Schroders
Economic and Strategy Viewpoint

Keith Wade
Chief Economist and Strategist
(44-20)7658 6296

Azad Zangana
Senior European Economist and Strategist
(44-20)7658 2671

Craig Botham
Emerging Markets Economist
(44-20)7658 2882

World economy shrugs off uncertainty…for now (page 2)

- Despite the increase in economic uncertainty, the world economy is strengthening with business surveys signalling an acceleration in growth. Concerns about Brexit and President Trump's populist policies have been swept aside, prompting talk of a crisis in economic forecasting.
- The dismal science seems to be living up to its name with economists out of step with the surge in business confidence. Growth forecasts are likely to be upgraded, but we still have doubts about the sustainability of the upswing now that oil prices and inflation are rising again. President Trump's rapid shift toward protectionism only threatens to exacerbate inflationary pressure whilst halting the nascent recovery in global trade.

Europe: improving momentum and fundamentals (page 6)

- Europe faces significant headwinds in 2017. Inflation is set to rise which will reduce the purchasing power of households, while political uncertainty, both at home and abroad, could weigh on confidence. Fortunately, cyclical indicators suggest growth was stronger than expected at the end of 2016, with the momentum continuing into January.
- Moreover, the economy's fundamentals are improving, with employment growth rising, and wages starting to recover. Monetary policy should remain ultra-loose despite protests from northern countries, while fiscal policy is generally supportive. So despite the political risk in 2017, a period of optimism is long overdue for Europe amongst investors.

China: a steady course becomes more challenging (page 10)

- Chinese growth has held a steady course, but continuing this policy will become more challenging as the global environment grows more unsettled. New US policies throw up a number of hurdles in particular, but we think the focus on Chinese reserves is somewhat alarmist at this stage.

Views at a glance (page 15)

- A short summary of our main macro views and where we see the risks to the world economy

Chart: Economic uncertainty hits new highs

Source: Thomson Reuters Datastream, Schroders Economics Group, 25 January 2017.

World economy shrugs off uncertainty…for now

"From this moment on, it's going to be America first"

Donald Trump, inaugural presidential address, 20 January 2017

President Trump takes office with protectionism high on the agenda

Now the real business begins: Donald Trump has taken office and has started to "rebuild" America. He has made it clear that this will be achieved by prioritising the United States in every decision on trade, taxes and immigration. "We will buy American and hire American". Protectionism is seen as the "route to greater prosperity" and "we will stop other countries making our products and stealing our jobs". His first move was to cancel the Trans-Pacific Partnership, the trade agreement between the US and Pacific Rim countries.

Meanwhile, the reflation trade appears to be alive in the equity markets with the Dow hitting 20,000. However, US treasury yields have moved sideways, whilst the dollar has weakened slightly amid confusion on President Trump's currency policy.

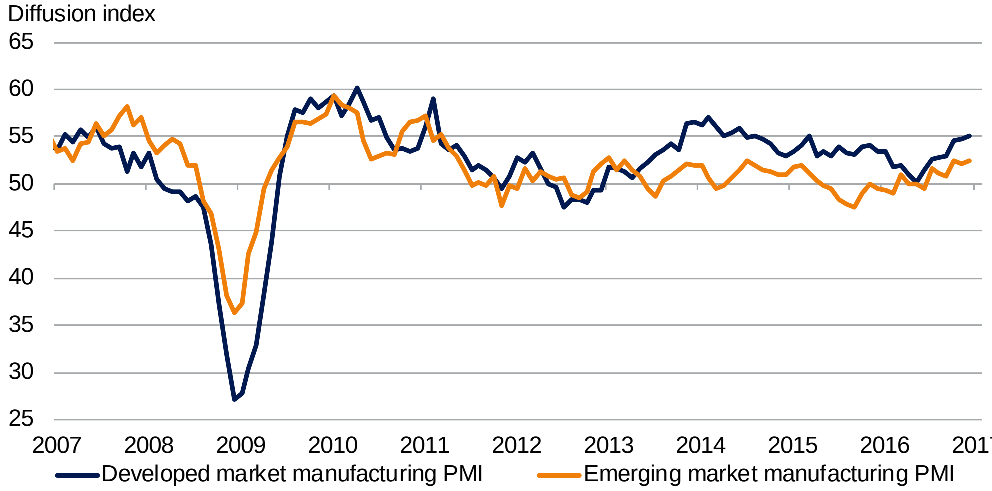
We remain sceptical on the ability of the new administration to generate a sustained upturn in growth and employment through fiscal policy and trade protection. This reflects the time likely to be taken to get a fiscal package through Congress and the actual growth impact of tax cuts aimed at corporations and the wealthy[1]. More fundamentally, we also believe that the US is late cycle with the labour market close to full employment, so stimulus is likely to deliver more in the way of inflation than jobs.

Doubts about Trump's policies persist, meanwhile growth is picking up

Meanwhile trade protection effectively limits the available supply of goods to a market, thus increasing upward price pressure. The same can be said of measures to prevent companies from trying to reduce costs by relocating abroad. Inflation remains the most likely outcome of the new president's economic policies.

These are the factors shaping our outlook, but in the near term the US economy is doing fine with surveys surprising on the upside and signalling healthy growth. The same can be said for the world economy in general: our growth trackers are strengthening and the macro surprise indices for both developed and emerging markets are touching record highs as we start the new year (see charts 1 and 2).

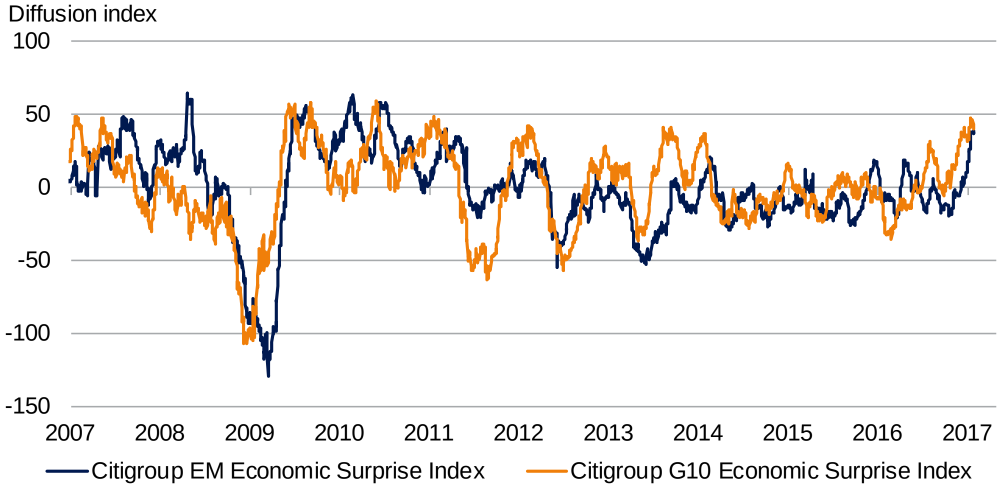
Chart 1: Global growth is lifting – PMIs accelerate



Source: Thomson Reuters Datastream, Schroders Economics Group, 25 January 2017.

[1]For more on fiscal policy and multipliers, see last month's publication here

Chart 2: Macro surprise indices



Source: Thomson Reuters Datastream, Schroders Economics Group, 25 January 2017.

