BOE SIGNAL POLICY TIGHTENING

October 2017

ROYAL LONDON
ASSET MANAGEMENT

Multi asset views from RLAM

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*As at 30/06/2017

This month's contributor
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At 4.3%, the UK's unemployment rate is at a 42 year low, and has fallen below the Bank of England's (BoE's) estimate of equilibrium and far below their original Forward Guidance threshold of 7%. In a surprise move, the Monetary Policy Committee (MPC) has now signalled that they wish to raise interest rates in the coming months, most likely at the next meeting in November. With the great benefit of hindsight, the market placed too much weight on core average earnings growth (modest), at expense of employment (rising) and unemployment rate (falling) in the MPC's reaction function, although survey data do suggest some pick-up in wage growth (see chart).

The Bank of England have given notice that they wish to tighten policy over the next few months, which we take to mean at the next meeting on November 2nd. This comes despite the fact that average earnings growth, a key domestic inflation indicator, has yet to show clear signs of sustainable recovery, although some survey data do suggest that upward pressure in wages is building (see chart below). With Q3 set to show a bounce in GDP growth and unemployment falling at a rapid clip, the MPC clearly feel there is a danger of falling "behind the curve".

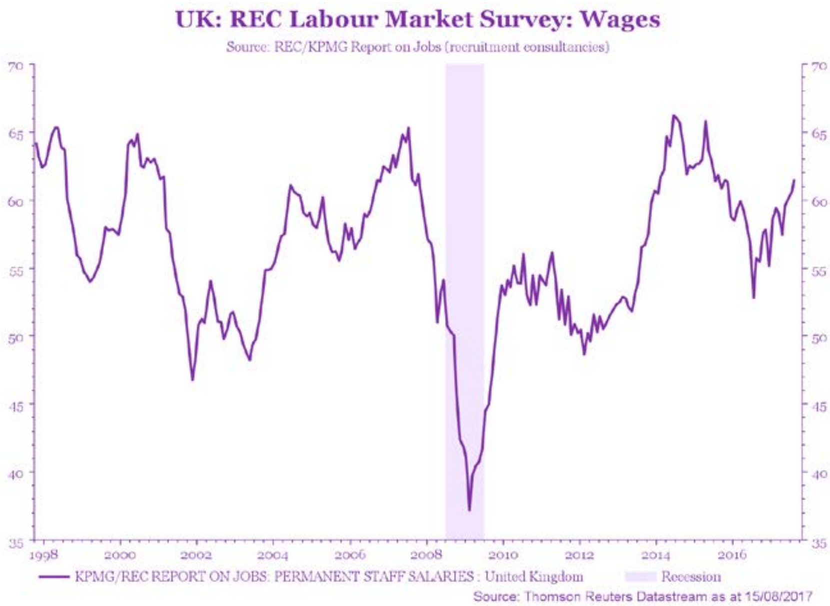
Summary

US GDP growth in the second quarter has now been revised up to 3.1% (annualised), the strongest outturn since Q1 2015. The Fed will begin their programme of balance sheet normalisation in October, and we expect a follow-up rate hike in December.

In China, the monthly run of data show that while some of the official data has slowed, the main business surveys do not yet suggest any significant slowdown. An ongoing challenge for authorities is to achieve high rates of GDP growth, while reducing financial stability risks. 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.

Eurozone GDP growth has strengthened over the past year. The pick-up has been broad-based across economies in the zone, with business surveys suggesting strong momentum during Q3. In the aftermath of the recent German election however, plans for greater fiscal and political union in the eurozone have suffered a setback.

In the UK, the unemployment rate has fallen to 4.3% and is now below the MPC's estimate of the equilibrium rate. Despite this, regular pay growth (excluding bonuses), grew by just 2.1% in the year to July, though survey data now suggest some upward pressure is building.



