Schroders
Economic and Strategy Viewpoint

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Forecast update and scenarios: rising political risk (page 2)

- An improvement in the outlook for Europe helps keep global growth on track in the coming year despite downgrades to our forecasts for the US and Japan. Inflation is set to pick up on the back of higher oil prices, but the impact is offset in some economies by weaker core rates. Both the Fed and Bank of England are expected to tighten this year, but rate rises will be tempered by a limited pick-up in wages.
- We introduce two new scenarios: "Trade wars" and "Brexit shakes the EU" to reflect the increase in political risk in the world economy. The balance of probabilities is still skewed toward weaker growth, but by less than in Q1 as a result of the reduced risk of a China hard landing or US recession.

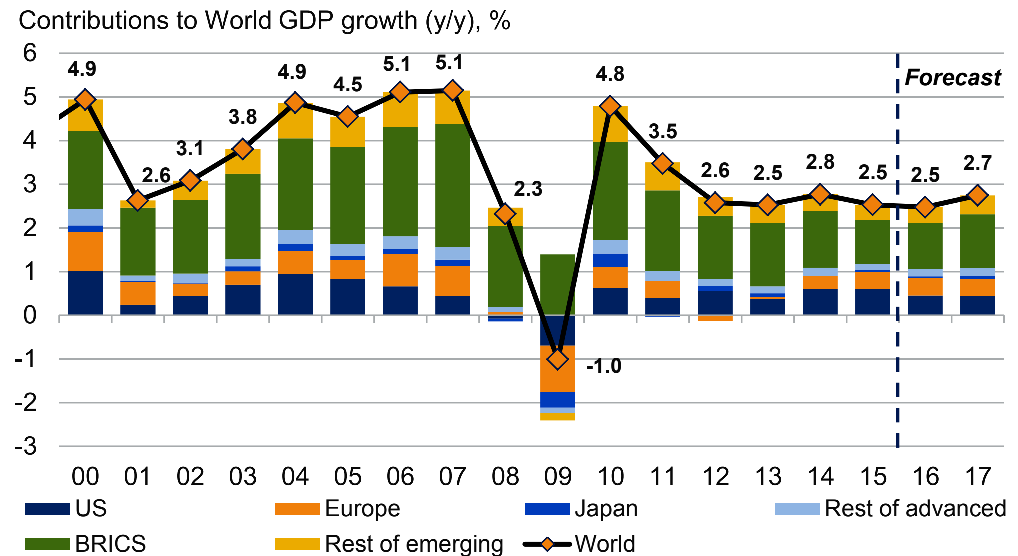
Eurozone growth upgraded (page 8)

- Better-than-expected growth data for the Eurozone have prompted upward revisions to our forecast. However, inflation remains too low for comfort and suggests the recovery still has some way to go.

Views at a glance (page 10)

- A short summary of our main macro views and where we see the risks to the world economy

Chart: World GDP forecast



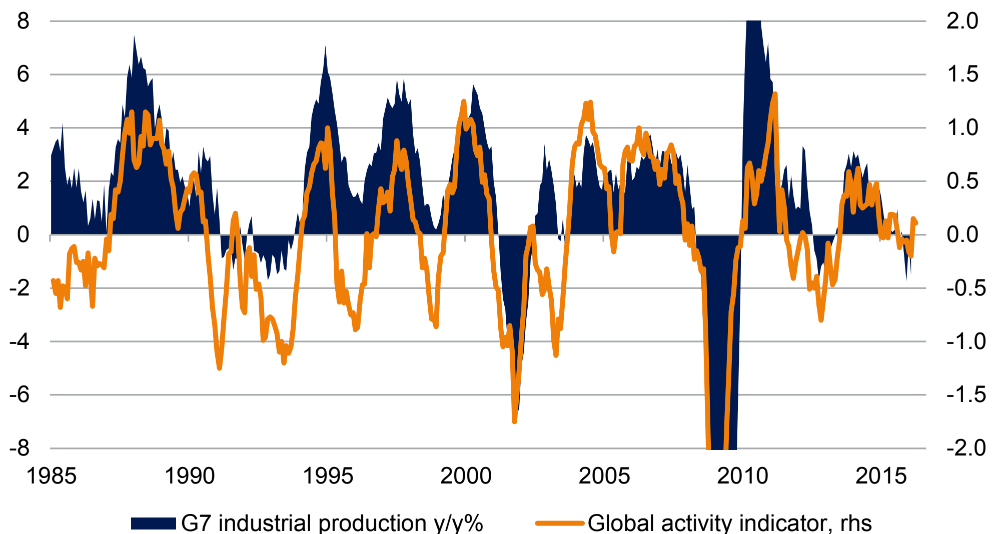
Source: Thomson Datastream, Schroders Economics Group. 23 May 2016. Please note the forecast warning at the back of the document.

