EY ITEM Club
Winter Forecast

Will the UK economy hold up as Brexit nears?

February 2018

Building a better working world

Contents

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Foreword

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Is the UK economy stuck in the middle lane?

A good start to the year …

It is always good to start the year with positive news, so receiving two encouraging stories in quick succession was particularly pleasing. First came the preliminary estimate of 1.8% for UK economic growth in 2017 – certainly better than many forecasters expected at the start of the year. This was closely followed by an increase in EY ITEM Club's 2018 forecast for GDP growth, up from 1.4% to 1.7% since their last outlook. EY ITEM Club's forecast reflects their expectation of a slight slowing of the inflationary squeeze on consumers in 2018 and a continuing improvement in trade as the strong global economy and a competitive pound combine to support UK exporters. This is consistent with the positive mood I found among UK manufacturers in my recent trips around the country, with higher export growth being the main driver of this sentiment.

… but hints that we are missing out …

Nevertheless, 1.8% growth in 2017 was the weakest UK expansion since 2012 and marked a relatively lacklustre performance, with the annualised rate of growth slowing through the year. It is also the case that UK GDP growth in 2017 looks weak when viewed in the context of improving global growth, which is estimated to have improved from 2.4% in 2016 to 3.0% in 2017, strengthening expansion in the Eurozone from 1.8% to 2.5%, and US GDP growth likely improved from 1.5% to 2.3%.

… and future concerns …

The further out we look, the less sign there is of an acceleration back to historic norms for UK growth. The EY ITEM Club's GDP growth projections beyond 2018 and 2019 (forecast growth of 1.7%) have been slightly reduced since their last forecast for 2020 (from 2.0% down to 1.9%), 2021 (from 2.2% down to 2.0%) and 2022 (from 2.3% down to 2.1%). The expectation is that the UK will remain below its trend rate of growth and also struggle to match the growth rates of our better-performing developed-country peers.

This concern about the future reflects the fact that the downgrades are mainly due to a lowering of expectations of the UK's productivity performance, on which much attention was focused in 2017. The Bank of England cited – as a contributory factor in its decision to raise interest rates in November – its belief that the economy's potential growth rate had lessened. Even more notably, the Office for Budget Responsibility (OBR) substantially reduced its expectations for UK productivity growth over the next five years when providing its forecasts for Chancellor Philip Hammond's November 2017 Budget.

… and the added challenge of uncertainty for investment …

This relatively flat outlook should be seen as subject to significant uncertainty, especially over how negotiations on the future relationship between the UK and EU will develop. The EY ITEM Club forecast assumes the UK and the EU will agree a transition agreement and that this will reduce uncertainty and underpin business investment. There is little scope for upside on this assumption, with risks of slower or worse progress being the downside.

Business investment in 2017 was — a bit like the economy as a whole — reasonable, but below the levels we would hope for and that the economy needs if we are going to be able to drive productivity improvements, prepare for Brexit and adapt to technological change. The fundamentals for business investment, such as corporate net rates of return, balance sheets and finances are largely healthy, the cost of capital currently remains low, and the availability of credit is at a healthy level. Last, and by no means least is the incentive to invest — for UK exporters and domestic firms competing with imports — provided by sterling's recent weakness. The EY ITEM Club expects business investment to rise 1.9% in 2018 after an estimated increase of 2.3% in 2017. Investment growth is seen picking up to 2.7% in 2019, helped by improved economic activity. A welcome improvement, but not at a level to drive the economy forward significantly faster.

… and in the labour market …

As EY ITEM Club points out, the unemployment rate came down to 4.3% in 2017, which is the lowest rate since 1975 and is below the 4.5% rate that the Bank of England currently considers to be the 'equilibrium' level. I hear the same message up and down the country from employers, that is, with the labour market now extremely tight, it is becoming increasingly difficult for companies to find suitable candidates in several sectors. There were some signs towards the end of 2017 that underlying pay growth was starting to creep up but pay rises remain below the level we would expect, given the low level of unemployment. The EY ITEM Club is forecasting that average earnings will rise by 2.7% in 2018, with a further increase to 3.1% expected in 2019, but the labour market remains a source of much uncertainty. Will the UK be able to attract the labour it needs? Will wage inflation suddenly accelerate?

… create a worry over the UK's future performance …

A significant risk is that prolonged uncertainty, concerns over the UK's economic outlook, and skills shortages end up weighing down markedly on business investment, thereby damaging the UK's economic potential. This could be compounded if foreign companies ended up markedly reducing their investment in the UK and this diluted any beneficial spillover of skills and knowledge. The result is that there is a real risk that the UK will find its ability to grow faster than it is currently, severely constrained. The UK Government must do all it can to create an environment that encourages UK-based businesses to invest in skills, capital and intellectual property, creating the conditions for strong growth in the future.

… and business must remain proactive.

With uncertainty and slow domestic growth, it would be easy for businesses to default to a defensive mode. This would be a mistake, and would mean a risk of missing out on global growth and failing to position for the future in the UK. Now is the time to review the global portfolio while ensuring risks are identified and managed in the UK, in addition to developing a strategy for the business post-Brexit.

Highlights

- GDP growth came in at 1.8% in 2017, a better performance than had been expected at the start of the year given Brexit uncertainties and the increasing squeeze on consumer purchasing power. Nevertheless, this was the slowest expansion since 2012 and marked a relatively lacklustre performance through most of the year with GDP growth limited to 0.3% quarter-on-quarter (q/q) during Q1 and Q2 2017 before picking up gradually to 0.4% q/q in Q3 and 0.5% q/q in Q4. Indeed, the annual growth rate moderated from 2.0% in Q4 2016 to 1.5% in Q4 2017. Furthermore, UK GDP growth in 2017 looks uninspired given substantially improved global growth and much stronger expansion in the Eurozone and the US.

- The GDP growth forecast for 2018 is raised from 1.4% to 1.7%. This reflects the stronger end to 2017 and the probability that the UK and EU will agree a transition arrangement in the first half to come into effect when Brexit occurs in late-March 2019, which will provide greater certainty to businesses and support investment. Nevertheless, considerable uncertainties are expected to persist over what form the UK's longer-term relationship with the EU is likely to take. Domestic political uncertainties could also weigh down on economic activity.

- The squeeze on consumers remains appreciable at the start of 2018 but it looks set to ease as the year progresses, due to inflation falling back and earnings growth picking up gradually. This should provide increasing support to consumer spending, although the upside will likely be limited by a less robust labour market compared to 2017 and still relatively fragile consumer confidence.

- GDP growth is forecast stable at 1.7% in 2019. Consumer spending should benefit from a further rise in real disposable income while business activity and investment will benefit from the anticipated transition arrangement. Nevertheless, business and consumer uncertainties may spike when the UK actually leaves the EU in March 2019 while there are likely to be persistent uncertainties over the UK's longer-term relationship with the EU.

- We have trimmed our GDP growth projections for 2020 (from 2.0% to 1.9%), 2021 (from 2.2% to 2.0%) and 2022 (from 2.3% to 2.1%) primarily due to a modest downgrading of our expectation of the UK's productivity performance. The OBR sharply revised down its productivity expectations for the next five years, leading to a significant downward revision in its GDP forecasts and a marked upward revision of projected budget deficits over the medium-term.

- While we have trimmed our productivity growth forecasts, we are less downbeat than the OBR and believe a rebound can finally occur. Indeed, it may well now be starting to get underway. Output per hour worked spiked 0.9% q/q in Q3 2017 (the best q/q performance since Q2 2011) and further clear improvement seemingly occurred in Q4. Admittedly, this followed falling productivity in H1 2017. Nevertheless, the H2 2017 pick-up in productivity suggests to us that there is considerable scope for UK businesses to utilise their workforce more efficiently.

- We suspect companies will increasingly seek to maximise workers' output, lifting productivity. A ready supply of cheap labour in recent years has limited pressure on companies to get the most out of workers. Labour market tightness is now making it harder for firms to find suitable candidates in several sectors. Furthermore, earnings growth will likely trend up amid increased recruitment difficulties, making labour more expensive. Companies are seen to be increasingly prioritising productivity-enhancing measures, and there will be a mounting incentive to undertake investment aimed at saving labour.

- Having finally tightened monetary policy in November 2017, the first time since 2007, the Bank of England is forecast to raise interest rates twice in 2018, from 0.50% to 0.75% in May and from 0.75% to 1.0% in November. We believe that moderating inflation over the coming months, only slowly rising pay growth and still significant Brexit uncertainties calls for gradual, limited rate hikes. With the economy seeing stable growth of 1.7% in 2019 and inflation likely to hover around 2%, there are uncertainties, likely to be fuelled by the UK leaving the EU in late-March. We expect the Bank of England to lift interest rates just once in 2019, taking the rate up to 1.25%.

