

# UK Economic Update

**Ross Walker**  
**Head of UK & European Economics**  
*[ross.walker@natwestmarkets.com](mailto:ross.walker@natwestmarkets.com)*

January 2017



This is Non-Independent Research, as defined by the Financial Conduct Authority. Not intended for Retail Client distribution. This material should be regarded as a marketing communication and may have been produced in conjunction with the NatWest Markets trading desks that trade as principal in the instruments mentioned herein. All data is accurate as of the report date, unless otherwise specified. NatWest Markets is a marketing name of The Royal Bank of Scotland plc.

[natwestmarkets.com](http://natwestmarkets.com)

# UK growth to slow – but avoiding ‘Brecession’

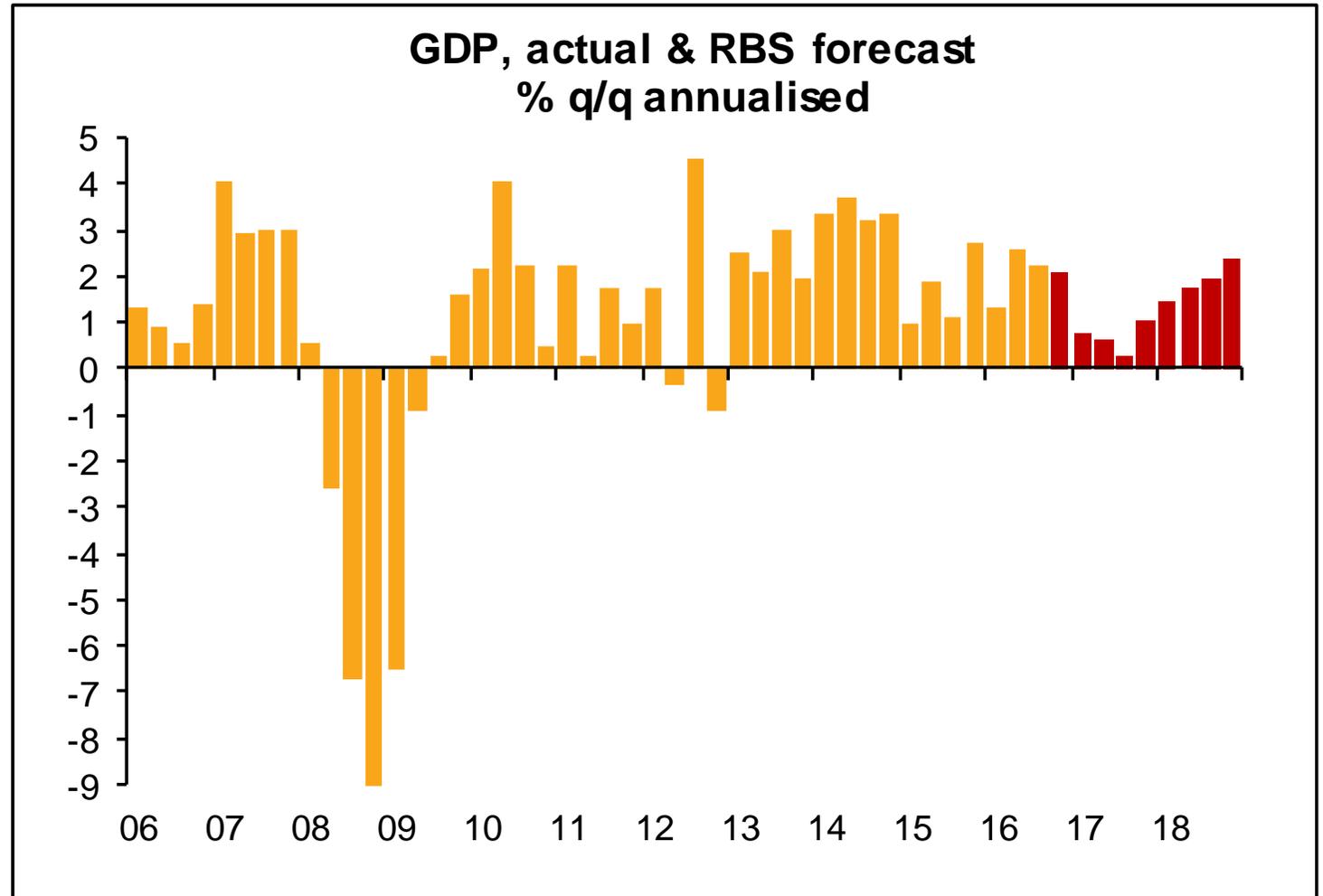
We forecast UK GDP growth to slow to 1.2% in 2017; staging a modest recovery to 1.5% in 2018. We expect the economy to come close to stagnation in mid-2017.

The medium-term Brexit economic shock is centred on the corporate sector, although we expect the deterioration in **capex** to be a ‘slow burn’.

**Consumer spending** faces more immediate pressures as inflation overshoots target in 2017-18 and, over time, the labour market deteriorates.

**Government spending** may be ‘reset’ (increased) but the new finance minister has left deficit reduction as the fiscal priority.

Sterling’s fall should provide some support for **exports**.



