2015 – The UK recovery to face a potential new administration? Will it make a difference?

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The global outlook – the changing fortunes for the big 4 economies

	GDP		
	2013 (A)	2014 (F)	2015 (F)
US	2.6	**1.7**	**2.8**
Euroland	-0.4	**0.8**	**1.3**
UK	1.7	**3.0**	**2.3**
India	4.6	**5.4**	**6.9**
China	7.7	**7.7**	**8.1**
Japan	1.7	**1.6**	**1.1**
Australia	2.4	**2.6**	**2.1**
South Africa	2.2	**2.6**	**3.9**

- *A lack of inflation in any of the major countries should be a detractor against early rate hikes, shouldn't it?*
- *Concerns over financial stability and some asset price inflation may prompt action earlier in 2015 than some expect.*

- *Some headwinds to growth still exist in the global economy, but better momentum is being generated in the UK, US and parts of Asia.*
- *Euroland is the outlier, with growth moving in the wrong direction and deflation worries growing.*
- *Cheap energy in the US could propel the economy to faster investment growth, whilst also supporting stronger consumption.*

	Policy Rate (%) - end period			
	2013 (A)	2014 (F)	2015 (F)	2016 (F)
US	**0.1**	**0.1**	**1.0**	**2.0**
Euroland	**0.3**	**0.1**	**0.1**	**0.1**
UK	**0.5**	**0.5**	**1.0**	**1.5**
India	**7.0**	**7.8**	**7.0**	**7.8**
China	**6.0**	**6.0**	**6.0**	**6.8**
Japan	**0.1**	**0.1**	**0.1**	**0.1**

Tables source: RBS

The UK economy – Downgrades to the BoE's projections

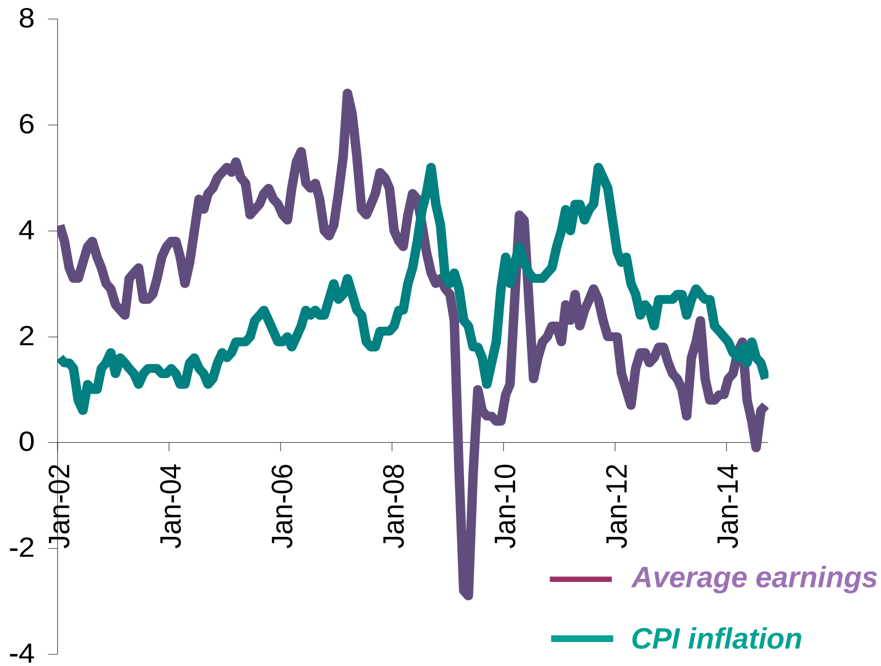
	2014 Q1	2014 Q2	2014 Q3	2014 Q4	2015 Q1	2013(A)	2014(F)	2015(F)
	%q/q					annual change (%)		
Consumers' expenditure	0.7	0.6	0.5	0.5	0.5	1.6	2.1	2.0
Government consumption	-0.3	1.0	0.4	0.3	-0.1	0.7	1.2	0.2
Fixed investment	2.4	1.3	1.5	1.5	0.9	3.2	7.9	5.0
GDP	0.7	0.9	0.8	0.7	0.5	1.7	3.1	2.3
	see row for measure					see row for measure		
Unemployment rate (%)	6.8	6.4	6.1	5.9	5.8	7.6	6.3	5.8
CPI (%y/y)	1.7	1.7	1.5	1.5	1.5	2.6	1.6	1.8
Policy rate (%)	0.5	0.5	0.5	0.5	0.5	0.5	0.5	1.0

