



Storm clouds gathering

UK Economic Outlook

Special focus

| Outlook for
| UK equities

December 2018

kpmg.com/uk/economicoutlook

Chief Economist's introduction



Looking ahead to 2019, we are bracing ourselves for one of the most eventful years in Britain's recent history.

It looks like Brexit is going to dominate a big part of next year's agenda, hopefully with more clarity on the future relationship between the UK and the EU allowing businesses, and government, to make the right preparations after a transition period.

The UK's economic challenges go beyond Brexit, and we should also strive to tackle two stumbling blocks for a prosperous UK future: improving productivity (and hence UK long-term growth potential) and social inclusion.

How does business view the year ahead? In this, and future editions of the Economic Outlook, we take the temperature on the ground through the views of two companies – in this edition National Grid and pharmaceuticals manufacturer Seqirus.

This time last year, my biggest concerns beyond the UK focused on the global political agenda becoming less growth supportive, asset price overvaluations, and the possible unintended consequences from monetary policy normalisation. It is important that here in the UK we don't let Brexit cloud our vision so we miss out on other opportunities and risks around us.

While tightening credit conditions globally and continued geopolitical tensions are sure to produce some hairy moments in 2019, resolutions could create new markets and products.

In this edition of our Economic Outlook you will find our latest forecasts for the UK economy and our thoughts on the outlook for UK regions and for UK quoted equities. One thing seems certain as I write this (a few days before Parliament's pivotal vote on the draft Brexit deal): the nature of the UK's departure from the European Union will have a major impact on the outlook for the UK economy both in the short and long term.

Whatever happens, next year is gearing up to be an interesting journey. We wish you all the best for 2019!

Yael Selfin,
Chief Economist, KPMG in the UK

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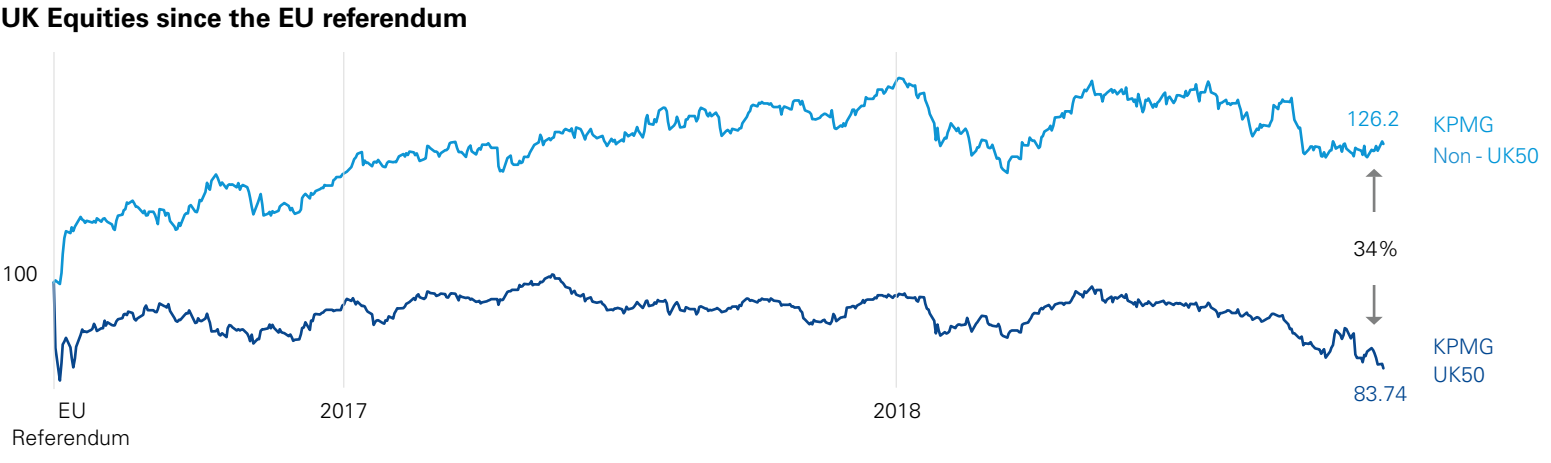
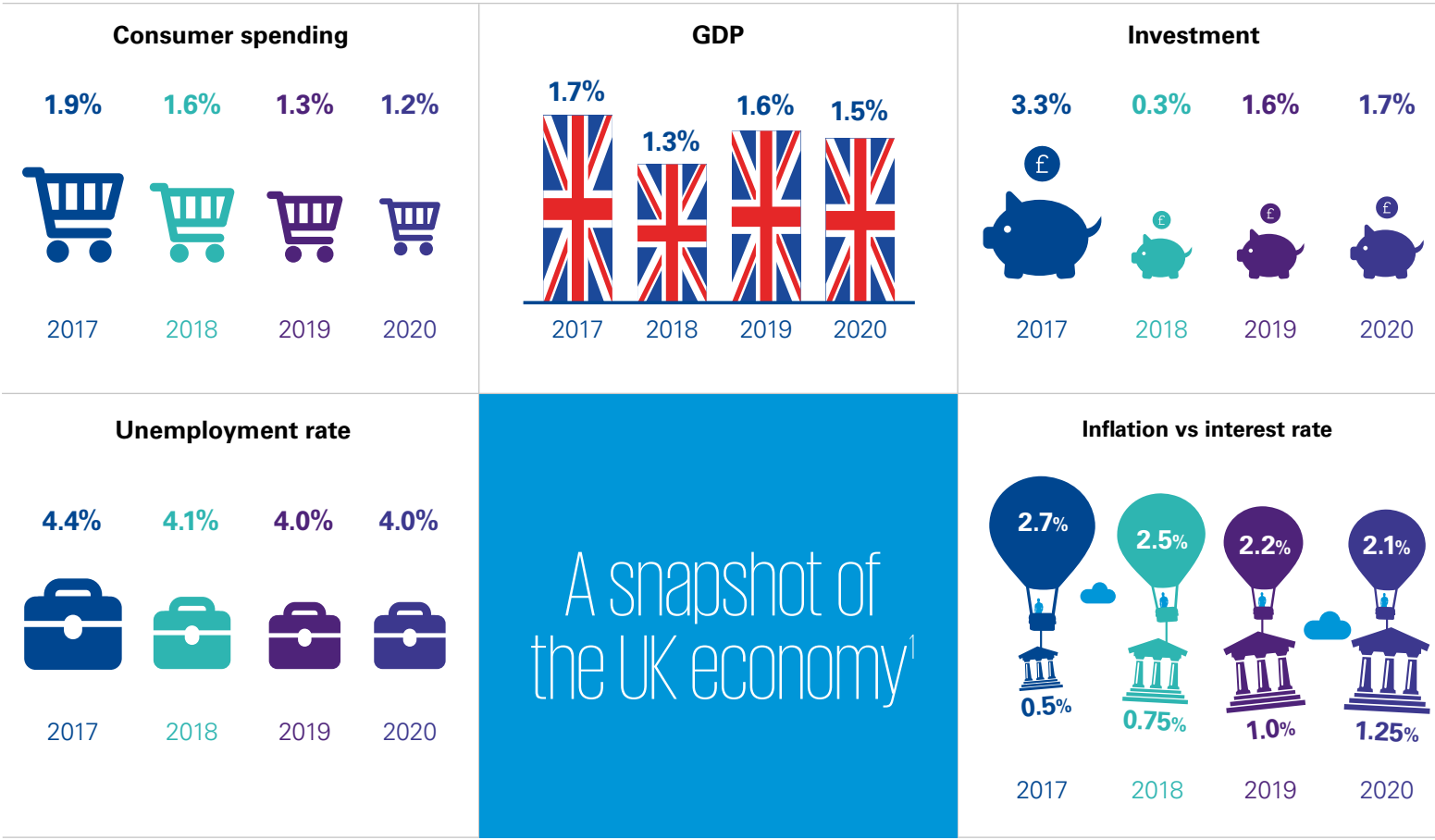
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Current Outlook

