perpetual wealth

Wellershoff & Partners

Quarterly Macro Report

2nd Quarter 2018

The upturn in the advanced economies continues. Consumers remain the driving force globally. Despite the steady increase in capacity utilisation levels, signalling that output gaps are closing, inflation has so far remained subdued. While economic trends appear favourable, recent political developments are more of a concern.

The past quarter saw further improvements in the main economic indicators in the advanced economies. In the United States in particular, business sentiment rose to new highs. Purchasing managers indices in both the manufacturing and services sectors reached levels last seen more than a decade ago.

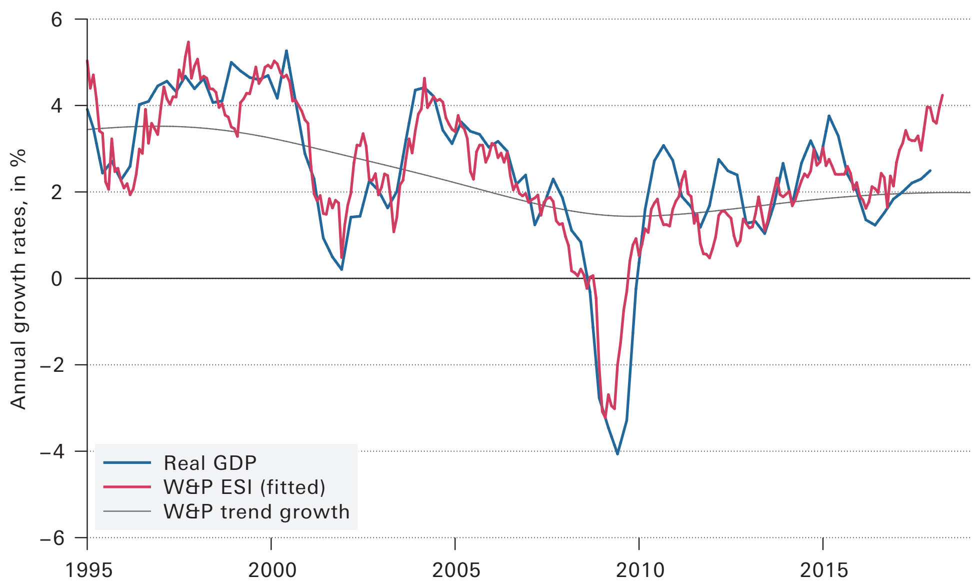
US consumer sentiment has also improved further. Driven by a persistently robust labour market and steady wage growth, consumer spending has been growing strongly. Together with the good news about reviving investment demand, we think annual real US GDP growth could accelerate to around 3 percent for the first quarter of 2018. As these indicators continue their upward trend, we believe growth may accelerate beyond that level in the second quarter. In sum, all signs are pointing to a buoyant first half-year for the US economy.

However, we probably should not expect any further significant near-term increase in growth impulses coming from consumers, however. Against the backdrop of positive developments in the real estate and stock market, US households have been increasing their spending at a faster rate than their earnings have grown for more than two years now. At the end of 2017, America's saving rate dipped to its lowest level since 2007. This should make it all the more difficult for another consumption-driven growth acceleration to emerge in the near term.

European growth still picking up steam

In the Eurozone, business sentiment levels point to a further improvement in economic growth. This expectation is also supported by improved consumer senti-

Fig. 1: Forward-looking GDP indicators for the US show above-trend growth



The survey-based W&P Economic Sentiment Indicator for the US economy (the red line) shows a marked acceleration in recent quarters, implying strong GDP growth in the first half of 2018. The blue line represents the actual, recorded GDP data. The US is currently growing well above its trend growth rate (the grey line).

Source: Thomson Reuters Datastream, Wellershoff & Partners

ment. In view of the continuing increase in employment and decent wage growth, we should see significant further support for vigorous private consumption in Europe.

Politics is seldom far from the Eurozone equation, however. The extent to which the outcome of the Italian elections will hurt the economic dynamics in that part of the Eurozone remains to be seen. Sometimes the EU's institutional set-up can be a stabilising factor. For example, the difficult coalition-building process in the Netherlands last year, and more recently in Germany, did not disrupt the Eurozone's economic momentum. On the contrary, sentiment indicators and actual economic growth in both countries improved during these periods of governmental limbo. And as we saw in 2010-2011, when Belgium could not agree on a new government coalition for 589 days, consumers do not appear to be all that bothered by political gridlock.

