



EY ITEM Club Autumn Forecast

Uncertainties and weak
global environment
weigh on UK economy

November 2019



EY

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Contents

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Foreword

Light at the end of the tunnel?

Uncertainty has been the dominant theme of the EY ITEM Club forecasts over the last three years since the Brexit referendum. With the UK recently agreeing a withdrawal agreement with the European Union (EU), hopes were raised that we might be about to move forward with more certainty. However, with the withdrawal agreement yet to be passed by Parliament, the outlook remains unclear.

Expectations may have been running ahead of themselves in any case. The withdrawal agreement only covers the next 14 months and as it defines the terms of the UK's exit, it offers almost no additional guidance on the future of the UK's trading and other relationships with the EU after 2020. In so far as we can glean anything about likely conditions after 2020, the political declaration suggests a much less comprehensive relationship than currently exists, which, other things being equal, the majority of forecasters believe is likely to mean a slower rate of UK GDP growth after 2020 as compared to staying in the EU.

Or more of the same?

In truth therefore, little has changed in the short term and as a consequence, the EY ITEM Club Autumn Forecast 2019 maintains the GDP growth projection of 1.3% for 2019 from the Summer Forecast 2019. More interestingly, the latest forecast markedly cuts expected expansion in 2020 to 1.0% from the 1.5% rate previously expected. This downgrading of growth in 2020 reflects an assumption that the UK will leave the EU at the end of January, the fact that uncertainty has not been significantly reduced by the UK and EU agreeing a withdrawal agreement, and that the EY ITEM Club now believes that the lack of clarity over the future UK and EU relationship will limit any recovery in business investment in the immediate future more than previously thought.

Despite concerns over uncertainty, it is interesting to note that the economy performed largely as expected over the past three months following the path set out in the Summer Forecast 2019. GDP contracted 0.2% quarter-on-quarter (q/q) in Q2 2019, and it currently looks like expansion of 0.4% q/q occurred in Q3. However, this was buoyed by strong growth in July and largely weak news on the economy for August and September, indicating that heightened Brexit, domestic political and global economic uncertainties are combining to create a very challenging environment.

With no clear pattern ...

Despite a relatively steady quarter, the economy remains difficult to understand because the individual components are likely to develop in different ways:

- Consumers are benefitting from better fundamentals but signs of softening in the labour market may add to the growing weakness in consumers' confidence and limit any increases in spending.

- ▶ The global economy is under pressure, with concerns over geopolitics and trade weighing down on activity, and trade is unlikely to contribute much to UK growth.
- ▶ On a positive note, fiscal policy will be more supportive than previously planned following Chancellor Sajid Javid's announcement in the Spending Review for 2020/21 that public spending will rise 4.1% in real terms, the fastest increase in 15 years. It is also highly likely that the Budget for 2020/21 will contain further fiscal loosening measures.

... plan for the worst ...

There is no obvious boost to growth in sight and investment analyses will remain difficult in this environment, due to the lack of clarity on the UK and EU relationship after 2020. It is certainly possible that agreeing a future relationship will not be possible in 14 months and the UK will then either find itself without a deal or will extend the transition period. Businesses should continue to plan for low growth and have contingencies around a possible future 'no-deal' scenario, while at the same time developing options for future investment that can be realised once more clarity emerges. The next 12 to 18 months are likely to be volatile, with the potential for sentiment to shift quickly in response to political developments.

... and look to the future

It is important not to let the short-term concerns stop businesses from thinking long term. I have been struck in recent weeks by just how significant concerns over the climate emergency and its potential implications for business have become. Combine these potential impacts with the changes that Brexit and technological change could bring to markets and supply chains, and it is clear that strategic thinking is required to identify the way forward in a dynamic economy. There will be winners and losers in this changing environment and companies need to do the work now to ensure they come out on the right side of the line.

Highlights

- ▶ The EY ITEM Club Autumn Forecast 2019 maintains the GDP growth projection of 1.3% for 2019 but it markedly cuts expected expansion in 2020 to 1.0% from the 1.5% rate we had expected in our Summer Forecast 2019. Our forecast is based on the assumption that the UK will leave the EU with a 'deal' by 31 January 2020. The Summer Forecast 2019 had been based on a 31 October UK exit with a deal.
- ▶ Our longer-term UK growth forecasts have been trimmed on the assumption that the UK's longer-term relationship with the EU will be less close than previously expected. The revised political declaration indicates that the UK wants a free-trade agreement with the EU with less regulatory alignment than had previously been planned. This suggests that UK companies will face higher non-tariff frictions when serving EU markets.
- ▶ The economy has largely developed over the past few months as we had expected in our Summer Forecast 2019. GDP contracted 0.2% quarter-on-quarter (q/q) in Q2 2019, and it looks like expansion of around 0.4% q/q occurred in Q3. However, this was buoyed by strong growth in July, and largely weak news on the economy for August and September indicates that heightened Brexit, domestic political and global economic uncertainties combined to create a very challenging environment. Indeed, we suspect that growth will be weaker in Q4 2019.
- ▶ Although the economy has largely developed as we expected since our last forecast, we believe the weakened global economic environment, as well as appreciable UK domestic political uncertainties, will mean that even with the UK leaving the EU with a deal by the end of January 2020, uncertainties are unlikely to diminish as much as previously seemed likely, so any boost to economic activity will be limited.
- ▶ Furthermore, Brexit uncertainties will probably remain relatively elevated after the UK's exit from the EU. Businesses in particular are likely to be concerned that the revised political declaration accompanying the withdrawal agreement points to a looser and potentially less economically favourable UK-EU relationship than had been planned under Theresa May's political declaration. Additionally, negotiations over the UK's longer-term relationship with the EU will be far from easy to negotiate. Indeed, the end of 2020 could well mark another cliff edge in the Brexit process as that is when the transition period is currently meant to end, and it looks improbable that the UK and EU will have agreed a long-term relationship by then.
- ▶ With uncertainties expected to remain relatively elevated and the global economy struggling, the pick-up in business investment after the UK leaves the EU with a deal is likely to be gradual and limited. The more challenging global economic and trading environment is also likely to weigh on UK exports more than we previously anticipated and it could also affect consumer confidence. We also suspect that while the fundamentals for consumers will remain relatively decent in 2020, they will likely be affected by earnings growth easing back from its recent highs together with a softer labour market.
- ▶ On the positive side for growth prospects in 2020 (and 2021), fiscal policy will be more supportive than previously planned following Chancellor Sajid Javid's announcement after the Spending Review for 2020/21 that public spending will rise 4.1% in real terms, the fastest increase in 15 years. Further limited fiscal stimulus is likely to be announced in the Budget for 2020/21 (whenever that is now enacted).
- ▶ The economy is unlikely to be hampered by higher interest rates in 2020; indeed, if the Bank of England does act on monetary policy in 2020, it now looks most likely to be to cut interest rates from 0.75%. However, we currently lean towards the view that interest rates are most likely to stay at 0.75% through to 2021.
- ▶ Should the UK still ultimately leave the EU without a deal (which is still not inconceivable despite becoming less likely), we suspect that GDP growth would be limited to just 0.2% in 2020, with the economy likely suffering mild recession for a time. Probable major uncertainty would negatively impact business sentiment and investment, and also affect consumers (albeit to a lesser extent). Trade would be substantially affected as non-tariff barriers kicked in. The impact of changes in tariffs is harder to judge as the Government has indicated that, under a temporary scheme, 88% of imports by value would be eligible for zero-tariff access compared to 80% of imports currently being tariff-free. Meanwhile, supply chains would be affected by any disruption at ports. While a likely sharp sterling fall would help UK exporters, it would also raise import prices, pushing up businesses' costs and consumer price inflation, thereby hitting households' purchasing power. As well as limiting their investment, businesses would probably be more cautious on employment and pay, with negative repercussions for consumers. We expect policymakers would react by easing both fiscal and monetary policy.

Introduction

As we launch our Autumn Forecast 2019, once again we have to acknowledge that the UK economy has faced major uncertainties, which currently persist. Our Autumn Forecast 2019 is based on the assumption that the UK will leave the EU with a deal by 31 January 2020. The Summer Forecast 2019¹ had been based on a 31 October exit with a deal.

While Boris Johnson's agreement of a new withdrawal deal with the EU in mid-October, its subsequent acceptance in principle by Parliament and the flexible extension of Brexit to 31 January 2020 has seemingly significantly increased the chances that the UK will leave the EU with a deal, there is still some way to go in the process, with more twists and turns seemingly inevitable. Indeed, the general election on 12 December could well be the next twist as it could significantly change the Parliamentary make-up, with major implications for Brexit. Then again, it may not. While the Conservatives currently hold a substantial lead in most opinion polls, which would suggest that they are headed for a clear majority in December's election, there could be a particularly high degree of tactical voting in the general election largely based on Brexit leanings that could significantly influence the result. It is also possible that the Conservatives could lose support to the Brexit Party for failing to deliver on Boris Johnson's pledge to leave the EU by 31 October.

It is also notable that the revised political declaration that accompanied Boris Johnson's withdrawal agreement with the EU indicates that his government are targeting a looser long-term relationship with the EU than had been the case with the Theresa May government. Furthermore, negotiations over the UK's long-term relationship with the EU are likely to prove highly challenging, which will likely sustain uncertainty. Indeed, the end of 2020 could well mark another cliff edge in the Brexit process as the transition period is currently meant to end then, and – given the tortuous way negotiations have gone so far in the Brexit process – it seems improbable that the UK and EU will have agreed a long-term relationship by then. While there is scope to extend the transition period by up to two years, should both sides agree, matters could conceivably once again go down to the wire.

On top of this, the global economic environment has become more difficult and unsettled with more evidence of slowing activity amid a recent renewed pick-up in trade tensions. This has been reflected in an ongoing downgrading of global economic growth forecasts.

The economy has essentially developed over the past few months almost exactly as we had had expected in our Summer Forecast 2019. GDP contracted 0.2% q/q in Q2 2019, and it currently looks like expansion of around 0.4% q/q occurred in Q3. At one stage over the summer, a stream of weak surveys fuelled concern that Q3 could see further contraction, thereby pushing the economy into recession, but these concerns were diluted by news that GDP grew 0.3% month-on-month (m/m) in July. Nevertheless, largely weak news on the economy since July together with heightened Brexit, domestic political and global economic uncertainties are currently combining to create a very challenging environment.

Despite the economy recently developing in line with our expectations, we have become more pessimistic over the outlook given the major uncertainties surrounding the economy and the weakened global economic environment. This means that even with the UK leaving the EU with a deal in the near term, the pick-up in growth will likely be limited.

Consequently, while we have kept the 2019 GDP growth projection unchanged at 1.3% in our Autumn Forecast 2019, we now expect GDP growth to be limited to just 1.0% in 2020 compared to the 1.5% expansion we had anticipated in our Summer Forecast 2019. This is despite the economy being assisted by a more helpful fiscal environment in 2020/21 than previously looked likely, and by the Bank of England probably keeping interest rates unchanged at 0.75% through to 2021. Indeed, if the Bank of England does act on interest rates in 2020, it is probably now more likely to be a rate cut rather than a hike.

We have also reduced our longer-term GDP growth forecasts reflecting the fact that the UK's longer-term relationship with the EU will likely be less close than previously expected. The revised political declaration accompanying Boris Johnson's withdrawal agreement with the EU indicates that the UK wants a free-trade agreement with the EU with less regulatory alignment than had previously been planned. This suggests that

¹ EY ITEM Club Summer Forecast 2019: more uncertain than ever. July 2019. See emeia.ey-vx.com/4838/129294/landing-pages/download-the-ey-item-club-summer-forecast-july-2019.asp

UK companies will face higher non-tariff barriers when serving EU markets. Specifically, GDP growth in 2021 is now seen at 1.5% (instead of 1.8%), rising to 1.7% (1.9%) in 2022 and 1.8% (2.0%) in 2023.

While it now looks unlikely, the possibility of the UK ultimately leaving the EU without a deal cannot be completely ruled out. Should this happen, we believe the near-term growth outlook would be noticeably weaker, as major uncertainty would negatively impact business sentiment and investment, as well as affect consumers. Trade would clearly be substantially affected as non-tariff barriers kicked in. The impact of changes in tariffs is harder to judge as the Government has indicated that, under a temporary scheme, 87% of imports by value would be eligible for zero-tariff access compared to 80% of imports currently being tariff-free. Meanwhile, there could be significant disruption at ports, which would affect supply chains. A sharp drop in the pound is likely in the event of a 'no-deal' exit by the UK from the EU and this would provide help to UK exporters, but it would also push up businesses' costs and consumer price inflation, thereby weighing down on households' purchasing power. In addition to limiting their investment, businesses would possibly adopt a significantly more cautious stance on employment and look to curb their costs by limiting pay, and this, alongside the expected rise in inflation, would have adverse repercussions for the consumer.

We suspect that the Bank of England would most likely respond by cutting interest rates, while there would also likely be a further substantial easing of fiscal policy on top of the extra public spending for 2020/21 announced in September. On balance, in the absence of a deal, we suspect GDP growth would possibly come in at just 0.2% in 2020, with the economy suffering mild recession for a time. Growth is seen picking up to 1.0% in 2021.

Brexit uncertainties have been intense as UK scheduled exit from the EU delayed again

Brexit uncertainties were intense over the summer and early autumn as it was highly questionable what would actually happen on 31 October when the UK was scheduled to leave the EU.

The replacement of Theresa May as Prime Minister by Boris Johnson in July led to the UK adopting a significantly different approach to Brexit negotiations, with Mr Johnson repeatedly stressing that the UK would leave the EU on 31 October. He also rejected the Irish backstop arrangement that had been agreed with the EU in Theresa May's failed deal. For some time, this seemingly increased the possibility that a 'no-deal' Brexit could occur on 31 October, even though Parliament legislated against such an event happening and instructed the Prime Minister to seek an extension from the EU for the UK's exit unless there was Parliamentary approval for a withdrawal agreement before the end of October. Meanwhile, Mr Johnson continued to insist that he would not seek an extension from the EU, maintaining that the UK would leave the EU on 31 October.

Prospects for the UK leaving the EU with a deal on 31 October seemed to be steadily diminishing until it was reported on 10 October that Boris Johnson and the Irish leader, Leo Varadkar, had declared after a meeting that they could see a "pathway" to a possible Brexit deal. This led to intense negotiations between the UK and the EU, ultimately resulting in the announcement of a deal on 17 October.

Parliament approved the revised withdrawal agreement in a second reading by a majority of 30 on 22 October but it subsequently rejected the three-day timetable proposed by the Government to enact it, which effectively scuppered the Prime Minister's pledge to achieve Brexit on 31 October. Consequently, the Prime Minister had to follow through on Parliament's legislated demand that he should seek a Brexit extension from the EU, although he made it clear to the EU that it was against his will. The EU responded by offering an extension to Brexit until 31 January, with the possibility of the UK leaving before then if the withdrawal agreement is ratified by Parliament.

While there is the very real possibility that Parliament – which could well look very different after the 12 December general election – could look to make significant amendments to Mr Johnson's Withdrawal Bill, we suspect that it is most likely to pass essentially in its current form after the general election and that the UK will leave the EU by 31 January 2020.

However, even if the UK does leave the EU by 31 January 2020 with a deal, Brexit uncertainties are likely to remain significant as attention will probably quickly focus on negotiations over the UK's longer-term relationship with the EU. An immediate concern for many businesses is that the revised political declaration

accompanying the withdrawal agreement points to a looser and potentially less economically favourable UK–EU relationship than had been planned under Theresa May’s political declaration. The Johnson government is aiming for a free-trade agreement with the EU with less regulatory alignment. This is seen as making a frictionless border between the UK and the EU less achievable. Uncertainty is also likely to be fuelled as 2020 progresses by the fact that the transition period after the UK leaves the EU is currently only scheduled to last until the end of 2020, and there seems little likelihood that agreement on the longer-term UK–EU relationship will be reached by then. While the transition arrangement can be extended to December 2022 if both sides agree, there is concern that the transition period could end in December 2020 without any agreement being reached.