Forecast update and scenarios: rising political risk

Europe keeps global growth on track following downgrades to the US and Japan

After a series of downgrades, our forecast for global growth in 2016 is unchanged. Reductions in our projections for the US and Japan are offset by increases to the Eurozone and China to leave our overall growth projection at 2.5%. Much of this reflects base effects from the first quarter with the US and Japan disappointing whilst European growth has been surprisingly resilient. Going forward though we still see growth picking up in the current quarter as companies gradually clear the inventory overhang built up at the end of last year and final demand improves. True to form the US seems to be enjoying a second quarter bounce led by retail sales and housing. Broadly speaking the business surveys indicate a turn in industrial activity, but it must be said that the level of global activity is still weak and best described as tepid (chart 1).

Chart 1: Global indicator turns up, but remains tepid

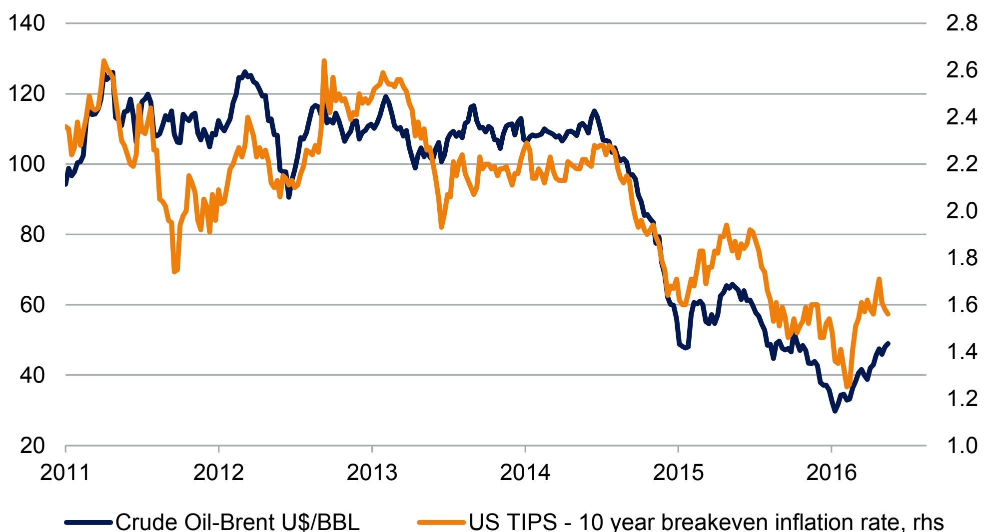


Source: Thomson Datastream, Schroders Economics Group, 26 May 2016.

Rising oil prices have pushed up market inflation expectations (chart 2) and with the forward oil curve now projecting higher prices than last quarter we have raised our inflation forecasts for the US.

Inflation forecasts steady as lower core offsets higher oil prices

Chart 2: Oil price lifts inflation expectations



Source: Thomson Datastream, Schroders Economics Group, 26 May 2016.

Elsewhere though the inflation picture is generally more subdued than before as the impact of higher oil prices is diluted by taxes and subsidies, whilst core rates

