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Economics Group

Special Commentary

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Does Recession Still Threaten the U.K. Economy?

Executive Summary

Since the Brexit referendum on June 23, British economic data have generally come in stronger than expected. Although we certainly acknowledge that economic activity has held up better than we expected a few months ago, we think it would be premature to claim that the British economy is completely out of the woods because a downturn in investment spending still looks likely, and if investment spending falls far enough, employment likely would weaken as well, which would weigh on consumer spending. The depreciation of the sterling is probably not enough, by itself, to produce significant acceleration in British exports. We still have a mild recession in our U.K. economic forecast. At a minimum, we believe that deceleration in British GDP is inevitable in the next few quarters and that the Bank of England likely will ease further in an effort to stave off any potential recession.

Data Since Referendum Have Not Been as Weak as Initially Feared

In a report written soon after British voters opted to leave the European Union in a referendum held in that country on June 23 (a.k.a., Brexit), we opined that the U.K. economy would slide into a mild recession in the second half of 2016.[1] At the time, we anticipated that the contraction would begin in Q3-2016 and last three quarters. However, British economic data have been stronger than expected on balance over the past few months, and it appears that real GDP growth remained positive in the third quarter.[2] For example, the manufacturing PMI, which plunged into contraction territory in July, rebounded in August and rose even further to a two-year high in September (Figure 1). The service sector PMI also returned to positive territory in August and remained there in September. Retail spending data for July and August were both stronger than most analysts had expected.

Are our out-of-consensus prognostications of a mild recession in the United Kingdom still on track? Although we certainly acknowledge that economic activity has held up better than we expected a few months ago, we think it would be premature to claim that the British economy is completely out of the woods at this point. Our initial bearishness on the U.K. economic outlook was based on our judgement that investment spending would weaken due to the uncertainties that Brexit entails for the ultimate economic relationship that the United Kingdom will have with the European Union. In that regard, there is some evidence to suggest that U.K investment spending will indeed soften.

We think it would be premature to claim that the British economy is completely out of the woods.

[1] **See "U.K. Recession Post-Brexit Referendum?" (July 1, 2016) which is available upon request.**

[2] **The National Institute of Economic and Social Research, a highly regarded think tank in the United Kingdom, recently estimated that real GDP grew 0.4 percent (not annualized) on a sequential basis in the third quarter.**

Figure 1

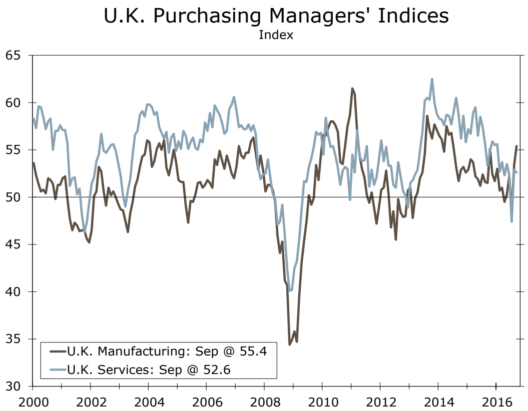
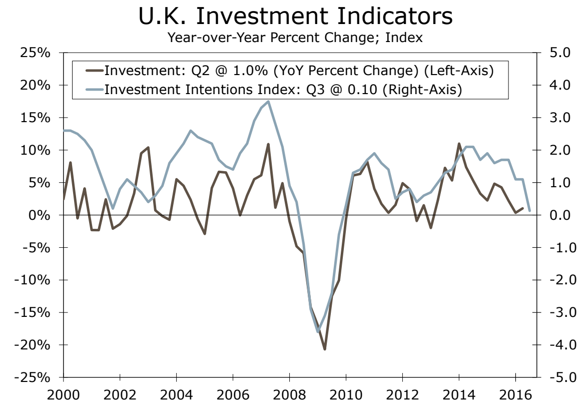


Figure 2



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

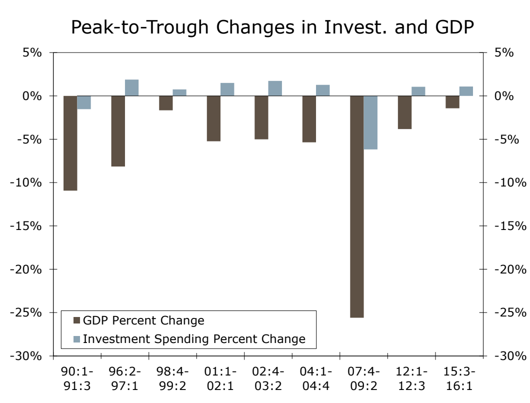
It All Depends on the Outlook for Investment Spending

As shown in Figure 2, there is a high degree of correlation between a survey of investment intentions among businesses and actual capital spending. The survey plunged in the third quarter to its lowest level since the climb out from the deep 2009 downturn, suggesting that growth in fixed investment spending, which weakened to only 1.0 percent on a year-ago basis in Q2-2016, may move into negative territory shortly. Production of capital goods by British manufacturers, which is a loose proxy for overall capital spending in the United Kingdom, was down more than 1 percent in August relative to its high in June.