Meanwhile, domestic political uncertainties intensified over recent months. The Conservatives lost the small majority that they held in Parliament which was provided thanks to their support from the DUP. This loss was the consequence of a number of MPs being expelled from the Conservative Party for voting against the Government on the ‘no-deal’ legislation as well as from voluntary defections and by-election losses. However, the Opposition parties repeatedly held off from agreeing to a general election, reflecting their determination to ensure that a ‘no-deal’ Brexit could not occur before the general election took place.

The EU’s extension of the Brexit deadline to 31 January (or earlier) opened the door to a general election, which will take place on 12 December. At the time of releasing this forecast report, most opinion polls show the Conservatives well ahead and suggest that they will gain a clear overall majority. However, it is far from certain that this will happen. With Boris Johnson failing to deliver his pledge to leave the EU by 31 October (which risks the Conservatives losing support to the Brexit Party) and Brexit emotions running high, a lot of tactical voting could well occur in the general election. This could result in many seats going against what the polls would suggest.

Our central forecast is based on the assumption that the UK leaves the EU with a deal by 31 January 2020 and that there is a Conservative government after a narrow win in the general election.

Global economic environment has deteriorated further

The global economic situation is largely unhelpful for UK growth prospects. Indeed, it has deteriorated further since our Summer Forecast 2019, with the bond markets in particular signalling the increasing risk of a global recession. In mid-August, US and UK 10-year bond yields both dipped below the two-year yield for the first time since 2008. This provides a particularly challenging environment for UK exporters while also reinforcing the concerns affecting many businesses, thereby threatening investment prospects. Manufacturing has continued to suffer.

Global growth seemingly slowed in Q2 2019. In particular, annualised GDP expansion in the US slowed to 2.0% in Q2 from 3.1% in Q1. Meanwhile, eurozone GDP growth halved to 0.2% q/q in Q2 from 0.4% q/q in Q1, limiting year-on-year (y/y) growth to 1.1%. Particularly notably, German GDP contracted 0.1% q/q in Q2 after growing 0.4% q/q in Q1. Additionally, Chinese growth eased back to 6.2% y/y in Q2 from 6.4% y/y in Q1. Meanwhile Japanese GDP slowed to 0.3% q/q in Q2 from 0.7% q/q in Q1.

Furthermore, Q3 2019 could well have seen a further slowdown in global economic activity. It has already been reported that Chinese GDP growth dipped to 6.0% in Q3, which was the weakest performance for nearly 30 years. Additionally, annualised GDP growth edged down to 1.9% in Q3. Furthermore, the JP Morgan Global Composite PMI weakened in September to be at its joint lowest level since mid-2016. However, eurozone GDP defied expectations of a further slowdown in Q3, although it remained weak at 0.2% q/q. Year-on-year growth slowed further to 1.1%. It looks highly possible that Germany suffered further slight q/q GDP contraction in Q3, which would mean it slipped into modest recession.

Disappointingly, the quarterly goods trade barometer of the World Trade Organization (WTO) fell to 95.7 in August (from 96.7 in May when the indicator was called the World Trade Outlook Indicator). This took it substantially below the baseline level of 100.0 which indicates trend growth in global trade. The indicator is based on merchandise trade volume in the previous quarter, export orders, international air freight, container port throughput, car production and sales, electronic components and agricultural raw materials.

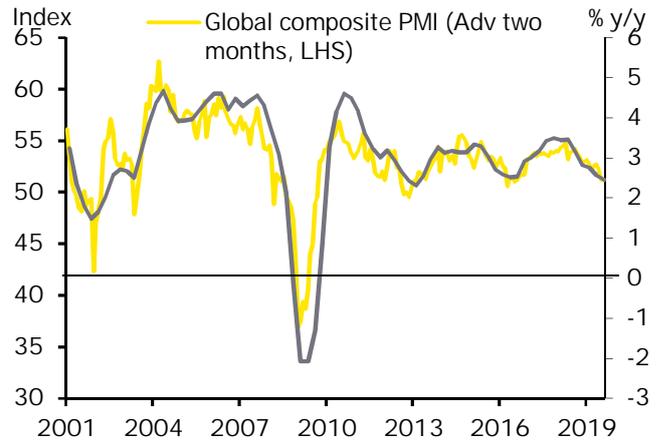
Worryingly, trade tensions between the US and China have intensified overall since our Summer Forecast 2019. Specifically, there have been a number of tit-for-tat increases in trade tariffs imposed and announced by the US and China. This was initiated on 1 August by President Trump's announcement that the US would impose a 10% tariff on an additional \$270b of Chinese goods from 1 September (although some \$160b of these (including on phones and computers) were subsequently delayed until 15 December to avoid spoiling Christmas for US consumers). This followed the latest round of bilateral trade talks between the US and China failing to make progress. Additionally, the US designated China a "currency manipulator" on 5 August.

China responded by announcing the imposition of additional 5%–10% tariffs on \$75b of US products, with some taking effect on 1 September and the rest on 15 December. President Trump responded to this by announcing that US tariffs on \$250b of imports from China would increase from 25% to 30% on 15 October while the threatened tariffs on \$300b of imports would rise from 10% to 15% (still maintaining the holiday delay for some goods). President Trump also ordered US companies to stop trading with China. By aggravating an already difficult global trading and growth environment, these actions are weighing down on sentiment and keeping uncertainty elevated.

Some much-needed respite came on 11 October, when the latest round of trade negotiations between the US and China produced a truce through a 'handshake' deal which was expected to be finalised in a text within five weeks. President Trump described it as a "very substantial phase one deal" that would lay the foundation for a broader agreement later this year; however, given what has gone on before, it is difficult to have any confidence in what may or may not happen. Under the truce, the US agreed to suspend the increase in tariffs from 25% to 30% on \$250b of imports from China that were due to come into effect on 15 October; however, the US kept in place the threatened 15 December tariff raises. Meanwhile, the Chinese agreed to make additional purchases of US agricultural goods, particularly soybeans and pork. China also made some commitments on intellectual property, financial services and its currency.

Global policymakers have responded to the weakening global economic environment. In the US, the Federal Reserve has cut interest rates three times (by 25 basis points in late July, mid-August and late October). Meanwhile, the European Central Bank (ECB) took its deposit rate further into negative territory on 12 September, cutting it to -0.50% from -0.40%. The ECB is also to resume quantitative easing which had been stopped at the end of 2018, with net asset purchases to be made of €20b from 1 November and to "run for as long as necessary to reinforce the accommodative impact of its policy rates, and to end shortly before it starts raising the key ECB interest rates."² The ECB had earlier provided further support to encourage bank lending by introducing a new series of targeted longer-term refinancing operations (TLTROs) that started in September. In China, the expectation is that the authorities can ramp up stimulus measures, particularly with regard to infrastructure spending and credit lending.

World: GDP and PMI

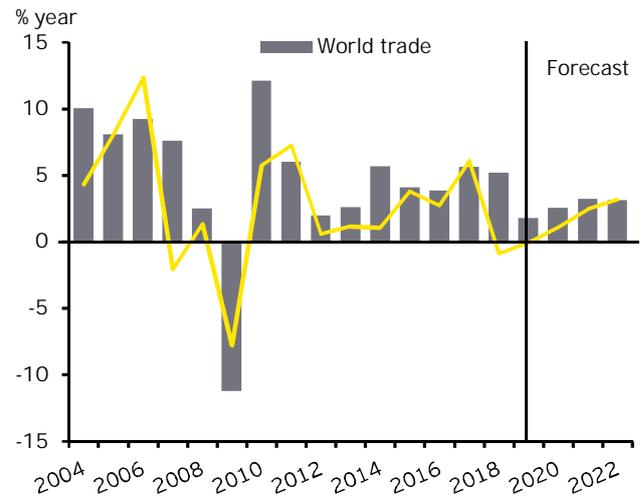


Source: EY ITEM Club/ Haver Analytics/IHS Markit

² Monetary policy decisions – press release. ECB. 12 September 2019. See [ecb.europa.eu/press/pr/date/2019/html/ecb.mp190912-08de50b4d2.en.html](https://www.ecb.europa.eu/press/pr/date/2019/html/ecb.mp190912-08de50b4d2.en.html)

The October 2019 edition of Consensus Forecasts³ projected that global growth would slow from 3.2% in 2018 (which matched the 2017 outturn) to 2.5% in 2019 and then stabilise at 2.5% in 2020. Significantly, the 2019 forecast of 2.5% global growth has been cut from 2.6% in the September issue, 2.7% in July, 2.8% in May and 3.0% in the December 2018 edition. Additionally, the 2020 growth projection was cut to 2.5% in the September edition from 2.6% in August, 2.7% in June and 3.0% at the end of 2018. Meanwhile, Oxford Economics forecasts that global trade growth will slow sharply to just 0.3% in 2019 from 4.8% in 2018 and a peak of 6.5% in 2017, before improving to a still modest 1.8% in 2020.

UK: Exports and world trade



Source: EY ITEM Club

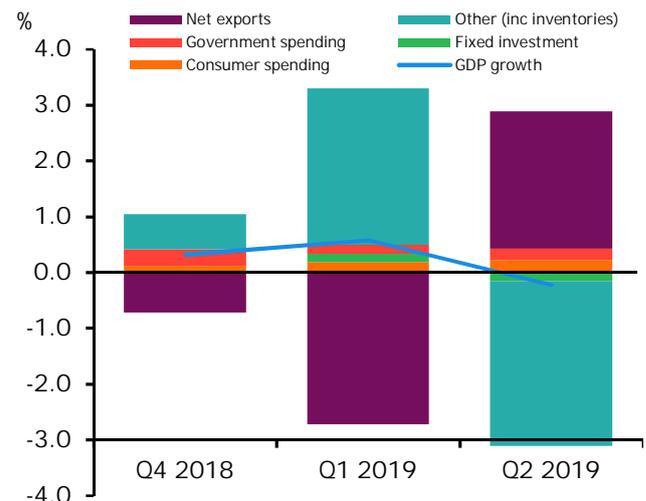
According to the October 2019 edition of Consensus Forecasts, eurozone GDP growth is seen as slowing appreciably from 1.8% in 2018 to 1.1% in 2019 and then weakening further to 0.9% in 2020. Expectations for the eurozone have weakened significantly recently; growth in 2020 had been seen at 1.1% in the September edition and 1.3% in August. Particularly notably, German growth is projected to slump from 1.4% in 2018 to just 0.5% in 2019 before recovering modestly to 0.8% in 2020. US growth is seen moderating from 2.9% in 2018 to 2.3% in 2019 and 1.8% in 2020, while Japanese GDP growth is projected to edge up from 0.8% in 2018 to 1.0% in 2019 before slowing to just 0.2% in 2020. Meanwhile, in September the OECD forecast that Chinese GDP growth would slow from 6.6% in 2019 to 6.1% in 2019 and 5.7% in 2020.

The economy clearly returned to growth in Q3 after Q2 contraction

GDP contracted 0.2% q/q in Q2 2019, thereby marking the first quarter contraction since Q4 2012. Even in weather-battered Q1 2018, the economy had managed to eke out GDP growth of 0.1% q/q. Consequently, y/y growth slowed appreciably to 1.3% in Q2 2019 from 2.1% in Q1 – this was the slowest annual growth rate since Q1 2018, and the second weakest since Q2 2012.

There was always going to be some payback for the UK economy in Q2 after Q1 GDP growth of 0.6% q/q was boosted by stockbuilding amid concerns that a disruptive Brexit could have occurred at the end of March. Additionally, the Q2 performance was further held back by car producers bringing forward their usual summer plant shutdowns to April from August, in case a disruptive Brexit occurred at the end of March and hit their supply chains.

GDP growth contributions in Q4 2018 and H1



Source: EY ITEM Club

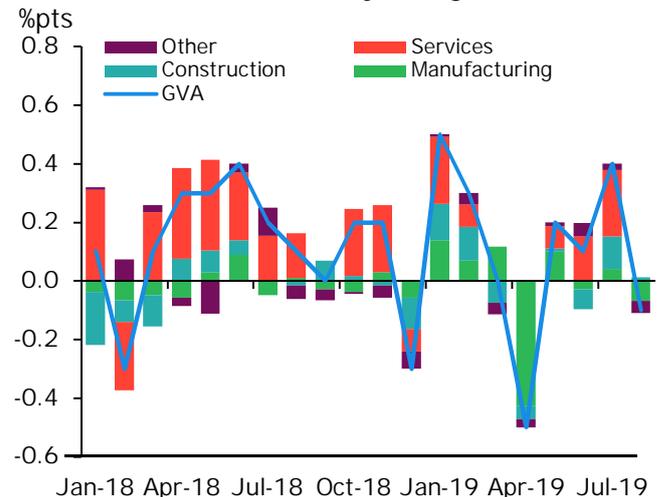
With a substantial running down of stocks and car plant shutdowns weighing particularly heavily on the economy in Q2 2019, it was only to be expected that the main weakness on the output side of the economy occurred in the manufacturing sector, where output fell back 2.8% q/q; this more than reversed the 2.0% q/q output gain achieved in Q1 (which had been stronger than in most other countries, especially in Europe, thereby indicating that special factors had been at play). Overall, industrial production dipped 1.8% q/q in Q2 after growing 1.1% q/q in Q1.

³ Consensus Forecasts. 14 October 2019. See [consensus-economics.com](https://www.consensus-economics.com)

Significantly though, the economy's weakness in Q2 was not confined to manufacturing. There was also contraction of 1.2% q/q in construction output as activity appeared to be hit by heightened uncertainties; this followed growth of 1.6% q/q in Q1. Meanwhile, output in the dominant services sector could only edge up 0.1% q/q in Q2, which was its weakest performance for three years and down from 0.4% q/q expansion in Q1. Within the services sector, there was only decent growth in the transportation, storage and communications sector (up 0.6% q/q). Activity was only flat q/q in both the distribution, hotels and catering sector and in business services and finance. There were indications that Brexit uncertainties and increased concerns over the domestic economy weighed on demand for business services.

The breakdown of the expenditure side of the economy shows that the running down of stocks knocked 1.2 percentage points (ppts) off q/q GDP growth in Q2 after making a positive contribution of 0.7ppts in Q1. It was also little surprise to see business investment suffer a renewed drop in Q2 amid substantial Brexit, UK domestic political and global economic uncertainties. Specifically, business investment contracted 0.4% q/q in Q2 2019 after it had risen for the first time in five quarters in Q1 2019 (by 0.8% q/q). This meant that business investment was down 1.4% y/y in Q2 and was 3.0% below its peak level achieved in Q4 2017. Overall investment fell 0.9% q/q in Q2 and was up just 0.3% y/y. The fall in business investment was accompanied by a marked 3.6% q/q decline in government investment.

