

### Arlingclose Treasury Advisors - Latest Economic Commentary and Outlook

**Economic background:** Commodity prices fell during the quarter, although oil prices rose, peaking at \$75 a barrel before falling slightly to just over \$73. The primary factor in the oil price's recent fall was the OPEC's (Organisation of Petroleum Exporting Countries) announcement that a deal had been reached with non-OPEC nations to increase nominal production by 1 million barrels a day.

UK Consumer Price Inflation (CPI) index fell over the quarter and the data released for May showed CPI at 2.4%, a 12-month low. The most recent labour market data for April 2018 showed the unemployment rate at 4.2%, a low last seen in 1975. However real wages (i.e. adjusted for inflation) grew only by 0.4%, a marginal increase unlikely to have had much effect for households. Q1 GDP data released in April and revised in May showed economic activity slowing to 0.2%. The Bank of England made no change to monetary policy at its meetings in May and June, however hawkish minutes and a 6-3 vote to maintain rates have raised expectations of a rate hike at the August meeting.

Having raised rates in March, the US Federal Reserve again increased its target range of official interest rates in June by 0.25% to between 1.75% and 2% and markets now expect two further rises in 2018.

Fears rose of a global trade war on the announcement of the Trump Administration implementing tariffs on \$200bn of imports, notably steel, aluminium, food and chemicals. Canada, the EU and China contemplated announced retaliatory tariffs as did Mexico. Many of these have since been instituted in early July. The announcements sparked a sell-off in global equity markets, with the major equity global indices falling.

The EU Withdrawal Bill, which repeals the European Communities Act 1972 that took the UK into the EU and enables EU law to be transferred into UK law, narrowly made it through Parliament, with a vote of 319 to 303, after the government gave assurances that Parliament would have a meaningful vote in the event of a no-deal Brexit. Very little progress was made in negotiating future trading arrangements, extending the period of uncertainty.

**Financial markets:** Gilt yields displayed marked volatility during the quarter, particularly following Italy's political crisis in late May when government bond yields saw sharp moves akin to those at the height of the European financial crisis with falls in yield in safe-haven UK, German and US government bonds. The yield on the 5-year benchmark gilt fell from 1.13% to 1.04% during the quarter, the 10-year gilt fell from 1.36% to 1.28% and the yield on the 20-year gilt rose marginally from 1.71% to 1.72%. Money markets rates remained low: 1-month, 3-month and 12-month LIBID rates averaged 0.38%, 0.55% and 0.84% in the quarter respectively.

**Credit background:** UK bank credit default swaps rose marginally over the quarter, but the overall level was still low against historic averages.

There were a few credit rating changes during the quarter. Moody's downgraded Barclays Bank Plc's long-term rating to A2 from A1 after the banking group completed its restructure to be compliant with UK bank ring-fencing requirements which come into effect in 2019. The agency also downgraded Royal Bank of Scotland plc's (RBS plc) long-term ratings to Baa2 from A3 on its view that the credit metrics of RBS plc, which will become the non-ring-fenced NatWest Markets plc, will become weaker and less diversified and the main functions of the bank would be in higher risk activities. Moody's and Fitch upgraded the long-term ratings of NatWest Bank and Ulster Bank on the view that their credit profiles are expected to improve following ring-fencing. The Authority

had suspended RBS as an investment counterparty ahead of the downgrade as it no longer met the Authority's higher credit rating threshold of A- in its 2018/19 strategy.

S&P revised the Royal Bank of Canada's outlook to stable from negative whilst affirming the long-term rating at AA- and Fitch revised the Commonwealth Bank of Australia's outlook to negative from stable, whilst affirming the bank's long-term rating at AA-.

### Outlook for the remainder of 2018/19

The MPC has maintained expectations of a rise in interest rates this year. Arlingclose's central case is for Bank Rate is to rise once in 2018 and twice more in 2019. The MPC has a definite bias towards tighter monetary policy. While policymakers are wary of domestic inflationary pressures over the next two years, it is believed that the MPC members consider both that: 1) ultra-low interest rates result in other economic problems, and that 2) higher Bank Rate will be a more effective weapon should downside Brexit risks crystallise.

|                                 | Jun-18 | Sep-18 | Dec-18 | Mar-19 | Jun-19 | Sep-19 | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 | Mar-21 | Jun-21 |
|---------------------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| <b>Official Bank Rate</b>       |        |        |        |        |        |        |        |        |        |        |        |        |        |
| <b>Upside risk</b>              | 0.00   | 0.00   | 0.00   | 0.00   | 0.25   | 0.25   | 0.25   | 0.25   | 0.25   | 0.25   | 0.25   | 0.25   | 0.25   |
| <b>Arlingclose Central Case</b> | 0.50   | 0.75   | 0.75   | 1.00   | 1.00   | 1.25   | 1.25   | 1.25   | 1.25   | 1.25   | 1.25   | 1.25   | 1.25   |
| <b>Downside risk</b>            | 0.00   | 0.25   | 0.25   | 0.50   | 0.50   | 0.75   | 0.75   | 0.75   | 0.75   | 0.75   | 0.75   | 0.75   | 0.75   |

Arlingclose's view is that the UK economy still faces a challenging outlook as the minority government continues to negotiate the country's exit from the European Union. Central bank actions and geopolitical risks, such as prospective trade wars, have and will continue to produce significant volatility in financial markets, including bond markets.