Economics

09 December 2016

Investec Bank plc (UK)

Global Economic Overview

2017 - The Birth of Reflation?

In a momentous year for political surprises, the stand out in terms of economic policy is the prospect of fiscal 'reflation' from the new US administration. Markets are currently in the dark over how much stimulus may be agreed between the White House and Capitol Hill. We do expect stronger global growth in 2017. This has been our expectation for some time and is largely unrelated to our new US fiscal policy assumptions. But there has been a major effect on market sentiment. Risk assets in developed markets have rallied, yields have risen (albeit from extremely low levels) and commodity prices have gained. There may be pressure on other economies to follow suit and alter the mix between monetary and fiscal policy.

Also, deflation fears appear set to be consigned to the history books. This was our primary downside risk 12 months ago. And while China appears to be experiencing a repeat performance of selling pressure on the currency and falling official currency reserves, it is on a much more modest scale than at this time last year. As we have noted before, even the IMF's assessment suggests that the downside risks are less pronounced. Alongside a fiscal boost, Mr Trump risks also bringing a bellicose approach to trade and foreign policy more generally – but our central view is that markets will shrug off these geopolitical risks.

Key calls for 2017:

- 2017 should be a year of firmer global GDP growth; our call is 3.7% from 3.1% in 2016, above historic averages and market expectations. A stronger US economy will be a supportive factor, but by no means the primary story; this is broad based global growth with a solid Chinese performance.
- Our 2017 forecasts envisage the Chinese economy expanding by 6.5%, similar to 2016 (6.6% forecast). We have upgraded our view of US GDP for 2017 to 2.8% from 2.5%; this would be its firmest growth rate since 2005. Mr Trump's stimulus would likely have a more significant boost yet for 2018.
- We see a breakaway from the era of 'lowflation'. The end of the energy price drag has helped to lift inflation numbers, but crucially we envisage reflation being driven by broad based economic improvements and tighter labour markets, particularly in the US, Euro area and in the UK, where fiscal policy now looks set to be less restrictive and even supportive in the US.
- Bond yields should continue to track upwards, lifted by reflation expectations. Markets now share our view that two Fed hikes are likely in 2017. But we are also now forecasting a further three 25bp rate moves in 2018; We see US 10-year Treasury yields reaching 3.00% by end-2017. We look for UK 10-year yields at 2.00% end-2017 and 10-year Bunds at 1.00%.
- We see the USD losing ground against the euro through 2017. A key driver in late-2017 will be talk of the ECB curtailing its QE buying from 2018 onwards. Our EUR:USD call is $1.14 at the end of next year.
- Too much bad Brexit news is factored into the pound - a sterling recovery seems on the cards, at least against the USD, given the scale of its undervaluation. Our end-2017 target is $1.35 from $1.26 now. Note a GBP rebound could weigh on the FTSE100 index as dollar denominated earnings are devalued in sterling terms.
- The rise of anti-establishment parties in a run of Euro area elections will be a key theme. But we do not see these threatening the stability of the Euro or the EU. We expect markets to remain calm in the presence of this political noise.

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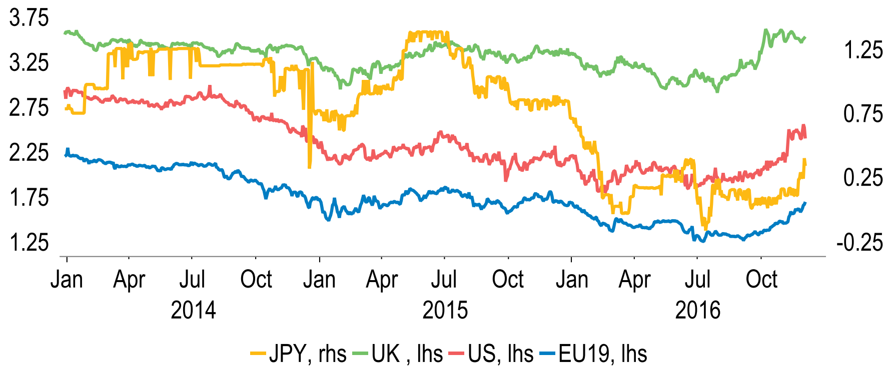
Global

12 months ago we viewed the biggest downside risk to the world economy to be a continued slide in commodity prices. Ultra-low headline rates of inflation for a longer period might have engrained a deflationary mindset to consumers and businesses, discouraging spending and prompting a nasty period of global economic stagnation. This scenario seems to have been averted, helped of course by the oil price recovery (now $54 per barrel), but also by hopes of US fiscal reflation, following Donald Trump's election victory. Market measures of inflation expectations in major economies have recovered sharply, away from the deflationary danger zone (Chart 1).

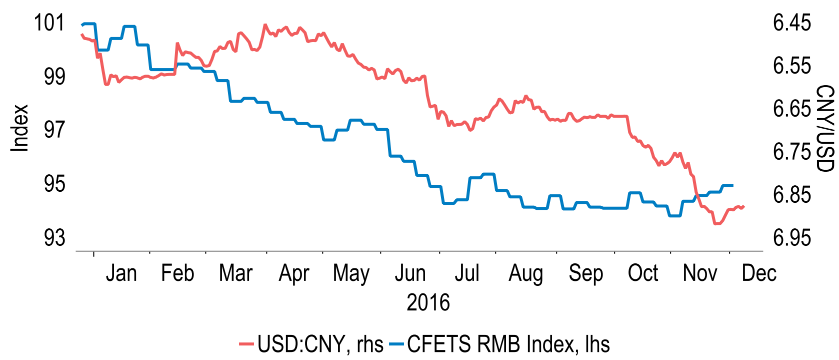
Chart 1: Reflation- global 5y-5y inflation swap forwards (%)



Source: Macrobond, Bloomberg

A further risk a year ago was Chinese financial instability spilling over to global activity. This still poses a threat in 2017 - the Yuan has reached 9y lows against the USD. But in contrast with the start of 2016, there are few fears of a sharp correction in the Chinese economy. Hence Yuan weakness is currently relatively contained and in terms of stocks, the Shanghai index is up by 10% since end-June. Note too Yuan weakness is arguably exaggerated by USD strength – the CNY trade weighted index has held up relatively well. Beijing is reportedly acting to stem capital flight, so while various dangers still lurk, we tend to the view that they pose less of a systemic threat than a year ago.

