Global Macro Views

“Sur-prise, sur-prise, sur-prise”

December 2017

By: The Standish Global Macro Committee
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World:

	2016	2017	Balance of Risks	2018	Balance of Risks
Real GDP Growth	2.9%	3.5%	–	3.5%	–
Inflation	6.0%	9.0%	–	8.3%	–

Source: Standish as of December 11, 2017.

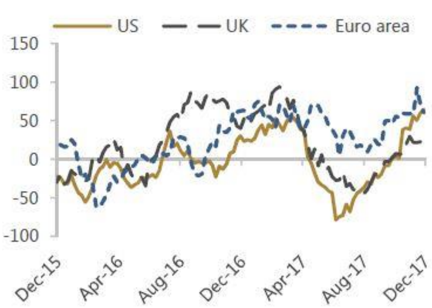
Developed Markets:

United States	2016	2017	Balance of Risks	2018	Balance of Risks
Real GDP Growth	1.6%	2.3%	–	2.5%	–
Inflation	1.3%	2.1%	–	2.3%	–

Source: Standish as of December 11, 2017

“Sur-prise, sur-prise, sur-prise” is what we learned from the incoming data for advanced economies over the past quarter. Unfortunately, only Jim Nabors, who died a few weeks ago, could deliver that message with the correct intonation. In his memory, we want to highlight three surprises across advanced economies. Data on output outstrips expectations, inflation continues to disappoint, and central bankers seem more worried about the former than the latter.

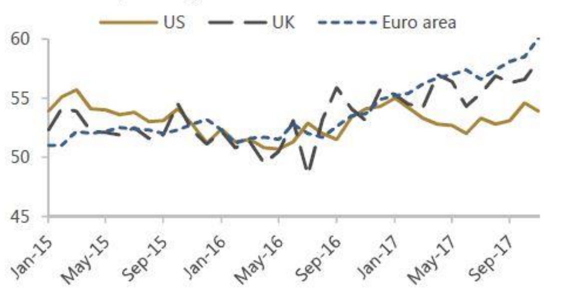
Economic Surpise Indexes



Source: Bloomberg, accessed 12/11/17

Manufacturing Purchasing Manager Intentions

diffusion index, unchanged = 50



Source: Market, via Bloomberg, accessed 12/11/17.

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↑ positive surprise more likely over next six months. ↓ negative surprise more likely over next six months – no bias
Inflation forecasts are yearly annual averages of headline CPI.

Another trademark of Nabors was a confounding transition from a squeaky soprano speaking voice to a rich baritone song delivery. That is how the US data on activity transformed, from posing an irritating and anemic worry to presenting reassuring and confident momentum. Oh, and Nabors' most famous song (after "Back home again in Indiana" to the Indianapolis 500) was "The Impossible Dream," which seems about to be achieved in Washington, D.C. Tax legislation will pass, and what the President will sign before Christmas has a higher component of reform than might expected in the first year of an administration.

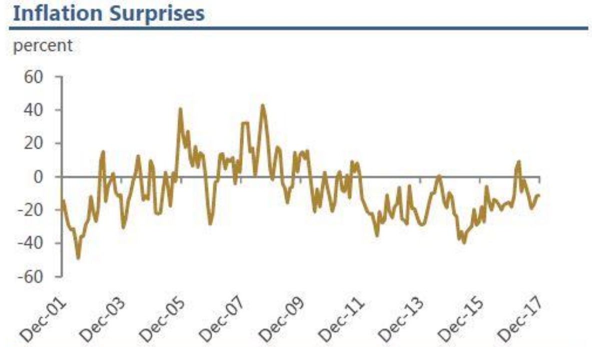
The first surprise is that economic data in advanced economies has consistently run stronger than expected. In the past four months, the US moved as distinctly into positively territory as it was in negative territory in late summer. But this was also true for the Euro area and the United Kingdom. The masculine switch from soprano to baritone is seen on many fronts, including purchasing managers' intentions on spending, which have been consistently above the 50 percent breakeven rate and rising.

The second surprise is that inflation continues to fall short of expectations. This is especially confusing for US economists because an unemployment rate close to 4 percent should be associated with increasing pressures on costs and rising inflation. A way to unpack the conundrum is to consider two underlying inflation gauges produced by staff at the Federal Reserve Bank of New York. The first, the blue line in the left panel, uses information of prices, activity, and slack to predict inflation. Inflation should be up noticeably, into the neighborhood of 3 percent. Limiting predictions to price data alone, inflation is still expected to rise (the red line) but on a flatter trajectory. The ingredients for a rise in inflation have been mixed, but it is not yet baked into the data.

