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UK: RETAIL SALES SURGE GIVES GREEN LIGHT FOR NOVEMBER BOE HIKE

Berenberg Macro Flash

UK Real retail sales (ex. auto fuel), Aug %

	yoy	mom
Actual	**2.8**	**1.0**
Previous	1.7	0.7
Consensus	1.4	0.1
Berenberg	-	-

Full steam ahead: After a little correction earlier in the year, the underlying picture of healthy retail sales growth has come to the fore again. On a monthly basis, real retail sales ex. auto fuel expanded by 1.0% in August after a 0.5% gain in July, marking the strongest growth since April 2017 and exceeding market expectations of 0.1% mom by a wide margin. Comparing the average for July and August to Q2, real retail sales ex. auto fuel rose by 1.2% - well above the five year quarterly average growth rate of 0.8%. On a monthly basis, all four main retail sectors contributed to volumes growth: food stores 0.1% mom, non-food stores 0.4%, non-store retailing 0.4%, and petrol station sales 0.1%. Solid retail sales in Q3 so far bodes well for continued gains in real household consumption. Along with strengthening data in export-oriented industrial sectors, this supports our call for an acceleration of real GDP growth to 0.4% qoq in Q3 from 0.3% in Q2. We forecast real GDP growth of 1.7%, 1.6% and 1.7% in 2017, 2018 and 2019, respectively – a little above the market consensus according to Bloomberg of 1.5%, 1.3% and 1.6% (taken 20/09/2017).

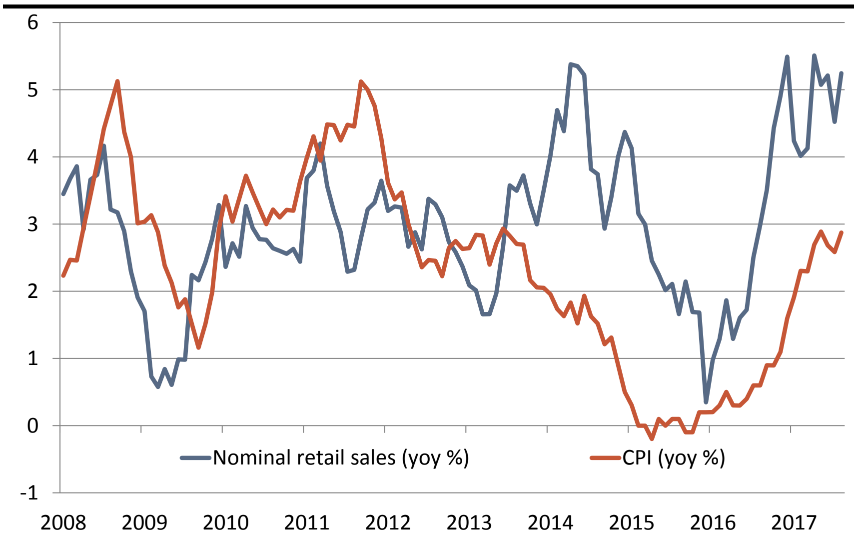
The lesson from the solid retail sales: The risks to consumers from rising inflation are exaggerated. Despite the media excitement and some predictions that households would reduce their spending as inflation rises to c3% this year, the reality remains far more sanguine. As we have argued since the Brexit vote, household fundamentals are strong enough for households to smooth their consumption this year as inflation temporarily outpaces wage growth. Household net wealth is currently at a record high. Households can afford to temporarily save less and borrow a little more until real wages begin to rise again. Consistent with historical trends, households are smoothing their real consumption amid some ups and downs in their real incomes. Continued strong employment gains have further added to household demand this year. As Chart 1 shows, instead of cutting back spending as inflation rises above wages, households are simply opening up their wallets to spend more in order to meet their growing real demand for goods and services.

For households, the worst of the near-term pain is probably over: After a tough year, there is finally light at the end of the tunnel. Households could already be past the worst of the real wage squeeze. Inflation might tick up a little more in the coming months – towards c3% – before gradually trending towards its medium-term underlying rate (c2.3%). But a likely continued acceleration in nominal wage growth – current 2.1% yoy –means that real wages will likely rise again over the medium term. While household confidence has dropped this year, continued gains in labour demand and a recovery in real earnings should underpin a rebound in household confidence at the start of next year. That said, the long-term risks to household incomes from slower long-term growth after Brexit loom large. In our base case, we expect Brexit to reduce trend real GDP growth to 1.8% per year from 2.2% before Brexit. The long-term impact on real wages could be of a similar magnitude.

It would take a major economic surprise for the BoE not to hike in November now: Our key UK calls for this year are that domestic demand will hold up and that the BoE will hike sooner than the market had anticipated as demand growth outpaces supply growth. In July we brought our forecast for the first 25 bps BoE hike forward to November 2017 from Q1 2018 previously while the market was pricing in a hike as late as 2019. The BoE's most recent guidance from its September MPC meeting that, 'some withdrawal of monetary stimulus is likely to be appropriate over the coming months, has now brought forward market expectation towards November. The unusually explicit guidance from the BoE shows that is it on the cusp of hiking and wants to avoid a potentially disorderly adjustment in markets and in the real economy. Now that markets are largely ready for the hike, today's solid reading of domestic demand for August will give the BoE further assurance that a rate hike is appropriate. After the first hike in November 2017, we continue to expect a very gradual tightening thereafter to sustainably return inflation to its 2% target, with four hikes in total between now and the end of 2019.

For more information on our UK monetary policy outlook, please see our report '[The BoE's job is done: it is time for rate hikes]' from 1 September 2017.

Chart 1: Retail sales versus headline inflation – annual changes



Monthly data. Source: ONS, Berenberg calculations. Retail sales data 3m/yoy.

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Real sales ex. auto fuel, % change	AUG	JUL	JUN	MAY	APR	MAR
Mom	1.0	0.7	0.6	-1.4	2.1	-1.0
3m/3m	1.2	0.3	1.0	0.6	0.3	-1.9
Yoy	2.8	1.7	2.8	0.8	4.6	2.9