EY ITEM Club Autumn Forecast

Can the economy overcome heightened Brexit uncertainties?

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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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Cloudy for some time over the UK economy

No let up for forecasters …

I noted when EY ITEM Club produced its Summer Forecast just how difficult it is to make predictions in an uncertain world. If anything, the situation has worsened since then with concerns over geopolitics, trade and Brexit all complicating the task.

The critical issue is that many of the potential developments we are trying to understand are either unprecedented, such as Brexit, or have parallels that have not happened for a long time, such as the rise of populism. We have nothing to fall back on in these circumstances, which is what makes forecasting so difficult.

When EY ITEM Club does look at the historic performance of the UK economy, the messages are not reassuring. Its comparisons suggest that we are nearing the end of the growth cycle – the current expansion has now lasted for longer than average and it is possible we are running out of road.

… but clearly the economy is struggling …

EY ITEM Club now expects the UK economy to grow at 1.3% in 2018, down from its forecast of 1.4% in the Summer Forecast. While there have been some positive developments in the last few months, such as a bounceback in retail sales and continued job creation, the suggestion of an uptick in real pay levels has weakened, and higher oil and utility prices are likely to squeeze consumer spending further. In addition, it seems even more likely that the global outlook is becoming more challenging – EY ITEM Club notes how the UK's trade performance has tailed off in recent months.

… and any significant improvement appears unlikely …

With consumer spending, investment and trade expected to remain under pressure throughout 2018, it is unlikely that Government spending, even with the Prime Minister's promise to reduce austerity, will be able to provide any noticeable boost to GDP growth this year. There will a modest uptick to 1.5% growth in 2019, 1.7% in 2020 and 1.8% in 2021 but nothing close to a reversion to the historic trend rate of expansion. Business is not going to be able to rely on the economy to deliver growth.

… and risks remain weighted to the downside.

And these projections assume a reasonably smooth Brexit, with a withdrawal agreement and an outline of the future trading relationship in place by the end of March 2019 – a far from guaranteed outcome. It is important to note that not only has the outlook worsened but the risks are weighted to the downside.

Foreword

Low growth should be the base case …

I continue to believe that the prudent planning approach is to adopt a base case assumption on the UK economy that is based on low growth for the next three years as a minimum. EY ITEM Club's forecast is based on the assumption of the EU and UK signing a withdrawal agreement that will support a stable transition. Hence no major shock to business investment is probably a best case assumption at this time and actual growth could be hit by lower investment.

Alongside the base case it is important to test a more adverse scenario. A realistic downside case could be based on severe disruption for four to six weeks as a result of a possible initial 'no-deal' Brexit followed by a gradual piecemeal solution. While we would expect a policy response to seek to mitigate the impacts, testing the robustness of the business and especially cash flow against a short period of severe disruption followed by a recession for three or four quarters would be a prudent approach to risk management. Even if the Brexit process goes smoothly, the cyclical risks to the UK economy mean this would still be a worthwhile exercise.

Longer term, the likely reduction in migration and the consequences of the UK's current relatively low level of capital investment are likely to reduce the UK's longer-term growth rate. It also seems reasonable to assume that, in line with the consensus from the overwhelming majority of economists, the UK's potential will be hit. Now is the time to start to think about the future shape of any UK business after 2020.

Highlights

- The latest EY ITEM Club forecast has slightly downgraded our view of UK economic prospects for 2018 and 2019. This partly reflects increased uncertainties currently facing the outlook due to the elevated risk of the UK leaving the EU without a deal in March 2019. It also reflects recent faltering developments in consumer purchasing power after limited improvement in late 2017 and early on in 2018. Meanwhile, a clear loss of economic momentum in the eurozone over the first half of 2018 and an uncertain global trade outlook, amid heightened trade disputes and the imposition of protectionist measures by the US and China, have created a more difficult environment for UK exporters.

- GDP growth likely improved to 0.6% q/q in Q3 2018 from 0.4% q/q in Q2, helped by a very strong performance in July which benefitted from the football World Cup and the heatwave. This would make Q3 the best quarter for growth since Q4 2016. However, we suspect growth will fall back to 0.3% q/q in Q4 2018 and through the first half of 2019. While we expect the UK and EU to ultimately agree a Brexit transition arrangement to come into effect in March 2019, we suspect that heightened uncertainties in the run-up to the UK leaving the EU and in the aftermath of the exit will fuel business and consumer caution. This is likely to result in weakened business investment and consumer spending.

- Consequently, we have trimmed our GDP growth forecast for 2018 to 1.3% (from the 1.4% projected in July), which would be down from 1.7% in 2017 and would represent the weakest expansion since 2009. Growth is seen improving modestly to 1.5% in 2019 (revised down from 1.6%).

- Should the UK leave the EU in March 2019 without any deal, we believe the near-term growth outlook at least would be weaker as major uncertainty would negatively impact business sentiment and investment, as well as significantly affect consumers. Trade would clearly be substantially affected as trade barriers, both tariff and non-tariff, kicked in. A likely sharp drop in the pound in the event of a ‘no-deal’ UK exit from the EU would provide help to UK exporters, but it would also push up businesses’ costs and consumer price inflation, thereby weighing down on households’ purchasing power.

- It is possible that the growth pattern could be distorted in late 2018 and 2019 if concerns about supply disruptions in the event of the UK leaving the EU without any deal cause companies to stockpile materials and finished products. This could be reinforced if consumers make panic buys. This would be liable to boost growth in late 2018 and early 2019 but weigh down on growth thereafter. The impact on growth would also depend to what extent this stockpiling was met through increased imports.

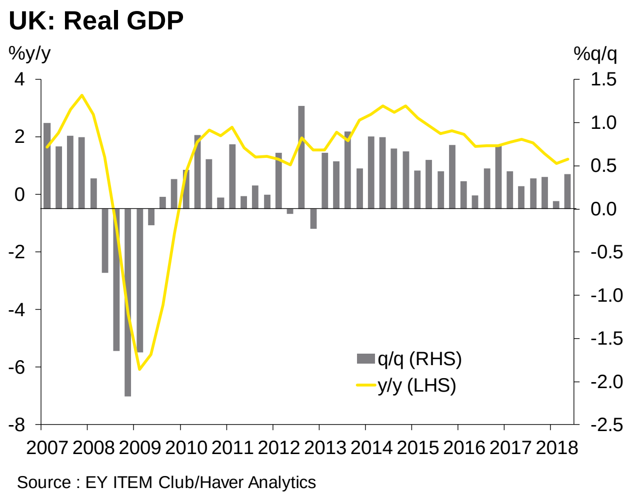
- We expect consumer purchasing power to gradually improve in late 2018 and during 2019. Consumer price inflation is seen as coming back down to 2.3% by the end of 2018 and 2.0% by mid-2019. Meanwhile, earnings growth should gradually improve following its Q2 2018 relapse as increased recruitment difficulties in several sectors fuel higher pay increases. However, the upside for consumer spending growth is likely to be limited by the household saving ratio reaching an overall record low of 4.2% in 2017 and then falling to 3.6% in Q1 2018, thereby causing consumers at the very least to be keen to avoid further dissaving. It improved modestly to 3.9% in Q2. August’s interest rate hike by the Bank of England’s Monetary Policy Committee (MPC) may reinforce consumer caution. Consumers may also limit their spending in the first half of 2019 amid heightened uncertainty in the run-up and immediate aftermath of the UK leaving the EU in March.

- Following August’s hike from 0.50% to 0.75%, we do not expect any more interest rate rises from the MPC until after the UK leaves the EU in March 2019, given the major uncertainties that are occurring in the run-up to the UK’s departure. Assuming the UK and the EU enact a Brexit transition arrangement in March 2019 and the economy thereafter achieves steady growth of around 0.4% q/q, we expect the MPC to next raise interest rates from 0.75% to 1.00% in August 2019. The MPC will probably want to see sustained evidence that the economy is holding up in the aftermath of the UK leaving the EU.

- We expect just one interest rate hike in 2019 followed by two in 2020 (taking rates up to 1.50% by the end of 2020) as the MPC seeks to gradually normalise monetary policy. However, all interest rate forecasts could clearly be blown out of the water if the UK leaves the EU next March with no deal.

Introduction

In most respects, the economy has developed in recent months as we had expected in our Summer Forecast, which was published in July.[1] GDP growth recovered to 0.4% quarter-on-quarter (q/q) in Q2 2018, having been limited to 0.1% q/q in the first quarter when activity was clearly hampered by the severe weather (most notably, retail and construction activity). Despite the Q2 pick-up, GDP growth over the first half of 2018 was the economy's weakest six-month performance since the second half of 2011. Furthermore, GDP growth in Q2 2018 was still only in line with the 0.4% q/q rate seen in both Q3 and Q4 2017, thereby indicating that the economy was unable to step up a gear – despite rebounds in retail and construction – from activity lost in Q1 to the 'Beast from the East'. Indeed, year-on-year (y/y) growth could only edge up to 1.2% in Q2 from 1.1% in Q1, which had been the weakest annual growth rate since Q2 2012.



The economy may well have seen a pick-up in growth to 0.6% q/q in Q3, primarily due to a strong performance in July when GDP expanded 0.4% month-on-month (m/m) as activity was boosted by the heatwave and the football World Cup. Construction activity also appeared to be buoyed by a further recouping of activity lost in Q1. While GDP was subsequently flat m/m in August, it was still up 0.7% on a three-month/three-month basis.

The current and very real risk that the UK could exit the EU without a transition withdrawal deal in March 2019 has added to the near-term uncertainties facing businesses and consumers. Recent weaker-than-expected developments in consumer purchasing power are also a concern for UK growth prospects. Meanwhile, a clear loss of economic momentum in the eurozone over the first half of 2018 and an uncertain global trade outlook amid heightened trade disputes are potential drags for UK exporters.