FRBNY Underlying Inflation Gauge

Source: FRBNY, accessed via Bloomberg, 12/8/17

Inflation Surprises



Source: Citigroup, accessed via Bloomberg, 12/8/17

The succession of our forecasts this year marks a similar transition as from the blue to the red lines because data matters. As shown in the right panel, inflation prints have consistently disappointed expectations for five years. The Fed seems to be listening to this, too, in that FOMC participants marked up real GDP through 2020 from their September to December forecasts by 0.8 percentage points without budging the inflation outlook. They are in denial about unemployment, which the median FOMC participant sees ending 2018 and 2019 at 3.9 percent even though the projections also show the gain in aggregate demand outstripping aggregate supply by 2 percentage points. The European Central Bank also upgraded its growth outlook and admitted inflation would not be at goal by 2020.

The third surprise is our surprise about markets. After the December hike and guidance for three more in 2018, market participants still price in two hikes next year. Double that:

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Inflation will rise, the proximate determinant of inflation for a Phillips' curve phobic institution will be scary (an unemployment rate beginning with 3 percent), and enthusiasm about policy impetus, both from legislation and deregulation will swell. A new Fed chair, one more conservative than the incumbent and more believing about the boost from current policy, will want to move more forcefully along the path of rate renormalization. We think that if, admittedly a big if, our forecast of a pick-up inflation materializes, the Fed will raise its benchmark rate one percentage point next year.

Four tightenings in 2018 is forward of expectations embodied in interest rate futures (around two), and economists (about three), and guidance from the Fed (at three). Been there, done that. Twelve months ago, three Fed moves were aggressive, even though they were hidden in plain sight in the dots. Subsequently, Fed officials talked the dot plot into markets so action seemed inevitable when it happened. We think Jay Powell of 2018 will be like Janet Yellen of 2017 in delivering on the dots. (Our explanation of current confusion in markets is here.) Moreover, as inflation rises, the dots move up, which is how we get to four quarter-point hikes. Of course, all decisions are data dependent and made meeting by meeting, sort of. Fed policy makers loathe surprising markets (to a disconcerting degree that may be an issue for the incoming chair), compelling them to pre-announce action. As a result, policy is made meeting by meeting for the next meeting. The confidence the Fed showed at the conclusion of its December confab suggests that they have considerable confidence about a March move. Remember that Newton's First Law applies as powerfully at central banks as the physical sphere, in that a body in motion stays in motion. If inflation does not rise, a December 2018 hike is at risk, but that is not our forecast.

The impossible dream is that there will be tax reform. For most of the year, we put seven out of ten chips on tax-reduction legislation, which is the relevant consideration in deciding how much to change our view now. The logic all along was that Republicans gravitate toward tax cuts and the 2018 midterm elections would push them toward a legislative "success." In the event, and the event is not closed until the President signs something, there is more reform than just tax cuts in the mark-up package. On balance, an assured legislative victory adds a couple tenths to our growth forecast for the US next year. In our forecast design, however, the more important contribution is that legislative success makes the White House less needy to push executive action (which is trade heavy and disruptive). Good legislation crowds out bad executive action.

Meanwhile, growth in the rest of the global economy looks assured. The economy that contributes almost 30 percent of global growth (in purchasing power terms) has a leader that consolidated power at the Party Congress. President Xi of China has reform on his agenda, we think, but on his own terms and slow enough to make us worry about risk of failure over the medium term but not so slow to put a tail event into the baseline. A modestly slowing anchor to the world economy still supports the growth of emerging market economies and commodity prices.

The outcome? Let's go back to Jim Nabors. "Shazaam."