The situation may be different in the UK, though, given Brexit's manifold uncertainties. The British economy has benefited from the strong economic growth on the Continent. Thanks also to the weak pound, sentiment in the UK's manufacturing sector has been supportive. However, in view of consumer weakness, as evidenced in the retail sector, and an increase in inflation that has eroded consumers' purchasing power, the near-term growth prospects for the British economy are still below average. The government's approach to the Brexit negotiations is a concern as well. In September 2017 we were told that Prime Minister May's "Florence Speech" would do the trick. Then just before Christmas we heard that the Northern Ireland dilemma was sorted out. The apparent inability of the UK side to sit down and negotiate the painful, detailed, line-by-line text of the exit – opting instead for debating-society point-scoring – only increases the likelihood of our core scenario of a hard Brexit. Meanwhile, the EU's tough response to the US on the issue of steel tariffs, and its continuing pressure on Switzerland to modify a bilateral arrangement that the EU no longer likes, should give the British negotiators pause for thought.

Protectionism becoming a dominant theme

The trade war that is now being instigated by the US could have a serious impact. While the products affected by punitive tariffs and countermeasures represent a relatively small part of global trade, we are concerned about the impact of this ugly fight on sentiment going forward. Uncertainty, particularly for companies, could

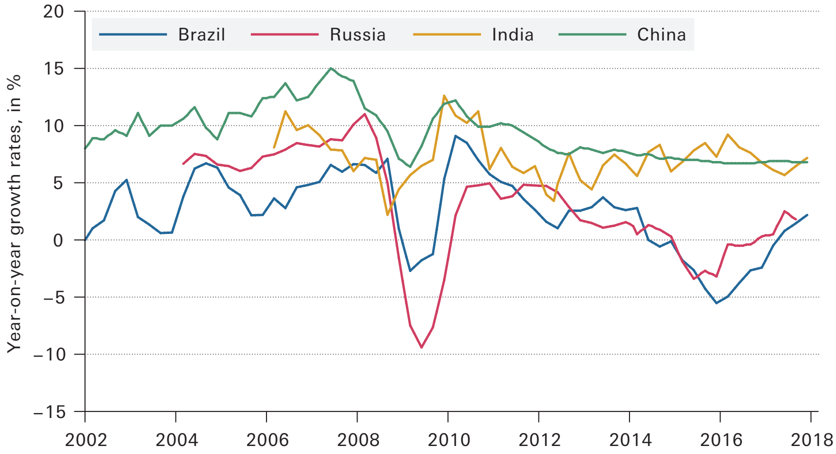
Table 1: Macro economic estimates

	Real GDP growth in %						Inflation in %					
	2016	2017	2018E	2019E	2018Δ	2019Δ	2016	2017	2018E	2019E	2018Δ	2018Δ
USA	1.5	2.3	2.5	2.0	-0.3	-0.5	1.3	2.1	2.4	2.3	0.1	0.1
Euro area	1.8	2.5	2.5	1.2	0.2	-0.6	0.2	1.5	1.5	1.3	-0.0	-0.2
Germany	1.9	2.5	2.5	1.4	0.1	-0.4	0.5	1.7	1.6	1.4	-0.1	-0.4
France	1.1	2.0	2.0	1.3	-0.0	-0.5	0.2	1.0	1.7	1.5	0.2	0.0
Italy	1.0	1.5	1.4	0.6	-0.0	-0.7	-0.1	1.2	1.0	0.6	-0.1	-0.8
Spain	3.3	3.1	2.9	1.6	0.2	-0.7	-0.2	2.0	1.6	1.5	0.1	-0.1
United Kingdom	1.9	1.7	1.5	1.4	-0.0	-0.1	0.7	2.7	3.1	2.5	-0.4	-0.4
Switzerland	1.4	1.1	1.9	1.5	-0.1	-0.3	-0.4	0.5	1.0	1.0	0.2	-0.0
Japan	1.0	1.6	1.7	1.0	0.3	-0.1	-0.1	0.5	1.0	0.8	0.1	-0.3
Brazil	-3.5	1.0	2.0	2.0	-0.6	-0.8	8.7	3.4	4.5	4.0	0.4	-0.2
China	6.7	6.9	6.5	6.0	-0.0	-0.3	0.6	-0.5	2.0	2.0	-0.3	-0.2
India	7.1	7.2	7.5	7.0	0.9	-0.3	4.9	3.3	4.0	4.0	0.3	-0.9
Russia	-0.2	-	2.0	1.0	0.1	-0.8	7.1	3.7	4.0	3.0	-0.1	-1.1
World (PPP)	3.2	3.7	3.8	3.4	0.5	0.3	2.8	3.1	4.7	2.5	0.1	-0.3