Can the upswing be sustained?

Upward revisions to growth forecasts likely

This creates a dilemma for investors as the politics says trade growth is likely to be hit by increased protectionism, whilst the data shows that activity is improving. For example, Asia, one of the most trade-dependent regions, has seen an improvement in export growth with the region experiencing 7.3% y/y in November (ex. China and Japan) whilst Japanese export volumes rose nearly 3% q/q in the final quarter of 2016. It certainly looks as though we are finally seeing the long-awaited turn in global activity; the question is whether it will gain momentum and become self sustaining.

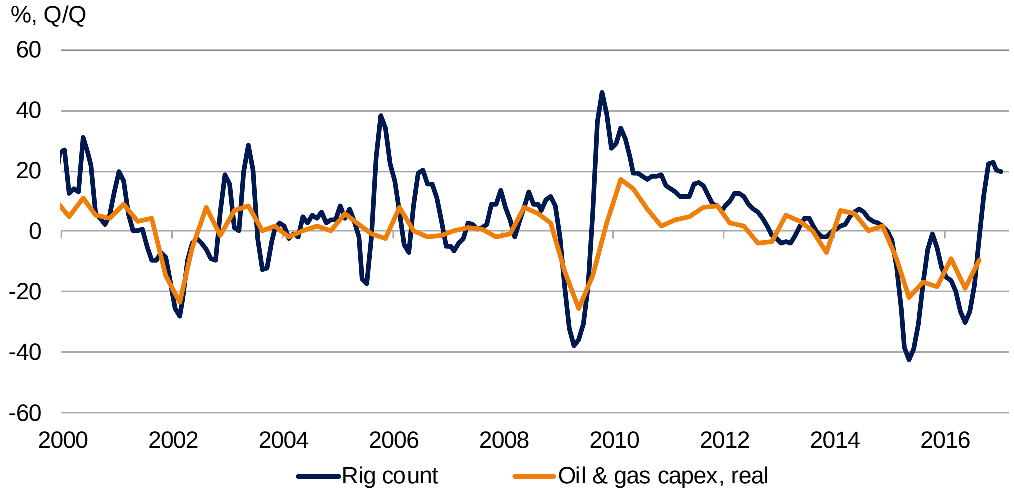
Global activity is getting a boost from (a) firmer consumer spending as gains in real household incomes feed through into expenditure, and (b) a turn in the inventory cycle. Manufacturing and trade have been the principal beneficiaries and are likely to have a good first quarter. Against this backdrop we will probably have to revise up our growth forecasts for 2017.

Oil prices rise: an initial boost then a drag later

However, we still expect the boost from these sources to fade. The improvement in real incomes owes much to the fall in inflation which is now beginning to reverse as energy prices begin to climb. The long-awaited consumer response to lower oil prices seems to have finally come through, but now that oil prices are climbing again its days are numbered. In the near term we should see some support for growth from oil and gas capex as indicated by the rise in the rig count (chart 3). In this respect, higher oil prices support growth in the near term via energy capex, but eventually act as a drag further out as inflation cuts into consumer spending.

Alongside a peak in the boost from the inventory cycle, this suggests that US growth may falter again later in the year before picking up in 2018 as fiscal stimulus comes through.

Chart 3: Rig count points to stronger oil and gas investment in the US



Source: Thomson Reuters Datastream, Schroders Economics Group, 24 January 2017.

Economic uncertainty, growth and the "crisis" in economics

Economy has surprised despite increased uncertainty

The upswing in activity has also posed a challenge to economists who generally believed that the recent increase in political uncertainty would adversely affect growth. The prime example being the effect of Brexit on the UK where many warned of the risk of recession in the event of a vote to leave the EU. Instead, the economy has remained robust, leading the deputy governor of the Bank of England, Andy Haldane, to admit to a crisis in economic forecasting.

There can be no doubt that policy uncertainty is high with the global Economic Policy Uncertainty index (EPU) currently running at elevated levels, around 2.5 times higher than the average since 1997 (see chart front page). This measure is based on search results for newspaper articles discussing policy-related economic uncertainty, the dispersion of forecasters' expectations for key macro measures, and additionally for the US, the number of temporary tax measures set to expire in the coming years. The global index uses data for 17 countries that account for two-thirds of global GDP.

Economists see uncertainty as bad for activity as it weighs on the ability of firms and households to plan and make investment decisions. Capital spending and purchases of large ticket durable goods would be expected to suffer. The decision to leave the EU was seen as hitting both of these.

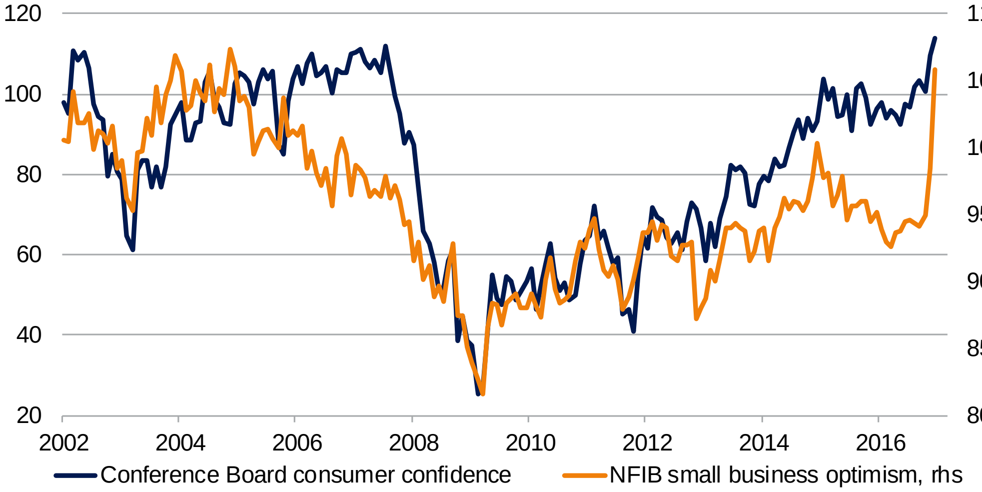
So should we ignore the high level of uncertainty and be less concerned about the forthcoming political events, such as the elections in Europe, for example? There are a couple of points to be made.

First, there is the policy response. In the UK the Bank of England cut interest rates and restarted quantitative easing (QE) in response to the Brexit vote. The pound also fell sharply. These moves amounted to a significant easing of monetary policy which will have helped support activity.

Wider population sees uncertainty in a more positive light than economists

More fundamentally though is the gap between how economists and the rest of the population view events. The election of Donald Trump is a factor which has increased policy uncertainty, but for many in the US this is seen as a positive as they believe it will start moving the economy in the right direction again. Some businesses may invest more as a result of promises on deregulation, approving the Keystone pipeline or simply that Trump will get America working again. Animal spirits, that key factor in business, have been stirred as evidenced by the business and consumer confidence indices (chart 4).

