Capita Asset Services Economic Update

1.0 UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were the strongest growth rates of any G7 country; the 2014 growth rate was also the strongest UK rate since 2006 and the 2015 growth rate is likely to be a leading rate in the G7 again, possibly being equal to that of the US. However, quarter 1 of 2015 was weak at +0.4% (+2.9% year-on-year (y/y)) though there was a rebound in quarter 2 to +0.7% (+2.4% y/y).

1.1 Growth is expected to weaken marginally to about +0.5% in quarter 3 as the economy faces headwinds for exporters from the appreciation of Sterling against the Euro and weak growth in the EU, China and emerging markets, plus the dampening effect of the Government's continuing austerity programme, although the pace of reductions was eased in the May budget. However, the Purchasing Manager's Index (PMI) for services issued on 5 October 2015 would indicate an even lower growth rate of around +0.3% in quarter 4 which would be the lowest growth rate since the end of 2012.

1.2 Despite these headwinds, the Bank of England August Inflation Report had included a forecast for growth to remain around 2.4% – 2.8% over the next three years. This has been driven mainly by strong consumer demand as the squeeze on consumers' disposable incomes has been reversed by a recovery in wage inflation at the same time that CPI inflation has fallen to, or near to, zero over the last quarter. Investment expenditure is also expected to support growth. Since then, worldwide economic statistics have been distinctly weak so it would not be a surprise if the next Inflation Report in November were to cut those forecasts.

1.3 The August Bank of England Inflation Report forecast was notably subdued with inflation barely getting back up to the 2% target within the 2-3 year time horizon. However, with the price of oil taking a fresh downward direction, and Iran expected to soon re-join the world oil market after the impending lifting of sanctions, there could be several more months of low inflation still to come, especially as world commodity prices have generally been depressed by the Chinese economic downturn.

1.4 There are, therefore, considerable risks around whether inflation will rise in the near future as strongly as previously expected. This will make it more difficult for the central banks of both the US and the UK to raise rates as soon as had previously been expected, especially given the recent major concerns around the slowdown in Chinese growth, the knock on impact on the earnings of emerging countries from falling oil and commodity prices, and the volatility we have seen in equity and bond markets in 2015 so far. All of which could potentially spill over to impact the real economies rather than just financial markets.

1.5 The American economy made a strong comeback after a weak first quarter's growth at +0.6% (annualised), to grow by no less than 3.9% in quarter 2 of 2015. While there had been confident expectations during the summer that the Fed. could start increasing rates at its meeting on 17 September, or if not by the end of 2015, the recent downbeat news about Chinese and Japanese growth, and the knock on impact on emerging countries that are major suppliers of commodities, was cited as the main reason for the Fed's decision to pull back from making that start.

1.6 The nonfarm payrolls figures for September and revised August, issued on 2nd October, were disappointingly weak and confirmed concerns that US growth is likely to weaken. This has pushed back expectations of a first rate increase from 2015 to 2016. However, there are increasing concerns, both in the US and UK, that the growth rates currently being achieved are only being achieved with monetary policy being highly aggressive with central rates at near zero and huge quantitative easing in place. This is causing an increasing debate as to how realistic it will be for central banks to start reversing such aggressive monetary policy until such time as strong growth rates are more firmly established and confidence increases such that inflation is likely to get back to around 2% within a 2-3 year time horizon.

1.7 In the Eurozone (EZ), the European Central Bank (ECB) fired its "big bazooka" in January 2015 in unleashing a massive €1.1 trillion programme of quantitative easing to buy up high credit quality government and other debt of selected EZ countries. This programme of €60bn of monthly purchases started in March 2015 and is intended to run initially to September 2016. This already appears to have had a positive effect in helping a recovery in consumer and business confidence and in starting to see a significant improvement in economic growth. GDP growth rose to 0.5% in quarter 1 2015 (1.0% y/y) but came in at +0.4% (+1.5% y/y) in quarter 2 and looks as if it may maintain this pace in quarter 3. However, the recent downbeat Chinese and Japanese news has raised questions as to whether the ECB will need to boost its quantitative easing programme if it is to succeed in significantly improving EZ growth and getting inflation up from the current level of around zero to its target of 2%.