Executive summary

- As March 29 approaches, we are finally seeing a narrowing of the different directions Brexit could take, allowing businesses to make more targeted contingency plans and potentially unlocking some of the investment that has stalled this year.
- Should the Withdrawal Agreement clear the UK and EU parliaments and the UK avoid a no-deal scenario, we expect to see a short-term surge in investment growth to 1.6-1.7%. As a result, we see a slight uplift in growth momentum, with the UK economy growing by 1.6% in 2019 followed by 1.5% growth in 2020. However, as per our September outlook [report](#), if a no-deal scenario cannot be avoided, GDP growth could fall to at least 0.6% in 2019 and 0.4% in 2020 due to temporary disruptions to supply chains and trade.
- Despite weakness in the economy, recruitment difficulties remain at an elevated level. Brexit is likely to exacerbate the problem with fewer EU workers available. Retention and recruitment will continue to be a challenge for UK employers. A tight labour market should support earnings growth at around the current level.
- With the impact of sterling depreciation and oil price hikes moderating, the rise in import prices is likely to be more limited, putting a check on aggregate business costs. We expect inflation to move closer towards its 2% target in the next year.
- The Bank of England has confirmed its commitment to continue raising interest rates gradually if the economy evolves as expected. The Bank has been reluctant to say what it will do in the event of a more negative Brexit outcome, but in practice it is more likely to keep rates low in order to cushion a blow to demand.
- Regionally, we have observed a broad-based improvement in the unemployment rate for eight out of 12 regions. Regional Purchasing Managers' output indices also hint at further economic expansion across most regions over the next six months. Nevertheless, the North-South gap continues to be an issue, with the North East experiencing a visible slowdown in earnings growth and job creation, in contrast to other regions.
- The UK economy saw a pick-up in growth following a weak first quarter. Both manufacturing and construction sectors enjoyed a positive bounce-back, whereas services growth moderated slightly in Q3. However, the more upbeat note since Q1 has not been strong enough to reverse the earlier slowdown. We continue to expect growth for 2018 to stay at a moderate 1.3%.
- Export growth recovered in Q3, while imports remained weak this year, with a significant decline in goods imported from the EU in Q3. This was most probably due to a reluctance from businesses to further their dependence on EU suppliers amidst Brexit uncertainties. A combination of the two resulted in the UK's lowest trade deficit since Q4 2014. Recent surveys, however, suggest that businesses are not confident about export strength lasting. We may also see a short boost to imports prior to Brexit, stemming from businesses building up inventories. These two factors could push the trade deficit back up.
- In his October budget, the chancellor made a difficult trade-off between ending austerity and exercising fiscal discipline. Despite a recent hit to the public finances (with cumulative deficit up to October surpassing the Office for Budget Responsibility (OBR)'s forecast for the full fiscal year), we are still on track to achieve the fiscal mandate. Nonetheless, OBR's forecasts assume the economy evolves relatively favourably. If there's a downturn over the short term, the fiscal buffer the chancellor will have is unlikely to be big enough to allow him to meet his target while providing some necessary support to the economy.
- The lukewarm performance of the UK economy has been reflected in the housing market. The moderate slowdown in house price growth with some regional rebalancing is consistent with the trend identified in our September report. We continue to expect Scotland to have the fastest growth and London to experience the most significant slowdown.
- Our analysis shows that multiple factors are going to drive volatility in UK equities over the next 12 months. Domestically, the conclusion of a Brexit deal should remove some of the risks around UK-focused companies. External risks such as global trade tensions and economic slowdown in the euro area, may lead to a downward revision of the value of non-UK-focused companies. An anticipated correction in the US stock market could also have some spill-over effects on the UK market. Investors need to be cautious in managing the complex mix of risks in the turbulent time ahead.



¹ These figures represent our central scenario under which the UK secures a transition agreement after Brexit and a relatively friction-free trade deal after that. 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 year.

A full-page background image featuring a person standing on a rocky mountain peak. The person is wearing a blue jacket and a yellow backpack. The mountain is covered in dry, brownish grass and rocks. In the background, there are more mountains shrouded in mist or low clouds. The overall tone is atmospheric and somewhat somber.

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Outlook under our central scenario

Our central scenario assumes that exit preparations evolve relatively favourably, with an agreed transition period followed by a permanent agreement that amicably resolves the potential major frictions to trade and to ongoing business relationships between the UK and the EU.

In these circumstances, where the possibility of an abrupt exit is removed and businesses are in a better position to make more targeted contingency plans, we expect a slight improvement in overall economic growth in 2019 to 1.6% (from an expected 1.3% in 2018) followed by growth of 1.5% in 2020.

A transition period with the EU would allow trade relations with the EU27 countries to remain unchanged until the end of 2020, although in practice we expect exports to be weaker than historically as companies anticipate more friction in future trading with the EU and adjust their efforts accordingly ahead of the exit. That said, recent data show imports already adjusting downwards, making net trade’s contribution to growth positive in the short term.

A recent pickup in wages, coupled with falling inflation, have alleviated some pressure on household budgets. However, economic uncertainty and the need to rebuild household savings are likely to hold back the extent to which earnings growth can drive up consumption in the near term.

We expect tightness in the labour market to continue, with the unemployment rate remaining near its 4% historic low. That means recruitment difficulties are likely to continue into 2019, and support consumer spending to some degree with growth decelerating from an expected 1.6% this year to 1.2% by 2020 (see Table 1).

More clarity around the Brexit deal would ease some of the restraints we’ve witnessed in business investment this year. However, many of the other factors contributing to weakness in investment in 2018 – including rising interest rates and global supply chain risks – will persevere. We do not expect the exceptional weakness in investment growth to continue into 2019, but the extent of the recovery will be limited to around 1.6% per year through to 2020.

Inflation is easing towards the Bank of England’s 2% target as the impact of rising oil prices and post-referendum sterling depreciation has waned over 2018. While imported inflationary pressure is likely to be less in evidence next year, there are signs that domestic inflation is starting to build up. A protracted period of tightness in the labour market, with stronger growth in earnings reported in recent months, is a growing concern for the Bank of England.

Given our expectation that inflation will stay close to the Bank’s 2% target through to 2020, we see the BoE keeping interest rates on hold before another 0.25 percentage point rise in the second half of 2019, followed by another rise in the first half of 2020.

Table 1: Our main scenario for the UK economy

KPMG economic forecasts	2017	2018	2019	2020
GDP	1.7	1.3	1.6	1.5
Consumer spending	1.9	1.6	1.3	1.2
Investment	3.3	0.3	1.6	1.7
Unemployment rate	4.4	4.1	4.0	4.0
Inflation	2.7	2.5	2.2	2.1
Base interest rates (end-of-period)	0.50	0.75	1.00	1.25

Source: OONS, 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 CPI and unemployment measure is LFS. Interest rate represents level at the end of calendar year.

Brexit scenarios and the UK economy

Over the next two years, the UK will face a series of binary choices that could radically alter the course of the economy. This means that forecasts are inherently highly uncertain at present.

We address the most likely course of events below and look at its potential impact on the UK economy. Given the significant uncertainty around how each scenario will unfold in practice, they should be regarded as the best judgement on the likely evolution of the economy in each case, rather than as forecasts.

Short-term scenarios

Current estimates for the costs of Brexit incurred to date suggest that the economy is now around 2%¹ smaller than if the referendum had not occurred. Looking ahead to the next two years, there are several options that could occur, including:

- The current Withdrawal Agreement gets approved and a transition commences in March 2019;
- The UK leaves the EU with no deal in March 2019;
- UK remains in the EU.

The choice regarding these options will also guide the many potential future relationships that the UK could have with the EU.

Exit under current Withdrawal Agreement

The current Withdrawal Agreement envisages a 21+ month transition to a new long-term relationship between the UK and the EU. During the transition period, the UK’s trade relationships do not change, there is continued freedom of movement, and payment into the EU budget. The length of the transition period can be extended and could last a further two years.

Following the transition period, the UK would shift to a new long-term relationship with the EU.

Current economic forecasts were largely made on the basis of this scenario and the existence of the transition period.

Crucially, a lot of the current weakness in business investment, which stems from the uncertainty around the shape of future trading relationship, will not go away until a new relationship with the EU is agreed.

On the longer-term future relationship, the main feature of the current Withdrawal Agreement is that it minimises the likelihood of a no-deal scenario.

No-Deal

A potential no deal scenario would lead to the UK leaving the EU on the 29 March 2019 and switching to World Trade Organization (WTO) rules as the basis for trade with the rest of the EU. The severity of this scenario on the economy will depend to a large degree on the extent of cooperation between the UK and the EU around the time of exit.

Assuming a relatively amicable and productive relationship, we still expect sterling to depreciate by around 7-10%. The effect will be immediate and may even occur before the formal exit date, once markets perceive its inevitability.

We also expect there to be a significant amount of disruption caused by delays at the border for goods and contractual uncertainty for services trade. The OBR has suggested that in the short-term, the experience of a no-deal exit will resemble the ‘three-day week’ introduced in early 1974, which led to a 3% drop in output.²

We think that the disruption will also lead to a temporary fall in the level of UK productivity, as supply bottlenecks and delays interrupt the productive capacity of enterprises predicated on easy access to the EU.

Counteracting this, a no-deal scenario could create a positive boost to investment, especially in 2019. Contrary to the scenario envisaged in the current Withdrawal Agreement, in the event of a no deal, many of the questions regarding the long-term relationship between the UK and the EU will be resolved.

1 See CEPR, 2018 <https://voxeu.org/article/300-million-week-output-cost-brexit-vote> and CER, 2018 <https://www.cer.eu/insights/whats-cost-brexit-so-far>

2 OBR, Brexit and the OBR’s forecasts, 2018.

Trade would take place on WTO terms with customs and migration controls; cross-border trade and the movement of labour would be hindered. Businesses would need to re-arrange their production networks to adapt to a new pattern of trade with the EU, and investment in new infrastructure and logistics would need to be accelerated. GDP growth in 2019 could fall to 0.6%. In 2020 we could see growth of 0.4%.

