

**ECONOMIC BACKGROUND**

**Economic background for 2016/17:** Politically, 2016/17 saw the UK voted to leave the European Union and Donald Trump was elected the 45<sup>th</sup> President of the USA. Uncertainty over the outcome of the US presidential election, the UK's future relationship with the EU and the slowdown witnessed in the Chinese economy in early 2016 all resulted in significant market volatility during the year. Article 50 of the Lisbon Treaty, which sets in motion the 2-year exit period from the EU, was triggered on 29<sup>th</sup> March 2017.

UK inflation had been subdued in the first half of 2016 as a consequence of weak global price pressures, past movements in sterling and restrained domestic price growth. However the sharp fall in the Sterling exchange rate following the referendum had an impact on import prices which, together with rising energy prices, resulted in CPI rising from 0.3% year/year in April 2016 to 2.3% year/year in March 2017. In addition to the political fallout, the referendum's outcome also prompted a decline in household, business and investor sentiment. The repercussions on economic growth were judged by the Bank of England to be sufficiently severe to prompt its Monetary Policy Committee (MPC) to cut the Bank Rate to 0.25% in August and embark on further gilt and corporate bond purchases as well as provide cheap funding for banks via the Term Funding Scheme to maintain the supply of credit to the economy.

Despite growth forecasts being downgraded, economic activity was fairly buoyant and GDP grew 0.6%, 0.5% and 0.7% in the second, third and fourth calendar quarters of 2016. The labour market also proved resilient, with the ILO unemployment rate dropping to 4.7% in February, its lowest level in 11 years. Following a strengthening labour market, in moves that were largely anticipated, the US Federal Reserve increased rates at its meetings in December 2016 and March 2017, taking the target range for official interest rates to between 0.75% and 1.00%.

**Financial markets 2016/17:** Following the referendum result, gilt yields fell sharply across the maturity spectrum on the view that Bank Rate would remain extremely low for the foreseeable future. After September there was a reversal in longer-dated gilt yields which moved higher, largely due to the MPC revising its earlier forecast that Bank Rate would be dropping to near 0% by the end of 2016. The yield on the 10-year gilt rose from 0.75% at the end of September to 1.24% at the end of December, almost back at pre-referendum levels of 1.37% on 23<sup>rd</sup> June. 20- and 50-year gilt yields also rose in Q3 2017 to 1.76% and 1.70% respectively, however in Q4 yields remained flat at around 1.62% and 1.58% respectively. After recovering from an initial sharp drop in Q2, equity markets rallied, although displaying some volatility at the beginning of November following the US presidential election result. The FTSE-100 and FTSE All Share indices closed at 7342 and 3996 respectively on 31<sup>st</sup> March, both up 18% over the year. Commercial property values fell around 5% after the referendum, but had mostly recovered by the end of March.

Money market rates for overnight and one week periods remained low since Bank Rate was cut in August. 1- and 3-month LIBID rates averaged 0.36% and 0.47% respectively during 2016-17. Rates for 6- and 12-months increased between August and November, only to gradually fall back to August levels in March, they averaged 0.6% and 0.79% respectively during 2016-17.

## Outlook for 2017/18

Globally, the outlook is mixed and risks remain weighted to the downside. It is likely that the UK is heading for a soft patch or recession, but the likely depth of this should be more limited than the last as the global backdrop is not as desperate as at the end of the last decade. It is anticipated however that the Bank Rate will remain at 0.25%.

Gilt yields have fallen as expected but the prediction is for yields to remain broadly stable during 2017, so no material rise in the PWLB rate is expected. This is set against the following Underlying assumptions:

- The outlook for the UK economy appears more uncertain following an inconclusive election result; that leaves the government re-thinking its Brexit strategy even as negotiations start. Even if the government takes a more conciliatory stance for a 'softer' Brexit, there is no guarantee the rest of the EU will agree to it.
- The growth outlook for the global economy also appears more mixed; US growth will only be satisfactory, while China's growth rate will continue to weaken. The Eurozone appears to be a relative bright spot at the moment.
- The outlook for the UK economy is challenging. As expected, economic growth is slowing as higher inflation and lower confidence weigh on activity UK Q1 GDP growth was just 0.2%. While there are signs of a recovery for Q2, the likelihood of a return to substantially higher growth rates is low.
- Household consumption growth, the recent driver of UK GDP growth, has softened; with employment plateauing and real wages contracting, a recovery back to strong 2016 rates in the short to medium term is improbable.
- The depreciation in sterling may assist the economy to rebalance away from spending. The usual negative contribution from net trade to GDP growth this likely to diminish, largely due to weaker domestic demand. Export volumes will increase, helped by a stronger Eurozone economic expansion.
- Given the pressure on household spending and business investment, the rise in inflation is unlikely to prompt monetary tightening by the Bank of England, with policymakers looking through import-led CPI spikes to the negative effects of Brexit on economic activity and, ultimately, inflation.
- Bank of England policymakers have, however, highlighted that excessive levels of inflation will not be tolerated for sustained periods, particularly if this feeds through into wage growth. Indeed, in a surprising outcome, three MPC members recently voted for a rate hike.
- The global environment remains uncertain, with repercussions for financial market volatility and long-term interest rates. The Federal Reserve is tightening US monetary policy, geo-political tension is elevated (Syria and North Korea), and the rally in risky assets is fading somewhat as markets re-assess the Trump administration's ability to deliver on its electoral policies.