ECONOMIC UPDATE

INVESTMENT CLOCK

PLUS ÇA CHANGE AT THE FED

November 2017

ASSET MANAGEMENT

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This month's contributor

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In early November, the Bank of England (BoE) raised the Bank Rate from its lowest level in 300 years to the second lowest. The UK's unemployment rate is at a four decade low, employment and vacancies are close to record highs, and there are some signs that wage growth is now responding. In short, slack in the economy appears limited, so policy settings put in place in the immediate aftermath of the referendum (when there was fear of a large economic shock) are no longer appropriate. The impact of the rate hike on mortgage rates will be curtailed by a rise in the share of fixed mortgage deals over the past decade.

This year has seen the strongest period of global GDP growth since the financial crisis. There has been a recovery in global investment growth, which may be an early indicator that the global equilibrium interest rate is now rising from a relatively low level.

Summary

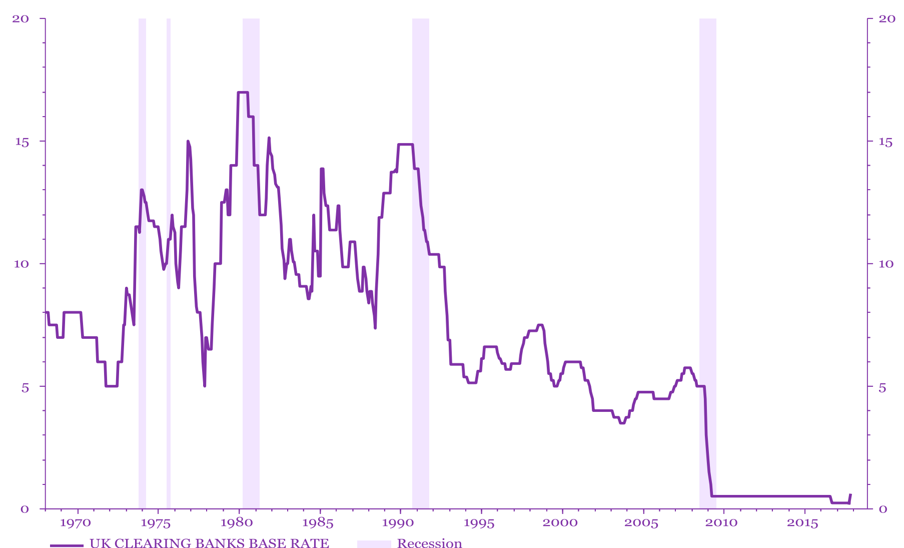
US GDP growth remains strong, supported by a rise in business investment. Labour market indicators continue to improve, and there is probably little spare capacity left in an economy which has been expanding for 8 years. At the US Federal Reserve (Fed), the new Chair designate, Jerome Powell, has been close to Chair Yellen's thinking in his assessment of the economic and policy outlook.

After slowing in 2015, GDP growth in China has remained close to target over the past two years, with the economy expanding by 6.8% year on year (y-o-y) in Q3. 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.

GDP growth in the eurozone was 0.6% quarter on quarter (q-o-q) in Q3, with a broad-based pickup across countries. The most recent Purchasing Managers' Indices (PMIs) for October remain strong, while monetary policy is still very loose and credit conditions have eased. Headline inflation was 1.4% in October, with core Consumer Price Index Inflation (CPI) just 0.9%, well below its long-term average.

UK GDP growth picked up slightly in Q3 to +0.4% quarter on quarter (q-o-q), led by the large services sector and bounce in manufacturing output. With unemployment so low, a majority on the Monetary Policy Committee (MPC) now feel that spare capacity in the economy has narrowed to the point where some tightening in monetary policy is required, and the Bank Rate has been raised to 0.5%.

