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UK in transition: the uncertainty principle

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Hermes Investment Management
October 2018

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- UK growth has been on a downward trend in recent years. Persistent uncertainty surrounding the outcome of Brexit negotiations, weaker external demand and rising protectionist risks mean conditions for growth will remain tough.
- The process of exiting the European Union (EU) is likely to persist as the main influence on the economy for a long time. Our base case is that the UK will eventually land not far from its pre-Brexit status, but the process is likely to be bumpy and drawn out.
- In this scenario, growth is likely to be lacklustre, reflecting a decline in economic potential. The supply side of the economy has weakened, reflecting poor productivity growth and unfavourable demographic dynamics.
- The Bank of England will probably maintain that a gradual and limited hiking cycle remains appropriate. But further tightening will be conditional on a smooth Brexit transition, an assumption that could unravel.
- The policy mix is likely to change, with the fiscal lever taking the front seat at the expense of monetary policy, especially in a no-deal Brexit scenario. The government has already softened its stance on fiscal austerity and the upcoming budget could see further easing.
- Irrespective of the type of Brexit that eventually emerges, UK policymakers must ensure that tackling low productivity growth remains at the top of the agenda.

The UK is approaching the end of the two-year process required to exit the EU. The special EU summit pencilled in for 17-18 November is the next deadline for reaching a withdrawal agreement and agreeing a political declaration on the future terms of the relationship between the UK and the EU; however, negotiations could potentially slip into December.

Lingering uncertainty and the inflationary impact of the large currency depreciation that followed the vote have already taken their toll on growth in the country. Yet, it is clear that the main challenges still lie ahead. In the short term, there is a risk of a no-deal Brexit, implying cliff-edge effects. The status of the border between Northern Ireland and the Irish Republic and the degree of access to the EU markets are prominent sticking points for both sides, but the main hurdle to a deal is the continuing lack of consensus in the UK Parliament about what form Brexit should take.

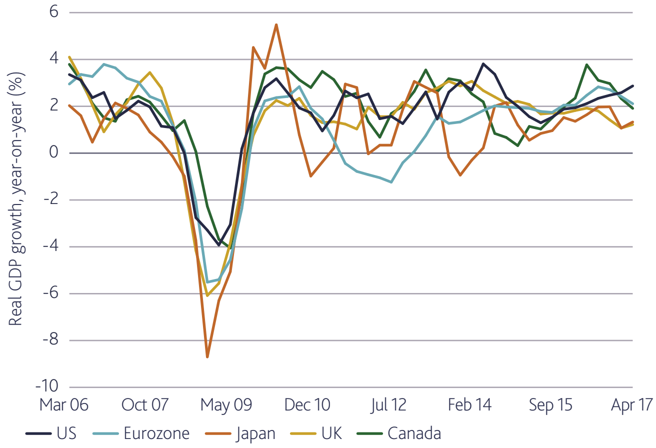
Our base case is that the UK will eventually land not far from its pre-Brexit status, but it will take time to adjust to a new equilibrium. Even in this relatively constructive scenario, the country will need to refocus its priorities – by tackling issues such as poor productivity – if it is to prevent its political soul-searching from causing further damage to its economic performance.

Growth: the slide and the squeeze

In the 18 months following the EU referendum, the UK economy did reasonably well. Brexit-related uncertainty and negative income effects from the large sterling depreciation had an adverse impact on growth, but the synchronised pick-up in global demand in 2017 provided a partial offset. The UK economy expanded by 1.7% in 2017, close to the rate it achieved in 2016 of 1.9%. However, the UK underperformed with respect to its G7 partners; the US and the eurozone, in particular, respectively recorded growth of 2.2% and 2.5% in 2017.

In early 2018, the external environment became more hostile. The recovery in global demand became sporadic (see chart 1), and the eurozone – still the UK's main trading partner – could not sustain its rate of growth. In addition, special factors have muddled the growth picture in recent quarters. In particular, a bitter winter impeded growth in Q1 2018, while a warm spring provided tailwinds in Q2. The warm weather and the positive sentiment around the football World Cup in Russia probably continued to provide support in Q3, as suggested by strong consumption data for July and August.

