LOWER FOR LONGER LIVES ON

May 2017

Multi asset views from RLAM

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*As at 31/03/2017

This month's contributor

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Senior Economist

With a UK General Election to be held on 8 June, markets have speculated that a larger majority for the Conservative Party, and a delay in the next election until 2022, creates scope for compromise and reduces the chances of a 'cliff-edge' outcome for Brexit. These developments helped push sterling back up through 1.30 against the US dollar. With the large Conservative opinion poll lead now falling, sterling is under renewed pressure.

Global growth has been more buoyant than for some time, however as we move into the second half of the year, markets will turn their attention to the outlook for 2018. With inflationary pressures still muted, we expect monetary policy settings to remain very loose, helping to extend the length of the current economic cycle.

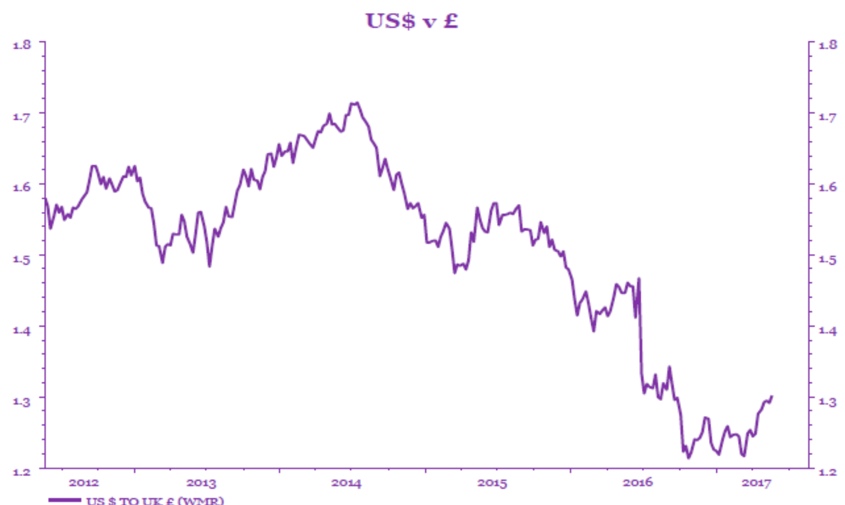
Summary

With surveys suggesting that consumer and business confidence remain high in many parts of the world, the outlook for global growth in 2017 looks positive. However, as this improvement in growth prospects is now well understood, the momentum of upside data surprises has slowed.

As we move into the second half of the year, markets will turn their attention to the outlook for 2018. Concerns about the outlook for China have risen, while any Trump fiscal stimulus to the US economy has yet to materialise.

Europe stands out as a source of positive news in recent months, with stronger economic data and falling political risk. We expect eurozone economic activity in 2017 to be supported by loose monetary policy and continued global economic expansion. Looking towards the end of 2017 however, we expect less support from the global upswing, while political risks have not disappeared completely, notably in Italy and Greece.

In response to stronger business survey and labour market news, the US Federal Reserve (Fed) increased the federal funds target rate in March, from 0.5-0.75% to 0.75-1%. We expect them to continue to raise rates this year, however, with underlying inflationary pressures remaining low in most major economies, we expect any shifts toward global monetary tightening to be very gradual.



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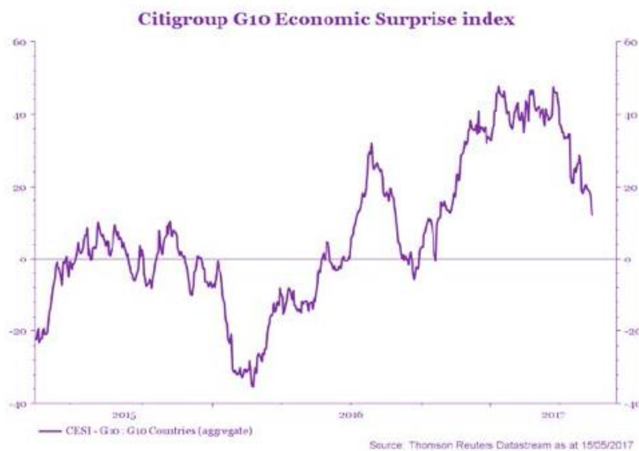
ECONOMIC OUTLOOK

Global: improved outlook for global economy now 'in the price'

With surveys suggesting that consumer and business confidence remain high in many parts of the world, the outlook for global growth in 2017 looks positive. The International Monetary Fund (IMF) has posted its first upward revision to near-term global growth since 2011, while prospects for global trade have also improved. This improvement in growth prospects is now well understood however, the momentum of upside data surprises has slowed.