The Bank of England could lower interest rates to 0.25% initially from 0.75% today. If the shock is judged to be particularly severe in some markets, the Bank of England might also opt to engage in targeted funding operations. However, this would be unlikely to mirror the response of the Bank of England in the immediate aftermath of the 2016 referendum, although the aim would be to minimise the potential fluctuations in output in favour of inflation as before.

We would also expect a no-deal scenario to generate a temporary burst of inflation, caused by a combination of sterling depreciation and the costs of tariffs. The rise in prices would unlikely be as high as seen in 2017, due to weaker domestic conditions off-setting the inflationary pressures. Our modelling indicates a potential for inflation to peak just below 3.5%.

Two more extreme versions of a no-deal scenario have been offered by the Bank of England³ : a Disruptive scenario and Disorderly one. In both of these scenarios, the UK economy experiences a large negative shock, causing sterling to fall by 15% to 25% and a spike in inflation to 4.25-6.5%. Other modelled conditions include an increase in risk and uncertainty, sharp falls in net migration and the imposition of tariff and non-tariff barriers.

In the Bank of England’s no deal scenarios, GDP falls by between 4.75% and 7.75% during 2019. This leads to an increase in the rate of unemployment to the range of 5.75% and 7.5%.

Remain in the EU

The last short term option we consider is the possibility that the UK remains a full member of the European Union by revoking its Article 50 notice.

In the immediate aftermath of such a decision, we expect to see the value of sterling appreciate by around 10-15%, reversing most of the drop that occurred after the referendum. This would cause the price of imported goods to drop substantially, easing cost pressures for UK businesses, which would gradually pass onto consumer prices in the form of weaker inflation rates. Sterling’s appreciation would exert downward pressure on UK inflation. Without taking the path of domestic demand or policy into account, the rate of inflation would tend to be 0.2% lower in 2019 and 0.8% lower in 2020.

The Bank of England could then delay the pace of interest rate increases due to the weakness in observed inflation in the UK, which would allow the economy to develop a positive level of the output gap for a short period. Interest rates may even stay on hold at 0.75% during 2019 under such scenario.

The increased certainty that businesses would have around the UK’s relationship with the EU would encourage businesses to increase the level investment – particularly due to the backlog of projects that were placed on hold by Brexit uncertainty. Expectations of stronger trading links with the EU and a bigger domestic economy, would also trigger more investment.

However, despite an improving outlook for the UK economy in this scenario, the increase in GDP growth relative to the baseline scenario is likely to be relatively minor in the short-term. With the economy already functioning at full capacity, there may be no spare resources available to be put to productive use as demand rose. Therefore, we would expect GDP growth would reach 1.7-1.9% in 2019-20.

Long term consequences of exiting the EU

In the longer term, the effect of Brexit on the economy will depend on the shape of the relationship that the UK establishes with the rest of the EU.

Generally, arrangements that impede trade through either tariff or non-tariff barriers will reduce the size of the UK economy, with the greatest effects on GDP from a relationship based on WTO rules under current proposed scenarios. A number of independent studies have also shown that the loss of trade with the EU could not be fully compensated with trade deals with other countries such as the US, given the importance of the European market to the UK. In addition, a reduction in the size of the labour force from a fall in the number of EU nationals in the UK would reduce the productive capacity of the economy, and hence its size.

Analysing the effect of potential long-term scenarios assuming that the current Withdrawal Agreement is approved, the National Institute of Economic and Social Research⁴ found that by 2030, the UK economy would be 5.5% smaller under a WTO trade-terms scenario, compared to if the UK decides to remain in the EU. Likewise, the UK economy would be 3.9% smaller if the UK obtained a Free Trade Agreement or 2.8% smaller if it fell back to the proposed backstop.

Analysis of the effect of Brexit published by the London School of Economics’ Centre for Economic Performance and King’s College London⁵ shows the difference between a WTO scenario and remaining in the EU to be 8.7% in terms of GDP per capita. A milder scenario depicting a deal with the EU including no tariffs and customs, but some border friction and lower EU migration, is estimated to lower GDP per capita by 5.5% by 2030.

Similar modelling by the UK Government⁶ suggests that leaving the EU on WTO terms would leave the UK economy between 7.7% and 9.3% smaller than if the UK remained in the EU.

If the UK negotiates for a Free Trade Deal, the impact on the overall economy is less severe: between 4.9% and 6.7% by 2033. Under a relationship based on EEA terms, the government’s model suggests GDP would be 1.4% lower by the same date.

Another modelled scenario, which is closer to the one that the government proposed in its July 2018 White Paper sees GDP between 0.6% (assuming minimal trade barriers and no change in migration arrangements) and 3.9% lower by 2033.

Once the short term adjustment has completed, the size of the UK economy over the longer term will be determined by how productive it becomes. Restrictions on trade will make it more challenging for the economy to gain market size and specialise, while reduced availability of labour will require more investment to raise the country’s productive capacity.

Overall, the UK economy outside the EU will be smaller and income per capita lower than it would have been had it remained inside the EU. Exactly how much that fall is depends on the relationship that will be established between the UK and EU.

3 Bank of England, November 2018

⁴ NIESR, 2018; The Economic Effects of the government’s proposed Brexit Deal

⁵ CEP, The UK in a Changing Europe; The economic consequences of the Brexit Deal

⁶ HM Government, 2018; EU Exit Long-term economic analysis

A business view of Brexit



Nicola Shaw CBE,
Executive Director,
National Grid

National Grid owns and operates the electricity transmission network in England and Wales, and operates the network in Scotland as well as owning and operating the gas National Transmission System in Great Britain.

Where does Brexit sit in terms of your big business issues?

Brexit is a significant event, but we don't currently see it on a par with other major infrastructure risks. We have done a lot of planning for all scenarios over the past 18 months, and do not expect any issues. We believe the System Operator has the right tools in place. In terms of its effect on the economy, we continue to plan for all scenarios.

Has Brexit led you to reassess how you finance National Grid's UK operations?

We continue to issue debt as needed to fund the investments we are making in our UK networks and so access to the debt markets is important to us. As you would expect we have looked very carefully at the debt situation under a range of different Brexit outcomes. We have taken appropriate action to ensure that the Group will continue to be able to fund these investments throughout the process of leaving the EU.

Are you finding recruitment more difficult given the tight labour market?

It has always been hard in particular niches, absolutely. For example it's hard finding digital skills right across the spectrum – from more traditional IT roles to hiring people who can help digitise our business.

In terms of European staff, we are putting in place contingencies for all scenarios but don't see any major issues. Subcontractors also have EU citizens in specialist positions such as overhead cable maintenance and we are working with them too.

Are frictions to physical supply chains an issue for you?

We did quite a lot of work on equipment in the summer to look right across all the parts and components coming to us from Europe. We are doing the last bit of that now to make sure we have anything really big we might need ahead of March. We aren't such a real time business but I want to make sure we have the contingency through summer 2019.

What would happen if the UK found itself outside the EU's internal energy market?

We are planning for all scenarios and have well developed plans. Even in a No Deal scenario we are confident that we have the right tools in place to manage any event. On gas, we have diverse supplies, including from LNG, which makes the UK secure.

In terms of the electricity markets, we see that power will continue to be traded via our interconnectors so I'm confident we will be fine. A better indication of the situation is the fact that our utility customers continue to forward purchase power for summer 2019. We also welcome the positive wording on energy in the Political Declaration on the future relationship.

To what extent does Brexit get in the way in the day-to-day running of UK operations?

We have advanced and well tested plans, but undoubtedly Brexit is a distraction. It probably takes up half a day of my week currently. The broad issue is the constant uncertainty among my staff. There's a general sense that, "we don't feel very comfortable at the moment" both among EU-born and British employees.



Gordon Naylor,
President, Seqirus

Seqirus, a subsidiary of Australia's CSL, is a world leading producer of influenza vaccines. Three years ago it chose Maidenhead, Berkshire, as the location for its global HQ. Seqirus manufactures vaccines in Liverpool as well as in the US and Australia and exports to global markets.

What impact is Brexit having on your business?

Without seamless market access, Brexit would add cost and complexity to our supply chain. For example, should the UK no longer be part of the European system of medicine regulation, the product testing and release processes that we undertake at our Liverpool plant will need to be duplicated in the EU. To manage this risk, we have established a new laboratory in Amsterdam – a cost which is purely driven by Brexit.

How are you mitigating its potential impact?

For about a year and a half we've been preparing for the possibility of a no-deal Brexit. We set up a cross-functional team that is putting in place contingency plans including our product registrations, testing and release processes, logistics and VAT. We also have a partial rollback plan if we avoid a 'no deal' or Brexit is cancelled altogether.

What are the potential opportunities from Brexit?

The negative consequences seem clear. If the consequences of Brexit were a further fall in the sterling, or triggered microeconomic reform in the UK, such as lower tax rates, that might make our UK operations more competitive globally.

What effect could Brexit have on your day-to-day operations?

In addition to the economic consequences, we worry about potential public health implications. Influenza vaccines can't be stockpiled (flu strains change frequently) and there's only a short window to give them to people each year so they are protected for winter. If there are any delays in transporting the product then the cost has to be measured in terms of people's health – on both sides of the Channel.

Are you facing hiring difficulties given the low jobless rate and a possible loss of EU staff?

