ROYAL LONDON ASSET MANAGEMENT

Investment Clock – Economic Update

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Multi asset views

Royal London Asset Management manages £169.3 billion in life insurance, pensions and third party funds*.

We have six Global Multi Asset Portfolios (GMAPs) across the risk return spectrum with a full tactical asset allocation overlay.

*As at 31 March 2024

This month's contributor

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US: With the Fed signalling they are in no hurry to cut rates and a likely weaker boost from fiscal policy, growth should stay slower than in late-2023. I still think the Fed will cut rates, but less and later than a few months ago.

China: I expect more policy support but also expect it to be insufficient to sustainably lift China's growth rate by much.

Eurozone: I expect modest GDP growth, constrained by less supportive fiscal policy. Without weaker pay and services inflation there are risks of fewer cuts than the three I have pencilled in for 2024.

Japan: Inflation remains high by Japan standards. I have added two rate hikes into my forecast. Uncertainty remains around how sustainable Japan's new inflation dynamics are, however.

UK: Activity growth in early 2024 has been stronger than I'd expected. I don't expect rate cuts until Q3, but services/pay inflation remain uncomfortably strong.

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For further details, contact: **multiassetsupport@rlam.co.uk**

Not so many cuts?

I expect just moderate positive global economic growth across most major economies, rather than sustained strong growth. With labour markets still relatively tight, policy is likely to become only gradually less restrictive in the US and in Europe (with Japan going the other way with rate hikes from very low levels). There are good reasons to expect domestic inflation to moderate further, but data are consistent with a lack of urgency to cut rates. Risks to both activity and inflation forecasts are two-way and elections bring some additional uncertainty. Fiscal policy looks set to remain a differentiator.

Summary

Post-recession…: Global activity looks to have picked up since the turn of the year, consistent with moderate economic growth. The euro area and UK economy bounced out of mild technical recession in the first quarter and the US economy appears to be growing at a decent pace, even if not as strong as in the second half of 2023. Positive real pay growth and at least some rate cuts should support activity, but past rate hikes, less supportive fiscal policy and already tight labour markets limit likely GDP growth rates.

…probably: There are two-way risks to the growth forecasts. On the upside, there is scope for consumers to save less (especially in Europe); immigration may provide support (as it has done in the US); fiscal policy may prove more supportive than expected (partly depending on the results of upcoming elections). On the downside, stickier-than-expected inflation could see central banks keep interest rates around current levels (or even higher); lags from monetary policy tightening may turn out longer than expected and downturns could follow; elections can result in enough uncertainty for business that investment stalls, while a new US government could see more tariff hikes and retaliation.

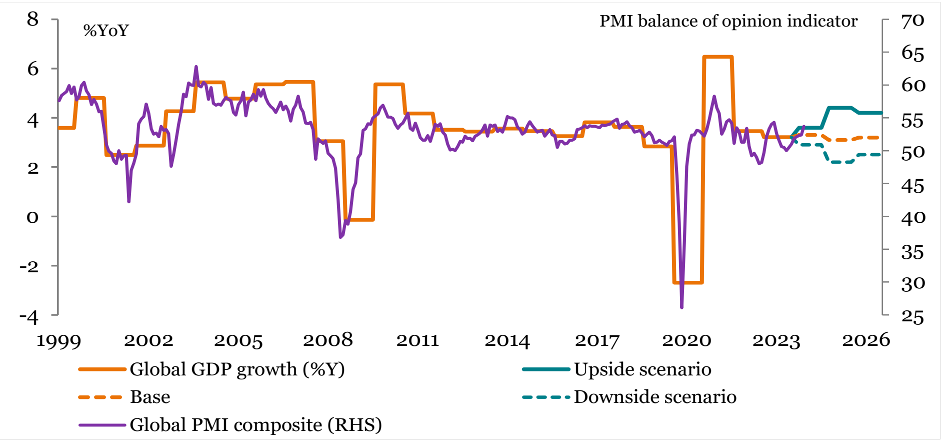
Much depends on inflation: Lower domestically driven inflation would give central banks space to cut rates significantly, but the data needs to start looking more reassuring. Lower headline inflation should feed through to lower pay settlements. Lower energy inflation arguably has still to fully feed into broader inflation. However, central bankers are unsure where neutral is and monetary policy settings may be much less restrictive than expected. Services inflation is already proving relatively sticky.

Cross-currents make the medium-term outlook murky: The economy is arguably still feeling the effects of the Covid shock and the subsequent policy response. Meanwhile, demographic trends are becoming much less favourable (likely inflationary); climate change brings challenges of adaptation, disruption and the need for investment; AI meanwhile brings a new set of scenarios (likely deflationary).

The **Royal London Asset Management Multi Asset team** see the economy as being 'in the crosshairs' in terms of their Investment Clock framework, with the Clock having recently edged out of the equity-friendly segments of the business cycle. My central economic forecasts should ultimately see a shift into more bond-friendly territory for multi-asset, alongside rate cuts, but the data aren't there yet. The team has been overweight equities since late 2022 but has recently reduced the size of this position as technical and macro factors have become less supportive.

For more, see the team's 'ClockWise' blog at www.rlam.com

Chart 1: Global growth central case: Moderate positive growth



Source: IMF, S&P Global (past data); RLAM (forecasts). PMI data is to May 2024

Economic forecast summary

May 2024 base case

Region	2023e GDP growth	2023e CPI end Q4	2023e Policy Rate Q4	2024e GDP growth	2024e CPI end Q4	2024e Policy Rate Q4	2025e GDP growth	2025e CPI end Q4	2025e Policy Rate Q4	2026e GDP growth	2026e CPI end Q4	2026e Policy Rate Q4
US	2.5	3.2	5.50	2.6	3.2	5.00	1.8	2.4	4.25	2.2	2.3	3.50
				2.0	*2.8*	*4.75*	*1.6*	*2.3*	*3.50*	*2.2*	*2.2*	*3.25*
China	5.2	-0.3	–	5.2	–	–	4.5	–	–	4.3	–	–
		–	*–*	*4.9*	*–*	*–*	*4.5*	*–*	*–*	*4.3*	*–*	*–*
UK	0.1	4.2	5.25	0.8	2.8	4.75	1.2	2.2	4.00	1.4	2.0	3.50
				0.1	*2.5*	*4.75*	*1.2*	*2.3*	*4.00*	*1.3*	*2.1*	*3.50*
Euro area	0.5	2.7	4.00	0.8	2.3	3.25	1.4	2.3	2.75	1.2	2.1	2.50
				0.3	*2.2*	*–*	*1.4*	*2.3*	*–*	*1.2*	*2.1*	*–*
Japan	1.9	2.9	-0.10	-0.1	1.8	0.10	1.1	1.8	0.25	0.8	1.7	0.50
				0.4	*1.7*	*0.00*	*1.0*	*1.6*	*0.00*	*0.8*	*1.6*	*0.00*
Global	3.2	–	–	3.3	–	–	3.1	–	–	3.2	–	–
		–	*–*	*3.2*	*–*	*–*	*3.1*	*–*	*–*	*3.2*	*–*	*–*

Source: LSEG Datastream, national statistics offices, Bloomberg Finance L.P. for past actual data. All forecasts (e) are RLAM. Current data and forecasts are in black. Forecasts from the February 2024 forecast update are grey and in italics. Some of the 2023 figures are now past actuals. Note: US policy rate is the upper end of the Fed Funds target range. Euro area policy rate is the deposit rate.

Key economic policy forecasts

- With taming inflation having been the driver of central bank tightening and with inflation now substantially lower, my central case is that peak rates have been reached (except in Japan) and that rate cuts will be triggered in 2024, starting in the second quarter in the euro area and the second half in the US and UK. I am assuming that moves are relatively gradual as central banks 'feel their way' amid significant uncertainty over the outlook, uncertainty about how restrictive the current stance of policy actually is and in the absence of sharply deteriorating economic data. In Japan, the forecasts assume that 2024 sees one more rate hike from the Bank of Japan and a further hike in 2025 but with the BoJ remaining relatively cautious against a backdrop of fragile confidence around inflation sustainability.
- Sharper-than-expected downturns and more unemployment would likely see further and faster cuts than in the base case (partly reflecting what would then be increased concerns around over-tightening). Higher-than-expected inflation, particularly pay growth, could mean rate cuts come later and less sharply than expected. A return to rate hikes can't be completely ruled out but I would see them more as a risk for 2025 in a scenario of persistent upside inflation surprises.
- Fiscal policy is generally expected to become less supportive over the forecast. However, sharp spending cuts are not in the central case, partly reflecting assumed spending to tackle longer-term challenges (e.g. climate change). The election will matter in the US but, in terms of overall deficit/fiscal sustainability, whether either party gets a clean sweep may matter more than who wins the presidency.

Global economic scenarios (Chart 1)

Upside scenario (20% probability): Growth picks up sharply, but without generating strong inflation

- Consumers dissave as confidence grows in the outlook and real pay growth remains positive. Consumer spending is much stronger than expected. That helps drive additional hours worked more than additional hiring against a backdrop of labour hoarding.
- Headline inflation stays relatively close to target, as higher productivity growth contains overall labour cost growth. Higher labour market participation and robust immigration also helps in some cases.
- Central banks prove less willing to cut rates, but aren't inclined to hike rates either given contained inflation pressures. Policy rates remain closer to pre-financial crisis norms than pre-pandemic norms.

Base case (60%): Moderate growth, closer to target inflation and lower rates

- 2024 sees moderate positive GDP growth. Bank lending conditions remain relatively tight and the lags of monetary policy still drag on the level of activity, even if the worst of the impact on GDP growth is in the past. Consumer spending is likely to be supported by positive real pay growth and business confidence by expectations of rate cuts.
- Domestically driven inflation pressures ease somewhat through 2024, even while headline inflation doesn't fall much. Gradual rate cuts follow.

Downside scenario (20%): Lagged impacts of rate hikes stronger than expected

- After a period of stronger-than-expected inflation this year, rate cut expectations fizzle out and business confidence drops significantly. Meanwhile, it turns out that the worst of the drag from monetary policy on GDP growth hasn't passed. Growth is lower and unemployment higher than in the central case.
- After a period of stronger-than-expected outturns, inflation falls more sharply than in the central case in 2025/26.
- Rate cuts are more rapid, but start later than in the central case (though do not fully return to pre-pandemic levels in most developed economies).

Probabilities are subjective and indicative such that we'd broadly see a 20% chance that the economy performs in line with/better than the upside case and a 20% probability that the economy performs in line with/worse than the downside case.

