

UK Economic Perspectives

UK: Overwhelmed by uncertainty –[Erratum]

Economics

United Kingdom

A significant rise in uncertainty is hitting the UK

The vote to leave the European Union means a significant rise in economic uncertainty is facing the UK economy. This is likely to be severe in the short term. In the medium term more clarity over the nature of the relationship between the UK and the EU should gradually mean a reduction in uncertainty, but the timing and degree of this itself is all very unclear.

Our new forecasts see UK growth in 2017 of just 0.5%

We have revised our UK forecasts for the new reality. In our central case we now see GDP growth in 2016 and 2017 of 1.3% and 0.5%, respectively. That compares to forecasts of 2.0% and 2.3%, previously. Under this view the UK avoids technical recession but slows to a standstill and experiences a protracted period of low growth.

We look at an upside and a downside scenario

We consider two scenarios. In our upside case, uncertainty is resolved speedily and the fall in investment is lower; additionally, UK consumption does not slow as much as in our central case as real income growth is sustained. Here GDP growth could reach 1.0% in 2017. In our downside scenario, we see an investment shock more akin to previous recessions and annual growth in 2017 is -0.2%.

Monetary policy settings to 'easy'

Under our central case the Bank of England cuts rates by 25 basis points in August and November, and the MPC re-engages 'QE'. We think the MPC will 'look through' the rise in inflation due to the fall in the currency. The August Inflation Report is a key staging post. If the Committee is convinced a sharp slowdown is in train, it could plausibly front-load the easing.

Gilt yields to fall to 0.65% by end 2016

With softer nominal growth expectations, a lower interest rate trajectory for the next several years and buying from the Bank of England, we expect a 10y Gilt yield of 0.65% for the end of 2016, with the yield spread against Bunds narrowing from 110bp to 45bp. *This note replaces an earlier version. In Figure 5 GBPUSD (EOP) 2016F is 1.29.*

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The Leave result means significant uncertainty for the UK

Following the UK's 23 June referendum and the decision to leave the European Union, in this note we set out our new central case forecast for the economy, as well as probably some discussion of the risk case.

We present new forecast details

Over our forecast period, 2016-2017, we think about the principal impact on the UK economy as being an uncertainty shock. Over this period the UK is widely expected to remain a member of the European Union (EU) and as such trading relationships will remain the same. As we have discussed before, the nature of the UK's 'final' relationship with the EU will be important to the level of UK GDP over a five- to ten-year horizon. But up front it is the uncertainty over the future relationship with the EU that will drive the UK's economic reaction over the forecast period.

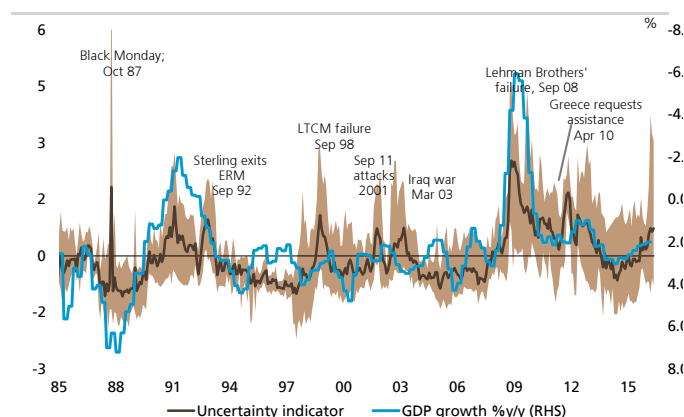
In essence the uncertainty shock that impacts the UK lowers risk-adjusted returns across a wide range of assets and economic decisions. To take a concrete example, investing in new plant and machinery that exports to the EU may yield a lower expected cash flow over the future should the UK's trading relationships be negatively impacted. Lower expected returns essentially mean for the economy that the optimal level of investment and employment will be lower for a time.

UK economy has been hit by uncertainty shock

The Bank of England, IMF and others have looked at the impact of economic uncertainty on the economy. The Bank of England work constructs a measure of economic uncertainty using indicators drawn from financial market volatility, surveys and news flow. It finds that a one standard deviation rise in this measure of uncertainty lowers the level of GDP by 0.5%, with the peak impact after four quarters. Thereafter the level of GDP rises as uncertainty eases.

