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UK UPDATE: MANUFACTURING WEAKNESS NOT A SERIOUS RISK

Berenberg Macro Flash

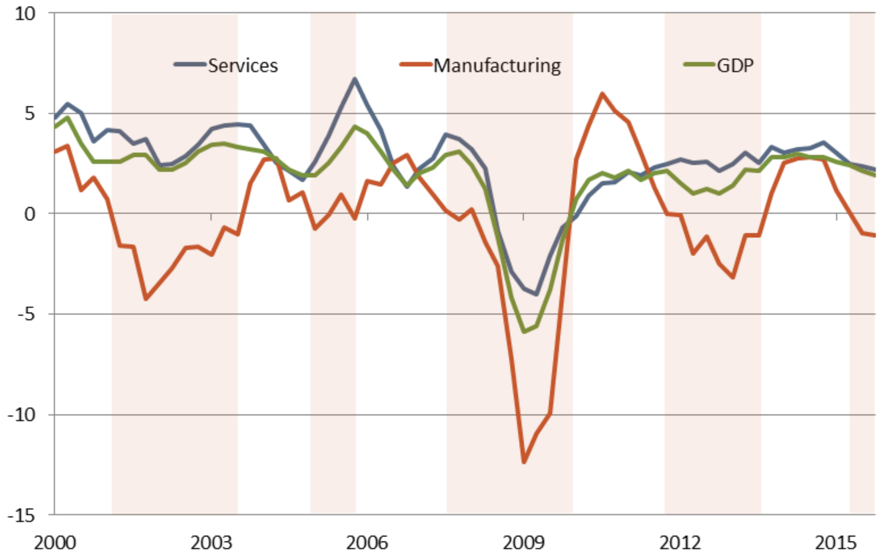
Industrial, mom %, January

Actual	**0.3**
Previous	-1.1
Consensus	0.4
Berenberg	0.5

Industrial output turns positive after a two month dip but it won't last: Industrial output grew by 0.3% yoy in January after contracting by 1.1% in December and 0.8% in November. Growth was slightly below expectations and comparing January to the Q4, industrial output contracted by 0.8%. Manufacturing output, which makes up over two-thirds of industrial output, was stronger than expected. Output increased on a monthly basis by 0.7% versus expectations of 0.2% growth. Comparing January to Q4, output increased by 0.3%. Going forward, we expect manufacturing and industrial output to contract again. Indeed, early indications suggest that demand declined sharply in February as the financial market rout intensified. February UK manufacturing PMI data disappointed, citing weakening external demand and China's trade data pointed to a sharper than expected drop in global trade flows. Declines in sterling might provide a modest boost but weakening global demand will take a greater toll and we expect industrial output to decline in the first quarter.

Manufacturing recessions can drag but they rarely point to serious risks in the economy. UK manufacturing output is volatile. As Chart 1 shows, the sector can go deep into deep and extended recession without taking the rest of the economy with it. In the early 2000's manufacturing output declined on an annual basis for ten consecutive quarters and the economy managed an average annual rate of growth of 2.9%. Again, early in the 2010's, the sector sank for seven quarters in a row while the economy grew at an average rate of 1.5% yoy. Chances are this is another one of those episodes. Declines in manufacturing will probably put a dent in near-term growth but UK fundamentals are robust. Unemployment is low, wages are growing modestly, there is a big tailwind from cheap oil and monetary policy is highly accommodative. Together, these factors point to strong domestic demand. This highlights the second argument shown in Chart 1, GDP mostly tracks services not manufacturing. Almost 80% of GDP is domestic oriented services. A dip in this sector – think 2008 – can spell disaster. Currently, domestic fundamentals point to stable gains in demand and data confirms that the services sector is doing fairly well. So long as the economy doesn't take a severe body blow like a Brexit or a global recession, we expect GDP growth to continue at a robust pace through 2016 (1.9% yoy) driven by domestic growth with only a small slip below trend in the first half of the year as global headwinds blow.

Chart 1: When manufacturing drops there's a 1 in 5 chance of a recession



Source: ONS. yoy %. Red shaded areas indicate when manufacturing output contracts

Industrial

% change	**JAN**	**DEC**	**NOV**	**OCT**	**SEP**	**AUG**
Industrial prod., yoy	0.2	-0.2	0.9	1.6	1.3	1.6
Industrial prod., mom	0.3	-1.1	-0.8	0.2	0.0	0.9
Manu. prod., yoy	-0.1	-1.7	-1.2	-0.2	-0.5	-1.1
Manu. prod., mom	0.7	-0.3	-0.3	-0.4	1.0	0.3

Source: ONS

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