Global economy: Out of recession warning zone

I expect moderate positive growth across most major economies this year, with a bit of a soft patch in the US and a lack of sustained strong growth across the board. My previous description of "lacklustre" seems insufficient though given the surprising strength of some of the activity data so far this year. However, without having experienced substantial recessions, sustained *strong* growth seems unlikely either. With labour markets still looking relatively tight, I continue to expect only gradual and cautious rate cuts. There are good reasons to expect domestically driven inflation to moderate further. Risks to both activity and inflation forecasts, however, are two-way and the path ahead is not as clear as it could be.

Status update: Perking up, with soft patches

Using the global composite PMI business survey as a proxy for global GDP growth (Chart 1), growth has picked up since the turn of the year and now looks consistent with a moderate pace of expansion. The US economy appears to have gone through a bit of a soft patch in the first quarter. Business optimism started to look a little shakier earlier in the second quarter too, likely related to the pull back in expectations of central bank rate cuts seen across major economies (Chart 2) and, potentially, the slowing in general deflationary trends with headline G7 inflation still above 2% year-on-year, for example (Chart 3). With major economies not bouncing out of substantial recessions and with a likely lack of headroom for growth to pick up (limited space capacity and far from loose labour markets – see Chart 4), doubts about the amount of policy stimulus likely in coming quarters should rationally add to questioning around how strong growth is going to be.

Summary outlook: Subdued growth, lower inflation…and gradual rate cuts

The forecasts on page 2 show somewhat stronger GDP growth than they did three months ago reflecting a stronger-than-expected Q4/Q1. The forecasts aren't what I'd describe as strong, even if I can't label them "lacklustre" again. There are enough positive supports, that we should see some GDP growth, including positive real pay growth (Chart 5). But there are still enough drags on activity from past rate hikes and potentially from fiscal policy in some places, that I don't expect growth to be strong. The bulk of the decline in headline inflation has happened and it's more about core and services inflation now which I expect to cool. That allows central banks to cut rates in my central case (bolstering activity growth), but cautiously: 1) insufficient progress is being made so far in subduing domestically driven inflation; 2) there is too much uncertainty around how restrictive current policy current settings are/where neutral rates are, and 3) the activity data aren't particularly weak.

There are two-way risks to the outlook. Things may not follow a neat historical pattern: the supply-side of economies has seen big changes in recent years (e.g. labour markets over the Covid and post-Covid period overlaid with shifting immigration patterns); we've had huge fiscal and monetary policy changes over recent years to absorb; climate change, demographics and AI are all potential forces of significant disruption.

I can make an upside case with a stronger consumer where real pay growth helps confidence build and households save less – especially Europe where savings rates are still above pre-pandemic norms (Chart 6). I can paint a worse scenario where the impact of earlier monetary policy tightening may make itself felt more strongly. It remains plausible that there is a slumpier period ahead: we haven't had any central bank rate cuts yet in the US; banks have reduced credit availability in recent quarters (Chart 7); household savings rates are already back to low levels in the US limiting how much upside risk I'd see from US consumers. Corporate insolvencies are already well above their lows in the UK, France, Germany and the US, even if some of that is likely just a lagged impact from the pandemic.

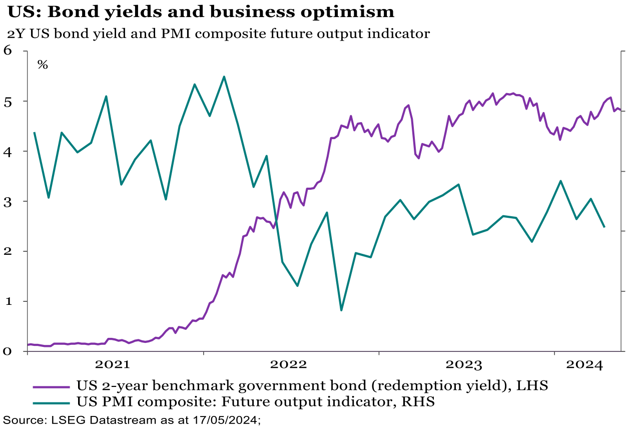
You can also argue that we may see both of these alternative scenarios in succession: stronger consumer spending drives more hiring, tighter labour markets and more inflation; rate hikes and tight financial conditions tip economies into downturns. If central banks aren't sure how restrictive policy is, it may not take much of an upturn in activity, boost to fiscal policy or rise in inflation from here to prompt serious discussions around hiking rates.

Lower inflation, but slower progress

Headline year-on-year inflation has fallen significantly from its peaks but generally remains above central bank targets. The forecasts pencil inflation close to central bank targets over the next couple of years, but averaging a bit above. Geopolitical and climate shocks can't be ruled out and could push inflation even higher than this and/or induce further 'spikes'.

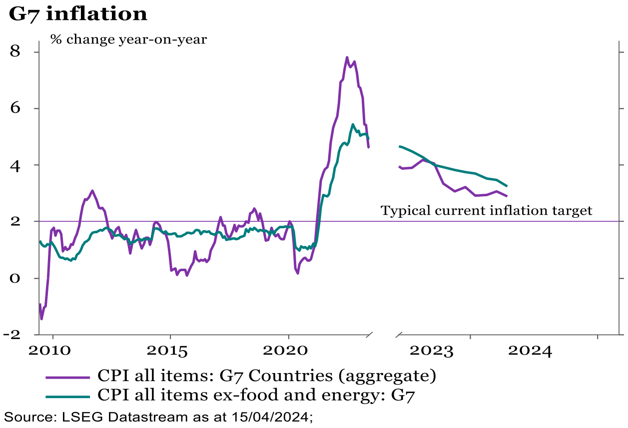
What central banks are preoccupied with is the risk that underlying/domestically driven inflation doesn't sustainably return to levels consistent with meeting the inflation target. I am expecting domestically driven/services inflation to slow, partly as lower headline inflation helps calm pay demands, but if it remains relatively sticky then expected rate cuts may not materialise.

Chart 2: Business optimism sensitive to rate expectations



Source: LSEG Datastream, S&P Global as at April 2024; Bond yield to 17th May.

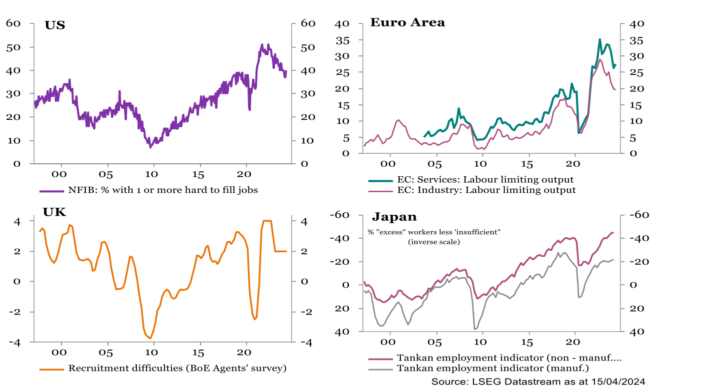
Chart 3: Stalling (headline) inflation



Source: LSEG Datastream, OECD. Data as at April 2024.

Chart 4: Business surveys indicate that labour markets have loosened (ex-Japan)…but aren't loose

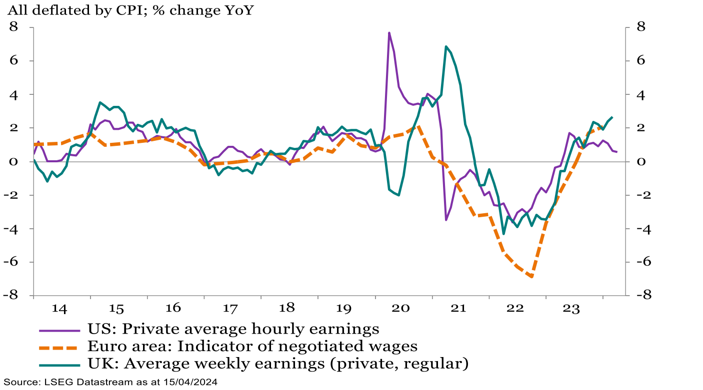
Business survey measures of labour market tightness



Source: NFIB, European Commission, BoE, BoJ. Data to April 2024/Q2 2024 except Tankan which is to Q1 2024.

Chart 5: Household real pay growth positive

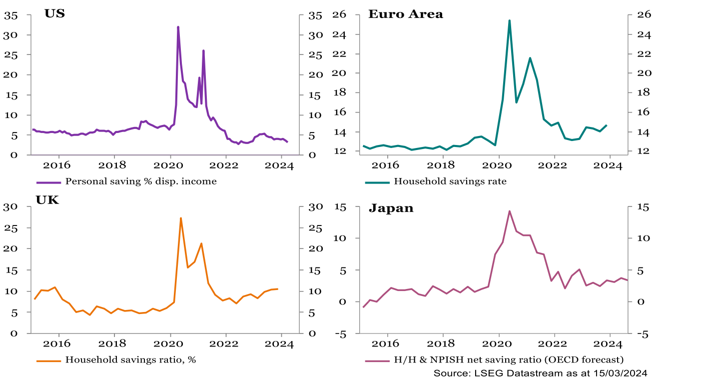
Selected real pay growth measures



Source: LSEG Datastream, BLS, ONS, ECB, Eurostat. Data is to April 2024 (US), March 2024 (UK), Q1 2024 (Euro area).

Chart 6: Households: Room to save less in Europe?

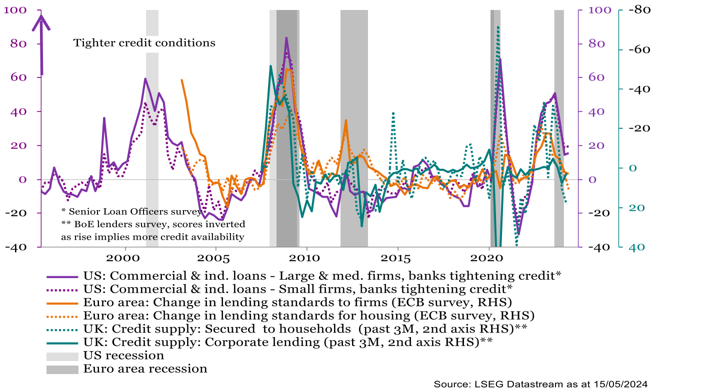
Household saving ratios



Source: LSEG Datastream, BEA, Eurostat, ONS, Cabinet Office. Data to March 2024 (UK, Euro area) and Q4 2023 (UK, Euro area, Japan).

