Quarterly Macro Report

4th Quarter 2017

Economic sentiment surveys are upbeat almost everywhere in the G20 space. However, they look far more credible in the Eurozone than in the United States. But it is the US Fed that has made real progress in normalizing monetary policy. Meanwhile, China's economy remains a focus despite some signs of stabilizing.

As we approach the final quarter of the year, positive sentiment persists in the global economy, particularly in the industrial sector. With the exception of South Korea, purchasing managers indexes in the world's twenty largest economies are all above the 50-point mark, indicating expanding production output ahead. And beyond the broad optimism in manufacturing, consumers also appear decidedly optimistic in most economies. Taken altogether, the W&P Economic Sentiment Index now points to growth of well above 4 percent for the global economy, implying a substantial surge towards the end of the year from the levels recorded in the second quarter.

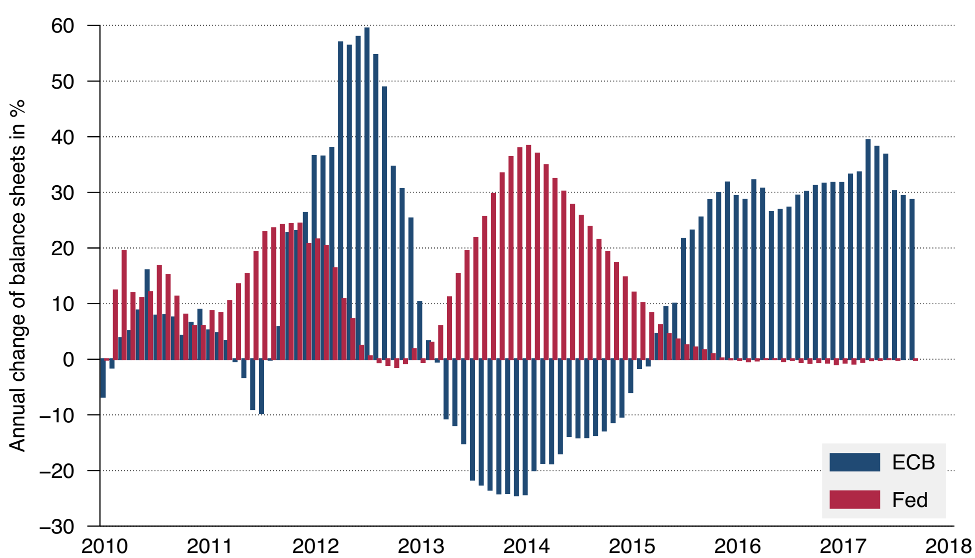
Do sentiment surveys always keep their promises?

As Fig. 2 shows, the W&P Economic Sentiment Index, which is based on surveys of both consumers and companies, has generally proven to be a reliable leading indicator. Still, the critical question must be asked as to whether those sentiment indicators will keep their promise this time, too. Interestingly, we have discovered that the degree to which the optimism of the sentiment indicators can be trusted in fact varies between the two world's largest economies, the Eurozone and the United States.

Upbeat Eurozone unfazed

After a strong second quarter, when the annual growth rate jumped over 2 percent, the pickup in Eurozone economic sentiment is still very broadly supported. The European Sentiment Indicator, a composite indicator based on European Commission data from all member countries, rose to 111.9 points in August, its highest

Fig. 1: The ECB still has a long way to go



At least until December, the ECB will continue purchasing government bonds at a rate of 60 billion euro per month, which translates into an annual growth rate of around 30 percent for the bank's balance sheet. Although it is widely expected that the ECB will start tightening monetary policy next year, it will remain in an expansionary mode for a while. This leaves the ECB with ample room for policy tightening, which has already shifted FX markets' expectations.

Source: ECB, Federal Reserve, Thomson Reuters Datastream, Wellershoff & Partners level in over a decade. In many countries, sentiment indicators are at or above record levels, both in the manufacturing sector and among consumers. Because the buoyant sentiment is so uniformly spread across almost all countries and sectors, we consider it quite likely that the aggregated sentiment indicators for the Eurozone, which now foresee a growth rate of 2.5 percent for the third quarter, will also actually be reflected in real economic data.

Consumption cannot drive US growth forever

Despite posting the same annual GDP growth rate in the second quarter as the Eurozone, we would argue that the outlook for the US economy does not look quite as bright. US economic growth in the second quarter was based almost entirely on private consumption. We think this does not represent a sustainable growth model over the long term. Households' rising expenditures in the US are increasingly financed by their declining savings rates, as growth in consumer demand can hardly be fuelled by the meagre wage growth. Nominal wage growth in the US has stagnated at 2.5 percent, while consumer price inflation is at an annual rate of 1.9 percent. That simply doesn't leave much money available to finance a significant real increase in consumption.

