

Quarterly Macro Report

4th Quarter 2018

While financial markets have recently been impacted by headlines around trade conflicts, Brexit, polarising politics, and the sharp fall of some emerging market currencies, the macro data continue to show above-trend growth in the US. The emerging markets, despite some obvious exceptions, are at or above trend growth.

We continue to see a strong US economy across a range of measures, including inflation. Our leading GDP indicator (see Fig. 1) suggests GDP growth in the region of 4 per cent, double the US economy's long-term growth trend. Unsurprisingly, the unemployment rate has declined from 4.4 per cent a year ago to 3.9 per cent. We are seeing the impact of this boom on the prices of goods and services. The US Federal Reserve's inflation objective, a core PCE of 2 per cent ("symmetrically"), has reached its reference point three times this year. Other measures of inflation are already higher. PCE inflation stood at 2.3 per cent in August, compared to 1.5 per cent a year ago. Core CPI currently stands at 2.4 per cent year-on-year, while the headline CPI number was 2.9. Clearly, members of the Fed no longer need to lie awake at night worrying about "deflation".

With its growth cylinders firing above long-term potential, US workers are being paid more. Average annual earnings are running at 2.9 per cent – the highest level of increase since summer 2009. Bear in mind, though, that a wage increase of 2.9 per cent minus a headline CPI number of 2.9 per cent equals zero. This means that real earnings are only just keeping up with inflation – even with a nominal increase of 2.9 per cent.

Against this background, US monetary policy continues to be accommodative. A Federal Funds target rate of 1.75 – 2.00 per cent means that the US central bank's reference rate continues to be negative in real terms and monetary policy thus remains loose. An interest rate in the 2 to 3 per cent range would be needed merely to compensate for current inflation. This is why markets expect the US Federal Reserve to continue rais-

Fig. 1: Growth outlook for the US continues to be favourable



The survey-based W&P Economic Sentiment Indicator for the US economy (the red line) shows fluctuation at a high level in recent quarters, and implies continued strong GDP growth over the next quarter. 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

ing interest rates, even though Trump has tweeted that he is not happy with higher rates.

The impact of oil, Turkey, Argentina and Brexit

While the economic recovery since the start of the financial crisis has been very slow to arrive, the current phase of the cycle has shown itself to be remarkably robust. There have been some potentially toxic headlines to digest along the way — sharp oil price fluctuations, Brexit uncertainties, trade disputes. But the real economy has hardly been disturbed by these bumps in the road.

Currently, it is turbulence in some individual emerging market countries that has been causing concern, particularly in Turkey and Argentina. What is the impact of these troubling stories on the global economy? The developed economies have so far simply shrugged them off. Economic indicators for the developed world continue to point to solid growth ahead. Given that the economic output of Argentina and Turkey account for less than 3 per cent of global output collectively, their overall economic importance to global growth is relatively minor.

Any regional impact from Turkey's woes on Europe is also low. As a market for German exports, for example, Turkey is only ranked 16th. And the outstanding

debts of Turkish companies and banks are small compared to the European banking system. That said, it cannot be ruled out that Turkey's economic problems could have a noticeable impact on profitability for certain individual banks. From a broader market perspective, however, these are not large amounts.

The importance of Argentina for Latin America, however, is significantly greater. Argentina is the second-largest economy in the region. There are several countries that are in danger of being infected by insecurity stemming from Argentina's woes, including Brazil, which is currently struggling with weak growth and volatile politics.

Brexit weighs on Sterling

The value of Sterling against the US dollar and its purchasing power parity can be seen in Figure 5. It can clearly be seen that, since the Brexit referendum, the pound has become markedly undervalued relative to its purchasing power parity rate. The most recent political uncertainties have reinforced this weakness.

The negotiations about Britain's exit from the EU are entering their decisive phase. The negative effects of a hard Brexit are becoming clearer and should continue to weigh on the pound unless that option is re-