UK: Contributions to monthly GVA growth



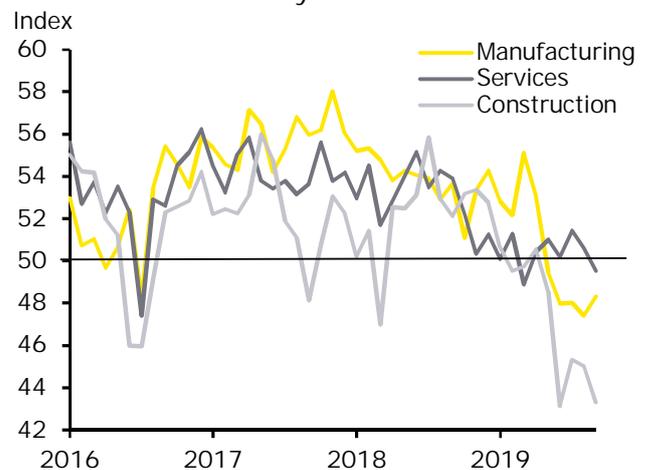
Source: EY ITEM Club calculations using data from Haver

At least the consumer remained pretty resilient in Q2 as personal expenditure rose 0.4% q/q which was actually up from 0.3% q/q growth in Q1. Consumers continued to benefit in Q2 from improved earnings growth, although employment growth slowed. The Office for National Statistics (ONS) reported that compensation of employees rose 1.5% q/q and 4.9% y/y in Q2. Additionally, public spending rose 0.6% q/q in Q2 after a gain of 0.3% q/q in Q1.

Meanwhile, there was a record positive contribution of 2.6ppts from net trade in Q2 after it had previously seen a record drag of 2.7ppts on q/q GDP in Q1. This reflected imports of goods and services falling back 13.0% q/q in Q2 after they had jumped 10.3% q/q in Q1. Imports had been lifted in Q1 by stockpiling of foreign products and production inputs as well as by large imports of non-monetary gold which were reversed in Q2. At the same time, exports of goods and services fell 6.6% q/q in Q2 2019 as global growth slowed after growing 1.6% q/q in Q1. The ONS stressed that both the trade and investment performances were substantially influenced in Q2 by large movements of non-monetary gold, as they had been in Q1. These do not affect the overall GDP figure as they influence trade and gross capital formation in opposite directions.

We believe the economy returned to growth in Q3 2019, with expansion of 0.4% q/q. Reasonable consumer spending growth, healthy tourism and positive contributions from government spending and investment probably helped the economy in Q3. Activity was also helped to a limited extent by car producers bringing forward their usual summer plant shutdowns to April from August (although some plants still shut down in August). It also looks as if there was some stockbuilding in September ahead of the 31 October Brexit date – although it looks to have been relatively limited so far. However, reduced business investment as well as weak exports are likely to have weighed on the economy in Q3.

UK: CIPS/Markit surveys



Source: Oxford Economics/CIPS/IHS Markit

For a time, there was genuine concern that the economy was in danger of suffering a second successive quarter of contraction in Q3, thereby falling into recession. This was fuelled by largely weak surveys of economic activity for July and August before

little hard data had been released. However, fears of further contraction in Q3 were dismissed by GDP growth of 0.4% m/m in July, which was the strongest monthly performance since January, and was encouragingly the result of growth across all sectors. Output in the dominant services sector rose 0.3% m/m while manufacturing output expanded 0.4% m/m (although overall industrial output only inched up 0.1% m/m). Construction output rose 1.8% m/m.

July's jump in GDP clearly overstated the economy's strength and it was little surprise to see GDP fall back 0.1% m/m in August. Even so, the three-month/three-month growth rate picked up to 0.3% in August from 0.1% in July and a drop of 0.2% in June. Economic activity in August was primarily dragged down by a 0.7% m/m drop in manufacturing output. Output in the transportation equipment sector disappointingly only edged up 0.3% m/m in August as several car plants still enacted summer shutdowns despite their April closures. Furthermore, output contracted in 10 out of 13 manufacturing subsectors. Overall industrial production was down 0.6% m/m. Services output was only flat m/m in August while there was a modest increase of 0.2% m/m in construction output.

Furthermore, September looks to have been a very difficult month for the economy. The purchasing managers reported that services activity contracted anew, with activity at a six-month low. Additionally, the purchasing managers' survey showed manufacturing activity still clearly contracting in September, although the rate of contraction was at least the slowest since May, helped by some stockbuilding occurring. Their third survey showed construction activity declining in September at the second-fastest rate (after June) since April 2009. Meanwhile, on the expenditure side of the economy, retail sales volumes were only flat m/m in September after dipping 0.3% m/m in August, although they were still up 3.1% y/y and grew by a reasonable 0.6% q/q over Q3 (largely due to a robust July performance). However, even if GDP contracted 0.1% m/m or 0.2% m/m in September, GDP growth would still have been 0.4% q/q in Q3, barring revisions to the July/August data.

Consumer fundamentals have improved markedly over 2019 but employment now faltering, and earnings growth may have peaked

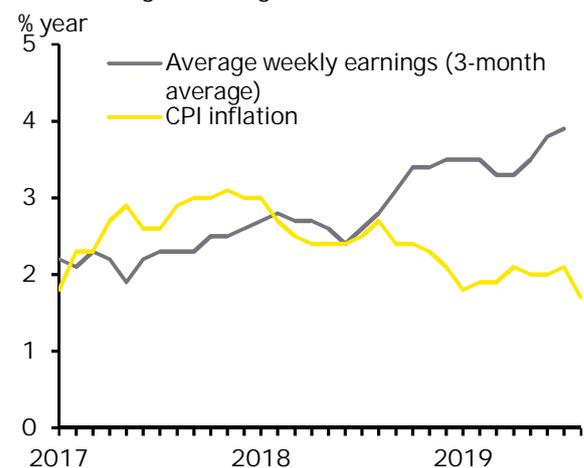
Crucial to the economy's future performance is the consumer, not least because consumer spending accounts for some 65% of GDP. Consumer spending remained relatively resilient over the first half of 2019 after modestly outperforming the overall economy during 2018. Specifically, consumer spending rose 0.3% q/q in Q1 2019 and then by 0.4% q/q in Q2.

Consumers have benefitted from clear improvement in purchasing power since mid-2018. Annual total average weekly earnings growth rose from 2.4% in the three months to June 2018 to 3.9% in the three months to July 2019, which was an 11-year high. Total earnings growth can be distorted by volatile bonus payments, but regular earnings growth (which excludes bonus payments) similarly reached an 11-year high of 3.9% in the three months to July.

Further helping consumer purchasing power is the fact that consumer price inflation has remained limited during 2019 so far. Indeed, it moderated to 1.7% (the lowest level since December 2016) in August, where it remained in September, having previously been locked in a narrow 1.8%–2.1% range over the first seven months of the year. This was down from an average of 2.5% in 2018 and 2.7% in 2017.

This meant that ONS data shows that annual real earnings growth rose from just 0.1% in the three months to June 2018 to 2.1% in the three months to July 2019; this was the best level since September 2015. During the same period, real annual regular pay rose from 0.3% to 1.9%.

UK: Average earnings & inflation

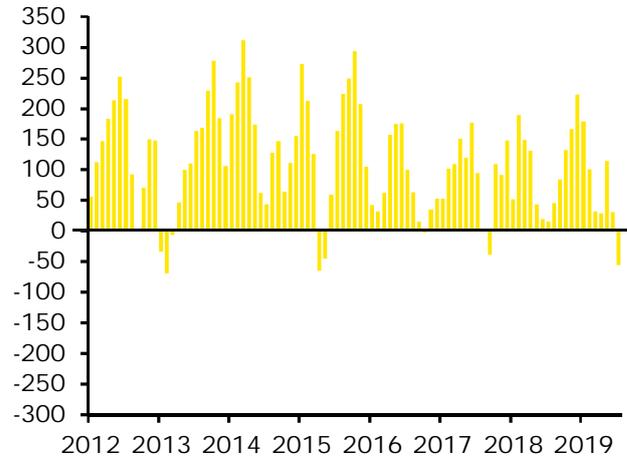


Source: EY ITEM Club/Haver Analytics

This improvement in earnings growth indicated that increasing labour market tightness has finally had a sustained upward impact on pay. And of course, the rise in employment to a record high of 32.811m in the three months to June 2019 was good news for consumers in itself.

However, we suspect the improvement in consumer fundamentals has peaked, although they are likely to remain relatively decent. Significantly, employment fell 56,000 in the three months to August, which took the level of employment down to 32.693m. The suspicion has to be that the labour market will falter further in the near term at least as companies face a soft domestic economy as well as serious concerns over Brexit, an unsettled domestic political environment and a challenging global economy. September's drop in vacancies to a 22-month low fuels this suspicion. Much obviously depends on what happens with Brexit on 31 October and how the economy reacts.

UK: Change in employment
'000s over previous three months



Source: EY ITEM Club/Haver Analytics

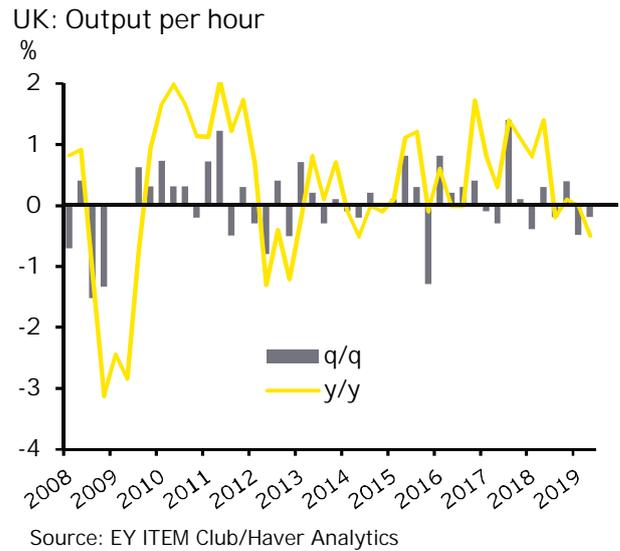
Additionally, earnings growth edged off its 11-year high in the three months to August, with both total and regular earnings dipping to 3.8%. Further slippage in earnings growth looks probable. With employment faltering, the economy soft and companies cautious over the outlook among the major uncertainties, employers look likely to try and contain pay increases. Meanwhile, employees may be reluctant to push hard for higher pay increases given fragile consumer confidence.

True, it can be argued that even if employment falters, the labour market will remain pretty tight and this will keep some upward pressure on pay. As at the three months to August 2019, the unemployment rate of 3.9% was only marginally above the recent low of 3.8%, which was the equal lowest since the end of 1974. Similarly, an employment rate of 75.9% was only just below the recent peak of 76.1%, which was the highest level since records began in 1971. The economic inactivity rate (the proportion of people aged from 16 to 64 years who were economically inactive) was 21.0% in the three months to August, which was only slightly above the 20.7% seen at the start of the year, which had been the lowest figure since comparable estimates began in 1971.

On the other hand, productivity developments are hardly conducive to granting higher pay increases. ONS data shows output per hour worked fell 0.5% y/y in Q2 2019, which was the sharpest drop since Q2 2014 and followed a flat y/y performance in Q1. Furthermore, Q2 2019 marked a fourth successive quarter of either flat or declining annual productivity. The poor productivity performance over the first half of 2019 followed an underwhelming performance in 2018, when output per hour rose just 0.5% over the year. This was below the annual average growth rate of 2.0% seen before the 2008/9 downturn.

There is survey evidence that pay awards may now be levelling off. Particularly notable was the latest survey by the pay analysis company XpertHR (released in late October), which reported that employers plan to scale back their pay increases for next year. Specifically, employers plan to offer median pay settlements of 2.1% between now and the end of August 2020, compared to an average 2.5% over the past 12 months. Basic pay settlements have levelled off at 2.5% in recent months, which is a 10-year high.

In the meantime, the Bank of England's regional agents reported in their September quarterly business conditions survey that "Pay growth steadied at between 2% and 3%. Contacts said this reflected a moderation in basic pay increases as well as an increase in deferred pay settlements and temporary wage freezes due to economic uncertainty. However, pay growth continued to rise in sectors experiencing labour shortages, such as IT, engineering and professional services. And pay growth for lower-paid employees had been supported by the rise in the National Living Wage. Contacts also reported increasing non-wage benefits to support staff retention. Nonetheless, contacts said they expected pay pressure to ease in the coming months, reflecting weaker employment intentions; lower staff churn; economic uncertainty and budget constraints, and a moderation in consumer price inflation."⁴

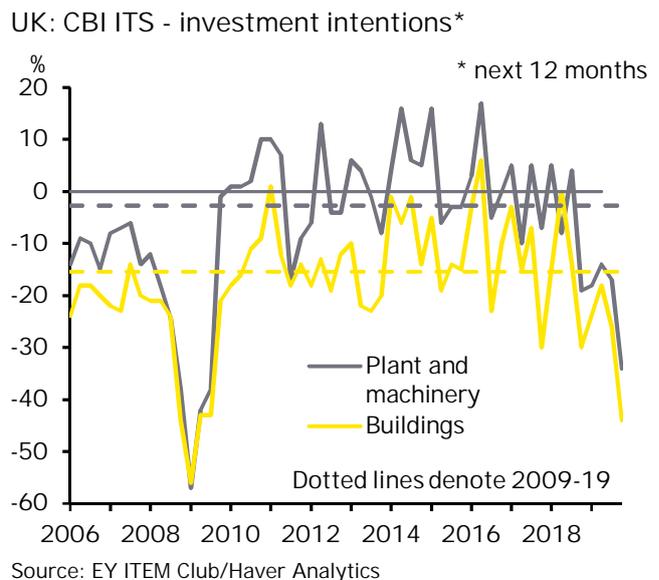


Business investment still contracting; any pick-up from Brexit deal likely to be limited by difficult and still uncertain environment

A renewed drop of 0.4% q/q in business investment in Q2 2019 confirmed suspicions that the rise of 0.8% q/q in Q1 2019 after four quarters of contraction had not marked a turning point. Indeed, business investment in Q2 2019 was down 1.4% y/y while it was 3.0% below the peak level seen in Q4 2017.

There can be little doubt that Brexit uncertainties have been a major factor behind the extended weakness in business investment – and these uncertainties have far from disappeared despite the deal reached between Boris Johnson and the EU. The Bank of England's February 2019 quarterly Inflation Report had observed "UK business investment growth dropped below growth in other advanced economies in the year to 2018 Q3, consistent with a UK-specific factor depressing investment."⁵ The central bank further observed in the August 2019 Inflation Report that "Brexit-related uncertainties have weighed heavily on UK business investment. The recovery of investment from the 2008 recession was broadly in line with previous episodes until the EU Referendum Act was passed in 2015. Since then, the recovery in business investment has stalled. Decision Maker Panel survey data suggests that the level of nominal investment may be between 6%-14% lower than it would have been in the absence of Brexit uncertainties."⁶

Contraction in business investment in five of the six quarters through to Q2 2019 occurred despite some supportive factors during much of this period, including decent rates of return on capital for companies, relatively cheap financing conditions and decent access to capital. In addition, the Bank of England considered that the economy was operating with little spare capacity towards the end of 2018, which should have been another incentive for businesses to invest. However, the economy's underlying below-trend



⁴ Agent's summary of business conditions – 2019 Q3. Bank of England. 19 September 2019. See bankofengland.co.uk/agents-summary/2019/2019-q3

⁵ Inflation Report – February 2019. Bank of England. 7 February 2019. See bankofengland.co.uk/-/media/boe/files/inflation-report/2019/february/inflation-report-february-2019.pdf

⁶ Inflation Report – August 2019. Bank of England. 1 August 2019. See bankofengland.co.uk/-/media/boe/files/inflation-report/2019/august/inflation-report-august-2019.pdf

performance during 2019 so far has led to some reopening of spare capacity.

It looks highly probable that business investment contracted again in Q3 2019. The Bank of England's regional agents reported in their Q3 survey of business conditions (released in mid-September) that "Investment intentions weakened a little further and remained at a nine-year low. Brexit uncertainty continued to dampen companies' appetite to invest. A large proportion of companies were holding off investments, even for projects where payback times were short. And a sizeable proportion of companies reported reducing, postponing or cancelling projects. There were reports of some larger companies diverting investment to EU subsidiaries and factories." Meanwhile, the October issue of the CBI Quarterly Industrial Trends Survey (ITS) showed that investment intentions for the next year for plant and machinery, buildings, and training and retraining were all at their weakest since the 2008/9 financial crisis. Investment intentions for product and process innovation were reported to be essentially flat.

