Global Macro Views: Rocket Science

June 2018

by The Global Macro Forum

Rebecca Braeu, PhD, CFA; Rowena Geraghty;[1]
Aninda Mitra;[2] Vincent Reinhart; Nicholas Tocchio

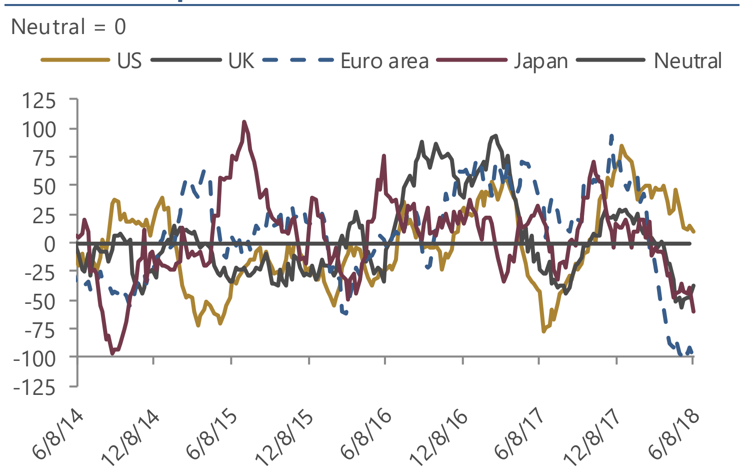
World:

	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	3.3%	3.3%	–	3.1%	–
Inflation	2.4%	2.7%	–	2.6%	–

Source: Firm analysis as of June 4, 2018

Putting an object into Earth's orbit is more complicated than aiming the pointy end of the rocket up and hoping. A projectile has to get high and fast enough to fall on a trajectory that matches the curvature of the planet's surface, continually falling but never crashing. And it is important to find a free spot, as there are about 21,000 objects in orbit larger than 4 inches in size. In spring, advanced economies appeared to have found the right trajectories in macroeconomic space, expanding along parallel paths that promised to limit cyclical and market strains among them.

Economic Surprises Index



Source: Citigroup Markets, accessed via Bloomberg June 12, 2018

Their places in this cosmos are less assured of late, as incoming data for the euro area have consistently disappointed expectations over the past two months. In part, spending sagged in light of internal political turmoil and external trade tensions. A slowing of such a large body of economic mass implies it shifts to a lower orbit and, in the transition, raises the risk of collision.

[1]*Employee of affiliated entity*
[2]*Employee of BNY Mellon Investment Management Singapore Pte. Ltd who provides non-discretionary research services to BNY Mellon Asset Management North America.*

STANDISH
BNY MELLON AMNA

↑ 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.

In particular, the major crash victim was our call on the foreign exchange value of the US dollar. A few months ago, on the assumption that advanced economies would expand in a parallel fashion, we forecasted modest dollar appreciation for a time, as investors came to understand fully the Federal Reserve's (Fed's) tightening plans. That forecast has swung to depreciation once the European Central Bank (ECB) was seen in play and the weight of US budget and current account deficits bore down on investor sentiment. We think this future is still ahead of us, but the transition from appreciation to depreciation will await a steadying of the euro area economy.

In our forecast, this happens as bad policy outcomes are avoided and temporary factors dissipate. On both sides of the Atlantic, political rhetoric is intense on many fronts, but meaningful policy change—for better or worse—in mature democracies is difficult to pull off quickly. Seasonal issues pose a problem for the European economy in the first quarter annually, and activity is still absorbing the drag posed by the earlier strength of the euro. There is also scope for a midcourse thruster boost given that fiscal space in Germany is enormous and, ground control to Major Mario, the ECB is still willing to do whatever it takes.

In no likely circumstance will Europe lap the US, which enjoys forward momentum driven by accommodative financial conditions and stimulative fiscal policy. US inflation is midflight, leading the Fed to keep tightening at press-conference meetings until it believes itself to be in the neighborhood of the equilibrium nominal funds rate. This is why we expect both inflation and the nominal funds rate to overshoot long-run levels, albeit modestly so as not to pose an outsized risk to economic expansion.

