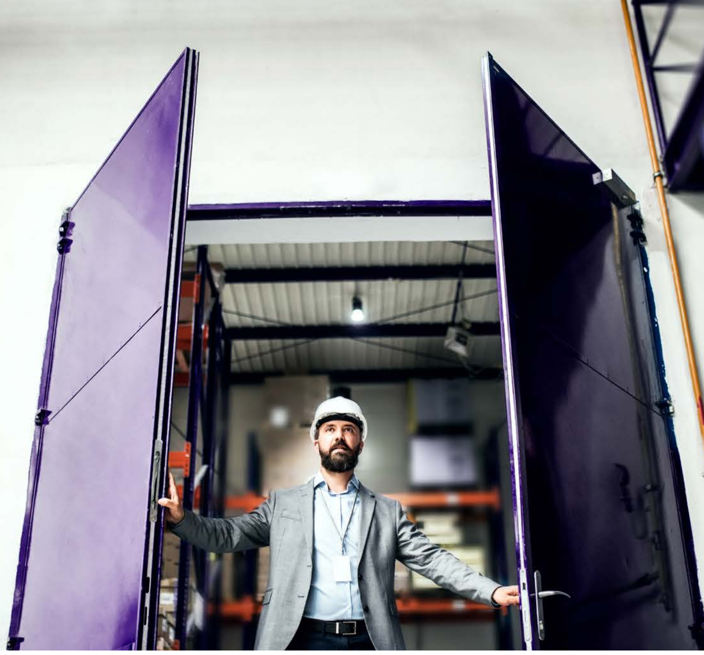

# New beginnings

## UK Economic Outlook

November 2020

As we approach the end of 2020, most of us will probably say that this year has been nothing like the one we had anticipated. This year brought many challenges, and sacrifices. It also brought big changes in the way we work and live, and caused us to re-assess our priorities.

Some of these changes are likely to stay even after the pandemic is over, which could be as early as the spring given the latest news on a potential vaccine. The pandemic has made us appreciate other ways of working, communicating and shopping. It has also put a higher value on things like quality of life, climate change and social equity.

The end of the pandemic is likely to mark the beginning of a new way of living and a new approach to life. We should all embrace it, as it is a positive direction, and begin planning now – if you haven't already – for the changes ahead.

- An early **vaccine** could see growth momentum accelerate from early next year, with the lifting of all social distancing restrictions from late spring bringing a particular boost to consumer-facing and travel sectors.
- While we expect a **Brexit** deal in our main scenario, UK borders are likely to experience some frictions during at least part of next year, making the trade in goods less smooth. Exports of services will also be affected, as they will not be covered by a deal, and Foreign Direct Investment (FDI) may be lower as a result of reduced access to the EU market.
- We expect the November lockdown in England to cause **GDP** to fall again in Q4. As a result, output in 2020 as a whole will contract by 11.2%, nearly three times the contraction during the 2009 recession. A partial recovery in 2021 could see growth of 7.2% next year. We do not expect output to reach pre-COVID levels before the end of 2022.
- The extension of the furlough scheme in November has potentially forestalled a sharp increase in **unemployment** in the final quarter of 2020. We now expect the rate of unemployment to peak at 7.8% around May next year before gradually subsiding.
- Changes to VAT and a stronger global economic backdrop could see **inflation** pick up next year and average 1.9% subsequently, just below the Bank of England's target.
- Despite this, the Bank of England is likely to stay focused on supporting the economic recovery with **interest rates** not expected to rise before late 2022.

### Table 1: KPMG forecasts

(Scenario assumes a vaccine is approved in Jan 2021 and the UK agrees a deal with the EU)

| | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|
| GDP | 1.3 | -11.2 | 7.2 | 4.9 |
| Consumer spending | 0.8 | -14.4 | 7.3 | 5.6 |
| Investment | 1.5 | -12.6 | 5.4 | 5.8 |
| Unemployment rate | 3.8 | 4.7 | 7.3 | 6.8 |
| Inflation | 1.8 | 0.9 | 1.4 | 1.9 |
| Base interest rate | 0.75 | 0.1 | 0 | 0.25 |

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


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# Outlook for GDP: The rocky road to recovery

The ongoing lockdown in England and elevated restrictions across the UK could lead to a 2% fall in GDP in the fourth quarter of this year. This means that GDP could shrink by as much as 11.2% in 2020, nearly three times as much as the fall during the recession in 2009. A recovery in 2021 could make up lost ground – we project growth could pick up to 7.2% – but would fall short of a full recovery back to pre-COVID levels, which could take until the end of 2022.