UK Bank Rate



Source: Thomson Reuters Datastream as at 02/11/2017

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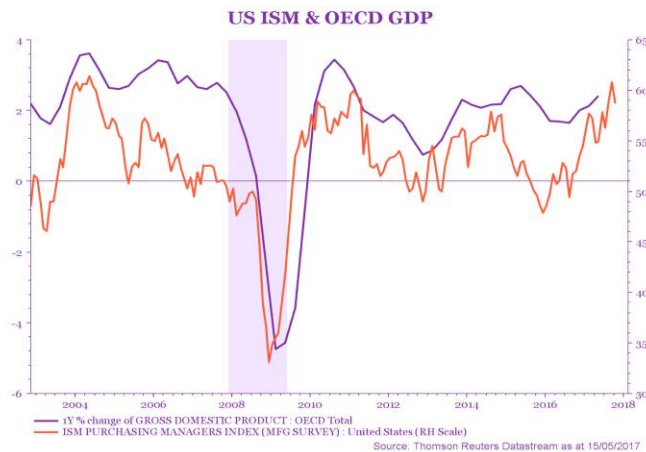
ECONOMIC OUTLOOK

Global: signs of a rise in equilibrium real rates?

As indicated by a range of robust official and survey data, this year has seen the strongest period of global GDP growth since the financial crisis.

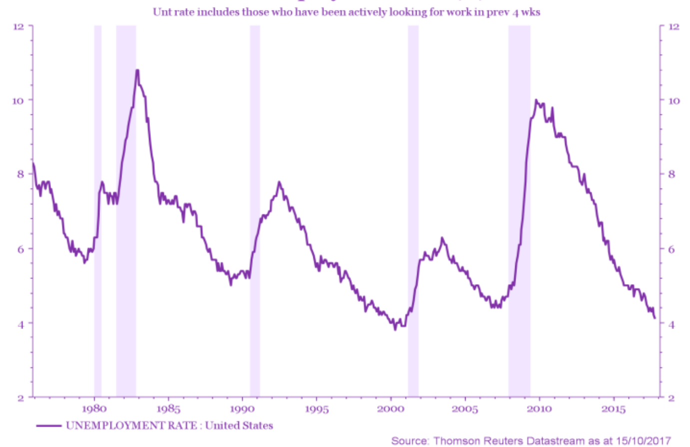


There has been a marked recovery in global investment growth, with a large rise in capital goods orders. This may be an early indicator that the global equilibrium interest rate is now rising from a relatively low level, after a long period where excess savings relative to investment was thought to be pushing real rates lower.

While headline inflation will be impacted by the recent rise in the price of oil, core inflation still remains very subdued in most economies, and wage pressures, a key indicator of medium-term inflation, are modest. Monetary policy settings are tightening very gradually and our base case is that the risk of global recession in 2018 is low.

US: change at the top of US Federal Reserve

GDP growth in Q3 was strong at 3% (annualised), supported by a rise in business investment. Labour market indicators continue to improve and there is probably little spare capacity left in an economy which has been expanding for eight years since the last recession. With the prospects for rapid employment growth now curtailed by low unemployment (see chart below), economic growth will be more dependent on the pace of productivity growth. Our base case assumes GDP growth remains close to trend in 2018, with a modest tax reform package likely to pass early in the New Year.



While we expect the Fed to continue to raise interest rates, we expect the Fed Funds rate to peak at a lower level in this cycle, reflecting a lower real equilibrium interest rate: the inflation adjusted rate consistent with the economy operating at full potential. Outgoing 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. The new Chair designate, Jerome Powell, has been close to Yellen's thinking in his assessment of the economic and policy outlook.

The Fed has begun to reduce the size of its balance sheet, which grew from around $800 billion to around $4.2 trillion in the period 2008-14 via the purchase of government debt and mortgage-backed securities. From October 2017, a proportion of the proceeds of maturing assets will no longer be reinvested, initially at the rate of up to $10 billion per month, rising to $50 billion per month over the course of a year.

China: no major shift in economic priorities

After slowing in 2015, GDP growth in China has remained close to target over the past two years, with the economy expanding by 6.8% y-o-y in Q3. 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. Total social financing growth has averaged around 13% per annum over the past two years, and the outstanding stock of credit to the non-financial sector has risen to 260% of GDP. While overall debt levels are indeed 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.

The main business surveys do not yet suggest any significant slowdown, with the key Caixin Purchasing Managers' Indices (PMIs) still in the expansionary zone.

