Economic Background

The uncertainty surrounding Brexit appears to be of little concern to either UK households or businesses and the latest business surveys point to another healthy performance in Q4. The November composite PMI reflects quarterly GDP growth of 0.5% so far, which would match the performance of Q3. These surveys are, it should be noted, offering signs of increasing price pressures, which raises concern about the impact on real incomes at the household level and the potential for these to be squeezed. These worries may, though, be in part allayed by the likelihood that importers and retailers will absorb some of the increases from imported goods, thus limiting the inflationary potential. Analysts do still see a decline in GDP growth next year, but this is likely to be moderate compared to the initial post-Brexit vote fears. The outcome of the US presidential election offers the possibility that Donald Trump's administration could deliver significant fiscal stimulus, despite the economy being at near full employment. Treasury yields and the US dollar have risen since the election as markets intimate that improved real economic growth and rising inflation will require the Federal Reserve to act more aggressively on interest rates than had been previously anticipated. Analysts are suggesting economic growth of 2.75% in 2017, but if CPI inflation moves towards 3%, this could see the Fed funds rate targeting 1.50-1.75% by the end of 2017. Despite the political uncertainty, both internal and external, the Eurozone economy has held up fairly well. The PMI and EC survey improved in November, to suggest that GDP growth could accelerate from the moderate levels of Q3. The hard data seen so far is, however, not fully reflective of that happening and the outlook for 2017, on the back of further political challenges, is not one of outright optimism. Indeed, on top of domestic elections, the recent Sentix survey has suggested that the increased likelihood of Italy exiting the EZ has not been fully priced into bond markets.

UK

Q3 growth estimates, so far, indicate 0.5% quarterly growth, driven by consumer spending, which posted strong growth. There was also a strong gain in business investment which dispelled some immediate worries that the vote to withdraw from the EU would dampen enthusiasm for spending. However, though robust over the quarter, the figure was still 1.6% lower on an annualised basis and business surveys indicate that capital expenditure will remain subdued. The November CBI Growth Indicator and the PMIs are pointing to further Q4 growth, to maintain momentum, but the PMIs are showing signs of heightened price pressures again, with the input prices index of the composite PMI now standing at a five year high. Though retail sales volume growth offered an upbeat picture of consumer activity, household spending growth slowed over Q3. Retail sales growth has continued into early Q4, with the October figure the strongest since April 2002. However, with confidence likely to soften, this rate of expansion is unsustainable. The November Gfk consumer confidence index saw a sharp decline, as concerns over the economic outlook rose. The CBI reported sales balance has been, and remains, below the levels to be expected from such sales volumes growth, however, which points to a slowing down at some point soon. Mortgage approvals picked up to not far short of pre-referendum levels in October, while the RICS report new buyer enquiries are also on the increase, underlining that confidence has returned rapidly to the UK housing market.

There was a widening of the goods and services trade deficit in September, but monthly figures have been volatile, thus the quarterly view offers a better indication of trend, and that for Q3 shows a narrowing of the deficit over the period. Net trade provided a positive input to Q3 GDP growth, having been a significant drag in Q2, as exports increased and imports declined, but a word of caution should be sounded as there was a large benefit from exports of non-monetary gold (i.e. that not held by authorities as reserves). The weakening of Sterling should help exports over time, though there may be a temptation for firms to use the exchange rate to bolster margins, as has been seen recently. Such a move would, though, blunt some of their competitive edge and therefore limit the potential export boost. Three month employment growth has slowed through August into September which suggests some impact from the Brexit vote on the labour market. Indeed, employment growth failed to match population growth, but this was offset by a decline in the participation rate which brought the unemployment rate to a post crisis low of 4.8%. A different perspective of the labour market is reflected by the claimant count measure of unemployment, which rose for a seventh month out of the last eight, and firms' employment intention measures, both of which indicate further slowing of job creation ahead. This will result in increased slack in the market, which will help to suppress wage growth and surveys support this with private sector wage growth set to be flat for the months ahead. Given the expectation for inflation to pick up, this will lead to stagnation in real wage terms. earlier in the year, when low oil prices raised concern about default risk on energy sector issuance. Potential fiscal stimulus and a rolling back of regulations has helped Wall Street to record highs, while the trade weighted value of the Dollar rose, likely on the prospect of a more aggressive outlook for Fed rate hikes as "Trumpflation" risks increase through 2017.

EZ

Activity indicators are indicating a slowdown in Q3 growth and surveys offer an indication that there could be acceleration in Q4. Unfortunately hard data has not backed that up. Q3 GDP growth was confirmed at 0.3% q/q, to match that in Q2 and leaves annual growth unchanged at 1.7%. German and French growth was disappointing but Spain fared rather better, while Greece seems to be turning a corner at last. Though there is political uncertainty in the bloc and abroad, November survey indicators were broadly improved. So far, the composite PMI reflects a pick-up in growth to 0.4% in Q4, while the EC Economic Sentiment Indicator points to annual growth of 2%, which implies that Q4 growth may be stronger. Consumer spending improved by 0.3% in Q3, adding 0.2% to growth, and signs are of a further acceleration in Q4. October retail sales data got Q4 off to a strong start, with robust monthly sales growth, largely driven by sales in Germany. Annual retail sales growth increased in the bloc despite retail price inflation picking up. November EZ consumer confidence hit a 2016 high, but this does not necessarily mean consumer spending growth and is more in keeping with annual growth being unchanged. Annual industrial production growth weakened in September but survey evidence suggests that this has gathered pace as the year winds down. Strong growth in August, reversed into sharp contraction in September, dragging annual growth lower, as consumer goods and capital goods production posted the largest declines. All four of the main economies saw industrial production declines in September, but early October indications show that Germany and Spain have posted minor expansion, while the November EZ manufacturing PMI pushed to a thirty four month high,

