Schroders

Macro and markets

Themes for 2018

Keith Wade, Chief economist

11 January 2018

For professional investors or advisers only

Some forecasts for US GDP in 2018

The White House is bullish…

"We're easily going to see 4%"

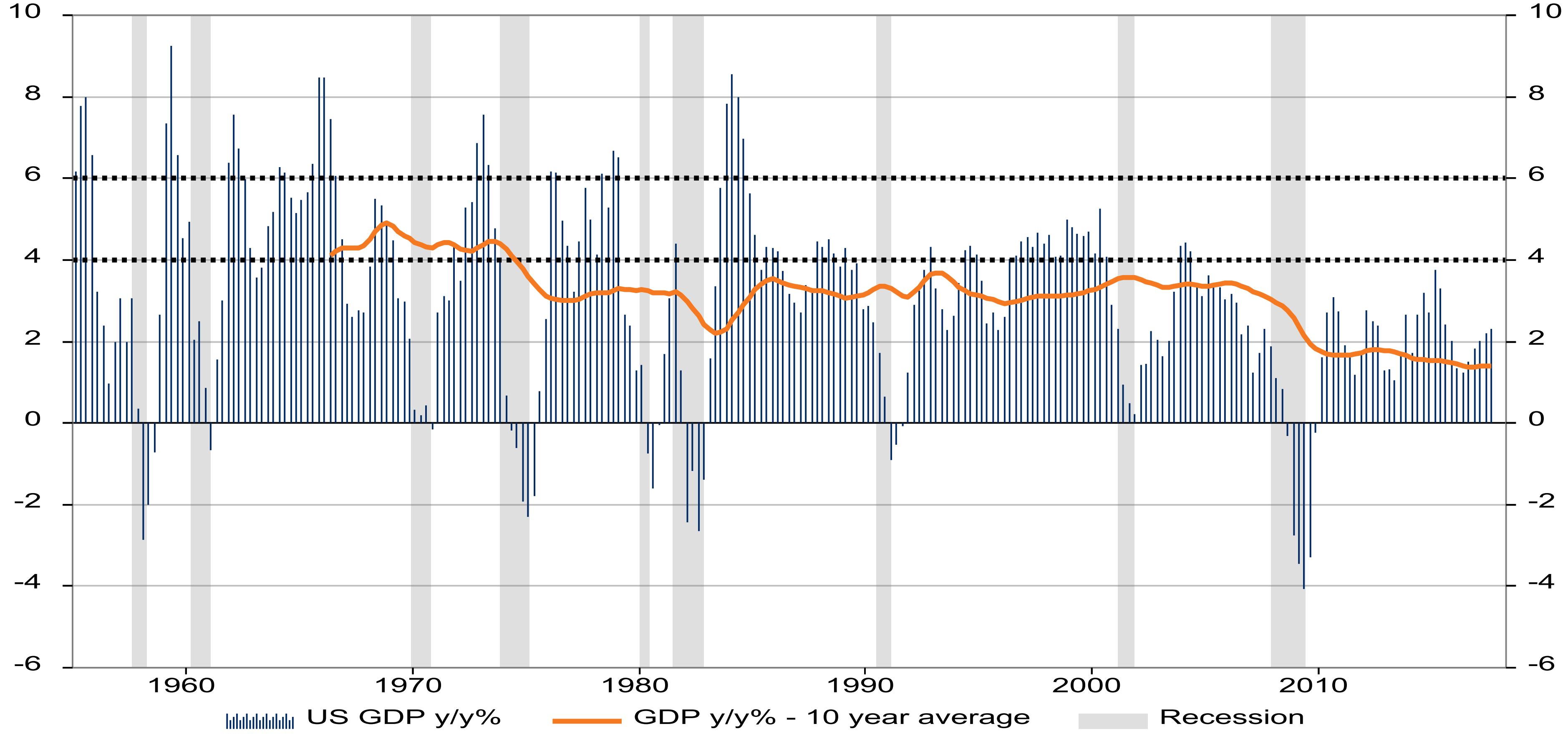
Gary Cohen, Director of the National Economic Council

"I see no reason why we don't go to 4, 5, even 6%"

President Trump

US growth since 1955

4% has become rare, 6% rarer still...



Source: Thomson Reuters Datastream, Schroders, Updated 10/01/2018

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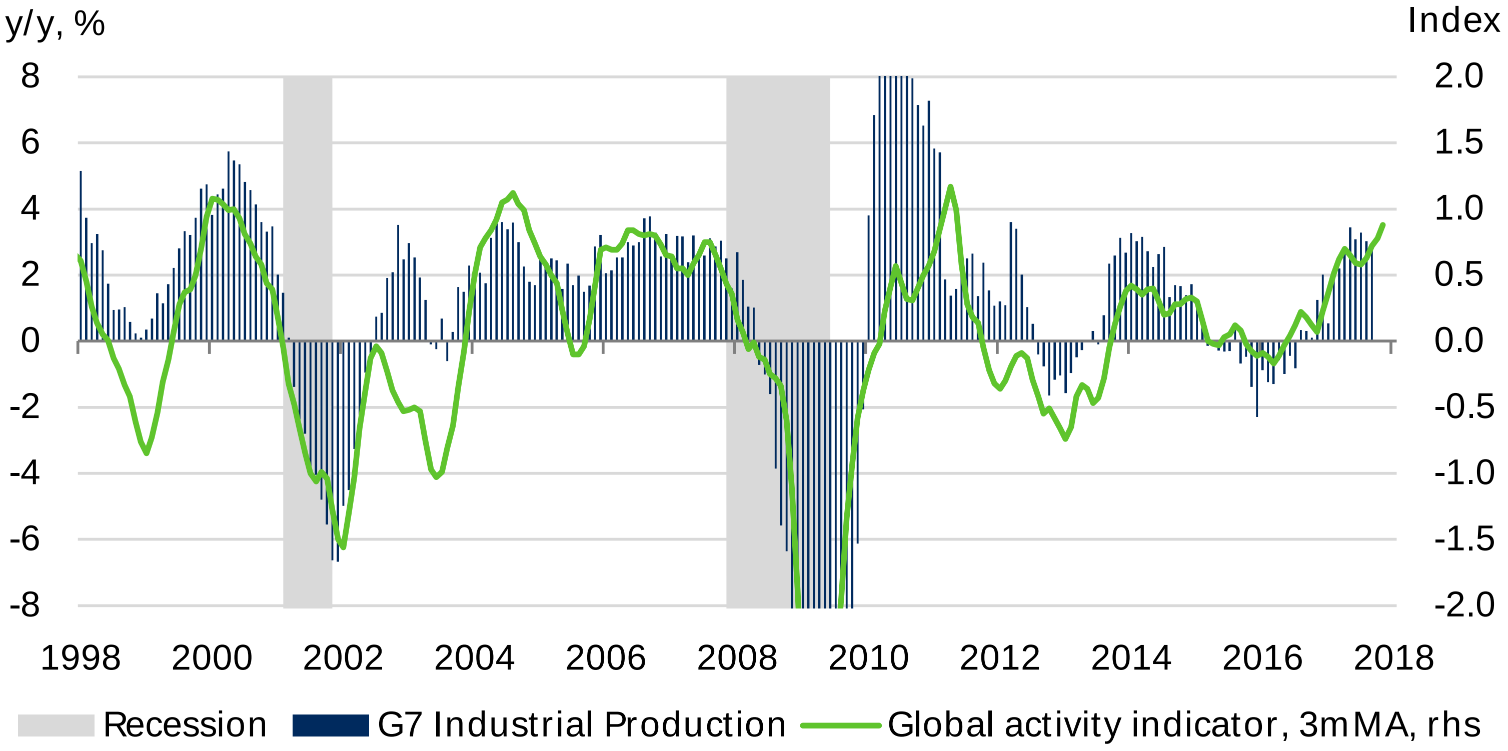
Macro outlook

Themes for 2018

Theme 1. Goldilocks gives way to reflation

Leading indicators remain robust

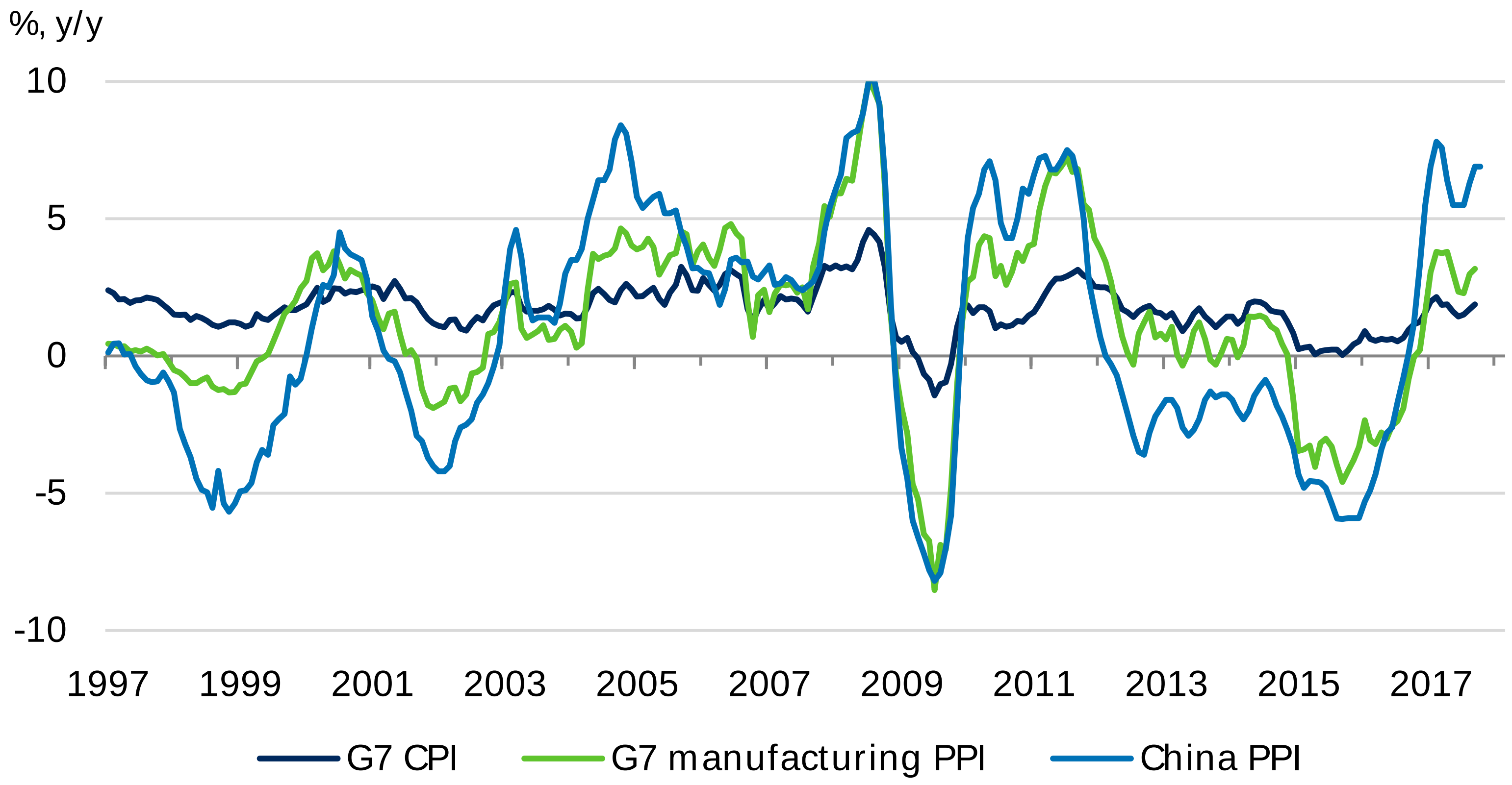


- As 2018 begins, the activity picture remains strong. Business is confident and leading indicators signal robust growth ahead
- We upgraded our global growth forecasts in November, but activity since then has proved to be even stronger than expected
- One of the key elements of the upswing is the revival in capital investment which is expected to continue judging from orders data in the US, Germany and Japan

