Quarterly Macro Report

4th Quarter 2016

The aftershocks of the Brexit vote have subsided. Our analysis indicates that its economic consequences will be far greater for the UK itself than for the Eurozone. In fact, a potential US recession still poses a greater risk to the global economy. Meanwhile, a hard landing for China has been avoided once more.

Without a doubt, the June 23 decision by British voters to leave the European Union has been the source of the greatest turbulence on financial markets so far this year. Besides inflicting new record-lows on UK Gilt yields and also burdening the bond yields of other governments, the Brexit vote sent the pound sharply downward.

Brexit hobbles UK growth

By now Brexit's first shock waves have subsided. The post-vote economic data already reveals signs of the impact of this divorce on the British as well as other economies. The drop in sentiment indicators for the UK economy since the vote has been substantial. For instance, the European Commission's broad sentiment indicator plunged by 4.4 percentage points in July, marking the largest monthly drop since the height of the European debt crisis, in 2012. Such a steep decline in sentiment will surely weigh on UK economic growth rates, although whether it will tip the country into recession remains uncertain. Compared to the first quarter, Britain's economy grew by a respectable 0.6 percent in the second quarter of 2016, although the uncertainty was already heightened throughout June. This second-quarter growth gives the UK a bit of a buffer against recession, for now.

Less ambiguous than recession risk, prices appear clearly to be rising sharply now in the UK. Given the decline in the pound and the resulting higher import prices, we expect the annual overall UK inflation rate to reach around 3 percent at the beginning of 2017, up from the current 0.5 percent rate. Probably in recognition of these inflation prospects, the *Bank of England* initially was reluctant to lower interest rates after the

Fig. 1: The importance of the UK market for the European economies

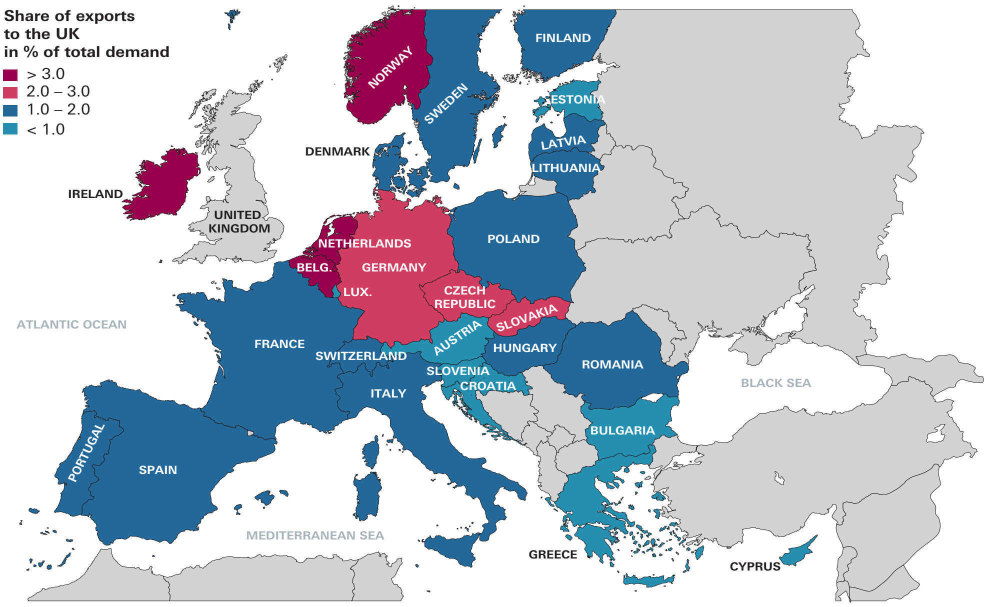


Figure 1 illustrates the topology of the trade flows towards the UK in Europe. It becomes clear that the immediate economic consequences of a potential downturn of the UK economy on the Eurozone will be rather limited. Even a sharp deterioration in the British demand would only have a modest effect for the vast majority of European economies. Only a few countries account for a share of over 3 percent of their total demand stemming from the UK.

Source: Eurostat, Wellershoff & Partners vote. But once the decline in economic sentiment became apparent, the BoE promptly trimmed 0.25 percent from its previous record-low rate of 0.5 percent.

