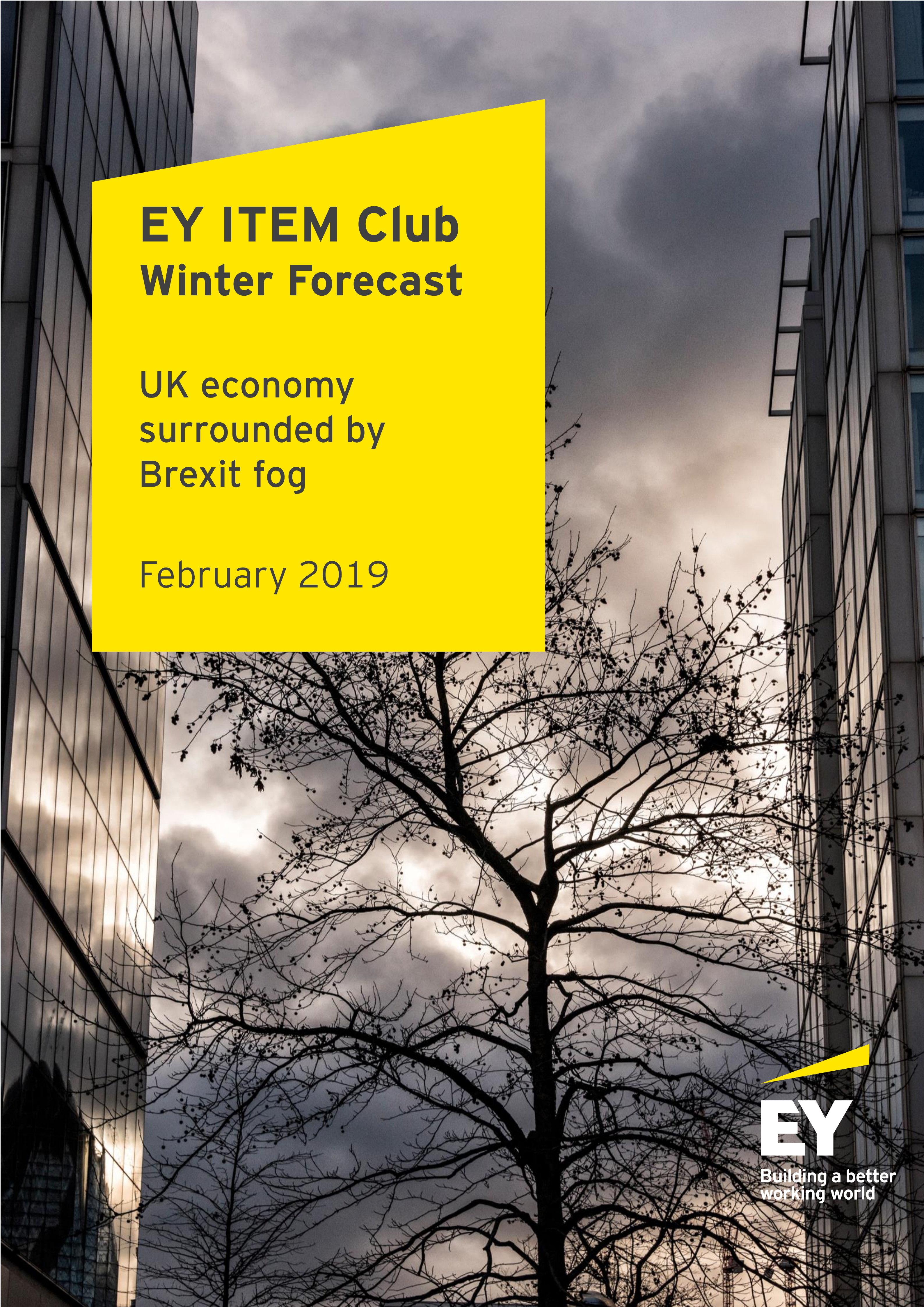


EY ITEM Club
Winter Forecast

UK economy surrounded by Brexit fog

February 2019

Building a better working world

Contents

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

Mark Gregory

EY Chief Economist, UK

@MarkGregoryEY

Mired in a Brexit fog

Hard to see very far ahead …

When discussing recent EY ITEM Club forecasts, I have pointed out how difficult it has been to make predictions given the uncertainty over Brexit, geopolitics and trade amongst other things. Nevertheless, the recent press reviews of 2018 forecasts confirmed that the EY ITEM Club, and other forecasting groups, produced accurate predictions for the UK last year. However, forecasting 2019 will be very challenging as there is still no clarity on either the basis of the UK's departure from the EU or the details of the future relationship.

The EY ITEM Club's Winter forecast assumes that the UK will agree a withdrawal agreement and leave the EU on the 29 March 2019. This reflects the Government's plan but there are clearly risks to this assumption businesses do need to consider the potential impact of a 'no deal' scenario on their operations.

… but the short term is likely to be challenging …

The EY ITEM Club now expects the final data will show that the UK economy grew by 0.3% in the final quarter of 2018, which will bring growth for the year to 1.4%, After a mid-year recovery from the impact of the 'Beast from the East', the economy lost momentum in the last few months of the year with retail sales disappointing in December and manufacturers finding the going tough as, outside of the USA, global growth slowed.

The labour market provided more positive news. The latest data showed employment continuing to rise and pay settlements continuing to edge upwards, with the highest nominal rise for a decade. How the labour market develops will be a key influence on the UK's economic performance in the coming year.

… even with a Brexit deal …

Even under the EY ITEM Club's assumption that a withdrawal deal is signed to facilitate the UK's exit in March 2019, consumer spending, investment and trade is expected to remain under pressure throughout 2019. There will a modest uptick in activity if uncertainty is reduced but the EY ITEM Club expect growth in GDP of 1.5% in 2019, 1.7% in 2020 and 1.8% in 2021, all well below the historic trend rate of expansion. Business is not going to be able to rely on the economy to deliver growth.

… and the risk is that things could turn out worse.

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. Forecasting the impact of a 'no-deal' Brexit is very difficult, not least because we don't know what this would entail and what the response would be by policymakers.

It is possible to argue that there was too much pessimism after the referendum and the same will be true again. However, in a ‘no deal’ scenario, it is likely that sterling will come under pressure and business confidence will fall as it did in 2016. However, consumers appear to have less capacity to keep spending if their incomes are squeezed in the current environment compared to 2016 and the global economy is unlikely to provide the boost it did at that time. Taken together, the EY ITEM Club believes growth could fall to 0.7% in 2019 and 0.6% in 2020 with the economy flirting with recession. This is far from a worst-case view but would still represent a significant slowdown with a loss of almost 2% of output over two years.

Be prepared for a ‘no deal’.

The EY ITEM Club forecast assumes that the EU and UK sign a withdrawal agreement that will support a stable transition. While the Chancellor has talked about a “Brexit dividend”, my view is that this forecast is close to a best case as there will still be significant uncertainty on the nature of the future EU-UK relationship under the current plans for an agreement.

As I have mentioned previously, alongside the base case it is important to test a more adverse scenario. The EY ITEM Club ‘no-deal’ estimates provide a starting point for the magnitude of the shock. 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.

Longer term, the likely reduction in migration and the consequences of the UK’s current relatively low level of capital investment are likely to impact the level and type of activity in the UK. It is important to continue to think longer term but hopefully this is a topic we can return to discussing in the next forecast with some more certainty of the future outlook.

Highlights

- The latest EY ITEM Club forecast has maintained GDP growth projections of 1.5% for 2019 and 1.7% for 2020 after estimated expansion of 1.4% in 2018 (edged up from expected growth of 1.3% in the 2018 *Autumn Forecast*). This reflects the fact that the economy developed largely as we had expected in late 2018. Indeed, the economy over 2018 as a whole performed broadly in line with expectations, with GDP growth, inflation and the Bank of England policy interest rate all coming in very close to the projections made at the start of 2018. The only real surprise was that the unemployment rate came in lower than expected in 2018, although earnings growth only showed clear signs of firming late in the year.
- The UK economy clearly changed down into a lower gear in the latter months of 2018 as heightened economic, political and Brexit uncertainties fuelled business and consumer caution. GDP growth likely relapsed to 0.3% quarter-on-quarter (q/q) in Q4 2018, after improving to 0.6% q/q in Q3 from 0.4% q/q in Q2 and 0.1% q/q in Q1 (when activity was hit markedly by the severe cold weather).
- The current very unclear Brexit situation makes 2019 a very challenging year to forecast the UK economy. Our forecast of GDP growth of 1.5% assumes that the UK ultimately leaves the EU in late March with some form of withdrawal deal. We expect GDP growth to be 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 as picking up modestly to a 0.4% q/q rate in Q3 and Q4 2019.
- We expect growth in 2019 to be supported by a gradual improvement in consumer purchasing power through the year. Inflation is seen as averaging a reduced 1.8% in 2019 while earnings growth is expected to at least retain the firmer tone seen in the latter months of 2018. However, consumer spending growth is set to be limited early on in 2019 by heightened concerns over the economic outlook amid Brexit uncertainties.
- Business investment is anticipated to be subdued in the first half of the year amid those same uncertainties, but to improve later on as they wane. Business investment is also likely to be lifted by some firms looking to increasingly invest in automation to make up for labour shortages and to try to boost productivity. Meanwhile Government spending will be lifted in 2019 by increased outlays on the NHS. Net trade is seen as marginally negative in 2019 as exports are limited by slower global growth and sterling firms after the UK leaves the EU with a deal.
- Assuming the UK does leave the EU with a deal and the economy does not suffer badly in the immediate aftermath of the exit, the Bank of England could very well raise interest rates from 0.75% to 1.00% in May. However, we suspect that the Bank could hold off hiking interest rates until August as the Monetary Policy Committee (MPC) may want to see sustained evidence that the economy is holding up in the aftermath of Brexit occurring. We would not rule out two interest rate hikes in 2019 but we believe one is more likely as significant uncertainties persist — with lower inflation easing the pressure for more aggressive Bank of England action.
- If the UK leaves the EU without a deal in late March, the growth outlook would likely be markedly weaker in the near term at least. Our best bet is that GDP growth would likely come in around 0.7% in 2019 and 0.6% in 2020, with the economy very possibly suffering stagnation or a mild recession over the second half of 2019.
- Major uncertainty would likely be fuelled by a 'no-deal' Brexit, negatively impacting business sentiment and investment, as well as affecting consumers. However, it must be remembered that consumer spending proved resilient in the aftermath of the June 2016 referendum vote for Brexit. Trade would clearly be substantially affected as trade barriers, both tariff and non-tariff, kicked in. With both export and import growth suffering, the effect on GDP growth from this source would be ambiguous. There could also be serious disruption at ports, which would affect supply chains. A likely sharp drop in sterling in the event of a 'no-deal' exit by the UK from the EU would help UK exporters, but it would also push up businesses' costs and consumer price inflation, thereby weighing on households' purchasing power. We expect policymakers would look to support the UK economy by easing both fiscal and monetary policy.

