



FED DELIVERS DOVISH HIKE

March/April 2017



ASSET MANAGEMENT

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*As at 31/12/2016

This month's contributor

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The cyclical peak in the Fed Funds rate (in real and nominal terms) has been falling for decades, and the current cycle should be no exception, thanks to a fall in the equilibrium rate of interest. The size of the Fed's Balance Sheet also offers an alternative source of "tightening" this time around, and we expect nominal Fed Funds to peak at c.2% in 2018, compared with a previous peak of 5.25%.

Higher US interest rates need not always be a barrier to equity markets. Much depends on how well the US Federal Reserve (Fed) have signalled their intentions, why they are raising rates, and how quickly. Markets were prepared for the most recent rate hike, the economic data have given some cause for optimism, and the Fed suggested that any increases will be gradual.

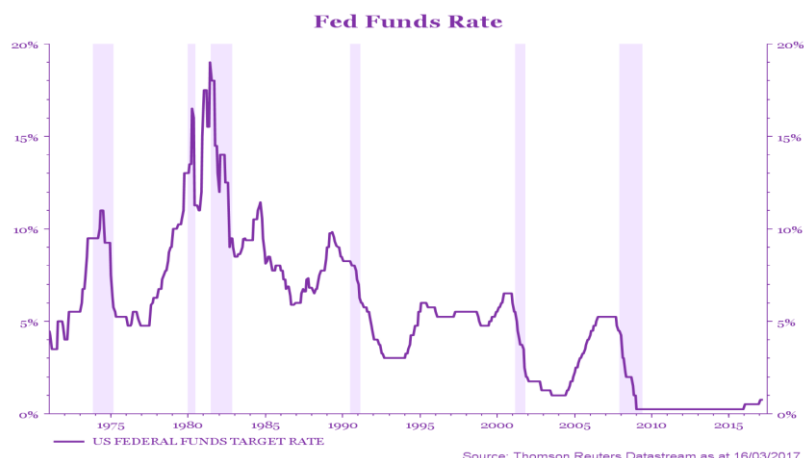
Summary

Since our last Economic Update, the Fed has raised interest rates by 25 basis points, a decision which had been flagged in advance. The Fed's statement and Summary of Economic Projections suggests little change in their thinking since December, and we expect them to continue to raise rates this year at a gradual pace. With the scale, mix and timing of any fiscal stimulus still unclear, the Fed is right to be cautious with the pace of tightening.

Instead of last year's incessant media commentary about "secular stagnation", the global economy has surprised to the upside this year, with some commentators convinced that the Fed is now "behind the curve", and not hiking interest rates quickly enough. Even the European Central Bank (ECB) is sounding more hawkish than before.

Prime Minister May's Lancaster House speech in January finally buried the "Brexit means Brexit" mantra, and set out the UK government's Brexit objectives. With the triggering of Article 50, a two-way process of negotiation will begin, and not all of the objectives may be obtainable. The UK seeks the freest and most frictionless trade possible with the European Union (EU), while wishing to gain control of the number of people coming to the UK from the EU, and remaining outside the jurisdiction of the European Court of Justice and Customs Union. This will be the central trade-off in the negotiations.

The first round of the French Presidential Election will be held on 23 April, with the second round following on 7 May. Parliamentary Elections will be held in June, when a new President will then choose a Prime Minister. The leading candidates in the presidential field are Marine Le Pen (Front National), Emmanuel Macron (Independent) and Francois Fillon (Republican), with Macron the favourite to win.



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ECONOMIC OUTLOOK

Global: can we bury secular stagnation?

In recent years, a popular narrative about the global economy was that it was stuck in a low gear, with central banks unable to tighten policy. Just 12 months ago, there was much talk about the pros and cons of negative interest rates. This year, instead of a barrage of media articles on “secular stagnation”, the global economy has surprised to the upside, with some commentators convinced that the Fed is now “behind the curve” and not hiking interest rates quickly enough. Even the ECB is sounding more hawkish than before.

