Centre for Asset Management Research & Investments
NUS Business School

CAMRI Global Perspectives

Monthly digest of market research & views **Issue 60, April 2019**

The UK Economy: The Self-Inflicted Victim of Brexit

By Brian Fabbri

Visiting Senior Research Fellow, CAMRI & President, FABBRI Global Economics

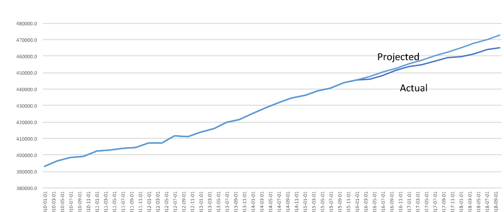
Great Britain no more

Britain, I hesitate to name this island nation Great Britain, since in the past three years the Brits have shed most, if not all, of their historical greatness in their deliberate foibles on Brexit. Three years ago, Great Britain boasted the 5th largest national economy in the world. And, three years from now, or sooner, they no longer will be the 5th largest economy in the world.

It is presently impossible for erudite, objective experts to predict the nature of Britain's exit from the EU, or even anticipate if they will eventually escape from the shackles of this highly successful economic union, the world's largest market for the free movement of goods, capital, services and labor. Soothsayers, tarot readers, astronomers and even economists can offer no practical answer to the present British dilemma. However, one thing is certain: the uncertainty of the eventual outcome of Brexit has heightened over the past three years to the point that many, if not all international business units currently located in the UK have already, or are in the process of shifting some, most, or all of their operations out of the UK and relocating them to continental locations in the EU.

This exodus of business, jobs and private investment will depress UK economic growth rates, reduce employment, and shrink the outstanding level of UK GDP now, and for years into the future.

UK Real GDP Lost from June 2016 to Present



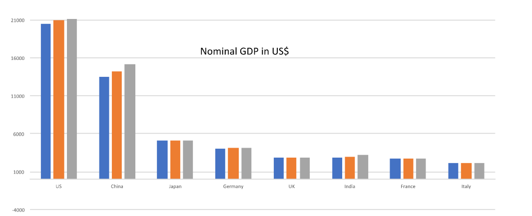
Lost economic activity

The UK recovered well from the grip of the 'great recession' of 2000-2009. In the subsequent six-and one-half years real GDP in the UK grew at an annual average rate of

2.2%. Since that fateful vote for independence in June 2016, real GDP increased at an annual rate of 1.6%. Had there been no vote and GDP growth maintained its post-recession pace, UK real GDP would have been 7.7 billion pounds larger than it presently is.

No longer 5th largest economy

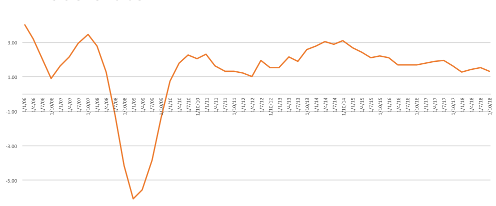
By 2020 India will be 5th Largest Economy*



* 2018 GDP DATA FROM IMF ESTIMATES OCTOBER 2018 ; 2019 AND 2020 ESTIMATES FABBRI GLOBAL ECONOMICS

In 2016, the UK was the 5th largest economy. Then, the British, who were under-informed about the pros and cons of Brexit, unwisely voted for it. Since then, UK economic growth has slowed by more than half a percentage point per year while other economies were growing significantly faster. This year India is very likely to inch ahead into 5th place in the global rankings table and perhaps in 2020, France may creep past the UK into 6th place, especially in the unlikely event that the British exit the EU without a trade agreement.

UK Real GDP Growth (y/y) Continues to Decelerate

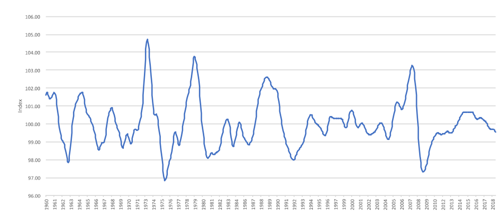


As the chart above reveals, UK GDP annual growth has been sliding lower for the past few years. After the Brexit vote in July 2016 GDP growth has renewed its decline with new vigor, as seen in the chart.