Even though the economy may well have seen improved growth of 0.6% q/q in Q3 2018, we suspect there will be some loss of momentum in Q4 2018 and during the first half of 2019. While we believe the UK and EU are most likely to ultimately agree a Brexit transition arrangement to come into effect in March 2019, we anticipate that heightened uncertainties in the run-up to the UK leaving the EU and in the aftermath of the UK's exit will fuel increased business caution especially, as well as consumer caution.

Consequently, we have trimmed our GDP growth forecasts for 2018 to 1.3% (from 1.4%) and for 2019 to 1.4% (from 1.5%). Over the longer term, our GDP growth forecasts are little changed at 1.7% in 2020, 1.8% in 2021 and 2.0% in 2022.

Should the UK exit the EU in March 2019 without any deal, we believe the near-term growth outlook at least would be weaker as major uncertainty would negatively impact business sentiment and investment, as well as affecting consumers. Trade would clearly be substantially affected as trade barriers, both tariff and non-tariff, kicked in. A likely sharp drop in the pound in the event of a 'no-deal' UK exit from the EU would provide help to UK exporters, but it would also push up businesses' costs and consumer price inflation thereby weighing down on households' purchasing power.

[1] *EY ITEM Club Summer Forecast: Will the clouds clear for the economy?* July 2018. See ey.com/Publication/vwLUAssets/EY-ITEM-Club-Summer-forecast-2018/$FILE/EY-ITEM-Club-Summer-forecast-2018.pdf

The Bank of England raised interest rates from 0.50% to 0.75% in August as we had expected in our Summer Forecast. Nevertheless, the slight downgrading of our GDP growth forecasts for 2018 and 2019 and our reduced near-term expectations for earnings growth means that we now expect the Bank of England to raise interest rates only once in 2019 (from 0.75% to 1.00%) rather than the two hikes that we had previously anticipated.

Economy recovered in Q2 after weather-influenced Q1 relapse

A rebound in GDP growth in the second quarter to 0.4% q/q from 0.1% q/q in Q1 was helped by a recovery in retail sales (which expanded 2.0% q/q – the best performance since Q1 2004), and construction output (which expanded 0.8% q/q after contracting 1.6% q/q in Q1). In addition to some catch-up from Q1, retail sales were given a lift in Q2 by the Royal Wedding and the football World Cup. The extended heatwave also seems to have helped retail sales overall by boosting demand for food and drink in particular (for barbecues and garden parties) and for summer clothing, although there was some negative impact on footfall from consumers being discouraged from going to the shops.

Despite the rebound in retail sales, consumer spending growth dipped to 0.4% q/q in Q2 from 0.5% q/q in Q1, although y/y growth edged up to 1.6% from 1.5%. This indicated that overall consumer spending continued to be constrained by relatively limited purchasing power and fragile confidence.

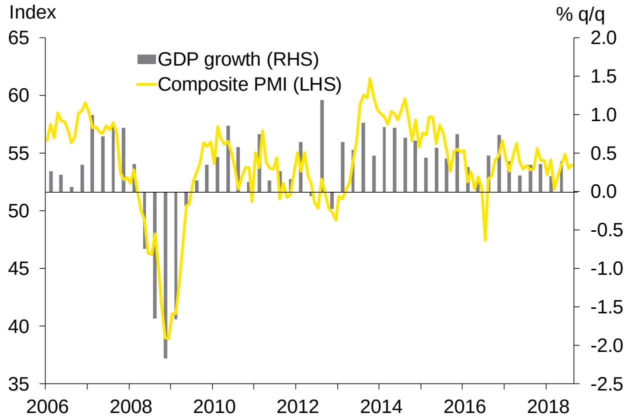
Disappointingly, business investment contracted 0.7% q/q in Q2, which was a second successive decline following a drop of 0.5% q/q in Q1. Consequently, business investment was down 0.2% y/y in Q2, pointing to business caution as Brexit draws ever nearer. Another disappointment was that net trade was sharply negative in Q2 (knocking 0.6 percentage points (ppts) off q/q growth) as exports of goods and services plunged 2.2% q/q. Imports fell by a much lower 0.2% q/q. While the trade performance was significantly influenced by a fall in exports of non-monetary gold (which correspondingly substantially lifted gross capital formation), the underlying performance was poor.

On the output side of the economy, in addition to the rebound in construction activity, Q2 saw a pick-up in services activity, which had been partly affected by the severe weather in Q1. This was particularly true of the retailing and wholesaling sectors. Specifically, services output growth doubled to 0.6% q/q in Q2 (which was the best growth rate since Q4 2016) from 0.3% q/q in Q1.

However, industrial production contracted sharply in Q2 (down 0.8% q/q), dragged down by a disappointing manufacturing performance (a decline of 0.7% q/q). This followed manufacturing output edging down 0.1% q/q in Q1 2018 and was in contrast to impressive output gains of 1.3% q/q in Q4 2017 and 0.9% q/q in Q3 2017. It is evident that the help to the manufacturing sector coming from a competitive pound and robust global growth waned over the first half of 2018 as the pound firmed overall from its 2017 lows, (despite bouts of weakness), and economic activity came off its highs in some overseas markets, notably the eurozone.

We believe that the economy probably grew at an improved rate of 0.6% q/q in Q3 2018. This is primarily due to the economy receiving a boost in July from the heatwave and from the football World Cup. Specifically, monthly GDP growth was reported at 0.4% m/m in July, with contributions from services output (up 0.3% m/m), industrial production (up 0.4% m/m) and construction output (up 0.5% m/m).. While GDP was subsequently flat m/m in August, it was still up 0.7% in the three months to August compared to the three months to May. Services output flatlined in August, while construction output fell back 0.7% m/m. However, the healthy underlying performance of both sectors over the summer was reflected in respective three-month/three-month gains of 0.5% and 2.9%.

UK: CIPS/Markit composite PMI and GDP growth



Source : Oxford Economics/Haver and CIPS/Markit

Meanwhile, industrial production rose 0.2% m/m in August and was up 0.7% on a three-month/three-month basis. On the expenditure side of the economy, retail sales volumes grew 0.7% m/m in July, followed by a 0.3% expansion in August. Survey activity for September from the purchasing managers points to an overall modest softening of activity, with slowdowns in services and construction activity but improvement in manufacturing. There were some signs in the surveys that clients were becoming cautious in placing major orders amid increased Brexit and political uncertainties.

Developments in consumers' purchasing power have been mixed

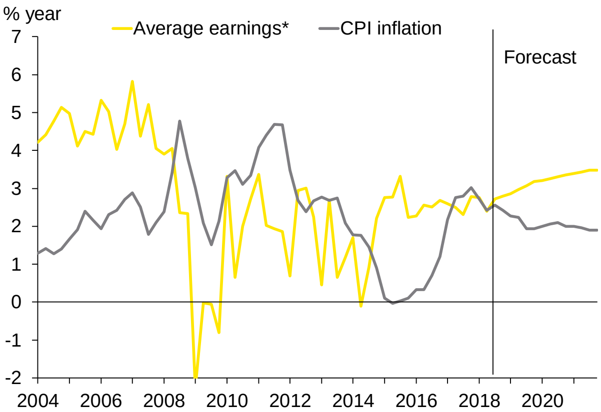
A worrying development for growth prospects has been a mixed picture for consumer purchasing power after the limited improvement in the latter months of 2017 and Q1 2018, following an extended squeeze. Having gradually improved from a low of -0.6% in the three months to May 2017 to 0.2% in the three months to February 2018, annual real growth in average weekly earnings hovered at 0.1%–0.2% in the second quarter of the year.

The pattern of real earnings growth in Q2 2018 was primarily the consequence of a relapse in earnings growth, as consumer price inflation trended down to 2.4% (the lowest level since March 2017) for three successive months through to June, from a peak of 3.1% in November 2017.

Q2's relapse in earnings growth occurred despite a further tightening in the labour market (the unemployment rate remained at 4.0% in the three months to July, the joint lowest level since February 1975). Headline (three-months-on-a-year-earlier) total average pay increased 2.3% in the three months to June compared to a year earlier, the weakest rise since the 2.2% recorded in the three months to May 2017. On the same headline basis, pay growth had earlier trended up to a peak of 2.9% in February 2018. Furthermore, annual average earnings growth was limited to 2.0% in June itself.

However, the latest data (covering July) offered more cause for optimism on earnings. Headline growth in total pay rose to 2.6%, an admittedly modest gain from June's 2.4%. But the single-month measure jumped to 3.1% from 2%, while single-month regular pay growth reached a three-year high of 3.1%. That said, with July 2017 delivering a markedly weak performance on these measures, base effects acted to exaggerate this July's gains, so it is still too early to conclude that pay growth has turned a corner.

UK: Average earnings and inflation



Source: EY ITEM Club *National Accounts measure

While earnings growth showed improvement in July, this was countered by consumer price inflation rising back up to 2.5% in July and then to a six-month high of 2.7% in August. Upward pressure on inflation has come from recent higher oil prices and the weaker pound. This could keep inflation sticky in the near term. There is also an upside risk from higher food prices as a result of the recent heatwave in the UK and Europe following on from severe cold weather in the first quarter. Thereafter, CPI inflation is expected to come down to 2.3% by the end of 2018 and then get down to 2.0% by mid-2019.

