Quarterly Macro Report

1st Quarter 2017

The economic implications of Donald Trump's surprising election victory remain unclear. That has not stopped financial markets from betting on favourable outcomes, driving equity markets and the US dollar higher. We would note that not only optimism has increased lately but also the potential for disappointment.

On January 20th, Donald Trump will be sworn in on the steps of the Capitol Building in Washington as the 45th president of the United States. That much seems certain. Not at all certain, however, are the policies president-elect Trump will pursue once he takes office. Ignoring the very considerable ambiguities about his fiscal, trade and regulatory policies, financial markets seem to have settled on an upbeat response to the election. Equity prices have surged, interest rates have risen and the US dollar has strengthened further, especially against most emerging markets currencies.

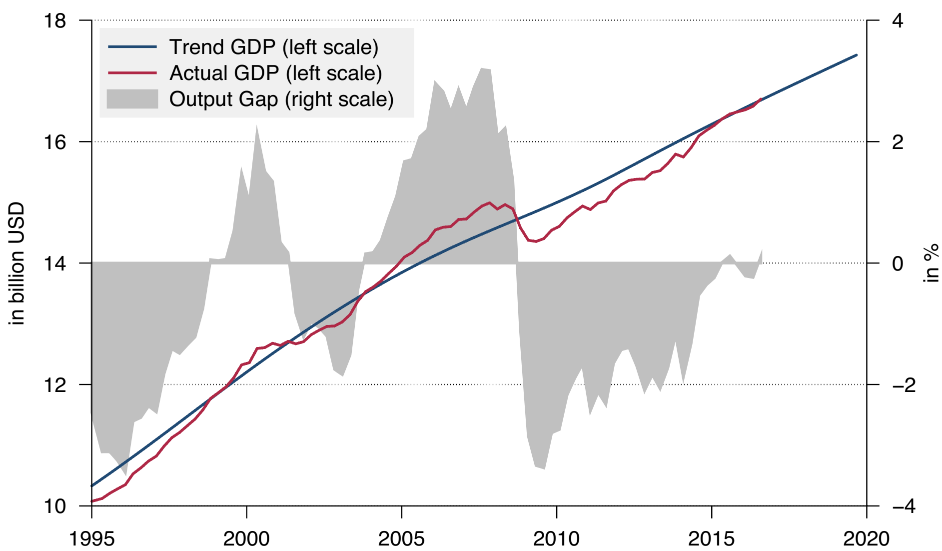
Sector-specific jump in US equity prices

On the first trading day after the election, after initially sagging, US stock markets revived and closed substantially higher. Optimism has persisted in the weeks that followed, with all major US stock indices posting record highs. The biggest winners so far are in the sectors that appear most likely to profit from candidate Trump's economic pronouncements. His vows to invest in infrastructure and increase defence spending have boosted share prices in the industrial and energy sectors. Financials have also surged, as investors recall Mr Trump's pledge to dismantle the regulatory constraints imposed after the 2008 financial crisis.

Improving economic sentiment

Along with the positive reaction on financial markets, post-election economic sentiment indicators have also tended higher. The improvement in consumer sentiment was most pronounced. Add the rising business sentiment indicators and the outlook for the overall US

Fig. 1: US economy operating at full capacity already



The output gap measures the difference between an economy's actual output and its trend. The latter is determined by rather long-term factors on the supply side of the economy such as demographic trends or the impact of productivity gains. The output gap naturally increases in recessions, as it did in 2008-09. Seven years later, the output gap has closed. Further acceleration of growth rates is not impossible but likely to be accompanied by inflationary pressure.

Source: BEA, Penn World Table, Wellershoff & Partners economy can look quite promising. But a closer examination of the storyline about a reviving US economy reveals some flaws. First of all, even as business sentiment seems to have regained positive momentum after a phase of weakness in early 2016, actual investments by businesses have yet to show any significant improvement. Corporate spending on equipment, which we find is a reliable leading indicator for the overall economy's growth outlook, has in fact declined for four consecutive quarters.

US economy already at full potential

Another damper on our enthusiasm stems from our assessment that even if improving business sentiment manages to revive corporate spending, we think a significant surge in US GDP growth rates – implicitly anticipated by bullish stock market investors – seems unlikely. Despite weak business spending, the overall US economy has been running at its long-term potential for quite some time. We see simply not much untapped potential for the US economy to grow.

The output gap as illustrated in figure 1 measures the difference between an economy's actual and potential performance. The latter is determined by rather long-term factors such as demographic trends or the impact of productivity gains. The output gap naturally increases in recessions, as it did in 2008-09. Seven years later, the output gap has closed.

