Quarterly Economic Briefing

July 2018

Contents

Introduction

Introduction

The purpose of this Quarterly Economic Briefing is to provide a focused quarterly assessment of a small number of key national and international economic trends to help inform future investment decisions and identify new opportunities.

The key economic indicators covered in this report are:

- GDP growth
- GDP forecasts
- Interest rates
- Inflation
- Unemployment
- Investment
- Productivity
- Exchange rates
- UK Trade
- Industry views
- Regional outlook

For each indicator we provide a short overview of the current trend along with a brief analysis of what it means for businesses. In addition to these indicators, we have also included an overview of the latest government and political situation at the front of the briefing to provide additional insight and context.

The next publication will be in October.

Headlines

Interest rate rise

The Bank of England's Monetary Policy Committee has raised the interest rate from 0.5% to 0.75%. This is the highest level since March 2009. The rate rise will have implications for interest costs for those with residential mortgages that have variable or tracker rates.

Modest growth

UK GDP was estimated to have increased by 0.2% in the three months to May (March to May) which was the same as that for Quarter 1 (January to March). The UK Quarter 1 growth of 0.2% was comparable to that seen in France (0.2%) and Germany (0.3%).

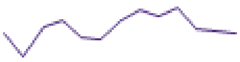
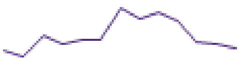
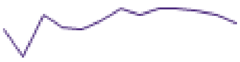
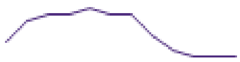
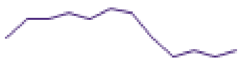
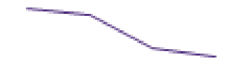
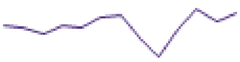
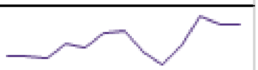
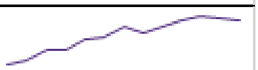
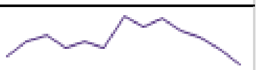
Historic low unemployment

The unemployment rate between December 2017 to February 2018 and March to May 2018 was 4.2%, down from 4.5% for the same period a year earlier and the joint lowest since 1975.

Productivity improvements

UK labour productivity, as measured by output per hour, is estimated to have grown by 0.9% in Quarter 1 (January to March) compared with the same quarter a year ago. This remains below the long-term trend observed pre-financial crisis when growth averaged nearly 2% per annum, and suggests that the 'productivity puzzle' remains unsolved.

Key indicators summary

Updated 26 July 2018		Latest	12mo trend
Bank base rate	*%*	*0.50*	
3mo LIBOR	*%*	*0.78*	
10yr gilt	*%*	*1.32*	
USD:GBP	*rate*	*1.32*	
EUR:GBP	*rate*	*1.13*	
CPI	*% y-o-y*	*2.40*	
RPI	*% y-o-y*	*3.40*	
Unemployment	*%*	*4.20*	
GDP	*% y-o-y*	*1.20*	
FTSE 100	*index*	*7,658*	
FTSE 250	*index*	*20,754*	
Baltic Dry	*index*	*1,772*	
Oil	*$/bbl*	*74.0*	
Gold	*$/oz*	*1,228.8*	

Key indicators

The table to the left sets out the historic trend for the key headline indicators.

Government & political update

Politics: Brexit Update

Brexit continues to dominate the political agenda.

Where are we in EU-UK negotiations?

The White Paper the government published at the beginning of July set out its negotiating position for ongoing talks with the EU. This is unlikely to be the end game as the EU may not agree all the proposals. The main principle of the White Paper is to seek something very close to single market membership for goods whilst seeking much greater divergence and greater change – and reduced access – for services.

The UK and EU need to agree on these principles of the future EU and UK trading relationship and also the 'backstop' options for ensuring there remains an open border between Ireland and Northern Ireland.

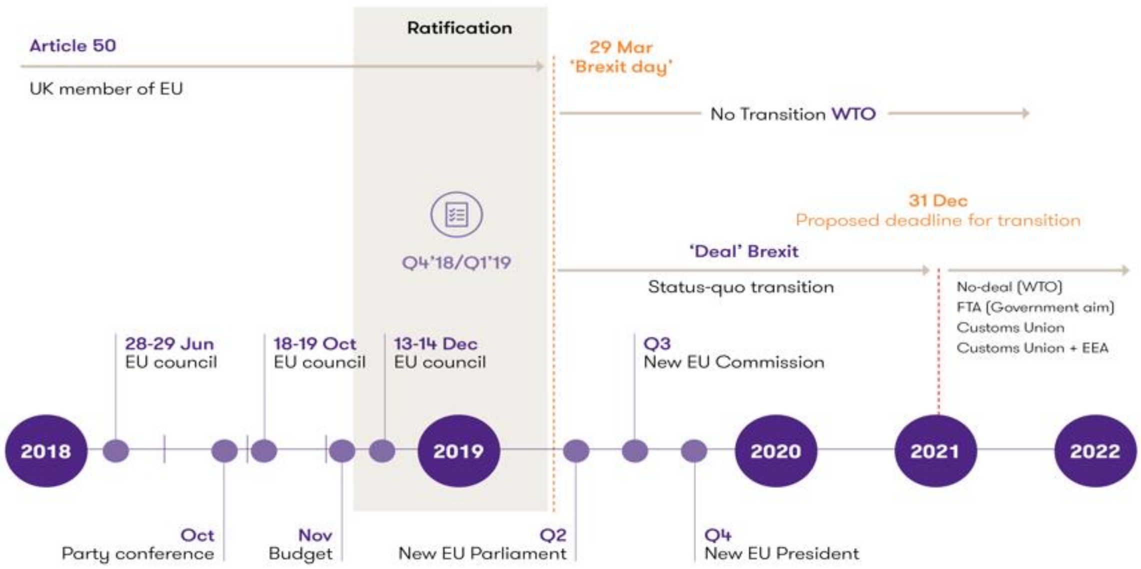
What happens next

We now need to see how the EU responds, whether the UK government compromises further and what is politically acceptable to the government and its own MPs.