Citigroup G10 Economic Surprise index



Supply side concerns remain, as there are few signs of improvement in productivity growth, so it appears that the speed limit for growth in the advanced economies, including the US, is still lower than it was in previous decades. We think Fed hikes will peak at a lower level than in the last rate hiking cycle, and the current pace of growth would need to hold for much longer in the face of Fed tightening to counter this base case. Much hangs on how far the equilibrium real interest rate in the US has fallen, and how quickly the Fed hikes interest rates (see below).

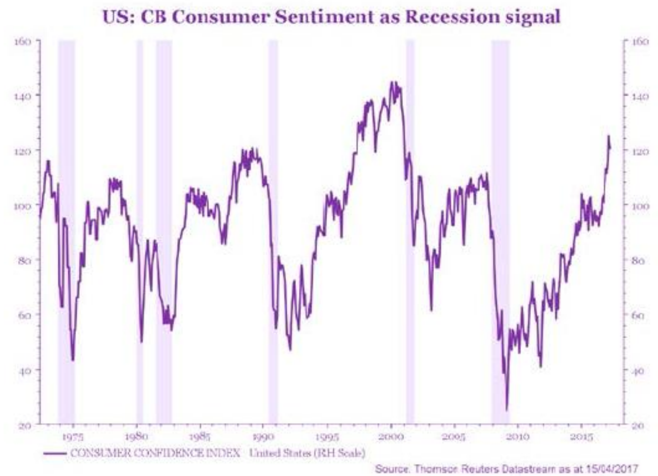
Looking into 2018, the major sources of global recession risk are an overly aggressive Fed, or a major financial crisis (e.g. a China debt crisis, or a return of euro crisis contagion risk). The rise of protectionism and 'beggar thy neighbour' trade policies is also a downside risk, though the new Trump administration has yet to follow through on much of the President's anti-free trade campaign rhetoric.

US: very weak GDP print for Q1 conceals a stronger picture

US GDP growth slowed to just 0.2%quarter-on-quarter in Q1, although as is often the case in the US, this was probably due to erratic factors, such as warm weather, which hit utilities output. By contrast, survey indicators of business and consumer confidence have been very strong and we expect any GDP weakness to unwind in Q2. Labour market data show employment growth remaining solid, with the unemployment rate falling to just 4.4% in April.

Our base case assumes US GDP growth remains close to trend in the rest of 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 consumer confidence remains high.

US: CB Consumer Sentiment as Recession signal



In response to the stronger survey and labour market news, the Fed increased the federal funds target rate in March, from 0.5-0.75% to 0.75-1%. We expect them to continue to raise rates this year, at a gradual pace, taking into account a fall in the equilibrium rate of interest. The Fed will also use balance sheet normalisation to contain the pace of hikes, with any reductions in the securities holdings accomplished primarily by phasing out reinvestments.

In theory, the equilibrium interest rate is the inflation adjusted rate consistent with the economy operating at full potential: expanding but not in overheat. This rate balances savings supply and investment demand. The rate has been falling over the last few decades, reflecting slower population and productivity growth. Also, an ageing population means higher savings levels and fewer workers in need of capital investment to work with (this is apart from a 'weightless economy' impact of a shift towards the digital economy). By contrast, stagflation in the 1970s can be traced to a large rise in baby-boomer workers, at time when total population growth was slowing, creating excessive demand at a time of constrained supply.

The equilibrium interest rate cannot be observed directly, however, Fed Chair Yellen has suggested a real rate of 1%, or just under. This would be consistent with the median longer run value for federal funds of 3%, assuming a 2% inflation objective.