Introduction

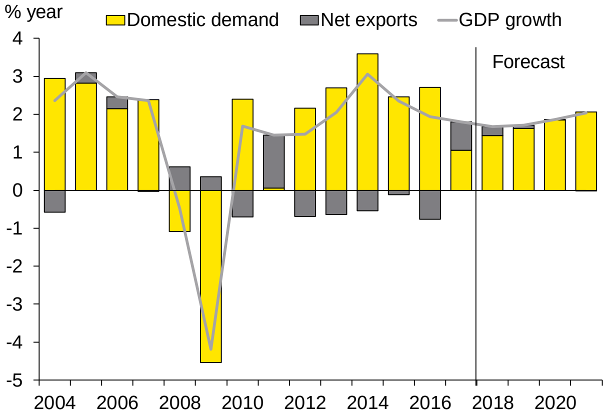
GDP growth in 2017 was 1.8%, above the 1.5% expected in the Autumn forecast and better than the 1.3% growth rate we projected at the start of 2017. Consequently, UK growth in 2017 held up much better than was widely expected given the Brexit uncertainties that were expected to — and duly did — persist through the year. On top of this, there was a substantial, extended squeeze on consumer purchasing power resulting from higher inflation in 2017 and weak earnings growth.

The overall GDP growth rate of 1.8% in 2017 masked a relatively lacklustre performance over much of the year. The increase in the 2017 growth estimate is partly due to the Office for National Statistics (ONS) upgrading the UK economy's performance for 2016 (revisions last December saw GDP growth lifted to 1.9% from 1.8% with Q4 2016 year-on-year (y/y) expansion raised to 2.0% from 1.6%) meaning that output started 2017 from a higher base than previously thought. Significantly, UK GDP growth was limited to 0.3% q/q in both Q1 and Q2 2017, before picking up slightly to 0.4% q/q in Q3, as we had expected in our Autumn forecast. On a positive note, GDP growth in Q4 2017 surprised on the upside as a preliminary estimate from the ONS shows that it picked up further to 0.5% q/q. Nevertheless, y/y GDP growth slowed from 2.0% in Q4 2016 to 1.5% in Q4 2017, which was the weakest annual expansion since Q1 2013.

Furthermore, UK GDP growth in 2017 looks relatively uninspired given improved global growth and much stronger expansion in the Eurozone and the US. Specifically, global growth is estimated to have improved from 2.4% in 2016 to 3.0% in 2017, with expansion in the Eurozone strengthening from 1.8% to 2.5%. US GDP growth likely improved from 1.5% to 2.3%.

We are raising our 2018 GDP growth forecast from 1.4% to 1.7%, partly due to the increased likelihood that the UK and the EU will agree a transition arrangement in the early months of the year. If this is the case, it should both help and be supportive to business confidence. Nevertheless, Brexit uncertainties seem set to remain appreciable through 2018 particularly regarding the likely nature of the UK's longer-term trading relationship with the EU.

UK: Contributions to GDP growth



Source: EY ITEM Club

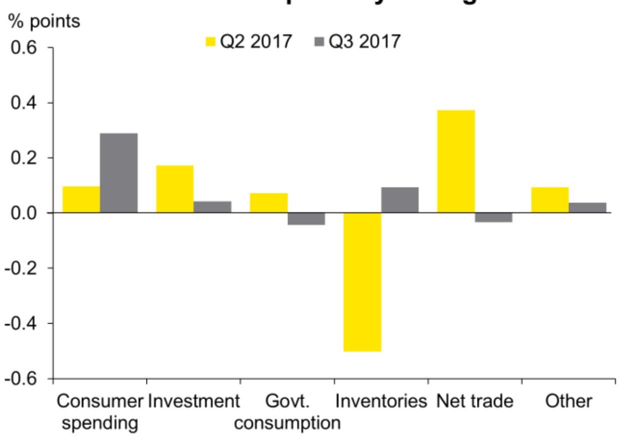
Further out, we have slightly reduced our GDP growth projections for 2019 (from 1.8% to 1.7%), 2020 (from 2.0% to 1.9%), 2021 (from 2.2% to 2.0%) and 2022 (from 2.3% to 2.1%) largely due to a modest downgrading of our expectation of the UK's productivity performance. Admittedly, UK productivity saw a pick-up in Q3 2017 and looks likely to have achieved further improvement in Q4, but this followed a particularly weak performance in the first half of the year with a sharp drop in Q1 followed by another small decline in Q2. Nevertheless, we are significantly less pessimistic about UK productivity prospects than the forecasts and analysis presented by the OBR in November's Budget. Moreover, the improvement seen in Q3 2017 and likely further gain that occurred in Q4 reinforces our suspicion that there has been an appreciable cyclical element in the past weak productivity performance and that there is scope for a significant rebound over the medium term.

The economy saw gradual pick-up in growth through H2 2017

The economy gradually gained momentum over the second half of 2017 after a subdued performance over the first half. GDP growth edged up to 0.5% q/q in Q4 2017, from 0.4% q/q in Q3 and 0.3% q/q in both Q1 and Q2. The Q4 performance was slightly stronger than we had expected in our Autumn forecast.

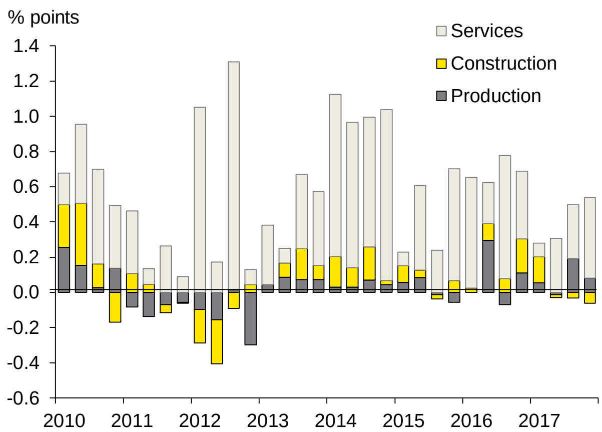
Growth in Q4 benefited from ongoing robust manufacturing output (estimated up 1.3% q/q). However, industrial production growth was limited to 0.6% q/q as the manufacturing performance was partly countered by a 3.9% q/q drop in extraction activity due to the closure of the Forties pipeline for most of December weighing on oil & gas output. Services output is estimated to have picked up to a solid 0.6% q/q from 0.4% q/q in the third quarter, but construction output contracted an estimated 1.0% q/q which was a third successive decline.

UK: Contributions to quarterly GDP growth



Source : EY ITEM Club calculations using data from Haver Analytics

UK: Contributions to quarterly GDP growth



Source: EY ITEM Club/Haver Analytics

The ONS has not yet released a breakdown of the expenditure side of GDP in Q4 2017 but it looks likely that consumer spending growth slowed as spending power was squeezed and confidence remained fragile. On a positive side, net trade probably made a positive contribution to growth as exports of goods and services rose more than imports.

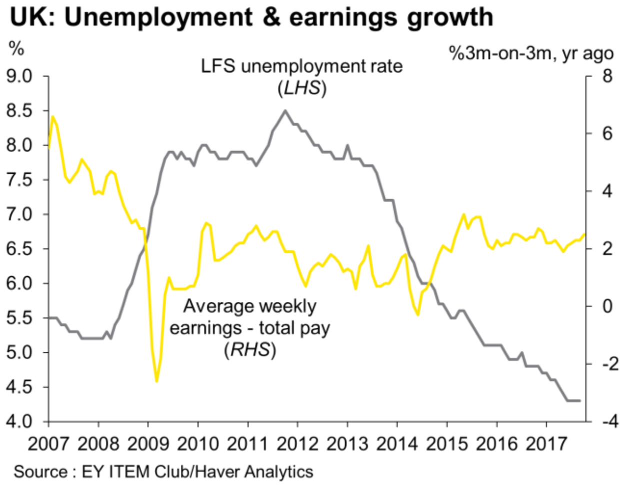
Consumer spending growth had picked up in Q3 as it was lifted by higher spending on cars after purchases in this sector had been held back by tax changes in Q2. It is also likely that consumer spending in Q3 benefited from the weak pound leading to more tourists visiting and spending in the UK, as well as more people holidaying at home. Business investment rose a steady 0.5% q/q in Q3 2017, thereby matching the Q2 performance. Meanwhile, net trade was essentially in balance in Q3 as exports rose 0.8% q/q and imports increased by 0.9% q/q.

Labour market healthy in 2017 but earnings growth remained weak

The labour market was healthy overall in 2017, although its performance in the second half of the year was more erratic with the number employed falling in the three months to both September and October before seeing a marked pick-up in November. Consequently, the number of people in work reached a record high of 32.207 million in the three months to November. This took the employment rate up to an all-time high of 75.3%. Meanwhile, the unemployment rate first came down to 4.3% in the three months to July, where it remained in the three months to November. This is the lowest rate since 1975 and below the 4.5% rate that the Bank of England currently considers to be the ‘equilibrium’ level.

The fall in employment in the three months to both September and October raised speculation that the UK labour market strength was starting to be diluted by extended lacklustre UK economic activity as well as heightened business uncertainty and concerns over the economic and political outlook including Brexit. There are also reports that employment growth in some sectors is being limited by a lack of suitable candidates. However, a rise of 102,000 employed in the three months to November suggested that the labour market has not yet run out of steam and that it may also have benefited from the pick-up in growth in Q4.

Earnings growth remained weak during 2017 despite the tightness of the labour market. Companies have been keen to limit pay as they face a highly challenging domestic economy, and as their input costs have been lifted markedly by the overall weakening of the pound. Meanwhile, workers appear to have been generally unwilling to push for higher pay despite increased inflation due to fragile confidence and uncertainties over the outlook.

