EY ITEM Club Spring forecast

Will the global economy help pave the way to Brexit?

April 2017

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Foreword

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Look beyond the headlines...

The EY ITEM Club Spring forecast for the UK economy shows GDP growth of 1.8% this year. At first glance, this forecast, which is in line with last year's out-turn, seems to suggest that it is steady as it goes for the UK.

There was also a muted reaction to the UK's decision to invoke Article 50, giving notice of our intention to leave the EU. Despite the intense debate in the run up to the formal move, markets had little reaction.

...because the UK economy is changing...

The overall mood suggests that there is no urgent need for businesses to act as there is no immediate pressure to change course. However, the change in the UK economy that we highlighted in the EY ITEM Club Winter forecast is becoming clearer. The similar headline growth rate for 2016 and 2017 masks a shift in the balance of demand associated with the fall in the exchange rate that accompanied the result of last year's referendum. The UK economy is already adjusting to prepare for life outside the EU: as a result, the domestic outlook is weakening while export growth is strengthening.

It is not just the balance of the economy that is changing. The forecast sees overall growth gradually slow during the course of this year. This loss of momentum continues, meaning that both 2018 and 2019 are looking weaker, with GDP growth forecasts of 1.2% and 1.5% respectively.

...with slowing domestic demand...

The retail sales figures suggest that, as predicted in the recent EY ITEM Club special report, consumer spending is now slowing down as inflation and other headwinds sap spending power. The rise in retail sales volumes in February was the first increase since last October, but on a three-month-on-three-month basis, sales were down by 1.4%, the weakest performance since March 2010. As the EY ITEM Club notes, absent an unprecedented rise in sales in March, the first quarter of this year will deliver the first quarterly retail contraction since 2013.

...but faster global growth...

There has been more positive news in recent months from all of the major economies of China, the USA and the Eurozone:

- Back in 2015, China was at the centre of global concerns, with worries that a financial crisis would spill over into the other emerging market economies and hit the main engine of world trade. Although worries about China persist, the authorities seem to have a grip on the situation and the commodity markets and emerging market economies have been recovering.

- The financial markets welcomed the new US administration, with the stock market up to new highs and the 10 year bond yield up nearly 70 basis points before falling back. This ‘Trump bump’ has been echoed in consumer and business – especially small business – confidence.

- Economic activity has picked up in the Eurozone, inflation has recovered somewhat and the recent forward looking indicators were positive. It appears that the bloc could record its strongest GDP growth in 2017 since the Eurozone crisis.

As a result, world industrial production is growing at its fastest pace in seven years, and the surveys suggest that this pace will be sustained well into this year. Moreover, there is positive momentum in many emerging markets as commodity prices have recovered. The overall picture is for stronger global growth than we have seen in the last couple of years.

…means businesses need to review their plans now…

As previously noted, the UK economy has performed better since the referendum on EU membership than many economists forecast. This, together with uncertainty over the specifics of the upcoming negotiations between the UK and the 27 other remaining members of the European Union, has in my view, created a "wait and see" mind-set among businesses.

This cautious approach was justified given the uncertainty about the likely shape of Brexit. However, as we can now see the shape of the UK economy changing, the decision to leave the EU is already having an impact and hence waiting is no longer the best option. The trends are becoming clearer and there is a clear need to evaluate the balance of resources between domestic and external activities.

…shoring up domestic activities…

It is understandably challenging to generate support for capital investment in a slowing domestic market, but the changing economy means action is needed. European immigrants have provided much of the extra labour employed by UK businesses in recent years, but many are already going home as a response to the referendum vote and the subsequent devaluation of the pound. This could prove to be a major headache for employers over the next few years, underlining the need for more investment in education, skills and training. Investment in robots and other labour saving machinery could also help in dealing with this problem.

…moving to exploit emerging opportunities…

The global outlook is improving and the UK Government has made clear its desire to make the UK more successful in the world economy. This means that investment will be needed both to build new export capacity but also to rebuild the domestic supply chain. There are always risks in internationally oriented investment but with faster global growth and a strong desire by the Government for the UK to sign new trade deals, it is important to start analysing the opportunities now.

…and ensuring Government plays its part.

Investment in capacity and skills is clearly going to be critical if the UK is to succeed in a competitive global market. Business has a key role to play here, but so does the Government. Infrastructure can help unlock investment and skills, and hence the industrial strategy is key to ensuring an integrated approach to position the UK for life after Brexit. Business must work with the public sector to identify the priority actions and the ways in which these can generate economic benefits.

Highlights

- The forecast foresees GDP growth of 1.8% this year, in line with last year's outturn. However, this disguises a shift in the balance of demand associated with the fall in the exchange rate that accompanied the result of last year's referendum and means that the economy is already adjusting to life outside the EU. Growth also slows during the course of this year, leaving 2018 and 2019 looking weaker at 1.2% and 1.5% respectively.

- Last year, consumption effectively provided all of the growth in demand, with overseas trade subtracting 0.4% from growth. But with the savings ratio at a record low, this year sees a major slowdown in consumption as inflation bites into spending power, while net trade is forecast to add to GDP in all of the years of this forecast.

- This adjustment is being helped by a timely revival in our overseas markets. World trade and industrial output are growing faster than at any time since 2010, when they bounced back from the recession. Economic data have surprised on the upside for a change, in the US and the Eurozone as well as the UK. This revival is partly a lagged response to the collapse in commodity prices in 2015, while their recent recovery has pushed inflation back close to target almost everywhere, easing worries about deflation, especially in the Eurozone.

- However, the global outlook remains at risk to political developments. In the US, the 'Trump bump' in the financial markets has been followed by another increase in consumer and business confidence. Consumer confidence is stronger now than at any time since the dot-com boom in the year 2000. However, as president, Donald Trump is facing political challenges in delivering on some of his campaign promises, which makes the likelihood, timing and magnitude of US policy initiatives very uncertain. These initiatives could greatly help or hinder the UK's adjustment to life outside the EU.

- UK exporters currently enjoy the benefits of Single Market membership as well as the devaluation and the revival in the world economy. We are assuming that they will be trading under WTO rules in two years' time, although it is possible that the Government will be able to negotiate more favourable transition arrangements, perhaps followed by free trade agreements. These arrangements would make the adjustment smoother than the WTO option and provide some upside potential.

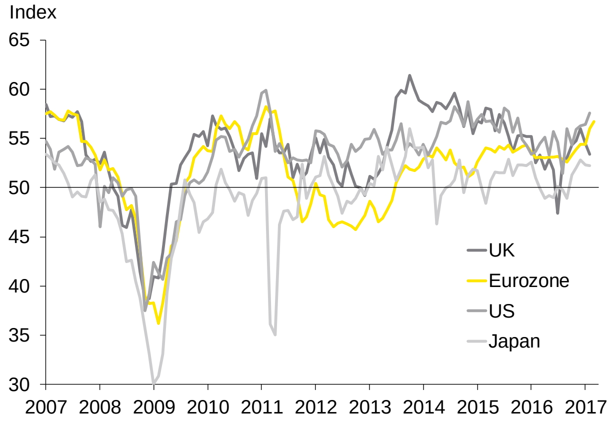
- Either way, investment in new export capacity and the UK supply chain is urgently needed to help businesses to adjust to leaving the EU and to help the economy to rebalance. Moreover, European immigrants have provided much of the extra labour employed by UK business in recent years, making skilled labour shortages a thing of the past. There have been anecdotal reports that some may have already left the UK, potentially leaving gaps in UK production facilities, underlining the pressing need for more investment in education, skills and labour saving machinery. However, firms may not have the confidence to invest until they see the shape of the new trading and immigration arrangements. The forecast sees investment falling this year and again in 2018, depressing demand and longer-term economic performance.