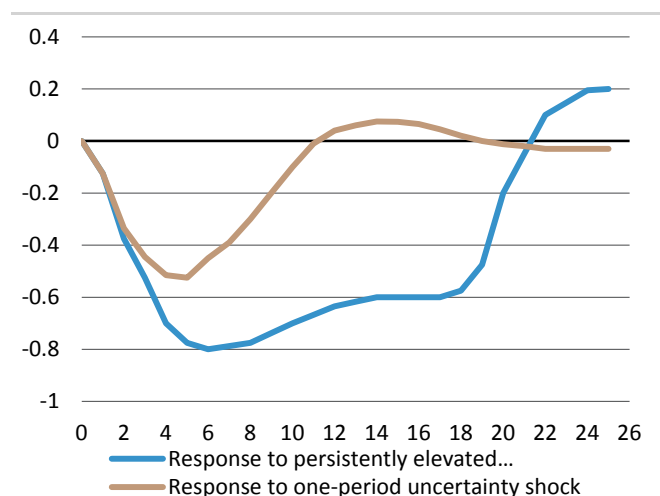
We have also constructed a measure of uncertainty similar to the Bank of England's (Figure 1). We find a rise in our measure of uncertainty has a broadly similar profile to that of the Bank's (Figure 3). Again, the implication is that the rise in uncertainty can depress the level of GDP for some time, though eventually the impact is reversed.

Figure 1: UBS measure of economic uncertainty and GDP growth (% y/y)



Source: Bank of England, CBI, GfK, Economic Policy Uncertainty indicator, UBS

Figure 2: BoE estimates of GDP impact of uncertainty shock



Source: Bank of England, UBS

As well as the size of the uncertainty shock, the duration is very important. The Bank work finds that usually uncertainty unwinds relatively quickly, such that half the rise in uncertainty unwinds within a year. If on the other hand the rise in economic uncertainty is persistently high for three years, then the peak impact of uncertainty on the level of GDP is closer to 0.8%, and it can take considerably longer (over three years) for the level of GDP to recover.

In the current situation facing the UK, we think there are two questions:

1. How large will the uncertainty shock be?
2. How will it evolve from here?

Our own uncertainty indicator was already pointing to a rise in uncertainty heading into the vote. With the vote having resulted in a decision to leave, economic uncertainty has likely risen significantly further.

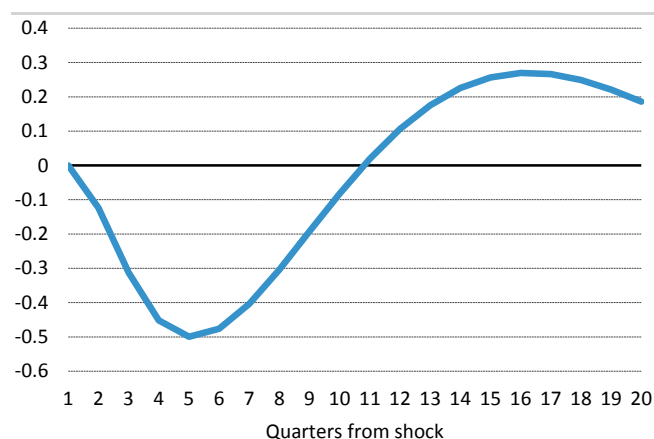
There had already been a pick-up in uncertainty ahead of referendum result

To provide a sense of scale of the impact of this rise in uncertainty, the Bank of England indicator suggests that the Lehman Brothers failure and the ensuing financial crisis saw around a four standard deviation rise in economic uncertainty. It seems reasonable to us to assume that the current UK crisis is not quite as extreme as this, though given its UK-specific focus it is still severe. If the shock we are seeing is around a three standard deviation rise in uncertainty, which would make it larger than any shock since the 1980s, then we would be looking at a GDP impact on the UK of perhaps around 1.5%.

How does uncertainty evolve from here?

