

Economic outlook for business

'Economic outlook for business' summarises the latest UK quarterly forecast by the ITEM Club, and gives its assessment of the implications for business

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Forecast highlights

- ▶ The UK economy is in danger of being crushed between the jaws of world credit and commodity markets, with little prospect of early relief. The MPC simply cannot cut interest rates while the risk of a wage-price spiral remains, and the Chancellor is certainly in no position to rescue us from this fate.
- ▶ With world demand weakening and company profits squeezed by commodity price increases, the prospects of a successful rebalancing of the economy towards exports and investment are receding. The forecast shows growth falling back from 1½% this year to just 1% in 2009 as the economy flirts with recession. This would be the weakest outcome since the early 1990s. CPI inflation is set to remain above the target range of 1-3% until next autumn.
- ▶ The forecast assumes that wage and domestic cost inflation remain subdued. Barring further hikes in commodity prices, this means that CPI inflation should fall back into line with the target once this year's food and fuel price increases have come out of the annual inflation calculation. ITEM expects base rates to fall to 4% by the end of next year, helping to put a cushion under the level of demand in the economy and set the scene for a recovery in 2010.

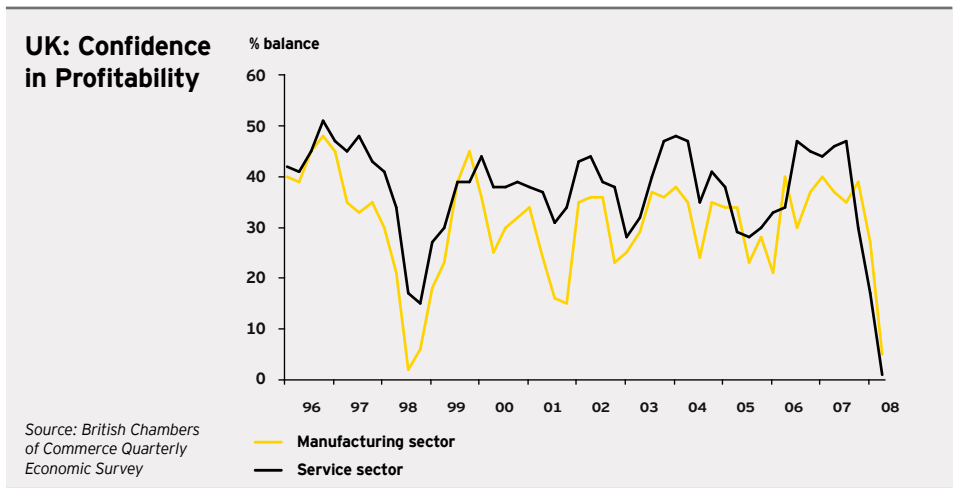
The economic outlook goes from bad to worse...

Economic prospects have deteriorated badly over the last three months. Oil prices, which had just passed \$100 a barrel when ITEM's last forecast was made in early April, are now just shy of \$150. Food and energy costs are set to push CPI inflation above 4%, delaying the prospect of further base rate cuts. The all-important service sector survey balance fell back to 47.1%. More of a surprise in view of the healthier prospects for exports, the balance for manufacturing fell by nearly 4 points to 45.8%, lower than at any time since 2001.

The FTSE100, which was trading at around 6000 at the time of ITEM's Spring forecast, is now testing 5200. The LIBOR-base rate premium has moved back up close to 1%, so market interest rates are higher despite the base rate cut in May. The wholesale markets remain frozen and the mortgage market has moved from feast to famine. Commercial and residential property prices are falling and the CIPS purchasing managers balance for construction plunged to 38% in June, the lowest since this survey started in 1994.

...with the housing market collapsing...

New mortgage approvals crashed in May. The figure of 42,000 was down 28% on April and 64% on a year earlier. The number of families moving house fell back to 100,000, about 40% down on the



average of the last few years. The RICS survey remains at rock bottom, with only a handful of respondents saying that prices are rising in their areas. CML data show that although refinancing activity is holding up, lending for house purchase has nosedived. Similarly, the Bank of England's June Credit Conditions survey suggests that the demand for mortgage borrowing is falling back faster than supply. The housing crisis is mutating from a credit crunch to a collapse in confidence as purchasers put their plans on hold in the expectation of much lower prices. Transactions will remain in limbo until sellers' expectations and prices come down to earth.

...but consumers are in denial...

