UK Economic Outlook

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UK GDP: Q1 2019 growth illusion

UK GDP grew by 0.5% q/q in Q1 2019, but this outturn appears to have been boosted artificially by Brexit-related stock-piling. This effect now appears to be unwinding: GDP looks set to stagnate in Q2.

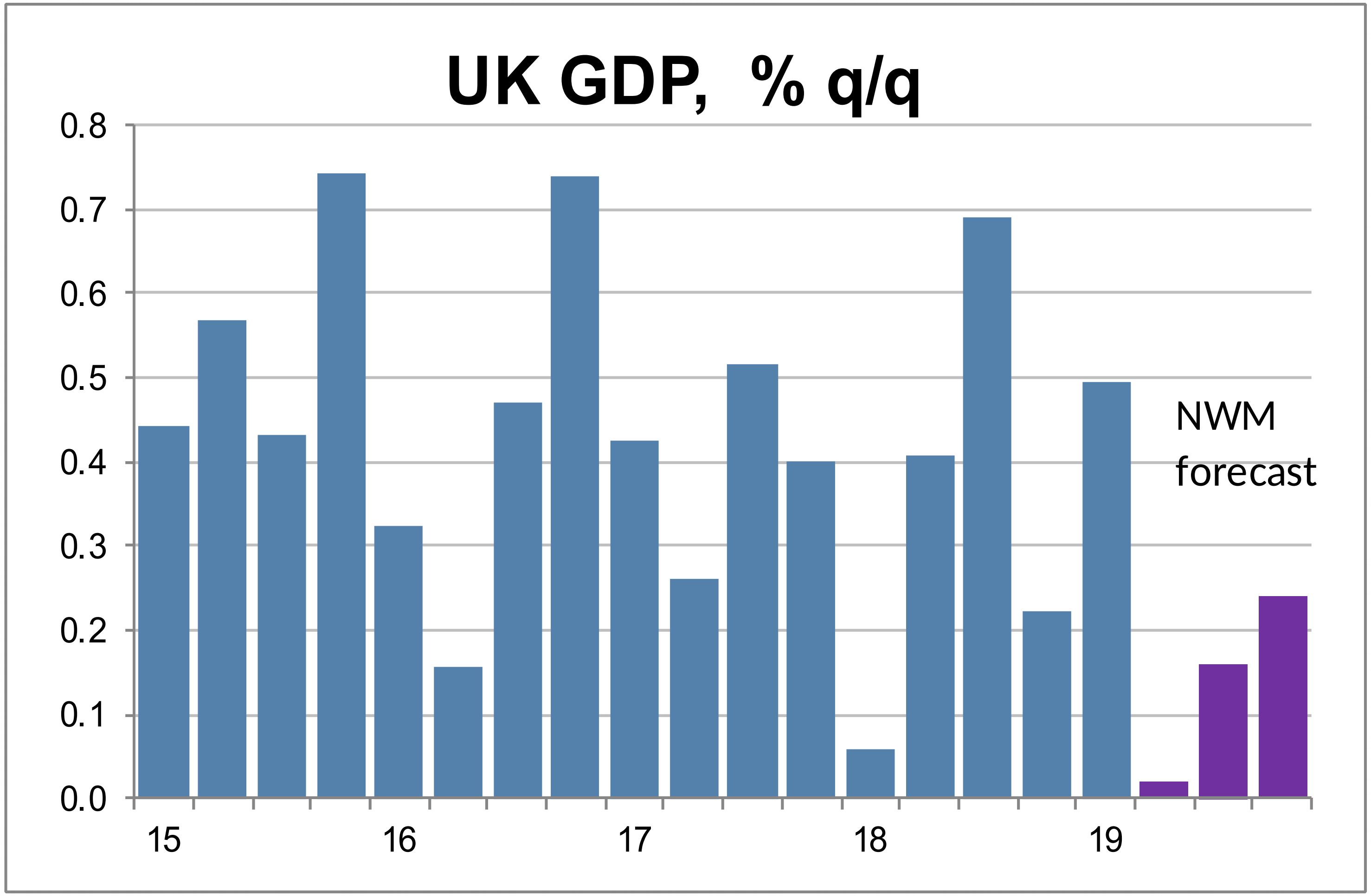
Underlying growth appears to have been closer to 0.2% q/q in H1 2019 – we the economy to grow at this sort of pace in H2 2019.

NatWest Markets UK GDP forecasts:

