EY ITEM Club Winter Forecast

Prospects for the economy as the UK prepares to leave the EU

January 2017


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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.

Foreword

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Economists are right, the UK economy is changing. Don't wait for Brexit and get left behind.

Economists have been the subject of criticism in recent months ...

Following the vote to leave the EU, the UK economy has performed better than some economists predicted. Not all forecasters envisaged a sharp post-referendum slowdown, nevertheless the difference between the outturn and what is perceived as having been the consensus economic forecast has been used by some commentators as evidence of failure of economic forecasting. If this mood persists, it risks creating a mistrust of economic forecasts in general.

Trust in economic forecasts may not improve in 2017. The impact of Brexit is just one of several factors making forecasting extremely challenging. While it is true that we know the outcome of the US presidential election, we are still waiting to understand the details of policy. In Europe, political uncertainty dominates the outlook with elections in major economies upcoming in 2017. These are just two of a range of variables that taken together point to a large degree of uncertainty surrounding the short to medium-term outlook and hence a greater risk of forecast error than normal.

...but writing off economic forecasts risks complacency...

The economy has not fallen off a cliff since the vote on June 23rd: consumers have continued spending and increasing their indebtedness; and businesses appear to have made very few significant changes in strategy as a result of the vote to leave the EU. Many commentators are suggesting that this shows that fears about the UK leaving the EU were over-stated.

However, we are at the start of the Brexit process and the reality is that it is too early to know what the impact of Brexit will be – the detail of the UK's negotiating position remains unclear and the EU response to any UK proposals even more so. There is a real danger that the current attitude to economic forecasts means that significant changes to the economic outlook will be ignored and risks not properly mitigated. Businesses and consumers need to avoid being lulled into a false sense of security about their future prospects.

...because the UK economy is slowing and changing...

As the EY ITEM Club Winter forecast demonstrates, there are already signs of significant change in the UK economy that will have consequences for businesses and their customers. As the UK moves towards Brexit in 2019, the key features of the UK economy for the next two years will include:

- **A lower pound.** The pound has fallen by around 15% on a trade weighted basis since January 2016 and the EY ITEM Club expects it to stay at these levels;

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- **Rising inflation.** CPI has already reached 1.6% and is forecast to touch 3% in 2017, averaging 2.8% for the year overall, a major shift compared to recent levels;

- **Lower consumer spending growth.** Consumer spending is expected to have grown at 2.8% in 2016 but will slow as household incomes are squeezed over the next two years, falling to 1.7% in 2017 and 0.4% in 2018;

- **Falling business investment.** EY ITEM Club expects business investment to fall in both 2017 and 2018 as overall growth slows, corporate confidence weakens and uncertainty remains high;

- **Improving external conditions.** World markets are improving and the lower pound will provide some support to UK exporters leading to growth of 3.3% in exports in 2017 and 5.2% in 2018.

In overall terms, the EY ITEM Club expects UK GDP growth to slow to 1.3% in 2017 and 1% in 2018. While there is uncertainty around the exact estimates, the broad direction of travel seems clear: slowing domestic demand not fully compensated for by stronger external demand and hence a shift in the balance of economic activity.

...even before Brexit.

Forecasting the likely outcome of the Brexit negotiations is extremely difficult given the lack of specific information in the public domain. The EY ITEM Club have assumed that the most likely outcome is for the UK's future trade with the EU to be governed, at least initially by WTO rules. This is only one of the possible scenarios and is not the Government's preferred outcome, but it remains a possible one given the risk that the ambitious objectives set out by Theresa May cannot be realised within two years. In this scenario, UK GDP growth continues to be challenged for the rest of the decade after 2018, failing to get back to 2% before 2020.

Brexit is only one of the issues to address.

I have consistently advocated "wait and see" as the sensible corporate response to Brexit, reflecting the absence of detailed information on which to base significant decisions. However, whatever the outcome of the Brexit negotiations, there are clear signs of change in the UK economy which point to a slowdown and shift in demand in the next couple of years, before any formal Brexit.

Now is therefore the time for businesses to review their strategies and associated business plans and to update these to reflect the slowing UK macro-environment. Slowing growth and rising inflation, together with a depreciating currency, could potentially be an unhealthy cocktail. It would not take much for the economy to spiral further downwards at which point starting to act may be too late.

The key short-term steps are:

- Review the next two years of the current business plan in the light of the changed UK macro-economic outlook and identify any realignment and risk mitigation activities that are required. Then assess the "knock on" effects for the post-Brexit plan.

- Evaluate the scope for changes in any international activities. The pound looks set to stay at current levels for some time and hence both export and import activities need to be re-assessed. The USA could become an increasingly attractive market if President Trump provides the stimulus he has alluded to. Equally, commodity and oil prices appear to be strengthening and this should boost growth in the emerging markets. However, imports will become more expensive and so sourcing and location strategies require review.

For the period beyond two years, Brexit will be the key issue to consider. The exact nature of any settlement remains difficult to call but it is important to be developing options for potential future moves. Certainly stress testing the business against a WTO option after 2019 would be sensible to understand the potential scale of the challenge in what would appear to be a plausible worst case outcome.

Finally, it is important to continue to provide the UK Government with guidance on the priorities for the exit negotiations and future trade priorities.

Highlights

- The forecast sees GDP growth slowing to 1.3% this year and just 1.0% in 2018, picking up slowly to 1.4% in 2019 and 1.8% in 2020. Trade performance is critical to this forecast, picking up this year as the consumer slows and then adding ¾% a year to GDP in 2018 and later years. CPI inflation moves up temporarily to 3.1% by the final quarter of this year, before falling back towards target next year. With wage inflation remaining subdued and the economy slowing, we think the MPC will hold base rates at their current 0.25% until the spring of 2018.

- Recent government statements, culminating in the Prime Minister's speech on Tuesday, have brought greater clarity on the shape of the UK's exit from the EU. This will have a major impact on the UK's economic performance in the next decade and is already influencing the economy even before the Article 50 talks have begun. We think the most likely outcome is that the UK will be trading with the EU under WTO rules by the end of this decade.

- Whatever the outcome, the fall in sterling has signalled the need for a major shift in the structure of the economy, away from an over-dependence upon domestic consumer markets towards a better performance in overseas markets. The consequent increase in inflation will force a progressive slowdown in household spending over the course of this year, adding to the pressures caused by the weakening labour market, the tepid growth in wages and the cash freeze in working age benefits.

- Trade performance continues to disappoint. So far, exporters have in the main taken advantage of the lower pound to increase their sterling export prices. With import prices increasing in tandem, a fall in the exchange rate tends to increase the sterling value of the visible deficit. However, the consequent surge in export profitability provides a big incentive to find overseas customers and build export capacity and expertise. We expect net exports to strengthen progressively this year as overseas markets strengthen and import volumes reflect the failing momentum in the consumer sector.

- Sterling's devaluation has already boosted the profits of UK multinationals and their stock market value. It has also boosted the value the nation's overseas assets and investment income. Export volumes are set to increase by 3.3% this year and 5.2% in 2018, while import volumes increase by 3.0% and 2.3% respectively. With balances on overseas income and (in 2019) international transfers also improving, net exports add 0.8% to GDP in 2018 and later years. We expect the deficit on the current account to narrow from 4.5% of GDP this year to 3.7% of GDP in 2018 and 2.5% in 2019.

