EY ITEM Club UK Winter forecast

January 2016

Building a better working world

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Foreword

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Weathering the storm...for now

With the new year economics headlines in the press being almost exclusively gloomy, I am pleasantly surprised to report that EY ITEM Club expects the UK economy to grow by 2.6% in 2016 and to continue with steady – albeit slightly slowing – economic growth for the next two years, followed by a modest acceleration in 2019 and 2020. This is actually a slightly more optimistic view than EY ITEM presented last time suggesting that the UK can weather the storm in global markets.

Consumers continuing to spend...

The consumer was the main driver of UK economic growth last year and EY ITEM expect this to be the case in 2016 as well. The recent falls in commodity prices, including oil, will ensure inflation remains low for even longer than previously forecast and with labour markets still strong, wage growth increasing, the abandonment of the tax credit reforms in the Autumn Statement and interest rates remaining at low levels, EY ITEM expect consumer spending to grow at 2.8% in 2016, very similar to the likely outturn for 2015.

However, 2016 is likely to be as good as it gets for consumer spending in this decade as increasing inflation, interest rate rises and welfare reform start to bite in later years with consumer spending growth decelerating to an average rate of around 2% annually from 2017 to 2020.

...and export prospects improving slightly...

Although global economic conditions remain challenging, key UK export markets such as the US and Europe have been growing and are forecast to continue to do so. The result has been improved export performance to these two markets. The value of exports to the US rose 34.7% in the three months to November 2015 compared to a year earlier and while export values to the EU fell, volumes were up 6%. This trend is expected to continue and to an extent offset challenging conditions in other markets.

... means businesses are expected to respond.

Businesses have already begun to react to higher demand with business investment reaching 10% of GDP in Q3 2015 for the first time since 2001 (allowing for changes in data classification). With favourable financial conditions (profitability, availability of funding and the cost of capital), continuing steady domestic growth and expansion in selected export markets, EY ITEM expects this trend to continue.

In addition, the introduction of the National Living Wage and accelerating wage growth in several sectors together with falling

Foreword

energy prices will increase the relative attractiveness of capital compared to employing people. This combination of higher demand and changing supply economics, points towards an increase in capital investment which will play a greater role in driving growth from 2016.

It is time to balance ambition…

The global economy remains dynamic and uncertain. Now is the ideal time to review existing plans and business models, giving priority to:

- **Geographic focus**: with the outlook for emerging markets remaining challenging, UK corporates should review their portfolios to ensure they are giving adequate focus to the improving economic prospects in the developed world (i.e. US and the EU).

- **Understanding the changing consumer landscape**: consumer spending is expected to remain strong but levels of income growth are likely to vary by segment. The National Living Wage will mainly benefit lower earners whereas mid-income employees may see technology eroding their bargaining power. Understanding the variations will be crucial and our February EY ITEM Club consumer spending special report will be a helpful resource.

- **Margins** are likely to come under increasing pressure with the introduction of the National Living Wage, increasing average earnings and an eventual interest rate rise. Businesses should review their business models and ensure their investment plans incorporate sufficient resources to drive productivity enhancing change.

- **UK regions**: The UK Government has embarked on a programme to devolve economic decision-making power to the UK regions. This will create new opportunities and our recent report on the UK region and city economic forecast is a good starting point for understanding these.

…with risk management.

While EY ITEM Club believe the UK is well placed to ride out the global storm, there are obvious risks to this view and hence a clear risk management plan should be high on the corporate agenda. Key areas to focus on are:

- **China**: the impact of a significant slowdown - which would impact both commodity and trade activity.

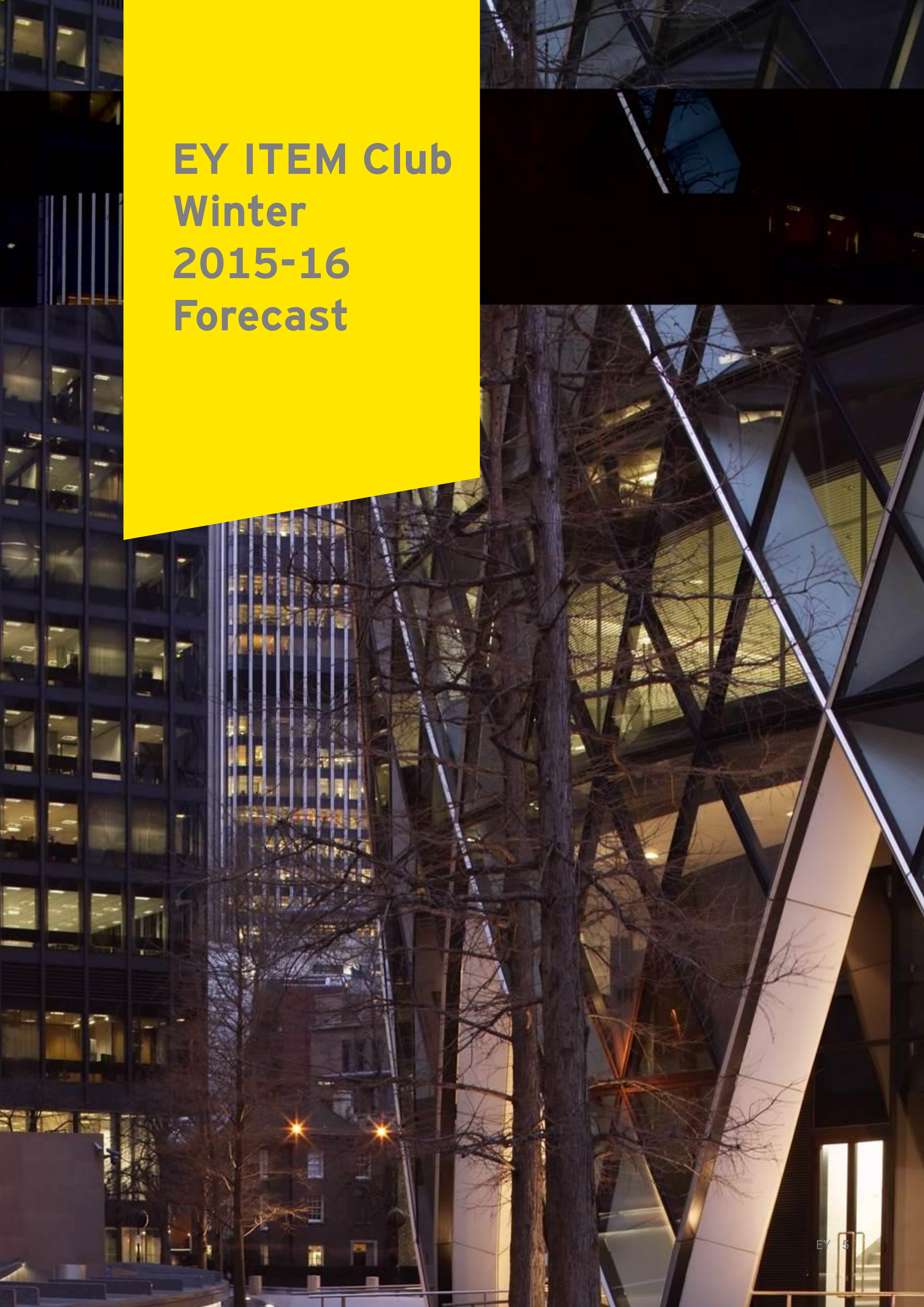
- **Geo-political risk**: if there was an unexpected spike in oil prices for example, this would impact net importers of oil, such as the US and the Eurozone, not as directly exposed to the China risk.

- **Currencies** are likely to remain hard to forecast in this complex global economy.

- **UK domestic activity** could slow and the Government could easily find its finances under strain.

- **Brexit** will loom ever larger in 2016

EY ITEM Club Winter 2015-16 Forecast



Highlights

- The New Year brought several stark reminders of the fragile global situation. Yet as we argued in October, the UK is relatively well placed to ride out these storms. We see growth picking up from a downwardly-revised 2.2% in 2015 to 2.6% this year, supported by low inflation and interest rates. The CPI is forecast to increase by just 0.7% and we do not expect the MPC to increase bank rate until November.

