UK Manufacturing Data May Cheer Theresa

- **Growth in the UK's manufacturing sector accelerated.**
- **This will be supportive to GDP growth in the third-quarter.**
- **Most new orders are domestic demand; exports holding steady.**
- **Bar the equity market, there is little reason to buy Sterling assets.**

Growth in the UK's manufacturing sector accelerated in August as output, orders and employment all showed signs of improvement.

The seasonally adjusted IHS Markit/CIPS UK Manufacturing PMI rose to a four-month high of 56.9 in August 2017 from an upwardly revised 55.3 in the previous month. This was much higher than the market expectations of 55, Figure 1.

Figure 1: UK Manufacturing PMI ● Expected ○ Actual Source: IHS Markit/CIPS

Production rose at the steepest pace recorded in seven months, receiving a boost from a faster intake of new work received, and employment growth was almost at a three-year high. Adding to the good news, business optimism improved to a three-month high in August whilst on the input side cost inflation accelerated for the first time in seven months. This latter point suggests that consumer price inflation (CPI), inflation set to pick up sharply over next few quarters, see Figure 2.

Inflationary signals

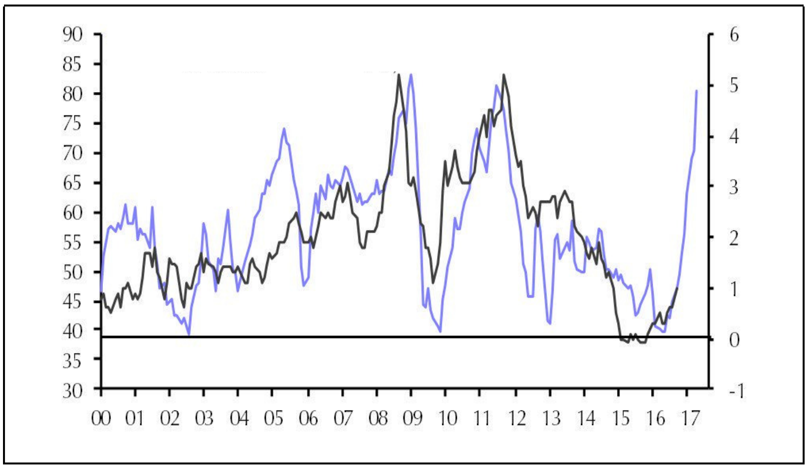

Figure 2: UK Input Prices and Consumer Price Inflation
Input Prices six-month advanced ***CPI YoY %***
Source: IHS Markit/CIPS

Figure 2 reveals that CPI tends to lead the level of input prices by approximately six to eight months and so no doubt the data released this morning will have rung a few bells within the corridors of the Bank of England.

Overall, 31% of the companies surveyed reported rising input costs as they cited increases in certain industrial commodity prices. Other reasons were bottlenecks in the supply chain that are a direct result of supply-side constraints, longer vendor times and inadequate infrastructure within the UK. All because investment levels are still 20% below the level seen post the Brexit vote on June 23, 2016.

The Markit/CIPS survey found that the production increase was helped by a pick-up in new orders with the domestic market proving to be the prime source of new contract wins. However, the trend in new export business also remained robust.

It was slightly disappointing that foreign demand eased from July's near-record high, this, however, is not a major concern for the moment as it is still strong cf. the body of evidence seen since new export orders data were first collected in January 1996.

Companies linked the level of new export work to increased business from mainland Europe, the US, China and Australia. The historical weakness of the sterling exchange rate, down 9.42% since the EU referendum, was also reported to have boosted export competitiveness as trade elasticities moved in the UK's favour. This view stems from our belief that trade flows because of comparative levels of real income and relative prices for goods that are either fair substitutes or are completely unique.

Joy for jobs, productivity still poor

The rate of job creation in the manufacturing sector rose at the fastest pace for 13 months. This underlines the recent improvement in manufacturing wages that have gained 1.2% in the past year although this still lags wage growth in the service sector.

