

## ECONOMIC BACKGROUND

**GLOBAL OUTLOOK.** World growth has been doing reasonably well, aided by strong growth in the US. However, US growth is likely to fall back in 2019 and, together with weakening economic activity in China, overall world growth is likely to weaken.

**Inflation** has been weak during 2018 but, at long last, unemployment falling to remarkably low levels in the US and UK has led to a marked acceleration of wage inflation which is likely to prompt central banks into a series of increases in central rates. The EU is probably about a year behind in a similar progression.

### KEY RISKS - central bank monetary policy measures

Looking back on nearly ten years since the financial crash of 2008 when liquidity suddenly dried up in financial markets, it can be assessed that central banks' monetary policy measures to counter the sharp world recession were successful. The key monetary policy measures they used were a combination of lowering central interest rates and flooding financial markets with liquidity, particularly through unconventional means such as quantitative easing (QE), where central banks bought large amounts of central government debt and smaller sums of other debt.

**The key issue now** is that that period of stimulating economic recovery and warding off the threat of deflation, is coming towards its close. A new period has already started in the US, and more recently in the UK, on reversing those measures i.e. by raising central rates and, (for the US), reducing central banks' holdings of government and other debt. These measures are now required in order to stop the trend of an on-going reduction in spare capacity in the economy, and of unemployment falling to such low levels that the re-emergence of inflation is viewed as a major risk. It is, therefore, crucial that central banks get their timing right and do not cause shocks to market expectations that could destabilise financial markets. In particular, a key risk is that because QE-driven purchases of bonds drove up the price of government debt, and therefore caused a sharp drop in income yields, this also encouraged investors into a search for yield and into investing in riskier assets such as equities. Consequently, prices in both bond and equity markets rose to historically high valuation levels simultaneously. This now means that both asset categories are vulnerable to a sharp downward correction. It is important, therefore, that central banks only gradually unwind their holdings of bonds in order to prevent destabilising the financial markets. It is also likely that the timeframe for central banks unwinding their holdings of QE debt purchases will be over several years. They need to balance their timing to neither squash economic recovery, by taking too rapid and too strong action, or, conversely, let inflation run away by taking action that was too slow and/or too weak. **The potential for central banks to get this timing and strength of action wrong are now key risks.**

The world economy also needs to adjust to a sharp change in **liquidity creation** over the last five years where the US has moved from boosting liquidity by QE purchases to reducing its holdings of debt. In addition, the European Central Bank has cut back its QE purchases substantially and is likely to end them completely by the end of 2018.

**UK.** The first half of 2018/19 has seen UK **economic growth** post only a modest performance. However, after an adverse weather depressed performance in quarter 1, growth has been recovering pace and the latest 3 month rolling average came in at a healthy 0.7%. The positive run of economic statistics was sufficiently robust for the Monetary Policy Committee, (MPC), to unanimously (9-0) vote to increase **Bank Rate** on 2<sup>nd</sup> August from 0.5% to 0.75%. Although growth looks as if it will only be modest overall at around 1.5% in 2018, the Bank of England's August Quarterly Inflation Report forecast that growth will pick up to 1.8% in 2019, albeit there

were several caveats – mainly related to whether or not the UK achieves an orderly withdrawal from the European Union in March 2019.

Some MPC members have expressed concerns about a build-up of **inflationary pressures**, particularly with the pound falling in value again against both the US dollar and the Euro. The Consumer Price Index (CPI) measure of inflation came in at 2.4% in September and is expected to fall back to the 2% inflation target over the next two years given a scenario of minimal increases in Bank Rate. The MPC has indicated Bank Rate would need to be in the region of 1.5% by March 2021 for inflation to stay on track. Financial markets are currently pricing in the next increase in Bank Rate for the second half of 2019.

As for the **labour market**, unemployment has continued at a 43 year low of 4% on the Independent Labour Organisation measure. A combination of job vacancies hitting an all-time high in July, together with negligible growth in total employment numbers, indicates that employers are now having major difficulties filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to 3.1%, (3 month average regular pay, excluding bonuses). This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 0.4%, near to the joint high of 0.5% since 2009. (The previous high point was in July 2015.) Given the UK economy is very much services sector driven, an increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. This tends to confirm that the MPC were right to start on a cautious increase in Bank Rate in August as it views wage inflation in excess of 3% as increasing inflationary pressures within the UK economy. However, the MPC will need to tread cautiously before increasing Bank Rate again, especially given all the uncertainties around Brexit.

