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Economic Research:

The U.K. Economy Makes A Show Of Brexit Resilience, But Can It Last?

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Table Of Contents

The ECB Is Now On Hold, But Looks Poised To Act in December

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(Editor's Note: This report is the latest in a biweekly series where S&P Global Ratings' economists examine economic and monetary developments in Europe, the Middle East, and Africa.)

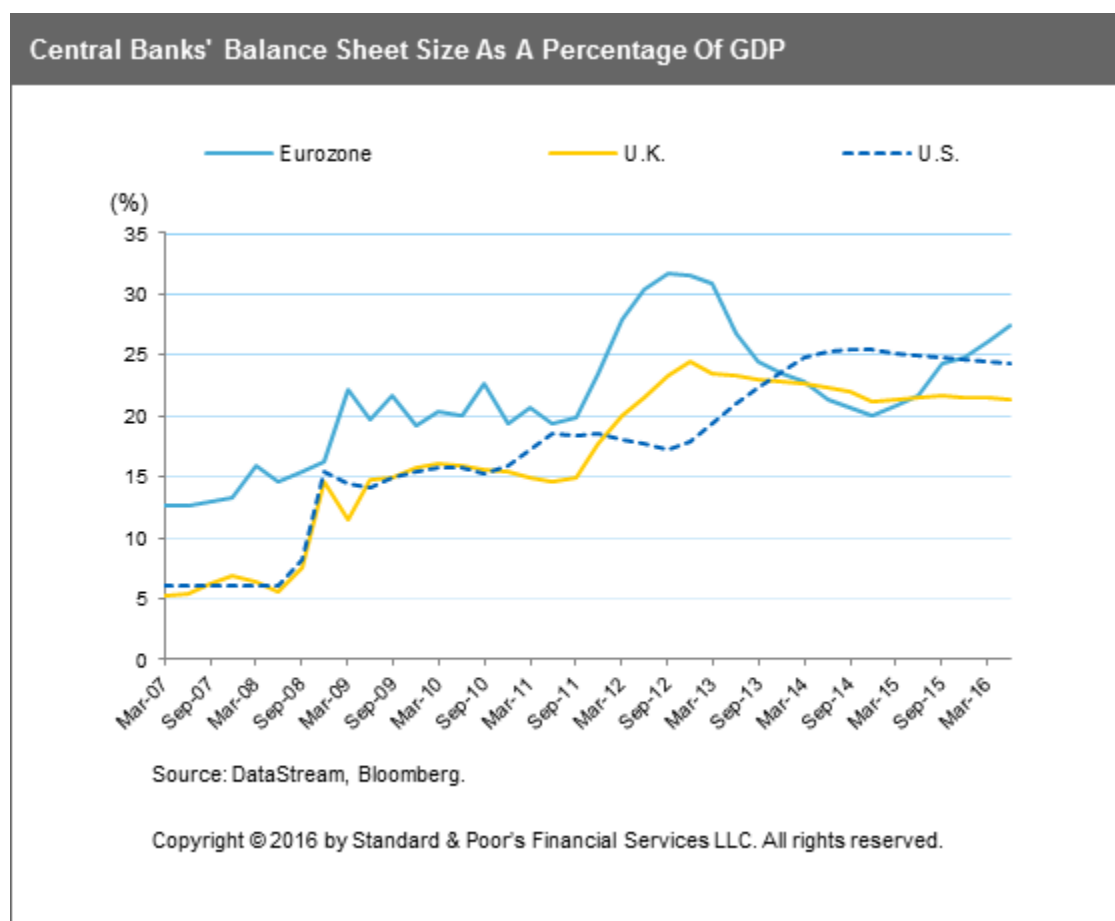
Eleven weeks after the U.K. voted to leave the EU in its referendum on June 23, data now suggest that the economy has shaken off the Brexit blues. While the news is encouraging, we believe it has no bearing on the cloudy longer-term outlook for the U.K. economy.

