United Kingdom

- **UK GDP growth is expected to resume a trend-like pace of 1½% this year—solid if unspectacular.**
- **CPI inflation has been much lower than most expected. Following a brief pause in mid-summer, we expect the downwards trajectory to resume through to year-end.**
- **We expect the BoE to hike Bank Rate at the August meeting on the back of signs that Q1's weakness was transitory and a near-term upwards surprise on inflation.**

GROWTH

We expect a trend-like expansion in the UK economy this year of around 1½% y/y. Against a backdrop of zero real household disposable income growth during the first half of the year as well as ongoing Brexit uncertainty; trend-like growth would be an achievement. However, that is damning with faint praise; a good outcome for growth these days is to grow in line with potential. Above potential growth is not on anyone's radar, despite ongoing accommodative monetary policy.

The first quarter of 2018 was plagued by adverse weather conditions, holding back the quarterly growth rate to just above zero. We expect normal service to be resumed during Q2, with output expanding by just under ½% q/q. We have not assumed any making up for lost output during Q1; merely a resumption of trend-like growth. We are moderately more optimistic about the pace of expansion over the second half of the year, mainly a reflection of the likely improvement in household real disposable incomes.

In the very near term, the focus is likely to be on the introduction of the new monthly GDP estimates from the Office for National Statistics. While we expect a robust Q2 GDP reading, the monthly GDP print for the 3 months to May is likely to be barely above zero. On the face of it, this would imply that the surprise weakness during the first quarter of the year was not just a weather effect and that something more fundamental might be at work. However, our judgement is that this outcome needs to be read with caution and the Q2 GDP reading released a month later will be a far better representation.

INFLATION

Inflation has fallen broadly in line with our forecast, but has been well below others' expectations during the first half of the year. We believe that downward trend is now being interrupted temporarily on the back of higher energy prices. Nonetheless, we expect the downwards trend to resume from the second half of summer onwards, dragging CPI inflation down to 2% y/y by end-year. We forecast that inflation will continue falling into 2019, reaching a low-point of 1¾% y/y.

All of the action has come from the exchange-rate-sensitive components of the CPI. More specifically, the surge in inflation over 2017 reflected the increase in imported inflation on the back of the sharp fall in the GBP exchange rate.

CONTACTS

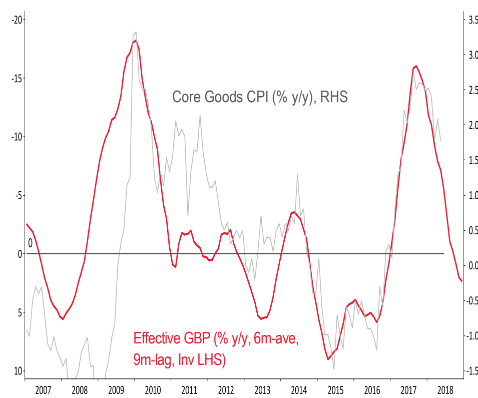
Alan Clarke, Head of European Fixed Income Strategy
44.207.826.5986 (London)
Fixed Income Strategy
alan.clarke@scotiabank.com

United Kingdom	2017	2018f	2019f
Real GDP (annual % change)	1.8	1.7	1.9
CPI (y/y %, eop)	2.9	1.9	1.9
Central bank policy rate (%, eop)	0.50	0.75	1.00
UK pound (GBPUSD, eop)	1.35	1.32	1.40

Source: Scotiabank Economics.

Chart 1

GBP exchange rate points to further slowdown for exchange rate sensitive components



Sources: Macrobond, Scotiabank FICC Strategy.

However, since the GBP has stopped falling (and in fact is a little stronger) the uplift from imported inflation is now fading. So, while inflation has proven lower than expected so far this year, there is plenty more downside to come from this source (chart 1).

The exchange rate sensitive (core goods) portion of the inflation basket is only half the story. The domestically generated (services) portion of the basket should be little affected by gyrations in the GBP. The lazy assumption among some forecasters is that the acceleration in wage inflation since late last year is a sign that services inflation will also gain altitude. We disagree. While there are some components of services inflation which do correlate with wage inflation (such as maintenance of the house or car—with high labour input content) these components are the exception rather than the rule.

