Economic Research

# WEEKLY ANALYSIS

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# Voters put an end to political foot-dragging in the UK

**Conservatives win absolute majority. The path to Brexit is becoming clearer. Lower levels of uncertainty favourable to the pound. Long-term rates rise. BOE ready to cut rates.**

## Key points

- British voters are done with political foot-dragging on Brexit
- Brexit will happen
- In a good position to negotiate a softer Brexit
- Although a technical recession was avoided in Q3, GDP was down already in October
- BOE prepared to cut rates
- Parliamentary election results likely to boost leading indicators
- Positive shift in sentiment
- Household confidence improves
- Real estate at a standstill
- Capital markets remain unattractive
- Brexit more favourable to the pound than expected?
- Persisting uncertainty with regard to equities and real estate

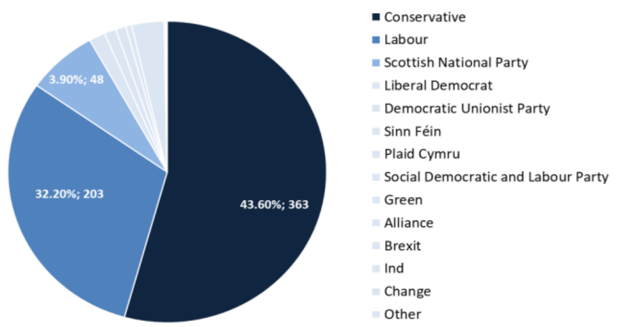
## British voters done with political foot-dragging on Brexit

**Parliamentary election results finally reshaped the playing field, with the Conservatives winning a very clear majority. Hard not to see this as the prime minister's victory, who will now have complete freedom to undertake the domestic reforms he had promised and implement Brexit expeditiously.**

**British voters were clearly swayed by his "Get Brexit done" slogan, as they were ultimately exasperated by and keen to put an end to foot-dragging amongst the political classes.**

**Given his parliamentary majority, he should have no difficulty getting his Brexit agreement passed by the Chamber of Commons before 31 January. Brexit will thus definitely happen, although its precise outline still has to be determined in negotiations with the European Union in 2020. However, Boris Johnson may now be less dependent on the party's hardliners thanks to his wide majority and to his 160-seat lead on Labour. Hard to say what strategy will win out at this stage, but recent trends in the pound's exchange rate suggest that business circles are seeing an increasing likelihood that a softer Brexit will prevail**

**UK parliamentary election results**



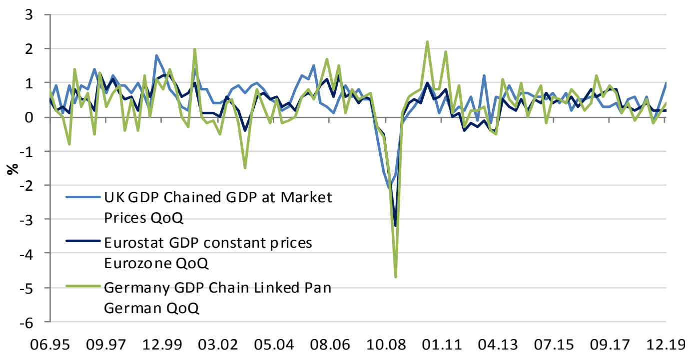

*Sources: The Guardian*

## Although a technical recession was avoided in Q3, GDP is down already in October

UK monthly GDP growth was nil in October and 0% yoy on a quarterly basis. This deterioration in economic conditions follows on the heels of the publication of Q3 GDP growth figures pointing to an improvement in the UK economy. GDP growth of +0.3% in Q3 came after a -0.2% contraction in Q2, once again avoiding a technical recession. However, the overall picture is far from reassuring. On an annual basis, GDP growth slid further, landing at +1.0%, significantly lower than the +1.8%

