KPMG

UK Economic update

13 February 2019

Heightened Brexit uncertainty and a weaker global backdrop see a material deterioration in short-term prospects for the UK economy

Given the deterioration in the domestic and external environment, we now expect the UK economy to remain practically flat in the first quarter of this year. We have revised our growth for 2019 as a whole to only 1.2%; we expect a modest pick up to 1.5% growth in 2020 (see table with our latest short-term forecasts).

Outlook for the **global economy** deteriorated sharply by the end of 2018. The 'goldilocks moment', with strong, synchronised growth across the world, seems to have passed. In the **US**, the positive effects of tax cuts, which served to lift growth, dwindled away. While the tightening of credit conditions in **China** hampered investment spending and caused its economy to slow down. Trade tensions with the US added an extra dampening effect.

A series of factors hit growth in the **eurozone**, ranging from production bottlenecks in Germany following the introduction of new emission standards for cars, to 'Gilets Jaune' protests in France. That weak patch seems to be more than just a temporary blip, with weaker China and frail Italy taking their toll on exports and sentiment.

Meanwhile in the UK, high levels of uncertainty about the outcome of Brexit negotiations and the proximity of the Article 50 deadline are paralysing business investment. Persistent weaknesses in productivity mar the longer-term outlook and they hold back potential economic growth.

The latest data show that the UK's GDP grew by only 0.2% in the **fourth quarter** of 2018, while monthly data (which can be volatile) show GDP contracted sharply by 0.4% in December. Growth for 2018 as a whole was 1.4%, which represents the weakest growth since 2012. **Services** showed some resilience, as the services component of GDP grew by 0.4% in Q4. This was in stark contrast to the **manufacturing** sector, which contracted every month in the second half of 2018. **Construction** output fell sharply in December: the current level of output wipes out half a year of growth.

The **outlook for the near term** has worsened as Purchasing Managers' Index plummeted to new lows in January: a three-month low for manufacturing with 52.8; a 10-month low in construction with 50.6; and a 30-month low in services with 50.1. All three remained barely above the no-growth 50 mark, indicating only a weak level of expansion.

Household spending has so far remained relatively resilient to the uncertainties generated by Brexit. We expect domestic consumption to be the main engine sustaining UK growth this year, given the weaker external environment. The KPMG-BRC retail sales index recorded a modest recovery in January 2018, with the non-food sector under more pressure than the food sector. This suggests shoppers are focussing on the essentials and are aware of the uncertainties in the wider economy.

Inflation fell to 1.8% in January, the lowest level for two years, and below the Bank of England's target of 2%. It was helped along by weaker global **oil prices,** which fell by 27% since the start of October 2018 in US dollar terms. The labour market remains extremely tight. The **unemployment rate** fell back to 4% in the three months to November 2018. The tightness in the labour market is translating into a sustained growth in **earnings**. Regular pay increased by 3.4% compared to a year ago in November; the fifth month in a row with earnings growth in excess of 3%. However, latest data on **productivity** show that it increased by just 0.2% in the year to 2018 Q3. This means in the current environment, the rapid growth in earnings translates, in large part to an increase in labour costs. Taken on its own, this would generally be a strong indicator of building domestic inflationary pressure.

Despite the strong indicators from the labour market, UK monetary policy has remained unchanged since August 2018. Guidance on further increases in **interest rates** suggests they will be 'gradual and to a limited extent'. With inflation close to target, and the economy being adversely affected by Brexit-related uncertainty and weaker global growth, there is little danger of the MPC significantly overshooting its 2% inflation target. This should provide more space for the Bank of England to hold off on further increases in rates, with the next rate increase expected in August 2019.

The current picture of the UK's **public finances** resembles a jigsaw with a lot of missing pieces. We know that public finances are a little worse than expected in the Budget last October. The latest estimates for the level of borrowing this fiscal year are around £5 billion worse. We also know that the decision by the ONS to include student loans in the calculation of public sector net borrowing could add around £12 billion to the level of the deficit after the change is introduced, in September 2019. A revision to economic forecasts, in line with those made by the Bank of England in its February Inflation Report, may cause the OBR to revise the amount of money available down by another £5-7 billion. This may make it more difficult for the Chancellor to meet the fiscal mandate in 2020-21; it may prompt a wholesale revision to the mandate.

Further down the line, the allocation of departmental spending after 2019 depends on the **Spending Review** taking place this year. None of the scope, timing or even the pot of money available to departments has yet been announced. It may be that the Chancellor uses the **Spring Statement** as an opportunity to fill in some of the blanks; the uncertainties around Brexit may push these announcements to later in the year, though. Crucially, we do not yet know what stance the Treasury will adopt in response to Brexit, or what kind of Brexit might take place.

Based on the more negative economic climate, we have revised our **forecasts** for the UK economy downward for the next two years. We've based our forecasts on the assumption that the government achieves a Brexit deal. We've also assumed that the transition arrangement the government puts in place does not seriously affect the UK's trading relationships in the short-run.

Short-term outlook for the UK economy

	2018	2019	2020
GDP	1.4	1.2	1.5
Consumer spending	1.9	1.4	1.4
Investment	0.0	(0.1)	1.5
Unemployment rate	4.1	4.0	4.0
Inflation	2.1	1.8	2.1
Base interest rate	0.75	1.00	1.00

Source: ONS, KPMG forecasts. Average percentage change on previous calendar year except for unemployment rate, which is average annual rate. Investment represents Gross Fixed Capital Formation, inflation measure used is CPI and unemployment measure is LFS. Interest rate represents level at the end of calendar year.

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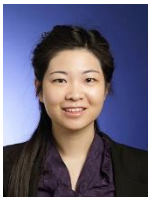

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