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BREXIT UPDATE: REFERENDUM IMPACT ON UK HOUSEHOLDS IN 4 CHARTS

Berenberg Macro Flash

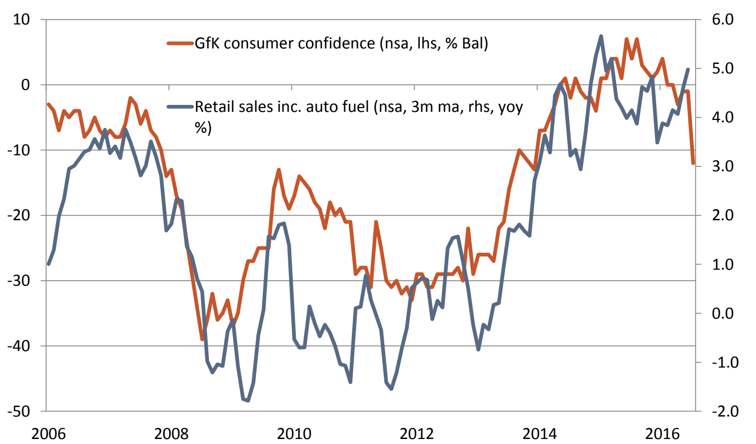
Households are the main engine of growth for the UK economy. 2/3 of GDP is private consumption. Brexit uncertainty started to weigh on consumer confidence in the run up to the referendum. Data for household conditions has deteriorated further in July. While gains in net trade from the weaker sterling may offset drops in business investment, the evolution of private consumption over the coming quarters will determine by how much GDP growth slows, or indeed, if the UK enters a recession.

We expect households to remain resilient, with growth stagnating in H2 2016, before picking up in 2017 to a sub-trend rate. The very limited data for the post-vote period supports this outlook. But uncertainty is high and risks are thus tilted to the downside.

Today, GfK published household survey data for the month of July. Key points are as follows:

While consumer confidence fell by the most since 1990, it remains consistent with a modest expansion in household demand – Chart 1. Consumer confidence dropped from -1 to -12 between June and July, its biggest single point drop in 26 years, but broadly in line with the average since 1990 (-10). Despite the sharp fall in confidence, the absolute level is consistent with a slowdown rather than a contraction in retail sales, which are a reliable indicator of domestic demand. **** The GfK survey was conducted between 1-15 July, thus capturing the highest period of domestic political uncertainty during the post-vote period. Theresa May became Prime Minister on July 13.** That the Conservative Party managed to elect a new leader and Prime Minister some two months earlier than expected removed a major source of uncertainty for households – this suggests that the monthly average could be higher than the sample period indicates.

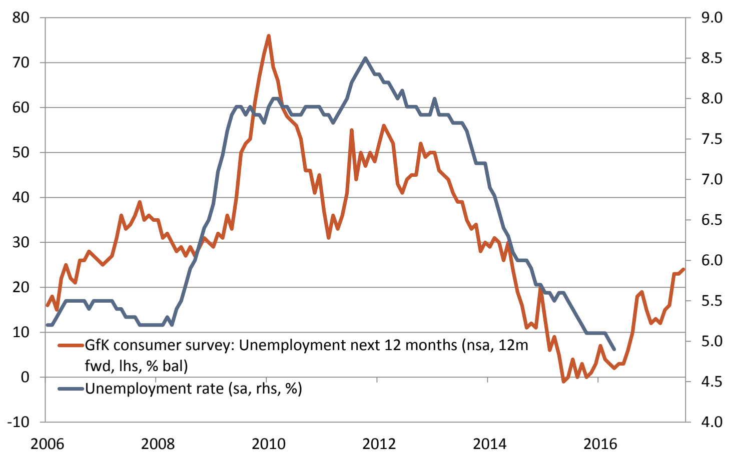
Chart 1: Consumer confidence versus retail sales



Monthly data. Source: GfK, ONS, Berenberg calculations

Unemployment expectations increased slightly, continuing the upward trend that started in mid-2015 – Chart 2. During the last 12 months, employment gains have been strong. At 74.4%, the current rate of employment in the UK is the highest on record (16-64 year olds). Despite the healthy gains in labour demand, unemployment expectations have consistently risen for over a year, with no notable additional impact in July coming from the Brexit-vote. The persistent weakness in the labour market outlook could be due to the cumulating risks beginning in 2015 such as financial market wobbles in Aug 2015 and Jan 2016 and heightened Brexit uncertainty in Q2 2016. Taking the 12 month ahead expectation at face value indicates that households expect unemployment to rise modestly in the near-term but remain below the levels during the financial and euro crises. The UK labour market has shown surprising resilience to heightened risk periods since late 2012. If the UK avoids a recession, we do not expect unemployment to rise by more than a few tenths of a percentage point above its current rate of 4.9%.

