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Solid Growth

Gerhard Winzer



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Some ten years after the outbreak of the Great Recession, global economic growth is positive and broadly based, inflation is low in the developed economies and falling in important emerging economies, and monetary policies are very supportive, cautious, and predictable. At the same time, company earnings growth has increased significantly, and the volatilities of many asset prices are low. This environment is generally positive for risky asset classes.

3.4% in Q2

Enough countries have released their initial estimate for aggregate output of goods and services in Q2 for the overall estimate to be reasonably precise. Real GDP growth (i.e. adjusted for price increases) amounted to 3.4% on a global scale in Q2, after 2.9% in Q1. This is the annualised value: quarter-on-quarter growth is multiplied by the factor 4x (four quarters per year).

Broadly supported

The broadly-based nature of growth both in terms of sectors (retail, private consumption, company investments, industrial output) and regions (developed and emerging economies) is a positive sign. The current growth rate of the global economy is therefore slightly above the growth expected for the long-term (2.7%).

Remarkably, two risks have not materialised: 1) the weak growth rate of the US economy in Q1 really was nothing but an outlier. GDP recorded a growth rate of 2.6% in Q2. 2) At 7%, growth in China was substantial despite measures to cool it down a bit. Also, the Eurozone remained on its healthy recovery path at 2.3%. After all, the Eurozone economy had not only shrunk

during the Great Recession (2008 – 2009), but also in 2012, at the pinnacle of the government debt crisis. The catch-up potential is thus larger than in other regions. The extremely expansive monetary policy of the ECB seems to be doing the trick.

Slight weakening

The leading indicators for the ongoing quarter also suggest solid growth. That being said, a slight weakening of global growth to 3% seems to be looming on the horizon. The purchasing managers' index provides us with a timely (July) and comprehensive (including many countries and to important sectors, i.e. services and manufacturing) overview. Core statements: 1) good absolute level (53.5); 2) slight weakening for the second consecutive month. The export and import data in China, down in July vis-à-vis June, had previously been the most up-to-date data suggesting a weaker tendency. Also, structural factors are preventing the growth trend from increasing. One example is the low growth of disposable income in the USA. Adjusted for inflation, it increased by only 1.2% in Q2 on a year-on-year basis.

Low interest rates

Will real interest rates, i.e. interest minus inflation, rise due to the good real growth rates? There are hardly any signs suggesting this scenario. The so-called real natural interest rate has fallen significantly across numerous parts of the developed economies. This is the interest rate that balances savings and investment demand at full employment in the long run. According to the latest estimate for the USA, said interest rate was at minus 0.22% in Q2. This is only slightly above the current real key-lending rate of minus 0.44%. Even though this estimate is subject to a high degree of uncertainty, the core learning point of the current real natural interest rate being very low remains valid. The reasons are manifold. The five most prominent ones are these: low productivity growth, low investment activity, low income growth, low population growth, and the rising average age of the population. The last bullet point seems to be counter-intuitive, seeing as one would assume that retired people draw down their savings to maintain their standard of living. But shortly before retiring, people seem to be saving the most.

Low inflation

The development of inflation is currently at least as important as real GDP and real interest rates. In the developed economies, it is still extraordinarily low. For example, consumer prices in the Eurozone only grew by 1.3% from July 2016 to July 2017. This is almost in line with the average rate of the past ten years (1.4%) and thus clearly below the inflation target of the ECB of slightly below 2%. In the USA, inflation (deflator for personal consumer spending exclusive of the volatile components energy and food) was at 1.5% in June. At 2%, the symmetric inflation target of the US central bank is significantly higher. Most projections suggest a moderate increase over the coming years, as more and more economies are approaching full employment. However, inflation is rather unlikely to rise, given that the relationship between the unemployment rate and wage inflation, which is described by the so-called Phillips curve, has fallen significantly in the past years. The most recent estimate for the USA suggests an increase of inflation to only 1.8% if the unemployment rate were to fall from currently 4.4% to a very low 3.6%.

Shrinking central bank liquidity

In view of the solid economic growth, the central banks in the USA and the Eurozone will be reining in their very supportive monetary policy. The Fed will soon (probably in September) start to abstain from reinvesting the expiring bonds. As a result, the central bank balance sheet will be shrinking slowly but surely (currently: about USD 4,000bn). The ECB will (probably) announce in autumn that the current bond purchase programme of EUR 80bn per month will be cautiously tapered next year. In Japan, the monthly purchase volume has fallen as well. This means that the market will be injected with falling volumes of liquidity in the coming years. As long as inflation remains low, central banks will be raising their interest rates very carefully. USA: Fed funds rate to be hiked in December if inflation is up. Eurozone: termination of the zero-interest rate policy at the earliest at the end of 2018. Japan: no change, as inflation is at zero percent.

Conclusion

The environment is favourable for risky asset classes. The combination of high valuations and low volatilities does, however, also point at an increased level of vulnerability. 1) Real growth could weaken more significantly than expected; 2) the real interest rate could increase after all; 3) inflation could surge; 4) central banks would have to react by raising key-lending rates more substantially than anticipated; 5) central bank liquidity (the sum of central bank balance sheets in the USA, the Eurozone, the UK, and Japan) will be shrinking next year. While this does not come unexpected, it is not clear whether it has been priced into the markets yet.

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