In our base case, advanced economies resume expanding in sync, and China continues to speed along, providing a stable gravitational field for other emerging market economies.

Developed Markets:

United States	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	2.3%	2.9%	–	2.3%	–
Inflation	2.1%	2.3%	–	2.2%	–

Source: Firm analysis as of June 4, 2018

Admittedly, the surest way to sap confidence in our outlook is to linger watching cable news. The US president generates disruptive waves in security and trade relations that is probably holding back investment globally and may shrink the volume of global trade if bad outcomes eventuate. But we do not think the outcomes will be as dire as that. The rhetoric remains substantially more incendiary than the reality. After confrontations in many quarters, trade will be somewhat more expensive and some trade routes, notably the ones to China, will open a little wider.

Meanwhile, US real GDP puts its 2½ percent first-quarter growth performance in the rearview mirror, we believe real GDP is set to accelerate to above 4 percent this quarter. Despite the equity market selloff and dollar appreciation, financial conditions support spending, especially recognizing that the rise in inflation eroded some of the Fed policy

↑ 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.

tightening in real terms. The recent mini-budget deal does not meaningfully dampen ongoing fiscal impetus, and US investment enjoys considerable support from the reduction in the corporate tax rate and repatriation of cash from abroad, which more than offsets any drag from trade uncertainty. (This is part of the reason for the lingering worry about the potential for US growth to decouple from other advanced economies; they only face the negative from trade.)

US monthly employment gains still average near 200,000, about double the run rate that keeps the unemployment rate unchanged. Even as those increases cool, our analysis suggests the unemployment rate will trace a downward arc in the sky, touching sub-3½ percent by year-end. The upward shooting star is inflation, which moves above the Fed's goal of 2 percent. Go too fast and the satellite falls less than the curvature of the Earth, elevating its orbit. Go way too fast and gravity loses its grip. We think the Powell-led Fed goes steady as it goes and too slow, overshooting of inflation. After a decade of undershooting on the other side of the inflation bogey, monetary policymakers are willing to take that risk. We expect Fed officials to continue one-quarter-point steps four times a year until they are sure policy is no longer easy. Policy may wind up too tight, but that is a lesson about fiery reentry.

Euro Area	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	2.3%	1.9%	–	1.8%	↓
Inflation	1.5%	1.4%	–	1.5%	–

Source: Firm analysis as of June 4, 2018

While the European macro data is about to turn, political risks are heating up in Italy and Spain. Political risks in Italy are more sinister compared to those in Spain, raising the risk of regional spillovers via Italy's trade deficit with the rest of the euro area. In Italy, we are forecasting a 1.1 percent growth rate for 2018, which now incorporates the adverse impact of higher sovereign spreads on the domestic economy as consumers and firms face higher borrowing costs. At the EA level, we also believe the trade tariffs and threat of tariff action on key sectors, such as the auto sector, will weigh on confidence for as long as the threat persists. Therefore, we lower our growth forecast in Germany and some small, related euro area countries. Our forecast for 2019 includes a resumption of economic activity, as the 2019 Italian budget passes with some expansionary policy and German fiscal spending moves forward. We note that, even though we downgraded the 2018 growth forecast by 0.3 percent, it remains well above the pace of natural growth. So while the output gap will close more slowly, it will close. Given the mounting balance of risks to the downside, the ECB will push back any material policy discussion on tightening by at least a month; still, they only have one month or so since they must provide clarity on the pace of their asset purchase program past September 2017. Our call for the first rate hike in mid-2019 is unchanged, but full taper is likely delayed until December 2018.

↑ 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.

