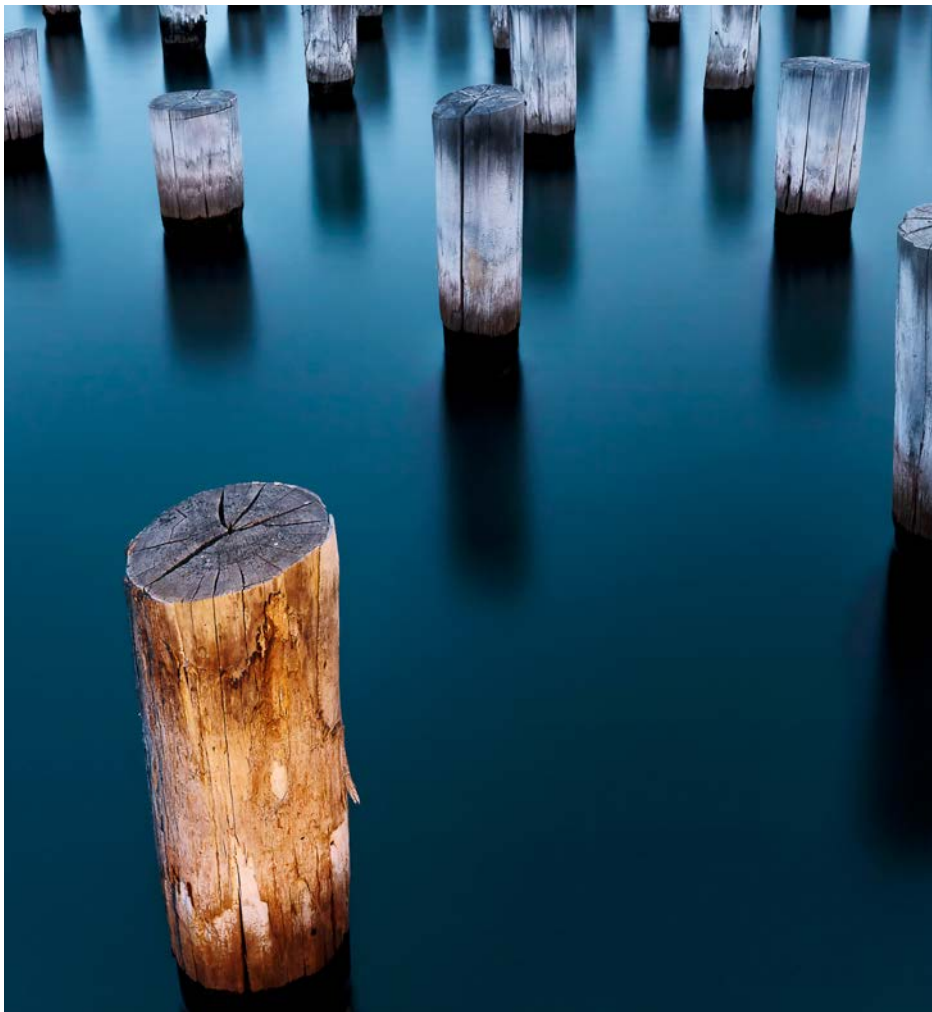


The unconventional becomes the norm



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It started with an unconventional recession, one that emanated from a near collapse in the financial system but which, in a number of larger economies, resulted in a comparatively modest increase in unemployment. Then we had unconventional monetary policy, encompassing a mix of huge injections of liquidity into the world monetary system and an extended period of exceptionally low interest rates. And now we seem to be in the era of unconventional political consequences. The connection between the financial crisis and the subsequent policy reaction is obvious and is still reverberating. While the link connecting economic (and policy) developments to

more recent political trends may seem less obvious, we believe it is just as strong.

Old problems fuel new order

Whether it be in the outcome of the UK referendum on EU membership, in the results of elections in the US, France and the UK, or in the more general increase in support for anti-establishment political parties, it is evident that electorates in many western countries are questioning the established order. Behind recent voting patterns seems to be a growing frustration that although economies have been recovering, the benefits of growth have not been feeding through to real incomes. In

the immediate aftermath of the recession, it was not too hard to convince voters that some tough policy medicine would have to be swallowed. But entering the eighth consecutive year of growth, it is becoming increasingly hard to get people to accept the ongoing stagnation in living standards.

Stagnant markets, stagnant thinking

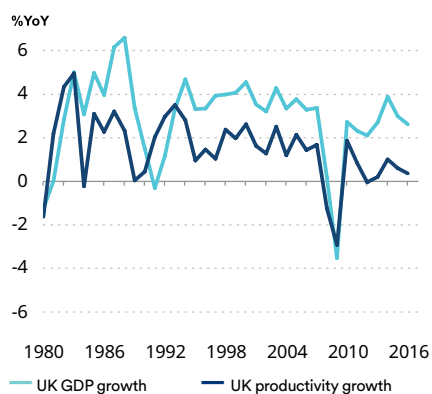
The cause of this stagnation is not too hard to determine. There is a feature of the recovery that has been and remains common to most advanced economies – unconventionally low productivity growth. Behind this, there has been a pervasive and persistent lack of productivity-enhancing capital spending. Instead, companies have preferred to employ more people when raising output levels. So the paradox has been that although unemployment has fallen very quickly in relation to achieved growth rates, the incomes of average working people have been almost static in real terms. So when politicians come along claiming that it does not have to be like this, they have an automatic and deeply interested audience. Furthermore, in this scenario, younger people are likely to feel greater dissatisfaction with the established order than older people who are probably more sceptical about promises of change and more likely to vote for the devil they know.