E Estimates Wellershoff & Partners   Δ Deviation from consensus economic forecasts

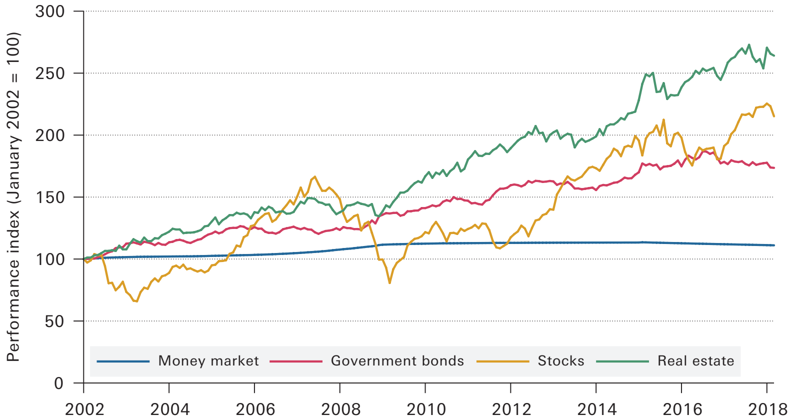
Source: Consensus Economics, Thomson Reuters Datastream, Wellershoff & Partners

Fig. 2: Economic growth in the BRICs



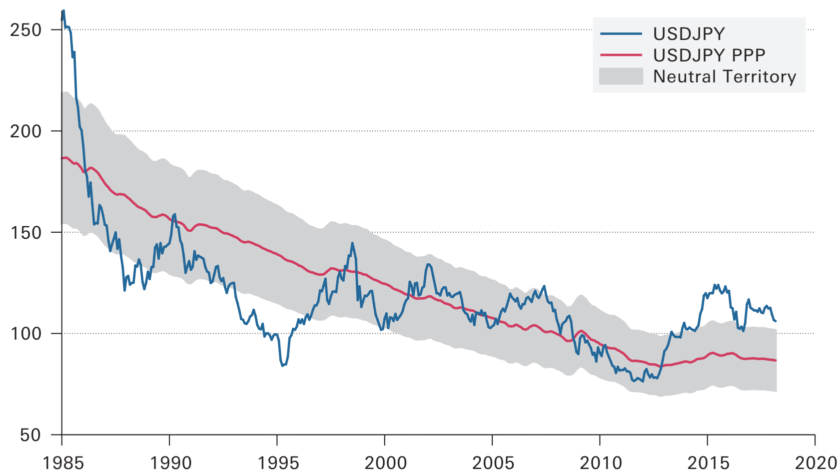
Economic growth has also picked up in the BRICs. Brazil and Russia are recovering from their sharp recessions. India's growth rate is back above China's, which is experiencing a structural slowdown.

Fig. 3: Performance of selected Swiss asset classes



The chart shows the performance of selected Swiss asset classes. The Swiss real estate market has been a major beneficiary of the global financial crisis: low interest rates boosted real estate prices, while investor concern about equities during the crisis caused a further shift into real estate. As interest rates begin to rise again, we expect the Swiss real estate sector to underperform in a diversified portfolio.

Fig. 4: The Japanese yen points towards its purchasing power parity again



The Japanese yen is one of the most undervalued currencies against the majors. In Q1 2018 the yen has been edging back in the direction of its purchasing power parity value against the US dollar. The yen still has a long way to go, of course, but we reiterate that freely traded currencies cannot ignore the fundamentals forever.

Source: Thomson Reuters Datastream, Wellershoff & Partners

seriously undermine the current upturn over the medium term. Business confidence and investment are crucial for sustaining the current boom.

Volatility is back – and that is a good thing

The market volatility that began in the first quarter of 2018 was initially attributed to concerns about higher US inflation. Adding to the turbulence was the argument that, even if higher US inflation were not to materialise soon, a stronger economy would in any case require higher real interest rates. This is a tricky bit of economics that is often poorly understood. There are times when higher interest rates simply reflect a strong economy – and that is good news.

