Economist's Weekly Market View

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Sterling recovers some ground as UK economy holds up

The UK economy grew by 0.6% for a third consecutive quarter in the final three months of 2016, continuing its impressive post-Brexit referendum vote performance. It means that the economy grew by 2% last year, only slightly slower than the 2.2% rate recorded in 2015.

Thus, numerous forecasts that the UK economy would slow sharply in the aftermath of the referendum vote to leave the EU have proved to be far wide of the mark. It was not economists' finest hour!

The UK economy looks to be in something of a Brexit 'sweet spot' at present, benefiting from the loosening of monetary policy and weakening of sterling that followed the vote before negative impacts, such as rising inflation and increased uncertainty, begin to impact. Growth forecasts, though, for 2017 and 2018 have been revised upwards on the back of the continuing resilience of the economy.

While detailed GDP figures for quarter four are not yet available, other data suggest that the UK economy continued to rely on consumption for much of its growth. For example, retail sales grew by 1.3% in the quarter, continuing their strong performance.

However, rising inflation could begin to temper the positive trend in consumption. Both headline and core CPI inflation rose to 1.6% in December. The underlying data show broad based price pressures. Meantime, the producer output price index has continued to rise, hitting 2.7% in December, its highest level since early 2012. This likely reflects the weaker sterling, leading to higher input costs for many companies.

Another worrying sign for the UK is a slowdown in employment growth over the autumn, although this has yet to translate into a rise in unemployment. It may well be that employers are holding off on hiring as they expect the economy to slow, while there is an on-going lack of clarity over the UK's future trading relationship with the EU. This uncertainty is unlikely to be resolved anytime soon.

The negotiating process to decide on the UK's EU exit terms and any new trading arrangement will drag on for quite some time. The outcome of these talks, which should begin in the coming months, will ultimately determine the long-run implications of Brexit for the economy.

Meanwhile, sterling has become much more stable since the autumn. Indeed, it has managed to regain some ground against the euro, even though it now looks like the UK may be heading for a 'hard' Brexit. The EUR/STG rate is currently around the 85p level compared to 90p last autumn.

The fact that the UK economy has performed much better than expected post the vote for Brexit has helped the currency. The markets now think that the next move in UK rates will be upwards, with the economy holding up and inflation on the rise.

Meanwhile, the UK government remains on course to trigger Article 50 next month, removing another element of uncertainty. The UK also seems increasingly confident that it can secure a trade deal with the EU. All this has helped create a more positive backdrop for sterling at a time of heightened political risks in the Eurozone and the US.

The UK currency could remain quite stable for much of this year, given that there is likely to be little real news flow on the Brexit negotiations in 2017, with market attention more focused on elections in Europe instead. Elections in the Netherlands, France, Germany and possibly Italy are expected to see anti-EU parties do quite well. Meantime, concerns about Greek debt have resurfaced in markets recently.

Downside risks, though, remain for the UK currency next year as the exit negotiations come to a head, with the process likely to prove fraught and punctuated by crises and much uncertainty about the final outcome. There is still a real risk of an outcome that is quite negative for the UK economy and sterling, with Prime Minister May alluding to the possibility that there may be no deal agreed.

For the time being, though, sterling looks to have entered relatively calm waters.

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