EY ITEM Club
Summer Forecast

Will the clouds clear for the economy?

July 2018

EY
Building a better working world

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

Contents

Foreword

Mark Gregory

EY Chief Economist, UK

@MarkGregoryEY

Cloudy for some time over the UK economy

Who would be a forecaster?

The first half of 2018 has been a difficult one for forecasters across the board. Unexpectedly harsh winter weather has been followed by an unusually warm start to summer, while at the World Cup, the England football team exceeded expectations for the first time in many years.

As the EY ITEM Club Summer Forecast demonstrates very clearly, economists are being confronted by an extremely dynamic economy with wide variations in the performance and outlook for individual sectors, which makes forecasting very challenging. And it is not just economists who are struggling to reconcile potentially conflicting information. It was very clear on my recent travels around the UK that businesses are finding it very difficult to form a clear picture of their prospects.

As the data continues to change …

EY ITEM Club now expects the UK economy to grow at 1.4% in 2018, down from its forecast of 1.6% in the spring. While there have been some positive developments in the last few months, such as a bounceback in retail sales and continued job creation, there has been little sign of an uptick in real pay levels, and higher oil and utility prices are likely to squeeze consumer spending. In addition, the relatively positive global outlook has softened a little as momentum slows and trade disputes hits sentiment.

… the outlook worsens …

Although EY ITEM Club notes that the public finances continue to improve, elsewhere in the economy they expect consumer spending, investment and trade to be challenged throughout 2018, hence the reduction in their expectations for GDP growth this year. There will be a modest but gradual improvement across the board from 2019 to 2021 with EY ITEM Club forecasting GDP growth of 1.8% in both 2020 and 2021, still below the recent trend and unlikely to provide a major boost to corporates.

… and risks remain to the downside

Not only has the outlook worsened but the risks are weighted to the downside. Brexit remains a major source of uncertainty with the potential to deliver a significant negative economic shock. Tensions over trade globally are another potential source of risk and although EY ITEM Club note the UK is relatively unexposed to a dispute between the US and China, there would be an impact from a global slowdown.

Low growth should be the base case …

It is clear to me that the base case assumption on the UK economy for business should be one established on low growth for the next three years as a minimum.

Whatever the outcome of the Brexit negotiations, the resulting adjustment is likely to act as a drag on the economy. The EY ITEM Club forecast of 1.4% growth in 2018, 1.6% in 2019 and 1.8% in 2020 and 2021 assumes that the EU and UK will sign a withdrawal agreement that will support a stable transition and hence avoid any major shock to business investment. This is probably a best-case assumption and actual growth could still be hit by lower investment.

While there was some evidence of a recovery in retail sales in the recent data, the overall consumer outlook continues to be challenging. There remain a number of risks to consumer spending such as the rate of wage growth, higher inflation if the pound falls or energy prices rise faster, alongside structural shifts that retail and consumer businesses are working to address already. For businesses in the consumer space, challenge and rigour in planning and forecasting are a must.

… and forward thinking is essential

The preceding discussion has highlighted how ensuring that businesses are positioned for a potentially challenging few years has to be their priority. However, there is also a need to start to think in detail about the future of individual businesses, given the likely changes to the UK economy. Issues to consider include:

- The potential impact of technology as a disruptor of existing business models across customer interactions, operations and supply chains.
- How the structural shift in the consumer market will play out and what this means for individual businesses. The immediate effect may be on those businesses selling directly to consumers but over time, business-to-business activity will also be impacted. For example, owners of retail real estate will face ongoing pressure on pricing, and investment goods providers may see less demand from consumer goods manufacturers.
- As the shape of Brexit becomes clear, the implications for trading operations, labour markets and regulation will begin to emerge and will have to be factored in to strategic and operational decision-making.

The recent announcements from UK retailers on job losses, restructurings, store closures and new alliances and partnerships should be seen as a call to action. This sector is first in line to face the emerging challenges but other sectors will soon find themselves facing similar pressures. Being prepared will be a major advantage when the time comes.

Highlights

- The latest EY ITEM Club forecast concludes that the balance of risks facing the UK economy has veered to the downside since our last assessment in the spring. Modest output growth in Q1, the adverse effects of higher oil prices on inflation and households' spending power, and a loss of momentum in the eurozone economy have caused us to cut our forecast for GDP growth this year to 1.4%, down from 1.6% expected in April. Growth in 2019 is predicted to run at 1.6%, slightly lower than April's 1.7% forecast.

- Recent months have seen a drumbeat of bad headlines about the struggling UK high street. But strong retail growth in April and May (backed up by robust CBI survey evidence for June) and some signs of green shoots in the new car market point to the consumer sector staging a decent recovery from weather-related weakness earlier in the year. But that bounceback may have been exaggerated by its own erratic factors. And the hoped-for dividend to consumers' purchasing power from falling inflation is now looking more fragile because of the rising price of oil and hikes in energy bills.

- Indeed, we now expect inflation to climb over the summer before heading down again later in the year. The CPI measure is forecast to end 2018 at 2.3%, compared to the 2% anticipated three months ago. Admittedly, the strength of the jobs market, including a record high employment rate, offers some counter to rising price pressures in supporting consumer spending. But following hopes earlier in the year that pay growth was finally starting to respond to an increasingly tight jobs market, more recent wage numbers have disappointed on that score.

- Moreover, with the household saving ratio hitting a record low in 2017 and continuing to decline in the early part of this year, the scope for consumption to be supported by saving less is looking more limited. All in all, these developments mean we have maintained a downbeat view of prospective growth in consumer spending, which is expected to run at only 1.3% this year, before picking up to 1.5% in 2019.

- The Bank of England's Monetary Policy Committee (MPC) will almost certainly look through what is likely to be a short-lived period of rising inflation. But with the Committee's recent public pronouncements choosing to emphasise the rebound in consumption in the early part of Q2 while downplaying the weakness of manufacturing and construction output, a near-term hike in Bank Rate is likely. We forecast a 25 basis points rise in August, although the weakness of pay growth and Brexit uncertainties mean that an increase could be delayed until November.

- A cloudier global economic outlook is another reason why the MPC may continue with a 'wait-and-see' approach for a bit longer. Notably, following a soft Q1, a hoped-for pick-up in momentum in the eurozone economy has underwhelmed. Admittedly, growth in the US has held up well and while Q1 saw net trade make only a marginal positive contribution to UK GDP growth, this was an improvement on the drag seen in the previous three months. But with the boost to competitiveness from sterling's past weakness fading, exporters' 'sweet spot' has clearly narrowed. Net trade is forecast to make a reduced positive contribution to growth in 2018 compared to 2017, and to marginally detract from output in 2019.

- Growing global protectionism, with early summer seeing a welter of tariffs imposed or threatened between the US and some of its major trading partners, could make a cloudy global outlook positively stormy. However, the UK's relatively small manufacturing sector and the nature of its exports should provide a degree of insulation from trade disputes denied to some other advanced economies. The fact that sterling has weakened against the US dollar should also help exporters in this respect.

- Given the relative export- and capital-intensive nature of manufacturing, a less positive outlook for exports has potentially adverse implications for business investment. Prospects for investment growth will continue to hinge in part on the outcome of the Brexit process. Our baseline maintains the assumption that following 'Brexit Day' on 29 March 2019, the UK will move into a transition phase with the EU where, in fact, nothing changes as far as trade relations are concerned. But the quandary presented by the challenges of ensuring no hard border on the island of Ireland, satisfying parliamentary arithmetic (which is against a 'hard' Brexit) and respecting the 2016 referendum result means that the possibility of the negotiations failing and the UK leaving with no deal still cannot be ruled out.

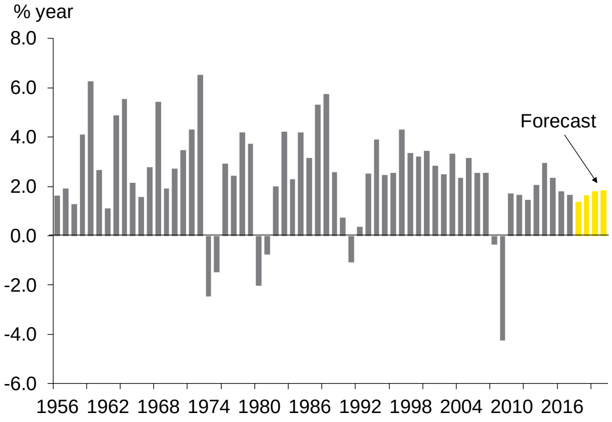
Introduction

"It's an ill wind that blows nobody any good". That old saying was very apt in describing the economic disruption caused by the heavy snow and freezing weather which blew over the UK in February and March this year, helping to drag quarterly GDP growth down to a very disappointing 0.2% in the first three months of 2018. When our spring forecast was published back in April, hopes rested on the economy making up the output lost in the first quarter and bouncing back to a more 'normal' rate of expansion.[1] But those aspirations have been met with mixed results. On the one hand, services output is on course for a decent Q2, business surveys have picked up, with June delivering a particularly upbeat set of results, and consumer activity appears to have staged something of a recovery, with the second quarter on course to have delivered a strong performance from retailers and some evidence of green shoots from what had been a battered new car sector.