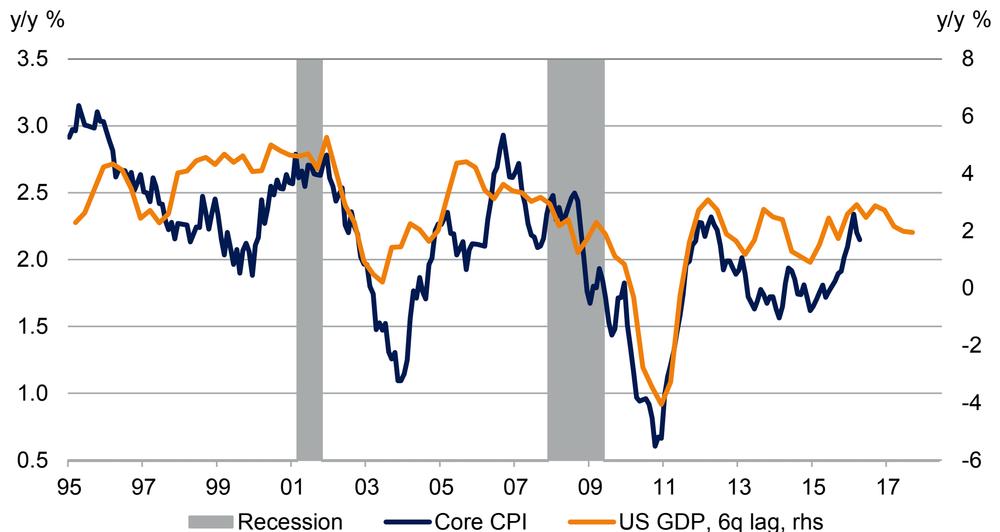
have been coming in below expectations. This is the case in the Eurozone and Japan where our inflation forecasts have been trimmed. In Japan the assumed postponement of the consumption tax increase also reduces our inflation forecast for 2017.

On balance, global inflation is forecast to rise to 2.2% this year (from 1.8% in 2015) and to 2.4% in 2017. The forecast for next year is partly influenced by the forward profile of oil prices (the oil curve is higher but less steep) and by our view that we will not see significant second round effects from higher inflation into wages.

This is critical given that unemployment rates are running at low levels. However, the experience of recent cycles has been that wages have become less responsive to changes in unemployment, a phenomena known as the flat Phillips curve. Increased globalisation and the rise of China, combined with factors such as the reduction in trade unionism account for much of this shift. More recently studies find that average wages are being suppressed by demographic factors as baby boomers retire and are replaced by younger workers. The more senior group tend to be better paid than the latter resulting in a decline in aggregate pay.

We are also aware of the long lags between activity and inflation. For example, for the US the slowdown in activity over the past 18 months will weigh on core inflation over the forecast period (see chart 3).

Chart 3: Long lags: slower growth will weigh on US core inflation



Source: Thomson Datastream, Schroders Economics Group, 26 May 2016.

Monetary policy: the Fed in an election year

US Federal Reserve to hike in September and December

Although a US rate rise in June remains a possibility we now expect Federal Reserve (Fed) chair Janet Yellen and company to delay their next move until September. The absence of significant wage pressure and concerns over a tightening of monetary conditions via the dollar account for the delay. We still expect the Fed funds rate to rise in two steps to 1% by end 2016 and by a further two hikes to 1.5% by end 2017.

We recognise that the 21 September Federal Open Market Committee (FOMC) meeting will be close to the presidential election date (8 November), however evidence suggests that the likelihood of a Fed rate change does not significantly decrease in the run up to a presidential election. There have been periods when the Fed has stopped hiking ahead of a presidential election, but this seems to have been unaffected by the impending vote as they did not resume tightening after the election. Looking at data since 1971, history suggests presidential campaigns have not had a significant effect on Federal Reserve policy actions.

As shown below, the probability of Fed policy action in and out of election years is very small (table 1).

Table 1: Federal Reserve policy changes in and out of election years:

	Non-election year	Election year	Difference
	Probability of a change in policy		
August	41%	36%	-5%
September	35%	27%	-8%
October	32%	36%	4%
November	38%	45%	7%

Source: Thomson Datastream, Schroders Economics Group, 23 May 2016 (based on monthly data since 1971). Please note the forecast warning at the back of the document.

ECB and BoJ to ease further, but BoE to raise rates in November after a vote to remain in the EU

Meanwhile, we look for the European Central Bank (ECB) to cut the deposit rate again in September, taking it to -0.5%, where it stays through 2017. The Bank of Japan (BoJ) is no longer expected to take rates lower following the adverse reaction to their move into negative territory in January. Fiscal support in the run up to the upper house elections in July and the further delay in the consumption tax relieve some of the pressure on the BoJ. However, we do expect them to start experimenting with helicopter money drops towards the end of the forecast period in 2017 in a renewed effort to stimulate growth in a moribund economy.

