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UK wages finally outpace inflation, what's actually going on?

Last week, we discussed how a lack of meaningful progress on Brexit talks, by either side, left UK growth prospects looking rather soggy. The Bank of England (BoE) believes economic growth will lag behind the Global pace as a result of the lingering uncertainty over Brexit detail.

UK workers will be relieved to hear then that, despite that gloomy picture, pay growth has finally increased faster than the rate of inflation. This means that Britons got their first real pay rise in over a year during Q1. Now, the question is: is this sustainable and what's the impact on interest rates?

Before we move on to the BoE, let's look at the latest labour market data. The Office for National Statistics (ONS) said that average earnings (excluding bonuses) increased 2.9% year-on-year (YoY) during Q1 – the quickest rate since August 2015. Inflation over the same period averaged 2.7%, as the effect of the post-Brexit fall in the Pound faded. This left workers a whopping 0.2% better off.

The ONS data suggests that skills shortages are forcing to increase pay in order to attract staff. The labour market appears to be in rude health, with the employment rate touching a record high of 75.6%. The economy added a better-than-expected 197k jobs between January and March, leaving the unemployment rate at a 43 year low of 4.2%.

The ONS data also reveals that employment growth was driven by UK nationals, which possibly reflects the fall in net migration since the Brexit vote. Employment among EU nationals fell 1.2%, the first annual decline since 2010.

How does this fit with the BoE's outlook?

The central bank, now heavily data dependent, elected to hold UK interest rates at 0.5% last week, owing to weaker GDP growth and a bigger than expected fall in inflation. So, while workers will welcome the real (albeit slight) gain in living standards, the fact that it wasn't accompanied by a rise in interest rates means we could see more inflationary pressures in the longer-term, particularly if the labour market tightens further.

At the BoE’s last rate decision, two MPC members voted for an immediate rate rise for May on the belief that rising pay growth would lead to “upside risks to inflation in the medium-term”. And, according to the central bank, its guidance towards “ongoing tightening of monetary policy” has been based on its view that “regular pay growth has picked up”, noting that it contributes to “continuing signs that domestic inflationary pressures are building gradually”.

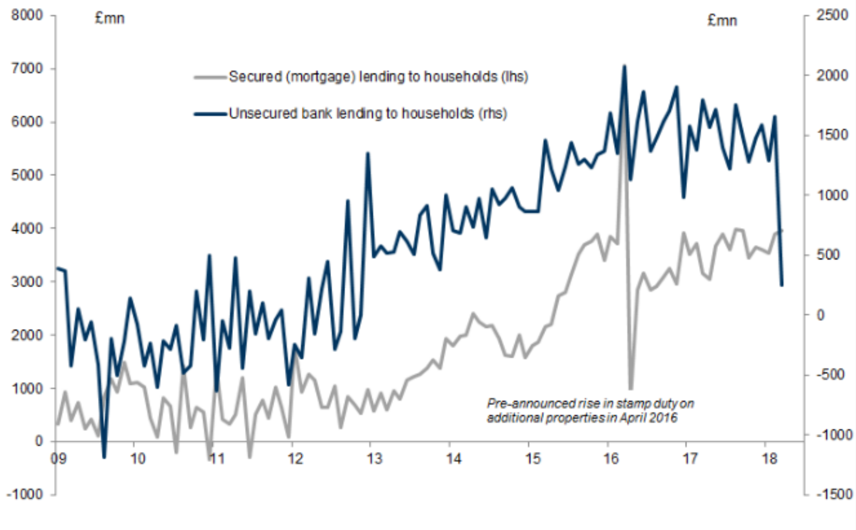
Sure enough, a look at recent pay deals does indeed suggest that there is a gradual build in wage pressures. An analysis by Goldman Sachs indicates that the simple, 3-month moving average of pay deals climbed to post-2008 highs in May. They noted that the ratio of pay deals that amount to a “pay freeze” (no increase) have fallen steadily, having spiked in the aftermath of Lehman Brothers’ collapse. Using April’s data, average pay agreed between employers and employees is likely to increase by around 2.8% in 2018.