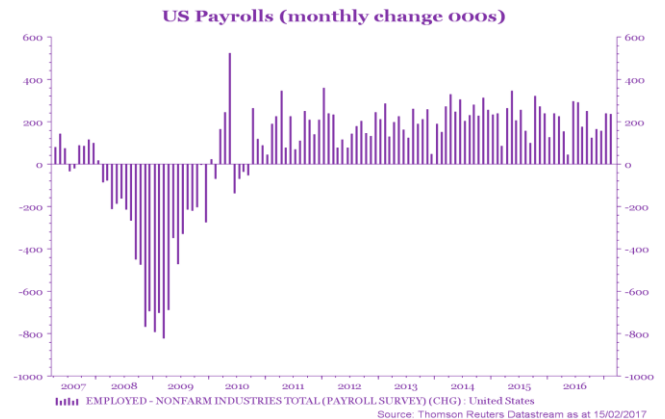
The stagnation thesis held that low global GDP growth and falling real interest rates were caused by one or other of two factors: inadequate global demand, as a consequence of low business investment, high savings rates in Asia, and income disparities; or inadequate global supply, the result of poor productivity growth and slowing growth in the labour force.

Recent evidence suggests that global growth is running at higher levels than anything seen since the temporary rebound after the Global Financial Crisis (GFC). Supply side concerns remain however: there are few signs of improvement in productivity growth, so although there has been a cyclical improvement in demand, there is as yet no reason to believe that the supply side of the global economy is performing any better than it was. In short, the speed limit for growth in the advanced economies, including the US, is still lower than it was in previous decades, hence we think Fed hikes will peak at a lower level than in the last rate hiking cycle.

The current pace of growth would need to hold for much longer in the face of Fed tightening, to counter our base case of a much lower Fed Funds peak. Much hangs on how far the equilibrium real interest rate in the US has fallen, and how quickly the Fed hikes interest rates.

US: Fed delivers dovish rate hike

Our base case assumes US GDP growth picks up in 2017, and the most recent survey indicators of output growth, as well as measures of consumer and business sentiment, tend to support this. Both Institute for Supply Management (ISM) surveys remain well into expansionary territory, while the rate of job creation picked up in the last monthly labour market report. Despite a fall in unemployment, growth in labour costs, as measured by the Employment Cost Index, has remained modest, at just 2.3% year-on-year (yoy) in Q4 2016.



Since our last Economic Update, the Fed has raised interest rates by 25 basis points, a decision which members of the Federal Open Market Committee (FOMC) had flagged in advance. The Fed’s statement and Summary of Economic Projections suggests little change in their thinking since December, and we expect them to continue to raise rates this year, at a gradual pace.

With the scale, mix and timing of any fiscal stimulus still unclear, the Fed is right to be cautious with the pace of tightening. The new Treasury Secretary, Steve Mnuchin, has indicated an intention to pass tax reforms before August, however given the need to replace the existing Affordable Care Act first, there is a risk of delay.

The new administration have cooled their protectionist rhetoric, and remain committed to raising GDP growth to 3% or higher. The economic theory behind these plans suggests that the recent slow rate of GDP growth can be blamed on the policies of the Obama administration, which will need to be reversed via tax and regulatory change. Tax cuts will “pay for themselves” if the economy responds to better incentives and grows faster as a result.

The main points of the House Republican Corporate Tax Plan are:

A steep cut in corporation tax from its current rate of 35%.

A Border Adjustment Tax (BAT) of 20%, which would “tax” imports implicitly, by removing the ability to deduct the cost of imported goods from taxable profits, while exempting export revenue from tax.

An end to taxation of the foreign profits of US companies (i.e. tax only US based earnings), with a one-off tax on repatriating offshore cash.

Companies to be allowed to write off capital expenditure in the year it takes place, rather than over a number of years.

An end to the deduction of interest payments from taxable profits, as this is thought to encourage over indebted capital structures



The most controversial element of the House Republican Plan is the BAT, which has polarised opinion in the corporate sector. Consumer orientated companies tend to be large importers, and are very much against a new BAT, while exporters tend to be in favour.

Supporters of the BAT argue that, assuming no change in international capital transactions and trade balances, a 20% BAT would push up the US\$ by 25%, so everything would remain as before. With imports accounting for \$600bn more than exports, a 20% tax would raise \$120bn of annual revenue¹.

