Will businesses pick up the Chancellor's gauntlet?

EY ITEM Club UK Summer Forecast

EY
Building a better working world

Contents

EY is the sole sponsor of the ITEM Club, which is the only non-governmental economic forecasting group to use the HM Treasury model of the UK economy. Its forecasts are independent of any political, economic or business bias.

EY ITEM Club UK Summer forecast

Highlights 2

Introduction 3

Forecast in detail 10

1. Fiscal Policy 10
2. Monetary Policy 10
3. Prices and Wages 11
4. Activity 12
5. Consumer Demand 13
6. The Housing Market 13
7. The Company Sector 14
8. The Labour Market 15
9. Trade and the Balance of Payments 16

Highlights

- The UK economy continues to be buffeted by world events, with the developments in Greece and the Chinese stock markets being of most concern recently. However, domestic demand remains buoyant and the pace of activity has picked up nicely since the slowdown apparent over the winter months. We see GDP growth of 2.7% both this year and next, with CPI inflation remaining well below target.

- The latest data show consumers racing away in the fast lane of the economy, fuelled by a strong labour market and low inflation. This pace looks set to continue into next year as the strong pound and weak commodity prices keep inflation subdued. However, with manufacturers well and truly stuck in the slow lane, the economy is becoming increasingly unbalanced.

- The recovery in our European markets seems to be well-established, although so far, the benefits to UK exporters have been offset by the weakness of the Euro. The US economy has revived after its winter freeze and the Fed is preparing to increase interest rates, perhaps as soon as September. Recent UK labour market data look similar to those in the US, but we do not think the MPC will be in a hurry to follow, largely because the move to a much tighter fiscal framework in the UK suggests an accommodative monetary stance. On this view, interest rates are unlikely to move above 3% until 2019.

- The path to prudence in the Summer Budget is more gradual than the rollercoaster we saw last March, but the new surplus target is very challenging. It means a major increase in taxes on households as well as a massive squeeze on welfare payments. The Chancellor has effectively passed the prime responsibility for supporting low income working people over to employers and this poses a clear risk to hours and employment.

- Moreover, if the public sector is to move from heavy deficit into surplus, the private and overseas sectors must move in the opposite direction. Despite the squeeze, households will be reluctant to move further into deficit, so realistically it is now up to companies to increase investment and exports to make the Budget strategy work. Otherwise growth and imports will have to slow down to swing the balance of payments and government accounts back into surplus.

- Ultimately the success or otherwise of the Budget strategy hangs critically on the way that the business community responds to the challenge. We believe that companies will respond positively and that spending on investment and training will both enhance efficiency and ease the difficult path towards a government surplus. We expect the continued success of UK service exports and the prospective recovery in overseas investment to lead to a substantial improvement in the balance of payments. This will also support the Budget strategy and help to rebalance the economy away from its dependence on consumer spending.

Introduction

The UK economy continues to be buffeted by world events, with the developments in Greece and the Chinese stock market providing the most recent worries. However domestic demand remains buoyant and the pace of activity has picked up nicely since the slowdown apparent over the winter months. This strength provided a very favourable background for the Chancellor's Summer Budget. We see GDP growth of 2.7% both this year and next, with CPI inflation remaining below target.

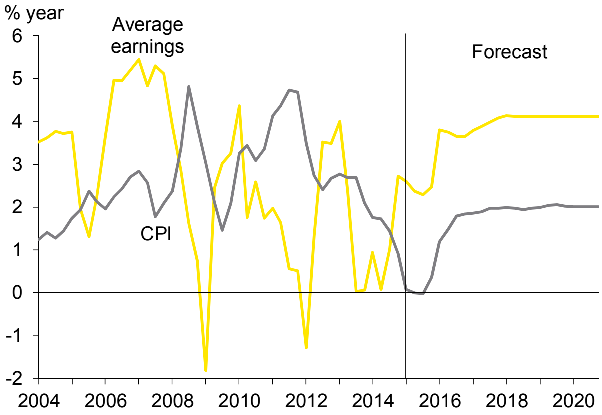
Consumers and consumer-facing firms have the fast lane all to themselves...

Consumer-driven markets are particularly strong, reflecting the revival in real earnings growth and the fall in world commodity prices. Real incomes sported an increase of 4.5% in the year to Q1, while consumer spending increased by 3.4%, the strongest reading since the end of 2007. Business and housing investment continued to move ahead despite worries about the general election. However, external demand remains soft and net exports in Q1 offset the positive contribution they had made to demand in the previous quarter.

...as exporters are left in the slow lane

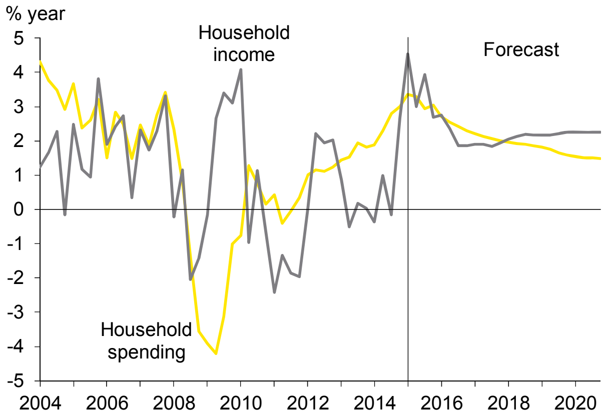
This differential pattern of demand is clearly reflected in the breakdown of GDP in terms of output components, where strength in consumer-led services has been seen alongside weakness in export-led manufacturing output. This pattern has been maintained in the second quarter. Average earnings in the three months to May, were 3.2% higher than a year earlier, the fastest growth in five years consumer confidence is the highest since the year 2000. The strong pound has helped depress the core rate of inflation, reinforcing the effect of falling commodity prices on the headline figures.

