



ASSET MANAGEMENT

UNCERTAINTY IS EVERYTHING IN THE UK

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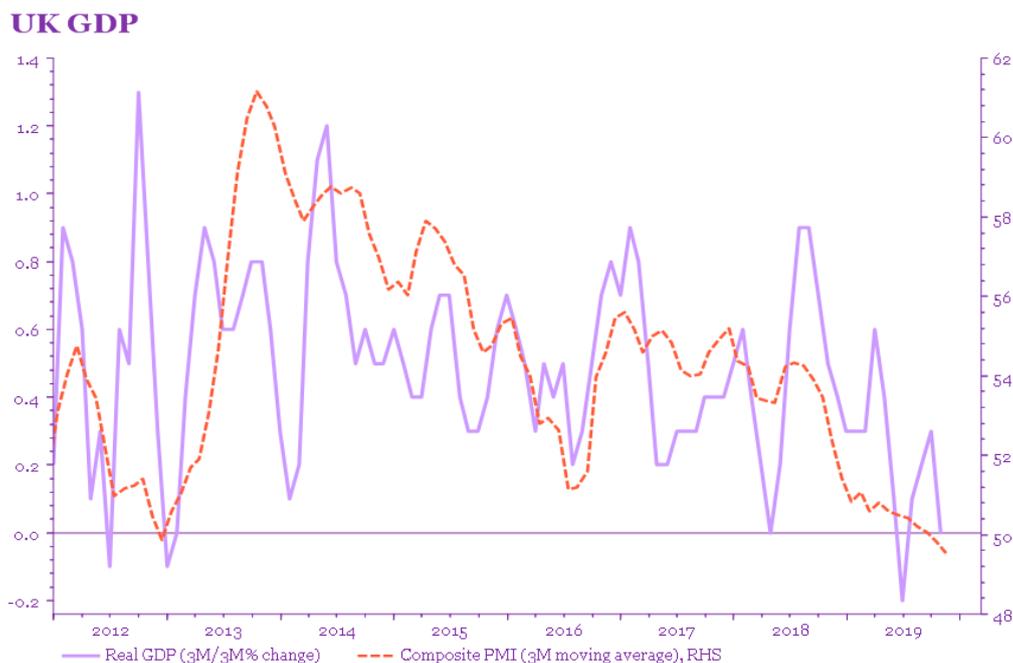
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The decisive general election result may have reduced the uncertainty about the Brexit process somewhat, but it has certainly not disappeared. Combined with further stimulus, UK activity growth should increase slightly as we progress through 2020. However, we are still pencilling in a rate cut until we receive more information on how business sentiment will respond to the new Brexit realities, and about how much fiscal stimulus we will get.

A weak starting point

The first thing to note is the poor state of the economy going into the election. The labour market has been fraying at the edges and economic growth has been slipping. That is exemplified in the chart below, whether you look at actual output growth or business surveys (in this case, the UK composite PMI).

UK Economy has slowed



Source: Refinitiv Datastream, ONS as at 31 October 2019.

What has driven this slippage? Slower growth has certainly played a role, but so has Brexit-related uncertainty.

Thinking about the party promises that were made during the election campaign, two questions stand out for the economic outlook:

1. Will the promised extra spending turn the UK's story around?
2. Will the uncertainty now lift?

Ramping up investment spending

All the major parties promised to ramp up fiscal stimulus in this election. Before the campaign had even started, Chancellor Sajid Javid had announced spending increases of more than half a percent of GDP. The Conservatives promised a modest increase in day-to-day government spending during the campaign, but broadly offset by net tax increases.

However, they made further investment spending pledges on top of that, which is where the real stimulus boost comes from. The Conservative manifesto mentions possible additional investment spending of £80bn over four years under the new fiscal rules. However, most of that hasn't been allocated, so we do not know if it will be front-loaded, back-loaded or evenly spread. It is not even clear that the spending will actually materialise.

