ARBUTHNOT BANKING GROUP PLC

PERSPECTIVES

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Disappointing GDP data in July, as the recovery slows

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Introduction: disappointing GDP growth in July…

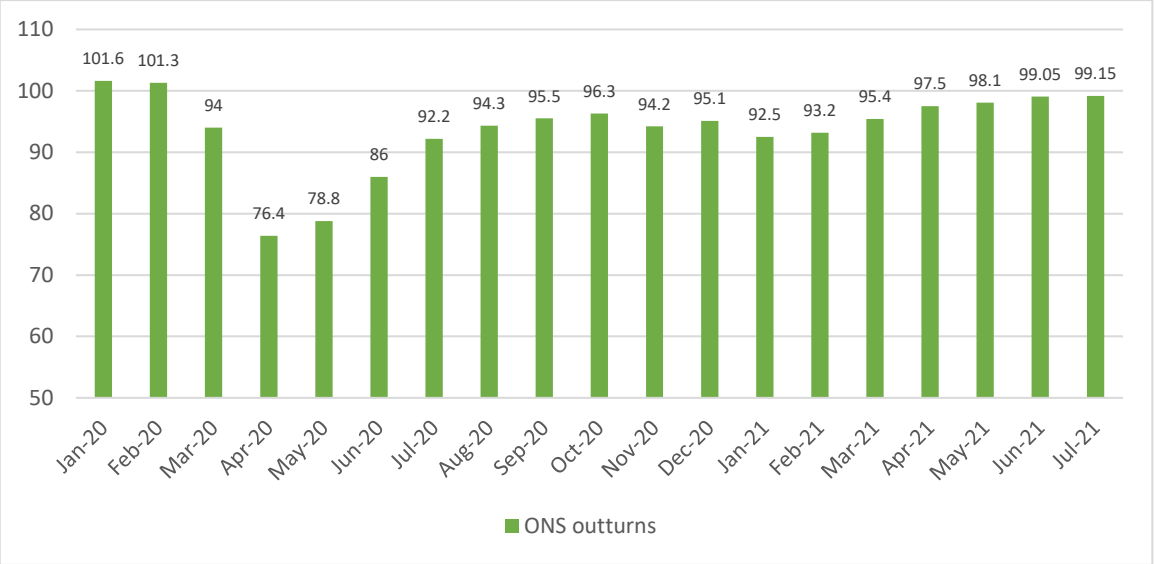
GDP rose by a disappointing 0.1% (MOM) in July (chart 1), even though there were further relaxations of government restrictions during the month (on 19 July).[1-4] However, the "pingdemic", with associated staff absences, operated throughout the month, with the relaxation of the self-isolation requirements of those contacted by Test and Trace only lifted on 16 August. Growth should, therefore, improve in August and the recovery should be sustained, but it is clear that growth has slowed significantly since earlier in the year. GDP in July was still 2.1% below pre-pandemic February 2020.

Concerning the industrial breakdown, production rose, services were flat, and construction contracted:[5-7]

- The service sector remained broadly flat (MOM) in July and was still (also) 2.1% below pre-pandemic February 2020. Within the total, "arts, entertainment and recreation activities" grew by 9.0%, boosted by sports clubs, amusement parks and festivals, and reflecting the easing of restrictions on social distancing from 19 July. But the output in consumer-facing services fell by 0.3% in July 2021, its first fall since January 2021, mainly because of a 2.5% fall in retail sales (mainly because of a fall in food and fuel sales).[8] Specifically, professional, scientific and technical activities fell by 2.3% (MOM), partly reflecting weaker legal activities and real estate activities after the partial end to the Stamp Duty holiday period in England and Northern Ireland from 1 July 2021. Overall, consumer-facing services were still 6.7% below their pre-pandemic levels, compared with all other services, which are just 0.9% below.
- Output in the production sector rose by 1.2% (MOM) and was the main contributor to GDP growth (but was still 2.1% (also) below February 2020). But manufacturing was flat in the month, with the manufacture of machinery and equipment falling 4.3% (MOM). However, the manufacture of motor vehicles, trailers and semi-trailers grew by 11.4% (MOM), reflecting reports that microchip shortages disrupting car production had eased. Mining and quarrying recovered in July (rising by 21.9% (MOM)), reflecting the reopening of an oil field production site, which had previously been temporarily closed for planned maintenance. Despite this growth, output in the extraction of crude petroleum and natural gas remained low by historical standards, with July 2021 output 19.1% below its July 2020 level.
- Construction output contracted for a fourth consecutive month, with output down by 1.6% (MOM) in July 2021 and it was 1.8% below its pre-pandemic level (February 2020). The fall in monthly construction output in July 2021 was driven by falls in both new work (1.1%) and repair and maintenance (2.4%). Anecdotal evidence from businesses responding to the Monthly Business Survey for Construction and Allied Trades suggested that price increases, caused by delays in the availability and sourcing of construction products (notably steel, concrete, timber and glass), were the main reason for the decline.

