PANTHEON MACROECONOMICS

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Strong Q2 GDP and July retail sales have fuelled claims the Brexit vote is not hurting the economy...

...But Q2 GDP relied on temporary support, and sales are poorly correlated with overall spending.

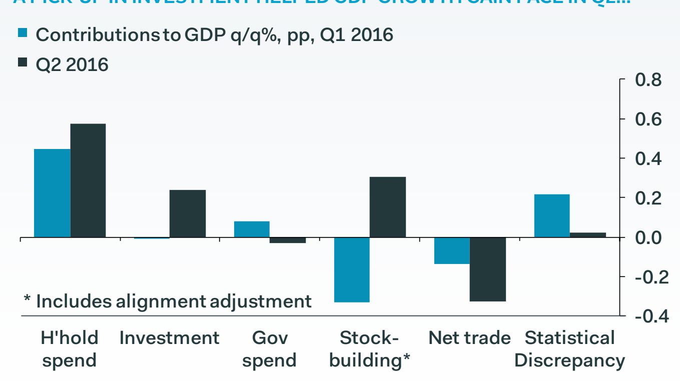
A slump in business investment remains the main threat to growth, and here the signs remain grim.

Reports of the Economy's Resilience are Greatly Exaggerated

Over the sleepy August holidays, a view has gained traction in the media that the U.K. economy is showing little damage from the Brexit vote. Optimists argue that the size and composition of the 0.6% quarter-on-quarter rise in Q2 GDP, the 1.4% month-to-month jump in retail sales volumes in July, and the slight dip in the unemployment claimant count demonstrate that the recovery is in good shape.

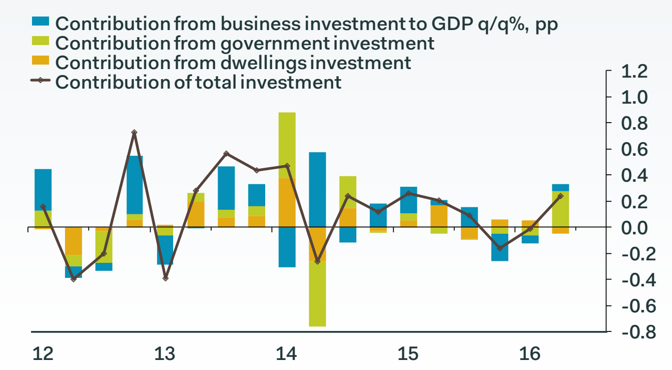
Regular readers will not be surprised to hear we think this reasoning is baloney. For a start, the overwhelming majority of firms and households expected the U.K. to vote to remain in the E.U., so Q2 GDP tells us little about the economy's ability to withstand the consequences of the vote.

A PICK-UP IN INVESTMENT HELPED GDP GROWTH GAIN PACE IN Q2...



The expenditure breakdown of Q2 GDP superficially looked healthier than the previous quarter's, with total investment rising by 1.4%, contributing 0.3 percentage points to overall growth. But this mainly reflected a 10.4% jump in government investment, which is erratic and therefore likely will *drag* on GDP growth in Q3. *Business investment rose by 0.5%, reversing only a small fraction of its 2.8% decline over the previous two quarters.*

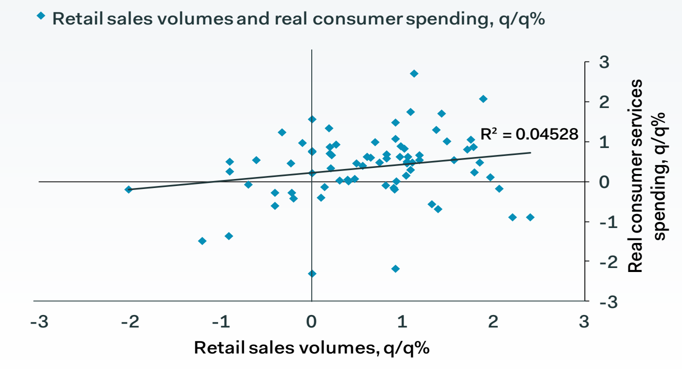
...BUT THE RISE REFLECTED VOLATILITY IN GOVERNMENT INVESTMENT



Meanwhile, retail sales are very volatile—July's surge followed a 1% month-to-month decline in June—and they correlate poorly with quarter-on-quarter changes in GDP. Most retail goods are manufactured overseas, so imports rise when retail sales grow strongly, offsetting most of the boost to growth.

