



Britain at a crossroads

UK Economic Outlook

Special focus

| UK house
prices

| Autumn
Budget

September 2019

kpmg.com/uk/economicoutlook



Chief Economist's introduction



The UK's economy is nearing an important milestone. Just over three years since the referendum, we are getting increasingly close to Brexit.

Given the time that has passed since the vote was cast, a casual observer would have assumed that by now arrangements between respective governments would have been made, businesses would be prepared and everyone would know what to expect from the future relationship between the UK and the EU.

The reality is different. The UK is fast approaching a crossroads where no one yet knows which path it will take on 31 October. Limited preparations done so far in comparison to the magnitude of the task ahead mean that an exit from the EU without a transition period could make a significant short term dent on the UK economy. On the other hand, a last-minute deal coupled with a two-year transition period could give the UK a respite to find its new place in the world economy.

It is rare to live in a period with such bipolar short term prospects. More will soon be revealed. Let's hope for the best and prepare for all eventualities.

Yael Selfin,
Chief Economist, KPMG in the UK

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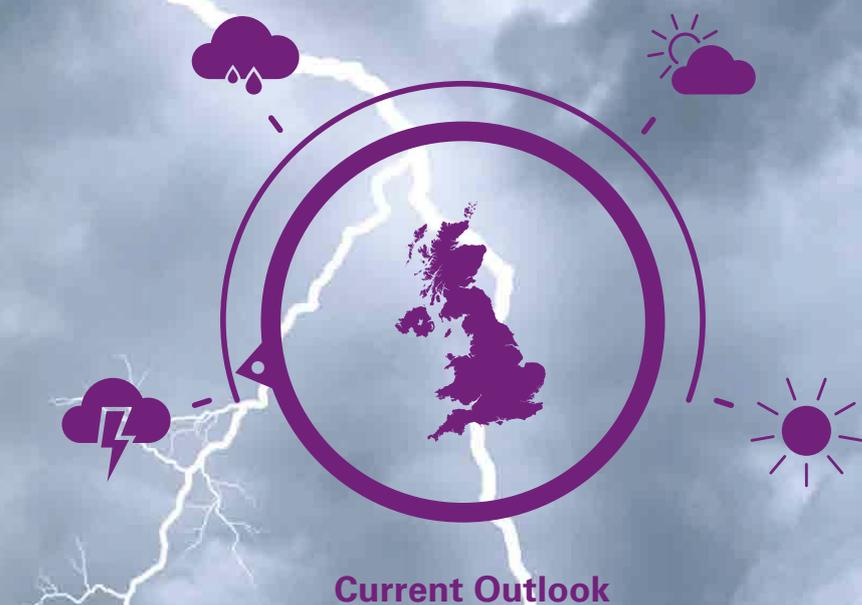
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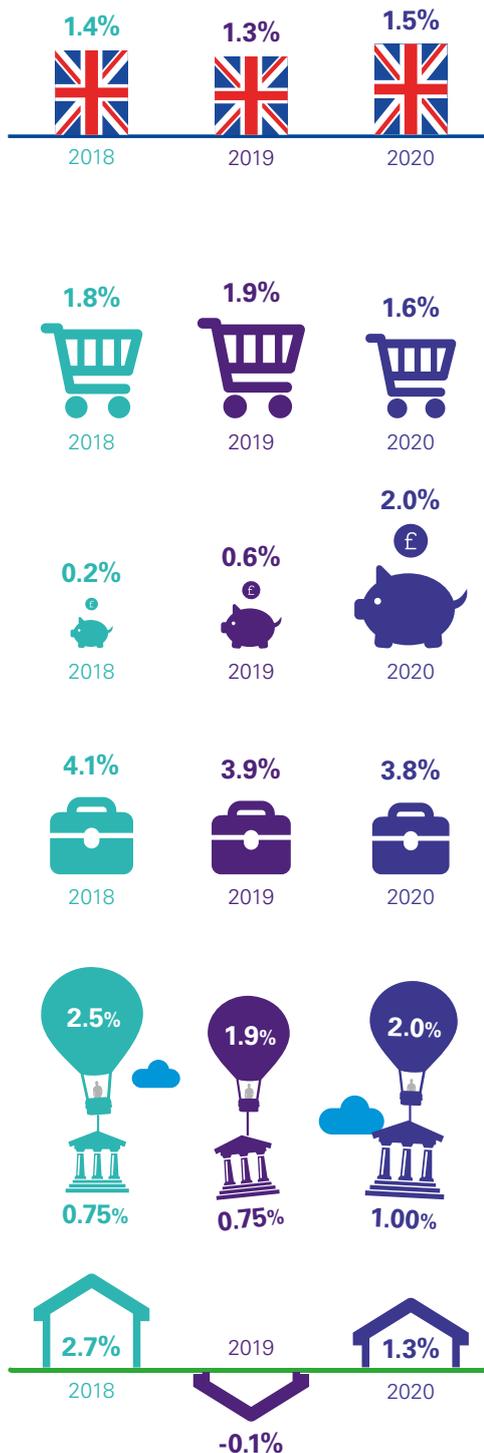
Executive summary

- With the new government in Whitehall resolved to leave the EU by 31 October, the outlook for the UK economy is increasingly bipolar for the year ahead.
- A **Brexit deal** will provide a boost to the economy, with GDP growth expected to rise to 1.5% in 2020, as investment recovers some ground. However, a slowing global economy, and limited spare capacity domestically, will constrain the upside to UK economic growth.
- Uncertainties about the UK's future trading relationship with the EU are unlikely to be resolved for several years following a deal in October. Some investments will continue to be delayed until a trade deal is agreed.
- The pound could appreciate by 10-15% on news of a deal, which together with lower energy costs, will see inflation in check close to its 2% target. This will allow the Bank of England to keep the base interest rate at the current 0.75% until at least November 2020.
- An exit from the EU without a deal on 31 October will result in a relatively shallow recession that lasts around four quarters, with GDP contracting by 1.5% in 2020 under our **no-deal Brexit** scenario.
- Delays to goods traded across the border are expected to make the strongest dent on the UK's business environment in the short term, while potential shortages of imported foodstuffs as well as medicines in the immediate term could negatively impact households' sentiment.
- Despite a further depreciation in the pound, by perhaps as much as 10%, and the resulting rise in inflation to 2.4% in 2020, the Bank of England is expected to lower the base interest rate to 0.1% shortly after the UK exits the EU with no deal.
- While preparations are made for a no-deal, unforeseen issues will inevitably arise. It is the danger of the potential impact of these 'unknown unknowns' that makes no-deal so risky for the economic health of the country.
- A third scenario could take place if the government did not manage to achieve an exit by 31 October. That will open the door for another extension, and a delayed deal or no-deal, pushing our deal and no-deal forecasts for the UK's economy further into the future.
- **House prices** in the UK should see improvements to growth across all regions by 2020 under a deal scenario, with Yorkshire experiencing the strongest rise followed by the North West. A no-deal will see falls in house prices of around 6% in 2020, with Northern Ireland bearing the heaviest impact on house prices. Falls in a no-deal scenario could be even larger, around 10-20%, based on historic market performance.
- Latest data on the state of public finances point to shrinking headroom for the Chancellor with deteriorating economic forecasts and an additional £15.5bn spending announced in the 2019 Spending Review. Nevertheless, the **Autumn Budget** is promising to be an interesting ride according to our tax experts, whose advice is to 'expect the unexpected'. Changes to corporation tax could potentially be most interesting, where a no-deal Brexit might usher in radical changes, including significant cuts to the headline rate of corporation tax, accompanied by increased investment incentives in relation to innovation.

A snapshot of the UK economy¹

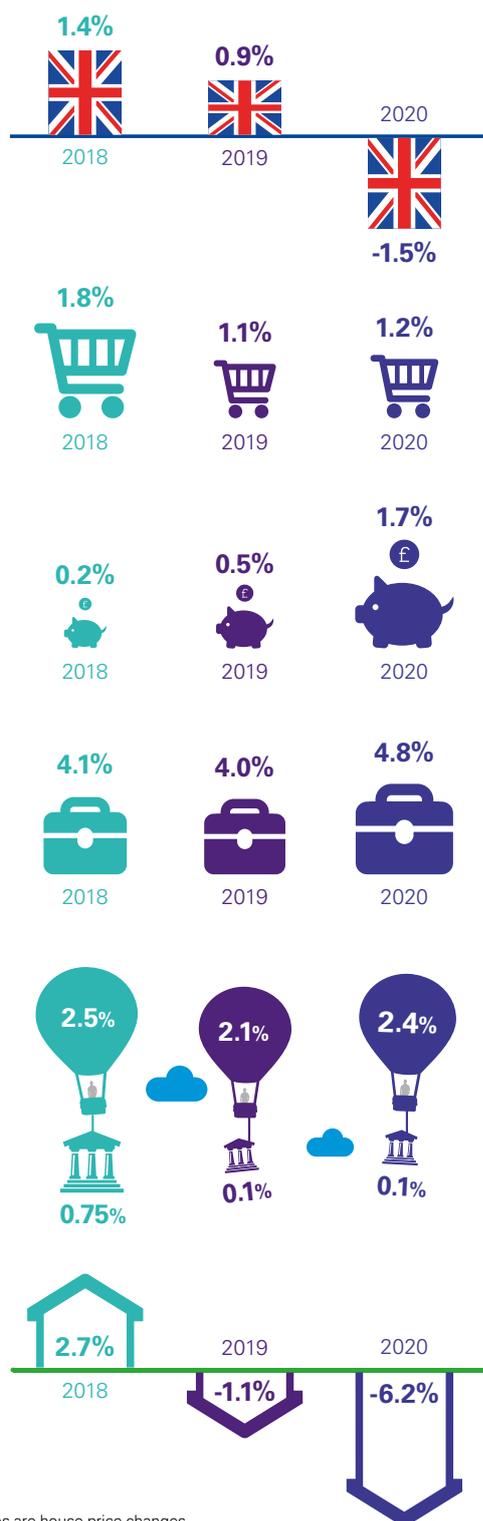
Deal scenario

These figures incorporate the government's stated preference to leave the EU on 31 October 2019 under the terms of a withdrawal agreement.



