UK Economic Outlook

Ross Walker
Senior UK Economist, RBS
ross.walker@rbs.com

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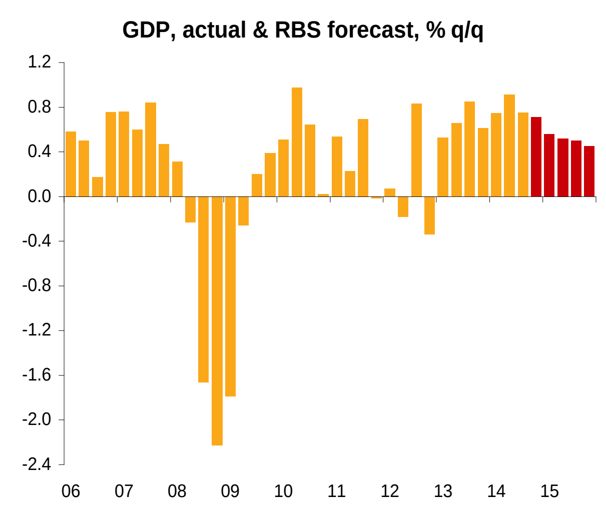
http://strategy.rbsm.com

UK growth to moderate in 2015



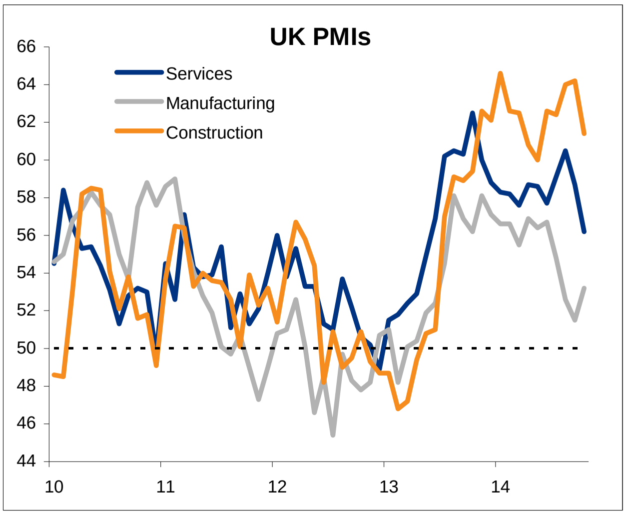
After a stuttering recovery in 2011-12, this year will bring GDP growth of 3.0% – the fastest expansion since 2006.

We expect growth to moderate in 2015, to 2.3%, as monetary and fiscal policy tightening together with weaker external demand slow GDP to a long-run trend-like pace.

Forecasts for global growth – especially in the euro area – are being revised down, so the UK will remain one of the best performing economies in 2015.

Source: ONS & RBS

Are business surveys signalling a sharper downturn?

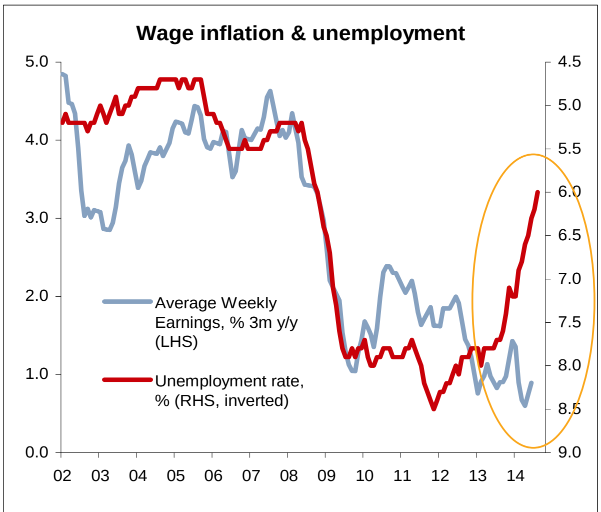


Overall, survey data remain fairly buoyant – in aggregate the PMI surveys are consistent with annual GDP growth of 3%-4%.

But there are signs of a slowdown, most obviously in the manufacturing sector (which is more vulnerable to contagion from the euro area) but also in the predominant services sector.

Construction sector strength is underpinned by residential housing (but construction is only 6% of UK GDP).