This does not mean that growth rates above trend, currently at annually 1.5 percent, are impossible. As it did so convincingly before the US housing bubble burst, the US economy could again operate above its trend GDP for some time. Still, our calculations show that when the output gap closes, it becomes increasingly difficult for an economy to sustain an economic upswing with growth above the long-term trend rates. Furthermore, at this stage in the business cycle, a pick-up in growth rates is usually accompanied by higher inflation rates, leading in turn to higher interest rates.

Rising US inflation to continue

Our optimism is also constrained by our assessment that, regardless of the election's outcome, inflation is likely to continue to rise in the US over the coming months. We look for the inflation effects of the volatile oil price to turn positive, after two slumps in the past two years. Thus, we expect US inflation to continue to rise as we move into 2017. In the first quarter, we think an overall US inflation rate above 2.5 percent is plausible. This, in turn, is likely to trigger an increase

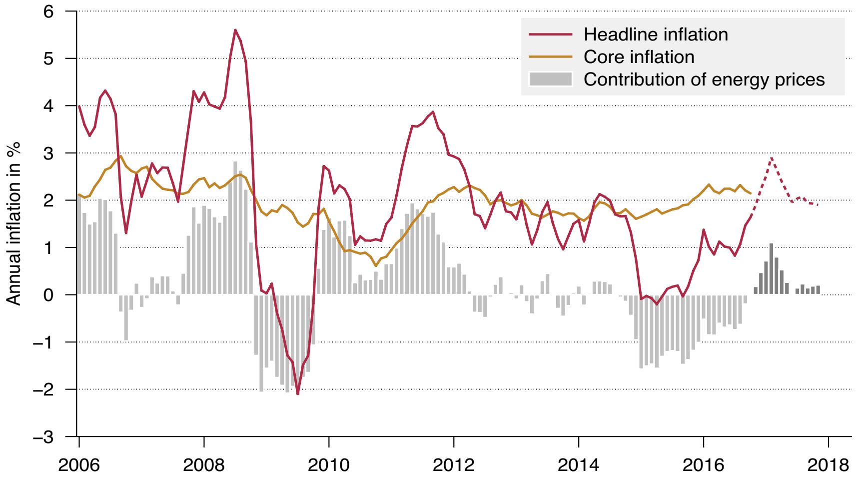
Table 1: Macro economic estimates

	Real GDP growth in %						Inflation in %					
	2014	2015	2016E	2017E	2016Δ	2017Δ	2014	2015	2016E	2017E	2016Δ	2017Δ
USA	2.4	2.6	1.5	2.0	-0.0	-0.2	1.6	0.1	1.4	2.4	0.2	0.1
Euro area	1.2	1.9	1.6	1.6	0.0	0.3	0.4	0.0	0.2	1.2	-0.0	-0.1
Germany	1.6	1.5	1.8	1.8	-0.0	0.5	0.9	0.2	0.5	1.5	0.1	-0.0
France	0.7	1.2	1.3	1.5	-0.0	0.3	0.5	0.1	0.2	1.2	-0.0	0.0
Italy	0.2	0.6	1.0	1.2	0.2	0.5	0.3	0.0	0.0	1.0	0.1	0.2
Spain	1.4	3.2	3.4	2.5	0.3	0.4	-0.2	-0.5	0.0	1.0	0.4	-0.3
United Kingdom	3.1	2.2	2.0	1.0	0.1	0.1	1.5	0.0	0.8	2.5	-1.0	-0.5
Switzerland	2.0	0.8	1.5	1.5	-0.0	0.1	-0.0	-1.1	-0.4	0.5	-0.0	0.2
Japan	-0.1	0.6	0.8	0.5	0.2	-0.4	2.7	0.8	-0.2	0.0	0.0	-0.4
Brazil	0.1	-3.8	-3.5	2.0	-0.3	0.8	6.3	9.0	9.0	7.5	1.9	2.3
China	7.3	6.8	6.0	6.0	-0.6	-0.3	-0.6	-0.5	1.9	2.8	-0.0	0.9
India	7.0	7.2	7.5	7.5	-0.1	-0.2	6.7	4.9	5.4	5.0	0.3	-0.1
Russia	0.7	-4.5	-0.7	1.0	-0.1	-0.2	7.8	15.5	7.1	5.0	0.8	-0.3
World (PPP)	2.7	2.6	2.4	2.6	-	-	3.2	2.8	2.1	2.7	-	-