No-deal scenario

These figures represent a scenario where the UK leaves the EU without a deal on 31 October 2019.



¹ Figures for GDP, consumer spending, investment and inflation represent % change on previous year. Figures for house prices are house price changes over the course of the year and interest rates are quoted at the end of the year. All figures represent annual averages, unless otherwise specified.

The global economic backdrop

Gloom about the prospects for global growth continues to build as economic deceleration has turned more pronounced than expected amongst the world's major economies. Weakening market confidence in the global economy has pushed long-term interest rates further down since our June report (Chart 1).

The ongoing trade dispute between the US and China remains a major downside risk for the global economy. During the summer, the row worsened, with both sides imposing further tariffs. Moreover, the trade dispute is likely to widen into a currency war.

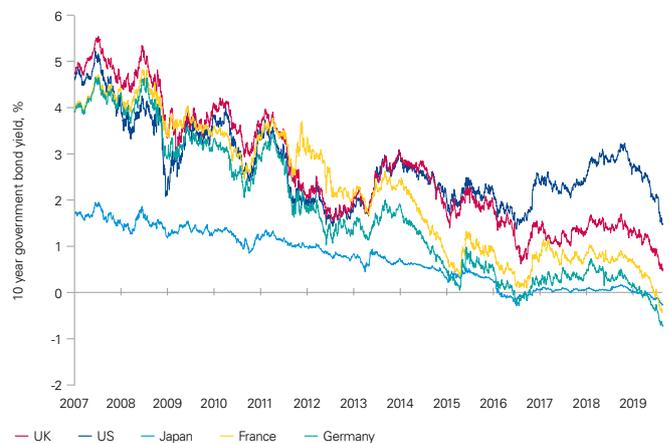
Growth in both the US and China slowed notably during the second quarter, with the decline at least partly traceable to their difficult trade relationship; as tensions escalate, the fallout could increase.

The escalating trade war between the US and China will serve to further dampen global business confidence, while central banks no longer have the tools to lift spirits substantially

Second quarter growth in the US slowed to 2.0% from 3.1% in the first quarter. Consumption continued to support growth, but net trade and business investment were both held back by concerns over the impact of the trade dispute. Growth in China slowed to 6.2% in the second quarter, the weakest rate in 27 years. With no end to the trade dispute in sight, this weakness in growth is likely to continue in both countries, with broader repercussions for the rest of the world. Latest forecasts see growth in the US moderating to 2% in 2020, while the Chinese economy could grow by a relatively more subdued 6% next year.

Policymakers are adjusting. On 31 July, the US Federal Reserve announced its first interest rate cut since 2008. The Fed's tone suggested it expected a limited response to slower growth rather than the return of a looser monetary policy cycle, but lingering economic stress may force its hand further down the road.

Chart 1: Long-term interest rates have declined further since June



Source: US Treasury, Bank of England, Banque de France, Deutsche Bundesbank, Japan Ministry of Finance via Haver

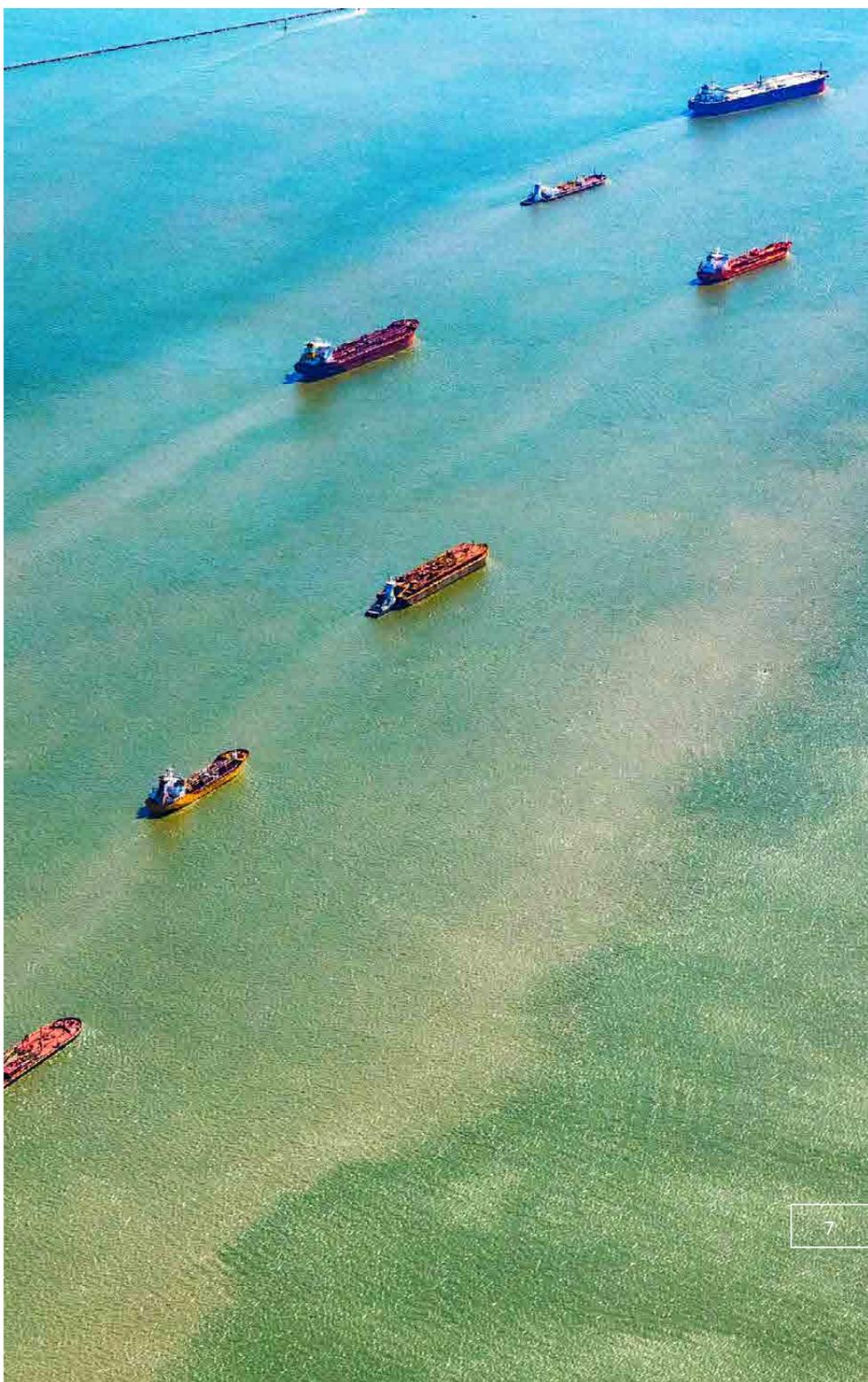
The eurozone also slowed further in the second quarter as the bloc's two largest economies, France and Germany, both posted weaker growth figures. In Germany, tumbling demand from Europe and the rest of the world prolonged the sluggishness in the manufacturing sector. The French economy has been more resilient due to its greater reliance on domestic consumers, but a slowdown in consumer spending caused growth to fall from 0.3% in the first quarter to 0.2% in the second. France and Germany are expected to grow by 1.4% next year².

² See European Commission, Summer 2019 Economic Forecast.

The fact that Italy's stagnant second quarter performance was taken as good news underlines the scale of the economic challenges it faces. With Prime Minister Giuseppe Conte's resignation in August, political turmoil is adding to the Italian economy's woes. Stronger growth in smaller economies such as the Netherlands and Ireland is unlikely to make up for the overall lacklustre performance of the eurozone as a whole, which is also expected to grow at 1.4% next year.

The European Central Bank (ECB) has signalled it is prepared to deliver a new stimulus package to support growth if needed. However, given that its current monetary policy is already extremely loose, there is limited room for manoeuvre; the ECB will have to lean on more quantitative easing.

Indeed, given the murky global growth prospects, leading central banks have recognised the need for further stimulus. However, the monetary tools at hand to cope with a potential recession are limited and focus will need to be redrawn towards more active fiscal policy.



A photograph of a forest with a large tree trunk in the foreground and a path leading into the woods. The image is split vertically by a purple bar. The left side shows a large tree trunk on a forest floor covered in fallen leaves. The right side shows a path leading into a dense forest of green trees.

Our forecast for the UK economy



Outlook for the UK economy depends on 31 October outcome

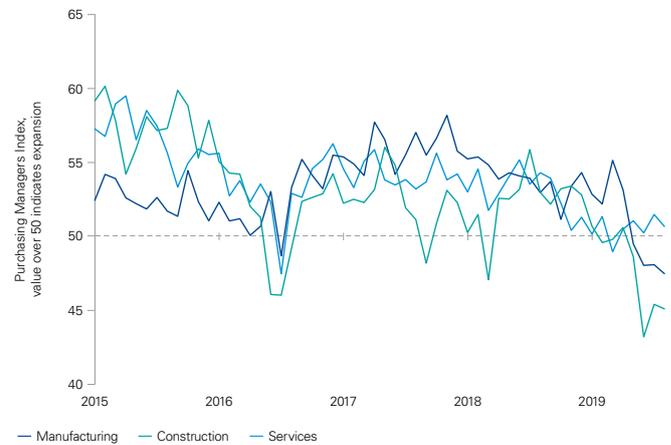
Since the new government took shape in late summer, its resolve to leave the EU by 31 October has become increasingly clear. The options on the table: leave with a deal or leave without a deal; and the proximity of the date make the outlook for the next two years rather bipolar.