On a hopeful note, the Bank of England's regional agents reported in their Q3 survey that "some contacts reported that if a no-deal Brexit were avoided, there could be some bounce-back in investment, though the timing of that was unclear".

However, while an easing of immediate uncertainties in the event of the UK leaving the EU with a deal should have some positive impact on business investment, we suspect the upside will likely remain constrained by companies' uncertainties over the future long-term UK–EU relationship – especially as it appears to be relatively loose under the political declaration. Furthermore, negotiations over the UK's long-term relationship with the EU are likely to prove highly challenging, which will likely fuel uncertainty. Indeed, the end of 2020 could well mark another cliff edge in the Brexit process as the transition period is currently meant to end then and it seems improbable that the UK and EU will have agreed a long-term relationship by that time. Additionally, many UK companies could also be cautious about significantly stepping up their investment in the immediate aftermath of the UK leaving the EU – even with a deal – as they may want to see how the economy performs for a while after Brexit before committing themselves, especially to costly investments.

A significant factor that is also expected to limit the upside for business investment is a weakened global economic environment, as it is likely to fuel companies' caution to commit to major investment projects.

More supportive fiscal policy likely to be reinforced by eventual Budget

Some help to UK growth in 2019/20 is coming from modestly supportive fiscal policy after it had been a significant drag on growth in fiscal year 2018/19. In the Budget for 2019/20, the then Chancellor, Philip Hammond, announced a looser fiscal policy than had previously been planned after the Office for Budget Responsibility (OBR) substantially revised down its forecasts for underlying government borrowing over the medium term. In particular, spending on the NHS was increased following Government pledges that had been made earlier in the year. Another significant measure announced by the Chancellor was an increase in income tax thresholds from April 2019. Consequently, the personal allowance threshold, the rate at which people start paying income tax at 20%, rose from £11,850 to £12,500 in April, which was a year earlier than had been planned. Additionally, the higher rate income tax threshold, the point at which people start paying tax at 40%, increased from £46,350 to £50,000 in April.

The OBR noted the October Budget largely “spent the fiscal windfall rather than saving it”. The OBR specifically commented that the “overall effect of the Budget measures is to increase the deficit by £1.1b this year and £10.9b next year, rising to £23.2b in 2023/24. This is the largest discretionary fiscal loosening at any fiscal event since the creation of the OBR.”⁷

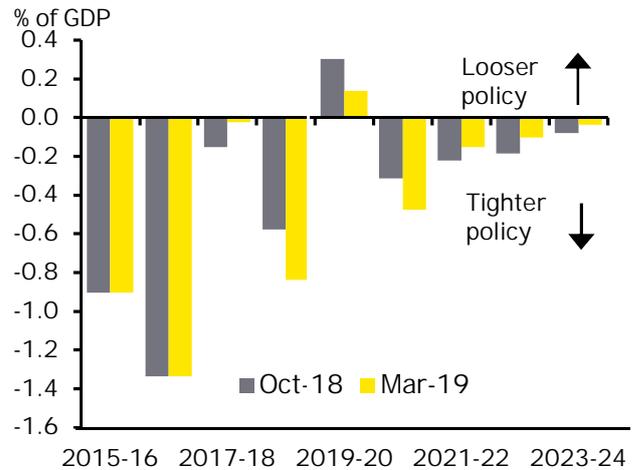
Fiscal policy was originally set to become modestly restrictive in 2020/21 after the 2019/20 loosening but the stance for the next fiscal year has already been loosened by the increased public expenditure announced in September’s Spending Review held by the new Chancellor, Sajid Javid. As matters currently stand, we see the expenditure measures announced in the Spending Review making a total positive contribution of around 0.3-0.4ppts over 2020 and 2021 compared to the previously indicated fiscal stance. Furthermore, the Budget for 2020/21 looks certain to further loosen the fiscal purse strings, whenever it is eventually held.

The Spending Review was unusually just for 2020/21 rather than for three years as is normally the custom, clearly a consequence of Brexit and domestic political uncertainties. The results presented at the start of September revealed that departmental current spending will rise by £13.8b in the next fiscal year or 4.1% in real terms, the fastest increase in 15 years. This builds on the planned 3.4% increase in 2019/20. Mr Javid confirmed previous pledges made by Prime Minister Boris Johnson to increase day-to-day spending on education and the police, and provided for the increase in health spending announced under Theresa May’s premiership. There was also a boost to spending on social care and local government. Moreover, no department will see a rise in spending in 2020/21 below inflation.

Further limited fiscal stimulus looks likely to occur whenever the Budget for 2020/21 is finally enacted (plans to hold it on 6 November were shelved by the ongoing Brexit uncertainties). Notably during his campaign to become leader of the Conservatives and Prime Minister, Boris Johnson promised to raise the 40% tax threshold from £50,000 to £80,000. He also wanted to raise the threshold at which workers’ pay national insurance contributions. Meanwhile, the Chancellor has pledged to raise the National Living Wage (currently ranging from £6.15 for those aged 18-20 to £8.21 for those aged 25 and over) to £10.50 within the next five years and to lower the threshold for those who qualify to 21 from 25. An initial step on this could well be taken in the Budget. The Chancellor has also hinted that he would like to cut inheritance tax.

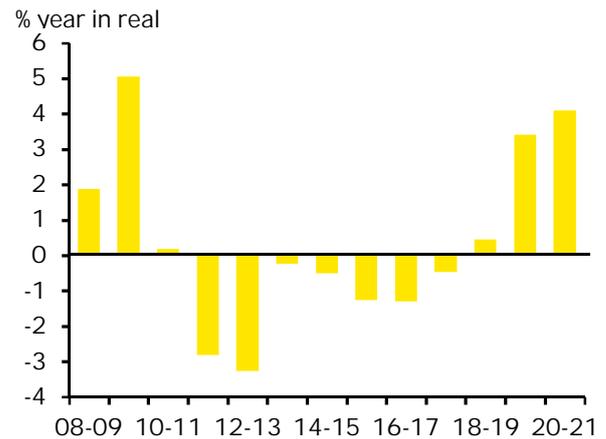
However, there are indications that the tax moves in the Budget are likely to be limited. It has been reported that Mr Javid now considers big tax cuts to be unaffordable, with the large spending increases announced since he became Chancellor jeopardising the UK’s fiscal credibility. Any money available for tax cuts is likely to be targeted at people earning less than £50,000. For the time being, Mr Johnson’s pledge to raise the 40%

UK: OBR estimates of fiscal tightening



Source: EY ITEM Club calculations using OBR forecasts

UK: Day-to-day spending by departments



Source : Oxford Economics/HM

⁷ Overview of the October 2018 Economic and Fiscal Outlook, page 83. Office for Budget Responsibility. 29 October 2018. See obr.uk/overview-october-2018-economic-fiscal-outlook/

tax threshold from £50,000 to £80,000 and Mr Javid's interest in cutting inheritance tax may remain on the shelf.⁸

The Government is likely to take further steps in the Budget to boost its infrastructure plan and take advantage of very low interest rates. Mr Javid has already pledged £5b for improving broadband access to areas in the country that are hardest to reach and £220m for improving bus networks. He has also confirmed the £25b pledge made by his predecessor for improving the road network.

Of course, if there is any government other than a Conservative one after the general election on 12 December, fiscal policy could be significantly different in 2020/21 and beyond.

Bank of England most likely to sit tight on interest rates through to 2021

The economy is clearly not going to be hampered by tighter monetary policy over the rest of 2019 and we expect interest rates to remain unchanged through 2020. The Bank of England has not adjusted monetary policy since raising interest rates from 0.50% to 0.75% in August 2018.

Even if the UK does leave the EU with a deal by 31 January, we believe it is now most likely that the Bank of England will keep interest rates at 0.75% through to 2021. In our Summer Forecast 2019, we had expected two 25 basis point interest rate hikes to occur in 2020 (taking rates up to 1.25% by the end of next year), but we now suspect below-trend UK growth and a very challenging global economic environment will result in the Bank of England holding fire. Even Bank of England inaction on interest rates would be in marked contrast to the loosening cycle in monetary policy increasingly being adopted by global central banks.

If the Bank of England does act on interest rates in 2020, it is probably now more likely to be a rate cut rather than a hike. Indeed, the MPC had warned at its September meeting that a delaying of Brexit risked uncertainty becoming more deeply entrenched, damaging growth prospects. However, provided any delay is not prolonged (which is not what we expect), we believe the Bank of England would still be most likely to keep interest rates at 0.75% over the rest of 2019 and through 2020.

We are dubious that the Bank of England would cut interest rates unless the UK economy took a major downward lurch, given the tightness of the labour market and the fact that fiscal policy is set to be loosened appreciably. The MPC considered that the increased government spending for 2020/21 announced in September's Spending Review could add 0.4ppts to UK growth over the forecast period. It is likely that further fiscal stimulus will be announced when the Budget for 2020/21 is eventually held.

It needs to be borne in mind that the current Bank Rate of 0.75% is some way below where the Bank of England judges rates will ultimately settle. In its August 2018 quarterly Inflation Report, the Bank gave its estimate of the so-called 'equilibrium interest rate'. This is defined as "the interest rate that, if the economy starts from a position with no output gap and inflation at the target, would sustain output at potential and inflation at the target".⁹ The Bank estimated that in real terms, the long-term equilibrium interest rate is 0%-1%. Adding the targeted inflation rate of 2%, this translates into a long-term equilibrium interest rate of 2%-3%. The Bank saw the equilibrium interest rate as lower in the near term due to still significant headwinds facing the economy, such as consumers' further need to repair balance sheets, fiscal drag and heightened uncertainty (particularly from Brexit).

In addition to Brexit developments, another uncertainty that could affect monetary policy is that Mark Carney will end his stint as Bank of England Governor at the end of January 2020.

Growth likely to be limited in 2020

Our forecast is based on the assumption that the UK will ultimately leave the EU by 31 January 2020 with a deal. Once this happens, nothing much is expected to change immediately as a transition arrangement essentially preserves the status quo until at least the end of 2020. Furthermore, the strong suspicion has to

⁸ Sajid Javid drops tax cuts in favour of higher public spending. Financial Times. 23 October 2019. See [ft.com/content/c3c5acc0-f4e7-11e9-a79c-bc9acae3b654](https://www.ft.com/content/c3c5acc0-f4e7-11e9-a79c-bc9acae3b654)

⁹ Inflation Report – August 2018, page 39. Bank of England. August 2018. See [bankofengland.co.uk/-/media/boe/files/inflation-report/2018/august/inflation-report-august-2018.pdf](https://www.bankofengland.co.uk/-/media/boe/files/inflation-report/2018/august/inflation-report-august-2018.pdf)

be that the transition arrangement will have to be extended significantly, not only due to the UK's substantially later than originally expected scheduled exit from the EU (planned for 29 March 2019) but also due to the likelihood that negotiations over the UK's longer-term relationship with the EU will prove to be difficult. Indeed, the end of 2020 could well mark another cliff edge in the Brexit process as the transition period is currently meant to end then.

The EY ITEM Club forecast for the UK economy, autumn 2019						
% changes on previous year except borrowing, current account, and interest and exchange rates						
	GDP	Domestic demand	Consumer spending	Fixed investment	Exports	Imports
2017	1.9	1.2	2.2	1.6	6.1	3.5
2018	1.4	1.4	1.6	-0.1	-0.9	0.7
2019	1.3	2.3	1.2	-0.3	-0.1	4.3
2020	1.0	0.8	1.4	-0.4	1.1	0.3
2021	1.5	1.8	1.8	2.7	2.5	3.1
2022	1.7	2.0	1.9	2.3	3.2	3.8
2023	1.8	2.0	2.0	2.6	3.5	3.7
	Net government borrowing*	Current account (% of GDP)	Average earnings	CPI	Bank rate	Effective exchange rate
2017	2.9	-3.5	2.6	2.7	0.3	77.4
2018	1.9	-4.3	3.0	2.5	0.6	78.5
2019	2.2	-4.8	3.7	1.8	0.8	78.6
2020	2.5	-4.2	3.4	1.9	0.8	83.1
2021	2.2	-4.3	3.5	2.1	1.1	84.9
2022	1.9	-4.1	3.5	2.0	1.6	85.3
2023	1.5	-4.2	3.5	2.0	2.0	83.7

*Fiscal years, as % of GDP

Source: EY ITEM Club

The forecast sees GDP growth slowing to 1.3% in 2019 from 1.4% in 2018 – this would be the weakest expansion since 2009. GDP growth is then seen moderating further to 1.0% in 2020, although a slight pick-up in activity is expected in the latter months of the year.

Following an expected return to growth with GDP expansion of 0.4% q/q in Q3 2019, we anticipate growth to be slower at 0.2% q/q in Q4, which would continue the pattern of an erratic, below-trend performance by the economy – although there is the possibility that it could be lifted by stockbuilding in October ahead of the 31 October planned date for Brexit.

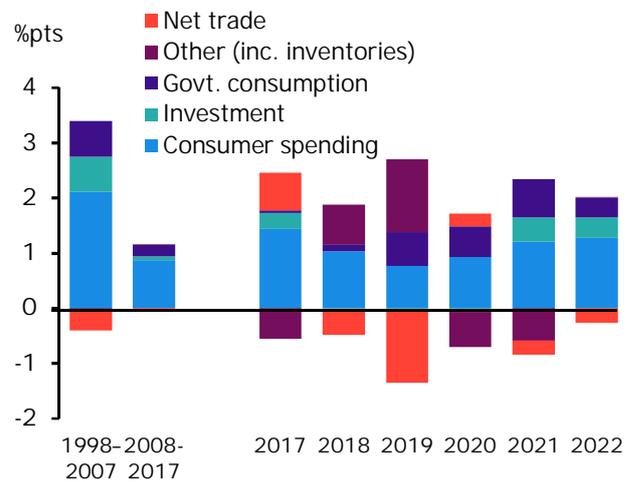
We had assumed that if a Brexit deal is agreed, the economy would benefit from reduced uncertainty which would particularly support business investment which fell for five out of six quarters through to Q2 2019. This was seen as helping GDP growth pick-up modestly as 2020 progressed. However, Brexit uncertainties are likely to remain significant through 2020 even with a UK exit from the EU with a deal by the end of January.

Furthermore, we now suspect that a more challenging global economic and trading environment will mean that the pick-up in business investment will be gradual and less pronounced than we had previously expected. This environment is also likely to weigh on UK exports more than we had previously anticipated and it could also affect consumer confidence by weighing on UK economic activity. There is also a risk that UK political uncertainties could weigh on economic activity in 2020 if December's general election fails to deliver a government with a clear mandate.

On the positive side, fundamentals for consumers should still be decent (although we expect earnings growth will ease back further from its July high, and employment may flatten out) while fiscal policy will be more supportive than previously anticipated. The economy is also unlikely to be hampered by higher interest rates in 2020; indeed, if the Bank of England does act on monetary policy in 2020, it now looks most likely to cut interest rates from the current level of 0.75%.

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

UK: Contributions to GDP growth



Source: EY ITEM Club

Growth seen taking substantial hit if 'no-deal' Brexit

While the likelihood of a 'no-deal' Brexit has reduced, it has not disappeared. There is still a possibility that the UK could fail to implement the withdrawal agreement before the new Brexit deadline of 31 January 2020 and there is failure to extend it further.