Euro Area	2016	2017	Balance of Risks	2018	Balance of Risks
Real GDP Growth	1.8%	2.4%	–	2.1%	↑
Inflation	0.2%	1.5%	–	1.4%	–

Source: Standish as of December 6, 2017

This year was the year of serial upgrading to euro area growth forecasts, with a final estimate of 2.4% in 2017 after hefty revisions to both Q2 and Q3 data. This is substantially above the growth rate of potential, estimated at roughly 1.2%. As a consequence, the output gap is closing at a quicker pace than expected earlier this year. As such, we are seeing a sharper-than-expected decline in the unemployment rate. The boon to growth was four-fold: an easing of fiscal policy, lagged effects of euro depreciation, the undeniable support of ECB policy to the domestic economy, and strong external demand. On a rather positive note, economic performance across the euro area is converging, with even Italy enjoying a burst of economic momentum. Looking forward, however, we expect the momentum in growth to wane so that 2017 will be the peak performance. Into 2018, the growth momentum is expected to remain above trend, but the same factors that supported a burst of economic energy in 2017 are set to peak, if not reverse. Therefore, given the sheer exuberance in the soft survey indicators that remains early into Q4 2017, we feel it prudent to forecast a slowdown in growth next year as China slows, euro appreciation kicks in, fiscal easing subsides, and the ECB lets off somewhat from the gas pedal. Despite the exuberance in economic momentum, slack remains in the euro area, which drives our inflation forecast of only a minor uptick of core inflation over the medium term. Looking forward, survey data indicate a balance of risks that is to the upside on our growth figures but we have confidence that the economic relationships underpinning our growth forecast will hold and that 2017 will have been the brightest year for Eurozone growth.

Japan	2016	2017	Balance of Risks	2018	Balance of Risks
Real GDP Growth	1.0%	1.6%	–	1.4%	–
Inflation	-0.1%	0.7%	–	1.0%	↑

Source: Standish as of December 11, 2017

Early Parliamentary elections, called by Prime Minister Abe, on October 22nd, secured a crucial victory for the ruling LDP party, enabling it to keep its supermajority status and clearing the way for a potential revision of the nation's pacifist constitution. From a macro perspective, the election ensures policy continuity. Accommodative policies are expected to persist even as the Bank of Japan continues to gradually pare back its asset purchases and prioritizes interest rate targeting. We expect either incumbent Governor Kuroda's term to be renewed beyond April 2018, or an equally dovish appointment to the same post. Any normalization of policy is not expected to begin until inflation crosses the half-way point of the BOJ's target, we also do not expect the government to raise the consumption tax any earlier than 2019, as it could impede the goal of raising core inflation.

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Amid stable-to-strengthening external demand conditions, this political and policy backdrop should sustain the demand rotation from the external sector to domestic sources, led by an acceleration of capex and firming household spending. GDP growth so far this year has been running around nearly 2% y/y and we expect the momentum to persist in 2018, though, base effects will lower the headline rate a bit to 1.4% y/y in 2018. Downside risks should remain limited by a pickup in construction activity related to the 2020 Tokyo Olympics. With potential growth estimated around 0.8%, Japan's output gaps have clearly turned positive. However, it will take more time for inflation to pick-up further –toward the BOJ's 2% target. This mainly highlights the drag from backward looking expectations and the absence of a firmer wage setting process due to the segmentation between full-time and part-time workers. Nonetheless, business—as well as consumer—confidence is on an improving trend, per Tankan surveys and PMIs. This is also exemplified by the de-coupling of Japan's equity market with the USDJPY exchange rate. Moreover, labor market tightness is fast becoming a binding constraint on production and we have noticed an incipient trend of a reduction of the part-time worker ratio. Increased hiring of full time workers, who earn more than twice as much as their part-time counterparts, ought to raise wage pressure as well as sustain further increases in consumption spending through 2018. Meanwhile, rising private capex and a further fiscal tilt toward social and human capital spending should boost productivity.

United Kingdom	2016	2017	Balance of Risks	2018	Balance of Risks
Real GDP Growth	2.0%	1.5%	–	1.5%	–
Inflation	0.7%	3.0%	–	2.5%	↑

Source: Standish as of December 11, 2017

The Bank of England raised the base rate by 25 basis points in November as expected, altering monetary policy for the first time since its post-Brexit emergency cut in August 2016. We expect the Bank of England to hike more than is currently expected in both 2018 and 2019, as the progress made with Brexit negotiations allows the Bank of England to become more confident in the economic outlook and hawkish in its communications in the February 2018 inflation report.

Our economic outlook and Bank of England view is predicated upon our Brexit base case where a deep and comprehensive trade agreement is put in place with the EU when the UK exits the EU single market and customs union. However, such a deal is unlikely to be fully detailed and agreed by October 2018 (the logistically required deadline), and thus instead focus on the transition phase. We expect this to be 3-5 years in duration (starting in 2019), and for it to be based on the status quo.

