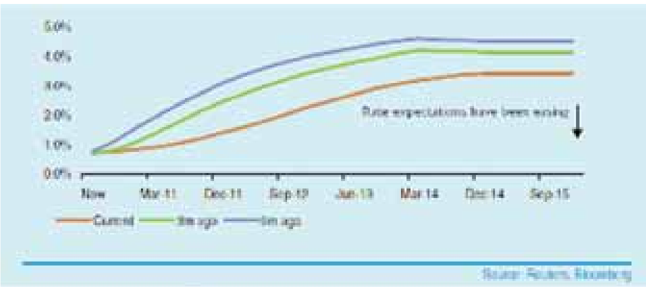
Economic outlook for the United Kingdom

By Dom Michon, Investec Bank (Channel Islands)

Ahead of Q2 GDP data, we have not changed our UK outlook for 1.2% growth this year and 2.6% next. The MPC faces a tricky combination of downside risks to growth and above target inflation for a further 18 months, and while it debated the possibility of providing further QE in its July meeting, Andrew Sentance continued to vote for a rate hike. The pound has received what seems like a positive re-rating following the Election and Budget – accordingly we have edged up our sterling forecasts

At the time of writing, we were awaiting Q2 GDP data, our expectation being a rise of 0.6% on the quarter. Delayed revisions to the national accounts failed to change significantly recent economic history, with the recovery still adjudged to have begun

Chart 1: 3-month sterling LIBOR expectations



in Q4 last year. The depth of the recession is now estimated to have been a little deeper, with a drop in output from peak to trough of 6.4% (previously 6.2%). Some have remarked that the extent of the UK recovery compares unfavourably with the US.

The key question though concerns H2 rather than Q2 and whether the economy is set to experience a slowdown, given a number of softspots elsewhere in the world economy. The housing market seems to be stalling with the level of mortgage approvals inching down and surveys such as RICS indicating that prices should flatten out. General survey evidence appears more mixed and we have not changed our GDP predictions for this year and next of 1.2% and 2.6% respectively.

CPI inflation eased back to 3.2% in June, but VAT changes mean that UK inflation is likely to have remained above target for more than two years. This does not constitute an inflation 'problem', as such, especially given that pay growth is running at subdued levels (ex-bonus earnings at 1.8%). But services inflation has risen, most recently reaching 3.9%. The January VAT hike explains some of the increase this year, but price pressures here are unexplainably 'sticky', especially given the degree of spare capacity in the economy.

The combination of events has clouded the outlook for rates still further, especially as July's MPC meeting included a debate on whether to ease policy again. The various downside risks suggest that a further round of QE should not be ruled out note that markets have pushed back their estimates of the timing of the first tightening, shown using expectations of 3-month LIBOR (see chart below) On the basis that the world economy is not due to re-enter a pronounced slowdown, we are still forecasting the first hike in Q1 next year, but fully acknowledge the uncertainties involved.

The pound has enjoyed something of a post-election renaissance since the election, and although it has slipped back a little very recently, it has still climbed against both the dollar and the euro, gaining around 2½% in trade weighted terms. Arguably the Coalition's degree of commitment towards reducing the deficit, and the associated lower risks of a sovereign downgrade, have contributed towards a modest re-rating of the UK currency. We have adjusted our sterling forecasts to a take into account a change to our EUR view, which leaves sterling in the $1.50s over the next 18 months.

Stocks have regained some poise, helped by a set of relatively decent Q2 US corporate earnings figures so far. However although at the time of writing the FTSE 100 index was back above the 5000 level, it is below its end-2009 value, in contrast to the FTSE 250 index which has made a net gain of some 7% (see chart below). The chart also shows the underperformance of the mining and oil and gas sectors (the latter of course savaged by the weakness of BP), which explain much of the divergence between the top and mid-line stock indices.

Chart 2: FTSE indices and key sub-indices so far this year (1Jan 2010 = 100)