Japan	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	1.5%	1.4%	↓	1.2%	↓
Inflation	0.4%	1.4%	–	1.7%	↓

Source: Firm analysis as of June 4, 2018

Japan's economy also hit a soft patch in the first quarter on poor weather and a reduction in private inventories. Some of the softness extends into the second quarter as well, leading us to lower our 2018 growth forecast by 0.1 percentage point, to 1.4 percent year over year. But we remain optimistic about our above-consensus growth estimate (consensus is at 1.1 percent) and the persistence of negative output gaps. Policy settings are accommodative, household consumption is firming, and corporate earnings are increasing steadily. In particular, firmer real wages and higher full-time hiring should lower the country's vulnerability to exogenous shocks. Indeed, the country's manufacturing PMIs have held up robustly, and exports have begun rebounding.

The ongoing labour market tightness, coupled with prolonged negative output gaps, should continue to steadily raise inflation. Higher oil prices and a normalization of the dollar-yen exchange rate, in line with US-Japan interest rate differentials, will also boost Japan-style core (ex food) inflation. Despite rising inflation, the Bank of Japan is likely to keep the yield-ceiling policy unchanged until well into 2019 or even 2020 and continue to lower the run rate of asset purchases. The main reason is that the near- and medium-term outlook for growth, as well as inflation, remains tilted to the downside. This is because of Japan's large intermediary presence in China-centric production supply chains and its potential susceptibility to a large or prolonged Sino-US trade conflict. Sustained global risk aversion could also strengthen the dollar-yen exchange rate and, thereby, lower corporate profits. Moreover, the risk of a waning construction boom in 2019 ahead of the 2020 Olympics and a near-simultaneous implementation of GST carries additional risks.

The September's scheduled party election, at the request of the ruling Liberal Democratic Party, should renew Mr. Abe's hold over the party and largely confirm policy continuity. To be sure, cabinet approval ratings have been dented by the financial scandal surrounding the Moritomo School's land acquisition. But the decline in the Prime Minister's approval ratings seems to have stabilized in the absence of any clinching evidence and the public's awareness of the need for credible leadership amid looming external challenges, ranging from North Korea-related geopolitics, Sino-U.S. trade conflict and the general unpredictability of the U.S. administration.

↑ 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.

United Kingdom	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	1.6%	1.6%	↓	1.6%	↓
Inflation	3.0%	2.5%	↓	2.5%	↓

Source: Firm analysis as of June 4, 2018

First-quarter economic data surprised to the downside—both growth and inflation—which led the Bank of England (BOE) to back away from a much-anticipated hike in May. By not hiking rates in May, the BOE demonstrated that monetary policy is now data dependent. Should the data evolve as we anticipate, this sets the BOE up for a 25 basis point hike in August 2018, and we continue to expect the BOE to hike more than is currently priced into markets. We expect a rebound in the growth data in the latter half of 2018, with both consumption and business investment likely to continue as the major growth drivers. At 1.6 percent growth, this is slightly above our estimate of potential growth for the UK. Meanwhile, we expect near 3 percent wage growth to continue to drive inflation higher in coming years (particularly as labor supply becomes tighter post-Brexit).

Australia and New Zealand:

Australia	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	2.3%	2.6%	↓	2.5%	↓
Inflation	2.0%	2.0%	–	2.1%	–

Source: Firm analysis as of June 4, 2018

New Zealand	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	2.9%	2.6%	–	2.3%	–
Inflation	1.9%	1.9%	–	2.2%	↑

Source: Firm analysis as of June 4, 2017

In Australia, the current environment of low wage growth and high household debt creates challenges for the Reserve Bank of Australia (RBA) to move monetary policy in either direction. We expect the next move in the RBA cash rate to be up, not down and probably not anytime soon.

Despite robust net job creation in 2017, wage growth is not signaling a pickup. Even in territories with tight labor markets, like New South Wales which has had an unemployment rate below the estimate of NAIRU for a year, wage increases remain benign. Meanwhile, lower retail sales and savings rates may indicate downside risks to consumption. The RBA is reliant on public infrastructure spending and business investment to deliver on its growth expectations in 2018.