In terms of monetary policy, these pay discussions particularly relevant to two main indicators watched by the central bank: unit labour costs and productivity (output per hour). Economics textbooks define unit labour costs as the cost of labour for producing a single unit of output, of which wages are a large component. So, if a worker produces the same output per hour, while obtaining higher pay, then unit labour costs go up.

Therefore, if productivity remains stable, higher wage growth increases unit labour costs, which then creates inflation pressures.

It is interesting then, that UK productivity saw a sharp decline during Q1, falling 0.5%, as hours worked increased 0.6% without a matching rise in economic growth. This follows an average gain of 0.9% over the past 2 quarters. Over the past 10 years, productivity growth has been stubbornly low, and this data suggests that trend might not have gone away yet. If firms expect productivity to remain poor despite wage increases, they could put prices up to protect their profit margins.

Exhibit 1: Unsecured bank lending to households in March was at its weakest since 2012



Source: Bank of England, Goldman Sachs Global Investment Research

So, the only reliable long-term way to boost pay growth and enhance living standards is to increase productivity. But this has long been lacking from the UK economic recovery and, on current evidence, that doesn’t look likely to change. Late last year, the Office for Budget Responsibility

(OBR) downgraded its forecasts for productivity growth, noting that a pick-up in growth was likely due to volatile changes in hours worked rather than an actual change in the post-crisis trend.

Another key area of focus for the BoE has been unsecured credit. The central bank has sought to reign in unsecured debt on the concern that it could lead to economic instability in a tighter interest rate environment. That effort seems to be having an effect; recent consumer unsecured credit flows during March printed at their weakest level since 2012, due to ongoing credit restrictions (i.e. lender caution or bank regulation).

The more difficult it becomes to obtain unsecured debt, the harder it is for households to smooth through the squeeze on real incomes (a result of the Brexit-induced fall in the pound) by borrowing. Rising real wage growth will help here, but the problem is compounded by recent troubles in the housing market, which have led to waning demand for secured credit (i.e. mortgages). All these factors help explain the recent softness in consumer spending.

On the one hand, low productivity and higher inflation should suggest a tighter monetary policy. On the other, weakness in the UK housing market and resulting softer credit demand might require a more neutral monetary policy stance, owing to their negative effects on overall consumer spending.

Unless there is a significant strengthening in overseas demand for UK goods and services, current domestic dynamics would suggest the BoE remains on hold (for now), amid a soggy Brexit-induced outlook.

Italy’s new government puts on the frighteners

Italian debt rose to its highest since October on Wednesday, after a draft coalition agreement between the countries two largest political parties surfaced. Today, with a new coalition agreement being put to the parties’ members, gaining the keys to government is only a matter of days.

The Five Star Movement (M5S) and the Northern League, both anti-establishment populist parties, emerged as the biggest forces in Italy’s parliament back in the March election. Since then, the prospect of their forming a government together was long thought of as the most disruptive outcome by European leaders. Now that they have formed a government that “binds two political forces that are and remain alternative,” according to the M5S leave leader Luigi Di Maio, that most disruptive outcome has become a reality

This could be hugely significant. Italy accounts for around 15% of the eurozone’s GDP, behind only France and Germany. In contrast, the Greek economy that caused so much panic years ago accounts for just 1.8% of eurozone GDP. In short, Italy matters.

The leak caused fear because it contained suggestions that Italy could abandon the single currency, adopt a much looser fiscal policy and ask the ECB to cancel its €250bn of Italian government debt. Both parties dismissed the leaked proposal as “old” and denied that they were considering taking Italy out of the Euro. But Friday’s coalition announcement re-enforced the yearning for a “pre-Maastricht” European economic policy, before the single currency and the common fiscal rules it brought. It also excludes a cancellation of the national debt, confirming that they wanted to exclude bonds bought by the ECB under their QE program from Italy’s debt-to-GDP calculations. But even that would contravene EU law and would be no doubt met with disapproval from European leaders.

