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## Strong growth and rising rates

Gerhard Winzer



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At the beginning of 2018, economic indicators are confirming the recovery scenario. Above all, the yields of government bonds are on the rise. Why is that the case, and what does it mean for the financial market as a whole?

### Surprisingly strong economic growth

Real economic growth remains strong and broadly based on a global scale at the beginning of 2018. A multitude of survey indicators suggest this, such as the purchasing managers indices. Remarkably, the growth projections are still being revised upwards. For example, the IMF revised its estimate for the growth of global real GDP in 2018 up to 3.9%. This is 0.2 percentage points above last October's estimate. The excellent environment affects many economic categories.

### Increasing resource utilisation

Resource utilisation is on the rise in many economies, i.e. the unemployment rates are falling. According to the OECD, it was only slightly below the optimum scenario last year anymore in the OECD region (-0.6% relative to the optimum utilisation level). Given that the current growth rate is above long-term growth, the output gap will turn positive in 2018. This is relevant particularly due to two reasons. The longer and more pronounced the output gap remains above the estimated optimum output, the more likely the cyclical inflation pressure will rise, and the more probable is the decline of the current real economic growth rate, which is currently above the long-term trend.

So far there are only weak signals for the former, and none for the latter (to date). The focus is on the USA. Since March 2017, the actual unemployment rate has fallen short of the estimate of the natural unemployment rate (source: CBO) and continues to decline (currently: 4.1%). The labour market in the USA is getting close to the point where any weakening of employment growth is not due to weaker demand anymore, but to scarcer supply (i.e. not enough people looking for jobs).

## **Inflation still low**

The dangerous aspect of inflation is the non-linear and inert connection between resource utilisation (i.e. the unemployment rate) and inflation. When the unemployment rate hits a low value (i.e. the natural unemployment rate, which unfortunately defies precise estimation) for a longer period of time, inflation will suddenly start rising. To date, the inflation rates across many developed economies have remained below the inflation target of the respective central bank. In the USA, core inflation was 1.5% p.a. in December, in the Eurozone it was 1.0% p.a. in January, in Japan 0.3% p.a. in December, and in Australia 1.8% p.a. in Q4. By contrast, in the UK inflation is elevated (2.5% p.a. in December), and in Canada it is within the target bandwidth of the central bank (1.9% p.a.). Inflation remains one of the most important indicators this year.

## **The increase of key-lending rates**

Hardly a week passes without a central bank tightening its monetary policy. In the past weeks, the central banks of Canada, Malaysia, and the Czech Republic have increased their respective key-lending rate.

The big central banks in the USA, the Eurozone, and Japan will also rein in their supportive monetary stance, at different speeds and extents. In the USA, the signals given by the Fed are in line with at least three hikes this year. That would put the target band for the Fed funds rate to a bandwidth of 2.00-2.25% (currently 1.25-1.50%).

The statements made in January by the EU and the Japanese central banks were cautious. Japan: no immediate increase of the yield target for 10Y government bonds of zero percent, even in the event of accelerating inflation. ECB: no change in the core terminology of the forward guidance given by the central bank officials during the January press conference. In particular, the first increase in key-lending rates will not happen before the end of the bond purchase programme, which is scheduled to last at least until September 2018. This is due to the fact that the ECB has no confidence (yet) in there being a sustainable increase of inflation towards the inflation target (slightly below 2% in the medium term), as well as to the development on the currency markets, i.e. the appreciation of the euro.

Not only the price of money (i.e. the interest rate) has been on a gradual increase. The growth of central bank liquidity has already declined significantly. In January, the ECB reduced the net purchase volume from EUR 60 to EUR 30bn, as announced. Next year, the aggregate money supply (M0) of the central banks of the USA, the Eurozone, the UK, and Japan will probably be shrinking (by about USD 230bn). In 2016, it still recorded a rise of USD 1,900bn.

## **Supportive credit environment**

Credit growth stopped weakening last year in the emerging markets (exclusive of China) as well. This is an important reason for the improvement of economic growth in the emerging economies. In the developed economies, the improvement of the credit environment had started a few years earlier. In January, the Bank Lending Survey by the ECB suggested a further loosening of the lending standards. This means that the credit environment supports the strong economic growth.

## **Widening of budget deficit**

Overall, the fiscal policy in the developed economies is neutral. The USA is an important exception. Here, the tax cuts have caused the budget deficit to widen. In a *ceteris paribus* analysis, this implies higher economic growth, higher inflation, more interest rate hikes, and less surplus liquidity (i.e. the government needs more capital).

## **Rising commodity prices**

Commodity prices have embarked on a rising trend, both for industrial metals and the energy sector. The focus is on the oil price, which in the meantime has increased to almost USD 70/barrel (from USD 47 last June). Research indicates that at least half of the increase is due to surprisingly strong demand. This is crucial because a supply shock (cuts in oil production) would be negative for economic growth.

## **Protectionism**

The main political risk is that of substantial protectionist measures by the USA. Two events were of particular relevance at the beginning of 2018. 1) The USA increase customs duties on washing machines and solar cells. These two areas account for only a small share of total US imports. The risk is that more measures could follow. 2) The US Secretary of the Treasury said that a weak US dollar would be good for the US economy. While this is correct, it is also an unusual statement coming from the Secretary of the Treasury, who represents the most important reserve currency. On the day after, ECB president Draghi

pointed out that he did not like this sort of statement. Possible trade conflicts remain an important risk factor. An important partial aspect is the fact that protectionist measures tend to come with an inflationary effect (i.e. higher import costs, higher production costs domestically).

### **Slightly worse situation on the financial market**

Rising real yields. The yield of the 10Y inflation-protected government bond in Germany has increased from -1.22% in December to currently -0.84%. The real price of money (i.e. the interest rate) is rising. This suggests a decline in surplus liquidity (strong economic growth, falling growth of central bank liquidity, higher budget deficit in the USA, rising commodity prices).

Increase in the inflation rates priced into the bond market. In the USA, the inflation rate priced into the 10Y bond segment of 1.20% two years ago has increased to 2.12%. The deflationary environment has yielded to an environment of (to date, slowly) rising inflation rates. Resource utilisation is on the rise.

Increasing expectations of interest rate hikes. The market has priced a Fed funds rate of 2.05% into the market for December 2018 in the USA. Last September, this value was still at 1.35%. Even for the Eurozone, the market expects an increase in key-lending rates for Q2 2019. Normalising monetary policy.

Rising nominal yields of government bonds. The 10Y benchmark bond yield currently amounts to 2.79% in the USA (2.04% in September). The economic environment suggests further increases.

High volatility. The volatilities (implied by option prices) have increased across various markets (equities, bonds, currencies). This reflects the rise in the risk of corrections on the markets.

### **Conclusion**

The combination of strong economic growth, low inflation, and expansive monetary policies supports risky asset classes such as equities. However, the sustainable, strong economic growth suggests an increase in inflation, interest rate hikes, and lower liquidity. This in turn implies yield increases for government bonds. This tendency is propped up by the expansion of the budget deficit in the USA, the commodity price increases, and the protectionist measures. The main focus is on what yield level could trigger a correction on the equity markets. The rising volatility reflects this risk.

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