The outlook for future growth is dim

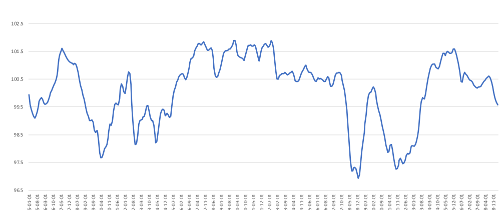
The OECD's index of leading indicators for the UK is flashing warning signs of imminent recession ahead for the UK economy (See next chart).

OECD Recession Indicator for the UK Flashing Warning



Moreover, UK consumers, who have been witnessing their government squirm over committing to the terms of Brexit have steadily lost confidence in their economic future.

UK consumer confidence survey heads down



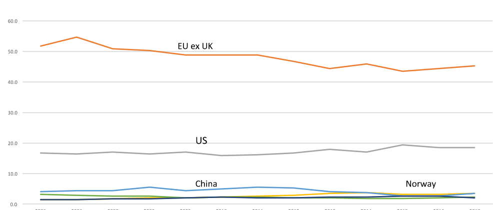
The economic costs of divorce from the EU

The world is becoming more interconnected every year as advances in digitalization, cloud, and soon 5G technology improve and disseminate ideas and information. And today the UK leadership wants to disconnect from the flow of international progress. This is a profoundly calamitous decision to make for a very open economy like the UK, where imports of goods and services account for 23% of GDP and exports tally 16.7% of GDP.

The UK is a very Open Economy

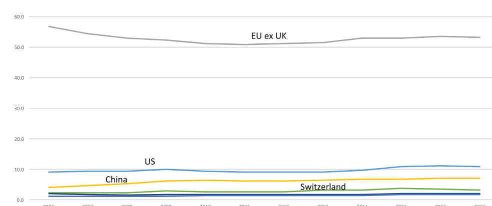
More to the point; the EU ex UK is the UK's biggest international client and counterparty. Of the 617 billion pounds of exports the UK shipped in 2017 over 289 billion pounds of exports were sent to EU ex UK. These EU clients represent a total of 45% of all UK exports. The next largest overseas market for UK exports is the US which accounts for 18.4% of the remaining exports. The next largest export destination is China and it imports only 3.6% of goods from the UK.

Exports from the UK (% of Total Exports)



The UK also imported 641 billion pounds of merchandise in 2017. A total of 340 billion pounds came from the EU ex UK. This represented 53% of all the imports into the UK. The next largest source of product came from the US, which accounts for 10.8% of the total. All the remaining economies supply less than 10% individually to the UK. Just think how costly, time consuming and inefficient it would be if tariffs were to be raised and inspections were to be made for all of these goods coming and going from the UK to the EU!

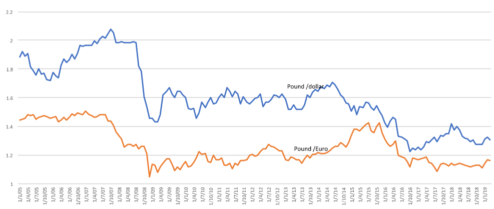
EU Dominates UK Imports (% of Total Imports)



The depreciating pound

Naturally, as the political fabric of the country unwinds, it reduces global confidence in the UK pound as a store of value, and, as businesses depart the country, it no longer is as necessary to use the pound to value transactions for financial and economic purposes. Consequently, the UK pound has depreciated against the dollar and the Euro over the past few years.

