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UK UPDATE: MACRO, BOE AND BREXIT

Berenberg Macro Flash

STILL COPING WELL IN A TOUGH ENVIRONMENT

The UK economy continues to hold up well despite the unhealthy politic backdrop of domestic political clashes and long-term uncertainty stemming from Brexit. The concerns that short-term demand could collapse after the referendum have not materialised in a serious way. Instead, sentiment among households and firms remains upbeat. The economy continues to outperform market expectations – Chart 1. Domestic demand remains resilient. Households are using their balance sheets to smooth consumption through the temporary real wage squeeze. Meanwhile, exports are improving thanks to the solid upswing in Europe and the more competitive sterling. Businesses continue to cautiously hire and invest in order to expand production to meet the growing demand.

While Q1 real GDP growth slowed to 0.2% qoq from 0.7% in Q4 – the slowest growth rate in a year - final domestic demand had the strongest quarter (0.6% qoq) since before the Brexit vote. All components of domestic demand - investment, private consumption and government spending – added to growth. The major drag came from a rise in imports, partly driven by imports of capital and semi finished goods. In a way, this is a positive sign, such items are typically used in the manufacturing process; suggesting producers are setting themselves up for higher production. Real GDP growth has probably rebounded in Q2 to 0.4% qoq - as indicated by the Q2 PMI data (see Chart 2). For 2017 and 2018, we forecast real GDP growth of 1.7% and 1.6%, respectively.

THE BOE IS READYING THE MARKET FOR RATE HIKES

Despite elevated political and economic uncertainty, the Bank of England seems to be heading for a first rate hike soon. Domestic inflationary pressures are building. Since mid-2015 core inflation has risen from below 1% to 2.6%. Services inflation has risen from 2% to around 3% over the same period. Unless the BoE begins to tighten its monetary policy soon it will overshoot its 2% inflation target even after the current, temporary sterling-driven inflation has passed.

For the past few months the BoE has been stepping up its hawkish signals to markets. First, MPC member Forbes voted in favour of a hike in March. In May, the MPC then introduced the guidance that, 'monetary policy could need to be tightened by a somewhat greater extent over the forecast period than the very gently rising path implied by the market yield curve', with Forbes again voting for a hike. In the most recent June meeting, three members – all known hawks – voted for a higher bank rate. In the last two weeks BoE governor Mark Carney and BoE chief economist Andy Haldane have signalled a hike in the near-term too. This gradual shift in stance represents the MPC's efforts to foretell and communicate a forthcoming hike.

But the BoE faces inflation uncertainty stemming from the different speeds at which current demand and supply are reacting to Brexit. Communicating its policy guidance amid lower long-term growth adds to its challenges. We look for a first hike of 25bp in Q1 2018 with risks tilted toward a hike sooner. We see a 40% chance of a rate hike before this year is over.

If the BoE hikes this year, it is more likely to happen at the November Inflation Report rather than the August Inflation Report. The MPC will probably want to ensure the economy held up in Q3 after the election before making a move. Even after the first hike, monetary policy will remain very easy. The bank rate will remain negative in real terms and the BoE's balance sheet large by historical standards. After the first hike, the continued tightening thereafter will be very, very gradual.

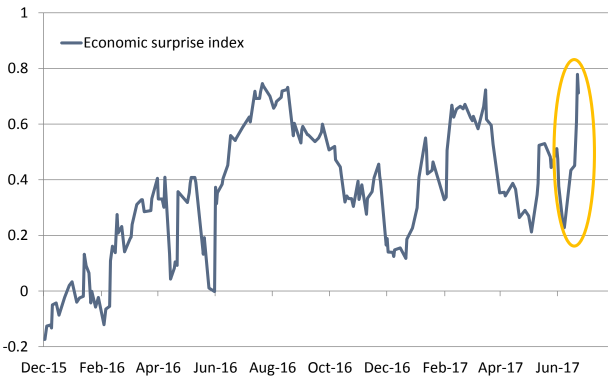
HEADING FOR A SOFT BREXIT? ONLY TIME WILL TELL

Has the UK general election changed the Brexit calculus? Probably, yes. Before the election, we saw a serious risk of a hard Brexit. But after the leading Conservative Party lost its majority some two weeks ago, that risk has receded. The election result has served to raise the influence of the pro-EU forces within the Conservative Party. Although the Conservative-DUP piecemeal 'confidence and supply' alliance is fragile, we expect the pro-EU and anti-EU factions of the government to find a compromise. The fear that far-left Labour leader Jeremy Corbyn could end up at Number 10, if the government failed and new elections were called, is the glue that will bind the government together. The bottom line is this, if push came to shove, we think the Conservative-Brexiteers would rather support a soft Brexit than a Labour Government. Although it is still early doors, since damaged-PM May has taken more of a back seat on Brexit since the election, the Conservatives are now more focused on trade and less on migration than before, especially since the pro-EU Chancellor Philip Hammond has become the driving force behind the parties' rhetoric on Brexit.

Although the first round of Brexit negotiations got off to a good start some two weeks ago, with no broad agreement in the UK on key issues like which parts of the Single Market the UK should aim to access after Brexit, and with the Brexit clock ticking, the government needs to act fast to secure a consensus in parliament on its strategy. While hopes for a soft Brexit have risen, the concept is meaningless unless MPs can agree on a strategy to take the UK through the tough Brexit negotiations. For now, only the aesthetics around Brexit have softened, the UK is not yet treading the path toward a more trade-focused Brexit. Hopefully, we will see more solid evidence of this as the Brexit negotiations continue during the rest of the year. Dates are set for 28 August, 18 September, and 9 October.

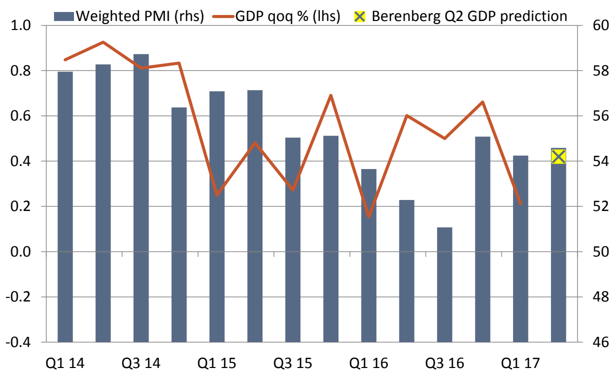
For more analysis on the outlook for Brexit, please see our note from the 20 June 2017, 'Analysing Brexit: the options and outlook'.

Chart 1: Economic surprise index



Source: Bloomberg

Chart 2: 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.

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