Wage inflation – ‘Shock and AWE’

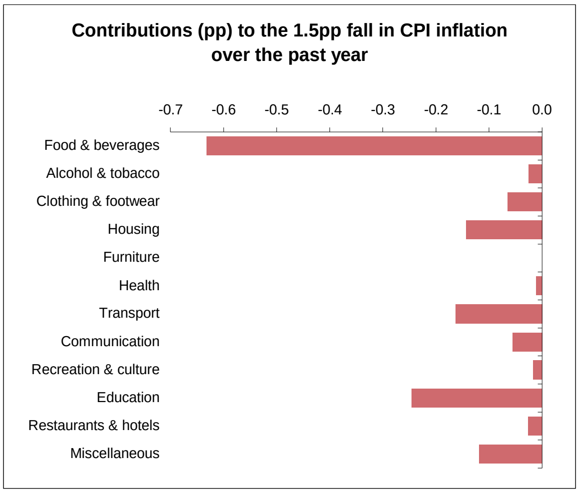


Current levels of unemployment (6.0%) would normally be associated with wage inflation of around 3-3½%. . .

. . . whereas, the latest Average Weekly Earnings data show growth of just 0.9% y/y.

Several factors help to explain such anaemic wage inflation: the relatively weak productivity performance, greater labour supply via net migration, welfare reforms and older people returning to/remaining in work.

UK inflation – Broad-based & mildly disinflationary



UK CPI inflation has fallen from 2.7% in September 2013 to 1.2% in September 2014.

The decline has been led by food and, to a lesser extent, energy but by no means confined to these categories – as the chart shows, 11 of the 12 main sub-categories have contributed to the decline.

The key issue is the extent to which this disinflation reflects structural changes (eg, increased price competition in the supermarket sector) or more temporary/cyclical influences.

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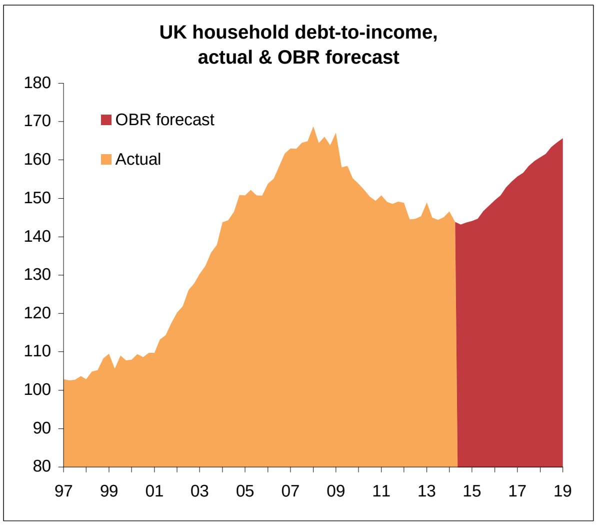
Source: ONS

UK households are still carrying a lot of debt . . .



UK households have achieved some deleveraging since the financial crisis.

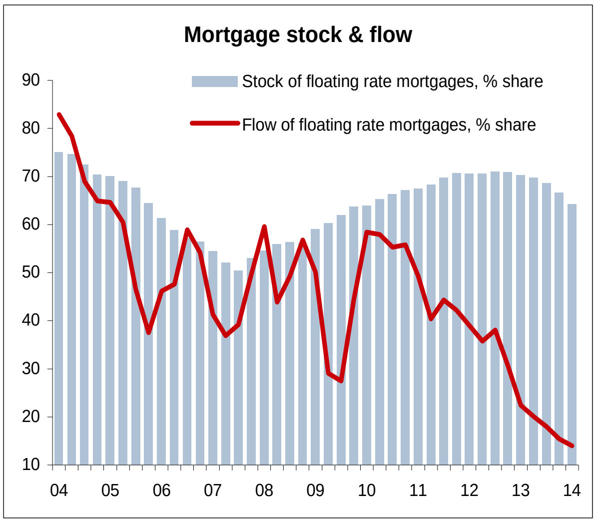
But debt levels remain very high – and are projected by the OBR to rise.