Retail sales also are a poor bellwether for consumer spending on other items. They exclude car sales, which are falling. Private new car registrations fell 6.1% year-over-year in July. The relationship between retail sales and consumer spending on services—which is approximately 50% larger than retail sales—also is weak, as our next chart shows, on page two. Surges in retail sales often come at the expense of spending on services. For instance, consumers funded the 2.4% quarter-on-quarter

RETAIL SALES AND SERVICES SPENDING ARE ONLY LOOSELY RELATED

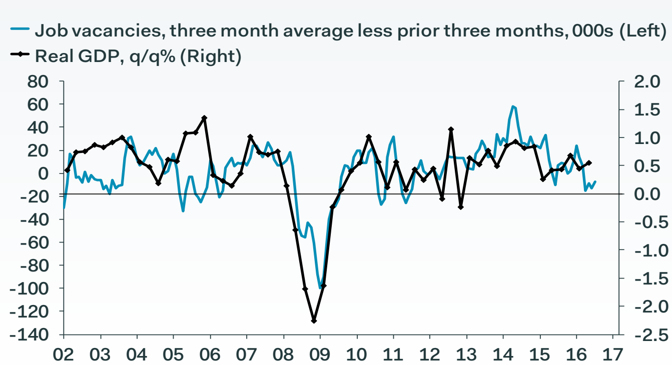


leap in retail sales volumes in Q4 2014—the biggest since Q4 1979—by reducing real services spending by a hefty 0.9%. Note too that in past downturns, consumers have cut spending on services much more keenly than on goods, as we showed here.

In any case, the thesis that the economy would enter recession in the wake of the Brexit vote did not rest on an immediate downturn in consumers' spending. Little changed immediately for households, but when inflation picks up in earnest early next year, and firms follow through on plans to freeze hiring, growth in households' spending will slow sharply.

The 9K month-to-month dip in the claimant count in July says little about firms' appetite for labour. The data were collated just three weeks after the referendum, and employment laws require firms to give workers at least one week's notice for each completed year of service, though just one week is required in the first two years. By contrast, business surveys point to a clear drop in firms' employment

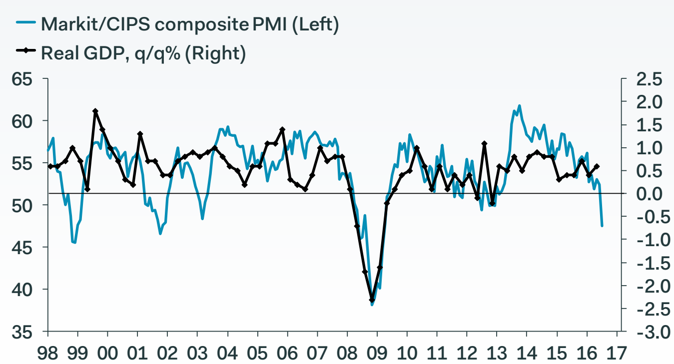
FALLS IN JOB VACANCIES ARE CONSISTENT WITH A SHARP SLOWDOWN



intentions. Likewise, the 7K fall in the number of job vacancies, between the three months ending July and the previous three months, also is consistent with a sharp slowdown in GDP growth in Q3. The vacancy measure also is a three-month average, so it is not a "clean" post-referendum sample.

The key near-term risk to the economy is that firms slash expenditure, especially investment. We have no hard data yet, but all the surveys have weakened since June. The indicator with the best track record is the composite PMI, which fell to just 47.5 in July, from 52.5 in June. If it holds steady in August and September, the PMI will be consistent with a 0.5% quarter-on-quarter *fall* in GDP in Q3. August's PMIs are published between September 1 and 5, and at this stage, we see no reason to anticipate a material improvement.

THE PMI HAS FLAWS, BUT IT THE BEST INDICATOR WE HAVE FOR NOW



In truth, we will have to wait for July's official data on industrial, construction and services output, released later this month, to make a truly informed assessment of the prospects for Q3 GDP growth. What's more, the tendency for initial GDP estimates to miss turning points—the official data called the start and end of the 2008 recession late—suggests that we should treat even the official data cautiously. ***From the indicators released so far, however, there is little to support the complacent but popular narrative that the economy has brushed off the referendum result.***

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THIS WEEK IN BRIEF

Note: "**D**" prefix denotes Datanotes for these releases.