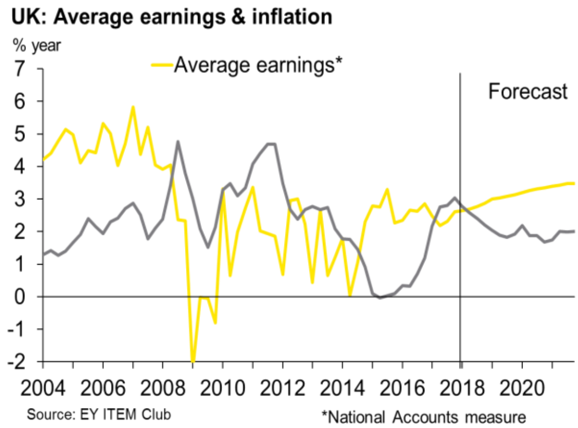


There were some signs towards the end of 2017 that underlying pay growth could be starting to creep up. Annual growth in regular pay (which excludes bonus payments) edged up to 2.4% in both November and October from 2.3% in both September and August and 2.1% in July. Consequently, regular pay was up 2.4% in the three months to November. This was up slightly from 2.3% in the three months to October and 2.2% in the three months to September, August and July.

Low pay keeping squeeze on consumers as inflation exceeded 3%

Persistent subdued earnings growth squeezed UK consumers hard during 2017 in tandem with higher inflation. Indeed, consumer price inflation reached 3.1% in November, the highest level since March 2012, before edging back to 3.0% in December. This compared to a rate of 1.6% at the end of 2016 and 0.4% in mid-2016.

Inflation was primarily driven up in 2017 by sterling's weakening over the second half of 2016 following the June Brexit vote. Higher oil prices and firming food prices were also significant factors.



The dip to 3.0% in December fuels belief that November's rate of 3.1% likely marked the peak in inflation. Admittedly, the rise in Brent oil prices to a three-year high of $70/barrel in January increases the risk that inflation could be sticky in the near term, but it should trend still lower as 2018 progresses. Sterling's sharp drop in the second half of 2016 should have now largely fed through the pricing chain and the impact of this is seen as increasingly fading. Meanwhile, we suspect that relatively lacklustre economic growth will continue to limit domestic price pressures, despite increased concerns from the Bank of England over diminishing slack in the economy. Earnings growth seems likely to pick up only gradually as many firms remain keen to limit their total costs in a challenging and uncertain environment. Consequently, we expect consumer price inflation to fall back close to 2.0% by the end of 2018, and it will likely dip below 2.0% during 2019.

The persistent squeeze on consumers in 2017 from higher inflation and weak earnings growth was highlighted by the ONS data. This showed that real regular earnings (earnings adjusted for inflation) were down 0.5% y/y in the three months to November, which was the ninth successive decline. Real total earnings (which include bonus payments) were down 0.2% y/y in the three months to November, which was an eighth successive decline.

Further gradual Bank of England policy tightening likely after November 2017 hike

2017 saw the Bank of England raise interest rates for the first time since 2007 as it hiked the Bank Rate from 0.25% to 0.50% in November. This reversed the cut from 0.50% to 0.25% that had been made in August 2016 in the aftermath of the Brexit vote.

The Monetary Policy Committee (MPC) had become increasingly hawkish in the run-up to November's interest rate hike. Keeping interest rates on hold could have risked damaging the Bank of England's credibility given the number of previous occasions the committee had discussed the prospect of a near-term interest-rate hike which, ultimately, was not realised.

A rise in consumer price inflation to 3.0% in September and the expectation that it would rise further in October; an unemployment rate at a 42-year low of just 4.3% in the three months to August; ongoing rapid consumer credit growth; and modestly improved GDP growth of 0.4% q/q in Q3, convinced a majority of MPC members that there was a justifiable case to edge up interest rates in November. There was also, critically, a view within the Bank of England that the economy's potential growth rate has lessened and that there is now little slack left. However, the fact that November's decision to raise interest rates was the result of a 7-2 rather than 9-0 vote within the MPC highlighted that there was also a realistic case to hold off from tightening monetary policy. In particular, the two dissenters pointed to the current lack of domestic inflationary pressures, particularly wage growth. They also considered that there could be more slack in the economy than assumed.

When raising interest rates from 0.25% to 0.50% in November, the MPC stressed that future interest rate increases are likely to be limited and gradual. The committee repeated this when keeping interest rates at 0.50% with a 9-0 vote at their mid-December meeting.

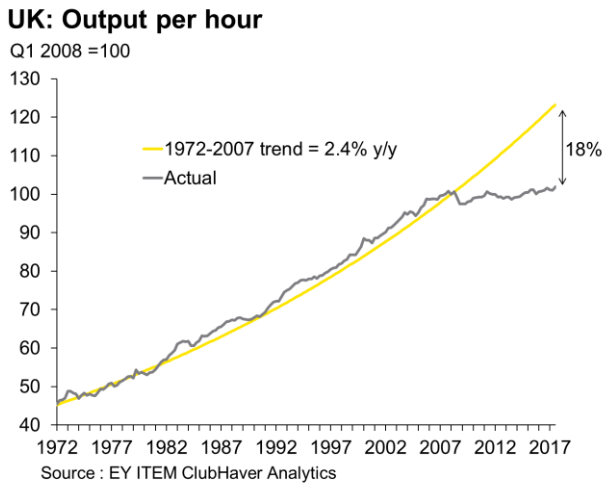
We expect the Bank of England to raise interest rates twice in 2018, although it is a close call and there could very well be just one hike. Moderating inflation, only gradually rising earnings growth and still significant Brexit uncertainties support the case for only gradual monetary policy tightening. Nevertheless, we just about lean towards the view that the Bank of England will raise interest rates from 0.50% to 0.75% in May followed by a further increase to 1.0% in November.

Despite the economy seeing stable growth of 1.7% in 2019 and inflation likely to hover around 2%, there are uncertainties, likely to be fuelled by the UK leaving the EU in late-March. We expect the Bank of England to lift interest rates just once in 2019, taking the rate up to 1.25%.

Productivity showed signs of much-needed improvement in H2 2017

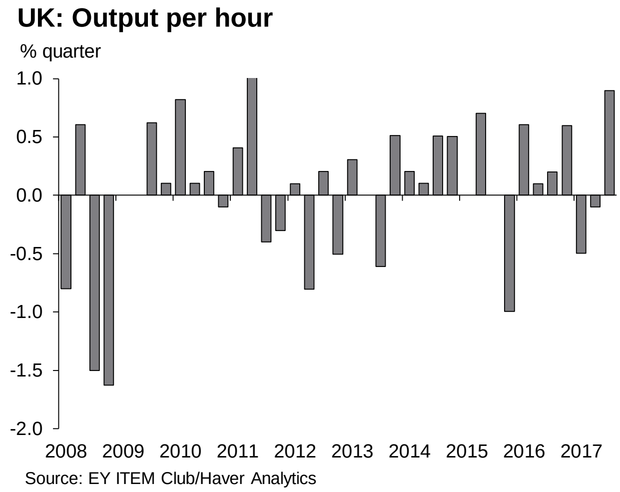
2017 saw much attention focused on the UK's productivity performance. The Bank of England cited its belief that the economy's potential growth rate had lessened as a contributory factor in its decision to raise interest rates in November. Even more notably, the OBR substantially reduced its expectations for productivity growth over the next five years when providing its forecasts for Chancellor Philip Hammond's Budget in November 2017. This led to a marked downgrading in the OBR's GDP growth forecasts and a raising of its projected budget deficits over the medium term. The OBR had repeatedly assumed in recent years that there would be a pick-up in the productivity performance, but this has so far failed to materialise.

Consequently, the OBR came to the conclusion in its November analysis and forecasts that some of the temporary factors that it believed were holding back productivity are having a permanent impact.



There is no denying that the UK's productivity performance has been significantly weaker since the 2008/9 downturn. It deteriorated over the first half of 2017 with output per hour worked falling 0.5% q/q in Q1 and 0.1% q/q in Q2.

Encouragingly though, there was a pick-up in productivity growth in Q3 2017 as the ONS reported that output per hour spiked 0.9% q/q. This was the best q/q performance since Q2 2011, although productivity was still only up 0.8% y/y. It was the consequence of gross value added in the economy growing by 0.4% q/q in Q3 2017 while the number of hours worked fell by 0.5% q/q. Furthermore, it looks highly likely that productivity saw further improvement in Q4 2017. The economy grew at an increased rate of 0.5% q/q in Q4 while latest data shows that hours worked fell by 0.5% in the three months to November.



