Strategic Economics Report
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Summary

The UK economy stuttered through the third quarter of 2016. Growth remained close to trend (2.3% per annum) whilst inflation started to tick up (to 1%) and unemployment to level out (at 4.9%). A negative reaction to the EU referendum in July was followed by a bounce back in August.

Consumers and businesses shrugged off the initial shock of "Brexit" but it is not clear whether this can be sustained. The fourth quarter has started with more reserve, with fears building about higher costs (reflecting an 18% drop in sterling and higher US$ oil prices).

The outlook is clouded by concerns about the trading relationships that will emerge after BREXIT – a prospect heightened by the government's apparent acceptance that a so-called "hard Brexit", with its likelihood of higher tariffs and other regulatory barriers to trade, might be the outcome of the Article 50 negotiations.

Worryingly, despite welcome commitment from Nissan to car production in the North East, there have been a range of reports of investment being postponed, cancelled or diverted - with Banks exploring the movement of trading and headquarter functions out of the City and local SW companies revising building and capital plans: switching their focus from output growth to cost control.

Against this background, with adverse activity and price effects in the offing, it is hard to see the economy accelerating in 2017. Most forecasters have revised down their outlook for growth. The potential benefits of the weaker pound for exporters are seen as more than offset by the increase in imported raw material and component costs and the threat to households and businesses of lower investment/profits and, thereby, fewer jobs.

The Bank of England cannot help much and the Treasury, even if promising more spending on infrastructure, cannot stimulate growth quickly. On balance, local SW firms remain fairly positive about their individual prospects for 2017. But, a slowdown seems possible as the future looks more uncertain.

Economic Profile

Recent Data & Trends:

	Annual (2015)	Quarterly	Monthly
Real GDP (%ch, yoy)	+2.2	+2.3 (Q3)	n.a.
CPI inflation (%ch, yoy)	0.0	+0.7 (Q3)	+1.0 (Sep)
LFS unemployment (%)	5.4	4.9 (Q2)	4.9 (Jun-Aug)
Trade deficit* (£bn)	-38.7	-12.7 (Q2)	-4.7 (Aug)
Base rate (end %)	0.5	0.25 (Q3)	0.25 (Oct)

Source: ONS *goods and services

In the third quarter, real GDP growth was tentatively estimated at 0.5% (Q3 2016 on Q2 2016) and 2.3% (Q3 2016 on Q3 2015) – see table above and chart below. We have little detail behind these numbers yet, but it appears that falls in the agriculture, construction and production sectors were more than offset by an expansion in services. We know consumption held up but, when we get more detail, it will be useful to see what happened to business investment and the negative net trade position.

As we have said before, investment-led productivity growth is the only way out of the current economic bind. The latest numbers show no sign of that. Yes, productivity (GDP per hour) was a little higher (+0.6%) in Q2 2016 but it has only just returned to pre-2008 levels. Furthermore, with UK GDP per hour 18% below the average for the rest of the G7 in 2015, there is a lot of competitive ground to make up. Sustained growth is not possible unless these indices accelerate significantly. With uncertainty over BREXIT to the fore, there is a risk that private investment will stall: there is little light in that particular tunnel.

Meanwhile, inflation is ticking up (see table and chart) and is likely to accelerate from here.

- The downward leg of the commodity cycle has run its course and prices of industrial and agricultural raw materials are rising again.

- Sterling has dropped 18% since July against the US dollar and strongly against other currencies. With the FX market breaking out of previous trading ranges, sterling parity against either or both of the dollar and the euro, and the consequent higher prices, is no longer unthinkable.

- The huge amount of liquidity pumped out by the central banks in recent years, hangs over the system. Active monetary growth (M2) has started to increase, especially in America, threatening potential inflationary consequences for the medium term.

Barring a severe downturn, UK homes and companies face higher inflation and higher interest rates over the next few years. Higher interest rates may not come soon but the longer they are delayed the worse the eventual "stagflation" may turn out to be.

The labour market remains remarkably benign for now but, given the growth and inflation background just described, this probably cannot last. Firms are going to focus more on cost control than growth in the period ahead and this is not an environment in which employment prospects are likely to improve. Unemployment may tick up over the next half year.

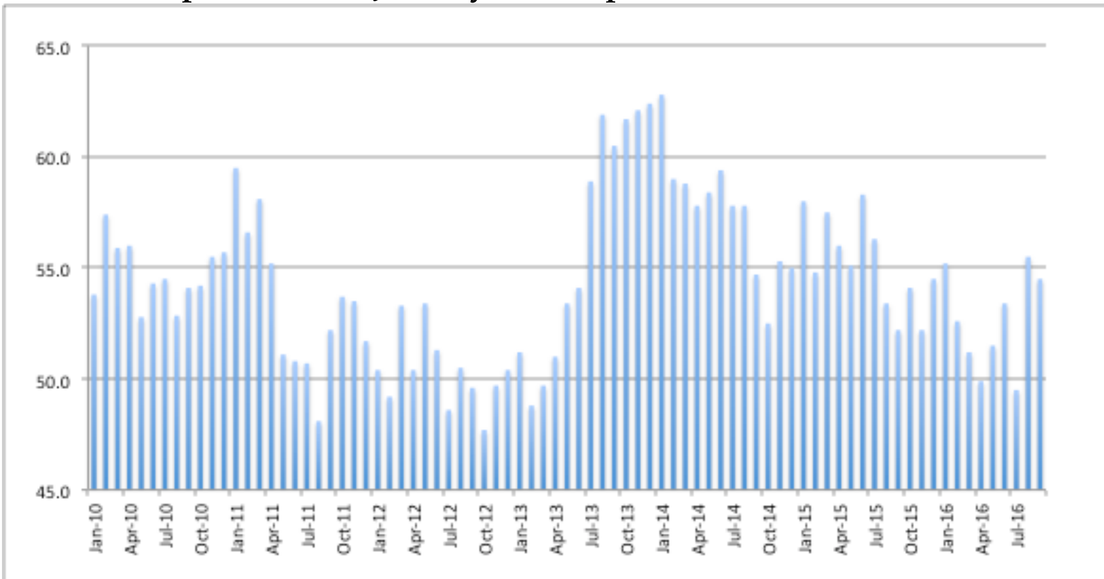
Growth, Inflation & Unemployment: 1989 Q1 – 2016 Q3