UK: Average earnings & inflation



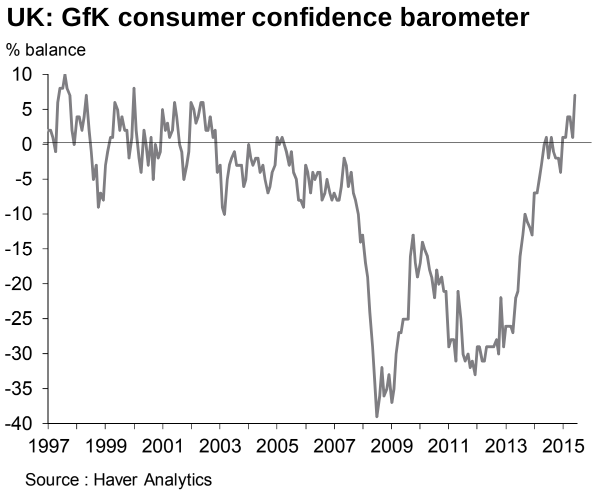
Source : EY ITEM Club

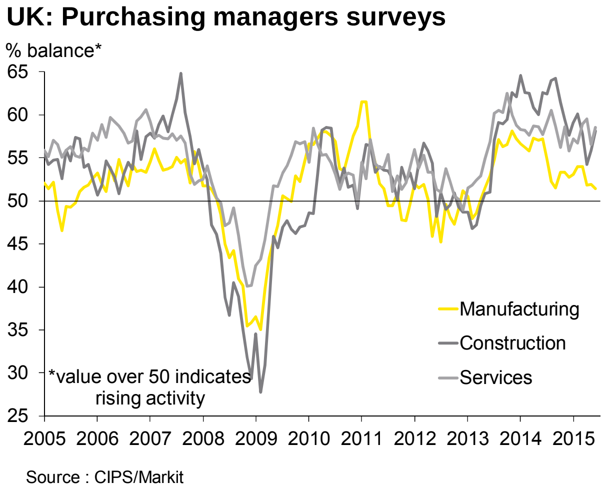
UK: Real household income and spending



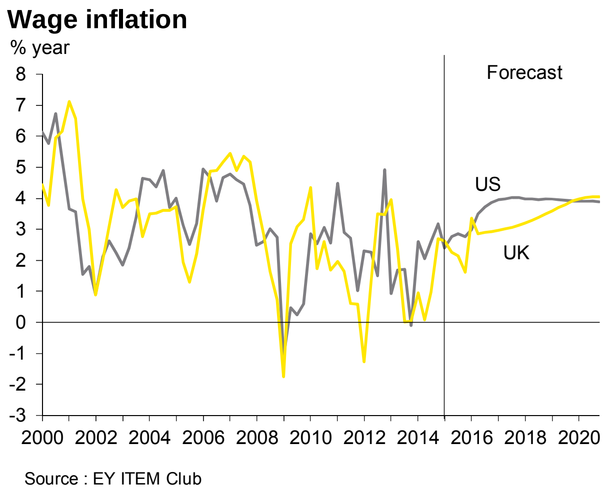
Source : EY ITEM Club

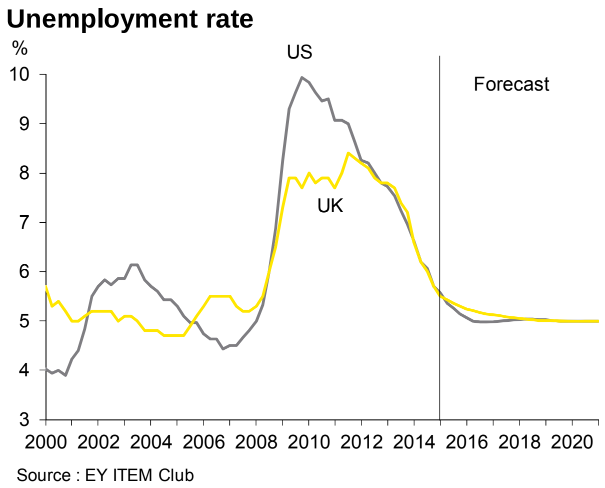
While the June PMI data showed renewed strength in services, manufacturers reported another fall in export orders. Although the recovery in the Eurozone has strengthened since the beginning of the year, the benefits appear to have been more than offset by the damage to competitiveness from the 10% appreciation of sterling against the euro. Given the deterioration in the Greek situation, the headwinds faced by UK manufacturers are likely to strengthen in coming months.





To set against this, exports to the US have picked up nicely after the slowdown seen over the winter, and commodity prices have begun to fall again following the Chinese stock market. Oil prices have been trading in a relatively narrow range despite an excess supply of around three million barrels a day, which has been going into stock. These burgeoning stocks provide a shock absorber, helping to keep prices low and less volatile. We expect a relatively stable oil price over the next year, followed by a gradual increase as the global economy recovers.



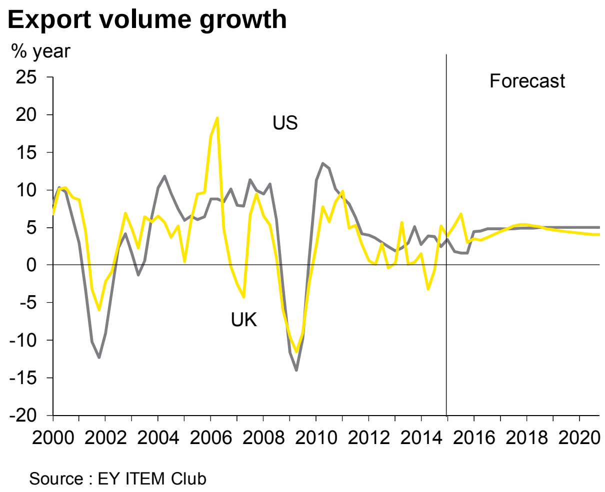


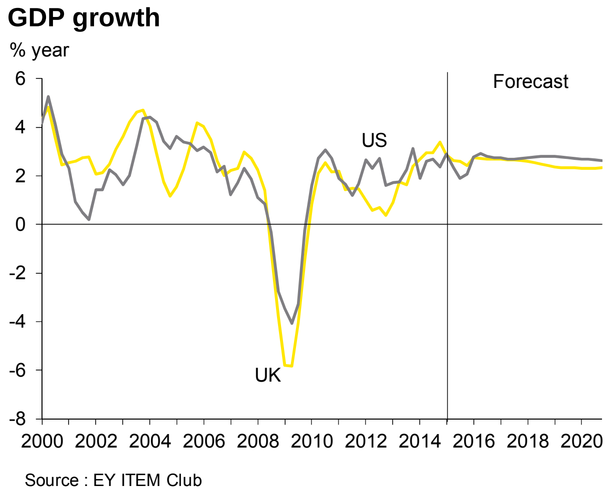
The Fed is preparing to raise US interest rates...

The rebound in the US economy means that the Fed will soon start to increase its policy rates, possibly in September. Wage inflation has picked up and unemployment has fallen back nicely in both the US and the UK. The introduction of the living wage in the Budget will also have the effect of pushing up earnings in the UK. It is tempting to think that the rebound in the economy and the revival of earnings growth in the UK will influence the MPC similarly, but that would be a mistake in our view.