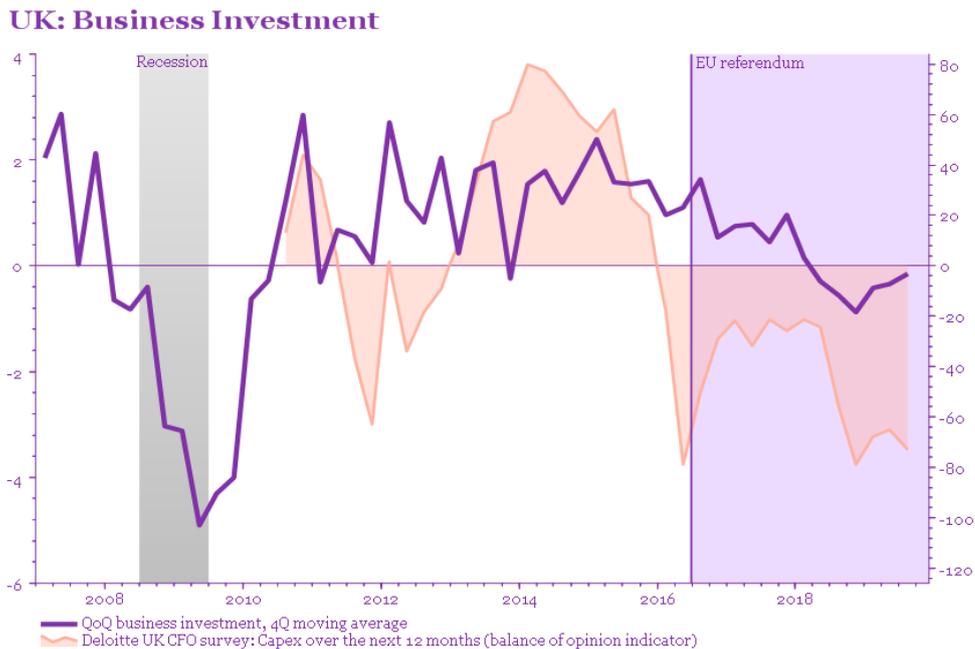
If we assume it will be spent, and evenly, there will be an extra £20bn a year in fiscal stimulus, equating to just under 1% of GDP a year. That would provide a significant and visible boost to economic growth, at a time in which the economy is only growing at around 1% a year.

Will business investment bounce back?

Uncertainty tends to weigh on economic growth because firms become disinclined to make expensive and difficult-to-reverse long-term decisions. The impact of uncertainty is best reflected in the business investment component of GDP.

The second chart shows UK business investment growth, which has been very subdued. The orange area in the chart shows business sentiment around capital expenditure plans. You can see that firms pulled back on investment spending plans after the referendum result.

Business Investment: Brexit uncertainty has weighed



Source: Refinitiv Datastream, ONS and Deloitte as at 15 August 2018

So, will levels of business uncertainty improve now?

Given the scale of the majority, it is reasonably safe to assume that the Withdrawal Bill *will* be approved by Parliament and that the UK *will* leave the EU on 31 January. So, in the near term the answer is unequivocally yes.

However, the *future relationship* between the UK and EU is far from settled. Once the UK has left the EU, the next phase of negotiations begins. Brexit uncertainty will not *disappear* on 31 January. It arguably lessens a bit, but it mostly just changes form...

'Hard' Brexit risks remain

The nightmare scenario for businesses is the one in which the policy and trading environment changes the most. In effect, the so-called 'hard' Brexit in which no trade agreement will be in place, especially if the change is abrupt.

The Conservatives promised not to extend the next phase of talks beyond December 2020. That's a very short period of time to negotiate a comprehensive trade agreement, let alone something broader. An extension decision would need to be made by the middle of the year. Without it, if negotiations are not finalised by the end of the year, then there is *some* likelihood of a disruptive shift to hard Brexit trading conditions.

Hence, even once the UK has left the EU on 31 January, businesses will probably continue to worry about the prospect of a 'hard' and disruptive Brexit. Consequently, while UK economic growth should rise with dampened uncertainty and greater stimulus, the improvement to

economic growth is likely to be ‘unspectacular’, below the pre-referendum trend rate of around 2.5%.

Hike or cut?

A final question worth asking is how the Bank of England (BoE) will respond. Business surveys have signalled very soft economic growth, and they have deteriorated in recent quarters, giving a strong case for an interest rate *cut*. Yet the BoE still forecasts rate rises, which seems reasonable considering that unemployment is at record lows, the UK does not have a low-inflation problem, and the drag of Brexit uncertainty should fade over time.

The BoE has said that it may be compelled to respond if global growth fails to stabilise or if Brexit uncertainties remain entrenched. Consequently, how businesses react to the uncertainties associated with the next phase of Brexit talks will be critical. How far, and when, the Conservatives stimulate the economy through fiscal spending also matters (we expect a Budget in February). It all comes down to the uncertainties.

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