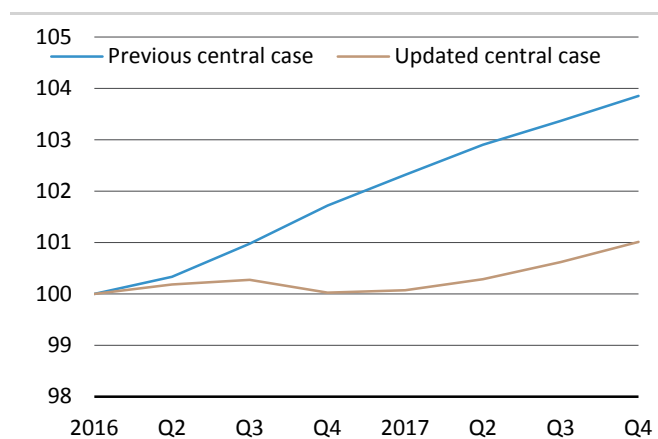
How uncertainty evolves from here is, of course, very unclear. The final position of the UK's relationship with the EU will not be settled for over two years. But that is not to say there cannot be a significant drop in uncertainty as the UK political situation becomes clearer and as the negotiating stance of the UK and the EU takes on more structure.

Figure 3: UBS estimate of impact on level of GDP of one unit uncertainty shock (deviation from base, %)



Source: UBS

Figure 4: Level of GDP (2016 Q1 = 100)



Source: UBS

Near term the Conservative Party Leadership contest, which opens this week, will provide an opportunity for candidates to clarify what kind of relationship with the EU they would seek. When the winner of that contest is announced on

2 September and subsequently becomes leader of the Conservative Party, they will have a further opportunity to set out their negotiating strategy.

So while UK uncertainty is currently very high in both political and economic senses, it seems plausible that this should gradually move lower in the coming quarters. As the UK and EU negotiations continue, there will be inevitable bouts of uncertainty, but we would expect the current peak uncertainty to ease back over our forecast period.

New forecasts

As we discussed in "It's 'Leave' – implications for UK, Europe and markets", the reality of the UK vote to leave the EU means we have downgraded our forecasts for GDP growth to 'around zero' in the second half of 2016 and early 2017. This embodies the view, as discussed above, that the rise in economic uncertainty following the vote is both large and likely to peak fairly early, with a gradual reduction over time. Figure 5 sets out the detail of our new forecasts.

