Mature Economies

Quarterly Cyclical Outlook

MacroFinance Research

2017 Q2

Extracts from the original document

Writing completed on April 04, 2017

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Executive Summary & Key Messages

Up to 2018H1, positive cyclical momentum supporting world economic growth, with upward inflationary pressures and the end of ultra-accommodative monetary policy measures. Tightening financial conditions will progressively create conditions for a cyclical reversal in 2018H2.

Critical time sequencing led by the US economic outlook

Cyclical timing issues are critical in our analytical approach. Our models suggest 3 sequential periods, stimulated by the US fiscal plan implementation around 2017H2.

- In 2017H1, our models suggest an economic resilience in G4 economies, with GDP growth close to 2% in US, EUZ and UK and slightly lower in Japan (1.0%-1.5%). Confidence and improving labor conditions support robust consumption in US and EUZ while Japan and UK are driven by investment and net exports (through currency depreciation).
- From 2017H2 to 2018H1, supportive fiscal policy implementation will boost US GDP growth around 2.5%-3.0%. The expected fiscal boost and tax cuts will create a virtuous cycle supporting confidence, demand, corporate earnings and equity markets. The transmission of higher US GDP growth, via trade dynamics, will sustain the Eurozone and Japan recovery and the positive momentum in emerging markets, despite threats of protectionism. In addition, political / systemic uncertainties should not induce major economic disruptions in EUZ as growth remains strong and the ECB fully alert. Positive post-Brexit economic development will progressively give way to more subdued GDP growth from 2017H2 as a result of rising inflationary pressures and a stronger wait-and-see investor behavior, though average GDP growth is revised upward given the positive global outlook.
- In 2018H2, the US will get into higher wage and price pressures (given the expected tightness in labor market conditions), and into progressively “biting” credit conditions (given the Fed gradual tightening and implications on bond yields), which will by then have cancelled the initial benefits of lower taxes / higher corporate profits and therefore create conditions for a cyclical reversal in the US. The size of the adjustment will depend on both equity valuations (the stronger the ex-ante euphoria, the strongest the reversal) and available policy room-to maneuver. Transmission of US cyclical reversal, reverting financial conditions with the end of ultra-loose monetary policies in G4 and higher inflation will progressively spread to mature economies, thus reducing the initial boost provided by the US GDP growth acceleration.
- Overall, G4 GDP growth should be at 2.0%-2.5% on average in 2017 (2.6% in the US, 2.0% in EZ, 1.7% in UK and 1.0%-1.5% in Japan) and between 1.5% and 2.0% in 2018 (2.2% in the US, 2.0% in EZ, 1.5% in UK and 1.5%-2.0% in Japan).

End of deflation risk and upward inflationary pressures

- Deflationary pressures are coming to an end in 2017 while inflation cycle will become a concern in 2018. Recently, inflationary pressures were pulled by energy-based effects on headline inflation; this should stabilize over the next few months, with our oil price models suggesting irregular oscillations around 55 $/bl (Brent price). During 2017, remaining slack in labor market will limit price acceleration through wages pressures. However, in 2018, the combination of trade protectionism, exhaustion of labor availability (particularly in the US) and higher producer prices in emerging markets will gradually raise concerns over higher inflation environment.
- Our inflation forecasts indicate a gradual increase in US headline inflation in 2017, between 2.5% and 3.0% end 2017, and a stabilization around 3.0% on average in 2018. UK inflation should continue to increase close to 3% in 2017 and 2018. Eurozone headline inflation would register a more limited upward move compared to other mature economies (1.6% end 2017 and moderate recovery through end 2018) as the high unemployment rate remains too elevated to translate into inflationary wage pressures in 2017/2018.

