

# Schroders

## Economic and Strategy Viewpoint

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### Global: The stop-go market (page 2)

- Equity markets appear to have shrugged off the UK’s decision to leave the EU despite warnings from the International Monetary Fund (IMF) on the impact on growth. We still see a drag on activity from the rise in uncertainty as well as an increase in political risks.
- Meanwhile, investors are counting on the increase in liquidity to drive risk assets, despite appearing to lose faith in central bank monetary policy earlier in the year. The rally is characterised by a renewed search for yield, creating a “stop-go” market ever more dependent on liquidity injections.
- Yet, although equity investors might be more focused on income rather than growth, even bond-like stocks require earnings to make pay-outs and dividend cover is at a two decade low in the US. The bigger threat though may come from a successful expansion of fiscal policy which would steepen yield curves and create significant market volatility as investors rotate themes.

### Brexit: First impact (page 6)

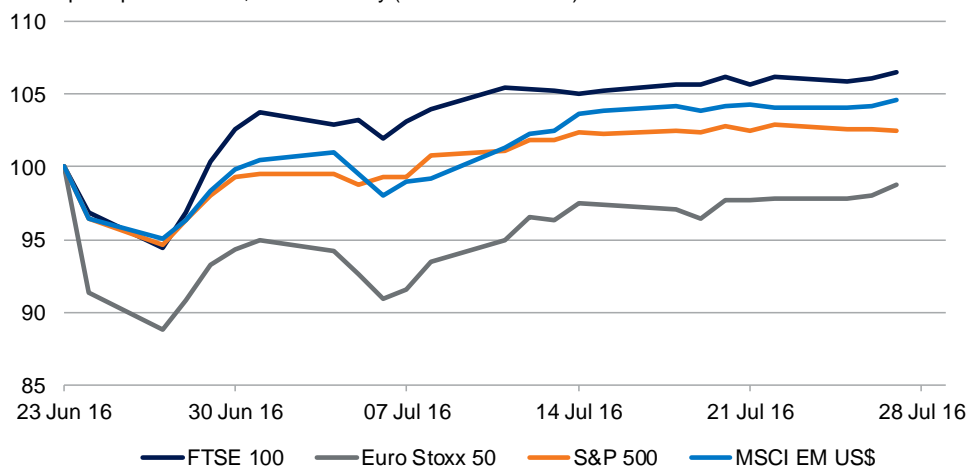
- The UK appeared to have enjoyed solid growth ahead of the EU referendum, but early evidence suggests that activity has slowed sharply since then. Private business surveys suggest output has fallen to levels not seen since the global financial crisis.
- Monetary and fiscal stimuli are likely to follow as the Bank of England (BoE) is expected to cut interest rates soon. The new Chancellor looks ready to reset fiscal policy and is likely to offer a combination of tax cuts and extra spending. Overall, we continue to place a 40% chance on a UK recession.
- While it is too soon to judge if political contagion will spread to other parts of the EU, there is little evidence of a macroeconomic impact.

### Tinderbox Turkey (page 11)

- The failed coup in Turkey will have long lasting and negative effects on the country’s economy and politics, as well as regional geopolitics.

### Chart: Equity markets shrug off Brexit

Index price performance, local currency (100 = 23/06/2016)



Source: Thomson Datastream, Schroders Economics Group, Updated 27 July 2016.

## Global: The stop-go market

Markets shrug off Brexit

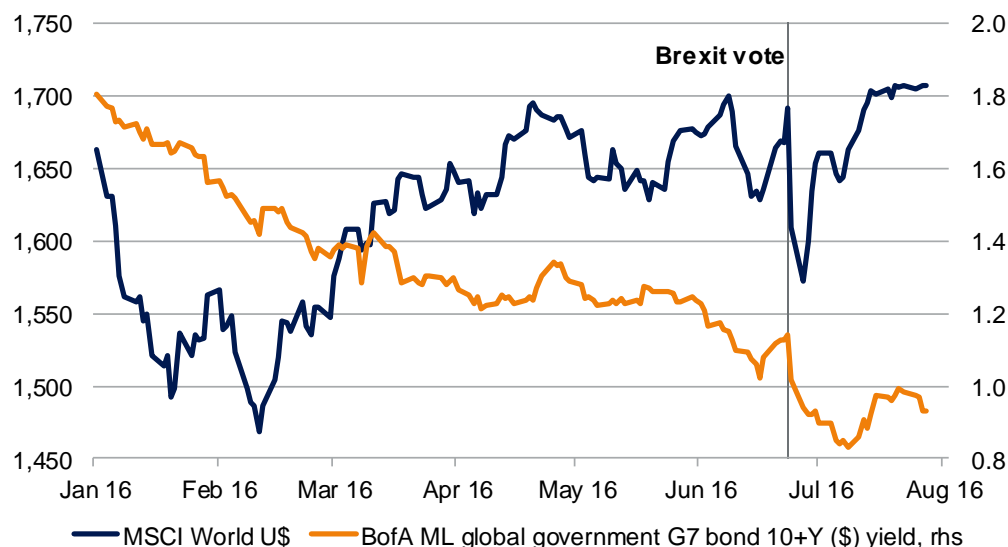
*“The outcome of the UK vote, which surprised global financial markets, implies the materialization of an important downside risk for the world economy”.* IMF World Economic Outlook Update, July 2016

*“Following the UK referendum on EU membership, our assessment is that euro area financial markets have weathered the spike in uncertainty and volatility with encouraging resilience”.* Mario Draghi, European Central Bank (ECB) President, 21 July 2016

Despite the warnings from the IMF over the global risks attached to Brexit, equity markets have rallied and the global MSCI World index has now risen above the levels seen before the vote. Even the UK equity market<sup>1</sup> has returned to pre-referendum levels. So after a short-lived dip, it would seem that the UK’s historic decision to leave the EU has barely moved the equity dial. As the European Central Bank (ECB) president noted at the central bank’s press conference, financial markets have been resilient.

Underpinning the rally in risk assets has been the response of central banks, with the Bank of England signalling a rate cut in August and, more generally, central bankers indicating they are ready to respond to any Brexit-related weakness. Rate markets are discounting an easier path for global monetary policy following the vote and government bond yields remain below pre-Brexit levels (see chart 1).

**Chart 1: Equity markets bounce back after Brexit vote**



Central banks, dismissed as impotent, now seen as saviours

Source: Thomson Datastream, Schroder Economics Group, 25 July 2016.

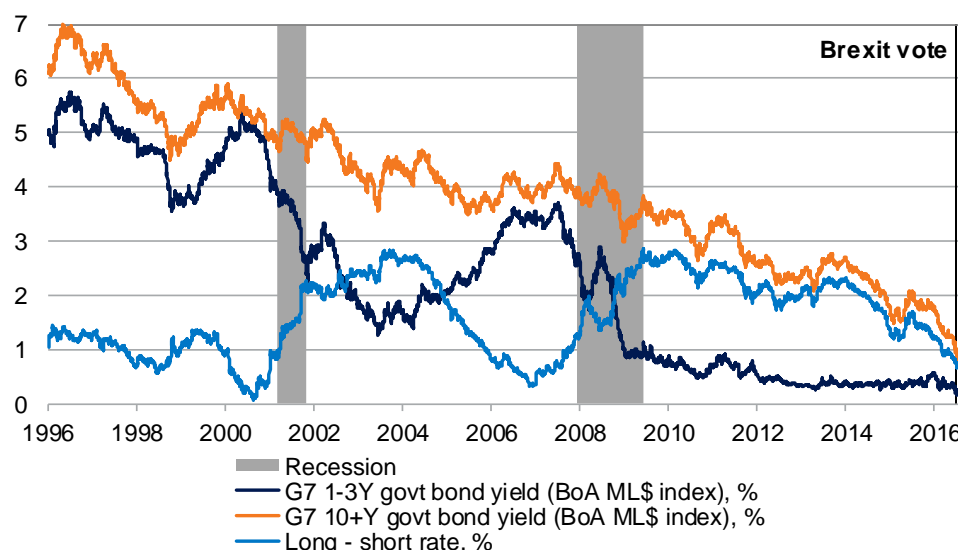
It would seem that central banks have come to the rescue once more. However, it is worth reminding ourselves that prior to the Brexit vote the concern in financial markets was that central banks had run out of ammunition. The monetary policy cupboard was empty with interest rates close to zero, negative rates creating problems for banks and quantitative easing (QE) having little or no impact on the real economy. The view was that central banks were finished. Now they are seen as saviours.