Introduction

The forecast foresees GDP growth of 1.8% this year, in line with last year's outturn. However, this disguises a shift in the balance of demand associated with the fall in the exchange rate that followed the result of last year's referendum. Last year, consumption provided all of the growth in demand, with overseas trade subtracting 0.4% from growth. This year sees a major slowdown in consumption as inflation bites into spending power, while net trade is forecast to add 0.2% to GDP, adding another 0.6% in 2018. Growth also slows during the course of this year, leaving 2018 and 2019 looking weaker at 1.2% and 1.5%.

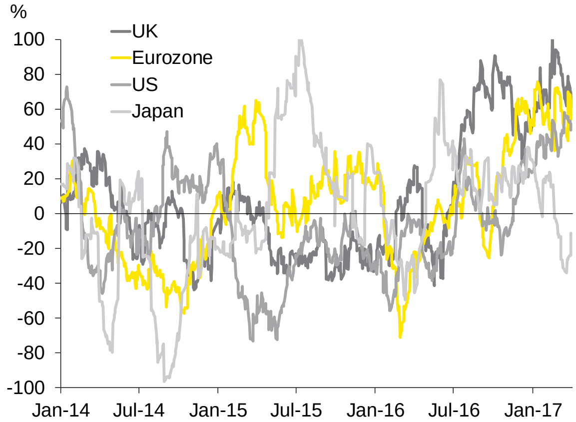
This adjustment is helped by a revival in our overseas markets. World trade and industrial output are growing faster than at any time since 2010 when they bounced back from the recession. Economic data have surprised on the upside for a change, in the US and the Eurozone as well as the UK. It looks like global policymakers will at last escape the zero lower bound on interest rates. The US Fed has already hiked its policy rates three times, with another two hikes pencilled in for later this year. In the Eurozone, the debate over the ECB's exit strategy has begun in earnest. With so many extraordinary measures in place, how long can the ECB risk keeping the pedal to the metal?

World: Composite PMIs



Source : EY ITEM Club/Markit

Citigroup Economic Surprise Index



Source : Haver Analytics

The revival in the global economy bodes well for the UK's Brexit prospects, which hinge critically on a rebalancing from consumption towards exports following the fall in the pound. Unlike 2008, the last time the pound had a big fall, we are now selling into buoyant markets. The growth in world trade which has been in the doldrums for years, is now stronger than at any time since the initial bounce-back from the recession in 2010. However, this recovery remains hostage to political events in the US and Europe. This report begins with an assessment of the durability of the global revival in the face of these political risks.

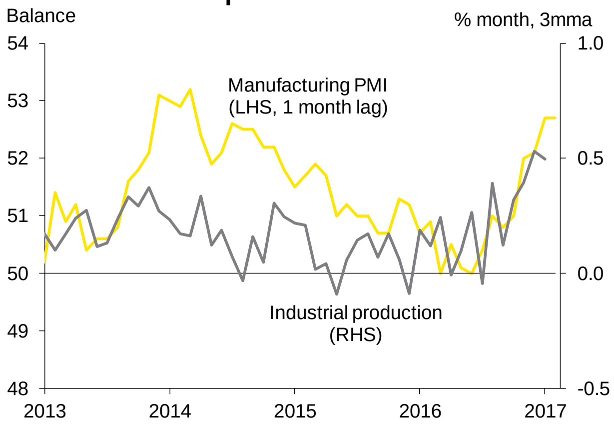
Goldilocks has revived global industry...

The recent revival in industrial output has been particularly marked, and has been clearly echoed in UK manufacturing output. Manufacturing activity accelerated dramatically across many large economies towards the end of last year, confirming earlier signals from survey-based indicators. World industrial production is growing at its fastest pace in seven years, and the surveys suggest that this pace will be sustained well into this year. This revival is due in large part to the collapse in energy and other industrial input prices that we saw in 2015. This also heightened fears of deflation, particularly in the Euro area, which early that year moved into an expansionary monetary stance that was extraordinary even by Anglo-Saxon standards.

...and pushed inflation back to target in most countries

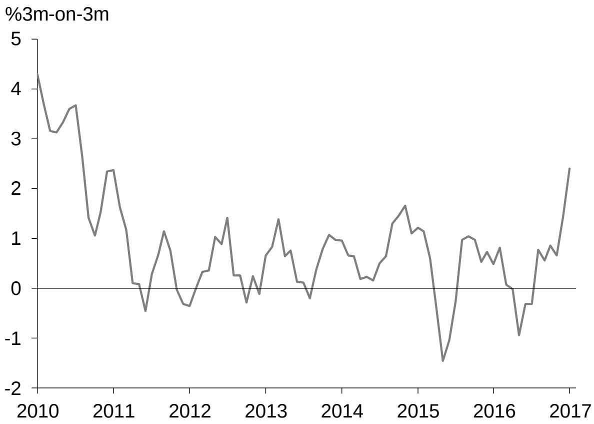
Back in 2015, China was at the centre of global concerns, with worries that a financial crisis would spill over into the other emerging market economies and hit the main engine of world trade. Now, the boot is on the other foot. Although worries about China persist, the authorities seem to have a grip on the situation and the commodity markets and emerging market economies have been recovering. Indeed, the revival in energy and commodity prices has pushed inflation back up towards target in many developed countries. In the US, the rate of inflation reached 2.7% in February, the highest level since 2012.

World: Industrial production and PMI



Source : EY ITEM Club/Haver Analytics

World: Trade volumes

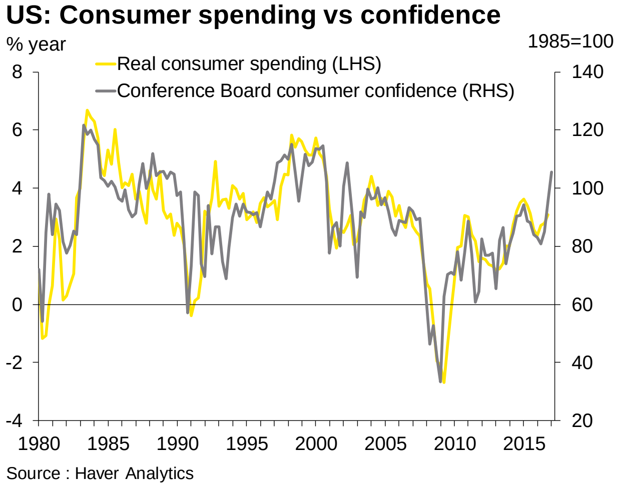


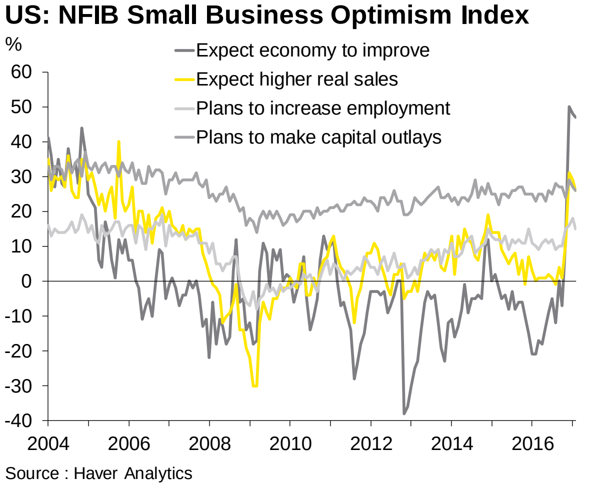
Source : CPB World Trade Monitor

Deflationary fears in the Eurozone have vanished as the weak euro and rising energy prices have pushed inflation rates up to numbers not seen for five years. However, the global landscape remains very uncertain, with worries about the effects of major US economic policy shifts and populism in the Eurozone coming to the fore.