Reducing divergence between monetary policies

- Despite monetary policy divergence in 2017H1 (Fed tightening while ECB, BoE and BoJ remaining fully accommodative policy), the ECB April asset purchases reduction and further tapering announcement, along with potential changes in the BoJ 10-year yield target will reduce this divergence. Albeit differentiated, the implementation of exit strategies among major central banks creates a turning point toward global increase in bond yields. The adjustments in monetary policies will be conducted with a close attention to markets' expectations and will remain very progressive to prevent any massive rise in bond yields. Potential financial disruptions (high valuation in US markets, sovereign risks in the Eurozone markets, uncertainties related to Brexit consequences…) remain the key constraints on stronger monetary tightening.
- Fed modest expected monetary tightening (+50 bp in 2017, +75 bp in 2018 for Fed Fund rates) will push US 10-year Treasury yield toward 3.0% end-2017 and 3.5% on average in 2018. Transmission to Eurozone bond markets will be ambivalent, with Germany's "specific strengths" keeping 10-year German bond yield around 0.5% end 2017 and 0.6% on average in 2018, while other sovereigns oscillate between re-pricing pressures and ECB buying. UK government bond yields are more likely to increase given inflationary pressures, with 10-year bond yield around 1.8% on average in 2018. Only 10-year Japanese bond yield remained anchored as a result of the BoJ policy of unlimited direct interventions in markets and yield curve targeting.
- In this context, the interest rate differentials (short- and long-term) remain the main drivers of exchange rates projections, with EUR/USD in a range 1.05-1.10 in 2017, moving progressively to 1.10-1.15 in 2018. After stabilizing in 2017H1, the GBP is expected to depreciate against EUR towards 1.15 in 2018, with likely volatile movements. The JPY appears less vulnerable according to our scenario of economic growth improvement in 2018, suggesting an equilibrium level at 115 against USD in 2017 and 2018.

Key risks on the 2017-2018 scenarios

- Political and geopolitical uncertainties and risks. Donald Trump's election in the US came after a long series of political changes clearly highlighting the growing influence of so-called "populist" leaders; notwithstanding a growing inability of the traditional political institutions to grasp the consequences and need for remedial action, such policies do have negative features that markets may have forgotten too soon: direct / personal interventions in business decisions, disregard for established institutions and media, intensity of the President's "personal" contacts in governing circles are signs of what could be called the "Putinization of US politics". The negative influence on policy making, on geopolitical decisions, and on future challenges or difficulties (budget, environment…) will be felt in the economy with lower productivity, lower innovation, much deeper social / ethnic tensions. The temptation of "scapegoating" and finger-pointing to "foreigners" every time a domestic difficulty or problem will arise reinforces the risk of geopolitical, trade or other disputes. Adding the fact that the populist trend is not over yet (cf. the next French and German elections in 2017, the preparation for renewal of China's Communist Party Standing Committee of Politburo in fall 2017), this creates the stage for a much larger global / geopolitical / political risk. Confrontation-prone areas include China's seas and Russian south-western flank, from Caucasus to the Middle-East, but also potentially the Baltics and Ukraine.
- Monetary policies and markets' expectations could become highly off-balance**.** As the Fed Chairwoman Janet Yellen mentioned, "a cyclical boost at this stage of the US cycle is not warranted", clearly stating the more difficult challenges for US monetary policy. Indeed, the balance between monetary tightening speed and magnitude and markets' expectations taking into account the change in inflation outlook will be increasingly under pressure and strains as the "policy-lag" is substantial and inflation could accelerate faster than anticipated. Later in the "Trump-extended-US cycle", a stronger tightening in overall financial conditions will be required, with potential disruptions in financial markets and large international transmission. A materialization of this risk scenario suggests that financial markets have lost their patience over D. Trump fiscal plan.

United States

Three distinct regimes of GDP growth in 2017-2018

Based on traditional business cycle analysis, US economy should be close to the end of the expansion period and GDP growth should decelerate somewhere in 2018. However, a bifurcation point concerns promise Trump fiscal boost and its implementation, which is likely to extend the business cycle for a period but time sequence is crucial. Our central economic scenario relies on the effective implementation of an expansionary economic policy in 2017H2 (or early 2018) and without major blunder in international relationship (managed trade restrictive policies, but restraint on key issues are China and Iran).

