Appendix A

Economic Background

UK data has been less robust in recent months and, in particular, all of the June Purchasing Manager Index (PMI) numbers turned lower, while consumer confidence dipped to its lowest level since the EU referendum. Household savings levels are at a record low, though there may be some temporary influences, and that raises doubts over the maintaining of Q1's already subdued household spending growth. The composite PMI is, though, reflective of 0.5% q/q growth in Q2, a level also indicated by the CBI's growth tracker. The largest drag on the economy in Q1 was the retail sector and there appears to have been a partial reversal of the declines in Q2. Overall, economists still expect a bounce in quarterly growth to around 0.5%.

EZ consumer price inflation eased to 1.3% y/y in June but the core rate increased to 1.1%, which is markedly higher than the average over the last two and a half years. This indicates that underlying price pressures may be on the rise. Looking from a national perspective, however, it looks like this pick up is being driven almost exclusively by Germany, with other economies seeing subdued pressures as slack remains a feature of the economy. High unemployment and low interest rate expectations in other areas should ensure that price pressure (excluding Germany) remains weak.

Recent economic releases back the view that the US economy is following the pattern of recent years … weak Q1, improving in Q2. Indeed, the latest figures point to growth surging to near 3% annualised in Q2 on real consumption growth. Underlying retail sales eased in May but previous strength saw the q/q annualised growth hit an 11 month high of 5.1%. Labour market conditions also continue to be healthy, with real income growth improving and consumer confidence at elevated levels. Analysts suggest these factors should help to boost real consumption to annualised growth of 2.5% for the remainder of the year.

The two leading Asian economies seem to be heading in slightly different directions. There is ongoing evidence that the Chinese economy is still experiencing some slowing, though buoyant external demand should underpin growth levels. Meanwhile, Japanese economic recovery is continuing, and though largely driven by export growth, there is evidence that domestic consumer spending is strengthening as employment conditions continue to improve. The lack of price pressures does suggest that private consumption levels have further to go.

UK

Q1 was confirmed as having experienced a sharp slowing in the rate of growth to 0.2% q/q, from 0.7% the previous quarter. Households are feeling the effect of rising inflation on spending capacity so the 0.4% q/q increase in consumer spending looks likely to weaken, as growth was supported by savings levels being cut to a record low. The decline in the savings ratio was in part due to temporary factors, but higher tax payments also hit disposable income. Elsewhere, output indices reflect an increased pace through Q1, which extended into Q2. Overall, analysts see Q1's tepid performance as a blip rather than an on-going problem.

Consumer spending growth slowed to 0.4% in Q1 on weaker retail spending but the sector is having a better Q2. If sales volumes held steady in June that would see strong quarterly growth of 1.2%. However, real household disposable income fell 1.4% q/q in Q1, which indicates less saving and increased borrowing. This was also evidenced by unsecured credit growth running at around 10% y/y. Though the saving ratio fell to a record low, confidence levels suggest that credit growth is set to continue.

Sterling's weakening has, to date, had little positive impact on the external sector, with net trade a drag on Q1 GDP growth, as imports grew at more than double the pace of exports. The volatile "valuables" component was the cause of most of the weakness over the quarter. The trade balance has improved little since the start of Sterling's decline, but the investment income deficit has narrowed markedly since Brexit. Indeed, the weak net trade performance has been put down to strong imports growth, for both goods and tourism services. But import growth has started to ease in recent months and surveys point to improved export prospects, both from a price and capacity perspective.

Employment growth picked up in the three months to April but the annual rate of growth was unchanged at 1.2%, as was the unemployment rate of 4.6%. Hiring intentions point to sustained growth in the short term but rising inflation and muted wage growth will increase pressure on real wages, with "real" annual wage growth (i.e. taking account of underlying inflation) slipping to -0.9% in April. Given the tightness of the labour market this is remarkable, but there has been a decline in hourly productivity levels in Q1 and weakness of productivity growth will restrict higher pay awards.