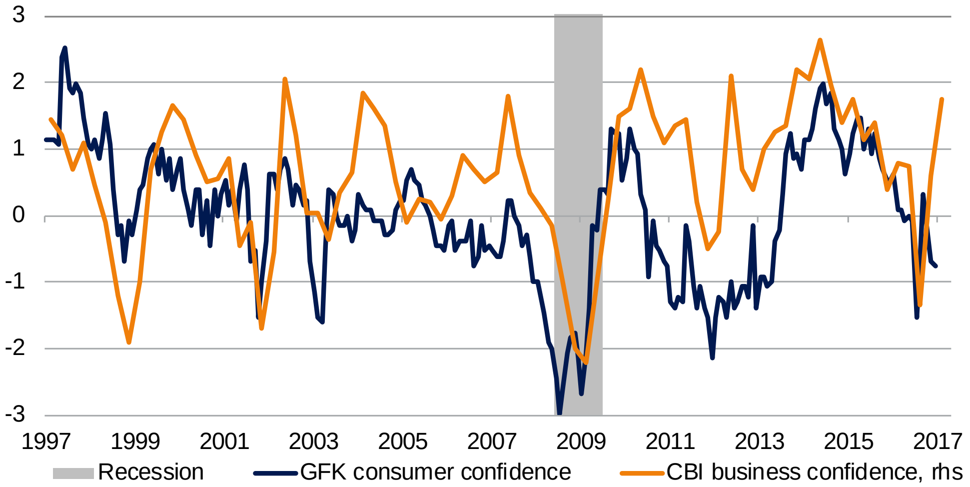
Chart 4: US business and consumer confidence surge post Trump win



Source: Thomson Reuters Datastream, Schroders Economics Group, 25 January 2017.

Similarly many voted for Brexit in the UK in the hope of getting something better. It may be that they are misguided and will ultimately be disappointed, but for the large number who voted for Brexit, there is see no reason to immediately start cutting back on spending. The confidence picture is more mixed than in the US. Both consumer and business measures fell sharply on the Brexit vote and both then rebounded, but more recently business confidence has strengthened whilst consumers have become more pessimistic (see chart 5).

Chart 5: UK mixed picture: business confidence picks up, but consumers becoming gloomy post Brexit vote



Source: Thomson Reuters Datastream, Schroders Economics Group, 25 January 2017.

We would be reluctant to say that there is a crisis in forecasting, but economists are probably guilty of projecting their own expectations onto a wider population who see developments in a far more positive light.

Our view is that Brexit, Trump and the potential election of other populists in 2017 will result in weaker rather than stronger global growth, particularly as international trade and foreign direct investment shrink back and inflation rises. It is early days and the effects are still to come through. Nonetheless, there will be winners and losers. If President Trump gains a bigger share of global economic growth for the US then, even if the overall pie is smaller, America will be first.

Europe: improving momentum and fundamentals

Higher inflation, political risk and external uncertainties are likely to slow growth in Europe in 2017. Inflation is likely to reduce the purchasing power of households. Elections in the Netherlands, France, Germany and potentially Italy all pose risks for economic stability, and the stability of the wider union. Meanwhile, the new US president appears to be enjoying the trouble Brexit is causing, and expects other countries to follow. Not the best way to introduce yourself to the battle-weary Europeans, as it appears that the relationship between the two largest economic zones in the world is fraying.

Despite these concerns, Europe is enjoying a good period of better than expected growth, which will help firms and households cope with the headwinds that will hit this year.

Leading indicators point to faster growth

Growth data for Q4 is expected to be stronger than our previous forecast

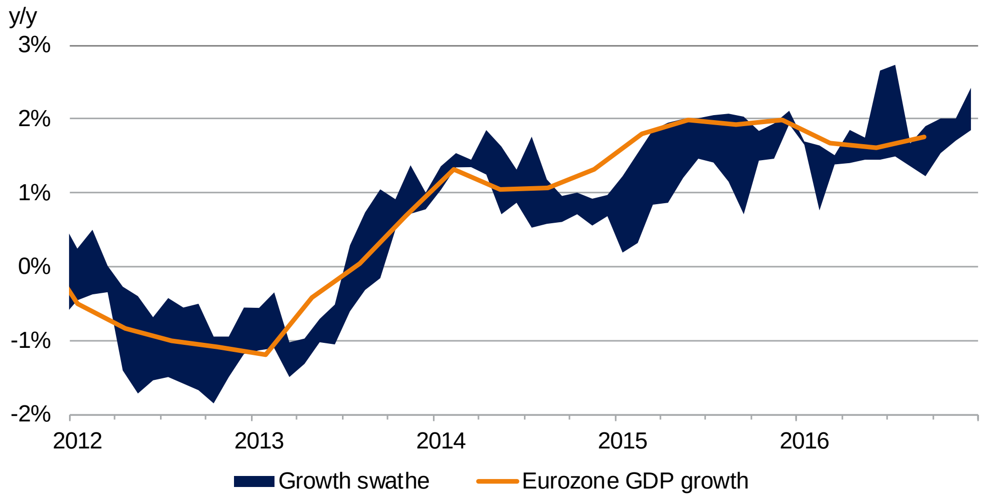
Compared to our forecast (updated last November), official GDP growth data for the eurozone should be a little stronger for the fourth quarter when released. Monthly retail sales data and figures on industrial production support this view, along with private business surveys. This should lead to an upgrade to the forecast (to be updated next month), as it puts the monetary union on a stronger footing to face the numerous headwinds this year.

Chart 6 shows GDP growth plotted against our new “growth swathe”, which shows the range of estimates of growth from our favourite three indicators. First, the Markit purchasing managers’ indices (PMIs), using the macro composite index. Second is the Belgian National Bank (BNB) survey of activity and third is the €-coin nowcast indicator, developed by the Centre for Economic Policy Research and the Bank of Italy. It is worth noting that while the first two indicators are private business surveys, the third is a real-time estimate of GDP using the latest possible official and survey data.

The growth swathe suggests GDP will rise from 1.8% y/y to between 1.9% and 2.4% y/y in the fourth quarter. On a quarterly basis, this translates to a pick-up from 0.4% to between 0.6% and 1.1% growth.

Chart 6: Eurozone growth swathe signals faster growth

Leading indicators suggest GDP growth accelerated to between 0.6% and 1.1% q/q



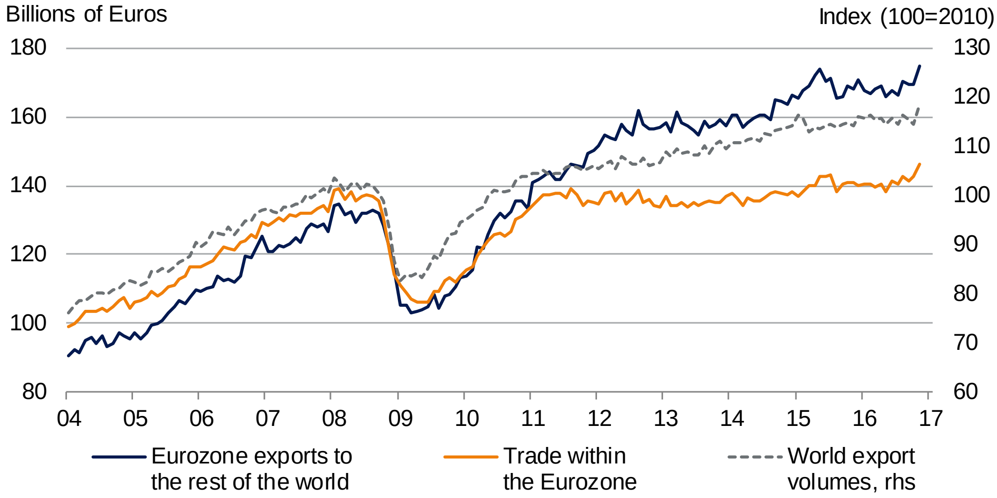
Source: Thomson Datastream, Markit, BNB, CEPR, Schroders Economics Group. 24 January 2017.