In this context, the key question is related to the divergence in US policies and opposing forces impacting GDP, i.e. in one hand the positive effect of the fiscal boost and, on the other hand, the negative effect of financial condition restrictions given Fed monetary tightening. In other words, when and how the initial taxes induced support will be counteracted by higher financial costs and create a reversal in corporate profits?

To answer it, two kinds of models are used. The first is our traditional methodology based on datamining models using cyclical, survey and confidence data to calibrate GDP scenario (without scenarios). The second model, called "PWIT model" (for Price, Wage, Interest, Taxes) has been developed specifically to assess the inflexion point between taxes boost and financial costs. This model takes into account the US distribution of national income and the decomposition of corporate profits (profits before/after taxes, salaries and wages). Assumptions of "Trumponomics", including the implementation of corporate tax cuts alongside with limited border tax adjustments, US labor market and multiplier effects are included to assess the time sequence.

The combination of both models results in three distinct phases of GDP growth. (1) 2017H1: no clear signal of GDP acceleration (2) 2017H2-2018H1 "Trump in heaven": supportive fiscal policy implementation enables net corporate earnings to remain strong, absorption of labor supply capacity and limited inflationary/wage pressures, creating a virtuous cycle supporting equity markets and confidence, thus generating higher economic growth, in the range 2.5%-3.0%. (3) 2018H2 "Back to reality" cyclical negative reversal: the combination of inflationary pressures (given full employment) and restrictive credit conditions (given the Fed gradual tightening) cancels the initial benefits of higher corporate profits and create the conditions of a cyclical reversal, with GDP growth likely to decelerate.

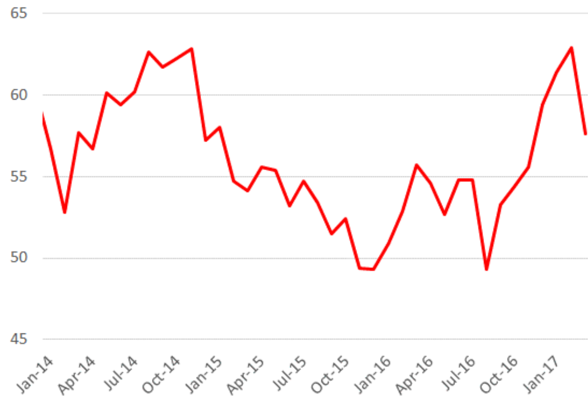
Overall, US GDP growth would reach 2.6% in 2017 while slightly decelerating in 2018 around 2.2%. However, the size of the adjustment in 2018 is likely to be strong if the 2017 euphoric performances have induced even more excessive valuations.

2017H1: solid activity but no signs of acceleration

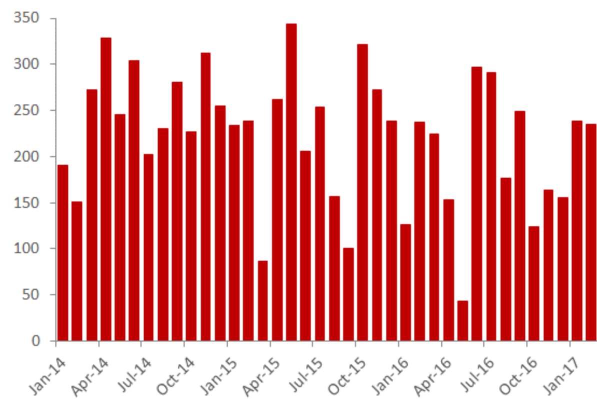
2017Q1 data indicate solid US economic activity, supported by positive confidence and consumption resilience given ongoing labor market gains (employment and wages).

But, without further fiscal support, US GDP growth may not accelerate given the present condition of the US economy, i.e. close to full employment, growing inflationary pressures and GDP growth close to its potential.