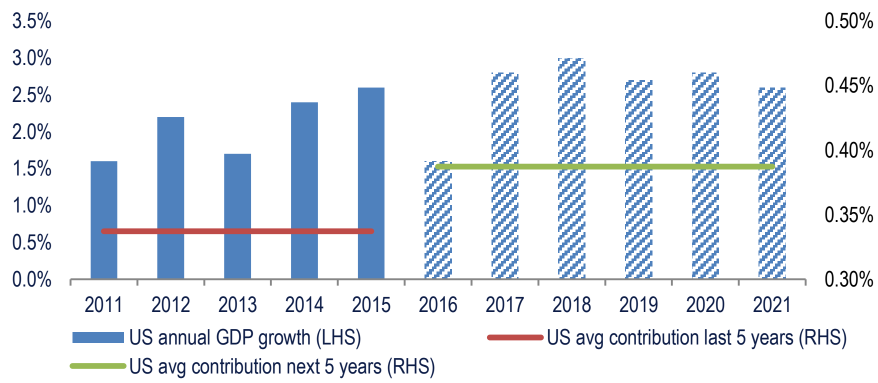
Chart 2: How much Yuan weakness? Performance vs USD and on trade weighted basis



Source: Macrobond

Global equities, in the shape of the MSCI World Index are some 4% higher than before Donald Trump's victory, fuelled by hopes of more expansive US fiscal policy. How much difference to world growth prospects could this make? Much hinges on the size of any package (see US section). But it is unlikely to be a game changer and certainly not comparable to the surge in Chinese growth during 2003-2007, when China added 0.2%-0.9% to annual global GDP (using a benchmark of its prior 5-year growth). For an impact of that magnitude, the US would need to grow between 3½%-8%. That said our world GDP forecast for 2017 stands at 3.7% above the long-term average of 3¼%-3½%.

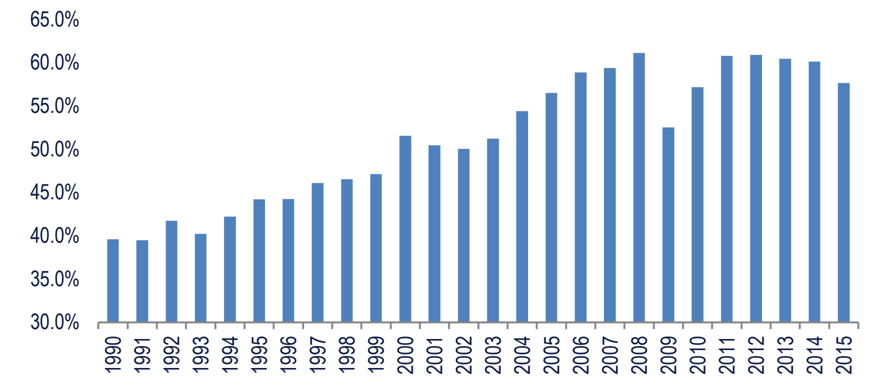
Chart 3: US historic and forecast growth and contributions to global growth



Source: Investec, IMF

One risk to the world outlook, discussed in October, is rising protectionism. Much of course depends on the way in which the US government frames trade policy. But even without an imposition of additional tariffs on economies such as China, the long-term trend of trade liberalisation seems to be coming to an end. Indeed the Trans Pacific Partnership deal is now dead in the water, while we see few prospects of the US/EU deal (TTIP) getting off the ground. Academic studies have long espoused the benefits to GDP of free trade. But unless those benefits are seen to reach key sections of the population, free trade is becoming a hard sell.

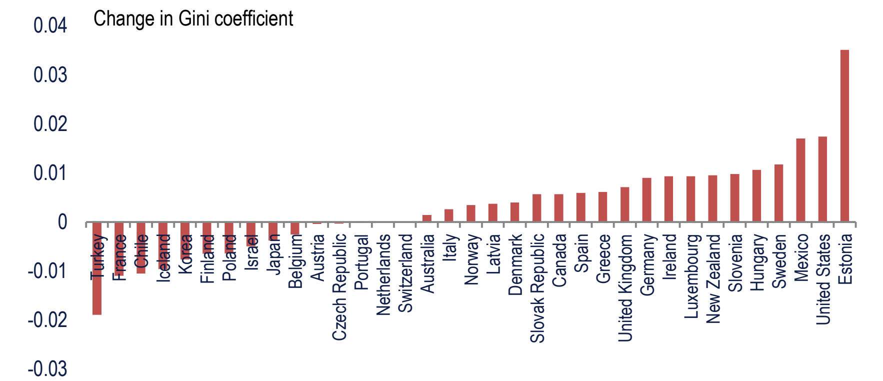
Chart 4: World goods and services trade % of GDP



Source: World Bank

A look at inequality data may provide some explanation behind antipathy towards globalisation and the various anti-establishment votes this year. Chart 5 shows changes in 'Gini coefficients' in OECD countries between 2010 and 2013/14. These show that 23 of the 35 countries recorded rising inequality. But simple measures such as this cannot account totally for hostility to free trade (and immigration) and the 2016 political backlash. They do not, for example capture properly middle income households, often the 'swing' group determining elections and referendums. In this respect a nuanced approach for individual countries may be more informative (see US and UK sections).

Chart 5: Income inequality risen in most OECD economies (change between 2010-2014)

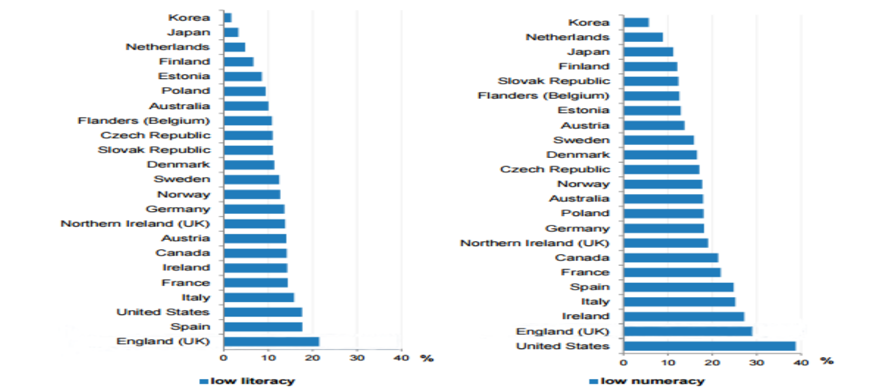


2010 data for Switzerland unavailable

Source: OECD

Another question for 2017 is the extent to which governments open up the infrastructure spending taps to stimulate their economies. Public sector capital investment is currently considered to be the holy grail to lift productivity. This probably makes intuitive sense in many western economies at present. Even so, it may be worth noting that capital expenditure is not necessarily always the answer, as China arguably currently demonstrates. A goal we would judge worthwhile is to improve literacy and numeracy rates. A 2012 OECD study (Chart 6) placed the UK and the US near the bottom of the pile on both measures. One problem is that this is a longer-term issue, outside political time horizons.