- Trade performance and output growth in 2019 and beyond will depend critically upon the exit terms that can be agreed with the EU27 and other countries. Though the Prime Minister's speech has given us greater clarity over the UK position, with elections in the Netherlands, France and Germany due later this year, it will take longer to get clarity on the views of the EU27 and the shape of the ensuing negotiations. In the meantime, the US election result has heightened uncertainty over US economic and foreign policy, which could also complicate Britain's exit from the EU.

Introduction

The forecast sees GDP growth slowing to 1.3% this year and just 1.0% in 2018, picking up slowly to 1.4% in 2019 and 1.8% in 2020. CPI inflation moves up to 3.1% by the final quarter of this year, but eases back to the 2% target next year. With wage inflation remaining subdued, we think the MPC will hold base rates at their current 0.25% until the spring of 2018.

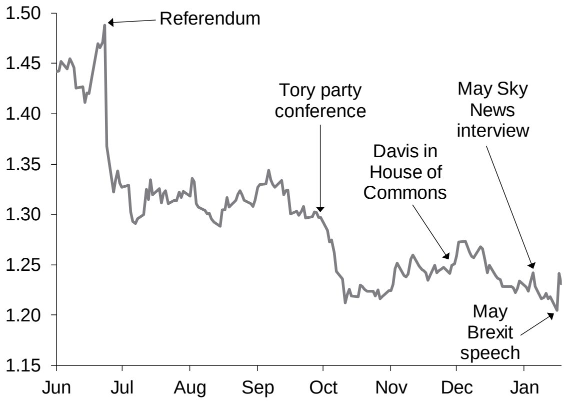
Speculation about the government's Brexit strategy...

The Prime Minister's speech on Tuesday brought much greater clarity on the shape of the UK's exit from the EU. Not only did Theresa May explicitly rule out the UK's membership of the Single European Market, but she went on to rule out full membership of the Customs Union. She appealed to the good sense of other European leaders in setting out the case for a Comprehensive Free Trade Agreement that would allow the UK tariff-free access to the single market in key industries like automotive and aerospace, while leaving us free to strike trade deals with other countries. But whatever the outcome of the Article 50 negotiations, the fall in sterling since the referendum has signalled the need for a major shift in the structure of the economy, away from an over-dependence upon domestic consumer markets towards a better performance in overseas markets.

...has undermined the exchange rate...

The pound has been very sensitive to political events and in particular news about the government's exit strategy and will probably remain so. It fell back from $1.481 on 23rd June, when it looked like a vote to remain was likely, to $1.363 the next day as the result was announced. It reached $1.315 the following Monday, 27th June.

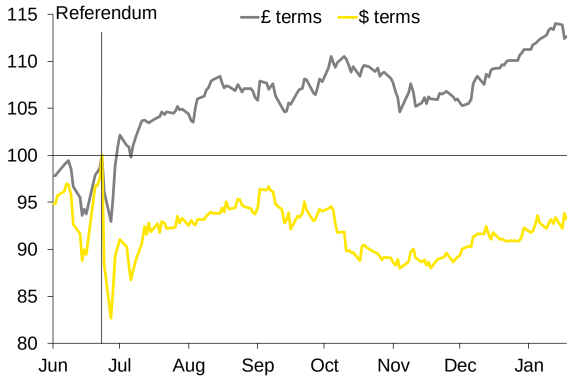
UK: US dollar/sterling exchange rate



Source : Haver Analytics

UK: FTSE All Share

Rebased, 23 Jun 2016 = 100



Source : Haver Analytics

The pound then stabilized at around that level and was trading at $1.299 the Friday before the Conservative Party Conference. The day after Prime Minister Theresa May's speech on Sunday 2nd October - which indicated that the Government were thinking in terms of a 'hard Brexit' - it fell to $1.283 reaching another low of $1.218 the following Wednesday. It then started to recover, reaching $1.262 on 1st December, after David Davis, the Secretary of State for Exiting the European Union, told the House of Commons that the UK would consider making payments to the EU post-Brexit to secure the best possible access to the single market. It increased by 1% on the day, moving up to a high of $1.272 by 6th December. It fell back by 1% the morning after Theresa May indicated in her New Year interview with Sky News on 8th January that the UK would not be a member of the single market after leaving the EU, reaching $1.215, before recovering to $1.230 following her speech on Tuesday.

…but the UK will leave the single market…

The weak pound has been reflected in the stock market value of companies with overseas earnings. Those that have also benefitted from the recovery in commodity prices have had spectacular gains. These developments have also boosted the UK's net International Investment Position and earnings from interest, profits and dividends. The boost to net exports is less certain, and likely to take much longer.

This report sets out our assumptions about the most likely outcome of the exit negotiations, which are expected to start in March, and some of the near-term implications for the economy. We then take a look at the state of the economy as the UK prepares to leave the EU.

…when it quits the EU

This forecast is based on the view that the UK will be trading under WTO rules come March 2019. In her speech on Tuesday, Theresa May made clear her ambition of negotiating a comprehensive FTA with the EU27 and said that she wanted to arrange transitional arrangements for key areas, to avoid the 'cliff edge' and allow businesses to prepare and plan for exit, However, as the difficulties with the recent Canadian FTA demonstrated, a comprehensive FTA would be tough to negotiate and would be subject to ratification by the 27 national governments and some regional administrations. It is possible that sector-specific FTAs could be negotiated for automotive and other industries, but this would take a lot longer than two years, without seriously affecting the shape of this forecast. In the meantime, we seem more likely to fall back on WTO rules rather than trying to extend our privileged access to the single market piecemeal beyond March 2019, as the Prime Minister suggested. Even if our former EU partners were amenable to such arrangements, this would be a hard sell politically as an election loomed.

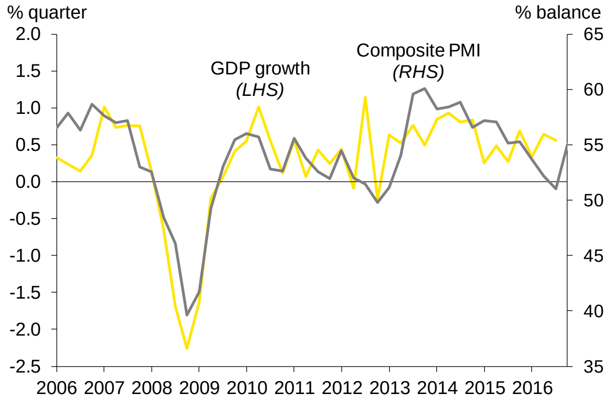
Business confidence has picked up since the referendum…

We have used the WTO option as the central case even since the July forecast. As we put it in our October report, if we cannot have unfettered access to the Single European Market we need to ensure unfettered access to cheap world markets in food and manufactures – which is the silver lining in the WTO cloud. The general feeling seems to be that it is in the economic interests of the EU27 to give the UK a good exit deal. However, it seems likely that the politics will as usual trump the economics. Some businesses seem to think that the government will be able to negotiate special deals for their sectors, so it will be business as usual come 2019. This feeling may have been encouraged by the consultation exercise that Whitehall is conducting to find out what different industries would ideally like. Some manufacturers, including one of the UK's largest car manufacturers,[1] have clearly been given assurances that they will not lose out in the European market under the new trading rules.