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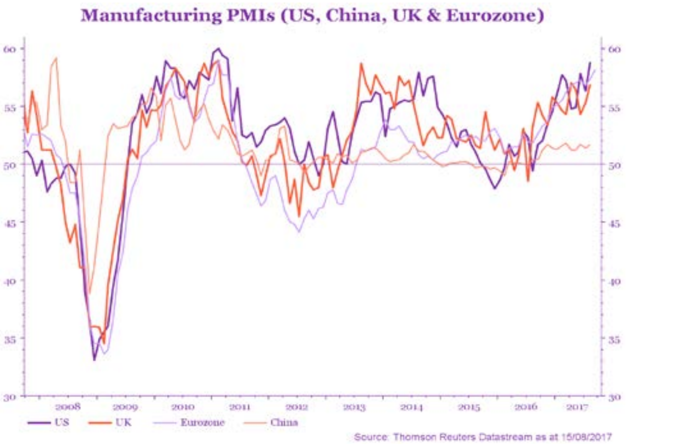
ECONOMIC OUTLOOK

Global: strongest momentum since global financial crisis (GFC)

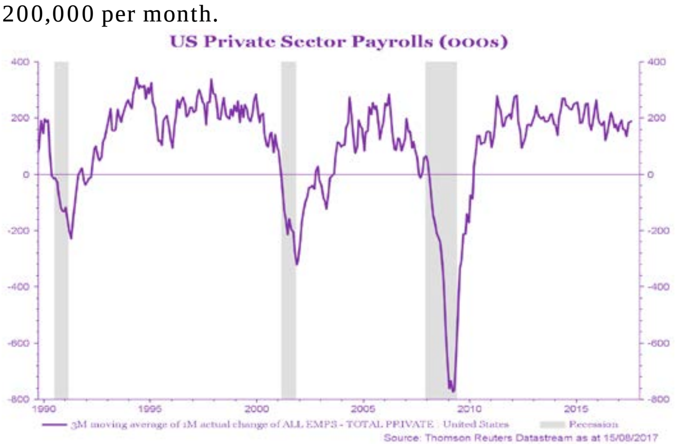
Strength in the global economy has been maintained for longer than we expected earlier in the year, with business and consumer surveys pointing towards continued momentum, especially in the eurozone and US. Global trade growth has also picked up. In short, over the past 12 months, we have seen the strongest momentum in the global economy since the Great Recession of 2008/9, though global growth still remains below its pre-crisis average.



Inflation has fallen across the globe, as past rises in the price of oil drop out of the annual comparison. Meanwhile, core inflation is very subdued in most economies, and wage pressures, a key indicator of medium-term inflation, remain modest. Monetary policy settings are tightening very gradually and our base case is that the risk of global recession in 2018 remains low.

US: Federal Reserve (Fed) moves towards quantitative tightening (QT)

GDP growth in the second of 2017 has been revised up to 3.1% (annualised), the strongest outturn since Q1 2015. Growth indicators for Q3 have also been reasonably robust, while total non-farm employment has been rising at a rate of just under 200,000 per month.



Our base case assumes US GDP growth remains close to trend in the rest of 2017, a modest rather than a robust outturn, and weaker than many had expected during the "Trumpflation" excitement of late 2016. On past experience, hurricane disruptions are unlikely to impact the national economy over the medium term.

In June, the Fed gave more details on how they will also use balance sheet normalisation as part of their policy tightening strategy. Reductions in the securities holdings will involve phasing out reinvestments, with caps on the runoff of treasuries and mortgage-backed securities (MBS) increasing quarterly over 12 months. Balance sheet normalisation will commence in October, and we expect a follow-up rate hike in December.