The survey data suggest that the UK manufacturing economy is in good health despite the Brexit uncertainty, and should help support on-going growth in the economy in Q3. We say this with some confidence as manufacturing makes up 10% of gross value added (GVA)and 45% of UK exports, and directly employs 2.7 Million people.

We expect that growth in the sector will be maintained given the recovery appears broadly based i.e. both large and small companies seeing conditions improve. Manufacturing's share of total UK employment is, however, still stuck below 20.0%.

Factory based productivity has grown by 2.8% on average per annum since 1948 cf. with 1.5% in the services industry. The long-term superiority soon fades if one looks at recent history. The 2008-09 economic downturn resulted in heavy declines in productivity in manufacturing; this has not recovered to its pre-crisis trend growth rates.

Hawkish cries

No doubt such the numbers today will see monetary hawks suggest the Bank of England needs to think about raising rates sooner as against later when it may be too far behind the curve to contain inflationary pressure driven by a weak exchange rate and an active industrial base.

Indeed, on August 3 the Bank of England signalled that households should prepare for an interest rate rise within a year if the economy continues to be buoyed by a booming jobs market and strengthening global recovery.

The Monetary Policy Committee (MPC) kept Base Rate on hold at a record low of 0.25% in August saying they saw stronger exports and investment offsetting slower growth in consumer spending as real incomes still faced a squeeze. Once again, the external policymakers Michael Saunders and Ian McCafferty reiterated their call to raise rates to 0.5% as the MPC voted by a majority of 6-2 to keep rates unchanged.

The Bank's Governor, Mark Carney, said the pressure on households resulting from higher inflation would start to ease at the turn of the year. He added that interest rates might have to rise even if the current rate of UK growth remains modest, i.e. 0.3% in the three-months to June 2017 citing ongoing low investment and weak productivity exposed the economy as even a modest recovery in demand could be enough to warrant interest rate hikes to keep a lid on inflation which was 2.6% as of July 2017.

Market meandering

Financial markets have currently priced in two increases of 25 basis points by the start of 2020, with the first priced in for Q3 2018.

Looking at the minutes of the August meeting one finds the statement:

"...If the economy were to follow a path broadly consistent with the August central projection, then monetary policy could need to be tightened by a somewhat greater extent over the forecast period than the path implied by markets. ..."

The members of the MPC expect growth for the rest of the year to remain around 0.3%. Given this ongoing consistency there has been no major shift in the level of the Sterling Index to break the slow corrective channel that has been in force since May as illustrated in Figure 3. The current price of 74.9 is extremely close to the middle ground located at a level of just 1.11 standard deviations from the running mean within the corrective channel. That really underlines the fact that in the foreign exchange market Sterling is as neutrally priced as could be expected.

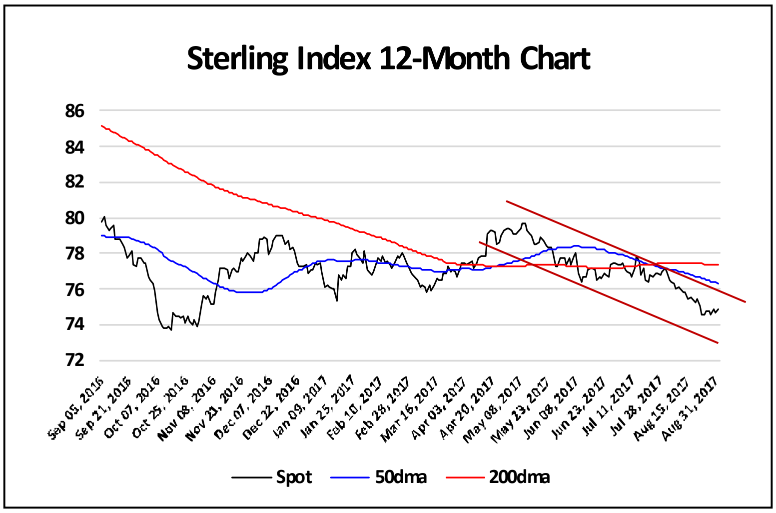

Figure 3: Sterling Index, 12-Month Chart Source: www.investing.com, Spotlight Ideas

The sterling index began the gentle decline in May, just one month before the general election called for June 8. It is well known that the foreign exchange market is certainly the fastest financial asset market and usually is one of the first to move.