CPI increased to 2.9% in May, the highest since 2013 as falling fuel prices were outweighed by gains in other areas. The pick-up in recent months is down to the import intensive areas of the basket of goods used to measure price changes. On the positive side, wholesale energy prices have receded, which will soften pressures on households if suppliers pass on cheaper costs, while food price inflation may be near its peak if historical correlations between domestic producer and imported food price inflation hold. The full Sterling impact may not be too far away but front end pipeline pressures are also easing, and higher household inflation expectations do not seem to be becoming entrenched. Domestic inflation has levelled off recently and it should be noted that not all inflation can be put down to Brexit as other economies have seen headline inflation increase too. Analysts are looking for CPI to peak around in the autumn before edging slowly back toward target. As rent growth has been stronger than that seen in other consumer sectors, CPIH (the BoE's preferred indicator) is likely to exceed CPI, while the spread between RPI and CPI should continue to narrow as house price inflation slows further.

EZ

The EZ economy has generated some momentum and GDP growth should accelerate in Q2, though the pace of expansion may slow later in the year. Q1 growth was revised higher to 0.6% q/q, which is the strongest for two years, with domestic demand leading the recovery and investment also a strong contributor. Softer industrial production figures in April were disappointing but May consumer spending has made up for that and led to stronger growth in Q2. Surveys have been

upbeat, with the EC Economic Sentiment Indicator hitting a near ten year high, which equates to annual GDP growth rising to 2.5% and a quarterly gain of 0.8%. Though the composite PMI is slightly less buoyant, falling in June, it also reflects a further rise in quarterly growth in Q2. At a national level, though, there is some divergence between members and the future output and new orders indices of the composite PMI offer an indication of growth slowing in the coming months.

Consumer spending grew 0.3% in Q1, the slowest rate for eleven quarters, pulling the annual rate of growth lower. However, the sector has had a positive start to Q2, and surveys indicate very healthy growth to come. Retail sales grew for a fifth month, rising in all of the major economies, led by France. Sales volumes have been hit by rising inflation but values have remained strong. Inflation is, though, starting to ease. There was a sharp improvement in consumer confidence in June, to a 74 month high, which should bode well for future spending growth. The bloc wide level was boosted by the gain in France, which posted one of the highest monthly gains in the index's history, as consumer confidence there nears record highs.

Industry had a weak Q1, but more recent indicators suggest an improvement in Q2. The sector grew by just 0.2% in Q1, but this was signalled by data over the quarter. Production rose 0.5% m/m in April which offers a positive opening to Q2. The manufacturing PMI made further gains in June, posting a 75 month high to be consistent with annual production growth increasing to 4.5%. The EC sentiment indicator for services also improved but suggests that Q2 output growth in the sector will be unchanged at 1.9%.

Q1 EZ GDP growth was held back by net exports but the outlook is more promising according to indicators. Goods and services trade added little to quarterly GDP in Q1 but impacted negatively on the annual rate. The April nominal goods and services trade surplus narrowed further. The net trade drag is down to import strength, rather than weak exports, indeed the value growth in the latter cannot be put down to exchange rate movements alone. Export volumes have been boosted by improved world trade, as well as healthy global GDP growth and the manufacturing PMI export orders index points to acceleration in volume growth in the coming months.

The labour market has seen recovery slow markedly with unemployment falling by just 16,000 in May, with the decline from April entirely down to volatility in Italy. The overall unemployment rate was unchanged at 9.3% but Italy saw a rise in its rate. The surveys suggest that the slowing was temporary with hiring intentions consistent with annualised employment growth around the 1.5% seen in Q1. The continued recovery should offer potential for wage growth, which on previous form would see increases of more than 2% by year end.

Though core inflation increased in some member countries, headline EZ inflation softened to 1.3% in June, as falling oil prices eased energy inflation. Core inflation picked up to 1.1%, but was this the effect of a bank holiday in Germany as elsewhere it remains relatively weak? Forecasts for the oil price and the value of the €uro indicate energy inflation being broadly stable but core inflation may tick higher given falling unemployment and increased inflation expectations. Consumer goods PPI, excluding food and energy, was, however, unchanged in May to indicate little in

the way of pipeline pressures. Inflation in individual member states will remain divergent with Germany already operating beyond capacity, which should imply rising price pressures, whereas the other major economies are still operating with output gaps, and subdued inflation.

Markets were shaken by comments from Mario Draghi at the end of the month, which were seen as hawkish, resulting in a tightening of the interest rate hike probability to June 2018, leaving bond yields higher across the board. Greece was the main exception as yields fell on creditors agreeing to pay the next tranche of bailout funds. While relative interest rates were unchanged, the €uro strengthened against the US$ on Draghi's speech, indicating that investors outlook for unconventional monetary policy has also changed. Equites did not respond well to the stronger currency, but remain in line with economic sentiment levels. However, they probably would have been lower were it not for the bailout of two regional Italian banks.

