Strategic Economics Report

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Headlines

The economic recovery is intact but, as predicted earlier in the year, it has started to soften. UK businesses expect to grow in the months ahead but more are less optimistic than they have been for over a year.

A number of global and national uncertainties have combined to make corporate planning more cautious. In business-to-business terms, a range of sectors face slower market growth this winter.

UK consumer expenditure seems to be holding up, supported by a little growth in average earnings and higher house prices. But, some financial assets (e.g. equities and commodities) have lost value recently and, with employment prospects levelling out, the push behind the recovery from final demand may waiver.

Moreover, the UK's external accounts and the productivity record remain dire. The rebalancing story are still more myth than reality.

The fiscal and monetary policy stances remain rooted in austerity and accommodation respectively. We have been in this policy vice for many years. The monetary stance may start to shift, albeit glacially, soon.

Locally, the pattern of economic performance is similar, with an already modest recovery losing some of its forward momentum. Across SW England, there are signs of a weakening of growth in sales and orders, as well as more modest intentions to invest and to hire. SE England is still relatively robust.

The more moderate outlook is not yet a cause for major concern: the recovery is not over. Nonetheless, there is some concern that more southern firms will choose to 'wait and see' rather than 'take the plunge' when it comes to investing for growth over the next half year.

Economic Profile

Recent Data & Trends:

Latest evidence

	Annual	Quarterly	Monthly
Real GDP (%ch)	+3.0 (2014)	+2.6 (Q2)	n.a.
CPI inflation (%ch)	+1.5 (2014)	+0.0 (Q2)	+0.0 (Aug)
LFS unemployment (%)	6.2 (2014)	5.6 (Q2)	5.5 (May-Jul)
Trade deficit (£bn)	-35.4 (2014)	-3.4 (Q2)	-3.4 (Jul)
Base rate (%)	0.5 (2014)	0.5 (Q3)	0.5 (Sep)

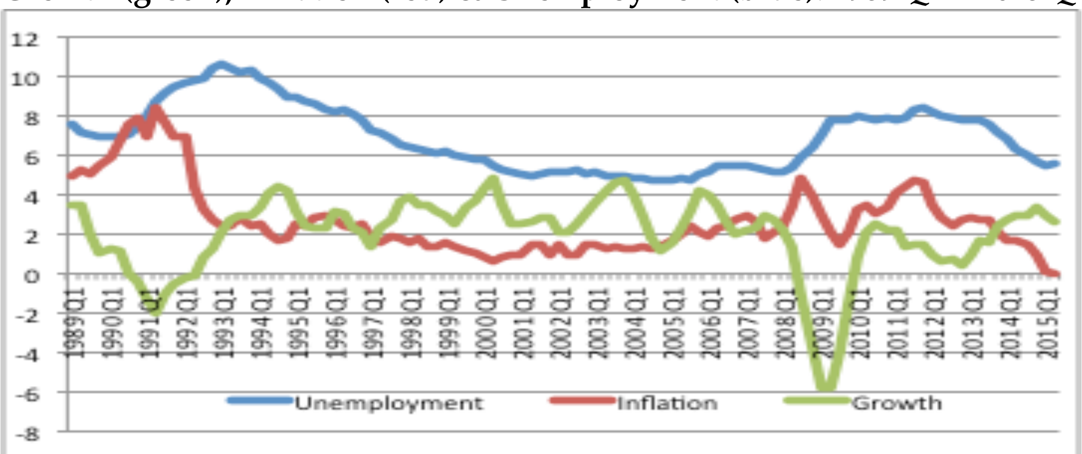
Source: ONS

According to official data, by mid-2015, the UK economic recovery had moderated, with growth a little slower and inflation and unemployment flat (see table above and chart below).

Moreover, in the third quarter (July-September), business and consumer confidence softened in response to:

- Adverse external news (problems in the Chinese economy, the Middle East/Balkans and in emerging, financial and commodity markets);
- Uncertainty about policy (July's Treasury Budget and expectations of higher interest rates from the Bank of England); and
- A series of business surveys showing weaker investment and hiring intentions this winter.

