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UK: CONFIDENCE CRISIS BUT NO EVIDENCE OF RECESSION YET

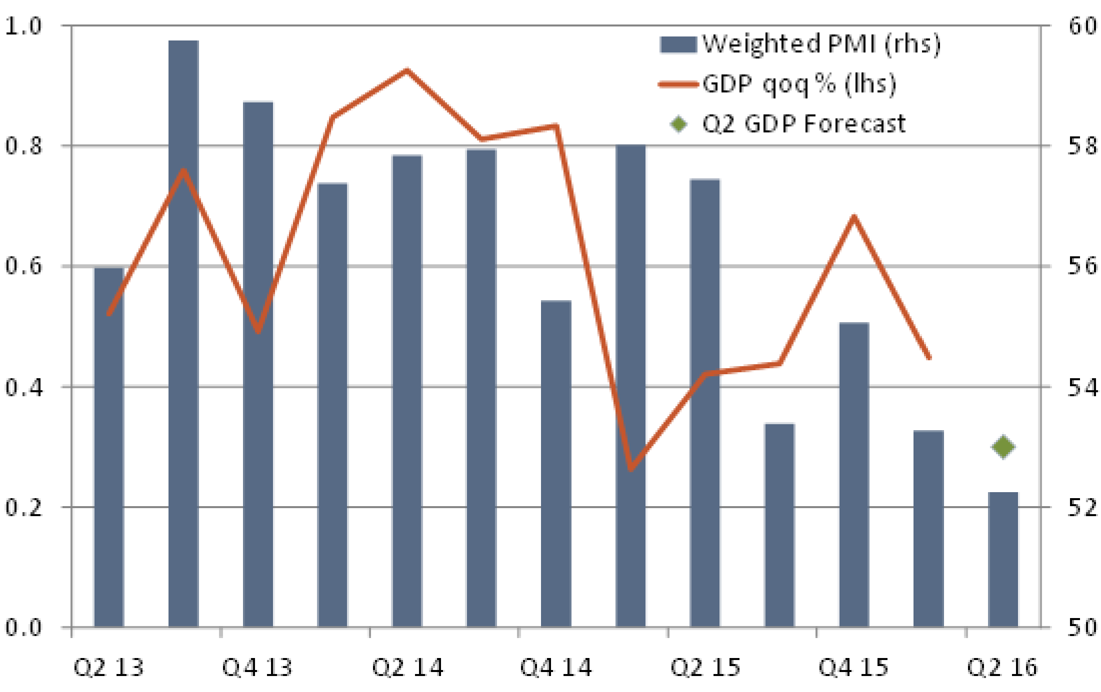
Berenberg Macro Flash

UK GDP growth decelerated in second quarter of the year ahead of the June 23 referendum

The uncertain business environment and economic outlook ahead of the Brexit vote weighed on GDP growth in the second quarter. The full set of PMIs for Q2 is in line with our call that the economy expanded by 0.3% qoq. UK growth has weakened significantly since the beginning of the year. Growth slowed to 0.4% qoq in Q1 following the worst start to a year in financial markets since 2008. This followed growth of 0.7% qoq in Q4 2015.

While underlying fundamentals are ok, the heightened uncertainty regarding the UK's future in Europe, along with bouts of financial market volatility triggered by global growth concerns, has reduced demand for long-lived assets since the start of the year. The slowdown in growth has been mainly due to weaker investment and construction, while short-term consumption growth has remained strong. Looking ahead, we expect this pattern of growth to persist until the outlook becomes clearer. Underlying fundamentals such as a strong labour market and less indebtedness should enable households and businesses to weather the storm and maintain a robust level of day-to-day spending. But some spending and investments that require significant commitments over time will be delayed.

Chart 1: Weighted PMI versus GDP growth outlook



Source: ONS, Markit/CIPS, Berenberg. Quarterly data

Post-referendum data so far point to stagnation rather than contraction

Heightened business uncertainty triggered by UK's decision to leave the EU is dampening medium-term growth prospects. The limited up-to-date data on economic developments since June 23 suggests that the outlook has weakened materially. So far, however, firms do not anticipate a sharp contraction in activity. A YouGov/CEBR survey carried out between June 28 and July 1 found that, although measures of business performance suffered broad declines since the vote, they remained neutral to modestly positive on balance see Tables 1 and 2). Business confidence and own company optimism had dropped sharply but remained positive, as did expectations for domestic sales in the next 12 months. Interestingly, export expectations for the next 12 months fell from strongly positive to neutral despite no immediate change in the medium-term trading arrangements between the UK and the EU and broad improvements in the economies of the UK's major trading partners, the EU and the US.