On fiscal stimulus, our base case still assumes the likelihood of tax reform is reasonably high, given that all branches of the governing Republican party are in favour, and there is a window of opportunity to pass legislation ahead of mid-term elections in 2018. We had assumed 1-1.5% fiscal easing of 1% of GDP in 2018-2019, however, with the timetable for reform

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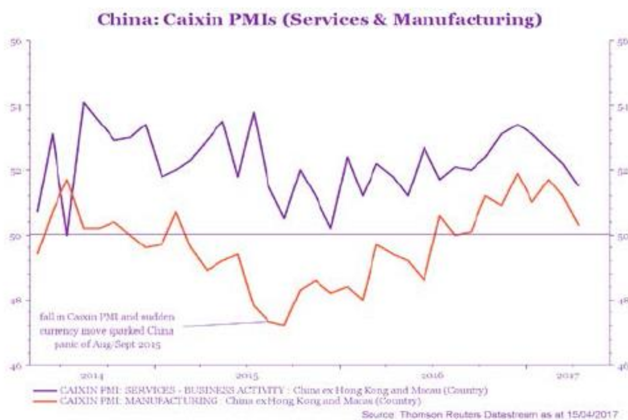
already slipping, and the Trump administration embroiled in a series of mishaps, the risks of inaction have risen.

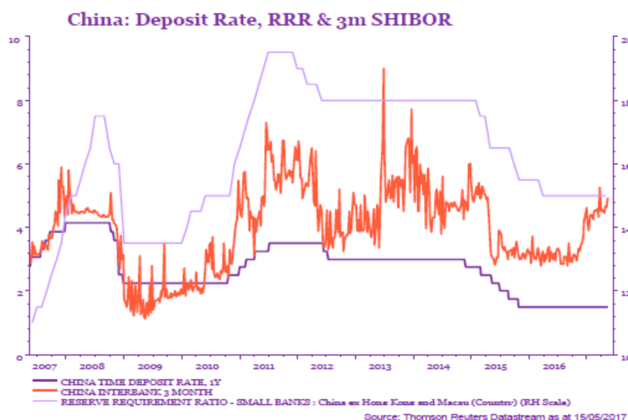
In a previous report, we suggested that markets would be keen to see that any legislation passed by the summer recess, with any signs of serious delay undermining the post-election equity market rally. While there has indeed been delay, equity markets remain sanguine, although sector and stock 'Trumpflation' trades have unwound.

China: signs of slowdown begin to appear

While the vagaries of the Chinese New Year holiday made reading the economic news more difficult in the early part of the year, it is now clear from a variety of indicators that the economy has passed a peak. The Caixin Purchasing Manager's Index (PMI) has fallen, though remains just into expansion territory, while industrial production growth has slowed in real and nominal terms.



The People's Bank of China (PBC) has allowed short-term interbank interest rates to rise, in part to reduce the risk of capital outflows in face of Fed hikes, but also to slow the rate of build-up of risks to financial stability in the non-bank sector. The money market rates have risen in nominal and more especially real terms (given the recent fall in inflation) and this has fed into rising loan rates.



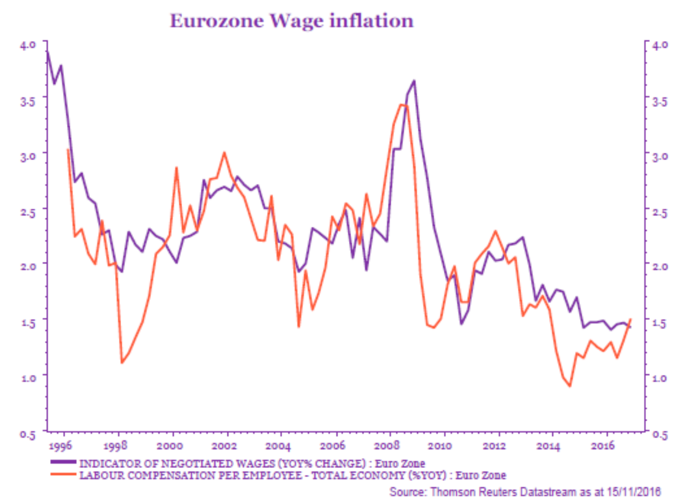
The trade-off between maintaining reasonable credit growth, while remaining vigilant on rising leverage, is a difficult balancing act and there are clear risks of overkill. With signs that the economy is now slowing, we expect the PBC to halt the rise in money market rates, and could actually ease policy more broadly, if data continues to weaken.

