UK: Rising optimism tempered by Brexit and virus risks

Despite rising optimism among firms, the risk of an abrupt change in trading relationship with the EU in 2021 means that investment is likely to remain under pressure. For the time being though, we expect interest rates to remain on hold at the next few Bank of England meetings

Source: Shutterstock

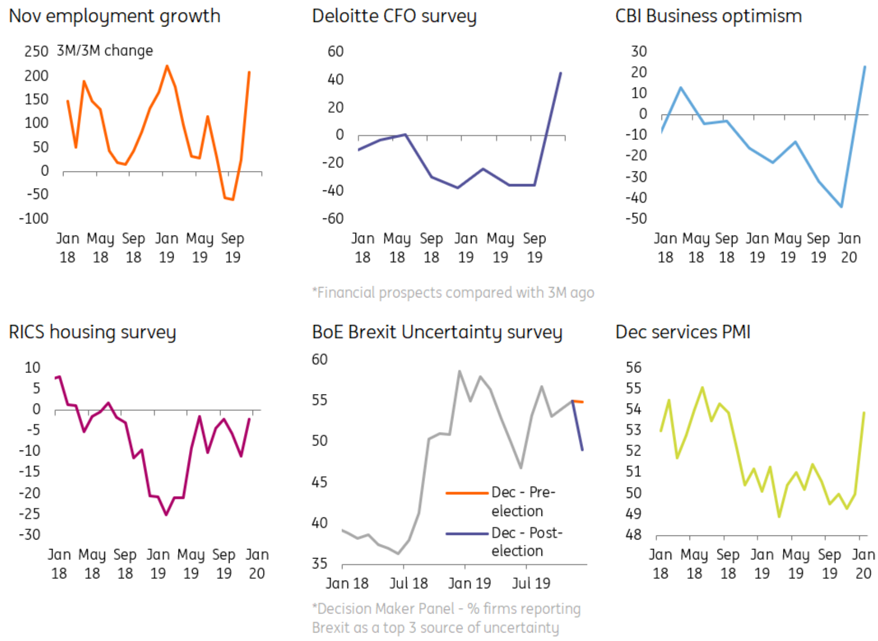
Rising optimism may not translate into faster growth

December's landslide election victory for Boris Johnson's Conservative party, coupled with the avoidance of 'no deal' Brexit at the end of January, has prompted a noticeable rise in sentiment. Virtually every business survey since the turn of the year has rebounded. The latest PMIs point to the fastest rise in 'business expansion' since mid-2018, while fewer business leaders are noting Brexit as a major source of uncertainty according to a recent Bank of England survey.

The key question now is, will this optimism translate into faster economic growth? We think the risk is that it won't, at least not as much as the surveys suggest. And that appeared to be the view taken by the Bank of England at its latest meeting too.

While the Bank noted the improvement in the survey data, its latest forecasts don't point to a sharp revitalisation in quarterly growth rates. Like us, policymakers are projecting 0.2% growth in the first quarter following zero growth in 4Q19.

Survey data has universally rebounded



Source: Macrobond, Bank of England

Coronavirus would hit consumer spending

In the near-term, the obvious downside risk comes from coronavirus. Global manufacturers are already reporting shortages of Chinese-produced components – and a reduction in inbound tourism could also be an issue for the UK. But if the virus were to become more widespread in Europe, then the 'fear' factor could begin to take its toll on consumer spending.

In principle, the consumer outlook looks a little brighter this year – falls in household energy costs mean real wages should rise more noticeably. But with restaurants, hotels and recreation making up 20% of UK consumption, these are areas that could feel the squeeze if the virus spreads, and individuals become warier of frequenting busy public spaces.

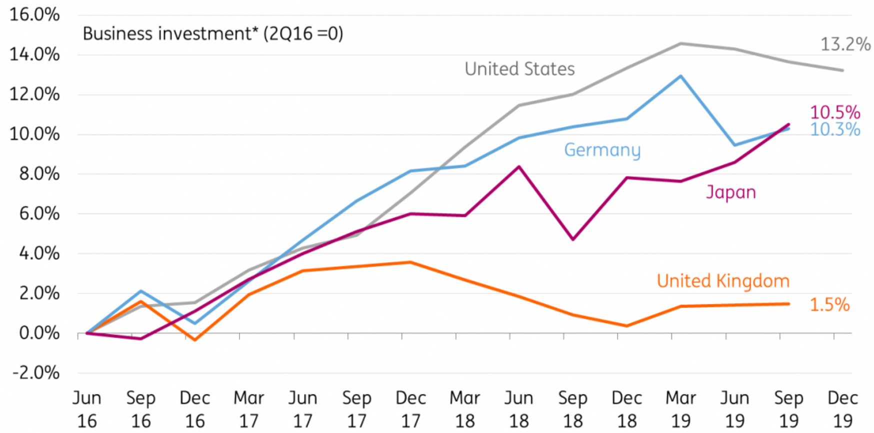
A free-trade agreement doesn't mean frictionless trade

The much bigger risk comes from the potentially abrupt change in the UK-EU trading relationship at the start of 2021. Both sides are aiming to negotiate a free-trade agreement this year, but the key thing to remember is that free trade doesn't equal frictionless trade. Firms will still need to fill in customs documentation, navigating the complicated world of 'rules of origin' (the stipulation that a certain percentage of a good should be made in the area it is being exported to), as well as regulatory checks and VAT payments.

A free-trade agreement will also mean greater frictions for services – in particular, those that rely on cross-border market access.

This suggests further risks to investment, which has already underperformed other G7 economies over the past few years. Business investment has risen by only 1.5% since the Brexit vote in 2Q16. The US, Germany and Japan have all seen double-digit growth in business investment since then, according to the most comparable data.

UK investment has significantly underperformed



Source: Macrobond, ING calculations

Directly comparable data for business investment isn't available. We have used private non-residential investment for US/Japan, non-government investment in machinery/equipment for Germany

Investment likely to remain under pressure

Admittedly, it is still too early to predict exactly how businesses may react to the free-trade agreement. However, the potential for delays at ports in the initial stages (given customs infrastructure may not be fully ready by the start of 2021), means we may see some renewed efforts to stockpile components/finished goods again ahead of the anticipated changes.

Equally, the prospect of greater trade frictions will almost certainly see some onshoring of production over the next couple of years. The FT reported earlier this week suggesting some carmakers are mulling increasing production for the domestic market. But it's worth remembering that this process would in effect be a cost for businesses, and would divert resources away from other potential investment.

The bottom line is that investment, particularly that with a longer-term horizon, is likely to remain under some pressure. For the time being though, we think the Bank of England is likely to keep interest rates on hold, barring any significant deterioration in the growth numbers.

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