growth posted in March. Consumption and government spending were up +0.4% and +0.3%, respectively, while investment stagnated and exports surged by +5.2%, after falling by -6.6% in the previous quarter. Fundamentals published more recently continue to point to a less dynamic fourth quarter in the UK. The upswings in industrial output (-0.3% to +0.1%) and manufacturing output (-0.4% to +0.2%) in October were significant, but this temporary increase in activity must be confirmed over the next few months. The construction sector on the other hand is once again in turmoil. Indeed, it slid by -0.2% in October for a yoy drop of -2.1%, disappointing results indicating a sharp deterioration of the situation since the month of September, when it was still up +0.5% yoy. Following Boris Johnson's win and the Conservative camp's now absolute majority, the growth outlook may improve. A decrease in uncertainty could boost investment, although in the absence of real clarity regarding the implications of the any potential withdrawal strategy, these positive reactions will likely remain constrained.

**Quarterly UK GDP growth**




*Sources: Bloomberg, BBGI Group SA*

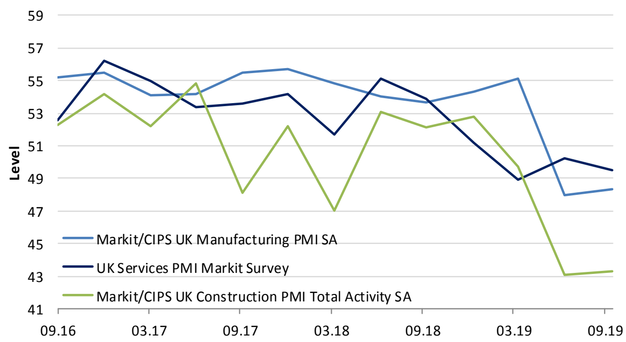
## BOE prepared to cut rates

Given the UK economy's current weakness, the Bank of England will remain especially cautious and attentive to any threat of slippage. It is thus highly unlikely that it will change its accommodative monetary policy. However, the Bank could be tempted to cut short-term policy rates to counter the ever more present risks of recession. The significant rise of the pound along with cooling inflation will likely provide the BOE with a little more leeway. The British central bank will doubtless wait to see what kind of Brexit deal is ultimately sought by the prime minister. Whatever the agreement reached with the EU, the short-term risks remain significant. Thus, the BOE will likely be inclined to bolster the economy by cutting rates early in 2020.

## Parliamentary election results likely to boost leading indicators

The parliamentary elections on 12 December resulted in a clear victory for the Conservatives and Prime Minister Boris Johnson, who can henceforth count on broad popular support. British voters clearly had had enough of political foot-dragging and finally decided to get Brexit done whatever the cost. The people thus expressed a clear preference for clarity of vision, which will likely have a non-negligible impact on the mindset of both leaders and citizens. Political uncertainty has thus been dispelled without however solving the concrete issues that will result from the implementation of Brexit; nevertheless, the degree of uncertainty has decreased substantially. The UK can now more calmly contemplate its uncertain future, which will likely translate into somewhat stronger confidence indicators and more optimistic PMI indices. The latest manufacturing PMI indices had already rebounded from their August low of 47.4 to 48.9 in November. The political crisis that was exacerbating popular discontent and fuelling uncertainty through August is now in the process of being resolved. We expect that the manufacturing PMI indicator could rapidly climb back above the threshold of 50 in the next few months, pointing to improved prospects for the UK's industrial sector.

**Manufacturing, services, and construction PMI**



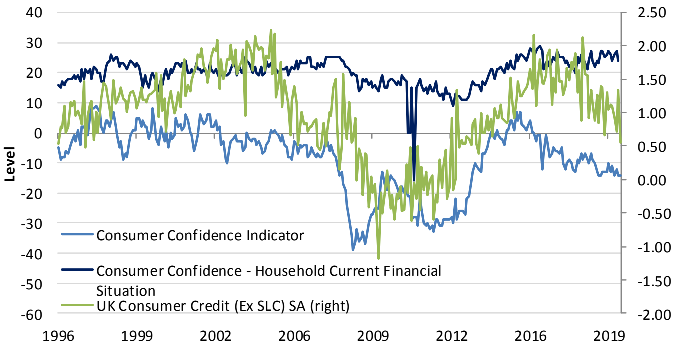

*Sources: Bloomberg, BBGI Group SA*

A trade agreement between China and the US will also have a positive impact on UK industry. Furthermore, as the services PMI also dropped significantly through November, it will likely benefit even more substantially from the expected improvement in sentiment and climb back above the growth threshold at the beginning of 2020.