Sovereign bond markets seem more sceptical. The fall in bond yields has been accompanied by a flattening of the global yield curve as long rates have fallen faster than short. Often seen as a harbinger of weaker growth by implying a

<sup>1</sup>Both the FTSE-100 and the mid cap 250.

reduction in the long run profile of rates, a curve of this slope was a lead indicator of recession in both the early and late 2000s (chart 2). Global equity markets subsequently fell significantly in both episodes.

**Chart 2: Yield curve flattens further**



Source: Thomson Datastream, Schroder Economics Group, 25 July 2016.

**Brexit increases downside risks for the world economy**

Arguably, the difference between then and now is that yield curves have been flattened by QE and so are no longer a reliable indicator of future growth. There is some truth in this; however, the growth outlook does remain weak and Brexit has increased the downside risks.

Those downside risks initially stem from the increase in uncertainty created by Brexit, which will impact the rest of the EU as well as the UK: businesses and households will delay decisions until trade agreements are in place, a process which unfortunately will probably take years. There is then the broader risk of a lurch toward more populist economic policies with Brexit being just a symptom of widespread voter dissatisfaction with the economic status quo.

As highlighted in our [July Viewpoint](#), the Brexit vote increases the tail risks in the world economy with a rise in the probability of a “trade wars” or “EU break-up” scenario. The populist rhetoric of the Brexit campaigners is echoed in the message of presidential candidate Donald Trump, now confirmed as the official Republican contender. The trade wars scenario could be triggered by a Trump victory and the imposition of tariffs on China and possibly Europe. He is currently one point ahead of the Democrat candidate, Hillary Clinton according to the [Real Clear politics](#) poll average.

Meanwhile, Europe faces a series of political challenges starting with the Hungarian referendum on immigration on 3 October, the Italian constitutional referendum (late October) and national general elections in the Netherlands, France and Germany in 2017.

Although ostensibly a vote on the constitution, the Italian vote will determine whether the government stands or falls as Prime Minister Renzi has said he will resign if the reform is rejected. The outcome will be closely linked to his success in persuading the EU to bend the rules of the banking union and allow a state bailout of parts of the Italian banking sector. We believe a solution will be found, and our assumption of a softer stance toward the peripheral economies post-Brexit has already come to pass in the relaxation of fiscal rules for Spain and Portugal. For Italy, it is quite likely that we follow the typical EU path of standoff and crisis before a last minute agreement is reached.

Market driven by intensifying search for yield

### Are equities really growth assets? The march of the bond proxies

From this perspective, the equity markets are ignoring the risks from Brexit and placing too much faith in the power of central banks to boost activity. However, that does not make the recent rally irrational. Low rates may not help the economy, but they can certainly drive asset prices by intensifying the search for yield.

Sector analysis supports this with bond proxy sectors such as utilities and telecoms performing strongly post-Brexit, although the story is not entirely consistent as staples have lagged whilst technology has also performed well. The better way to track the impact on the equity market is through outperformance of indices that target dividend paying stocks, such as the S&P Dividend Aristocrats Index, which continues to track Treasury yields (chart 3).

**Chart 3: Dividend stocks tracking Treasury yields**



Source: Thomson Datastream, Schroder Economics Group, 25 July 2016.

Such analysis supports the idea of an equity market being driven by the search for income rather than growth in earnings. Perhaps investors should stop fretting about the lack of growth in the world economy and instead focus on the income generating qualities of equities in a zero rate environment. Equities are often termed “growth” assets, but they have now become more “income” like.

If correct that means we are in a “stop-go” equity market where injections of liquidity drive bond yields lower and equity prices higher. Once adjusted to the new level of interest rates, equities than run out of steam until bond yields drop further. This is very different from an earnings-driven market where investors are balancing stronger earnings-per-share (EPS) against the potential for tighter monetary policy.

### What might bring an end to the stop-go market?

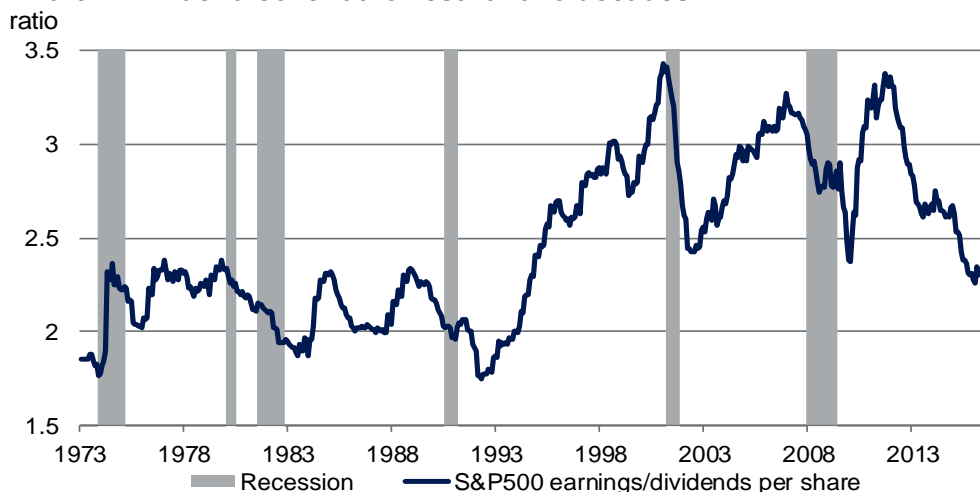
The bond-driven, stop-go equity market has persisted for some time and may well continue. However, its life will be determined by how much further bond yields can fall and whether the income generating abilities of equities are curtailed by a lack of growth.

On the first, with \$8.9 trillion of bonds already on negative yields, just under one-third of the JP Morgan Global Government Bond Index, it might seem that the end is already nigh. However, with the Bank of Japan (BoJ) and ECB still fully committed to QE, bond prices can defy gravity for longer. The challenge will come when they eventually decide to taper, but that is an issue for 2017 at the very earliest (and the subject of a future Viewpoint).

Dividend pay-outs are looking stretched relative to earnings

The second potential constraint brings us back to growth. Companies can keep paying out in a low growth environment by allocating more of their earnings to distributions. However, with dividend cover at its lowest level for more than two decades in the US (chart 4), we may be approaching the point at which this is unsustainable without an increase in earnings. (Note that dividend cover was lower before the mid-1990s, but this was before the shift toward share buybacks).

**Chart 4: Dividend cover at lowest for two decades**



Source: Thomson Datastream, Schroder Economics Group, 25 July 2016.

The other means of keeping dividends going in this environment is by borrowing and there is some evidence that companies have used the proceeds of bond issuance in this way. Again though, this raises questions over sustainability, not to mention tax efficiency.

The emphasis on distributions raises an issue we have discussed in the past about companies focusing on providing their shareholders with immediate gratification, rather than the promise of higher returns in the future through capital investment. Cash is the winner today, an outcome which of course matches the needs of those who are holding equities as bond proxies. Arguably this is also a factor behind the weakness of business capital spending (capex), an adverse side effect of QE.

**Careful what you wish for**

Consequently, we should be wary of the stop-go market, but perhaps the bigger threat comes from the current call for expansionary fiscal policy (possibly funded by helicopter drops). At the time of writing, Japan’s Prime Minister Abe has just announced a ¥28 trillion fiscal package (5.5% GDP), but we await further details before we know how much represents an actual real increase in spending. Meanwhile, the new UK government is shifting away from austerity and all this could be nothing compared to the fiscal expansion that a President Trump might deliver.