Chart 7: Less tightening (and some loosening) in bank lending conditions

Selected Credit Conditions measures



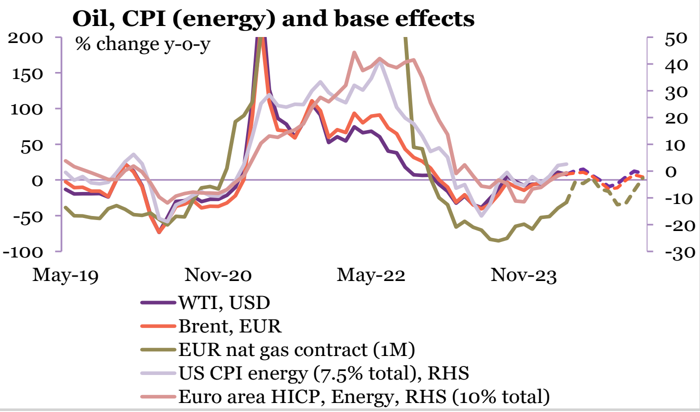
Source: LSEG Datastream, Federal Reserve, ECB, BoE. Data to Q1 2024 (UK); Q2 2024 (Euro area, US).

Inflation #1: Likely limited downside for goods inflation

We have likely seen most of the downside pressure that we are going to get from external/global factors. The energy components of CPIs are sensitive to where energy prices go from here, but base effects look set to push up inflation rather than pull it down (Chart 8). Meanwhile, various indicators of import and input prices suggest there may be a bit further to go on the downside in Europe, but less so in the US and Japan (Chart 9).

External risks to the inflation outlook continue to include commodity prices/shipping costs as geopolitical tensions rise and fall; weather/climate affecting food prices in particular; tariff changes. Inflation in China remains weak, fuelling discussions of China 'exporting deflation'. However, China producer price inflation is above its trough (Chart 10) and China's share of goods exports to the EU and US has been flat to falling, rather than rising, over the last three years (Chart 11).

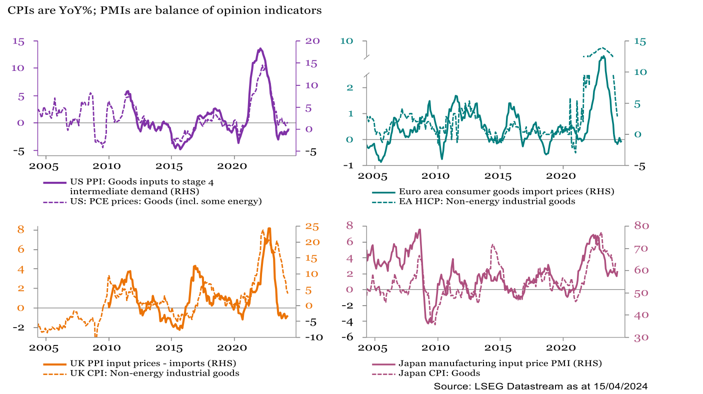
Chart 8: Oil base effects: Adding to inflation



Source: LSEG Datastream, BLS, Eurostat, RLAM. Chart shows as dashed lines, the path for commodity price inflation if levels remain at spot rates as of 17th May 2024. CPI data as of April 2024.

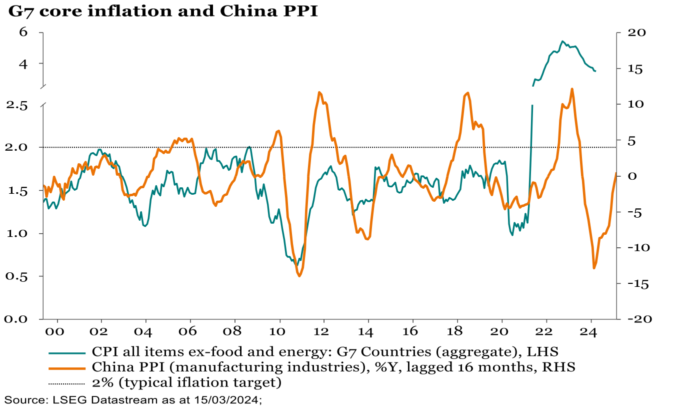
Chart 9: Import and input price indicators suggest most of the downside has already fed through to CPI goods prices

Goods CPI and input/import prices



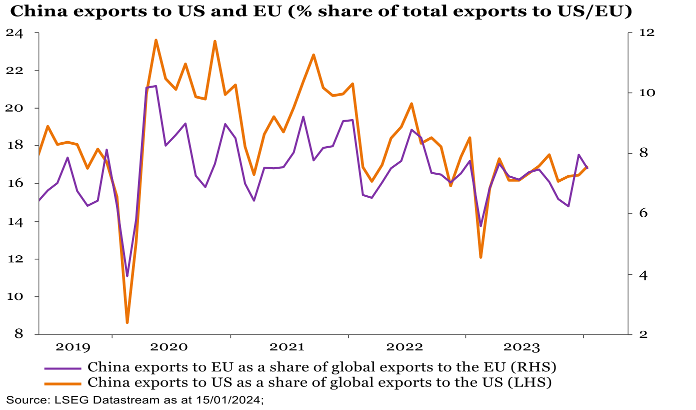
Source: LSEG Datastream, BLS, BEA, Eurostat, ONS, Japan Statistics Bureau, S&P Global. Data as at April 2024 except US PCE, UK series, Japan CPI (March 2024), Euro area import prices (February 2024).

Chart 10: China producer price inflation off the lows



Source: LSEG Datastream, OECD, China NBS. Data as of March 2024 (G7), April 2024 (China).

Chart 11: China's US and EU export share has dropped



Source: LSEG Datastream, IMF. Chart shows goods exports only and calculations are in USD. Data as of January 2024.

Inflation #2: Services…should fall further

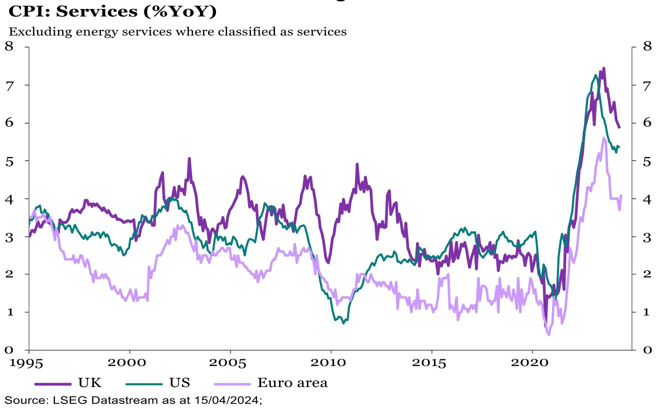
Services inflation in the US, UK and euro area is off the highs, but it is a long way above pre-pandemic levels.

The most domestically driven bits of inflation have cooled, but not enough. In the US, euro area and UK, services inflation is well off the highs but remains high (Chart 12). US pay growth trends are somewhat reassuring, but European wage inflation still looks stronger than would be consistent with hitting a 2% inflation target given average post-financial crisis productivity growth (Chart 13).

The forecasts assume a significant further fall in services inflation: Lower food and energy inflation should feed through to lower services inflation too with energy prices a key input (see Chart 24 for the US). Lower headline inflation should also help moderate inflation expectations as well as wage demands/settlements. A bit more labour market slack would help too. There, the picture looks mixed country-by-country but looks consistent with *looser* labour markets, albeit not *loose* labour markets (see Charts 4 and 14). There isn't complete agreement about what has driven the surge in services inflation and the role of supply matters for the outlook:

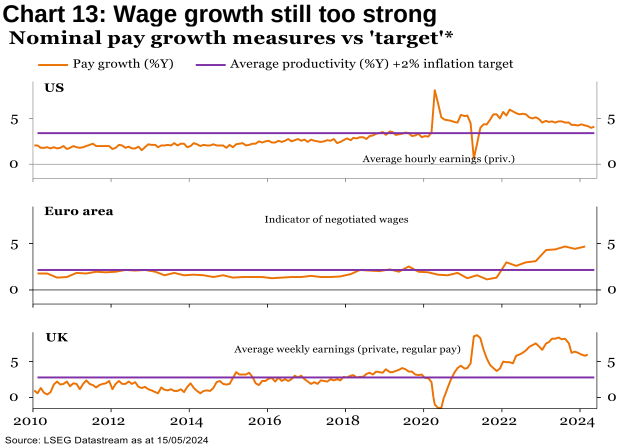
- **Role of the labour market – upside and downside risks**: Against a backdrop where global growth is expected to be reasonable, but where working age populations are shrinking/look set to shrink, labour markets may tighten again and services inflation prove stickier than expected. However, if there is still significant labour hoarding, activity growth can rise without generating much more hiring and inflationary pressure. Higher immigration could also play a role in containing any renewed build up in inflation pressures associated with stronger-than-expected demand (a talking point in economies like the US, Canada and Australia for example).
- **Adjusting to supply shocks**: You could argue that higher energy prices, food prices and supply chain problems raised input prices directly for services and led to step change adjustments in wages. In which case, things could normalise quickly once these adjustments have fully taken place.

Chart 12: Services CPI still high



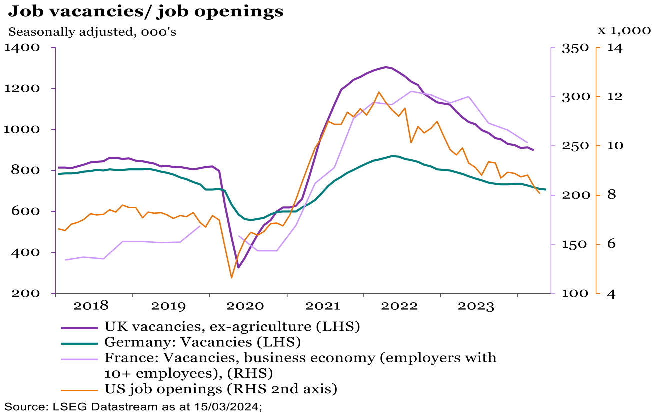
Source: LSEG Datastream, ONS, BLS, Eurostat as at April 2024.

Chart 13: Wage growth still too strong



Source: LSEG Datastream, RLAM, BLS, ECB, ONS. Pay data to May 2024 (US), Q1 2024 (Euro area) and March 2024 (UK). *Productivity measures used are output per hour (US), Total economy labour productivity (euro area), Whole economy output per worker (UK) and series are averaged from 2000.

Chart 14: Labour market loosening: Vacancies still drifting down



Source: LSEG Datastream, ONS, Deutsche Bundesbank, Eurostat, BLS. UK data to March 2024, France data to Q1 2024, US job openings data to April 2024; Germany data to April 2024.