Our underlying analysis of the economy's likely performance should a 'no-deal' Brexit occur is little changed from our Summer Forecast 2019. Specifically, if the UK leaves the EU without a deal in the near term, we suspect GDP growth would slow from 1.3% in 2019 to just 0.2% in 2020 – with the economy likely suffering mild recession for a time. Growth is seen improving to a modest 1.0% in 2021.

Leaving the EU without a deal and switching to WTO trading rules would obviously have major ramifications for the UK's economic outlook.

However, in putting together any forecast for this eventuality, it needs to be borne in mind that economic projections made in the immediate aftermath of the vote in June 2016 for the UK to leave the EU proved overwhelmingly pessimistic. In particular, consumers kept on spending post-referendum as it took time for sterling's sharp drop following the vote for Brexit to feed through to lift inflation and squeeze purchasing power. Consumer confidence weakened sharply immediately following the June 2016 vote, but it then recovered pretty quickly as consumers' circumstances were little changed in the immediate aftermath of the referendum vote. Meanwhile, nothing changed regarding trading conditions or supply chains.

The critical point this time around is that the circumstances facing the UK after 31 January would immediately be different, whereas nothing really changed in the immediate aftermath of the vote for Brexit in June 2016.

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

On the positive side, while the delaying of Brexit from 29 March to 31 October and now 31 January 2020 has extended the uncertainties facing the economy, it has given businesses and the Government more time to prepare for a 'no-deal' UK exit from the EU. Even so, there seems to have been some levelling off in how prepared companies believe themselves to be. The Bank of England's regional agents in their Q3 2019 survey of (379) companies on their preparations for EU withdrawal (published in mid-September) observed that "around two-thirds of respondents felt their company was 'as ready as can be' for a 'no-deal' Brexit, down slightly from the June and July surveys. The proportion of companies that did not feel ready for a 'no-deal' Brexit rose to around one in six, from just below one in ten in the previous two surveys."

In a January survey, around 50% of companies had considered themselves ready for a 'no-deal' Brexit. The survey also reported that "almost one in five respondents said they planned to do more contingency planning ahead of the October Brexit deadline, down slightly from around a quarter in July." Finally, the regional agents further reported that "even companies that felt 'ready' for a 'no-deal' Brexit still expected output, employment and investment to be markedly lower in that case compared with a scenario with a deal and transition period."¹⁰

Sterling is likely to fall following a 'no-deal' Brexit from the EU – as it did after the referendum vote in June 2016 – and this is likely to feed through to lift import prices and inflation, thereby squeezing consumers' purchasing power and pushing up companies' input costs. The Government has indicated that it would look to mitigate the overall impact on inflation by making overall reductions to import tariffs compared to the current situation, but the suspicion is that this will be insufficient to prevent inflation from rising materially.

On the positive side, the weaker pound should give some support to UK exports. Trade will be affected as both the UK and the EU levy tariffs and non-tariff barriers (NTBs) are introduced across a range of sectors. However, the Government has indicated that it would make overall reductions to tariffs in the event of a 'no-deal' Brexit. Specifically, under a temporary scheme 88% of imports by value would be eligible for zero-tariff access compared to 80% of imports which are currently tariff-free. With both exports and imports suffering, the effect on GDP growth from this source would be ambiguous.

We believe that heightened business uncertainty after a 'no-deal' Brexit would decidedly weigh down on business investment, although it should be borne in mind that it would already have been weak for a prolonged period. Indeed, it contracted for five quarters out of six through to Q2 2019, and probably declined again in Q3.

Additionally, facing a more uncertain and weakened economic outlook, businesses would possibly adopt a significantly more cautious stance on employment and look to curb their costs by limiting pay, and this, alongside the expected rise in inflation, would have adverse repercussions for the consumer. Heightened uncertainty would also be likely to have some dampening impact on consumer spending, although there is the very real possibility that consumers would be less worried about the heightened uncertainties resulting from a 'no-deal' Brexit than businesses would be, and thus consumer spending could well again prove surprisingly resilient.

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

Meanwhile, emergency fiscal measures would likely be introduced in the event of a 'no-deal' Brexit and we suspect that there would be an appreciable further loosening of fiscal policy on top of the extra spending for 2020/21 announced by Chancellor Sajid Javid in September's Spending Review.

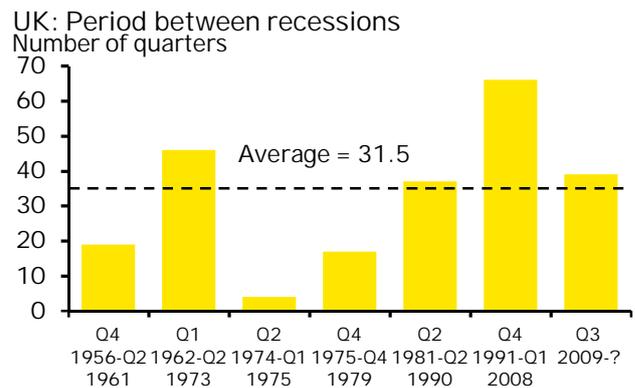
¹⁰ Agents' survey on preparations for EU withdrawal. Bank of England. 19 September 2019. See [bankofengland.co.uk/agents-summary/2019/2019-q3/agents-survey-on-preparations-for-eu-withdrawal-2019-q3](https://www.bankofengland.co.uk/agents-summary/2019/2019-q3/agents-survey-on-preparations-for-eu-withdrawal-2019-q3)

Risks and uncertainties to forecast

Apart from Brexit, a downside risk to our growth outlook is that global growth could continue to deteriorate and be significantly weaker than we expect over 2020.

The highly unsettled domestic UK political situation poses uncertainties for the UK economic outlook. Our central forecast is based on the assumption that there is a Conservative government after a narrow win in the 12 December general election. Obviously, if whatever government is formed after the general election does not feature the Conservatives, it would likely lead to very different policies being followed that would affect the economy, most obviously on fiscal policy and microeconomic policy. There could also be major implications for business confidence and how the markets react.

An upside risk to the growth forecast is that earnings growth could be stronger than we anticipate over the coming months in reaction to increased recruitment difficulties in a number of sectors, thereby leading to higher than expected consumer purchasing power and spending. However, this would likely lead to interest rates starting to rise in 2020.



Source: EY ITEM Club/Haver Analytics

Even with a Brexit deal, it is also somewhat of a leap of faith to forecast consistent UK GDP growth continuing out to 2023 given the length of the current expansionary cycle. Indeed, 2018 marked a ninth year of growth since UK GDP last contracted (by 4.2% in 2009). In its forecasts provided for the October 2018 Budget, the OBR observed that “in the 63 years for which the ONS has published consistent quarterly real GDP data, there have been several recessions – suggesting that the chance of a recession in any five-year period is about one in two. So the probability of a cyclical downturn occurring some time over our forecast horizon is fairly high”.¹¹ There is also the concern that in the event of a recession, the Bank of England would not have much ammunition to fight it, given that interest rates are so low.

However, there are good reasons to think that the current UK economic upturn could continue for some time to come. The overall strength of the UK expansion since 2009 has been relatively limited, and it followed a particularly deep contraction over 2008/9. There is currently little sign that inflation is about to take off, with earnings growth still modestly below the average level largely seen before the 2008/9 recession, despite reaching an 11-year high in the three months to July, and the unemployment rate currently being at its lowest level since late 1974. Indeed, earnings growth edged back from its July high in the three months to August while employment dipped and the unemployment rate edged up. Furthermore, it may well be that there is more slack in the labour market than the official figures indicate. Consequently, it looks highly unlikely that the Bank of England will need to sharply raise interest rates, which would rein in growth. However, there really does need to be a clear pick-up in productivity growth over the medium term for UK expansion to have the best chance of continuing.

¹¹ Overview of the October 2018 Economic and Fiscal Outlook, page 83. Office for Budget Responsibility. 29 October 2018. See obr.uk/overview-october-2018-economic-fiscal-outlook/

Forecast in detail

1. Fiscal policy

The public finances have taken a hit from the ONS, in its release of the August data incorporating changes in the way it treats student loans. This reflected the fact that around half of them are not expected to be repaid. For the latest completed fiscal year 2018/19, it added £12.4b to Public Sector Net Borrowing excluding banks (PSNBex). Along with other revisions, PSNBex in 2018/19 was marked up to £41.4b (1.9% of GDP) from the previously reported £23.6b (1.1% of GDP).

Nevertheless, at £41.4b in 2018/19, PSNBex was still the smallest deficit since 2006/7 and the ratio of 1.9% of GDP was the lowest since 2001/2. It was down from £56.5b (2.7% of GDP) in 2017/18, £56.2b (2.8% of GDP) in 2016/17 and a peak of £158.3b (10.2% of GDP) in 2009/10.

Specifically, PSNBex amounted to £39.0b over the first six months of fiscal year 2019/20 up 17.7% from £33.2b during April-September 2018. On the basis of April-September, PSNBex is headed for £48.8b in fiscal year 2019/20.

Having been a drag on the economy in recent years, fiscal policy in 2019/20 is modestly expansive following the then Chancellor, Philip Hammond, choosing to take advantage of the OBR's cutting of the underlying budget deficits in their forecasts for the October 2018 Budget by introducing fiscal stimulus measures, most notably through increased spending on the NHS, as well as an earlier than previously planned raising of income tax thresholds.

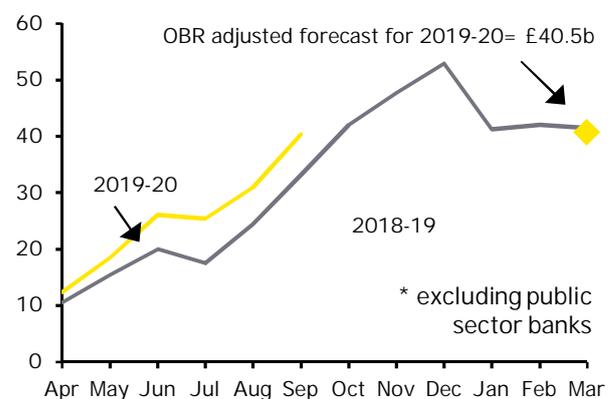
The £13.8b (4.1% in real terms) increase in government department current spending announced in Chancellor Sajid Javid's September Spending Review means that fiscal policy will be more helpful to growth in 2020/21 than previously planned and the Budget, when it is eventually held, looks set to see a further loosening of the fiscal purse strings.

This looser fiscal policy – along with the change in the way that student loans are treated – means that the OBR's last set of forecasts for the public finances contained in the March 2019 Spring Statement will undoubtedly be lifted sharply higher in the Budget. In March, the OBR forecast that PSNBex would be £29.3b (1.3% of GDP) in 2019/20 and then come down progressively to £21.2b (0.9% of GDP) in 2020/21, £17.6b (0.7% of GDP) in 2021/22, £14.4b (0.6% of GDP) in 2022/23 and £13.5b (0.5% of GDP) in 2023/24. The OBR and ONS have indicated that after adjusting for the student loans treatment change, the March PSNBex forecast for 2019/20 could be around £40.5b.

Given the underlying overshoot in the public finances so far in 2019/20, the changed treatment of student loans and the expected softness of the economy over the rest of the fiscal year, we expect PSNBex to come in at £49.0b (2.2% of GDP) in 2019/20. Thereafter – given the expected looser than previously planned fiscal policy – we see PSNBex significantly higher than the OBR's March 2019 forecasts. Specifically, we project PSNBex to rise to £57.0 (2.5% of GDP) in 2020/21 before coming down to £52.0b (2.2% of GDP) in 2021/22, £45.9b (1.9% of GDP) in 2022/23 and £38.0b (1.5% of GDP) in 2023/24.

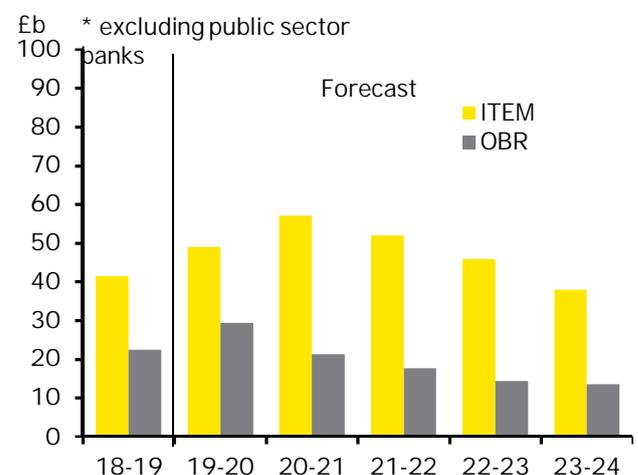
This means that we see PSNBex being some £146b higher over the five-year period 2019/20 to 2023/24 than the OBR forecast back in March. In addition, we see the budget deficit still being up at

UK: Public sector net borrowing*
£b, cumulative



Source: Haver Analytics and OBR

UK: Public Sector Net Borrowing*



Source: EY ITEM Club, OBR (March 2019), ONS

1.5% of GDP in 2023/24 compared with the OBR's expectation of 0.5% of GDP in March's Spring Statement.

It also means that the UK's fiscal rules as they currently stand will be broken, but it is clear that a new set of rules will be announced by Mr Javid whenever the Budget eventually takes place. The current rules were set out by the then Chancellor Philip Hammond in the 2016 Autumn Statement and legislated in the Charter for Fiscal Responsibility, which was last updated in January 2017. The OBR summarised them in March 2019:

1. The structural deficit (cyclically adjusted net borrowing) to lie below 2% of GDP by 2020–21 (the 'fiscal mandate').
2. Public sector net debt to fall relative to GDP in 2020–21 (the 'supplementary target').
3. Welfare spending (excluding the state pension and payments closely linked to the economic cycle) to lie below a 'welfare cap'. The latest version sets the effective cap 3% above our November 2017 forecast for 2020–23 at £135b, with the level of spending to be adjusted for subsequent changes in our inflation forecast.¹²

Additionally, the Charter for Fiscal Responsibility states that the Government's objective for fiscal policy is "to return the public finances to balance at the earliest possible date in the next Parliament". At the time that it was drawn up, the next Parliament was expected to run from 2020 to 2025.

We suspect that the new fiscal rules will be designed to give the Chancellor much more scope to borrow to invest. It is possible that the new target could simply be to have public sector net debt falling as a percentage of GDP. There could also be a target to have just the current Budget in balance by a certain time period (i.e. stripping out government investment from the target).

Of course, if there is any government other than a Conservative one after the general election on 12 December, fiscal policy could be significantly different in 2020/21 and beyond.

2. Monetary policy

The September 2019 MPC meeting saw the Committee hold interest rates at 0.75% following a unanimous 9–0 vote. This was the last MPC meeting to take place before the UK was scheduled to leave the EU on 31 October. Given the prevailing heightened Brexit, domestic political and economic uncertainties, it was unimaginable that the MPC would do anything else other than remain firmly in "wait and see" mode. The drop in consumer price inflation to a below-target rate, 32-month low of 1.7% in August gave the Bank of England flexibility on monetary policy despite earnings growth reaching an 11-year high in the three months to July.

At its September meeting, the MPC observed that "increased uncertainty about the nature of EU withdrawal means that the economy could follow a wide range of paths over coming years" and that "the appropriate path of monetary policy would depend on the balance of the effects of Brexit on demand, supply and the exchange rate."¹³

The MPC observed that Brexit-related developments are making the UK economy harder to read but held to the view that looking through the distortions, underlying growth appeared to have slowed but remains "slightly" positive. Business investment remained under pressure, but consumer spending remained resilient supported by improved purchasing power. While the MPC acknowledged that monthly GDP growth of 0.3% m/m in July (subsequently revised up to 0.4% m/m) had been stronger than they expected, the general impression was that growth in Q3 was similar to the underlying below-trend performance seen over the first half of the year. This slower growth was leading to "a degree of excess supply" opening up within companies.