In the **political arena**, there is a risk that the current Conservative minority government may be unable to muster a majority in the Commons over Brexit. However, our central position is that Prime Minister May's government will endure, despite various setbacks, along the route to reaching an orderly Brexit in March 2019. If, however, the UK faces a general election in the next 12 months, this could result in a potential loosening of monetary policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.

**USA.** President Trump's massive easing of fiscal policy is fuelling a, (temporary), boost in consumption which has generated an upturn in the rate of strong growth which rose from 2.2%, (annualised rate), in quarter 1 to 4.2% in quarter 2 and 3.5%, (3.0% y/y), in quarter 3, but also an upturn in inflationary pressures. With inflation in danger of moving towards 3%, the Fed increased rates another 0.25% in September to between 2.00% and 2.25%, this being four increases in 2018. They also indicated that they expected to increase rates four more times by the end of 2019. The dilemma, however, is what to do when the temporary boost to consumption wanes, particularly as the recent imposition of tariffs on a number of countries' exports to the US, (China in particular), could see a switch to US production of some of those goods, but at higher prices. Such a scenario would invariably make any easing of monetary policy harder for the Fed in the second half of 2019. However, a combination of an expected four increases in rates of 0.25% by the end of 2019, together with a waning of the boost to economic growth from the fiscal stimulus in 2018, could combine to depress growth below its potential rate, i.e. monetary policy may prove to be too aggressive and lead to a reverse of policy.

The tariff war between the US and China has been generating a lot of heat during 2018, but it is not expected that the current level of actual action would have much in the way of a significant effect on US or world growth. However, there is a risk of escalation.

**Eurozone.** Growth was 0.4% in quarters 1 and 2 but fell back to 0.2% in quarter 3, though this is probably a temporary dip. In particular, data from Germany has been mixed and it could be negatively impacted by US tariffs on a significant part of manufacturing exports e.g. cars. For

that reason, although growth is still expected to be in the region of nearly 2% for 2018, the horizon is less clear than it seemed just a short while ago. Having halved its quantitative easing purchases of debt in October 2018 to €15bn per month, the European Central Bank has indicated it is likely to end all further purchases in December 2018. Inflationary pressures are starting to build gently so it is expected that the ECB will start to increase rates towards the end of 2019.

**China.** Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems. Progress has been made in reducing the rate of credit creation, particularly from the shadow banking sector, which is feeding through into lower economic growth. There are concerns that official economic statistics are inflating the published rate of growth.

**Japan** - has been struggling to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy. It is likely that loose monetary policy will endure for some years yet to try to stimulate growth and modest inflation.

**Emerging countries.** Argentina and Turkey are currently experiencing major headwinds and are facing challenges in external financing requirements well in excess of their reserves of foreign exchange. However, these countries are small in terms of the overall world economy, (around 1% each), so the fallout from the expected recessions in these countries will be minimal.

## **INTEREST RATE FORECASTS**

The interest rate forecasts provided by Link Asset Services in paragraph 3.2 are predicated on an assumption of an agreement being reached on Brexit between the UK and the EU. In the event of an orderly non-agreement exit, it is likely that the Bank of England would take action to cut Bank Rate from 0.75% in order to help economic growth deal with the adverse effect of this situation. This is also likely to cause short to medium term gilt yields to fall. If there was a disorderly Brexit, then any cut in Bank Rate would be likely to last for a longer period and also depress short and medium gilt yields correspondingly. It is also possible that the government could act to protect economic growth by implementing fiscal stimulus.

### **The balance of risks to the UK**

- The overall balance of risks to economic growth in the UK is probably neutral.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates, are probably also even and are broadly dependent on how strong GDP growth turns out, how slowly inflation pressures subside, and how quickly the Brexit negotiations move forward positively.

One risk that is both an upside and downside risk, is that all central banks are now working in very different economic conditions than before the 2008 financial crash as there has been a major increase in consumer and other debt due to the exceptionally low levels of borrowing rates that have prevailed for ten years since 2008. This means that the neutral rate of interest in an economy, (i.e. the rate that is neither expansionary nor deflationary), is difficult to determine definitively in this new environment, although central banks have made statements that they expect it to be much lower than before 2008. Central banks could therefore over or under do increases in central interest rates.

**Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:**

- **Brexit** – if it were to cause significant economic disruption and a major downturn in the rate of growth.
- **Bank of England monetary policy** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the **Eurozone sovereign debt crisis**, possibly **Italy**, due to its high level of government debt, low rate of economic growth and vulnerable banking system, and due to the election in March of a government which has made a lot of anti-austerity noise. At the time of writing, the EU has rejected the proposed Italian budget and has demanded cuts in government spending which the Italian government has refused. The rating agencies have started on downgrading Italian debt to one notch above junk level. If Italian debt were to fall below investment grade, many investors would be unable to hold Italian debt. Unsurprisingly, investors are becoming increasingly concerned by the actions of the Italian government and consequently, Italian bond yields have risen sharply – at a time when the government faces having to refinance large amounts of debt maturing in 2019.
- Weak capitalisation of some **European banks**. Italian banks are particularly vulnerable; one factor is that they hold a high level of Italian government debt - debt which is falling in value. This is therefore undermining their capital ratios and raises the question of whether they will need to raise fresh capital to plug the gap.
- **German minority government**. In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. Then in October 2018, the results of the Bavarian and Hesse state elections radically undermined the SPD party and showed a sharp fall in support for the CDU. As a result, the SPD is reviewing whether it can continue to support a coalition that is so damaging to its electoral popularity. After the result of the Hesse state election, Angela Merkel announced that she would not stand for re-election as CDU party leader at her party's convention in December 2018. However, this makes little practical difference as she is still expected to aim to continue for now as the Chancellor. However, there are five more state elections coming up in 2019 and EU parliamentary elections in May/June; these could result in a further loss of electoral support for both the CDU and SPD which could also undermine her leadership.
- **Other minority eurozone governments**. Spain, Portugal, Netherlands and Belgium all have vulnerable minority governments dependent on coalitions which could prove fragile. Sweden is also struggling to form a government due to the anti-immigration party holding the balance of power, and which no other party is willing to form a coalition with.
- **Austria, the Czech Republic and Hungary** now form a strongly anti-immigration bloc within the EU while **Italy**, this year, has also elected a strongly anti-immigration government. Elections to the EU parliament are due in May/June 2019.
- Further increases in interest rates in the US could spark a **sudden flight of investment funds** from more risky assets e.g. shares, into bonds yielding a much improved yield. In October 2018, we have seen a sharp fall in equity markets but this has been limited, as yet. Emerging countries which have borrowed heavily in dollar denominated debt, could be particularly exposed to this risk of an investor flight to safe havens e.g. UK gilts.
- There are concerns around the level of **US corporate debt** which has swollen massively during the period of low borrowing rates in order to finance mergers and acquisitions. This has resulted in the debt of many large corporations being downgraded to a BBB credit rating, close to junk status. Indeed, 48% of total investment grade corporate debt is now rated at BBB. If such corporations fail to generate profits and cash flow to reduce their debt levels as expected, this could tip

their debt into junk ratings which will increase their cost of financing and further negatively impact profits and cash flow.

- **Geopolitical risks**, especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

#### **Upside risks to current forecasts for UK gilt yields and PWLB rates**

- **Brexit** – if both sides were to agree a compromise that removed all threats of economic and political disruption.
- **The Fed causing a sudden shock in financial markets** through misjudging the pace and strength of increases in its Fed. Funds Rate and in the pace and strength of reversal of QE, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.
- The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflation pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.
- **UK inflation**, whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

#### **Brexit timetable and process**

- March 2017: UK government notified the European Council of its intention to leave under the Treaty on European Union Article 50
- March 2019: initial two-year negotiation period on the terms of exit to be followed by a proposed transitional period ending around December 2020.
- UK continues as a full EU member until March 2019 with access to the single market and tariff free trade between the EU and UK. Different sectors of the UK economy may leave the single market and tariff free trade at different times during the transitional period.
- The UK and EU would attempt to negotiate, among other agreements, a bi-lateral trade agreement over that period.
- The UK would aim for a negotiated agreed withdrawal from the EU, although the UK could also exit without any such agreements in the event of a breakdown of negotiations.
- If the UK exits without an agreed deal with the EU, World Trade Organisation rules and tariffs could apply to trade between the UK and EU - but this is not certain.
- On full exit from the EU: the UK parliament would repeal the 1972 European Communities Act.
- The UK will then no longer participate in matters reserved for EU members, such as changes to the EU's budget, voting allocations and policies.

