Quarterly Macro Report

1st Quarter 2018

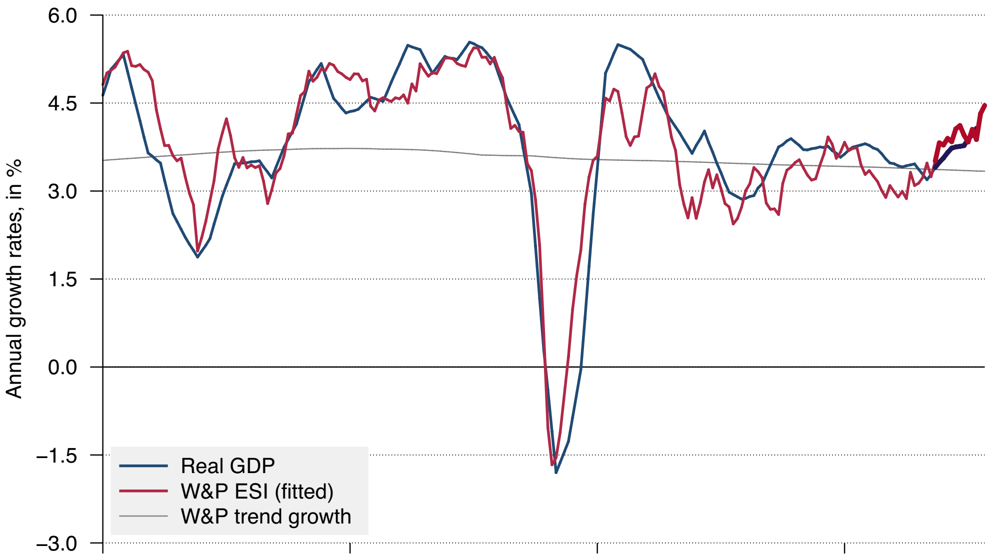
As 2017 comes to an end, a broad range of economic indicators paint a vibrant picture for the start of the New Year in the advanced economies. With growth rates above trend and slowly building inflationary pressure, however, we think central banks may soon face an environment that demands faster normalization of monetary policies. Meanwhile, emerging market growth still lags behind.

Looking at the fundamentals, the world's advanced economies are poised for a good start in 2018. Output gaps are steadily closing, labour markets are near full employment or at least are strongly improving, and economic sentiment indicators are upbeat across sectors and regions. But this glowing outlook applies far less to emerging markets, which at best have merely stabilized. In some emerging economies, notably in China, weaker growth momentum reflects official economic policies. In view of the favourable global environment, most central banks have started to normalize their monetary policies. But while price and wage growth are subdued, the pace of normalization is generally slow. Yet, with third-quarter growth rates well above trend – 2.3 percent in the US and 1.5 percent in the Eurozone – and inflation picking up, pressure may grow on central banks to speed up their adjustments.

Sentiment indicators signal a gloomy economy

The W&P Economic Sentiment Index has risen steadily over the past several months, and despite a recent slowdown in growth dynamics, it still signals a very robust growth outlook ahead. Indeed, the implied aggregate growth rate of the Index amounts to 4.5 percent for 2017. Based on both consumer and business surveys, this suggests that the global economy is expanding at a good pace. The Index reflects the consistent positive development in the underlying fundamentals, as reflected in the solid growth rates posted in advanced economies. At the same time, we note that the upswing has been underway for more than 30 quarters in the US and Japan, and nearly 20 quarters in the Eurozone and the UK. The Eurozone has outperformed the US in recent economic sentiment dynamics. Still, confidence indi-

Fig. 1: Sentiment indicators signal solid growth momentum for 2018



The survey-based W&P Economic Sentiment Indicator for the global economy has continuously improved over recent months. The aggregated indicator now implies an annual growth rate of 4.5 percent for 2017. Lately, the increased confidence has been buoyed primarily by Eurozone member countries, whereas a slight decrease in confidence in the United States has reduced the latter's contribution to sentiment growth.

Source: Thomson Reuters Datastream, Wellershoff & Partners cators in almost all advanced economies are at very high levels and an economic downturn anytime soon seems unlikely, in our view.

Will US tax reform boost the economy?

