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A SHORT BUT SWEET FEBRUARY FOR ECONOMY WATCHERS

Economic and market outlook

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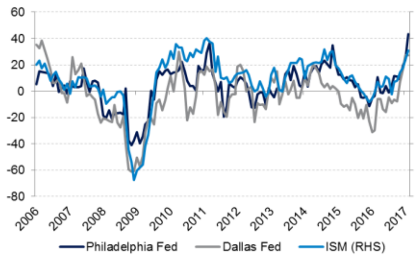
We wrote in our last commentary that 2017 would be a year of awakening in monetary and fiscal policy, politics and economics. As the year progresses, there are clearer signs of global reflation, meaning both higher growth and inflation.

US

While the US economy was already running at a robust pace prior to the election, it received a further boost from President Trump's victory. Post-election data showed a phenomenal pick-up in confidence amongst consumers and businesses; which can be attributed to the President's pro-growth electoral promises of tax cuts, infrastructure spending and deregulation.

US manufacturing business surveys (index level)



Source: Datastream.
The ISM Manufacturing Index monitors employment, production, inventories, new orders and supplier deliveries.

While it is still early days, there are signs that rising confidence has buoyed activity in both the services and production sectors. In services, retail sales excluding auto fuel picked up markedly in January, supported by the ongoing strength in the labour market and economic optimism. Existing home sales surged to the highest level in a decade, with home inventory declining to a record low. To date, therefore, there is little evidence that higher mortgage rates are denting buyers' confidence. On the supply side of the economy, regional business surveys pointed to a surge in output and new orders, thanks to an improved external environment (despite the strong US dollar), robust domestic activity and a recovery in the oil drilling sector.

Despite these positive trends in demand, output and confidence, there remains uncertainty around whether, and to what extent, the promised reflationary stimulus will be delivered, and how higher spending and tax cuts will be financed. President Trump has begun to fulfil his electoral promises (e.g. on tightening border controls and renegotiating trade agreements) via executive orders, therefore we are reasonably optimistic with regard to his ability to deliver in some form on the economic pledges. This implies there is upside potential to growth associated with higher capital investment and consumer spending.

With consumer price inflation (CPI) picking up to the highest rate seen in about five years (+2.5% YoY) and the simultaneous strength in almost all economic data we track, it is not surprising that a few Federal Reserve Open Market Committee (FOMC) members have sounded more hawkish in recent interviews. We believe the conditions are ripe for a rate increase at the next FOMC meeting on March 15th, a move to which markets are ascribing close to a 100% chance.

Eurozone

The eurozone has exhibited solid economic momentum in the opening months of 2017, despite heightened political uncertainty. The eurozone composite Purchasing Managers' Index (PMI), a survey of business activity, showed the fastest pace of expansion in six years in February. Business optimism, new order books and job creation all surged to multi-year highs, pointing to a robust start to the year. The labour market also continued to improve, with the unemployment rate falling to the lowest level since the financial crisis, reflecting the fastest pace of job creation (according to PMIs) in nearly a decade. Growth is starting to look more balanced across the Eurozone area, with trade between the individual member states showing a notable pick-up after stagnating for the past few years.

Germany's industrial sector will be a beneficiary of more positive global growth trends (in particular a pick-up in emerging markets), helped by the weaker euro, and also the broader eurozone recovery. Confirming this boost, Germany's manufacturing PMI sustained its robust trend and expanded at the fastest pace in nearly six years in February. A note of caution is that the PMI may be overstating actual activity, as Germany factory orders had a disappointing start in 2017. However, factory orders are highly volatile on a monthly basis and the weakness in January came after a very strong fourth quarter. The overall positive macro backdrop and rising confidence indicators do not suggest any deleterious impact on activity from political uncertainty. However, the approaching French election remains an obvious tail risk.

Germany factory orders vs eurozone composite PMI

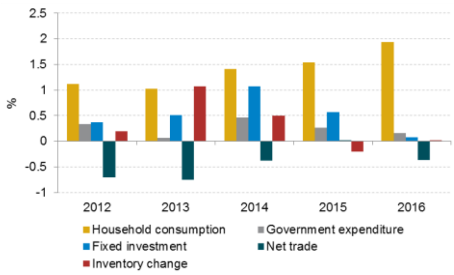
Source: Datastream

The extent to which faster activity will lead to an increase in inflationary pressure in the eurozone remains the subject of debate. While headline consumer price inflation rose to 2.0% in February, the fastest rate in four years, core inflation remained muted at 0.9%. In addition, Germany apart, wage growth is sluggish as unemployment rates in most countries are still comparatively high despite the gradual recovery. This implies there will be limited domestically-generated pressure on core inflation. Hence, we expect the European Central Bank to keep interest rates on hold for the foreseeable future, although there is a possibility that it will lower the amount of monthly asset purchases towards the year end.

UK

The UK gained momentum in the last quarter of 2016, expanding by 0.7% QoQ, an upwards revision from the initially estimated 0.6% and also the fastest pace of expansion in a year. However, 2016 annual growth was revised down to 1.8% from 2.0% due primarily to a downwards revision to growth in the first quarter. For 2016 as a whole, household consumption contributed to 1.9% growth, but there was a fractionally negative contribution from net trade; other components of aggregate demand had negligible impact.

Contributions to UK GDP growth



Source: Datastream

While the Bank of England has raised its growth forecast for 2017 to 2.0%, there are clear downside risks to this prediction. Our main concern is that rising inflation will impede the growth in real household incomes and, thereby, the growth in consumption. Already, real earnings growth has more than halved since mid-2016 (from 1.7% to just 0.8% in January 2017), and without faster wage inflation this squeeze is likely to intensify. Underlining this concern, retail sales contracted again in January, following a large fall in December, with across-the-board weakness especially in online and household goods sales. Simultaneously, the latest GfK consumer confidence report revealed meaningful weakness in elements that are linked to future discretionary consumption, for instance in the response to the question relating to prospective personal finances. Overall, this suggests that household consumption will make a more modest contribution to growth in 2017 than in 2016. On the other hand, however, improved competitiveness in both import and export markets should lead to a positive contribution to growth from net trade and it is also possible that business investment will confound the pessimists and prove helpful to aggregate demand. As a result, we expect growth in the economy in 2017 to be at a similar pace to that seen last year.

Given these developments and, perhaps more significantly, recent policy statements from the Bank of England, the general view is that interest rates will remain on hold this year, despite the probability that inflation will edge towards 3%. As a signal of intent (or the lack thereof), the Governor of the Bank of England has stated that the only factor causing inflation to rise will be the Brexit-induced weakness in the pound. In other words, he does not foresee any increase in domestically-generated inflation. But a note of caution is worthwhile at this point. We should not ignore entirely the possibility that the tightness in the labour market will result in appreciably faster wage inflation. Were this to happen, the Bank of England could be forced into taking more aggressive policy action rather earlier than it, or the markets, currently anticipate.