A deal by 31 October will see some renewed momentum in the economy, helped by the continuation of existing trade links, while a no-deal will see the UK falling into a year-long recession in late 2019, according to our latest forecasts. There is a third option that the government will not manage to achieve an exit by 31 October. That will open the door for another extension, and a delayed deal or no-deal, therefore pushing our two scenarios for the UK economy further into the future.

In light of the risks ahead, the latest PMI surveys point to a weakening outlook for the months ahead, with construction and manufacturing both signalling contraction in output, and services expecting only a weak pace of expansion (Chart 2).

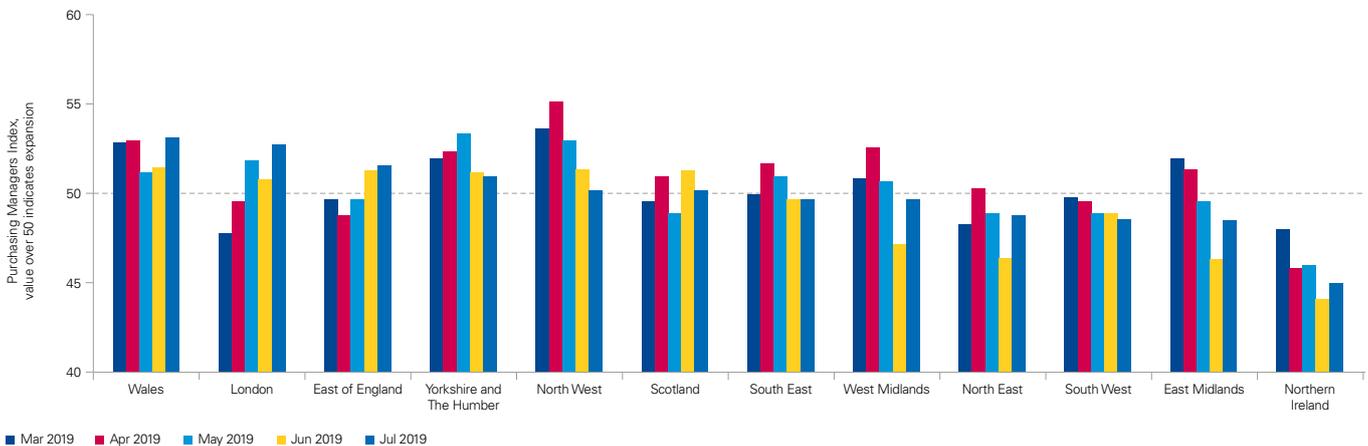
The short term outlook for the UK's regions painted by PMIs is similarly weak, with half of all regions expected to contract. The downturn is expected to be most severe in Northern Ireland, but even across the half-dozen regions still expected to grow, the highest value in Wales is relatively low, indicating a weak pace of growth (Chart 3).

Chart 2: Latest PMIs point at a weak economy in the short term

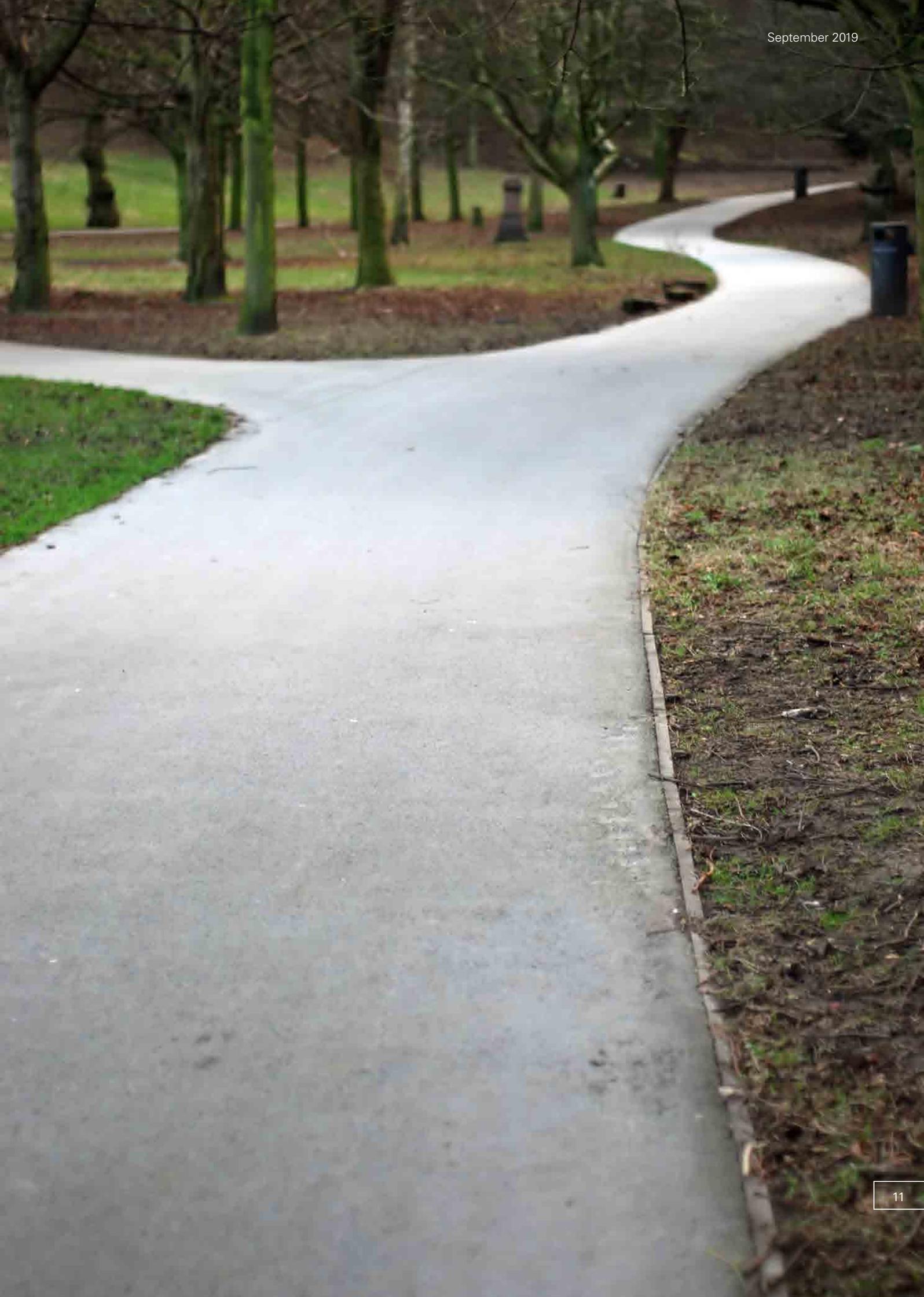


Source: IHS Markit

Chart 3: PMIs see half of all UK regions contracting in the short term



Source: IHS Markit



Our forecast for the UK economy under a deal scenario

Our first scenario incorporates the government's stated preference to leave the EU on 31 October with a deal. While the process may take a little longer in practice, as a last-minute deal may come at too short notice to allow a full implementation straight away, we assume under this scenario that a transition period will last until the fourth quarter of 2021 before the UK embarks on a new trading relationship with the EU that is to be negotiated next.

The upside of a deal scenario will be constrained by a slowing global economy, limited domestic spare capacity and continued uncertainty about future trading relationships

The announcement of a deal will be followed directly by an appreciation of the pound, by 10-15% in our deal scenario, as markets take the risk of no-deal off the table. A deal will also trigger a rebound in investment, as companies revisit their plans now that the cloud of no-deal uncertainty is lifted, and prepare for life outside the EU. However, key questions about the UK's future trading relationship with the EU are unlikely to be resolved for several years. For businesses, this means delaying some investments until sufficient clarity is secured.

A strong labour market will continue to support growth in consumer spending at around its historic average, although a slowing global economic backdrop, and limited spare capacity in the domestic business environment, will limit the upside to economic growth over the next year. GDP is expected to rise by 1.3% in 2019 and by 1.5% in 2020.

A strong pound, limited upsurge in output growth and lower energy costs will keep inflation in check at around the Bank of England's 2% target. This means the Bank of England could hold back from changes to its base interest rate at least until November 2020.

Table 1: KPMG forecast – deal scenario

	2018	2019	2020
GDP	1.4	1.3	1.5
Consumer spending	1.8	1.9	1.6
Investment	0.2	0.6	2.0
Unemployment rate	4.1	3.9	3.8
Inflation	2.5	1.9	2.0
Base interest rate	0.75	0.75	1.00

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

Our forecast under a no-deal scenario

If the UK were to leave the EU without a deal on 31 October the short term impact on the economy is likely to be significant, triggering a recession outright. An exit without any alternative arrangements for trade will see a substantial fall in exports. While imports will also suffer, they are unlikely to be replaced by domestic production at least in the short term, with the net impact from trade weighing heavily on the UK economy.

An instant further depreciation of the pound, by perhaps as much as 10%, will not serve to alleviate exporters' woes in the short term, as the key stumbling blocks to trade are likely to centre on delays at the border, confusion over required permits and the regulations to be followed. Delays would negatively impact production for the UK market as well as exporters. The most damaging impacts could come from potential shortages of imported foodstuffs as well as medicines in the immediate term, negatively impacting households' sentiment.