Source:RBS

- *Manufacturing growth has recently slowed sharply and surveys point to slower growth from all major sectors.*
- *Private investment and consumers' expenditure should drive growth, with government spending slowing through 2015.*
- *Weak global growth undermines the prospect of the trade deficit improving.*
- *The UK labour market should continue to print impressive jobs growth, although expect a slowing in progress in 2015.*
- *There remain concerns over current account imbalances, which show little signs of correcting.*
- *Fixed investment growth has picked up, but remains well below its pre crisis peak.*

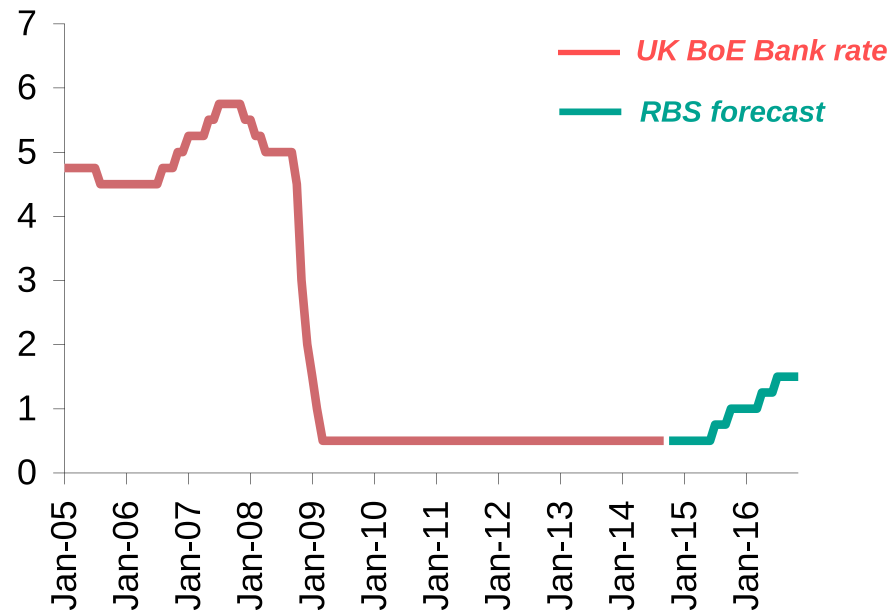
Monetary policy – inflation subdued

Inflation & average earnings (%y/y)



Source: ONS

BoE Bank rate, %

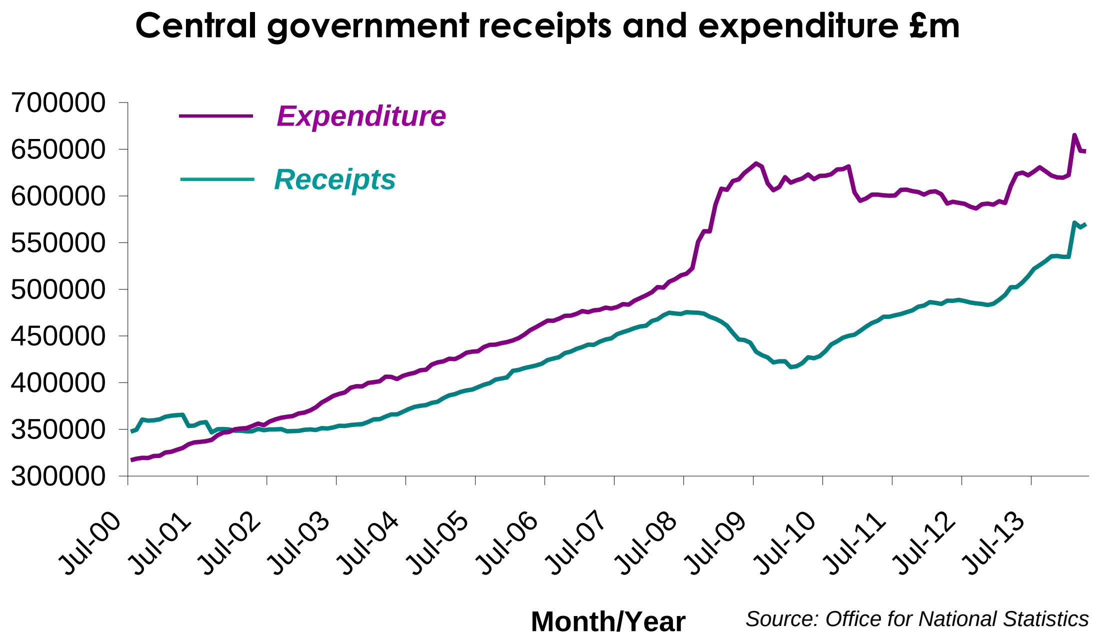


Source: BoE & RBS

- *CPI inflation has been heading lower over recent years, but continues to head lower, reaching 1.2% in the latest reading.*
- *Weak inflation expectations and average earnings growth remain a key constraint arguing against UK rate hikes.*

