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UK GROWTH: 10 REASONS TO BE OPTIMISTIC FOR 2017

Berenberg Macro Flash

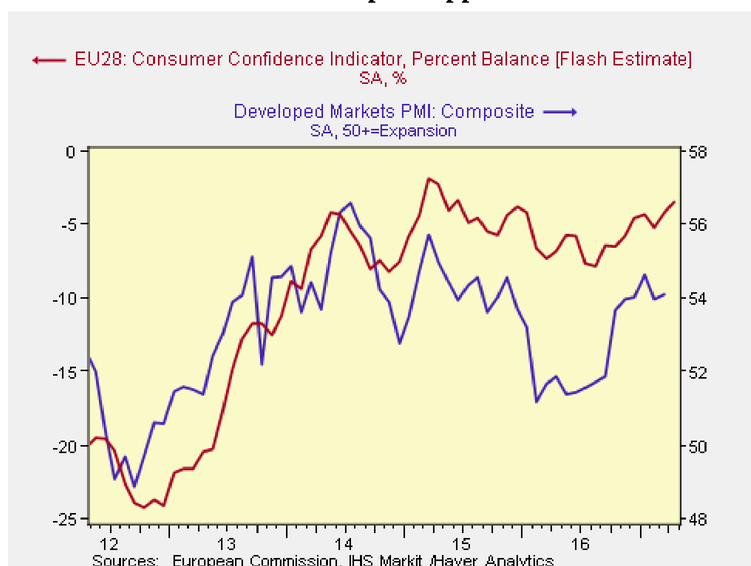
Bad news sells: Sometimes we need to ignore the headlines. UK GDP data for Q1 due tomorrow at 9:30am will likely show that the quarterly growth rate slowed to 0.4% qoq from 0.7% in Q4. Is the UK heading for a sharp slowdown this year? We don't think so. The UK's quarterly trend growth rate is around 0.4-0.5%. Growth is merely easing back toward more normal rates after an unexpected surge in the second half of 2016. Overall, the UK story remains positive. Even with the slowdown in the quarterly rate, we expect real GDP to expand by 2.0% in 2017, in line with the recent upgrades by the IMF and BoE. The market looks for real GDP growth of 1.8% according to the Bloomberg consensus estimate after a 1.8% real GDP gain in 2016.

The UK is enjoying a broad-based expansion: All components of demand are contributing to growth amid a much needed rebalancing. Whereas consumption growth moderates as inflation normalises, export-oriented industrial producers are benefiting from the upturn in global demand and the more competitive sterling exchange rate. While the result of the upcoming general election could modestly raise the risk of a hard Brexit (see report), a stronger majority for PM Theresa May improves the chances that Brexit goes smoothly. May could rely on her – potentially large – majority to push the final deal through parliament without the support of other parties. This would reduce medium-term economic uncertainty and increase the chances of the UK gradually easing toward its new long-term post-Brexit growth path.

In economics, as in life, there are always risks. Most of the time, most of them do not materialise. And while Brexit will hurt, it is not the end of the world. If Brexit reduces long-term trend growth to 1.8%, from 2.2% pre-Brexit, as we expect, the UK would remain the fastest growing major economy in Europe. The UK is currently in its eighth year of economic expansion and growth seems well entrenched. Under such conditions, households and companies can handle a few bumps in the road.

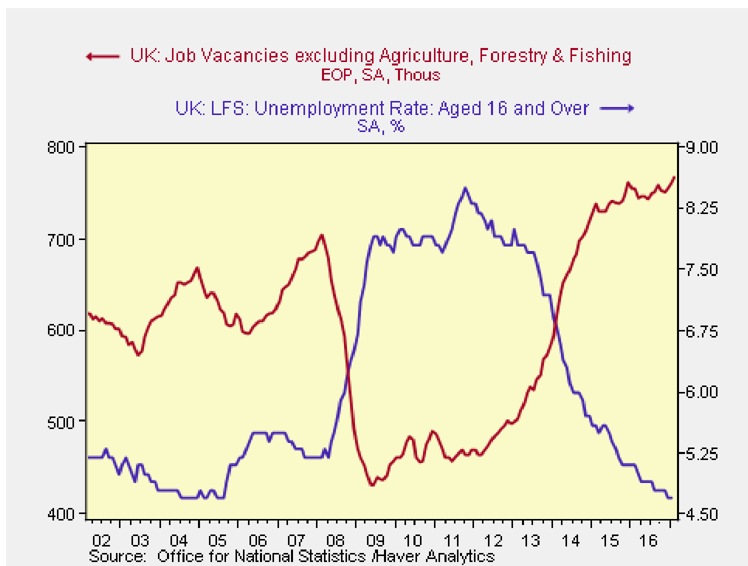
The following ten charts show the economy from a range of angles. The takeaways are as follows: (1) the UK is in good shape and continues to expand at a healthy pace, and (2) risks to growth are skewed a little to the upside.