**Fiscal policy would boost growth...and market volatility**

Undoubtedly, fiscal expansion would boost growth as the multipliers are high in the current environment in our view. However, stronger activity and higher budget deficits would put pressure on bond yields and steepen the yield curve. Equity markets would be challenged as such a move would alter the drivers of the market. Investors would have to do a complete rethink: cyclicals would look more attractive, but higher yields would pull the rug from the market as investors sold their bond proxies. Some would be better placed than others. For example, the more cyclical emerging markets would probably outperform. The dust would eventually settle, but higher growth via fiscal expansion would be a recipe for considerable financial market volatility.

## Brexit: First impact

The Bank of England disappointed markets and most economists when the monetary policy committee decided not to cut interest rates in July, owing to the lack of data since the initial shock of the UK's referendum vote to leave the European Union.

Since then, GDP figures published suggest the economy performed well in the run up to the referendum. However, survey-based evidence covering the weeks immediately after Brexit do not make for pretty reading, suggesting a dramatic decline in activity, and a significant risk of recession.

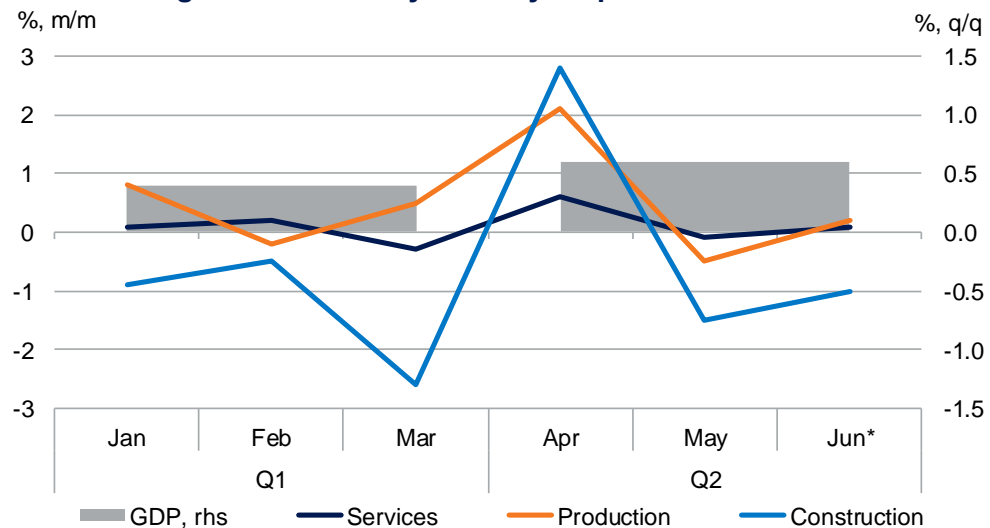
## Calm before the storm

The preliminary estimate of second quarter UK GDP growth shows a strong economy ahead of the EU referendum. The economy grew by 0.6% quarter-on-quarter, an acceleration compared to the 0.4% growth in the first quarter. The results were also better than expected as consensus estimates were looking for 0.5% growth. Year-on-year, growth was running at 2.2% – a healthy pace consistent with falling unemployment.

Growth was driven by the services sectors as usual, although the production sectors also made a noticeable contribution over the quarter (0.3 percentage points), thanks to the fastest quarterly growth in industrial production since 1999. Both the construction and agriculture sectors made small negative contributions, but the overall picture looks robust. However, once we delve further into the details of the GDP report, we find that the initial data that the Office for National Statistics (ONS) has collected shows that most of the growth in the three main sectors of the economy came in April. The ONS's estimates suggest the economy then probably contracted in May, before eking out a little growth in June (chart 5).

**Q2 GDP surprised on the upside, suggesting a robust economy ahead of the EU referendum...**

**Chart 5: UK growth tracked by monthly output**



\*June is estimated by the ONS. The ONS uses fixed weights from 2013 for GDP: Production (14.6%); Services (78.8%), Construction (5.9%); Agriculture (0.7%). Source: ONS, Schroders Economics Group. 27 July 2016.

**...although on closer inspection, the economy was losing momentum through Q2.**

The ONS warns that the latest data is only a preliminary estimate, as it only has 44% of the responses required compared to a final estimate. The estimate for June is even more uncertain as the ONS only has 35% of the required data, and so it is worth remembering that these figures could be revised up as well as down. If, however, we take the ONS's estimates at face value, they suggest the economy was already losing momentum as the UK approached the EU referendum.



### Warning bells ringing loud and clear

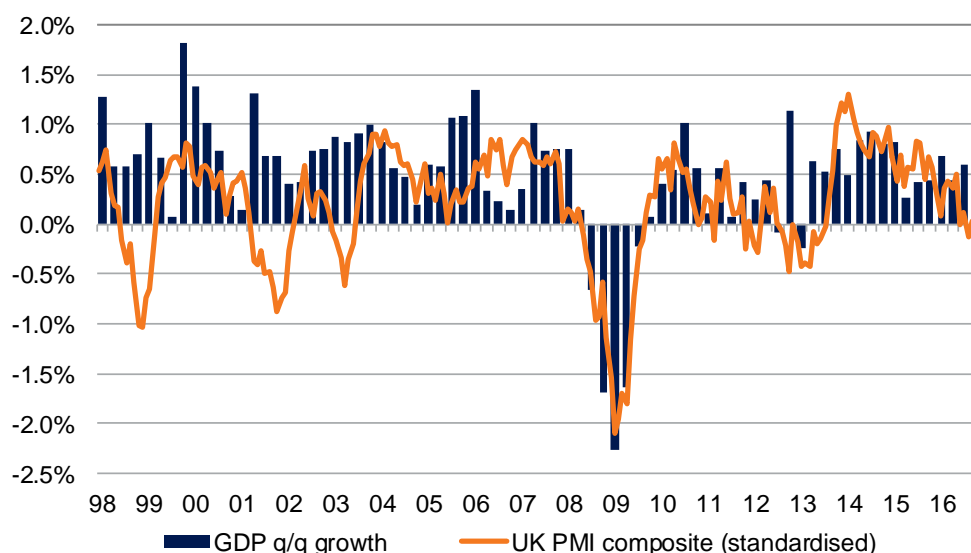
Official GDP figures for Q3 are not due until late October...

The difficulty in assessing the impact of Brexit is the lack of economic data in the next few months. For example, the first estimate for GDP growth for the third quarter will not be available until late October. There will be other useful data such as production output, and retail sales, but even these will not be available for a couple of months. As a result, private business surveys, which offer more timely but less accurate readings of activity, have already started to grab the headlines.

Data firm Markit released an extraordinary one-off set of “flash” purchasing managers’ indices (PMI) for the UK, showing a sharp decline in reported activity. The macro composite PMI fell from a balance of 52.4 to 47.7, well below the neutral mark of 50 and suggesting a contraction in economic activity. Compared to consensus estimates of 49.0, the result was worse than expected and represents the lowest reading since the global financial crisis (2009). If the macro composite was to remain at this level, it would suggest the economy will contract by 0.5% in the third quarter. However, it is too soon to draw such a conclusion from only a few weeks of data. Moreover, PMIs have a history of overreacting to global shocks. As chart 6 shows, the Asia crisis in 1998, the 9/11 attacks in 2001, and the hangover from the tech-bubble bursting in 2003 all prompted the PMIs to collapse, yet the UK economy remained resilient.

**Chart 6: PMI suggests UK economy is contracting**

...but early survey evidence suggests activity has slowed to levels not seen since 2009.

