perpetual wealth

Wellershoff & Partners

Quarterly Macro Report

3rd Quarter 2017

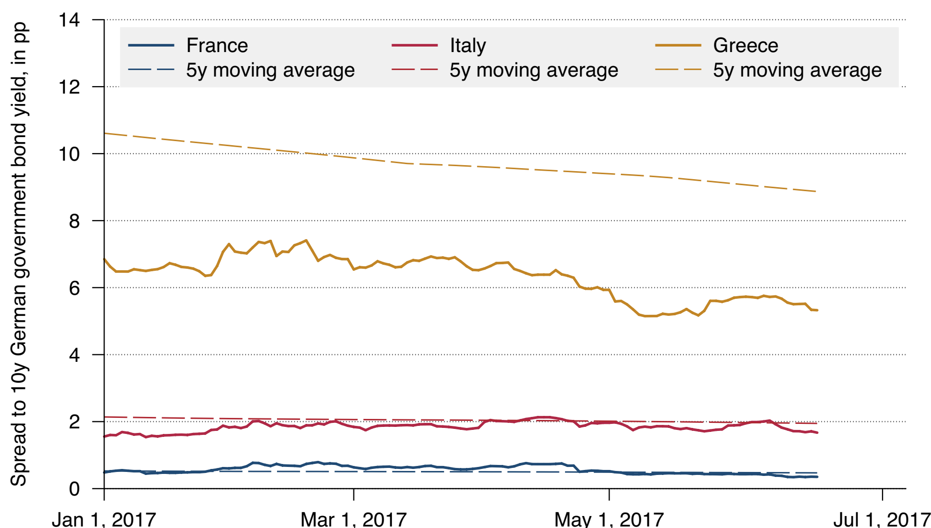
With economic sentiment at a post-crisis high and some country-specific risks fading, the Eurozone is presently one of the most economically favourable regions in the industrialised world. US economic indicators may have slipped a bit from high levels, but we think the downturn in China bears closer watching.

Not only did Emmanuel Macron soundly defeat right-wing populist Marine Le Pen to become France's new president, his newly formed party, *La République En Marche*, also scored a landslide victory in the recent parliamentary elections. *En Marche* gained 350 of the 577 total seats in France's National Assembly, granting the new president a comfortable majority in parliament. This clear outcome, utterly unexpected a few months ago, may drive economic sentiment still higher. Nonetheless, we would point out, Mr Macron remained vague about much of his programme during the campaign. What's more, even if the new president would spur improvement in sentiment, neither he nor the National Assembly can raise productivity growth overnight. Liberalising the rigid French labour market, Mr Macron's declared goal, will be a first test for his presidency – and for his approval ratings.

Eurozone's outlook brightens further

With the risk of a right-wing populist taking the helm of the Eurozone's second-largest economy now safely nullified, the region's overall economic outlook quickly improved, and we see signs of it improving further. First of all, Eurozone GDP growth accelerated once again in the first quarter of 2017. A quarter-over-quarter increase of 0.6% pushed the region's annual GDP growth rate to 1.9%. Wellershoff & Partners' proprietary economic sentiment indicator is also pointing upwards for the second quarter, signalling a GDP growth level above the 2% mark. In addition, some unhelpful country-specific risk factors in the Eurozone, in particular in Greece and Italy, have also declined lately. In Greece, a new European loan is disbursed to the government after the Greek parliament passed further aus-

Fig. 1: Country-specific risks subside in the Eurozone



Not only has economic sentiment in the Eurozone recently set a new post-crisis high; some country-specific risks in the region have also subsided. In France and Greece this has already led to narrowing ten-year government bond spreads versus German bunds. Additionally, in Italy, we believe the latest changes to the electoral system make a parliamentary majority by the eurosceptic Movimento 5 Stelle quite unlikely, which could lead to a further reduction in spreads.

Source: Bloomberg, Wellershoff & Partners

terity measures. In Italy, where first-quarter GDP growth had to be revised significantly upward, a solution was found with the EU to provide *Banca Monte dei Paschi* some urgently needed capital. Finally, and importantly, in Italy the agreement on revising the electoral system and the failure of the anti-establishment *Movimento 5 Stelle*'s to win a majority in any jurisdiction in recent regional elections have substantially lowered political risks in the Eurozone's third-largest economy.