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Australia and New Zealand:

Australia	2016	2017	Balance of Risks	2018	Balance of Risks
Real GDP Growth	2.5%	2.2%	–	2.2%	↓
Inflation	1.3%	1.9%	–	2.0%	–

Source: Standish as of December 11, 2017

New Zealand	2016	2017	Balance of Risks	2018	Balance of Risks
Real GDP Growth	2.8%	2.6%	–	2.6%	–
Inflation	0.7%	1.9%	–	2.2%	–

Source: Standish as of December 11, 2017

The environment of low wage growth and high household debt creates challenges for the RBA to move monetary policy in either direction. The market expects the next move in the RBA cash rate to be up, rather than down. While in agreement that the RBA is looking to renormalize the cash rate, we think that the first hike will not occur until 2019.

This year, the labor market has showed signs of significant improvement and employment data finally converging to the strong business confidence surveys. Employment growth in 2017 has been solid and the trend unemployment rate has grinded lower this year to 5.4% from 5.7%. Despite the growth in jobs, wage growth is not signaling a pickup. Even in territories with robust labor markets, like New South Wales which has had an unemployment rate below NAIRU for a year, there is still no wage growth. Meanwhile, lower retail sales and savings rates indicate some downside risks to consumption. The RBA is reliant on public infrastructure spending and business investment to deliver on its 3% growth goal next year.

Inflation remains benign and should be tempered in 2018 as the deflationary force of Amazon has just only entered the Australian marketplace. We think Governor Lowe is too aware of financial stability and household debt to just tighten on a theory that inflation will eventually pickup. With macroprudential already doing a degree of tightening for the RBA and a mortgage market that would be sensitive to higher rates, an “on-hold” stance seems appropriate to us over the balance of next year as the Australian economy is allowed more time to generate better wage growth.

In New Zealand, a surprise election outcome has resulted in a ruling Labour-Greens-NZ First coalition. A set of policies announced by the new government present a higher level of economic uncertainty for next year. These include immigration limits, a higher minimum wage, RBNZ dual mandate, foreign-buying ban on existing homes, among others. While many of these look to be inflationary, it will take time to unfold. Looking at the labor market and other fundamentals, the kiwi economy looks set to generate inflation regardless.

We also received news that Adrian Orr will be appointed as the next Reserve Bank Governor at the end of March. Orr is very well-respected in New Zealand’s financial circles, and has spent the last 10 years as CEO of the New Zealand Superannuation Fund. Prior to that, he was Deputy Governor at the RBNZ. Orr has a reputation of being a straightforward communicator

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and is certainly well-credentialed. So far, we do not see any immediate implications of the appointment for the direction of New Zealand's monetary policy.

Emerging Markets:

Asia:

China	2016	2017	Balance of Risks	2018	Balance of Risks
Real GDP Growth	6.7%	6.8%	–	6.3%	↑
Inflation	1.8%	2.0%	–	2.4%	↑

Source: Standish as of December 11, 2017

The recently concluded 19th Party Congress of the Communist Party has strengthened President Xi's political status to levels unseen since the Mao era. The apotheosis of Xi, and appointments to the State Council and the Central Committee suggest that state-led reforms will prioritize the quality rather than the quantity of growth; in fact, the authorities seem to be signaling a jettisoning of medium-term GDP growth targets altogether. The second big takeaway from the party congress is that reforms are being re-sequenced to emphasize much greater macro oversight and financial stability, over riskier market-oriented reforms. Finally, China can be expected to aggressively pursue its geo-economic interests to advance its strategic footprint and secure an advantageous position for its companies in high-tech industries.