Central case is spike in uncertainty then gradual decline

Figure 5: Updated forecasts

%/y unless stated	2015								2016F				2017F			
	2014	2015	2016F	2017F	Q1	Q2	Q3	Q4	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Real GDP (%q/q)	-	-	-		0.5	0.6	0.4	0.6	0.4	0.2	0.1	-0.1	0.0	0.2	0.3	0.4
Real GDP (%y/y)	2.9	2.3	1.3	0.5	2.6	2.4	2.2	2.1	2.0	1.6	1.2	0.5	0.2	0.2	0.5	1.0
Private consumption	2.6	2.8	2.5	1.2	2.9	2.8	2.7	2.7	2.6	2.6	2.6	2.3	1.8	1.2	0.9	1.0
Government consumption	2.5	1.5	1.5	0.2	1.1	1.1	1.5	2.2	2.1	1.7	1.1	0.9	0.6	0.3	0.2	0.0
Fixed investment	7.3	4.1	-0.2	-1.3	6.2	4.9	3.4	2.1	1.1	0.3	-1.1	-1.0	-2.0	-2.5	-1.1	0.6
Exports	1.2	5.1	1.2	1.6	5.3	6.9	6.0	2.2	2.1	0.0	1.2	1.5	2.0	1.6	1.4	1.5
Imports	2.4	6.3	3.0	0.8	8.0	5.8	6.7	4.7	2.0	5.3	2.6	2.0	1.2	0.6	0.6	0.3
Stocks *	0.2	-0.4	0.0	-0.3	0.3	-0.8	-0.7	-0.4	-0.6	1.0	0.0	-0.5	-0.5	-0.5	-0.2	0.1
Domestic demand	3.2	2.6	1.7	0.3	3.5	2.1	2.3	2.5	1.7	3.0	1.6	0.8	0.0	0.0	0.3	0.8
Net trade *	-0.4	-0.5	-0.6	0.2	-1.0	0.2	-0.4	-0.9	-0.1	-1.7	-0.5	-0.2	0.2	0.3	0.2	0.2
Money GDP	4.7	2.6	2.4	3.0	3.3	2.7	2.2	2.2	2.5	2.1	2.3	2.8	2.8	3.0	3.0	3.2
Industrial production	1.3	0.0	-0.6	-0.1	0.7	1.3	1.2	0.8	0.2	-0.4	-1.1	-1.2	-0.7	-0.7	0.1	1.0
LFS ue rate (%) -Q4	5.7	5.1	5.0	5.8	5.6	5.6	5.3	5.1	5.1	5.0	5.0	5.0	5.1	5.3	5.5	5.8
RPI	2.4	1.0	1.9	4.4	1.0	1.0	1.0	1.0	1.4	1.4	1.8	2.9	4.0	4.8	4.7	4.1
CPI	1.5	0.0	0.8	3.4	0.1	0.0	0.0	0.1	0.3	0.3	0.8	1.9	2.9	3.7	3.6	3.2
AWE (Total Pay)	1.2	2.4	2.4	2.4	2.4	2.4	3.0	2.0	2.0	2.6	2.5	2.4	2.6	2.6	2.3	2.2
Current Account (% of GDP)	-5.1	-5.2	-3.7	-2.4	-5.3	-4.1	-4.3	-7.0	-5.3	-4.2	-2.7	-2.7	-2.5	-2.5	-2.4	-2.4
PSNB (% of GDP)	-5.0	-4.0	-3.4	-2.8	-	-	-	-	-	-	-	-	-	-	-	-
Bank rate (%) (EOP)	0.50	0.50	0.0	0.0	0.50	0.50	0.50	0.50	0.50	0.50	0.25	0.0	0.0	0.0	0.0	0.0
10yr gilt rate (EOP)	1.76	1.96	0.65	0.95												
EURGBP (EOP)	0.78	0.74	0.90	1.00	-	-	-	-	-	-	-	-	-	-	-	-
GBPUSD (EOP)	1.56	1.48	1.29	1.20	-	-	-	-	-	-	-	-	-	-	-	-

Source: UBS

*Contribution to growth

Our top-line forecasts for GDP growth in 2016 and 2017 are now 1.3% and 0.5%, respectively. That compares to the previous forecasts of 2.0% and 2.3%. Over the forecast we see unemployment rising to 5.8% by the end of 2017. The pass-through of sterling weakness into inflation means that we forecast a large rise in inflation, averaging 3.2% in 2017, rather than the previous forecast of 1.5%.

Lower GDP growth, large rise in inflation

Figure 4 illustrates the path of our new forecast for GDP relative to our previous base case. A flat GDP profile over the course of 2016 H2 and a more muted reacceleration in the rest of 2017 implies that by the end of 2017 the level of GDP is around 2.8% lower than we previously forecast. In other words our revisions downwards are large and consistent with a significant uncertainty shock (perhaps around a three standard deviation shock in terms of the Bank of England indicator), which is a fairly fat tail of uncertainty even as things gradually become clearer over time.

In terms of the components of GDP we think there are principally two main channels of impact:

Investment, then consumption, are the drivers

Investment

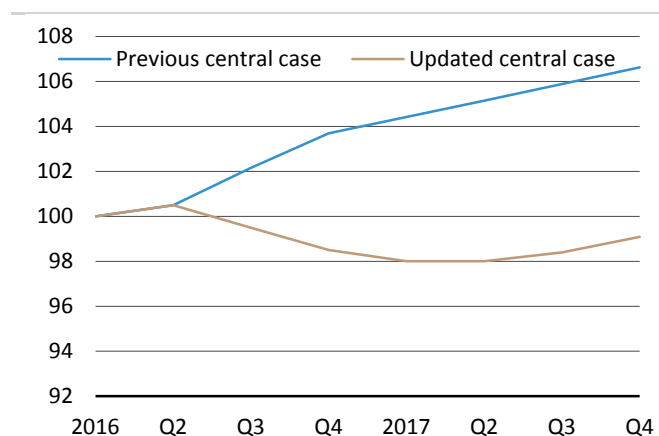
Clearly there is a component of investment decisions that will be negatively influenced by the lower risk-adjusted returns that the UK exit from the EU implies. We therefore forecast a fairly abrupt reduction in investment up front, with its weakness concentrated in the second half of this year.