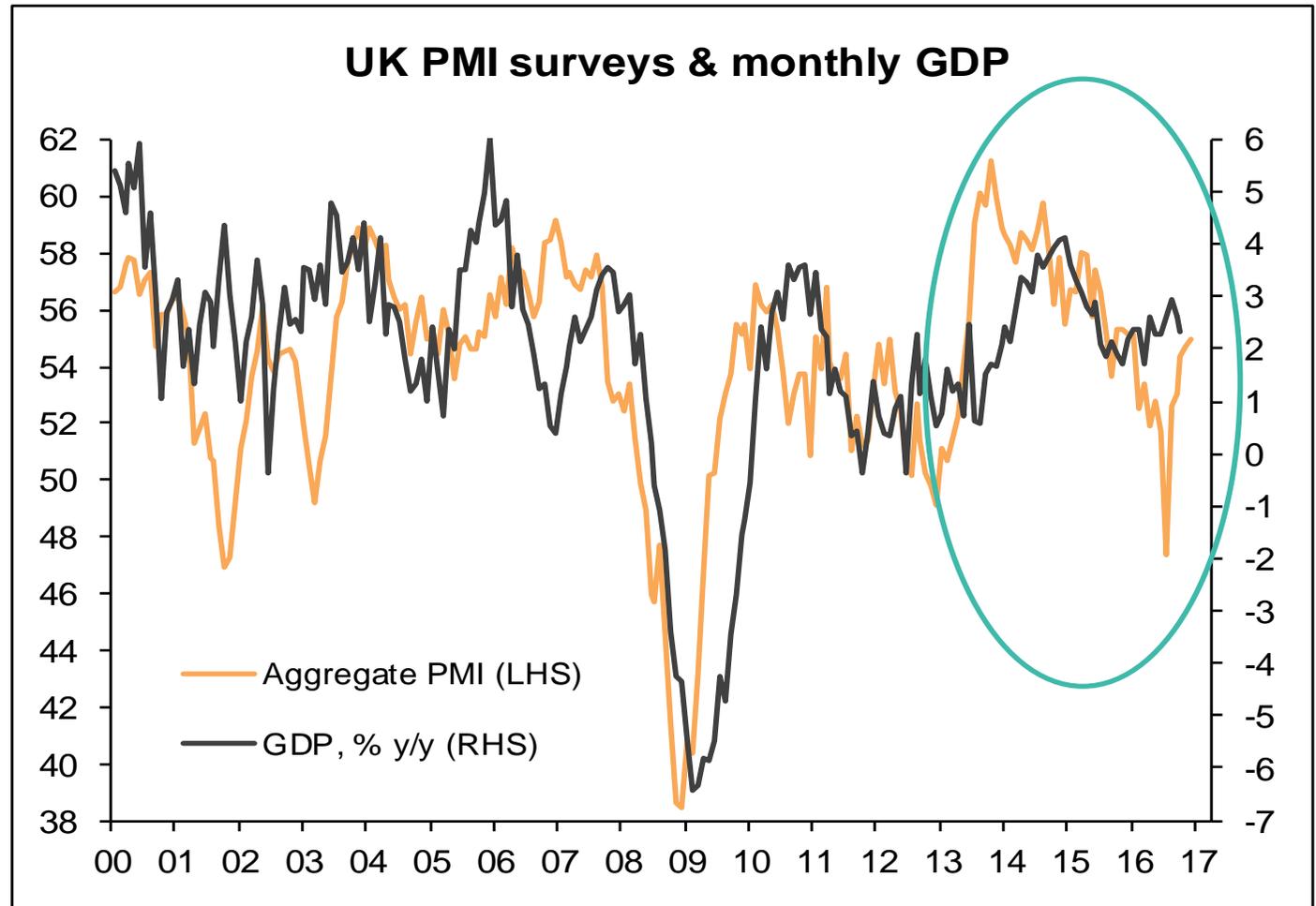
Source: ONS, NatWest Markets

# Business surveys have remained resilient – but the big tests are still to come

High-frequency business surveys have typically rebounded since the EU referendum in June 2016.

The latest PMI surveys (chart opposite) for December are, collectively, at levels consistent with **annualised GDP growth of 2.9%**. Taking the average PMI outturn in Q4 as a whole, the surveys are signalling growth of **2.5%** – above our forecast of 0.5% q/q).

Survey data have not been uniformly strong – medium-term gauges of capex and hiring intentions remain more subdued. And the principal Brexit economic shocks have yet to be felt.



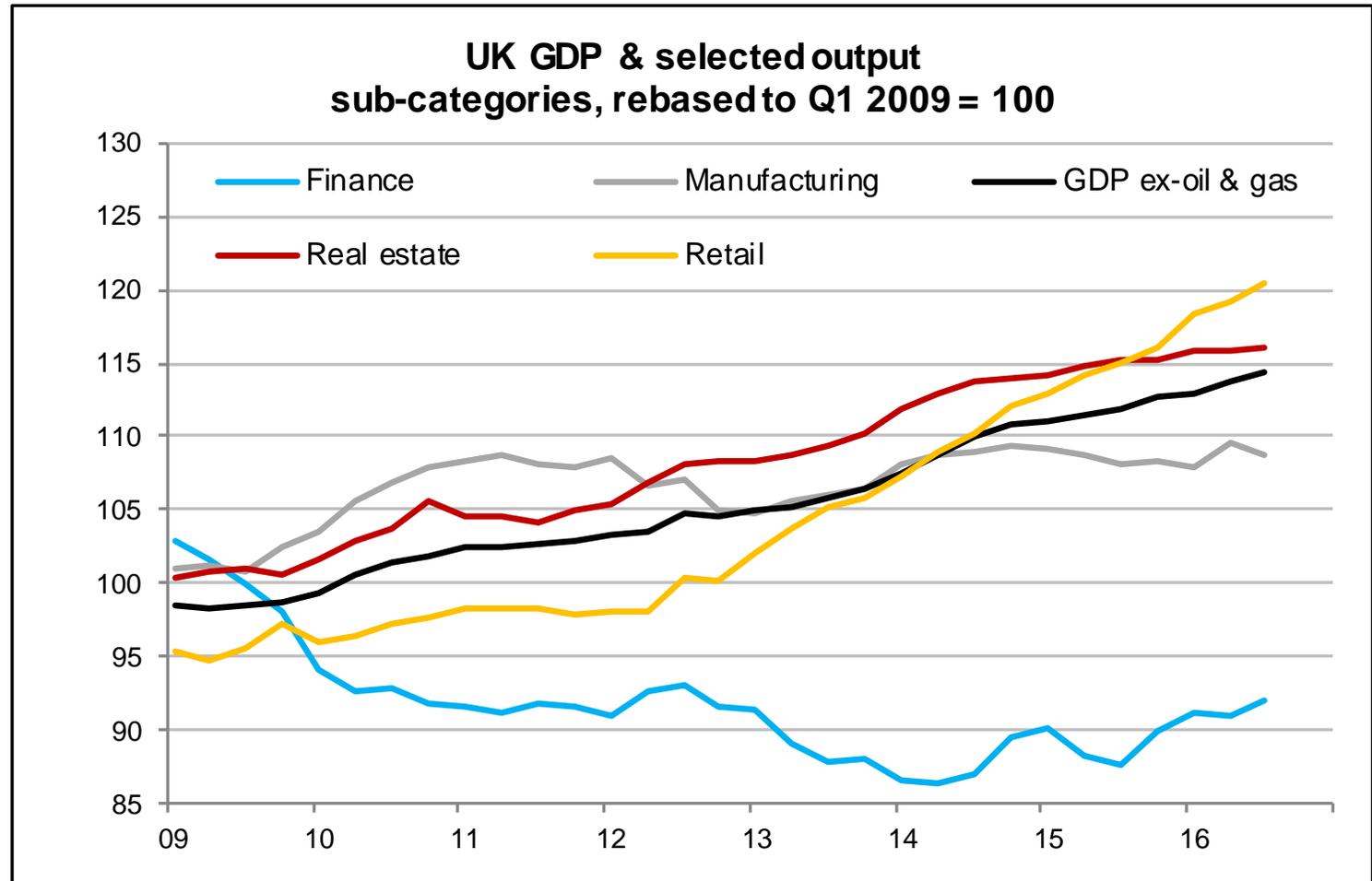
Source: ONS, Markit & NatWest Markets

# Re-emerging UK economic imbalances

The earlier phases of the UK recovery (2009-10) saw more broad-based, balanced expansion – manufacturing output even out-paced overall GDP growth.

More recently, British industry has slipped back into recession, leaving economic growth increasingly reliant on **consumer-facing and real estate services**. It is doubtful this is either desirable or sustainable over the medium-term.

UK **financial services** sector is in structural decline – what will plug the gap?