The MPC warned that delaying Brexit past 31 October could lead to further uncertainty and damage growth prospects – with the damage being greater the longer that the delay is.

¹² Economic and Fiscal Outlook. Office for Budget Responsibility, 13 March 2019. See cdn.obr.uk/March-2019_EFO_Web-Accessible.pdf

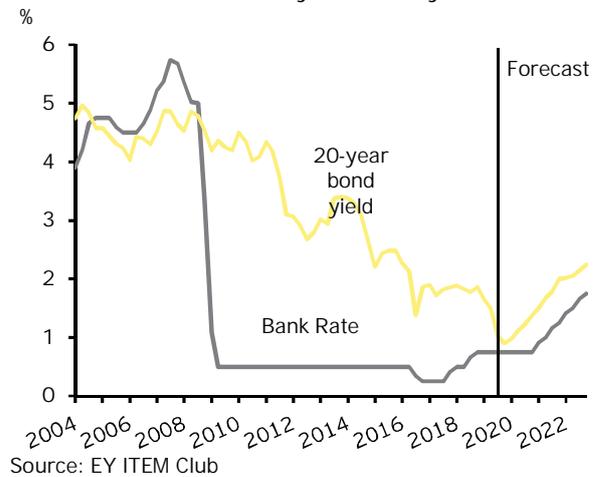
¹³ Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 18 September 2019. Bank of England, 19 September 2019. See bankofengland.co.uk/-/media/boe/files/monetary-policy-summary-and-minutes/2019/september-2019.pdf

The MPC also observed that the global outlook had deteriorated since its August meeting with the trade war between the US and China intensifying. Nevertheless, the MPC held to the view that if there is a “smooth” UK departure from the EU, the UK would likely need a gradual and limited increase in interest rates to sustainably meet its 2.0% inflation target. This also assumes that there is some recovery in global growth.

Regarding inflation, the MPC considered that consumer price inflation (1.7% in August, where it subsequently remained in September) was likely to stay just below its 2.0% target in the near term before rising close to the target level early in 2020, partly due to energy price developments. Annual pay growth had reached an 11-year high of 4.0% in the three months to July amid a tight labour market. However, the MPC noted the labour market “does not appear to be tightening further” with latest data and surveys pointing to employment growth softening.

Even with the UK leaving the EU with a deal by 31 January 2020, we believe it is now most likely that the Bank of England will keep interest rates at 0.75% through to 2021. We suspect that below-trend UK growth and a very challenging global economic environment will result in the Bank of England holding fire.

UK: Bank Rate and 20-year bond yield



Indeed, if the Bank of England does act on interest rates in 2020, it is probably now more likely to be a rate cut rather than a hike. Nevertheless, we doubt the Bank of England will cut interest rates unless the UK economy takes a major downward lurch, given the tightness of the labour market and the fact that fiscal policy is set to be loosened. Even Bank of England inaction on interest rates would be in marked contrast to the loosening cycle in monetary policy increasingly being adopted by global central banks, notably the US Federal Reserve and the ECB.

If the UK ultimately leaves the EU without a deal, the Bank of England has repeatedly held to the view that interest rates could move in either direction. The September minutes observed that “In the event of a no-deal Brexit, the sterling exchange rate would probably fall, CPI inflation rise and GDP growth slow. The Committee’s interest rate decision would need to balance the upward pressure on inflation, from the likely fall in sterling and any reduction in supply capacity, with the downward pressure from any reduction in demand.” However, comments by Governor Mark Carney have repeatedly suggested that he thinks that it is most likely that the economy would need stimulus if there is a ‘no-deal’ Brexit, thereby indicating that an interest rate cut would be more likely than a hike. Public comments and speeches also suggest that this is the view of a number – but not all – MPC members. We strongly lean towards the view that interest rates would be far more likely to be cut than increased if there is eventually a ‘no-deal’ Brexit. Specifically, we suspect that interest rates would quickly come down from 0.75% to 0.25%. Mark Carney has recently repeatedly stated that he does not see negative interest rates as a tool in the UK.

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

Sterling’s recent movements have continued to be influenced significantly by the market’s views on whether or not the UK is likely to leave the EU with a deal, although it has also been affected by largely disappointing UK economic news in recent months and market perception that the Bank of England’s next move will be to cut interest rates from their current level of 0.75%. At the same time, sterling’s downside has been limited by largely weak economic news from other countries as well as by the US Federal Reserve and the ECB cutting interest rates.

The pound weakened to a 31-month low of \$1.206 in early August when concerns over a ‘no-deal’ Brexit were particularly elevated while UK economic news was particularly poor. While this partly reflected the general strength of the dollar, the pound also fell to its lowest level since October 2016 of £0.9326/euro on 12 August. Sterling came modestly off these lows before receiving a significant boost after it was reported on 10 October that Boris Johnson and the Irish leader, Leo Varadkar, had declared after a meeting that they could

see a “pathway” to a possible Brexit deal. The subsequent achieving of a deal between the UK and the EU on 17 October sent the pound up to a five-month high just above \$1.30 and it also achieved a five-month high against the euro of £0.862/euro. However, the pound eased back from these highs after Parliament rejected the Government’s three-day timetable to enact the withdrawal agreement legislation.

We suspect sterling will make modest gains on the assumption that the UK leaves the EU with a deal by Q1 2020. However, sterling’s upside is likely to be limited by relatively weak UK growth over 2020 and the likelihood that if the Bank of England does act on interest rates, it will be most likely to cut them. At the same time though, both the dollar and the euro are likely to be hampered by market expectations of further interest rate cuts by the US Federal Reserve and ongoing weak eurozone economic news, as well as very loose ECB monetary policy. Consequently, we see sterling trading around \$1.30 at the end of 2019 and \$1.35 at the end of 2020.

3. Prices

Consumer price inflation came down from a peak of 3.1% in November 2017 to end 2018 at 2.1% before coming down further to 1.8% in January 2019, which was the lowest level since December 2016 and modestly below the Bank of England’s 2.0% target rate. Inflation largely came down as the impact of sterling’s marked depreciation on import prices (especially for oil and commodities) after the June 2016 referendum vote to leave the EU waned. A marked falling back in oil prices after they reached a four-year high in October 2018 helped bring inflation down to January’s low when there was also a marked downward impact in January itself resulting from Ofgem’s cap on consumer energy prices coming into effect.

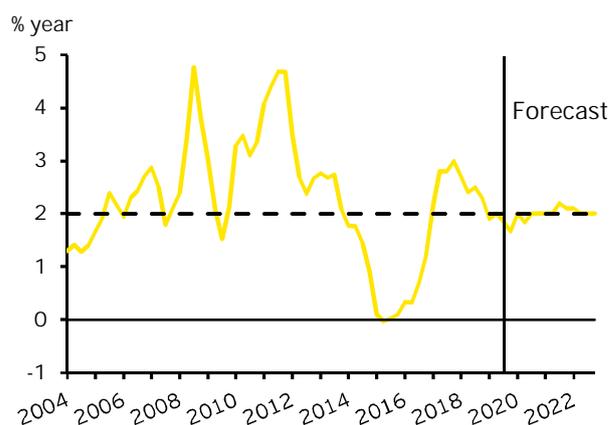
Consumer price inflation remained in a narrow 1.8%–2.1% range through to August when it dipped to a new low of 1.7%. This was down from 2.1% in July. Inflation was helped lower in August by favourable base effects, reflecting the fact that it had risen in August 2018. Additionally, there was an unwinding of some of the price hikes seen in July for some of the more erratic components, notably computer games and consoles. A marked downward impact came from clothing and footwear where prices rose less after the summer sales than in August 2018, causing them to be down 0.9% y/y. Core inflation moderated to 1.5% in August (the lowest level since November 2016) after rising to a six-month high of 1.9% in July from 1.8% in June. It had previously been locked in a 1.7%–1.8% range since February.

Inflation was stable at 1.7% in September as it was primarily limited by lower petrol prices while there was also some downward impact from utility prices and second-hand car prices. This countered some upward impact from prices for furniture, household appliances and hotel rooms. Core inflation rose back up to 1.7% in September.

We believe consumer price inflation is likely to remain under 2% over the rest of this year, and it could even edge lower in the near term. There will be some downward impact on inflation in October from lower energy prices for millions of people after Ofgem lowered the price cap for electricity and gas prices from October.

Meanwhile, oil prices have come back down pretty quickly following the spike that followed Saudi Arabia’s production facilities being damaged by a drone attack in mid-September, thereby diluting a potential near-term upside risk to inflation. Brent oil spiked as high as \$71.95/barrel from around \$61/barrel following the attack, but it has since fallen back to recently largely trade around \$60/barrel as Saudi Arabia resumed full production in early October. Consequently, relatively low oil prices still look likely to help limit inflation. We expect Brent oil to average around \$60/barrel over Q4 2019.

UK: CPI inflation



Source: EY ITEM Club

Domestic inflation pressures are expected to be limited over the next few months at least by below-trend UK growth which is likely to limit companies’ pricing power. Admittedly, earnings growth rose to an 11-year high of 3.9% in the three months to July, but this was still not unduly high compared to long-term norms (earnings growth of 4.0%–4.5% used to be considered consistent with the Bank’s target inflation rate of 2.0%). Furthermore, we suspect that earnings growth has peaked, and it did ease back to 3.8% in the three months to

August. Earlier concerns that sterling weakness could have some upward impact on inflation have been eased by the pound coming well off its August lows (it traded at a five-month high above \$1.30/£ in mid-October, having hit a 31-month low close to \$1.20/£ during August).

Price pressures further down the price chain were softer in September and benign, which bodes well for consumer price inflation. Indeed, producer input prices were down 2.8% y/y in September (the largest annual decline since May 2016) as they dipped 0.8% m/m. Meanwhile, the annual increase in producer output prices slowed markedly to a three-year low of 1.2% in September (from 1.7% in August) as they edged down 0.1% m/m.

Consumer price inflation is seen staying just under 2% through to Q3 2020 as GDP growth is below trend over the year as a whole, despite an anticipated gradual pick-up in activity as the year progresses. Additionally, an expected firmer pound (assuming the UK has left the EU with a deal) will help to limit the rise in inflationary pressures while oil prices are seen modestly softer overall, with Brent oil averaging around \$58/barrel over 2020 compared to \$63.5/barrel over 2019.

4. Activity

GDP growth slowed to 1.4% in 2018 from 1.9% in both 2017 and 2016. This was the weakest expansion since 2009. GDP growth slowed to 0.3% q/q in Q4 2018 after picking up to 0.6% q/q in Q3 (when it was buoyed by the heatwave), from 0.5% q/q in Q2 and expansion of just 0.1% q/q in Q1 (when economic activity suffered from extreme cold weather). Growth y/y edged back to 1.5% in Q4 2018 after improving modestly to 1.6% in Q3 from 1.1% in Q2 and 1.1% in Q1.

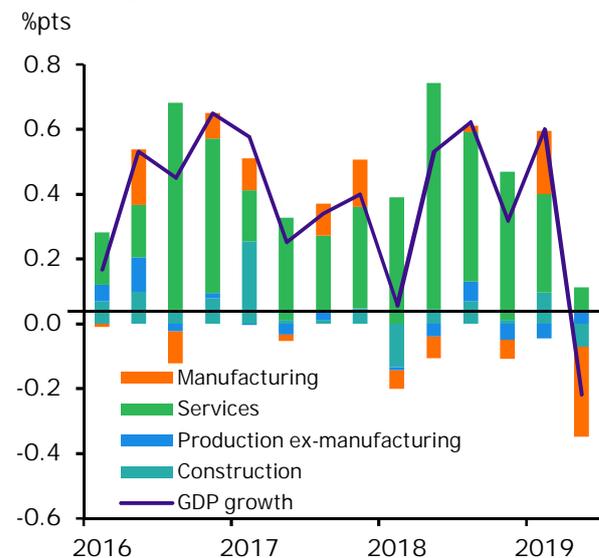
The economy registered a highly uneven performance over the first half of 2019. While GDP growth spiked to 0.6% q/q and 2.1% y/y in Q1, this was a deceptively strong start to the year as there was a major boost to activity (particularly the manufacturing sector) from stockpiling, as businesses and, very possibly to a limited extent, consumers, looked to protect their supplies in case a disruptive 'no-deal' Brexit occurred at the end of March. Additionally, unseasonably warm weather gave a boost to consumer spending in Q1. Consequently, the economy suffered considerable payback in Q2 when GDP declined 0.2% q/q which was the first contraction since Q4 2012; this caused y/y growth to slow sharply to 1.3%. In addition to a sharp running down of the stocks that had been built up in Q1, economic activity was further hit in Q2 by car producers bringing forward their usual summer plant shutdowns to April from August because of concerns that their supply chains could be disrupted if a 'no-deal' Brexit had occurred at the end of March.

So just as Q1 2019 overstated the strength of the UK economy, so Q2 overstated its weakness. However, taking an overall view of the first half of 2019, it is evident that the economy underperformed amid Brexit, domestic political and global economic uncertainties.

On the output side of the economy, manufacturing output fell back 2.8% q/q in Q2 after growth of 2.0% q/q in Q1 as the stocks correction and car plant shutdowns took a major toll. Industrial production overall dipped 1.8% q/q in Q2 after expanding 1.1% q/q in Q1. Construction output also contracted (by 1.2% q/q) in Q2 after growth of 1.6% q/q in Q1 as it was hit by uncertainties. Meanwhile, services output could only edge up 0.1% q/q in Q2, which was its weakest performance for three years and down from growth of 0.4% q/q in Q1.

On the expenditure side of the economy, a running down of inventories knocked 1.2ppts off q/q GDP growth in Q2 which was an even larger impact than the positive contribution of 0.7ppts seen in Q1. Additionally, business investment contracted anew in Q2 by 0.4% q/q amid the major uncertainties after growing 0.8% q/q in Q1, which had been the first increase in five quarters. Relatively resilient consumer spending (up 0.4% q/q after growth of 0.3% q/q in Q1) saved the economy from an even worse fate in Q2. There was also government spending growth of 0.6% q/q in Q2 after an increase of 0.3% q/q in Q1. Finally, there was a record positive contribution from net trade in Q2 after it had been a record drag on q/q GDP in

UK: GDP growth and contributions



Source: EY ITEM Club/Haver Analytics

Q1. This reflected imports of goods and services falling back 13.0% q/q in Q2 after they had jumped 10.3% q/q in Q1. Imports had been lifted in Q1 by stockpiling of foreign products and production inputs as well as by large imports of non-monetary gold which were reversed in Q2. In the meantime, exports of goods and services fell 6.6% q/q in Q2 2019 as global growth slowed after growing 1.6% q/q in Q1.

While we expect the economy to have returned to growth in Q3 with GDP expanding 0.4% q/q, this was primarily due to 0.4% m/m growth in July. GDP fell back 0.1% m/m in August and largely weak news for September indicates that the economy continued to find life challenging amid heightened Brexit uncertainties ahead of the planned 31 October date for the UK to leave the EU and substantial UK domestic political uncertainties. In the meantime, the global economic environment is becoming ever more challenging.

We expect growth to be weaker in Q4 2019, possibly around 0.2% q/q, although it may have received some help from stockbuilding in the run-up to the scheduled 31 October Brexit departure date. Consequently, GDP growth is seen at 1.3% over 2019. October survey evidence from the CBI pointed to very weak manufacturing activity and lacklustre retail sales.

Even if the UK does manage to leave the UK with a deal by early 2020, we now believe GDP growth will only be 1.0% in 2020. This would be an 11-year low, although we do expect economic activity to pick-up in the second half of the year.