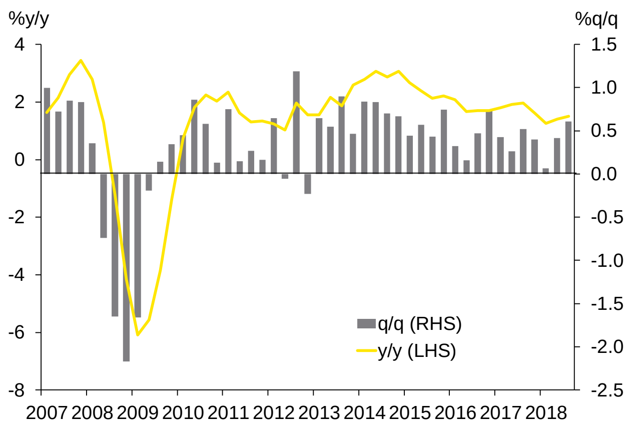
Introduction

In many respects, the economy performed broadly as expected in 2018 despite the tortuous twists and turns on Brexit that occurred. In our 2018 *Winter Forecast*[1] released in early February, we projected GDP growth at 1.7% in 2018, consumer price inflation to average 2.2% in the fourth quarter (and average 2.5% over 2018) and the Bank of England to edge interest rates up from 0.50% to 0.75%. All these forecasts proved to be in the right ballpark. The Bank of England did indeed hike interest rates by just 25 basis points in 2018 taking them up to 0.75% in August. Meanwhile, our current estimate of GDP growth in 2018 is 1.4% (based on three quarters of actual q/q GDP data and monthly GDP data for October and November). Consumer price inflation averaged 2.3% over 2018, averaging 2.5% in Q4.

The main surprise in 2018 was the ongoing strength of employment. Like most forecasters, we had expected the unemployment rate to be broadly steady in 2018 and end the year at 4.5% (compared to 4.4% at the end of 2017, which was slightly up from a low of 4.3% during the year). Instead, the unemployment rate trended down to a new 43-year low of 4.0% during 2018. However, this did not have a major upward impact on pay overall during the year. Indeed, earnings growth suffered a relapse in the early months of 2018, before finally seeing some firming in the latter months. Latest data shows that annual average earnings growth was 3.4% in the three months to November. While this was the highest rate for a decade it was only up from 2.5% at the end of 2017. We had forecast earnings growth to get up to 3.0% at the end of 2018.

Not only was the overall UK economic performance in 2018 broadly in line with our expectations at the start of last year, but the economy's performance over the final months of 2018 was consistent with the analysis in our 2018 *Autumn Forecast*[2], which was released in October. GDP growth did indeed pick up to 0.6% q/q in Q3 from 0.4% q/q in Q2 and 0.1% q/q in Q1, while it looks likely that there was a marked slowdown in Q4, to 0.3% q/q as we had anticipated.

UK: Real GDP



Source: EY ITEM Club/Haver Analytics

The reason why UK GDP growth looks likely to have come in at 1.4% in 2018 rather than 1.3% as we had expected in the *Autumn Forecast* is that upward revisions to GDP growth in 2017 (it was upgraded to 1.8% in December 2018 from the 1.7% previously reported) meant that the UK economy started 2018 from a slightly higher base. Nevertheless, GDP expansion of 1.4% in 2018 would still have been the UK's weakest growth performance since 2009.

The ongoing uncertainties through the final months of 2018 (which continued early on in 2019) about whether or not the UK will leave the EU with a deal in late March was also fully in line with our expectations in our *Autumn Forecast*. This was seen weighing down on business and confidence and holding back economic activity in Q4 2018 and continuing to do so in Q1 2019.

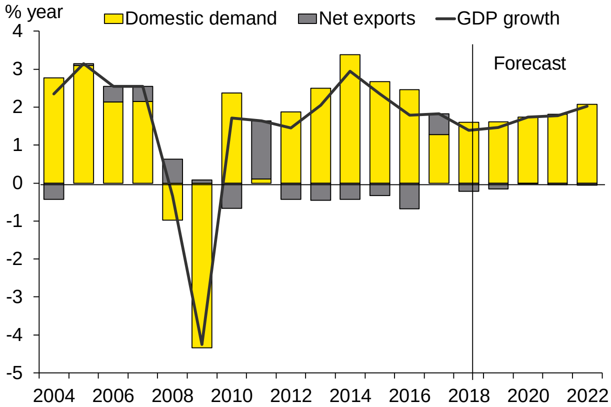
2019 is likely to be a much more difficult year for forecasters of the UK economy given the current major uncertainties over what will happen with Brexit. Our forecast assumes that the UK ultimately leaves the EU in late March with some form of withdrawal deal. Should this fail to be the case, the chances are that our forecasts will turn out to be markedly too optimistic in the near term at least.

[1] *EY ITEM Club Winter Forecast 2018: Will the UK economy hold up as Brexit nears?* February 2018. See ey.com/Publication/vwLUAssets/ey-item-club-winter-forecast-2018/$File/ey-item-club-winter-forecast-2018.pdf
[2] *EY ITEM Club Autumn Forecast 2018: Can the economy overcome heightened Brexit uncertainties?* October 2018. See ey.com/Publication/vwLUAssets/ey-item-club-autumn-forecast-2018/$FILE/ey-item-club-autumn-forecast-2018.pdf

Assuming a Brexit deal, we forecast the UK economy to expand at a marginally faster rate of 1.5% in 2019, with growth picking up modestly further to 1.7% in 2020. These projections are unchanged from our *Autumn Forecast*. Our longer-term projections are also unchanged, with growth seen at 1.8% in 2021, 2.0% in 2022 and 2.1% in 2023.

Consumer spending in 2019 should be supported by a gradual improvement in consumer purchasing power as earnings growth firms modestly and inflation eases back overall during the year. Meanwhile, business investment should benefit from ultimate agreement on a Brexit deal and it is also likely to be lifted by some firms looking to increasingly invest in automation to make up for labour shortages and to try to boost productivity. But ongoing uncertainties about the longer-term UK–EU relationship are likely to limit the upside for business investment. Government spending will be lifted in 2019 by increased spending on the NHS. However, net trade is likely to be essentially neutral as the 'sweet spot' facing UK exporters is further diluted by slowing global growth and a firmer pound after a Brexit deal.

UK: Contributions to GDP growth



Source: EY ITEM Club

Should the UK exit the EU at the end of March without any deal, we believe the growth outlook for 2019 and 2020 at least would be markedly weaker as major uncertainty would negatively impact business sentiment and investment, as well as affect consumers. Trade would clearly be substantially affected as trade barriers, both tariff and non-tariff, kicked in. With both export and import growth suffering, the effect on GDP growth from this source would be ambiguous. There could also be serious disruption at ports, which would affect supply chains. A likely sharp drop in the pound in the event of a 'no-deal' exit by the UK 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.

We suspect that the Bank of England would most likely respond by cutting interest rates (although the Bank has indicated that monetary policy could move in either direction in the event of a 'no-deal' Brexit), while there would also likely be some easing of fiscal policy. On balance, in the absence of a deal, we suspect GDP growth would likely come in around 0.7% in 2019 and 0.6% in 2020 — with the economy very possibly suffering stagnation or a mild recession over the second half of 2019.

Despite improved GDP growth of 0.6% q/q in Q3 2018, it was no surprise that the Bank of England held interest rates at 0.75% through Q4, having lifted them by 25 basis points from 0.50% in August. This was the only adjustment of monetary policy by the Bank of England in 2018. On the assumption that the UK and the EU ultimately enact a Brexit deal and transition arrangement in March 2019, and the UK economy holds up in the immediate aftermath of the exit from the EU, it is very possible that the Bank could raise interest rates from 0.75% to 1.00% in May. However, we suspect that the Bank could hold off hiking interest rates until August as the MPC may want to see sustained evidence that the economy is holding up in the aftermath of the UK leaving the EU. We would not rule out two interest rate hikes in 2019 but we believe one is more likely as significant uncertainties persist — with lower inflation easing the pressure for more aggressive Bank of England action.

The economy seemingly faltered in Q4 2018 amid heightened uncertainties

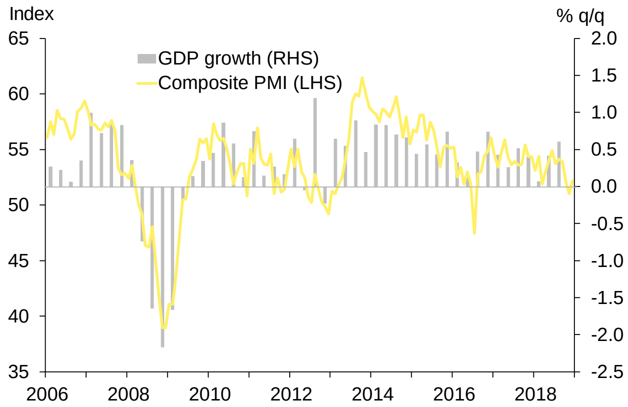
The UK economy clearly changed down into a lower gear in the latter months of 2018 as heightened economic, political and Brexit uncertainties fuelled business and consumer caution. Not only was GDP growth limited to just 0.1% month-on-month (m/m) in both November and October but it had been flat m/m in both September and August. Admittedly, GDP growth was a healthy 0.6% q/q in Q3, but this was largely due to a robust July performance.

The slowing in the economy was highlighted by the three-month/three-month growth rate in GDP moderating to 0.3% in the three months to November. This was the weakest performance since the three months to May and was down from growth of 0.4% in the three months to October, 0.6% in the three months to September and a peak of 0.8% in the three months to August.

On a three-month/three-month basis, there was modest growth of 0.3% in November in services output. Construction output was up a robust 2.1% on a three-month/three-month basis, although it should be remembered that the construction sector only accounts for 6% of GDP. Disappointingly, industrial production contracted 0.8% on a three-month/three-month basis in November, so looks likely to have been a significant drag on GDP growth in Q4. Within this, manufacturing output was down 0.8% on a three-month/three-month basis in November. The weakness in manufacturing activity has been widespread and it has been particularly hampered by problems in the car sector as manufacturers have struggled with new emission regulations, as well as dwindling demand for diesel cars and cautious consumer and business purchasing of new vehicles.

GDP growth actually picked up to 0.2% m/m in November itself after expansion of just 0.1% m/m in October and a flat performance in September. This was primarily due to output rising 0.3% m/m in the dominant services sector as activity in the retail sector was boosted by consumers seemingly taking advantage of Black Friday discounting, with retail sales volumes jumping 1.4% m/m in November after falling 0.4% m/m in both October and September. There was healthy growth of 0.6% m/m in construction output in November. However, the woes of the manufacturing sector continued in November as output fell 0.3% m/m, contributing to industrial production falling 0.4% m/m.

UK: CIPS/Markit composite PMI and GDP



Source: EY ITEM Club/Haver Analytics and CIPS/Markit

Survey evidence suggests the economy remained lacklustre in December while retail sales volumes fell back 0.9% m/m after a Black-Friday driven spike of 1.3% in November. Consequently, we expect Q4 GDP growth to have come in at 0.3% q/q. Survey evidence for the services sector was largely weak, although there is evidence that manufacturing activity was lifted by stock-building and both domestic and foreign clients lifting their demand to guarantee supplies amid heightened concerns of a disruptive UK exit from the EU in March.

The economy had earlier seen GDP growth improve to 0.6% q/q in Q3 2018 from 0.4% q/q in Q2 and just 0.1% q/q in Q1 when economic activity suffered markedly from extreme cold weather. Year-on-year (y/y) growth improved to 1.5% in Q3 from 1.4% in Q2 and 1.3% in Q1, which had been the weakest annual growth performance since Q2. The improved Q3 growth performance was primarily due to strong activity in July when the heatwave, along with the football World Cup, buoyed consumer spending. It is also likely that there was an ongoing catch-up on activity lost in Q1 to the extreme cold weather. Certainly, this helped construction activity.