But could political developments in the US upset the applecart?

The financial markets welcomed the new US administration, with the stock market up by nearly 10% to new highs and the 10 year bond yield up nearly 70 basis points, before falling back. This ‘Trump bump’ has been echoed in consumer confidence and business expectations. However, President Trump is facing political challenges in delivering on some of his campaign promises, such as garnering enough votes in congress to replace the Obama Affordable Care Act. This could leave the administration short of much needed cash for other initiatives and makes the likelihood, timing and magnitude of US policy initiatives even more uncertain. Depending on the outcome, both the upside potential and downside risk for the US and world economies could be very significant, either helping or hindering the Brexit adjustment in a big way.

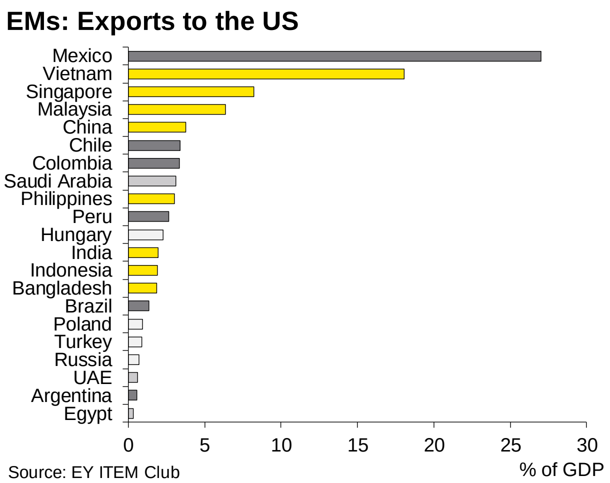


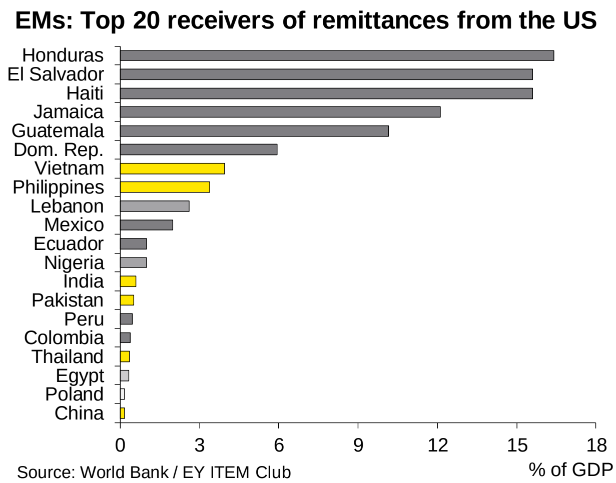


On the upside, we could be looking at as much as $2 trillion of tax cuts, including a favourable tax rate for repatriated foreign profits. Tax reform is long overdue and some progress still seems likely here. An increase in infrastructure investment may also be warranted but, with the Republican Congress worried about the Federal Debt, this would likely have to be offset by cuts in spending elsewhere. Moreover, any boost to the US economy will come late in the economic cycle, when inflation and interest rates are already increasing, reducing the net benefit to the US and world economies. A stronger dollar would also put pressure on dollar borrowers, particularly those in the emerging markets.

Deregulation is another area where the White House and Congress could find a common cause, with parallels being drawn with the Reagan presidency of the 1980s. Bank stocks have already moved up strongly on the prospect of the reform of the Dodd-Frank legislation. However academic studies suggest that the US is one of the lightest regulated economies in the world, and that the scope for reducing red tape is much less than in the 1980s.

The big worry on the downside is over US trade policy, where the White House has greater freedom of action. Campaign promises of 45% tariffs on Chinese and 35% on Mexican imports seem to have been replaced by pledges to renegotiate agreements and to impose tariffs on a limited and targeted basis. Even so, the potential risk to international trade remains a concern. Campaign promises to reduce immigration and increase repatriation of illegal immigrants could also slow US productive potential. Caribbean and Latin American countries could also suffer a serious loss of overseas remittances on this scenario.





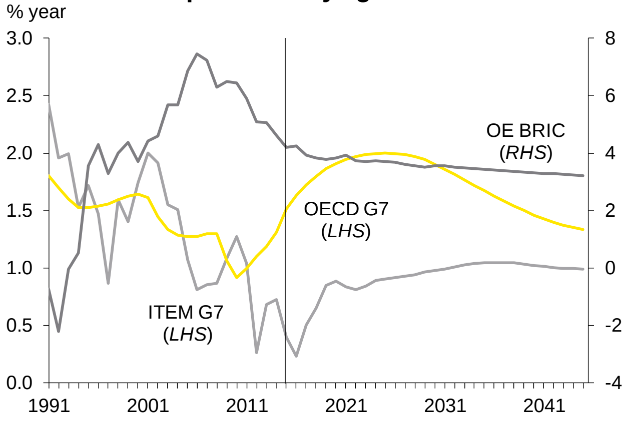
Colour code: Dark grey: LatAm and Caribbean; Yellow: Emerging Asia; Mid-grey: MENA; Light grey: Eastern Europe

Could Brexit and Trump be followed by other populist victories in the French presidential election and elsewhere? We are less concerned about the potential impact of this on the UK. Both campaigns saw promises of fiscal largesse, which other populist leaders are unlikely to be able to match because of institutional barriers or lack of fiscal space. The difficulty that UK and US politicians are now having in delivering on campaign promises may cause other electorates to be more sceptical about such pledges.

US interest rates have escaped the lower bound...

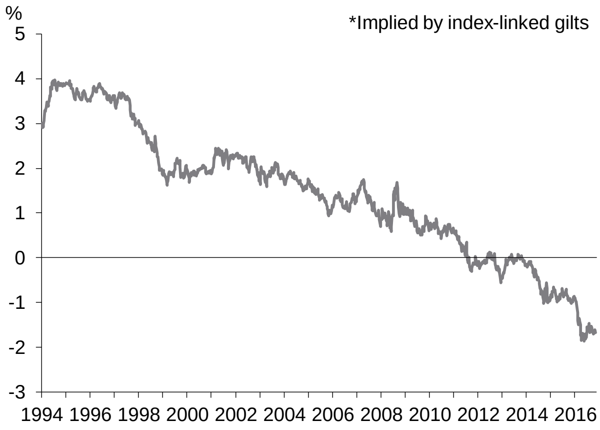
So have we seen the last of the zero lower bound on interest rates? Looking at the list of factors that lead us into this gives some cause for optimism. The recapitalisation and reform of US and UK banks has hopefully made the financial system more resilient. The retrenchment made by US and UK households since the financial crisis has reduced debt/income ratios, although it has been offset by a build-up of government debt and has done nothing to reduce the world savings glut, quite the opposite.

World: labour productivity* growth



Source : EY ITEM Club/Haver Analytics * Potential GDP/employment

UK: Real interest rates*



Source: Datastream

Moreover, despite the increasing use of robots and other AI technologies, there has been little increase in investment. Productivity growth has fallen almost everywhere since the crisis. Investment is remarkably weak when seen against the background of strong profitability, a highly-valued stock market and a low cost of capital. Recent research at the Bank of England suggests that the equilibrium real interest rate necessary to sustain investment and growth has fallen well below the levels seen before the financial crisis, leaving the advanced economies prone to deflation. On this view, we may not have seen the last of the zero lower bound.

...but may yet return

It seems that UK policy rates will need to remain on the floor for another year or more to help with the adjustments implied by Brexit. As in the case of the US, the major political uncertainties concern the future of trade relationships and immigration. However, the fall in the exchange rate means that the UK is already adjusting to life outside the EU.