Currency wise we still look for the US Dollar (USD) to strengthen against the Euro, but the US unit now has a weaker profile against the Japanese Yen (JPY), Chinese Yuan and sterling (GBP) in 2016. Although the interest rate differential will move further in favour of the US, past experience suggests that other factors such as the current account position come into play after the Fed has started tightening. The GBP is expected to benefit from a vote to remain in the EU in the referendum on 23 June, although this means that the Bank of England (BoE) is expected to raise rates in November.

New scenarios: Trade wars and Brexit shakes Europe reflect rising political risk

Scenario analysis

We have made some significant changes to our scenarios this quarter. Political risks have risen and in response we are adding in a “trade wars” scenario and a “Brexit shakes Europe” scenario.

The former is based on the election of Donald Trump as president of the US, which brings a significant increase in tariffs on imported goods. Mr Trump has consistently targeted China and companies who have outsourced supply chains overseas. Expect a Trump administration to increase trade barriers and for rapid retaliation from those that have been hit with the result that global trade contracts whilst inflation is pushed higher.

The second new scenario follows from a UK vote to exit the EU, which galvanises anti-EU support across Europe and results in a number of similar referenda across the continent. The resulting increase in uncertainty slows growth as companies postpone major investments and households delay purchases of big ticket items, much as we are seeing in the UK currently.

In terms of their impact on global activity, both new scenarios are ultimately seen as stagflationary. In the “trade wars” scenario this is clear cut as higher inflation from tariff increases makes goods more expensive and hence reduces the volume of transactions. At a higher level, the allocation of resources will also be less efficient resulting in weaker growth and higher prices.

The impact of the “Brexit shakes Europe” scenario is more complex: the initial shock is deflationary as European domestic demand falls, but this then gives way to higher inflation in Europe as the GBP and EUR depreciate significantly. Softer

commodity prices result in weaker currencies and higher inflation in the emerging markets. At the global level, this is mildly stagflationary, but we would see this scenario as being deflationary for economies like the US and Japan with the key takeaway being one of weaker global growth.

China hard landing and US recession risks remain, but are reduced

On the deflationary side we have retained "China hard landing" and "US recession". The former is now driven by a wave of debt defaults and the seizing up of the banking system, rather than via an equity market collapse as before. Investors are currently focused on the extraordinary growth of debt in China and are asking how this can be unwound without a crisis. Meanwhile, the US recession scenario is still driven by the slowdown in profits growth which feeds through into weaker capital spending and employment.

We have dropped the deflationary "Emerging markets (EM) defaults emerge" scenario. Although the risk remains, the number of defaults has been slow to materialise as governments have intervened and the pressure on many companies is now being relieved by the rally in commodity prices.

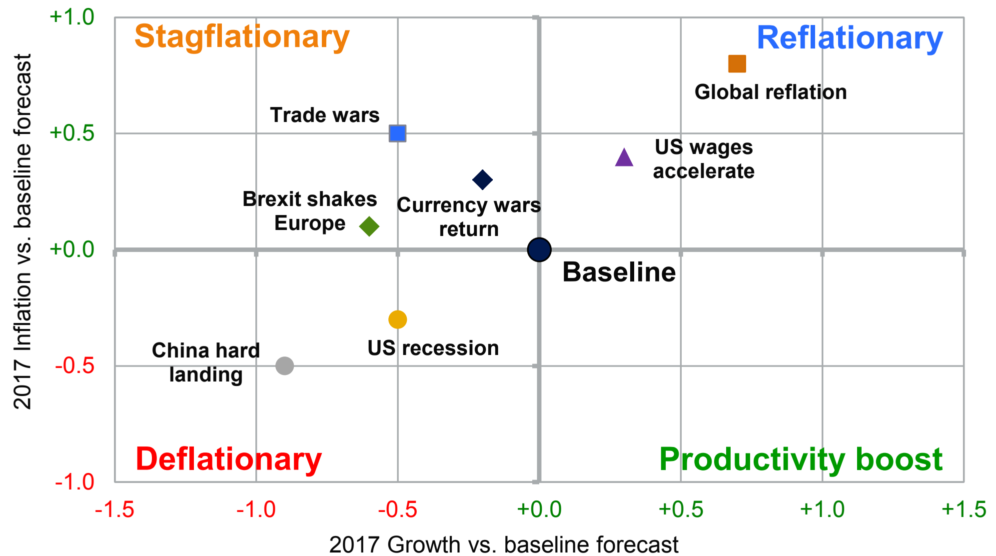
Note that the "Currency wars return" scenario has moved from the deflationary to the stagflationary box as a result of the change of time horizon (chart 4). Initially deflationary as a result of the increase in financial market volatility, the scenario becomes more stagflationary as inflation rises through weaker currencies. As with the "Brexit shakes EU" scenario, we would characterise this as more deflationary with currency moves generally cancelling each other out, while global activity suffers from increased uncertainty and financial market volatility as countries pursue beggar-thy-neighbour currency moves.

