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UK Q3 GDP: BREXIT VOTE IMPACT - NO DOOM, SOME GLOOM INSTEAD OF A BOOM

Berenberg Macro Flash

UK GDP (a), real, qoq %, Q3 2016

Actual	**0.5**
Previous	0.7
Consensus	0.3
Berenberg	0.4

The first estimate of Q3 GDP showed that the economy expanded by 0.5% qoq – at a faster rate than our own above consensus call of 0.4% qoq. The expansion was driven by broad growth across the consumer-driven services sector (0.8%) while the industrial (-0.4%) and construction (-1.4%) sectors contracted. **Although the economy slowed compared to the above-trend growth rate in Q2 (0.7% qoq), the economy has weathered the initial-Brexit shock much better than was initially expected immediately after the referendum**. Today's data suits our above consensus call for 2017 GDP growth of 1.5% versus the Bloomberg consensus of 0.8%.

The first estimate of GDP gives a limited picture of the underlying economy - covering GDP only on an industry basis. The second estimate - published in the coming weeks - will provide a detailed breakdown of consumption, government spending, investment and trade for the quarter. It will offer a better look at how the different components of the economy responded to the surprise Brexit-vote. It is likely to show that consumption continued to expand at a healthy pace, that business investment contracted amid the heightened uncertainty, and that the trade-balance improved a little as the sterling depreciation over the course of 2016 started have a positive effect. On a trade-weighted basis sterling is currently down 21% compared to November 2015.

The resilient post-referendum performance does not, however, say anything about the UK's ability to perform outside of the EU. After all, Brexit hasn't happened yet. The good quarter of growth merely reflects the momentum heading into the vote and the healthy underlying fundamentals after some three years of good growth. Today's data does not alter our long-term view that Brexit will lower UK trend growth, to around 1.8% from 2.2% per year, via less trade, migration and investment with its major market, the EU.

Medium-term outlook
Over the medium-term, Brexit uncertainty will continue to weigh on growth prospects, driven by nervous businesses pausing investments and a slowdown in consumption growth as the higher inflation erodes real incomes. The weaker sterling will provide a modest tail-wind to exports while weakening import demand – leading to an improvement in the trade balance. We forecast below trend growth of 1.5% in 2017 and 2018 with risks tilted to the downside if the heightened risk of a hard Brexit begins to further weigh on confidence.

On a sector basis, we anticipate a slowdown in services sector growth as real incomes are squeezed. But household fundamentals will remain in ok shape. Employment is likely to remain at a high level. Household financing conditions are likely to remain favourable. The outlook for the industrial sector is mixed. While the weaker sterling should boost foreign demand, offsetting some of the weakness in domestic demand, higher costs for dollar priced inputs and energy will squeeze margins for some firms. Private construction is likely to contract as firms and households delay spending on long-lived assets. We expect Chancellor Hammond to announce an increase in infrastructure spending at the Autumn Statement (November 23). This should lead to a rise in public construction over the medium-term.

Bank of England outlook

Despite recent comments from Governor Carney on the 'limits' to how much BoE officials can tolerate an overshoot of inflation above the 2% target, the probability of the BoE tightening policy in response to the falling sterling is very low. As long as the sterling selling is orderly, we see no major reason for the BoE to step in.

The weaker sterling reduces household real incomes. Interest rate hikes on top of that would further damage the domestic economy. The better than expected near-term performance is likely to keep the Bank of England on hold for now. However, if the economy weakened over the coming quarters, we would expect the BoE to ease monetary policy again and look through the temporarily higher inflation.

qoq %	**Q3 16**	**Q2 16**	**Q1 16**	**Q4 15**	**Q3 15**	**Q2 15**
GDP	0.5	0.7	0.4	0.7	0.3	0.5
Services	0.8	0.6	0.7	0.9	0.5	0.5
Production	-0.4	2.1	-0.1	-0.4	0.0	0.7
Construction	-1.4	-0.1	0.8	0.6	-0.8	0.7