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BREXIT UPDATE - POLITICS, MONETARY POLICY AND HOUSING

Berenberg Macro Flash

Brexit means Brexit (eventually), as May sets up a Brexit cabinet

Reuters report that the UK's new prime minister Theresa May spoke to German chancellor Angela Merkel and French president Hollande last night to convey the message that Britain will exit the EU, but that she will need some time to prepare for negotiations. Preparation began in earnest last night as the new UK prime minister announced a raft of changes to the Conservative Party cabinet plus two new top rank positions in light of the Brexit vote. George Osborne was replaced by ex-foreign secretary Philip Hammond. Osborne was not offered an alternative position. Hammond has a reputation as a fiscal hawk, which potentially conflicts with May's pledge to ease up on the pace of austerity. As a best guess, we will likely see a compromise between these two positions at November's Autumn Statement. Looser fiscal policy in the near-term while demand is weak with the major cuts pushed to the back of the forecast when economic growth is likely to improve.

The other cabinet changes were dominated by the Brexiteers. Boris Johnson has been appointed foreign secretary. The two new roles, minister for exiting the EU and minister for international trade, have been given to David Davis (former Europe minister) and Liam Fox, respectively. Amber Rudd (Remainer) is the new home secretary. Filling the new cabinet with Brexiteers should help bring the Conservative Party together. May has sent a signal that while she herself had campaigned to remain, albeit quietly, she is serious about Brexit. This limits the potential for some future re-eruption within the Conservative Party. The new roles given to Davis and Fox that focus on negotiating trade deals and the EU exit will probably diminish some of the power of the foreign secretary, suggesting Boris will take on an ambassadorial role. Davis and Fox are hard euro-sceptics, raising the risk that the withdrawal process goes ahead in a less-than amicable way, to put it mildly. On the other hand, since pro-EU Rudd will have a big say on immigration in her new role as home secretary, this suggests a fairly big scope to compromise with the EU on the UK's border policy.

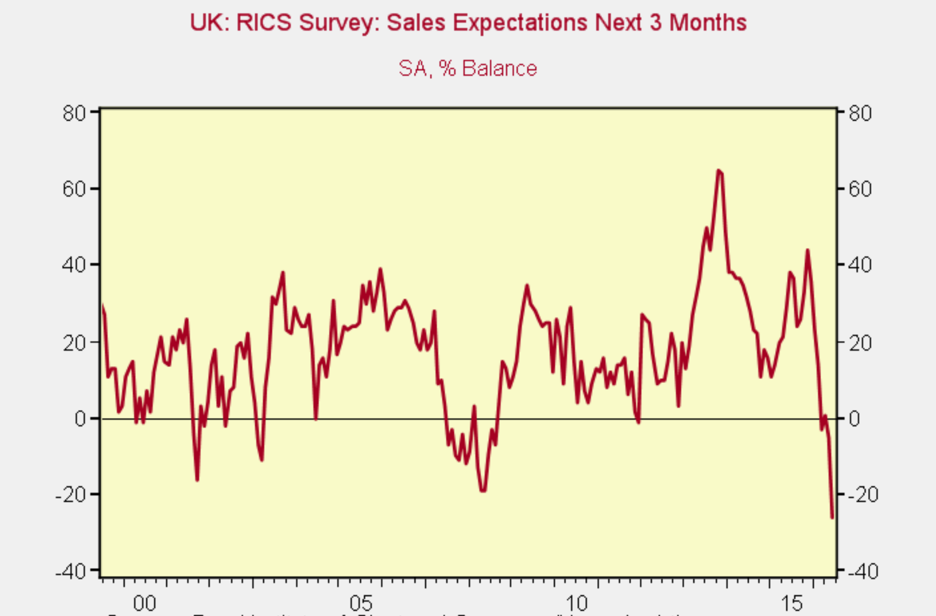
May had previously suggested that she would not trigger Article 50 until next year. But the Conservative Party is mobilising much faster than anticipated. That the new Conservative leader and PM was elected two months sooner than expected and that a fresh cabinet dominated by Brexiteers was set up just hours after the changeover from Cameron to May suggests that London will probably trigger Article 50 sooner rather than later. Starting to discuss the divorce terms and the new terms of trade as soon as possible in a constructive rather than confrontational way could support a quicker economic recovery as a reduction in uncertainty can mitigate the downside risks to business investment and hiring.

