UK

Brexit taking its toll on the economy

- Brexit continues to take its toll on the British economy. Underlying growth is likely to remain in the range of 1.0-1.5% in the years ahead. The labour market has been quite resilient for a long time but recently we have become more concerned.
- The general election is decisive for the Brexit outcome but unfortunately, it is very difficult to predict the outcome.
- The acknowledged MRP model from YouGov predicts The Conservative Party will win an absolute majority and so make it possible for Boris Johnson to pass his Brexit deal before Christmas, which is now our base case. The UK will then leave the EU by 31 January 2020 and start the negotiations on the future relationship. There is risk of a "no deal Brexit" by 31 December 2020 if no deal is reached or the transition period is not extended.
- If the opposition wins, we expect a second EU referendum. The risk is another hung Parliament with no stable majority, which would require another extension.
- We expect the Bank of England to cut at its meeting in January 2020 and think it is a close call whether or not there will be another cut in the second half of 2020.

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Brexit is taking its toll on the economy

Brexit continues to take its toll on the British economy. Although the first estimate of GDP growth in Q3 showed that it grew by 0.3% q/q, GDP declined in both August and September. Looking at the annual growth rate, GDP growth is at its lowest since the European debt crisis in 2011-13. The PMIs in October were not encouraging and signalled a weak beginning to Q4.

The prolonged Brexit uncertainty has mainly hit businesses and not so much consumers. Private consumption remains the main growth driver although it is not growing as fast as a couple of years ago. The UK is still in an investment recession although business investments were flat in Q3. Looking at the year-over-year growth rate, business investments are still lower than a year ago. This is quite extraordinary nearly 10 years into the expansion when comparing to previous expansions and the rest of the world. Around 55% of the companies think Brexit is among the top three sources of uncertainty and many companies have postponed investments decisions due to Brexit. With Brexit postponed once again, the outlook for business investments still looks weak. It does not help that growth in the rest of the world has slowed due to (among other things) the ongoing US-China trade war. Hopefully, this will soon be resolved.

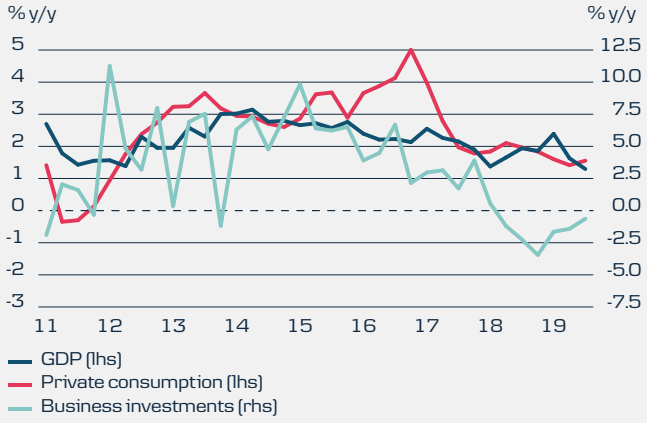
The labour market has been quite resilient to Brexit uncertainties so far, but recently we have become more concerned about its development. Although the jury is still out (employment data are very volatile), the most recent jobs reports have shown falling employment in July and August, although it rebounded slightly in September. Soft indicators suggest weak or even negative employment growth may continue. If this is the beginning of a new trend, this may start a downward spiral, which would lead to a more severe economic slowdown.

Even if we assume Brexit happens soon, we do not expect investments to kick off, as businesses still do not know what the future relationship will look like. These negotiations are only about to start when the UK leaves the EU formally, and they are going to be much more complicated than the negotiations on the withdrawal terms. It could be that we are too pessimistic here and that companies may start to invest in more projects than they had postponed due to Brexit.

We are having a hard time seeing much higher growth over the forecast horizon and think growth will remain in the 1.0-1.5% range over the coming years (against 2.0-3.0% before Brexit was a theme). We will probably not surprise anyone in saying that Brexit makes it difficult to make precise forecasts for the economy, in particular with the stockpiling ahead of the Brexit deadlines.

