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Kallum Pickering, Senior Economist | Kallum.pickering@berenberg.com | +44 20 3465 2672

BREXIT UPDATE: UK ECONOMY HIT HARD, EUROZONE RESILIENT SO FAR

Berenberg Macro Flash

UK – stagnation ahead, significant downside risks: Data released today from the Confederation of British Industry (CBI) showed that industrial orders remained resilient following the Brexit vote while the level of optimism in the UK industrial sector fell to its lowest level since 2009. CBI trends orders remained upbeat at -4 versus -2 in June and above the long-term average of -16. CBI business optimism fell to -47 versus expectations of -15. Industrial production (2/3 manufacturing) is the UK's second largest sector making up around 15% of total GDP. Softer domestic demand coupled with increased input costs from the weaker sterling will make conditions even harder for export-oriented industrial firms which have been hit especially hard in recent years by the fall in global trade. While some exporters might receive a boost from the weaker sterling – down 15% on a trade-weighted basis since November - evidence from past depreciations suggests the boost to exports will be modest.

Today's industrial orders data, in addition to confidence data and field work from the Bank of England, support our call that growth will stagnate in H2 and that the UK can avoid recession. But July PMI data published last Friday pointed to a sharper than expected slowdown in June services sector output (80% GDP) – raising the risk the UK GDP contracts in Q3. Please see: (1) UK July PMIs – Knee jerk reaction to Brexit vote and (2) Can the UK avoid a recession? for coverage on the other data releases since June 23.

UK Q2 GDP stable despite Brexit vote - The first estimate of second quarter GDP for the UK will be published on Wednesday. After slowing since the start of the year – from 0.7% qoq in Q4 2016 – due to heightened financial market volatility, UK growth probably remained stable in the second quarter at 0.4% qoq despite Brexit uncertainty. While indicators of sentiment for the UK were downbeat in the run up to the EU referendum, official data generally improved, suggesting some upside risk to our call. Q2 will however, probably be the last decent reading for UK growth until late next year following a sharp negative shock to confidence caused by the Brexit vote.

UK fiscal policy 'reset' in November: Reports last Friday and over the weekend that the UK's new chancellor Philip Hammond will 'reset' fiscal policy support our call that the UK Treasury will announce a package of fiscal measures at the November Autumn Statement. The expansionary measures will focus on supporting demand following the Brexit vote. We expect the changes to come in the form of tax cuts to support consumption (raising the tax free threshold?) and a shovel ready capital spending programme which will offset the likely fall in private sector investment and support jobs in the likely-to-be hard-hit construction sector. Near-term risks to the housing market could also prompt the government to reduce stamp duty or bulk up existing policies such as Help to Buy to support the demand side of the market.

Could Northern Ireland have an independence vote from the UK? UK PM Theresa May visits Northern Ireland today for talks on the implications of Brexit on Northern Ireland. Northern Ireland voted 56% in favour of staying in the EU compared to just 48% for the UK overall. Brexit raises the prospect of an EU external border separating it from EU member Ireland. The nature of the border dividing the emerald isle would depend principally on whether the CTA (common travel area) between the UK and Ireland can survive the Brexit vote. Nationalists and republicans might argue that re-imposing the border would threaten the very basis of the Good Friday Agreement of 1998 that largely ended the sectarian violence in Northern Ireland. The proportion of Catholics in the Northern Irish population has risen from below 30% in

1971 to 41% in 2011. In 2011, Protestants and other non-Catholic Christians made up 42% of the population. Based on these trends, the mostly pro-Irish Catholics should become the major religious group in the next few years, further raising the prospect of a Northern Irish referendum to leave the UK and possibly re-join the EU as an independent country or part of the Republic of Ireland some time in the future.

Eurozone Q2 GDP - slowdown versus strong Q1: The first estimate of second quarter GDP for the Eurozone will be published on Friday. It is likely to show that the rate of GDP growth slowed to 0.2% qoq following a strong growth rate of 0.6% qoq in Q1. The expected slowdown in Eurozone growth mostly reflects the unusually strong first quarter rather than a deterioration in underlying fundamentals. Although Eurozone growth is likely to remain sluggish, staying at a sub-trend driven by weak investment, as long as the risk of other countries copying Britain remains low, we expect Eurozone growth to return to its trend rate again in early 2017.

Eurozone – withstanding the Brexit shock – some risks to the outlook: In contrast to data for the UK in the month of July which has sharply deteriorated, Eurozone data remains modestly positive on-balance. Data so far suggests that the Eurozone economy is weathering the immediate shock well, with measures of current activity moving side-ways, compared to measures of expectations that have dropped off. While the ZEW expectations data for July declined to 2012 lows for the Eurozone (-14.7 versus 20.2 in June) and Germany (-6.8 versus 19.2 in June), July PMI data were more optimistic. The composite PMI for France increased to 50.0 from 49.6 in June and for Germany to 55.3 compared to 54.4 in June. Ifo data on the German economy released today falls in line with this general trend. On a positive note, the expectations component of the German Ifo, while down, was better than expected – see German Ifo after Brexit: Encouragingly resilient.

Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7878
www.berenberg.com
Kallum.pickering@berenberg.com