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UPTURN IN UK INDUSTRIAL PRODUCTION HITS A BUMP IN THE ROAD - WEAK STERLING IS A DOUBLE-EDGED SWORD

Berenberg Macro Flash

Oct, 2016	**Industrial, mom %**	**Manufacturing, mom %**
Actual	**-1.3**	**-0.9**
Previous	-0.4	0.6
Consensus	0.2	0.2
Berenberg	0.2	0.3

The cyclical upturn in UK industrial production stalled again in October
Industrial production – circa 15% of GDP – unexpectedly declined by 1.3% mom compared to consensus expectations of growth of 0.2%. That followed a contraction of 0.4% in September. On a 3m/3m basis industrial production declined by 0.9%. Monthly data are volatile and should be interpreted with caution. There were a few temporary factors that played a significant part in the sharp downturn.

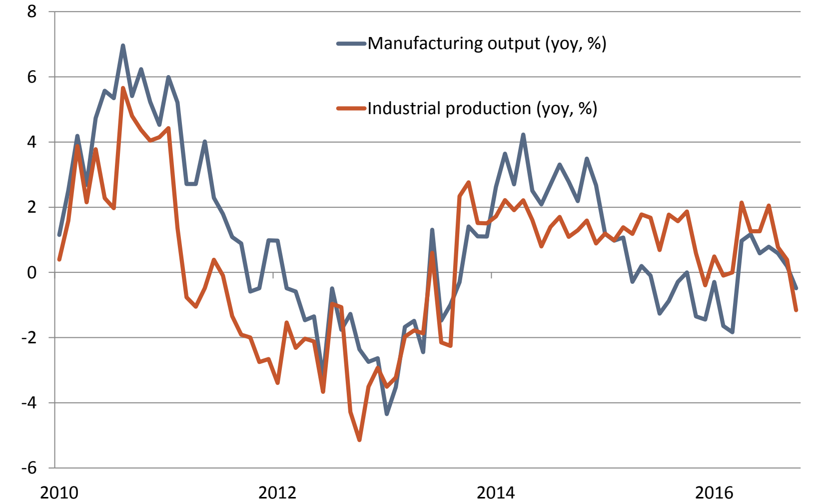
An 8.7% mom decline in mining and quarrying provided the largest drag. The Department for Business, Energy and Industrial Strategy attributed the contraction to maintenance at some large North Sea oil fields. The production of oil and gas declined by 10.8% mom. Meanwhile, the sharp contraction in manufacturing (0.9% mom) - the largest industrial sub-sector - is likely to be partly a correction for the stronger-than-expected rise in the previous month (0.6% mom). The relatively small electricity, gas, steam and AC and water supply and sewerage sub-sectors both made positive contributions to monthly output, increasing by 3.5% and 1.8%, respectively.

The decline in output in October is likely to prove temporary. We continue to expect a modest uptick in UK industrial production over the near-term, supported by a stable expansion in domestic demand and an improvement in external demand in both Europe and the US - where the forthcoming Trump-fiscal stimulus may provide some additional support.

But weak sterling is a double-edge sword for export-oriented industrial producers.
The upside: There is good reason to expect some improvement in external demand for price-elastic goods exports following the weakness in the sterling exchange rate. On an annual basis, trade-weighted sterling is currently down by around 13% on the back of Brexit-related uncertainty. In particular, the 13% yoy depreciation of sterling against the euro, plus the continued stable recovery in the Eurozone, should lead to a pick-up in UK goods exports. Demand from the Eurozone already started to improve during the middle of 2016 – Chart 2. This follows a five year period of declining exports to the Eurozone that began during the euro crisis.

The downside: While a weaker exchange rate is a positive for export demand it raises input costs. Exacerbated by the c20% depreciation against the dollar, the price of a barrel of oil in sterling terms is up by around 50% yoy, while the price of natural gas has doubled. This sharp rise in input costs will squeeze margins and could limit the extent to which some exporters can pass the gains from a more competitively priced sterling onto foreign consumers. This problem is likely to be especially prevalent for producers who buy inputs in dollars and then sell to the Eurozone where sterling has depreciated by less than versus the dollar.

Chart 1: Annual change in industrial production and manufacturing output



Source: ONS, Berenberg calculation

Chart 2: UK goods exports to the EU

Source: ONS, Berenberg calculation

% change	OCT	SEP	AUG	JUL	JUN	MAY
Industrial prod., yoy	-1.1	0.4	0.8	2.1	1.3	1.3
Industrial prod., mom	-1.3	-0.4	-0.3	0.2	0.0	-0.6
Manu. prod., yoy	-0.4	0.1	0.6	0.7	0.6	1.1
Manu. prod., mom	-0.9	0.6	0.2	-0.8	-0.3	-0.6

Source: ONS

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