US

Q1 growth was weak but, as has been the case in recent years, the outlook for Q2 is rather stronger, with annualised growth looking to jump from 1.2% to 3%, as the ISM surveys remain high and indicative of improved growth. In particular, stronger global growth and a weaker Dollar point to better times ahead than there have been for a while. Indeed, small business sentiment remains very strong having hit long time highs in the wake of the Presidential election.

Consumption showed some recovery in March, after a difficult start to the year, and April was also a positive month. Retail sales figures reflect strong underlying sales, with core sales growing at around 5% y/y. Weak new vehicle sales, though, will weigh on consumption growth, a consequence of a mass of ex-lease vehicles undermining used car prices and tighter auto-loan conditions. The pace of auto sales declines will be maintained at Q1 levels and other forms of credit seem unrestricted. Fundamentals remain strong, with real disposable incomes increasing again and consumer confidence levels very high, and consistent with strong consumption growth.

The pickup in drilling activity could be threatened by falling crude oil prices. Having surged by 460% annualised in Q1, mining investment is likely to be more restrained for the remainder of the year. However, business investment prospects are better with orders and shipments of capital goods bouncing strongly in the last year. Survey capex intentions are markedly higher than through the last two years and, while commercial and industrial loans have been weak, corporate bond issuance is higher this year resultant from fresh declines in bond yields. Housing starts have dropped which seems strange given low inventory levels, but this suggests weak residential investment levels in Q2. Construction spending data is more positive, so after declining in Q1 government investment should level off.

There has been a widening of the trade deficit but it is not much above the average of recent years. The April increase was the result of stronger imports combining with lower exports, thus net trade is set to be a drag on annualised Q2 GDP growth. Analysts are looking for export growth to accelerate as the impact of the Dollar appreciation has faded and a recent weaker Dollar should help export growth.

Surveys are encouraging, indicating real exports might expanded at 8% y/y, largely on improvements in the Eurozone. Imports may also increase, though increased domestic crude oil output should see imports level off.

The weak non-farm payroll gain of 138,000 in May is a continuation of broader slower growth in recent years. The recent weakening of job creation has come in the low wage sectors and retail in particular, though this does point to the overall mix of new jobs being improved. Slower employment gains have, though, continued to pull the unemployment rate down, with the May rate of 4.3% a 16 year low. Survey indications are that the rate could dip below 4% in the months ahead, but that may prove a bit too upbeat. The strength of the labour market has drawn prime working age people back into the workforce in greater numbers and that growth in activity of 25-54 year olds should put pressure on wages at some point.

The CPI measure of inflation has fallen back to 1.9% from a five year high 2.7% earlier in the year, largely on declining energy prices, a situation that should not persist. Core inflation, though, has slowed markedly to 1.7% in May, with the three month annualised rate at a seven year low 0%. Weakness at the core has been broad but exacerbated by steep declines in specific areas, such as medical care. As noted earlier, the large number of former lease vehicles coming to market has weighed on auto prices and with the vehicle pipeline set to rise there could be further deflationary pressures brought to the market. The core PCE inflation level (the Fed's measure of choice) is little changed, but is weaker, though there are reasons why CPI should bounce soon. There have been no indications of weakness in producer prices, with core PPI hitting a three year high in May. The PPI consumer services pickup points to a similar move in PCE services, while the US $ is no longer having a dampening effect on import prices, thus core goods inflation may start to increase. Inflation compensation has eased recently, but they remain low. Meanwhile, survey based measures of consumer inflation expectations are starting to bounce.

The Fed raised interest rates again in June and reiterated that the intention is for gradual tightening. However, markets are still only looking for another 25 basis points increase by the end of next year, while the 10 year Treasury bond yield has actually fallen. The flattening of the yield curve is seen as a bearish signal for the economy by some. Dollar weakening has continued with the Fed's trade weighted dollar index having reversed its previous surge, post-election. The stock market has taken the Fed's tightening programme in its stride so far, and Wall Street sees indices hitting record highs. But there are still concerns about the lack of policy delivery from the Trump administration.