Private capital expenditure intensions in Australia continue to underwhelm. Across the Tasman in New Zealand, business surveys are also downbeat.

↑ 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.

The Reserve Bank of New Zealand underwent leadership change in March, with Adrian Orr, former CEO of New Zealand's highly successful superannuation fund, taking over as Governor. Governor Orr left the cash rate on hold in his first rate decision and communicated a balanced risk outlook for markets. While near-term inflation looks benign in New Zealand, a material acceleration of inflation in 2019, due to minimum wage increases, a weaker New Zealand dollar, higher oil prices and a tight labor market, looks to be a risk.

Emerging Markets:

Asia:

China	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	6.8%	6.5%	–	6.1%	↓
Inflation	1.6%	2.6%	–	2.0%	↑

Source: Firm analysis as of June 4, 2018

China's growth momentum remained firmer than expected, and despite the ongoing risk of trade conflict, full-year GDP growth remains on course to reach the authorities' 6.5 percent year-over-year target. Surprising strength in the real estate sector, with property sales picking up in lower-tier cities, underpinned the firmer activity during the first few months of the year. Economic strength was confirmed by firmer PMIs and industrial indicators, as well as a small rebound in producer prices and industrial profits. The better-than-expected growth backdrop provides authorities with the scope to maintain tight regulatory and credit conditions, and continue with the ongoing crackdown in shadow banking. To be sure, the authorities' efforts to tackle leverage will continue to weigh on the corporate sector and local government financing vehicles (LGFVs). Indeed, onshore credit spreads have risen alongside the specter of onshore corporate defaults.

The policy response to the looming risk of prolonged trade tensions and rising onshore credit pressure has become more nuanced. On the Sino-US trade and investment front, tensions are likely to remain chronic. Even if the tone of trade talks wax and wane, underlying tensions—as exemplified by disagreements about "Made in China 2025"—will not go away. In view of this, the authorities have begun to highlight the need for a structural reliance on domestic growth drivers to meet medium-term growth targets. In view of this, The People's Bank of China (PBOC) has begun cutting the bank's high reserve requirement rates (RRR) to keep aggregate money and credit growth from slowing too rapidly. Meanwhile, as onshore credit pressures have risen, the authorities have widened the eligible pool of collateral against which medium-term funding can be obtained. These policy responses highlight a counter-cyclical but flexible approach to managing a slow glide path in economic growth.

As such, we maintain our 6.5 percent year-over-year growth forecast with a neutral balance between plausible downside and upside risks. Our forecast assumes nothing worse than a minor trade skirmish—with no more than 25 percent tariffs by both sides imposed on a base value of goods not exceeding $50 billion. The main risk stems from a much larger trade conflict, a much stronger US dollar or a steeper US Treasury yield curve. As the impact of trade conflicts will be felt in 2019, should they materialize, we think there will be greater downside risks to

↑ 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.

China's growth outlook in 2019 and beyond. Inflation, however, could face more upside risk in 2019 as employment shortages and higher labor income, coupled with a slightly faster rebalancing toward domestic consumption, pushes up wages. One macro trend to watch out for is the dwindling surplus in China's current account. The emergence of a current account deficit is still some ways off. But it could prove more challenging for maintaining financial stability if the overall balance payments shift back into sizeable deficits.

South Korea	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	3.1%	2.9%	–	2.8%	↓
Inflation	2.0%	1.9%	↓	1.7%	↓

Source: Firm analysis as of June 4, 2018

Korean growth will slow gradually this year, despite a decent run of electronics exports, as sluggish construction and consumption activity become more dominant drivers. Domestic consumption spending remains weighed down by high household debt and slow job growth. Construction activity is easing on tighter policies for restraining property market prices and household leverage. Despite a large, 16 percent, increase in minimum wages at the start of the year, the lack of broader labor market reform will slow hiring and the economy-wide growth of wages. A potential improvement in relations between the two Koreas, following from the Trump-Kim talks in Singapore, could boost domestic sentiment. Moreover, a gradual reduction of tourism restrictions by China, in response to earlier Terminal High-Altitude Area Defense (THAAD) deployment by Seoul, should also boost tourism activity. But it remains hard to see a broader revival of corporate sector investment. As such, we remain wedded to our longstanding call of a "one or none" rate hike call from the Bank of Korea, as against the two or more priced in by the market.