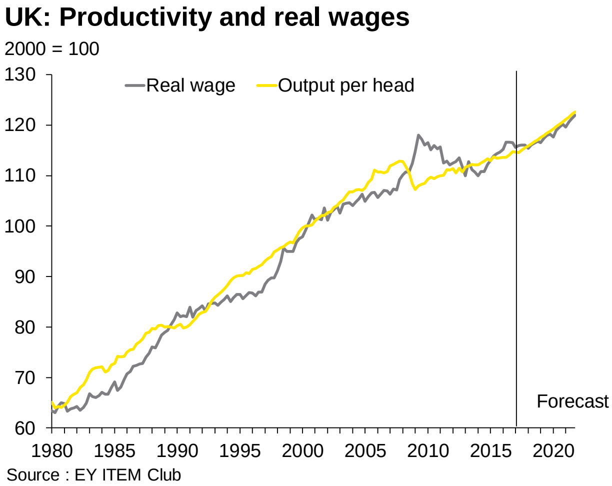
The Q3 2017 productivity pick-up suggests at least some of the recent weakness may have been cyclical rather than structural. While GDP growth was subdued over the first half, some businesses remained keen to employ given the low cost of labour and may have also been influenced by concerns over potential shortages of labour. In addition, given the uncertain economic and political outlook and the low cost of labour relative to capital, some companies may have also tried to meet the demand for extra work by taking on labour rather than committing to investment. This is magnified by the fact that business investment is less easy to reverse.

While the Q3 2017 rebound in productivity is highly welcome, there needs to be sustained improvement to ease concerns over the UK's overall poor productivity record since the deep 2008/9 recession. This is highlighted by the ONS reporting in the accompanying statistical release that "*Examining UK productivity growth on a rolling 10-year basis suggests that the recent UK performance has been among the weakest since official records began and may not be comparable with any period since the early-1820s*." The ONS also reported that "*Comparing the pre- and post-downturn periods, output per hour growth was weaker in all but one industry— construction — over this period. Labour productivity in manufacturing, which grew by more than 1.0% per quarter on average before the downturn, grew by just 0.3% per quarter on average between Quarter 4 2008 and Quarter 3 2017. Finance and insurance productivity growth also fell markedly, while falls in output per hour growth for non-financial services were more modest*".

A number of factors may have held back UK productivity

The UK's 'productivity puzzle' is a source of much debate and analysis. Part of the UK's recent poor labour productivity performance has undoubtedly been that low wage growth has increased the attractiveness of employment for companies. This was clearly a major factor causing employment to hold up well during the 2008/9 downturn and to pick-up as growth returned. However, several factors may have hurt productivity on a more lasting basis. Many of the new jobs that have been created are in less-skilled, low-paid sectors where productivity is limited.

Meanwhile, the economy's past prolonged weakness and financial sector problems may have hurt productivity through under-investment by businesses and an inefficient allocation of resources. There is particular concern that an extended inability to access capital may have held back innovation and investment by smaller companies. Furthermore, there has been concern about the impact of so called 'zombie' companies. Not only are these companies generally less productive, but there is concern that they are preventing both credit and resources being reallocated to newer companies and the backing of new products and processes.



A significant risk is that prolonged uncertainty and concerns over the UK's economic outlook weighs down further on business investment, thereby holding back productivity prospects. The probability of a Brexit transition arrangement being agreed during the first half of 2018 seemingly dilutes this risk. However, negotiations over the long-term relationship between the UK and EU are likely to be difficult and lengthy with the outcome highly uncertain. This could be compounded if foreign companies ended up reducing their investment in the UK and this diluted any beneficial spillover of skills and knowledge.

Nevertheless, the pick-up in productivity in Q3 2017 and probable further improvement in Q4 fuels our belief that there is scope for UK businesses to use their workforce more efficiently in the future. With the labour market now extremely tight, it is becoming increasingly difficult for companies to find suitable candidates in several sectors. Furthermore, earnings growth is likely to trend gradually up given the tightness of the labour market, which will make it relatively less attractive to take on workers. Some companies are likely to increasingly prioritise productivity-enhancing measures, and there is likely to be a growing incentive to undertake investment aimed at saving labour.

Brexit uncertainties still high despite likely UK-EU agreement on transition arrangement in H1 2018

Following the triggering of Article 50 in late March 2017, Brexit negotiations between the UK and EU were slow and difficult for much of the year. This was influenced by domestic political challenges, as well as having to negotiate with the EU.

Nevertheless, at the end of 2017, the UK and EU finally came to an agreement on the first phase of Brexit negotiations. This saw agreement on how the UK's financial settlement over its exit from the EU will be calculated; agreement on the rights of UK and EU citizens; and sufficient progress was deemed to have been made on the Irish border problem. In the end it was the Irish border problem that proved to be the most challenging, and there is much still to be done to resolve it fully.

Agreement on the first phase of the Brexit negotiations opened the door to talks on trade and on a transition arrangement between the UK and EU to come into effect in March 2019 when Brexit formally occurs. The suspicion is that the trade talks could prove even more challenging than the first phase – not least because the UK Government has not yet made clear exactly what future relationship it wants with the EU. The Government has indicated that it regards both the Norwegian and Canadian arrangements with the EU as inadequate for the UK. While the Norwegian model would allow the UK to remain close to the EU in regulatory terms, it would come at a price regarding freedom of movement and payments to the EU, with the UK being essentially a rule taker and having limited say. Meanwhile, although the Canadian model offers greater freedom in terms of rules, the scope of the agreement is much more limited. In particular, the UK is keen for any agreement to include services. The indication is that the UK believes that it can come to a better, bespoke arrangement with the EU which would build on the regulatory harmonisation that the two sides currently enjoy (the term "Canada plus plus plus" has been bandied about). However, some parties in the EU have indicated that a bespoke agreement for the UK is not possible, although others have suggested more flexibility.

While the trade talks are expected to prove lengthy and highly challenging, the indications are that a transition arrangement between the UK and the EU could be agreed in the early months of 2018. This is expected to essentially preserve the status quo on current trading and other arrangements between the UK and the EU for two years from March 2019 (and the suspicion is that this could eventually be extended). However, the UK will not have any say on EU rule-making during the transition period.

The earlier that a transition arrangement can be agreed in 2018, the better for UK economic prospects. UK businesses have long been pushing hard for such an arrangement to avoid a 'cliff edge' exit for the UK from the EU at the end of March 2019. It is evident that uncertainty about what will happen in March 2019 has affected business behaviour and had a limiting impact on investment in particular. While major uncertainties will persist over the longer-term UK relationship with the EU, agreement on a transition arrangement should give EU-focused businesses enough certainty to plan for the next couple of years and to become more inclined to invest.

Economy seen as improving gradually during 2018 and beyond, as squeeze on consumers eases and likely Brexit transition period eases uncertainty

The forecast sees GDP growth at 1.7% in 2018, up from 1.4% in our Autumn projection. This assumes that growth largely continues around 0.4% q/q. While the squeeze on consumers remains appreciable at the start of 2018, it is expected to ease as the year progresses due to inflation falling back and earnings growth picking up gradually. This should provide increasing support to consumer spending, although the upside will likely be limited by a less robust labour market compared to 2017 and still relatively fragile consumer confidence.

Businesses are likely to remain relatively cautious over investment, but agreement on a Brexit transition arrangement in H1 2018 is expected to provide some support. Nevertheless, ongoing uncertainties over the UK's longer-term relationship with the EU will likely limit the upside for investment while domestic political uncertainties may also weigh down on business sentiment. Meanwhile, net trade is likely to be modestly positive in 2018. Although the pound has come well off its 2017 lows, it is still at a competitive level and should remain so in 2018. Additionally, global growth and trade is expected to remain strong in 2018 after increasing sharply in 2017.

GDP growth is forecast to be stable at 1.7% in 2019. This assumes that a transition arrangement between the UK and the EU starts when Brexit occurs in late March of that year. Lower inflation and a further pick-up in earnings growth should lift households' real disposable income further and support consumer spending. Meanwhile, business activity and investment will benefit from the anticipated Brexit transition arrangement. Nevertheless, business and consumer uncertainties may spike when the UK actually leaves the EU in March 2019 while there are likely to be persistent uncertainties over the UK's longer-term relationship with the EU. Monetary policy is seen as modestly tighter in 2019 but the economy will face a less restrictive fiscal policy than previously expected due to stimulative measures announced in the November 2017 Budget.

The EY ITEM Club forecast for the UK Economy, Winter 2018
% changes on previous year except borrowing, current account and interest & exchange rates

	GDP	Domestic Demand	Consumer spending	Fixed investment	Exports	Imports
2015	2.3	2.3	2.6	2.8	5.0	5.1
2016	1.9	2.2	2.9	1.8	2.3	4.8
2017	1.8	1.2	1.4	3.0	6.1	3.1
2018	1.7	1.4	1.3	1.7	3.7	2.7
2019	1.7	1.6	1.6	2.0	3.2	2.8
2020	1.9	1.8	1.9	2.5	3.1	2.9
2021	2.0	2.0	2.1	2.7	3.5	3.4
	Net Govt Borrowing(*)	**Current account (% of GDP)**	**Average earnings**	**CPI**	**Bank Rate**	**Effective exchange rate**
2015	4.2	-5.2	2.8	0.0	0.5	91.5
2016	2.8	-5.8	2.6	0.6	0.4	82.0
2017	2.2	-4.5	2.4	2.7	0.3	77.4
2018	2.0	-3.8	2.7	2.5	0.7	77.8
2019	1.7	-3.0	3.1	1.9	1.1	76.9
2020	1.5	-2.6	3.3	1.9	1.5	79.2
2021	1.4	-2.5	3.4	1.9	2.0	79.3

(*) Fiscal years, as % of GDP
Source: EY ITEM Club

Risks and uncertainties

While the probability of a Brexit transition arrangement being agreed in H1 2018 has seemingly diluted uncertainties and reduced near-term downside risks to the outlook, they have far from disappeared. It is possible that the transition arrangement will prove more troublesome and take longer to agree between the UK and the EU than currently expected. The longer it takes to reach agreement, the more potential damage to economic activity. Furthermore, if negotiations between the UK and the EU over the longer-term trade arrangement become confrontational it is also likely to adversely affect the economy.