ISM production



US Job creations (thousands)



Source: TAC ECONOMICS

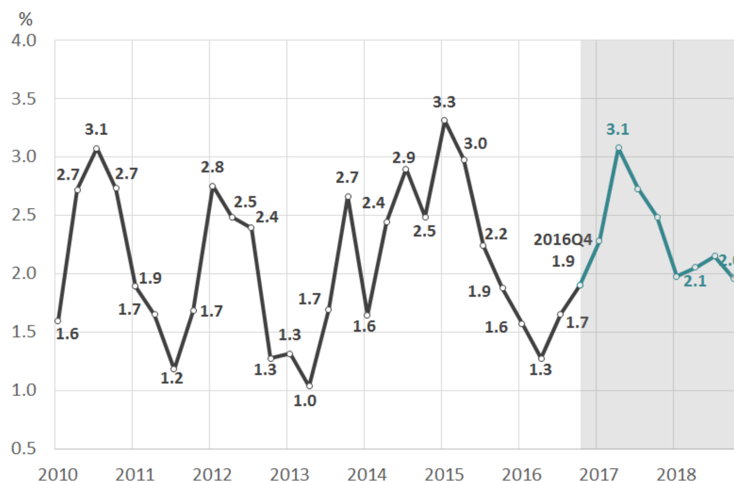
2017H2 - 2018H1: "Trump in heaven", GDP acceleration

Over the period from 2017H2 to 2018H1, fiscal policy implementation enables net corporate earnings to remain strong (around 10%-20%), thus creating a virtuous cycle supporting equity markets (despite expansive equity valuations) and confidence.

Moreover, discouraged workers may re-entered the labor market, suggesting a potential of increase in participation rate yet (possibly towards 65%) and decline in involuntary part time jobs. Calculations based on shares of non-employed people on working age population and pace of job creations suggest that 10 more months (i.e. until early 2018) will be necessary to achieve full employment (and create strong pressures on wages). Therefore, wage growth will increase moderately over that period and wage pressures on corporate sector will remain modest compared to previous cycle as tax cuts may provide a counter pressure factor. Despite deceleration in bank lending and higher rates on corporate/households' loans, gradual wage increase will pursue supporting disposable income and corporate margins will improve sufficiently to absorb financial condition tightening (with two additional 25bp cuts in 2017 and three moves expected in 2018). Our PWIT model indicates that the short-term impact on "Trumponomics" will generate an increase in corporate profits around 10%-20% from 2017H2 to 2018H1.

Overall, our models indicate a GDP growth around 2.5%-3.0% over the 2017H2-2018H1.

US GDP growth central scenario (y/y)



Sources: TAC ECONOMICS

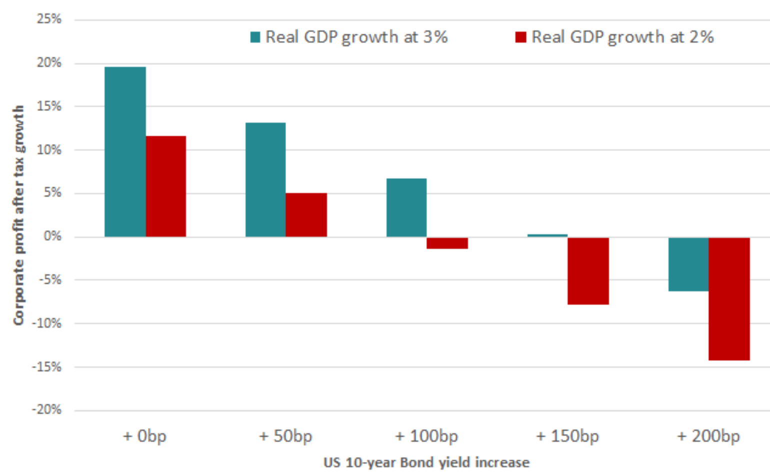
2018H2: “Back to reality”, negative cyclical reversal

Two main arguments suggest that fiscal boost effect on GDP growth is expected to be temporary after the initial tax induced support.