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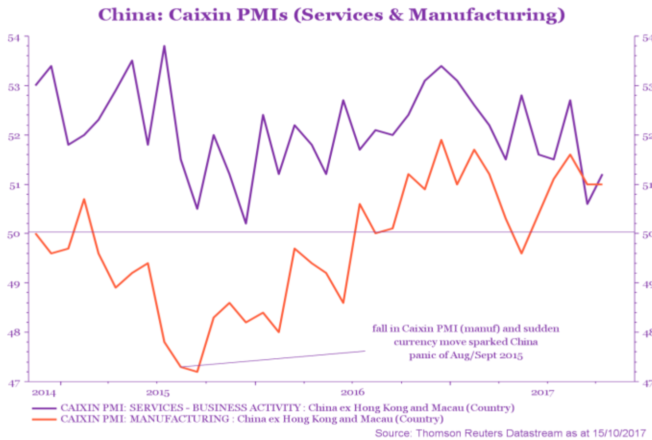
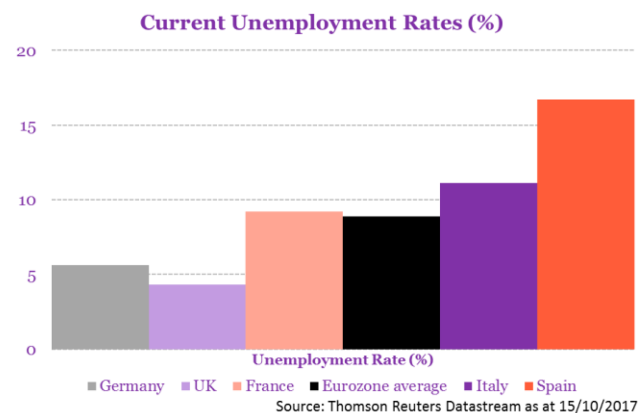


In his opening speech to Party Congress last month, President Xi did not mention the annual GDP growth target, so if there is to be any change to this, it is likely to be set by the Central Economic Working Conference in December. Before the 2015 slowdown forced the authorities to "pump prime", China was focused more on quality of growth rather than the speed. Our base case is that they return to that strategy, making the annual growth target more flexible (say 6-6.5%). Growth has held up well this year, so creates some room to lower 6.5% GDP growth target a little, and still meet the goal of doubling living standards in the decade 2010-2020. Nevertheless any attempt to de-lever will be carried out slowly, as they will not want to repeat the 2015 experience. Over time, the government ought to be more comfortable in setting a lower GDP growth target, as China's potential rate of growth is declining, due to demographic factors and a slowdown in productivity gains.

Eurozone: ECB reluctant to tighten too fast

GDP growth in the eurozone was 0.6% q-o-q in Q3, with a broad-based pickup across countries. The most recent PMIs for October remain strong, while monetary policy is still very loose and credit conditions have eased. Headline inflation was 1.4% in October, with core CPI just 0.9%, well below its long term average. The headline rate of unemployment fell to 8.9% in September, down from 9.9% a year earlier, although there is a wide range between countries (see chart).



Wage growth has yet to pick up materially, suggesting unemployment remains some way above its equilibrium rate. Labour market reform in some countries (e.g.Portugal and Spain) has likely led to a decline in the equilibrium rate of unemployment.

In October, the European Central Bank (ECB) announced that it would continue its asset purchase programme until at least September 2018, reducing the pace of purchases from €60 billion to €30 billion per month from the beginning of 2018.

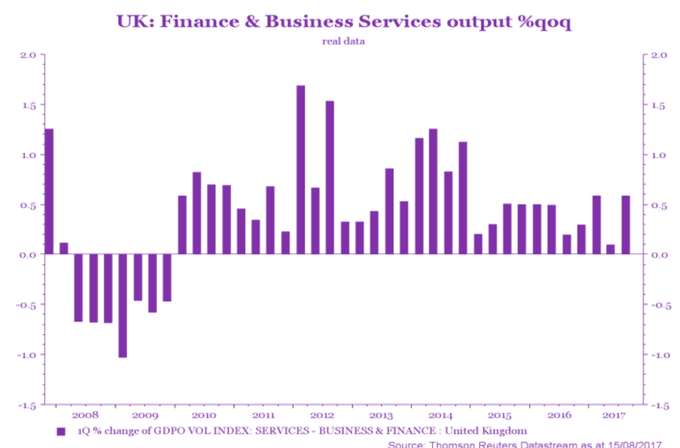
With greater than expected political stability in the eurozone this year, there is now renewed pressure to move towards greater fiscal and political union. President Macron of France wants a central budget for the eurozone, to be overseen by a finance minister. Eventually, this process may imply pan-eurozone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