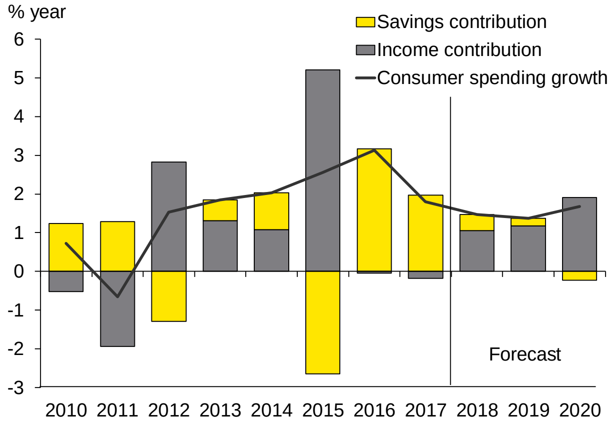
Some recent signs of life on the earnings front will no doubt comfort the Bank of England in its view that earnings growth will firm gradually over the coming months, reflecting growing recruitment difficulties in some sectors. The MPC argues that survey evidence largely bears this out, including a special survey conducted over the summer by the Bank's regional Agents.[2] While this is a view we broadly share, we are nevertheless edging down our forecast of earnings growth (on a National Accounts

[2] '*The labour market and pay*', Section 3 of the Bank of England *Inflation Report*, August 2018. See bankofengland.co.uk/inflation-report/2018/august-2018/the-labour-market-and-pay

basis) to 2.7% this year (from 2.9% in our Summer Forecast), which is only modestly up from the 2017 outturn of 2.5%. The 2019 projection for earnings growth has been trimmed to 3.0% from 3.1%.

This downgrading in expected earnings growth is reflected in our forecasts for consumer spending growth, which is seen limited to a six-year low of 1.5% in 2018, then slowing further to 1.4% in 2019. There are other factors that are likely to limit consumer spending. With the household saving ratio reaching an overall record low of 4.2% in 2017 and then being limited to 3.6% in Q1 2018, consumers may at the very least be keen to avoid further dissaving. Perhaps an early sign of this was the household saving ratio rising to 3.9% in Q2 2018.

UK: Contributions to consumer spending



Source: EY ITEM Club

Also, significantly, lenders have become less prepared to make unsecured credit available to consumers, with a tightening in lending standards evident in recent surveys of credit conditions from the Bank of England. And we expect annual employment growth to slow significantly from 1.2% in 2018 to 0.5% in 2019.

Moreover, consumer spending growth could be limited in the early months of 2019 by heightened uncertainties in the immediate run-up and aftermath of the UK leaving the EU in late March.

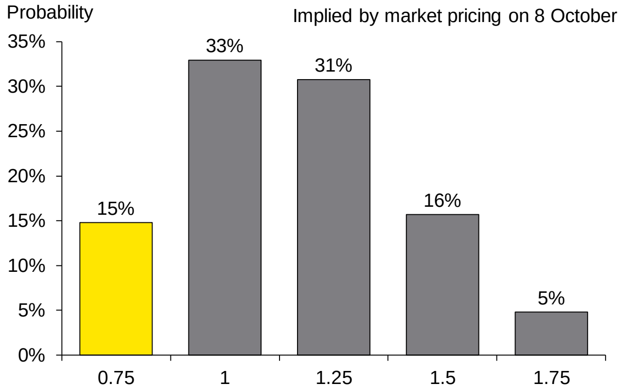
Bank of England now likely to hike interest rates just once in 2019

Another potential headwind to the consumer comes from rising borrowing costs. Having been deterred by the economy's Q1 relapse from raising Bank Rate in May (despite earlier building up expectations of such a hike), the Bank of England finally delivered a 25 basis points (bps) increase in the official interest rate from 0.5% to 0.75% at the August MPC meeting with a unanimous 9–0 vote.

The MPC chose to hike in August despite the slowdown in earnings growth in Q2 and heightened Brexit uncertainties. MPC members clearly felt that a rebound in growth to 0.4% q/q in Q2 (in line with the Bank of England's view that the economy's supply-side growth potential runs at around 1.5% per year), a further tightening of the labour market and the perception of little – if any – slack left in the economy justified lifting interest rates to 0.75% from 0.5%.

Despite August's unanimous vote, we now suspect that the Bank of England will only raise interest rates once in 2019 (most likely next August) rather than twice as we had expected in our Summer Forecast. We do not expect any more rises in interest rates until after the UK leaves the EU in March 2019 given the major uncertainties that may occur in the run-up to the UK's departure. A modest downgrading of our GDP growth and earnings forecasts for 2018 and 2019 are factors in our reduced interest rate expectations for 2019.

UK: Probability of Bank Rate after December 2019 MPC meeting



Source: EY ITEM Club/Bloomberg

On the assumption that the UK and EU arrive at a withdrawal agreement in March 2019 and the economy thereafter sustains steady growth of around 0.4% q/q, we expect the Bank of England to raise interest rates from 0.75% to 1.00% in August 2019. We doubt that the Bank of England would act before August 2019 as the MPC will probably want to see sustained evidence that the economy is holding up in the aftermath of the UK leaving the EU.

Thereafter, we expect the Bank of England to deliver two interest rates a year (evenly spaced out at six monthly intervals), until Bank Rate reaches 2.5% in 2023 as the MPC looks to gradually normalise monetary policy. This plateauing of interest rates at 2.5% is the same as we had expected in our Summer Forecast, but it now occurs in 2023 rather than 2022.

The minutes of the August MPC meeting[3] and the forecasts contained in the August Bank of England Quarterly *Inflation Report*[4] indicated that the MPC are in no hurry to raise interest rates again and that future tightening of monetary policy will be both gradual and limited. Furthermore, the interest rate outlook is clearly clouded by how Brexit developments will play out over the coming months and years.

In its August *Inflation Report*, the Bank of England forecast GDP growth at 1.4% in 2018. Growth was seen improving to 1.7% in 2019 and then stabilising at this level in 2020. The Bank of England currently believes that the economy's supply-side potential growth rate is 1.5% and that there is currently little slack left. Consequently, these growth forecasts led the MPC to judge that "a small margin of excess demand emerges by late 2019 and builds thereafter". Additionally, the Bank of England expects the unemployment rate (which was 4.2% at the time the *Inflation Report* was published and subsequently fell to 4.0% in the three months to June) to dip to 3.9% by the end of 2018 and then stabilise at that level through 2019 and 2020.

This feeds through to generate gradually rising domestic costs. Earnings growth is seen rising from 2.5% in 2018 to 3.25% in 2019 and 3.5% in 2020. Consequently, the Bank of England forecasts consumer price inflation to average 2.5% in Q3 2018, then to edge back to 2.3% in Q4. Inflation is then seen edging down to 2.2% in Q4 2019 and to 2.0% in Q4 2020, and then stabilising through to Q3 2021.

The Bank's forecasts were based on the market assumption of just one to two further interest rate hikes over the next three years. This implied a Bank Rate at 1.0% in late 2019/early 2020 and 1.1% in Q4 2020, a level expected to be unchanged in Q3 2021. However, as consumer price inflation was seen marginally above its 2.0% target rate on a two-year horizon (a forecast at 2.1% in Q3 2020), this implied that interest rates could rise a little faster than markets expected.

It is also notable that in the August *Inflation Report* the Bank, for the first time, gave its estimate of the so-called 'equilibrium interest rate'. This is defined as "the interest rate that, if the economy starts from a position with no output gap and inflation at the target, would sustain output at potential and inflation at the target".[5]

The Bank estimated that in real terms, the long-term equilibrium interest rate is 0%–1%. Adding the targeted inflation rate of 2%, this translates into a long-term equilibrium interest rate of 2%–3%. The Bank sees the equilibrium interest rate as lower in the near term due to still significant headwinds facing the economy, such as the further need for consumers to repair balance sheets and fiscal drag as well as heightened uncertainty (particularly from Brexit).

Increased Brexit uncertainties cloud outlook and could weigh down on investment

The chance of the UK leaving the EU in March 2019 without a transition arrangement has undoubtedly risen recently, and we have become less confident of an orderly exit. In August, the Government published 75 technical notes advising companies and households how to prepare for any disruption that could arise in the aftermath of the UK exiting the UK without any deal. Nevertheless, we still think it is

[3] Bank of England, Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 1 August 2018. See bankofengland.co.uk/-/media/boe/files/monetary-policy-summary-and-minutes/2018/august-2018.pdf
[4] Bank of England *Inflation Report* August 2018. See bankofengland.co.uk/-/media/boe/files/inflation-report/2018/august/inflation-report-august-2018.pdf
[5] See page 39 of the Bank of England *Inflation Report* August 2018. See bankofengland.co.uk/-/media/boe/files/inflation-report/2018/august/inflation-report-august-2018.pdf

more likely than not that the UK and EU will ultimately come to a deal, although it could very well be uncomfortably late for ratification by March 2019.

The aim has been for the UK and EU to agree a divorce deal and a broad outline of the UK's future relationship with the EU by the 18–19 October summit of EU leaders, so that there would be ample time for ratification. However, this now looks increasingly uncertain with slippage seen into November, or even December. On the divorce deal, the Irish border issue remains a major sticking point, while there remains a lack of clarity over the UK's ultimate relationship with the EU.

The Chequers agreement forged in early July by Prime Minister Theresa May setting out UK government proposals for future relationships with the EU has been criticised by hard-line Brexiteers (led by the Conservative European Research Group), pro-Europeans and the EU. Key features of the Chequers proposals include: (1) a free-trade area for goods (including food and agricultural products) with a "common rule book" established for regulatory standards; (2) a "Facilitated Customs Arrangement" whereby the UK will set its own tariffs for goods destined for the UK market, but collect tariffs on behalf of the EU if goods enter the UK destined for other markets within the EU. This is aimed at maintaining frictionless trade between the UK and EU and avoiding problems across the Irish border; (3) Services would not be part of the free-trade area. The Chequers plan calls for "regulatory flexibility" for services but acknowledges neither the UK nor EU would enjoy "current levels of access" to each other's markets.

Concerns mounted during September and early-October that the UK and EU will not be able to agree a withdrawal deal and Brexit transition arrangement before the UK formally leaves the EU on 29 March 2019. While there were signs in mid-October that the UK and EU were making progress on a withdrawal deal (although the Irish border issue was still proving sticky), doubts remained as to whether there would be sufficient support in Parliament for it. We take the view that with it not being in the interests of either side for the UK to leave the EU without a transition arrangement next March, some form of deal will ultimately be reached. The history of EU negotiations being concluded in a flurry of last-minute deal-making offers some reason to be hopeful for such an outcome.