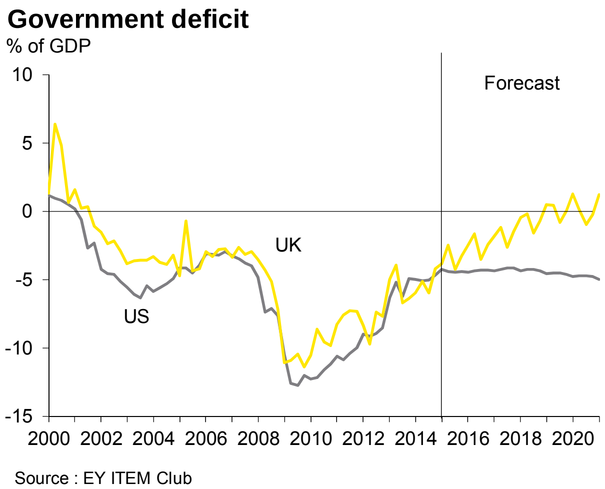
...but the MPC is unlikely to be in a hurry to follow

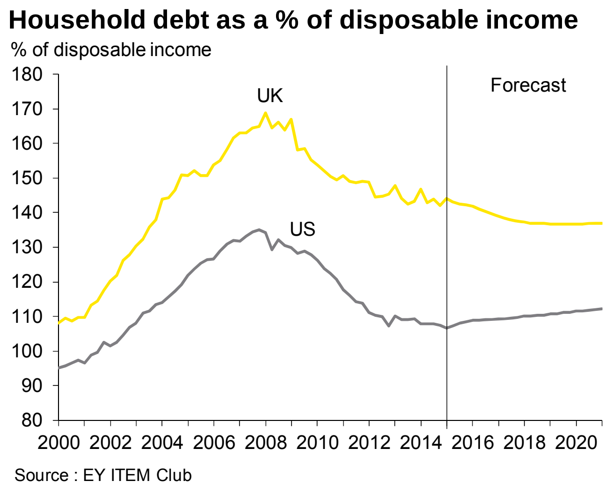
Despite the superficial resemblance to the US, the UK is different in several key aspects. First, as the problems besetting the Euro remind us, US geography allows it to tap into Asian and other Pacific markets, while we remain heavily dependent upon Europe. Second, the recovery was initially much weaker in the UK, meaning that although the public sector borrowing fell back in both countries, the need for corrective fiscal measures was greater.





Public sector borrowing is now running at about 5% of GDP in both countries. However, the Chancellor aims to show a surplus in the UK, while there are no significant corrective measures planned in the US despite the occasional political hold-ups over the Federal debt ceiling. This means that monetary policy needs to be much more accommodative in the UK. Reflecting this, we now assume that UK base rates will remain at 0.5% until August of next year, remaining below 3% until 2019.

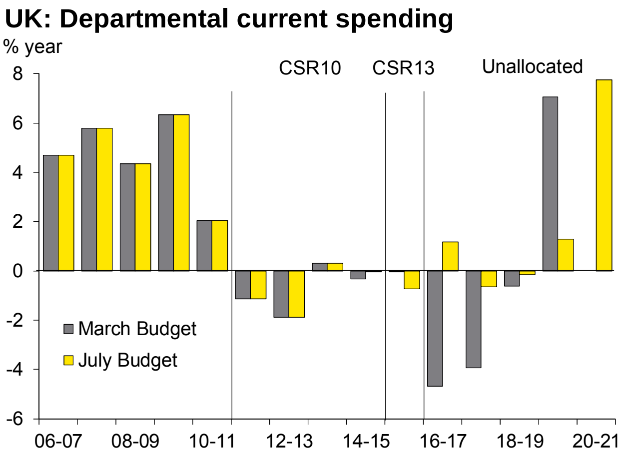




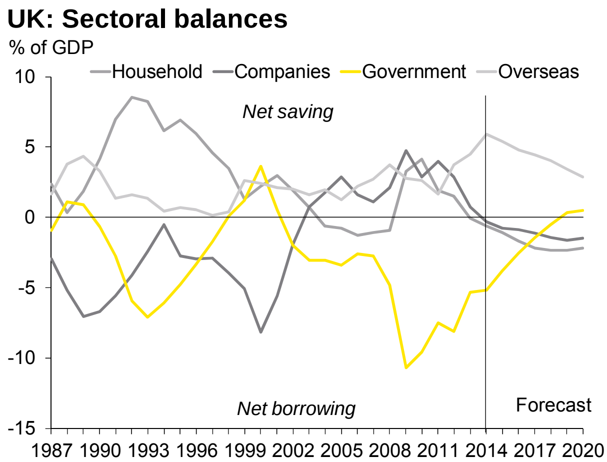
The Budget put the target date for the first fiscal surplus back to 2019-20, but this plan is nevertheless ambitious. The economy faces a £37 billion dose of fiscal medicine over the next four years. With large areas of public spending protected this will not be easy to manage, despite the Chancellor's conversion to Fabian gradualism. It will not be an easy ride for the economy either. That is because the government can only be in surplus if the private (household, company or overseas) sectors are in deficit.

Fiscal prudence must be accommodated by private profligacy...

Historically, the public sector has only been in surplus during an investment boom when companies have been borrowing heavily. We saw this for example at the end of the Lawson boom in the late 1980s and again during the dot-com boom at the turn of the millennium. These government surpluses also reflected reductions in the household sector financial surplus. They moved into deficit before the financial crisis, but households rarely moves into deficit for very long. Nor does the overseas sector: in other words, the UK rarely runs a sustained surplus on the current account of the balance of payments. This normally requires a strong world market to coincide with a weak UK market. The last time we saw this was during the late 1990s.



Source : EY ITEM Club calculations using OBR forecasts



Source : EY ITEM Club

The sectoral balances chart shows how we expect the public sector surplus to be accommodated this time. We think it will be difficult to get other sectors to move into deficit. The household sector has moved back into broad financial balance since 2013, but seems unlikely to move into substantial deficit given the hangover of debt from the pre-crisis period. Household debt has fallen back from 175% of income in 2007 to around 140% now. But this ratio is still very high and borrowers and lenders (not to say their regulators) seem reluctant to see it move back up to pre-crisis levels.

... and needs companies to step up to the plate

Here again, there is an interesting comparison with the US, which has seen a similar fall in the household debt ratio, but from a much lower level. Moreover, the use of non-recourse mortgage loans in many US states meant that a lot more property was repossessed during the crisis, causing much distress. However, these debts were written off, while many UK household are still highly leveraged despite the recovery in house prices.

Realistically, the Chancellor can only get his surplus if companies step up their capital expenditure programmes by borrowing or if we can persuade overseas buyers to take more of our exports. The only other way this can happen is if imports slow, which means that *faute de mieux*, growth will have to slow down to get the balance of payments and government accounts back into surplus. The exchange rate would fall as part of this adjustment, partly because as we have argued, it would restrain any increase in interest rates. This leaves the economic outlook hanging critically on the outlook for investment and exports.

The forecast

The EY ITEM Club forecast for the UK Economy, Spring 2015

% changes on previous year except borrowing, current account and interest & exchange rates

	GDP	Domestic Demand	Consumer spending	Fixed investment	Exports	Imports
2014	3.0	3.5	2.5	8.6	0.5	2.4
2015	2.7	2.9	3.2	5.6	5.1	5.5
2016	2.7	2.9	2.5	7.1	4.1	4.6
2017	2.4	2.7	2.1	6.7	3.8	4.3
2018	2.4	2.4	1.9	5.9	4.2	4.1
2019	2.6	2.3	1.7	5.3	4.2	3.3
2020	2.7	2.3	1.5	4.9	4.0	2.9
	Net Govt Borrowing(*)	**Current account (% of GDP)**	**Average earnings**	**CPI**	**Bank Rate**	**Effective exchange rate**
2014	4.6	-5.9	1.3	1.5	0.5	87.0
2015	3.7	-5.4	2.7	0.1	0.5	92.0
2016	2.2	-4.8	3.6	1.6	0.6	92.2
2017	1.2	-4.4	3.9	1.9	1.4	89.5
2018	0.3	-4.0	4.1	2.0	2.2	87.4
2019	-0.4	-3.4	4.1	2.0	3.0	85.6
2020	-0.5	-2.9	4.1	2.0	3.5	84.5