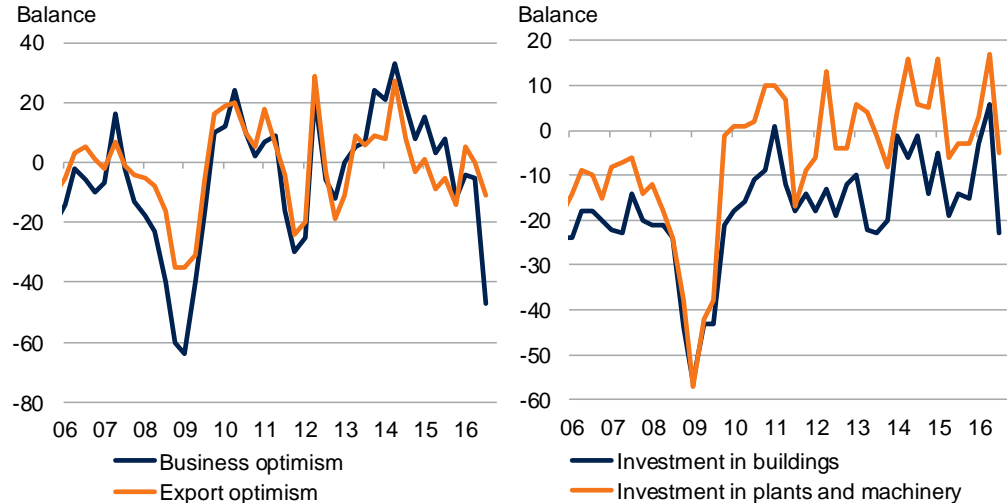


Source: Thomson Datastream, Markit, ONS, Schroders Economics Group. 27 July 2016.

However, in addition to the weak results from the flash PMI reports, the Confederation of British Industry’s (CBI) Industrial Trends Survey also showed a fall in business optimism to 2009 levels (chart 7). Interestingly, the survey showed optimism amongst exporters only slightly down, possibly as the fall in sterling should be helpful for boosting overseas demand, or profits, if the exported goods and services are priced in foreign currencies.

Business optimism has fallen sharply, which may lead to a drop in investment in coming months

**Chart 7 and 8: Exports holding up as companies look to trim investment**



Source: Thomson Datastream, CBI, Schrodgers Economics Group. 25 July 2016.

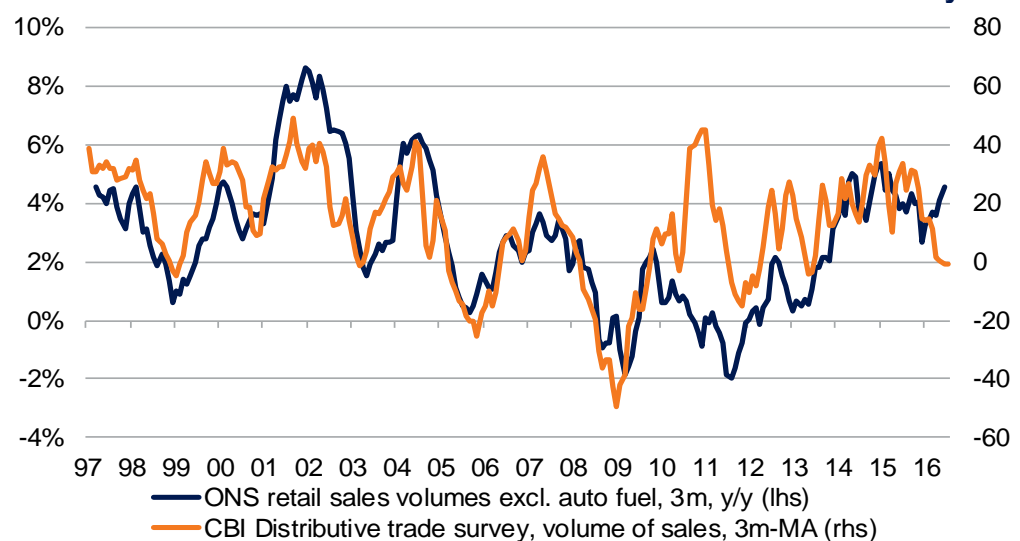
The CBI survey also includes questions on investment intentions for buildings, along with plants and machinery (chart 8). These tend to be good leading indicators for business investment. Both data series fell sharply in the latest report, although both were reasonably elevated just beforehand. Business investment is expected to be the key area that is adversely impacted by Brexit in our forecast.

In addition to evidence from manufacturers, the retail sector has also reported a sharp slowdown in the CBI's Distributive Trade survey. The survey of 132 firms, of which 66 were retailers, showed that sales volumes (which includes intermediary sales used for inventories) declined more rapidly than at any time since January 2012, with the CBI linking the decline to weaker consumer confidence immediately following the EU referendum.

Comparing the CBI retail survey data to official retail sales volumes, we find a reasonable relationship once some smoothing has been applied (chart 9). As there is a slight bias in the CBI data, the decline currently reported would not lead to an outright fall in retail sales, but a slowdown to around 2% per annum growth. Therefore, if the official retail sales data follows the CBI survey data (which is not always the case), the signal is weak, but not yet recessionary.

Meanwhile, the retail sector is also reporting a sharp fall in the volume of sales

**Chart 9: Official retail sales volumes vs. CBI Distributive Sales survey**



Source: Thomson Datastream, CBI, ONS, Schrodgers Economics Group. 27 July 2016.



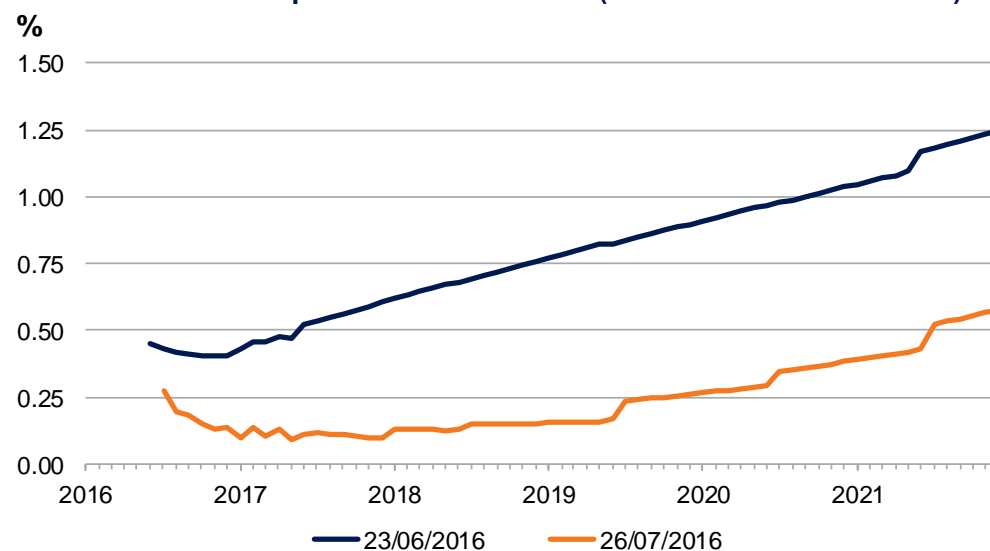
**The BoE is set to cut interest rates in August, and potentially add more QE in the future**

### Policy stimulus on the way

Despite the Bank of England disappointing in July by not changing policy, as we had predicted, we do expect the BoE to act at the 4 August meeting. The bare minimum has to be a 0.25% cut in interest rates, but a larger cut is possible. More QE is also an option, while restarting the Funding for Lending Scheme seems likely. We think the BoE will cut by 25 basis points, and keep more QE as an option for later. After all, government bond yields are close to record lows, while weakening sterling further would not only raise near-term inflation, but also squeeze the real disposable income of households.

Over the medium term, we think interest rates could be kept on hold until at least 2019. Money markets on the other hand are pricing in more than a 50% chance of a further cut, with interest rates only returning to the current level of 0.5% at the end of 2021 (chart 10). This is a dramatically different picture to what was priced in just before the referendum, where markets were starting to think about rate hikes.