Growth (green), Inflation (red) & Unemployment (blue): 1989 Q1 – 2015 Q2



Source: ONS: growth = real GDP % change year-on-year (yoy), Inflation = CPI % ch yoy, Unemployment = LFS % rate

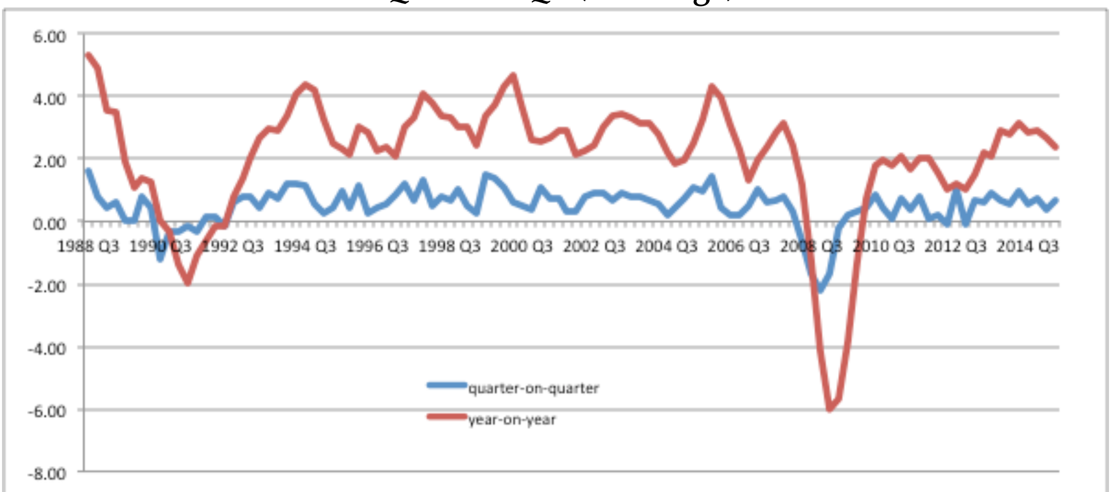
This recovery was always going to struggle because the fundamental weaknesses of the UK economy have not been corrected. Recent evidence only reiterates the country's longstanding problems:

- The huge trade deficit (current account deficit c5% of GDP in first half)
- The appalling productivity record (20% below the G7 average in 2014)
- The low investment and persistent skills gaps
- The abnormal financial conditions and some adverse global factors

Furthermore, the recent rise in sterling will not help an economy still trapped by the risks of deflation.

The detail of recent growth trends is shown in the next chart below. It shows a moderating pace of increase for both quarter-on-quarter and year-on-year growth since late 2014. The striking features of this recovery are its relative lack of momentum and how growth may have peaked at a relatively low rate (just over 3% year-on-year). As the upturn slows, the debate will be whether the moderate recovery can support its longevity into a third upward phase or whether it suggests an early drop back into mild recession in 2016/17/18.

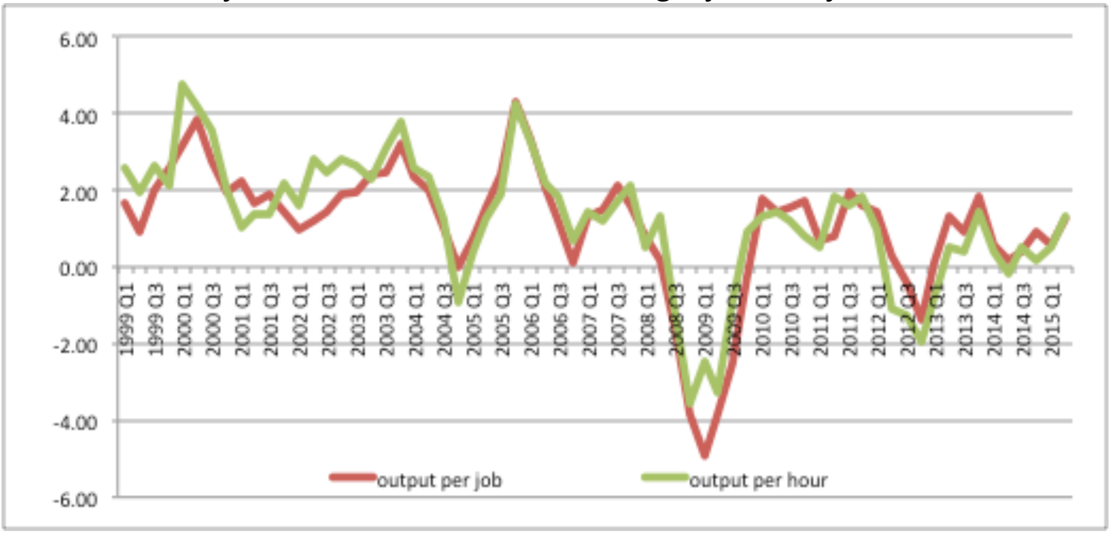
UK real GDP trends: 1997 Q1 - 2015 Q2 (% change)