In the three months to July GDP rose by 3.6% (QOQ), mainly reflecting growth in the services sector (4.5%). Production growth was just 0.4% whilst construction output fell 0.6%.

Chart 1 GDP (2018=100), ONS outturns, since January 2020



Source: *ONS*, "GDP monthly estimate: July 2021", 10 September 2021.

…and the trade balance deteriorated modestly in July

The total trade (goods and services, including precious metals) balance showed a deficit of £3.1bn in July 2021, as the goods deficit continued to outweigh the services surplus, compared with a deficit of £2.5bn in June (see annex table 1).[9] The services surplus edged up to £9.6bn from £9.5bn in the month.

Concerning July's goods trade (including precious metals):

- The visible (goods) deficit widened to £12.7bn (from £12.0bn in June), as exports slipped by 1.0% (MOM) whilst imports rose by 1.1%. The deterioration reflected a worsening EU balance, the non-EU balance marginally improved.
- The deficit with the EU widened to £5.7bn (from £5.0bn). Exports fell 6.5% (MOM), whilst imports fell by just 0.5%. Falling monthly exports of goods from EU countries in July 2021 were driven by medicinal and pharmaceutical products following an increase in June 2021, whilst falling imports of goods from EU countries were driven by slight falls in miscellaneous manufactures, particularly clothing and footwear.
- The deficit with non-EU countries narrowed to £7.0bn (from £7.1bn). Exports rose 5.0% (driven by oil) whilst imports rose 2.7% (driven by precious metals).

The fall in exports to the EU was, therefore, almost offset by the rise in exports to non-EU destinations in July. But as the ONS pointed out, monthly data can be very erratic. Enlarging on the theme they said "…exports to the EU overtook non-EU countries in May 2021 and remained higher in June 2021, however, non-EU exports became higher again in July 2021. This is likely because monthly data are erratic and therefore small movements should be treated with caution. Imports from non-EU countries continue to be higher than the EU for the seventh consecutive month. With the ongoing coronavirus pandemic and recession, it is difficult to assess the extent to which this reflects short-term trade disruption or longer-term supply chain adjustments".

The ONS points out another complicating factor relating to the trade data in that they are potentially distorted by swings in trade of precious metals (including non-monetary gold (NMG)). They, therefore, publish two sets of data: a total series (including precious metals, see above) and their preferred "underlying" series (excluding precious metals). The distorting effects were not, however, especially large June and July. The "underlying" data (excluding precious metals) showed a minor deterioration in the

goods and services trade deficit to £2.2bn in July (compared with June's deficit of £2.1bn), see annex table 1. There was a larger deterioration in the balance on precious metals, giving a deficit of £0.9bn in July (from £0.4bn in June). The distorting effects on trade caused by precious metals mainly, but not entirely, relate to non-EU trade, rather than to EU trade.