2019 1.3%

2020 0.8%

2021 1.2%



Source: ONS, NatWest Markets

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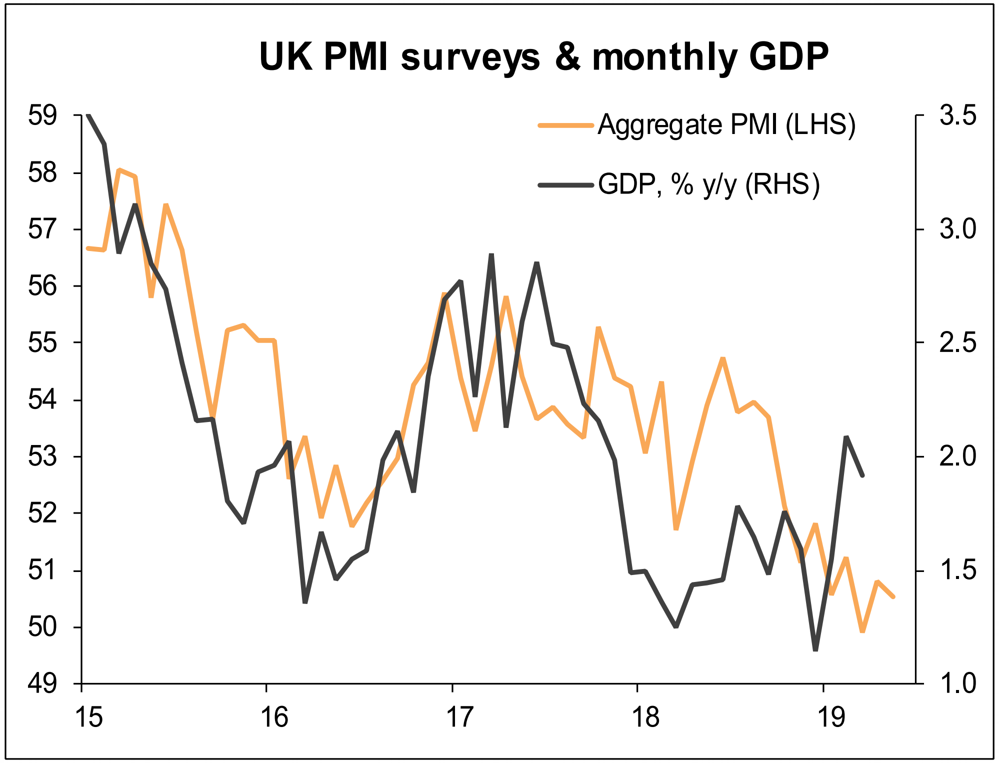
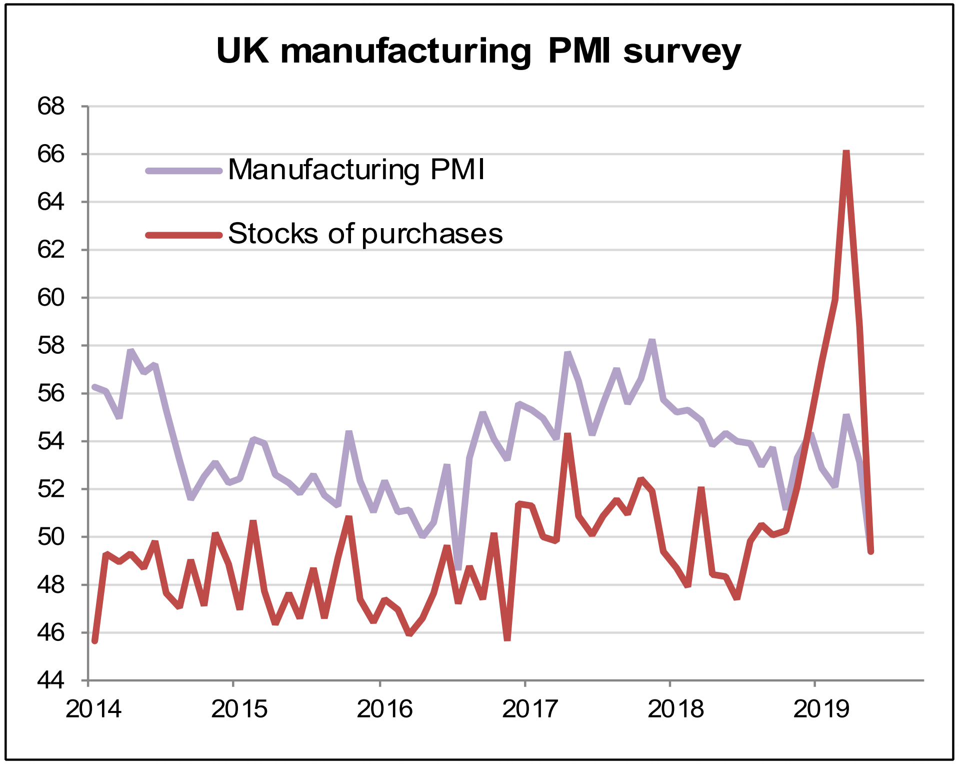
UK PMI surveys signal slippage

The PMI (Purchasing Managers Index) has been trending lower for over a year. **The latest data (May 2019) are at levels consistent with *annualised* GDP growth of just 0.5%.** Whilst this may exaggerate the extent of the underlying slowdown in Q2, the survey does tend to highlight the downside risks for the UK economy.



The PMI survey also provides an indication of the (temporary) boost to economic growth from inventories in Q1 2019.