These developments have provided reassurance and helped confidence to recover since the initial shock of the referendum result. Business sentiment has picked up nicely in recent months. Manufacturing, construction and service PMIs moved up again in December and the composite PMI, which weights them according to their contribution to GDP, reached a 17- month high of 56.7. The British Chamber of Commerce's fourth quarter survey was also encouraging, showing an increase in investment intentions, which was quite sharp for manufacturing. However, this revival in confidence is vulnerable to disappointing news on the Brexit front.

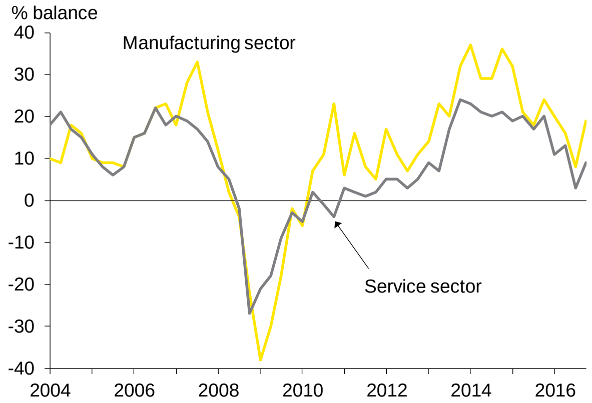
[1] See page 3 of '*Economic and fiscal outlook*', Office for Budget Responsibility, November 2016, http://budgetresponsibility.org.uk/download/economic-and-fiscal-outlook-november-2016/

UK: GDP vs composite PMI



Source : ONS/CIPS/Markit

UK: Investment intentions



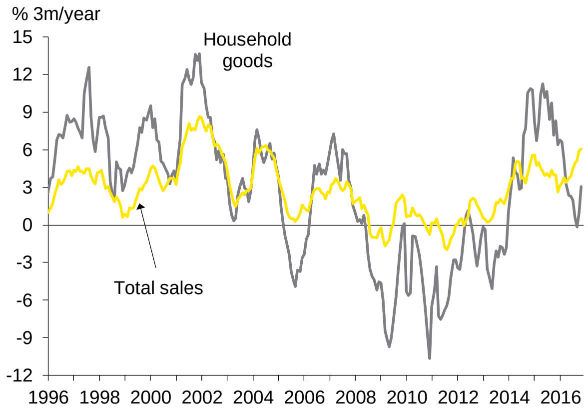
Source: BCC

…but this confidence is liable to disappointment…

It would certainly surprise us if the Article 50 negotiations lead to a nice quick deal. We expect the negotiations to be tough and prone to setback. Reflecting this, our new forecast is more optimistic about the outlook for 2017, but more pessimistic about 2018 and 2019. We see the effect of EU exit on the economy as being shallower, but more prolonged.

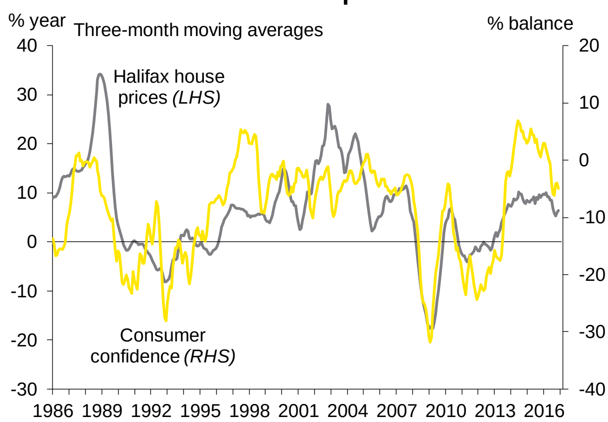
In the meantime, consumers face a bleak New Year as a result of rising inflation and a weakening labour market, undermining the two major supports that households have enjoyed in recent years. Consumers added 1.4 % to GDP in 2014 and another 1.5% in 2015. Employment increased by 2.4% and 1.8% in these two years respectively, while 2015 saw inflation fall back to zero. With inflation remaining low and employment continuing to expand, we estimate that consumption grew by a hefty 2.8% last year, increasing GDP by 1.8% and thus accounting for almost all of the growth in the economy.

UK: Volume of retail sales



Source: Haver Analytics

UK: Confidence and house prices



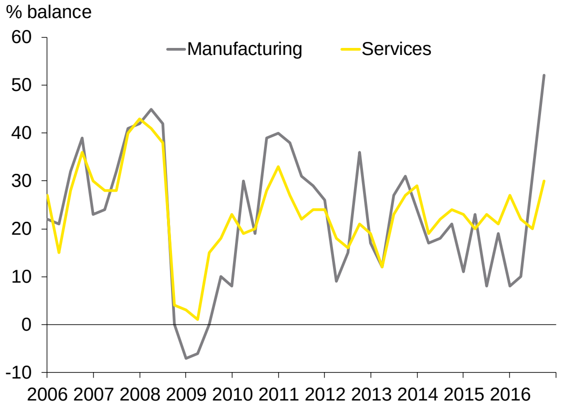
Source: Haver Analytics

Retail sales were particularly strong last year, although they may have been flattered by the fall in the pound, which attracted high-spending tourists and perhaps encouraged savvy consumers to forestall the effect on prices this year. The November figures point to another strong showing in the final quarter. However, they also showed an increase of 0.1% in shop prices on the year, the first increase since June 2014 and a dramatic turnaround from the year to November 2015, when prices fell by 3.2%. The goods price component of the CPI index returned to positive territory for the first time in two years in November, adding to the effect of the strong base-year effects from last year's collapse in petrol prices. CPI inflation increased from 0.9% in October to 1.6% in December - the highest rate since July 2014. It normally takes about a year before the peak effect of a weaker currency on consumer prices is felt. So we think this turnaround largely reflects the decline in the value of sterling in late-2015 and the early months of 2016, with most of the impact of the steep post-referendum depreciation, and indeed higher energy and commodity prices, still to come. The forecast sees CPI inflation close to 3% by the end of this year, before easing back to the 2% target in 2018.

...and business surveys highlight the expected surge in inflation

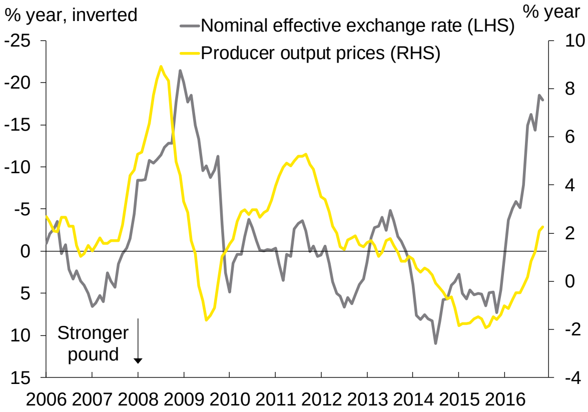
These price pressures are however already passing through the pipeline. Producer input costs increased by 15.8% in the year to December, a five-year high. All of the recent business surveys have highlighted the effect of the pound on import costs, indicating that this will lead to an acceleration in output prices. The British Chamber of Commerce (BCC) fourth quarter survey reported a sharp increase in the proportion of firms planning to raise their prices, pushing the manufacturing balance up to a record high and that for services up to the highest level in nearly six years. Both sectors attributed increased inflationary pressures to higher raw material costs. These price pressures will be felt by consumers as we move through 2017.

