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UK GDP – A LITTLE ACCELERATION IN Q3

Berenberg Macro Flash

PMI composite, September	
Actual	**54.1**
Previous	54.0
Consensus	53.8

UK ON TRACK FOR A STRONGER H2

While the headline composite PMI actually declined a little between the second and third quarter – 54.8 in Q2 vs. 54.1 in Q3 – the UK looks set for slightly stronger growth in H2. A composite PMI reading of around 54 is consistent with quarterly real GDP growth of 0.4% - a little below the UK's post-Brexit vote potential of 0.45% qoq (0.55% pre-Brexit vote). So far this year the PMIs have over-estimated growth – Chart 1 – as one-offs such as the correction in industrial production in Q2 weighed on total GDP growth. But such factors do not seem to have persisted in Q3. As Chart 2 shows, survey data from the Confederation of British Industry suggests that industrial output growth reached a post-Lehman high in Q3 – Chart 2. Meanwhile, the acceleration in real retail sales growth suggests that real household consumption growth picked up a little in the third quarter too – Chart 3. Taken together, along with the continued moderate gains in investment and hiring, we estimate that real GDP expanded by 0.4% qoq in Q3, up from 0.3% in Q2.

While the short-term risks to demand since the Brexit vote have not materialised in a serious way, the UK economy should be faring much better today on the back of the on-going global upswing. Uncertainty from Brexit is weighing on firm and household confidence. As neighbouring Eurozone growth accelerates to a decade high of 2.2% this year, UK growth looks set to slow to a modest 1.6% – well below its pre-Brexit potential rate of 2.2%. After managing one of the strongest post-Lehman recoveries of all advanced economies, the UK growth rate would probably be nearer 2.5% this year if it weren't for Brexit.

BoE - ALL CLEAR FOR A NOVEMBER HIKE

The BoE's most recent guidance from its September MPC meeting that, 'some withdrawal of monetary stimulus is likely to be appropriate over the coming months', has now brought forward market expectation towards November. The unusually 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. Now that markets are largely ready for the hike, today's reading of modest demand gains in Q3 will give the BoE further assurance that a rate hike is appropriate. 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.

Is the BoE making a mistake by going for a rate hike? No. Even though real GDP growth has slowed a little this year, because of Brexit, firms are not supplying goods and services quickly enough to meet the growing demand. As a result, underlying inflation is rising. Without modestly tighter monetary policy to keep inflation expectations firmly anchored at the 2% target, underlying inflation would continue to rise and the BoE would have to raise rates by more at a later date which would risk choking off the expansion. It is far safer for the BoE to go early and slowly than later and faster.

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

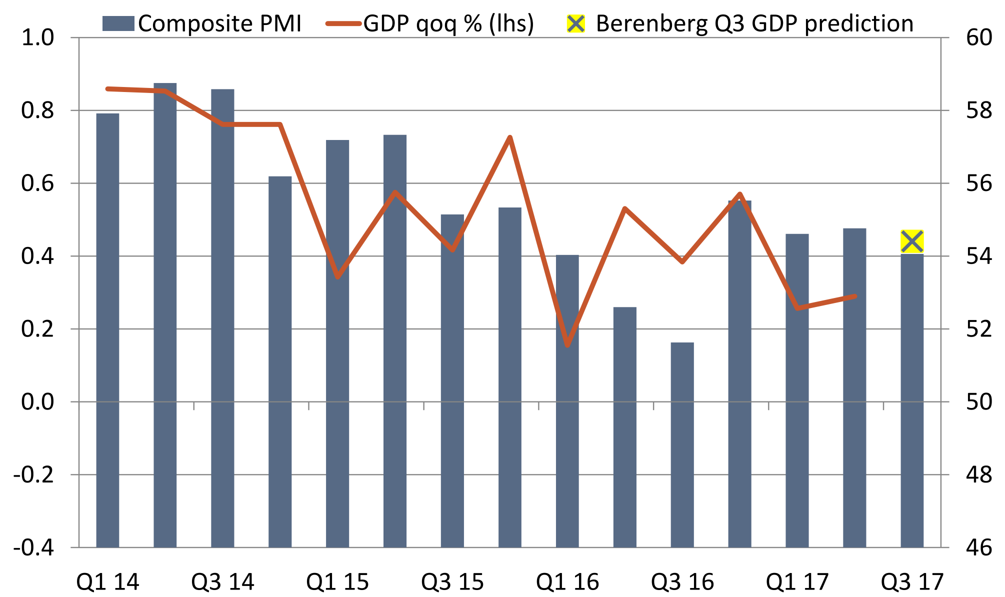
100bps higher, the real policy rate would remain negative and the bank's balance sheet large by historical standards. Monetary policy will remain highly accommodative over the medium-term and will not do much to thwart a continued gradual pick up in wages and productivity toward their long-term trend rates. For more information on our UK monetary policy outlook, please see our report 'The BoE's job is done: it is time for rate hikes' from 1 September 2017.

LONG-TERM BREXIT RISKS LOOM LARGE

We maintain our key call that the UK will agree to the EU's terms of divorce around the turn 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 such a world, as the terms of Brexit becomes more certain, household and firm confidence will begin to rise and downside risks to the UK economy will begin to reduce. This should underpin a smooth(ish) transition to the UK's new long-term post-Brexit growth path.