The Pound Has Lost Value Against the Dollar and Euro Since 2016

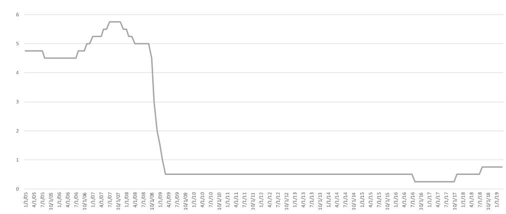


Currency depreciation has two direct economic impacts: one good and the other not so good. A cheaper pound helps make UK products more competitive on global markets thereby bolstering UK exports. It also helps to improve final demand in the UK by increasing UK production. In contrast, a cheaper pound will immediately translate into higher prices for imports. While higher import prices may shift some UK demand away from imported goods, it will also raise inflation rates in the UK from all the other imported commercial goods and services that the British continue to consume. As inflation rises it will tilt the policy stance of the Bank of England toward more restraint than otherwise. Re-imposition of tariffs from the UK and to the UK in the absence of a Brexit trade agreement raises prices in both economies.

It's not up to monetary policy

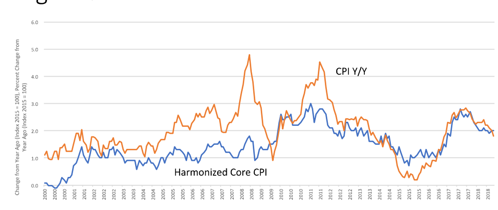
The Bank of England raise their official interest rate twice since the Brexit vote and probably won't raise it again in the near future. At their latest policy meeting the BOE decided to maintain their policy rate at .75 basis points and stabilize their portfolio of below investment grade bonds and sovereign UK government bonds.

Bank of England raised Official Rate twice after vote



Helping the Bank of England make this decision was the steady decline in the rate of inflation back into target range in the past 18 months. Consequently, BOE has paused its earlier plan to raise its official rate similar to the recent decision made by the Federal Reserve in the US, as it observes that the high frequency indicators of the economy's strength are facing stronger headwinds.

Inflation Has Decelerated in Past Year Down to Target 2%



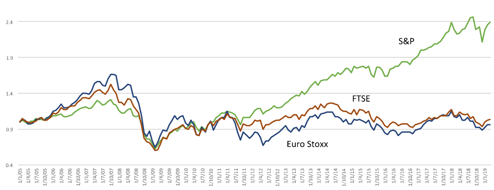
The BOE also specifically addressed Brexit. They said that their 'response to Brexit, whatever form it takes, will not be automatic and could be in either direction.'*

The financial price of Brexit has been high

As the following chart vividly demonstrates, the UK stock market (FTSE 100) has sputtered in an almost static trend since the

Brexit vote in July 2016. It appreciated 9.5%. over the past 34 months. Meanwhile, the corrosive effect from Brexit has also contributed to the EU stock market's inability to appreciate as much as the US stock market did in the same period. The Euro Stoxx 50 index gained 18.5% versus 35% for the S&P 500 gain of 35%.

Both FTSE and Euro Stoxx Stock Indexes Failed to Appreciate in the Post Recession Era



The comparison becomes even more glaring when the indexes are viewed over a longer period. For example: during the early years of this century between 2005 and 2010 the movements of the three indexes were extremely highly correlated. Regressions relating the FTSE against the S&P500, and the S&P 500 plus the Euro Stoxx had R-squared's of 0.957 and 0.985, respectively and were statistically significantly. In comparison, the close performance relationship between stock market indexes broke down from 2011 to date. Regressing the FTSE against the S&P500 was totally insignificant (an R-squared of 0.02). FTSE's relation to other stock market indexes improved somewhat when the Euro Stoxx was included. The correlation between the FTSE and the Euro Stoxx index remained relatively stronger than the FTSE's relation with the S&P 500 and this raised the combined relationship up to a significant 0.73#.