These levels of debt are only manageable with low rates of interest (the average mortgage rate is around 3¼% – although there is a sizeable variation depending on the amount of equity – with the average unsecured interest rate closer to 8%).

RBS

Source: ONS, BoE & OBR

. . . Which is linked to variable interest rates



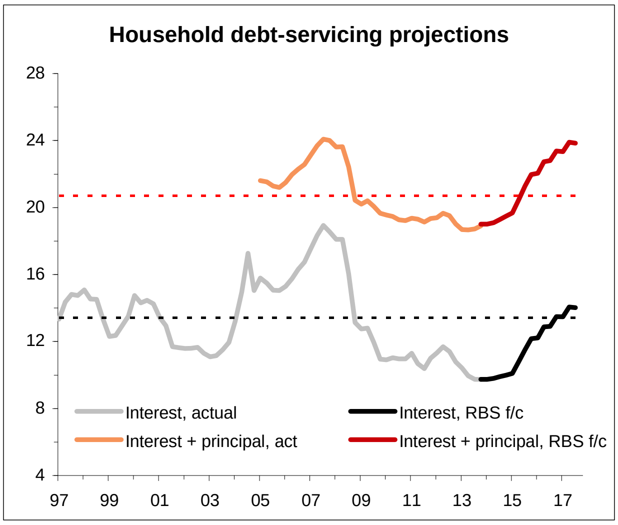
Around two-thirds of the outstanding stock of household debt (mainly mortgages) is linked to variable interest rates.

Although the recent flow of new mortgages shows a tendency to lock-in to fixed rates, flows have been light (hence the small change in the stock), and fixes are for short periods (2-3 yrs).

The prevalence of variable rate debt leads us to expect a large and rapid pass-through from BoE policy rates to ‘real world’ interest rates.

Source: ONS, BoE & CML

. . . So modest rises in Bank Rate will control inflation



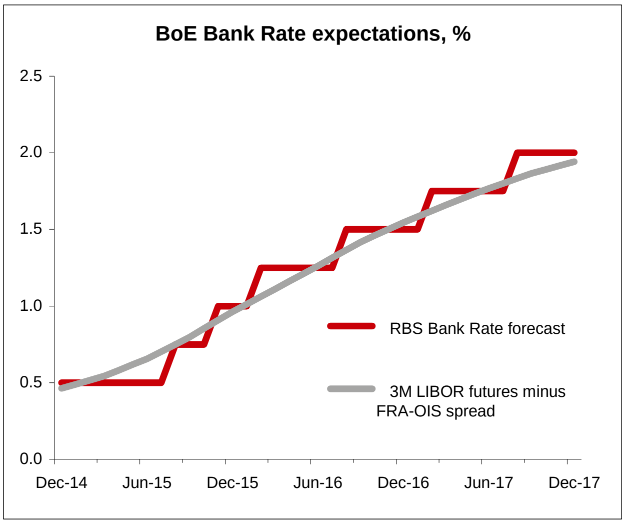
On our central scenario (1st Bank Rate hike in Q3 2015, reaching 1.5% by end-2016 and 2.0% by end-2017) the debt-servicing burden will rise to around pre-crisis peaks by early 2017.

This will dampen household sector demand (out-weighing any benefit to net savers).

Our projections assume borrowing growth of 5%-6% and income growth picking up gradually to 3% in 2016.

Source: ONS, BoE, CML & RBS

BoE Bank Rate forecasts



The RBS forecast is for the first BoE Bank Rate rise to come in August 2015 (+25bp).

We forecast a slow, cautious pace of policy tightening, with Bank Rate reaching **1.0% by end-2015, 1.5% by end-2016 and 2.0% at end-2017.**

A combination of high levels of debt, weak income growth and fiscal policy tightening (including tax rises) suggest a materially lower level of interest rates will be sufficient to achieve the 2% inflation target.