Source: ONS data

To answer this debate, an answer to the on-going productivity conundrum is needed. As the next chart below highlights, there has been a little more growth of output per hour and per job in early 2015 but it remains a modest improvement. If the pace of growth in productivity were to rise back above 2%, it could be good for the sustainability of the prospects for growth in the years ahead. There are some signs that firms are planning to engage in more productivity boosting efforts this winter, by investing in workforce, machinery and equipment. It remains to be seen, however, if plan becomes reality and whether this follows through to a real increase in productive potential that can sustain the recovery into the medium term.

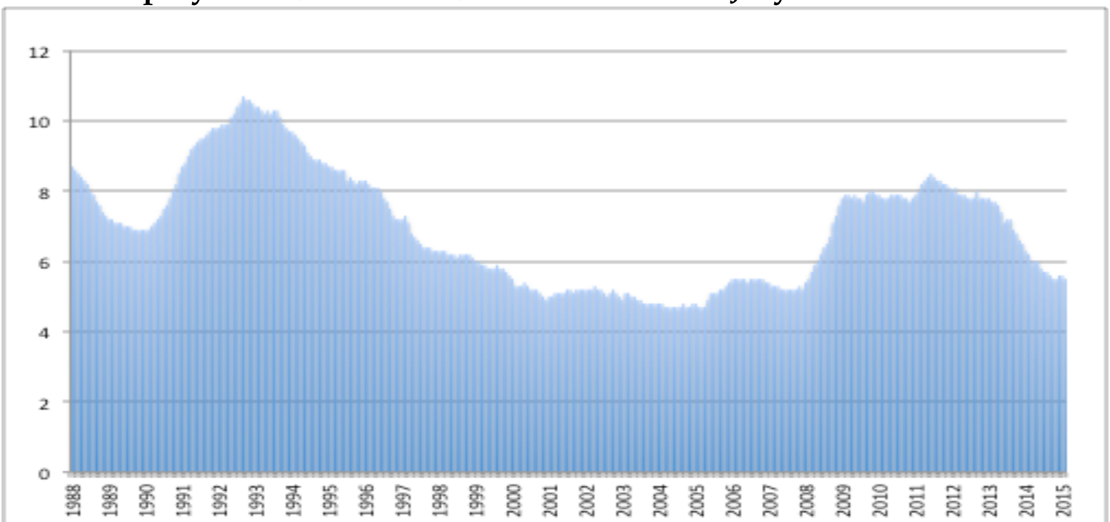
UK Productivity: 1990 Q1 to 2015 Q2 (% change, year-on-year)



Source: ONS data

At a time of slower overall growth, the obverse of some, albeit minor, recovery in productivity is a smaller rate of decline in unemployment. The next chart indicates that the UK rate may be levelling out at about 5.5%: a rate higher than the lows seen in the 'noughties' but better than some earlier historic lows.

