THE YEAR OF THE FIRE ROOSTER

A YEAR OF AWAKENING IN POLICY, POLITICS AND ECONOMICS

Economic and market outlook

Janet Mui, CFA – Global Economist

2016 went down in history as a year of political shocks and seemingly-counterintuitive reactions. At times, indeed it was hard to fathom the year of the Red Monkey, as financial markets turned out to be much more resilient than was widely expected. So, what will the year of the Fire Rooster bring us in 2017? For ancestors with no alarm clocks, the crowing of roosters provided a natural wake-up call. 2017 may turn out to be a year of awakening in monetary and fiscal policy, politics and economics. Below, we outline some of the issues that are causing anxiety and some of those that we think should be of less concern.

Developments that may cause concern in 2017

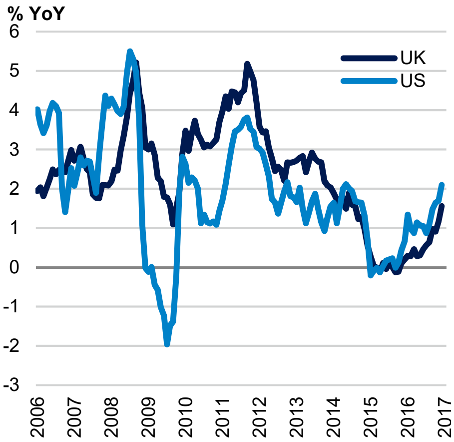
Pace of US monetary tightening

2016 ended with a more hawkish bias emerging from the Federal Reserve (the Fed), which now sees three rate increases in 2017, up from two previously. Markets are now pricing in the next US interest rate hike for June 2017. If the solid economic momentum is sustained and wage growth accelerates, the Fed could well tighten earlier than markets are currently expecting. Nonetheless, the pace and extent of the Fed's action will remain heavily influenced by both the trend in the dollar and the incoming administration's fiscal actions. The eventual pace of the tightening may provide us with insights with regard to the future inflation tolerance of the Fed. Later in the monetary cycle, we will receive similar signals with regard to attitudes in other central banks. During 2017 however, no major central bank apart from the Fed is expected to raise rates.

Inflation overshoot

Inflation in both developed and emerging economies is projected to pick up in 2017, partly due to the recovery in commodity prices but also reflecting country-specific factors. Headline consumer price inflation (CPI) will likely reach 2.7% in the UK and 2.3% in the US by the end of 2017, with the former driven by the higher cost of imported goods (from the depreciation in sterling), and the latter due to faster growth in the economy and a tightening labour market. Throughout 2017, the Fed's pace of tightening will be a test of its inflation tolerance and also that of other central banks.

UK vs US headline CPI

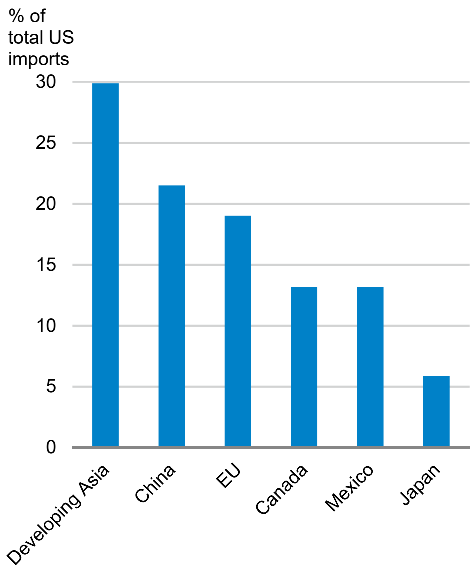


Source: Datastream.

European politics

The rise in populism, which contributed to the Brexit vote and President Trump's victory, took the world by surprise in 2016. In 2017, there is potential for anti-establishment/Eurosceptic movements to gather pace across Europe, with key elections in the Netherlands, France and Germany scheduled for the year. A lesser but still notable risk event is the French presidential election to be held in April, as the far-right contender Marine Le Pen has promised a euro referendum if she wins. Although commentators ascribe a very low probability to Marine Le Pen winning, a key takeaway from 2016 is that we should remain sceptical of the consensus view.