We haven't had big issues in hiring yet but there has been something of a chilling effect on professionals coming out of Europe. Post Brexit, any barriers to the movement of skilled labour is going to make it harder for us to recruit from the EU – we're a specialised organisation and we won't be able to find everyone we need from the UK.

Has Brexit changed your perception of the UK as a place to do business and invest?

Three years ago, we scanned the world to decide where to place our global HQ. A stable tax policy, stable government and law, easy access to the EU, good access to a highly skilled workforce and proximity to Heathrow helped swing it for Maidenhead. Brexit clearly has the potential to erode a number of these benefits.

How would you describe businesses conditions and the outlook in general?

The critical importance of influenza vaccines means that we're fairly resilient to economic cycles and our innovation agenda is driving growth. So overall our outlook is positive, and we are prepared – regardless of which way Brexit ultimately unfolds.

Regional data show UK slowdown is nationwide

Looking at the UK economy from a regional perspective indicates that the weakening growth picture extends broadly across the country. While employment levels remain impressive in all regions, forward indicators point to a slowdown across virtually the whole country in the near term.

In fact, the Regional Purchasing Managers' output index shows that while managers in every region bar one expect output to grow, the trend is overwhelmingly negative. Only in Northern Ireland did the prospects for output increase from September to October and only in the South East did the picture improve from August to October.

In the North East – the only region currently in negative territory – purchasing managers reported a further contraction in output, with a fall in the index to 47.4 (see Chart 1).

Wales and the East Midlands have shown the most resilience. Despite posting falls in both September and October, they had the highest Purchasing Managers' Index (PMI) levels at 53.6 and 54.2 respectively.

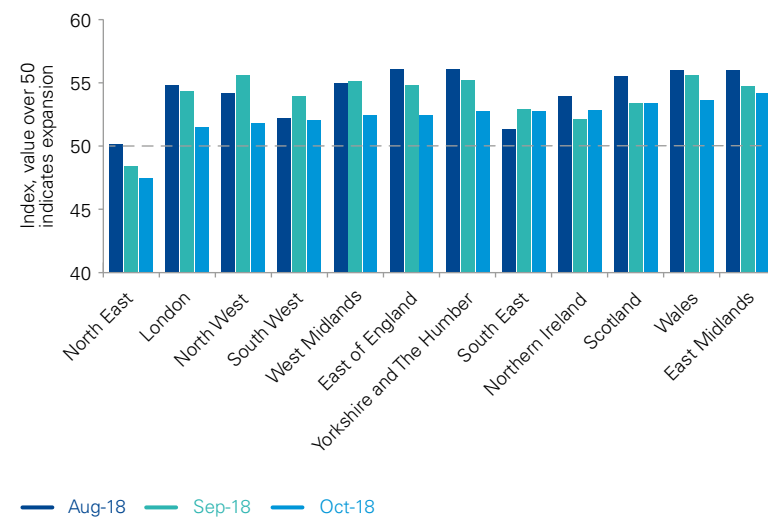
Unemployment

Unemployment rates improved across most regions year on year in the three months to September. The latest data show that, in every part of the UK, the unemployment rate is now at, or below, 5% (see Chart 2).

The North East and the West Midlands – both with a high of 5.5% a year ago – delivered sharp falls in their headline rates of unemployment to 5% and 4.9%, respectively.

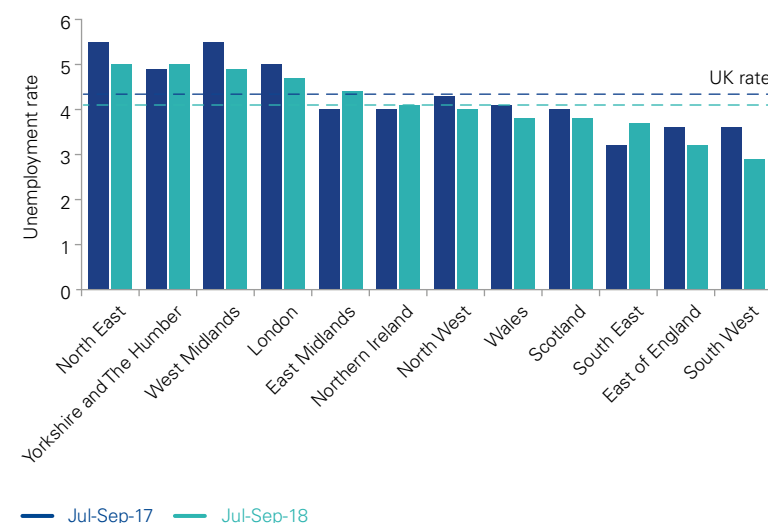
There were four regions where the unemployment rate rose over this period: the South East, Northern Ireland, East Midlands, and Yorkshire and The Humber. However all these regions were below the UK average rate to start with. It is only in the East Midlands that unemployment has increased to above the national rate.

Chart 1: Regional Purchasing Managers' output indices



Source: IHS Markit/NatWest

Chart 2: Unemployment rate across different UK regions



Source: ONS

Employment

Similarly, the level of employment increased in most UK regions, with the strongest growth in Wales and the West Midlands. These regions also experienced large falls in the rate of unemployment. The fastest pace of earnings growth took place in the East Midlands and in the East of England, where wages for full-time workers grew by 7.4% and 6.6% respectively (see Chart 3).

In three regions, total employment fell, year on year, between July and September: Scotland, the North East and the South East. In both Scotland and the North East, average earnings also fell during this period.

The picture in the North East gives us most cause for concern. Reinforcing the negative view shown in the PMI data, it appears that the rapid fall in the unemployment rate in this region is more the result of people dropping out of the labour force than new jobs being created.

Housing

The prospects for the UK housing market remain consistent with the broad slowdown in house-price growth we identified in the September edition of our Economic Outlook⁷. Overall house prices in the UK increased by 3.5% in the 12 months to September 2018. The strongest growth, of 6.1% and 6%, was in the West and East Midlands.

The London region remains the most affected, house prices fell over the same period by 0.3%. We continue to expect that the fastest growth of house prices will take place in Scotland, increasing by 4.9% in 2018. This is in line with the latest data and would represent a moderation from a current rate of growth of 5.8%.

Chart 3: Changes in regional employment and earnings between Jul-Sep 2017 and 2018



Source: ONS

⁷ See full details of our forecast at kpmg.com/uk/economicoutlook



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Stronger third-quarter growth rate masks underlying weakness

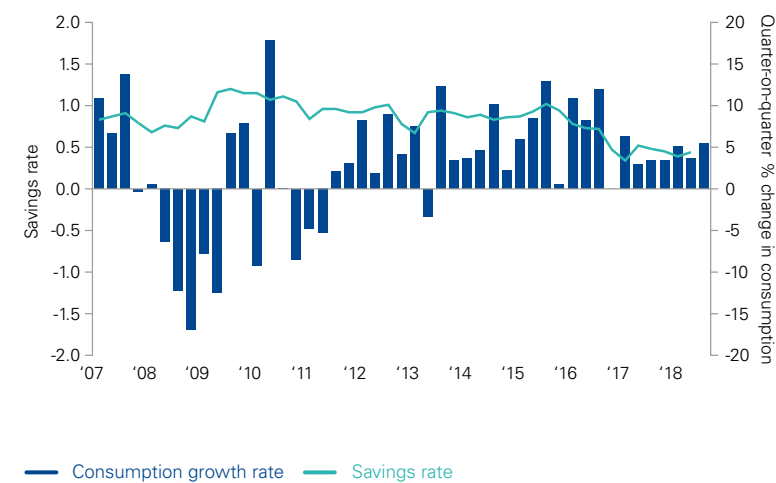
Following a weak first quarter and some recovery in the second, the UK economy perked up in Q3, growing by 0.6%. However, this momentum is unlikely to last. Looking at monthly performance, only the first month of Q3 – July – saw growth, with good weather helping boost demand for retail and hospitality sectors. Overall output was flat in both August and September.

Consumption growth has peaked in the short term

Quarterly consumption growth has picked up a little so far this year, despite the bad weather at the start and uncertainties around Brexit continuing. Firmer earnings and subsiding inflation are handing more spending power to households, but they are unlikely to trigger a further rise in consumption growth. The BRC-KPMG Retail Sales Monitor reported subdued retail sales growth for October and November. The Black Friday week gave a significant boost to online purchases, but did little to lift overall sales, with total sales growth in November falling to its lowest rate in seven months. The trend observed is in line with earlier ONS figures showing two consecutive months of decline in total retail sales in September and October.

Faced with falling real incomes in most of 2017, households chose to smooth spending by drawing down on savings. But with the current saving rate at around 4% (see Chart 4) there is limited scope for them to repeat the trick next year. The rising cost of consumer credit and stock market wobbles further drain consumer confidence in the economic outlook.

Chart 4: UK consumption growth rate and savings rate



Source: ONS

Falling business investment due to Brexit uncertainties

While overall investment spending picked up in Q3 thanks to a strong rise in government investment, business investment declined for the third consecutive quarter (see Chart 5 below). Uncertainties around Brexit are likely to be behind the poor performance, with other factors such as rising interest rate also contributing.

