POLITICS TAKES CENTRE STAGE

October 2016

Multi asset views from RLAM

Royal London Asset Management manages £93.8 billion in life insurance, pensions and third party Funds*.

We have launched six Global Multi Asset Portfolios (GMAPs) across the risk return spectrum with a full tactical asset allocation overlay.

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This month’s contributor
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Since devaluation in 1967, sterling has fluctuated between 2.60 and 1.05 against the US dollar. For a medium sized and relatively open economy, a free floating currency should take much of the strain in any economic adjustment. Other things being equal, a weaker currency will make the UK a more attractive place to invest, helping fund the large current account deficit. Other things may not be equal, however. The UK remains dependent on the kindness of strangers, and the government should cool its anti-globalisation rhetoric. Devaluation will also push up inflation, although the resultant import price inflation may not all be passed on to consumers.

Sterling volatility has been a dominant theme in recent weeks. More than three months on from the Brexit vote, markets have finally woken up to the prospect that the UK is actually going to leave the EU, and is unlikely to compromise on free movement of labour. A lengthy period of negotiations lies ahead. Outside the UK, the global macroeconomic picture looks somewhat brighter.

Summary

Prime Minister May has signalled that the UK will trigger Article 50 before March 2017. This gave investors a timetable to focus on, and sterling jumped from trading mainly on the UK economic data (which had been better than expected) to trading on political risk: fears of a “hard” Brexit and divisions within the government over strategy.

US labour markets continue to improve and with inflation still low, consumer confidence measures remain strong. There are few signs of imminent recession, although corporate profits have been hit by a sharp squeeze on the energy sector over the past two years. With the recovery of the oil price, shale should become less of a drag on the US economy.

Policy stimulus in China has succeeded in stabilising the economy this year, with the main output, expenditure and monetary data consistent with a pick-up in growth over the past six months.

With positive global growth and a loose policy mix, we remain overweight stocks, with a bias in favour of emerging market equities.

Sterling close to the lows

US$ v £

For professional investors only, not suitable for retail investors.
ECONOMIC OUTLOOK

Global: International Monetary Fund (IMF) maintain global growth forecasts

The IMF have left their global growth forecasts unchanged, at 3.1% for 2016 and 3.4% in 2017. Downgrades in advanced economies have been offset by upgrades in emerging economies. While global growth remains below pre-crisis rates of 4%, it is still some way above global recession levels.

US: labour market data remain consistent with a post-election hike in US Federal Reserve (Fed) Funds

US GDP growth has disappointed in recent years, though it has been strong enough to trigger a marked improvement in labour markets. This suggests a significant shift lower in potential growth since the Global Financial Crisis (GFC). The Congressional Budget Office (CBO) estimate that potential growth fell from 3.5% between 1950 to 2007, to less than 2% in the post-crisis period, so it takes much less momentum to trigger a fall in unemployment.

We pay close attention to trends in labour market data, and the latest labour market report for September is consistent with a further modest improvement. Employment rose and unemployment fell, although the overall unemployment rate ticked up slightly, on the back of a rise in labour market participation. Over the past 12 months, the participation rate has shown signs of bottoming out, as more workers have been encouraged back into the labour market.

With labour markets improving and inflation still low, consumer confidence measures remain strong, with few signs of imminent recession, although corporate profits have been hit by a sharp squeeze on the energy sector over the past two years. Consumer spending growth remains robust, supported by rising employment and real income growth.

We still favour a December hike in the Fed Funds rate, with market views moving in this direction over the past few weeks. This assumes the labour market data do not show any significant deterioration, and there is no major shift in global risk appetite as a result of the US presidential election, the Italian constitutional referendum, or weaker sterling.

China: a run of stronger data is pushing up consensus growth forecasts

Chinese policy stimulus has succeeded in stabilising the economy this year, with the main output, expenditure and monetary data consistent with a pick-up in growth. The Li Ke Qiang Index, which combines data on bank lending, rail freight and electricity production, also suggests an improvement in GDP growth. Deflationary pressures in the industrial sector have eased.

While this improvement is to be welcomed, coming as it does after a period when fears of a major economic slowdown in China dominated investor sentiment, we still think the pace of economic growth will slow further over the medium to long term, due to demographic factors and a slowdown in productivity gains.
Debt levels in China have risen sharply, however since the government already underpins most lending, this limits the risk of sudden contagion. China has a closed capital account and a reasonably strong government balance sheet, with state controlled banks. Also, the pick-up in nominal GDP growth, as deflation eases, should ease some of the pressure on debt levels.