While these indicators only provide a signal for the end of last year, Markit has just released its “flash estimate” of the eurozone composite PMI, which was largely unchanged, suggesting that momentum has been maintained into January.

The pick-up in growth towards the end of last year also coincided with a notable rise in exports to the rest of the world – a source of growth which had appeared to have stalled since 2015 (chart 7).

A revival in world trade appears to be helping the eurozone's exports, but also internal trade

Chart 7: Eurozone exports revival



Source: Thomson Datastream, Eurostat, CPB, Schroders Economics Group. 25 January 2017.

Export volumes world-wide also jumped, not a surprise given the open nature of Europe's economy. Moreover, due to the highly integrated supply chains across Europe, trade within Europe also accelerated. This means that not only will the usual winners from trade benefit, such as Germany and the Netherlands, but intermediate-goods producers like parts of southern and eastern Europe will also benefit.

Trade has been a useful boost for growth of late, along with stronger business investment, and faster consumption growth. In fact, the breadth of the stronger than expected data has been surprising in itself. This can be seen with the rise of the Citi economic surprise index for the eurozone (chart 8). The diffusion index works by comparing reported growth/activity economic data against consensus expectations (usually polled by Bloomberg). It then nets off positive versus negative surprises and tracks the breadth of those surprises over time.

Economic surprises have been broad in recent months, suggesting economists have been too pessimistic

Chart 8: Economic surprises highest since 2010

Source: Thomson Datastream, Citi, Schroders Economics Group. 24 January 2017.

Using a five-day moving average, the index has risen sharply in recent weeks, with a recent peak matching highs of 2010. The rise in the index also suggests that economists have been too pessimistic in recent months, and will probably have to revise up their forecasts in due course. This explains the mean-reverting properties of the series.

Better fundamentals

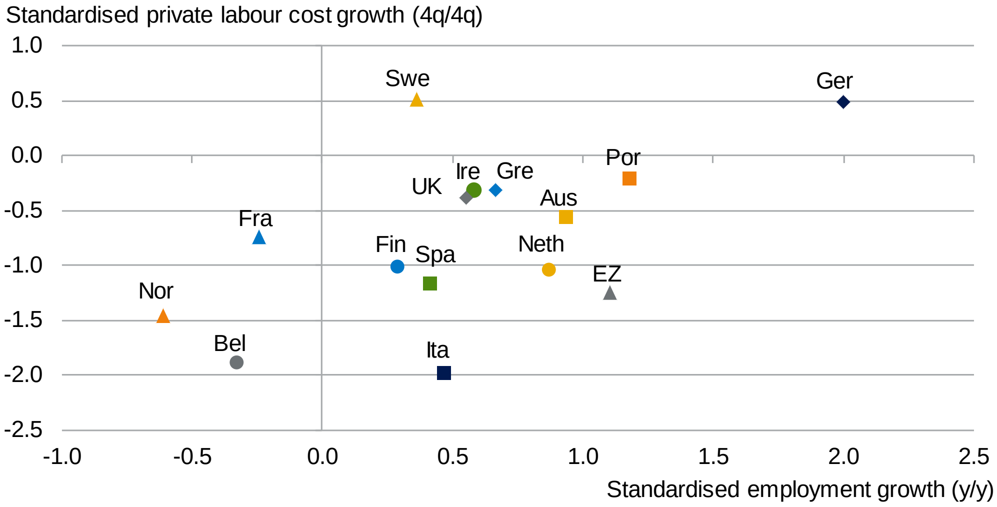
Not only has recent cyclical data been improving, but slower moving fundamental indicators have made good progress, thanks to support from fiscal and monetary policy. In particular, the labour market continues to show improvement for many countries and will be key in supporting growth in the coming months as higher inflation and political uncertainty take their toll.

In addition to better cyclical data, the fundamentals of the economy are also improving...

At the eurozone aggregate level, employment growth accelerated to 1.9% y/y (third quarter), which was the fastest growth rate since the end of 2007. This suggests that demand in the economy is growing at a healthy pace, helping to create jobs, which in turn creates more demand in the economy. Meanwhile, nominal private sector wage growth (as measured by labour costs) grew by just 1.4% y/y. This is over a standard deviation below its average since the year 2000, and highlights the high degree of spare capacity (high unemployment) at present.

Within member states, most are in a similar position to the eurozone aggregate; however, there are a few in better or worse situations. Plotting standardised scores of employment growth versus wage growth (mean zero and each point represents one standard deviation from the mean), we can build a labour market conditions map to see the progress of member states. Indeed, chart 9 displays the results of the analysis.

Chart 9: Labour market conditions map



Source: Thomson Datastream, Eurostat, Schroders Economics Group. 25 January 2017.

The way to read the grid is the countries in the bottom right hand quadrant are experiencing fast enough economic growth to then have employment growing faster than trend, but still have excess slack in the labour market, which is why wage growth is growing below trend. The majority of countries including the eurozone aggregate fall into this quadrant.

The countries in the top right are in a stronger position, with both employment and wages growing faster than trend. Indeed, it is worth noting that while German wages are only growing half a standard deviation above average, employment growth is two standard deviations above its average (a 5% distributional observation).

…although some countries like France and Belgium need to take more action to boost growth

Those countries in the bottom left hand quadrant are seeing both weak wage growth, owing to too high unemployment, and below average employment growth, due to below trend growth. For these countries, including France and Belgium, faster growth is urgently required. Policy makers should quickly provide support through fiscal policy, but also examine growth boosting structural reforms.

Lastly, the top left hand quadrant is akin to the slowdown phase of the economic cycle, where wage growth is still running high, but employment growth is slowing. None of the major European countries fall into this quadrant at present.

In time, assuming growth continues at above trend rates, many of the countries in the bottom right hand quadrant will eventually reduce unemployment to the point where slack is limited, and wages start to accelerate faster than trend. This rate of unemployment is often referred to as equilibrium unemployment, or the non-accelerating inflation rate of unemployment (NAIRU).

Conclusions

It is encouraging to see leading indicators suggest that growth accelerated at the end of 2016. Momentum appears to have been maintained in January, which will help firms and households cope with the rise in inflation due in the coming months. Political risk is also high this year, and while similar events appear to have had almost no impact in the UK and US last year, it is worth remembering that Europe is in a more fragile situation and has suffered more from similar events in the past (even causing recessions).

Nevertheless, fundamentals in Europe are also improving. Good momentum has built up in the labour market, with employment growing at rates not seen since 2007. Wages are lagging behind, but should accelerate in due course. Monetary policy is expected to remain ultra-loose through this year, although northern representatives on the European Central Bank's governing council will certainly challenge Mario Draghi's policy. Finally, fiscal policy is likely to be slightly supportive, with very few countries under pressure to tighten. So despite the political risk in 2017, a period of optimism is long overdue for Europe amongst the investor community.