Source: Thomson Datastream, Schroders Economics Group, 20 December 2017

Goldilocks gives way to reflation

Pipeline pressures are building

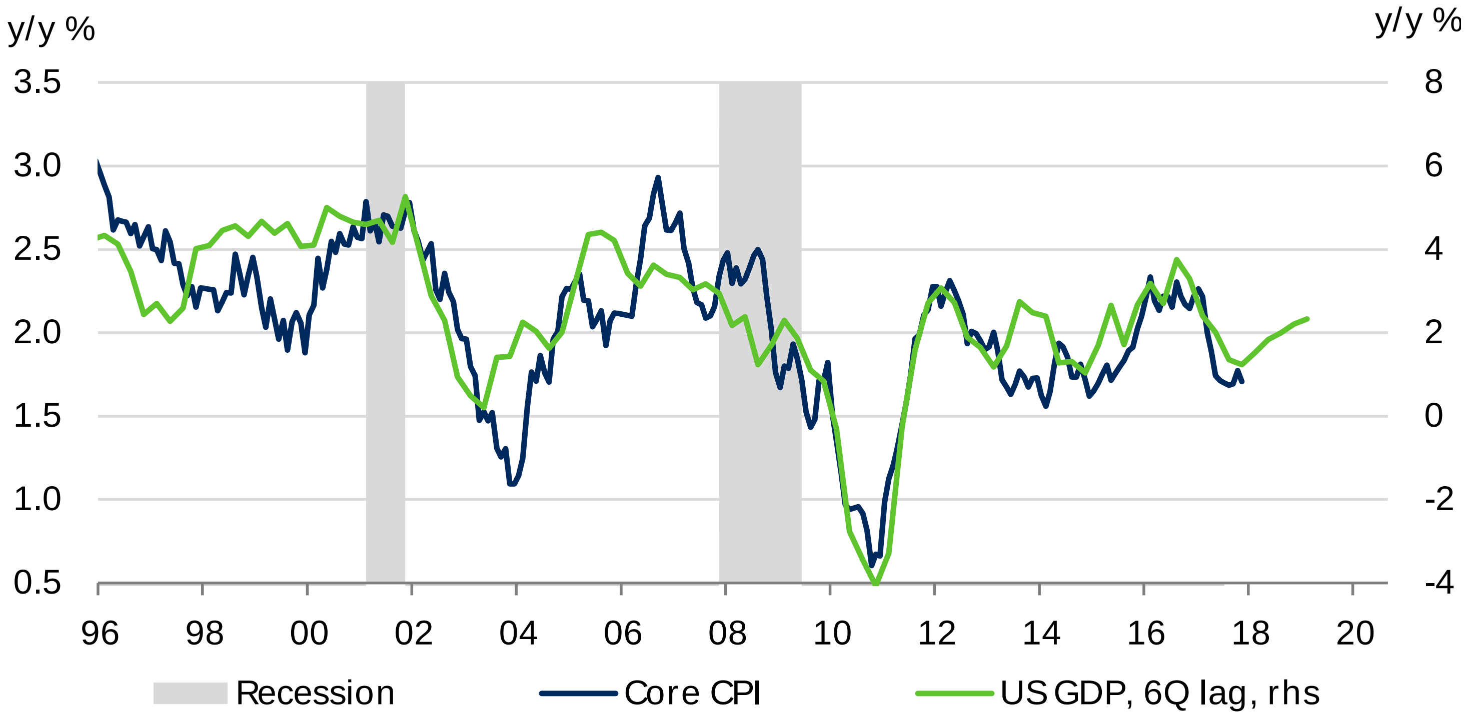


- We forecast global inflation to remain at 2.3% in 2018
- This is reinforced by higher oil and commodity prices and reflected in the pick-up in producer price inflation around the world in recent months

Source: Thomson Datastream, Schroders Economics Group, 22 November 2017

Goldilocks gives way to reflation

Cyclical forces to push up core inflation in the US



- Pipeline pressures are rising and we expect firms to respond to the recovery in growth by raising prices more aggressively in 2018
- We have highlighted the long lags between GDP growth and inflation many times over the past year as one of the best explanations for the weakness of core inflation in 2017
- Going forward it is a key element in our reflation forecast

Source: Thomson Datastream, Schroders, 20 December 2017

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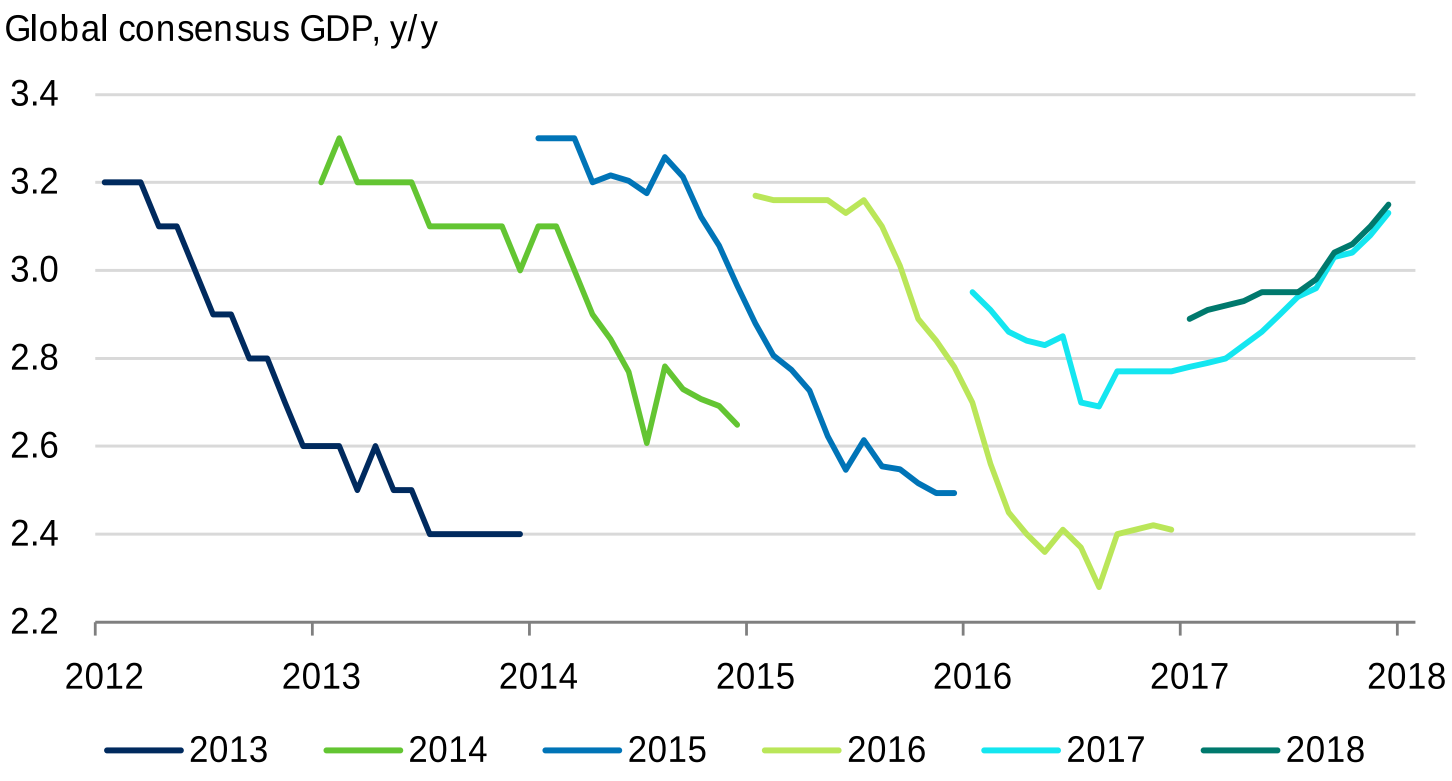
Goldilocks gives way to reflation

Growth outlook positive, but expectations for 2018 have risen

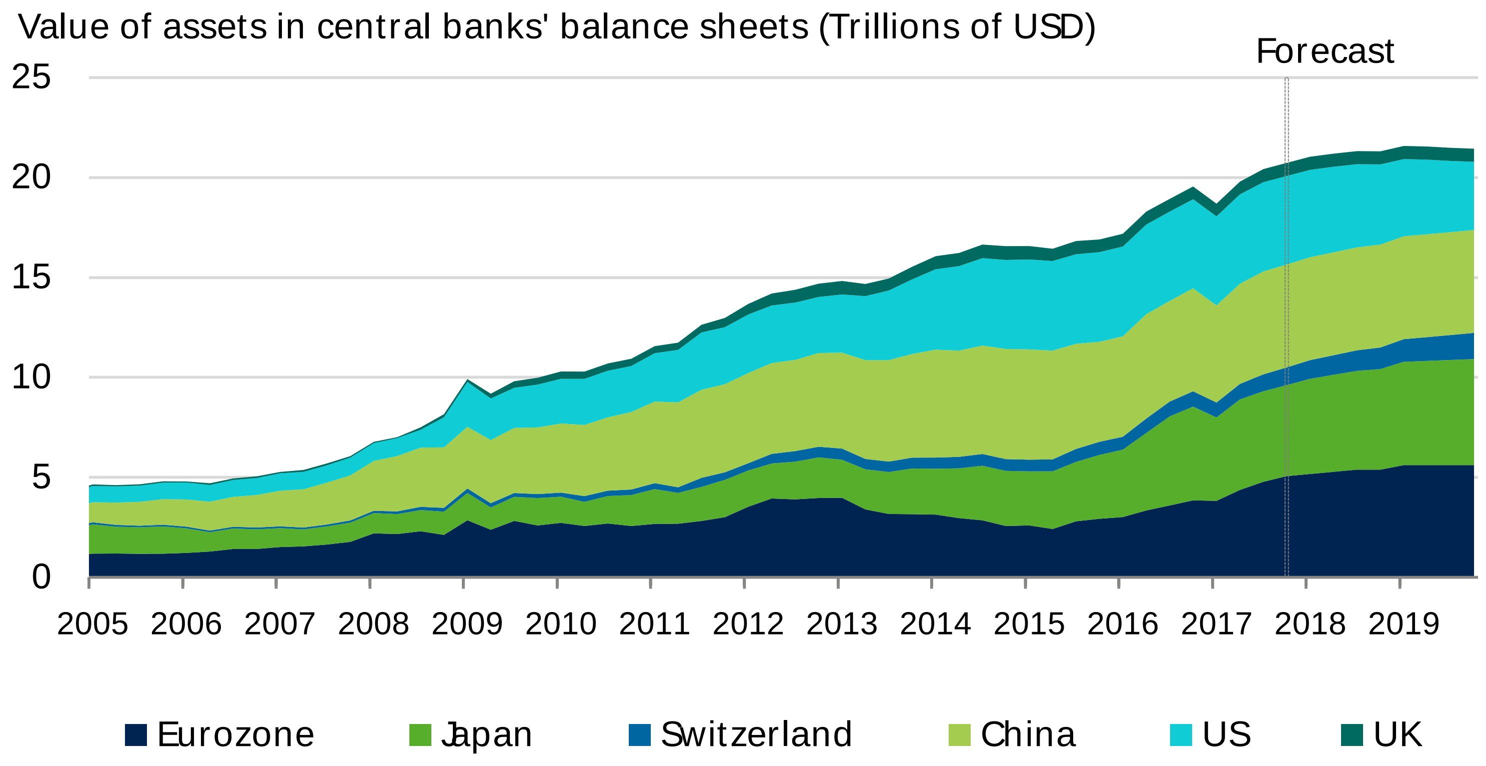


- The growth picture is good; however markets will face two challenges
- First, growth expectations are higher than a year ago. At that time the consensus for global GDP growth in the year ahead was 2.8%. Today the equivalent figure is 3.2%
- Second, unlike in 2017, stronger growth is more likely to be accompanied by higher inflation and higher interest rates

Source: Thomson Datastream, Schroders Economics Group, 21 December 2017

Theme 2. The long farewell to QE

Global liquidity set to slow

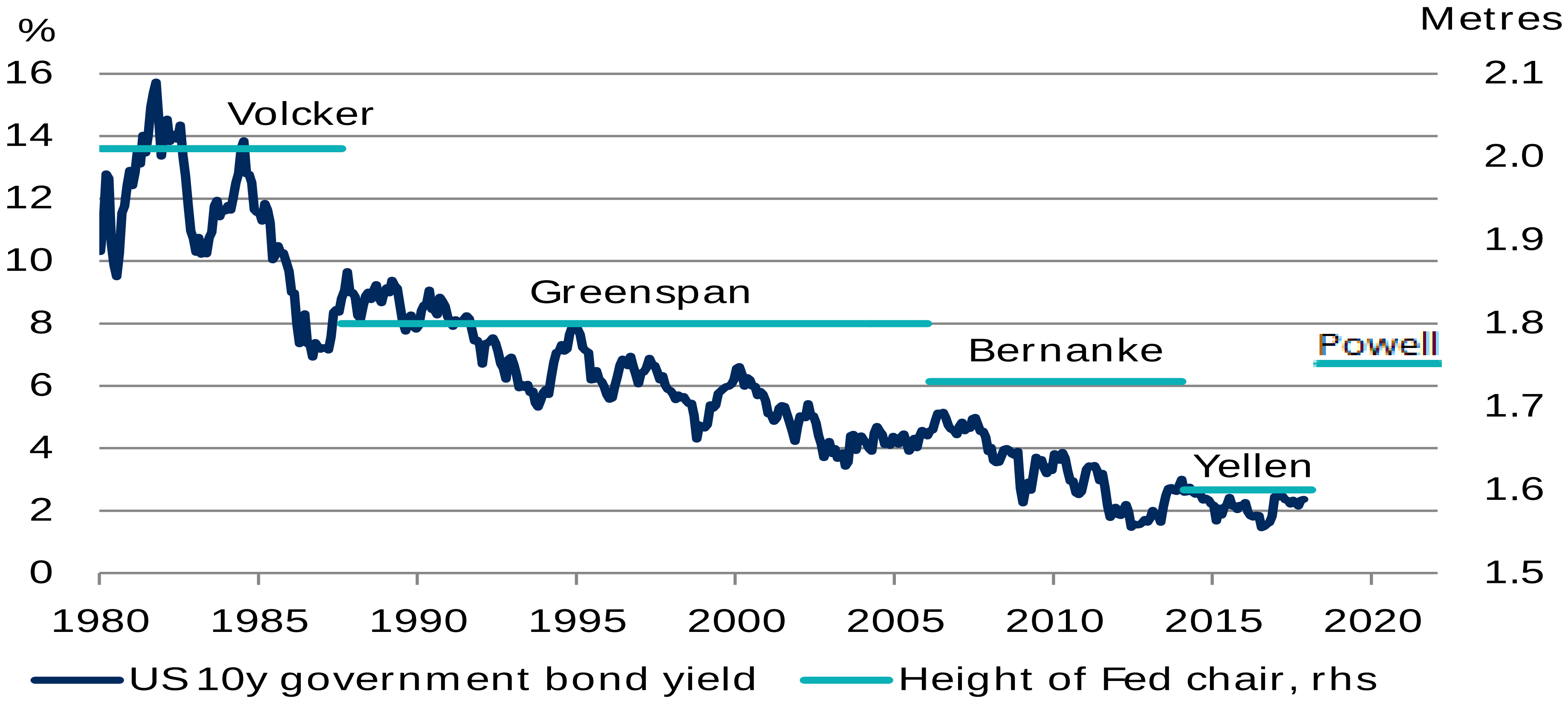


- Higher inflation expectations will affect bond yields, a move which could be exacerbated by the end of the great quantitative easing (QE) experiment
- The ECB's asset purchase programme is set to halve to €30bn per month from January
- The Fed started to reduce its balance sheet in October
- The overall level of global liquidity is set to slow in 2018 and begin to contract in 2019

Source: Thomson Datastream, Schroders Economics Group. 20 December 2017

The long farewell to QE

Are yields heading higher under Powell?