Source: ONS, NatWest Markets

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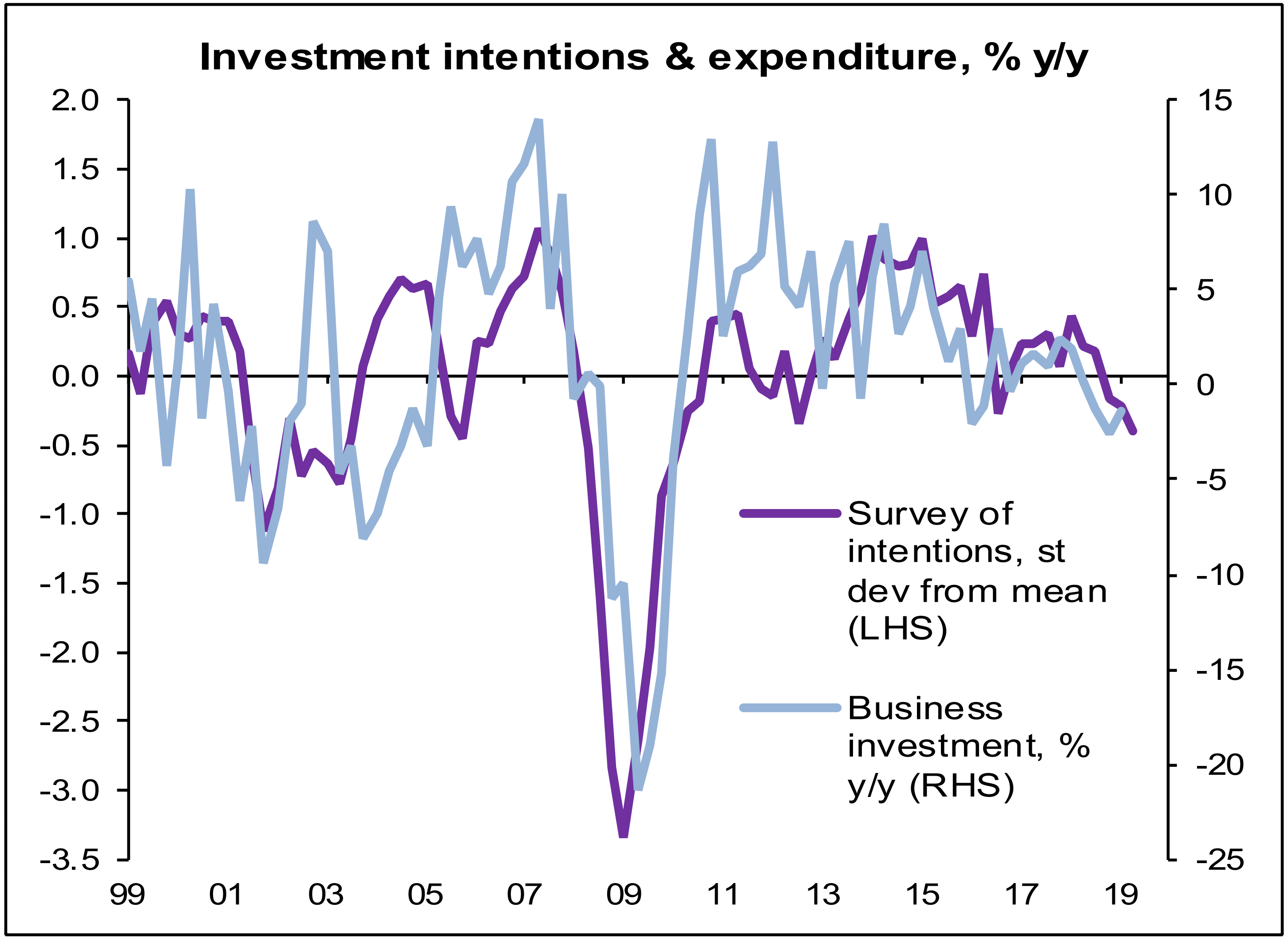
UK capex surveys – recession warning?

Business investment intentions surveys (BoE Agents, BCC, CBI) are now running below long-run averages (and a 9-year low), having faltered in late 2018 & early 2019.

These investment intentions surveys are consistent with annualised business investment growth of -2¾% in H2 2019 (vs official data at -1.4% y/y in Q1).

2018 saw an unusual combination of falling business investment expenditure alongside buoyant employment growth . . . This doesn't feel sustainable.



Source: ONS, BoE, BCC, CBI, NatWest Markets

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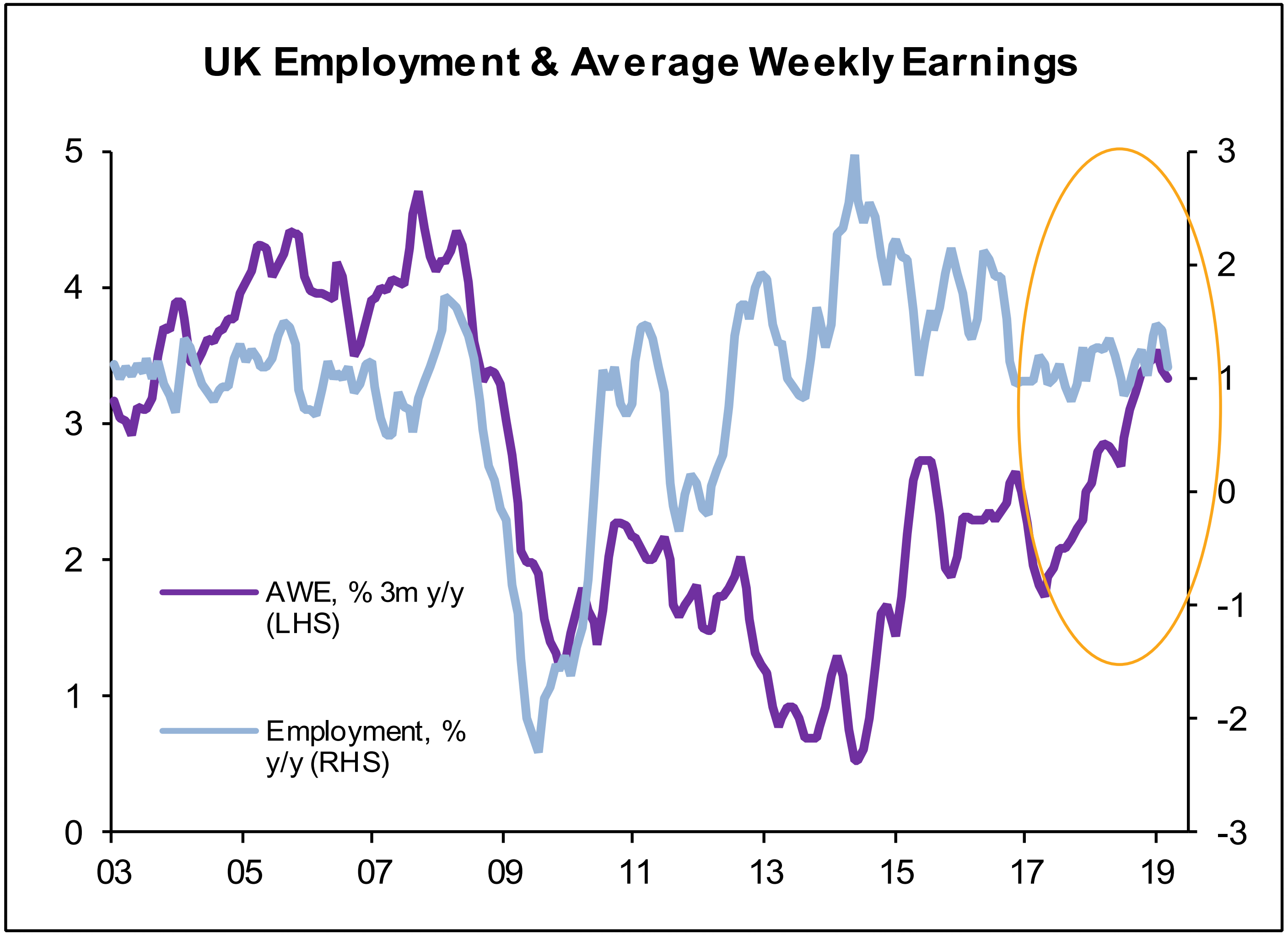
Reasons to fade UK *recession* risks in 2019

