2017 Economic Outlook: Rates, the Pound… and the Bank of England

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"Wherever you go, no matter what the weather, always bring your own sunshine." Anthony J. D'Angelo

Hands up if you remember the 'surprise' 1987 hurricane that tore across a swathe of Southern England? You may recall that the stock market crash that occurred in the same year occurred at a pretty similar point. Well this almost unique mixing of stock market and meteorological extremities was given another airing in early January when Andy Haldane, the highly respected Chief Economist of the Bank of England, observed that economic forecasting in the current epoch was about as well respected as weather forecasting was just shy of thirty years ago.

The decisions made by the Bank of England back in August to not only cut interest rates, but also re-impose quantitative easing stimulus, was broadly seen as a response to the greater economic uncertainty resulting from the Brexit referendum result, following various UK Treasury and internal Bank of England forecasts that showed the risk of a recession, before the end of the decade, had materially increased.

Five months later… the economic weather may not be the equivalent of blazing sunshine, but those threatening storm-laden clouds have moved away. Recent UK economic data has been remarkably solid given that there has been little clarity in the Brexit timetable or debate. A charitable view would be that the Bank of England has provided a suitably accommodative policy backdrop that has allowed the UK economy to continue moving forward despite the challenges out there.

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So what comes next? Back in the late 1980s, the prevailing rule of thumb at the UK Treasury was that a 4% fall in the exchange rate equated to a 1% fall in interest rates, so applying this to the around 16% fall of the UK currency against currencies such as the US dollar suggests that policy has been dramatically loosened. Has the Bank of England gone too far, too fast?

If you have a very inflation-centred perspective you may well be very nervous. Assisted by the fall of the Pound and the rise of the oil price over recent months, the likelihood that official UK inflation will move – at least transitorily – to clearly over 3%, is very high. Given the prevailing economic doctrine that has underpinned many central bank inflation actions over the past generation has been to try to keep inflation under 2%, the obvious reaction should be that it is time for the Bank of England to raise interest rates, mirroring the increase in bond yields over recent months.

But what about the fear concerning Brexit outcome? The current uncertainty about the timetable and impact of so many issues around this debate suggests erring on the side of caution, and – in any case – economic growth forecasts for 2017 for the UK economy are typically only modestly above the 1% level, which is way below the typically hoped-for 2%+ growth. Economic growth numbers at face value argue against any form of imminent and material interest rate increase.

The concluding and ultimately most influential view may well come from the performance of the Pound during 2017. Having finished 2016 by lurking in a global currency table position juxtaposed between the Turkish lira and Argentine peso – not natural performance bedfellows for the UK currency – it is not surprising that considerable scepticism about the Pound's performance in 2017 is apparent.

I would argue though, that to expect a better 2017 for the Pound is a reasonable scenario. The magnitude of the Pound's fall during 2016

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UK ECONOMIC GROWTH RATES %		
	FOR 2016	FOR 2017
November 2016 *est*	2.00%	1.20%
September 2016 *est*	1.80%	1.40%
June 2016 *est*	1.60%	2.00%

Source: OECD

has only been materially beaten, in relatively modern economic history, by the 23% fall in the value of the UK currency at the time of the 1976 economic bail-out by the International Monetary Fund. Even the confidence-sapping 1992 Exchange Rate Mechanism forced exit – which famously made hedge fund speculator George Soros in excess of a billion dollars – induced a fall only broadly akin to what we have seen occur in the past seven months or so. Even a modest recovery in the Pound helps moderate some of the excesses above. Inflationary pressures are clipped a little, and very loose policy – via the effective tightening of a higher exchange rate – starts to moderate. I would also expect the Bank of England to halt its newly re-imposed quantitative easing actions during 2017 as overall conditions are not as worrisome as thought in the aftermath of the Brexit referendum vote – and it is always good to have some new policy tools to unveil again if conditions dictate.

So, pulling all this together… our call is for UK interest rates to stay where they were in 2016, and the Pound to rise. Economic growth will be positive – but relatively modest – and in all likelihood we will still be talking about the options around Brexit at the end of the year.

And faith in forecasting? Well, just like the weather, there will be a lot of continuing debates around the water coolers at all investment firms. After all, if we could forecast outcomes easily, the finance world as we know it probably would not exist.

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KEY TAKEAWAYS:

- The Bank of England were suitably worried about economic prospects to loosen policy dramatically last August
- The UK economy is unlikely to face short-term recessionary conditions, so time to tighten policy?
- Our view is that a rise in interest rates is unlikely. Rather, new QE will stop and the Pound will rise in 2017
- Forecasting remains as much as an art as a science

DISCLOSURE

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