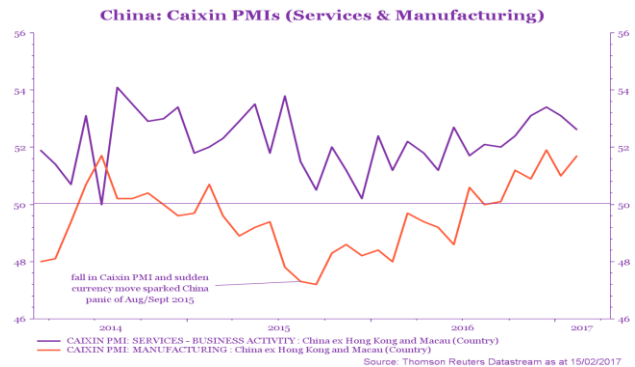
House Republicans would prefer a revenue-neutral budget, while the Trump proposal makes no commitment to the funding provisions, nor does it include a BAT. Some Senate Republicans are also cool on the BAT idea, given the likely adverse economic impact on some, mainly southern, states. Without the revenue raised by the BAT, the Budget loses its neutrality, so would then face opposition in the House, illustrating the compromises which will have to be made between a President who is not a fiscal conservative, and Congressional Republicans who are. As a further example, The White House would also like a 10% increase in annual defence spending, but no quid pro quo reductions in Medicare and social security spending.

Even before the recent friction surrounding healthcare reform, we assumed some compromise on the overall Trump fiscal stimulus, with tax and spending plans totalling 1-1.5% of GDP, rather than the 3%+ outlined during the election campaign. Markets will be keen to see that any legislation is passed by the summer recess. Any signs of serious delay and a key plank of the post-election equity market rally could be undermined.

China: the government reaffirms economic targets

While the vagaries of Chinese New Year holiday make reading the economic news more difficult in the early part of the year, business survey indicators point to continued GDP growth. The Caixin Purchasing Manager's Index (PMI) remains well into expansion territory, Industrial Production grew by 6.3% in the year to February, while Fixed Asset investment rose by 8.9% over the same period.

¹ This assumption does not take into account the likelihood that resources would flow into export production (given tax benefits) and the \$600bn excess would fall. Also, such a large spike in US\$, if it happened, would be de-stabilising for the global economy, especially emerging markets with significant amounts of \$ debt.



Growth in the service sector also remains robust, and this sector now accounts for more than half of economic activity, with scope for further growth in many areas, such as healthcare and leisure, which are underdeveloped. The rise in nominal GDP growth has eased revenue and debt servicing pressures in the corporate sector. Thus, a pick-up in inflation has been a positive for China.

Domestic demand growth has become increasingly dependent on credit growth, which poses a risk to the medium-term sustainability. House price inflation has slowed, and with housing by far the largest share of household wealth, a large property crash remains the biggest downside risk to the economy.

This year will be critical for President Xi Jinping, as he prepares for a leadership transition. This will determine whether he will be able to push through difficult economic reforms during his second term. While the impact of the 2015/16 stimulus will wane, we would not expect growth to weaken materially during 2017. The government's new macroeconomic targets are broadly unchanged: real GDP growth of "around 6.5%", Consumer Price Index (CPI) inflation at 3%, Budget deficit of 3%, M2 growth of 12%.

In the medium term, policymakers should become more comfortable in setting a lower growth target, as China's potential rate of growth declines due to demographic factors and a slowdown in productivity gains. At some point the official GDP growth target will be reduced to a range below 6%, to take into account a shift to services, and a peak in working population size.

Eurozone: ECB tempers dovish signal

Eurozone GDP growth was 0.4% in Q4 2016, the same as in Q3. Employment growth has picked up, while the unemployment rate has fallen from 12% three years ago, to less than 10% now. Headline CPI has risen sharply, to 2% in February, although this reflects the diminishing drag from past falls in commodity prices, rather than a pick-up in underlying inflation. Core CPI is still less than 1%, and despite the fall in unemployment, wage growth has remained muted, at just 1.4% year-on-year (yoy) in Q4 2016.

We expect activity to be supported by loose monetary policy, a more expansionary fiscal stance, and stronger global demand, however rising longer-term interest rates and the cost of energy will offset this to some extent. In contrast to the US,



which will see a stabilisation in energy investment, the boost from cheaper energy in the eurozone (a large net energy importer) is now waning, with headline inflation set to rise, squeezing still modest nominal income growth and consumer demand.