When MPs get back from their holidays in September, there will be just 6 months to go before Brexit day – 29th March when the UK is due to leave the EU.

In that time the UK government and the EU need to reach an agreement on our future relationship, Parliament need to approve that, and so does the European Parliament.

What might happen and when?



Business impact

The turbulent economic and political environment has continued to negatively impact business confidence in the past quarter. For more information see the overview of the ICAEW Business Confidence Monitor in the Regional outlook section.

What’s the outlook?

Expect a stormy autumn and winter.

UK politics will continue to be in turmoil. The resignations, rebellions and bitterness of July in Parliament will look like a picnic compared to the carnage we can expect in the autumn.

The UK and EU governments are aiming for an agreement of heads of terms in mid October. This looks increasingly unlikely and any agreement may be as late as December.

As more and more people are warning, there is a very real chance of a No Deal Brexit. A No Deal scenario could mean a hard Brexit with no trade agreement in place by March next year, no transition period and a cliff edge into trading on WTO terms.

Uncertainty remains and that will continue for some time. Organisations should do scenario planning and have contingency plans in place if they have not done so already.

Summary of the most likely Brexit outcomes

No deal / Hard Brexit
No agreement reached between EU and UK. Trade on WTO terms

Orderly Brexit / FTA
Free trade agreement (FTA) with EU after transition period

Soft Brexit / Single market
UK stays in single market (EEA membership) and Customs Union

GDP growth

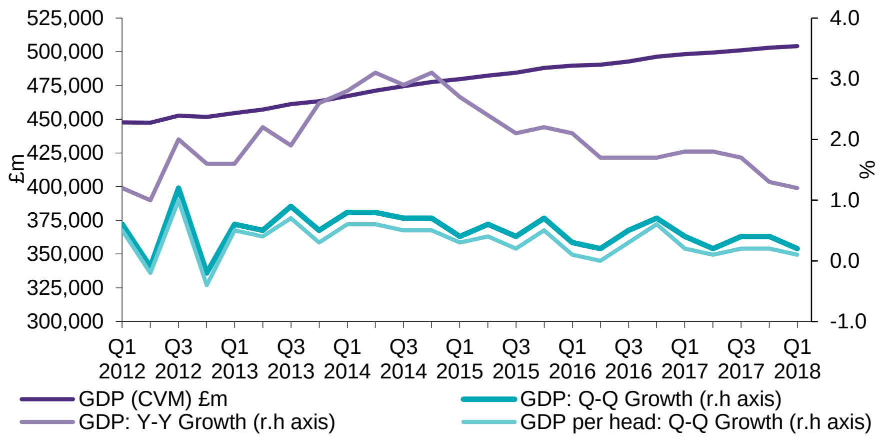
Change in Gross Domestic Product (GDP) is the main indicator of economic growth. Office for National Statistics data illustrates that UK GDP was estimated to have increased by 0.2% in the three months to May (March to May) which was the same as that for Quarter 1 (January to March).

The Office's Head of National Accounts states that the modest growth over this period was driven by the service sector, which was partially offset by falls in construction and production. Retail, computer programming and legal services all performed strongly, while housebuilding and manufacturing both contracted. Services in particular grew strongly after boosts from the warm weather and the royal wedding.

The UK Quarter 1 growth of 0.2% was comparable to that seen in France (0.2%) and Germany (0.3%), but much lower than the average of the Eurozone (2.5%).

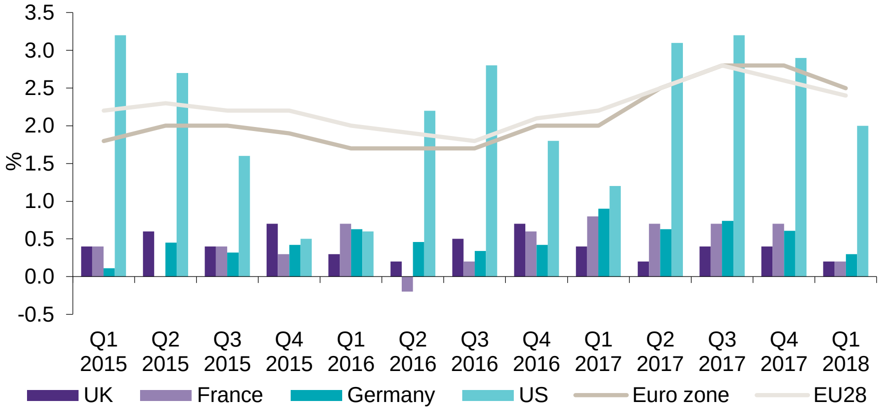
For more information see the latest ONS releases on Gross Domestic Product.

GDP Growth



Source: ONS

Country GDP growth



Source: National Statistics offices

Business impact

Economic growth is important for all businesses in a variety of different ways. Over time a period of prolonged economic growth leads to major improvements in living standards, expansion of existing markets and opening of new ones. It sees the creation of new job opportunities and wage increases. However, the converse is also true for a period of economic contraction.