One possibility could be for the UK and EU to strike a divorce deal while adopting a vague approach to the UK's future ties with the EU. The *Financial Times* reported in early September that "While the EU continues to have fundamental reservations about Mrs May's Chequers plan for close integration with the EU after Brexit, the bloc's main priority is concluding a withdrawal deal with the UK, including guarantees to avoid a hard border across the island of Ireland. Diplomats expect many hard choices over future relations to be left until after Brexit." [6] The *Financial Times* also reported that the EU wants the political declaration to specify that the UK and EU are working towards agreeing a "free-trade agreement with customs cooperation" by the end of the transition period in December 2020. [7]

Current appreciable concerns about the UK leaving the EU next March without any withdrawal agreement and transition arrangement could very well increase business caution over committing to major investment expenditure over the next few months. However, there could be some offsetting boost from firms seeking to 're-shore' supply chains from the EU to the UK to avoid potential disruption from any new trade barriers between the two parties (discussed in more detail below). And the boost to exporters' profitability from the cheap pound appears to have spurred some capital spending, particularly among relatively export-orientated manufacturers. Manufacturing investment rose 9.9% y/y in Q4 2017, a 10-quarter high, albeit then slipping to 7.8% in Q1 of this year and then dipping 1.6% in the second quarter of the year.

If a Brexit transition arrangement is reached as we expect, this will at least provide some certainty for businesses over 2019 and 2020. The outlines of the transition arrangement that was reached in March

[6] *Financial Times 'EU ready to give Barnier mandate to close Brexit deal'*, 9 September 2018. See ft.com/content/477ac3e4-b433-11e8-bbc3-ccd7de085ffe

[7] *Financial Times 'The Danger of a "blind Brexit"'*, 6 September 2018. See ft.com/content/1f3a606c-af6d-11e8-8d14-6f049d06439c

implied that in trade terms, nothing would change between the UK's formal departure from the EU next March and the end of a transitional period in December 2020.

However, even if a Brexit transition arrangement is reached, business investment's upside is likely to be limited by ongoing major uncertainties over what form the UK's post-Brexit relationship with the EU is likely to take.

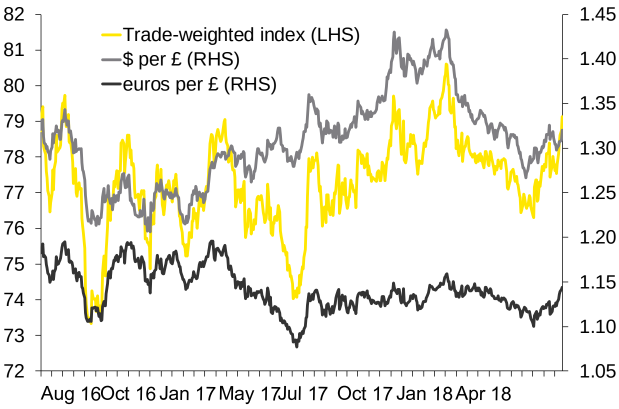
Sweet spot facing UK exporters has shrunk

There was much talk during 2017 of the 'sweet spot' facing UK exporters, with global growth and trade buoyant, and with sterling highly competitive following its sharp weakening in the aftermath of the June 2016 referendum vote for Brexit. Meanwhile, as it was still a member of the EU, the UK was not facing any change in its trading conditions with other member states. This confluence of favourable factors helped net trade add 0.5 ppts to UK GDP growth in 2017.

Disappointingly, conditions have not been so sweet for UK exporters in 2018. Growth has slowed in some key UK export markets, most notably the eurozone. Specifically, GDP growth in the eurozone slowed to 0.4% q/q in both Q1 and Q2 2018, which was the weakest expansion since Q2 2016 and down from 0.7% q/q in Q4 2017. Consequently, the September edition of *Consensus Forecasts* projected that eurozone GDP growth would slow from 2.5% in 2017 to 2.1% in 2018 and 1.8% in 2019.[8] On the positive side, growth has been stronger in the US.

UK: Sterling exchange rate

January 2005=100



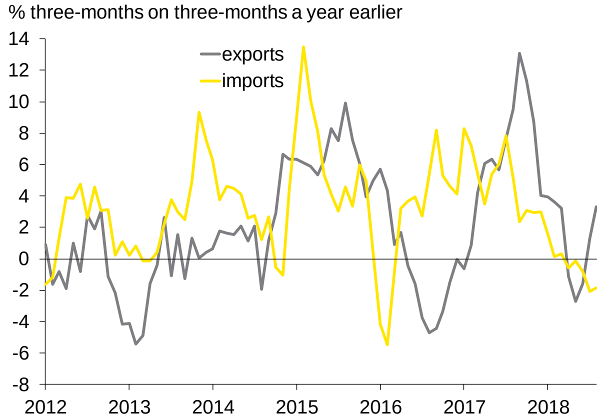
Source : EY ITEM Club/Haver Analytics

Furthermore, the global trading environment has become much more fraught, with trade disputes between the US on one side and China and EU on the other leading to protectionist measures being enacted, with the threat of more to come. Meanwhile, sterling has largely traded well above its 2017 lows, although it has recently come under pressure (primarily from heightened Brexit uncertainties) causing it to fall to a 13-month low against the US dollar and a 12-month low against the euro in August.

Consequently, real exports of goods and services fell 0.8% q/q in Q1 2018 while imports of goods and services edged down 0.3% q/q, with the result that net trade made a small negative contribution of 0.1 ppts to GDP growth – just 0.1% q/q in Q1. Q2 saw real exports contract 2.2% q/q while imports were down 0.2% q/q. The result was that net trade made a greater negative contribution of 0.6 ppts to Q2 GDP growth of 0.4% q/q. Year-on-year growth in UK real exports of goods and services slowed from a peak of 10.5% in Q3 2017 to 4.3% in Q1 2018 and just 0.8% in Q2 2018.

UK: Goods export & import volumes

% three-months on three-months a year earlier



Source : EY ITEM Club/Haver Analytics

Q2's trade performance was adversely affected by a decline in exports of non-monetary gold (which correspondingly lifted gross capital formation). But the underlying performance was still poor, with growth in export volumes, excluding oil and erratics, broadly grinding to a halt over the summer. However, the drag on net trade in Q2 from movements in non-monetary gold suggests there may well be

[8] *Consensus Forecasts*, 10 September 2018. See consensuseconomics.com

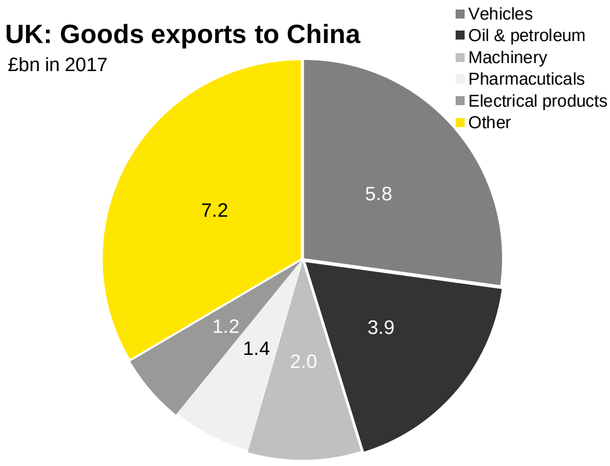
an unwinding of this impact in the near term. And given the extent to which the trade data tends to be revised over time, there is also the possibility that the adverse impact of net trade on GDP growth in the second quarter could eventually be revised down. Certainly, early data for Q3 showed an improvement in the UK's trade performance.

The UK should avoid the worst consequences of US–China trade troubles

Moves towards greater trade protectionism have gathered pace since our last forecast report was published. Late September saw the US impose higher tariffs on an additional $200bn of imports from China, adding to the extra duties charged on $53bn of imports in July and August. This means that about half of all Chinese imports to the US are now subject to higher tariffs. China in turn imposed extra tariffs, also coming into effect towards the end of September. These apply to a total of $110bn of imports from the US, covering the great majority of goods bought from the US annually ($130bn in 2017).

But as we argued in our Summer Forecast, the UK looks relatively well-positioned among advanced economies to weather the adverse spillovers of a US–China trade conflict.

This reflects both the nature of the UK's export sector and its exports to China. In 2017, goods accounted for 55% of total UK global exports, with services' share running at 45%. The former proportion is much lower than for most major economies, where goods typically account for 70%–80% of total exports. It follows that the UK is less exposed to increased barriers on trade in goods than many of its peers.



Source: EY ITEM Club/International Trade Centre

In terms of the *type* of goods vulnerable to those barriers, exports of capital goods rank high on the list. For example, if Chinese industrial production drops because of US tariffs, demand for machinery used in that production will also decline. But this remains an area the UK is not particularly exposed to. In 2017, cars accounted for the largest chunk of UK goods exports to China (27% of the total), followed by oil and petroleum products (18%), with machinery coming in at third place at 9% (accounting for a mere 0.4% of global UK goods exports). In contrast, machinery made up 21% of German goods exports to China (1.6% of total German goods exports) in the same year.

Trade diversion could add an extra channel of impact if US tariffs encourage Chinese producers to try and divert sales to non-US markets. This would deliver lower prices for consumers, but at the expense of UK producers competing with Chinese imports. But the UK does not major in the production or export of the type of Chinese-made goods which the US tariffs are targeting, or the agricultural products Chinese retaliation has focused on. For example, in 2017, the UK imported £11.2bn of electrical machinery and equipment from China, while UK exports to China in the same category amounted to less than £1bn. So it is not inconceivable that that the UK could actually *gain* from any trade diversion effects, if import prices were to fall as a consequence. Of course, slower growth in those UK trading partners hit harder by tariffs would ripple through to lower demand for UK goods and services. But overall, it seems most likely that there will be only a very modest effect on UK growth from the escalation of the US–China trade dispute.

