PROPONOMICS

APRIL 2018

BREXIT – SPORTS CAR TOWING A CARAVAN

The move towards Brexit has not derailed the UK economy, but ending the uncertainty would be a game changer for growth – if the politicians dare to be brave.

Headlines

The UK economy is still growing, despite the Brexit uncertainty, but at a below par rate

Major relocations of firms out of the UK have not occurred – firms have set up EU outposts

The EU appears to be getting its way in the Brexit negotiations, suggesting little will change for the UK economy

A soft Brexit could have a transformational effect on job creation and investment

We are now less than one year away from Brexit, and if one sets aside the political theatre and war of words, four important trends are emerging:

1. The European Union is generally getting its way in each phase of the Brexit talks. The phase one agreement matched the EU's broad objectives. The transition deal leaves the UK with all of the obligations of full membership, but no vote.
2. Neither side is showing a willingness to follow through on threats to go down the 'no deal' route.
3. Through a combination of the transition deal and the reluctance to go for the 'no deal' option, from an economic perspective little for the UK will change for years to come.
4. The UK economy is continuing to grow at a rate that is lacklustre by historic standards, but fast enough to make previous forecasts of a recession look unlikely.

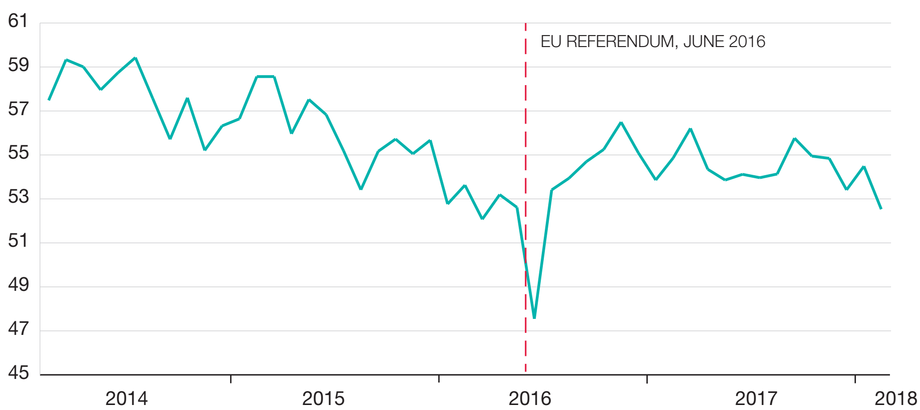
A good analogy for Britain's economy during the Brexit process would be a sports car towing a caravan. We are moving forward, but everyone knows the car could move much faster without the appendage. The UK economy was growing at over 2.0% per annum (the twenty year average figure) in 2014/2015. In 2016/2017, growth fell below the 2.0% mark, even though the global economy strengthened. There is no other obvious culprit for that deceleration than the uncertainty introduced by Brexit.

Other indicators appear to confirm this mixed picture of the UK economy, which is neither showing signs of distress nor shrugging off Brexit completely. Unemployment at 4.2%, versus 8.5% for the euro area, is at its lowest since 1975. Yet, the UK's PMI business activity index looks disappointing compared to pre-referendum days (see figure 1).

No mass exodus

We are not seeing the mass relocations out of the UK by international firms that some commentators predicted. London-based banks are opening EU satellite offices in places like Frankfurt and Dublin, but usually involving relatively few jobs – often less than 100 staff per bank. However, concerns over disruption remain in the financial sector, as

FIGURE 1
UK PMI - Business Activity Index



Source: IHS Markit / Knight Frank

JAMES ROBERTS
Chief Economist

"A good analogy for Britain's economy would be a sports car towing a caravan. We are moving forward, but everyone knows the car could move much faster without the appendage."

Follow James at @KF_JamesRoberts

For the latest news, views and analysis on the world of property, visit Knight Frank's blog www.knightfrank.co.uk/blog is also the case in the aviation, chemicals and motor manufacturing industries. Firms want to hear what the final Brexit deal will be, and until that happens business investment and job creation will occur piecemeal.

In summary, the UK economy is showing enough positive indicators to suggest ending the Brexit uncertainty would quickly lead to an improvement in growth – but when can we expect this to happen?

The logical thread running through points one to four above is that Brexit is heading towards a fudge outcome, and one where there is little real change; the outcome some commentators call 'BINO', or Brexit in name only.

Britain is heading towards this outcome because the UK negotiating position in the Brexit talks was undermined by the advent of a minority government. Brexit needed a large government Parliamentary majority to cope with the inevitable backbench rebellions that would face such a controversial policy. Minority governments are more likely to get a law passed when it has broad-based support – in Brexit's case that moves the pendulum from hard to soft.

Growth or Brexit?

Moreover, most political problems facing a government tend to ease considerably when the economy achieves strong growth. Higher GDP brings in the tax revenue that prevents NHS funding crises, and delivers the pay growth that keeps voters content. Returning to our motoring metaphor, this requires unhitching the car from the caravan, and ending the Brexit uncertainty. If the upcoming local elections bring disappointment for the Conservatives, the pressure to prioritise the safety of GDP growth over the risks of Brexit will increase.

Up until now, it has been easier for the government to avoid a crunch moment where it publicly chooses between soft and hard Brexit. However, events will soon force a decision. In Parliament, the pressure on the government to seek a Customs Union is becoming intense. If the government is forced to seek a Customs Union with the EU, discussion will quickly move on to staying in the Single Market.

The temptation for Downing Street to choose a growth friendly soft Brexit path will be high in the coming weeks. Given the lack of Parliamentary majority, it is perhaps Hobson's choice?

All this comes with a big political caveat. The 70 or so hard Brexiteers in Parliament have a track record of wringing concessions from the government, and negotiations between the UK and the EU could still collapse, resulting in a hard Brexit by default.

Towards compromise

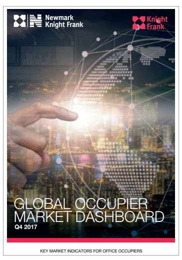
However, the general trend of the Brexit negotiations has been towards compromise, usually with the UK making the concessions, and it is our view this will be the case for the remaining stages of the talks. This could clear a path for the UK economy unhitching its growth-sapping caravan later this year. Job creation and overseas investment could quickly follow. A UK property market, where yields look attractive compared to many European cities, would be well positioned to benefit.

"A UK property market, where yields look attractive compared to many European cities, would be well positioned to benefit."

RECENT MARKET-LEADING RESEARCH PUBLICATIONS

M25 offices Q1 2018

The London Report 2018



Global Occupier Dashboard Q4 2017

The Germany Report H1 2018

Knight Frank Research Reports are available at **KnightFrank.com/Research**

COMMERCIAL RESEARCH

James Roberts
Chief Economist
+44 20 7861 1239
james.roberts@knightfrank.com

Newmark Knight Frank