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ECONOMY

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Global Economy
Steve Barrow

Moving Forward™

Global outlook in 2017

A year of volatility in financial markets

2017 looks to be a year in which growth risks are skewed to the high side, not the low side. But, a better global growth outlook comes tinged with heightened political risk. This comes not only from ramifications of last year's shocks, such as Trump's election victory in the US and the Brexit decision in the UK, but also from a spate of elections in the euro zone. If nothing else, it looks set to be a year of volatility in financial markets.

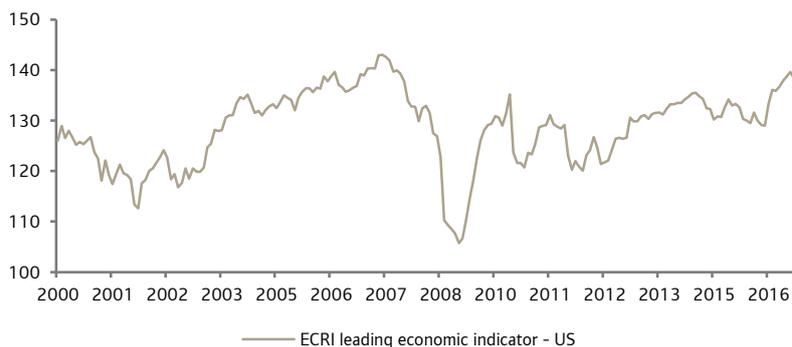
It seems fair to say that Trump's shock election victory last November has galvanised the corporate sector

Solid basis

We look for global growth this year to be in the 3.5%-4.0% range, compared to last year's likely outcome of between 3% and 3.5%. It's not a huge step up, and many will claim that major economies are still mired in a secular stagnation stranglehold. But momentum seems to be improving, with much of this coming from the US. It seems fair to say that Trump's shock election victory last November has galvanised the corporate sector, no doubt spurred on by the prospect of a twenty percentage point cut in the corporate tax rate. Many have compared Trump's fiscal strategy as similar to that of Ronald Reagan in the 1980s. We think that there's some truth to this. The key is whether fiscal action and an 'America first' stance will re-awaken the dormant animal spirits within firms that seem to have been asleep in the US (and much of the rest of the developed world). The initial signs seem good, with many leading indicators pushing ahead strongly (Figure 1).

Our growth forecast of 2.7% for the US this year lies above the FOMC's median 2.1% call and the 2.2% rate that forms the Bloomberg consensus of near 70 analysts

Figure 1: Reawakening animal spirits



Source: Economic Cycle Research Institute

While it's very plausible that this optimism could fizzle out quickly, we are more hopeful that it will not. Hence, our growth forecast of 2.7% for the US this year lies above the FOMC's median 2.1% call and the 2.2% rate that forms the Bloomberg consensus of near 70 analysts.

We believe that global growth will improve this year

Ordinarily we might argue that faster US growth will help pull others up given the US's role as the great global consumer. But the Trump administration's focus on trade deficit reduction could weaken the link between US growth and that of the rest of the world, especially those that export heavily to the US, such as China and Mexico. But, even taking this risk into account, we believe that global growth can improve this year, helped by signs of better momentum in the Eurozone, China and commodity-producing emerging-market economies.

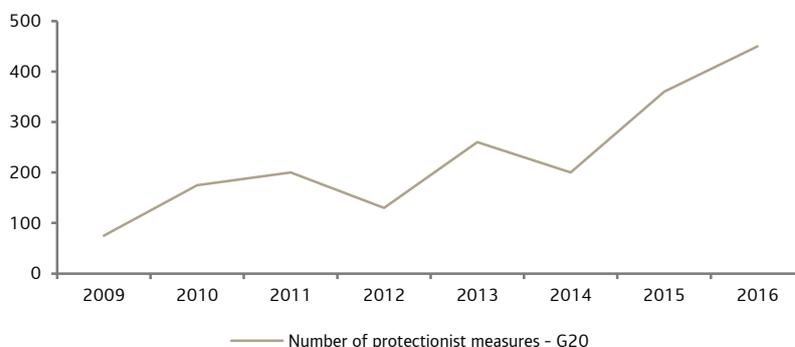
Political outlook a lot darker

Political risks

While the economic outlook might have brightened, there are some aspects of the political outlook that have grown a lot darker. For a start, there are the ramifications of some of the shock outcomes we saw last year such as the US election, the UK Brexit vote and the failure of the constitutional reform referendum in Italy. We've mentioned that the incoming Trump administration may have many positive effects on the