The ECB plans to continue its asset purchase scheme to December 2017, at a reduced rate of €60 billion per month from April, however there is no sense of urgency to ease policy further from a current refi rate 0% and deposit facility rate of -0.4%. Mr Draghi has noted, perhaps prematurely, that the risk of a rate cut has diminished, as has the downside risk to growth. Post the French election, we would expect some movement towards a tapering signal, which would then be announced officially in the autumn. The ECB remains a major support for sovereign bond markets, so it must be careful how this is unwound.

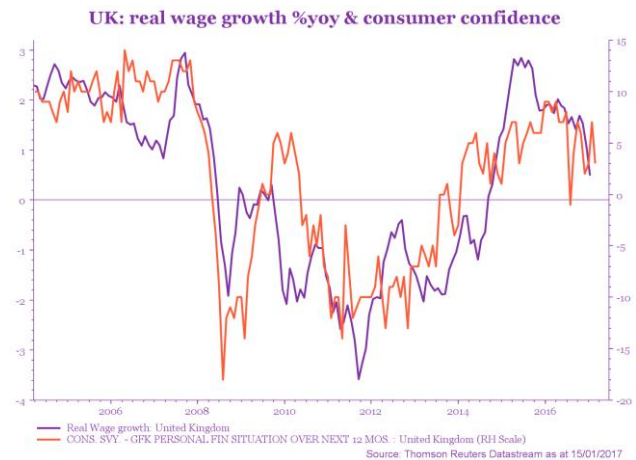
Longer term, we think the current arrangements for the euro remain sub-optimal, in the absence of greater fiscal and political union. A monetary union without political and fiscal union (or something very close), or a convergence in unit labour costs is flawed, and monetary unions preceding political union tend to fail. Germany appears unwilling to recycle its surpluses, or support a fiscal union: voters will not tolerate a “transfer union” in which taxation and spending are pooled, especially when the German population is ageing and will require an increase in health spending.

With large variations in Unit Labour Costs (competitiveness), a one-size-fits-all monetary policy will mean some economies run “hot” and some run “cold”. As an example, Germany runs a large current account surplus, driven up by the one-size-fits-all euro, and a constitutional balanced budget rule, which stops German public sector from running a deficit. The size of this surplus has attracted the ire of the new Trump administration, however Mrs Merkel has replied that this is an inevitable consequence of Germany’s membership of the Euro. Ahead of the September election, there is a growing debate within Germany about scope for fiscal stimulus. In itself, this would be welcomed by the rest of the EU and elsewhere, but is a poor substitute for full fiscal union.

UK: Budget improvement in public finances down to one-off factors

Since our last report, the Bank of England (BoE) has revised up its “Nowcast” for quarterly GDP growth in Q1 2017 to 0.6%, 0.1 percentage points higher than at the time of the February *Inflation Report*. While the composite PMI has weakened, there has been relatively little evidence from the output indicators of a significant slowdown in overall GDP growth.

There are some signs of weakness in household consumption however: official retail sales volumes fell sharply in the three months to February, while BoE Agents’ contacts in the retail goods sector have also said they expect a pronounced slowing in demand in the year ahead. While consumer confidence remains steady, we expect this to weaken, as real incomes are squeezed by higher inflation.



Looking at the outlook for monetary policy, the Monetary Policy Committee (MPC) expect a moderate slowdown in consumption, so if this does not materialise, the committee may well become concerned about medium-term inflation prospects, and especially if overall aggregate demand growth holds up well, thanks to a post-devaluation boost from net trade.

The unemployment rate has now fallen to 4.7% in the three months to January, and with an increase in the average number of hours worked per week, the total number of hours worked in the economy has continued to rise. Despite this, regular pay growth has fallen to 2.3% in the three months to January, compared with its recent peak of 2.7% near the end of 2016. As a key indicator of domestically generated inflation, prospects for wages remain a critical determinant of monetary policy.

The MPC’s central outlook depends on three main judgements: sterling’s devaluation impacts inflation in the near term, but does but not feed into a rise in domestically generated inflation; pay growth remains modest; household spending shows modest slowdown, and is not offset by other components of demand, principally net trade.