China: a steady course becomes more challenging

The final quarter of 2016 capped the year with a slight acceleration in growth, despite apparent policy tightening. Though slower than 2015, growth of 6.8% in the final quarter saw 2016 growth come in at 6.7%, well within the tolerance of the official target. Compared to our expectations before the year began, when policy discussions were full of talk about reducing spare capacity and containing excesses, it is fair to say this has come as a surprise.

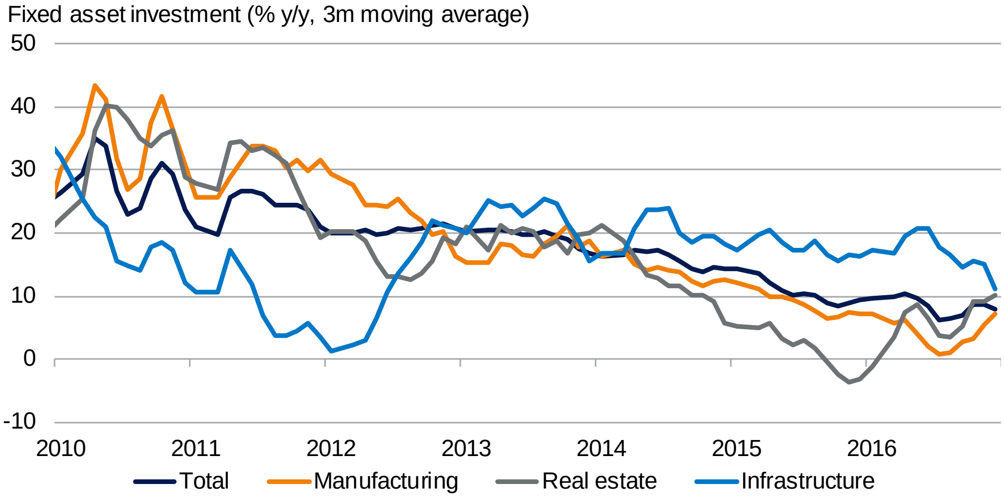
2016 finishes on a positive note, but bigger challenges await

Though a positive surprise in terms of growth, it is not an unalloyed good. A breakdown of GDP shows that growth was supported in the final quarter by investment, as consumption's contribution declined. On an industry basis, the primary sector, or "Old China", has been accelerating for much of the year. Neither of these facts fits with the supposed rebalancing of the economy. One potential positive here has been the growing contribution of the tertiary sector. Though for much of the year this would have reflected real estate growth, hardly calming fears about stability, in the final quarter real estate actually slowed. Higher growth in the tertiary sector was driven instead by "Other services"; which includes media, education, utilities and social services. The exact breakdown is not revealed, but given the latter two elements we can see the hand of the state may be the guiding force here too.

Investment of course is not always wasteful, and even in a service-driven economy is an important part of the growth mix. But in China's case, the data has shown that for much of the year it has been the state, rather than the private sector, driving the investment figures. It is true that in the final quarter of the year, investment growth appears to have been focused in property and manufacturing, rather than state-led infrastructure. It is also true that some of this is likely productive investment; rising global and producer prices should prompt investment by manufacturers. But the revival here also coincides with an easing of production restrictions in coal. If spare capacity reduction efforts are made in earnest, we have doubts over the sustainability of this growth.

Sustainability of investment driven growth in doubt

Chart 10: Infrastructure gives way to real estate and manufacturing



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

Looking ahead, a slowdown in 2017 seems likely, but its scope will be modest. Credit growth in China has only recently slowed, and even then only marginally. It will be at least another quarter before this feeds through to activity. We are sceptical that real cuts to spare capacity industries will be undertaken ahead of the Party congress towards the end of 2017, given the importance of the event to President Xi. That we expect a slowdown at all reflects recent policymaker statements on the need for stability over growth, but we have heard these noises before and seen only the slightest of course corrections.

Trump risk: Is China a currency manipulator?

As hinted above, we currently assume little change in policy direction from China this year, with respect to growth or the currency. But this assumes that the Chinese government is able to write the script unhindered. President Trump may end up jostling Xi's otherwise steady hand.

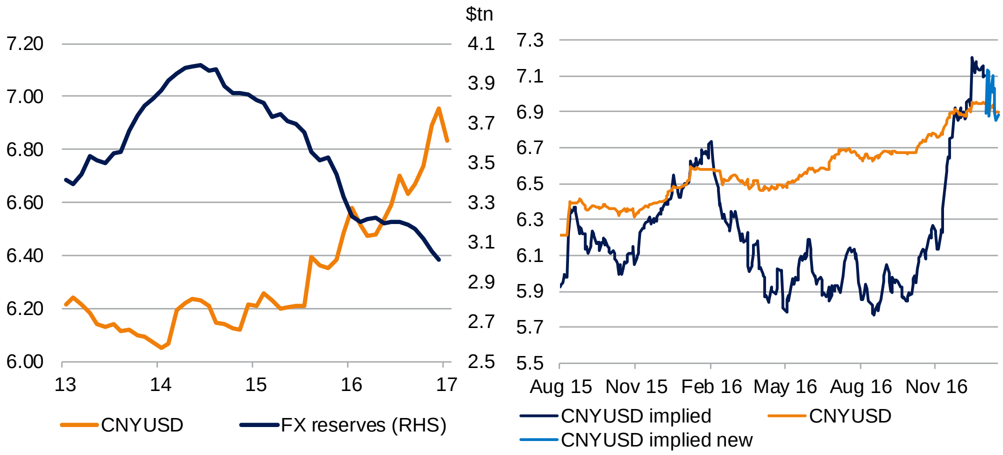
External shocks from Trumpism threaten Sino stability

Alongside the threats of tariffs and trade wars, President Trump has previously expressed a belief that China is manipulating its currency to America's disadvantage. Cabinet appointments have reinforced the perception of the new president as a China hawk and raised the probability that he will brand the country a currency manipulator. Under Obama, the US Treasury department concluded in October 2016 (as part of a regular review process) that China did not meet the official criteria. However, Trump's administration could quite easily alter the criteria as they see fit.

Ironically, though China is undoubtedly manipulating its currency, it is doing so in a way that helps rather than hurts the US. The chart below shows China has been steadily burning through its reserves since 2015 in a battle to slow the depreciation of the renminbi (RMB). We can see this too if we look at how the constituents of the RMB's trade weighted basket have performed versus the dollar. Though it is true that a genuine trade weighted peg would have seen currency strength for much of 2016, the final quarter of the year has seen significant dollar strength which has been resisted by the authorities. Most recently, the basket was expanded to cover more currencies, reducing the importance of the dollar. All in all, Chinese currency policy is no longer an authentic concern for the US – but it is a tool that could be used in retaliation should President Trump impose harsh tariffs on Chinese goods.

The days of deliberate undervaluation are behind us

Chart 11: China has been fighting currency weakness at some expense



Source: Thomson Datastream, Schroders Economics Group. 19 January 2017.

China's reserves: $3 trillion is not what it used to be

The rate of decline in reserves has been sharp enough to prompt concerns that a devaluation could be forced by the market before long, regardless of international relations. Discussion of Chinese reserves inevitably involves the invocation of the IMF's metric for reserve adequacy. Some analysts using the IMF methodology arrive at a number of $3 trillion, and so take a very bearish stance on the outlook for the currency. With a new year, and a renewal of the $50,000 per person foreign currency quota in China, it is understandable that this should now face a resurgence of interest.