All of this sent Italy’s 10-year government bonds to 2.12%, while the FTSE MIB, the country’s main stock index, fell 2.3% on Wednesday. In the last two weeks, Italy’s debt yield has gone up nearly

0.4%. For comparison, the German 10-year has stayed within a 0.1% range over the same time, and the Eurostoxx 600 index edged slightly higher.

Could this cause a wider problem for investors or the financial system? Yes, and here's why.

Italian government bonds have long offered some of the highest yields in the European investment grade bond sphere. Even Portugal and Spain's debt yields less than Italy's, at 1.8% and 1.4% respectively, which makes Italian bonds very attractive for those chasing yield. This has led to concerns that widespread ownership of Italy's debt could cause trouble if the political problems persist, leaving many vulnerable.

However, despite the relative attractiveness, foreign investors actually own only a small portion of Italian bonds. According to research from Nomura, domestic savers own 69% of outstanding Italian debt, an unusually high number. For comparison, in Germany that number is 47%, while Spanish savers own 59% of their national debt. What's more, overseas (non-EU) buyers own just 5% of Italian bonds. While that 31% does translate into a significant amount of assets, the fact that it is mostly Italians who hold their government's debt insulates the problem somewhat.

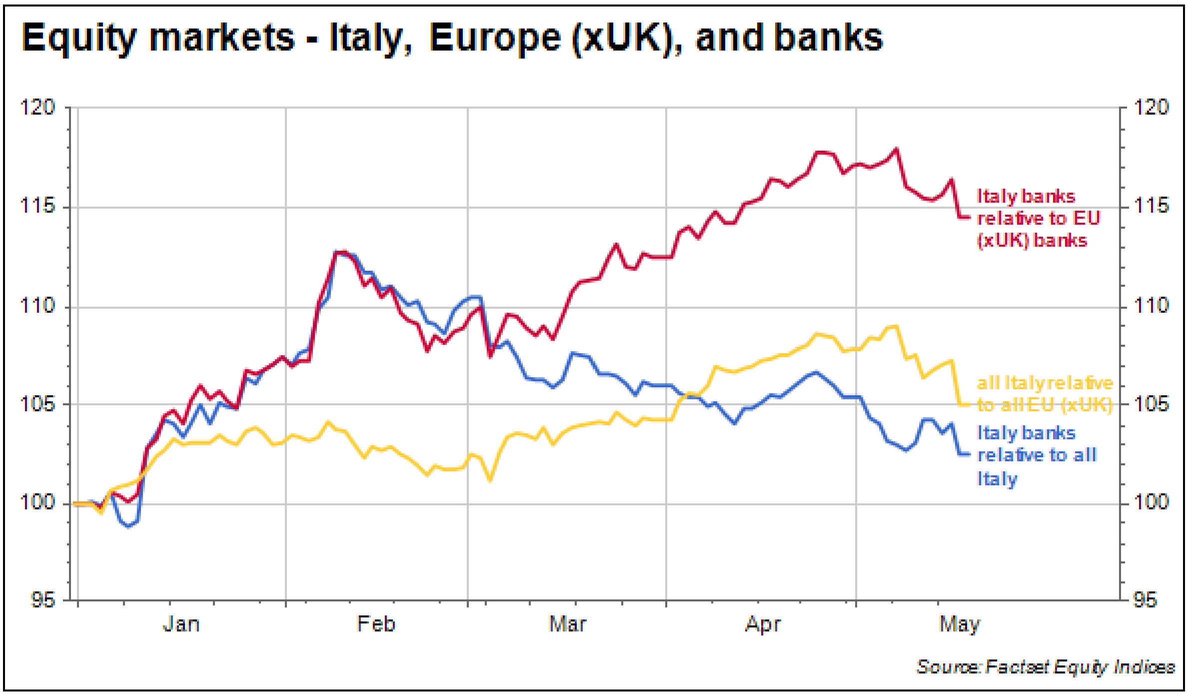
But this does highlight a problem of complacency among investors into Italy. Despite the recent spike, Italy's bond yields are still extremely low relative to developed countries outside the EU, both at the long and short end. For all the scare from the political side, Italy's 2-year bonds have only just risen above 0%. Compare that with the US, where 'risk-free' 2-year treasuries yield around 2.6%, and it looks harder to justify how expensive Italian debt is.

