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UK UPDATE: BEYOND THE BREXIT RISK – FIRST RATE HIKE IN NOVEMBER

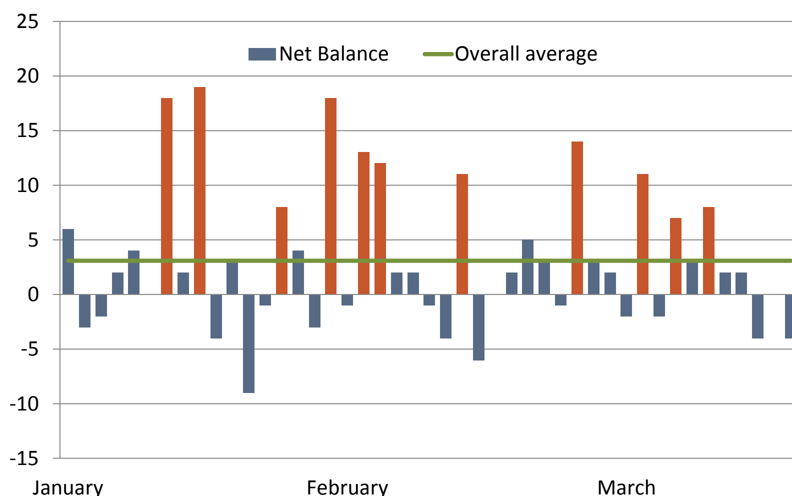
Berenberg Macro Flash

When considering the upcoming EU referendum on June 23 we need to remember two things: (1) To subtract the noise and instead focus on the underlying trend when assessing the real risk of a Brexit – the UK remaining in the EU is still the most likely outcome. (2) To still pay attention to the other key risks and trends for the UK economy in 2016.

Another day, another opinion poll: The latest poll on the EU referendum showed a 4 point lead for the 'leave' vote. Should we pay much attention to it? No. The poll doesn't reflect the underlying trend. From almost all angles, analysis of poll data shows the 'remain' camp slightly ahead. Dissecting the 2016 polls so far yields a few key takeaways:

(1) Two thirds of the polls suggest a vote to 'remain'
(2) On average, the 'remain' camp is ahead by 3 points
(3) The average of the telephone polls shows the 'remain' camp ahead by almost 13 points (red bars in chart)
(4) Online poll averages show an equal split for 'remain' and 'leave' (blue bars in chart)
(5) The percentage of undecided votes is higher in the online polls (18%) versus the telephone polls (13%)

2016 opinion polls on the UK referendum: online versus telephone polls



Source: Various, Berenberg calculations. Telephone polls shown in red, online polls shown in blue.

Conclusion: polls clearly show that a vote to 'remain' in the EU is the most likely outcome. As part of large and systematic divergence between the online and telephone polls, online polls show a much higher number of undecided votes (around 5 ppt more) than the telephone polls. This suggests that, on vote day, undecided voters are more likely to sway towards 'remain' rather than 'leave'.

We see 35% chance of a Brexit. For a comprehensive overview on the impact of a Brexit, please see our recent report "The day after Brexit: what would happen next?"

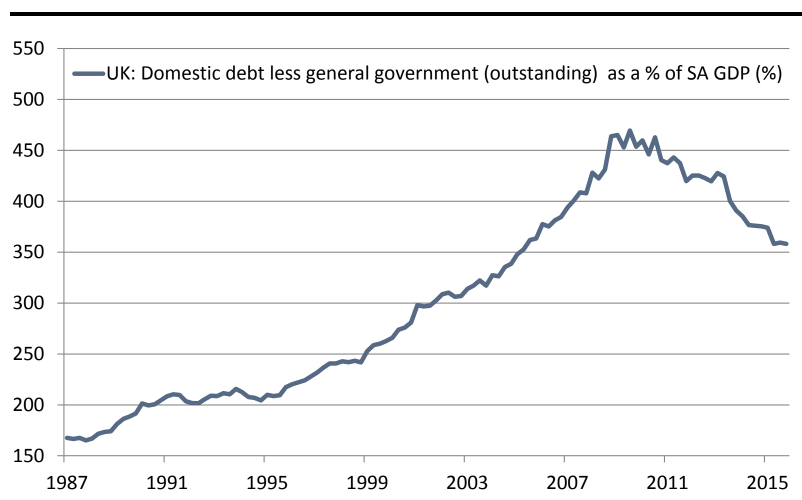
After the EU referendum, attention will turn to the Bank of England.

Since the UK is more likely to remain in the EU, we look through the referendum debate and consider when the Bank of England is likely to go ahead with the first hike.

As long as the UK votes to stay in the EU and financial markets are not excessively volatile at the time, we expect the BoE to hike by 25 bps in November. There are always arguments for and against hiking. That is the nature of markets. But come November, we expect the BoE to judge the balance of risk in favour of hiking. Here are three reasons why the UK is ready for a rate hike:

(1) The private sector can handle higher interest rates: Excluding government, which is the only part of the economy that has increased its debt as a share of GDP, private sector outstanding debt as a % of GDP has fallen from 470% to close to 360% (see below) since 2008. Households and both financial and non-financial corporations have deleveraged considerably. The private sector can easily handle modest hikes in the bank rate. Back in 2007 Q2 when the bank rate was 5.75%, total private sector debt was close to 410% of GDP. That is 50 ppt higher than it currently is at a Bank rate of 0.5%. Even for the government, whose debt has continued to rise, small increases in the bank rate shouldn't pose a problem. Government debt as % of GDP is now stable and should begin to fall either this year or next.

Private sector debt as a % GDP



Source: ONS, Berenberg calculations

(2) By H2 2016, GDP will likely be growing at trend and inflation will be closing in on the 2%. The underlying growth trend in the UK is robust, even if it is a little unbalanced. GDP growth accelerated between Q2 and Q4 of last year and absent of the financial market volatility, growth would have probably remained at around trend heading into 2016. We expect the near-term dent in growth to 0.4% qoq in Q1 and Q2 from 0.6% in Q4 2015 to reverse after the referendum. Growth will probably return to trend of around 0.5% qoq. However, there is a reasonable chance of even faster growth, depending on how strongly business invest-

ment and consumer spending rebound. From zero in most of 2015, inflation has now started to slowly recover – 0.3% in February. Excluding energy and food, inflation is around 1.2%. As the impact of the falls in the price of oil drop out of the headline rate, inflation should gradually increase over the course of the year. We expect inflation to reach 1.6% by the end of the year helped along by the lagged effect of full employment in the labour market driving faster growth in wages.

(3) The UK needs rate hikes to encourage more saving and prevent a rise in household debt. The UK savings rate has fallen sharply from a peak of 12% in 2010 to its current rate of less than 4%. Household borrowing is rising too. Consumer credit growth has reached a decade high and for the first time since 2008, household debt outstanding is starting to increase as a % of GDP. Aside from its duty as guardian of inflation, the BoE needs to judge the level of risk appetite in the economy and determine its implications for loan demand. When risk appetite is elevated, households borrow too much and save too little. It is the job of the central bank to raise interest rates and correct this behaviour. In the UK, that time has come. Higher interest rates will encourage more saving and less borrowing. If it comes at the expense of slower growth then so be it. The growth the UK does get will be more sustainable.

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