Economic Research

WEEKLY ANALYSIS

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Negotiations between the UK and the EU have stalled

A preliminary financial agreement is crucial. GDP is flagging. Inflation remains high. The devaluation of the pound is having a limited impact. Rate hike likely in November.

Key points

- A financial agreement with Europe before negotiating other aspects of Brexit
- Is Theresa May still in charge?
- The pound rises and stabilises against the major currencies
- Overall, the depreciation of the pound is having a negative impact on GDP
- The BOE elucidates the likelihood of a rate hike
- Consumers remain wary, as does the BOE
- GDP is flagging, but leading indicators seem more positive
- Real estate prices decrease in London
- Inflation still not stabilising
- Long-term rates back on upward trend
- Insufficient visibility with regard to UK equities

A financial agreement with Europe before negotiating the other aspects of Brexit

"We want our money back," declared the French finance minister recently, in support of Chief Negotiator Michel Barnier, who aims first to reach a financial agreement with the UK before undertaking negotiations regarding the other aspects of Brexit.

The European Parliament is increasingly irritated with the lack of progress achieved in discussions with the British negotiators. The legislators noted in particular that the fourth round of negotiations failed to generate any forward momentum on priority issues and recommended via a resolution adopted by an overwhelming majority that the European Council postpone its evaluation of the situation.

This perspective obviously contrasts with the position of Theresa May, who offers a different interpretation of the on-going negotiations.

The settlement of the UK's financial obligations is in fact a crucial concern in the negotiations. Estimated at between 60 and 100 billion euros, the tab is far from reassuring or acceptable to the British. However, this is a key issue for the EU, which clearly has no intention of setting it aside, even temporarily, to move forward on other topics.

The European Parliament is decrying the lack of progress on fundamental issues, which is preventing further discussion regarding the future partnership between Brussels and London. The Europeans are also pointing to instances of illegal discrimination against EU citizens already arising in the UK both in the job market and in access to housing. The irritation is palpable, and it will disrupt the dialogue if the British cannot come to an agreement amongst themselves and propose a clearer line of negotiation. The ball is thus once again in the British camp, and it is up to Theresa May to unite the Conservative Party and smooth over disagreements, which are penalising the negotiation process.

After her resounding defeat in the 8 June elections, it will not be easy for Theresa May to find common ground among the differing positions of actors such as Boris Johnson, who favours a clear split from the EU, for instance, or Finance Minister Philip Hammond, who prefers a more flexible approach.

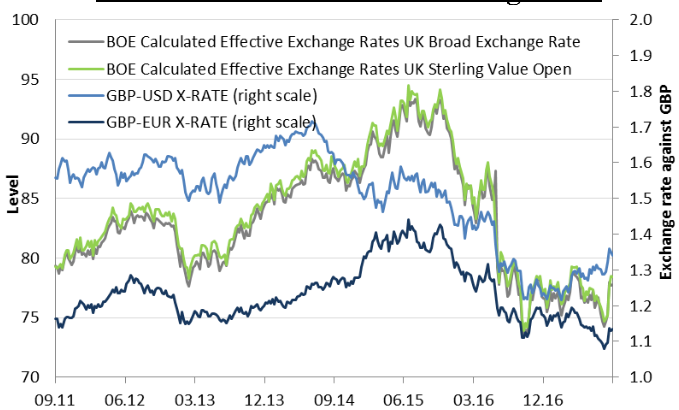
Is Theresa May still in charge?

In this regard, it is easy for Europeans to point to the lack of coherence on the British side, even alluding to the 'cacophony' within Theresa May's government. Between the Prime Minister Theresa May, Foreign Minister Boris Johnson, and Brexit Minister David Davis, it is not clear whom European negotiators should turn to. Whether Theresa May is the right person to see the negotiations through is now a legitimate question. Frustration has also reached new heights within the Conservative Party, with many members thoroughly exasperated by Boris Johnson's behaviour, some of whom are clearly convinced that he is aiming for the Prime Minister's post. The Tories thus need to tidy up their ranks in a hurry, perhaps pushing out those whose voice is too often discordant. The finance minister, who supports a softer pro-business Brexit, has pointedly noted that "no minister is unsackable", a direct reference to Johnson, who is sowing dissent and hampering negotiations with the EU. Theresa May is at the helm, but she appears to be having difficulties holding the course amidst this storm.

The pound rises and stabilises against the major currencies

After the pound dropped following the surprise vote for Brexit, we noted in 4Q16 that the British currency had likely already reached a valuation level enabling a more lasting consolidation pending greater visibility with regard to the country's economic outlook. Since then, the volatility of the British currency has decreased, and its exchange rate has in fact ticked up against the franc (1.20 to 1.30) and the dollar (1.20 to 1.35) in particular. The pound has stabilised above 1.10 against the euro in a context favouring the single currency.

Effective and dollar/euro exchange rates



Sources: Bloomberg, BBGI Group SA

We believe the British currency is unlikely to be able to benefit from new circumstances that would allow it to appreciate significantly against the other major currencies.

