

Quarterly Macro Report

3rd Quarter 2018

Even though forward-looking indicators for the industrialized countries still point to an acceleration of growth, the outlook for the global economy has deteriorated slightly in recent months, partly due to waning business sentiment.

After a two-year period during which the Eurozone grew faster than the US, recent data from Europe has been somewhat disappointing. The year-over-year GDP growth rate has slowed from the 2.8 percent recorded in the second half of 2017 to 2.5 percent in Q1 2018. Developments in the labor market remain positive. At 8.5 percent, the Eurozone's unemployment rate is already 1 percentage point below its historical average. This should have a positive effect in the medium term, as employment and wage growth should support European consumption. The outlook for investment also looks positive, although business sentiment has grown slightly less optimistic in recent months. What exactly triggered this dampening in sentiment is difficult to identify. Possible causes include the growing trade tensions with the US and perhaps the renewed political flare-up in Italy.

Italy back on the radar

We had not expected to revisit the question of the survival of the euro so soon after the last crisis. Yet between mid-April and the end of May, Italian yields spiked and the euro slipped from 1.24 to 1.15 against the US dollar.

However, the majority of Italians are not yet at the point where they want to exchange their euros for lira. As long as the Italian government wants to stay in the Eurozone, we expect the EU's politicians and institutions – not least, the European Central Bank (ECB) – to find a way to keep Italy in the fold. In the past, with each crisis, the single currency's rulebook has always been “updated” and we expect the same to happen again.

Nevertheless, the potential for financial markets to be concerned about the further weakening of business confidence in Europe is both real and significant. The

Fig. 1: Forward-looking sentiment indicators continue to signal strong global growth



The optimism that prevailed at the beginning of the year that global economic growth rates might accelerate to 5 percent or more has been trimmed back. Despite this slight set back, however, sentiment still indicates that the world economy should grow favourably in the short term.

Source: Thomson Reuters Datastream, Wellershoff & Partners

new Italian government says it wants to take a different course on a range of issues, including fiscal policy.

But rather than reacting to each headline like viewers at a tennis match, we would advise investors to monitor the potential for risks to grow and to revise their views according to changes in sentiment data on investment and business confidence – given the strong connection these factors have to GDP development. After all, recent years have often shown how little influence political noise actually has on the economy in the short and medium term. For example, despite all the unorthodox statements and policies emerging from the Trump administration or the Brexit decision, their actual impact on the global economy is not yet easy to identify.

Supportive US near-term growth outlook

Developments in the US partly outweigh the lackluster economic news from Europe. With a Q1 quarterly growth rate of 0.5 percent and 2.8 percent annually, the US economy has resumed growing faster than the Eurozone's. The dip in US business sentiment seems to have come to a stop, which is also supportive for the US economy. As a result, it is likely that growth in America should accelerate slightly over the summer.

While investment is currently very strong, due to the sharp increase in corporate profits, we do worry a bit about US consumers. The growth contribution that private consumption makes to GDP weakened in the first quarter. The culprit: the household savings rate has fallen below 3 percent. The rising price of oil has not helped household budgets either. As in Europe, higher energy prices have set inflation rates on an upward course. With the Consumer Price Index rising by 2.8 percent in the US and 1.9 percent in the Eurozone year-over-year, we think it likely that the normalization of monetary policy in the major industrial nations should continue in the coming months.

Trade now at risk

The Trump administration's increasing focus on trade policy has become a lot more worrying recently. While the tariffs imposed so far have had no noticeable impact on the economy, another round of escalation could be problematic. For example, an increase in the price of automobiles would hit end-users more directly than the increase in the price of the primary products aluminum and steel. But matters would be graver still if trade-restricting measures and countermeasures were to erode business and consumer sentiment. Then in-