There is also the potential for the economy to be impacted by domestic political uncertainty, particularly given that the Conservative Party is reliant on the Democratic Unionist Party (DUP) to remain in government.

There are upside risks to the outlook as well. With the global economy robust and a Brexit transition arrangement looking probable, business optimism may be better than expected in 2018 supporting significantly stronger investment and higher employment. A stronger-than-anticipated pick-up in pay growth could also cause an upside growth surprise, although it would likely result in a modestly faster pace of monetary policy tightening by the Bank of England.

Forecast in detail

1. Fiscal policy

The November 2017 Budget saw Chancellor Philip Hammond stick to his fiscal targets and deliver a relatively low-key Budget overall, despite pressure for bold action to counter public dissatisfaction with austerity and to try to boost the Conservative's popularity with younger voters. Given the major uncertainties facing the economy centred on Brexit, Mr Hammond was perhaps concerned that investor confidence in the UK could be damaged if he abandoned the fiscal framework adopted only a year ago. It is also likely that the Chancellor wants to keep some room for manoeuvre should the economy suffer a major slowdown over the coming years as the Brexit process develops.

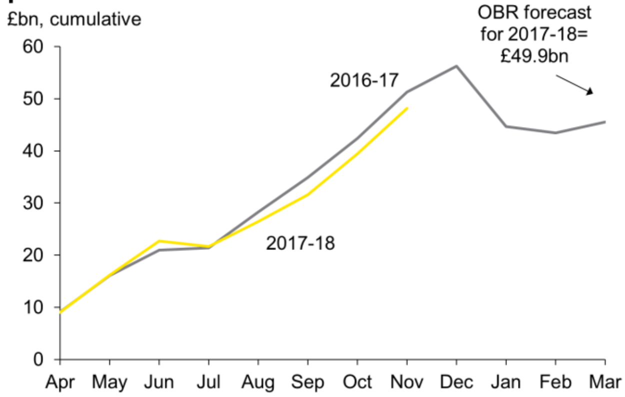
While the November 2016 Budget saw the Chancellor hold off from bold initiatives, a more stimulative approach was adopted for 2018/19 and, more so, 2019/20. Specifically, the OBR reported *"Faced with a weaker outlook for the economy and the public finances, and growing pressures on public services following years of cuts, the Government has chosen to deliver a significant near-term fiscal giveaway. This adds £2.7bn to borrowing next year and a larger £9.2bn (0.4% of GDP) in 2019–20."* The OBR observed that *"the policy easing is then scaled back in future years, with a small fiscal tightening ultimately pencilled in for 2022–23 in the form of further cuts in public services spending as a share of GDP."*

The Chancellor's most eye-catching measure in the Budget was the abolition of stamp duty for first time buyers for properties costing up to £300,000 (and on the first £300,000 for properties costing up to £500,000). There was also a significant easing in previously planned cuts to current departmental spending and a boost to capital spending. Indeed, the housing sector was the main focus for the Chancellor in the Budget as he sought to increase the number of new builds to 300,000 a year.

The Budget saw the OBR revise down expected budget deficits in the near term, reflecting the better-than-expected performance of the public finances in 2016/17 and the first seven months of fiscal year 2017/18. However, forecast budget deficits were lifted appreciably further out due to the OBR taking a significantly more pessimistic view of the likely UK productivity performance so reducing anticipated GDP growth.

Specifically, Public Sector Net Borrowing excluding banks (PSNBex) in 2017/18 is now seen as coming in at £49.9bn rather than the £58.3bn shortfall that had been expected in the March 2017 Budget, a reduction of £8.4bn. The expected shortfall in 2019/20 was edged down to £39.5bn from £40.8bn. Latest data suggest PSNBex will come in less than the OBR forecast in 2017/18.

UK: Public sector net borrowing excluding public sector banks



Source: EY ITEM Club/Haver Analytics, OBR

However, with longer-term GDP growth forecasts cut, the Chancellor is now seen as having a budget deficit of £34.7bn instead of £21.4bn in 2019/20, and the shortfall is still as high as £25.6bn in 2022/23. This means that the Chancellor still achieves his target of getting the cyclically adjusted budget deficit below 2.0% of GDP in 2021/22 but he is now seen as having a buffer of around £14bn instead of £26bn. With an expected budget deficit of £25.6bn in 2022/23, it also looks increasingly questionable as to whether the Chancellor can get the budget into balance by the middle of the next decade.

2. Monetary policy

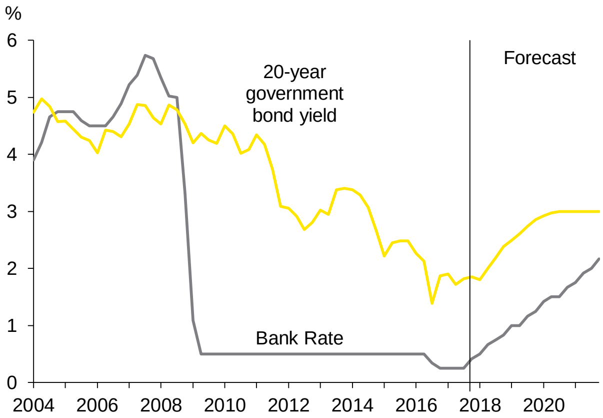
The Bank of England raised interest rates from 0.25% to 0.50% in November 2017, marking the first hike since 2007. This followed a 7-2 vote by the MPC in favour of tighter policy. Prior to November's hike, the MPC had adopted a more hawkish tone as consumer price inflation trended up to 3.0% in September, thereby moving well above the Bank of England's target rate of 2.0%, the unemployment rate fell to a 42-year low of 4.3% and the economy saw slightly improved growth of 0.4% q/q in Q3 2017. A significant factor in the MPC's decision to raise interest rates was a view that the economy's potential growth rate has lessened and there is now little slack left. Specifically, the minutes of the November MPC meeting observed that "*Brexit-related constraints on investment and labour supply appear to be reinforcing the marked slowdown that has been increasingly evident in recent years in the rate at which the economy can grow without generating inflationary pressures*."

However, the fact that two MPC members voted against November's interest rate hike highlighted that there was also a realistic case for keeping interest rates at 0.25%. The two dissenters pointed to the current lack of domestic inflationary pressures, particularly wage growth. They also considered that there could be more slack in the economy than assumed.

When raising interest rates in November, the Bank of England made clear that further tightening in monetary policy would take place gradually with the minutes specifically stating that all MPC members "*agree that any future increases in Bank Rate would be expected to be at a gradual pace and to a limited extent*." This was repeated in the minutes of the 13-14 December MPC meeting when the committee voted 9-0 for unchanged interest rates.

It is a close call, but we now expect the Bank of England to raise interest rates twice in 2018 rather than just once. Specifically, we expect the MPC to lift interest rates from 0.50% to 0.75% in May, followed by a further increase to 1.0% in November.

UK: Bank Rate and 20-year bond yield



Source: EY ITEM Club

With the economy now seemingly on a slightly firmer footing, the labour market tight and interest rates of just 0.50% still essentially marking an emergency rate, there is a clear case for the Bank of England to move towards normalising monetary policy. At the same time, there is a clear case for the MPC to act gradually given the major uncertainties still facing the economy and the likelihood that inflation will fall back through 2018.

Admittedly, consumer price inflation reached 3.1% in November, which was the highest level since March 2012 and more than one percentage point above the Bank of England's target rate of 2.0%. However, it looks probable that November was the peak in inflation. It edged back to 3.0% in December and it should progressively fall back through 2018 as the impact of sterling's past sharp drop fades. Indeed, we expect consumer price inflation to be back close to the 2.0% target level by the end of 2018.

Significantly, pay growth remains weak and appears to be only gradually trending up. Meanwhile, major uncertainties persist over the economic outlook despite the late-2017 agreement between the UK and the EU to move on to the second phase of Brexit talks.

Despite the economy seeing stable growth of 1.7% in 2019 and inflation likely to hover around 2%, there are uncertainties, likely to be fuelled by the UK leaving the EU in late-March. We expect the Bank of England to lift interest rates just once in 2019, taking the rate up to 1.25%. A further gradual rise to 1.75% is seen by the end of 2020.

Sterling has been firmer against a generally softer dollar recently and it reached $1.43 in late-January 2018. This was its highest level since the June 2016 Brexit vote and up from its early-2017 lows of around $1.20. However, this reflects a generally weaker dollar and the pound has made less progress against a well-supported euro. Nevertheless, sterling did trade at a seven-month high against the euro in late-January and it also reached a 14-month high on its trade-weighted index.

The pound is seen easing back modestly in the near-term as still significant Brexit uncertainties and softening consumer price inflation focus market attention on the probability that the Bank of England will only gradually tighten monetary policy. Additionally, UK economic activity will still likely lag the Eurozone and US. However, sterling is expected to gain some support from the anticipated UK and EU Brexit transition arrangement during the first half of 2018, while we expect the Bank of England to raise interest rates in May and November. Consequently, we see sterling largely trading in a $1.35-1.40 range during 2018.

