GLOBAL MACROECONOMICS

Peter Little

In our previous Strategy report (July 2017), we noted that the two key drivers of global markets were the approaching normalisation of global monetary policy, and the increasingly synchronised quality of global economic growth. Those two factors remain in force and, in light of recently sanguine financial markets, have given wider currency to the notion of a "beautiful normalisation": that is, a normalisation which does not derail economic growth. However, as explored in previous editions of this report, the global business cycle (though particularly in the US) appears to be reaching a mature phase. Although the cyclical indicators may not be flashing red lights, some are flashing orange. Macro strategy at present, then, appears to demand a kind of triangulation between asset allocation, the "beautiful normalisation" and the warning lights of a maturing business cycle. This will form the connecting thread of this quarter's report.

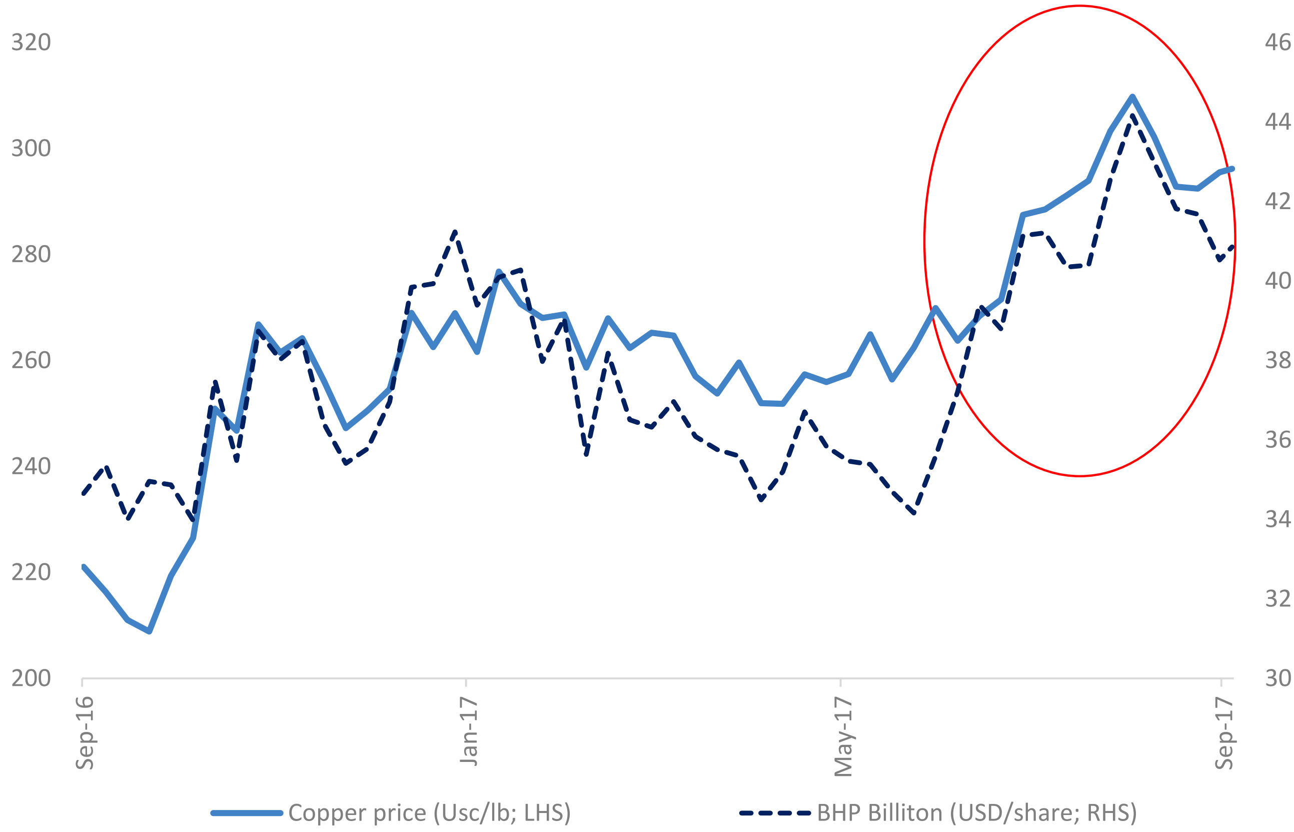
Both currencies and commodities saw dramatic moves during the quarter just ended. Currency movements, particularly the euro vs the US dollar rate, reflected movements in interest rate differentials between the US and other major economies. Weakness in the US dollar is also associated with increasing risk-appetite, which was registered in commodity price strength seen during the quarter (Figure 4.2 and 4.3). Movements in interest rates, currencies, commodity prices and equity markets are all interconnected phenomena. One of the most noteworthy features of the prior quarter was the degree of pro-growth buoyancy in these key variables.