But the more 'physical' parts of the economy — manufacturing and construction — have shown less momentum, with the former possibly held back by an unexpected slowdown in the eurozone economy. April saw manufacturing output contract for the third successive month (although survey evidence, including that from the CBI, has since pointed to a limited recovery). And while construction activity expanded in April, the rise reversed only a fraction of the drop seen in January, February and March. Furthermore, a sharp drop in construction new orders in the first quarter and mixed survey evidence in May and June points to the sector struggling to gain traction.

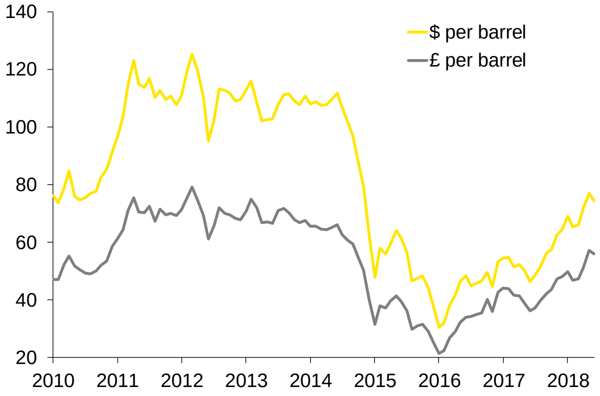
A weaker-than-expected outturn in Q1, the ambiguous picture since, and less buoyancy overseas (exacerbated by fears of global trade disputes), have all made us more pessimistic on the economic outlook, a combination of developments not helped by the rising price of oil and subsequent pressure on inflation and households' spending power. We now forecast GDP to grow by 1.4% this year, down from the 1.6% expected in April. This would be the weakest performance since 2012 and well below the 2% annual increase averaged over the current expansion, let alone the post-war norm of 2.4%. Forecast growth in 2019 runs at 1.6% (previously 1.7%).

UK: GDP growth



Source: EY ITEM Club/Haver Analytics

UK: Price of Brent crude



Source: EY ITEM Club/Haver Analytics

In breaking down the softer outlook, a downgraded global growth forecast means that net trade is forecast to make a reduced contribution to GDP growth this year, having made an unusually large positive contribution in 2017. Meanwhile, the support to consumer spending anticipated from declining inflation now looks more fragile given recent oil price developments. Furthermore, earnings growth has recently relapsed, diluting expectations of a clear, if limited, pick-up earlier this year. And investment will continue to be caught in a battle between positives from elevated profitability and cheap financing

[1] *EY ITEM Club Spring Forecast: Sluggish but stable*, April 2018. ey.com/Publication/vwLUAssets/ey-item-club-spring-forecast-2018/$File/ey-item-club-spring-forecast-2018.pdf

versus a drag from Brexit-related uncertainty. On the latter subject, June's meeting of the EU's European Council saw a lack of progress on withdrawal negotiations, heightening concerns over the prospect of a 'no-deal' outcome.

One silver lining is that we now expect the MPC to push through only one 25 basis points rise in Bank Rate this year. This will most likely be in August, although a delay until November is possible. This compares with our previous expectation of two hikes in 2018. And with the Government's announcement in June of sizeable rises in NHS spending from 2019 onwards (at least by the standards of the recent past), the appetite for continued fiscal austerity may be waning. But we will have to wait until the Budget towards the end of 2018 to get a clear idea of how much the fiscal taps might be turned on.

Consumers' inflation dividend is looking more fragile …

The succession of bad news stories in 2018 about high street firms struggling or going into administration means that it would be easy to take a gloomy view of the consumer sector's performance and near-term prospects. The weakness of consumption in Q1 was certainly consistent with such a view. A 0.2% quarterly rise in consumer spending was the slowest increase since the end of 2014, while year-on-year growth plumbed a six-year low of just 1.2%.

However, as of late, the hard data has presented a more upbeat picture. March and April delivered monthly rises in retail sales volumes of 1.8% and 1.3% respectively. This was the first time since 2007 when we saw two consecutive months of +1% growth, setting up Q2 for a strong performance. Additionally, the headline balance of June's CBI Distributive Trades Survey rose to a nine-month high. Moreover, May was the second month in a row to deliver a year-on-year rise in private new car registrations, a consistent run of growth not seen since the end of 2016. Total registrations were 10.1% higher than a year earlier, building on April's whopping 26.3% increase and bringing an end to 12 successive months of negative year-on-year growth. Helping matters, consumer confidence reached its equal highest level for a year in May, although it dipped in June.

However, erratic factors probably exaggerated the buoyancy of consumer activity. Some rebound in retail sales and car sales were always to be expected in April and, possibly, May, after consumer activity took a marked hit in March from the severe weather. Furthermore, retailers' performance in May was bolstered by the royal wedding and unseasonably warm weather, while June's sales appear to have been helped by a continuation of the latter and the football World Cup. And the rapid pace of growth in car registrations was flattered by sales a year earlier being depressed by purchasers buying ahead of April 2017's reforms to Vehicle Excise Duty (VED) (registrations in April and May 2017 were 14% down on a year earlier). Notwithstanding recent signs of life in the market, new car sales in the first five months of the year were still 7% lower than the same period in 2017.

Given the role played by elevated inflation in dragging on households' purchasing power and consumer spending in 2017, the evolution of price pressures will be crucial in driving the sector's performance in the near future. On the face of it, the news here has been pleasing. Although annual CPI inflation of 2.4% in May was unchanged from the previous month, it represented the joint lowest rate in a year and a sizeable drop from the recent peak of 3.1% last November. As a result, having fallen through most of 2017 and early 2018, average inflation-adjusted wages have recently seen a return to modest growth.

… a consequence of dearer oil and utility price hikes …

But stability in the CPI measure in May disguised some less happy developments. Notably, buttressed by more expensive oil (which, in dollar terms, hit a three-and-a-half-year high of almost $80 per barrel in May), petrol prices surged 3.8% on the month, the biggest rise since 2011. And one of the factors which offset this — an unusually weak increase in electricity bills — looks likely to unwind over the course of the summer, as the 'Big Six' energy suppliers implement preannounced hikes in utility prices, which will - in some cases - be sizeable.

Granted, the inflationary consequences of dearer oil and higher energy bills will face a fight from disinflationary forces arising from movements in sterling. We expect the pound to see a modest appreciation over the second half of this year and into 2019, comparing favourably from an inflation perspective with the near 20% year-on-year decline (on a trade-weighted basis) in late 2016, a rate of depreciation that was still running at around 10% in the summer of 2017.

But overall, the steady downward progression in CPI inflation observed earlier this year looks likely to reverse course, at least temporarily, over the next few months. As a result, we now expect the CPI measure to rise back up to 2.7% in the near term before softening anew to end 2018 at 2.3%; this compares to the level of 2% predicted for the end of 2018 in our last forecast. On a calendar-year basis, 2018 is forecast to deliver CPI inflation of 2.6% (previously 2.4%), followed by 2% next year (up from May's forecast of 1.9%).

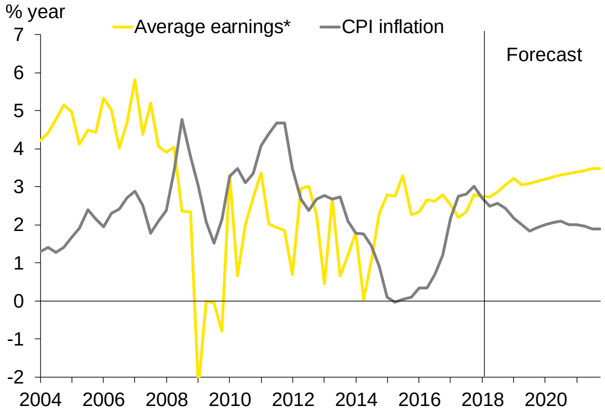
One area which has continued to develop in a consumer-friendly direction is employment. The three months to April saw the number of people in work reach an all-time high of 32.394 million, while the proportion of those in work aged 16 to 64 reached a new record peak of 75.6%. Somewhat confounding the apparent weakness of activity growth, a 1.4% annual increase in employment in the same period was the biggest gain since the summer of 2016. Admittedly, the Labour Force Survey (LFS) unemployment rate remained unchanged at 4.2%. But this was a consequence of rising economic activity offsetting employment gains (boding well for the economy's potential rate of growth). And the proportion of people out of work still represented a joint 43-year low.

