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UK GDP GROWTH ACCELERATED IN Q3 – RATE HIKE NEXT WEEK

Berenberg Macro Flash

GDP (a), qoq %, Q3 2017	
Actual	**0.4**
Previous	0.3
Consensus	0.3
Berenberg	0.4

UK HEADING FOR A SLIGHTY FIRMER H2

After one-off factors weighed on growth in the first half of the year UK real GDP growth accelerated by 0.1pt to 0.4% qoq in Q3, in line with our own forecast but a little above what the market had expected (0.3%). Data published in the first estimate breaks GDP down by sector rather by type of spending. The data show stable gains in the services sector (+0.4 qoq). Services make up c79% of total GDP. The expansion in the domestic-oriented services sector was led by computer programming, motor trade and retail. Industrial production (c14% of GDP) rebounded after a subdued Q2 (-0.3% qoq) with output expanding by 1.0%. Export-oriented manufacturing, the largest industrial sub-sector expanded by 1.0%. UK export-related sectors currently benefit from the healthy expansions in the UK's major trading partners, the US and the Eurozone, and a tailwind from the weaker sterling – which is down 12% on a trade-weighted basis since the Brexit vote on 23 June 2016. Although output in the construction sector (c5% of GDP) remained well above its pre-crisis level, it shrank for the second quarter in a row (-0.7% qoq in Q3 and -0.5% in Q2). While this puts the sector in technical recession, the nature of construction, with its large and lumpy orders, is typically volatile and will likely rebound in the coming quarters.

The current pace of UK GDP growth is ok, but it could be better. While the short-term risks to demand since the Brexit vote have not materialised in a serious way, the UK economy should be riding high 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. Further out, we expect real GDP to expand by 1.6% in 2018 and 1.7% in 2019, above the market consensus of 1.3% and 1.6%, respectively (Bloomberg consensus on 25/10/2017).

BoE – EXPECT A RATE HIKE NEXT WEEK

In line with its recent guidance we expect the BoE to hike for the first time by 25 bps at its November MPC meeting next Thursday. Thereafter, we expect a continued tightening to sustainably return inflation to close to its 2% target, with four 25bps hikes in total between now and the end of 2019 (two in 2018 and one in 2019). While the market now expects the first hike in November, having recently brought forward its expectations from as late as 2019, current pricing suggests the market is anticipating only one further hike in 2018. We therefore expect the BoE to strengthen its guidance after the first hike, leading to a somewhat steeper gilt curve and possibly a stronger sterling on a trade-weighted basis by the turn of the year.

Is the BoE making a mistake by going for a rate hike? No. Even though real GDP growth has slowed a little this year compared to 2016, 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.

qoq %	**Q3**	**Q2**	**Q1 17**	**Q4**	**Q3**	**Q2**	**Q1 16**
GDP	0.4	0.3	0.3	0.6	0.4	0.5	0.2
Services	0.4	0.4	0.1	0.6	0.7	0.4	0.8
Production	1.0	-0.3	0.3	0.7	-0.5	2.2	-0.1
Construction	-0.7	-0.5	1.9	2.2	0.5	2.1	0.5

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