Conclusion: Between a rock and a hard place

The latest decision to postpone the final deadline date of Brexit merely extends and extrapolates the growing uncertainty for citizens and businesses in and out of the UK. It specifically provides more time for businesses to assess the potential damage and to make preparations to shift more of their European operations out of the UK to other EU cites. Moreover, this indecision demonstrates the gross ineptitude of the present government and governing bodies, tarnishes the past sterling image of the UK, and creates an image of economic instability.

The UK has, and will continue, to lose pieces of its current GDP as companies reduce investment in the UK and transfer operations out of the UK. and Brexit will diminish the UK's present and future economic growth. This is particularly relevant now with economic growth of the major economies in the world slowing to a crawl. The national valuation metrics such as the pound and the stock market will proceed to languish behind other global advanced economies.

As globalization intensifies through automatic intelligence and digitalization the UK will be left further behind as it attempts to close its doors to global progress. A closed UK will decelerate future GDP growth, shrink external investment, marginalize future economic opportunities, and diminish global confidence in UK stability and political relevance in global affairs.

- The regression results were done between January 2005 and March 2019. The monthly index data was segregated intro two periods: January 2005 to December 2010 and January 2011 to March 2019.

2005-2010

FTSE = -3451.64 +10.91*S&P500 Adj. R^2 0.957

FTSE = 6.61*S&P500 +0.87*Eurostoxx50-2130.72 Adj. R^2 0.985

2010-2019

FTSE = 9223.61 +0.24*S&P500 Adj R^2 0.011

FTSE = 3951.27 +0.41*S&P500 + 1.76*Eurostoxx50 Adj R^2 0.077

*Bank of England March 2019 policy statement.

For more information, please contact
camri@nus.edu.sg

	KEY INDICATORS TABLE (AS OF 29 MARCH 2019)							
INDEX	**LEVEL (LC)**	**%1MO (LC)**	**%1MO (USD)**	**%1YR (LC)**	**%1YR (USD)**	**INDEX**	**LEVEL**	**%1YR**
S&P500	2834.40	1.94%	1.94%	9.48%	9.48%	3MO LIBOR	2.60	12.46
FTSE	7279.19	3.29%	1.16%	7.64%	-0.23%	10YR UST	2.40	-12.19
NIKKEI	21205.81	-0.11%	0.39%	0.74%	-3.39%	10YR BUND	-0.07	-114.08
HANG SENG	29051.36	1.59%	1.59%	0.01%	-0.01%	10YR SPG	1.10	-5.78
STI	3212.88	0.26%	0.00%	-2.76%	-5.965	10YR SGS	2.07	-9.68
EUR	1.12	-1.35%		-8.97%		US ISM	55.30	-10.71
YEN	110.86	-0.48%		4.31%		EU PMI	47.50	-15.87
CMCI	1242.83	-0.14%		-2.27%		JP TANKAN	12.00	0.00
Oil	60.14	5.10%		-7.39%		CHINA IP	5.70	-8.06

Source: Bloomberg

APPENDIX

GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis. In US$ where applicable)
S&P500: capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)
FTSE: capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)
NIKKEI: capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)
HANG SENG: capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)
STI: cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)
EUR: USD/EUR exchange rate: 1 EUR = xx USD (EUR)
YEN: YEN/USD exchange rate: 1 USD = xx YEN (JPY)
CMCI: Constant Maturity Commodity Index (CMCIPI)
Oil: West Texas Intermediate prices, $ per barrel (CLK1)
3MO LIBOR: interbank lending rate for 3-month US dollar loans (US0003M)
10YR UST: 10-year US Treasury yield (IYC8 – Sovereigns)
10YR BUND: 10-year German government bond yield (IYC8 – Sovereigns)
10YR SPG: 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)
10YR SGS: 10-year Singapore government bond yield (IYC8 – Sovereigns)
US ISM: US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)
EU PMI: Purchasing Managers' index for the 17 country EU region (PMITMEZ)
JP TANKAN: Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)
CHINA IP: China's Industrial Production index, with 1-month lag (CHVAIOY)
LC: Local Currency