UK: BCC survey - pricing expectations



Source : Haver Analytics

UK: Producer output prices & exchange rate



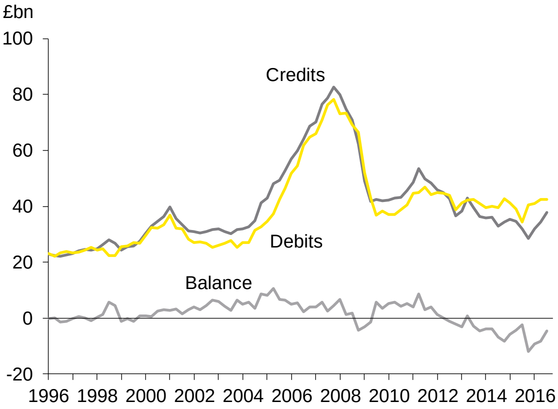
Source : Haver Analytics

Recent business surveys also suggest that employment prospects have picked up of late. However the employment data show that the strong growth of previous years slowed progressively during 2016. It would be a mistake to set too much store by a couple of months' worth of data, but recent Labour Market statistical releases have suggested a flattening out in employment growth, if not an about-turn. Comparing the September to November period with the previous three months showed a 9,000 drop in employment, the second successive decline after more than a year of increases. Unemployment fell by 52,000 on the wider (LFS) measure, but this fall was smaller than in previous releases. And it was associated with a fall in labour force participation. The number of economically inactive people increased by 85,000 on the quarter, possibly a sign that people think the prospects of finding a job are deteriorating. Consistent with this, the latest labour market release showed hours worked flat, a fall in the number of full-time workers and a second successive drop in vacancies (the latter for the October-December period). The only bright spot in the release was a modest pickup in wage growth, with headline regular pay growth reaching a 15-month high of 2.7% in November.

The hiatus in employment growth may reflect post-referendum caution on the part of employers, but may also reflect concerns that pre-date the referendum. Even before then, we were expecting the engine of job creation to slow down, largely as a result of rising labour costs. Besides the introduction of the National Living Wage, employers face the cost of auto-enrolment of pensions and the new apprenticeship levy. However, we expect worries about Brexit to progressively undermine the jobs market over the next two years.

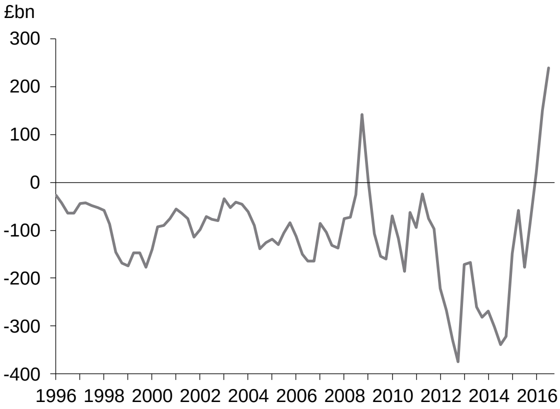
While undermining the consumer, the fall in the value of the pound should help manufacturers and benefit the balance of payments. So far however, the evidence for a revival in manufacturing and exports is decidedly mixed. Manufacturing output fell back in October, but recovered in November, leaving the three month average up just 0.3% on the year. Exports of finished manufactures jumped 4.8% in October, and this level was sustained in November, but left the three-month average down 0.6% (excluding erratics) on the year. December's manufacturing PMI of 56.1 was the strongest reading since June 2014. Prospects for output and new business are strong and there is evidence that a weaker pound is helping to support export demand.

UK: Investment income



Source : Haver Analytics

UK: Net overseas assets



Source : Haver Analytics

The effect of the depreciation of sterling can already be seen in the UK's International Investment Position and the balance of interest, profit and dividend income. It is having the effect of boosting the sterling value of overseas assets (which are largely denominated in foreign currency) relative to liabilities (which are, apart from bank deposits, largely denominated in sterling). The UK's net external liabilities were pushed up to £238.2 billion by the end of the third quarter of 2016, from minus £177.2 billion a year earlier. This currency translation effect is already reflected in an improvement in the UK's net overseas earnings, and should lead to a further improvement as sterling edges lower over the rest of the forecast period.

The forecast shows three years of slow growth…

The forecast sees GDP growth slowing to 1.3% this year and just 1.0% in 2018, picking up slowly to 1.4% in 2019 and 1.8% in 2020. CPI inflation moves up to 3.1% by the final quarter of this year, but eases back to the 2% target by 2020. With wage inflation remaining subdued we think the MPC will hold base rates at their current 0.25% until the spring of 2018.

Retail sales have maintained their confident pace in recent months and this strength has been reflected in the performance of the service sector. Output of services increased by 0.3% in October, up 3.2% on the year. Retail activity contributed 0.14 percentage points to the overall increase in October. However, households had increasingly to resort to consumer credit to keep going last year. Their real disposable income fell by 0.6% year-on-year in the third quarter, putting them under increasing pressure. Households ran a financial deficit of £4.9 billion in the quarter, taking the total for the first three quarters to a hefty £9.5 billion, after just £2.8 billion in the whole of 2015 and surpluses in previous years. Unsecured borrowing increased by £1.9bn in November, the highest since March 2005, pushing the annual growth rate up to 10.8%. The GfK consumer confidence barometer fell back again in November and December, suggesting that households are getting the message that 2017 is going to be a difficult year for them and for the economy. Nevertheless, in view of the strength seen earlier, it seems likely that GDP will post an increase of 0.5% in the final quarter.

The EY ITEM Club forecast for the UK Economy, Winter 2016-17 % changes on previous year except borrowing, current account and interest & exchange rates						
	GDP	Domestic Demand	Consumer spending	Fixed investment	Exports	Imports
2014	3.1	3.4	2.2	6.7	1.5	2.5
2015	2.2	1.9	2.4	3.4	6.1	5.5
2016	2.0	1.9	2.8	0.7	1.0	2.5
2017	1.3	1.3	1.7	-0.3	3.3	3.0
2018	1.0	0.2	0.4	-0.5	5.2	2.3
2019	1.4	0.7	0.9	0.9	4.3	2.0
2020	1.8	1.1	1.3	1.4	3.9	1.6
	Net Govt Borrowing(*)	Current account (% of GDP)	Average earnings	CPI	Bank Rate	Effective exchange rate
2014	4.9	-4.7	1.3	1.5	0.5	87.0
2015	4.1	-4.3	2.5	0.0	0.5	91.4
2016	3.5	-4.9	2.5	0.6	0.4	81.9
2017	2.9	-4.5	2.9	2.8	0.3	74.4
2018	2.3	-3.7	3.0	2.3	0.6	73.0
2019	1.0	-2.5	3.0	1.8	1.2	71.5
2020	1.0	-1.6	3.0	2.0	1.8	70.5