UK unemployment (% LFS rate) December 1988 – July 2015



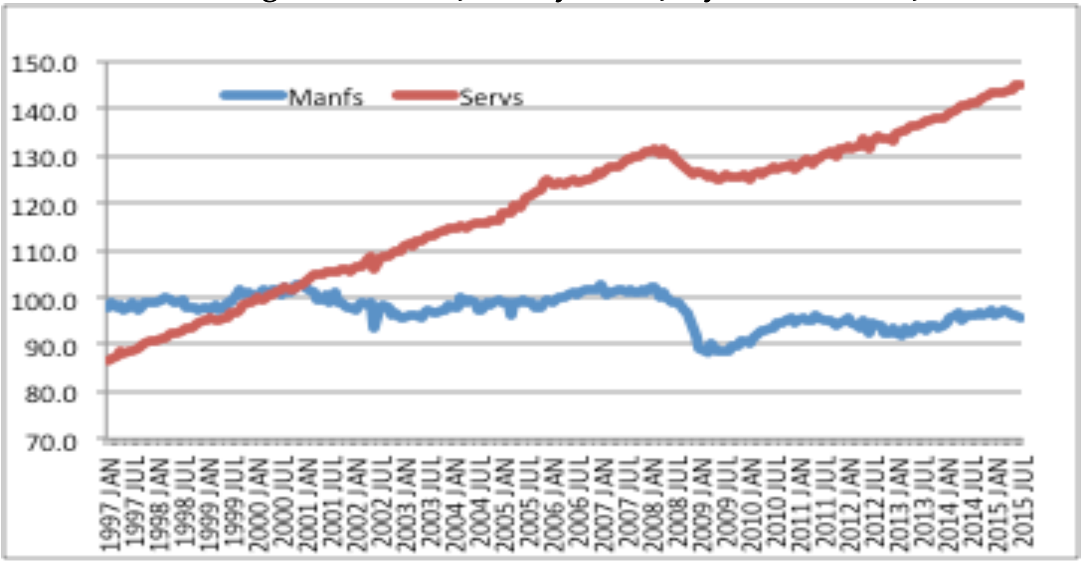
Source: ONS data

On the broader supply side (see next chart), in the year to July, industrial production was merely 0.8% higher with manufacturing still more than 6% below its pre-'Great Recession' peak. In contrast, the services aggregate was

2.8% higher than a year ago and more than 10% above the previous peak.

Transport equipment, including cars, remained the strongest parts of manufacturing and transport and related services were the strongest parts of services. Overall, the sector pattern remains very mixed but, generally, private services and consumer durables are performing better than other areas. The issue is whether this will change in the months ahead as the slowdown in export markets and the strength of sterling bites on 'tradeables', throwing industry back on expenditure by the domestic consumer.

UK Manufacturing & Services: January 1997–July 2015 (levels, Jan '00 = 100)

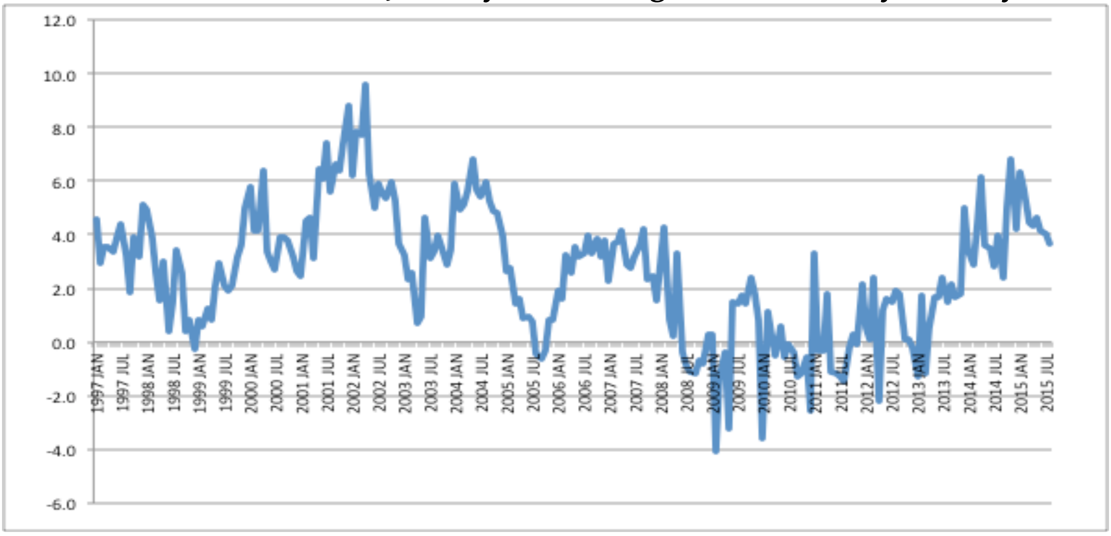


Source: ONS data

The consumer has held fairly firm in the year to date (see next chart), averaging annual growth of 4% or more in retail volume terms. There was a dip below that in August, however, and the rate of increase has been easing since it peaked in January. As yet, there is nothing to raise too much alarm here but, if the rate of change continues to soften, it may be a cause of concern – pointing to emerging real weakness in domestic demand.

Within the total, household goods (+4.6% year to August) have been most robust whereas foods have been sluggish (+0.7%). The improvement in real incomes over the last year seems to have supported household spending on durables in the year-to-date, some of it driven by replacement demand. If this is sustained, we can be more sanguine about future trends. As always, the Christmas period will be important here, especially as some of the austerity measures to cut some benefits will be sent out to recipients in December.

