Economic Update

FEB 2017

US: Faith in Trump, for now...

The financial market's positive view of President Donald Trump's economic policy platform has now spread to market and official economists alike. As a result, economic growth and inflation forecasts have both been revised upward, and the expectation is the US Federal Reserve will be raising official rates more than was seen in 2016.

The Minutes from December's Federal Open Market Committee (FOMC) meeting demonstrated the more positive outlook, as its real GDP forecasts were revised slightly upwards for 2017 to 2.1%. The FOMC also noted in its press release that the path of its real GDP growth forecasts "...over the next several years was slightly higher, on balance, largely reflecting the effects of the staff's provisional assumption that fiscal policy would be more expansionary in the coming years". And indeed the minutes highlighted that "expansionary fiscal policy" was a key consideration in the Fed's economic outlook.

Importantly this overall assessment led to FOMC members' median interest rate expectation to be revised upwards for the first time since publishing its "Dot Plot" in 2011. The Fed is now expecting three interest rate hikes in 2017, as opposed to its previous forecast of two.

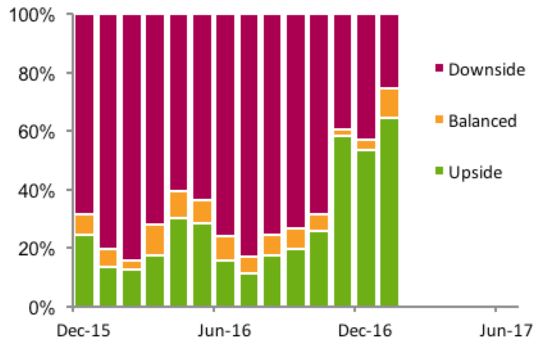
Market economists have followed suit. Before the US Presidential election the median forecast for growth stood at 2.1% over the twelve months to the December quarter 2017 – it is now 2.3%. CPI inflation forecasts for the same period were also revised up to 2.4%yoy, as were interest rate expectations.

There has also been a marked shift in economists' perception of their own forecasts. As of January around 65% of economists thought there was upside risk to their central GDP growth forecast and 10% thought risks were balanced. This is in stark contrast to the just 19% of economists that thought there were upside risks before the election (average over the preceding 11 months) and 73% that perceived risks to the downside.

However it is arguable this outlook is too focused on near term policy initiatives that risk being delayed. Most notable amongst these are proposed reductions in corporate and personal taxation rates and significant increases in infrastructure expenditure – both key expansionary policies. By contrast there may not be enough focus on the growth-impeding anti-globalisation, anti-trade and anti-competitiveness policies which the new administration is also contemplating.

Balance of risks to surveyed real GDP forecasts

Less downside risks to the US economy?



Source: IFM Investors, Wall Street Journal Jan 2017 Economist survey.

What is evident in the initial stages of this new administration is that President Trump is intent on keeping true to his campaign pledges. This suggests that we should arguably be expecting some medium term downside risks to economic growth as these protectionist policies are formulated and implemented.

The Border Adjustment Tax (BAT) is just one such policy currently receiving attention. This measure would see taxes being paid on the offshore production of US companies should those goods be imported and consumed in the US. The purpose of the BAT is to deter US companies from heading offshore to take advantage of lower tax rates and inexpensive labour supplies at the expense of the American worker.

The objective of these protectionist measures overall is to reinvigorate the US manufacturing industry and (re)create jobs in the sector – a task likely to be challenging. In the first instance the BAT would more than likely be strongly inflationary, with any tax on imports pushing up prices for consumers in the short term. A subsidy on the export side included in the BAT proposal is argued to offset the inflationary pressure somewhat, as it would support an appreciation of the US dollar. However, the dollar value of imports far outweighs exports, as a result of which the inflationary impact could prevail, potentially placing upward pressure on rates.

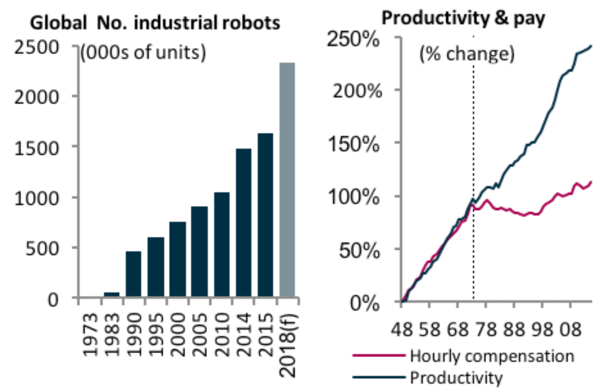
The medium term impact would also likely be inflationary. Higher labour costs as manufacturing is forced back onshore would result in higher prices for goods that neither the US nor global consumer would want to pay. As a result, the BAT risks putting US corporate profitability under pressure.

