



Kallum Pickering, Senior Economist | Kallum.pickering@berenberg.com | +44 20 3465 2672

UK UPDATE: MACRO, ELECTION, BREXIT, IMPACT OF TERROR ATTACKS

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PMIS POINT TO REBOUND IN GROWTH IN Q2

Despite on-going political noise coming from the snap elections (8 June) and the start of Brexit negotiations, UK demand is holding up well, with the improving international backdrop offsetting the normalisation in domestic demand after a surge in late 2016. PMI data for the first two months on Q2 indicate that real GDP growth accelerated after slowing to 0.2% qoq in Q1 from 0.7% in Q4 2016. This comes despite data released today for the UK services sector – which makes up c80% of total output – coming in a little below expectations. The services PMI for May was 53.8, below expectations of 55.0. Our weighted PMI – which integrates data across all key sectors – for April and May rose to 55.1 versus 54.3 in Q1, reflecting a broad-based expansion in demand. Although the PMIs have not tracked the underlying economy too well in the past year, taken at face value, the Q2 uptick is in line with our expectation that growth has accelerated to 0.5% qoq in Q2 – Chart 1.

Downside risks to near-term demand from Brexit uncertainty and rising inflation have not yet materialised in any serious way. The UK is currently enjoying a broad-based expansion. All major components of demand are contributing to growth. Export-oriented producers continue to benefit from the upturn in global demand and the more competitive sterling. Although real household spending growth is slowing as inflation rises, current spending is accelerating. Instead of cutting back spending as inflation picks up, households are digesting the inflation by spending more in order to target a desired level of real consumption. We continue to forecast robust growth of 1.8% in 2017 and 1.7% in 2018.

ELECTION ON THURSDAY – RISK OF EMBARRASSMENT FOR MAY?

While all the polls still project that the Conservatives will be ahead on 8 June, the party's lead continues to narrow versus the Labour Party led by far left Jeremy Corbyn – Chart 2. A recent poll by Survation showed the Conservatives just one point ahead. Amid the sharp narrowing in the polls, poor poll reliability in past votes, plus an unusually high level of uncertainty about the key issues and how different groups could vote, last week we reduced our estimate of a Conservative victory to 65% from 80% previously – see [‘UK vote: don't bet the farm on a Tory landslide’](#).

Of the 65% probability we put on a Conservative win, we see a 35pt chance the Conservatives increase their majority from their current 17 seat majority in the House of Commons and a 30pt chance they win with a lower majority. We see a 25% chance of a hung parliament and a 10% chance of a Labour majority. That implies a 65% chance of an embarrassment for Theresa May who called the election just a few weeks ago on the back of a commanding 20plus poll lead.

WHAT WOULD BE THE BEST ELECTION OUTCOME FOR BREXIT?

By harming flows of; (1) trade, (2) investment and (3) labour between the UK and its biggest market the EU, Brexit could reduce UK trend growth to 1.8% from the pre-Brexit rate of 2.2%. In the case of a hard Brexit, trend growth could fall to 1.5%. As a prime minister May would find it easier to play hard-ball with the EU if she increased her majority, we see that election outcome as potentially the most damaging for the UK's long run economic outlook. Although it might materially reduce medium term confidence, a narrow majority win for May (or Corbyn), or a hung parliament, would probably be the best outcome for the economy, eventually. Around two-thirds of UK MPs are pro-EU, but these are mostly outside of the Conservative



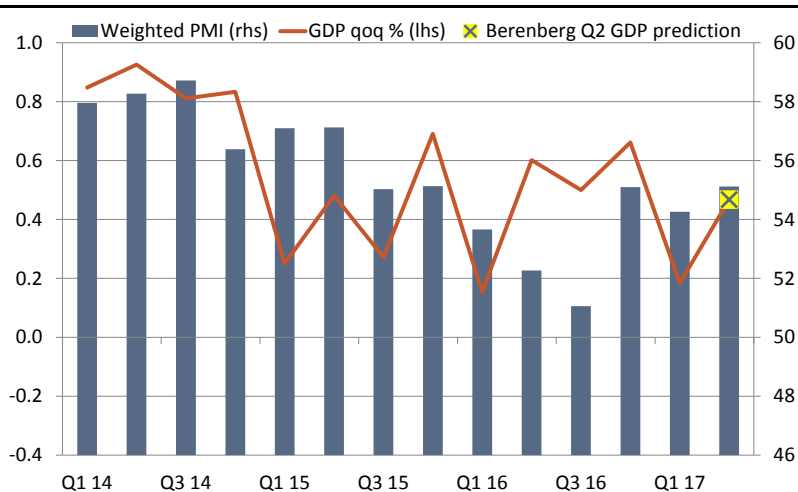
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Party. An election outcome that required a cross-party compromise would therefore raise the chance of a softer Brexit strategy, and may turn out to be positive in the long run after some serious initial confusion.

IMPACT OF TERROR ATTACKS

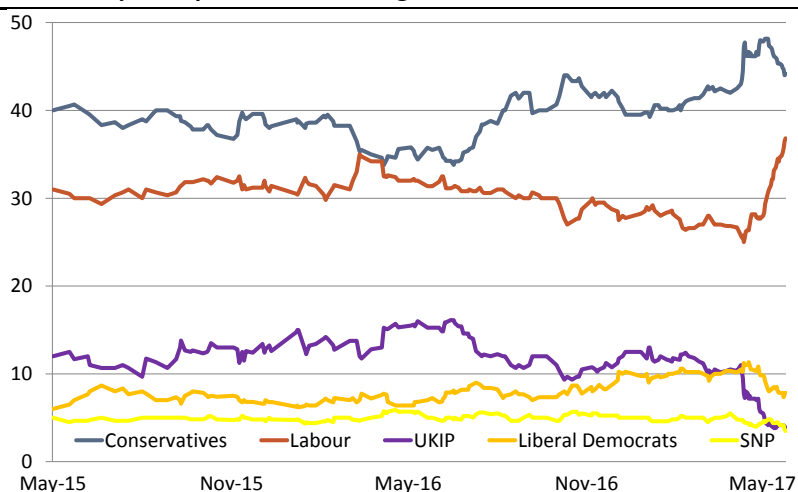
After the cowardly attack in London on Saturday, our thoughts are with the victims and their families. Such attacks do not usually have significant economic implications. This is the clear lesson from the series of attacks that have hit the western world in recent years. The direct economic impact will likely be small and brief. In the near term, we might see a temporary confidence shock that could weigh on leisure spending and tourism. Ahead of the election, the attacks could strengthen support for PM Theresa May and the Conservatives – who pledge the toughest stance on post-EU border control and migration of the major parties. However, we didn't see such a poll response after the Manchester attacks some two weeks ago.

Chart 1: Weighted PMI versus GDP



GDP is quarterly data. PMI is monthly data. Weights: 80% services, 15% manufacturing and 5% construction. Source: Markit/CIPS, Berenberg calculations.

Chart 2: Opinion polls are narrowing as the 8 June election nears



SNP: Some data points include voting intentions for Plaid Cymru. Source: National opinion polls, Berenberg calculations. Rolling average shown.



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Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7859
www.berenberg.com
florian.hense@berenberg.com