A no-deal scenario largely represents a leap into the unknown for the UK economy, but is likely to trigger a relatively shallow recession outright

A weaker pound will increase the cost of imports, which will gradually feed into higher inflation in coming years. However, just as before, we would expect the Bank of England to see through the temporary increase in inflation and seek to support the economy in the short run by lowering the base interest rate. Following an initial assessment of the early economic data, we would expect the Monetary Policy Committee to cut the base interest rate to 0.25% in the November meeting, and to follow through with a further cut to 0.1% in the December meeting or early in 2020.

Likewise, the UK government is expected to announce extra spending to cushion the impact on the UK economy in the medium term. However, given the already high level of public debt and the strain of adjustment to a no-deal environment, the additional increase in spending may be limited in the short term.

There are still many unknowns about the impact on economic growth of a no-deal Brexit. To a large extent this depends on the scale and persistence of the disruption that arises from an immediate change to the UK's trading relationship with the EU. Our forecast is based on the scenario assumed by the Office for Budgetary Responsibility (OBR) in its assessment of fiscal risks facing the UK economy. It implies a relatively shallow recession that lasts for around four quarters, beginning from the moment that the UK opts to leave the EU without a deal, with GDP growth slowing to 0.9% in 2019 followed by a contraction of 1.5% in 2020 (Table 2).

Table 2: KPMG forecast – no-deal scenario

	2018	2019	2020
GDP	1.4	0.9	-1.5
Consumer spending	1.8	1.1	1.2
Investment	0.2	0.5	1.7
Unemployment rate	4.1	4.0	4.8
Inflation	2.5	2.1	2.4
Base interest rate	0.75	0.1	0.1

Source: ONS, KPMG forecasts based on OBR no-deal modelling. Average % change on previous calendar year except for unemployment rate, which is average annual rate. Investment represents Gross Fixed Capital Formation, inflation measure used is the CPI and unemployment measure is LFS. Interest rate represents level at the end of calendar year.

Our modelling suggests this outcome could lead to further falls in the price of houses throughout the UK, with prices falling by an average of just over 6% in 2020. However, a deeper house price crash of 20% is possible, if the market responds in a similar fashion to previous shocks³.

It is important to stress that a no-deal scenario largely represents a leap into the unknown for the UK economy. While preparations can be made in some areas, unforeseen issues will inevitably arise, where the UK will be far less prepared. It is the danger of these potential 'unknown unknowns' that make the impact of this scenario difficult to assess with any degree of certainty: this is what makes no-deal so risky for the economic health of the country.

³For more details, see our section on future house prices in this report.



The story so far

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UK economy shrinks for the first time in seven years

The UK's economy shrank during the second quarter of 2019, the first time in seven years. Two factors in particular were at play: the longer-term cyclical slowdown of growth and investment across the global economy; and the shifting Brexit deadlines that caused short term volatility. The second quarter contraction was partly the result of firms unwinding the stock they had built up ahead of the supposed Brexit deadline of 29 March.

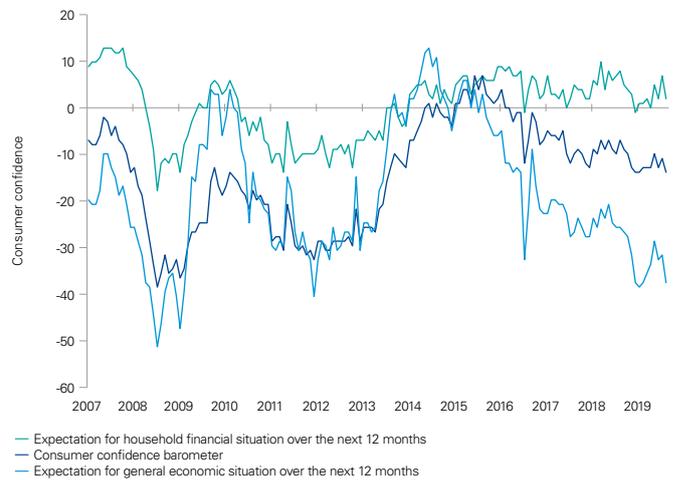
Consumption resilient despite ongoing uncertainty

Household consumption was the only bright spot for the UK economy in the second quarter. Indeed, posting a relatively healthy growth rate of 0.5%, consumption remains the main driver of UK economic growth.

Consumer confidence remained relatively subdued this year despite a brief pickup in Q2. Confidence has been gradually falling since peaking in 2015, but was just below post-2009 average at the start of Q3 (Chart 4). Consumers' expectations of the general economic situation have been deteriorating notably since the second half of 2014, while households' view of their own financial situation has been more robust. A tight labour market and strong pay growth have so far encouraged Britons to continue spending.

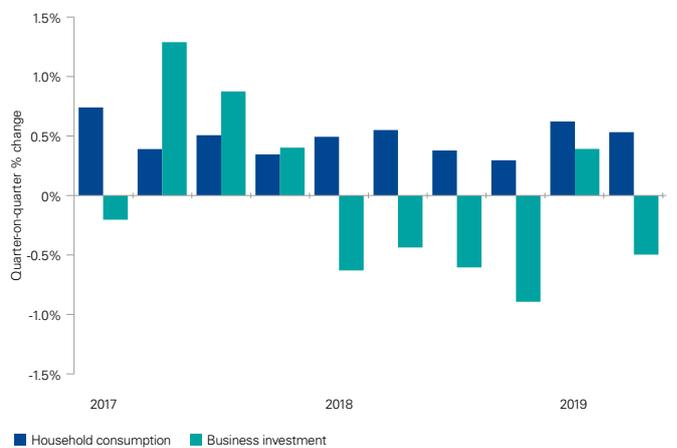
Nevertheless, early data for Q3 suggests that consumer angst over where the economy is going may filter through to consumer spending. In August, the CBI survey of retailers reported the worst slump in retail sales since 2008. Data from the KPMG-BRC Retail Sales Monitor confirmed the trend with a 0.4% contraction year-on-year reported in total retail sales in the three months to August. Weakening consumer spending may yet become an additional threat to the already strained growth prospects of the UK economy.

Chart 4: Consumer expectations of the general economic situation have deteriorated in recent years, but expectations for households' own finances have remained relatively stable



Source: GfK NOP/ European Commission via Haver

Chart 5: Brexit uncertainty has severely hit business investment over the past two years, but households' consumption has been stable



Source: ONS via Haver

Business investment intentions slump

Businesses have responded more visibly to concerns over the economic outlook. Despite the accommodative credit conditions, the uncertainties of Brexit continue to worry many organisations. Business investment contracted once again in the second quarter following a temporary rebound in Q1. This is an ongoing story: as Chart 5 shows, while household consumption has proved resilient, business investment slowed significantly from 2017 onwards and contracted from the first quarter of 2018. A small rebound in the first three months of this year turned out to be modest and short-lived.

UK GDP fell by 0.2% in Q2, with continued weakness in business investment casting doubts over the UK's ability to lift productivity

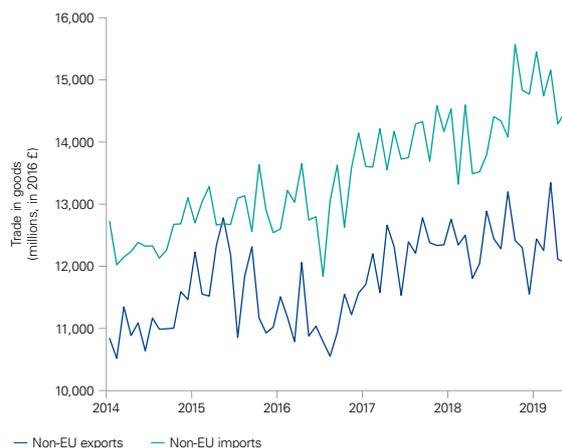
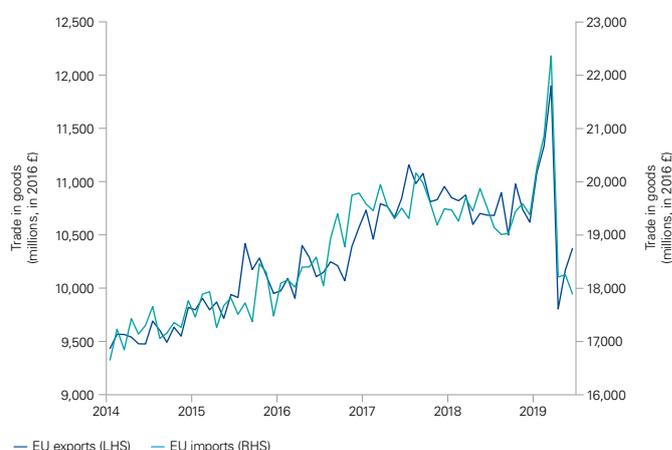
Trade with both EU and non-EU countries suffers from weakening demand

The UK's trade balance improved dramatically during the second quarter. However, this reflects a sharp decline in both imports and exports, rather than healthy growth of the latter.

Trade in services has been stable, with exports supported by the recent depreciation in the value of sterling. The service sector recorded a marked increase in new orders from abroad in July.

By contrast, trade in goods has been affected by shifting Brexit deadlines. Imports and exports of goods with EU countries declined markedly during the second quarter as firms on both sides of the Channel unwound stocks built up before March. Goods trade with non-EU countries was less volatile, but slowed as sluggish domestic and global demand took their toll.