Figure 4.1: Our current macroeconomic forecasts

	2016A	2017E	2018E
GDP growth (on prior year)			
- World	3.2	3.5	3.5
- USA	1.5	2.3	2.3
- China	6.7	6.8	6.4
- Euro Area	1.8	2.2	1.9
- SA	0.3	0.6	1.3
Inflation (year average)			
- USA core PCE	1.8	1.6	1.8
- EU CPI ("HICP")	0.2	1.5	1.4
- SA headline CPI	6.3	5.1	5.3
Interest Rates (year-end)			
Fed funds	0.75	1.50	1.75
Number of Fed hikes	1	3	1
Us 10 Yr Govt Bond	2.44	2.40	2.55
SA 10 yr Govt Bond	8.92	8.60	8.75
Currency (year-end)			
USDZAR	13.74	13.75	14.30
EURUSD	1.05	1.18	1.18

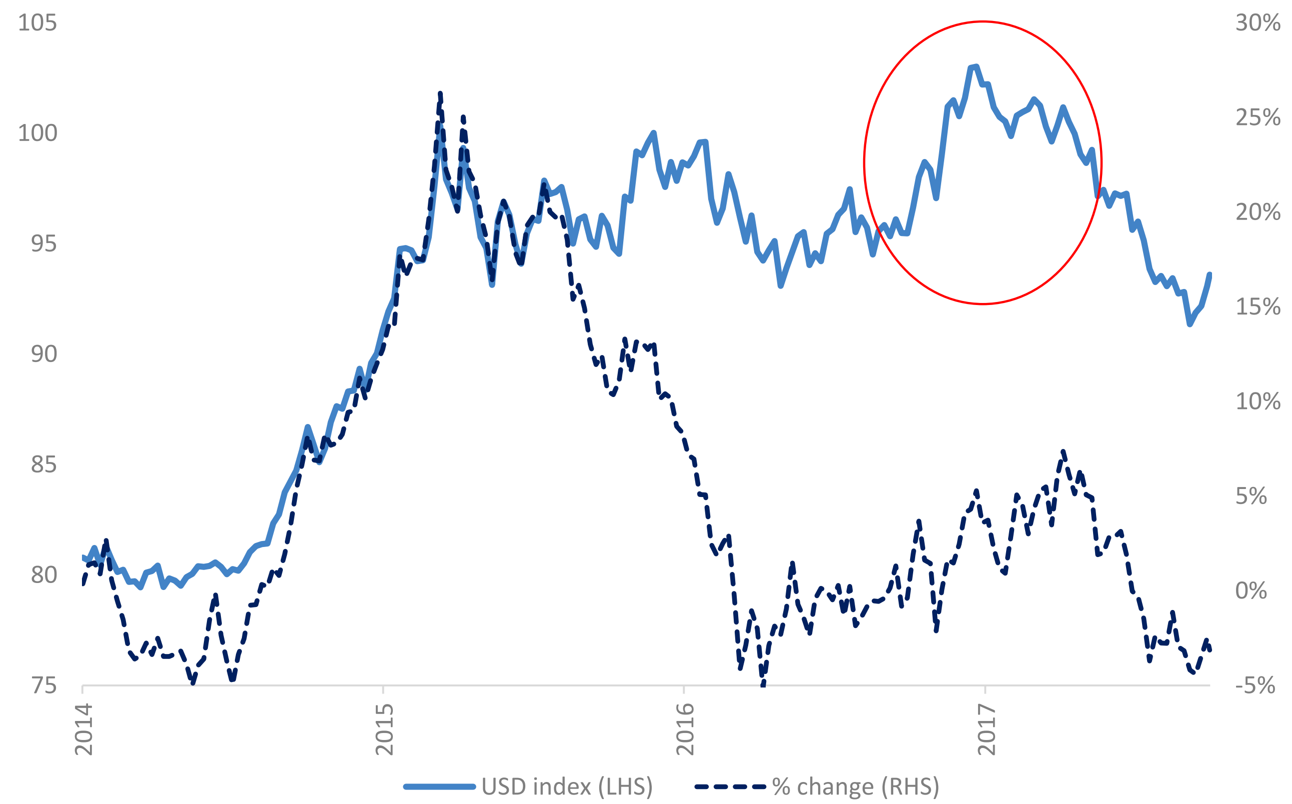
Source: Bloomberg; Anchor estimates

