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UK UPDATE: BREXIT, POLITICS, MACRO, BOE

Berenberg Macro Flash

BREXIT NEGOTIATIONS – ALL TALK NO ACTION YET

Theresa May's Florence speech last week may have created a 'new dynamic' in the Brexit negotiations according to EU chief negotiator Michel Barnier, but the change in tone has not yielded results yet. The fourth round of talks which ended yesterday did not bare any fruit. Instead, Mr Barnier said that the talks fell short of the 'sufficient progress' needed on Brexit – the divorce bill, citizens rights' and the Irish border question – to move onto talks of a transitional period and post-Brexit trade. While markets responded positively to the tone of yesterday's press conference, we look toward the Conservative Party annual conference next week which will give the UK government a chance to settle its differences out in the open.

Pro-EU factions of the UK government – chancellor Hammond and home secretary Rudd - would prefer to concede to the EU's divorce demands in order to swiftly move onto trade talks. But the hard-line Eurosceptics – who do not see major costs from Brexit – want to play hard ball with the much stronger EU. Key conference speeches from PM May, Brexit secretary Davis, chancellor Hammond, foreign secretary Johnson and trade secretary Fox will demonstrate which way the government is leaning. We take May's softer stance in Florence last week, and Mr Barnier's remarks on the improved atmosphere in the latest talks with Davis, as signs the UK is gradual conceding on the key issues. While such a trend may embarrass the UK government, it is the way to a Brexit that minimises the long-term economic damage for both sides.

We maintain our key call that the UK will agree to the EU's terms of divorce before the end of the year. This can allow the UK and the EU to work toward a transitional arrangement in 2018 that would come into force when Brexit actually happens in March 2019. We expect this agreement to retain preferential trade in most goods and some services. Over time, this arrangement will probably solidify into the final terms for post-Brexit trade between the UK and the EU. In our base case, Brexit could reduce trend growth to 1.8% from the pre-Brexit rate of 2.2%. In the case of a hard Brexit (30% chance), trend growth could fall to 1.5%.

THE SILVER LINING OF THE CORBYN RISK – MAY SEEMS TO BE TAKING ANOTHER SENSIBLE U-TURN

The fear that far-left Labour leader Jeremy Corbyn could win the next election is the glue that is holding the fragmented Conservative government together. The message from this week's Labour Party annual conference in Brighton was clear; if Labour is elected, expect higher taxes, more regulation in product and labour markets while politically sensitive industries would be taken under government control. By distorting the process of price discovery in markets and creating additional cost burdens on the already highly leveraged private sector, the combination of such policies would create significant downside risks for the UK's long-run growth potential, in our view. On Brexit, Labour indicated it wants a longer transitional period of four rather than around two years as put forward by PM May, along with keeping the UK inside the EU Customs Union. Since no non-EU countries are currently fully inside the EU Customs Union, it is doubtful that such an option would even be available.

Yesterday, PM May got a chance to respond to the Labour economic agenda put forward at its conference. Somewhat surprisingly, May seemed to drop her modestly-interventionist tilt on economic policy that she had carried through her failed election campaign. Instead, she adopted a more Thatcherite stance at a BoE conference, arguing the merits of fiscal conservatism and free markets. Whether this was just the PM taking an angle that could win over an audience made up of mostly bankers and other similar occupations,

who knows? At any rate, we will keep a careful eye on any future speeches. It seems that, both on Brexit and matters of the economy, the PM is willing to do the right thing in the end, that is, after she has tried everything else.

REAL GDP GROWTH IS ACCELERATING IN THE SECOND HALF OF 2017

Soft and hard data continue to indicate that real GDP growth is accelerating modestly in the second half of the year. Data published today showed improved consumer confidence, up to -9 in September, from -10 in August. Despite uncertainty from Brexit and a modest temporary real wage squeeze, consumer confidence remains well above its ten year average of -16. In Q2 real GDP expanded by 0.3%, driven by gains in exports, business investment and consumption. Modest gains in real incomes (up 1.9% qoq) and a higher savings ratio in Q2 (5.9% versus 4.0% in Q1) along with continued growth in real consumption should help to alleviate exaggerated fears about the fragility of UK households.

The mix of soft and hard data signals healthy gains in real household consumption in Q3 along with strengthening data in export-oriented industrial sectors. This supports our call for an acceleration of real GDP growth to 0.4% qoq in Q3. We forecast real GDP growth of 1.7%, 1.6% and 1.7% in 2017, 2018 and 2019, respectively – a little above the market consensus according to Bloomberg of 1.5%, 1.3% and 1.6% (taken 29/09/2017).

RATE HIKES IN THE 'RELATIVELY NEAR-TERM' ACCORDING TO CARNEY

BoE governor Mark Carney today reiterated the BoE's guidance from its September MPC meeting that 'some withdrawal of monetary stimulus is likely to be appropriate over the coming months'. Recent BoE messages have now brought forward market expectation for the first rate hike towards November. On BBC Radio today Carney explained 'what we have said, that if the economy continues on the track that it's been on, and all indications are that it is, in the relatively near-term we can expect that interest rates would increase somewhat'. The continued explicit guidance from the BoE shows that is it on the cusp of hiking and wants to avoid a potentially disorderly adjustment in markets and in the real economy. After the first hike in November 2017, we continue to expect a very gradual tightening thereafter to sustainably return inflation to its 2% target, with four hikes in total between now and the end of 2019.

Importantly, a first 25bps hike would have trivial effects on the real economy. It would remove no more than a third of the emergency stimulus the BoE introduced back in August 2016. Even if the bank rate were 100bps higher, the real policy rate would remain negative and the bank's balance sheet large by historical standards. Monetary policy will remain highly accommodative over the medium-term and will not do much to thwart a continued gradual pick up in wages and productivity toward its long-term trend rate.

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