(*) Fiscal years, as % of GDP

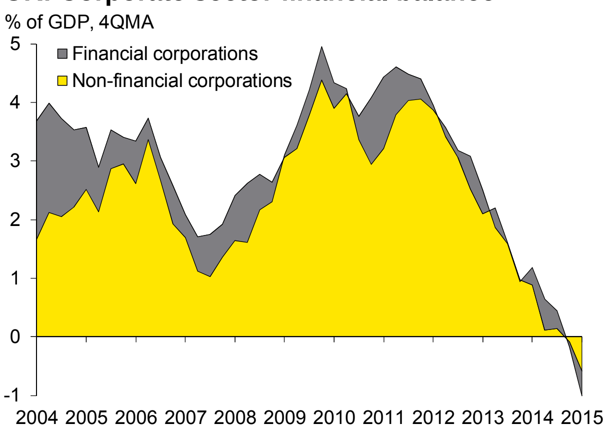
Source: EY ITEM Club

The UK consumer, having been lashed by rising fuel and food prices for so long, is taking a welcome break this summer. Until recently, the recovery in household incomes has been due to rising employment rather than wages, but now the tightening labour market is at last pushing wages up, while the weakness of commodity prices and the strong pound crushes inflation. Real disposable incomes are forecast to increase by 3.5% this year and 2.2% in 2016.

Consumers are not likely to be hogging the fast lane for much longer...

However, the Budget heralds a major increase in taxes on households as well as a massive squeeze on welfare payments. As we have argued, households are already loaded up with debt. They have been trying to pay this down since the crisis and few will be prepared to see to see it move back up again. The forecast sees consumer spending increasing by 3.2% this year and another 2.5% in 2016. However, the growth in real disposable income then slows to 1.9% in 2017 as the Budget squeeze begins to take effect and that the growth in real disposable incomes and spending falls back below 2% a year over the next three years.

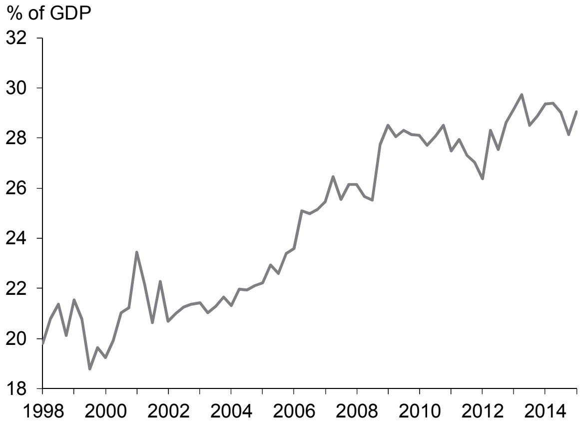
UK: Corporate sector financial balance



Source : Haver Analytics

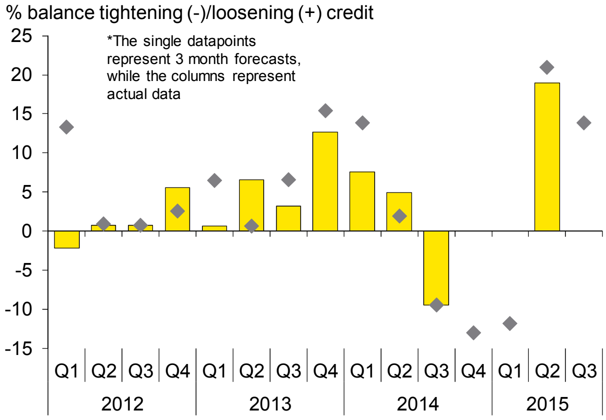
As we have seen, we need to see a major increase in company spending and borrowing to ease the path to prudence in the public accounts. The company sector is already moving back into deficit, but the large surpluses run over the last decade have left large PLCs with strong balance sheets, well placed to invest for higher efficiency. Lending to SMEs is at last picking up, which will also help investment finance. However, the shortage of engineering and other technical skills remains an obstacle to higher investment & exports and hence to the Chancellor's fiscal objectives.

UK: PNFC deposits to GDP ratio



Source : Haver Analytics

UK: Credit availability for small firms



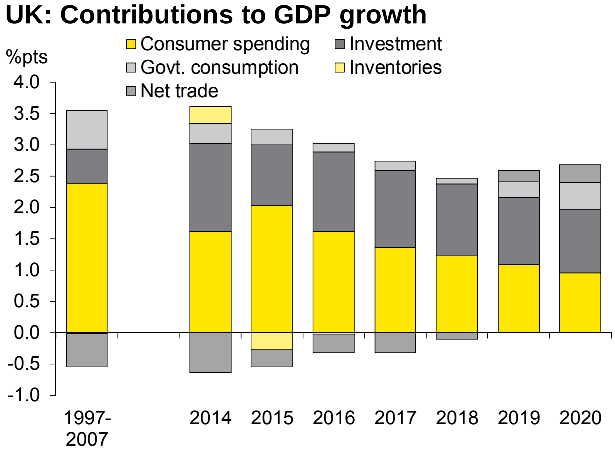
Source : Bank of England Credit Conditions Survey

The Chancellor is clearly aware of this and his Budget measures are designed to alleviate these problems. The incentives for capital investment and the apprenticeship levy should stimulate company spending and borrowing as well as help increase productivity. The replacement of the minimum wage by the higher living wage and the ambition of increasing this progressively to £9 an hour, was primarily designed to offset the withdrawal of tax credits, effectively handing over the responsibility for supporting low paid workers over to employers. But it should also have the effect of spurring investment by making labour more expensive, reinforcing the effect of the tightening labour market. That said, there is a clear risk that that companies that mainly employ unskilled workers will scale back their activities, reducing both employment and investment. Ultimately, the success or otherwise of the Budget strategy depends upon how the business community responds to the challenge.

...but business spending is picking up again

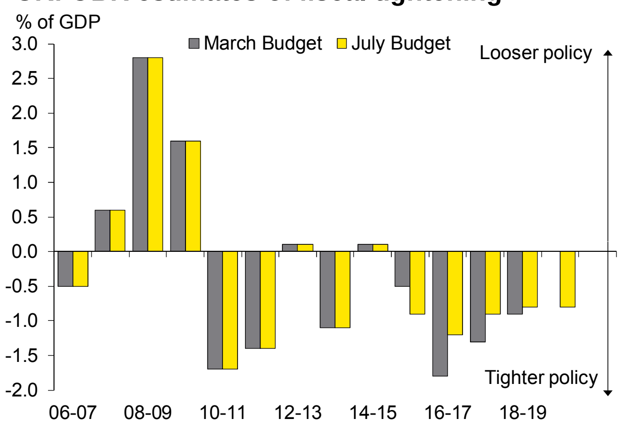
The forecast sees the growth in business investment easing back to 5.1% this year from 8.0% in 2014. However, it picks up pace again, growing by 7.4% next year and 7.1% in 2017. Further increases push business investment up to 12.7% of GDP by 2019, back to the level seen at the turn of the millennium. With interest rates remaining low, housing also remains strong despite the Budget's move to restrict mortgage tax relief for buy-to-let investors. The relaxation of the planning regime for brownfield sites should also be simulative. Growth in housing investment increases from 10.3% this year to 12% in 2016, before easing back in the later years of the forecast. The household sector shows a small financial deficit over the forecast period, but this remains consistent with a very gradual increase in household debt ratios.