Chart 1: Out of harmony: the global recovery has become less synchronised in 2018

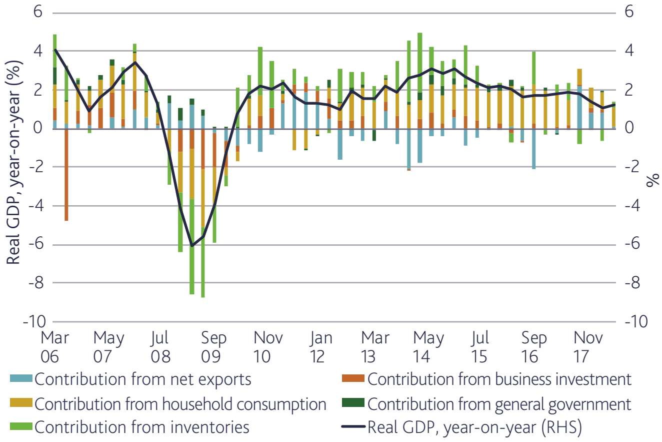


Source: Reuters Datastream, based on National Sources, as of Q2 2018.

Beneath the choppy surface waters of quarter-on-quarter volatility, the underlying trend in real GDP is one of slowing growth. The mix of weaker global growth momentum and policy uncertainty (both domestic and external) has steepened the downward growth trajectory in 2018. UK growth is on track to come in at 1.2% in 2018, the slowest rate since 2009 (when the economy contracted sharply by 4.2%), and down from a cyclical peak of 3.1% in 2014.

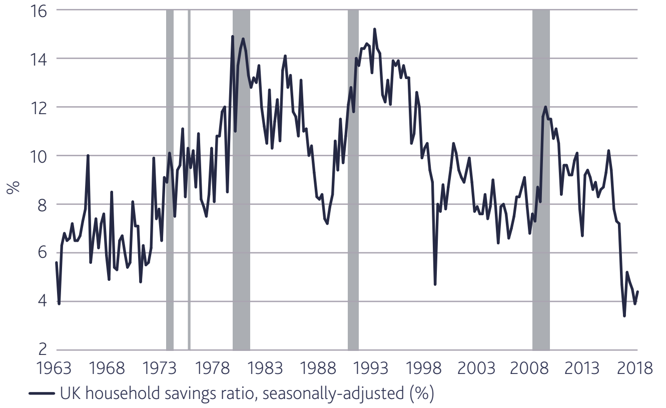
It also appears that **the base of growth is quite limited**, which makes any recovery more fragile still. For all the talk of rebalancing the UK economy away from consumption towards business investment and exports – an expectation that still featured in the Bank of England's latest forecasts – growth is still predominantly dependent on consumer demand. Even the recent and unexpected increases in growth have stemmed from consumption, while business investment and trade have remained sluggish (see chart 2).

Chart 2: UK GDP growth is still heavily reliant on consumer demand



Source: The Office for National Statistics as of Q2 2018.

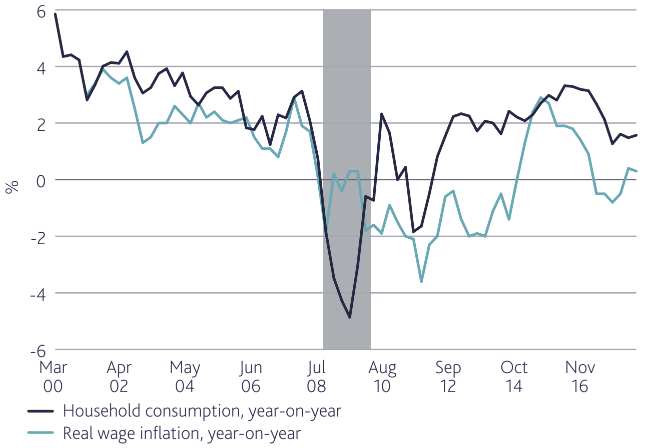
Chart 4: The household savings ratio is approaching record lows



Source: The Office for National Statistics as at Q2 2018.

Fundamentals for consumption are mixed, pointing to limited growth in the short term. Employment growth has been solid in recent years, but real wage growth has been subdued. Real wage inflation turned positive again early this year, having been suppressed by high consumer inflation last year, but remained subdued relative to history (see chart 3). In addition, the savings rate is running close to a record low[1] (see chart 4). It looks like UK consumers resorted to depleting their savings in the immediate aftermath of the Brexit vote to finance consumption ahead of likely price increases (typically lagging currency developments by two-to-three quarters). There may now be a case to rebuild savings if uncertainty remains high, which could affect consumption growth. The recent performance of the GfK Consumer Confidence Index is consistent with modest consumption growth in the short term. The index has stabilised near its long-term average so far this year, having been in a downward trend since mid-2015.

