

Economics update (Link Asset Services – August 2018)

UK. The first half of 2018/19 has seen UK economic growth post a modest performance, but sufficiently robust for the Monetary Policy Committee, (MPC), to unanimously (9-0) vote to increase Bank Rate on 2nd August from 0.5% to 0.75%. Although growth looks as if it will only be modest at around 1.5% in 2018, the Bank of England's August Quarterly Inflation Report suggested that growth will pick up to 1.8% in 2019, albeit there were several caveats – mainly related to whether or not the UK achieves an orderly withdrawal from the European Union in March 2019.

Some MPC members have expressed concerns about a build-up of **inflationary pressures**, particularly with the pound falling in value again against both the US dollar and the Euro. The Consumer Price Index (CPI) measure of inflation is currently running at 2.5% but is expected to fall back towards the 2% inflation target over the next two years given a scenario of minimal increases in Bank Rate. The MPC has indicated Bank Rate would need to be in the region of 1.5% by March 2021 for inflation to stay on track. Financial markets are currently pricing in the next increase in Bank Rate for the second half of 2019.

As for **unemployment**, this is now at a 43 year low of 4% on the Independent Labour Organisation measure, but despite that, wage inflation is currently weak. This is a global theme for the major economies of the world. Indeed, with UK wages running in line with the CPI measure of inflation, real earnings are, in effect, neutral. Given the UK economy is very much services sector driven, any weakness in household spending power is likely to feed through into tepid economic growth. This is another reason why the MPC will need to tread cautiously before increasing Bank Rate again, especially given all the uncertainties around Brexit. Additionally, business sentiment surveys, such as the Purchasing Managers Index collated by Markit, suggest the UK is set for only modest **GDP growth** in the second half of 2018 with the monthly updated figure for annual growth being 1.5% as at the end of July. The **housing market** is going through a weak phase – with UK-wide house price growth averaging 2 to 3%, but with London and the south-east experiencing price falls.

As for the **political arena**, there is a risk that the current Conservative minority government may be unable to muster a majority in the Commons over Brexit. However, our central position is that Prime Minister May's government will endure, despite various setbacks, along the route to Brexit in March 2019. If, however, the UK faces a general election in the next 12 months, this could result in a potential loosening of monetary policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.

USA. President Trump's massive easing of fiscal policy is fuelling a (temporary) boost in consumption which has generated an upturn in the rate of strong growth to around 1% in Q2 2018, but also an upturn in inflationary pressures. With inflation moving towards 3%, the Fed has already tightened the Fed Funds interest rate to between 1.75% and 2%, and a further two increases to 2.25% - 2.5% are expected before the end of 2018 with the prospect of another increase or two next year. The dilemma, however, is what to do when the temporary boost to consumption wanes, particularly as the recent imposition of tariffs on a number of countries' exports to the US, (China in particular), could see a switch to US production of some of those goods, but at higher prices. Such a scenario would invariably make any easing of monetary policy harder for the Fed in the second half of 2019.

EUROZONE. Growth has undershot early forecasts for a strong economic performance in 2018. In particular, data from Germany has been mixed and it could be negatively impacted by US tariffs on a significant part of manufacturing exports e.g. cars. For that reason, although

growth is still expected to be in the region of 2% for 2018, the horizon is less clear than it seemed just a short while ago.

CHINA. Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

JAPAN - has been struggling to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.