Source: Thomson Datastream, Schroders Economics Group, 9 November 2017

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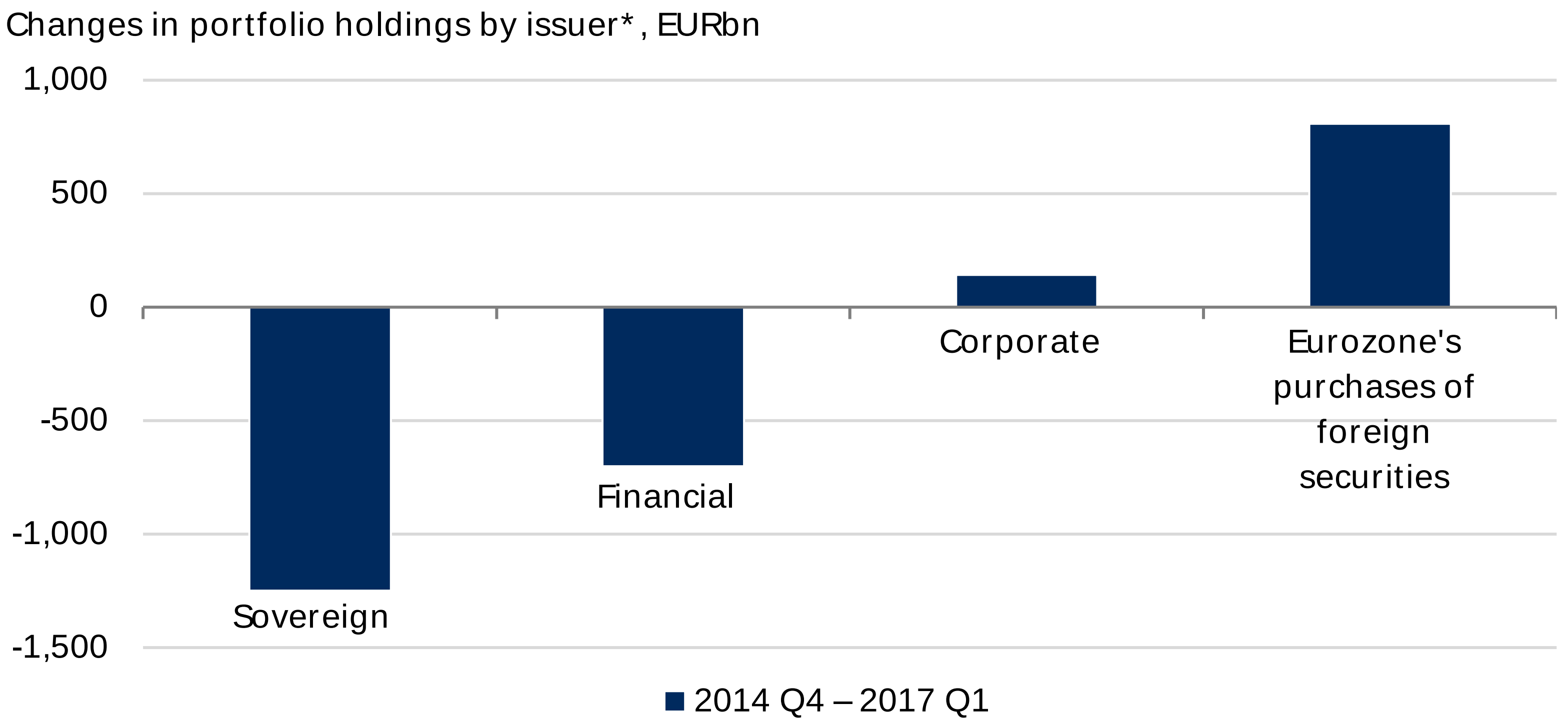
ECB QE has had a significant impact on capital flows

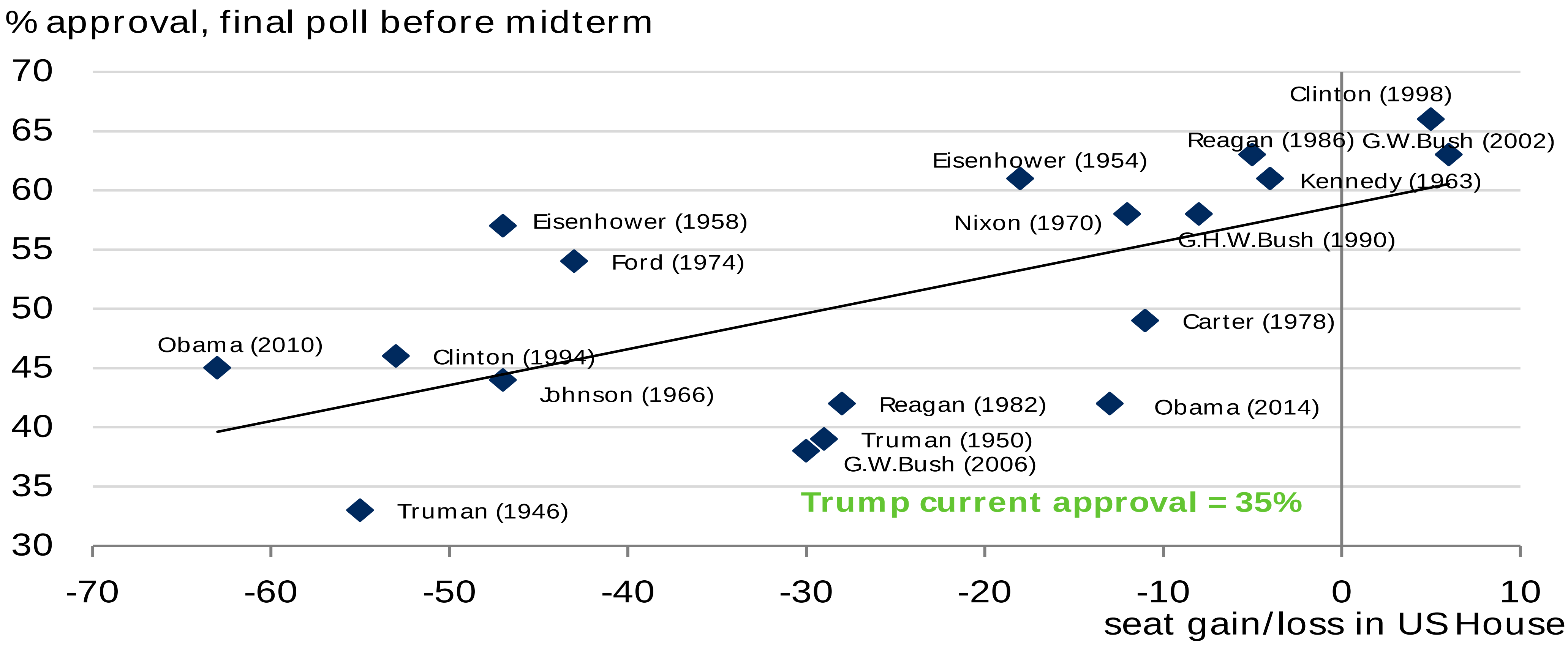
ECB's action has had international impact



*Private holdings by Eurozone investors. Source: Oxford Economics, Haver Analytics, Schroders Economics Group, 25 September 2017

Theme 3. The return of political risk

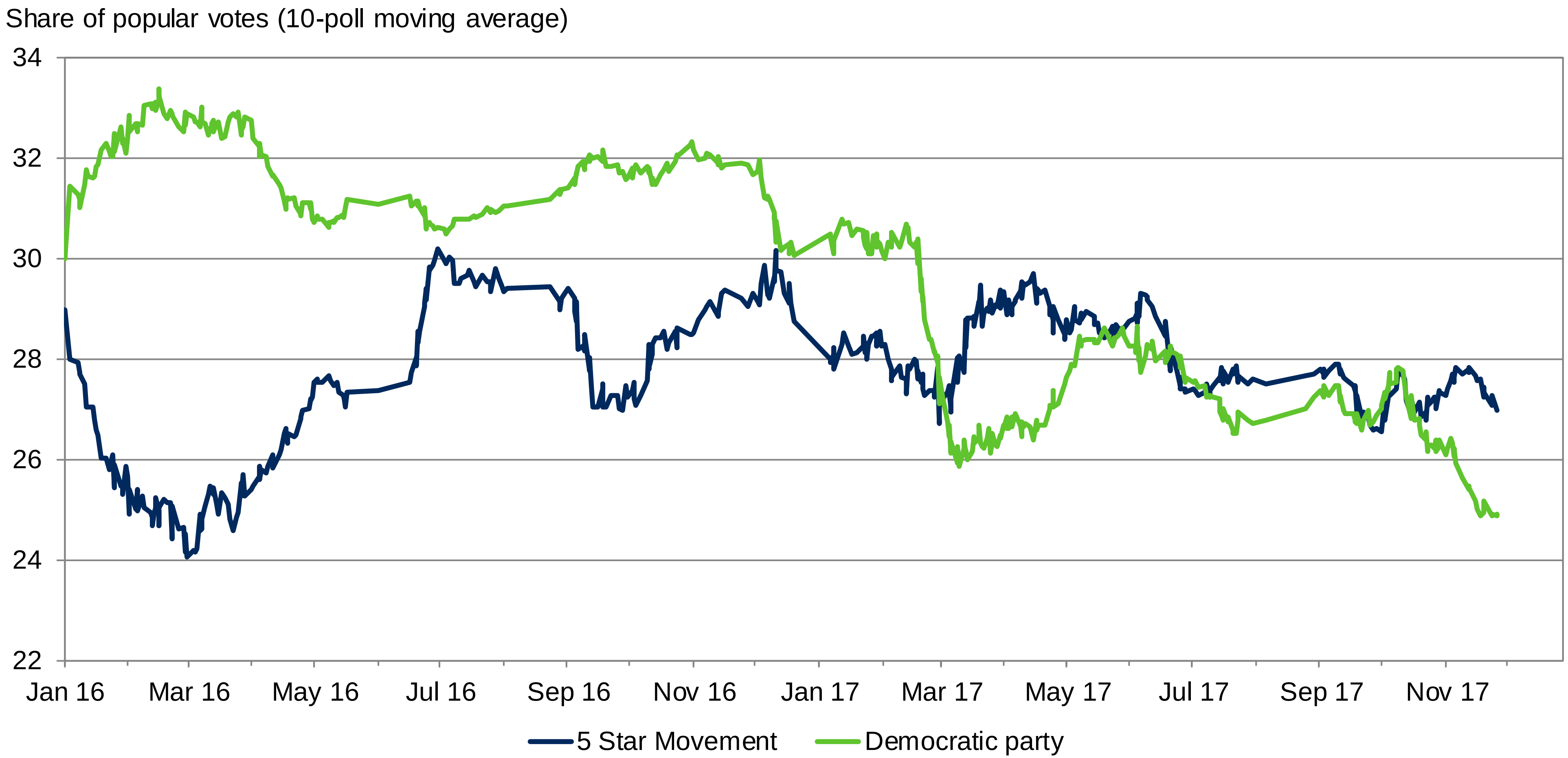
US mid-terms - Republican party to lose the House?



