FINURA PARTNERS

POINTS OF VIEW

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THE POST-REFERENDUM SIREN OF THE UK ECONOMY

Whilst the most recent business and consumer surveys show a sharp fall in confidence in the immediate aftermath of the Brexit vote, it is still too early to conclude that activity has deteriorated.

On the business side, the UK Purchasing Managers' Index (PMI), a survey-based indicator of business activity, dipped into contraction territory for both the manufacturing and services sectors. There was particular weakness in the services sector, with its PMI dipping to the lowest since March 2009. The New Business Index also slumped to the lowest since March 2009 and the Employment Index entered contraction for the first time in nearly four years.

On the consumer side, the GfK "Brexit special" consumer confidence survey shows the sharpest monthly fall in 21 years. In particular, general economic outlook and Major Purchase Index dropped sizeably. While these indicators point to a high risk of recession in the second half of 2016, it is worth noting that survey data are generally more prone to knee-jerk over-reaction. It is important to focus on how hard data evolves over the next couple of months to gauge the actual economic impact from the Brexit vote.

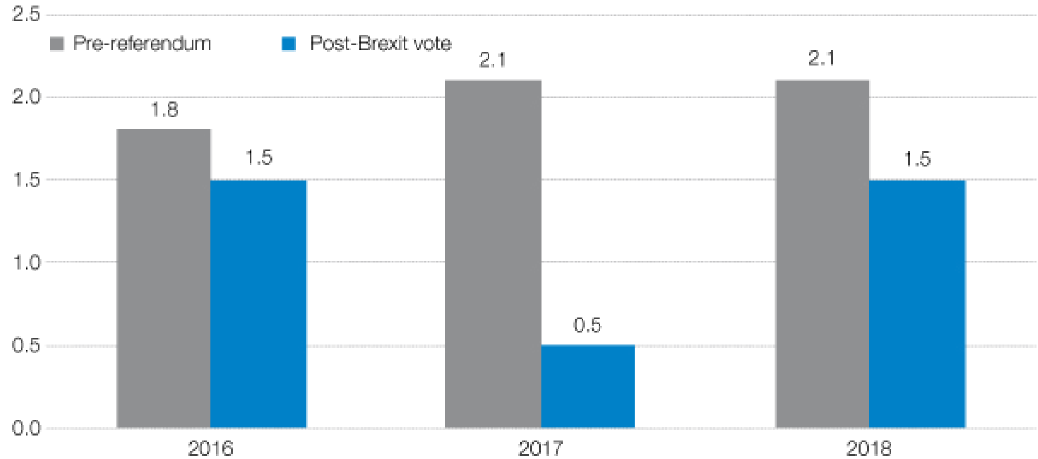
UK labour market

One reason to be less pessimistic is that the labour market strengthened further in the run-up to the referendum, suggesting fundamentals for consumption remain resilient despite the fall in confidence. There was a 176,000 gain in employment over the three months leading up to May, and the unemployment rate fell to 4.9% which is the lowest since September 2005. While job vacancies continued to hover at near-record high levels (750,000) in May, hiring plans may be put on hold as corporates re-evaluate strategies. While we are likely to see a hiatus in hiring due to uncertainty, it is business-as-usual for now until more clarity is known. As long as the labour market remains resilient, consumption is likely to remain steady and provide a cushion to growth.

UK growth

Unsurprisingly, growth estimates for the UK have been lowered after the Brexit vote, from 1.8% to 1.5% in 2016 and from 2.1% to 0.5% in 2017, respectively.

Consensus estimates for UK GDP growth (%)



Source: Bloomberg

While we acknowledge that UK growth will slow, we think expectations have turned too pessimistic. There is some evidence that the weaker sterling is helpful in attracting foreign interest in UK assets. Corporates are likely to remain business-as-usual and in wait-and-see mode within the next six to 12 months. Moreover, both monetary and fiscal policy will likely be loosened to support the economy. Hence, UK growth may not slow as drastically as some have pencilled in.