… while hopes of a revival in pay growth have receded …

However, hopes earlier in the year that pay growth was finally starting to respond to an increasingly tight jobs market have been dampened by more recent wage numbers. Total average pay increased 2.5% in the three months to April compared to a year earlier, the weakest rise since last November. This was a relapse from 2.6% in the three months to March and 2.8% in the three months to February. Regular pay growth also eased to 2.8% in the three months to April from March's 2.9%. And annualised three-month-on-three-month growth in regular pay, a measure previously cited by the MPC as evidence of rising pay pressure, slowed to a 12-month low in April. This weakness has caused us to become more cautious on the outlook for pay. Average earnings are forecast to rise 2.9% (on a National Accounts basis) this year, followed by 3.1% in 2019. Consequently, combined with a higher inflation projection, the pay of the average worker looks set to benefit from only a marginal real increase this year.

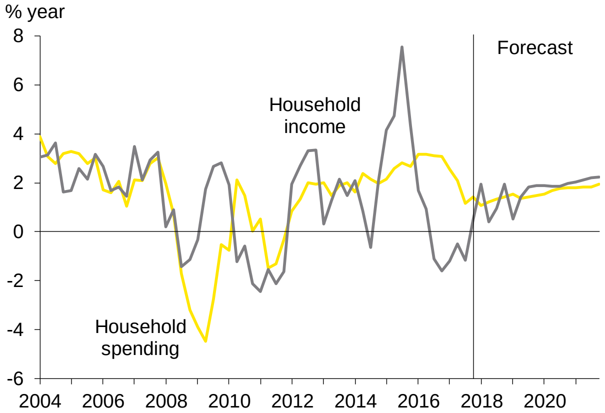
By saving a smaller share of their incomes through 2016 and 2017, households adjusted gradually to the weakness of real income growth without triggering a crash in consumer spending growth. Indeed, last year saw the household saving ratio drop to 4.1%, the lowest since records began in 1963. A declining ratio continued into the first quarter of 2018, suggesting that the scope for consumers to compensate for limited income gains by saving less is becoming more limited.

UK: Average earnings and inflation



Source: EY ITEM Club *National Accounts measure

UK: Real household income and spending



Source: EY ITEM Club

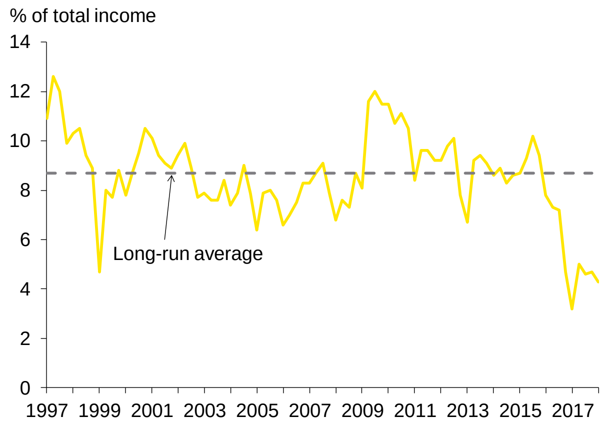
With the inflation outlook looking less promising and the saving ratio so low, the omens for consumer spending have deteriorated in some respects since we last assessed prospects in April. However, the fact that employment gains have remained surprisingly strong provides a little more optimism on that score. So after increasing by 1.4% in 2016 and 1% in 2017, we see employment rising by 1.2% this year before growth slows to 0.5% in 2019, while the LFS jobless rate is expected to broadly stabilise at current levels. However, short of an about-turn from the Chancellor in the Budget later this year, the cash freeze on working-age benefits, which began in 2015–16, is set to remain in place until 2019–20.

Collectively, these forces leave growth in household disposable income at a forecast 1.3% this year, followed by a rise of 1.4% in 2019. A return to pre-financial crisis 'normality' (annual real income growth averaged 3.1% in the 10 years to 2007) remains a distant prospect. And with the household saving ratio projected to creep up, forecast growth in consumer spending of 1.2% and 1.5% in 2018 and 2019 respectively will also be very sub-par by historical standards.

... but the MPC should respond with a more accommodative approach

The 'will they, won't they' attitude of the MPC since the spring has complicated predictions of where UK interest rates are headed. The weakness of the economy in Q1 had caused the Committee to swerve away from what had been a previously strongly signalled rate hike for May (with comments by Bank of England Governor Mark Carney in February that rate increases might well come "somewhat earlier and to a somewhat greater extent" than previously expected).[2] However, with the MPC seemingly confident that the economy's travails in the early part of the year were a weather-related blip, and with the Bank's longer-term growth forecasts in May's *Inflation Report* unchanged from three months earlier, a temporary pause in the rate rise cycle rather than a long-running hiatus looked to be on the cards.

UK: Household saving ratio



Source : EY ITEM Club/Haver Analytics

But the subsequent mixed set of economic data as well as poor tidings from abroad (including a slowdown in eurozone growth and international trade tensions) both offer good reasons for the UK's monetary policymakers to tread carefully. And with underlying price pressures, particularly from wages, difficult to discern and consumer and business sentiment vulnerable to uncertainty over what type of Brexit the UK will face, (and a recent lack of progress in the negotiations between the UK and EU), as well as a volatile global backdrop, the risks from continuing a 'wait-and-see' approach seem minimal.

However, August probably offers the best presentational opportunity this year for a hike in Bank Rate, with inflation set to be (temporarily) pushed up over the summer by rising oil prices and increases in energy bills. And the fact that June's MPC meeting saw the minority on the Committee in favour of an immediate rate rise expand to three members and the minutes of the meeting majoring on positive economic developments in Q2, there are other reasons to think that the Bank will make a move in late summer. On balance, we think that August will most likely deliver a 25 basis points rise in Bank Rate, but that the MPC will then leave rates unchanged for the remainder of the year.

Further ahead, we continue to expect two rate hikes in 2019, in May and November, with a pattern of rises occurring every six months thereafter until Bank Rate levels off at 2.5% in 2022. Hence, compared to the spring forecast, we see a delay — but not a dilution — of the rate rise cycle.

[2] *Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 7 February 2018*.
bankofengland.co.uk/-/media/boe/files/monetary-policy-summary-and-minutes/2018/february-2018.pdf

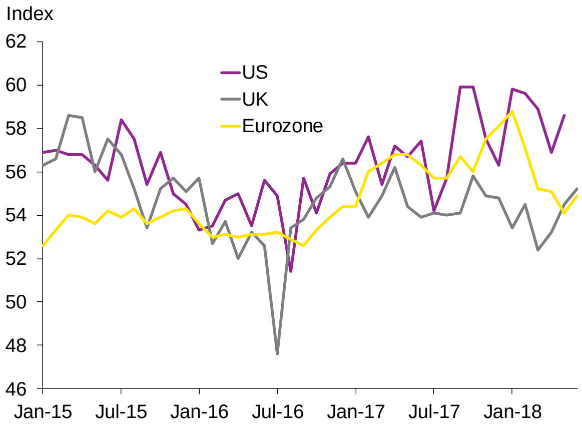
The global backdrop has lost some oomph …

If one wants an illustration of the fickle nature of economic forecasting, a look back to a few months ago at commentary on global economic prospects should provide food for thought. Then, talk of a 'euro-boom' was widespread, a reflection of the eurozone economy having enjoyed its strongest year of growth in 2017 since 2007. And activity in the US was expected to be spurred by the Trump administration's tax cuts.

Since then, the global outlook has become more mixed, with equally uncertain implications for a relatively open economy like the UK's. Notably, growth expectations for the eurozone have been downgraded. GDP in the common currency area rose by 0.4% in Q1 of this year, down from 0.7% in the last three months of 2017 and the weakest rate of expansion for seven quarters.

It had been hoped that this slowdown reflected one-off factors, including bad weather and an influenza outbreak. But the rebound in activity since the first quarter has been much softer than expected, suggesting more structural problems may be at work. Indeed, the composite Purchasing Managers Index (PMI) for the eurozone in May fell below the UK's for the first time in 16 months, a development that continued in the following month. However, as witnessed in part by strength in the same survey, the US has held up better, with a run of disappointing data in March quickly reversing, unemployment at a 20-year low and Q2 looking on course to have delivered annualised growth of over 4%.

Composite PMIs by economy



Source: EY ITEM Club/Bloomberg

As to what this has meant for the UK's tradable sector, net trade added 0.1 percentage points (ppts) to GDP growth in Q1, down from the 0.3ppts contribution in the previous three months. Export volumes were flat, while imports fell 0.2% in the three months to December 2017. In the same period, the trade deficit fell to £3.8bn. At 0.8% of GDP, this was the smallest deficit in GDP terms since Q1 1998.