Source: Gallup, Schroder Economics group, 20 December 2017

Italy's election is now Europe's biggest risk event

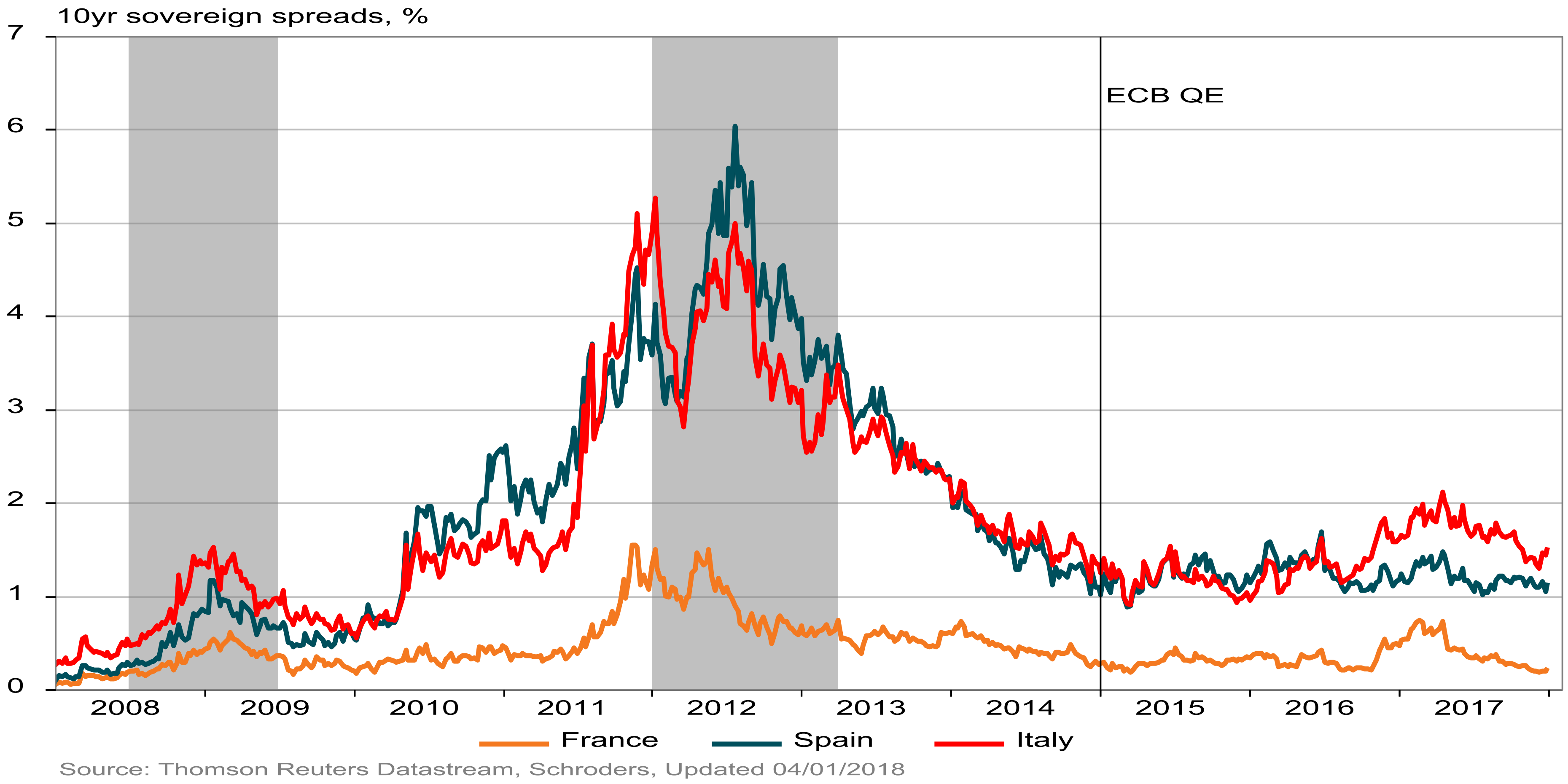
M5S are slightly ahead of the PD, but who will work with them?



Source: Wikipedia, Schroders Economics Group. Updated 1 December 2017.

Themes 2 & 3. QE and the return of political risk

End of ECB QE could see higher yields and spreads in the periphery



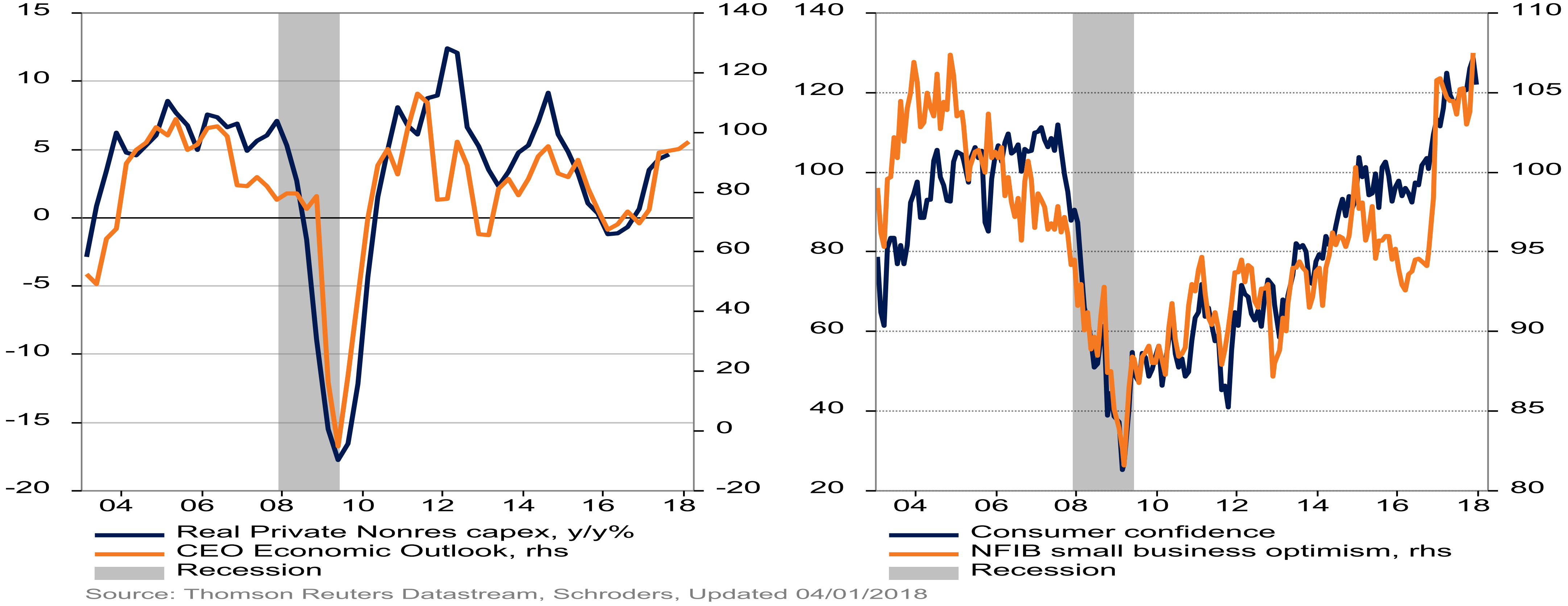
Source: Thomson Datastream, Schroders Economics Group, 04 January 2018.

US

Return of the Trump trade?

Return of animal spirits in the US

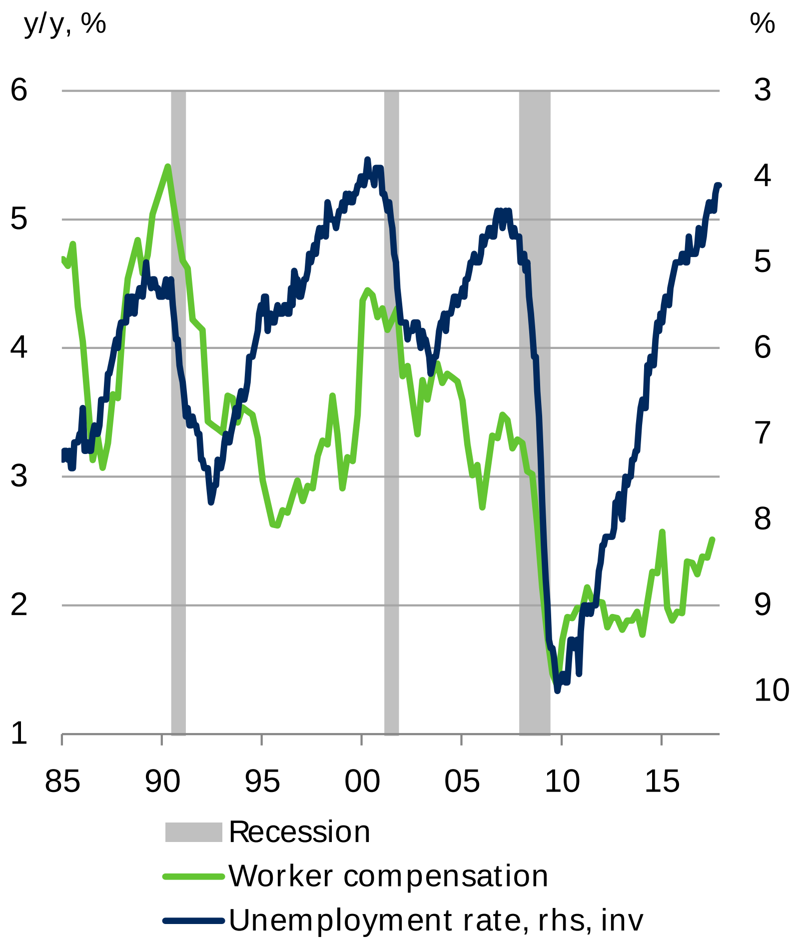
Confidence has surged in the US and capex is following

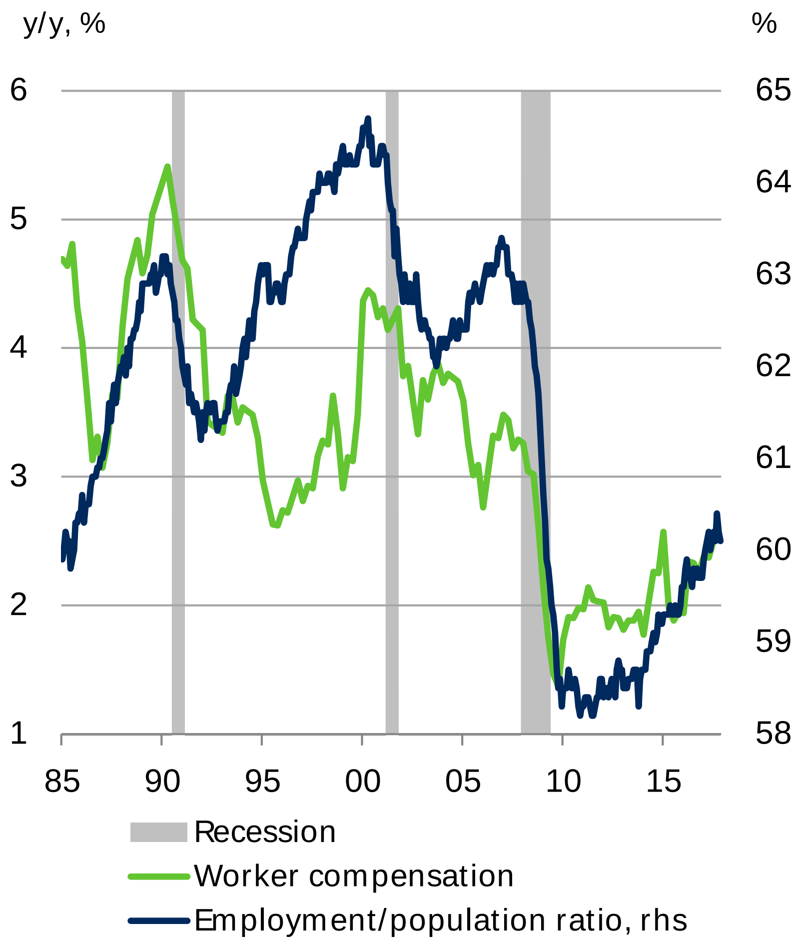


Source: Thomson Datastream, Schroders Economics Group. 2 October 2017.

Inflation continues to surprise on the downside

Wages and the labour market – still some slack?





Source: Thomson Datastream, Schroders Economics Group, 8 December 2017.

Tax cuts for 2018

The US “just passed the biggest in history Tax Cut and Reform Bill” president Trump

Key changes in Tax Cuts and Jobs Act (-$1.46tn)

Business taxes (-$654bn)

- Corporation tax reduced from 35% to 21% and repeal corporate Alternative Minimum Tax (-$1.4tn)
- Reduce taxes on pass-through business income (-$415bn)
- Limits on business interest deductibility from fully deductible to 30% of business’ adjusted taxable income until the end of 2021 and excluding depreciation after 2022 ($253bn)

Individual taxes (-$1.13tn)

Tax rates go from 10%, 15%, 25%, 28%, 33%, 35%, 39.6% to 10%,12%, 22%, 24%, 32%, 35%, 37%, ends 2025 (-$1.2tn)

- Individual Alternative Minimum Tax (AMT) exemption increased, ends 2025 (-$637bn)
- Increase the standard deduction, ends 2025 (-$720bn)

International tax reform ($324bn)

- Repatriation of profits; 15.5.% tax on liquid investments and other untaxed foreign earnings at 8%. Future foreign earnings not taxed ($339bn)

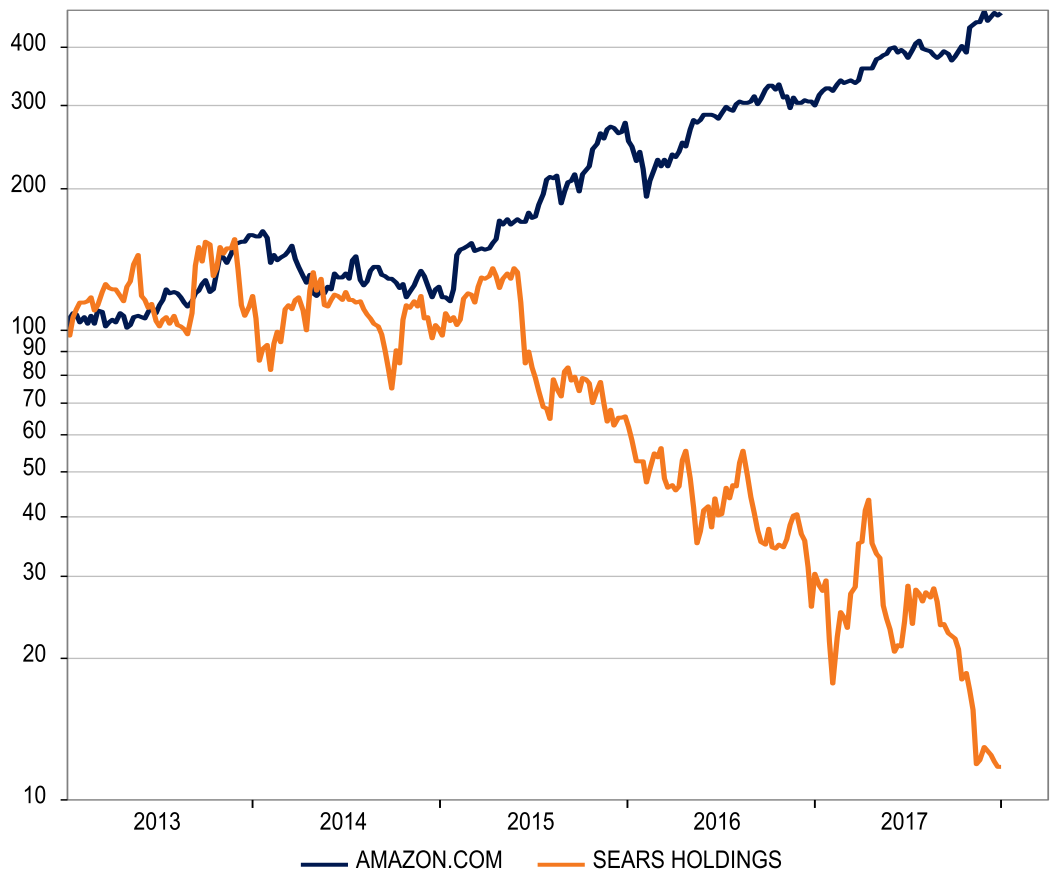
Impact

- Oxford Economics estimate the package will boost US GDP growth by 0.4 percentage points in 2018 (adding 0.3 pp to consumption and 1.4 pp to business investment)