Figure 4.2: Commodities reflected an improving growth environment



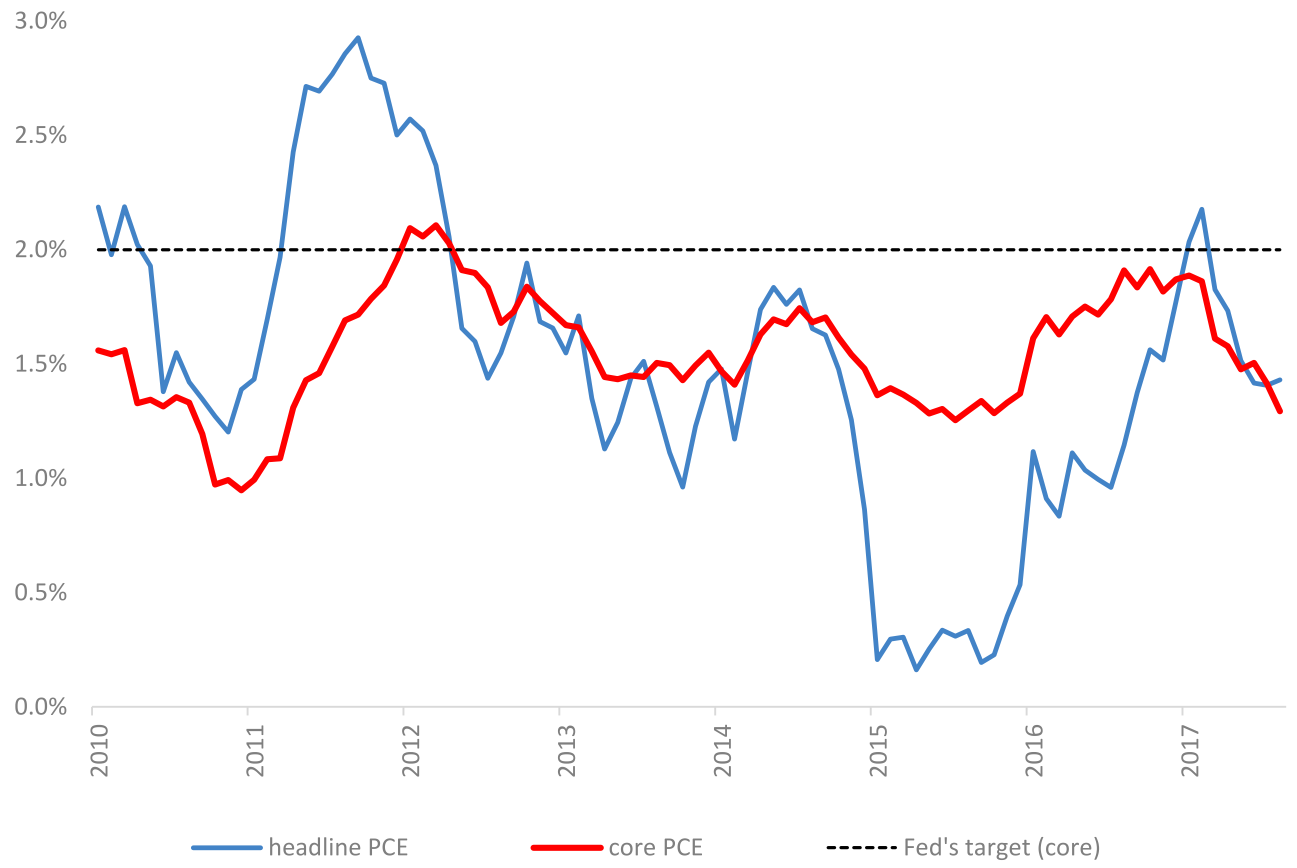
Source: Bloomberg; Anchor estimates

Figure 4.3: US dollar weakness has characterised 2017



Source: Bloomberg; Anchor estimates

Figure 4.4: Slumping US inflation failed to prevent Fed hikes



Source: Bloomberg; Anchor estimates

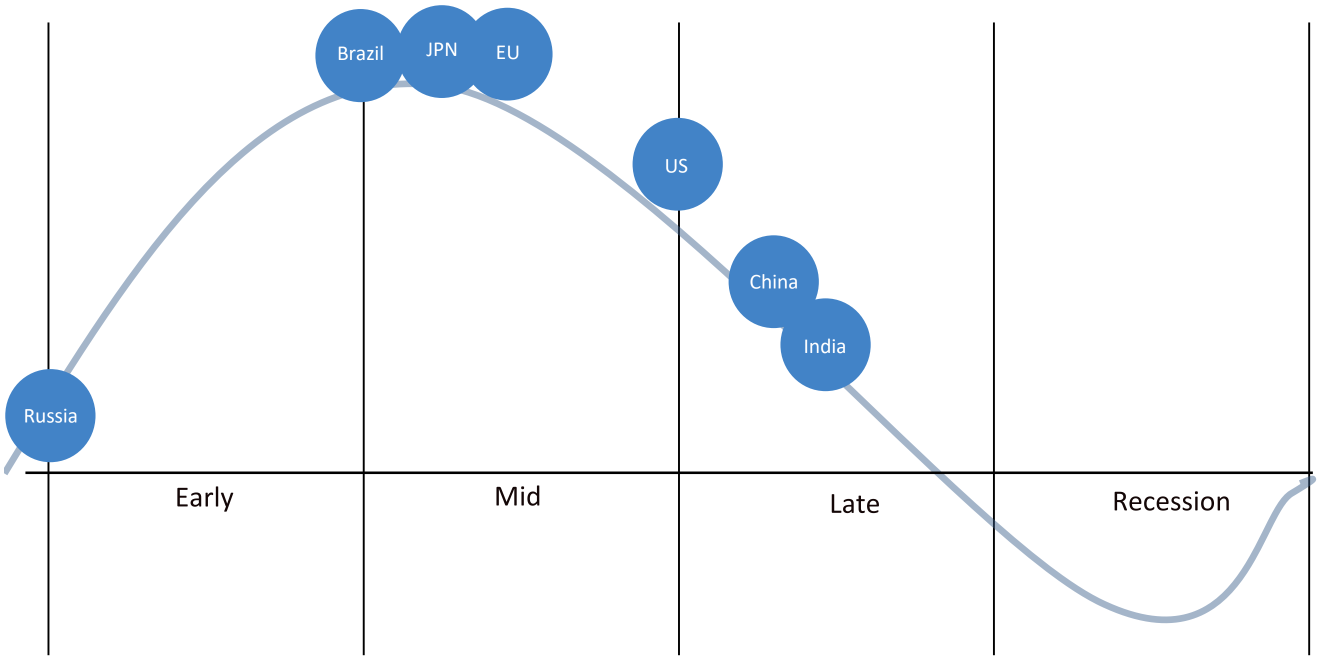
Fed Chair, Janet Yellen surprised markets in September by warning of the risk of hiking too slowly. This hawkishness seemed out of step with an inflation print that has continued to wilt at levels comfortably below the Fed's 2% target. One of the keys to understanding this move lies in the Fed's emphasis that rates are calibrated with reference to where it expects inflation to be in the medium term, and not relative to historical prints. This is both because rate hikes take 12-24 months to exert their full effects on inflation, and because some central drivers of inflation operate with a similar time lag. In particular, the recent US dollar weakness and oil price rebound are both inflationary and, while they may reflect very rapidly in headline CPI, it takes somewhat longer for them to filter into the more important core PCE number.