The complacency comes from investors' assumption that the ECB would act as a backstop for European bonds, guaranteeing a 'Draghi put' which essentially removes the risk involved. But the central bank's QE bond purchases are set to taper to a close by the end of the year, and Italy has been one of the biggest recipients of that program. And the odds of the ECB cancelling some or all of Italy's debt as per the populists' request are very low, to put it politely.

As has often been the case throughout history when investors go chasing yield, they could end up with far more risk than they bargained for.

What does this mean for the wider economy? Undoubtedly there is potential for trouble for Italy's banks, who hold a great deal of their government's debt and would be hit hard by a euro-exit scare. The country's banking system has already been struggling for years under the weight of a stockpile of non-performing loans. These have hampered bank's lending ability and therefore growth in Europe's 3rd largest economy. Because of these issues, markets often view Italian banking stocks as a proxy for political risk in the country. Sure enough, they were some of the worst hit by coalition fear.

The main question, however, is whether that trouble could spread Europe-wide. The interconnected nature of Europe's banking system means that's at least a possibility, if only due to markets getting spooked. If there is a fear of contagion throughout Europe's banks, it could put upward pressure on Euribor (European interbank offered rate). That would be significant, because a huge number of mortgages throughout Europe use Euribor as a reference point for interest rates.



Of course, there are plenty who expect little to come of this, and for M5S and the League to back down in the face of pressure from the 'eurocrats' – much like the case with Syriza in Greece. Again, however, we think this view is complacent. The leaders of the two parties show no signs of backing down. "I see a certain fear among the Eurocrats." Said Luigi Di Maoi, M5S leader. "But they don't scare me." More importantly, Italy has far more leverage than Greece ever had – its 'too big to fail' status can clearly embolden the populists. And while Syriza was critical of many EU measures, they never expressed general doubt about the European project or the euro. M5S and the League have already shown some antagonism toward both.

The threat of one of its founding members leaving is already putting downward pressure on the euro. Ironically, that dynamic will likely reinforce the sell-off of Italian bonds, as dollar strength sees 'risk free' US treasuries become far more attractive. As ever with European crises, this could well cause problems for leaders and the single currency in the short term. In the long term, it's yet another reminder that the problems were there all along.