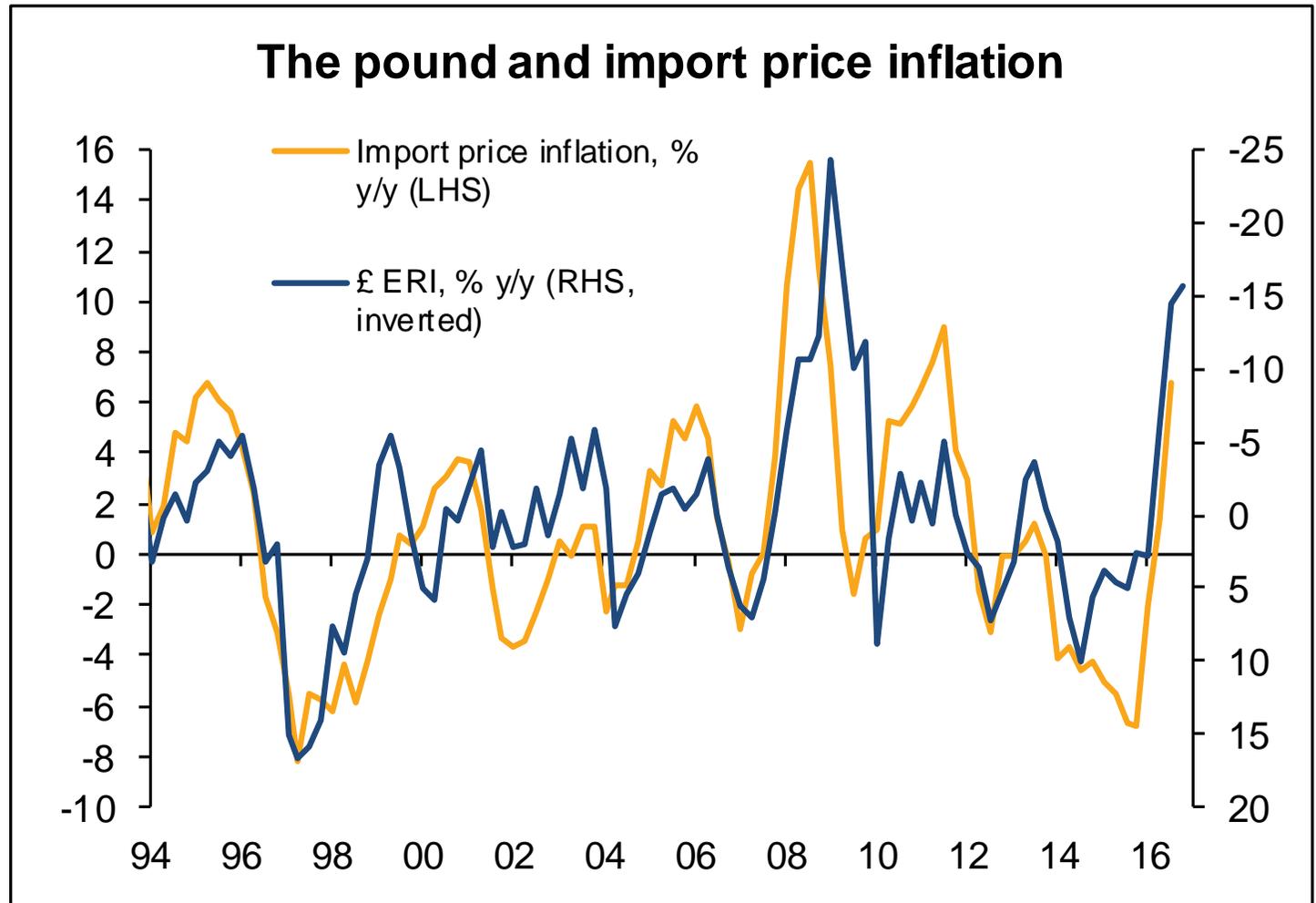
Source: ONS, NatWest Markets

# UK Inflation – sterling & import price pressures

We estimate that a sustained 15% depreciation (appreciation) in sterling boosts (lowers) import price inflation by 7½% pts.

Imports constitute around 30% of the CPI basket, so a 15% trade-weighted decline in GBP (broadly what we have seen since the 'leave' vote) would add 2-2½% pts to CPI inflation.

There is considerable uncertainty about the extent to which firms will be able to pass on cost increases to consumers and whether this will trigger wage inflation – we are sceptical.



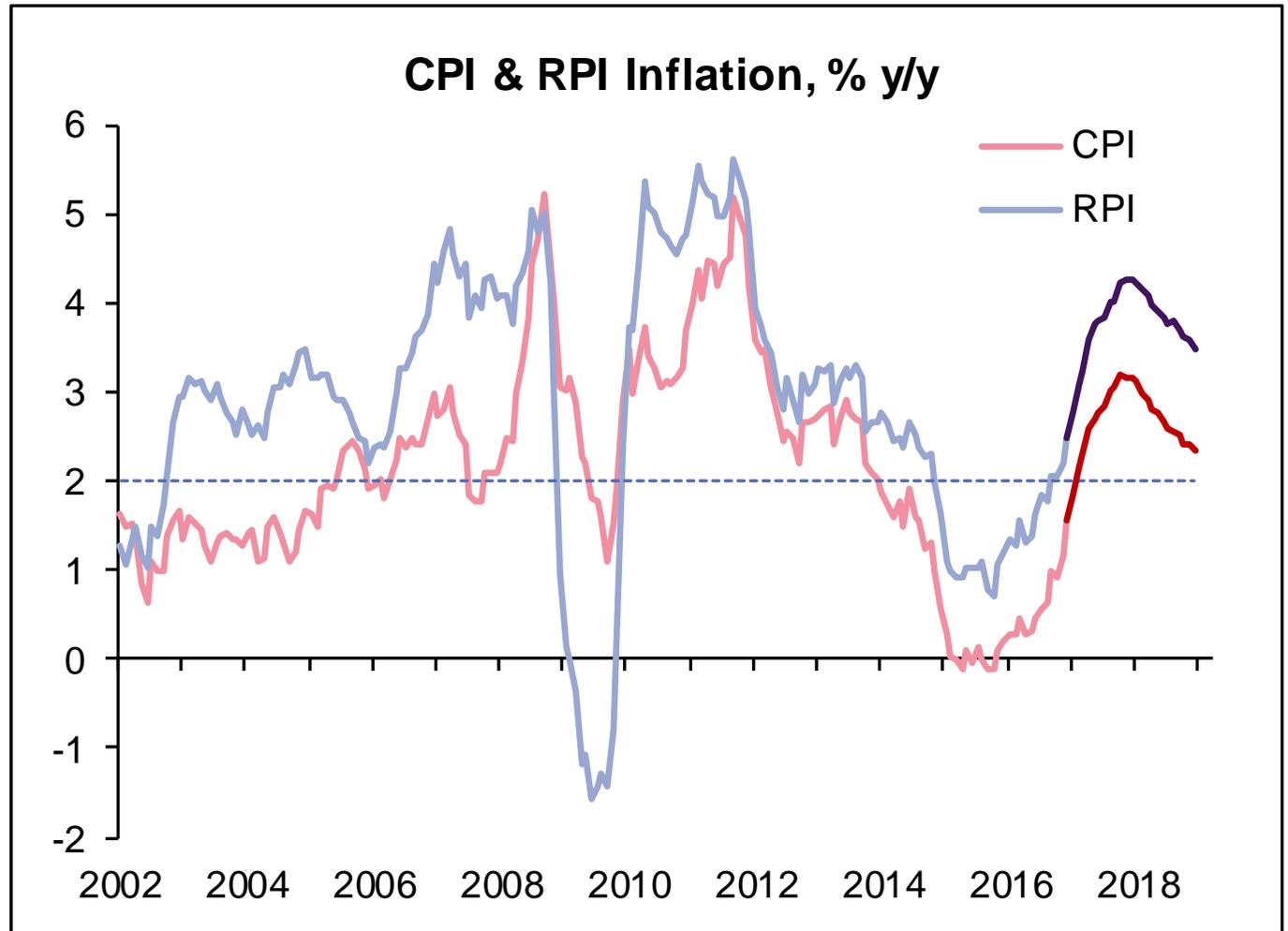
Source: ONS, Bloomberg, NatWest Markets

# UK Inflation forecasts – What goes up . . .

**We forecast CPI inflation to rise relatively sharply over the next 12-18 months, as the pound's depreciation boost import prices.**

We forecast CPI inflation to peak at 3.2% in Q4 2017, with Core CPI inflation also peaking at 3.2%.

**We estimate the 'first-round' impact of sterling's fall will raise CPI inflation by almost 2% pts.** The key issues are how firms' pricing behaviour and wage setting are affected over the medium-term. Against the backdrop of a weak recovery and expected rise in UK unemployment, we forecast inflation to be edging down by early 2018.



