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The global economy based on the Goldilocks principle

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The global economy is growing moderately, inflation is low, and the monetary policy is loose. This environment supports many asset classes from bonds to equities. The political uncertainty has been absorbed rather well so far too. Will this situation last?

In order to answer this question, let us first look at the USA. The persistent reduction of the yield differential between short- and long-term US Treasuries (i.e. the flattening of the yield curve) is remarkable. This tendency might suggest a decreasing momentum.

Global economy in recovery – Eurozone picking up speed

The global economy is growing at a rate of 3% (source: Erste AM), i.e. slightly above the long-term expected growth (the so-called potential growth). As a result, the unemployment rates are falling. While the global economy continues to produce below capacity, the so-called output gap has been gradually turning less negative. In other words, the global economy has been in recovery mode since 2009. The leading indicators such as purchasing managers indices for the month of May suggest a continuation of this trend. The Eurozone stands out: here, some indicators such as the business climate index of the European Commission suggest a further acceleration of real economic growth (from 2.0% in Q1 to 2.5% in Q2; source: Bloomberg and Erste AM).

Asia and USA raining on parade

Of course, there is a fly in the ointment: some indicators in Asia (e.g. industrial production) and in the USA (e.g. property market) are on the weaker side. This is also reflected in the globally falling economic data surprises; a trend led by the aforementioned two regions.

Low inflation

The acceleration phase is not only over in the economic growth department. Inflation is also not on the rise anymore. The underlying inflation thus remains on low levels. The inflation development in the USA also illustrates the low levels of inflation pressure. At 4.4% (source: Bloomberg), the unemployment rate is also subdued – which did not prevent core inflation from falling recently (1.5% in April y/y). In the Eurozone, core inflation has been an average 0.8% since the beginning of 2014 (source: Bloomberg) with hardly any indication of an imminent increase. Globally, data surprises for inflation are falling much like economic data surprises. In tandem with this scenario, the inflation priced into the bond market has also been on a decline.

Less expansive monetary policy

On 8 June, the European Central Bank will presumably change the assessment of its future monetary policy, in short, the forward guidance, in two ways. Firstly, it will describe the economic risks as balanced (currently: downside risk). And secondly, the statement according to which the key-lending rates could also decrease and the bond purchase programme could be expanded as well could be diluted or even taken out completely. This would mean another small step towards the next reduction of the bond purchase programme.

Further interest rate hikes in the USA

Analysts expect the US Fed funds rate to be stepped up by 25bps to a target bandwidth of 1% to 1.25% on 14 June. In addition, members of the FOMC have indicated the start of a cautious reduction of the central bank balance sheet in the second half of the year.

The character of the monetary policy is still very expansive. At the same time, a further moderate reduction of central bank support is starting to take shape on the horizon. The growth of central bank liquidity will continue to decrease.

Tightening in China

Credit growth has been extraordinarily high in the past years in China. This was largely due to the so-called shadow banking system. In line with this, the financial stability indicators are suggesting an increased level of risk. With the deflation of 2015 overcome, the economic policy has gradually had its focus shifted to the excesses in the credit sector. The tightening of the regulatory environment in the financial sector resulted, among other things, in a significant interest rate increase. The 3M interbank rate has increased from 2.8% at the beginning of September 2016 to currently 4.6% (source: Bloomberg). The heart of the matter is to find the right balance between deleveraging the shadow banking system and providing sufficient amounts of liquidity for the entire economy. To date there are still hardly any signs that would suggest a drastic decrease in growth. The ones that do stand out are the falling trend of the purchasing managers index for the manufacturing sector since the beginning of the year and the declining commodity prices for metals.

Political uncertainty

The political uncertainty remains a crucial driving factor for the markets. In the USA, the domestic issues of the Trump cabinet have reduced the likelihood of stimuli. In Brazil, President Temer is facing accusations of bribery. This has dimmed the hope of structural reforms (pensions, job market). In the UK, the lead of the Conservative Party over the Labour Party has decreased in the run-up to the parliamentary elections on 8 June, as has the likelihood of a soft Brexit. In Italy, the probability of snap elections in autumn has increased. The only positive development: in France, the movement of President Macron is ahead in the polls for the parliamentary elections on 11 June (first ballot) and 18 June (second ballot). The movement might even achieve an absolute majority in terms of seats.

Financial markets are resilient

The combination of moderate growth, low inflation, and a market-friendly monetary policy reminds us of the Goldilocks principle. In the popular fairy-tale “Goldilocks and the Three Bears” one bowl of porridge has the temperature that is just right. This notion of “just right” is also used in the description of economic data. However, there are enough arguments to remain vigilant. On a positive note, both the global economy and the financial markets have proven remarkably resilient after the Great Recession almost ten years ago.

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