## Household confidence improves

British consumers, justifiably anxious after a summer full of uncertainty and given the endless political crisis surrounding Brexit, will likely be slightly more optimistic as 2020 rolls around. Consumer confidence, which had reached a six-year low at the beginning of 2019, remained weak through November prior to the parliamentary elections. Although the job market remained solid, this absence of confidence was essentially due to the uncertainty tied to Brexit, with consumers remaining in wait-and-see mode.

**Consumer confidence**



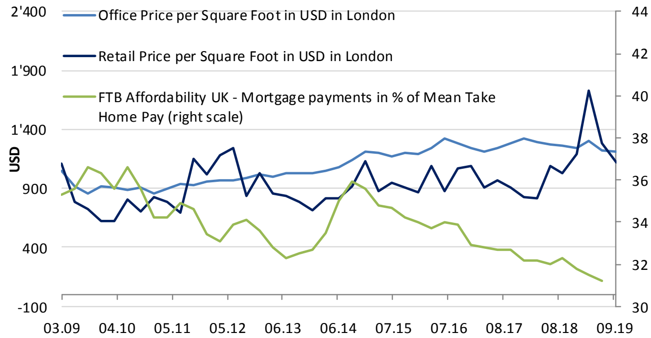

*Sources: Bloomberg, BBGI Group SA*

The election results have now offered better visibility regarding Brexit, and whatever the final outcome, this will have a positive impact on household confidence over the next several weeks. The latest yoy wage growth figures (+3.6%) remain strong, although they slackened very slightly, and are still at a 10-year high. The jobless rate stabilised at 3.8% in September, still at the bottom of the cycle, but job creation dropped into negative territory over the past two months, with -58,000 fewer jobs in September. Wage growth, which had reached +3.8% yoy in July, declined slightly to +3.6% in September, although it remains much higher than inflation (+1.5%, or +1.7% ex food and energy), which means that purchasing power increased by close to 2% in 2019. This situation should persist over the next few quarters, in particular due to the appreciation of the pound, which will likely keep twelve-month forward inflation growth under the currently expected 3.1%.

## Real estate at a standstill

The construction PMI remained in the contraction zone at 45.3 in November. Various measures of real estate price trends continue to point to declining prices and general stagnation. The Nationwide Building Society's price index confirms that real estate prices are stagnating, with price growth of barely +0.8% yoy. Monthly figures were somewhat volatile in 2019, but while the real estate market has remained resilient so far in the face of Brexit-related uncertainty, buyers' enthusiasm has waned. In the medium term, the imbalance in the real estate market should continue to bolster demand and prices, in particular if borrowing costs going forward remain as low as they are today and if job market conditions stay robust. Wage growth has stabilised, and mortgage rates are still at record lows. Mortgage loan approvals fell for the third consecutive month to 64,600.

**Real estate prices per square foot**

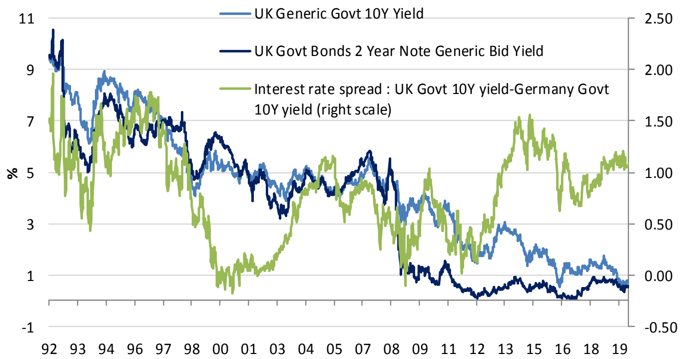



*Sources: Bloomberg, BBGI Group SA*

## Capital markets remain unattractive

While long-term rates dropped from 1.6% in September 2018 to only 0.4% at the end of August 2019, the last decline in long-term rates in the UK over the summer was followed by a rapid upswing to above 0.8%.