UK Retail Sales Volumes: January 1997 – August 2015 (% ch year-on-year)



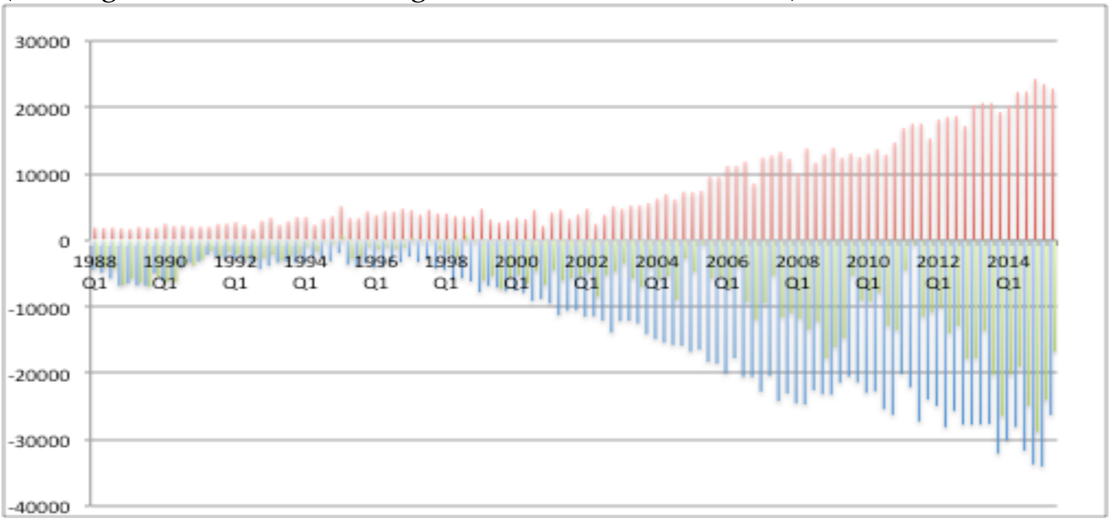
Source: ONS data

If anything, the international perspective has deteriorated in recent months. The financial and business market 'headlines' have been full of dropping commodity prices, slowdowns in the Far East (China) and several emerging markets (including the other BRICs), and a range of crisis issues for Europe and the Middle East (Greece, war and migration). North America has stood up relatively well and this has helped UK businesses. Overall, however, as the IMF confirmed in its recent annual meetings, the prospects for international trade and growth seem to have deteriorated.

This is reflected in the UK balance of payments (chart below), which continues to record a large and unsustainable gap between what we sell, what we buy and what we earn from investments as a nation. At 5% or more of GDP, the current account deficit remains a source of great concern for UK economic prospects and well being over the long run.

Although, right now, the UK economy is living off the fact that it seems "better than its peers" in many current economic aspects, this will not sustain healthy living standards forever. Vitally, the forthcoming EU referendum (by 2017) will shine a light on our ability to 'pay our way' in the world and whether this will be better within or without the European Union. As well as the politics of 'in or out', the mounting debate will focus more attention on UK international trade and the detail of export competitiveness behind the current account figures over the next couple of years.

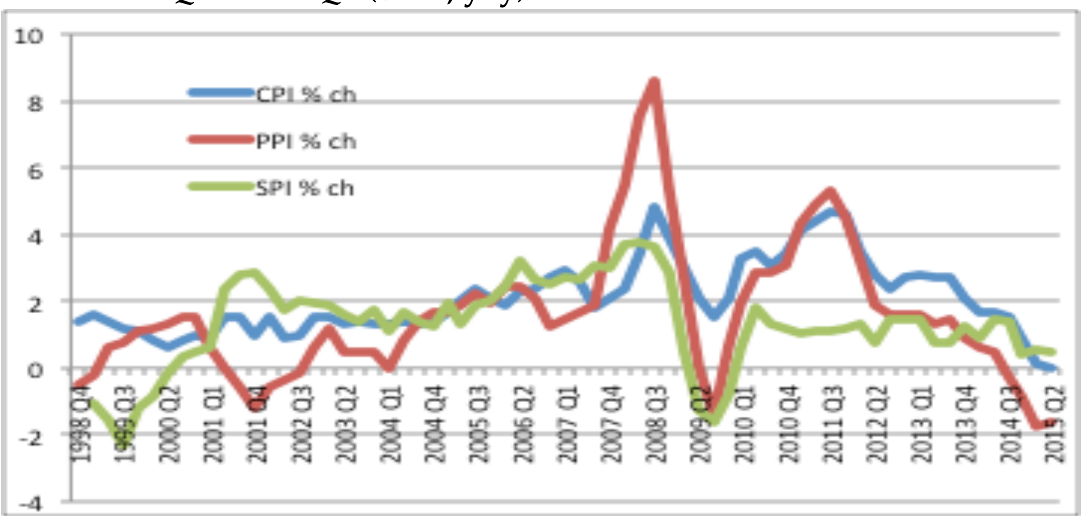
UK Balance of Payments: 1988 Q4 – 2015 Q2 (£mn):
(blue - goods, red – services, green - net current account)



