The UK economy contracts – should we be worried?

Firms unwound stock levels during the second quarter, tipping the UK into negative growth for the first time since 2012. Decent consumer spending suggests a technical recession should be avoided, but the potential for business investment to decline further is still a cause for concern

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The UK economy shrank by 0.2% during the second quarter, the first negative GDP growth figure since the end of 2012. So should we be worried?

Well, the inventory story was always going to dominate these latest figures – and in the end, it seems like the drag was larger than expected. Inventory levels increased dramatically during the first quarter as firms attempted to insulate themselves against possible 'no deal' supply disruption.

We think the UK economy should avoid a technical recession, and it's probably too early to talk about rate cuts or the Bank of

England resuming its tightening cycle

While we suspect some firms will have had no choice but to reduce stock levels given the working capital and storage costs involved, the Bank of England's Agents network had indicated most had kept stock levels high. However, it seems that the effect may have been larger than thought.

And while imports correspondingly fell too, which is positive for growth, manufacturing output has also come to a virtual standstill given the knock-on effects for British firms involved in EU supply chains. The earlier timing of annual car production shutdowns will also have been a drag.

-0.2% UK second quarter growth

(QoQ%)

Worse than expected

Business investment heading south

All of this is essentially noise, but the underlying picture doesn't look much prettier. In particular, business investment has resumed its downward trend having fallen in every quarter of 2018 (and may only have bucked the trend in Q1 because of IFRS accounting changes).

Brexit uncertainty, and to a lesser extent, weaker global demand, has reduced firms' appetite to expand. Meanwhile, contingency planning activities for a 'no deal' Brexit are costly and often resource-intensive, reducing scope to lift capital spending. We expect this trend to continue for the rest of the year.

That said, consumer spending was much stronger than we had anticipated, growing 0.5% QoQ quarter and following on from a decent first-quarter performance. While this doesn't completely tally with all measures of retail activity during the second quarter, it does suggest that the improved fundamental backdrop from rising real wages is providing some support.

UK to avoid recession, but growth is nevertheless weak

The fact that inventories declined during the second quarter could perhaps preempt a renewed increase during the third quarter as firms resume preparations for a possible 'no deal' Brexit in October. This, combined with more resilient performance of consumer spending, implies that the economy should avoid a technical recession (two-quarters of consecutive negative growth).

The strong wage growth backdrop, argues that it's probably too early to be talking about UK rate cuts. However, given the fact that business investment is set to fall further implies that the Bank of England is equally a long way off from considering resuming its tightening cycle.

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