Domestic demand growth has become increasingly dependent on credit growth, which poses a risk to medium-term financial sustainability. With housing by far the largest share of household wealth, a large property crash remains the biggest downside risk to the economy, although the negative impact here would probably work via corporate balance sheets rather than the household sector, where leverage levels are not especially high.

This year will be critical for President Xi Jinping, as he prepares for a leadership transition and the 19th Party Congress, which will determine whether he will be able to push through difficult economic reforms during his second term. Post the autumn congress, policymakers should become more comfortable in setting a lower GDP growth target. China's potential rate of growth is declining, due to demographic factors and a slowdown in productivity gains. This is a high savings country with a closed capital account. High savings are matched with high debt, however a 6.5% GDP growth target requires excessive credit growth and we would expect the official GDP growth target to be reduced to a range below 6%, to take account of a shift to services, and a peak in working population size.

Eurozone: French election result reduces near-term political risk

Eurozone GDP growth was 0.5%quarter-on-quarter in Q1 2017, the same as in Q4 2016. The unemployment rate has continued to fall, though remains high at 9.5%, which is around 2 ppts above its 2007–08 low. Wage growth remains very low at just 1.5%year-on-year in Q4, suggesting there is ample spare capacity in the economy.



Both headline and core Consumer Price Index (CPI) inflation have risen in recent months, although the impact of the oil price and the timing of Easter have been temporary influences. Since our last report, the European Central Bank (ECB) has

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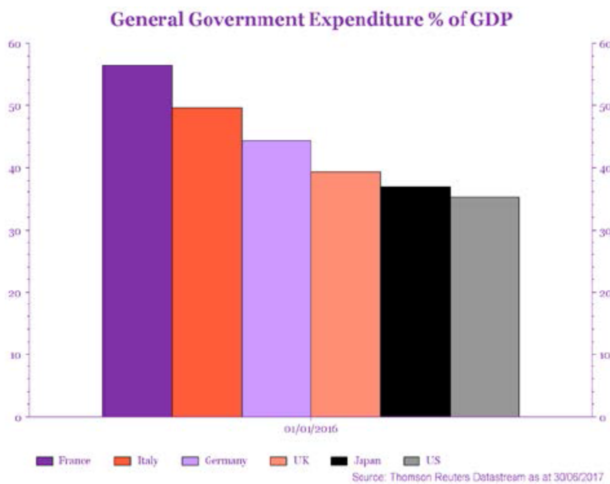
made no changes to monetary policy: the rate of asset purchases was reduced from €80 billion per month to €60 billion in April, and we expect these purchases to continue until December 2017. With unemployment still high in the eurozone (even allowing for a higher equilibrium unemployment rate in Europe than in the US or UK), wage pressures muted and peripheral debt markets dependent on monetary medicine, we think the ECB will be very cautious with any plans to change their current policy stance.

Business survey indicators remain strong and consistent with a further pick up in quarterly GDP growth in Q2. We expect eurozone economic activity in 2017 to be supported by loose monetary policy and continued global economic expansion, however the rising cost of energy and a slowdown in China will offset this to some extent.

Emmanuel Macron won the French presidential election and has appointed Prime Minister Edouard Philippe from the centre-right. President Macron ran on a pro-EU platform, and looks set to promise domestic economic reform in return for German support for eurozone fiscal union, including a Eurozone budget and finance minister. With the UK leaving the EU, and without British reluctance as an excuse to delay, the true appetite for further political union in EU will now become clearer. It remains to be seen whether French workers will tolerate any significant economic reform, without crippling street protests and creating conditions for the return of Le Pen in 2022. Likewise, whether German voters will accept a pan-European 'transfer union', in which taxation and spending are pooled is uncertain.