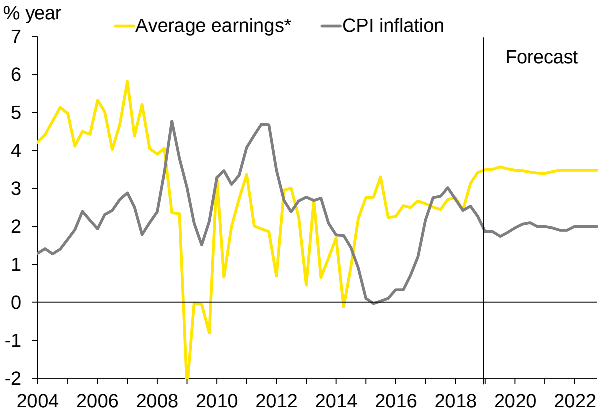
Consumers boosted as real earnings growth sees recent improvement

A positive for UK growth prospects is that consumer purchasing power benefitted from clear improvement in earnings growth in the latter months of 2018 after a mixed performance earlier in the year. This fuelled belief that a tight labour market may finally be feeding through to lift pay. However, it should be borne in mind that there have been several false dawns on the UK earnings front (the latest being a relapse in Q2 2018).

Specifically, latest data from the Office for National Statistics (ONS) shows that annual total average weekly earnings growth climbed to 3.4% in the three months to November, which was the best level since the three months to July 2008. It was up from 3.3% in the three months to October and 2.4% in the three months to June. It had previously relapsed to June's level from 2.8% in the three months to February.

Annual regular earnings growth (which strips out sometimes volatile bonus payments) was stable at 3.3% in the three months to November, which was also the best level for a decade. It was up from 2.7% in the three months to June. It had earlier dipped to June's rate from a previous peak of 2.9% in the three months to March. It is up from 2.1% in the three months to August 2017.

UK: Average earnings and inflation



Source: EY ITEM Club *National Accounts measure

The pick-up in earnings growth occurred as UK employment rose 141,000 to reach a record 32.535 million in the three months to November. The employment rate stood at 75.8% in the three months to November, which was a record high. Meanwhile, the unemployment rate was 4.0% in the three months to November, which was the equal lowest since the three months to February 1975.

Further helping real earnings growth is the fact that after rising back up from 2.4% through the second quarter to 2.7% in August, consumer price inflation fell back to 2.1% in December (which was the lowest level since January 2017).

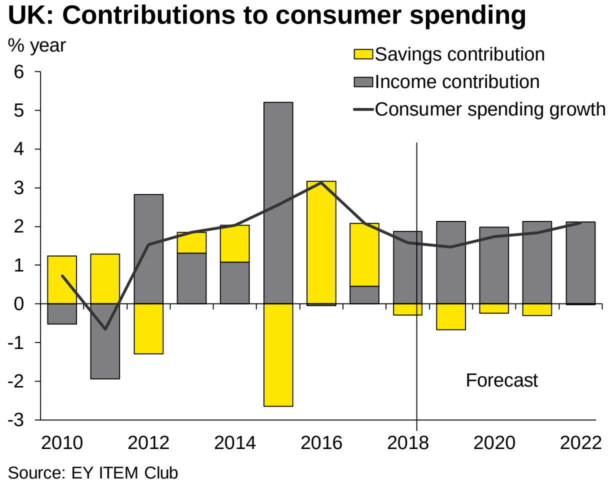
Consequently, the ONS reported that annual real earnings growth improved from 0.1% in the three months to June to 1.2% in the three months to November, which is the best level since the end of 2016, although still appreciably below long-term norms.

While we expect earnings growth to retain its recent firmer tone, we are doubtful that earnings will push much higher in the near term at least. Admittedly, survey evidence indicates that labour market tightness has been pushing up starting salaries and, seemingly, also salaries for people switching jobs. The monthly *IHS Markit/REC Report on Jobs* indicated that starting salaries for people placed into permanent jobs increased at one of the fastest rates in three years in December, although it had come off its recent high.

However, employers currently appear to still be only offering modest pay increases for their existing staff. In their December survey of business conditions the Bank of England's regional agents reported that "Pay settlements continued to be slightly higher than a year ago, and remained in a range of 2½%–3½%. Despite the tightening labour market, many contacts managed to contain pay bill growth by targeting pay awards at key skills or staff".[3] Additionally, a survey released in November by the Chartered Institute of Personnel and Development (CIPD) indicated that employers plan to raise pay by only 2% over the coming year, the same as three months ago. It appears that companies have been facilitated in giving modest pay rises to existing staff by a marked reluctance of many workers to change their jobs amid heightened economic uncertainties, with Brexit being a significant factor in this.

[3] *Agents' summary of business conditions – 2018 Q4*, Bank of England, 20 December 2018. See bankofengland.co.uk/agents-summary/2018/december-2018

Nevertheless, we forecast earnings growth to average 3.5% over 2019, which would be up from an average of 2.9% over 2018. Meanwhile, we expect consumer price inflation to moderate from an average of 2.5% in 2018 to 1.8% in 2019, further boosting real earnings growth.



Even so, a number of factors may limit consumer spending in 2019. Despite the recent improvement, growth in consumer purchasing power is still relatively limited compared to past norms, while confidence is fragile. Indeed, according to GfK, consumer confidence in December was at its lowest level since July 2013, where it remained in January. Meanwhile, with the household saving ratio being very low, consumers may at the very least be keen to avoid further dissaving. The August rise in interest rates may have reinforced consumer caution. Also significantly, lenders have cut back on the availability of unsecured consumer credit. Furthermore, 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 to and aftermath of the UK leaving the EU in late March.

Looser fiscal policy should help growth in 2019

Some help to UK growth in 2019 will come from the changes to fiscal policy that were announced in the Budget for 2019/20, held on 29 October 2018. As a result of markedly better-than-expected public finances over the first half of fiscal year 2018/19 and the Office for Budget Responsibility (OBR) concluding that it had systematically been underestimating income tax and corporation tax receipts, the OBR substantially revised down its forecasts for underlying Government borrowing over the medium term.

This gave Chancellor Philip Hammond some room for manoeuvre in October’s Budget, although his hands were partly tied by Government pledges made earlier in 2018 to lift spending on the NHS. Coming into the Budget, the Chancellor had also faced the Prime Minister’s pledge at the Conservative Party conference at the start of October to end austerity.

Consequently, rather than letting the budget deficit (Public Sector Net Borrowing excluding banks — PSNBex) come down quicker than previously forecast, Mr Hammond chose to spend most of his windfall on the public finances, with most of the stimulative measures helping the economy in 2019. In addition to the increased spending on the NHS, another significant measure announced by the Chancellor was an increase in income tax thresholds from April 2019. Specifically, the personal allowance threshold, the rate at which people start paying income tax at 20%, is to be increased from £11,850 to £12,500 in April, which was a year earlier than had been planned. Additionally, the higher rate income tax threshold, the point at which people start paying tax at 40%, is to rise from £46,350 to £50,000 in April.

So while expected public borrowing was revised down substantially for the current fiscal year 2018/19, the projections thereafter were only revised down modestly. This reflects the fact that in the words of the OBR, the October Budget largely “spent the fiscal windfall rather than saving it”. The OBR specifically commented that the “overall effect of the Budget measures is to increase the deficit by £1.1

billion this year and £10.9 billion next year, rising to £23.2 billion in 2023–24. This is the largest discretionary fiscal loosening at any fiscal event since the creation of the OBR."[4]

Bank of England seen hiking interest rates just once in 2019

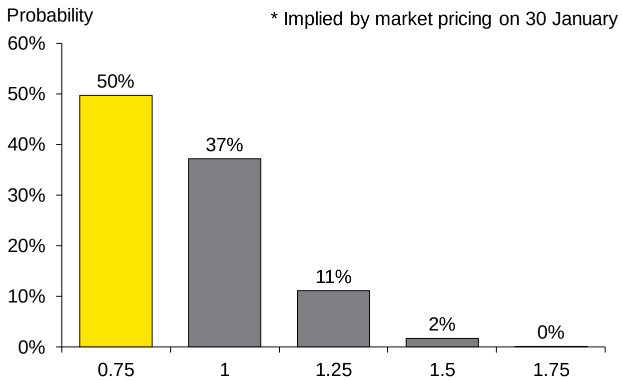
The economy is unlikely to be hampered by markedly tighter monetary policy in 2019. The Bank of England hiked interest rates just once in 2018, lifting them from 0.50% to 0.75% in August. This was the second hike in the current cycle of a tightening monetary policy as the Bank had earlier lifted interest rates by 25 basis points to 0.50% in November 2017, taking them up from the emergency rate of 0.25% that had been introduced in August 2016 to bolster the UK economy in the aftermath of the vote to leave the EU in the June 2016 referendum.

The Bank of England is clearly in 'wait and see' mode on monetary policy until the Brexit situation becomes clearer. On the assumption that the UK ultimately leaves the EU in late March with a deal and the economy holds up relatively well, it seems highly likely that the Bank will look to press ahead with a gradual normalisation of monetary policy. The underlying view of the MPC is that "an ongoing tightening of monetary policy over the forecast period, at a gradual pace and to a limited extent, would be appropriate to return inflation sustainably to the 2% target at a conventional horizon."[5]

The current interest rate of 0.75% is some way below where the Bank judges rates will ultimately settle. In its August 2018 quarterly *Inflation Report*, the Bank of England 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".[6] 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 consumers' further need to repair balance sheets, fiscal drag and heightened uncertainty (particularly from Brexit).

The Monetary Policy Committee (MPC) perceives that aggregate supply and demand in the UK economy are now "broadly in balance". The Bank of England perceives that the economy's growth potential on the supply-side is 1.5%. Consequently, with the economy now seen as having no slack left and the Bank of England currently expecting UK GDP growth to be 1.8% in 2019 and 1.7% in 2020, the MPC expects a "margin of excess demand to build, feeding through into higher growth in domestic costs." In contrast, external cost pressures are projected to ease over the forecast period.

UK: Probability of Bank Rate after December



Source: Bloomberg

On the assumption that the UK and the EU ultimately enact a Brexit transition arrangement in March 2019 and the UK economy does not weaken in the immediate aftermath of the exit from the EU, we believe the Bank of England could very well raise interest rates from 0.75% to 1.00% in May. However, it is entirely possible that the Bank could hold off hiking interest rates until August as the MPC may want to see sustained evidence that the economy is holding up in the aftermath of the UK leaving the EU.

[4] *Overview of the October 2018 Economic and Fiscal Outlook*, Office for Budget Responsibility, 29 October 2018. See obr.uk/overview-october-2018-economic-fiscal-outlook/

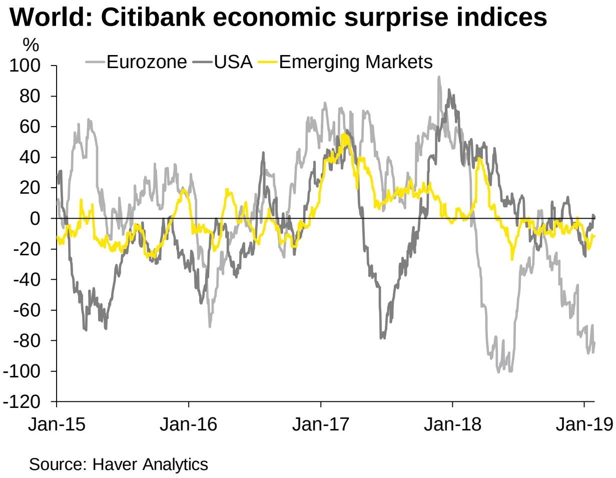
[5] *Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 19 December 2018*, Bank of England. See bankofengland.co.uk/-/media/boe/files/monetary-policy-summary-and-minutes/2018/december-2018.pdf?la=en&hash=F24C72E2CB5537763E7794F5CB0C6C1AF782FA4E

[6] 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

We would not rule out two interest rate hikes in 2019 but we believe one is more likely as significant uncertainties persist — with expected lower inflation easing the pressure for more aggressive Bank of England action. We expect this to be followed by two interest rate hikes in 2020 (taking rates up to 1.50% by the end of 2020) as the MPC seeks to gradually normalise monetary policy. We see a further two interest rate hikes in 2021, causing the rate to rise to 2.0% by the end of 2021. Interest rates are seen eventually plateauing at 2.50% in 2023.