1. The international backdrop is supportive



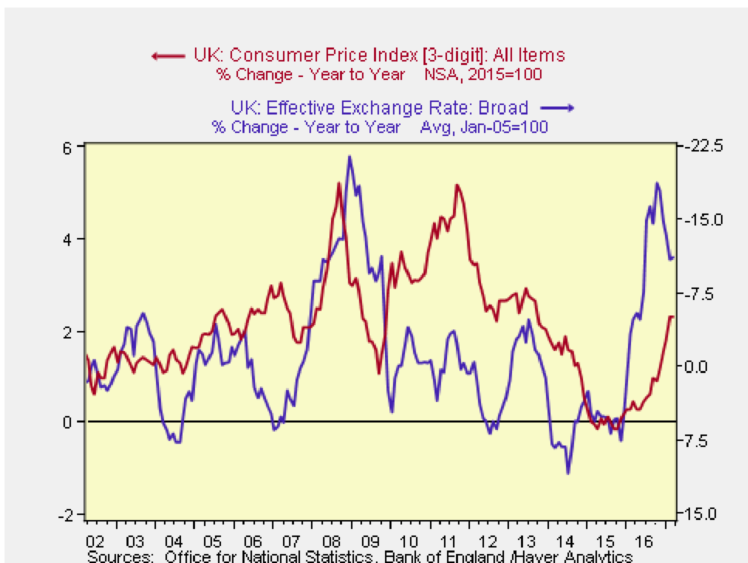
As a medium-sized, open economy the UK depends on its neighbours. UK real GDP growth is c80% correlated with its major trading partners, the Eurozone and the US. The upturn in the western world that began last year, helped along by expectations of a fiscal stimulus in the US and the recent acceleration in the Eurozone recovery, sets a positive backdrop for a continued economic expansion in the UK.

2. The labour market is solid



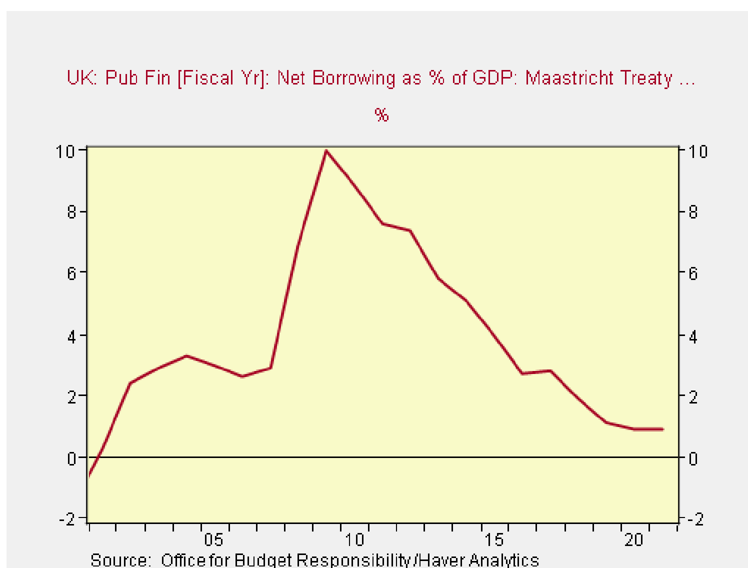
Record employment (74.6% for 16-64 year olds), low unemployment (4.7%), and a record level of vacancies point to growing labour market pressure. Following on from the sharp rise in inflation over the past six months, nominal wage growth should begin to accelerate at faster rates later on in the year from current rates of around 2.3% yoy.