E Estimates Wellershoff & Partners Δ Deviation from Consensus (Consensus Economic Forecasts)

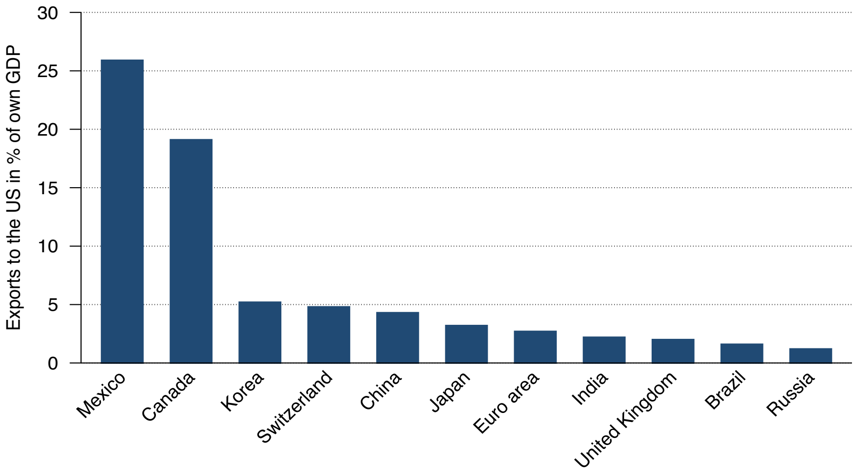
Source: Thomson Reuters Datastream, Wellershoff & Partners

Fig. 2: Rising US inflation rates set to continue



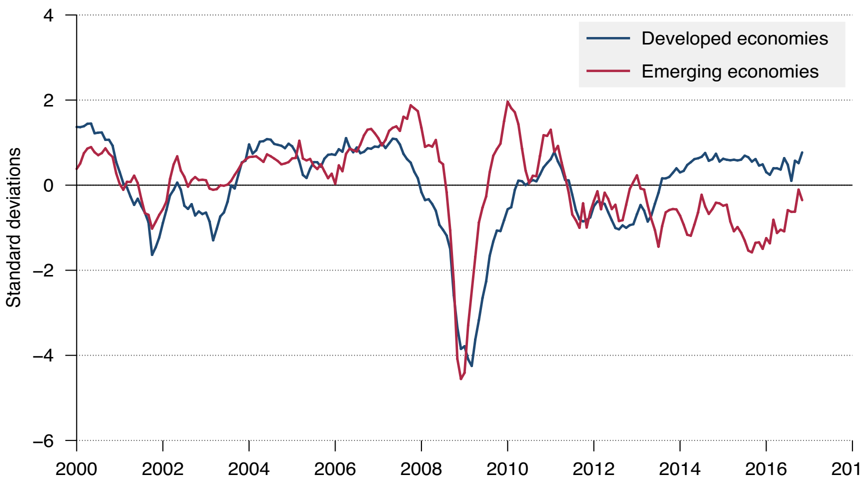
After two consecutive slumps in crude oil prices since 2014 headline inflation rates had diverged from core inflation in most advanced economies, most pronouncedly in the United States. As crude oil prices have stabilised this year headline inflation rates have increased again. Assuming an unchanged oil price of 50 US dollar per barrel, we estimate that the contribution of energy prices to headline inflation should even reverse itself in the first quarter of 2017. With today's US core inflation at 2.1 percent this signals an increase to above 2.5 percent.

Fig. 3: Fears on US protectionism understandably the highest in Mexico



If candidate Trump's wild campaign had a recurring topic, than it was his inflammatory rhetoric on implementing protectionist measures. Thus it is no surprise the Mexican peso has suffered most of all emerging markets currencies since the US election. The Mexican economy is the most exposed to the United States. Exports to its northern neighbour are equivalent to over 25 percent of its own GDP. Except for Canada, exports to the US are less than 5 percent of GDP in most other major economies.

Fig. 4: Surge in emerging markets' economic sentiment indicator



Economic indicators have improved steadily in emerging marktes over the course of 2016. Besides a stabilisation in China, this increase was vastly caused by increasing optimism in Brazil and Russia. Although both economies are still contracting at the moment - GDP decreased by 0.8 and 0.6 percent in the third quarter, respectively - we think the return to positive growth is only a matter of time. Undoubtedly, in both cases stabilisation of commoditiy prices in the first half of 2016 supported the recovery.

Source: Census, IMF, Thomson Reuters Datastream, Wellershoff & Partners in capital market interest rates. Facing higher inflation expectations, we think the Fed or more specifically its FOMC's voting members are likely to raise its projected interest rate path for 2017.