The devaluation means that the UK is already adjusting to Brexit...

Recent data suggest that the combination of sterling's devaluation and the revival in world markets may at last have begun to boost UK manufacturing and exports. Manufacturing production put in a good performance in the final quarter of last year, and although it fell back in January, it was still up 1.9% on the year, with strong performances by pharmaceuticals and transport equipment. The monthly trade figures have been flattered by movements in gold and other erratic items, but excluding these, the balance of trade in goods and services improved modestly from a deficit of £9.4 billion on 2016 Q3 to £8.2 billion in Q4.

As we have noted in previous reports, net overseas earnings respond very quickly to a change in the exchange rate due to the currency translation effect. In balance sheet terms, the UK's net external asset position, which is the difference between the sterling value of our overseas assets and foreign investments in the UK, shot up to 24% of GDP by the end of last year, the highest value since records began in 1997. Reflecting this, as well as the recovery in the earnings of UK-based oil majors and miners, the deficit on overseas earnings fell back sharply from £12.0 billion in Q4 2015 to £3.9 billion in Q3 and just £0.6 billion in Q4 of last year. All in all, the current deficit fell from £25.8 billion in Q4 2015 and £25.7 billion in Q3 and £12.1 billion in Q4 of last year.

Weighing down on the other side of the scales, the retail sales figures suggest that the consumer is now slowing down as inflation saps spending power. Retail sales volumes improved in February, but on a three-month-on-three-month basis, sales were down by 1.4%, the weakest performance since March 2010. Annual shop price inflation increased to 2.8% in February, another 5-year high. CPI inflation reached 2.3% in February and has already overtaken average earnings growth, which apparently slowed to just 2.2% in January.

This weakness seems to have extended to other consumer sectors, notably the car industry. Indeed, the motor industry looks like a microcosm of the economy at the moment. According to the Society for Motor Manufacturers and Traders, car production has just enjoyed its best February for 17 years, increasing by 8.0% on the year and pushing the rolling year total up to a similar high. However, this strength was driven by exports, which were up 12.1% in the year to February, in strong contrast to production for the home market which fell by 5.6%. Almost 80% of all UK cars are now exported, with most of these going to other EU countries. The weak home market was also reflected in the SMMT January forecast which saw new car registrations falling by 5.0% this year and another 2.9% in 2018. UK car manufacturers and other exporters are currently enjoying the full benefits of the European single market and the devaluation that followed the referendum. However, this position would be threatened if market access were made more difficult, as noted by the Chief Executive of the SMMT in commenting on their February figures.

...but investment will be needed to maintain this progress...

European immigrants have provided much of the extra labour employed by UK business in recent years, making skill shortages a thing of the past. However, there are anecdotal reports that some may already be going home as a response to the referendum vote and the subsequent devaluation. This could prove to be a major headache for employers over the next few years, underlining the pressing need for more investment in education, skills and training. Investment in robots and other labour saving machinery could also help in dealing with this problem. The proportion of respondents to the CBI's manufacturing survey saying that a shortage of skilled labour is an impediment to new investment is now at its highest level since late-2013. Investment is also urgently needed to build new export capacity and rebuild the domestic supply chain.

...and this depends upon greater clarity about the shape of Brexit

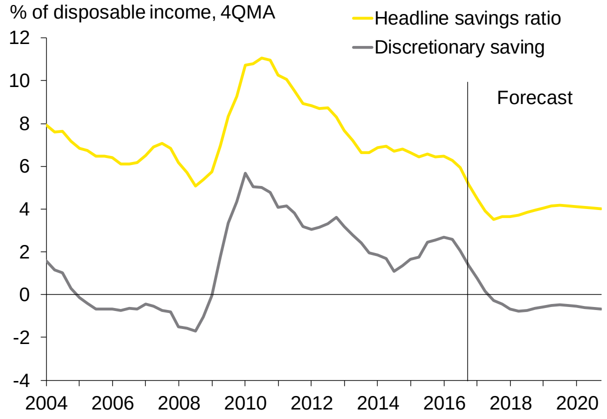
However, firms may not have the confidence to commit to these expenditures until the shape of the new trading arrangements becomes clear. As in previous forecasts, our central case is based on the assumption that UK-EU trade will be conducted under WTO rules come April 2019. However, there is the potential for an upside surprise if transitional arrangements can be put in place, perhaps followed by a Free Trade Agreement later.

The forecast shows two years of slow growth as the economy begins to rebalance...

The forecast sees GDP growth of 1.8% this year, in line with last year's outturn. However, this disguises a shift in the balance of demand associated with the fall in the exchange rate. Last year consumption provided almost all of the growth in demand, with overseas trade subtracting 0.4% from growth. This year sees a major slowdown in consumption as inflation bites into spending power, while net trade is forecast to add 0.2% to GDP, adding another 0.6% in 2018. With wage inflation remaining subdued, we think the MPC will hold base rates at their current 0.25% until the autumn of 2018.

Households dipped into savings and used their credit cards to increase their spending last year, pushing the saving ratio down to the lowest rate since records began in 1963. They ran the largest financial deficit since those records began in 1987. The growth in consumer credit has been running at record rates, prompting the Bank of England to ask the Prudential Regulatory Authority to investigate the loan criteria employed by the major lenders. 2017 is likely to be a very tough year for the consumer, with limited scope to offset the headwinds from higher inflation by borrowing.

UK: Savings ratio



Source : EY ITEM Club

The EY ITEM Club forecast for the UK Economy, Spring 2017
% changes on previous year except borrowing, current account and interest & exchange rates

	GDP	Domestic Demand	Consumer spending	Fixed investment	Exports	Imports
2014	3.1	3.4	2.2	6.7	1.5	2.5
2015	2.2	1.9	2.4	3.4	6.1	5.5
2016	1.8	1.5	2.8	0.5	1.8	2.8
2017	1.8	1.4	2.0	-0.5	6.9	5.7
2018	1.2	0.5	0.6	-0.4	5.3	3.1
2019	1.5	0.8	0.9	0.9	4.3	2.3
2020	1.8	1.3	1.3	2.1	3.9	2.5
	Net Govt Borrowing(*)	**Current account (% of GDP)**	**Average earnings**	**CPI**	**Bank Rate**	**Effective exchange rate**
2014	4.9	-4.7	1.3	1.5	0.5	87.0
2015	4.0	-4.3	2.5	0.0	0.5	91.5
2016	2.8	-4.4	2.5	0.6	0.4	82.0
2017	2.9	-3.3	2.7	2.8	0.3	75.3
2018	2.2	-2.9	2.8	2.3	0.4	73.0
2019	1.2	-1.9	2.8	1.8	1.0	71.5
2020	1.1	-1.2	2.8	2.0	1.6	70.5

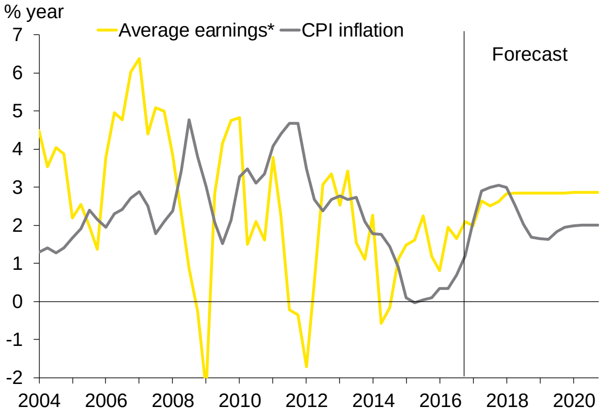
(*) Fiscal years, as % of GDP
Source: EY ITEM Club

The housing market has also weakened in recent months. Transactions have been in the doldrums since the stamp-duty related distortions in the first half of 2016. Mortgage approvals have slowed in recent months and the Nationwide Building Society reported that prices fell by 0.3% in March, the first monthly fall in two years. The annual rate of price increase fell back to 3.5%, from 4.5% in February. It seems that the slowdown in the high street and the housing market is feeding through into consumer-facing service industries. Service sector output fell in January, following a noticeable loss of momentum through Q4. The March manufacturing Purchasers Managers Index also reported a slowdown in consumer goods industries.