While a Brexit deal would dilute some uncertainties, they are unlikely to disappear altogether as there will still be concerns over the UK's longer-term relationship with the EU. Indeed, the end of 2020 could well mark another cliff edge in the Brexit process as that is when the transition period is currently meant to end and it looks highly doubtful that the UK and EU will have agreed a long-term relationship by then. While there is scope to extend the transition period by up to two years, should both sides agree, this could well see matters going down to the wire again. In addition, a more challenging global economic environment is likely to weigh down on the UK economy. On the positive side, the fundamentals for consumers should still be relatively decent (although we suspect they peaked around mid-2019) while fiscal policy will be more supportive than previously planned. The economy is also unlikely to be hampered by higher interest rates in 2020. Indeed, if the Bank of England does act on monetary policy in 2020, it now looks most likely to cut interest rates.

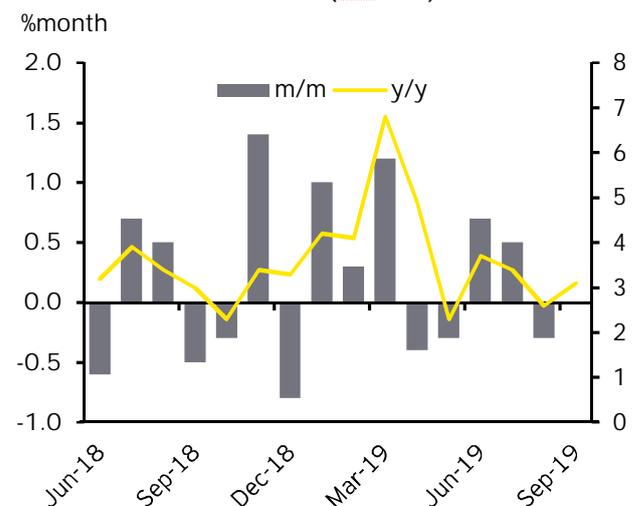
5. Consumer demand

Consumer spending has just about maintained its position as the most resilient sector of the economy so far in 2019, after growth of 1.6% in 2018 modestly outstripped overall GDP growth of 1.4%. Nevertheless, it should be noted that the 1.6% growth in consumer spending in 2018 was still its weakest growth since 2012 and was down markedly from growth of 2.3% in 2017 and 3.8% in 2016.

Consumer spending grew 0.3% q/q in Q1 2019, which was actually only half the GDP growth rate of 0.6% q/q; it was up 1.3% y/y. Consumer spending then held up pretty well in Q2 expanding 0.4% q/q in marked contrast to the 0.2% q/q contraction seen in GDP. Nevertheless, y/y growth in consumer spending moderated to 1.1% in Q2.

Consumers' spending resilience over the first half of 2019 was largely centred on retail sales, which grew 1.7% q/q in Q1 and then by a further 0.7% q/q in Q2. Unseasonably warm weather provided some help to retail sales in Q1 and it is also very possible that there was some limited stockpiling by consumers in case a disruptive 'no-deal' Brexit occurred at the end of March. It is also possible that some consumers brought forward purchases amid concern that prices could rise if a disruptive Brexit at the end of March led to sterling weakening sharply.

UK: Retail sales volumes (inc fuel)



Source: EY ITEM Club/Haver Analytics

However, private new car sales fell 3.2% over the first half of 2019. Meanwhile, consumer spending on services seems to have been lacklustre. The Q1 2019 Bank of England's regional agents' survey of business conditions observed "Annual growth in consumer services values remained modest – even compared with a

year ago when activity was adversely affected by the severe winter weather”.¹⁴ Their Q2 survey indicated that there had been a “small” pick-up in consumer services growth.

Available evidence for Q3 suggests that spending held up pretty well overall, but consumers seemingly became more cautious as the quarter progressed. Retail sales volumes were only flat m/m in September after dipping 0.3% m/m in August, but they still grew 0.6% q/q over Q3 largely due to a robust July performance (up 0.5% m/m). Annual growth in retail sales actually improved to 3.1% in September from a three-month low of 2.6% in August as sales had fallen m/m in September 2018. Meanwhile, private new car sales remained weak through Q3 as they edged up just 0.1% y/y in September after drops of 1.7% y/y in August and 2.0% in July. Furthermore, September’s marginal rise came from a very weak base as private new car sales had plunged 20.1% y/y in September 2018 when supplies were hit hard by car manufacturers struggling with new emission regulations. Finally, the Bank of England’s regional agents reported in their Q3 survey (released in mid-September) that y/y growth in consumer services values had slowed, although this was influenced by base effects due to the strong summer 2018 performance. The latest survey from the CBI pointed to lacklustre retail sales in October, although there was some improvement on September.

For much of 2019, consumers seemed largely able to brush off any concerns over Brexit and the economy, helped by improved purchasing power and a generally healthy labour market. Supportive to consumer spending, real earnings growth picked up between mid-2018 and Q3 2019 while employment reached a record high of 32.811m in the three months to June. Specifically, real earnings growth reached a near four-year high of 2.1% in the three months to July, which was up from 0.1% in the three months to June 2018. This was the consequence of annual earnings growth rising to an 11-year high of 3.9% in the three months to July while inflation has been relatively modest, recently hovering around 2%.

However, a number of surveys indicate that consumers have recently become more concerned by the combination of a struggling domestic economy, heightened domestic political and Brexit uncertainties and a deteriorating and more fractious global economic environment. The GfK consumer confidence measure fell in October to be at its equal lowest level since January and also at its equal lowest level since mid-2013. Meanwhile, the YouGov/Cebr Consumer Confidence Index weakened in September to be at its lowest level since May 2013. Additionally, the IHS Markit Household Finance survey indicates that consumers in September had become the most pessimistic about their future finances since November 2013 while their willingness to make major purchases was the lowest since December 2013. While there was some recovery in expectations for consumers’ future finances in October, their willingness to make major purchases remained low.

While leaving the EU with a deal by Q1 2020 will ease some of the uncertainties, any pick-up in consumer confidence may be limited as other concerns persist.

In the meantime, we suspect that the improvement in consumer fundamentals has probably peaked and will soften in the near term at least, although they should remain relatively decent. Employment is now faltering, and we expect it to remain under pressure in the near term at least. On the assumption that the UK leaves the EU with a deal by the end of Q1 2020, we expect employment growth to slow from 1.2% in 2018 to 1.0% in 2019 and 0.6% in 2020. We expect the unemployment rate to rise modestly from 3.9% currently to 4.0% in the early months of 2020 before edging back to 3.9% by the end of the year.

We also suspect that earnings growth will ease back from the 11-year high of 3.9% seen in the three months to July (it dipped to 3.8% in the three months to August). Specifically, we expect average earnings growth to pick-up from 3.0% in 2018 to 3.7% in 2019 then ease back to 3.4% in 2020.

On the positive side for consumer purchasing power, inflation is expected to remain limited. Additionally, the budgets of some households will be helped by the freeze on welfare benefits coming to an end after four years in 2020, while inflation is expected to remain subdued. Consequently, following an increase of 2.5% in 2018,

¹⁴ Agents’ summary of business conditions – 2019 Q1. Bank of England. 21 March 2019. See [bankofengland.co.uk/agents-summary/2019/2019-q1](https://www.bankofengland.co.uk/agents-summary/2019/2019-q1)

we expect real household incomes to rise by 2.0% in 2019 and 1.7% in 2020. The 2020 gain could be lifted if significant personal tax cuts occur in the Budget for 2020/21.

There are other factors which may limit consumer spending over the coming months, although we feel that higher interest rates are unlikely to be one of them, with the Bank of England highly likely to sit tight on monetary policy through to 2021. In particular, with the household saving ratio still being relatively limited at 6.8% of GDP in Q2 2019, consumers may at the very least be keen to avoid further dissaving – especially given current major uncertainties. Meanwhile, lenders have cut back on the availability of unsecured consumer credit. Indeed, the latest Bank of England's Credit Conditions Survey indicated that lenders reduced the amount of unsecured credit available to consumers in Q3 2019 for the 11th successive quarter, and they expected to reduce it further in Q4. Additionally, lenders were reported to have markedly further tightened their lending standards for granting unsecured consumer credit in Q3 2019, which was the 12th successive quarter of tightening. A significant further tightening of lending standards was anticipated over Q4 2019. Latest Bank of England data shows that annual unsecured consumer credit growth slowed to 6.0% in September; this was the lowest rate since July 2014 and was down from 7.5% in December 2018 and a peak of 10.9% in November 2016.

Consequently, consumer spending growth is seen moderating from 1.6% in 2018 to 1.2% in 2019, before edging up to 1.4% in 2020.

6. Housing market

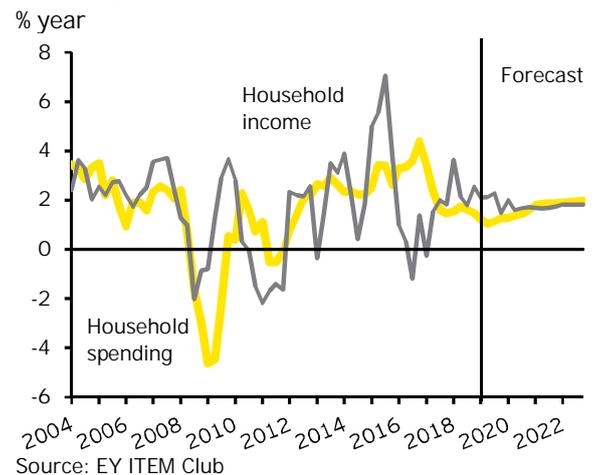
Housing market activity picked up modestly over the summer, but it has since fallen back. Specifically, latest Bank of England data shows mortgage approvals for house purchases edged up to 65,919 in September after falling back to a 3-month low of 65,681 in August from a 17-month high of 67,109 in July. Mortgage approvals had previously climbed to July's high from 66,344 in June, 65,558 in May and a 15-month low of 62,622 in March. Despite being at a 17-month high of 67,109 in July, mortgage approvals had actually still been in the 63,000–68,000 range that has broadly held since late 2016, and September's level of 65,681 took them back to the middle of that range.

It is possible that mortgage activity may have got a recent modest lift from some people looking to complete their house purchases before the scheduled Brexit deadline of 31 October, given the major uncertainties as to what would actually happen then. Markedly improved earnings growth, in tandem with recent record high employment, may also be providing some help to housing market activity.

However, the fact that mortgage approvals have come off their July high suggests that any pick-up in housing market activity is currently likely to be short-lived amid major uncertainties. It is also notable that the labour market is now showing increasing signs of faltering.

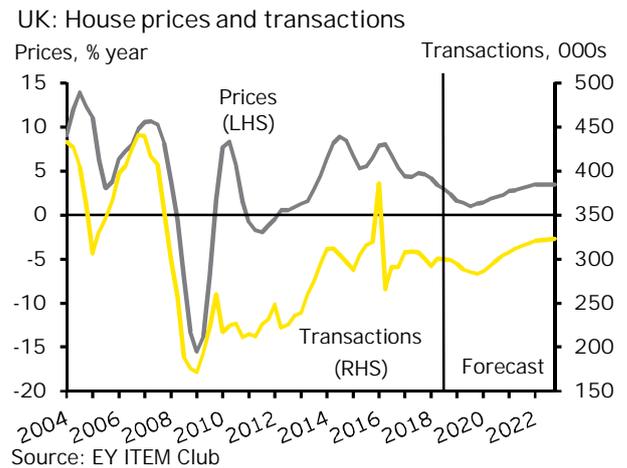
Meanwhile, house prices remain soft. In particular, the Nationwide reported that the annual rise in house prices was just 0.4% in October; this was up slightly from an 8-month low of 0.2% in September but still close to the near six-year low of 0.1% seen in January. House prices rose 0.2% m/m in October after a dip of 0.2% m/m in September. The 2019 y/y high on the Nationwide measure was 0.9% in April. Latest data from the Halifax shows the y/y increase in house prices fell back markedly to 1.1% in September (the lowest since April 2013) as prices dipped 0.4% m/m, which was the first monthly drop since May. The annual rate had previously risen to a four-month high of 1.8% in August from a low of 1.2% in June. The 2019 annual peak rate on the Halifax measure was 2.8% in March. Finally, latest data from the Land Registry/ONS shows the y/y increase in house prices rose to 1.3% in August having slowed to 0.8% in July (which was the lowest rate since October 2012) from 1.1% in June and 2.0% at the end of 2018. House prices on this measure rose an unadjusted 0.8% m/m in August, which was above the 0.3% m/m increase seen in July 2018.

UK: Real household income and spending



With the economy largely struggling and the outlook highly uncertain on a number of fronts (Brexit, domestic political, global economy), we suspect that the housing market will continue to find life challenging in the near term at least, keeping prices soft. Consequently, we expect house prices to only rise by around 1.0% on most measures over 2019.

There are positives for the housing market – consumers' purchasing power has picked up since mid-2018 (real earnings growth improved from 0.1% in the three months to June 2018 to 2.0% in the three months to July 2019 before edging back to 1.9% in the three months to August). Employment reached a record high in the three months to June (although it was lower in the three months to August) while mortgage interest rates are still at historically low levels. Indeed, there is strong market belief that the Bank of England's next move could actually be to cut interest rates, although we think it is more likely that they will stay at their current level through to 2021.



Meanwhile, a shortage of houses on the market will also likely offer some support to prices. The latest RICS survey showed new instructions to sell fell anew in September and were at the weakest level since June 2016; properties coming on to the market had previously broadly stabilised over June–August following 11 months of declines through to May. Consequently, average stock levels on estate agents' books in September were close to the lowest level in the survey's history. In the meantime, even if ultimately successful, the Government's recent – and ongoing – initiatives to boost house building will take time to have a significant effect so are unlikely to markedly influence house prices in the near term at least.

However, the labour market has recently faltered, and it looks likely to continue to do so in the near term at least as companies face a soft domestic economy, still-significant Brexit uncertainties, an unsettled domestic political situation and a challenging global environment. Indeed, employment fell by 56,000 in the three months to August. It also looks more likely than not that earnings growth peaked in the three months to July and it edged back in August.

In the event of the UK leaving the EU with a deal by 31 January, we believe reduced uncertainty could see house prices rise by around 2% in 2020. Housing market activity – and possibly to a lesser extent, prices – could be given a lift in 2020 if the Government cuts stamp duty significantly in the Budget for 2020/21, when it is eventually delivered. However, the economy still looks set for a challenging 2020 even if there is a Brexit deal, so the upside for house prices is likely to be limited.

If the UK ultimately leaves the EU without a deal, we believe house prices could quickly drop by around 5% amid heightened uncertainty and weakened economic activity.

7. Company sector

Business investment suffered a relapse in Q2 2019, which confirmed our suspicion that the return to growth seen in Q1 did not mark a return to a sustainable upturn. In truth, this never seemed likely as the economy faced ongoing Brexit developments, a highly unsettled domestic political economy and a weakening and increasingly troublesome global economy. In such an environment, it always seemed probable that businesses would retain a cautious approach to committing to new investment and projects.

Specifically, business investment fell back 0.4% q/q in Q2 2019 after growth of 0.8% q/q in Q1 had marked the first quarterly expansion since Q4 2017. Indeed, business investment had previously suffered a pretty torrid 2018 as it fell 1.6% after growth of 2.9% in 2017 with q/q drops occurring in each quarter. This was the first time that business investment had fallen for four successive quarters since the deep economic downturn of 2008/9. Specifically, business investment fell 1.0% q/q in Q1 2018, 0.6% q/q in Q2, 0.8% q/q in Q3 and then at a sharper rate of 1.0% q/q in Q4.