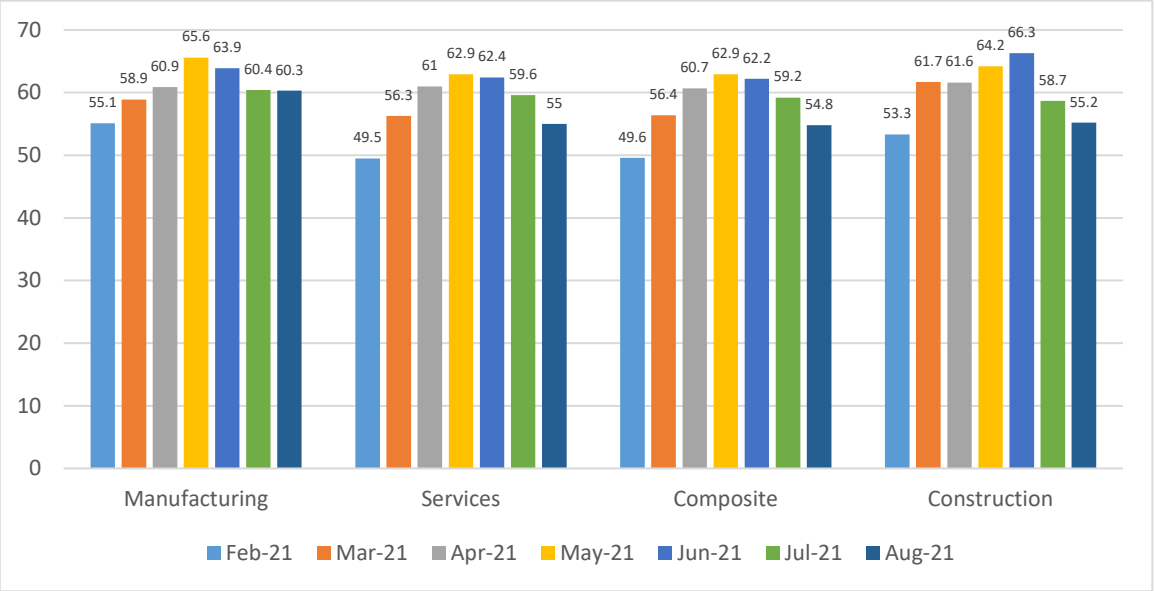
Markit indicators suggest further slowdown overall…

Markit surveys for August suggested growth was still continuing in all three sectors, though it slowed in services and construction; manufacturing was little changed (chart 2). As we commented above, given the very weak ONS GDP figure for July, we would expect some pick-up in the ONS GDP figure for August, but this does not invalidate Markit's findings as there are timing and coverage differences. The August data were likely, at least in part, to be adversely affected by the "pingdemic", but the relaxation on 16 August of the self-isolation requirements of those contacted by Test and Trace should subsequently have alleviated the resulting business problems. The surveys were notable for their continued concerns about staff and supply problems and inflationary pressures. However, all three sectors remained optimistic.

For the record, the results of the August survey were:

- The Manufacturing PMI was little changed in August, at 60.3, after July's 60.4, suggesting still strong growth.[10] Shortages of inputs and delivery delays disrupted production schedules, leading to slower output growth and marked increases in input prices. Companies, nonetheless, still achieved solid gains in output, new orders and employment. The outlook for the UK manufacturing sector also remained bright in August; almost 66% of companies indicated that they expected output to rise over the coming year, compared to only 4% forecasting a decline.
- The Services PMI Business Activity Index slipped further to 55.0 in August, down from 59.6 in July and well below May's record high of 62.9.[11] The rate of expansion in August was the slowest since the service sector returned to growth after lockdown. Softer new order growth was partly linked to the end of the full stamp duty holiday and a subsequent cooling in consumer demand arising from residential property transactions. Subdued export orders also weighed on overall new business intakes. The rate of job creation surged higher than the previous record seen in June 2014 and a subsequent lack of candidates to fill vacancies led to steep increases in wages. Strong pay pressures, rising fuel bills and greater transport costs were the main factors contributing to higher operating expenses in August. However, despite escalating costs and severe supply disruptions, service providers remained highly optimistic about the outlook for business activity growth during the next 12 months.
- The seasonally adjusted UK Composite Output Index fell to 54.8 in August, after July's 59.2 in July, signalling a slower speed of recovery across the private sector economy.[12] The composite index has registered above the 50.0 no-change threshold in each month since March, but the latest reading was the weakest over this period.
- The Construction Total Activity Index was 55.2 in August, after July's 58.7, suggesting the rate of increase was the softest since February as restricted supply of materials and transport began to weigh on activity (and note the ONS data, above, suggest falling construction output).[13] Companies widely noted sustained, and severe, supply chain disruption in August, which contributed to an accelerated rise in input prices. Commercial work was the best performing broad category of construction output in August, though the rate of expansion eased to the slowest for six months. This was followed closely by housebuilding, while civil engineering remained the slowest growing subsector for the fourth month in a row. Looking ahead, construction companies remained highly upbeat about their growth prospects over the coming 12 months.

Chart 2 UK Markit/CIPS PMIs, February-August 2021



Sources: (i) Markit releases for manufacturing, services and construction PMIs for August 2021; (ii) previous releases for previous data.

…and two other indicators

There were two other indicators of note released last week.

Firstly, The SMMT reported that August's new car registrations were 22.0% (YOY) lower, in what is traditionally one of the quietest months for new car registrations ahead of the plate-change in September.[14] Moreover, the monthly performance was the weakest since August 2013, partly reflecting "…constrained supply as the global shortage of semiconductors…continued to undermine production volumes". Concerning the year-to-date data, registrations in the eight months to August 2021 were 20.3% higher YOY, but showrooms were closed for much of the equivalent period in 2020.

