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UK UPDATE: GROWTH RESILIENT AT THE START OF 2018 DESPITE RISKS

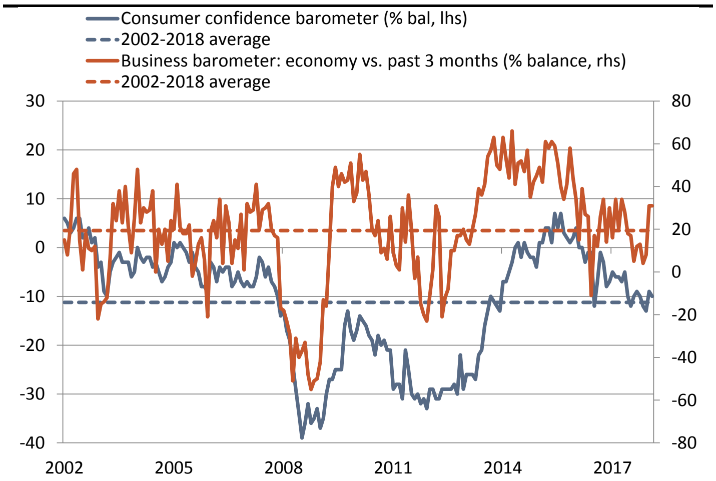
Berenberg Macro Flash

So far…so…ok: The UK economy continues to outperform the market's depressed growth expectations that have endured since the Brexit vote in 2016. The serious short-term downside risks from Brexit so far remain just that, risks. Helped along by above-trend growth in its major trading partners, the US and Eurozone, the UK is managing growth at its post-Brexit trend rate of around 1.7% yoy. Trend growth is acceptable amid the very high level of uncertainty about the new-nature of the UK's relationship with its biggest market, the EU. Trend growth is sufficient for the UK to maintain its unbroken eight year growth streak and record employment. Early indicators suggest the UK economy has maintained its late 2017 pace so far in 2018. After growth of 1.7% in 2017, we continue to remain above consensus in our calls for 2018 (1.7%) and 2019 (1.8%) real GDP growth. (Bloomberg consensus taken on 5/2/2018: 2018 at 1.5%, 2019 at 1.5%). Without Brexit, UK real GDP growth would probably be at least 2.5% yoy in the current global environment.

Soft data point to 0.4% growth in Q1: Economic activity continues to rise across all pillars of demand while confidence remains in line with long-term averages. As an open economy, UK benefits from the building global momentum. The healthy global dynamics are showing up in stronger production, investment and exports relative to recent years. Consumer confidence fell after the Brexit vote from a post-Lehman high as the sterling driven rise in inflation toward 3% squeezed real wages. But strong labour demand and the gradual acceleration in nominal wage growth in in H2 2017 (1.8% in April to 2.5% in December) seem to have helped consumer confidence stabilise at just above its long-term average. Meanwhile, business confidence has recovered after a dip in Q4 – Chart 1. Along with today's PMI composite data, the most timely broad measure of economic activity, the overall batch of soft indicators suggest that real GDP growth is running at around 0.4% qoq in Q1 – in line with our own estimate (Chart 2).

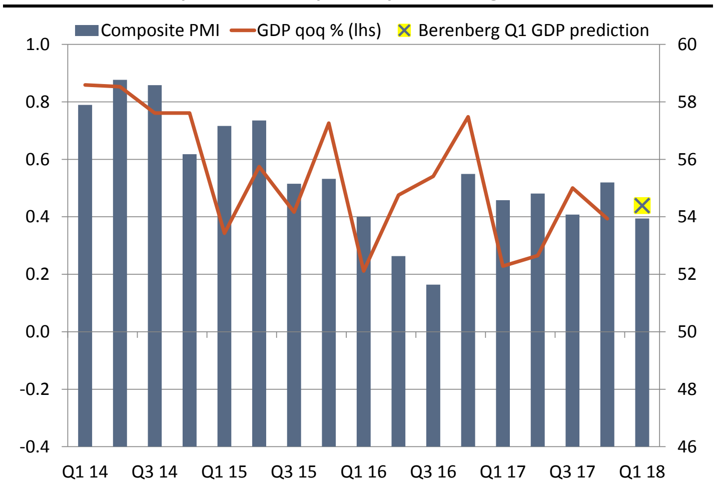
Despite the short-term resilience, long-term economic uncertainty has risen: By damaging its ties with its biggest market, the EU, the UK will harm its long-term supply potential. By just how much depends on the nature of the future trade deal between the UK and the EU. Our estimates range from c2.0% in a no-Brexit scenario to less than 1.5% in a hard-Brexit scenario. Last Friday's speech by UK prime minister Theresa May did little to dampen the recent rise in Brexit uncertainty coming from the increasing tensions between UK and EU negotiators over key details – the UK's future migration policy and a tangible solution to the Irish question - needed to move talks forward. Due to the increased uncertainty about the outlook for Brexit, we have fattened the tails in our distribution of possible Brexit outcomes. Please see Brexit tail risks loom larger than before for more detail. While we still expect the UK and the EU to strike a compromise of a semi-soft or soft Brexit (65% probability), the tails risks of a hard Brexit (25%) or no Brexit (10%) have increased.

Chart 1: Business and consumer confidence versus long term average



Monthly data. Source: GfK, Lloyds Bank, Berenberg calculations

Chart 2: PMI composite versus quarterly real GDP growth (%)



Quarterly data. Q1 PMI estimate based on Jan/Feb average. Source: Markit/CIPS, Berenberg calculations.

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