The Sterling market, whilst under pressure does appear relatively phlegmatic cf. the spread of the 2-Year Gilt over 2-Year German debt. This truth is amply illustrated in Figure 4 where one can an extreme widening of Gilts over Germany when the Conservatives barely squeaked home having to form a minority government in this June's election.

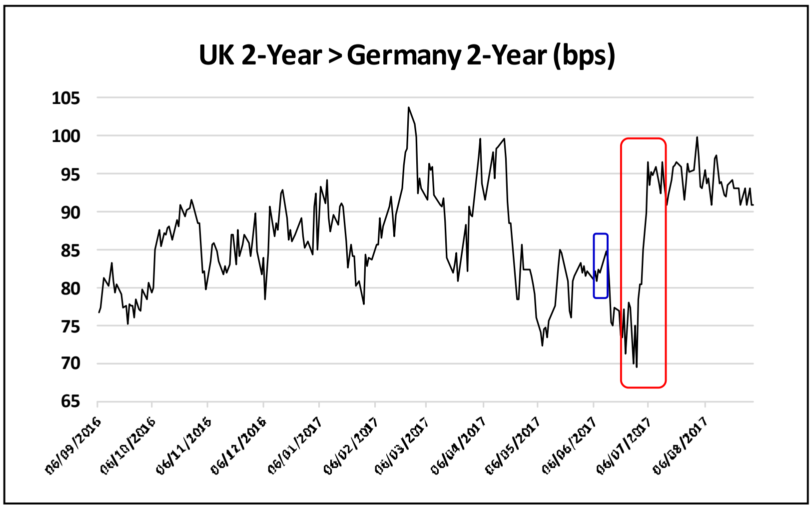

Figure 4: Spread of UK over Germany, 2-Year Maturity ***June 8/9 2017*** ***Aftermath***
Source: www.investing.com, Spotlight Ideas

When the Prime Minister called the general election, the Conservative Party held a 24% lead over Labour. There was no pundit that the Conservatives would fail to boost the majority and possible see off the far-left policies of Jeremy Corbyn once and for all. Of course, history will look back in amazement at how the lead evaporated to just 2.5% on polling day as the so-called *"Dementia Tax"* created a backlash among the voters whom the centre-right had taken for granted.

The Gilt market sold off aggressively as there was suddenly a very real prospect of another election in 2017 with Corbyn's Labour squeezing out a small victory and opening the doors to a wave of Gilt issuance. It is not surprising that the 2-Year spread soared from +70 basis Points to +100 bps. Even now, as in the aftermath of the election Labour's lead has fallen from 8% in mid-July to just 1% on August 28, the front of the Gilt market is on high alert for another sudden poll and of course, a surprise hike in rates.

We cannot say that Sterling is a hot area for foreign exchange investment, although we do sense the technical sentiment out to one week is looking for a small recovery. On a longer-term basis, the technical sentiment very much favours a gentle sell-off to 73.89, i.e. -1.35%. This is not foreseen as a volatile move, rather, just a gentle continuation of the trend.

As for the front-end Gilt spread over Germany, we expect a small tightening as we get nearer the German election on September 24, however, that will be hard pressed to move beyond +85 basis points given that the only question really being asked in Germany is not will Mrs Merkel win, but who will she forge a coalition with. If she works with the Free Democrats we would favour German assets even with their negative yields.

Today, the UK had a good set of data, however, there is little to say that other than the FTSE 100 or 250, there is any compelling reason to be overweight in UK currency or assets.