On the reflationary side we retain the "US wages accelerate" and "Global reflation" scenarios. The latter reflects a co-ordinated fiscal stimulus to growth by the major economies along the lines being called for by the International Monetary Fund (IMF) and Japan ahead of the recent G7 summit.

Arguably we could have dropped the "Wages accelerate" scenario given the lack of progress in this area. However, the US labour market remains tight and higher headline inflation is likely to raise inflation expectations as we have already seen in the financial markets. We are assuming a modest wage acceleration in the baseline and this scenario pushes that further with US wages, currently running at just over 2.5% for average hourly earnings, picking up to a 4% pace by end-2016 and 5% by end-2017. Note that although categorised as reflationary, this scenario is ultimately stagflationary as the Fed tighten more aggressively (raising rates to 3% by end 2017). See chart 4 for the impact of the scenarios relative to the base on global activity in 2017 and for fuller descriptions see page 19.

Balance of probabilities skewed toward weaker growth, but by less than in Q1

Chart 4: Impact of scenarios on growth and inflation versus base

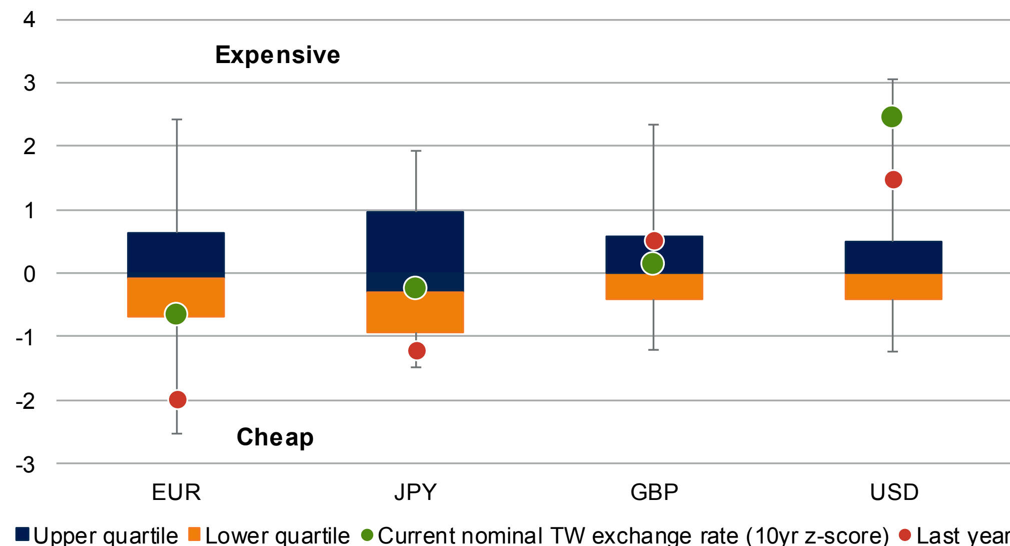


Source: Schroders Economics Group, 23 May 2016. Please note the forecast warning at the back of the document.

Balance of probabilities

In terms of probabilities, in our view the "Currency wars return" scenario has eased to 8% (previously 10%) with the informal truce agreed at the April G20 meeting in Shanghai and the move by the US to warn against currency manipulation responsible for the reduction. The risk remains though given the unease in Tokyo at the recent strength of the Japanese yen which is now close to its 10 year average (chart 5).

Chart 5: JPY returns to its 10-year trade weighted average



Source: Thomson Datastream, Schroders Economics Group. 26 May 2016.