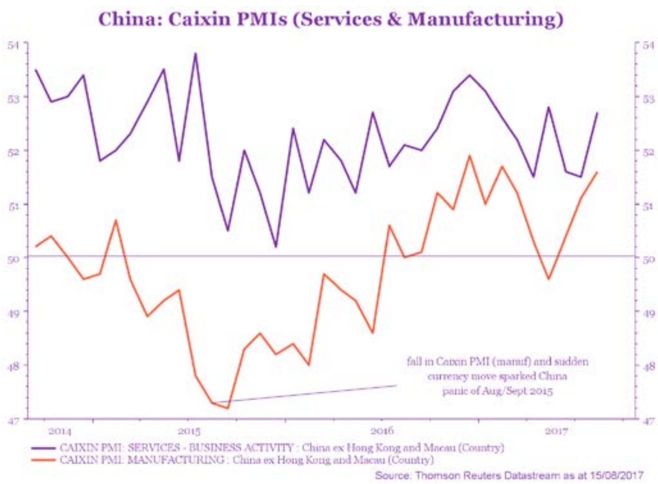
The Fed Funds rate should peak at a lower level in this cycle, reflecting a drop in the real equilibrium interest rate: the inflation adjusted rate consistent with the economy operating at full potential. The rate has been falling over the last few decades, reflecting a number of factors, including demographic change and rising debt levels, which make the economy more sensitive to debt service costs. Chair Yellen has suggested an equilibrium real rate of 1% in the medium term, which would be consistent with a median value for federal funds of 3%, assuming the 2% inflation objective is met. We suspect the peak in Fed Funds will be a little lower than that during this cycle, and our base case is just 2% during 2018. One major upside risk here is the extent of any fiscal stimulus during 2018.

China: all eyes on the Autumn Party Congress

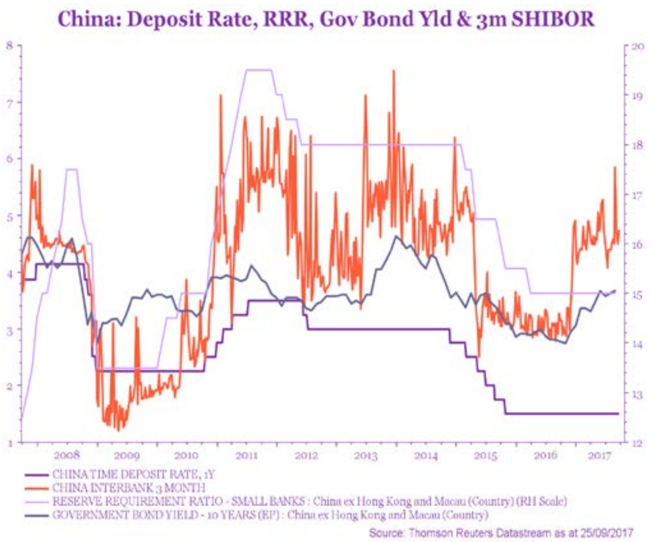
GDP growth in China has been broadly stable over the past year and a half. Stronger global growth has supported industrial production, however domestic demand is still dependent to a large extent on rapid credit growth, raising concerns about financial stability over the medium term.

The monthly run of data show that while some of the official data has slowed (eg. industrial production growth slipped to 6.0% in August from 7.6% in June), the main business surveys do not yet suggest any significant slowdown, with the key Caixin manufacturing purchasing managers index (PMI) rising to 51.6 in August.

An ongoing challenge for authorities is to achieve high rates of GDP growth, while reducing financial stability risks. While overall debt levels are high, China has little external debt and large foreign exchange reserves. The government could also fund itself using the sale of State Owned Enterprise (SOE) assets if needed, while households have a relatively high savings rate of c.30%. Compared with many advanced countries, political conditions within China appear relatively stable and predictable, notwithstanding the situation on the nearby Korean peninsula.