Macron aims to cut the public spending share of GDP from 55% to a still very high 52%, the number of civil service posts by 120,000, maintain the official retirement age, reduce corporation tax from 33% to 25%, while sticking to a 3% budget deficit target. National Assembly elections in June will determine his room for manoeuvre.

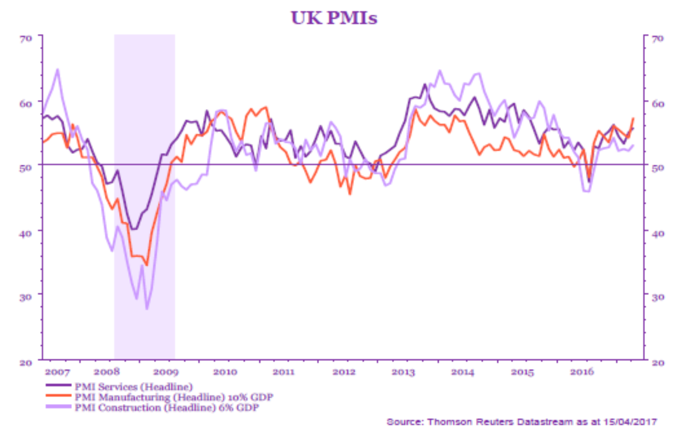


UK: household sector slowing as real incomes squeezed

UK domestic economic activity slowed 2017 Q1, with the preliminary estimate of GDP growth 0.2%quarter-on-quarter, versus 0.7% in 2016 Q4. Weakness in household consumption looks set to be a significant factor in any slowdown, as real income growth is squeezed. House price inflation has also weakened in Q1 and housing transactions have been flat, while the Royal Institution of Chartered Surveyors (RICS) survey shows a fall in new buyer enquiries and instructions to sell.

The most recent Bank of England (BOE) Credit Conditions Survey shows that lenders are tightening credit conditions. Consumer credit growth has been on an upward trend since 2012, with much of the strength attributed to car financing. While cheaper and more easily available credit has supported household consumption, the net flow of consumer credit was equivalent to just 1.2% of household consumption in 2015 and 1.5% in 2016, so real income growth remains the key driver of consumption.

Consumer confidence has fallen only a little and remains close to historical averages, while business surveys (often a more reliable guide to economic growth) have been stronger, and it is possible that early estimates of Q1 GDP will be revised up at some point in the future.



The UK is still trading on pre-Brexit arrangements, at time when global growth has picked up and sterling has fallen. Weaker sterling has helped create a large drop in the current account deficit to 2.4%, driven by an improvement in the trade deficit and primary income balance.

Headline inflation has risen to 2.7% creating a squeeze on real household incomes. However, despite a fall in the unemployment rate to just 4.6% , regular pay growth in the whole economy has slowed to 2.1%, while private sector settlements in the spring pay round have been weak, running at just 1.2%, down from 3.4% a year earlier. The BOE believe this could reflect companies' uncertainty about the outlook, with some unwilling to raise wages at a faster pace until they had more clarity about future costs and markets in the face of Brexit.

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As a key indicator of domestically generated inflation, prospects for wages remain a critical determinant of monetary policy. Subdued wage growth may be the result of a lengthy period of near zero headline inflation from early 2015 until mid-2016 or simply, poor productivity growth. Also, there may be greater slack in the labour market than the 4.6% headline unemployment rate would suggest. The relationship between headline unemployment and wage growth appears to have shifted, due to the rise in involuntary part-time and self-employment, and the threat of future job losses thanks to the march of automation. Looking ahead, we would expect inflation to fall back next year, so real wage growth should benefit, even if nominal wages show only a modest improvement.

Since their remit permits temporary deviations from the inflation target in the face of events such as the recent depreciation of sterling, we expect the BOE to keep interest rates on hold throughout this year and next. Also given the current low level of interest rates, the Bank has much less room to ease as to tighten, so it's best err on the side of caution.

On Brexit, our base case assumes that the UK leaves the EU in Q2 2019, and that a Free Trade Agreement (FTA) can be signed which includes a suitable implementation period. With a General Election now scheduled for 2022, this raises the probability of a lengthy transitional period after UK formally leaves EU in 2019, avoiding a so-called 'cliff edge'. In short, a later election could give the UK Prime Minister important room to be flexible over the terms of any agreement.

