



World First briefing note:

# 2017 Economic Outlook Let Them Eat Chaos



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'Have your cake and eat it' was seen on a set of Brexit negotiation notes as a civil servant walked into Downing Street a few weeks ago. Donald Trump's plans for the US economy seem to be based on Marie Antoinette's 'Let them eat cake' but I feel the phrase 'Let them eat chaos' would be more appropriate for the world in 2017.

As I head into the Christmas period and shortly enter into the New Year, I have to think that markets are neatly balanced for the optimistic side of 2016's political and financial developments – Brexit, Trump, trade wars and an aggressive Russia – and therefore there is a significant risk of further volatile and challenging market conditions.

The election of Donald Trump is a pertinent case in point. Little more than three hours after it became clear that the real estate mogul was on course to become the 45th President of the United States, equity markets and the US dollar were pricing in heavy stimulus and inflationary pressures. The lag between the vote result and a positive market positioning was next to nothing in the case of the recent Italian referendum that saw PM Renzi resign. Markets are almost too quick to discount the negative at the moment and that will contribute to an ongoing feeling of overconfidence.

I have to doubt whether this conditioning can continue through another assault course of political risk and the focus of my fears for the upcoming 12 months are on three assets in particular; the euro, sterling and wider Emerging Market currencies. For these three, it could be a truly chaotic year.

## The European Acid Test

As it stands at the moment, there are four large political risks in Europe that investors have in the front of their minds when looking at EURUSD and the single currency on a wider basis; the fallout from the Italian constitutional referendum, and the elections in the Netherlands, France and Germany respectively.

Italian PM Matteo Renzi tied his future to winning the vote and lost so we have another political air pocket at the top of a European government. In the main, it points to an inability within Rome to adequately enact reforms capable of driving growth, reducing a huge debt pile or recapitalising banks. Italy was and remains the 'I' in the 'PIGS' acronym that defined the Eurozone countries that were pressured on their debt piles through the Global Financial Crisis and the situation has not improved despite low interest rates and an accommodative central bank. I anticipate an election in 2017.

It is France and the Netherlands however where people are looking for a populist win in an election that may mirror what Donald Trump managed to pull off in the United States. Geert Wilders and Marine Le Pen are the leaders of the PVV party in the Netherlands and the Front National in France respectively and are both in the lead in the latest opinion polls.

Within the Brexit campaign, vote and aftermath, focus on the popularity of the European Union as a whole was at the front and centre of the European political conversation. Wilders and Le Pen have both commented positively on the Brexit phenomenon and will use lessons learnt from the campaigns to drive engagement and popularity in their respective votes.



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## So what about the euro?

It may be simple and reductive to sit here and say that it was impulses that propelled both the UK referendum on EU membership and Donald Trump votes, but currency markets and particularly those who trade them can be simple and reductive.

Today, I think that markets are overstating the longer-term political risk within Europe, but near-term I see significant weakness in the single currency, especially against the USD. The referendum loss of the Italian government has caused traders to further price in populist pressures in 2017. For now, my estimates remain that centrist, status quo parties actually carry French and German elections with those in the Netherlands more difficult to call at the moment. I see the chances of a populist win (PVV, Front National or a Merkel loss) in the Netherlands at 50%, in France at 25% and in Germany at 20%.

Issues of growth and inflation or the lack thereof in the Eurozone will also act as a persistent pressure moving forward and any moves by the European Central Bank to create either will give speculators another reason to sell. Parity in EURUSD is a common call in times of European angst and I think that the circumstances of a strong, Trump driven dollar and European political issues makes now a better opportunity for that price level to be reached than in the past.

### British businesses and the euro

The euro has been neither friend nor foe to British businesses this year and the travails of the currency are minimal compared to the likely oscillations caused by the negotiations around the UK's exit from the EU. Businesses whose supply chain incorporates a relationship in Europe are battle-hardened from years of Eurozone crises and are continuing to make sure that they are hedging their exposures appropriately. A little clarity on Brexit would go a long way to solidifying investment plans in the UK and wider EU, but businesses seem prepared to put up with politicians flattering to deceive.





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## Brexit begins in earnest

For all the heat and noise from the referendum and the near six months that has passed since that morning in June, there are few things that I am more certain of than when the UK went to the ballot box. I know that Article 50 will be invoked by the end of Q1 in all likelihood and that will start the stopwatch on two years of negotiations.

Everything else is up for debate and, more pertinently, negotiation.

I was wrong in my assertions that the UK economy would immediately suffer as a result of the Brexit vote, but the economic data remains balanced on a knife edge. Heading into 2017 it is inflation that worries us the most.

Inflation will likely be the main, basic economic indicator of damage from the EU referendum vote, the triggering of Article 50 and the eventual separation of the UK from the EU and I believe that that pain will be held off until next year.