Deep downturns in capex could drag the broader economy into recession.

But will the incipient contraction in investment spending necessarily produce a downturn in the overall British economy? Since 1990, there have been nine “recessions” in U.K. investment spending. (In this context, we define recession as at least two consecutive quarters of negative growth in investment spending.) However, there have been only two periods since 1990 in which U.K. GDP contracted for at least two consecutive quarters, which is a working definition of a broader economic recession. The most recent economic downturn prior to the “Great Recession of 2008-2009 occurred in the early 1990s (Figure 3). In both cases, investment spending fell in excess of 10 percent on a peak-to-trough basis. In short, the overall British economy can withstand a period of modest weakness in investment spending, but deep downturns in capex could drag the broader economy into recession as well.

Figure 3



Source: IHS Global Insight and Wells Fargo Securities

So how deep could any downturn in investment spending be, and would it be enough to produce an overall recession? Unfortunately, it is more or less impossible to derive precise estimates, but we may be able to get some insights by disaggregating the overall British economy into broad sectors. Goods tend to be traded more internationally than services, so it stands to reason that any recalibration of the economic relationship between the United Kingdom and the European Union should have a more profound effect on the manufacturing sector than on other sectors of the British economy.

Table 1 shows that exports to EU countries account for 20 percent of the output of the British manufacturing sector, whereas the comparable ratio for the service sector is only about 5 percent. Investment in the manufacturing sector could weaken markedly if British manufacturers believe that their tariff-free access to continental markets could be threatened. However, the manufacturing sector accounted for only 14 percent of total capex spending in the U.K. economy last year. The service sector, which is not as directly exposed as the manufacturing sector to exports to the European Union, accounts for more than 60 percent of investment spending. How bad could a drop in overall investment spending in the United Kingdom be?

Table 1: U.K. Economic Indicators By Sector

Sector	*Gross Exports to EU/Total Production*	*Sector Investment as Percentage of Total Investment*	*Sector Employment as Percentage of Total Employment*
Manufacturing	20.0%	13.6%	9.7%
Other Goods Producing	5.3%	24.9%	10.1%
Services	5.2%	61.5%	80.3%

Source: Organisation for Economic Cooperation and Development, Office for National Statistics, IHS Global Insight and Wells Fargo Securities

There is a fair degree of correlation between investment in manufacturing and other sectors of the economy.

Although service providers may not cut capital expenditures as much as manufacturers due to the direct effects of Brexit, there could be more meaningful indirect effects that could weigh on investment spending in other sectors of the economy. If service producers fear that sales to manufacturers may weaken because of cutbacks in that sector, they too may shelve investment plans. In that regard, there is a fair degree of correlation between year-over-year growth rates in investment spending in the manufacturing sector and in the non-manufacturing part of the economy (Figure 4).[3]

A meaningful cutback in investment spending, should one transpire, could cause employment to weaken as well. Figure 5 shows that growth in overall investment spending and growth in employment tend to be correlated, although the latter does not generally move into negative territory unless there is a deep downturn in the former.[4] If employment were to weaken, growth in real personal consumption expenditures, which account for more than 60 percent of British GDP, would undoubtedly downshift. In that event, the United Kingdom could be facing its first economic contraction since the Great Recession.

[3] **The correlation coefficient between both year-over-year growth rates is 0.59.**

[4] **The correlation coefficient between the year-over-year rates of growth in investment spending and employment is 0.56.**

Figure 4

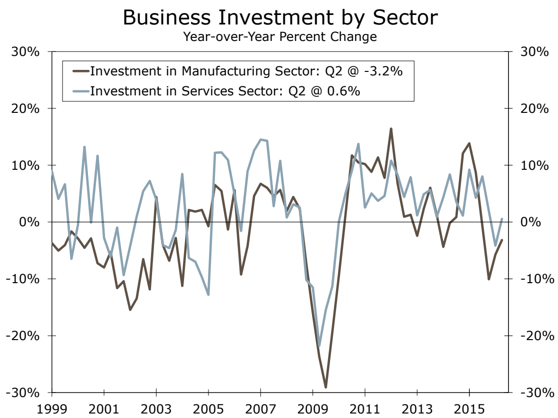
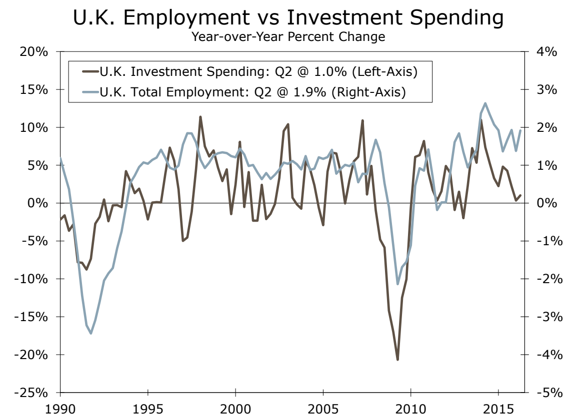


Figure 5



Source: Office for National Statistics, IHS Global Insight and Wells Fargo Securities

Could Exports Save the Day?