Fast-forward Fed, relatively

Despite the economic outlook looking more fragile in the US than in the Eurozone, it is the US Fed that has actively pursued the normalization of its monetary policy. At their last meeting, in mid-September, Chair Janet Yellen announced that the Federal Reserve intends to start trimming its bloated balance sheet in October already - after having hiked interest rate four times in recent years another major step in normalizing US monetary policy.

The Federal Reserve and Janet Yellen have good reasons to move ahead with monetary policy tightening. First, Yellen's term as Chair ends in February 2018. It still remains uncertain whom US President Donald Trump will nominate to chair the bank. Second, and even more importantly, it is worth remembering that all economic upswings sooner or later come to an end. As Fig. 3 shows, the current US economic recovery has lasted for over 30 consecutive quarters now, far longer than the historical average. Although the above-mentioned sentiment indicators do not foresee any immediate economic downturn, let alone a recession, we consider it quite likely that there will be a slump at some point in the next few years. As illustrated by Fig. 4, even if the Fed has been moving faster than other

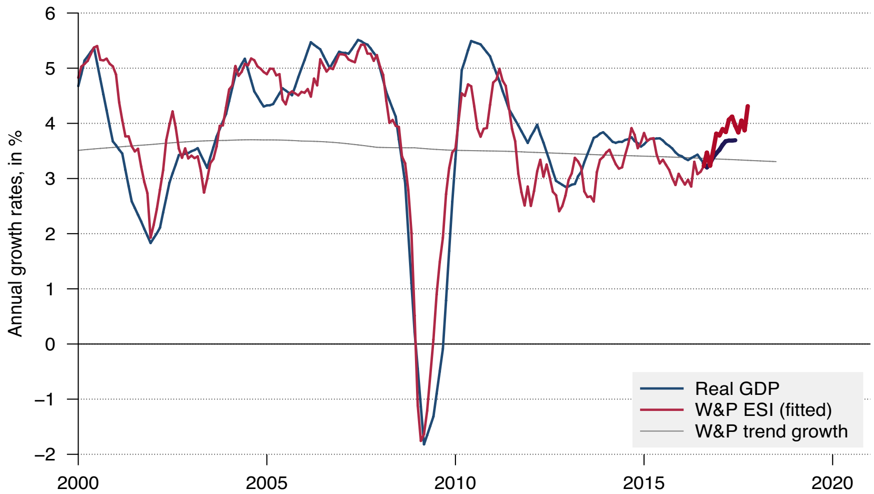
Table 1: Macro economic estimates

	Real GDP growth in %						Inflation in %					
	2015	2016	2017P	2018P	2017Δ	2018Δ	2015	2016	2017P	2018P	2017Δ	2018Δ
USA	2.9	1.5	2.0	1.8	-0.1	-0.6	0.1	1.3	2.4	2.5	0.4	0.5
Euro area	1.9	1.8	2.0	1.6	0.0	-0.2	0.0	0.2	1.5	1.6	0.0	0.3
Germany	1.5	1.8	2.0	1.6	0.2	-0.2	0.2	0.5	1.6	2.0	-0.1	0.4
France	1.0	1.1	1.5	1.5	-0.1	-0.1	0.0	0.2	1.4	1.8	0.3	0.6
Italy	0.7	1.0	1.2	1.0	0.0	0.0	0.0	-0.1	1.2	1.5	-0.2	0.3
Spain	3.2	3.4	3.0	2.5	-0.1	-0.1	-0.5	-0.2	2.0	1.5	0.0	0.1
United Kingdom	2.2	1.8	1.5	1.2	-0.1	-0.2	0.0	0.7	2.8	2.5	-0.7	-0.8
Switzerland	1.2	1.5	1.0	1.5	-0.4	-0.2	-1.1	-0.4	0.5	1.0	0.1	0.4
Japan	1.2	0.8	1.2	1.0	-0.2	-0.1	0.8	-0.1	0.2	0.5	-0.3	-0.3
Brasil	-3.8	-3.3	0.4	2.2	0.0	0.1	9.0	8.7	4.5	5.0	1.0	0.8
China	6.9	6.7	6.4	6.0	-0.3	-0.3	1.4	2.0	2.0	2.5	0.2	0.4
India	8.0	7.5	7.0	7.5	-0.3	-0.1	4.9	4.9	4.0	4.0	0.4	-0.6
Russia	-2.8	-0.7	2.0	1.0	0.5	-0.7	15.5	7.1	5.0	4.0	0.9	-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

