UK economy

UK economy: forecast downgrade

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Dean Turner, Economist, UBS AG; Christof Koumoudos, Analyst

- We are downgrading our growth forecast for the UK economy for this year and next, and are adjusting our interest rate path accordingly. We now expect the UK economy to expand by 1.5% this year, and 1.2% in 2020, and for the Bank of England to hike rates on only one occasion this year, most likely at its November meeting.
- The downgrade to growth comes amid ongoing uncertainty around the Brexit negotiations. Delay to the UK’s leaving date, something that seems increasingly likely, is likely to compound those concerns and result in a prolonged period of sluggish business investment. In addition, a weaker backdrop for global demand where lead indicators point to slowing activity in the first quarters of the year will present further headwinds.
- The pound has staged a recovery in recent days as the threat of the UK leaving the EU on March 29 without a deal has receded. While we would agree with this assessment, the threat of no deal hasn’t yet been eliminated, suggesting that volatility could return to the currency if the current stalemate cannot be broken.

Our view
We are downgrading our growth forecasts for the UK economy for this year and next. We now expect the economy to grow at 1.5% in 2019 and 1.2% in 2020 (1.8% and 1.3% previously).

If, as we expect, Prime Minister Theresa May eventually secures parliamentary ratification for a version of the Withdrawal Agreement she negotiated, then we expect the Bank of England to hike later in the year, most likely at its November meeting and once in the second quarter of next year.

For the time being we remain wary of taking directional views on sterling and UK assets. Although much seems like it has changed, the reality is that very little has. The options facing the UK are narrowing in on either accepting May’s Withdrawal Agreement or delaying Article 50 to seek an alternative path. Within portfolios, exposure to sterling-denominated assets should be maintained at benchmark levels until more clarity emerges.

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We are downgrading our growth forecasts for the UK economy for this year and next. We now expect the economy to grow at 1.5% in 2019 and 1.2% in 2020 (1.8% and 1.3% previously). Our updated forecasts can be seen in fig. 1.

There are three reasons for this downgrade.

First, growth outturns for the final quarter are likely to be a little weaker than we previously forecast, in part due to the weaker-than-expected global backdrop. The first estimate of fourth quarter 2018 GDP growth is scheduled for release on 11 November; we now expect this to print at 0.3% quarter-on-quarter held back by a combination of Brexit uncertainty and a weaker global backdrop. Thus momentum coming into 2019 is likely to be a little weaker than previously forecast.

Second, we expect that Brexit uncertainty will continue to weigh on the economy as each deadline comes and passes without resolution. The effects of this uncertainty are being felt primarily by businesses, who continue to hold back on much-needed investment (fig. 2). In addition, Brexit uncertainty is manifesting itself in surveys of consumer confidence which point to slower consumption in the near term (fig. 3). The longer uncertainty persists, and with delay to Brexit looking increasingly likely, the greater the likely drag on the UK economy.

Third, a weaker outlook for the global economy in the near term. The UK is not alone in seeing a weak end to the year in 2018; Europe, and in particular Germany, saw a notable slowdown. Consequently, surveys of business confidence have seen a noticeable slump across most of the major economies (fig. 4). The reasons for the slowdown in the global backdrop range from concerns about the US-China trade dispute to specific, one-off factors affecting car production in Europe, and the impact of the lengthy government shutdown in the US. As a small, open economy, it is likely that the weaker global backdrop will present a headwind for the UK economy.

Notwithstanding the headwinds discussed above, there are still a number of positives that are likely to see the UK continue to grow this year. A fiscal easing amounting to some 0.3% of GDP is penciled in by the chancellor, and there are more people in work as a share of the labor market than at any time on record. Moreover, inflation is subsiding a little faster than previously expected, which should boost household income growth in real terms. This a reversal of one of the main drags on the economy in 2017 and 2018. If, as we expect, May eventually seeks approval for her Withdrawal Agreement and the UK moves onto a transition arrangement, we should see growth pick up in the second half of this year, which could also coincide with a modest recovery in the external backdrop.