The new "Trade wars" scenario also comes in at 8%: Trump has been consistently written off by all the experts and could prove them wrong again particularly against a candidate such as Hilary Clinton who faces questions over her use of an email server whilst Secretary of State.

However, as argued above, the distinction between deflation and stagflation is more blurred than usual and we would combine the two which on balance have declined in probability. This suggests that the balance of probabilities remains

skewed toward a weaker growth outcome versus the baseline, but by less than in Q1 (see table 2).

Table 2. Balance of probabilities by scenario outcome vs. baseline

Scenario	Probability February 2016, %	Probability May 2016, %	Change %
Stagflationary	4	20	+16
Deflationary	28	7	-21
Reflationary	10	10	0
Productivity boost	0	0	0
Baseline	55	60	+5

Source: Schroders Economics Group. 23 May 2016. Please note the forecast warning at the back of the document.

Eurozone growth upgraded

Better-than-expected growth numbers out of Europe have lifted sentiment, but disappointing inflation data suggest there is still a long way to go before the monetary union is out of the woods.

Eurozone growth surprises to the upside

Eurozone growth was better than expected in Q1…

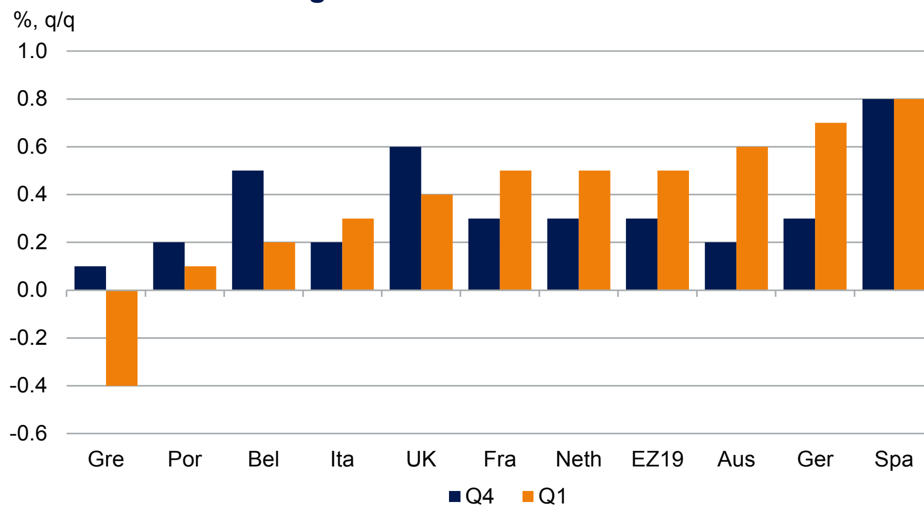
Eurozone GDP growth jumped to 0.5% in the first quarter compared to 0.3% in both the third and fourth quarters of 2015. The acceleration in growth comes as a surprise as most business surveys over the first quarter suggested a slowdown due to external weakness. Although not yet confirmed, it appears domestic demand remained resilient, while the drag from overseas trade eased.

Within member states, Germany saw its growth rate rise from 0.3% to 0.7% (chart 6), as domestic demand held steady, but the negative contribution from net trade moderated. Investment growth accelerated over the quarter while household consumption remained robust. German exports recovered from the contraction seen over the fourth quarter, but imports rose more sharply (reflecting the stronger domestic demand) resulting in another quarter where net trade proved a headwind to growth.

Elsewhere, French GDP rebounded in the first quarter to 0.5% growth from 0.3% in the fourth quarter of 2015, and against consensus expectations of a smaller pickup of 0.4%. We had expected such a bounce back as activity had appeared to slow in reaction to the Paris terrorist attacks last year. Indeed, the main improvement in the latest data was due to an acceleration in consumption and business investment growth. It also means that if confidence has now recovered from the events of last year, we should see growth moderate over the rest of this year, rather than this pace of growth being maintained. In a similar fashion to France, we suspect the terrorist attacks in Brussels and subsequent shut down of services may have contributed to the slowdown in Belgium in the first quarter. Activity should at least partially rebound in the second quarter.

…as most member states saw an improvement.

Chart 6: Eurozone growth accelerates in Q1



Source: Eurostat, Schroders Economics Group. 25 May 2016.