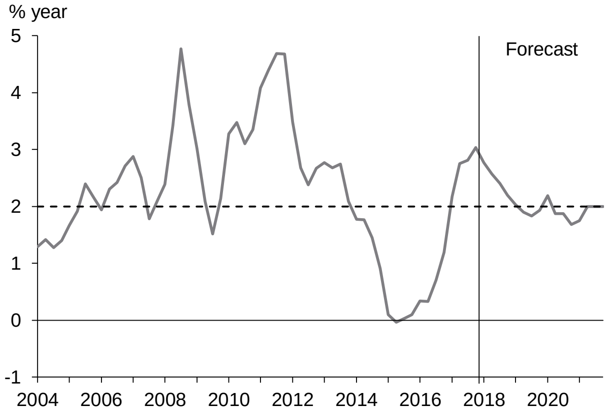
3. Prices

Consumer price inflation edged back to 3.0% in December after reaching 3.1% in November, which was the highest level since March 2012. It was up from 1.6% at the end of 2016 and just 0.4% in June 2016. Inflation is currently well above the Bank of England's 2.0% target level and it has been above target since February 2017.

Inflation has primarily been driven higher since mid-2016 by sterling's sharp weakening over the second half of 2016 following the June Brexit vote. Markedly higher oil prices and firming food prices have also been significant factors.

The dip in consumer price inflation to 3.0% in December fuels the belief that November's rate of 3.1% should mark the peak. Admittedly, the rise in Brent oil prices to a three-year high above $70/barrel in January increases the risk that inflation could be sticky in the near term, but this should be at least partly countered by sterling rising to its highest level against the dollar since the June 2016 Brexit vote.

UK: CPI inflation



Source: EY ITEM Club

Specifically, we expect consumer price inflation to fall back to 2.1% by the end of 2018, before hovering around 2.0% during 2019. Sterling's sharp drop in the second half of 2016 should have now largely fed through the pricing chain and the impact of this will increasingly fade. Indeed, sterling is seen as modestly firmer overall in 2018 compared to 2017. Additionally, we expect oil prices to eventually ease back with Brent oil seen as averaging $67/barrel over 2018.

Meanwhile, we suspect domestic price pressures will pick-up only gradually despite increased Bank of England concern over diminishing slack in the economy. In particular, we see earnings growth rising only slowly and to a limited extent as firms remain keen to limit their total costs in a challenging and uncertain environment. Fragile consumer confidence is likely to deter workers from pushing hard for markedly increased pay rises despite recent higher inflation. Surveys indicate that households' short- and longer-term inflation expectations are still largely anchored in line with long-term norms.

Retail price index (RPI) inflation will be higher than the consumer price index (CPI) measure over the forecast period. 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 spread between RPI and CPI 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 rise gradually.

4. Activity

The economy grew 1.8% in 2017, which was slightly down from expansion of 1.9% in 2016 and the weakest performance since 2012. GDP growth was limited to 0.3% q/q in both Q1 and Q2 2017 before gradually picking up to 0.4% q/q in Q3 and 0.5% q/q in Q4.

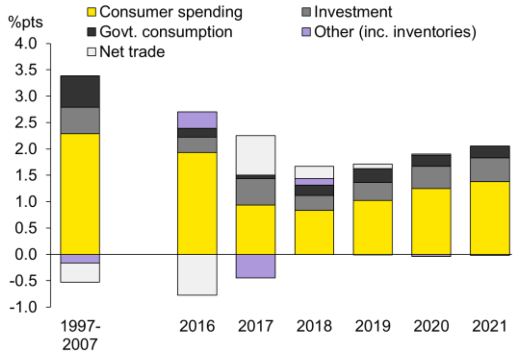
Modestly improved GDP growth of 0.4% q/q in Q3 2017 benefited from a pick-up in consumer spending which rose 0.5% q/q after gains of just 0.2% q/q in Q2 and 0.1% q/q in Q1. This was despite purchasing power continuing to be squeezed by higher inflation and muted earnings growth. Furthermore, employment dipped in Q3. Total investment rose 0.3% q/q in Q3 after gains of 1.0% q/q in Q2 and 0.5% q/q in Q1, while business investment growth was stable at 0.5% q/q. Surveys had largely suggested that businesses were cautious over investment in Q3 following the economy's lacklustre first-half performance and a widely expressed desire for greater clarity over the UK's likely relationship with the EU once Brexit occurs. Meanwhile, Government consumption fell 0.2% q/q in Q3 after gains of 0.4% q/q in Q2 and 0.1% q/q in Q1 as it was restricted by efforts to limit the still appreciable budget deficit. Consequently, domestic demand grew 0.4% q/q in Q3 2017. Net trade was essentially in balance in Q3 as exports rose 0.8% q/q and imports increased by 0.9% q/q.

On the output side of the economy, Q3 GDP growth was lifted by improved industrial production (up 1.3% q/q with manufacturing output also up 1.3% q/q). This outweighed contracting construction activity (down 0.5% q/q) while services expansion was steady at 0.4% q/q.

A preliminary estimate from the ONS based solely on the output side of the economy shows GDP growth improved to 0.5% q/q in Q4 2017, which was the best performance since Q4 2016. Manufacturing output growth was again buoyant at an estimated 1.3% q/q, although industrial production expansion was estimated at a lesser 0.6% q/q as the robust manufacturing performance was partly countered by a significant fall in oil and gas extraction, caused by repair work made to the Forties pipeline. Services output is estimated to have improved to 0.6% q/q in Q4, led by strong gains in business services and finance, and in transport and communication. However, construction output is estimated to have contracted 1.0% q/q in Q4er, which was a third successive decline.

While the preliminary Q4 GDP release was based solely on the output side of the economy, it is worth noting that consumer spending was likely muted as squeezed purchasing power and weakened confidence impacted. Significantly, retail sales volumes growth was limited to 0.4% q/q in Q4, which was the weakest performance since Q1. There could very well have been a positive contribution from net trade in Q4 as exports rose more than imports.

UK: Contributions to GDP growth



Source: EY ITEM Club

We see the economy growing 1.7% in 2018. This assumes growth is centred around 0.4% q/q.

Growth in 2018 should be helped by the squeeze on consumers easing as the year progresses. We expect inflation to fall back from 3.0% in December to close to 2.0% by the end of 2018 as the impact of sterling's past weakness increasingly fades. Meanwhile, earnings growth looks likely to pick-up modestly during 2018 as a consequence of recruitment difficulties in some sectors and higher inflation fuelling some increased pay awards. Consistent with this view, the December report of business conditions by the Bank of England's regional agents indicated that a "*significant*" number of their contacts expected pay awards to rise modestly to a 2.5–3.5% range in 2018 from 2.0–3.0% in 2017. However, consumers may well be hampered by the labour market being less robust in 2018 than in 2017.

Economic activity is likely to be hampered during much of 2018 by Brexit uncertainties which will likely limit business investment in particular. Domestic political uncertainties may also weigh down on business sentiment and behaviour. While the UK and EU have moved on to phase two of the Brexit negotiations, these are likely to prove difficult. Much will likely depend on how quickly a transition arrangement can be agreed between the UK and the EU. If a transition arrangement can be agreed early on in 2018, this would likely provide a boost to investment prospects over the year, although businesses would still likely be cautious amid considerable uncertainty over the nature of the UK's future long-term relationship with the EU.

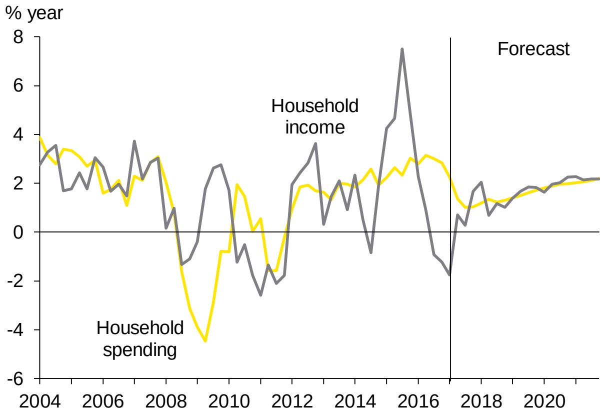
Net trade is expected to make a modest positive contribution to growth in 2018 as the pound remains at a relatively competitive level and global growth is robust.

GDP growth is seen stable at 1.7% in 2019. A further improvement in consumer purchasing power should help consumer spending. Inflation is seen as averaging 1.9% in 2019 while earnings growth is expected to modestly pick up further. Meanwhile, business activity and investment will benefit from the anticipated Brexit transition arrangement. Nevertheless, business uncertainties may spike when the UK actually leaves the EU in March 2019 while there are likely to be persistent uncertainties over the UK's longer-term relationship with the EU. Monetary policy is seen as slightly tighter in 2019 with the Bank of England expected to raise interest rates from 1.0% to 1.25%. Meanwhile, the economy will face less restrictive fiscal policy than previously expected in 2019 due to stimulative measures announced in the November 2017 Budget. Specifically, the Budget contained a fiscal giveaway of £9.2bn (0.4% of GDP) for 2019–20.