Global economic environment likely to be more challenging in 2019; but reasons not to be too pessimistic

There have recently been mounting concerns about the global economic outlook. Economic data and surveys released towards the end of 2018 and at the start of 2019 were clearly skewed towards the softer side, particularly relating to manufacturing activity. This has been accompanied by a sharp sell-off in financial markets that started around last September.



Slower global growth and trade obviously have ramifications for the UK economic outlook, most obviously through affecting export prospects and business confidence. It is also worth noting that the recent sharp weakening in global equity markets has an adverse impact on consumers' wealth as well as potentially affecting businesses' operations.

The January 2019 edition of *Consensus Forecasts*[7] projected that global growth would ease back from an estimated 3.2% in 2018 (which would have been unchanged from the 2017 outturn) to 2.9% in 2019. Significantly, the 2019 forecast of 2.9% global growth was revised down from 3.0% in the December edition. The current suspicion is that global economic forecasts will be revised down further.

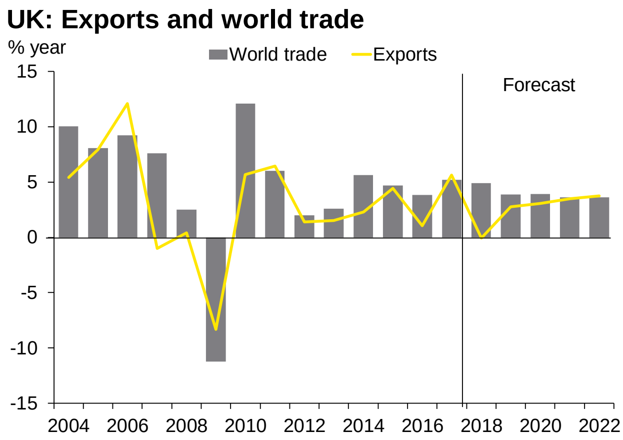
There has been particular recent concern about signs of slowing activity in China while the eurozone clearly suffered a marked loss of momentum in the second half of 2018 (eurozone GDP growth was likely limited to 0.2% q/q in Q4 as it had been in Q3). Additionally, Japanese GDP contracted 0.6% q/q in Q3 2018, although this was hit significantly by special factors.

Concerns about the global outlook have focused on a number of factors, notably including: (1) the US–China trade dispute and imposition of tariffs with the threat of more to come; (2) a sharper-than-expected slowdown in China; (3) the financial market sell-off having increasing spillover effects; (4) a hard Brexit; (5) an over-aggressive tightening of monetary policy and (6) a crisis in Italy with the government and the EU Commission clashing over the Italian budget while the country teeters on the brink of recession.

However, while it looks highly probable that global growth will be slower in 2019 than in 2018, there are good reasons not to be overly pessimistic. The impacts of trade tariffs on growth should be limited overall, while the US–China decision in early December to delay the imposition of further trade tariffs to the end of March and to resume dialogue/negotiations offers some hope for an easing of tensions. Seemingly positive talks in Beijing in early January increased speculation that the imposition of tariffs will be delayed further beyond the end of March, and boosted hopes that a deal will eventually emerge that means a lasting suspension of new tariffs. Meanwhile, the risk of a sharp Chinese slowdown is likely to be alleviated by policymakers taking measures to support the economy. The December Central Economic Work Conference gave a mandate for more fiscal and monetary support in 2019, and several easing steps were announced in the early weeks of 2019.

[7] *Consensus Forecasts*, 14 January 2019. See consensuseconomics.com

While the eurozone undeniably suffered a much sharper loss of momentum over the latter months of 2018 than had been expected, there are again reasons not to overdo the pessimism for 2019. Some of the eurozone slowdown in late 2018 was influenced by special factors (such as the hit to automotive output, especially in Germany, from manufacturers struggling to deal with new emissions regulations, and the hit to economic activity in France from unrest). Meanwhile, consumers' incomes were squeezed by higher inflation. Looking ahead, eurozone growth should be helped in 2019 by a decent environment for consumers, with lower inflation and firmer wage growth supporting purchasing power while the unemployment rate is at a decade low of 8.1%. Furthermore, overall fiscal policy across the eurozone in 2019 is expected to be the most expansive it has been for many years.



Source: EY ITEM Club

Meanwhile, concerns over a crisis in Italy have been alleviated by the government reaching agreement with the EU Commission on the 2019 Budget in December. This followed the government reducing its planned budget deficit for 2019 from 2.4% of GDP to 2.04% of GDP. Nevertheless, the situation in Italy is challenging, with the very real possibility that the country entered mild recession in the second half of 2018 (Italian GDP growth may well have contracted in Q4 2018 after edging down 0.1% q/q in Q3).

The sharp falling back in oil prices from the four-year highs seen in October should be supportive overall to the global economy in 2019. Brent oil traded around $60/barrel in early 2019, down markedly from a peak of $86.7/barrel in October 2018. This eases inflationary concerns for 2019 and dilutes the risk of an over-aggressive tightening of monetary policy. Indeed, with core inflation remaining muted in most economies, it seems most likely that central banks generally will pursue only measured policy normalisation and will have scope to delay interest rate hikes if growth concerns deepen or financial market developments lead to an unwarranted marked tightening of conditions.

Modest pick-up in growth expected if a 'no-deal' Brexit avoided

Our forecast is based on the critical assumption that the UK will ultimately leave the EU on 29 March with a withdrawal deal.

The forecast sees GDP growth edging up to 1.5% in 2019 after estimated expansion of 1.4% in 2018, down from 1.8% in 2017 and the weakest expansion since 2009. Estimated expansion of 1.4% in 2018 assumes that Q4 expansion was 0.3% q/q.

The forecast for 2019 assumes that GDP 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.

One upside risk to growth in Q1 2019 is that it could be lifted by businesses (and possibly some consumers) stockpiling amid heightened concerns that there will be a disruptive 'no-deal' UK exit from the EU in late March. It is notable that the December manufacturing purchasing managers' survey indicated that activity in the sector had been lifted to a six-month high by stock-building (of both input materials and finished products) as well as both domestic and foreign clients lifting their demand to guarantee supplies amid Brexit concerns. However, if appreciable stock-building does occur in Q1 2019 (and also occurred to some extent in Q4 2018), there could be some adverse impact on GDP growth in Q2 and, possibly, Q3 2019 as the stockpiling is unwound. How much this stockpiling will affect overall growth in Q1 2019 is also dependent on the extent to which this stockpiling is met through increased imports.

The EY ITEM Club forecast for the UK economy, winter 2019
% changes on previous year except borrowing, current account, and interest and exchange rates

	GDP	Domestic demand	Consumer spending	Fixed investment	Exports	Imports
2016	1.8	2.4	3.1	2.3	1.0	3.3
2017	1.8	1.4	2.1	3.5	5.6	3.5
2018	1.4	1.6	1.6	0.2	-0.1	0.6
2019	1.5	1.6	1.5	1.1	2.8	3.2
2020	1.7	1.7	1.7	2.5	3.1	2.9
2021	1.8	1.8	1.8	2.2	3.5	3.4
2022	2.0	2.0	2.1	2.9	3.8	3.8
	Net Government borrowing*	**Current account (% of GDP)**	**Average earnings**	**CPI**	**Bank Rate**	**Effective exchange rate**
2016	2.6	-5.3	2.5	0.6	0.4	82.0
2017	2.2	-3.4	2.6	2.7	0.3	77.4
2018	1.4	-4.0	2.9	2.5	0.6	78.5
2019	1.4	-3.5	3.5	1.8	0.9	79.2
2020	1.2	-3.2	3.4	2.0	1.3	82.7
2021	1.1	-3.3	3.5	1.9	1.8	82.1
2022	0.9	-3.3	3.5	2.0	2.1	82.8

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

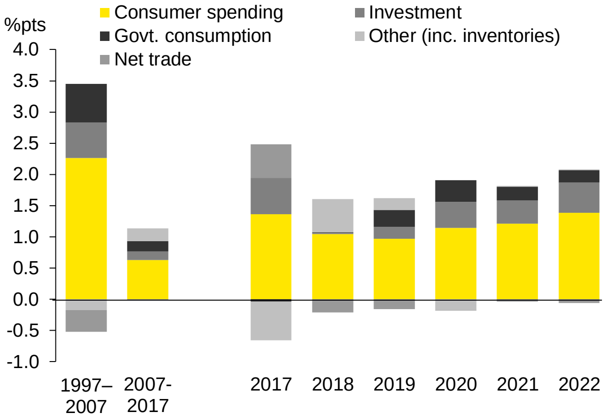
Growth in 2019 is expected to be supported by a gradual improvement in consumer purchasing power through the year. Inflation is seen as averaging a reduced 1.8% in 2019 while earnings growth is expected to at least retain the firmer tone seen in the latter months of 2018. However, consumer spending is seen as limited early on in 2019 by heightened concerns over the economic outlook amid Brexit uncertainties. It is notable that the GfK consumer confidence index in December weakened to its lowest level since July 2013.

Business investment is anticipated to be subdued in the first half of the year amid Brexit uncertainties, but it is expected to improve later on in 2019 as those uncertainties wane. Business investment is also likely to be lifted by some firms looking to increasingly invest in automation to make up for labour shortages and to try to boost productivity. Meanwhile Government spending will be lifted in 2019 by increased spending on the NHS.

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.

GDP growth is seen improving to 1.7% in 2020 as the economy sustains expansion of around 0.4% q/q. Consumer spending growth is seen picking up modestly from 1.5% in 2019 to 1.7% in 2020 amid reasonably solid real income growth, modest employment growth and firmer confidence. Meanwhile, business investment growth is seen as stronger amid reduced uncertainties and an ongoing need/desire to save labour and lift productivity. Meanwhile, net trade is seen as essentially in balance over 2020.

UK: Contributions to GDP growth



Source: EY ITEM Club

However, it is possible that GDP growth could be adversely affected later on in 2020 by increasing uncertainty as the transition arrangement under the UK's withdrawal agreement with the EU is scheduled to come to an end. However, we strongly suspect that this will need to be extended (and there is scope to do so) as it seems highly unlikely that the UK and EU will have been able to sort out their future trading relationship by then. Certainly, the negotiations that have taken place so far do not inspire confidence that there will be any quick resolution of what will undoubtedly be complex dealings.

But what is the outlook if no Brexit deal?

Formulating an economic forecast for the UK economy at the moment is like trying to look through a thick fog. Indeed, a mid-January article in the *Financial Times* observed, "Lack of clarity over the shape of Brexit has made it impossible to produce a single growth forecast for the UK's economy, according to an increasing number of economists who are now publishing multiple predictions based on different outcomes." [8]

Our forecast assumes that the UK will ultimately leave the EU on 29 March with a withdrawal deal. This reflects the fact that there is seemingly a clear majority within Parliament against a 'no-deal' UK exit from the EU, so when push ultimately comes to shove, we believe the odds just about favour some form of deal being ultimately agreed amid political manoeuvring and possibly some tweaking of Theresa May's deal.