UK: Contributions to GDP growth



Source : EY ITEM Club

UK: OBR estimates of fiscal tightening



Source : EY ITEM Club calculations using OBR forecasts

The subdued pace of consumption and the lower exchange rate should slow import growth and encourage UK producers to shift their focus from domestic to overseas markets. We think that the recovery in European markets is now well established. Exports to these markets have been held back by the strength of the pound against the Euro but that should fade as Europe picks up and the UK consumer markets slow.

The invisibles should also help smooth the path to prudence

The forecast sees the trade deficit moving up from £123 billion this year to £183 billion by 2020. However, the continued success of UK service exports means that this increase is outweighed by an improvement in the balance of trade in services, from £96 billion this year to £157 billion in 2020. The recovery in European property markets should improve the returns on our investments there, helping to repair the damage that their earlier plunge did to our Interest, Profit and Dividend account. So on this forecast, an improvement of £34 billion in the balance of payments, from £100 billion this year to £66 billion by 2020, provides most of the room for the Chancellor's budget surplus and helps to rebalance the economy away from domestic spending.

...but the Budget adds to the uncertainty associated with the economic forecast

The economy continues to be buffeted by world events, with developments in Greece and China providing the most recent worries. The Budget strategy hangs critically upon whether the business community rises to this challenge and this adds to the uncertainty around economic forecasts at the moment. The OBR has assumed that the higher living wage will do little damage to employment levels and will largely offset the impact on household incomes of the very large cuts to welfare spending. However, there is a risk that the damage to household incomes and therefore consumer spending turns out to be greater. Whether this summer's sunshine is strong enough to help with the extensive roof repairs the Chancellor is planning remains to be seen.

Forecast in detail

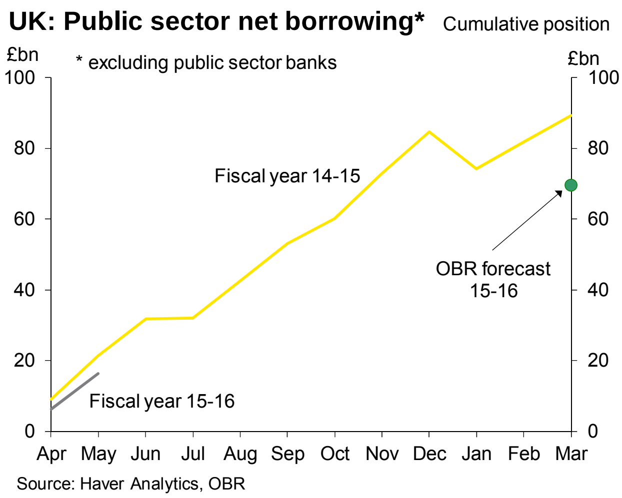
1. Fiscal Policy

The Chancellor's post-election 'Summer Budget' saw pragmatism trump ideology, with a relaxation of the squeeze on departmental spending and a slower path of deficit reduction. But the price for this was a sharp cut in the welfare budget and a hike in the taxes. Overall, fiscal policy is set to remain a drag on the economy.

We had long doubted the feasibility of, and noted the risks around, the severe squeeze on departmental spending implied by the plans set out in March's Budget. Mr Osborne happily saw the light, with cash spending on departments now forecast to be broadly flat over the next three years, compared to the average 3% annual cut proposed in March.

However, higher departmental spending was offset in part by a decision to go ahead with £12bn of welfare cuts over the course of the current Parliament. The Government's commitments to protect the 'triple-lock' on state pension uprating, universal pensioner benefits and child benefit meant that the cuts will fall on the working-age benefits bill, mainly via spending on tax credits.

Moreover, the Budget announced net tax increases amounting to £6.5bn by 2020-21, with the bulk of the extra revenue coming from reforms to dividend taxation and Vehicle Excise Duty, a hike in insurance tax and measures to reduce tax evasion and avoidance.



That said, overall, the Budget did announce a slower path of deficit reduction. Public sector net borrowing in 2015-16 was revised down from £75.3bn to £69.5bn, reflecting stronger than expected tax receipts in the early part of the fiscal year, the 'in-year' spending cuts announced in June and Budget tax rises which will kick in this year. But borrowing over the next five years was revised up by a cumulative £18bn, with the public finances now expected to return to surplus in 2019-20, a year later than the pre-election plans.

Meanwhile, the Budget also announced a new 'Charter for Budget Responsibility'. This will commit the Government to run a budget surplus by 2019-20 and to ensure that public sector net debt falls as a share of GDP in each year from 2015-16 to 2019-20. And a budget surplus will have to be run in each year after 2019-20 as long as the economy remains in "*normal times*".

"*Normal times*" have been defined by HM Treasury as the economy growing by at least 1% on a rolling four-quarter on four-quarter basis. On this definition, the economy has been in a 'normal' state in 30 of the last 40 years. But fiscal surpluses have been run in only five of those 40 years, with the economy clearly overheating in at least two of those years. So sticking to the new mandate will require a sea-change in fiscal discipline compared to previous post-war history. Persistent surpluses also imply the tight fiscal/loose monetary stance of recent years becoming firmly embedded.

2. Monetary Policy

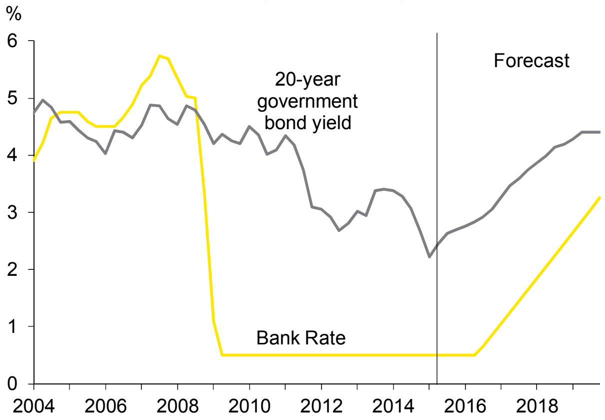
Although 2015 has so far seen the MPC unanimous in voting for interest rates to remain unchanged, it appears likely that this consensus will be broken soon. The minutes of recent meetings have noted that for two members – most likely Martin Weale and Ian McCafferty – the decision has been "*finely balanced*", with their belief being that stronger wage growth will soon warrant a rate hike. Indeed, in a recent interview Mr Weale suggested that the economy could be in this state as soon as August.