Secondly, the Halifax reported that the average UK house price picked up by 0.7% (MOM) in August, whilst the annual growth rate eased to 7.1% (after in July's 7.6%), the lowest since March.[15-16] The Halifax commented that "…much of the impact from the stamp duty holiday has now left the market, as highlighted by the drop in industry transaction numbers compared to a year ago". However, there had been other significant drivers of house price inflation, with structural factors, such as the demand for more space amid greater home working, driving record levels of buyer activity. The Halifax took the view that these trends were likely to persist, and the price gains made since the start of the pandemic were unlikely to be reversed once the remaining tax break ended at end-September. Moreover, the macroeconomic environment was becoming increasingly positive. This, coupled with the tight supply of properties, "…should continue to support prices in the near-term".

In comparison, the Nationwide reported last week that house prices, somewhat surprisingly, rose by 2.1% (MOM, seasonally adjusted) in August to be 11.0% higher YOY after July's annual growth of 10.5%.[17-18] For the record, the SDLT nil rate threshold (for England and Northern Ireland) was reduced from £500,000 to £250,000 on 1 July and will revert to £125,000 on 1 October. The tax holiday ended on 31 March 2021 in Scotland and on 30 June 2021 in Wales.

The number on furlough continues to fall…

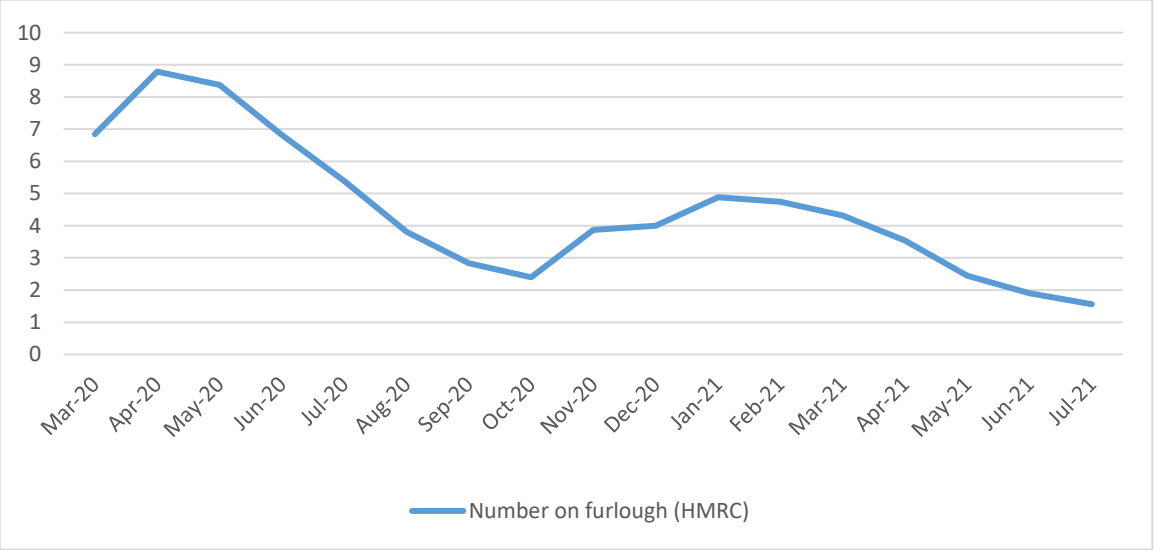
The HMRC has reported that the number of employments (sic) on furlough was 1.56mn on 31 July 2021, some 340,000 lower (MOM) than on 30 June when the number of employments on furlough was 1.90mn (chart 3).[19-20] The number of employments on furlough had peaked at 8.9mn on 8 May 2020, prior to falling

to 2.4mn on 31 October. It then rose again to 5.1mn on 19 January 2021 and has fallen since then. Employees continue to receive 80% of their current salary for hours not worked on the scheme, whilst the employer contribution towards the cost of unworked hours was 10% in July, rising to 20% in August and September.