But the truth of the matter is that this is highly uncertain, and that there could very well be a UK exit from the EU at the end of March without any deal. It is possible that the UK's exit from the EU is delayed through an extension of Article 50 (and if this is the case, how long will the extension be for?), while another referendum being held on UK membership of the EU cannot be ruled out.

Out of the possible alternatives for the UK to our central assumption and forecast, an exit from the EU at the end of March without any deal looks the most likely. This is the default legal position of the Article 50 leaving process, and while there may be a clear majority within Parliament against a 'no-deal' UK exit from the EU, there does not appear to be a majority for any other outcome.

Leaving the EU without a deal at the end of March and switching to WTO trading rules would obviously have major ramifications for the UK's economic outlook. However, in putting together any forecast for this eventuality, it needs to be borne in mind that economic projections made in the immediate aftermath of the vote in June 2016 for the UK to leave the EU proved overwhelmingly pessimistic.

The critical point this time around is that the circumstances facing the UK after 29 March will immediately be different, whereas nothing really changed in the immediate aftermath of the vote for Brexit in June 2016. In particular, consumers kept on spending after the referendum as it was some time before sterling's sharp drop following the vote for Brexit fed through to lift inflation and squeeze

[8] "Growth forecasts lost in the fog of Brexit", *Financial Times*, 14 January 2019. See ft.com/content/05051918-15ce-11e9-a581-4ff78404524e

purchasing power. Consumer confidence weakened sharply immediately following the June 2016 vote but it then recovered pretty quickly so consumers' circumstances were little changed in the immediate aftermath of the referendum vote. Meanwhile, nothing changed regarding trading conditions or supply chains.

If a 'no-deal' Brexit occurs at the end of March, there will be an immediate change of trading circumstances and some developments will be harder to assess than others. In particular, there is no knowing at this stage just how much disruption will occur at ports and how badly supply chains will be affected. And if there are scenes of chaos, how much will this affect business and, also, consumer confidence and behaviour?

Sterling is likely to fall markedly following a 'no-deal' Brexit from the EU — as it did after the referendum vote in June 2016 — and this is likely to again eventually feed through to lift inflation, squeeze consumers' purchasing power and push up companies' input costs.

However, the weaker pound should give some support to UK exports. Trade will be affected as both parties levy tariffs and non-tariff barriers (NTBs) are introduced across a range of sectors. With both export and import growth suffering, the effect on GDP growth from this source would be ambiguous.

We believe that heightened business uncertainty after a 'no-deal' Brexit would weigh down markedly on business investment, although it should be borne in mind that it has already been weak for a prolonged period in the run-up to Brexit, with latest available ONS data showing that it contracted for a third successive quarter in Q3 2018 when it was down 1.1% q/q and 1.8% y/y. This was the first time that business investment had fallen for three successive quarters since the depths of the 2008/9 financial crisis. Heightened uncertainty would also be likely to have some dampening impact on consumer spending, although this could well again prove surprisingly resilient.

We suspect that policymakers would look to provide both fiscal and monetary policy support to the economy in the event of a 'no-deal' Brexit. The Bank of England has repeatedly stated that interest rates could either go up or down should there be a 'no-deal' UK exit from the EU, depending on the balance of how the UK's supply capacity and demand side of the economy are perceived to be affected. Exchange rate movements will also be a factor. However, we strongly lean towards the view that interest rates would be far more likely to be cut than increased if there is a 'no-deal' Brexit. With Bank Rate currently only at 0.75%, there is of course limited scope for taking interest rates lower, although the Bank of England could also reactivate quantitative easing.

Meanwhile, Chancellor Philip Hammond has indicated that a new budget for 2018/19 could be held in the event of a 'no-deal' Brexit and we suspect that he would announce some loosening of fiscal policy. However, how much fiscal stimulus the Chancellor would be able to provide would likely be limited by the fact that the public finances are still far from healthy despite the recent marked improvement. There is also the concern that a sharp loosening of fiscal policy could further undermine investor confidence in the UK, at a time when it would already likely have been pressurised markedly by a 'no-deal' exit from the EU.

On balance, we suspect GDP growth would likely come in around 0.7% in 2019 and 0.6% in 2020, if there was a 'no-deal' Brexit — with the economy very possibly suffering stagnation or a mild recession over the second half of 2019. Although forecast GDP growth is lower overall in 2020 than in 2019, this masks an expected gradual pick-up in growth through the year as the UK gradually adapts to its changed circumstances.

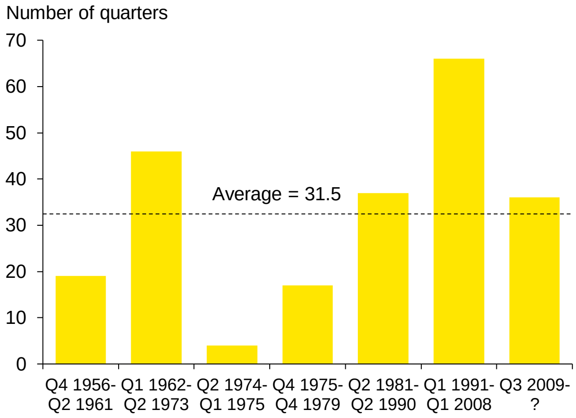
Risks to forecast look skewed to downside

Taking everything into consideration, it does appear that the risks to our UK forecast of GDP growth of 1.5% in 2019 and 1.7% are skewed to the downside. Most obviously, there is the very real risk of a 'no-deal' Brexit. Meanwhile, global growth looks more likely to come in lower rather than higher to the central expectation of only a modest slowing in 2019.

Even if there is a Brexit deal, precarious parliamentary arithmetic leaves the Government vulnerable to rebellions, and the current Prime Minister, Theresa May, is vulnerable despite surviving a leadership challenge in late 2018. These factors 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.

It is perhaps a leap of faith to forecast consistent UK GDP growth out to 2023 given the length of the current expansionary cycle. Indeed, 2018 marked a ninth year of growth since UK GDP last contracted (by 4.2% in 2009). In its forecasts provided for the October 2018 Budget, the OBR observed that "in the 63 years for which the Office for National Statistics has published consistent quarterly real GDP data, there have been several recessions – suggesting that the chance of a recession in any five-year period is about one in two. So the probability of a cyclical downturn occurring some time over our forecast horizon is fairly high".[9] There is also the concern that in the event of a recession, the Bank of England would not have much ammunition to fight it, given that interest rates are so low.

UK: Period between recessions



Source: EY ITEM Club calculations using data from Haver Analytics

However, there are good reasons to think that the current UK economic upturn could continue for some time to come. The overall strength of the UK expansion since 2009 has been relatively limited, and it followed a particularly deep contraction over 2008/9. There is currently little sign of inflation about to take off, with wage growth remaining largely muted despite the unemployment rate recently being at its lowest level since 1975. It may well be that there is more slack in the labour market than the official figures indicate. Consequently, it looks highly unlikely that the Bank of England will need to sharply raise interest rates, which would rein in growth. However, there really does need to be a clear pick-up in productivity growth over the medium term for UK expansion to have the best chance of continuing.

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.

Another risk to the growth outlook is that Brexit does not take place and the UK ultimately stays in the EU. We believe that this would most likely lift growth prospects for the economy in 2020 and over the medium term. However, what impact it would have on UK growth in 2019 is questionable as if Article 50 is delayed and another referendum is ultimately called, this would likely extend the current business and consumer uncertainty, thereby weighing down on near-term growth prospects.

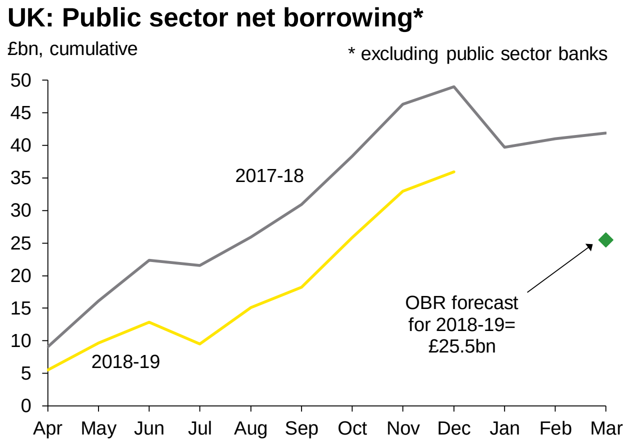
[9] Page 83 of *Overview of the October 2018 Economic and Fiscal Outlook*, Office for Budget Responsibility, 29 October 2018. See obr.uk/overview-october-2018-economic-fiscal-outlook/

Forecast in detail

1. Fiscal policy

The public finances have seen substantial y/y improvement over the fiscal year 2018/19 so far. This has continued the recent consistent pattern of the budget deficit (measured in terms of Public Sector Net Borrowing excluding banks — PSNBex) coming in below the projections made by the Office for Budget Responsibility (OBR). This led the OBR to conclude in October when preparing the forecasts for the 2018 Budget that it had systematically been underestimating income tax and corporation tax receipts. Consequently, the OBR substantially revised down its forecasts for underlying Government borrowing over the medium term.

PSNBex amounted to £35.9 billion over the first nine months of fiscal year 2018/19 (April–December). This was the lowest deficit for the period for 16 years and was down 26.7% from £49.0 billion in April–December 2017. If this rate of improvement continued over the full fiscal year, PSNBex would come in at £30.7 billion (1.5% of GDP) over 2018/19. This would be the lowest shortfall since 2001/2 and would be down from £41.9 billion (2.0% of GDP) in 2017/18. This was down from £44.9 billion (2.3% of GDP) in 2016/17 and a peak of £153.1 billion (9.9% of GDP) in 2009/10.



Source: Haver Analytics and OBR

In October's Budget for 2019/20, the OBR slashed its forecast for PSNBex in 2018/19 to £25.5 billion (1.2% of GDP) from the £37.1 billion (1.8% of GDP) that it had projected in the March 2018 Spring Statement. There were further reductions — albeit more limited — over a five-year horizon with the 2019/20 PSNBex cut to an expected £31.8 billion (1.4% of GDP) from £33.9 billion (1.6% of GDP) right through to the 2022/23 shortfall reduced to £20.8 billion (0.9% of GDP) from £21.4 billion (0.9% of GDP). The budget deficit is seen dipping further to £19.8 billion (0.8% of GDP) in 2023/24, which would be a 20-year low. In total the OBR has cut the projected budget deficits over the five years 2018/19 to 2022/2023 by a cumulative £18.5 billion.

The main reason why the expected PSNBex was slashed for 2018/19 but only trimmed for future years was that Chancellor Philip Hammond chose to take advantage of the OBR's cutting of the underlying budget deficits by introducing fiscal stimulus measures, most notably through increased spending on the NHS, as well as an earlier than previously planned raising of income tax thresholds. The Chancellor was under pressure to take a more relaxed fiscal stance in October's Budget after Prime Minister Theresa May unexpectedly promised an end to austerity at the Conservative Party conference in early October.

The Chancellor also indicated in October's Budget that 2019's Spending Review will see annual average spending growth of 1.2% in real terms. Mr Hammond implied that this could be just a taster of things to come, indicating that spending could rise more if a 'Brexit dividend' comes from a smooth UK exit from the EU at the end of March, allowing him to use up some of the £15.4 billion fiscal buffer he has put aside and causing the OBR to raise its growth forecasts.