While the recent growth is an encouraging sign the economy remains fragile and continues to lag behind other international economies. In light of this all business cases and investment plans should include a range of sensitivities that assess both positive and negative GDP growth.

GDP forecasts

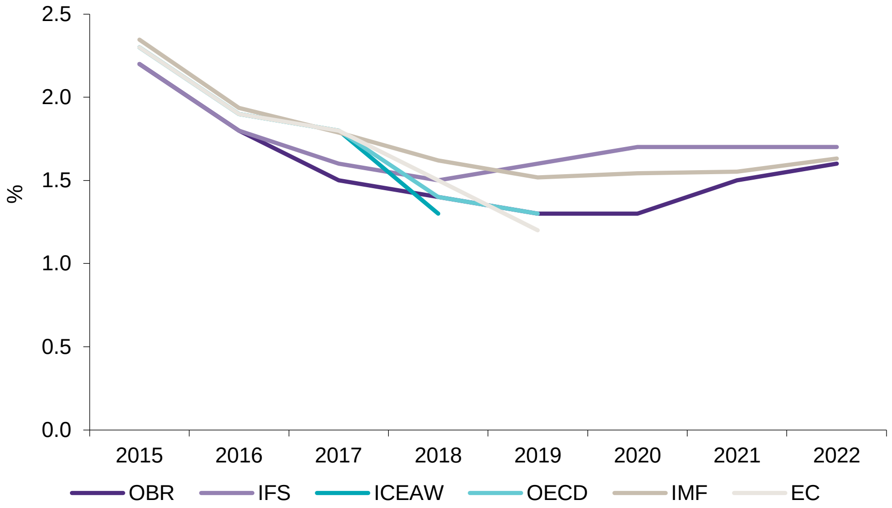
This section sets out expectations for future GDP growth for the UK from a number of institutions. The graph below plots these GDP forecasts.

The ICAEW UK Economic Forecast anticipates growth of 1.7% in 2018, which will be the third consecutive year of growth below 2%. They state that there is little reason to expect an acceleration of any sector or the economy in 2018 with drags on growth likely to persist. With inflation falling only slightly, consumers will likely remain squeezed. Meanwhile a stronger pound could mean that the best competitive conditions for exporters are already behind us.

The OECD Economic Forecast (May 2018) expects UK economic growth to remain modest at 1.4% in 2018 and 1.3% in 2019, owing to uncertainty around the outcome of Brexit negotiations. They also state that there is little slack in the economy following years of strong growth and unemployment is projected to remain below 5%. While inflation is projected to fall gradually to slightly above the 2% central bank target by the end of 2019.

The European Commission Spring 2018 Economic Forecast expects the slowdown in growth to continue in 2018 and 2019. As a result, modest UK GDP growth of 1.5% in 2018 is expected. For 2018, private consumption growth is expected to remain subdued despite support from lower inflation, while household saving rates are at historic lows. Business investment growth is projected to remain relatively weak while uncertainty persists. Net trade contributions to growth are expected to be moderate as sterling's appreciation takes effect.

GDP Forecasts



Source: Various

Business impact

As noted previously the biggest implications of these forecasts is the uncertainty that they highlight. Therefore, all business cases and investment plans should include a range of sensitivities that assess both positive and negative GDP growth.

Interest rates

The Bank of England's Monetary Policy Committee (MPC) sets monetary policy to meet the 2% inflation target and help sustain economic growth and employment.

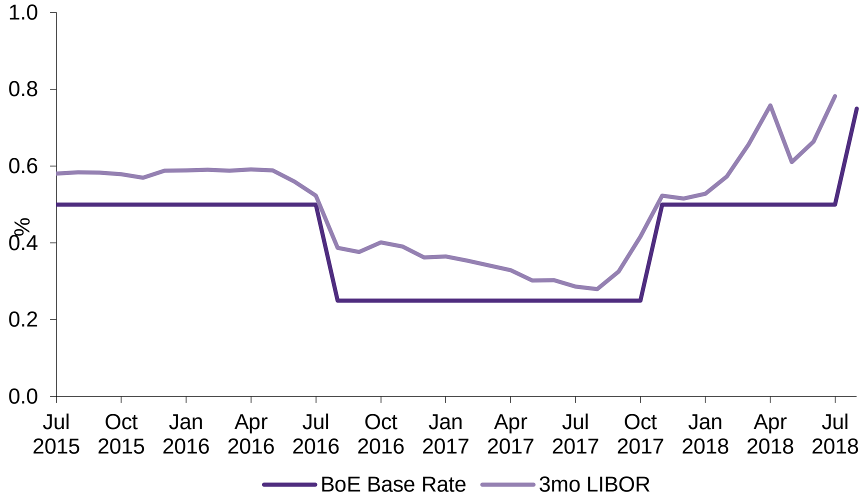
In the latest meeting on 2nd August 2018 the members of the MPC voted unanimously to increase the Bank Rate by 0.25 percentage points, to 0.75%. The rate rise will increase the interest costs for those with residential mortgages that have variable or tracker rates. It could be beneficial to savers, if the benefits are passed on by banks.

The MPC also voted unanimously to continue the programme of Quantitative Easing by maintaining the stock of sterling non-financial investment-grade corporate bond purchases, financed by the issuance of central bank reserves, at £10 billion, and to maintain the stock of UK government bond purchases, financed by the issuance of central bank reserves, at £435 billion.

Since the MPC's last Inflation Report in May, the near term outlook has developed broadly in line with the MPC's expectations. The dip in output in the first quarter of 2018 appears to have been temporary, with momentum recovering in the second quarter and is expected to maintain this pace for the rest of the year.