economy stemming from things such as tax cuts and regulatory reforms. But there could be some very damaging changes as well, such as the imposition of punitive tariffs on large exporters to the US. Well before Trump was elected the global tide had turned towards a more nationalist agenda, with protectionist policies on the rise and global trade on the wane (Figure 2).

Figure 2: Rising protectionist policies



Source: Global Trade Alert

Even if the overall economic ramifications of the shock outcomes of Brexit and Trump prove benign, they certainly seem to create the prospect of much greater financial market volatility

Trump tapped into this mood, as did the Brexiteers in the UK who successfully engineered an EU withdrawal decision from the electorate in the June referendum. Starting this year, those who voted for Trump and Brexit – and those that did not – will face the consequences of these decisions. Even if the overall economic ramifications of these shock outcomes prove benign, they certainly seem to create the prospect of much greater financial market volatility as the winners reveal their plans.

There is also the risk that the nationalism, protectionism and populism that caused upset in the US and UK could do likewise in the euro zone this year. National elections take place in the Netherlands in March, in France in April and May, in Germany in September or October and, most likely Italy sometime in the summer. Trump claimed before the election that his victory would be a “Brexit times ten” event. We’d argue that a similar shock in France, for instance, could prove a ‘Trump times ten’ shock for Europe as it would throw into doubt, once again, the longevity of the euro zone project. We don’t anticipate such a shock in France or any of the other countries holding elections this year. But after the Brexiteers and then Trump defied the odds – and all the predictions – last year, it would be foolhardy to hold views about euro zone election outcomes with any sort of confidence. Opinion polls suggest that there won’t be upsets in the Netherlands, France and Germany – but polls have been wrong before.

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The crucial question is whether the better global growth outlook will be knocked off course by the ramifications of last year’s shocks in the US and UK and the elections to come in Europe. We think the answer is ‘no’ but discovering the answer to these questions could lead to significant amounts of financial market volatility through the year. And if this volatility becomes sufficiently intense and disruptive, it will surely undo any good work that might have been done by recent political shocks and any that might occur in the future.

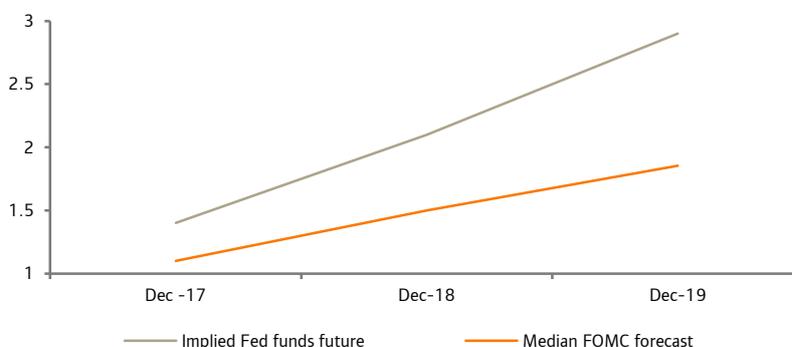
Fed to deliver

For policymakers, navigating this maze of economic and political risks will be a big challenge

For policymakers, navigating this maze of economic and political risks will be a big challenge. Nowhere is this greater than in the US given that the Trump administration could unleash significant fiscal expansion when the economy is already close to – or at – full employment. FOMC members took this risk on board at the last meeting in December not just by lifting the fed funds target range another 25 bps to 0.5% – 0.75% but also by forecasting more rate hikes next year (three) than previously (two). The money market and bond market in the US responded to Trump’s victory in a similar sort of manner but, as is customary, financial markets continue to price in a more benign

monetary tightening cycle than the median FOMC forecast envisages (Figure 3). In our view the likely outcome this year will be a rate-hike profile that is closer to the FOMC's view than that of the market. This being said, it seems unlikely that the Fed will rush the rate hikes through early in 2017 as it, like everybody else, will need more clarity on the budget outlook. Hence, we think that the rate hikes won't start until the June meeting.