**Eurozone: with rising political risks in 2017, economic growth remains tepid and inflation is still too low**

Though there has been limited economic fallout from the Brexit vote in the eurozone, economic growth shows few signs of breakout, while inflation remains far below the European Central Bank’s (ECB’s) 2% target. There is little sense that the region is about to embark on a more robust GDP growth phase, especially as the boost from cheaper energy begins to wane.

Political risks will build from now on, beginning with the Italian referendum on constitutional change, to be held on 4 December. A “No” vote will not automatically trigger a general election, even if Prime Minister Renzi resigns, with a temporary arrangement likely until scheduled elections are held in 2018. Renzi’s coalition has 377 of 630 seats in the lower house and 164 of 315 seats in senate, so it would be difficult to lose a vote of confidence. There is some market risk around the December vote, however with the ECB active in government bond markets, Italy’s position in Europe being under serious question and with many hurdles still to overcome, we think this will be confined to Italian spreads. Next year, there are major elections in the Netherlands, France and Germany.

Longer-term however, we think the current arrangements for the Euro remain sub-optimal, in the absence of greater fiscal and political union. Brexit may open up an opportunity to create such a union, however even among Euro member countries, there will differences of view in the right direction to take. As the largest and most successful economy, Germany remains reluctant to be a carte blanche provider to weaker economies, which is what would normally take place in a currency and fiscal union, such as the UK or US.

**UK: markets finally accept that Brexit will happen**

With economic data covering the third quarter so much better than expected, the pressure for a “Regrexit” second referendum has eased. Paradoxically, this has created more concern about the economic outlook, as markets finally come to terms with the fact that Brexit is now likely to happen. “Soft Brexit” options, based on European Economic Area (EEA) membership, look to be a non-starter with the UK government.

It’s been a difficult few weeks for sterling. At the end of September, we were reminded of the size of the UK’s current account deficit, at almost 6% of GDP.

This is not a new story in itself, but capital inflows are needed to fund the deficit, which argues for sterling to take the strain. What really spooked the markets however wasn’t the deficit news, but a signal from the Prime Minister that the UK would trigger Article 50 before March 2017. This finally gave investors a timetable to focus on, and sterling jumped from trading mainly on the UK economic data (which has been better than expected) to trading on political risk – fears of a “Hard Brexit”, and divisions within the government over strategy.

The term “Hard Brexit” means different things to different people. To some, hard and soft are binary: hard means anything that does not involve full membership of the Single European Market (SEM). There is no middle ground: if you are not in the SEM, there is no bespoke deal to be done, and the UK will lose any preferential access to the EU. Also, until the UK leaves the EU, it cannot strike trade deals with non-EU states. This would mean a limbo period, in which the UK was without any formal trade deal. To others, including seemingly Prime Minister May, the hard/soft dichotomy is a false one: there is a middle way between full SEM membership and no formal trade deal, so a compromise arrangement is still potentially likely. The current favoured option in Whitehall appears to be “Canada Plus”. The recent trade deal between the EU and Canada abolishes 98% of tariffs on goods. The “plus” part for the UK would be some access to the single market for services.

Markets have sold sterling as the best way to express the quite reasonable fear that anything other than Soft Brexit must mean Hard Brexit, or at the very least, the probability that this tail risk may materialise.

Despite the stronger than expected data and the recent fall in sterling, we still expect the Bank of England to be concerned enough about the outlook for 2017 to cut the Bank Rate to 0.1% in November. The most recent Monetary Policy Committee (MPC) minutes indicate that a majority of members supported lowering the Bank Rate further – ‘close to but a little above zero’. The Bank have spent some time establishing their stance on a new lower bound, so we would expect this to hold for now. A move to negative rates has been ruled out on bank profitability/interest margin grounds, though perhaps the real fear is that such a move would backfire, sending a signal to households and firms that the economic situation was so serious, they would have to pay to keep money in a bank.
SPECIAL TOPIC 1 –
US ELECTION

What might a Trump victory mean for the US economy and global markets?

The US presidential election is set to take place on 8 November. The winning candidate does not necessarily require a majority of the national vote, instead he or she will need to win a majority in the electoral college – 270 votes out of 538 votes are needed. Past experience suggest that the vote will be decided by a few key swing states, such as Ohio and Florida.

Since independence in 1776, the US political system has built in a system of checks and balances. There is a tri-partite arrangement, in which the President must share power with Congress and The Supreme Court. The President can make treaties and exit trade agreements, but much of his power is checked by Congress. This is important in the case of a Trump presidency, since he is an outsider in his own party, lacking the broad support of Republicans on Capitol Hill, especially over issues such as free trade and a possible large deficit financed fiscal stimulus.