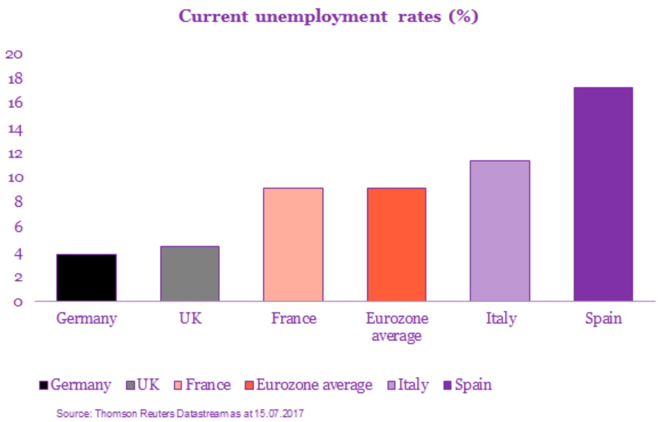
During H1 2017, the People's Bank of China (PBC) allowed short-term interbank interest rates to rise, in part to reduce the risk of capital outflows in face of Fed hikes, but also to slow the rate of build-up of risks to financial stability in the non-bank financial sector. Money market rates rose in nominal and more especially real terms, and this fed into rising loan rates. This process has yet to reverse and so creates some downside risk to growth going forward.



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. The Congress will open in early November and will be concluded with an election of the Central Committee, which will then elect the Politburo members and the Standing Committee, the Party's top leadership. The Political Report, presented by Xi Jinping, will set the policy priorities for the country in the next five years. Post the 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.

Eurozone: purple patch continues

Eurozone GDP growth has strengthened over the past year, with GDP rising by +0.6% in 2017 Q2. The pick-up has been broad-based across economies in the zone, with business surveys suggesting strong momentum during Q3. Monetary policy remains very loose and credit conditions have eased, while the unemployment rate has fallen, though remains relatively high at 9.1%.



Meanwhile, headline and core inflation rates have fallen back sharply, having picked up in April: core inflation in the eurozone is just 1.2%year-on-year.

Since our last report, the European Central Bank (ECB) has made no significant changes to its policy signal, although comments on economic conditions have become more upbeat. President Draghi has maintained that accommodative policy is still required, emphasising the subdued outlook for underlying inflation. The rate of ECB asset purchases was reduced from €80 billion per month to €60 billion in April, and we expect these purchases to continue until December 2017, before a further tapering, to be announced in late October.

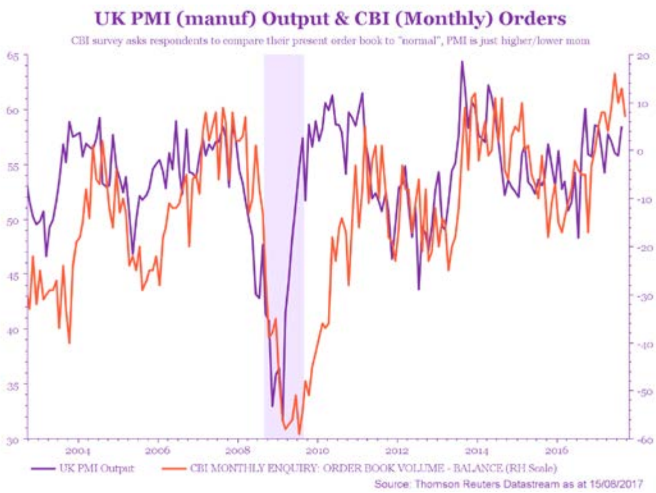
With greater than expected political stability in the eurozone this year, there is now renewed pressure to move towards greater fiscal and political union. President Macron of France wants a central budget for the eurozone, to be overseen by a finance minister. Eventually, this process may imply pan-eurozone debt issuance, even if there is no mutualisation of existing debt.

In the aftermath of the recent German election, where there was a rise in the eurosceptic vote, plans for greater fiscal and political union in the eurozone have suffered a setback. Nevertheless, the creation of a eurozone banking union is already underway. This aims to break the vicious circle between bank debt and sovereign debt. The two main aspects are "bail-in" — banks' creditors accept losses on their investments to protect taxpayers against risks taken by bank managers – and "pan-eurozone regulation". The bail-in creates de facto risk-sharing between countries, since making write-downs a regular practice will mean transfers from creditors to debtors, or effectively from surplus to deficit countries. The net savings of the former are typically lent to the latter. A eurozone deposit insurance scheme has yet to be agreed.