Chart 6: Trade in goods with EU countries declined sharply during the second quarter as firms unwound stocks



Source: ONS via Haver
 Figures exclude oil and erratics

Few sectors are insulated from the weakening economy

The second quarter contraction reflected a notable slowdown or reversal across almost all sectors of the economy. The slowing service sectors – with overall growth declining for the third successive quarter – is particularly worrying. Services account for more than 70% of the UK economy and compared to manufacturing, they have been less distorted by the short term effect of pre-Brexit stockpiling. Its lacklustre performance therefore partly reflects the weakness of underlying economic growth.

Retail sales represent a bright spot for consumer services

Consumer-facing services performed better than business services during the second quarter. This is in line with the overall strength of consumption and sluggishness of business investment. Retail trade posted a growth rate of 0.7% quarter-on-quarter, not far off the post-financial crisis average, though a weak start to Q3 puts the sustainability of this strength under question.

The retail and IT sectors have been rare bright spots in recent months, with most industries feeling the pinch of slowing growth

However, there are segments of the consumer market that do not seem to be reaping the benefits of good consumer sentiment. Hotels and restaurants contracted by 0.8% during the second quarter, though this may prove to be a temporary blip if consumer spending stays resilient.

Another weak spot is car sales: new car registrations have declined 3.4% in the year to August, compared to the same period last year. This meant a downwards trend in dealership car finance since the end of 2016; the wholesale and retail services for motor vehicles sector has barely grown during this time.



Weakness across business services raises alarm

Business services have struggled to grow in the first half of the year. Administrative and support services contracted during the second quarter and while professional services returned to positive growth, a disappointing gain of 0.1% did not make up for the 0.4% lost in the previous quarter (Chart 7). Overall economic weakness appears to be the likely culprit, as these sectors have mirrored the fortunes of the wider economy.

The IT sector did manage to grow well, even given the challenging growth environment. In particular, computer programming services achieved above-average growth of 1.9% quarter-on-quarter, although the rate has moderated slightly from the previous three months. Despite depressed investment intentions, businesses appeared to be prioritising IT spending.

Following a lacklustre performance in the first quarter, there was little sign of any improvement in financial services during the second quarter of the year. The financial services sector is particularly vulnerable to Brexit because of its regulatory complexity and strong links with the EU. Since the referendum, the sector has contracted steadily, and it continued on that path during the second quarter.

Weakness in housing led to fall in construction

The output of the construction sector contracted in the second quarter following modest growth in the first. While commercial construction has been falling for the past two years, private construction of housing grew at the start of the year. However, despite support from the government’s Help-To-Buy scheme, output of private housing construction fell by 3.4% in Q2.

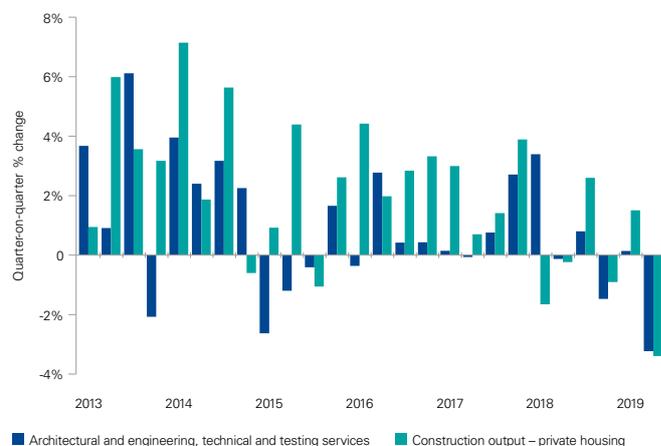
As the potential vulnerability of the housing market has filtered through, housing construction has come under pressure. Construction output for housing suffered the severest contraction since the 2008 financial crisis during the second quarter (Chart 8). Architectural and engineering, technical and testing services also suffered. Public work continues to grow modestly, but up until now this has not been sufficient to reverse the current downward trajectory for the construction industry.

Chart 7: Both professional services and administrative and support services have been weak recently



Source: ONS via Haver

Chart 8: Housing construction as well as architectural, engineering and technical services were hit in Q2



Source: ONS via Haver

UK manufacturing suffers with the rest of the world

The manufacturing sector suffered a significant 2.3% contraction in the second quarter. Ongoing Brexit-related volatility and global economic weakness have both taken their toll on this export-intensive sector; it has come up against a combination of domestic and international headwinds.

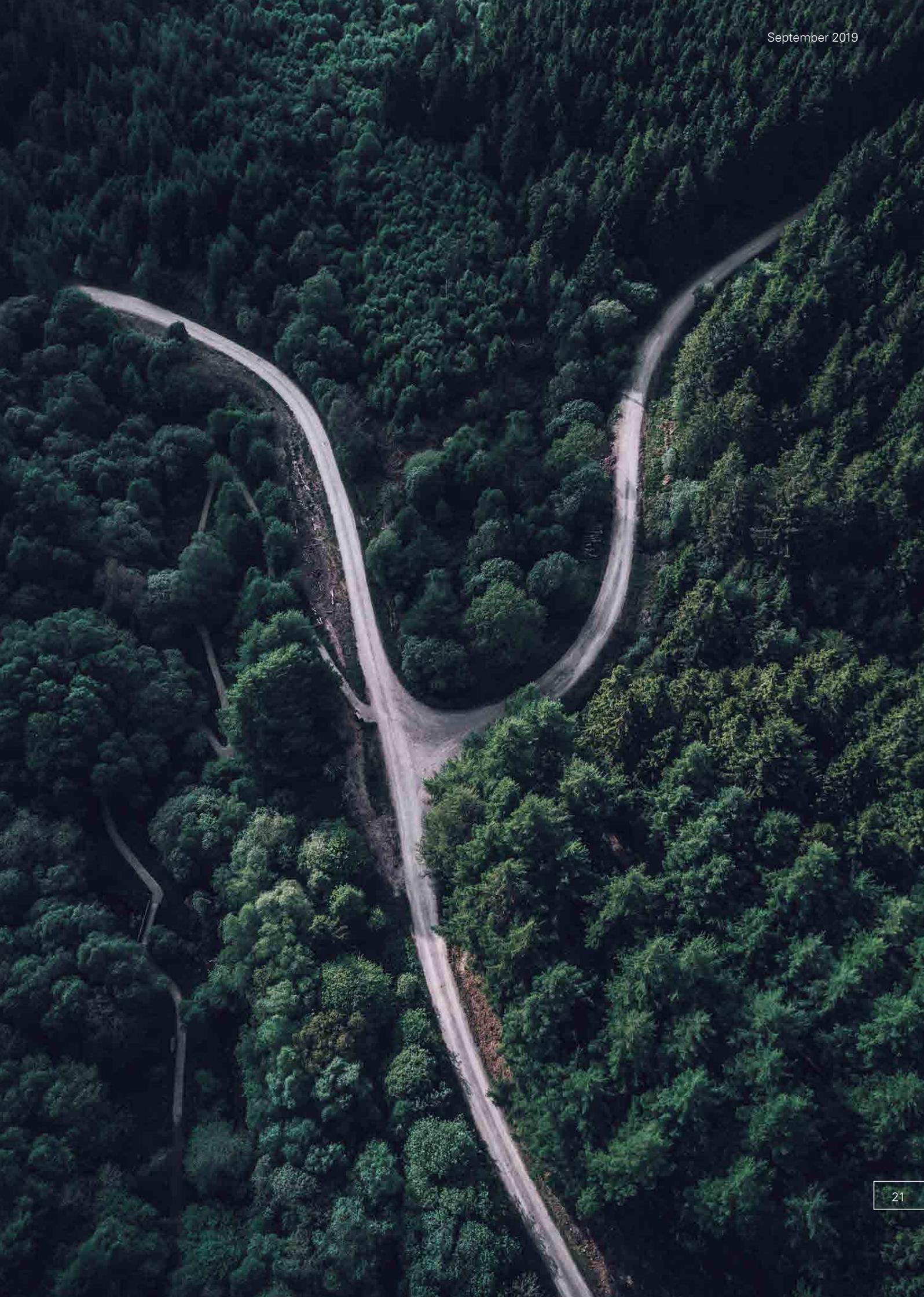
The second quarter contraction can partly be attributed to firms unwinding the stocks built up before the previous Brexit deadline in March (Chart 9). However, leaving Brexit-related volatility aside (circled on the chart), UK manufacturing output has been particularly weak since 2018, reflecting the dimmer global economic prospects and problems in specific industries such as automobile.

The situation in the UK’s manufacturing sector is not unique. For example, German manufacturers have experienced a much more severe contraction of 7% of output since production peaked at the end of 2017, while US industrial output began to decline in January of this year. The inter-connected nature of the international economy has created the conditions for a synchronised business cycle in manufacturing. And with global value chains connecting more countries, the manufacturing slowdown in key advanced economies can have much broader repercussions across the world.

Chart 9: Manufacturing sector slowdown in selected advanced economies



Source: ONS, Deutsche Bundesbank and Federal Reserve Board via Haver



Tight labour market shows early signs of easing

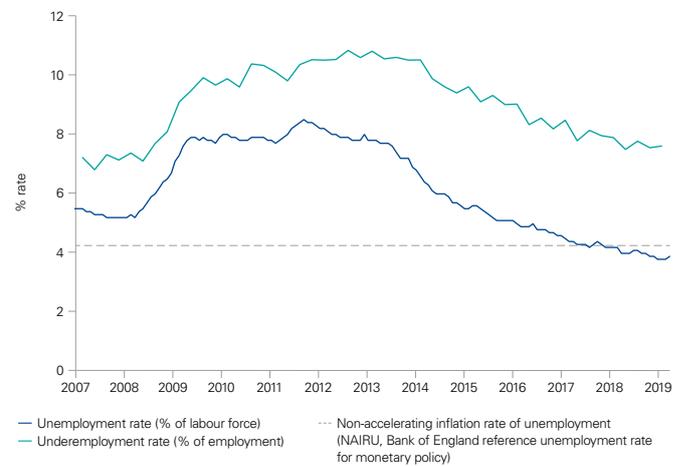
The UK labour market has proved resilient despite slowing growth. The UK's unemployment rate picked up slightly to 3.9% during the three months to June, but remained below the Bank of England's estimated equilibrium rate of unemployment of 4.25% (Chart 10). Firms reluctant to commit to long-term investment find themselves more reliant on increased input from labour to fulfil customer demand or expand capacity.