- The UK consumer had a welcome holiday from inflation and austerity in 2015, and given the recent plunge in oil and other commodity prices and the Chancellor's change of heart on working tax credits, we expect this to continue well into 2016. Last year, consumption lagged the increase in real incomes, but this year we expect consumption to increase by another 2.8%, just behind an increase in real incomes of 3%. Strength in the housing market should also support spending, increasing both housing transactions and investment.

- But every holiday must come to an end. Inflation and austerity will return in 2017, slowing the GDP growth rate to 2.3% and then to 2.2% in 2018. The changes to the welfare budget in the Autumn Statement and the new plans for departmental spending will add £6.2 billion to government borrowing in 2016-17. Yet the Chancellor's has stuck to his plan for a financial surplus in 2019-20. Taxes and levies on consumers and companies are going up and the roll-out of Universal Credit will claw back last autumn's concessions to low earners.

- Low inflation and interest rates are helping the Chancellor, but reflect the risky global outlook which may yet impact the UK and the fiscal figures. More realistic OBR revenue models also help, but leave a smaller cushion should this sort of risk materialise. There is surely no room left for another major fiscal give-away in this parliament.

- Uncertainty over the EU Referendum could hit business investment this year as firms wait to see the outcome. However, the momentum in the UK as well as US and European economies should be enough to underpin capital spending this year. Lower energy and higher labour costs (including pension auto-enrolment, the National Living Wage and next year's apprenticeship levy) also favour plant and machinery at the expense of labour. Companies are in a good position financially to expand capacity in this way.

- The revival of our traditional export markets has so far compensated for the fall in exports to Emerging Markets. In the 3 months to November, the value of UK exports to the US increased by 33%, which was more than enough to offset falls of exports to China of 37% and to Hong Kong of 25%. The revival of these markets is also steadily repairing the damage to our overseas investment income account which has which has been primarily responsible for the increase in the current deficit in recent years. This narrowed from a deficit of £11.2 billion in the final quarter of 2014 to £3.1 billion in the third quarter of 2015 and we expect further improvement over the period of the forecast.

Introduction

The New Year headlines, echoed by the Chancellor's speech in Cardiff, brought several timely reminders of the fragile global economic and geopolitical situation. Oil prices have fallen, but the spillover effects from the mounting tensions in the Middle East could be extensive, reaching as far as Europe. China's stock market jitters have revived worries about economic management and the rebalancing of the economy. Yet as we argued in October, the UK is relatively well placed to ride these global storms. Falling commodity prices provide a silver lining, benefitting consumers in the UK and other developed countries. Strength in our traditional export markets is compensating for the fall in exports to Emerging Markets.

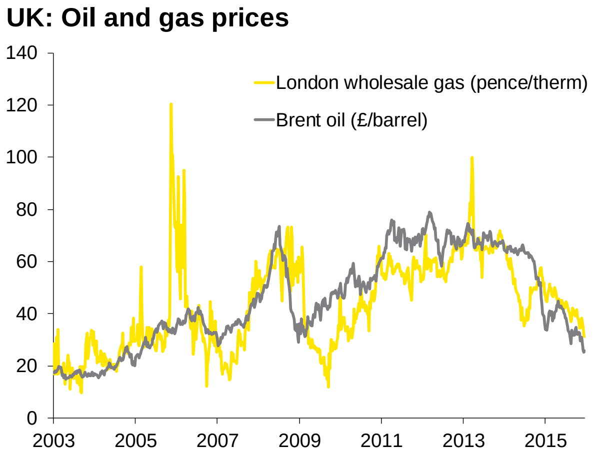
The second shoe has dropped in the oil market...

In October, we said that the consumer would be restrained by rising prices and taxes this spring, with hefty welfare cuts also due to kick in in April. However, after further falls in commodity prices and a surprisingly generous Autumn Statement from the Chancellor, it now seems clear that the holiday from inflation and austerity seems set to last longer than we thought. The forecast shows growth picking up from last year's downward-revised 2.2% to 2.6% in 2016, while the CPI increases by 0.7%. However, inflation and austerity will then bear down again on consumer spending power, slowing the growth rate to 2.3% next year and 2.2% in 2018.

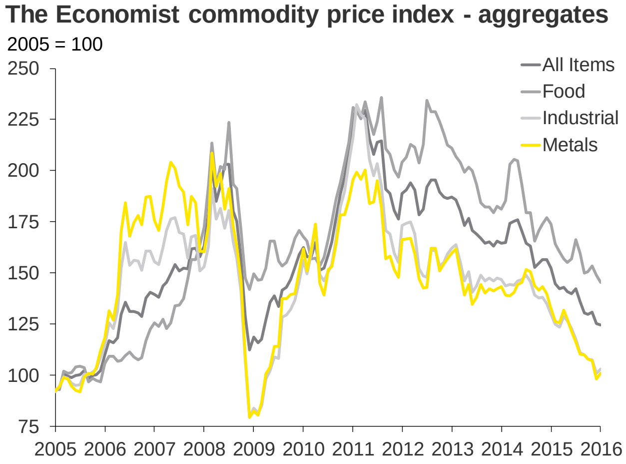
The recent collapse in the oil price, coming on the back of the persistent falls in industrial, food and other commodity prices, will now subdue the bounce-back in inflation next year, making it difficult for the MPC to follow the Fed in raising interest rates. Low inflation and interest rate projections provided yet another windfall for the Chancellor in the Autumn Statement. He was able to cancel the planned welfare cuts, helped by a beneficial change in the OBR's model of NICs, VAT and other tax receipts.

The recent plunge in oil prices clearly reflects the persistent excess supply in the market, which has been running at around three million barrels a day for most of last year. This excess has gone into storage and strategic stockpiles, stretching storage capacity and putting downward pressure on prices. Expectations that US shale producers would cut back in response to the collapse in prices last winter have been disappointed and now the US Congress has revoked the ban on oil exports, increasing the supply to world markets and narrowing the discount of West Texas to Brent and other international prices.

Russia and some other non-OPEC producers have responded to the price falls by increasing output, while the Saudis and other OPEC members are reluctant to cut back to make way for Iranian exports, following the lifting of sanctions next year. In December, the OPEC meeting ended in disarray, while the Paris agreement on climate change added to concerns about the long-term outlook for demand as emission rules get tighter. This time last year it was not clear whether the collapse in the oil price was a flash in the pan like it was in 2009, or the herald of a long period of low energy prices like the late 1980s. This weakness may not last as long it did then, but it is not likely to be reversed any time soon.

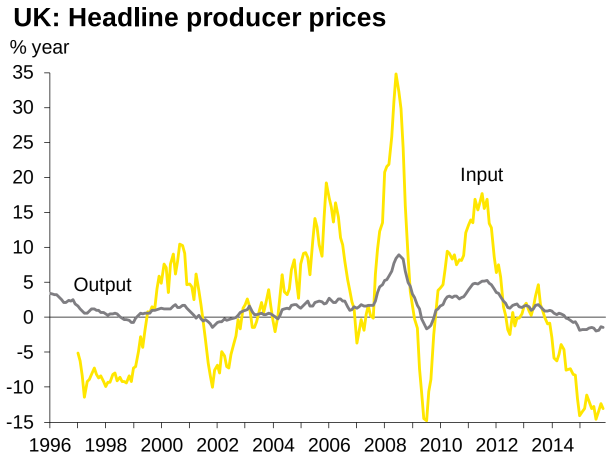


Source : Datastream

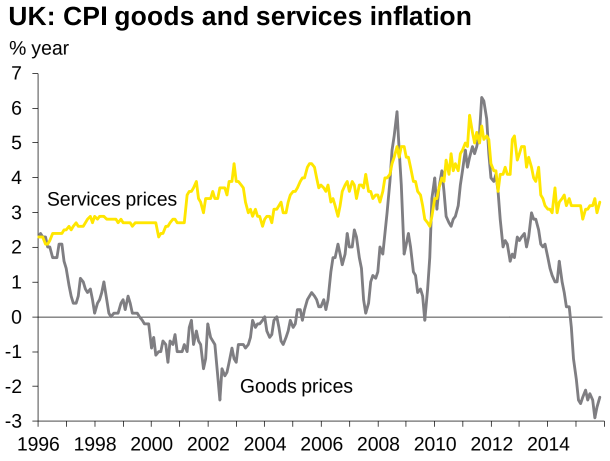


Source : The Economist

The oil price has fallen so far this year despite the recent increase in political tensions in the Middle-East. It is hard to see how it can recover without a more convincing expansion in the global economy, one which is strong enough to reduce the overhang of excess supply. The forecast assumes that the price of Brent will stay close to $36 in Q1 2016 before moving up gradually towards $50 by the end of 2017 and $70 by the end of 2020, in line with futures prices at the time of writing. As proved to be the case last year, extended weakness in the global economy would have the effect of putting back this recovery.



