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PARTNERSHIP SINCE 1590

MACRO NEWS 20/07/16

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BREXIT UPDATE: CAN THE UK AVOID A RECESSION?

Berenberg Macro Flash

Following the UK's vote to leave the EU on June 23 uncertainty about the long-term outlook has risen. But so far, the limited information on the economy for the period since the referendum is consistent with a stagnation in the near-term rather than an outright recession.

While consumer confidence data for July saw the biggest one-month drop since 1994, it fell from a relatively high level and remains comfortably above Lehman-crisis and euro-crisis levels (Chart 1). If consumer confidence stays at current levels or even falls a little further, it would remain consistent with a slowdown, rather than a contraction in consumption. That the Conservative Party managed to elect a new leader and Prime Minister some two months earlier than expected has removed a major source of uncertainty for households – this is a major positive development for the near-term growth outlook.

Business will have to wait a while longer before enjoying similar relief from uncertainty. While the faster-than-expected election of a new Prime Minister may provide a little boost to business confidence, businesses will likely stay focused on the outcome of withdrawal negotiations with the EU. Until the UK agrees its terms of trade with its biggest market, the EU, business investment is likely to remain suppressed. We expect the UK to formally begin divorce negotiations (trigger Article 50) before the end of the year – business uncertainty could remain elevated until the withdrawal negotiations begin to bear fruit. As such, beyond the near-term stagnation, we expect the UK growth rate to remain below trend until EU divorce proceedings begin in earnest. On a positive note, a report published today by the Bank of England suggests that so far, businesses have mostly remained resilient to the Brexit shock.

BoE agent's summary of business conditions: "no clear evidence of sharp general slowing"

While near-term risks are strongly tilted to the downside, a BoE report published today supports our call that the UK can avoid a recession. The BoE's summary of business conditions for July (normally covering the previous month) included an ad hoc component summarising business conditions since the referendum.

The BoE's findings are as follows.

-Businesses reported a sharp rise in uncertainty due to a lack of information relating to future UK-EU trading relations.
-One third of firms expect the Brexit-vote to affect near-term capital spending – a majority however, do not expect a near-term impact on capital spending.
-There is little evidence of an impact on consumer spending on services and non-durables, although there was some noted hesitancy on purchases of high-value goods.
-While there was no specific mention of lay-offs, the Brexit-vote is expected to have a negative effect on hiring in the coming 12 months.
-Credit conditions had "tightened slightly" in financial markets. While banks' appetites to lend had been maintained, demand for credit had eased, along with a fall in investment intentions.

Economy is in better shape than 2008 to buffer a period of turbulence

Fundamentally, the economy is in better shape than in the run up to the Lehman-crisis and the euro-crisis. While this current expansion has been less vigorous than in the past – with the quarterly growth rate averaging just 0.5% qoq versus 0.7% qoq in the pre-Lehman expansion – a number of positive trends have emerged. The private sector has deleveraged – private debt as a proportion of GDP fell to 360% last year, from 460% in 2009. The total debt of households and businesses as a percentage of GDP is now back to 2005 levels. Household balance sheets have strengthened – debt to income has fallen to 130% from almost 160% in 2009. And labour market participation has reached a record high – 74.4% in May 2016. The near-term Brexit-induced confidence shock promises to reverse some of these positive trends. However, with appropriate policy support, the UK economy is well positioned to buffer a period of economic uncertainty and softer demand.

Monetary easing in August ahead of modest fiscal stimulus in November

Policy support is warranted, to lift growth expectations that have been lowered following the Brexit vote, and to help underpin a recovery in confidence.

In the July Monetary Policy Committee meeting last week, the BoE sent a strong signal that it will ease monetary policy on 4 August at the next Inflation Report. The minutes noted that "most members of the Committee expect monetary policy to be loosened in August". In past easing cycles, the BoE has normally cut the policy rate by around 3ppt. This time around, with the bank rate at 0.5%, headroom for rate cuts is clearly limited. The BoE will need to look beyond lowering the policy rate to support growth. We therefore expect a rate cut – probably 25bp – and see a 60% chance that the BoE restarts its asset purchase programme ("quantitative easing", QE). The BoE purchased GBP200bn of assets in 2009 during the financial crisis and GBP175bn in 2011-12 during the euro-crisis. As a start, we expect the BoE to purchase around GBP100bn of gilts to send a signal to markets, businesses and households that it will take the necessary steps to support a quick recovery.