Consumption

UK consumer spending has shown good momentum going into the UK referendum and consumer confidence has been at relatively high levels. Consumer spending has been supported by robust growth in real income and a drift down in the savings rate.

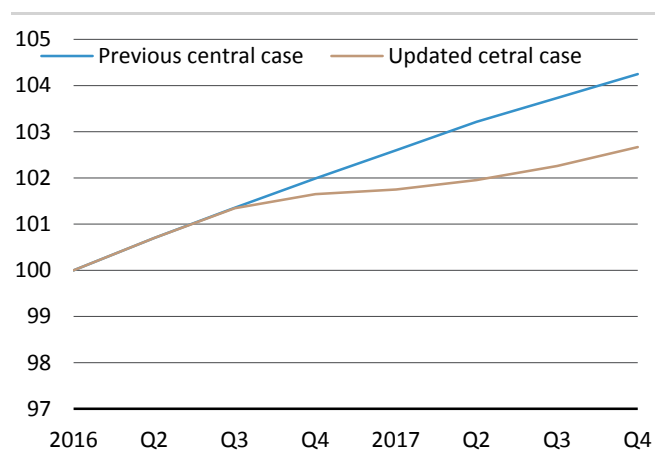
But we think the rise in UK inflation comes from the sharp decline in sterling we have seen to date, and further prospective weakness means that UK real income growth should weaken sharply over the forecast – we do not expect there to be much scope for wage growth to rise to offset higher inflation. At the same time, with the UK saving rate already low we believe there is little scope for a reduction in savings to act as a shock-absorber. So, consumption growth, while positive, is likely to be materially weaker.

Figure 6: Level of investment (2016 Q1 = 100)



Source: UBS

Figure 7: Level of consumption (2016 Q1 = 100)



Source: UBS

Figure 6 and Figure 7 show our new investment and consumption profiles relative to the previous central case. UK investment is now significantly weaker than our central case, with the level of investment at the end of the forecast 7% lower. For consumption, as is typically the case, the downswing should be more gentle. Nonetheless, consumer spending is around 1.5% below our previous assumption.

How could things be worse?

Point forecasts are currently (even more than usually) subject to very wide degrees of uncertainty – they are almost certain to be wrong. In particular, how the evolution of UK politics progresses and how the UK's relationships with its EU partners is renegotiated are subject to very wide possible outcomes. In our base case we try and look through the current market uncertainty and make an assumption that over the coming months some semblance of 'order' returns.

Not all period of heightened economic uncertainty result in recessions. For example, the terrorist attacks in the US on 11 September 2001 resulted in high levels of economic uncertainty for a period, but in the UK GDP growth in 2001 and 2002 averaged 2.6% per annum. Economic uncertainty was also high around the time the UK exited the Exchange Rate Mechanism (September 1992), though after that event the UK experienced robust growth. The Eurozone crisis was a long period of heightened uncertainty over which the UK also showed positive growth.

Of course, the UK is the very focus of current uncertainty and as such a more adverse reaction is possible. Additionally, it is possible that political uncertainty remains acute. Under these scenarios a more adverse reaction from investment is certainly possible. In the UK recession in the early 1990s, investment fell 7.9% in 1991 and 1.6% in 1992. In 2008, UK investment fell 5.9%, and in 2009 14.4%.

If we use these experiences as a guide to possible investment behaviour then we calibrate than UK GDP could show an annual growth rate of -0.2% in 2017 (vs 0.5% in the base case), with a shallow recession over the end of 2016 and not ending until the middle of 2017.

How could things be better?

We believe the main way our base case could prove too pessimistic is if there is a quicker and clearer reduction in uncertainty. For now, this looks difficult to achieve, given that the political process with the UK and with its EU partners will take time. Nonetheless, it is possible that by the fourth quarter, say, of this year, there could be significantly more clarity on the direction of travel between the UK and the EU.