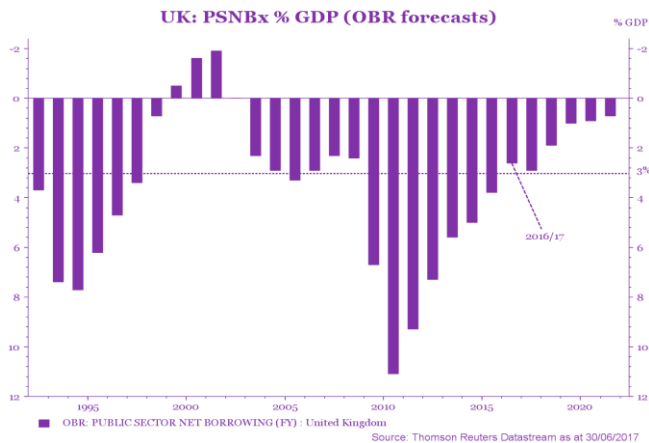
On fiscal policy, the Office for Budget Responsibility (OBR) have revised up their GDP growth forecasts for this year, in line with the new Bank of England forecast, to 2%. GDP growth is expected to slow to 1.6% in 2018. Looking beyond that, OBR growth forecasts are a tad lower than their November forecast, although the level of GDP in 2021 is projected to be the same as in the Autumn Statement in November.

Tax receipts have been higher and spending lower than the OBR expected in November, so the budget deficit has been revised lower, to £51bn in the current fiscal year. At 2.6% of GDP, this is a much stronger position than the 10% deficit which the coalition government inherited in 2010.



ECONOMIC UPDATE

INVESTMENT
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The OBR has deemed any improvement in the public finances as down to one off factors, so there was little room for any major change in the fiscal stance at this point. That said, the Chancellor still has some room for extra borrowing, thanks to the new fiscal rules introduced last year.

Ahead of the triggering of Article 50, we already have some insight into the government's Brexit objectives, however this will be a two-way process of negotiation, and not all of these objectives may be obtainable. The UK seeks the freest and most frictionless trade possible with the EU, while wishing to gain control of the numbers of people coming to the UK from the EU, and remaining outside the jurisdiction of the European Court of Justice. This will be the central trade-off in negotiations.

While we acknowledge that there are a range of possible outcomes, our base case assumes that the UK leaves the EU in Q2 2019, and that a Free Trade Agreement can be signed, which includes a suitable implementation period. We also assume the UK retains a relatively open migration regime (although different from the current one), with net inward migration falling back towards, though perhaps not as far as, levels last seen in the early 2000s. There is a significant risk however that no deal satisfactory to both parties can be agreed, and that in the immediate aftermath, UK trade volumes will suffer as a consequence.



FRENCH PRESIDENTIAL ELECTION

A watershed event for Euro political risk, however Parliamentary Elections in June will also be crucial.

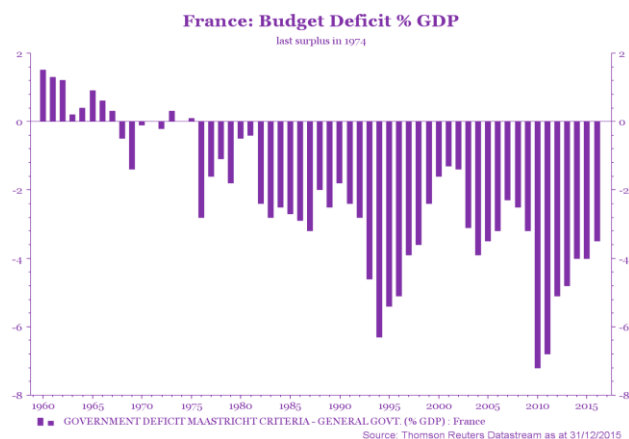
The first round of the French Presidential Election will be held on 23 April, with the second round following on 7 May. Parliamentary Elections will be held in June, when a new President will then choose a Prime Minister. The leading candidates in the presidential field are Marine Le Pen (Front National), Emmanuel Macron (Independent) and Francois Fillon (Republican), with Macron the favourite to win.