**Chart 10: Markets expect interest rate cuts (GBP OIS\* forward curves)**



\*Overnight index swaps. Source: Bloomberg, Schroders Economics Group. 26 July 2016.

**Fiscal policy is likely to reverse course, moving from austerity to stimulus**

In addition to monetary policy, the new Chancellor of the Exchequer, Philip Hammond, has already indicated that he is prepared to reset fiscal policy, which we assume means abandoning the government's target of running a fiscal surplus by 2020. Under the previous Chancellor, George Osborne, fiscal policy was due to be tightened by around 1% of GDP over the next five years. Now our forecast includes a fiscal expansion over the next year worth 1% of GDP, which will probably be announced in the Autumn statement. Ideally, tax cuts would be more prominent as they are likely to have a more powerful impact, especially if they are targeted to incentivise investment (the likely area of weakness). However, we suspect some of the stimulus will come through additional government spending, which is less likely to have an impact in the near-term given the usual delays in implementing government spending/investment.

### Beyond the UK, Europe remains calm

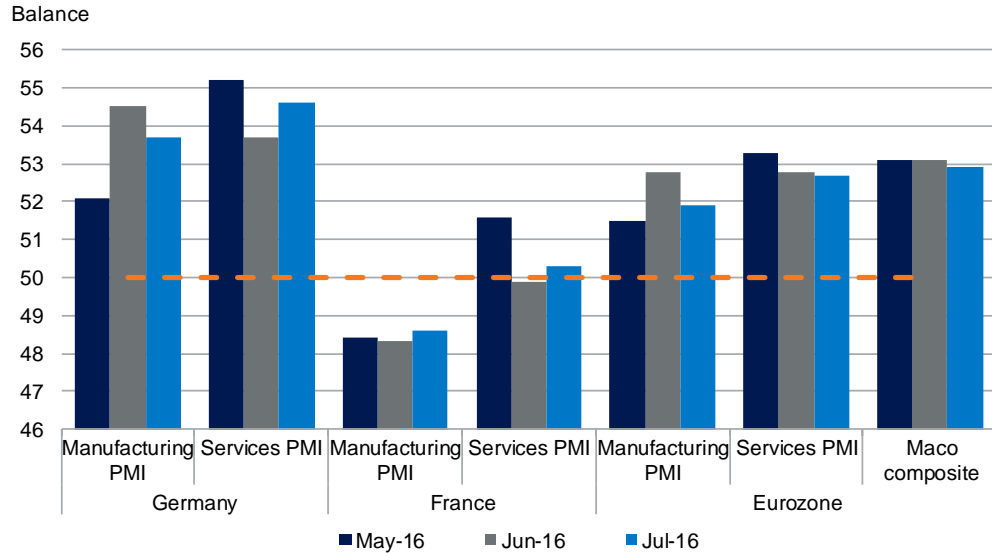
Political stability in Europe was a key concern just after the EU referendum result, as many investors projected the UK's animosity towards the EU on to other member states. While it is too soon to judge the political fallout, so far, the economic impact appears to be limited.

Along with the UK flash PMIs, Markit released the regular flash surveys for Europe, which showed some slowdown in activity, but not by much, with most

surveys remaining above the neutral 50 mark (chart 11). While the German manufacturing PMI dipped, the overall macro composite rose from 54.4 to 55.3 owing to stronger services activity. In France, the manufacturing survey improved, but remained below 50, which the services PMI and composite index both moved back above 50. As both the German and French macro composite indicators moved higher for July, the dip in the Eurozone aggregate composite (from 53.1 to 52.9), suggests weakness in other countries like Italy and Spain. This will be confirmed when the final PMIs are published in early August.

So far, there are few signs that Brexit has had much of an impact on the Eurozone

**Chart 11: No significant Brexit impact on European activity**



Source: Thomson Datastream, Markit, Schroders Economics Group. 27 July 2016.

**Conclusions**

It appears that the UK was on a reasonably robust footing ahead of the EU referendum, although the early indicators since the vote for Brexit suggest a marked slowdown to follow. We continue to place a 40% probability on the UK experiencing a technical recession, but do expect both monetary and fiscal stimulus to follow in the near future. So far, there are few signs that the Brexit referendum has impacted Europe, although it is too soon to make a conclusion on political contagion.

## Tinderbox Turkey

**The failed coup will have severe consequences**

Turkey was already ranked as one of the more vulnerable and risky emerging market economies before the failed coup on 15 July. With a state of emergency now announced, to last for a minimum of three months, we examine the likely consequences for one of the most stubbornly and persistently fragile emerging market economies.

### **Snap election likely in pursuit of power**

Coups, successful or not, typically end with a rewriting of the political landscape. Turkey should be no different, but opinions differ on what exactly the fallout will be from the abortive attempt on 15 July, with a power grab on the cards. Beyond the domestic scene, there will be substantial consequences for foreign policy and geopolitics as well.

There is a strong expectation that President Erdogan will seek to capitalise on the turmoil, exploiting it to move Turkey closer to his dream of an executive presidency, with himself at the helm. This is generally perceived as a negative outcome given Erdogan's preference for what might politely be called heterodox economic policies, and the likely weakening of institutions that would follow. Perhaps the most negative scenario is one in which Erdogan pursues this goal through divisive means, deliberately further polarising Turkish society.

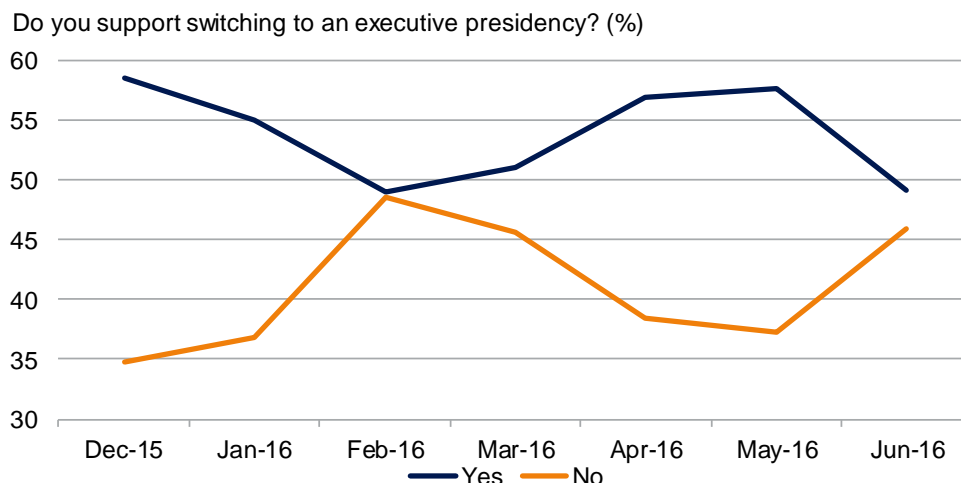
**Institutional strength will be eroded further**

This is a well-worn path for Erdogan, who has in recent years targeted Turkish Kurds, members of opposition parties, and followers of the cleric Fethullah Gulen ("Gülenists") in an attempt to build support for himself and his party, the AKP. This has seen purges of the police force and judiciary, the removal of legal immunity for opposition MPs and subsequent launching of criminal investigations, and legislation for judicial reforms allowing appointments to be determined by the AKP controlled Justice Ministry. A continuation of this would serve to heighten tensions and weaken social stability at the worst possible time, and increase the likelihood of further disruptions.

An alternative scenario is one in which Erdogan plays the role of unifier, working to heal a divided nation and so entrench power without polarising Turkey further. He need not eschew the politics of division altogether, but could focus animosity on "Gülenists". Fethullah Gulen's "Hizmet" movement was once a key ally of Erdogan, assisting the AKP's rise to power from the late 1990s. The movement gradually gained power and influence as a result of their alliance with the AKP, including positions in both the military and judiciary. However, after the 2013 protests and corruption investigations which laid charges at the doors of prominent AKP members, the alliance dissolved. Erdogan accused Gulen of running a "parallel state" and launched a purge of his supporters. Gulen now lives in exile in the US. Blaming Gulen for the coup (correctly or not), and by association the US, could unify disparate domestic groups including opposition parties and even some Kurdish elements.