But the closure of the Forties oil and gas pipeline last December (which cut fuel exports and raised fuel imports) and its subsequent reopening in January suggests a more downbeat picture for net trade in Q1 once one-off factors are stripped out. And a shift in the US towards trade protectionism and the international reaction to this threaten to reduce the scope for export-led growth in the near term. Protectionist moves began with the US's imposition of new tariffs on steel and aluminium imports from the EU, Canada and Mexico in May, followed in June with the announcement of 25% tariffs on $50bn of Chinese imports, with an additional 10% import tax on up to $400bn of imports threatened. The US has also mooted higher tariffs on cars imported from the EU. Those impacted by the US action have in turn responded with actual or threatened tariffs of their own.

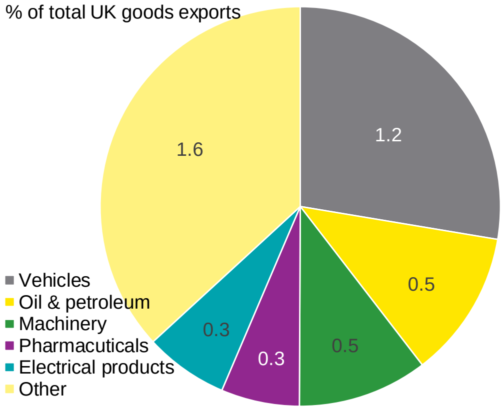
… but the UK is relatively well insulated from a US–China trade dispute …

However, delving beneath the sometimes alarmist headlines, the direct consequences for the UK of global trade angst are likely to be modest. As far as US tariffs on EU products are concerned, UK exports of steel and aluminium to the US in 2017 accounted for only around one-fifth of one per cent of total global goods exports. That said, if implemented, the threat of new US taxes on imports of vehicles and vehicle parts would be more significant — in the same year, the UK exported £7.5bn of products in this category to the US, 2.2% of total goods exports.

But as things stand currently, the UK's relatively small manufacturing sector (10% of GDP) and the nature of exports to China should provide a degree of insulation from a US–China trade dispute, compared to some other advanced economies. When it comes to increased protectionism in US-China trade, arguably it is exports of capital goods which are most vulnerable to tariffs imposed by the former on the latter (if Chinese industrial production drops because of US tariffs, demand for machinery used in that production will also decline). But this is not an area the UK is particularly exposed to. In 2016, cars accounted for the largest chunk of UK goods exports to China (27% of the total), followed by oil and petroleum products (12%), with machinery coming in at third place at 10% (accounting for a mere 0.5% of global UK goods exports). In contrast, machinery made up 21% of German goods exports to China (1.25% of total German goods exports) in the same year.

UK: Goods exports to China

% of total UK goods exports



Source: EY ITEM Club/International Trade Centre

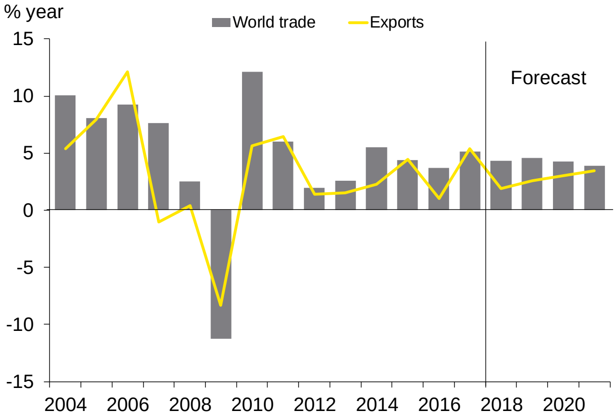
Trade diversion could add an extra channel of impact if US tariffs encourage Chinese producers to try and divert sales to non-US markets. This would deliver lower prices for consumers, but at the expense of UK producers competing with Chinese imports. But the UK does not major in production of the type of Chinese-made goods which the US tariffs are targeting, or the agricultural products Chinese retaliation has focused on. Of course, slower growth in those UK trading partners hit harder by tariffs would ripple through to lower demand for UK goods and services. But short of a serious further escalation, it is hard to see anything other than a very modest effect on UK growth from ongoing trade disputes.

… helped in part by a weaker pound

A recent weakening in sterling, mainly against the dollar, will also go some way to insulating the UK's export sector from the reality of, or potential for, increased global trade barriers. Reflecting a reining back in market expectations for UK interest rate rises but further rate hikes by the US Federal Reserve and the announcement by the European Central Bank (ECB) that it will cease asset purchases at the close of this year, as of the end of June 2018, sterling's trade-weighted value was 1% below the average level in the first quarter and just over 2% weaker than the recent peak in late March. This was almost entirely a consequence of weakness against the US dollar — at just over $1.31, the pound was 5.5% and 8% down on the Q1 average and late March level respectively. On the same comparison, sterling was only marginally cheaper against the euro.

UK: Exports and world trade

% year



Source: EY ITEM Club

On a trade-weighted basis, we expect sterling to stage a modest recovery over the second half of this year, albeit running below the profile predicted in April thanks to a delay in the MPC's path of monetary policy tightening. But a combination of uncertainty stemming from Brexit, the end of the ECB's quantitative easing, and further monetary tightening by the Federal Reserve will continue to put a cap on the pound's value. Sterling is forecast to end 2018 at $1.38, before reaching $1.43 by the middle of next year and $1.47 by the end of 2019.

This appreciation — along with the boost to competitiveness from the pound's steep fall in 2016 having been exhausted, a rising import bill from higher oil prices and a slowdown in the eurozone, the UK's single largest export market — leads us to think that net trade will have a reduced positive impact on GDP growth this year, adding 0.2ppts to the annual rate, compared to a 0.6ppts boost to growth in 2017.

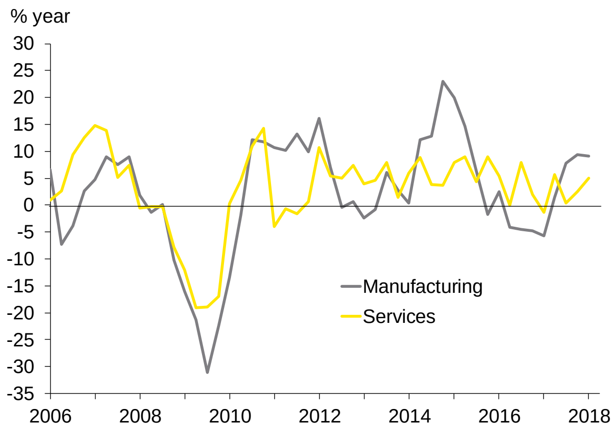
A more uncertain global outlook will be a constraint on investment

Given the relative export- and capital-intensive nature of manufacturing, a less positive outlook for overseas sales has the potential to drag on what has recently been an already subdued performance from headline business investment. Total spending by firms on transport equipment, buildings and other non-financial assets fell by 0.4% in real terms in Q1 2018 on the previous three months, the first quarterly drop since Q1 2017. This left year-on-year growth at 2%, less than half the rate averaged since the current economic expansion began in 2009.

However, the headline number continued to be distorted by major swings in investment in the extraction sector (mainly North Sea oil and gas production) and other small sectors. On an ex-extraction basis, business investment was flat quarter-on-quarter in Q1, little different from the 0.1% rise in Q4 2017, still a very weak showing. But investment by services and manufacturing firms (which collectively account for almost 80% of total business investment) put in relatively good performances in the first three months of this year, rising 9.1% and 5% on a year earlier respectively.

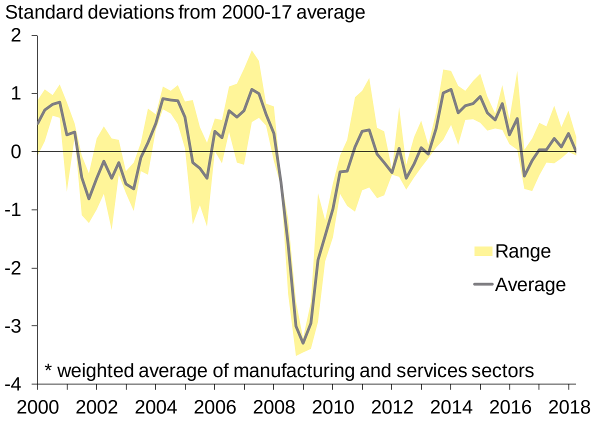
Meanwhile, forward-looking indicators have offered some cause for optimism. Recent survey evidence from the CBI, BCC and the Bank of England has shown investment intentions broadly in line with the long-run norm. The results of the Bank's 'Decision Maker Panel' Survey quoted in May 2018's *Inflation Report* suggested that the drag on investment growth from Brexit uncertainty had eased over the second half of 2017.[3] And EY's latest *UK Attractiveness Survey* found that the UK remained the number one destination for foreign direct investment (FDI) in Europe, ahead of Germany and France.[4]

UK: Real business investment



Source: EY ITEM Club/Haver Analytics

UK: Investment intentions* (CBI, BCC, BoE)



Source: EY ITEM Club/Haver Analytics

But the same EY survey did report a decline in sentiment from foreign investors towards the UK as a place to invest. And continued uncertainty over how, when and in what form Brexit will ultimately take place, risks another fall-off in confidence. The history of EU negotiations being concluded in a flurry of last-minute dealmaking offers some reason to be sanguine about the apparent lack of progress over recent months in arriving at a withdrawal agreement between the UK and the EU. The outlines of a transition arrangement were reached in March, implying that in trade terms, nothing would change between the UK's formal departure from the EU next March and the end of a transitional period in December 2020.