Brexit's limited contagion for European economies

Granted, Brexit will also be felt in other economies, but we expect its consequences will hit the UK economy first and worst. Since the vote, some Anglo-Saxon economic pundits have argued that Brexit could tip the Eurozone into a full-blown economic crisis. Our analysis yields a different conclusion: Brexit's economic impact on the Eurozone will be rather limited. First, at the macroeconomic level, we calculate that even a sharp deterioration in British import demand would have little real impact on most European economies. Just a few EU countries have a share of over 3 percent of their total demand stemming from the UK. And downbeat economic sentiment – whether from fear of political contagion or heightened market volatility – may indeed weigh on Eurozone growth but only lightly. *Wellershoff & Partners*' survey-based economic climate indicators support this view. They show that the drop we have seen in UK sentiment indicators to date would lower the Eurozone's GDP growth by less than 0.2 percentage points. For comparison, we calculate that a comparable slump in US economic sentiment would cut a far more substantial 0.5 percentage points from the Eurozone's GDP growth.

Anemic US investment activity

Recession remains a troubling possibility in the United States, posing, we think, a far larger risk to the global economy than Brexit. After a weak first quarter, many observers expected a rebound in the US economy, as had been the case the past few years in the second quarter. But with the economy growing by only 0.3 percent quarter-over-quarter, the year-over-year growth rate fell to just 1.2 percent, its lowest level in three years. As was the case in the previous quarter, sluggish investment spending was one of the main reasons for the US economy's below-long-term-trend growth in the second quarter. Although a pick-up in the overall growth rate is expected for the current quarter, the prospects for seeing increased investment remain weak, as *Wellershoff & Partners*' early warning indicator reveals. This means that private consumption will once again be – even more than it has been already – the salvation of US growth. Fortunately, most recent consumer sector data have not shown any sign of weakness yet.

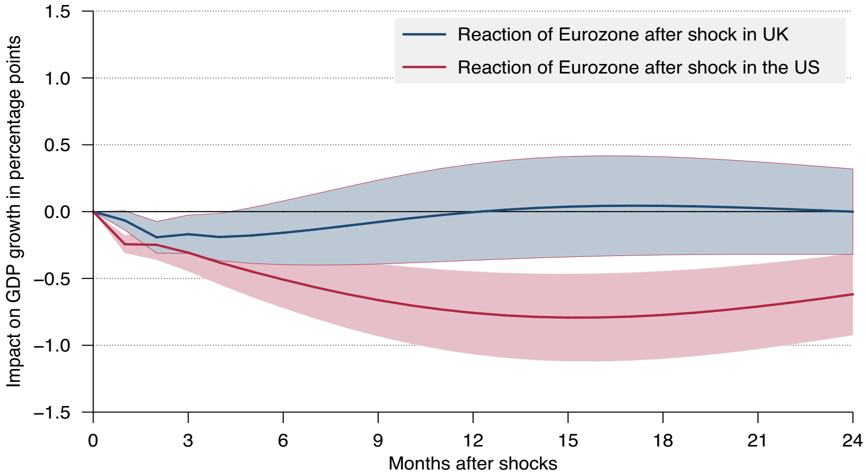
Tab. 1: Macro economic estimates

	Real GDP growth in %						Inflation in %					
	2014	2015	2016E	2017E	2016Δ	2017Δ	2014	2015	2016E	2017E	2016Δ	2017Δ
USA	2.4	2.6	1.5	1.8	-0.4	-0.4	1.6	0.1	1.5	2.0	0.2	-0.3
Eurozone	0.9	1.6	1.6	1.8	0.1	0.5	0.4	0.0	0.5	1.5	0.2	0.2
Germany	1.6	1.5	1.8	1.8	0.2	0.5	0.9	0.2	0.8	1.8	0.4	0.3
France	0.7	1.2	1.3	1.6	-0.2	0.3	0.5	0.1	0.5	1.5	0.2	0.3
Italy	-0.3	0.6	1.0	1.2	0.1	0.3	0.3	0.0	0.3	1.2	0.3	0.3
Spain	1.4	3.2	2.5	2.2	-0.3	0.1	-0.2	-0.5	0.0	1.0	0.4	-0.3
United Kingdom	3.1	2.3	1.0	0.5	-0.6	-0.2	1.5	0.0	1.5	3.0	-0.3	-0.0
Switzerland	1.9	0.8	1.0	1.5	-0.0	0.2	-0.0	-1.1	-0.5	0.5	-0.0	0.2
Japan	-0.1	0.6	0.8	0.6	0.3	-0.2	2.7	0.8	0.0	0.5	0.1	-0.1
Brazil	0.1	-3.8	-3.5	2.0	-0.2	1.2	6.3	9.0	8.0	6.0	0.8	0.6
China	7.3	6.8	6.2	5.8	-0.3	-0.5	2.0	1.4	2.0	2.0	-0.0	0.0
India	7.0	7.2	7.8	8.0	0.2	0.4	6.7	4.9	6.0	6.0	0.8	0.9
Russia	0.7	-4.5	-1.0	1.0	-0.2	-0.2	7.8	15.5	8.0	6.0	1.4	0.5
World (PPP)	2.7	2.5	2.3	2.7	-	-	3.2	2.8	2.2	2.5	-	-

