The Prospects Service

LEADING ECONOMIC ANALYSIS, FORECASTS AND DATA

UK Prospects, December 2016

Toplines

- We expect the UK economy to grow by 1.8% in 2016, compared to an earlier expectation of 2.0%. The downward shift is more a result of revised GDP data being released for the first three quarters of the year, than of a material change in our view for the rest of 2016.
- Similarly, we have marginally downgraded our expectations for 2017 growth from 1.0% to 0.8%. This is also a result of the revisions to existing data, but weaker employment figures and higher oil prices also played a part.
- Cebr still expects the Bank of England to keep the Bank Rate at its current 0.25% level until mid-2018 at which point they will begin to rise gradually. We expect the Bank to maintain its expanded quantitative easing (QE) programme throughout 2017.
- In November inflation on the Consumer Price Index (CPI) measure stood at 1.2% year-on-year – the highest value in two years. The trend of rising inflation is set to continue with prices rising 2.7% over 2017.
- With higher inflation and stagnant earnings growth, some households will find that their budgets have tightened. Hence, we anticipate that consumer spending will expand by 0.9% over 2017 in volume terms – a third of the growth rate seen in 2016.
- In the latest sign that 2017 will be a year marked by challenges, for the first time in 2016 total employment declined in the three months to October. Keeping in mind the latest data, Cebr now expects employment to expand by 0.4% next year – a marginal downgrade from the 0.5% forecast at the time of the November report.
- In the years immediately following 2017, growth is expected to return to rates similar to this year's. Beyond 2020 we expect GDP growth to hover around 1.5% annually.
- Our near-term forecasts are dependent on the progress of Article 50 negotiations between the UK and the EU. Should the UK be unsuccessful in securing favourable agreements with the EU, our forecasts will face further downward revisions. Securing trade agreements with the rest of the world will also be crucial for growth.

Forecast summary

- A key determinant of the UK's short and medium term performance will be the progression of the negotiations to leave the EU. Since the November prospects report few concrete developments have taken shape on this front. One significant change, has been the Government's decision to publish a detailed plan for leaving the EU. As we noted last month, the Government initially claimed it would not set out its objectives as that would hurt its negotiating position.
- However, following calls from a range of parties including businesses and the Labour Party for more guidance and transparency, the Government now plans to publish Brexit plans before triggering Article 50 in the coming three months.

- Cebr still expects the UK to leave the European single market by early 2019 and we now also consider a customs union unlikely. The most likely scenario is that the two parties will reach a free trade agreement which will still allow the UK preferential access to the European market. Hence, the trade between the UK and the EU will not have to resort to World Trade Organisation (WTO) terms.
- The question remains of how long it would take to negotiate a free trade agreement. If other similar arrangements around the world are any indication, it will probably take well over two years, which is the time allocated for Article 50 negotiations. Cebr considers an interim deal likely, but in its absence trade would suffer after 2018.
- Even with the Government's decision to publish its Brexit strategy, much uncertainty remains. Hence, we expect many businesses to take a 'wait and see' approach leading to a 3.9% decline in business investment over 2017.
- Inflation is already rising sharply and Cebr expects it to stand at 2.7% over 2017. The primary reason behind the upward revision (we were expecting 2.4% at the time of the November report) is an uptick in oil prices. At the very end of November the Organisation of the Petroleum Exporting Countries (OPEC) agreed to a production cut for the first time in years. The move sent Bent prices to above $55 per barrel, compared to an average of $43 over the first 10 months of the year. Higher oil prices impact inflation directly through higher prices at the pump, but also indirectly as the transport and production of various goods becomes more costly for producers.
- The marginal downgrades to our 2016 and 2017 GDP forecasts and the upward revision to inflation expectations have not changed our interest rate outlook. We still expect the Bank of England to look through rising prices and support growth by keeping the base interest rate at its current 0.25% level. A change in rates is unlikely until at least mid-2018.