Table 1	Business confidence	Own company optimism	Economy optimism
21-23 June	112.6	118.7	105.1
28 June – 1 July	105.0	109.4	86.8

Source: YouGov UK Economic Index. 100 = no change

Table 2	Domestic sales index – next 12 months	Exports index – next 12 months	Capital investment index – next 12 months
21-23 June	118.6	115.3	108.0
28 June – 1 July	104.9	99.8	100.1

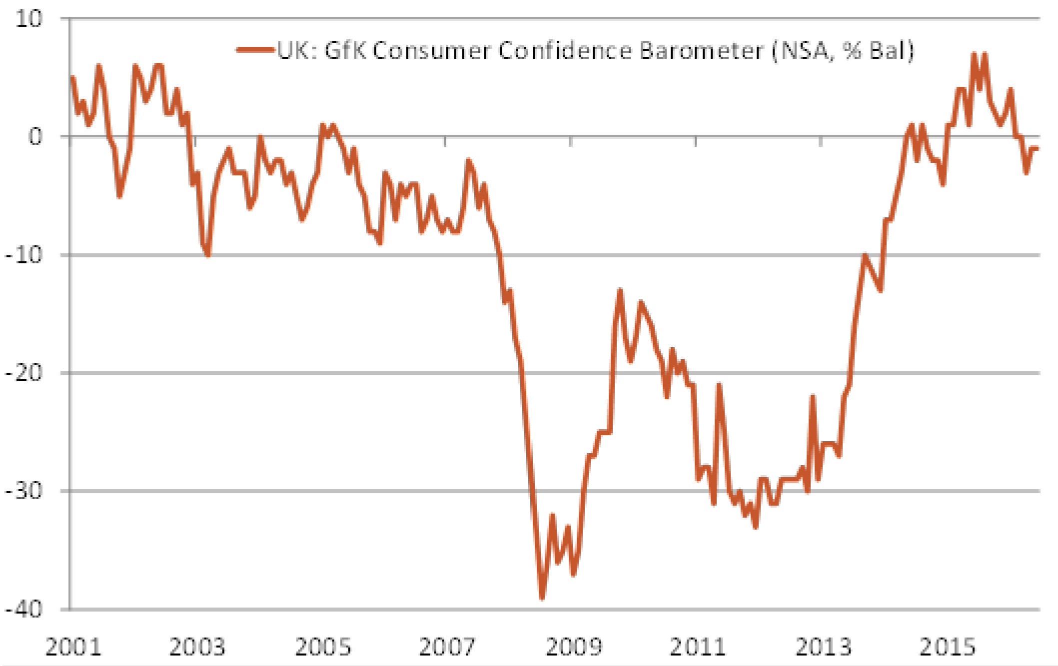
Source: YouGov UK Economic Index. 100 = no change

Confidence crisis ahead – but fundamentals are ok

We expect the UK economy to stagnate in the second half of the year as political uncertainty in the UK remains elevated until a new Prime Minister is elected and negotiations about future UK-EU relations begin. Political uncertainty hurts confidence. As Chart 2 shows, UK confidence sank in the UK at the outbreak of the euro-crisis. UK GDP growth slowed to 1.5% in 2011 and 1.3% in 2012 following growth of 1.9% in 2010. Confidence recovered strongly in 2013 as Europe overcame the risk of contagion. While confidence is starting at a much higher level this time around we expect a similar sharp drop in the near-term. This short-term shock should recede once the outlook becomes clearer. Beyond the near-term uncertainty that domestic political infighting creates, the depth and duration of the confidence shock will depend on progress in the UK's coming negotiations with the EU-27. When households and firms have clear guidance on the future arrangements between the UK and its largest trading partner, the EU-27, confidence and economic momentum should improve.

Although the Brexit will probably reduce long-term UK trend growth, perhaps to 1.8% from 2.1%, UK economic fundamentals are stronger than they were during the euro-crisis in 2011-2012. Private sector balance sheets are healthier and the labour market is stronger. Unemployment has fallen to 5% today versus 8% in 2011. Total private sector debt is 360% of GDP today versus 440% in 2011. Cheap oil helps too. More importantly, this crisis is UK specific - if Europe manages to contain the domino risks (see report) and the US continues to grow at a healthy pace, the softer domestic demand will not be compounded by weaker external demand. With the immediate measures taken by the Bank of England to counter financial market volatility around the vote, the reduction in capital requirements announced today as well as some monetary easing in August, plus some temporary fiscal measures to boost growth, the UK economy could avoid a recession. We forecast GDP growth of 0.0% qoq for Q3 and 0.1% qoq for Q4 2016 and annual average gains in GDP of 1.5% in 2016 and 1.3% in 2017.

Chart 2: Consumer confidence



Source: GFK. Monthly data

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