United Kingdom

- **The Bank of England looks very likely to raise Bank Rate at the May meeting, in line with our long-held view.**
- **Notwithstanding a number of one-off disturbances, the fundamentals facing output are improving and we expect an upwards trend for GDP growth this year.**
- **Inflation has begun to slow and we expect plenty more downside from here.**

The Bank of England looks very likely to hike Bank Rate at the mid-May Monetary Policy Committee (MPC) meeting—in line with our long-held view. Thereafter, our view is that the MPC will hike rates again in November, though we expect it to be a bumpy ride between then and now. In terms of the May MPC, enough boxes have been ticked for an immediate rate hike. In particular, signs of accelerating wage inflation, further tightening in the labour market and solid GDP growth all support the case for the second rate hike in this cycle. We expect further acceleration in GDP growth and wage inflation to support the case for a hike in November. However, we fully expect this view to be challenged over the coming months if our view that inflation will fall sharply comes good.

GROWTH

Recent output data have suffered from one-off shocks and noise and that is set to continue for the time being. For example, an outage in a major North Sea oil pipeline subtracted almost 0.1% point from GDP growth during Q4; it is now back in service and this should add a similar amount back onto growth during Q1-2018. Adverse weather conditions could offset this boost to Q1, though we have our doubts.

These shocks are pure noise and we suspect that the BoE will look through them. Indeed, under the surface, the fundamentals facing growth are improving. In particular, CPI inflation has started to slow and wage inflation is accelerating and both are likely to continue doing so over the remainder of the year. In turn, that points to faster real disposable income growth, which should translate into faster household consumption and overall GDP growth. Essentially, we expect 2018 to be the reverse of 2017. We are starting to see the earliest tentative signs that this view is beginning to crystallise via firmer consumer confidence. However, it is likely to be several months before there is concrete evidence of this embodied in the official retail sales or GDP data.

In the near term, media coverage has highlighted troubles in the retail and restaurant sectors. We view this as a legacy of last year's slump in real household disposable income growth, which should soon pass. This is backwards-looking and should not obstruct a near-term BoE rate hike.

Overall, we expect UK GDP growth to be on a rising trajectory throughout this year. While our full year 2018 growth forecast of 1¾% y/y suggests a similar pace of growth to 2017, that masks the underlying picture. Growth was trending downwards through 2017; we expect an upwards trend this year. We expect slightly faster growth (just under 2% y/y) during 2019.

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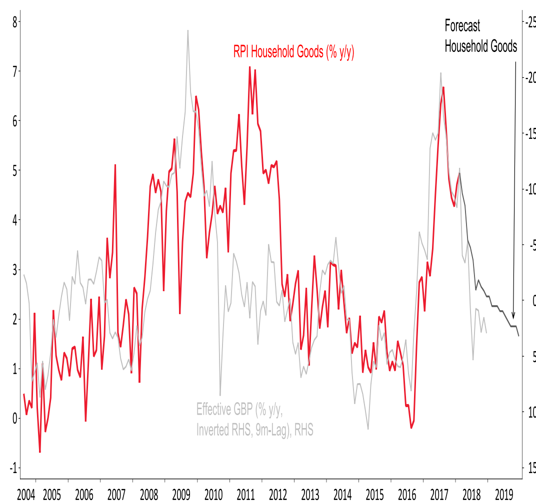
United Kingdom	2017	2018f	2019f
Real GDP (annual % change)	1.8	1.7	1.9
CPI (y/y %, eop)	3.0	1.9	1.9
Central bank policy rate (%, eop)	0.50	1.00	1.50
UK pound (GBPUSD, eop)	1.35	1.47	1.50

Source: Scotiabank Economics.

Chart 1

GBP exchange rate points to further slowdown in RPI household goods inflation



Sources: Macrobond, Scotiabank FICC Strategy.

INFLATION

In the context of inflation, the woes in the retail and restaurant sectors of late suggest to us that pricing power is lacking. For some time we have aimed low for inflation this year on the back of falling goods inflation. In turn, this is because we expect the uplift from imported inflation (on the back of the weakening in sterling following the Brexit vote) to fade increasingly throughout this year. Some components of inflation are already showing confirmation that this is happening (chart 1) and we expect plenty more where that came from.

Where our view diverges with that of the consensus and the Bank of England is the outlook for services inflation. Others take the view that faster services inflation will largely offset the effect of slowing goods inflation, leading to only a modest slowdown in overall inflation. In turn, this is based on the lazy assumption that just because wage inflation is accelerating, so too will services inflation. However, if you drill down into exactly what makes up services inflation, it is less compelling to assume that wages will drive services inflation higher—at least this year. In particular, there are a number of pre-programmed price cuts or known knowns that we expect to keep services inflation relatively muted again this year.