Sources of growth

- In the coming year, sentiment among businesses will be greatly shaped by Brexit negotiations. A transparent negotiations process will help support confidence, but ultimately any signs hinting at a final outcome of Brexit will have the greatest impact on investment. Given that leaving the EU will prove to be a long and complicated process, we expect business investment will decrease by nearly 4% next year.
- The trinity of higher inflation, higher oil prices and modest wage growth will limit consumer spending growth. We expect consumer spending to expand by less than 1% over 2017.
- The impact of Brexit on trade in the longer term will be determined by the new trade deals that the UK manages to secure. In the short term, the weaker pound will discourage imports (which are a subtraction from GDP) and make those UK exports which compete primarily on price more attractive to foreign buyers.

Industry outlook

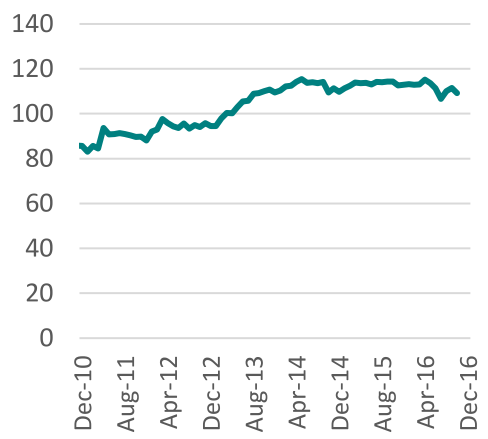
- Upward revisions to output from the business services and finance industries were the primary factor behind the higher than initially estimated quarter-on-quarter GDP growth in Q3. However, the sector faces a challenging period with passporting (i.e. the right for a company authorised in one EU country to operate across the entire EU) high on the list of Brexit negotiators. Still we expect the industry to expand in 2017, albeit at a slower pace of 1.0%.
- Similarly, we expect the retail sector to expand at a subdued 1.4% in volume terms as many households choose to spend more cautiously.

- On the other hand, given the declining attractiveness of Buy-to-let and reduced demand for commercial properties, Cebr expects construction output to fall by 1.0% next year.

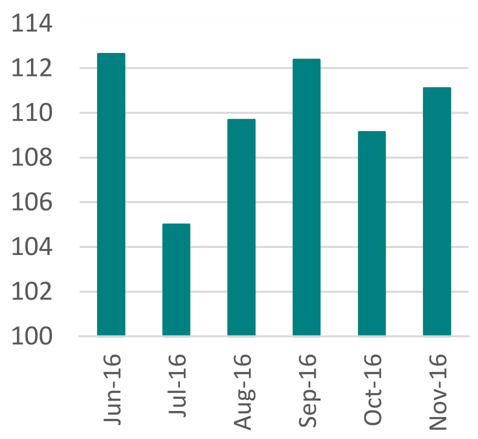
Leading indicators

- In December, consumer confidence declined to the lowest level since the immediate aftermath of the EU referendum, but remains high by historic standards.
- Higher inflation is one of the causes. Additionally, petrol has become more expensive due to a rise in the oil price and the weak pound, leading to higher costs for UK motorists.
- Still, despite the downtick that started in September, consumers are rather confident by historic standards. This is largely explained by the fact that Brexit has thus far not materially affected many people's lives.
- Despite a relatively robust housing market performance throughout 2016, many are concerned about the future value of their home – this has further weighed on confidence.
- On the other hand, business confidence strengthened notably in November, although it is still below pre-referendum levels. Businesses are feeling more optimistic about overall economic prospects as well as less pessimistic about their own organisation's prospects in the coming year.
- While the uptick in business confidence certainly bodes well for investment and hiring (both of which have a great impact on overall economic performance) one swallow does not a summer make. With many Brexit questions still unanswered, we expect 2017 and 2018 to see volatility in business confidence levels.

Cebr/YouGov Consumer Confidence Index



Cebr/YouGov Business Confidence Index



Economic risks over the coming 12 months

	Risk likelihood	Comment
High inflation	High	As we anticipated, inflation rose in November and now stands at a two-year high. With prices for essentials such as food and gas set to rise, households will have less money available for discretionary spending.
Hiring slowdown	Medium	In the three months to October the employment rate declined marginally to 74.4%. Although only slightly below the record high of 74.5%, the shift suggests the labour market may have passed its peak. This is further evidenced by the claimant count which rose month-on-month and year-on-year in November.
Difficulties eliminating the budget deficit	Medium	In November the Government borrowed £12.2bn – the highest monthly figure in a year. As GDP growth is set to slow next year, debt will rise relative to GDP. Further down the line, meeting even the less ambitious target of a 2% deficit by 2020 may prove unachievable and the ever-moving target of eliminating the budget deficit may have to shift into the mid-2020s.