**UK 10-yr and 2-yr government yields**



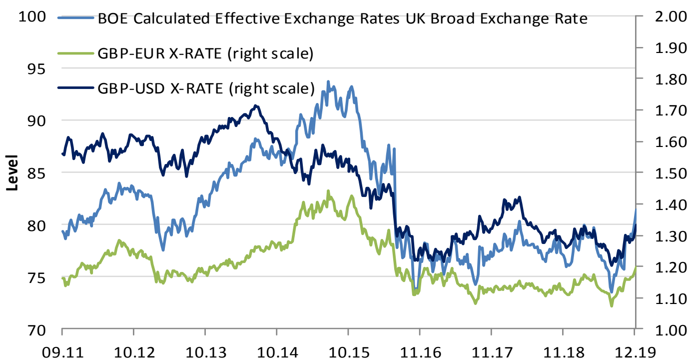

*Sources: Bloomberg, BBGI Group SA*

The global context improved somewhat over the period, but economic risks remain high in the UK, still in search of a political solution to the Brexit issue. The uncertainty resulting from the absence of a Brexit deal and the risks of a real collapse in economic activity in the event of a no deal had first pushed long-term rates below the lows reached just after the 2016 vote. The parliamentary election results will likely strengthen the trend seen in the past three months, pushing pound yields above 1%. However, pound capital markets are still unattractive, as yields are significantly lower than those in US, Australian, and Canadian dollar markets. Political risks have subsided considerably, but while there is now a higher likelihood of seeing an orderly Brexit take form, Boris Johnson still has to determine its final shape. The risks to the UK economy are still high at the beginning of 2020 following zero growth in Q4 of last year. We may have to remain patient in terms of seeing any significant economic upturn in the UK. However, if the job market remains strong and wage growth continues to be higher than inflation thus boosting purchasing power, consumption, services, and industry may surprise on the upside in 2020. A negotiated withdrawal of the UK is now more probable, and the risks of recession will then likely be adjusted downwards, with a gradual increase in long-term rates and stabilisation of the pound as likely corollaries. The risks of holding pound-denominated bonds seem sufficiently high in this context to avoid overly aggressive positioning in this market. Given the uncertain context, we recommend that international investors avoid any exposure to capital markets in pounds and take positions in other bond segments.

## Brexit more favourable to the pound than expected?

As we mentioned previously, the pound will be affected for a long time by the political situation in the UK and by the shape Brexit ultimately takes. The British currency had lost -20% against the US dollar in the wake of the June 2016 vote, falling from 1.50 to 1.20. In 2019, the pound regained more than +10%, climbing to 1.35 in anticipation of a clear political result following the December elections and more visibility regarding future relations between the UK and the EU. As we predicted, the pound stabilised above 1.24 and appreciated towards 1.30-1.35 in anticipation of a Conservative victory. Consequently, we are not predicting any significant further increase of the pound in Q1 2020.

**Effective and dollar – euro exchange rates**




*Sources: Bloomberg, BBGI Group SA*

## Persisting uncertainty with regard to equities and real estate

The political and stock market environment now seems less uncertain. However, the equity market's risk/expected return ratio does not seem much more attractive in relative terms than the bond market's. We continue to recommend caution with regard to UK equities, in spite of reasonable valuations and attractive dividend yields. As for securitised real estate, the risks of a further deterioration in market conditions seem significant enough to recommend waiting. Recall that the BOE noted that real estate prices could fall by up to 25% if the negative scenario of a no deal came to pass.

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