The Brexit vote means the Bank of England (BoE) will remain extremely accommodative in the foreseeable future. A 0.25% rate cut is expected at the Monetary Policy Committee meeting in August, after strong signalling from its July meeting minutes. Unconventional easing will likely be discussed and is possible, but providing a big stimulus package (a rate cut plus an increase in the size of asset purchase program) in August seems a bit premature, especially as the new government is likely to scale back on austerity. We continue to believe inflation risks are increasing in the UK, fuelled by the over 10% fall in sterling and the recovery in energy prices.

However, we believe the BoE has an asymmetric view on the risk of inflation, favouring easier policy over an overshoot in inflation. With a more dovish BoE, slowing growth and prolonged uncertainty, we think sterling is susceptible to further weakness.

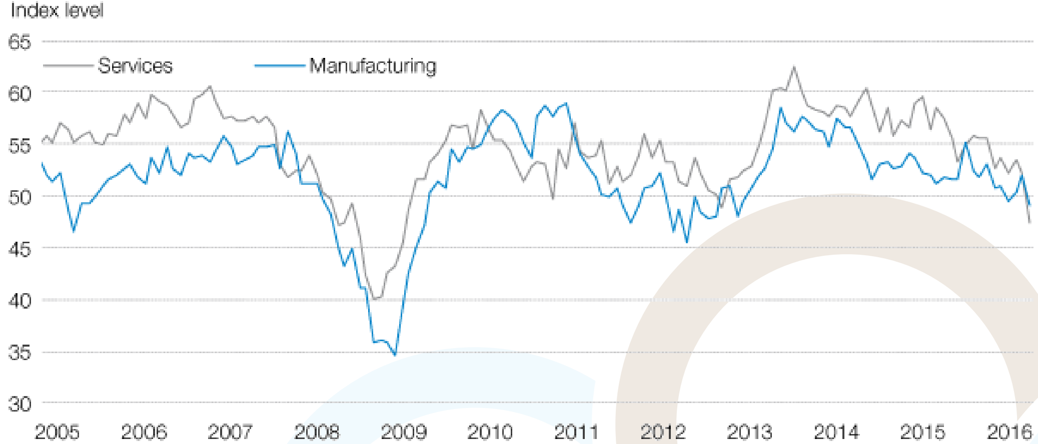
International outlook

With the UK being the fifth largest economy in the world, countries with close economic linkages to the UK are unlikely to be unaffected. We believe Brexit may pose modest downside risk to eurozone growth, but limited impact to economies elsewhere. On the reassuring side, the latest round of eurozone PMIs show resilience post Brexit vote, with both services and manufacturing PMI down only trivially in July. However, the PMI Business Expectation Index fell to a 19-month low and the ZEW survey, a measure of investor confidence, fell to a four-year low in July.

While real activity is impacted little for now, risk to growth is modestly skewed to the downside post the Brexit vote. Both economic and political uncertainty are likely to undermine investment, while the recovery in energy prices since early this year may restrain consumption growth. In the near-term, the Italian constitutional referendum in October is likely to inject political uncertainty as it is a symbolic vote of confidence for the current administration.

Last but not least, the European banking system is potentially vulnerable to problems in the Italian banking sector, related to the huge number of non-performing loans. Although we believe the situation is manageable with an eventual resolution, the major issue is the lack of confidence in the banking system, which may hold back the credit-driven recovery in the region. As a result, we have turned more cautious on the eurozone.

UK Purchasing Manager Indices (PMIs)