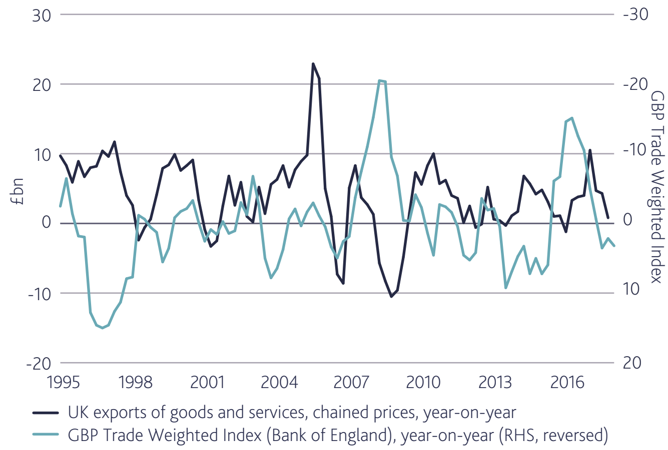
Chart 3: Real wage growth resumed in early 2018 but remains subdued, which is likely to drag on consumption



Source: The Office for National Statistics as at July 2018.

Meanwhile, the persistent uncertainty surrounding the outcome of Brexit negotiations and weaker external demand mean business investment and trade are unlikely to be significant sources of growth. Brexit-related uncertainty is likely to continue to drag on business investment, as major decisions have been put on hold. Exports have been supported primarily by external demand, with currency moves having little influence (see chart 5). Recent surveys suggest that global growth momentum faded further in September, with the manufacturing sector one of the worst affected. From a UK perspective, uncertainty about future trade agreements and the rise of protectionist tensions imply additional downside risk for exports. In particular, the National Institute of Economic and Social Research estimates that UK total trade (of goods and services) would decline by 22%[2] in a scenario where access to the EU Single Market is replaced by a free-trade agreement covering goods only. Compensating for that loss by trading more with the rest of the world would be extremely difficult.

Chart 5: The correlation between export performance and FX developments has been loose



Source: The Office for National Statistics and the Bank of England as of September 2018.

[1] This series can be revised significantly as new information becomes available.
[2] "Will New Trade Deals Soften the Blow of Hard Brexit?", published by the National Institute of Economic and Social Research on 27 January 2017.

The looming spectre of Brexit

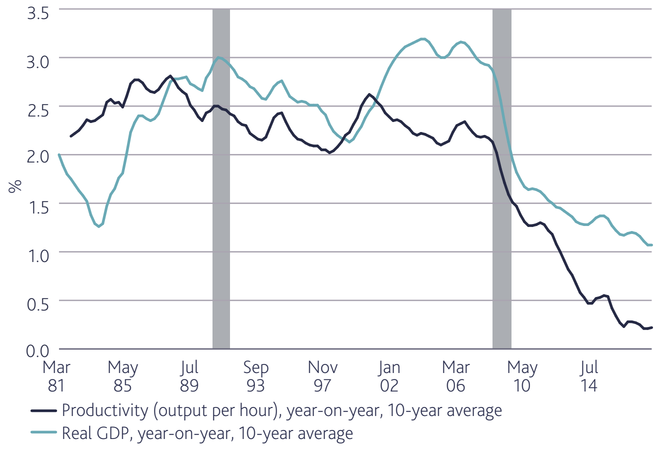
Brexit-related uncertainty has already had a negative impact on the UK economy. According to Mark Carney, Governor of the Bank of England, "the cumulative impact of these [confidence] effects has been material. By the first quarter of this year, UK GDP had increased by one percentage point less than the monetary policy committee had projected just prior to the referendum (…). Factoring in stronger-than-anticipated growth in the European and global economies and more supportive monetary and fiscal policies, the shortfall increases to around 1.75%-2% (…) This is despite the fact that Brexit has not happened yet and that UK financial conditions have remained supportive since the referendum, in contrast to previous periods of elevated uncertainty."[3]

The process of exiting the EU is likely to persist as the main influence on the economic outlook for a long time. Our base case is that the UK will eventually land not far from where it started – meaning it will manage to maintain close ties with the EU. Incentives to maintain a constructive and close collaboration are strong for both sides, and they go beyond economics. But the process is likely to be bumpy and drawn out.

In the short term, our base case is that the UK and the EU will reach a withdrawal agreement by the end of the year, which will probably include a two-year transition period up to the end of 2020. However, details of the arrangement that would eventually prevail will probably be finalised only later, during the transition period. In other words, there should be some clarity for the short term but more fundamental decisions will probably be postponed and some degree of uncertainty is likely to linger – and have lasting effects.