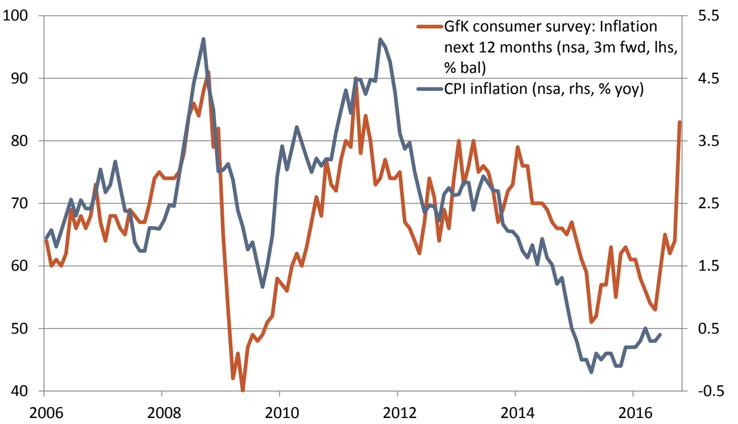
Chart 2: Unemployment expectations 12m fwd. versus unemployment rate (%)



Monthly data. Source: GfK, ONS, Berenberg calculations

Inflation expectations jumped to the highest level since 2011 – Chart 3. Inflation is set to increase sharply from its current rate of 0.5% to 1.9% by early 2017, driven by a rise in import prices from the weaker sterling. While there could be some upside risk to our call, we do not expect near-term inflation to rise to back to 2011 levels. Today, commodity prices are a disinflationary force whereas in 2011 when the oil price peaked at almost $110 per barrel, commodity price rises were an inflationary force. Nonetheless, weaker labour demand coupled with rising inflation will squeeze real incomes, further dampening the outlook for private consumption.

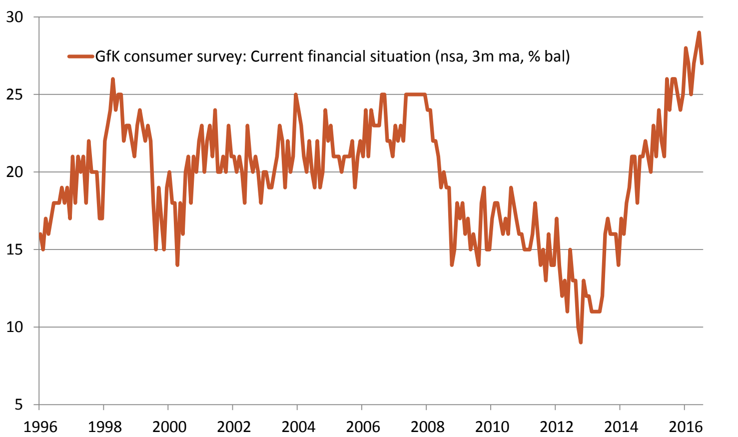
Chart 3: Inflation expectations 3m fwd. versus inflation rate (%)



Monthly data. Source: GfK, ONS, Berenberg calculations

Household's assessment their current financial situation in July remained broadly unchanged mom – Chart 4. Households reported the strongest financial situation on record in June. Beyond the normal monthly volatility, the Brexit vote has not impacted household's assessment of their current financial situation. When households feel better off, they spend more freely, continue to borrow and save less – supporting domestic demand growth. The key risk to this outlook is the evolution of house prices. Historically, house prices and household consumption have tracked closely at ratio of around 4 to 1 - 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 – we monitor this risk carefully.

Chart 4: Current financial situation of households



Monthly data. Source: GfK