Source: Haver Analytics

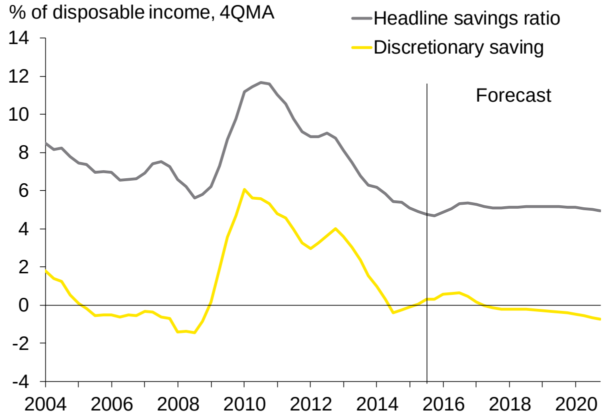


Source: Haver Analytics

Although the fall in agricultural and industrial commodity prices has been more gradual, it has also been very important in delivering this extended period of low inflation. Producer input costs fell by 15% last year, reducing output prices. The basket of goods used to calculate the CPI still makes up nearly half of the index and has been dragged down by food & energy prices, as well as the strength of sterling last year. These deflationary effects are still working through the pipeline and will keep inflation low even as the effects of the big price falls seen a year ago drop out of the calculation. We are now forecasting CPI inflation of just 0.4% in the first quarter of next year. It seems unlikely to reach the key 1% benchmark until the final quarter.

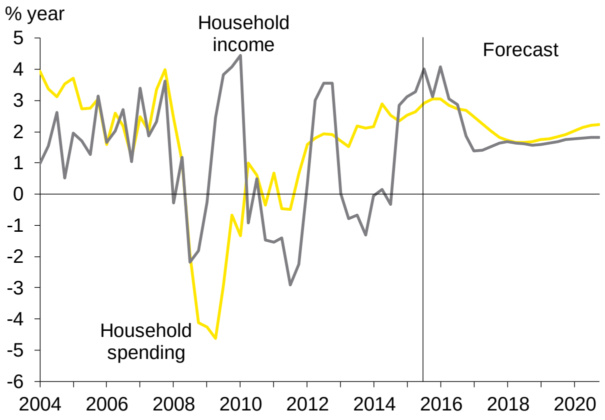
This spell of zero inflation came in the nick of time for the consumer-led recovery. It is now apparent that this had been financed entirely by a fall in the amount that people saved as they became more confident about their jobs. The latest figures indicate that there was practically no growth in real household disposable income between 2010 and 2014. Household consumption increased by 1.9% in 2013 and another 2.6% in 2014, without any overall improvement in real disposable income. The saving ratio fell back from 11.6% in 2010 to 8.8% in 2012 and then 5.4% in 2014. Discretionary saving, which removes the allowance for increasing household equity in pension funds, fell to minus 1% in 2014, a rate last seen just before the crisis in 2008. It seems very unlikely that the momentum in consumption would have been maintained in 2015 without a recovery in real incomes.

UK: Savings ratio



Source : EY ITEM Club

UK: Real household income and spending



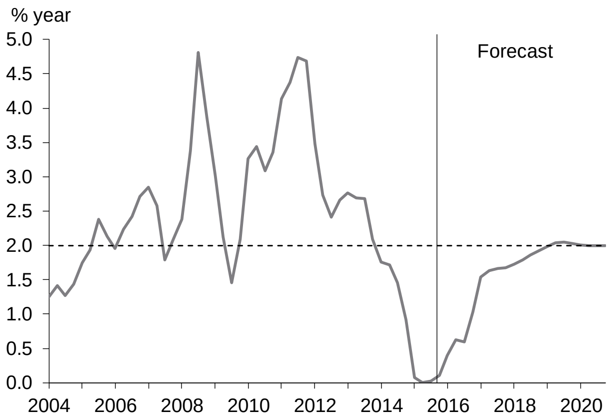
Source : EY ITEM Club

With employment continuing to grow and wage inflation picking up, real household disposable incomes increased by 4% in the year to the third quarter. Consumer spending was not as strong, growing by 3%. Thus it seems that households are using some of the increase in their real incomes to try to restore their financial position. They could also be taking time to adjust to the strength in real incomes, which should last well into this year.

...giving the consumer recovery another leg...

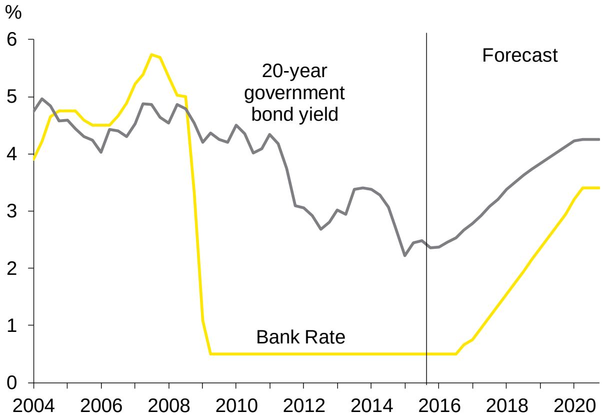
The growth in employment has strengthened in recent months, after slowing down earlier in the year. The employment rate reached a new record high in October and the LFS unemployment rate fell to 5.2%, the lowest since the beginning of 2008. However, the growth in headline average earnings slipped from 3% in September to 2.4% in October, a seven-month low. Growth in regular pay dropped from 2.4% to 2.0% and from 3.4% to 2.7% in the private sector.

UK: CPI inflation



Source : EY ITEM Club

UK: Bank Rate & 20-year bond yield



Source : EY ITEM Club

With the supply of labour remaining buoyant, driven by immigration, late retirement, welfare reform and other powerful factors, the demand for labour needs to be very strong to stop the market falling back into the dynamic of employment-rich and wage-weak expansion that characterised the early part of the recovery. The fall in inflation may be another factor. December's Bank of England's Agents' survey pointed to low inflation feeding into subdued pay claims, supporting a hypothesis raised by the MPC in the minutes of December's Committee meeting. If further evidence builds that this is the case, the case for delaying a rise in interest rates until well into 2016 will be indisputable. The risks of low inflation and low pay growth feeding off each other could add weight to the view previously expressed by the Bank of England's Chief Economist, Andrew Haldane, that a cut in interest rates is not completely out of the question.

…helped by the Chancellor's change of heart…

Nevertheless, those at the lower end of the pay scale will certainly see a big increase in their disposable incomes as the new National Living Wage (NLW) of £7.20 comes into effect this April. It is thought that 2¾ million workers that currently earn less than this will benefit directly, with another 2 million likely to benefit as employers attempt to preserve differentials. Moreover, these benefits will not now be offset by the reduction of tax credits that was announced in the July Budget. This is not so much a reprieve as a stay of execution, since working families will be treated less generously as they are moved on to Universal Credit over the next three years. Nevertheless, they will be supported by the continued increase in the NLW, which is likely to top £9 by 2020.