IMF reserve adequacy determines the level of reserves needed for a crisis…

The method of calculating the level of adequate reserves varies depending on the type of economy. The IMF divides economies into various categories, broadly: developed, emerging, and lower income, but with further subdivisions based on financial market depth and capital market access. For China, the correct metric to use is the emerging markets category.

For emerging markets, according to the IMF, reserves are useful in a crisis to cover:

- Lost export income from a terms of trade shock or a drop in external demand
- Capital flight, the likely extent of which is determined by the money supply, M2
- Short term debt repayments, in the event debt rollover becomes difficult
- Other portfolio flows

Total reserve adequacy is the sum of each element – so sufficient to cover short term debt needs, capital flight, lost export income, and other liabilities, all at once.

These four are chosen because, historically, they are seen as the channels which have destabilised emerging markets in crises, or what the IMF calls FX market pressure episodes. Risk weights are chosen based on the empirical evidence. i.e. for the 10th percentile of emerging market (EM) economies during a pressure episode, coverage of 30% of short-term debt has been needed to safeguard against rollover risks.

However, the reason estimates of the adequate level of reserves for China seem to vary so much is that the appropriate risk weights depend on whether a country has a fixed or floating exchange rate, and whether it has effective capital controls (table). A floating rate and effective capital controls reduce the risk weights and so reduce the level of reserves needed. In China's case, the currency is clearly not on a hard peg versus the dollar (or its trade weighted basket), but is instead what economists call a managed float. So there is an argument for not taking the very highest level of reserves. Meanwhile, capital controls are, anecdotally, proving effective for now.

…how likely is an old school EM currency crisis in China?

Table 1: IMF reserve adequacy risk weights

Coverage needed for a given exchange rate regime (%)	Short term debt	Other liabilities		Broad money		Exports
	With and without capital controls	No capital controls	Capital controls*	No capital controls	Capital controls	With and without capital controls
Fixed	30	20	10	10	5	10
Float	30	15	7.5	5	2.5	5

Source: IMF. The reserve number is calculated as the sum of all components. *Controls on non-resident outflows.

For China, the 2016 estimate from the IMF is $1.8 trillion with capital controls, and $3 trillion without, if we treat the exchange rate regime as fixed. Under a floating regime, these numbers reduce to $1 trillion and $1.7 trillion, respectively.

Next, there is the question of how to interpret the "adequate" level. For example, if $3 trillion is the right number, will China be forced to abandon the managed float at $2.9 trillion? This seems a strange assertion to make, as presumably that $2.9 trillion can still be used to make some defence of the currency.

Consider the IMF criteria: it seems to state that in an FX crisis, we typically see outflows consistent with the risk weights from each of the four areas. Consequently, as long as reserves are equal to the combined value, they can completely offset the outflows and so leave the currency value unchanged. But, we should bear in mind that it would be very rare for one country to be hit on all four channels at once. For example, why should export demand collapse because there is capital flight from the domestic economy? It is certainly possible to imagine a scenario in which this happens (a global financial crisis that sees a rush to safety, for example) but this is a more a worst case scenario than an inevitability. More generally, the metric seems best interpreted as the level beyond which a full blown currency crisis could not be seen off by the central bank, rather than the level which guarantees a collapse. We still need a trigger for an FX crisis, and there we come back to some long running questions:

Fears focusing on Chinese reserves are overblown

- How likely is a run on the banks in China when the system is fully funded by deposits? If not at all likely, we do not need to worry about the broad money risk weights being fully realised. This is probably the case for now, but we would have concerns about the outlook in 2019, based on current trends
- Without a run on banks, could we still see significant pressure from M2 outflows? Rising US yields pose a threat here, with local returns in China now 4 – 5%
- How effective are capital controls, and is the government willing to pull back from the internationalisation of the RMB to support them? Seemingly, very

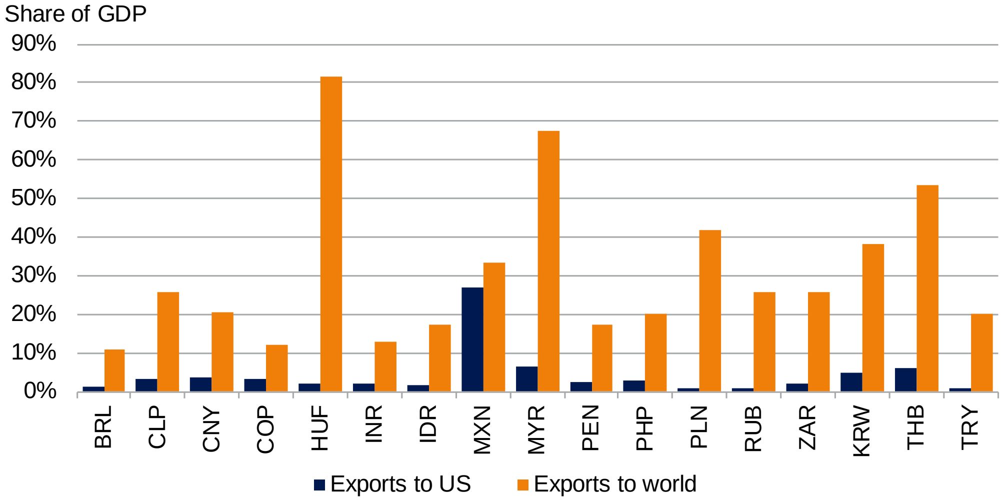
Overall, we take the view that there is currently undue alarm over the level of reserves in China, especially where analysts focus on the $3 trillion level. $1.8 trillion is a better estimate of the level of adequate reserves, so it is unlikely to be the issue that forces the government’s hand on devaluation this year. China does not appear to be on the brink of a currency crisis, and in any event is capable of imposing fairly effective capital controls which reduce the needed level of reserves. One caveat perhaps is that the increased severity of capital controls indicates to us that there is growing pressure from capital flows. The issue is likely to remain very visible on the global agenda, particularly given President Trump’s pronouncements, but beware the China bears claiming the country will have no choice but to devalue in 2017. Instead, look ahead to 2018, when President Xi Jinping is likely to have consolidated his position, and so readied to undertake meaningful shifts in policy.

Trump risk: Trade wars

China would not be the worst hit in a global trade war

Trump’s other key threat, of course, has been to impose tariffs. At 4% of GDP, Chinese exports to the US are not crucial to its growth, but tariffs would still generate a degree of discomfort. Not a recession, but some concentrated pockets of unemployment and a slight to the country that the Chinese government would feel compelled to respond to. A risk, which we and others have flagged, is that retaliation begets retaliation, ultimately bringing much of the world into a trade war as countries seek to offset the impact of duties elsewhere. For emerging markets, typically dependent on export-driven growth, this is bad news. The pain will evidently be felt more in some countries than others, and dependent on how far the dispute goes. Many emerging markets actually have limited direct exposures to the US; Mexico is clearly exposed but beyond that it is mainly a few of the Asian economies with meaningful trade links. Global exposures, however, are another story. Few economies look insulated in the event that a trade dispute becomes a global trade war: Brazil, India and Colombia are perhaps safer bets than the rest. We could also hazard a guess that tariffs would not be imposed on imports of oil in many cases, so Russia (which anyway may benefit from a more amicable bilateral relationship with the US) could also be largely shielded.