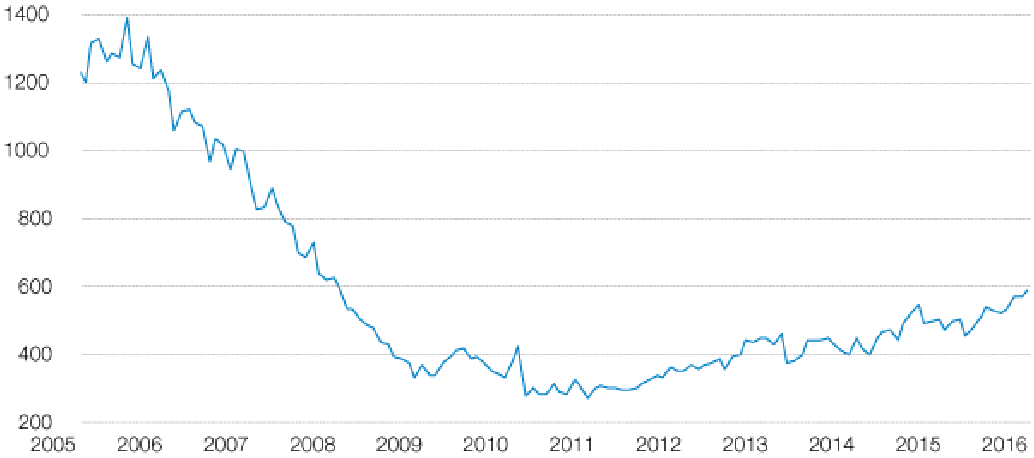


Source: Bloomberg

With regards to monetary policy, the European Central Bank (ECB) is likely to leave policy on hold as it takes time to assess Brexit's impact on the eurozone. It is clear from comments made by Mr. Draghi that the ECB may add further stimulus if needed. We think a further rate cut is unlikely given the negative impact on banks. Instead, the ECB may make technical changes to its asset purchase program, such as relaxing the capital key, as more government bonds have become ineligible for purchase due to negative yields.

Being relatively shielded from the uncertainty in Europe, the US continues to show good momentum. US data continues to suggest solid economic activity on all fronts, from job growth and housing market activity to industrial output and household demand. In particular, the strong bounce in nonfarm payrolls in June (287,000 after a disappointing 11,000 in May) removed concern on a reversal in the strength in the labour market. The Institute of Supply Management Index, a survey-based measure of business activity, showed manufacturing and services output growth picking up to the fastest rates since February 2015 and December 2015 respectively. Recent US housing data continue to suggest the momentum in the sector remains positive, with existing home sales reaching the highest level since early 2007 and new home sales trending at an eight-year high.

US new home sales (K)



Source: Bloomberg

Despite strong domestic activity that would seem to warrant continued policy normalisation, the Fed has turned more cautious after the Brexit vote. Futures markets are no longer looking for a Fed funds rate increase in 2016, with the earliest move expected in March 2017. We think there is chance for one rate increase this year if the global economy holds up better than expected after the Brexit vote and financial markets remain resilient.

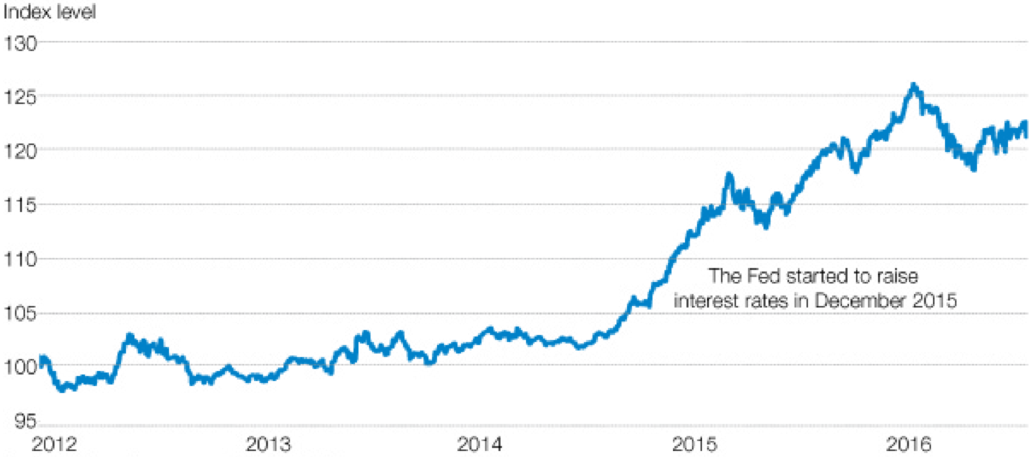
First published on 29th July 2016 by Janet Mui, Global Economist at Cazenove Capital Management.

WHAT IS NEXT FOR THE US DOLLAR?

The trade-weighted US dollar has gained more than a quarter from the end of 2013 to the start of 2016. So, has the dollar peaked?

To answer this question, we need to look at the key drivers of the dollar rally and examine whether their influence can be sustained.

US trade-weighted dollar index



Source: Bloomberg as at August 2016.