For more information see the Bank of England's latest Monetary Policy Summary and Minutes and Inflation Report. The next MPC meeting is Thursday 14th September 2018.

Interest rates



Source: Thomson Reuters Datastream

Business impact

Given the predicted rate rise it will be interesting to see whether consumer spending reacts or whether further change is needed. With household real income squeezed in the near term, consumer spending is likely to remain sluggish.

Inflation

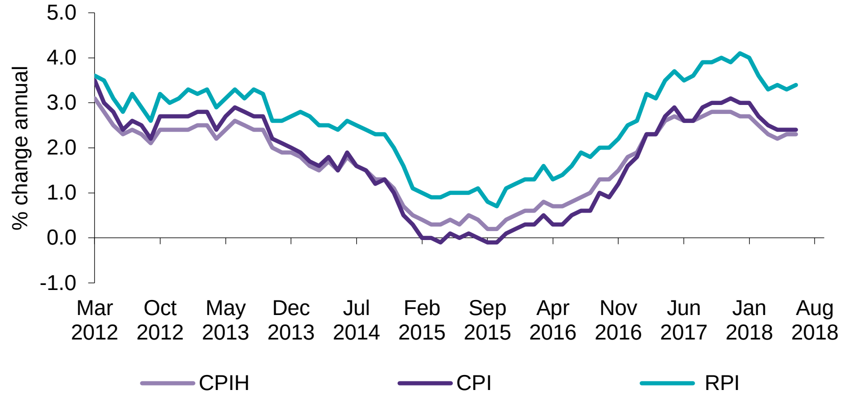
The ONS Consumer Prices Index including owner occupiers' housing costs (CPIH) 12-month inflation rate was 2.3% in June 2018, unchanged from May 2018. From a high of 2.8% in Autumn 2017 the rate had fallen steadily to 2.3% in March 2018 where it has remained.

The largest upward contribution to the CPIH 12-month rate came from transport, where prices increased by 5.3% in the 12 months to June 2018, leading to a 0.67 percentage point contribution to the CPIH 12-month rate. Of which, motor fuels made the largest contribution where prices increased 11.6% in the 12 months to June 2018.

In the Bank of England's MPC's most recent projections, set out in the May Inflation Report, there is an expectation that inflation will pick up slightly more than projected in the near term, reflecting higher dollar oil prices and a weaker sterling exchange rate. It also states that most indicators of pay growth have picked up over the past year, while labour markets remain tight. As a result, domestic cost pressures are anticipated to continue to firm gradually.

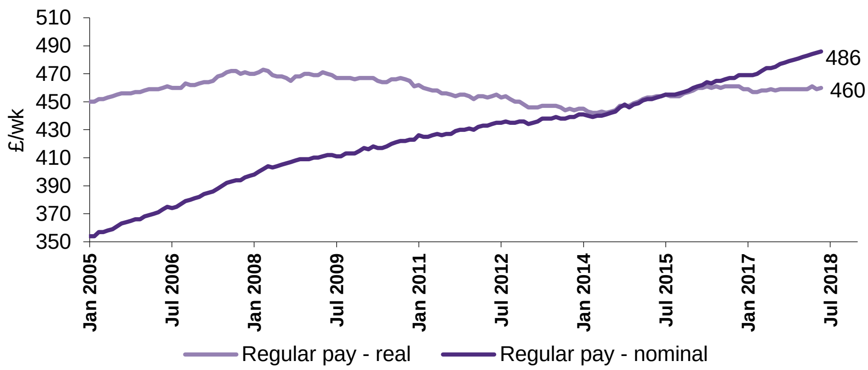
For more information see the latest ONS Inflation and Price Indices update and the Bank of England's Inflation Report. The next ONS release is 15th August 2018.

Inflation rates



Source: ONS

Average Weekly Earnings



Source: ONS

Business impact

One of the primary effects of inflation is the impact that it has on employees and the extent to which they are feeling 'squeezed'. This in turn impacts on salary expectations and demands. This is particularly true for companies that use inflation to set pay increases.

The knock on impact of 'squeezed consumers' is a reduction in consumer spending which will impact those businesses whose business model is B2C.

The latest ONS estimates show that average weekly earnings for employees in nominal terms (not adjusted for inflation) increased by 2.7% (both excluding and including bonuses) between March to May 2018 compared to the same period a year earlier. In real terms (adjusted for price inflation) they increased by just 0.4% over the same period.

Unemployment

Unemployment is a valuable indicator of the overall health of an economy and the extent to which prosperity and economic growth is filtering through the economy. The unemployment rate, measured by the Office for National Statistics, is the proportion of the economically active population (those in work plus those seeking and available to work) who are unemployed.

ONS estimates from the Labour Force Survey show that, between December 2017 to February 2018 and March to May 2018, the number of people in work has increased again, while the number unemployed has fallen. The number of people aged 16 to 64 years not working and not seeking or available to work (economically inactive) has also declined.