E Estimates Wellershoff & Partners Δ Deviation from Consensus (Consensus Economic Forecasts)

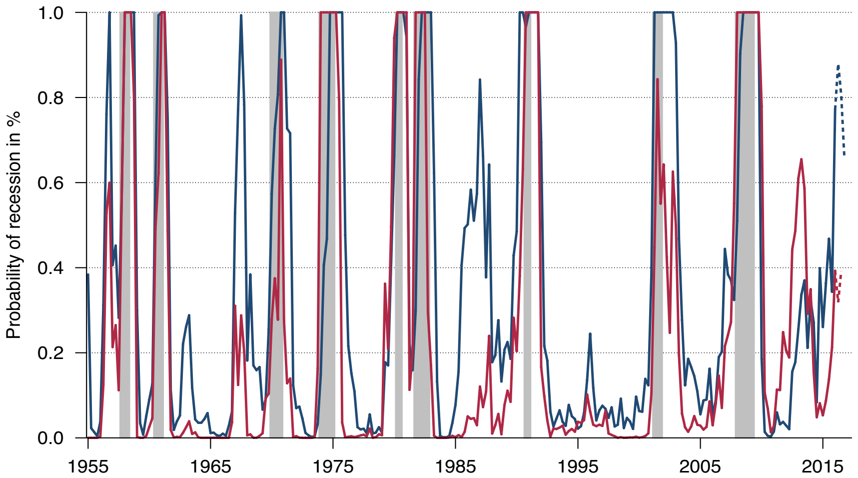
Source: Thomson Reuters Datastream, Wellershoff & Partners

Fig. 2: Limited economic impact of a shock in UK's economic sentiment for the Eurozone



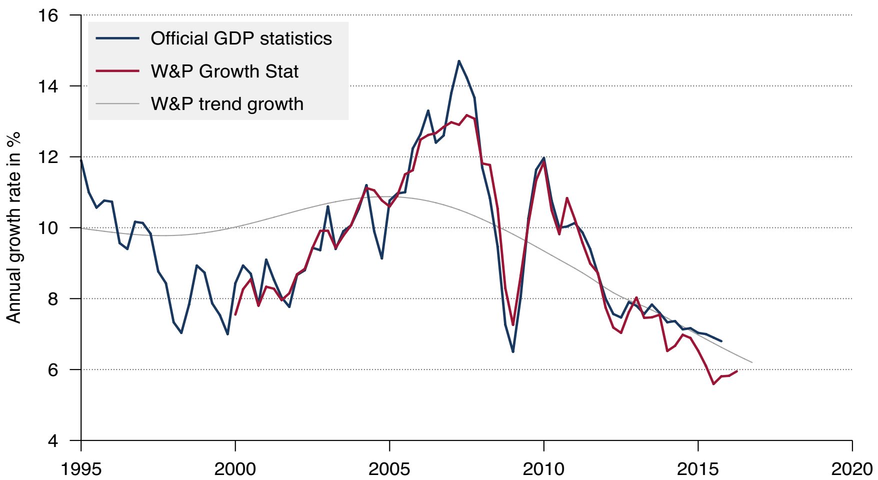
Using Wellershoff & Partners' survey-based economic climate indicators as well as vector autoregression (VAR) models it can be shown that a sharp decline in British sentiment indicators would hamper Eurozone's GDP growth only a little bit. A comparable slump in the United States would have far greater effects. The figure illustrates the effects of an economic sentiment shock the size of one historical standard deviation.

Fig. 3: Recession risk of the US economy remains elevated



According to the Wellershoff & Partners' investment climate early warning indicator investment activity will remain weak in the United States. This leaves the probability for a recession of the US economy at an elevated level. The figure shows that the used probit model indicated past recessions quite reliably (blue line). There were false alarms only in 1967 and 1986/87, with projected probabilities of over 90 percent. A second model explicitly accounting for the consumption-supporting effect of low oil prices yields somewhat lower probabilities (in red).

Fig. 4: The W&P Growth Stat for China tends slightly higher than in the previous quarter



By using production data from key sectors in a bottom-up analysis the W&P GDP Growth Stat for China yields an undistorted picture of China's GDP performance. Furthermore, it also has a lead-time of up to three months on the much less reliable official statistics. Since 2012, the Growth Stat clearly shows a more volatile and weaker GDP growth than officially reported. More recently, the indicator suggests that China's latest slump is behind us. Although still markedly lower than the official statistics the indicator is up from the previous quarters.