Steady sedate growth likely to continue if a 'no-deal' Brexit avoided

The forecast sees GDP growth at 1.3% in 2018. This is down from 1.7% in 2017 and would be the weakest expansion since 2009. This assumes that growth improved to 0.6% q/q in Q3 but falls back to

0.3% q/q in Q4 as heightened Brexit uncertainties weigh down on business investment and may also fuel increased consumer caution.

Growth in late 2018 should be helped by consumer purchasing power gradually resuming an upward trend while also benefitting from employment growth. However, recently higher oil prices, a weaker pound and the general softness of pay growth could well continue to hold back further improvement in purchasing power in the near term. Despite heightened Brexit uncertainties, investment is expected to be modestly positive over the rest of 2018, helped by some firms looking to increasingly invest in automation to make up for labour shortages and to try to boost productivity. Meanwhile, net trade may struggle to make a positive contribution to growth. Economic activity has come well off its highs in some important overseas markets, notably the eurozone. The recent renewed weakness in the pound may provide some help, although it is still clearly above its 2017 lows.

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

	GDP	Domestic demand	Consumer spending	Fixed investment	Exports	Imports
2015	2.3	2.3	2.6	3.4	4.4	5.5
2016	1.8	2.4	3.1	2.3	1.0	3.3
2017	1.7	1.2	1.8	3.3	5.7	3.2
2018	1.3	1.3	1.5	-0.1	1.8	1.5
2019	1.5	1.5	1.4	1.1	3.4	3.5
2020	1.7	1.7	1.7	2.3	3.0	2.9
2021	1.8	1.8	1.9	2.3	3.5	3.4
	Net Government borrowing*	**Current account (% of GDP)**	**Average earnings**	**CPI**	**Bank rate**	**Effective exchange rate**
2015	4.0	-4.9	2.8	0.1	0.5	91.5
2016	2.6	-5.3	2.5	0.6	0.4	82.0
2017	2.3	-3.8	2.5	2.7	0.3	77.4
2018	1.6	-3.3	2.7	2.5	0.6	78.8
2019	1.4	-2.8	3.0	2.1	0.9	81.0
2020	1.2	-2.4	3.3	2.0	1.3	82.2
2021	1.1	-2.5	3.4	1.9	1.8	81.5

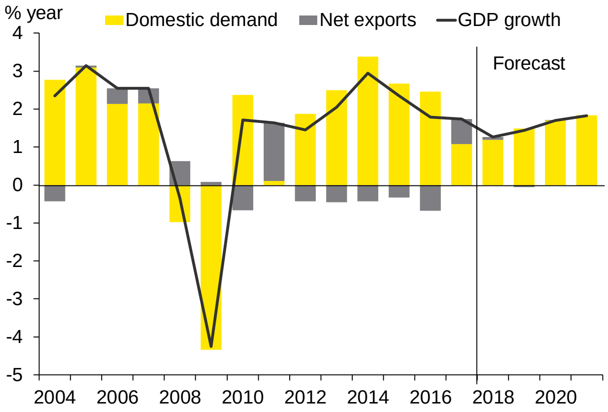
*Fiscal years, as % of GDP

Source: EY ITEM Club

We see growth improving modestly to 1.5% in 2019. This forecast assumes that growth is limited to 0.3% q/q in both Q1 and Q2 2019 as a consequence of heightened uncertainty in the run-up to the UK leaving the EU in late March and in the immediate aftermath of the UK's departure. Thereafter growth is seen picking up to a 0.4% q/q rate in Q3 and Q4 2019.

Growth in 2019 is expected to be supported by a gradual improvement in consumer purchasing power through the year. Inflation is seen as averaging a reduced 2.0% in 2019 while earnings growth is expected to modestly pick-up further. Meanwhile, business investment is anticipated to be subdued in the first half of the year amid Brexit uncertainties, but to improve later on as those uncertainties wane.

UK: Contributions to GDP growth



Source: EY ITEM Club

While the UK will formally leave the EU in late-March 2019, nothing much is expected to change immediately as a transition arrangement essentially preserves the status quo until at least the end of 2020. However, negotiations over the UK's longer-term relationship with the EU are likely to remain challenging and uncertain, which will limit the upside for business investment. It is also likely that net trade will be hampered in 2019 as global growth slows modestly. The pound is also seen firming modestly as it is supported by the UK's Brexit transition arrangement.

However, if the UK does end up exiting the EU without a deal next March, growth in 2018 is likely to come in lower as major uncertainty hits consumer and business sentiment and investment. Trade will also be affected, although, with both export and import growth suffering, the effect on GDP growth from this source would be ambiguous.

It is also possible that the growth pattern could be distorted in late 2018 and 2019 if concerns about supply disruptions in the event of the UK leaving the EU without any deal cause companies to stockpile materials and finished products. This could be reinforced if consumers panic buy. This would be liable to boost growth in late 2018 and early 2019 but weigh down on growth thereafter. The impact on growth would also depend to what extent this stockpiling was met through increased imports.

Risks and uncertainties

The risks to the forecast currently look loaded to the downside.

As repeatedly highlighted, the main uncertainty and downside risk facing the economy is that the UK leaves the EU next March without a withdrawal agreement and transition arrangement. There is a very real possibility of a 'cliff-edge' Brexit next March, along with the trade barriers, both tariff and non-tariff, which would follow.

Meanwhile, precarious parliamentary arithmetic leaves the Government vulnerable to rebellions, and the current Prime Minister, Theresa May, to a leadership challenge. These raise the possibility of a general election before the current parliament is due to end in 2022. A change in government would have severe implications, for example, for fiscal policy, interest rates and microeconomic policy.

A further downside risk to the forecast is if current trade tensions and tariff measures escalate substantially and major trade disputes break out beyond the US and China. These would weigh down markedly on global trade and would fuel business uncertainties, thereby dragging down global growth.

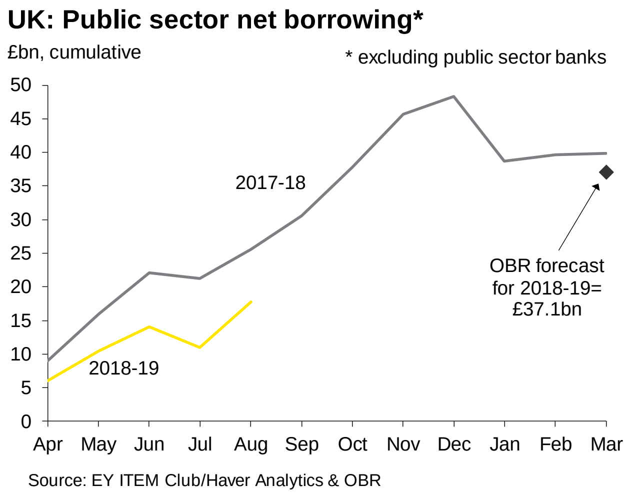
A potential upside risk to the growth outlook is that earnings growth could finally pick-up significantly in reaction to increased recruitment difficulties in a number of sectors, thereby leading to higher than expected consumer purchasing power and spending.

Forecast in detail

1. Fiscal policy

Recent months have generally seen a faster-than-expected decline in public sector borrowing, suggesting that the pattern of the Office for Budget Responsibility (OBR) taking an excessively pessimistic view of the fiscal outlook has continued. With borrowing falling more rapidly than the official forecaster predicted and the Government announcing a sizeable increase in NHS spending, some further easing back on austerity seems likely in the Budget due to be held on 29 October.

The budget deficit (PSNBex) amounted to £17.8bn from April to August which was down 30% from £25.6bn in the first five months of fiscal year 2017/18. It was the lowest April–August deficit since 2001/2.



The 30% year-on-year drop in public borrowing in April–August was well ahead of the 18% decline forecast by the OBR in March's Spring Statement for 2018–19 as a whole. Moreover, revisions to past data have led to a better starting point for the fiscal year than previously believed.

Total borrowing in 2017–18 is now estimated to have run at £39.9bn, £5.3bn less than the OBR expected in March and almost £20bn below the official forecaster's projection in November 2016. This deficit equated to 1.9% of GDP, the smallest deficit/GDP ratio since 2001–02 and below the post-war average of 2.5% of GDP.

Admittedly, it is still early days as far as predicting 2018–19's fiscal performance is concerned. Much of the narrowing in the deficit in April–August reflected subdued spending due to timing effects from EU and debt interest payments (central government current expenditure was up 1.9% y/y over the first five months of the fiscal year, with a faster rise in August suggesting that timing effects were beginning to unwind). Encouragingly, central government current receipts were up a decent 4% y/y, helped by a robust labour market and improved growth in the second quarter. Much will depend on how well the economy holds up over the coming months after GDP growth recovered to 0.4% q/q in Q2.

Nevertheless, it looks odds-on that government borrowing this year will undershoot the OBR's full fiscal year forecast of £37.1bn, adding to the room for manoeuvre enjoyed by the Chancellor of the Exchequer with the deficit historically low and gilt yields also very depressed by long-run standards.

We have already seen some potential signs of slippage in the Government's fiscal austerity plans, with the Prime Minster announcing in June an uplift in NHS spending growth from 2019–20 onwards. But as yet, it is unclear how much of this extra spending will be financed by higher taxes versus higher borrowing and consequently the implications for future deficits are unknown.