[3] See page 14 of the May 2018 Bank of England *Inflation Report*. bankofengland.co.uk/-/media/boe/files/inflation-report/2018/may/inflation-report-may-2018.pdf
[4] EY, *UK Attractiveness Survey: In transition*, June 2018. ey.com/uk/en/issues/business-environment/ey-uk-attractiveness-survey

However, that transition period remains conditional on a withdrawal deal being reached between the two parties, which will require a resolution of what, so far, is proving to be an intractable quandary — ensuring no hard border on the island of Ireland, satisfying UK parliamentary arithmetic (which is against a 'hard' Brexit) and respecting the 2016 referendum result.

The Government's proposal in June that the UK could remain in a 'customs territory' with the EU beyond the end of the transition period, with the UK continuing to apply the EU's common external tariff, would at least ensure the absence of customs checks on UK–EU trade beyond December 2020.[5] But in trade terms, borders are not just about tariffs and customs issues, but also regulatory checks. A temporary customs union does not deal with the latter issue, the resolution of which would require the UK to maintain regulatory alignment with the EU or, alternatively, for both sides to agree to the mutual recognition of standards.

So speculation that a withdrawal agreement may not be reached until the end of the year is unsurprising, meaning that the drag on investment from Brexit uncertainty is unlikely to go away anytime soon.[6] And beyond Brexit, there are more structural factors which suggest a surge in investment growth is unlikely. In common with other advanced economies, the UK is likely to see the long-running shift from relatively capital-intensive industry towards less capital-intensive services continue. The growing importance of intangible investment and the greater difficulty of measurement may be understating the true level of investment. And, somewhat counter-intuitively, the rapidity of advances in technology may be holding back some capital spending. Firms might worry that new investment in products will be quickly rendered less valuable by better future products. Or the hope of exploiting spillovers from new technology may encourage a 'wait-and-see' approach. Overall, given the weakness of the headline number in Q1, we expect business investment to expand by only 1.3% in 2018. But as Brexit uncertainty diminishes, growth should pick up to 2.8% in 2019.

The outlook presents more risks than opportunities

Developments since our last forecast three months ago have made the task of interpreting the economy even trickier than normal. One source of uncertainty has concerned the scope for a bounceback from Q1's weakness. Although there have been promising signs from the consumer sector, the weakness of the official manufacturing and construction data means that the economy will probably need to rely heavily on services growth continuing its robust performance in April and May if our forecast for GDP growth of 0.4% in the second quarter is to materialise (the Office for National Statistics (ONS) will publish its first estimate of GDP in Q2 on 10 August). And even that pace of expansion would imply that little of the activity lost in the first quarter had been made up. Adding to that the adverse effects of more expensive oil, a slowdown in the eurozone economy and global trade strife, means our GDP growth forecast this year has been cut to 1.4% from the 1.6% expected in April. Growth is then forecast to pick up to 1.6% in 2019, marginally below April's prediction of 1.7%.

In supporting activity, the hoped-for boost from easing inflation and stronger household purchasing power now looks more tenuous, at least in the near term, thanks to higher petrol and utility prices. Further ahead, a lower inflation dividend should become more apparent and the delayed process of monetary policy tightening, relative to previous forecasts, will also take some pressure off households. But our expectation that spending growth will broadly run in line with (relatively soft) rises in incomes implies that the next year or two will deliver an unspectacular performance from consumer spending.

[5] HM Government, *Technical note: Temporary customs arrangement*, June 2018. assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/714656/Technical_note_temporary_customs_arrangement.pdf
[6] Financial Times, *Brexit deal unlikely until year-end as officials revise expectations*, 18 June 2018. ft.com/content/844710ba-72e4-11e8-b6ad-3823e4384287

The EY ITEM Club forecast for the UK economy, summer 2018 % changes on previous year except borrowing, current account, and interest and exchange rates						
	GDP	Domestic demand	Consumer spending	Fixed investment	Exports	Imports
2015	2.3	2.3	2.6	3.4	4.4	5.5
2016	1.8	2.4	3.1	2.3	1.0	3.3
2017	1.7	1.3	1.8	3.4	5.4	3.2
2018	1.4	1.1	1.3	0.6	1.9	0.9
2019	1.6	1.7	1.5	1.7	2.6	2.7
2020	1.8	1.8	1.7	2.3	3.0	2.9
2021	1.8	1.8	1.9	2.3	3.5	3.4
	Net Government borrowing*	Current account (% of GDP)	Average earnings	CPI	Bank Rate	Effective exchange rate
2015	4.2	-5.2	2.8	0.0	0.5	91.5
2016	2.8	-5.8	2.6	0.6	0.4	82.0
2017	2.1	-4.1	2.5	2.7	0.3	77.4
2018	1.8	-3.9	3.0	2.4	0.7	78.8
2019	1.6	-2.9	3.1	1.9	1.2	79.6
2020	1.3	-2.5	3.3	1.9	1.7	81.2
2021	1.1	-2.6	3.4	2.0	2.0	81.9

*Fiscal years, as % of GDP

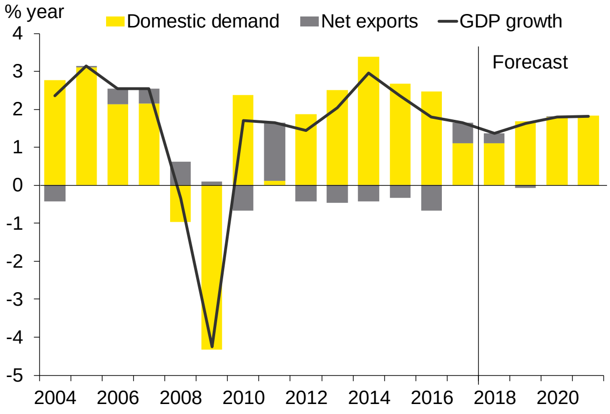
Source: EY ITEM Club

2017's 'sweet spot' for UK exporters, with firms enjoying a double dividend from a cheap currency and a buoyant world economy, particularly the eurozone, has clearly shrunk. As with the UK, it remains unclear whether the eurozone economy's soft patch in Q1 was a temporary aberration or the start of something more worryingly persistent. But what is likely is that, short of an irretrievable breakdown in Brexit negotiations and the probable sharp drop in sterling that would follow, the boost to the competitiveness of the UK's tradable sector from big currency swings has passed.

On a less downbeat note, the small size of the UK's manufacturing sector and the nature of its trade with the US and China means that the UK should lose less than many of its peers from developing global trade protectionism.

Prospects for export and investment growth will continue to hinge in part on the outcome of the Brexit process. Our baseline maintains the assumption that following 'Brexit Day' on 29 March 2019, the UK will move into a transition phase with the EU where, in fact, nothing changes as far as trade relations are concerned. While not eliminating the prospect of an ultimate and disruptive 'cliff-edge', arriving at a withdrawal agreement should boost confidence and promote previously deferred investment to come back on stream.

UK: Contributions to GDP growth



Source: EY ITEM Club

Risks and uncertainties

Our downgraded GDP forecast for 2018 is premised in part on the assumption that the ONS' latest growth estimate for Q1 will remain unchanged. In practice, the pattern in the past has been for early GDP estimates to generally be revised up over time. Those estimates have had a tendency to particularly overstate the weakness of the economy following severe weather events (Q4 2010 being a good example, when an initial estimate that output had fallen 0.5% in the quarter was ultimately revised up to growth of 0.1%).[7] Indeed, Q1's National Accounts have already seen a modest upgrade from the preliminary 0.1% q/q rise in GDP to 0.2% q/q. A repeat of past tendencies would imply the first quarter's estimated performance being pushed up further over time. This would mechanically raise forecast growth for 2018.

Meanwhile, precarious parliamentary arithmetic leaves the Government vulnerable to rebellions, raising the possibility of a general election before the current parliament formally ends in 2022. A change in government would have implications, for example, for fiscal policy, interest rates and microeconomic policy.

As already noted, the UK and EU conditionally agreed earlier this year that a transitional period will follow the UK's formal departure from the EU, something which we assume in our baseline forecast. But this has not eliminated the possibility of a 'cliff-edge' Brexit next March, and the trade barriers, both tariff and non-tariff, which would follow. A transition phase is still dependent on a satisfactory withdrawal agreement being reached, including provisions on the future status of Northern Ireland, an issue on which the two sides currently have very different views. The consequences of failure mean that a compromise is the most likely outcome, but this will require one, or both sides to make substantial concessions, so the possibility of a breakdown in talks cannot be ruled out.