Fiscal policy in the US is clearly committed to an expansionary path. Congress has just passed a massive tax reform bill, to be implemented in 2018 with a time horizon of a decade, and two questions now arise: to what extent will this legislation provide economic stimulus, and how will it affect general government debt? Empirical evidence suggests that the impact of expansionary fiscal policy is considerably less powerful in periods of strong economic activity than it is in recessions. Therefore, output effects should be modest, at least over the coming several months. Contrary to the assumptions inherent in the legislation, we furthermore do not expect that the fiscal multiplier effect will be able to compensate for the costs of the reform in terms of reduced tax revenues. Rather, we believe that the new tax reforms will further increase the US government's deficit, which is already at 4.6 percent of GDP. Given the lack of significant cuts in expenditures, this could result in the deficit rising well above 6 percent of GDP. Additionally, previous experience has shown that the current account deficit has increased markedly after fiscal expansion, due to the US dollar appreciation. Inflation may, however, be a desired side effect, even though there is much uncertainty about the extent of such a stimulus.

Why is inflation low?

With inflation rates well below the target of many central banks, and in particular below the 2-percent target of both the US Fed and the European Central Bank, this might exactly be what monetary policymakers are looking for. With core inflation at 1.7 percent in the US and 0.9 percent in the Eurozone, central banks have long been reluctant to unwind their quantitative easing programmes. In some other countries – for example, the UK – inflation is brisk, but this is largely due to the pound's downward spiral lately. The Phillips Curve, which describes an inverse relationship between rates of unemployment and inflation, would indeed suggest a faster rise in prices. But both wage growth and inflation rates remain subdued. Nevertheless, central bankers still believe in the Phillips Curve. With support from monetary policy, they think that inflation will pick up in the coming months. We also believe that price stability is not an issue at present.

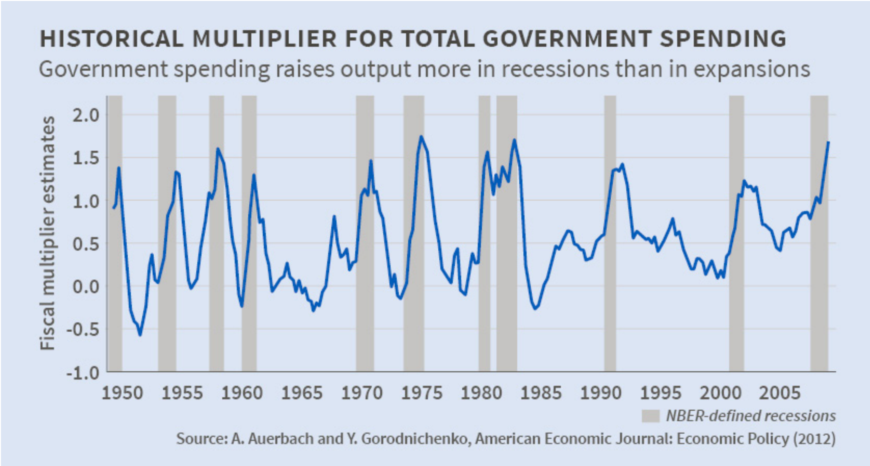
Table 1: Macro economic estimates

	Real GDP growth in %						Inflation in %					
	2015	2016	2017E	2018E	2017Δ	2018Δ	2015	2016	2017E	2018E	2017Δ	2018Δ
USA	2.9	1.5	2.2	2.5	0.0	0.0	0.1	1.3	2.1	2.2	0.0	0.1
Euro area	2.0	1.8	2.2	2.2	-0.1	0.1	0.0	0.2	1.5	1.6	0.0	0.2
Germany	1.5	1.8	2.2	2.2	-0.1	0.0	0.2	0.5	1.8	1.7	0.1	0.0
France	1.0	1.1	1.5	1.6	-0.3	-0.2	0.0	0.2	1.0	1.0	0.0	-0.3
Italy	0.9	1.0	1.2	1.0	-0.3	-0.3	0.0	-0.1	1.2	1.5	-0.1	0.4
Spain	3.4	3.4	3.0	2.5	-0.1	0.0	-0.5	-0.2	2.0	1.8	0.0	0.4
United Kingdom	2.4	1.8	2.0	1.2	0.4	-0.3	0.0	0.7	3.0	2.6	0.3	0.0
Switzerland	1.2	1.5	0.8	1.5	-0.1	-0.4	-1.1	-0.4	0.5	1.0	0.0	0.3
Japan	1.2	0.8	1.5	1.0	0.0	-0.3	0.8	-0.1	0.5	0.8	0.1	0.0
Brasil	-3.8	-3.3	0.5	1.5	-0.3	-0.9	9.0	8.7	3.5	4.5	0.4	0.5
China	6.9	6.7	6.5	6.5	-0.3	0.1	1.4	2.0	1.5	2.0	-0.1	-0.1
India	8.0	7.5	6.0	7.5	-0.8	0.0	4.9	4.9	3.0	4.0	-0.5	-0.6
Russia	-2.8	-0.7	2.0	2.0	0.3	0.2	15.5	7.1	4.0	4.0	0.4	-0.1
World (PPP)	2.7	2.5	3.0	3.1	-	-	2.8	2.8	2.5	2.5	-	-