Overview

- After sinking immediately on the back of the country's June 23 vote to leave the EU, the latest data show a bounce for the U.K. economy.
- Any celebration about the rebound in August and conclusion that life has returned to "business as usual" may prove to be a mirage, at least in the longer term.
- Meanwhile, we still expect the ECB to ease again in December amid expected little progress in core inflation.

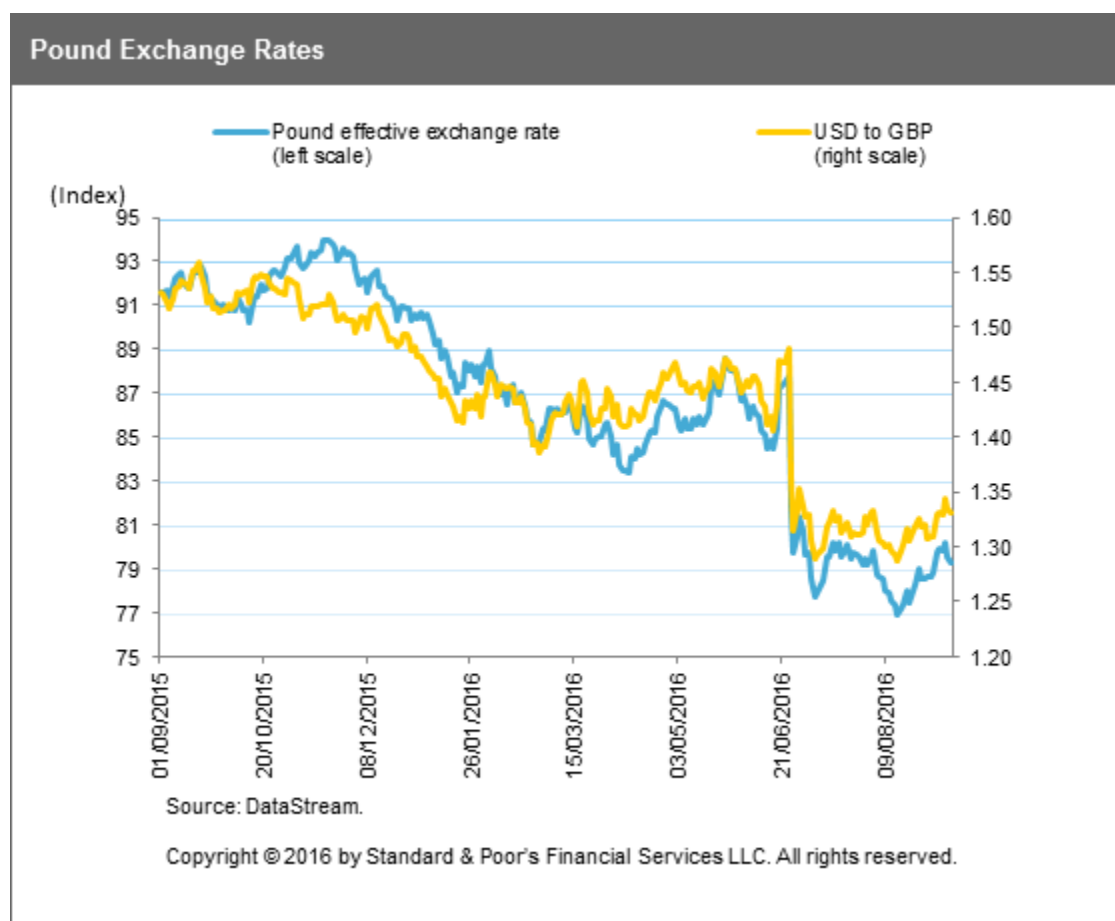
Immediately after the vote, in July, most surveys and some financial market data pointed to a substantial hit to the economy coming from the referendum outcome. In particular, the widely watched composite Purchasing Managers' Index (PMI), a forward-looking indicator, had fallen into clearly contractionary territory. Consumer confidence and some property market indicators (such as the RICS U.K. Residential Market Survey) had also deteriorated markedly. And, of course, the pound was trading around 10% below its pre-referendum levels. Given the deterioration in soft data, along with a more pessimistic medium-term outlook, the Bank of England (BoE) on July 4 cut its policy rate by 25 basis points to 0.25% and deployed a range of additional easing measures to pre-empt financial market instability and support the economy, including a £60 billion increase in the overall asset purchase scheme as part of quantitative easing (QE), from £375 billion to £435 billion. As a result, the BoE balance sheet is set to expand again from its current level of 21% GDP (see chart 1).