Meanwhile, the components of services inflation which account for the bulk of the weight within services tend to be uncorrelated with wage inflation. Moreover, we have a lot of information about these weighty components. For example, rent (which accounts for almost 20% of the overall CPI) has been very muted since the former Chancellor's policy of a 1% per year cut in social housing rent over a 4-year period. This is a known-known which has nothing to do with wage inflation which is almost guaranteed to maintain a drag on services inflation. Similarly, recreation and personal services (which includes package holidays and restaurants) also appear more likely to subtract from inflation rather than add to it.

The bottom line is that we expect services inflation to drift sideways at best for the next six to twelve months. Combined with the ongoing slump in core goods inflation, this should help headline CPI inflation to fall below the Bank of England's 2% by early 2019.

MONETARY POLICY

The Bank of England refrained from hiking Bank Rate at the May meeting in order to observe whether the weakness in the data during Q1 was transitory. We believe that growth will resume a trend-like pace during Q2, that inflation will exceed that Bank's near-term projection and that slack will continue to erode. As such, we continue expect the MPC to hike Bank Rate at the August meeting.

We believe that there is a narrow window of opportunity for the Committee to raise rates this year. By November, we expect CPI inflation to be at, or slightly below target. So while it has never been about current inflation, it would be hard for the MPC to argue the case for raising Bank Rate when inflation is already at or below target and on a falling trajectory. Furthermore, by November the MPC is scheduled to be reviewing its view on the likely impact of Brexit, which could imply further caution on monetary policy. Given our sub-target CPI forecast for 2019, there is a good chance that monetary policy remains on hold through next year.

BREXIT / PUBLIC FINANCES / POLITICS

The UK and EU sides of the negotiations are gridlocked with regards to customs arrangements, especially along the Northern Ireland border. Until that issue is resolved, it will be hard to move on to more concrete plans, including what tariffs may apply or regarding the issue of trade in services between the two economies.

A key waypoint in the process is scheduled to be October (although there are already signs of slippage to later in the year). On current plans, UK MPs will vote on whatever deal has been agreed between the UK and the EU. To be clear, this is not a case of whether the UK remains in the EU or leaves; rather it is a case of accepting the deal that has been agreed, or rejecting that deal. Currently MPs are hammering out what might happen if we go down the 'no deal' route. A second referendum is still possible, as is a cliff-edge Brexit.

As long as the transition deal that has been agreed remains intact, there should be no tangible changes once the UK leaves the EU in March 2019. For now the main impact on the economy is coming from confidence, uncertainty or preparations for Brexit. Meanwhile the full blown direct consequences of leaving the EU should only materialise just over two years from now when the transition deal expires. However, there has been some suggestion that the transition period could be extended.

Eurozone

- **The end of ECB QE is in sight. However, we think that talk of an ECB hike is premature, with 2020 the earliest opportunity.**
- **Headline inflation is now in line with the ECB's price stability mandate, but is unlikely to rise further. Meanwhile, core inflation is still languishing around 1%, but should creep higher as economic slack narrows.**
- **Above-trend growth, albeit not as robust as previously hoped, should continue over the forecast horizon.**

MONETARY POLICY

The end of QE is in sight. The ECB has announced a further tapering off in its asset purchase programme. From September to December, the ECB will halve the monthly pace of asset purchases, down from EUR30bn per month to EUR15bn per month. After that point (based on the current economic outlook) the purchases will come to an end. These further purchases should take the total size of the Asset Purchase Programme to over EUR2.5 trillion which represents over 22% of eurozone GDP.

True to form, no sooner is the end of policy easing in sight than we get speculation about the timing of the first ECB rate hike. We believe this is premature. Having delivered an unprecedented injection of policy easing, the Governing Council is not going to be in a rush to withdraw this accommodation. As such, we doubt that we will see a rate hike at least until 2020.

INFLATION

The economic backdrop is largely supportive of the ECB's decision to back away from asset purchases. In particular, headline HICP inflation has rebounded to 1.9% y/y—essentially meeting the ECB's price stability mandate. However, underneath the surface, core CPI inflation remains at a lowly 1.1% y/y and has struggled to remain above 1% y/y over the past year. Given the ongoing fall in unemployment and above-trend GDP growth, there is good reason to believe that core inflation will gain altitude over the coming year or so (chart 1). Much of the acceleration in headline inflation has come from non-core inflation, in turn partly a reflection of base effects. Core inflation has only been a secondary source of upside pressure. If overall inflation is to stay elevated, let alone rise further, it will require more support from core components.