…on tax credits…

Employers will be looking for higher productivity to offset these pay increases. They will also need to finance the Chancellor's apprenticeship levy that comes into effect in 2017-18. This is in effect a payroll tax like National Insurance Contributions. Together with the cost of pension auto-enrolment, this could restrain wage inflation and help spur efficiency savings.

The changes to the welfare budget that the Chancellor announced in the Autumn Statement will cost him £3 billion in 2016-17 and together with the new plans for departmental spending will add £6.2 billion to government borrowing in that year. The OBR estimate that this relaxation will add 0.2% to GDP in 2016-17. Net benefits and taxes will nevertheless subtract over 1½% from household disposable incomes in that year, with further large deductions pencilled in for the later years of the parliament.

…but this leaves the public finances…

The Autumn Statement also saw the adoption of a more optimistic and transparent revenue modelling methodology by the OBR. While more realistic than the previous one, it is less cautious, leaving less leeway if the economy and tax receipts underwhelm. This, together with the prospect of low inflation & interest rates and the delay in reversing the programme of quantitative easing, allowed the Chancellor to maintain his ambition of a fiscal surplus by the turn of the decade.

However, these fiscal benefits clearly reflect the weakness in global markets, which has adverse implications for economic activity in the UK and in particular the balance of the economy. They leave the public finances vulnerable to a downturn in the economy or perhaps a loss of confidence in sterling associated with the upcoming Euro referendum. Moreover, any slippage in tax receipts or increase in spending due to a slowdown in the economy will have to be neutralised by discretionary fiscal action, because the new fiscal regime announced in the July Budget only allows the automatic stabilisers to work if growth drops below 1%. It is certainly hard to think that there will be room for another major U-turn on fiscal policy in this parliament.

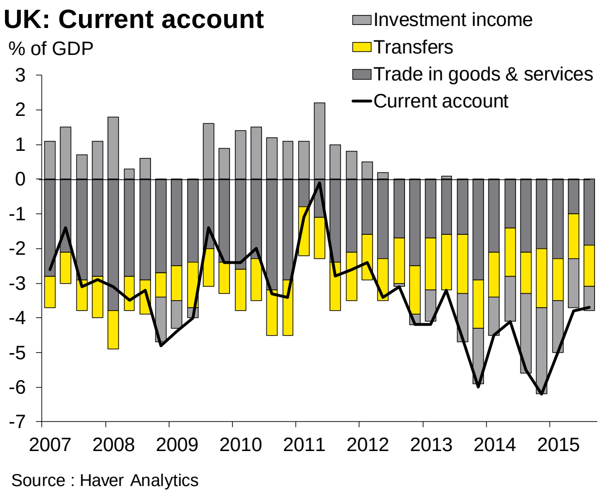
… more exposed to unfavourable shocks

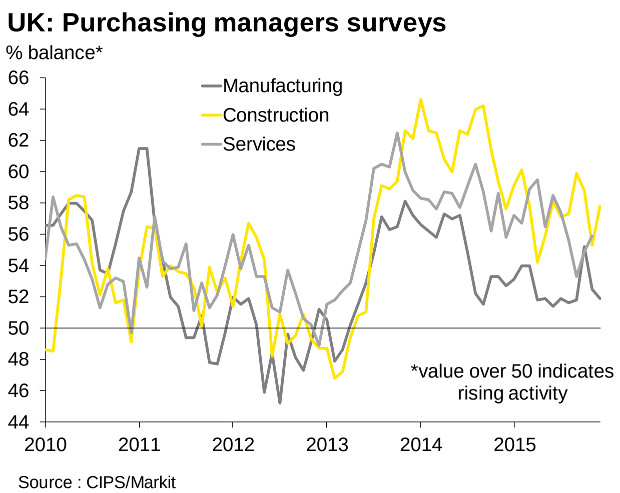
The extended delay in raising interest rates and unwinding QE could also leave the MPC short of ammunition to deal with an adverse shock. However, the MPC has steadfastly kept base rate at 0.5%, which was significantly higher than in the US and the Euro area. The new range of 0.25-0.5% announced by the US Fed at its December meeting is only now consistent with that stance. Moreover, last years' experience in the Eurozone showed that the zero lower bound is something of a fiction, with ECB rates falling to minus 0.2 and then to minus 0.3%. Central bank intervention rates are also negative in Switzerland, Sweden and Denmark.

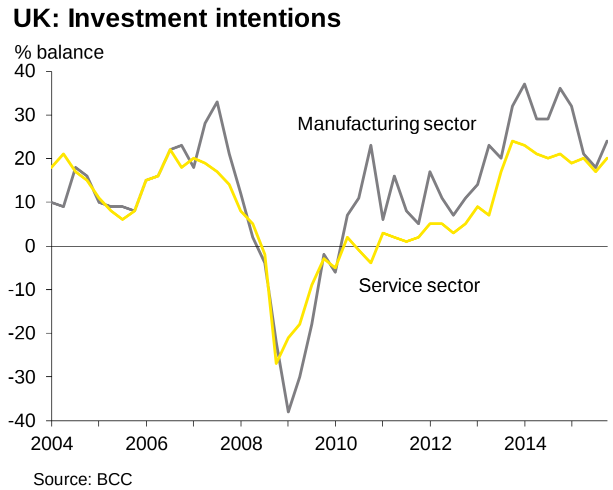
This year is likely to see the referendum on the UK's membership of the EU. This will be a momentous decision that will shape our relationship with Europe for at least a generation. The opinion polls currently indicate a majority in favour of continued membership, but with the outcome of the reform negotiations still unclear, the serious debate has yet to begin. As we saw in the case of the Scottish Referendum, the polls could narrow as people consider their position, providing jitters in the financial markets. There is also the concern that uncertainty over the outcome could hit business investment and consumer confidence.

The problem is that the imbalances in the economy leave us reliant upon overseas investor confidence to support our living standards, and this could be threatened by ruptures in trade and political arrangements. Having said that, this exposure is less than it appeared to be in the run up to last year's general election. Favourable revisions to the current account data for 2014 mean that this stands at 5.1% of GDP and is likely to have fallen to a more manageable 4.1% in 2015. Recent trade data have been extremely erratic but are consistent with a stable trend. Thankfully, the deterioration in the Emerging Markets has been offset by an improvement in the UK's traditional markets. In particular, the value of exports to the US in the three months to November was up by 34.7% on the same period a year earlier. The value of exports to the EU fell, but the volume increased by 6%.

However, the really good news last year came on the primary (basically investment) income account, which has been primarily responsible for the increase in the current deficit in recent years. This narrowed from a deficit of £11.2 billion in the final quarter of 2014 to £6.2 billion in the second quarter of 2015 and then to £3.1 billion in the third quarter. The respective figures for the current account deficit showed this narrowing from £28.5 billion to £17.5 billion in both the second and the third quarters. We continue to expect the primary income deficit to narrow as our key trading partners expand and our investments in their economies perform better.







The forecast

Recent surveys point to a significant easing of the pace of growth in the business sector. However, these largely pre-date the most recent fall in oil prices and the forecast shows growth picking up from last year's downward-revised 2.2% to 2.6% in 2016, supported by the growth in household real incomes.

Average earnings are assumed to increase by 3.4% this year, helped by the increase in the NLW in April, while the CPI increases by 0.7%. However, inflation and austerity will then bear down once more upon consumer spending power, slowing the GDP growth rate to 2.3% next year and 2.2% in 2018.

The EY ITEM Club forecast for the UK Economy, Winter 2015-16

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

	GDP	Domestic Demand	Consumer spending	Fixed investment	Exports	Imports
2014	2.9	3.2	2.5	7.3	1.2	2.4
2015	2.2	2.4	2.8	4.4	5.6	5.9
2016	2.6	2.6	2.8	5.1	4.0	4.3
2017	2.3	2.5	2.1	5.7	4.8	5.0
2018	2.2	2.1	1.7	5.1	4.6	4.0
2019	2.5	2.2	1.8	5.1	4.3	3.0
2020	2.7	2.5	2.2	4.9	4.0	3.3
	Net Govt Borrowing(*)	**Current account (% of GDP)**	**Average earnings**	**CPI**	**Bank Rate**	**Effective exchange rate**
2014	4.9	-5.1	1.4	1.5	0.5	87.0
2015	3.9	-4.1	2.8	0.1	0.5	91.5
2016	2.5	-3.7	3.4	0.7	0.5	89.0
2017	1.2	-3.4	3.4	1.6	1.1	86.4
2018	0.2	-3.0	3.4	1.8	1.9	84.3
2019	-0.5	-2.6	3.4	2.0	2.7	82.6
2020	-0.6	-2.4	3.4	2.0	3.4	81.5

(*) Fiscal years, as % of GDP

Source: EY ITEM Club

Low inflation will keep base rates on hold until the Autumn...