5. Consumer demand

Consumer spending growth is estimated to have essentially halved from 2.9% in 2016 to 1.4% in 2017. It was particularly weak in the first half of 2017, expanding just 0.1% q/q in Q1 and 0.2% q/q in Q2. This was the weakest six-month performance since the second and third quarters of 2011 and was largely a reflection of the substantial squeeze on consumer spending power coming from rising inflation and weak earnings growth. Additionally, consumer confidence was fragile not only due to concerns over personal finances but also due to worries and uncertainties over the economic situation and outlook. The only real support to consumer spending came from high and still rising employment. Indeed, employment reached a record high of 32.207 million in the three months to November.

UK: Real household income and spending



Source: EY ITEM Club

Consumer spending picked up to 0.5% q/q in Q3 2017 despite ongoing high inflation and weak earnings growth. Furthermore, employment dipped in Q3. Consequently, real household disposable income rose by just 0.2% q/q and 0.4% y/y in Q3 while the household savings ratio dipped to 5.2% in Q3 from 5.6% in Q2. The ONS indicated that consumer spending was lifted in Q3 by spending on cars picking up after being held back by tax changes in Q2. Consumer spending may also have been lifted in Q3 by the weak pound leading to more tourists visiting the UK and spending, as well as more people holidaying at home. Even so, consumer spending was still only up 1.0% y/y in Q3, the weakest annual growth rate since Q1 2012.

Consumer spending looks likely to have been soft in Q4 2017. Retail sales volumes rose by only 0.4% q/q in Q4, which was only half the growth rate seen in Q3. This meant that retail sales volumes grew 1.9% overall in 2017, which was the weakest performance since 2013. New car sales were also weak in Q4 2017, so any growth in consumer spending will have been highly dependent on spending on services. On a positive note, there were reports that consumers spent more on going out in December.

The squeeze on consumers currently remains painful with the latest data from the ONS showing that total real earnings fell 0.2% y/y in the three months to November. Regular real earnings (which exclude bonus payments) were down 0.5% y/y in the three months to November. Regular earnings growth crept up to 2.4% in both November and October from 2.3% in September and 2.1% in July, but it remained appreciably below inflation (which reached 3.1% in November before edging back to 3.0% in December). Meanwhile, already fragile consumer confidence seemingly took a further hit from the Bank of England raising interest rates in November. Indeed, the GfK consumer confidence index fell to a four-year low in December, although there was a subsequent pick-up in January. On a positive note for consumers, employment picked up late in 2017 after edging down in Q3 with the number in jobs rising by 102,000 in the three months to November.

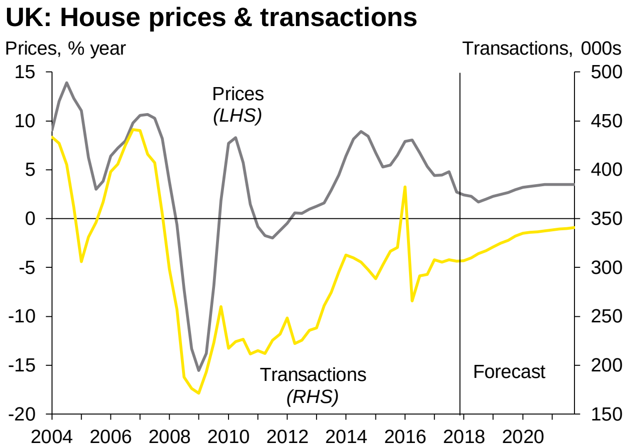
While the squeeze on consumers remains appreciable at the start of 2018, it should progressively ease as the year goes on due to inflation falling back significantly and pay gradually picking up. Specifically, we believe inflation will fall back from 3.0% in December to close to 2% by the end of 2018 (largely due to the impact of sterling's sharp fall dropping out). Meanwhile, we expect earnings growth to pick up modestly as a consequence of recruitment difficulties in some sectors and higher inflation fuelling some increased pay awards.

However, employment growth is likely to be modest in 2018 while still significant economic, political and Brexit uncertainties are likely to weigh down on consumer confidence. Meanwhile, some lenders are becoming less prepared to make unsecured credit available to consumers and they are also tightening their lending standards. At the same time, it appears consumers are cutting back on their demand for credit. The Bank of England's Q4 2017 Credit Conditions Survey reported that lenders reined in the amount of unsecured credit available to consumers for a fourth quarter running and expect a further "significant" decrease to occur in Q1 2018. The latest Bank of England data shows that unsecured consumer credit growth slowed to a near two-year low in November before rising modestly in December 2015. Specifically, unsecured consumer credit growth rose to 9.5% in December after moderating to 9.3% in November (the lowest rate since December 2015) from a peak of 10.9% in November 2016.

Overall, we forecast consumer spending growth to be limited to 1.3% in 2018, although it is expected to gradually pick up during the year. Consumer spending growth is forecast to pick up to 1.6% in 2019 as spending power improves further.

6. Housing market

Housing market activity is currently subdued. The latest data from the Bank of England shows mortgage approvals for house purchases slowed markedly to 61,039 in December (the lowest level since January 2015) from 64,712 in November; this extended the downward trend from 69,425 in July. At 61,039 in December, mortgage approvals were well below the average monthly level of 81,587 seen during 1993-2017.



Source: EY ITEM Club

Latest survey evidence also points to lacklustre housing market activity. The Royal Institution of Chartered Surveyors' (RICS) influential survey for December reported that the results "*continue to display a lack of momentum at the headline level. Near-term activity indicators reported on are still either broadly flat or slightly negative.*" RICS revealed that new buyer enquiries edged lower during December, having shown signs of stabilisation in the previous report, while agreed sales fell at a faster rate. 86% of respondents indicated that they had not seen an immediate increase in first time buyer enquiries following the changes to stamp duty in the Autumn Budget.

As far as prices are concerned, data from the Nationwide shows that annual house price inflation moderated to 2.6% in December 2017 from 4.5% at the end of 2016. However, it was up from a low of 2.1% in August (which had been the lowest level since June 2013). Meanwhile, the Halifax reported that annual house price inflation slowed to 2.7% in the three months to December 2017 from 6.5% in the three months to December 2016. The 2017 low point was 2.1% in the three months to July, which had been the lowest rate since the three months to April 2013.

2018 looks like it will be a very challenging year for the housing market with activity likely to be slow and house price rises limited to around 2%.

The fundamentals for house buyers are likely to remain challenging over the coming months with consumers' purchasing power continuing to be squeezed by inflation running higher than earnings growth. Additionally, housing market activity is expected to be hampered by fragile consumer confidence and limited willingness to engage in major transactions.

House buyers may also be concerned about further interest rate hikes in 2018 following November's tightening of policy by the Bank of England. While the increase in interest rates was just 0.25% and mortgage rates are still at historically very low levels – with the impact further limited by the fact that the share of mortgages on variable rates has fallen to around 40% from a peak of 70% in 2001 – the fact that it was the first rise in interest rates since 2007 could have a significant effect on housing market. Having said that, the Bank of England has repeatedly stressed that interest rates will rise only gradually and to a limited extent.

Housing market activity and prices are also likely to be pressurised by stretched house-prices-to-earnings and tight checking of prospective mortgage borrowers by lenders. According to the Halifax, the house-prices-to-earnings stood at 5.66 in December, and while down from 5.71 in November, it is only modestly below the nine-year high of 5.76 seen in December 2016 and is well above the long-term (1983–2017) average of 4.23. Furthermore, mortgage lenders are under pressure from the Bank of England to tighten their lending standards.

The downside for house prices should be limited by the shortage of houses for sale. High employment is also supportive for the housing market while mortgage interest rates are still at historically low levels despite November's increase. The latest RICS survey showed new instructions to sell fell again in December, meaning that there have now been 23 successive months without a positive reading. Consequently, average stock levels on estate agents' books in November remained close to June's record low.

Additionally, the abolition of stamp duty for first time buyers for properties costing up to £300,000 (and on the first £300,000 for properties costing up to £500,000) in last November's Budget should also provide some support to house prices. However, even if successful, the Chancellor's measures to boost house building in November's Budget will take time to have a significant effect so are unlikely to influence house prices in the near term at least.

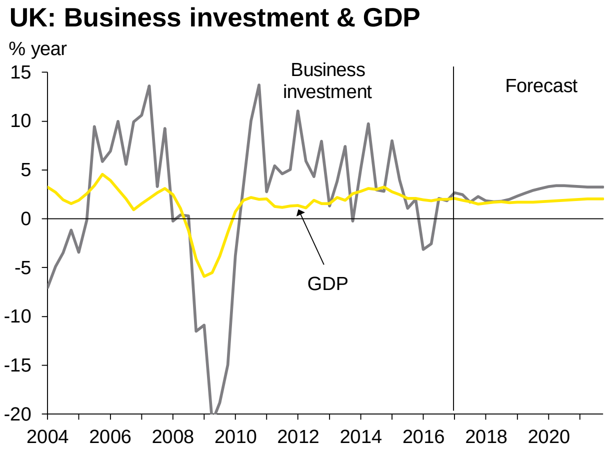
7. Company sector

Business investment has undoubtedly been affected by corporate caution amid Brexit uncertainties, but it has proved more resilient than many feared. Business investment fell 0.5% in 2016, which was the first drop since 2009, and was down from growth of 3.7% in 2015 and 5.1% in 2014. However, it was adversely affected by a drop in capital expenditure in the extraction sector amid weakened oil prices.