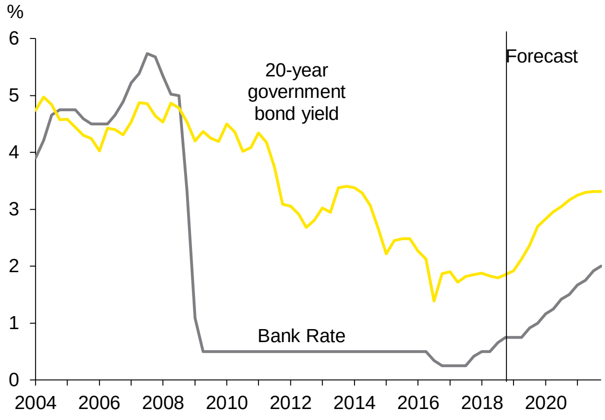
At the Conservative party conference in early-October, Theresa May unexpectedly promised an end to austerity. This was accompanied by two policy announcements: that fuel duty will be frozen in the October budget for a ninth successive year and that the cap on the amount that councils can borrow to build more homes will be removed. Nevertheless, it looks like the Chancellor will find it hard to deliver on the Prime Minister's pledge given the still significant budget shortfalls and his fiscal targets.

All else being equal, a slightly downgraded forecast for GDP growth this year and next compared to our expectation three months ago implies a bigger fiscal deficit. However, with the downward revision to borrowing in 2017/18 providing a better starting point and the strong start to 2018/19 further fuelling belief that a given amount of GDP growth may have become more tax 'rich', our deficit forecast is modestly reduced. Borrowing is forecast to run at £34bn this year, falling to £32bn in 2019–20.

2. Monetary policy

Having held off from raising interest rates earlier in the year as a marked growth slowdown in Q1 raised concerns about the economy's underlying strength, the Bank of England finally delivered a hike from 0.50% to 0.75% at the early-August meeting with a unanimous 9–0 vote from the MPC.

UK: Bank Rate and 20-year bond yield



Source: EY ITEM Club

With markets pricing in around a 90% chance that the MPC would raise interest rates in August and most analysts agreeing that there would be a hike, the Committee may have risked criticism of its communication had it not delivered an increase. This was despite the fact that heightened Brexit/political uncertainties, global trade tensions, recently relapsing earnings growth and lower-than-expected inflation in June provided scope for the MPC to hold off from hiking in August.

MPC members clearly felt that an apparent (later confirmed) rebound in GDP growth to 0.4% q/q in Q2 (in line with the economy's perceived supply-side potential), a further tightening of the labour market and perceived little – if any – slack left in the economy justified lifting interest rates to 0.75% from the previous 0.50%.

The general tone of the MPC minutes and the forecasts contained in the August Quarterly *Inflation Report* suggest that the Committee will be in no hurry to raise interest rates again and that future increases will be both gradual and limited. There was a 9–0 MPC vote at their mid-September meeting to keep interest rates at 0.75%.

We do not expect any more interest rate rises until after the UK leaves the EU in March 2019 given the major uncertainties that may occur in the run-up to the UK's departure and in the immediate aftermath. On the assumption that the UK and the EU reach a Brexit withdrawal agreement in March 2019 and the economy achieves growth around 0.4% q/q thereafter, we expect the MPC to next raise interest rates from 0.75% to 1.00% in August 2019.

We expect just one interest rate hike in 2019 followed by two in 2020 (taking rates up to 1.50% by the end of 2020) as monetary policymakers seek to gradually normalise monetary policy.

What is likely to be a limited and gradual rise in Bank Rate will exert upward pressure on long-term interest rates. But a falling fiscal deficit and the fact that more than half of the UK's gilt stock is owned by the Bank (via its quantitative easing programme) and 'captive' buyers in the form of insurance companies and pension funds, will constrain the extent to which gilt yields increase.

Sterling has come under pressure over the summer, falling to a 13-month low against the dollar and a 12-month low against the euro in August. This partly reflects a scaling back of market expectations for further Bank of England rate hikes but also heightened Brexit uncertainties. Sterling is unlikely to see any significant recovery until Brexit uncertainties ease. On the assumption that the UK and EU will ultimately approve a Brexit withdrawal agreement, we expect sterling to trade around $1.30 at the end of 2018, and then improve to $1.35 by mid-2019 and $1.42 at the end of 2019.

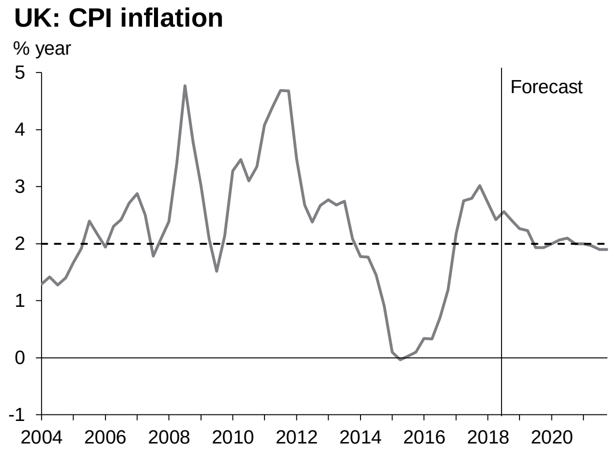
3. Prices

With the effect of sterling's 2016 depreciation on import prices fading, inflationary pressures eased during the early part of this year, taking consumer price inflation down from a peak of 3.1% in November

2017 to 2.4% in April, which was the lowest level since March 2017. Inflation then remained at 2.4% through to June, before edging up to 2.5% in July and then to a six-month high of 2.7% in August.

Upward pressure on inflation over the summer primarily came from higher prices for transport and recreational goods like computer games. There was also an upward impact from motor fuel prices which fell less than in the same period a year earlier. This was partly countered by lower prices for clothing and footwear. Core inflation picked up to 2.1% in August, but this was still some way below the recent peak of 2.7% reached at the end of last year.

While inflation may well have peaked at 2.7% in August, we expect it to remain sticky in the near term with upward pressure coming from recent higher oil prices and the weaker pound. For example, British Gas and Scottish Power have both recently announced that they will increase their standard variable tariffs in October, by 3.8% and 3.7% respectively (in both cases, representing a second increase this year). There is also an upside risk from higher food prices as a result of the heatwave in the UK and Europe following on from the severe weather in the first quarter.



Source: EY ITEM Club

Inflation should resume a modest downward trend towards the end of the year, helped by favourable base effects as the impact on import prices of sterling's sharp drop after the Brexit referendum continues to unwind (although this may be limited by the pound's recent renewed weakness). We also expect oil prices to largely stay close to their current levels with Brent seen averaging $77/barrel in 2019.

Meanwhile, domestic inflation pressures are expected to pick-up only modestly over the coming months amid no more than middle-of-the-road UK growth. Regular earnings growth is trending up only gradually (and actually relapsed during the second quarter of this year) despite the tight labour market, and we expect this to remain the case. Some firms remain keen to limit their total costs in a challenging and uncertain environment. Fragile consumer confidence will probably deter workers from pushing hard for markedly increased pay rises despite recent higher inflation and a tight labour market.

As a result, we expect consumer price inflation to drop to 2.3% by the end of 2018 and then to 2.0% by mid-2019. We expect inflation to then hover close to 2% over the second half of 2019.

RPI inflation will be higher than the 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) and the impact of a gradual increase in interest rates on mortgage interest payments.

4. Activity

GDP growth recovered to 0.4% q/q in Q2 2018 after expansion of just 0.1% q/q in Q1 when there was clearly some hit to activity from the severe weather. The economy's overall performance in the first half of 2018 was the weakest six-month expansion since the second half of 2011. Furthermore, growth in Q2 2018 was no better than the expansion seen in both Q3 and Q4 2017. The apparent failure of the economy to make up any of the Q1 lost ground in Q2 suggests that underlying activity was steady but lacklustre.

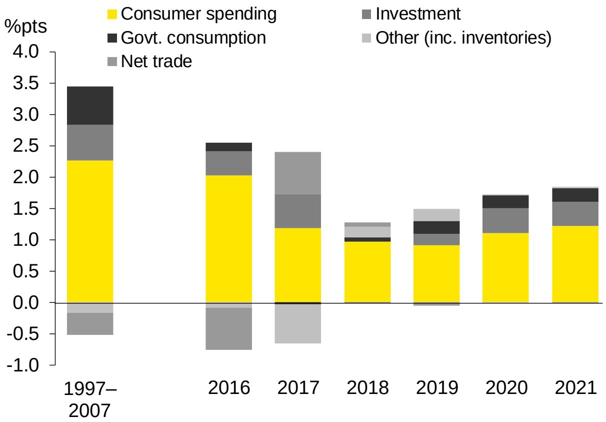
Consumer spending grew 0.4% q/q in Q2 after expansion of 0.5% q/q in Q1, although y/y expansion edged up to 1.6% from 1.5%. Disappointingly, business investment contracted by a further 0.7% q/q in Q2 after a drop of 0.5% q/q so was down 0.2% y/y. Further disappointment saw net trade sharply negative in Q2 knocking 0.6 ppts off growth as exports of goods and services plunged 2.2% q/q while imports fell by a much lower 0.2% q/q. Even allowing for Q2's trade performance being adversely affected by a fall in exports of non-monetary gold (which correspondingly lifted gross capital formation), the underlying performance was poor.

On the output side, the economy benefitted from growth in services output doubling to 0.6% q/q in Q2 from 0.3% q/q in Q1. There was also a turnaround in construction output which expanded 0.8% q/q in Q2 after contraction of 1.6% q/q in Q1 when it was hampered by the severe weather and the collapse of Carillion. Disappointingly though, industrial production contracted 0.8% q/q in Q2 as it was dragged down by manufacturing output slumping 0.7% q/q. This followed a 0.1% q/q drop in manufacturing output in Q1.

We expect GDP growth of 1.3% in 2018, which assumes that growth improved to 0.6% q/q in Q3 (buoyed by a very strong performance in July) but then slows to 0.3% q/q in Q4 as activity is hampered by heightened Brexit uncertainties.

Growth over the rest of 2018 should be helped by consumer purchasing power gradually resuming an upward trend, with households also benefitting from further employment growth. However, recently higher oil prices and a relapse in earnings growth in Q2 could well hold back further improvement in purchasing power in the near term.