The end game to all of this is the move to an executive presidency, possible via a referendum or parliamentary majority. While June polling showed an approval rating of just 38% for President Erdogan, when the Turkish electorate are asked whether they favour an executive presidency, support is much closer to the 50% mark (chart 12). Still, a victory via referendum is not assured even if we assume a popularity boost from the coup attempt, particularly given the margin for error in polling. Erdogan would also need 330 seats, compared to the AKP's current 317, to call a referendum. The alternative, of a parliamentary change to the constitution, requires 367 seats. Against the backdrop of these numbers, the removal of immunity for opposition parliament members seems to have an obvious goal.

**Chart 12: Public backing for executive presidency not guaranteed**



Source: HSBC, local media polls, Schroders Economics Group. 26 July 2016. Chart depicts monthly average of polls.

**Polarisation will strain the social fabric further as security deteriorates**

Meanwhile, the security situation is likely to worsen with the military undergoing purges, and trust between the military and civilian security forces damaged. Not only are attacks by so-called “Islamic State” more likely in this environment, but polarisation of society seems set to ramp up tensions in the country’s south east; support for Kurdish paramilitary groups would presumably swell if Erdogan stokes up anti-Kurdish sentiment and arrests the Kurdish parliamentary representatives.

Finally, the ripples of the failed coup do not stop at Turkey’s borders. While we will not speculate here on the range of conspiracy theories, there is no denying the feeling within Turkey that the coup had Western influence. This suspicion was not eased by the slow condemnation by Western allies of the coup, and the comments from US Secretary of State John Kerry that a crackdown might imperil Turkey’s NATO membership. This will only hasten Turkey’s pivot to the east, particularly China and Russia. This has implications for the war in Syria, for the flow of refugees into Europe, and for regional stability more broadly - none of which are positive for the West.

**Coup fallout negative for economy**

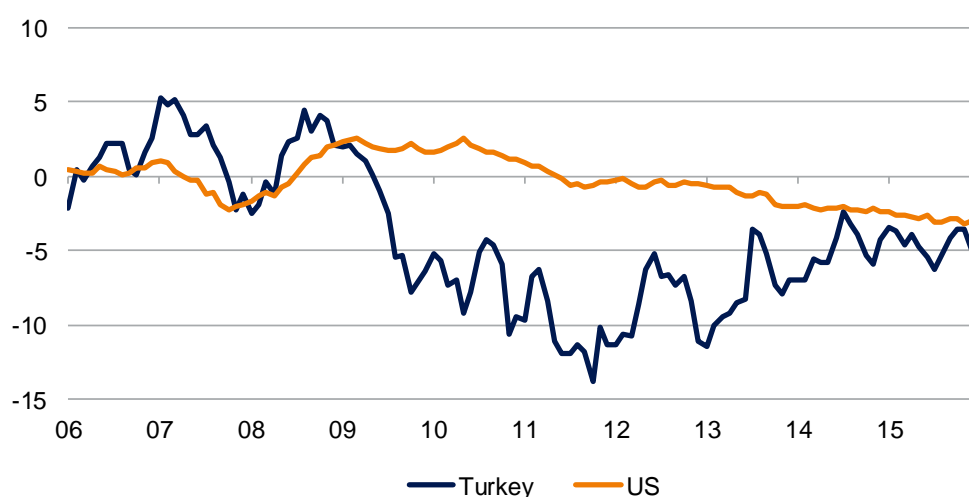
**Heterodox policies more likely if Erdogan gains executive powers**

Many of the economic consequences are as yet unknown, and dependent on how the political situation evolves. A stronger mandate, and executive powers, for President Erdogan would most likely see a continuation and extension of his heterodox policy set. The replacement of relatively orthodox economic policymakers in the form of the head of the central bank, and the Prime Minister, in April and May respectively, with candidates more in tune with President Erdogan’s thinking, serves to highlight this risk.

One casualty of Erdogan’s unique school of economic thought has been monetary policy, even before the new appointment at the central bank. For some time, President Erdogan has railed against what he calls the “interest rate lobby”; essentially any economist who suggests that Turkey should hike rates to fight inflation. In the eyes of Erdogan, these are self-serving comments designed to generate profits for foreign banks. This has piled pressure on the central bank to keep rates low and cut them if possible, despite high inflation. On chart 13, we plot the gap between the central bank rate and the policy rate implied by a simple Taylor rule (which assumes a central bank is targeting inflation and unemployment in equal measure). For context, we show this for both Turkey and the US, given the criticism the Federal Reserve has faced for keeping rates too low for too long in some quarters.

**Chart 13: Sticking it to the interest rate lobby**

Spread between policy rate and Taylor rule implied rate (ppts)



Source: Bloomberg, Schroders Economics Group. 27 July 2016.

**Higher inflation and dollarisation likely**

The chart shows that the central bank caved to government pressure in the years following the crisis, setting rates between five and fifteen percent lower than they should have been, but had begun to fight back from 2014. With the former governor removed, we suspect a return to the policy settings of 2011–13 is due, implying cuts at current inflation levels of around 300 bps or more.

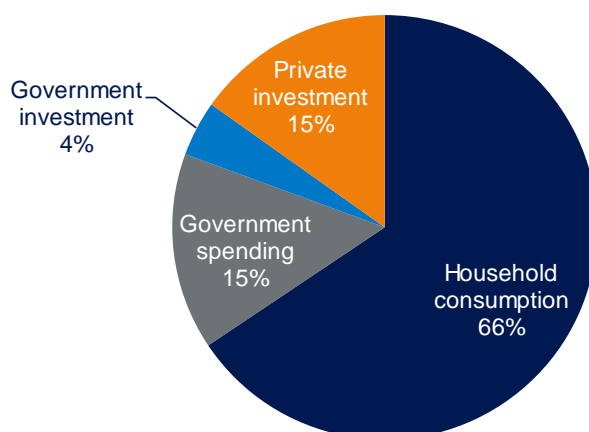
A more inflationary environment then lies ahead for Turkey, and this is even before we consider the impact of the currency. The Turkish lira (TRY) weakened markedly on the back of the coup and will deliver a strong inflationary impulse if not brought under control. Unfortunately, with the outlook for monetary policy we described above, this seems an unlikely prospect. Making matters worse, political shocks in Turkey typically see a wave of dollarisation in the domestic economy. In 2013, for example, following the Gezi Park protests, the second half of the year saw residents' dollar purchases of \$20 billion, after sales of \$5 billion in the first half. More recently, prior to the coup attempt, residents had been buying TRY on weakness. Time will tell which trend dominates, but this is undoubtedly a risk to TRY stability and the inflation profile.

**Uncertainty will weigh on growth and investment**

On growth, as the UK is discovering, political uncertainty generates headwinds. For one, a prolonged period of uncertainty is likely to hit confidence and private spending, particularly investment decisions. Furthermore, the gradual erosion of institutional strength, in the judiciary as well as the central bank, creates a negative environment for business investment, both domestic and foreign. A breakdown of Turkish GDP (chart 14) reveals that the economy should be able to survive a slowdown in investment growth, with private investment worth around 15% of GDP, though large swings are common and could deliver a sizeable hit to GDP. Consumption is a much larger driver, and government spending, including investment, is close to 20% of GDP. With a fiscal deficit of around 1.1% GDP on a twelve month cumulative basis, there is space for the government to offset the hit to the economy from slower private investment.

There are, however, other likely hits to growth on the horizon. Tourism, which is worth 3% of GDP and directly employs 8% of the population, is already sharply lower (down 35% y/y in May) and could fall further as the social and security situation deteriorates.

