Sentiment toward the U.K. and its currency, economy, and assets has been mired in contrasting views of what will be the ultimate outcome of the Brexit negotiations. Many an analyst has fretted over whether or not the U.K. economy would slip into recession or pound sterling would have to endure a sharp depreciation to correct a yawning current account deficit. Brexit has indeed cast a pall over the economy. However, even with the uncertainty, the U.K. has avoided a recession and the currency appears to be mustering some strength. Below we take a look at some U.K. indicators to assess the status of the economy. Is it still possible to be constructive on the U.K.?

Still on the Path

1. **The Economy.** The U.K. economy has defied the predictions of a Brexit-induced recession. Chart 1 shows an economy still growing, albeit at a slower pace. The third quarter saw growth of 1.5% and that very likely will be the average growth for the full year, only slightly less than last year’s 1.8%. Brexit remains an unknown looming over the economy, but a slowdown in U.K. economic growth relative to the eurozone should not come as a big surprise. Since 2012, U.K. growth has outpaced that of the eurozone (see Chart 2). Fortunes have now reversed, favoring the eurozone; however, the eurozone began to outperform the U.K. two quarters before the Brexit vote.

---

Chart 1: U.K. Gross Domestic Product (GDP)

*At Market Prices, As of 9/30/2017*

---

*Source: Thomson Datastream*
2. **Consumer Spending.** The fate of the consumer remains a source of concern. Despite a historically low unemployment rate, wage growth is tepid with average weekly earnings in manufacturing rising just 1.7%. When adjusted for inflation, wages actually declined 1.3%. Inflation has risen recently to 3% (see Chart 3), prompting the Bank of England to remove its Brexit rate cut at the last meeting. Small wonder confidence has fallen. Spending has been supported though by rising unsecured loans, with the Bank of England’s Financial Policy Committee indicating that at 15% of income, these loans do not pose a huge financial risk at the moment. Additionally, mortgage loan approvals are trending higher and there is a sign that inflation may be peaking. The effect of the earlier weakness in sterling pushed import prices higher, which fed into overall inflation. Chart 3 shows a strong correlation between import and consumer prices. Import prices are moving down. Headline inflation should move lower, lessening a constraint on the consumer. Again, this comes as no surprise given the recent strength in pound sterling.
Initially pound sterling had been driven lower following the Brexit vote. That weaker sterling should have helped the U.K. economy stage a rebalancing of its gaping current account deficit. Chart 4 suggests the currency is having the desired effect on the current account deficit, mainly through the reduction of the nation’s primary income deficit. The primary income deficit is the difference between the return earned on British foreign assets abroad less the return earned by foreigners on U.K. assets. The pickup in global growth should enhance the return on U.K. foreign investments, perhaps eclipsing the return earned by foreigners and further mitigating the primary income deficit. The earlier weakness in sterling has also increased Asian demand for commercial real estate. Pound sterling appears to have done its job, with the fall in the currency helping exports. This effect should support growth and boost the pound. The CBI Industrial Trends Survey data points to fatter total order and export order books (see Chart 5). Additionally, the Purchasing Managers’ Index (PMI) for exports is expanding, and this trend correlates positively with industrial production growth (see Chart 6).
Chart 4: U.K. Income and Current Account Deficits
Balance of Payments, Percent of GDP, As of 6/30/2017

Source: Thomson Datastream

Chart 5: U.K. CBI Industrial Trends
Percent Balance, As of 11/30/2017

Source: Confederation of British Industry / Haven Analytics
Good Brexit News Still Needed. Pound sterling has climbed a wall of worry against the dollar but has depreciated this year against the euro. The elephant in the room is Brexit, particularly the transition period and the U.K.’s future trading relationship with the European Union. Some constructive news has recently emerged from the U.K.-EU discussions. Agreement on the amount of the “divorce bill” has been forged, which has impacted the currency; sterling has appreciated 3% against the euro over the past three months. Chart 7 indicates a lessening of the bearish sentiment around sterling. So far, pound sterling has withstood the threats of a “hard” Brexit and the doomed June snap elections that led to Prime Minister Theresa May forming a minority government with the help of the Democratic Unionist Party. Before advancing to discussions on trade, the Irish border issue remained a high hurdle and potentially the thorniest obstacle encountered so far. However, some good Brexit news has emerged. Prime Minister May and Jean-Claude Juncker, the president of the European Commission, agreed to a progress report that will allow the U.K.’s exit from the EU to move to phase two of the negotiations. A compromise has been reached on the Irish border question, to the grudging satisfaction of Arlene Foster, head of the Irish Democratic Unionist Party. The U.K. remains on the path toward Brexit.
Conclusion

The U.K. economy has clearly slowed, partly a by-product of the uncertainty created by Brexit, the inflation boost from an earlier deprecating currency, and the fact that the U.K. is later in its economic cycle. By the same token, the currency weakness has set in motion the expected economic healing, i.e., a lower current account deficit and increased export demand. Sentiment toward pound sterling appears to be improving and investors could be increasingly drawn to an attractively valued currency. U.K. equity markets have held up well, as the FTSE 250 (which includes domestically exposed companies) is up 32% off the post-Brexit lows. Inflation could be peaking, a factor lessening the chances of more Bank of England tightening. Unfortunately, Prime Minister Theresa May’s leadership has been less than inspiring, as she navigates the demands of the backbone of her governing coalition, the Northern Irish Democratic Unionist Party, and the more hardline Brexeters in her party, like Secretary of State for Foreign and Commonwealth Affairs Boris Johnson. Until the U.K. and the EU can move past the transition and trade stages of the negotiations, U.K. confidence, spending, pound sterling, and markets will all be held captive by Brexit. Given the recent, historic agreement between the U.K. and the European Commission, which allows the negotiations to proceed to transition and trade, we will soon learn what comes next for Brexit, and perhaps the air of uncertainty can begin to clear. However, the deal could be a fragile one, which means the path forward may not be completely smooth.

Groupthink is bad, especially at investment management firms. Brandywine Global therefore takes special care to ensure our corporate culture and investment processes support the articulation of diverse viewpoints. This blog is no different. The opinions expressed by our bloggers may sometimes challenge active positioning within one or more of our strategies. Each blogger represents one market view amongst many expressed at Brandywine Global. Although individual opinions will differ, our investment process and macro outlook will remain driven by a team approach.
Social Media Guidelines

Brandywine Global Investment Management, LLC ("Brandywine Global") is an investment adviser registered with the U.S. Securities and Exchange Commission ("SEC"). Brandywine Global may use Social Media sites to convey relevant information regarding portfolio manager insights, corporate information and other content.

Any content published or views expressed by Brandywine Global on any Social Media platform are for informational purposes only and subject to change based on market and economic conditions as well as other factors. They are not intended as a complete analysis of every material fact regarding any country, region, market, industry, investment or strategy. This information should not be considered a solicitation or an offer to provide any Brandywine Global service in any jurisdiction where it would be unlawful to do so under the laws of that jurisdiction. Additionally, any views expressed by Brandywine Global or its employees should not be construed as investment advice or a recommendation for any specific security or sector.

Brandywine Global will monitor its Social Media pages and any third-party content or comments posted on its Social Media pages. Brandywine Global reserves the right to delete any comment or post that it, in its sole discretion, deems inappropriate or prevent from posting any person who posts inappropriate or offensive content. Any opinions expressed by persons submitting comments don't necessarily represent the views of Brandywine Global. Brandywine Global is not affiliated with any of the Social Media sites it uses and is, therefore, not responsible for the content, terms of use or privacy or security policies of such sites. You are advised to review such terms and policies.