UK: Contributions to GDP growth



Source: EY ITEM Club

Consumers may also become more reluctant to spend amid Brexit uncertainties. Business investment is expected to be modestly positive over the rest of 2018, helped by some firms looking to increasingly invest in automation to make up for labour shortages and to try to boost productivity. However, Brexit uncertainties are likely to continue to have a significant limiting impact on business investment. Meanwhile, net trade may struggle to make a positive contribution to growth. The 'sweet spot' facing UK exporters has shrunk as economic activity has come well off its highs in some important overseas markets, notably the eurozone. A weakening in sterling in recent months may provide some help although it is still clearly above its 2017 lows.

We forecast GDP growth to strengthen modestly to 1.5% in 2019. This assumes that a UK–EU transition arrangement ultimately comes into effect in March. While the UK will formally leave the EU in late-March 2019, nothing much is expected to change immediately as a transition arrangement essentially preserves the status quo until at least the end of 2020.

Nevertheless, GDP growth is seen as limited to 0.3% q/q in both Q1 and Q2 as business investment is curtailed by heightened uncertainties in the immediate run-up to and aftermath of the UK leaving the EU. GDP growth is seen as improving to 0.4% q/q in both Q3 and Q4 2019 as business investment improves amid reduced uncertainty. However, negotiations over the UK's longer-term relationship with the EU are likely to remain challenging and uncertain, which will limit the upside for business investment. Consumer spending may also be limited by heightened Brexit-related uncertainties in the early months of 2019, but it is seen as firmer over the year as a whole, supported by an improvement in consumer purchasing power. It is also likely that net trade will be hampered in 2019 as global growth slows modestly. Consequently, net trade is seen as making an essentially neutral contribution to GDP growth in 2019.

5. Consumer demand

Consumer spending rose 0.4% q/q in Q2 2018 after an increase of 0.5% q/q in Q1 which occurred despite retail sales being hampered significantly by the severe weather. The slight q/q slowdown in consumer spending in Q2 was largely due to households spending less on energy after a Q1 jump. Q1 consumption had also been lifted by spending on miscellaneous goods (particularly on life insurance). Year-on-year growth in consumer spending edged up to 1.6% in Q2 from 1.5% in Q1.

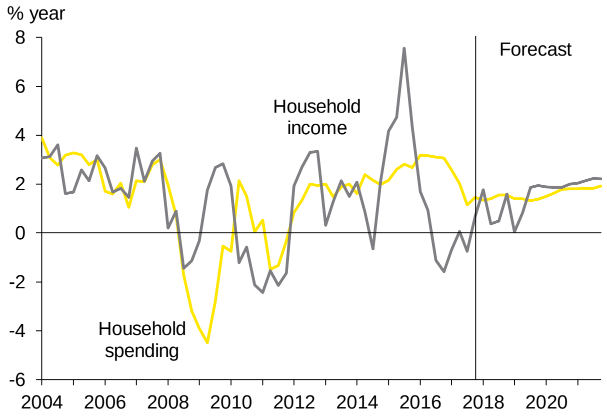
Retail sales volumes recovered strongly in Q2, rising by 2.0% q/q (the strongest performance since Q1 2004) after contraction of 0.3% q/q in Q1. In addition to a bounceback element from Q1, retail sales were buoyed in Q2 by the Royal Wedding, the football World Cup and the hot weather boosting demand for food and drink in particular (although there was some dampening impact on consumer footfall).

With retail sales rebounding strongly, growth of 0.4% q/q in consumer spending in Q2 implies that consumers were careful in their spending elsewhere as purchasing power remained limited and confidence fragile.

Retail sales saw a strong performance in the first two months of Q3 with volumes up a robust 0.9% and 0.3% in July and August respectively, implying another good quarterly performance, albeit not as strong as that seen in Q2.

We expect consumer spending growth to be limited to 1.5% in 2018, and to be little changed at 1.4% in 2019. This would be down from growth of 1.8% in 2017 and 3.1% in 2016.

UK: Real household income and spending



Source: EY ITEM Club

Having seen limited improvement earlier this year following an extended squeeze, consumer purchasing power has recently come under renewed pressure with earnings growth stuttering in Q2, thereby countering a fall in inflation to 2.4% from April–June. While earnings growth showed some sign of improvement with a July pick-up, this was countered by inflation moving back up to 2.5% in July and 2.7% in August. Meanwhile, consumer confidence remains fragile amid economic and Brexit uncertainties. The main support to consumer spending has come from high and rising employment, although the rate of improvement slowed over the summer.

Hopefully, the gradual improvement in consumer purchasing power will resume later on this year. We expect inflation to resume a downward trend from the autumn and to be down to 2.3% by the end of 2018 and 2.0% by mid-2019. Meanwhile, earnings growth should see gradual improvement despite its recent relapse as a consequence of recruitment difficulties in some sectors and recent higher inflation fuelling some increased pay awards. Nevertheless, the budgets of some households will continue to be pressured by the cash freeze on working-age welfare benefits as well as a headwind from interest rate hikes. And employment growth is forecast to slow from 1.2% in 2018 to 0.5% in 2019. Consequently, we expect real household incomes to rise by a modest 1.3% this year, followed by 1.4% in 2019.

Other factors are likely to limit growth in consumer spending. With the household saving ratio reaching an overall record low of 4.2% in 2017 and then being limited to 3.6% in Q1 2018, consumers may at the very least be keen to avoid further dissaving. The household saving ratio rose modestly to 3.9% in Q2 2018. August's rise in interest rates may reinforce consumer caution, and we expect the Bank of England to raise interest rates once more in 2019. Higher saving is also likely to be prompted by a rise in pension auto-enrolment rates, which increased from 1% to 3% for employees in April. Meanwhile, lenders have become less prepared to make unsecured credit available to consumers and they have also tightened their lending standards. Significantly, the growth rate in unsecured consumer credit moderated to 8.1% in August, which was the lowest level since September 2015 and down from a peak of 10.9% in November 2016.

We also suspect that consumer spending could be limited in the final months of 2018 and the early months of 2019 by heightened uncertainties in the immediate run-up and aftermath of the UK leaving the EU in late March.

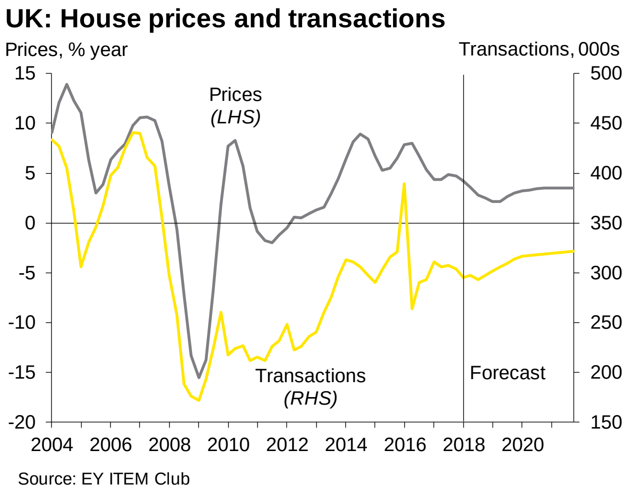
6. Housing market

While housing market activity has climbed off its 2018 lows, it is still far from racing ahead.

Latest data from the Bank of England showed mortgage approvals for house purchases rose to a seven-month high of 66,440 in August after dipping to 65,156 in July from 65,616 in June. Mortgage approvals are up from a 2018 low of 63,073 in April (which had also been the second lowest level after December 2017 since August 2016).

Despite reaching a seven-month high in August, mortgage approvals still look relatively sluggish. Indeed, they were down marginally (0.4% y/y) from 66,696 in August 2017. They were also 18.1% below their long-term (1993–2018) average of 81,137.

We still get the impression that the housing market is finding it hard to really step up a gear in the face of still-limited consumer purchasing power, fragile consumer confidence and wariness over higher interest rates.



The same influence may have been at work on property prices. Latest data from the ONS/Land Registry show the year-on-year increase in house prices dipped to 3.1% in July, which was the lowest rate since August 2013. It was down from 3.5% in April and a peak of 5.1% in October 2017. More recent data from the Nationwide shows annual house price inflation at 2.0% in September, which matched the five-year low seen in August and June. The Halifax reported house price inflation at 2.5% in the three months to September, which was up modestly from a low of 1.8% in the three months to June (which had matched February's lowest level since the three months to March 2013).

We suspect that the upside for the housing market will remain constrained over the coming months. We expect activity to remain lacklustre as limited consumer purchasing power only gradually improves, consumer confidence remains fragile and appreciable caution persists over engaging in major transactions. Caution over making major purchases may well be magnified in the near term at least by current heightened uncertainties over Brexit. Potential house buyers may also be concerned that they are likely to see further interest rate hikes over the medium term following August's increase in Bank Rate. Furthermore, house prices are relatively expensive relative to incomes, with the Halifax house price to earnings ratio standing at 5.69 in August, which was well above the long-term (1983–2018) average of 4.26.

The downside for house prices is being limited by a shortage of houses for sale. High and currently rising employment is also supportive for the housing market while mortgage interest rates are still at historically low levels and will remain so even if the Bank of England does modestly hike rates further over the medium term.

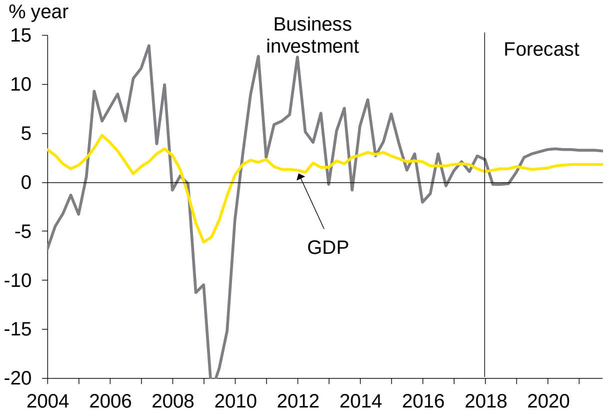
Consequently, we expect house prices to rise by 3.3% this year with the end-of-year rate standing at 2.5% (on the ONS/Land Registry basis). Annual house price inflation is seen as hitting a low of 2.1% early on in 2019, before edging back up to 3.0% by the end of the year to give an average increase of 2.5% over 2019.