UK employment growth has remained above longer-run averages – and has been surprisingly strong relative to GDP.

Wage inflation has also been picking up steadily, reaching ~3¼% y/y rates.

These factors will support household income growth in 2019. **NWM forecast: RHDI growth of 1.2% in 2019 and 1.0% in 2020** – significantly better than 0.0% in 2016 & 0.5% in 2017.

However . . .



Source: ONS, NatWest Markets

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UK wage inflation forecast – up and under(whelming)

Wage inflation recovered during 2017 & 2018, but evidence is building that the data have reached a peak.

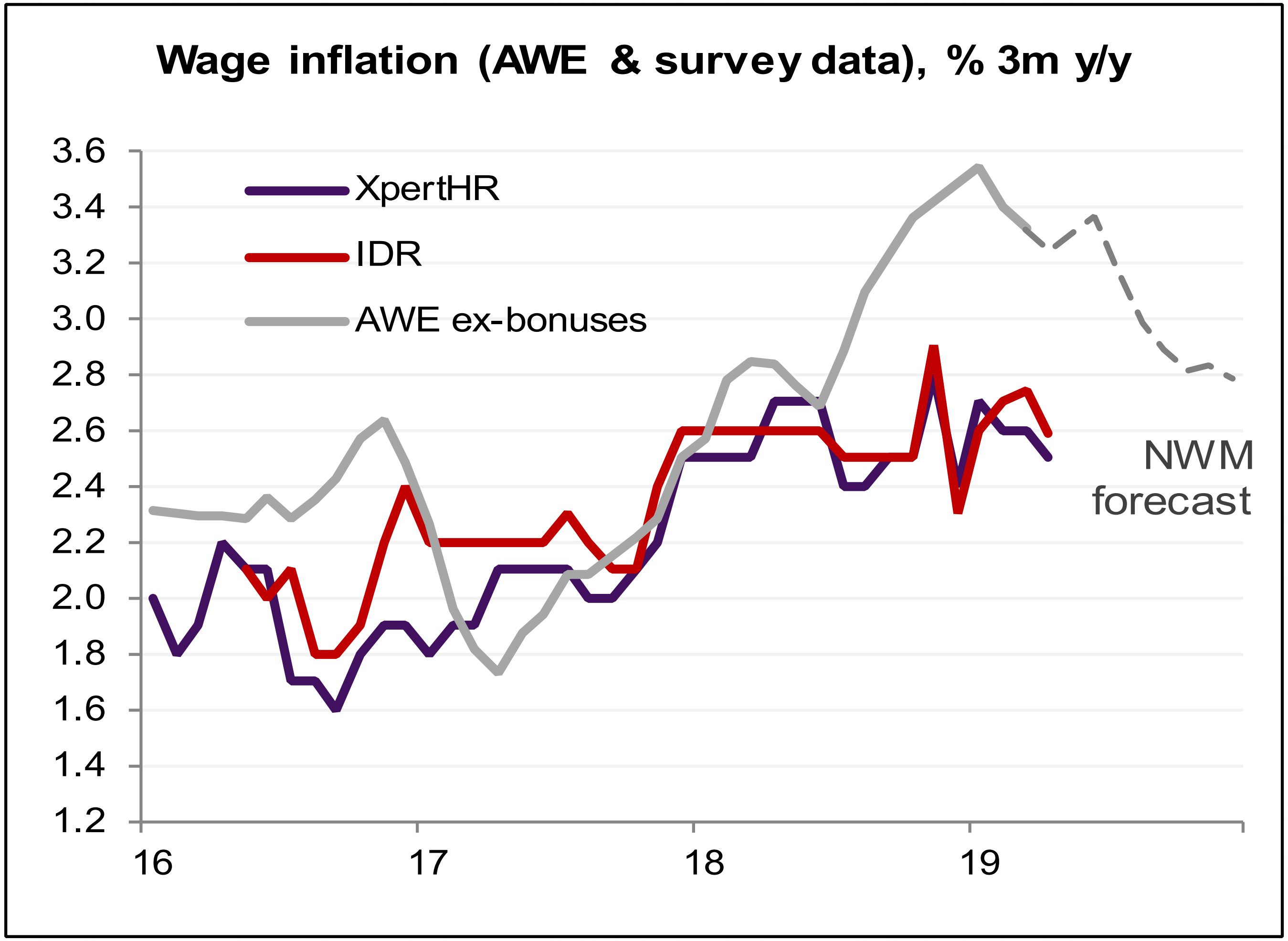
Basic pay settlements rose by ~0.25% points in early 2019, but are already beginning to fall back. Growth in bonuses is also slowing. Ongoing Brexit uncertainty is clearly not supportive for pay increases.