Business investment expanded in each of the first three quarters of 2017, growing 0.8% q/q in Q1 and 0.5% q/q in both Q2 and Q3. Consequently, business investment was up 1.7% y/y in Q3 2017.

This was despite survey evidence indicating that many companies were delaying or reducing business investment until there was more clarity on what would happen with Brexit. First and foremost, companies wanted to see the UK and EU agree a transition arrangement to ensure that the UK would not crash out of the EU in late March 2019 without any agreement on trade and other relations with the EU. Further out, many businesses want to know exactly what form the UK's relationship with the EU will take, as well as what relationships the UK will form with other countries/regions. Many businesses' reluctance to invest in this highly uncertain environment may well have been reinforced by the fact that the cost of labour is currently very cheap relative to capital. This increases the incentive for businesses to try and meet or generate any extra business by employing more workers rather than committing to potentially costly and lengthy capital investment projects.

On the positive side, several fundamentals for business investment remained favourable. Companies' net rates of return are relatively high overall while corporate balance sheets and finances are largely healthy. Additionally, if companies want or need to borrow to invest, the cost of capital currently remains low and availability of credit is at a healthy level. Last, and by no means least is the incentive to invest — for UK exporters and domestic firms competing with imports — provided by sterling's weakness.



Source: EY ITEM Club

With the UK and EU having finally reached agreement on the first phase of Brexit talks at the end of 2017, we expect agreement to be reached on a transition arrangement in the early months of 2018. This is likely to essentially maintain current trading and operating conditions for UK companies at least until March 2021, and very possibly beyond. If this is the case, it should give businesses a greater degree of certainty and be supportive to business investment.

Consequently, we expect business investment to rise 1.9% in 2018 after an estimated increase of 2.3% in 2017. Investment growth is seen picking up to 2.7% in 2019, helped by improved economic activity.

8. Labour market and wages

The labour market was robust over the first half of 2017, despite relatively lacklustre growth and considerable uncertainties over the outlook affecting businesses. Indeed, the number of people in employment reached a record high of 32.136 million in the three months to July. This took the employment rate up to an all-time high of 75.3%. Meanwhile, the number of unemployed fell to 1.455 million in the three months to July, taking the unemployment rate down to 4.3%, which is the lowest rate since 1975 and below the 4.5% rate that the Bank of England currently considers to be the 'equilibrium' level.

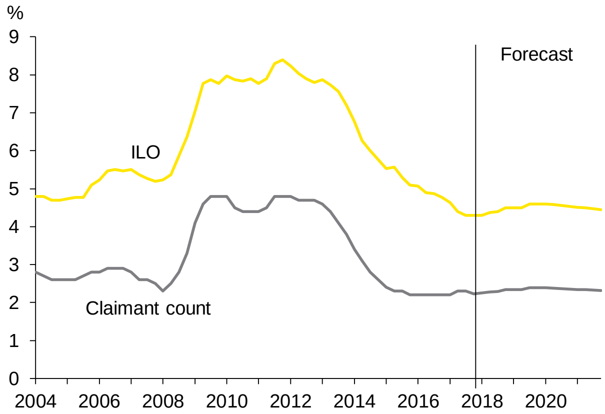
The attractiveness of employment was supported by earnings growth remaining weak with workers effectively pricing themselves into jobs. Certainly, in a very uncertain environment, it has been relatively attractive and less risky for companies to look to meet any extra business by taking on extra workers rather than investing in costly plant and machinery. It may also be that a number of UK companies have been keen to take on workers or at least hold on to them given concerns over labour shortages in some sectors and reports of fewer EU workers coming to the UK since the June 2016 Brexit vote.

The labour market was more erratic in the latter months of 2017. Indeed, the number employed fell by 14,000 in the three months to September and by 56,000 in the three months to October. This saw the employment rate dip to 75.1% and prompted speculation that extended relatively lacklustre UK economic activity as well as heightened business uncertainties and concerns over the economic and political outlook including Brexit were starting to have some dampening impact on the labour market. There are also reports that employment growth in some sectors is being limited by a lack of suitable candidates.

However, there was a rebound in employment in the three months to November, with the number in jobs rising by 102,000. This took employment up to a new record high of 32.207 million and saw the employment rate rise back up to 75.3%. Meanwhile, the number of unemployed edged down by 3,000 in November to 1.439 million, keeping the unemployment rate at 4.3%.

With growth expected to be slightly weaker at 1.7% in 2018, significant uncertainties remaining over the outlook and recruitment difficulties emerging in some sectors, we expect employment to rise at a reduced rate of 0.5% in 2018. Consequently, we see the unemployment rate edging up from 4.3% at the end of 2017 to 4.5% at the end of 2018. The unemployment rate is seen as edging up further to 4.6% by mid-2019 but it is then seen stabilising at that level.

UK: Unemployment rate



Source: EY ITEM Club

Despite the tightness of the labour market, earnings growth remained slow during 2017. Companies were keen to limit pay as they faced a highly challenging domestic economy and as their input costs were lifted noticeably by the weakened pound. Meanwhile, workers appear to have been generally unwilling to push for significantly higher pay despite increased inflation due to fragile confidence and uncertainties over the outlook.

There were some signs towards the end of 2017 that underlying pay growth could be creeping up. Annual growth in regular earnings (which excludes bonus payments) edged up to 2.4% in both November and October from 2.3% in both September and August and 2.1% in July. Consequently, regular pay was up 2.3% in the three months to November. This was up slightly from 2.3% in the three months to October and 2.2% in the three months to September, August and July.

We expect earnings growth will gradually trend higher in 2018, influenced by increased recruitment difficulties in some sectors. However, a sharp move up in pay looks unlikely, despite higher inflation in 2017 given companies' ongoing determination to limit their costs and generally fragile consumer confidence. Significantly, the Bank of England regional agents reported in their November 2017 survey of business conditions that *"Recruitment difficulties had increased and were above normal in a range of activities. That had contributed to a slight increase in pay growth, with expectations that settlements next year could be clustered around 2½%–3½% rather than 2%–3% during 2017"*.

Specifically, we forecast average earnings to rise by 2.7% in 2018. A further modest increase to 3.1% is expected in 2019.

9. Trade and the balance of payments

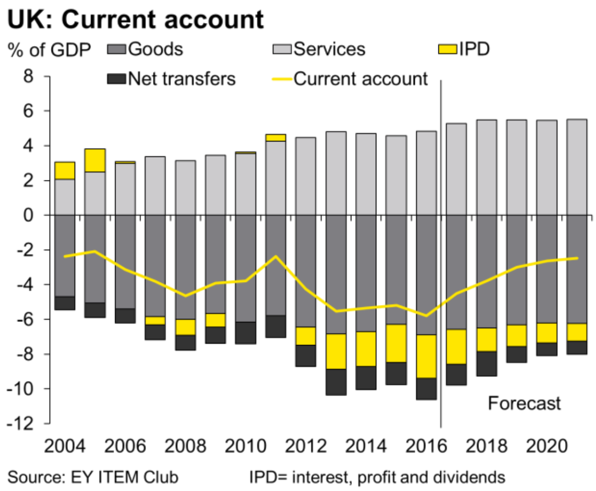
The weakened pound and robust global growth have combined to support UK exports. It looks like net trade made a positive contribution of some 0.6 percentage points to UK GDP growth in 2017. However, the trade data has been distorted by erratic factors, most notably movements in non-monetary gold.

We expect net trade to make a modest positive contribution to GDP growth in 2018. The pound is seen as firmer overall compared to 2017, but it will still be at a competitive rate. Additionally, global growth and trade is forecast to remain at an elevated level. Meanwhile, only modestly improving domestic demand will likely limit UK import volumes, and this could be reinforced by the relatively weak pound leading to some import substitution.

Some welcome news saw the current account deficit narrow in Q3 2017, although it remains too high for comfort and a potential source of vulnerability for the UK economy – particularly if there was any major loss of investor confidence in the UK, perhaps relating to heightened Brexit concerns. Specifically, the current account deficit narrowed to £22.8bn (4.5% of GDP) in Q3 after widening to £25.8bn (5.1% of

GDP) in Q2 from £21.6bn (4.3% of GDP) in Q1. There was a modest narrowing of the trade deficit in Q3. Additionally, the net deficit on the primary income account dipped to £11.4bn from £13.2bn.

The current account deficit will hopefully be generally lower over the coming quarters. A competitive pound and healthy global growth should support exports. There could also be some import substitution. Furthermore, the primary income account should be helped by the weakened pound lifting the value of UK investment earnings overseas when translated into sterling. It is also very possible that UK earnings on investments overseas do better than foreign earnings on investments in the UK due to likely slower growth in the UK than in Europe and the US



Having narrowed from £113.6bn (5.8% of GDP) in 2016 to an estimated £91.8bn (4.5% of GDP) in 2017, we expect the current account deficit to come down to £79.7bn (3.8% of GDP) in 2018. A further narrowing to £65.2bn (3.0% of GDP) is anticipated in 2019.

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