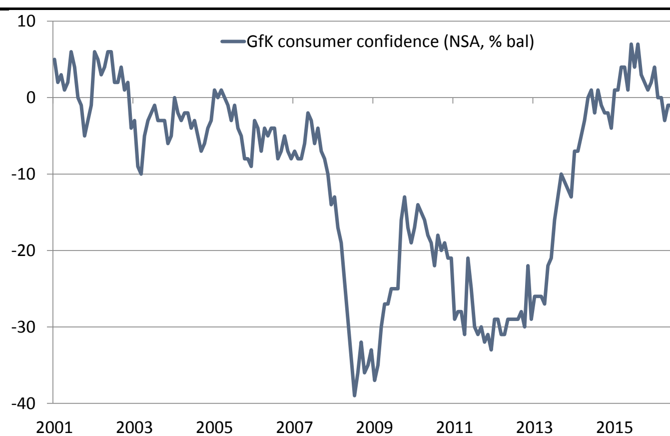
In addition to some monetary easing, we expect that new Chancellor Philip Hammond will probably announce a temporary fiscal stimulus at the November Autumn Statement to buffer medium-term demand. A shovel-ready public investment programme along with some tax cuts to boost consumption – possibly by further raising the income tax threshold – could help offset weaker medium-term demand. Record-low gilt yields, despite recent downgrades by rating agencies, illustrate that demand for UK debt is high despite Brexit and the weaker growth outlook. Utilising low borrowing costs to temporarily manage demand and limit the downside risks to growth would be a positive step.

Watch out for the housing market risk

RICS reports that house price growth slowed in the three months to June to the slowest pace since January 2015 and price expectations fell to the lows seen during the euro crisis (Chart 2). Historically, house prices and household consumption have tracked closely at a ratio of around four to one - e.g. a 10% rise in house prices yoy would normally imply 2.5% growth in consumption. While household balance sheets have improved since 2009, the average house price/income ratio has risen to 6.2 from 4.5. Even modest declines in house prices could affect the regular spending habits of homeowners who are highly leveraged.

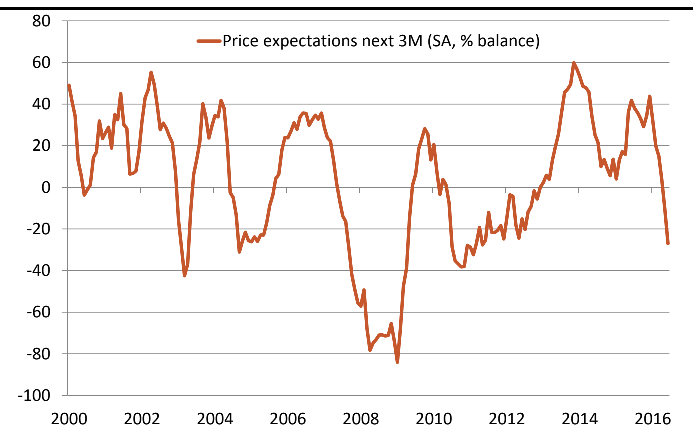
A lack of housing supply, combined with existing policies that raise demand, like Help to Buy and Help to Buy London, plus low interest rates, should prevent a sharp drop in house prices. In addition, house builders will respond to weaker demand by reducing the supply of new houses. This will help to preserve the wedge of excess demand until the economy begins to regain momentum. A sharp drop in house prices remains, however, one of the key risks to the near-term growth outlook and it is important that housing market sentiment stabilises quickly in the coming months. The possibility of a sharp fall in house prices would present a significant recession threat.

Chart 1: Consumer confidence falling from high level



Monthly data. Source: ONS, GfK

Chart 2: 3 months ahead house price expectations fell to euro crisis levels in June



Monthly data. Source: RICS

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