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WHAT BREXIT? UK SUSTAINED ABOVE TREND GROWTH IN Q4, DRIVEN BY STRONG GROWTH IN SERVICES

Berenberg Macro Flash

UK GDP (a), real, qoq %, Q4 2016

Actual	0.6
Previous	0.6
Consensus	0.5
Berenberg	0.5

Brexit did not have a major effect on the UK economy in 2016. After growing a little above trend in the middle of the year (0.6% qoq in Q2 and Q3), the quarterly growth rate remained stable in Q4 (0.6% qoq). Looking at 2016 overall, the January sell-off in markets on the back of fears for global growth hurt the expansion at the start of the year (0.3% qoq in Q1). But beginning in Q2, and despite the June 23 Brexit vote, the economy performed strongly in the final three quarters of the year. On an annual basis, the UK economy expanded by 2.0% in 2016, slowing a little from 2.2% in 2015.

Keeping in line with the post-Lehman trend, the Q4 expansion was highly unbalanced – see chart. The 0.8% expansion in services contributed all of the growth in Q4 to ‘2 decimal places’ according to the ONS. Stable gains in employment, modest increases in real wages and a rising consumer credit supported the strong expansion in consumer-oriented sub-sectors such as retail sales and travel agency services. For the UK, services is the make-or-break sector, it makes up 80% to total GDP.

Weak industrial production mainly due to one-off factors: Headline output was flat quarter-on-quarter. Manufacturing, the largest industrial sub-sector, expanded by 0.7% in Q4. It was offset by falls in mining and quarrying, mainly due to maintenance on the Buzzard oil field in the North Sea. The large depreciation of sterling since the Brexit vote should support an expansion in export-oriented industrial sectors in 2017. Rising demand from the Eurozone, where demand already started to improve during the middle of 2016, should be a notable bright spot. On the downside, the weaker exchange rate raises input costs which will squeeze margins for some exporters, and could limit the extent to which they pass the gains onto foreign consumers. Still, net-net, the more competitive exchange rate is a positive for UK exporters.

The 0.1% qoq expansion in construction is more impressive than it looks. The age of caution following the Lehman-crisis has led to increased risk aversion, weakening demand for long-lived investments. Construction demand has suffered a lot. That the sentiment driven construction sector didn’t suffer more in H2 2016 indicates that confidence remained firm despite the long-term uncertainty stemming from Brexit. Nevertheless, the challenging environment of heightened uncertainty coupled with labour and skill shortages in the sector could weigh heavily construction prospects in the coming years.

Brexit looks to be no more than a modest demand-side shock in 2017 and 2018 that principally stems from the sterling-driven inflation drag on real incomes and spending. The weaker sterling is likely to provide a sizeable buffer through the trade balance while attracting more tourists into the UK. The better-than-expected economic performance since the UK voted to leave the EU on 23 June 2016 has so far suited our above-consensus calls for growth. **We project growth of 1.6% (1.2%) this year and 1.5% (1.3%) in 2018**

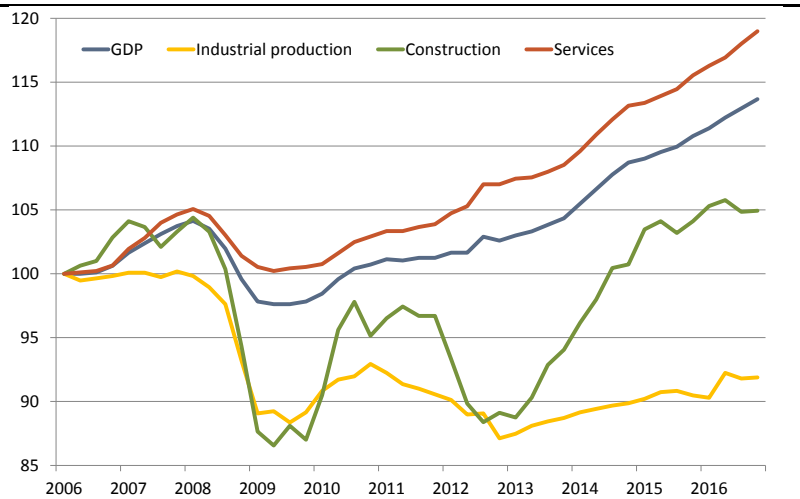


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(Bloomberg consensus in brackets). The continued strong momentum at the end of 2016 tilts risks to our near-term outlook strongly to the upside.

But remember, Brexit hasn't happened yet. The strong performance since the Brexit vote does not alter our long-term view that Brexit will lower UK trend growth, to around 1.8% from 2.2% per year, via slower growth in trade, migration and investment with its major market, the EU.

Chart: UK real GDP performance by sector (2006 = 100)



Quarterly data. 2006=100. Source: ONS, Berenberg calculations.

qoq %	Q4 1	Q3 16	Q2 16	Q1 16	Q4 15	Q3 15
GDP	0.6	0.6	0.6	0.3	0.7	0.3
Services	0.8	1.0	0.6	0.6	1.0	0.5
Production	0.0	-0.4	2.1	-0.2	-0.4	0.1
Construction	0.1	-0.8	0.5	1.1	-0.9	0.6

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