UK: labour market trends remains key for Bank of England (BoE) policy

GDP growth slowed in the first quarter of 2017 to just +0.2%quarter-on-quarter, and remained sluggish in Q2 at 0.3%. The slowdown since 2016 is largely accounted for by weaker growth in the service sector output, which in turn reflects a squeeze on real household incomes. Consumer spending growth slowed to just +0.1%q-o-q in Q2, while the household saving ratio fell from 3.3% to 1.7% in Q1, although part of the sharp fall in savings was caused by a temporary increase in the amount paid in taxes on dividends, leading to some dividend payments being brought forward. We expect consumption to remain subdued in H2, however the current squeeze on real incomes should abate, as inflation declines in 2018.

While economic growth has become more sluggish, the main survey indicators of activity growth do not suggest a major economic slowdown is underway. Indeed, many of the manufacturing surveys are close to record highs, thanks to a combination of devaluation and strong global growth. We expect net trade to be supported by the depreciation and on-going strength in global demand.

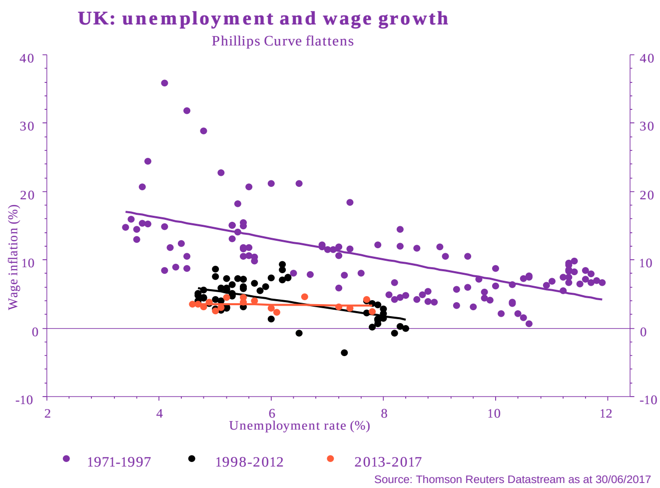


Business investment is estimated to have been flat in Q2, although this series can be volatile. Surveys of investment intentions do not suggest significant weakness in this area, although BoE agents report that Brexit uncertainty has meant that some larger firms have been delaying medium and longer-term investment plans.

For some time now, ultra loose monetary policy has come under fire, for creating an environment where inefficient borrowing is made easier, and helping to skew household balance sheets towards an overemphasis on real estate. Consumer credit conditions have eased in recent years, as banks' funding costs have fallen, with loan interest rates close to record lows and lengthening interest-free periods on credit card balance transfers. Growth in consumer credit has picked up in recent years, with car finance accounting for a large share of growth. Car dealership finance has grown to the point where 4/5 cars are now purchased on financial plans, although this type of lending still accounts for just £60bn of a total of £2trn household debt (most household debt is secured against property).

The BoE's Financial Policy Committee has highlighted concerns in this area and increased the countercyclical capital buffer rate, levied on banks' total risk-weighted UK assets, from 0% to 0.5%, with a further increase to 1% due in November.

The unemployment rate fell to 4.3% in the three months to July and is now below the MPC's estimate of the equilibrium rate of unemployment (this estimate is reviewed annually). Despite lower unemployment, regular pay growth (excluding bonuses), grew by just 2.1% in the year to July, though survey data now suggest some upward pressure. Hitherto, the weakness in wage growth is likely to reflect low productivity growth, while new technology and globalisation have weakened the bargaining power of workers. Globalisation has increased the size of the available labour force and created longer supply chains. Rising numbers of self-employed, part-time and temporary workers mean that the *marginal* worker is much more likely than in the past to be working more flexibly. In short, the wage Phillips Curve (the relationship between unemployment and wages) has shifted down and also looks to be flatter (see chart below), as the relationship between the unemployment rate and wage growth has weakened.



In a surprise move, the MPC has now signalled that they wish to raise interest rates in the coming months, most likely at the next meeting in November. With the great benefit of hindsight, the market placed too much weight on core average earnings growth (modest), at expense of employment (rising) and unemployment rate (falling) in the MPC's reaction function, although survey data do suggest a pick-up in wage growth.