While polls suggest a Trump victory on 8 November is unlikely, such polls have failed to call important votes in the recent past – most notably the 2015 UK General Election and the 2016 Brexit referendum. The fact that Donald Trump is a candidate at all, is evidence of the continued backlash against globalisation. Even if Trump is beaten by Clinton, support for these ideas is a growing feature of many western democracies.

The 2016 election comes at a time when the economic benefits of decades of globalisation are being questioned by electorates around the world. The tensions between a globalised economy and the need to seek democratic legitimacy have never been more apparent, and these differences may be irreconcilable.

The process of globalisation has lifted millions out of poverty in the developing world, and history suggests that re-erecting trade barriers can be an excellent way of slowing economic growth. Yet the current wave of globalisation is now seen as disruptive by many voters in the developed world, who are now looking to the state to tame these forces, and give some degree of protection against them. This is a particular problem for centre-left parties, who are broadly in favour of globalisation, but have seen large parts of their core vote become alienated from it. These tensions between globalisation and the nation state are also paralleled on right of politics (Trump is against the US trade agreement with Canada and Mexico, while much of the Republican establishment is pro free trade), however it is the left which appears to have suffered most in electoral terms, particularly in Europe.

Those who perceive themselves to be losers from globalisation are more numerous, and increasingly likely to turn out and vote.

What do we know about Trump’s policies?

The most eye catching of Trump’s proposals are a GDP growth target of 3.5%, and a pledge to create 25mn new jobs over 10 years. This would be more than three times the rate of job creation since 2006 and comes at a time when both domestic and global fundamentals have held back the pace of US expansion.

Potential GDP growth was 3.5% during the 1950-2007 period, when labour force growth was 1.6% year on year, boosted by rising female and baby boomer participation, while productivity growth remained close to 2% pa. Since the global financial crisis however, potential growth has slowed (CBO now estimate 1.4% 2008-2015), as boomers retire and labour productivity has slowed. Even if productivity picks up a bit, it’s hard to see potential growth much in excess of 2%, thanks to the ongoing demographic drag.

With trend growth lower, thanks to structural demographic pressures on participation, and the unemployment rate already quite low, it is difficult to see the US economy growing at 3.5% without running into inflationary overheat, and a more hawkish Fed. Assuming steady population growth and likely restrictions on immigration if Trump wins, such a rapid rise in employment would require a jump in participation rate, given that the unemployment rate is now much closer to its equilibrium level.

Unlike many Republicans, Trump is not a fiscal conservative, wishing to cut taxes and increase government spending. The difference between taxation and spending will be made up with increased borrowing, although he has claimed that the US national debt can be paid off in eight years, via the benefits of growth.

Trump has positioned himself as a straightforward anti-free trade politician, arguing that the costs far outweigh the alleged benefits. He appears especially keen on punishing China for alleged currency manipulation. China is a major investor in US government debt.

As a supplement to his growth, fiscal and trade policies, Trump believes that the Fed is too political, and that ultra-low interest rates risk create instability and asset bubbles. In summary, tighter immigration controls, greater fiscal stimulus and anti-free trade rhetoric suggest a more inflationary bias in the Trump economic programme.

We think a Clinton victory will be less disruptive for markets and the global economy than a Trump victory. Mrs Clinton is a well-known political figure of 25 years standing, so her views and probable actions on a variety of issues would likely come as less of a surprise. A Clinton presidency would represent continuity from the Obama presidency, with political and economic uncertainty falling post-election. By contrast, a
Trump victory would be the trigger for a spike in global political and economic uncertainty. In particular, markets would be concerned that his trade policies would create an unwelcome and unnecessary dislocation in global economy, at a time when global growth is slower than pre-crisis norms. His growth and fiscal policies would be of some concern to the bond market, and most likely lead to a more aggressive tightening in monetary policy. We would expect US assets to attract a higher risk premium and the gold price to rise.
**SPECIAL TOPIC 2 – UK FISCAL POLICY**

**We look ahead to the Autumn Statement on 23 November**

In his Mais lecture of 1984, Chancellor Nigel Lawson set out how, in his view, monetary policy should take the lead in setting the macroeconomic environment, while fiscal policy should be used for micro purposes.

For most of the UK post-war period, the conventional wisdom was that since unemployment was a consequence of inadequate economic growth, fiscal stimulus should be used as first resort to tackle this issue, with monetary policy very much in a passive role. Inflation was seen as a microeconomic issue, to be controlled with income policies and subsidies.