Apart from the good news of a stronger economy, the increased volatility and turbulence in the equity and bond markets are probably evidence that we are transitioning from one kind of equilibrium to another. We seem to be moving from a phase where rates were held artificially low to one where the GDP data strongly suggests that central banks should be tightening. It has long been recognised that the time will eventually come for "quantitative tightening". But to expect that central banks will guarantee this process to be smooth and gradual is to assume too much, in our view. We reiterate that investors should prepare for more market turbulence and volatility ahead, not less.

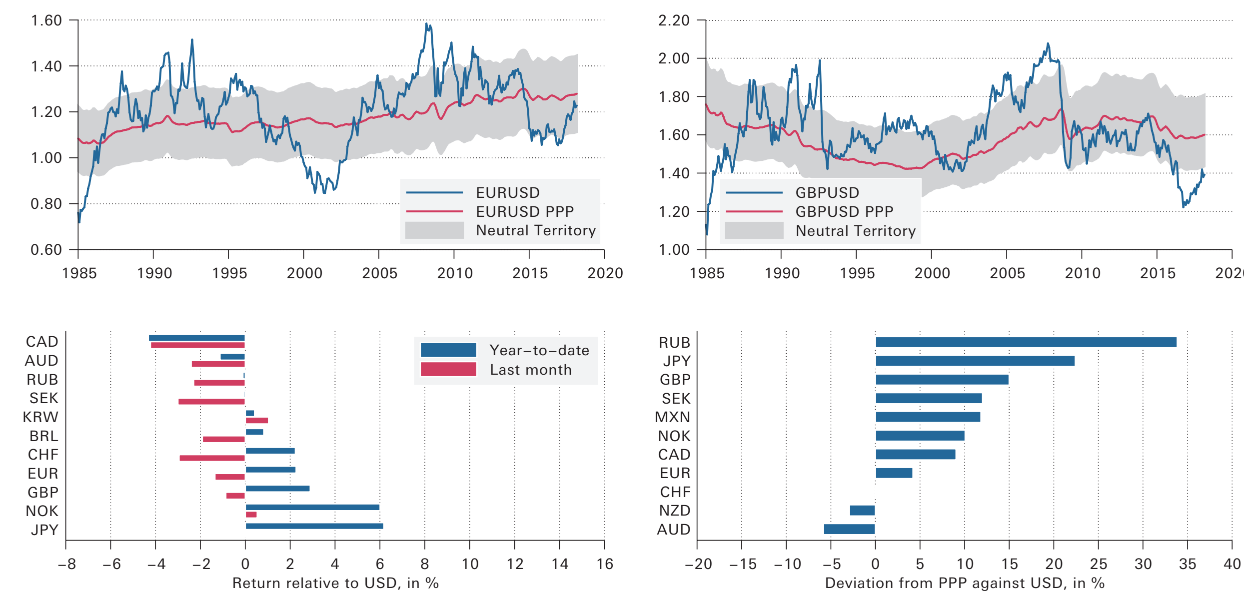
FX markets

At the end of 2017, the Japanese yen stood at 112.7 against the US dollar. In Q1 2018 it strengthened to below 106. Our purchasing power parity estimate for USDJPY is around 87 – a gap of more than 20 percent from spot. Our neutral range, representing one standard deviation of the historical variation around PPP, is in the region of 72 to 102 (see Fig. 4).

The Swiss franc appears fairly valued relative to the US dollar at present, as our PPP estimate for USDCHF is around 0.96. But the franc is currently around 6 percent too expensive relative to the euro, given that our PPP estimate for EURCHF is 1.22. In view of the current strong tailwinds from growth in the Eurozone, we see a likelihood for the euro to overshoot against both the USD and CHF.

Inexpensive European currencies relative to the Swiss franc currently include the NOK, the SEK and the GBP. Our PPP estimate for GBPCHF is 1.54, implying that Sterling is currently undervalued by about 14 percent against the franc. Investors should beware of Brexit, however.

Fig. 5: FX performance and valuations



PPP estimates based on producer price indices
Positive deviations from PPP indicate an undervaluation against the respective currency and *vice versa*.

Source: Thomson Reuters Datastream, Wellershoff & Partners

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