E Estimates Wellershoff & Partners Δ Deviation from consensus economic forecasts

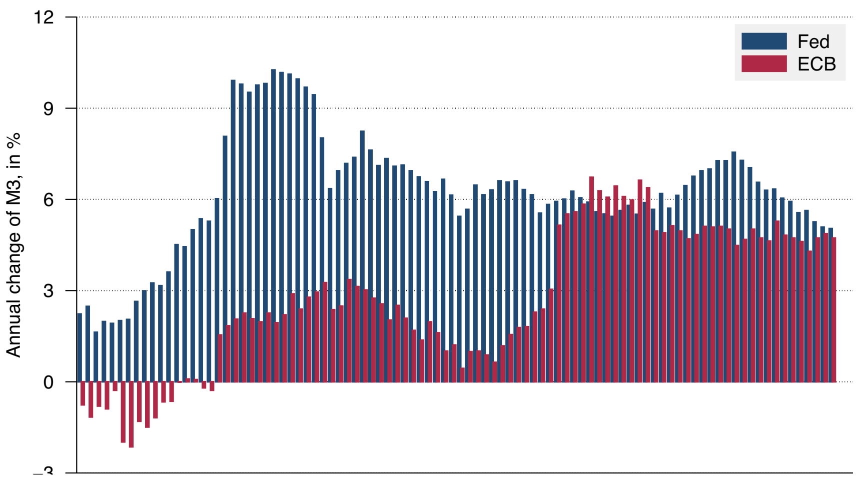
Source: Consensus Economics, Thomson Reuters Datastream, Wellershoff & Partners

Fig. 2: Fiscal multipliers have limited power in boom times



Empirical research suggests that fiscal multipliers are much less powerful or even negative in periods of economic expansion than in recessions. The magnitude of their impact also depends on how serious the recession is. With US tax reform coming into effect in 2018 and a still favourable US economic outlook, the economic impact of the reform, at least in the near term, will probably be muted. Source: http://www.nber.org/reporter/2015number2/auerbach.html.

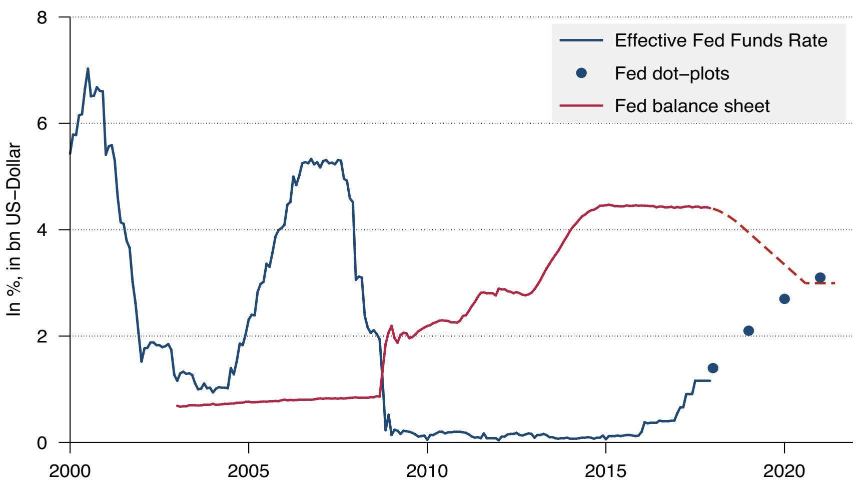
Fig. 3: Money supply keeps growing, faster than GDP



Source: ECB, Federal Reserve, Thomson Reuters Datastream, Wellershoff & Partners

The money supply in the US and the Eurozone is currently growing at a similar, rapid pace but the US Fed has already implemented a more restrictive monetary policy, as illustrated in this graph. The ECB will reduce the volume of its quantitative easing program from 60 to 30 billion euros per month, starting January 2018. It will thus still operate in an expansionary mode. The money supply has grown faster than nominal GDP, indicating that liquidity is expanding, too. If invested in assets, this drives up asset prices, as we are currently observing.

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



Source: Federal Reserve, PWT, Thomson Reuters Datastream, Wellershoff & Partners

The Fed is ahead of the ECB in exiting its quantitative easing programme. However, the Fed's strategy extends over a very long time horizon. Given its exceptionally loose monetary policies, a downturn or a recession in the coming quarters may require the Fed to return to unconventional measures like quantitative easing. The Fed's next chair, Jerome Powell, seems committed to this path.