Monday, August 29

- **No significant data released.**

Tuesday, August 30

- **D: Money & Credit (7)/09:30 BST**

Mortgage approvals likely fell sharply in July. The BBA's measure of approvals by the main high street banks—which account for two-thirds of overall mortgage lending—fell by 5.3% month-to-month. Specialist mortgage lenders appear to have being gaining market share recently, though, so we have pencilled in a 4% drop in the official measure of approvals to **62.0K** in July, from 64.8K in June. Meanwhile, the 1.4% month-to-month rise in retail sales volumes in July suggests that net consumer lending remained strong; we look for a **£1.5B** rise. Elsewhere, data on borrowing by businesses will provide an early indication of whether firms have lost their appetite for investment in the wake of the Brexit vote. **Consensus: Approvals 62.0K, consumer lending £1.7B.**

Wednesday, August 31

- **D: GfK Consumer Confidence (8)/00:01 BST**

Consumer confidence likely recovered slightly in August, to **-8** from -12, but we doubt it has returned to pre-referendum levels. The YouGov/CEBR consumer confidence index rose to 109.8 in August, from 106.6 in July, but it remained well below its 113.2 average in the first half. **Consensus: -8.**

- **D: Nationwide House Prices (8)/07:00 BST**

We think that the Nationwide's measure of house prices fell by about 0.3% month-to-month in August, dragging down the year-over-year growth rate to **4.5%**, from 5.2% in July. The slowdown in year-over-year growth in the BBA's measure of the average mortgage value to 0.7% in August, from 4.7% in July, signals that prices have started falling since the referendum. **Consensus: 4.8%.**

Thursday, September 1

- **D: Markit/CIPS Report on Manuf. (8)/09:30 BST**

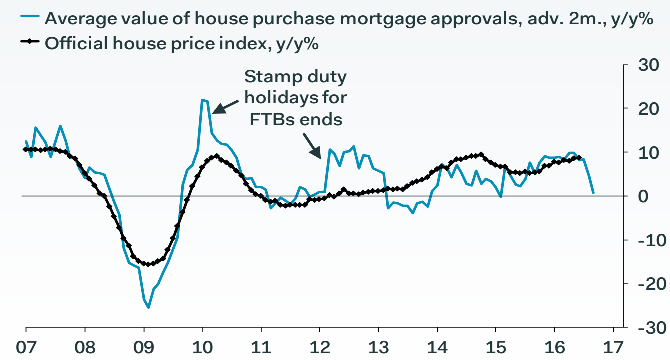
We doubt that conditions in the manufacturing sector improved in August. Producers will be feeling the impact of firms' cutbacks to investment and retailers' decisions to run-down stock levels instead of placing new orders. Meanwhile, past experience suggests that it still is too soon for exports to pick up in response to the weaker pound. Accordingly, we think that the PMI rose only to **48.5** in August, from 48.2 in July. **Consensus: 49.0.**

Friday, September 2

- **D: Markit/CIPS Report on Construction (8)/09:30 BST**

The construction sector likely won't return to growth until business confidence in the medium-term economic outlook revives. That won't happen until the government signals that it will adopt a pro-business stance in Brexit negotiations with the EU. Accordingly, we expect the construction PMI to come in at about **46.0** in August, trivially above July's 45.9 reading. **Consensus: 46.5.**

CHART OF THE WEEK: MORTGAGE DATA SIGNAL FALLING HOUSE PRICES



PANTHEON'S FINANCIAL FORECASTS

		End-month:				
	4pm Fri.	Sep	Dec	Mar	Jun	Dec 17
Bank Rate	0.25	0.25	0.10	0.10	0.10	0.10
3m Libor	0.39	0.30	0.30	0.30	0.30	0.30
12m Libor	0.74	0.60	0.60	0.60	0.60	0.70
2-year Gilt	0.17	0.10	0.20	0.30	0.40	0.70
10-year Gilt	0.56	0.60	0.80	1.20	1.40	2.00
30-year Gilt	1.27	1.40	1.60	1.80	2.00	2.40
FTSE 100	6838	6500	6500	6500	6600	6700
USD/GBP	1.31	1.30	1.32	1.34	1.36	1.40
EUR/GBP	1.17	1.18	1.26	1.28	1.31	1.35
Sterling TWI	78.0	78.5	82.5	83.7	85.6	88.1

PANTHEON'S ECONOMIC FORECASTS

	Period average:						
	Q1 16	*Q2 16*	*Q3 16*	*Q4 16*	*2015*	*2016*	*2017*
GDP, q/q%	0.4	0.6	-0.2	-0.2	-	-	-
GDP, y/y%	2.0	2.1	1.5	0.5	2.3	1.5	0.5
Employment, y/y%	1.3	1.9	1.2	0.4	1.8	1.2	0.0
Unemp. rate, %	5.1	4.9	5.1	5.4	5.4	5.4	5.8
Wkly earnings, y/y%	2.0	2.1	2.4	2.7	2.3	2.7	3.0
CPI, y/y%	0.4	0.3	0.6	1.0	0.0	0.6	2.6
RPI, y/y%	1.4	1.5	1.7	2.0	1.0	1.6	3.5
PSNB FY, £B	-	-	-	-	75	75	90
Cur. acc't., % GDP	-6.9	-5.0	-4.2	-3.8	-5.2	-5.0	-3.0
House prices, y/y%	7.9	8.4	5.1	2.8	6.0	6.0	0.0