60% chance BoE cut rates today as the MPC holds first office meeting since Brexit vote

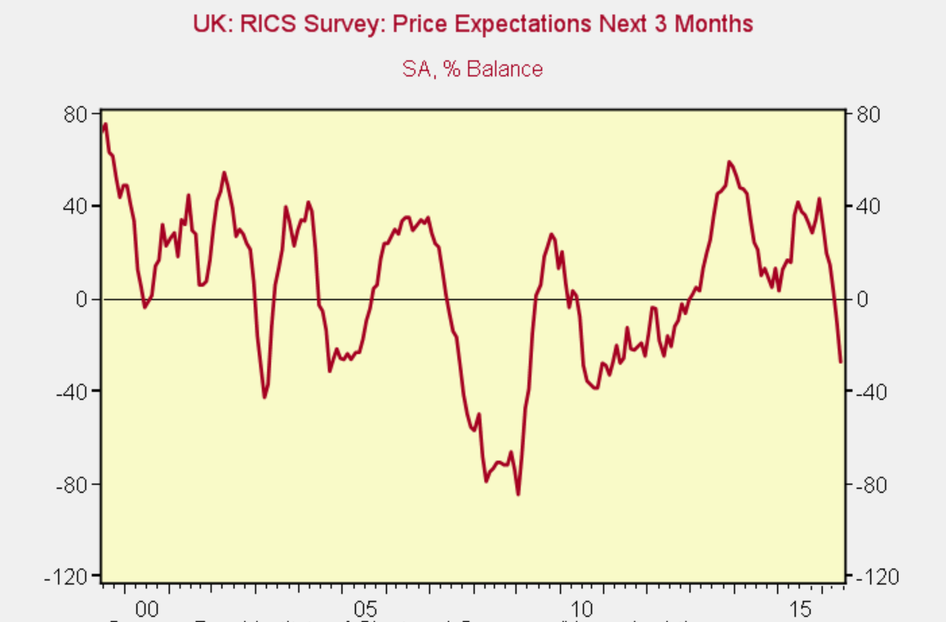
The July minutes of the MPC meeting will likely reveal a downbeat assessment of the economy since the Brexit vote, marked by sharp fall in confidence and a rise in political uncertainty. A rate cut (probably 25bps) or close vote to hold policy for now coupled with a negative assessment of the economy could suppress sterling and gilt yields a little further. It will be the second key message on monetary policy since the Brexit vote. It follows Governor Mark Carney's speech on 30 June where he said that 'some easing will likely be required over the summer'. Since Carney's words, much of the potential easing has been priced in already. In addition to a rate cut in either July or August, we see a 60% chance that the BoE restarts its asset purchase programme ("quantitative easing", QE) in August. As a start, we expect the BoE to purchase around GBP100bn of gilts.

Housing activity slowed sharply in June according to RICS.

Economic uncertainty deters spending on long-lived assets such as houses. That the UK housing market slowed sharply in the months leading up to the EU referendum comes as no surprise. RICS report that house price growth slowed in the three months to June to the slowest pace since January 2015. Price expectations fell to the lows seen during the euro crisis while expected sales fell to the lowest ever on record (see charts below). But fundamental market imbalances will probably limit house price declines: a lack of housing supply combined with existing demand side policies like Help to Buy and Help to Buy London - plus low interest rates. In addition, house builders will likely respond to weaker demand by sharply reducing the supply of new houses. This will help to preserve the wedge of excess demand and limit the falls. According to Nationwide, house prices declined by 14% across the UK during the financial crisis.



Source: Royal Institute of Chartered Surveyors /Haver Analytics



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