2. Monetary policy

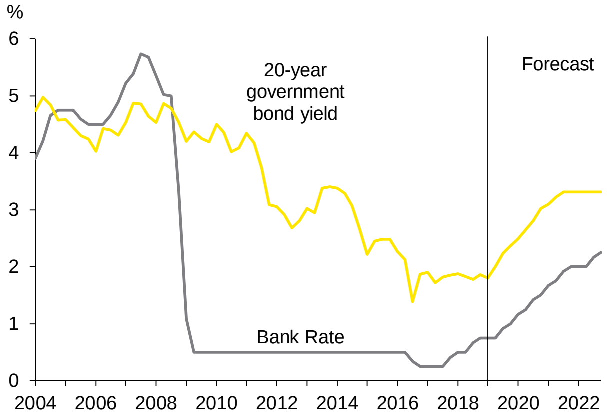
The Bank of England's Monetary Policy Committee (MPC) ended 2018 very much in 'wait and see' mode as they held interest rates at 0.75% with a unanimous 9–0 vote on 20 December after their regular six-weekly meeting. This meant that the Bank of England raised interest rates just once in 2018, with a 25-basis point hike from 0.50% to 0.75% in August.

The minutes of the December MPC meeting observed that Brexit uncertainties had "intensified considerably". Supporting the view that interest rates are unlikely to change for some time, the MPC downgraded its expectation for GDP growth in Q4 to 0.2% q/q (from 0.3% q/q), citing heightened Brexit uncertainties and slowing global economic activity. Meanwhile, the MPC acknowledged that inflation was likely to be significantly lower than expected in the near term due to the sharp falling back in global oil prices. Inflation averaged 2.27% in Q4 2018, below the 2.46% forecast for Q4 in the November quarterly *Inflation Report*. Furthermore, the MPC believed that inflation is likely to fall as low as around 1.75% in January and then remain below its 2% target level for the subsequent few months.

Supporting the case for higher interest rates further out, the MPC considered that the fiscal loosening enacted in the late-October Budget was likely to add 0.3ppts to GDP growth over the Bank of England's forecast horizon. The MPC considered that this "would be expected to boost inflation slightly during the second half of that period. The near-term inflation news from Budget 2018 was slightly to the downside, however, reflecting the freezing or part-freezing of some duties".

Additionally, the MPC noted that recent pay growth had been higher than expected. Specifically, annual growth in both total and regular (which excludes bonus payments) earnings growth picked up to a decade high of 3.3% in the three months to October (and subsequent data shows total earnings growth picked up further to 3.4% in the three months to November). In the November quarterly *Inflation Report*, the Bank of England forecast that earnings growth would pick up relatively gradually from 2.75% in 2018 to 3.25% in 2019 and 3.50% in 2020.

UK: Bank Rate and 20-year bond yield



Source: EY ITEM Club

Once again, the Bank of England stressed that Brexit uncertainties very much clouded the outlook for the economy and interest rates. The MPC specifically indicated that a 'no-deal' UK exit from the EU next March could result in interest rates moving in either direction, depending on the balance of how the economy's supply capacity and demand side are perceived to be affected. Exchange rate movements would also be a factor.

On the assumption that the UK and the EU ultimately enact a Brexit transition arrangement in March 2019 and the UK economy holds up in the immediate aftermath of the exit from the EU, we believe the Bank of England could very well raise interest rates from 0.75% to 1.00% in May. However, it is entirely possible that the Bank of England could hold off hiking interest rates until August as the MPC may want to see sustained evidence that the economy is performing reasonably well in the aftermath of the UK leaving the EU.

We would not rule out two interest rate hikes in 2019 but we believe one is more likely as significant uncertainties persist – with lower inflation easing pressure for more aggressive Bank of England action. We expect this to be followed by two interest rate hikes in 2020 (taking rates up to 1.50% by the end of 2020) as the MPC seeks to gradually normalise monetary policy. We see a further two interest rate hikes in 2021, causing Bank Rate to be at 2.0% at the end of 2021.

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 been largely pressurised in recent months, reflecting heightened concerns that the UK could leave the EU at the end of March without a Brexit deal. Evidence that the UK economy lost momentum in the latter months of 2018 has also weighed on the pound. Sterling briefly traded at a 20-month low of $1.2409 on 3 January and also hit a 16-month low of £0.9102/euro in early January (although its weakness was magnified by a ‘flash crash’ in Asia). In the near term, sterling is likely to be very much driven by Brexit developments, likely gaining on any signs that a ‘no-deal’ Brexit is becoming less likely and weakening on increasing concerns that the UK could leave the EU at the end of March without a deal. On the assumption that the UK and EU will ultimately approve a Brexit withdrawal agreement, we expect sterling to improve to trade around $1.35 by mid-2019 and to $1.42 at the end of 2019. Further modest gains are expected in 2020, when sterling could trade above $1.45 for a while, helped by the Bank of England gradually normalising monetary policy.

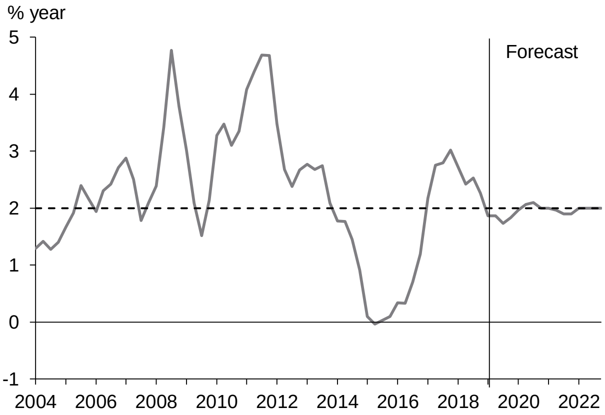
3. Prices

Consumer price inflation dipped to 2.1% in December, taking it down to the lowest level since January 2017. This was down from 2.3% in November, 2.4% in both October and September, and a 6-month high of 2.7% in August 2018. Inflation had peaked at 3.1% in November 2017.

Consumer price inflation averaged 2.5% over 2018, which was slightly down from a five-year high of 2.7% in 2017 when inflation had been primarily pushed up as a consequence of sterling’s sharp overall weakening following the June 2016 referendum vote for the UK to leave the EU.

Inflation was primarily brought down in December by lower fuel prices. Petrol prices fell by 6.4p/litre between November and December 2018, compared with a rise of 0.8p/litre between October and November 2017. Also bringing down annual inflation in December were smaller increases in air and sea fares. Tobacco prices also had a downward effect in December after spiking in November due to the duty increases in October’s Budget.

UK: CPI inflation



Source: EY ITEM Club

Core inflation edged back up to 1.9% in December after dipping to 1.8% in November from 1.9% in October. There were upward impacts from hotel accommodation and mobile phone charges. Further small rises occurred in food prices and recreation and culture prices.

Consumer price inflation could very well dip below 2% in January and stay below that level for much, if not all of 2019. We see inflation averaging 1.8% over 2019 and it could very well get as low as 1.6%.

Lower oil prices are the key factor behind the inflation outlook, while Ofgem’s price cap will put some downward pressure on domestic energy prices from January. Although oil prices have firmed from their late-December lows, Brent oil is currently trading around $60/barrel compared to last October’s four-year high of $86.7/barrel. We expect Brent oil to average $63/barrel in 2019, which would be down from an average of $71.1/barrel in 2018.

Indeed, evidence of waning price pressures further down the supply chain was evident in producer input prices falling 1.0% m/m in December, causing the y/y increase to moderate sharply to 3.7% (the lowest since mid-2016) from 5.3% in November, 10.3% in October and 10.7% in September. This was primarily due to crude oil prices falling 9.7% m/m in December. The annual increase in producer output prices dipped markedly to 2.5% in December from 3.0% in November and 3.3% in October.

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. While earnings growth has firmed recently (it hit a decade high of 3.3% in the three months to October), it is still relatively moderate compared to long-term norms and is likely to see only limited further gains, despite the tight labour market. Firms remain generally 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.

Consumer price inflation is seen firming modestly to average 2.0% in 2020 as stronger GDP growth increases domestic inflationary pressures. However, an expected firmer pound will help to limit the rise in inflationary pressures while oil prices are seen only modestly firmer, with Brent averaging around $66/barrel over 2020.

If there is a ‘no-deal’ UK exit from the EU at the end of March, the inflation outlook will be clouded by a number of factors — most notably what happens to sterling, how well the economy holds up and what tariffs come into effect.

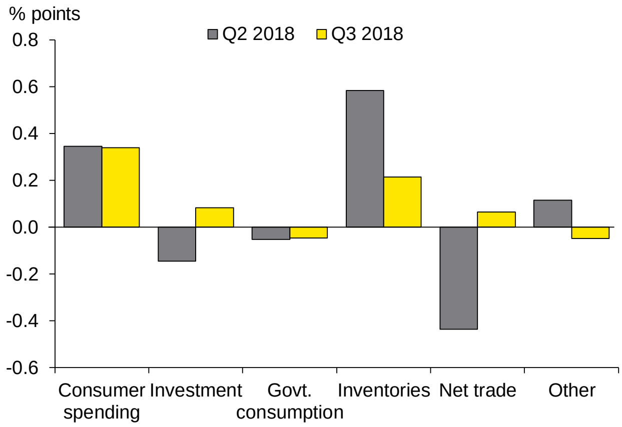
RPI inflation will be higher than the CPI measure over the forecast period. This is largely due to the so-called ‘formula effect’ (i.e. the different methods of aggregation between the RPI and CPI measures that place an upward bias on RPI) and the impact of a gradual increase in interest rates on mortgage interest payments.

4. Activity

GDP growth is estimated to have slowed to 1.4% in 2018 from 1.8% in both 2017 and 2016. This would have been the weakest growth performance since 2009. Our estimate of 1.4% growth in 2018 assumes that the economy grew at a reduced rate of 0.3% q/q in Q4 after growth improved to 0.6% q/q in Q3 from 0.4% q/q in Q2 and just 0.15% in Q1, when activity took a significant hit from the severe weather (the ‘Beast from the East’).

GDP expansion of 0.6% q/q in Q3 2018 benefitted from contributions from all parts of the output side of the economy, which was led by construction output jumping 2.3% q/q. The dominant services sector saw solid growth of 0.5% q/q. Meanwhile, industrial production rebounded 0.6% q/q after contracting 0.7% q/q in Q2. Within this, manufacturing output grew 0.4% q/q in Q3 after contracting in both Q2 and Q1.

UK: Contributions to quarterly GDP growth



Source: Haver Analytics

On the expenditure side of the economy, GDP growth in Q3 was helped by decent consumer spending (up 0.5% q/q). While it was buoyed by spending during the heatwave and the football World Cup, the overall increase in personal expenditure was held back by very weak new car sales in September, which was influenced heavily by supplies being affected by new emission regulations.

Disappointingly and worryingly, business investment fell 1.1% q/q in Q3, which was the third successive decline and caused it to be down 1.8% y/y. This followed q/q declines in both the second (by 0.7%) and first (by 0.4%) quarters. This strongly suggests businesses were increasingly cautious over investment as doubts mounted as to whether a Brexit transition arrangement would come into being in March 2019, and companies looked for greater clarity over the UK’s likely long-term relationship with the EU. Meanwhile, net trade made a modest contribution of 0.1ppts to Q3 GDP growth having been a substantial drag in Q2. Exports of goods and services rose 1.1% q/q in Q3 after a drop of 1.4% q/q in Q2. Imports climbed 0.8% q/q.

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 the 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 compared to 2018. The pound is also seen firming modestly after March as it is supported by the UK's Brexit transition arrangement. Consequently, net trade is seen making a slightly negative contribution to GDP growth in 2019.

GDP growth is forecast as modestly stronger at 1.7% in 2020. Consumer spending growth is seen picking up modestly amid reasonably solid real income growth, modest employment growth and firmer confidence. Meanwhile, business investment growth is seen being lifted by reduced uncertainties and an ongoing need/desire to save labour and lift productivity. Meanwhile, net trade is seen essentially in balance over 2020.