Chart 1



A barrage of new data for August suggests that the economic hit may have been a temporary reaction. Indeed, the PMI rebounded strongly, signaling that the economy expanded again in August. Importantly, this included the services sector, which makes up by far the largest share of the U.K. economy. The bounce also extended to other areas, such as residential property (according to the RICS survey) and the labor market, for which the Markit/REC survey reported a rise in new permanent jobs for the first time in three months. Meanwhile, on the financial markets, the FTSE 100 Index rebounded 15% from its June lows, while the pound recovered 3% against the dollar (to \$1.33 per pound) and also in trade-weighted terms from August lows (see charts 2 and chart 3).

Chart 2



The rebound suggests that the short-term impact of the Brexit vote is less severe than many had thought. Unfortunately, it doesn't categorically rule out any negative short-term impact. Take, for instance, the PMI readings for both July and August, which are consistent with broadly stagnating economic activity over the two-month period. And with only one more month to go in the third quarter, and given that activity in May and June was already relatively weak, GDP growth for the quarter may turn out to be very weak—though probably not negative. Moreover, even after rebounding, some indicators remain below pre-referendum levels. Consumer confidence, for example, recovered somewhat from the decline in July, but remains close to levels last seen in late 2013, when household budgets were still being squeezed by high inflation and unemployment was still high.

Any celebration about the rebound in August and conclusion that life has returned to "business as usual" may prove to be premature or even a mirage. The uncertainty surrounding the U.K.'s future outside of the E.U. and the associated economic risks, which we think are pronounced and predominantly skewed to the downside, is likely to gradually take its toll, particularly on investment, as businesses start dealing with the new Brexit reality.

The ECB Is Now On Hold, But Looks Poised To Act in December

At its first meeting after the Brexit vote, the European Central Bank decided to keep its monetary policy unchanged, leaving its main interest rates on hold and refraining from extending its QE program. The deposit rate remains at -0.4% and the asset purchase program is still running at a pace of €80 billion per month until the end of March 2017 "or beyond, if necessary."

Part of the reason is the resilience of the most recent activity indicators in the eurozone, even after the Brexit vote. The eurozone composite PMI for August came in at 52.9, slightly weaker than July's reading, but has remained confined in a very tight range since the beginning of the year. So far, both the composite PMI and the Economic Sentiment Index (ESI) have remained broadly unchanged in the third quarter from the second, and are pointing to quarterly GDP growth of around 0.3%—similar to the actual second-quarter figure. In addition, resilient consumer demand continued to support the positive growth signal in July, with retail sales rising 1.1% on the month and 2.4% year on year. Thanks to robust fundamentals, we believe the domestic sector will continue to drive the economy in the foreseeable future, despite a disappointing performance in the second quarter. Rising exports were the main support to eurozone GDP growth in the second quarter, with domestic demand growing by an unimpressive 0.2%.

There were also positive developments in Europe's financial and credit markets. Equities rebounded after their initial Brexit plunge (see chart 3). The Stoxx Europe 600 Index gained 13% since the end of June's low, mitigating negative equity price spillovers to the real economy from the start of the year and in the month of June. Plus, bank lending flows to the private sector continued to improve in July (see chart 4). Loans to households (adjusted for sales and securitization) rose 1.8% year on year while credit to nonfinancial corporations was up 1.9% (see chart 2). These rates are undoubtedly still modest historically but, given the concerns about the impact of negative interest rates on banking system profitability, it remains encouraging that actual lending data and the ECB bank lending survey show continued improvement.