Figure 3: FOMC still well ahead of the market



Source: Federal Reserve, Reuters

Other central banks in major developed nations are still some considerable way behind the Fed in the monetary policy cycle. Indeed, it is somewhat ironic that consistent calls from the likes of G20 for countries to engage in fiscal easing to lift growth have only really been answered by the one country – the US – that no longer seems to need such action. Countries with the fiscal room – and need – to ease, such as Germany, remain steadfast in their opposition. Only Canada has embraced the fiscal easing strategy with the same gusto that the new US administration is promising. The result is that the burden of economic support outside of North America still lies with the central banks in places where fiscal policy remains stymied such as Japan and the euro zone. And the upshot of this is that their central banks will have to continue to supply significant monetary accommodation. The ECB is already locked into a year-long program of quantitative easing, while the BoJ is committed to holding the 10-year JGB yield close to zero. It might be the case that neither central bank has to add any more monetary accommodation than this but recent talk that the ECB, for instance, might need to cut short its bond-buying plan because of rising inflation seems very premature.

Bond cycle turning?

The prospect of easier fiscal policy in the US and a faster pace of Fed tightening have only served to feed the view that the long-running bull market in government bonds has come to an end. However, it would be wrong to put such a sentiment shift down to the outcome of the US election alone. Bond yields in the UK have risen dramatically following the Brexit vote last June, and yields in the euro zone have moved higher as well on issues such as rising inflation and political risks. Only Japan of the major nations has been able to buck the trend of rising long-term yields but this has been done by the Bank of Japan adjusting its JGB purchases to keep 10-year JGB yields close to zero. This policy effectively relinquishes control of the BoJ's balance sheet and, in our view, that's always a dangerous thing to do, just as the Swiss National Bank found out when it tried to stop euro/Swiss from falling below the 1.20 level. In the end that policy had to be abandoned, such were the pressures on the balance sheet, and the BoJ could experience similar problems if international yields soar and the BoJ does not lift the 10-year JGB target. We suspect that the BoJ will be reticent to lift the JGB target rate, not least because it would signal monetary tightening at a time when the inflation rate is still a long way below the 2% target.

The BoJ's success in holding its zero percent 10-year JGB target will be heavily dependent on the movement in treasury yields. If these continue to rise significantly, the pressure to adjust the JGB target or abandon the yield curve control policy will

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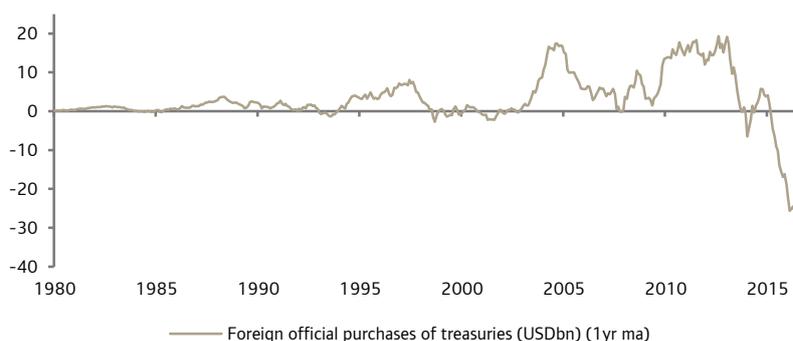
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Better growth, higher inflation, fiscal easing and tighter Fed policy should all lift US yields and so exert a 'pull' factor on yields internationally even if, as we suspect, yield increases in the US outpace other major nations