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

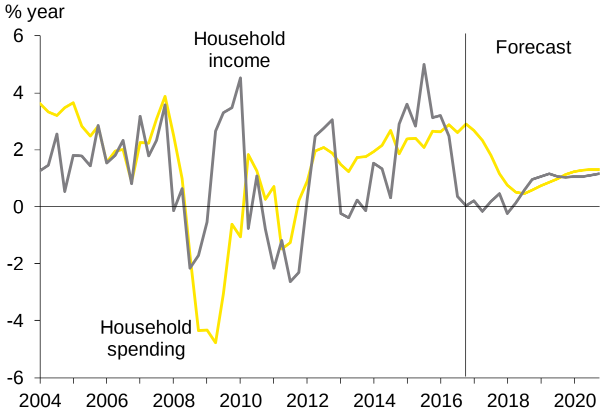
The forecast sees a progressive slowdown in household disposable income and spending as the labour market slows and inflation temporarily overtakes the growth in average earnings. After increasing by 1.8% in 2015, and 1.4% last year, we see total employment slowing to 0.6% in 2017, falling by 0.1% in 2018 and flat in 2019. With inflation picking up sharply, and the Government's welfare cuts hitting those on low incomes, household real disposable income is forecast to increase by just 0.2% in 2017 and 0.4% next year. The growth in consumer spending slows from 2.8% last year to 2.0% this year and just 0.6% next year. The growth in real income and spending then recovers very slowly over the rest of the forecast period.

UK: Average earnings & inflation



Source : EY ITEM Club *National Accounts measure

UK: Real household income and spending

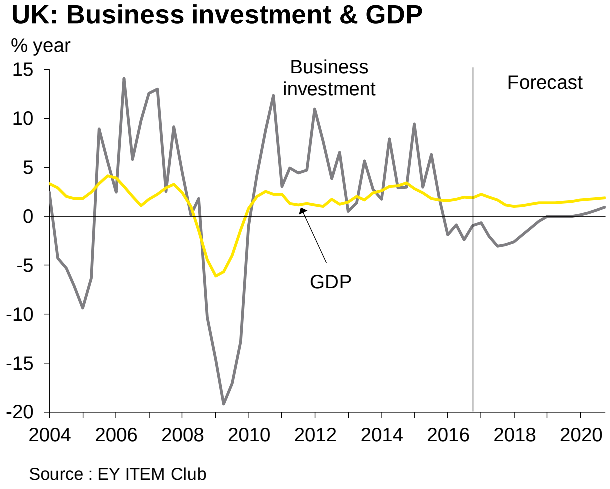


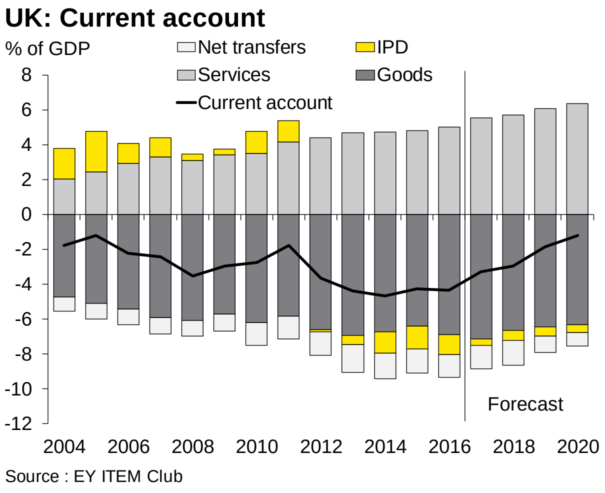
Source : EY ITEM Club

With a squeeze on real incomes in prospect this year, it is difficult to envisage any meaningful pickup in housing market activity and we expect 2017 to be a pretty flat in terms of transactions, prices and housing investment. We expect transactions and mortgage approvals to remain subdued by recent standards. House price inflation slows from 7.4% last year to 2.7% this year, and just 0.2% in 2018. Housing investment, which grew by 4.0% in 2015 and 3.4% last year slows to 1.0% this year and 0.6 % in 2018.

...and companies worry about the new trading environment...

Business confidence has picked up over the last few months. However business investment remains very weak and is vulnerable to disappointing news on the Brexit front. As we have argued, there is a pressing need for investment to help the UK to adjust to life outside the EU, but this is unlikely to materialise until managers have more clarity on the outcome of the current negotiations with the EU. It seems unlikely that the more competitive position of sterling will provide enough support to prevent business investment easing back over the next two years. Business investment fell by 1.5% last year, and the forecast sees another fall of 2.2% this year and a decline of 1.5% in 2018.





...leaving growth heavily dependent upon trade performance

The balance of payments outlook has brightened considerably since sterling's devaluation. Net exports add 0.2% to GDP this year and another 0.6% in 2018, contributing as much to growth in that year as consumption. As noted, a currency translation effect is already apparent in an improvement in the UK's net overseas earnings. The UK's deficit on Interest Profits and Dividends, which reached £24.5 billion when the pound was strong in 2015, was £21.7 billion in 2016 but is expected to fall back to £7.0 billion this year.

International transfers will be affected by the UK's exit from the EU and are a major area of uncertainty. The UK's contributions to the EU budget are likely to rise in the near term as it settles its accounts, although the final bill will be subject to negotiation. Then, assuming that the UK no longer contributes once we leave, we should see an improvement in the balance of international transfers. All in all, the forecast shows the current account deficit narrowing from £84.5 billion last year to £66.6 billion this year, falling back progressively to £19.5 billion by 2021, just 0.8% of GDP.

Risks and uncertainties

The global economy is shaping up very nicely, helping the economy to rebalance post-devaluation and paving the way to Brexit. But political developments in the US or Europe could upset the applecart and could seriously complicate Britain's exit from the EU. Trade performance and output growth in 2019 and beyond will also depend critically upon the exit terms that can be agreed with the EU27 and other countries. As in previous forecasts, our central case is based on the assumption that UK-EU trade will be conducted under WTO rules come April 2019. However, there is the potential for an upside surprise if transitional arrangements can be put in place, perhaps followed by a Free Trade Agreement later.

Forecast in detail

1. Fiscal policy

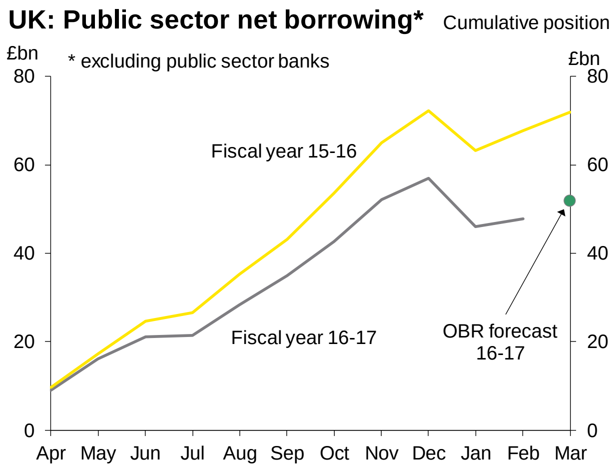
The March 2017 Budget always looked like being low-key, given its proximity to the 2016 Autumn Statement and the fact that the main fiscal set piece will move to Autumn from later this year. And so it proved, with the smallest package of policy measures for any fiscal event since at least 2010.