Enduring currency unions (e.g. US) tend to have an automatic stabiliser arrangement for fiscal transfers, rather than the European Monetary Fund (EMF) idea being floated in some quarters. As with the International Monetary Fund (IMF), support for an EMF would come with the obligation to carry out comprehensive debt restructuring to ensure debt sustainability. This is not what fiscal union looks like and would actually be countercyclical, given the strict conditions attached to any help. In a normal currency union, the gap between regional budget deficits can be very large indeed, with the UK a prime example. If anything, there is now growing pressure *within* EU states (e.g. Spain and Italy) for *reduced* fiscal transfers *between* regions. In short, the source of tension within the structure of the single currency has yet to be removed.

UK: Bank of England (BoE) raises interest rates for first time in a decade

Growth

GDP growth picked up slightly in Q3 to +0.4% q-o-q, led by the large services sector and bounce in manufacturing output. Within services, the business services and finance sector was the main contributor to GDP, increasing 0.6% q-o-q and contributing 0.2% q-o-q to total GDP.



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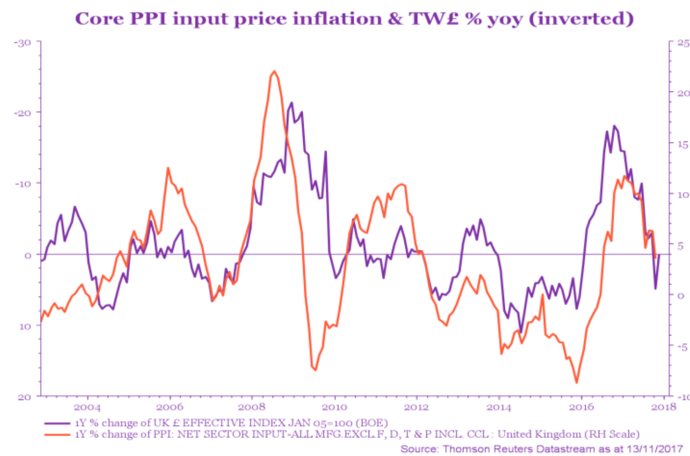
On the expenditure side of GDP, business investment grew by 2.5% in the year to Q2 2017, somewhat faster than earlier estimates, although the level of investment remains low relative to the size of the capital stock.

Looking ahead into 2018, we expect GDP growth to be supported by a modest improvement in household consumption, as real income growth recovers. Net trade and investment growth should also be supportive, assuming continued strong global growth and some stabilisation in housing investment. The major downside risk factor continues to be how households and companies respond to Brexit.

Inflation

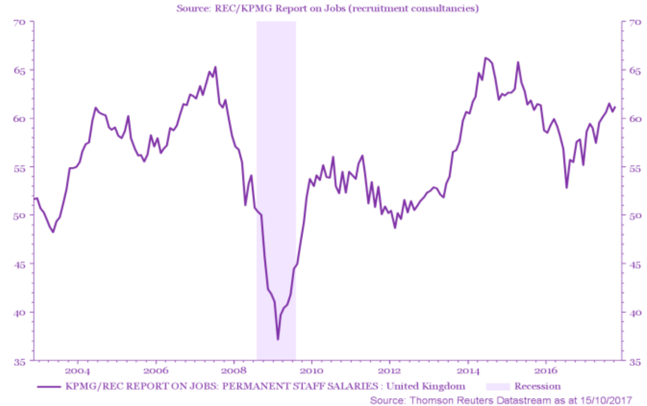
CPI inflation has risen over the past year, with the depreciation of sterling a major driver. We expect inflation to fall back towards the 2% target next year, as the impact of sterling devaluation gradually weakens.



The path of inflation will then depend more on the domestic pricing pressures, with growth in average earnings a key indicator.

Labour market

At just 4.3%, the unemployment rate is at a four decade low, while total employment and vacancies are at record highs. There are now some signs that wage growth is responding to limited slack in the labour market, meaning that domestic cost pressures are likely to build gradually. More people are moving from one job to another, suggesting a rise in confidence among employees. The most recent Recruitment & Employment Confederation (REC) survey suggests wage growth has risen for new recruits.