Monetary policy divergence between the Federal Reserve (the Fed), the European Central Bank (ECB) and the Bank of Japan (BoJ) was arguably the most important driver of the dollar rally. The dollar started to gain momentum when the Fed began to taper its quantitative easing program in December 2013, a process that concluded in October 2014. As the US labour market continued to tighten, the Fed began warming the markets to the idea of policy normalisation. Meanwhile, the ECB and the BoJ were actively rolling out aggressive monetary stimulus.

The dollar reached a peak after the Fed raised interest rates in December 2015, the first increase in nine years, further widening interest rate differentials between the US and other major economies.

At the start of 2016, financial markets faced a turbulent time due to the unexpected negative interest rate policy by the BoJ, as well as further devaluation of the Chinese yuan. Although the Fed has a domestic mandate of full employment and a 2% inflation target, international developments have become increasingly dominant to its reaction function. After the Brexit vote, the Fed has become even more cautious, citing increased uncertainty over global growth and confidence.

Although most indicators point to robust US activity, pockets of weakness and occasional data disappointment have been enough to unnerve markets and influence expectation with regard to Fed policy. For instance, the US economy expanded by only 1.2% (quarter-on-quarter annualised) in the second quarter of 2016, a pick up from the first quarter but well short of expectations. As a result of this, and also reflecting heightened external uncertainty, futures markets are no longer looking for a Fed funds rate increase in 2016, with the earliest move not expected until September 2017.

For the moment, it seems that the extent of monetary policy divergence the markets had been expecting is unlikely to be realised. As a result, the key catalyst of the dollar's strength is losing its strength, and it seems probable that the dollar has peaked for the time being. Nonetheless, the US still enjoys the best growth prospects and has the highest government bond yields amongst major economies. Together, these are likely to mean the dollar remains stable and is unlikely to weaken significantly.

First published on 4th August 2016 by Janet Mui, Global Economist at Cazenove Capital Management.

MIXED POLICY SIGNALS THREATEN TO UNDERMINE CONFIDENCE

Following its August meeting, the Monetary Policy Committee (MPC) of the Bank of England (BoE) has announced three changes to policy.

First, it has reduced Bank Rate from 0.5% to 0.25%, the first change since March 2009. Second, it has introduced additional quantitative easing (QE) of £70 billion. Third, the Bank has introduced a Term Funding Scheme. Clearly, the MPC felt it needed to be seen to be taking action, following the economic uncertainty created by the referendum result. However, we think it is unlikely that these policy measures will have a significantly positive impact on activity. Indeed, through the implication that the economy is being hit harder by the Brexit vote than actually seems to be the case (or we judged likely), the MPC is risking sending a signal that will have detrimental consequences for growth.

The contrary argument is that for the Bank to do nothing in the face of uncertainty would be unacceptable, and that such seeming indifference would also send the wrong signals. It could also be contended that the directly negative consequences of the new measures are unlikely to be substantial and, therefore, that they are worth instituting even if the positive impact turns out to be limited. To reiterate, however, we believe that policy over-reaction risks eliciting a negative economic response, by suggesting to households that it would be better to undertake a precautionary reduction in spending and to companies that it would be prudent to postpone capital investment.

Even if you believe that Brexit will have a relatively severe impact on the economy over the period ahead, it is hard to understand why that outlook would be changed materially by the latest policy package. For instance, if investment programmes are put on hold as a result of uncertainty, it is unlikely they will be reinitiated simply because interest rates are fractionally lower or the BoE is buying corporate debt.

I have long been sceptical about efficacy of the QE programme. There is little evidence that it had a measurable impact on economic activity on the post-recession environment, although it is possible that in the early days it provided some reassurance vis-à-vis the availability of liquidity in the monetary system. In current circumstances, with gilt yields already exceptionally low and with demand for investment-grade corporate bonds very healthy, it is hard to understand what the beneficial impact will be of £60 billion of gilt purchases and £10 billion of investment-grade non-financial corporate bonds. Ironically, the BoE is likely to find it problematic sourcing £10 billion of corporate bonds, even though the buying programme is to take place over a period of 18 months. The gilt purchases are due to take place over the coming six months. Both programmes are due to begin in the week beginning 8th August.