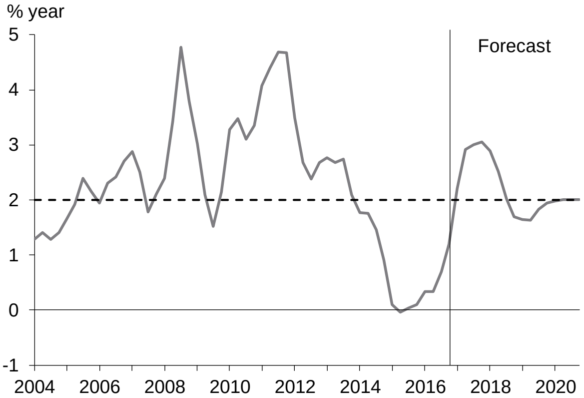
(*) Fiscal years, as % of GDP

Source: EY ITEM Club

...as the headwinds facing the consumer pick up again

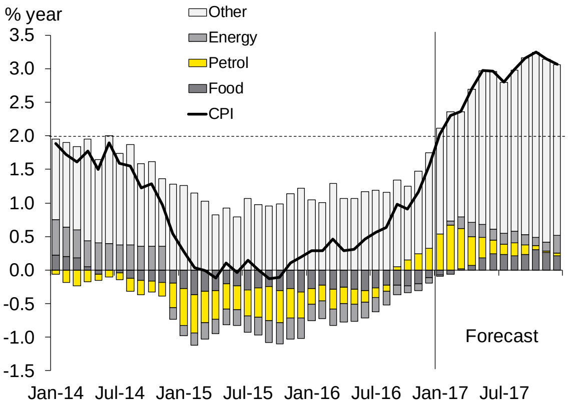
The forecast sees a progressive slowdown in consumer spending next year as the engine of employment stalls and CPI inflation catches up with growth in average earnings. After increasing by 1.8% in 2015, and 1.4% last year, we see total employment increasing by just 0.2% in 2017, falling by 0.2% in 2018 and flat in 2019. The growth in subsequent years is very subdued by recent standards. To set against this, a move by the government to reduce the influx of migrant workers once we leave the EU would tend to reduce the labour supply and mitigate the consequences for unemployment and wages. The forecast sees ILO unemployment rising from 4.8% in the final quarter of last year to 6.3% by the end of 2019, while the claimant count rises from 2.3% to 3.0%.

UK: CPI inflation



Source : EY ITEM Club

UK: Contributions to CPI inflation



Source : Oxford Economics

With inflation picking up, and the government's welfare cuts hitting those on low incomes, household real disposable income is forecast to fall by 0.3% in 2017, recovering by just 0.2% the following year. The year on year growth in consumer spending slows to 0.9% by the final quarter of 2017 and 0.5% by the final quarter of 2018. The effect is to slow the calendar year growth to 1.7% in 2017 and 0.4% in 2018. The growth in real incomes and spending recovers very slowly over the rest of the forecast period.

We see little to support the housing market in this situation. After stamp-duty related distortions in the first half of 2016, the second half of the year saw activity settle at similar levels to those seen in 2014 and 2015. Mortgage approvals reached an 8 month high in November, while net mortgage lending held steady at £3.2bn for a third successive month. With a squeeze on real incomes in prospect this year, it is difficult to envisage any meaningful pickup in mortgage activity and we expect 2017 to be a pretty flat in terms of transactions, prices and housing investment.

…and companies worry about the new trading environment…

As noted, business confidence has picked up nicely over the last three months. However business investment remains very weak and is vulnerable to disappointing news on the Brexit front. It seems unlikely that the more competitive position of sterling will provide enough support to prevent business investment easing back over the next eighteen months. The forecast sees business investment falling by 1.0% this year and by another 2.0% in 2018.

...leaving growth heavily dependent upon trade performance

The balance of payments outlook has brightened considerably since sterling's devaluation. As noted, the currency translation effect is already apparent in an improvement in the UK's net overseas earnings, and should lead to a further improvement over the rest of the forecast period. The forecast sees the deficit on primary investment income halving from £26.1 billion last year to £13.0 billion in 2018. This, together with the associated increase in export earnings, will provide much needed support for UK output and incomes over the next two years. International transfers will be affected by the UK's exit from the EU and are a major area of uncertainty. The UK's contributions to the EU budget are likely to rise in the near term as it settles its accounts, although the final bill will be subject to negotiation. Then, assuming that the UK no longer contributes once we leave, we should see an improvement in the balance of international transfers.

There are signs that the devaluation is boosting export volumes, but so far, exporters have in the main taken advantage of the lower pound to increase their sterling export prices. Indeed, import and export prices are increasing in tandem, tending to increase the sterling value of the visible deficit. With European and many other export markets remaining weak, and import volumes supported by the residual momentum in the consumer sector, export volumes are forecast to increase by 3.3% this year and 5.2% in 2018, while import volumes increase by 3.0% and 2.3% respectively. Net exports add 0.8% to GDP in 2018. As a result, the forecast shows the current account deficit narrowing from £90.9 billion this year to £76.4 billion in 2018 and £52.3 billion in 2019.

Risks and uncertainties

It goes without saying that trade performance and output growth in 2019 and beyond will depend critically upon the exit terms that can be agreed with the EU27 and other countries. Although the Prime Minister has now clarified her ambitions for Brexit, with elections in Germany, France and elsewhere in 2017, it will take much longer to get clarity on the views of the EU27 and the shape of the ensuing negotiations.

The election of Donald Trump to the US Presidency adds to the list of political and economic uncertainties. It seems very likely that his plans for tax cuts and perhaps infrastructure spending will be enacted, providing a boost to the US economy. Unfortunately this boost will come very late in the economic cycle, when inflation and interest rates are already increasing. His foreign policy, especially trade policy, remains unclear and could complicate Britain's exit from the EU.

Forecast in detail

1. Fiscal policy

The Chancellor had promised a “reset” of fiscal policy in the Autumn Statement and in some senses he delivered, with yet another new set of fiscal rules. However, the stimulus package was very modest and is unlikely to have a material impact on the outlook.

The new fiscal rules are essentially looser versions of the previous goals. The Government still aims to eliminate the budget deficit, but the timing has become vaguer – to "return to balance as early as is practicable in the next Parliament". However, the Chancellor did make a firm commitment to achieve a cyclically-adjusted budget deficit of no more than 2% of GDP in 2020-21. In addition, public sector net debt must be falling as a share of GDP by the end of the current Parliament, while expenditure on welfare in 2021-22 is to be contained within a predetermined cap.

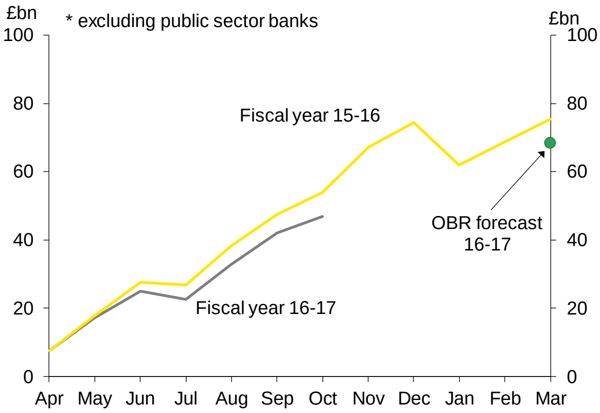
The new, much looser, fiscal rules offer substantial wiggle room. Even though the OBR revised down its growth forecast and pencilled in higher borrowing throughout the forecast horizon, there is around £27bn of headroom between the OBR’s forecast for borrowing in 2020-21 and the new limit for the structural deficit. This offers plenty of room for slippage in future forecasts, although some of this leeway will be required to finance the Government’s as-yet largely unfunded commitments to increase the tax-free personal allowance to £12,500 and the 40% threshold to £50,000.