Lawson sought to overturn this approach, and in so doing, laid the groundwork for inflation targeting and Bank of England independence in the 1990s. The conquest of inflation should be the objective of macroeconomic policy, while fiscal policy should be used mainly in the microeconomic sphere, to create the conditions conducive to growth and employment.

In the main, this approach holds well today, however in certain circumstances, governments will use fiscal policy to give a macroeconomic boost to the economy, and this may be one of those times.

Before the Brexit referendum, the then Chancellor George Osborne claimed that, in the event of a vote to Leave, he would have to cut public spending and increase taxes in an Emergency Budget. Mr Osborne said this could include raising income and inheritance taxes, and cutting the NHS budget. Instead, new Chancellor Philip Hammond, has announced there is to be a “fiscal reset” in next month’s Autumn Statement, with the previous budget surplus target scrapped.

**What do we expect the Chancellor to announce?**

A reduction in the Office for Budget Responsibility’s (OBR’s) GDP growth forecast is very probable, given the spike in Brexit related uncertainty. In itself, this will ensure a higher deficit profile, via the so-called “automatic stabilisers”, even without a discretionary stimulus: tax revenues will be lower than forecast in the March Budget, while spending on benefits will be higher. The OBR rule of thumb is that 1% drop in GDP will add 0.5% to Public Sector Net Borrowing (PSNB) in year 1, so there will be lots of red ink, even before he decides how much room there is for extra easing.

The March Budget had a fiscal tightening profile of c.1% GDP per annum, so what we are really interested in is how big any discretionary fiscal stimulus will be (relative to this baseline), and how it will be implemented.

In an economic slowdown, the evidence suggests that increased spending has a larger impact on growth than tax cuts, which may be saved if there is a rise in household uncertainty. In economic parlance, the average short-term multiplier is much larger for government spending, than for tax cuts.

In September, the Chancellor spoke of well-designed stimulus, limited in duration, quick in impact and contributing to the long-term investment needs of the UK. He has suggested road, rail and housing as key areas of infrastructure investment. With the cost of finance so low, it should be easy to find projects with a positive Net Present Value. Consumption appears to have held up well since the Brexit referendum, so a cut in VAT now looks less likely. It is in the area of investment where the greatest impact of Brexit uncertainty is thought to lie.

The existing budget deficit target on PSNB is 2.9% for fiscal year 2016, however the numbers have been coming in shy of this total, and when the impact of the automatic stabilisers and a discretionary stimulus are added, a deficit of c.4% GDP looks likely. This would compare with a deficit of 3.8% for 2015/16.

As is often the case with UK fiscal policy making, the Prime Minister and the Chancellor will have different intentions when it comes to the Autumn Statement. For the PM, this will be a major political moment, drawing a line under the Osborne years and in tune with her rhetoric about greater state involvement and re-distributional policies.

By contrast, the Chancellor will be keen not to lose hard won fiscal credibility, so he will have to tread carefully: we expect a slower pace of austerity, rather than a large net easing, since a much larger discretionary easing would prevent the budget from returning to balance on a reasonable timescale. Any new fiscal rules are likely to be on a rolling basis (rather than fixed to a particular year), with capital spending and current spending treated differently.
We see three potential Autumn Statement scenarios -

1. A very light package, not much more than automatic stabilisers, as fear of the size of the deficit and debt level prevails.

2. A modest infrastructure package of around 1% GDP over 3 years, on top of the automatic stabilisers.

3. All of the above, plus a reduction in VAT of 2.5 percentage points for one year.

We favour the middle scenario. A modest discretionary fiscal easing relative to the March Budget (£20bn, or just over 1% GDP) and spread over a few years seems likely. This would be focussed on investment, rather than current spending. Given the higher multipliers on investment spending, even a modest discretionary easing would be a positive for growth, at a time when monetary policy is also very loose, and sterling has fallen to very competitive levels.
1. Following a slowdown in recent years, the IMF expect growth in emerging economies to improve this year and next.

2. Shale investment should become less of a drag on US GDP going forward. Stabilisation in the rig count points to a stabilisation in energy profits, which in turn means better news for other sectors dependent on shale activity. This should improve the outlook for business investment more generally.

3. The latest UK BRC-Nielsen shop price index for September showed how strong competition is bearing down on food and non-food retail prices. How far the rise in import price inflation feeds into retail price inflation will depend on the degree of competition on the high street, and to what extent margins can take the strain. Some retailers, notably Tesco, are already resisting attempts by food manufacturers to pass on the full impact of import price rises to the consumer.

4. Subdued nominal wage growth in the eurozone and Japan helps to explain the continued easing bias of the European Central Bank and Bank of Japan.

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