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

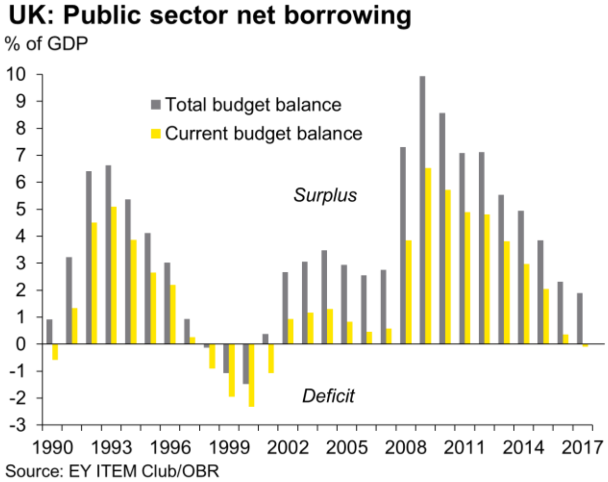
[7] See page 13 of *What's going on?* Speech given by Dave Ramsden, Deputy Governor for Markets and Banking, Bank of England, Barclays Inflation Conference, London, 7 June 2018. bankofengland.co.uk/speech/2018/dave-ramsden-speech-at-barclays-inflation-conference

Forecast in detail

1. Fiscal policy

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

April and May delivered combined public sector borrowing of £11.8bn, down from £16bn in the same period a year earlier and the smallest deficit for the first two months of the fiscal year since 2007–08.



A 26% drop in year-on-year borrowing in April and May was well ahead of the 18% decline forecast by the OBR in March's Spring Statement for 2018–19 as a whole. Moreover, revisions to past data have led to a better starting point for the fiscal year than previously believed.

Total borrowing in 2017–18 is now estimated to have run at £39.5bn, £5.7bn less than the OBR expected in March and almost £20bn below the official forecaster's projection in November 2016. This deficit equated to 1.9% of GDP, the smallest deficit/GDP ratio since 2001–02 and below the post-war average of 2.5% of GDP.

Admittedly, it is still early days as far as predicting 2018–19's fiscal performance is concerned. Much of the narrowing in the deficit in April and May reflected lower spending due to timing effects from EU and debt interest payments. Moreover, relatively modest year-on-year growth in tax receipts of 3% in the three months to May suggested that the weakness of the economy in the early part of this year was making its presence felt.

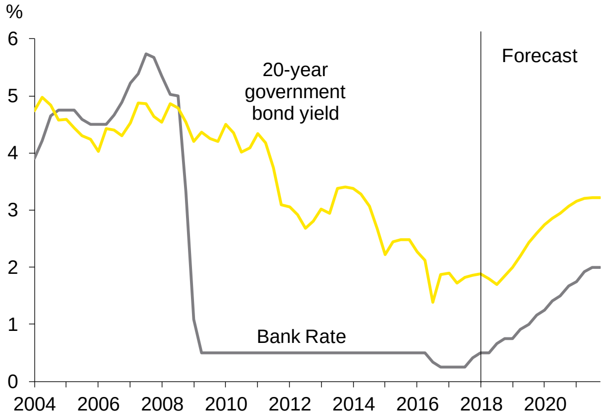
But there seems a reasonable chance that the borrowing this year will undershoot the OBR's forecast of £37.1bn, adding to the room for manoeuvre enjoyed by the Chancellor of the Exchequer with the deficit historically low and gilt yields also very depressed by long-run standards.

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

All else being equal, a downgraded forecast for GDP growth this year and next compared to our expectation three months ago implies a bigger fiscal deficit. However, with the downward revision to borrowing in 2017–18 providing a better starting point and the evidence suggesting that a given amount of GDP growth has become more tax 'rich', our deficit forecast is little changed. Borrowing is forecast to run at £37bn this year, falling to £34bn in 2019–20.

2. Monetary policy

UK: Bank Rate and 20-year bond yield



Source: EY ITEM Club

In recent months, the Bank of England has seemingly edged towards, then reversed its sentiment around a hike in the Bank Rate. We expect one rate rise this year, with August the most likely date. But with underlying inflationary pressure weak, future monetary policy 'normalisation' will be a very gradual process.

The early part of this year had seen strong hints from the MPC that a tightening in monetary policy was approaching, leading to markets essentially fully pricing in a May interest rate hike. Notably, the minutes of February's Committee meeting noted that rate increases might well come "somewhat earlier and to a somewhat greater extent" than previously anticipated.

However, expectations that May would see a hike in Bank Rate were confounded by the weakness of the economy in Q1. While the MPC erred on the side of the quarter's negligible growth being a weather-related blip, the lack of risk in pursuing a 'wait-and-see' approach resulted in policy being kept unchanged.

But June's meeting, which delivered an upbeat assessment of the economy's post-Q1 performance and saw the minority of MPC members favouring an immediate rate rise increase to three, suggested that a near-term tightening in policy is back on track. We think that August will most likely see Bank Rate raised from 0.5% to 0.75% — although there is a significant possibility that the hike could be delayed until November. Two further 25 basis points hikes are expected to follow in 2019, in May and November.

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

Recent months saw sterling lose some of its previous gains against the US dollar, reflecting more dovish rate expectations in the UK and rate rises by the US Federal Reserve. Over the same period, the pound saw little significant movement against the euro, although it did dip to a three-month low in late June.

Sterling is expected to appreciate modestly overall through the second half of the year, ending 2018 at $1.38 before rising to $1.47 a year later. The pound should be supported by a higher Bank Rate and our expectation that the UK and EU will arrive at a Brexit withdrawal agreement, boosting sentiment towards the UK economy and sterling.

3. Prices

With the effect of sterling's 2016 depreciation on import prices fading, inflationary pressures eased during the early part of this year. But more expensive oil and hikes in utility bills mean that the CPI measure is likely to pick up over the next few months. However, the weakness of underlying price pressures suggests this should be only a temporary upswing.

Having peaked at 3.1% last November, annual CPI inflation fell to 2.4% in April, the lowest rate in 12 months, as the inflationary consequences of the pound's fall in 2016 and early 2017 washed out of the year-on-year data.

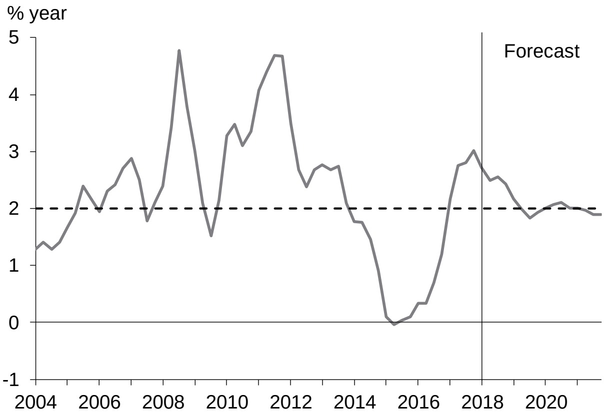
However, May saw an interruption to what had been a steady downward progression, with the CPI rate unchanged from the previous month. That lack of movement reflected competing pressures from a 3.8%

monthly increase in petrol prices, the largest since 2011, versus a fall in the price of recreational goods and a sharp slowdown in increases in the price of electricity.

Given lags between changes in the price of oil (which was up more than 50% year-on-year in sterling terms as of late June) and petrol prices, the latter could well rise further over the coming months. Moreover, the summer will see the 'Big Six' utility companies push through rises in energy bills of up to 5.5%.

These pressures are likely to push up CPI inflation to around 2.7% in July and August. With extra crude supply coming on stream but demand also strong, we think that the oil price will stabilise at around $80 per barrel, implying a 10% uplift on the level as of mid-June. Hence, the inflationary impulse from dearer oil is likely to be sustained for some time. However, base effects and muted underlying inflationary pressures, particularly weak pay growth, should see this rise reversed as the year progresses, with the CPI measure ending 2018 at 2.3%. Core inflation, which excludes volatile items like fuel, ran at 2.1% in May and should see a more modest up and down movement.

UK: CPI inflation



Source: EY ITEM Club

Overall, this balance of forces leads us to expect CPI inflation to average 2.5% this year, only 0.1ppts down from 2017, before falling to 2% in 2019.