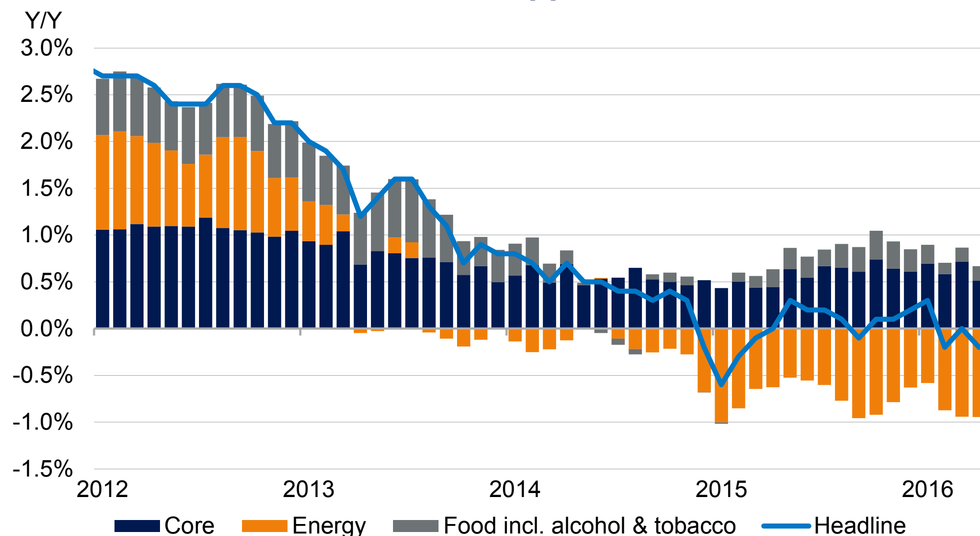
Spain also surprised to the upside by growing by 0.8% for the third consecutive quarter, despite a marked slowdown in manufacturing output over January and February. This bodes well for the rest of the year, although we do expect the annual growth rate to temper from its current rate of 3.4% to around 3% on the back of continued political uncertainty. Otherwise, Austria also surprised to the upside as growth accelerated to from 0.2% to 0.6% over the same period – its fastest quarterly growth rate since the start of 2015.

Eurozone inflation fails to rise

While Eurozone growth appears to be on the right track, the same cannot be said for inflation which slipped to -0.2% year-on-year in April disappointing consensus expectations. Energy continues to be the biggest drag on the headline rate, although the core rate of inflation (excluding food, energy, alcohol and tobacco) also fell from 1% in March to 0.8% in April (chart 7). The early Easter holiday would have caused inflation to be a little higher than normal in March and then lower in April, but the overall picture is still very weak, with inflation in some member states deeply negative (Spain -1.2%). The recent strength of the euro, despite stimulus measures from the European Central Bank (ECB), has undoubtedly played a role in keeping inflation subdued.

Inflation in Europe has disappointed, showing little sign of progress and weakening core inflation

Chart 7: Eurozone inflation disappoints



Source: Eurostat, Schroders Economics Group. 25 May 2016.

Eurozone forecast: brighter outlook

Upward revisions to GDP growth data for the second half of 2015 paint a very different picture to what was visible during our last forecast. Rather than a loss in momentum at the end of last year, which we had expected to come about as the result of the slowdown in China and other emerging markets, Eurozone growth was instead fairly robust, holding steady at over 1.5% year-on-year. This, taken together with the upside surprise in the first quarter growth means we are left needing to revise our growth forecast upward. We now expect growth to accelerate to 1.8% year-on-year by the end of this year, before moderating again to 1.6% over 2017 (chart 8 on next page).

As for inflation, weaker core inflation has led us to conclude that there is greater spare capacity in the economy than previously anticipated. Moreover, it seems to be taking longer than usual for inflation in energy to rebound following the rise in wholesale prices. In addition, the recent appreciation in the euro has lowered the inflation of imported goods, which may persist over the rest of this year. Overall, we have lowered our Eurozone headline inflation forecast from 0.7% for 2016 to 0.5%, and from 1.6% for 2017 to 1.2% (chart 9 on next page). We continue to expect inflation to recover over the rest of the year as the drag from food and energy prices fall out of the annual comparison, but recent developments suggest a delay in the pick up in price inflation, and that headline inflation may peak at a lower level: sub 1.5% in 2017.