Crucial for central banks: The example of the UK in Chart 15 is illustrative. There have been long periods of time where core inflation has hit 2% on average: During the early 2000s, there were times when services inflation was around 4% and core goods inflation negative – periods where there was a lot of deflationary pressure via higher imports from China. Pre-pandemic, core goods inflation was 0-1%, perhaps where we will head back to. However, in that period services inflation was around 3%. In short, if you want to *sustainably* hit the 2% inflation target, at least in the UK, services inflation needs to be closer to 3% than 6% where it has been recently.

Two-way medium-term inflation risk: Ageing + climate vs AI

Ageing may boost inflation through several channels including lowering labour supply relative to overall demand; increased bargaining power of labour; and potentially higher fiscal deficits to fund increased age-related spending demands.

Climate change and associated transition costs also seem likely to lead to recurrent upside pressures (see Why you can't forecast inflation without considering climate change, January 2023).

On the downside, AI promises transformative effects on the labour market that seem likely to prove deflationary. AI may prove productivity enhancing for existing workers. In more disruptive scenarios, it could also make some categories of work redundant and see wage compensation fall to the cost of the technology (see section on AI scenarios).

Central bank policy: Cuts (ex-Japan)…but how many and how quickly?

Despite a forecast for moderate growth, and not much in the way of lower headline inflation, I am expecting some rate cuts (Chart 17):

1) Policymakers in Europe and the US generally think rates are above neutral. They can cut and policy settings would remain restrictive.

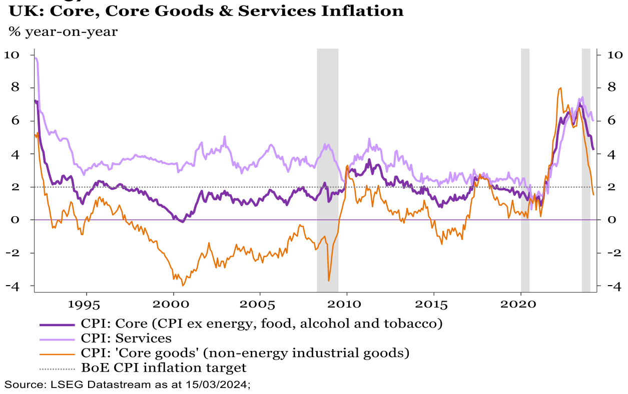
2) Domestically driven inflation is expected to cool further – that should give central banks more confidence that inflation is sustainably at, or heading to, target. It is that lack of confidence around *sustainability* that explains why rate cuts have been limited so far.

However, activity data have perked up globally (Chart 1), unemployment is low and the domestically driven bits of inflation are still on the 'too strong' side in the US, euro area and UK (Chart 12). These economies are still coming out of a period of high inflation and central bankers will be wary of prompting a revival. The activity data are not telling them that they need to rush to slash rates here. Although they think rates are restrictive, they don't have confidence in where neutral is. Pulling all that together, any cuts are very likely to be gradual and cautious.

Triggers for rate cuts largely remain unchanged. Inflation falling to target or close to target removes an obstacle to rate cuts but isn't sufficient. More data that supports inflation *staying* at 2% is what's required. To differing extents, a sharp deterioration in activity data could also supply central banks with the 'urgency' they are missing to cut rates, especially if the deterioration is centred on the labour market.

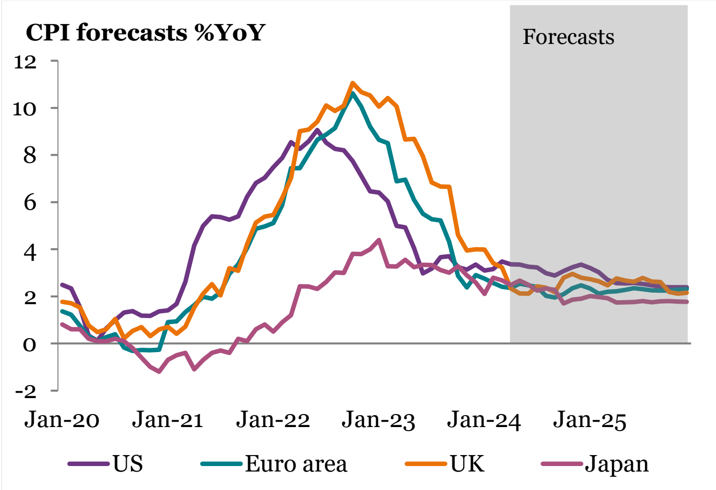
- For the **Federal Reserve (Fed)**, progress on core and services inflation looks especially important, helping to explain the 'no urgency to cut' messaging of late after inflation surprised on the upside in the first three months of the year. They have also been clear though that an unexpected weakening in the labour market could also prompt rate cutting (in line with their dual mandate and against a backdrop where inflation has fallen from its highs).

Chart 15: UK inflation break down (aka services inflation too strong)



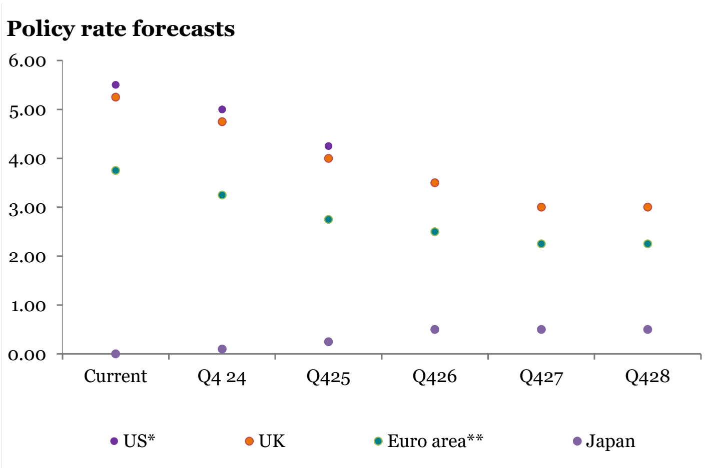
Source: LSEG Datastream, ONS. Data to March 2024.

Chart 16: My central inflation forecasts



Source: Past data: LSEG Datastream, BLS, Eurostat, ONS, Japan Ministry of Internal Affairs and Communications. Forecasts are RLAM, consistent with forecasts on page 2.

Chart 17: Rate cuts forecast, except in Japan



Source: National central banks/LSEG Datastream (past actuals). All forecasts (from Q4 2024 onwards) are RLAM estimates.

- Having cut in June following relatively clear messaging from **European Central Bank (ECB)** speakers, their signalling around the path for rates beyond June has been more mixed. President Lagarde was clear in the June press conference that there was a big focus on incoming data and that the speed and timing of the (rate cut) path ahead were very uncertain.
- The **Bank of England (BoE)** continue to highlight that they want evidence of labour market loosening, lower pay growth and services inflation. A rate cut seems likely later in the summer as evidence increasingly support all three trends improving (at least in my central case).

Are rate hikes really a risk? Rate hikes are part of my Japan central case. Elsewhere, rate hikes look more of a risk for the US than the UK or euro area, but remain far from my central case. The probability has increased compared to late last year after upside surprises in Q1 US inflation data. A further sequence of upside inflation figures, combined with some renewed strength in activity data would prompt the Fed to further consider whether rates really are restrictive enough. Some Fed speakers have already expressed the view that the obstacle to rate hikes is relatively high, even if they can't be *ruled out*; The more likely risk is that the Fed keep rates on hold for longer. A large part of the transmission mechanism operates through rate expectations/financial conditions and the pass-through to bond yields/loan rates. Shifting expectations away from substantial rate cuts towards keeping rates steady for longer can itself be powerful in helping reduce inflation pressures.

Central banks can diverge, but how much? That will depend on tolerance for consequences: None of the BoE, the BoJ or ECB could be described as Fed-*dependent*. All three central banks have diverged from Fed rate setting for significant periods, notably post-financial crisis when the Fed raised rates to 2.25%-2.50% between late 2015 and mid-2019 while the ECB lowered the deposit rate further into negative territory and the BoE raised rates to only 0.75%. The interest rate differential between Japan and the US remains very large.

One of the most obvious places that changing rate divergences may make themselves felt is in currency markets. That post-financial crisis period, where the US hiked ahead of others, roughly coincided with a relatively strong period for the trade-weighted US dollar. 2023 saw strong rate increases in the US, UK and euro area but not in Japan. Weakness in the yen has reached manifestly uncomfortable levels for Japanese authorities.

Relatively low tolerance to higher inflation seems likely to limit the extent and pace of central bank divergence. Currency weakness in the euro area and UK might be an especially unwelcome result if the ECB and BoE cut rates significantly far ahead of the Fed. Having just come out of a period of high inflation, sterling and euro weakness might translate more rapidly/strongly than usual into upside risks for inflation. I would expect the BoE and ECB to react to currency weakness rather than anticipate it, however.

R* – in vogue, but of limited help…: While discussions and debates around R*/r* or neutral rates continue, they remain unobservable and easy to disagree on. My estimates of a longer-term nominal equilibrium/neutral interest rate (r* plus the inflation target) are currently (only) around 3.00% in the UK and the US and 2.50% in the euro area, arrived at by averaging several different methodologies/sources rather than taking any single approach. Those should still be taken as very uncertain, but they act as an anchor-point in my forecasts for the kinds of declines in policy rates that might materialise over the next 2-5 years in a central case where central banks cut rates gradually towards neutral (rather than cut rates quickly *below neutral* as recessionary conditions develop).

Fiscal policy: Trouble ahead?

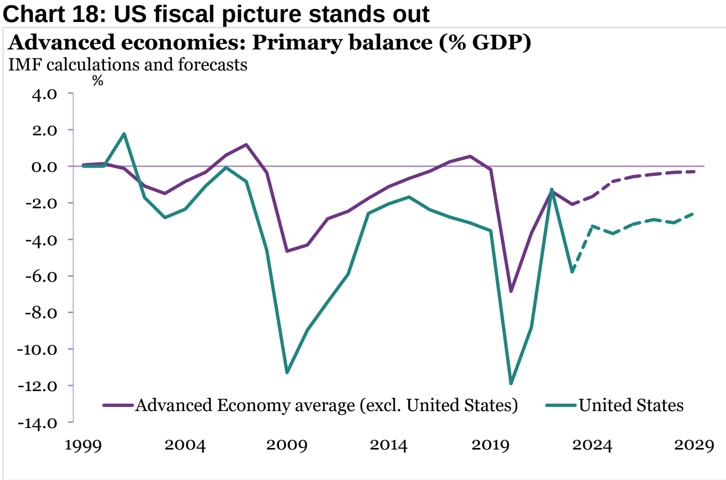
Fiscal policy is often pinpointed as a factor behind relatively strong recent growth in the US compared to elsewhere. The US fiscal deficit is certainly high compared to developed economy peers (Chart 18). The result of the upcoming US election matters for the likely fiscal path. However, the big differences in overall fiscal stance may not be between a Trump or Biden presidency (though the tax/spend mix of incremental fiscal policy seems likely to differ in each case), but between a clean sweep or a non-clean sweep outcome. In the event of the make-up of Congress not matching the Presidency, I'd pencil in tighter fiscal policy than otherwise. The combination of the Infrastructure Investment and Jobs Act (IIJA), Inflation Reduction Act (IRA) and CHIPS act looks to have had a significant impact on the US economy, but the incremental impact on investment seems likely to fade. The expiry of Trump era tax cuts in late 2025 seems an obvious fiscal focal point for next year. I'd assume a Trump clean sweep would see the cuts extended and a Biden clean sweep potentially see the funds partly spent in some other way.