*() is revenue impact for fiscal year 2018-27 from Joint Committee on Taxation (JCT) Source: Schroders Economics Group, JCT, 20 December 2017

Coping with structural change

The Amazon effect in US retail



Source: Thomson Reuters Datastream, Schroders, Updated 04/01/2018

Source: Thomson Reuters Datastream, Schroders, Updated 04/01/2018

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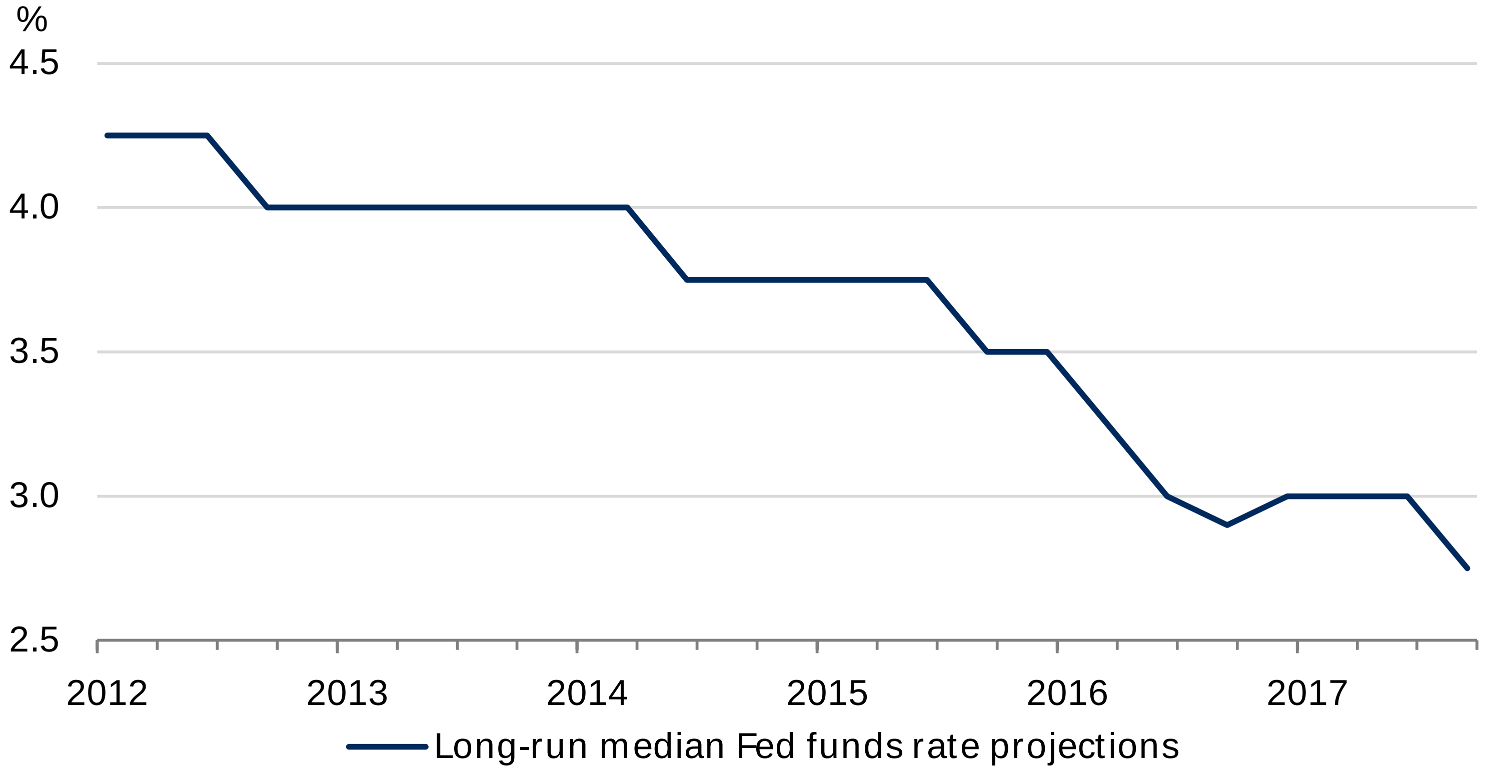
Where is the new normal for rates?

The “long run” dot from the Fed



- We now expect three US rate hikes in 2018
- Given the reduced trend rate of US growth, the rate peak in this cycle should be well below previous cycles

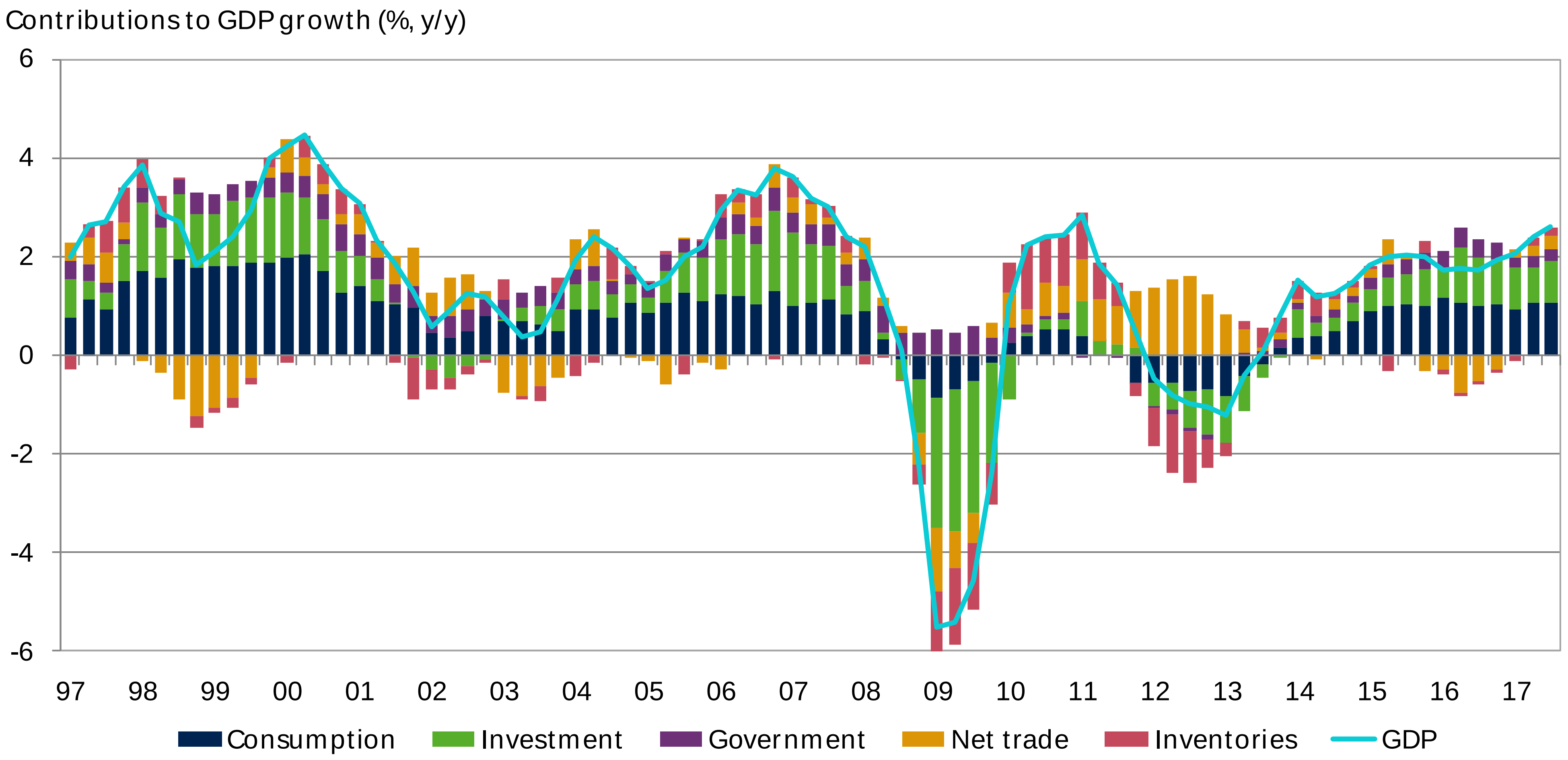
Source: US Federal Reserve FOMC projections, Schroders Economics Group, 22 November 2017

Europe

Is current growth sustainable?

Domestic demand recovery has been key

Contributions to GDP growth

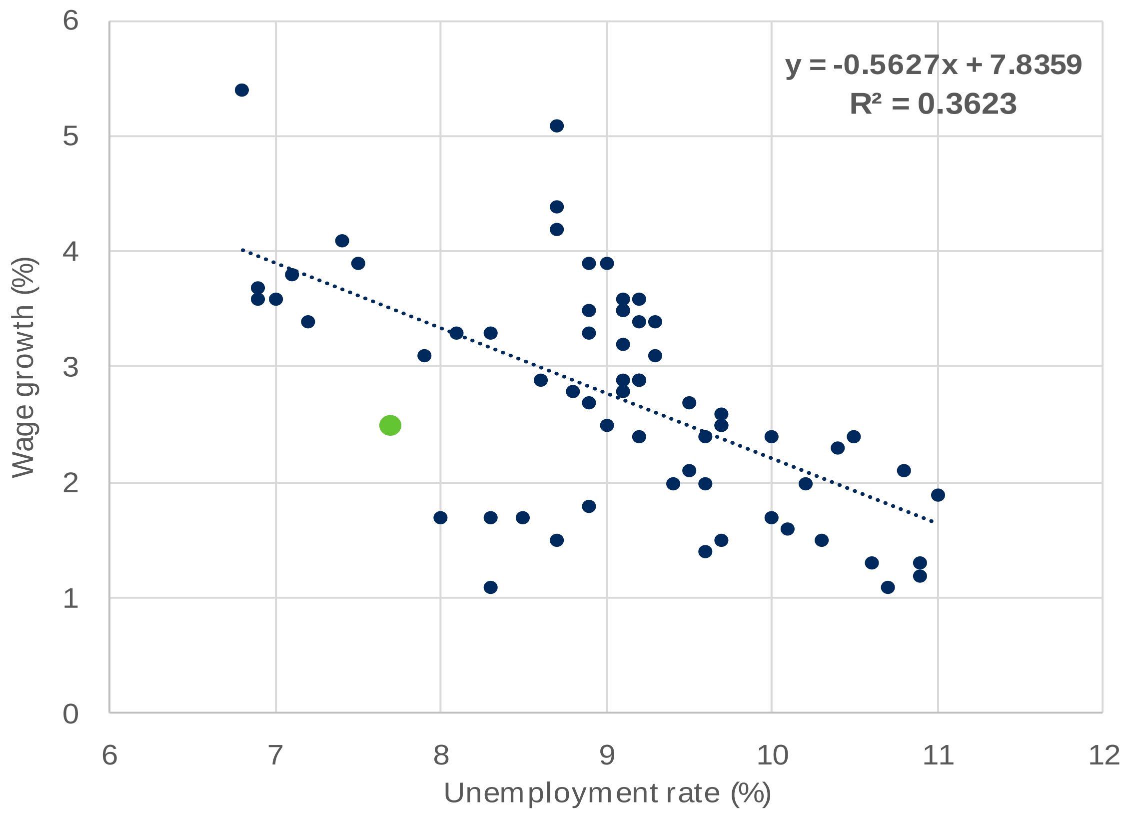


Source: Thomson Datastream, Eurostat, Schroders Economics Group. 8 December 2017.