The emphasis on both kinds of lags – from US dollar movements to effects on inflation, and, in the opposite direction, from interest rates to inflation – has characterised the Fed's discourse for some time. One might recall Stanley Fischer's Jackson Hole speech of 2015, which preceded the first rate move of this hiking cycle, in which he noted the "considerable lags" between a movement in the US dollar and its effect on inflation. Similarly, he highlighted that "because monetary policy influences real activity with a substantial lag, we should not wait until inflation is back to 2% to begin tightening." The point of this flashback is to emphasise that the impulse to continue gradually hiking, in spite of sub-par trailing inflation prints, is consistent with an apparently longstanding understanding of inflation at the Fed. The bank has not changed tack.

The past quarter's cyclical growth indicators continued to underwrite the theme of synchronised global growth. One of the most welcome features of such a growth story is that it effectively erases the risk that strong GDP prints are anomalous, won by means of a "beggar thy neighbour policy" of currency manipulation. Synchronicity is also more likely to result in self-reinforcing growth momentum. It is noteworthy that 2018 is the first year since 2007 in which no major economy is expected to be in contraction.

The 2017 year has seen GDP surprise on the upside, to varying degrees, in Europe, China, Japan and the US. We have consequently raised our GDP estimates for most regions in 2017 and 2018, although with a little more caution in the latter year. While we do expect eurozone growth to remain strong in 2018, the effects of this year's sizeable euro rally may weigh on growth, as the region's exports become relatively more expensive.

Figure 4.5: Major economies are at different stages of their respective business cycles



Source: Bloomberg; Anchor estimates

Our 2018 GDP forecasts have also been held in check by our assessment of the business cycle in major economies. That all major economies are growing does not mean they are all at the same stage of their cycle. The apparent simplicity of synchronised growth must allow for a more nuanced picture of business cycles which are, inevitably, not entirely synchronised.

While cyclicality suggests a repetitive and therefore predictable pattern, the reality is that each business cycle is unique and complexly related to tactical and structural cycles. Having said that, we have plenty of indicators that give us a rough idea of where we are. In this regard, we track variables such as: GDP growth, employment, industrial production, trends in income, credit and corporate profitability, as well as inventory levels, monetary policy and fiscal policy. On the basis of this analysis, we estimate that Russia and Brazil are in the early stages of their business cycle, Japan and Europe are mid-cycle, while the US, China and India are within, or moving into, the late stage of their respective expansions.