3. Inflation will peak soon



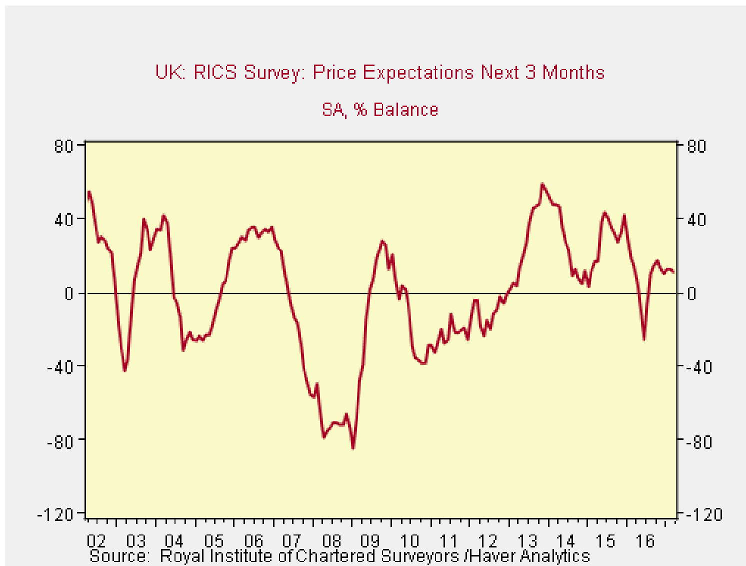
Despite the dramatic decline in the exchange rate immediately after the Brexit vote and the rise in the oil price in sterling terms since mid-2016, the bounce in inflation remains modest compared to recent history. During the financial crisis of 2008/2009, sterling declined by almost 30% on a trade-weighted basis while the oil price hit at almost £70 a barrel. And in 2012 oil prices reached nearly £80 per barrel. During both periods, headline CPI peaked at 5.1%, before dropping sharply thereafter. Sterling is down only c10% on a trade-weighted basis since June 23 and the oil price is c£40 per barrel. Today's inflation story is much less severe and thus has much smaller implications for the economic outlook. We expect headline inflation to rise from its current rate of 2.3% over the coming months before peaking at 2.9% in Q3 2017 and easing a little thereafter. We forecast 2.7% inflation for 2017 overall – a little above the BoE's 2% target.

4. Fiscal deficits are down



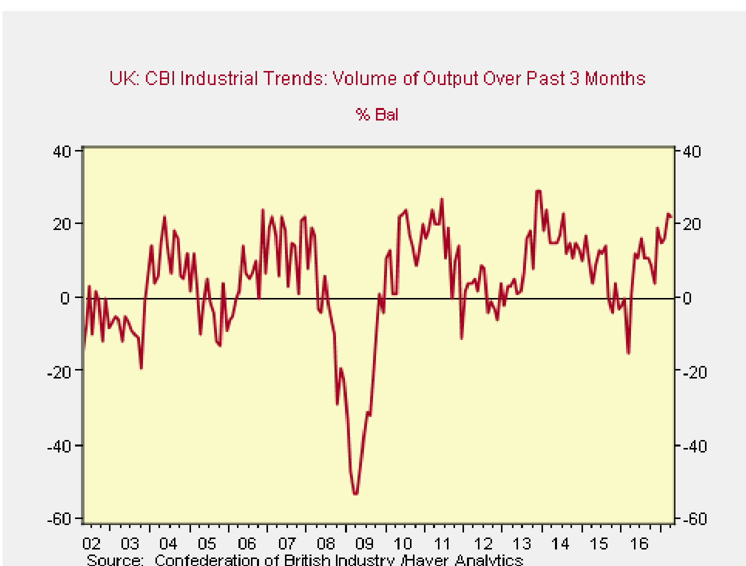
The UK's gradual approach to deficit reduction has been a success. The risks associated with UK public sector debt were exaggerated during the financial crisis and in the years that followed. Meanwhile, the slow pace of deficit reduction since the financial crisis has not led to a sharp rise in borrowing costs. Still, that the UK's fiscal position is gradually becoming more sustainable is positive for the long-term growth outlook. With the deficit on track to stabilise at a around 1% within two years, the modest drag to growth stemming from the fiscal consolidation will soon be over.

