Market Letter

UK markets in a middle ground

August 12, 2019

We have forecasted UK GDP-growth based on financial variables in two different ways. The first shows that if Brexit works smoothly without eruptions, the UK economy will recover during next year, after a spell of low growth already visible in the newly released figures. The other shows that financial markets do not fully discount a recession. If this would be the case, there are room for a further decline of the pound, stock market underperformance and lower bond yields from here. Given the huge uncertainties of both the outcome of Brexit and its effects, it's understandable that the financial markets now are in a middle ground.

What do financial markets say about UK growth?

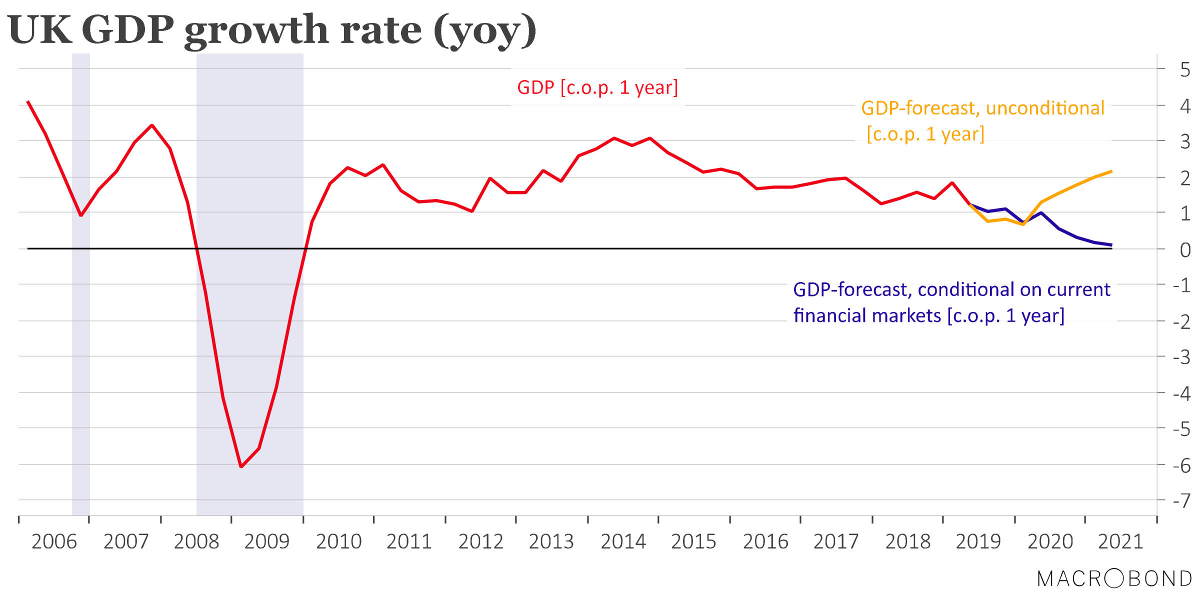
Brexit is only one of several uncertainties confronting financial markets currently. Prices on equities, bonds and currencies must consider not only the kind of Brexit that will result, but also the effects on corporate profits, growth and inflation from an uncertain outcome. The idea of forecasting the effects of something that is so uncertain and has no precedent is rather meaningless. However, that has not deterred economists of different shades to make predictions of the economic effects of Brexit (see for example https://en.wikipedia.org/wiki/Economic_effects_of_Brexit).

We skip these highly uncertain exercises and instead take a closer look at what financial markets currently have to say about the future growth of the UK economy. The results are in no way exact predictions of the future, but at least it is based on historical relationships between bonds, equites, the pound and UK GDP. To our help we have Indicio, which is a software that tests the accuracy of our chosen variables and contains a library of 30+ different econometric time-series models that are evaluated given the selected variables. The aim is to find models with a strong ability to forecast UK GDP ("out-of-sample accuracy").

We have experimented with several different financial variables and the ones that work best at predicting GDP are EUR/GBP, the 10-2-year yield curve, the 10-year UK bond yield spread vs US bond yields and the relative performance of UK equities (FTSE) vs S&P 500. Furthermore, we have weighed together the different models' forecasts based on their accuracy in the "out-of-sample" tests. This should result in a nuanced picture of the forecasting models' outcomes of what financial markets currently implicate for UK growth in the years ahead.

UK growth rate to slow down further in 2020.

We have made two forecasts. The first one is unconditional in the sense that Indicio generates internally consistent scenarios for all input variables, based on their historical relationships. In this case, without any structural breaks or exogenous shocks, UK growth will continue to decline, to below 1% in the beginning of next year. (See the chart below.) The annual growth rate has only been that low during two previous occasions during the last 20 years. Thereafter, in the course of 2020 the economy will recover and reach a growth rate of around 2% in the second quarter of 2021. The forecast is roughly in line with Bank of England's recent forecast for the British economy, of a growth rate of 1.4% in Q3 2020, which was published earlier this month. (See https://www.bankofengland.co.uk/inflation-report/2019/august-2019.)



The second forecast is made under the condition that the financial variables remain at current levels. This is one way to uncover the future growth rate implicit in the current financial market valuations. In this scenario GDP-growth quickly declines, to just marginally above 0% in the second quarter of 2021. The underperformance of the UK stock market, the fast decline of the pound, the flatter yield curve and the fact that UK bond yields have not followed US yields downwards during 2019, all points to slower future growth. (See the chart below.)

UK financial markets do not discount a recession, yet.

One of the conclusions that can be drawn from this exercise is that if Brexit works smoothly without eruptions, the UK economy will recover during next year, after a spell of low growth already visible in the newly released Q2 figures. On the other hand, if the UK economy is expected to fall into recession, as a result of Brexit or any other factor, financial markets have not discounted that to the full extent. In that event the pound, the stock market and bond yields will decline further from here. Alternatively, if a hard Brexit inevitably will result in a recession, the interpretation is that financial markets are not currently fully discounting a hard Brexit. Given the huge uncertainties of both the outcome of Brexit and its effects, it's understandable that the financial markets are in a middle ground.

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