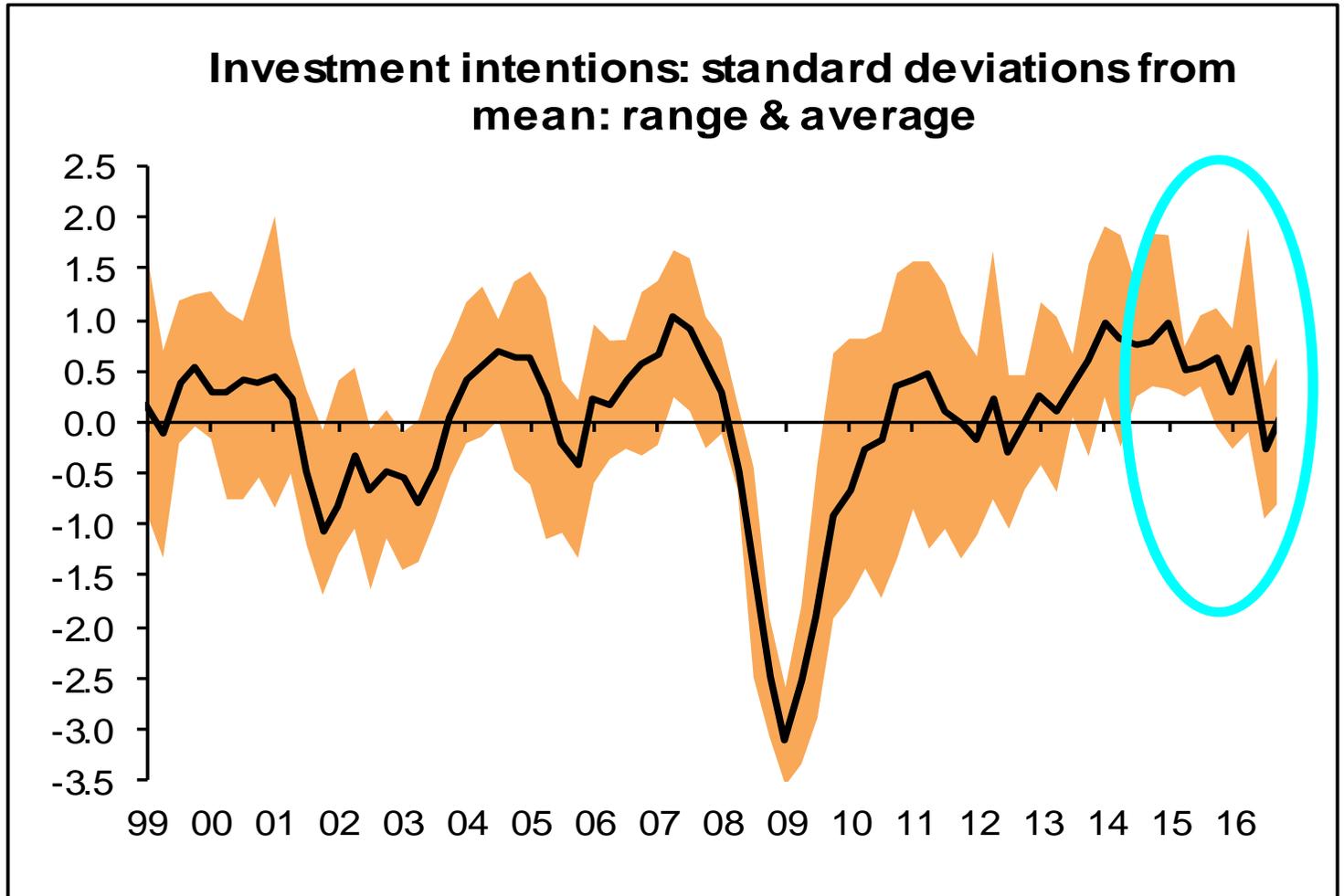
Source: ONS, NatWest Markets

# Brexit risks – Investment intentions at 4-year lows

Surveys of UK businesses' investment intentions (plant & machinery, IT, R&D, training etc), are running at 4-year lows.

The deterioration began before the EU referendum but the pace of decline has increased during H2 2016. The latest surveys suggest some stabilisation in intentions but the macroeconomic outlook means there is scope for further declines in the surveys in the months ahead.

The latest survey estimates are consistent with broadly stagnant investment spending. However, we expect a further slowdown against the backdrop of difficult Brexit negotiations and **forecast a fall in UK capex of 0.7% in 2017.**

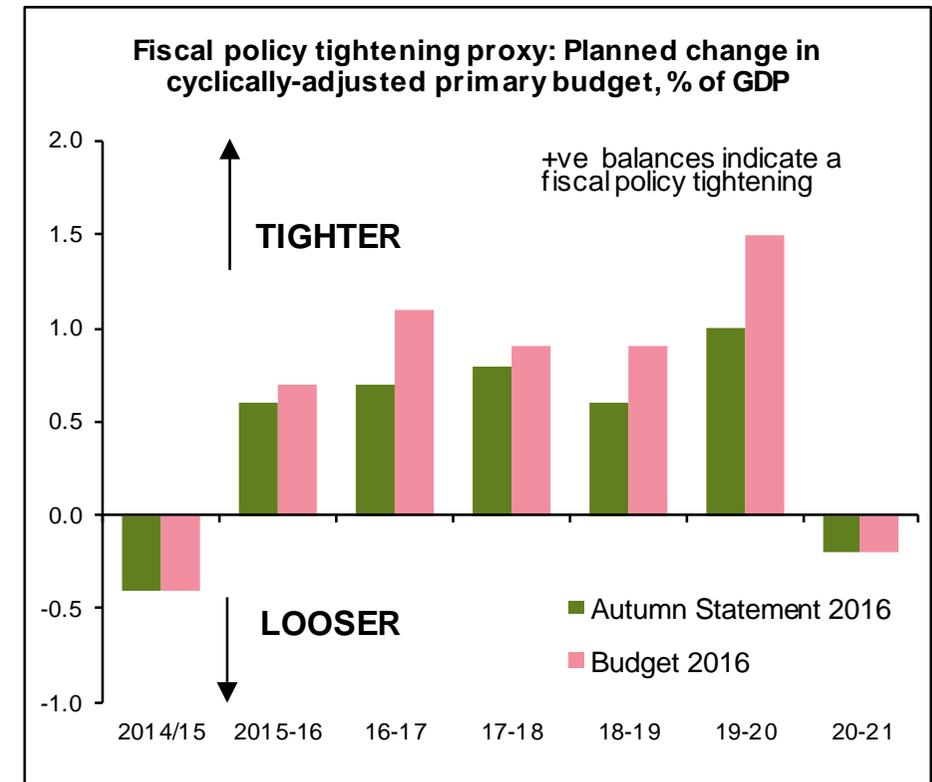
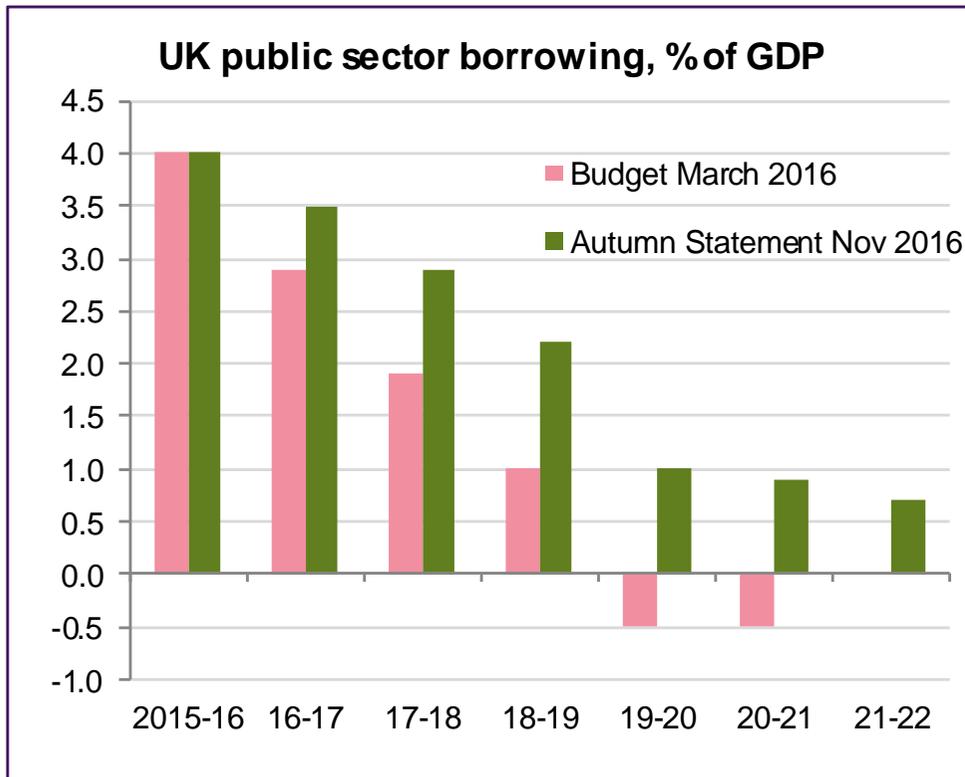