Chart 6: A slow (but critical) win? Estimated innumeracy and illiteracy rates

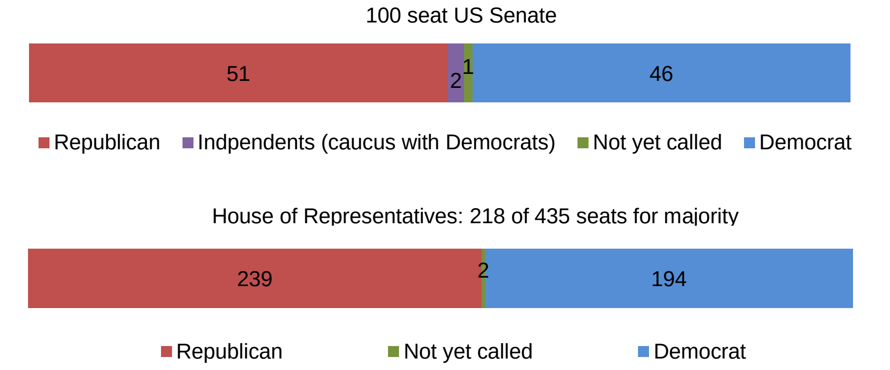


Source: OECD PIAAC survey (2012)

United States

From 20 January 2017 Donald Trump will assume the US Presidency with the new Congress in place from 3 January. That will see the Republicans 'controlling' the White House, Senate and House of Representatives. It does not mean that the new President will have free rein to implement his far reaching election trail promises. The balance of power in the Senate is such that the Democrats can readily filibuster (delay) proposals. And even amongst the Republicans in Congress, Mr Trump will need to moderate his plans to gain widespread approval, particularly on the fiscal front. Indeed, we note that recent Republican tax plans (the Brady/Ryan plan) were made in a more conservative fiscal framework than Mr Trump's ideas.

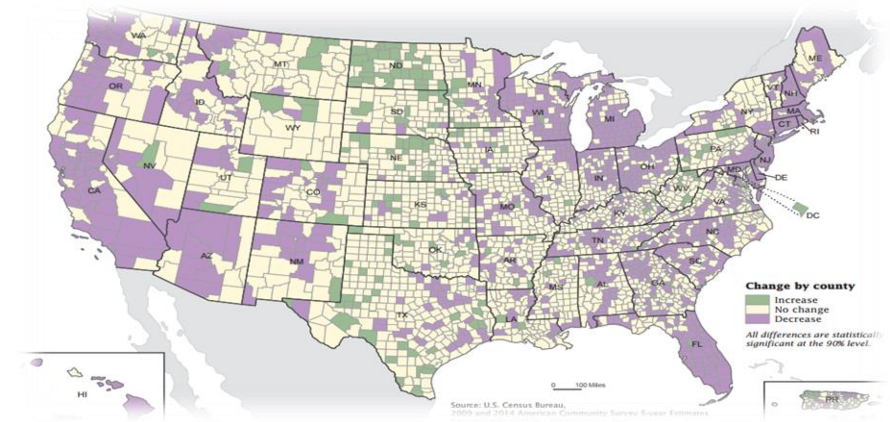
Chart 7: US Congress Republican controlled, but not with free rein



Source: Investec

The President-Elect succeeded in the election campaign by appealing to the 'squeezed middle', many of whom have been frustrated that their income has shrunk over President Obama's recent term (Chart 8). We imagine Mr Trump's advisers are telling him that he has to get incomes growing again to maintain support of these groups. In that context it is not surprising that Mr Trump has touted a huge fiscal stimulus and massive tax cuts over the election campaign, with the aim of getting growth up to 3-4%. Mr Trump has talked of $550bn of infrastructure spending and tax cuts that could amount to 2-3½% of GDP over the next few years. Given Congressional restraints we do not expect all this to be approved, but…

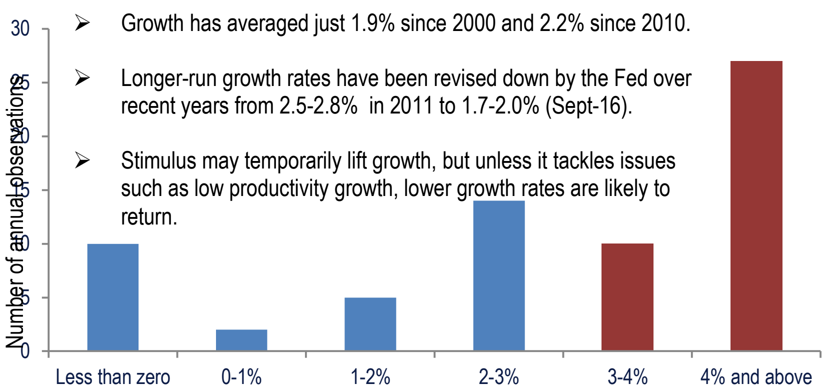
Chart 8: Change in real gross median household income 2005-2009 to 2010-2014



Source: US Census Bureau

…even working off conservative estimates of fiscal multipliers from the Congressional Budget Office, our analysis points to a notable uplift to growth (Chart 9). Our expectation is that H2 2017 and 2018 is when the stimulus boost really arrives with the new Treasury Secretary, Steven Mnuchin driving this forward, within Congressional constraints. We look for GDP to expand by 2.8% in 2017 (prev. 2.5%) and 3.0% in 2018. However we note that any boost to growth could prove temporary; unless Mr Trump tackles issues such as labour force growth and the US's low productivity growth, ambitions of returning to 3-4% rates permanently, may well be a tall order (Chart 9).

Chart 9: US annual growth rates since 1948 – 4% plus used to be the norm – now a tall order?