Donald Trump's election has delivered another boost to inflation expectations. This is because even if policy specifics are still missing, his campaign promises to increase spending and cut taxes makes one thing abundantly clear: the US government's deficit seems likely to expand markedly in the coming years.

The dollar's mispricing grows starker

As inflation and the federal funds rate make its way upward, we think that the rising trend in capital market interest rates, underway since last summer, is likely to continue. Given the broad expectation that US interest rates will rise sharply, the US dollar gained in value against all major currencies. These latest gains further expand the US dollar's longstanding overvaluation versus the euro according to purchasing power parity (PPP), a method determining long-term equilibrium prices for currency pairs using inflation rate differentials. The dollar's current overvaluation versus the euro amounts to more than 15 percent, which we think suggests interesting investment opportunities.

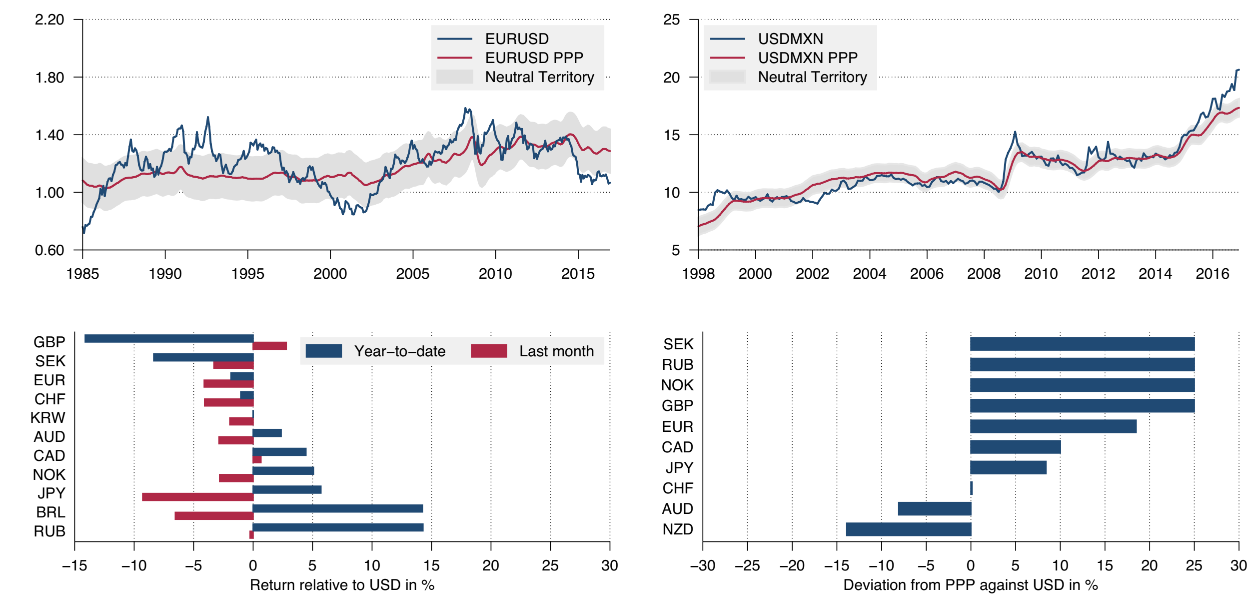
Protectionism fears weigh on EM currencies

While Trump's election victory can so far be regarded as a positive for the US economy, it has hammered emerging markets currencies. No wonder: if Trump's campaign had a recurring topic, it was his inflammatory rhetoric promising a wave of protectionist measures. Thus it is no surprise that the Mexican peso has suffered most of all the emerging markets currencies, given Mexico's vast economic exposure to the US. Over a quarter of its GDP derives from exports to its northern neighbour. Other losses in emerging market currencies were largely related to their exposure to dollar-denominated debt.

Recovery is underway in Brazil and Russia

Putting the turbulence on FX markets aside, the economic outlook has been improving in most of the largest emerging markets. Although their economies are still contracting, sentiment indicators in Brazil and Russia clearly show that recovery has been underway for several months now. As in Brazil, Russia's brighter outlook reflects the rise in crude oil prices, which also helped to insulate the ruble from the strengthening US dollar. Nevertheless, the ruble remains largely overvalued to the US dollar, according to PPP. //

Fig. 5: FX performance and valuations



PPP estimates based on producer price indices

Source: Thomson Reuters Datastream, Wellershoff & Partners

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