India	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	6.7%	7.4%	–	7.6%	↑
Inflation	3.6%	4.4%	↑	4.5%	↓

Source: Firm analysis as of June 4, 2018

The headwinds from the twin shocks of de-monetization and GST implementation continue to wane, and a domestic capital expenditure cycle is firming. First-quarter GDP data confirmed these trends. But the growth dynamic remains heavily reliant on government spending, in the absence of larger credit availability. Moreover, long-term rates have hardened on tight liquidity, thin bank profitability and the absence of more accounting forbearance. Additionally, smaller export firms are likely to remain encumbered by the paucity of working capital until GST refunds kick in more heavily. These factors will keep India from growing at a faster pace. Lingering output gaps will keep inflation risks anchored, but higher oil prices will pressure headline inflation and the current account deficit. We expect the Reserve Bank of India to remain on a prolonged hold.

↑ 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.

Russia, Turkey, South Africa, CEEMEA:

Russia	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	1.8%	1.8%	↑	2.0%	↑
Inflation	2.8%	3.5%	–	3.5%	–

Source: Firm analysis as of June 4, 2018

Turkey	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	7.0%	4.0%	↓	4.0%	↓
Inflation	11.0%	12.0%	↑	10.0%	↑

Source: Firm analysis as of June $, 2018

South Africa	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	2.6%	1.5%	↓	1.6%	–
Inflation	5.0%	4.7%	↓	4.5%	–

Source: Firm analysis as of June 4, 2018

Poland	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	4.3%	3.5%	↑	3.0%	–
Inflation	1.8%	2.1%	↓	2.2%	–

Source: Firm analysis as of June 4, 2018

Within CEEMEA, the main focus has been on Turkey. The lira depreciated more than 10% against the dollar during May, driven by concerns about external imbalances within the Turkish sovereign balance sheet, the upcoming Parliamentary and presidential elections, and a weaker external funding environment for emerging markets. The response from Turkish authorities was particularly delayed, although culminated in a combined 300 basis point emergency rate hike and simplification of the monetary policy framework.

Looking ahead into the second half of 2018, we expect growth will slow down, inflation will peak in the summer at around 14 percent and then fall, and fiscal spending will be reined in. Thus, external imbalances will get smaller, creating less pressure on lira going forward. With regards to the upcoming elections on June 24, we expect the opposition to get a majority of seats in the Parliament. In the presidential election, we expect it to go to a second round (to be held on July 8) where the polls suggest it is a coin toss between Erdogan and the opposition candidates.

↑ 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.

Disclosures

This commentary is provided for general information only and should not be construed as investment advice or a recommendation. You should consult with your advisor to determine whether any particular investment strategy is appropriate. These views are current as of the date of this communication and are subject to change as economic and market conditions dictate. Though these views may be informed by information from publicly available sources that we believe to be accurate, we can make no representation as to the accuracy of such sources nor the completeness of such information. Please contact BNY Mellon Asset Management North America Corporation for current information about our views of the economy and the markets. Portfolio composition is subject to change, and past performance is no indication of future performance.

BNY Mellon is one of the world's leading asset management organizations, encompassing BNY Mellon's affiliated investment management firms, wealth management services and global distribution companies. BNY Mellon is the corporate brand for The Bank of New York Mellon Corporation. BNY Mellon Asset Management North America is a registered investment adviser and BNY Mellon subsidiary.

Effective on January 31, 2018, The Boston Company Asset Management, LLC (TBCAM) and Standish Mellon Asset Management Company LLC (Standish) merged into Mellon Capital Management Corporation (Mellon Capital), which immediately changed its name to BNY Mellon Asset Management North America Corporation.