Source: Bloomberg, RBS

UK Economy conclusions

1. **GDP growth outlook: moderation not meltdown. Over-optimistic City and BoE forecasts for 2015 are being revised down, but next year is still expected to see respectable, if unspectacular, growth in the UK.**
2. **Labour market: job creation without wage inflation: supply-side flexibility will constrain wage inflation.**
3. **Inflation: broad-based mild disinflation will bring some relief for cash-strapped households and Bank of England policymakers who are in no rush to raise interest rates.**
4. **UK households still have too much debt. A subdued wage inflation outlook means the debt:income ratio is unlikely to fall quickly (or indeed at all).**
5. **BoE interest rate policy: precaution outweighs pre-emption. A cautious pace of policy tightening and lower 'terminal rates'.**

Markets & International Banking

The Royal Bank of Scotland

Strategy

IoA, November 2014

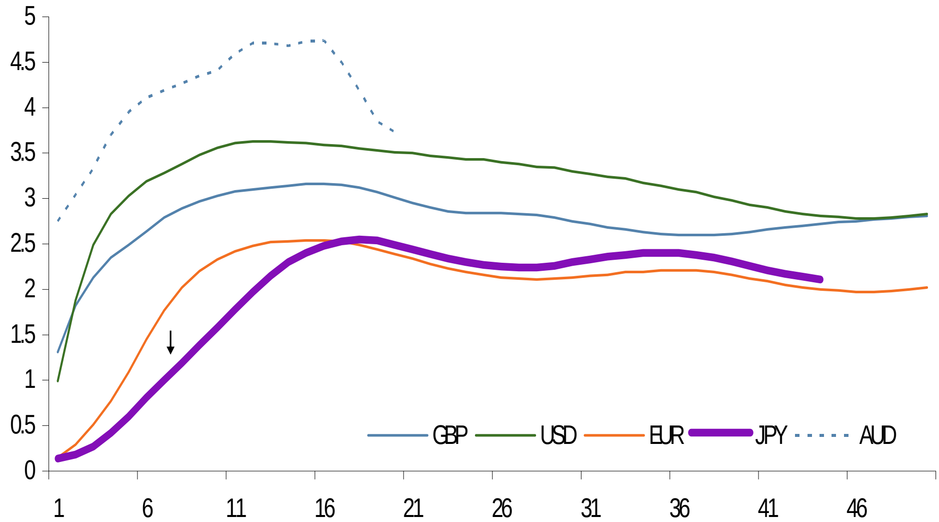
Andrew Roberts

Head of European Economics, Rates, & CEEMEA Research

Andrew.Roberts@rbs.com

"Hello everybody, I am Baxter. I've come to replace 47% of you"

Japanification



Various 1y forward curve

Source: RBS, Bloomberg

The cloud. 3D printing. The top inventions in history?

"Moreover, the technological frontier was still advancing globally and there was scope for the United Kingdom to take advantage of that as a source of higher productivity."

Feb 2014 MPC Minutes http://www.bankofengland.co.uk/publications/minutes/Pages/mpc/pdf/2014/mpc1402.aspx

World's greatest revolution taking place and that is all it merits in CB speak?

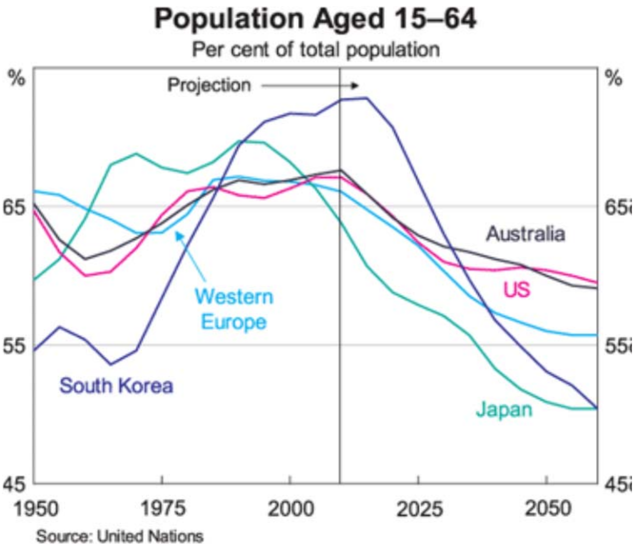
If you want to continue the theme . . . robotics

Source: RethinkRobotics.com

TED talk on Baxter:

http://www.ted.com/talks/rodney_brooks_why_we_will_rely_on_robots?utm_source=rethinkrobotics.com&awesm=on.ted.com_RodneyBrooks&utm_content=awesm-publisher&utm_campaign=&utm_medium=on.ted.com-static