Economic activity takes time to react to a tightening of credit and money market conditions. Domestic expenditure fell in the first quarter, but that was largely due to a fall in spending on inventories and investment. Households remained in denial, digging even deeper into savings to keep spending moving ahead in the face of rising tax, food and energy costs. The household saving ratio fell back from 3% to just over 1%.

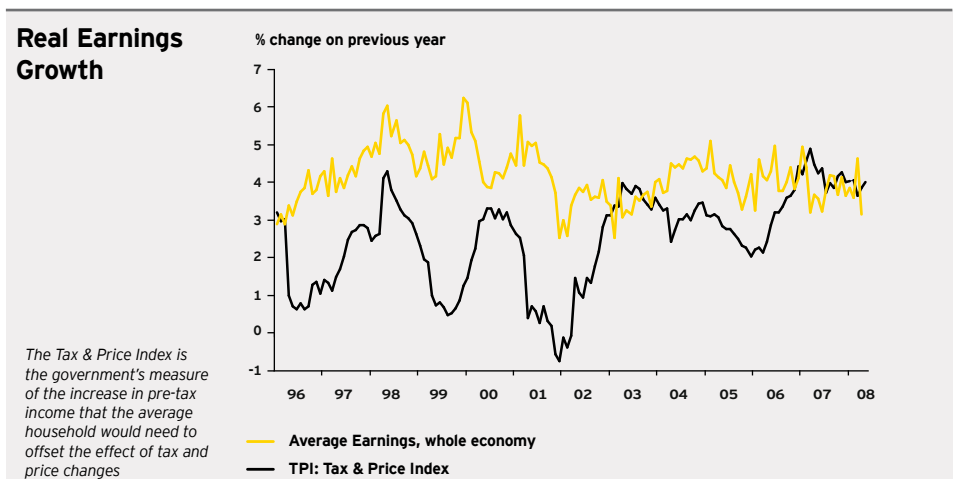
Mortgage equity withdrawal fell back to £5 billion in the first quarter (2.2% of consumer

spending), from £13.9 billion (6.6%) in the first quarter of last year, and ITEM expects it to fall further. With secured lending becoming less freely available, people are increasingly resorting to unsecured borrowing. This raised £1.4 billion in May, with credit card borrowing increasing by £0.6 billion, the largest figure for two years.

...and denial could turn to despair.

Now, May is beginning to look like the last dance at the summer ball. Top retailers like John Lewis and Marks & Spencer have turned very negative. The worry is that without the required medication from the Bank of England, consumers will now move straight from denial into despair.

With its credibility clearly on the line, the MPC cannot reduce base rates for the time being. Inflationary expectations are rising in line with the headline inflation figures and there is an increasing risk of a significant push for higher wages to offset the price increases that families are facing. This risk is most acute in the public sector, where pay increases have been held below those in the private sector and below the cost of living for nearly two years. Unison and other public sector unions want three-year pay deals to be reopened, but the government



knows it cannot cave in on this one because that would mean base rate hikes which would cost it the election. Collective bargaining is less important in the private sector, where employees are subject to the weak markets that their employers face.

Domestic cost inflation is still subdued...

Price increases already in the pipeline will push CPI inflation to 4% or more in the coming months, sustaining the letter-writing activity at the Bank of England. However, the big increases are almost entirely in food and energy prices. The core CPI inflation rate (which excludes the direct costs of food and fuel price increases) remains subdued at 1.6%. Providing that line can be held, inflation will drop back into line with the target over the next 18 months as commodity prices flatten out or fall back. The slowdown in the economy should help here, and a major collapse in world oil prices would bring a reduction somewhat sooner.

...allowing base rates to be cut this winter.

ITEM expects a slowdown in the high street to pave the way for a rate cut this winter, possibly as soon as November. After that, much depends upon the behaviour of commodity prices. The forecast broadly follows the expectation of the futures market that oil prices will peak at \$150 a barrel this autumn, before easing back towards \$100 over the next two years. The world economy is cooling off rapidly. Demand for oil in the industrial economies has been easing back for some time and the rapid growth in demand from the newly industrialising Asian economies will

moderate as they slow next year. They have been running too fast for comfort and are now being forced to curb fuel subsidies and tighten monetary policy. Once commodity prices cool down, UK inflation rates will fall back into line with the core rate. Provided that wages remain restrained, the MPC will be able to shore up the economy next year with further rate reductions.

The forecast shows activity, profits and investment falling back...

With CPI inflation now at 3.8% and further transport, energy and food price increases yet to register, the pressure on household incomes is set to intensify over the rest of this year, particularly at the lower end of the income scale, while falling house and equity prices will surely be a negative factor higher up the scale. The forecast assumes a peak-to-trough fall of 15% on the DCLG house price index. The number of families moving home will be down by about 40%. This will have a direct impact on the associated expenditure on household goods and services. Housing investment is likely to fall by 30% peak-to-trough.