NWM Average Weekly Earnings forecasts:

3.1% in 2019

2.9% in 2020.

BoE has argued 3% wage inflation is consistent with 2% CPI inflation target over the medium-term.



Source: ONS, NatWest Markets

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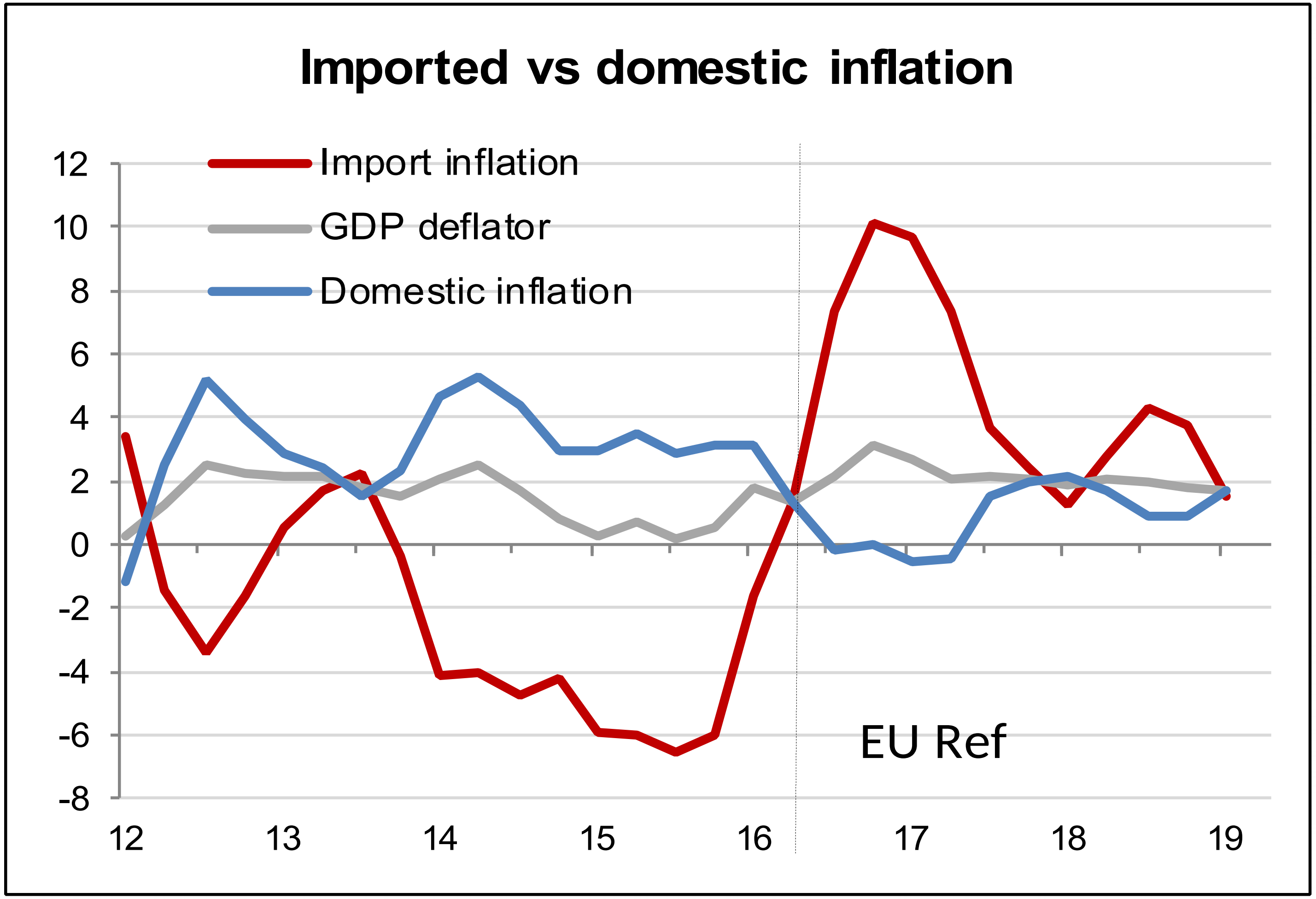
The UK does *not* have an inflation problem

The overshoot in UK inflation in 2017 and 2018 was ENTIRELY the result of the import price shock which followed the EU referendum in June 2016.

This import price shock proved to be temporary – a one-off adjustment relating to sterling's ~10% depreciation. It has unwound in line with previous imported shocks – there is no evidence of more persistent price pressures or inflation expectations becoming dislodged.

Estimates of domestically-generated inflation remain subdued, below longer-run averages.



Source: ONS, NatWest Markets

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NWM UK inflation forecast: Below target in 2019 & 2020

NWM forecast: CPI inflation to trend lower, albeit with significant volatility around utility pricing.