In these sort of circumstances, it would likely be reasonable to also expect the exchange rate to come under less sustained downward pressure. This could imply any uptick in inflation would be lower and the real income position of consumers would be less sapped. So we need to watch how the level of EURGBP evolves from the current spot to give a sense of the likelihood of the short-run upside transpiring.

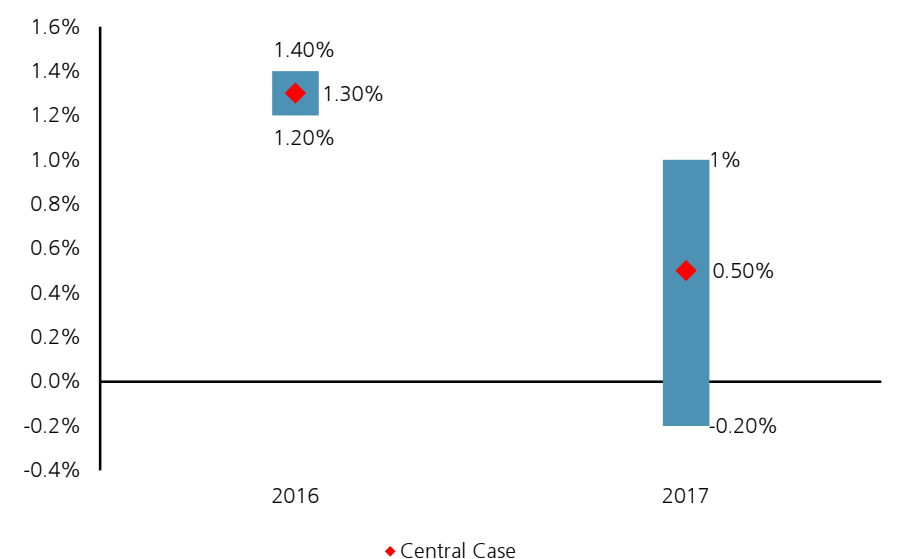
Under the scenario we sketch above, we estimate that UK GDP could show growth of 1.0% in 2017 (vs 0.5% in the base case), avoiding a technical recession and showing low but consistent positive GDP growth over the forecast period.

As Figure 8 illustrates, on balance we see the risks relative to our central case lying to the downside, particularly for 2017.

In a 'bad' case, uncertainty could continue at very high levels for a protracted period

In a 'good' scenario there may be more clarity by Q4

Figure 8: Central case and scenarios, GDP (% , y/y)



Source: UBS

Policy

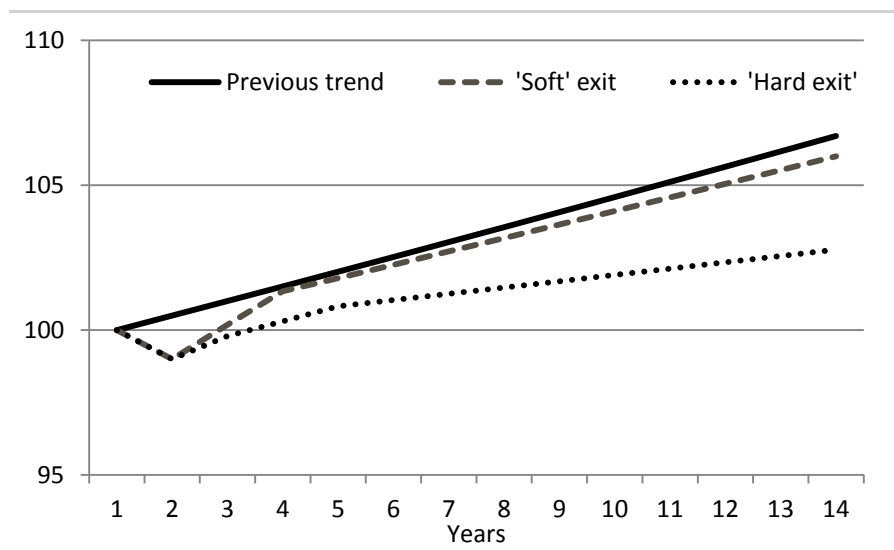
As we discussed in **"It's 'Leave' – implications for UK, Europe and markets"**, we see our central case outlook for the economy as consistent with monetary easing from the Bank of England.