Rising commodity prices will also depress company profits. Business spending on inventories and investment weakened in the first quarter, as did spending on advertising. The forecast shows investment spending increasing by just 1% next year, after 3% this year. With world demand now weakening too, exports are unlikely to provide relief on the scale the ITEM Club expected at the time of its Spring forecast. Nevertheless, it still expects export growth to pick up from 2% this year to over 5% next year in response to the recent fall in the exchange rate.

The ITEM Club Forecast for the UK Economy, July 2008

All figures are % changes on previous year (except interest and exchange rates)

Year	GDP	Domestic demand	Consumer spending	Fixed investment	Exports	Imports	Manufacturing output	Average earnings	RPI headline rate	CPI (Consumer Price Index)	3-month interest rate [1]	Effective exchange rate [1]
2006	2.9	2.8	2.0	7.6	10.7	9.8	1.5	4.4	3.2	2.3	4.8	104.6
2007	3.1	3.8	3.2	6.0	-5.1	-2.4	0.6	4.2	4.3	2.3	6.0	107.2
2008	1.5	1.1	2.4	-1.6	2.0	0.8	0.8	4.0	4.6	3.5	5.8	96.0
2009	1.0	0.5	0.2	-1.9	5.4	3.4	1.4	4.4	3.0	3.0	4.5	93.3
2010	2.5	1.9	1.4	2.8	6.5	4.2	1.9	4.5	2.8	2.0	4.3	92.9
2011	3.1	2.8	2.5	3.9	6.8	5.5	2.3	4.7	3.5	2.0	5.0	92.5

[1] Average over calendar year

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...with unemployment topping two million...

Company balance sheets and business confidence remain strong. Yet it is hard to see many employers taking on new staff in this depressed environment, while large numbers of jobs are being lost in the financial services, construction and retail sectors. It seems likely that the recent immigration flows will reverse as employment prospects deteriorate - indeed there are already signs of that happening - helping to reduce the impact of job losses on the unemployment figures. Nevertheless ITEM expects unemployment on the LFS measure to increase from the low point of 1.6 million reached at the end of last year, topping the 2 million mark in time for the election in 2010.

...and consumer spending on a plateau.

Against this bleak background, consumer spending is unlikely to defy gravity any longer. The weakening labour market should curb wage demands and employment income despite the rise in inflation. ITEM thinks that households will be lucky to see real disposable income growth of 1% this year, with perhaps 1½% in 2009. With credit repayments becoming more burdensome, the forecast shows consumer spending growing by just 0.2% next year. A slowdown on that scale should however pave the way for a resumption of rate cuts, allowing the MPC to put a support under the economy. On this view, base rates could be reduced to 4% by the end of 2009.

But the picture is very uncertain.

ITEM points out that the error margins around this forecast are much larger than usual. Besides the effects of the credit crunch, the most obvious threats to the economy come from a relentless rise in commodity prices and the risk of a hike in wage settlements and interest rates. However, there is an increasing risk of a collapse in commodity prices, if only because the higher they go, the further they have to fall. These markets are beginning to exhibit the characteristics of a speculative bubble, with all of the consequent risks of deflation. Oil prices are particularly prone to fall back after a big increase. A significant reversal in commodity prices could push

the headline inflation figures into negative territory. Longer term, a collapse in commodity prices would make it much more difficult to secure the adjustments that are necessary to deal with climate change and the emergence of the Asian nations.

Implications for business

- ▶ Although the commodity price squeeze could frustrate the rebalancing of the economy towards investment and exports, the balance of demand is changing. Areas like construction and mortgage broking are now in recession. The winners include manufacturers, who will benefit from the lower exchange rate. Exports should grow by 5% next year, helping manufacturing output to outpace GDP growth.
- ▶ While it is still too early to call an end to the surge in commodity prices, there is a good chance that the weakening world economy and in particular the outlook for its construction and motor industries could depress prices next year. Manufacturers would again be in the best position to benefit from this.
- ▶ Counterparty risk is an increasing concern as recession spreads from construction to other areas. Consumer debt problems will increase with unemployment, particularly if interest rates cannot be cut next year.
- ▶ With credit remaining very tight and cash flow increasingly volatile, it is important to ensure that funding lines remain adequate and in place. Banking relationships and shareholder communications are crucial in this environment, where covenants and profit warnings can spell disaster.