Firstly, stimulating US demand is expected to have a limited effect on production given expected full employment reached in 2018H1 and growth is already above potential GDP growth. However, productivity gains should help sustaining GDP growth at higher level for a longer period.

Secondly, higher financial costs and stronger financial constraints will become more important and create a reversal in corporate profits. The integration of our US bond yield / monetary policy scenarios in our PWIT model suggests that a +100bp / 150bp appreciation of US 10-year bond yield will cancel the initial boost in corporate profits, through a contraction of the corporate profit after tax growth. The materialization of this sequence is likely to occur in 2018H2. Then, the cyclical reversal becomes unavoidable and GDP growth is likely to decelerate. The size of the adjustment is likely to be strong if the euphoric performances have induced even more excessive valuations.

WPIT123 – Impact of US 10-year bond yield increase on US corporate profit growth after tax

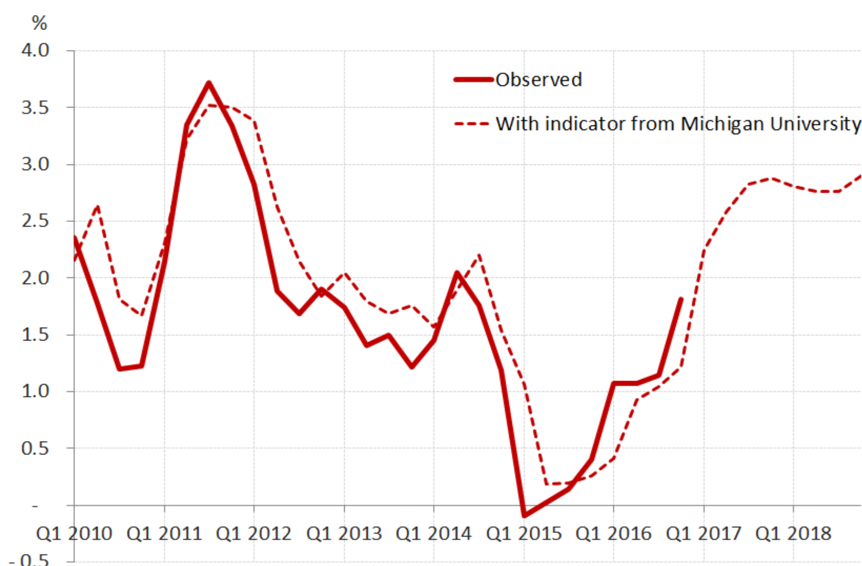


Sources: TAC ECONOMICS

Moderate inflation acceleration and gradual monetary policy normalization

Compared to the current situation (+2.7% in Feb.17), our models indicate a moderate inflation growth, between 2.5% and 3.0% in 2017-2018, as labor market slack adjustment limits wage pressures. Moreover, while positive contribution to energy prices will dissipate in 2017H2, core goods inflation may gradually increase given effect of imported inflation (related to boarder tax).

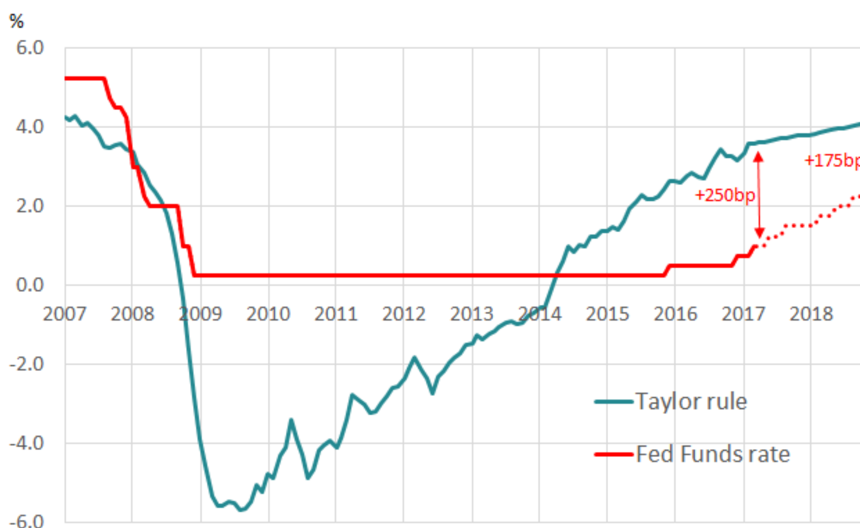
US inflation projections (y/y)