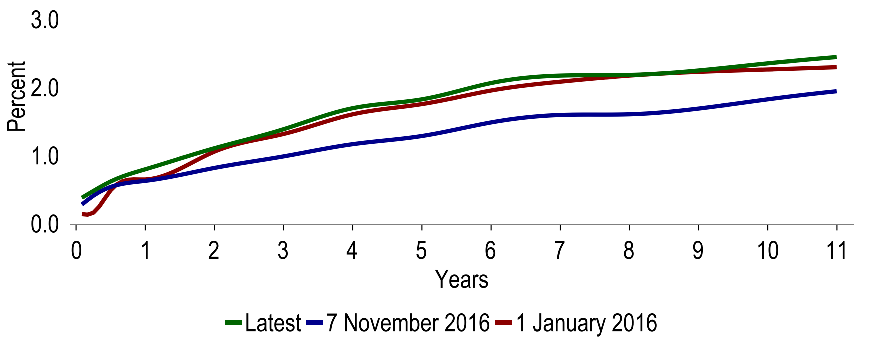


Source: BEA data, Investec

Investec

At face value the Trump fiscal plans have significant implications for the public debt trajectory. Under current law debt is forecast to rise from 77% to 86%, of GDP by 2026. Under Trump's plans, the Committee for a Responsible Budget estimates that debt would be up to 127% by 2026. And whilst we expect only a partial enactment of Trump's plans, these numbers give us a firm steer on the direction of trend. Alongside markets betting that the stimulus will lead to higher inflation too, Treasury yields have moved up; indeed, Chart 10 shows how the yield curve has reverted to its year open position post-election, as if the low yield period never happened. Our expectation is that Treasury yields will continue to drift upwards over the next two years; we forecast 3.00% end-2017.

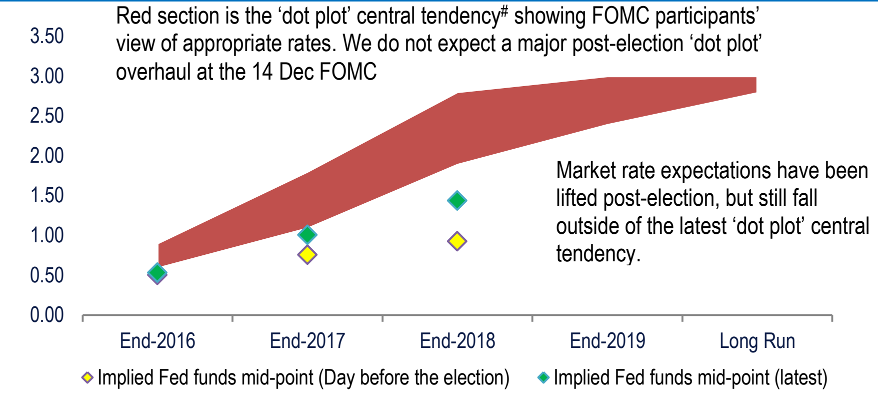
Chart 10: Post-Election, the yield curve reverted to start-of-year levels



Source: Macrobond

Steady Fed tightening will be one driver alongside rising inflation expectations and a rising debt trajectory. The election has budged interest rate expectations up, closer to our own prediction (50bp of increases next year, with the Fed funds rate at 1-1.25% end-2017). One debate has been over whether the Fed will tighten more quickly on expectations that a looser fiscal stance will spark too much inflation. However Fed Chair Yellen is cautious and, at least until her term ends in 2018, we expect the Fed to tread carefully waiting for greater clarity on how much stimulus Mr Trump enacts. We expect that Dr Yellen will be replaced with a Trump pick once her term ends in February 2018, but it may not be a radically more hawkish candidate, given the President-Elect's growth ambitions.

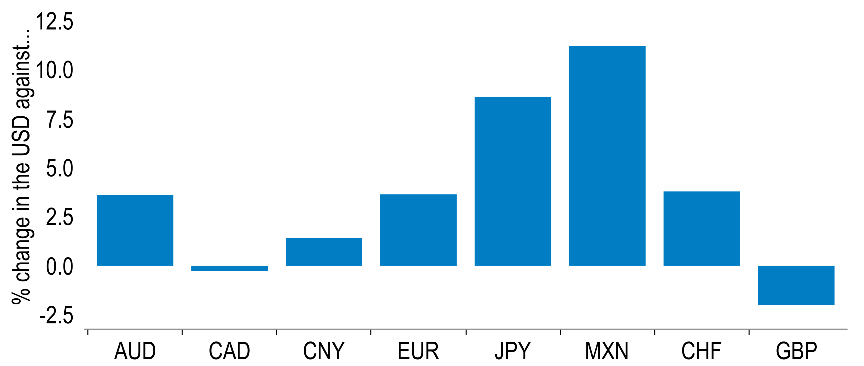
Chart 11: FOMC 'dot' plot – Fed to make few changes to rate guidance post-election?



#This is the 21 September 'dot plot' with the next update due on 14 December. Central tendency excludes the top 3 and lowest 3 FOMC participant forecasts. Source: Federal Reserve Board, Bloomberg, Investec

Near term, it seems likely that the Fed funds target rate will be raised from 0.25-0.50% to 0.50%-0.75% on 14 Dec. We expect this to help the dollar hold its recent strength at end-2016. However, with more Fed tightening 'priced-in' through 2017 we expect that the year ahead could bring something of a retracement in the dollar, particularly as the ECB talks more about bringing its QE purchases to a halt. Hence our forecast is for the Euro stand at $1.14 against the USD at end-2017. However we caution that any visible steps by Mr Trump that ignite fears of a tariff war, could spark greater dollar strength as investors seek safe haven cover.

Chart 12: US dollar is up against most major currencies since the election – will it stick?