Robots arrive just in time to look after the boomers



Source: UN; BIS speech by Philip Lowe, Dep Gov RBA, 12 Mar 2014

Robotics and AI

Higher profits % GDP, low wage growth, low capital intensity = Low inflation

Bring on the personal trainers

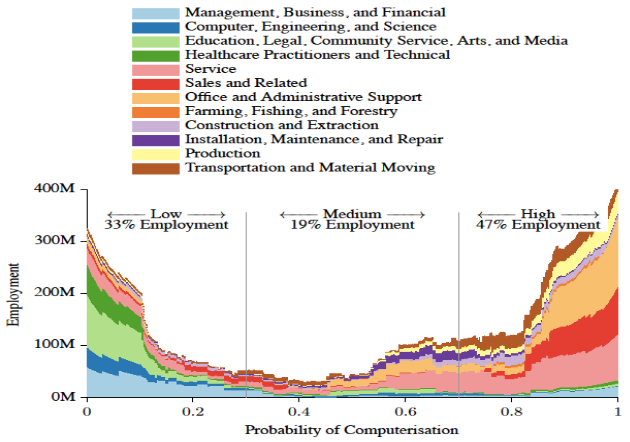
Probability that computerisation will lead to job losses within the next two decades, 2013 (1=certain)

Job	Probability
Recreational therapists	0.003
Dentists	0.004
Athletic trainers	0.007
Clergy	0.008
Chemical engineers	0.02
Editors	0.06
Firefighters	0.17
Actors	0.37
Health technologists	0.40
Economists	0.43
Commercial pilots	0.55
Machinists	0.65
Word processors and typists	0.81
Real estate sales agents	0.86
Technical writers	0.89
Retail salespersons	0.92
Accountants and auditors	0.94
Telemarketers	0.99

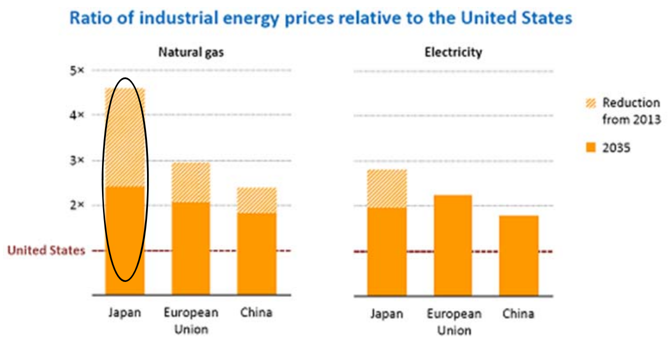
Source: "The Future of Employment: How Susceptible are Jobs to Computerisation?" by C.Frey and M.Osborne (2013)

"While computerization has been historically confined to routine tasks involving explicit rule-based activities, algorithms for big data are now rapidly entering domains reliant upon pattern recognition and can readily substitute for labour in a wide range of non-routine cognitive tasks.

In addition, advanced robots are gaining enhanced senses and dexterity, allowing them to perform a broader scope of manual tasks. This is likely to change the nature of work across industries and occupations."



Commodity energy supply to be disflationary theme

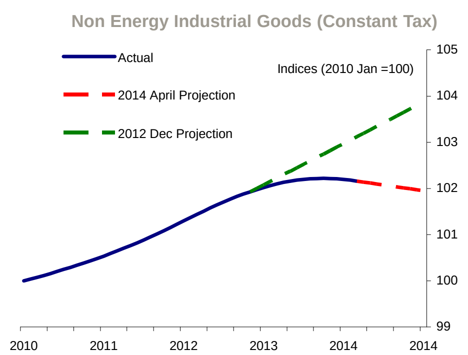


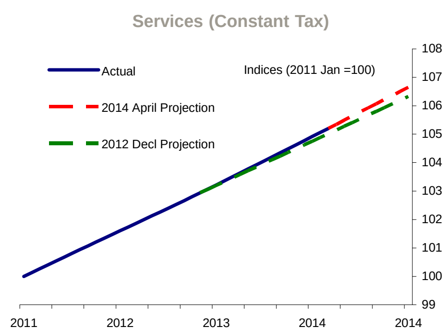
Regional differences in natural gas prices narrow from today's very high levels but remain large through to 2035; electricity price differentials also persist