One of the factors behind the lack of action was the stable backdrop provided by the OBR's forecasts. Though it revised up its near-term growth forecasts and downgraded its projection for borrowing in 2016-17, the OBR's view of the economy's medium-term potential was unchanged from November. As such, there was no pressure on the Chancellor to alter policy, with a sizeable £26bn margin for error against his main fiscal rule.

The few policy measures that we did see were relatively 'cheap' with only one measure on the Budget scorecard amounting to more than £1bn annually. The two main giveaways were aimed at quelling some negative headlines. First, there was a modest amount of additional funding for social care, designed to plug a hole until the Government can complete a comprehensive review of social care funding. Second, there was some transitional support for firms negatively affected by the revaluation of business rates.

The main takeaway was abandoned after only a week. The Chancellor had planned to move the tax system towards a more equal treatment of the self-employed and employees, by raising the rate of Class 4 National Insurance Contributions paid by the self-employed from 9% to 11% by 2019. However, a lack of support amongst MPs meant that this idea was shelved. The fiscal cost of the U-turn was negligible – the policy was due to bring in just £0.6bn in 2020-21, a drop in the ocean compared with the £26bn margin for error against the main fiscal rule – so it would seem unlikely that the Chancellor will opt to change policy elsewhere in order to offset the loss of revenue.

The OBR downgraded its 2016-17 borrowing forecast from £65.2bn (based on the current accounting rules, which reflect the ONS's change of methodology around the treatment of corporation tax receipts) to £51.7bn. Subsequent favourable data revisions and another solid set of borrowing figures for February offer the possibility that borrowing may come in a little lower still.



Source: Haver Analytics

Further out, we expect the Chancellor to meet his fiscal rules and to be able to fund his manifesto commitments to raise the tax-free personal allowance to £12,500 and the 40% income tax threshold to £50,000 by the end of the parliament. However, it will be much harder to achieve his stated aim of eliminating the deficit '*as soon as is practicable*' in the next parliament and he will probably need to implement further fiscal tightening if he is to have any chance of achieving this target.

2. Monetary policy

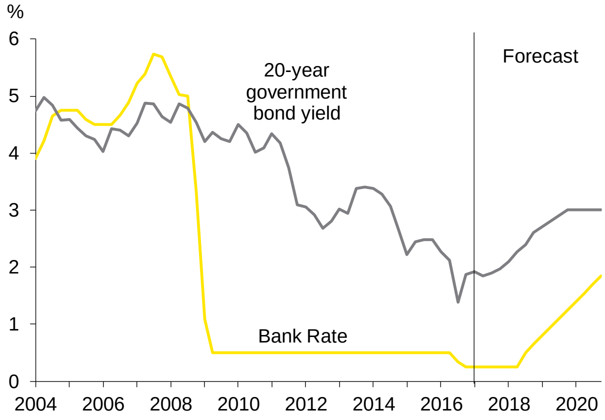
The monetary policy outlook has become surprisingly interesting over the past couple of months, following two unexpected changes of tone from the MPC. However, we still expect Bank Rate to remain on hold for the foreseeable future.

February's *Inflation Report* saw the MPC upgrade its short-term growth forecast but make similar upward revisions to its view of the supply-side, meaning that its inflation projections were little changed. With

Mark Carney presenting a relatively dovish tone in the accompanying press conference, this caused market expectations for an interest rate rise to shift back significantly. However, March's meeting saw Kristin Forbes surprisingly vote for a rate hike and the minutes suggest that "some" other members were considering voting for higher rates if there were further upside surprises on growth and inflation.

Markets interpreted the March minutes as being indisputably hawkish and brought their expectations for the first post-crisis rate hike back in. However, we think the chances of a 2017 hike are low. Kristin Forbes will leave the Committee in June, growth is likely to slow as real incomes are squeezed and austerity bites, while there is still scant evidence of any underlying inflationary pressures. As such, we continue to expect Bank Rate to see no increase until Q3 2018.

UK: Bank Rate & 20-year bond yield



Source : EY ITEM Club

Gilt yields have fallen back in recent months off the back of global developments. We expect the 20-year yield to end 2017 at 2.0% and 2018 at 2.6%.

Sterling has staged a mini-recovery against the dollar through March, reflecting the aforementioned concerns about the sustainability of the US rally. However, with monetary policy set to diverge over the coming year and market sentiment vulnerable to Brexit developments, we expect sterling to resume its slide, ending 2017 at $1.21 and 2018 at $1.19.

3. Prices and wages

Inflationary pressures have continued to build, with the CPI measure finally rising back above the 2% target for the first time in more than three years. But we still see little evidence to suggest that this is anything other than a temporary, sterling-driven, spike.

Annual CPI inflation accelerated to 2.3% in February, the highest rate since September 2013. As recently as May 2016 the CPI measure had been just 0.3%, with the steep pickup reflecting a combination of two factors. First, powerful base effects, with winter 2015/16's declines in petrol and food prices steadily dropping out of the inflation calculation. And second, a steep rise in petrol prices resulting from a sharp increase in the oil price and the plunge in the value of sterling. This has meant that the sterling oil price has risen by 50% compared with a year ago, while retail petrol prices have risen by around 15%.

Petrol prices have seen the quickest pass-through of sterling's depreciation, but in most other areas it is likely that the bulk of the impact is still to come. Price pressures are continuing to build along the supply chain, with producer input cost inflation running at an annual pace of around 19%. And factory gate inflation accelerated to 3.7% in February, the strongest pace since the end of 2011. Meanwhile, business survey data suggests that further increases in manufacturers' selling prices are likely in the short-term.

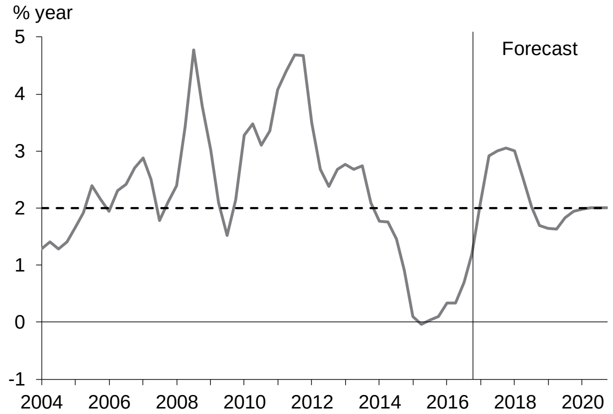
Therefore, with the bulk of the last year's depreciation still working its way along the supply chain into consumer prices, inflation is likely to continue to accelerate. The literature suggests that it usually takes around a year for the maximum impact to be seen. This is consistent with our forecast that CPI inflation is likely to peak above 3% in the second half of 2017 and average 2.8% over the year as a whole.

However, aside from the influence of a weaker pound, we still see very little evidence of core inflationary pressures and this is likely to remain the case, with the prospect of relatively weak GDP growth meaning that the degree of spare capacity is likely to remain significant. Therefore, once exchange rates effects have washed through and the anticipated appreciation has started to take hold, inflation is likely to slow.

We expect the CPI measure to average 2.3% in 2018, moving back below the 2% target in the final quarter of the year.

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). Moreover, the spread between RPI and CPI should widen further over the back end of the forecast horizon due to our expectation that house prices will rise more quickly than general prices and that interest rates will eventually be increased.