Source: Macrobond

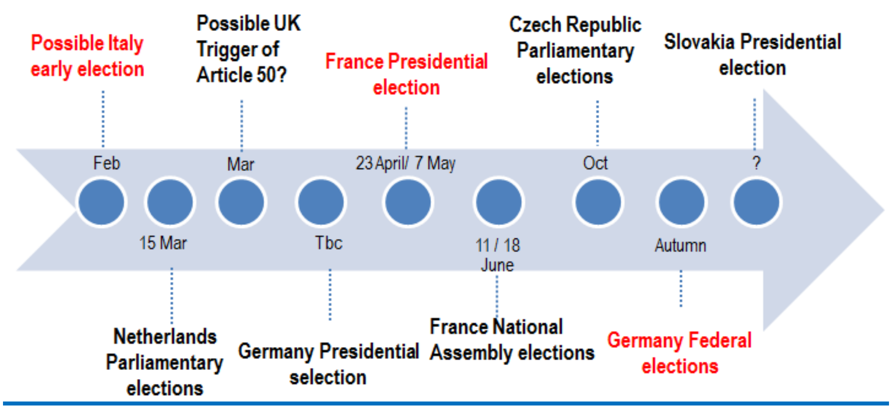
Eurozone

2017 is set to be a critical year for politics in the Euro area with a long string of elections scheduled, possibly including an election in Italy after the 'no' vote in the constitutional reform referendum. The obvious context is the rise of anti-establishment parties and the threat to 'risk on' markets. But we are tempted to question this given economic or market reactions to 'protest' results such as the UK's EU referendum, Donald Trump's victory and the Italian 'no' vote. One lesson may be that markets are resilient to such outturns, perhaps as they are sceptical over how much policy will change for the worse. And when there is a 'negative' reaction it can be restricted to certain markets. That said, a government threatening to leave the euro might face a different reaction.

Ten years ago, several of these 'protest' parties did not exist, including Spain's Podemos, Italy's 5 Star and Germany's AfD. And whilst 'protest' parties are evident in a number of geographies, not all represent the same ideology; it is those that pursue an active desire for euro or EU membership referenda which are of most concern. In particular, the 5 Star in Italy and Geert Wilders' Freedom Party in the Netherlands are two such worries, with both polling strongly. However it should be noted that even if 5 Star were to gain power, constitutionally a euro referendum might be difficult to achieve, and a majority remains in favour of euro membership. Meanwhile an EU referendum in the Netherlands is also seen as facing notable legal issues.

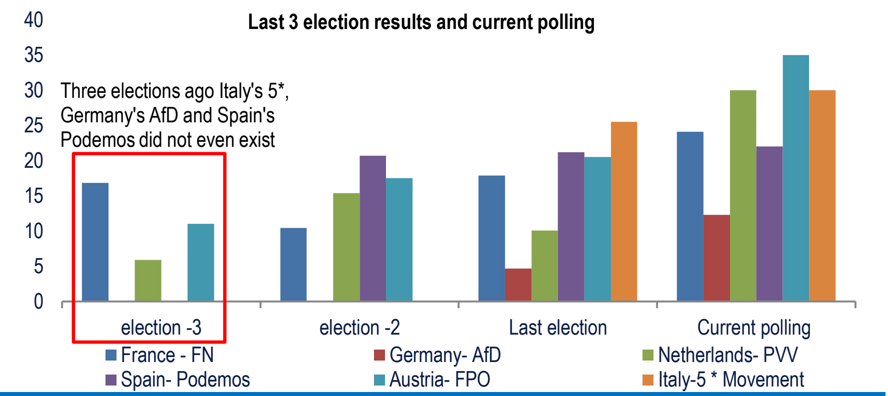
There are many diagrams depicting the extent to which markets have persistently overestimated central bank interest rates and bond yields. So when we restate our Euro area growth forecast of 1.8% next year, after 1.7% this, it might be met with relative disdain. But consensus forecasts have not proved overoptimistic in recent years. As Chart 15 shows, GDP growth in 2014 and 2015 *overshot* expectations at the start of the year, with forecasts for 2016 seemingly spot on. Stronger world growth should be one driver (though as we note, not really due to US fiscal reflation), with the competitive level of the euro and positive credit dynamics helping.

Chart 13: Political timeline – key European elections in 2017



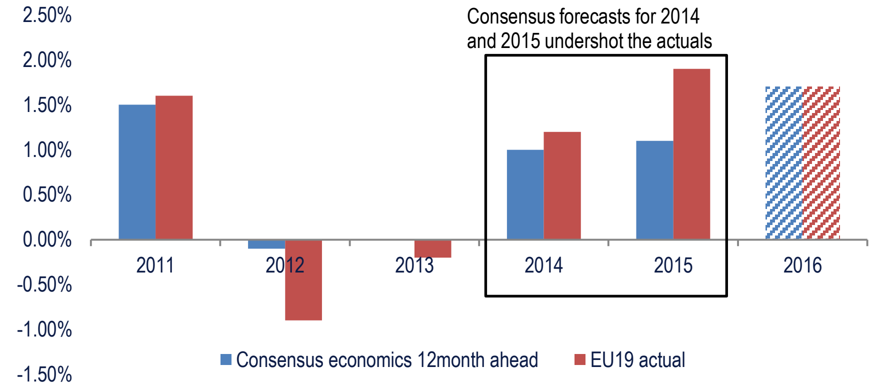
Source: Investec

Chart 14: The rise of the anti-establishment parties over the last decade



Source: Various election

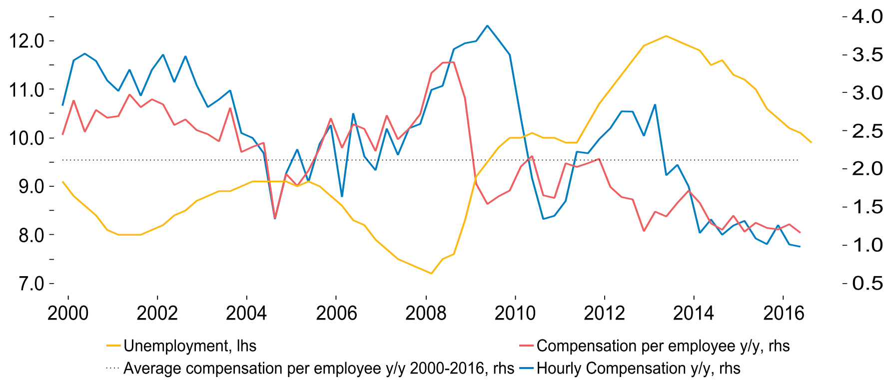
Chart 15: Consensus economics forecasts for Euro area growth proved too pessimistic



Source: Eurostat, Consensus Economics

The spectre of deflation, which hung over the eurozone at the start of 2016 looks set to fade further over 2017. HICP inflation should trend back above 1%, due to the fading effects of past energy price falls. Meanwhile a key focus for the ECB will be the progress of core inflation towards 2%. On this front, a firming in employee compensation thanks to falling unemployment and a closing output gap generally, should be supportive. The ECB's own forecasts envisage pay growth strengthening to 1.7% in 2017 and 2.1% 2018. The European Commission forecasts a closing in the output gap to -0.2% in 2018, from the current estimate of minus 1.0%.