5. The housing market is stable



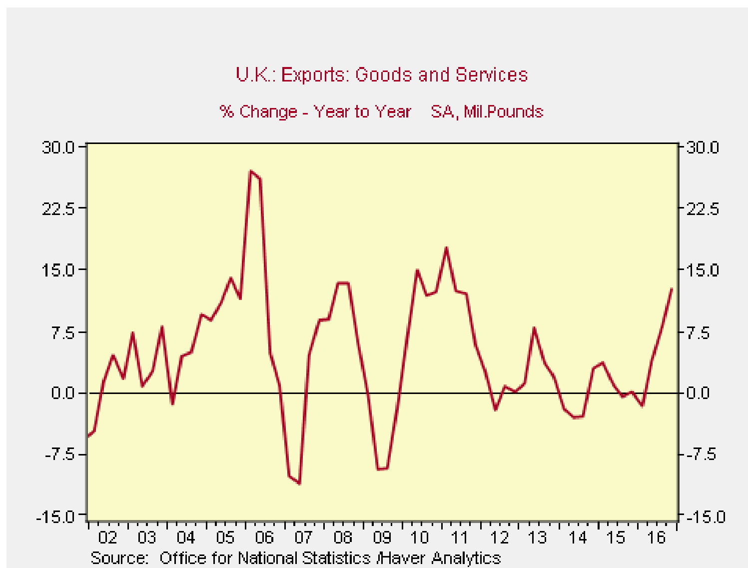
Historically, house prices and household consumption have tracked closely at a ratio of around 4 to 1 - a 10% rise in house prices yoy would normally imply 2.5% growth in real private consumption. Consumption makes up almost two thirds of UK GDP. While household balance sheets have improved since 2009, the average house price/income ratio has risen to 6.2 from 4.4. Even modest declines in house prices could affect the regular spending habits of homeowners who are highly leveraged. More than in other countries, we need to pay extra attention to the housing market in the UK. While price growth has slowed recently, and some areas of London are correcting where prices had surged in recent years, low interest rates and a lack of housing supply, combined with existing policies that raise demand like Help to Buy and Help to Buy London, should prevent a major correction.

6. Industrial production is ticking up



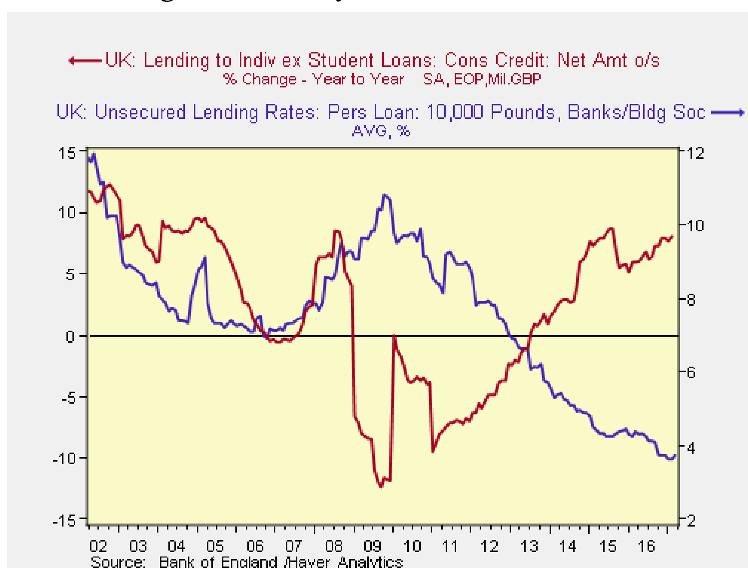
While the drop in trade-weighted sterling pushes up costs of inputs for some producers, it improves the competitive position of all UK firms that sell their wares abroad. Driven by healthy domestic demand and the global upswing that began in H2 last year, the UK industrial sector is enjoying a long-overdue upswing.

