below the levels implied solely by interest rate expectations. **Sterling plausibly could weaken to \$1.15 and €1.08 if a hard Brexit becomes inevitable.** Faster increases in U.S. interest rates than markets currently expect likely also will weigh on cable. But a soft Brexit likely would see most of this risk premium disappear and boost interest rate expectations, enabling sterling to recover back to about \$1.40 and €1.27.
- * Meanwhile, we think that **gilt yields will continue to rise** this year, with 10-year yields finishing 2017 at about 2.0%, up from 1.4% currently. Gilt yields have remained closely correlated with Treasury yields, which we expect to rise sharply. Markets' inflation expectations also still look too low to us.

THE FISCAL CONSOLIDATION WILL INTENSIFY THIS YEAR



WE EXPECT THE HARD BREXIT RISK PREMIUM TO DECLINE IN 2017



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Economic Activity (year-over-year, %)	2014	2015	2016	2017	2018
Household spending	2.1	2.5	2.8	1.5	1.2
Fixed investment	6.7	3.4	0.6	-1.0	1.0
Government spending	2.3	1.3	0.8	0.7	0.5
Inventories, cont. to GDP growth	0.7	-0.2	-0.4	-0.1	0.1
Domestic demand	3.4	1.9	2.0	1.0	1.1
Exports	1.5	6.1	1.2	3.5	4.0
Imports	2.5	5.5	2.8	2.5	2.5
GDP	3.1	2.2	2.0	1.2	1.5

Labour Market, Costs and Prices (year-over-year, %, unless stated)

Output per worker	1.0	0.7	0.6	0.8	0.8
Employment	2.4	1.8	1.4	0.4	0.6
Unemployment rate (%)	6.2	5.4	4.9	5.2	5.1
Average weekly wages	1.2	2.4	2.4	2.5	2.8
Unit wage costs	0.4	1.4	1.7	1.7	2.0
CPI	1.5	0.0	0.6	3.0	2.8
Core CPI	1.6	1.1	1.3	2.9	2.7
RPI	2.4	1.0	1.7	4.0	4.0
House prices, Nationwide measure (end year)	7.7	6.9	5.7	2.0	3.5

Other

Current account, % GDP	-4.7	-4.3	-5.0	-4.5	-3.0
Budget deficit, £B, FY	96.3	76.0	70.0	65.0	55.0
Budget deficit, % GDP, FY	4.5	3.8	3.5	3.2	2.6
Bank Rate, December	0.50	0.50	0.25	0.25	0.25
Asset Purchase Facility, £B, December	375	375	435	435	435
10-year gilt yields, end year	1.76	1.96	1.24	2.00	2.80
30-year gilt yields, end year	2.51	2.67	1.88	2.40	3.00
\$ per £, end year	1.56	1.47	1.23	1.30	1.40
€ per £, end year	1.29	1.36	1.17	1.24	1.27
FTSE 100, end year	6566	6242	7143	6500	6800