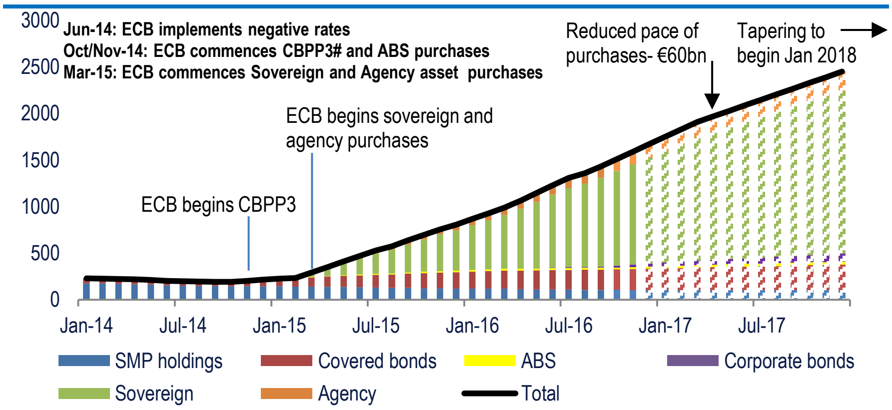
Chart 16: Euro area unemployment (%) and employee compensation (% y/y)



Source: Eurostat, Macrobond

In the short-term however, ECB policy is set to remain highly accommodative. December's Governing Council meeting saw the ECB extend asset purchases for another 9 months beyond the current end date of March 2017, although this is at a reduced pace of €60bn. This, as President Draghi stressed, is not a taper. Our expectation is that a formal tapering of asset purchases will be an issue that becomes significant for markets towards the end of 2017. We anticipate that the pace of purchases would be wound down over the first half of 2018 with the ECB not raising rates (deposit rate) until a year later in June 2019.

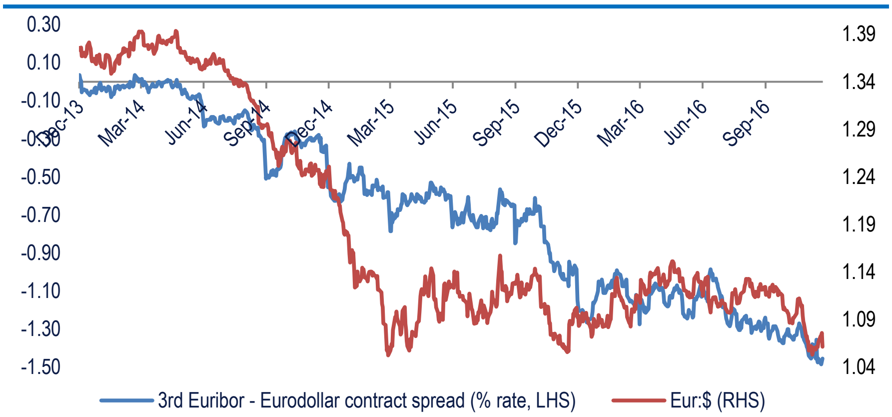
Chart 17: ECB asset purchase holdings and Investec forecasts (cumulative, €bn)



Covered Bond Purchase Programme 3 (CBPP3) Source: ECB, Investec

ECB policy will be a key driver in a euro appreciation next year, overshadowing any short term political bouts of volatility. Whilst the re-pricing of Fed policy has supported the USD, we suspect that an end to ECB QE will see a similar euro revaluation pushing €:$ to $1.14 by end-17. The expectation of the ECB halting QE purchases and the prospect of ECB rates moving higher at some point, might have a similar effect to when the Fed started winding down QE purchases. Between the Fed taper announcement in Dec-13 and the halting of purchases in Oct-14, the USD strengthened 13% against the euro, with the introduction of a negative ECB deposit rate a further drag on the euro. Our $1.14 target would imply a rise of half this magnitude.

Chart 18: ECB monetary policy re-evaluation to support euro in 2017?

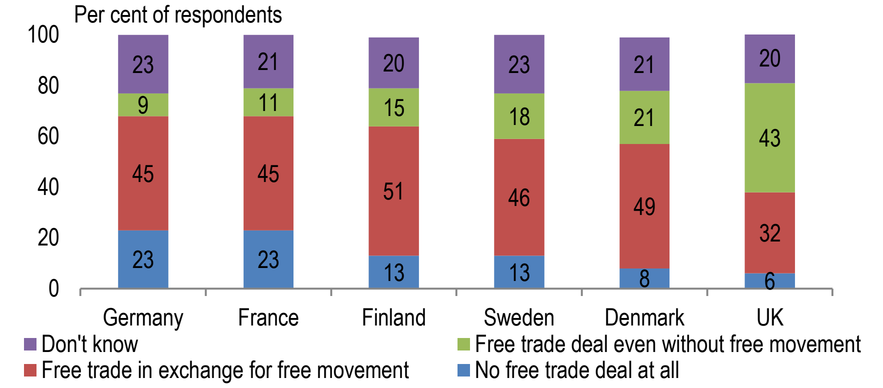


Source: Bloomberg

United Kingdom

2017 is likely to mark the start of two difficult years (plus) of negotiations over the UK's Brexit arrangements. Current plans see 'Article 50' being triggered in March 2017. But this timing of formal Brexit talks could slip if legal proceedings currently underway rule that Parliament needs to be given a vote. The British government would clearly like to have its cake and eat it, seeking to maintain as much access to the single market as possible whilst also seeking to limit migration markedly. But, consistent with the mood of their electorates (Chart 19) EU officials have been clear that the UK cannot end up with better terms than existing members, for fear it might trigger more exit momentum.

