RISK, CHALLENGE AND OPPORTUNITY

Strategy and economics

Richard Jeffrey - Chief Investment Officer

One of my key themes over the past few years has been that, because trend growth rates in Western economies are currently appreciably below those recorded during the 10 to 15 years prior to the recession, we feel more vulnerable to potentially negative shocks. And there is no doubt that we have just experienced a very significant shock, with the result of the Brexit referendum being that the UK is now on a course that will take it out of the European Union. The risk is, however, that our greater feeling of vulnerability leads us to overstate the immediate negative consequences of Brexit for the economy.

Looking at the currently published UK GDP data for the 15-year period between 1993 and 2007, there were only three quarters in which the year-on-year growth rate was below 2%: 1.9% in both Q4 2004 and Q1 2005, and 1.4% in Q4 2006. We now know of course, that the average growth rate of 3.0% over the period was unsustainable, if not reckless, and that the authorities should have paid more attention to the escalating debt levels and the deterioration in the trade accounts that accompanied this growth. However, to the extent that the Bank of England and Treasury were happy to parade the UK's resplendent growth, it is unsurprising that there developed during this time a sense of invulnerability. How foolish we were.

With a trend growth rate now of 2%, it is inevitable that bumps in the road seem more disturbing. Losing momentum from this rate could take us quickly into territory that has recessionary characteristics – although not necessarily defined 'technically' as a recession (two consecutive quarters of negative quarter-on-quarter growth). And that is the fear now, with the suggested logic being that reduced capital investment and heightened uncertainty lead to an overall decline in aggregate demand.

Another theme that I have written about on a number of occasions relates to monetary policy. Specifically, I have written that the Monetary Policy Committee (MPC) should have used the emergence of above-trend growth between mid-2014 and end-2015 as an opportunity to begin the process of normalising interest rates. One of my arguments was that in doing so, the MPC would create room for policy manoeuvre should the economy be subject to a shock. So, it would have been helpful had the MPC been able to initiate an easing in monetary policy, albeit temporary, in order to reassure nervous households and companies. Of course, the MPC is not precluded from cutting rates from their current level of 0.5%, but this would be of much lesser benefit. It could also embark on additional quantitative easing, although this could easily prove counter-productive.

Inevitably, in the immediate aftermath of the referendum, economists and commentators have concentrated on the potentially negative near and medium-term consequences of the UK leaving the EU. Indeed, it is almost as if the UK were not just leaving the EU but being physically cut off from continental Europe, with our islands being dragged into the mid-Atlantic (gone are the days, it seems, when creating a mid-Atlantic economy was seen as a panacea). Some of us, with longer memories, can remember similar forecasts of an approaching economic cataclysm following our unseemly exit in 1992 from the Exchange Rate Mechanism. In fact, that apparent monetary disaster kick-started a period of strong recovery from recession.

The downside risks now are greater than they were in 1992 and the political consequences of Brexit for both the UK and the EU could turn out to be profound. However, it is wrong to ignore the positive impact that the fall in the pound could have on exporters and companies competing with imports. While the initial impact on the trade accounts will be negative, due to the higher cost of imports, volume effects resulting from improved competitiveness could be meaningfully beneficial to growth. Equally, while the prevailing mood at the moment is one of uncertainty and concern, it is not too difficult to see this becoming more positive, as companies begin to talk about improving export opportunities. Indeed, the shake-up that approaching Brexit gives to the economy could prove invigorating, in that it will force companies to look for new arenas in which to do business.

As a barometer of how investors regard the likely consequences of Brexit, the financial markets initially seemed to confirm people's worst fears. Fairly quickly however, markets stabilised. While the currency has – helpfully – remained at lower levels, equity markets have been recovering from their initial falls. This does not mean there will not be further reverberations, possibly triggered by political developments. However, it cannot be taken as anything but a positive sign that at the time of writing, the FTSE 100 is showing a positive total return over the year-to-date.

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Cazenove Capital Management, 12 Moorgate, London, EC2R 6DA
T +44 (0)20 7658 1000 **F** +44 (0)20 7658 3827
www.cazenovecapital.com