Disbursements are ongoing in the EU under the NextGeneration programme, but fiscal policy looks set to be something of a drag overall, with 11 EU countries including France and Italy potentially being sanctioned under the EU's so-called 'excessive deficit procedures' (Chart 19). A renewed burst of stimulus seems unlikely and a period of fiscal consolidation looks a more sensible central case (Chart 20).

For developed economies generally, fiscal policy looks set to drag on/be less of a boost to growth. Relatively high debt levels (with associated significant debt service costs), continue to restrain governments' fiscal room for manoeuvre (Chart 21).

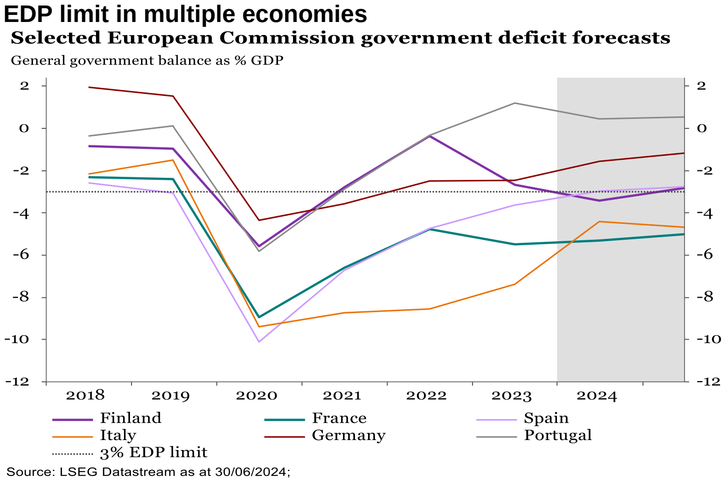
Fiscal sustainability could become more of a focus/talking point for some economies. Lacklustre economic growth; relatively high debt service payments (compared to pre-pandemic); ageing populations weighing on tax revenue, while requiring more spending on health and social care; and even the potentially disruptive power of AI on the labour market and income tax revenue, all justify more focus on this theme. Elections could be triggers for reappraisal of these risks. The Spring IMF World Economic Outlook noted that the size of fiscal adjustment needed to ensure government debt sustainability was large, and that projected fiscal adjustment was often insufficient to stabilise debt to GDP at 2019 levels for example. On their analysis, global public debt is projected to approach 99% GDP by only 2029, "driven by China and the United States where, under current policies, public debt is projected to continue rising beyond historical peaks." (IMF Fiscal Monitor, April 2024)

Chart 18: US fiscal picture stands out



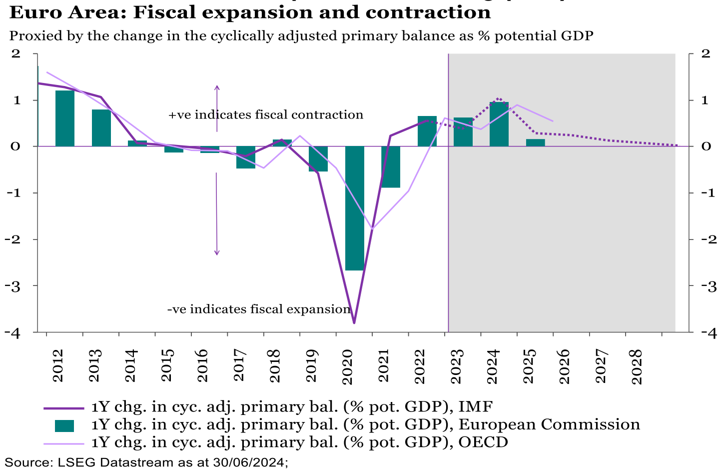
Source: IMF. Data from the IMF's April 2024 fiscal monitor.

Chart 19: European Commission expects deficits above the 3% EDP limit in multiple economies



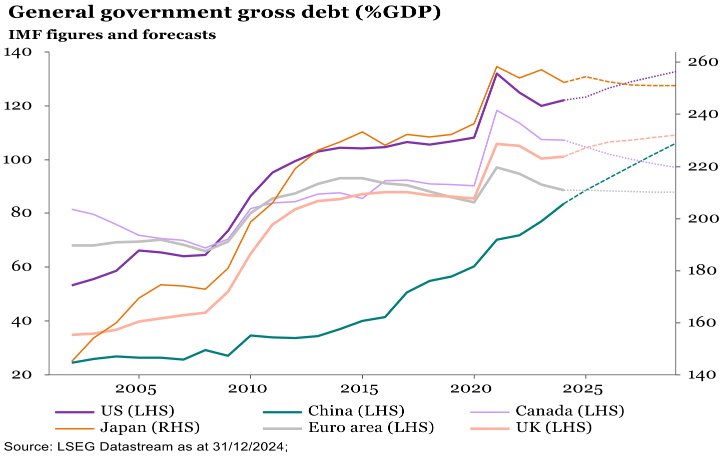
Source: LSEG Datastream; EU Commission (as of May 2024).

Chart 20: Euro area example: Fiscal to drag (a bit)



Source: LSEG Datastream, IMF (April 2024); EU Commission (as of May 2024) and OECD (May 2024).

Chart 21: High government debt



Source: LSEG Datastream, IMF as of April 2024.

Politics: Election risks still in focus

Elections still to come this year include the US and UK (the general election in the latter is now scheduled for July 4).

On the US side, a Biden presidency would represent a degree of continuity (depending on the make-up of Congress). A Trump presidency could again bring a change in policymaking style as well as substance. Without a clean sweep, one area of policy action again seems likely to be tariffs. Trump has already said that he will raise tariffs on all trading partner imports by 10pp and suggested a tariff on China imports of at least 60%. Increases in tariffs can in theory be offset by currency moves where exchange rates are flexible. However, should trading partners retaliate by raising their own tariffs, and given companies' recent experience at passing on cost shocks (in contrast to the period of Trump's first term), a new round of tariff activity could prove more inflationary overall and more damaging to growth.

Whoever wins the UK election will have some tough decisions to make on fiscal policy. The real terms spending cuts that are currently pencilled in for the coming years look questionable given how stretched public services already are. Tax rises may be needed in coming years. The polls would have Labour winning by a relatively clear margin for now. In terms of policy stance, Labour have well telegraphed their employment law plans. Perhaps what might have more of an impact on growth expectations might be their approach to the EU. They do seem to want a much closer relationship with Europe and any substantial progress on that front could be a positive surprise for the economic outlook and lead to some currency strengthening.

Elections always have the potential to bring about economic (and other) policy change. As a central case, however, 2024 elections are not assumed to be potential triggers for major economic policy changes in the US and UK in 2024 at least. Risks for 2025 may be easier to assess once campaigns (especially in the US) get fully underway.

AI scenarios

AI could well be both transformative and disruptive for the global economy. Speed and extent of development of the technology seem two key determinants for economic outcomes at this stage, but the speed and breadth of adaptation/application by companies will be critical to determining the impact on productivity for example. The slower the technology spreads/develops, potentially the less disruptive. More time could allow those whose jobs are affected more of a chance to better understand how to harness the technology, and give more opportunity to retrain or do something else where necessary. The regulatory structure could be especially important in terms of the speed and extent of transformation in some industries. Scenario analysis seems a valid way at this stage to think about and approach the opportunities and threats AI poses to the global economy.

AI could be a productivity enhancing development and a vehicle that speeds up discovery in all sorts of fields. Harnessing the power of AI could boost global output substantially. Evidence so far is clearly limited, but there have been some academic studies suggesting large productivity improvements in some areas (for example, a study finding that customer support agents using an AI tool show a 14% increase in productivity with large gains for the lowest skilled/least experienced though zero or small effects on the most experienced/able workers).

In a less positive scenario, the technology develops very quicky in a way that moves ahead of governments' ability to regulate but also of people's capacity to adapt to the new technology in a relatively non-disruptive way. Economist Anton Korinek , in an IMF publication, (link) runs through three scenarios centred around how long it takes for artificial general intelligence (AGI) – AI that can perform any intellectual task that a human can – to be realised. In the scenario where this happens on a five-year horizon, scarcity of labour is no longer a constraint on output, output can rise substantially… and wages plummet. If such a scenario were to materialise, that would come with implications for many spheres of the economy, not least tax revenue.

Climate and the economy: On the watchlist

For now, food-related commodity prices are well below their 2022 peaks, but we are not out of the woods yet. This year has already brought significant weather disruption including the Dubai storms that resulted in almost a year's rainfall in 24 hours. El Nino effects may be worsened by climate change and this year has seen an El Nino event; Price effects may take more time to feed through (see, for example, work done by the ECB). In the UK, farmers report problems related to historically wet weather (see, for example, FT). More generally I continue to worry about the impact of climate change on prices through impacts on agricultural prices in particular but also on productivity and via transition costs as companies adapt to changing weather patterns and economies incur near-term costs associated with attempts to lower carbon emissions. Climate change is a key reason why I have pencilled in medium-term central inflation forecasts that tend to hover above a little above target in major economies.

United States: Can the Fed really cut rates?

US activity growth seems to have slowed somewhat after a strong second half of 2023. A few recession indicators still stubbornly flash warning signs. My central forecast assumes that GDP growth remains slower than in late 2023. With the Fed signalling they are in no hurry to cut rates, financial conditions are somewhat tighter compared to late last year. Growth should also get somewhat less of a boost from fiscal policy. However, with data still painting a picture of reasonable/solid activity and job generation and with a sequence of upside inflation surprises in the first months of 2024, a Fed hike is no longer a far-fetched scenario for 2024. I still think they will cut, but less and later than a few months ago.

Status update: Soft patch…?