- *The Bank of England will continue to stand pat on policy until domestic inflation pressures pick up and more of the spare capacity is used up.*
- *RBS expects rates to remain on hold until Q3 '15.*
- *Even when rates do rise, increases are likely to be slow in materialising.*

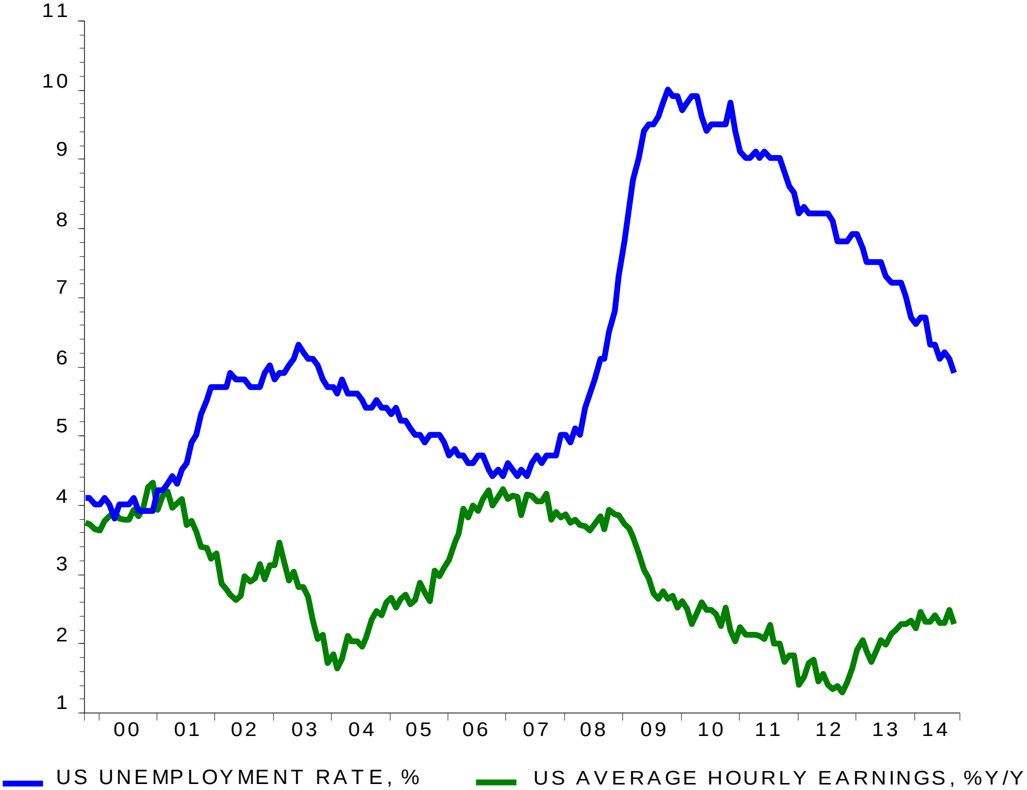
The public finances – austerity will persist



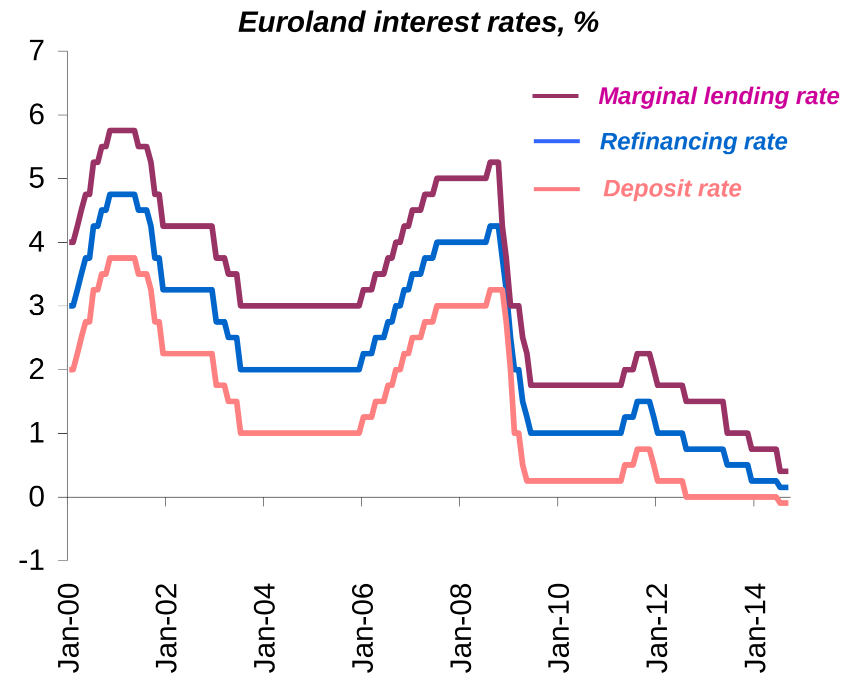
"We still have to deal with the structural element of the deficit" – Nick Clegg, CBI Annual Conference Nov 2014