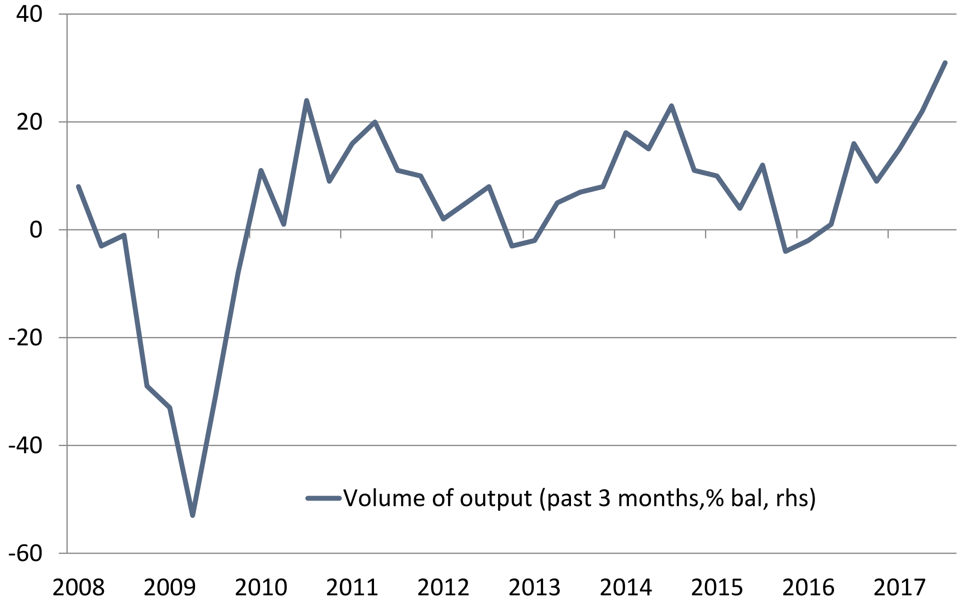
But the hard-Brexit risk looms large. Pro-EU factions of the UK government – chancellor Hammond and home secretary Rudd - would prefer to concede to the EU's divorce demands in order to swiftly move onto trade talks. But the hard-line Eurosceptics – who do not see major costs from Brexit – want to play hard ball with the much stronger EU. If this division prevents Brexit talks with the EU moving forward, the UK runs the risk of sleep walking off the Brexit cliff-edge in March 2019. We therefore see a 30% chance of a hard Brexit. In the short-run, this would pose significant downside risks to demand. And in the long-run, a hard Brexit could reduce trend growth to 1.5%.

Chart 1: Composite PMI versus quarterly real GDP growth (%)



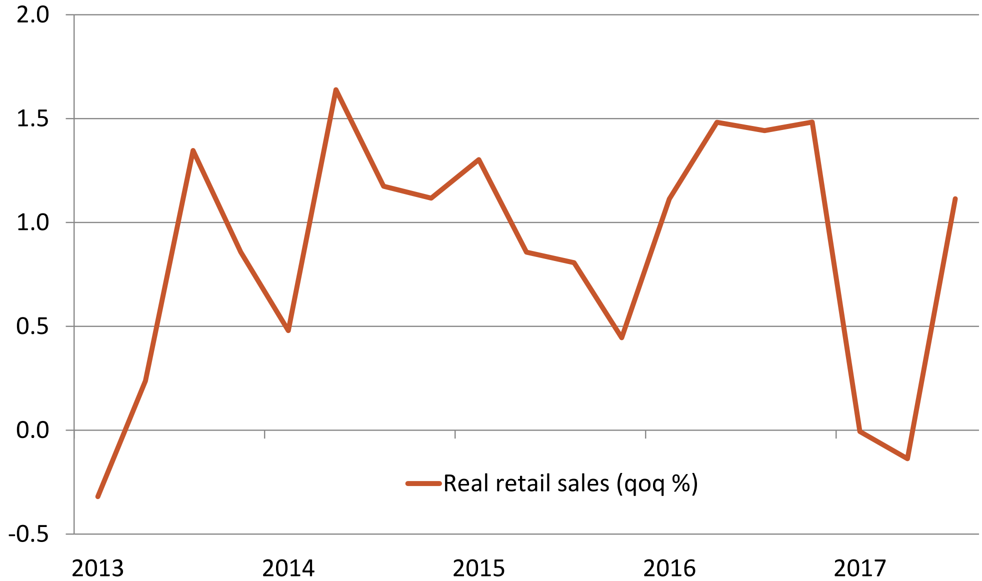
Quarterly data. Source: Markit/CIPS, Berenberg calculations.

Chart 2: CBI industrial trends: volume of output over past 3 months (% bal)



Quarterly data. Source: Confederation of British Industry

Chart 3: Retail sales volumes excluding automotive fuel (qoq %)



Quarterly data. Source: ONS, Berenberg calculations. Q3 data based on July and August only due to current data availability.

Index	Q3	Q2	Q1 2017	Q4	Q3	Q2 2016
Composite	54.1	54.8	54.6	55.5	51.6	52.6
Service	53.5	54.3	54.3	55.3	50.9	52.7
Manufacturing	55.9	55.9	54.7	54.5	52.3	51.1

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