Ulster Bank

Consumer sweet spot to turn sour?

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To say that 2016 was an eventful year would be an understatement. Political surprises have become the order of the day with the vote for Brexit & Trump ("BRUMP") the highlights. The political landscape at the end of 2016 looks vastly different to what we had at the start of the year. The same holds true for the local economy.

Some sectors of the economy ended 2016 on a much stronger footing than they started the year. Our manufacturing, retail and agriculture sectors fall into this camp. Conversely, local construction firms started the year on a more positive note, with buoyant GB demand. However, as noted in the Ulster Bank Northern Ireland PMI, this soon petered out, with the sector posting contraction in three of the last four quarters.

Sterling weakness was a key theme in 2016, particularly following June's referendum result. This has been largely responsible for the three key developments during 2016 – relating to exports, retail, and inflation.

The record rates of growth in export orders in H2 2016 has been accompanied by the strongest set of retail sales figures in Q4 in the PMI survey's 14-year history. Demand from the Republic of Ireland is boosting exports and retail sales considerably. As a result, Northern Ireland's retail sector continues to post the fastest rates of job creation of all the sectors.

The retail expansion has been evident across our towns and cities with a notable increase in the number of cafes and restaurants. Several UK multiples expanded in 2016 (e.g. Pizza Express). Meanwhile there were also some newcomers (e.g. Patisserie Valerie). This has been a lagged response to strong demand as consumers found themselves in a sweet spot. As a result, 2015 and 2016 have been dubbed the year of the consumer. Falling petrol, energy and food prices coincided with a return of wage growth. Disposable incomes received a significant boost, and retailers moved in to capitalise on this.

But don't expect 2017 to fall under this moniker. Northern Ireland's consumer sweet spot is approaching its 'use by' date.

This is because the downside of having a competitive exchange rate is import price inflation. At the start of last year a pound was worth €1.36 and $1.47 against the euro and the US dollar respectively. This compares with €1.145 and $1.22 today and represents a depreciation of around 16/17%.

Sterling weakness is exacerbating rising inflationary pressures at a global level. Global input price inflation in December climbed at its fastest rate in almost 5½ years. For example, oil and food prices are on the rise. Back in January last year, a barrel of oil dipped below £20 per barrel. Today that same barrel has increased by 130% to £46pb.

Motor fuel is also on the rise. At the start of last year the price of petrol and diesel was around £1 per litre. Today it is averaging £1.18 (Petrol) - £1.21 (diesel) per litre. Retailers and manufacturers have borne the brunt of input cost inflation. This is being passed onto consumers with retailers and manufacturers increasing prices in Q4 2016 at their fastest rate on record.

UK consumer price inflation was marginal at the start of 2016 but accelerated to 1.2% by November. The annual rate is expected to more than double by the end of 2017.

In this rapidly changing cost environment, 'shrinkflation' has been deployed to keep price rises to a minimum. This is whereby the size of products (e.g. Toblerone) is reduced in size to keep prices unchanged. Birds Eye responded to a 12% increase in costs by reducing the number of fish fingers in a box from twelve to ten.

So, whilst the Northern Ireland economy begins 2017 with significant momentum, there are real challenges ahead. This is primarily because the retail sector is largely driving the growth we have been experiencing, and inflationary pressures and benefit freezes will act as speed bumps for consumer spending and economic growth this year.

Therefore the next 12 months are likely to see the consumer sweet spot turn sour, impacting on the fortunes of the retail sector and the economy as a whole. Though, consumers from the Republic of Ireland and beyond these shores, in the shape of tourists and cross-border shoppers, will provide some offset for the malaise in the domestic market.

In this context, it highlights the need for Northern Ireland to redouble its efforts to make businesses, rather than consumer spending, a more significant driver of the economy. That means an even greater focus on entrepreneurship, developing our indigenous businesses, and attracting foreign direct investment.

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