Our growth revisions suggest policy easing to us

We acknowledge that the Monetary Policy Committee (MPC) will need to be careful in communicating its policy strategy against a background of rising inflation due to the fall in the exchange rate. But similarly to the 2007/08 decline, the MPC will likely argue that the price level shock from the lower pound will not become a self-sustaining inflationary shock unless inflation expectations adjust upwards. In our view, with the economy and the labour market weakening, it is not likely that inflation expectations will rise over this period – quite the contrary.

From another perspective, there will also be parallels with the fall in the exchange rate during the financial crisis. The uncertainty shock and also the possibility of a reduction of the integration of the UK goods and service exports sector with the rest of Europe is akin to a 'total factor productivity' shock. The consequence of this is that UK real wages will need to fall relative to the counterfactual of staying in the EU. This decline in real wages could involve a significant rise in unemployment if it were to occur via nominal wage adjustment. But if it occurs via a rise in the price level brought about via the exchange rate, then this could potentially be both faster and less painful for the labour market. At the time of the financial crisis, the MPC made similar arguments.

Figure 9: Illustrative GDP profiles following the EU referendum



Source: UBS

In terms of the easing, we expect to see the MPC cutting interest rates at both the August and November policy meetings, by 25bps at each. That would take the level of Bank Rate to zero. We also anticipate a return to Quantitative Easing not later than the February MPC meeting. In the first instance, we look for GBP 50-75bn of conventional gilt purchases, most likely over three months.

It is possible that the easing we anticipate is delivered faster than our timetable. In this regard, the upcoming August Inflation Report is key. If the MPC feels confident that it is already seeing significant weakness coming through the economic data, then it could potentially cut Bank Rate to zero in one move. That would then imply a return to QE before the end of 2016.

Some of the longer-term challenges for monetary policy are illustrated in Figure 9. The uncertainty following the UK vote may at first depress the level of UK GDP over a number of years. As the future relationship with the EU becomes clearer and uncertainty unwinds, we might expect some catch-up in the economy towards its previous trend. But if the outcome involves a 'hard exit' in which the freedom of movement of goods, services, capital and labour is significantly restricted, then GDP will face a sustained adjustment phase. This could occur over a fairly long time horizon, and over that period growth could remain lower. On the other hand, a 'soft exit', which preserves many of the freedoms, would see a convergence towards a level of GDP plausibly not too far from the old trend.

For policymakers, the challenge will be being able to separate the news from the noise, and also all the other influences on the economy. And of course in 'real-time' we will not know whether we are heading to a 'hard' or 'soft' exit for some time. To make life harder still, the MPC will need to determine the balance between demand and supply shocks over the next few years. We expect them, consistent with our rate call, to see demand-side influences dominating. But there are no easy decisions from here.

We see rates at zero and more QE

Chance it comes 'up front'

Long-term challenges for monetary policy

New Rates forecasts

With the UK economy now forecast to slow to a standstill over the rest of 2016 and into next year, we anticipate additional monetary easing from the Bank of England, with Bank Rate expected to be cut to 0.0% before the end of this year, and a resumption of QE by early 2017. The impact of weakening demand, and anticipation of QE well ahead of its introduction, are likely to drive Gilt yields lower, with softer nominal growth expectations and expectations of a lower interest rate trajectory for the next several years at least also a factor. These may be offset to a degree by a dip in demand from overseas investors, though that is only likely to persist until the majority of the downward adjustment in sterling has run its course, in our view. Thereafter, as was seen after the dramatic fall in sterling during the financial crisis in late 2008, demand is likely to reaccelerate. Ratings agency downgrades have already been triggered following the vote to leave the EU, and these have had no discernible impact on Gilt valuations. Domestic safe-haven demand in uncertain economic and political times should more than cancel out any predictions of higher Government borrowing in response to that softer economic trajectory.

