Macro Matters.

What now for the UK economy and sterling?

For professional advisers and trustees only

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Willem is a strategist in LGIM's Asset Allocation team. In this role he is responsible for macro research and idea generation for the Multi-Asset funds managed by the team. Willem joined LGIM in 2014 from BNP Paribas Investment Partners where he held the title of Head of TAA Research and Strategies after joining in 2001 and holding various positions in the multi-asset solutions team, including managing absolute return portfolios and GTAA overlay portfolios.

Hetal Mehta - Senior European Economist

Hetal is a European economist and is responsible for providing macroeconomic research and forecasts for the fixed income, asset allocation and equity teams. She joined LGIM in 2011 from Daiwa Capital Markets where she held the role of UK economist. Prior to that, she was a senior economic adviser to the Ernst & Young ITEM Club and an economist at the Oxford Economics Consultancy. Hetal has also worked for HM Treasury and the Office for the Deputy Prime Minister. Hetal graduated from the University of Bath in 2004 and holds a BSc and MSc in economics.

In the face of a largely unexpected referendum outcome, the UK is now facing a prolonged period of heightened economic and political uncertainty. The pound has dropped, but has the penny dropped as well?

It's not EU, it's me

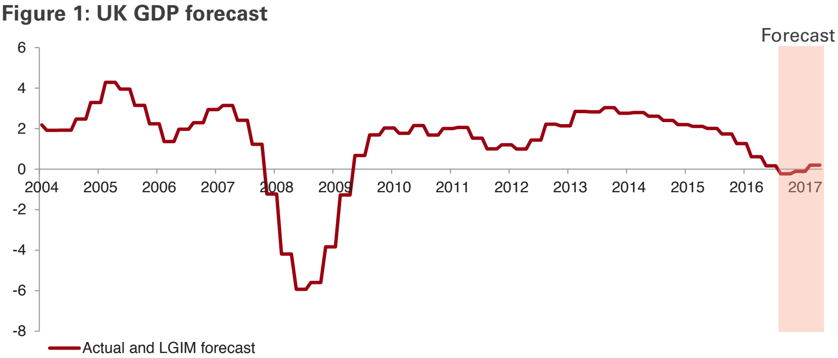
Economic forecasting is tricky at the best of times. Under the current foggy circumstances, however, the range of outcomes is rather wide and highly dependent on a number of key assumptions and financial variables, particularly sterling.

In our central case, we expect the UK to experience a mild technical recession in the second half of this year, after what has been a relatively resilient first six months **(figure 1)**. This is likely to be transmitted through a number of channels. Firstly, the weakness of the pound is likely to push up import prices and cause inflation to pick up more quickly. This, combined with some job cuts, could squeeze real incomes and cause consumption to grind to a halt. In turn, we also expect house prices to weaken.

Additionally, the 'confidence shock' that results in uncertainty remaining elevated could hurt both hiring intentions and capital spending. Credit conditions could also be a key channel. The Bank of England's immediate policy response has focused on maintaining market functionality. In addition, further policy stimulus in the form of interest rates cut to zero, more quantitative easing and possible credit easing schemes, is expected over the summer. This ought to counter a significant tightening of credit conditions.

On the fiscal side, Chancellor George Osborne has done an about-turn, from talking just days before the referendum about an austerity budget, to abandoning the budget targets, with plans to cut corporation taxes. The longer-term outlook is even more unclear and depends on the type of relationship the UK has with the rest of the EU. We are currently expecting a relatively favourable deal to be struck, including free trade in services in exchange for minor limitations to movement of labour and less influence. However, this is still highly uncertain and relies on the negotiating stance of the future Prime Minister.

Figure 1: UK GDP forecast



Source: LGIM

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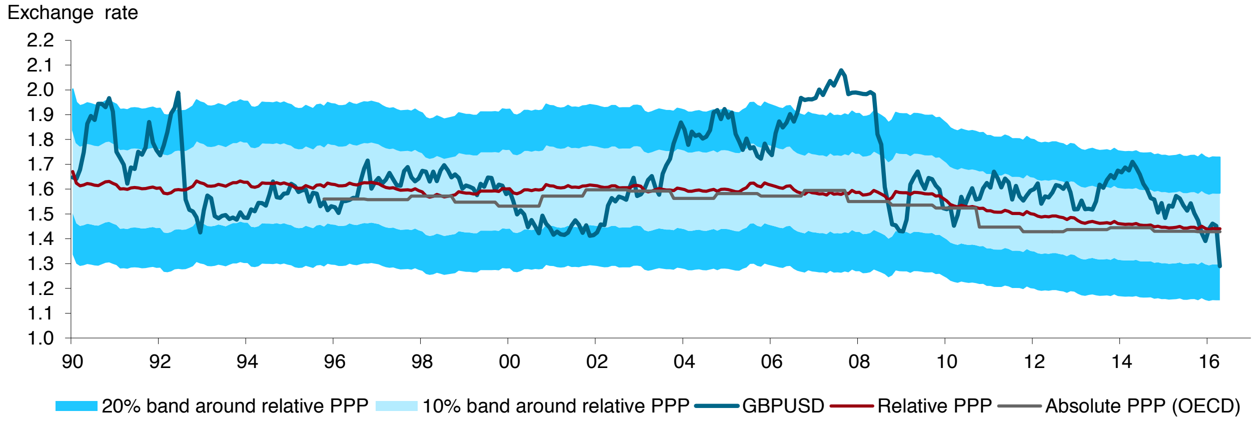
Figure 2: Pound sterling vs US dollar PPP



Source: LGIM

A politicking time bomb?