We thus believe that the pound will continue to stabilise over the next several months.

Overall, the depreciation of the pound is having a negative impact on GDP

Since the Brexit vote, the pound's weakness has significantly affected a number of economic variables. Some of these effects have only recently begun to materialise, such as the overall impact on the country's growth rate. While the pound's decline may initially have been perceived as favourable to British exports and for the economy as a whole, its net effects already appear to be diminishing. Over a year after the vote, the drop in the exchange rate has not really energised foreign trade. Export volumes have risen only very slightly, and ultimately, the impact on the trade balance was penalised by an increase of imports in pounds. Nevertheless, export sectors are benefitting from an increase in competitiveness, although consumption has been hit by imported inflation. While the expectation of rising inflation had caused household spending to increase, the loss of purchasing power that then materialised has weighed on consumption in the last several quarters.

Overall, the outcome is rather unfavourable to GDP growth in the UK, as imported inflation has penalised consumption without sufficiently boosting export volumes.

The BOE elucidates the likelihood of a rate hike

The BOE could well increase interest rates during its next meeting in November, which would be the first hike since 2007. GDP growth is slowing down, but it remains positive, while inflation is showing few signs of stabilising. The central bank is likely deeming that conditions are now right to exit the crisis mode that had led to a further rate cut following the Brexit vote. However, it is unlikely that this initial hike will be hastily followed by further tightening. Indeed, it is likely that economic growth will slow down further in 2018 and that Brexit-related outcomes will lead to a demand shock causing a further decline in consumption and finally the stabilisation of inflation.

The next rate hike could well be followed by a long period of inaction.

The BOE is wary, as are consumers

Since the June 2016 vote, consumer confidence has plummeted. Private consumption has stagnated (+0.1%), posting its weakest increase since 4Q14. The cautious attitude that was already manifest, affecting demand for non-essential goods and new vehicle sales for instance, has further taken hold. The uncertainty is now impacting the car market in particular. Vehicle sales and new registrations continue to drop. In April, registrations fell -19.8%, though the latest figures for August show a yoy decline of -2.4%. Consumers are adjusting their spending in line with the decline in their purchasing power, whose risk of long-term deterioration they perhaps now perceive more clearly. Consumer loan growth is still close to +10% yoy. This trend is seen both in the car loan and credit card segments. The BOE is not enthusiastic about this increase in household debt, which is unlikely to continue at the same pace going forward. Moreover, funding costs are unlikely to stay as low over the next few quarters, which increases risk from the BOE's perspective. The latter is increasingly concerned regarding the risk related to consumer credit and is recommending that banks set aside an additional 10 billion pounds in reserves to address a potential crisis. Consumption and the services sector had been key pillars of GDP growth. A lasting dip in consumption would be enough to push GDP into recession.

As the actual Brexit draws nearer, a growth slump or an upswing in interest rates could cause a solvency crisis.

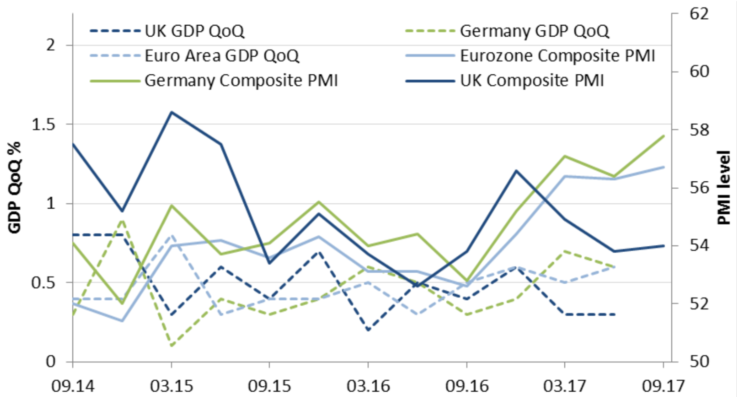
GDP is flagging, but leading indicators seem more positive

Q2 GDP figures confirm the previously detected slowdown in the UK's economic momentum, which seems to be settling into a quarterly pace of +0.3%. Yoy growth fell to +1.5%, which reinforces our prediction of lower growth for FY2017. Exports contributed positively, progressing +1.7%. Consumption, up +0.2%, remains key to GDP growth, while public spending advanced +0.1%.

Leading indicators also support the argument of a resilient economy, with GDP growth remaining positive in 2017, albeit at a reduced rate.

Indeed, the most recent published indicators suggest growth in both the manufacturing and the services sectors in H2. The Composite PMI ticked up slightly to 54.1 in September, while the Manufacturing PMI posted a slight decline (55.9). The Services PMI, stable at 53.6, also seems relatively resilient. In this context, the unemployment rate rather surprisingly dropped to a mere 4.3% in July, in line with the previous quarter's job creation figures (181,000), which were much higher than the consensus forecast (150,000). It is somewhat surprising to witness this kind of development in the job market in current conditions. This bright spell is unlikely to persist in 2018, and inflationary pressures are thus likely to emerge. As for industrial production, it has declined, posting growth of just +0.4%, while manufacturing production picked up slightly with annual growth of +1.9%.