Source: BCC, BoE, CBI, NatWest Markets

# The UK is tightening fiscal policy

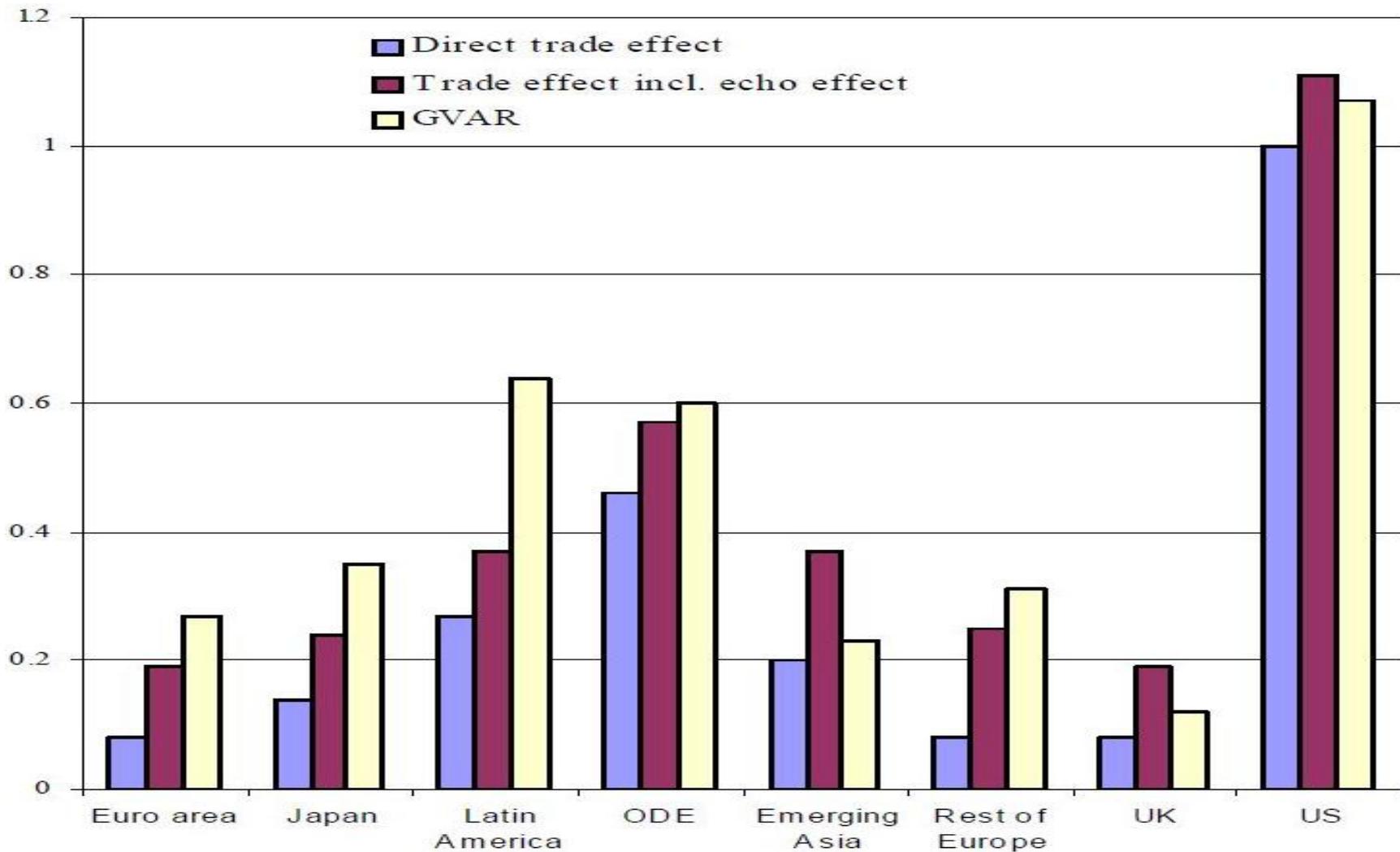
The Autumn Statement brought a significant upward revision to borrowing: +£139bn (6.3% of GDP) over the 6 years to 2021-22 FY. The UK is forecast to continue running fiscal deficits throughout the official forecast period (to 2021-22 FY). The Government has loosened its self-imposed fiscal targets to allow larger amounts of borrowing for longer.

Although the November 2016 Autumn Statement brought a modest dilution of fiscal tightening (0.2-0.3% of GDP per year) the overall position remains that UK fiscal policy is being tightened by an average of 0.8% of GDP per year until 2019-20 FY.