7. Exports are rebounding strongly



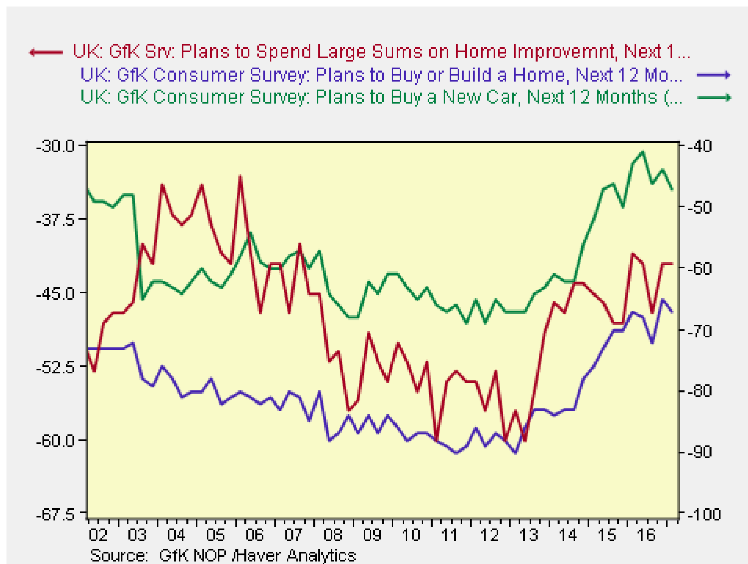
After five years of close to zero growth, exports are surging thanks to the more competitive exchange rate and the upturn in global demand. Over time, the rise in exports can help reduce the UK's current account deficit to more sustainable levels. Quarterly current account data can be volatile, but following a surge in exports in Q4 2016, the UK current account deficit dropped to 2.5% from 5.3% in Q3 2016.

8. Borrowing costs are very favourable



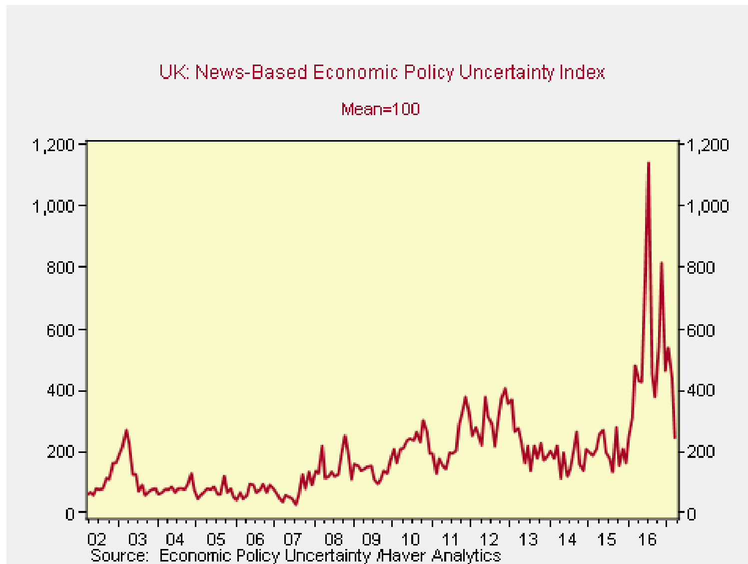
Due to the ultra-accommodative monetary stance by the BoE, household borrowing costs have fallen to near-record lows since the Lehman-crisis. Until recently, households had utilised the low borrowing costs to strengthen their balance sheets. That provided a good argument to delay the BoE's tightening cycle. But in recent quarters, households started to gear up again. The household savings rate is at a record low (3.3%), consumer credit growth remains close to decade highs and debt to income levels are rising. Modestly tighter monetary policy can help to discipline household behaviour by reducing the impetus to borrow and raise the incentives to save. By tempering growing animals spirits, the BoE could prevent a build-up of consumer excesses before it takes hold and promote a longer economic upswing. We expect the BoE to hike for the first time in Q1 2018, with a 40% chance they hike sooner. In an environment of growing household demand for debt, higher borrowing costs should be viewed positively.

9. Household intentions to make major purchases remain high



Household balance sheets have strengthened since the Lehman-crisis; debt-to-income is lower and household wealth has risen. Thanks to low oil prices, households have also enjoyed three years of solid real wage gains. Feeling confident after seven years of economic growth, UK household appetite to make major purchases has grown considerably. Household plans to buy a new car, buy a new home or spend large sums on home improvement remain at high levels relative to the ten-year trend.

10. Uncertainty is falling



After spiking around the 2016 EU referendum on 23 June, economic and policy uncertainty is at its lowest rate since early 2016. As the Brexit negotiations unfold and we learn more about the post-Brexit relations between the UK and the EU27, uncertainty can fall further. With more certainty, households and firms will begin to feel more confident planning ahead, and will begin to raise their long-lived liabilities, capital investments and demand for real estate.

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