**Chart 14: Breakdown of Turkish GDP (2015)**



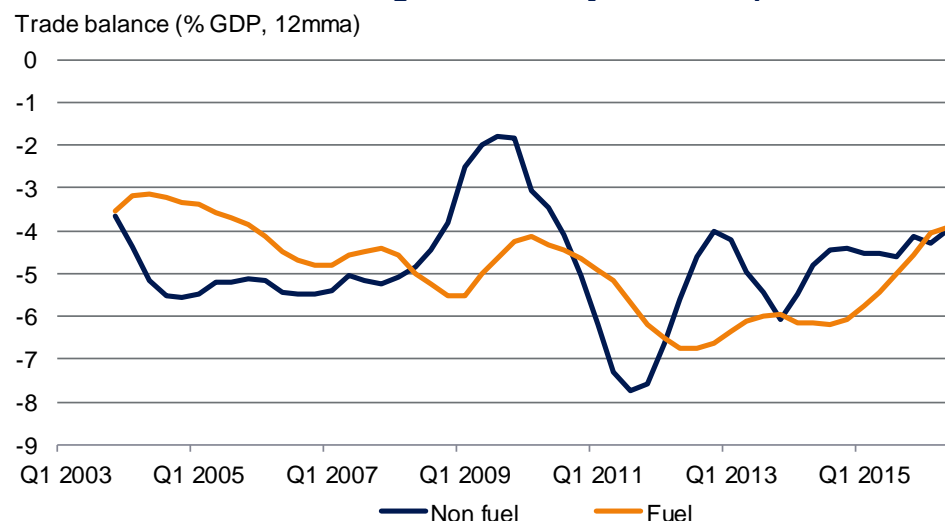
Source: Thomson Datastream, Schroders Economics Group. 27 July 2016.

**External liabilities could resurface as a focus for markets**

**Rising political risk will reduce willingness to lend...**

Another worry for Turkey, which we flag every time the country comes up for discussion, is the external liabilities position. Turkey has one of the largest external financing requirements as a share of GDP in EM, having actually risen since the 2013 Taper Tantrum to over 19% of GDP. The current account deficit, though reduced, is still high at 4.1% of GDP, with much of the improvement in the trade balance since 2014 driven by lower oil prices (chart 15) rather than fundamental shifts in the Turkish economy.

**Chart 15: Oil has driven the gains in Turkey's external position**



Source: Thomson Datastream, Schroders Economics Group. 27 July 2016.

**...as would a sovereign downgrade to sub-investment grade**

These imbalances in the external account are likely to receive more attention with the political risk premium rising. Although the composition of capital flows has shifted to longer-term flows, such as bank financing, this can still be at risk if political uncertainty is prolonged. Net portfolio liabilities for banks are around \$15 billion, with a further \$85 billion in loan liabilities, while the corporate sector has a net short position of \$192 billion, or 26% of GDP. If foreign investors start to demand higher rates to compensate for higher risk, this will serve as a headwind to investment spending.



Adding to the political risk is the possibility of a downgrade of the country's debt rating, currently clinging on to investment grade, though already rated junk by Standard and Poor's. A review by Moody's is due on 05 August, with the possibility of a downgrade to junk which would force the hand of mandate-driven investors. Moving from investment to sub-investment grade would drive up the cost of borrowing not only for the sovereign but also for Turkish banks and corporates. Consider that the private eurobond stock has increased to \$37 billion (around 5% of GDP) since the upgrade to investment grade in 2012 – if this begins maturing as sub-investment grade in 2017, the additional debt service costs would be substantial.

Overall it is hard to see the coup as anything other than negative for the Turkish economy. The extent of the pain will depend on the political and policy response. Should Erdogan achieve his goal of an executive presidency, erosion of institutional quality will accelerate and investment would likely weaken, reducing both short term and trend growth. A pro-growth, inflationary bias is likely to take hold in both monetary and fiscal policy, which could provide a short-term boost at the cost of long-term pain, exacerbated by lira weakness as policy credibility falls and dollarisation rises. Perhaps the best that can be hoped for is a negative reaction to any attempt to exploit the coup for political gain, manifesting as electoral disappointment for the AKP (i.e. falling short of the seats needed to amend the constitution), though we think this would still see a steady tightening of Erdogan's grip. From a global perspective, while it is a positive that the coup failed inasmuch as a Turkey in the grip of civil war would be a true disaster, managing both the conflict in Syria and the refugee problem for Europe will be much harder with Turkey distracted, if not hostile.

## Schroders Baseline Forecast

## Real GDP

y/y%	Wt (%)	2015	2016	Prev.	Consensus	2017	Prev.	Consensus
<b>World</b>	100	2.5	2.5	(2.5)	2.4	2.6	↓ (2.7)	2.7
<b>Advanced*</b>	62.9	1.9	1.7	(1.7)	1.6	1.5	↓ (1.7)	1.7
<b>US</b>	24.9	2.4	2.0	↑ (1.8)	1.9	1.7	↓ (1.8)	2.2
<b>Eurozone</b>	19.2	1.6	1.6	↓ (1.7)	1.5	1.3	↓ (1.6)	1.3
<b>Germany</b>	5.5	1.4	1.8	↓ (2.0)	1.6	1.7	↓ (2.0)	1.3
<b>UK</b>	4.2	2.3	1.6	↓ (1.9)	1.6	0.8	↓ (1.6)	0.7
<b>Japan</b>	6.6	0.6	0.6	↑ (0.5)	0.5	0.9	↓ (1.1)	0.8
<b>Total Emerging**</b>	37.1	3.6	3.8	(3.8)	3.8	4.4	↓ (4.5)	4.4
<b>BRICs</b>	23.8	4.2	4.4	(4.4)	4.4	5.1	↓ (5.2)	5.1
<b>China</b>	14.8	6.9	6.4	(6.4)	6.5	6.2	(6.2)	6.3

## Inflation CPI

y/y%	Wt (%)	2015	2016	Prev.	Consensus	2017	Prev.	Consensus
<b>World</b>	100	1.8	2.2	(2.2)	2.0	2.5	↑ (2.4)	2.4
<b>Advanced*</b>	62.9	0.2	1.0	(1.0)	0.7	1.8	↑ (1.7)	1.7
<b>US</b>	24.9	0.1	1.7	(1.7)	1.3	2.1	↓ (2.2)	2.3
<b>Eurozone</b>	19.2	0.0	0.6	↑ (0.5)	0.3	1.4	↑ (1.2)	1.3
<b>Germany</b>	5.5	0.1	0.5	↑ (0.4)	0.5	1.7	↑ (1.4)	1.5
<b>UK</b>	4.2	0.0	1.2	↑ (0.8)	0.7	2.5	↑ (1.8)	2.4
<b>Japan</b>	6.6	0.8	-0.1	↓ (0.0)	-0.1	0.8	↓ (1.0)	0.6
<b>Total Emerging**</b>	37.1	4.4	4.3	↑ (4.2)	4.2	3.7	(3.7)	3.6
<b>BRICs</b>	23.8	4.5	3.9	↑ (3.8)	3.6	3.4	↑ (3.3)	3.2
<b>China</b>	14.8	1.4	2.2	↑ (2.1)	2.0	2.0	↑ (1.9)	2.0

## Interest rates

% (Month of Dec)	Current	2015	2016	Prev.	Market	2017	Prev.	Market
<b>US</b>	0.50	0.50	0.75	↓ (1.00)	0.88	1.25	↓ (1.50)	1.05
<b>UK</b>	0.50	0.50	0.25	↓ (0.75)	0.30	0.25	↓ (1.00)	0.30
<b>Eurozone (Refi)</b>	0.00	0.05	0.00	(0.00)	-0.33	0.00	(0.00)	0.30
<b>Eurozone (Depo)</b>	-0.40	-0.30	-0.50	-		-0.50		
<b>Japan</b>	-0.10	0.10	-0.10	(-0.10)	0.01	-0.10	(-0.10)	0.01
<b>China</b>	4.35	4.35	3.50	(3.50)	-	3.00	(3.00)	-