While the UK's labour market has remained remarkably robust, with employment and wage growth continuing to strengthen, there are now signs of weakness creeping in

The tight labour market has helped push up pay levels. Year-on-year growth in nominal earnings (regular pay excluding bonuses) reached 3.9% in June, the second highest figure recorded since the global financial crisis. Rising economic uncertainty has depressed workers' appetite for switching jobs; low candidate availability has forced firms to compete more intensively for workers with the right skills. April's increase in the national living wage, which boosted pay for two million workers, was also a factor.

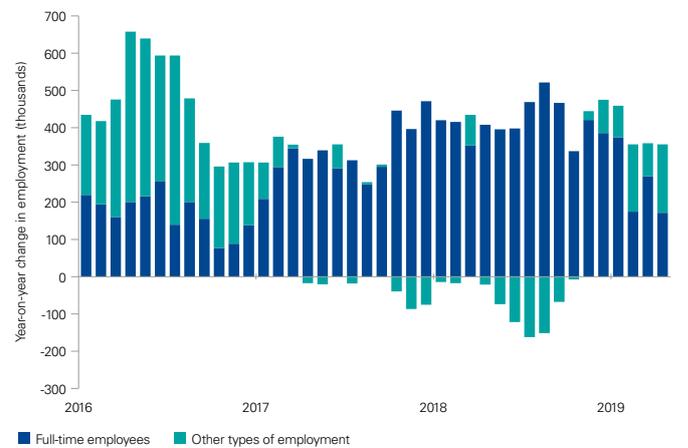
Nevertheless, the labour market may not be as tight as the headline unemployment rate suggests. Although the underemployment rate has declined in conjunction with the unemployment rate since 2014, it remains above the level before the financial crisis. Overall employment has continued to grow, but mainly due to contributions from self-employment. Growth in full-time employment has declined visibly since the second half of 2018 (Chart 11).

Chart 10: Labour market conditions remain tight



Source: ONS via Haver

Chart 11: Although employment is still growing overall, firms started to hold back on full-time hires from the second half of 2018



Source: ONS via Haver

Survey evidence from the latest KPMG-REC Report on Jobs suggests easing in the labour market is quite broad-based, with three out of four English regions in the survey recording a slowdown in the growth of permanent vacancies in the first half of 2019 (Chart 12). All four regions recorded weakening growth in the supply of temporary vacancies.

The drop in the supply of vacancies was most pronounced in London, and in April and May the permanent vacancies index for London fell below the worst reading recorded during the financial crisis, before picking up slightly in the following two months. This could be a sign of the London economy's greater exposure to the potential repercussions of Brexit and the slowdown of the global economy.

Chart 12: Three out of four English regions saw growth in their permanent vacancy numbers decline during the first half of 2019



Source: KPMG REC Report on Jobs

Monetary tightening in question

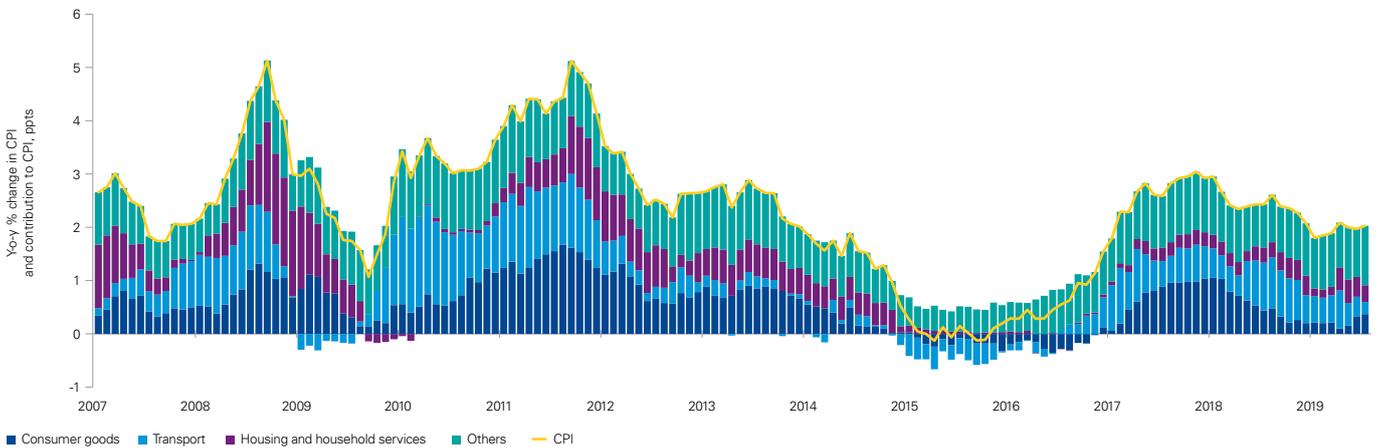
Inflation remains around target

With inflation around target, the Bank of England’s Monetary Policy Committee (MPC) maintained the policy rate at 0.75% at its August meeting. But the MPC also pointed out that it remains committed to a gradual increase in interest rates, assuming that the UK is able to complete a smooth Brexit and that there is some recovery in global economic growth.

Tight labour market and a weaker exchange rate stoke inflationary pressures, but inflation remains close to target as concerns about growth are mounting

Consumer price inflation rose to 2.1% in July (Chart 13), with the rise largely driven by higher prices for consumer goods, with toys, and clothing and footwear making particularly notable contributions.

Chart 13: Consumer price inflation rose to 2.1% in July, largely driven by consumer goods



Source: ONS via Haver and KPMG analysis

Consumer goods prices are linked relatively closely to exchange-rate movements as imports account for a significant proportion of UK goods consumption (Chart 14). Since our June report, the perceived likelihood of a no-deal Brexit and disappointing second quarter GDP data have generated downward pressure on the pound. There is a risk that the higher import costs associated with the fall in the exchange rate will be passed onto consumers, if sterling remains weak. Nonetheless, the Bank is usually reluctant to tackle the effect of import costs with monetary policy actions unless the rise in prices triggers further price increases within the domestic economy.

The other main external impact on inflation has come from energy prices. Recently, slack global demand has kept the oil price in check, with prices hovering around US\$60/barrel. Domestic energy prices, therefore, are on downtrend. After introducing a retail market energy price cap in January and increasing the cap in April, the gas and electricity regulator Ofgem announced a reduction in the cap level in August in response to recent falls in wholesale energy prices. As a result, household energy bills are likely to make a negative contribution to inflation from October onwards.

Domestic inflationary pressure is on the rise

Against that, domestic inflationary pressure is set to increase as productivity growth lags behind rises in labour costs. Real earnings growth remains strong, but productivity suffered a further 0.2% fall in the second quarter of the year, following a 0.6% decline in the first quarter. Currently, businesses appear to be absorbing higher labour costs. Without a return to productivity growth, this will not be sustainable and rising costs will eventually have to be passed on through higher prices.

Chart 14: Sterling exchange rate impacts consumer goods inflation



Source: ONS and Bank of England via Haver

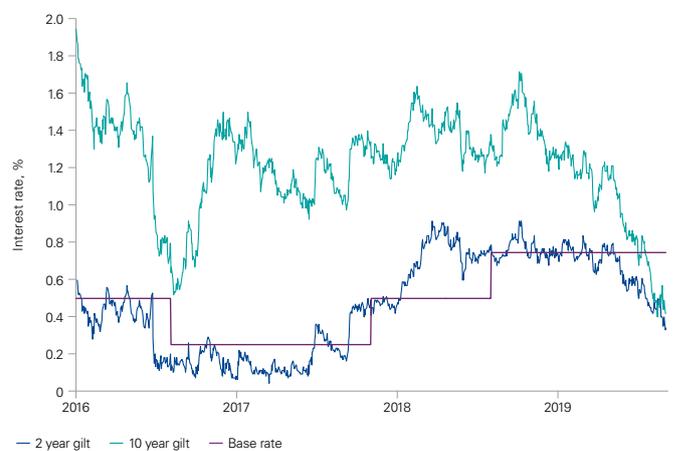
Inversion of the yield curve raised an alarm

Yields on 10-year gilts fell temporarily below those on 2-year paper in mid-August. This has generated some alarm as an inverted yield curve has historically been a signal of an impending recession.

Nevertheless, given the historically low level of current interest rates, the present environment may not be directly comparable to the past. The increased use of long-term bonds by financial institutions under regulatory requirements has also put permanent downward pressure on 10-year yields.

That said, the anxiety over weakening global growth is real. Both the Federal Reserve and the European Central Bank recently demonstrated some willingness to pause the tightening cycle in the face of mounting risks to growth. The Bank of England confronts an additional challenge of a no-deal Brexit, but even in the case of a smooth Brexit, further tightening will take longer and be more limited than in previous cycles.

Chart 15: The yield curve in the gilt market inverted briefly in mid-August



Source: Bank of England and Reuters via Haver



Outlook for UK house prices



Outlook for house prices in the UK

- As Brexit approaches, the type of exit will impact the fortune of house prices in the UK in the medium term.
- If the UK exits on 31 October with a deal, we expect house prices to stabilise in 2019 and to rise by 1.3% in 2020.
- On the other hand, a no-deal Brexit on Halloween could cause house prices to fall by between 5.4% and 7.5% across the different UK regions in 2020.