The MPC will no doubt continue to 'look through' these low inflation numbers and focus on the outlook for 2017 and beyond, which depends on wage inflation, productivity and the strength of the economy. However, it will be difficult to justify an increase in interest rates while inflation remains so low and we do not expect an increase in base rates until this moves above the 1% benchmark in the Autumn.

...and help support the consumer

The UK consumer is a major beneficiary of low inflation and interest rates. Disposable incomes increase by another 3.6% in 2016, a real terms increase of 3.0%. Real income grows at about half this rate over the remaining years of the forecast but remains supportive throughout. Consumer confidence remains high and the forecast sees real household consumption increasing by 2.8% in both 2015 and 2016, before slowing to 2.1% and 1.7% in 2017 and 2018 respectively. The saving ratio moves up from 4.7% in 2015 to 5.4% this year, before easing back to just over 5% in subsequent years. This is consistent with a household debt to income ratio that is broadly stable.

Housing market indicators suggest that the market ended the year on a high note, after pausing for breath over the summer. Mortgage approvals in November recovered to their highest level since August. Net mortgage lending of £3.9bn was the highest since April 2008 while consumer credit was up by 8.3% on the year. We expect the mortgage and housing markets to remain buoyant during the quarter as buy-to-let landlords anticipate the higher stamp duty that they will face in April. Combined with a phasing out of mortgage interest tax relief, this is then likely to slow the buy-to-let market. We see house prices increasing by 6.5% this year, before easing back to 4.7% in 2017 and 4.5% over the remaining years of the forecast. Housing investment recovers strongly, helped by recent government initiatives. After growing by just 2.1% in 2015 it increases by 6.9% this year and 8.3% in 2017.

Business confidence has weakened…

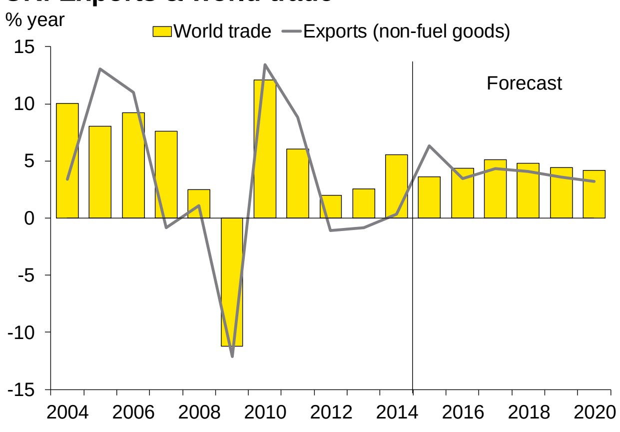
Recent surveys point to a significant easing of the pace of growth in the business sector. December's manufacturing PMI came in at 51.9 and was the lowest in three months. The services PMI slipped from 55.9 in November to 55.5 in December, which was a touch above the long-term average but was some way below the balances seen during the first half of 2015. The detail of December's services survey was broadly positive, with strong gains in new orders and employment at a pace which was in excess of historical norms, but slower than the previous month. Indeed, the survey as a whole gave a clear impression of a sector which has cooled from the rapid pace of growth seen in the early part of 2015 to something close to the long-term trend.

There is a significant risk that uncertainty over the Referendum on EU membership could hit business confidence this year. However, the momentum in the UK consumer market should be reflected in investment and the recovery in US and European markets should be enough to underpin capital spending this year despite these concerns. Financial conditions strongly favour investment and firms still need to make up for the lost years of the recession. The sustained fall in energy costs and increase in wages and salaries will also favour energy intensive plant and machinery at the expense of labour. The forecast suggest that business investment will grow by 5.8% this year, accelerating to 6.4% in 2017 and 6.6% in 2018. With housing investment also accelerating and public investment treated relatively favourably in the Autumn Statement, total investment grows by 5.1% in 2016 and 5.7% and 5.1% respectively in the next two years.

The balance of payments looks less alarming this year…

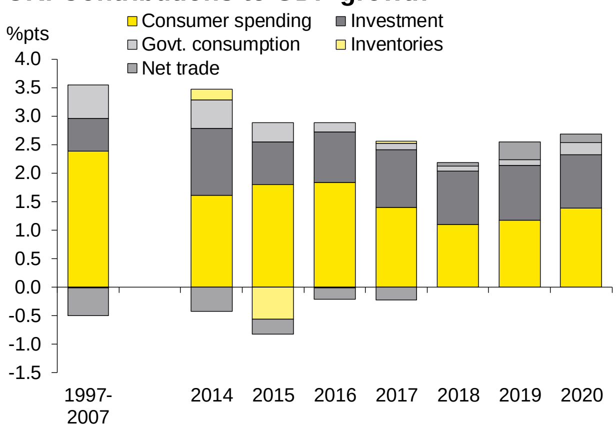
The ONS has revised its recent figures for import and export prices down and revised volumes up. These data support the idea that export volumes are growing nicely as our important US and European markets move ahead. Our calculations suggest that exports grew by 5.6% in 2015, while imports grew by 5.9%. Factoring in the improvement in interest, profits and dividends noted earlier, the current account deficit is likely to have fallen from 5.1% of GDP in 2014 to a more manageable 4.1% in 2015. However, the trade figures have been very erratic of late and it is hard to be sure about the true picture.

UK: Exports & world trade



Source : EY ITEM Club

UK: Contributions to GDP growth



Source : EY ITEM Club

This year, exports to the US should be helped by the fall in the pound against the dollar and the forecast shows an increase of 4.0% in export volumes, with import growth of 4.3%, supported by the continued strength of consumer spending. The forecast sees the visible trade deficit increasing marginally from £123.5 billion last year to £128.1 billion this year and £158.8 billion by 2020. However, the continued success of UK service exports means that this increase is outweighed by a steady improvement in the balance of trade in services, from £91.8 billion in 2015 to £142.6 billion in 2020. At the same time, the continued recovery in overseas asset markets should help eliminate the deficit on interest, profits and dividends. So on this forecast, the current account deficit falls from £76.7 billion (4.1% of GDP) this year to £54.6 billion (2.4%) in 2020.

…but there are plenty of other things to worry about

We have noted that the New Year brought several stark reminders of the fragile global situation. Weak world trade and commodity price trends have tilted the economy excessively in favour of domestic demand and although the risk of a loss of confidence by overseas investors is less acute, we still rely upon them to support a deficit of over 4% of GDP. This support is dependent upon the UK's reputation for political stability, which could be called into serious question if the forthcoming referendum on membership of the EU leads to Brexit. In the meantime, uncertainty over the outcome could hit business investment, as uncertainty about the future of the Euro appeared to do in 2012.

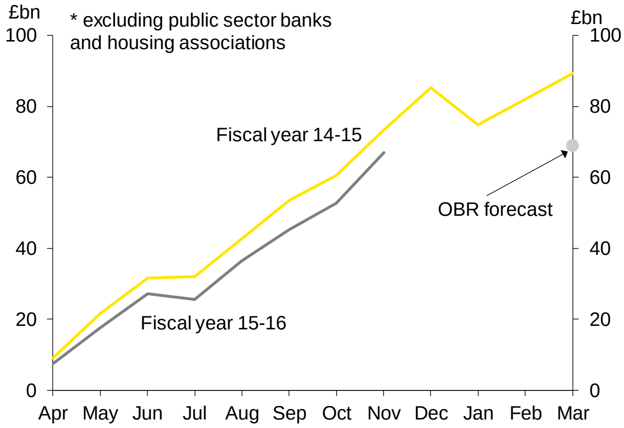
Forecast in detail

1. Fiscal policy

Recent months have seen the earlier improvement in the public sector finances seemingly stall. Public sector net borrowing excluding public sector banks came in at £14.2bn in November, 10% higher than a year earlier.