One major reason for the post-crisis fall in wage growth has been the shift down in productivity growth, meaning that output growth has relied on an increase in hours worked. Productivity has been flat over the past 10 years, compared with average growth rates of 2% per annum pre-crisis. This reflects low levels of investment and weak growth in total factor productivity (TFP), the efficiency with which companies combine capital and labour. The BoE think weakness in TFP growth may in part reflect "low diffusion of technology between the most productive firms and the rest".

A fall in equilibrium unemployment and high net inward migration flows have boosted labour supply, so the economy has still managed to grow, despite the hit to productivity. Looking ahead however, the only sustainable source of economic growth and rising living standards will be an improvement in productivity growth.

Monetary policy

The orthodox approach to modern monetary policy uses a New Keynesian Phillips Curve approach: for a given rate of expected inflation, the degree of upward pressures on prices rises as overall demand and the employment of resources increases above long-run sustainable levels. In forecasting inflation over the medium term (2-3 years), the BoE links faster growth in demand over potential supply to the erosion of slack in the economy, and a rise in domestic inflationary pressure.

With unemployment so low, a majority on the MPC now feel that spare capacity in the economy has narrowed to the point where some tightening in monetary policy is required, and Bank Rate has been raised to 0.5%.

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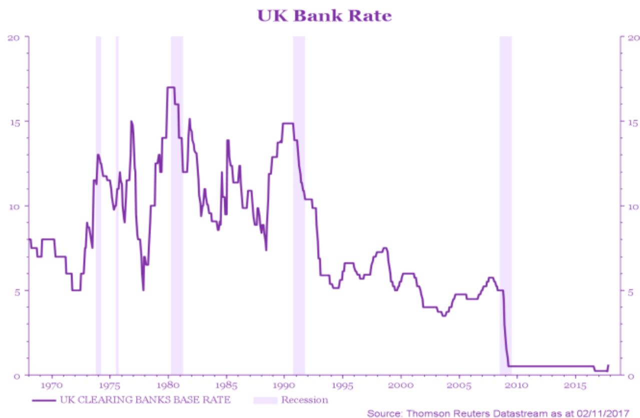

Granted, overall GDP growth rates have been low relative to historic norms, however these norms may no longer be appropriate if trend growth has fallen. In short, slack in the economy appears limited, so policy settings put in place in the immediate aftermath of the referendum (when there was fear of a large economic shock) are no longer appropriate.

Around one third of households have a mortgage on their home, with an average outstanding balance of £125,000 and 16 years left to run. If passed on in full, the hike in the Bank Rate would add c.£15 per month to the average mortgage, however the impact of the rate hike on mortgage rates will be curtailed by a large rise in the share of fixed mortgage deals over the past decade to c.60% of stock. Households with those mortgages will only face changes in their interest payments when the fixed term of their deal ends. Recent falls in credit spreads mean that current fixed-rate deals are lower than those prevailing two to five years ago.

Fiscal policy

Ahead of The Budget on 22 November, September's deficit on public finances narrowed to its lowest level for that month in a decade. Office of Budget Responsibility (OBR) forecasts for the current fiscal year are already someway off mark. Cumulative borrowing for the first half is 7.2% *lower* than last year, compared to the 13% *ris*e in borrowing the OBR forecast in the spring, reminding us that forecasting the public finances even a few months out can be difficult. On current trends, borrowing for 2017/18 will come in about £16bn below the OBR's forecast of £58bn (2.9% GDP).

At the time of the March Budget, the broad path of fiscal policy was unchanged, with cyclically adjusted borrowing falling on average 0.6% GDP p.a. over three years, leaving just over 1% GDP (£26bn) to spare for a rainy day. While the near-term deficit outcomes have been better than expected, any reduction in the OBR's estimate of trend growth could make it harder for the Chancellor to balance the books by mid 2020s. No doubt there will be enough flexibility in these later year forecasts to allow some limited relaxation in the pace of deficit reduction in the near term, probably via a reduction in the public sector wage squeeze.