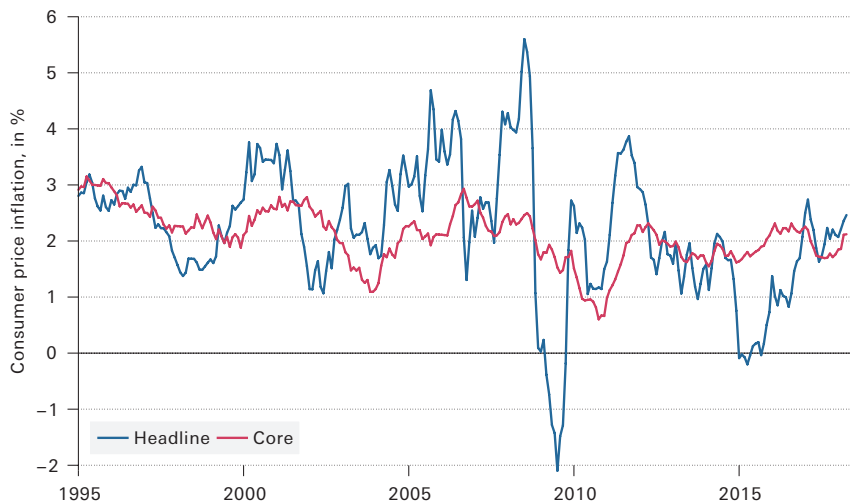
Table 1: Macro economic estimates

	Real GDP growth in %						Inflation in %					
	2016	2017	2018E	2019E	2018Δ	2019Δ	2016	2017	2018E	2019E	2018Δ	2018Δ
USA	1.5	2.3	2.7	2.1	-0.1	-0.5	1.3	2.1	2.5	2.8	0.0	0.1
Euro area	1.8	2.5	2.4	1.4	0.0	-0.5	0.2	1.5	1.6	1.8	0.1	-0.1
Germany	1.9	2.5	2.5	1.4	0.2	-0.4	0.5	1.7	1.7	1.9	-0.0	0.0
France	1.1	2.0	1.9	1.3	-0.0	-0.5	0.2	1.0	1.6	1.8	0.1	0.1
Italy	1.0	1.5	1.3	0.8	-0.2	-0.4	-0.1	1.2	1.0	1.4	-0.1	0.1
Spain	3.3	3.1	2.8	1.6	0.1	-0.7	-0.2	2.0	1.6	1.9	0.1	-0.1
United Kingdom	1.9	1.7	1.4	1.8	0.0	0.3	0.7	2.7	2.3	2.1	-0.2	-0.1
Switzerland	1.4	1.1	2.4	1.8	0.2	0.0	-0.4	0.5	1.0	1.0	0.2	-0.0
Japan	1.0	1.6	1.4	1.1	0.1	-0.0	-0.1	0.5	0.8	1.0	-0.2	-0.1
Brazil	-3.5	1.0	1.8	1.8	-0.8	-1.0	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	7.9	7.5	2.0	0.7	4.9	3.3	4.0	4.7	0.3	-0.2
Russia	-0.2	-	1.5	1.0	-0.4	-0.8	7.1	3.7	4.2	4.2	0.1	0.1
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

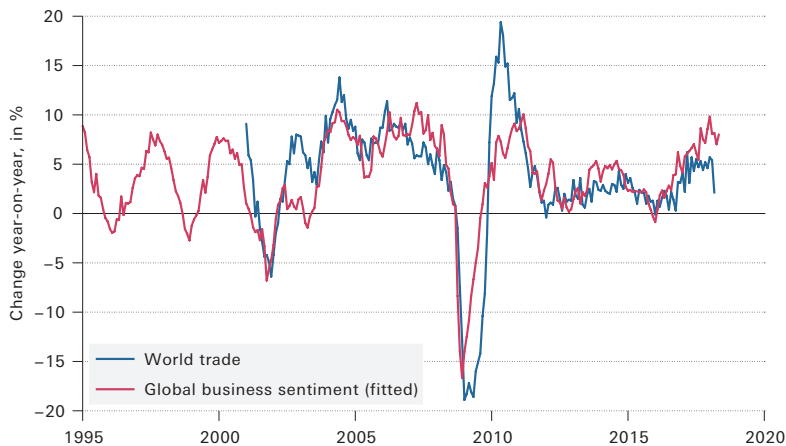
Source: Consensus Economics, Thomson Reuters Datastream, Wellershoff & Partners

Fig. 2: Inflation finally picking up



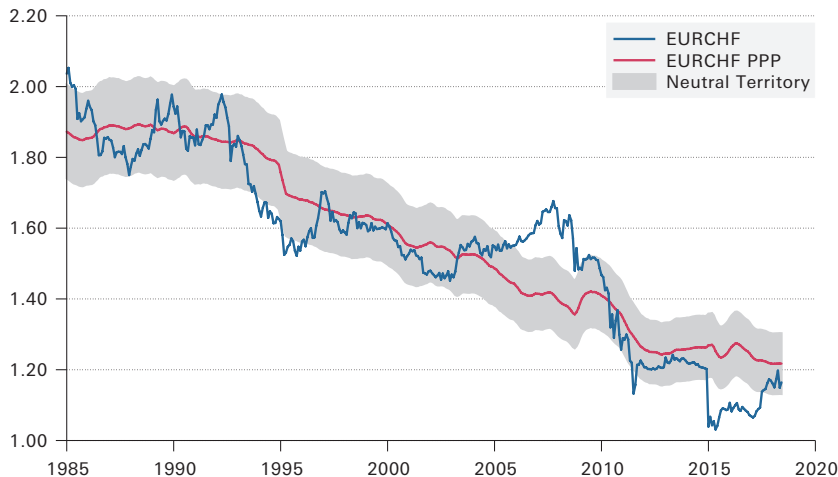
The US Federal Reserve should be pleased that both headline and core inflation are now around its 2 percent target, supporting the “normalization” of interest rates.