indicative of annual growth running at around 3%. Annual services output growth was unchanged in Q3 as was the November services sentiment indicator, at its 2016 high, which suggests that levels of growth will be sustained for the rest of the year. Unsurprisingly the German services sector is the strongest, while that in France is the weakest. Net trade proved a small drag on Q3 GDP growth, as exports posted limited growth over the quarter, but imports increased slightly more strongly. Indicators point to export growth picking up in the near future, with the export orders balances of the manufacturing PMI and the EC business survey pointing to annual export growth of near 5%, or possibly more. Export indices are similar across the bloc's main economies, but Spain's prospects appear the strongest. The labour market continues its slow recovery with 178,000 removed from the unemployment roll in October, and revisions to prior figures, pulling the unemployment rate to 9.8%, its lowest level since July 2009, with one million less out of work from the previous year. The number of employed people in the bloc is now getting back towards pre-crisis peak levels. The EC's estimates put the actual rate of unemployment at below its structural rate, which suggests that further structural reform will be required to avoid a sharp slowing in employment growth. The composite employment PMI and EC economic sentiment index are both indicative of slowing annual employment growth. Greek and Spanish unemployment levels remain more than double pre-crisis lows. Inflation has continued to edge higher, but price pressures are not a great concern. Headline consumer price inflation rose to 0.6% in November, a thirty one month high, on a pick-up in food, alcohol and tobacco prices. Energy inflation eased, but core inflation was unchanged at just 0.8%. However, rising energy prices will push inflation sharply higher over the next six months, though core inflation should remain subdued as previous declines in producer prices filter through and subdued wage gains keep service sector inflation soft. Inflation expectations have picked up on the markets, but are low, and gains may be more a reflection of the uncertainty surrounding the inflation outlook. Consumer expectations also increased in November but are still at levels pointing to continued weak core inflation. The referendum in Italy has had limited impact on the markets, but the prospects of an Italian withdrawal from the EZ has increased to an all-time high, near 20%. Bond spreads have narrowed since the result, while Italian bank stocks have rallied on a potential government bailout. The Trump election success has been the greater driver on the markets, as European bond yields tracked US Treasury yields higher, though at a slower pace, on a pick-up in inflation compensation. The €uro has dipped against the US Dollar on an expectation of US interest rate rises, but this has lifted equity markets in the region, which have been broadly flat in recent months.

Asia

The Chinese economic turnaround has been driven by the property market, which is now starting to cool as restrictions on home purchases in the largest cities bite, with declines there rippling out to smaller cities. With the property rally running out of steam, fiscal support diminishing and credit growth increasing there is a prospect that the economic bounce looks set to stall before too long. There have long been concerns that the official data has not truly reflected the state of the economy.
Meanwhile, in Japan, price pressures remain subdued, with inflation hovering just above zero. Spare capacity in the economy is narrowing and growth in part time pay starting to rise. The exchange rate weakened sharply after the US election. Overall the Bank of Japan is not expected to change policy for the foreseeable future.

The authorities in both countries will be keeping an eye on external developments, in the US in particular. As major exporters to the US, the direction of trade policy of the incoming Trump administration could have a significant effect on the performance of both economies.

Summary

Though not having an effect at present, the uncertainties surrounding Brexit will raise concern, particularly the longer that the process of withdrawal is drawn out. Five months after the vote there is still no clarity on matters and whether the UK will be able to avoid a "hard" Brexit. There is the risk of the winds of change sweeping across Europe, if the events in the UK, US and Italy are a guide, and those risks could add to uncertainty. With elections including France and Germany, politics in the bloc could be in for a potential facelift. That uncertainty spreads beyond Europe, with the Fed certain to raise rates in December and in 2017 and the markets' focus clearly on the arrival of Mr Trump at the White House. The main questions will be over whether he will, or will not, deliver on his campaign commitments, with some, particularly surrounding Obamacare, already veering to a softer approach than he had promised.

Markets

	Open	Close	High	Low
FTSE 100	6,954	6,784	6,997	6,677
£/$	$1.2235	$1.2504	$1.2673	$1.2204
€/£	£0.8967	£0.8465	£0.9048	£0.8457
5y Gilt	0.614%	0.614%	0.737%	0.466%
10y Gilt	1.276%	1.419%	1.498%	1.115%
25y Gilt	1.879%	2.016%	2.130%	1.757%
50y Gilt	1.740%	1.828%	1.961%	1.612%

On the markets, we have seen Sterling drop 3.2% on a trade weighted basis over the month, extending post-Brexit losses to 16%. That is not a position supported by relative interest rate expectations, but points to there being a fear of a "hard Brexit" adding a weight to pressures on the currency. Sterling recovered some lost ground through November to leave its post-Brexit decline at around 10%, while the "hard Brexit" premium that affected the £/$ exchange rate has largely dissipated. However, the fluctuations will continue to be driven by the UK's evolving relationship with the EU and the upside for the currency looks limited in the short term.

Rising US Treasury yields have helped to lift UK gilt yields, as "Trumpflation" from expected US fiscal stimulus, along with the increase in underlying UK inflation expectations, has had an upside impact. As inflationary pressures increase, with the weakness of sterling a factor, yields have the potential to push higher. The FTSE 100 fell over the month, in part down to the effect of rising Sterling on overseas generated profits. However, given the underwhelming performance of the UK-centric FTSE 250 and the broader global equity bourses, it would seem that Sterling's performance is not the only cause of the 100's weakness.