The second challenge may be due to US companies, subject to the above measures or not, increasingly having an alternative to relatively expensive labour in the form of technology and automation. The stock of industrial robots is already estimated to have increased by around 55% over the five years to 2015, with a further 40% growth expected by 2018. Therefore, instead of replacing US workers with cheaper Chinese ones as had previously been the trend, US companies would invest in this increasingly sophisticated fixed capital rather than in higher cost workers.

The impact of automation has been observable for many decades. Since the 'rise of the machines' in 1973, US productivity has risen by a cumulative 73% with only an 11% increase in workers compensation. In the decades before automation productivity rose 97% and compensation by 91%. It is unlikely that US corporates are going to allow this trend to unwind materially.

US: Automation a threat to reinvigorating jobs

The trend towards automation to accelerate



Source: IFM Investors, Wall Street Journal Jan 2017 Economist survey.

It seems reasonable to conclude that the new administration's policies will be positive for both growth and see a reacceleration of inflation. Either way the "reflation trade" that was already gaining momentum before the US election is likely to continue.

BoE could go either way

The economic data in the UK still paints a picture of resilience despite the now imminent triggering of Article 50 and negotiations to facilitate its exit from the European Union. Speculation around what Brexit could mean continues, with questions around immigration levels and the country's access to the single market – both key issues. Prime Minister Theresa May's Brexit speech in January, despite being light on detail, was viewed positively by markets as the fore-runner to a formal exit plan. Also positive was that despite the UK Supreme Court ruling the Brexit process needed to be approved by both chambers of Parliament its passage went relatively smoothly. Prime Minister May can now trigger Article 50 in early March as planned, pending a vote in the upper house, and formally begin the UK's transition away from the economic bloc.

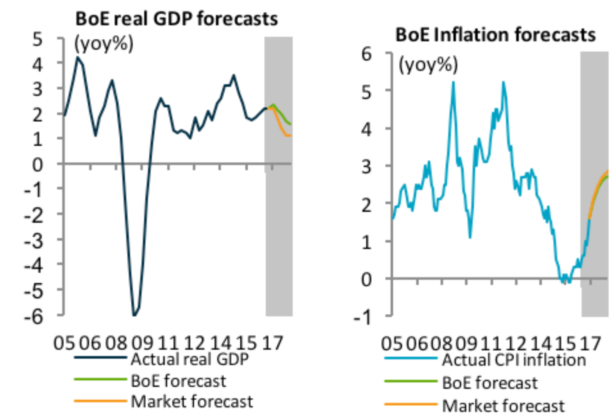
Meanwhile, the Bank of England (BoE) is clearly keeping its policy options open depending on how the outlook unfolds. The central bank noted in its recent Quarterly Inflation Report (QIR) that "...there is scope for monetary policy to be loosened..." but also that "...monetary policy may need to be tightened...".

The risks to policy are seemingly skewed to the downside with Brexit approaching. Nonetheless the BoE did surprise with the forecasts contained within the QIR. It upgraded its real GDP growth expectation to a solid 2.0%yoy, placing the BoE at the upper end of market consensus. The improved forecast was achieved without an accompanying higher inflation assumption by lowering the bank's natural rate of unemployment assumption. Its move largely reflects the better than expected data to date rather than any confidence in the medium term.

It is this growth and inflation trade-off which will determine the course of monetary policy over the coming years. The key debate within the BoE will center around how much economic growth is appropriate while the rate of inflation overshoots its target? At trend growth and solid labour market performance would risk wage inflation which, in turn, could underpin imported inflation from the lower pound sterling the BoE currently plans to "look through". Inflation hawks on the Monetary Policy Committee will be less tolerant in this environment and there is potential for a hike – or at least dissenting votes as the BoE errs on the side of caution and keeps rates on hold.

UK: GDP growth to slow, inflation to accelerate

The trade-off between GDP and CPI important for the BoE



Source: IFM Investors, BoE Quarterly Inflation Report February 2017

However the prospect of raising rates in the next two years on the basis of inflation, while Brexit uncertainty is at its greatest, risks being a policy mistake. This is because the growth outlook would remain uncertain for an extended period and the BoE runs a heightened risk of having to reverse any policy tightening.