Chart 12: EM reliance on exports makes trade wars a worrying prospect



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

We should also recall that trade is one of the key ways many EM economies generate foreign currency, so a trade war could see a rise in defaults across emerging markets, particularly those with large short-term foreign currency borrowing requirements. In this regard, we would be particularly concerned about Turkey and South Africa, but also much of Latin America and Malaysia. Chinese exposure in this regard is still limited.

We should, in the spirit of optimism, point out that a trade wars scenario is not our base case. Further, we believe it would take some time for the necessary legislation to be enacted, and President Trump might wish to delay potential damage to US growth until the effects of fiscal stimulus are being felt. But for all the focus on China, it is other emerging markets who stand to lose the most.

Schroder Economics Group: Views at a glance

Macro summary – February 2017

Key points

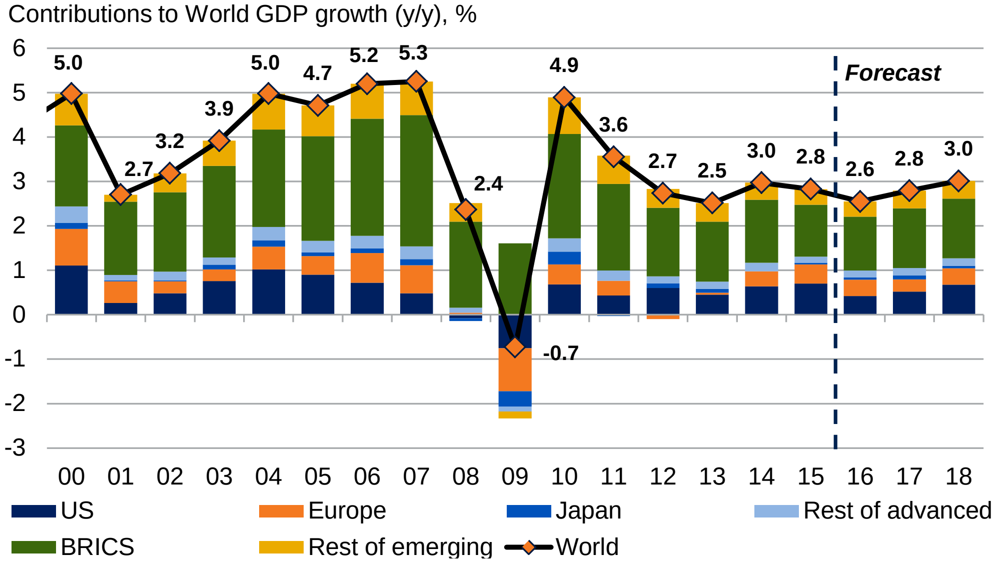
Baseline

- Global growth is expected to come in at 2.6% in 2016 as a result of a better than expected outturn for Q3 and continued momentum in Q4. The growth forecast for 2017 has been upgraded to 2.8%, led by a more optimistic view on the emerging markets, the UK (smaller Brexit effect than expected) and the US (boost from fiscal loosening). Inflation rises modestly due to higher oil prices. In 2018, global growth is expected to accelerate to 3% thanks to the full impact from fiscal loosening in the US, and falling inflation in Europe helping to boost demand.
- The US Fed is expected to raise rates twice in 2017 taking fed funds to 1.25% by end year. With growth strengthening and inflation rising, the pace of tightening is expected to increase in 2018 with four rate hikes taking the policy rate to 2.25% by end year.
- UK inflation is set to rise sharply due to the fall in the pound, which will reduce disposable income of households and encourage cuts in spending. Investment is already weak, and has started to impact employment. The BoE is expected to remain on hold, constrained by higher inflation. Growth remains below trend in 2018 causing unemployment to rise.
- Eurozone growth is set to ease in 2017 as a temporary rise in inflation constrains household spending. Political uncertainty will also weigh on business investment, though we assume the establishment holds on to power. The outlook for 2018 is more promising as inflation falls back, and external performance is boosted by better growth elsewhere. The ECB should maintain low rates and QE beyond the end of 2017, but will come under pressure to tighten.
- Japanese growth forecast at 1.4% in 2017 and inflation at 0.8% supported by looser fiscal policy and a weaker yen. No further rate cuts from the BoJ, but more QE is expected as the central bank targets a zero yield for the 10 year government bond.
- Emerging economies benefit from modest advanced economy demand growth and firmer commodity prices, but tighter US monetary policy weighs on activity. Concerns over China's growth to persist, further fiscal support and easing from the PBoC is expected.

Risks

- Risks skewed towards weaker growth on fears of secular stagnation, political risk in Europe and a US recession. Inflationary risks stem from more aggressive Trump policy on tax cuts and trade.

Chart: World GDP forecast



Source: Thomson Datastream, Schroders Economics Group, November 2016 forecast. Please note the forecast warning at the back of the document.

Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2015	2016		Prev.	Consensus	2017		Prev.	Consensus	2018
World	100	2.8	2.6	↑	(2.3)	2.5	2.8	↑	(2.6)	2.9	3.0
Advanced*	62.6	2.1	1.6	↑	(1.5)	1.6	1.7	↑	(1.6)	1.9	2.0
US	27.0	2.6	1.6	↑	(1.5)	1.6	1.9	↑	(1.8)	2.3	2.5
Eurozone	17.4	1.9	1.6	↑	(1.5)	1.6	1.2	↓	(1.3)	1.5	1.8
Germany	5.1	1.5	1.8	↑	(1.7)	1.8	1.4	↓	(1.7)	1.3	1.9
UK	4.3	2.2	2.1	↑	(1.7)	2.0	1.4	↑	(0.6)	1.4	1.5
Japan	6.2	0.6	0.8	↑	(0.7)	0.7	1.4		(1.4)	1.1	0.9
Total Emerging**	37.4	4.1	4.2	↑	(3.8)	4.1	4.7	↑	(4.4)	4.5	4.7
BRICs	24.2	4.8	5.0	↑	(4.4)	5.0	5.5	↑	(5.1)	5.4	5.5
China	16.4	6.9	6.6	↑	(6.4)	6.7	6.5	↑	(6.2)	6.4	6.2

Inflation CPI

y/y%	Wt (%)	2015	2016		Prev.	Consensus	2017		Prev.	Consensus	2018
World	100	1.6	2.0	↓	(2.2)	0.0	2.4	↓	(2.5)	2.5	2.3
Advanced*	62.6	0.2	0.8	↓	(0.9)	0.0	1.7		(1.7)	1.9	1.5
US	27.0	0.1	1.3	↓	(1.5)	0.0	2.0	↓	(2.3)	2.4	2.3
Eurozone	17.4	0.0	0.2	↓	(0.3)	0.0	1.3	↑	(1.0)	1.4	0.9
Germany	5.1	0.1	0.4	↓	(0.5)	0.0	1.3	↓	(1.7)	1.7	0.8
UK	4.3	0.0	0.8	↓	(1.0)	0.0	2.9	↑	(2.6)	2.5	1.9
Japan	6.2	0.8	-0.3	↓	(-0.1)	0.0	0.8	↓	(1.2)	0.6	0.9
Total Emerging**	37.4	3.9	4.1	↓	(4.4)	0.0	3.7	↓	(3.8)	3.6	3.6
BRICs	24.2	3.9	3.6	↓	(4.0)	0.0	3.3	↓	(3.5)	2.9	3.2
China	16.4	1.4	2.0		(2.0)	0.0	2.3	↑	(2.0)	2.0	2.2