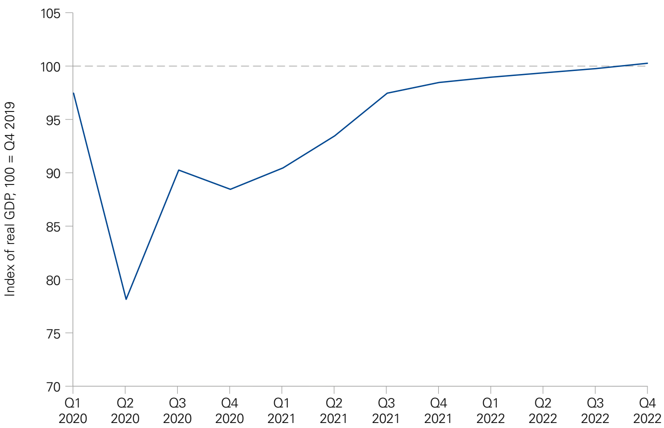
Our main scenario assumes a vaccine is approved by early January 2021 and rolled out over the following four months. This will allow all restrictions associated with the pandemic to be lifted by the end of April. Growth is expected to pick up even before then, as consumers and businesses will be able to plan with increased confidence. This scenario appears more likely given the encouraging early results in the Phase III trials of potential COVID vaccines.

However, this fillip to growth will be partially offset by the effect of the UK leaving the EU, which is likely to have a negative impact on growth during 2021. In our main scenario, we expect that a deal will be struck between the UK and the EU and this will limit the friction at borders for goods. However, some delays and cancelations are expected, while services will not be covered by the deal.

The COVID-19 recession has so far been characterised by the significant damage to consumer-facing services, which account for the 14% fall in consumer spending this year. A recovery next year could be hampered by rising unemployment and potentially weaker pay growth. This would affect consumers' ability, and willingness, to spend.

Investment could fall by 12.6% in 2020 driven by both pandemic and Brexit-related uncertainties, as well as by the need of firms and households to conserve cash during the crisis. A partial recovery in investment during next year could see it grow by 5.4%. However any continuing fallout from Brexit could be a key factor in holding back a fuller recovery in Foreign Direct Investment (FDI).

Chart 1: UK economy is expected to return to pre-COVID size in the fourth quarter of 2022




Source: ONS, KPMG forecasts

# Sector outlook: COVID's long shadow

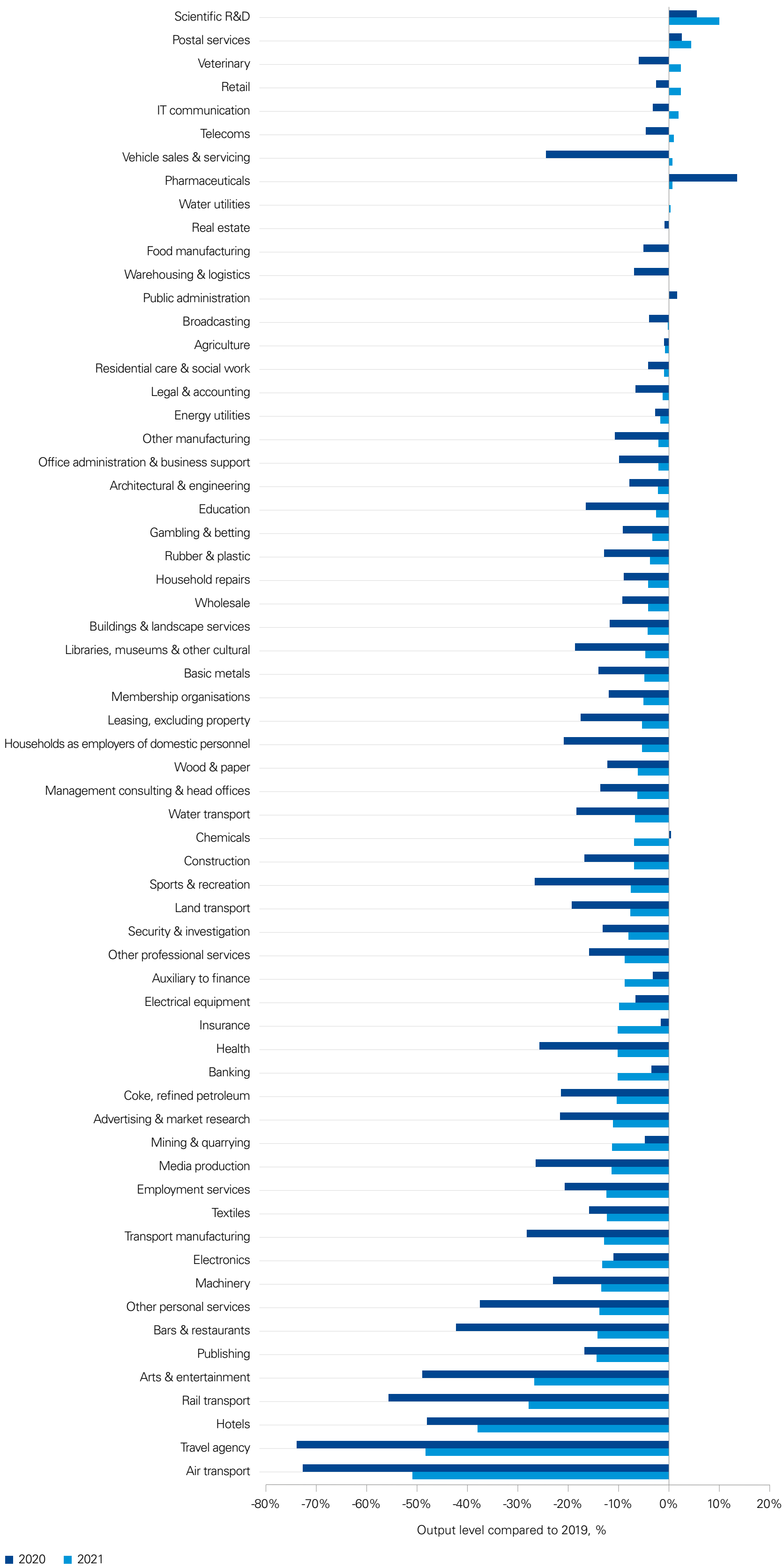
Social distancing restrictions have taken a major toll on many sectors this year. Our main scenario expects restrictions to still be in place at the start of next year and these will continue to weigh on activity across the consumer-facing and travel sectors. The roll-out of a vaccine should see the gradual lifting of restrictions and a steady pick-up in demand.

In parallel, sectors that trade heavily with the EU are likely to feel the impact of Brexit from early next year, slowing the pace of recovery. While some sectors, like food manufacturing, could see a boost in domestic demand as consumers shift away from imported goods, the overall impact will be dominated by lower sales in the EU.

A third element influencing sectors' performance next year will be the longer-term impact of the pandemic on consumers' behaviour and ways of working. A mixed pattern of home and office working may become more prevalent, leading to a fall in commuter traffic and a knock-on effect on public transport usage. It would also shift the pattern of consumption. While, as a group, bars, cafes and restaurants could recover to within 14% of their performance in 2020, much of this demand will be in different locations, away from city centres.

The travel industry has been badly hit by restrictions introduced this year, with air travel down 73% on 2019. Starting the year from a low point, the rate of recovery in 2021 may only bring the sector to 50% of 2019 levels. Business travel may remain lower, even after restrictions are lifted, as people swap face-to-face meetings with online alternatives. This will have a significant impact on profitability and the business models of airlines, hotels and the associated hospitality industry.

## Chart 2: Impacts of COVID-19 on UK sectors




Source: ONS, KPMG forecasts

# The labour market during the COVID recession: Scarring and recovery

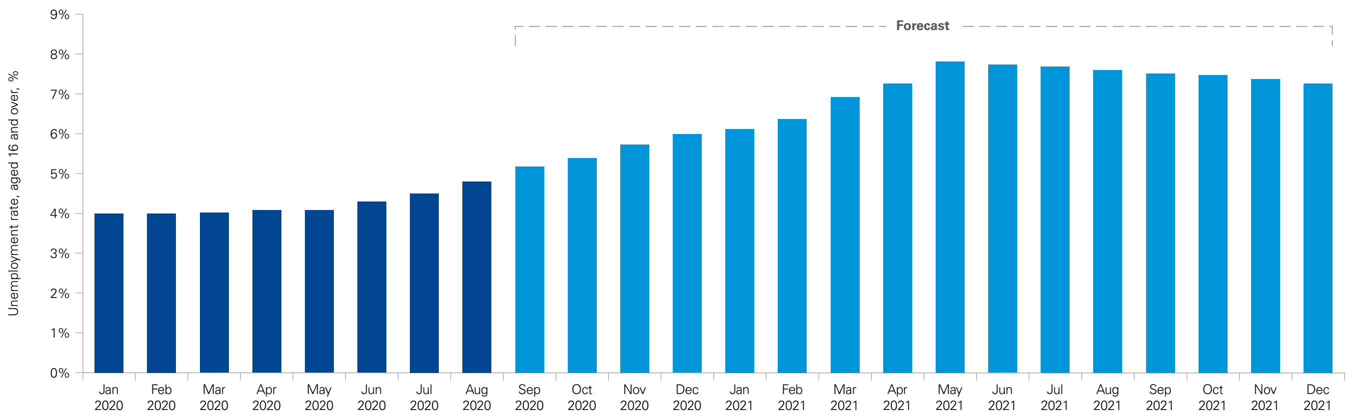
The decision to extend the JRS (Job Retention Scheme)[1] until the end of March 2021 has forestalled a sharp increase in unemployment in the final quarter of 2020. We now expect the rate of unemployment to rise only gradually while the furlough scheme is in place and reach 6% in December. For the jobs that are lost, we expect those to be the result of a longer-term shift in customers' preferences accelerated by the crisis, which have made some business activities no longer viable, as well as a result of business closures due to the severity of the current crisis.

We expect the majority of jobs in viable businesses to resume after the JRS ends, especially as many businesses may need to beef-up staff levels before they reopen. Given that some jobs will disappear, we expect the unemployment rate will peak around May next year at 7.8%, before gradually subsiding as the economy continues to recover (chart 3).

Post-Brexit, changing relations with the EU will lead to a loss of output in the manufacturing sector and this is likely to generate some job losses over the course of 2021. Further losses in employment in financial services and some professional services linked to EU clients may also ensue, making the recovery in overall employment levels in the UK somewhat weaker.

The worst affected sectors during the COVID recession, including hospitality and travel, may re-hire employees in the first half of 2021 to meet rising demand. However, given the extent that the COVID crisis has fundamentally shifted demand, there is likely to be a relatively large proportion of workers that would need to find new jobs in a different sector or business. These workers will likely require training before they can transition to new roles in growing sectors of the economy or areas such as health and social care, where there are likely to be increased staff shortages post-Brexit. Jobs in the traditional retail sector may be the worst affected, as the shift from traditional bricks-and-mortar stores to online shopping is likely to endure after the crisis is over and manifests itself in the job market.

Chart 3: Unemployment rate expected to fall gradually after Spring next year




Source: ONS, KPMG forecasts

1 https://www.gov.uk/government/news/government-extends-furlough-to-march-and-increases-self-employed-support

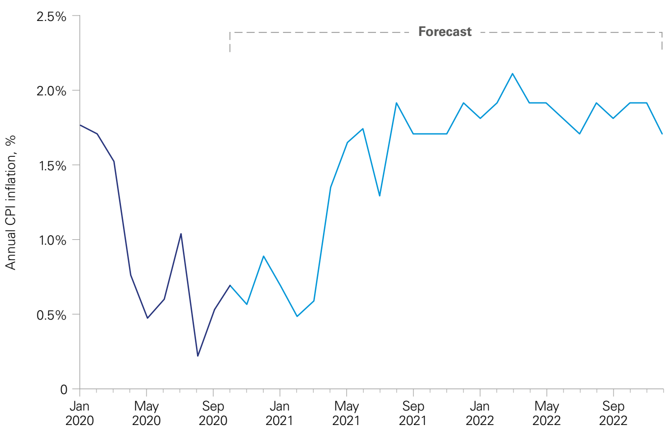
# Inflation is on the rise while rates are expected to stay low

As the economic recovery takes hold, inflation could bounce back to near the Bank of England's 2% target in spring next year. The rapid increase owes less to the domestic economic recovery as it does to temporary factors such as changes to VAT and global oil prices. April is set to see the end of the cut to VAT for hospitality businesses, which could translate into higher prices. In addition, the impact of the sharp drop in oil prices that took place earlier this year will no longer affect the year-on-year increases in the index, which helps push up the headline rate of inflation.

We expect the Bank of England to stay focused on supporting the economic recovery, with a potential fall in headline policy rates to zero at the February meeting of the Monetary Policy Committee (MPC). This will provide an additional boost to the economy but would refrain from the untested policy of negative interest rates.

Following an increase in the total target stock of assets, or Quantitative Easing (QE), to £895 billion in the November meeting of the Monetary Policy Committee, it may now choose to hold the target at its current level. Until now, the scale of QE has closely followed the financing needs of the UK government.

## Chart 4: Inflation is expected to pick up in 2021




Source: ONS, KPMG forecasts

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