In this context, we expect the cyclical buoyancy to continue waning on account of tightening financial and property market regulations. These have already begun slowing credit and property sales; and are even lowering the growth rate of infrastructure activity. The regulatory crackdown on shadow banking and structured products is tightening financial conditions: it has resulted in an unwinding of fixed income positions which have sharply raised onshore risk-free bond yields and pushed up onshore credit spreads. However, we do expect policy hawkishness to relent as the authorities will not want to disrupt the property market which, with its backward and forward linkages, amounts to around 25% of Chinese GDP. The FX reserve and liquidity drain from balance of payment leakages have subsided as stricter capital controls have curtailed outward capital flows. However, this stability could prove tenuous as China's current account position is on a deteriorating path and its errors and omissions (unaccountable outflows) remain large. Efforts to gain inclusion in global bond indices will likely be partially successful, and bring in some inflow. Moreover, the overall macro focus on macro stability and de-risking the economy should gradually begin to ease aggregate debt and slowly improve the marginal productivity of capital. In our view, while this approach is likely to contain near-term financial and macro risks, it still leaves medium-term macro stability vulnerable to unanticipated shifts in confidence and heightened trade conflict.

South Korea	2016	2017	Balance of Risks	2018	Balance of Risks
Real GDP Growth	2.8%	3.1%	–	2.9%	–
Inflation	1.0%	1.9%	–	2.0%	↑

Source: Standish as of December 11, 2017

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Improving external, and especially tech, demand continues to spur a strong upturn in exports and investment. These trends have offset sluggish consumption spending which continues to remain weighed down by high household debt, slow job growth and anemic wage increases. Domestic confidence and the tourism sector have also weathered provocative missile tests by Pyongyang and Beijing's trade and tourism restrictions following the partial deployment, by Seoul, of the THAAD missile defense system. The new President wants to introduce a "paradigm shift" in Korea's growth model, predicated on enhancing household income above corporate, especially, Chaebol, profitability. However, this shift is unlikely to raise the Korean government's budget deficit significantly. Rather the composition of public expenditure, labor regulations and minimum wages are likely to change sizably to emphasize the re-distributive and welfare oriented priorities. Even then, the Moon administration will encounter significant opposition from vested interests allied with the parliamentary opposition, and could require several years to accomplish its goals. Meanwhile, upside surprises on exports and Q3 2017 growth lead us to raise Korea's GDP growth forecast by 0.3ppts this year and by 0.2% in 2018. But our inflation outlook continues to hover around 2%y/y –the lower end of the Bank of Korea's 2% to 3% inflation target range. The central bank began raising rates on October 30^{th}, for the first time since 2011 –with a 25 basis point hike in the 7 day repo rate to 1.5%. However, we think policy rate hikes will remain contained to around 1-2 hikes rather than the 2-3 which is priced in by the market.

India	2016	2017	Balance of Risks	2018	Balance of Risks
Real GDP Growth	7.1%	6.6%	–	7.6%	↑
Inflation	5.3%	3.8%	–	4.3%	–

Source: Standish as of December 11, 2017

The growth downturn from the twin shocks of de-monetization and GST has waned. Q3 2017 GDP growth staged a recovery, back to a 6% y/y handle, with rising investment and manufacturing—highlighting a recovery of production and renewed demand for capital goods. Net exports' contribution to GDP growth also improved—highlighting a reduction of supply chain disruptions which had, temporarily, boosted imports. Notwithstanding the domestic political noise around GST implementation and continuing attacks from the opposition about the adverse impacts from de-monetization, India's economic reforms are raising the level of formal activity, improving the business environment and, by 2018, should begin speeding up insolvency procedures and shoring up tax revenues (% share in GDP). The recent public sector bank re-capitalization package, was well received by the markets, and, will set the stage of a sustained recovery of actual as well as potential growth. We are penciling in 7.6% real GDP growth in 2018 –the fastest growth rate of any major economy.

For the foreseeable future, lingering output gaps and better managed food prices should keep inflation pressure well contained a bit below the RBI's 4% inflation target. But we are penciling in a small increase in inflation to 4.3%y/y in 2018 on an anticipated pick-up in aggregate demand and overall GDP growth.

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Russia, Turkey, South Africa, CEEMEA:

Russia	2016	2017	Balance of Risks	2018	Balance of Risks
Real GDP Growth	-0.2%	1.8%	–	1.8%	↑
Inflation	7.0%	3.8%	–	3.5%	↓

Source: Standish as of December 11, 2017

Turkey	2016	2017	Balance of Risks	2018	Balance of Risks
Real GDP Growth	2.9%	5.0%	–	3.5%	↑
Inflation	7.8%	11.0%	–	9.0%	↑

Source: Standish as of December 11, 2017

South Africa	2016	2017	Balance of Risks	2018	Balance of Risks
Real GDP Growth	0.5%	0.7%	–	1.0%	↓
Inflation	6.2%	5.0%	–	4.5%	↓

Source: Standish as of December 11, 2017

Poland	2016	2017	Balance of Risks	2018	Balance of Risks
Real GDP Growth	2.8%	4.2%	–	3.5%	↑
Inflation	-0.6%	1.8%	–	2.1%	↓

Source: Standish as of December 11, 2017

As we look into 2018, we expect another year of strong growth across Central and Eastern Europe. Growth will continue to be driven by increasing domestic demand (particularly from households as real incomes continue to rise) although external demand will also remain robust. Strong inflows of EU funds will continue in 2018.

