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THE POST-REFERENDUM SIREN OF THE UK ECONOMY

Economic and market outlook

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Whilst the most recent business and consumer surveys show a sharp fall in confidence in the immediate aftermath of the Brexit vote, it is still too early to conclude that activity has deteriorated. On the business side, the UK Purchasing Managers' Index (PMI), a survey-based indicator of business activity, dipped into contraction territory for both the manufacturing and services sectors. There was particular weakness in the services sector, with its PMI dipping to the lowest since March 2009. The New Business Index also slumped to the lowest since March 2009 and the Employment Index entered contraction for the first time in nearly four years. On the consumer side, the GfK "Brexit special" consumer confidence survey shows the sharpest monthly fall in 21 years. In particular, general economic outlook and Major Purchase Index dropped sizeably. While these indicators point to a high risk of recession in the second half of 2016, it is worth noting that survey data are generally more prone to knee-jerk over-reaction. It is important to focus on how hard data evolves over the next couple of months to gauge the actual economic impact from the Brexit vote.

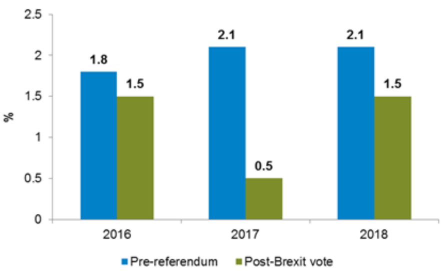
UK labour market

One reason to be less pessimistic is that the labour market strengthened further in the run-up to the referendum, suggesting fundamentals for consumption remain resilient despite the fall in confidence. There was a 176,000 gain in employment over the three months leading up to May, and the unemployment rate fell to 4.9% which is the lowest since September 2005. While job vacancies continued to hover at near-record high levels (750,000) in May, hiring plans may be put on hold as corporates re-evaluate strategies. While we are likely to see a hiatus in hiring due to uncertainty, it is business-as-usual for now until more clarity is known. As long as the labour market remains resilient, consumption is likely to remain steady and provide a cushion to growth.

UK growth

Unsurprisingly, growth estimates for the UK have been lowered after the Brexit vote, from 1.8% to 1.5% in 2016 and from 2.1% to 0.5% in 2017, respectively.

Consensus estimates for UK GDP growth



Source: Bloomberg.

While we acknowledge that UK growth will slow, we think expectations have turned too pessimistic. There is some evidence that the weaker sterling is helpful in attracting foreign interest in UK assets. Corporates are likely to remain business-as-usual and in wait-and-see mode within the next six to 12 months. Moreover, both monetary and fiscal policy will likely be loosened to support the economy. Hence, UK growth may not slow as drastically as some have pencilled in.

The Brexit vote means the Bank of England (BoE) will remain extremely accommodative in the foreseeable future. A 0.25% rate cut is expected at the Monetary Policy Committee meeting in August, after strong signalling from its July meeting minutes. Unconventional easing will likely be discussed and is possible, but providing a big stimulus package (a rate cut plus an increase in the size of asset purchase program) in August seems a bit premature, especially as the new government is likely to scale back on austerity. We continue to believe inflation risks are increasing in the UK, fuelled by the over 10% fall in sterling and the recovery in energy prices. However, we believe the BoE has an asymmetric view on the risk of inflation, favouring easier policy over an overshoot in inflation. With a more dovish BoE, slowing growth and prolonged uncertainty, we think sterling is susceptible to further weakness.

Global outlook

With the UK being the fifth largest economy in the world, countries with close economic linkages to the UK are unlikely to be unaffected. We believe Brexit may pose modest downside risk to eurozone growth, but limited impact to economies elsewhere. On the reassuring side, the latest round of eurozone PMIs show resilience post Brexit vote, with both services and manufacturing PMI down only trivially in July. However, the PMI Business Expectation Index fell to a 19-month low and the ZEW survey, a measure of investor confidence, fell to a four-year low in July.

UK Purchasing Manager Indices

Source: Bloomberg.

While real activity is impacted little for now, risk to growth is modestly skewed to the downside post the Brexit vote. Both economic and political uncertainty are likely to undermine investment, while the recovery in energy prices since early this year may restrain consumption growth. In the near-term, the Italian constitutional referendum in October is likely to inject political uncertainty as it is a symbolic vote of confidence for the current administration. Last but not least, the European banking system is potentially vulnerable to problems in the Italian banking sector, related to the huge number of non-performing loans. Although we believe the situation is manageable with an eventual resolution, the major issue is the lack of confidence in the banking system, which may hold back the credit-driven recovery in the region. As a result, we have turned more cautious on the eurozone.

With regards to monetary policy, the European Central Bank (ECB) is likely to leave policy on hold as it takes time to assess Brexit's impact on the eurozone. It is clear from comments made by Mr. Draghi that the ECB may add further stimulus if needed. We think a further rate cut is unlikely given the negative impact on banks. Instead, the ECB may make technical changes to its asset purchase program, such as relaxing the capital key, as more government bonds have become ineligible for purchase due to negative yields.

Being relatively shielded from the uncertainty in Europe, the US continues to show good momentum. US data continues to suggest solid economic activity on all fronts, from job growth and housing market activity to industrial output and household demand. In particular, the strong bounce in nonfarm payrolls in June (287,000 after a disappointing 11,000 in May) removed concern on a reversal in the strength in the labour market. The Institute of Supply Management Index, a survey-based measure of business activity, showed manufacturing and services output growth picking up to the fastest rates since February 2015 and December 2015 respectively. Recent US housing data continue to suggest the momentum in the sector remains positive, with existing home sales reaching the highest level since early 2007 and new home sales trending at an eight-year high.

US new home sales

Source: Bloomberg.

Despite strong domestic activity that would seem to warrant continued policy normalisation, the Fed has turned more cautious after the Brexit vote. Futures markets are no longer looking for a Fed funds rate increase in 2016, with the earliest move expected in March 2017. We think there is chance for one rate increase this year if the global economy holds up better than expected after the Brexit vote and financial markets remain resilient.