Higher growth vs. increased political uncertainty

Gerhard Winzer

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The first weeks of the new year have already picked up from where the trends that started in 2016 and the hypotheses for 2017 left off: higher growth, normalisation of inflation, increased uncertainty with regard to the effects of Trumponomics, and a gradual end of the loose monetary policy.

The estimates for economic growth are now not subject to upward revisions anymore, in contrast to previous years. This also applies to those by the International Monetary Fund, which in January left its previous estimate of October for real global economic growth unchanged at 3.4%, after 3.1% for 2016.

Higher growth

In addition, some of the important cyclical economic indicators are still on the rise, such as the global purchasing managers index of the manufacturing sector. The preliminary estimate for this index, which is based on the preliminary data for the USA, the Eurozone, and Japan, increased yet again in January. This suggests a further increase of growth in global industrial production and a continued growth of the global economy above the value expected for the medium term (i.e. potential).

Normalisation of inflation

The growth of the global economy above potential reduces deflation pressure. In the countries that have already achieved full employment (i.e. USA; Germany), the risk of inflation is rising. Global consumer price inflation increased to 2.0% y/y in December from 1.8% in November. This change can be explained by the increase in inflation in the industrialised nations from 1.1% to 1.6%, which was due to the so-called base effect. Energy prices have stabilised after the drastic slump in previous years. As a result of the year-on-year analysis of inflation, the indicator has increased temporarily. The crucial question is whether the so far stable underlying inflation will also begin to rise. The market has in fact started to price in such an eventuality.
In contrast to the developed economies, inflation declined from 3.3% to 3.1% in the emerging markets in December, which was due to three remarkable developments. First, these rates are based in important countries with elevated inflation (Brazil: 6.3%; India: 3.4%; Russia: 5.4%) in a falling trend. Second, the rates of inflation in countries with generally low inflation (CEE and China) are on the rise. In China, this does not affect consumer prices, but it does affect producer prices. And third, countries with weak currencies have experienced a rise in inflation (Mexico: 3.4%; Turkey: 8.5%).

"The Wall"

In addition to higher government spending, lower taxes, and measures aimed at deregulation, the main tenet of the new US government is protectionism. The announced building of a wall on the border of Mexico is a strong symbol to this effect. Trump's advisors have called it the Trump Trade Doctrine: every agreement has to boost economic growth, cut the trade deficit, and strengthen the manufacturing sector. This is a modern version of the well-known economic policy of mercantilism.

Other fact(or)s remaining equal, such measures translate into a stronger currency (given that the trade deficit falls) and a higher level of interest rates (given that real economic growth and inflation increase). That being said, a protectionist policy tends to imply a weak currency (in order to support exports and limit imports). This could be achieved by a situation where the central bank increases interest rates at levels below the rate of increase of inflation, which would in turn cause real interest rates to decline and the US dollar to depreciate. Assuming a combination of both arguments (strong vs. weak US dollar), the benefits for the USA (higher growth) will probably outweigh the disadvantages (only moderate appreciation of the US dollar).

"Nasty surprises"

In a recent speech, US Fed chairwoman Yellen said that it made sense to dial down the monetary support gradually towards a neutral level. Otherwise, one might be at the risk of nasty surprises. This statement came after an earlier, different sort of opinion, according to which excessively fast rate hikes were risky. The US central bank clearly prefers to continue in its cycle of interest rate increases. In the most likely scenario, the US Fed funds rate will be stepped up three times this year at 0.25 percentage points each.

By contrast, EZB president Draghi said at his most recent press conference in January that substantial monetary support was needed in order to achieve the inflation target of the Eurozone. However, within the ECB the pressure to reduce ("taper") the bond purchase programme has been building. Draghi has mentioned four criteria for this to happen: 1) the inflation target of close to 2% applies in the medium term; 2) the increase in inflation has to be of a substantial nature; 3) once inflation has reached the target, it has to be able to remain at that level without monetary support; 4) the inflation target applies to the entire Eurozone. The latter point is relevant, because in Germany inflation increased from 0.8% in November to 1.7% in December. The risk of the ECB launching discussions on tapering earlier than expected has increased.

Equities preferred

We have translated the tendency of higher nominal economic growth (i.e. real economic growth plus inflation) in our asset allocation accordingly: underweighting of credit-safe government bonds, overweighting of equities. However, in doing so, we remain cautious, seeing that the elevated level of political uncertainty is dampening the risk appetite of investors.

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