NWM forecasts in 2019 & 2020:

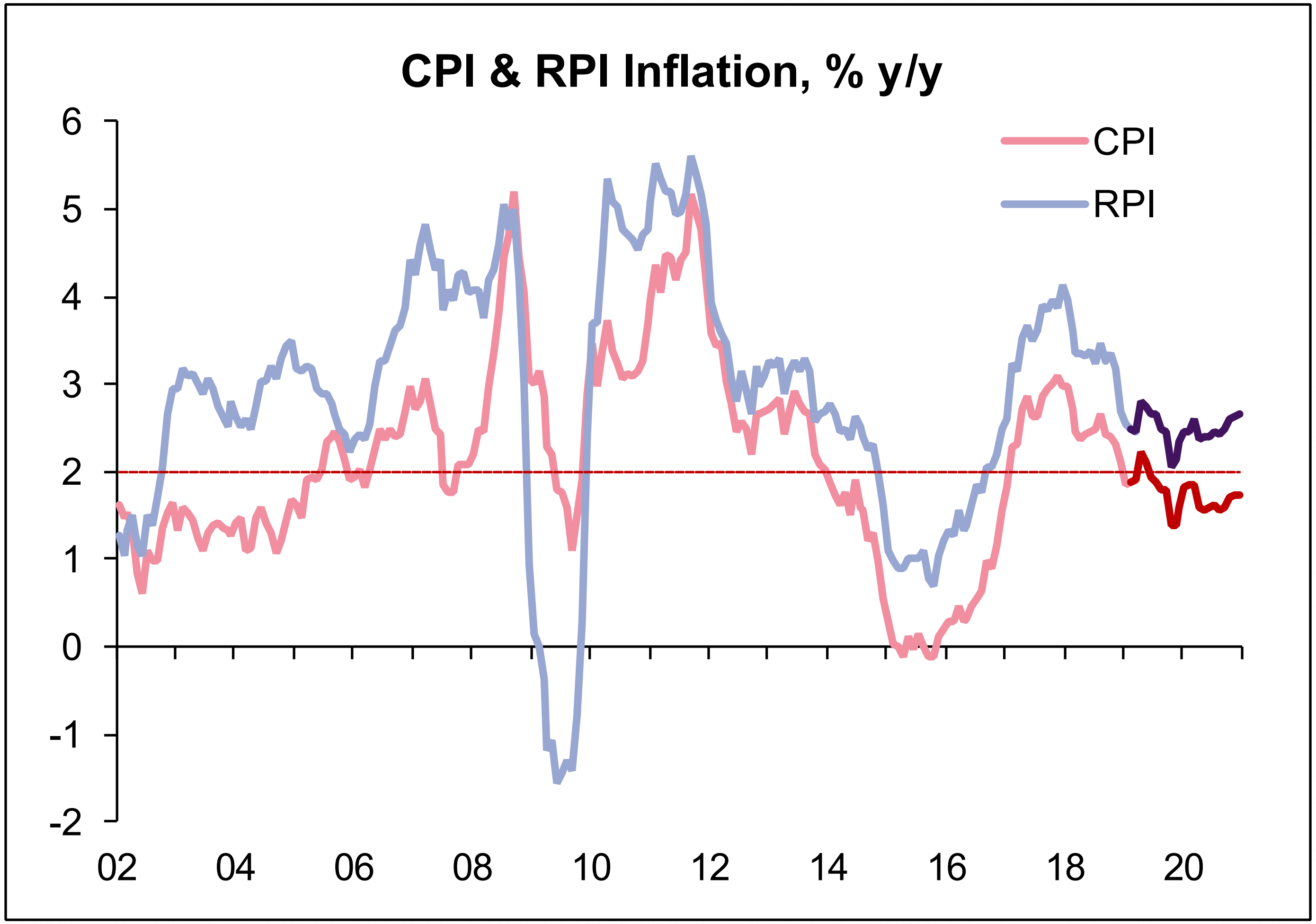
Headline CPI inflation: 1.8% & 1.8%.

Core CPI inflation: 1.8% & 1.7%

RPI inflation: 2.6% & 2.7%.

Little compelling evidence to suggest a sustained, material pick-up in CPI inflation – wage inflation and survey data suggest pricing power remains constrained.

BoE projections of a more marked pick-up in domestic inflation rest on (contentious – or at least inconclusive) notions that slack is almost entirely eroded and potential supply growth has fallen to a little below 1½% y/y.



Source: ONS, NatWest Markets

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Brexit – Where Next?

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Brexit probabilities – gridlock in 2019

What does 'the market' expect?