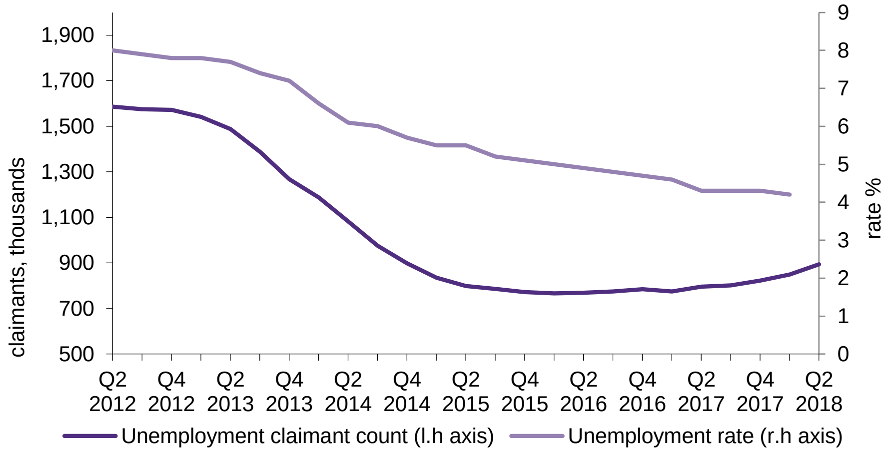
There were 1.41 million unemployed people (people not in work but seeking and available to work), 12,000 fewer than for December 2017 to February 2018 and 84,000 less than for a year earlier. The unemployment rate (proportion of those in work plus those unemployed, that were unemployed) was 4.2%, down from 4.5% for the same period a year earlier and the joint lowest since 1975.

There were 32.40 million people in work, 137,000 greater than for December 2017 to February 2018 and 388,000 greater than for a year earlier. The employment rate (proportion of people aged 16 to 64 years who were in work) was 75.7%, higher than for a year earlier (74.9%) and the highest rate since records began in 1971.

There were 8.64 million people aged 16-64 years who were economically inactive (not working and not seeking or available to work), 86,000 fewer for than for December 2017 to February 2018 and 184,000 fewer than for a year earlier. The inactivity rate (proportion of people aged from 16-64 years who were economically inactive) was 21.0%, lower than for a year earlier (21.5%) and the joint lowest since comparable records began in 1971.

For more information see the latest ONS Unemployment update. The next data release for unemployment figures from the ONS is 14th August 2018.

Unemployment



Source: ONS

Business impact

With unemployment at record lows, getting the balance right between high employment and high productivity is a challenge for the United Kingdom, and it is one that businesses can play an important role in addressing. It is something that we see as critical in helping to create a vibrant economy, not least because of the clear link between improved productivity and improved prosperity.

A key issue for businesses is that with record levels of employment, skills gaps and hard to fill vacancies will increase – already an issue for many employers. This may be compounded by the perception – if not yet the reality – that government will reduce immigration in the near future. Businesses therefore need to think about how they develop and attract talent.

Should rising unemployment return as an issue, for many businesses this is less likely to impact on business decisions and operations. However, rising unemployment would have a number of important implications for organisations in the public and third sectors, many of whom would need to change policy or practice in order to respond to increasing levels of people out of work.

Investment

Investment in new equipment influences the productive capacity of the economy. It can also be seen as a measure of business optimism as to the future growth of the economy.

The ONS measure business investment as net investment by private and public corporations. This includes investments in transport, information and communication technology (ICT) equipment, other machinery and equipment, cultivated assets (such as livestock and vineyards), intellectual property products (IPP, which includes investment in software, research and development, artistic originals and mineral exploration), and other buildings and structures.

Business investment does not include investment by central or local government, investment in dwellings, or the costs associated with the transfer of non-produced assets (such as land).

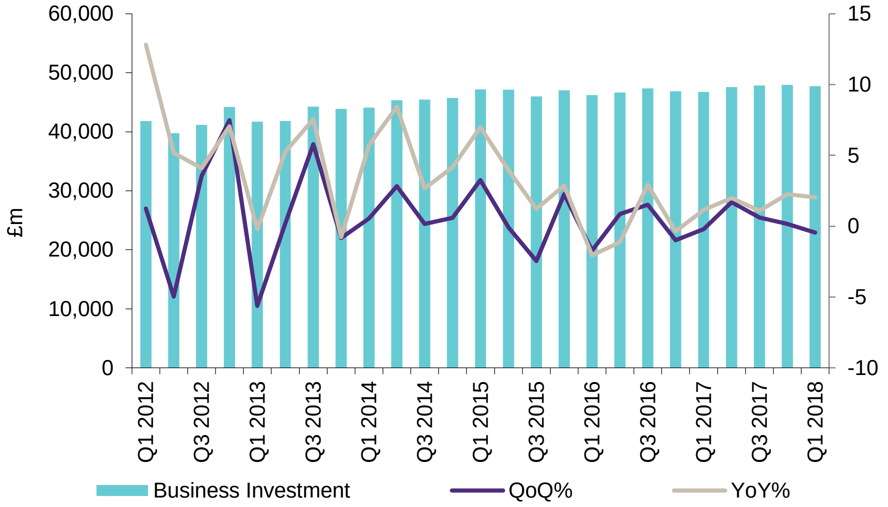
Business investment was estimated to have fallen by 0.4% to £47.7 billion between Quarter 4 (October to December) 2017 and Quarter 1 (January to March) 2018. This was the first fall since Quarter 1 of 2017.

Transport equipment was the only asset to have grown, with falls for other buildings and structures, other machinery and equipment within information and technology equipment and other machinery and equipment, and software within intellectual property products.

Over the longer term, business investment is now 13.7% above the pre-economic downturn peak of Quarter 1 2008 and 37.5% above the level at the lowest point of the economic downturn.

For more information see the latest ONS release on Business Investment. The next update is on 28th September 2018.

Business investment



Source: ONS

Business impact

The Bank of England, in its most recent Agents' summary of business conditions, stated that investment intentions remain modestly positive among manufacturers and in business services. Some manufacturers are investing in capacity in order to meet export demand, others in automation to overcome labour shortages or in diversification to insure against weak consumer activity and competition.