As a result, our forecast for inflation is between ¼ and ½ percentage points below most other forecasts. We expect CPI inflation to slow to 1¾% by the end of 2018—a small margin below the BoE's 2% target and around ¾% percentage points below the Bank's forecast. We expect inflation to drift broadly sideways during 2019.

In turn, that circles back to why we expect a bumpy ride between now and the November BoE decision. On paper, lower-than-expected CPI inflation argues for no further BoE rate hikes after the May meeting. However, there are a number of reasons why the Bank should hike. We expect the Bank to look through the components that artificially hold inflation lower (government implemented cuts in rent, the unwind of last year's rise in fx-sensitive components, etc.). Moreover, higher inflation killed growth last year, holding back BoE rate hikes. We expect the opposite this year; lower inflation leading to faster growth and boosting the case for higher rates.

BREXIT / PUBLIC FINANCES / POLITICS

The UK and EU have reached an agreement for a 'transition deal'. This essentially means that the UK's trading and legal arrangements with the rest of the EU will stay largely the same for the first 2 years after the UK has formally left the EU in March 2019. While it has been labelled a 'transition deal', we do not yet know the end-point that we are transitioning towards. We still do not know what kind of trading relationship the UK will have with the rest of the EU after that transition deal has expired. Our assumption is that there will be a relatively smooth exit from the EU, with a bespoke trade deal covering both goods and services between the two economies. Compromises are likely (such as fish for finance) and we also suspect that the UK will agree to pay money into the EU budget to help secure access to EU markets.

Overall, we suspect that UK growth will suffer in light of its departure from the EU, at least initially. Thus far the economy has been dealing with the indirect consequences of Brexit, namely the squeeze on real incomes as inflation surged on the back of the weaker GBP. This should ultimately prove transitory. Meanwhile, the more direct consequences of Brexit are yet to materialise fully since the UK hasn't left the EU yet. As much as the UK Government aspires to a frictionless border with the rest of the EU, there are likely to be logjams and administrative barriers which prove to be an impediment to output. Investment is likely to be a double edged sword. Outward facing companies could relocate away from the UK, damaging growth. Meanwhile, it is also possible that inward facing companies invest more as the UK has to become more self-sufficient in certain industries as sources of goods from abroad prove less plentiful. Overall, we suspect that trend output in the UK has been reduced to around 1.6% y/y from close to 2% y/y previously.

While the advocates of a hard Brexit will be disappointed at the extent of the concessions offered to the EU, we doubt whether there will be a leadership challenge or (another) General Election in the immediate year or two. While there is a risk of a leadership contest (October being most likely) this is not our base case. Nonetheless, we fully expect media coverage to fan the flames of market uncertainty.

The public finances have continued to perform better than expected. If this trend continues throughout 2018, the Chancellor has pledged to use any windfall to increase public spending. The pace of tightening in the public finances is already projected to be relatively mild over the coming years and the drag on growth is negligible.

Eurozone

- **Eurozone GDP growth should outperform the cautious consensus expectations, despite some softening in upstream indicators.**
- **Core inflation has been stubbornly muted; though narrowing in slack suggests that underlying inflation should accelerate over the course of this year.**
- **We expect the ECB to terminate its asset purchase programme at the end of the current instalment which is scheduled to run until September.**

GROWTH

There has been some moderation in upstream indicators of eurozone growth of late. However, we believe that the emphasis should be "less hot" not "cooling off". In particular, while surveys such as the Ifo have lost altitude in recent months, the declines have been from multi-decade highs. That said, while the consensus outlook for growth has risen towards our upbeat forecast, we have been a little disappointed by the % q/q pace of GDP growth readings of late. The relationships between growth and the upstream survey indicators point to q/q growth readings of close to 1% q/q, yet the actual readings have been just above 0.5% q/q. That is still a very respectable pace of growth, just a little short of what the survey had suggested was possible.

One positive development in recent months has been the improvement in the CRB world trade volumes index. Despite gloomy headlines regarding trade wars, etc., the CRB index has risen abruptly, pointing to stronger export growth, at least temporarily (chart 2). Meanwhile, the manufacturing PMI remains very elevated, pointing to ongoing strength in investment. Likewise, strong consumer confidence coupled with falling inflation (which should have boosted real incomes) bodes well for household consumption.

By country, Germany continues to lead the charge, with growth of almost 3% y/y by the end of 2017. Spain grew fractionally faster, but accounts for a smaller share of overall eurozone GDP. The main laggard seems to be Italy, with growth of just 1.5% y/y during 2017.