The pound as the mood barometer for erratic Brexit negotiations

Meanwhile, at the Eurozone's doorstep in Great Britain, political risks have not subsided at all lately. On the contrary, they have risen. Calling for a snap election to cement her negotiating authority backfired badly on UK Prime Minister Theresa May and her *Conservative Party*. As if the Brexit negotiations alone were not a challenging enough task, May has entered into a coalition with Northern Ireland's Democratic Union Party, with possibly disruptive consequences that the British political system seems ill-prepared to manage. On top of all that, the UK economy's outlook has dimmed lately, after coping rather well since the Brexit vote a year ago. For example, rising inflation has turned real wage growth negative. Under the present circumstances, we think the pound will likely get little support from the *Bank of England* in the form of monetary tightening. Instead, in the months to come, Sterling will probably be treated as a mood barometer of the tedious, potentially erratic, Brexit negotiations. Therefore, we caution that some elevated risk is entailed in investing in assets denominated in the British pound, despite the pound's sizeable purchasing-power-parity undervaluation versus most other larger currencies, including the euro and the US dollar.

Right after the French presidential election, capital inflows into the Eurozone increased, leading European equities to outperform their US counterparts. We think this development is likely to continue, as the Eurozone's broadly positive outlook and reduced country-specific risk factors have combined to make *Old Europe* the world's most dynamic industrialised economy at the moment. The only reason this good economic news has not yet translated into tighter monetary policy from the *European Central Bank* is a stubbornly low inflation rate. Nevertheless, we think ECB president Mario Draghi will soon introduce a plan to wind down the ECB's quantitative easing programme, potentially at the next press conference in September.

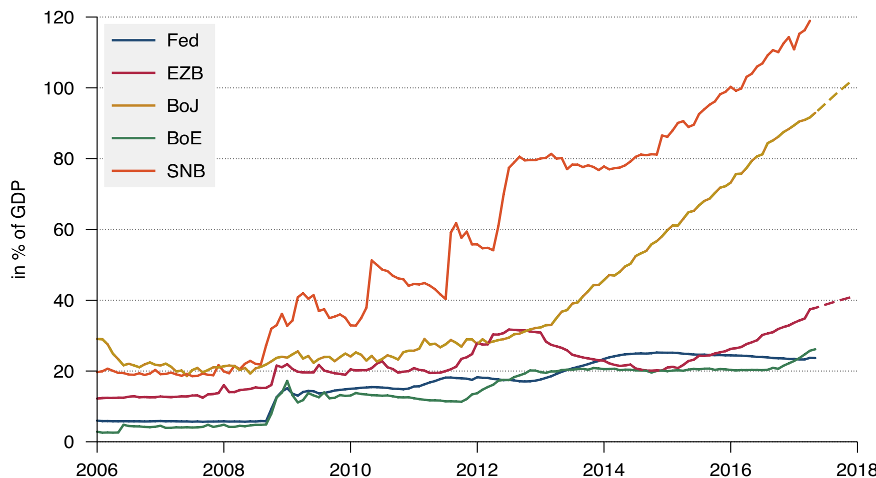
Table 1: Macro economic estimates

	Real GDP growth in %						Inflation in %					
	2015	2016	2017P	2018P	2017Δ	2018Δ	2015	2016	2017P	2018P	2017Δ	2018Δ
USA	2.6	1.6	2.0	1.8	-0.2	-0.6	0.1	1.3	2.4	2.5	-0.1	0.2
Euro area	1.9	1.7	2.0	1.6	0.3	0.1	0.0	0.2	1.5	1.8	-0.1	0.4
Germany	1.5	1.8	2.2	1.6	0.6	0.0	0.2	0.5	1.6	2.0	-0.2	0.3
France	1.2	1.1	1.3	1.2	0.0	-0.2	0.1	0.2	1.4	1.8	0.1	0.4
Italy	0.7	1.0	1.2	1.0	0.3	0.1	0.0	-0.1	1.0	1.5	-0.3	0.2
Spain	3.2	3.4	2.5	2.0	-0.1	-0.2	-0.5	-0.2	1.5	1.5	-0.7	0.0
United Kingdom	2.2	1.8	1.5	1.2	-0.2	-0.1	0.0	0.7	2.8	2.5	-0.7	-1.0
Switzerland	0.8	1.5	1.5	1.5	0.0	-0.2	-1.1	-0.4	0.5	1.0	0.0	0.3
Japan	1.3	0.8	1.2	0.8	-0.1	-0.2	0.8	-0.1	0.0	0.5	-0.7	-0.5
Brasil	-3.8	-3.3	1.8	1.5	1.2	-1.0	9.0	8.7	4.5	5.0	0.3	0.6
China	6.9	6.7	6.4	6.0	-0.1	-0.2	1.4	2.0	2.5	2.5	0.2	0.2
India	7.6	7.5	7.5	7.0	0.2	-0.6	4.9	4.9	5.0	5.0	0.2	0.0
Russia	-2.8	-0.7	1.0	1.0	-0.2	-0.7	15.5	7.1	5.0	4.0	0.8	-0.2
World (PPP)	2.7	2.4	2.6	2.4	-	-	2.8	2.8	2.7	2.7	-	-