The better than expected performance of the economy since the EU referendum meant that the Chancellor opted for only a modest discretionary fiscal loosening. The bulk of the action was on the spending side, including the creation of a ‘National Productivity Investment Fund’. While this will deliver a helpful kick to public sector investment, the largest increases are not due to take effect until the 2020s. In the current parliament, average investment spending as a share of GDP will still be below that of the previous five years.

There was a modest row-back on previously announced cuts to working-age benefits. But this will only go a small way to relieving the hit to benefit recipients from the remaining cuts, a hit that will only intensify in an environment of faster inflation. There was little to report on tax policy, with a rise in some ‘stealth’ taxes offset by a continued freeze on fuel duty.

Over the first eight months of fiscal year 2016-17, borrowing was £7.7bn or 11.5% down on a year earlier. The OBR’s full-year forecast requires borrowing to fall by 10.3% and with self-assessment income tax receipts likely to be boosted by forestalling associated with the pre-announced increase in dividend tax, the deficit looks likely to come in close to the OBR’s forecast for 2016-17. Further out, we expect the Chancellor to meet his new borrowing rule, though there will probably need to be more fiscal tightening in the next parliament if the Government is to ever achieve its long-desired budget surplus.

UK: Public sector net borrowing* Cumulative position



Source: Haver Analytics

2. Monetary policy

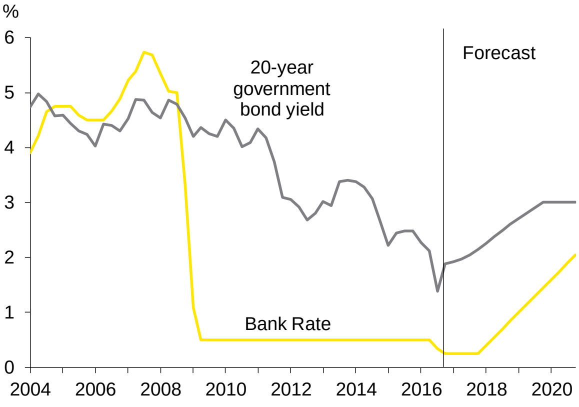
The prospect of a fairly modest economic slowdown in the near-term combined with a period of above-target inflation has already caused the MPC to move away from expectations of further monetary loosening and suggests that the Committee will adopt a neutral stance this year. While the next movement in interest rates is likely to be up not down, but we do not expect this to happen until early 2018.

The economy's performance in the second half of 2016 proved much more resilient than the Bank had forecast in the aftermath of the Brexit vote. This was reflected in upgraded near-term growth forecasts in November's Inflation Report and the MPC's decision to "expire" its previous guidance of further monetary loosening in the event of the economy weakening in line with expectations in August.

A more resilient economy is not the only reason to expect monetary policy to err away from further easing this year. November's Inflation Report also raised the Bank's inflation forecast, with the CPI measure predicted to reach 2.7% by the end of 2017, up from a forecast of 2% in August and well above the MPC's 2% target (although the subsequent strengthening in sterling suggests this may be pared back in the next forecast round).

Gilt yields have risen in recent months off the back of global developments, including expectations of a stronger performance from the US economy. But having touched pre-referendum levels in November, yields have fallen back in the last few weeks. We expect the 20-year yield to end 2017 at 2.1% and 2018 at 2.6%.

UK: Bank Rate & 20-year bond yield



Source : EY ITEM Club

Sterling's trade-weighted value has staged some recovery since the autumn. However, this entirely reflects a rise against the euro, with the common currency pushed down by a continuation of asset purchases by the ECB and a stronger-than-expected-performance from the UK economy. But the pound has continued trading at a historically low level against the dollar, reflecting a rate rise by the Federal Reserve in December and expectations of stronger growth under President Trump. We forecast sterling to drift further against the dollar this year, ending 2017 at $1.21, but it should hold on to its partial recovery against the euro.

3. Prices and wages

The UK economy has enjoyed two years of very low rates of inflation. But with the effects of last year's sharp depreciation in the value of sterling set to become increasingly influential, a marked acceleration in price growth looks likely in 2017.

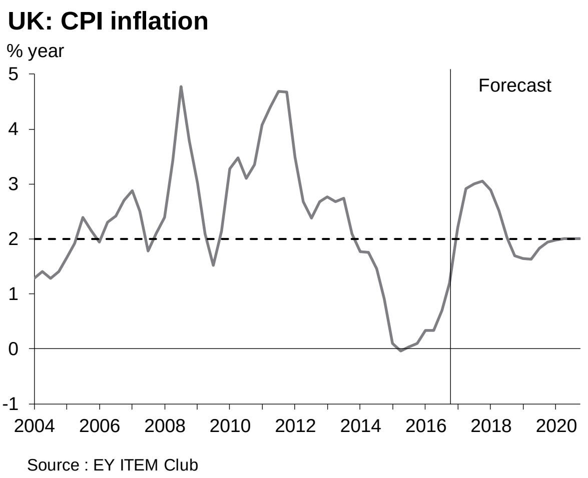
Annual CPI inflation accelerated from 1.2% in November to 1.6% in December, the highest rate since July 2014. The pickup was mostly due to powerful base effects related not just to last winter's drop in petrol prices but also to the falls in food prices in late-2015/early-2016, which are now dropping out of the inflation calculation. This upward move in headline inflation looks set to continue, with further base effects still to come and escalating pipeline pressures likely to steadily pass through to consumer prices.

The increase in inflationary pressures along the supply chain has been due to the combination of rising commodity prices and the weakness of sterling. As of mid-January, the pound was down by 15% on a trade-weighted basis compared with a year earlier and by around 17% since the recent peak reached in July 2015.

This has pushed up import prices, compounding the pressures from rising commodity prices – in sterling terms, the price of oil has doubled over the past year. As a result, producer input cost inflation is currently running at an annual pace of around 16%, while factory gate inflation has accelerated to 2.7%, its strongest pace for more than four years. And business survey data suggests that a further acceleration in manufacturers' selling prices is likely in the short-term.

Therefore, though we expect only a modest decline in the value of sterling through 2017, with the bulk of the earlier depreciation still working its way along the supply chain into consumer prices, inflation is likely to accelerate sharply. The literature suggests that it usually takes around a year for the maximum impact to be seen and this is consistent with our forecast that CPI inflation is likely to peak above 3% in the second half of 2017, averaging 2.8% over the year as a whole.

However, aside from the influence of a weaker pound we still see very little evidence of core inflationary pressures and this is likely to remain the case, with the prospect of relatively weak GDP growth meaning that the degree of spare capacity is likely to remain significant. Therefore, once exchange rates effects have washed through, inflation is likely to slow and we expect the CPI measure to average 2.3% in 2018 and 1.8% in 2019.