Asia

The Chinese activity indicators are hinting at a further deceleration in May. Investment growth continued to slow in nominal terms, but this was largely due to pricing effects, and in real terms was stable. State led infrastructure spending has underpinned investment, though even this has slowed over the last year. Consumer indicators point to weak auto sales, but the labour market remained healthy in Q1, though there have been recent signs of conditions weakening. Business indicators have also highlighted some slowing, with conditions for larger companies deteriorating. However, this has been offset by a sharp improvement in conditions

for small and medium sized firms. External indicators suggest that external demand has held up well and is buoyant, with the trade surplus widening further in May. Chinese inflation has picked up in the last three months, after the sharp fall in February, led by a pick-up in food price inflation. The People's Bank of China has been pushing market interest rates higher since last October but analysts believe that the tightening cycle is now at an end. The ebbs and flows in the Chinese economy are largely masked by official data releases that smooth out these movements. While this does distort the month by month picture of the economy the overall annual performance tends to be truly reflected, and in 2017 analysts believe that the economy will just about meet target levels, or fall just shy of them.

The Japanese economy has been helped by a surge in exports but there is evidence that domestic consumption is also starting to play a role, with spending looking to be in line for another strong quarterly pick up in Q2. Output and activity has seen the economy grow for a fifth successive quarter in Q1. There has been some moderation in export growth but the rise in industrial production indicates that momentum has been maintained into Q2. Consumption seems to be picking up on broad increases in goods and services activity and households seem upbeat, which could result in a dip in the savings rate. With corporate profits hitting record highs and firms having strong balance sheets, the business indicators are suggesting further solid gains in economic activity. Job growth remained strong and there are rising numbers of jobs available, but wage growth is still subdued. It appears that higher energy prices are putting upside pressures on inflation, but despite expectations that underlying inflation will start to pick up as well analysts do not see price pressures strengthening much more. The Bank of Japan has continued to ease back on its bond purchasing programme, while a stronger Yen has not prevented the Nikkei hitting fresh highs. Nevertheless, equities are looking to be fully valued and have limited upside.

Summary

Politics is playing an increasingly influential role in the state of the markets at present. In the UK there has been a sense of mounting turmoil in the wake of the lack of a clear mandate for the ruling Conservative party at the General Election. With Brexit negotiations starting for real there is a sense of divide among Mrs May's Cabinet, which threatens to add to the uncertainty, while there appears to be no clear plan for withdrawal. Constant speculation about the length of Mrs May's tenure at Number 10 does not help matters. At the end of the month the Bank of England seemed to take a more hawkish stance, raising speculation of an earlier than expected rate hike. However, against a background of political uncertainty, very mixed economic data and a workforce seeing real wages in decline, it seems that a hike sometime soon is a bit fanciful.

Meanwhile in the US, Donald Trump continues to make waves. Amidst all of his squabbles with the press and noise surrounding his campaign team's involvement, or not, with the Russians, more concerning is that there has been no great progress on his political agenda which won him the election. Never mind the President's first 100 days it may be a case of the first 100 delays and the possibility is that the first year of his White House occupation could deliver little or nothing of note.

Markets

	Open	Close	High	Low
FTSE 100	7,520	7,313	7,561	7,303
£/$	$1.2887	$1.3025	$1.3030	$1.2587
€/£	£0.8721	£0.8769	£0.8846	£0.8649
5y Gilt	0.486%	0.697%	0.728%	0.354%
10y Gilt	1.049%	1.259%	1.292%	0.928%
25y Gilt	1.711%	1.877%	1.913%	1.641%
50y Gilt	1.539%	1.693%	1.728%	1.468%

The General Election result saw markets react to the Government's loss of an absolute majority, which leaves it reliant on an agreement with the Irish Democratic Unionist Party.

Sterling slipped to a 3 month low on a trade weighted basis, but recent, end of month hawkish MPC comments have seen a bounce. This has left the currency only marginally lower against the €uro and the US$.

That change in MPC mood has seen markets pull expectation of the first 0.25% rate hike in to Q2 2018, which is a year earlier than had been priced in a month or so ago. As a consequence there was a sharp firming in gilt yields at the close of the month.

Equities have underperformed compared to those elsewhere as the election outcome has weighed on investor sentiment. Firms with a more domestic lien on income have fared worse than the more internationally engaged.