Focus On: A labour market past its peak

- In the three months to October, the UK unemployment rate stood at 4.8% - the lowest level in more than a decade.
- Further good news came from the latest earnings publication. Over the same three month period, average wages were 2.5% higher on the year, or 2.6% if bonuses are excluded. This is an acceleration from 2.4% (for both) in the three months to September.
- Given the low unemployment and modest, but consistent wage growth it may be difficult to think of the labour market as anything but robust.
- However, other indicators suggest that a labour market softening may not be far off.
- Compared to the May to July period, employment decreased by 6,000. If we consider only those aged 16 to 64 the decrease was significantly greater at 29,000.
- The proportion of people in work also fell slightly from the record high of 74.5% to 74.4%.
- One of the most timely labour market statistics, the benefit claimant count, increased both month-on-month (by 2,400) and year-on-year (by 23,500) in November.
- With the economy set for a slowdown in 2017 and 2018, many firms will find themselves reluctant to hire. A worst case scenario could even see some firms lay off existing staff. For instance, many companies that rely on imports find themselves in a tricky situation given that a weaker pound has increased their production costs but they are unable to raise prices drastically due to fear of losing market share. One option for such firms will be to cut down on spending by reducing head counts.

- A slowdown in hiring would have far-reaching repercussions. This is especially true given the dependence on consumer spending – a source of growth that is more likely to persist for as long as wage growth does.
- On the bright side, although the labour market may be past its peak it has a long way to fall before posing a grave danger to the economy. While we expect the unemployment rate to rise to 5.3% in 2017, this is still below 2015 and 2014 levels. The real risk lies within wage growth which has already been unimpressive in the post-crisis period and now stands to be overtaken by inflation.