A closer look at investment categories reveals weak investment intentions across the board. Recent Confederation of British Industry (CBI) surveys show subdued investment intentions on 'land and buildings' and 'plant and machinery' across all of manufacturing, consumer services, business and professional services, and financial services sectors. The slowdown in capital investment is unhelpful in addressing the UK's productivity challenge.

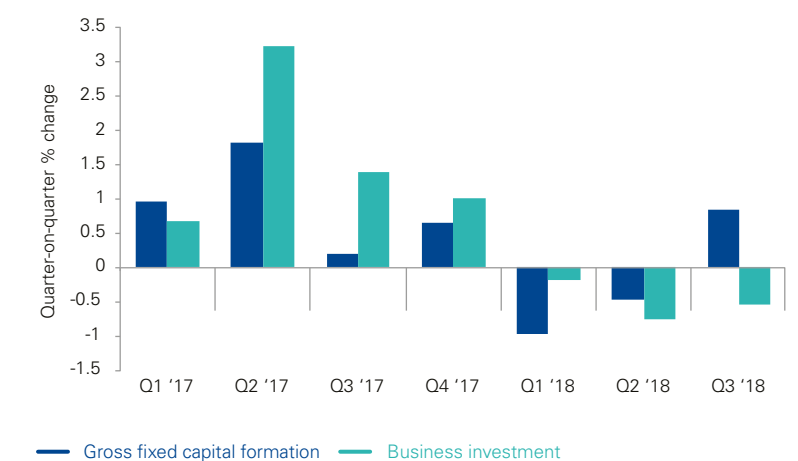
Within the subdued investment picture – and despite myriad sources of uncertainty – most businesses are clear about the need to upgrade their IT infrastructure. The October CBI survey reported intentions to increase IT investment across the consumer services, business and professional services, and financial services sectors.

Strong exports unlikely to be sustained

Exports grew robustly in Q3 after contracting in the first half of the year. Moreover with imports flat during Q3, the UK recorded its lowest trade deficit in real terms since Q2 2014 (see Chart 6). Exports to both EU and non-EU trading partners were strong, while a sharp decline in imports from EU countries was partially offset by increased imports from non-EU countries.

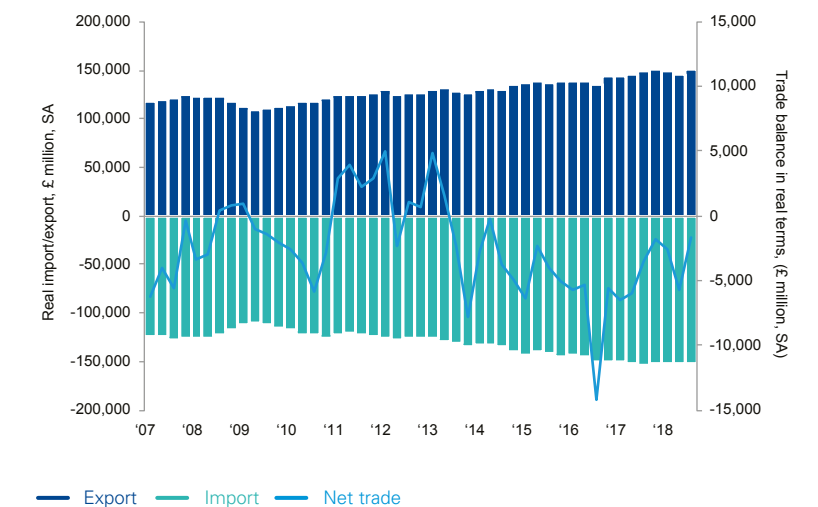
With quarterly export performance relatively volatile, it is too early to tell if this improved performance will continue. Signs of global economic slowdown and rising protectionism suggest it may be harder to sustain. Both September and October manufacturing PMI surveys recorded decline in foreign demand, with inflows of new orders from EU countries severely affected by the uncertainties around Brexit and new orders from non-EU countries insufficient to make up for the loss.

Chart 5: Business investment declined for the third consecutive quarter



Source: ONS

Chart 6: Q3 was the lowest trade deficit since Q2 2014



Source: ONS

The sector view: all expanding, but new work is slowing momentum

After a difficult start to the year, both the manufacturing and construction industries enjoyed a sizable rebound in Q3. But recent strength is unlikely to secure a similarly strong performance for 2018 as a whole compared to 2017.

Meanwhile, growth in the services sector continued on a steady, if insipid, path. Rising economic uncertainties – both in the UK and abroad – are making their impact felt across the whole economy.

Construction: strong recovery following a cold winter

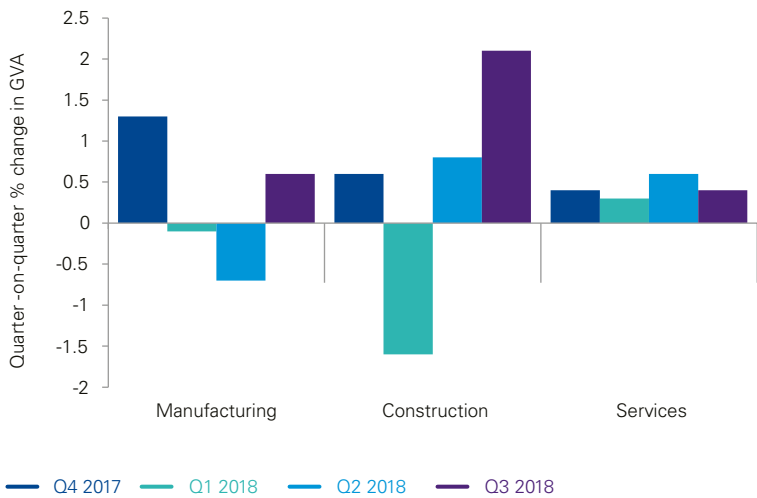
After being hit by the unseasonably cold weather at the start of the year, the construction sector enjoyed a particularly strong Q3 with 2.1% growth on the previous quarter (see Chart 7). The increase was mostly attributable to new work which, after two quarters of decline, rose by 2.8% in Q3. Within new work, new housing – both public and private – experienced strong growth. Infrastructure also saw the strongest growth rate since Q1 2015.

However, the latest positive output data may not last. The latest construction PMI surveys in the two months of Q4 point to slower growth in new orders than in Q3, with uncertainties around Brexit taking their toll.

Services: steady yet unremarkable performance

Services growth moderated slightly in Q3 to 0.4% (See Chart 7), while growth was relatively broad-based across sub-sectors. Financial and insurance services achieved reasonable growth of 0.5% in Q3 after a flat Q2 (see Chart 8). Professional services and administration support also exhibited slightly stronger growth of 0.4% after a sluggish Q2, although performance remained weak relative to historical growth numbers.

Chart 7: Manufacturing and construction rebounded, while services moderately declined



Source: ONS

At the same time three industries saw a moderate decline in growth rate in the third quarter – transport, storage and communication; hotels and restaurants; and wholesale and retail trade. The first of these was the strongest performer within services for the second consecutive quarter. Computer programming also continues to be the pillar for growth within this sector.

The slowdown in Q3 signals that expansion in services activities may have been losing momentum recently. The latest services PMI surveys highlight weakening new business growth reaching 50.4 in November, the lowest level since the immediate aftermath of the EU referendum. Brexit is again the looming factor behind poor optimism among businesses and clients’ reluctance to commit to new orders.

Manufacturing: weakening global demand and trade tensions

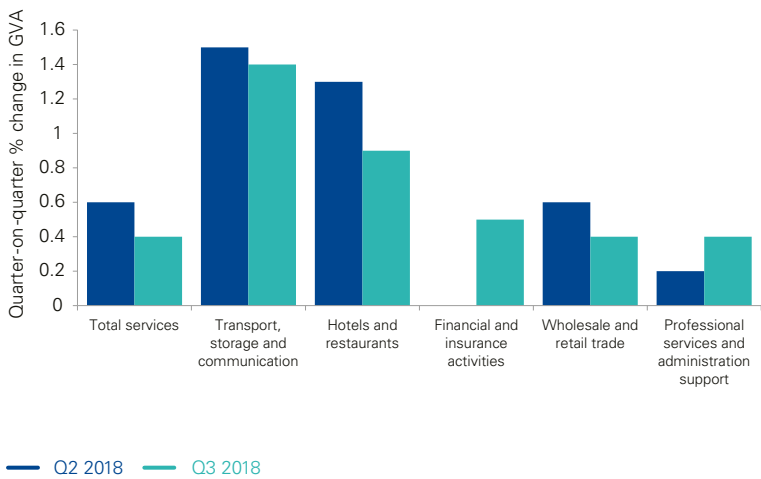
In our September report, we noted the disappointing performance of UK manufacturing, especially manufacturing exports, in an environment of weak sterling and strong global demand. After two quarters of decline in Q1 and Q2, we have seen a bounce-back in manufacturing output in Q3 with 0.6% quarter-on-quarter growth.