- This is the no.1 chart. Very good news for US relatively
- The rise of US exceptionalism? A la post WWII?
- I regard US relative growth as a disinflationary force on this basis

Source: IEA World Energy Outlook 2013

China theme coming into play…EMU CPI

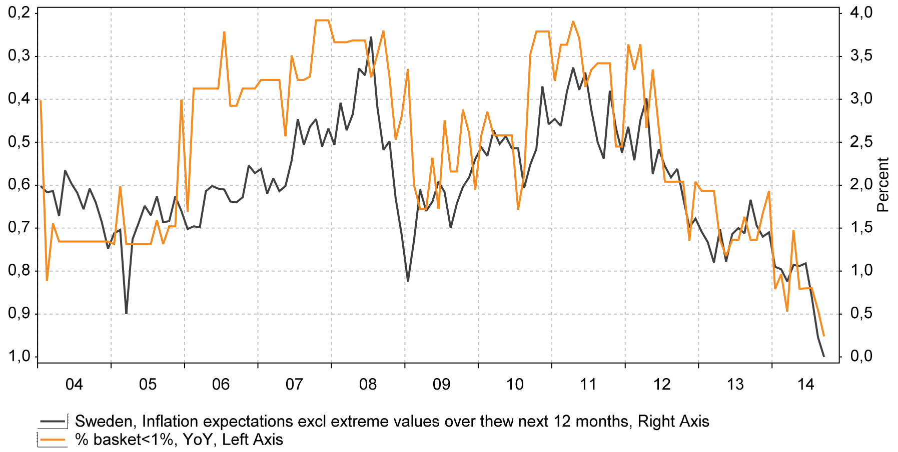




Source: RBS, Bloomberg

There is something happening in the world . . .

Central banks, beware household inflation expectations collapsing



Source: RBS, Bloomberg

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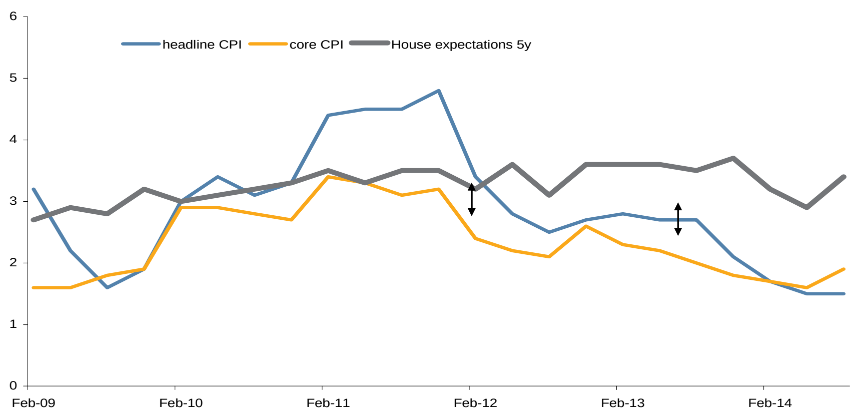
There is something happening in the UK? Not yet

UK has stable expectations. Or, to put another way:

Households have not yet adapted to/adopted a lower inflation world!