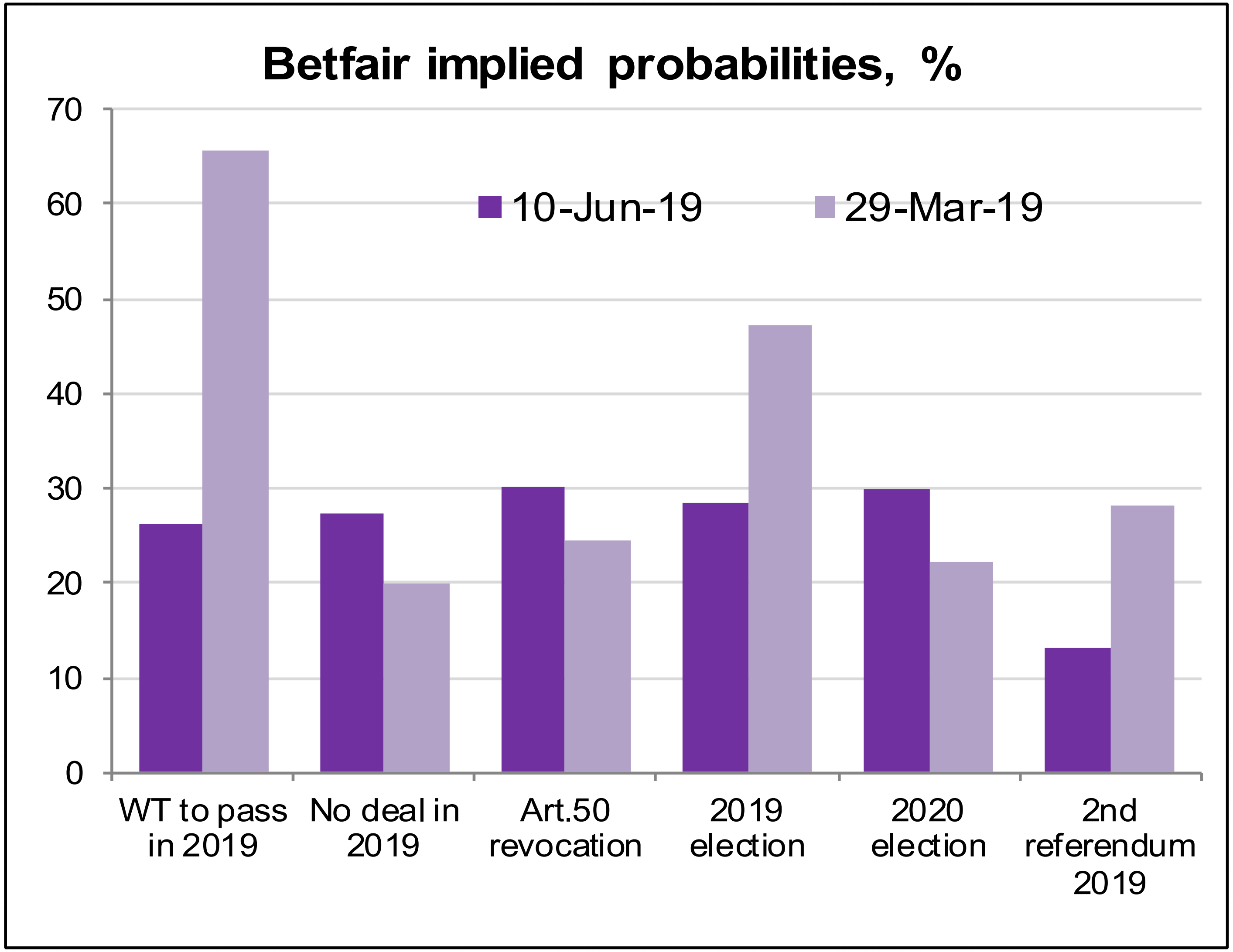
A Brexit deal (passing the Withdrawal treaty) is unlikely in 2019 (26% probability).

No Deal is unlikely in 2019 (27% probability).

Revocation of Article 50 is unlikely (30% probability).

Expectations of an **election** are not expected in 2019 or 2020 (~30% probability).

Nor is a **2nd referendum** (13% probability). . . .



Source: Betfair, NWM

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Brexit: Deal or No Deal?

***2019* Brexit scenarios: Deal or No Deal on Withdrawal Treaty & Future Framework Declaration**		
Outcome & probability	Notes	Markets
1. A Deal (& Transition) **~30% probability**	Parliamentary ratification of *a* Withdrawal Treaty (WT) & Future Framework Declaration (FFD) by end-October 2019, securing transition period to end-2020	**Bank Rate**: Unchanged at 0.75% in 2019-20. **10-yr Gilt yields**: +15bp to ~1.20%. **£/$**: +5% to ~$1.33, **€/£**: -3% to ~0.85
2. Extension / Revocation **~50% probability**	Includes: Lengthy Art.50 extension (eg, to end-2020), unilateral revocation of Article 50, & UK remaining in the EU (presumably after 2nd referendum)	**Bank Rate**: Unchanged in 2019 & 2020. **10-yr Gilt yields**: +25bp to ~1.30%. **£/$**: +6% to ~$1.34, **€/£**: -4% to ~0.845
3. No Deal **~20% probability**	Default outcome in absence of WT ratification. UK would leave EU on 1 November 2019, acquiring immediate third-country status with a limited WTO trading arrangement	**Bank Rate**: -75bp to 0.0% (within a month or two). QE resumption & fiscal expansion. **10-yr Gilt yields**: -45bp to ~0.60%. **£/$**: -13% to ~$1.10, **€/£**: +13% to ~0.99

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Source: NatWest Markets

Macroeconomic impact of leaving the EU

UK Treasury study of the long-term impact on the UK economy of EU membership and the alternatives (April 2016).

'EEA' outcome would be a 'Norway' type deal, with a high degree of EU single market access (including financial services).

'Bilateral' agreement would be akin to a 'Canada' or 'Switzerland' type free trade agreement.

'WTO' is a 'no deal' outcome (tariffs on goods, no deal in services) – the hardest realistic Brexit.

Annual impact of leaving the EU on the UK after 15 years (difference from being in the EU)

	EEA	Negotiated bilateral agreement	WTO
GDP level (%) – central	–3.8	–6.2	–7.5
GDP level (%)	–3.4 to –4.3	–4.6 to –7.8	–5.4 to –9.5
GDP per capita – central[a]	–£1,100	–£1,800	–£2,100
GDP per capita[a]	–£1,000 to –£1,200	–£1,300 to –£2,200	–£1,500 to –£2,700
GDP per household – central[a]	–£2,600	–£4,300	–£5,200
GDP per household[a]	–£2,400 to –£2,900	–£3,200 to –£5,400	–£3,700 to –£6,600
Net impact on receipts	–£20 billion	–£36 billion	–£45 billion

[a] *Expressed in terms of 2015 GDP in 2015 prices, rounded to the nearest £100.*

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Source: HM Treasury

UK interest rates

Financial markets have begun to price-in some probability of BoE Bank Rate cuts.