Chart 19: Don't let them eat cake! Few EU voters want free trade without free movement…*

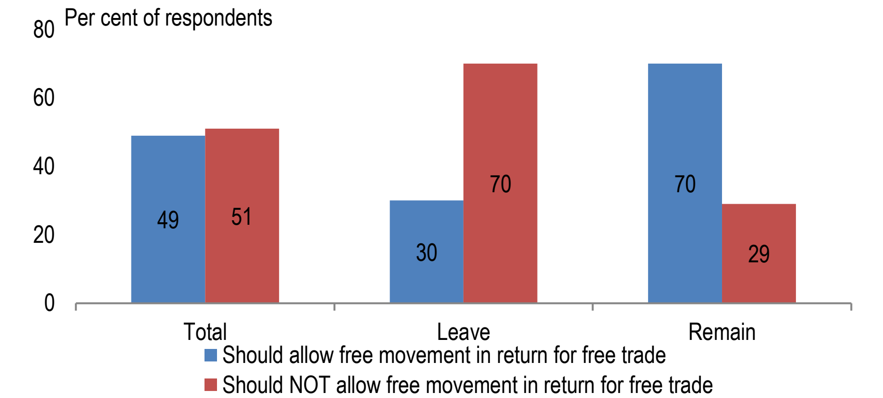


*YouGov Survey Jul 2016, "[regarding a UK-EU deal], which of the following best reflects your view?"

Source: YouGov

While migration limits are a government priority, UK public opinion, faced with the migration/trade dilemma, might be more nuanced than the headlines suggest. Chart 20 shows that about one half of UK voters would allow 'free movement' in return for 'free trade' (of course the definitions are open to interpretation). Interestingly, this broadly reflects the result of the EU vote itself. The Cabinet appears to be divided over this too, not helping the government develop a clear negotiating plan. Our hope is that an optimal point along this trade-off can be reached next year. Recently, talk has been over the UK entering a transitional arrangement when the negotiating period ends in spring 2019.

Chart 20: …half of UK voters would accept free movement for free trade – scope for a deal?*

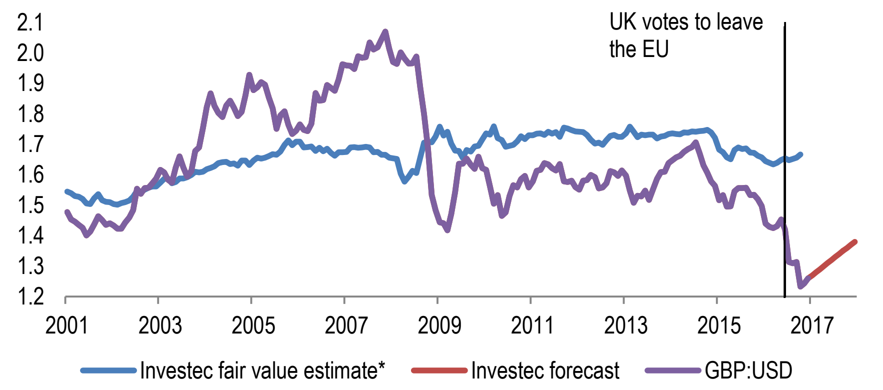


*NatCen survey Nov 2016, "Should Britain allow people from the EU to live and work here in return for free trade?"

Source: NatCen Social Research

Transitional arrangements might include the government paying into the EU budget after 2019 to maintain trade access whilst new trade deals are struck. This possibility has sparked something of a recovery in the pound which is now 6% above October lows, in trade-weighted terms. Our expectation is that with UK Bank rate steady through 2017 (see below) and Fed rate moves 'priced-in', we see sterling climbing a little above its extremely undervalued level (Chart 21); we forecast $1.35 versus the USD end-2017. We note that sterling gains will drag on UK corporates' dollar denominated earnings. So the sterling related fillip to the FTSE 100 seen since the Brexit vote might start to unwind.

Chart 21: As Brexit talks calm down, we see sterling rising – that could weigh on the FTSE 100

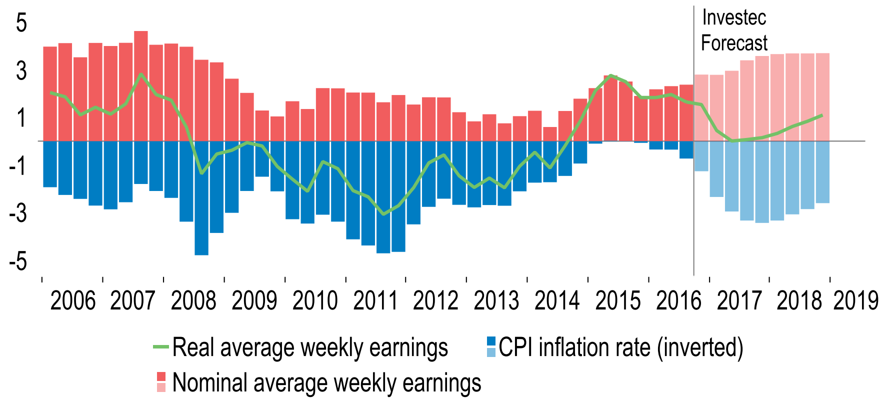


Source: Datastream, Marobond, Investec calculations

Investec

The economy has held up remarkably well since the Brexit vote. Higher uncertainty has not led businesses to slash investment and hiring. With Q4 data to be published, we see 2016 GDP growth of 2.0%, close to last year's 2.2%. But challenges lie ahead. For one, we do still expect corporate spending to be soft next year, given continued Brexit-related uncertainty. And although the weaker pound should provide a fillip to exporters, we think it will also drive CPI inflation to 3%-plus by the end of next year. Although we see nominal wage growth rising a little next year (Chart 22) higher inflation will squeeze real household incomes and spending. So we think that growth will slow (to 1.4%) next year.

Chart 22: A squeeze on households is coming (pp contributions to y/y real wage growth)



Source: Macrobond, Investec

With the UK only set for a moderate slowing, the new Chancellor has seen little need to loosen fiscal policy dramatically. While Philip Hammond has ditched George Osborne's plan to close the budget deficit by the end of the decade, consolidation is set to continue – the OBR expects government spending to fall from 22% to 20% of GDP between now and 2022. But the tone of debate has changed a little. 'Word clouds' comparing Mr Osborne's 2010 Autumn Statement with Mr Hammond's 2016 speech show fewer mentions of "responsibility" and "balanced budgets" and more nods to "investment" and "infrastructure".