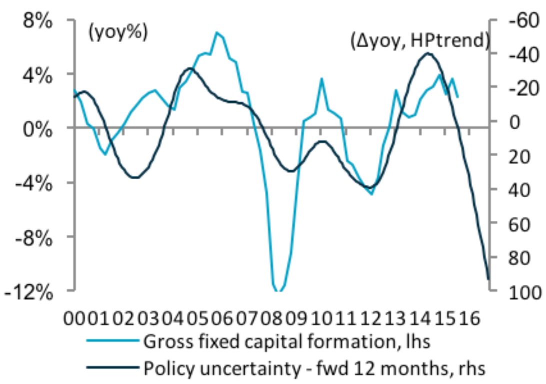
Should downside risks prevail the BoE would be unlikely to take rates into negative territory, given the negative and distortionary effect observed in economies that have taken policy to this extreme. And any forthcoming monetary accommodation would likely be aimed at Quantitative Easing (QE) to lower corporate borrowing costs (especially if US yields continue to edge higher).

The ECB confident on inflation, but growth?

Growth in the European economy has surprised on the upside recently with a 2.0% annualised rate prevailing at the end of 2016. This unexpectedly robust growth has given the European Central Bank (ECB) the confidence to suggest the worst of the downside risks to inflation have now passed.

However there is a risk that growth will slow over the course of 2017 as tailwinds from fiscal easing and last year's lower oil prices start to wane. Compounding this risk is a reasonable expectation businesses will become increasingly cautious as Brexit negotiations begin in March and European elections come into focus.

Euro-area: Uncertainty & business investment
Downside risks to investment?



Source: IFM Investors, PolicyUncertainty.com, ECB

No surprises are expected from the Dutch, French or German elections with regard to any populist victory. However in the Dutch and French elections these parties will likely perform well, if not well enough for either Geert Wilders and his Party for Freedom to form government, or Front National's Marine Le Pen to take the presidency. Nonetheless markets will remain cautious until this election risk has subsided – most likely after the German election late in the year. This is as they will not want to overly discount any result given the surprises received from both the Brexit vote and election of Donald Trump in 2016.

Australia: RBA has no appetite for a cut

In Australia, the key economic release of 2017 so far has been the December quarter CPI report. It showed that inflation was slightly weaker than expected with an outcome of 0.5%qoq, lifting the annual headline rate of inflation to just 1.5%, well below the Reserve Bank of Australia's (RBA) 2-3%yoy target band. The core measures of inflation also came in at 1.55%yoy, a slight acceleration but still below the target band. But importantly, this result was broadly in line with the RBA's expectations which is therefore likely enough to keep rates on hold, in the absence of any materially weaker activity or employment data.

In other data, building approvals fell and are in trend decline. But as property market activity continues to be solid, and given the high level of indebtedness of Australian households this means the hurdle for further rate cuts remains a high one.

Strong bulk commodity price increases were reflected in a surprise trade surplus which was supportive of the Australian dollar. As a result, these price rises ensure the rebound in the terms of trade will continue in the fourth quarter and likely the first quarter of 2017 at least. The data gives confidence that the 'reflation' of the Australian economy should take place following the negative income shock imparted by the terms of trade decline of recent years. The improvement will be reflected in better nominal GDP growth and hopefully higher inflation – both of which are to the benefit of the government's budget position in particular and the economy more broadly.

Importantly the prospect of 'reflation' allows the RBA to be more confident leaving rates on hold – at least in the short term. It is evident from the RBA's first meeting of the year that the bank has little appetite for further policy easing, a view reinforced by the Statement on Monetary Policy and a speech by Governor Phil Lowe – both containing a relatively upbeat narrative.

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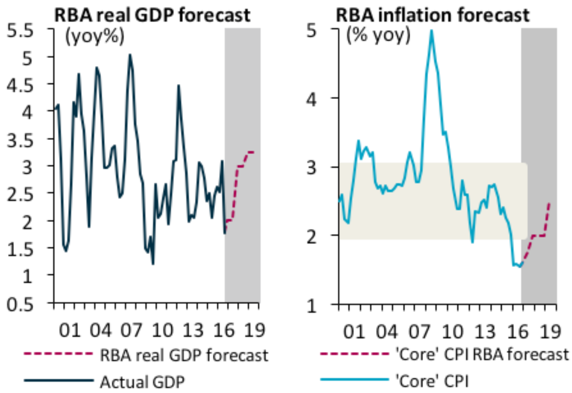
Australia: RBA forecasts for growth and inflation
Expecting a pick up...



Source: IFM Investors, RBA Statement on Monetary Policy February

The bank's central scenario is for economic growth to rebound to 3.0% and for 'core' inflation to gradually return to the target band over the course of a year – tolerating inflation below target as long as it is moving in the right direction. The RBA further expects the unemployment rate to stay in the 5-6% range. It should be noted that a significant proportion of growth will come from net exports, a situation which leaves domestic demand relatively weak, and that therefore the balance of risks to official interest rates will remain to the downside for much of 2017.

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*as at 31 December 2016

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