Sources: TAC ECONOMICS

In view of realized and expected labor market conditions and inflation, the FOMC decided in March 2017 to raise the target range of the Federal Funds rate for 0.75% to 1%, the second hike in three months, although the stance on monetary policy remains accommodative. According to our Taylor rule model, the gap between the policy rate and our estimates is actually close to +250bp and would decline to +175bp at end-2018 based on FOMC "dot plot".

US monetary policy reaction function



Sources: TAC ECONOMICS

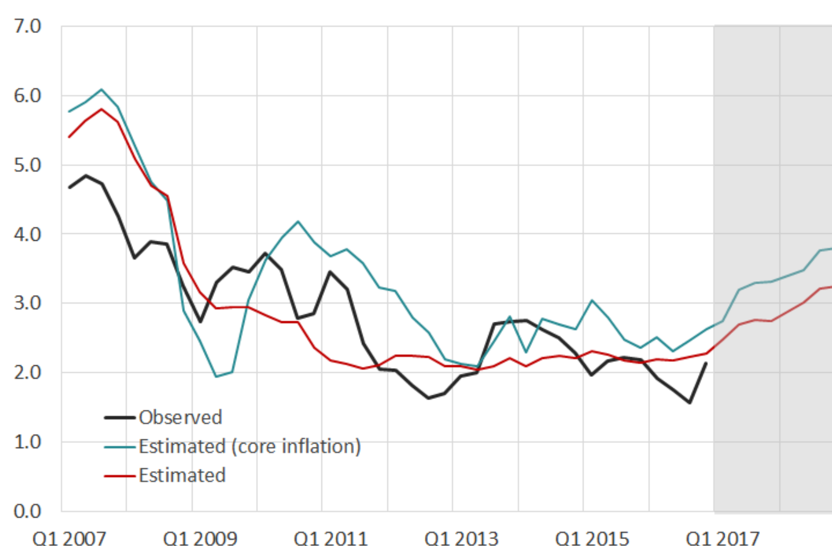
Moreover, the Fed governor, Janet Yellen, reaffirmed that the path of future rate hikes would be gradual in accordance with market expectations. If 10-year bond yield increase, with a gap higher than 200bp approximately, the Fed will be likely to raise policy rate. Our forecasting bond yield curve datamining models are consistent with this scenario of gradual Fed Funds rate increase in 2017 and 2018, suggesting a continued positive slope of the US bond yield curve (with a gap between 10-year and 3-month on average between 200bp and 250bp) as long as targeted Fed Funds rate is lower than 2%. Consequently, our models foresee a

gradual upward parallel translation of the entire US yield curve rather than a flattening of the curve until end-2018.

Gradual bond yield increase and equity valuation supported by the cycle and corporate tax cuts

Our econometric model on 10-year US bond yield indicates a gradual increase by 3.0% end-2017, and 3.5%-4.0% end-2018. The moderate increase compared to the Treasury bond increase observed since the US election is consistent with the reappraisal of inflation expectations (already adjusted). Upward pressures on US Treasuries are likely to be more induced by its real yield component rather than inflation expectations compared to the last quarter.