Overall, we expect GDP growth of 2½% y/y this year, slightly faster than the latest ECB projection. We expect a slight moderation next year down to 2¼% y/y. While growth is good, there is still a sizeable margin of spare capacity to make up for years of sub-par output. Hence robust growth represents making up for lost time rather than posing a risk of overheating.

INFLATION

Headline inflation slowed largely as expected over the past 12 months, hitting a low-point of 1.1% y/y in February. In turn, much of the slowdown has been related to base effects—which are now largely exhausted. Petrol price base effects should help to boost headline inflation between now and July, while food price base effects should be a small drag.

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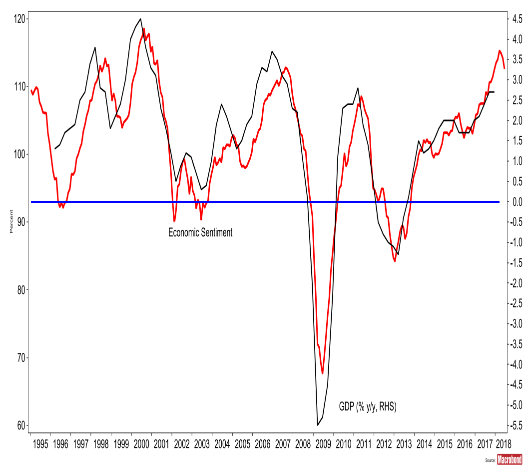
Eurozone	2017	2018f	2019f
Real GDP (annual % change)	2.5	2.5	2.3
CPI (y/y %, eop)	1.4	1.5	1.5
Central bank policy rate (%, eop)	0.00	0.00	0.50
Euro (EURUSD, eop)	1.20	1.30	1.35

Source: Scotiabank Economics.

Chart 1

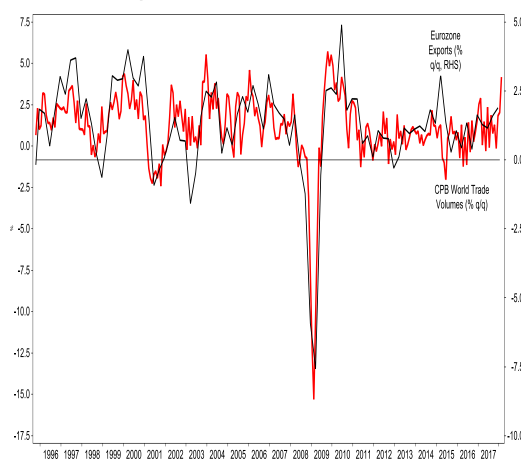
Eurozone GDP growth vs economic sentiment



Sources: Macrobond, Scotiabank.

Chart 2

Eurozone exports vs CRB world trade volumes



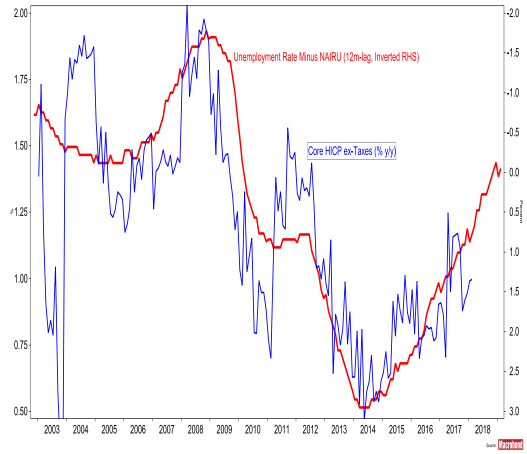
Sources: Macrobond, Scotiabank.

Essentially, the above is largely noise, and the ECB should care more about what is happening to underlying inflation. In this context, there is relatively little new news. Core inflation 'should' drift higher over the coming year, thanks to the fall in the unemployment relative to the NAIRU (chart 3) and the more generalised erosion of slack. However, thus far there has been precious little evidence that core inflation is gaining traction, currently standing at 1% y/y.

Overall, we expect headline CPI inflation to reside between 1½ and 1¾ by end-2018, with further gradual upside during 2019. Most of the acceleration in inflation is likely to be due to non-core components, with underlying inflation gaining only around ¼% over the course of this year to hit 1¼% by end-year.

Chart 3

Eurozone core inflation vs unemployment relative to the NAIRU



Sources: Macrobond, Scotiabank.

MONETARY POLICY

The main dilemma on the monetary policy front is whether the ECB makes no further asset purchases once the current round of QE comes to an end in September, or whether the programme is phased out more gradually. While continued muted underlying inflation does provide some support for a further expansion in asset purchases, we doubt that the ECB can continue to loosen monetary policy against a backdrop where the Fed and BoE are firmly in hiking mode. Hence we expect the ECB asset purchases to come to an end in September when this latest instalment has been exhausted.

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