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UK JULY PMIS - KNEE-JERK REACTION TO BREXIT VOTE

Berenberg Macro Flash

July, PMI	Manufacturing	Services
Actual	**49.1**	**47.4**
Previous	52.1	52.3
Consensus	48.7	48.8
Berenberg	47.0	48.0

The Brexit vote and the short but messy period in British politics immediately after June 23 present serious downside risks to the near-term outlook. The limited soft data for the period since the UK voted to leave the EU has been mixed so far. Confidence indicators and Bank of England field work point to resilient demand, and stagnation rather than recession in the coming quarters. But the PMI data for July released today point to a sharp drop in economic activity. The risk of a recession in H2 2016 is significant. We expect the Bank of England to respond to this threat with a fairly aggressive stimulus package at the upcoming Inflation Report on the 4 August. We look for a 25bps rate cut with a 60% chance of QE – circa £100bn.

Record drops in output and orders

Output and orders for the composite PMI index fell by the most on record in July. While manufacturing outperformed services compared to consensus expectations, indexes for both sectors were below the crucial 50 mark - in the past, the 50 threshold has proved to be a fairly reliable indicator for growth (see chart). In services, activity and new orders fell by the most since the financial crisis. For manufacturers, while the weaker sterling saw new export orders rise at the highest rate in two years, purchase price inflation increased by the fastest rate in 5 years.

A knee-jerk reaction to political uncertainty

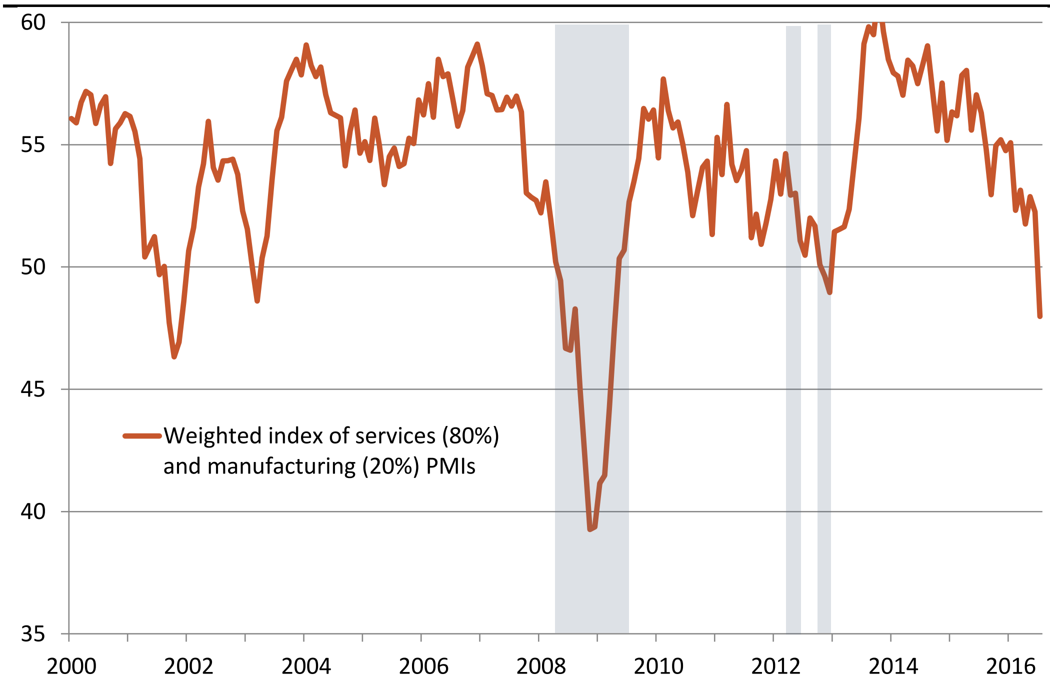
The Brexit vote has dragged our weighted average of the services and manufacturing PMIs to the lowest level since April 2009 (see chart). If today's PMI reading proves to be reliable, it indicates a rate of decline in economic activity last seen only during the financial crisis. Our hunch is that the PMIs have overreacted somewhat as they are in contrast to other soft data since June 23. A report published earlier this week by the Bank of England pointed to a slowdown in activity since the referendum, rather that a sharp contraction. Similarly, while consumer confidence for July dropped at its sharpest rate for over twenty years, it fell from a high level and remained consistent with a slowdown rather than a decline in household consumption.

V or U shaped recovery?

Two additional points are worth noting. First, although the UK economy was accelerating over the course of 2015, PMI data were trending down – suggesting a pessimistic bias in the index. Second, strong expectations, ex-ante, that the impact of the Brexit-vote could be very negative in the short-term could be feeding into purchasing manager's current assessments. Financial market volatility has been limited beyond the initially sharp falls, consumer confidence remains resilient, and domestic political risks have diminished quickly with the sooner-than-expected election of a Prime Minister (PM). That the new PM

Theresa May has spent the past few days shaking hands and smiling on camera with Chancellor Merkel and President Hollande will bolster expectations of an amicable divorce from the EU. Altogether, this suggests a V shaped recovery in economic activity and sentiment rather than a protracted U shaped slump. Next month's data should be better – watch this space closely.

Weighted monthly PMI index – shaded area indicates quarters when GDP declined qoq



Monthly data. Source: Markit/CIPS, Berenberg calculations. Value above 50 indicates growth

Index	JUL	JUN	MAY	APR	MAR	FEB
Services	47.4	52.1	50.4	49.4	50.9	53.0
Manufacturing	49.1	52.3	53.5	52.3	53.7	55.6

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