On paper at least, a deal on goods trade should be easy to agree, since the UK has a large deficit here, while markets already well integrated, however the UK seeks a much more ambitious deal, which includes services. We 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. A compromise agreement would also see the UK agree to pay something for selective access to the Single European Market (SEM) in certain sectors, and for some EU programmes.

Key central bank views

1. Fed stays gradual – two more hikes this year
2. ECB maintains current stance, with no taper until 2018
3. BOE on hold throughout pre-Brexit period
4. PBC ready to easy on any signs of slowdown

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BREXIT AND THE WTO OPTION

We reassess our Brexit base case and look at the implications of "no deal is better than a bad deal".

With a General Election to be held on 8 June, markets have speculated that a larger majority for the Conservative Party, and a delay in the next election until 2022, creates scope for compromise and reduces the chances of a 'cliff-edge' outcome for Brexit. The Conservative Party manifesto commits them to seek "a smooth and orderly departure from the European Union and forge a deep and special partnership". These developments helped push sterling back up through 1.30 against the US dollar, however the large Conservative opinion poll lead has now narrowed and sterling has come under renewed pressure.

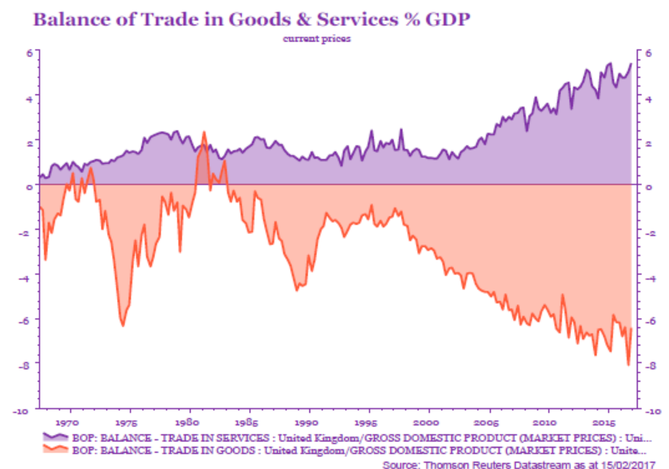
Our Brexit base case has been that an FTA, including a suitable post Brexit implementation phase is the most likely outcome. This phase will help avoid a so-called 'cliff-edge' situation. The UK government are insisting that a new FTA is agreed before any implementation phase begins, with the final destination known at the time of Brexit in 2019. This arrangement will allow all parties (public, private and household sectors) to adapt any change in rules and regulation, or to implement new customs systems.

A key question is how comprehensive any FTA will be: a no-tariff deal on goods trade ought to be easy to negotiate, especially given the scale of the UK goods deficit with the EU. Non-tariff barriers (NTBs) and the trade within the services sector will be more difficult issues to deal with, especially in the financial services sector[1].

As global goods tariffs have declined, the importance of non-tariff barriers (e.g. product standards, licensing regimes & regulation) has grown, particularly in services trade. While tariffs impact the price of a product, NTBs determine whether or not the product can be sold and under what conditions.

The Single European Market has sought to minimise NTBs through the harmonisation of standards and regulation and/or mutual recognition of differing rules and standards. As a current member of the EU, UK standards are already aligned with the rest of the EU, however the key will be to ensure compatibility going forward if non-tariff barriers to trade are not to increase and product and service standards in the EU and UK diverge.

The services sector accounts for almost 80% of UK GDP and almost 43% of total UK exports. The UK runs a large surplus on services trade, which goes some way to offset the deficit on goods trade.



Unlike the single market in goods, the single market for services is still incomplete, although it does facilitate the exchange of services amongst EU members. Financial services are a particularly important industry for the UK. At present, UK firms can rely on 'passporting' to do business in the rest of the EU. These arrangements allow firms in any European Economic Area (EEA) state to carry on permitted activities in any other EEA state, by either establishing a branch or providing cross-border services.