The furlough scheme ends at end-September. Other policy changes to note include:

- The nil rate threshold of £250,000 for Stamp Duty Land Tax (SDLT), introduced on 1 July 2021, will revert to £125,000 on 1 October 2021 (for England and Northern Ireland), as noted above.
- The £20 a week uplift for Universal Credit is due to end on 6 October 2021.[21]
- The 100% business rates relief for retail, hospitality and leisure properties ended at end-June 2021, replaced by 66% business rates relief from 1 July 2021 to end-March 2022.[22]
- The VAT payments deferral scheme ended at end-June 2021.[23]
- Applications for the fifth grant of Self-Employed Income Support Scheme (SEISS) close on 30 September 2021.[24]

Chart 3 Number of employments on furlough (millions), HMRC data (end-month, to end-July 2021)



Source: *HM Government*, "Coronavirus Job Retention Scheme (CJRS) statistics", 9 September 2021", HMRC data.

…and the Governor of the Bank of England gives evidence

The Governor of the Bank of England (along with four colleagues) gave evidence to the Treasury Select Committee last week.[25] In August the MPC expressed their concerns about recruitment difficulties and labour market mismatches, whilst mentioning uncertainties surrounding the impact of the ending of the furlough scheme. They said "…there appear to have been difficulties in matching available jobs and workers. These frictions are for a period reducing effective supply in the economy. Overall, the MPC judges that spare capacity has been eroded over the past couple of quarters, as demand has outstripped growth in effective supply. Frictions in the labour market are judged likely to dissipate over the forecast period, boosting growth in effective supply capacity. There is uncertainty around these judgements, including how the economy will adjust to the end of the furlough scheme".[26-27]

Pursuing this theme, the Governor told MPs he was concerned about worker shortages persisting, identifying the problem as a key issue.[28-29] He said that the end of the furlough scheme ought to help with current worries about "getting jobs filled" but added that, while other pressures on the economy caused by supply chain bottlenecks and higher commodity prices looked likely to fade, he had a "bit more concern about persistence in the labour market story". On the economy generally he noted that "…at the moment we are seeing some levelling off in the recovery." He also revealed a division in the MPC as to when the Bank might start to scale back the emergency monetary policy measures. There had been a 4-4 split

between MPC members (in August) on the issue of whether the economy had recovered enough to meet the minimum conditions needed to start tightening policy.

The Budget and Spending Review will be on 27 October…

The Chancellor launched Spending Review 2021 (SR21), which will set out the government's spending priorities for the remainder of the current Parliament, on 7 September.[30] The Spending Review will be released on 27 October 2021 alongside the Autumn Budget.

The three-year review will set UK government departments' resource and capital budgets for FY2022-FY2024 and the devolved administrations' block grants for the same period. And as part of the launch the Chancellor set the envelope for spending over the next three years (see annex table 2). The plans (including the additional funding for health and social care announced on 7 September, see below), will mean that "core departmental spending will grow in real terms at nearly 4% per year on average over this Parliament". By FY2024 this meant that core departmental spending will be £140bn more per year in cash terms than at the start of the Parliament (see annex table 2).

…and the PM's announcement on health, social care and National Insurance

The PM's statement on the Government's Plan for Health and Social Care was made on 7 September, with accompanying command paper.[31-32] The main points were:[33-34]

- A UK-wide 1.25% Health and Social Care Levy based on National Insurance contributions (NICs) will be introduced. The Levy will be effectively introduced from April 2022 (FY2022), when NICs for working age employees, self-employed and employers will increase by 1.25%. From April 2023 (FY2023), once HMRC's systems are updated, the 1.25% Levy will be formally separated out and will also apply to individuals working above State Pension age, and NICs rates will return to their FY2021 levels. Revenues will be ringfenced for health and social care.
- The Government will also increase the rates of dividend tax by 1.25% from April 2022.
- There will be a "significant investment in health and social care of around £12bn per year on average across the UK, including funding for further real-terms uplifts to NHS England", with a good proportion going to the NHS to deal with the pandemic-related backlog of cases. About £1.8bn for year was earmarked for social care.
- Concerning social care, from October 2023 people will no longer pay any more than £86,000 in care costs (that is, for actual care, rather than accommodation) over their lifetime. Anyone with assets of less than £20,000 will not have to make any contribution for their care from their savings or the value of their home. Anyone with assets of between £20,000 and £100,000 will be eligible for some means-tested support.

Another way of expressing the changes from October 2023 to social care costs is:[35]

- If a person's total assets are over £100,000, full fees must be paid. The maximum that a person will have to pay over their lifetime towards personal care costs will, however, be £86,000 as a result of the new cap.
- If a person's total assets are between £20,000 and £100,000, their Local Authority is likely to fund some of their care. People will be expected to contribute towards the cost of their care from their income.
- If a person's total assets are less than £20,000, they will not have to pay anything for their care from their assets. However, people may still need to make a contribution towards their care costs from their income.