Schroder Economics Group: Views at a glance

Macro summary – June 2016

Key points

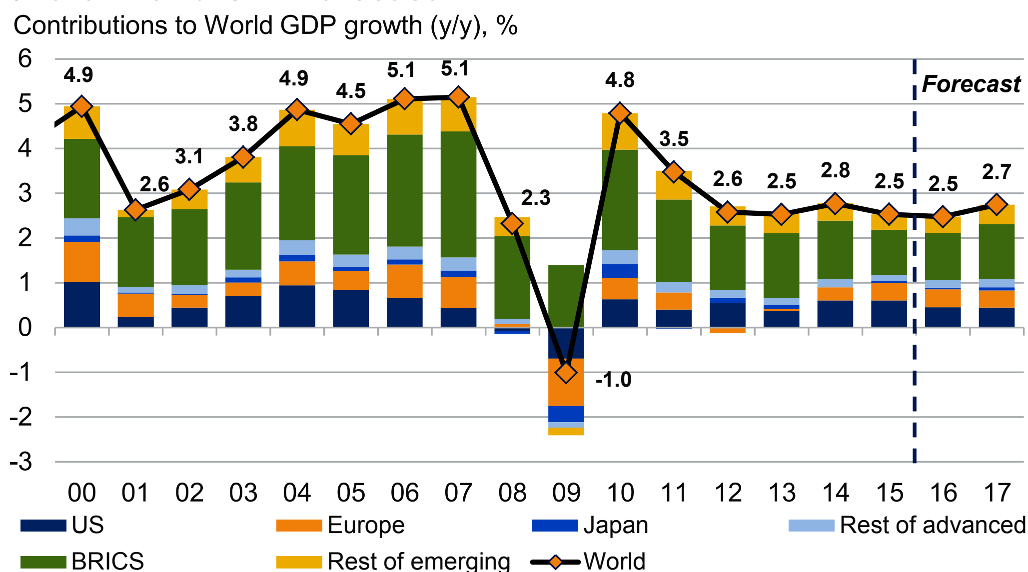
Baseline

- Stronger growth in Europe offsets downgrades to the US and Japan to leave our global growth forecast at 2.5% for 2016. The inflation profile is affected by the pick-up in oil prices although is little changed in aggregate as lower core inflation in the Eurozone and a further postponement of the consumption tax in Japan weigh on prices. For 2017, our forecasts are little changed, with growth strengthening modestly as a result of more stable emerging market activity.
- The US Fed is expected to raise rates in September and December by 25 bps, so taking fed funds to 1% by end year. Further increases are expected in 2017 to 1.5% by end year, with the Fed moving cautiously on concerns about its impact on the rest of the world and the strength of domestic recovery.
- UK recovery to continue, but to moderate as a result of Brexit uncertainty and the resumption of austerity. Interest rate normalisation to begin with first rate rise in November 2016 following a vote to remain in the EU at the referendum in June. BoE to move cautiously, hiking 25bps in November, peaking at around 1% in February 2017 when weaker activity will force a pause.
- Eurozone recovery continues in 2016, but does not accelerate as tailwinds fade and the external environment drags on growth. Inflation to turn positive again in 2016 and rise modestly into 2017. ECB to cut rates further with the deposit rate falling to -0.5% by the end of the year where it stays through 2017.
- Japanese growth now forecast at 0.5% this year and inflation at 0.0%. Following the adverse reaction to negative interest rates, the BoJ focusses on QE and introduces helicopter money in 2017H2. Fiscal policy is eased in 2016 and the consumption tax hike pushed out from 2017 to 2019.
- Emerging economies benefit from modest advanced economy demand growth and firmer commodity prices, but tighter US monetary policy weighs on activity. Concerns over China's growth to persist, further fiscal support and easing from the PBoC is expected.

Risks

- Risks skewed towards weaker growth on fears of China hard landing, currency wars and a US recession. New scenarios trade wars and Brexit shakes EU would also result in weaker growth, but also higher inflation. Inflationary risks stem from a significant wage acceleration in the US, or a global push toward reflation by policymakers.

Chart: World GDP forecast



Source: Thomson Datastream, Schroders Economics Group, May 2016 forecast. Please note the forecast warning at the back of the document.