- *The problems with the public finances was how slowly receipts recovered in the first half of the last decade, as well as the explosion in spending in H2 '00s.*
- *Receipts as a percentage of GDP have remained remarkably stable over recent cycles, within a point or so of 38% during upturns and downturns.*
- *But in spending that figure has fluctuated wildly, from 34% - just <50% at the height of the financial crisis.*
- *Austerity is here to stay until spending slows to meet revenues or revenues pick up.*
- *Expenditure is expected to drop by 1% in FY '15/16 in real terms, according to OBR forecasts.*

Euroland/US – the ECB bring out credit easing/the US to raise rates



Souece: Bureau of Labor Statistics & Datastream

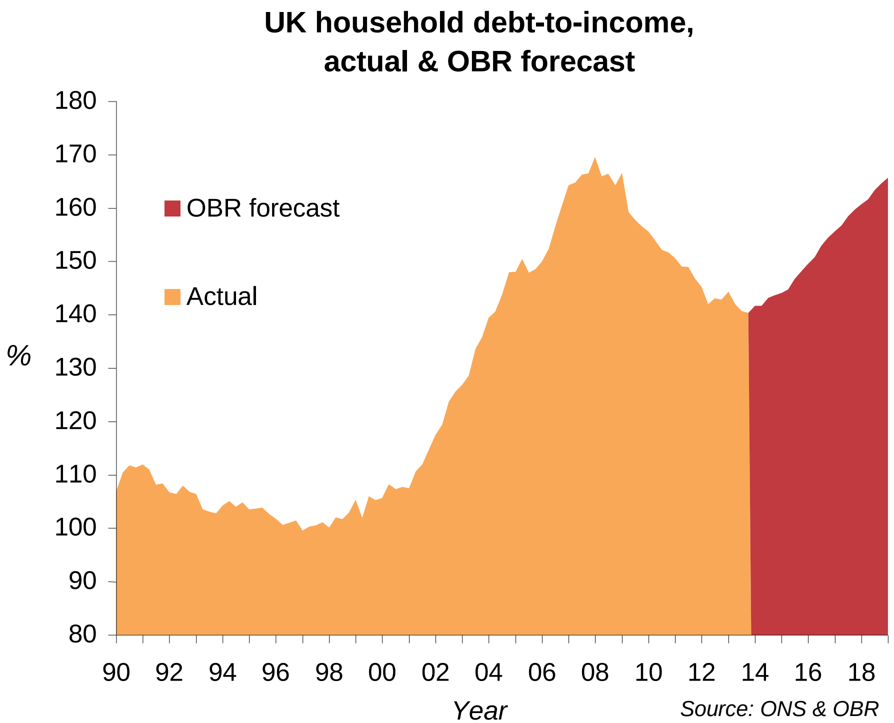


Source: ECB & Datastream

- *US QE3 finished at the end of Oct, having added just shy of $0.8 trillion to total assets.*
- *How quickly will the Fed decide to tighten is then the question. We think that a rate hike will come in Q2/Q3 2015, thanks to the improving labour market.*