The Budget and Spending Review on 27 October will, of course, incorporate these policy changes. The following should also be noted:

- The Work and Pensions Secretary announced on 7 September that the "triple lock" for state pensions will be temporarily scrapped for a year from April 2002, owing to the "inflated" level of earnings increases. State pensions will be increased by the higher of 2.5% or the CPI inflation rate.[36]

- The Chancellor announced some very significant tax changes in the March 2021 Budget. Measures included raising the main corporation tax rate to 25% (from FY2023) and freezing personal tax allowances and thresholds (at FY2021 levels).[37-38]
- The IFS noted that the tax burden (tax/GDP ratio) will reach around 35% by FY2023.[39] And the tax increases "…push taxes to their highest-ever sustained share of the economy. Equivalently, government spending is set to reach a record peacetime level. Long-term challenges around rising costs of health and social care means this increase in the size of the state is likely here to stay."

The ECB slows pace of PEPP purchases…

At its latest meeting (9 September) the Governing Council of the ECB judged that "…favourable financing conditions can be maintained with a moderately lower pace of net asset purchases under the pandemic emergency purchase programme (PEPP) than in the previous two quarters".[40] It also "confirmed its other measures, namely the level of the key ECB interest rates, its forward guidance on their likely future evolution, its purchases under the asset purchase programme (APP), its reinvestment policies and its longer-term refinancing operations."

Specifically, the ECB's September decisions were:

- The interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will remain unchanged at 0.00%, 0.25% and -0.50% respectively. The Governing Council "…expects the key ECB interest rates to remain at their present or lower levels until it sees inflation reaching 2% well ahead of the end of its projection horizon and durably for the rest of the projection horizon, and it judges that realised progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at 2% over the medium term. This may also imply a transitory period in which inflation is moderately above target". The ECB has a symmetric 2% inflation target.
- Net purchases under the APP will continue at a monthly pace of €20bn. The Governing Council "…continues to expect monthly net asset purchases under the APP to run for as long as necessary to reinforce the accommodative impact of its policy rates, and to end shortly before it starts raising the key ECB interest rates". It also intends "…to continue reinvesting, in full, the principal payments from maturing securities purchased under the APP for an extended period of time past the date when it starts raising the key ECB interest rates".
- The Governing Council "…will continue to conduct net asset purchases under the PEPP with a total envelope of €1,850bn until at least the end of March 2022 and, in any case, until it judges that the coronavirus crisis phase is over". But, as already noted, it judged that "…favourable financing conditions can be maintained with a moderately lower pace of net asset purchases under the PEPP than in the previous two quarters".

…and upgrades its forecasts

The ECB upgraded its GDP forecasts in September compared with June.[41-43] They explained "…the euro area economy is recovering swiftly despite continued uncertainty related to the coronavirus pandemic and supply bottlenecks. It rebounded more strongly than expected in 2021Q2 and should continue to grow rapidly during the second half of the year, with real GDP exceeding its pre-crisis level by the end of 2021. Growth is subsequently expected to remain strong but to gradually normalise". Specifically, GDP was forecast to recover by 5.0% in 2021 (4.6% in June), 4.6% in 2022 (4.7% in June) and 2.1% in 2023 (unchanged), chart 4a.

The forecast for consumer prices inflation (HICP) was also revised higher, chart 4b. As the ECB explained "…the inflation outlook remains characterised by a hump in 2021 followed by more moderate rates in 2022 and 2023. Inflation is expected to average 2.2% in 2021, driven by temporary upward factors. These include: a rebound in energy inflation amid strong base effects; strong increases in input costs related to supply disruptions; one-off increases in services prices as COVID-19-related restrictions ease; and the

reversal of the German VAT rate cut. As these factors fade from the beginning of 2022 and temporary imbalances between supply and demand ease, HICP inflation is expected to decline to rates of 1.7% and 1.5% in 2022 and 2023, respectively". Finally, the outlook for the unemployment rate improved for 2021, averaging 7.9% (8.2% in June), with further improvements in 2022 (7.7%) and 2023 (7.3%), chart 4c.