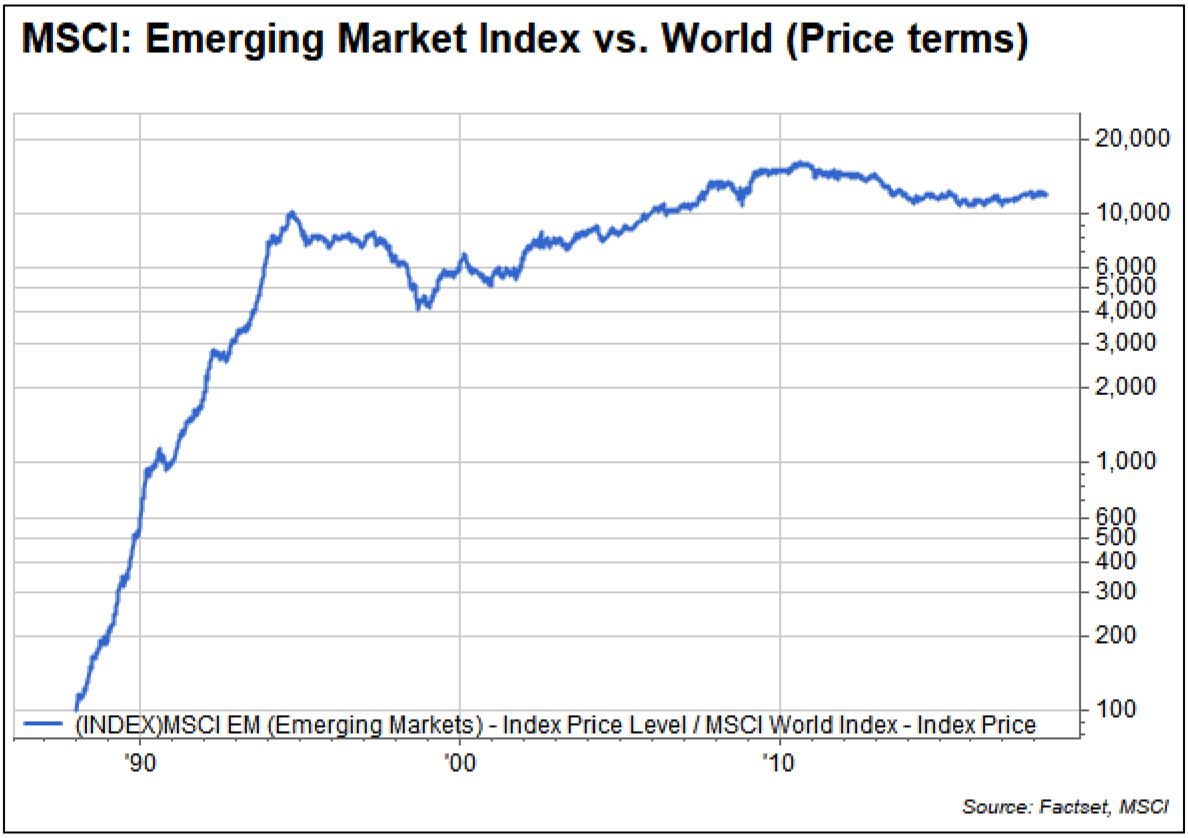
Emerging Markets – "It's so unfair"

Being a parent teaches you a lot about fairness. We encourage kids to behave and tell them that good things would come to them if they do. Of course, the other lesson that children have to learn is that sometimes, no matter how well you behave, you can't always get what you want. Any parent will tell you that they're used being told "it's so unfair".

Emerging market companies will probably be sharing that sentiment at the moment. Emerging markets, via both equities and bonds, have been under relative pressure for the past few weeks. This is despite the fact that, as Goldman Sachs pointed out in their Emerging Market Daily of 16th May, domestic demand in the countries that make up the MSCI's emerging market group has been good.

It's a bit of a simplification but, a good working description of an "emerging" country is *a country that has significantly greater potential production than their consumption*. That idea has a lot of knock-on effects. The obverse of little domestic demand is a shortfall of internal wealth. The nation will need external capital to build their companies, and external demand to consume the goods that they produce. Over time, the country will retain wealth; people will gain skills, workers will get paid, and savings will build. However, until domestic demand is sufficient and people are wealthy enough to consume what they produce, the country is subject to vagaries of changing external demand and external capital.