Capital goods and intermediate goods showed positive growth, unlike consumer goods. Output of motor vehicles, trailers and semi-trailers – the largest contributor to the strength in manufacturing growth in Q3 – increased by 3.4%, partially recovering from the 3.9% decline observed in Q2. Basic pharmaceutical products, the fastest growing sector in Q2, suffered from the sharpest decline in Q3 – down 3.2%.

The strong growth performance in Q3 should not obscure the fact that one quarter of recovery alone has not been enough to return manufacturing to the level of output recorded at the end of last year.

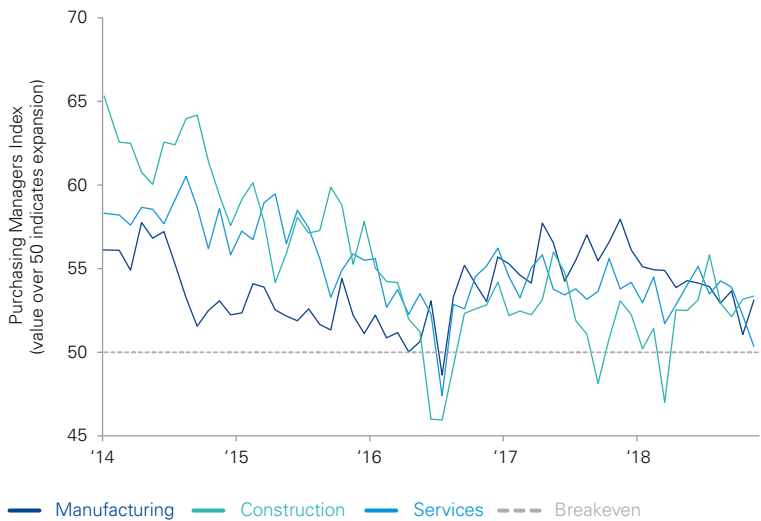
Headline indicators from manufacturing PMI surveys have been on a downward trend since November 2017. Although the overall reading recovered a little from October’s 27-month low in November, it is still close to the lower end of the range in the past two and half years (see Chart 9). Domestic new orders saw a modest increase from a low base in October, but export orders fell for the second month in a row. Manufacturers’ confidence also reached its lowest level since August 2016. More clarity around a Brexit deal could help alleviate other concerns such as rising trade tensions more globally.

Chart 8: Moderate decline in services growth rate across most industries



Source: ONS

Chart 9: Manufacturing PMI on a declining trend



Source: CIPS/IHS Markit

Staff shortages prompt rising wages

Despite the slight increase in the rate of unemployment to 4.1% in the three months to September, there are signs that the labour market remains tight nevertheless. Earnings growth has picked up since July, as businesses appear to be stepping up efforts to retain and hire staff in an increasingly competitive market.

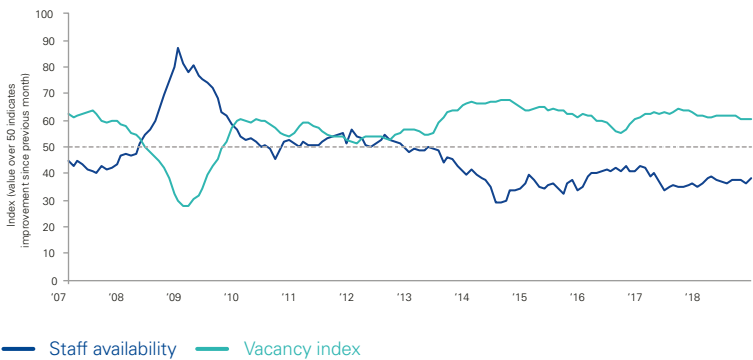
Based on results from the KPMG-REC survey, there are signs suggesting the tightness in the labour market is starting to be driven more by staff shortages than by a rise in the number of vacancies (see Chart 10, which tracks the proportion of businesses experiencing increases in vacancies and a separate index for the number of available staff). Normally, these two indicators move in opposite directions since vacancies will tend to rise when there are fewer workers to fill those jobs. However, since the start of the year, the vacancy index has consistently drifted downwards.

Despite the slowing in the rate of growth of new job openings, the total number of vacancies increased to 845,000 in the three months to October. This compares to 801,000 a year ago, and means there are now 2.8 vacancies for every 100 filled jobs in the economy – the highest rate since records began in 2001.

The September edition of this Outlook pointed out the puzzling fact that record low rates of unemployment had not resulted in a faster pace of pay growth. There are now signs that this has finally happened and staff shortages meant that nominal growth in regular pay rose to 3.3% in August – the fastest rate in almost a decade.

Regular pay growth has since eased slightly to an annual rate of 3.2% in September, which is still relatively high by recent standards. Chart 11 shows the relationship between the rate of vacancies and pay increases since the start of 2007, which have tended to move in line with one another. The big break seems to have come in 2013, where even as the economy began to recover strongly, the rate of pay growth lagged behind.

Chart 10: KPMG-REC survey on jobs



Source: KPMG-REC survey

The most acute staff shortages were recorded in the accommodation and food service sector, where the ratio of vacancies to filled jobs was 4.1%. As businesses in this sector find it more difficult to recruit staff, so earnings growth in this sector, measured with wholesale and retail trade has picked up – reaching 4.7% in August versus 2% at the start of the year.

Will pay growth return to levels last seen between January 2001 and December 2008, when the average rate of annual pay growth was 4%? It seems unlikely. The missing factor is productivity growth, which between 2001 and 2008 grew at an annual rate of 1.9% (measured as output per hour). This compares to an increase of just 0.1% in the year to the third quarter of 2018.

Nevertheless, policymakers at the Bank of England will worry that high rates of pay growth could lead to higher inflation down the road.

Chart 11: Relationship between vacancy rate and pay increases



Source: ONS

Imported inflation under control, while domestic inflation is building up

Imported inflation wanes as sterling stabilises

Sterling has depreciated significantly against major currencies since the Brexit referendum in June 2016. The sterling Exchange Rate Index (ERI), a weighted basket of the sterling exchange rate against the currencies of UK's major trading partners, lost around 7% of its value on referendum day and has stayed around the 77-81 range most of the time since then (see Chart 12).

After a short-lived rise in the summer, Consumer Price Index (CPI) inflation has shifted back to a downward trend towards the Bank of England's target rate of 2%.

Sterling weakness has been a major driver behind above-target level of inflation since early 2017 as a large segment of the UK consumer goods basket is sensitive to the price of imports. From the second half of 2016, the contributions of import-intensive sectors to inflation – including food and non-alcoholic drinks, furniture and household goods, and clothing and footwear (see Chart 13) – increased steadily until early 2018. After that we saw the level of inflation largely stabilising around the 2.4-2.5% level, reflecting the weakening effect of sterling depreciation on import prices.

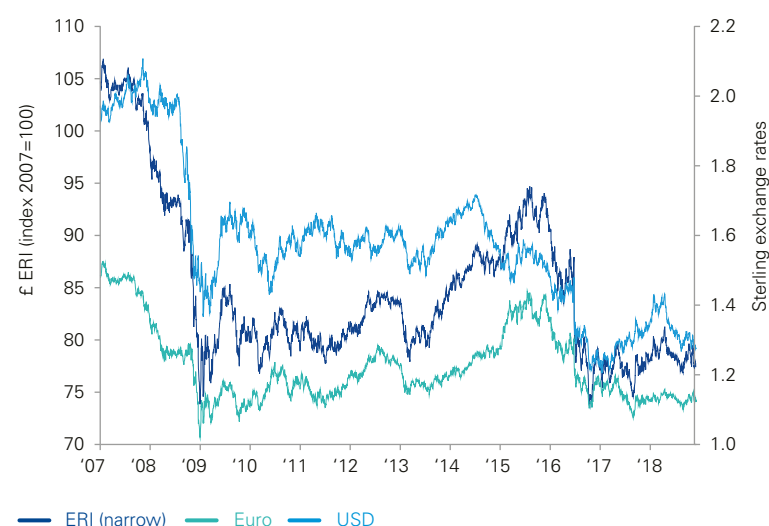
In recent weeks we have seen more volatility in sterling. That is likely to persist as we move closer to Brexit day and the market reacts to any news that veers away from expectations. That said, we expect the extent of any volatility to be limited and, in the near term, we do not foresee another major round of sterling depreciation and therefore do not expect higher imported inflation either.

Oil prices in retreat

Rising oil prices over the past two years has been another driving force behind UK inflation. Its impact is reflected in the increasing contribution of transport costs as well as housing & household services costs to CPI since the second half of 2016 (see Chart 13).

