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Recession increasingly likely in UK

Industrial output down -2.7% and GDP down -0.4% in April. Pressure on the pound. BOE steps back. Seven contenders for Theresa May's job.

Key points

- Who wants to replace Theresa May?
- Boris Johnson favourite among seven contenders
- Leading indicators deteriorated in May
- Manufacturing PMI drops under 50
- Industrial output plunged by -2.7% in April
- Economic contraction in Q2
- Monthly GDP down -0.4% in April
- Consumer confidence improves
- Job market still solid
- Jobless rate decreases to 3.8%
- No longer any reason for the BOE to hike rates
- Stabilisation of real estate market
- Too much risk in capital markets
- Risk of recession weighs on the pound
- Caution on equities and real estate

Who wants to replace Theresa May?

Three years after the Brexit vote, Theresa May wrested from the EU a final extension of the withdrawal deadline until October 2019 before bowing out. Uncertainty persists in spite of May's departure, but it would seem that the Brexit issue has been sidelined to some extent as a consequence of the delay. The crucial question now is 'who wants to replace Theresa May?'.

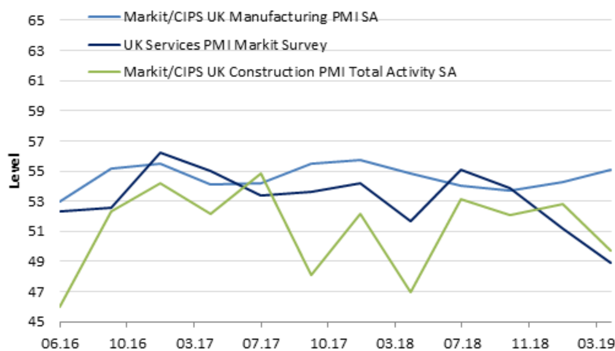
The nomination process started with a vote among Conservative MPs, which designated seven candidates. At the end of the process, only two candidates will be put to the ballot of the 160,000 party members. The name of the winner should be known before the end of July. The frontrunner seems to be Boris Johnson, who has come out well ahead of Foreign Affairs Minister Jeremy Hunt, garnering three times as many votes as the latter. We will have to wait a few weeks to ascertain what approach will be adopted between Johnson's hard line, as he has clearly always been prepared to leave the EU with or without a deal, and the more pragmatic approach put forward by the former health secretary, who is advocating for a renegotiation of the withdrawal agreement and putting together a new negotiating team representing a wider political spectrum in order to avoid a no-deal withdrawal on 31 October.

Leading indicators deteriorated in May

The manufacturing PMI dropped rather abruptly from 53.1 to 49.4 in May, killing faith in the resilience of British manufacturing, which had held up comparatively well to the pressure weighing down on most industrialised countries. The PMI's dip below its growth threshold of 50 is thus one more sign of the likely downturn of the UK economy in Q2. Contrary to other countries, the UK's manufacturing sector seemed to bounce back after steadily declining in 2018, surging from 52 to 55.1 in March. With the recent correction, the sector has fallen back into line with global trends. With regard to services, which were more resilient overall in other economies over the past several months, British PMI indicators had already slipped under their growth threshold in March (48.9). The upswing to 51 over the past two months suggests a slightly better outlook. In terms of the UK economy overall, months seem to be going by with no clear solution in sight to the political crisis, which is getting worse day by day, exacerbating the feeling of uncertainty among businesses and consumers. The shifts in opposite directions of the two PMI indicators offset each other with regard to the composite index, which remained steady at 50.9 in May. Leading indicators also weakened in the construction sector. The construction PMI (48.9) dropped significantly below 50, posting one of

its worst scores of the past three years. The UK economy is moving away from the growth zone, and the risk of recession is increasing.

Manufacturing, services and construction PMIs

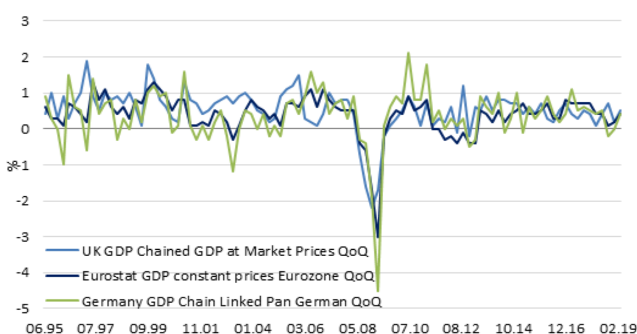


Sources: Bloomberg, BearBull

Collapse of industrial output

UK GDP increased by +0.5% in Q1. Growth accelerated after slowing by -0.2% at the end of 2018. Private consumption and public spending as well as gross fixed capital formation contributed positively to growth, while foreign trade contributed negatively. However, these trends are not solid and are essentially driven by rising inventories in preparation for potential supply disruptions in the wake of Brexit. Preliminary Q2 results already seem to confirm this analysis. Industrial output in the UK fell by -2.7% in April, which is much worse than the consensus forecast (-1%), due to a collapse in factory activity (-3.9%) and in electricity and gas production (-3.2%). It is the biggest contraction in activity since 2012, which likely resulted in part from issues related to the Brexit delay as well as from the -24% drop in vehicle production due to temporary plant shutdowns. The decline in manufacturing output was thus the steepest in seventeen years. These data highlight the fragility of the UK economy, which remains heavily impacted by the Brexit issue, with no solution in sight for now. Construction also contracted by -0.4% in April, while the service sector remained stable.

