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UK: MARKET TURMOIL AND BREXIT JITTERS HIT Q1 GDP GROWTH

Berenberg Macro Flash

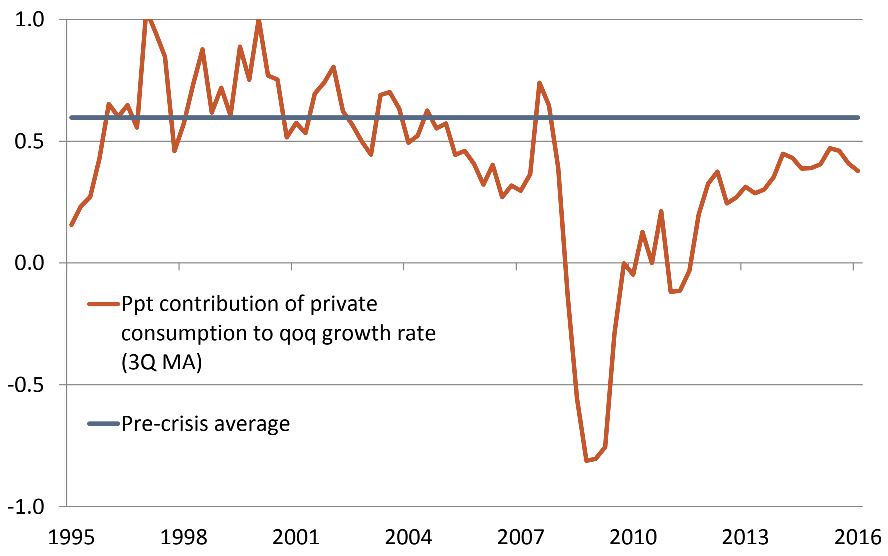
UK GDP, real, qoq %, Q1 2016

Actual	**0.4**
Previous	0.6
Consensus	0.4
Berenberg	0.4

The worst start to a year in financial markets since 2008 and heightened uncertainty over the UK's fate in the EU damped growth momentum at the start of the year. Domestic demand provided all of the growth while trade dragged. The quarterly growth rate slowed to 0.4% in Q1 from 0.6% in Q4, in line with expectations. Private consumption accelerated to 0.7% qoq from 0.6% in Q4. Government consumption expanded by 0.4% qoq following growth on 0.3% in Q4. Gross fixed capital formation grew by 0.5% after an oil-related contraction of 1.1% in Q4 2015. However, business investment continued to decline. In its latest Inflation Report, the Bank of England noted that while the financing conditions on the supply side had continued to improve in Q1, there had been a slowdown in demand for loans for large companies. This probably relates to the broader hesitancy by businesses ahead of the EU referendum that has been noted in other surveys. Despite a sharp fall in trade weighted sterling in the first quarter, the trade deficit widened to £18.0b in Q1 from £16.4b in Q4. Changes in exchange rates often take time to affect demand for imports and exports. It is therefore too early to expect a material boost in demand for UK goods from the weaker sterling. Indeed, if companies do not expect the weakness in sterling to be sustained if the UK votes to stay in the EU, which seems likely, the temporary weakness in sterling might not show up in the trade balance at all. UK exporters may decide instead to bank the higher margins rather than cut prices as a form of precautionary saving in case of a Brexit.

Further slowdown in Q2 ahead of EU referendum likely before growth accelerates in H2. Short of a Brexit, the pace of UK growth should recover in the second half of the year. We see a 35% risk of the UK leaving the EU on June 23. Measures of confidence, political uncertainty, orders and investment all point to Brexit risk weighing on the appetites of households and businesses ahead of the vote. We expect a further modest slowdown to a quarterly rate of 0.3% in Q2, driven by softer consumption and investment, before recovering to a growth rate of 0.6% in Q3 if the UK votes to stay in the EU. Domestic fundamentals remain healthy. Over the medium-term the risks to the downside for growth are limited. Private consumption, which accounts for almost two-thirds of UK GDP, continues to make a robust recovery (see Chart 1). Household balance sheets are in much better shape than pre-crisis. Household debt as a percentage of GDP has fallen to 90% from its peak of 107% in 2009. And households' ability to manage the debt has improved significantly. The ratio of household debt to disposable income has fallen from 165% of GDP in 2008 to 136% of GDP in 2015 – back to 2003 levels. Combined with record employment, modest but accelerating wage gains, cheap oil and highly accommodative policy from the Bank of England we expect this recovery to continue and with it, annual GDP growth to accelerate to 2.1% in 2017 from 1.9% this year.

Chart 1: Recovery in private consumption continues



Source: ONS, Berenberg calculations

% change, sa	**Q1'16**	**Q4**	**Q3**	**Q2**	**Q1'15**	**Q4**
GDP, qoq	0.4	0.6	0.4	0.6	0.5	0.7
yoy	2.0	2.1	2.2	2.4	2.6	2.8
Private consumption, qoq	0.7	0.6	0.6	0.7	0.8	0.6
Government spending, qoq	0.4	0.3	0.7	0.7	0.4	-0.3
GFCF, qoq	0.5	-1.1	0.4	1.3	1.5	0.1
Exports, qoq	-0.3	0.1	-0.5	2.8	-0.1	3.8
Imports, qoq	0.8	0.9	2.9	-2.5	3.5	2.8
Business investment, qoq	-0.5	-2.0	1.3	0.7	2.9	-0.1

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