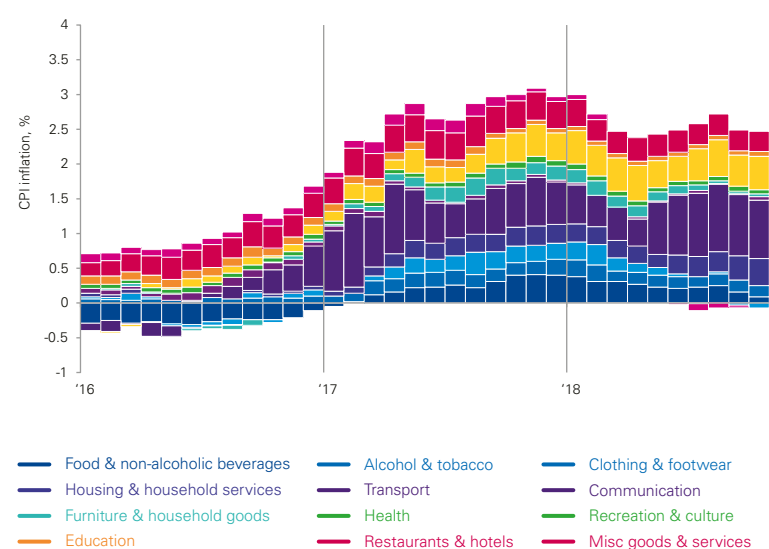
The most recent CPI data in October reveal that rising utility bills and petrol prices offset the falls in prices for food and clothing, leaving CPI inflation unchanged at 2.4%. The good news is that the rising trend in the oil price since the start of 2016 may have come to a halt in early October (see Chart 14), which will further ease imported inflationary pressures.

Chart 12: Sterling exchange rates



Source: Bank of England

Chart 13: Contributions to annual rate of CPI inflation



Source: ONS

Interest rates remain on a rising track

While imported inflation is gradually subsiding, domestically-generated inflationary pressures have been building up.

With unemployment rate below the level judged by the Bank of England to be sustainable alongside stable inflation, labour market tightness has started to translate into a pick-up in earnings growth. Additional evidence has come from the Services Producer Price Index, which saw its sharpest increase in the third quarter since Q2 2010.

The output gap, which measures how far the actual output of the economy falls short or exceeds its potential, has also turned positive, with the OBR estimating it to reach 0.2% in 2018 and to rise to 0.3% in 2019.

Unless productivity surprises on the upside, the UK economy is heating up.

With growing signs of domestic inflationary pressures, the Bank of England raised interest rates to 0.75% in August. The MPC also confirmed its intention to continue raising rates gradually should the economy evolve as expected.

The MPC was reluctant to prescribe a course of action in the event of a more negative Brexit outcome, such as 'no deal', in its November statement and the Inflation Report. It pointed to the possibility of raising rates should it judge the productive capacity of the economy to be very tight. Their argument was that if output were low because of supply-related difficulties, rates would need to rise in order to adjust demand accordingly and hence prevent inflationary pressures from escalating.

In practice, we believe that in the event of a more turbulent Brexit, while the MPC may prove more cautious in providing a monetary stimulus to the economy, it will still act when needed to bolster individual markets and lower rates somewhat to cushion demand.

Chart 14: Crude oil price



Source: Energy Information Administration

Forecast windfall in public finances channelled into health spending

October’s Budget struck a compromise between an ambition to end austerity and maintaining the fiscal discipline needed to improve public finances. In that aim, the OBR’s revisions to public finance forecasts proved to be a big help.

The government achieved an ‘end to austerity’ in the very narrowest sense of the word. Departmental spending is now set to increase by 1.2% per year in real terms. The caveat to this is that health takes most of the increase in spending, which helps push up the average (see Chart 15).

For unprotected departments, some real-term cuts in spending per person may continue, the 2019 spending review will decide which. The same applies to planned cuts to welfare, which are also set to go ahead.

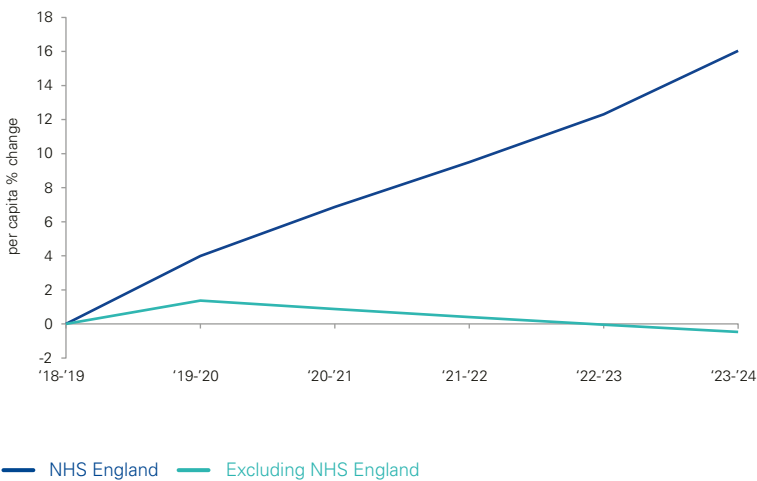
Room for the increase in spending was made thanks to a number of revisions to forecasts and recognition of past forecast errors by the OBR compared to what actually happened. The deficit for 2017-18 was £5.4 billion lower than the OBR had expected. Projections for this year’s deficit were also revised downwards due to better-than-expected actual figures in the fiscal year to date, thanks to higher corporate tax receipts. And lastly, the OBR revised its growth estimate for 2019, from 1.3% to 1.6% at the time of the chancellor’s March statement.

Chart 16 shows how all these changes between the March forecast and October (pre-measures) forecast would have led to lower borrowing requirement in every year of the OBR’s forecast.

But it also shows how the government’s new spending plan, outlined in October, increases forecast borrowing every year after 2018-19 to the original deficit path set out in March.

Some of the increases in day-to-day departmental spending will be funded by cutting back on the size of capital budgets (the OBR estimates these will fall by £5.4 billion in 2020-21). Our concern is that this reallocation could lead to the public sector playing a less active role in raising the UK’s productivity since capital budgets are used to fund public investment.

Chart 15: Cumulative change in real day-to-day departmental budgets from 2018-19 fiscal year



Source: OBR

The government’s own fiscal mandate requires it to keep its cyclically adjusted public sector net borrowing below 2% of GDP by 2020-21 (coupled with a falling debt-to-GDP ratio). Before the budget was announced, net borrowing was expected to be 1.3% of GDP in 2020-21, and now after the changes to both forecast and spending plan, it is unchanged at 1.3% of GDP. This leaves room for an additional £15bn increase in spending – funds kept in reserve against unforeseen Brexit emergencies.

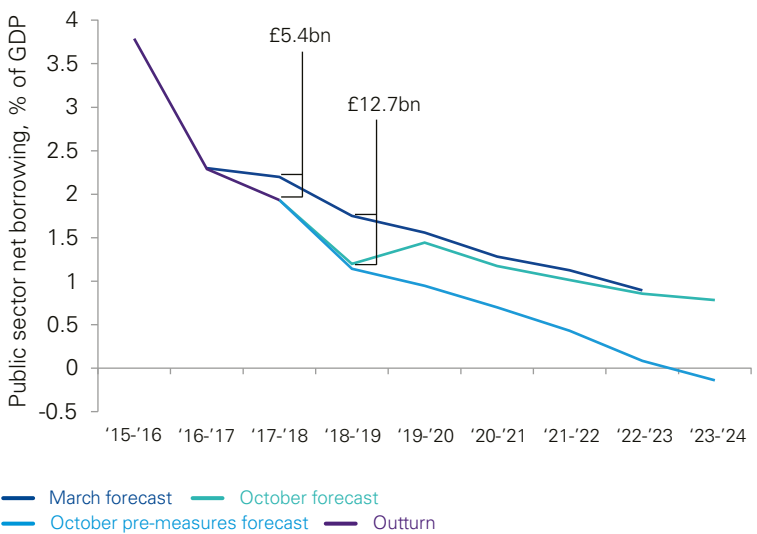
With the target for the fiscal mandate still two years away, there is currently no reason to doubt the government’s ability to meet this goal, as long as the economy continues to grow at current estimates.

However, should the economy slow significantly between now and 2020, then it is unlikely that the current level of the ‘fiscal room’ will be enough and the mandate would need to be revised, if not completely abandoned. By choosing to spend the ‘windfall’ from the improved forecast, the chancellor has not seized the opportunity to make it more likely for him to meet his target by increasing the available headroom.

In fact, based on data published a month after the Budget, public finances have already taken a big hit. For the 2018-19 fiscal year, the cumulative deficit up to the month of October has now reached £26.7 billion – higher than the OBR’s forecast for the full year.

The Budget sought to deliver a finely-balanced compromise between a modest increase in spending while sticking closely to past deficit reduction plans. But with so much hinging on uncertain forecasts about the future path of the economy and public finances, targets may not be as easily met.

Chart 16: Revisions to public sector net borrowing plans and expected effects of budget measures



Source: OBR



Outlook for UK equities

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Outlook for UK equities

The FTSE 100 has more than doubled in value since touching a low of 3,512 during the 2007-08 Great Recession. But the rise since then has not been the story of one continuous bull market. We saw corrections, most recently in October and before that in February and with rising interest rates and the uncertainty of Brexit, get ready for more volatility.

Here we explore some of the key trends affecting UK stocks and how they could play out over the next 12 months.

If markets are functioning efficiently, then the current share price should reflect all available information on future profitability. Aggregating all share prices should broadly reflect the performance of the overall economy.