In my estimates, it will be the early part of the New Year that sees the majority of the price rises. Retailers have held off on price rises into Christmas but that will end soon. Of course, the tightness of budgets in the retail environment means that any price rises are going to be painful – and low cost operators and discounters will be ready to pounce – but they will have to come or we will likely see additional seasonal and structural unemployment increases in 2017. Even so, I cannot rule out an increase in unemployment through the year. Growth will remain weak, while investment will remain stilted.

## Another leg for sterling?

Is sterling oversold? Absolutely. Does that mean that it cannot go any lower? Absolutely not. While the pound has only been weaker on a trade-weighted basis twice since the end of Bretton Woods, the nature of Brexit and its existential risk to the UK's position in the world and its trading relationships across the globe arguably make for a more complicated policy cocktail than anything I have seen before. I believe that upside to sterling will return, possibly by the end of the year, although this depends almost exclusively on an easy path of negotiations between the UK and the EU. I think it is therefore prudent to wait until the government has laid out its negotiating plan before becoming bullish on GBP.

It is also my belief that the Bank of England will not make any changes in policy to support the pound. Whilst inflation may run above target, Governor Carney at the most recent inflation report made it clear that the Bank was very much in a neutral stance and communicated that earlier guidance to cut interest rates further had 'expired'.

Within his statement, Carney emphasised the almost binary nature of the classical guidance problem that the Bank of England faces; higher inflation or fewer jobs. There is not much the Bank can really do right here; predictions will be picked over by either side of the referendum divide and with policy at record lows and its credibility being unfairly dragged through the streets, the Bank will sit on its hands and wait for the data to show it something more than higher inflation and lower growth.

The one bright spot for sterling may be its ability to keep its head above water against the euro given the political issues on the continent. Sterling has been used as a haven of late from issues within European politics.



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## British businesses and sterling

Business is all about margins and 2017 is likely to be a year wherein margins of British businesses are likely to be compressed and strangled. We are going to spend a lot of 2017 talking about inflation and the pressures that higher import prices are putting on businesses and latterly consumers. Businesses are going to have to deal with higher costs via imported inflation, weaker consumer sentiment and a labour market that is close to record employment.

Something will have to give; either the pound gains 15%, consumers load up on credit and keep the spending levels going or people start to lose their jobs.

We remain optimistic on the longer-term possibilities for sterling and the wider UK economy, but feel that 2017 and 2018, in all likelihood, will be a tough year for UK businesses.

## Emerging markets

Countries and the businesses within them that have flourished on a wave of internationalisation and global productivity must now prepare for a tougher regulatory environment – this will be felt more keenly than anywhere in emerging markets courtesy of the election of Donald Trump.

That is not to say that global trade imbalances did not need to be addressed in the coming years. The rebalancing of the Chinese economy and the shift in the global economic centre of gravity from West to East meant that ongoing trade difficulties would need attention at some point in this Administration's term regardless of whether it was the Republicans or Democrats sat in the Oval Office. Trump however represents an almost existential risk to trade. He is an enemy of international trade as done through NAFTA, TTIP and the TPP deals and is set to take a combative stance in trading negotiations with countries both seen as rivals and those previously thought of as allies.

China is not an ally however and on the campaign trail Trump threatened to label China as a currency manipulator on his first day in office. He can do this unilaterally, provoking an instant 15% tariff on Chinese goods into the US for a period of 150 days. I would wager that such a measure would lead to a modicum of reprisal from Chinese authorities (sales of iPhones for example) and damage would be wrought on both economies.

Once again I have little knowledge about Trump's willingness to doggedly pursue these reforms once in office and risks remain that China will feel the need to meaningfully stimulate their economy via both additional fiscal spending and looser monetary policy despite concerns over their longer term effects.

Similarly I must be aware of the pressure that a combative US and strong US dollar will put on places like Singapore and Korea who rely on US funding and a free and easy trade environment or Indonesia and Malaysia given the volatility in their currencies of late.

Finally, I must turn to Mexico which will likely face more pressures than anywhere else; Trump's trade policies are bully tactics and bullies pick on the weak (Mexico) more than the strong (China).



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## British businesses and emerging markets

If the picture for UK businesses is one of margin compression, those in emerging markets will be dealing with potentially the most perilous trade environment since the 1970s. However, while Trump is kicking sand at important trade relationships, the wider EU - which Britain remains a part of for at least another two years - will stand to benefit.

Just because Trump doesn't want to trade, it doesn't mean that everybody doesn't want to trade. British exporters are able to benefit from a near 15% discount on their goods to markets that are still creating a burgeoning middle class hand over fist.

## So what to expect...

2016 has set the foundations for 2017 in a way that few would have believed at the beginning of the year; the past 12 months has been a lesson in hubris and the danger of echo chambers. While the moves of the past year have been political, the moves of the upcoming 12 months will centre on the policies that these decisions and votes have heralded.

I entered 2015 and 2016 cautiously optimistic, but 2017 is more a case of expectantly pessimistic. I hope I am proved wrong.

## Wonder what this might mean for you?



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