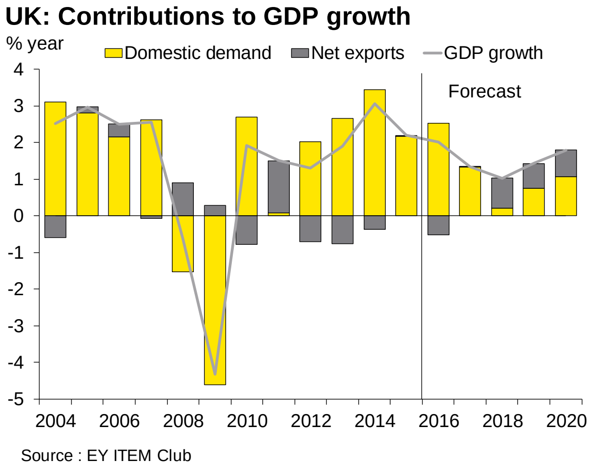
RPI inflation will be higher over the forecast period than the CPI measure. This is largely due to the so-called 'formula effect' (i.e. the different methods of aggregation between the RPI and CPI measures that place an upward bias on RPI). Moreover, the size of this effect should widen further over the back end of the forecast horizon due to our expectation that house prices will rise more quickly than general prices and that interest rates will eventually be increased.

4. Activity

The Quarterly National Accounts contained a mixture of good and bad news. On the plus side, Q3 GDP growth was revised up from 0.5% to 0.6%. But this positive news was balanced by downgrades to previous quarters. The expenditure breakdown for Q3 was wearingly familiar, with the consumer sector doing virtually all of the heavy lifting and net trade once again detracting from growth.

The high frequency data point to quarterly GDP growth of around 0.5% in Q4 2016, which would mean that growth in 2016 as a whole comes in at 2%. The CIPS surveys strengthened through Q4 but the official series for the production and construction sectors were very weak in the early part of the quarter.

While the economy continued to enjoy a solid pace of growth in H2 2016, the near-term outlook looks more challenging. In particular, having been boosted by low inflation over the past few years, consumer spending growth will come under pressure from much higher rates of inflation in 2017 as the impact of the recent depreciation of sterling feeds through. With softening activity likely to mean that the labour market offers little support and household spending power also under pressure from the Government's welfare reforms, we see consumer spending growth slowing from 2.8% in 2016 to 1.7% in 2017 and just 0.4% in 2018.



Prospects for business investment are also relatively subdued. Though the corporate sector continues to enjoy a strong financial position, business investment looks set to have fallen by around 1.4% in 2016. And though we do expect to see a modest recovery this year, Brexit-related uncertainty is likely to encourage some firms to postpone capital spending plans, at least until the UK's future trading relationship with the EU begins to become clearer.

There will be some offset from a stronger net trade performance, as the boost to competitiveness supports export growth and encourages some import substitution. But this is unlikely to be sufficient to offset the headwinds from weaker consumer spending growth and we expect GDP growth to slow from 2% in 2016 to 1.3% this year and 1.0% in 2018.

5. Consumer demand

Consumer spending growth maintained a robust pace over the course of 2016. But looking ahead, higher inflation and weaker hiring implies slower growth in household incomes, to the detriment of the consumer sector.

Consumer spending rose by a strong 0.7% in Q3 2016, matching the growth seen in the first two quarters of the year. And with Q4 seeing strong growth in retail sales and consumer credit it looks likely that the consumer sector put in a similarly robust performance in the last three months of the year.

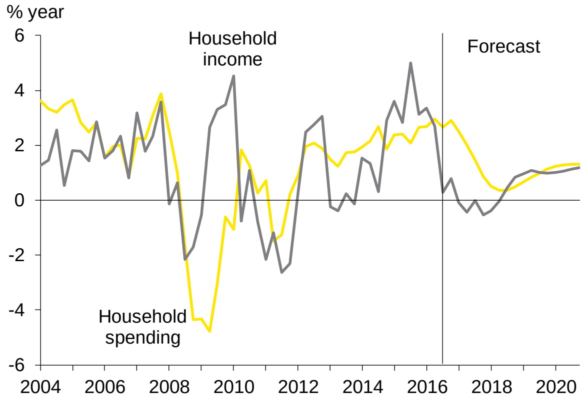
But 2017 looks set to deliver a weaker performance. One reason is that the rise in consumer spending seen in the latter part of last year may have partly reflected consumers bringing forward expenditure in anticipation of price rises related to sterling's post-referendum fall.

More importantly, the prospect of higher inflation in an environment where pay growth is still set to be subdued will squeeze household's purchasing power. Indeed, having grown by an estimated 1.8% last year, household real disposable income is forecast to fall by 0.3% this year, before seeing only a marginal 0.2% rise in 2018. The effect of this squeeze on spending may be exacerbated if weaker hiring by firms encourages more precautionary saving among consumers.

However, the environment for consumers will benefit from some props. The action taken by the MPC last August to loosen monetary policy has fed into record low rates on new mortgages and consumer credit, cutting debt-servicing costs. And with growth in consumer credit currently running at an 11 year high, households may be borrowing more to compensate for a temporary period of weaker spending power. Nevertheless, with the household savings ratio close to record low levels, it is unlikely that consumers will be able to engage in this behaviour for anything other than a relatively short period.

All in all, the balance of forces points to consumer spending growth slowing markedly this year. We expect a rise of 1.7%, down from 2.8% in 2016. Growth is then expected to slow further to 0.4% in 2018. And this forecast is conditional on households saving a historically low share of their incomes over the forecast period.

UK: Real household income and spending



Source : EY ITEM Club

6. Housing market

Though the distortions caused by April 2016's increase in stamp duty on buy-to-let properties and second homes have now washed through, the various housing indicators continue to send mixed messages on the state of the market, particularly in terms of the strength of price pressures.

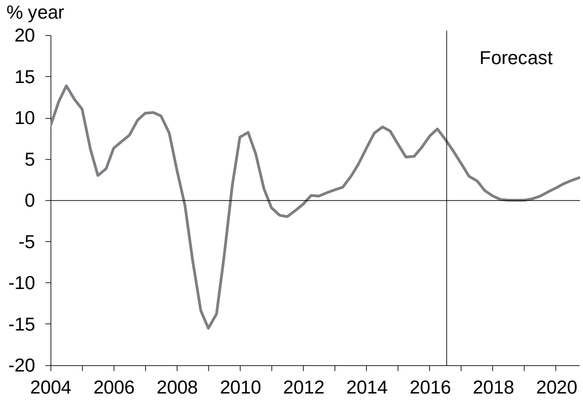
On the activity side it appears that there was a modest recovery in both transactions and mortgage approvals through H2 2016. Both are relatively close to the levels that they have averaged for much of the past couple of years, though remain well short of pre-financial crisis norms. With regard to prices, the story is more mixed; though all of the main measures report that inflation continues to run some way ahead of household income growth, the scale of recent annual price rises ranges from 4.5% (Nationwide) to around 7% (ONS/Land Registry and Halifax).

One segment which does appear to be suffering is the prime central London investment market. This market has reported much lower rates of activity and falling prices, with the heightened uncertainty surrounding the economic outlook dampening confidence and adding to the drag from higher rates of stamp duty.

In terms of the wider market, the RICS survey suggests that we are likely to see more of the same in the near-term, with the combination of new instructions being flat and a steady increase in new buyer enquires, set to drive further modest price rises in early-2017.

However, further out we expect the market to flatten off as demand-side factors offer less support. In particular, employment is expected to remain broadly flat over the next year, while real income growth is set to slow sharply, although the historically low level of mortgage rates will provide some offset. Though prices remain overvalued relative to most historical metrics, we think that the chances that a softer economic outlook will cause a sharp correction in property values are low; there is unlikely to be a material rise in forced sales while housing supply set to remain very tight. After rising by 7.5% in 2016, our forecast shows house price growth slowing to 2.7% this year, with prices then being broadly flat in 2018-19.