Market implied probabilities of a 25bp Bank rate cut:

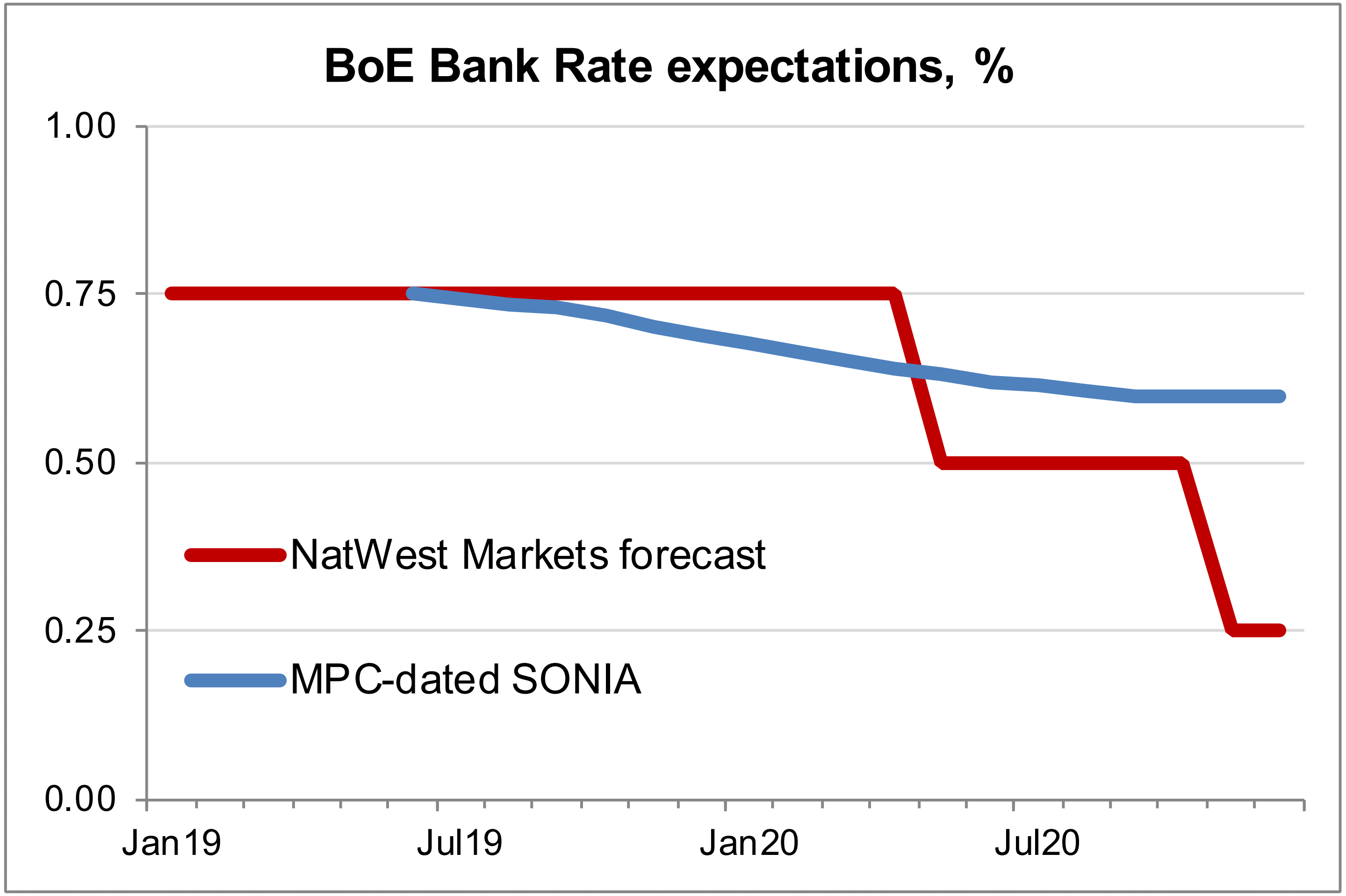
~25% by end-2019

~50% by mid-2020

~60% by end-2020.

NatWest Markets is more dovish, forecasting a 25bp cut by mid-2020 with risks of 50bp by end-2020.

BoE policy signalling (May 2019) suggests two 25bp Bank rate rises over the next 3 years.



Source: Bloomberg, NatWest Markets

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Conclusions

ECONOMIC GROWTH: Increasing downside risks as *headwinds* from declining UK business investment, rising UK political risk and deteriorating external demand outweigh *tailwinds* from 2019 fiscal stimulus. **NWM GDP forecasts: 1.4% in 2019 & 0.9% in 2020.**

INFLATION: **Headline CPI inflation to be volatile in 2019 on energy price cap changes but to generally remain below its 2% target in 2019 & 2020.** Wage inflation pressures appear to be peaking.

MONETARY POLICY: Bank of England 'hawkish' policy guidance is being challenged (again). **NWM Bank Rate forecast is for the next move to be a cut (25bp by mid-2020, risks of 50bp by rend-2020).**

FISCAL STANCE: 2019 fiscal policy easing (~0.3% of GDP) **with rising risks of this stimulus being extended into 2020**.

BREXIT: **Rising political risk: 'No Deal' by end-October 2019 and an early general election (autumn 2019 / spring 2020?).** UK may well be faced with the stark choice of: No Deal (heightened recession risks in 2020) or Revocation (forcing an election in 2020) by 31 October deadline.

STERLING: **Structural downside risks**. EUR/GBP to ~0.90, GBP/USD to ~1.23.

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