# The 'Trump Effect' – Not so 'braggadocious' for Europe

GDP impact of a 1% point boost to US economic growth



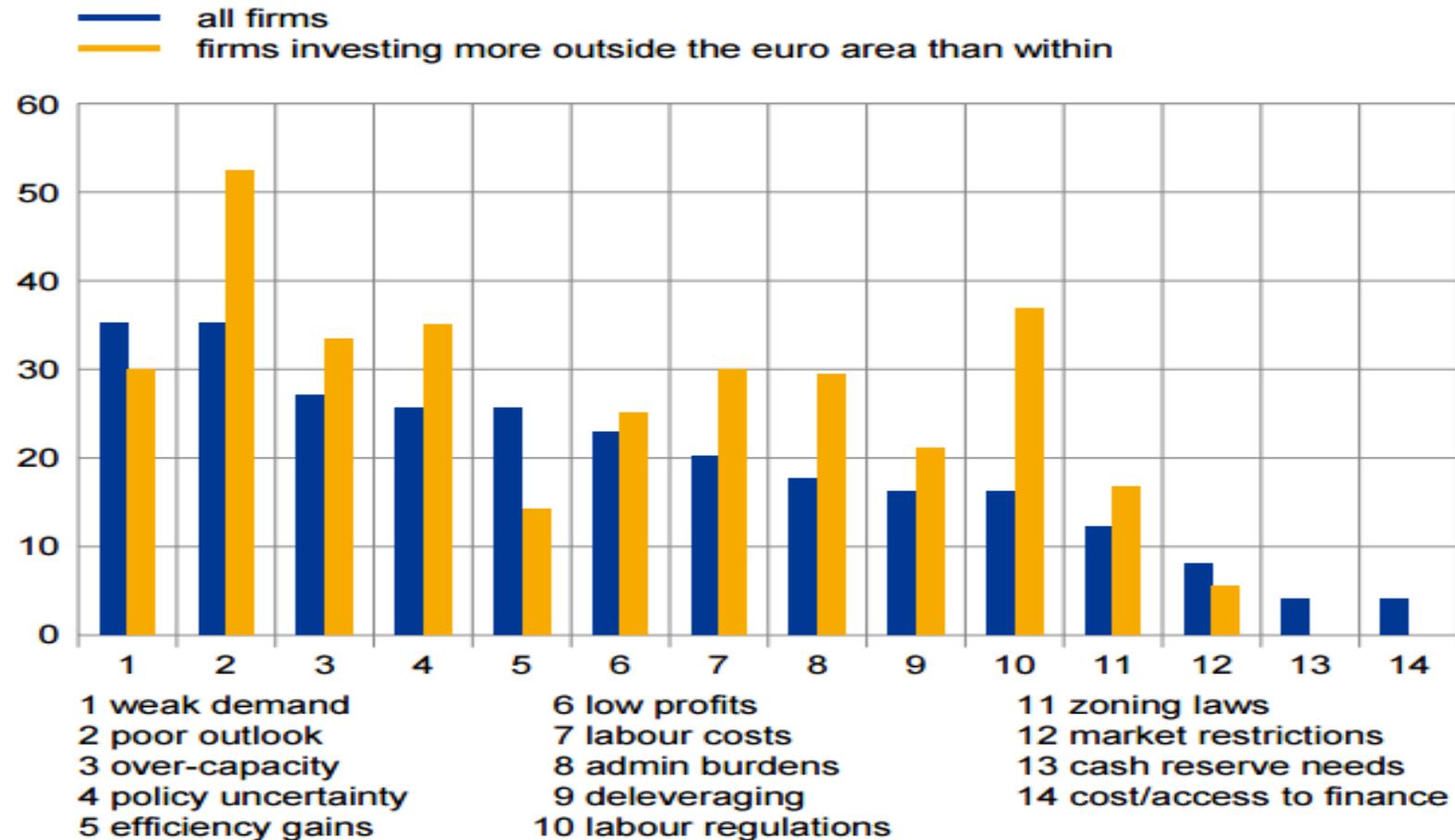
Source: ECB

# EMU lending: A demand rather than a supply problem

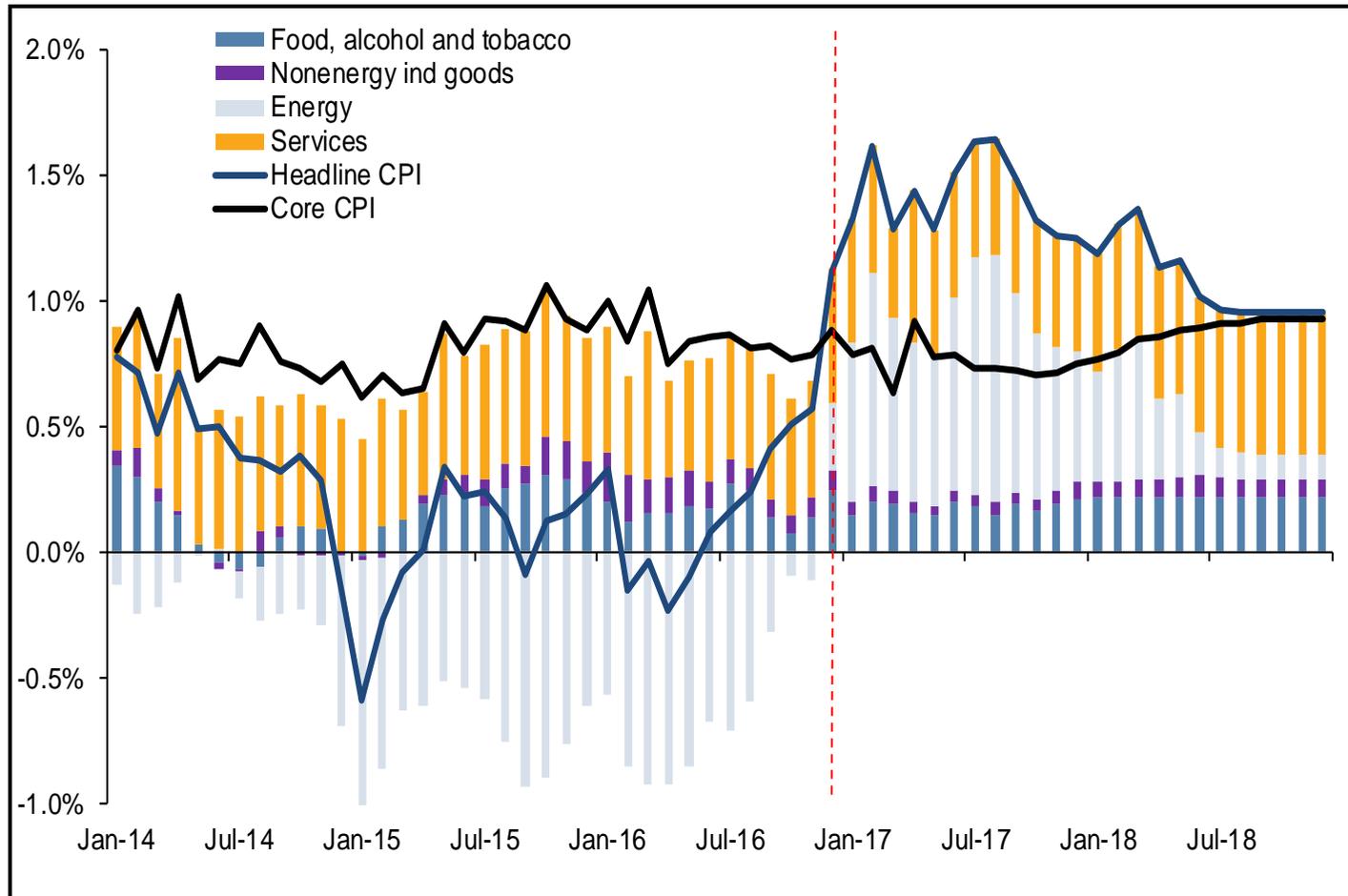
QE is 'working'. But it may be pushing on a string

## Constraints on euro area investment

(percentage of firms reporting)



# Euro Area Inflation – Energy fuels headline CPI, core moves sideways



**Headline CPI inflation expected to rise on energy base effects in 2017** (light blue bars in chart) – to 1.7% y/y in Feb 2017. But full-year 2017 CPI is just 1.4%, with Core CPI at 0.8%.