For the first eight months of 2015-16, borrowing of £66.9bn was 8.9% lower than the same period in 2014. While the lowest year-to-date deficit since 2008-09, this was close to chancellor's target of £69.5bn for the fiscal year as a whole.

UK: Public sector net borrowing* Cumulative position



Source: Haver Analytics

Weakness in receipts was the main culprit. Annual growth in central Government receipts slowed in the latter part of 2015 from a three-month average of 5.4% in July to 2.4% in November. A sharp slowdown in growth in cash GDP (which is highly correlated with movements in tax receipts) appears to be partly to blame.

A continuation of the pattern of the first eight months of 2015-16 over the remainder of the year would see borrowing come in around £10bn more than forecast by the OBR in November's Autumn Statement. But there are reasons to think that the pace of deficit reduction will pick up over the next few months. Policy decisions at previous fiscal events should boost self-assessment receipts in January and February, in-year spending cuts announced in June have still to be delivered in full and the cost of December 2014's stamp duty reforms should stop depressing receipts growth in the first quarter of 2016. So the OBR's forecast may be met.

Looking further ahead, the OBR presented more favourable medium-term prospects for the public finances in November. This partly arose from improvements to the modelling of NICs and VAT receipts. The Exchequer also gained from a cut in forecast spending on debt interest. This reflected an expectation of lower market interest rates and the Bank of England's announcement that it will not start to reverse quantitative easing until Bank Rate reaches 2%. Consequently, the Government can continue to finance more of its debt at Bank Rate, rather than gilt rates, for longer.

The Government took advantage of this improved outlook to announce a net fiscal loosening. Planned spending by departments was raised and smoothed compared to the plans set out in July's Budget. And the main tax credit cuts announced last July were reversed, at least in the short-term.

The OBR's forecast showed the Government on course to meet its fiscal mandate of an absolute budget surplus by 2019-20. In our view, this judgement looks reasonable, albeit with the risks to growth skewed to the downside there is a still a good chance that at some point the Chancellor will have to choose between missing his target or further austerity.

2. Monetary policy

The pattern of voting on the MPC has been set in aspic since August, with eight of the nine Committee members consistently voting to keep policy on hold. And there is little reason to expect any shift in views until towards the end of 2016.

The recent mood music of the MPC has been firmly dovish. For example, having signalled in 2015 that he expected to be considering raising interest rates around the turn of this year, Mark Carney has said that this timetable is likely to slip because cost pressures have increased more slowly than anticipated.

And other Committee members have highlighted the absence of sustained stronger wage growth as a reason to hold back on a rate hike.

Meanwhile, the economy's slowdown in both real and nominal terms is another reason to expect a further period of unchanged interest rates. Downward revisions to recent GDP growth estimates mean that the economy remains a long way from one of the Governor's criteria for considering a rate hike – sustained growth of above 0.6% per quarter.

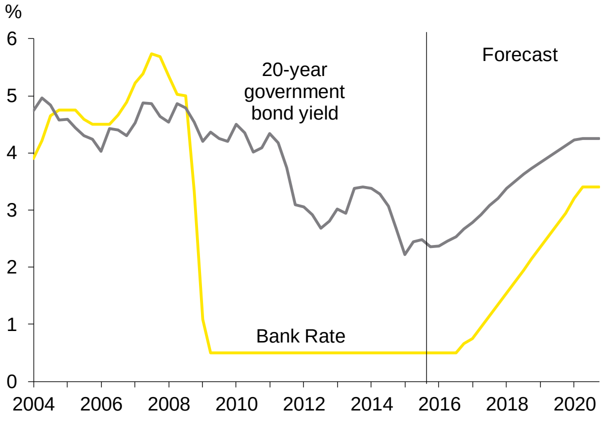
Granted, the more hawkish members of the MPC have argued in favour of a rate rise "sooner rather than later" in order to head off nascent inflationary pressures. But with the Bank's own forecast predicting CPI inflation will not breach 1% until the second half of the year, any urgent need for a pre-emptive monetary strike is lacking.

Consequently, we do not expect the first post-crisis hike in Bank Rate until the last quarter of 2016, with the risks, both domestic and global, suggesting that an even more prolonged period of record low rates is not out of the question.

As stressed by the MPC, subsequent rises in interest rates are set to be slow and gradual. As such, we expect Bank Rate to only reach 1% by the middle of 2017 and end next year at 1.5%.

Sterling has weakened of late following the US Fed's decision to raise rates and a less dovish than expected statement from the ECB. With the MPC unlikely to follow the Fed's action for some time, sterling looks likely to weaken further against the dollar, but with the ECB continuing to loosen policy via QE, sterling should recover a little ground against the common currency.

UK: Bank Rate & 20-year bond yield



Source : EY ITEM Club

3. Prices and wages

Inflation was becalmed in 2015, with the CPI measure averaging just 0.1%. Very low rates of inflation have largely been a function of falling prices in the food, petrol and energy categories, which cumulatively reduced CPI inflation by around 1ppt through 2015.

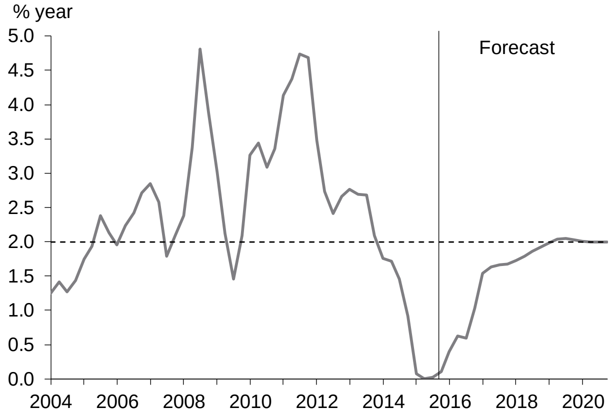
However, it is not just the more volatile components which have kept inflation subdued. Core inflation averaged only just above 1% in 2015, suggesting that underlying pressures have also been weak. Some of this weakness will be a reflection of the impact of cheaper oil on transportation costs, while the strength of the pound has also been a factor, particularly in terms of the impact on the prices of goods imported from the Eurozone. But it is also likely to reflect the large amount of spare capacity in the economy, which continues to weigh on pricing power.

However, it is likely that we have now passed the trough in inflation rates, if only due to strong base effects. The most severe falls in food, energy and, in particular, petrol prices came towards the end of 2014 and in early 2015 – petrol prices fell by 14% between October 2014 and February 2015 – and these are now starting to fall out of the year-on-year calculation. Having reduced CPI inflation by 1ppt in 2015, the cumulative contribution of food, petrol and energy prices is expected to moderate to -0.5ppt by mid-2016 before moving into positive territory by the end of the year.

This represents a slower easing of the downward pressures than we had forecast three months ago, reflecting the renewed fall in the oil price since then, from $50 per barrel at the start of October to around $35 now. Though we expect the oil price to gradually rise through 2016, petrol prices are likely to continue to fall on a year-on-year basis until the latter months of the year, meaning that they remain a drag on inflation. In addition, lower oil prices will maintain the disinflationary pressures coming along the supply chain.

Underlying inflationary pressures are also likely to remain muted. While we expect a steady recovery in earnings growth, it should be offset in part by an improvement in productivity. And the degree of spare capacity in the economy is unlikely to diminish quickly, preventing firms from doing much to improve their profit margins. Therefore, CPI inflation is forecast to average just 0.7% in 2016, requiring Mark Carney to write a further series of explanatory letters to the Chancellor. And beyond that inflation is likely to remain below the 2% target for a prolonged period, averaging 1.6% in 2017 and 1.8% in 2018.