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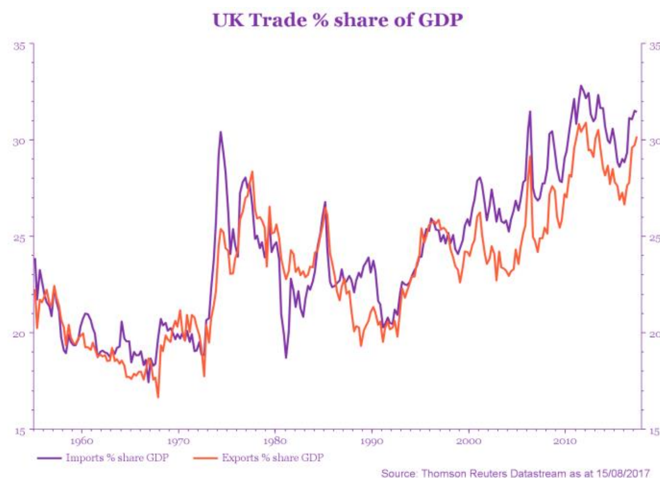
WHAT HAPPENS IF NO BREXIT DEAL?

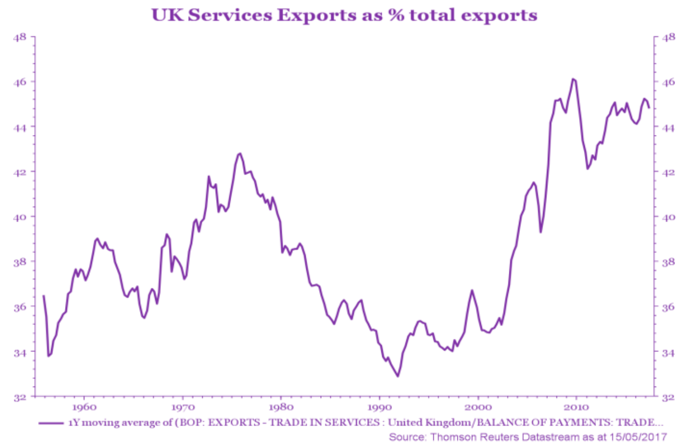
Maintaining a high degree of openness in the UK economy will be essential to post-Brexit success. Trade enables countries to specialise in economic activities which play to their relative strengths. Consumers benefit from free trade through the impact of lower tariffs on the price of imported goods (e.g. large fall in import prices for textiles over the past 20 years) and indirectly through the associated productivity gains of domestic and foreign firms.

World trade has more than doubled as a percentage of the global economy since 1960, driven by two major trends - intra-industry trade (the import and export of the same or similar goods), and the rise of cross-border supply chains (e.g. UK plays a key role in global autos chain). Most global trade is now in intermediate (unfinished) products, or in capital goods used in the production of other goods.

The UK is a medium sized open economy, with exports and imports, each accounting for about 30% of GDP in 2016.



Between 2010 and 2016, the value of UK goods exports rose by 12%, with the value of UK services exports rising by 40%. Services now account c.45% of the value of UK exports, although they account for just 20% of the value of world trade. Thus, the UK has a clear comparative advantage in services.



Our base case assumes the UK strikes a Free Trade Agreement (FTA) with the EU[1]: tariff free goods trade between the parties would continue, but after a suitable period, the UK would have latitude to set tariffs on trade with third countries.

If there is no withdrawal agreement by the end of March 2019, then EU treaties cease to apply and the UK will leave the EU without a trade deal. We examine the likely implications of such a course.

The main implications would be:

- Uncertainty over the legal position of EU immigrants to the UK and UK citizens in the EU
- The EU budget would face a serious short-fall
- UK-EU trade would be based on WTO (World Trade Organisation) rules, meaning the imposition of two way tariffs on trade in goods.

It is this third implication has attracted most attention and is worth exploring in greater detail.

World Trade Organisation (WTO) rules are based on the principle of non-discrimination, meaning one member cannot treat any member less advantageously than the rest: outside a formal FTA, any preferential treatment must be extended to all or none, and the tariff that applies to the Most-Favoured Nation (MFN) must similarly apply to all. Setting the level of tariffs would involve a trade-off between lower prices for domestic consumers on the one hand, and bargaining power in future trade negotiations on the other.

The EU's MFN tariffs have generally fallen over time (see chart overleaf), and in any case sterling would likely move lower to adjust for any shift in competitiveness.

[1] One quick fix, advocated by some commentators, is for the UK and EU to register their existing no-tariff trade terms as a ready-made agreement at the WTO. This would avoid having to create a new FTA.