We forecast a 10y Gilt yield of 0.65% for the end of 2016, with the yield spread against Bunds narrowing from 110bp to 45bp, and against Treasuries moving from -50bp to -70bp. By the end of 2017, we anticipate higher yields as the current EU exit-related uncertainties should have been fully resolved, the economy should have stabilized, and safe-haven demand should have moderated. We forecast a 10y Gilt yield of 0.95% for the end of 2016, with the yield spread against Bunds unchanged at 45bp, and against Treasuries moving from -70bp to -55bp.

Gilt yields likely softer

We forecast a 0.65% 10y Gilt yield by end 2016

Figure 10: Key UK data and events in coming months

Date	Indicator	Comment
1-Jul-16	Markit UK PMI Manufacturing sa (Jun)	Probably too early to show much impact from the referendum decision
5-Jul-16	Markit/CIPS UK Services PMI (Jun)	
5-Jul-16	Carney Publishes BOE Financial Stability Report	Focus on how the system is coping
7-Jul-16	Manufacturing Production (May)	
13-Jul-16	RICS House Price Balance (Jun)	How was the housing market doing before the vote?
14-Jul-16	Bank of England Bank Rate (Jul)	Key. MPC likely to acknowledge deterioration in outlook. Can't rule out a pre-emptive cut in rates
19-Jul-16	Inflation Data	Focus on rising inflation in coming months. This may be too early to pick it up.
20-Jul-16	Labour Market Data	Labour market data is very lagging – this data covers three months to May
27-Jul-16	GDP (Advance) (Q2)	We expect % q/q to be 0.2%, confirming downtrend heading into vote
28-Jul-16	GfK Consumer Confidence (Jul)	One of the first gauges of how consumers are reacting to developments
29-Jul-16	Mortgage Approvals (Jun)	Gauge on pre-referendum housing activity
1-Aug-16	Markit UK PMI Manufacturing sa (Jul)	First surveys for July. Should see sharp declines.
3-Aug-16	Markit/CIPS UK Services PMI (Jul)	First surveys for July. Should see sharp declines.
3-Aug-16	Markit/CIPS UK Composite PMI (Jul)	First surveys for July. Should see sharp declines.
4-Aug-16	Bank of England - August Inflation Report	Key meeting. We expect MPC to cut rates to 0.25% and produce very downbeat forecasts
9-Aug-16	Manufacturing Production (Jun)	
9-Aug-16	Manufacturing Production (Jun)	
10-Aug-16	RICS House Price Balance (Jul)	Post referendum look at housing market activity
16-Aug-16	Inflation Data	Could plausibly start to see some upward impacts
17-Aug-16	Labour Market Data	Labour market data is very lagging – this data covers three months to June
18-Aug-16	Retail sales Ex Auto Fuel (Jul)	Have retail sales reacted to the vote? Data for July
30-Aug-16	Mortgage Approvals (Jul)	A look at the pipeline of housing activity post referendum
30-Aug-16	GfK Consumer Confidence (Aug)	Are consumers holding up?
1-Sep-16	Markit UK PMI Manufacturing sa (Aug)	
2-Sep-16	Markit/CIPS UK Construction PMI (Aug)	Should show more evidence of slowdown
5-Sep-16	Markit/CIPS UK Services PMI (Aug)	
7-Sep-16	Manufacturing Production (Jul)	First hard manufacturing data post referendum
7-Sep-16	RICS House Price Balance (Aug)	
9-Sep-16	Construction Output sa (Jul)	How has construction reacted to the vote?
9-Sep-16	NEW CONSERVATIVE LEADER/PM ANNOUNCED	
13-Sep-16	Inflation Data	Clearer evidence should be emerging of upswing in inflation
14-Sep-16	Labour Market Data	We may begin to see signs of labour market slowdown
15-Sep-16	Retail sales Ex Auto Fuel (Aug)	
15-Sep-16	Bank of England Bank Rate (Sep)	All meetings now are 'live', though this should be one where the MPC pauses
29-Sep-16	Mortgage Approvals (Aug)	Evidence of housing market slowdown?
2-Oct-16	Conservative Party Conference begins	
20-Oct-16	European Council	First opportunity for new PM to meet other EU leaders

Source: UBS

Valuation Method and Risk Statement

Risks include macroeconomic variables (such as GDP growth rates and inflation), economic slowdown, a weakening currency, global economic events, and government policy changes.

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