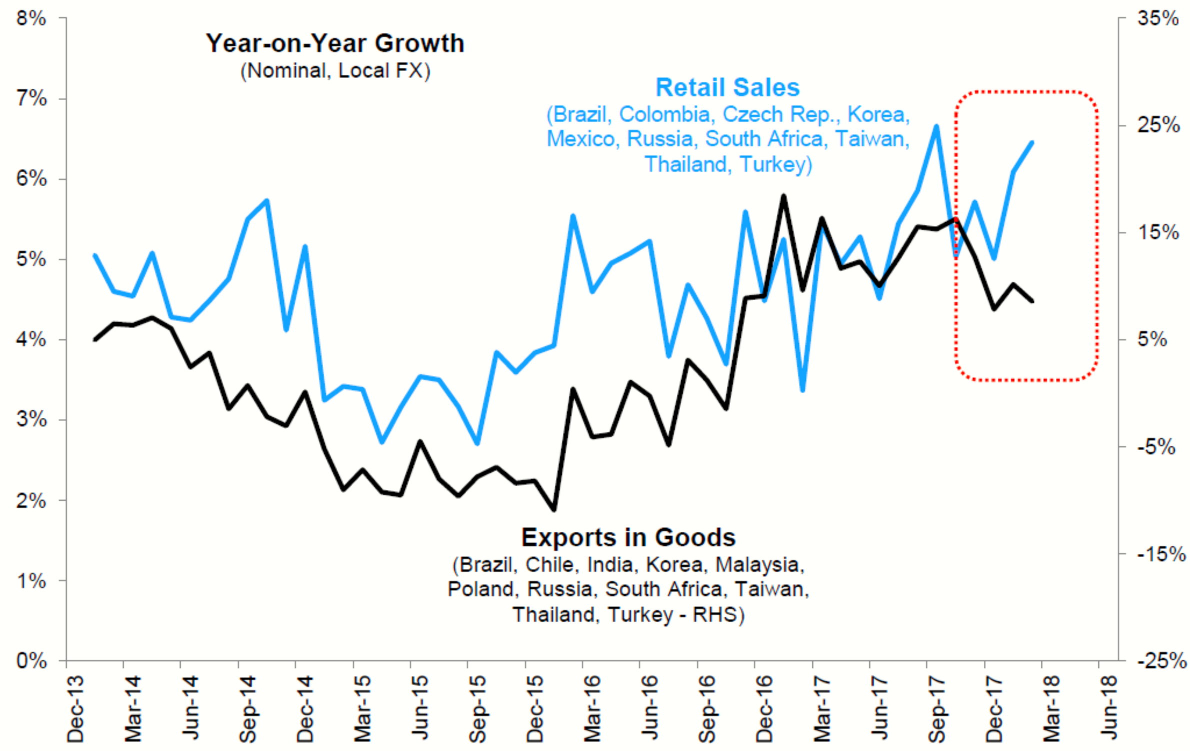
The MSCI Emerging Market Index started in 1987. Here's a chart of the price performance (not including dividends) relative to the MSCI World Index since inception on a log scale:



The first 8 years dominate. To steal a phrase of the Fidelity Magellan Fund manager Peter Lynch, it was a 100 bagger; the relative index goes from 100 to 10,000! It ranks as one of the great bull markets of all time.

So, globalisation has meant that capital has flowed to emerging markets, and the world has bought increasing amounts of their production. Over the long period, emerging countries have changed, becoming owners of capital and suppliers of demand themselves. Some are "emerging" only in a loose sense; China and Taiwan are the foremost examples.