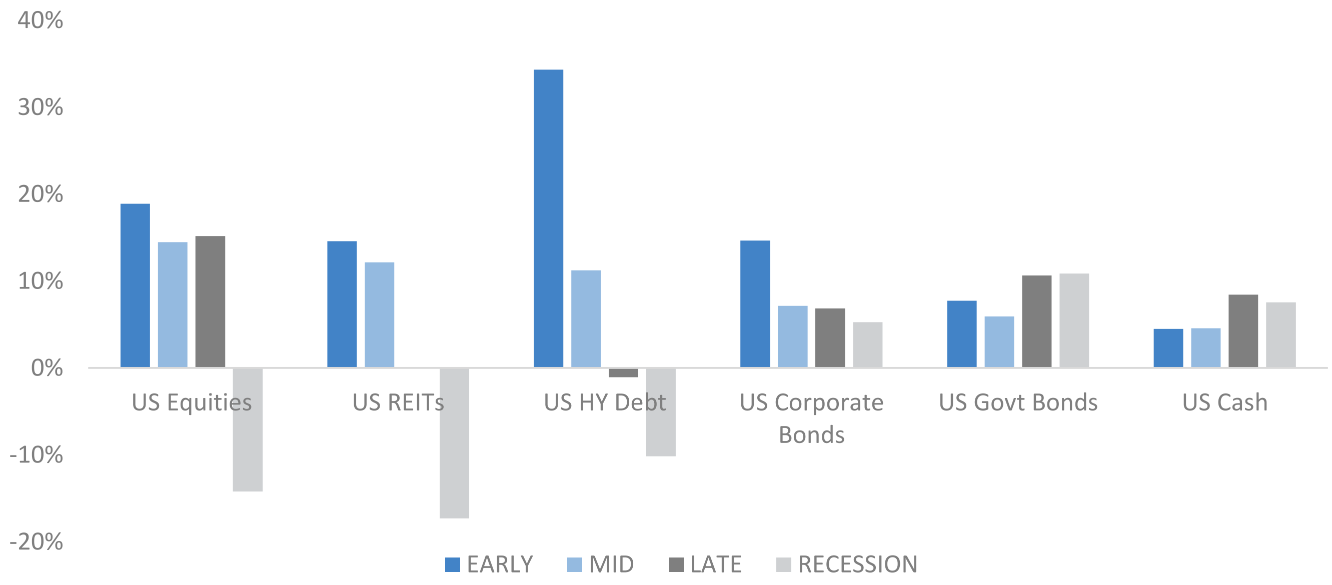
These 7 economies make up about 70% of global economic activity. China's position in the business cycle is probably the most challenging to estimate. The economy and the data supplied by the government are notoriously opaque, while the government has a heavy hand in guiding the economy. Further, many of these economies are closely linked: a recession in China, for example, would likely cut the business cycles of commodity exporting economies, like Brazil and Russia, short.

While the US is moving into a late stage of its business cycle, and China and India appear already to be there, we think the 'late stage' could last for an unusually long time. This is probably the most important judgement in this entire report. It is supported by a number of observations, two of which are: the current US expansion has been very tepid by historical standards, roughly half the quantum of a normal expansion. Second, as noted above, the world economy is moving more decisively into a synchronised growth phase which appears to be self-reinforcing. There is also a self-reinforcing link between asset prices and GDP growth: while the latter clearly drives the former, asset prices also drive growth via the wealth effect. This is part of the reason both bull and bear markets can get into self-fulfilling spirals.

Consequently, the current synchronicities suggest that any future slowdown in growth is more likely to come from overheating, as opposed the spreading of zones of weakness which might tip the scales of global growth into recessionary or stagnationary territory. The latter scenario was a central risk as recently as June 2016, when worries about Brexit threated to add the UK economy to its already soft Japanese, tepid European and recessionary Brazilian counterparts; thereby, as it were, tipping the scales in the wrong direction. As the world economy has now shifted so decisively away from this scenario - yet without, as yet, signs of overheating - our judgement is that, at present, it is appropriate to retain our existing pro-growth bias.

Financial markets tend to anticipate changes in the business cycle, and to move ahead of shifts in the coincident indicators. Our global strategy process forms asset class preferences on the basis of their expected 12 month return profiles. Business cycle analysis also helps us to form expectations of these returns. Thus, if one divides previous business cycles into four approximate phases, it is possible to estimate the performance of different asset classes at each stage (Figure 4.6). In general, much of the result is quite unsurprising: equities perform well in a growth environment, poorly during recessions, while bonds deliver the converse performance. But it also presents some complexities: although US equities have, on average, performed quite well in a late-cycle period, the data are not normally distributed by any means. While equity returns during the two late-cycles of the 1980's were stellar, about 32% in each of the periods ending December 1981 and December 1989, they were poor in the two late-cycle periods thereafter: minus 9% for the phase ending December 2000, and 6% for the late-cycle of 2007. In short, business cycle analysis suggests that we should expect lacklustre returns from equities, and not be overly bearish on the medium-term outlook for bonds. Our outlook for these asset classes is considered in more detail in the following sections of this report.

Figure 4.6: US asset class performance across business cycle phases (1974-2016; average annual return)



Source: Bloomberg; Anchor estimates