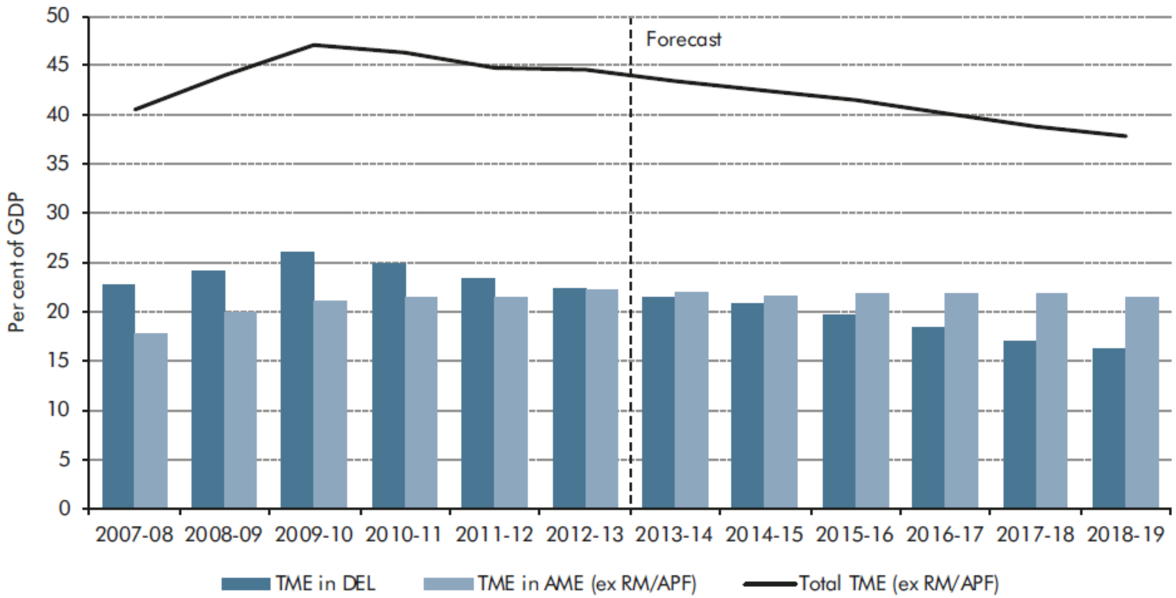
- *By contrast, Euroland has a deflation problem that seemingly isn't going away. The ECB have had to deal with this through further rate cuts (deposit rate now below zero) and credit easing. THIS IS NOT ENOUGH.*
- *We note the deflation issues are coupled with growth problems also. Not a healthy mix for fixing the Euroland public finances!*

Household leverage – a limit on the peak in official rates



- *With debt to income levels still elevated in personal finance (and similar issues in corporate debt), the Bank of England will be limited in how high rates can rise.*
- *Projections from the OBR (Office for Budget Responsibility) suggest leverage levels will climb once again.*
- *If house price rises don't moderate, and or earnings rise more quickly than current rates, then we believe debt leverage on secured borrowing will climb.*
- *Concerns over lending aside, construction and manufacturing output remains well below its pre crisis peak.*

The general election – will it change the economic outlook?



Source: ONS, OBR

AME = Annual Managed Expenditure

DEL = Departmental Expenditure Limits

TME = Total Managed Expenditure

- *Note that under this administration the share of government spending that is AME (viewed as fixed), has steadily increased.*
- *All sides of the political spectrum are arguing for ring-fencing of one or more elements of spending that are currently in DEL.*
- *That means it is likely that the 'unprotected' areas of spending will take a further sharp hit to spending in the next parliament.*
- *The downside risks to spending are irrespective of which party/parties win power in 2015, and there is relatively little debate that the cuts envisaged in the OBR forecast are accurate.*
- *Some parties suggest raising further taxes will help close the structural deficit. We are unconvinced.*
- *Overall government spending, as a % of GDP will have to drop to below 38%, which given AME commitments will squeeze DEL further.*

Summary

- ***Global growth is recovering.*** *However, Euroland is moving in the wrong direction and deflation risks are building. The credit easing sanctioned by the ECB is still insufficient, in our view, to bring about recovery.*

- ***The UK is performing strongly.*** *Growth is expected to be 3.0% in ’14, and 2.3% in ’15 (with modest upside risks to 2015).*

- ***RBS expects UK rates to rise in August 2015****. However, there is a perceived risk of an earlier rise, perhaps in Q1 ’15.*

- ***UK fiscal deficits have stalled,*** *and the structural overspend in the public finances persists. Austerity will remain in place whatever the government in 2015.*

- ***What happens in Euroland could continue to affect the rest of the world, and weak demand, labour markets and prices undermines others recoveries.*** *US growth is expected to strengthen, and US monetary policy ‘normalise’ over the coming 1-2 years.*

- ***The UK Bank rate is likely to peak far lower than in previous cycles*** *because of levels of personal indebtedness. The interconnectedness of consumption and investment means a peak of likely no more than 3%.*

- ***Whoever wins the next general election will have a major problem on their hands****. Departmental spending will suffer disproportionately in any future attempts to bring budgets into balance.*

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