Source: FRED, Thomson Reuters Datastream, Wellershoff & Partners

Costly stabilization in China

The situation in China has improved somewhat in recent months. This recovery is evident in the *W&P GDP Growth Stat for China*, a statistical indicator of China's GDP performance that has proven more reliable than official Chinese economic statistics.

As our indicator shows second-quarter GDP growth of 5.9 percent for the Chinese economy, is still markedly lower than the 6.7 percent presented by officials but is up from the previous quarter. However, the risk of a hard landing for China's economy has declined only thanks to fresh stimulus measures by the government which successfully revived China's crucial housing market. So, recovery was accompanied by an extraordinary surge in debt. At the end of 2015, China's public and private sectors had accumulated debt totaling 240 percent of GDP – more than any other emerging economy in history. Therefore, despite the recent stabilization, China's long-term risks – most of them stemming from this huge pile of debt – have increased.

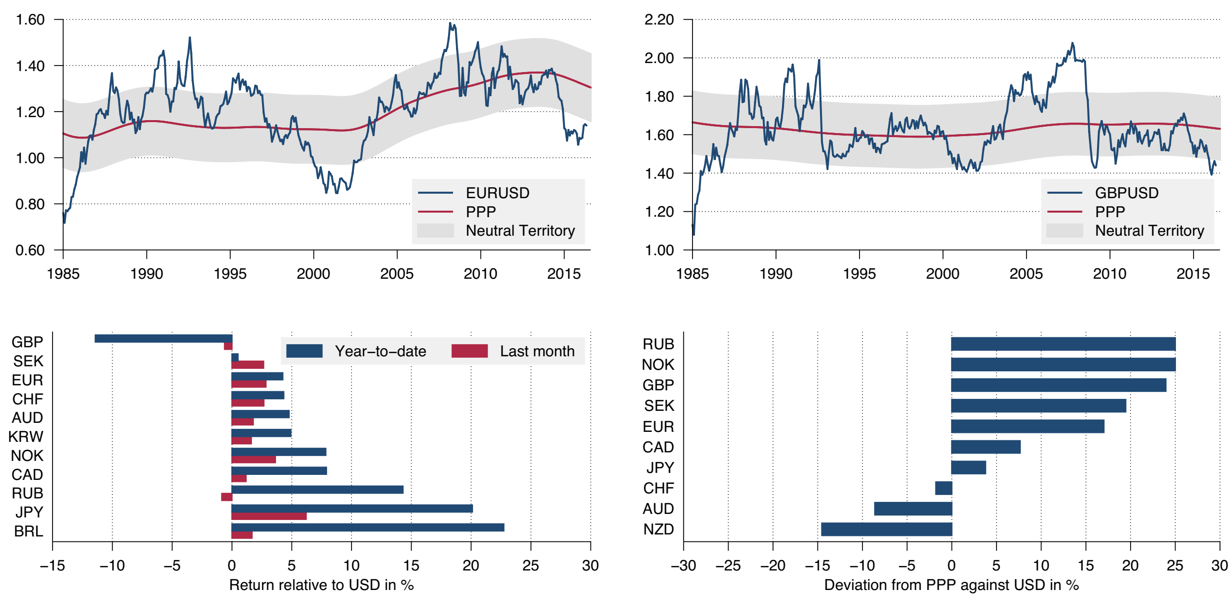
Cautious outlook on the US dollar

Energy prices will cause inflation rates to rise substantially through the end of the year. As we expect this rise in inflation to be the largest in the US, the narrative about the divergent monetary policies of the *Fed* and the ECB could reappear, causing investors to expect a rising US dollar versus the euro. We are rather cautious in this regard. We find the evidence that interest differentials affect exchange rates over time is rather weak. Instead, we think differences in inflation rates matter more, as shown by our purchasing power parity models. From a PPP perspective, the US dollar is already overvalued against the euro, which makes further appreciation of the dollar rather unlikely.

Risky choice on the British pound

Within two days following the Brexit vote, Sterling depreciated by more than 10 percent versus the US dollar, hitting its lowest level in 30 years. Together with the depreciation already seen leading up to the vote, the trade-weighted value of the pound fell by over 15 percent year-over-year, its steepest decline since the global financial crisis of 2007-8. Our PPP models suggest that the pound is more likely to appreciate versus the US dollar. But given our expectation for a surge in UK inflation, perhaps further easing measures from the *Bank of England*, and considering the political uncertainty about Britain's future relationship with the EU, we think the pound a risky choice right now. //

Fig. 5: FX performance and valuation



PPP estimates based on producer price indices

Source: Thomson Reuters Datastream, Wellershoff & Partners

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