7. Company sector

Business investment fell 0.7% q/q in Q2 2018, which was a second successive decline coming after a 0.5% q/q drop in Q1. These were the first q/q declines suffered in business investment since Q4 2016 and resulted in a 0.2% y/y decline in Q2. Overall business investment had previously expanded 1.8% in 2017 after a 0.2% drop in 2016.

The second successive and deeper q/q decline in business investment in Q2 suggests that companies were cautious over capital expenditure as doubts mounted as to whether a Brexit transition arrangement would come into being next March. Businesses were also looking for greater clarity over the UK's likely long-term relationship with the EU.

UK: Business investment and GDP



Source: EY ITEM Club

The Bank of England's regional Agents reported in their Q2 survey of business conditions that "Brexit uncertainty was weighing down discretionary or expansionary investment for some medium to larger-sized businesses, or those with a greater international focus. SMEs and domestic-facing businesses were more likely to maintain a business as usual approach to investment as potential Brexit effects remained unclear."[9]

Looking ahead, business investment is likely to grow modestly, possibly helped by some firms looking to increasingly invest in automation to make up for labour shortages and to try to boost productivity. According to the Bank's regional Agents "investment intentions remained modestly positive among manufacturers and in business services". Still relatively cheap credit and decent profitability is supportive to investment. Latest ONS data shows that the net rate of return for non-financial UK companies edged up to 12.6% in Q2 2018 from 12.5% in Q1 and was above the long-term (1997–2018) average of 12.0%.

However, business investment could be pressured if business uncertainty and concerns are fuelled by increasing concerns of a 'no-deal' Brexit next March. Even if a transition agreement is ultimately enacted, as we expect, business investment may well be limited in late 2018 and the early months of 2019 by heightened concerns in the immediate run-up to, and aftermath of, the UK leaving the EU in March. Overall, we expect business investment to expand by only 0.4% in 2018. On the assumption that the UK and EU do ultimately agree a Brexit transition deal, growth in business investment should pick-up to 2.4% in 2019.

8. Labour market and wages

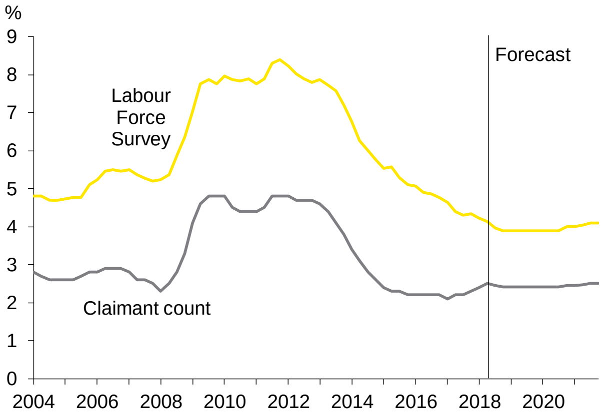
Job creation has held up well during 2018 so far, particularly given the relapse in GDP growth in Q1. The employment rate reached a record high in the three months to May and the jobless rate fell to a 43-year low in the three months to June. But the continuing unresponsiveness of pay to this apparent tightness, quelled only slightly by evidence of a pick-up in earnings growth in July, suggests that labour market slack has not been exhausted.

The latest labour market data was somewhat mixed. Employment growth slowed markedly to 3,000 in the three months to July from 42,000 over the previous three months and 137,000 in the three months to May. But in level terms, 32.397m people in work in the same period was only fractionally down on the record high reached earlier in the year.

[9] Bank of England: Agents' summary of business conditions and results from the Decision Maker Panel Survey, 2018 Q2. See bankofengland.co.uk/-/media/boe/files/agents-summary/2018/2018-q2.pdf

Despite slower employment growth, the number of unemployed fell by 55,000 to 1.36m. This reflected the number of inactive people rising by 77,000 in Q2. Consequently, the Labour Force Survey (LFS) unemployment rate remained at 4.0% in the three months to July (the lowest rate since February 1975).

UK: Unemployment rate



Source: EY ITEM Club

Slower employment growth may well be at least partly caused by some employers finding it harder to find suitable candidates, perhaps influenced by fewer workers coming from the EU. There is certainly evidence of this in a number of surveys (including from the Bank of England's regional Agents and CIPS/Markit). Indeed, it is notable that despite reduced employment growth, the number of vacancies rose to a record 833,000 in the three months to July.

With the strength of the labour market over the first half of the year, we expect employment growth to pick-up from 1.0% in 2017 to 1.1% in 2018, but then slow to 0.5% in 2019. The unemployment rate is expected to edge down further to 3.9% before the end of 2018, and then stabilise at that level.

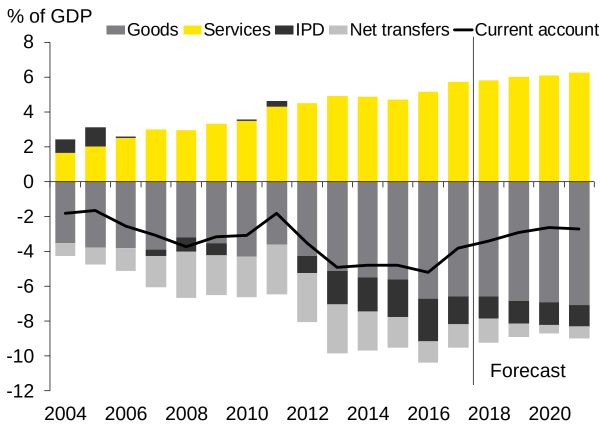
However, strength in labour market quantities has been matched by a mixed picture on pay growth. Q2 2018 saw rises in average weekly earnings slow. After firming gradually from 2.0% in mid-2017 to reach a peak of 2.8% in the three months to both February and March, total average annual pay growth relapsed to 2.4% on the same basis in June (the weakest rise since last November). That said, July saw growth recover to 2.6%, although base effects flattered the comparison. Meanwhile, three-month regular pay growth on a year earlier (which excludes bonus payments) trended up gradually from a low of 1.8% in April 2017 to a peak of 2.9% in March 2018, before easing back to 2.7% in June and then recovering to 2.9% in July.

The erratic nature of the recovery in pay growth suggests that still-elevated underemployment and the reduction in worker power presented by developments like globalisation and fear of competition from migrant workers, are still making their presence felt. As a result, growth in average earnings is forecast (on a National Accounts basis) to run at 2.8% this year, followed by 3.0% in 2019, both a long way from the 4%–5% pace seen before the financial crisis.

9. Trade and the balance of payments

2017 saw net trade add 0.5 ppts to GDP growth, one of the biggest gains from this source in the last 25 years. Real exports of goods and services grew 5.4% in 2017, the strongest performance for six years. Imports of goods and services rose by a lower rate of 3.2%. But the factors which assisted with that contribution – robust global growth, particularly in the eurozone, and sterling's post-referendum weakness – have both become less favourable this year. To put it another way, the 'sweet spot' enjoyed by UK exporters has shrunk.

UK: Current account



Source: EY ITEM Club IPD= interest, profit and dividends

Real exports fell 0.8% q/q in Q1 2018 while imports edged down 0.3% q/q, with the result that net trade made a marginal negative contribution of 0.1 ppts to GDP growth in Q1. The second quarter of 2018 saw real exports contract 2.2% q/q while imports were down 0.2% q/q. Consequently, net trade knocked 0.6 ppts off Q2 GDP growth. Q2's trade performance was dragged down significantly by a fall in exports of non-monetary gold (which correspondingly lifted gross capital formation), but the underlying performance was clearly poor.

The appreciable drag on net trade in Q2 from movements in non-monetary gold suggests that there may well be an unwinding of this impact in the remainder of 2018. And given the tendency for trade data to be revised over time, net trade's adverse impact in Q2 could eventually be revised down.

Nevertheless, net trade may struggle to make positive contributions to growth over the coming months. Economic activity has come well off its highs in important overseas markets, most notably the eurozone. While the recent renewed weakness in the pound (it hit 2018 lows against both the dollar and euro in August) may provide some help to UK exporters, sterling remains above its 2017 lows. While sterling is unlikely to see any significant recovery until Brexit uncertainties ease, we expect it to make gains in 2019 on the assumption that the UK and EU ultimately agree a transitional withdrawal deal. Consequently, we expect net trade to have an essentially neutral impact on GDP growth in both 2018 and 2019, in marked contrast to the positive contribution of 0.5 ppts in 2017.

Net trade-positive factors contributed to a substantial narrowing in the current account deficit in 2017. That year recorded a deficit of £76.5bn (3.7% of GDP) compared to £102.8bn (5.2% of GDP) in 2016. The current account deficit came in at £15.7bn in Q1 2018; this was 3.0% of GDP which was the second-smallest shortfall in six years. The deficit benefitted in Q1 from a reduced shortfall in the trade balance while the net deficit on primary income account narrowed to the lowest level since Q1 2017.

Disappointingly, the current account deficit widened back out to £20.3bn (3.9% of GDP) in Q2 2018, which was the largest shortfall for a year. This was a consequence of the trade deficit nearly doubling to £6.1bn from £3.2bn in Q1. Additionally, the net deficit on the primary income account increased to £8.8bn in Q2 from £6.7bn in Q1 as payments on investment income rose more than receipts.

Despite the weaker performance in Q2 2018, we think that the UK's overseas investment income will continue to be boosted by a still reasonable rate of economic expansion overseas. This should help the current account shortfall to continue to decline, albeit at a slower pace than occurred in 2017, coming in at £69.5bn (3.3% of GDP) in 2018 and £60.4bn (2.8% of GDP) in 2019.

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