Consumer Price Index (CPI) inflation has risen over the past year, with the depreciation of sterling a major driver. We expect inflation to fall back towards the 2% target next year, as the impact of sterling devaluation falls out of the annual comparison. As this impact wanes, inflation will depend more on the domestic pricing pressures, with growth in average earnings a key indicator.

GLOBAL ECONOMIC SCENARIOS

Upside scenario (15%) - strong global economic recovery with central banks "behind curve"

- Gl0bal growth recovers to pre-crisis rates
- Inflation risk rises, as labour markets tighten
- Central banks behind curve, as bond yields spike

Base case (70%) - global economic growth remains in post-crisis range; UK growth improves as real income squeeze eases

- Global growth remains close to recent rates, but below its pre-crisis average
- UK growth supported by falling inflation in 2018, however uncertainty about post-Brexit trading arrangements acts as a constraint
- Inflation pressures contained
- Central banks stay cautious: Fed and BoE deliver gradual hikes; ECB, BOJ maintain easy policy

Downside scenario (15%) - weak world economy; Brexit impact more severe

- Global growth slows to bottom of post-crisis range: US growth <2% with no fiscal stimulus; China growth falls below 6%; dysfunctional Eurozone returns to stagnation
- Brexit talks break-down with no agreement
- Deflation fears return as US and China both slow from low inflation starting point
- Central banks abandon plans to withdraw stimulus; bond yields fall to new lows, equities hit by weaker earnings

BREXIT SCENARIOS

Upside scenario (10%) – negotiations proceed rapidly to conclusion

- Limited Brexit impact, as early deal retains high openness with EU, with potential for other non-EU free trade agreements (FTAs)
- Business confidence revives
- Sterling higher, helping contain real income squeeze
- BoE tightens policy more aggressively in 2018

Base case (70%) – FTA plus transition period agreed by Q3 2018

- Growth supported by falling inflation in 2018, however uncertainty about post-Brexit trading arrangements acts as a constraint
- Transition period avoids "cliff edge"
- Sterling remains close to current levels, until new trading arrangements become clear
- BOE cautious on policy tightening