Origins of US imports



Source: Bloomberg.

President Trump's trade policies

Donald Trump's election victory has increased the risk of increased global trade protectionism. So far, he has taken a verbally aggressive stance in remarks about trade with Mexico and China, including threats to impose 35% import tariff on cars that are not manufactured in the US. For the US, the initial impact on growth may be positive from potentially higher job creation and a reduction in trade deficit. However, there may be longer term costs, not only to the US but also globally, if growth in US trade partners slows and trade protectionism is reciprocated and then becomes ubiquitous. Meanwhile, emerging markets, especially in Latin America and Asia, could suffer as their export sectors are heavily reliant on US demand.

Capital outflow from China and instability in currency markets

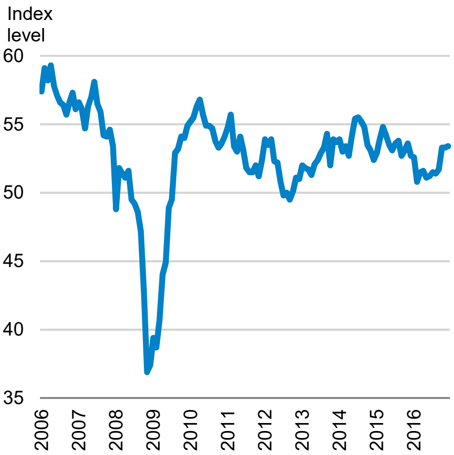
In China, there are signs of a housing bubble and more stringent capital controls. This may further weigh on sentiment towards the Chinese currency, which has experienced considerable downside pressure since 2015, consequently on the secular slowdown in growth. Expected increases in US rates in 2017 and a stronger US dollar may also provide headwinds to the still-delicate recovery in emerging markets (EM), potentially causing higher volatility in EM currencies.

Issues that we think will give rise to less concern in 2017

Weaker global growth

In the final months of 2016, US business and consumer confidence indices reached their highest levels in over 10 years. In the eurozone, the composite Purchasing Managers' Index (PMI) (a survey of business activity) rose to the highest since May 2011, despite concerns about political developments and the banking sector.

Global Composite Purchasing Managers' Index (PMI)



Source: Datastream.

In the UK, economic data continue to confound the widespread forecasts of a post-referendum hiatus in growth, and we remain optimistic that 2017 will see better-than-predicted economic momentum. Meanwhile, emerging markets should benefit from better demand in advanced economies, with Brazil and Russia exiting recession, helped also by the recovery in commodity prices.

Brexit induced UK slowdown/recession

The UK is now estimated to have grown by 2.0% in 2016, the fastest amongst the Group of Seven (G7) economies. This was in defiance of the significant and widespread downward revisions to UK growth expectations in the immediate aftermath of the EU referendum in June. Momentum in the run up to 2017 remains good, with the composite PMI close to a one-and-a-half year high in December, reflecting better activity across services, manufacturing and construction. At one stage, City forecasts for growth in 2017 were as low as 0.3%. While the consensus has now risen to 1.2%, we believe this is still too low.

Deterioration in US labour market

The labour market has continued to tighten in the US, with employment creation averaging 180,000 a month in 2016, initial jobless claims dipping to a multi-decade low and wage growth accelerating to the fastest since April 2009. The outlook for the US labour market in 2017 remains favourable - according to the National Federal of Independent Businesses survey there is robust demand for labour and rising wage pressure. In addition, small and mid-sized companies cited increasing difficulty in filling job vacancies and an increasing requirement to raise workers' compensation.

Tighter policy in the UK and the eurozone

The UK's growth and inflation profiles have been similar to those of the US. While this may put pressure on the Bank of England to raise rates, it is likely to use Brexit uncertainty as the excuse to keep policy on hold, unless inflation overshoots the 2% more significantly than expected. Although economic activity in the eurozone has improved, subdued underlying inflation, continuing problems in peripheral economies and the banking system and rising political risk will constrain the European Central Bank from reducing stimulus too aggressively in 2017.