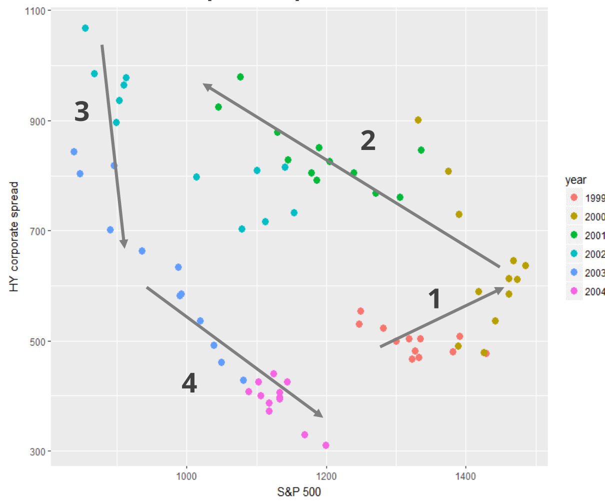
US 10-year Treasury constant maturity rate model (%)



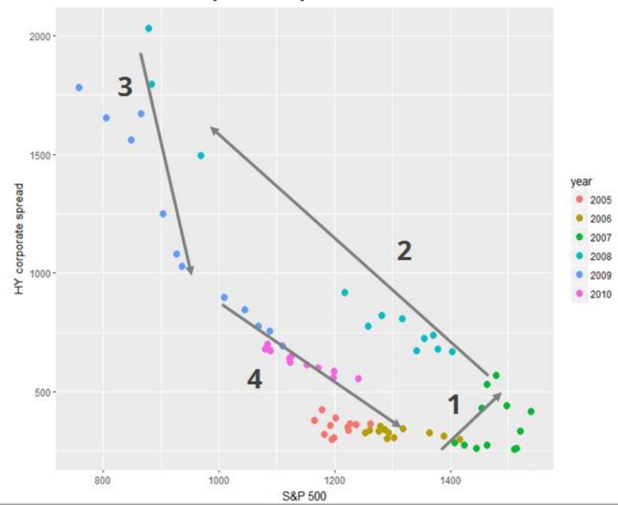
Sources: TAC ECONOMICS

Our US economic and Fed monetary policy scenarios suggest for 2017 that the US corporate profits outlook may be sustained given (1) the expectations of fiscal plan (2) the Fed gradual adjustment to market's expectations, thus reducing short term risk of financial disruptions (significant volatility but no sudden "sell-off") (3) the gradual increase in bond yield induced by the repricing of real yields. Thus, sustainable corporate profits for this year provide potential of US equity surge, but combined with questioning over its overvaluation, this raise concerns about potential disruption in global financial markets. To answer this question, analyses of historical equity (S&P500) / credit (High yield corporate spread) cycles are useful to highlight time sequence of both variables, focusing particularly over the periods 1999-2004 and 2005-2010). As observed over the following graphs, four phases are identifiable within each cycle: (1) crisis start: HY corporate spreads starts deteriorating while S&P500 performs (1999-2000, 2006-2007) (2) crisis deepens: strong adjustment on both equity and corporate credit markets (2001-2002, 2008) (3) Adjustment: improvement in credit conditions and slight improvement in equity market (2002-2003, 2009) (4) Mature growth: S&P500 and HY corporate spreads improve (2003-2004, 2009-2010).

S&P 500 and HY corporate spread 1999-2004



S&P 500 and HY corporate spread 2005-2010



Source: TAC ECONOMICS

When applying this "historical sequence" to the current cycle (2011-2017), we noticed that the current cycle is different. After the "traditional phases" of adjustment and mature growth (2011-2014), a beginning of a potential crisis seems to materialize through deterioration in corporate credit conditions (2015-2016). However, the current period analysis shows that a new "mature growth" phase seems to rebuild. It indicates that without any substantial corporate spread adjustment, the current US equity valuation is not inconsistent with the economic cycle.

S&P 500 and HY corporate spread 2011-2017

Source: TAC ECONOMICS