Productivity

The first graph shows different measures of UK productivity over the past five years released by the ONS. Movements are shown for output per hour, output per job and output per worker.

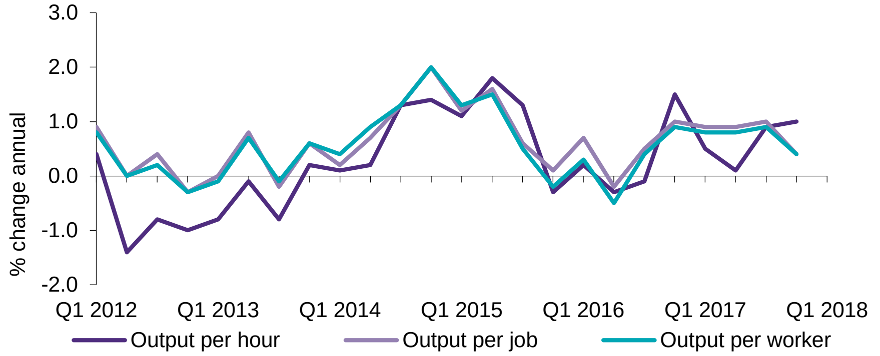
UK labour productivity, as measured by output per hour, is estimated to have grown by 0.9% compared with the same quarter a year ago. This remains below the long-term trend observed pre-financial crisis when growth averaged nearly 2% per annum, and suggests that the 'productivity puzzle' remains unsolved.

UK labour productivity is estimated to have fallen by 0.4% in the first three months of 2018. This is a result of employment growing at a greater rate than output growth. This is the first fall in output per hour since the second quarter of 2017.

The second graph shows historic and forecast productivity growth rates, as measured by GDP growth, for the OECD, France, Germany and the USA. In Quarter 2 of 2018 USA (1.42%) had the greatest rate of productivity growth, higher than the OECD Total (1.09 %), Germany (0.88%), France (0.59%) and the UK (0.60%).

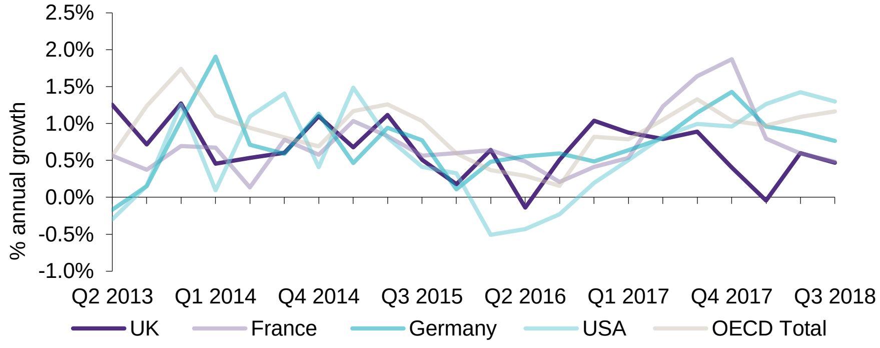
For more information see the latest ONS Labour Productivity update and OECD Productivity Statistics. The next ONS release is 5th October 2018.

UK productivity



Source: ONS

OECD Productivity inc forecast



Source: OECD

Business impact

Brexit could have further implications for UK productivity. The OECD highlights estimates that Brexit could reduce total factor productivity (ie the portion of output not explained by labour and capital used in production) by approximately 3% over the next ten years through diminished trade openness, weaker research and development intensity and a smaller pool of skills.

The extent that the labour market is kept open to foreign workers could be of critical importance.

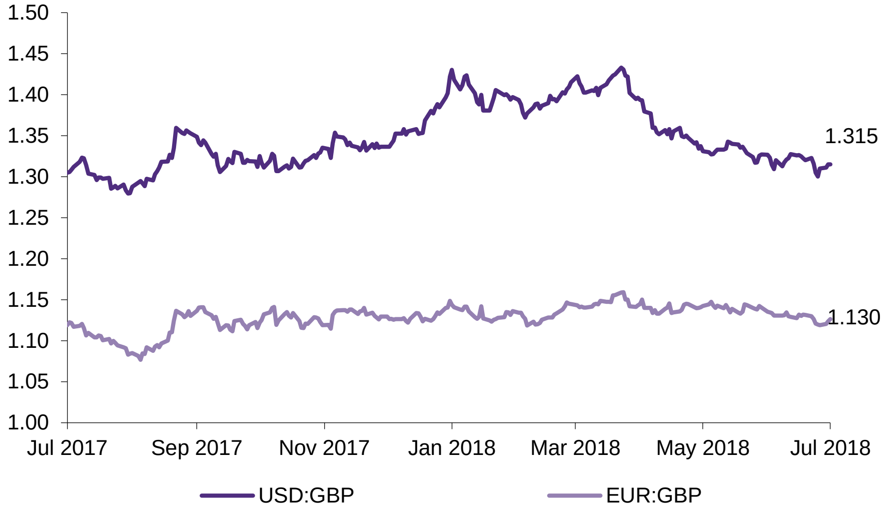
In the Autumn Budget Government announced plans to address the UK's productivity challenge, including: cutting corporation tax to support business investment; improving skills through increased numbers of apprenticeships and the introduction of T-levels; and, delivering infrastructure projects like the Mersey Gateway Bridge, the Northern Hub in Manchester and Crossrail. The extent to and timeframe over which these policy decisions will begin to impact is unknown.

Exchange rates

As has been the case in previous versions of this briefing, the continued uncertainty around Britain's exit from the European Union means that the pound remains relatively weak compared to historical levels, but has strengthened slightly.