## Other monetary policy

(Over year or by Dec)	Current	2015	2016	Prev.	2017	Prev.
<b>US QE (\$Bn)</b>	4483	4487	4496	(4496)	4514	(4514)
<b>EZ QE (€Bn)</b>	185	652	1548	(1548)	1788	(1788)
<b>UK QE (£Bn)</b>	375	375	375	(375)	375	(375)
<b>JP QE (¥Tn)</b>	406	383	436	↑ (435)	476	↑ (475)
<b>China RRR (%)</b>	17.00	17.50	15.00	15.00	13.00	13.00

## Key variables

FX (Month of Dec)	Current	2015	2016	Prev.	Y/Y(%)	2017	Prev.	Y/Y(%)
<b>USD/GBP</b>	1.31	1.47	1.25	↓ (1.50)	-15.2	1.25	↓ (1.48)	0.0
<b>USD/EUR</b>	1.10	1.09	1.06	↓ (1.10)	-2.4	1.06	↓ (1.08)	0.0
<b>JPY/USD</b>	104.6	120.3	100	↓ (107)	-16.9	110	↓ (120)	10.0
<b>GBP/EUR</b>	0.84	0.74	0.85	↑ (0.73)	15.1	0.85	↑ (0.73)	0.0
<b>RMB/USD</b>	6.68	6.49	6.85	↑ (6.70)	5.5	7.15	↑ (7.00)	4.4
<b>Commodities (over year)</b>								
<b>Brent Crude</b>	44.7	52.7	46.1	(46.1)	-12.4	51.8	↑ (51.5)	12.3

Source: Schroders, Thomson Datastream, Consensus Economics, July 2016

Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.

Market data as at 26/07/2016

Previous forecast refers to May 2016

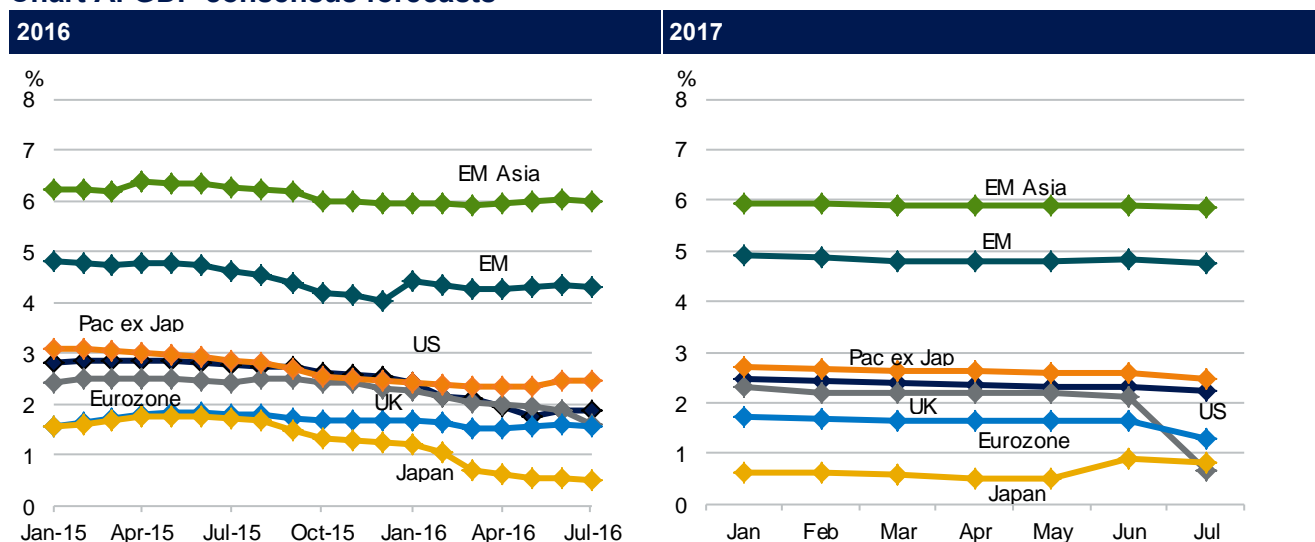
\* **Advanced markets:** Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, United Kingdom, United States.

\*\* **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.

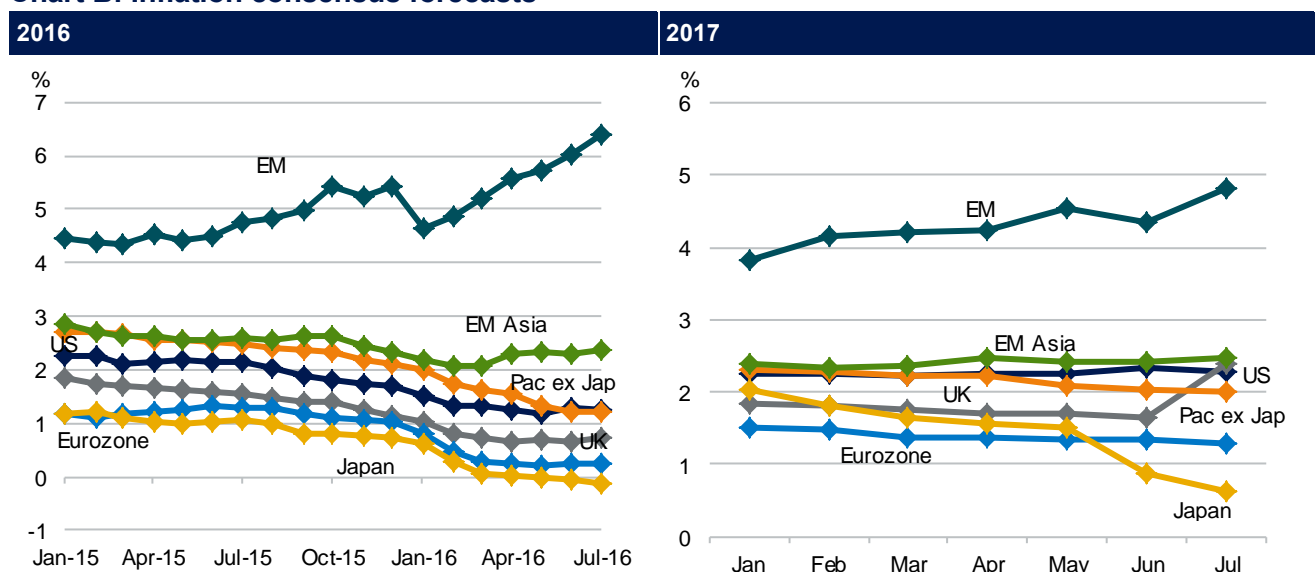
### Updated forecast charts – Consensus Economics

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**



**Chart B: Inflation consensus forecasts**



Source: Consensus Economics (July 2016), 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.

The forecasts included should not be relied upon, are not guaranteed and are provided only as at the date of issue. Our forecasts are based on our own assumptions which may change. We accept no responsibility for any errors of fact or opinion and assume no obligation to provide you with any changes to our assumptions or forecasts. Forecasts and assumptions may be affected by external economic or other factors. The views and opinions contained herein are those of Schroder Investments Management's Economics team, and may not necessarily represent views expressed or reflected in other Schroders communications, strategies or funds. This document does not constitute an offer to sell or any solicitation of any offer to buy securities or any other instrument described in this document. The information and opinions contained in this document have been obtained from sources we consider to be reliable. No responsibility can be accepted for errors of fact or opinion. This does not exclude or restrict any duty or liability that Schroders has to its customers under the Financial Services and Markets Act 2000 (as amended from time to time) or any other regulatory system. Reliance should not be placed on the views and information in the document when taking individual investment and/or strategic decisions. For your security, communications may be taped or monitored.