Kallum Pickering, Senior UK Economist | Kallum.pickering@berenberg.com | +44 203 465 2672

UK MACRO: THE WEEK AHEAD

Berenberg Macro Flash

THERESA MAY SPEAKS ON BREXIT STRATEGY – VEERING TOWARD A HARD(ISH) BREXIT (TUESDAY 17TH JANUARY)

While UK prime minister Theresa May has previously stated that she doesn't recognise the concept of a 'hard Brexit' the market clearly does. Comments by May hinting at a hard Brexit sent the pound lower over the weekend. But is any of it new information? No, not really. May has stated on several occasions that she will prioritise regaining control of the UK's borders and laws over access to the single market. In May's speech tomorrow we expect her to reiterate the same message, again.

While the prime minister hasn't gone so far as to plainly state the potential impacts of such an arrangement, her broad aims for post-EU Britain have been consistently clear for some time now. The commonly heard 'uncertainty' about May's intentions is hard to justify. Unless May does a complete U-turn from here, any hope of full single market access for post-EU Britain is more or less out of the question. We can presume also, given that May has gone to the effort of setting up a trade department, currently headed by MP Liam Fox, and has stated on a number of occasions that the UK should be able to strike its own trade deals independently of the EU, that an exit from the EU customs union is likely too.

We do not expect May's speech to alter our base case by much, if at all. We currently expect the UK and EU27 to agree a deal in which the UK maintains a good level of access to the EU's goods markets and limited access to the less developed services markets. Crucially, we expect the UK to lose its EU financial services passport. This follows from the UK raising some modest barriers to migration from the EU.

By lowering growth in trade, investment and migration with the UK's biggest market (EU) we expect our Brexit base case to reduce UK potential growth to 1.8% per year from its pre-referendum rate of 2.2%. The accumulated costs of Brexit could add up badly over time.

Looking a little further ahead: In the next couple of weeks the Supreme Court will likely announce its ruling on whether parliament needs to vote before Article 50 can be triggered. If the Supreme Court reiterates the High Court ruling in favour of a vote by MPs, then we should expect May and her Brexit team to publish a paper on the government's broad aims for Brexit – probably in February – that MPs can debate and vote on in time to trigger Article 50 by March (May's self-imposed deadline). If the Supreme Court decides that the prime minister can trigger Article 50 without a vote in parliament then we do not expect May to reveal much more of her Brexit strategy before the negotiations with the EU begin.

INFLATION – UP, UP, AND AWAY (TUESDAY 17TH JANUARY)

Data for December is likely to show that headline inflation rose to 1.4%, below the Bank of England's 2% target but up from 1.2% the previous month. The inflationary effects of rising costs of inputs and imported goods following the large depreciation in sterling will become more pronounced in the coming months. We expect inflation to peak in Q3 at 2.8% before gradually declining back towards the 2% target by the end of 2018.