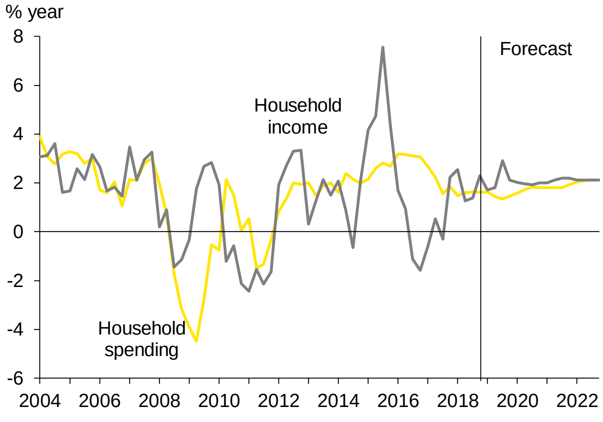
5. Consumer demand

Consumer spending is estimated to have expanded 1.6% in 2018, which would have been the slowest growth in personal expenditure since 2011 and down from increases of 2.1% in 2017 and 3.1% in 2018. We expect consumer spending was pretty muted in Q4 2018 after expanding 0.5% q/q in both Q3 and Q2. Personal expenditure had earlier risen 0.3% q/q when there had been some limiting impact on consumer spending from the severe weather in late February and March making it harder to get to the shops.

Consumer spending rose 0.5% q/q in Q3 2018 as it was clearly boosted by the heatwave and staging of the football World Cup in June/July. However, the overall increase in personal expenditure was held back by very weak new car sales in the key month (due to the number plate change) of September, which was influenced heavily by supplies being affected by new emission regulations. Indeed, new car sales plunged 20.5% y/y in September. Real household disposable income was flat q/q in Q3 and was up a mediocre 1.4% y/y. Consequently, the 0.5% q/q rise in consumer spending came at the expense of the household saving ratio deteriorating to an equal (with Q1 2018) record low of 3.8% in Q3 from 4.1% in Q2. This was down markedly from average household saving ratios of 6.6% in 2017 and 9.4% in 2016.

Belief that consumer spending was muted in Q4 2018 is fuelled by retail sales volumes falling 0.2% q/q, which was down from increases of 1.4% in Q3 and 1.8% in Q2. Retail sales volumes fell back 0.9% m/m in December after spiking 1.3% m/m in November, when they were clearly lifted by consumers looking to take advantage of Black Friday and related promotions. Retail sales volumes had previously fallen 0.6% m/m in October and 0.5% m/m in September. Meanwhile, new car sales remained weak, falling y/y through Q4 2018.

UK: Real household income and spending



Source: EY ITEM Club

We expect consumer spending growth to slow marginally to 1.5% in 2019. On a positive note for consumer spending prospects, real earnings growth is currently on an upward trend and presently stands at the highest level since late 2016. Annual earnings growth climbed to 3.4% in the three months to November, the best for a decade. Meanwhile, inflation fell back to 2.1% in December, its lowest level since January 2017. Consequently, real earnings growth is now just above 1%, the best level since the end of 2016. Further helping matters, employment reached a record high of 32.535 million in the three months to November.

We expect earnings growth to retain its recent firmer tone to average 3.5% in 2019 while consumer price inflation is seen dipping further to average 1.8%.

Nevertheless, consumer spending is likely to be limited in the early months of 2019 by heightened uncertainties in the run-up to and immediate aftermath of the UK leaving the EU at the end of March. Significantly, consumer confidence weakened in December 2018 to its lowest level since July 2013, according to GfK, primarily reflecting heightened concerns over the economy's recent performance and outlook. Furthermore, lenders expect demand for unsecured consumer credit to fall in the first quarter of 2019 at the fastest rate since records began in 2007, according to the latest Bank of England credit conditions survey.[10]

A number of other factors may also limit consumer spending. Despite the recent improvement, consumer purchasing power is still relatively limited compared to past norms. Meanwhile, with the household saving ratio being very low, consumers may at the very least be keen to avoid further dissaving — especially given current major uncertainties and the likelihood that interest rates will rise modestly further in 2019 after August's hike by the Bank of England (we expect one 25 basis point increase, taking Bank Rate up to 1.0%). Higher saving could also be prompted by a rise in pension auto-enrolment rates, which increased from 1% to 3% for employees last April. Furthermore, lenders have cut back on the availability of unsecured consumer credit. Latest Bank of England data show consumer credit growth slowed to a four-year low of 6.6% in December from 7.2% in November; this extended the downward trend from a peak of 10.9% in November 2016.

Also significantly, the budgets of some households will continue to be pressured by the cash freeze on working-age welfare benefits. And employment growth is forecast to slow from 1.2% in 2018 to 0.6% in 2019. Consequently, we expect real household incomes to rise by only a slightly stronger 2.1% in 2019 after estimated expansion of 1.9% in 2018.

Consumer spending growth is seen improving modestly to 1.7% in 2020, helped by reduced uncertainty, although this could mount later on in the year with the transition arrangement under the UK's withdrawal agreement from the EU scheduled to finish at the end of 2020. Earnings growth is seen remaining around 3.5% in 2020 while employment is expected to again rise by around 0.5%. Consumer price inflation is seen slightly higher overall at 2.0%. Consequently, real household disposable income is seen as growing by 2.0%. The Bank of England is expected to raise interest rates twice in 2020 by a total of 50 basis points, taking them up to 1.50%.

6. Housing market

The housing market ended a largely subdued 2018 on the back foot as Brexit uncertainties seemingly added to a challenging environment resulting from relatively limited consumer purchasing power (despite some recent improvement), fragile consumer confidence and, very possibly, wariness over higher interest rates — although there are varying performances across regions with the overall national picture dragged down by the poor performance in London and parts of the South East.

Latest Bank of England data shows mortgage approvals for house purchases fell back appreciably to an eight-month low of 63,792 in December, having previously trended up gradually to a nine-month high of 67,029 in October from a 2018 low of 63,394 in March (which had also been the second-lowest level after December 2017 since August 2016). December's level of 63,792 took mortgage approvals for house purchases towards the bottom of the 63,000–68,000 range that has broadly held for the past two years. This compares to a long-term (1993–2018) average of 80,937.

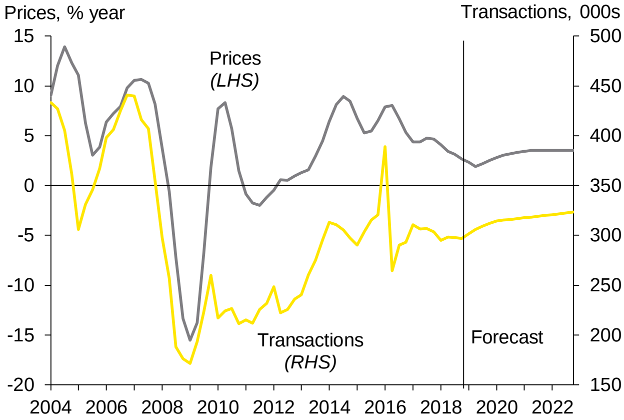
Furthermore, latest survey evidence is largely downbeat with the influential December RICS survey reported to show "the year ending on a weak note, with key activity indicators continuing to slip at the headline level. Political uncertainty is increasingly being cited as a constraint on the market, alongside

[10] *Credit Conditions Survey 2018 Q4*, Bank of England, January 2019. See bankofengland.co.uk/-/media/boe/files/credit-conditions-survey/2018/2018-q4.pdf?la=en&hash=FD0861731F5330D0B2328147BE869D8DD38A62CF

the well-established challenges around affordability and a lack of stock available for purchase." Specifically, new buyer enquiries fell for a fifth successive month and at an appreciable rate. Newly agreed sales were also down for a fifth month running.[11]

The same influence may have been at work on property prices. Latest data from the ONS/Land Registry shows house prices edged down 0.1% m/m in November, which was the third successive decline. The y/y increase in house prices was 2.8%, marginally up from 2.7% in October (the lowest level since July 2013). It was down from 3.2% in September, 4.7% at the end of 2017 and a peak of 5.1% in October 2017. More recent data from the Nationwide shows annual house price inflation at just 0.5% in December (down from 1.9% in November) which was the lowest rate since February 2013. The Halifax reported house price inflation at 1.3% in the three months to December, which was up from a low of just 0.3% in the three months to October, which had been the lowest level since the three months to December 2012.

UK: House prices and transactions



Source: EY ITEM Club

If the UK manages to leave the EU with a deal at the end of March, we expect UK house prices to eke out a modest gain of 2.2% over 2019, with the end-of-year rate standing at 2.5% (on the ONS/Land Registry basis). Reduced uncertainty could help housing market activity pick up along with a likely gradual pick-up in consumers' real income growth. Meanwhile, high employment, still low interest rates and a shortage of houses on the market will also likely offer some support to prices.

However, the upside for house prices is likely to be limited by purchase prices still being stretched compared to earnings. Latest Halifax data shows that the house price to earnings ratio was 5.57 in December, which was well above the long-term (1983–2018) average of 4.26. Furthermore, house price buyers may be wary of further interest rate hikes by the Bank of England.

If the UK leaves the EU at the end of March without a Brexit deal, house prices could fall by up to 5% in 2019 amid heightened uncertainty and weakened economic activity.

7. Company sector

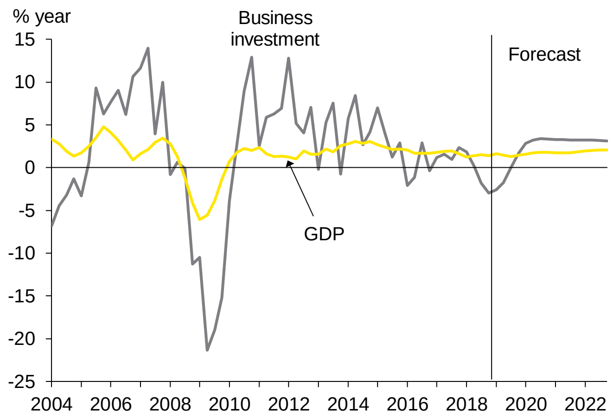
Business investment fell 1.1% q/q in Q3 2018, which was the third successive and deeper decline after falls of 0.4% q/q in Q2 and 0.7% q/q in Q1. This was the first time that business investment had fallen for three successive quarters since the deep economic downturn of 2008/9. Consequently, business investment was down 1.8% y/y in Q3 2018. With business investment very possibly falling again in Q4 2018, we estimate that it contracted 0.7% over 2018. This would follow business investment growth of 1.5% in 2017 and contraction of 0.2% in 2016 (when it was hit by uncertainty in the aftermath of the Brexit referendum vote and also by a drop in capital expenditure in the extraction sector amid weakened oil prices).

The third successive and deeper q/q decline in business investment in Q3 suggests that companies were increasingly cautious over investment as doubts mounted as to whether a Brexit transition arrangement would come into being in March 2019, and companies looked for greater clarity over the UK's likely long-term relationship with the EU.

