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Economics Group

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U.K. GDP Surprises to the Upside in Q3

Data released this morning confirmed that the British economy did indeed decelerate a bit in the third quarter. However, growth was not as weak as many analysts would have expected in the aftermath of the Brexit vote.

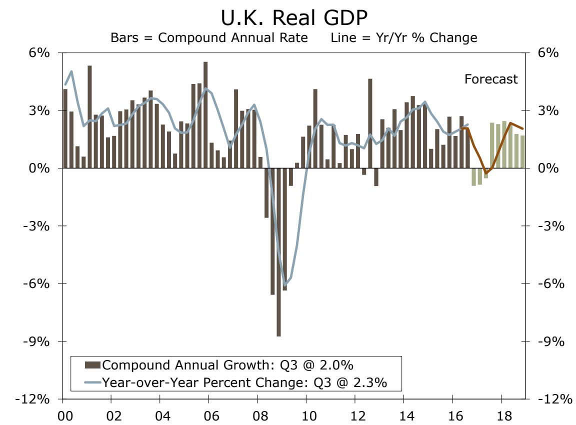
Weathering the Storm

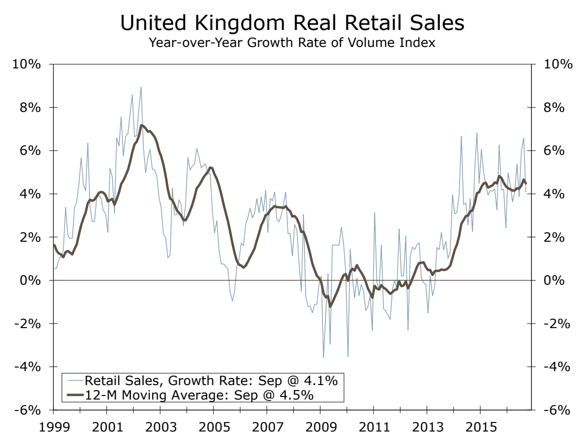
In the immediate aftermath of the Brexit vote, many analysts, including ourselves, expected that the ensuing uncertainty would cause growth in U.K. economic activity to weaken, if not turn negative. This morning, preliminary data on economic growth in Q3 confirmed that activity slowed to a sequential rate of 0.5 percent (2.0 percent on an annualized basis), which represents a modest slowdown from the 0.7 percent rate that was registered in Q2. However, this output slowdown beat estimates which predicted a lesser 0.3 percent sequential rate of growth.

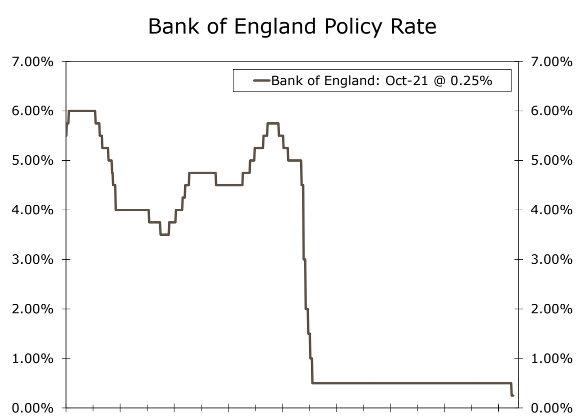
A breakdown of the GDP data into its underlying components will not be available for another month, but the preliminary industry breakdown that is available now offers some insights into the underlying drivers of the British economy in Q3. Growth in the third quarter was driven almost entirely by the service sector, which points to strength in consumer spending. This sector's strength is consistent with the monthly retail sales data through September which shows healthy spending growth. Construction, on the other hand, contracted 1.4 percent on the quarter, which is consistent with our prediction that the uncertainty surrounding the future of the U.K. will lead to a pull-back in investment spending. Construction has now contracted in two consecutive quarters, the first time since Q4 2013 and Q1 2014. Likewise, the manufacturing sector contracted 1.0 percent and provides further clues that suggest investment spending likely weakened during the quarter.

Darkening Clouds

Despite robust consumer spending, which has buoyed headline growth in the aftermath of the Brexit referendum, we still expect the U.K. economy to slip into a modest recession in the coming quarters. The cloud of uncertainty that hangs over the Brexit negotiations will continue to cast a shadow of doubt over the future relationship of the United Kingdom with the European Union. This sense of doubt should weigh on investment spending, which in turn could drag the U.K. into a period of economic contraction. The Bank of England (BoE) stands by to provide further rate cuts/accommodative monetary policy if the economy looks like it cannot stay afloat on its own. However, given today's stronger-than-expected GDP print, we now expect the BoE to remain on hold next week and wait until early next year, when signs of a weakening economy surface, before cutting rates. Our currency strategy team believes the pound will remain under pressure and head lower against the dollar over time as the monetary policy stances of the Federal Reserve and the Bank of England diverge.







Source: Bloomberg LP, IHS Global Insight and Wells Fargo Securities

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