Kallum Pickering, Senior UK Economist | Kallum.pickering@berenberg.com | +44 20 3465 2627

UK: DEFYING EXPECTATIONS - GDP EXPANDED STRONGLY IN Q2, SERVICES SECTOR GROWTH BETTER THAN EXPECTED IN JULY

Berenberg Macro Flash

UK GDP, real, qoq %, Q2 2016

Actual	**0.7 (revised from 0.6%)**
Previous	0.4
Consensus	0.6
Berenberg	0.6

No signs of Brexit in Q2: The UK economic expansion accelerated to 0.7% qoq in Q2, up from 0.4% in Q1, driven by robust quarterly gains in private consumption (0.9%) and a recovery in gross fixed capital investment (1.6%) following two consecutive quarters of decline. Households further drew down on their savings to finance spending. In Q2 the savings rate fell to 5.1% - its lowest rate since 2008. But household fundamentals look healthy: employment is at a record level, real wages are rising at a healthy rate, homeowners benefit from the wealth effects of recent rises in house prices, and cheap oil and credit provide tailwinds.

The drag from trade increased: The strong expansion in domestic demand continued to drive a rise in imports despite the weaker sterling in Q2 relative to 2015 levels. Imports increased by 1.3% qoq while exports declined by 1.0% - widening the trade gap to a two-and-half-year-high. The upward revision was mainly due to stronger growth in services output (0.6% qoq revised from 0.5% qoq) and business investment (1.0% qoq revised from 0.5% qoq).

Hard data at odds with the soft data: The cyclical performance of the UK economy improved in the second quarter despite widespread signs in the soft data that economic growth was slowing, weighed down by the uncertainty related to the 23 June Brexit vote. This trend had continued in Q3 until recently when most soft data started to show a robust improvement. Meanwhile, hard data has remained firm during Q3, especially in household and consumer driven sectors such as retail sales and services (see below).

UK services, mom %, July

Actual	**0.4**
Previous	0.3 (revised from 0.2)
Consensus	0.1
Berenberg	0.2

The UK service sector expanded at its fastest pace in four months in July: Output grew by 0.4% mom versus expectations of 0.1%. Since services make up almost to 80% of the UK economy, today's data all but confirm that GDP continued in the month after the Brexit vote, despite the sharp drop in PMIs and other soft data. All major sub-sectors within the services industry contributed to the monthly expansion in output; distribution, hotels and restaurants (0.01ppt), transport, storage and communication (0.22ppt), business services and finance (0.12ppt) and government and other services (0.06ppt).

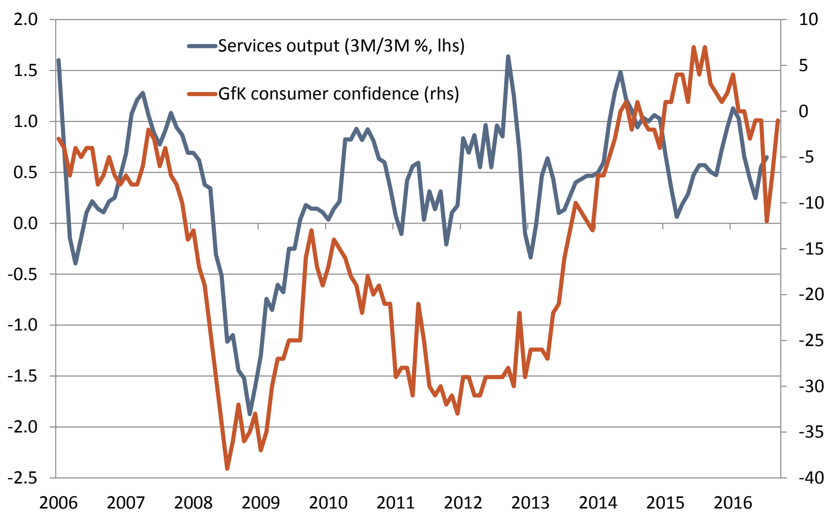
Upside risk for Q3 GDP: The solid expansion in July meant that services output growth held steady at 0.6% on a 3M/3M basis. While we remain significantly above consensus next year - we forecast growth of 1.3% yoy versus consensus of 0.7% - data for Q2 so far suggest significant upside risk to our call for sharp slow-down in H2. As data published this morning by GfK showed, confidence has rebounded quickly after the sharp drop in July – see chart. We put the rebound in confidence down to three key factors.

(1) **Aggressive monetary policy**: The BoE's decision to provide extra liquidity around the vote and then to announce a suitably large monetary stimulus to support domestic demand and lower borrowing costs has offset an immediate reduction in the supply of loanable funds to the real economy. Consumer credit has continued to expand a decade high after the vote (+10% yoy).

(2) **A sharp reduction in political risk:** That the Conservative Party managed to elect a leader two months faster than the party's initial election schedule had envisioned played a significant role in steadying the ship and bolstering domestic confidence. Pragmatic prime minister Theresa May proved to be a major calming influence during the initial post-vote period of shock, both in the UK and abroad. And while the lack of progress on starting Brexit negotiations with the EU is a serious issue, her non-confrontational approach to Brexit and numerous "friendly" public appearances with key EU leaders helped to stabilise confidence.

(3) **Resilient external demand:** The economic expansions in the UK's key trading partners, the US and EU, to which two-thirds of all UK exports go, have continued at a satisfactory pace since the Brexit vote. Following the 17% depreciation in trade-weighted sterling since November 2015, surveys continue to report that UK exporters are experiencing a pick-up in export demand. This should begin to modestly benefit the trade balance in H2 as higher import costs weaken demand for foreign products while luring more tourists into the UK and boosting the competitiveness of UK goods and services.

Chart 1: Services output (3M/3M %) versus GfK consumer confidence



Source: ONS, GfK, Berenberg calculations

% change, sa	Q2	Q1'16	Q4	Q3	Q2	Q1'15
GDP, qoq	0.7	0.4	0.7	0.3	0.5	0.3
yoy	2.1	2.0	1.8	2.0	2.7	2.9
Private consumption, qoq	0.9	0.7	0.4	1.0	0.6	0.8
Gov. spending, qoq	0.0	0.4	0.0	0.6	1.0	0.4
GFCF, qoq	1.6	-0.1	-1.3	0.9	0.9	1.7
Exports, qoq	-1.0	0.1	4.3	-0.3	-1.1	2.2
Imports, qoq	1.3	0.2	2.6	0.5	-1.7	3.4

Source: ONS

% change, sa	Jul	Jun	May	Apr	Mar	Feb
Services, mom	0.4	0.3	0.0	0.6	-0.3	0.2
3m/3m	0.6	0.6	0.3	0.5	0.7	1.1

Source: ONS