Much financial regulation is set internationally, rather than at EU level and there is an argument that as long as UK sticks to international standards, these are likely to be EU equivalent. The UK already undertakes substantial financial services trade outside the EU, while London's position as a major global financial centre is founded on much more than just EU membership. Under 'equivalence', the EU recognises that the regulatory or supervisory regime of a non-EU country is equivalent to the corresponding EU regime.

[1] The most recent data show that 44% of UK exports went to EU27, with exports to EU27 countries worth about 13% of UK GDP. EU27 exports to the UK are worth around 3-4% of GDP. The UK has a goods deficit with the EU27 (£89 billion in 2015), but a surplus on services (£28 billion in 2015). The deficit in goods unevenly distributed among the EU27, with Germany and the Netherlands accounting for the lion's share. Note that goods exported to, or imported from, a non-EU state via Rotterdam will be counted as EU trade and such will tend to overstate actual UK-EU trade. This is known as 'the Rotterdam effect'.

The main problem with this arrangement is that it can be rescinded at short notice. Equivalence also covers a more restricted set of permissions than passporting. Regulatory standards may be equivalent to begin with, however we do not know how the situation will evolve, and UK and EU standards may drift apart over time, thus breaching equivalence.

What would the World Trade Organisation (WTO) option look like?

Under this option, sometimes termed 'Hard Brexit', the UK would set its own tariffs on imports, up to a WTO (World Trade Organisation) ceiling. The UK would have no special access to the SEM, over and above access given to other WTO members[2].

While FTA is our central case, the initial negotiating position of EU and UK government over issues such as a financial settlement and post-Brexit role of the ECJ (European Court of Justice) seem far part. This raises the risk that talks beginning on June 19th will break down. The EU is asking for a large 'divorce' settlement and also wants the ECJ to retain a role in protecting 3 million EU workers in the UK. Allowing a role for any 'foreign' court in the UK legal process would create obvious problems for a UK government, let alone a court such as the ECJ, although there may be a role for the ECJ during any transition period.

The UK government's official position is that "no deal is better than a bad deal", but has yet to cost this. If talks fail, perhaps over the size of any exit bill, or no set of transitional arrangements is in place by 2019, the UK will have to trade with the EU and the rest of the world under WTO rules, as there will be no 'grandfathering' of EU FTAs.

Most Favoured Nation (MFN)[3] tariffs constitute a maximum or 'ceiling' to which WTO members must adhere. Actual tariffs can be set at lower rates, right down to zero, on a unilateral basis. Trading under WTO rules alone would mean that UK exports to the EU would face tariffs, so exporters would need to raise prices, cut costs, or take a hit on profit margins in order to maintain market position.

MFN tariffs set by the EU are low, on average just 2.7%, however, there are a few important exceptions where tariffs are much higher, notably the automotive and textile industries, and the agricultural sector. For the autos sector, there is a 10% tariff on vehicles and an average 4.5% tariff on components. This would raise the cost of production and cost of purchase. German car makers in particular would suffer, as their list prices rose relative to other comparable makes.

For the services sector, there are no tariffs, so barriers to trade take the form of NTBs, such as regulation. WTO rules in cross-border services trade, investment, and movement of people are typically more liberal than the EU's commitments, however, there is no uniform EU services trade regime for suppliers from outside the EU. Thus the impact of leaving the EU on access for UK service providers would differ across EU member states and sectors.

In extremis, some argue that the UK should adopt a unilateral free-trade model, removing all tariffs on imports, just as Singapore has done. Under this arrangement, UK exporters would pay the tariffs imposed by the countries in which they sell their products, but without 'retaliation'. There would be no formal FTA.

If Brexit talks breakdown, UK trade flows would face significant disruption. The government have yet to set out their view on the economic implications of "no deal", however it is likely that the degree of openness [4] enjoyed by the UK economy would suffer, at least in the short-run. This would harm economic growth and the variables which depend on that growth – employment, wages and tax revenues.

[2] The UK will have to renegotiate its WTO status outside the EU.
[3] A country that has been accorded MFN status may not be treated less advantageously than any other country with MFN status by the promising country.
[4] Openness to trade and capital flows impacts productivity and therefore trend growth via a number of routes, including implications for Foreign Direct Investment (FDI), which encourages the adoption of new technologies and processes from overseas.