UK politics has been thrown into turmoil by the result of the EU referendum. It always looked inevitable that David Cameron would be unable to continue in office in the event of a vote to leave the European Union. However, the twists and turns in the race to replace him as Conservative Party leader have been staggering. The competition was whittled down to a straight fight between Theresa May (the Home Secretary) and Andrea Leadsom (Minister of State for Energy), but before that race could culminate Andrea Leadsom pulled out, leaving Theresa May as the incoming Prime Minister.

While some of the feared political uncertainty is falling, the process for withdrawing from the EU is still undecided, as there is no clearly articulated plan for leaving. Is the UK seeking to emulate Norway, Switzerland, Turkey, Albania or Canada in its relationship with the EU? What is the timeframe over which we are formally intending to declare our intention to leave and trigger the two-year countdown to exit? What will be the UK government's negotiating position (and priorities) over the free movement of people, single market access and budget contributions?

Chronic uncertainty on these issues is one of the principal factors undermining the confidence of potential foreign investors in UK assets. Her public statements (and position during the referendum campaign) suggest that Theresa May will consistently reach a less eurosceptic answer to those questions: favouring a later and softer withdrawal from the EU.

Under the Fixed Term Parliament Act, it is difficult for the government to trigger a new general election before 2020. In this context, the disarray in the Labour party feels like a sideshow. More important are the efforts by the Scottish National Party to use the Brexit vote as a pretext for a renewed independence push in Scotland. In the wake of the EU referendum, Scottish polls have unsurprisingly swung in favour of independence (from 53/47 in favour of staying, to 53/47 in favour of leaving). Getting to another independence vote is not straightforward (not least because the SNP has lost its majority in the Scottish parliament), but the risk could now persistently overhang UK markets.

Hardly a sterling outlook

The increased political and economic uncertainty makes finding a fair value for the pound difficult. Without an anchor, the pound could struggle to stabilise until there is more hard data on the impact of Brexit on the real economy, or more visibility on the new relationship between the UK and the EU.

The UK is running a large current account deficit, the financing of which relies on continuing material capital inflows. Brexit is very likely to have a negative impact on foreign direct investments into the UK and certain portfolio inflows may be impacted as well. There have recently been redemptions across UK property funds in the industry and we know that the UK commercial real estate market had previously experienced strong inflows of capital from overseas for many years. The clear risk is that these redemptions spread to other UK assets as well.

There are a number of ways to estimate the fair value of the pound. Any attempt that uses other financial market variables is erroneous as those prices are affected by the same heightened risk premium. Looking at the level of the pound that would sufficiently reduce the current account deficit misses the point that the deterioration over recent years is not really driven by net trade (i.e. goods and services exports less imports), but by net income from abroad (i.e. earnings on foreign investments minus payments made to foreign investors). In addition, we have learned after the great recession that the sensitivity of trade to the level of the pound is low. Approaching it from a capital account perspective is not helpful either. For capital flows to return, UK assets would have to cheapen sufficiently. However, an important part of this process is a weaker pound itself, so this approach becomes circular.

As a result, we have resorted to looking at purchasing power parity (PPP)[1] and initially focus on the pound against the US dollar. We do not argue that the pound should trade at PPP levels, but we estimate how cheap (to PPP) the pound could trade by looking at previous shocks. At this stage it doesn't matter too much whether one looks at absolute PPP or relative PPP, as both approaches yield a similar answer. A trading band of 20% captures most of the large swings in the pound away from PPP, while a band of 10% captures the normal volatility in the exchange rate (see **figure 2**). Two clear outliers are the pound's slide out of the European exchange rate mechanism in 1992 and the great recession (including the bank run on Northern Rock), but both involved serious systemic shocks, however this time financial authorities appear to be better prepared.

Given our central economic outlook and the aforementioned political uncertainties, we believe that more weakness in the pound is to be expected, but we do not subscribe to the view that the pound will fall to extremely cheap levels. As such we do not expect the pound to trade sustainably below 1.20 to the US dollar, and we are inclined to start to become less negative on the pound if we reach 1.25 and start to increase exposure to a more neutral position.

The European economy, with the UK as an important export destination, is likely to be negatively impacted as well, but it is mainly the political uncertainty about the future of the EU and euro area that keeps a lid on the euro against the US dollar. This uncertainty is stoked by many national elections (e.g. German, French and Dutch) and possibly more referendums across Europe (e.g. Italy, Hungary). On balance, we would prefer expressing a short pound position against the US dollar today, but think a short against the euro also continues to make sense.

[1]Purchasing power parity is a method to compare national income levels between countries. The basic idea is to find out what a basket of common items, including for example a Big Mac or an iPad, cost in each country's currency; the PPP-exchange rate is the rate at which both countries have the same purchasing power to buy the same basket of goods. We use it as a tool to establish a long-term fair exchange rate between two countries.