[11] *December 2018 UK Residential Market Survey*, RICS. See rics.org/globalassets/rics-website/media/knowledge/research/market-surveys/uk-residential-market-survey-december-2018-rics.pdf

The Bank of England's regional agents reported in their Q4 2018 survey of business conditions (published in December) that "Investment intentions for the next 12 months continued to ease. Contacts reported a reluctance to commit to capital investment in the short term, preferring to wait for more clarity on the UK's future trading relationship with the EU. However, contacts continued to invest in projects aimed at increasing efficiency and productivity, particularly when faced with growing labour constraints and rising costs. There was increased investment in contingency infrastructure, such as warehousing, logistics and port capacity. And business and consumer services contacts invested in compliance-related IT upgrades."[12]

UK: Business investment and GDP



Source: EY ITEM Club

Looking ahead, business investment is anticipated to be subdued in the first half of this year amid Brexit uncertainties, but it is expected to improve later on in 2019 as those uncertainties wane. Business investment is also likely to be lifted by some firms looking to increasingly invest in automation to make up for labour shortages and to try to boost productivity. 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 rose to 12.7% in Q2 2018 from 12.5% in Q1 and was above the long-term (1997–2018) average of 12.0%.

However, the upside for business investment is likely to be limited by ongoing uncertainties about the nature of the UK's long-term relationship with the EU. It could also be pressurised in the latter months of 2020 with the transition arrangement under the UK's withdrawal agreement from the EU scheduled to finish at the end of that year.

Overall, we expect business investment to contract by 0.7% in 2019, although this fall masks expected q/q increases from the second quarter. Business investment is forecast to rise 3.2% in 2020.

8. Labour market and wages

While the economy performed largely in line with expectations in 2018, the jobs market proved surprisingly strong, especially in the first half of the year. However, it was only later on in 2018 that there were signs that the tighter labour market was feeding through to lift earnings growth. The relative unresponsiveness of pay to the apparent tightness of the labour market suggests that labour market slack has not been exhausted.

The unemployment rate stood at 4.4% at the end of 2017 and the general expectation at the start of 2018 was that it would stabilise around that rate through the year. However, the unemployment rate trended down through the first half of 2018 (despite the weakness of the economy in Q1) to be as low as 4.0% in the three months to July (the lowest rate since the three months to February 1975). It was still at 4.0% in the three months to November. Meanwhile, the employment rate reached a record high of 75.8% in the three months to November.

Despite a marked pick-up in the three months to November, the labour market was less robust overall in the second half of 2018, which may reflect companies finding it harder to find suitably skilled candidates – in some cases significantly influenced by fewer workers coming from the EU. ONS data shows that the number of EU nationals working in the EU was down 132,000 in the year to September, which was the biggest fall since records began in 1997. It is notable that the number of vacancies was a record 853,000 in the three months to December. Significantly, the Bank of England's regional agents reported

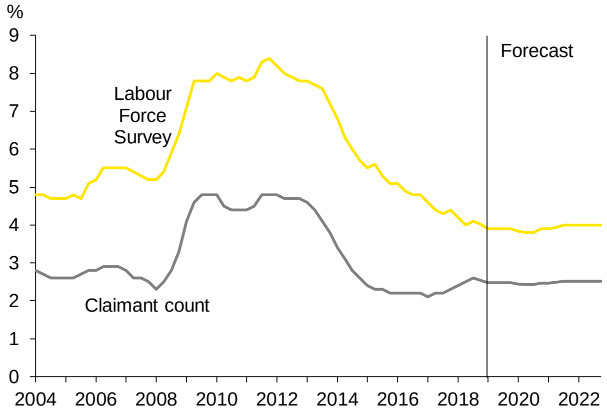
[12] *Agents' summary of business conditions – Q4 2018*, Bank of England, December 2018 Q2. See bankofengland.co.uk/agents-summary/2018/december-2018

in their December quarterly report on business conditions (cited above) that, "Recruitment difficulties intensified further and became more widespread. Contacts in areas including IT, professional services, construction, engineering, hospitality, health and social care and logistics reported that the inability to recruit sufficient numbers of staff was constraining output growth. They also reported that a lack of availability of EU migrant workers had exacerbated recruitment difficulties. In order to address the issue, companies were increasing intakes of apprentices and graduates, upskilling existing employees and investing in automation and technology."

Despite the high number of vacancies, it is also possible that some companies have recently become more cautious about employing as economic, political and Brexit uncertainties heightened.

The latest labour market data shows that employment rose 141,000 in the three months to November to reach a record high of 32.535 million. This was an improvement following a rise of 79,000 in the three months to October, 23,000 in the three months to September and a drop of 5,000 in the three months to August (which had been the first decline since late 2017). November's rise was in line with the robust increases seen in the first half of 2018 (for example, there had been an increase of 146,000 in the three months to May). Employment was up 328,000 y/y in the three months to November, an increase of 1.0%. The employment rate rose back up to reach a new record high of 75.8% in the three months to November after dipping to 75.5% in the three months to August from the previous high of 75.7% in the three months to May.

UK: Unemployment rate



Source: EY ITEM Club

The number of unemployed rose 8,000 in the three months to November to 1.372 million. This followed increases of 20,000 in the three months to October and 21,000 in the three months to September. Consequently, the number of unemployed was still modestly above the low of 1.363 million seen in the three months to August. The unemployment rate dipped back down to 4.0% in the three months to November (the lowest rate since early 1975) after edging up to 4.1% in the three months to October and September from 4.0% in the three months to August. The fact that the number of unemployed rose slightly in the three months to November despite employment rising 141,000 was due to the level of economically inactive people falling by 100,000.

Looking ahead, we expect employment growth to be slower in 2019, especially in the early months of the year, reflecting heightened business caution over the economic outlook given Brexit uncertainties, as well as ongoing difficulties in finding suitable candidates in some sectors. We expect employment growth to be 0.7% over 2019, with the unemployment rate edging down to 3.9%. Employment is seen rising 0.5% in 2020, causing the unemployment rate to come down to a low of 3.8%.

The second half of 2018 saw earnings growth trending up after a relapse in Q2. Specifically, latest ONS data shows that annual total average weekly earnings growth climbed to 3.4% in the three months to November, which was the best level since the three months to July 2008. It was up from 3.3% in the three months to October and 2.4% in the three months to June. It had previously relapsed to June's level from 2.8% in the three months to February. Annual total earnings growth actually fell back to 3.2% in November itself after spiking to 4.0% in October from 2.9% in September; this reflected volatile movements in bonus payments as well as the developments in regular earnings growth.

Annual regular earnings growth (which strips out sometimes volatile bonus payments) was stable at 3.3% in the three months to November, which was also the best level for a decade. It was up from 3.2% in the three months to September and 2.7% in the three months to June. It had earlier dipped to June's rate from a previous peak of 2.9% in the three months to March. It is up from 2.1% in the three months to August 2017. Regular earnings growth edged back to 3.4% in November itself, after climbing to 3.5%

in October from 3.1% in September and 2.6% in April. Regular earnings growth in the private sector dipped to 3.4% in November after reaching a peak of 3.7% in October.

Despite the recent pick-up, earnings growth remains muted compared to the situation seen before the 2008/9 downturn. While we expect pay growth to retain its recent firmer tone, we are doubtful it will pick up much more. Indeed, the slight easing back in annual regular earnings growth in November itself fuels our suspicion that further acceleration could prove difficult.

This partly reflects a suspicion that still significant 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. Latest survey evidence suggests that while companies are having to offer higher starting salaries and, seemingly, also raise salaries for people switching jobs, they are still able to give only modest pay rises to existing staff amid a marked reluctance of many workers to change their jobs amid heightened economic uncertainties.

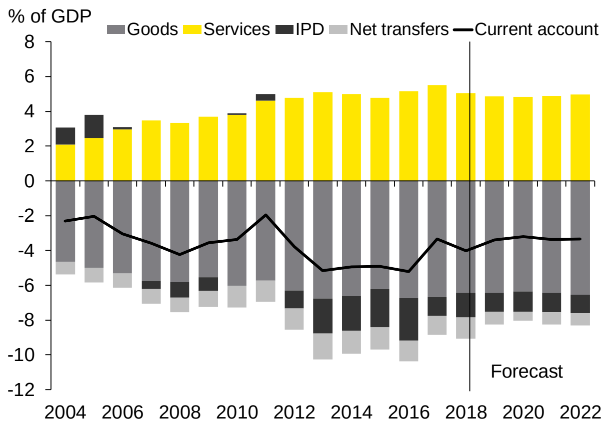
Consequently, we forecast earnings growth to average 3.5% over 2019 (on a National Accounts basis) and to remain around this level in 2020. While up from an average of 2.9% over 2018, it is still below the 4%–5% pace seen before the financial crisis.

9. Trade and the balance of payments

It looks like net trade was a modest drag on UK GDP growth in 2018. This would be in contrast to 2017 when net trade added 0.5ppts to GDP growth, one of the biggest gains from this source in the last 25 years. Real exports of goods and services grew 5.6% in 2017, the strongest performance for six years. Imports of goods and services rose by a lower rate of 3.5%.

But the factors which assisted with that healthy positive trade contribution in 2017 — robust global growth, particularly in the eurozone, and sterling's post-referendum weakness — became less favourable in 2018. In particular, eurozone growth slowed markedly in the second half of 2018. Meanwhile, having weakened noticeably from an average of 82.0 in 2017 to an average of 77.4 in 2017 (with a low of 76.6 in Q3 2017), sterling's trade-weighted index firmed modestly to average 78.5 in 2018. To put it another way, the 'sweet spot' enjoyed by UK exporters shrank.

UK: Current account



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

We estimate that net trade knocked 0.2ppts off UK GDP growth in 2018 as real exports of goods and services edged down by 0.1% while imports rose a modest 0.6%. Latest data shows that exports of goods and services rose 1.1% q/q in Q3 2018; however this followed falls of 1.4% q/q in Q2 and 1.1% q/q in Q1. Consequently, exports of goods and services were down 1.3% y/y in Q3. Meanwhile, imports of goods and services rose 0.8% q/q in Q3 after edging up 0.1% q/q in Q2 and dipping 0.2% q/q in Q1; imports were up 0.2% y/y in Q3. It should be borne in mind that the trade data has been influenced at times by movements in non-monetary gold.

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 global trade growth has slowed. This is likely to counter some help coming to UK exporters from the recent weakness in the pound — sterling briefly traded at a 20-month low of $1.2409 on 3 January and also hit a 16-month low of £0.9102/euro in early January. However, we suspect that sterling will make gains after the end of March on the assumption that the UK and EU ultimately agree a Brexit deal. Sterling's trade-weighted index is seen rising from an average of 78.5 in 2018 to 79.2 in 2019 and 82.7 in 2020. Consequently, we expect net trade to have a marginally negative impact on GDP growth in 2019 and to be essentially in balance in 2020.

The UK's weakened trade performance in 2018 has contributed to a renewed widening in the current account deficit after it narrowed markedly to a five-year low of £68.4 billion (3.3% of GDP) in 2017 from £102.8 billion (5.3% of GDP) in 2016.

We estimate that the current account deficit widened to £85.3 billion (4.0% of GDP) in 2018. Latest ONS data shows that the current account disappointingly deteriorated to a two-year high of £26.5 billion (4.9% of GDP) in Q3 2018 from £20.0 billion (3.8% of GDP) in Q2 and £17.8 billion (3.4% of GDP) in Q1. The increase in the deficit in Q3 was primarily due to increases in the trade deficit and, especially, in the shortfall of primary income as payments. This was largely due to increased profits made by overseas investors on their foreign direct investment in the UK.

The current account is expected to come back down modestly to £74.5 billion (3.4% of GDP) in 2019 and £72.5 billion (3.2% of GDP) in 2020. The trade deficit is expected to be modestly wider but the current account is expected to benefit from reduced net transfers. Additionally, the UK's overseas investment income should benefit from a still reasonable rate of economic expansion overseas. An expected modest firming of the pound later on in 2019 and in 2020 should boost the UK's overseas investment income when translated into sterling.

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