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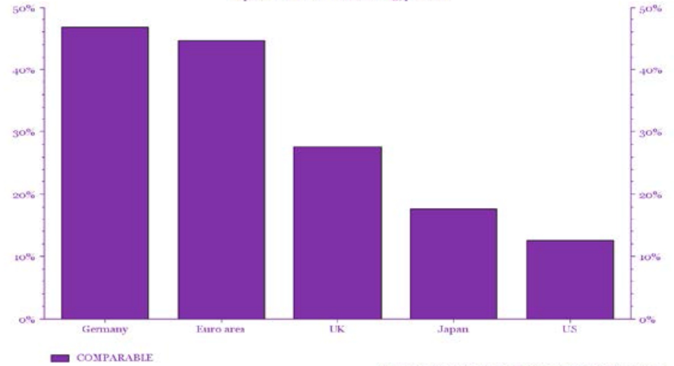
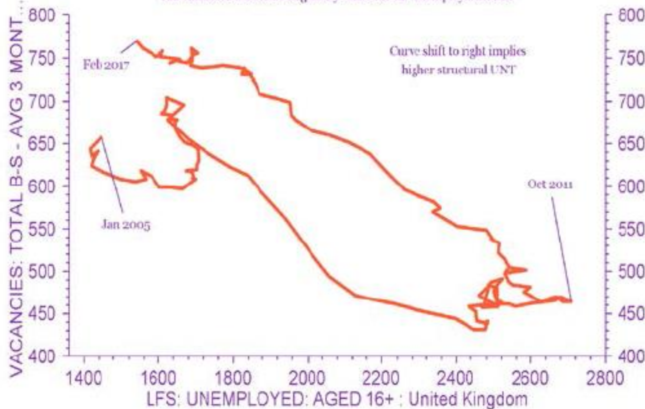
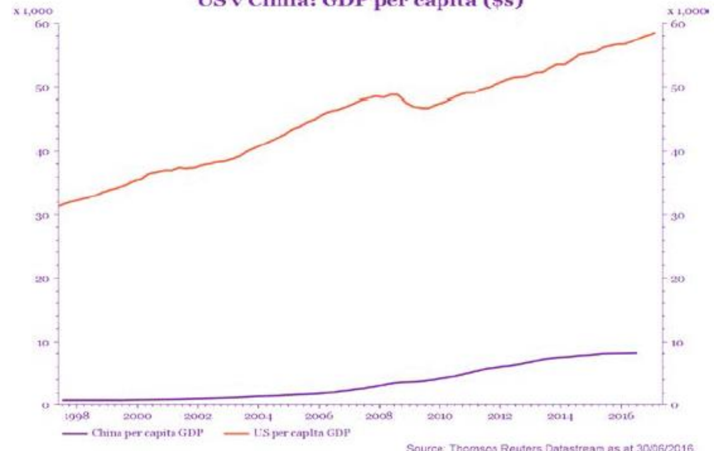
CHARTWATCH







1. After a lengthy period of weakness, global trade growth (as proxied by world exports) has risen above its 5 year moving average.
2. Openness to trade flows is often measured by exports as a percentage share of a country's total GDP. A key Brexit risk for the UK is that its degree of economic openness will begin to decline.
3. The Beveridge Curve describes the relationship between the vacancy rate and the unemployment rate. When vacancies and unemployment both rise, this implies a reduction in efficiency e.g. skills mismatch due to change in technology. The recent shift in the curve up and to the right implies higher structural unemployment, since there are more vacancies relative to a particular level of unemployment.
4. China per capita GDP is far below the 80% of US threshold when Japan GDP growth showed a significant slowdown. In demographic terms however, China looks more like Japan 1980 than Japan 1970, and in terms of debt, more like 1990. There is an understandable fear that, as in Japan, monetary policy will become impotent. China needs to boost Total Factor Productivity, in other words productivity gains which exclude growth in labour & capital productivity. The list of structural reforms needed is well known, and include freeing up sectors dominated by state owned enterprises, enshrining property rights and other legal reforms.

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