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The UK is dancing all by itself

Chris Bailey, *European Strategist, Raymond James Euro Equities**

"The UK is participating a little less in this global upswing" Bank of England Governor Mark Carney

I pointed out in the most recent Investment Services Quarterly that over the past fifteen or twenty years October had a slightly rude reputation as a bad month for equity market investors. October 2017 will go down in the history books as not only being a positive month for almost all global investors, but additionally one which saw many well-regarded volatility measures continuing to bump along the bottom. Good returns and low volatility... this sounds like some form of investment nirvana.

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And think about the backdrop too. After the decision in September by the Federal Reserve to overtly reduce the size of their quantitative easing (QE) boosted balance sheet over the next couple of years, the big central bank pronouncement of October was the conclusion of the European Central Bank to reduce the size of their QE efforts from the start of next year, as the best economic backdrop in the Eurozone for a decade continued to build. Europe, during the month, even suffered the Catalan political crisis in Spain which - in less forgiving times - would have provided free pre-Halloween spooks for the region's markets. However, any concerns were materially abated by the end of the month, albeit at the cost of the imposition of rarely used central government laws in Spain and a likely regional election a week or so before Christmas. Overall, add in Prime Minister Abe being re-elected in Japan, despite underwhelming many with his first term's efforts, plus a well-received Chinese National People's Congress meeting and the easy conclusion is that the global economy got better during October and financial markets rightly noticed.

However, as the quote above from Bank of England Governor Mark Carney above shows, not everything - or everywhere - is awesome. The decision by the Bank of England, a couple of days into November, to raise interest rates feels consistent with the evolutions in both Federal Reserve and European Central Bank policy, an acknowledgement of the improving economic backdrop. Look more closely though and, in the case of the UK, it is clearly not.

UK economic growth rates are not the worst of the G20 by any means but they are showing the worst momentum. Additionally, if you scratch below the surface, one of the big reasons why the Bank of England decided to edge interest rates up, for the first time in a decade, is that they are concerned the UK economy may otherwise struggle to keep inflation under control at 2% or less.

Wow. Most other major global central banks have the opposite issue of trying to generate inflation but, of course, the UK has some special

*An affiliate of Raymond James & Associates and Raymond James Financial Services factors to consider. Governor Carney said the Brexit issue 'was having a noticeable impact' and leaver or remainer alike would have to acknowledge that the fall of the Pound in the second half of 2016 continues to boost the inflation rate. Now all of this ultimately works its way through, especially as the Pound has recovered against the US dollar during this year. However there is now a new challenge. Due to a combination of poor underlying productivity growth over recent years and more recent impacts, such as lower labour availability from non-UK workers, the Bank of England are now concerned the UK economy cannot grow even modestly quickly without threatening to generate a bit of inflation. And all this means that ultra-loose monetary policy cannot stay so ultra-loose.

Now here's the big question. UK-specific issues have induced some of the above, but the broader issue of low productivity and potential challenges of an economy running at firm levels of economic growth without generating overt inflation, are very globally relevant. If you go back to your economics textbook, the classic route to get out of such challenges lays not with keeping interest rates very low, or tapping the QE tiller, but through improving the flexibility of an economy. The policy baton handover from central banks raising interest rates or reducing/reversing stimulus measures, to government policy makers charged with applying supply side changes like tax changes, encouraging entrepreneurship and labour market reforms, remains the most important theme for global investment market returns in 2018.

In the UK then, all eyes are on the upcoming UK budget later this month. Elsewhere, keep thinking about the various ongoing economic reform and structural change initiatives. Investment nirvana will not persist forever and it is hard not to conclude that the outperformers of 2018 will be the countries/regions that enact the most surprising level of change versus current expectations.

Still, it is not all bad news for UK allocations. It is noteworthy that global allocations to UK equities have been, persistently, over recent months in the most well-known fund manager sentiment survey, the most underweight of all major investment class areas. In short, much pessimism has already been factored in but government policymakers still need to step up... wherever they are in the world.

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