Source: ONS data

Meanwhile, the inflation story remains unchanged, with many signals still showing deflationary rather than inflationary trends. The chart below highlights that, led by weak fuel (oil) and other commodity input prices, producer prices have been falling, year-on-year, over the last twelve months. This has brought the consumer price index down to zero and is lowering the services index too. House prices, especially in southern England +6.7% in SE and +4.2% in year to July), continue to buck the overall trend. Generally, however, there is little or no inflation pressure on the monetary authorities to shift interest rates until they are sure that it is necessary. In the short run, low inflation and a strong currency is a boost to household spending power and, thereby, demand-led growth.

UK Inflation: Services (green), Producers (red) & Consumer Prices (blue): 1997 Q1 – 2015 Q2 (% ch, yoy)



Source: ONS data

There is concern, however, that the monetary overhang from quantitative easing, (here and overseas), persists. The issue is surely not what damage any likely increase in interest rates might do over the next year or so to growth or even debts and debtors. (Any increase is going to be modest and would a base rate rise from 0.5% to no more than 2% really undermine growth?) It is more what damage are low interest rates now doing to fundamental economic drivers like savings and investment incentives.

High liquidity persists and the search for value threatens further bubbles in some asset values. The mass of inactive money in the banking system continues to carry a threat of higher inflation to come, unless the authorities can neutralise the excess liquidity. The Monetary Policy Committee is very hesitant to start the readjustment of monetary policy 'back to normal'. It is to be hoped they are not dismissing too lightly some of the financial risks and concerns being voiced by the Financial Policy Committee.

Meanwhile, the fiscal outlook seems unchanged. In July, the Office of Budget Responsibility (OBR) issued another set of forecasts to accompany the new government's Budget. In macroeconomic terms, things changed little and its impact on the fiscal ratios was also relatively muted (see table below). Overall, the OBR confirmed that public sector austerity will buy a gradual, but slow, fiscal improvement over the life of this Parliament.

OBR Forecasts (March 2015)

	2015/16	**2016/17**	**2017/18**	**2018/19**	**2019/20**
Debt ratio (% GDP)	**80.3**	**79.1**	**77.2**	**74.7**	**71.5**
Budget deficit (% GDP)	**1.7**	**0.5**	**-0.3**	**-1.1**	**-1.8**

Source: Office of Budget Responsibility

The July Budget endorsed the Chancellor's approach to austerity backed by fiscal tinkering to adjust tax and other incentives. The 'Living Wage' has taken a lot of the business headlines. This will probably be good for productivity and growth in the long term, even if it hurts an already slowing economy a bit in 2016.

The next big fiscal issue, however, is the Comprehensive Spending Review (CSR - to be announced with the Chancellor's Autumn Statement in late November or early December). It is not just the scale of public sector spending cuts for the next four years that is important but also where those cuts will actually fall. We await the CSR with bated breath.

Local Overview

Since our last report, the local southern economy has experienced a robust SE economy but a softening SW economy. As a result, performance has varied widely by sector. For example, domestic-orientated services enjoyed a better summer than exporting manufacturers but, even within these groups, there was a lot of variability. After a season of less than ideal summer weather, for example, some important consumer services (e.g. tourism) made only modest progress whereas other, consumer industries (e.g. car sales) grew well.