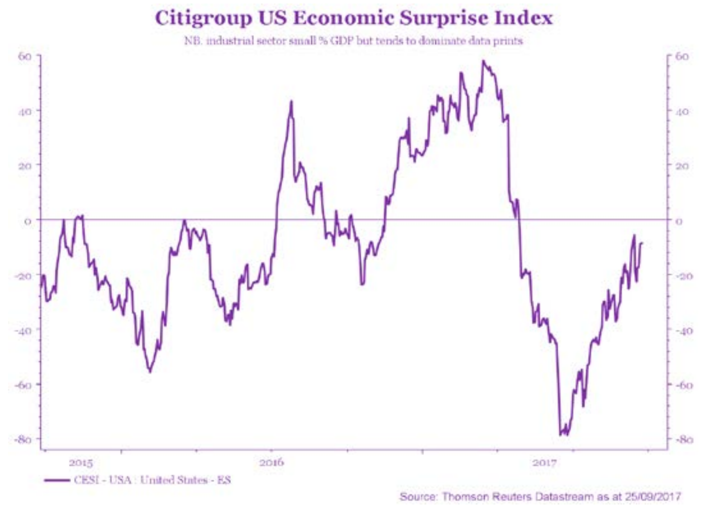
Downside Scenario (20%) – No Deal

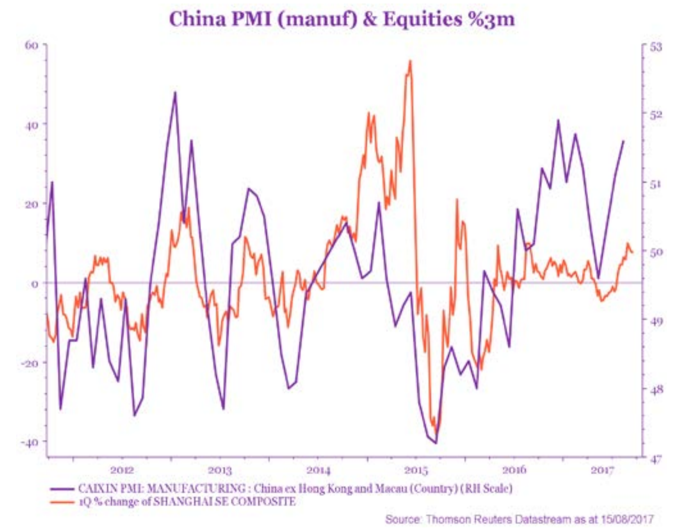
- Brexit impact more severe - no deal or poor deal hit openness
- sterling falls sharply, creating spike in CPI
- Unemployment rises

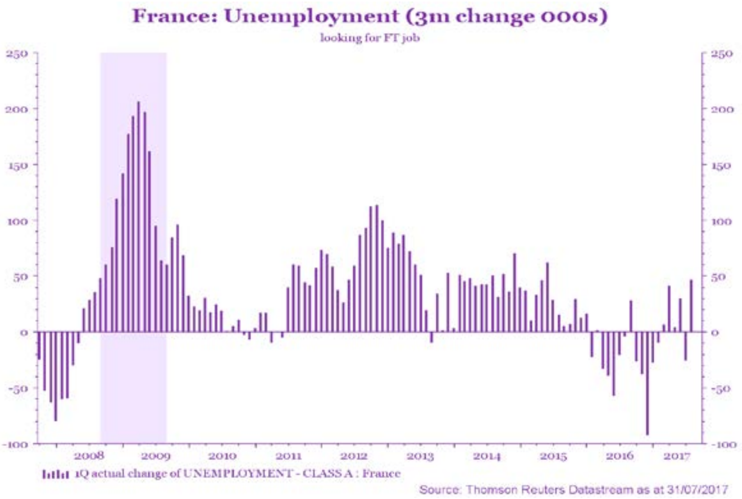
Key central bank views

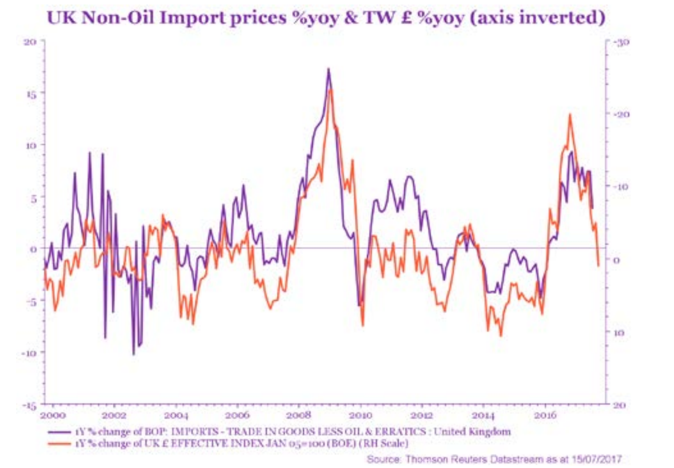
- Fed stays gradual – one more hike this year, followed by two hikes in 2018
- ECB taper QE in early 2018
- BoE hike in November, followed by one hike in 2018
- PBC on hold, but ready to ease on any signs of slowdown

CHARTWATCH









1. Following a period of weaker economic news earlier in the year, data surprises in the US are now moving higher. While severe weather events will have a negative impact of Q3 GDP, reconstruction should give boost to Q4.
2. China business surveys have yet to signal any major slowdown in economic growth
3. In France, the recent fall in unemployment appears to have stalled. President Macron now engaged in labour market reform, with the intention of lowering the rate of structural unemployment.
4. With pipeline inflation already showing signs of slowing, we think UK CPI inflation will peak in H2 2017 before falling back next year, as the impact of sterling devaluation wanes.