The British pound nosedived versus most currencies in the immediate aftermath of the Brexit referendum. The real effective exchange rate plunged about 8 percent between May and July, and the subsequent weakness of sterling versus most currencies suggests that the price competitiveness of British goods and services has improved further (Figure 6).[5] Some analysts hold out hope that the depreciation of sterling will lead to a surge in British exports. We are not so sure.

Figure 6

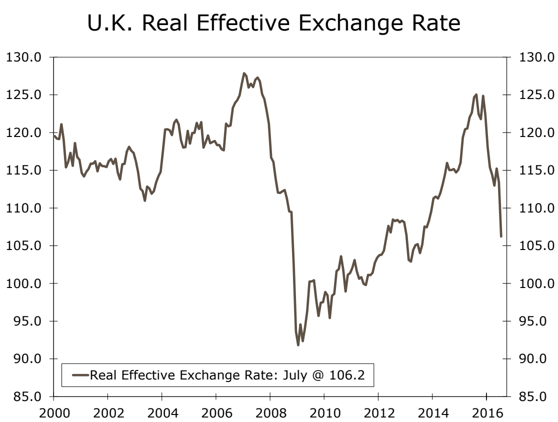


Figure 7

Source: IHS Global Insight and Wells Fargo Securities

We are dubious that significant acceleration in U.K. exports is just around the corner.

We acknowledge that sterling depreciation likely will stimulate British export growth, at the margin. However, we are dubious that significant acceleration in U.K. exports that would produce a meaningful boost to British GDP growth is just around the corner. As we have discussed previously in the context of American exports, the rate of economic growth in the rest of the world is the most important determinant of a country's export growth. Our statistical analysis confirms that this finding holds for British exports as well.[6] If foreign economic growth largely determines

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5 A country's nominal effective exchange rate is the trade-weighted value of its currency vis-à-vis the currencies of its trading partners. Making price-level adjustments to the nominal effective exchange rate produces a country's real effective exchange rate. In short, the real effective exchange rate measures the price competitiveness of a country's goods and services vis-à-vis its trading partners.

6 See "Can America Double Its Exports in Five Years?" (February 14, 2011), which is available upon request. Our econometric results for U.K. export growth are also available upon request.

a country's export growth, then the structure of British trading relationships makes sharp acceleration in U.K. exports unlikely, at least in the near term.

As shown in Figure 7, the United Kingdom sends nearly one-half of its exports to the European Union and another 30 percent to advanced economies such as the United States and Japan that are outside of the European Union. Unfortunately for British exporters, most of these economies are growing at lackluster rates at present. Developing economies are generally growing faster than their advanced-economy counterparts, but the former account for only one-quarter of the U.K.'s exports. In sum, British export growth will probably remain largely in check, at least for the foreseeable future, despite the significant depreciation of the sterling since the Brexit referendum.

Most of the United Kingdom's major trading partners are growing slowly at present.

Conclusion

Since the Brexit referendum on June 23, British economic data have generally come in stronger than expected, and we estimate that real GDP grew 0.3 percent (not annualized) on a sequential basis in the third quarter. That said, there are some troubling signs that investment spending may weaken even further in coming quarters. For example, a survey of investment intentions plunged in the third quarter to its lowest level since the British economy was exiting the Great Recession.

Whether or not the United Kingdom experiences a mild recession in coming quarters will ultimately depend on how much investment spending weakens. British manufacturers are generally more exposed to trade with the European Union than their service sector counterparts, and a reasonable case can be made that capex by manufacturers will weaken until producers have a clearer sense of how Britain's economic relationship with the European Union will change on account of Brexit. If manufacturing capex falls enough, service providers could also pull in their horns. A significant downturn in investment spending could cause employment and consumer spending to weaken, thereby producing a modest recession in the overall economy. The depreciation of the sterling that has occurred over the past few months is probably not enough, by itself, to produce significant acceleration in British exports.

We admit that we have an out-of-consensus forecast—most analysts are forecasting that GDP growth will not turn negative in coming quarters—and we acknowledge that our recession scenario is contingent on a number of "ifs." Although we have scaled back the peak-to-trough decline in real GDP that we project, we still have a mild recession in our U.K. economic forecast. At a minimum, we believe that deceleration in British GDP is inevitable in the next few quarters and that the Bank of England likely will ease further in an effort to stave off any potential recession. The initial breakdown of the Q3 GDP data into its underlying demand components will be available on November 25, and we will be looking closely at this data to ascertain whether our recession scenario is still on track.

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