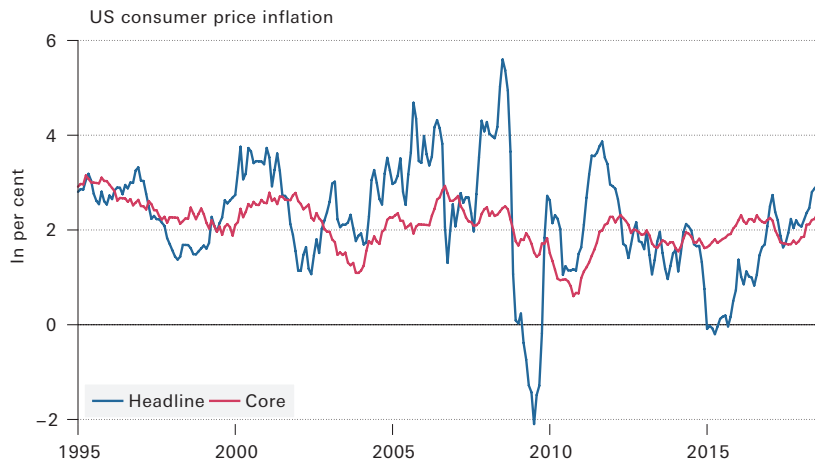
Table 1: Macro economic estimates

	Real GDP growth in %						Inflation in %					
	2016	2017	2018E	2019E	2018Δ	2019Δ	2016	2017	2018E	2019E	2018Δ	2018Δ
USA	1.6	2.2	2.9	2.3	0.0	-0.3	1.3	2.1	2.7	2.5	0.2	0.3
Euro area	1.8	2.5	2.0	1.4	-0.1	-0.4	0.2	1.5	1.8	1.9	0.1	0.3
Germany	1.9	2.5	2.1	1.7	0.1	0.0	0.5	1.7	1.9	1.8	0.0	-0.1
France	1.1	2.3	1.6	1.3	-0.1	-0.4	0.2	1.0	2.0	2.0	0.1	0.4
Italy	1.0	1.6	1.2	0.9	0.0	-0.2	-0.1	1.2	1.3	1.7	0.0	0.3
Spain	3.3	3.1	2.9	1.7	0.2	-0.6	-0.2	2.0	1.8	2.0	0.0	0.3
United Kingdom	1.8	1.7	1.3	1.3	0.0	-0.2	0.6	2.7	2.5	2.3	0.1	0.2
Switzerland	1.4	1.1	3.0	2.0	0.8	0.3	-0.4	0.5	1.1	1.2	0.1	0.2
Japan	1.0	1.7	1.1	0.9	0.0	-0.3	-0.1	0.5	1.0	1.0	0.1	-0.1
Brazil	-3.5	1.0	0.8	1.3	-1.0	-1.2	8.7	3.4	3.6	4.5	0.1	0.3
China	6.7	6.9	6.6	6.0	0.0	-0.4	0.6	-0.5	2.3	2.4	-0.2	-0.2
India	7.1	6.6	7.6	7.4	0.3	-0.1	4.9	3.3	4.6	5.0	-0.4	0.0
Russia	-0.2	1.5	1.5	1.0	-0.2	-0.5	7.1	3.7	2.7	3.5	-0.1	-0.2
World (PPP)	3.2	3.7	3.8	3.6	-0.1	-0.3	2.8	3.0	3.6	3.5	0.1	0.1

E Estimates Wellershoff & Partners Δ Deviation from consensus economic forecasts

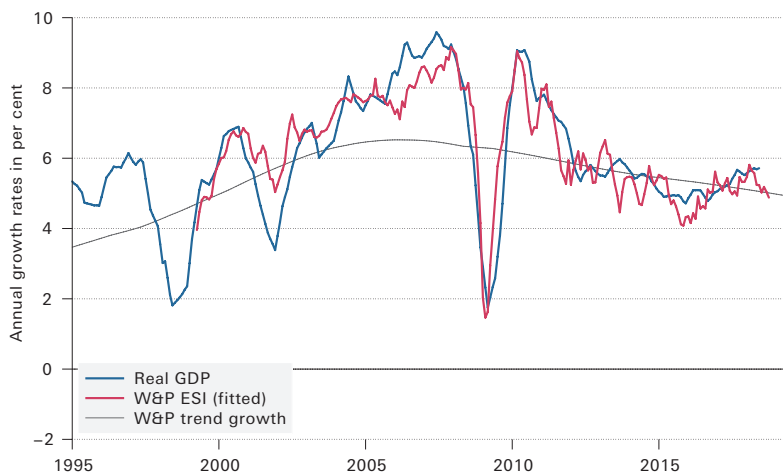
Source: Consensus Economics, Thomson Reuters Datastream, Wellershoff & Partners

Fig. 2: Prices on the rise in the US



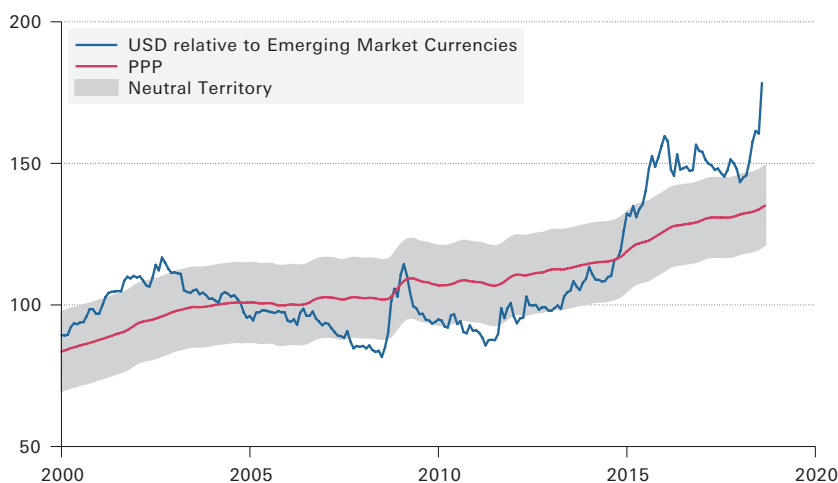
The US Fed’s preferred inflation target is 2 per cent for “core PCE”. This number was reached three times so far this year. Another measure, the core CPI number, is now at its highest level in ten years with 2.4 per cent, and the headline CPI rate stood at 2.9 per cent, the highest since early 2012.

