



Quarterly Economic Outlook

Short-term disruption unlikely to derail the fundamental factors driving the global business cycle upswing

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Markets have been grappling with a combination of uncertainties, including intensifying trade tensions, the strengthening US dollar, Brexit and the slow-burn financial and political problems of the Eurozone. While these may rattle markets in the short term, I believe that none of these issues are sufficient on their own to derail the fundamental factors driving the global business cycle upswing. I also do not expect the current interest rate increases in the US, the first of the major economies to have initiated the process of monetary policy normalisation, to stifle the current upswing.

Periods of rising US interest rates generally come in two types: either as mid-course corrections - or normalisations - during business cycle expansions or as end-of-cycle increases designed to curtail rising inflation. I believe that the current interest rate increases in the US are of the first type, comparable to the rate increases of 1994-95 and 2004-05. This type of interest rate adjustment may be temporarily disturbing to financial markets, but is usually benign.

In essence, US interest rates are being raised to forestall excess money growth and economic overheating, enabling the business cycle expansion to continue for several years longer. I see no fundamental upward shift in the US inflation rate and continued low rates of money and credit growth, meaning that there will not be any need for the US Federal Reserve to continue raising interest rates once they reach "neutral" levels.

Meanwhile, inflation rates are still well below the 2% target figure in other key economies such as the Eurozone and Japan. I therefore see no risk of policy being tightened in an abrupt or destabilising manner. For the advanced economies overall, this means that there will be at least two years, perhaps three or four, during which the global business cycle can expand without hitting the traditional inflationary roadblock. This in turn means that the ultimate peaks in equity and real estate markets for the cycle could occur several years after the series of current interest rate increases is completed.

From a country perspective, recent reports of stronger economic data suggest that the first-quarter slowdown in the US was merely transitory. While many analysts expect the Trump tax cuts at the end of 2017 to contribute strongly to US GDP growth over the next year, I believe that the fiscal stimulus has been significantly offset by slow growth of money and credit, implying that while it may lead to some "crowding out" effects on interest rates, its growth and inflationary impact is likely to be limited. I therefore forecast real GDP growth of 2.5% for the US economy in 2018.

Meanwhile, the European Union has been grappling with Spanish separatism, coalition crisis in Italy, and a European-wide debate over immigration which threatened to become critical for German Chancellor Merkel, while the Brexit negotiations have continued at a halting pace. These political developments have weighed on economic activity the Eurozone. Looking ahead, I expect economic activity to soften further through the summer amid trade disputes with the US, persistent problems in the banking system and continued sluggish credit growth.

The latter implies that when the European Central Bank ends its asset purchases in December, deposit and hence M3 growth across the region will relapse to a lower rate. This could serve as a brake on economic growth and could cause inflation to fall back towards 1% or less. I forecast real GDP growth in 2018 of 2.1% for the Eurozone as a whole.

In the UK, a shift towards exports and export-related investments has reduced the economy's dependence on consumption over the past couple of years. However, in recent quarters that trend has faded as uncertainties over post-Brexit trading arrangements have caused companies to delay investment. Coupled with weakness in real wages and slow money and lending growth, this means that UK growth will likely continue to underperform both the US and the Eurozone in the near term. I forecast 1.4% real GDP growth for 2018 as a whole.

In Asia, Japan continues to show mediocre performance reflecting a lack of growth in the labour force associated with the aging of the population and a chronic lack of domestic demand. Japan's broad money growth (M2) is not yet rapid enough to generate sustained price inflation. This means inflation, on average, will continue to fall well below the BoJ's 2% target, and will be accompanied by low nominal GDP growth, subpar wage growth, and disappointing consumer spending. I forecast real GDP growth of 0.9% for Japan in full year 2018.

In China, measures to reduce leverage after several years of excessive debt accumulation in the local government, corporate and non-bank financial sectors are paying off. Slower money growth has caused domestic demand to weaken somewhat. On the external side, two contradictory forces are at work. On the one hand, China's exports have been enjoying a moderate recovery, while on the other hand the adverse effects of the Trump administration's import tariffs - targeted at many of China's most advanced sectors - are coming into effect.

While it is too soon to say definitively how the Trump trade war will evolve, there are two plausible scenarios. Under the first, the US and China resume negotiations and China offers concessions during the next four months ahead of the US mid-term elections in November. Under the second scenario, China fully matches the US tariffs with equivalent countermeasures, causing the Trump administration to up the stakes again and the trade war to continue for an indefinite period, with potentially meaningful damage to world trade and Sino-US relations. For now, I expect China's official real GDP growth figure to be 6.7% in 2018.

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