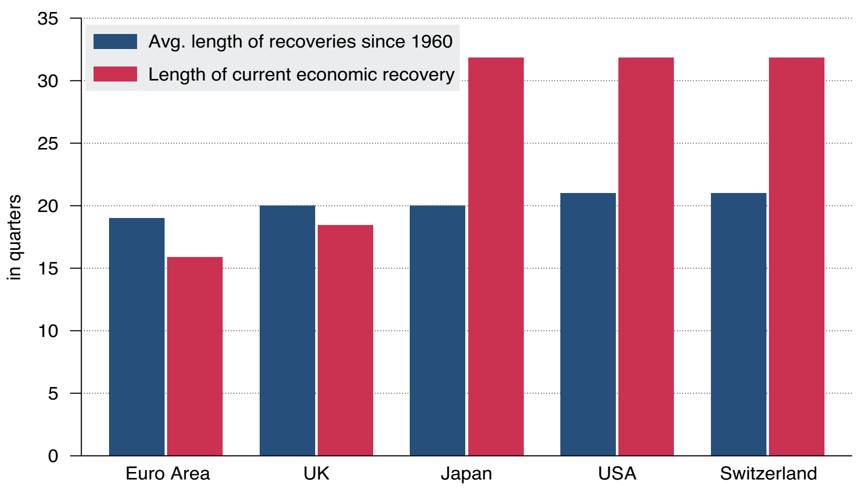
Source: Consensus Economics, Thomson Reuters Datastream, Wellershoff & Partners

Fig. 2: Sentiment indicators paint a bright picture for the global economy



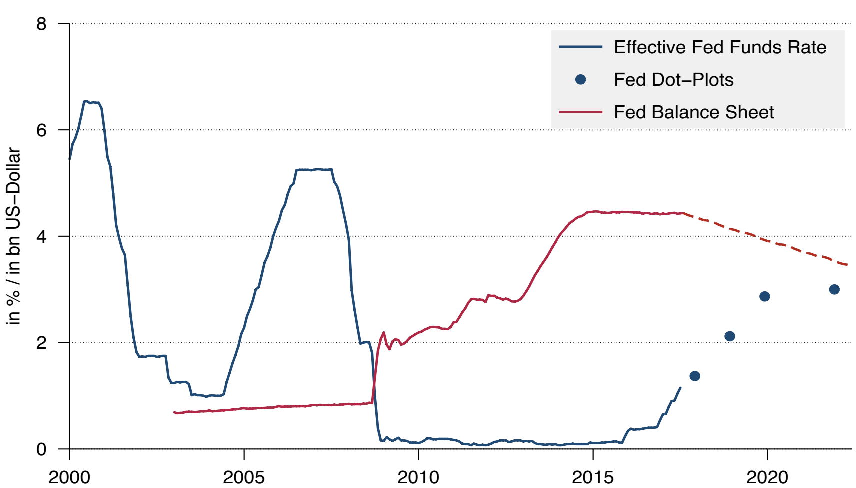
The survey-based W&P Economic Sentiment Indicator for the global economy has risen substantially in the past months. The indicator now points to an annual growth rate of well above 4 percent on an aggregated level, the highest reading since 2011. Despite this indicator have proven very reliable in the past, we believe that such an actual increase in growth rates is more likely to manifest itself in the Eurozone than in the United States.

Fig. 3: An economic downswing looms for the US



This graph compares the average durations of economic upswings since the 1960s with that of the current recovery for different economies. It clearly shows that the length of the current recovery in some countries – for example, Japan, the United States and Switzerland – clearly surpasses historical averages. Therefore, it seems plausible that central banks liked the Fed start creating buffers by hiking interest rates as well as by reducing their balance sheets in order to be able to cushion their economies when the next downturn comes.

Fig. 4: The Fed's plan to normalize its monetary policy



Even if the Fed has been moving faster than other central banks in normalizing its monetary policy, its announced plan employs a very long time horizon. We see a substantial risk that the next economic downturn could disrupt this lengthy process. A downturn, let alone a recession, would it not only make impossible to complete the normalization; it could well see a return of unconventional central bank measures like quantitative easing.