UK: CPI inflation



Source : EY ITEM Club

RPI inflation will be higher over the forecast period, reflecting the so-called 'formula effect' (i.e. the different methods of aggregation between the RPI and CPI measures which place an upward bias on RPI), our expectation that house prices will rise more quickly than general prices and, from late 2016, the impact of interest rate hikes on mortgage interest payments.

4. Activity

Growth in 2015 is likely to have come in at a soft 2.2%, a disappointing performance in light of the boost to activity provided by cheap oil and 'noflation'. But this year the economy should see a modest pick-up, reflecting continued robust growth in consumer spending and some improvement in the international environment.

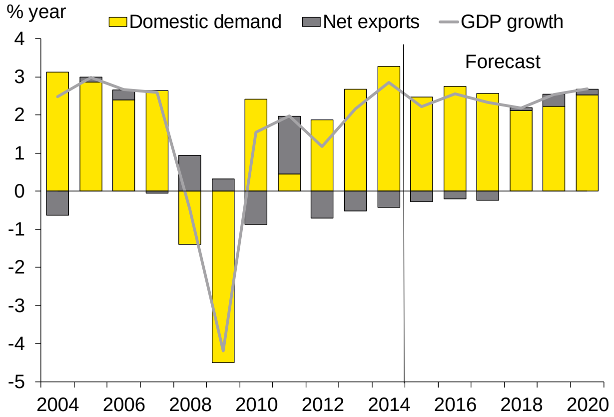
Q3's National Accounts revised down growth in Q2 from 0.7% to 0.5% and Q3's estimate from 0.5% to 0.4%. This left annual growth in Q3 at 2.1%, the weakest for two years. The expenditure breakdown showed a strong 0.9% gain in consumer spending and business investment up by 2.2%. But weakness in exports and strong import growth resulted in a sizeable drag from net trade.

A slowdown was particularly evident in growth in cash GDP, which eased from 5.4% in Q2 2014 to 2.5% in Q2 2015 and just 2.1% in the third quarter of last year. Only 2009 and a single quarter in 1958 have seen a weaker rate since records began in 1955.

Real GDP growth in 2016 should benefit from a number of tailwinds. Consumer spending should continue growing at a robust rate, thanks to the effect of a tighter labour market on earnings growth and April's introduction of the 'Living Wage'. Meanwhile, while inflation is set to rise, it will do so only slowly, and planned welfare cuts have been eased, at least in the short-term. And a healthy consumer picture should support continued growth in business investment, although uncertainty around a 'Brexit' referendum may see some weakening in sectors exposed to the EU market. Meanwhile, growth will enjoy a modest gain from the net fiscal loosening announced in last November's Autumn Statement.

Our forecasts show a gradual strengthening in demand from the US and Eurozone, a development which will be supported by the recent fall in sterling. So while net trade is unlikely to boost GDP this year, it should at least make less of a negative contribution. That said, the global outlook is particularly opaque at present and presents the biggest downside risk to our forecast.

UK: Contributions to GDP growth



Source : EY ITEM Club

Overall, we expect GDP to expand by 2.6% in 2016, an improvement on 2015's rate but broadly in line with the economy's long-run average.

5. Consumer demand

Consumer spending was the main driving force behind GDP growth last year, a trend we expect to continue in 2016. While household spending power will see some erosion from a rise in inflation, this should be offset by stronger pay growth.

The strength of consumer spending growth in Q3 (up by 0.9% q/q) tied in with a fall in the household saving ratio to 4.4% in Q3. This left the average ratio for the first three quarters of 2015 at 4.6%, lower than in any calendar year since records began. The rise in consumer spending was also consistent with strong growth in unsecured borrowing, which increased by 8.2% y/y in the three months to November, a nine-year high.

A positive interpretation is that on the back of the growing economy and falling unemployment, consumers are confident to borrow and spend. Indeed, annual growth in real household incomes of 4% in Q3 was the highest since 2010.

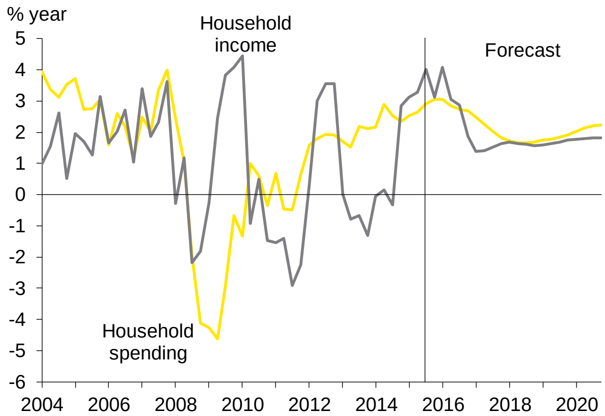
Looking forward, consumption should benefit from further rises in employment and a pick-up in pay growth, reflecting an ever-tighter labour market. While rising inflation will erode some of the gain in real incomes, the CPI measure is forecast to end 2016 at just 1%, still very modest by historical standards. Meanwhile, non-work incomes will benefit from delays to the welfare cuts.

Stronger household balance sheets should also support purchases. Total household debt amounted to 142.5% of incomes in Q3 2015 compared to 143.9% a year earlier. This ratio remains well down from its peak of 168.2% in 2007.

The likelihood that the Bank of England won't raise interest rates until towards the end of the year is another positive for the consumer. And UK households look to be in a better position to face an interest rate rise when it happens. The Bank of England's annual NMG survey of household finances showed 31% of mortgage holders said they would cut back spending or work longer hours if interest rates rose by two percentage points, down from 37% in 2014, and 44% in 2013.

Overall, there seems little reason why consumer spending growth this year can't match the 2.8% rise we expect 2015 to have yielded. This would be the second consecutive year to see consumption outpace the rise in overall GDP. However, the government's plan to reduce welfare spending by £12bn by the end of the parliament means that consumer prospects look weaker further out, with consumer spending growth forecast to slow to just 1.9% a year from 2017-19.

UK: Real household income and spending



Source : EY ITEM Club

6. Housing market

Housing market activity has continued to gradually pick up pace in recent months. Mortgage approvals for house purchases rose to 70,410 in November, only just short of August's eighteen-month high, while net mortgage lending of £3.9bn was the highest April 2008. The pickup in activity has been a function of the strong recovery in household incomes and continued low borrowing costs.

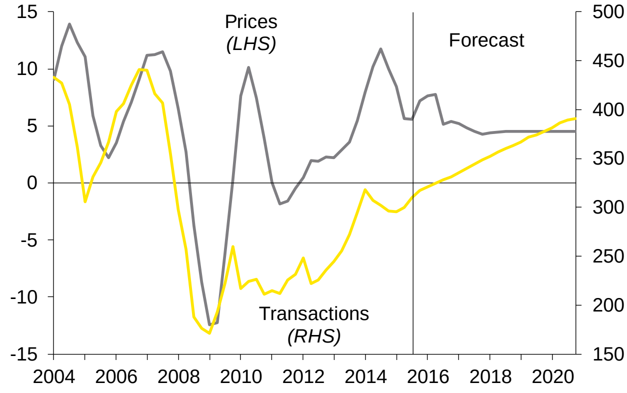
The data on house prices is harder to read but, by and large, it suggests that stronger activity has not yet had a marked effect on house price growth. Both the Nationwide and Halifax report that prices are rising by a little over 1% on a three-month-on-three month basis, which is broadly in line with nominal income growth, although the ONS series has been running at roughly twice that pace of late.

There have been some tentative signs of late that demand may be starting to level off. In particular, the balance for new buyer enquiries from the RICS survey has fallen for four successive months and is now signalling only modest increases in demand. However, with household incomes set to continue to grow strongly and interest rates likely to be on hold for some time yet, the chances of demand for housing falling back to any great extent look remote.

Furthermore, the RICS survey suggests that the number of new sellers has continued to shrink. And with levels of housebuilding remaining well short of what would be needed to satisfy demographic changes – let alone what would be required to compensate for the persistent shortfalls since the financial crisis – supply remains very constrained, particularly in London and parts of southern England.