Retails sales in EM has not slowed with softening export data

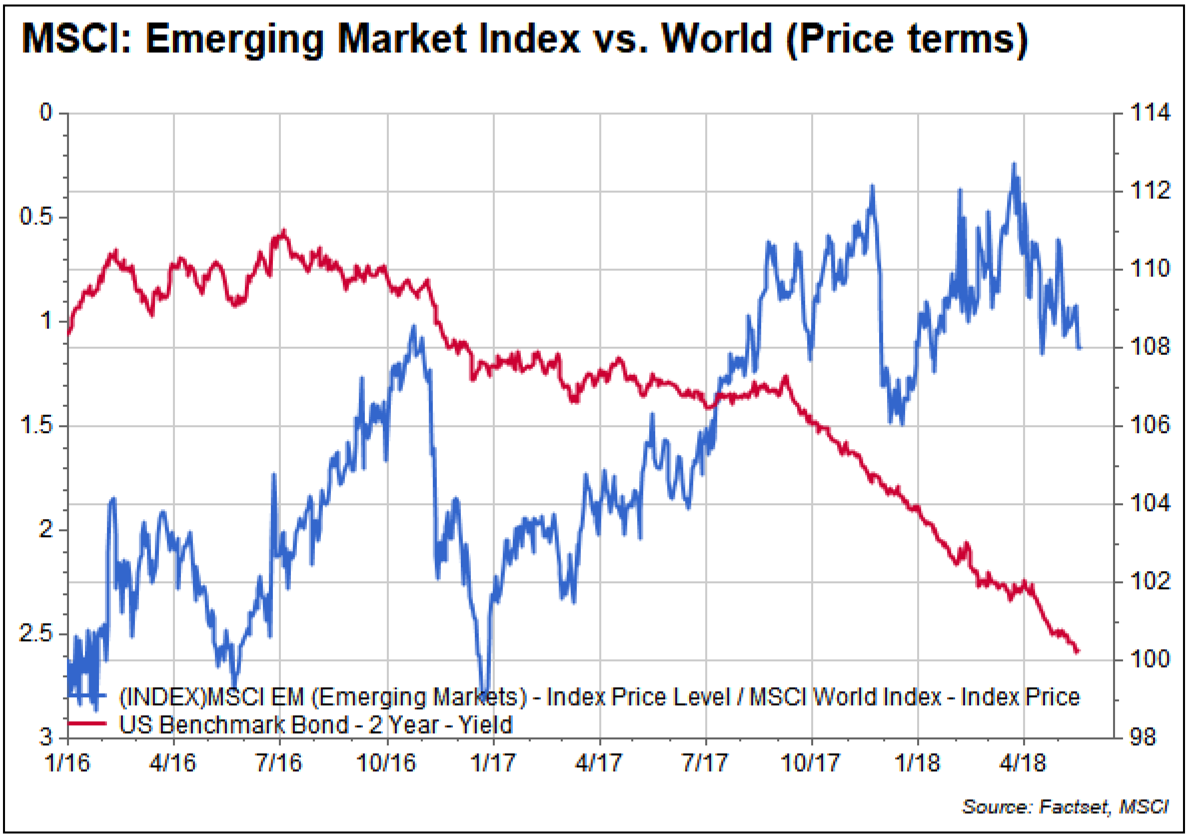


Source: Haver Analytics, Goldman Sachs Global Investment Research

The chart above (from Goldman Sachs, which does not include China) shows that the recent economic underpinning for these nations looks strong, in terms of domestic demand. Meanwhile, the level of export growth has slipped. They're doing what the rest of the world (particularly the US) wants.

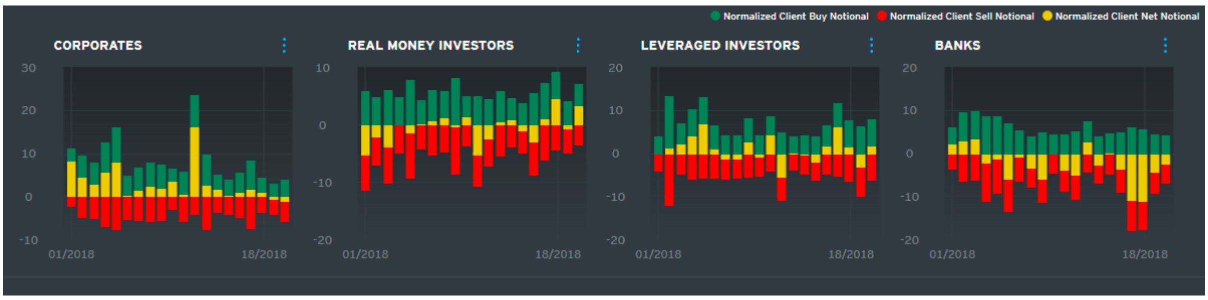
However, while these countries are being good, unfortunately they are still reliant on external capital and demand – albeit less so than in the past. International capital flows may not force emerging market equities to halve in price (as happened in 1997-8) but they have been a major influence in the recent underperformance of emerging market equities:

So, here is the same series as the first chart, since the start of 2016, but with the US 2-year government bond yield (on the right, reversed):



“Risk-free” dollar assets are looking a lot more attractive. Meanwhile, credit spreads have widened and the US dollar itself has appreciated. It’s a triple-whammy for EM companies. They are more exposed to dollar-based financing than other nations, so their interest costs rise, as does the cost of paying back maturing dollar-based debt. EM nations’ stable domestic demand isn’t enough to offset these effects.