UK: CPI inflation



Source : EY ITEM Club

4. Activity

The last quarter of 2016 saw the economy continue to expand at a decent pace. But the dependence of growth on consumer spending raised concerns. This year offers the promise of a better-balanced expansion, albeit at a gradually slower pace as the consequences of rising inflation bite.

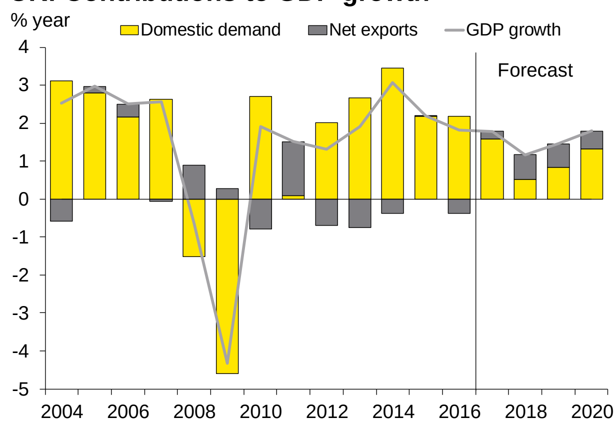
The Quarterly National Accounts for Q4 2016 confirmed that the economy had expanded by 0.7% q/q. This left the calendar-year expansion at 1.8%, the slowest pace since 2012 but the strongest among the G7 economies, bar Germany. However, the profile of growth during Q4 pointed to the economy losing steam as it moved into 2017. And the monthly output data for January showed the services, industrial and construction sectors all contracting on December levels, the first concurrent monthly drop since June 2012.

A steadily increasing squeeze on households' spending power from rising inflation is the most apparent pressure on activity growth. With the household saving ratio at a record low, the scope for households to mitigate lower real income growth by dissaving is more limited. And while strong growth in household wealth last year and low unemployment will offer some support, consumer spending growth is forecast to slow from a nine-year high of 2.8% in 2016 to 2% this year and 0.6% in 2018.

Meanwhile, although corporate profitability is at historically high levels, companies appear reluctant to spend. Business investment fell in 2016 for the first time since 2009. A softer consumer outlook, along with uncertainty around the UK's future trading relations with the EU will put a cap on investment growth this year. That said, the tradable sector may prove some exception to this, with the depressed level of sterling supporting export growth and helping domestic UK firms competing with imports. We expect net trade to add 0.2pp to GDP this year followed by 0.6pp in 2018.

This rebalancing of activity is forecast to have a neutral effect on GDP growth this year, matching 2016's 1.8% pace. But the dominance of the consumer sector in the economy and headwinds from inflation are set to become more apparent in 2018, with growth slowing to 1.2%.

UK: Contributions to GDP growth



Source : EY ITEM Club

5. Consumer demand

Annual growth in consumer spending reached a nine-year high in 2016. While boom is unlikely to turn to bust this year, pressure on households' incomes from rising inflation, slower employment growth and welfare cuts imply a weaker outlook for the consumer sector.

A 2.8% rise in consumer spending in 2016 was the fastest since 2007 and well above the average rise of 1.9% seen since 2000. Although wage growth remained subdued, households' appetite to spend was buoyed by falls in foods and energy prices and continued growth in employment.

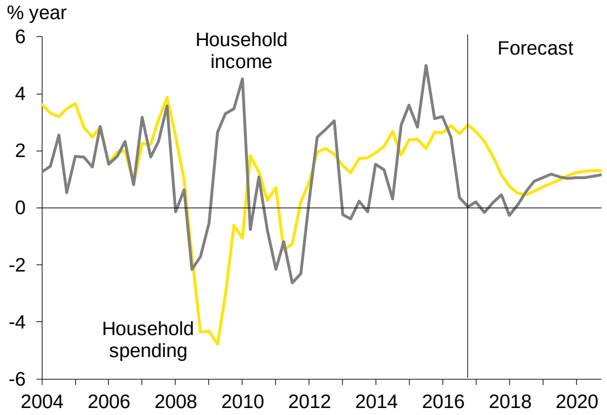
But the latest data has pointed to a slowdown. Retail sales volumes fell in each of the three months to January, with a return to growth in February making up only part of the earlier drop. And private car registrations have put in a weak underlying performance, dropping by 4.4% y/y in February.

A squeeze on consumers' spending power from rising inflation suggests this softening will persist. Annual CPI inflation climbed to 2.3% in February and is forecast to peak above 3% later this year. With growth in cash pay unlikely to keep pace, a fall in real earnings is in prospect. Meanwhile, a record high employment rate implies less room for incomes to grow via more people entering into work. And the Government has remained committed to cuts in the welfare budget, hitting the incomes of 11.5m households.

Admittedly, there will be some mitigating factors in play. The MPC's loosening of monetary policy last August has contributed to interest rates on mortgages and consumer credit falling to new record lows, cutting debt-servicing costs. And households' balance sheets are historically strong, with net financial wealth representing almost four times the average households' income, the highest ratio since records began in 1987.

But against this balance sheet strength, with the household saving ratio hitting a record low in Q4 2016, it is unclear whether consumers will be willing to save less and borrow more to compensate for a period of weaker real income growth. Overall, we forecast consumer spending growth to slow to 2% this year and, as the effect of elevated inflation becomes more marked, 0.6% in 2018.

UK: Real household income and spending



Source : EY ITEM Club

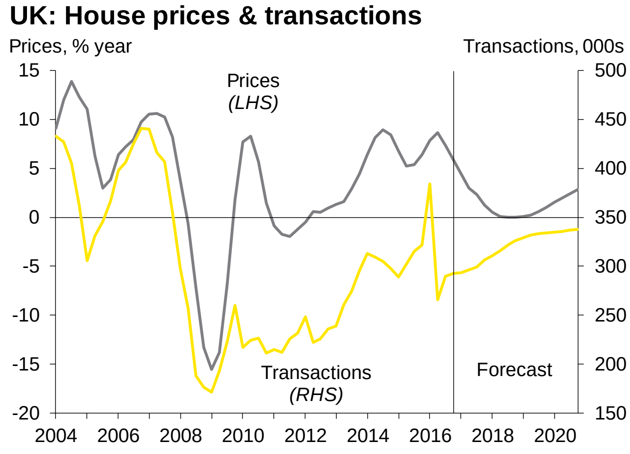
6. Housing market

Recent months have seen evidence of a gradual deceleration in house price inflation on most measures. With real incomes coming under pressure from rising inflation and a more subdued jobs market, price growth is likely to moderate further. But the housing market will remain a long way from a crash.

On the activity side, 2017 began with a certain degree of stasis in the market. Mortgage approvals remained in the narrow range of 67,000-69,000 observed since last October, while housing transactions were modestly down on levels a year earlier (although forestalling in early 2016 in advance of a rise in stamp duty will have distorted the numbers). Both approvals and transactions have continued to run well short of the pre-financial crisis norm.

As far as prices are concerned, both the Nationwide and Halifax measures have trended down on an annual basis since the middle of last year. The three months to March saw the former touch a 16-month low of 4.1%, while growth in the Halifax measure slipped to 4.8% in the three months to February, half the rate of a year earlier. The ONS/Land Registry measure has been something of an outlier, showing an acceleration in price growth in recent months.

The RICS survey suggests that a more becalmed market is likely to persist. The survey's balance relating to new buyer enquires dropped to the lowest in six months in February. But with the volume of sales instructions also weakening, there is no obvious imbalance between demand and supply to drive prices down. And with average mortgage rates hovering at record lows, very favourable credit conditions should act as another prop to the market.



Source : EY ITEM Club

However, with the demand for housing influenced by income growth, the squeeze on households' spending power and ability to save from rising inflation is likely to have some influence on the property market. The likelihood of employment growth tailing off will also act as another headwind in this respect. We forecast house price growth to moderate to 2.7% this year from 7.4% in 2016 before then broadly stagnating in 2018.

7. Company sector

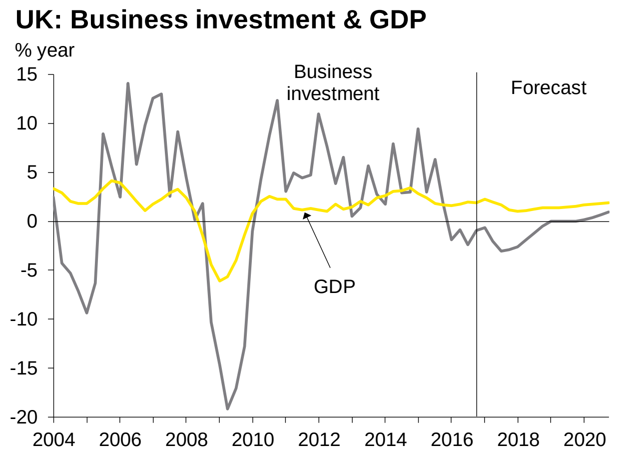
Business investment performed poorly in 2016, recording the first annual drop since 2009. A weaker consumer outlook and uncertainty around the UK's future trading relationship with the EU suggests a gloomy outlook. But very low borrowing costs and the boost to corporate profitability from the weak pound will offer some mitigation.

Business investment ended 2016 on a downbeat note, dropping by 0.9% in Q4 compared to the previous quarter. This left spending by firms down by 1.5% for the year, the first calendar-year drop since 2009.

Granted, the investment numbers are volatile and prone to significant revision. But to the extent that the data continue to indicate that business investment declined last year, it may be that uncertainty following the EU referendum weighed on investment relatively quickly.

With Article 50 now triggered, EU-related uncertainty is likely to continue to represent a headwind to investment spending this year. But the prospect of a slowdown in the consumer sector probably presents a more significant reason to expect firms' appetite to spend to remain muted.

That said, there are upside risks. Surveys of investment intentions from the Bank of England and the CBI have continued to recover from post-referendum falls. Credit conditions for corporate borrowers remain loose and companies have continued to accumulate assets – Q4 2016 saw non-financial companies record the largest financial surplus in four years. And recent strong growth in the production and import of capital goods are at odds with fears of a severe retrenchment in investment spending.



Source : EY ITEM Club

Moreover, the boost to exporters' profitability from the weak pound should encourage investment to expand production for overseas markets and offset some of the negative Brexit effect.

But while these factors should stave off too severe a drop in business investment, we still anticipate this year seeing a 2.2% fall, followed by a further 1.5% contraction in 2018.

8. Labour market

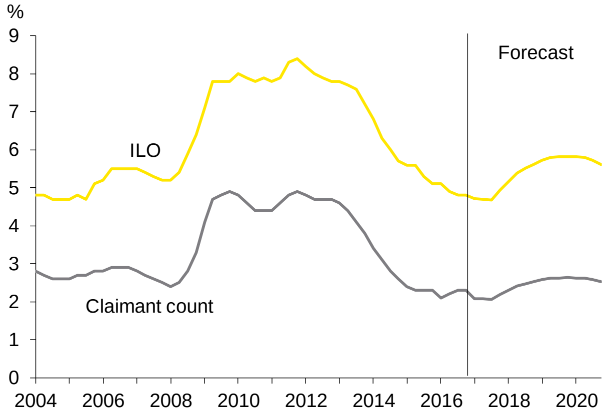
The long-running improvement in the jobs market has ebbed somewhat of late, while wage growth has remained subdued. Though we anticipate some improvement, it looks unlikely that the labour market will offer much support to offset the impact of higher inflation.

Employment rose by 92,000 in the three months to January, while the LFS unemployment rate dropped back to 4.7%, the lowest level since mid-2005. Over the past year the pace of employment growth has been roughly half of that in the previous year, but this is not particularly surprising given the tightness of the jobs market.

The single month data for January suggests that momentum has continued to ebb and, with growth in activity likely to cool as we move through the year, this points to a relatively soft period for the jobs market. We expect employment to rise by 0.6% in 2017, down from 1.4% last year, before falling by 0.1% in 2018. Alongside this we expect to see a steady uptick in unemployment, from the current rate of 4.7% to 4.9% at the end this year and 5.6% by Q4 2018.

There had been better news on the earnings front last autumn but since then the situation has regressed. Having reached 2.8% in the three months to November, headline (3-month average of the annual rate) average weekly earnings growth slowed to just 2.2% in January.

UK: Unemployment



Source : EY ITEM Club

Looking forwards, there are several competing forces influencing the outlook for wage growth. On the plus side, rising inflation may prompt higher pay demands from some workers, as might the increasing tightness of the labour market. And compositional factors related to shifts in the structure of the workforce, which have been weighing on wage growth for some time, appear to finally be easing. But these factors will be countered by employers' greater reluctance to pay more in the face of a weaker growth outlook and the pressures on firms' cost bases from the introduction of the apprenticeship levy in April and ongoing auto-enrolment into workplace pensions.

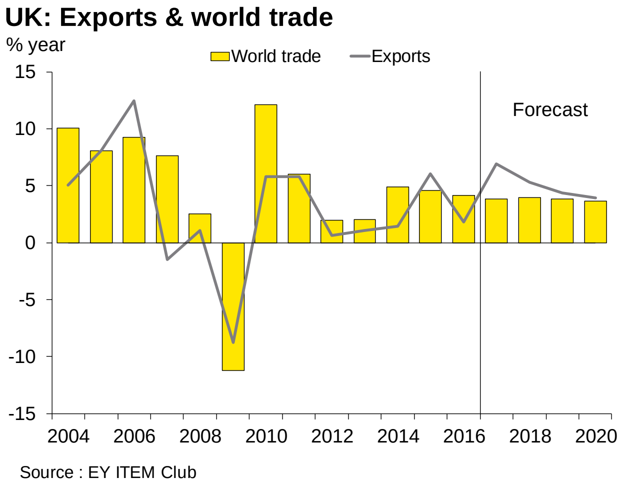
Overall we expect a modest pickup in wage growth from 2.5% in 2016 to 2.7% this year – just below the expected inflation rate of 2.8% – and 2.8% in 2018.

9. Trade and the Balance of Payments

The trade data have continued to be influenced by erratic factors. But the underlying picture suggests that the weak pound and a more buoyant global economy are working to boost exports. While this external support is unlikely to be enough to offset a weaker consumer sector, net trade will become an increasingly important source of support to the economy.

Net trade added 1.7 percentage points (pp) to GDP in Q4 2016, the biggest contribution from this source in almost six years. Admittedly, unusually large exports of gold distorted the data for that period. But excluding such erratic factors, goods export volumes rose by 6.8% in the three months to January on the previous three months, a 71-month high.

Survey evidence from CIPS and the CBI are consistent with exports continuing to grow at a robust rate. Meanwhile, the prospect of a slowdown in consumer spending growth will take its toll on imports. We expect net trade to add 0.2pp to output this year, followed by a 0.6pp addition in 2018.



The weakness of sterling also appears to be playing a role in narrowing the UK's current account deficit. The shortfall shrunk from 5.3% of GDP in Q4 2016 to 2.4% in the last three months of the year, the smallest deficit since Q2 2011 and the biggest quarterly decline since records began in 1955. With a sterling effect particularly apparent in boosting the UK's net investment income from abroad, the current account deficit is forecast to narrow from 4.4% of GDP last year to 3.3% in 2017 and to below 1% by the end of the decade.

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