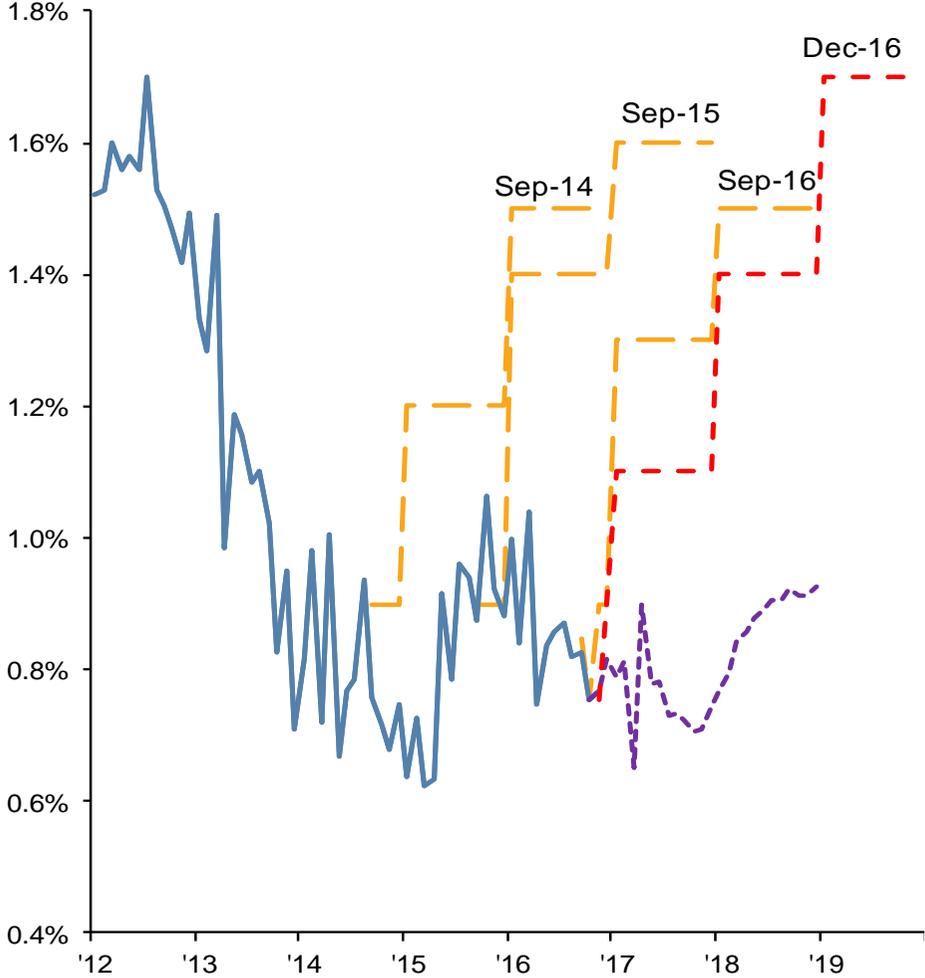
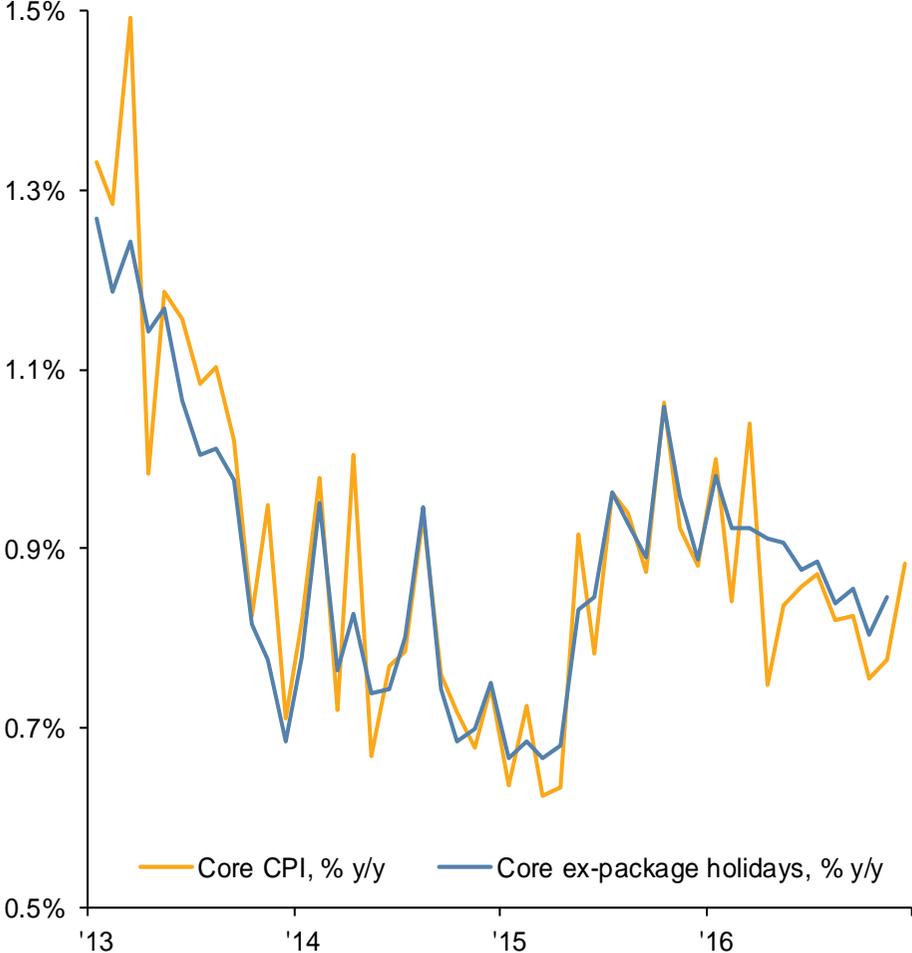
**As base effects fade, inflation is forecast to decline back to depressed levels** (1.3% by end-2017 on our forecast). Headline CPI is expected to remain notably below the ECB’s target over the forecast horizon (2019 and likely beyond).

**Medium-term inflation weakness is driven by lack of underlying price pressures, reflecting large output gap and an absence of wage inflation.**

Rise on ECB forecast to 1.7% in 2019 is seemingly mainly a function of mean-reverting variables in the ECB’s model.

Source: RBS projections, Eurostat

# Core CPI to remain subdued. ECB tapering will only be gradual



# Summary of Key UK Economy Views

---

1. **2017 will bring the slowest UK economic growth since the financial crisis – though forecasts are being revised higher.** Brexit is a different shock to the 2008-09 financial crisis – more of a ‘slow burn’.
2. **CPI inflation is set to peak a little above 3% in late 2017** driven by sterling’s c.10% trade-weighted fall. We do not expect significant second-round inflationary effects – the import price shock will force employers to cut costs, resulting in an ongoing wage squeeze.
3. We still forecast further BoE monetary policy easing, though the probability of further loosening is diminishing. More importantly, we remain of the view that the MPC will become more **reactive**, following the political flak around pre-referendum warnings. We forecast a final, largely symbolic, **cut in Bank Rate of 15bp to 0.1%** and a **£60bn increase in QE gilt purchases to £495bn in May 2017** (risks of delay until August 2017).
4. The UK’s dilution of its planned fiscal policy tightening in the November 2016 Autumn Statement was marginal. Overall, the **UK fiscal tightening will amount to a 3.1% of GDP over the 4 years to 2019-20 FY.**
5. **Political risk** is rising and the UK still appears to be heading for some form of a ‘harder Brexit’ – ie, materially less SEM access than at present. We expect Article 50 to be invoked **before the end of July 2017**. Markets appear to assume that greater parliamentary involvement will increase the probability of a ‘soft Brexit’ – we are sceptical.

