Macro: 10 theses for 2017

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What are the topics that will be relevant this year? In commemoration of the fifth centenary of Martin Luther posting his 95 propositions, we, too, want to suggest ten theses for 2017.

1) Political changes

Probably the biggest change can be summed up as Trumponomics. Against the backdrop of a rise in the inequality of income distribution, the anti-establishment movements have been on the rise. Last year, the Yes vote for Brexit, i.e. the UK leaving the EU, and the election of Donald Trump were the two most far-reaching events. The common denominator of these movements is particularly their protectionism (anti-globalisation, nationalism, nativism, and the rejection of supranational organisations). This comes with two learning points: a) election forecasts come with a statistical margin of error, and b) austerity policies are no substitute for a comprehensive and inclusive political approach.

In the Eurozone, three important elections are scheduled for 2017 (Netherlands, France, Germany). We might also see snap elections in Italy. The anti-status quo parties have declared themselves in favour of leaving the EU. So we are about to face a hot political year. The pressure on a change of politics is mounting.

2) The end of austerity

The budget deficit, adjusted for cyclical effects, is not falling any longer in the developed world. As such, an important dampening factor for economic growth already ceased to exist in 2016. This is due to the fact that many key-lending rates hit zero per cent and the bond purchase programmes were expanded drastically. Additional monetary stimulus has become increasingly less effective. The effectiveness of the monetary policy overall has fallen. The risk of a liquidity trap (i.e. ineffective monetary policy) and a secular stagnation (i.e. real interest rates are negative but still too high) remains elevated. As a result, the pressure for an expansive fiscal policy (i.e. a policy that supports the economy) has increased. For the time being, such a development is only foreseeable in the USA: higher government spending and tax cuts will cause the budget deficit in the USA to rise.

3) Temporarily higher growth

Real global economic growth has been remarkable steady in the past quarters despite numerous negative shocks. The trend of growth disappointments has come to an end. The estimates for economic growth are not revised downwards anymore. Some factors suggest the notion of a slight acceleration of economic growth:

- The global purchasing managers index has been on the rise for months
- This suggests, among other things, a slight acceleration of the low growth rate of industrial production. Most recently, production growth in Asia has improved.
- There are signs that suggest improvement of the low growth rate of capex as well, such as the increase in order intake.
- Trumponomics provide the US economy with stimulus (higher government spending, tax cuts, deregulation, repatriation of profits, possibly the support of “animal spirits”). However, it will take a few quarters for the effects to feed through into the real economy.
- In the Eurozone, the expansive monetary policy is keeping economic growth above its potential (1.5% vs. 1%).
- In Japan, the anchoring of the 10Y government bond yield at zero per cent has caused the yen to depreciate, inflation expectations to rise, and the real yield consequently to fall.
- In the commodity-producing countries the stabilisation of the commodity prices has led to an improvement of the terms of trade (i.e. the difference between export and import prices).
- One of the effects of the strong US dollar is the “redistribution” of growth and inflation in the rest of the world.

There are only few signs of an improvement of potential growth (i.e. economic growth under full employment). The growth rate of the employable population has been falling on a global basis, productivity growth has decreased significantly, the weak world trade might decline further due to protectionist ambitions, and the high level of debt inhibits a positive credit impulse (i.e. acceleration of credit growth).

4) Deflation no (immediate) risk, inflation no problem (yet)

For the assessment of inflation, two developments are relevant:

Commodity prices have stabilised, which has caused deflation pressure to fall. The prices of goods are still falling, but at a lower rate. Also, overall inflation rates are on the rise due to the base effect (year-on-year commodity price data).

The output gap (i.e. difference between the GDP at full employment and the current GDP) is falling globally, but still exists. Core inflation (exclusive of energy and food) will therefore be going sideways in the foreseeable future. With one important exception: in the USA, the economic stimulus measures are being taken in an environment that is close to full employment. Therefore, the inflation risk has increased in the USA.

5) No additional stimulus from the monetary policy

The times when the central bank policies were "the only game in town" are over. This reflects the decreased deflation pressure and means that the markets are rather more left to their own devices. This is a gradual change, however: the ECB and Bank of Japan policies will continue to influence the markets a great deal also in 2017.

The US Fed has increased the Fed funds rate twice by 0.25bps each time. For 2017, further rate hikes totalling 0.75bps are expected.

The key-lending rates in the Eurozone remain unchanged at very low levels. However, the bond purchase programmes will be reduced from EUR 80bn to EUR 60bn per month from April onwards. The way ECB President Draghi prepares the market participants for a further reduction ("tapering talk") will be of particular significance this year.

The Japanese central bank will maintain its target of the 10Y government bond yield at zero per cent.

6) Rising commodity prices

The commodity prices have stabilised after the sharp declines in 2016. The signs of slightly higher growth of the global industry also suggest an equally slight increase in commodity prices.

7) Trend of falling interest rates coming to an end

The decade of falling interest rates and yields has come to an end. Much like the assessment of inflation indicates, we will also not see an upward trend in interest rates in the near future. The current pressure for higher yields is due to the decreased deflation pressure and the cyclical improvement of the economy.

8) Stronger US dollar

The US dollar is already very strong relative to a basket of other currencies. This is due to the quicker and more profound recovery of the US economy. On top of that, fiscal stimulus measures are expected for the USA. The pressure for further appreciation remains intact as long as the (interest rate) differential between the USA and the rest of the word is growing.

9) Rising profits

Company profits are on a quarterly rise. The falling deflation pressure and the improvement of the economic indicators suggest this trend will continue.

10) Risks and imbalances

The unsolved problems and risks remain our constant companion. They concern a possible economic slump in China, the centrifugal forces in the EU and the Eurozone, and the uncertainty about the actual effects of the new cabinet in the USA.

Let me conclude on an optimistic note: the period ahead, when deflation will be no (immediately relevant) risk anymore and inflation is no problem (yet) is generally a favourable environment for risky assets.

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