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**Fig. 1: UK economic forecasts**

<table>
<thead>
<tr>
<th>UK economic table</th>
<th>2018f</th>
<th>2019f</th>
<th>2020f</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth, %</td>
<td>1.4</td>
<td>1.5</td>
<td>1.2</td>
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<tr>
<td>Private consumption, % y/l</td>
<td>1.6</td>
<td>1.6</td>
<td>0.2</td>
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<tr>
<td>Government consumption, % y/l</td>
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<td>1.4</td>
<td>1.5</td>
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<td>Fixed Investment, % y/l</td>
<td>0.0</td>
<td>0.5</td>
<td>1.5</td>
</tr>
<tr>
<td>Exports, % y/l</td>
<td>0.0</td>
<td>2.4</td>
<td>2.5</td>
</tr>
<tr>
<td>Imports, % y/l</td>
<td>0.4</td>
<td>1.5</td>
<td>1.2</td>
</tr>
<tr>
<td>Unemployment rate, %</td>
<td>4.1</td>
<td>3.9</td>
<td>4.1</td>
</tr>
<tr>
<td>CHF, % y/l (year-end)</td>
<td>2.1</td>
<td>2.1</td>
<td>2.3</td>
</tr>
<tr>
<td>General government budget balance, % GDP</td>
<td>-1.9</td>
<td>-1.4</td>
<td>-1.8</td>
</tr>
<tr>
<td>Revenue, % GDP</td>
<td>36.0</td>
<td>36.0</td>
<td>36.0</td>
</tr>
<tr>
<td>Expenditure, % GDP</td>
<td>37.8</td>
<td>37.4</td>
<td>37.8</td>
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<tr>
<td>Primary balance, % GDP</td>
<td>-0.1</td>
<td>0.1</td>
<td>-0.3</td>
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<tr>
<td>Public sector debt (gross), % GDP</td>
<td>85.4</td>
<td>83.3</td>
<td>81.8</td>
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<tr>
<td>Current account balance, % of GDP</td>
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<td>-3.8</td>
<td>-4.0</td>
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<tr>
<td>Roll base rate, % (year-end)</td>
<td>0.75</td>
<td>1.00</td>
<td>1.25</td>
</tr>
</tbody>
</table>

Source: UBS, as of January 2019

**Fig. 2: UK business investment is on hold until a conclusion to Brexit is found**

UK Business Investment, year-on-year, %

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**Fig. 3: Consumer confidence surveys have taken a downward turn**

UK GfK Consumer Confidence Barometer, % Bal

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**Fig. 4: The slowdown in business surveys isn’t just confined to the UK**

Composite Headline PMI

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Source: Markit, Haver Analytics, UBS as of January 2019
Interest rates – on hold for now
The Bank of England will remain inactive for some time yet given the conundrum it faces of balancing medium-term inflation pressures against the potential Brexit outcomes. Even if May’s negotiated withdrawal agreement is ratified in due course, it still seems likely that the leaving date of March 29 will have to be delayed to facilitate passing the legislation the UK needs in place before it can leave the EU.

In our view, the ongoing uncertainty weighing on business investment is likely to persist until clarity on the terms of the UK’s EU withdrawal are known. Absent a recovery in business investment, economic growth is likely to remain sluggish, which will likely give the BoE pause for thought.

Nevertheless, we expect the BoE to retain a relatively hawkish stance during its next few meetings. The labor market remains healthy, with rates of unemployment at multi-decade lows (fig 5) and, perhaps more importantly for central bankers, wages are growing at the fastest rate we have seen in the current cycle (fig 6). Thus, inflation pressures are building, something that the BoE will be keen to quash.

If, as we expect, May eventually secures parliamentary ratification for a version of the Withdrawal Agreement she negotiated, then we expect the Bank of England to hike later in the year, most likely at its November meeting and once in the second quarter of next year.

The pound – still weighing up the options
For the time being we remain wary of taking directional views on sterling and UK assets. Although much seems like it has changed, the reality is that very little has. The options facing the UK are narrowing in on either accepting May’s Withdrawal Agreement or delaying Article 50 to seek an alternative path. Both options offer a range of upside and downside scenarios for the pound with little certainty as to which scenario is most likely to unfold. In the meantime we expect that uncertainty will remain high and UK markets will stay volatile. Within portfolios, exposure to sterling-denominated assets should be maintained at benchmark levels until more clarity emerges.
Appendix

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