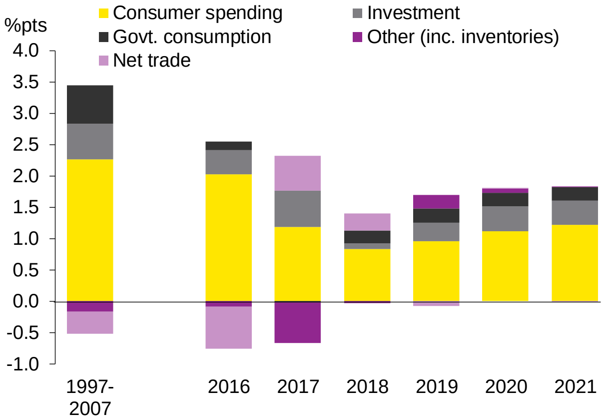
RPI inflation will be higher than the CPI measure over the forecast period. This is largely due to the so-called 'formula effect' (i.e. the different methods of aggregation between the RPI and CPI measures that place an upward bias on RPI) and the impact of a steady increase in interest rates on mortgage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

4. Activity

A weak first quarter, with GDP rising by 0.2% q/q, got the economy off to a bad start to 2018. While more recent evidence has suggested some rebound in activity, it is difficult to see how economic growth this year will be anything other than tepid.

Disruption caused by severe weather in February and March along with the collapse of Carillion, the UK's second-largest construction company, dragged GDP growth in Q1 down to 0.2% q/q, the joint weakest rate since the last quarter of 2012. Construction was the chief culprit in explaining this weakness – output dropped 0.8% q/q in Q1.

UK: Contributions to GDP growth



Source: EY ITEM Club

A rebound in consumer activity in Q2 and a decent set of Chartered Institute of Procurement & Supply (CIPS) surveys suggest that activity has enjoyed some bounceback, with quarterly growth expected to have run at 0.4%. But continued weakness in manufacturing and a mixed performance from construction suggests that the economy has not recouped the loss made in the first quarter. And further ahead, the ingredients for strong growth are lacking. Notably, with households expected to grow spending more closely in line with incomes and pressure from rising interest rates, consumer spending growth is forecast to slow to 1.2% this year from 1.7% in 2017, before creeping up to 1.5% in 2019.

Meanwhile, the environment for business investment continues to benefit from high corporate profitability and cheap financing. But uncertainty stemming from Brexit and global trade disputes presents an opposing force, although the former should hopefully diminish as the year progresses.

A cloudier global outlook, including a slowdown in the eurozone economy, the consequences of rising trade protectionism and a stabilisation in the pound's value, lead us to expect that 2017's sizeable boost to GDP growth from net trade will fall back this year. Indeed, we expect the positive contribution from that component of GDP to halve to 0.2ppts in 2018 from 0.4ppts in 2017.

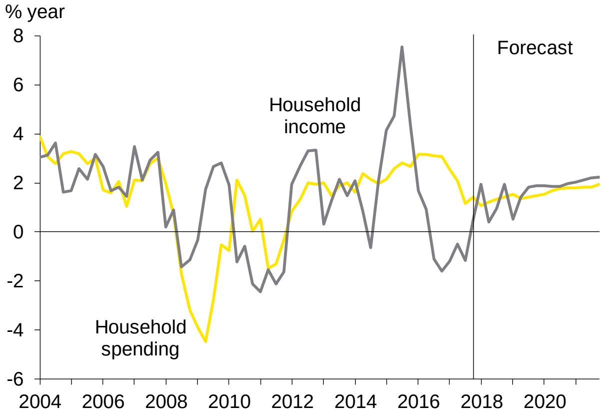
In aggregate, these forces point to a slowdown in GDP growth this year to 1.4% from 2017's 1.7%. This would be the weakest performance since 2012 and well below the 2% annual increase averaged over the current expansion.

Growth is then forecast to pick up to 1.6% in 2019, supported by a further improvement in consumer purchasing power and modestly firmer business investment as a UK–EU transition arrangement comes into effect. Inflation is seen as averaging 2.0% in 2019 while earnings growth is expected to pick up further, albeit modestly. While the UK will formally leave the EU in late March 2019, nothing much is expected to change as a transition arrangement will essentially preserve the status quo until at least the end of 2020. However, negotiations over the UK's longer-term relationship with the EU are likely to remain challenging and uncertain, which will limit the upside for business investment. It is also likely that net trade will be hampered in 2019 as global growth slows modestly.

5. Consumer demand

A very modest rise in consumer spending in Q1 was probably explained in part by the temporary effect of severe weather in deterring shoppers. But with the boost to spending power from lower inflation now looking more fragile and evidence that households are rebuilding their savings, this year is likely to deliver a soft performance from the dominant part of the economy.

UK: Real household income and spending



Source: EY ITEM Club

A 0.2% quarterly increase in consumer spending in Q1 was down from 0.3% in the previous three months and was the slowest rise since the last quarter of 2014. However, heavy snow in February and March probably played a part in this weakness, particularly causing a sharp fall in retail sales.

Falling inflation earlier this year and some pick-up in pay growth eased the squeeze on households' real income and should deliver a better performance from household spending in Q2. But the effect of more expensive oil on petrol pump prices and increases in energy bills over the summer are likely to see inflation re-emerge as a consumer headwind, at least temporarily.

Meanwhile, growth in cash pay has remained stubbornly unresponsive to falling unemployment, reflective of still-elevated underemployment and a loss of worker bargaining power. And the budgets of some households will continue to be pressured by the cash freeze on working-age welfare benefits as well as a growing headwind from interest rate hikes. Consequently, we expect real household incomes to rise by 1.3% this year, followed by 1.4% in 2019, a long way from the 3.1% annual increase averaged in the 10 years to 2007.

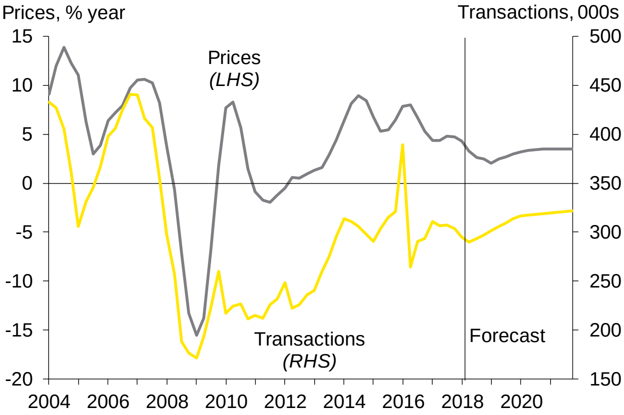
Recent years have seen households support spending in the face of sluggish real income growth by saving less. Indeed, the household saving ratio reached a record low of 4.1% in 2017. With the ratio so depressed by historical standards, there seems a good chance that households will want to restore their balance sheets to a degree. Higher saving is also likely to be prompted by a rise in pension autoenrolment rates, which increased from 1% to 3% for employees in April. This would imply spending rising more closely in line with incomes going forward.

This expectation is the key driver in our forecast that consumer spending will rise by only 1.2% this year, down from 1.7% in 2017 despite a more favourable inflation environment. Growth then picks up to 1.5% in 2019 as inflation falls back and earnings growth picks up modestly, but employment gains also slow. Consumers will also likely face modestly higher interest rates in 2018 as the Bank of England looks to gradually normalise monetary policy.

6. Housing market

Activity in the housing market has been stable but sluggish in recent months, reflecting pressures on real incomes, stretched affordability and, a more tentative explanation, expectations of rising interest rates. Given the persistence of these factors, 'stable and sluggish' is likely to continue characterising the housing market.

UK: House prices and transactions



Source: EY ITEM Club

Mortgage approvals for house purchase have drifted down since the start of the year, fluctuating between 62,000 and 67,000 compared to an average of 66,000 in 2017 (both a long way from the 81,000 averaged since records began in 1993). Over the same period, transactions (which include cash purchases) have run at just over 100,000 a month, slightly above the long-run, post-2005, average of 96,000. Hence, it appears that last November's hike in Bank Rate and the MPC's mood music earlier this year that further rises were on their way, may have had some effect on mortgage demand, albeit modest.

The same influence may have been at work on property prices. National house price inflation has slowed marginally over the last few months. The three months to May saw annual price rises of a little above 2% on both the Nationwide and Halifax measures. However, the ONS/Land Registry measure has continued to be an outlier, reporting much stronger price growth of 4.4% over the same period.

With no obvious reason to anticipate a shift in fundamentals, both mortgage demand and house price inflation are likely to remain subdued over the remainder of this year and into 2019. A hoped-for recovery in real household incomes will be held back by a stickier outlook for inflation, and record high employment will reduce the scope for further jobs gains. And while interest rates are set to increase at a slow pace, dearer money will nevertheless act as a headwind at the margin.

Moreover, even with house price inflation running at low levels, the ratio of prices to average earnings is still very stretched by historical standards (a ratio of 5.58 in May according to the Halifax, compared to an average since 1983 of 4.24). These factors lead us to expect house prices to rise by 3.2% this year with the end-of-year rate standing at 2.5% (on the ONS/Land Registry basis). Annual house price inflation is seen as hitting a low of 2.0% early on in 2019, before edging back up to 3.0% by the end of the year to give an average increase of 2.5% over 2019.