Quarterly UK GDP growth



Sources: Bloomberg, BearBull

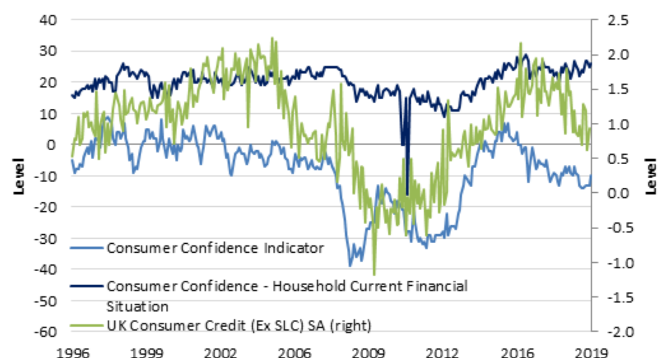
Economic contraction in Q2

Leading indicators had been pointing to a contraction of GDP, and April data clearly indicates a downturn in economic activity following a relatively strong start to the year. The -0.4% contraction in GDP over the month follows a decrease of -0.1% in March, driven mainly by the decline in industrial output. The growth shock is much worse than consensus expectations (-0.1%), showing that Brexit had a much bigger impact than anticipated. Manufacturing firms had built up inventory in preparation for Brexit, which shored up GDP at the beginning of the year, but the extension of the deadline to October has had the opposite effect over the last few weeks. For the three months ending in April, GDP growth slowed but remained positive (+0.3%). Yoy GDP growth slowed from +1.9% in March to +1.3% in April. Annualised growth for the past three months stood at +1.1%. The UK's trade deficit decreased to 12.1 billion pounds following a fall in both imports and exports. By volume, exports fell by -10.9% in April, while imports fell by -14.4%. Given the current context, the outlook for Q2 is not very positive, but the growth outlook for the year as a whole remains close to +1.4%.

Consumer confidence improves

British consumers were more optimistic in May in spite of the political uncertainty. Households seem to have a more favourable outlook on their financial situation and are claiming to be less pessimistic with regards to the country's overall economic situation. British consumers, still active in Q1 with household consumption up +0.7%, remain the main driver of GDP growth. Since 2016, they have bolstered domestic demand, although without generating enough momentum to significantly boost consumption. The unemployment rate, now below 4%, is a positive factor that will boost wages and purchasing power, as inflation is actually rather moderate for now (+1.8%). Households' real disposable income has increased, but household debt also rose for the ninth quarter in a row.

Consumer confidence



Sources: Bloomberg, BearBull

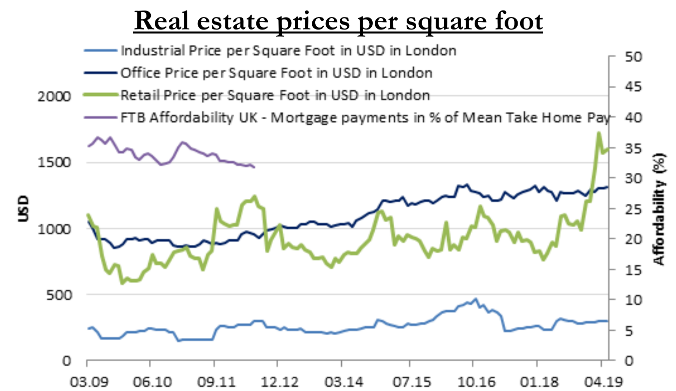
No longer any reason for the BOE to hike rates

The Bank of England has a little more wiggle room now that inflation (+1.8%) has dropped back under the 2% threshold, although inflation remains sufficiently lively to continue to be factored into the assessment of threats and opportunities with regard to the BOE's monetary policy. As for production prices, they increased by +1.1% in April and +3.8% yoy. The BOE had had to raise rates twice in 2017 and had then abstained from any further action in a context where the pound was stabilising, inflation was cooling, and the economy was decelerating. The BOE will continue to pay close attention to Brexit-related political developments, likely hoping that a no-deal withdrawal in October can be avoided. However, its main concern currently is to prevent further deterioration in the economy. Initial figures indicate that GDP may have contracted by -0.2% in Q2, which will surely compel the BOE to keep its monetary policy steady and its benchmark rate at 0.75%. These developments will have a greater impact than that of the job market. Current economic weakness will prevent the BOE from raising rates as was still being considered just a few months ago. We continue to anticipate, as we did several months ago, that the BOE is unlikely to act swiftly and that it will keep its benchmark rate steady at 0.75% in 2019.