Real GDP growth was very strong in H2 2023, then slowed in Q1 2024 (albeit domestic demand indicators looked stronger than the headline). ISM and PMI business surveys, however, have looked consistent with more sluggish activity growth than the GDP figures for most of the past twelve months though perked up in May (Chart 21). Housing-related activity has cooled substantially from post-pandemic peaks. Non-farm payroll gains have been robust on average, but the unemployment rate has risen. Consumer confidence remains below pre-pandemic levels. Small business sentiment remains relatively downbeat. The activity data, on the whole, though aren't consistent with the US economy slowing substantially.

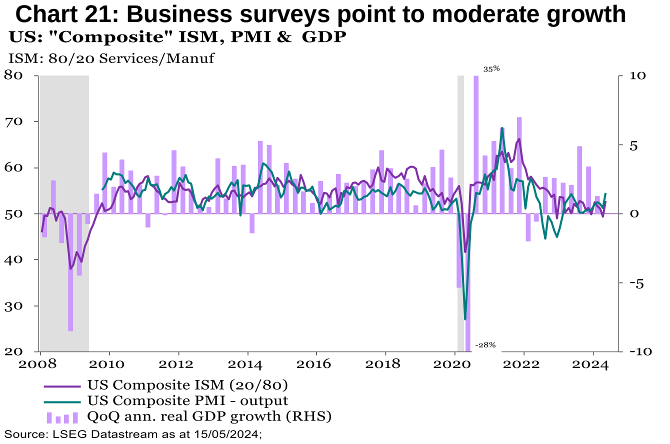
Rate cuts need a sequence of more reassuring inflation data (or a proper recession)

The US central bank has a dual mandate, and is no longer overwhelmingly focused on the inflation side of that mandate now that inflation has fallen substantially from its peak. However, the labour market picture hasn't deteriorated enough for that to dominate decision-making either. It isn't impossible that a recession knocks the labour market entirely off course, as the impact of monetary policy on credit conditions (Chart 7) and debt service hits with a lag, just unlikely at this stage. It is also possible to paint a scenario where sticky inflation and a resilient economy leave the Fed keeping policy restrictive enough for long enough, alongside expiry of the Trump era tax cuts perhaps, that mean a late 2025/2026 recession isn't a far-fetched scenario either. For now, however, the most likely trigger for rate cuts is a rebuild of evidence that inflation is heading *sustainably* towards a 2% inflation target. That probably means core inflation of around 0.2% month-on-month or less for several months in a row. Recent robust immigration boosts the chances that the US can grow at a decent pace (Chart 22) without generating strong inflationary pressure (by boosting labour supply).

So, will US inflation start behaving itself? Probably

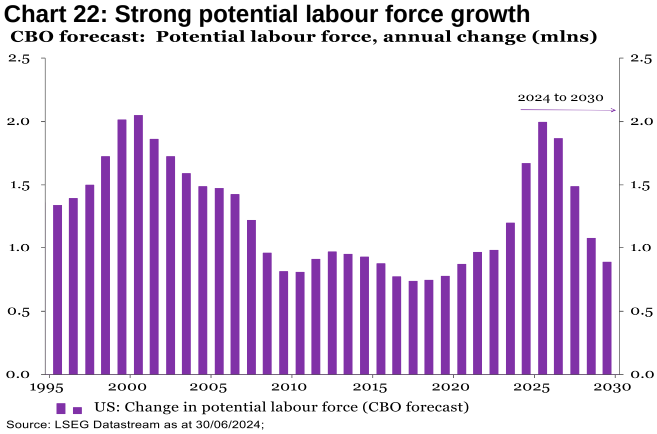
In my central case, the Fed experience enough months of inflation-target-consistent core/super-core inflation, especially on the PCE measure, that they start being able to contemplate rate cuts again before the end of Q4. That needs inflation data to look more reassuring in short order though, including a return to core inflation measures annualising around 2% (Chart 23). I am not counting on core goods inflation to help cool inflation *much* further – the bulk of gains appear to have fed through already (Chart 9). Pay growth at least looks more inflation-target consistent than it does in the euro area or UK already, likely helped by stronger-than-expected immigration. Lower past energy inflation can still feed through into lower services inflation (Chart 24). Meanwhile some of the drivers of recent strong inflation are likely to be temporary, for example vehicle insurance where we are partly seeing lagged effects from the post-pandemic rise in car and car parts prices.

Chart 21: Business surveys point to moderate growth



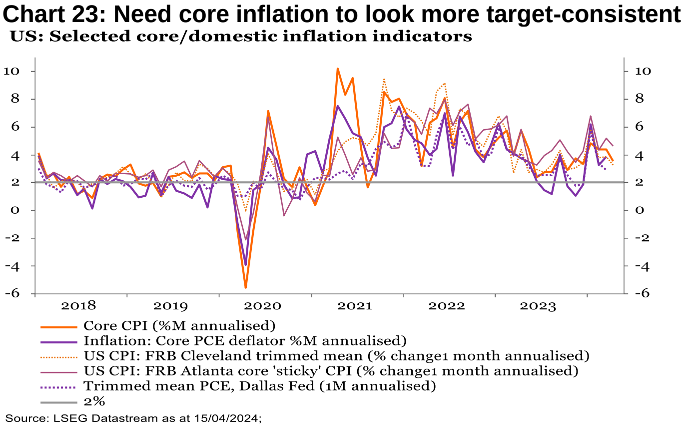
Source: LSEG Datastream, BEA, S&P Global, ISM. Data to Q1 2024 (GDP), May 2024 (PMIs, ISMs).

Chart 22: Strong potential labour force growth



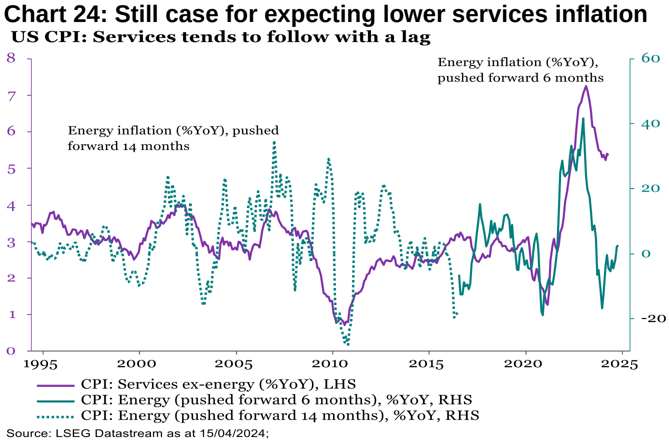
Source: LSEG Datastream, CBO. Forecasts from February 2024.

Chart 23: Need core inflation to look more target-consistent



Source: LSEG Datastream, BLS, BEA, Federal Reserve banks. Data to April 2024 except Dallas Fed and PCE measures (March 2024).

Chart 24: Still case for expecting lower services inflation



Source: LSEG Datastream, BLS. Data to April 2024.

China: Still worried about the medium term

China's economic data remains mixed, though policymakers continue to provide support. My forecasts assume that policy support is insufficient to sustainably lift China's growth rate by much and still show slower growth in the medium term. That forecast assumes that authorities fail to pursue a more domestic-demand centric growth path and that demographics start to drag more.

Status update: Patches of weakness

Q1 GDP was stronger than expected (5.3% year-on-year), but retail sales figures have had a tendency to disappoint; aggregate financing growth has weakened. The May composite NBS PMI was above 50. Still, recent data disappointments, alongside very low consumer price inflation and continued falls in house prices, help support analyst calls for more policy easing.

Continued growth challenges

Property still in focus: Low consumer confidence (Chart 25) is likely still being partly fed by problems in China's property sector and falling house prices. If policy easing and piecemeal interventions continue to fail to solve China's property problems and to significantly lift the overall growth rate, that lack of confidence may persist. With a lack of confidence is likely to come a reluctance to run down savings that could have more substantially boosted consumer spending. The property market has also bolstered local tax revenue over the years so that continued issues in the property market can also hold back the impact of wider government spending by limiting the availability of local government funds.

Long-term challenges remain substantial: Long-term challenges facing China still include an overhang of private sector debt and population ageing (Chart 26). Working age population growth has been negative for several years. China's stance towards Taiwan continues to present a risk to China's economic outlook should any action against Taiwan prompt a deterioration in economic relations elsewhere. China's authorities are pursuing a focused industrial strategy which may or may not have picked the 'right' industries and/or at the expense of spending on other strategies that might have been more successful at generating sustainable growth.

Policy still supportive: December's Central Economic Work Conference (CEWC) acknowledged that China's economy faced challenges and laid out several steps aimed at maintaining stability and promoting 'high-quality' growth including expanding domestic demand. Actions in Q1 included the PBoC cutting the five-year loan prime rate (LPR) by 25bp to 3.95% (a key benchmark rate for mortgages). The authorities published an "around 5%" growth target – arguably somewhat ambitious given the strong base (GDP grew 5.2% in 2023), but a little less so after relatively strong GDP growth in Q1. Fiscal plans were adjusted. Inflation remains low, allowing room for more monetary policy easing even if authorities remain wary of stoking financial stability risks.

To the extent China exports deflation, that could be helpful in dampening inflation elsewhere and might be welcomed in that respect at least by US and European economies. However, the big deflationary impacts of the early 2000s are not set to be repeated and China's producer price inflation looks to have troughed in 2023.

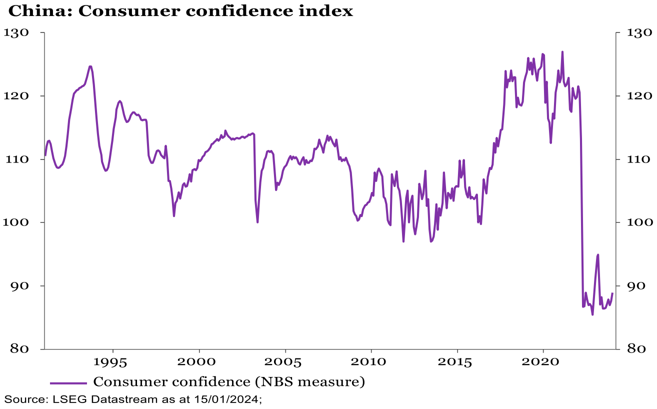
US election risks

Whether Biden or Trump win the US presidency, the US-China relationship is likely to remain challenging. Biden has recently raised tariffs on a number of Chinese goods although the direct impact of those moves on the Chinese economy looks limited given the small percentage of Chinese exports those represent. Currency movements and trade diversion to (and through) other economies can ameliorate the impact. However, China's share of US imports has been dropping and Trump has said he will put a 60% tariff on imports from China. A Trump presidency seems unlikely to improve sentiment around China's economic outlook and US officials are also likely to be alert to any attempts to work around tariffs (Trump has also threatened 100% tariffs on Mexican-made cars by Chinese firms). With China's industrial strategy leading to industrial dumping worries elsewhere, the US may not be the only economy imposing tariffs or taking other action against China either, e.g. rules of origin requirements for broader imports.