Chart 4a ECB forecasts, Eurozone GDP growth (%): March 2021, June 2021, September 2021

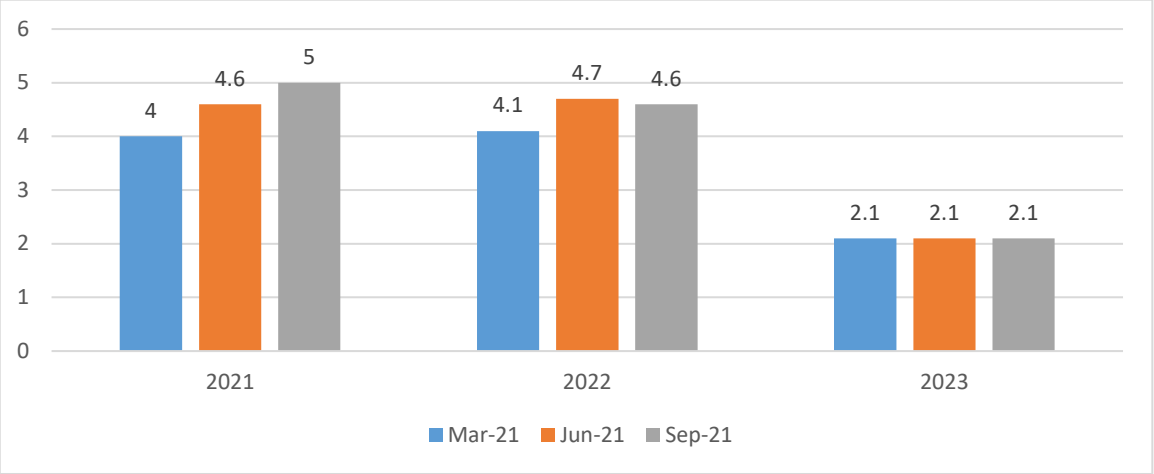


Chart 4b ECB forecasts, Eurozone HICP inflation (%): March 2021, June 2021, September 2021

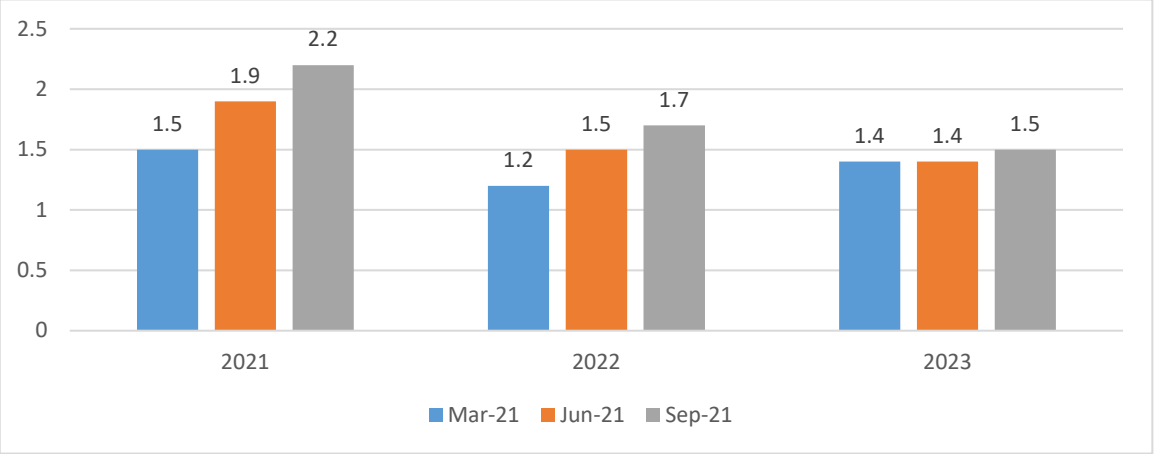
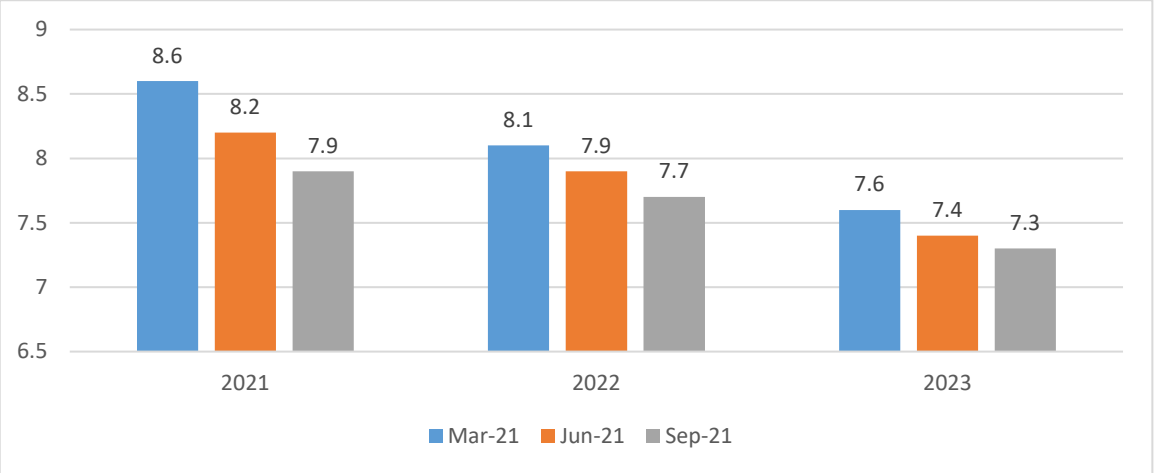