Interest rates

% (Month of Dec)	Current	2015	2016		Prev.	Market	2017		Prev.	Market	2018	Market
US	0.75	0.50	0.75		(0.75)	0.99	1.25		(1.25)	1.53	2.25	2.01
UK	0.25	0.50	0.25	↑	(0.10)	0.38	0.25	↑	(0.10)	0.58	0.25	0.86
Eurozone (Refi)	0.00	0.05	0.00		(0.00)	-0.31	0.00		(0.00)	-0.25	0.00	-0.09
Eurozone (Depo)	-0.10	-0.30	-0.50		(-0.50)		-0.40	↑	(-0.50)		-0.40	
Japan	4.35	0.10	-0.10	↑	(-0.30)	0.06	-0.10	↑	(-0.40)	0.08	-0.10	0.10
China	4.35	4.35	4.35	↑	(3.50)	-	3.50	↑	(3.00)	-	3.50	-

Other monetary policy

(Over year or by Dec)	Current	2015	2016		Prev.		2017		Prev.		2018
US QE ($Bn)	4452	4487	4448	↓	(4475)		4430	↓	(4493)		4412
EZ QE (€Bn)	215	159	455	↓	(1552)		1355	↓	(2512)		1455
UK QE (£Bn)	388	375	428	↓	(438)		444	↓	(565)		445
JP QE (¥Tn)	457.2	383	467	↑	(453)		547	↑	(493)		667
China RRR (%)	17.00	17.50	17.00	↑	15.00		16.00	↑	13.00		16.00

Key variables

FX (Month of Dec)	Current	2015	2016		Prev.	Y/Y(%)	2017		Prev.	Y/Y(%)	2018	Y/Y(%)
USD/GBP	1.26	1.47	1.25		(1.25)	-15.2	1.20		(1.20)	-4.0	1.12	-6.7
USD/EUR	1.07	1.09	1.06		(1.06)	-2.4	1.00	↓	(1.04)	-5.7	0.95	-5.0
JPY/USD	114.7	120.3	110.0	↑	(100.0)	-8.6	112.0	↑	(105.0)	1.8	115.0	2.7
GBP/EUR	0.85	0.74	0.85		(0.85)	15.1	0.83	↓	(0.87)	-1.7	0.85	1.8
RMB/USD	6.88	6.49	6.90	↑	(6.85)	6.3	7.15		(7.15)	3.6	7.50	4.9
Commodities (over year)												
Brent Crude	56.5	53	44.9	↑	(43)	-14.8	50.1	↑	(47)	11.6	53.0	5.9

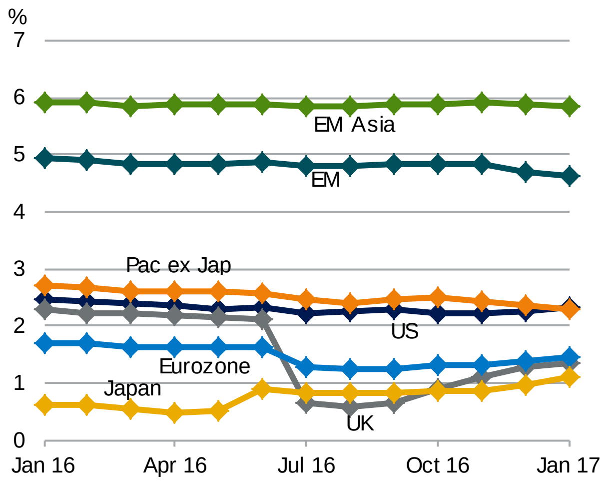
Source: Schroders, Thomson Datastream, Consensus Economics, January 2017
Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.
Market data as at 26/01/2017
Previous forecast refers to August 2016. Latest forecast includes historic revisions and revised weights to the contribution of global GDP
* **Advanced markets:** Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, United Kingdom United States.
** **Emerging markets**: Argentina, Brazil, Chile, Colombia, Mexico, Peru, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia, Lithuania.

Updated forecast charts – Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart A: GDP consensus forecasts

2017	2018



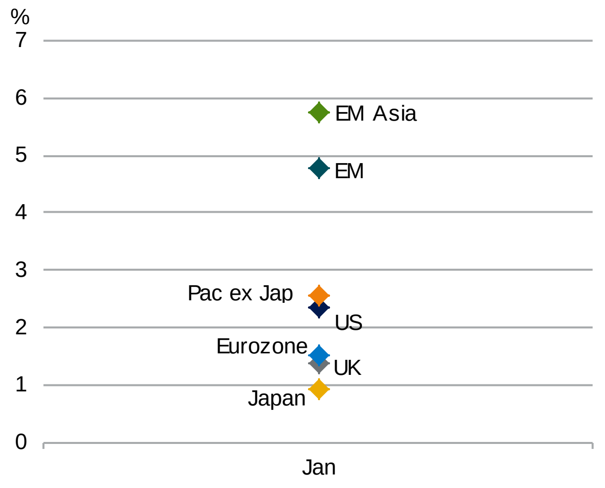
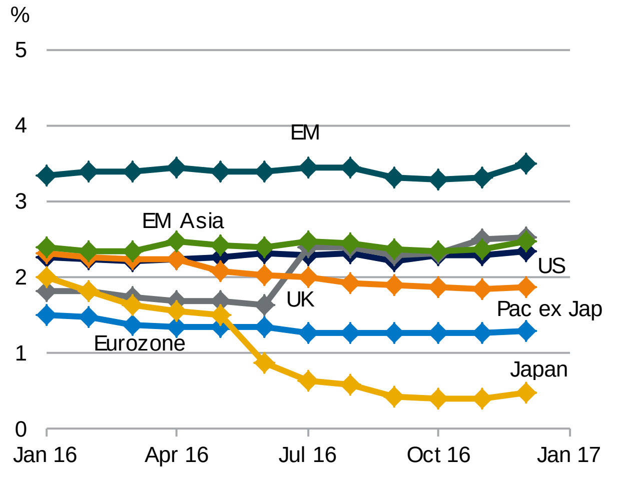
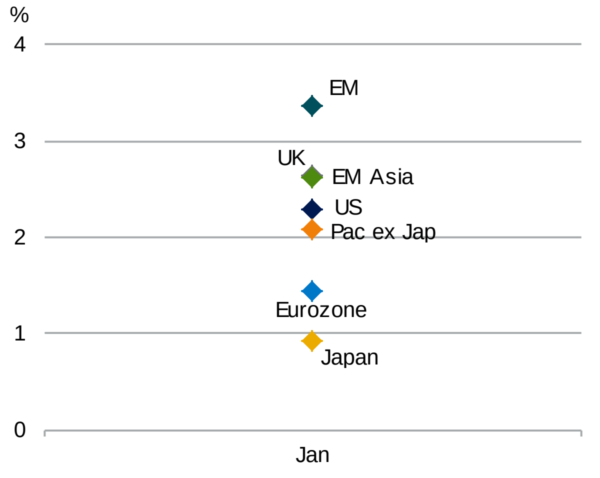


Chart B: Inflation consensus forecasts

2017	2018





Source: Consensus Economics (January 2017), Schroders.

Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore.

Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand.

Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, Venezuela, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania.