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UK GDP: TEMPORARY FACTORS WEIGH ON Q2 GROWTH, MODEST REBOUND LIKELY

Berenberg Macro Flash

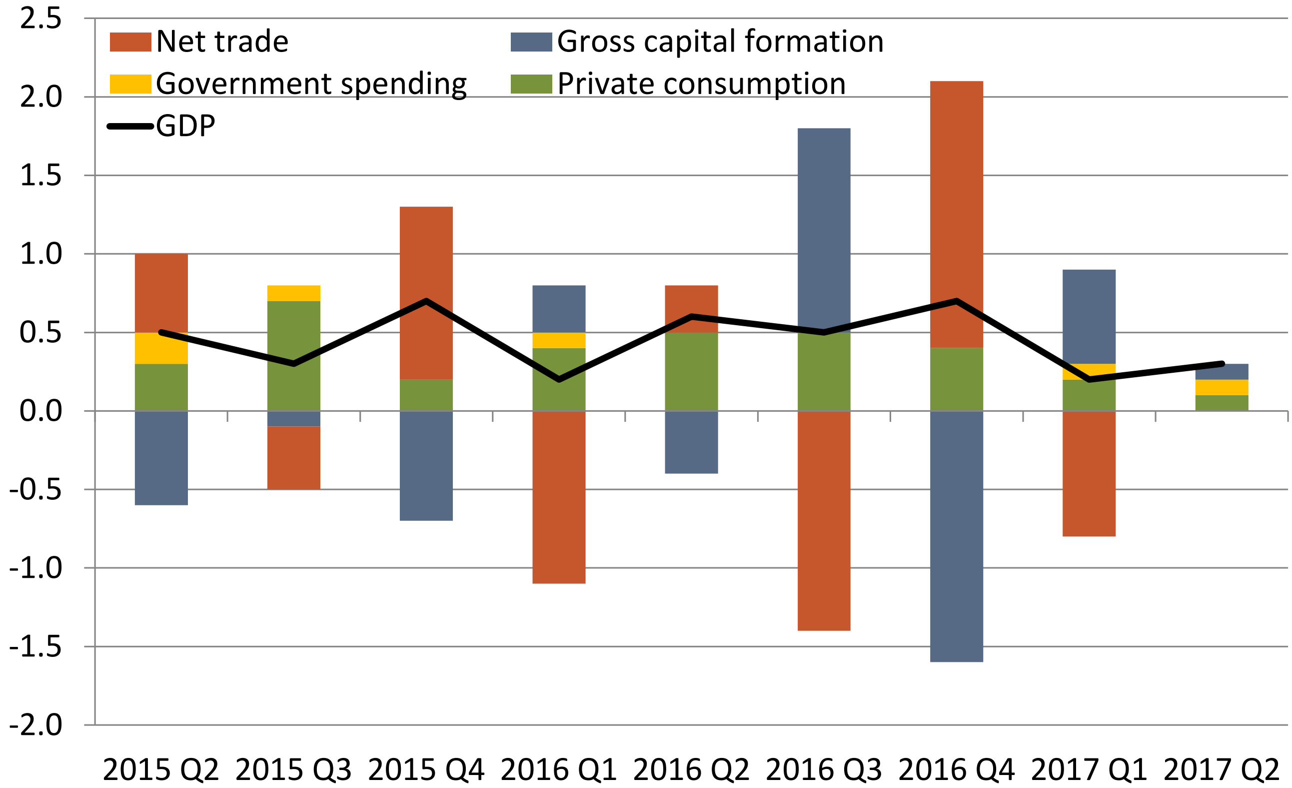
Real GDP, qoq %	Q2 2017
Actual	**0.3%**
Previous	0.3%
Consensus	0.3%
Berenberg	0.3%

In H1 2017 the UK economy grew by just 1% annualised - the slowest annualised pace in four years. After an unexpected surge in real GDP growth in the second half of 2016 (2.3% annualised), the economic expansion eased sharply in the first half of 2017. While the quarterly rate of real GDP growth accelerated a little to 0.3% qoq, from 0.2% in Q1, it remains below its potential rate of 0.45% (pre-Brexit vote = 0.55%). Should we be concerned about the slowdown in H1? Not much, the dip is probably temporary. Soft data for industrial production and other export-oriented industries suggest that net-trade will add to growth in the second half of this year. We anticipate real GDP growth of 0.4% qoq in H2 and 1.7% for 2017 overall. Meanwhile, the outlook for domestic demand – consumption + investment + government spending – remains robust. Growth in government spending and gross fixed capital formation (the broadest measure of capital investment) each contributed 0.1pt to the quarterly growth rate, respectively. Real household consumption added just 0.1pt to growth, the smallest contribution in three years (see below). Following growth of 0.7% qoq in both exports and imports, net trade neither added nor subtracted from growth. This follows a drag of 0.8pt from net trade in Q1. A critical point is that, despite the c20% drop in sterling after the Brexit vote, and improving global demand, net trade continues to disappoint because UK household demand for imports remains strong even as exports rise.

Despite the hit to real incomes from higher import prices consumption remains resilient. While the headline real rate of private consumption slowed from 0.1% qoq to 0.4% qoq in Q1, it was mainly driven by a drag from car sales, which declined sharply in Q2 following a tax-related boost in Q1. Data published today by the Society of Motor Manufacturers and Traders, show that car production for the domestic market grew by 17.7% in July yoy – indicating the Q2 dip was probably temporary. Other measures of household spending such as retail sales (up 1% qoq) remained solid in Q2. Instead of buying fewer goods and services as inflation rises, households are opening up their wallets more in order to target a desired level of real consumption. Household balance sheets have strengthened since the Lehman crisis. The ratio of debt-to-income is lower, mortgage affordability has improved, wealth has risen and, thanks to cheap oil, households have enjoyed solid real wage gains over the past three years. Feeling confident after seven years of economic growth, households can borrow more and save less for a while. We expect broadly flat real consumption growth again in Q3 as the real wage squeeze peaks. But as inflation moderates over the medium-term and nominal wage growth accelerates a little, the rate of real consumption growth can pick up again as real wage begin to rise. The impact of higher inflation on households is mainly showing up in lower confidence rather than spending. As we have argued before, the markets' worries about the impact on consumers from rising inflation are exaggerated and distract from the real threat coming from the housing market – see '[UK housing – the risk to watch]'.

Stable investment outlook rests on 'smooth Brexit': Gross fixed capital formation has rebounded this year after a disappointing performance in 2016, expanding by an average of 0.9% qoq following an average quarterly growth of 0.2% last year. Business investment was flat qoq, in line with estimates, after 0.6% growth in Q1. Scarred by the excesses that led to the Lehman crisis, firms have been reluctant to pursue aggressive capital spending plans, despite healthy demand at home and abroad, low costs of capital and healthy profits and cash flows. While key leading indicators for investment are positive, the outlook remains uncertain. Firms will likely stay extra cautious amid Brexit uncertainty. If the UK governments continues its ongoing shift toward a softer Brexit, firms can gain the confidence to raise investment by more. But if Britain and the EU do not make progress, nervous firms will reign in their capital spending plans. Investment growth will likely remain lumpy well into the medium-term. At best, we may see a modest expansion in investment at a pace a little above 2% yoy until after Brexit – March 2019. Compared to other major developed economies where investment has turned up sharply at the start of the year, the UK investment outlook looks comparatively soft.

Contributions to GDP growth (ppt) of main components. GDP – qoq %



Quarterly data. Source: ONS, Berenberg calculations

% change, sa	**Q2**	**Q1'17**	**Q4**	**Q3**	**Q2**	**Q1'16**
GDP, qoq	0.3	0.2	0.7	0.5	0.6	0.2
yoy	1.7	2.0	1.9	2.0	1.7	1.6
Private consumption, qoq	0.1	0.3	0.7	0.8	0.8	0.7
Gov. spending, qoq	0.6	0.7	0.0	-0.1	0.2	0.4
GFCF, qoq	0.7	1.0	0.1	0.6	0.2	0.0
Exports, qoq	0.7	-0.7	4.6	-2.1	1.3	-2.9
Imports, qoq	0.7	1.7	-1.0	2.3	0.3	0.4

Source: ONS

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