E Estimates Wellershoff & Partners Δ Deviation from consensus economic forecasts

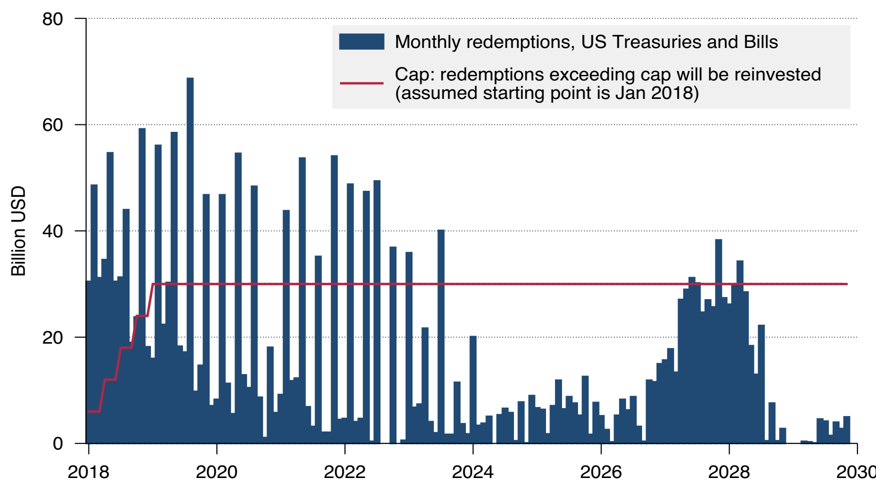
Source: Consensus Economics, Thomson Reuters Datastream, Wellershoff & Partners

Fig. 2: The era of expansionary monetary policy is slowly coming to an end



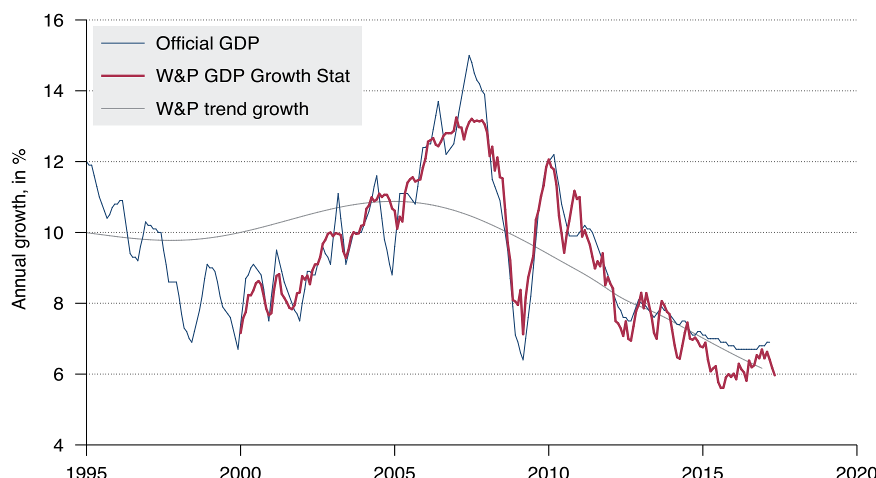
In mid-June, not only did the Fed raise interest rates for the second time this year. Fed Chair Janet Yellen also presented a detailed plan for reducing the bank's balance sheet. The Fed is the central bank furthest along in the process of normalising its monetary policy. Even though the ECB's balance sheet continues to expand, recent changes in its language indicate that the ECB's asset-purchasing programme will be phased out in 2018. Thus, the period of extremely expansionary monetary policy appears to be coming to an end.

Fig. 3: The Fed's balance-sheet diet plan



At its Federal Open Market Committee (FOMC) meeting on June 14, the Fed presented a detailed plan for trimming its bloated balance sheet. The biggest item to address is 2.3 trillion dollars in US Treasury bonds. To date, proceeds from expiring bonds have been reinvested. The proposed plan involves gradually increasing the amount of expiring bonds, starting at USD 6 billion per month. The chart shows the expiring volumes of US Treasuries as well as the possible path for the maximum amount to be trimmed.

Fig. 4: W&P Growth Stat for China reveals more weakness than official data indicates



On top of an ongoing slide in sentiment indicators in China's manufacturing sector, effective production data has also started to show some signs of weakness. W&P's GDP Growth Stat for China signals that China's effective annual GDP growth rate is set to decline to 6%. We are closely monitoring the widening gap between official data and W&P's Growth Stat. Ultimately, however, since this slippage is mostly due to a government-imposed (and equally reversible) shortage of loans, we have not been too worried yet .