Chart 4c ECB forecasts, Eurozone unemployment rates (%): March 2021, June 2021, September 2021



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Annex

Table 1 Trade (goods and services) in June, balances (£bn), exports and imports (% change)

	Monthly balances (£bn)			Exports and imports (July, MOM, %)	
	June 2021	July 2021	Change	Exports	Imports
Total balances:					
Goods (total): of which EU/non-EU:	-12.0	-12.7	-0.7	-1.0	1.1
• EU	-5.0	-5.7	-0.7	-6.5	-0.5
• Non-EU	-7.1	-7.0	0.1	5.0	2.7
Services	9.5	9.6	+0.1	1.2	1.1
Goods and services	-2.5	-3.1	-0.6	-0.1	1.1
"Underlying" balances:					
Goods (excluding precious metals): of which EU/non-EU:	-11.6	-11.8	-0.2	…	…
• EU	-4.9	-5.7	-0.8	…	…
• Non-EU	-6.7	-6.1	0.6	…	…
Services	9.5	9.6	+0.1	…	…
Goods and services	-2.1	-2.2	-0.1	…	…
Precious metals: of which EU/non-EU:	-0.4	-0.9	-0.5	…	…
• EU	0	0	0	…	…
• Non-EU	-0.4	-0.9	-0.5	…	…

Source: *ONS*, "UK trade: July 2021", 10 September 2021. There are rounding errors in the table.

Table 2 Spending Review 2021 Resource and Capital DEL envelopes (£bn, unless otherwise stated)

	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024	FY2019-FY2024		
							Average annual growth (real) (%)	Average annual growth (%)	Nominal increase (£bn)
Budget 2021, spending assumption: core resource DEL excluding depreciation:	343.0	362.7	385.0	393.4	409.6	426.7	2.5%	4.4%	83.7
O/W DHSC Group	133.4	140.3	147.0	153.7	162.4	165.8	-	-	-
O/W NHS England & improvement	123.7	129.9	136.1	142.8	151.3	154.5	-	-	-
O/W Non-NHS England & improvement	9.7	10.4	10.9	10.8	11.1	11.3	-	-	-

New resource DEL spending: Health & Social Care (HSC), UK-wide:	-	-	-	15.0	12.4	13.8	-	-	-
O/W HSC (UK-wide)	-	-	-	13.3	10.7	12.0	-	-	-
O/W DHSC Group & additional LA social care grants	-	-	-	11.2	9.0	10.1	-	-	-
O/W Barnett consequentials	-	-	-	2.1	1.7	1.9	-	-	-
O/W estimated compensation to PS for employer costs of HSC levy	-	-	-	1.7	1.7	1.8			
SR2021 envelope: resource DEL excluding depreciation:	-	-	-	408.4	422.0	440.5	3.1%	5.0%	97.5
O/W DHSC Group & additional LA social care grants	-	-	-	164.8	171.4	175.9	-	-	-
O/W NHS England & improvement	-	-	-	243.5	250.7	264.6	-	-	-
SR2021 envelope: core capital DEL	70.4	91.6	99.8	107.3	109.1	112.8	7.3%	9.3%	42.5
SR2021 envelope: core total DEL	413.4	454.3	484.8	515.6	531.2	553.3	3.9%	5.8%	139.9

Source: *HM Government*, "Chancellor launches vision for future public spending", 7 September 2021.
O/W = of which. HSC=Health and Social Care. DHSC=Department of Health and Social Care.
PS=public sector. SR=Spending Review. DEL=Departmental Expenditure Limits.