When looking at the structure of bond yields in the UK and other major markets, it is hard not to conclude that QE programmes have caused major market distortions. A fair-value level of gilt yields, which combines expected inflation and productivity growth rates, suggests a level of around 3.75% for 10-year gilts. Following the policy changes announced today, the 10-year yield fell to just 0.67% – which is one third of the 2% inflation rate that is targeted. While the adjustment to more normal (positive real) gilt yields may not take place for some while, when it does begin, it will be a painful process, and is likely to cause significant disruption in financial markets.

Interestingly, while the vote in favour of reducing interest rates was unanimous, three of the nine-member MPC voted against extending QE. Maybe they have similar concerns to those expressed above.

Through the Term Funding Scheme, the BoE is aiming to provide funds to commercial banks at interest rates close to Bank Rate. This is designed to ensure the benefit of the 0.25% reduction in Bank Rate is passed on to borrowers. Of course, it is possible that Brexit uncertainty will cause banks to restrict the supply of credit to households and companies. However, it is too early to judge whether this is happening. Were it to happen, we see no reason why banks would change their assessment of the risks of lending simply because they have access to slightly cheaper funding. At the same time, there is no evidence to suggest that interest rates of 0.5% have been acting as a deterrent to borrowing – in fact, the prevailing evidence would lead to the opposite conclusion. Albeit the latest data are for June (and, therefore, largely pre-Brexit), the year-on-year growth in consumer credit of 10.3% is high – arguably, worryingly so.

Another adverse consequence of reducing interest rates could be that, notwithstanding the Term Funding Scheme, the further reduction in the structure of rates make lending less profitable and is thereby unhelpful to credit provision in the wider economy. On this score, there is marginal comfort in the apparent rejection by the Governor of introducing negative interest rates in the UK.

The evidence to date on the post-Brexit performance of the economy is equivocal, but largely reassuring. The negative response from the supply side of the economy, as evident in the sharp falls in the Purchasing Managers' Indices for activity in the manufacturing and services sector, was to be expected but should be treated with caution. While some economic disturbance was to be expected, following the Brexit shock, it is significantly too early to judge the likely extent and longevity of the impact.

Looking at data relating to consumer confidence and demand, the numbers are reassuring. While, according to the latest GfK confidence survey, there has been a dip in the positive balance of households saying they are more optimistic about the outlook for their finances over the next year, a reading of -1% is by no means worrying. More 'real' evidence on spending – as provided, for instance, by the weekly sales numbers published by John Lewis – show no obvious Brexit effect.

Of course, the MPC can point to the sharp reduction in growth forecasts for 2017 as justification for the easing package. Recent surveys suggest that economists have cut growth expectations for 2017 to an average 0.5% from 2.1% prior to the Brexit vote. However, it is evident that the spread of forecasts is very wide (from -1.3% to +1.5%), and we suspect that knee-jerk changes to forecasts have been too extreme.

The MPC's forecast, published in the Inflation Report alongside the policy announcements, is that growth in 2017 will dip to 0.7% from 2.0% in 2016 (these projections are based on Bank Rate remaining at 0.25% and also on the Bank's assessment of the likely revisions to historic growth rates). We are more optimistic with regard to growth in 2017, based partly on what we anticipate will be a positive response from the corporate sector to the challenges posed by Brexit.

Consistent with its growth expectations, the MPC now expects the unemployment rate to rise over the remainder of this year to 5.1% from 4.9% currently, and then again in 2017 to 5.6%.

With regard to prices, the MPC has acknowledged that the recent fall in sterling is likely to lead temporarily to higher inflation. For the fourth quarter of this year, it is now looking for the annual rate of increase in the CPI to be 1.3%, compared to its May forecast of 1.0%. For the fourth quarter of next year, inflation is expected to be 2.0%, an increase from the previous forecast of 1.8%. We believe this understates inflation risks, given the decline in sterling.

While the MPC's forecasting track record is not strong, one observation can be made about the latest changes in its projections – and about the policy announcements that have been made – they are consistent with the dire forecasts for the performance of the economy it made prior to the referendum.

First published on 4th August 2016 by Richard Jeffrey, Chief Investment Officer at Cazenove Capital Management.

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