UK: House prices



Source : EY ITEM Club

7. Company sector

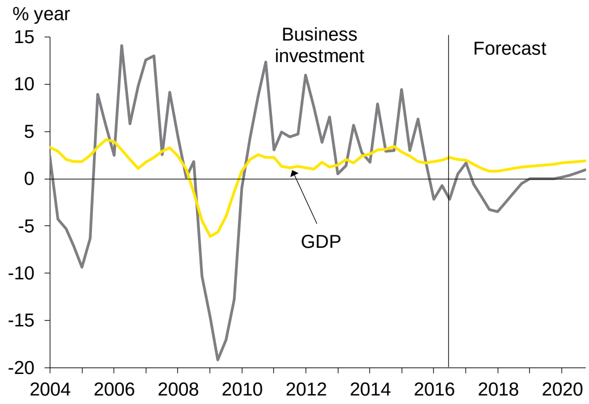
Although the EU referendum did not trigger the immediate drop in business investment many had feared, the ingredients for a fall in 2017 are present. That said, there are also positives at play which should limit the extent of any decline.

Having dropped by 1.5% in Q1 2016, business investment rose modestly in the subsequent two quarters by 1.2% and 0.4%, respectively. However, this still left investment in Q3 down on a year earlier.

Although the likely triggering of Article 50 this spring should provide a bit more clarity on Brexit, continued uncertainty around the outcome of leaving the EU will caution European-exposed firms from taking investment decisions, particularly in the real estate sector. A weaker pound will increase the cost of imported capital equipment. And the softer outlook for consumer spending will inject more caution into investment decisions.

But these headwinds should be offset in part by some investment-friendly developments. Rising long-term interest rates have cut corporate pension fund deficits, with the aggregate shortfall down to £329bn in October 2016 from a recent peak of £459bn last August. Hence, pressure to reduce deficits by diverting cash from spending on capital equipment should ease.

UK: Business investment & GDP



Source : EY ITEM Club

Moreover, financial conditions remain supportive for firms borrowing to invest, helped by the MPC's action in August, including the programme of corporate bonds purchases. Revenue gains as a result of sterling's decline should boost the resources and incentives of firms in the tradable sector to invest. And the extra government infrastructure spending announced in November's Autumn Statement should act as a modest spur to private sector capital spending.

All in all, the balance of forces points to business investment dropping by 1% this year. With uncertainty expected to continue weighing on sentiment, 2018 is forecast to see investment see a further 2% dip, with growth resuming the following year.

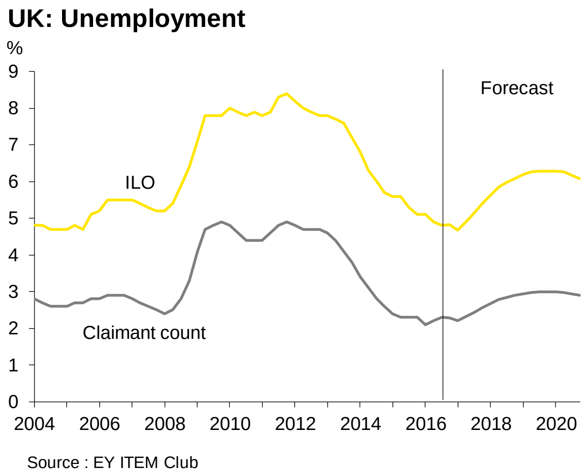
8. Labour market

Recent data suggests that the long-running improvement in the jobs market is running out of steam. This in part reflects an increasingly tight labour market, with the unemployment rate falling to an 11-year low. But a slowdown in the economy points to a further weakening ahead.

Employment fell by 9,000 in the three months to November, a second successive decline after more than a year of rising job numbers. And a 52,000 drop in unemployment was also modest by recent standards. However, the LFS unemployment rate was unchanged at 4.8%, the joint lowest since 2005.

Given the tightness of the jobs market, some softening is not too surprising. And while the number of job vacancies has recently slipped, they remain close to an historic high. So fears that employers would react sharply to Brexit-related uncertainty have yet to manifest themselves.

But a weaker outlook for demand points to a further deterioration in the jobs market over the next year or two. We expect employment to rise by only 0.2% in 2017 compared to 1.4% last year, with the LFS unemployment rate increasing to 5.4% by the end of the year. That said, the observed flexibility of UK workers to respond to weaker activity via adjustments in wages means the forecast increase in unemployment is modest.



On the earnings front, there has been better news of late, with average earnings rising by 2.8% in the three months to November, well above the 2.3% averaged in the first ten months of 2016.

Rising inflation may prompt increased pay demands from some workers. But this will be countered by employers' greater reluctance to pay more in the face of a weaker growth outlook. The introduction of the apprenticeship levy in April and, ongoing auto-enrolment into workplace pensions will also weigh on pay rises.

Consequently, earnings growth is forecast to average 2.9% in 2017, with a slight acceleration to 3% the following year. Against average CPI inflation of 2.5% in those two years, the rate of improvement in real pay growth observed since the end of 2014 is set to ease markedly.

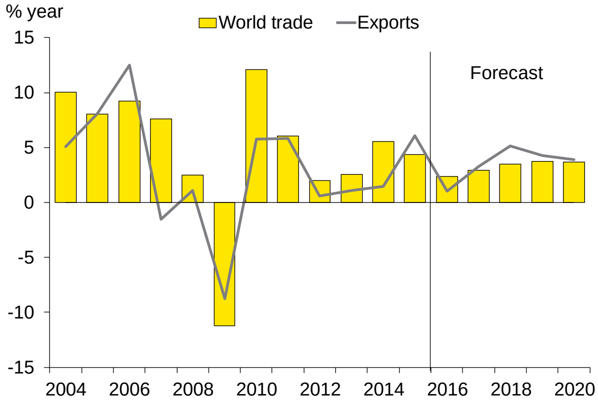
9. Trade and the Balance of Payments

The volatility of the trade numbers along with sizeable revisions to the data has made it very difficult to discern any clear trends in recent months. But sterling's sharp decline suggests that this component of GDP should increasingly support activity over the next few years.

Net trade knocked 1.2 percentage points off GDP growth in Q3 2016, the biggest drag from this source since early 2012. But the ONS had previously suggested that trade had made a positive contribution to output, with the revision reflecting the correction of errors in the ONS' previous trade estimates.

Recent survey evidence suggests that 2016's sharp weakening in sterling should result in a more favourable trade picture this year. December's CIPS manufacturing survey pointed to export orders growing for the seventh successive month, while evidence from other surveys, including the CBI ITS, has also been upbeat. Our forecast shows exports rising by 3.3% in 2017 and 5.2% in 2018 which, alongside softer import growth, results in net trade boosting GDP at an increasing pace from next year.

UK: Exports & world trade



Source : EY ITEM Club

At 5.2% of GDP, Q3 2016 recorded the largest current account deficit since the end of 2015. But stronger growth in exports, weaker import volumes and the boost to the UK's net overseas investment income from the cheaper pound should all contribute to a narrowing of the deficit. We expect the shortfall on the current account to narrow from 4.5% of GDP this year to 3.7% of GDP in 2018 and 2.5% in 2019.

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