7. Company sector

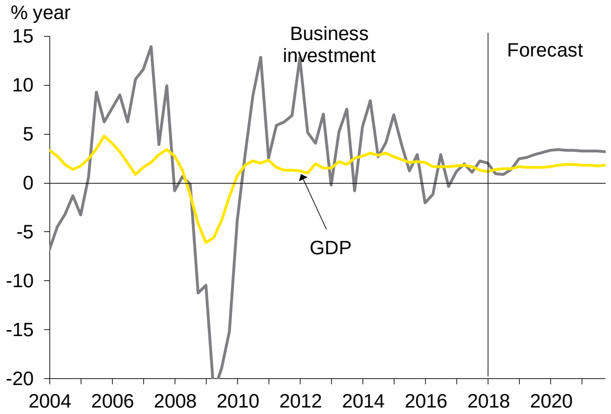
On a headline basis, businesses' appetite to invest declined in the first quarter of 2018. But the total figure continued to be distorted by extreme volatility in individual sectors. 2018 may see some of the weight of Brexit uncertainty lifted if progress is made towards a UK–EU deal and a transition arrangement agreed in March moves towards ratification. But it will be some time before this headwind fades completely.

Business investment dropped by 0.4% q/q in Q1 2018, the first fall since the last three months of 2016. But the aggregate number continued to be distorted by extreme volatility in capital spending by the extraction sector (mainly North Sea oil and gas). On an ex-extraction basis, Q1 delivered no change in business investment.

Recent survey evidence from the CBI, BCC and the Bank of England has shown investment intentions broadly in line with the long-run norm. And the latest results of the Bank of England's 'Decision Maker Panel' Survey suggested that the drag on investment growth from Brexit uncertainty had eased over the second half of 2017.

However, the same survey indicated that a drag still remained present and the lack of public progress made so far in 2018 on Brexit negotiations suggests that uncertainty from this source is likely to have continued weighing on capital spending.

UK: Business investment and GDP



Source: EY ITEM Club

Admittedly, cheap credit, elevated profitability and decent growth in some of the UK's major trading partners, particularly the US, represent some investment-positive factors, particularly for manufacturing.

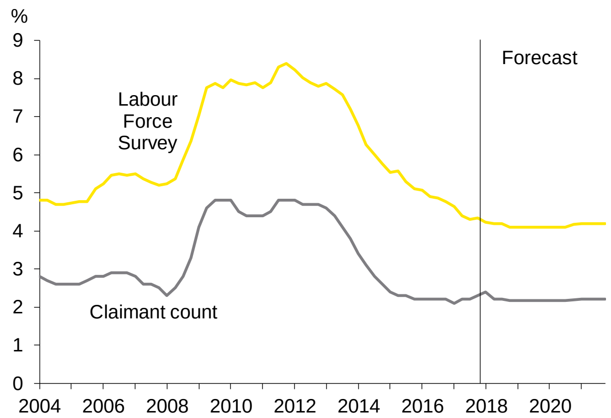
But a lack of Brexit progress at June's meeting of the European Council, and domestic political strife, offer some counters to these positives, And structural factors, such as the long-running shift from relatively capital-intensive industry towards less capital-intensive services, is likely to cap firms' willingness to spend, as might the sheer speed of technological advancements.

Overall, given the weakness of the headline number in Q1, we expect business investment to expand by only 1.3% in 2018. But assuming an easing of Brexit uncertainty, growth in business investment should pick up to 2.8% in 2019.

8. Labour market and wages

The strength of jobs creation in recent months has been at odds with the apparent weakness of economic activity. The employment rate reached a record high and the jobless rate has stabilised at a 43-year low. But the unresponsiveness of pay to this apparent tightness suggests that labour market slack has not been exhausted.

UK: Unemployment rate



Source: EY ITEM Club

The three months to April saw the number in work rise by 146,000 to a record 32.394 million, lifting year-on-year employment growth to 1.4%, the strongest since the summer of 2016. Moreover, it pushed up the employment rate to a new record high of 75.6%. Although joblessness dropped by 37,000 over the same period, a fall in inactivity kept the LFS unemployment rate unchanged at a 43-year low of 4.2%.

The levels reached by employment suggest that room for further gains will be more constrained. However, the fact that a slowdown in growth in the foreign-born workforce, which has accounted for the bulk of growth in workers in recent years, has so far been compensated for by a rise in participation by UK-born adults, offers cause for optimism. This, combined with the strength in jobs observed in the year-to-date, leads us to forecast a pick-up in employment growth from 1% in 2017 to 1.2% this year, before easing back to 0.5% in 2019. The jobless rate is expected to stabilise at current levels.

However, strength in labour market quantities has not been matched by a significant, sustained upturn in pay growth. After firming gradually from 2.0% in mid-2017 to reach a peak of 2.8% in the three months to both February and March, total average annual pay growth relapsed to 2.5% in April, (the weakest rise since last November). Meanwhile, regular pay growth (which excludes bonus payments) trended up gradually from a low of 2.0% in the three months to April 2017 to a peak of 2.9% in the three months to March 2018, but then edged back to 2.8% in April. And annualised three-month-on-three-month growth in regular pay, a measure previously cited by the MPC as evidence of rising pay pressure, slowed to a 12-month low in April.

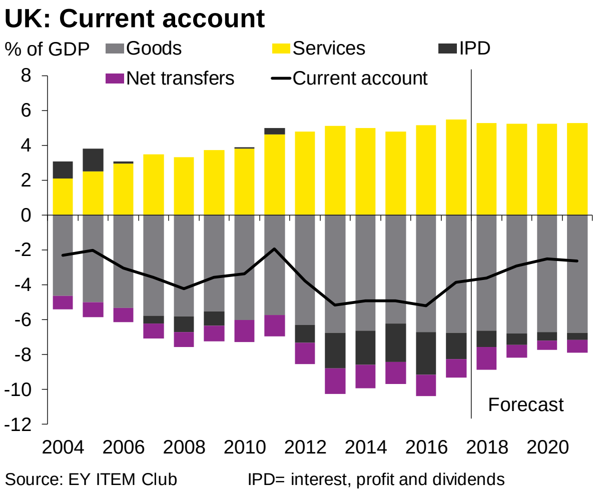
This lack of response suggests that still-elevated underemployment, and the reduction in worker power presented by developments like globalisation and competition from migrant workers, are still making their presence felt. As a result, growth in average earnings is forecast (on a National Accounts basis) to run just below 3% this year, followed by 3.1% in 2019, both a long way from the 4%–5% pace seen before the financial crisis.

9. Trade and the balance of payments

The boost to net trade in 2017 from strong global growth and sterling's past depreciation has remained present, albeit with diminishing power. Q1 2018 delivered no change in export volumes on the previous quarter, compared to a 1% rise in Q4 2017. However, imports dropped by 0.2%, the second consecutive quarterly decline. Meanwhile, the trade deficit narrowed to 0.7% of GDP, a 20-year low.

2017 saw net trade add 0.6ppts to GDP growth, one of the biggest gains from this source in the last 25 years. But the factors which assisted with that contribution – robust global growth, particularly in the eurozone, and sterling's post-referendum weakness – are both looking less promising this year.

Notably, GDP growth in the eurozone almost halved in Q1 2018 to 0.4%, with the evidence mixed on a rebound in the second quarter. Moreover, international trade disputes threaten to sap global growth more broadly. And as of mid-June, the pound's trade-weighted value was more than 6% up on the post-referendum low reached in October 2016 (albeit with the currency still cheap by historical standards and weakening again in recent months). These less favourable developments lead us to expect net trade to make a reduced contribution to GDP growth this year compared to 2017, followed by a marginally negative effect in 2019.



Net trade-positive factors also contributed to a narrowing in the current account deficit in 2017. That year recorded a deficit of 3.9% of GDP compared to 5.2% in 2016. And Q1 2018 saw the deficit decline further to 3.4% of GDP, the second smallest shortfall in six years. That said, with the UK's overseas investment income boosted by a still reasonable rate of economic expansion overseas, we think that the current account shortfall will continue to decline, albeit at a slower pace, running at 3.6% and 2.9% of GDP in 2018 and 2019 respectively.

EY | Assurance | Tax | Transactions | Advisory

About EY

About EY ITEM Club

EY ITEM Club is the only non-governmental economic forecasting group to use the HM Treasury's model of the UK economy. ITEM stands for Independent Treasury Economic Model. HM Treasury uses the UK Treasury model for its UK policy analysis and Industry Act forecasts for the Budget. EY ITEM Club's use of the model enables it to explore the implications and unpublished assumptions behind Government forecasts and policy measures.

Uniquely, EY ITEM Club can test whether Government claims are consistent and can assess which forecasts are credible and which are not. Its forecasts are independent of any political, economic or business bias.

Ernst & Young LLP

ey.com/uk/item