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UK UPDATE: CONSUMERS RESILIENT AMID SHARP RISE IN UNCERTAINTY AHEAD OF EU REFERENDUM

Berenberg Macro Flash

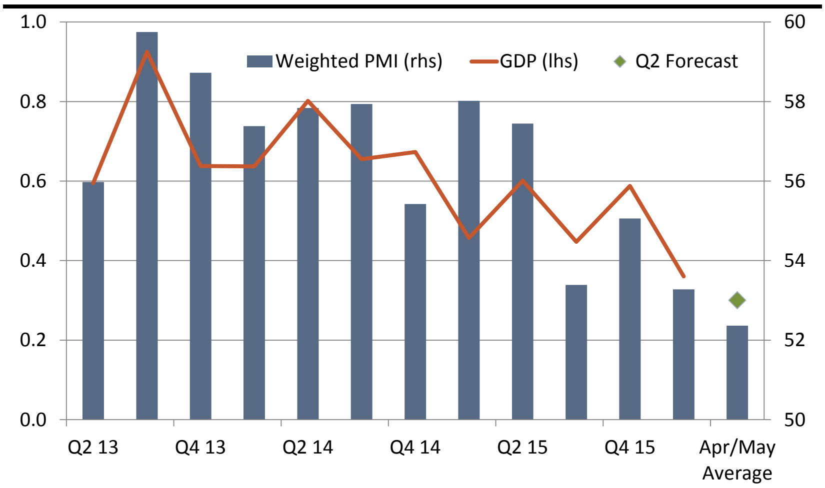
There are widespread signs across the UK economy that Brexit jitters are starting to bite and that growth has slowed in the run up to the EU referendum on 23 June. While consumers remain relatively upbeat, political uncertainty has risen to the highest level on record. Short of a Brexit, we expect growth to snap back in the second half of the year. We discuss these issues in turn:

Soft data signals a slowdown in growth momentum

Even though PMI data improved in May, on balance, compared to April, our weighted PMI index looks set to fall for a second consecutive quarter. The headline PMI for the services industry surprised on the upside in May. The index increased to 53.5 compared to 52.3 in April and was above expectations of 52.3. The construction PMI dropped a little on a monthly basis and was marginally below expectations – 51.2 versus 52.0 – for May. The manufacturing PMI increased marginally in May compared to April and beat expectations – 50.1 versus 49.6. Across all industries, around one third of firms reported that Brexit uncertainty is having a detrimental impact on business. Referendum uncertainty, as expected, is causing some firms and households to temporary pause investment and consumption until the UK has decided on its membership in the EU.

Financial markets have recovered following the worst start to the year since 2008. But the market volatility that triggered a fall in business confidence and global demand which hit investment and exports in Q1 has been followed up by the Brexit risk in Q2. As such, the economy has struggled to recapture the momentum it had during late 2015. But underlying fundamentals are mostly sound. Driven by robust household demand, the economy should manage a rate of growth of around 0.3% qoq in Q2, following the slowdown to 0.4% qoq in Q1 from 0.6% in Q4 last year.

Chart 1: Weighted PMI

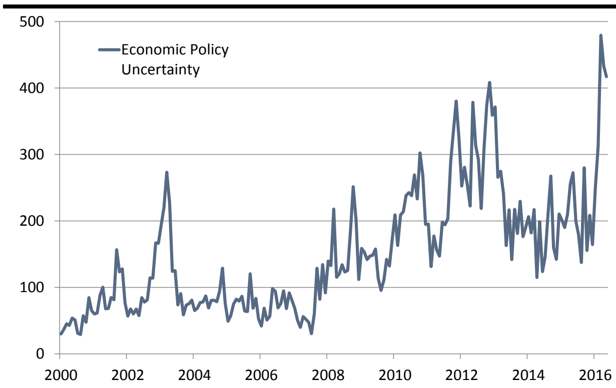


Source: Markit/CIPS, Berenberg calculations

Consumer confidence remains above pre-crisis average while uncertainty reaches a record high

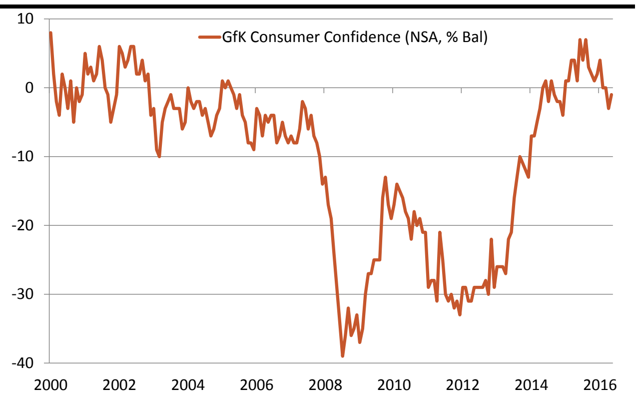
Despite some serious political uncertainty (Chart 2), UK households have a lot to be happy about. Employment is at a record high, cheap oil is boosting real wage growth - offsetting most of the weakness in nominal wage growth, house prices are rising strongly and consumer credit growth is at a decade high. Strong consumer confidence reflects these favourable circumstances. Although there has been a modest dent to confidence in the first half of the year owing to the market turbulence in Q1 and now the Brexit risk, consumers are more confident than they were during most of the so called 'good years' before the financial crisis. Households will be relied upon to provide almost all of the growth in the second quarter.

Chart 2: Economic policy uncertainty



Source: Economic Policy Uncertainty

Chart 3: Consumer confidence



Source: GfK

Growth expectations hinge on the referendum result – watch out for messy politics

The referendum will not settle the divisions on Europe within the leading centre-right Conservative party. If the UK votes to leave, we expect prime minister Cameron to resign. This could trigger a messy leadership battle and exacerbate any economic damage inflicted by the vote to Brexit. And if the UK votes to stay, there will likely be a significant proportion of unhappy Eurosceptics within parliament that will continue to cause some trouble.

Even with some post-vote political head-butting in the UK, the sharp rise in uncertainty seen in the past months should recede just as sharply if the UK votes to remain in the EU – we see a 30% risk of a Brexit. A vote to remain is our central case. While the outcome of the referendum remains open and potential event risks continue to loom large, recent trends suggest the risk of a Brexit has fallen – please see report.

In a our central case, the UK votes to remain in the EU and the economy snaps back to life in the second half of the year driven by a strong improvement in business investment and a marginal pick-up in the already robust pace of consumer spending. Trade will continue to drag due to weak global demand and stronger sterling. We expect the quarterly growth rate to accelerate to 0.6% qoq in Q3 before returning to its trend rate of around 0.5% in Q4. On an annual basis, we expect the UK economy to grow by 1.9% in 2016 and 2.1% in 2017.

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