At the other end of the spectrum, Bank Chief Economist Andy Haldane has continued to argue that the next move in interest rates was as likely to be down as up. Were the Greek crisis to continue to worsen then this could be a possibility, but as things stand a rate hike looks relatively unlikely.

However, an early rate hike looks to be a similarly distant prospect. While some other members have also made more hawkish comments of late, particularly around the risks of combining stronger wage growth with weak productivity, none seem to be as close as Weale and McCafferty to voting for higher rates. Raising interest rates with inflation well below target would pose communication challenges, while the downside risks from the Greek crisis provide a further argument in favour of the "wait-and-see" approach.

On balance we now expect the first increase in Bank Rate to come in Q3 2016, two quarters later than our previous forecast. Thereafter, the normalisation of monetary policy is likely to be very slow given the large amount of spare capacity in the economy and the need to offset further fiscal tightening. Consequently, we expect Bank Rate to end 2016 at only 1% and 2017 at 1.75%. This will also keep long rates low, with 20-year yields expected to end 2015 at 2.7% and 2016 at 3.1%.

UK: Bank Rate & 20-year bond yield



Source : EY ITEM Club

Sterling strengthened through H1 2015, with the ECB's QE programme weakening the euro and markets pushing back their expectations for the first US rate hike, which has weighed on the dollar. With the US set to raise interest rates in September, sterling looks likely to give back some of the gains against the dollar, but with the ECB continuing to loosen policy via QE, sterling should maintain its recent strength against the common currency in the short-term. However, over the medium-term we expect the exchange rate to drop back, as part of the adjustment that we describe in the *Introduction*.

3. Prices and Wages

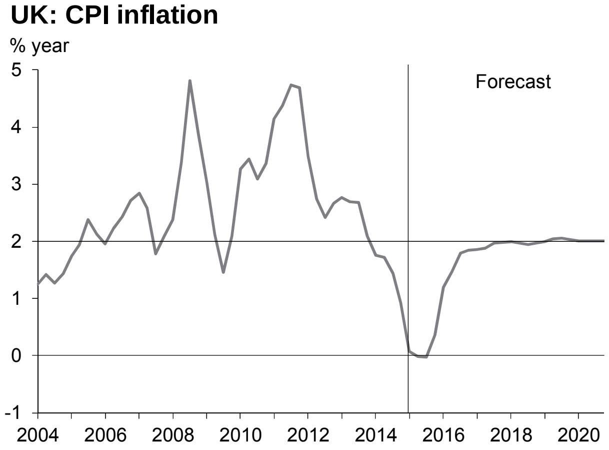
CPI inflation has bumped around close to zero throughout 2015, even briefly turning negative for the first time in 55 years in April. The low rates of inflation are largely a function of falling prices in the food, petrol and energy categories. Cumulatively these categories have reduced CPI inflation by around 1ppt through H1 2015, which represents a complete reversal of the experience from 2011-13, when these categories were responsible for a large chunk of the persistent overshooting of the inflation target.

However, it is not just the more volatile components which are keeping inflation low. Core inflation was just 0.8% in June, suggesting that underlying pressures are weak. Some of this weakness will be a reflection of the impact of cheaper oil on transportation costs, while the strength of the pound has also been a factor, particularly in terms of the impact on the prices of goods imported from the Eurozone. But it is also likely to reflect the large amount of spare capacity in the economy, which continues to weigh on pricing power.

It is difficult to see why inflation will deviate far from zero in the short-term. Data from DECC suggests that petrol prices have stabilised of late, having rallied earlier in the year, and our assumptions for oil prices suggest little movement in retail petrol prices over the remainder of the year. Meanwhile, the producer prices data suggest that there are no inflationary pressures coming through the supply chain. There is a good chance that we will see the CPI measure of inflation briefly turn negative once more during the summer and we expect it to average just 0.1% in 2015 as a whole.

As we move towards the end of the year, the sharp declines in petrol prices at the end of 2014 will begin to provide powerful base effects which, in the absence of further sharp declines in the oil price, will start to push headline inflation rates back up again.

However, underlying inflation pressures are likely to remain muted. We expect only a steady recovery in earnings growth, which should be offset in part by an improvement in productivity. And the degree of spare capacity in the economy is unlikely to diminish quickly, preventing firms from doing much to improve their profit margins. Therefore, in spite of the powerful base effects, CPI inflation is only expected to average 1.6% in 2016 and we expect it to take until 2018 before inflation moves back into line with the 2% target.



Source : EY ITEM Club

RPI inflation will be higher over the forecast period, reflecting the so-called 'formula effect', our expectation that house prices will rise more quickly than general prices and, from the second half of 2016, the impact of interest rate hikes on mortgage interest payments.

4. Activity

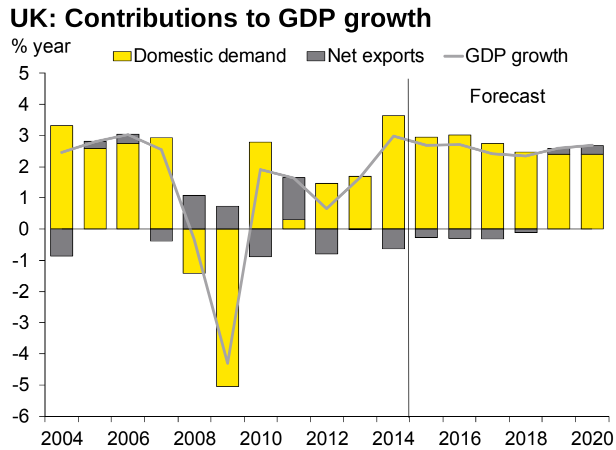
Evidence that GDP growth has accelerated on Q1's pace points to recent concerns that the economy's expansion was losing steam being misplaced. That said, the expansion is set to remain a domestically-driven one.

The official data available so far for Q2 has been fairly promising. Output in the services and industrial sectors rose in April and while construction output dipped, this followed a strong rise in March. Meanwhile, retail sales have put in a robust performance and the CIPS activity surveys suggest that growth at least held pace with Q1's expansion. Our short-term GDP model points to GDP rising by 0.7% in Q2, up on Q1's 0.4%.

There are a number of reasons to expect growth to run at a similar pace in the second half of the year. One is the ongoing stimulus from cheap oil. As of July, the price of oil was 40% lower in sterling terms than a year earlier. This should contribute to keeping inflation close to zero over the next few months, boosting consumers' purchasing power. We expect real incomes to rise by 3.5% in 2015, the strongest performance since 2001.

Investment has been punching above it weight in driving recent growth, rising by 2% q/q in Q1 2015 and confounding predictions that the general election would stymie spending by firms. A healthy environment for consumer spending should continue to give firms the confidence to spend their sizeable cash piles.

But the long-running dependence of growth on domestic activity shows little sign of going away. Tentative signs of recovery in the Eurozone economy risk being derailed by a potential 'Grexit'. And while recent evidence from the US has been promising, the economy stagnated in Q1. Moreover, with sterling's trade-weighted value reaching a seven-year high in July 2015, net exports look unlikely to make any significant contribution to growth.