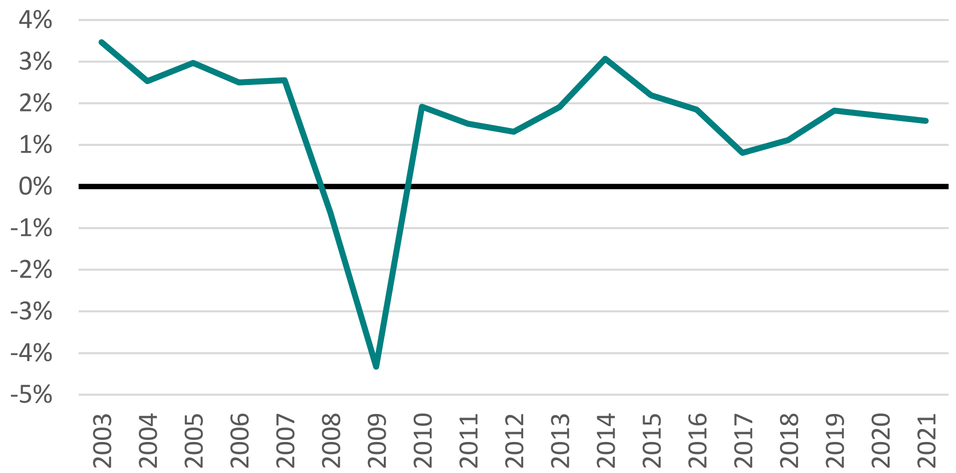
Forecast tables

Year-on-year change, unless otherwise indicated	2014	2015	2016	2017	2018	2019	2020	2021
GDP	3.1%	2.2%	1.8%	0.8%	1.1%	1.8%	1.7%	1.6%
Consumer spending	2.1%	2.5%	2.7%	0.9%	1.2%	1.9%	1.6%	1.5%
Household disposable income	1.5%	3.7%	2.1%	0.8%	1.0%	1.6%	1.6%	1.5%
Business investment	3.9%	5.1%	-1.4%	-3.9%	0.3%	5.3%	3.3%	1.6%
Imports	2.5%	5.5%	2.6%	0.2%	1.5%	3.9%	3.2%	2.5%
Exports	1.5%	6.1%	1.0%	1.5%	2.4%	2.8%	2.6%	2.4%
Unemployment rate (%)	6.2%	5.4%	5.0%	5.3%	5.4%	5.4%	5.4%	5.0%
Average gross employee earnings (incl bonuses)	1.3%	2.4%	2.2%	2.1%	2.5%	2.7%	2.7%	2.6%
CPI inflation	1.5%	0.0%	0.7%	2.7%	2.3%	2.2%	2.2%	2.2%
Bank rate	0.5%	0.5%	0.4%	0.3%	0.4%	0.9%	1.5%	1.5%
$/£	$1.65	$1.35	$1.35	$1.22	$1.27	$1.28	$1.28	$1.28
€/£	€ 1.24	€ 1.38	€ 1.23	€ 1.16	€ 1.16	€ 1.16	€ 1.16	€ 1.16
UK 10 year gilt yields, %	2.6%	1.9%	1.3%	1.6%	2.0%	2.0%	2.0%	2.0%
Real output, manufacturing	2.9%	-0.1%	0.2%	0.6%	0.7%	0.7%	0.7%	0.7%
Real output, construction	8.0%	5.0%	1.4%	-1.0%	0.7%	2.3%	2.1%	1.5%
Real output, financial & business services	3.9%	2.9%	2.5%	1.0%	1.4%	2.3%	2.2%	2.1%
Real output, wholesale & retail	5.3%	4.5%	4.5%	1.4%	1.4%	1.8%	1.6%	1.5%
Public sector net borrowing (financial years), £ billion	103.0	91.9	76.0	68.0	67.6	66.7	58.2	52.4

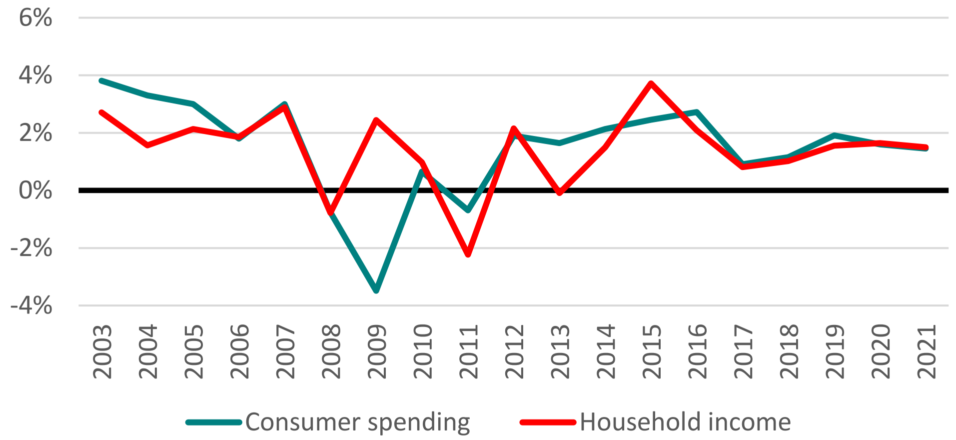
More UK forecasts can be found by accessing the Cebr databank: www.cebr.com/databank