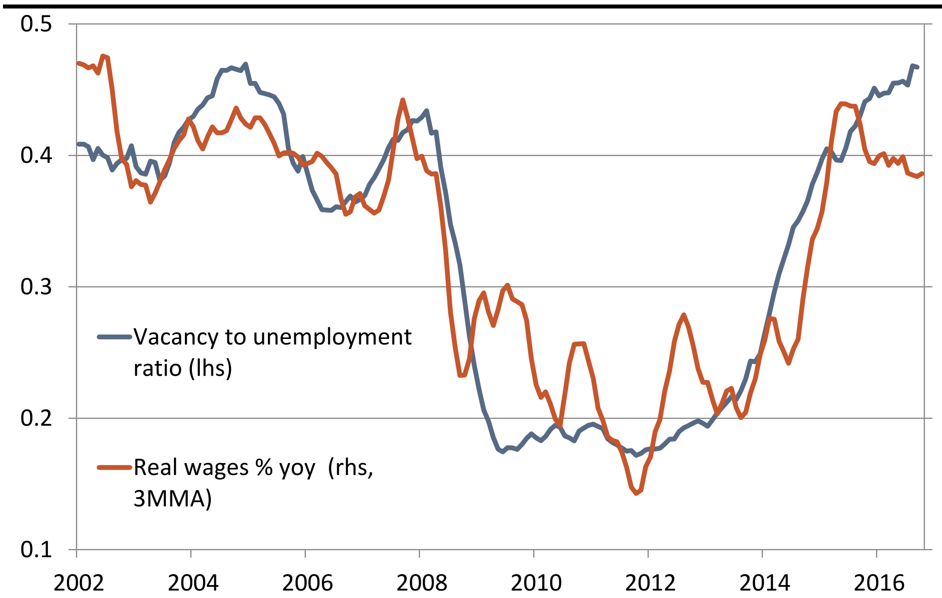
Unless nominal wage growth surprises on the upside in 2017, rising inflation will likely lead to a slowdown – or even a decline – in real wages for the first time since 2014. This will act like a modest drag on consumption growth in 2017 and 2018. We expect the slowdown in consumption (two-thirds of GDP) to be the major force behind the slowdown in the economic expansion in 2017, which, in turn, will keep the BoE in a neutral gear all year despite the above-target rise in inflation. However, if growth in GDP and real wages surprise on the upside over the medium term, the BoE will raise its longer term estimate for inflation – possibly above the 2% target - after the sterling effects have passed. We see a 30% chance that the first rate hike comes later in the year.

LABOUR MARKET – STILL GOING STRONG (WEDNESDAY 18TH JANUARY)

Now that the labour market has reached full employment – unemployment below 5% with employment at a record high – job gains are starting to slow. The critical question going forward is whether the economy can sustain a sufficient level of real output growth amid Brexit risks such that firms' labour demand remains high and nominal wage growth begins to accelerate a little from its currently level of c2.5% yoy. Our base case for real GDP growth of 1.6% in 2017 and 1.5% in 2018 should enable firms to offer modest increases in nominal wages that will partially offset the expected rise in inflation.

Overall, we do not expect to see major changes to the headline numbers in the November data for unemployment (cons. exp. 4.8%) and wage growth ex. bonuses (cons. exp. 2.6% yoy). Instead, we pay close attention to the more timely data (December) for vacancies and jobless claims change. The number of vacancies signals firms' demand for labour, since the vote it has remained at close to record levels (c750,000). Changes in this indicator normally predict changes in employment and unemployment. In the past, the ratio of vacancies to unemployment has also been a good predictor of real wage growth too – see chart.

Vacancy/unemployment ratio versus real wages (yoy %)



Monthly data. Source: ONS

RETAIL SALES – HOW LONG CAN THE UPTURN IN CONSUMER SPENDING BE SUSTAINED? (FRIDAY 20TH JANUARY)

Despite a likely modest monthly correction - following five consecutive monthly gains - we expect annual retail sales growth ex. fuel to have remained strong on an annual basis (c6.5% yoy). While retail sales make up less than 20% of GDP, they provide a timely measure of household spending and are one of our favourite series to track domestic demand and underlying momentum in the UK economy.

Monthly retails sales provide an early indication of where the quarterly consumption data is heading. Looking ahead, real consumption growth is set to slow from an average growth rate of 2.6% yoy in 2015 and 2016 to 1.7% in 2017 and 2018 as real wage gains are eroded by rising inflation and job gains slow with the labour market reaching full employment.

Risks to the upside? Critically, the recent surge in consumer credit – in part induced by the aggressive BoE easing in August – suggests that households' appetite for debt is rising again. If households borrow a little more than last year and draw down on savings, they could easily sustain the current high growth rate of household consumption. That real wage growth could surprise on the upside too reinforces the positively skewed risks to consumption growth.

For an more information on our key calls for the UK in 2017 and beyond please see 'The UK economy: 10 questions for 2017'.

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