Source: Bank of England, RBS

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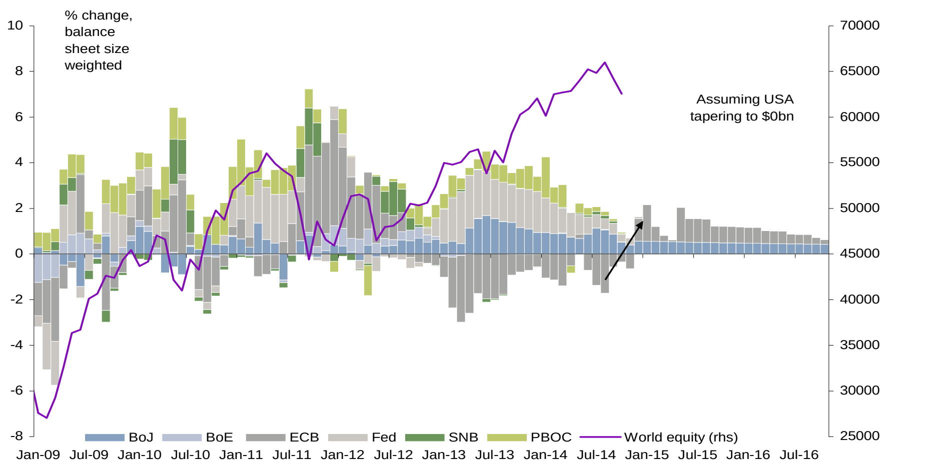
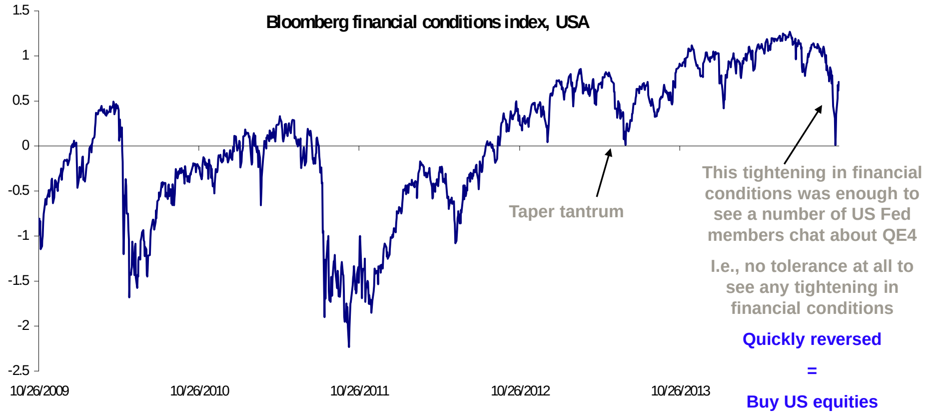
Liquidity: my no.1 theme. Equities up due to liquidity. China + ECB + CEEMEA + JPY in 2014



No assumption for Swedish QE yet

Source: RBS, Bloomberg, National Central Banks

Liquidity: this is how/why we talk of a permanent excess liquidity world. Tightening is not tolerated



I.e., no tolerance at all to see any tightening in financial conditions

Quickly reversed

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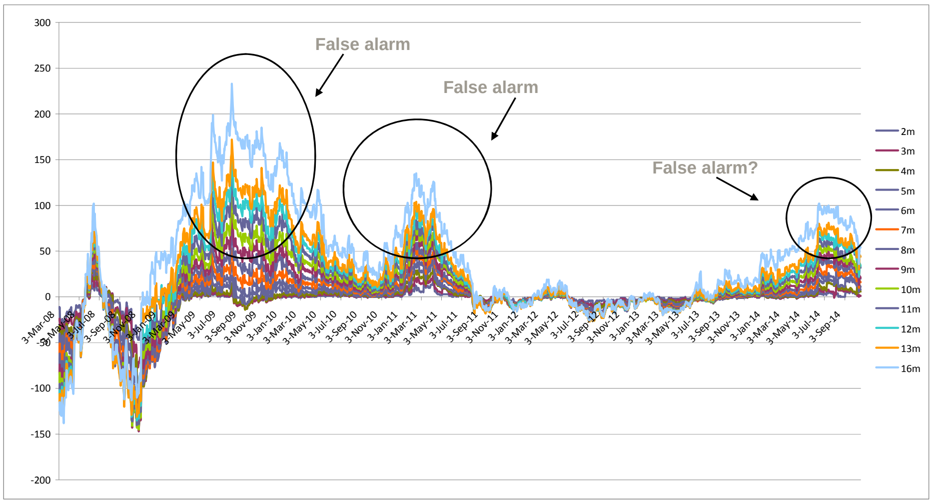
Buy US equities

Source: RBS, Bloomberg

UK: hike expectations, over time



What is discounted for the 1m SONIA rate using different forwards, eg 1m SONIA in 16m time was discounting 2% rates in Sep 09

Source: RBS analytics

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