Source : EY ITEM Club

Overall, we expect the economy to grow by 2.7% this year, just short of the 3% achieved in 2014. This should give the UK a good chance of repeating 2014 and taking the number-one spot amongst G7 economies. But with GDP set to grow by little more than its long-run average, the prospect of output catching up with the level implied by the pre-crisis tend is looking ever-more remote.

5. Consumer Demand

The UK consumer has displayed a textbook reaction to the collapse in the oil price since late-2014. Allied to falls in food and energy prices, this fall has driven inflation down to zero at the same time as wage growth has been steadily accelerating. The net effect has been a substantial improvement in household spending power, with real incomes rising by 4.5% over the year to Q1 2015. The improvement in spending power has been accompanied by a strengthening in sentiment, so households have been quick to spend their extra resources; annual consumer spending growth of 3.4% in Q1 was the strongest for seven years.

The recent strength of retail sales – which were up 1% in the three months to May compared with the previous three months on an excluding fuel basis – suggests that consumer spending growth is likely to have remained robust in Q2.

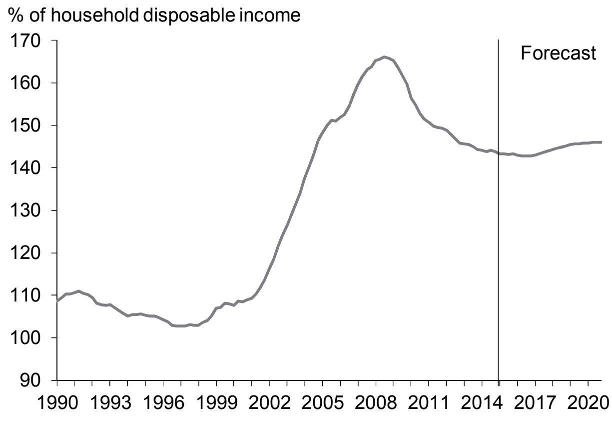
It looks as if the boost to spending has further to run. Inflation is likely to remain close to zero for much of the year, while wage growth should continue to steadily rise as the labour market tightens and skills shortages appear. And spending power has been further enhanced by April's generous increase in the tax-free personal allowance from £10,000 to £10,600, which was worth £120 to all basic and higher rate taxpayers. With interest rates unlikely to rise until the middle of next year and consumer confidence at its highest level since January 2000, we expect consumer spending to grow by 3.2% in 2015, the strongest growth since 2004.

The boost from low inflation is likely to ease as we move into next year and the government's decision to make severe cuts to welfare spending will weigh on household incomes. However, these factors should be mitigated by a further pickup in pay – partly as a result of the new compulsory living wage – and continued growth in employment.

Admittedly, households are likely to have to contend with rising interest rates from next year. But the normalisation of monetary policy is set to be gradual and households are in better shape to weather rate hikes, with the debt-to-income ratio around 25ppts lower than its 2008-peak

Therefore, though consumer spending growth is expected to slow to 2.5% in 2016 and 2.1% in 2017, it will remain a key contributor to GDP growth.

UK: Household debt-to-income ratio



Source : EY ITEM Club

6. The Housing Market

The housing market has shown signs of reviving following the slowdown seen towards the end of 2014. Record low interest rates and strongly rising real incomes should continue to support activity. But already-elevated values suggest that property price growth is unlikely to accelerate significantly.

A range of housing market indicators have shown increased activity as 2015 has progressed. Mortgage approvals rose by 10% y/y in April, reaching a 14-month high of 67,580 (although some of this rise reversed in May). And the new buyer enquiries balance of the RICS survey climbed in May to its highest level in just over a year. Meanwhile, the number of housing starts in England rose to 141,290 in Q1, the highest since the second quarter of 2008.

Some upturn in activity was to be expected given the tailwinds supporting the market. Notably, mortgage rates have continued to decline. The average interest rate on a new mortgage fell to 2.59% in

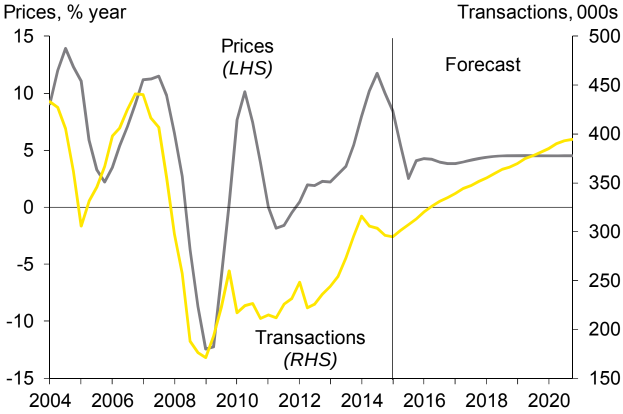
May, compared to 3.13% a year earlier and the lowest since records began in 2004. Meanwhile, growth in real household incomes has picked up sharply and consumer confidence is running at historically high levels.

However, rising activity has not yet translated into an acceleration in house price growth. On the contrary, Nationwide reported that the three-month average of annual price growth fell from 7.5% in January to 4.4% in June. On the same basis, the Halifax measure was unchanged.

The growing unaffordability of property is likely constraining price rises. According to the Halifax, the ratio of average house prices to incomes reached 5.1 in Q1 2015, the highest since the third quarter of 2008.

Going forward, recent increases in long-term interest rates suggest that mortgage rates are unlikely to continue falling, while unaffordability will remain a key constraint. But these effects will be mitigated by an imbalance between increasing demand for houses alongside limited supply (the RICS new instructions balance remained in negative territory in May for the fourth consecutive month). We expect property prices to rise by 5% in 2015 followed by 4.1% in 2016.

UK: House prices & transactions



Source : EY ITEM Club

7. The Company Sector

The softening in businesses' appetite to invest seen in the second half of 2014 appears to have been a temporary hiatus, with Q1 seeing a strong rise in spending by firms. And the outlook for investment looks bright.

Following two quarters of stagnation in the second half of 2014, business investment rose at a quarterly rate of 2% in the first three months of 2015. This left spending by firms 5.7% up on a year earlier.

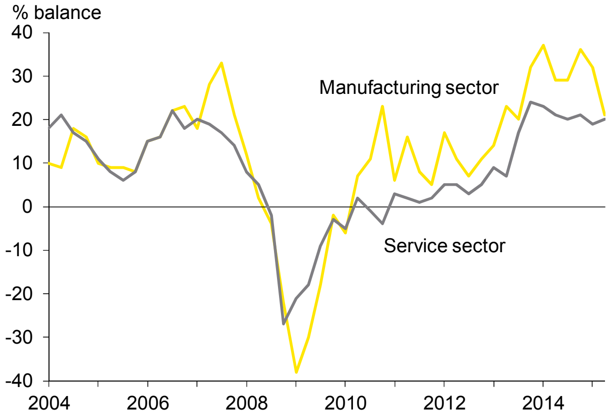
So predictions that uncertainty around the outcome of May's general election would deter investment appear to have been wide of the mark. Indeed, according to the CBI, the proportion of firms citing demand uncertainty as a constraint on business spending fell in both Q1 and Q2 2015, dropping in the latter quarter to its lowest level in a year.