# Summary of Key Euro Area Economy Views

---

1. We forecast **subdued growth of 1.2% y/y in 2017 and 1.4% y/y in 2018**, marginally below the 1.3% & 1.5% consensus expectations.
2. Private **consumption is expected to slow** in 2017, primarily as the boost to real disposable incomes from lower oil prices in H1 2016 fades, **but the outlook for investment is where risks seem most concentrated** given the uncertain backdrop.
3. We see **no more than a 0.1-0.2%-point positive impact on Euro Area GDP from a fiscal policy-related boost to US growth**. Direct spill-overs tend to be small and any boost to corporate or consumer confidence in the Euro Area is unlikely to offset more domestically-centred concerns.
4. Our **inflation forecasts are below those of the consensus and the ECB in 2017 and, more notably, 2018**. This is underpinned by our core inflation projections indicating underlying price pressures will struggle to recover.

---

**All data is accurate as of the report date, unless otherwise specified.**

This communication has been prepared by The Royal Bank of Scotland plc, and should be regarded as a Marketing Communication, for which the relevant competent authority is the UK Financial Conduct Authority.

Please follow the <http://www.rbsm.com/MARDisclosures> link for the following information:

- MAR Disclaimer
- Conflicts of Interest statement
- Glossary of definitions
- Historic Trade ideas log

This communication has been prepared by The Royal Bank of Scotland N.V., The Royal Bank of Scotland plc or an affiliated entity ("RBS").

This material is a Marketing Communication and has not been prepared in accordance with the legal and regulatory requirements designed to promote the independence of investment research and may have been produced in conjunction with the RBS trading desks that trade as principal in the instruments mentioned herein. This commentary is therefore not independent from the proprietary interests of RBS, which may conflict with your interests. Opinions expressed may differ from the opinions expressed by other business units of RBS. No part of the remuneration of the author(s) is directly tied to any transactions performed, or trading fees received, by any entity of RBS Group.

This material includes references to securities and related derivatives that the firm's trading desk may make a market or provide liquidity in, and in which it is likely as principal to have a long or short position at any time, including possibly a position that was accumulated on the basis of this analysis material prior to its dissemination. Trading desks may also have or take positions inconsistent with this material. This material may have been made available to other clients of RBS before it has been made available to you and is not subject to any prohibition on dealing ahead of its dissemination. This document has been prepared for information purposes only. Other than as indicated, this document has been prepared on the basis of publicly available information believed to be reliable but no representation, warranty or assurance of any kind, express or implied, is made as to the accuracy or completeness of the information contained herein and RBS and each of its respective affiliates disclaim all liability for any use you or any other party may make of the contents of this document. The opinions, commentaries, projections, forecasts, assumptions, estimates, derived valuations and target price(s) or other statements contained in this communication (the "Views") are valid as at the indicated date and/or time and are subject to change at any time without prior notice. There are no planned updates to this communication at the time of publication. RBS does not accept any obligation to any recipient to update or correct any such information. Views expressed herein are not intended to be, and should not be viewed as advice or as a personal recommendation. The Views may not be objective or independent of the interests of the authors or other RBS trading desks, who may be active participants in the markets, investments or strategies referred to in this material. RBS makes no representation and gives no advice in respect of any tax, legal or accounting matters in any applicable jurisdiction. You should make your own independent evaluation of the relevance and adequacy of the information contained in this document and make such other investigations as you deem necessary, including obtaining independent financial advice, before participating in any transaction in respect of the securities referred to in this document. This document is not intended for distribution to, or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation. The information contained herein is proprietary to RBS and is being provided to selected recipients and may not be given (in whole or in part) or otherwise distributed to any other third party without the prior written consent of RBS.

RBS and its respective affiliates, connected companies, employees or clients may have an interest in financial instruments of the type described in this document and/or in related financial instruments. Such interest may include dealing in, trading, holding or acting as market-makers or liquidity providers in such instruments and may include providing banking, credit and other financial services to any company or issuer of securities or financial instruments referred to herein. Issuers mentioned in any material may be investment banking clients of RBS Securities Inc. and RBS Securities Inc. may have provided in the past, and may provide in the future, financing, advice, and securitization and underwriting services to these clients in connection with which it has received or will receive compensation. Accordingly, information included in or excluded from this material is not independent from the proprietary interests of RBS Securities, Inc., which may conflict with your interests.

In the U.S., this Marketing Communication is intended for distribution only to major institutional investors as defined in Rule 15a-6(a)(2) of the U.S. Securities Act 1934 (excluding documents produced by our affiliates within the U.S.). Any U.S. recipient wanting further information or to effect any transaction related to this trade idea must contact RBS Securities Inc., 600 Washington Boulevard, Stamford, CT, USA. Telephone: +1 203 897 2700.

In Singapore, this Marketing Communication is intended for distribution only to institutional investors (as defined in Section 4A(1) of the Securities and Futures Act (Cap. 289) of Singapore). The Royal Bank of Scotland plc, Singapore branch [UEN: S85FC3595J] is authorised and regulated by the Monetary Authority of Singapore.

In Hong Kong, this Marketing Communication is intended for distribution only to Professional Investors (as defined in Schedule 1 of the Securities and Futures Ordinance of Hong Kong). The Royal Bank of Scotland plc and The Royal Bank of Scotland RBS N.V. are authorised institutions in Hong Kong and regulated by the Hong Kong Monetary Authority and the Hong Kong Securities and Futures Commission.

This Marketing Communication is issued in Australia to Wholesale investors only by The Royal Bank of Scotland plc Australia Branch (ABN 30 101 464 528), 88 Phillip Street, Sydney NSW 2000, Australia which is authorised and regulated in Australia by the Australian Securities and Investments Commission (AFS License No. 241114) and the Australian Prudential Regulation Authority.

RBS Securities Japan Limited, Tokyo branch [Kanto Financial Bureau (Kin-sho) No. 202] is incorporated in Hong Kong No 0170798 with limited liability and is authorised and regulated by the Japan Financial Services Agency.

The Royal Bank of Scotland N.V, India is regulated by the Reserve Bank of India (RBI) and has been granted a licence to carry on banking business in India under licence No. MUM: 86 dated 11 May 2010.

The Royal Bank of Scotland plc. Incorporated and registered in Scotland No 90312 with limited liability. Registered Office: 36 St Andrew Square, Edinburgh EH2 2YB. Authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and Prudential Regulation Authority. National Westminster Bank Plc. Incorporated and registered in England and Wales No 929027 with limited liability. Registered Office: 135 Bishopsgate, London EC2M 3UR. Authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and Prudential Regulation Authority. The Royal Bank of Scotland plc is authorised to act as agent for National Westminster Bank Plc. The Royal Bank of Scotland N.V. is incorporated with limited liability in the Netherlands, authorised and regulated by the De Nederlandsche Bank and has its seat at Amsterdam, the Netherlands, and is registered in the Commercial Register under number 33002587. Registered Office: Gustav Mahlerlaan 350, Amsterdam, The Netherlands. The Royal Bank of Scotland plc is, in certain jurisdictions, an authorised agent of The Royal Bank of Scotland N.V. and The Royal Bank of Scotland N.V. is, in certain jurisdictions, an authorised agent of The Royal Bank of Scotland plc. Securities business in the United States is conducted through RBS Securities Inc., a FINRA registered broker-dealer (<http://www.finra.org>), a SIPC member ([www.sipc.org](http://www.sipc.org)) and a wholly owned indirect subsidiary of The Royal Bank of Scotland plc.

For further information relating to materials provided by RBS, please view our RBSM Terms and Conditions.

NatWest Markets is a marketing name of The Royal Bank of Scotland plc, National Westminster Bank Plc, RBS Securities Inc. and RBS Securities Japan Limited.

Copyright © 2016 The Royal Bank of Scotland Group plc. All rights reserved.

Version 18.11.2016