RESEARCH

PROPONOMICS

JANUARY 2018

UK GDP – TALES OF THE UNEXPECTED

The Q4 GDP figures surprised on the upside, but are more unexpected plot twists ahead?

Headlines

UK GDP in Q4 2017 came in ahead of expectations

Investors are looking again at the UK, speculating that a soft Brexit is coming

Wage inflation has been restrained, but that could change quickly

The shifting macro environment will chase property investors up the risk curve

The 0.5% Q4 2017 GDP growth figure reported last week was ahead of expectations, and coincided with a reassessment of the country's outlook by financial markets. Investors have been gaining confidence in recent weeks on the outlook for Britain, as demonstrated by the upwards trajectory for the pound/dollar exchange rate, and UK government bond yields.

At $1.41 at the time of writing, sterling is approaching levels last seen prior to the June 2016 referendum on EU membership. This is a far cry from October 2016 when the pound had sunk to $1.21 in the aftermath of a speech by Prime Minister May seen as pointing to a hard Brexit. Indeed a recent story in the *Financial Times* noted a surge in investors going long on sterling in futures and options contracts.

Investors are drawing confidence from signs that soft Brexit is emerging as the more likely outcome for the UK's departure from the EU. This could lead to the UK gaining more exposure the wider global economic recovery. Indeed it is noteworthy that GDP growth picked up after the government lost its majority in the June 2017 General Election, an event that immediately reduced the likelihood of a hard Brexit. Also, the pound has rallied markedly since the UK and EU reached an agreement on phase one of the Brexit negotiations in December.

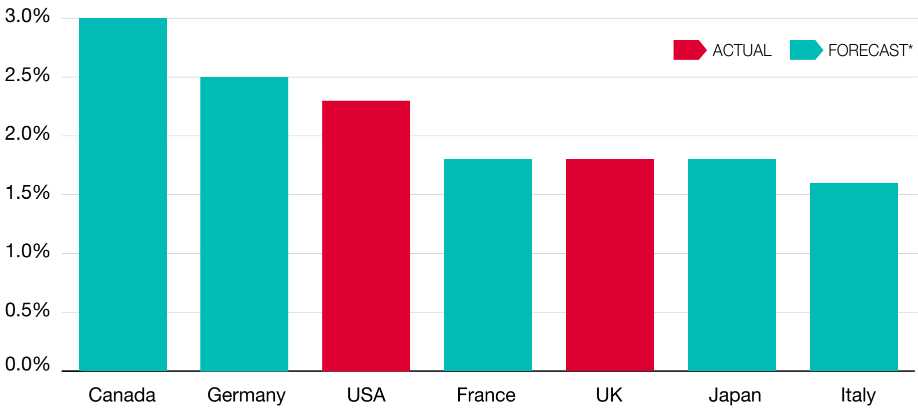
Gilts soften

Meanwhile, the ten year Gilt yield, which had sunk as low as 0.53% in early August 2016, has now softened to 1.46%. This has several causes, ranging from the Bank of England moving from loose policy to tightening, to a general upwards drift for bonds issued by advanced economies. Yet, a willingness for investors to move out of the safe haven of bonds is part of the story.

That the Bank of England is feeling confident enough to tighten policy despite the move towards Brexit is a statement of confidence in the economic outlook. The UK is advancing along the road of normalising policy, which should be regarded as a sign the economy is robust, not weakened by Brexit doubts.

FIGURE 1

G7 nation GDP growth in 2017 – actual or forecast



Source: BEA, IMF, ONS

* IMF World Economic Outlook Jan 2018

JAMES ROBERTS

Chief Economist

"Investors have been gaining confidence in recent weeks on the outlook for Britain, as demonstrated by the upwards trajectory for the pound/dollar exchange rate."

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Reviewing the risks

The UK economy looks in a better place in January 2018 than it did a year ago. However, times of optimism like now are a good moment to review the potential risks.

Firstly, soft Brexit is gaining wider acceptance, but it still faces vocal and determined opponents in Parliament. We should be ready for another bout of political turbulence between now and the summer, as those who want a hard Brexit will not give in easily having seen their goal come within sight. As encouraging as the pound's recent rally has been, a volatile spring is a possibility, buffeted by the angry rhetoric.

Second, at present the Bank of England is guiding that policy will be tightened gradually, and given the current temperature of the economic statistics, that feels about right. However, one surprise of the post-referendum months has been the manner in which a tight labour market (a 4.3% unemployment rate is as good as saying zero unemployment) has not resulted in higher wage inflation.

However, by the autumn, if we are seeing clear signals that a soft Brexit is going to be the final outcome, workers may have the confidence to job hop. At present, there is little sign of a wage / price spiral as a risk, but some of the ingredients are there, and if it were to emerge, rates would rise faster than expected.

Third, the good news for the economy has not been universal. The upbeat GDP figures owe much to strength in office-type industries, like financial and business services, but consumer industries continue to report varied trading conditions. Manufacturing industries reported a strong Q4 performance, but previous upside for the sector from the cheap pound last year will now recede.

Selective targeting

Applying this thinking to property points to careful and selective targeting of assets, and taking geographic analysis down to the sub-market level. Offices let to financial firms were considered to be a risky area in 2017, due to expectations of Brexit-related job losses, which do not appear to have materialised. This presents buying opportunities in CBDs. Mixed messages on the consumer and improving output for manufacturing will keep industrial a preferred property sector over retail for now.

A rising interest rate environment will necessitate more risk taking for property investors in 2018, and migrating towards value add assets. The message from the GDP figures is that the economy is defying the gloom and expanding at an accelerating pace; but developers have largely been on the side lines since the referendum. Time to find an under supplied market and refurbish some stock?

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

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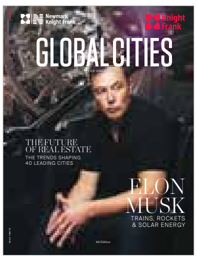

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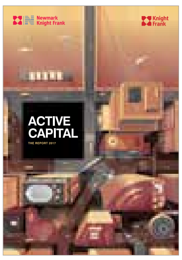

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