The Bank of England's most recent Agents' summary of business conditions notes that the impact of past depreciation in sterling on cost rises has weakened. Despite this, material cost inflation has remained steady for businesses. In particular, with construction materials, metals and oil-derived products. While for consumers the pressures of goods price inflation seems to have eased, reflecting the diminished effect of the past fall in sterling and wider competitive pressures.

Exchange rates



Source: Thomson Reuters Datastream

Business impact

Exchange rates have a direct implication for any international work and investment affecting both the cost of doing business as well as the potential profits that can be realised. Contingencies – positive and negative – should therefore be applied to any investment plans and business cases within this investment priority.

This is particularly the case for businesses who export goods and/or import raw materials.

For those that import raw materials, many of which are paid for in dollars, this change is likely to squeeze profits significantly.

For those that export there may be an increase in demand as products and services become cheaper. Although given the uncertainty and nervousness that exists within the Eurozone currently this demand may be tempered.

UK trade

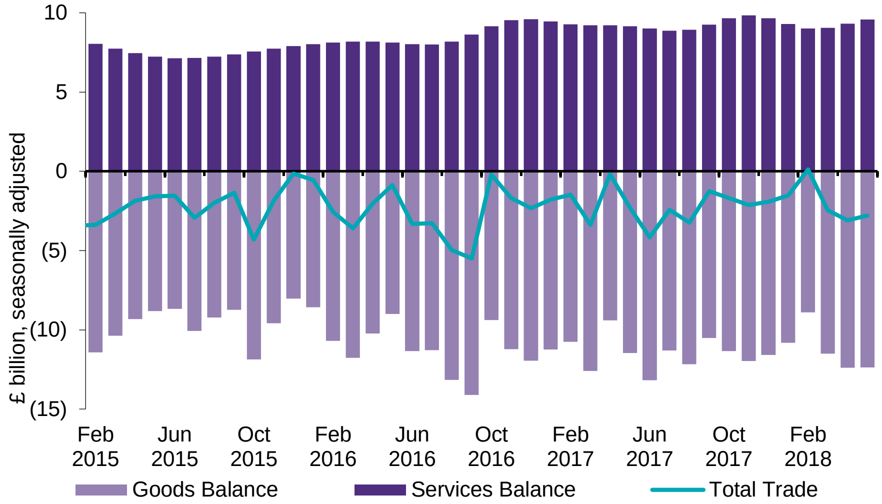
UK trade shows import and export activity and is the main contributor to the overall economic growth of the UK.

The Office for National Statistics states that in the three months to May 2018 the total UK trade (goods and services) deficit widened by £5.0 billion to £8.3 billion. This was due to a £5.0 billion widening of the trade in goods deficit, resulting from a combination of falling goods exports (£3.1 billion) and rising goods imports (£1.9 billion). Services imports and exports mostly offset each other with both increasing by approximately £0.5 billion, which led to a small decline in the trade in services surplus.

The UK did however return a small overall surplus of £0.1 billion in February 2018. The last time the UK trade balance returned a surplus was in February 2011 when there was also a £0.1 billion surplus. The last time there was a larger surplus than this was in January 1998 when there was a £0.5 billion surplus.

For more information see latest ONS update on UK trade statistics. The next release is 10h August 2018.

Balance of UK trade



Source: ONS

Business impact

Despite hopes that the weaker pound would boost demand for British goods, exports have remained subdued.

There is optimism in the market that this might improve, with manufacturers anticipating a rise in outputs in the latest PMI Index (See 'Industry Views' section).

The outlook for export growth will also depend on any changes to the United Kingdom's trading arrangements and how companies anticipate and respond to these.

As noted previously the extent to which individual businesses are exposed to EU export and import markets will present both threats and opportunities to business growth.

Industry views

The first chart shows the Markit Purchasing Managers Index for the Construction, Services and Manufacturing sectors. The Index is based on survey responses from panels of senior purchasing executives who are asked to state whether business conditions for a number of variables have either improved, deteriorated or stayed the same compared to the previous month.

Services sector activity had its strongest rise since October 2017, **with the index increasing from 54.0 in May to 55.1 in June.** UK service providers indicated the fastest expansion of business activity for eight months in June, which continued the recovery in growth after weather disruption in March. However, Job creation remained modest in June, reflecting challenges in staff recruitment.

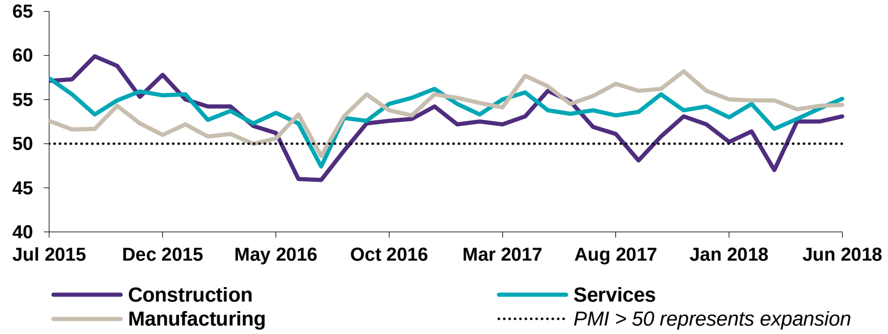
Construction output reached a seven month high, increasing from 52.5 in May to 53.1 in June. Solid expansion of overall construction activity was underpinned by greater residential work and an uptake in commercial building. The near-term outlook for growth also appears positive with the strongest rise in new orders since May 2017 and the largest increase in input purchases for two and a half years.