Stabilisation of the real estate market

Surprisingly, real estate prices rose by +0.5% in May, well exceeding analysts' price stabilisation expectations according to mortgage lender Halifax. Prices rose +5.2% yoy. Monthly data were somewhat volatile in 2019, but prices are clearly still trending upwards following on over a decade of growth. Concerns stemming from Brexit have been weighing on the UK market, which will likely continue to be impacted by worries regarding the looming threat. However, the imbalance in the real estate market remains favourable to a continuation of current trends, in particular if borrowing costs remain as low as they are currently and if the job market remains robust. The number of mortgage approvals increased, exceeding 66,000 mortgages approved in April, close to the highest levels seen over the past eighteen months.

Real estate prices per square foot



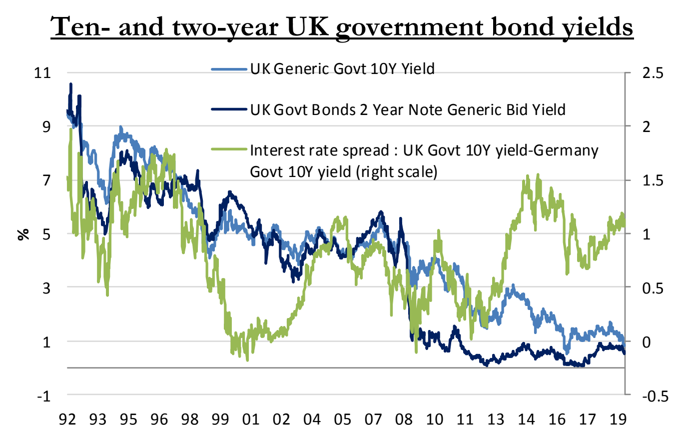
Sources: Bloomberg, BearBull

In spite of the oppressive uncertainty surrounding Brexit, the unemployment rate in the UK continued to decline in April, dropping to a 10-year low of a mere 3.8%, well below the 2011 high of 8.5%. Wage increases as measured by total weekly earnings stalled slightly in April for the second time since June 2018, as the +3.1% increase was slightly lower than the +3.5% increase seen in February. However, the job market is solid, as indicated by the 32,000 new jobs created in April.

Too much risk in capital markets

The extension to October of the deadline for the UK's withdrawal from the EU offers investors a temporary reprieve, as they can set aside for a time the immediate threat of a no-deal exit, which would have potentially disastrous consequences in terms of the valuation of the pound, inflation, and growth. Brexit worries have been put on the backburner for now due to the UK economy's loss of momentum in Q2. It is now likely that the UK will enter into recession over the summer, just before the next deadline. Long-term interest rates had stabilised above 1.2% before the decision to delay Brexit, falling rapidly to 0.8% in reaction to the increase in the risk of economic contraction. These low levels are associated with a risk of sudden capital losses as well as a risk of currency devaluation.

Ten- and two-year UK government bond yields



Sources: Bloomberg, BearBull

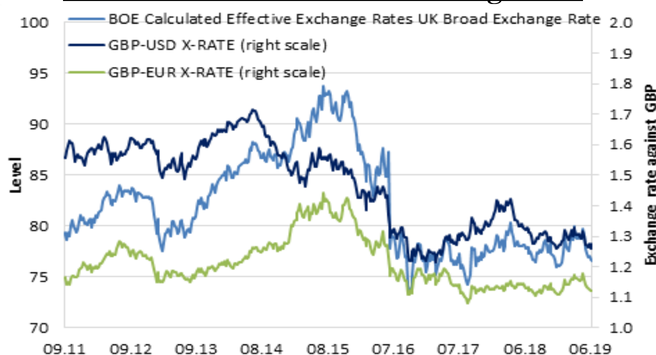
We view this environment as relatively unattractive and do no recommend maintaining any exposure to the UK rate market. Inflation in the UK had reached 3.1% in 2017 with the depreciation of the pound before gradually declining to 1.8% in March. The risk that inflation will heat up following Brexit obviously depends on how the issue is resolved and will certainly be much higher in the event of a no-deal withdrawal.

Risk of recession weighs on the pound

The pound is more than ever hostage to the complex political situation surrounding Brexit. The UK should have exited the EU on 29 March without an agreement.

The political impasse remains intractable despite the extension of the deadline to October. The British currency is now being affected by the slowing economy and increasing risk of recession. Given this context, we maintain our caution vis-à-vis the pound. We expect that the pound is likely to further depreciate below its December 2018 level of 1.25 against the dollar.

Effective and dollar – euro exchange rates



Sources: Bloomberg, BearBull

Caution on equities and real estate

Given the highly uncertain context surrounding the Brexit talks, the equity market's expected risk/return ratio does not seem attractive. The pound is now under pressure due to the economic downturn underway. We thus maintain our recommendation to stay cautious on UK equities, in spite of reasonable valuations and attractive dividend yields. With regard to securitised real estate, the uncertainty as to what Brexit will ultimately look like will put a damper on REITs. The risks of further deterioration of market conditions appear significant enough to recommend staying away from this market for now, as the BOE has mentioned that real estate prices may plummet by 25% in the pessimistic scenario of a no-deal Brexit.

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