This summary of broad local performance is supported by a number of recent surveys. For example,

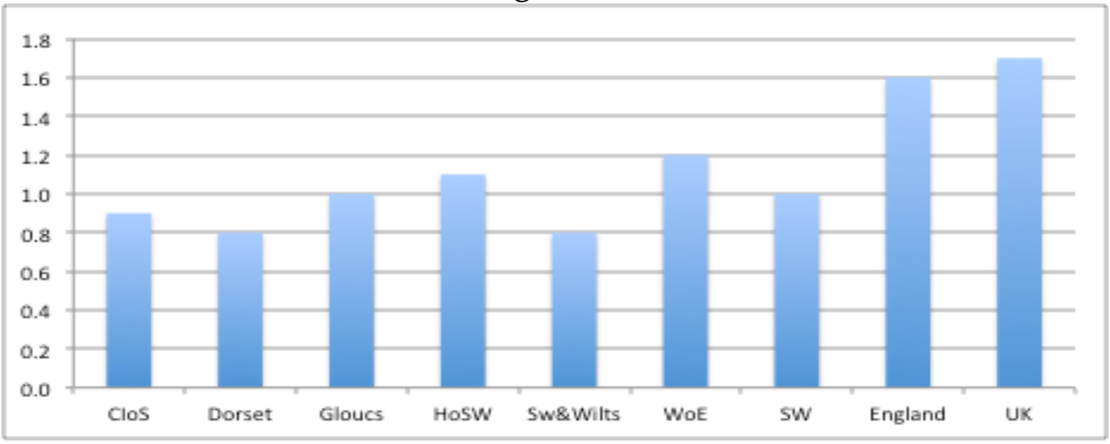
The British Chamber of Commerce described the economy as "facing serious challenges" with weaker growth in services and manufacturing in the third quarter of 2015. The SW survey was described as "tough reading with a decrease in all major indicators". The SE survey was more positive, talking more about the problems of success (such as skills shortages).

The ICAEW Economic Forecast (Q3 2015) revised its growth target upwards for 2015 (to +2.6% UK real GDP). It expects the same rate in 2016. It sees business investment up 7.4%, but slowing to 5.9% next year. Nevertheless, despite a mini-bounce in the South East, the latest ICAEW *Business Confidence Monitor* shows a levelling out of confidence amongst SW respondents at a lower overall balance than in many other areas.

The latest *MAS Barometer of SW manufacturers* recorded balances below 50, signalling a net decline for sales turnover, staffing and investment for the second half of the year. In contrast, there were high numbers for intentions to improve productivity through investment in the workforce, machinery and equipment. The latter might indicate an overdue but natural reaction to the maturing of the recovery. It suggests more growth will be based on increased efficiency rather than on new jobs in the year ahead.

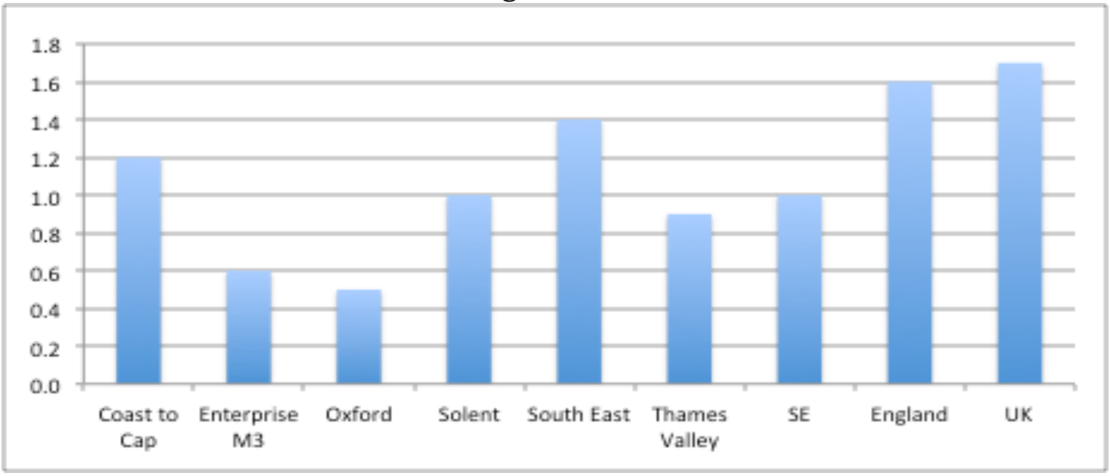
The *Lloyds regional PMIs* (purchasing managers index) for August showed a drop in output and employment balances. Both variables were in positive territory (SW England 53.4 and 51.4, and SE England 55.8 and 53.5 respectively) but both were lower than before. Across southern England, new orders and business outstanding have softened in the last couple of months. But, there is a divergence between the more robust activity to the east and the weaker trend to the west of the southern region.