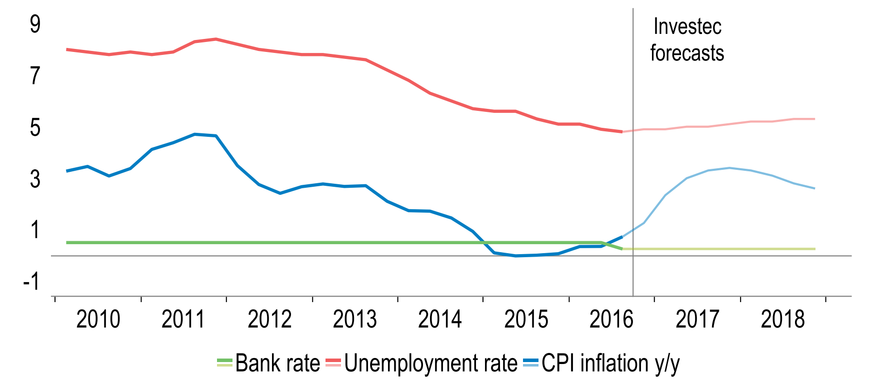
Chart 23: A slightly softer fiscal tone? Autumn Statement speech 'word clouds'*

*The size of a word increases with the number of times it is mentioned in the statement

Source: Word It Out, UK Parliament, Investec

Faced with an economic outlook outlined above, the Bank of England faces a dilemma. The 3%-plus inflation rate we are forecasting next year is well above the MPC's 2% target. But with the economy set to slow (albeit modestly) our view is that the unemployment rate will begin to edge upwards (Chart 24). But the currency effect on inflation should drop out over the following two years. Mindful of this, and aiming to guard against sharper rises in unemployment, we see the MPC standing pat on policy for the whole of next year, with Bank rate at 0.25%. The risk of the wage-price spiral necessitating sharp rises in Bank rate is a low one.

Chart 24: Despite higher inflation, Bank rate to stay at 0.25% to keep unemployment in check



Source: Macrobond, Investec

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Global Forecasts

GDP Growth (%)

	Global	US	Japan	China	UK	EU19	Germany	France	Italy
2011	4.2	1.6	-0.1	9.5	1.5	1.6	3.7	2.1	0.7
2012	3.5	2.2	1.5	7.8	1.3	-0.8	0.7	0.2	-2.9
2013	3.3	1.7	2.0	7.7	1.9	-0.2	0.6	0.6	-1.7
2014	3.4	2.4	0.2	7.3	3.1	1.1	1.6	0.7	0.2
2015	3.2	2.6	1.2	7.2	2.2	1.9	1.5	1.2	0.6
2016	3.1	1.6	1.0	6.6	2.0	1.7	1.7	1.2	1.0
2017	3.7	2.8	0.9	6.5	1.4	1.8	1.6	1.3	1.2

Source: Datastream, Investec

Key Official Interest rates (%, end quarter):

	US Fed funds	Eurozone refi rate	Eurozone deposit rate#	UK Bank rate	Japan call rate*	Australia cash rate
Current	0.25-0.50	0.00	-0.40	0.25	-0.10	1.50
2016						
Q1	0.25-0.50	0.00	-0.40	0.50	-0.10	2.00
Q2	0.25-0.50	0.00	-0.40	0.50	-0.10	1.75
Q3	0.25-0.50	0.00	-0.40	0.25	-0.10	1.50
Q4	0.50-0.75	0.00	-0.40	0.25	-0.10	1.50
2017						
Q1	0.50-0.75	0.00	-0.40	0.25	-0.10	1.50
Q2	0.75-1.00	0.00	-0.40	0.25	-0.10	1.50
Q3	0.75-1.00	0.00	-0.40	0.25	-0.10	1.50
Q4	1.00-1.25	0.00	-0.40	0.25	-0.10	1.50
End year 2018	1.75-2.00%	0.00	-0.40	0.25	-0.10	1.50

We expect the ECB deposit rate to remain at -0.40% until June 2019 and the refi rate to remain at zero until Q3 2019. We expect the ECB to announce a taper of its QE programme in Q4 2017.

* The BoJ's rate relates to its short term policy interest rate as part of its new Yield Curve Control policy – the BoJ currently applies a negative interest rate of -0.1% to the Policy-Rate Balances in current accounts held by financial institutions at the Bank

Source: Reuters, Investec

10-year government bond yields (%, end quarter):

	US	Germany	UK	Japan
Current	2.42	0.36	1.39	0.04
2016				
Q2	1.47	-0.13	0.87	-0.22
Q4	2.50	0.25	1.50	0.00
2017				
Q2	2.75	0.50	1.75	0.00
Q4	3.00	1.00	2.00	0.00

Source: Reuters, Investec

FX rates (end quarter/ annual averages)

		Current	2016				2017				2015	2016	2017
		9-Dec	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	average	average	average
Euro	€:$	1.061	1.14	1.11	1.12	1.07	1.08	1.09	1.12	1.14	1.11	1.11	1.10
Sterling	€:£	0.845	0.793	0.831	0.865	0.84	0.85	0.85	0.84	0.85	0.73	0.81	0.85
	(£:€)	1.18	1.26	1.20	1.16	1.19	1.18	1.18	1.19	1.18	1.38	1.23	1.18
	£:$	1.26	1.44	1.34	1.30	1.27	1.27	1.28	1.33	1.35	1.53	1.37	1.30
Yen	$	114.5	112	103	101	113	111	109	107	106	121	108	109
	€	121.5	128	114	114	120	120	119	120	121	134	120	120
	£	143.9	162	137	132	143	141	140	143	143	185	148	142
Aussie Dollar	$	0.747	0.77	0.75	0.77	0.75	0.75	0.76	0.76	0.76	0.75	0.75	0.76
	€:AUD	1.421	1.49	1.49	1.47	1.42	1.44	1.43	1.47	1.50	1.48	1.49	1.45
	¥	85.5	86.1	76.4	77.6	84.8	83.3	82.8	81.3	80.6	91.1	80.5	82.5
	£:AUD	1.682	1.88	1.79	1.69	1.69	1.69	1.69	1.75	1.78	2.03	1.83	1.72
Swiss Franc	€	1.08	1.09	1.08	1.09	1.09	1.10	1.11	1.11	1.12	1.07	1.09	1.11
	$	1.02	0.96	0.97	0.97	1.02	1.02	1.02	0.99	0.98	0.96	0.98	1.01
	£	1.28	1.38	1.30	1.26	1.30	1.29	1.31	1.32	1.33	1.47	1.34	1.31

Source: Reuters, Investec