Fig. 3: Emerging markets slightly weaker



Unlike the US, the forward-looking growth indicators for the emerging markets (the red line) suggest trend growth (the grey line), which points to GDP growth that is somewhat slower than recently recorded (the blue line).

Fig. 4: Emerging market currencies at historic levels of undervaluation



The undervaluation gap for a diversified basket of emerging market currencies against the US dollar stood at around 44 per cent in August 2018 (based on monthly data). By historical standards, this is an extreme level of undervaluation.

Source: Thomson Reuters Datastream, Wellershoff & Partners

versed or moderated, which still seems possible. The collateral damage for Europe is above all cyclical. But more is at stake for Switzerland.

Economically, a hard Brexit would also be a setback for the Eurozone. Cyclically, we would have to expect a damper in the economies closely intertwined with the UK, namely Germany, Belgium and the Netherlands. Structurally, however, the euro could even gain in stability, because it would be clear what disadvantages a withdrawal from the EU could have. For Switzerland, too, much depends on the outcome of the Brexit process. The direct political impact will affect the political calculus as to what kind of special arrangement Switzerland could obtain from the EU. Indirectly, Brexit might already be having an impact today because the franc, which has strengthened in parallel with the weakness of sterling, could further delay a normalisation of the SNB's monetary policy.

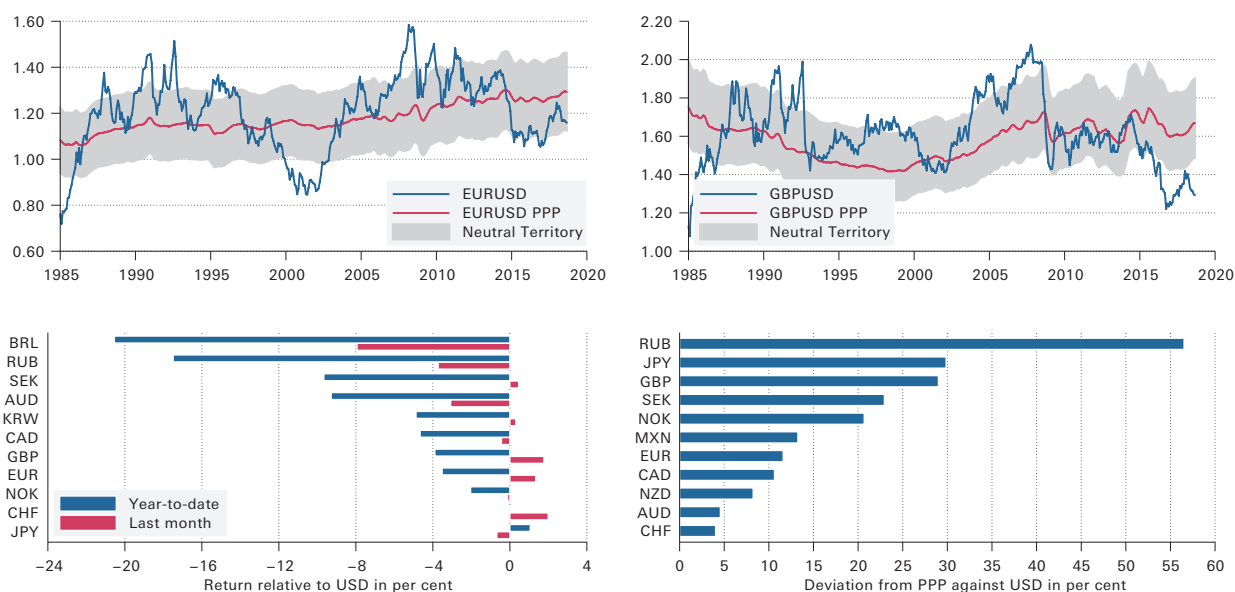
Emerging market currencies and spillovers

As can be seen from Figure 4, a diversified basket of emerging currencies is currently at its most extreme levels of undervaluation, relative to purchasing power parity, since the start of the century. The valuation gap against the US dollar and the Swiss franc for this diver-

sified basket stood at around 44 per cent in August 2018, 30 per cent against the euro and 15 per cent against a weak British pound. Emerging market currencies are weak across the board, therefore. This weakness also happened relatively quickly. In January of this year, the gap still stood at 11 per cent against the US dollar.

However, even though notable exceptions such as Turkey and Argentina are currently struggling, most emerging markets remain at or above trend growth. Sentiment is slightly lower than actual GDP and economic confidence in the advanced economies, but the fact remains that most emerging economies are in a better shape today than they were towards the beginning of the century. For example, the vast majority of them are no longer dependent on foreign capital and in fact export their own. In our view, the current situation in EM financial markets is driven more by market sentiment than economic fundamentals. Currencies do not keep drifting away from their underlying value forever. At some point the currencies become so cheap that physical arbitrage becomes possible. The current valuation gap offers investors an opportunity.

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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