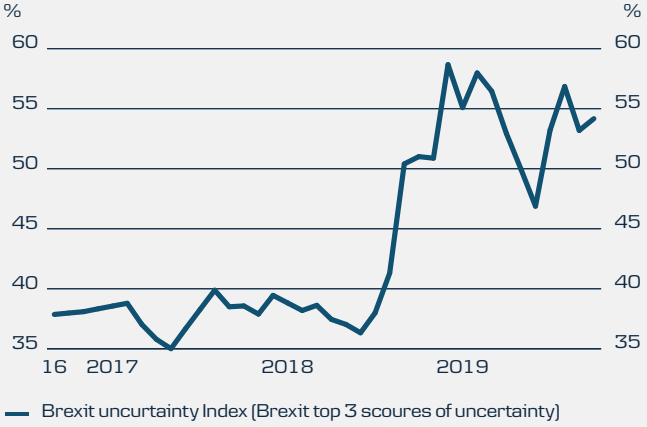
We forecast GDP growth of 1.4% this year, 1.0% in 2020 and 0.9% in 2021 but stress that Brexit remains a big source of uncertainty.

UK is still in an investment recession due to high Brexit uncertainty



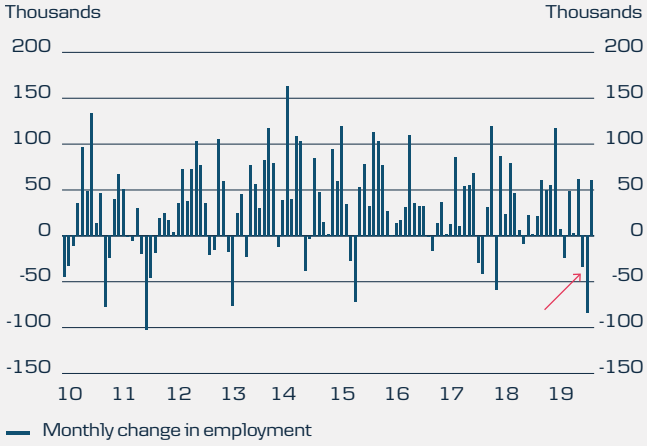
Source: ONS, Macrobond Financial

Brexit is among the top 3 sources of uncertainty for many companies



Source: Bank of England, Macrobond Financial

Early signs that the UK labour market has taken a hit



Source: ONS, Macrobond Financial

Election is an EU referendum in disguise

In line with our long-held view, Brexit has been extended again (new Brexit Day is 31 January 2020) and a general election has been called (Election Day 12 December). In our view, the election is an EU referendum in disguise. Unfortunately, it is difficult to translate polls into mandates due to the 'winner takes all' election system. The long-awaited results from YouGov's so-called MRP model predicts an absolute majority for The Conservative Party. The YouGov MRP model was the only one to correctly predict Theresa May would lose her absolute majority in 2017. Based on the model's results, we now think a Conservative majority is the most likely outcome.

If it turns out to be right, PM Boris Johnson will be able to pass his Brexit deal before Christmas without too many problems (Friday 20 December has been circulated as a potential voting day) and the negotiations on the future relationship will begin soon afterwards. The negotiations on the future relationship are complicated and there is not much time, as the transition period ends on 31 December 2020 and Johnson has rejected the idea of extending it. In other words, there is another looming risk of a no deal Brexit by the end of the transition period if the UK and the EU27 cannot agree either on a permanent deal or an extension of the transition period.

While Labour is unlikely to win an outright majority, the five opposition parties (Labour, LibDems, SNP, Plaid Cymru and Greens) may have a majority together. If so, we think a second EU referendum will be called although the parties have difficulties working together. LibDems, SNP, Plaid Cymru and Greens are all campaigning for a second EU referendum with 'remain' as one of the options on the ballot. Labour wants to renegotiate with the EU before asking the people whether to remain or leave with the 'Labour deal'. 'Remain' is slightly ahead in opinion polls.