Opinion polls, much distrusted after the Brexit vote and US elections, suggest that while Le Pen could win the first round, she is unlikely to win the second, as anti-Front-National forces unite around the other candidate.

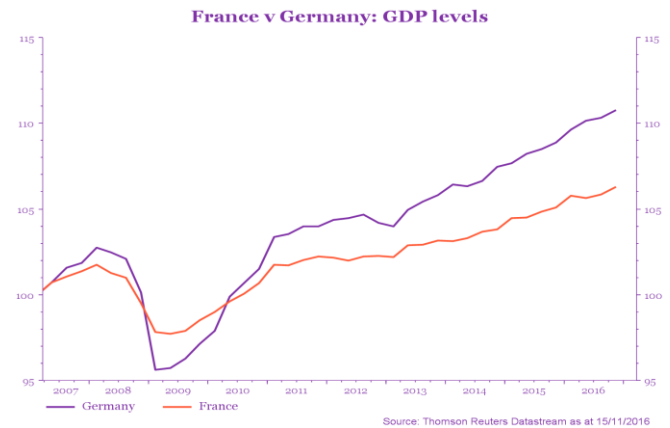
The three candidates are offering distinctive manifesto commitments: Le Pen aims to re-introduce a national currency to replace the euro and hold a referendum on EU membership. It is this policy which remains the principal concern for markets, fearing a re-run of the Euro crisis, as markets speculate about the possible break-up of the single currency.

Both Macron and Fillon promise economic reform, though to varying degrees. Macron wants to avoid shock therapy by cutting the public spending share of GDP from 55% to 52%, the number of civil service posts by 120,000, maintaining the official retirement age, reducing corporation tax from 33% to 25%, while sticking to a 3% budget deficit target. Fillon wants to be more radical in reducing the size of the state, and raising the retirement age to 65. Both Macron and Fillon want to reform the infamous “35 hour week”, though Fillon has the more radical approach.

Talk of economic reform in France goes back many years. France has not run a budget surplus since 1974, while the public spending share of GDP is very high by the standards of other developed economies.



In terms of GDP growth, France has lagged its main competitors for many years. If economic reform is possible (NB. there is a history of resistance to labour market reform in France), this could boost growth prospects, especially when taking into account the favourable demographic gap between France and other EU states.



Although there is understandable focus on the Presidential Election, if anything the Parliamentary Elections in June are just as important, if not more so. Unless Le Pen wins the Presidency and sufficient support in Parliament, she will find it very difficult if not impossible to enact her “Frexit” policies. European Union membership is enshrined in the French constitution. Likewise, a Macron presidency forced to share power in a “cohabitation” arrangement, could find it difficult to pass significant economic reform legislation.

Following the Fillon financial scandal, Macron is now the favourite to win. Yet there is a possibility that such a “Blairite” candidate (and ex investment banker), in seeking to appeal to left and right leaning voters simultaneously, will be out of tune with the current fractious mood of French voters.

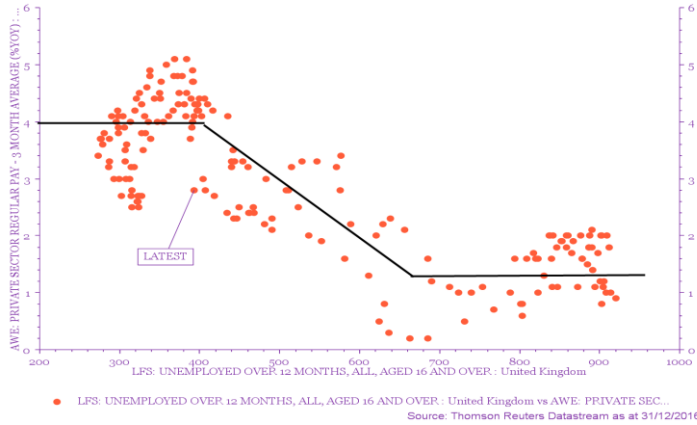
Our central case is the Le Pen does not win in the second round of voting, in which case there will be a fall in the Euro political risk premium. There is a strong chance that she performs very well in the first round, which may create some volatility in markets. With the French Presidential election out of the way, the Parliamentary elections will determine the scope for near term economic reform.