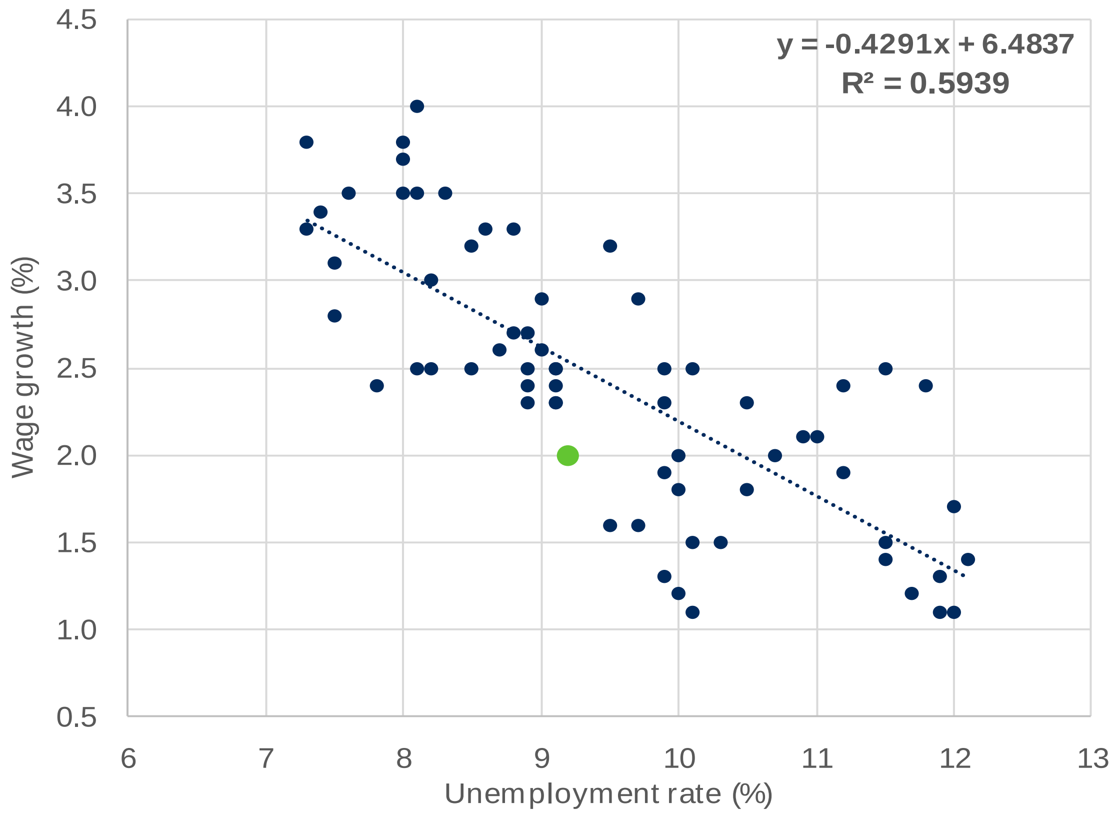
Philips curve still works at EU and EZ levels

Free movement of labour has made national Philips curves flatter

EU's Philips Curve (2001-2017)



Eurozone's Philips Curve (2001-2017)



Source: Thomson Datastream, Schroders Economics Group. 4 December 2017.

Brexit

Deal or no deal?

Brexit negotiations to move to phase II

A broad agreement reached on citizens' rights, Northern Ireland and the divorce bill

- The 8 December agreement on citizens' rights, Northern Ireland and the divorce bill paves the way to begin phase II of negotiations, which will include a framework for trade.
- Northern Ireland is not fully resolved yet, but a commitment to maintain the 1998 peace accord could lead to a softer Brexit, possibly EEA membership.
- The UK still believes it can get a bespoke deal, with a full withdrawal from the single market and separate trade deal for tariff free access.
- Some restrictions on migration are politically necessary for the UK, along with repatriation of power from the ECJ.
- Minimum 2-year transitional period is very likely, with ongoing discussions over finer details.

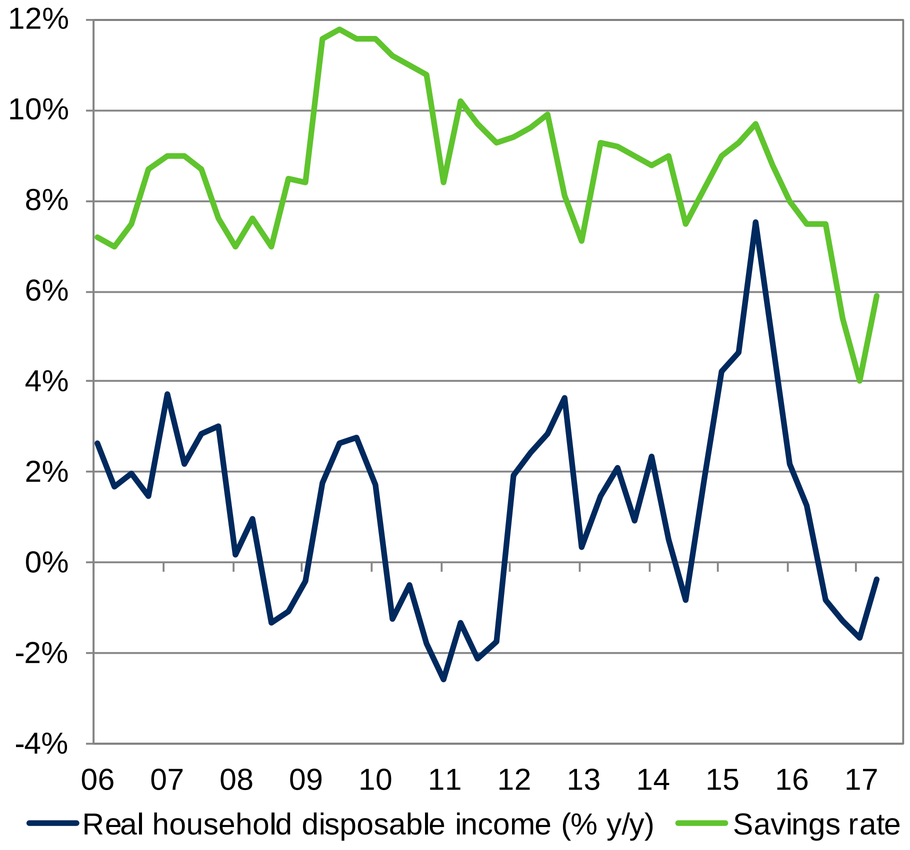
GBP: the Brexit barometer

Source: Schroders Economics Group. 8 December 2017.

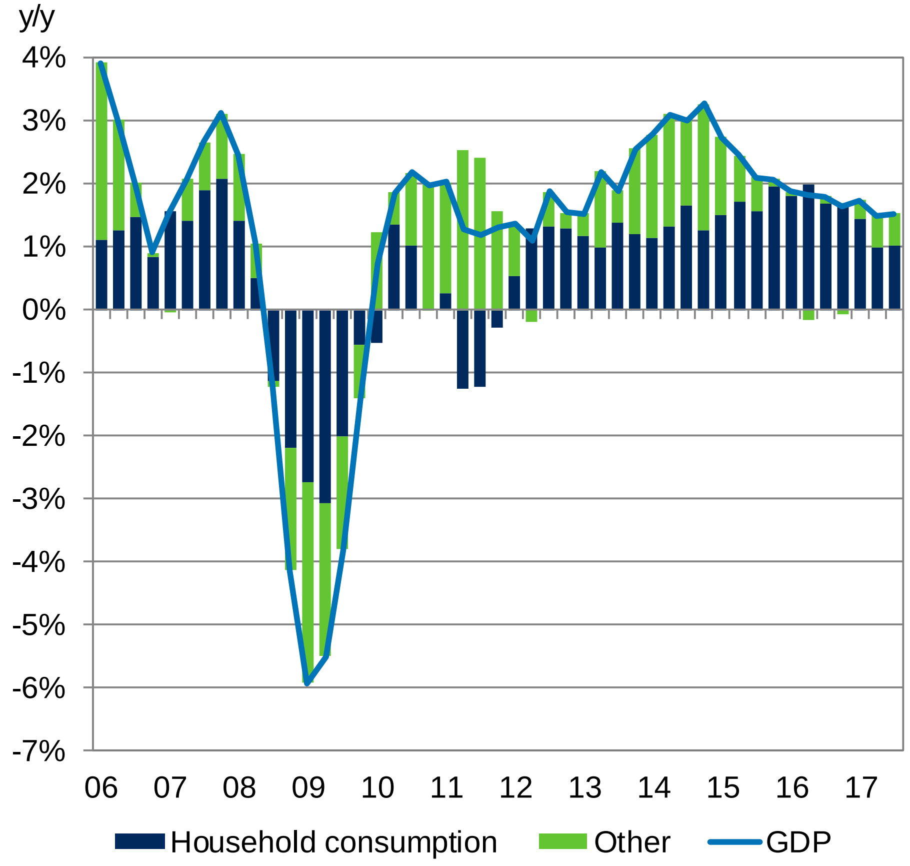
Higher inflation has squeezed households and slowed growth

Household consumption is the key reason for recent better than expected growth

Disposable income vs. savings rate



Consumption vs. other components of GDP



Source: Thomson Datastream, ONS, Schroders Economics Group. 8 December 2017.

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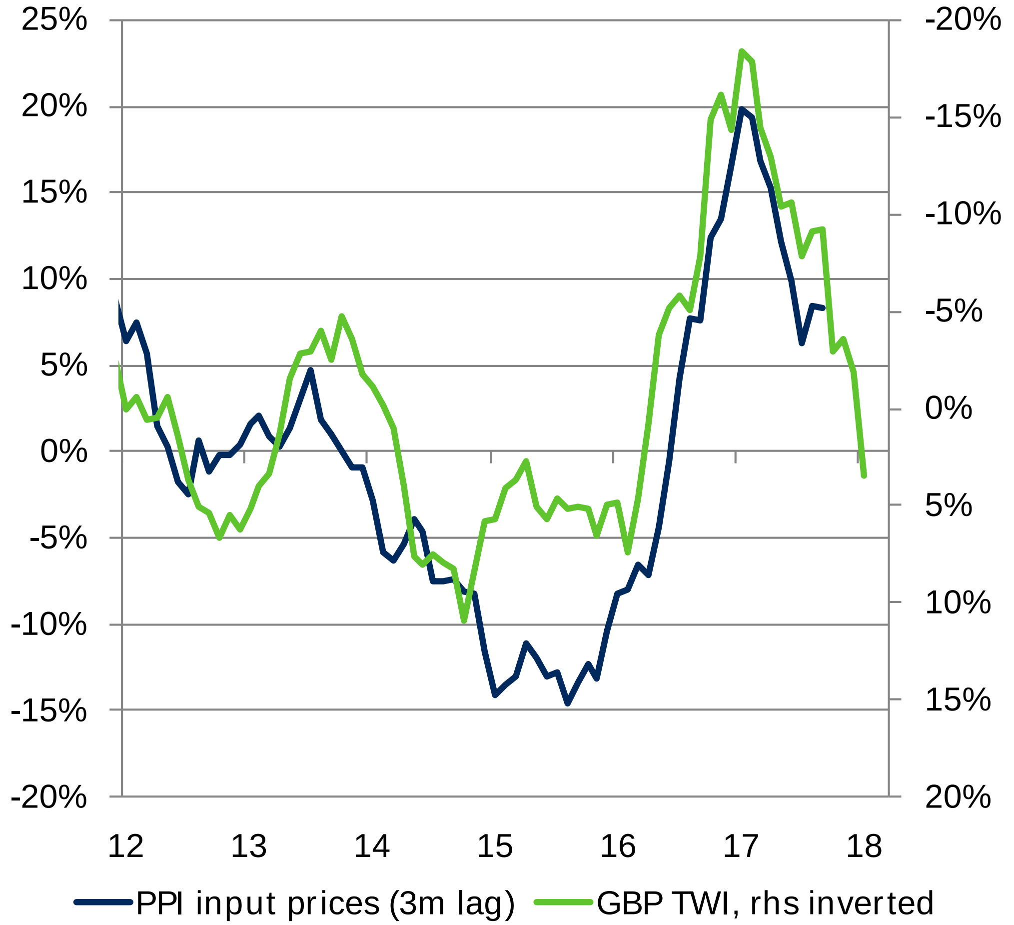
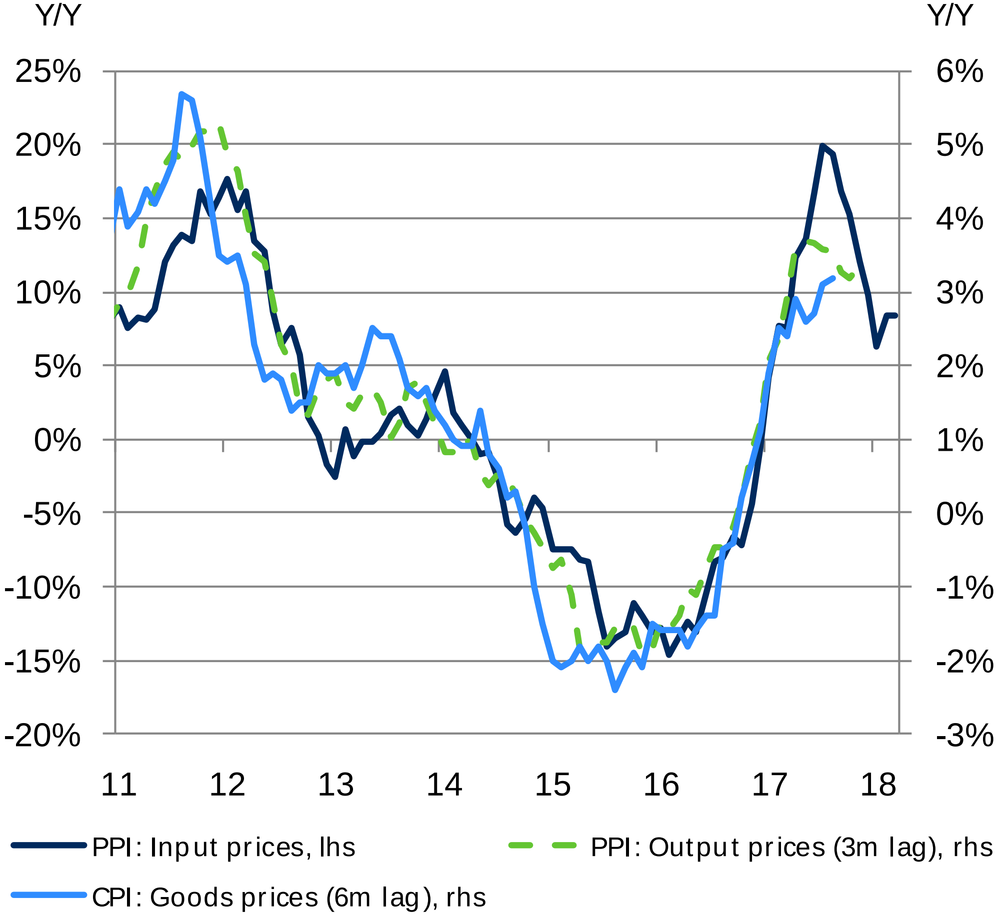
Sterling pass-through is nearly done

How much of the depreciation has fed through already?