GROWTH

Upstream survey indicators continue to point to above-trend GDP growth, albeit less buoyant than was the case six months ago. Indeed, we interpret the surveys as pointing to growth of 2 to 2½% y/y this year and next, well above the trend pace of close to 1% but below the 3% y/y suggested when surveys were at their peaks. In comparison with 6 months ago, consumer sentiment remains as elevated as it has been this cycle, pointing to robust household consumption

CONTACTS

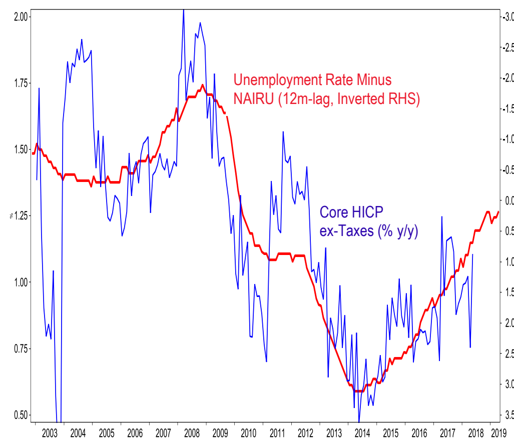
Alan Clarke, Head of European Fixed Income Strategy
44.207.826.5986 (London)
Fixed Income Strategy
alan.clarke@scotiabank.com

Eurozone	2017	2018f	2019f
Real GDP (annual % change)	2.6	2.5	2.3
CPI (y/y %, eop)	1.4	1.5	1.5
Central bank policy rate (%, eop)	0.00	0.00	0.00
Euro (EURUSD, eop)	1.20	1.20	1.35

Source: Scotiabank Economics.

Chart 1

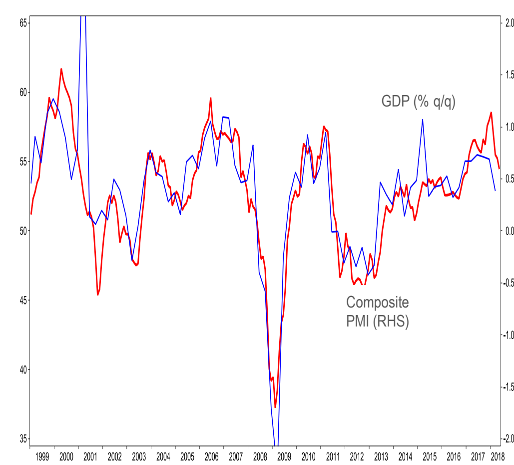
Eurozone core inflation vs unemployment relative to the NAIRU



Sources: Macrobond, Scotiabank.

Chart 2

Eurozone GDP growth vs composite PMI



Sources: Macrobond, Scotiabank.

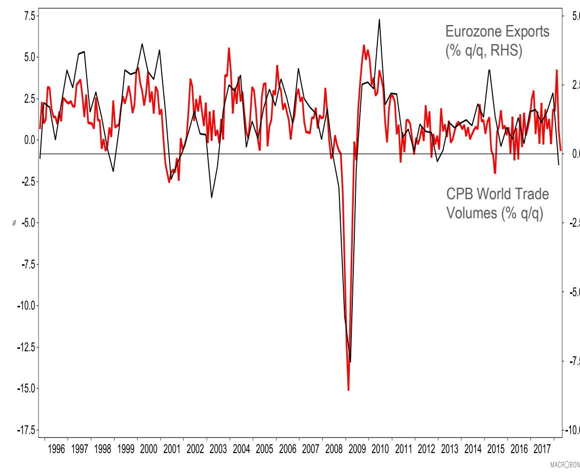
growth. Meanwhile, the composite PMI has lost ground (both on the manufacturing and services sides of the economy). The fall in the manufacturing PMI points to less support from investment over the coming quarters.

Last but not least, the CPB World Trade Volumes series has suffered a tangible setback, having previously pointed to an elevated pace of eurozone export growth (chart 3).

Overall, robust growth combined with headline inflation on target with prospects for core inflation to accelerate suggests that the ECB's work is done. There should be a prolonged period of unchanged monetary policy once the purchases are completed at the end of this year, before a rate hike becomes plausible in 2020. Political flashpoints do threaten to challenge this goldilocks outlook for the eurozone. However, as the recent Italian political jitters demonstrated, the region has learnt from past mistakes and has learnt to nip things in the bud when a situation arises.

Chart 3

Eurozone exports vs CPB world trade volumes



Sources: Macrobond, Scotiabank.

Fixed Income Strategy (London)

www.gbm.scotiabank.com