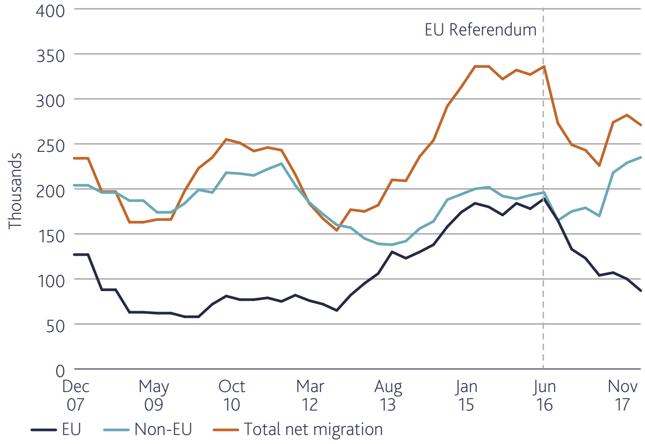
In our baseline scenario, the economy is likely to be lacklustre, reflecting a decline in economic potential. The supply side of the economy is weaker than it used to be, reflecting poor productivity growth and unfavourable demographic dynamics. Labour productivity growth has slowed substantially since the global financial crisis (see chart 6), from an average of 2.2% in the 10 years to 2008, to an average of 0.2% in the last 10 years – which implies a lower speed limit for the economy. This phenomenon is common across developed markets, but Brexit-related uncertainty constitutes a more serious challenge for the UK. In addition, slower population growth is likely to constrain potential growth. The Office for National Statistics estimates population growth of around 0.5% going forward, but this is likely to prove to be optimistic. Indeed, net immigration has already declined since mid-2016 (see chart 7) and the trend is set to continue. Total net migration came in at 271,000 in the year ending March 2018 – down from 336,000 in the year ending June 2016, reflecting a sharp slowdown in migration from the EU (which more than halved to 87,000 in the same period). Combining projections for labour productivity growth and demographics, it looks like the potential rate of economic growth probably stands somewhere between 1% and 1.5% – well below past trends.

Chart 6: Foot off the accelerator: labour productivity (output per hour) growth has plummeted over the last decade; GDP growth is heavily dependent on employment growth



Source: The Office for National Statistics as of Q2 2018.

Chart 7: Net migration to the UK has fallen sharply in the aftermath of the EU referendum, with a halving of arrivals from the EU



Source: The Office for National Statistics as of Q1 2018.

That said, there is a possibility that a hard Brexit could happen by accident. In general, a hard Brexit is defined as a shift from full access to the EU Single Market to a regime where trade between the two regions is regulated by World Trade Organisation (WTO) rules. Most analyses on the impact of a hard Brexit focus on **long-term effects** and implicitly assume a smooth short-term transition to a WTO regime. For instance, the UK Department for Exiting the EU released an analysis earlier this year[4], showing that the shift to a WTO regime would result in UK GDP being 8% lower after 15 years compared to a status quo scenario. Higher tariffs, non-tariff barriers and migration restrictions would all be long-lasting drags on growth. In addition, a no-deal Brexit could be highly disruptive of economic activity in the **short-term**, particularly if the EU were not to agree to some emergency provisions to allow for continuity in exchanges between it and the UK. In such a cliff-edge scenario – which is admittedly improbable – a recession would be likely. A no-deal Brexit would act as a supply shock. It could significantly delay, or even temporarily freeze, the trade of goods and

[3] "From Protectionism to Prosperity – speech by Mark Carney," published by the Bank of England on 5 July 2018.
[4] "EU Exit Analysis, Cross Whitehall Briefing," published by the House of Commons Exiting the EU Committee in in January 2018.

services between the UK and the EU. Integrated supply chains would be considerably affected. Higher costs for exporters and producers would ultimately affect consumers.

Think different: time to change the policy mix?

The Bank of England (BoE) has no tools with which to effectively target productivity, as monetary policy has, at best, a limited impact on the supply side of the economy. Indeed, the central bank regularly takes stock of supply-side developments as an input for its framework. In November last year, it downgraded its forecasts for the supply side of the economy, in light of lacklustre productivity performance.

That gloomier take on the supply side of the economy has been the main justification for tighter monetary policies over the last year: in a context of sluggish potential growth, the limited spare capacity left in the economy is quickly disappearing, and excess demand is building. In order to avoid a last-minute overreaction to the inflationary pressures which are likely to emerge – and taking into account the fact that monetary policy works with a lag – the BoE has embarked on a gradual and limited tightening cycle, hiking rates in November 2017 and August 2018.