SW LEPs Claimant Count rates: August 2015



Source: ONS

SE LEPs Claimant Count rates: August 2015



Source ONS

In labour market terms, the South of England continues to outperform other areas and the UK averages. Generally, employment is high in quantitative terms. The LFS unemployment rates were 4.1% and 4.5% respectively for SW and SE England in the three months to July compared with a UK average of 5.5%. The respective SW and SE employment rates were 73.7% and 71.6%.

Moreover, at a claimant count level, virtual full employment is evident across the South. As the two charts above show for the twelve LEP areas featured, claimant count rates averaged no more than 1% in August with all areas showing lower rates than a year earlier. At such low rates, however, this indicator has lost some of its usefulness as a measure of labour market tightness or slack.

Economic Prospects

To an extent, economic forecasters are still playing catch up. Many underestimated the pace of recovery in 2014 and, therefore, have been adjusting growth rates higher for 2015 in recent months, just when there is evidence that the economy may be starting to slow down a bit.

In July, the OBR's latest economic forecasts (table below) for the medium term showed a very stable pattern of low growth (about trend but with a bit more input from productivity), low inflation (slowly returning to target) and flattish unemployment (slightly below where it is now). Such stability over five years is unusual in economic history.

OBR Forecasts July 2015

Annual years	**2015**	**2016**	**2017**	**2018**	**2019**
Growth (% ch yoy)	2.4	2.3	2.4	2.4	2.4
Inflation (% ch yoy)	0.1	1.1	1.6	1.8	1.9
Employment (% ch yoy)	1.6	1.0	0.3	0.3	0.6
Productivity (% ch yoy)	0.8	1.3	2.1	2.1	1.8
Unemployment (% rate)	5.4	5.1	5.2	5.3	5.4

Source: OBR

In September, the Treasury's comparison of independent forecasters averaged real GDP growth for this year of 2.6% (see table below) and suggested a very modest slowdown over the next few years. Inflation and unemployment rate forecasts were similarly moderate, with inflation gradually returning to target (2%) and unemployment levelling out.

This largely benign outlook, however, comes with a health warning. Being composed of an average of averages, it tends to minimise the potential risks. The herd of economic forecasters do not like to stick their necks out to attract the attention of the media and policy predators.

UK Macro Forecasts: September 2015

	2015	2016	2017	2018
Growth	2.6	2.4	2.4	2.4
Inflation	0.3	1.7	1.9	2.0
Unemployment	5.3	5.2	5.0	4.9

Source: HM Treasury

The balance of risks is that the future is more volatile than this central view. There are growth risks about current overseas crises, reflected in a stronger pound sterling, which might harm both export sales volumes and their price competitiveness. The government sector is expected to remain a net negative factor, especially after the Comprehensive Spending Review is announced later this autumn. This puts the onus on business investment and consumer spending to drive the UK economy forward. The former may be constrained by weaker global prospects and concerns about the general direction of policy. The latter, however, may surprise on the upside, if real incomes growth remains more positive.

There is probably more concern and uncertainty about inflation and monetary conditions. Deflationary pressures remain strong and yet the liquidity mountain from quantitative easing around the world casts a long shadow. UK, US and EZ monetary policies are in danger of building up adverse pressures for the future. A modest increase in official interest rates should not worry the markets, businesses and households. The monetary flood that is being held back by a weak dam is the real 'elephant in the room'.

The key economic question for our time is easy – how do we get the current account deficit and public deficits down in order to 'crowd in' more positive business productivity, and thereby, higher incomes before financial concerns resurface? As always, the answer is hard … and elusive.

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Afterword

This is the eleventh of our **Strategic Economics Report** (SER) series, summarising the state of the economy and its prospects. It is updated about three times a year. The next is planned for early 2016.

The **SER** covers current trends and structural changes that are likely to interest and influence sector and spatial development in the foreseeable future. It also considers the broad policy environment and its likely impacts on the economic future for businesses and workers.

The **SER** aims to be brief but authoritative, using economics in a form that readers will find easy to understand and can relate to their own situation. It is offered free to all interested partners.

Those seeking more detail or an extension of its themes should contact us directly to take advantage of our bespoke services for clients. Please see www.strategiceconomics.co.uk .

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