Chart 3

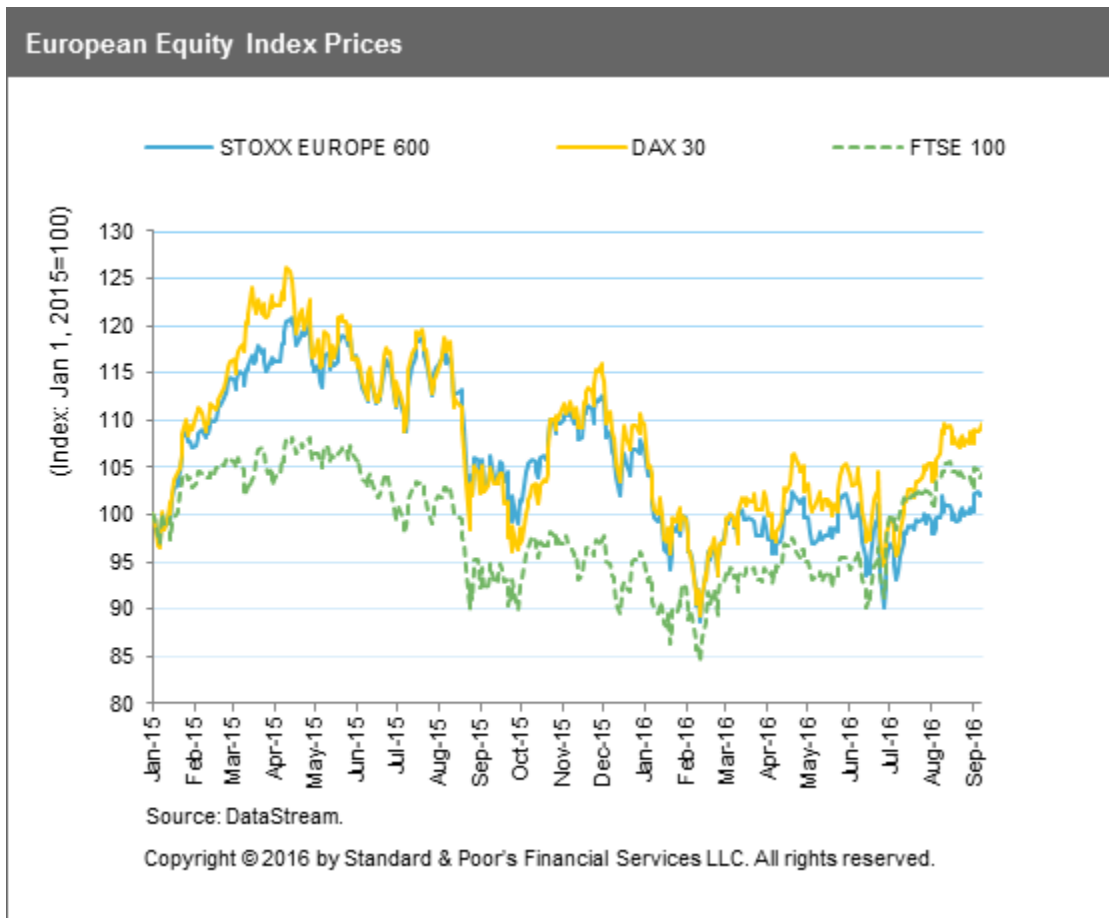
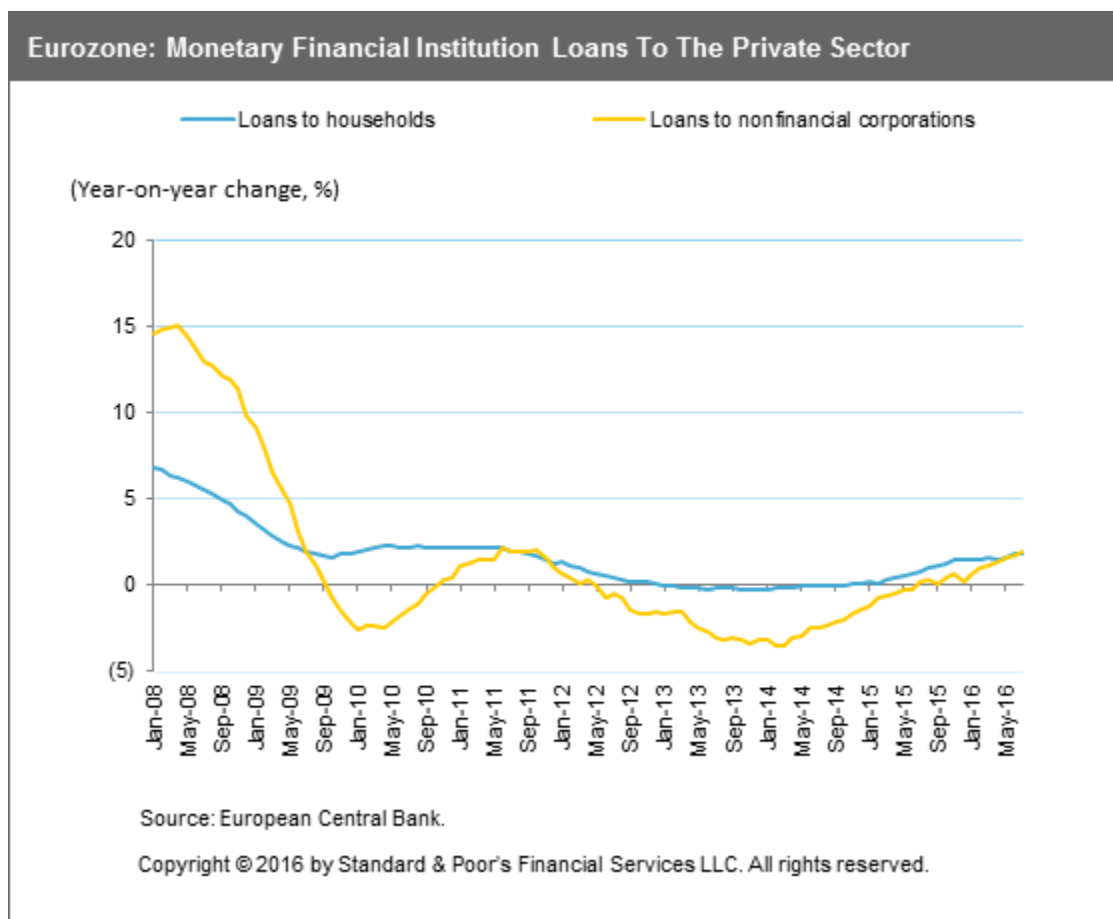


Chart 4



Given the resilience seen in the business surveys and positive feedback from financial markets, the ECB has revised its growth forecasts only slightly downward, and primarily on the back of downward revisions to data for the U.K. The bank raised its forecast for GDP growth for 2016 by 0.1 percentage point to 1.7%, while revising downward 2017 and 2018 forecasts by only 0.1 percentage point to 1.6%.

Our baseline scenario remains for the ECB to act in December. Despite the expected rise in headline inflation by the end of the year, primarily due to fading downward effects from past declines of energy prices, the bank should remain in easing mode amid expectations for weakness in core inflation. And, Mr. Draghi did announce during the September press conference that committees will "evaluate the options that ensure a smooth implementation of our purchase programme," probably implying that the bank is looking at the best way to address the scarcity issue of certain government bonds. Our longstanding view remains that the bank will extend its QE program beyond March 2017 to at least through the end of 2017. We also anticipate that it will modify its eligibility criteria (in particular the requirement that yields exceed -0.4%) so that it can tap a larger pool of securities. Finally, we view the ECB extending its QE program to certain equities as a distinct possibility.

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