Key charts

UK real GDP – annual % change

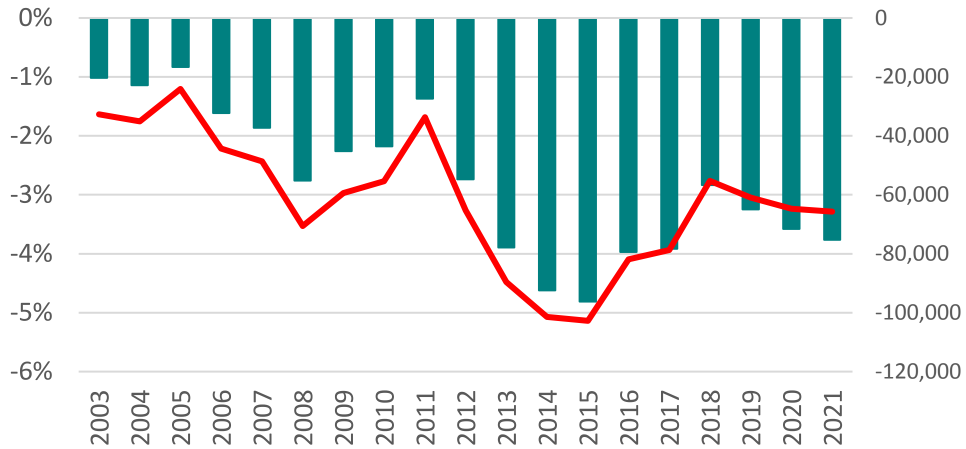


Total real consumer spending and household disposable income, annual % growth



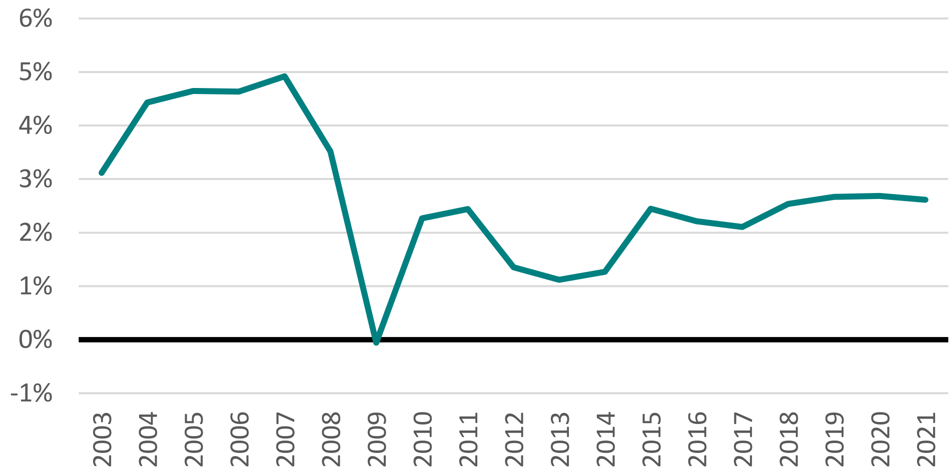
Real business investment, annual % change

UK current account balance, £ billions (RHS) and percentage of nominal GDP (LHS)