Quarterly GDP and PMI: UK, Eurozone, Germany



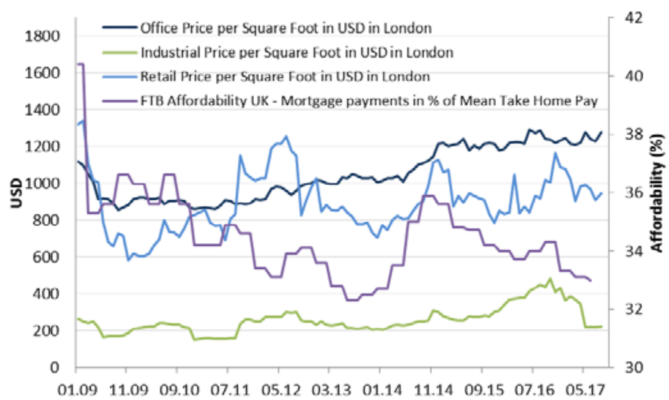
Sources: Bloomberg, BBGI Group SA

Growth prospects for the British economy are thus increasingly less optimistic. Growth in Q3 and Q4 could still come it at +0.3% or +1.3% for FY2017.

Real estate prices decrease in London

London is no longer an exception, as shown by the -0.6% yoy decrease in prices posted in September, and is in its turn suffering from the drop in real income (-0.4%) of the British population. It is the first time that the capital falls to the bottom of the list in terms of real estate performance in the country since 2005. Overall, the growth in real estate prices has plunged to barely +2% in September according to the Nationwide Building Society (NBS).

Real estate prices – Real estate affordability index

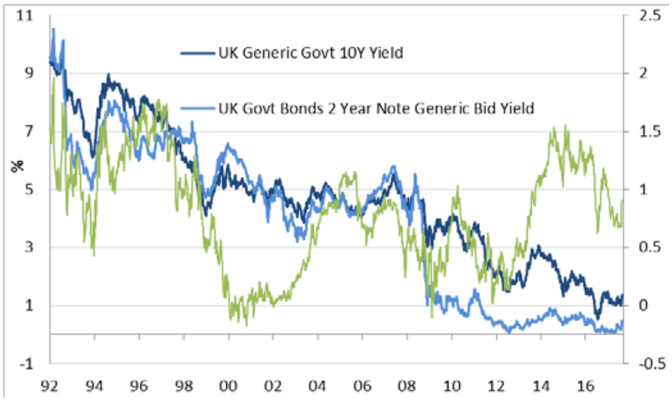


This weakness in prices was expected, and even if supply remains low and inventories are at record lows, the short-term outlook is not promising. However, we are not observing any real contraction in domestic demand yet, as seen in mortgage loan approval rates, which remain steady (66,600). We can also confirm our recent comments suggesting that the stabilisation of the pound could boost residential demand given the sustained interest of international investors.

The bond market will not be able to ignore the return of inflation for long

Inflation remained high in August (+2.9%) and seems on the verge of climbing beyond 3% in spite of the stabilisation of the pound and the relative decrease of imported inflation. Retail prices are also up +3.1% over the same period. After an initial increase of +20% in production prices yoy in January 2017, price growth decreased to +7.6% in August. We continue to predict that inflation will exceed the BOE's 2% target in the next several quarters and could even reach 4% by 2020. It is surprising in the context of general prices increases that long-term interest rates are not more affected by changes in expectations.

2- and 10-yr UK government rates



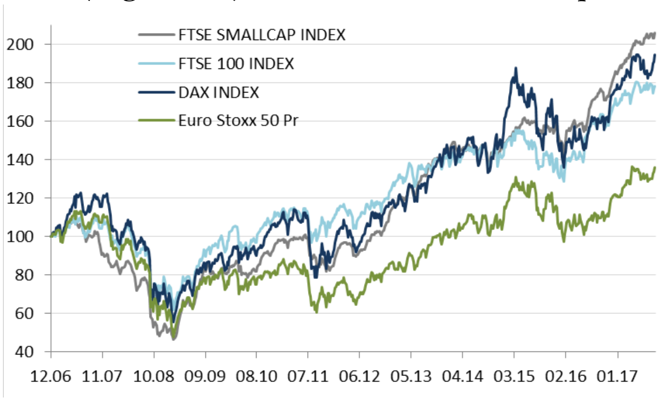
Sources: Bloomberg, BBGI Group SA

The UK bond market is likely to be increasingly impacted by domestic fundamentals, which will push long-term rates toward 1.8%.

Insufficient visibility with regard to UK equities

At approximately 14x 2018 earnings, the UK market is somewhat dearer than other European markets for a slightly higher yield (4.3%). The stabilisation of the pound has effectively stopped the progression of British equities. We continue to recommend caution with regard to the UK equities market, which is likely to be further penalised as Brexit's potential tangible impacts on the British economy and corporate earnings come to light.

UK (large, small), Eurozone, and German equities



Sources: Bloomberg, BBGI Group SA

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