This fundamental imbalance between supply and demand should ensure that house prices continue to rise. However, we do expect the growing unaffordability of property – the Halifax reported that the price-to-income ratio was 5.5 in November, the highest since early-2008 – to prevent an acceleration in price growth. Consequently, we expect house price inflation to ease from 6.7% in 2015 to 6.5% this year, before weaker household income growth causes a slowdown to 4.5% a year in 2017-18.

UK: House prices & transactions



Source : EY ITEM Club

7. Company sector

Growth in business investment significantly outpaced rises in overall GDP over the course of 2015. And a generally benign investment climate augers for another year where spending by firms punches above its weight in driving the expansion.

2015 saw firms spend increasing amounts on investment, with growth averaging 2.6% q/q over the first three quarters of the year. As a result, business investment reached 10% of GDP in Q3, the first time this threshold had been breached since 2001 (excluding data reclassifications).

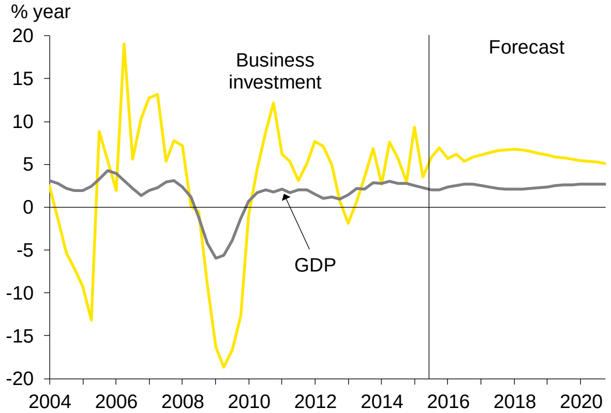
Our forecast of robust growth in consumer spending will support a healthy environment for business investment in 2016. Indeed, surveys of investment intentions remain firm and the CBI's Industrial Trends Survey points to traditional constraints on investment continuing to ease.

Moreover, the resources to fund more capital spending are there. The ratio of profits to GDP for the private non-financial corporate sector rose from 18.3% in Q2 2015 to 18.9% in Q3, a ratio exceeded only three times in the last 10 years. And the availability of external finance also looks more positive. The second half of 2015 saw lending by UK banks to companies turn consistently positive on an annual basis for the first time since 2009.

That said, firms in net terms are still in saving mode. UK corporations ran a financial surplus of 2.9% of GDP in Q3, the largest in more than three years. So companies are still displaying some risk aversion, which may be exacerbated by uncertainty around a 'Brexit' referendum.

Meanwhile, resources for investment will face competition from other demands. The National Living Wage and its upward effect on pay bills comes into effect this April, and, for large companies, the Apprenticeship Levy, due to be introduced in April 2017, represents another new

UK: Business investment & GDP



Source : EY ITEM Club

burden. Moreover, the recent further fall in oil prices may further undermine investment in the North Sea sector. That said, rising labour costs should encourage firms to invest in labour-saving technology. This, and the influence of other factors supporting spending by firms, leads us to forecast that business investment will grow by 5.8% in 2016, followed by 6.4% next year.

8. Labour market

The UK jobs market has aroused a sense of déjà vu in recent months with a (relative) comeback of the 'jobs-rich/pay-poor' trend that was in evidence for much of the period since 2010. But while the average worker may not be enjoying as rapid growth in earnings as some expected, the scope for unemployment to continue falling without cost pressures taking off is looking increasingly solid.

Having been broadly unchanged over the first half of 2015, the LFS unemployment rate embarked on a renewed decline in the second half of the year. As of the three months to October, the rate stood at 5.2%, the lowest since early-2008.

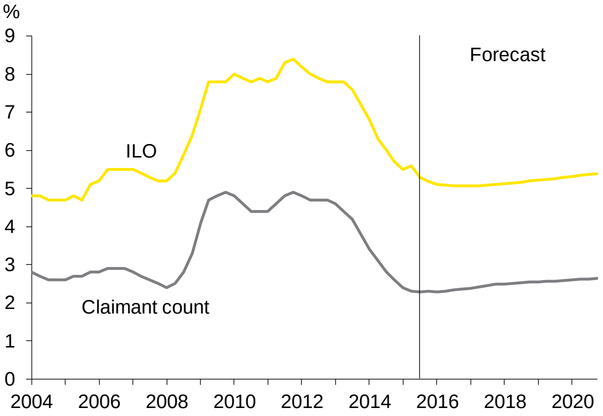
Meanwhile, the employment rate reached a record high of 73.9% in the same period. But pay growth has not accelerated in response to a tightening labour market. In fact headline (three-month average) pay growth fell to 2.4% in the year to October, down from 3% in September. This was the slowest pace since February 2014. So the UK's unemployment/inflation trade-off is looking increasingly favourable.

Stronger productivity also points to a structurally healthy labour market. Output per hour rose by a quarterly 0.5% in Q3 after a gain of 0.8% in Q2. This left the annual rate at 1.3%. While still short of the pre-crisis average (2% from 1994-2007) recent productivity growth has been well above the pace of recent years – growth in output per hour averaged 0.1% from 2009 to 2014. So there is good cause to believe that at least some of the previous weakness in productivity was cyclical and is now in the process of being corrected.

Higher productivity will give firms the resources to pay more. Wage growth will also be spurred by the introduction of the 'Living Wage' in April. But if the cost of the Apprenticeship Levy, which will come into effect in April 2017, is passed on to workers in the form of slower wage growth, something the OBR expects, the effect of the Living Wage on the national pay bill will be largely mitigated.

Overall, the UK jobs market look like continuing in a "sweet spot" of rising employment, pay and productivity. Given the extent of the previous fall in joblessness, the LFS rate is likely to see only a modest further decline to around 5.1% by the end of 2016.

UK: Unemployment



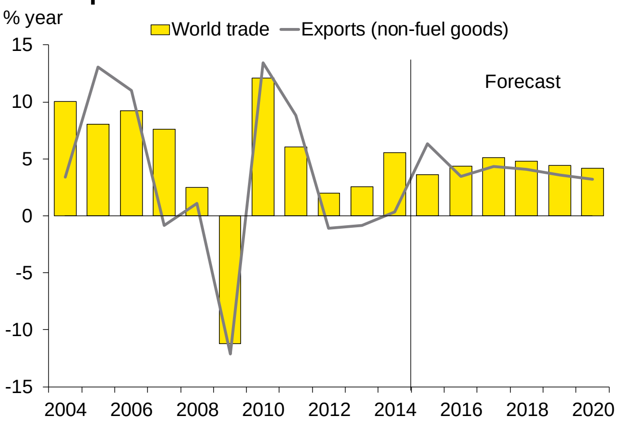
Source : EY ITEM Club

9. Trade and the Balance of Payments

The trade data have been exceptionally volatile over the past couple of years, with the six quarters to Q3 2015 having seen net trade make large, alternating, positive and negative contributions to GDP growth.

Evidence from the CIPS and CBI surveys suggests that exporters struggled for most of 2015 in the face of the strong pound and subdued demand from the Eurozone, although there were some tentative signs that this was beginning to turn towards the end of the year. Our forecasts assume that both the US and Eurozone economies strengthen over the coming two years and we expect the pound to stabilise on a trade-weighted basis. These factors should offer greater support to UK exports but, with consumer demand likely to remain reasonably firm and underpinning sustained growth in imports, we do not expect net trade to make any meaningful contribution to GDP growth in the near-term.

UK: Exports & world trade



Source : EY ITEM Club

The poor performance of UK investments abroad has been the key factor behind the widening of the current account deficit since the financial crisis. However, this situation began to turn around during 2015 and, with our key trading partners forecast to enjoy stronger economic growth over the coming years, the performance of UK investments abroad should continue to improve. As such, we expect the primary income balance to move back into surplus, which should enable a gradual narrowing of the current account deficit from a record high of 5.1% of GDP in 2014 to 3.7% this year and, ultimately, 2.4% by 2020.

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