Manufacturing output remained subdued at the end of the second quarter, with the index at 54.4 in June it was only marginally higher than the 54.3 recorded in May. While output and new orders increased across the consumer, intermediate and investment goods industries, the overall rate of expansion in manufacturing slowed. Business optimism remained positive in June with over 51% of respondents anticipating a rise in output over the coming year.

For more information see the latest IHS Markit PMI releases.

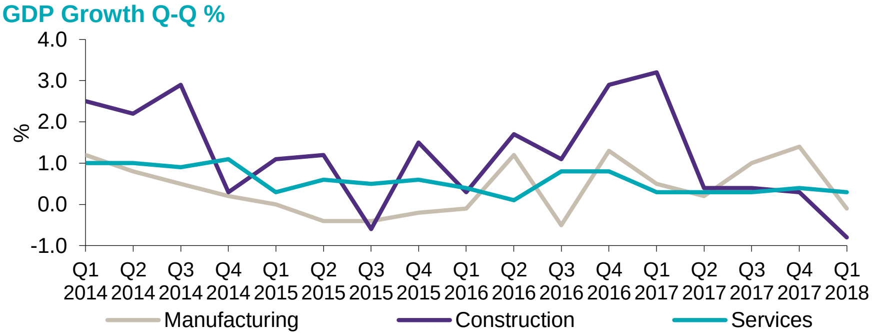
The second chart illustrates quarterly GDP growth across the three industries. Services activity increased 0.3% in Quarter 1 in 2018, while Manufacturing activity declined by 0.1% and Construction declined by 0.8% over the same period.

Purchasing Managers' Index



Source: Markit /CIPS

GDP Growth Q-Q %



Source: ONS

Business impact

Business confidence directly impacts on business investment decisions. Continued levels of uncertainty over the longer term with Brexit may limit levels of business investment and delay any major new investment from Government.

Regional outlook

The ICAEW Business Confidence Monitor is conducted every quarter, and gathers opinions on past performance and future perspectives for members' businesses, as well as investigating perceived changes in impact of factors such as availability of skills, government regulation and the tax regime.

In the second quarter of 2018 confidence was positive in ten of the eleven regions, suggesting confidence across the UK.

In particular, the North West, Wales and South West showed the greatest levels of optimism. Companies in the North West seem to have gained confidence from growth in exports as they recorded the greatest level of confidence in this area relative to the other regions. While businesses in Wales reported the lowest proportion of respondents that are working below capacity.

Also notable was the return to a positive result for London's businesses, albeit weak. This was the first positive result in a year, possibly reflecting increased sales growth and progress with Brexit negotiations.

For more information see the full ICAEW UK Business Confidence Monitor Report.

Business impact

In the context of government negotiations on the UK's exit from the European Union the ICAEW stresses the need for businesses to focus on maintaining their positioning and competitiveness in a growing global marketplace.

They also state that businesses are currently emphasising their focus on short term cost savings to deliver profit with the hope of increasing profit margins over the next 12 months.

Indicator glossary

Measure	What is it?	Why is it interesting?
Index of Services	Short-term indicator of services sector performance	Understand which service sectors are growing and what rates
Balance of Payments	Estimates about UK's trade, income and investment flows with the rest of the world	Trends in trade and also inbound and outbound overseas investment
Productivity	Output per hour, important for our economic performance in the long run	Productivity can be influenced by the structure of the labour market, investment and infrastructure, and the economic environment
UK Trade	Size of the import/export trade deficit on goods and services	Signs of change in the balance of exports compared with imports. The sharp depreciation in sterling post-referendum could be a key influence by making our exports cheaper and imports more expensive
Business Investment	Gross fixed capital formation and business investment	Look for change reflecting businesses' assessment of the economic and their financial situations post referendum
Index of Production	Early indicator of growth in the output industry	Manufacturing is dependent upon both upon domestic and overseas demand - changes will how UK trade is faring in the post referendum world
Retail Sales	Value and volume of retail sales	Indicates consumer confidence, prices and the overall financial position of households
Construction Output	Summarises ongoing and new construction work	Indicator of how confident enterprises and government are in investing in buildings and infrastructure, as longer term assets.
Inflation	Movements in prices of consumer goods and services	Reflects the degree of strength of domestic demand, domestic supply and changes in the UK prices of imports
Producer Prices Index	Factory gate prices and input costs	Changes could be due to changes in labour and energy cost; sterling depreciation could cause imported inputs to be more expensive
House Price Index	Change in house prices	An indicator of household's confidence in their financial situation
Labour Market Statistics	Employment, unemployment and average weekly earnings	Labour market trends will reflect changes to the overall economy
Public Sector Finances	Public sector net borrowing and tax revenues	Indications of the level of activity in the economy, changes in fiscal and BoE policy

Business impact

This table sets out the economic measures and data that are assessed in the economic briefing. This includes a brief explanation of what the measure is and why it is important to the health of the economy.

If you would like any further measures to be assessed in the next economic briefing, please get in contact with the one of the Insight & Analytics contacts on the following page.

Insight & Analytics contacts

Phillip Woolley

Partner

T +44 (0)7771 812 258
E phillip.woolley@uk.gt.com

Robert Turner

Director

T +44 (0)7584 185 371
E rob.g.turner@uk.gt.com

Karen Douglass

Associate Director

T +44 (0)207 728 2674
E karen.douglass@uk.gt.com

Ashley Turner

Assistant Manager

T +44 (0)207 728 2215
E ashley.dc.turner@uk.gt.com