Meanwhile, the UK corporate sector ran a financial deficit equal to 1.2% of GDP in Q1. This was the fourth consecutive quarterly deficit, following 46 quarters of surpluses. So after a long period of saving by corporates, firms look increasingly willing to dip into their financial resources in order to fund spending.

And prospects for continued growth in investment look promising. Both the BCC's and the Bank of England's Agents measures of investment intentions have been running at above-average levels in recent months. Meanwhile, although corporate profitability, excluding the North Sea sector, has dropped back from the 13-year high recorded in Q3 2014, it remains well above the long-term average. And financial conditions remain favourable, with borrowing costs faced by companies close to record lows.

Granted, the lack of a recovery in the price of oil will continue to hold back capital spending by oil producers. While the extraction sector accounts for only 2% of GDP, it represents around 6% of all business investment.

UK: Investment intentions



Source: BCC

But the balances of influences points towards growth in business investment remaining strong. We expect this component of GDP to rise by 5.1% in 2015 and 7.4% the following year, in excess of overall GDP growth and implying a rising share of investment in national output.

8. The Labour Market

Much of the period since 2008 has been an unusual one for the labour market, with strong growth in employment but a historically weak performance for pay and productivity. However, there are increasing signs that the revival in the economy is returning the jobs market to a more 'normal' state.

For one, the previous heavy reliance of jobs growth on part-time and self-employment has receded in favour of full-time work. As of May, the number of full-time employees was up by 1.2% y/y, but the number working part-time was flat over the same period, while self-employment was down 2.8%.

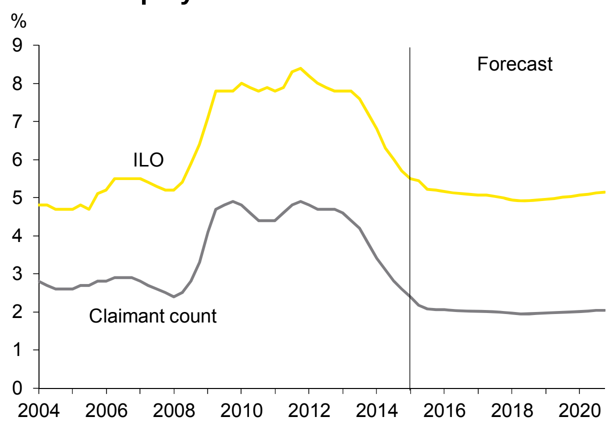
Second, wage growth has shown convincing signs of picking up, with headline average weekly earnings growth reaching a five-year high of 3.2% in May 2015. A tighter labour market should see pay growth accelerate further. A 3% rise in the minimum wage due in October will also support earnings. Our forecast shows nominal pay growth rising from 1.3% in 2014 to 2.7% in 2015 and 3.6% in 2016.

That said, a sustainable recovery in pay will require a pick-up in productivity. After a long period of stagnation, the omens here are looking more promising, a third sign of returning labour market normality. Output per hour rose at annual rate of 1.3% in Q1 2015, the best performance for three years. Granted this still left the level of productivity 14% below that implied by the pre-financial crisis trend. But the rate of improvement is moving closer to the historical norm, capping growth in unit labour costs even as pay rises become more generous.

A recovery in productivity may help to explain the slowdown in jobs growth seen since the end of 2014. A more efficient workforce will allow firms to expand output in a less labour-intensive fashion, with employment growth forecast to slow from 2.3% in 2014 to 1.7% in 2015 and 1.1% in 2016. But the changes to tax credits announced by the Chancellor may also slow workforce growth in a less benign way if they reduce the incentive for people to take accept low-income employment.

The precipitate drop in unemployment seen in recent years is also likely to slow. We expect the ILO rate to decline from 6.1% in 2014 to 5.4% in 2015 and 5.1% in 2016.

UK: Unemployment



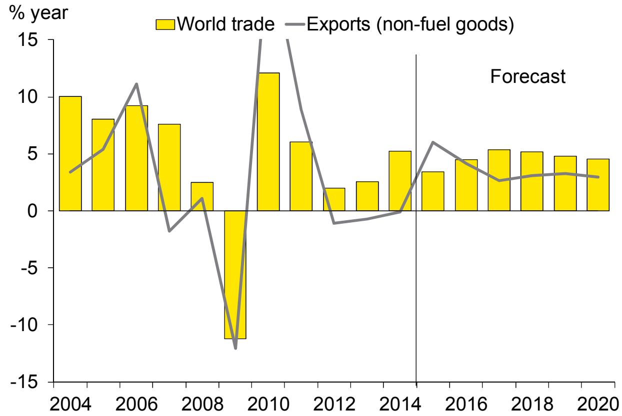
Source : EY ITEM Club

9. Trade and the Balance of Payments

The official trade data have been exceptionally volatile over recent quarters, making the underlying trend difficult to identify. But business surveys point to a relatively subdued performance, with the boost from stronger activity in the US and Eurozone being more than offset by the damage to competitiveness from the 10% appreciation in the value of sterling against the euro since the beginning of the year.

Looking forwards, our forecast assumes a further modest strengthening in both the US and Eurozone economies, which should provide some support to UK exports. However, we anticipate a further appreciation in the value of sterling on a trade-weighted basis, which is expected to limit export growth to 4.1% in 2016 and 3.8% in 2017.

UK: Exports & world trade



Source : EY ITEM Club

The current account deficit was 5.8% of GDP in Q1 2015, only a little narrower than 2014's record shortfall. That the external deficit has become so large largely reflects a sharp increase in the deficit on the primary income account, with UK investments abroad yielding poorer returns than foreign investments in the UK. This should gradually turn around as the performance of the global economy improves and, therefore, returns on the UK's investments abroad are boosted. But this will take some time and, with import growth likely to remain strong as the domestic economy continues to perform well, this means that the current account deficit is expected to narrow only very slowly to around 5.4% of GDP in 2015 and 4.8% in 2016.

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

About ITEM Club
The ITEM Club is the only non-governmental economic forecasting group to use the HM Treasury's model of the UK economy. ITEM stands for Independent Treasury Economic Model. HM Treasury uses the UK Treasury model for its UK policy analysis and Industry Act forecasts for the Budget. ITEM's use of the model enables it to explore the implications and unpublished assumptions behind Government forecasts and policy measures.

Uniquely, ITEM can test whether Government claims are consistent and can assess which forecasts are credible and which are not. Its forecasts are independent of any political, economic or business bias.

Ernst & Young LLP

The UK firm Ernst & Young LLP is a limited liability partnership registered in England and Wales with registered number OC300001 and is a member firm of Ernst & Young Global Limited.

Ernst & Young LLP, 1 More London Place, London, SE1 2AF.

ED None

10653.indd (UK) 07/15. Artwork by Creative Services Group Design.

In line with EY's commitment to minimise its impact on the environment, this document has been printed on paper with a high recycled content.

ey.com/uk