The weakness in business investment in 2018 occurred despite some supportive conditions which were succinctly summarised by the Bank of England in its May 2019 quarterly Inflation Report, which observed: "Many of the determinants of business investment have remained supportive. The cost of finance is low relative to historical norms, rates of return on capital are robust, the labour market remains tight and survey measures suggest that firms are operating with limited spare capacity. All of this should increase firms'

incentive to invest. The weakness of business investment despite these supportive factors suggests that Brexit-related uncertainties have had an impact. Indeed, evidence from the Decision Maker Panel (DMP) survey suggests that impact has increased over the past year. Investment by firms that viewed Brexit as an important source of uncertainty fell at the end of 2018, compared to a rise in investment among those firms that did not.¹⁵

The 0.4% q/q drop in business investment in Q2 2019 meant that it was down 1.4% y/y and also 3.0% below the peak level seen in Q4 2017. It also meant that business investment was only 0.4% above the level seen in Q2 2016, which was essentially the last quarter before the UK voted to leave the EU in the referendum in June of that year. The strong suspicion has to be that business investment contracted again in Q3 2019.

While a Brexit deal should dilute some of the uncertainties causing businesses to limit their investment, substantial concerns are likely to remain, which will limit any upturn in capital expenditure. Not only is there likely to be business concern over a potential looser long-term relationship with the EU

than had previously been envisaged, but businesses also still face a weakened global economic environment as well as possible ongoing significant UK domestic political uncertainties. Furthermore, negotiations over the UK's long-term relationship with the EU are likely to prove highly challenging which will likely fuel uncertainty. Indeed, the end of 2020 could well mark another cliff edge in the Brexit process as the transition period is currently meant to end then and – given the tortuous way negotiations have gone so far in the Brexit process – it seems improbable that the UK and EU will have agreed a long-term relationship by then. There is scope to extend the transition period by up to two years, but this needs both sides to agree and it is easy to see matters going down to the wire.

Meanwhile recent and expected further below-trend UK growth is easing pressure on capacity and diluting pressure for investment from this source. The Bank of England considered that a “small margin” of excess capacity emerged over the first half of 2019 and this looks set to widen further. Indeed, given the current deteriorating UK economic environment, a number of companies may well be wary about stepping up their investment in the immediate aftermath of the UK leaving the EU, even with a deal, as they may want to see how the UK economy performs for a while after Brexit before committing themselves, especially to costly investments.

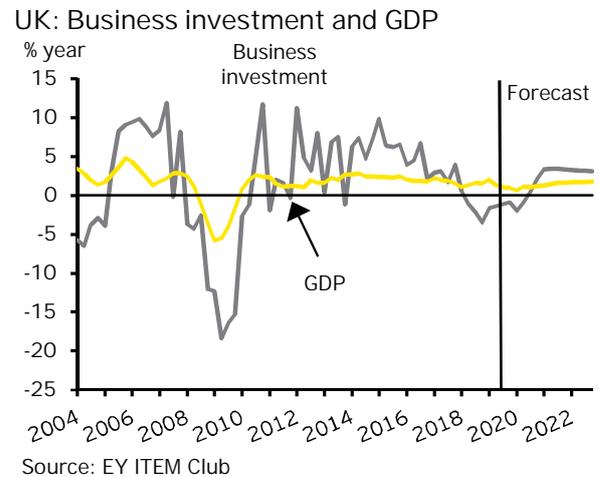
Nevertheless, there are some supportive factors for business investment. Still relatively cheap and available credit – as well as ongoing reasonable rates of return – remain supportive to investment. Latest ONS data shows that the net rate of return for non-financial UK companies was 12.3% in Q1 2019. This was up slightly from 12.2% in Q4 2018 although it was just below the overall 2018 average of 12.4%. While the net rate of return has come down from an average of 12.8% in 2017 and 13.0% in 2018, the Q1 2019 rate of 12.3% was still above the long-term (1997–2018) average of 12.0%.

Meanwhile business investment is likely to be lifted by some firms looking to increasingly invest in automation to make up for labour shortages and to try to boost productivity. Furthermore, the recent extended weakness of business investment suggests that some companies have delayed replacing plant and equipment or investing in new processes, and this will eventually need to be addressed.

On balance, we forecast business investment to be essentially flat over 2020 after contraction of 1.3% in 2019. However, it is expected to start growing in Q2 2020 and gradually strengthen as the year progresses.

8. Labour market and wages

The labour market saw a particularly strong start to 2019 after a robust performance in 2018 which had occurred despite the economy's lacklustre performance and mounting uncertainties centred on Brexit. Indeed,



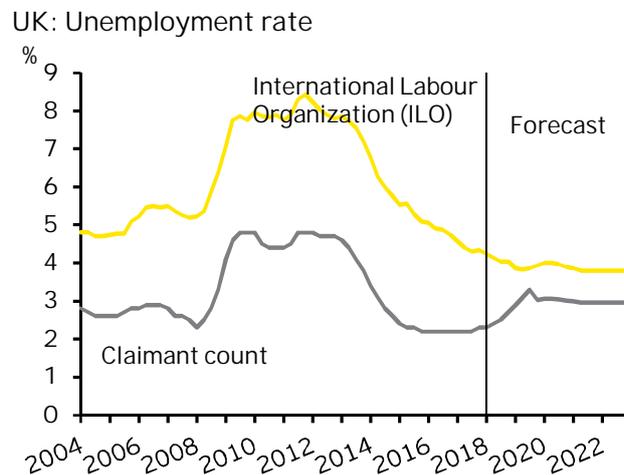
¹⁵ Inflation Report – May 2019. Bank of England. May 2019. See [bankofengland.co.uk/-/media/boe/files/inflation-report/2019/may/inflation-report-may-2019.pdf](https://www.bankofengland.co.uk/-/media/boe/files/inflation-report/2019/may/inflation-report-may-2019.pdf)

employment rose 222,000 in the three months to January, which was the largest gain since the three months to November 2015.

The labour market continued to hold up well over the early months of 2019, but it then started to show some signs of fraying. Employment growth slowed to 28,000 in the three months to May (which was the smallest gain since August 2018) before spiking up to 115,000 in the three months to June when the number in work reached a new record high of 32.811m. However, employment growth fell back to 31,000 in the three months to July when the level was below its June peak at 32.777m. The employment rate was stable at a record high of 76.1% in the three months to July, having first reached this level in the three months to April. Meanwhile, unemployment fell a modest 11,000 in the three months to July (after a rise of 31,000 in the three months to June) to stand at 1.294m. This was just above the low of 1.292m seen in the three months to May. The unemployment rate was 3.8% in the three months to July (the lowest since the end of 1974); it had first come down to this level in the three months to March.

August data was markedly weaker across the board suggesting that the labour market's resilience was increasingly buckling. Employment fell 56,000 in the three months to August, which was the largest drop for over four years. It took the employment level down to 32.693m, compared to the record high of 32.811m achieved in the three months to June. The employment rate dropped to 75.9% from 76.1%. Also, notably, job vacancies slowed again in the three months to September to be at a 22-month low of 813,000. Meanwhile, the number of jobless rose 22,000 in the three months to August to 1.314m, causing the unemployment rate to rise back up to 3.9%.

The fact that the labour market is only now really faltering is a remarkably resilient performance – which has been good news for UK consumers but has been bad news for UK productivity given lacklustre growth. The labour market has undoubtedly been helped by businesses preferring to employ rather than commit to investment given current heightened uncertainties and the fact that employment is relatively low cost and easier to reverse if business subsequently stalls. It also needs to be borne in mind that employment is a lagging indicator so the overall weakness in economic activity since Q1 2019 and mounting uncertainties are probably only now markedly filtering through. There is evidence that many employers are currently adopting a 'wait and see' approach on employment given the current heightened uncertainties.



Source: EY ITEM Club

Looking ahead, we expect employment to remain under pressure over the rest of 2019, as companies tailor their behaviour to a relatively lacklustre domestic economy, still-significant Brexit uncertainties, a fraught domestic political situation and a challenging global environment. Employment growth may also be limited by increased difficulties in finding suitable candidates in some sectors. Specifically, we expect employment growth to be 0.8% over 2019 (largely due to the strong gains at the start of the year), with the unemployment rate remaining at 3.9% through to the end of the year.

With the economy expected to continue to struggle early on in 2020, and then to see only modestly improving activity, we expect the unemployment rate to edge up further to 4.0%, where it is expected to remain for much of the year before edging back down to 3.9% in the latter months. Employment is seen flat over 2020, although it is expected to start rising in the second half of the year after softness over the first half.

Earnings growth firmed from mid-2018 through to the three months to July 2019, indicating that the tightening labour market was finally having a sustained upward impact on pay after several false dawns. Indeed, annual average earnings growth notably reached 3.9% in the three months to July, which was an 11-year high and up from 3.5% at the end of 2018 and 2.4% in the three months to June 2018. Even so, this was still below the 4%–5% seen before the 2008/9 financial crisis. Annual regular earnings growth (which strips out bonus payments, which can be volatile) also hit an 11-year high of 3.9% (both in the three months to July and to June), which was up from 3.4% at the end of 2018 and 2.7% in the three months to June 2018.

However, annual earnings growth edged off its highs in the three months to August, when both the total and regular rates dipped to 3.8%. We suspect that earnings will slip back further from its July peak levels. With employment faltering and businesses cautious over the outlook among major uncertainties, we suspect that they will increasingly look to contain pay increases. Meanwhile, heightened consumer concerns and uncertainties may increasingly facilitate companies' ability to limit pay.

Consequently, we expect annual earnings growth to average 3.7% over 2019, up from the 2018 outturn of 3.0%. This level would still be below the pre-financial-crisis norm of 4.5%-5.0% annual growth. Annual earnings growth is forecast to average a lower 3.4% over 2020.

9. Trade and the balance of payments

Net trade was a drag on UK GDP growth in 2018, knocking 0.5ppts off the rate of expansion. This was in contrast to 2017 when net trade added 0.7ppts to GDP growth, one of the biggest gains from this source in the last 25 years. Exports of goods and services contracted 0.9% in real terms in 2018, after expansion of 6.1% in 2017, which had been the best growth for six years. Meanwhile, growth in real imports of goods and services moderated from 3.5% in 2017 to a seven-year low of 0.7% in 2018.

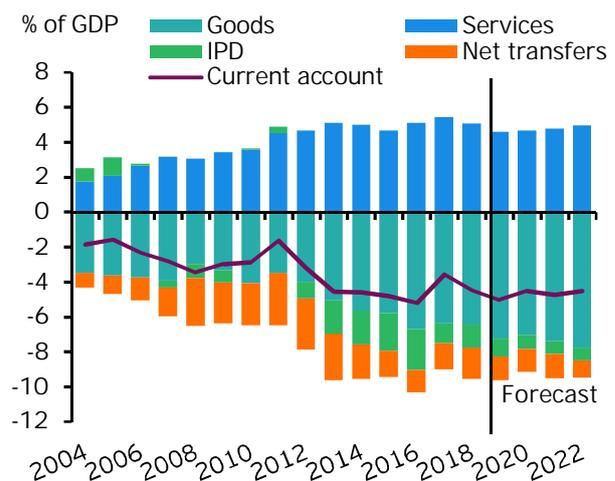
The factors which assisted with the healthy positive trade contribution in 2017 – robust global growth, particularly in the eurozone, and sterling's post-referendum weakness – became less favourable in 2018. In particular, eurozone growth slowed in the second half of 2018. In the meantime, having weakened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

Net trade made a record negative contribution of 2.7ppts to GDP growth in Q1 2019. Imports of goods and services surged 10.3% q/q and were up 14.9% y/y as they were clearly lifted by stockpiling of foreign products and production inputs amid concerns that there could be a disruptive 'no-deal' Brexit in late March. Also, significantly, the ONS reported that there were 'notable' imports of unspecified goods in Q1 and stated "These unspecified goods include non-monetary gold (NMG) and account for the large and offsetting impacts to gross capital formation and net trade. These movements do not affect headline GDP as they are recorded as equivalent offsetting impacts in the UK National Accounts, but this is reflected in the composition of GDP growth." The ONS further commented that there was "a sizeable increase of imports of unspecified goods, which includes NMG." Meanwhile, exports of goods and services rose 1.6% q/q in Q1 2019 and were up 2.8% y/y.

There was a marked turnaround in net trade's performance in Q2 when it made a record positive contribution of 2.6ppts. This reflected imports of goods and services falling back 13.0% q/q in Q2 after the Q1 boost from stockpiling of foreign products and production inputs; imports were down 0.4% y/y in Q2. There was also a reversal in Q2 of the large imports of NMG which had occurred in Q1. Disappointingly, exports of goods and services fell 6.6% q/q in Q2 2019 as global growth slowed, causing them to be down 1.4% y/y.

Despite the Q2 turnaround in the UK's net trade performance, it still looks highly likely that it will make an appreciable negative contribution to UK GDP in 2019. This is expected to be primarily the consequence of substantially slower global growth, notably including markedly weakened expansion in the eurozone. Meanwhile, we suspect that sterling will be only modestly weaker overall in 2019 compared to 2018. Specifically, sterling's trade-weighted index is seen at 77.4 over 2019, compared to an average of 78.5 in 2018. It is also very possible that imports could again be boosted in the final run-up to the UK's planned exit from the EU on 31 October by more stockpiling of foreign products and production inputs.

UK: Current account



Source: EY ITEM Club

IPD= interest, profit and dividends

We expect net trade to make a modest positive contribution to GDP growth in 2020. Global trade may well see slight improvement in 2020 after a particularly poor performance in 2019, and there is expected to be limited recovery in growth in the eurozone. However, it has to be acknowledged that there are serious downside risks to the global outlook. Meanwhile, UK exporters are expected to face a stronger pound as we anticipate it will firm if the UK does leave the EU by Q1 2020, with the trade-weighted index seen picking up from an average of 81.3 in Q4 2019 to 83.9 in Q4 2020.

The UK's weakened trade performance contributed to a renewed widening in the current account deficit to £92.5b (4.3% of GDP) in 2018 after it had narrowed to a five-year low of £72.3b (3.5% of GDP) in 2017 from £104.0b (5.2% of GDP) in 2016. The total deficit on trade in goods and services widened to £37.7b in 2018 from £25.1b in 2017. Additionally, there were increases in the deficits on primary income to £28.9b in 2018 from £24.7b in 2017 and on secondary income (mainly transfers) to £25.9b in 2018 from £22.5b in 2017.

The current account deficit increased sharply further to £33.1b (6.0% of GDP) in Q1 2019; this was the highest shortfall since late 2016 and was up from £27.6b (5.1% of GDP) in Q4 2018 and £23.2b (4.3% of GDP) in Q1 2018. A more than doubling of the trade deficit drove the first quarter's sharp jump in the current account deficit; this outweighed a marked drop in the shortfall on the primary income account to £3.4b from £10.4b in Q4 2018, which was primarily due to reduced profits made by investors in the UK on their foreign direct investment.

The current account deficit came down in Q2 while remaining at a relatively elevated level of £25.2b (4.6% of GDP). While the trade deficit came sharply back down in Q2 after its Q1 jump, this was partly countered by the shortfall on the primary income account widening back out to £7.1b in Q2. This was primarily due to increased payments to foreign investors on their investments in the UK.

Following the elevated shortfalls over the first half of the year, the current account deficit is expected to widen back out to £105.4b (4.8% of GDP) in 2019. The total deficit on trade in goods and services is seen higher at £57.2b. The current account deficit is seen coming down modestly to £95.3b (4.2% of GDP) in 2020 as the trade deficit narrows slightly to £54.3b. An expected modest firming of the pound as 2020 progresses should also boost the UK's overseas investment income when translated into sterling.

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