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THE **UNITED KINGDOM** IN 2016

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Further Slowdown Won't Deter the MPC From Raising Rates in 2016

* The U.K.'s economic recovery is set to slow further in 2016, with GDP rising by just 1.5%. But a revival in inflation, concerns over financial stability and a faster-than-expected tightening of U.S. monetary policy will compel the MPC to raise interest rates. **We expect the first increase in May.**

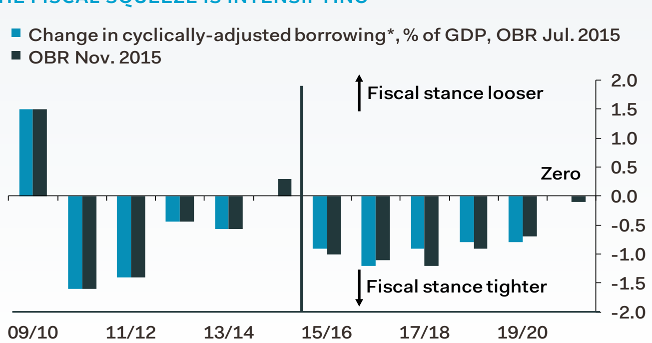
* The U.K.'s outperformance over the last three years partly has reflected a pause in fiscal consolidation. But the squeeze will intensify in fiscal 2016/17—starting April 1st—and borrowing overshoots in the current year mean the Chancellor can't change course if he is to meet his goal of a budget surplus by the end of the parliament. **The impending tightening is likely to be more damaging than the austerity imposed after the 2010 election, because the easiest, least-detrimental savings already have been made.**

* **The drag on GDP growth from net trade also is set to increase in 2016.** The real effective exchange rate has appreciated by nearly 15% over the last two years and it is now back to its pre-recession peak. Long lags mean that the peak impact of the stronger exchange rate on net trade will be felt in early 2016, when it likely will subtract about one percentage point from year-over-year GDP growth.

* Cheaper oil is a net positive for the U.K., but it will gain less than other countries because production accounts for more than half of consumption. True, oil output surged 18% year-over-year in the third quarter, boosting GDP growth by 0.4 percentage points, as producers sweated assets to maintain revenues. But production likely will fall sharply now that oil prices have fallen below extraction costs and investment has nose-dived.

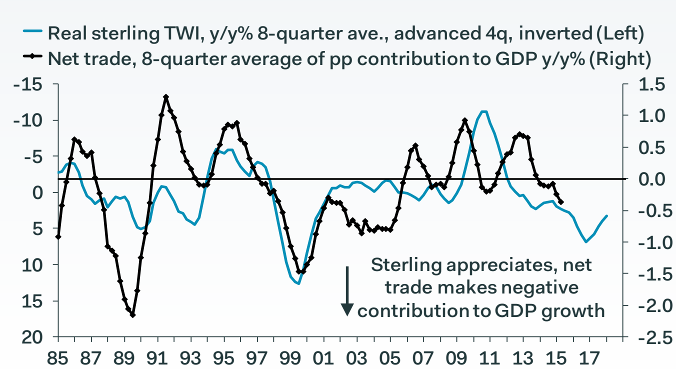
* Strong growth in employment has enabled the U.K. economy to grow quickly, despite lacklustre improvements in productivity. **But now, the pool of suitable surplus labour has run dry.** The unemployment rate has withered to just 5.2%—its level shortly before the recession began—and firms are reporting unprecedented difficulty in finding suitable workers. Labour inactivity has collapsed to a record low and full-time workers are responding to real wage rises by *reducing* their working hours in favour of more leisure time.

THE FISCAL SQUEEZE IS INTENSIFYING



* Excluding impact of Royal mail pension fund transfer in 12/13

NET TRADE IS SET TO KNOCK 1PP OFF GDP GROWTH IN EARLY 2016



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* **With the labour market now very tight, employees will continue to extract wage gains unsupported by advances in productivity.** On the face of it, the renewed decline in headline, three-month average growth in average weekly wages, to just 2.4% year-over-year in October from a 2015 peak of 3.3% in May, suggests that hidden labour market slack is still keeping a lid on wages. But the slowdown largely has reflected compositional effects—like strong growth in low-productivity jobs—and the decline in average hours. Unit wage costs rose 2.6% year-over-year in Q3, and will accelerate further, if the lagging relationship between unemployment and earnings growth is maintained. The introduction of the National Living Wage, 7.5% above the current legal minimum, will put additional upward pressure on wages.

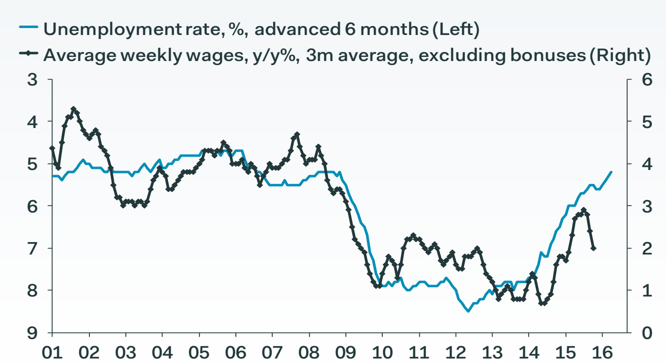
* **As a result, inflation this year looks likely to bounce back faster than markets currently expect.** Intensifying wage pressures, alongside the fading drag from lower import and commodity prices, should ensure that CPI inflation returns to the 2% target by the end of 2016.