The UK's housing market has been stuck in the slow lane since 2016, with annual house price growth slowing to 0.9% in June 2019, from a rate of 8.2% three years previously according to data from the Land Registry. Changes to stamp duty introduced in 2014 and 2016 – which raised the costs for buyers of higher-value homes and second properties – and the uncertainty of Brexit, have put the market on the back foot.

The slowdown has been good news for first-time buyers looking to get on the property ladder, especially in areas of the country facing shortages of available housing such as the South East and London. House prices in these markets have now been falling for more than a year.

Buyers are taking a cautious approach to purchasing decisions, with many opting to wait for a resolution to the Brexit saga. A potential no-deal represents the worst case scenario for homeowners; a sudden departure from the European Union could have significant repercussions for the UK's economy and housing market.

After a long period of muted activity in the housing market, the Brexit deadline of 31 October is a symbolic Rubicon – when the UK decides to either exit the EU with no-deal; or accept a form of withdrawal agreement allowing for an orderly transition out of the European Union. With some uncertainty potentially resolved on that date, the outlook for house prices depends on the prevailing scenario.

It is still possible that an intervention in the form of a further delay could push the exit date back, leading to weeks and perhaps months of continuing uncertainty and a lack of buyer confidence. But even a delay would largely return to the same binary choice between a deal and a no-deal.

Our house price forecasts in a deal scenario

Our first scenario assumes that Brexit is resolved smoothly, either with a deal in time for the 31 October deadline or through a very brief delay that results in the ratification of a withdrawal agreement. The key feature is that the UK does not leave the EU without a deal.

In this scenario, the UK's economy enjoys a small uplift, with GDP growth rising to 1.5% in 2020⁴.

Table 3: House price growth in our deal scenario

	2018	2019	2020
East Midlands	4.3%	-0.6%	1.4%
East of England	1.5%	0.0%	1.7%
London	-0.4%	-4.7%	-0.2%
North East	0.5%	0.3%	2.0%
North West	3.2%	1.6%	2.1%
Northern Ireland	5.1%	-1.2%	0.6%
Scotland	2.9%	1.4%	1.4%
South East	0.6%	0.4%	1.1%
South West	3.1%	0.5%	0.9%
Wales	4.5%	0.6%	1.6%
West Midlands	4.4%	-0.6%	0.9%
Yorkshire and the Humber	2.9%	1.1%	2.4%
UK average	2.7%	-0.1%	1.3%

Source: Land Registry, KPMG analysis

In this case, we expect there to be little change in house prices during 2019, with an average fall across the UK of just 0.1%. The fall in London's house prices will continue throughout 2019 to reach 4.7% for the year as a whole. The North West will be the strongest performer in 2019, with house prices increasing by 1.6%. Looking at next year, the region with the strongest price rises will be Yorkshire and Humberside, where house prices will increase by 2.4%. On average, we expect the pace of house price growth to accelerate to 1.3% across the UK in 2020, representing a modest recovery on 2019.

Valuations are the main drivers for house prices in this scenario, with the biggest corrections taking place in regions where valuations are already stretched.

⁴See our forecast section in the September Economic Outlook for details.

Our house price forecasts in no-deal scenario

An alternative is that the UK leaves the EU without a deal on October 31. We modelled this scenario taking into account the potential impact of Brexit on local economies⁵, with larger falls in house prices experienced by the more heavily affected regions.

Table 4: House price growth in our no-deal scenario

	2018	2019	2020
East Midlands	4.3%	-1.5%	-5.4%
East of England	1.5%	-1.1%	-6.4%
London	-0.4%	-4.8%	-7.0%
North East	0.5%	-1.3%	-6.5%
North West	3.2%	0.3%	-6.1%
Northern Ireland	5.1%	-2.2%	-7.5%
Scotland	2.9%	0.7%	-6.0%
South East	0.6%	-0.6%	-6.7%
South West	3.1%	-0.4%	-5.9%
Wales	4.5%	-0.3%	-5.4%
West Midlands	4.4%	-1.3%	-5.8%
Yorkshire and the Humber	2.9%	-0.2%	-5.7%
UK average	2.7%	-1.1%	-6.2%

Source: Land Registry, KPMG analysis

The initial impact of a no-deal scenario on the UK's property market is a larger fall in 2019 of 1.1% on average, followed by a more significant decline in average house prices of 6.2% in 2020, with the variation across regions reflecting the differences in exposure to a no-deal.

While no regional market escapes unharmed in the event of a no-deal, London and Northern Ireland fare the worst, owing to their greater exposure to EU trade, with house prices in 2020 falling by 7% and 7.5% respectively in these regions.

Taking this together, Table 5 shows the average house price in each of the two scenarios, by the end of 2020.

Table 5: Average UK house prices by end of 2020

	Deal	No-deal
London	453,000	422,000
South East	327,000	299,000
East of England	296,000	269,000
South West	260,000	240,000
West Midlands	196,000	182,000
East Midlands	191,000	177,000
North West	167,000	152,000
Yorkshire and the Humber	164,000	150,000
Wales	164,000	151,000
Scotland	153,000	141,000
Northern Ireland	135,000	123,000
North East	129,000	116,000

Source: Land Registry, KPMG analysis

London is set to remain the region with the highest cash prices in 2021, with an average property costing £453,000 if Brexit proceeds smoothly. In the event of no-deal, this would drop to £422,000 by the end of 2020. Other regions feature smaller differences, although in all cases house prices are lower in the event of no-deal than in our deal forecast.

⁵We took the estimated regional impacts from Dhingra, S., Machin, S., & Overman, H. (2017). Local Economic Effects of Brexit. *National Institute Economic Review*, 242(1), R24–R36. <https://doi.org/10.1177/002795011724200112>



Transactions volumes will likely fall much more than prices – making government housing delivery targets impossible to achieve and slowing new building across the sector.

The level of leverage in the housebuilding sector is also much lower – meaning that volume housebuilders will be under less pressure to materially reduce prices. This helped create the downward spiral of prices in the global financial crisis.

Jan Crosby,
Head of Housing, KPMG in the UK

Overall, while our forecast represents a plausible response of house prices to the shock of no-deal, the overall impact is highly uncertain. It is possible that the demand for housing is further affected by a fall in confidence, with homebuyers becoming ever more reluctant to commit to house purchases over the coming year. For this reason we have looked at past episodes of house price falls across the different regional market as a guide to what could happen if market conditions become even more severe.

Since the start of the 1990s, the UK has suffered two major house price corrections. The first took place in the early 1990s, linked to the recession in 1991, when house prices for the UK fell by 20% between 1989 and 1993. The other major house price drop occurred during the global financial crisis in 2008. The most abrupt yearly falls during these periods were in 2008, when house prices fell by 15%, and in 1990, when prices fell by 11%. While we expect the correction to be milder this time, a further shock to buyer confidence could tip the overall market into a much deeper slump.

There are still good reasons to believe this time will be different. Compared to the run-up to the financial crisis of 2008, house prices are now lower in relation to earnings in most regions of the UK, having only risen substantially in London and the South East. Also, interest rates are nowhere near the levels prevailing at the time of the 1991 recession: at the start of 1991, the Bank of England base rate was 13.88%, compared to just 0.75% today. Mortgage payments are therefore substantially more affordable.

Overall, while a no-deal Brexit could dent property values in the short term, it may make less impact on one of the fundamental factors driving the market: the stock of regional housing. Housebuilders are expected to reduce the supply of new housing in some regions in the short term as a response to a deteriorating economic outlook. So, while there will be fallout from the initial economic shock following a no-deal Brexit, the market is expected to recover most ground in the long run to the extent the economy finds a new successful path.

Looking forward to 2020, next year promises to be a delicate year for the housing market. Even if Brexit can be resolved relatively smoothly, the travails of the global economy will impact growth in the UK, making prospects for house prices relatively subdued. One upside could come from government plans to change stamp duty. Potential changes include shifting the burden of stamp duty to the seller, exempting properties below £500,000 and reversing the surcharge for additional properties. If delivered in time for the Autumn Budget, this could lead to a significant increase in demand from buyers, providing a short term boost to the housing market. Still, the Treasury may be unwilling to part with the revenues that stamp duty brings.

A look ahead to the Autumn Budget



A look ahead to the Autumn Budget

The government has been handed another challenge as borrowing figures deteriorated this summer, constraining its ability to announce large spending plans in the short term. Cumulative levels of borrowing in the current financial year reached £16bn in April to July. Based on average borrowing patterns from the last three years, borrowing for the full financial year is set to be around £5bn over the Office for Budget Responsibility's March forecast of £29.3bn.

The extra borrowing implies that meeting the fiscal targets set by the previous Chancellor will be more difficult, as the headroom for any extra spending could shrink to just £22bn.

The Chancellor announced an extra £15.5bn of government spending in the September Spending Review, of which £13.4bn is to fall in the 2020-21 fiscal year. Additional spending is expected to be announced in the Autumn Budget alongside a relaxation of fiscal targets.

Melissa Geiger from KPMG Tax Practice says that with a new Prime Minister and Chancellor in office, Brexit still on the horizon and political upheaval expected in the autumn, predicting tax announcements for the Autumn Budget feels quite dicey.

Timing of the Autumn Statement

Melissa thinks that the first issue is knowing when the Autumn Budget might be. The expectation was that it would be in November, shortly after 31 October, the date we are due to leave the EU. But within a few days of Boris Johnson's election as leader of the Conservative Party, rumours of an emergency Budget were swirling and the Chancellor, Sajid Javid, has not ruled out having one before Brexit. Currently, mid-October seems to be the most likely option.