Following that, the next major European political event will be the German General Election in September. The scope for a Eurosceptic surprise here is much lower, indeed a “win” for the pro-European Social Democrats would increase the chance of an easier fiscal stance, and greater Euro solidarity.

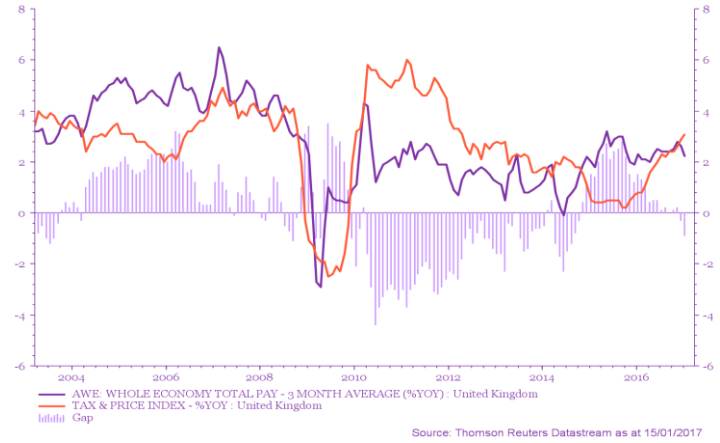


CHARTWATCH

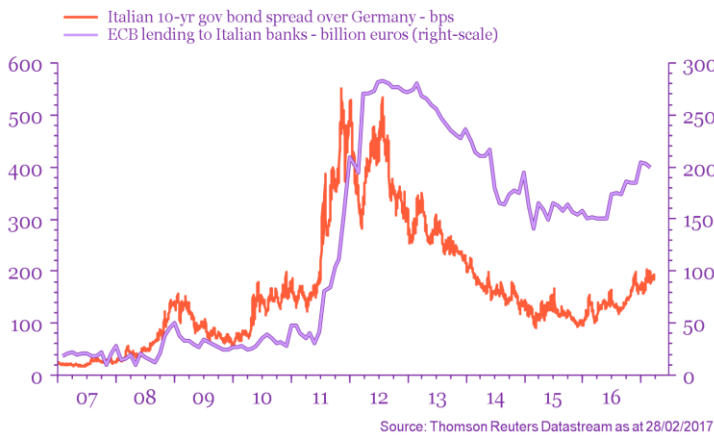
UK Long term unemployment and wage growth (P Curve)



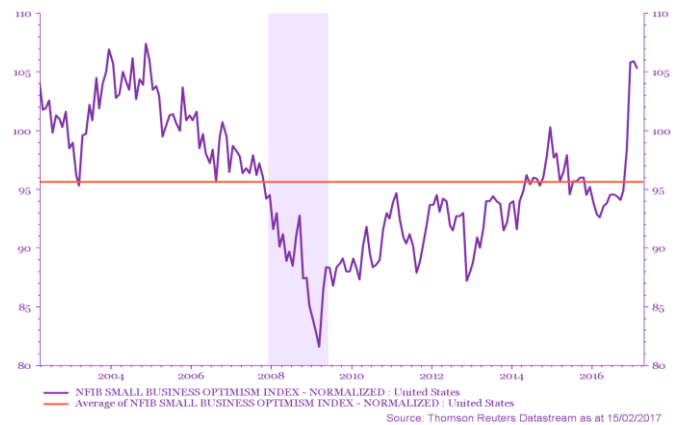
UK: Real Earnings Growth



ECB funding to Italian banks



US: NFIB Small Business Index



1. In the UK, the number in long-term unemployment has fallen sharply, however this has yet to feed into a significant increase in wage growth, with the latest data suggesting a weaker relationship between the two variables.
2. With disappointing wage growth and rising inflation, a squeeze on real incomes will act as a headwind for UK household consumption.
3. ECB quantitative easing has helped contain peripheral spreads in the Eurozone. Italy remains a key weak point heading into expected Tapering next year.
4. With campaign rhetoric coming up against political realities on Capitol Hill, some commentators have cast doubt on the post-election economic optimism evident in many US business surveys. History shows that while surveys can overreact to shock one-off events, such as 9/11 or Brexit, they often provide a timely indicator of economic activity ahead of official data.

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