CUSTOMER TREASURY SERVICES

Economist's Weekly Market View

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UK rates to remain on hold in run-up to Brexit

The UK economy performed much better than expected in the second half of last year, in the aftermath of the referendum vote in favour of Brexit. However, the effects of that vote would appear to be catching up with the economy in 2017.

GDP growth slowed in the first quarter of 2017 to 0.3% from 0.7% in the final quarter of 2016. The breakdown of GDP shows that the slowdown was primarily due to the services sector. It grew by 0.3%, compared to 0.8% in the previous quarter. The retail trade was the largest contributor to the slowdown in services. Meantime, output from production industries rose by 0.3%, matching its performance from the fourth quarter of 2016, largely as a result of a continued solid performance by manufacturing.

While expenditure based GDP figures are not available yet for quarter one, other data suggest that the volume of consumer spending slowed, or even possibly declined, in the quarter. Retail sales volumes fell by 1.4%, the first decline in over three years and their largest fall since the opening quarter of 2010.

Meantime, despite the weaker sterling, the UK has not seen an improvement in its trade balance. Imports rose by 3.3% in value terms in quarter one, while exports fell 0.5%. The resultant widening in the trade deficit suggests that external trade may have acted as a drag on growth in the quarter.

Rising prices are becoming a concern for the UK economy and the key factor behind the slowdown in consumer spending. CPI inflation rose to 2.3% in March. Unlike in the Eurozone, 'core' inflation has also risen, picking up to 1.8%. This likely reflects higher import prices as a result of the weaker sterling. This is also impacting on producer output price inflation. It has continued to accelerate in recent months, hitting 3.6% in March.

Meanwhile, the labour market has seen some slight signs of improvement recently, after job growth weakened in the aftermath of the referendum vote. Employment rose by 39,000 in the three months to February, having declined by 9,000 in the previous three month period. Overall, employment growth has slowed to 1% year-on-year from 2% before the referendum. The unemployment rate, though, remains low at 4.7% in February, as labour force growth has weakened, possibly reflecting lower immigration.

In another sign that Brexit is impacting the economy, wage growth has slowed this year, with the annual rate decelerating to 2.3% in the three months to February from 2.8% in the previous three month period. Combined with rising inflation, this suggests that consumer spending will remain under pressure in the UK.

Not surprisingly then, last week's meeting of the Bank of England's Monetary Policy Committee concluded with no changes to policy and the key bank rate being kept at 0.25%. However, the Bank did hint that it could raise rates a bit earlier than when the market is expecting in early 2019.

The Bank, though, is taking a very benign view of Brexit. It is looking for the economy to grow at a steady pace of close to 2% per annum over the next three years. We think growth could be softer than this. We also expect the pick-up in UK inflation to prove transitory as wage inflation is actually easing in the current uncertain environment. The recent recovery in sterling will also help mitigate some of the upward pressure on import prices.

Hence, we think the Bank of England will sit tight until it becomes apparent what the Brexit negotiations actually bring. This is unlikely to become clear until late 2018 or early 2019. Only then are we likely to have an idea where the UK economy and monetary policy are heading over the medium term.

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