probably become overwhelming. We suspect that treasury yields will continue to rise, with 10-year yields set to move into a 3.0%-3.5% range late in the year. This presupposes that growth will be robust, inflation rises to, or above, the 2% target for PCE prices, and that President Trump will make good on his promises to cut certain taxes, like the corporate tax rate and deliver on spending increases, such as infrastructure. The rise in yields to date presumably reflects the anticipation of easier fiscal policy but if some estimates of the fiscal consequences of a Trump presidency are to be believed, such as the near USD6tr reduction in federal revenues over the next decade as suggested by the Tax Foundation, it seems unlikely that yields have risen enough. Of course there's a great deal of controversy about these estimates. Even the Tax Foundation's range of estimates is very wide at USD4.4tr – USD5.9tr. At the same time, leading Administration figures counter that huge changes to things like trade policy, energy policy and the regulatory environment will generate sufficient revenue to counterbalance the tax cuts and spending increases. However, it is fair to say that the mainstream view among economists and investors is one of scepticism towards any such 'fiscally neutral' claims.

Better growth, higher inflation, fiscal easing and tighter Fed policy should all lift US yields and so exert a 'pull' factor on yields internationally even if, as we suspect, yield increases in the US outpace other major nations. The rotation out of government bonds and into 'riskier' assets such as equities should be another factor in the equation as investors fear the end of the bull cycle in government bonds. Quite clearly there might be events in 2017 that force a return to the safety of the bond market and force yields back down again. A political upset in one of the many euro zone elections this year could generate such an outcome. A 'trade war' between the US and China could do the same although it is notable that China, amongst others, has been shedding treasuries for some time. Indeed the pace of net outflows from treasuries by overseas central banks has been remarkable (Figure 4). It might only be the flip-side of the currency intervention that China and others have had to do to limit FX weakness, but it does remove one pit-prop from the treasury market, and it does bring into question how foreign official investors will react should the Trump Administration start a trade war with China and others.

Figure 4: Falling fast



Source: Reuters datastream

Forex uncertainties

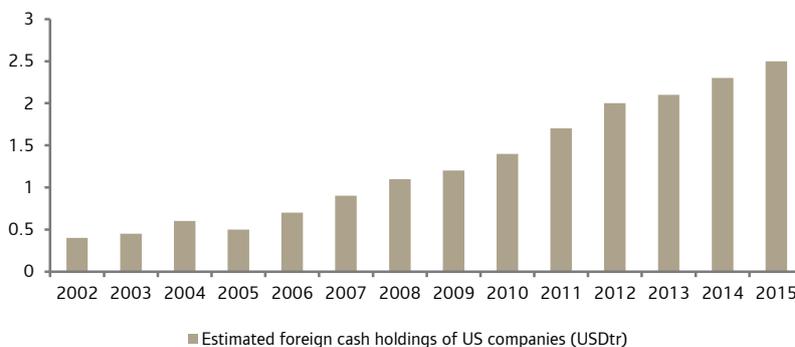
A number of factors will affect major currencies this year. The dollar will presumably be driven by the policy choices of the Trump administration and how the Fed chooses to respond. In Europe, politics will be the key, with the euro governed by the outcome of a number of national elections and the pound heavily influenced by the likely start of Brexit negotiations. In Asia, the yen will be driven largely by treasury yields given that the BoJ is holding the 10-year JGB yield close to zero and the treasury/JGB spread is a key factor determining the yen. However, there will be a secondary factor here as well, which will impact other Asian currencies as well, most notably the Chinese renminbi. It is the prospect of trade reprisals from the US. So, while we expect dollar/yen to press on

to 130 as treasury yields rise, local policymakers may have to lean against the wind of dollar strength, even if only verbally, to stop excessive yen weakness from making it onto the US Administration’s radar screen. The same goes for dollar/renminbi, which we expect to reach at least 7.30 in 2017.