* The housing market will continue to heat up. Banks are shifting their focus away from raising more capital to meet tougher standards towards gaining market share. The Financial Policy Committee's restriction—mortgages with loan-to-income ratios greater than 4.5 cannot account for more than 15% of banks' mortgage book—is still not close to biting. Meanwhile, housing supply looks set to be restricted by shortages of skilled construction workers, and existing homeowners' expectation that prices will continue to rise sharply.

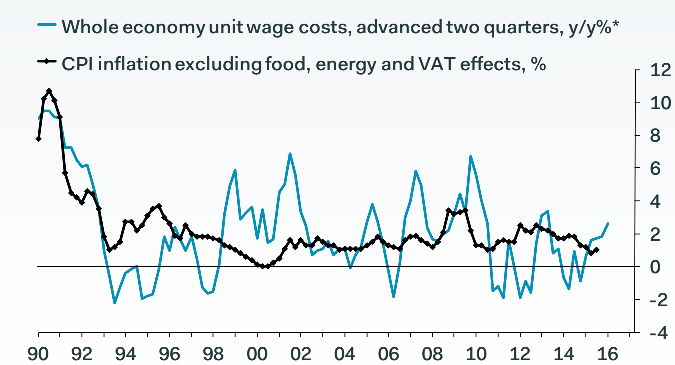
* Meanwhile, the MPC isn't truly independent from the U.S. Fed, despite its protestations. If a large gap emerged between U.K. and U.S. interest rates, sterling would weaken sharply, increasing the risk that inflation overshoots the 2% target in 2017. **So, despite the slowdown, we expect the MPC to raise official interest rates to 1% by the end of 2016, with the first 25bp hike to 0.75% coming in May, about six months earlier than markets expect currently.** We expect gilt yields to rise more decisively, as investors reappraise the outlook for short rates, with 10-year yields finishing 2016 at about 2.80%, up from the current 1.90%.

* The U.K. is likely to vote to remain a member of the E.U. in the referendum, which probably will be held this year. "Brexit" would entail short-run costs for only the possibility of long-term gains; we believe inherently cautious voters will reject this gamble. That said, support for Brexit is growing, and the risk could be sufficient to persuade firms to delay investment, and overseas' residents to demand greater compensation for financing the U.K. current account deficit. **A sharp, referendum-related fall in sterling cannot be ruled out.**

THE RECENT WEAKNESS OF WAGE GROWTH LIKELY IS A BLIP



THE JOB MARKET IS TIGHT ENOUGH TO LIFT INFLATION TO TARGET



Economic Activity (year-over-year, %)	2013	2014	2015	2016	2017
Household spending	**1.9**	**2.6**	**2.9**	**2.0**	**2.2**
Fixed investment	**2.6**	**7.3**	**4.3**	**3.0**	**3.5**
Government spending	**0.5**	**2.5**	**1.6**	**0.8**	**0.3**
Inventories, cont. to GDP growth	**0.7**	**0.2**	**-0.7**	**-0.2**	**0.1**
Domestic demand	**2.6**	**3.2**	**2.3**	**1.7**	**2.2**
Exports	**1.2**	**1.2**	**5.2**	**0.0**	**2.0**
Imports	**2.8**	**2.4**	**5.3**	**1.0**	**2.0**
GDP	**2.2**	**2.9**	**2.2**	**1.5**	**2.2**

Labor Market, Costs and Prices (year-over-year, %, year average unless stated)	2013	2014	2015	2016	2017
Output per worker	1.0	0.7	0.9	0.6	1.4
Employment	1.2	2.3	1.4	0.9	0.8
Unemployment rate (%)	7.6	6.2	5.4	5.0	4.8
Average weekly wages	1.2	1.3	2.5	3.0	3.5
Unit wage costs	0.0	0.1	1.6	2.4	2.0
CPI	2.6	1.5	0.0	1.4	2.2
Core CPI	2.1	1.6	1.1	1.9	2.1
RPI	3.1	2.4	1.0	2.6	3.3
House prices, Nationwide measure (end year)	3.2	9.8	4.5	8.0	4.0

Other	2013	2014	2015	2016	2017
Current account, % GDP	-4.5	-5.3	-4.4	-4.5	-4.0
Budget deficit, £B, FY	98.5	89.2	78.0	55.0	40.0
Budget deficit, % GDP, FY	5.7	4.9	4.1	2.8	1.9
Bank Rate, December	0.50	0.50	0.50	1.00	2.00
Asset Purchase Facility, £B, December	375	375	375	375	375
10-year gilt yields, Q4 average	3.02	1.76	1.96	2.80	3.50
30-year gilt yields, Q4 average	3.67	2.51	2.67	3.30	4.00
$ per £, Q4 average	1.66	1.56	1.47	1.42	1.40
€ per £, Q4 average	1.20	1.29	1.36	1.41	1.40
FTSE 100	6749	6566	6242	6400	6800