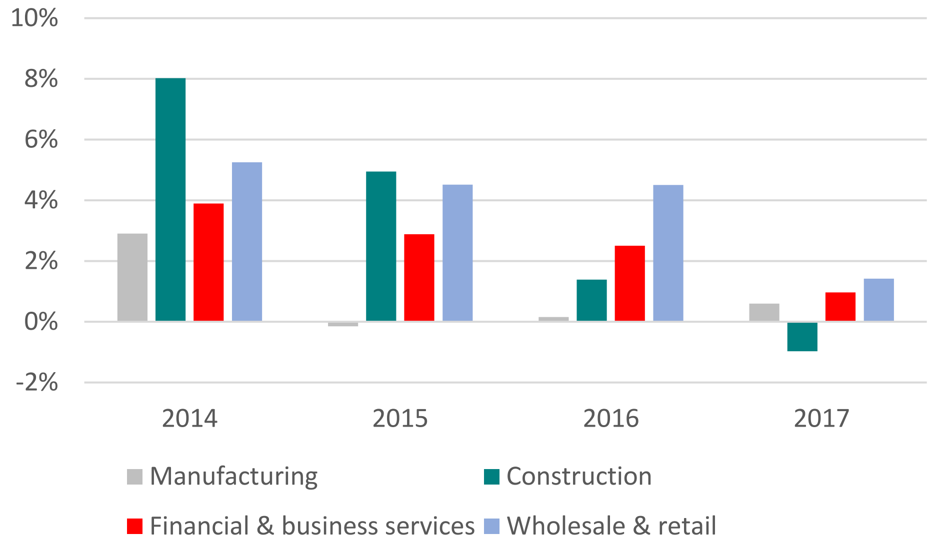


UK unemployment rate, %

Average gross employee earnings (incl bonuses), annual % change

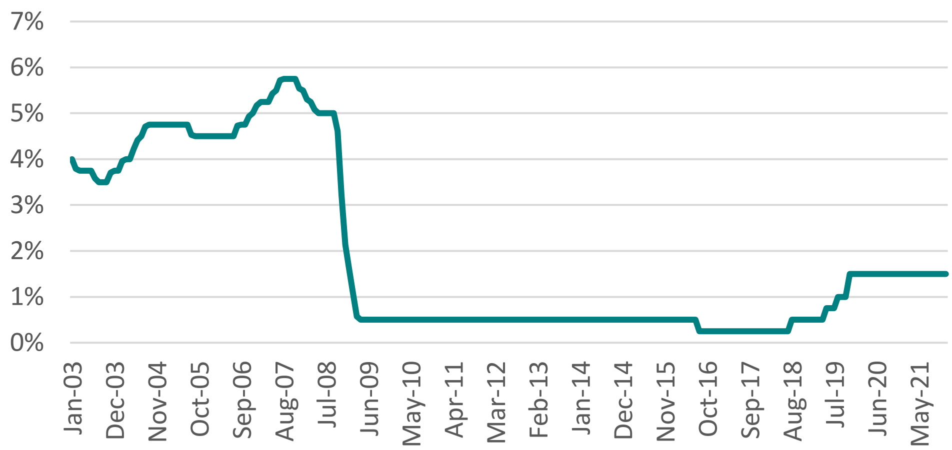


Real output, annual % change, by industry sector

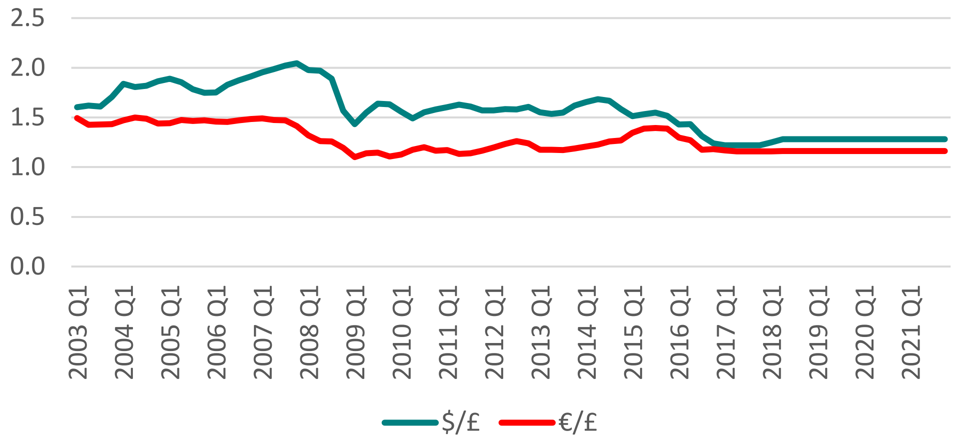


Consumer price inflation, annual % change

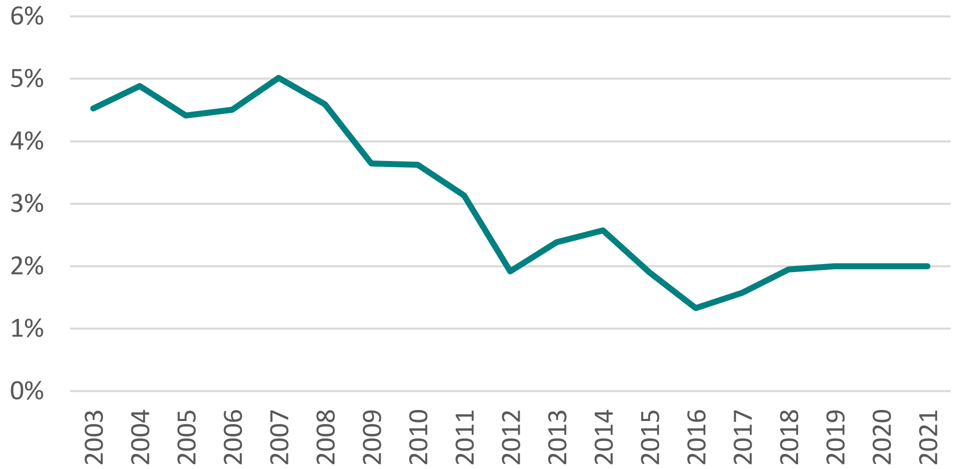
Bank of England base interest rate, %



Sterling exchange rate versus US dollar and euro



UK 10 year gilt yields, %



More UK forecasts can be found by accessing the Cebr databank: www.cebr.com/databank

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