Policy action needed

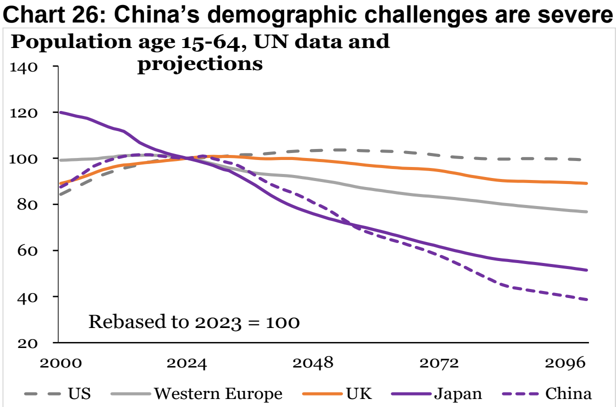
There seems to be widespread agreement among China analysts that further policy stimulus and support for the economy is necessary. Further monetary policy action seems likely but with inflation already low there isn't an obvious trigger for the pace of easing to step up. China's authorities continue to have multiple levers they *can* pull but potentially painful structural reforms that could jolt the economy don't look a high probability. In the meantime, a large chunk of China's current economic problems appear tied to the property sector, but policy action there seems relatively piecemeal.

Chart 25: Still weak consumer confidence



Source: LSEG Datastream, NBS. Data is to March 2024 .

Chart 26: China's demographic challenges are severe



Source: LSEG Datastream, UN. Data updated February 2024.

Euro area: How far will the ECB really cut rates?

The euro area economy looks to have bounced in Q1 after a very mild recession in the second half of 2023 and business survey data suggests that positive growth is on track to continue in Q2. The ECB cut rates in June, but prospects beyond that look murkier especially without further substantial progress being seen on pay growth and on services inflation. In my central case, positive real pay growth and rate cuts should support GDP growth in 2024 through 2025. However, less supportive fiscal policy and the cumulative effects of past rate hikes, including the tightening in bank lending conditions, are likely to act as a restraint.

Status update: Out of recession, but surveys send mixed messages on momentum

After back revisions, the euro area looks to have experienced a very mild technical recession in the second half of 2023 with back-to-back 0.1% quarter-on-quarter declines in GDP, followed by stronger-than-expected GDP growth in Q1 (0.3% quarter-on-quarter). Having slipped below the 50 ‘no growth level’ in July 2023, the composite PMI business survey indicator started to signal positive growth in March 2024, but that improved further in April and May and is now at the kind of levels seen pre-pandemic in 2019 (characterised by OK-ish positive growth). The European Commission’s economic confidence indicator, however, continues to signal a weaker picture.

Inflation – more or less encouraging for the ECB?

Alongside that more upbeat picture for activity and still very low unemployment rate (by euro area standards), headline inflation is a bit above target consistent levels month-on-month (Chart 27) and services inflation remains high year-on-year (Chart 12), as does pay growth (Chart 13). Productivity growth has also been weak. An upturn in activity against the backdrop of what appears to be a still tight labour market could see pay growth remain at uncomfortably high levels. On the more encouraging side (from an ECB perspective) pay growth at least looks to have peaked. Lower headline inflation should help pay settlements slow. Services inflation, however, has still to sustainably fall below the 4% year-on-year mark having been stuck there for most of the past six months.

I still expect that the ECB have started what will prove a gradual, careful rate cutting cycle in June 2024, but risks are skewed towards them doing less and more slowly than the central forecast. With the unemployment rate at such low levels (by euro area standards), a continued bounce out of recession may lead to stronger-than-expected inflation. ECB messaging at their June meeting remained ‘data dependent’ and they did not signal any urgency around a further rate cut (which makes sense given activity data picking up, headline year-on-year inflation still above target and strong services and pay inflation).

Growth may still disappoint, but there are some upside risks too

Business surveys aren’t at strong levels and business sentiment may be vulnerable to changes in sentiment around the ECB; The market may push expected rate cuts back. Other sources of weaker growth could include the cumulative effect of tighter bank lending conditions in recent quarters; the last ECB lending survey showed what appeared to be a sizeable drop in credit demand from companies in Q1 (Chart 28). Bank lending remains the dominant source of debt financing for firms in the euro area – especially smaller ones, but at least bank lending standards no longer appear to be tightening much (Chart 7).

The manufacturing sector in the euro area still seems to be struggling compared to the services sector. The euro area manufacturing PMI for example remains below 50. As of March, the level of manufacturing production wasn’t above pre-pandemic levels. Any turn in the global inventory cycle could be helpful for euro area manufacturers but may only provide a short-term boost.

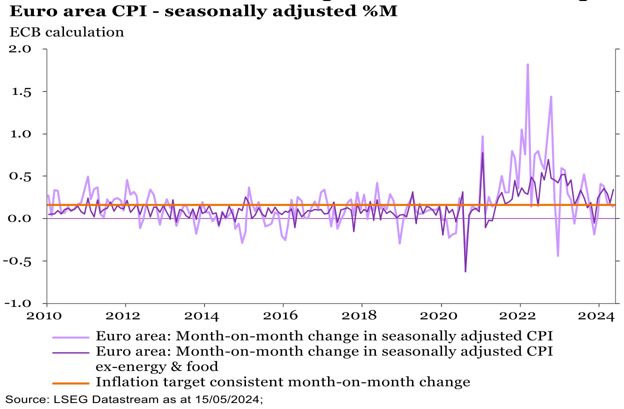
Upside risks to euro area growth arguably come from the consumer. Real pay growth is positive and unemployment rates still very low by euro area standards. Unlike the US, savings rates have not continued to drop in the aftermath of the pandemic. Savings rates still don’t look ‘normalised’ and could provide a source of upward consumer spending momentum if they were to normalise. Consumer confidence isn’t high, but has improved dramatically in the euro area from its 2022 lows. Combined with the onset of rate cuts, that could help persuade euro area households to save less.

Longer-term challenges linger too though with adverse demographic trends (Chart 26) and with business and innovation potentially hampered by incomplete capital markets union and a lack of harmonised regulation in some areas across the region.

Fiscal drag

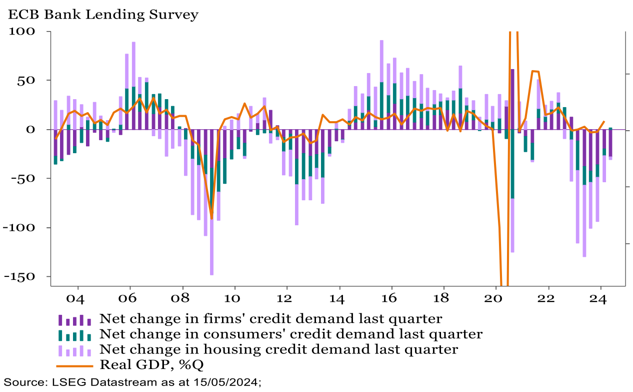
Fiscal policy looks set to drag on growth (Chart 17). Although Next Generation funding will still be flowing into investment spending, my forecasts don’t assume that adds to *growth*. Meanwhile, agreement on the fiscal framework means the restart of ‘excessive deficit procedures’ (EDP) for some economies and pressure for fiscal consolidation. More borrowing at EU level could be a welcome development to help fund the green transition, for example, but appetite seems limited for now. EU elections may help shift priorities, for example onto industrial policy and release more funding for initiatives, but it is also plausible that institutions are left more divided.

Chart 27: Inflation above target consistent levels again



Source: LSEG Datastream, ECB (data to April 2024).

Chart 28: Business loan demand still weak



Source: LSEG Datastream, Eurostat, ECB. Data to Q1 2024 (GDP), Q2 2024 (credit demand).

Japan: More hikes?

The Bank of Japan finally raised rates in March. Japanese policymakers continue to signal that they want more evidence that Japan will be able to sustainably hit its inflation target and are not signalling that the March hike was necessarily the start of a rate hiking *cycle*. Inflation remains high by Japan standards but it is not yet clear that Japan's inflation dynamics/expectations have shifted upwards in a lasting way. Currency weakness has complicated things and adds to pressure for another hike.

Status update: Mixed

Measures of inflation remain elevated in Japan – by Japan standards (Chart 29). Notably, services inflation remains around 2% year-on-year and so-called 'core core' inflation (inflation less fresh food and energy) is still above 2% even if it has cooled. The picture coming from business surveys and some of the hard data has been mixed (Chart 30), with more upbeat surveys but mixed hard data. First quarter GDP fell by more than expected (-0.5% quarter-on-quarter). Although the fall looked driven by temporary factors (disruption to production in the autos sector in January), Q1 consumer spending was disappointingly weak. Recent business surveys suggest growth is on track to bounce in Q2 though, and consumer confidence remains well off its 2022 lows. Higher real pay growth should support consumer activity ahead (Chart 5).

Policy settings remain accommodative after the rate hike with the policy rate at very low levels and the March rate hike arguably more symbolic than economically meaningful. Bond yields have risen over the last couple of years, but remain well below levels seen in other developed economies and real rates are negative. Fiscal policy remains supportive after the November fiscal stimulus, with debt sustainability worries for now contained by low bond yields and high BoJ levels of JGB ownership alongside good nominal GDP growth. As ever, however, given how low Japan's real trend GDP growth still is, there is still a good chance of another negative GDP growth quarter over the next few quarters.

Longer-term change

Wage settlement indicators were strong enough to see the BoJ hike rates in March, but it still feels too early to be sure that Japan's inflation dynamics have sustainably shifted upwards. Diffusion indicators show that the proportion of prices that are rising remains very high, but has been falling (Chart 29). Inflation expectations on the Tankan survey measure remain above 2% which is encouraging, but it may take another year's pay settlements and inflation expectations figures to really build a more convincing narrative around longer-term change. However, so far indications are promising that a more positive price-wage cycle is developing.