Source: Federal Reserve, PWT, Thomson Reuters Datastream, Wellershoff & Partners central banks, its plan to normalize monetary policy utilizes very long time horizons. Thus, we see a substantial risk that the next downturn could significantly disrupt the normalization process. This would mean that instead of completing its monetary policy normalization, the Fed might once again be forced to adopt unconventional measures when the next crisis hits.

Procrastinating ECB

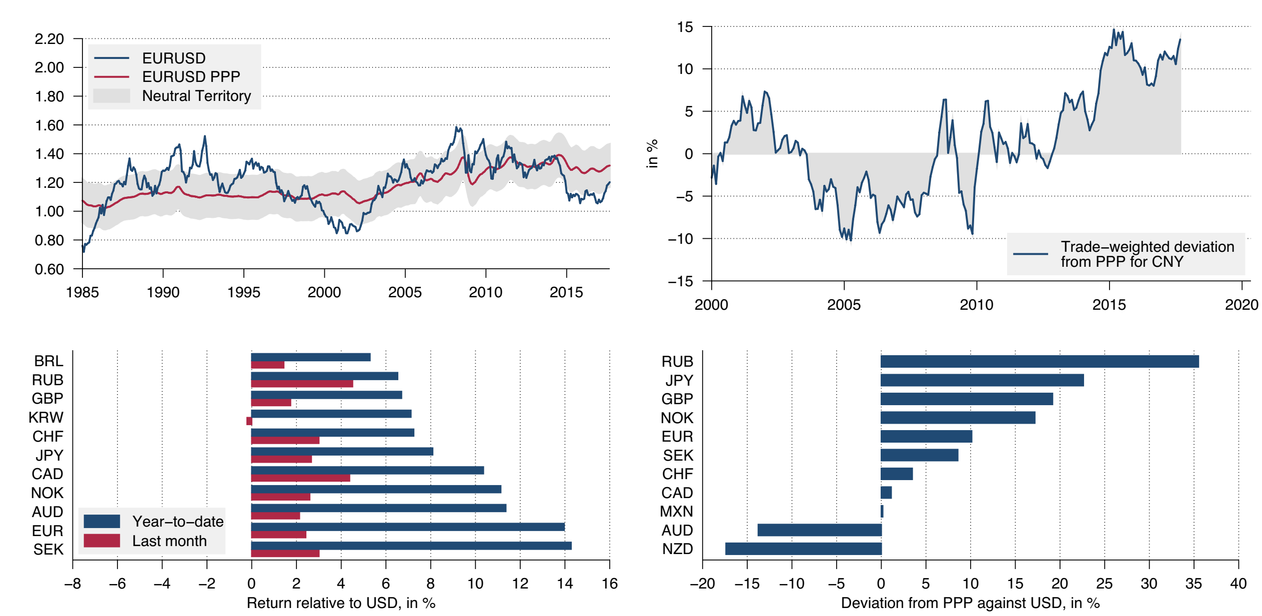
Compared to the lengthy US recovery, the upswing in the Eurozone is just a toddler, since the Eurozone was hit by a second financial crisis in 2011/12. It is, therefore, not surprising that the ECB lags well behind in redirecting its expansive monetary policy from crisis mode. At least ECB president Mario Draghi has recently mooted the prospect that the bank's ultra-expansionary monetary policy is not eternal. However, as the figure on the first page illustrates, even if the ECB were to start unwinding its monetary policy at the beginning of next year, it starts from an extremely expansionary level. Therefore, it will surely take months before the ECB's policy actually moves into a restrictive, rather than expansive, mode.

However, the ECB's highly expansionist stance also means that there is much room for it to become more restrictive. And this shift has already been anticipated by investors' adjusted expectations, probably playing a role in resolving the imbalances on currency markets in recent months – first and foremost between the two world's mostly traded currencies, the US dollar and the euro. EURUSD has rebounded around 14% year-to-date, among the largest moves of any major currency pair this year (see Fig. 5). Given that the ECB has still so much room to further tighten its monetary policy, and given that the euro is still undervalued against the US dollar, we think the euro could strengthen further.

China revives ahead of a political mega-event

Last but surely not least, China is another important country in the global economy where economic indicators have improved in the recent months. While the ongoing rebound in world trade has undoubtedly contributed to this recovery, government measures to spur lending have also played a substantial role. That the government has recently been more supportive of the economy should come as no surprise. The Communist Party Congress, held every five years, kicks off on October 18. Ahead of China's most important political event, the Party does not want to give any reason to be criticized because of sluggish economic development.//

Fig. 5: FX performance and valuations



PPP estimates based on producer price indices

Source: Thomson Reuters Datastream, Wellershoff & Partners

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