Fig. 3: World trade shows unexpected weakness



Global trade data indicates growth rates have slowed significantly in recent weeks. But this also likely reflects weakness in several important emerging markets.

Fig. 4: Swiss franc displays safe-haven characteristics again



EURCHF has shown more haven-related volatility in recent months. Whenever the fundamentals reassert themselves, however, we would expect the Swiss franc to move in the direction of its EURCHF purchasing power parity of around 1.22.

Source: Thomson Reuters Datastream, Wellershoff & Partners

vestment and consumption would indeed be threatened by a slowdown, and not only in the US.

Flagging emerging market momentum

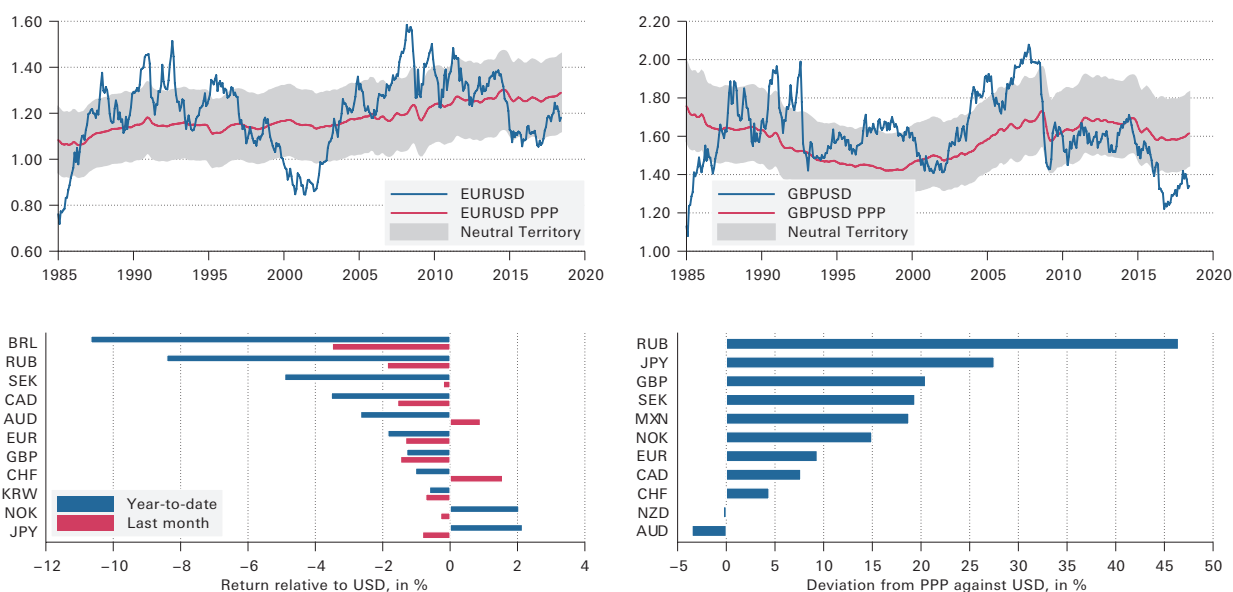
The larger emerging market economies are on different growth trajectories. While India continues to grow dynamically, there are increasing signs that the government is vital to keeping economic growth on track in China. Industrial production in China is currently growing in the range of 3 to 4 percent, the slowest pace ever since this statistic has been tracked. Although the government should be able to keep growth above 6 percent over the medium term, this will not be enough to provide any boost to the growth momentum of the rest of the emerging economies.

The situations in Turkey, Russia and – once again – Brazil remain a concern. The recent losses of confidence in their respective governments are also evident in the poor performance of their currencies against the US dollar. FX weakness in several emerging market countries has caused their currencies to fade further against the dollar in terms of purchasing power. This in turn opens up opportunities for more adventurous investors. In any case, we think higher volatility is likely against the backdrop of further Fed interest rate hikes.

EURCHF shows more haven-related volatility

During the recent weakness of the euro against the US dollar, in response to political turmoil in Italy, the Swiss franc appreciated also against the euro, reflecting its well-known safe-haven characteristics. If the Swiss National Bank stays on the sidelines, we expect uncertainty about Italy’s political situation to continue fomenting volatility in EURCHF. But whenever the fundamentals reassert themselves, we would expect the Swiss franc to make its way back toward its EURCHF purchasing power parity, which we currently estimate to hover around 1.22.

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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