Dollar strength against Asian currencies should be mirrored elsewhere, with euro/dollar, for instance, expected to fall to 95 cents. Stronger US growth, fiscal easing and faster monetary tightening are all part of this story

Dollar strength against Asian currencies should be mirrored elsewhere, with euro/dollar, for instance, expected to fall to 95 cents. Stronger US growth, fiscal easing and faster monetary tightening are all part of this story. There is one additional factor as well, which is the likelihood that the US Administration will reduce the tax rate on company profits that are repatriated to the US. Estimates suggest that US firms are holding around USD2.5tr of profits overseas (Figure 5). These have risen fivefold since President Bush Jnr invoked a similar tax holiday in 2005. Of course we can’t be certain that Trump will choose, or be able to see through this plan. We also can’t be sure that large numbers of firms will take up the offer. And, even if they do, much of the cash that’s parked overseas could be held in dollars and hence have no bearing on the greenback’s value if it is repatriated to the US. However, in spite of all these issues, we see a fair risk that this factor could aid the dollar; indeed, just the anticipation of its implementation could create speculative dollar purchases by investors.

Figure 5: The overseas cash pile keeps growing



Source: Standard Bank Research

The ‘strong dollar’ policy that’s effectively been in place since Robert Rubin became treasury secretary in 1995 might be ditched for something that’s more in keeping with the aim of trade deficit reduction

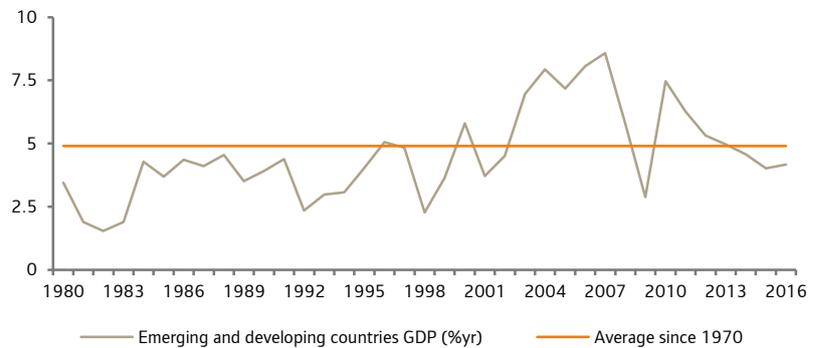
But, while the dollar might gain more strength in the early stages of the Trump presidency, we have to bear in mind that the new administration is vowing to reduce the trade deficit and a much stronger dollar could clearly frustrate this aim. The ‘strong dollar’ policy that’s effectively been in place since Robert Rubin became treasury secretary in 1995 might be ditched for something that’s more in keeping with the aim of trade deficit reduction. So, while the first 6 – 12 months of the Trump presidency could see the dollar’s trade-weighted value rise by 5% – 10%, we’d expect this entire rise, and more, to be reversed in time.

Emerging market recovery

A moderately stronger outlook for developed country growth should help growth in emerging and developing nations to move up into a 4.5% – 5.0% range this year from a likely 4.0% – 4.5% last year. Emerging economies have grown on average a bit below 5% per year since the early 70s, and hence this year should see a return to that average. But, as mentioned previously, it is possible that protectionist pressures weaken the link between developed country growth and that of developing nations. The most obvious sign of this is the wall across the Mexican border threatened by president Trump. But there are many other friction points between the US and other emerging market nations, especially China, as well as the wider rise in protectionist actions we described earlier. The headwinds for many emerging market countries also include a faster rate-hike cycle from the Fed as this could hurt those countries that have borrowed in dollars on an unhedged basis. Perhaps fortunately, many such borrowers have been warned by the likes of the IMF and BIS to temper their enthusiasm for cheap dollar funding, and

the message seems to have got through. With this in mind, we take a slightly more optimistic view of growth in emerging and developing nations this year.