The second issue is the growing likelihood of a general election in October or shortly thereafter. The government's lost majority and its determination to stick to the 31 October Brexit deadline have made an election almost inevitable.

Put all this together and it is not clear whether the government is in election mode or Brexit management mode. The truth is probably that they are in both. In the meantime, what might be announced on tax?

What we have heard so far

The starting point is perhaps what both the Chancellor and the Prime Minister said during their respective Conservative party leadership bids.

Both candidates suggested tax cuts, but Mr Johnson's were by far the most ambitious.

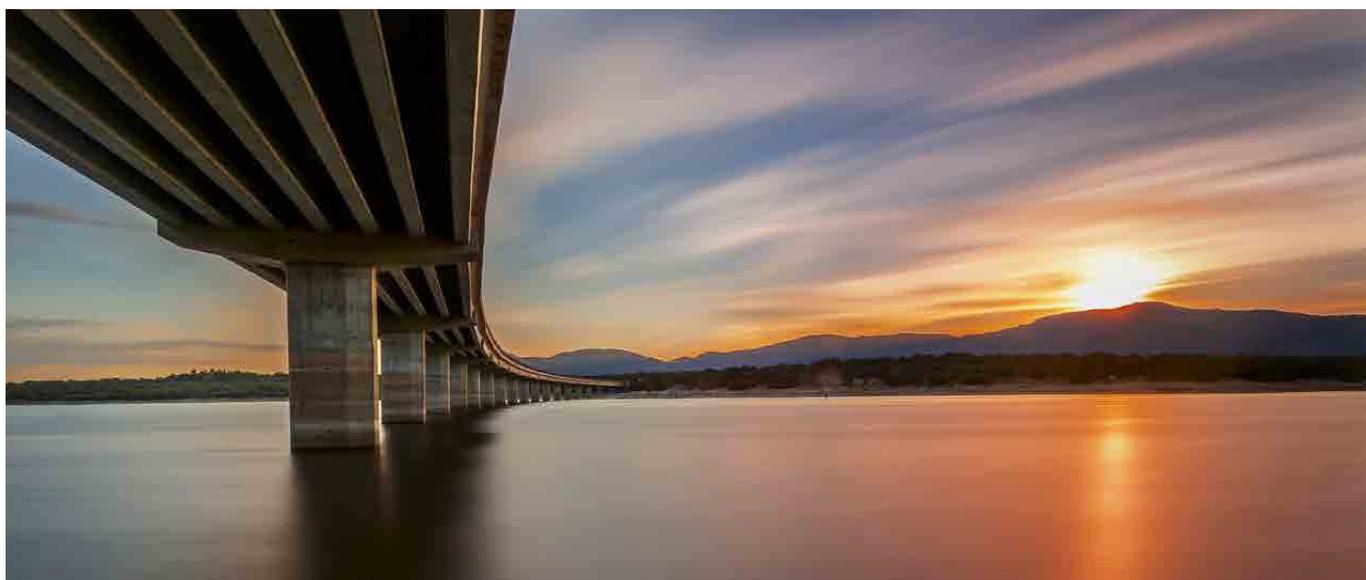
In relation to personal taxes he had two main tax proposals: raising the higher-rate threshold for individuals from £50,000 to £80,000, and raising the threshold at which National Insurance contributions (NIC) begin to be paid.

The justification for the increase of the higher-rate threshold was to remove the effect of years of fiscal drag that was gradually pulling more people into higher rate taxes (the increases in the threshold failing to keep up with income growth). The news was not all positive for those higher earning individuals. The upper earnings limit for NIC purposes (at which point individuals move from paying 12% NIC to 2%) is normally linked to the higher rate threshold. So if the two thresholds were to remain pegged, any tax saving would be in part counteracted by NIC increases.

The measure would be eye-wateringly expensive: the Institute for Fiscal Studies (IFS) predicted it would cost about £9bn and benefit four million of people with the highest incomes. Those with the most to gain would be high-income pensioners who do not pay NIC on their earnings and would realise the tax break in full.

Mr Johnson also suggested raising the level at which people start to pay NIC which would help low earners but, again, this would be expensive to implement. The IFS predicted a £1,000 increase in the threshold would take 600,000 workers out of NIC and cost the government £3bn a year. Most of the heavy lifting on redistribution for those on low incomes is done by the benefits system rather than the tax system and several commentators have been quick to point out that changes to universal credit might be a better way of helping those on low incomes.

Mr Johnson didn't just comment on personal taxes, however, he also proposed cutting the rate of corporation tax. The corporate tax rate in the UK currently stands at 19% and is due to decrease to 17% in 2020. It is already reasonably low in comparison to most of the G20.



Mr Johnson did not state the rate to which he would seek to cut corporation tax (and whether he would want to match former Conservative Party leader candidate Jeremy Hunt's ambitious 12.5% proposal) but his justification was that cutting the corporation tax rate would increase tax revenues.

Total tax revenue, however, is a function of the tax base as well as the tax rate, and the base for corporates in the UK has been broadening for some time. The extent to which the headline rate cut is responsible for increased corporate tax revenues is therefore questionable. And whilst businesses will always welcome a rate cut, offering increased tax simplicity and certainty might be a better way to encourage international competitiveness and generate foreign investment and jobs.

Finally, Mr Johnson hinted at stamp duty changes – raising the threshold at which stamp duty becomes payable to £500,000 and reducing the highest rate from 12% to 7%.

By contrast, Mr Javid was relatively light on tax policy announcements during his leadership bid other than saying he would consider an emergency budget that would help prepare for a no-deal Brexit and would include tax cuts for businesses and individuals.

There were no bold reforms, although he said he would like to cut taxes for the lowest earners. He also mooted removing the 45% tax rate for those on incomes of over £150,000. As a measure this would primarily benefit the top 1% of earners and his justification was that this would increase 'dynamism'. There may be some credence to this, as the reduction in the additional rate from 50% to 45% initiated by George Osborne is considered to have resulted in additional tax revenues (although some argue these figures are distorted by higher earners delaying bonus payments).



With a new Prime Minister and Chancellor in office, Brexit still on the horizon and political upheaval expected in the autumn predicting what might happen in the Autumn Budget feels quite dicey

Melissa Geiger,
Head of International Tax and Tax Policy, KPMG in the UK

Specific tax policies remain hard to pin down

Since being appointed Chancellor there has been no clear policy signalling from Mr Javid. He declares himself to be a fan of a simpler tax system, as all Chancellors do. He also described himself as a “low tax guy”, wanting efficient taxes that focus on maximising revenues which, he says, does not mean imposing the highest rate possible.

It is in relation to stamp duty that he has made the most waves after being reported to be considering shifting stamp duty from the buyer to the seller in an attempt to help first time buyers. He later distanced himself from the idea, although he seems to believe that something radical is needed in relation to housing.

There is some degree of crossover between Mr Javid’s and Mr Johnson’s approaches to tax.

Both Mr Javid and Mr Johnson seem comfortable with a loosening of the fiscal purse strings, at least in the short term, to give a shot in the arm to the economy.

The radical raising of the higher-rate threshold, however, seems to be too fundamental a change. It would drive a hole in the public finances that would be significant and Mr Johnson’s contention that it would be paid for by fiscal headroom seems ambitious.

Mr Javid may, however, pursue the removal of the 45% rate which, whilst it would benefit the highest of earners, may well generate an overall increase in tax revenue. It might also have the knock-on effect of appealing to a more Conservative voting base and keeping the more mobile earners in the UK.

Without a doubt they will seek to do something for lower earners, perhaps an increase in the NIC threshold, but also through changes to universal credit.

It is likely that there will be some measures around stamp duty but probably more along the lines of tinkering with rates than fundamental reform. A reduction of the highest rate, which was mooted by Mr Johnson during his leadership bid, might help relieve stickiness at the top end of the market, particularly in London, and again would appeal to a more Conservative voting base.

Several media outlets also report there may be a temporary reduction in the VAT rate from 20% to 17.5%. This would potentially boost spending, particularly at a time when the falling pound is making some consumer goods more expensive.

The complications of pensions tax relief, particularly in relation to NHS workers, has attracted multiple headlines over the last few months. The government has announced some proposals which will increase flexibility for such workers. There has, however, been increasing noise about extending the changes to all public sector employees and, of course, the pensions tax charges can also impact on private pension schemes. All of this may lead to an announcement of a more root-and-branch review of the current pensions rules, which are widely seen as too complicated and difficult to understand.

Business taxes may provide more surprises

It is in relation to corporation tax that any budget will be more interesting with Brexit playing a pivotal role in defining the direction of travel. A no-deal Brexit might usher in radical changes, including significant cuts to the headline rate of corporation tax, accompanied by increased investment incentives in relation to innovation.

It will be interesting to watch the UK Digital Services Tax proposals. The tax is due to come into force in 2020 and will impose a 2% tax on revenues from certain types of digital activity relating to UK users. Philip Hammond positioned this as a temporary, but necessary, tax that would be reviewed (in 2025) once the OECD had completed its wider international project on how to tax an increasingly digitalised economy.

In the meantime, however, France has enacted a similar Digital Services Tax that has been met with a strong response from the US. We can expect a similar reaction in relation to the UK proposals.

However, the UK Digital Services Tax was never intended to be a big revenue raiser and bearing in mind the positive mood music from the US in relation to post-Brexit trade deals, it is possible that the UK Digital Services Tax will be sacrificed on the altar of international relations.

All in all, the Autumn Budget is promising to be an interesting ride and perhaps the best prediction is to ‘expect the unexpected’.



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