Great expectations

The challenge facing advanced economies for the next phase of the recovery cycle is to move onto a stronger investment-productivity path. Implicit within forecasts for the US economy for the past three

UK GDP GROWTH AND UK PRODUCTIVITY GROWTH, 1980–2016

SOURCE: DATASTREAM



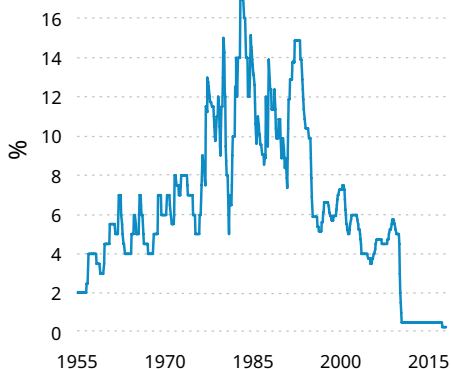
years has been the assumption that this was imminent. Such hopes were disappointed in both 2015 and 2016, and it would seem that 2017 is set to be another year of high expectations dashed by reality. For the EU, prospects are slightly better when compared to the past, with momentum gradually picking up. However, this has yet to become an investment-led recovery even in normally higher productivity economies such as Germany.

Reasons to be cheerful

The UK is facing additional challenges. Eventually, we believe that the Brexit process will encourage capital spending as companies with less easy access to the EU pool of labour prepare to expand into new markets. However, it may take more time for this to come through, particularly against the backdrop of increased political uncertainty. This is also true of the positive trade impacts that should eventually result from the post-referendum drop in the

BANK OF ENGLAND OFFICIAL BANK RATE, 1950–2017

SOURCE: DATASTREAM



pound. More obviously, at the moment, households are being tested by the inflationary consequences of higher import costs. The even greater squeeze on real income growth is now being reflected in a loss of momentum in household spending.

These contrasting forces on economic activity make the likely growth rates for the UK over the next two years difficult to assess. While the hazards are obvious, we believe that many commentators are understating the more positive influences that could come through.

With Japan still struggling to engender stronger core growth, the implications of current trends for advanced economies as a whole are clear: growth is set to remain dull and is unlikely to breach the 2% level for the foreseeable future. Consequent on the more temperate expansion in demand in developed economies, emerging manufacturers, commodity producers and others that had previously thrived on exporting to the developed world will also continue to see comparatively unexciting growth.

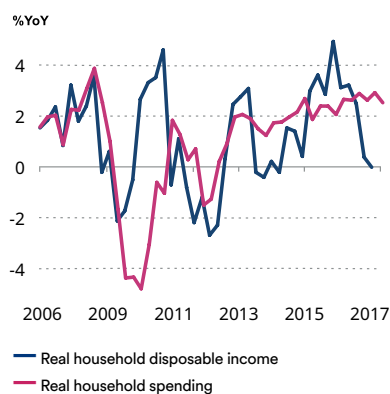
Looking ahead

The second quarter of 2017 has seen a further grind upwards in equity markets as the backdrop of synchronised global growth has combined with good quarterly earnings to provide impetus. European equities, an asset class we upgraded at the beginning of the quarter, were the star performers in sterling terms, driven higher by a combination of growth, earnings, valuation and a more stable political outlook following the election of Emmanuel Macron as French President. The US market performed well in local currency terms, but a weak dollar was a drag to sterling returns. Asian and emerging markets in general continued their positive performance of the first quarter. The UK equity market was the laggard as the general election had a clear impact on sentiment.

There was a marked divergence in performance of different sectors, as weaker inflation and lower commodity prices caused the underperformance of financials and resources, while technology,

UK REAL HOUSEHOLD DISPOSABLE INCOME, 2006–2017

SOURCE: DATASTREAM



healthcare and defensives performed very well.

Given the apparent rolling over of inflation in the US, government bond yields fell a little, giving small positive returns to investors, while high yield and investment grade credit spreads continued to narrow to levels not seen since 2007.

We continue to believe that the backdrop of synchronised global growth will be positive for equities in the second half, but our current neutral positioning is predicated on valuations that can no longer be described as cheap, and our continued view that the central banks will begin to reverse the quantitative easing that has been seen for almost the last decade. Our fixed income positioning continues to have a preference for index-linked securities over conventional government bonds.

UK REAL WAGE GROWTH SLOWS DESPITE FALLING UNEMPLOYMENT RATE 2006–2017

SOURCE: DATASTREAM

