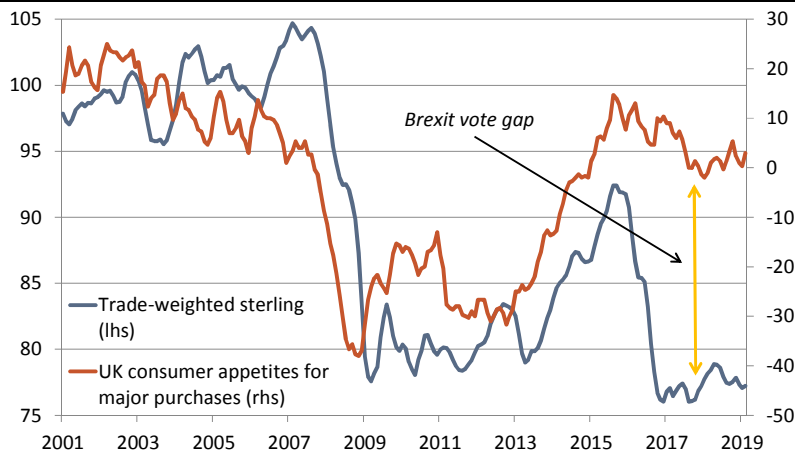


8 March 2019

## UK confidence gap – consumers versus markets

Consumer appetite for major purchases versus trade-weighted sterling



Monthly data. Data show three-month moving averages. Sterling: January 2005 = 100. Consumer data expressed as % balance. Source: BoE, GfK

- Mind the confidence gap:** Consumers only want to make big purchases when they feel confident about their current and expected situation. Similarly, currencies reflect global financial markets' perceptions of an economy's present and future prospects. Economic logic suggests that these two variables should correlate over time. As our chart shows, this was broadly true in the UK for the early 2000s, during the 2008/09 mega-recession, and for much of the post-Lehman upswing. But in June 2016, when the UK voted for Brexit, a gap emerged. While sterling plunged 16% from its pre-referendum peak, consumer demand has remained firm.
- The strength at home:** Despite the temporary squeeze on household real incomes from mid-2016 to early-2018, as the drop in sterling pushed up import prices, household fundamentals have continued to hold up well. The labour market is solid. Employment and job openings are at record highs and rising. Annual weekly earnings growth has edged above inflation towards a post-Lehman high of 3.4%. With rising net wealth and easy access to cheap credit, the situation for households is auspicious. Despite serious risks ahead in the event of a hard Brexit, the facts on the ground do not justify major softness in household confidence yet.
- Forward looking markets:** On its own, the slowdown in UK real GDP growth from an average of 2.4% yoy in the two years up to the Brexit vote to 1.6% thereafter and the rate hikes by the BoE hardly vindicate the market's pessimism, reflected by the sharp correction in sterling. Since June 2016, however, forward-looking markets have paid more attention to the potential negative consequences of a hard Brexit than to the facts on the ground. In our view, a no-deal-no-transition hard Brexit would risk a recession near-term and could lower UK potential growth to below 1.5% from 2.1% before the Brexit vote. In this context, the big drop in sterling makes sense.
- Big week ahead:** Next week, parliament will have three key votes on Brexit: on Tuesday, it will likely vote against May's Brexit deal for a second time; on Wednesday, it will probably vote against a hard Brexit; and on Thursday, it will likely vote for the UK to seek to delay Brexit. Such a pattern of votes would demonstrate to markets that the UK is not prepared to go over the hard-Brexit cliff edge. This would be a plus for sterling and UK risk assets.
- Fully closing the gap in time:** We see only a 15% risk of a hard Brexit. Instead, we look for the UK and EU to eventually ratify an agreement that preserves the current terms of UK-EU trade in goods, with an outside chance that services will be covered too. How soon this happens depends on whether the UK parliament can quickly form a majority around an alternative Brexit if it votes down May's deal once again. If it manages to do so, only a short delay – about two months – would be needed to provide the time for the UK and EU to ratify the deal. This remains our base case. We therefore expect sustained gains for sterling over the medium term. Look for GBP/USD at 1.47 by end-2020. However, if parliament cannot make up its mind fast, Brexit may need to be delayed by more than a year. This would prolong the uncertainty that is weighing on sterling and delay a rebound in the economy.

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