The evidence is that the capital flowing out of emerging markets has been nowhere near large enough to be destabilising. A lot of it is money and bond related rather than equity. Banks have been the largest actors in the FX market, according to the flows seen by Citi. The chart below shows their weekly FX flows (1-19 indicate the week numbers, the net flows shown in yellow):



If US bond yields and credit spreads stop rising, emerging market equities should stabilise too. However, it would take quite a sharp reversal in the recent bond trend to cause a significant bounce in our view. We expect emerging market equities to remain under pressure for at least a few weeks.

Emerging markets will just have to accept that sometimes it isn’t fair. Luckily for them as for anyone, it gets easier as you grow.

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7762.8	0.5	38.3	→
FTSE 250	20980.7	0.9	195.1	→
FTSE AS	4266.2	0.6	24.2	→
FTSE Small	6015.6	0.6	34.6	→
CAC	5606.6	1.2	64.7	→
DAX	13055.1	0.4	53.8	→
Dow	24747.7	-0.3	-83.4	→
S&P 500	2714.0	-0.5	-13.8	→
Nasdaq	6884.0	-1.0	-68.6	→
Nikkei	22930.4	0.8	171.9	→
MSCI World	2125.6	-0.3	-6.4	→
MSCI EM	1144.1	-1.8	-20.4	→

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.35	-0.52	OIL	79.3	2.9
USD/EUR	1.18	-1.49	GOLD	1291.6	-2.1
JPY/USD	110.72	-1.20	SILVER	16.5	-1.3
GBP/EUR	0.87	0.97	COPPER	308.5	-0.9
CNY/USD	6.38	-0.72	ALUMIN	2293.0	-1.8

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.500	4.0	0.06
US 10-Yr	3.073	3.5	0.10
French 10-Yr	0.832	5.6	0.04
German 10-Yr	0.579	3.6	0.02
Japanese 10-Yr	0.061	29.8	0.01

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.8	13.5x	14.0x	17.1x
FTSE 250	2.6	15.5x	14.9x	17.0x
FTSE AS	3.6	13.7x	14.1x	16.7x
FTSE Small	3.1	11.6x	-	-
CAC	2.8	16.7x	14.7x	15.4x
DAX	2.4	13.3x	13.1x	16.9x
Dow	2.1	19.7x	15.7x	15.3x
S&P 500	1.8	19.9x	16.4x	17.5x
Nasdaq	1.0	25.1x	20.1x	20.2x

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.3
2-yr Fixed Rate	1.7
3-yr Fixed Rate	1.8
5-yr Fixed Rate	2.0
Standard Variable	4.14
Weighted Average Interest Rate (BoE)	1.7
Nationwide Base Rate	2.50
Halifax Standard Variable	3.99

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
PADDY POWER BETFA	21.0	VODAFONE GROUP	-8.2
BURBERRY GROUP	7.9	BT GROUP	-6.5
COMPASS GROUP	5.5	OLD MUTUAL	-5.7
MICRO FOCUS INTERN	5.0	SMURFIT KAPPA	-5.3
EXPERIAN	4.9	MEDICLINIC INTERNA	-4.0

* LTM = last 12 months' (trailing) earnings; **NTM = Next 12 months' estimated (forward) earnings

For any questions, as always, please ask!

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The value of your investments can go down as well as up and you may get back less than you originally invested.

Lothar Mentel