Figure 6: Looking for improvement

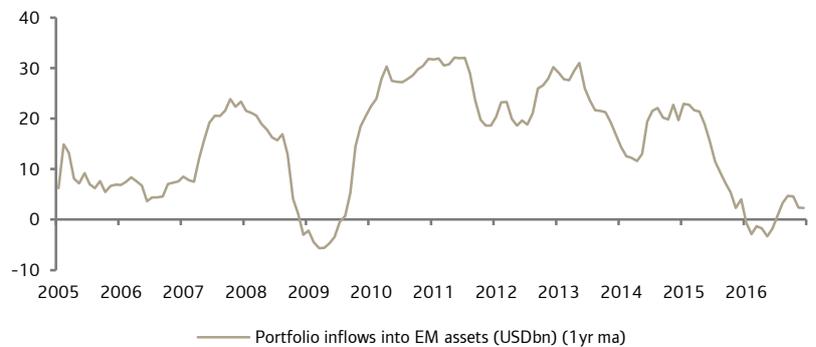


Source: IMF

Investor perceptions

The economic growth story might look a little brighter for emerging market nations; but, will global investors see this as sufficient to counterbalance the international political risks that have mushroomed in the past few months and the local political problems that still exist for many countries? Investment in emerging market bonds and stocks has been on a downslope for some time, with the fledgling recovery in inflows last year upended at least temporarily after the US presidential election. We suspect that global investors will remain cautious towards emerging market assets until the dust settles on the Trump presidency, at least with respect to the new administration’s relationship with key emerging market nations such as China and Russia.

Figure 7: Rebound over?



Source: Bloomberg

The Sino-US relations could well hold the key to not just China’s economic and financial market performance this year but also that of other emerging economies

The Sino-US relations could well hold the key to not just China’s economic and financial market performance this year but also that of other emerging economies. For instance, commodity prices have recovered nicely thanks, in part, to stronger demand from China and this has clearly helped commodity-producing emerging market countries. Undoubtedly it does seem as if some commodity prices may have overheated somewhat as a result, such as iron ore but, given our call for China’s growth this year to come in around the 6.5% mark, we anticipate that the country’s performance will act as a help to other EM nations, especially in the region, not a hindrance. But China’s economic performance could clearly be set back by some of the trade-related threats coming from the new US administration. President Trump bemoans the way China has allegedly manipulated its currency for competitive gain. That might have been a valid accusation in the past but at the moment the PBOC is working tirelessly to prevent renminbi weakness. China has shed a quarter of its reserves since the spring of 2014 and there’s no sign that this is about to stop. Indeed, sabre rattling from Washington could turn a

Needless to say, a trade/currency war of this type would decimate emerging market currencies and other assets. We doubt that it will come to this but the mere possibility of such a dire outcome could be sufficient to keep EM investors on the defensive

Economic growth is likely to be stronger overall, and past and future commodity price strength should prove beneficial for many

flood of capital outflows into a torrent as individuals and businesses fear trade restrictions from the US. We expect the renminbi to fall to the 7.30 region against the dollar this year but, if the flood becomes a torrent, this level will be surpassed substantially. Worse still, Beijing could retaliate by essentially giving the US what it wants: a freely floating renminbi, except that this would clearly produce dramatic currency weakness and not the strength that the Trump administration wants to see. Needless to say, a trade/currency war of this type would decimate emerging market currencies and other assets. We doubt that it will come to this but the mere possibility of such a dire outcome could be sufficient to keep EM investors on the defensive.

Glass half-full

There's no doubt that the performance of emerging market economies and their financial markets could be hindered by external events, rendering investors reticent to put cash to work in emerging market stocks and bonds. Three Fed rate hikes this year could pose a challenge, as that's quite a step up from the single hikes that we have seen in 2015 and 2016. Allied to this, rising inflation and the prospect of fiscal easing in the US should lift treasury yields still further, possibly eroding the carry-trade attraction of many emerging markets. There's also the threat of protectionism emanating from the US and political risks in Europe associated with the UK's Brexit decision and the raft of national elections in the euro zone.

And yet, for all these risks, we take a glass-half-full view of emerging markets. Economic growth is likely to be stronger overall, and past and future commodity price strength should prove beneficial for many. Also we should not forget that many emerging markets have been pulled through the wringer in recent times and could offer value now, or in the near future, for emerging market investors. Countries that come to mind here include the likes of Brazil, Russia and possibly Turkey in the future. Allied to this is the fact that global investors have been cautious when it comes to investment in emerging markets. It is very possible that likely fiscal changes in the US, such as corporate tax cuts, could help keep this developed-market bias for a little while longer. But eventually investment flows into emerging markets should recover more profoundly although, as we've mentioned, this does require a year in which the external risks listed previously prove benign, not malign.

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