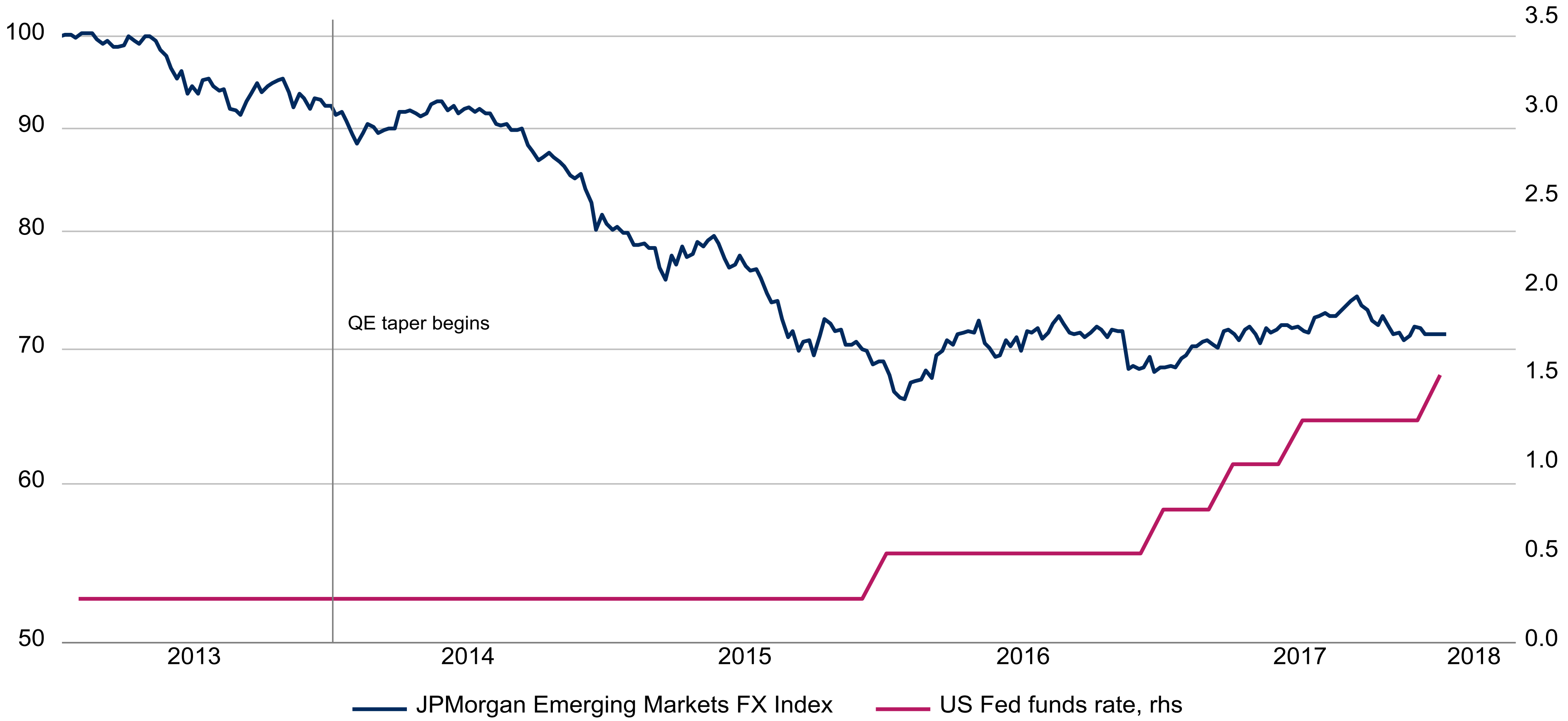


Source: Thomson Datastream, Schroders Economics Group. 6 November 2017.

Emerging markets

Emerging markets and the Fed

EM currencies fell during taper tantrum, before the Fed started rate hikes

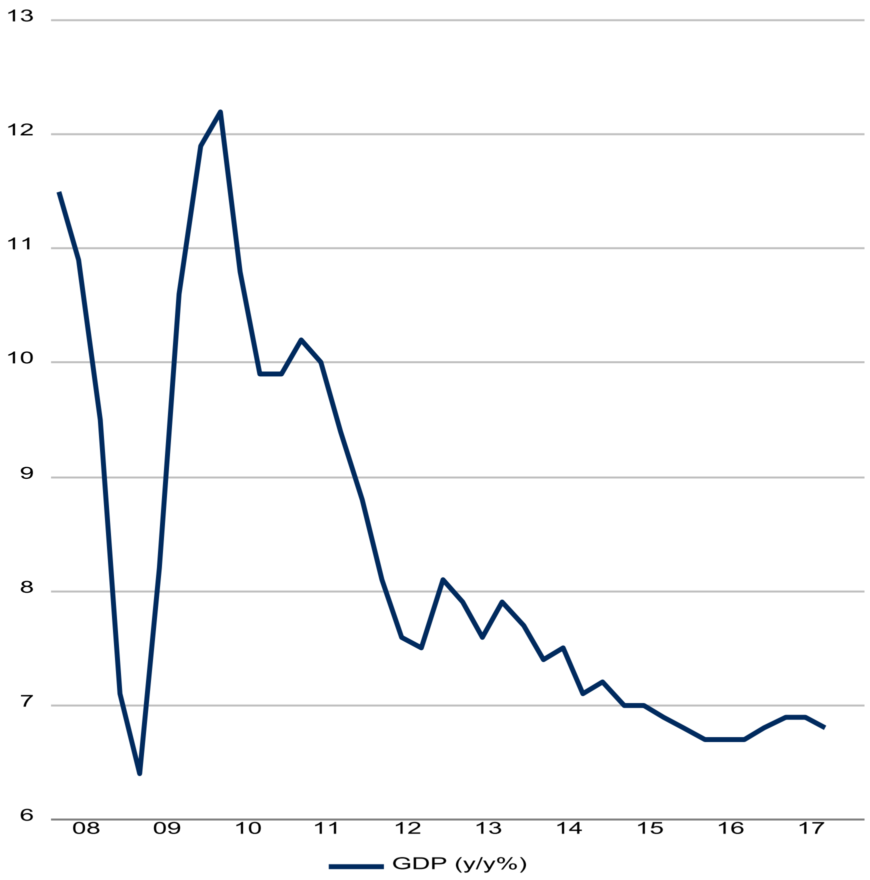


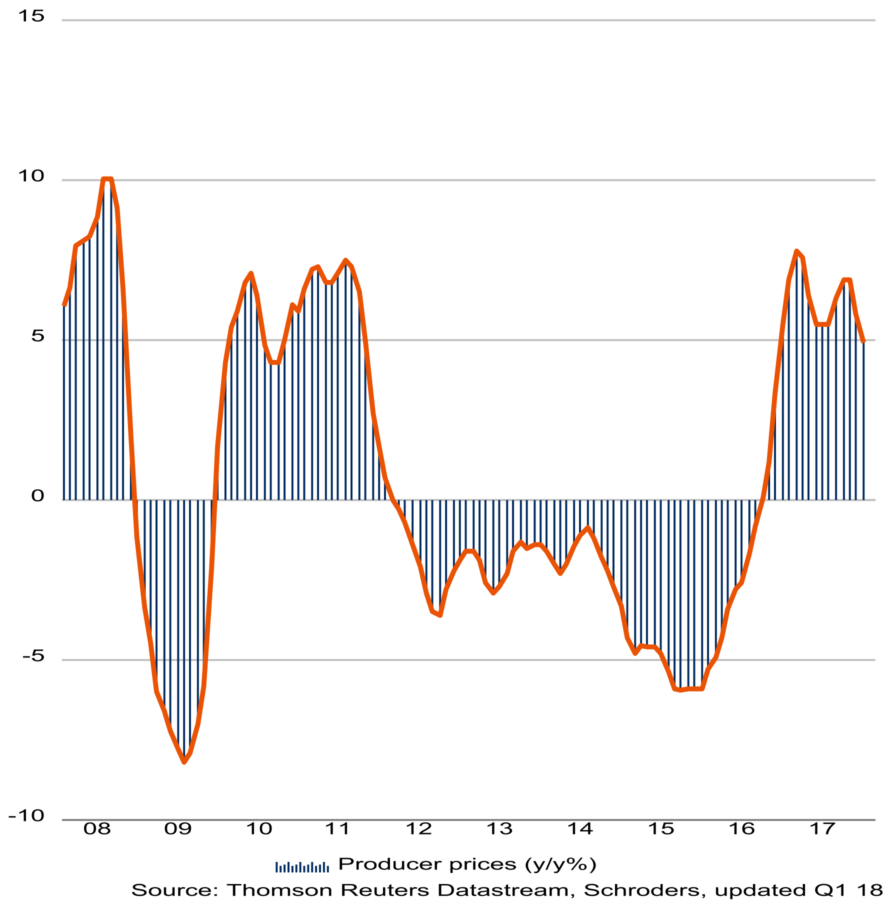
Source: Thomson Reuters Datastream, Schroders, updated 09/01/2018

Source: Thomson Datastream , Schroder Economics, 10 January 2018

China: growth and inflation

Significant switch from deflation to inflation





Source: Thomson Datastream, Schroders Economics Group. 10 January 2018

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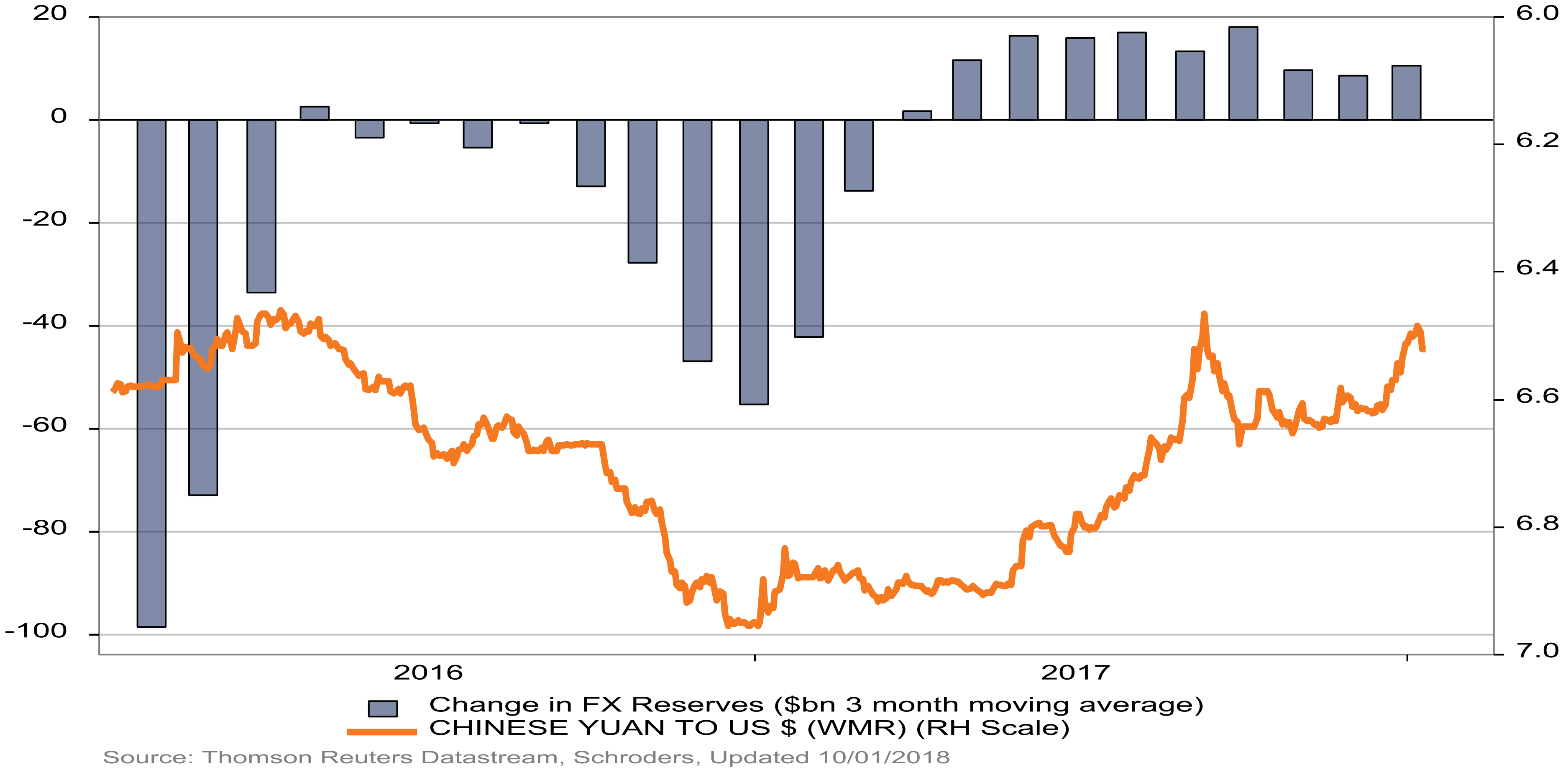
China fx reserves are growing again