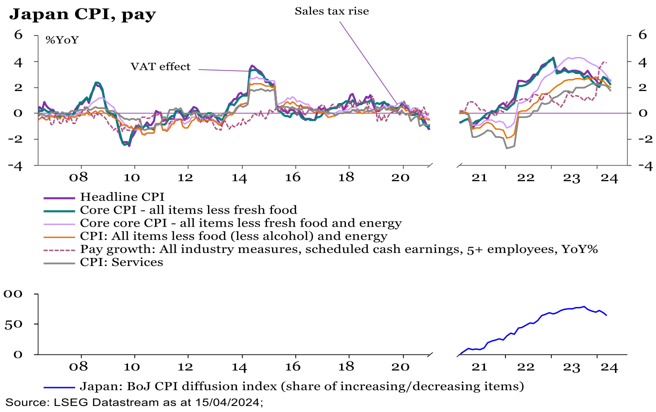
Changes ongoing in labour market practices should help improve productivity growth, which, alongside improved female labour participation and subsequent higher trend growth, could also help ease some of Japan's longer-run overhanging fiscal risk and encourage investment in Japan while offsetting some of Japan's ongoing demographic challenges; the 'working age' population aged 15-64 has continued to decline (Chart 26).

Even higher rates?

In March, as had been looking more likely after recent strong wage settlement figures, the Bank of Japan decided to finally raise their policy rate out of negative territory. From -0.1%, the BoJ announced a new target range of 0.0-0.1%. They also scrapped the yield curve control programme. It makes sense for the BoJ to adopt a cautious approach to tightening monetary policy given the very long period of low inflation that Japan has only recently emerged from. Markets are already testing Japanese authorities' limits, however, with persistent currency weakness (Chart 31) being met with assumed intervention in late April. Unless currency weakness feeds through visibly into higher inflation pressure, I am not assuming that currency weakness itself is the trigger for another rate hike though.

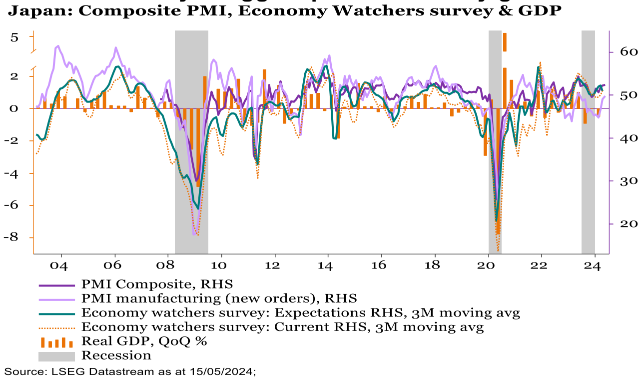
Having raised my inflation forecasts modestly, I have pencilled in another couple of rate hikes into my forecast for the BoJ over the next couple of years, but see two-way risk to that assumption depending how the data evolves. My medium-term inflation forecasts are not strong enough to justify a big hiking cycle, but the longer inflation and wages stay at more inflation consistent levels, the higher the chance that Japan's longer-run fundamentals have changed and my forecasts are too conservative.

Chart 29: Core core and services inflation above 2%



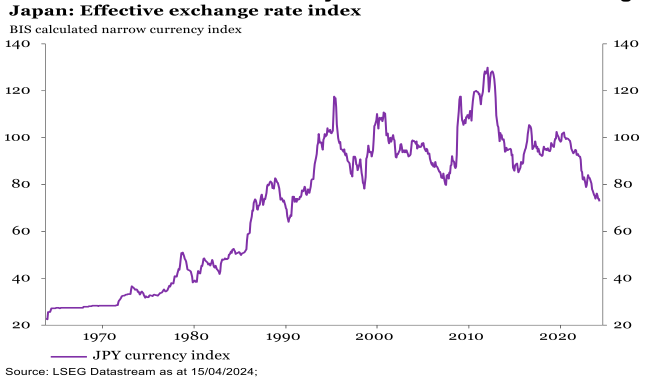
Source: LSEG Datastream, Ministry of Internal Affairs & Communication, Ministry of Health, Labour and Welfare, Bank of Japan as of April 2024 (pay series to March 2024).

Chart 30: Surveys suggest positive activity growth



Source: LSEG Datastream, S&P Global, Cabinet Office. GDP data is to Q1 2024, Economy Watchers to April 2024, PMI to May 2024.

Chart 31: Persistent currency weakness a BoJ challenge



Source: LSEG Datastream, BIS. Data to April 2024.

United Kingdom: Out of recession

The UK was in a mild technical recession in H2 2023 and emerged from that in Q1 with a stronger growth rate than I'd anticipated. I don't expect the Bank of England to cut rates until Q3 with them likely to need more convincing that upside inflation risks have faded, especially if the activity data show signs of picking up again. Positive real pay growth and additional fiscal support have improved the outlook and there are potential upside risks to consumer spending. I am still not expecting a sustained, significant pick-up in growth rates this year beyond Q1, however. Neither am I expecting the general election to be an economic gamechanger.

Status update: Bouncing out of recession

After a mild technical recession in H2 2023, the UK economy bounced more strongly than expected in Q1 (0.6% quarter-on-quarter). Meanwhile, the PMI composite business survey points to continued positive growth in private sector activity (Chart 32) in Q2. There are some weaker spots in the data, including indicators of falling employment. While headline inflation has fallen substantially, 'domestic' underlying inflation still looks a bit too strong for (central bank) comfort and I assume a rate cut in August 2024 rather than sooner.

Positive pay growth, rate cut expectations and temporary fiscal boosts

There are plenty of things that can support UK growth near-term. The UK government has been adding near term fiscal stimulus including in the form of tax cuts for households. Household savings rates have room to fall back to pre-pandemic levels which would boost spending further. Wage growth remains above inflation levels and that gap should continue to help households claw back some of the real spending power they lost when inflation surged. The ONS measure of aggregate real household disposable income is already back at 2021 peaks; the OBR estimate of household disposable *labour* income (arguably more relevant as a measure for many families and in terms of reflecting liquid available resources), once I deflate it by CPI, is improving though still below previous peaks (Chart 33). Benefits upratings, state pension increases and the near-10% increase in the minimum wage this year will help. Falls in employment have been modest so far. Meanwhile, consumer confidence remains well off its lows and mortgage rates are below their recent highs.

The UK election on July 4 is widely expected – given current polls – to bring a change in government. Depending on size of majority that may bring expectations of a period of relative political stability and of closer relations with Europe, though I am not expecting it to substantially change the UK economic outlook given the fiscal constraints any incoming government will be under the relatively centrist nature of both main parties' current platforms.

Several things limit likely growth though. Fiscal plans still indicate future tightening. As nominal incomes rise, net gains to households are dented by households moving onto higher tax bands. Lower rates this year would bring lower interest income for savers. As elsewhere, business sentiment and optimism may be dented if the BoE fails to cut rates as expected. Business insolvencies remain at high levels for now; though that will partly reflect high levels of business formation during the pandemic period, it may also indicate some pressure from higher costs and interest rates – the BoE in their latest Monetary Policy Report note weak SME lending with firms still repaying borrowing under Covid loan schemes.

The UK still faces significant long-term challenges including projections for falls in working age population and fiscal challenges (longer-term OBR fiscal estimates still describe UK finances as on as on an unsustainable path and current government projections for the fiscal deficit build in what look like very tough – potentially unrealistic – spending settlements while public services are already under strain). Productivity growth remains weak.

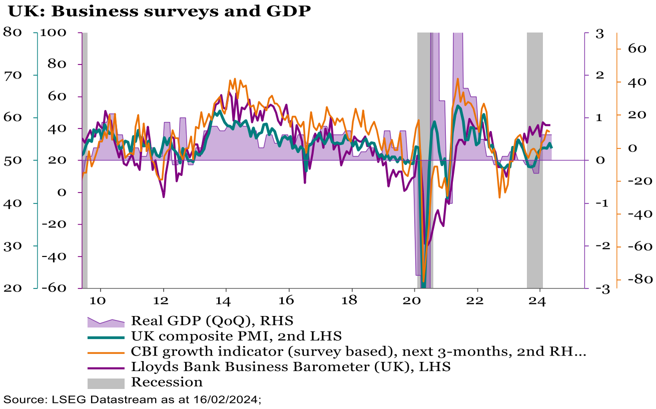
Inflation: Back to target, but how sustainably?

The forecasts assume that CPI stays around 2% year-on-year over April-June 2024. Energy inflation has fallen significantly. Core goods inflation may fall a bit further, but the bulk of that shift looks to have already taken place given the usual relationship with producer price/import prices (Chart 9).

The bigger question is still around services where, to sustainably hit a 2% inflation target, it makes sense for the BoE to want services inflation around 3%, not 6% (Chart 15). Lower headline inflation, labour market loosening and lower energy price inflation should help see lower pay settlements and services inflation respectively, but my forecasts do not assume that UK inflation stays comfortably at 2%.

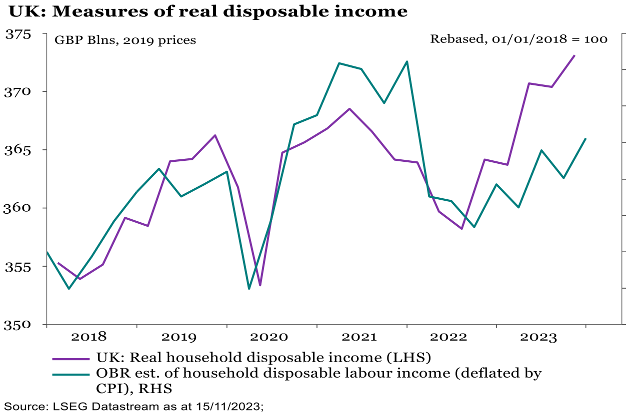
Recent BoE business survey data (the Decision Makers Panel) suggested that in Q1 2024, firms' expectations for wage growth over the following 12 months were 4.9%; a lot lower than in 2023. However, given the UK's history of woeful productivity growth, pay growth much above *3%* might be considered 'too high' to be inflation target consistent. Meanwhile, though the unemployment rate has risen, past periods haven't shown a clean relationship between wage growth and the unemployment rate. The UK's limited potential growth rate (low productivity growth and ageing population) and loss of labour supply flexibility post-Brexit may make the economy prone to domestically driven inflation. Much may also end up depending on two key questions: 1) How much labour hoarding there has been? The Bank of England think there has been some over the past year. That could mean a pick-up in activity would not necessarily result in more hiring and a tighter labour market. 2) How far do increases in input costs get passed onto consumer prices? If consumer demand is picking up and consumers are more confident, they might also prove more willing and able to accept price increases.

Chart 32: PMIs consistent with continued growth



Source: LSEG Datastream, ONS, CBI, Lloyds, S&P Global. Data is to April 2024 except PMI which is to May 2024 and GDP which is to Q1 2024.

Chart 33: Household real disposable income improved



Source: LSEG Datastream; ONS, OBR estimate. Data to Q4 2023 (LHS), Q1 2024 (RHS).

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Investment risk: The value of investments and any income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

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