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UK GDP - RESILIENT TO BREXIT RISK IN Q2

Berenberg Macro Flash

UK GDP (a), real, qoq %, Q2 2016

Actual	**0.6**
Previous	0.4
Consensus	0.5
Berenberg	0.5

The UK economy accelerated in the second quarter of the year despite the notable weakness in soft data in the months before the EU referendum. GDP expanded by 0.6% qoq compared to 0.4% in Q1 and versus expectations of 0.5%. The acceleration in the second quarter is in sharp contrast to Q2 PMI data that suggested growth of 0.3-0.4% qoq, indicating that soft data somewhat exaggerated the impact of Brexit uncertainty. If this trend continues, it supports our call that the UK will stagnate and avoid recession in the near-term in reference to the sharp weakness soft data since the Brexit vote on June 23.

The first estimate of GDP is based on less than half of the data required to produce the final estimate and is thus occasionally subject to small revision – with no notable upward or downward bias. It is compiled using two months of official data and one months predicted industry data.

The services sector – 79% of GDP – expanded by 0.5% qoq in Q2, down from 0.6% in Q1 and its slowest rate of growth since the same quarter in 2015. The slowdown in growth in business services and finance industries to 0.5% qoq in Q2 from 0.7% in Q1 was the main driver of the services slowdown. The weaker spending by firms could reflect heightened uncertainty in the lead up to the referendum and is likely to persist in H2. A slowdown in household demand growth in the coming months will also weigh on the outlook for services.

Production – 15% of GDP - grew by 2.1% qoq, its fastest rate of growth since 1999 following a decline of 0.2% qoq in Q1. Manufacturing, the largest production sector, expanded by 1.8% from a decrease of 0.2% in Q1. In contrast to other periods of sterling weakness, export-oriented industrial producers seem to be benefitting from the weaker currency. During the financial and euro crises the weaker sterling did not deliver a notably stronger performance of exports. But in 2008/09 and 2011/12, the US and European economies were much weaker. If the European and US economies continue to expand at stable rates in the second half of 2016, as we expect, the 15% drop in trade-weighted sterling since last November could help UK exporters cushion against weaker domestic demand.

Construction output is the smallest of the UK's major sectors and accounts for just 6% of GDP. Construction output, decreased by 0.4% qoq in Q2, this follows a decrease of 0.3% Q1. During periods of heightened uncertainty, consumption of long-lived assets typically falls. Looking ahead, construction will remain the weak spot of the economy until the EU negotiations begin in earnest and the Brexit uncertainty passes. Public sector construction could receive a generous boost if the government announces a short-term capital spending program at the November Autumn Statement.

Implications for monetary policy: While the strong Q2 performance is a positive sign that the UK economy can weather uncertainty, the broad and sharp declines in soft data since the referendum will be the main focus of the BoE's deliberations at the forthcoming August Inflation Report and Monetary Policy Committee meeting. Following the shock to confidence and near-term demand from the Brexit vote, the recent past is not a reliable indicator of the near-term outlook. We expect consumption growth to slow sharply in the near-term and business investment to contract. As evidenced in today's data, the weaker sterling could boost the trade balance. As such, we continue to expect the BoE to send a strong signal to support confidence and demand at the next meeting on 4th August. We look for a rate cut of 25bps and some additional quantitative easing (circa £100bn) on top of the bank's existing £375bn of QE assets.

qoq %	Q2 16	Q1 16	Q4 15	Q3 15	Q2 15	Q1 15
GDP	0.6	0.4	0.7	0.4	0.4	0.3
Services	0.5	0.6	0.9	0.6	0.4	0.2
Production	2.1	-0.2	-0.3	0.1	0.7	0.4
Construction	-0.4	-0.3	0.7	-1.1	1.0	1.9

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