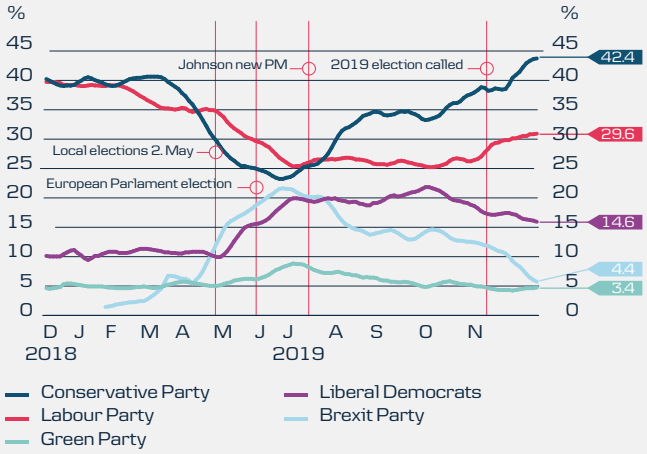
In case of a hung parliament without a clear/stable majority, the period of high uncertainty and confusion will continue and the UK may need another extension beyond 31 January. Despite Brexit fatigue in Brussels, we expect another Brexit extension will be granted eventually.

GBP in the hands of Brexit

Brexit remains the most important driver for GBP. We think the tail risk of a no deal Brexit in the short-run has declined substantially and investors have priced out a lot of negativity in GBP. EUR/GBP is currently trading just above 0.85 down from 0.93 in early August when investors thought PM Johnson's no-deal Brexit threat was credible. If PM Johnson wins the election, EUR/GBP may move slightly lower. If the opposition wins, it would spur hopes of Brexit being undone and should support GBP. A hung parliament would probably be GBP negative by creating renewed political uncertainty, but upside in EUR/GBP would still probably be capped around 0.90. If a Brexit deal passes, we see a risk that EUR/GBP will move higher again, as investors may start repricing a no-deal Brexit risk premium during the transition period.

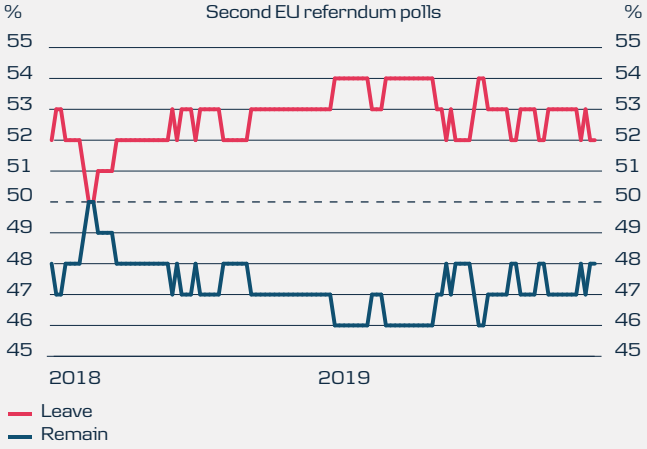
Following the dovish policy signal sent by the Bank of England at its November meeting, we now expect a 25bp cut in January 2020 and think it is a close call whether or not there will be another rate cut in the second half of 2020.

Conservatives have surged in polls since Johnson took over



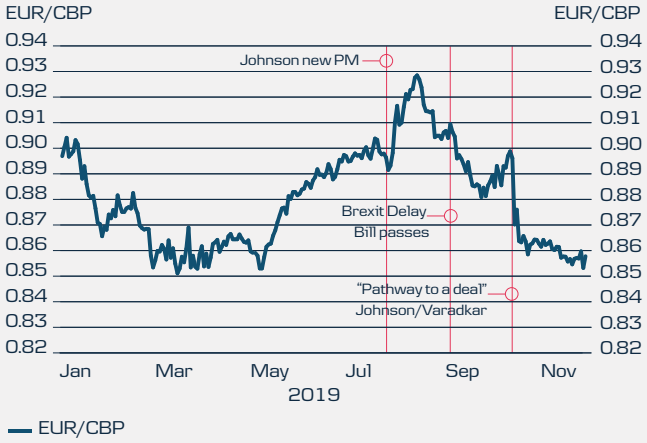
Source: Britain Elects, Macrobond Financial