For the UK, the picture is more complex with many large multinational companies in the FTSE 100 and FTSE 250 that earn a large proportion of their revenues outside the UK. The pound value of these companies' earnings depends on the exchange rate – if sterling were to depreciate, their earnings expressed in

pounds increase and that should translate into higher share prices in sterling.

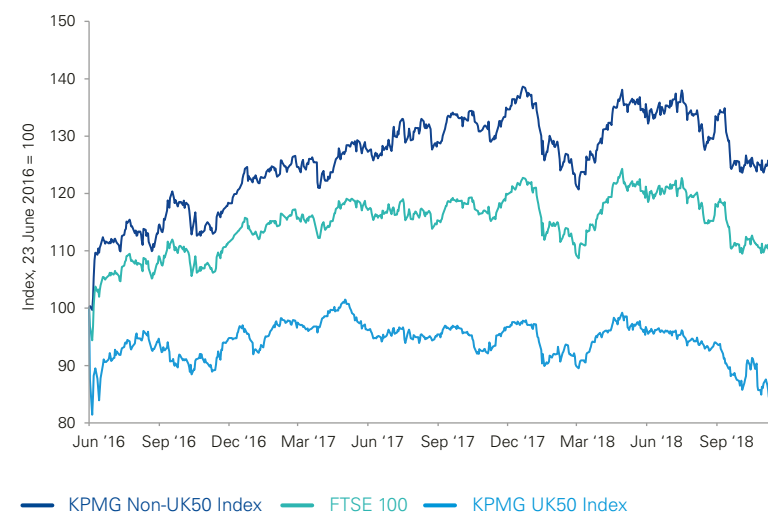
Creating a UK and non-UK index

To see this effect more clearly, we created two indices. The KPMG-UK50 consists of the 50 largest UK companies from the FTSE 350 that derive at least 70% of their earnings inside the UK. Meanwhile the KPMG Non-UK50 comprises the opposite: an index of the 50 largest companies from the FTSE 350 that draw at least 70% of their revenue from outside the UK. Chart 17 shows how much better the Non-UK50 has performed than the UK50 since the EU referendum.

A gap between the two immediately opened up as investors anticipated that restrictions to trade would negatively affect UK companies and was also due to an 11% fall in sterling in that first week – pushing up the value of non-UK companies.

Within a week of the referendum, the Non-UK50 was 18.1% higher than its UK focused equivalent.

Chart 17: KPMG Indices performance since the EU referendum



Source: Thomson Reuters, KPMG Macroeconomics

Not just a forex story

Two-and-a-half years later, the latest data show that the gap has now widened to nearly 34%. However this is not just a story of weaker sterling boosting foreign-focused firms. Chart 18 cancels out the exchange rate effect by rebasing the performance of both indices in US\$ terms, and comparing them against the FTSE All World index.

Up until the start of this year, the performance of the KPMG Non-UK50 index was broadly in line with the FTSE All World index – up 24% and 26% respectively – in other words, a small discount on UK-quoted stocks.

However, since the start of this year the discount on UK-quoted stocks has widened with a 13% fall in the Non-UK50 index compared to a 5% drop for the FTSE All World. Looking ahead to 2019, the FTSE seems to be finding less support from the exchange rate than it has until recently.

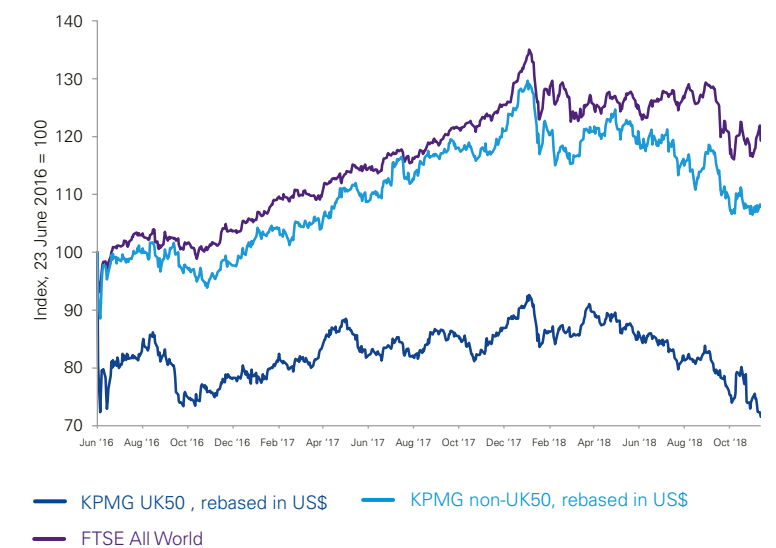
To understand what's behind these movements and what might drive market sentiment around the final outcome of the Brexit process it's worth examining how close

their fortunes contrast or coincide. Chart 19 shows the percentage difference between the two KPMG indices, adjusted for the effect of the exchange rate⁸.

There appear to be three distinct stages, which mirror phases of the Brexit process itself. In the first, from the referendum to the triggering of Article 50, uncertainty was arguably at its height on what the result meant for the future EU-UK relationship: from remaining in the Single Market and Customs Union at one extreme to trading on WTO terms at the other. Therefore it's perhaps unsurprising that the gap between the two indices swung sharply over nine month period.

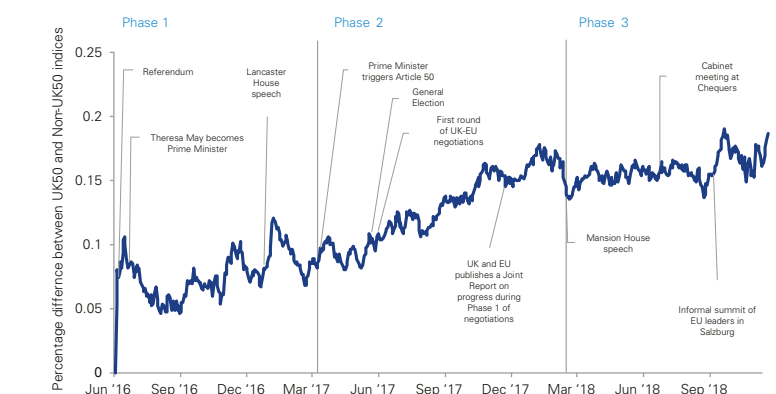
The second stage, from the triggering of Article 50, to the day of the prime minister's Mansion House speech showed a gradual widening of the gap between the two indices. It appears that over this time, market participants were gradually gaining a better understanding on the potential Brexit outcome and the course of the process.

Chart 18: KPMG UK50 and Non-UK40 indices, rebased in US Dollars



Source: Thomson Reuters, KPMG Macroeconomics

Chart 19: Percentage difference between KPMG UK50 and Non-UK50 indices, adjusted for exchange rate



Source: Thomson Reuters, KPMG Macroeconomics

⁸ The adjustment was done by subtracting the percentage change in the trade-weighted exchange rate from the series for the percentage difference between the UK50 and non-UK50 indices. What remains should be a measure of the change in investors' expectations for the future profitability of these stocks.

Unlike the first period, this was a more ordered phase of information discovery, with fewer large fluctuations and less frequent reversals. The indices tended to drift apart – with the Non-UK50 further outstripping its domestic equivalent – as the government reaffirmed a commitment to carry out the referendum result and the option of remaining in the Single Market lost ground politically in favour of a more distant future relationship with the EU.

The last phase, which began from the date of the Mansion House speech to now, appears to show a stable, if fluctuating gap between the two.

It appears that the proposals contained in the ‘Chequers plan’ did not have a powerful effect favouring UK or non-UK. There was, however, a sharp spike in the gap between the two indices after the EU leaders’ summit in Salzburg. This may reflect a sudden realisation that a no-deal Brexit was now more likely.

Implications for equities in 2019

The path of the two indices provides a useful guideline as to what might happen in the next 12 months. We consider some of the main influences that could drive the direction of UK equities:

- **A smooth Brexit transition.** This scenario should eliminate the risk of a more damaging outcome involving sharp and sudden trade restrictions. A potential mild appreciation of sterling would tend to push down the value of our Non-UK index, while less uncertain and improved prospects for the domestic UK economy would lift the value of UK focused companies. Depending on the shape of the deal, the gap between the two could narrow.

- **External risks from trade frictions, or a slowdown in the euro area.** External weakness in the EU or US economy will tend to lift sterling against the euro and US dollar, as well as lead to a downward revision in the potential profitability of non-UK-focused companies. While the index of domestically-oriented companies is likely to be largely unaffected in this scenario, the values of the KPMG Non-UK50 would drop more significantly.
- **General market correction.** In line with other markets around the world, particularly in the US, where the S&P 500 had an elevated price to earnings ratio of 19 in early December, we could see further significant corrections. This could lead to a potential correction for UK equities, although with a P/E ratio of 11.5, the FTSE 100 appears to be on a more solid footing.

At the start of 2018, many commentators had predicted the FTSE 100 would break 8,000 this year. It got close in May, reaching 7,903, but now threatens to close the year below 7,000 instead. Investors should not expect any easing in the high volatility we’ve seen this year, as even a favourable resolution of issues like Brexit could herald a sharp realignment in share prices.

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