In a departure from 2017 though, inflation will rise and move closer to inflation targets across the region – prompting central banks to tighten monetary policy. The Czech central bank will continue to tighten monetary policy, and the Romanian central bank will also join them with rate hikes early in 2018. We do not expect rate hikes from the Polish central bank until Q4 2018, whilst the Hungarian central bank will continue to distinguish itself through its unorthodox easing measures which are set to continue.

As for politics, Fideuz should easily win another majority in the Hungarian Parliamentary elections, whilst the departure of PSD Head Dragnea in Romania which may lead to early elections.

As ever, Russia, Turkey and South Africa are likely to be the key sources of volatility in EMEA in 2018.

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In Russia, we are expecting another year of economic recovery supported by robust oil prices. Inflation will continue to remain low relative to the central bank's inflation target and this will allow the central bank to ease more than is currently expected – we are anticipating a decline in the real interest rate buffer from the current 2/3% before the end of 2018. Fiscal finances continue to improve. We expect Putin to be re-elected as President in March 2018, although turnout and his choice of PM (a potential President successor) will be the most focused upon variables in the political space – we expect both low turnout and a mediocre choice of PM.

In Turkey, the issue most at the fore-front of investors' minds will be the central bank's willingness to take the monetary policy actions required to bring inflation down into single digits during Q1 2018. We expect the central bank to raise the average cost of funding through the unorthodox route of the late liquidity window, rather than the more traditional routes - although this should be enough to stabilise TRY. We expect growth to slow organically in 2018 as fiscal stimulus is withdrawn, and to be below the 5% potential growth we estimate. We are not expecting early elections in Turkey during 2018.

In South Africa, we expect the economic recovery to gather a little steam but still remain below potential – hence inflation will remain around the mid-band of the central bank target and allow monetary policy easing from the SARB. We expect 40bn ZAR fiscal consolidation in the February budget, although recognise risks to the IG rating from Moody's and WIGB inclusion should this not occur. The new ANC leader will seek to embed themselves in the party during 2018, with a focus on the transition out of Zuma.

Latin America:

Brazil	2016	2017	Balance of Risks	2018	Balance of Risks
Real GDP Growth	-3.6%	1.0%	–	2.3%	–
Inflation	6.3%	3.1%	–	4.0%	–

Source: Standish as of December 11, 2017

Mexico	2016	2017	Balance of Risks	2018	Balance of Risks
Real GDP Growth	2.3%	2.0%	–	2.3%	–
Inflation	3.4%	6.4%	–	4.0%	–

Source: Standish as of December 11, 2017

The Latin American recovery is ongoing, supported by stable commodity prices and accommodative monetary policy. Argentina's reform process is showing promise. President Macri managed to increase political capital during mid-term elections and his high approval ratings give him strong footing going forward. In Mexico, risks remain regarding the future of the North American Free Trade Agreement. Ongoing negotiations cloud the outlook for Mexico and are stifling investment. Our working assessment is for a successful agreement to be reached between the United States, Mexico, and Canada; however, little progress has been made on the three most controversial topics: local auto content rules, potential for a sunset

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clause, and access to government procurement. U.S. demands on these topics look aggressive and as they currently stand would be difficult for Mexico and Canada to accept. The negotiating deadline has been extended until the end of March 2018, with the next major round of negotiations occurring next month in Montréal. We will be looking for some signs of progress to be made on these major issues in order to have a clearer picture on the final outcome.

Politics will be very important to take into consideration for the outlook next year. 80% of the population of Latin America will have a chance to vote in a major election over the next 18 months. In sequence, there will be presidential elections in Chile, Costa Rica, Colombia, Brazil, and Mexico before the end of 2018. Many of these races are wide open and there are no incumbents. We will be closely following these elections throughout next year and their implications for the region.