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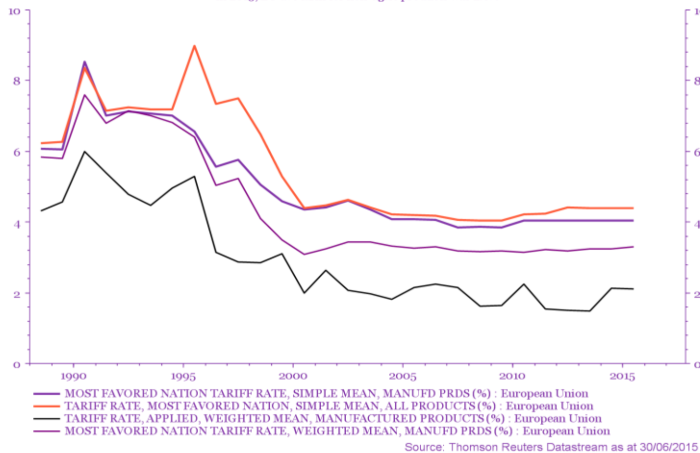

At first glance then, the costs of moving to WTO rules are not great, given the sterling safety valve. UK exporters would need to comply with EU rules when selling into the single market, however the same happens now when UK firms accept US rules when selling into the US market. At any rate, global standards lie behind many EU ones, so it would be sensible for the UK to maintain these.

On the other hand, lower sterling would put upward pressure on inflation and squeeze real incomes further. More significantly, while EU tariffs are low on average, they are high for some sectors, with the EU quite protectionist in the areas of auto production[2] and food, especially the latter. Agricultural subsidies provide more than half of UK farming income at present. The government has promised to keep subsidies going until 2020, however after that the situation is unclear. Import tariffs keep EU food prices high relative to those on world markets (in order to protect farmers from global prices), while Non-Tariff Barriers (NTBs) such as food standards also play a key role in EU trade (e.g. chicken sanitised with chlorinated water and beef farmed with the use of growth hormones are prohibited).

Although starting off from the same point, NTBs in general (i.e. not just in food) could begin to rise under a "No Deal" scenario, as product standards, labelling and packaging requirements began to diverge between the UK and the EU. There would be regulatory uncertainty created in key sectors such as aerospace, financial services and pharmaceuticals. UK pharmaceutical products would no longer be accredited for sale in the EU, while the financial sector would lose passporting rights overnight. The BoE have highlighted potential legal issues surrounding cross-border contracts for financial products, with a risk that the derivatives market could seize up without legal certainty in a "No Deal" scenario.

The EU has no incentive to do a "better" deal with the UK than existing UK-EU arrangements, so logically any new deal will reduce openness between the two economies. The question is how much of a reduction and whether this can be offset by increasing openness elsewhere, or other benefits such as greater control over budgets, regulations etc.

While our base case assumes an "FTA plus Implementation Period", there is a non-negligible risk of a "No Deal" outcome and the UK civil service would be wise to scenario plan for such an outcome. Weaker sterling would take much of the strain here, as markets sought to find a level at which the UK could offset any initial reduction in competiveness. While the shock would hit business confidence, especially in the most exposed sectors, a government led by either of the main political parties would likely introduce significant fiscal easing in an attempt to head off any major economic slowdown. By contrast, assuming a "No Deal" outcome resulted in a reduction in openness, the impact on the supply side of the economy (i.e. potential growth) would limit the ability of the BoE to ease monetary policy. Much would also depend on the state of the global economy at the time of exit.

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[2] In the autos sector, WTO rules would mean a 10% tariff on vehicles and an average 4.5% on components.

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GLOBAL ECONOMIC SCENARIOS

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

- Global 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, Bank of Japan 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 FTAs
- Business confidence revives
- Sterling moves higher, helping contain real income squeeze
- The BoE tightens policy more aggressively in 2018

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

- Growth is 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 hits openness
- Sterling falls sharply, creating spike in CPI
- Unemployment rises

Key central bank scenarios

- Fed stays gradual – one more hike this year, followed by two hikes in 2018
- ECB taper QE in early 2018
- BoE hike again in H2 2018, assuming greater visibility in post-Brexit trading arrangements
- People's Bank of China on hold, but ready to ease on any signs of significant slowdown

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