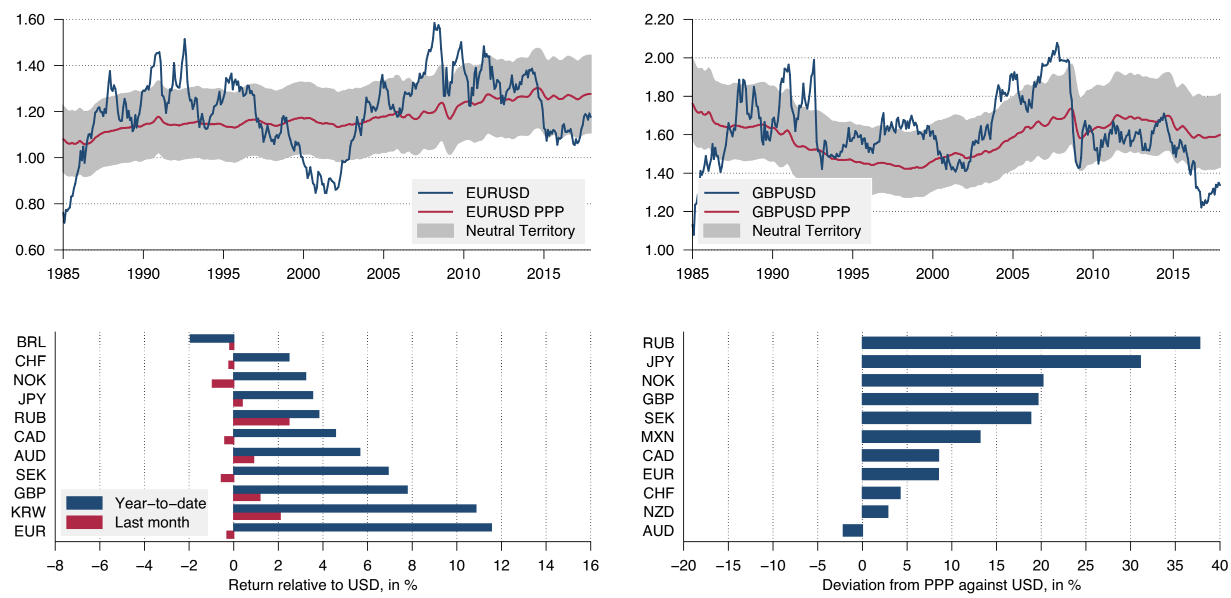
Central banks start tapering

Indeed, the central banks of the major economies have already started gradually normalizing their respective monetary policies. Amidst the stable economic prospects, the ECB is trimming its quantitative easing programme in 2018, reducing monthly bond purchases to 30 billion euros, and leaving interest rates at zero at least until September 2018. Thus, the ECB remains committed to providing substantial growth stimulus to the Eurozone economies. It surely does not want to choke off the recovery prematurely. At the same time, the Fed has already embarked on a programme of raising interest rates, delivering a third hike, by 25 basis points to 1.25 to 1.5 percent, at its December meeting. We expect no major changes in the direction of monetary policy under the next chair, Jerome Powell, but since the Fed has four vacancies to fill, starting in February, President Trump can exert considerable influence on the Fed's policies over the next decade and more. The challenges facing the new members of the Fed and the president are daunting. Obviously, with growth rates well above trend and inflation rates that may pick up at any time, central banks may come under pressure to act more quickly than they may have planned, and also to employ more unconventional policy tools. The loose monetary policies of recent years, we note, have also created substantial risks in financial markets. All these developments are having an effect on currency markets, and particularly on the EURUSD exchange rate. As the ECB has more scope for reduced money supply than the Fed does, the euro still has more room to appreciate against the US dollar over the medium and longer term. Furthermore, we expect that fiscal stimulus may allow the US dollar to appreciate but only temporarily.

Meanwhile in China

Things look rather less upbeat in the emerging markets generally, where economic growth has subdued. Brazil and Russia are still suffering from lower commodity prices, and economic growth has just begun to stabilize there. China's economy is growing slightly below trend, but the People's Bank of China has recently raised interest rates by five basis points, following the latest Fed rate hike. The PBoC's decision, however, is in line with its announced intention to reduce the level of private debt in China, which has reached the disturbing level of over 200 percent of GDP. So far, the central bank seems to have succeeded, as private debt in China has barely risen recently.

Fig. 5: FX performance and valuations



PPP estimates based on producer price indices

Source: Thomson Reuters Datastream, Wellershoff & Partners

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