Looking ahead, the BoE has provided guidance that "gradual" means roughly one hike per year over the next few years. In addition, its targeted rate will be well below the pre-crisis norm of about 5%. That reflects a neutral rate that has structurally declined over time and now probably stands at around 2-3% (according to a range of estimates provided by the central bank in its August Inflation Report[5]), while Brexit-related uncertainty implies an even lower neutral rate of 1.5-2% in the short term.

For the BoE, tactics matter as much as strategy. The central bank exploited its opportunity window to hike rates twice, helping to create more of a buffer in the policy rate ahead of the next downturn. In addition, its tightening bias has probably contributed to the stabilisation of the currency.

The BoE is likely to refrain from further interventions in the near future as Brexit negotiations approach a crucial stage and uncertainty is high. It will probably maintain a mild tightening bias, reiterating that a gradual and limited hiking cycle is appropriate under most Brexit scenarios. But a rate hike around the middle of next year is conditional on a smooth Brexit transition, an assumption that could unravel, should negotiations turn sour.

In a no-deal scenario, the BoE's response is not obvious. A no-deal Brexit would immediately act as a supply shock, giving way to weaker activity and high inflation. The BoE would therefore face a trade-off, and its response would depend on the relative changes in aggregate demand and supply and on corresponding implications for inflation down the road. While the central bank could not prevent the move to a new regime of slower potential growth, we think that it would eventually try to smooth out the transition by maintaining accommodative policies. In addition, the fact that Carney will stay at the helm of the BoE until the end of January 2020 should allow for some continuity in monetary policy.

At any rate, the BoE will also take account of any changes in **financial conditions** after Brexit and it would probably provide liquidity as necessary to maintain the smooth functioning of the financial system. In a no-deal scenario, it might adopt emergency liquidity measures, which would probably be larger and more immediate than those applied in the aftermath of the EU referendum. Developments in the currency would also matter: in a no-deal scenario, the pound would likely depreciate further. While that would ease financial conditions (as it would make exporters more competitive, partially making up for the loss of market access), it would also have negative income effects by increasing input costs and consumer prices.

There is also a material possibility of a change in the policy mix, with the fiscal lever taking the front seat at the expense of monetary policy. Chancellor Philip Hammond has already softened the government's fiscal austerity policy (in November last year) and has hinted at more easing in his spring statement in March. Moreover, Prime Minister Theresa May announced an end to austerity during her speech at the annual Conservative Party Conference in early October. That has raised expectations in the run-up to the budget on 29th October. However, we expect fiscal easing to be limited at this stage, focused on providing higher funding for the National Health Service in England (fulfilling the promise, made in June, of an extra £20bn a year by 2023). The Chancellor has some limited room to loosen the government's purse strings, given that net borrowings are tracking £10-15bn lower than forecast by the Office for Budget Responsibility for the current fiscal year. A more decisive u-turn on fiscal austerity might take place once the UK leaves the EU, especially in the event of an acrimonious divorce.

Finally, irrespective of the ultimate relationship agreed between the UK and the EU, productivity growth will be the main driver of UK living standards in the long run; therefore, **tackling low productivity growth should remain at the top of the policy agenda**. There is still an open debate on the reasons for this lacklustre productivity, including resource hoarding in zombie firms – companies that don't make enough money to service their debts – and mismeasurement issues, notably with respect to intangible assets (and the real output associated to them). Opinion is divided over which firms across the productivity distribution are most responsible for the shortfall. The BoE's Chief Economist, Andrew Haldane, suggested that the shortfall is concentrated in the "long tail" of companies struggling to catch up with firms at the technological frontier[6]. By contrast, another sectoral analysis by BoE staff suggested that the most productive firms are "failing to improve on each other at the same rate as their predecessors did"[7]. Whatever the explanation for the productivity puzzle, several initiatives have been announced in recent years to improve infrastructure and human capital[8]. And further targeted policy efforts will be needed in the future.

[5] "Inflation Report," published by the Bank of England in August 2018.

[6] See, for instance, "Productivity puzzles - speech by Andrew Haldane," published by the Bank of England on 20 March 2017.

[7] "The UK's productivity puzzle is in the top tail of the distribution", published by Bank Underground on 29 March 2018.

[8] For instance, the introduction of T-level qualifications and the apprenticeship levy; the creation of a £31bn National Productivity Investment Fund for investments in transport, housing, digital, and research and development; the fiscal remit for the National Infrastructure Commission for sustained public infrastructure investment of 1-1.2% of GDP over the long-term (see "IMF Concluding Statement of the 2018 Article IV Mission to the UK," published by the IMF on 17 September 2018).

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