Source: Bloomberg, Penn World Table, Thomson Reuters Datastream, Wellershoff & Partners

Federal Reserve is serious about tightening

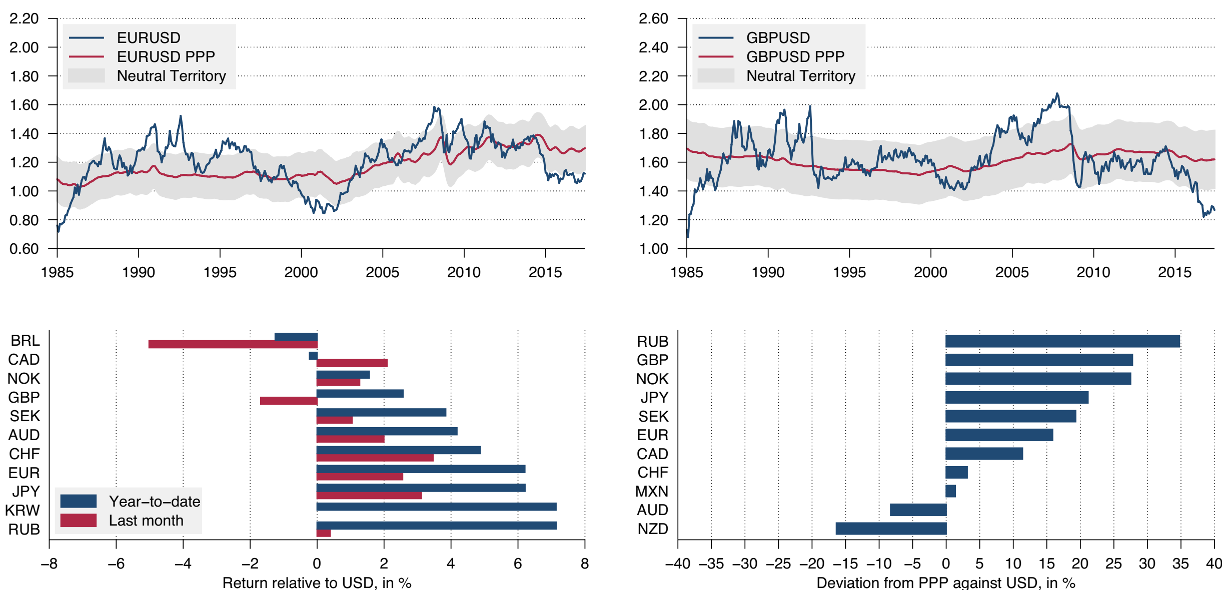
One central bank is far further down the road of monetary policy normalization — the US *Federal Reserve*. And announcing its second rate hike this year was not all the news from the Fed in mid-June. Fed Chair Janet Yellen also presented a detailed plan for reducing the central bank's 4.2 trillion dollar portfolio of US Treasury bonds and mortgage-backed securities, most of which were purchased in the three quantitative easing rounds from 2008 to 2013. By stating that implementing this plan might already be an option later this year, the Fed is comfirming its confident outlook for US economic growth. Although leading economic indicators have slipped somewhat in recent months, as political turmoil has hindered the Trump administration from implementing any growth-enhancing reforms, we expect the US economy to rebound in the second quarter. W&P's economic climate indicator for the US signals that annual GDP growth rate should exceed 2.5%.

Government-induced downturn in China

In China, on the other hand, we observe more than a slight decline in the leading economic indicators. On top of the ongoing sentiment slippage in the manufacturing sector, effective production data has also started to show some signs of weakness lately. *Wellershoff & Partners' GDP Growth Stat for China*, which is based on ample and reliable industrial production data rather than official GDP announcements, now indicates China's effective annual GDP growth rate is set to fall to 6.0%. Thus, the gap between W&P's independent growth estimate and official assessments, which reported first-quarter growth of 6.9%, looks set to widen again.

While significant, we have remained untroubled by our indicator's signal for China yet, given that the emerging slowdown in the country's economic growth is mainly due to a government-imposed shortage of loans. With its recent measures, the authorities intend to slow the pace of China's soaring debt levels, especially in the corporate sector. In any case, we are confident that if a downturn were to persist, it would be simple enough for the authorities to revive growth by yet again reopening the credit flows. This scenario grows more plausible in view of the political calendar in China. In the autumn, the 19th National Congress of the *Chinese Communist Party* will be held in Beijing. We find it unlikely that President Xi Jinping, embarking on the second half of his ten-year term, will tolerate much decline in the official GDP growth rate leading up to this event. //

Fig. 5: FX performance and valuations



PPP estimates based on producer price indices

Source: Thomson Reuters Datastream, Wellershoff & Partners

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