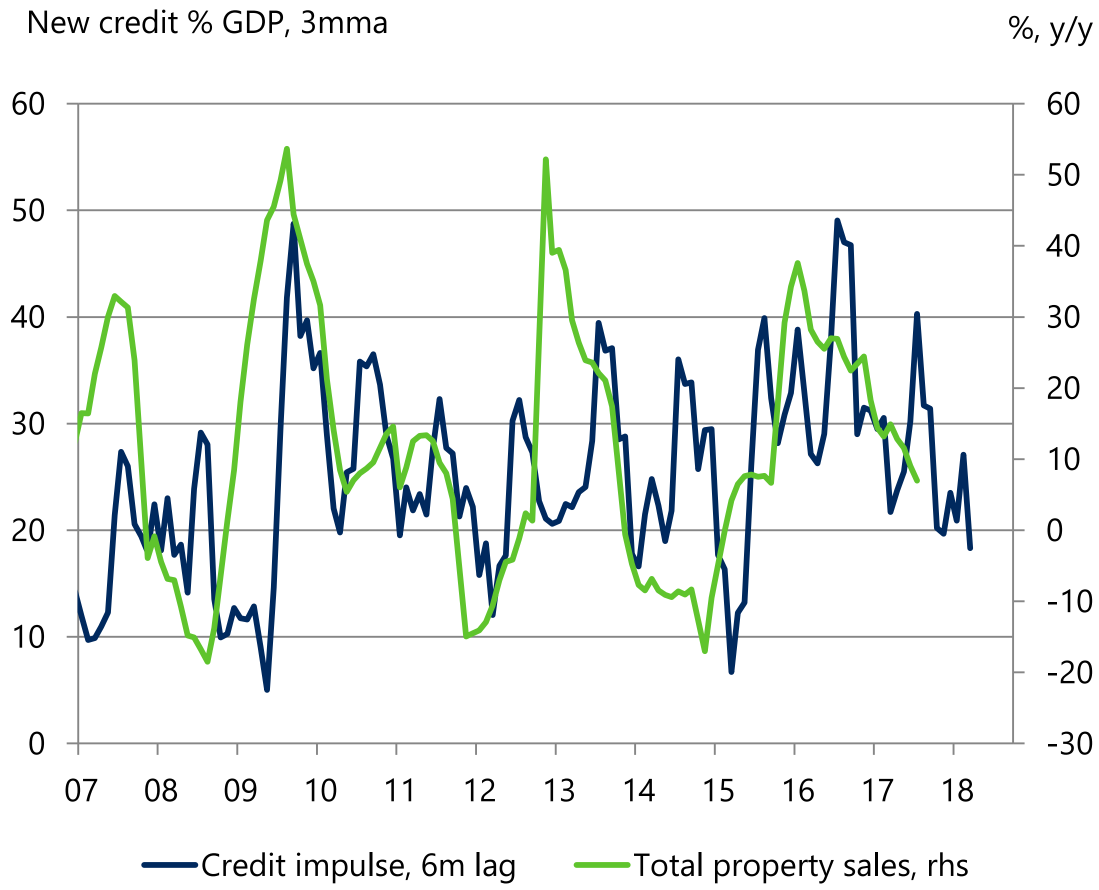
Policy measures stem capital outflows



Source: Thomson Datastream, Schroders Economics Group. 10 January 2018.

China credit crackdown continues

Property sector set for further slowdown



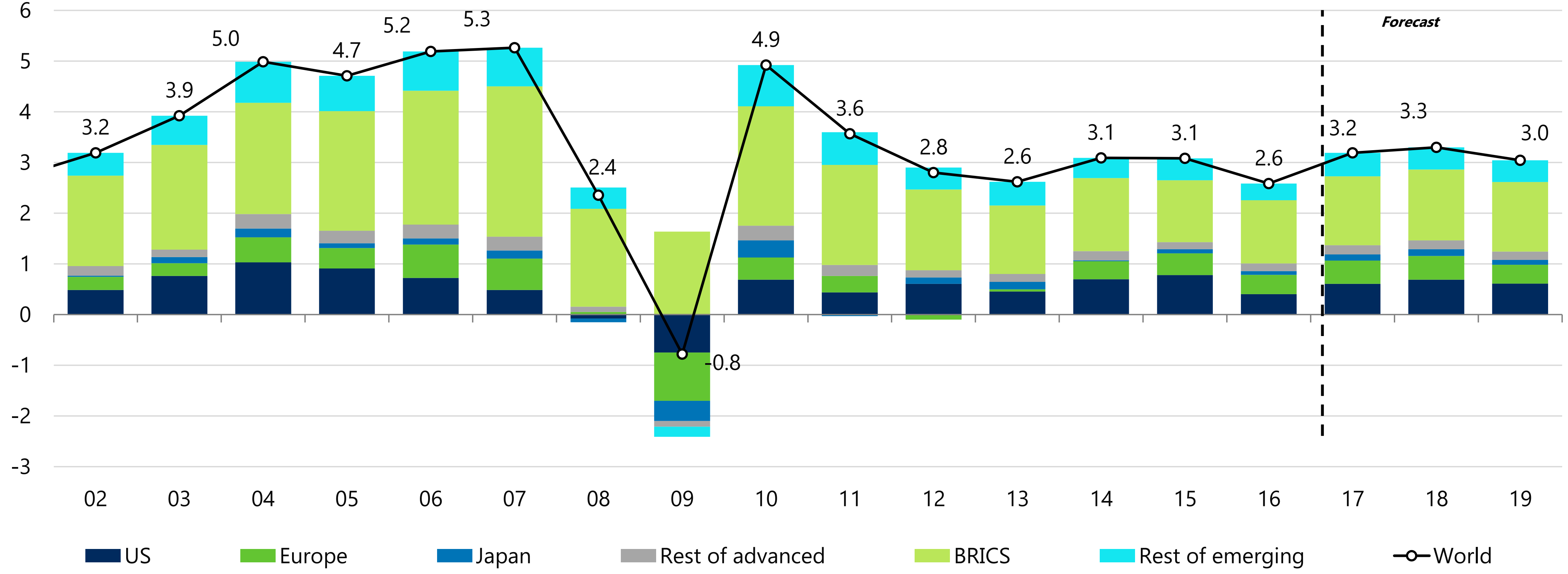
Source: Thomson Datastream, Schroders Economics Group. 30 November 2017

Forecasts & Scenarios

We expect the strongest year for growth since 2011 this year

Trend remains below the pre-crisis levels

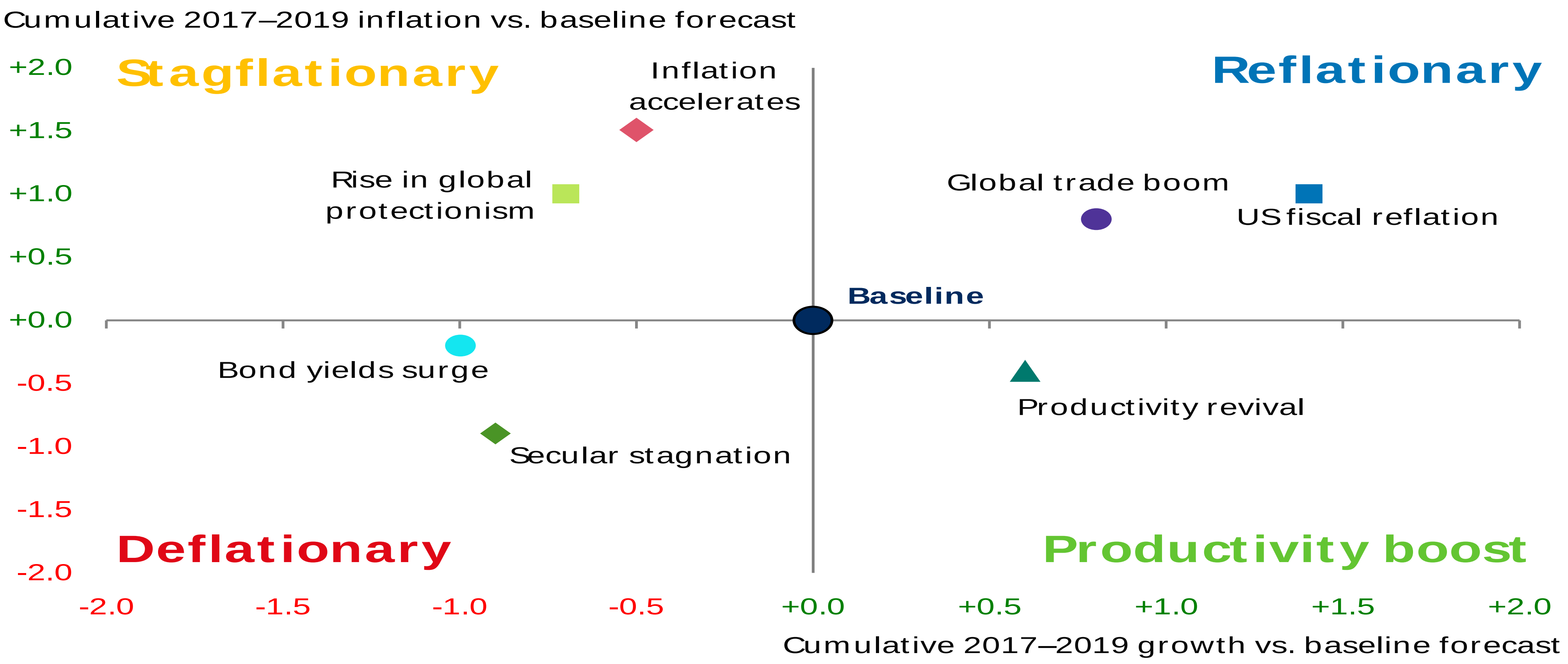
Contributions to World GDP growth (y/y), %



Source: Thomson Datastream, Schroders Economics Group, 30 November 2017.

Scenarios

Risks are becoming more balanced



Source: Schroders Economics Group. 27 November 2017. Please note the forecast warning at the back of the document.

Appendix

Forecast table

Schroders baseline forecast

November 2017 forecast

Real GDP

y/y%	Wt (%)	2016	2017		*Prev.*	Consensus	2018		*Prev.*	Consensus	2019
World	100	2.6	3.2	↑	*(3.0)*	3.2	3.3	↑	*(3.0)*	3.2	3.0
Advanced*	62.8	1.6	2.2	↑	*(2.0)*	2.1	2.3	↑	*(1.9)*	2.1	2.0
US	27.1	1.5	2.2	↑	*(2.0)*	2.2	2.5	↑	*(2.0)*	2.5	2.2
Eurozone	17.4	1.8	2.3	↑	*(2.1)*	2.2	2.3	↑	*(1.9)*	1.9	1.9
Germany	5.1	1.9	2.6	↑	*(2.1)*	2.0	2.6	↑	*(2.0)*	2.0	2.0
UK	3.8	1.8	1.5	↓	*(1.6)*	1.6	1.6		*(1.6)*	1.4	1.4
Japan	7.2	1.0	1.7	↑	*(1.6)*	1.6	1.8	↑	*(1.5)*	1.3	1.3
Total Emerging**	37.2	4.2	4.9	↑	*(4.8)*	5.0	4.9	↑	*(4.8)*	4.9	4.8
BRICs	24.2	5.2	5.6		*(5.6)*	5.7	5.8	↑	*(5.6)*	5.8	5.7
China	16.4	6.7	6.8	↑	*(6.7)*	6.8	6.4	↑	*(6.3)*	6.4	6.3

Inflation CPI

y/y%	Wt (%)	2016	2017		*Prev.*	Consensus	2018		*Prev.*	Consensus	2019
World	100	2.0	2.3		*(2.3)*	2.2	2.3	↑	*(2.2)*	2.3	2.5
Advanced*	62.8	0.7	1.7	↑	*(1.6)*	1.7	1.7	↑	*(1.6)*	1.7	1.9
US	27.1	1.3	2.1	↑	*(1.9)*	2.1	2.1	↑	*(1.9)*	2.1	2.4
Eurozone	17.4	0.2	1.5		*(1.5)*	1.5	1.4	↑	*(1.1)*	1.3	1.4
Germany	5.1	0.4	1.7		*(1.7)*	1.7	1.7	↑	*(1.5)*	1.6	1.8
UK	3.8	0.7	2.7	↑	*(2.6)*	2.7	2.2	↓	*(2.3)*	2.6	2.2
Japan	7.2	-0.1	0.4	↓	*(0.5)*	0.4	0.9	↓	*(1.0)*	0.7	1.6
Total Emerging**	37.2	4.1	3.2	↓	*(3.3)*	3.2	3.4		*(3.4)*	3.3	3.4
BRICs	24.2	3.5	2.2	↓	*(2.4)*	2.1	3.0		*(3.0)*	2.8	2.9
China	16.4	2.0	1.7	↓	*(1.8)*	1.6	2.3		*(2.3)*	2.1	2.2

Source: Schroders Economics Group: November 2017 Forecast. Previous forecast refers to August. Please see the forecast risk warning on the important information slide.