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

Local Overview

The Dorset economy did not waiver much during the summer of 2016 and, according to published surveys and direct contacts, many/most local businesses expect growth to continue over the next two years. The mood, however, is more sombre.

SW PMI output balances January 2010-September 2016



Source: Markit

The **SW PMI** index (chart above), which reflects business sentiment and reports on overall prospects for output and other business measures, dropped sharply in July, rebounded in August and eased, whilst remaining positive (i.e. above 50) in September. This accords with the general perception that after the initial shock of BREXIT, the region experienced a return to 'normal'. Given the loss of momentum evident in the chart over the last two years, however, the question is whether the late summer bounce proves to be a "dead cat" one - a temporary recovery, caused by short-term adjustments to a drop, then followed by renewal of the underlying, softer trend.

In this light, the latest **British Chamber of Commerce** survey showed a pattern of moderating activity across the region, especially in services, during the summer. In particular, the survey found reasonable current activity but, with cash flow and confidence easing, expectations about the future were more reserved. About half of respondents reported a good or strong situation in their own sector but also indicated that investment plans (especially for plant and machinery) had been revised lower. Looking ahead, competition, inflation and exchange rates were highlighted by businesses as particular matters of concern. Businesses are "still hopeful but more uncertain".

Economic Prospects

According to **the latest consensus** compiled by HM Treasury from a wide range of forecasters of the UK economy (see table below for median averages), there has been a dramatic change of mood in recent months. For example, estimates of the 2017 growth rate have plummeted from an average consensus above 2% earlier in the year to only 1% now: not a recession but a far from buoyant prospect.

Many economists are now predicting negative investment growth (-2.5%) and much slower consumption growth (+1.2%) for 2017. Unfortunately, investment withdrawal is just what the economy does not need right now. Moreover, with savings ratios, particularly in cash terms, virtually gone (0.5% in the Q2 2016), interest rates so low and the business sector losing confidence, there is little leeway for positive 'animal spirits' to re-assert themselves without borrowing by already overstretched households.

At the same time, inflation expectations for next year (+2.5%) have gone above the official target (2% per annum). The Bank of England's loosening of monetary policy after the EU referendum now looks redundant and in need of reversal. Meanwhile, employment growth is now expected to be flat and the forecast unemployment rate is rising.

Finally, the current account deficit is expected to moderate, presumably reflecting the drop in the pound, but the risk is that he deficit will get worse before it gets better as prices adjust more quickly than demand and supply. Public sector net borrowing is now deemed to stall.

UK Consensus Forecasts: October 2016

	2016	*2017*
Growth	+1.9	+1.0
Inflation	+1.1	+2.5
Unemployment	5.1	5.4
	2016/17	*2017/18*
Current Account (£bn)	-104.3	-80.1
PSNB (£bn)	69.1	69.3

Source: HM Treasury

The UK economy, and the SW part of it, suffers from some longstanding structural problems, namely low productivity, low investment, large public and external deficits, and an over-borrowed (on average) household sector.

These imbalances need to be addressed if our economy is to sustain long-term growth. This conclusion would apply whether the majority had voted remain or leave last June. BREXIT brings these issues into sharper relief: by increasing the risks of economic disruption as the negotiations proceed and become resolved – or not.

Mitigation, through revised individual, corporate and public plans, strategies and policies, is the order of the day.

- The optimist says local people remain inventive and innovative. SW businesses are entrepreneurial and competitive. SW youngsters, entering the labour force/business, are skillful and dynamic. There is opportunity as well as challenge in this period of change.

- The pessimist notes that, as the financial markets are telling us – (foreign exchange and bonds, commodities and property, and the wider share indices and monetary indicators), the downside risks have increased.

In this context, it will be fascinating to see what the 'new' Industrial Strategy, currently flagged to be at the centre of the imminent Autumn Statement and scheduled for November 23rd, has to offer.

There is "nothing new under the sun" in the world of regional economic development but any re-focus or re-emphasis on sub-national infrastructure for growth will be of great local interest. Perhaps, there will be a refreshed role for the local enterprise partnerships (LEPs) with consideration as to whether the current mix of the 39 is effective and efficient..

Afterword

This is the latest of our **Strategic Economics Report** (SER) series, summarising the state of the economy and its prospects.

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 .