Remain slightly ahead in second EU referendum polls



Source: : NatCen Social Research, Macrobond Financial

Investors have priced out a lof GBP negativity



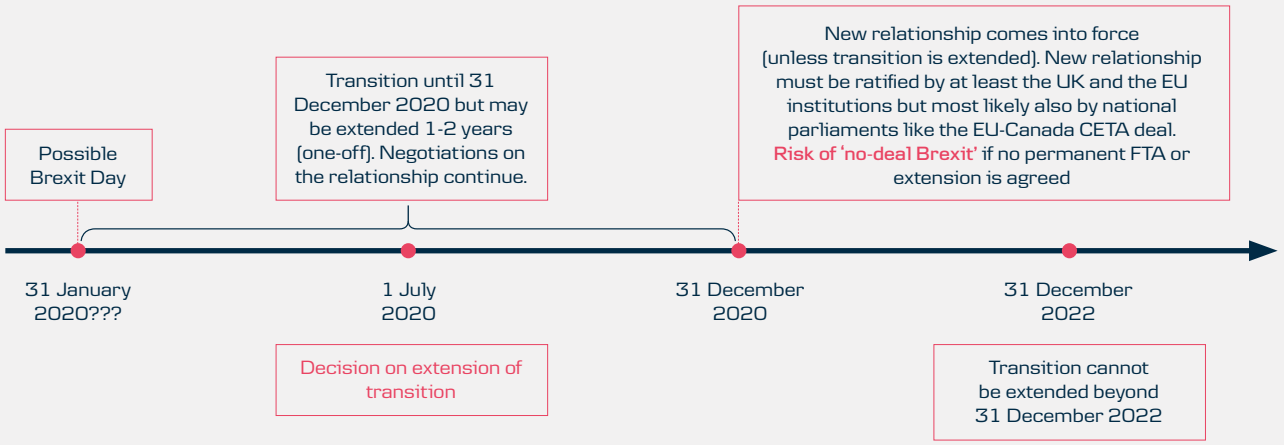
Note: Past performance is not a reliable indicator of current or future results
Source: Bank of England, Macrobond Financial

Macro forecasts - UK

% change q/q	2020				2021						
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2019	2020	2021
GDP	0.4	0.2	-0.2	0.3	0.3	0.3	0.3	0.3	1.4	1.0	0.9
Private consumption	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	1.3	1.4	1.4
Government consumption	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	3.3	1.3	0.6
Fixed investments	-0.8	0.0	0.3	0.3	0.3	0.3	0.3	0.3	-0.1	-1.5	0.9
Exports	0.0	0.3	0.5	0.5	0.5	0.5	0.5	0.5	0.5	1.7	2.0
Imports	-1.0	-1.0	0.5	0.5	0.5	0.5	0.5	0.5	3.3	-2.4	1.6
Domestic demand[1]	0.1	0.3	0.3	0.3	0.3	0.3	0.3	0.3	1.4	0.9	1.2
Net exports[1]	0.3	0.4	0.0	0.0	0.0	0.0	0.0	0.0	-0.9	1.2	0.1
Inventories[1]	0.0	-0.5	-0.5	0.0	0.0	0.0	0.0	0.0	0.8	-1.1	-0.4
Unemployment rate (%)	3.8	3.8	3.8	3.7	3.7	3.7	3.7	3.7	3.8	3.8	3.7
Wage growth (% y/y)[2]	3.2	3.1	3.2	3.6	3.7	3.7	3.7	3.7	3.5	3.4	3.7
CPI (% y/y)	1.7	1.3	1.2	1.6	1.6	1.6	1.6	1.7	1.8	1.4	1.6
Core CPI (% y/y)	1.8	1.7	1.7	1.8	1.8	1.7	1.7	1.8	1.8	1.7	1.8
Public budget[3]									-1.4	-1.1	-1.1
Public debt[3]									83.8	82.9	82.2
Current account[4]									-3.5	-3.7	-3.7
BoE Bank Rate (%) (end of period)	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	0.50	0.50

1) Contribution to GDP growth
2) Average weekly earnings excluding bonuses. % y/y
3) % of GDP. OBR forecasts
4) % of GDP. EU Autumn forecast
Source: OBR. EU Autumn forecast. Danske Bank

Brexit timeline



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